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MENA DEVELOPMENT REPORT

Financial Access and Stability

A Road Map for the Middle East and North Africa

THE WORLD BANK

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A Road Map for the Middle East and North Africa

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with
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Foreword

This finance flagship report provides a diagnostic of financial development in the Middle East and North Africa (MENA) region and proposes a roadmap for expanding access to finance while preserving financial stability. The companion flagship report on private sector development—*From Privilege to Competition*, published in 2009—identified some of the main obstacles to competition in MENA, including restricted access to finance. The finance flagship examines in greater detail the access-to-finance problems that hinder private sector participation and constrain competition and growth in the region. Both flagship reports provide coherent and comprehensive analyses of the challenges faced by MENA policy makers and present an agenda for promoting growth and employment.

Over the past decade, many countries in the region have implemented financial reforms to strengthen their banking systems and promote financial development. These reforms have been insufficient: most financial systems remain excessively bank based, uncompetitive, and exclusive. Banks have focused on large and well-connected enterprises and failed to provide access to large segments of the population and the enterprise sector, especially small and medium enterprises. Poor access has contributed to the slow growth of per capita incomes and the limited supply of employment and housing for MENA's young and growing populations.

MENA banking systems dominate the region's financial landscape, with average assets amounting to 130 percent of gross domestic product (GDP). Most other segments of the financial sector remain undeveloped. On average, insurance companies and mutual funds account for less than 5 percent of GDP, leasing and factoring amount to less than 1 percent of GDP, and private pension funds are negligible. The microfinance sector is also very small, with outstanding microcredit accounting for just 0.2 percent of GDP. Equity markets are large in some countries, but market capitalization is dominated by financial and infrastructure companies. Private fixed-income instruments, such as corporate and mortgage-backed bonds, remain very limited.

MENA's banking systems are generally well capitalized, and they generally weathered the effects of the global financial crisis well, although the recent political turmoil is putting pressure on several non-Gulf Cooperation Council (GCC) countries, especially those directly affected by the Arab Spring. The banking systems dominated by state banks are probably under greater pressure than other systems, given their larger volumes of nonperforming loans and weaker financial conditions. Credit recovery may prove slower than expected in these countries, especially those directly affected by political unrest.

The speed and depth of the credit recovery are important policy questions facing MENA policy makers today. However, the breadth of the recovery is possibly an even more important question for MENA's long-run performance. Large segments of the household and enterprise sectors may remain deprived of credit because MENA's financial systems are not inclusive. Banking systems may be large and generally well capitalized, but the region also has the highest loan concentration ratios in the world, reflecting the focus of banks on large and well-connected enterprises. A large share of the population does not have access to financial services, especially in remote areas. Small and medium enterprise finance and microfinance are not well developed in most countries, and housing finance is still in a nascent stage. These deficiencies have limited the growth performance of MENA countries and hindered their capacity to generate employment and housing for their young and growing populations.

Poor access to finance reflects three sets of interconnected factors. First, the region's financial infrastructure is still poor: coverage and depth of credit information are still limited, and collateral and insolvency regimes remain extremely deficient. Second, bank competition is weak, because of the massive presence of state banks in some countries, restrictions on license procedures, limited credit information for smaller banks, lack of strict supervision of large exposures and connected lending in many countries, and lack of alternatives to bank finance. Third, non-banking financing institutions and instruments are undeveloped, because of the lack of enabling legislation and the absence of benchmark yield curves, among other reasons. This lack of development hinders bank competition and prevents the development of adequate funding for sound long-term lending.

Most MENA countries face a challenging financial development agenda designed to substantially expand access to finance. Credit information must be strengthened significantly, possibly through the introduction of more private credit bureaus. Collateral regimes must be overhauled, especially for movables. Bank competition must be strengthened with the reduction of the role of state banks in some countries; the review of

licensing procedures; the improvement in credit information for small banks; stricter supervision of large exposures and connected lending; the development of alternatives to bank finance (corporate bonds, leasing, factoring); and the introduction of competition agencies. Nonbank financial institutions and instruments need to be developed through specific and well-articulated reform agendas for each sector and market. Foreign investors should be allowed to play a greater role, as they can boost market development, especially during the period in which private domestic institutional investors are being developed.

The financial development agenda needs to be matched by a financial stability agenda ensuring that financial systems remain resilient as access is expanded and new risks emerge. The financial stability agenda comprises improvements in microprudential supervision (further progress in Basel II implementation, stronger capital buffers in the non-GCC region, stronger supervision of concentration and mismatch risks); substantial improvements in bank governance (more professional and independent boards, stronger board committees, strong and more independent risk management functions); and the strengthening of macroprudential supervision (better institutional arrangements to address systemic risk and crisis management, introduction of a broad set of macroprudential/countercyclical tools). It is hoped that implementation of this combined agenda of financial development and stability will increase prosperity in MENA economies in this decade and beyond and contribute to the improved well-being of the region's population.

Shamshad Akhtar
Regional Vice President
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Abbreviations

ALM	Asset liability management
AMF	Arab Monetary Fund
API	Arab Payment and Securities Settlement Initiative
BRIC	Brazil, Russian Federation, India, and China
CAR	Contractors all risks
CAR	Capital adequacy ratio
CEO	Chief executive officer
CPM	Crédit Populaire du Maroc
CRO	Chief risk officer
DIFC	Dubai International Financial Center
EU	European Union
FCI	Factors Chain International
GCC	Gulf Cooperation Council
GDP	Gross domestic product
ICI	Investment Company Institute
IFC	International Finance Corporation
IFRS	International financial reporting standard
IMF	International Monetary Fund
IPO	Initial public offering
ISDB	Islamic Development Bank
LIBOR	London interbank offered rate
MENA	Middle East and North Africa
MENA-5	Arab Republic of Egypt, Jordan, Lebanon, Morocco, and Tunisia
MSME	Micro, Small, and Medium Enterprises
MTPL	Motor third-party liability
NID	National identification number
OECD	Organisation for Economic Co-operation and Development
PMA	Palestine Monetary Authority

QFC	Qatar Financial Center
SME	Small and Medium Enterprises
SPO	Secondary public offering
UAB	Union of Arab Banks
UASE	Union of Arab Stock Exchanges
WFE	World Federation of Exchanges

Overview

The political turmoil that spread through the Middle East and North Africa (MENA) region in early 2011 revealed deep-seated frustrations and a sense of political, social, and economic exclusion, especially within the region's large young populations. The political turmoil—labeled the "Arab spring"—prompted a renewed search for the causes of the region's political and economic malaise and calls for political and economic reforms.

The factors that triggered the turmoil were predominantly political, but the underlying economic factors were equally important. The events revealed the incapacity of most MENA countries to generate sufficient growth, employment opportunities, and housing for their large and young populations. This report argues that MENA's financial systems contributed significantly to these unsatisfactory outcomes by failing to provide affordable access to finance to large segments of the enterprise and household sectors. The financial sector is part of the problem and therefore needs to be part of the solution. Any effort to develop a new growth agenda for the region will need to include a significant component of financial sector reforms.

Main Objectives and Structure of This Report

This report contributes to the effort to improve MENA's growth and employment performance by providing a diagnostic of MENA's financial systems and proposing a roadmap for more diversified, competitive, and inclusive financial systems. The report recognizes the need to complement the financial development agenda by a financial stability agenda, to ensure that financial systems remain resilient as access is expanded and new risks emerge.

The report starts by briefly reviewing the main causes of MENA's unsatisfactory growth and employment performance, identifying the region's broader growth agenda and the role of financial development in this agenda. It proceeds by reviewing the size and structure of MENA's financial systems, showing that most of these systems are excessively bank based and undiversified. The chapter provides a battery of access indicators showing that access outcomes have been very poor relative to those in other regions. It discusses the main causes of these poor outcomes and proposes a comprehensive agenda for financial development and financial stability. The report emphasizes the many common challenges faced by MENA countries, but it also recognizes the differences and tailors policy recommendations to the initial conditions in each of the main subregions.

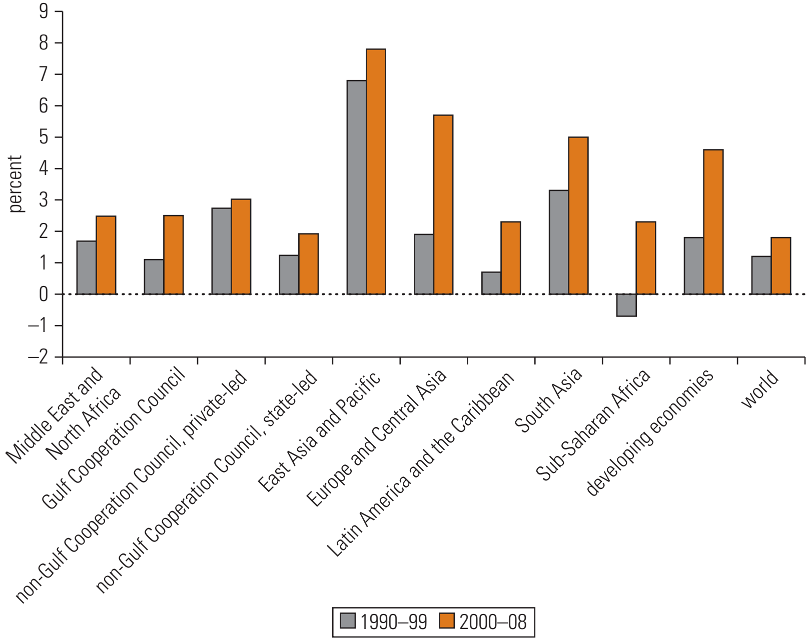
The Region's Weak Growth and Employment Performance and Its Main Causes

Countries in the region were able to improve their growth performance and social indicators in the 2000s, as a result of global growth and a number of reforms implemented in this period. However, the average increase in real per capita incomes was unimpressive relative to other emerging regions (figure 1) and insufficient to generate the levels of employment required by a large and rapidly growing population. MENA has the highest youth unemployment rates among emerging economies (figure 2), rates that are particularly high among university graduates. Moreover, the magnitude of the employment challenge is masked by the low rates of labor force participation, especially among women (figure 3).

The relatively weak growth performance reflects a combination of insufficient reforms and weak reform implementation. In recent decades, countries in the region have reduced the role of the state and enhanced the role of the private sector through the privatization of state enterprises and banks, regulatory reforms aimed at improving the business environment, and the reduction of restrictions in foreign trade and investment. However, these reforms did not go far enough or were not well implemented. The state still plays a dominant role in some countries, and these are the regions with the weakest growth performance (see figure 1). Moreover, public institutions charged with implementing reform continued to privilege state enterprises and older private enterprises with established political connections, through formal and informal barriers to entry and nontariff barriers. The lack of competition and dynamism is reflected in the low ratios of private sector investment (figure 4), the high average age of enterprises, the low business density, and the poor export diversification (World Bank 2009).

FIGURE 1

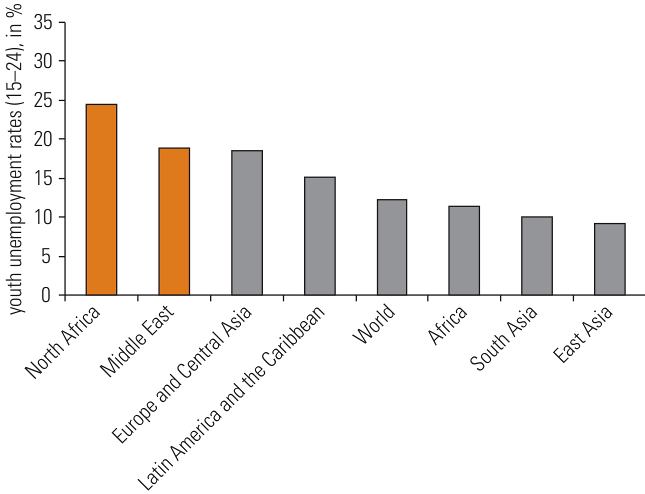
Per Capita Income Growth, by World Region, 1990–99 and 2000–08



Source: World Bank 2011.

FIGURE 2

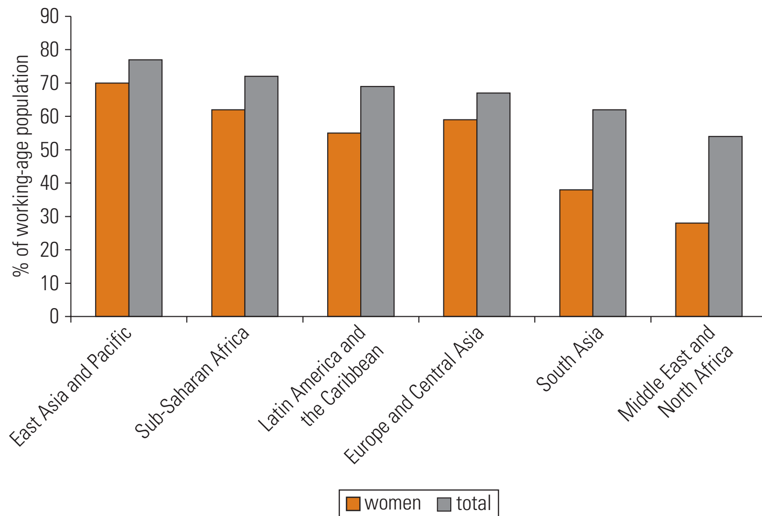
Youth (Ages 15–24) Unemployment Rates, by World Region, 2008



Source: ILO 2010.

FIGURE 3

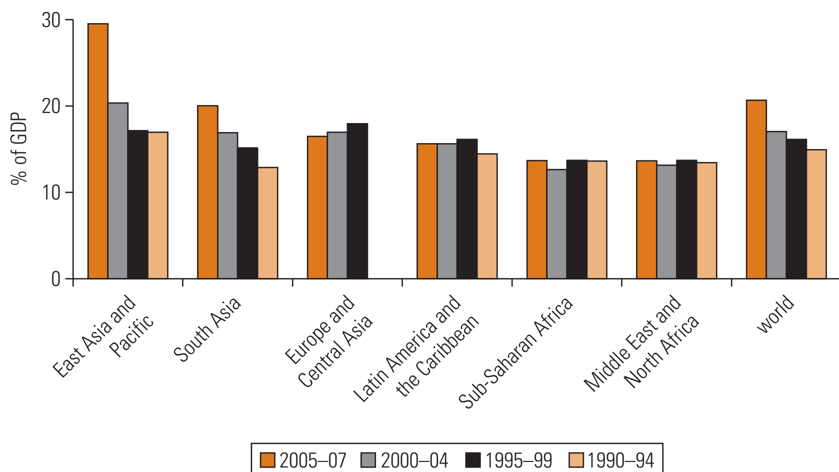
Labor Force Participation, by World Region, 2008



Source: ILO 2010.

FIGURE 4

Private Investment Rates, by World Region, 1990–2007



Source: World Bank 2009.

Note: GDP = gross domestic product.

The weak growth and employment performance in MENA also reflects the lack of depth of financial sector reforms. Although many countries in the region made progress with financial sector reforms, in most countries these reforms were also insufficient and failed to create a level playing field between state and private enterprises and within the

private sector. Countries in the region have large banking systems but also the highest rates of credit concentration in the world. The lack of access to finance affects primarily younger enterprises that would be able to grow at faster rates and generate more employment opportunities, as well as the large number of young households looking for affordable housing. The restricted access to finance in MENA has been the result of many factors, including a weak financial infrastructure, weak competition in the banking sector, regulatory tolerance toward large exposures and connected lending, and the lack of nonbanking institutions and markets providing alternative sources of finance. Moreover, these factors are closely connected and have to be addressed jointly.

The structural weaknesses of MENA's financial sectors imply that access to finance may remain restricted even with a full recovery of credit activity. Credit activity had been recovering in MENA and other emerging regions in the aftermath of the global financial crisis (figures 5 and 6). However, the recovery has leveled off in many MENA countries and may falter in the countries more directly affected by political turmoil, possibly hindering output recovery. The consolidation of credit recovery in the region is therefore an important short-run policy objective, although there is no guarantee that even a full recovery will benefit a wide range of economic agents. Large segments of the population and the enterprise sector were deprived of finance before the global financial crisis and the regional turmoil and may remain deprived in the absence of substantive reforms. The key medium- and long-run objective is therefore to ensure that the recovery benefits a much wider range of economic units.

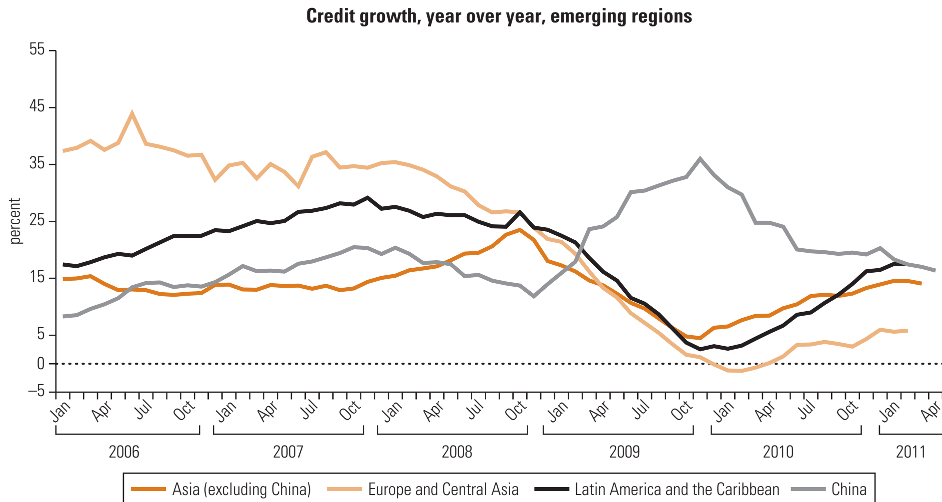
The Region's Long-Run Growth Agenda and the Role of the Financial Sector

Countries in the region thus face an ambitious reform agenda, capable of rectifying two decades of relatively poor output and employment performance. As stressed in the flagship report for private sector development and in regional diagnostics of MENA's growth performance (World Bank 2009, 2011), improving growth performance will require further reforms on several fronts, including finance, fiscal, trade, and labor market reforms. Most important, it will also require greater efforts to fully implement recent and future reforms and ensure a level playing field through reforms of public institutions and regulatory agencies dealing with the private sector. This will in turn entail an agenda that improves governance, disclosure, and the accountability of public institutions.

Financial development should be a central component of MENA's growth agenda.[1] Addressing the problem of restricted access to

FIGURE 5

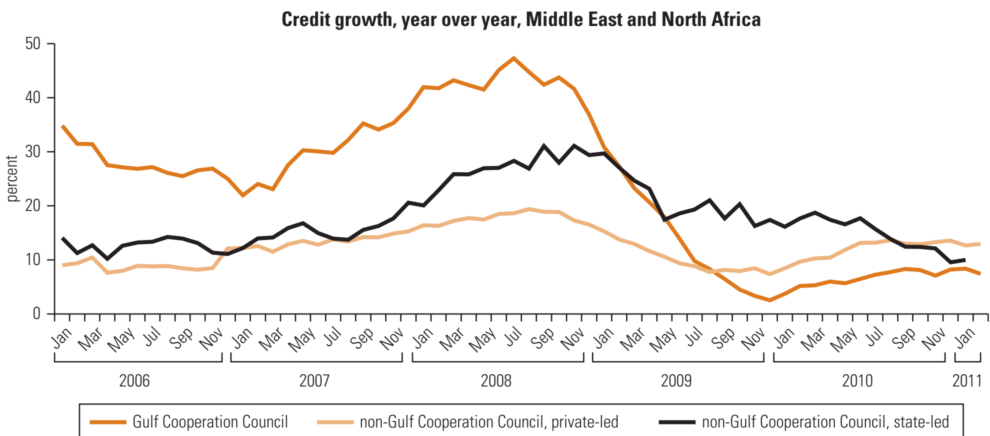
Annual Credit Growth in Emerging Regions, 2006–11



Source: IMF 2011.

FIGURE 6

Annual Credit Growth in the Middle East and North Africa, 2006–11



Source: IMF 2011.

finance will require implementation of a comprehensive financial development agenda that includes improvements in financial infrastructure (credit information and creditor rights); measures to enhance banking competition and address the historical connections between large banks and large industrial groups; and measures to diversify the financial system through the development of nonbanking

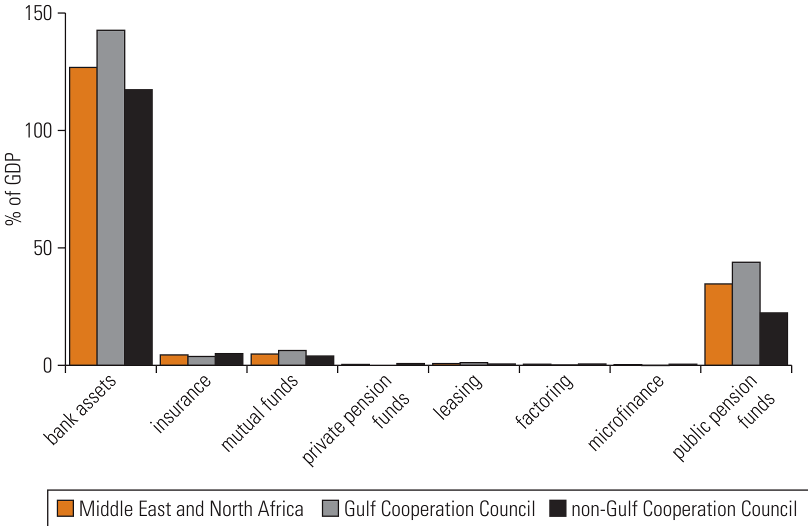
institutions, instruments, and markets. MENA policy makers must also ensure that financial systems remain resilient as access is expanded and new risks emerge. Ensuring such resilience implies the need to implement a complementary financial stability agenda that entails improvements in bank governance and a stronger architecture of financial regulation and supervision.

The Region's Excessively Bank-Based and Undiversified Financial Systems

Banks dominate the financial landscape of MENA countries. On average, bank assets account for 130 percent of gross domestic product (GDP) in MENA, eclipsing all other sectors (figure 7). The Gulf Cooperation Council (GCC) average is higher, at about 145 percent of GDP, reflecting much higher income levels, but the average ratio in the non-GCC region is also high, at 120 percent of GDP. However, there are significant differences between the two non-GCC subregions. On average, bank assets amount to 140 percent of GDP in the emerging economies where

FIGURE 7

Assets of Financial Institutions as a Percentage of GDP



Source: World Bank staff compilation based on data from Axco, Euromoney, Factors Chain International (FCI), International Monetary Fund (IMF), Investment Company Institute (ICI), Micro Finance Information Exchange (MIX), World Bank, and national sources.

Note: Data are from 2009 or latest year available.

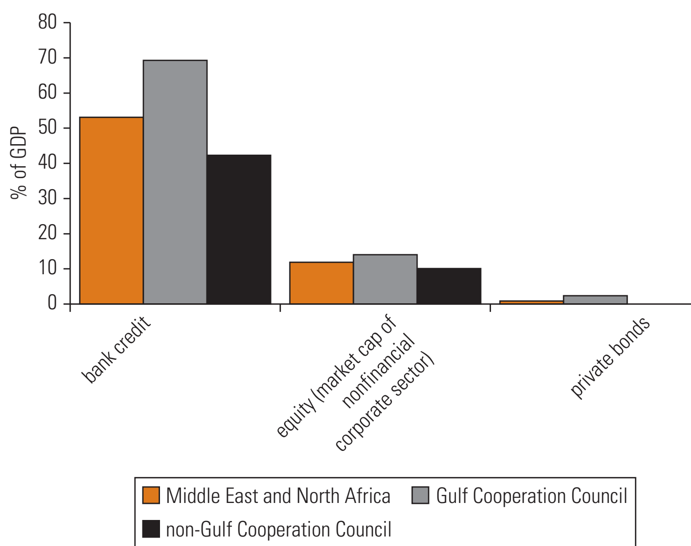
private banks are dominant (the Arab Republic of Egypt, Lebanon, Jordan Morocco, Tunisia, the Republic of Yemen) but only 65 percent of GDP in the countries where state banks lead financial intermediation (Algeria, Iraq, Libya, the Syrian Arab Republic).

Nonbanking financial institutions remain small or negligible, with very few exceptions. On average, insurance companies and mutual funds account for less than 5 percent, leasing and factoring amount to less than 1 percent, and outstanding microcredit accounts for just 0.2 percent of GDP. Private pension funds are negligible or nonexistent. Public pension funds managing the reserves of public pay-as-you-go schemes have become large in some countries but have not made a strong contribution to capital market development.

Bank credit is generally high by international comparison and constitutes the main source of private sector finance in MENA (figure 8), but credit remains very concentrated in many countries. Private credit amounts to 70 percent of GDP in the GCC average, reflecting higher per capita incomes and less financing of government deficits. The non-GCC average is lower, at 40 percent of GDP, reflecting lower incomes and a larger volume of public sector financing. However, the non-GCC average masks large differences between the two main subregions. Private credit exceeds 60 percent of GDP in countries with private-led banking

FIGURE 8

Financing Sources to the Private Sector as a Percentage of GDP



Source: World Bank staff compilation based on data from Bloomberg, IMF, and World Bank.

Note: Data are from 2009 or latest year available.

systems and only 12 percent in countries with state-led systems, as a result of extensive financing of state enterprises. Except for this last group of countries, private credit in MENA is high by international comparison, but credit remains concentrated in the region, benefiting a relatively narrow segment of the private sector.

The average equity market capitalization is high at 60 percent of GDP, but this ratio is deceptive, because capitalization is dominated by financial and infrastructure firms. The share of nonfinancial corporates (industry and services) in market capitalization is only 20 percent, the lowest among emerging regions. Equity market capitalization for industry and services is only 12 percent of GDP (figure 8). Furthermore, the lack of a solid private institutional investor base, combined with the presence of a large number of uninformed individual investors, raises questions about the quality of turnover and price discovery.

The stock of private fixed-income instruments is negligible in MENA. The stock of traded government securities is sizable in some non-GCC countries, but government debt markets remain undeveloped and illiquid and draw little interest from foreign investors. The lack of a reliable benchmark yield curve is one of the reasons private markets have not developed. In non-GCC countries, private bond issues have been small and limited largely to banks. The stock of corporate bonds and mortgage-backed securities remains negligible, and mortgage-covered bonds do not exist. In the GCC, there have been large but sporadic issues by sovereign and corporate entities of conventional debt and *sukuk* in recent years, but a large share is internationally syndicated, issued in U.S. dollars, and listed offshore.

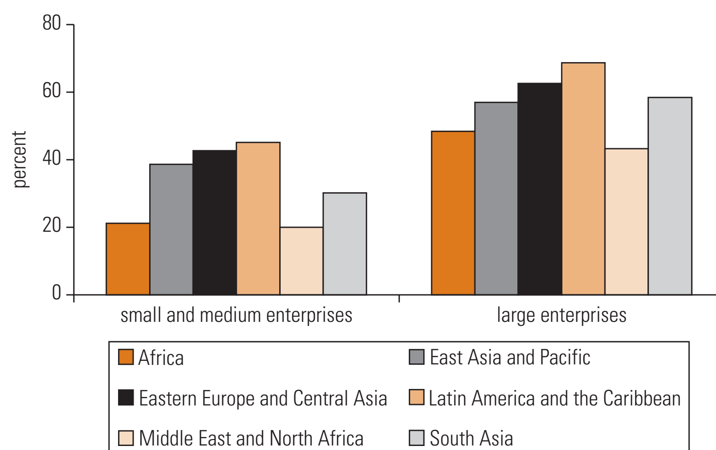
Large Banking Systems but Poor Access Outcomes

Access remains limited in most MENA countries. Banks are generally well capitalized, and the credit-to-GDP ratio is generally high by international standards, but credit is much more concentrated than in other regions. Many important segments, such as small and medium enterprises, remain deprived of bank credit, and alternatives to bank finance are limited, even for larger enterprises. The outreach of the microfinance industry is restricted, and housing finance is in a nascent stage.

A battery of indicators based on enterprise- and bank-level data confirm the lack of access to finance in the region. Enterprise surveys indicate that enterprises, especially small and medium enterprises, are financially constrained: only 20 percent of small and medium enterprises in MENA have a loan or line of credit, a significantly lower share than in all other regions except Africa (figure 9). A larger share of large enterprises in MENA has loans or lines of credit, but the region does not compare well

FIGURE 9

Share of Enterprises with a Loan or Line of Credit, by Firm Size and World Region



Source: World Bank surveys conducted between 2005 and 2010.

at this level either. As a result of the restricted access to bank credit and the lack of alternatives, such as equity, leasing, and factoring, enterprises, especially small and medium enterprises, have to rely more on internal resources to finance working capital and investment (figure 10).

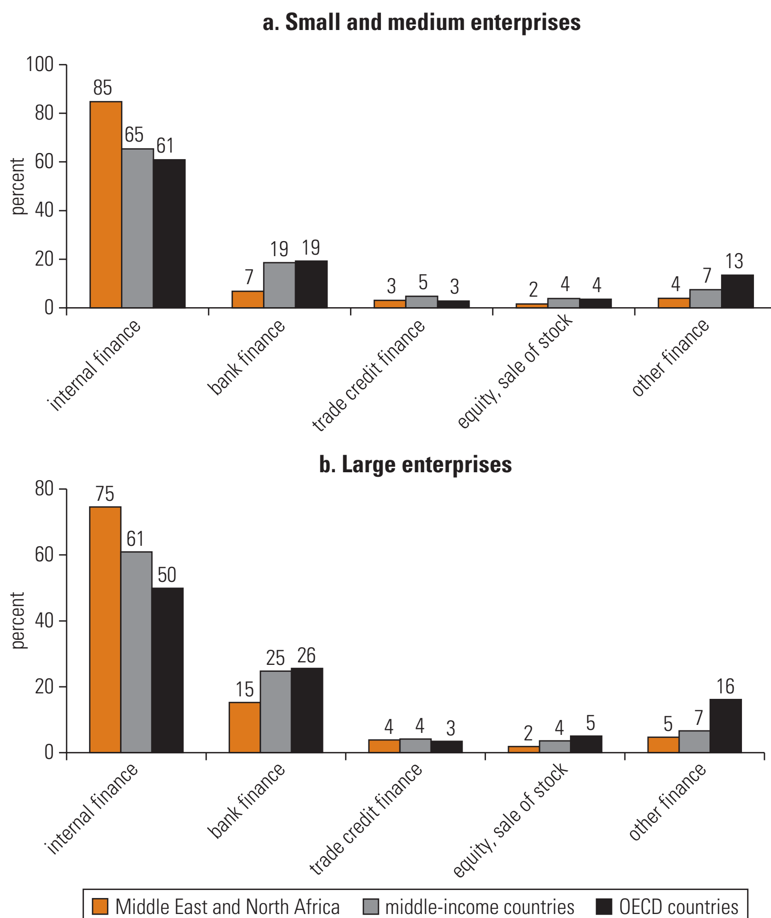
MENA countries have a smaller number of deposit and loan accounts per adult than most other regions, and its ratios are lower than those in other regions except South Asia and Africa (figure 11). These results reflect both limited banking penetration and restricted access to credit. Countries in the region compare even more poorly considering the large size of their deposits and credits relative to GDP. This is a revealing result, reflecting the lack of a close correlation between financial depth and financial access.

MENA has the highest average loan concentration ratio in the world, measured by the ratio of the top 20 exposures to total equity (242 percent). This ratio reflects the focus of banks on large enterprises (figure 12). The average loan concentration ratio in the GCC is a bit lower, indicating the region's progress in developing consumer lending and the larger equity base. The still high GCC ratio is a sign of large loans to real estate and the oil and gas sectors. In both regions, high loan concentration reflects historic connections between large banks and large enterprises and groups.

Lending to small and medium enterprises amounts to a small share of the loan portfolio in many countries. The average share of small and medium enterprise loans in total loans is only 8 percent (figure 13), a

FIGURE 10

Sources of Investment Finance, by Firm Size and Country Group



Source: World Bank surveys conducted between 2005 and 2010.

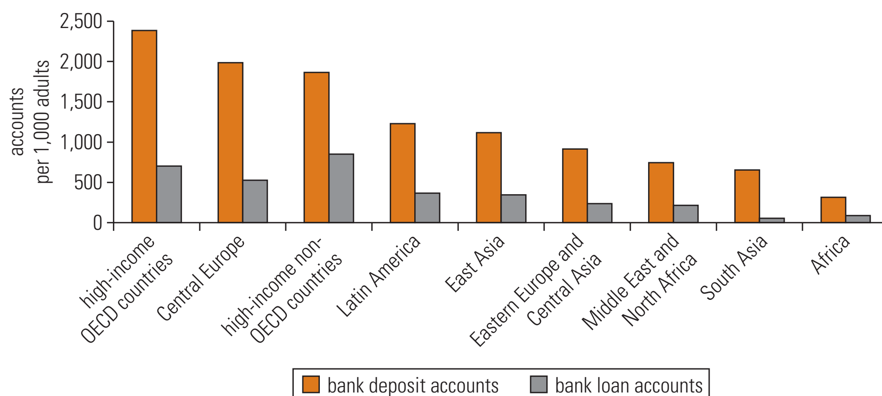
Note: OECD = Organisation for Economic Co-operation and Development.

small fraction by international comparison. The average share in non-GCC countries is higher, at 13 percent, but still lower than in the subregion's peer groups. Lending by microfinance providers reaches only 1.8 percent of the adult population, half the proportion in South Asia or Latin America.

Residential housing finance has started to develop only recently in MENA, at least as a market-based activity. Mortgage loans account for less than 10 percent of the loan portfolio (figure 14), a very low share by international standards. Market development is still in its infancy, and the region lags other regions of comparable or lower income levels.

FIGURE 11

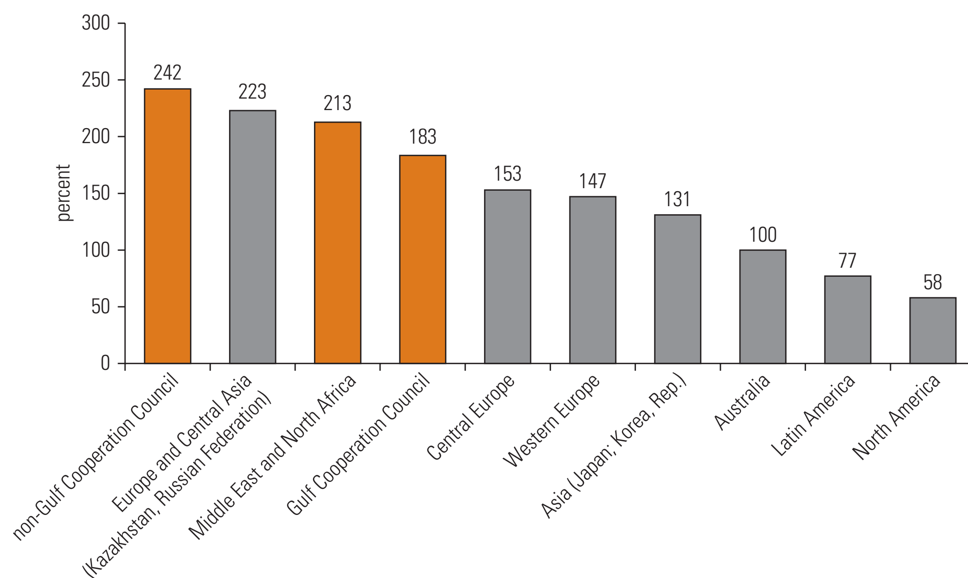
Number of Bank Deposit and Loan Accounts, by World Region, 2009



Source: CGAP 2010.

FIGURE 12

Top 20 Exposures as a Percentage of Total Equity, by World Region



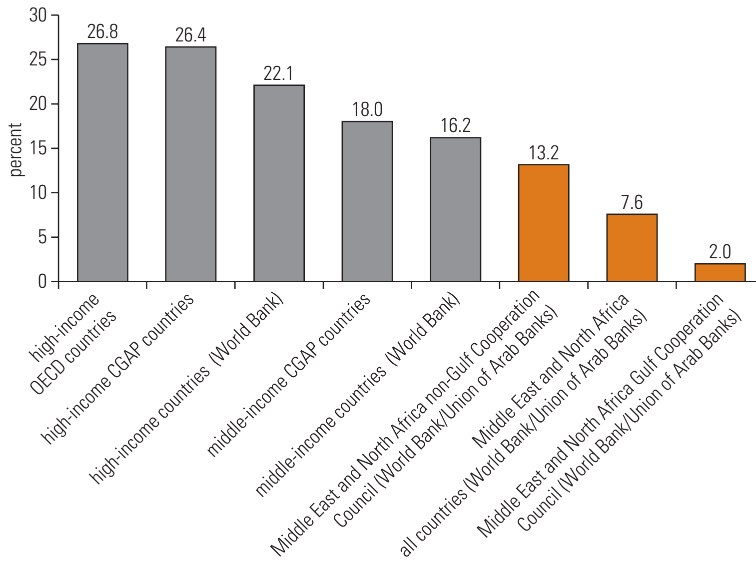
Sources: Standard & Poor's 2005a, 2005b, 2007, 2010.

Main Factors Limiting Access to Finance in the Region

The reasons behind MENA's access problems include weak financial infrastructure, weak banking competition, and flaws in the institutional and legal framework that hinder the growth of nonbank financial institutions,

FIGURE 13

Small and Medium Enterprise Loans as a Percentage of Total Loans, by Country Group, 2005–09

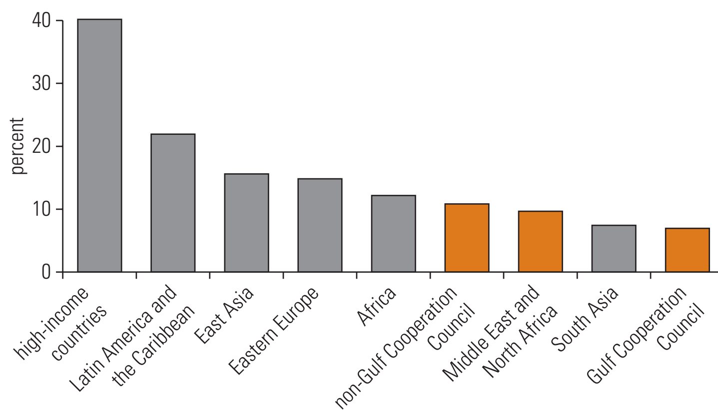


Source: World Bank staff compilation based on data from IFC 2010; CGAP 2010; Beck, Demirgüç-Kunt, and Martinez Peria 2009; Rocha and others 2010.

Note: Group averages computed. CGAP = Consultative Group to Assist the Poor.

FIGURE 14

Housing Loans as a Percentage of Total Loans, by World Region



Source: World Bank staff calculations based on data from national sources and the World Bank Housing Finance Unit database.

Note: Data are regional averages computed on 2010 figures or latest available year.

instruments, and markets. These factors are closely connected and together contribute to poor access outcomes. Policy interventions have mitigated access problems but have not addressed the root causes.

Credit information has improved in recent years, but MENA is still overly dependent on traditional public credit registries, and much remains to be done to improve coverage and the quality of information. MENA's credit reporting systems have improved in recent years with the upgrading of public credit registries and the introduction of new private credit bureaus in Egypt, Morocco, Saudi Arabia, and the United Arab Emirates. However, 60 percent of countries in the region still rely entirely on public registries, a much higher share than in other regions except Africa. The excessive reliance on traditional public registries is possibly one of the reasons MENA still compares poorly with other regions in the coverage and depth of credit information.

MENA lags other emerging regions in the introduction of collateral regimes that strengthen creditor rights and promote lending. It ranks last in a regional comparison of the Legal Rights Index of Doing Business, with the MENA country that scores best ranking 106th. Most countries in the region have severe weaknesses in all the components of the chain of secured lending. The types of movable collateral that can be used are limited; the priority of secured creditors in the case of default is unclear; registration of collateral is paper based, fragmented, and does not provide easy access to information on existing security rights; and the enforcement of security rights is very difficult, with no established procedures for out of court enforcement.

Weak bank competition is another explanation for the high loan concentration and restricted access to finance in MENA countries. The reduction in the share of state banks in most countries and the entry of foreign banks in recent years bodes well for the future, but these changes in structure may not have been sufficient to increase competition in the main credit markets. Research conducted for this report shows that MENA banking systems remain less competitive than those in other regions, as a result of stricter entry requirements, weak credit information systems (which prevents a level playing field for small and large banks), and lack of competition from capital markets and nonbanking institutions. The high loan concentration may also reflect poor regulation and enforcement of large exposures and connected lending.

The slow development of nonbank financial institutions, instruments, and markets is partly the result of the lack of enabling legislation. Gaps in legislation or weak supervision and enforcement have prevented the faster growth of sectors such as insurance, mutual funds, leasing, and factoring. The lack of private fixed-income assets partly reflects the

underdevelopment of the key government debt market, but it also reflects the absence of sound enabling legislation for instruments such as corporate bonds, mortgage-covered bonds, and mortgage-backed securities. The small size of nonbank financial institutions limits the demand for instruments and the lack of suitable instruments constrains the growth of nonbank financial institutions. Efforts in both areas could generate important synergies and further the diversification and development of MENA's financial systems.

A Roadmap for Expanding Access and Preserving Stability

MENA countries need to adopt a challenging financial reform agenda that will expand access and contribute to growth and employment generation in the current decade and beyond. The roadmap proposed in this flagship report is comprehensive, because the lack of access in MENA reflects a large number of interconnected factors. The agenda must address the very high level of loan concentration in the region and create the conditions for a sustainable expansion of access to finance in all critical areas, including small and medium enterprise, consumer, micro, housing, and investment finance. A battery of coherent and mutually reinforcing reforms will be needed that address regulatory and institutional weaknesses in many areas.

The main thrust of the agenda is to enable a stronger engagement of private financial institutions through an improved enabling environment while reserving an important role for the state as an enabler and regulator as well as a guarantor and provider if market failures persist. The roadmap includes reforms in financial infrastructure; reforms in banking regulation designed to improve competition and preserve financial stability; and reforms to promote the development of nonbanking institutions, markets, and instruments.

The proposed reform plan starts with recommendations to strengthen financial infrastructure, one of the weakest components of MENA financial systems. Strengthening credit information and creditor rights would not only have a direct positive impact on access by reducing creditor risks, but also have an indirect impact by leveling the playing field for banks of different sizes and promoting bank competition.

The recommendations include regulatory reforms in banking designed to enhance the levels of competition. The banking sector will remain the dominant component of MENA's financial systems for the foreseeable future. The structure of MENA's banking systems is evolving

in the right direction but not at a sufficient pace to break the access to finance gridlock. In many countries, the approach to regulation and supervision may need to be revised in critical areas such as entry regulations and the regime for large exposures and connected lending.

The roadmap also includes reforms designed to diversify MENA's financial systems, creating new institutions and instruments that do not exist or are negligible. This component does not aim to transform MENA's bank-based systems into market-based systems. However, the negligible size of nonbanking institutions and financial instruments implies the absence of essential services, hinders competition in the banking sector, and deprives the banks of tools with which to manage their risks and expand access in a sound manner. Therefore, specific proposals are put forward for building an institutional investor base, building key instruments and markets, and developing additional financial services and sources of finance. The approach to policy interventions, including the use of state banks and guarantee schemes, also needs revision. State banks have played an access role in many MENA countries, but their performance has been mixed. The reform plan recognizes that the state may have an important role to play in financial development but that this role must evolve over time. Moreover, state institutions must be subject to much improved mandates and governance structures. Other policy interventions designed to expand access to finance should also be better targeted. Credit guarantee schemes offer better perspectives than other interventions, but the design of MENA guarantee schemes should be reviewed to improve their additionality.

The roadmap emphasizes the potential contribution of foreign institutions and investors while acknowledging the need to mitigate the risks of their increased participation. The recent financial crisis has shown that financial openness implies higher exposure to external shocks, but the lack of openness has also had a negative impact on the efficiency of the financial system and its capacity to provide access. Foreign banks can enhance competition and access, but they have not reached critical size in many countries. Foreign investors can contribute to market development, especially as domestic institutional investors are being developed, but their presence is still negligible in debt markets and limited in many equity markets. The challenge lies in maximizing the benefits of foreign participation while mitigating its risks.

Financial development needs to be complemented by a financial stability agenda to ensure that financial systems remain resilient as access is expanded. Some of the proposed reforms may reduce some risks, such as concentration risk. Other reforms designed to expand access may imply new risks for the banks. For this reason, it is imperative to ensure that the banks are capable of managing these risks—through improvements in

bank governance and the overall architecture of bank regulation and supervision.

Addressing long-standing fiscal constraints would complement financial reform. In the non-GCC countries, persistent budget deficits contribute to a symbiotic relationship between banks and the government. Governments get a stable funding source, and banks gain the margin between their low funding costs and the yields on government securities. In the GCC, banks serve as the intermediary between hydrocarbon wealth and the financing of the nonoil domestic economy. In both subregions, the existence of a stable and profitable business line with the government blunts the momentum of the reform agenda. Deficit reduction (outside the GCC) and an agenda of diversification beyond the narrow focus on government employees and large corporates (within the GCC) would loosen the current relationship with governments and enable financial systems to play their intermediation role more effectively.

First Things First: Strengthening Financial Infrastructure

Improving credit information

The combination of a public credit registry and a new private credit bureau may prove to be the most effective solution for expanding the coverage and depth of credit information. However, some countries in MENA favor upgrading their public registries and making them operate like best-practice credit bureaus. This approach may prove effective in some cases. In particular, the public credit registry established by the Palestine Monetary Authority merits examination, especially by countries with lower credit penetration and a weaker legal and institutional environment.

Countries considering introducing a private credit bureau should develop specific legislation. A customized credit reporting law is the best legal foundation for information sharing. Jordan and Saudi Arabia have chosen this path. The Saudi private credit bureau (SIMAH) has made impressive gains in coverage and in the provision of value added services such as credit scores and small and medium enterprise ratings; it merits examination by other countries. Egypt and Morocco have introduced private credit bureaus through central bank regulations, an approach that may also prove feasible elsewhere. The Moroccan model of delegated management by the central bank is particularly innovative and merits examination by other countries as well.

Regulators should encourage the engagement of microfinance institutions and the use of nontraditional data by private credit bureaus. A huge critical mass of powerful and predictive information on utilities, retailers, and mobile phone operators normally goes unused because of lack of

regulation or excessive restrictions. These data are crucial to start building credit histories for potential borrowers who do not have them. Alternative data can bridge the information gap for millions of people outside the credit mainstream, who tend to be the poor and less advantaged. Harnessing the power of alternative data is paramount to formalize the informal economy.

Strengthening creditor rights

The most appropriate way to strengthen creditor rights entails drafting a specific law that regulates every aspect of the chain of secured lending. The scope of the secured transactions law should be broad, allowing pools of assets with only a generic description, thus allowing inventory and receivables to be used as collateral. The creation of security interests should be simplified, and the law should allow the parties to freely agree on the conditions of the secured transaction in the credit agreement. Secured creditors should be able to predict their priority with respect to other creditors. Movable collateral registries should be modernized. The registry fulfills an essential function, which is to notify parties about the existence of a security interest in movable property and to establish the priority of secured creditors.

Enforcement must be substantially strengthened, especially through the introduction of effective out of court enforcement. Weak enforcement of collateral and collection of debts is one of the major obstacles to access in MENA. More than 100 countries worldwide with different legal systems have adopted out of court enforcement procedures, frequently by introducing private enforcement agents and regulating out of court enforcement to prevent abuse. Countries in the region should also address this major weakness in financial infrastructure.

Strengthening Bank Competition

In most countries in the region, there is no authority responsible for promoting sound competition. As a result, anticompetitive behavior (including actions that prevent state banks from exercising unfair advantages relative to private banks) is not addressed. The experience of the European Union, whose regime is implemented by the European Commission's Competition Directorate General, is relevant. MENA countries should consider giving competition authorities a clear mandate to promote sound competition in the banking sector. A second-best solution would entail empowering the bank supervisor to address competition issues in the sector.

Bank regulators should give greater weight to sound competition when implementing licensing criteria. Surveys of bank regulation suggest that entry regulations in MENA are generally restrictive and that MENA has the largest share of denied license applications among emerging

regions. Licensing decisions still lie with the ministry of finance in some countries and are made on grounds other than soundness (such as claims that the new entrants would not add value, that the system is overbanked, or that national champions could lose market share). These factors do not justify restricting the entry of reputable banks that could increase competition and access. Bank licensing approaches could be revisited without relaxing the quality of entry.

Strengthening the large exposures and connected lending regimes could also contribute to increased competition, which would increase access. Credit concentration regimes are primarily prudential tools, but they may increase competition. If supervisors applied stricter limits on large exposures and stricter definitions of connected lending and imposed additional capital requirements for banks with excessive credit concentration, large clients would have more incentives to tap capital markets (either because less bank financing is available or because it becomes more expensive) or distribute their business among several banks.

Developing Nonbanking Finance Institutions: An Agenda for Each Sector

Developing the insurance sector

Reducing the presence and participation of state insurers would stimulate competition and innovation and contribute to faster development of the insurance sector. A number of MENA countries, including Algeria, Egypt, Libya, and Syria, are still dealing with the legacy of state involvement in insurance and are reforming their systems. State insurers should undertake financial and operational audits and develop plans for corporatization and privatization.

Expanding the scope of compulsory insurance and enforcing compliance of compulsory lines would accelerate the growth of the sector and generate positive externalities. Introducing compulsory insurance in lines such as workmen's compensation and insurance of construction companies and transport providers would substantially increase premiums and generate a social good. GCC countries could consider introducing health insurance for expatriates and eventually their domestic populations. Enforcing compliance of existing compulsory lines, such as motor third-party liability insurance, would also stimulate the growth of the industry and generate positive externalities. Policy makers must address the causes of limited premiums by introducing aggressive enforcement measures and relaxing price controls.

Changing tax regimes and authorizing the use of *banc-assurance* while improving consumer protection could accelerate the development of life

insurance. Turnover taxes applied to life premiums and the *Zakat* tax applied to policyholder funds penalize the savings component of life insurance products. The rapid growth of the life insurance sector in Morocco is partly a result of distribution through *banc-assurance*, but this distribution model needs to be regulated to avoid cross-selling and the perception that clients are purchasing a bank-guaranteed product. More generally, improving consumer protection is essential for reversing the pervasive public mistrust of the insurance sector.

Insurance supervisors must have the resources and independence to ensure the sound growth of the industry. One solution would be to place insurance supervision in the central bank; this may be a next step for many supervisors in small MENA countries. An alternative would be to establish an independent supervisor with its own funding sources. Developing risk-based supervision should start with simple solvency requirements. Overly complex risk-based models are not appropriate given the nascent stage of the industry and supervisory capacity.

Takaful insurance is a potential solution to making insurance consistent with religious and cultural traditions, but operationalizing *takaful* insurance remains a challenge. The current fragmented approach to *takaful*, with numerous interpretations and hybrid structures, holds back the potential of the industry. There is a need for a more coordinated approach, involving greater centralization of *Shariah* guidance and new structures for capital support.

Enhancing the contribution of the pension sector

The prospects for rapid growth of private pension funds over the next 10–20 years are limited; a more promising path entails reforms to the large public pension funds. Rapid growth of private pension funds would require major structural reforms in public pension systems entailing the downsizing of benefits to sustainable levels and a robust regulatory framework for private funds. Such reforms, even when implemented aggressively, take many years to have a significant impact on the financial sector. Three major initiatives are required for public pension funds: strengthening fund governance and public disclosure, improving the professionalism of asset management, and creating a pluralistic structure in asset management.

Strengthening fund governance and public disclosure is a major requirement for enhancing the performance of public pension funds. Fund governance should ensure the insulation of boards of directors from political influence. Investment policies and results should be disclosed and subject to external scrutiny by independent experts. Increasing the professionalism of asset management requires the appointment of professional boards of directors and the adoption of modern asset allocation

strategies. Investment policies should aim to achieve risk diversification and prevent the use of public pension funds as a captive source of finance for the public sector.

Creating a pluralistic structure in asset management will contribute to capital market development. A large public pension fund may acquire a dominant position in local markets, distorting market prices and investment decisions. A more pluralistic structure in asset management would avoid these problems. It could take two forms. The first would involve establishing several competing public sector entities responsible for managing a fraction of the assets of the pension fund. The newly created funds would set their own investment policies and compete with the other public funds and private asset managers. The second would require public pension funds to hire several external asset managers through a competitive bidding process and award mandates for different segments of the portfolios.

Stimulating the development of mutual funds

Licensing criteria and capital requirements should be strengthened. These requirements should include “fit and proper” rules for the owners and managers of mutual funds, requirements for the professional qualifications of investment managers, and reasonable minimum capital requirements. Some countries in the region impose minimum net asset requirements for fund managers; such requirements can deter the growth of the industry and should be replaced by risk-based capital requirements.

Mutual funds should be subject to adequate disclosure rules, and valuation and redemption rules must be substantially improved. MENA mutual funds have shortcomings in disclosure and valuation. Disclosure is the basis for mutual fund regulation. Promotion of any mutual fund should center on a public prospectus that provides investors with relevant information. Net asset values should be calculated on a daily basis. The sale and redemption of mutual fund shares should be based on forward pricing to ensure that all fund shareholders are treated equally. In MENA, only about a third of funds by number, accounting for 62 percent of assets under management, calculate daily net asset values, and some countries still use backward pricing.

Mutual fund development seems to suffer from constraints on distribution channels. Bank dominance of the mutual fund industry may have impeded its development. Encouraging large foreign fund managers to establish local operations could counter this dominance. Consolidating the mutual fund industry could lead to greater economies of scale and lower operating fees; developing supporting services would promote efficiency and strengthen investor protection.

Developing alternative sources of finance for small and medium enterprises: Leasing and factoring

Strengthening the legal framework for leasing in MENA would be best achieved through a specialized leasing law rather than the current fragmented approach involving several pieces of legislation. The definition of leasing needs to be clear, and a fairer balance established between the rights and responsibilities of the parties to a lease. The process for registering leased assets should be strengthened, with the development of registries. Ideally, there should be a unified registry for movable collateral in which all leased assets are recorded. In addition, repossession procedures and tax rules must be substantially improved.

Countries in the region should explore means to develop both factoring and reverse factoring to provide alternative financing sources for small and medium enterprises. Egypt has recently implemented reforms to foster the factoring industry, including the amendment of regulations to the investment law, setting rules governing factoring activities, licensing, registration requirements, and procedures. Reverse factoring is a more recent and attractive arrangement that would allow small and medium enterprises to receive more financing at lower cost. The scheme relies on the creditworthiness of large buyers rather than that of small and medium enterprises. Reverse factoring could become an important source of working capital financing for exporters and small and medium enterprises in countries struggling with poor credit information. The Mexican experience in this area is particularly relevant for MENA countries.

Developing microfinance

Countries in the region should provide a regulatory and supervisory framework that supports wide financial inclusion. They are encouraged to introduce specific microcredit legislation. Countries that have no clear regulatory and supervisory frameworks should bring microfinance institutions under the umbrella of financial regulatory authorities and develop specialist supervisory capacity. Consumer protection should be strengthened as access increases, ensuring that customers can make well-informed decisions. Microfinance institutions should operate under a sound credit information environment, best achieved by integrating microfinance institutions into public credit registries or private credit bureaus rather than relying exclusively on narrow microfinance information-sharing systems.

Stronger, well-performing microcredit nongovernmental organizations (NGOs) should have the option of graduating to regulated financial institutions, such as a finance company model. A finance company can provide the necessary clarity for banks and investors on key questions

such as ownership, capital base, governance, and risk management. A finance company model can more effectively tap into commercial bank and microfinance investor sources of finance and do so on more favorable terms than an NGO or association model.

Developing Capital Markets

Developing government debt markets

Developing fixed-income markets in MENA starts with government debt markets, which provide the benchmark yield curve for pricing private issues as well as the needed market infrastructure. Developing government debt markets requires improving each of the main building blocks: money markets, primary markets, secondary markets, and the investor base.

Improving money markets requires market-friendly intervention instruments and a sound repurchase agreement framework. MENA central banks need to improve liquidity forecasting, develop adequate intervention instruments, and develop a sound repurchase agreement framework given its multiple benefits for money markets, primary dealers, and the efficiency of monetary operations.

In the primary market, governments should consolidate short-term benchmarks in order to build reliable long-term references. Building a yield curve will require the systematic consolidation of debt in a smaller number of benchmarks. Liability management operations (reopenings, buybacks) should also support benchmark building. A balanced maturity structure of outstanding debt should be maintained at all times, with a regular and predictable supply of instruments at key maturities. Once the yield curve has been gradually lengthened, governments should maintain regular issues of all key maturities and avoid opportunistic behavior. In the secondary market, price transparency could be improved by collecting indicative prices or collecting and publishing prices from market makers at a given time each day. Stricter reporting obligations of pretrade and posttrade prices would also support price transparency.

The investor base needs to be diversified, including through the greater presence of foreign investors. Building domestic institutional investors may take time in many countries. In the meantime, increased foreign investor participation in government debt markets would improve liquidity and contribute to market development. In many countries, foreign investors are an important source of funding in the medium- and long-term segments; they contribute to market liquidity, price discovery, and the transfer of knowledge. However, governments should be able to calibrate the entry of foreign investors, if needed, by changing auction rules or adjusting primary dealer regulations. Placing

debt through syndications could also be a powerful tool to ensure a diversified investor base. Governments should also be ready to address volatility and refinancing risk in times of crisis by building cash reserves and conducting buyback or debt exchange operations.

Developing private fixed-income instruments

In the absence of a developed government debt market and a solid institutional investor base, the development of corporate bonds is a medium-term agenda in most MENA countries. Countries in the region that wish to develop corporate bonds should refrain from imposing unnecessary restrictions in their company and securities laws. Successful experiences with market development indicate that it is important to maintain flexibility in primary market regulation to avoid overregulation of issues targeted at sophisticated investors. In nascent markets where investors are not institutionalized and market intermediaries are unsophisticated, a simple form of nonautomated trading system may be sufficient for the limited secondary trading that would take place.

Many countries in the region could consider introducing mortgage-covered bonds; only a few should contemplate introducing mortgage-backed securities. Covered bonds are issued by originating banks with priority recourse to a pool of high-quality mortgage loans. They would allow banks to better manage the risks associated with growing maturity mismatches and offer a low-cost funding instrument. However, only a few countries should contemplate introducing mortgage-backed securities for the moment. The global crisis highlighted the risks associated with poorly regulated securitizations. More advanced countries may consider this instrument in the coming years, as they build pools of housing loans and meet the preconditions for successful securitizations.

Enhancing the contribution of equity markets

Successful experiences in increasing access to equity markets have invariably entailed efforts to improve disclosure and governance, including minority shareholder protection. Increased access to equity markets in the European Union and other emerging markets in recent decades was preceded by reforms designed to strengthen disclosure and governance, especially shareholder protection.

Information disclosure requirements should be enhanced to provide a more secure and attractive environment to investors. Financial disclosure should be strengthened through further implementation of international financial reporting standards (IFRS). Surveys conducted in recent years indicate that at least 23 percent of banks and 42 percent of other listed companies in MENA have not adopted IFRS (Hawkamah and IFC 2008).

Greater reliance on international audit firms, stricter rules on audit rotation, and the use of board audit committees made up of independent directors would increase the reliability of financial reporting. More widespread promulgation of codes of best practice and company-level codes of corporate governance are desirable.

Many jurisdictions need to improve protections for minority shareholders. Necessary measures include implementation of international standards in the area of takeover bids, earlier provision of information to shareholders ahead of annual meetings, and increased liability for chief executive officers and directors, such as greater opportunities for courts to void related-party transactions, award monetary damages, impose fines, or try shareholder lawsuits. Special efforts should be made to fight insider trading and market abuse.

Free floats need to be raised in a number of markets, and companies that are not traded should be delisted. Stock exchanges should normally require any listed company to maintain a free float of at least 25 percent, although justified exemptions should be allowed. Compliance with these free float goals should be promoted, and family-controlled corporations should be encouraged to open up and improve their governance. Thinly traded companies can easily become targets for price manipulation and speculation, which can undermine price discovery and market stability.

The development of equity markets also depends on the buildup of a domestic institutional investor base and greater participation of foreign investors. There is evidence that foreign investors have contributed to liquidity and price discovery. In this regard, it would be desirable to relax limits on foreign ownership of listed companies, especially in various GCC jurisdictions.

Qualitative improvements in the provision of investment services by market professionals would be desirable. Such improvements could be achieved by enhancing market intermediaries' capabilities by setting up professional accreditations for securities analysts, compliance officers, fund managers, and other market professionals, such as heads of clearing and settlement operations within brokerage firms. For the sake of improving price discovery, some jurisdictions should ease restrictions that prohibit brokers from offering research products or investment advice.

The performance of dedicated small and medium enterprise exchanges in MENA has been disappointing, but there is a case for persevering. The size of qualifying enterprises should not be capped at very low levels, as this may reduce liquidity and discourage the participation of fund managers. Public float should have a minimum size, as an excessively low float will also constrain liquidity. A large minimum number of shareholders

may be required to improve liquidity. Lock-up periods of 6–12 months or longer during which insiders cannot sell their stake following an initial public offering would curtail insider trading. Governments may consider tax incentives for small and medium enterprises that go public.

The independence and empowerment of capital market supervisors should be strengthened. The majority of the members of the board of the capital market authority should be independent and have financial sector experience. The regulator should have the technical and financial means to carry out its missions. It should have its own funding and not depend exclusively on annual appropriations from the government budget. Its salaries should be high enough to attract and retain qualified staff. The capital market authority should have the authority to impose penalties on registrants and issuers and rapidly bring cases before public prosecutors and courts for civil and criminal penalties.

Improving the Provision of Long-Term Finance

Housing finance

Given the nascent stage of housing finance in MENA, enhancing its availability requires a package of reforms, some of them very basic. Reducing registration costs would encourage the formalization of transactions. Countries in the region need to develop housing price indexes, using in particular the information in land registries, and create real estate market observatories. Guidelines for appraising assets need to be strengthened.

Strengthening the capacity to monitor mortgage lending and the prudential framework for housing finance is an extensive agenda in MENA. Authorities could improve statistical information on residential, developer, and commercial mortgages by tracking new lending by vintages/cohorts and monitoring loan-to-value ratios, debt service–to–income ratios, and nonperforming loans. Banks should conduct affordability assessments for housing loans, especially for low-income groups. Lenders should be required to conduct stress tests at origination on certain types of loans, such as floating rate mortgages. These tests should be periodically conducted to assess the impact of financial or real estate market shocks on mortgage portfolios. Regulators should develop a set of countercyclical prudential measures, adjusting parameters such as debt service–to–income ratios, loan-to-value ratios, and differentiated risk weights to real estate market conditions.

The legal framework to enable long-term funding needs to be developed in MENA. It is critical to start developing adequate arrangements or funding instruments to mitigate liquidity and interest rate risks. The type of security or arrangement depends on market capacity and acceptance. For example, central mortgage refinance companies

are well suited to markets in the early stages of development with limited origination, small lenders, and investor demand restricted to simple bonds. The development of mortgage-covered bonds and mortgage-backed securities would also contribute to the sound development of mortgage finance, but their successful development depends on initial country conditions, and the requirements are much more demanding in the case of securitizations.

Expanding access to housing in MENA will require addressing a number of nonfinancial constraints, particularly the availability and affordability of land and the effective management of land resources. In this regard, it is important that MENA governments allocate more efficiently the large tracts of land they own themselves; promote orderly and efficient urban expansion through adequate planning (relevant examples include the new towns and projects developed in Egypt, Saudi Arabia, and Tunisia); and curb speculative investments in land through adequate regulatory or tax measures.

Investment finance

State support to investment finance may be needed for some time in many countries, particularly in the case of infrastructure. The involvement of state banks in long-term lending, however, would require state bank restructuring and the review of mandates and governance to ensure a good selection of projects and prevent the accumulation of nonperforming loans in several countries. Greater private bank participation in long-term lending would be welcome, but it would imply the need to combine prudential elements with well-designed guarantees. Governments may consider the introduction of liquidity/rollover guarantees on medium-term corporate or bank bond issues to finance investment, as this could help jumpstart the bond market and generate better outcomes than direct investment lending by state banks.

The GCC financial centers provide one option for deepening long-term finance. The centers (in Bahrain, Dubai, and Qatar) have already gained significant investment finance capacity. Bahrain leads in syndicated lending and crossborder banking; Dubai has created a corporate bond market. The flexibility offered by financial centers also provides a platform for crossborder banking within the region, which would facilitate links between the pools of wealth in the GCC and the significant investment needs of the rest of the region.

Improving the Effectiveness of Policy Interventions

There is scope for reducing the market share of state banks in the countries in which they still dominate financial intermediation. The

policy objectives that may justify the presence of state banks can be met with fewer state banks holding a much smaller market share. It is easier to clarify policy mandates and monitor the performance of state banks when they are fewer in number and there is a critical mass of private banks leading financial intermediation and providing a benchmark for performance.

There is also scope for clarifying the mandates, improving the governance structures, and strengthening the operational efficiency of most state banks in MENA. Although state banks may not be able to achieve the same levels of profitability as private banks (as a result of their policy mandates), these banks could meet their mandates more effectively if they were allowed to operate independently, able to reduce the excessive employment of low-skilled personnel, and able to recruit better-trained staff able to adopt better lending and risk management technologies.

Credit guarantee schemes offer the best perspectives for improving the targeting of policy interventions promoting small and medium enterprise finance, but there is scope for improving the design of most schemes. The required changes in design depend on initial conditions. Most guarantee schemes should consider reducing the ceilings on firm and loan size to improve targeting, but some schemes are too strict and should consider increasing their ceilings instead. Most schemes should consider reducing slightly their coverage ratios to levels closer to international standards and linking both coverage ratios and fees more closely to risk. Guarantee schemes should also conduct systematic assessments of outreach and additionality.

Implementing the Financial Stability Agenda

Strengthening microprudential regulation and supervision

Implementing effective risk-based supervision remains a challenge in MENA. A transition from compliance to risk-based supervision needs to be completed in the most advanced countries and initiated in others. Risk-based supervision requires a “cultural” transition from focusing on regulatory compliance to understanding and assessing banking group risk profiles and strategies. This generally calls for new supervisory methodologies, new staff with market experience, and a closer dialogue with banks’ managers and directors.

Credit concentration needs to be gradually reduced to ensure banks’ resiliency. Although the largest borrowers are often considered to be well known and low risk (often leading to “name lending”), large groups failed in the recent crisis. Disclosure in MENA is at best limited to some of these groups’ entities; it is difficult to identify all group members and

monitor their links on an ongoing basis. A stricter definition of the large exposure and related-party regime is a first step toward reducing credit concentration.

Supervisors should take advantage of risk-based approaches to reduce loan concentration. Supervisors should gradually lower credit concentration limits and proactively implement supervisory actions against outliers. Banks that are exposed to high credit concentration risk should ultimately be subject to additional capital requirements. These actions would improve the resiliency of such banks and affect their pricing policy, thereby also creating incentives for the largest corporations to distribute their banking business and find alternative sources of finance.

MENA banks seem to be increasingly involved in long-term lending and are becoming exposed to growing maturity mismatches. Banks have enjoyed cheap and stable funding thanks to sizable customer deposits kept captive by the lack of alternative investment opportunities. However, the increase in housing and investment finance will imply further maturity mismatches and therefore will require well-articulated asset and liability management frameworks and closer supervisory monitoring to avoid excessive liquidity, interest rate, and credit risks.

As financial conglomerates develop in MENA, consolidated supervision needs to be significantly strengthened. Financial conglomeration is not yet a critical issue in many countries, but it will become a regulatory concern as financial systems diversify. Addressing the problem requires that supervisors be able to assess links within financial groups and impose necessary requirements. Cooperation and exchange of information among different supervisors will be increasingly necessary.

Revising deposit insurance and resolution mechanisms

Implicit deposit insurance schemes providing de facto full guarantees have undermined market discipline in MENA. Most countries in the region had implicit but effectively full deposit guarantees before the global crisis; some transformed these guarantees into explicit blanket guarantees during the crisis. Implicit schemes have always been understood as blanket guarantees in a region where banks are not allowed to fail.

Countries in the region are advised to introduce explicit, limited coverage deposit insurance systems when economic and financial conditions stabilize. Well-designed deposit insurance system may contribute to market discipline, but they should be introduced only under stable economic and financial conditions. The large presence of state banks and Islamic banks will pose challenges to the introduction of explicit schemes. Cross-border coordination needs to be enhanced as countries transition to explicit schemes to avoid negative spillovers.

The transition to explicit deposit insurance should be accompanied by the adoption of special resolution regimes to provide flexible crisis management and resolution tools. Special resolution regimes empower authorities to temporarily continue the core operations of an institution; have shareholders absorb losses, pay off senior creditors only at estimated recovery value, and change management, in order to minimize moral hazard; and provide the conservator with adequate flexibility to minimize damage to the economy and cost to taxpayers. Countries in the region should consider the introduction of special resolution regimes in the coming years, in order to send a signal that financial institutions cannot be expected to be rescued at no cost to them.

Strengthening corporate governance of banks

Good governance requires a professional and independent board of directors. Boards need to provide more strategic guidance. They need more diversified composition, including a larger representation of independent board members, an enhanced mix of relevant experience, and more formalized nomination procedures. In countries with a small pool of qualified experts, this implies greater reliance on board members from abroad. The roles of the key board committees (audit and risk management) should be clearly defined. The risk management function needs to be strengthened in most banks with the requirement of a chief risk officer. Moreover, the risk management function must have sufficient organizational stature, authority, and access to independent communication channels to alert the board to existing or building risks.

Significant improvements have been made, but transparency and disclosure, in particular nonfinancial disclosure, need to be enhanced. Nonfinancial disclosure needs upgrading, in particular in the areas of ownership, including controlling ownership; nonexecutive board membership; board members' and executives' professional qualifications; board member attendance at board meetings; and remuneration packages.

Surveillance of banks' financial statements needs to be more active. Rectifying inaccurate statements of banks' financial positions will require further enhancement of regulatory powers and resources. It will also require market players, such as smaller investors, rating agencies, and industry associations, to continue to actively review, critique, and demand greater disclosures.

State banks should be subject to additional governance requirements. Mandates, ownership arrangements, and performance criteria should be made transparent, as should the performance of the institution. State banks should adopt clear conflict of interest policies and not exercise undue political influence over and above their public mandates. The nomination and selection of board members should be based on an objective

and standardized process. The board should incorporate a mix of relevant skills and experience and should not be limited to public servants. State banks should be regulated and supervised like private sector banks.[2]

Introducing macroprudential regulation and supervision

The extension of the perimeter of prudential regulation will be increasingly important in MENA. As financial systems become more diverse and complex, the current approach to banking regulation and supervision will prove insufficient to address systemic risk. In most MENA countries, banking supervision is under the central bank; nonbank financial supervisors are usually less independent and weaker. Supervision of nonbank financial institutions needs to be strengthened and coordinated among oversight authorities. If MENA authorities do not create an integrated supervisor, stronger coordination among supervisors will prove vital to monitor systemic risk and prevent regulatory arbitrage.

Crisis simulation exercises should be undertaken to identify weaknesses in crisis management and foster cooperation among financial authorities. Such simulations expose key public decision makers to a plausible crisis scenario and identify areas where improvements are needed. Only two countries in the region have conducted such exercises, which are now a key component of financial stability frameworks in the European Union and the United States.

Macroprudential oversight needs to be strengthened. Several GCC countries are already using a number of tools that are recommended in recent reform proposals, such as limits on debt service–to–income ratios, loan-to-deposit ratios, and sectoral concentration. Given the overreliance of these economies on hydrocarbon revenues leading to strong cycles, GCC countries could complement these initiatives by introducing dynamic provisioning, limiting dividend payments in good times to build up capital buffers, and increasing capital requirements for particular exposures such as real estate. Non-GCC countries would also benefit from a more active use of macroprudential tools. Although many non-GCC countries are not yet ready to adopt more sophisticated risk management methodologies, a gradual increase in capital buffers and the adoption of more basic macroprudential instruments would help them contain the buildup of systemic risk.

Countries in the region are encouraged to conduct regular macroprudential assessments and to publish financial stability reports. Only two countries (Bahrain and Qatar) currently publish financial stability reports. These reports could improve the transparency of risk recognition in the financial system and facilitate broad communication with the financial community. Stress testing should also become an integral part of systemic surveillance. These activities could best be achieved by setting up well-staffed macroprudential units within the supervisory agencies.

Preparing the preconditions for successful financial integration

Greater involvement by foreign institutions and foreign investors would increase efficiency and access, but financial integration—regional or global—requires careful planning and the capacity to manage the associated risks. Financial integration needs to be preceded by efforts to upgrade and harmonize financial infrastructure and financial regulation, build supervisory capacity, and strengthen supervisory coordination. MENA countries have just started to take these steps in the area of financial infrastructure.

Ongoing efforts to strengthen and harmonize financial infrastructure are commendable and should be expanded. In 2005 the World Bank and the Arab Monetary Fund (AMF) launched the Arab Payment and Securities Settlement Initiative (API), with the objective of supporting reforms in payment, remittances, and securities settlement systems in the Arab region. The API is conducted in cooperation with the International Monetary Fund. In 2010, the Arab central bank governors endorsed a feasibility study on the API, which should be initiated in 2011/12. The API will pave the way for further integration efforts. A similar joint program by the World Bank Group and the AMF in the area of credit reporting—the Arab Credit Reporting Initiative (ACRI)—is playing an important role in improving the quality of credit information in MENA. A new joint program of the World Bank Group and the AMF addressing the problem of weak creditor rights is being launched in 2011. It will include the development of a model law or model principles to serve as a basis for secured transactions reforms in the region. These initiatives may pave the way for sounder crossborder lending and investments in the future.

Further integration should be preceded by efforts to measure crossborder financial flows and identify the regulatory obstacles to further financial integration, as well as upgrade and harmonize financial regulation. The AMF and the World Bank have designed a new survey that measures the volume of crossborder flows and identifies regulatory constraints in banking, debt, and equity markets. This important initiative should be fully implemented, as it will provide the information required for further integration efforts. Ongoing joint efforts by the World Bank and the AMF to survey the quality of banking regulation should also be fully implemented, as they will provide the basis for future efforts to strengthen and harmonize financial regulation and supervision.

For financial stability to be preserved, any capital account liberalization measures have to be country specific and carefully sequenced, and they must take into account recent emerging market experience with excessive inflows and outflows. Foreign strategic and portfolio investors would bring benefits in many areas, including stronger competition, transfer of know-how, better risk management, and improved liquidity

and price discovery. However, foreign investors may also import increased volatility through links with international markets. Therefore, policy makers and regulators must be able to control the exposure of institutions and markets to crisis and mitigate the impact of any crisis. For example, foreign borrowings by banks should be strictly regulated to prevent exposure to shocks and sudden stops, the participation of foreign investors in debt markets could be calibrated to prevent excessive exposure to volatility, and large selloffs could be absorbed through appropriate reserves. More generally, capital account liberalization needs to be carefully sequenced; the experience of other emerging markets in curtailing excessive inflows and outflows should be studied. The adoption of macroprudential instruments and oversight would also help MENA regulators mitigate the impact of external shocks.

Notes

1. Demirgüç-Kunt and Levine (2008) provide a review of the literature on finance and growth.
2. Scott (2007) and Heinz (2009) discuss the governance of state banks and give examples of state banks that have performed their mandates reasonably well.

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CHAPTER 1

Introduction

The Main Lessons of the Global Financial Crisis for the Middle East and North Africa

The global financial crisis that erupted in 2007 is a sobering reminder of the critical role financial systems play in economic development. When financial systems perform their resource and risk allocation well, they enhance investment and productivity and contribute to higher growth of output and employment and to declining poverty and inequality. When they malfunction, financial markets hinder growth and exacerbate inequality. At their worst, they are breeding grounds for waste, corruption, and crises and can cause sharp and prolonged contractions in output and living standards.

The global financial crisis highlighted the potential trade-offs between access to finance and financial stability. Retail and small and medium enterprise lending expanded significantly in many developed countries and emerging economies during the decade before the global crisis. The increase in lending to underserved sectors was frequently hailed as a victory for financial inclusion. In many cases, however, the increase was based on unsound practices, including poor credit underwriting and excessive borrowing, leveraging, and recourse to poorly regulated securitization. One of the major lessons of the crisis for all countries, not only those directly affected, is the need to recognize the potential trade-off between the design of financial development policies and the approach to financial regulation.[1] This lesson is particularly relevant for the Middle East and North Africa (MENA), where access to finance remains very restricted.

The global financial crisis triggered major changes in the approach to financial regulation, but it did not result in major paradigm shifts in financial development policies. The reforms proposed by the G-20 and the Financial Stability Board have emphasized the role of macroprudential

regulation and countercyclical policies, and these are welcome developments. However, there have been no major shifts in the approach to financial development. The potential countercyclical and access roles state banks play have been acknowledged, but without leading countries to contemplate a return to state-dominated financial systems. The crisis has shown the exposure of open financial systems to volatility, but the inefficiencies of closed financial systems continue to be understood as well. All in all, there have been no major paradigm shifts, although the crisis has resulted in greater awareness of the preconditions for financial reform, more care in the sequence and speed of reform, acknowledgment of market failures, and appreciation for well-designed policy interventions and tailored approaches to financial development policies.

The Fragile Recovery and Long-Run Financial Development Agenda

The region had been recovering from the global financial crisis in 2010 before the political turmoil of 2011 interrupted the pace of recovery in many countries. The Gulf Cooperation Council countries (GCC) were more affected by the global crisis than countries elsewhere in the region, as a result of their open financial systems and more overextended banks, but they rebounded quickly in 2010, as a result of strong financial and fiscal support programs (see chapter 2). Most non-GCC countries experienced a more moderate slowdown of credit and economic activity, as their financial systems were less open and their banks less overextended, but they, too, started resuming credit and output activity in 2010.

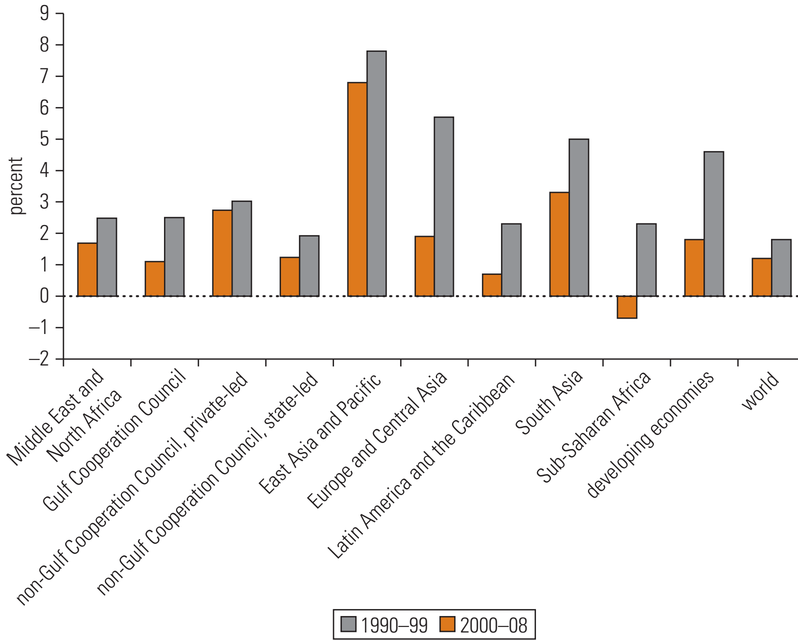
The political turmoil in early 2011 interrupted the pace of recovery in many MENA countries, especially in the non-GCC region. The experience of past crises shows that full credit recovery takes time. The current political unrest in the region has added uncertainty about the strength and speed of the credit and output recovery.

The political turmoil reveals deep-seated frustrations and a sense of political, social, and economic exclusion, especially among the region's large population of young people. Countries in the region improved their growth performance and social indicators in the 2000s as a result of global growth and a number of reforms (see Noland and Pack 2007; World Bank 2009, 2011). However, the average increase in real per capita incomes was unimpressive relative to other emerging regions (figure 1.1), and insufficient relative to the region's needs.

MENA has the highest youth unemployment rates among emerging economies (figure 1.2), especially among university graduates, as well as the lowest rates of labor force participation (figure 1.3), especially among

FIGURE 1.1

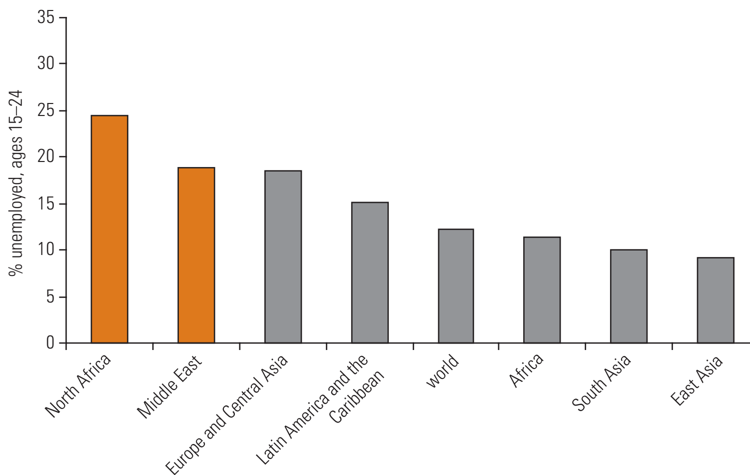
Per Capita Income Growth, by World Region, 1990–99 and 2000–08



Source: World Bank 2011.

FIGURE 1.2

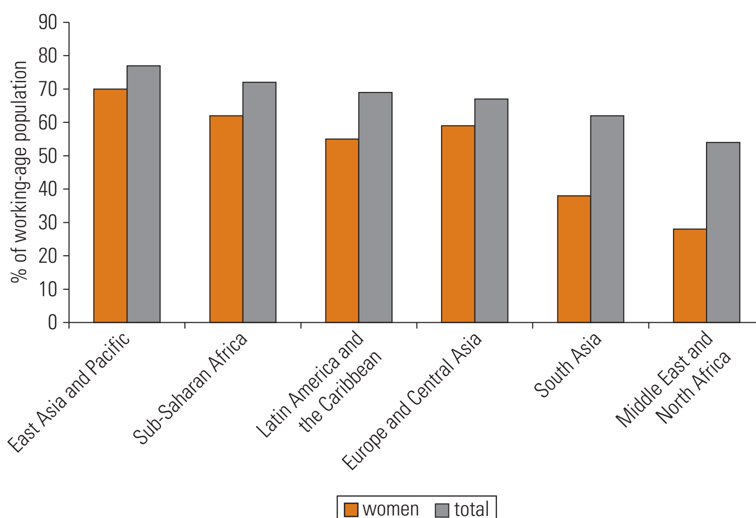
Youth (Ages 15–24) Unemployment Rates, by World Region, 2008



Source: ILO 2010.

FIGURE 1.3

Labor Force Participation, by World Region, 2008



Source: ILO 2010.

women. These outcomes reveal the failure of countries in the region to generate stronger and inclusive growth, as well as the limitations of the strategy of employing university graduates in the public sector.

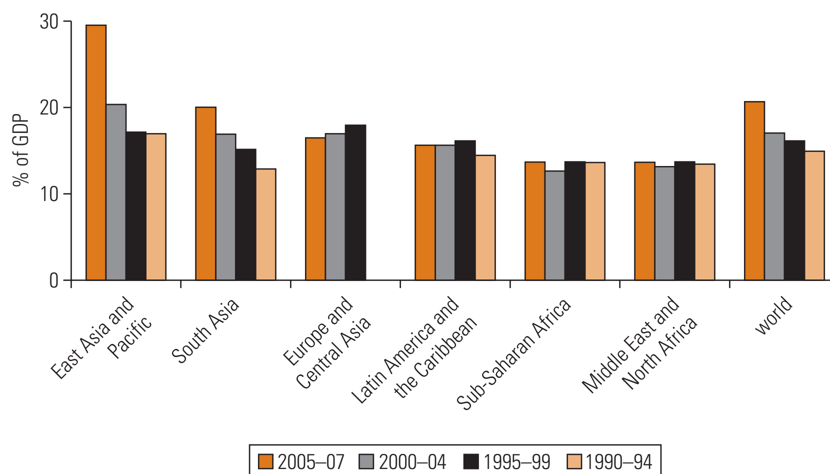
A combination of insufficient reforms and flawed implementation explain the region's relatively weak historical growth performance. In recent decades, most MENA countries moved from a model of state-led growth to a model that relies more on the private sector. The change was achieved by privatizing state enterprises and banks, adopting several regulatory reforms aimed at improving the business environment, and reducing restrictions on foreign trade and investment.

These reforms did not go far enough, however, or were not well implemented. The state still plays a dominant role in some countries, and these are the countries with the weakest growth performance (see figure 1.1). Public institutions charged with implementing reforms continued to privilege state enterprises and older private enterprises with established political connections, through formal and informal barriers to entry and nontariff barriers. The lack of competition and dynamism is reflected in the low ratios of private sector investment (figure 1.4), the high average age of enterprises, low business density, and poor export diversification (World Bank 2009).

Weak growth and employment performance also reflects the lack of depth of financial sector reforms. Although many countries adopted reforms (box 1.1), in most countries the reforms failed to create a level

FIGURE 1.4

Private Investment Rates, by World Region, 1990–2007



Source: World Bank 2009.

BOX 1.1

Financial Reforms in the Middle East and North Africa

Most countries in the region implemented financial reforms in the past decade, in efforts to promote financial development and expand access to finance. This box summarizes the key reform efforts in each of the main components of the financial system and highlights the main reform challenges.

Financial Infrastructure

Credit information is a key area in which MENA remains weak by comparison with other regions. Many economies have made efforts to improve credit information by upgrading their public credit registries (Lebanon, Oman, Tunisia, the West Bank and Gaza) or establishing private credit bureaus (Bahrain, the Arab Republic of Egypt, Jordan, Kuwait, Morocco, Saudi Arabia, the United Arab Emirates). The upgraded public registry in the West Bank and Gaza operates like a best-practice private bureau. GCC countries have led the introduction of private credit bureaus, with Saudi Arabia making impressive progress in recent years. Non-GCC countries have also made recent progress in this area. Much remains to be done, however, to expand the coverage and depth of credit information, especially for small and medium enterprises.

(Box continues on the next pages.)

BOX 1.1 (continued)

MENA also remains weak in the area of creditor rights. Most countries have outdated legislation and lack modern collateral registries. Kuwait's collateral registry is noteworthy for being the only electronic, and one of the few centralized, registries in the region. Insolvency systems are generally weak, although countries are moving to modernize bankruptcy regimes. Morocco and Tunisia are providing insolvency training for judges in commercial courts.

Bank Competition

Most countries in the region have reduced the share of state banks, through restructuring and privatization, and allowed the entry of new private banks, including foreign banks. Algeria, Egypt, Iraq, Morocco, the Syrian Arab Republic, and Tunisia have made efforts to restructure state banks. However, this reform remains unfinished in many MENA countries, where state banks still dominate financial intermediation and the restructuring of state banks has not gone far enough, as indicated by the large volume of nonperforming loans. Private banks have increased their market share, but entry remains restricted in many countries in the region, which has the highest ratio of denied applications for bank licenses among all emerging regions.

Nonbank Financial Institutions

The insurance sector is very small, but most countries are making efforts to develop it, by passing new legislation and strengthening the insurance supervisor. Morocco's insurance industry is the most developed in the region, as a result of regulatory reforms implemented in the past decade, but the sector is growing in many countries as a result of more supportive legislation, albeit from a very small base. Premiums are reaching reasonable levels in countries such as Egypt, Jordan, and Tunisia.

Private pension funds are negligible in most MENA countries. Egypt and Jordan have adopted reforms that may promote the growth of this sector, and GCC countries are planning to expand the private pension coverage of expatriate staff. Public pension funds are large in many countries but have not yet contributed to capital market development. Morocco and Jordan have pioneered reforms that have improved the governance, disclosure, and investment policies of public funds.

Mutual funds have reached a meaningful size only in Bahrain and Morocco, but the sector seems to be growing in Egypt, Kuwait, Saudi Arabia, and Tunisia as a result of regulatory reforms adopted in recent years.

Capital Markets

The stock of government debt is large in many countries, especially outside the GCC, but government debt markets remain generally undeveloped, and no country has been able to build a reliable and liquid benchmark yield curve. Egypt and Morocco have made the most progress in developing this critical market; they are

(Box continues on the next page.)

BOX 1.1 (continued)

the only two countries in the region included in key international bond indexes, albeit with small shares. Egypt in particular has made impressive improvements in its debt management strategy in recent years, attracting greater interest from foreign investors as a result. Additional efforts to develop this key market are needed in Egypt and other countries in the region.

Private Fixed-Income Markets

No country outside the GCC has developed private fixed-income markets. Morocco and Tunisia pioneered legislation on mortgage-backed securities, but few securitization transactions were concluded, and the nascent markets stalled as a result of the subprime crisis and structural flaws in the securitization chain. Morocco is in the process of developing legislation on mortgage-covered bonds; it may be the first MENA country to develop this key instrument for housing finance.

Within the GCC, there have been large headline issues by sovereign and corporate entities of conventional and *sukuk* (Islamic financial instruments) bonds in recent years, but issues remain sporadic and small as a share of GDP. Trading in these securities is limited, but the Dubai International Financial Center provides a relatively deep market in private debt securities, and listing requirements have generated a discipline of disclosure.

Equity Markets

Equity market capitalization is high in many MENA countries, especially in the GCC. Initial public offerings (IPOs) and mandatory listings for financial institutions have increased total listings and the size of the equity market. Many countries have made significant efforts to improve the regulatory framework and strengthen the autonomy of capital market authorities (recent examples include Egypt, Kuwait, and Morocco). Syria very recently started creating its equity market: the Damascus Securities Exchange was established in 2009 and became a full member of the International Organization of Securities Commissions (IOSCO) in June 2010. The number of listed companies and financial intermediaries doubled in the first year of operations, thanks in part to mandatory listings of financial institutions.

These advances notwithstanding, the development of equity markets remains an important component of the financial development agenda in most if not all MENA countries. Market capitalization is still dominated by financial institutions and infrastructure companies, with only a modest presence of industry and services. Turnover ratios are high by international comparison, but the quality of price discovery is still weak, as indicated by the very strong co-movement of stock prices. Turnover seems dominated by uninformed small retail investors in many countries. Market development will require the build-up of a private domestic institutional investor base, reforms in the operations of large state investors, and greater participation by foreign investors.

Source: Authors.

playing field between state and private enterprises and within the private sector. MENA countries have large banking systems but also the highest rates of credit concentration in the world. The lack of access to finance affects younger private enterprises—which, given greater access to credit, would be able to grow more rapidly and generate more employment opportunities—as well as the large number of young households looking for affordable housing (Ayyagari, Beck, and Demirgüç-Kunt 2003; IFC 2010). Restricted access to finance in MENA reflects many factors, including weaknesses in financial infrastructure, insufficient competition in the banking sector, regulatory tolerance of large exposures and connected lending, and the lack of nonbanking institutions and markets providing alternative sources of finance. As this report shows, these factors are closely connected and have to be addressed jointly.

The structural weaknesses of MENA's financial sectors imply that access to finance may remain restricted even with the full recovery of credit activity. Although the consolidation of credit recovery in the region is an important short-run policy objective, there is no guarantee that it would benefit a wide range of economic agents. Large segments of the population and the enterprise sector were deprived from finance before the crisis and may remain deprived in the absence of substantive reforms.

Countries in the region thus face an ambitious reform agenda capable of reversing two decades of relatively slow output growth and employment generation. As stressed in the companion flagship report for private sector development (World Bank 2009) and the regional diagnostics of MENA's growth performance (World Bank 2011), overcoming this poor historical performance will require reforms on several fronts, including financial, fiscal, trade, and labor reforms. Most important, it will also require much greater efforts to fully implement recent and future reforms and ensure a level playing field through the reform of public institutions and regulatory agencies dealing with the private sector. This, in turn, entails an agenda of governance, disclosure, and accountability of public institutions.

Financial development should be a central component of MENA's growth agenda.[2] Addressing the problem of restricted access to finance will entail the design and implementation of a comprehensive financial development agenda that includes improvements in financial infrastructure (credit information and creditor rights); measures to enhance banking competition and address the historical connections between large banks and large industrial groups; and measures to diversify the financial system through the development of nonbanking institutions, instruments, and markets that are currently negligible or nonexistent. MENA policy makers must ensure that financial systems remain resilient as access is expanded and new risks emerge. Doing so implies the need to implement a complementary financial stability agenda that entails improvements in

bank governance and a stronger architecture of financial regulation and supervision.

Main Objectives and Approach of the Report

The main objective of this report is to provide a diagnostic of MENA financial systems and define a roadmap that will guide policy makers in shaping inclusive and resilient financial systems. The diagnostic covers all the dimensions of financial development, including depth, diversity, access, efficiency, and stability. The report is also meant to be a vehicle for policy dialogue with member countries, donors, and international organizations.

The report highlights the common challenges faced by MENA countries while also recognizing differences and tailoring its policy recommendations to the initial conditions in subregions and countries. Countries in the region share several common challenges in their financial development agendas, as shown throughout this report. However, significant differences across the main subregions and individual countries also exist must also be taken into account in the design of financial development agendas.

This report classifies countries in the region into three major subgroups, according to their per capita income and key characteristics of their financial systems (table 1.1). The composition of country groups is similar to those used in other World Bank reports, although the criteria for classification differ in some key aspects. GCC countries form a well-defined group, because of their high per capita income, large banking systems, and mostly private-led systems (table 1.2). The second group includes low- to middle-income non-GCC countries that have moderate to large banking systems led by private banks. The third group includes middle-income non-GCC countries that have banking systems of moderate size led by state banks. The criteria for country classification prioritize income levels, ownership structures, and other characteristics of financial systems, but they yield

TABLE 1.1

Composition of Main Country Subgroups

Subgroup	Economies
GCC	Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates
Non-GCC with private-led banking systems	Djibouti; Arab Republic of Egypt; Jordan; Lebanon; Morocco; Tunisia; West Bank and Gaza; Yemen, Rep.
Non-GCC with state-led banking systems	Algeria, Iraq, Libya, Syrian Arab Republic, Iran

Source: World Bank staff.

TABLE 1.2

Financial Sector Characteristics of Main Country Subgroups

Subgroup	Per capita income	Size of banking system	Share of state banks	Size of nonbank financial institutions	Size of equity markets	Size of private fixed-income markets	Access to finance
GCC	High	Large	Small to moderate	Small	Large capitalization, high bank share	Negligible	Moderate to restricted
Non-GCC with private-led banking systems	Low to middle	Moderate to large	Small to moderate	Small	Moderate/large capitalization, high bank share	Negligible	Generally restricted
Non-GCC with state-led banking systems	Middle	Moderate	Large	Small	Small capitalization	Negligible	Generally restricted

Source: World Bank staff.

essentially the same country groupings used in other reports that rely on the status of oil exporter/importer as the major criterion.

Each subgroup has important unique and shared characteristics (table 1.2). Banking systems are large in the GCC, moderate to large in the second group, and moderate in the third group. State banks play a dominant role in the third group. The number of common features is also striking. The size of nonbank financial institutions is very small across all groups, with few exceptions. Equity markets look large, but banks account for a large share of market capitalization, and the free float is small in many countries. Private fixed-income markets are negligible in all countries, and access remains restricted in most countries, even where the banking system is large by international standards.

Building Blocks of the Report

This report benefitted from early consultations with countries in the region and partnerships with regional financial institutions. The flagship team conducted early consultations with policy makers, regulators, and market participants, in order to discuss the scope of the report and identify the main policy challenges. The flagship team also benefitted substantially from partnerships with regional financial institutions, especially the Arab Monetary Fund, the Islamic Development Bank, the Union of Arab Banks, and the Union of Arab Stock Exchanges. The partner institutions contributed in many forms, including responding to joint surveys, providing data and research material, contributing background papers, and participating in joint workshops.

The report builds on several background papers covering the main segments of MENA's financial systems as well as the main crosscutting themes. The background papers review the problems in financial infrastructure, examine the structure and performance of the banking sector, and assess the lack of progress in developing nonbank financial institutions.[3] They also examine the equity market and the problems in developing government debt markets within and outside the GCC. Several background papers cover special themes, such as financial inclusion; microfinance; and small and medium enterprise, housing, and Islamic finance.

Structure of the Report

This report comprises 10 chapters. Chapter 2 examines the impact of the global financial crisis and recent regional events on MENA countries, with a focus on financial systems. Chapter 3 provides an overview of the size and structure of the region's financial systems, including a comprehensive international benchmarking analysis of financial indicators. Chapter 4 examines the performance of MENA financial systems, with a focus on access to finance. This critical chapter documents poor access outcomes with a battery of access indicators. Chapter 5—arguably the core chapter of this report—examines the main factors that have restricted access to finance in MENA. Chapter 6 examines one of the region's greatest weaknesses: financial infrastructure. It includes an analysis of credit reporting systems, collateral regimes, and insolvency regimes. Chapter 7 examines the evolution of banking systems and the main regulatory challenges in this core sector. Chapter 8 reviews why nonbank financial institutions (insurance companies, pension funds, mutual funds, leasing, and factoring) have not developed in the region. Chapter 9 examines the mixed development of equity markets and the lack of development of fixed-income markets, with a focus on government debt markets. Chapter 10 provides a roadmap for crafting more inclusive financial systems capable of contributing to improved growth and employment performance. It also highlights the measures needed to ensure that these systems remain resilient as access is expanded and new risks emerge.

Notes

1. An extensive literature examines the causes of the financial crisis and proposed reforms in regulation and supervision. See, for example, BIS (2010), Haldane (2010), and U.K. Treasury (2011).

2. There is an extensive empirical literature showing that finance matters for growth. A. Demirgüç-Kunt and R. Levine (2008) provide a recent review of the literature.
3. All the papers are available at http://www.worldbank.org/mna.

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CHAPTER 2

The Impact of the Global Financial Crisis and Regional Political Instability on Regional Financial Systems

Financial systems in MENA were generally less affected than those in other regions, although they were not spared from the global financial crisis. There were significant differences within the region. The crisis had a stronger impact on countries in the Gulf Cooperation Council (GCC), where financial systems were more globally integrated and banks more overextended. Countries elsewhere in the region weathered the crisis better. Countries that were less integrated and had financial systems dominated by the state were least affected, although these mitigating factors have negatively affected their financial and economic development and will constrain future performance (see chapters 3 and 5).

The political instability unfolding since early 2011, however, has been taking its toll on several countries. Credit started to recover in 2010 in most countries, although the speed and strength of the recovery remain uncertain and could reverse, especially in countries affected by political instability. If previous crises provide any guidance, it will take some time for credit to recover fully.

In addition to questions about its speed and strength, an important issue for long-run growth performance is the scope or breadth of recovery. There is little reason to believe that in the absence of reforms this recovery will be inclusive, expanding finance to a large number of economic units and creating the conditions for a high and sustained growth of output and employment in the long run—the region's main challenge.

This chapter briefly reviews the impact of the global financial crisis on the region's financial systems, touches on the effect of the unfolding political turmoil, and assesses the strength of the credit recovery. The chapter is structured as follows. The first section examines the impact of the global crisis and the recent regional turmoil on the region's equity and bond markets. The second section assesses the impact of the global crisis

on banking systems, identifying the channels of transmission in the main subregions. In the absence of recent data, the impact of the regional political unrest on banking systems cannot yet be quantified. However, the third section assesses the likely pace and strength of the credit and output recovery in light of recent political turmoil.

Impact on Regional Equity and Bond Markets

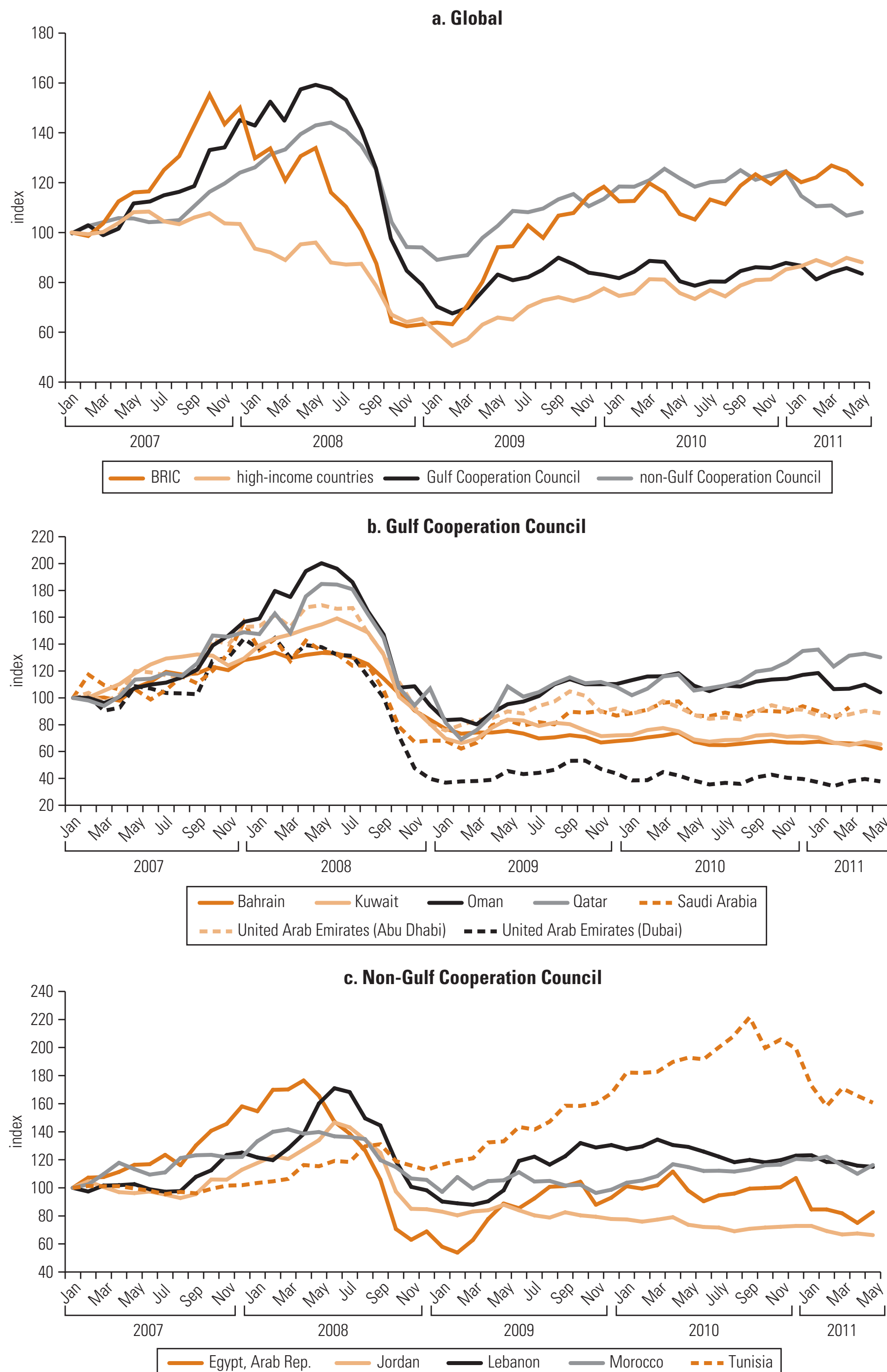
MENA stock markets reacted to the global financial crisis with a lag in comparison to markets in high-income and other emerging economies: as a result of high oil prices, they held up better than markets elsewhere until the third quarter of 2008 (figure 2.1). However, both the GCC and non-GCC stock markets crashed with other stock markets around the world during the worldwide panic in the fourth quarter of 2008, following the bankruptcy of Lehman Brothers. The fall of stock prices in the GCC was more pronounced, reflecting the burst of the real estate bubble and the subregion's greater openness relative to other parts of the region.

Since early 2009, MENA stock markets have followed the major trends in mature and key emerging equity markets, but political unrest has had a negative impact on several markets. GCC markets and the Arab Republic of Egypt are more globally integrated than their non-GCC peers and have fluctuated more in line with global sentiment. The regional political turmoil that erupted early in 2011 led to a decline in GCC indexes and to government intervention aimed at improving market sentiment in some countries. Markets rebounded slightly in March 2011, but as of April 2011, all GCC indexes, especially the Dubai index, were still well below their peak in mid-2008. The slow rebound partly reflects the fact that stock prices were overvalued in the very high-liquidity environment of the precrisis years.

Non-GCC stock markets also recovered after the global crisis, but the recent turmoil has affected them more significantly. Egypt's stock market—the largest and most globally integrated in the subregion—showed the highest correlation with advanced and Brazil, the Russian Federation, India, and China (BRIC) markets. Other markets in non-GCC countries are small and insufficiently liquid to draw major global investors; prices in these markets have been driven more by domestic prospects than by global trends. Equity markets rebounded from the crisis more strongly in Tunisia, Morocco, and Lebanon than in high-income countries or the GCC. Jordan underperformed its peers, because its banking sector put the brakes on lending to the economy as the crisis unfolded. The political crisis in the region had major effects on local stock markets, especially in Tunisia and Egypt. Tunisia's market declined

FIGURE 2.1

Stock Market Indexes in Selected Country Groups, 2007–11



Source: Bloomberg database.

Note: BRIC = Brazil, the Russian Federation, India, and China.

substantially, and Egypt's market was closed for almost two months. After being threatened with exclusion from the MSCI Emerging Markets index, Egypt reopened its market on March 23, 2011, with a substantial decline in prices.

The impact of the global financial crisis on the region's sovereign debt broadly mirrored global trends, with a sharp spike in credit spreads as a reaction to the Lehman bankruptcy and a rapid decline as the panic subsided. The compressed credit spreads observed in the precrisis period in all major emerging regions increased dramatically in the aftermath of Lehman's collapse (figure 2.2). However, credit spreads fell in 2009 in all emerging regions, as risk appetite and global liquidity improved.

FIGURE 2.2

Debt Spreads in Selected World Regions, 2007–11

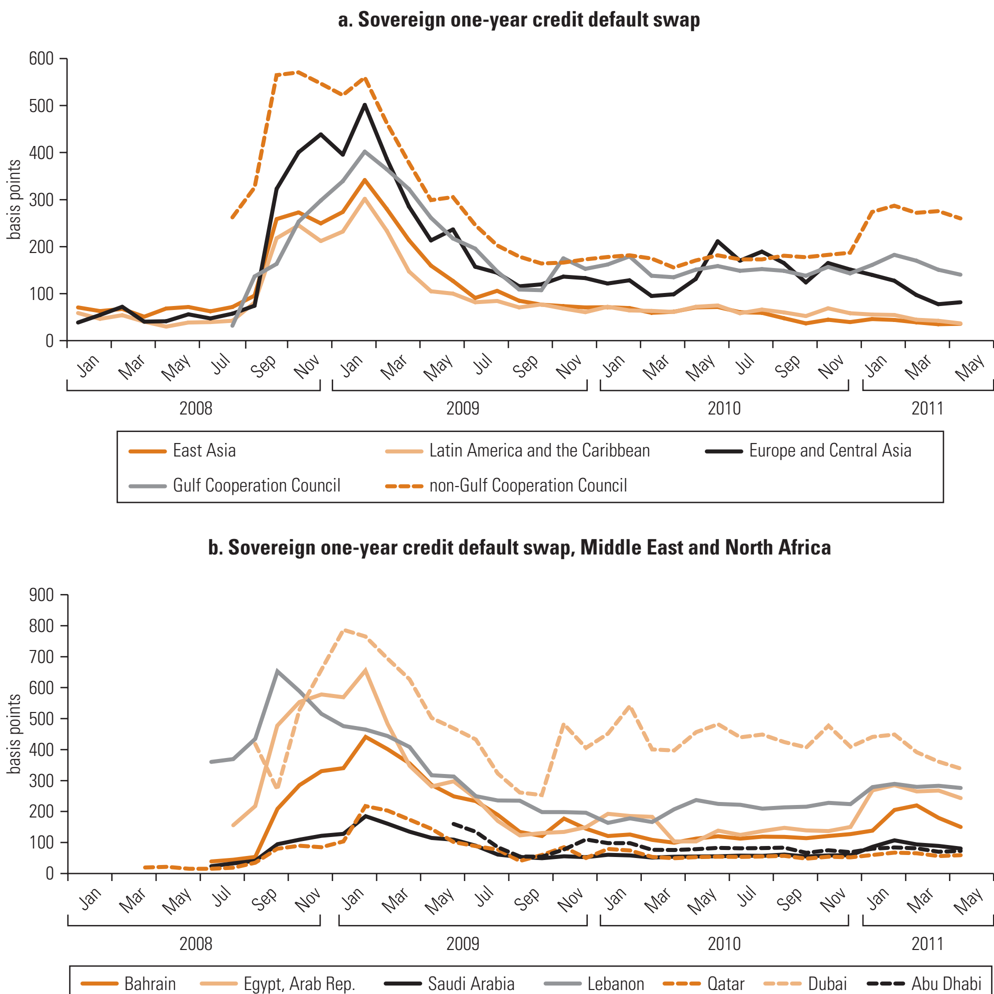


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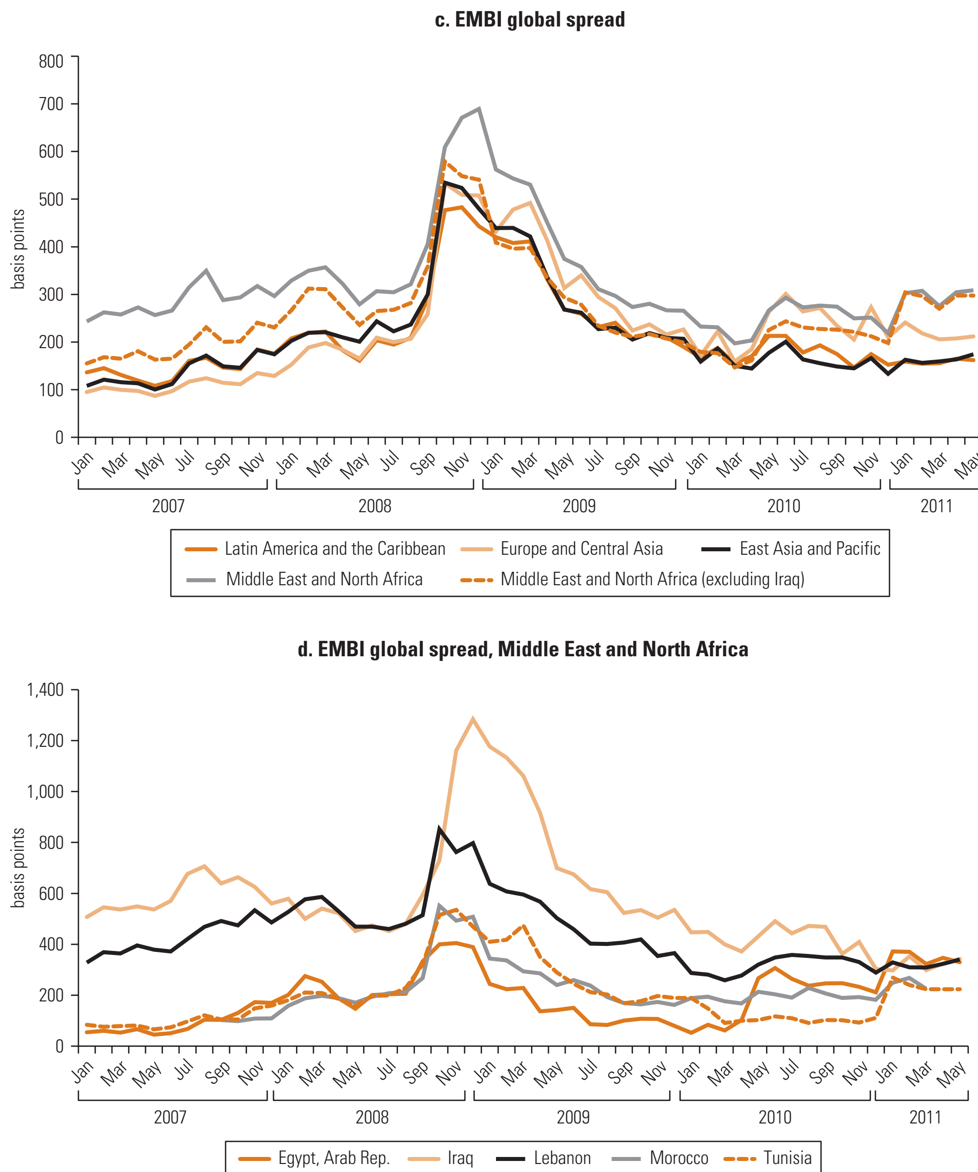
FIGURE 2.2 (continued)



Source: World Bank staff compilation based on data from Bloomberg, Datastream, and MorganMarkets databases.

The Dubai World event in late 2009 had an immediate impact on credit default swap spreads in the GCC and Egypt, but spreads remained wide only in Dubai. Debt concerns related to Greece affected world debt markets in the second quarter of 2010, but spreads stabilized in the second half of 2010.

The political crisis that began in Tunisia in December 2010 and spread to Egypt, the Republic of Yemen, Libya, Bahrain, and the Syrian Arab Republic in early 2011 led to significant market reactions for the

region's sovereign debt instruments. Contagion from the Tunisian crisis was negligible; from Egypt it was stronger and led to an immediate increase in credit default swap spreads in almost all countries in the region. The effect of the crisis in Libya and Bahrain has been even stronger, because of fears that oil production could be affected.

Domestic fixed-income markets in emerging non-GCC countries in the region have been largely insulated from the global financial crisis, but markets suffered in countries with prolonged political unrest in 2011. Domestic markets for government securities are undeveloped and relatively illiquid, and private fixed-income markets are virtually nonexistent (see chapter 9). Although Egypt, Jordan, Lebanon, Morocco, and Tunisia have sizable domestic government debt markets, their global integration is marginal. Only Egypt has attracted foreign investor interest; low liquidity and other structural problems have made the other markets unattractive to global investors. Unlike the global crisis, the regional political crisis had a major effect on local government securities markets in countries most affected by the turmoil. In Egypt, government securities yields spiked, and foreign investors (who made up about 10 percent of the investor base and invested primarily in short-term securities) withdrew from the market.

The GCC debt/*sukuk* market grew rapidly between 2003 and 2007; as the global financial crisis erupted, the market, especially its corporate segment, suffered a setback (figure 2.3). The Dubai World event in November 2009 was a major shock to GCC debt markets. The large gap in spreads over the London interbank offered rate (LIBOR) between GCC *sukuk* and conventional instruments had been narrowing throughout 2009, but the Dubai World and Nakheel standstill announcements caused a jump in all spreads and a widening gap between conventional and *sukuk* spreads. By early 2011 the spread had largely dissipated (figure 2.4). The spread reflects a premium on *sukuk* over conventional bonds, as a result of the legal uncertainties regarding *sukuk*s revealed by the Nakheel *sukuk* debacle. The recovery of the issuance by the United Arab Emirates reflected the continued market access for Abu Dhabi issuers. Nearly three-quarters of GCC issues were internationally syndicated and denominated in U.S. dollars. Only Kuwait and Qatar (since 2011) have nonnegligible local currency government debt.

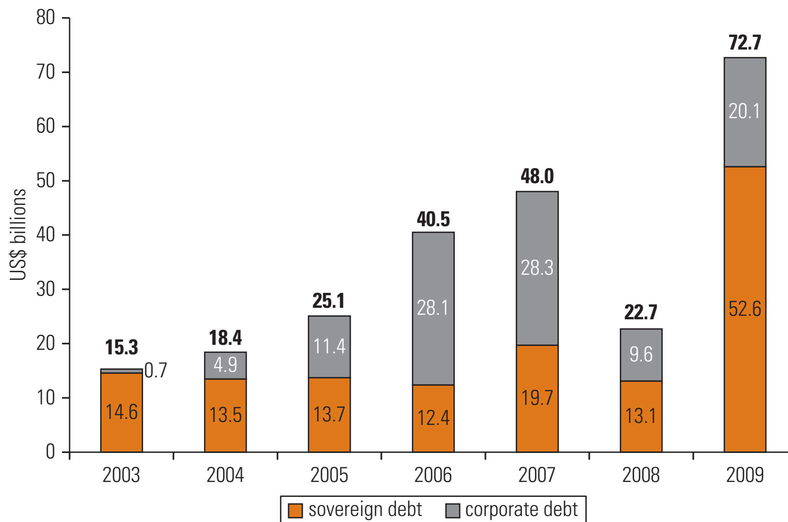
Impact on Regional Banking Systems

Impact on Credit Growth

The global financial crisis was preceded by a credit boom in most emerging regions. Credit growth rates were particularly high in the

FIGURE 2.3

Debt/*Sukuk* Issuance in the Gulf Cooperation Council, 2003–09

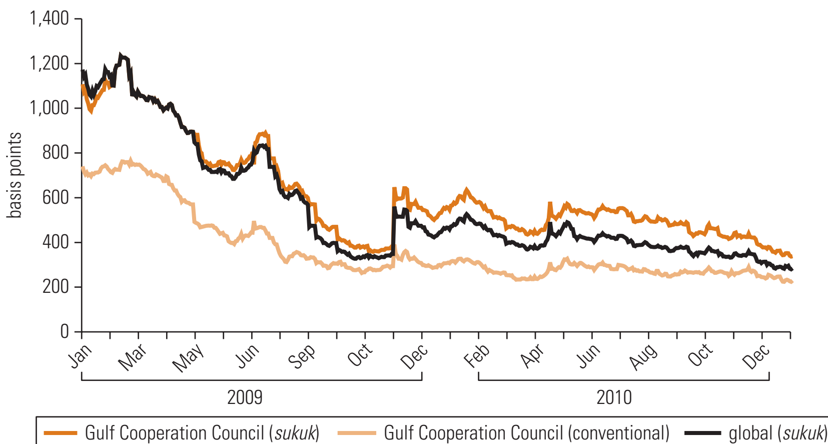


Source: World Bank staff compilation based on data from the GCC Bond Market Survey and Markaz database.

Note: Sukuk is an Islamic financial certificate that complies with Islamic religious law.

FIGURE 2.4

Spreads over LIBOR in the Gulf Cooperation Council, January 2009–January 2011



Source: HSBC.

Europe and Central Asia region, where they averaged about 35 percent a year (figure 2.5). Average credit expansion in Latin America and the Caribbean was also substantial, approaching the levels in Europe and Central Asia in fall 2007. Average credit growth rates in Asia were lower,

FIGURE 2.5

Annual Credit Growth in Emerging Regions, 2006–11

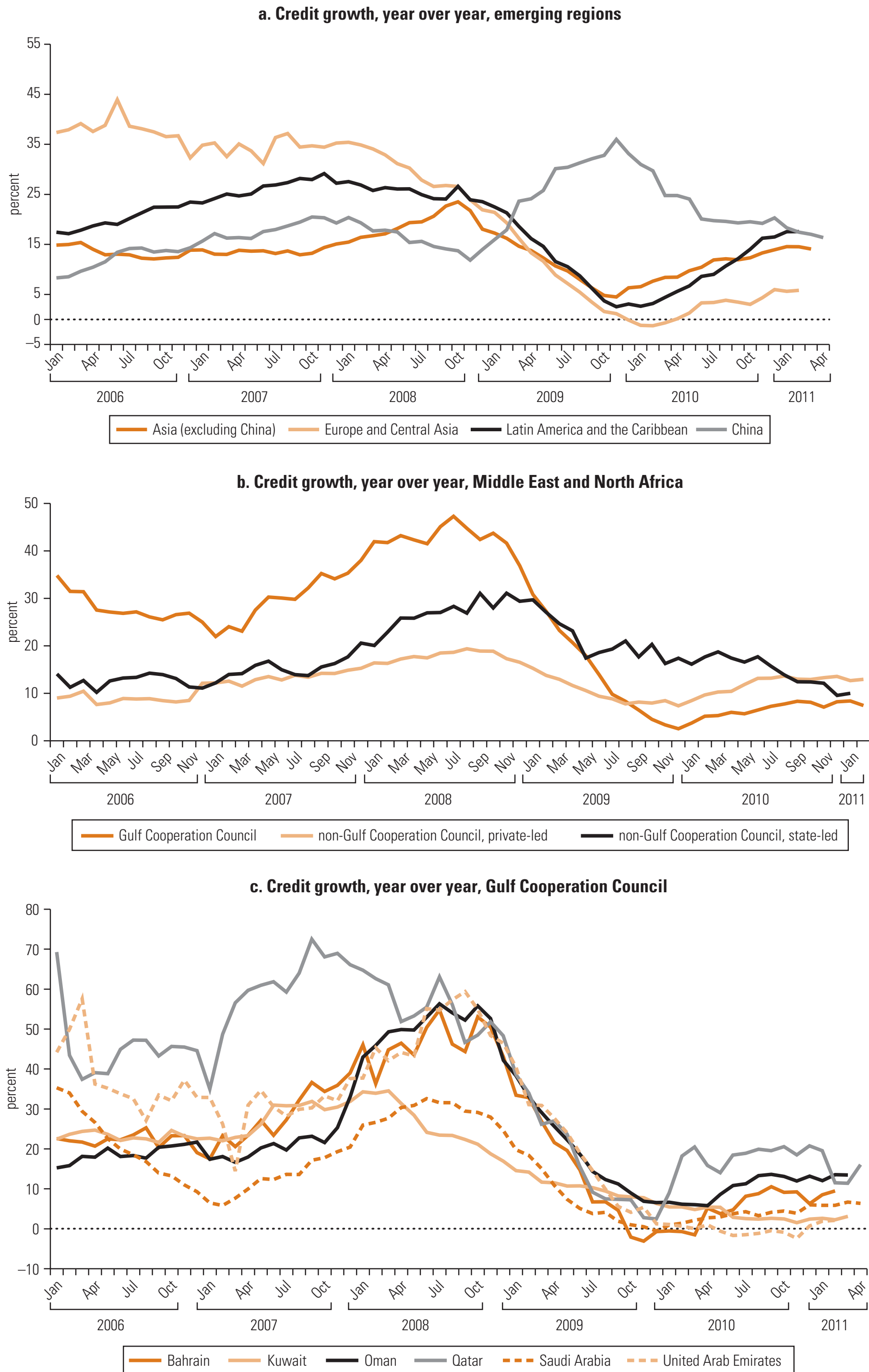


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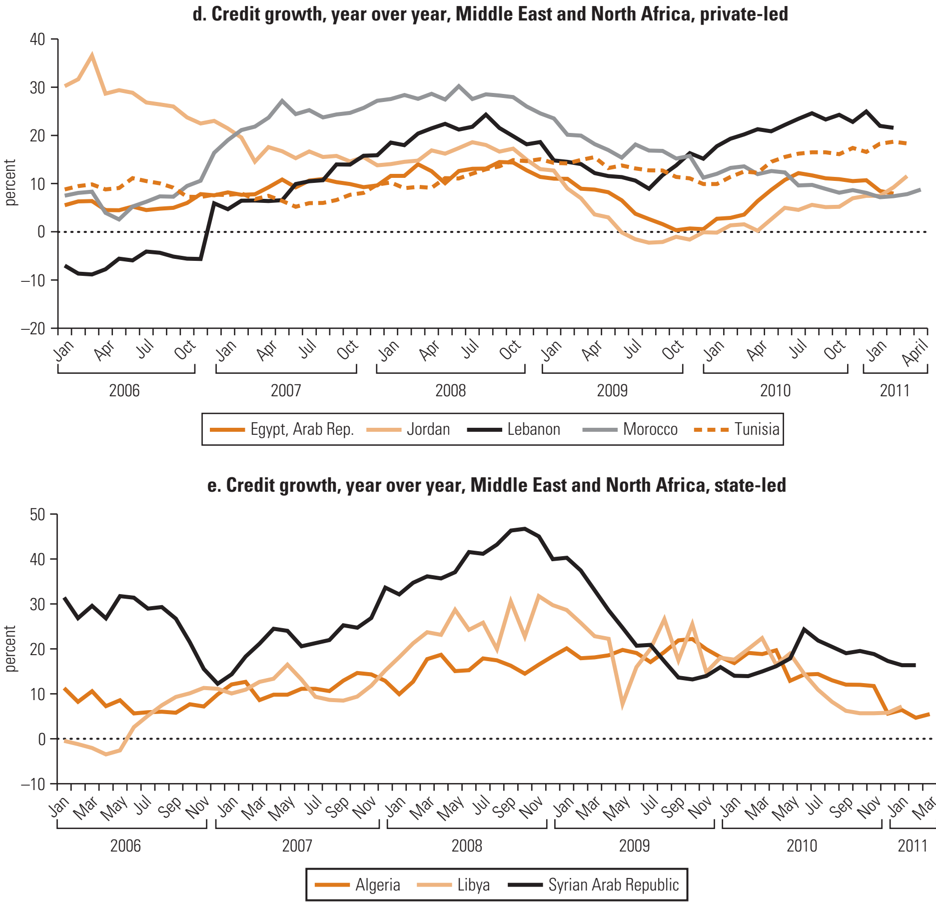
FIGURE 2.5 (continued)



Source: IMF 2011.

at about 18–20 percent a year. Credit growth quickly collapsed around the world following Lehman's bankruptcy in September 2008.[1]

In the run-up to the financial crisis, credit growth had been on an upward trend in all three MENA subregions. During the oil boom years of 2003–08, abundant liquidity in the GCC countries led to excessive credit growth that topped 50 percent in Qatar, the United Arab Emirates, Bahrain, and Oman and exceeded 30 percent in Kuwait and Saudi Arabia at the peak (Khamis and Senhadji 2010a). The GCC credit expansion—which entailed a large component of real estate lending and in some countries increasing reliance on foreign funding—accelerated during most of 2008, in contrast with trends in other regions. In comparison with the GCC, credit expansion was moderate in emerging non-GCC countries in the region, where financial systems are less globally integrated, and the

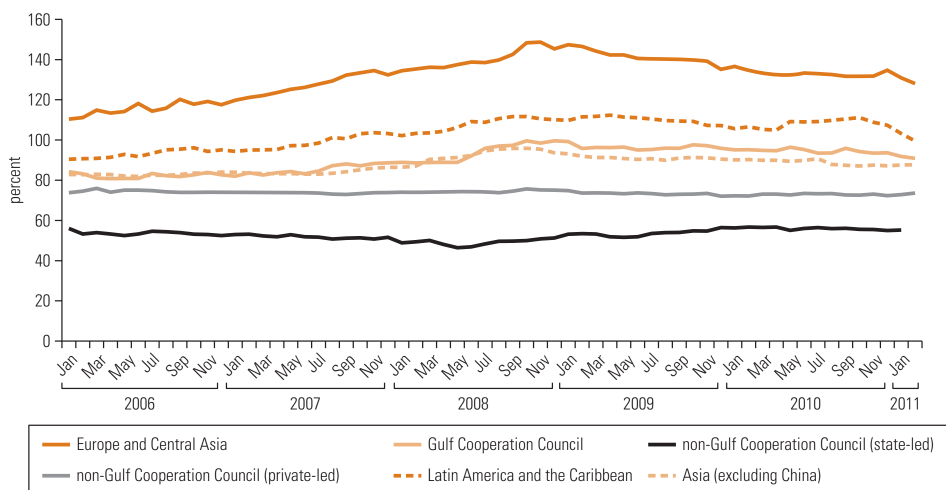
banks were neither overextended nor reliant on foreign funding for credit expansion. Credit growth averaged about 10–15 percent a year in this subregion, although it was much higher in Jordan in 2006 and Morocco in 2008.

With the collapse of asset and commodity prices and the freezing of financial markets, the crisis reached emerging economies and led to a sharp slowdown in lending in virtually all MENA countries, especially those in the GCC. The very sharp credit slowdown in the GCC reflected not only reduced oil inflows but also restricted access to foreign borrowing and domestic banks' curtailing of real estate lending. The prompt and forceful reaction by the GCC authorities included fiscal stimulus, monetary easing, and exceptional measures to support the financial sector (IMF 2009a, 2009b, 2010a, 2010b; Khamis and Senhadji 2010a). Despite the aggressive measures, the balance sheet adjustment of the banking system was still sizable: credit growth collapsed as a result of both supply and demand factors, as banks had to reduce their high loan-to-deposit ratios and reduce foreign borrowing in some cases. The oil and real estate sectors in particular took a major hit.

The global liquidity squeeze had a milder effect on non-GCC countries. Their much lower loan-to-deposit ratios (averaging less than 80 percent) indicate that these banks were not overextended and relied primarily on their deposit bases (figure 2.6). As an indication of the modest

FIGURE 2.6

Loan-to-Deposit Ratios in Selected World Regions, 2006–11



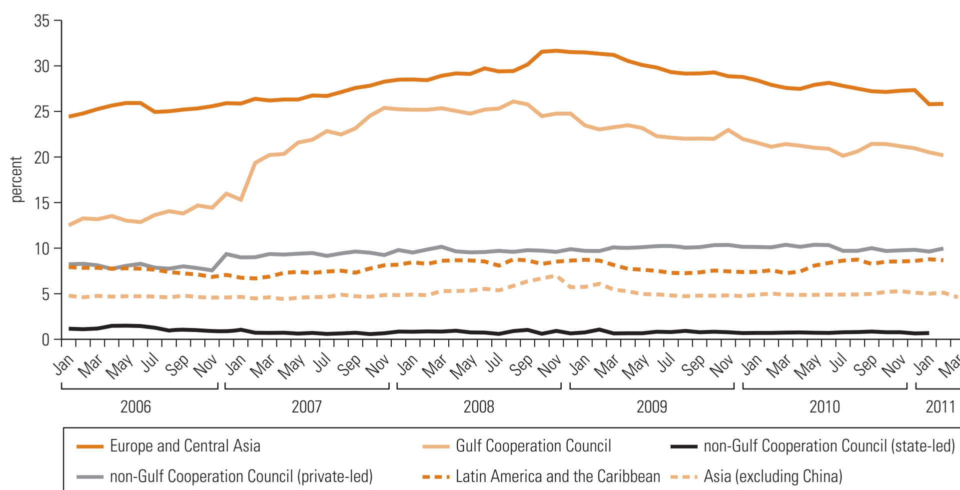
Source: IMF 2011.

global integration of their banking systems, these countries, especially those with state-run financial systems, had low average ratios of foreign liabilities to total liabilities (figure 2.7). Nevertheless, net lending slowed in all countries during 2009 and came to a halt in Jordan and Egypt. Policy measures by the authorities were more modest than in the GCC. Given high debt levels, the fiscal space allowed for only modest countercyclical measures. Monetary easing entailed mainly lower reserve requirements; central banks were cautious to cut interest rates (IMF 2009a, 2009b, 2010a, 2010b). Financial measures included the announcement of a blanket deposit guarantee in Jordan and the reiteration of the existing blanket guarantee in Egypt.

The non-GCC countries with state-dominated banking sectors maintained credit expansion over 10 percent in the wake of the crisis. The credit patterns in these countries reflect the lack of ties to the global financial system and the major role of state banks. In Algeria and Libya, banks smoothed the effect of the global crisis. Banks reacted more strongly in Syria, where credit growth declined substantially in 2009. The lack of global integration may have alleviated the immediate adverse impact of the crisis on the economy and the financial sector, but it has also hindered financial development in these countries, as shown in chapter 3. Moreover, there is evidence that the precrisis performance of state-owned banking systems in MENA was significantly worse than

FIGURE 2.7

Foreign Liabilities as a Percentage of Total Liabilities in Selected World Regions, 2006–11



Source: IMF 2011.

that of private-led banking systems. Sheltering state-owned banking systems from global integration is unlikely to produce sustainable gains in performance (Farazi, Feyen, and Rocha 2011).

Although it is premature to assess the impact of the political turmoil in the region, there are early signs that economic activity and credit growth are being significantly affected. In other emerging regions, credit recovery is gaining momentum. In contrast, there are signs that credit growth has leveled off or declined in most countries in MENA (see figure 2.5).

In summary, the impact of the global crisis on bank lending reflects the distinct characteristics of the three main MENA subgroups. The peak-to-trough contraction in credit growth was the largest, at 45 percentage points, in the GCC countries, the group with the highest financial openness index (as measured by the Chinn-Ito Index [Chinn and Ito 2007]), the highest precrisis loan-to-deposit ratio, the largest share of foreign liabilities in total liabilities, and the smallest role of state-owned banks (table 2.1). Although significant, the decline in the average credit growth rate was much lower, at 21 percentage points, in the emerging MENA group, where financial systems are less integrated but not closed, have lower loan-to-deposit ratios, and rely less on foreign funding, and where, on average, state-owned banks play a moderate role (although with significant cross-country differences). The MENA subgroup with the largest share of state-owned banks, the greatest isolation from the global financial system, and very low loan-to-deposit ratios and foreign liabilities experienced the smallest decline in credit growth rates. However, as shown in this report, the apparent advantages of this group of countries in the face of a crisis represent significant limitations on financial and economic development in the long run.

TABLE 2.1

Main Characteristics of Banking Systems in the Middle East and North Africa, 2008

Subregion	Decline in credit growth (percent from peak to trough)	Financial integration index (Chinn and Ito 2007)	Loan-to-deposit ratio (percent) (peak in 2008)	Foreign liabilities ratio (percent) (peak in 2008)	Share of state banks (percent) (2008)
GCC	44.9	2.01	97.1	24.9	28
Non-GCC countries with private-led banking systems	20.9	1.07	73.8	11.4	29
Non-GCC countries with state-led banking systems	12.0	−1.37	49.5	4.3	86

Source: World Bank staff calculations based on data from IMF 2011.

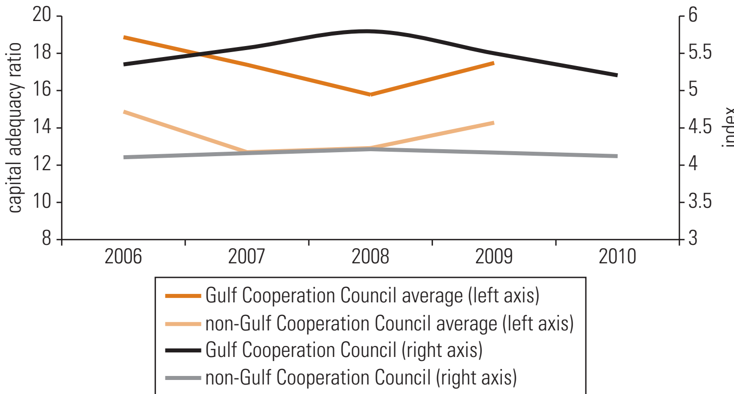
Resiliency of the Banking Sector

Standard indicators of banking system soundness and the lack of systemic consequences underscore the resiliency of MENA banking sectors to the global financial crisis. Banking systems in GCC countries were highly capitalized in the precrisis years, and capitalization increased further in 2009 (figure 2.8).[2] The authorities' forceful measures to support the banking systems following Lehman's bankruptcy contributed to the rise in capital adequacy ratios (CARs). Average CARs were significantly lower in non-GCC countries. The minimum regulatory CAR is on average lower in the non-GCC than in the GCC, and some non-GCC banking systems have been struggling with high percentages of nonperforming loans and reduced ability to generate and retain profits. Bank ratings confirm the resiliency of MENA banking systems in the face of the global crisis (figure 2.8). Ratings in GCC countries have been significantly higher, in line with their higher CARs, although the impact of the crisis was generally stronger, as reflected in the decline in ratings. Ratings in non-GCC countries are generally lower, in line with their lower CARs, but the impact of the crisis was more moderate, as reflected in their stable ratings. The crisis reinforced the presumption of government support (no bank failure policies), especially in the GCC.

The immediate impact of the crisis on asset quality and profitability was more significant in the overextended and more globally integrated GCC banking systems than in non-GCC countries. Before the global

FIGURE 2.8

Average Capital Adequacy Ratios and Bank Ratings in the Middle East and North Africa, 2006–10



Source: World Bank staff compilation based on data from IMF 2011 and Moody's.

crisis, nonperforming loan ratios had declined significantly, to 1–3 percent, as a result of high credit and output growth, and return on assets had been relatively high. Rapid credit growth, especially in the retail segment, has been the main driver of profitability in the GCC. Between 2006 and 2008, nonperforming loan ratios declined in non-GCC MENA banking systems as well, although some Egyptian and Tunisian banks were still undergoing restructuring and struggling with nonperforming loan ratios of more than 15 percent.[3] Profitability indicators were less favorable in the emerging MENA group than in the GCC, especially in Egypt and Tunisia.

The regional political crisis and the unwinding of countercyclical measures will test the resiliency of emerging MENA banking sectors. There has been significant disruption in economic activity in countries experiencing long protests and turmoil. These disruptions will lead to reduced lending activity and deteriorating asset quality and profitability of banks, to different degrees across countries.

Impact on Islamic and Conventional Banks

Although it is still too early to draw definitive conclusions about the final impact of the global crisis on Islamic and conventional banks, the immediate effects indicate that certain characteristics worked in favor of Islamic banks. The financing activities of Islamic banks are tied more closely to real economic activities, Islamic banks avoided direct exposure to exotic and toxic financial derivative products, and Islamic banks in general kept a larger proportion of their assets in liquid form (Ali 2011). The better performance of Islamic banks' stocks is an indication of their advantages in the crisis so far (Beck, Demirgüç-Kunt, and Merrouche 2010).

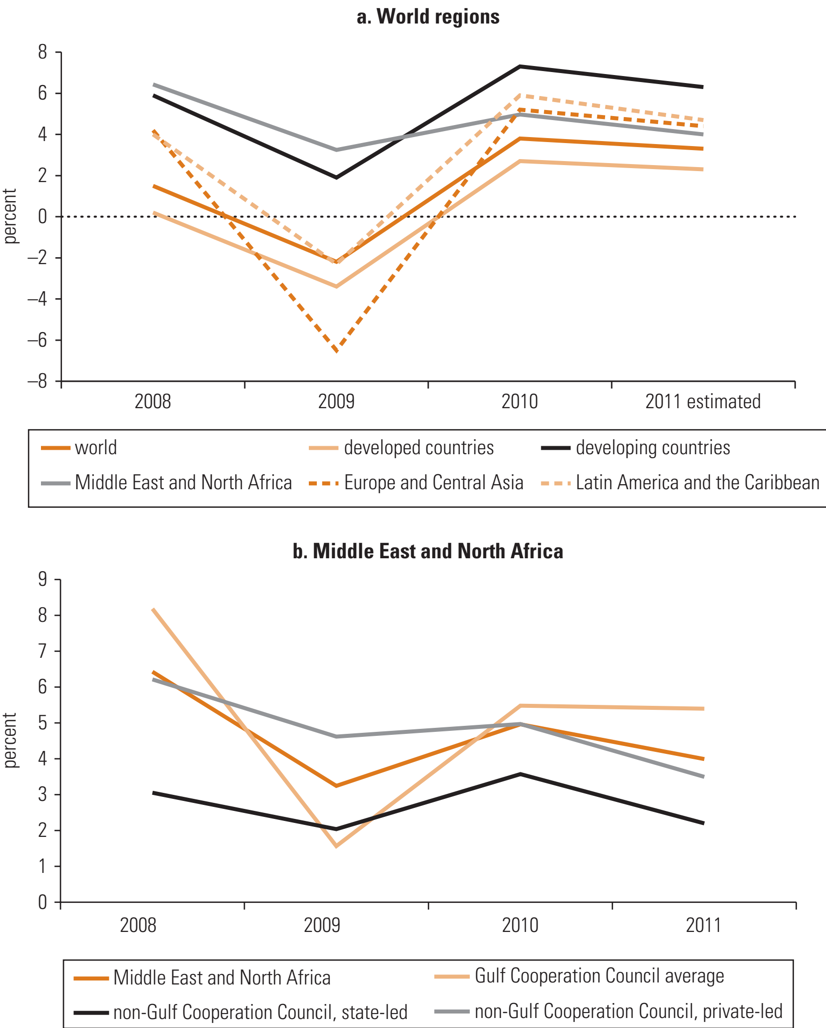
Despite their resilience in the early stages of the crisis, Islamic banks have not been immune to the second-round effects of the crisis. As the global financial crisis turned into a global economic crisis, Islamic banks and financial institutions started to be indirectly affected. The business model of many Islamic banks—which relied on *murabaha* financing and invested predominantly in the real estate sector and in the previously growing equity markets—has been facing higher risks (Ali 2011). Although this business model helped contain the adverse impact on profitability in 2008, weaknesses in risk management practices—related in particular to high sectoral and name concentration—led to larger declines in profitability compared with conventional banks in 2009 (Hasan and Dridi 2010). These weaknesses highlight the regulatory and supervisory challenges the Islamic finance industry is facing today.

Challenges to the Fragile Credit and Output Recovery

Recovery from the global crisis has been less vigorous in MENA than in regions that experienced sharper contractions; political turmoil, as well as rising food and commodity prices, adds to downside risks for several countries. Although the recovery was under way everywhere in the region in 2010, prospects were different across countries (figure 2.9).[4]

FIGURE 2.9

Actual and Projected GDP Growth Rates in Selected World Regions, 2008–11



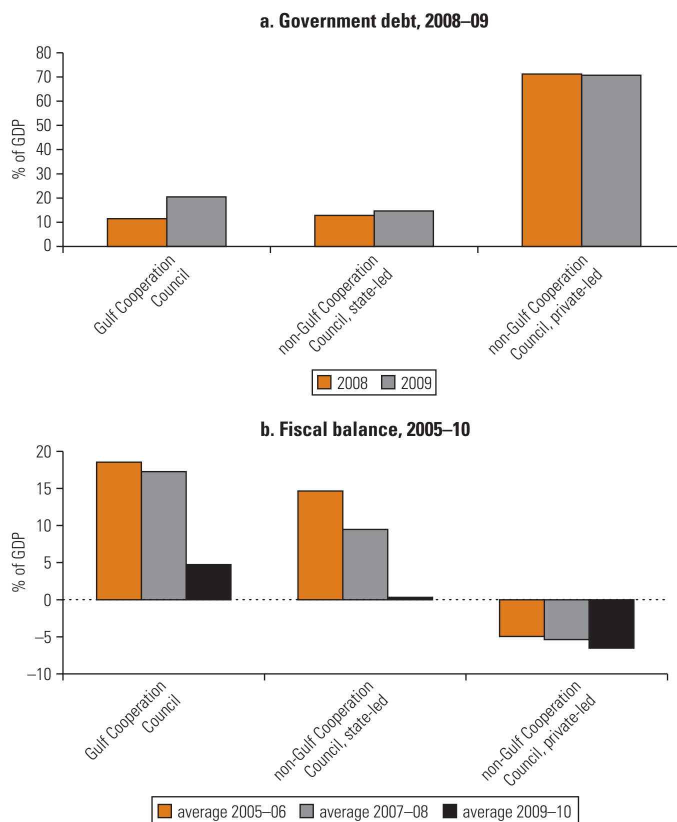
Source: World Bank staff compilation based on data from IMF 2011and World Bank 2011.

GCC countries were hardest hit by the global crisis, but they recovered quickly on the back of strong fiscal stimulus, exceptional financial sector measures, and the increase in demand for oil, which picked up as a result of the rapid recovery in emerging markets. With rising oil prices, government spending and growth in the GCC are expected to accelerate in 2011, although the sluggish credit recovery may slow the full recovery of the nonoil sector. Bahrain, which has experienced prolonged political unrest, is likely to be negatively affected. However, GCC countries have ample fiscal space to respond to political unrest and rising food and fuel prices with increased spending (figure 2.10).

Non-GCC countries were less affected by the global crisis. They recovered in 2010, but current prospects for a sustained pick-up in credit and output growth look challenging. Prospects for countries with strong ties to Europe (for example, Morocco, Tunisia, and Egypt)

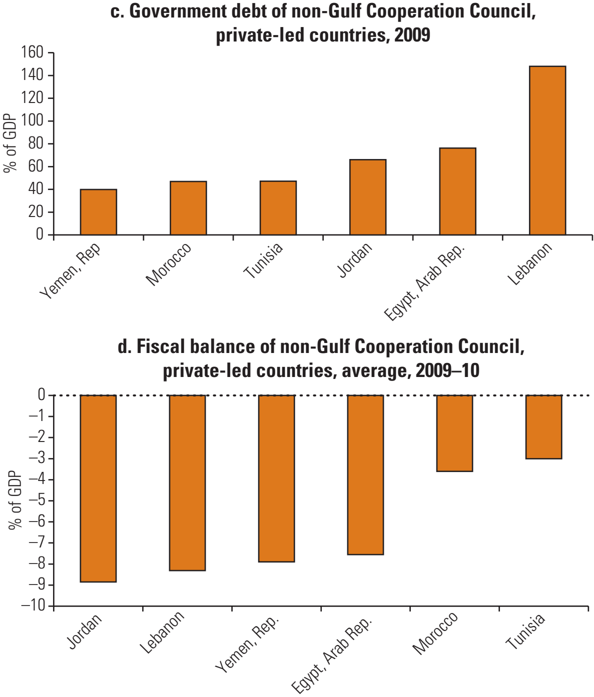
FIGURE 2.10

Fiscal Balance and Government Debt as a Percentage of GDP in the Middle East and North Africa



(Figure continues on the following page.)

FIGURE 2.10 (continued)



Source: World Bank 2011.

have been dampened by anemic growth and sovereign debt problems there, which will reduce exports, remittances, tourism revenues, and foreign direct investment. The regional political turmoil is expected to exacerbate the situation of several non-GCC countries, hindering their recovery. Oil-importing emerging countries in the region do not have the fiscal space for further stimulus. Lebanon has been an outlier in terms of recovery, experiencing a boom in construction and trade driven by foreign inflows into the real estate and banking sectors (the Lebanese Diaspora views the banking sector as a safe haven in times of crisis). Nevertheless, continued instability in the region, as well as higher food and fuel prices, are expected to have a negative impact on Lebanon as well.

Recovery has been weak in non-GCC countries with state-dominated banking systems, which are especially vulnerable to oil price volatility. Real GDP growth recovered only moderately in 2010; as a result of severe political instability, it may not pick up in 2011, even with higher oil prices. Credit activity will probably remain subdued throughout 2011, as a result of political and economic uncertainty, dampening further the prospects of a pick-up in output.

The full recovery of credit and output is an important policy objective for countries in the region in the short and medium runs, but there is no guarantee that even a full recovery of credit will benefit a wide range of economic agents. As argued in chapter 1, if credit remains as concentrated as it has been in the past, MENA economies will probably continue to grow below their potential and fail to generate the required number of jobs for the region's young and growing population. A sustained and broad recovery will require substantial progress in implementing a financial reform agenda that addresses the structural factors that have blocked access to finance in the past, namely, a very deficient financial infrastructure, weak bank competition, and the dearth of nonbanking financial institutions, markets, and instruments. This agenda also needs to ensure that financial systems remain resilient as access is broadened. These issues are discussed in more detail in the following chapters.

Notes

1. China was a notable exception, experiencing a vigorous credit expansion during 2009 that was driven by state banks.
2. Between 2006 and 2008, capital adequacy ratios (CARs) declined in all GCC countries except Qatar, albeit from a high base. This decline was driven primarily by high credit growth, which increased the volume of risk-weighted assets. In addition, GCC banking systems have a relatively large share of *Sharia*-compliant banks, which tend to have higher capitalization than conventional banks. As GCC countries are generally advanced in the implementation of Basel 2, in some cases extra capital charges weighed on their CARs.
3. Financial soundness indicators are less straightforward to interpret in the state-dominated banking systems of Algeria, Libya, and Syria, because state-bank accounts are generally not audited according to international standards.
4. This section draws on IMF (2010a, 2010b); Khamis and Senhadji (2010a, 2010b); and World Bank (2011).

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CHAPTER 3

The Size and Structure of Regional Financial Systems

This chapter provides an overview of the size and structure of MENA's financial systems. It shows that, with very few exceptions, these systems are very undiversified. Banking systems are generally large, except in countries in which state institutions lead the financial system. Nonbanking financial institutions are undeveloped, with few exceptions. Equity markets are large, but aggregate indicators are deceptive, masking a small free float in many countries as well as the small share of nonfinancial corporations. Private fixed-income instruments are negligible. The analysis reveals only a moderate level of financial development overall. Countries in which state banks lead financial intermediation are at a much lower level of financial development.

The chapter is structured as follows. The first section examines the overall structure of MENA's financial systems from three perspectives: financial institutions, financial instruments, and sources of finance to the private sector. It examines simple averages of the size of financial institutions and instruments as shares of GDP for MENA as a whole as well as for the Gulf Cooperation Council (GCC) and the two non-GCC subregions. The second section provides international comparisons based on various benchmarking techniques. Appendix A describes the model used for benchmarking, provides additional benchmarking exercises, and presents the dataset of financial indicators by segment of the financial sector and by country.

A Bird's Eye View of MENA's Financial Systems

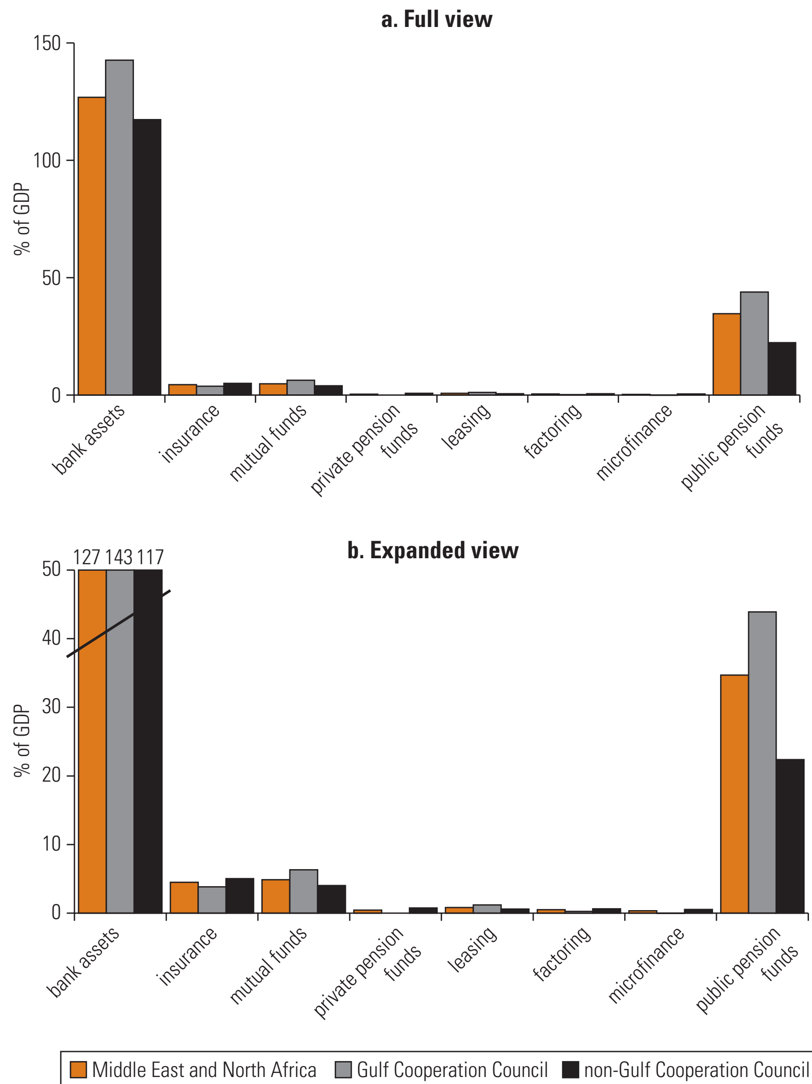
Financial Institutions

Banks dominate the financial landscape of MENA countries. Bank assets account for 130 percent of GDP in MENA, eclipsing all other sectors

(figure 3.1a). The GCC average is higher (about 145 percent of GDP), not surprising in view of the much higher income levels there, but the average ratio in the non-GCC group is also high (120 percent of GDP), despite lower income levels. However, there are significant differences within the non-GCC group. By contrast, the average size of nonbanking financial institutions is very small or negligible in both regions.

FIGURE 3.1

Assets of Financial Institutions as a Percentage of GDP



Source: World Bank staff compilation based on data from Axco, Euromoney, Factors Chain International (FCI), International Monetary Fund (IMF), Investment Company Institute (ICI), Micro Finance Information Exchange (MIX), World Bank, and national sources.

Note: Data are from 2009 or latest year available.

The small size of nonbanking financial institutions in MENA is highlighted in figure 3.1b. On average, insurance companies and mutual funds account for less than 5 percent of GDP, and other nonbanking financial institutions account for less than 1 percent of GDP. The region does not have savings or credit cooperative sectors, as Latin America and Central Europe do. Investment companies providing consumer finance, investment banking services, and other services have been developed in Kuwait but not in other countries in the region (they are therefore not reflected in figure 3.1).

Public pension funds are large in some MENA countries. They manage the reserves of public pay-as-you-go pension systems. Some countries have prefunded their future pension obligations and accumulated large reserves as a result of the young demographic profile of their populations. Public pension funds are shown and treated separately for three main reasons. First, they are large in just a handful of countries, especially outside the GCC (for example, Jordan and Morocco). Second, their assets may decline significantly in the next two decades as their populations mature. Third, most of these funds provide limited information on their governance structures, investment policies, portfolio compositions, and returns. Public pension funds may contribute to capital market development, but their performance in other regions has been very mixed (Impavido, Vittas, and O'Connor 2008; World Bank 2004). Their design, size, and performance are examined in chapter 8.

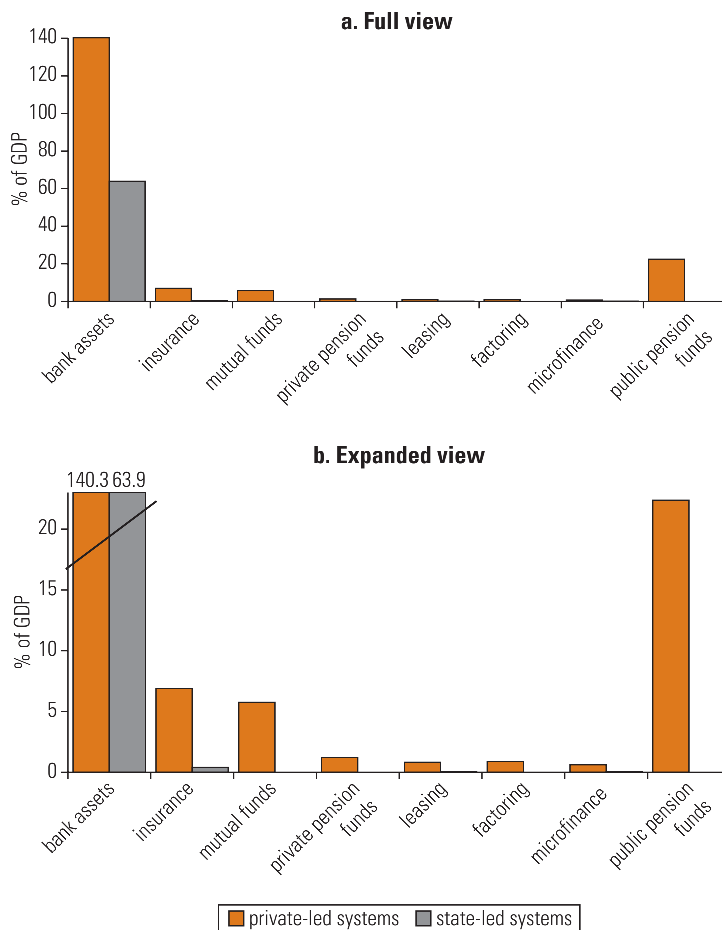
The level of financial development differs significantly in the two non-GCC subregions. Bank assets average 140 percent of GDP in countries where private banks lead financial intermediation, a ratio that is close to the GCC's average ratio (figure 3.2). In this group, the private banks account for 50–100 percent of total bank assets. By contrast, total bank assets account for only 65 percent of GDP in countries where state banks lead intermediation, with their market shares ranging from 70 to 90 percent of total bank assets. The second group maintained a relatively closed financial system for a long period, relaxing entry restrictions and allowing the entry of private banks, including foreign banks, only in the past decade. Nonbanking financial institutions are significantly smaller or simply absent in these state-led countries.

Financial Instruments

The financial landscape in MENA is dominated by bank deposits, followed by equities and government bonds. Bank deposits are the main instrument available for portfolio investment (figure 3.3). The average stock of equity is large, as measured by the ratio of market capitalization to GDP. However, the stock available for portfolio investment is

FIGURE 3.2

Assets of Financial Institutions as a Percentage of GDP in Non-Gulf Cooperation Council Countries



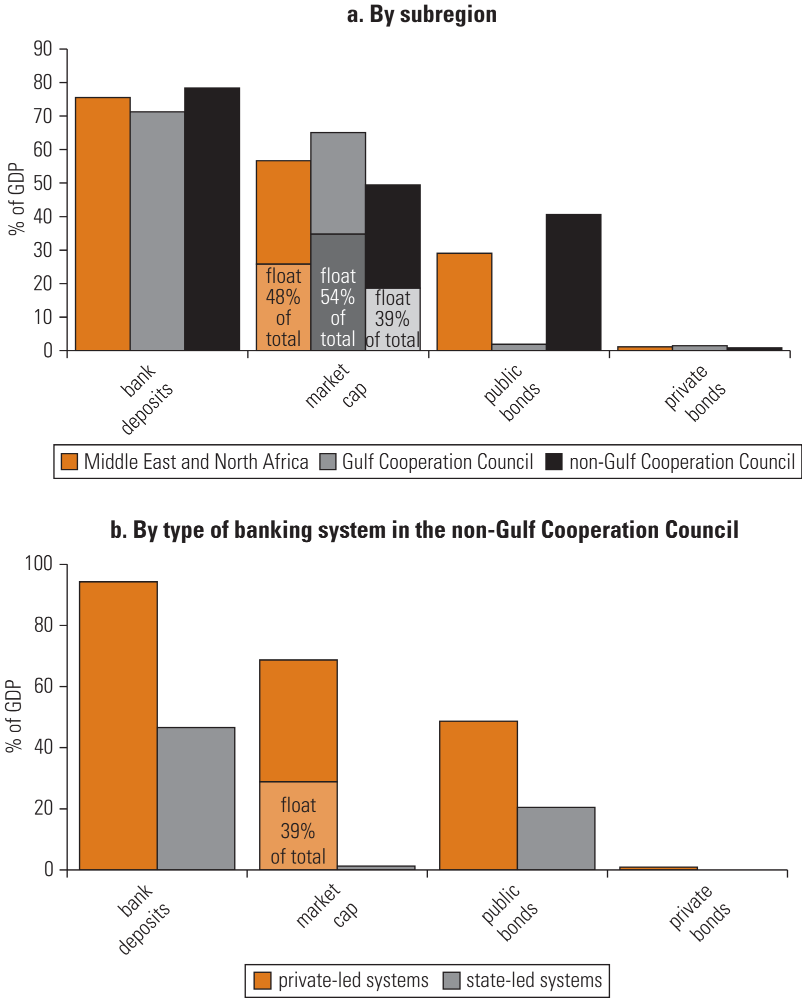
Source: World Bank staff compilation based on data from Axco, Euromoney, FCI, ICI, IMF, MIX, World Bank, and national sources.

Note: Data are from 2009 or latest year available.

smaller in many countries, as indicated by the low free float, especially in the non-GCC region (39 percent, compared with an international average of 55 percent, as shown in chapter 9). The low free float reflects the large number of family-controlled companies and concentrated ownership structures in the region, as well as lax listing requirements in some countries. The stock of traded public bonds is sizable in some non-GCC countries and constitutes an important instrument for domestic portfolios, although government debt markets remain illiquid and have not attracted the interest of foreign investors.

FIGURE 3.3

Financial Instruments as a Percentage of GDP



Source: World Bank staff compilation based on data from Bloomberg, IMF, and World Bank.

Note: Data are from 2009 or latest year available.

The stock of private fixed-income instruments is negligible in MENA. In non-GCC countries, the volume of private bond issues has been small and limited largely to banks. In some countries, banks have issued debt to build up Tier 2 capital (Morocco) or comply with regulations limiting maturity mismatches (Tunisia). Mortgage refinance corporations have issued bonds in Jordan and the Arab Republic of Egypt, although the volume of these issuances is very low. The stock of corporate bonds remains negligible. Asset-backed securities are also negligible, and mortgage-covered bonds have not been developed anywhere in the region.

In recent years, there have been large but sporadic bond issues by sovereign and corporate entities in the GCC. These issues are of two types. The first are bonds that are placed privately or through syndication and listed offshore or not at all. These issues have originated in the United Arab Emirates and Qatar. The second are bonds in local currency or dollars that are listed either on national exchanges or on the Nasdaq Dubai. These issues have originated mainly in the United Arab Emirates and Saudi Arabia. Because of their potential connectivity to domestic financial sectors, only the listings on national exchanges are reflected in figure 3.3. Although some of these bonds have large headline amounts, they are small as a share of GDP. There is essentially no local market for corporate bonds in Kuwait, Oman, and Qatar.

GCC bond exchanges are dominated by *sukuk*, with the funding needs of government-related enterprises in Saudi Arabia and the United Arab Emirates being a major driver. Bonds are listed locally in Saudi Arabia, Dubai, Abu Dhabi, and Bahrain, as well as on the Nasdaq Dubai. As of March 2011, GCC local bond listings amounted to US$18 billion, including US$15 billion of *sukuk*. The total value of GCC local bond listings, including listings on the Nasdaq Dubai, was US$39 billion, including US$29 billion of *sukuk*. The major GCC market is Saudi Arabia, with US$9.5 billion in listings, all *sukuk*. The domestic Dubai Financial Market has US$3.3 billion in listings, mostly government and conventional bonds. Bahrain has a mixture of *sukuk* and conventional bonds. Nasdaq Dubai has US$6 billion in conventional and US$16 billion in *sukuk* bonds, nearly all related to the funding of government-related enterprises. Trading in these securities is limited, but the scale of Nasdaq Dubai provides the potential for a deeper market in debt securities, and the listing requirements have generated a discipline of disclosure.

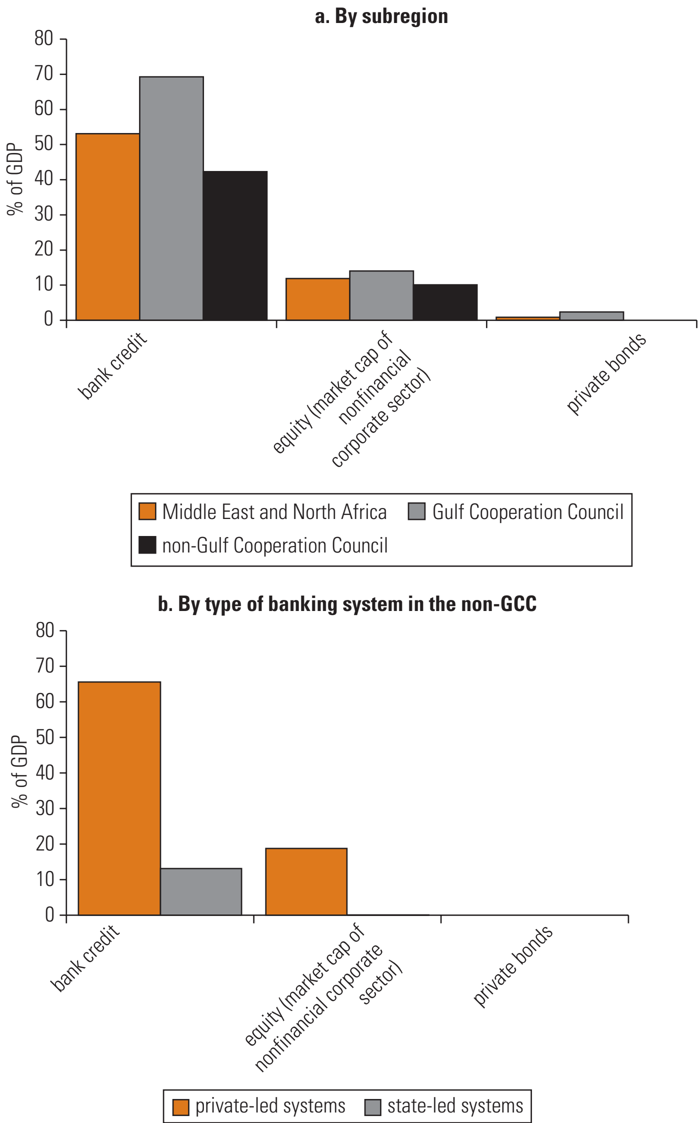
The large equity markets in MENA are not supported by a solid domestic private institutional investor base. The lack of private institutional investors (insurance companies, mutual funds, and private pension funds) operating in capital markets is one of the main peculiarities of the region, raising questions about the characteristics of these markets. As shown in chapter 9, turnover indicators seem reasonable, and there has been an increase in the number of firms conducting equity research in the region (examples include Bank Audi [Lebanon], Beltone and Hermez [Egypt], Global Investment House [Kuwait], and NCB Capital [Saudi Arabia]). However, the lack of a diversified private institutional investor base, combined with a large number of uninformed small individual investors, a few high net worth individual investors, and large state investors, raises questions about the quality of price discovery. Although turnover indicators seem reasonable, there is also evidence that MENA equity markets have a high degree of price synchronicity, suggesting that the quality of price discovery may be deficient.[1]

Sources of Finance to the Private Sector

Bank credit remains the dominant and frequently sole source of finance to the private sector. Average credit to the private sector amounts to 55 percent of GDP, overshadowing other sources of finance (figure 3.4). Based on total market capitalization, equity finance would seem to be important, but the market capitalization of

FIGURE 3.4

Financing Sources to the Private Sector as a Percentage of GDP



Source: World Bank staff compilation based on data from Bloomberg, IMF, and World Bank.

Note: Data are from 2009 or latest year available.

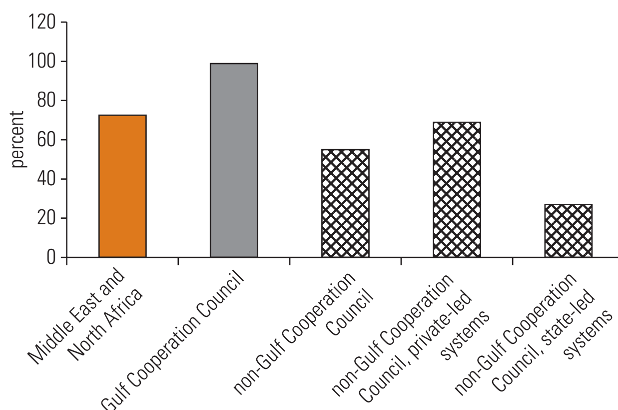
the nonfinancial corporate sector is small. This is another peculiarity of the MENA region, where listed financial companies (mostly banks) account for 58 percent of market capitalization, a share that is twice the average of other regions.[2] Infrastructure amounts to 21 percent of market capitalization, and the share of the nonfinancial corporate sector (also 21 percent) is one of the lowest among emerging regions. Corporate bonds, leasing, and factoring (not shown in figure 3.4) are negligible sources of finance.

The average ratio of private credit to GDP is higher in the GCC than in non-GCC countries. As the average deposit base is similar in the two regions, the higher ratio of private credit to GDP in the GCC reflects less financing of government deficits, as well as greater recourse to external borrowing to sustain credit growth. These factors are reflected in the higher average loan-to-deposit ratio in the GCC relative to the non-GCC (figure 3.5). The loan-to-deposit ratio of some GCC countries is too high, reflecting excessive credit growth and excessive reliance on foreign funding before the crisis (chapter 2). In contrast, the loan-to-deposit ratio of most non-GCC countries is very low. In the case of non-GCC oil importers that have private-led financial systems, this low ratio primarily reflects large fiscal deficits and debts financed by state and private banks, especially the former. In the case of non-GCC oil exporters with state-led financial systems, the low loan-to-deposit ratio reflects large loans to state-owned enterprises.[3]

Within the non-GCC region, private credit is much greater in countries with private-led banking systems. The average ratio of private credit to GDP in such countries is 65 percent, a high ratio by

FIGURE 3.5

Average Private Loan-to-Deposit Ratios, 2009



Source: IMF.

international standards (see figure 3.4). By contrast, the ratio of private credit to GDP in state-led systems is only 13 percent, reflecting extensive financing of state-owned enterprises by the dominant state-owned banks (figure 3.4). Equity finance is limited in the first group and practically nonexistent in the second, reflecting their incipient equity markets.

International Comparison of Financial Systems

The benchmarking analysis presented in this section shows that relative to other regions, banking systems in MENA are generally large, nonbank financial institutions are mostly undeveloped, and private securities markets, especially the nonfinancial corporate sector, are small. Comparisons are made for each segment of the financial sector in two steps. First, simple regional averages are compared. Second, the actual and predicted values are shown for each country based on a regression model using a large panel and the following explanatory variables: per capita income, population, population density, the age dependency ratio, inflation, and a dummy variable for oil exporters.

Different benchmarking techniques do not materially change the major conclusions or the relative positions of individual countries. The benchmarking technique adopted is more effective than simple peer group comparisons or traditional comparisons controlling only for per capita income. The regression model is not exhaustive in the number of variables but captures the main structural determinants of the size of each segment of the financial sector. (Appendix A provides a basic discussion of the benchmarking technique and additional results using a different regression technique. The major conclusions and the relative country positions do not change materially.[4])

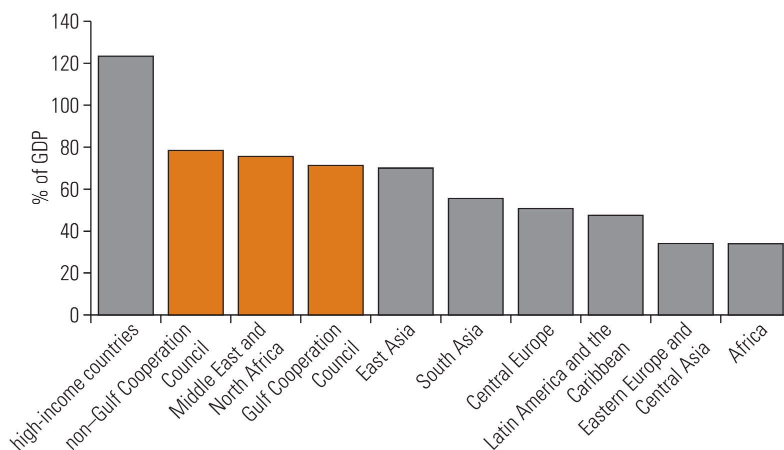
Banking Sector

Countries in the region compare well with other countries regarding the size of their deposit base. The average ratios of bank deposits to GDP in MENA and its two main subregions are higher than in other world regions (figure 3.6). This result is not surprising in the case of the GCC countries, where the large deposit base is largely in line with the levels predicted by the countries' high per capita income, oil-exporting status, and other characteristics. However, many non-GCC countries have much larger deposit ratios than the levels predicted by their income levels and demographic profiles (figure 3.7).

The large deposit base in many non-GCC countries reflects workers' remittances and capital flows from within the region. Panel a in figure 3.8

FIGURE 3.6

Bank Deposits as a Percentage of GDP in Selected World Regions, 2009



Source: World Bank staff compilation based on data from IMF and World Bank.

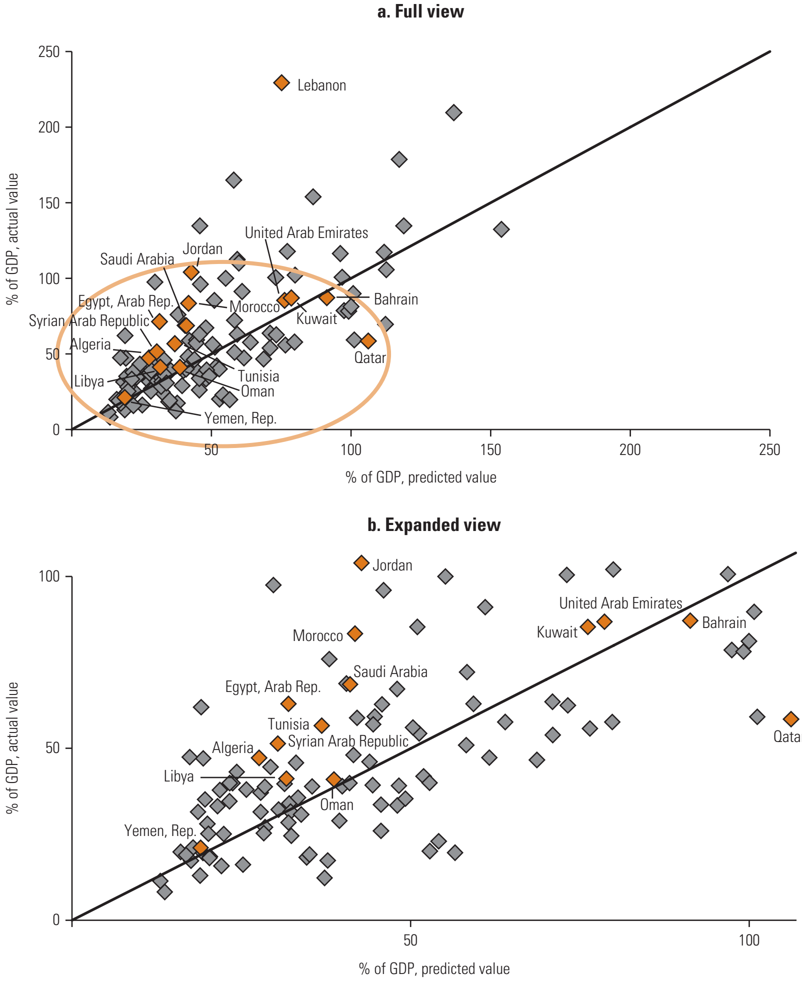
shows that Lebanon is an outlier in this regard: its very large deposit base reflects large remittances from its nationals abroad (the Lebanese Diaspora) and other inflows from the region, especially GCC countries. Other non-GCC countries with larger than predicted deposits include Jordan, Morocco, Tunisia, and Egypt (see figure 3.7, panel b). These countries are also recipients of workers' remittances and other foreign inflows from the region.[5] The deposit base of other non-GCC countries is largely in line with their income levels and demographic profiles.

Countries in the region also compare well with other countries regarding the volume of private credit. The average ratio of private credit to GDP in the GCC is higher than in other world regions (figure 3.8). This finding is not surprising given their large deposit bases and an average loan-to-deposit ratio of almost 100 percent. GCC countries have ratios of private credit to GDP that are generally in line with the levels predicted by their high per capita income, demographic profiles, oil-exporter status, and other characteristics (figure 3.9).

Non-GCC countries compare well with other countries regarding the size of private credit, albeit less well than in the case of deposits. The average ratio of private credit to GDP in the non-GCC is lower than those in most other regions (figure 3.8), but the low ratio largely reflects their relatively low income levels and other factors. Controlling for these factors, their credit ratios generally look reasonable, and many countries, especially Jordan, Morocco, and Tunisia, have higher than predicted

FIGURE 3.7

Actual and Predicted Bank Deposits as a Percentage of GDP, by Country, 2009

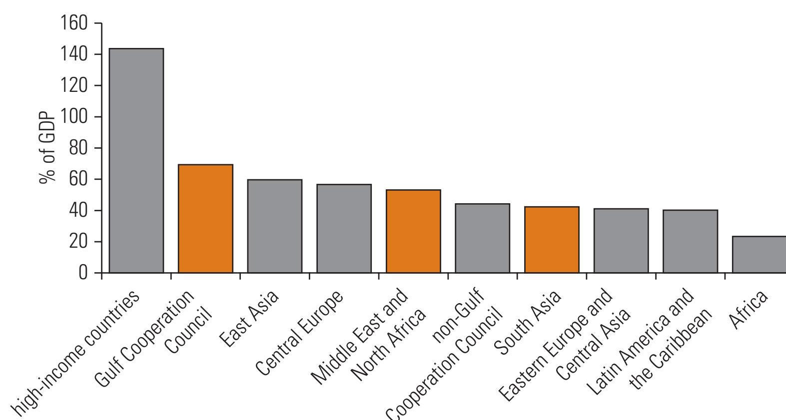


Source: World Bank staff calculations based on data from IMF and World Bank. See Appendix A.

ratios (figure 3.9). However, it is also apparent that the large deposit base of many non-GCC countries is being partly channeled to finance the government, resulting in less credit to the private sector. From a different angle, their initial advantage in resource mobilization is partly eroded by a large share of government finance. Lebanon is an extreme case: nearly one-third of its bank assets consist of government securities. However, the difference between deposits and private credits is also large in other countries, such as Egypt, Jordan, and Morocco. As shown in chapter 2, all these countries have large fiscal deficits and debts financed largely by the domestic banking system. Non–GCC countries with state-dominated systems

FIGURE 3.8

Private Credit as a Percentage of GDP in Selected World Regions, 2009



Source: World Bank staff compilation based on data from IMF and World Bank.

do not have large fiscal deficits and debts, but they have comparatively low private credit ratios, reflecting large loans to state-owned enterprises.

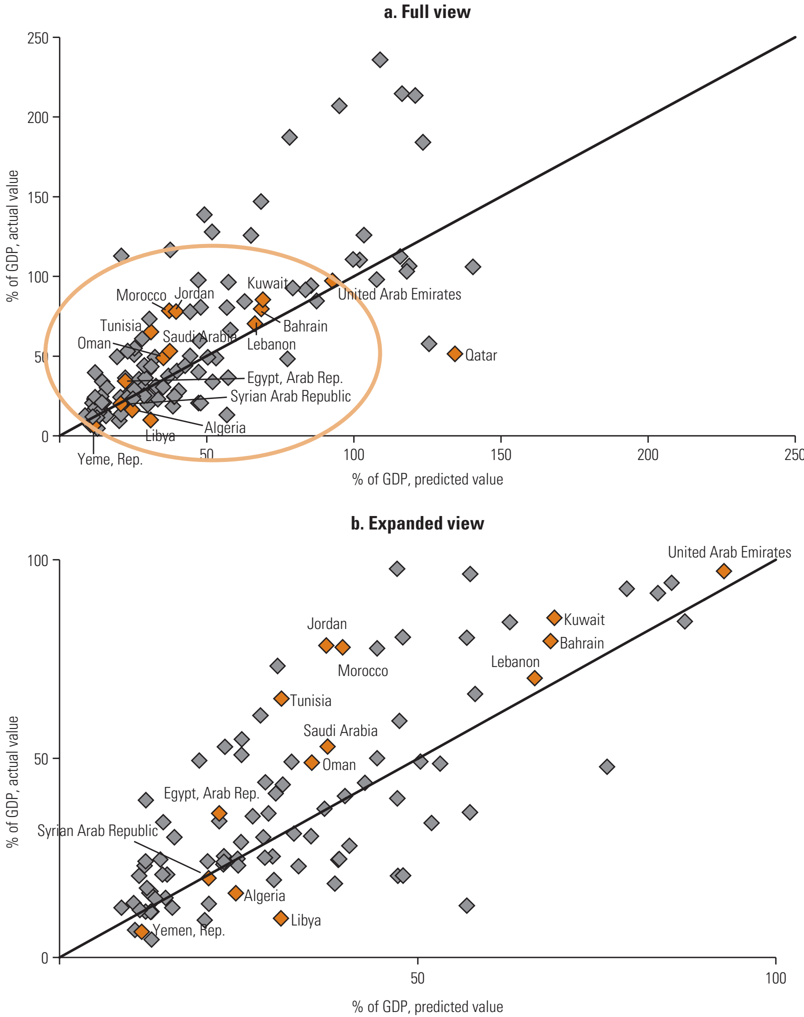
Insurance Sector

The insurance sector remains generally undeveloped in MENA, especially in the GCC. The average ratio of insurance assets to GDP in MENA is low relative to other world regions (figure 3.10). The non-GCC average compares better, but this result largely reflects the effect of a single country—Morocco, the only country that has succeeded in developing the insurance sector—whose total assets are well above the levels predicted by the country's income level and demographic profile (figure 3.11). Morocco's success reflects many factors, including a regulatory framework that has tracked developments in the European Union, a private sector–led financial sector, well-regulated and enforced mandatory insurance classes, the rapid growth of life *banc-assurance*, and the provision of supplementary pensions (see chapter 8). Egypt, Jordan, Lebanon, and Bahrain have also made some progress in developing the sector, with actual assets in line with those predicted. In contrast, the other countries in the region, especially the GCC countries, still have very small insurance sectors. Their actual assets lie well below their predicted levels.

The life insurance sector is very undeveloped and has hindered the overall growth of insurance assets in the region. This sector accumulates more assets than the nonlife sector, in order to meet the future obligations

FIGURE 3.9

Actual and Predicted Private Credit as a Percentage of GDP, by Country, 2009

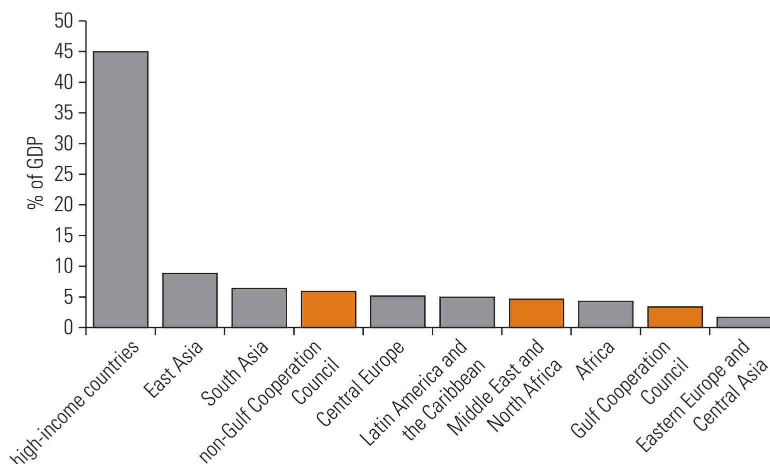


Source: World Bank staff calculations based on data from IMF and World Bank. See Appendix A.

of contracts with much longer durations, such as life insurance policies, retirement products, and annuities. The very small size of life premiums in most countries in the region helps explain the small volume of assets (figure 3.12). Morocco is the only country with life premiums well above predicted levels (figure 3.13). Its success reflects several factors, including rapidly expanding life *banc-assurance*. Lebanon and Bahrain have generated reasonable life premiums, but they remain below their potential. Egypt is doing reasonably well for its income level. Most other countries in the region still have negligible life insurance sectors.

FIGURE 3.10

Insurance Assets as a Percentage of GDP in Selected World Regions, 2008



Source: World Bank staff compilation based on data from Axco, World Bank, and national sources.

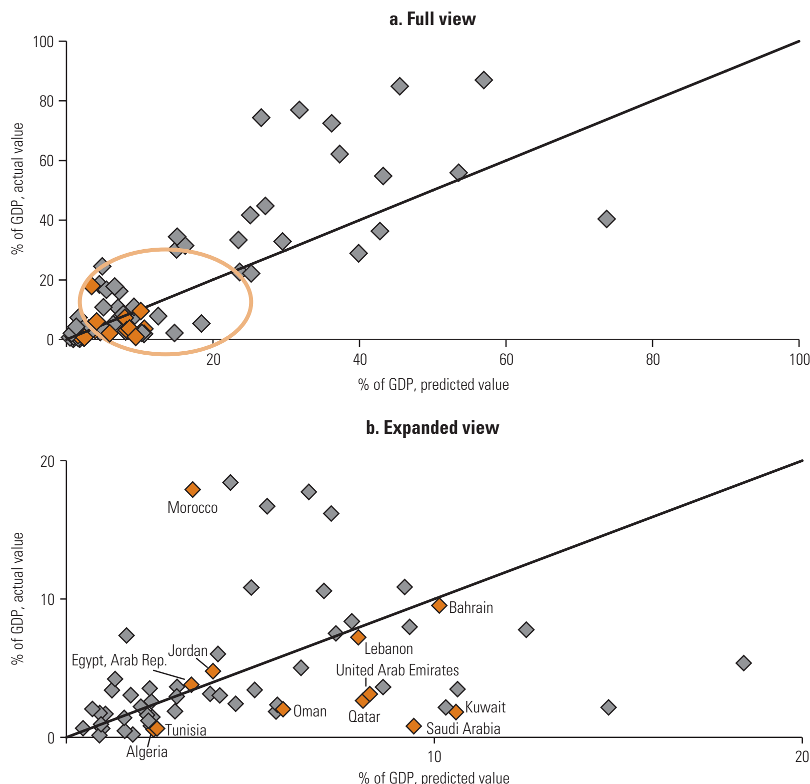
MENA's nonlife sectors are somewhat more developed than their life sectors (see figure 3.14), but they, too, remain undeveloped in many countries. The nonlife sector does not generate the same volume of assets as the life sector, but it performs fundamental functions of risk management and contributes to financial and economic development. In cross-regional comparisons, the average nonlife premium in MENA compares better than the average life premium, but only because of the performance of a handful of countries, especially Morocco, Jordan, and Tunisia (figure 3.15). The Syrian Arab Republic and Bahrain seem to be doing well for their respective income levels and demographic profiles. Other countries are below their potential, and most GCC countries still have very small nonlife sectors.

Many countries in the region have not generated meaningful non–life insurance premium revenues even in mandatory lines such as car insurance, as a result of lack of compliance, understatement of claims, and price controls. In many countries, the industry runs losses in car insurance as a result of these factors (see chapter 8).

The lack of development of the insurance sector in MENA is a matter of concern. The sector performs essential functions of risk management, reducing the risk of large losses for enterprises and households and contributing directly to investment and output activity. The sector also contributes to the growth of other segments of the financial system, such as the private bond market (by providing credit enhancements and the

FIGURE 3.11

Actual and Predicted Insurance Assets as a Percentage of GDP, by Country, 2008



Source: World Bank staff calculations based on data from Axco and national sources. See Appendix A.

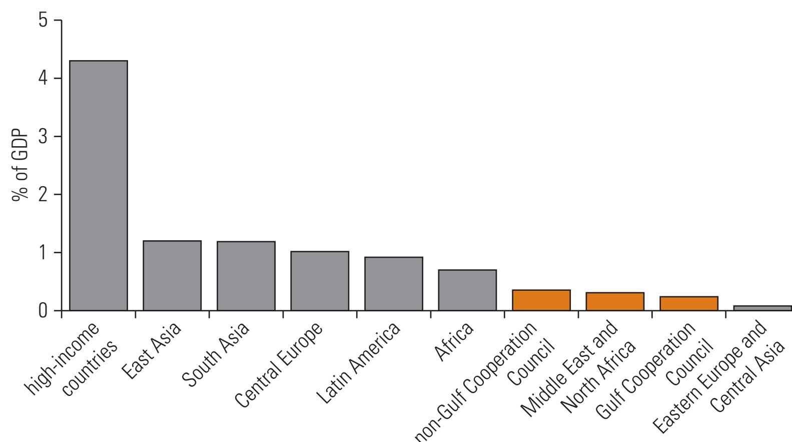
demand for long-term securities) and the credit market (by reducing creditor risks through life and homeowners' insurance and by enhancing the value of loan collateral). The insurance sector can contribute to both deeper and broader credit markets through its risk management function. (Chapter 8 examines the reasons that have hindered the development of this critical sector in more detail.[6])

Mutual Funds

Countries in the region have not developed other types of institutional investors, including mutual funds. (Private pension funds are so negligible that they are not covered here.) The mutual funds sector remains undeveloped, especially in the non-GCC region (figure 3.16). Even considering the relatively small free float of equity markets, especially in non-GCC countries, the difference between the sizes of equity markets

FIGURE 3.12

Insurance Premiums as a Percentage of GDP in Selected World Regions, 2008



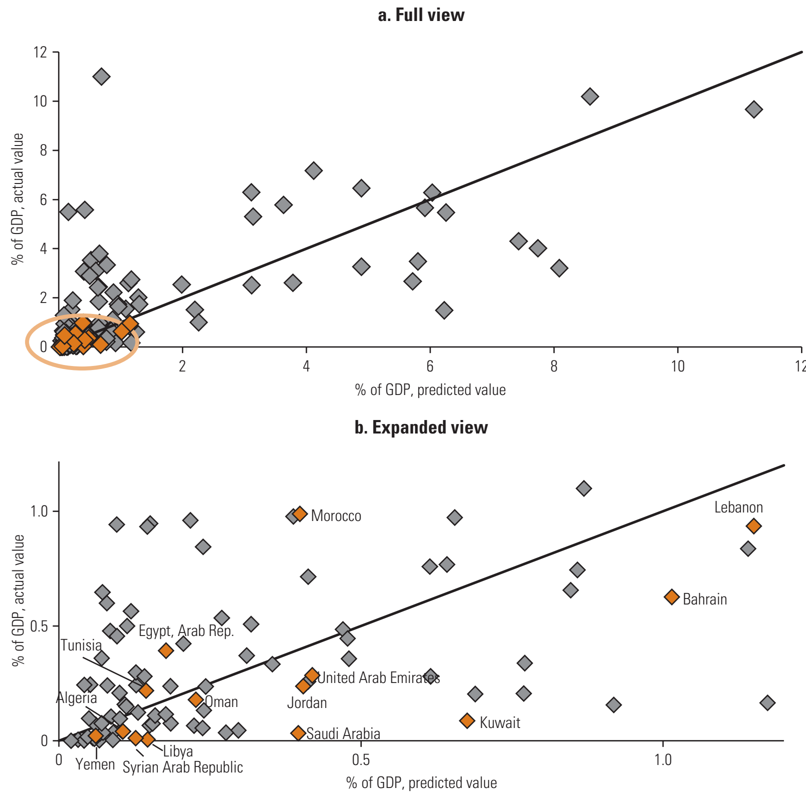
Source: World Bank staff compilation based on data from Axco, World Bank, and national sources.

and mutual funds is striking. Moreover, averages mask wide disparities across countries. Mutual funds remain extremely small in most countries; only Morocco and Bahrain seem to have developed sizable mutual fund industries (larger than predicted by their income levels and other characteristics) (figure 3.17). The Moroccan mutual fund industry is boosted by the insurance sector and public pension funds. Bahrain has become a center for regional mutual funds in the GCC. Tunisia has achieved some progress, as have Egypt, Saudi Arabia, and Kuwait. In the other countries, the industry remains miniscule.

Equity funds account for roughly half of the assets under management by mutual funds in MENA. Fixed-income funds account for 25 percent, money market funds for 15 percent, and hybrid funds for the remaining 10 percent. The prevalence of equity funds is not surprising, as they are the dominant financial instrument other than bank deposits. The relatively small size of fixed-income funds is not surprising either. Private fixed-income instruments do not exist, and although many countries have sizable stocks of government bonds, the lack of liquidity of government securities raises problems for pricing and valuation of portfolios and redemption of mutual fund shares. Money market funds are a new and welcome development in MENA that have enabled corporate treasuries to conduct more effective liquidity management, but this development still seems limited to Egypt, Morocco, and Saudi Arabia.

FIGURE 3.13

Actual and Predicted Life Insurance Premiums as a Percentage of GDP, by Country, 2008



Source: World Bank staff calculations based on data from Axco, World Bank, and national sources. See Appendix A.

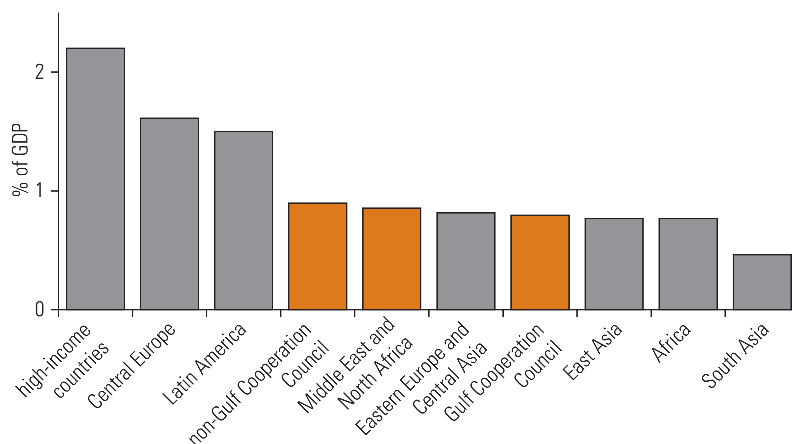
Mutual funds in MENA tend to invest in their own countries of domicile. This trend reveals both restrictions on crossborder investments and the home bias of fund managers. Whatever the dominant factor, it results in missed opportunities for better portfolio diversification and risk-return combinations for savers. Chapter 8 provides more details on the mutual fund industry and the factors that have hindered its development.[7]

Leasing and Factoring

The leasing and factoring industries remain very small relative to other regions (figures 3.18, 3.19). The small size of the leasing industry in MENA is disappointing. The industry is *Sharia* compliant by its nature and could provide an important alternative source of

FIGURE 3.14

Non–life Insurance Premiums as a Percentage of GDP in Selected World Regions, 2008



Source: World Bank staff compilation based on data from Axco, World Bank, and national sources.

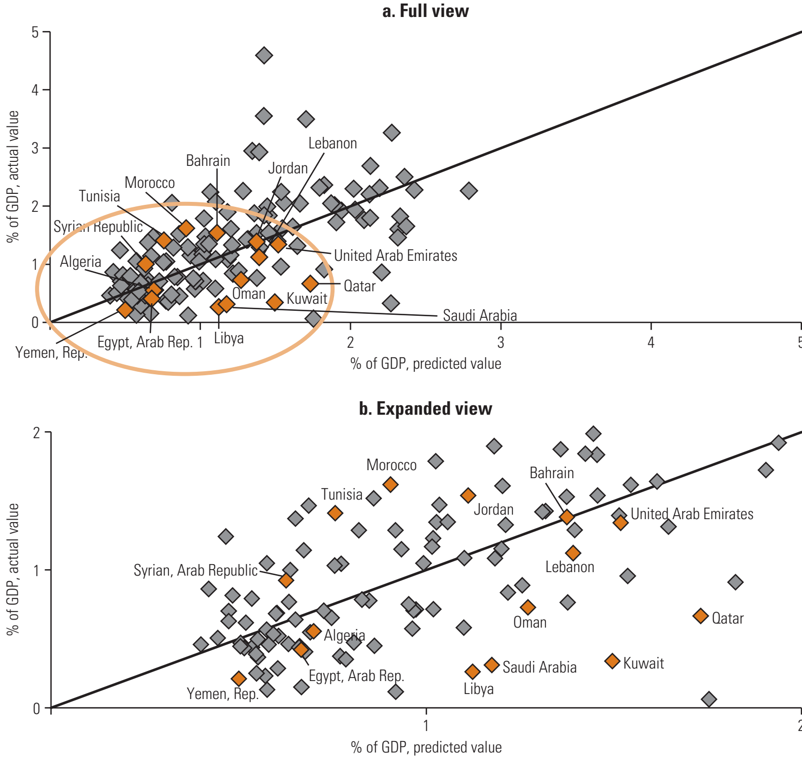
investment finance for small, medium, and even large enterprises, especially in a region where the collateral regime remains weak, depriving many enterprises of credit. Many Central European countries rapidly developed the leasing industry to provide an alternative to bank finance during the transition years.[8] Chapter 8 provides more detail on the leasing industry in MENA. The factoring industry also remains very small, depriving enterprises of an alternative source of working capital finance.

Microfinance

Measured by the ratios of microcredit loans to GDP and especially to total bank credit, microcredit in MENA is small and undeveloped compared with other regions (figure 3.20). Even in Morocco, the country that has made most progress in developing the industry, microcredit loans barely exceed 1 percent of total bank credit. Moreover, the rapid expansion of microcredit in Morocco resulted in a crisis in the microcredit industry because of the lack of credit information sharing (which allowed multiple borrowings) and poor governance structures (the industry remains excessively based on nongovernmental organizations). Chapter 8 describes the reasons for the weak development of the industry in MENA and draws lessons from the Moroccan experience.[9]

FIGURE 3.15

Actual and Predicted Non–life Insurance Premiums as a Percentage of GDP, by Country, 2008



Source: World Bank staff calculations based on data from Axco, World Bank, and national sources. See Appendix A.

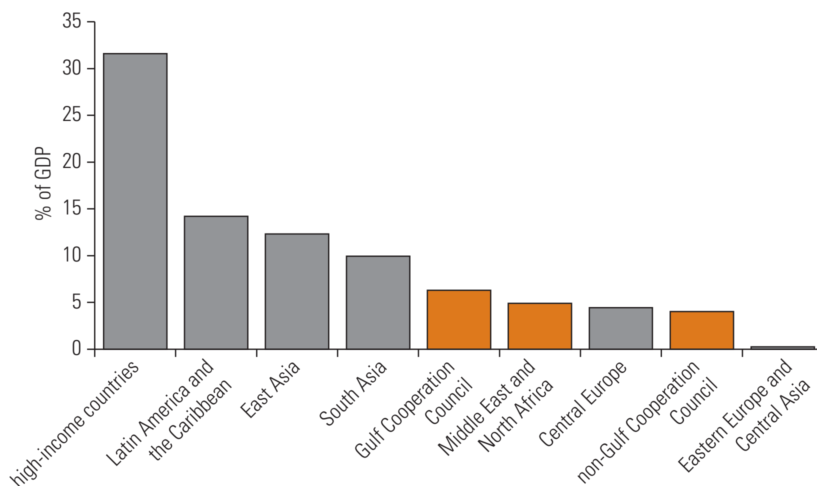
Capital Markets

Equity markets

Countries in the region compare well in equity market capitalization (figure 3.21), although this comparison becomes much less favorable when it excludes banks and infrastructure (figure 3.22). The average market capitalization in MENA is higher than in all other regions, with capitalization particularly high in the GCC. Most countries in the region have market capitalization ratios that are higher than or in line with their income levels, demographic profiles, and other characteristics (figure 3.23). The exceptions are countries with closed and state-led financial systems. MENA's position looks much less impressive when the large share of banks and infrastructure (electricity, water, gas, transport, telecommunications) is excluded from market capitalization, revealing that the nonfinancial corporate sector has been much less present in the market and has not resorted extensively to equity finance.

FIGURE 3.16

Mutual Funds as a Percentage of GDP in Selected World Regions



Source: World Bank staff compilation based on data from ICI, OECD, World Bank, and national sources.

Note: Data are from 2009 or latest year available.

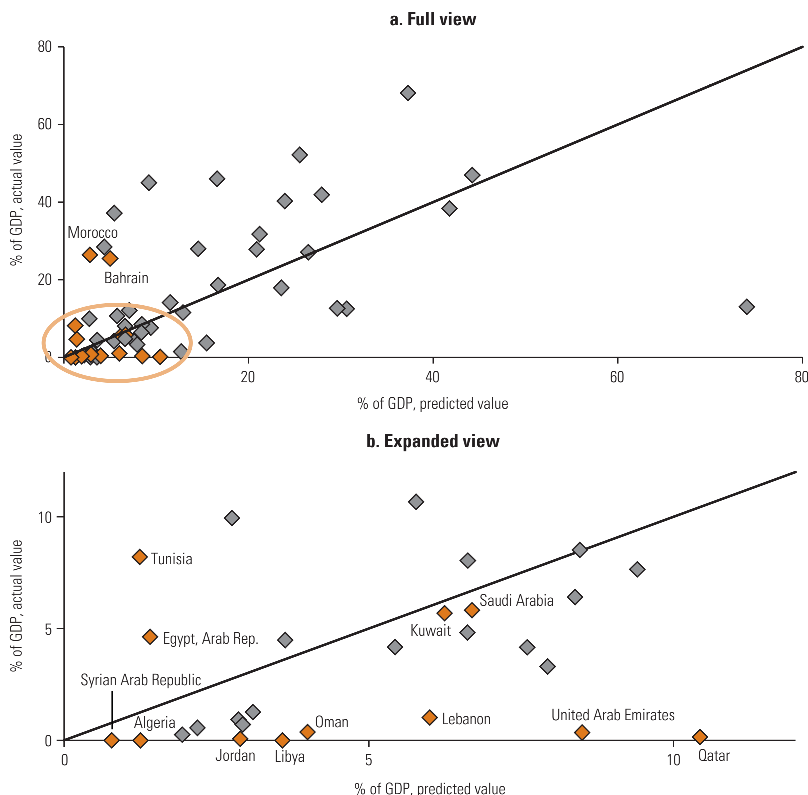
The combination of a large market capitalization and a thin private domestic institutional investor base raises questions about the effectiveness of equity markets in MENA. Equity markets can perform important functions, including the provision of finance for corporate investment, the efficient allocation of resources through price discovery and valuation, and efficient corporate governance through disclosure and a market for corporate control, as well as the provision of instruments to savers. Chapter 9 shows that equity markets in the region have failed to perform many of these functions well, as a result of several problems, including the lack of private institutional investors, restrictions on foreign investors, and gaps in regulation. (Mako, Feyen, and Sourrouille [2011] provide a more detailed analysis of equity markets in the region.)

Fixed-income markets

The stock of domestic government debt is sizable in many MENA countries, especially non-GCC countries, but government debt markets remain undeveloped. Large stocks of domestic debt reflect the large deficits in these countries, which have led to a high regional ratio of debt to GDP (figure 3.24). However, government debt markets are undeveloped in MENA and remain underrepresented in global bond indexes

FIGURE 3.17

Actual and Predicted Mutual Funds as a Percentage of GDP, by Country, 2009



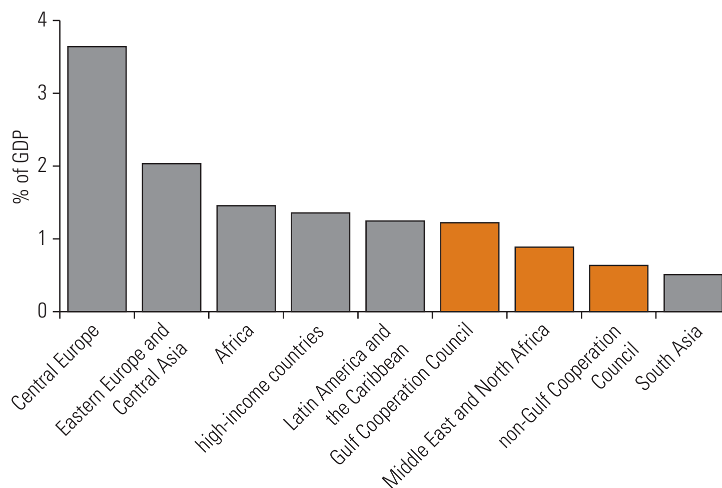
Source: World Bank staff calculations based on data from ICI, OECD, World Bank, and national sources.

(figure 3.25). These indexes are based on investability criteria that include capital controls, taxes, secondary market liquidity, size of the institutional investor base, quality of regulations, and market infrastructure. Only two countries in the region—Egypt and Morocco—are included in these indexes and both have very small shares, reflecting their relatively low scores. The lack of investability conditions (especially liquidity) has resulted in the very limited participation of foreign investors in MENA debt markets, further hindering their development.

Private fixed-income markets remain negligible in MENA (figure 3.26). Instruments such as corporate bonds, mortgage bonds, mortgage-backed securities, and other asset-backed securities practically do not exist. Part of the problem lies in the lack of developed government debt markets, including the lack of a reliable yield curve for government

FIGURE 3.18

Leasing Volumes as a Percentage of GDP in Selected World Regions

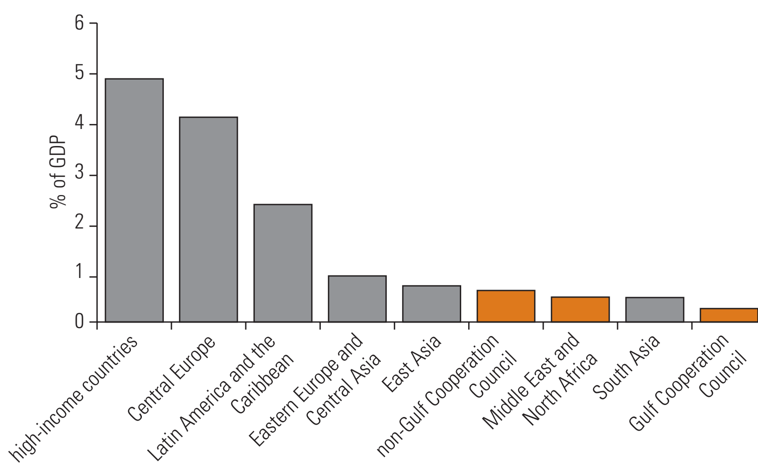


Source: World Bank staff compilation based on data from Euromoney.

Note: Data are from 2008 or latest year available.

FIGURE 3.19

Factoring Volumes as a Percentage of GDP in Selected World Regions

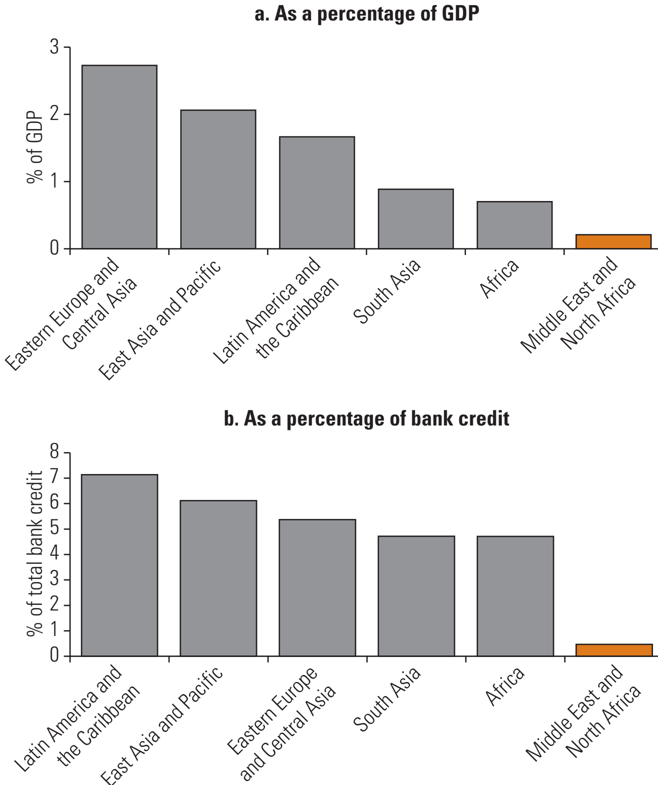


Source: World Bank staff compilation based on data from FCI.

Note: Data are from 2008 or latest year available.

FIGURE 3.20

Microfinance Loans in Selected World Regions, 2009



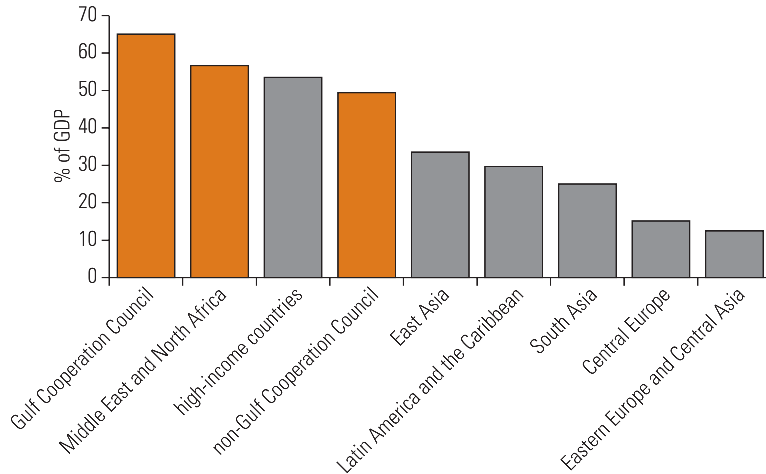
Source: World Bank staff compilation based on data from MIX.

securities that provides a pricing benchmark for private securities. Some of the problems that hinder the development of public markets—such as the lack of an institutional investor base—also hinder the development of private markets. Other factors, including the absence of basic laws and regulations, also limit the development of private markets. For example, no MENA country has prepared legislation on mortgage-covered bonds, an instrument used extensively in the European Union to fund housing loans. There have been some limited securitizations, but growth has been limited by flaws in the regulatory and institutional framework (lack of a housing price index, lack of ratings, flaws in the securitization chain).

The absence of private fixed-income markets in MENA is worrisome. The lack of a corporate bond market means there is no alternative to bank finance, especially for investment, and less competition in the banking system than there otherwise would be. The absence of other

FIGURE 3.21

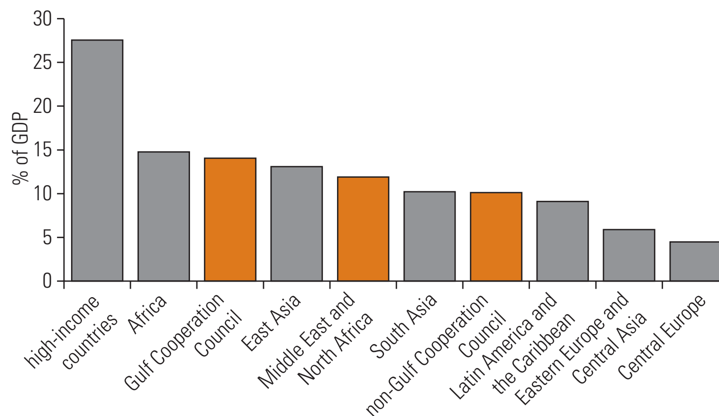
Market Capitalization as a Percentage of GDP in Selected World Regions, 2009



Source: World Bank staff compilation based on data from Standard & Poor's and World Federation of Exchanges.

FIGURE 3.22

Market Capitalization of the Nonfinancial Corporate Sector as a Percentage of GDP in Selected World Regions, 2009

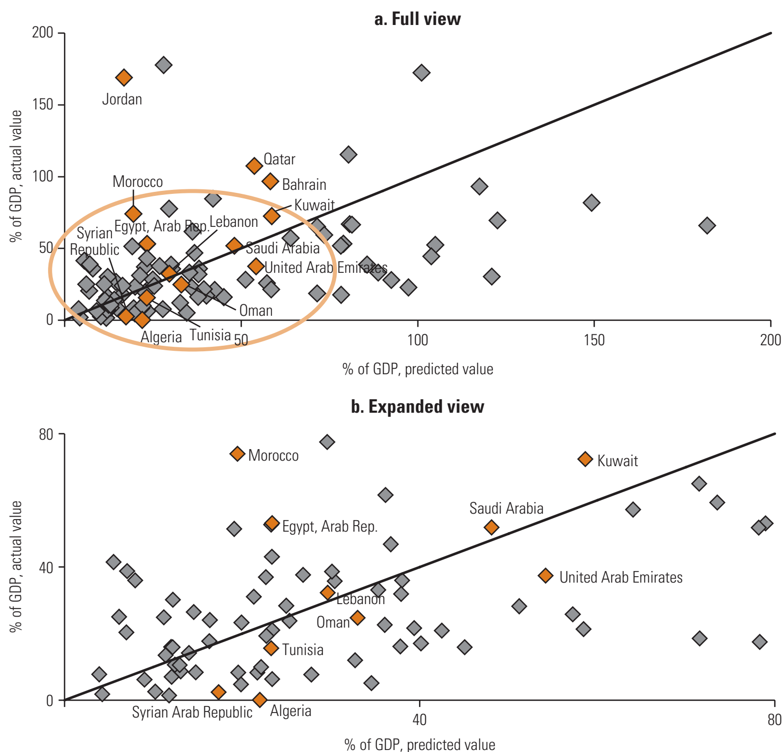


Source: World Bank staff compilation based on data from Standard & Poor's and World Federation of Exchanges.

funding instruments—such as covered bonds and mortgage-backed securities, limits the scope for banks to expand long-term mortgage lending while hedging their interest rate and liquidity risks. These issues are examined in more detail in chapter 9.

FIGURE 3.23

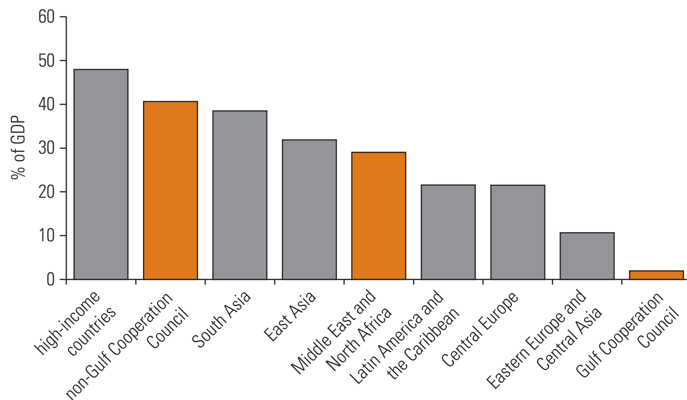
Market Capitalization as a Percentage of GDP, by Country, 2008



Source: World Bank staff compilation based on data from Standard & Poor's and World Federation of Exchanges. See Appendix A.

FIGURE 3.24

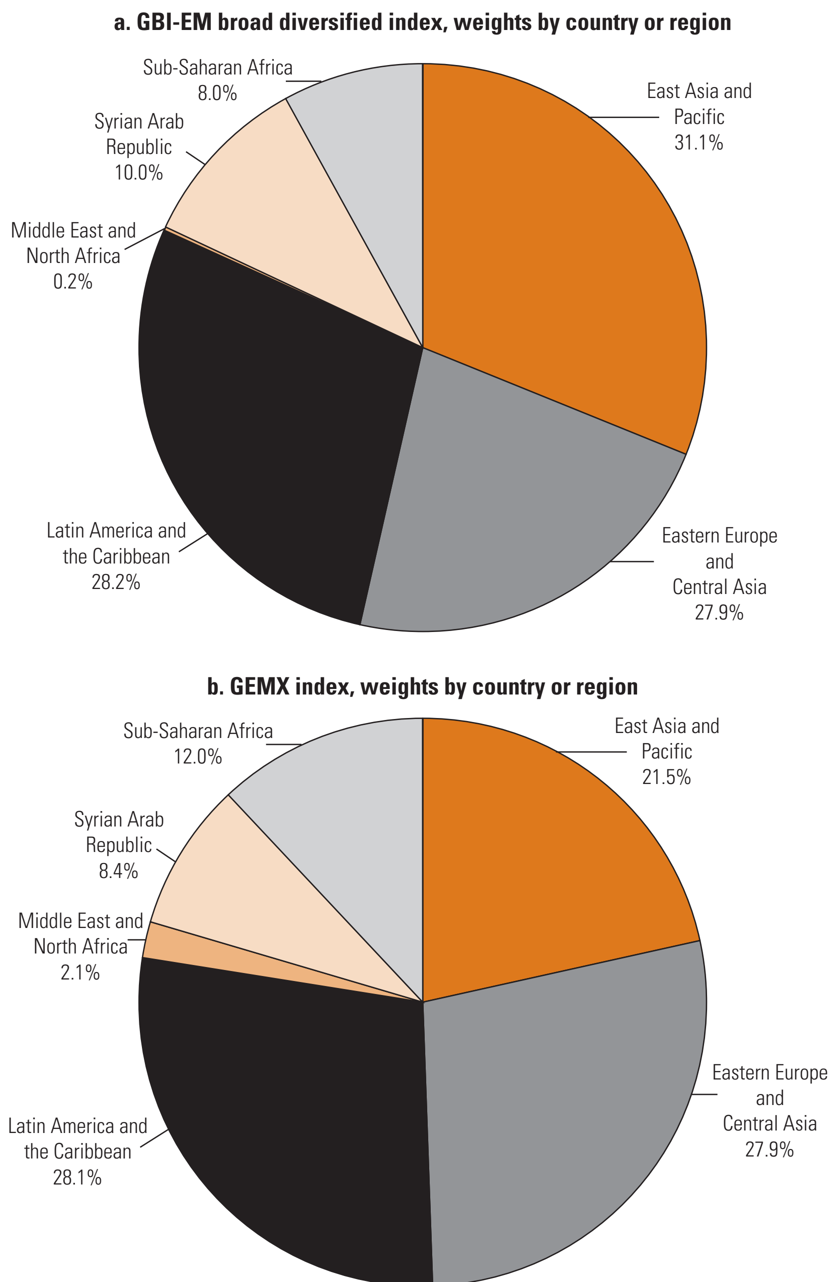
Domestic Public Bonds as a Percentage of GDP, by Region, 2009



Source: World Bank staff calculations based on data from the Bank for International Settlements, World Bank, and national sources.

FIGURE 3.25

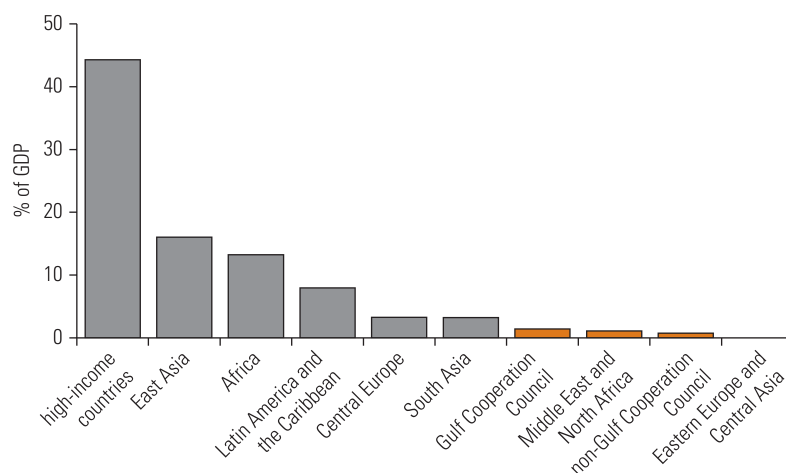
GBI-EM Broad Diversified and GEMX Index Weights, by Country or World Region, 2009



Sources: Government Bond Index–Emerging Markets (GBI-EM); GEMX Index.

FIGURE 3.26

Domestic Private Bonds as a Percentage of GDP, by Region, 2009



Source: World Bank staff calculations based on data from the Bank for International Settlements, World Bank, and national sources.

Notes

1. There is some evidence that price synchronicity declines with the presence of foreign investors, suggesting that these investors have contributed positively to fundamental equity valuation and price discovery (see chapter 9).
2. A large share of banks in MENA are listed (see Farazi, Feyen, and Rocha 2011).
3. Garcia-Kilroy and Silva (2011) show that banks dominate the market for government securities in non-GCC countries. Farazi, Feyen, and Rocha (2011) show that state banks provide more government finance than private banks.
4. The benchmarking technique is discussed in more detail in Beck and others (2008). The annex summarizes this discussion and provides additional results based on quantile regressions on panel data.
5. The benchmarking model does not include remittances and other foreign inflows, but Aggarwal, Demirgüç-Kunt, and Martinez Peria (2006) show that workers' remittances help explain the ratio of bank deposits and credits to GDP. Calderon and Kubota (2009) show that financial depth is also influenced by financial openness, as measured by the volume of foreign assets and liabilities.
6. Lester (2011) provides a thorough analysis of insurance sectors in MENA. Feyen, Lester, and Rocha (2011) present a comprehensive cross-country analysis of the sector that provided the empirical basis for Lester's paper and this report.
7. Mako and Sourrouille (2010) and NCB Capital (2010) provide a detailed analysis of MENA's mutual funds.
8. Bakker and Gross (2004) document the rapid growth of leasing in Central Europe during the 1990s and early 2000s. They argue that this growth was motivated by weak creditor rights that restricted lending to small and medium enterprises.
9. Pearce (2011) examines the microfinance industry in MENA.

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CHAPTER 4

Do Financial Systems in the Region Provide Access?

This chapter assesses the performance of MENA financial systems, with a focus on their capacity to provide access to finance. It examines whether these undiversified, heavily bank-based financial systems have delivered access to credit and other financial services to enterprises and individuals.

The analysis of access outcomes is based on a battery of access indicators based on enterprise- and bank-level data. These indicators include the share of enterprises with a loan, the sources of investment financing, the number of bank deposit and loan accounts, loan concentration ratios, the volume of small and medium enterprise and mortgage lending in loan portfolios, and the reach of the microcredit industry. Some of these indicators can be considered final outcome indicators; others can be viewed as intermediate outcome indicators. However, combined they form a coherent picture of the progress achieved in providing access to finance.

The chapter shows that access outcomes have been generally disappointing in most MENA countries. Although MENA banks are generally well capitalized and the ratio of credit to GDP is generally high by international standards, the region does not compare well with other regions in access outcomes. The volume of bank credit may be large by international standards, but credit is much more concentrated than in other regions. Many important segments, such as small and medium enterprises, remain deprived of credit, and alternatives to bank finance are generally lacking, even for larger enterprises. Housing finance is still undeveloped. The outreach of the microfinance industry is limited.

The findings in this chapter are fully consistent with those of a recent World Bank flagship report on private sector development (World Bank 2009) that notes the existence of two private sectors in the region. The first consists of older, well-connected firms that face little competition. The second consists of new and younger investors, who generally manage smaller firms and struggle to expand. The private sector development report notes that productivity gains and growth are more likely to come

from the generation of new investors than the expansion of existing firms. This chapter shows the access-to-finance restrictions facing this new generation of investors.

The chapter also shows how traditional indicators of financial development can be deceptive. The literature on financial development frequently relies on depth indicators, such as the ratio of private credit to GDP or the ratio of market capitalization to GDP as key measures of financial development. The literature recognizes that depth and access are two different dimensions of financial development and have to be assessed separately but the two dimensions are expected to be correlated. The MENA region provides a good example of how the two dimensions can be disconnected. It also shows the importance of a holistic assessment of the financial sector with the use of a wide variety of indicators.

The chapter is structured as follows. The first section analyzes enterprise-level indicators, built on enterprise surveys conducted by the World Bank. The second section reports a battery of bank-level indicators, including the number of deposit and loan accounts, loan concentration ratios, and the volume of small and medium enterprise and mortgage lending. The third section examines access in the small but important microcredit sector. The last section discusses the lack of access in areas where good indicators are not available. The evidence provided in this chapter paves the ground for the next chapter, which addresses the central question posed in this report, namely, why access to finance is so restricted in MENA.

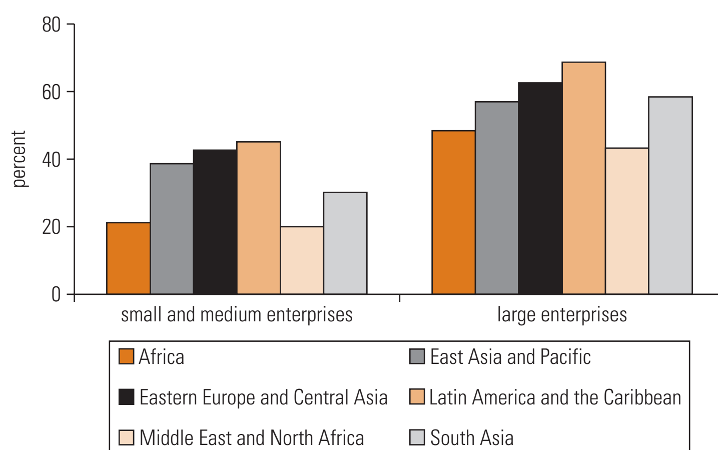
Enterprise-Level Indicators of Access

Enterprise-level surveys conducted by the World Bank show that MENA enterprises, especially small and medium enterprises, are financially constrained. Just 20 percent of small and medium enterprises in MENA have a loan or line of credit, a significantly lower share than in all other regions except Africa (figure 4.1). A larger share of large enterprises in MENA has a loan or line of credit (about 42 percent), but the region does not compare well at this level either, having essentially the same average share as Africa and a much smaller share than other regions. These data suggest that even among large enterprises, firms with better-established connections have captured most of the credit, a possibility that is consistent with the very high loan concentration ratios shown below.

Relative to businesses elsewhere in the world, enterprises in MENA rely more on internal sources of finance for their working capital needs, which account for 84 percent of working capital finance for small and medium

FIGURE 4.1

Share of Enterprises with a Loan or Line of Credit, by Firm Size and World Region



Source: World Bank surveys conducted between 2005 and 2010.

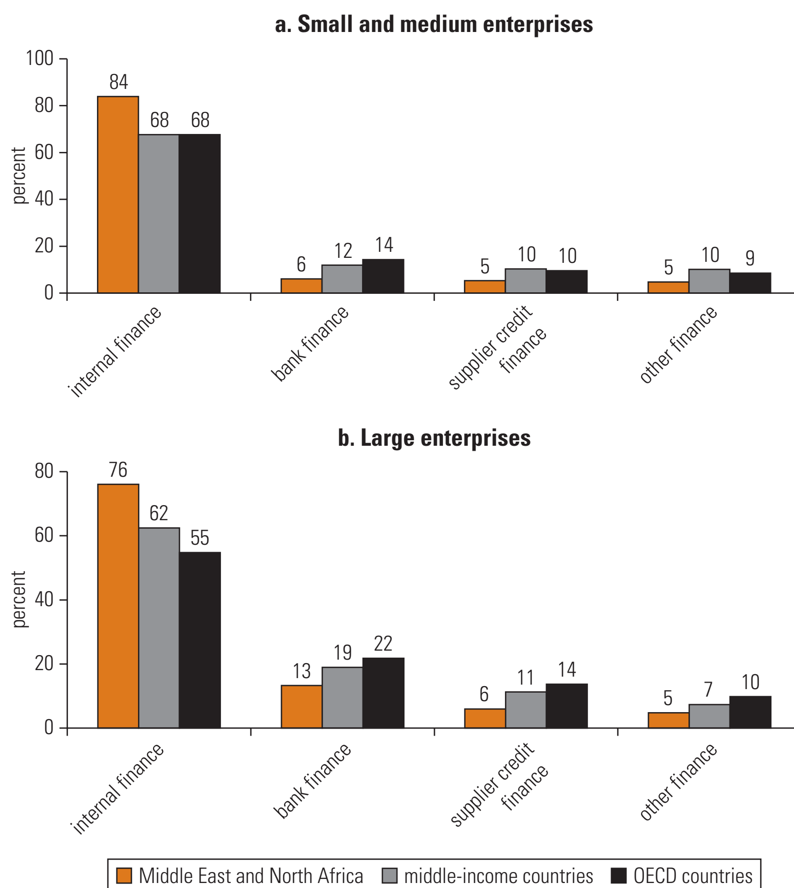
enterprises and 76 percent of working capital finance for large enterprises (figure 4.2). These shares are larger than in other emerging economies, reflecting the greater scarcity of external sources. Access is more restricted for small and medium enterprises, but access by large enterprises in MENA also seems more restricted than in other emerging economies.

MENA enterprises seem to face more restricted access to all external sources of finance. They generally make less use of bank finance, supplier credits, and other sources of finance than their counterparts in other emerging regions. The limited access of small and medium enterprises to bank credit to finance working capital needs is noteworthy. Their lack of access to factoring (an alternative source of short-term financing for small and medium enterprises in many countries), reflected in the low shares of financing from suppliers' credit and other finance, is consistent with the limited development of the factoring industry in the region shown in chapter 3. The situation of large enterprises is better than that of small and medium enterprises but worse than that of large enterprises in other emerging economies.

Relative to businesses in other regions, enterprises in MENA also rely more on internal sources of finance for their investment needs. Internal sources account for 85 percent of investment finance among small and medium enterprises and 75 percent among large enterprises (figure 4.3). Enterprises in other regions also rely extensively on internal finance to implement their investment programs, but the shares for emerging economies and developed countries are much smaller.

FIGURE 4.2

Sources of Working Capital Finance, by Firm Size and Country Group



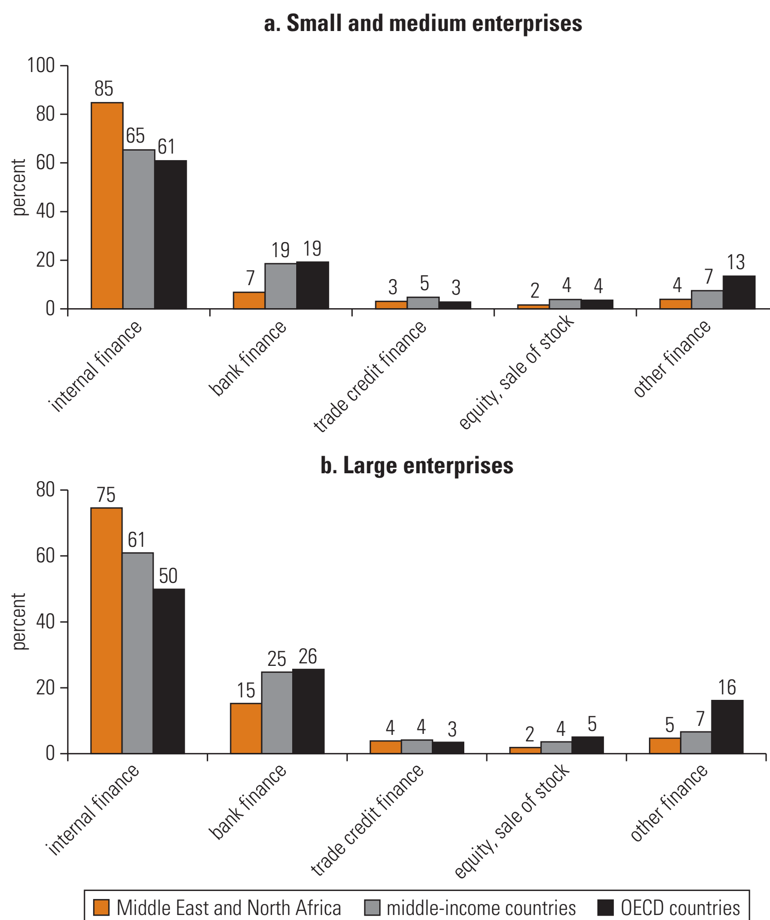
Source: World Bank surveys conducted between 2005 and 2010.

Note: OECD = Organisation for Economic Co-operation and Development.

The region's small and medium enterprises have little access to bank credit to finance their investment programs. The share of equity finance is also smaller, partly reflecting the more limited development of the private equity industry and the modest results of the dedicated exchanges for small and medium enterprises in the Arab Republic of Egypt and Tunisia.[1] Small and medium enterprises also have less access to other sources of finance, a residual category in enterprise surveys that captures a variety of sources, including leasing. This result is consistent with the limited development of the leasing industry shown in chapter 3. Large enterprises also report less recourse to equity finance, a finding that is consistent with the modest capitalization of enterprises in industry and services shown in chapter 3. They also report less recourse to other sources of finance.

FIGURE 4.3

Sources of Investment Finance, by Firm Size and Country Group



Source: World Bank surveys conducted between 2005 and 2010.

Note: OECD = Organisation for Economic Co-operation and Development.

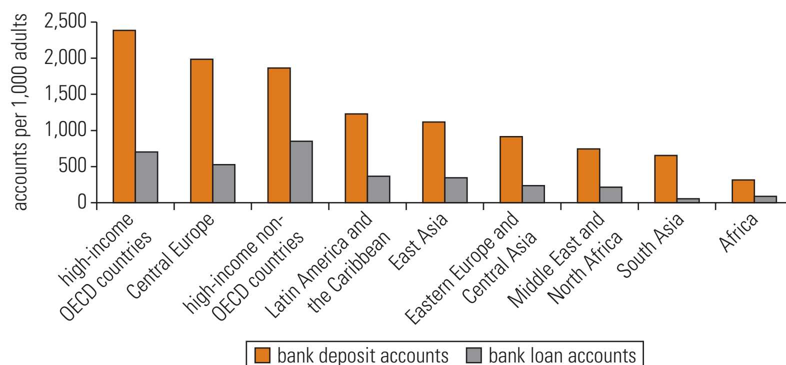
Bank-Level Indicators of Access

Number of Deposit and Loan Accounts per Adult

The number of deposit and loan accounts per adult in MENA is lower than in all regions except South Asia and Africa (figure 4.4). These important indicators reflect both limited banking penetration and restricted access to credit. Most countries in the region are below a simple regression line that shows the values predicted by income levels (figure 4.5). Lebanon, whose banking system is very large relative to the country's per capita income, is one of the notable exceptions.

FIGURE 4.4

Number of Bank Deposit and Loan Accounts, by World Region, 2009



Source: CGAP 2010.

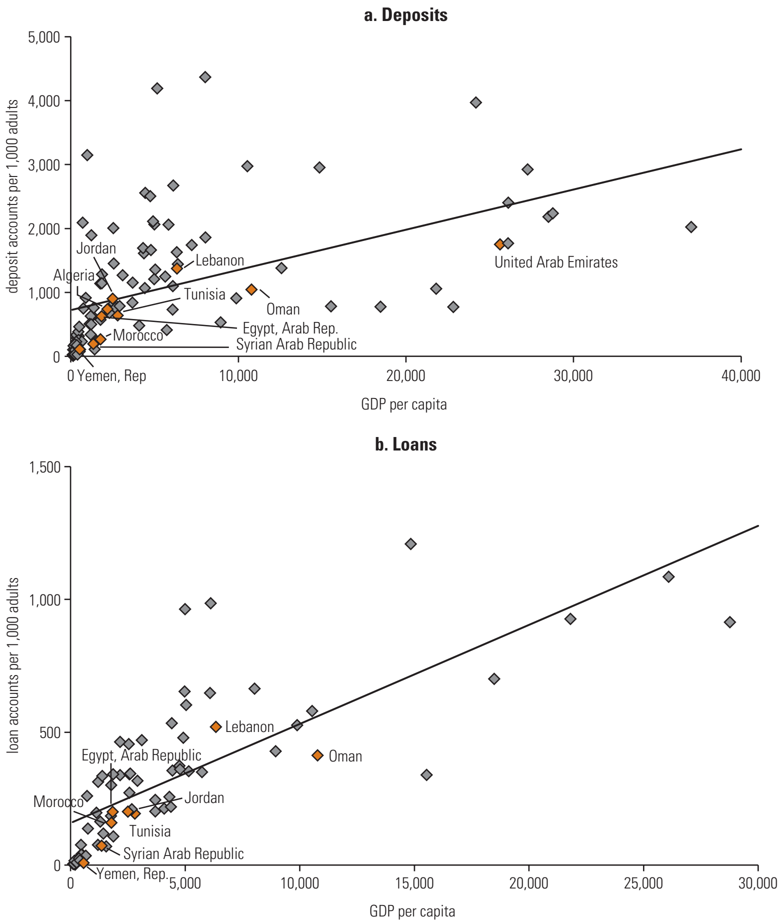
Most countries in the region compare even more poorly with other regions considering the large size of their deposits and credits relative to GDP. Figure 4.6 plots the number of deposit accounts per 1,000 adults against the ratio of deposits to GDP. Figure 4.7 plots the number of loan accounts per 1,000 adults against the ratio of private credit to GDP. Both figures show a positive association between these variables, but most countries in the region fall well below the regression line. This result is revealing, reflecting the lack of a close correlation between depth and access in MENA and the comparatively large average value of deposits and loans in the region. It is noteworthy that Lebanon's large deposit base is not matched by a commensurate number of deposits, possibly reflecting the large average value of deposits of nonresidents.

Postal savings banks and post offices are important providers of savings and payment services for the low-income population in MENA. Several countries in the region, including Egypt, Morocco, Tunisia, and the Republic of Yemen, have postal networks that provide financial services to the population. The financial services provided by the Moroccan post office are being transferred to a new postal bank created with the objective of expanding banking services in remote areas. If the accounts of these postal offices and banks were included, deposit penetration figures would improve significantly for these countries, but the benchmarking sample would need to include the deposits of postal offices and banks, as well as the deposits in savings and credit cooperatives in all the other countries, to ensure a fair comparison.[2]

Mobile phone banking, which could significantly increase banking penetration, has not yet taken off in MENA. Promising countries for

FIGURE 4.5

Correlation between Number of Bank Deposit and Loan Accounts per Adult and GDP per Capita in the Middle East and North Africa, 2009

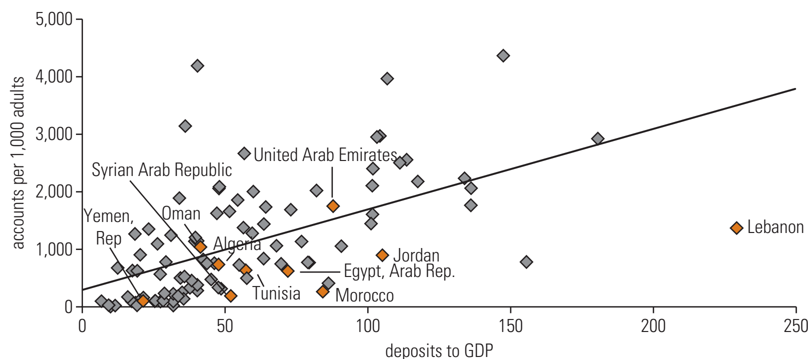


Source: World Bank staff calculations based on data from CGAP 2010 and World Bank 2010.

mobile banking include Egypt, Jordan, Morocco, Tunisia, and the Republic of Yemen, all of which have large rural populations and high mobile penetration, but few mobile phone–based financial services have been launched. However, regulators in high-potential markets such as Egypt and Morocco are starting to ease regulatory constraints and allow banks to link with mobile operators to launch financial services through mobile phones. An emerging example of the harnessing of technology in MENA is the use of electronic wallets linked to cards and mobile phones that can be used to withdraw cash, pay bills, make deposits, and send or receive money transfers.[3]

FIGURE 4.6

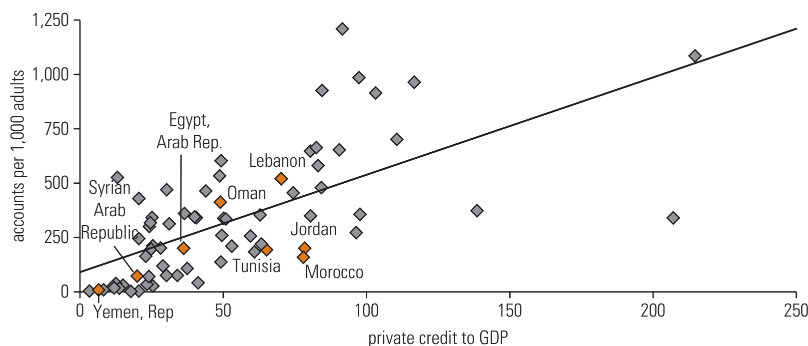
Correlation between Number of Deposit Accounts and the Ratio of Deposits to GDP, 2009



Source: World Bank staff calculations based on data from CGAP 2010 and World Bank 2010.

FIGURE 4.7

Correlation between Number of Loan Accounts and Ratio of Credit to GDP, 2009



Source: World Bank staff calculations based on data from CGAP 2010 and World Bank 2010.

Loan Concentration Ratios

MENA has a high average loan concentration ratio, measured as the ratio of the top 20 exposures to total equity.[4] The average loan concentration ratio outside of the Gulf Cooperation Council (GCC) is the highest in the world, reflecting the focus of banks on large enterprises and the concentrated loan portfolio of many banks in the region (figure 4.8). The average loan concentration ratio in the GCC is somewhat lower, reflecting the region's greater progress in developing retail lending, especially consumer loans, as well as the larger equity base.

However, the GCC ratio is still high by international comparison, reflecting large loans to real estate developers and companies in the oil and gas sectors and the lack of progress in developing small and medium enterprise and mortgage lending. In both regions, high loan concentration reflects the existence of long-established connections between large banks (both public banks and family-controlled private banks) and large enterprises and economic groups that has been documented in other reports (World Bank 2009).

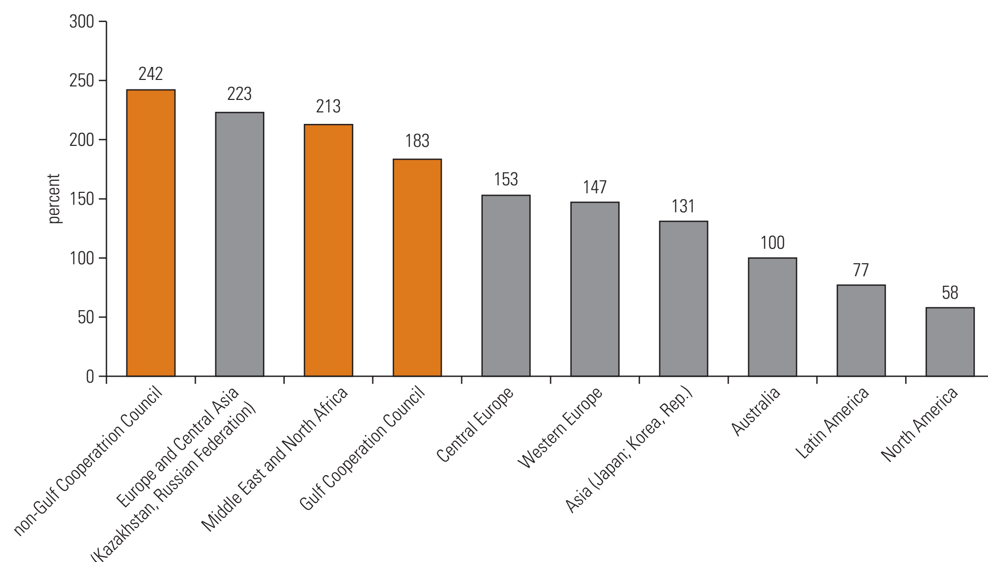
The ratio of top 20 exposures to total loans—arguably a better measure of access[5]—is also higher in non-GCC countries (figure 4.9). (These ratios are not available for regions other than MENA.) High loan concentration could imply that even some large enterprises face restricted access to credit, as noted in figures 4.1–4.3. However, the individual ratios reveal that loan concentration is also associated with little progress in developing business lines such as small and medium enterprise lending and mortgage finance.

Small and Medium Enterprise Lending

Lending to small and medium enterprises is expanding in MENA, but it still accounts for only a small share of the loan portfolio in many coun-

FIGURE 4.8

Top 20 Loan Exposures as a Percentage of Total Equity, by World Region

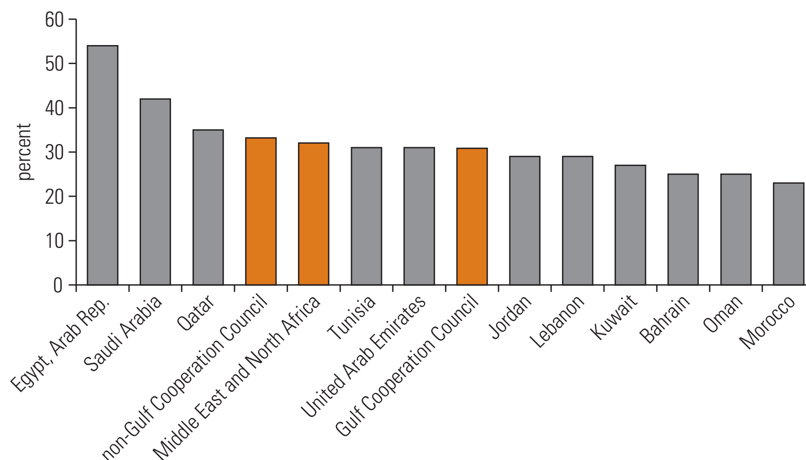


Sources: Standard & Poor's 2005a, 2005b, 2007, 2010.

Note: Data are regional averages computed between 2005 and 2010.

FIGURE 4.9

Top 20 Loan Exposures as a Percentage of Total Loans in the Middle East and North Africa, by Country, 2010



Source: Standard & Poor's 2010.

tries. The average share of small and medium enterprise loans in total loans is only 8 percent for the region as a whole, a low ratio by comparison with other benchmark groups of developed and developing countries (figure 4.10). The average share of small and medium enterprise lending in the GCC region is still very small, amounting to only 2 percent of total loans. The average share in the non-GCC countries is higher, at 13 percent of total loans, but it is still lower than the ratio in other comparator groups.

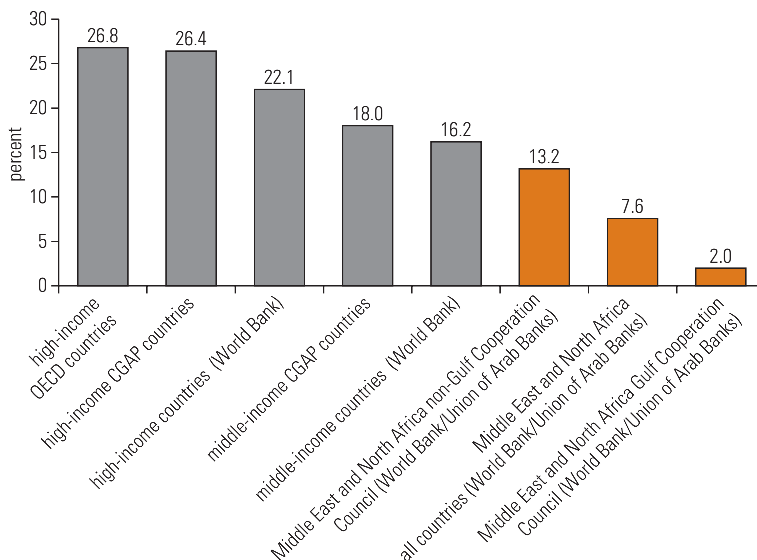
There is a wide dispersion in the share of small and medium enterprise loans among non-GCC countries. In contrast, the share in the GCC is low across all countries (figure 4.11). The share of small and medium enterprise loans ranges from 4 to 24 percent of total loans among non-GCC countries, with Morocco, Lebanon, and Tunisia among the top lenders; the share of small and medium enterprise loans in total loans is small in Egypt and the Syrian Arab Republic.

The various access indicators portray a very consistent picture of the status of small and medium enterprise lending in the region. For example, among non-GCC countries, Lebanon and Morocco have lower loan concentration ratios and the largest shares of small and medium enterprise loans in total loans, as shown in figures 4.9 and 4.11.

Also worthy of note is the broad consistency between the results of enterprise- and bank-level surveys in figure 4.12. This comparison is available only for non-GCC countries (no enterprise surveys have been

FIGURE 4.10

Small and Medium Enterprise Loans as a Percentage of Total Loans, by Country Group, 2005–09

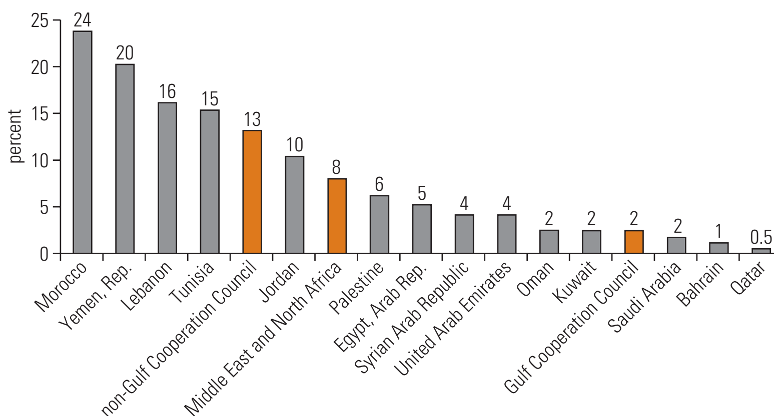


Source: World Bank staff compilation based on data from IFC 2010b; CGAP 2010; Beck, Demirgüç-Kunt, and Martinez Peria 2008; Rocha and others 2011.

Note: Group averages computed.

FIGURE 4.11

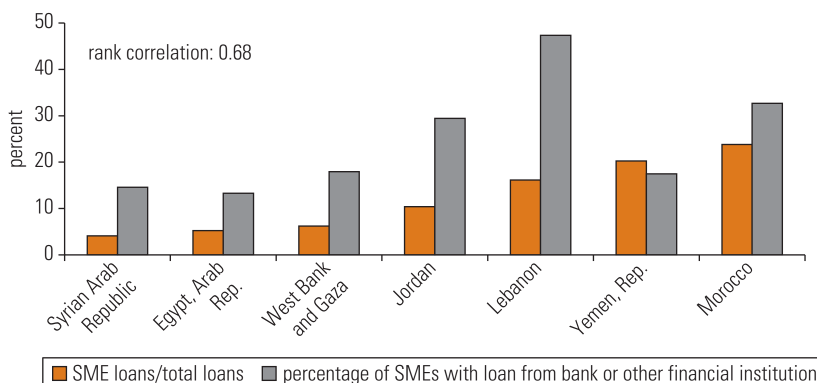
Small and Medium Enterprise Loans as a Percentage of Total Loans in Selected Economies in the Middle East and North Africa, 2009



Source: Rocha and others 2011.

FIGURE 4.12

Loans to Small and Medium Enterprises as a Percentage of Total Loans and Share of Small and Medium Enterprises with Loans from a Bank, in Selected Economies in the Middle East and North Africa



Source: Rocha and others 2011.

Note: SMEs = small and medium enterprise, SME lending in non-Gulf Cooperation Council Middle East and North Africa: Results from two surveys.
SME loans/total loans, 2009; SMEs with loan: average of enterprise surveys, 2005–10.

conducted in GCC countries), but in general, the countries with the largest share of small and medium enterprises with a loan from a bank are also those with the largest share of small and medium enterprise loans as a percentage of total loans (for example, Lebanon and Morocco).

The differences in lending to small and medium enterprises across countries in the region reflect differences in economic structures as well as differences in financial infrastructure and the scope and nature of policy interventions. The differences between the GCC and non-GCC averages reflect the more concentrated structures of oil economies. But other factors also explain the differences across the two regions and individual countries, including the quality of financial infrastructure; the active role of state banks in some countries, such as Crédit Populaire du Maroc; and the existence of special support mechanisms, such as partial credit guarantee schemes. The factors restraining small and medium enterprise finance and the effectiveness of policy interventions are examined in more detail in chapter 5.[6]

Mortgage Lending

Residential housing finance has started to develop only recently in MENA, at least as a market-based activity. Without taking into

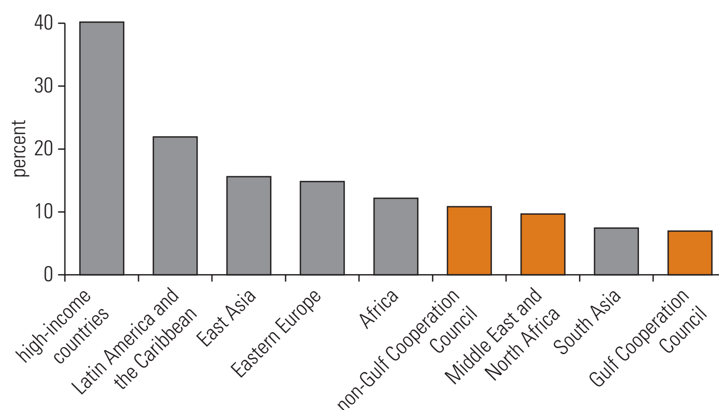
account housing loans directly extended to nationals by government agencies and financed from the budget (a common practice in GCC countries), most countries are still in the infancy phase of market development. The region lags other regions of comparable and even lower income levels (figure 4.13). The lack of adequate mortgage lending is cause for concern, given the region's young population and large housing needs.

Within MENA there are significant differences in the stage of market development. Residential housing loans as a share of GDP and total lending are highly correlated with per capita income and other structural characteristics and therefore amenable to more rigorous benchmarking. Kuwait, Morocco, and Tunisia seem to have made more progress in developing this important business line. Lebanon, Jordan, and the United Arab Emirates have also made progress, although they seem to be performing below their potential (figure 4.14). Note that progress in developing residential housing finance is also correlated with the loan concentration ratios shown in figure 4.9.

Several countries in the region are at an earlier stage of market development, in some cases because of direct financing by the government and the industry's overreliance on nonresidential real estate lending. GCC countries provide subsidized loans to nationals. These programs have met a large share of housing needs, although they frequently entail waiting lists or rationing and can be poorly targeted.[7] Nonresidential real

FIGURE 4.13

Housing Loans as a Percentage of Total Loans, by World Region

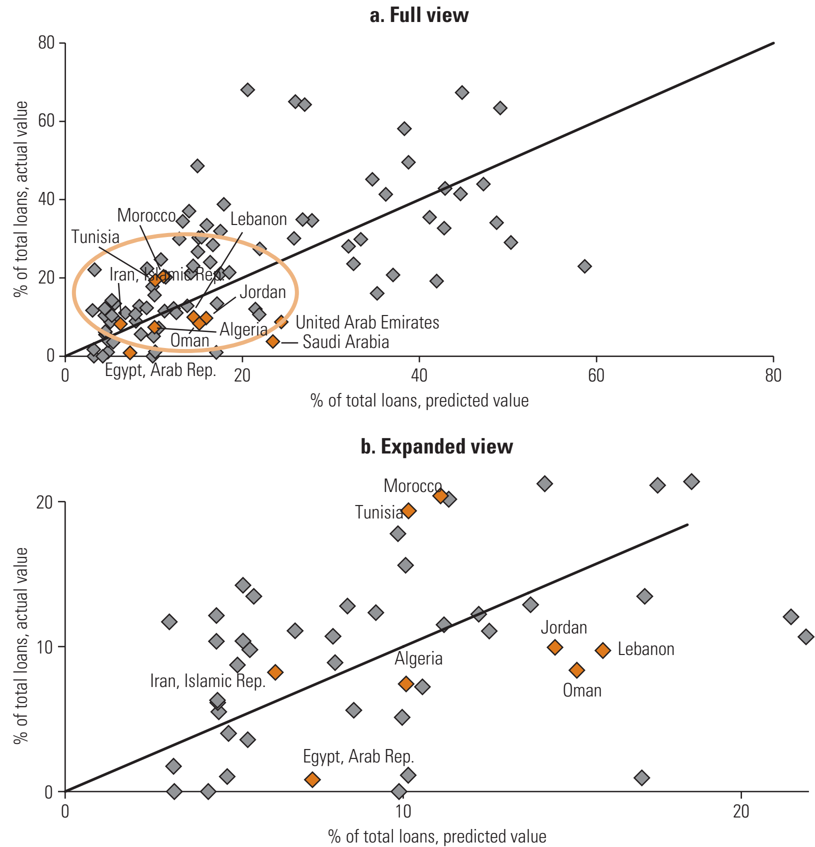


Source: World Bank staff calculations based on data from national sources and the World Bank Housing Finance Unit database.

Note: Data are regional averages computed on 2010 figures or latest available year.

FIGURE 4.14

Actual and Predicted Volume of Housing Loans as a Percentage of Total Loans, 2009



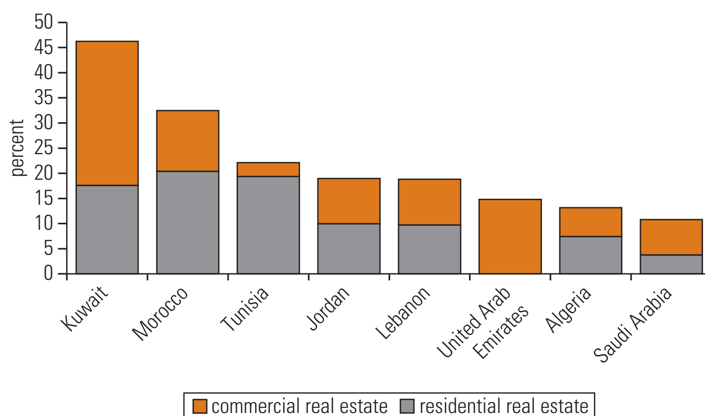
Source: World Bank staff calculations based on data from national sources and the World Bank Housing Finance Unit database.

estate lending (the financing of developers and commercial real estate) is significant in some countries (figure 4.15). This mode of real estate lending can meet the needs of enterprises and households, but it entails much greater risks, as a result of the much larger size of individual loans, the greater risk of mismatches between supply and demand, and the risk of connections between lenders and developers, which increases credit risk at loan origination.

Residential housing finance is a fundamental component of a broader housing finance system. A well-functioning mortgage finance system contributes to both improved access and the mitigation of the risks associated with real estate lending. Developing this system is challenging, however, and still lies ahead for several MENA countries.[8]

FIGURE 4.15

Residential and Commercial Real Estate Loans as a Percentage of Total Loans in Selected Countries in the Middle East and North Africa, 2009



Source: Hassler 2011.

Chapters 5 and 10 examine the problems related to mortgage finance and the roadmap for market development.[9]

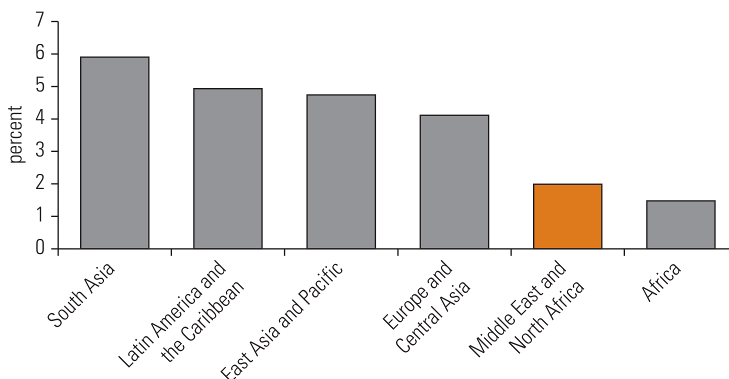
Microcredit Outreach

The outreach of microcredit institutions remains limited. The coverage ratio of specialized MENA microfinance providers is only 1.8 percent, half the proportion in South Asia or Latin America (figure 4.16). The low penetration reflects the limited volume of microcredit relative to GDP and to total bank credit, as shown in chapter 3. The proportion of women clients in MENA (more than 60 percent) is higher than in all regions except Asia (figure 4.17), but the value of this achievement is reduced by the limited total outreach.

Very few countries in MENA have achieved coverage ratios comparable to those in other regions. Morocco and Jordan have achieved high rates of access to microcredit, in line with averages in other regions (figure 4.18). The growth of microcredit in Morocco was impressive, although the foundations for this rapid expansion proved to be flawed. A weak credit information system did not allow microfinance institutions to detect and control multiple borrowings, and the industry structure was too heavily based on nongovernmental organizations, which lacked transparency, sound governance structures, and risk management capacity. The regulatory framework for the Moroccan microcredit sector is being overhauled. Its experience provides valuable lessons for other countries.[10]

FIGURE 4.16

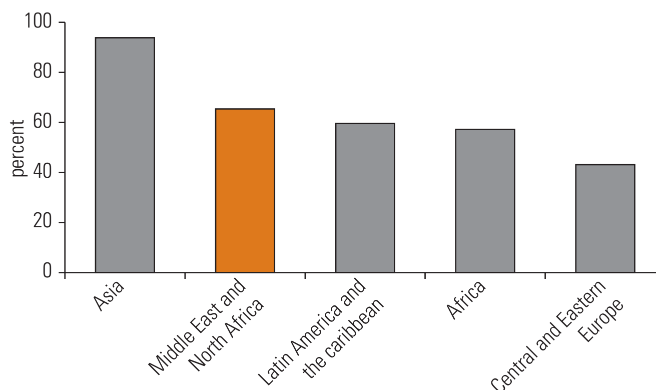
Active Microcredit Borrowers as a Percentage of the Working-Age Population in Selected World Regions, 2009



Source: World Bank staff compilation based on data from Micro Finance Information Exchange (MIX) and World Bank.

FIGURE 4.17

Percentage of Women Microcredit Borrowers in Selected World Regions, 2009



Source: World Bank staff compilation based on data from Micro Finance Information Exchange (MIX) and World Bank.

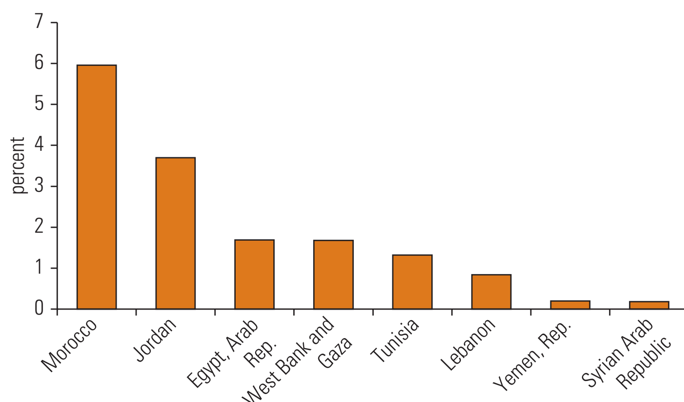
Access to Other Financial Services

Investment and Long-Term Finance

Investment lending in the GCC is frequently provided by specialized state banks or institutions. Commercial banks also participate, through syndications, although the extent of their involvement is difficult to assess, because of deficiencies in data reporting. Specialized

FIGURE 4.18

Active Microcredit Borrowers as a Percentage of the Working-Age Population in Selected Economies in the Middle East and North Africa, 2009



Source: World Bank staff compilation based on data from Micro Finance Information Exchange (MIX) and World Bank.

state institutions do most of the long-term lending in the GCC. Private banks participate in loan syndications and usually benefit from some government guarantee. Deficiencies in data reporting do not allow an accurate assessment of the maturity of investment loans, but most private banks do not seem to extend loans beyond five years. Many of these loans are provided at floating rates, exposing the borrower to interest rate risk. Some large institutions have issued corporate bonds/*sukuk*s, but they do not constitute a regular source of investment finance.[11]

Outside the GCC, the role of state banks in investment finance varies significantly across countries. In systems dominated by the state, state banks provide most investment lending. For example, the Commercial Bank of Syria provides 95 percent of investment loans in Syria. State banks are also involved in other countries such as Morocco, where the Caisse de Depôts e Gestion and Crédit Populaire du Maroc provide investment lending and organize syndicates with private banks. In countries without state banks (Lebanon, Jordan), private banks provide all long-term finance. Smaller loans are provided directly; larger loans are provided through syndications (to diversify risks and comply with limits on large exposures). Loan maturities vary from three to seven years but usually do not exceed five years. Banks typically charge the London interbank offered rate (LIBOR) plus a premium.

It is difficult to measure the degree of access to investment finance from bank data, because of deficiencies in financial reporting and disclosure rules. Enterprise surveys indicate that MENA banks provide a small contribution to investment finance relative to banks in other regions (see figure 4.3). Bank financial statements do not provide information on maturities and business lines, preventing an accurate assessment of investment finance from the side of banks (and revealing a deficiency in financial reporting). The limited information available suggests that most large enterprises have access to term finance and that state banks play an important role in this area, especially regarding state enterprises. State banks have been more willing to provide longer tenors and charge fixed rates, whereas private banks usually limit their exposures to five years and charge variable rates. Several state banks are also active with small and medium enterprises: the average share of investment loans in small and medium enterprise loans is 32 percent for state banks and 22 percent for private banks (Rocha and others 2011).

Risk Management

Access to risk management tools is restricted in MENA, limiting private bank participation in some important areas and creating large risk exposures. Long-term funding instruments are not developed, leaving banks and enterprises exposed to interest rate and liquidity risks when they lend long term. Some countries (Egypt, Jordan) have introduced mortgage refinance corporations to deal with these risks, but these arrangements are limited to mortgage finance. In the absence of these arrangements, private banks take defensive positions, shortening their exposures or shifting some of these risks to their customers. Interviews with bank managers and regulators suggest that private banks in MENA are increasing their share of long-term lending for investment and housing. Monitoring and managing these risks will be one of the key challenges faced by regulators in the coming decade, as discussed in chapters 7 and 10.

Emerging derivatives markets have grown rapidly all over the world, but they are a missing market segment in MENA, with meaningful trading only in Bahrain, Saudi Arabia, and the Dubai International Financial Center.[12] Daily turnover of foreign exchange derivatives amounted to US$3.8 billion in Bahrain in 2010, with US$3.6 billion in foreign exchange swaps, a significant increase over previous years. In Saudi Arabia, daily foreign exchange derivatives trading amounted to US$2 billion in 2010, with nearly US$1.3 billion in foreign exchange swaps. Interest rate derivative turnover is very modest in the region.

The foreign exchange derivatives market is the most developed derivative market segment in most emerging economies. It has failed to develop in MENA for a variety of reasons. Most countries in the region have longstanding exchange rate pegs and impose restrictions on capital flows or nonresidents' transactions in local currency, and shallow local capital markets are unattractive to foreign investors who would use foreign exchange derivatives as hedging, speculative, or funding instruments in these markets. Interest rate derivatives are a smaller segment than foreign exchange derivatives in emerging economies, but they have been growing rapidly. Interest rate derivatives are used only sporadically in MENA countries, however, as a result of the lack of deep underlying money and bond markets, benchmark yield curves, and the limited presence of foreign investors in these embryonic local fixed-income markets.

Notes

1. Egypt and Tunisia introduced stock exchanges for small and medium enterprises (NILEX and Marché Alternatif), in an effort to facilitate access by reducing costs and loosening stringent criteria; neither market is particularly active (see chapter 9).
2. MENA countries do not have savings and credit cooperatives, an important sector in many emerging regions, such as Latin America and Central Europe.
3. Pearce (2011) provides a comprehensive analysis of financial inclusion in MENA.
4. The concept of adjusted total equity is elaborated in Standard & Poor's (2004, 2005a, 2005b, 2007). The authors are grateful to the Paris office of Standard & Poor's for the updated figures for MENA reported in figure 4.8.
5. The risks associated with high loan concentration can be offset by a large equity base, leading to lower ratios of the top 20 exposures to equity. However, high loan concentration implies restricted access to credit, especially by small and medium enterprises and individuals, which is captured in the ratio of top 20 exposures to loans, regardless of the size of equity.
6. Rocha and others (2011) provide an analysis of small and medium enterprise lending in MENA based on a joint survey conducted by the Union of Arab Banks and the World Bank.
7. In Saudi Arabia the ratio of nonperforming loans reached 36 percent of total loans in 2006, and there were 450,000 waiting applicants and a 12-year waiting period (World Bank 2006).
8. Egypt has made substantive progress in recent years; Saudi Arabia has started facing this challenge through a comprehensive package of mortgage lending recently prepared by the government.
9. Hassler (2011) provides a detailed analysis of housing finance in MENA.
10. Pearce (2011) provides a detailed analysis of financial inclusion, including the microcredit industry.
11. Large wholesale banks in Bahrain also organize long-term finance for large projects in the GCC, mostly in real estate. The most popular form of project

finance is the special purpose vehicle model. The lead bank identifies a project, raises equity contributions from high-net-worth investors, establishes a special purpose vehicle in which it typically holds a 5 percent stake, and uses the proceeds to finance the project. The special purpose vehicle subsequently raises additional financing from other wholesale banks.

12. The triennial survey of foreign exchange and derivatives markets conducted by the Bank for International Settlement tracks over-the-counter foreign exchange and interest rate derivatives. Of the 53 central banks that participated in the 2010 survey, only two (Bahrain and Saudi Arabia) were in MENA.

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CHAPTER 5

Main Factors Limiting Access to Finance

This chapter identifies the main factors that have hindered access to finance in the MENA region. Chapter 3 provided an overview of the size and structure of MENA's financial systems, showing how these systems are heavily bank based and undiversified. Chapter 4 showed that access to finance is very restricted in MENA in comparison with other emerging regions. This chapter examines the institutional, legal, and regulatory factors that have contributed to poor access outcomes in the region. It pulls together various pieces of research and diagnostic work in order to analyze the causes of poor access outcomes. Chapters 6–9 provide more detail on the institutional and regulatory weaknesses identified in this chapter.

The chapter argues that MENA's access problems are the result of a variety of factors, including weak financial infrastructure, weak banking competition, and flaws in the institutional and legal framework that have hindered the growth of nonbank financial institutions, instruments, and markets. Moreover, these factors are closely connected. Various policy interventions have mitigated the problems of access, but they have not addressed the roots of the problem.

The analysis is not a judgment of the merits and drawbacks of bank-based and market-based systems. The long-standing debate on this issue is largely inconclusive (Levine 2002). Policy makers have instead focused on building resilient, competitive, and inclusive financial systems. These efforts have increased the diversification of financial systems, including bank financing, market financing backed by institutional investors, and alternative sources of finance, such as leasing and factoring. It is important to stress in this regard the deep transformation of financial systems in the European Union (EU) in the past three decades, from bank-based systems to diversified systems combining elements of bank and market finance, including a solid base of nonbank financial institutions (Rajan

and Zingales 2002 and Issing 2003, cited in Gaspar, Hartmann, and Sleijpen 2004).

The chapter is structured as follows. The first section discusses financial infrastructure and the lack of competition in the banking system, providing selected examples of the regulatory factors underlying the absence of nonbank financial institutions and the absence of markets. The second section assesses the effectiveness of the policy interventions that have been introduced to improve access, including the use of state banks, credit guarantee schemes, and other types of interventions. The last section sums up the chapter's findings and conclusions.

Main Factors Hindering Access to Finance

Inadequate Financial Infrastructure

Credit reporting systems

Credit reporting systems comprise public credit registries and private credit bureaus. They play two key functions in a financial system: supporting banking supervision and promoting access to finance by reducing risks for lenders.[1] Supervisors use credit reporting systems to predict bank portfolio performance. Lenders use credit reporting systems to screen potential borrowers and monitor their performance. Public credit registries usually jumpstart credit reporting in a country, but the substantial gains in coverage and depth of information are usually achieved by private credit bureaus. In the absence of solid credit information, lenders adopt defensive positions, requiring substantial collateral, increasing interest rates, or rationing credit, all of which hinder the growth of segments such as the small and medium enterprise sector.

Credit reporting has improved in recent years, but MENA is still overly dependent on traditional public credit registries, and both the coverage and the quality of information need improvement. MENA's credit reporting systems have improved in recent years with the upgrading of public credit registries (in Lebanon, Oman, Tunisia, the West Bank and Gaza, and the Republic of Yemen) and the introduction of new private credit bureaus (in the Arab Republic of Egypt, Morocco, Saudi Arabia, and the United Arab Emirates). These improvements increased the region's credit information index (see chapter 6). However, almost 60 percent of countries in the region still rely entirely on public credit registries, a much higher share than in all other regions except Africa (table 5.1). The excessive reliance on traditional public credit registries may be one reason that MENA still compares poorly with other regions in credit information coverage (figure 5.1).

TABLE 5.1

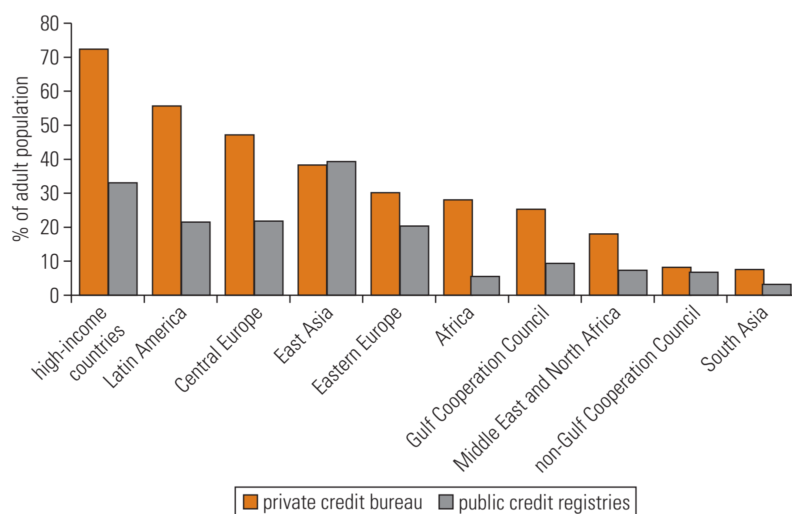
Number and Percentage of Countries with Public Credit Registries and Private Credit Bureaus, by World Region, 2010

Region	Both public credit registry and private credit bureau		Private credit bureau only		Public credit registry only		Not available/ negligible coverage
	Number	Percent	Number	Percent	Number	Percent	Number
Organisation for Economic Co-operation and Development (OECD)	7	26.9	17	65.4	2	7.7	0
Latin America and the Caribbean	13	72.2	3	16.7	2	11.1	3
South Asia	1	20.0	3	60.0	1	20.0	2
Europe and Central Asia	7	33.3	7	33.3	7	33.3	2
East Asia and Pacific	1	11.1	4	44.4	4	44.4	4
Middle East and North Africa	3	17.6	4	23.5	10	58.8	1
Africa	0	0.0	8	26.7	22	73.3	13
All regions	32	25.4	46	36.5	48	38.1	25

Source: World Bank 2011.

FIGURE 5.1

Coverage of Private Credit Bureaus and Public Credit Registries, by World Region, 2010



Source: World Bank 2011.

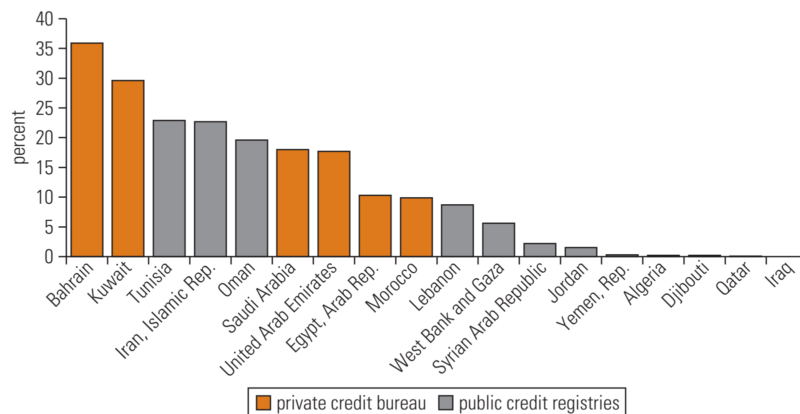
Note: Averages are computed only for countries with operating private bureaus or public registries.

Countries in the Gulf Cooperation Council (GCC) have taken the lead in introducing private credit bureaus. Bahrain, Kuwait, Saudi Arabia, and the United Arab Emirates have introduced private credit bureaus and generally gained more coverage as a result, particularly in the case of bureaus introduced early in the 2000s (Bahrain and Kuwait) (figure 5.2). This increase in coverage facilitated the expansion of retail lending in the GCC during the decade. The Saudi private credit bureau started as a consumer bureau but now also operates as a commercial bureau, which has recently made impressive gains in coverage (not yet reflected in the coverage statistics). By contrast, only two non-GCC countries, Egypt and Morocco, have introduced private credit bureaus in recent years.[2] These young private credit bureaus are likely to increase the coverage and quality of credit information in coming years, but improvements will ultimately depend on efforts to expand the number of reporting entities (especially microfinance institutions, utilities, and retailers) and to widen the type of data collected.

Most public credit registries in MENA have played the traditional and limited role of collecting information from regulated entities and disseminating the data in an aggregate format. A few new public credit registries, such as those in Oman and the West Bank and Gaza, seem to operate like private credit bureaus; others (in Algeria, Lebanon, Libya, the Syrian Arab Republic, and the Republic of Yemen) are undergoing upgrades. It is too early to assess whether these efforts will generate the required gains in coverage and depth of information, but the experience of other countries

FIGURE 5.2

Maximum Coverage of Private Credit Bureaus and Public Credit Registries, by Economy, 2010



Source: World Bank 2011.

suggests that effective credit reporting systems are rarely limited to public credit registries. Most countries have either maintained both types of entities or have introduced and regulated a private credit bureau to serve the functions of supervision and credit information. Improvements in credit information also depend on how the private credit bureau is designed and regulated. Credit reporting is further discussed in chapter 6.

Creditor rights

MENA lags other emerging regions in the introduction of effective collateral regimes that strengthen creditor rights and promote lending to underserved sectors. This is possibly the weakest component of the financial infrastructure. As one indication of the severity of problems in this area, the region ranks last in a cross-regional comparison of the legal rights index of *Doing Business*; the MENA country that scores best ranks 106th overall.

Most countries in the region have severe weaknesses in all the components of the chain of secured lending, including serious problems with the following:

- Scope of the law (the types of movable collateral that can be used are limited)
- Creation of secured rights (the legal requirements to create a right against property are cumbersome)
- Priority given to secured creditors in case of default (unlike other regions, secured creditors in MENA do not have clear priority rights outside or inside bankruptcy)
- Registration of collateral (most countries lack a unified electronic database with all information on existing security rights, accessible to all lenders for a reasonable fee in real time)
- Enforcement of security rights (the process of seizing collateral when the debtor defaults is difficult; there are no established procedures for out of court enforcement)
- Final sale or disposition of the collateral (the rules guiding the sale of the collateral can be cumbersome, requiring public auctions with minimum prices set by the courts).

The weaknesses in almost all of the components of collateral regimes in countries in the region reveal the need for an overhaul of these regimes. This fundamental weakness in financial infrastructure has been identified in recent surveys and research as a major constraint to bank lending to small and medium enterprises (Rocha and others 2011); it also affects other areas of finance, such as mortgage finance and leasing. The collateral regime has been improved in some countries for fixed collateral,

especially in the area of registration, but enforcement and disposition of fixed collateral remain difficult. All components of the collateral regime for movable collateral remain weak. Chapter 6 provides further analysis of collateral regimes (see also Alvarez de La Campa 2010).

Financial infrastructure for mortgage finance

The financial infrastructure required for an effective mortgage finance system includes all the elements listed above plus additional ones that are lacking in some MENA countries. In addition to effective credit information and collateral regimes, mortgage finance requires physical identification of properties (cadastres) and clear definition of owners (titling). These components are generally of high quality in GCC countries and some non-GCC countries, such as Lebanon and Jordan. Algeria and Egypt have also made improvements in these areas. Elsewhere in the region, the cadastre and titling functions require improvements.

In addition, the development of mortgage finance in MENA has also been hindered by a number of non-financial constraints whose discussion is out of the scope of this report, but that have to be briefly mentioned because of their importance. In particular, the lack of availability of land in many MENA countries has had an adverse impact on housing prices often affecting their affordability. Constraints on land availability can be due to physical factors and/or to policy weaknesses. For example, the large extension of desert areas and the use of scarce land for agriculture have constrained physically the areas available for residential or commercial construction. In some cases, however, land scarcity is primarily due to policy weaknesses reflected in the narrowness of free land markets, speculative investments in land, or inefficient use of the available land (reflected in the large number of low density developments). Hassler (2011) provides a detailed analysis of housing finance in MENA.

Weak Competition in Banking Systems

Weak bank competition is another plausible explanation for the strong loan concentration and restricted access to finance in most countries in the region. Despite low net interest margins in most of the region, especially non-GCC countries and positive trends in market structure; the decline in the market share of state banks; and the increase in the market share of foreign banks (see chapter 7), there is evidence that the region's banking systems are still less competitive than those in other regions. The reduction in the share of state banks in non-GCC countries and the entry of foreign banks in recent years bodes well for the future, but these changes in structure may have not been sufficient to increase competitive pressures in the main credit markets. Moreover, empirical estimates of banks' market power suggest that banking systems in MENA

remain less competitive than banking systems in other regions, because of stricter entry requirements, weak credit information systems, and lack of competition from capital markets and nonbanking institutions, among other factors (box 5.1).

The results of empirical research identifying the factors that restrict banking competition provide a useful and credible roadmap for enhancing competition. They suggest that improving competition may require a package of reforms that includes relaxing licensing requirements and procedures without sacrificing the quality of entrants,[3] improving financial infrastructure, and developing alternatives to bank lending. Although the share of foreign banks has increased in many countries, many of these banks remain small and do not seem to be challenging incumbent banks in their main credit markets. Their failure to do so could reflect a deliberate strategy of exploring a niche (upscale consumer lending, trade finance), but it could also be a result of the lack of credit information.

More effective credit information systems would level the playing field between large and small banks (including new foreign banks) and allow these banks to expand more rapidly. Small banks would expand more rapidly if they had access to reliable information on the creditworthiness of potential borrowers. Therefore, improvements in financial infrastructure would increase access through two channels: reducing risks for all lenders regardless of their size and enabling smaller banks to compete more effectively. Competitive pressures could be applied on all segments of the credit market by offering leasing and factoring as alternative sources of finance to small and medium enterprises and by strengthening institutional investors (mutual funds, insurance companies) as a means of broadening the investor base for corporate issues.

Reducing loan concentration may also require stricter supervision of large exposures and connected lending. In many cases, the high loan concentration in MENA reflects long-established connections between large banks (including state banks and family-controlled private banks) and industrial groups. Such lending frequently entails large exposures and connected lending that may not have been well regulated or supervised. Therefore, a stricter approach to regulation and supervision of large exposures and connected lending may need to be included in a package of reforms aimed at reducing loan concentration and improving competition.

Missing Institutions and Markets

One of the key questions addressed in this report is why nonbanking financial institutions and markets have been so slow to develop in MENA. The sections above discussed how financial infrastructure and nonbanking financial institutions and instruments could contribute to access by

BOX 5.1

Bank Competition in the Middle East and North Africa

Higher levels of bank competition are associated with lower prices for banking products, greater efficiency, and wider access to finance. Traditional measures of competition, such as the Herfindahl index and the share of the top banks, are not reliable, because they do not capture market contestability. Measures such as net interest margins are not reliable either, because they do not take into account concentrated lending to favored sectors (government, state-owned enterprises, large and connected enterprises), which can result in low lending interest rates and low margins.

Preferred indicators of competition include the Lerner index (a markup measure) and the *H*-statistic, defined as sum of the elasticities of a firm's revenue with respect to the firm's input prices. A value of 1 indicates perfect competition; a negative value indicates a monopoly. Estimates of the Lerner index and the *H*-statistic suggest that competition in MENA is lower than in most emerging regions (Anzoategui, Martinez Peria, and Rocha 2010).

Moreover, cross-country regressions designed to explore the determinants of the *H*-statistic provide insights on the factors restricting bank competition in MENA. The results suggest that MENA banking systems have been less competitive as a result of an inferior credit information environment, stricter regulations and practices governing bank entry, and lack of competition from nonbanking financial institutions and capital markets.

BOX TABLE 5.1.1

Determinants of the *H*-Statistic of Banking Competition

Explanatory variable	Dependent variable: *H*-statistic	
Dummy MENA = 1	−0.11	−0.02
	[−1.97]*	[−0.20]
Concentration (share of assets held by top three banks)	−0.035	−0.167
	[−0.20]	[−1.06]
Credit information index	0.02	0.03
	[1.87]*	[2.09]**
Minimum capital requirement (billions of dollars)	−0.17	−0.03
	[−1.05]	[−0.16]
Percentage of bank license applications denied	−0.27	−0.08
	[−2.25]**	[−0.81]
Number of entry requirements	−0.11	−0.09
	[−3.30]***	[−2.92]***
Stock market capitalization	0.14	
	[3.21]***	
Nonbank financial institutions		0.17
		[3.10]***
Observations (number of countries)	45	43
R-squared	0.50	0.46

Source: Anzoategui, Martinez Peria, and Rocha 2010.

Note: Robust *t*-statistics in brackets.

* significant at 10 percent; ** significant at 5 percent; *** significant at 1 percent.

reducing risks to lenders, providing alternative financing sources on their own right, and enhancing competition. The weaknesses in infrastructure were briefly discussed above. This section provides illustrative examples of the factors that have hindered the emergence of nonbank financial institutions, markets, and instruments. Chapters 6–9 provide more detailed analysis of these factors.

To a large extent, the slow development of nonbank financial institutions, instruments, and markets has been a result of the lack of enabling legislation in some key areas. The absence of legislation reveals the lack of interest by incumbent institutions in promoting alternatives to bank finance and enhancing competition in their own markets.[4] It also reveals the lack of more proactive policies for financial development and financial access by policy makers and regulators. The situation differs from country to country; in some countries regulators have been very active, drafting new legislation and making efforts to promote new institutions, markets, and instruments. However, the number of cases in which enabling primary legislation or key secondary regulations are missing merits highlighting.

The leasing sector has not been developed in many countries in the region, as a result of basic flaws in legislation, including the absence of legislation that introduces clear definitions of leasing and rights and responsibilities of the parties to a lease. The lack of registries for leased assets and the problems of repossessing leased assets in the case of default have also hampered the growth of the sector. Tax rules that do not recognize leasing as a financing mechanism have created an uneven playing field between leasing and other forms of finance, hindering the sector's growth. These are important findings, because countries in Central Europe and other regions have shown that it is feasible to address these flaws and develop a leasing industry that serves small and medium enterprises and compensates for the lack of bank lending as a result of weak creditor rights (Bakker and Gross 2004). Chapter 8 reviews the main issues in the leasing sector.

The lack of development of the insurance sector is also a result of a wide range of regulatory and supervisory gaps, including the absence of mandatory insurance in key areas; the predominance of state companies in some countries, which stifles competition and innovation; basic gaps in supervision, including the lack of enforcement of compulsory insurance, such as auto insurance; controls on insurance premiums; unsupportive tax regimes; fragmented market structures; and the lack of products that reflect cultural and religious preferences. The case of Morocco described in chapter 3 illustrates the possibility of developing the insurance sector more rapidly. Chapter 8 provides a more detailed diagnostic of this sector.

The lack of private fixed-income instruments is also a result of factors that are within the reach of policy makers. One of the preconditions for the development of private fixed-income securities is the development of a reliable benchmark yield curve for government securities. No MENA country has been able to build a reliable yield curve. The agenda for the development of a government debt market may be challenging, but it is within the reach of policy makers, as demonstrated by small countries in Central Europe and Latin America. The development of fixed-income instruments also depends on enabling legislation that in some cases has not been drafted. As mentioned in chapter 3, MENA country has drafted legislation on mortgage covered bonds, the instrument used by many EU countries to fund their mortgage loans. Chapter 9 provides a more detailed analysis of the development of markets and instruments in MENA.

Policy Interventions to Expand Access: Have They Been Effective?

The restricted access to finance in MENA has led many countries to introduce policy interventions to expand access. This has included the active use of state banks, credit guarantee schemes, interest subsidies, and exemptions on reserve requirements. This section provides a brief review of these interventions and an assessment of their effectiveness.

The Financial Performance of State Banks and their Contribution to Access

The share of state banks in MENA has declined in the past decade, although there are significant differences across countries, ranging from no state banks in Jordan and Lebanon to a 70–90 percent market share in countries like Algeria, Iraq, Libya, and Syria. State banks still play an important role in many countries but their contribution to access has been mixed and uneven across countries as indicated below.

The financial performance of state banks has been significantly weaker than that of private banks. A study of nine non-GCC countries shows that state banks have much lower levels of profitability, as a result of larger holdings of government securities (which reduces their interest income), higher ratios of overhead costs to assets (despite lower average wages) as a result of much higher ratios of employment to assets, and higher ratios of loan loss provisions to loans, which reflect the much larger shares of nonperforming loans in their loan portfolios (Farazi, Feyen, and Rocha 2011). Chapter 7 provides further discussion of these results.

Financing of government deficits helps explain the poor financial performance of state banks. It may also have generated other negative

effects. Large state banks providing a captive market for government securities may have undermined fiscal discipline in some non-GCC countries, contributing to persistently large deficits and reducing the room for private sector financing. The dominant presence of state banks may also have contributed to the limited development of government debt markets, reflected most clearly in the lack of reliable and liquid yield curves (see chapter 9).

Development mandates could also explain the poor financial results of state banks, but the evidence that they actually executed these mandates is both mixed and uneven across countries. State banks tend to have large branch networks and may provide essential financial services in remote areas, where access to finance is constrained by high fixed costs. They may also address market failures resulting from asymmetric information and poor enforcement of contracts that ultimately restrict access to credit by enterprises and individuals. However, the effectiveness of state banks in fulfilling these mandates has been mixed and uneven, as noted below.

There is no evidence that state banks have made a significant contribution to expanding access to financial services in remote areas, despite their large employment base. The large employment base and overhead costs could reflect the maintenance of branches in remote areas with low density. However, as explained in more detail in box 5.2, a larger presence of state banks in the banking system does not translate into a larger number of deposit accounts per adult, controlling for other relevant factors, such as per capita income, the number of branches per population, and the share of the urban population. It is possible that some state banks fulfill this mandate more effectively; the exercise described in box 5.2 does not include agriculture banks, postal services, or postal banks, which have more penetration in rural areas. However, these results show that the large staffs of state banks are probably a result of outdated technologies and labor redundancies rather than a well-articulated strategy to promote access in remote areas. Pearce (2011) also shows the limited contribution of state banks to access in remote areas.

State banks in some countries have contributed to financing small and medium enterprises, although they do not seem to have developed the capacity to manage the associated risks. The average share of small and medium enterprise lending of state banks (9 percent of the loan portfolio) is similar to that of private banks (11 percent of the loan portfolio) and are not significantly different controlling for other factors (box 5.3). Moreover, state banks have taken on more risks in this area than private banks, by being less selective in their targeting strategies and maintaining a lower share of collateralized loans and a higher share of investment loans in total small and medium enterprise lending. Evidence shows that state banks have contributed to access in a segment where private banks are

BOX 5.2

State Banks and Banking Penetration in the Middle East and North Africa

There is a widespread assumption that state banks increase access, through extensive branch networks, especially in remote areas not covered by private banks. This hypothesis was tested for MENA using a simple regression analysis in which the dependent variable is the number of deposit accounts per 1,000 adults, an indicator of access widely used in empirical research. The explanatory variables include the logarithm of GDP per capita; the share of the urban population in the total population; the total number of branches per capita; and the share of state banks in total bank assets, which is used as a proxy for the share of state bank branches in total branches, under the plausible assumption of a high correlation between the two variables. The regression also controls for country fixed effects. The results suggest that state banks in MENA have not contributed to banking penetration or greater access to financial services. These results do not take into account the possible contribution of agriculture banks, postal services, or postal banks in some MENA countries.

BOX TABLE 5.2.1

Main Determinants of Number of Deposit Accounts

Explanatory variable	Dependent variable: Deposit accounts per 1,000 adults
Log GDP per capita	556.9
	[7.4]***
Urban population as share of total population (percent)	1.2
	[0.3]
Number of branches per 100,000 adults	7.1
	[1.9]*
Share of state banks in total assets (percent)	–2.4
	[11.4]***
Observations	31
R-squared	0.99
Number of countries	9

Source: Farazi, Feyen, and Rocha 2011.

Note: Robust *t*-statistics in brackets. * significant at 10 percent; ** significant at 5 percent; *** significant at 1 percent.

still reluctant to lend as a result of the weak financial infrastructure. There are significant differences across countries, however, and in some countries their contribution has been limited. Moreover, state banks have weaker lending technologies and risk management systems: a smaller share of state banks has dedicated units for small and medium enterprises, makes use of credit scoring, or conducts stress tests (Rocha and others

BOX 5.3

Determinants of Bank Lending to Small and Medium Enterprises

Enterprise surveys show that only 20 percent of small and medium enterprises in MENA have a loan or line of credit—a smaller share than in other regions. These results motivated the design of a survey conducted by the World Bank and the Union of Arab Banks in 2009. The survey confirms that the share of small and medium enterprise loans in total loans is smaller in MENA than in other comparator group.

The survey also enabled the statistical analysis of the factors promoting lending to this sector. The main dependent variable is the share of small and medium enterprise loans in total loans. The results suggest that large banks are less involved in small and medium enterprise lending, a result that probably reflects the presence of large wholesale banks that do not lend to this sector. Banks in GCC countries are less engaged in small and medium enterprise lending than their non-GCC counterparts. However, there is no significant difference between lending by state and private banks. There is evidence of relationship lending, based on the results for the number of branches and the existence of a separate unit for small and medium enterprises. The coverage of credit bureaus or registries has a positive impact, but it does not significantly explain small and medium enterprise lending (it has a greater impact on the amount of investment lending to the sector, not shown in table 5.3.1). The quality of the legal

BOX TABLE 5.3.1

Main Determinants of Lending to Small and Medium Enterprises in MENA

	Dependent variable: Share of small and medium enterprise loans in total loans					
Explanatory variable	(1)	(2)	(3)	(4)	(5)	(6)
Log total loans	−2.53 [4.59]***	−2.26 [4.08]***	−1.33 [2.48]**	−2.53 [6.51]***	−2.14 [5.36]***	−1.72 [4.22]***
GCC dummy	−6.14 [2.80]***	−7.44 [3.46]***	−11.71 [4.98]***	−6.21 [3.61]***	−8.14 [4.23]***	−9.79 [4.75]***
State ownership dummy	2.00 [1.18]	0.96 [0.60]	1.54 [0.96]	2.23 [1.39]	1.65 [1.10]	1.75 [1.12]
Log number of branches	1.20 [1.43]	1.72 [2.16]**	0.69 [0.94]			
Separate unit for small and medium enterprise clients dummy				5.25 [2.56]**	6.12 [3.05]***	4.45 [2.18]**
Maximum coverage of registry or bureau	−0.01 [0.22]	0.08 [1.69]*	0.03 [0.61]	−0.02 [0.32]	0.06 [1.12]	0.01 [0.21]

(Box continues on the next page.)

BOX 5.3 (continued)

BOX TABLE 5.3.1 (continued)

	Dependent variable: Share of small and medium enterprise loans in total loans					
Explanatory variable	(1)	(2)	(3)	(4)	(5)	(6)
Legal Rights Index	1.92 [2.27]**			1.53 [1.79]*		
Time to register property		−0.07 [4.27]***			−0.06 [3.78]***	
Time to enforce contracts			−0.03 [5.91]***			−0.02 [4.17]***
Credit guarantees as percentage of GDP	10.31 [3.95]***	8.51 [3.09]***	7.19 [2.66]***	12.47 [4.92]***	10.98 [4.02]***	10.12 [3.91]***
Observations	239	239	239	220	220	220
R-squared	0.37	0.37	0.42	0.41	0.41	0.42
Number of countries	15	15	15	15	15	15
Number of banks	96	96	96	88	88	88

Source: Rocha and others 2011.

Note: Robust *t*-statistics in brackets.

* significant at the 10% level. ** significant at the 5% level; *** significant at the 1% level.

framework (measured by three variables) has a significant impact on small and medium enterprise lending. Although countries in the region are generally weak in this area, the result shows that countries that have strengthened creditor rights have been rewarded. Credit guarantee schemes have contributed to small and medium enterprise lending. This robust result holds after controlling for endogeneity bias.

The result shows that many countries in the region have used state banks and partial credit guarantee schemes to increase small and medium enterprise lending in a region characterized by weak financial infrastructure. Although these interventions have achieved some positive results, sustained expansion of sound small and medium enterprise lending will require the strengthening MENA's credit information and creditor rights systems.

2011). This lack of risk management capacity reflects a weaker skills base (consistent with lower wages) and has probably contributed to the poor financial results mentioned above.

State banks have also contributed to the development of housing finance in many MENA countries, although in several cases political interference led to poor financial outcomes and the need for bailouts. State banks pioneered the development of housing finance in Algeria,

Egypt, Morocco, Syria, and Tunisia. This development mandate was critical in the early stages of market development, when financial infrastructure was extremely weak and private banks were reluctant to lend for housing. However, the quasi-monopoly, political interference in pricing and client screening, and transfer of risks to the state eventually led to large losses and bailouts in many of these countries. Most MENA governments are now trying to create the enabling conditions for a mortgage market with many private suppliers, and the role of the state is shifting from one of direct provider to one of maturity refinancer, guarantor, and regulator. The new mortgage markets have been growing, but many challenges lie ahead, as discussed in chapters 7 and 10 (see also Hassler 2011).

State banks have contributed to investment financing, although in some countries such financing seems associated with large stocks of nonperforming loans. As discussed in chapter 4, in many countries state banks or institutions still dominate long-term finance for investment, partly as a result of the lack of long-term funding instruments and derivatives that would allow private banks to manage the associated risks. Private banks also provide investment financing, especially where state banks do not exist. They have traditionally managed these risks by providing loans with shorter tenors and charging variable rates, which may discourage investment in many cases. Therefore, the contribution of state banks or institutions to investment finance remains important in many countries, but the effectiveness of investment projects financed by these institutions is open to question, as indicated by their much larger shares of nonperforming loans, especially in countries where they dominate financial intermediation (see chapter 7).

Contribution of Partial Credit Guarantee Schemes

Ten MENA countries have already established partial credit guarantee schemes to facilitate access to finance by small and medium enterprises. A recent survey examined the objectives, rules, operating procedures, and preliminary outcomes of these schemes (Saadani, Arvai, and Rocha 2011). These schemes seem to have played an important supporting role in many countries, especially in a period in which banks operate with weak financial infrastructure.

Credit guarantee schemes seem to have contributed to more lending to small and medium enterprises in MENA. Countries that have larger credit guarantee schemes (Lebanon, Morocco, and Tunisia) also have larger shares of loans to small and medium enterprises in total loans and larger shares of investment lending to small and medium enterprises. Moreover, a larger share of small and medium enterprises in these countries has a loan or a line of credit (see Rocha and others 2011). This result

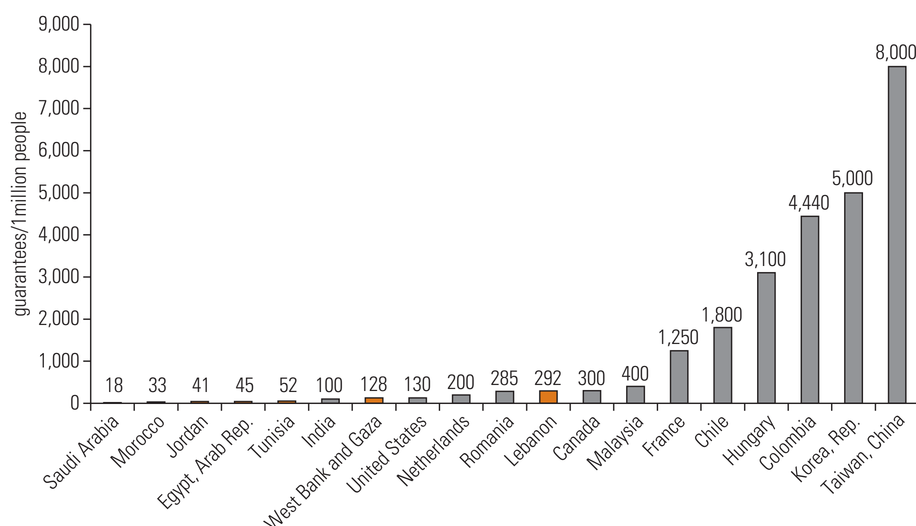
holds, controlling for other factors as well as for endogeneity bias (box 5.3 illustrates the empirical results; Rocha and others 2011 provide detailed results). The result shows that these schemes may have mitigated the weaknesses in credit information and creditor rights and facilitated small and medium enterprise finance.

At the same time, these results do not necessarily imply that partial credit guarantee schemes in MENA are cost-effective, are additional, or promote good-practice lending to small and medium enterprises. The results do not show whether the partial credit guarantee schemes are able to target effectively the more constrained small and medium enterprises and reach the maximum number of credit-constrained enterprises with the volume of guarantees offered. The larger volumes of small and medium enterprise lending could reflect lending to very constrained enterprises or to less constrained enterprises as well (for example, a medium enterprise that could have obtained a loan without a guarantee).

The analysis of outreach of MENA partial credit guarantee schemes suggests that there is ample room for improvement in outcomes for the same volume of guarantees. The average size of guarantee schemes (0.3 percent of GDP) is in line with the international average. However, the number of guarantees issued per year (scaled by the population) is low by international comparison (figure 5.3), and the average value of

FIGURE 5.3

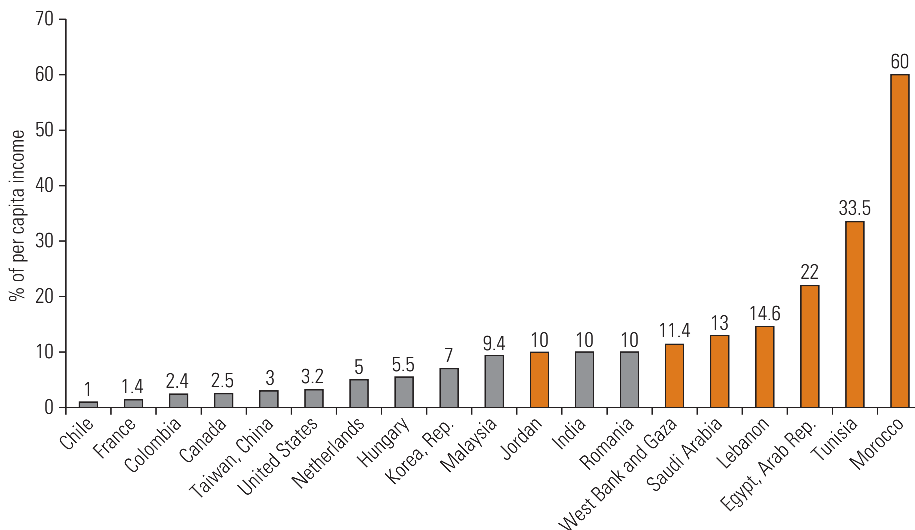
Number of Guarantees per Year in Selected Economies in the Middle East and North Africa, 2009



Source: Saadani, Arvai, and Rocha 2011.

FIGURE 5.4

Average Value of Guarantee as Percentage of per Capita Income in Selected Economies in the Middle East and North Africa, 2009



Source: Saadani, Arvai, and Rocha 2011.

guarantees (scaled by per capita income) is high (figure 5.4). These results suggest that guarantees may still be concentrated in a relatively limited segment of firms (perhaps medium-size firms) and do not yet reach a significant number of smaller and more constrained firms. The assessment of the design of these schemes suggests that there is scope for calibrating their rules and achieving gains in outreach and additionality (see chapter 10).

Other Types of Policy Interventions

State banks and partial credit guarantees are the most common interventions used to address perceived market failures and promote access to finance. Some countries in the region have also introduced other types of interventions, such as subsidized interest rates (Lebanon) and exemptions on reserve requirements (Egypt and Lebanon).

Exemptions on reserve requirements may not be an effective instrument for inducing small and medium enterprise lending when the fundamental problems constraining access stem from weak financial infrastructure. Exemptions on reserve requirements linked to small and medium enterprise lending tend to reduce spreads and lending rates for all small and medium enterprises, failing to target enterprises that are

credit constrained. The reduction in interest rates resulting from the exemption would probably be small relative to the risk component of interest rates to small and medium enterprises (box 5.4). Therefore, expansion in lending triggered by the decline in lending rates may include a very small share of credit-constrained small and medium enterprises. If the fundamental cause of credit rationing is the lack of credit information and weak creditor rights, the problem may be more effectively addressed by a well-designed credit guarantee scheme (that reduces creditor losses upon default). Small and medium enterprise lending in Egypt has remained small despite exemptions on reserve requirements in place for many years (Rocha and others 2011). Lebanon has generated more small and medium enterprise lending, but the increase may be a result of other types of interventions.

Lebanon provides a battery of incentives that seems to have induced more lending to favored sectors. Within the region, Lebanon, which has no state banks, has introduced the largest number of interventions to induce private banks to lend to small and medium enterprises and housing. Credit guarantees, interest subsidies, and exemptions on reserve requirements probably contributed to the positive access outcomes

BOX 5.4

Exemptions on Reserve Requirements and Lending Rates: A Stylized Example

In a simple balance sheet structure in which $L + R = D$, where L = loans, R = compulsory reserves (equal to rR, where r is the reserve ratio), and D = deposits, the zero profit condition for a bank is $i_L = i_D + fD$, where i_L = lending rate, i_D = deposit rate, and f = operating costs per unit of deposits. The equilibrium lending rate is $i_L = (i_D + f)/(1 - r)$.

Assuming i_D = 5 percent a year, f = 1.5 percent, and r = 15 percent (reasonable assumptions for many MENA countries), the annual lending rate would have to be 7.6 percent to cover funding and operating costs as well as the costs of reserve requirements. Exemptions on reserve requirements in this case would reduce the lending rate by about 1.1 percent (from 7.6 percent to 6.5 percent a year) or 110 basis points. Although this reduction is not negligible, it would probably be small relative to the risk component of the interest rate to small and medium enterprises, which can amount to several hundred basis points for enterprises perceived as risky. If the small and medium enterprise is perceived to be very risky, creditors will not lend at any rate.

described in chapter 4. However, the cost-effectiveness of these schemes has not been evaluated. Lebanon is a unique case in many aspects, as a result of an overfunded banking system and a sovereign that is poorly rated because of its high level of debt and perceived high political risk.[5] This has resulted in high interest rates on government securities and a high floor on lending rates, which penalizes the entire private sector.[6] The battery of incentives, designed largely to neutralize these adverse conditions, may well be justified in the Lebanese case. However, it is costly, probably entails cross-subsidies, and can hardly be justified for other countries.

Summing Up

MENA's access problems are a result of many factors, including inadequate financial infrastructure, weak banking competition, and flaws in the institutional and legal framework that have hindered the growth of nonbank financial institutions and markets. Poor financial infrastructure is one of the weakest components of its financial systems. Weak infrastructure has not only a direct adverse impact on access (by raising creditor risks) but also an indirect impact (by reducing banking competition). Weak competition in banking is also a result of entry restrictions, lenient regimes of large exposures and connected lending, and lack of competition from capital markets and nonbank financial institutions. The lack of development of nonbank financial institutions and markets reflects a variety of factors, including the lack of enabling legislation in these areas. Chapters 6–9 examine these problems in greater detail.

State banks have mitigated some access problems, but their interventions have sometimes come at a cost. The performance of state banks in fulfilling development mandates has been both mixed and uneven across countries. State banks do not seem to have made a significant contribution to expanding access to remote areas. They have contributed to small and medium enterprise finance but do not seem to have the capacity to manage the associated risks. State banks have contributed to the development of housing finance, but they have suffered losses and have had to be financially rescued in several countries. They have contributed to investment finance in many countries, but the results in are mixed and uneven across countries. The large stock of nonperforming loans held by state banks in many countries suggests that the selection of these investments has been poor, especially when they involve state enterprises. These experiences indicate that state banks can mitigate access constraints caused by a weak enabling environment but that these interventions frequently entail a

significant cost. This report did not conduct a detailed valuation of the performance of individual state banks, but chapter 10 provides examples of better-governed state banks and discusses the conditions under which state banks may better perform their development mandates.

Other interventions, such as credit guarantee schemes, seem to have fared better, although there is scope for improving the design of these schemes. Partial credit guarantees have increased lending to small and medium enterprises, but there is evidence that the number of guarantees per person is small and the average value high in comparison with other countries. These results indicate that MENA guarantee schemes are not yet targeting smaller and more constrained firms, suggesting scope for improvements in scheme design.

Chapters 3–5 identified the countries in the region that have made most progress in developing the financial sector and expanding access. Morocco has been particularly successful in this area. It has a high ratio of private credit to GDP and the lowest loan concentration ratio in the region. It also has one of the largest shares of small and medium enterprises with a loan, the largest share of small and medium enterprise loans in total loans, and mortgage loans in total loans, as well as the highest microcredit penetration rate. It has made more progress in developing the insurance sector and other nonbanking financial institutions and diversifying its financial system than any other country in the region. Box 5.5 summarizes Morocco's experience with financial reform and financial development.

BOX 5.5

Morocco's Experience with Financial Reforms and Financial Development

Morocco has made impressive progress in financial development, as illustrated by the indicators in chapters 3 and 4. It has been able to build a deep and diversified financial system, as shown by the comparatively large assets of its banking system, nonbanking financial institutions, and microfinance sector. These positive developments have translated into increased access in many areas, including small and medium enterprise finance, microfinance, housing finance, consumer lending, and long-term finance. Financial sector soundness has been maintained as new risks have emerged.

Such progress was made possible by financial sector reforms in recent decades. Policy makers and regulatory authorities demonstrated the ability and readiness to

(Box continues on the next page.)

BOX 5.5 (continued)

continuously monitor the evolution of the financial system, identify flaws in regulation and supervision, and address these flaws. These reforms have generally entailed a shift from direct state interventions toward more market-based mechanisms accompanied by effective regulation and supervision. The supportive macroeconomic environment (moderate fiscal deficits, low inflation, large remittances) has also contributed to positive outcomes. The government has better targeted interventions to expand access, including the use of state banks and guarantees, and made them more effective.

Key reforms in the past decade included the restructuring of state-owned specialized banks and an enhanced regulatory and supervisory framework. Pragmatic approaches were adopted for restructuring the three main public banks: one was wound down, and two were converted into commercial banks (one privatized and the other restructured by a new management tasked with cleaning its portfolio and making it profitable). The share of state banks declined from about 65 percent to less than 40 percent of banking assets as a result of privatization, new entry, and the expansion of private banks. A 2006 law gave the central bank increased independence and broader regulatory and supervisory powers. The central bank engaged in close supervision to ensure swift restructuring of state banks, including full regulatory compliance. Such reforms helped create a level playing field for all institutions and promote competition.

Morocco is one of the few countries in the region with sizable nonbank financial institutions. The life and nonlife insurance sectors developed as a result of the dominance of private companies; the enactment of a modern regulatory framework that has tracked EU developments; the authorization of *banc assurance*, accompanied by market conduct rules; effective regulation and enforcement of mandatory insurance classes, such as motor third-party liability, workman's compensation, professional liability, and mortgage insurance. Public pension funds have made reasonable progress in disclosure and adoption of modern asset liability management (ALM) approaches, although more needs to be done. The insurance and pension sectors contributed to the development of mutual funds, which was also facilitated by an improved regulatory framework for the securities sector (the 2004 UCITS law, the 2006 Supervisor Law, initiatives on corporate governance) and more forceful enforcement of regulations. The regulation and supervision of the microfinance sector is being substantially strengthened in response to excessive credit growth, multiple borrowings, and the emergence of nonperforming loans.

Beyond regulatory initiatives, the state continues to directly support financial development, in a more targeted and market-friendly fashion. A large public bank (Crédit Populaire du Maroc) has contributed to small and medium enterprise finance

(Box continues on the next page.)

BOX 5.5 (continued)

through its presence in local communities and a governance structure that reduces political interference (see chapter 10). The design of the partial credit guarantee scheme was revamped to better support small and medium enterprises and low-income housing finance while ensuring its financial sustainability, although there is room for improvements in design. In 2010, postal financial services were transferred to a new postal bank, licensed and supervised by the central bank and tasked with serving low-income households.

Morocco plans to maintain the pace of reform to keep expanding access to finance while preserving the resiliency of the financial system. A modern private credit bureau was launched in 2009, through an innovative delegation approach by the central bank that merits examination by other countries. Draft legislation on covered bonds is being prepared to provide long-term funding for housing loans. Legislation on derivatives markets and securitization was enacted. Efforts to improve government debt markets and build a reliable yield curve are ongoing. Like other MENA countries, Morocco needs to strengthen financial infrastructure and become less dependent on policy interventions for access. The collateral regime, which evolved little in recent years, also needs overhauling.

Notes

1. This section is based on Madeddu (2010).
2. Jordan approved new legislation creating a private credit bureau in 2010.
3. Bank regulation surveys indicate that the percentage of rejections of applications for bank licenses was larger in MENA than in other regions during the mid-2000s (Anzoategui, Martinez Peria, and Rocha 2010).
4. This "privileged" position of incumbents is discussed in World Bank (2009), in the context of the development of the private sector in MENA. Rajan and Zingales (2002) discuss the history of financial development in the United States and the European Union during the past century and make similar remarks on the opposition of incumbents to reform and innovation.
5. Lebanon is rated "B" by Standard & Poor's, three notches below investment grade.
6. Within the region, Lebanon has paid the second-widest spreads on its bonds (after Iraq) and its credit default swap spreads (after Dubai) (see figure 2.2 in chapter 2).

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CHAPTER 6

Financial Infrastructure

Financial infrastructure consists of credit reporting systems (public credit registries and private credit bureaus), collateral and insolvency regimes, accounting and auditing standards, and payment and settlement systems. A well-developed financial infrastructure enables effective operation of financial intermediaries by reducing information asymmetries and legal uncertainties, which increase risk to lenders and impede the supply of credit. Improving financial infrastructure can increase access to finance for all, particularly consumers and small and medium enterprises, as problems of opacity and information asymmetry are more severe for them.

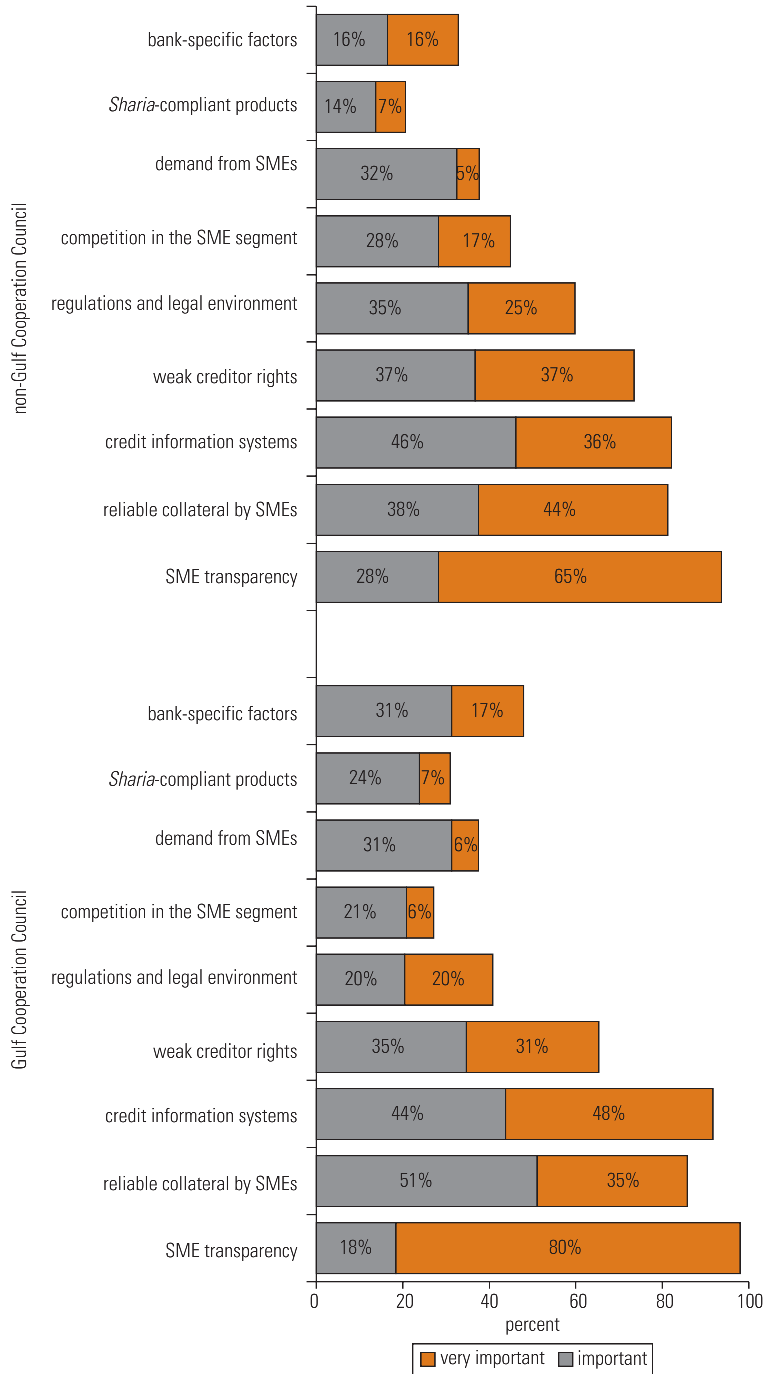
MENA has much weaker financial infrastructure than other regions. Its weaknesses, reflected in all the main relevant indicators, are highlighted in a recent survey of lending to small and medium enterprises in the region (Rocha and others 2011). MENA banks complain primarily about the opacity of small and medium enterprises and weak financial infrastructure (lack of reliable collateral, weak credit information systems, and weak creditor rights) (figure 6.1). The contrast with other surveys is striking. In global surveys (Beck, Demirgüç-Kunt, and Martinez Peria 2008) and surveys of Latin America (de la Torre, Martinez Peria, and Schmukler 2010), banks identify many obstacles to small and medium enterprise lending, including macroeconomic factors, regulations, and excessive competition; they complain less about the quality of financial infrastructure.[1]

This chapter reviews the status of financial infrastructure in the region and identifies the main design and regulatory challenges. It focuses on credit information and creditor rights because the focus of the report is on access.

The chapter is structured as follows. The first section gives an overview of credit reporting systems and assesses these systems in MENA. The second section discusses collateral regimes in MENA and highlights weaknesses in the secured lending chain. The last section

FIGURE 6.1

Results of Survey on Importance of Obstacles to Lending to Small and Medium Enterprises, 2009



Source: Rocha and others 2011.

Note: SME = small and medium enterprises.

provides an overview of insolvency regimes in the region, summarizing the main problems.

Credit Reporting Systems

Credit Reporting Systems outside the Region

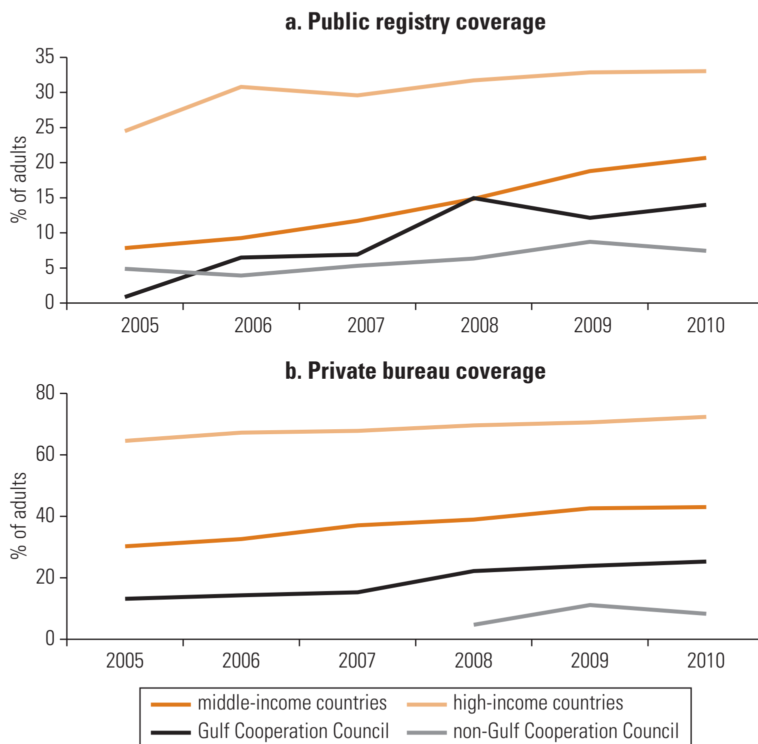
Public credit registries and private credit bureaus form the core of a country's credit reporting system.[2] Public credit registries are managed by central banks or bank supervisors. They mainly collect information from supervised institutions. Private credit bureaus are generally owned by private international or local providers, with rare involvement of public entities. Because participation in public credit registries is mandatory, these institutions can build a picture of the regulated financial system relatively quickly and support supervisory functions. In contrast, private credit bureaus typically collect a greater volume of both positive and negative information from all sectors with more accuracy and detail. They thus develop a more complete picture of a borrower's financial dealings, especially if provision of data is mandatory.

Public credit registries can jump-start credit reporting in a country and play an important role in the early stages of financial development. Public credit registries are in operation in about 80 countries, but almost half of the countries that rely only on public credit registries are low-income countries in Africa (see table 5.1 in chapter 5). In contrast, less than 8 percent of high-income countries rely exclusively on public credit registries. Private credit bureaus have been established in about 80 countries; most middle- and high-income countries rely on private credit bureaus or a combination of private credit bureaus and public credit registries.

Several middle-income countries have retained their public credit registries, but the large gains in coverage and depth of information have been achieved by private credit bureaus. The average coverage ratios of private credit bureaus are twice those of public credit registries for high- and middle-income countries (note the different scales in figure 6.2). Moreover, private credit bureaus substantially improve the depth of credit information. Most public credit registries outside MENA collect data from regulated financial institutions; a much smaller share collects data from other institutions, including microfinance institutions (figure 6.3). Private credit bureaus collect information not only from banks but also from nonfinancial data providers (retailers, utilities, credit card issuers, mobile telephones). Improvements in data collection from microfinance institutions are noteworthy, with the share of private credit bureaus worldwide collecting

FIGURE 6.2

Coverage of Public Credit Registries and Private Credit Bureaus, by Country Group, 2005–10



Source: World Bank 2006–11.

data from these institutions increasing from 8 percent in 2005 to 58 percent in 2010.

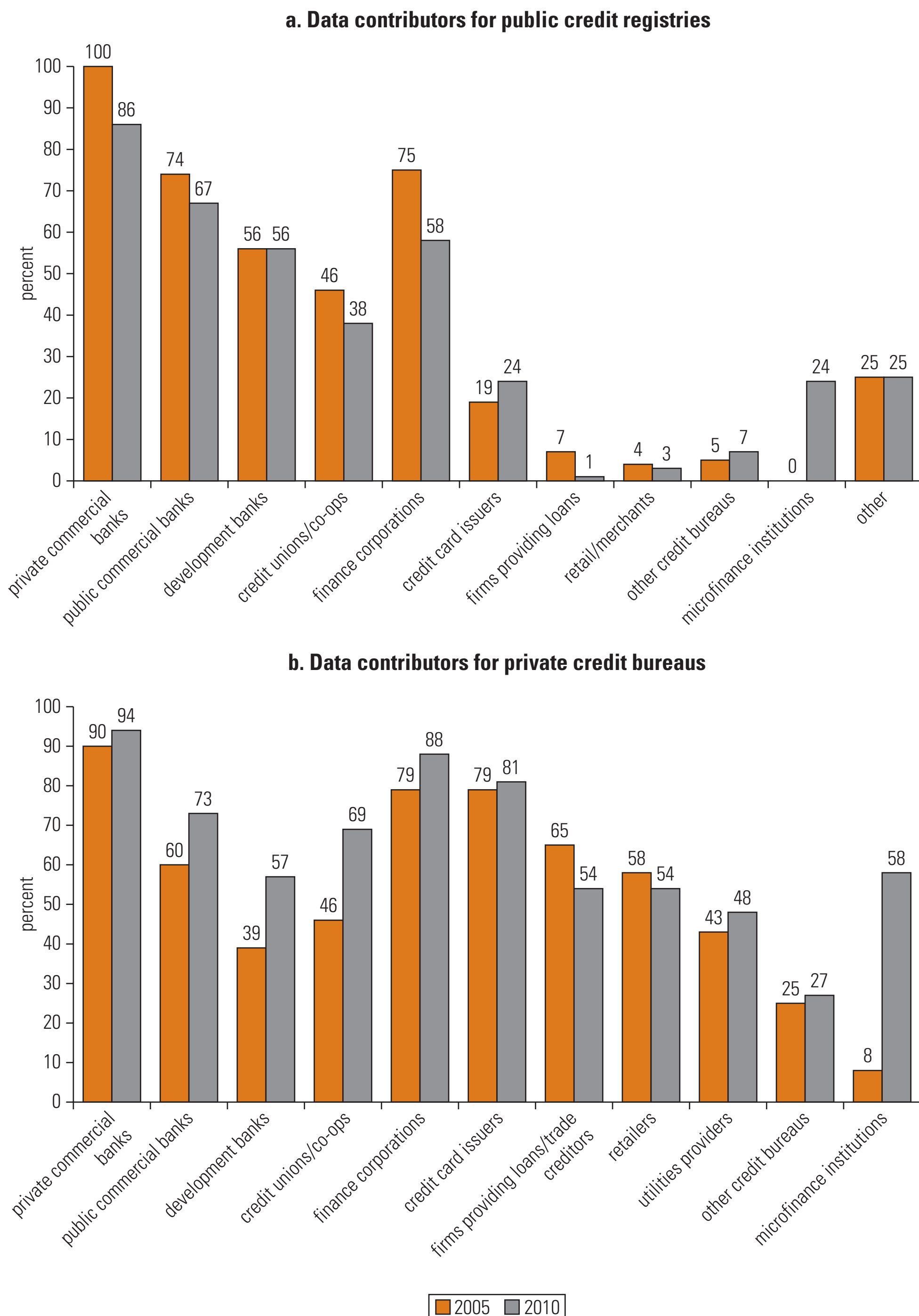
In addition to providing raw information in the form of credit reports, private credit bureaus can develop a range of value added services thanks to the wealth of information they collect. Provision of credit bureau scores and ratings of small and medium enterprises can help lenders make better decisions about new credit applicants. The development of value added services generally represents a more advanced phase in the activity of a private credit bureau; it requires sufficient historical data and an adequate evolution of the market.

Credit Reporting Systems within the Region

About 60 percent of countries in the region still rely entirely on public credit registries, a larger percentage than all regions except Africa. The establishment of private credit bureaus in MENA is a relatively recent

FIGURE 6.3

Institutions Providing Data to Public Credit Registries and Private Credit Bureaus, 2005 and 2010



Source: World Bank 2005, 2010.

phenomenon. Ten economies in the region still rely entirely on public credit registries; four rely entirely on private credit bureaus (Bahrain, Kuwait, Morocco, and Saudi Arabia); and three have both public credit registries and private credit bureaus (the Arab Republic of Egypt, the Islamic Republic of Iran, and the United Arab Emirates) (table 6.1).

The introduction of new private credit bureaus and the upgrading of some public credit registries have increased the depth of credit information in MENA. New private credit bureaus have been introduced in Bahrain, Egypt, Morocco, Saudi Arabia, and the United Arab Emirates; Lebanon, Tunisia, and the United Arab Emirates have improved their public credit registries; and Oman and the West Bank and Gaza have introduced new, modern public credit registries. These improvements resulted in a significant increase in the credit information index for MENA, which rose from 1.8 in 2005 to 3.2 in 2010 (World Bank 2010). The range of institutions providing information to registries and bureaus has also increased since 2005, although there is substantial room for improvement.

Although the architecture of credit information in MENA is improving, much remains to be done. Coverage, especially of public credit registries, remains low (see figure 6.2). The average coverage of private credit bureaus is more than twice that of public credit registries, but it remains substantially lower than in emerging economies. The low coverage is explained largely by the fact that most private credit bureaus are new and just starting to expand their operations; it could also reflect lack of sufficient regulatory efforts to encourage the more rapid engagement of unregulated institutions, including microfinance institutions.

TABLE 6.1

Public Credit Registries and Private Credit Bureaus in the Middle East and North Africa

Public credit registry and private credit bureau	Private credit bureau only	Public credit registry only	Not available
Egypt, Arab Rep. (2008)	Bahrain (2005)	Algeria	Iraq
Iran, Islamic Rep.	Kuwait (2002)	Djibouti	
United Arab Emirates (2007)	Morocco (2009)	Jordan	
	Saudi Arabia (2004)	Qatar	
		Lebanon	
		Oman	
		Syrian Arab Republic	
		Tunisia	
		West Bank and Gaza	
		Yemen, Rep.	

Source: World Bank 2010.

Note: Years in parentheses indicate year private credit bureau was established.

The number of institutions providing information to private credit bureaus, especially finance corporations and credit card issuers, has been increasing. Private credit bureaus have also started collecting information from nonbank and unregulated institutions; more effort is needed to collect information from microfinance institutions. These improvements in data collection should deepen as the young private credit bureaus consolidate their databases and expand their operations. In this regard, further efforts are needed to engage microfinance institutions, including efforts to improve and harmonize their less sophisticated information technology systems, as well as efforts to reduce the fees charged by these institutions. Private credit bureaus have also been able to gather more information on payments performance. A larger share of public credit registries provides information on bad checks, but a larger share of private credit bureaus provides positive information on other payment events, especially on-time payments.

Most public credit registries in MENA operate as traditional public credit registries, collecting information from regulated entities and disseminating the data to lenders in aggregate format. The functional and technological systems of public credit registries vary across the region. Most public credit registries were established to support bank supervision and still operate with this objective. However, a few new public credit registries (in Oman, the West Bank and Gaza) aim to offer the same quality and service as best-practice private credit bureaus. Some public credit registries (in Algeria, Lebanon, Tunisia, and the Republic of Yemen) have recently been upgraded or are in the process of being upgraded. Some (in Libya) have been established recently or are trying to make the big jump to paperless online technology (in Djibouti, the Syrian Arab Republic). These efforts are commendable, although the extent to which these public credit registries will be able to expand coverage and significantly improve the depth of credit information is open to question, as suggested by the experience of other countries (see figures 6.2 and 6.3).

The Palestine Monetary Authority (PMA) has established one of the most effective public credit registries in the region. It has pioneered credit reporting and educated lenders on the importance of sharing credit data. All banks and major microfinance institutions (representing more than 80 percent of the market) are part of the sharing scheme. Microfinance institutions are not regulated by the PMA but participate in the sharing scheme on the basis of a memorandum of understanding signed with the consent of the PMA and consumers. The private credit bureau provides users with a Web-based online facility for inquiries and data sharing. The credit report it provides is more like a private credit bureau report, displaying detailed information at the account level, including historical data, arrears, and account performance. The credit bureau has benefited

from technical assistance from an international private credit bureau to build a scoring model and aims to provide the same quality of service as a best-practice private credit bureau.

Credit scoring is still undeveloped in MENA, but some countries are making impressive efforts in this area. Less than half of the banks in MENA have some form of scoring model, and less than 30 percent rely on scoring methods for automated decisions. Credit risk assessment is generally centralized and relies excessively on high collateral. Credit applicants usually have to satisfy a long list of requirements, and credit underwriting is generally a lengthy process that can take 2–30 days. However, some private credit bureaus and public credit registries are developing credit scoring and rating models and promoting their use among banks. The private credit bureau in the West Bank and Gaza is building a scoring model, and the Moroccan private credit bureau is planning to build one. The Saudi Arabian private credit bureau may be the registry that has made the greatest progress in this area. In cooperation with commercial banks, it is building a database that generates probabilities of default at the sectoral level, allowing banks to benchmark the performance of their own portfolios. It has also built individual credit scores and, more recently, credit ratings for more than 20,000 small and medium enterprises, as part of a broader effort to develop more lending to such businesses.

Legal Framework for Credit Reporting

The development of the credit reporting industry in many countries in the region remains hindered by a weak legal framework. The legal framework plays a critical role in the development of credit reporting, as it can boost lenders' and consumers' confidence about data privacy. In some countries, the regulatory framework on information sharing systems remains fragile. Lenders and regulators in Lebanon, Syria, and Tunisia, for example, cite bank secrecy as one of the major constraints to establishing credit information infrastructure. A variety of legal approaches has been adopted to reach a fair balance between bank secrecy and information sharing. These approaches are briefly discussed below.

Credit bureau law

A customized law on private credit bureaus represents the best foundation for information sharing that enhances consumers' rights and develops a credit reporting system. Jordan opted for this approach in 2008 to reform its credit reporting system and establish its first private credit bureau. In May 2010, the government approved the credit information bureau law.

After years of credit reporting operations based on a simple code of conduct and consent model, Saudi Arabia approved a new credit reporting law in July 2008. In 2007, the United Arab Emirates drafted a credit reporting law, which was approved by the government in October 2010.

Central bank regulations

Some countries have adopted central bank regulations to establish a credit reporting system. This approach consists of regulations, not laws, approved by the banking supervisor that aim to regulate information sharing and clarify consumers' rights as well as the responsibilities of lenders and private credit bureaus. Noteworthy examples are the regulations adopted by the central banks of Egypt (in 2006) and Morocco (in 2007), enabling effective private credit reporting through different information sharing schemes (voluntary in Egypt, mandatory in Morocco).

Codes of conduct

Codes of conduct have been adopted in countries in which the banking authorities were not empowered to enact a specific credit reporting regulation or a specific law was not in place. The Saudi Arabian Monetary Agency (SAMA) initially encouraged the banks to establish a private credit bureau simply on the basis of consumers' consent and a code of conduct. It used its full moral suasion over lenders, encouraging the banks to start a private credit bureau even without a strong legal framework. The private credit bureau operated for years without any bespoke legislation or regulation. The Saudi Arabian authorities eventually concluded that a specialized law would provide a much sounder legal basis for credit reporting and introduced such a law in 2008. Other countries, such as Bahrain, have also adopted a code of conduct model accompanied by consumers' consent.

Collateral Regimes

Secured transaction systems are still very underdeveloped in MENA, which ranks last among world regions in the area of creditor rights, as measured by the legal rights index (table 6.2).[3] On average, more than 80 percent of loans granted in MENA require some form of collateral (World Bank 2006–10). In-depth analysis indicates that the source of the problem is not the availability of collateral but the ability to translate valuable assets into productive use. MENA lacks the legal framework that would allow enterprises to use their movable assets as collateral.

MENA countries have weaknesses in all components of the secured lending chain. A survey of 140 MENA banks asked if they experienced

TABLE 6.2

Legal Rights Index, by World Region

Region	Legal rights index
Organisation for Economic Co-operation and Development (OECD)	6.8
Europe and Central Asia	6.6
East Asia and Pacific	5.7
Latin America and the Caribbean	5.5
South Asia	5.3
Africa	4.6
Middle East and North Africa	3.3

Source: World Bank 2010.

Note: Scale ranges from 0 to 10.

difficulties in three components of the chain of secured lending: registration, enforcement, and the selling of collateral (Rocha and others 2011). Banks reported problems in all three components, especially for movable collateral (figure 6.4). Although a relatively small share of banks reports serious problems with the registration of fixed collateral, a large proportion reports that registries of movables remain very deficient. Enforcement of collateral is a bigger problem, especially for movables but also for fixed collateral in the case of banks in countries outside the Gulf Cooperation Council (GCC). An even larger share of both GCC and non-GCC banks reports problems selling seized fixed and movable collateral.

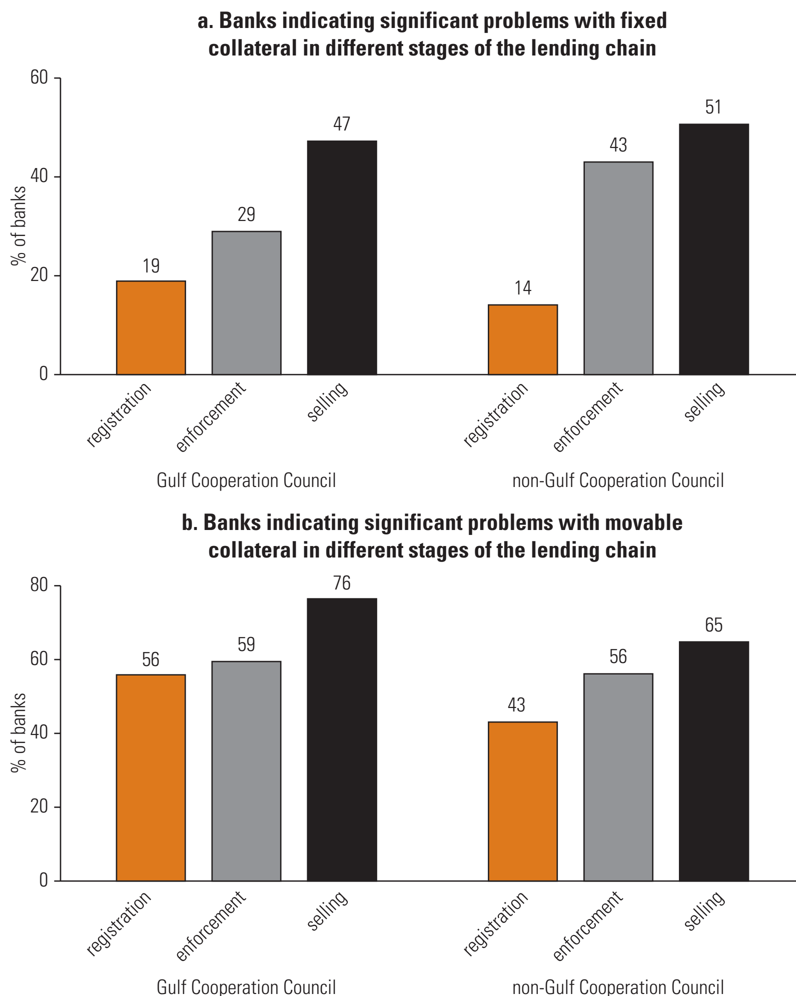
Scope of the Law

None of the countries in the region has a modern law on secured transactions. Most countries have obsolete and fragmented provisions for secured transactions that are governed by different laws that have not been reformed for many years. The range of assets that can be used as collateral is quite limited. Immovable property is still used as the prevalent form of collateral. With regard to tangible movable property, vehicles are a widely accepted form of collateral, as a result of the region's relatively well-developed vehicle registration framework. Only a few MENA countries allow inventories, receivables, securities, bank accounts, and salaries to be used as collateral.

An important obstacle in expanding the range of movable collateral is the requirement to describe each piece of collateral. Certain assets, such as inventory or accounts receivable, exist as a pool whose individual elements change on a daily basis. It is impossible to make new adjustments to a security agreement for each change. Advanced financial systems do not require borrowers to document each piece of collateral.

FIGURE 6.4

Percentage of Banks Indicating Problems with Fixed and Movable Collateral



Source: Rocha and others 2011.

Creation of Security Interest

In many countries in the region, the creation of enforceable security is cumbersome and includes formalities that make the system more burdensome. Lebanon, Oman, Saudi Arabia, Tunisia, and the Republic of Yemen, for example, require security interests to be registered in specific institutions (courts, notaries) in order to be enforceable. A credit agreement between debtor and creditor should be enforceable without any other requirements. A distinction should be made between enforceable

agreements and the priority of claims against third parties (for which registration in a public registry is necessary).

Registration of Collateral

MENA is possibly the only region in the world without a modern collateral registry system. Registries in several countries in the region tend to be depositories for documents that neither publicize security interests nor prioritize the rights of creditors. Most registries are decentralized (exceptions are Kuwait, Lebanon, Oman, and the West Bank and Gaza), with data registered in different locations (table 6.3). Moreover, most registries in MENA are paper based rather than electronic (Kuwait, which has a fully electronic registry, is the only exception). They are therefore not searchable by the public and do not help lenders or borrowers establish priority among security interests held by multiple lenders. Most registries limit the registration to a few types of movables (equipment, enterprise pledges) and do not provide information

TABLE 6.3

Mapping of Collateral Registries in the Middle East and North Africa

Economy	Collateral registry	Centralized	Electronic or paper based	Easily accessible to public for searches
Algeria	Various	No	Paper	No
Bahrain	Various	Only for commercial registry	Semielectronic	—
Egypt, Arab Rep.	Various	No	Paper	Somewhat
Iran, Islamic Rep.	Various	No	Paper	—
Iraq	No	No	—	—
Jordan	No	No	Paper	Somewhat
Kuwait	Ministry of Justice	Yes	Electronic	—
Lebanon	Various	Yes	Paper/electronic	—
Libya	—	—	—	—
Morocco	Various	No	Paper	Somewhat
Oman	Various	Yes	Paper/electronic	—
Qatar	Vehicles	No	—	—
Saudi Arabia	Various	No	Paper	—
Syrian Arab Republic	No	—	—	—
Tunisia	Various	No	Paper	—
United Arab Emirates	Not for movable collateral	No	—	—
West Bank and Gaza	Vehicles	Yes	Electronic	No
Yemen, Rep.	No	—	—	—

Source: World Bank 2010.

Note: — = not available.

on different types of security rights. A number of countries in the region have a variety of registries, depending on the type of movable collateral secured (vehicle, securities, enterprise charges, floating charges).

Priority Schemes for Creditors

A priority scheme for creditors consists of rules that determine the order in which competing claims against secured collateral can be executed in the case of default. An effective priority system should have a public policy for each priority and a clear set of rules regulating the order of priorities to facilitate these policies. The general priority rule used in more developed systems is based on notice and the "first to register rule" (meaning that the first party to register has priority over the collateral).

Priority schemes in the region do not provide clear and favorable laws and regulations for creditors (table 6.4). Proper priority systems are absent. They place secured creditors on top of the priority list when it comes to recovering assets and debts outside of bankruptcy. Countries should have a clear scheme that specifies the priority position of each creditor so that they can accurately assess the risk associated with taking collateral as security.

Enforcement of Collateral

Enforcement refers to the process for implementing a claim against collateral when the debtor defaults on a secured obligation. Enforcement mechanisms should be speedy and inexpensive. They can be made most effective when parties agree on rights and remedies upon default, including seizure and sale of the collateral outside the judicial process.

TABLE 6.4

Priority of Secured Creditors with Respect to Other Creditors, by World Region, 2010

Region	Percentage of countries providing absolute priority outside of bankruptcy
Europe and Central Asia	75.0
OECD	59.1
East Asia and Pacific	58.3
Latin America and the Caribbean	38.1
Africa	25.6
Middle East and North Africa	16.7
South Asia	14.3

Source: World Bank 2010.

An efficient procedure is particularly important for movable property, which usually depreciates in value over time. Under a nonjudicial enforcement mechanism, the secured creditor takes the property from the debtor without court assistance. Some jurisdictions have a prejudgment procedure in which, upon presentation of proof of the security agreement and default by the creditor, the court issues an order of seizure of the property. In other systems, the proof may be simply a sworn affidavit of the creditor.

Out of court enforcement procedures are nearly nonexistent in the region. Legislation in only three countries (Bahrain, the Islamic Republic of Iran, and Qatar) allows out-of-court procedures; there is no evidence on how the process works in practice. Few countries in the region have a framework for recovery of debts outside the judicial system. In fact, the region lags all other regions in this area (table 6.5). Although creditors constantly mention enforcement as a major issue, countries have not taken any concrete steps to resolve the problem. Some positive initiatives include Jordan's 2008 Leasing Law, which introduced out-of-court procedures for leased assets. It remains to be seen whether the law will be expanded to include other security interests in movable assets.

Enforcement of security through courts is a last resort for creditors: only when out-of-court options are not available should the creditor opt to take the borrower to court to recover debt. A modern secured transaction law should include procedures that are rapid enough to permit recovery before loss of value of the assets without undue risk of concealment or sale of assets by the debtor. Jordan, Lebanon, Morocco, Oman, and the United Arab Emirates report court enforcement that is time consuming, expensive, and unpredictable. In some countries, such as Tunisia, the fast-track processes in court to recover debts seem to be working well and could serve as models for other countries in the region.

TABLE 6.5

Existence of Out-of-Court Procedures for Enforcing Claims on Collateral Recovery, by World Region, 2010

Region	Percentage of countries
South Asia	85.7
OECD	77.3
Europe and Central Asia	75.0
East Asia and Pacific	58.3
Africa	41.0
Latin America and the Caribbean	33.3
Middle East and North Africa	16.7

Source: World Bank 2010.

Sale of Collateral

The disposition of secured assets is one of the major constraints facing financial institutions in MENA (figure 6.4). In many countries, collateral must be sold through a public or judicial auction that involves cumbersome rules and minimum bids that are often based on unrealistic values, making it difficult to dispose of the property. This constraint delays the sale, resulting in devaluation of the assets, and may not be appropriate for certain types of assets for which there are no organized and liquid markets. Although the problem is an issue for both movable and fixed assets, movable property is more difficult to sell after a default and the repossession of the asset. Private sales of secured assets, which are usually associated with extrajudicial enforcement mechanisms, are rare in MENA.

Insolvency Regimes

A healthy insolvency system provides predictability to debtors and creditors in case of financial distress while balancing liquidation and reorganization.[4] The lack of efficient exit mechanisms inhibits market entry, because entrepreneurs cannot be released from debts relating to previous failures. An insolvency procedure should be widely accessible: both debtors and creditors should be able to file for insolvency easily, and debtors should be provided opportunity to object to protect themselves from inappropriate creditor harassment. The rights of creditors and priorities of claims established before insolvency should be upheld to preserve the expectations of the economic agents. Although some new claims (such as costs of the administration of the estate) will take priority, in general the insolvency process should not undermine ordinary creditor priorities that exist outside of bankruptcy.

Reorganization is one of the most important features of a modern insolvency regime. In many countries, bankruptcy has historically been synonymous with liquidation. In a modern system, the insolvency system allows a potentially viable debtor company to attempt to reorganize and survive its financial distress in order to continue operations. Reorganization can help companies that are in distress but fundamentally viable, that is, companies that need time and some legal protection to survive and continue operating productively.

A modern insolvency regime must also include efficient liquidation procedures for nonviable enterprises. The most frequent use of bankruptcy is liquidation, a process through which the assets of a nonviable company in financial distress are sold to other economic agents and its

human capital (owners, employees) redeployed. Liquidation is invoked when attempts to reorganize a company in distress fail. Under such circumstances, conversion to liquidation should be swift and efficient.

Insolvency systems in MENA are by and large underdeveloped. One of the main problems is approaching debtors as wrongdoers rather than economic agents in distress. There is varying use and understanding of insolvency. Countries that have insolvency regimes usually use them as a tool for collection by creditors and the winding up of companies.

Some economies, including the Islamic Republic of Iran, Iraq, and the Republic of Yemen, do not have insolvency laws. Jordan does not have a cohesive bankruptcy law, although it has acquired practice in winding up companies drawing on provisions from several laws. Qatar, Saudi Arabia, the United Arab Emirates, and the West Bank and Gaza report very low usage of their bankruptcy systems. In contrast, Morocco and Tunisia are modernizing their bankruptcy regimes by adding commercial courts and insolvency training for judges.

The rights of creditors during bankruptcy proceedings are often unprotected in MENA countries. Rights that are given priority over creditors' rights as a matter of public policy are court costs, taxes, the costs of the estate, and debts to employees and servants. Egypt, Jordan, Kuwait, Morocco, and Qatar give higher priority to public policy exceptions, making it unclear if secured creditors' rights are preserved in insolvency.

There are few enterprise reorganizations in MENA countries, despite the fact that many countries have reorganization provisions in their laws. Most provisions are in the form of a conciliation procedure that allows a delay in the declaration of bankruptcy in order to reach an amicable settlement with creditors. One of the most important shortcomings is the lack of institutional capacity. Institutions, particularly courts, are inflexible and tend to be bureaucratic and formalistic. There is a lack of restructuring experts and insolvency professionals experienced with creditor negotiation and debt restructuring. The lack of experience with reorganization seems to be reinforcing the lack of its practice.

No MENA country can claim an efficient liquidation mechanism by international standards. Despite being the most commonly used procedure in the region, liquidation is a time-consuming process marked by delays and inefficiencies. Procedures for selling assets are not efficient and often require auctions with cumbersome procedures. Efficient recovery and maximization of assets is not the norm, and bankruptcy is seen as a last resort. Creditors often expect little or no recovery and use a bankruptcy declaration as a threat to motivate payment. Bankruptcy then becomes a tool for creditor collection, essentially a bilateral dispute over continuation or dismissal of the bankruptcy based on satisfying a debt.

Notes

1. Although the statistical analysis of the global data set revealed that the quality of the legal framework had an impact on small and medium enterprise lending (Beck, Demirgüç-Kunt, and Martinez Peria 2011).
2. This section is based on Madeddu (2010).
3. This section is based on de la Campa (2011).
4. This section is based on Uttamchandani (2010).

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CHAPTER 7

The Banking System: The Challenge of Expanding Access to Finance While Preserving Stability

Although the structure of MENA banking systems has been evolving in a positive direction, several structural and regulatory weaknesses still limit the systems' potential to contribute to inclusive and sustainable economic growth. The most striking feature of banking systems in the region is that despite their large size and resiliency to recent shocks, they have been providing only limited access to finance to households and small and medium enterprises, inadequate long-term finance and risk management instruments, and insufficient housing finance. This chapter analyzes this apparent paradox by examining the structures of MENA banking systems, their performance and soundness, and the main regulatory and supervisory issues.

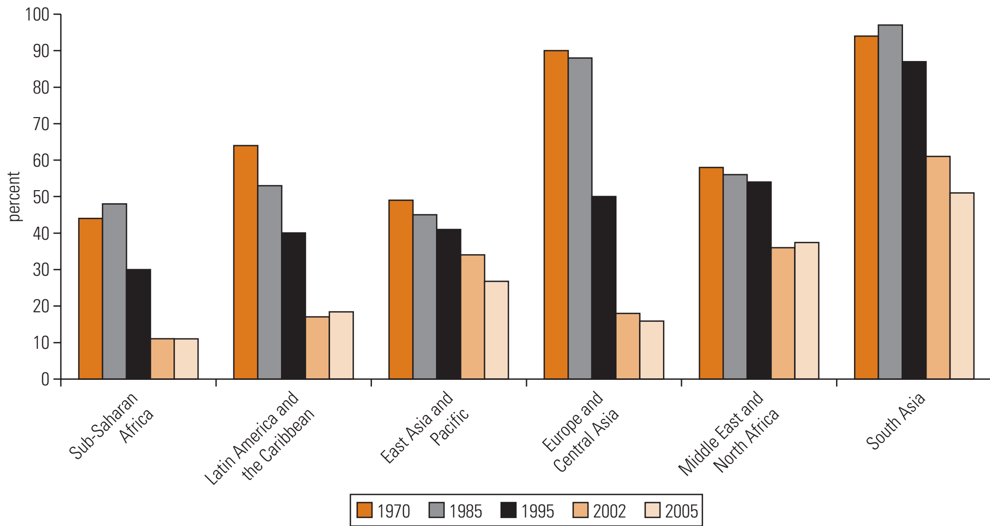
The chapter is structured as follows. The first section compares the structure of MENA's banking systems with banking systems in other regions. It also compares banking systems by ownership structure and examines the differences and similarities between Islamic and conventional banks. The second section analyzes bank performance indicators. The third section assesses the resilience of banking systems in the region. The last section discusses the main regulatory and supervisory issues.

Structure of MENA Banking Systems

As in other emerging regions, state ownership has been on the decline and foreign ownership on the rise in MENA (figures 7.1–7.3). Eastern Europe and Central Asia underwent the largest decline in state ownership in the past two decades, followed by Latin America and Africa. State banks controlled 10–20 percent of banking assets in these three regions in 2008. Although the role of state banks declined in MENA as well, they still accounted for 33 percent of total assets in 2008, placing MENA between East Asia and South Asia. Foreign ownership increased

FIGURE 7.1

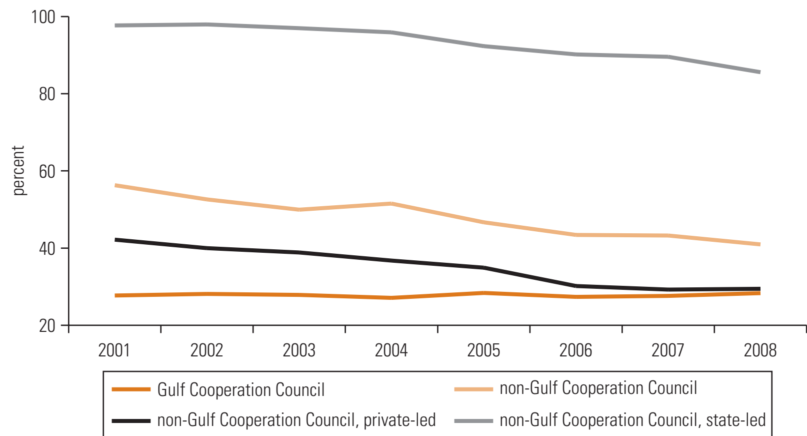
Share of State Banks in Total Bank Assets, by World Region, 1970–2005



Source: Farazi, Feyen, and Rocha 2011.

FIGURE 7.2

Share of State Banks in Total Bank Assets in the Middle East and North Africa, by Country Group, 2001–08

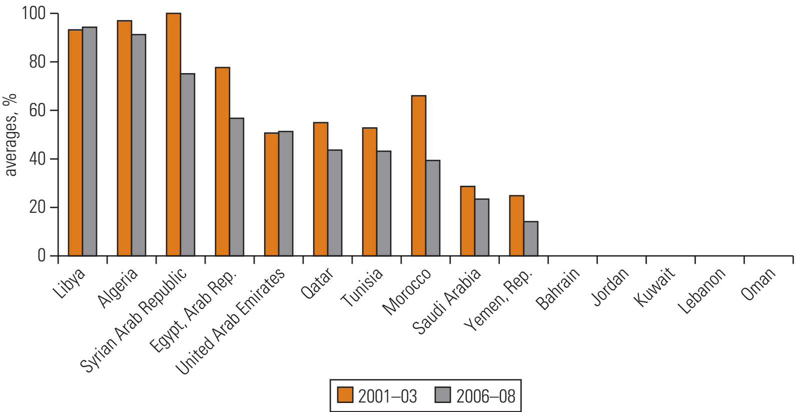


Source: Farazi, Feyen, and Rocha 2011.

from 18 percent of total bank assets in 2001 to 20 percent in 2008. This modest rise masks a moderate decline in the Gulf Cooperation Council (GCC) and a more significant rise in non-GCC banking systems (figure 7.4). Islamic banks gained ground particularly quickly in the GCC in the last decade and have started to penetrate non-GCC countries as well (figure 7.5).

FIGURE 7.3

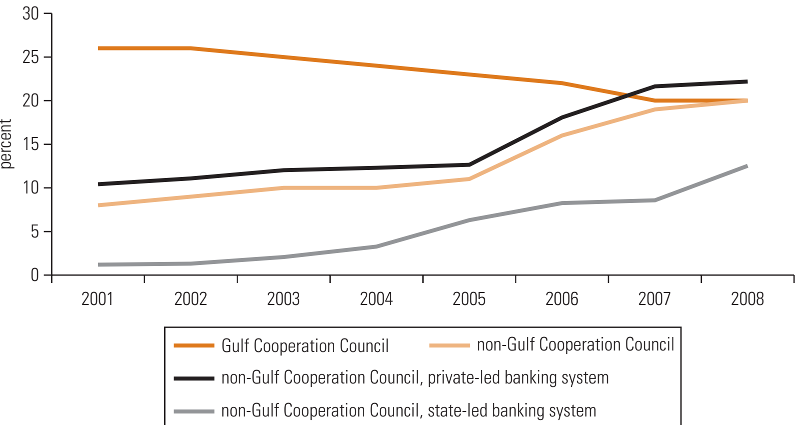
Share of State Banks in Total Bank Assets in the Middle East and North Africa, by Country, 2001–03 and 2006–08



Source: Farazi, Feyen, and Rocha 2011.

FIGURE 7.4

Share of Foreign Banks in Total Bank Assets in the Middle East and North Africa, by Country Group, 2001–08

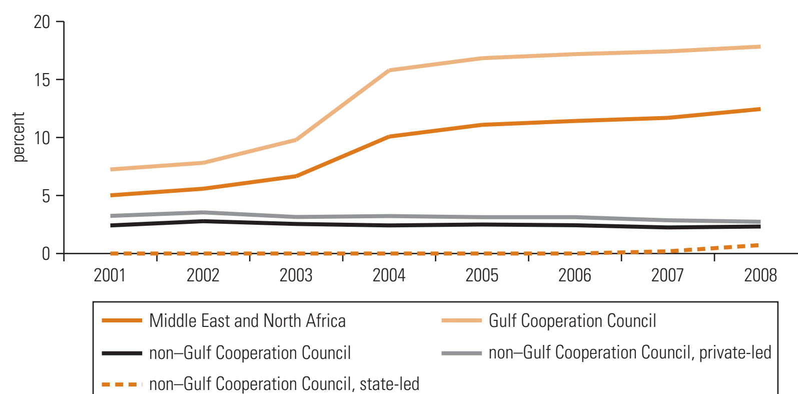


Source: Farazi, Feyen, and Rocha 2011.

Despite the common trends, banking system structures are diverse across MENA countries, with some systems still dominated by state banks and the majority privately led. The average share of state banks in the GCC countries was stable in the last decade (see figure 7.2 and table 7.1). However, GCC banking systems are not homogeneous. The United Arab Emirates and Qatar have a sizable share of state banks; Bahrain, Kuwait, and Oman have private-led systems; and Saudi Arabia is between the two groups, with more than 20 percent state ownership.

FIGURE 7.5

Share of Islamic Banks in Total Bank Assets in the Middle East and North Africa, by Country Group, 2001–08



Source: Farazi, Feyen, and Rocha 2011.

TABLE 7.1

Bank Ownership Structure in the Middle East and North Africa, 2001–08

Country group and type of bank	2001	2002	2003	2004	2005	2006	2007	2008
Middle East and North Africa								
Public	40.9	39.0	37.4	37.5	35.7	33.6	33.5	32.7
Private	59.1	61.0	62.6	62.5	64.3	66.4	66.5	67.3
Domestic	41.6	42.7	44.0	44.3	45.9	46.8	47.0	47.3
Foreign	17.5	18.4	18.6	18.2	18.4	19.6	19.5	20.0
International	7.8	8.0	8.4	8.1	8.0	9.1	9.5	9.7
Regional	9.8	10.4	10.2	10.1	10.4	10.5	10.0	10.3
Commercial	95.0	94.4	93.3	89.9	88.9	88.6	88.3	87.6
Islamic	5.0	5.6	6.7	10.1	11.1	11.4	11.7	12.4
Listed	55.8	57.9	63.9	66.3	69.7	74.7	75.6	78.3
Private	48.7	50.2	52.5	52.9	55.1	59.7	60.1	61.5
Public	7.2	7.7	11.4	13.4	14.6	14.9	15.6	16.8
GCC								
Public	27.7	28.1	27.9	27.1	28.4	27.4	27.6	28.3
Private	72.3	71.9	72.1	72.9	71.6	72.6	72.4	71.7
Domestic	46.7	46.0	47.1	48.6	48.5	50.7	52.4	51.7
Foreign	25.6	25.9	25.1	24.3	23.1	22.0	20.0	19.9
International	12.1	12.1	11.6	11.0	10.0	9.0	8.0	8.5
Regional	13.5	13.8	13.5	13.2	13.1	12.9	12.0	11.4
Commercial	92.8	92.2	90.2	84.2	83.2	82.8	82.6	82.2
Islamic	7.2	7.8	9.8	15.8	16.8	17.2	17.4	17.8
Listed	78.8	79.2	84.1	85.5	86.4	89.4	88.9	90.3
Private	65.5	65.3	67.0	68.1	66.6	69.2	68.4	68.4
Public	13.3	13.9	17.0	17.4	19.7	20.2	20.5	21.9

(Table continues on the following page.)

TABLE 7.1 (continued)

Country group and type of bank	2001	2002	2003	2004	2005	2006	2007	2008
Non-GCC, private-led								
Public	42.2	40.0	38.8	36.8	34.9	30.2	29.3	29.5
Private	57.8	60.0	61.2	63.2	65.1	69.8	70.7	70.5
Domestic	47.4	48.9	49.1	50.9	52.4	51.7	49.1	48.4
Foreign	10.4	11.1	12.0	12.3	12.6	18.1	21.6	22.2
International	3.5	3.6	4.9	5.1	5.7	11.2	14.8	14.1
Regional	6.9	7.5	7.1	7.2	6.9	6.8	6.9	8.1
Commercial	96.8	96.5	96.8	96.8	96.9	96.9	97.1	97.3
Islamic	3.2	3.5	3.2	3.2	3.1	3.1	2.9	2.7
Listed	38.6	39.5	45.7	53.3	55.1	64.5	66.5	66.3
Private	38.6	39.5	40.8	42.4	46.4	56.0	58.3	58.1
Public	0	0	4.9	10.9	8.7	8.6	8.3	8.2
Non-GCC, state-led								
Public	97.7	97.9	97.0	95.9	92.3	90.2	89.6	85.6
Private	2.3	2.1	3.0	4.1	7.7	9.8	10.4	14.4
Domestic	1.1	0.7	0.9	0.8	1.4	1.6	1.9	1.9
Foreign	1.2	1.3	2.1	3.3	6.3	8.3	8.6	12.5
International	0	0	1.0	1.1	2.0	2.5	2.5	3.7
Regional	1.2	1.3	1.1	2.1	4.3	5.8	6.0	8.9
Commercial	100.0	100.0	100.0	100.0	100.0	100.0	100.0	99.3
Islamic	0	0	0	0	0	0	0	0.7
Listed	0	0.7	2.1	2.5	4.8	6.3	11.7	14.2
Private	0	0.7	2.1	2.5	4.8	6.3	6.8	11.2
Public	—	—	—	—	—	—	4.9	3.1

Source: Farazi, Feyen, and Rocha 2011.

Note: — = not available.

In some GCC countries, public investors play a central role in private banks, which can blur the distinction between state and private ownership.

In contrast to the GCC, the average market share of state banks in the non-GCC countries declined significantly, from 56 percent of total assets in 2001 to 41 percent in 2008. Within the non-GCC region, two groups of countries can be identified. In the first group—consisting of Algeria, Libya, and the Syrian Arab Republic—state banks play a dominant role, controlling 86 percent of total bank assets in 2008. In the second group—made up of the Arab Republic of Egypt, Jordan, Lebanon, Morocco, Tunisia, and the Republic of Yemen—private banks lead financial intermediation, with a 71 percent asset share. The average share of state banks declined by a similar amount in the two groups (about 13 percent of total assets), but the decline took place from very different initial positions. The continued decline of state ownership during the global financial crisis implies that state banks in these countries did not play a countercyclical role, as they did in some countries in Latin America and Asia.

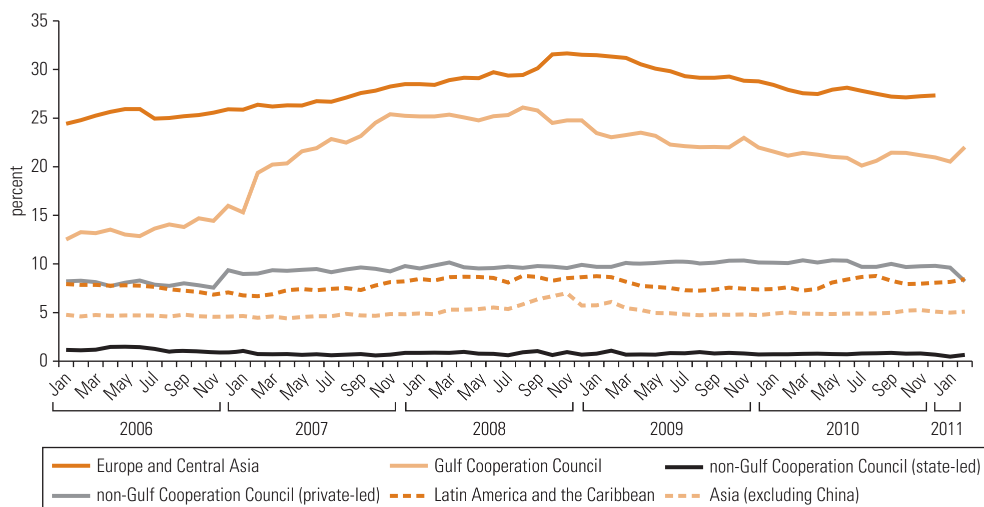
Average foreign bank penetration barely changed between 2001 and 2008, but these figures mask a decline in the GCC and a slow rise in the

non-GCC (see figure 7.4). In the non-GCC group, foreign banks increased their presence in Egypt, Morocco, and Syria. In Egypt, foreign bank entry included the establishment of de novo banks and the privatization of a major state-owned bank. In Syria, foreign banks entered the market as joint ventures with domestic investors, and no bank privatization took place. The origin of foreign banks reveals that in non-GCC countries, entrants from outside MENA increased their share more than regional entrants.

Despite increasing foreign bank entry, the integration of non-GCC banking systems with the global financial system remains generally limited. By way of illustration, in non-GCC banking systems in 2006–11, the ratio of foreign liabilities to total liabilities was below 5 percent for state-led banking systems and slightly above 10 percent for private-led systems (figure 7.6). Capital controls, a large domestic deposit base, and modest loan growth have limited the demand for foreign borrowing. Relatively modest foreign ownership has also reduced the level of integration with the international financial system. This limited integration dampened the impact of the financial crisis, especially as non-GCC banks were not vulnerable to a sudden stop by an outflow of foreign funding. At the same time, greater foreign entry would have facilitated the transfer of technology and know-how, improved access to foreign funding, and, in the case of the privatization of state banks, strengthened bank performance and efficiency.

FIGURE 7.6

Foreign Liabilities as a Percentage of Total Liabilities, by World Region, 2006–11



Source: IMF 2011.

The number of Islamic banks has grown rapidly, but their presence is highly uneven across country groups (see figure 7.5) (Ali 2011). The most developed Islamic banking sectors can be found in the GCC, in particular in Bahrain, Kuwait, and the United Arab Emirates. Islamic banking is expanding rapidly in Qatar, Saudi Arabia, and the United Arab Emirates. Although most asset growth has been taking place in the GCC countries, non-GCC countries have also witnessed a rise in Islamic banking in recent years, both by new domestically incorporated Islamic banks and by crossborder expansion of GCC–based Islamic banks through their subsidiaries (box 7.1). The majority of Islamic banks are privately owned. In some jurisdictions, conventional banks offer Islamic windows. In early 2011, Qatar issued a circular requiring that Islamic and conventional bank assets be separated into different entities.

BOX 7.1

Islamic Banking

Islamic finance has been gaining ground rapidly in MENA. It caters to the financial needs of a large number of people without conflicting with their social and religious values. Islamic banking is the largest segment of Islamic finance.

Ali (2011) provides an introduction to the main principles of Islamic finance and describes the major asset and liability structures. His analysis of Islamic banking is based on a sample of 30 banks. The sample is representative of the banking sector in the region, excluding the Islamic Republic of Iran.

Identifying the main growth factors can help policy makers formulate policies for the sector at the national, regional, and global levels. However, rigorous analysis of these issues requires extensive micro and macro data on social, behavioral, economic, and financial variables that are not currently available. The research findings cited here must therefore be viewed as preliminary.

The panel regression analysis focuses on three factors: general financial sector development, regulatory support and political will, and demand for Islamic finance. The dependent variable—the growth of Islamic banking—is measured by two proxies: the ratio of assets of the average Islamic bank to GDP and the ratio of deposits of the average Islamic bank to GDP. Among the independent variables, the ratio of broad money (M2) to GDP is used as a proxy for general financial sector growth. Demand for Islamic finance is measured by GDP per capita multiplied by awareness of Islamic finance, which is measured by the ratio of the number of news items pertaining to Islamic finance reported in Google News to the total number of news

(Box continues on the next page.)

BOX 7.1 (continued)

items reported in Google News. This method of calculating awareness excludes advertisements and relies on news counts, not analysis of news content. Regulatory support is measured by a dummy variable that can take values of 1, 0, and –1 to signify the jurisdictions in which Islamic finance is actively supported (1), looked upon with indifference (0), and discouraged (–1).

The regression results indicate that regulatory support is the most important factor, followed by general financial sector development for the expansion of both assets and deposits of Islamic banks. Contrary to expectations, the coefficient of the proxy variable to represent demand for Islamic banking is very small and has a negative sign. All three factors and the constant term turn out to be statistically significant. The effect of the very low importance of demand for Islamic finance is further investigated by separating the two components of the proxy variable for demand (that is, per capita income and the ratio of Islamic finance news items to total financial news items). The coefficient for the ratio of Islamic finance news items to total financial news items, HITRATIO, is negative and statistically significant at the 5 percent level, but the coefficient for GDP per capita is very small and not significant. The negative coefficient for HITRATIO is counterintuitive. One potential explanation is that the variable may have become biased during the financial crisis period (the years spanning the sample), because the number of news items on general finance (the denominator) may have been growing more rapidly than the number of Islamic finance and economic news items (the numerator), thus yielding a negative relationship with the growth of Islamic finance.

Source: Ali 2011.

GCC banks have stronger links with global financial systems than banks elsewhere in the region. GCC banking systems have been more integrated with the global system through more open crossborder flows. Some GCC countries relied excessively on foreign funding before the crisis and eventually suffered sudden funding stops and a stronger crisis impact. The GCC is also more integrated with global financial systems, through its three financial centers (box 7.2).

Despite the positive evolution of the structure of most MENA banking systems, bank competition still appears to be weaker than in most other regions. Traditional indicators such as net interest margins indicate that MENA systems are competitive, but these indicators can be deceptive, because they reflect the peculiar asset composition of MENA banks, which includes large shares of financing to governments, state-owned

BOX 7.2

Status and Prospects of Financial Centers in the Gulf Cooperation Council

Although there is no single definition of what constitutes a financial center, there is general agreement that a financial center is a hub for international—especially nonresident—financial transactions. The GCC has three active financial centers (Bahrain, the Dubai International Financial Center [DIFC]), and the Qatar Financial Center [QFC]). At least three more (in Abu Dhabi, Kuwait, and Riyadh) are at various stages of development.

GCC centers evolved from the single specialization of Bahrain during the first petrodollar wave in the 1970s to ambitious multifunction centers seeking a role in the allocation of funds outside and inside the GCC. The financial centers in Dubai (established in 2004) and Qatar (established in 2005) have scaled up activity rapidly. The business case for the DIFC and QFC was helped by the second petrodollar wave, during the 2004–08 oil price boom; all three centers have also taken advantage of emerging market capital flows to the GCC, especially to fund the nonoil sectors. Each center has capabilities that target nonresidents. To some extent, they are therefore separated from the domestic financial system. Nonetheless, they are not classic offshore centers or centers with a highly specific niche.

The three GCC centers differ significantly in regulatory structure. In Bahrain, the central bank is the unified regulator for all types of financial firms, and there is no distinction between an onshore and offshore sector in terms of regulation. Dubai and Qatar have separate legal structures for their financial centers, which are managed and supervised under institutional arrangements that are independent of their domestic financial sectors.

The centers also differ in the treatment of local currency transactions. The DIFC does not allow dealing in local currency transactions. In contrast, the QFC does not prohibit local currency intermediation, although no license for such transactions has yet been issued. In Bahrain's nomenclature, both retail and wholesale banks can accept deposits and provide credit to residents and nonresidents in any currency (although there is a minimum transaction size for wholesale banks with domestic residents); retail banks are required to show that provision of credit is a substantial part of their business.

Bahrain is the only GCC center with significant nonresident banking activity when measured either by foreign assets of the banking system or estimates of crossborder booking activity. In this respect, the DIFC and QFC look more like domestic financial hubs facilitating the foreign financing of local nonoil investments, notably in real estate. Nonintermediation services such as consulting, advisory, and legal services appear to be important for these centers, especially

(Box continues on the next page.)

BOX 7.2 (continued)

the DIFC. Bahrain shows the clearest gains in employment of nationals from specializing in financial activities. The 2011 political turmoil has called some of these gains into question.

The prospects for GCC–based centers are brightest when it comes to the financing of large investment projects in the region. Even in this respect, however, the local role will be limited by the financing appetite of local banks. The centers may thus function primarily to support global consortia and syndicates.

Capital markets in the region are underdeveloped. Whether these centers have sufficient momentum to act as vehicles for deepening capital markets remains unclear. Nevertheless, there are signs of emerging specializations in Islamic finance and investment banking, and the reach of the common law systems of the DIFC and QFC is extending into the domestic economies, which should strengthen financial infrastructure.

Source: Carey and Sensenbrenner 2011.

enterprises, and large corporate entities, including well-connected, family-owned firms. Recent empirical research based on nonstructural measures of competition indicates that MENA banking sectors lag in terms of competition (Anzoategui, Martinez Peria, and Rocha 2010), a result that is consistent with the high loan concentration in the region. Differences in banking competition between MENA and other regions can be explained by the weaker credit information environment, stricter implementation of regulations governing bank entry, and weak competition from outside the banking system (see chapter 5). Although foreign banks have entered MENA, their market share has remained low, possibly as a result of the weak financial infrastructure and the lack of a level playing field.

Performance of Banking Systems

Balance Sheet Structure

Loan concentration in non-GCC countries is very high, with the average ratio of the top 20 loan exposures to total equity in the non-GCC region the highest in the world. Very high loan concentration ratios in the region reflect the established connections between large banks on the one hand and large industrial groups and state-owned enterprises on the other.

Most countries recently put lending to small and medium enterprises at the forefront of their financial development agendas, because of such firms' contribution to employment, but only Lebanon and Morocco succeeded in developing adequate volumes of lending to the sector as well as mortgage lending.

Loan concentration is somewhat lower in the GCC, but it still exceeds most emerging regions. Retail credit has grown rapidly in recent years in most GCC states, supported by the creation of private credit bureaus; on average it represents 30 percent of loan portfolios (Fitch 2009). The dominant retail product in the GCC has been personal loans in which the borrower's salary is assigned to the bank. This arrangement alleviates somewhat the problem of weak creditor rights. However, lending to small and medium enterprises remains extremely limited, at 2 percent of loan portfolios, suggesting lingering problems in the enabling environment. Sectoral concentration in the undiversified Gulf economies has been a concern, especially the high exposure to the real estate sector. The impact of the global crisis was strong in this sector, as the real estate price collapse and related debt restructurings in Dubai reveal.

Loans to the public sector account for a large share of the balance sheet in a number of MENA countries. Government financing is one of the major mandates of state banks; unsurprisingly, a very large share of credit flows to the government and state-owned enterprises in Algeria, Egypt, Iraq, Libya, and Syria. Exposure to the government through government securities is also high in Lebanon and nonnegligible in Jordan. With the exception of Lebanon, banking systems with high exposure to the government are also the ones in which state ownership is relatively high, as state banks finance the government and the public sector more than private banks do (Farazi, Feyen, and Rocha 2011). In an environment of excess liquidity and in the absence of a strong private institutional investor base and foreign investors, banks (together with public funds in some countries) are in effect captive investors for government debt. This phenomenon leads to illiquid secondary debt markets and distorted yields (Garcia-Kilroy and Silva 2011).

Currency mismatches on bank balance sheets have not been a major source of vulnerability in most MENA countries. Non-GCC countries have prevented the build-up of currency mismatches on bank balance sheets. Tight foreign exchange and capital controls prevented large-scale foreign borrowing by banks, and some highly liquid banking systems, such as those in Lebanon and the West Bank and Gaza, accumulated sizable foreign asset buffers. Nevertheless, several countries in the region have high dollarization rates, on both the asset and liability side. Most notable is Lebanon, where the share of foreign currency assets and liabilities exceeds 60 percent. Despite the relatively minor foreign exchange

mismatch, vulnerability to exchange rate changes may be significant in countries that have a high share of foreign currency loans, as foreign exchange risk potentially turns into credit risk in the face of adverse events. Foreign borrowing built up quickly in GCC banking systems before the crisis, but it did not pose vulnerabilities in terms of currency mismatches, given the very strong external position of these countries.

MENA banking systems seem to be exposed to a growing maturity mismatch, although deficiencies in data reporting do not allow an accurate assessment. Banks have a comparatively large share of demand deposits in total liabilities (about one-fourth), and interviews with banks and regulators suggest that the maturity of loan portfolios has been lengthening in many countries, exposing banks to interest rate and liquidity risks. Private banks have traditionally charged floating rates on their medium-term loans, shifting this risk to the borrower, although some banks in Morocco and Tunisia increasingly charge fixed rates. Liquidity risk has been mitigated partly by sizable liquidity reserves in many banks but still seems to be growing. Banks and regulators seem to rely on the stability, or "stickiness," of customer deposits. Overall, the lack of concern about maturity mismatches in the region is striking, with only a few countries reacting to the growing mismatch. This issue is further discussed in the regulatory section of this chapter.

Maturity mismatch can be a source of risk for two reasons: the impact on income from interest rate risk and the impact on system liquidity from funding risk. Most banks charge floating interest rates on loans, which allows rapid repricing of assets if funding costs move against the bank. The appreciation of funding risk is highly dependent on assumptions about the stability of deposits as the main funding source. The Basel III liquidity coverage ratio provides the template for assessing funding risk on a consistent basis across countries. Non-GCC banking systems generally depend for their funding on retail deposits, which are considered stable. Some GCC banking systems could face problems meeting the Basel III liquidity coverage ratio because of their larger share of more price sensitive large corporate deposits.

Bank Performance Indicators

This section examines the behavior of various performance ratios. The analysis draws on the econometric results of Farazi, Feyen, and Rocha (2011), which are summarized in box 7.3.

Net interest margins were lower in MENA than in other regions for the 2005–08 period (table 7.2), possibly because banks in the region tend to serve primarily well-connected large private firms, state-owned enterprises, and the government, all of which typically pay prime lending rates.

BOX 7.3

Empirical Analysis of Bank Ownership and Performance in the Middle East and North Africa

Using a bank-level panel data set for the period 2001–08, Farazi, Feyen, and Rocha (2011) document ownership trends and assess the impact of ownership on bank performance, controlling for key bank characteristics such as size and balance sheet composition. Their sample includes data for about 120 banks in 9 non-GCC countries in the region (Algeria, Egypt, Jordan, Lebanon, Libya, Morocco, Tunisia, Syria, and the Republic of Yemen) between 2001 and 2008, yielding 600 bank/year observations. Most of the data come from the Bankscope database.

The empirical results include standard two-group comparison tests and bank-level multivariate panel regression analysis. The regressions employ simple ordinary least squares on pooled annual bank data and include country and time fixed effects to mitigate omitted variable bias (box table 7.3.1).

BOX TABLE 7.3.1

Regression Results on Bank Ownership, Profitability, Interest Margin, and Securities in the Middle East and North Africa

(unweighted)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Variable	Return on equity	Net interest margin (total assets)	Total securities to assets (all countries)	Overhead to assets	Employment to assets	Wages (overhead)	Loan loss provisions to gross loans
Dummy public ownership	–6.731	-0.061	5.304	0.364	0.035	–18.476	1.26
	[3.02]***	[0.48]	[2.55]**	[3.61]***	[7.17]***	[5.79]***	[2.84]***
	(2.02)**	(0.26)	(1.18)	(2.17)**	(4.38)***	(4.40)***	(2.12)**
Dummy foreign ownership	1.333	0.107	–2.337	0.268	0.008	–2.8	–0.057
	[0.83]	[1.20]	[2.28]**	[3.51]***	[2.01]**	[1.29]	[0.27]
	(0.53)	(0.65)	(1.18)	(2.05)**	(0.98)	(0.73)	(0.19)
Dummy listed	3.654	0.241	–3.317	0.25	0.004	7.038	–0.32
	[2.70]***	[3.01]***	[2.62]***	[3.05]***	[1.15]	[2.56]**	[1.54]
	(1.99)**	(1.79)*	(1.57)	(1.95)*	(0.72)	(1.89)*	(1.25)
Lag total assets (log)	1.457	–0.025	1.521	–0.186	–0.01	8.737	–0.031
	[2.60]***	[0.77]	[3.50]***	[5.80]***	[10.09]***	[10.02]***	[0.39]
	(1.91)*	(0.45)	(1.92)*	(3.75)***	(5.90)***	(7.09)***	(0.36)
Noninterest income to assets	2.197	–0.219	–1.248	0.275	0.007	1.76	0.58
	[3.24]***	[4.13]***	[2.01]**	[6.02]***	[2.54]**	[1.18]	[3.25]***
	(2.63)***	(2.74)***	(1.38)	(5.00)***	(1.96)*	(1.16)	(2.79)***
Deposits to assets	0.151	–0.027	0.02	–0.012	0.0002	–0.69	0.044
	[1.64]	[6.00]***	[0.36]	[1.82]*	[1.15]	[4.85]***	[3.45]***
	(1.44)	(3.68)***	(0.20)	(1.53)	(0.73)	(3.37)***	(2.98)***

(Box continues on the next page.)

BOX 7.3 (continued)

BOX TABLE 7.3.1 (continued)

Variable	(1) Return on equity	(2) Net interest margin (total assets)	(3) Total securities to assets (all countries)	(4) Overhead to assets	(5) Employment to assets	(6) Wages (overhead)	(7) Loan loss provisions to gross loans
Loans to assets	–0.119	0.002		0.006	0.0002	0.02	–0.017
	[2.73]***	[0.67]		[2.07]**	[1.82]*	[0.28]	[2.03]**
	(1.94)*	(0.43)		(1.45)	(1.02)	(0.20)	(1.63)
Observations	516	557	573	575	387	384	489
R-squared	0.15	0.41	0.49	0.4	0.55	0.66	0.38
Number of countries	9	9	9	9	9	9	9
Number of banks	119	119	117	120	102	104	115

Source: Farazi, Feyen, and Rocha 2011.

Note: Regressions are estimated using ordinary least squares at the bank level for 2001–08. Robust *t*-statistics appear in brackets; bank-level clustered *t*-statistics appear in parentheses. All regressions control for time and country dummies. The inverse of the number of banks in a country in a given year is used as the weight.

* significant at the 10% level; ** significant at the 5% level; *** significant at the 1% level.

This explanation is corroborated by the observation that loan concentration in both GCC and non-GCC banking systems is among the highest in emerging economies. Average profits are also lower, possibly reflecting the same factors. However, the average profits of GCC banks are higher than those of non-GCC banks, reflecting less government financing, higher noninterest income, and lower average costs, as well as the smaller share of state banks in the GCC.

In line with the experience of other emerging regions, state banks outside the GCC are significantly less profitable than private domestic banks. This result reflects both development mandates imposed on state banks and their low levels of operational efficiency and risk management capacity, as discussed in chapter 5. State banks finance more government credit than do private banks, a result that reflects a government financing mandate and contributes to lower net interest margins. They also carry out a development mandate in areas such as small and medium enterprise, housing, and investment finance. Their effectiveness in performing this mandate is mixed and uneven across countries. State-owned banks tend to generate much larger nonperforming loans than private banks and have had to build larger loan loss provisions. These results reflect the lower return and higher risks inherent in lending to state enterprises and

TABLE 7.2

Bank Performance Indicators, by World Region, 2005–08
(percent)

Region	Net interest margins	Return on assets	Overhead cost to assets
Middle East and North Africa	3.34	1.59	1.70
GCC countries	3.03	2.66	1.43
Non-GCC countries	3.51	1.01	1.84
Central Europe	3.68	1.65	2.92
South Asia	3.95	1.17	2.48
East Asia	4.55	1.65	3.14
Eastern Europe and Central Asia	6.23	2.19	5.81
Latin America	6.37	1.80	5.47
Africa	6.93	2.19	6.00
High-income countries	1.63	0.66	1.42

Source: Bankscope/FinStats.

favored sectors, but the adverse outcomes are exacerbated by extensive political interference and internal deficiencies in risk management that are associated with a very low skills base.[1]

Foreign banks in the non-GCC group have higher interest margins and profit ratios than private domestic banks, but the differences are not significant. They have higher cost ratios and higher ratios of employees to assets, even after controlling for their much smaller size. They seem to be able to offset these higher costs through higher interest and noninterest income, although many of these results are not statistically significant. Moreover, the entry and expansion of foreign banks is a recent phenomenon in many non-GCC countries. Most of these banks remain small and apparently unable to challenge the domestic banks in their main credit markets, because of the absence of a branch network or a weak financial infrastructure. Foreign banks would probably expand more quickly and contribute to more competitive and efficient financial systems if they had access to more and better credit information.

Resilience of Banking Systems

A crucial question is whether MENA banks have sufficient capital buffers and adequate liquidity and risk management tools to withstand shocks, sustain a credit recovery, and expand new lines of business. MENA banking systems showed resilience during the crisis, as a result of strong initial capital positions, forceful measures by country authorities, and the comparatively benign effect of the global crisis in the region, as noted in chapter 2. There was no systemic stress. The United Arab

Emirates, the worst-affected banking system, withstood the pressure from the global liquidity freeze and the domestic real estate crash with government support.

The recent political unrest in the region will have a significant impact on several banking systems. Although the events are still unfolding, there are signs that countries experiencing a longer period of unrest and slowdown in economic activity will be more strongly affected.

Countries in the Gulf Cooperation Council

Despite being affected by the global financial crisis, GCC banking systems remain in a strong capital position to sustain the credit recovery. GCC banks have enjoyed strong sovereign support that is reflected in their ratings. They were highly capitalized and profitable, with small shares of nonperforming loans in the precrisis years (see table 7.3). Between 2006 and 2008, capital adequacy ratios (CARs) declined in all countries except Qatar, but the decline began from a high base. The decline was driven primarily by high credit growth, which increased the volume of risk-weighted assets. In addition, GCC banking systems have a relatively high share of *Sharia*-compliant banks, which tend to have higher capitalization than conventional banks. As GCC countries are generally advanced in the implementation of Basel II, in some cases extra capital charges weighed on their capital adequacy ratios.

High loan concentration in the real estate and construction sectors continues to be a problem. Periods of rapid credit growth are typically

TABLE 7.3

Soundness of Banking Systems in the Middle East and North Africa, 2006–09

(percent)

Indicator and country	2006	2007	2008	2009
Capital adequacy ratio				
GCC				
Bahrain	22.0	21.0	18.1	19.6
Kuwait	21.2	19.4	17.1	18.0
Oman	17.2	15.8	14.7	15.5
Qatar	14.3	13.5	15.5	16.1
Saudi Arabia	21.9	20.6	16.0	16.5
United Arab Emirates	16.6	14.0	13.3	19.2
Non-GCC, private-led banking system				
Egypt, Arab Rep.	14.7	14.8	14.7	15.1
Jordan	21.4	20.8	18.4	19.6
Lebanon	—	12.5	12.1	12.4
Morocco	12.3	10.6	11.2	11.8
Tunisia	11.8	11.6	11.7	12.4

TABLE 7.3 (continued)

Indicator and country	2006	2007	2008	2009
Non-GCC, state-led banking system				
Algeria	15.2	12.9	16.5	21.9
Libya	11.6	11.8	12.2	14.5
Syrian Arab Republic	7.0	6.5	6.5	6.5
Nonperforming loans to total loans				
GCC				
Bahrain	4.8	6.0	2.3	3.9
Kuwait	3.9	3.2	5.3	9.7
Oman	4.9	3.2	2.1	3.5
Qatar	2.2	1.5	1.2	1.7
Saudi Arabia	2.0	2.1	1.4	3.3
United Arab Emirates	6.3	2.9	2.5	4.8
Non-GCC, private-led banking system				
Egypt, Arab Rep.	18.2	19.3	14.8	13.4
Jordan	4.3	4.1	4.2	6.7
Lebanon	13.5	10.1	7.5	6.0
Morocco	10.9	7.9	6	5.5
Tunisia	19.3	17.6	15.5	13.2
Non-GCC, state-led banking system				
Algeria	34.2	35.5	28.2	21.8
Libya	25.4	27.2	19.2	16.9
Syrian Arab Republic	4.7	5.3	5.1	5.1
Provisions to nonperforming loans				
GCC	—	—	—	—
Bahrain	—	—	83.0	
Kuwait	47.8	48.2	41.6	38.5
Oman	109.6	111.8	127.3	104.0
Qatar	94.3	90.7	82.8	—
Saudi Arabia	182.3	142.9	153.3	89.8
United Arab Emirates	98.2	100.0	100.8	85
Non-GCC, private-led banking system				
Egypt, Arab Rep.	76.2	74.6	92.1	100.4
Jordan	79.6	67.8	63.4	51.9
Lebanon	54.4	56.6	61.3	64.4
Morocco	71.2	75.2	75.3	74.1
Tunisia	49.0	53.2	56.8	58.3
Non-GCC, state-led banking system				
Algeria	54.0	55.0	—	—
Libya	69.0	66.0	—	—
Syrian Arab Republic	61.0	23.7	—	—

Source: IMF 2010.
Note: — = not available.

accompanied by low nonperforming loan ratios, as newly extended loans improve asset quality in the portfolio. Thus, it is not surprising that rapidly growing GCC banking systems had very low nonperforming loan ratios (1–3 percent) at end-2008. These concentrated loan portfolios eventually took a toll, as indicated by the immediate impact of the crisis on asset quality: nonperforming loans increased substantially everywhere in the GCC. Kuwait suffered the greatest shock, with nonperforming

loans jumping to nearly 10 percent by end-2009. The United Arab Emirates was also hit hard by falling real estate prices, leading to debt restructuring and various forms of government support.

To preserve the resilience of GCC financial systems, more progress is needed in upgrading the regulatory and supervisory framework, improving liquidity management, and developing debt markets. GCC countries implemented certain macroprudential tools before the crisis, especially in order to contain retail lending, although these measures often came late in the credit boom. Given the undiversified nature of GCC economies relying on hydrocarbon revenues, credit and asset price cyclicality could be reduced by the expanded use of macroprudential tools (see IMF 2010 and the regulatory section). Liquidity management frameworks are weak, especially for Islamic banks, and domestic fixed-income markets are shallow. In addition to providing a complementary source of funding, debt instruments would allow banks to reduce interest rate risk and maturity mismatches on their balance sheets. Regulatory challenges are discussed in more detail in the next section.

Countries outside the Gulf Cooperation Council

The stability of non-GCC banking systems has been preserved in recent years primarily by cautious lending policies, a stable macroeconomic environment, and weaker channels of transmission to global shocks. Despite their high liquidity, banks in most countries remained focused on large, established clients and the public sector. In the absence of an adequate enabling environment, they have been reluctant to expand lending in riskier business lines, such as small and medium enterprise or mortgage finance. Foreign exchange and capital account restrictions precluded large-scale foreign borrowing, and fixed exchange rates shielded the financial sector from turbulences in international financial markets. These restrictions protected non-GCC banking systems from the effects of the global crisis, but these banking systems are failing to support economic growth and job creation to their full potential.

The main challenge in coming years will be to preserve financial stability in a deteriorating macroeconomic environment while expanding finance to underserved segments. The resilience of the banking sector will be challenged by the uncertainty about the global recovery, the more difficult macroeconomic environment as fiscal consolidation takes place, and the impact of the current political unrest. Banking activity has been severely disrupted in the countries most affected by political unrest, reducing banks' profitability and asset quality. Even countries experiencing more moderate protests are affected, as tourism and investment

inflows decline. As a result, nonperforming loans are likely to rise in most non-GCC countries, at varying rates.

The resilience of non-GCC banking systems is limited by smaller capital buffers, high nonperforming loans in some cases, and weaker sovereign support capacity in case of distress. The immediate impact of the global financial crisis was generally more subdued in non-GCC banking systems than in systems in the GCC, as shown in chapter 2. However, CARs were also lower in these countries when the crisis unfolded. Capitalization increased only moderately between 2008 and 2009, primarily as a result of balance sheet adjustments, and there is little potential for significant profit generation to build further capital buffers in a weak macroeconomic environment.

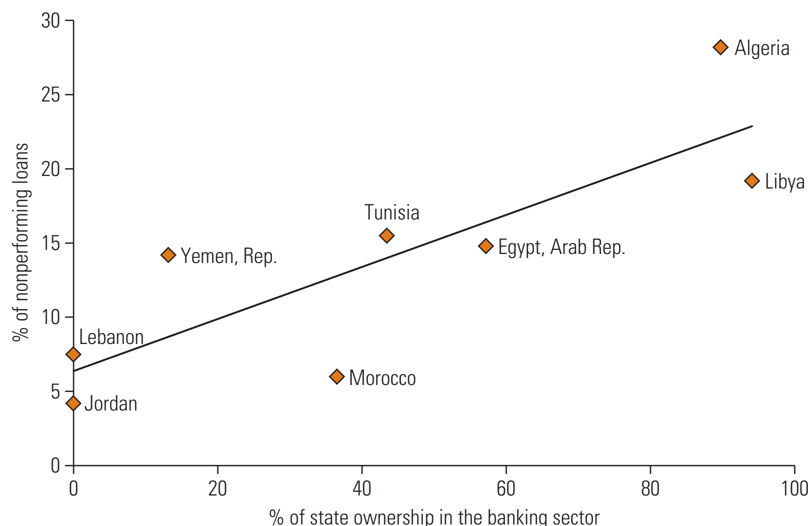
Some non-GCC countries have been struggling with the legacy of high shares of nonperforming loans, but asset quality and provisioning have generally improved. Only Jordan experienced an increase in nonperforming loans in 2009 (table 7.3). Lebanon, which improved its macroeconomic and banking sector indicators throughout the global crisis, is an outlier. In some MENA countries—most notably Egypt and Tunisia—the improvement in asset quality is partly a result of the ongoing resolution of old nonperforming loans. Despite the improvements, the nonperforming loan ratio still exceeded 13 percent in Egypt and Tunisia in 2009.

Indicators of financial soundness are less straightforward to interpret in the state-dominated banking systems of Algeria, Libya, and Syria. State bank accounts are generally not audited according to international standards. Nevertheless, very high volumes of nonperforming loans in Algeria and Libya are an indication of the history of directed lending to inefficient state-owned enterprises (figure 7.7). In Syria nonperforming loans in state-owned banks are likely to be significantly understated.

The agenda to strengthen the resilience of non-GCC banking systems in order to ensure sustainable access to finance is even more extensive. Maintaining macroeconomic stability is a precondition for financial stability. Doing so may be a challenge, given the limited fiscal space in many countries and ongoing political turmoil. Balance sheet cleanup needs to continue in countries with high nonperforming loans, especially for state banks. At the same time, sustainable improvement in state bank portfolios can be achieved only if their restructuring is accompanied by the restructuring of state-owned enterprises, which have been at the root of the problem of nonperforming loans and low profitability of state banks. In some countries, the restructuring of state-owned enterprises has lagged that of state banks.[2] The agenda to strengthen resilience also includes several other factors, such as improvements in financial infrastructure, the development of better funding and risk management

FIGURE 7.7

Relationship between State Ownership of Banking Sector and Percentage of Nonperforming Loans, by Country, 2008



Source: World Bank staff calculations based on data from IMF 2010 and Bankscope.

instruments, and improvements in the regulatory and supervisory framework, as discussed in the next section.

Main Regulatory and Supervisory Issues

The Microprudential Regulatory and Supervisory Framework

Despite improvements in supervisory processes, the lack of effective risk-based supervision remains the main challenge to the sound growth of MENA's banking systems.[3] All supervisors have strived to adopt international standards, though some countries have fallen behind in this process and still need to fill major gaps in their regulatory framework. Convergence to international standards has contributed to some regional convergence of regulatory standards, but situations remain very diverse, largely in line with the different levels of sophistication of the region's financial systems.

Improvements in banking supervision can be delivered only by independent and accountable authorities. Further progress is needed in increasing both independence and accountability. The fact that banking supervision function is carried out by central banks facilitates better access to financial and human resources and can reduce the risk of

political or industry influences. A combination of amendments to the legal framework, clear public communication on commitment to supervisory independence, and the appointment of well-respected heads of supervision strengthened the independence of supervisors in some countries. However, independence is still impaired in most countries as a result of (a) the absence of a term mandate for heads of supervision and legal protection for supervisors and (b) the fact that central bank governors serve as cabinet members, former senior central bankers run large domestic banks (often state owned) without a sound conflict of interest framework, and central banks hold direct stakes in banks. Public oversight also appears limited, with accountability to parliament rare.

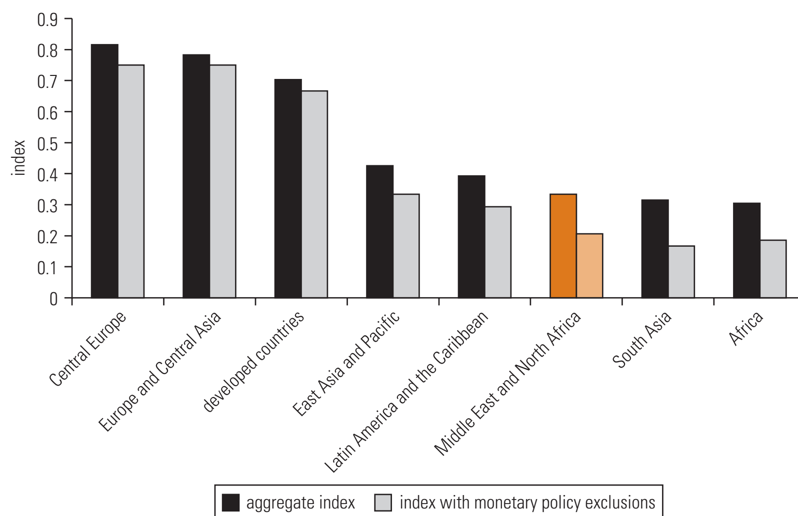
The political autonomy of central banks is weaker than in other regions. A clear delineation between government and central bank authority is critical to ensuring transparent and accountable central bank supervision. MENA ranks poorly in a cross-regional comparison of the Grilli, Masciandaro, and Tabellini (GMT) Central Bank Political Autonomy Index, scoring worse than all regions but Africa and South Asia (figure 7.8). The index's subcomponents include assessments of government involvement in governorship appointments and central bank board representation, as well as the length of mandates (that is, whether mandates have a stipulated five-year term minimum). MENA scores .33, compared with .82 in Central Europe and .39 in Latin America and the Caribbean. The rankings hold when the index is recalculated excluding monetary policy components.

The mandates of many central banks still include the promotion of economic and financial development. These are legitimate concerns, but they should not conflict with supervisory independence, because they could ultimately result in the build-up of excessive risks. In state-dominated banking systems, the independence of the supervisor is often weakened by the pivotal role played by the ministry of finance in bank ownership. For example, approval is required to access key audit reports for state-owned banks or engage enforcement actions. As a result, bank supervisors in some countries have no power to effectively supervise state-owned banks. Disclosure by supervisors on their activities is also missing in many cases.

Countries in the region are making progress in implementing Basel II. Most countries that have introduced Basel II are opting for the standardized approaches; only a few countries contemplate introducing advanced approaches in the following years. The global financial crisis and the regulatory response had an impact on Basel II implementation plans in several MENA countries. A number of countries recently postponed offering the foundation and advanced Internal Rating Based (IRB) approaches for credit risk (BIS 2010c). With few externally rated

FIGURE 7.8

GMT Central Bank Political Autonomy Score



Source: Arnone and others 2007.

Note: Central Europe includes the countries that joined the European Union. GMT is Grilli, Masciandaro, and Tabellini (1991). Subcomponents of the GMT Political Autonomy Index include the following: (a) the central bank governor is appointed without government involvement; (b) the appointment is for more than five years; (c) the board is appointed without government involvement; (d) board members are appointed for at least five years; (e) there is no mandatory participation of government representatives on the board; (f) government approval is not needed for monetary policy formulation; (g) monetary stability is one of the central bank's primary objectives; and (h) legal protection strengthens the central bank position in the event of conflict with the government. Subcomponents (f) and (g) were omitted from the recalculated index with monetary policy exclusions.

counterparties, the introduction of standardized approaches means improved capture of all risk exposures (especially off balance sheet); lower capital requirements for sound retail lending (for example, low-risk mortgage loans); a well-articulated risk mitigation regime; and a new capital charge for operational risk. Overall, the introduction of Basel II has led to stable or slightly higher capital requirements.[4]

The immediate impact of new international financial reforms that respond to the global financial crisis appears limited in the region (box 7.4). MENA banks in general and GCC banks in particular have higher capital adequacy than banks in advanced economies or the new regulatory minimum. In the medium term, however, the new liquidity and stable funding requirements of Basel III are likely to pose a challenge to MENA countries. The countercyclical features of the new framework will be a welcome addition, especially for countries with pronounced oil cycles, but calibrating cyclical buffers is likely to be challenging.

BOX 7.4

Implications of International Financial Reforms

Some international financial reforms are not relevant in the Middle East and North Africa, whose financial markets are less sophisticated than those in the G-20 with respect to the use of over-the-counter derivatives and securitization, the presence of hedge funds, and reliance on credit rating agencies.[a] In fact, for most countries in the region, the existing reform agenda—which calls for more intrusive supervision, the development of institutional and legal underpinnings for the financial system, and an increase in financial access—remains valid, although in certain cases global reform measures have implications for domestic financial systems that need to be taken into account.

Only a few domestic banks in the region could be significantly affected by the proposed new capital rules. Most banks' regulatory capital is already of a relatively high quality, actual capital adequacy is generally high, the types of credit exposures whose capital treatment is being significantly tightened under Basel III are not commonly used, and some countries (in the GCC in particular) already operate certain macroprudential tools. Some banks have been able to operate with relatively low capital buffers (compared with their peers and other banking systems). They would need more capital under Basel III (which their earning power alone may not be able to provide) and be subject to more intense supervision when they cannot maintain an adequate capital buffer (for example, the contemplated 2.5 percent conservation buffer). There could also be some indirect effects arising from the fact that large international banks active in the region and responsible for a large proportion of credit growth in recent years (in, for example, the GCC) may curb or adjust their activities in response to these rules.

Banking systems in Lebanon, Morocco, Syria, and Tunisia have been able to operate with relatively low capital levels compared with other systems in the region. As Basel III forces advanced economies' banks to increase their capital, the supervisory authorities in these countries should be aware that their banks will need to follow suit to some extent. Basel III imposes a 2.5 percent buffer above the regulatory minimum; many banks in these countries would operate within the conservation buffer, thereby exposing themselves to greater supervisory intrusion, such as limits on dividend distribution.

Undiversified economies, heavy dependence on commodity prices, and the lack of independent monetary policy (given pegged exchange rate regimes) in several countries in the region can result in capital inflow–driven credit booms and asset price bubbles tied to commodity price cycles. There is consequently a need for macroprudential frameworks and policy tools to mitigate these tendencies.

(Box continues on the next page.)

BOX 7.4 (continued)

The Basel Committee proposals for a countercyclical capital regime are therefore highly relevant. However, more analysis is needed to determine whether the credit-to-GDP ratio is the most appropriate indicator of systemic risk build-up in MENA; the already high capital adequacy ratio of many banks in the region may make this tool nonbinding. Other tools—such as sectoral loan-to-value ratios, expected loss provisioning, foreign currency lending limits, and additional liquidity requirements—to be used at national discretion may be more appropriate in this context.

The new Basel III requirements on liquidity and net stable funding will pose a challenge for many MENA banks, given the lack of liquid fixed-income markets. In addition, most GCC countries lack high-quality assets, as governments have been reluctant to overfund the budget. If banks intend to increase much needed longer-term lending, the net stable funding ratio requirement implies that many banks need to increase the issuance of longer-term liabilities, a challenging prospect in the absence of well-functioning debt markets and a sizable institutional investor base.

The prudential reform agenda relating to (national as opposed to global) systemically important financial institutions may be relevant for some countries in the region, given the dominance of their financial systems by a few large banks. This is particularly the case when some of these institutions are too large relative to the ability of the authorities to provide support. International initiatives to establish crossborder resolution frameworks are also relevant to the region, as some banks have significant crossborder activities. Efforts in this direction should complement efforts at the domestic level to set up well-designed special resolution regimes.

a. BIS 2010a, 2010b. The documents are available at http://www.financialstabilityboard.org; http://www.bis.org/bcbs/basel3.htm; and http://www.ifrs.org/Financial+crisis/Response+to+the+credit+crisis.htm.

Source: Stephanou 2011.

Minimum capital adequacy requirements are increasingly set above the international minimum, but like Pillar 2 of the Basel II framework measures are not sufficiently used. In the last decade, many MENA countries introduced minimum requirements of more than 8 percent. Supervisory actions are increasingly linked to compliance with CAR triggers following the introduction of prompt corrective action regimes in some countries. However, many supervisors are not yet empowered to require individual institutions to hold CARs above the minimum level, and in

some cases they are not using their existing powers. In this regard, supervisory authorities should introduce the Basel III capital conservation buffer to enhance their ability to intrude into bank management practices before excessive risk-taking depletes capital to regulatory minimums.

Large exposure regimes have had limited success in reducing loan concentration. Although individual large exposures are generally set at conservative levels (10–25 percent of own funds), the definition of connected parties and related parties is often too narrow. Enforcement is often deficient, and significant exceptions exist, with regulatory or case-by-case exceptions granted by supervisors, generally on the basis of strategic national interests and with limited disclosure. Moreover, limits on aggregated large exposures are often set at very high levels or do not exist. Few countries have started taking supervisory actions when credit concentration is excessive. Supervisors also face difficulties in identifying risk from multiple, unconsolidated exposures to private conglomerates. The region's weak corporate governance practices and financial disclosure make it hard to track ultimate beneficiaries of loans on a consolidated basis.

Supervisors seem to pay inadequate attention to the growing maturity mismatches. This area has so far been subject to limited international harmonization and has been left to national supervisors. Maturity mismatch can be a source of risk as a result of the impact on income (as a result of interest rate risk) and liquidity (as a result of funding risk). Most countries in the region have often set minimal risk management requirements in this regard, established no or limited reporting requirements, and exercised limited supervision in the absence of significant progress in risk-based supervision. The new Basel III liquidity requirements will help supervisors improve the monitoring of maturity mismatches.

Introducing international financial reporting standards (IFRS) helped improve accounting regimes in the most advanced MENA countries, but other countries still have significant efforts to make. Most advanced jurisdictions (the GCC, Jordan, Lebanon, Morocco) introduced IFRS for banks, albeit sometimes only for listed banks or consolidated accounts. In markets with limited liquidity, the implementation of the fair value option often remains challenging. In non-IFRS jurisdictions, consolidated standards are also generally weak, and some banks with subsidiaries do not prepare consolidated accounts or comply with consolidated prudential requirements. Despite significant progress in the most advanced countries, disclosure generally remains weak, especially when it comes to qualitative and prudential disclosure (for example, exposures on related parties or largest nonperforming loans) and nonlisted banks.

Several countries (GCC countries, Morocco) have embarked on ambitious programs to build risk-based supervision. Limited market

experience among supervisory staff remains a constraint. A key challenge is to maintain effective supervision while implementing this transition. The global crisis highlighted that in some advanced countries, the transition to Basel II advanced approaches absorbed such a large share of supervisory resources that it significantly reduced supervision of banks' risks. As banking systems grow in size and complexity (including cross-sector and crossborder linkages), the transition to risk-based supervision becomes critical for all countries in the region.

The Role of Market Discipline

The architecture of market discipline in MENA does not provide adequate means or incentives for market players to monitor banks' performance. Pillar 3 of the Basel II framework relies on the assumption that market discipline imposes strong incentives on banks to conduct their business in a safe, sound, and efficient manner. It complements the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2). Its aim is to encourage market discipline by developing a set of disclosure requirements that will allow market participants to assess a bank's capital, risk exposures, and risk assessment processes. Despite improvements in recent years, disclosure of banks in MENA falls short of the ideal. At the same time, both the strong implicit deposit insurance amounting to de facto blanket guarantees and the absence of bank failures and credible bank resolution arrangements that wipe out shareholders and subordinated creditors have reduced the incentives for all stakeholders to monitor the banks.

Disclosure of banks' financial position has improved in recent years, as regulators have raised requirements, but there is room for improvement. Most banks are required to disclose financial statements at least annually and usually semiannually or quarterly. Some countries require all banking institutions to take the form of joint stock companies and to be listed on the domestic stock exchange, thereby requiring them to disclose IFRS–compliant financial statements. Review of information reveals inconsistent disclosures, particularly in the area of consolidated financial reporting, as well as differences in the valuation of common exposures. Nonfinancial disclosure is less developed than financial disclosure throughout the region, hindering the assessment of banks' risk governance. The disclosure of ownership information is particularly poor. In a number of markets, information about bank ownership is considered confidential and is not publicly available. Most banks disclose little or no information about "beneficial" or "ultimate" shareholders. Market surveillance of banks' financial statements and the quality and integrity therein can be improved. Market regulators take actions for material,

inaccurate statements of banks' financial positions (imposing penalties, requiring the restatement of published financial statements, or taking more rigorous actions) only infrequently.

Banks across MENA face external audit requirements; most banks are audited annually. In a number of countries, the audit business is concentrated, and some firms have long-standing ties to the banking sector. Although regulation, audit firm policies, and banks may require partner or firm rotation, high concentration makes doing so challenging. In some countries, only local auditors are allowed to sign bank audits. In these cases, international firms often work with national auditors, with the local auditor signing the report. The local auditors signing the audit, and not the associated firm, may bear all the liability associated with an inadequate audit. In other instances, audit firms may not be prohibited from providing nonaudit services. External audit staff with skills in banking and banking-related activities are lacking in some countries, requiring further development and depth.

Deposit Insurance

Many countries in the region continue to rely on explicit or implicit blanket guarantees to maintain financial stability (table 7.4).[5] These guarantees are not only potentially costly, they have also created deep-rooted expectations that bank failures will not be tolerated. The public expects regulators to step in and resolve any systemic or bank-specific crisis. These expectations create incentive problems by rewarding risky banks at the expense of sound ones and placing a heavy burden on supervision.

Transition away from blanket coverage faces serious challenges. The main challenge is to eliminate the long-standing belief in the MENA

TABLE 7.4

Classification of Deposit Insurance in the Middle East and North Africa

Economies with explicit limited-coverage deposit insurance systems	Economies with blanket coverage	
	Implicit blanket coverage	Explicit blanket coverage
Algeria; Bahrain; Jordan; Lebanon; Libya; Morocco; Oman; Yemen, Rep.	Iran, Islamic Rep.; Iraq; Qatar; Syrian Arab Republic[a]; Tunisia; West Bank and Gaza[b]	Egypt, Arab Rep.[c]; Jordan[d]; Kuwait; Saudi Arabia[e]; United Arab Emirates[f]

a. The Central Bank of Syria is drafting a law for a limited-coverage system that is expected to be adopted in 2011.
b. The Palestine Monetary Authority requested assistance from the World Bank to set up a limited-coverage system.
c. Several political statements have been made indicating that the government would provide a blanket guarantee on all deposits.
d. The explicit blanket guarantee was introduced by political announcement, with an expiry date set for the end of 2009. The date was extended to the end of 2010.
e. At the outset of the global financial crisis, the higher economic council made a statement indicating that the government would ensure the safety of deposits and financial soundness of banks, without specifying a term limit.
f. The blanket guarantee was adopted by regulation for three years ending in November 2011.

region that the government will not let any bank fail. Doing so will require carefully crafted and well-communicated plans that might be part of a larger and more comprehensive plan aimed at advancing consumer education.

Some of the blanket guarantees are explicit and adopted as part of policy responses to the global financial crisis. They were adopted by political statements in Egypt, Jordan, and Saudi Arabia; in Kuwait and the United Arab Emirates, regulations were enacted to provide guarantees. Other blanket guarantees are implicit but widely and strongly believed by the population, as supervisors have stood ready to support any bank facing financial difficulties, including transitory liquidity problems and actual insolvencies. Severe bank problems have typically been addressed through coordinated mergers and acquisitions to avoid explicit bank failures and liquidations.

The explicit deposit insurance systems in MENA have adopted organization structures that are largely in line with the Core Principles of the International Association of Deposit Insurers (IADI). They are either pure "paybox" systems managed directly by the central bank or administratively independent organizations governed by a board of directors and chaired by the central bank governor. The mandate of the administratively independent organizations is wider than pure paybox systems and typically includes responsibilities for receivership and liquidation.

There is a divergence from international principles in several areas. Adoption of good governance practices is uneven. The level of coverage seems excessive in some countries and inadequate in others, ranging from just US$3,000 in Lebanon (0.5 times per capita income) to almost US$200,000 in Libya (14 times per capita income). The lack of legal protection for the staff of deposit insurance systems as well as the lack of access to emergency liquidity are areas of concern. Enhancements to crisis preparedness and planning are being introduced in many MENA countries, but deposit insurance systems are usually not included in these arrangements.

One of the major impediments facing the introduction of explicit limited-coverage deposit insurance systems in certain countries is the large presence of state-owned banks. These banks may create a conflict between the limited deposit insurance systems coverage and government insurance of deposits held by state-owned banks.

Only Bahrain and the Republic of Yemen have mandatory membership requirements for Islamic banks in their explicit limited-deposit insurance systems, but insurance for *Sharia*-based deposits is getting increased attention. Deposits held by Islamic banks in Jordan are not insured, as the deposit insurance system allows for voluntary membership for those banks. The Jordanian regulations, however, are being reviewed

with the intention of extending compulsory membership to Islamic banks. In the region as a whole, deposit insurance systems are moving toward providing equal insurance to both conventional and *Sharia*-based deposits. All blanket guarantees by government in the region, whether explicit or implicit, cover *Sharia*-based deposits in addition to conventional deposits.

Bank Corporate Governance

Banking ownership in MENA is highly concentrated.[6] Ownership patterns represent one of the most important determinants of the prevailing governance culture in the region. Many banks are part of large and closely controlled business groups that established banks to service commonly owned or controlled companies. Ownership can become particularly clouded in cases of nominee shareholders and domestic or crossborder corporate ownership. Although ownership (or affiliations) may be generally known to the regulator and perhaps the public, in many instances the ultimate beneficial owners are not publically or officially disclosed, hindering thorough understanding of the banking system's ownership configuration and control, associated fund flows, and related and affiliated parties. Legal shareholder redress by regulators is encumbered if a bank requires additional capital or remedial action and if the ultimate beneficial owner is not identified and therefore not accessible.

Related-party relationships and transactions are often not easily identifiable, because ownership structures and interests of both owners and board members may not be comprehensively disclosed. Where controlling ownership is not well defined and the ultimate owner may be several degrees removed from the immediate shareholding, connections can exist through affiliates or within a complex network of individuals and companies. In these cases, related-party transactions can create significant concentrations of credit risk to the bank. Although legislation exists in most countries defining related parties and prescribing the disclosure or reporting requirements, the definitions may not encompass the full contingent of possible connections or parties that are actually related to the given bank. Furthermore, many banks have not yet developed their own internal systems dedicated explicitly to identifying, monitoring, and reporting related parties.

Bank boards lack diversified composition, including a larger representation of independent board members and an adequate mix of relevant experience. Many boards represent the direct interests of the controlling owners and have few outside independent members who could counterbalance other stakeholders' interests. The role of the board varies across countries in the region. Even in more developed environments, where

boards are active in considering strategy, the strategic decision making and performance measurement are often motivated by growth and market share, without adequate assessment of risks and available capital to support growth. In some cases, strategic operational and growth decisions may be made by a few individuals, potentially bypassing the authority and responsibility of the full board to vet and discuss key corporate plans.

Banks have made progress in setting up relevant board committees, but there is room for improvement. Specialized board committees increase efficiency and allow sharper focus in specific areas. Regulation has been significantly enhanced in this area, and boards have taken the initiative to review and formalize their structures. Audit committees are generally in place. Risk management committees are increasingly being set up, although many exist only at the management level. Nominations and compensation committees are less common, although awareness is increasing on the importance of this function and the need to link remuneration to medium- and longer-term institutional performance. Although international standards encourage a majority of independent directors and nonexecutive members to sit on the audit committee, most audit committees in MENA do not yet have an adequate proportion of independent directors.

Despite considerable progress, most banks in the region still lack the sophisticated risk management functions that are appropriate for rapidly evolving risk profiles. Risk governance is often referred to as the process through which boards oversee the establishment of internal risk identification and monitoring processes. Many regulators in the region have revised or introduced more rigorous guidance on risk management and internal controls, partly as a consequence of the adoption of Basel II. Many banks have recently established risk management functions and are in the process of building staff, measurement systems, and monitoring processes. The degree of integration and pace of development vary considerably. Generally, larger and privately owned banks have progressed further than smaller and publicly owned banks, which are at earlier stages of development. To varying degrees, foreign-owned banks tend to rely on head office risk functions and approaches, with some banks outsourcing more to the head office than others. A number of governance challenges remain for state-owned banks. In most settings, the role of the government in the financial sector is not well articulated, and separate units through which the government administers its ownership responsibility do not exist. Unclear ownership organization exists in many governments. The government assumes a number of functions typically conducted or overseen by the board and management, such as planning, internal audit and control, expenditure decisions, staffing and salaries, and capitalization and dividends, thereby making the role and authority of the banks' boards and management ambiguous. There is no clear system of accountability or

responsibility for performance of government-appointed board members or executive management. Many board members do not possess sufficient skills or experience to effectively guide the bank. In the majority of cases, most members are civil servants with limited background in banking or related expertise. Compliance with the law and regulation is often low, in particular with respect to risk management, internal audit, and control procedures, and disclosed financial information is often incomplete. Nonfinancial disclosures, including disclosures on performance that are publicly mandated, are inadequate. Conflict of interest policies that address inappropriate directions from politicians and governmental sources and guide reactions and reporting mechanisms are not in place.

Macroprudential Regulation and Supervision

The global financial crisis highlighted the need for a better understanding of macrofinancial linkages and the importance of macroprudential oversight in addition to microprudential regulation and supervision. It showed that inadequate attention had been paid to systemic risk in the financial system in a great number of countries. A general goal of macroprudential policy is to limit the risk of systemwide distress that has significant macroeconomic costs (Borio and Drehmann 2009). The toolkit of effective macroprudential policy includes numerous financial reporting instruments, such as dynamic provisioning; regulatory capital (for example, higher regulatory capital requirements for certain types of exposures or systemic capital surcharges); funding liquidity standards, such as foreign exchange lending restrictions; collateral arrangements, such as conservative maximum loan-to-value ratios and valuation methodologies for collateral; risk concentration limits, such as quantitative limits to growth of individual types of exposures; compensation schemes; profit distribution restrictions; insurance mechanisms, such as contingent capital infusions; failure management and resolution; and risk measurement methodologies, such as risk measures calibrated through the cycle (Galati and Moessner 2011).

Although some countries in the region have adopted certain elements of macroprudential regulation, comprehensive macroprudential regulation is not yet in practice. Several countries, especially in the GCC, used macroprudential instruments in the precrisis period. Although not tied explicitly to the cycle, minimum capital adequacy ratios were increased in Morocco, Oman, and the United Arab Emirates, as banking systems experienced rapid asset growth and declining CARs. In most cases, these measures resulted from a pragmatic approach and were essentially sound, but they did not reflect structured macroprudential analyses. Saudi Arabia's experience with countercyclical provisioning in the boom

period—when provisions reached 140 percent of nonperforming loans—is notable, as is Qatar's adoption of limits on the loan-to-deposit ratio. Since 2010, the United Arab Emirates has restricted dividend payments by banks in order to build up capital buffers in the event of further deterioration in asset quality.

In addition to these idiosyncratic measures, GCC regulators became concerned about rapid retail credit growth and systematically made use of some macroprudential tools to curtail lending before the financial crisis (Fitch 2009). Retail lending picked up in the GCC after 2005, reaching 40–50 percent annual growth in some countries by 2008. Regulators in Bahrain, Kuwait, Oman, Qatar, and Saudi Arabia introduced regulation limiting debt-service coverage ratios (capping monthly repayments of retail loans as a percentage of the borrower's monthly salary). Kuwait and Qatar imposed an absolute ceiling for customer borrowing. Some GCC regulators capped the maximum tenor of retail loans and limited the number of loan renewals. In mid-2008, Kuwait increased the risk weightings applied to retail lending and property exposure when calculating regulatory capital. In 2008, Oman set risk concentration limits by capping local banks' retail lending at 40 percent of total loans and residential mortgage lending at an additional 10 percent. These regulations had some success in reducing retail lending as a share of total lending, although they did not prevent excessive growth in other parts of the loan portfolio.

Very few countries in the region have structured arrangements to monitor systemic risks and take coordinated action when necessary. Very few central banks have well-staffed financial stability departments that conduct financial stability analysis. Only 2 of the approximately 60 countries producing financial stability reports, Bahrain and Qatar, are in MENA. Regular and structured financial stability analysis and further adoption of macroprudential policies would help the region's supervisors contain the build-up of systemic risks in their financial systems. Financial stability analysis would be especially important for oil-exporting countries subject to high volatility related to oil price cycles.

Crossborder Supervision

Although MENA banks are expanding across borders, crossborder supervision and crisis management and resolution strategies are lagging. The global financial crisis, especially in Europe, highlighted the need for supervisory cooperation across countries. Abundant capital in several MENA countries, particularly in the GCC, prompted banks to expand across borders in recent years, a trend that is expected to continue. At the same time, supervisors do not regularly conduct comprehensive and up-to-date data collection and analysis of banks' detailed

crossborder exposures. Provisions for information sharing with foreign supervisors are often inadequate, and strategies for crossborder crisis management and resolution are generally missing. Improved cooperation and harmonization of standards is especially important for Islamic financial institutions, which are expanding aggressively across borders; crisis management and resolution frameworks for these institutions are untested even within borders.

Notes

1. The profitability of state banks may be inflated by interest accrual on nonperforming loans and underprovisioning. In some cases, the accumulated losses have resulted in the insolvency of these institutions and a large fiscal cost. Farazi, Feyen, and Rocha (2011) provide a more detailed analysis of bank ownership and performance in MENA.
2. Central European economies could overcome the heritage of inefficient enterprise and banking sectors only as they restructured state-owned enterprises and banks in parallel.
3. This section is based on Mousset (2011).
4. Low-income countries with the least sophisticated banking systems have decided to postpone implementation of Basel II in order to focus on more pressing issues.
5. This section is based on Al-Jafari and Walker (2011).
6. This section is based on Ard (2011).

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CHAPTER 8

Why Have Nonbank Financial Institutions Not Developed in the Region?

Nonbank financial institutions play an important role in the financial system (see, for example, Arena 2008; Carmichael and Pomerleano 2002; Catalan, Impavido, and Musalem 2000; and Feyen, Lester, and Rocha 2011). They complement banks, expanding the range of financial services offered to companies and households. They also compete with them, prodding them to be more efficient and responsive to their clients. Nonbank financial institutions comprise institutional investors, such as insurance companies, pension funds, mutual funds, and leasing and factoring companies.

Institutional investors perform their own core functions, but they also stimulate the development of securities and derivatives markets. Insurance companies insure the risks of their clients, pension funds promote retirement savings, and mutual funds enable investors to diversify their savings. In pursuing their primary objectives, these institutional investors also play a catalytic role in the development of securities and derivatives markets. Securities and derivatives provide alternative sources of finance to the corporate sector and enable efficient risk management by financial institutions and corporations.

Other nonbank financial institutions, such as leasing and factoring companies, provide alternative sources of finance and may compete directly with banks. Leasing companies purchase the equipment that has been selected by an enterprise and allow the use of that equipment for a period of time in return for regular payments. In a factoring transaction, an enterprise sells its accounts receivable (invoices) to a factoring company at a discount in return for immediate payment to finance its operations. Leasing and factoring allow enterprises (especially small and medium enterprises) to diversify their financing sources and obtain funds on conditions that may be better tailored to their needs than bank loans.

With few exceptions, nonbank financial institutions are not well developed in MENA. This chapter focuses on the reasons why their development

lags behind that in other regions. It comprises five sections, each of which discusses a major type of nonbank financial institution. Each section briefly reviews the sector's state of development in MENA and identifies the main reasons for its underdevelopment. Chapter 10 identifies the main policy measures that could be adopted to promote the expansion of each sector.

The Insurance Sector[1]

State of Development

The insurance sector in MENA remains underdeveloped, even after controlling for income levels and demographic profiles (see chapter 3). Of the two main branches of insurance, life and nonlife, life insurance is particularly underdeveloped. Life insurance premiums average less than 0.3 percent of GDP—considerably less than in other regions (see figure 3.13 in chapter 3). Only Morocco reports levels of life insurance premiums and total insurance assets that are significantly higher than predicted (see figures 3.12 and 3.14 in chapter 3). The Arab Republic of Egypt, Jordan, and Lebanon are close to the predicted levels; the life insurance premiums and insurance assets of most other countries in the region are much smaller than predicted by their income levels and demographic profiles.

In nonlife insurance, premiums are closer to the average levels in other regions, but there are significant differences across countries (see figure 3.14 and 3.15 in chapter 3). Jordan, Morocco, and Tunisia have nonlife insurance sectors above their predicted levels. Lebanon, the Syrian Arab Republic, and the Islamic Republic of Iran are close to them. All other countries in the region are significantly below predicted levels.

The slow pace of development of the insurance sector is a result of a number of factors. These factors include the lack of compulsory insurance in key areas (or lack of enforcement of compulsory lines); pervasive public mistrust, especially of vehicle insurers; myriad weaknesses in the regulatory and supervisory regime, including in basic business lines such as vehicle insurance; the predominance of state companies in some countries, which stifles competition and innovation; extreme market fragmentation, which leads to weak risk pools; inadequate tax rules; lack of professional skills; and cultural and religious factors. These issues are addressed below.

Mandatory insurance lines have promoted the growth of the sector in many emerging markets. In MENA they are still limited and not always enforced. In most countries, motor third-party liability (MTPL) insurance is typically the first insurance class to be made compulsory. It is often followed by other liability coverage that exposes the public to the risk of enterprises, such as contractors all risks, public transport, and certain

professional liabilities. MTPL insurance is now compulsory in most countries in the region. It is also a prime example of ineffective enforcement, as discussed below. Several business lines that are compulsory in other countries are not compulsory in MENA. Contractors all risks coverage is required in some countries in the region where government projects are involved, but it is not always enforced. Lester (2011) provides a detailed description of compulsory insurance lines in the region.

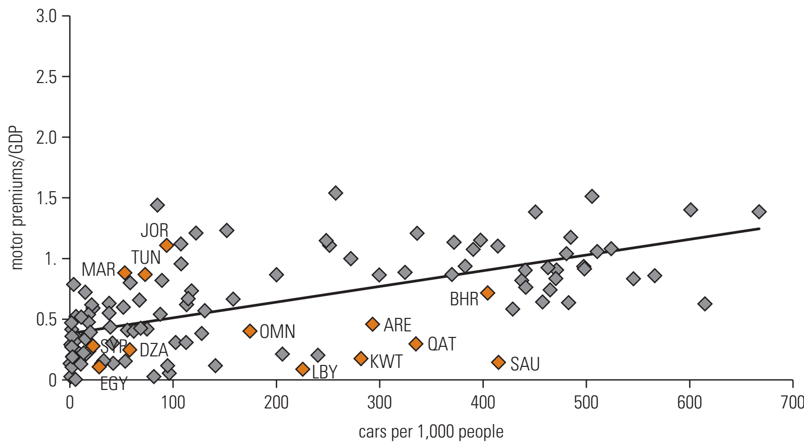
Some Gulf Cooperation Council (GCC) countries have introduced compulsory health insurance for expatriates. Making such insurance mandatory is meeting an important social objective and also boosting premiums and spurring the growth of the sector. Kuwait has a blended voluntary system for expatriates, in which private insurers act as distributors. It is now planning a single specialist health insurer (owned jointly by the government, the public, and the insurers) that will handle all health insurance. Libya recently announced that compulsory health insurance for all residents will be provided through the market.

Motor insurance accounts for almost half of nonlife premiums in MENA, but most countries collect much less in premiums than would be predicted given the size of their car fleets (Jordan, Morocco, and Tunisia are exceptions) (figure 8.1).

Several factors limit motor premium revenues in MENA. They include lack of compliance, understatement of provisions for outstanding claims, and price controls in some countries. The level of compliance

FIGURE 8.1

Motor Third-Party Premiums and the Ratio of Cars per 1,000 People, 2008



Source: World Bank staff calculations based on data from Axco and World Bank.

Notes: ARE = United Arab Emirates; BHR = Bahrain ; DZA = Algeria; EGY = Egypt, Arab Rep.; JOR = Jordan; KWT = Kuwait; LBN = Lebanon; LBY = Libya; MAR = Morocco; OMN = Oman; QAT = Qatar; SAU = Saudi Arabia; SYR = Syrian Arab Republic; TUN = Tunisia; YEM = Yemen, Rep.

with compulsory motor insurance seems low. Large segments of the population do not seem to understand the importance of this type of insurance, which they regard as a tax. The requirement in most countries to provide evidence of insurance before registering a vehicle has not led to compliance in MENA. False policy documents not issued by insurers, poor validation procedures, and misclassification of vehicles contribute to weak compliance.

Other reasons for the low level of motor premiums include the understatement by insurers of provisions for motor third-party claims and price controls. Provisions for outstanding claims feed directly into the calculation of premium levels; when understated, they result in inadequate pricing. The understatement of the costs of motor claims (and hence of technical premiums) is an even more serious issue where MTPL rates are approved by the government (often the ministry of the interior) and have a political aspect. Rates have gone unadjusted for many years in numerous countries, including Kuwait and, until recently, Egypt. Price controls have resulted in losses for providers in many countries.

Life insurance has the greatest potential to contribute to financial sector development, but, with some notable exceptions, it has been held back by several constraining factors. These factors include social security systems that promise generous retirement benefits, lack of effective distribution channels, lack of supportive tax regimes, weak regulatory frameworks, and underdeveloped mortgage markets. The lack of products compatible with *Sharia* law has also been an important constraint factor in many countries, especially in the GCC, although the emergence of *takaful* products may be able to reduce cultural resistance to insurance and promote the growth of the sector.[2]

The life insurance sector in Jordan, Tunisia, and especially Morocco has benefited from several positive features. These features include a more robust and supportive regulatory framework that has tracked developments in the European Union (EU), especially in Morocco; the important role of private companies; well-regulated and enforced motor insurance; mortgage markets that are more developed than elsewhere in the region; the successful promotion of *banc-assurance* (especially in Morocco); and a tax regime that is more supportive than regimes in other countries. In addition, cultural factors do not seem to have hindered the development of the life insurance sector in these countries.

Industry Structure and Performance

MENA countries have on average 25 licensed insurers, the bulk of which are licensed as nonlife insurers or composites. The number of life insurers is small, reflecting the low level of development of this sector.

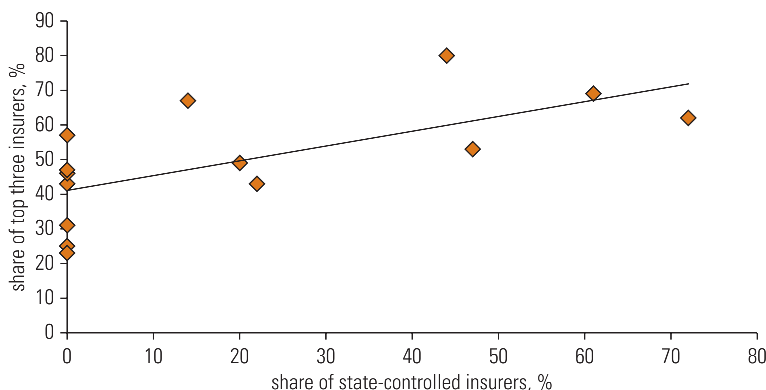
The average market share of the top three companies is about 52 percent, but there are wide variations across countries, with some markets very concentrated. State insurers still hold a significant share of the nonlife market in Algeria, Egypt, Libya, and Syria. There is a positive correlation between the share of state insurers and the share of the three largest companies (figure 8.2). This relationship reflects the historical legacy of state monopolies exercised through large state companies in these countries.

State insurers have not contributed effectively to the development of the sector and have stifled innovation and competition. Research shows that insurance systems dominated by state-owned companies are less developed than other systems, controlling for many other factors (Feyen, Lester, and Rocha 2011). In MENA, the legacy of state monopolies contributed to the slow development of the sector in Algeria, Egypt, Libya, and Syria. Egypt has pioneered reforms in this area, allowing the entry of private companies and restructuring state insurers.

Banc-assurance is becoming a significant distribution system, but it is not well regulated in several countries. Insurers have had relationships with banks for some time, but this relationship is strengthening as *banc-assurance* becomes more prevalent. *Banc-assurance* is formally regulated only in Egypt, Jordan, Morocco, Oman, and Tunisia. It accounts for 95 percent of sales by major life insurers in Egypt and 70 percent in Morocco; in Lebanon, it accounts for almost 30 percent of all insurance sold. In other countries, such as Algeria, *banc-assurance* is also beginning

FIGURE 8.2

Share of Top Three Insurers and Share of State Insurers in Selected Economies in the Middle East and North Africa, 2008



Source: World Bank staff calculations based on data from Axco.

Note: Selected economies are: Bahrain; Egypt, Arab Rep.; Jordan; Kuwait; Lebanon; Libya; Morocco; Oman; Qatar; Saudi Arabia; Syria; Tunisia; United Arab Emirates; and Yemen, Rep.

to appear. Recently, the United Arab Emirates agreed on its first *banc-assurance* arrangement.

Many countries in the region seem to suffer from overcapacity, in terms of both capital and the number of competitors. The average ratio of net premiums (gross premiums minus reinsurance) to capital is only 78 percent, significantly lower than in the Organisation for Economic Co-operation and Development (OECD), which is 310 percent (table 8.1). The MENA ratio reflects the abundance of capital and the significant entry of new companies, despite the small size of these markets and the relatively high capital requirements. Excess capital in the insurance sector can sometimes lead to predatory price competition, particularly in some lines of business, such as MTPL, medical, and small property insurance. The reported loss ratios in MTPL and other lines are consistent with this syndrome.

The low average premium per insurer also suggests an excessive number of players. The average ratio of gross premiums per insurer (adjusted for per capita income) is half that in the OECD, with some countries reporting extremely low ratios (see table 8.1). In particular, some GCC

TABLE 8.1

Indicators of Industry Capacity Utilization, by Economy and Region, 2008

Economy or region	Net premium/ capital (percent)	Gross premium per insurer/ per capita income	Retained nonlife premium (net premium over gross premium, percent)	Minimum nonlife capital (US$ millions)
Algeria	n.a.	1.4	67	2.3
Bahrain	105	0.1	57	13.3
Egypt, Arab Rep.	75	2.4	49	10.6
Jordan	83	0.4	60	11.3
Kuwait	38	0.1	n.a.	17.4
Lebanon	185	0.2	72	1.5
Libya	53	0.2	50	7.5
Morocco	74	4.5	84	5.5
Oman	89	0.1	48	13.0
Qatar	32	0.2	43	10.0
Saudi Arabia	106	0.3	64	26.7
Syrian Arab Rep.	98	1.5	n.a.	15.4
Tunisia	52	1.0	67	7.0
United Arab Emirates	55	0.2	55	27.3
Yemen, Rep.	56	0	30	2.0
Middle East and North Africa	78	0.8	57	11.4
OECD	310	1.6	83	5.9
Emerging economies	—	—	—	4.4

Source: World Bank staff compilation based on data from Axco and World Bank data.

Note: n.a. = not applicable. — = not available.

countries seem to have issued too many licenses given potential demand. Combined with heavy minimum capital requirements, the overly high number of licenses can lead to excessive competition or the existence of fronting insurers that are really brokers or investment houses in disguise.

In many countries, the excessive number of players includes a large number of small fronting insurers, including small insurers owned by family-controlled economic groups. These groups write business from their affiliates and pass on the risk to international reinsurers, who do the underwriting. They often receive generous commissions (typically 5–15 percent) and are able to operate with small overhead costs. Where capital is plentiful, as in a number of GCC countries, fronting insurers can become essentially investment vehicles providing employment for members of the controlling families. However, fronting insurers can create regulatory problems when they write noncaptive business and rely on less reputable reinsurers.

The average retention ratio (the ratio of net premiums to gross premiums) in nonlife insurance is low in MENA, suggesting lack of underwriting capacity and the presence of brokers and investment houses disguised as licensed insurers. Only a few countries, notably Morocco, Lebanon, and Tunisia, have retention ratios close to 70 percent. The low retention ratios in many countries reflect market fragmentation, as the retention ratio tends to increase more than proportionately with size. Small companies do not have the capacity to build adequate risk pools, take risk internally, underwrite contracts, or innovate. Fragmentation may have been one of the key factors hindering the development of the sector in the region.

Main Regulatory and Supervisory Issues

Minimum capital requirements are generally high by international standards, but they have not prevented entry in a capital-rich region. Minimum capital requirements are a traditional supervisory tool to screen the number and quality of applicants in insurance and other sectors. In MENA, they have not prevented excessive numbers of insurers, some of which play only a marginal role as noted below.

Licensing requirements in most countries generally follow international norms, but fit and proper rules are not always well designed, and restrictions on branches and foreign investments seem questionable. Most countries have fit and proper rules, but information on board directors and owners is not always required. Fit and proper rules have not improved the screening of applicants or prevented the entry of insurers that do not play meaningful roles. In addition, some countries (Egypt, Libya, Morocco, Qatar, Saudi Arabia, Syria, and Tunisia) do not allow

branches to be established or restrict the share of a local insurer that can be held by nonnationals. Some of these restrictions are questionable.

Some countries still require mandatory placement of insurance or reinsurance, including mandatory placements of certain risks with government insurers or locally owned insurers, mandatory placements of reinsurance cessions to local or regional insurers, and placements of in-house risks to insurers owned by industrial groups (which are often controlled by family groups). Government business still tends to be placed with insurers in which the government has a significant interest, although this practice is gradually breaking down.

The solvency regime in most countries in the region follows the original EU Solvency 1 regime, but some solvency requirements are lax. Jordan and Syria have adopted a modified U.S. risk-based capital approach, which implicitly allows for a graduated response to deteriorating insurer solvency. Saudi Arabia has implemented such an approach in the context of a modified European solvency formula. Lebanon and Oman have flat solvency requirements that are low by international standards. The Republic of Yemen has no solvency requirements.

A majority of countries in the region still follow national accounting standards, although an increasing number require listed companies and banks to follow international financial reporting standards. However, many insurance companies are unlisted, and the frequent presence of family and financial and industrial groups in the insurance sector raises a number of transparency and governance issues. Standards and the level of professional oversight will need to be strengthened if unlisted financial sector insurers are to gain public trust. The quality of accounting and auditing is limited by lack of skills in these areas.

Only a few countries have regulated *banc-assurance*, although an increasing number are aware of the importance of market conduct. *Banc-assurance* can promote the growth of the life sector, but it needs to be regulated to avoid abuse. Some countries are already taking a careful line, with Kuwait and Qatar forbidding banks from accepting commissions from insurers and Egypt placing a temporary ban on new arrangements until an acceptable set of rules is agreed on. In Jordan, new rules allowing for *banc-assurance* were promulgated. Oman also introduced formal requirements, although they are based on principles rather than rules. In the absence of specific rules, bank regulators in most countries in the region have banned bundling bank and insurance products, a prohibition that is in line with emerging international best practice.

Many insurance supervisors in MENA do not enjoy adequate levels of legal, administrative, or budgetary independence. In eight countries, insurance supervision is still conducted by units inside government ministries, which rarely operate with sufficient administrative autonomy and

are not able to attract and retain qualified personnel. Jordan, Morocco, Syria, and Tunisia have created a separate supervision agency; Bahrain and Saudi Arabia have placed insurance supervision inside the central bank; and Egypt and Oman have merged insurance supervision with the capital market authority or other regulators.

Supervisory capacity varies considerably across the region. Leading supervisory jurisdictions include Bahrain, Jordan, Morocco, and Tunisia. Egypt and Libya are in transition, in parallel with their reform programs. Newly formalized markets that have rapidly demonstrated a strong intervention capacity include Saudi Arabia and Syria, although these countries are still building their resources and supervisory models. Most catch-up work is required in some GCC countries, where insurance development has been viewed as a secondary issue.

Financial sector assessments conducted by the World Bank and the International Monetary Fund have identified several common weaknesses in supervisory practices. Limitations include weak financial reporting; the lack of adequate enforcement of reserving policies for outstanding claims (especially for MTPL insurance); the lack of early intervention and enforcement actions; weak corporate governance; problems with illegal and excessive payments to agents and brokers; problems ensuring that *banc-assurance* products and distribution rules meet adequate market conduct standards; the lack of consumer protection mechanisms; the absence of informative websites in most countries (Egypt, Jordan, and Morocco are notable exceptions); the absence of provisions for bankruptcy procedures and limited legal protection of policyholders in such circumstances; and inadequate dealing of *takaful* insurance (in practice most supervisors apply normal supervisory methodologies and allow a *Sharia* board to deal with product issues).

Pension Funds

Private pension funds are rare in MENA.[3] The few private funds that exist in some countries (such as Egypt and Jordan) cover privileged employees of banks and insurance companies or members of professional associations (table 8.2). These funds are based on defined-benefit plans, tend to invest conservatively in government bonds and bank deposits, and often operate with large actuarial deficits. The contribution to these pensions to financial sector development has been very limited, and most face an uncertain future.

Some countries have recently taken steps to promote the development of private pension funds, but the prospects of rapid growth are very limited. In 2010, Egypt enacted a law that introduced a funded mandatory

TABLE 8.2

Pension Assets of Selected Countries in the Middle East and North Africa, 2002–08
(percentage of GDP)

Country	2002	2003	2004	2005	2006	2007	2008
Public pension reserves							
Bahrain	22.3	47.5	49.8	46.8	42.5	44.1	35.4
Egypt, Arab Rep.	47.1	47.9	46.3	48.0	43.1	37.7	32.6
Jordan	23.7	26.6	31.3	47.5	34.5	39.4	30.0
Kuwait	—	—	—	—	50.1	—	—
Morocco	12.6	14.5	16.8	18.9	20.3	22.1	28.8
Oman	—	—	—	—	—	—	22.5
Saudi Arabia	—	—	—	—	—	50.7	36.0
Private pension funds							
Egypt, Arab Rep.	2.9	2.9	2.9	3.1	3.0	2.7	2.7
Jordan	3.4	—	—	—	—	—	—

Source: World Bank staff compilation based on reports by social security institutions and pension supervisors.

Note: — = not available.

component in the pension system. This component will manage part of the mandatory contributions to pensions and unemployment insurance, but it applies only to new entrants to the labor market, and its impact will be gradual and slow.[4] Egypt also has a system of voluntary defined-contribution private pension plans, but they start from a very low base and have not yet accumulated large financial resources. The same is also true of Jordan. In addition to their small size, privately managed pension funds are unregulated or underregulated, and information regarding their size and portfolio composition is very limited.

Several reasons explain why private pension funds are underdeveloped in MENA. As in the case of life insurance, the main obstacle is the existence of social security systems that offer generous benefits. Public pension schemes offer replacement rates that exceed 75 percent of covered earnings in most countries in the region and entail internal rates of return that are often more than double their long-term sustainable level (Robalino 2005). The generosity of benefits reduces pressure for structural reforms, even though current benefits are not sustainable in the long run. Other important factors include the absence of enabling environments and supportive tax regimes that exempt contributions and investment income in the accumulation phase.

Although private pension funds remain underdeveloped, public pension funds have accumulated large reserves in several countries (see table 8.2). Public pension funds manage the reserves of public pay-as-you-go pension systems. Many of these funds have accumulated large reserves, as a result of the young demographic profile of their populations.

Accumulated reserves exceed 20 percent of GDP in Bahrain, Egypt, Jordan, Kuwait, Morocco, Oman, and Saudi Arabia. They could be equally large in Qatar and the United Arab Emirates (regular information on their size and asset composition is not readily available).

Most public pension funds in MENA do not disclose their investment policies or provide detailed information on their portfolio composition and performance. The available information suggests that in many cases the structure of assets is not matched to the structure of liabilities, and asset management is not outsourced to independent investment managers. In some countries (for example, Egypt), the reserves of public pension funds are invested in nontradable government bonds, resulting in their effective assimilation into unfunded pension schemes. In other countries, public pension funds adopt conservative investment policies that include large holdings of government securities and bank deposits and restrict holdings of foreign assets. There are exceptions, as well as a growing awareness among public fund managers of the need for better investment policies and practices. For example, in Jordan and Morocco, public pension funds seem to be adopting more modern asset allocation strategies and have expanded their allocations to equities, although investments in foreign assets are subject to low limits. In Saudi Arabia, portfolios have become reasonably diversified, and asset management is partly outsourced. However, in most countries, portfolios do not seem well diversified, asset management is still conducted largely in-house, and ownership rights in equity holdings are not well exercised.

The reserves of public pension funds will come under pressure in the near future, as public plans mature and covered populations age. Financial projections conducted in several countries in the region reveal that in the absence of structural reforms, the reserves of public pension plans will be depleted within the next two decades. With fairly young demographic structures, governments have so far delayed reforming their pension systems. This situation is changing, however, with Jordan approving integrated social insurance reforms in September 2009 and Egypt doing so in June 2010.

Mutual Funds

Mutual funds offer investors the advantages of portfolio diversification and professional management at a relatively low cost.[5] They expand the range of investment opportunities and add liquidity to the holdings of individual investors. Like other institutional investors, mutual funds can also contribute to market liquidity, more effective price discovery, and a lower cost of capital, potentially improving the level and quality of capital formation. They can also have a positive impact on corporate governance,

by voicing shareholders' interests to corporate management directly or through direct monitoring and possible exit.

Mutual funds are generally better developed in the region than other types of nonbank financial institutions, although they are still smaller and less diverse than mutual funds in other regions. In 2009, total mutual fund assets under management in MENA amounted to US$67 billion, equal to just 4.4 percent of GDP in the region (table 8.3). In Bahrain and Morocco, the assets of local mutual funds amount to 25 percent of GDP. In Bahrain, assets under management of all authorized funds, including nonlocal funds, amount to 44 percent of GDP. Egypt, Kuwait,[6] Saudi Arabia, and Tunisia have total assets under management of 5–7 percent of GDP. In all other countries, the presence of mutual funds is negligible. In general, mutual fund assets in MENA are well below the levels predicted by their per capita income and demographic variables (see figure 3.17 in chapter 3). Morocco is the only outperformer in the region, with a mutual fund industry that is boosted by the holdings of the life insurance sector and public pension funds.

High incomes and large savings have not yet translated into a large and diversified institutional investor base in the GCC. The profile of

TABLE 8.3

Assets under Management by Mutual Funds in the Middle East and North Africa, by Economy, 2009

		Assets under management			
Economy	Number	US$ millions	Percentage of total	Percentage of GDP	Average size (US$ millions)
Algeria	0	0	0	0	0
Bahrain (local funds)	134	5,580	8.3	25.5	41.6
Bahrain (authorized funds)	2,747	9,630		44.0	3.5
Egypt, Arab Rep.	59	8,735	13.0	4.6	148.1
Iraq	0	0	0.0	0	0
Jordan	3	17	0.0	0.1	5.7
Kuwait	65	5,514	8.2	5.7	84.8
Lebanon	13	352	0.5	1	27.1
Libya	0	0	0	0	0
Morocco	294	21,552	32.1	23.4	73.3
Oman	9	191	0.3	0.4	21.2
Qatar	9	122	0.2	0.1	12.3
Saudi Arabia	153	21,464	31.9	5.7	140.3
Syrian Arab Republic	0	0	0	0	0
Tunisia	88	2,889	4.3	7.2	32.8
United Arab Emirates	27	785	1.2	0.3	29.1
West Bank and Gaza	0	0	0	0	0
Yemen, Rep.	0	0	0	0	0
Total	854	67,201	100.0	4.4	78.7

Source: World Bank staff compilation based on data from Zawya and local stocks exchanges and regulators.

institutional investors there is different from that of the rest of the world and remains dominated by sovereign wealth funds, public pension funds, and family offices; collective investment schemes account for a minority of assets under management.[7] Nevertheless, mutual funds are the leading (private) institutional investors in the GCC, with equity funds the most dominant type of funds. Short-term money market and trade finance funds (comparable to money market instruments) are relatively large in Saudi Arabia; fixed-income funds are small everywhere in the GCC, reflecting the nascent nature of conventional bond and *sukuk* markets.

The structure of the industry by type of mutual fund varies considerably across countries. The assets of equity funds account for 23 percent of total mutual fund assets in MENA (table 8.4). Equity funds tend to be more prevalent in the GCC; they are the only type of fund in some GCC countries. The disproportionate difference between the size of equity market capitalization and the size of mutual funds is a peculiarity of MENA. The share of mutual funds in equity market capitalization is generally low (except in Morocco and Tunisia), revealing the prevalence of retail investors in the region and raising issues about the quality of price discovery in equity markets (figure 8.3). Chapter 9 provides additional discussion of this important issue.

Fixed-income funds amount to only US$15 billion, 25 percent of total assets under management. The fixed-income holdings of mutual funds in Morocco, which has a more developed insurance sector and a deeper government bond market than most other countries in the region, account for US$12 billion, or 76 percent of total fixed-income funds in MENA.

TABLE 8.4

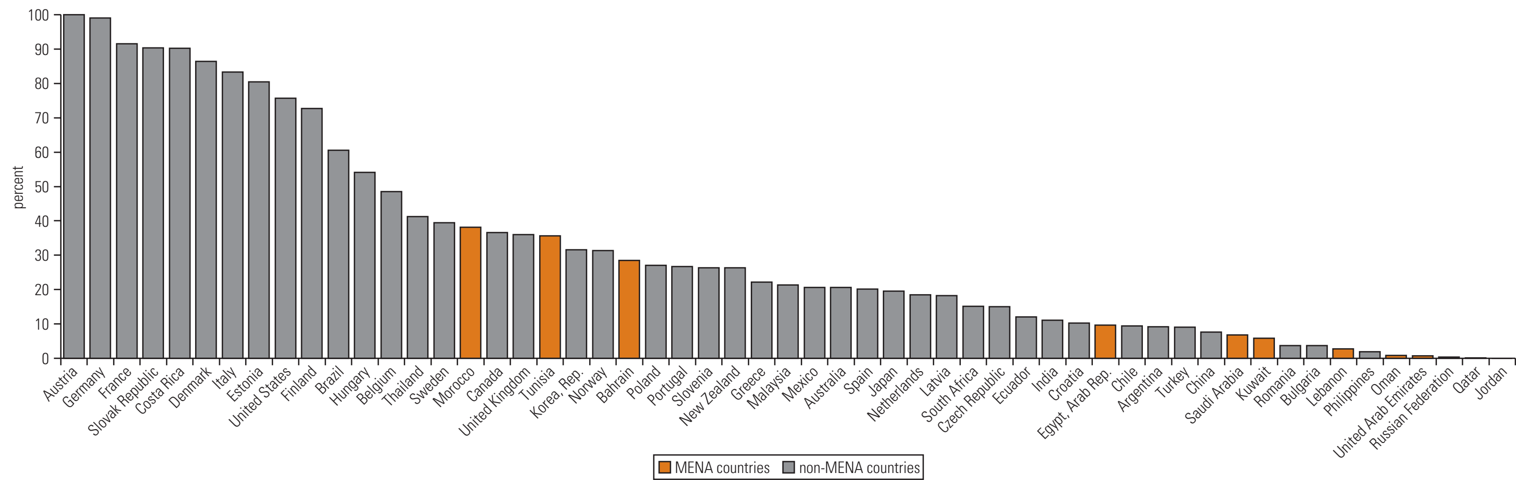
Types of Mutual Funds in the Middle East and North Africa, 2009
(percentage of all mutual funds)

Country	Equity	Fixed income	Short term	Hybrid	Total
Bahrain	73.2	26.3	0	0.4	100
Egypt, Arab Rep	5.6	0.4	90.1	3.9	100
Jordan	0	0	0	100.0	100
Kuwait	75.1	9.3	14.9	0.6	100
Lebanon	0.0	68.1	0.0	31.9	100
Morocco	10.5	54.4	31.1	3.9	100
Oman	100.0	0	0	0	100
Qatar	100.0	0	0	0	100
Saudi Arabia	24.6	0.2	73.2	1.9	100
Tunisia	8.1	88.4	0	3.4	100
United Arab Emirates	92.9	5.3	1.2	0.6	100
Total	22.8	24.6	49.6	3.0	100

Source: World Bank staff calculations based on data from Zawya and local stock exchanges.

FIGURE 8.3

Mutual Funds as a Percentage of Equity Market Capitalization in Selected Countries, 2009



Source: World Bank staff calculations based on data from ICI, Zawya, World Federation of Exchanges, and local stock exchanges.

Mutual funds in Morocco are also extensively used by insurance companies, pension funds, and corporate investors. Fixed-income funds are negligible in all other countries except Tunisia. To a large extent, this reflects the underdevelopment of debt instruments and markets in most MENA countries, starting with the underdevelopment of government debt markets (see chapter 9). Given worldwide *sukuk* issuances of about US$100 billion, it is clear that many of these instruments are held by banks, family offices, and institutions other than mutual funds.

Short-term funds account for 50 percent of total assets under management, reflecting the large relative size of money market funds in Egypt, Saudi Arabia, and Morocco. Short-term funds, which invest in money market or trade finance instruments, represent 90 percent of assets under management in Egypt, 73 percent in Saudi Arabia, 31 percent in Morocco, and 15 percent in Kuwait. In Saudi Arabia, trade finance funds account for 64 percent of mutual fund assets, reflecting the preference for *Sharia*-compliant instruments. The emergence of money market funds is a welcome development, as it gives the corporate sector an instrument for short-term liquidity management.

MENA mutual funds invest almost exclusively in the country in which they are domiciled (94 percent of assets under management); GCC–focused and MENA–wide funds account for very small shares of total assets under management. Bahrain has emerged as a modest center for regional investment funds. The most attractive destinations for outbound mutual fund investments are other GCC countries, followed by MENA-wide mutual funds. There is considerable scope to encourage more crossborder portfolio investments, especially in equities.

The development of mutual funds has been constrained by the lack of an adequate supply of suitable instruments. The lack of fixed-income instruments (especially private fixed-income instruments), the small free float in several equities markets, and constraints on crossborder investments constrain diversification, a sine qua non for investment fund development. Even where a critical mass of fixed-income securities exists, issuances are restricted to government securities, and market liquidity is usually very low, making net asset valuation difficult. Even in countries such as Morocco, where the market is more developed, fund managers have to allocate a significant part of the fund's portfolio to cash and bank deposits to create a liquidity buffer and maintain the ability to meet redemption requests. This highlights the need to further develop government debt markets in MENA (see chapter 9).

Transparency and investor protection are mixed in the region. Pricing and valuation of mutual fund assets are problematic for many funds. Best practice would be for investment funds to provide daily updates on their net asset value. Less than a third of MENA investment funds do so,

although such funds represent 62 percent of assets under management, suggesting that smaller (and probably less efficient) funds tend to provide less frequent reporting than other funds (Mako and Sourrouille 2010). Almost one-fifth of funds update net asset value less than once a week.

Investment fund development in most countries in the region also suffers from other regulatory and market constraints. A survey by the International Organization of Securities Commission of 30 emerging economies included only four countries in the region (Jordan, Morocco, Oman, and Tunisia) (IOSCO 2009). It therefore does not give a comprehensive picture of regulation of the investment fund industry in the region. However, joint diagnostics by the World Bank and the International Monetary Fund and additional interviews with regulators and market participants complemented the survey results and revealed a number of additional regulatory and market problems that hinder the development of the industry. In some countries, tax regimes discriminate against mutual fund investments as opposed to individual investments. Some regulators are not empowered to regulate and supervise all relevant aspects of mutual fund activities. Disclosure requirements are not appropriate in many countries, failing to prescribe sufficient information on investment policies, returns, and fees. Many countries lack a critical mass of fund managers and supporting service providers. Experts also stress the local investor culture and savers' preference for holding stocks and bonds directly rather than through mutual funds. Regulatory limits on distribution channels have been withholding industry development in some countries, as have banks' dominance in the financial sector. Limits on foreign participation (both direct and portfolio investment) are very common, and fragmentation of investment management in several countries has acted as a constraint. Smaller funds often lack the critical mass to support investments in internal controls, fundamental equity research, or corporate monitoring. Consolidation of investment management in some countries thus seems warranted.

Leasing

Leasing offers some potential advantages over bank lending.[8] Leasing companies retain ownership of the leased asset and are in principle able to repossess it more easily in case of default. In principle, they can overcome the effects of weak creditor rights that hinder commercial bank lending to small and medium enterprises. They are often established as joint ventures between equipment manufacturers and financial institutions and benefit from the technical support of their founders. Leasing companies also benefit in principle from the preferential tax treatment

conferred on investments in fixed assets and equipment. They can apply accelerated depreciation allowances to profits from other business ventures, sharing the tax benefits with lessees.

Leasing should be particularly attractive for small and medium enterprises in MENA. For enterprises that do not have a long credit history or a significant asset base for collateral, the lack of a collateral requirement offers an important potential advantage in countries with weak creditor rights. In addition, as an asset-based financing operation, leasing is inherently a *Sharia*-friendly product. In the *Sharia* context, such a product is referred to as *ijarah*.[9]

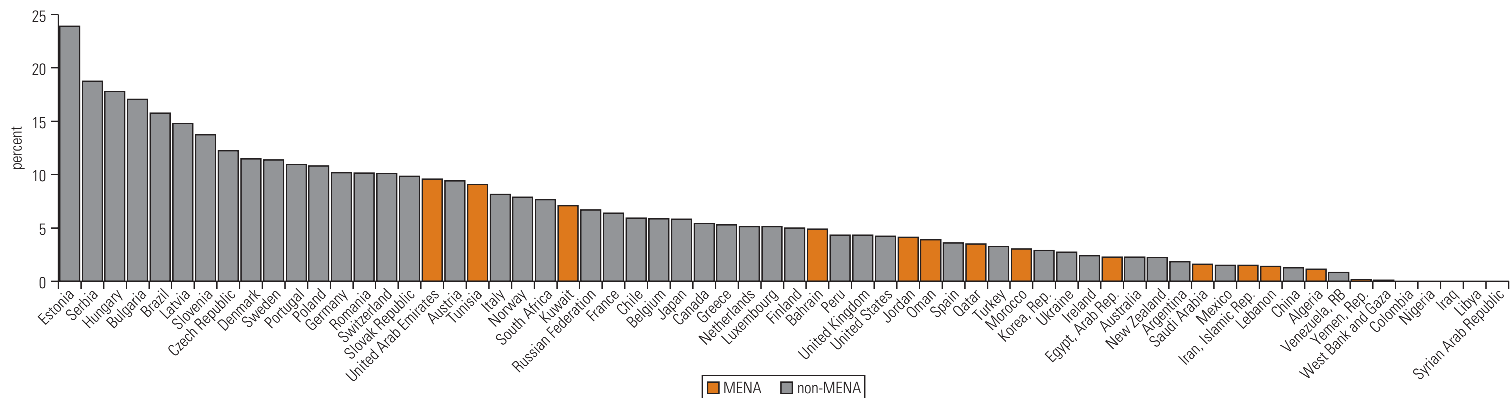
Despite these potential advantages, the leasing industry is small by international standards, as shown in chapter 3 and figure 8.4. The top four leasing markets are the United Arab Emirates, Tunisia, Kuwait, and Bahrain, which together constitute more than 60 percent of the leasing market in MENA. The second tier comprises eight countries: Jordan, Oman, Qatar, Morocco, Egypt, Saudi Arabia, the Islamic Republic of Iran, Lebanon, and Algeria. The Republic of Yemen, the West Bank and Gaza, Iraq, Libya, and Syria do not have leasing activities. Leasing markets are growing quickly in Egypt, Jordan, and Morocco. These trends reveal strong demand for the product and the potential for further growth.

The dominant types of lessors are banks and bank-related institutions. Their prevalence is partially a result of their easier access to funding. Stand-alone leasing companies often face difficulties financing their growth. Banks can rely on their deposit base, and bank-related institutions can rely on funding from their banks. By contrast, stand-alone companies must rely on equity or longer-term loans at market conditions to fund their portfolios, both of which are more costly than bank deposits. The scarcity of fixed-rate funding for stand-alone leasing companies has increased their exposure to interest rate and currency risks, restricting their expansion. Despite the advantage that banks and bank-related lessors have in funding leasing operations, less than 30 percent of MENA banks offer leasing products to their clients, as shown by a recent survey of 140 banks (Rocha and others 2011). These results suggest that the major constraints lie in other areas.

The absence of specific leasing legislation frequently leads to ambiguous roles and responsibilities of the parties to a lease and leaves many legal issues unaddressed. Key issues, such as what is considered a financial leasing transaction and how to differentiate leasing from other sources of finance, remain unclear. A sound legal framework for leasing requires a specialized leasing law and appropriate provisions in other laws addressing a number of critical elements, including the enforcement of contractual and proprietary rights; the existence of an effective registry for leased

FIGURE 8.4

Leasing Volumes as a Percentage of Gross Fixed Capital Formation in Selected Economies, 2008



Source: World Bank Group staff compilation based on data from Euromoney and World Bank Group.

assets; repossession procedures of a leased asset when a lessee defaults; effective treatment of lessors and lessees under bankruptcy; and neutral tax rules that do not favor other forms of credit over leasing. These elements are missing in most MENA countries.

The absence of registries for leased assets increases risks for lessors and hinders the expansion of leasing operations. Ideally, there should be a unified collateral registry where all security interests, including lessors' interests in leased assets, are recorded. Pending its development, a registry for leased assets could be established, something few countries have done.

Effective repossession by lessors is unavailable in most MENA countries. Self-help repossession procedures that avoid lengthy court litigation are available only in Jordan and the Republic of Yemen. In Morocco and Tunisia, commercial courts efficiently handle the repossession of leased assets. In most other countries, cumbersome and lengthy repossession procedures increase the credit and liquidity risks for lessors and weaken their position with respect to lessees, hindering the expansion of the industry.

The majority of jurisdictions in MENA do not clarify the rights of lessors and lessees under bankruptcy. In cases where the lessee is bankrupt and defaults on the lease, the lessor should have the right to repossess the asset. The general norms of bankruptcy law apply, with the insolvent pool of assets consisting only of those owned by the insolvent company. What does not belong to the insolvent company should be returned to the owner (lessor). Only Jordan and the Republic of Yemen have clear legal provisions defining the rights of the parties under insolvency.

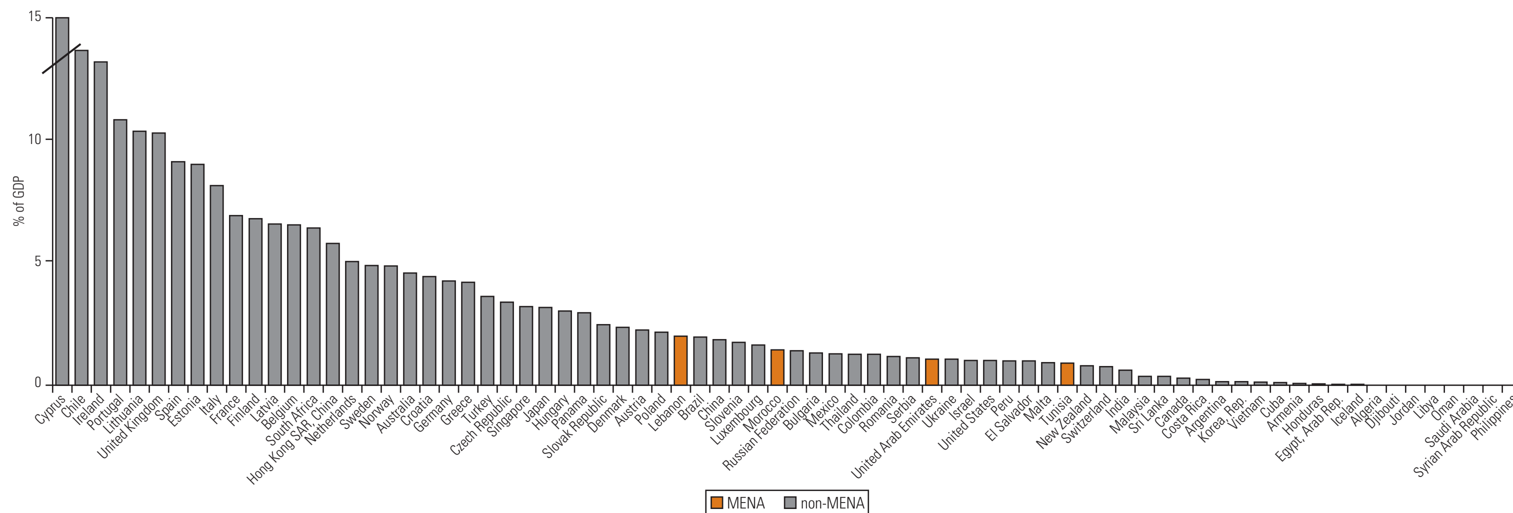
Leasing in MENA suffers from the lack of clear and neutral tax rules. Tax policy should level the playing field for leasing versus other forms of finance and avoid special treatment for either, thus avoiding market distortions. The income tax treatment of leasing and loans should be similar, as there is little difference between leasing and loan finance. Sales tax and valued added tax rules should clarify that a leasing operation is a financial service, not the sale of a good. Even in jurisdictions where leasing is treated as an exempted financial service, legislation does not clarify which part of the lease payment—the total value of the contract (asset value and financial return) or only the financial return—is exempted.

Factoring

Factoring penetration is very low in the region, with very few exceptions (figure 8.5). Many countries have technological, regulatory, and judicial barriers to the expansion of factoring, as well as a shortage of information on small and medium enterprises, which may be involved in such a

FIGURE 8.5

Factoring as a Percentage of GDP in Selected Economies, 2008



Source: World Bank staff compilation based on data from Factors Chain International and World Bank.

transaction. Tunisia is a positive regional example of growth from a low base, with US$352 million of invoices purchased in 2008 (up 10 percent from 2007), involving 511 firms and 24,156 buyers. No MENA country has developed reverse factoring, which can be an important source of working capital financing for small and medium enterprises in countries with poor credit information (Klapper 2006).

Notes

1. This section is based on Lester (2011).
2. Feyen, Lester, and Rocha (2011) show that life insurance premiums and assets are lower in countries with majority Muslim populations.
3. This section is based on DeMarco (2011).
4. For details on the new Egyptian pension scheme, see Maait and Demarco (2010).
5. This section is based on Mako and Sourrouille (2010).
6. The size of mutual funds in Kuwait could be underestimated. The country has a large investment companies sector, whose total assets represent 29 percent of GDP. Some of the activities of investment companies include investments and asset management on behalf of their clients.
7. See NCB Capital (2010) for a comprehensive discussion of institutional investors in the GCC.
8. This section is based on Al-Sugheyer and Sultanov (2010).
9. *Ijarah* means "to give something on rent." The development of conventional leasing has lagged the development of *ijarah*. Although *Sharia* provides the basic ground legislation for *ijarah*, the absence of a number of key regulatory requirements has held back the expansion of conventional leasing.

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CHAPTER 9

Capital Markets

This chapter investigates the main constraints to the development of fixed-income and equity markets in MENA. Private fixed-income instruments such as corporate bonds provide alternatives to bank finance; mortgage-backed securities and mortgage-covered bonds provide long-term funding for banks to expand housing finance. Well-developed government securities markets are a precondition for the sound development of private fixed-income markets, as they provide the benchmark yield curve for pricing private issues and the institutional infrastructure required for market development and the management of financial risks.

Local currency government bond markets have grown considerably in many emerging markets, but they remain relatively undeveloped in MENA. Several common weaknesses explain the underdevelopment of government debt markets in the region. Most important among these are the lack of development of money markets and a diversified institutional investor base, opportunistic primary issuance practices, and captive demand by banks, which dominate bond markets. These problems have led to highly concentrated buy-and-hold portfolios by banks and state-owned institutions, poor price discovery, and lack of liquidity in secondary markets.

Well-functioning equity markets can also complement the banking sector and contribute to efficient resource allocation. Key functions of equity markets include providing complementary funding for investment projects and an exit mechanism for entrepreneurs, discovering market prices, privatizing state-owned enterprises, facilitating corporate restructuring, providing vehicles for savings and wealth accumulation, and promoting good corporate governance.

The findings of this chapter indicate that MENA equity markets do not perform their key functions adequately. Despite high market capitalization, markets do not provide a meaningful complement to

bank finance for enterprises in most countries in the region, the quality of price discovery seems generally poor, there is scope for further use of equity markets for privatization of state-owned enterprises and corporate restructuring, and corporate governance could be substantially improved.

This chapter is structured as follows. The first section examines fixed-income markets in the region. The second section examines equity markets.

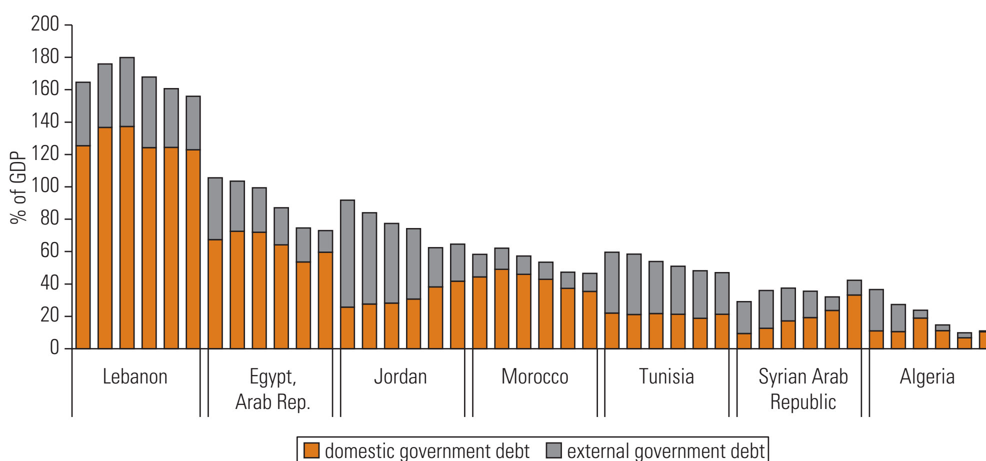
Fixed-Income Markets

The Limited Development of Government Debt Markets outside the Gulf Cooperation Council

This section examines the current stage of development of government securities markets in non-GCC countries in the region and highlights key bottlenecks of market development.[1] The focus is on five countries that have government bond markets of minimum size and greater potential for market development: the Arab Republic of Egypt, Jordan, Lebanon, Morocco, and Tunisia (MENA-5). These countries have sizable debt-to-GDP ratios and domestic tradable debt, and, to different degrees, have implemented measures to develop their debt markets (figures 9.1 and 9.2). However, the analysis is relevant for other countries in the region as well.

FIGURE 9.1

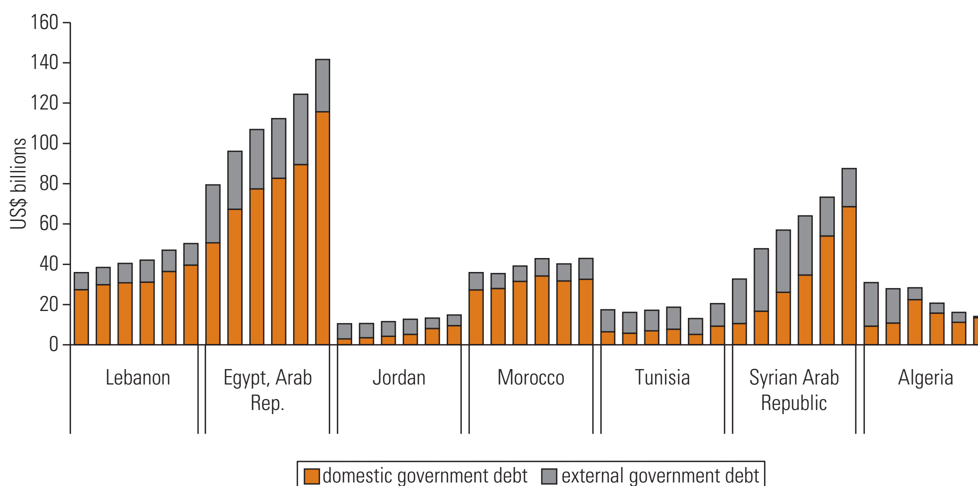
Total Central Government Debt as a Percentage of GDP, in Selected Countries in the Middle East and North Africa, 2004–09



Source: World Bank database.

FIGURE 9.2

Total Central Government Debt in Selected Countries in the Middle East and North Africa, 2004–09



Source: World Bank database.

The analysis focuses on the five building blocks that sustain deep and liquid public debt markets: money markets, primary markets (issuance policy and placement mechanisms), secondary markets, the investor base, and clearing and settlement infrastructure. Market development in MENA requires actions in all key building blocks, from improvements in monetary policy implementation and liquidity management to enhancements in issuance practices, price transparency, and clearing and settlement. Measures to improve the role of mutual funds and foster foreign investor presence are also critical to increase competition and investor diversification in these markets.

Money markets

The preconditions for well-functioning money markets are missing in MENA, depriving banks of the ability to actively manage liquidity. In advanced economies, well-functioning money markets are the cornerstone of efficient domestic debt and equity markets. MENA money markets are shallow, as a result of structural excess liquidity that is ineffectively sterilized, the central bank's choice of sterilization instruments that are not supportive of market development, and poor money market operational arrangements.

Excess structural liquidity is not sterilized fully, as a result of difficulties in liquidity forecasting and the high costs of sterilization. Relatively

high reserve requirements are used in all countries in the region as a first recourse to absorb excess structural liquidity. The choice of additional sterilization instruments, mainly short-term auctioned deposits and overnight standing facilities, is inadequate to support effective liquidity absorption. These instruments are used in advanced economies to fine-tune operations or when liquidity forecasting errors are smaller. The operational framework to support money market transactions is unevenly developed in MENA-5. In their infrequent liquidity operations, central banks use an ad hoc secured lending facility similar to a repurchase agreement. The interbank repo market is practically nonexistent, except in Morocco. In addition to the lack of incentives to manage liquidity actively, other regulatory, tax, and infrastructure constraints impede its development.

Primary markets

MENA-5 countries have basic market-oriented issuance policies, including the correct choice of instruments (discounted Treasury bills for the short term, fixed-coupon Treasury bonds for the medium and long term), but they prioritize low funding costs over market development. A sound issuance policy is the first step in a strategy to develop a liquid domestic debt market. To different degrees and depending on the country, key shortcomings are found in the maturity structure, auction calendars, concentration of demand, and lack of liability management techniques (table 9.1). The maturity structure is generally unbalanced and skewed toward the long term, which impedes the creation of liquid

TABLE 9.1

Main Features of Primary Public Debt Markets in MENA-5 Countries, 2008

Feature	Egypt, Arab Rep.	Jordan	Lebanon	Morocco	Tunisia
Preannounced calendar	Yes	No	No	Yes	Yes
Compliance with calendar	High	n.a.	n.a.	Medium	Medium
Reopenings	Yes	No	No	Yes	Yes
Bid-to-cover ratio	1.5	1.4	1.5	7.0	3.0
Auction participation	15 exclusive primary dealers	Any financial institution	Banks	Banks and 6 nonexclusive primary dealers	12 banks and 1 nonexclusive primary dealer
Treasury bonds as percentage of total bonds	36	61	94	76	98
Average maturity (years)	2.1	2.0	1.7	5.9	5.3

Source: Ministries of finance and central banks (annual reports and web sites).

Note: n.a. = not applicable.

benchmarks at all points of the yield curve. With the exception of Egypt, countries do not comply with a predictable auction calendar, and there is irregular supply at auctions of the whole range of debt maturities. The concentration of demand by state banks and other state institutions lowers the degree of competition in several countries. Countries in the region make limited use of liability management techniques to consolidate issues, enhance liquidity, and reduce rollover risk. All MENA-5 countries conduct multiple price auctions.

The current debt term structure, which is biased toward long maturities in most countries in the region, combined with the illiquidity of secondary markets are the main obstacles to market development. Though extending the average debt maturity to reduce rollover risk is a legitimate objective of debt management, from a market development perspective, longer maturities are desirable only as long as their issuance is sustainable and pricing is market based. Issuing long maturities too quickly without price references at the shorter end of the yield curve creates uncertainty over the pricing of Treasury bonds.

Without short-term price references, governments have been tempted to place their long-term debt at off-market prices. This practice has been facilitated in MENA-5 by captive demand resulting from excess liquidity; dominant state banks and institutions (for example, public pension funds); and lack of alternative investments. Relying on captive demand distorts pricing. Although this strategy may lower the cost of debt in the short term and reduce rollover risk, it creates a vicious circle, further reducing market liquidity. It introduces a strong incentive for a buy-and-hold strategy, which avoids the realization of latent capital losses. It weakens the balance sheet of financial intermediaries, even if losses are not realized, and increases liquidity risk in the financial sector, particularly in the event of a liquidity crunch. Finally, it unnecessarily segments debt into pools of locked-in portfolios, delaying reforms to create liquidity at the shorter end of the yield curve even further.

Secondary markets

Secondary markets are generally shallow in MENA-5 as a result of excess liquidity, inappropriate issuance policies, a nondiversified investor base, and a primary dealer system that does not perform its functions adequately. Therefore, reforms in all building blocks mentioned in this report are preconditions for improving secondary market liquidity and pricing. Government securities are traded predominantly in over-the-counter wholesale markets and marginally on exchanges. Reporting obligations are very minimal in all markets, as a result of low secondary market activity, and there are no pretrade price dissemination requirements in any MENA market.

Secondary markets in MENA-5 may be classified into three different profiles. In the first group, Egypt has the most active Treasury-bill market and a gradually increasing trade volume in the Treasury-bond market, reflecting an improved issuance policy. In the second group, comprising Morocco and Tunisia, the combination of long average maturity and low secondary market liquidity has led to a disproportionately high use of repos to manage liquidity. In Morocco, the general repo legal framework work is robust, but the spot market to sustain credible valuation of collateral is missing. Repos account for 99 percent of all trading activity in Morocco. In Tunisia the legal framework is weaker. Formal repos have not taken off there, although banks use an unregulated substitute called *ventes à réméré*s to manage liquidity. In the third group, Jordan and Lebanon have almost no secondary market trading, as a result of excess liquidity, a very fragmented debt structure, and poor market infrastructure.

The common feature of all three primary dealer systems in MENA-5 (Egypt, Morocco, and Tunisia) is that primary market obligations are enforced and secondary market obligations are not. In general, primary dealer programs can be very useful to ensure primary market placements and supply liquidity in the secondary market. The lack of enforcement of secondary market obligations is in part explained by the structural difficulties of trading activity—it is unrealistic to enforce market-making obligations as found in advanced markets. A potential solution is to reassess rules so that secondary market obligations are in line with the degree of market development.

Investor base

A large and diversified investor base is important for ensuring high liquidity and stable demand in the fixed-income market. A heterogeneous investor base with different time horizons, risk preferences, and trading motives ensures active trading and stimulates liquidity, enabling the government to execute its funding strategy under a wide range of market conditions.

In Egypt, Jordan, and Lebanon, banks and state-owned entities are more dominant buyers of domestic debt than in peer regions. In MENA-5, unlike many other emerging markets, there is no evidence of a declining trend in the share of these entities in favor of institutional investors. Egypt, Jordan, and Lebanon have the least diversified investor bases, with banks and state-owned entities holding more than 75 percent of issued debt (table 9.2). The main drawback for debt market development is not the predominant role of banks but the circumstances that make them buy-and-hold investors. Under normal conditions, banks should trade their securities portfolio to support their liquidity management operations. As explained above, excess liquidity and primary issuance policies

TABLE 9.2

Composition of Investor Base for Government Debt in MENA-5 Countries, 2009

Type investor	Egypt, Arab Rep.	Morocco	Tunisia	Jordan[a]	Lebanon
Banks	55	23	33	81	62
Public sector and pension funds[b]	30	27	1	—	36
Insurance companies	3	12	0	—	0
Mutual funds	1	22[c]	29	19	0
Foreign investors	10	1	0	0	1
Other	1	15	37[d]	0	1
Total	100	100	100	100	100

Source: World Bank staff compilation based on national sources.

Note: — = not available.

a. Holdings of banks and nonbanks only.

b. Egypt: National Bank of Egypt and Social Security; Morocco: Caisse de Depôts et Gestion; Lebanon: Central Bank.

c. Caisse de Depôts et Gestion holds 29 percent of the industry's assets.

d. Individuals.

are not supportive of secondary market trading, and the lack of alternative investments make banks buy and hold, reducing liquidity and investor diversification in public debt markets.

The institutional investor base is generally small across MENA-5 countries. In other regions, pension funds, insurance companies, and investment funds typically play a major role in the development of government securities markets. In contrast, in MENA, private pension funds are still negligible and public pension funds are not playing a significant role in debt market development in most countries. Except in Morocco, the contribution of the insurance sector to public debt markets is very limited, as a result of the sector's small size across the region. Egypt, Morocco, and Tunisia have nonnegligible investment fund industries, but these markets do not focus on retail investors; they have a unique wholesale profile tightly linked to banks (see Garcia-Kilroy and Silva 2011).

Foreign investors' presence in MENA-5 government debt markets is negligible outside Egypt. Foreign investors have been key agents in developing local currency government bond markets in many emerging markets. They have supported the lengthening of the yield curve and been active secondary market traders. They have also been instrumental in the development of foreign exchange and derivatives markets as instruments to fund or hedge their investments in local currency (BIS CGFS 2007). Foreign investors hold less than 1 percent of government debt in Jordan, Lebanon, Morocco, and Tunisia; in Egypt, they held about 10 percent in April 2010, almost entirely in Treasury bills.

MENA markets have not attracted foreign investors because of their limited investability (Garcia-Kilroy and Silva 2011). Only Egypt and Morocco have met the minimum conditions required by foreign investors and for inclusion in the GEMX index, and they score among the lowest emerging markets. Although increased global integration through the presence of foreign investors can increase volatility in the local debt market, as demonstrated by the recent global market turmoil, there are ways to mitigate this risk, as discussed in chapter 10.

Clearing and settlement infrastructure

The clearing and settlement infrastructure in MENA-5 is adequate for the current stage of market development, but it needs significant upgrades to support more liquid and investable markets. Only Morocco's central securities depositary has the versatility required by wholesale and over-the-counter government debt markets. All other countries need to formulate a roadmap for a phased upgrade of their existing systems. An alternative option for some countries, such as Egypt, would be to follow the same strategy used for the real time gross settlement system and develop a state-of-the-art central securities depositary system. The rationale is the mutual dependency of both systems and the future need to have similar levels of information technology and operational performance.

The Negligible Size of Fixed-Income Markets outside the Gulf Cooperation Council

Underdeveloped government securities markets are a major constraint to the development of private fixed-income markets in MENA. Well-developed government securities markets provide a reliable benchmark yield curve for pricing and developing private instruments. Well-developed government securities markets also provide the institutional infrastructure for capital markets, including experienced dealers and brokers, dealer financing, futures and options markets, clearing, settlement, book entry, and registry functions, as well as oversight and regulation. The lack of development of government debt markets in MENA also helps explain why private fixed-income markets have not developed.

Other regulatory and institutional constraints have also hindered the development of private fixed-income instruments. For example, no country in the region issued covered bonds, as a result of the lack of enabling legislation. Morocco is the first MENA country that is developing draft legislation and holding consultations with market participants.

Securitization is in its infancy. Morocco and Tunisia were the first countries to develop a legal framework for securitization, in the early

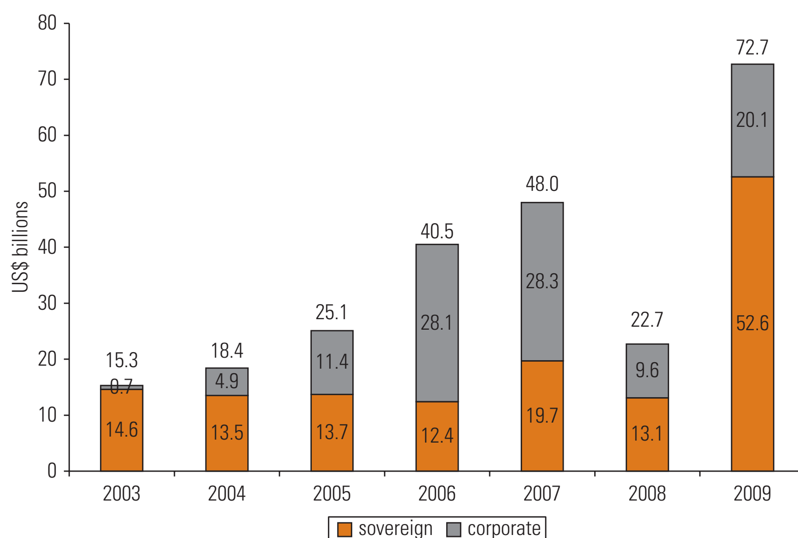
2000s, but very few transactions were conducted. The subprime crisis of 2007 stalled the infant market shortly after the first deals. The lack of further market development also reflects regulatory weaknesses, such as the lack of a housing price index, the absence of rating agencies, and flaws in securitization structures, including concentration of roles by the loan originators, leading to conflicts of interest.

The Status of Fixed-Income Markets in the Gulf Cooperation Council

The GCC debt/*sukuk* market grew rapidly in the precrisis years.[2] The investment boom in Dubai led to corporate issues surpassing government issues in 2006 and 2007 (figure 9.3). The share of *sukuk* issues also increased in this period (figure 9.4). When the global financial crisis hit the region, in 2008, the GCC market in general and its corporate segment in particular suffered a setback. The *sukuk* market entered a turbulent period, following a string of standstill announcements in the GCC, with the real estate giant Nakheel's *sukuk* event in the United Arab Emirates the most prominent. The recent setback of the Islamic securities market has revealed challenges to the market's growth.

FIGURE 9.3

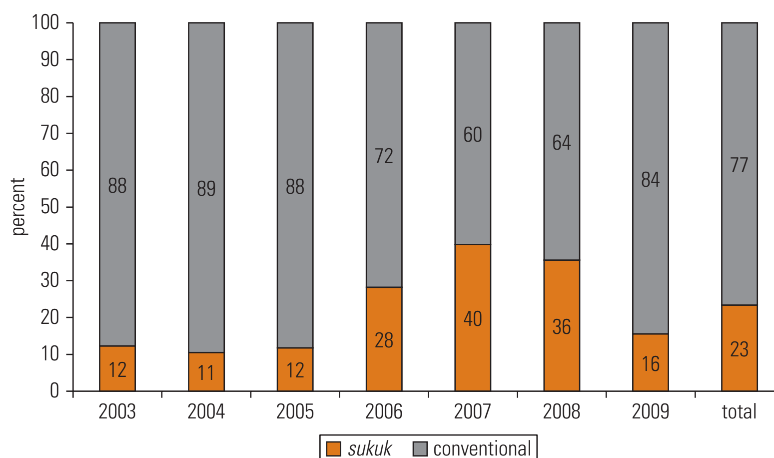
Issuance of Debt/*Sukuk* Securities in the Gulf Cooperation Council, 2003–09



Source: World Bank staff compilation based on data from the GCC Bond Market Survey and Markaz database, 2010.

FIGURE 9.4

Sukuk versus Conventional Debt Securities in the Gulf Cooperation Council, 2003–09



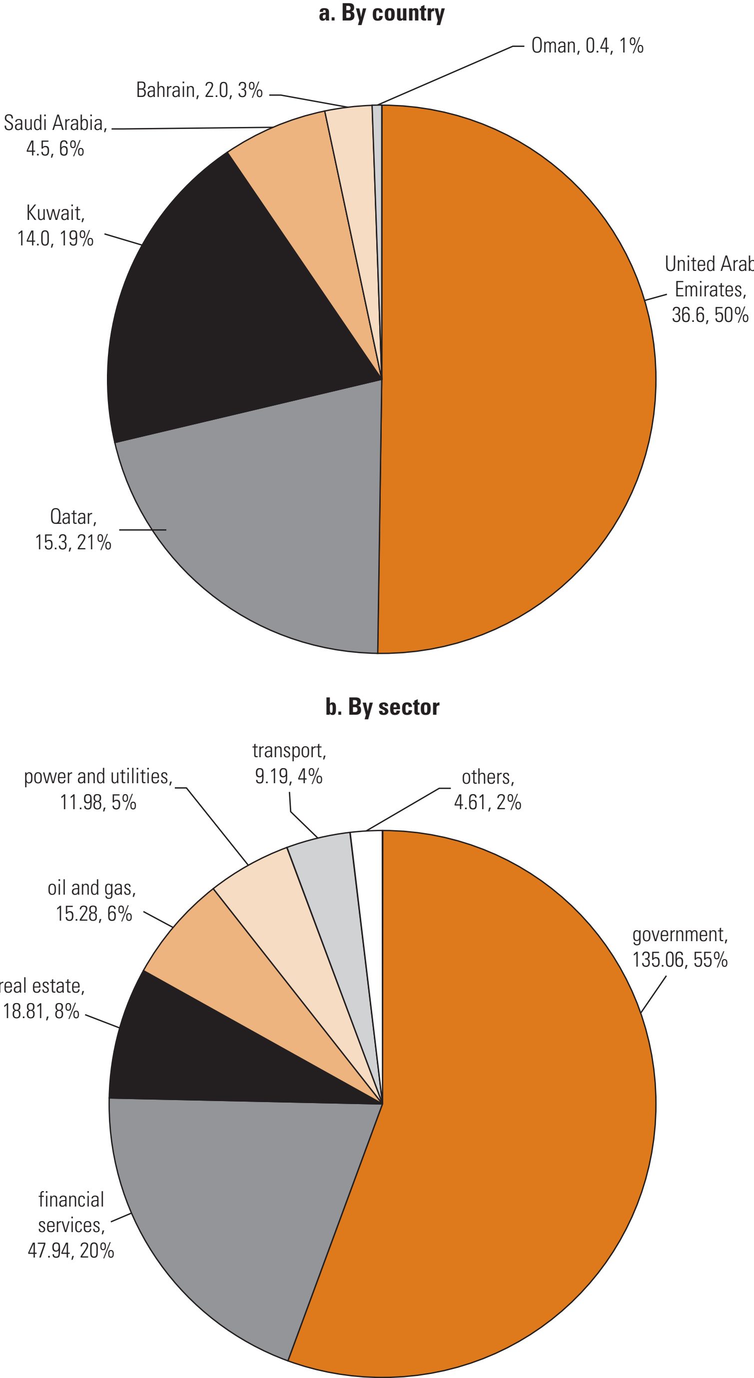
Source: World Bank staff compilation based on data from the GCC Bond Market Survey and Markaz database, 2010.

As a result of large debt/*sukuk* issues by corporations in the United Arab Emirates and issues by the federal government to finance its intervention in troubled corporations in Dubai, the United Arab Emirates accounts for the largest cumulative issuance in the GCC. Its issuances amounted to 50 percent of total GCC stock in 2009 (figure 9.5, panel a). A significant part of those issues financed real estate development projects and banking operations in the United Arab Emirates. By contrast, most of Kuwait's issues were government bonds, which were issued regularly for the central bank's open market–type operations to drain liquidity from the banking system. The Qatari government's large issues with maturities of 5, 10, and 30 years totaled US$7 billion, putting it in third place in 2009.

Nearly three-quarters of GCC issues were denominated in U.S. dollars, with issuances concentrated in a few sectors. The United Arab Emirates and Qatari issues accounted for 98 percent of U.S. dollar–denominated GCC issues in 2009. Kuwaiti dinar–denominated issues represented the largest outstanding amount among GCC currency issues in 2009. The sectoral composition of the GCC debt/*sukuk* stock reveals that among corporate issues, the financial services and the real estate sector accounted for more than half of the outstanding amount, followed by the oil and gas sector and utilities (figure 9.5, panel b). This sectoral composition is in line with the undiversified structure of GCC economies and is similar to that of equity markets in the region (see next section).

FIGURE 9.5

Outstanding Debt/*Sukuk* Securities in the Gulf Cooperation Council, 2009



Source: World Bank staff compilation based on data from the GCC Bond Market Survey and Markaz database, 2010.

Islamic securities (*sukuk*s) have been meeting the financial needs of many issuers in the Islamic world by observing the teachings of Islam in the context of modern investment banking.[3] The Islamic investment banking community has developed an array of *sukuk* structures to meet particular investment, financing, or *Sharia* compliance needs. In all structures, a special purpose vehicle is set up as the issuer of Islamic securities and the trustee of assets underlying the securities. The great majority of *sukuk*s are variable rate securities, for which secondary market trading is thin. Fast-growing Islamic banks are the primary investor base for *sukuk*s.

The GCC *sukuk* market is entering a critical stage of its growth, following several years of high-paced expansion. Challenges for market development include the generally nascent nature of the GCC market, uncertainty about the legal treatment of Islamic characteristics of *sukuk*s in a secular legal system, the unresolved nature of religious legitimacy in Islamic securities structuring, and excess liquidity and the lack of government financing needs in the GCC. The bankruptcy resolution of *sukuk* defaults has not been clarified; it is related to the ranking of *sukuk* holders' claims, creditors' access to the underlying assets, and the local enforceability of foreign legal decisions (Standard & Poor's 2010). The workout of recent bankruptcy cases is expected to set some precedence for resolution of bankrupt *sukuk* issuers.

In many ways, the development agenda in the GCC is similar to that of non-GCC countries, but budget surpluses and low debt in GCC countries pose additional challenges for market development. In order to build a reliable benchmark yield curve, policy makers need to build their internal debt management capacity, conduct regular and predictable issues, build an appropriate market structure, and introduce market making and repos. Developing the market in GCC countries would involve overfunding the budget, entailing nonnegligible costs. Sustaining a liquid government debt market would require that monetary, fiscal, and debt/asset management policies be well coordinated. Market segmentation between conventional and Islamic securities is another potential problem, as the cost of maintaining liquid benchmarks for both types of securities could prove prohibitive.

There is significant potential for regional harmonization of market regulation and infrastructure in the GCC. Primary areas for regional harmonization include accounting and auditing rules, intermediary licensing, and securities offering and trading. Likely areas for regional integration or networking in market infrastructure would be those sensitive to economies of scale, in particular securities depositories and payment systems. So far, progress has been limited.

Equity Markets

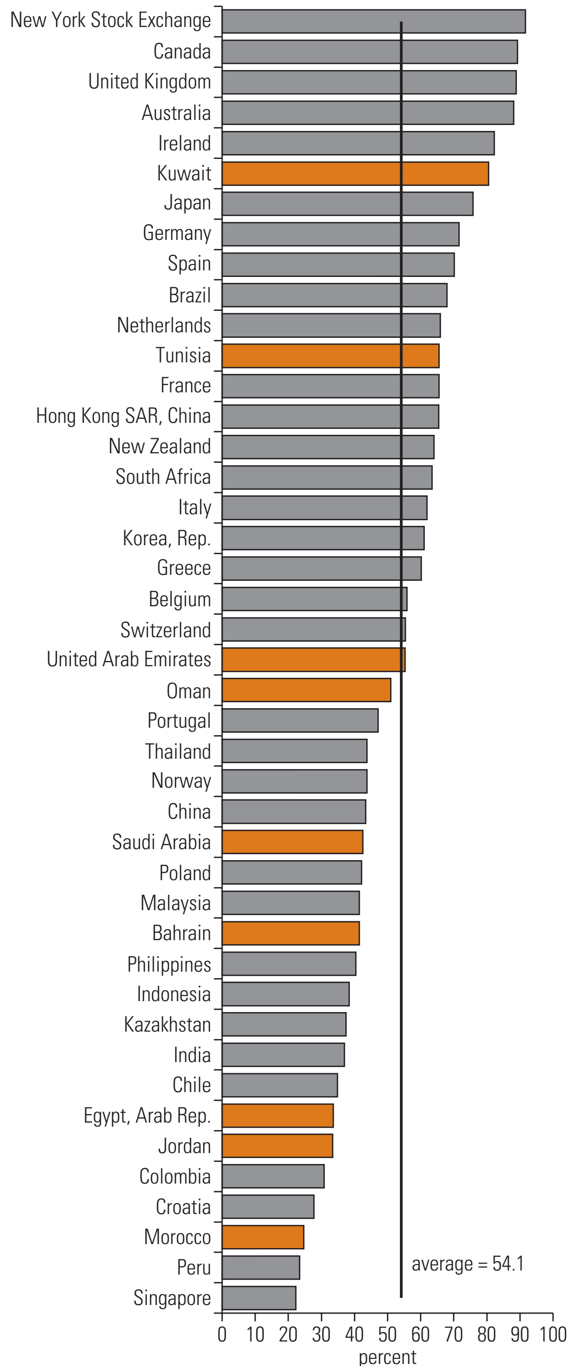
Market capitalization in MENA is large by international comparison, but free floats are thin in many countries.[4] Between 2005 and 2010, 1,500 or more companies were listed on MENA's major stock exchanges. Their total market capitalization reached US$1.2 trillion in 2007, declining to US$870 billion by end-2009, as a consequence of the global financial crisis. GCC countries account for half of MENA's listed companies and three-quarters of the region's market capitalization. Free floats appear very reasonable in Kuwait, Tunisia, and the United Arab Emirates but small in other MENA countries, especially outside the GCC (figure 9.6). Thin free floats often reflect large residual state shareholdings in (partially) privatized companies or large family shareholdings in companies whose small public share offerings may have been motivated by the desire for prestige or other factors, such as tax incentives.

Average market capitalization of listed firms varies widely across the region. It is generally high in the GCC. The average is highest for firms in Saudi Arabia (US$4.2 billion), Qatar (US$2.0 billion), and Abu Dhabi (US$1.5 billion). It is US$80 million–US$150 million for firms in Jordan, Oman, and the West Bank and Gaza. Especially in GCC countries, where average market capitalizations exceed those in most developed markets, equity markets are dominated by banks and large former state-owned enterprises. In both the GCC and the rest of MENA, there is substantial potential for medium-size manufacturing and service firms to list and become active.

Financial institutions account for half of MENA's market capitalization, a larger share than in any other region except Africa (table 9.3). Industry commands a smaller share of market capitalization than it does in any other developed or emerging region, and the service sector's share is equal to that in Africa. This pattern reflects both the lack of economic diversification in some countries, especially in the GCC, and the fact that firms in the industry and service sectors do not see advantages in listing. The transparency and disclosure requirements for listing are considerable. Financial firms, especially banks, are generally subject to higher reporting requirements than nonfinancial firms, and some countries require financial firms (banks in the Arab Republic of Syria, insurance companies in Saudi Arabia) to list. However, family-owned firms in industry and services generally avoid the transparency and disclosure requirements that accompany stock market listings. Industry and service sector access to equity markets is especially low in Kuwait, Lebanon, Morocco, Qatar, Saudi Arabia, Syria, the United Arab Emirates, and the West Bank and Gaza. The large share of financial institutions in Bahrain reflects that economy's status as an offshore financial center.

FIGURE 9.6

Free Float as a Percentage of Market Capitalization in New York Stock Exchange and Selected Economies, End-2009



Source: World Bank staff compilation based on data from World Federation of Exchanges and national exchanges.

TABLE 9.3

Sectoral Composition of Market Capitalization, by World Region, 2009
(percent)

Region	Financial	Infrastructure	Industry	Services
East Asia and Pacific	28.0	33.1	29.9	9.0
Europe and Central Asia	25.5	37.1	32.6	4.8
High-income OECD	22.8	32.0	33.1	12.1
High-income non-OECD	40.4	26.2	20.0	13.4
Latin America and the Caribbean	40.7	28.8	25.3	5.3
Middle East and North Africa	49.5	29.5	17.1	3.9
GCC average	47.1	31.4	16.8	4.8
Non-GCC average	51.6	27.9	17.3	3.1
South Asia	22.4	36.7	36.4	4.4
Sub-Saharan Africa	54.0	9.7	32.3	4.0

Source: World Bank staff calculations based on data from Bloomberg database.

Note: OECD = Organisation for Economic Co-operation and Development.

Countries in the region generally compare very well with countries outside the region in market turnover (turnover/market capitalization), but high turnover ratios do not necessarily reflect effective price discovery. Turnover ratios in MENA look high controlling for GDP per capita, demographics, and status as an oil exporter (figure 9.7). Actual turnover ratios exceed predicted values by a wide margin in Saudi Arabia and are above expectations in most other MENA countries. Countries in the region also compare well in other indicators of market trading and liquidity, such as the ratio of turnover to GDP and the share of the top 10 companies in turnover (see appendix C). However, the large volume of trading revealed by these indicators does not necessarily reflect effective price discovery or equity valuation, as discussed below.

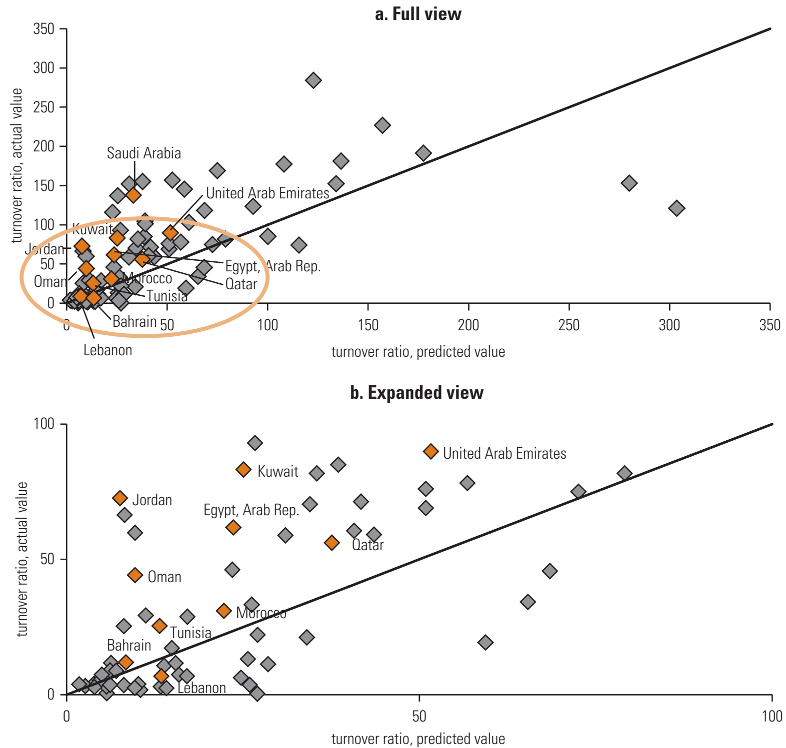
This rest of this section explores how effective these large and active MENA stock markets are in contributing to overall economic development. Although equity markets can be a valuable dynamic mechanism for price discovery—facilitating capital investment, entrepreneurial equity finance, privatization, corporate restructuring, and corporate governance—there are grounds for concern that MENA's stock markets are falling short in performing these functions.

Price Discovery

MENA equity markets display reasonable turnover indicators, but they do not seem to perform well in price discovery. Developed equity markets enjoying more disclosure and transparency, stronger governance standards, and professional asset management should promote arbitrage trading based on information about a firm's fundamentals. In such an

FIGURE 9.7

Market Turnover in the Middle East and North Africa and in Peer Markets, 2008



Source: Bank staff calculations based on data from World Federation of Exchanges and World Bank.

Note: Orange diamonds indicate countries in the region; grey diamonds indicate countries outside the region.

environment, prices will incorporate more firm-specific information and co-move less with the market (Morck, Yeung, and Yu 2000). Two indicators of price synchronicity—the first measuring the co-movement of stock prices, the second measuring the portion of stock returns explained by the market (that is, the average R^2 of a regression of a company's biweekly stock returns on overall market returns for the period 2004–09)—were computed, in order to assess the quality of price discovery (see appendix B). The two indicators are highly correlated; the second is used here, because it has been more extensively used in the empirical literature to measure price synchronicity and allows international comparisons. Low R^2 values indicate low levels of price synchronicity and suggest an effective price discovery function. The results for MENA (table 9.4) are compared with a similar exercise for 40 countries outside the region (table 9.5) (Alves, Peasnell, and Taylor 2010).

TABLE 9.4

Portion of Biweekly Returns Explained by the Market in Selected Countries in the Middle East and North Africa, 2004–09

Country	2004	2005	2006	2007	2008	2009	Mean 2004–08
Bahrain	0.15	0.21	0.22	0.16	0.25	0.18	0.20
Egypt, Arab Rep.	0.17	0.26	0.30	0.12	0.41	0.27	0.25
Jordan	0.27	0.23	0.26	0.14	0.30	0.16	0.23
Kuwait	0.21	0.14	0.31	0.16	0.37	0.32	0.25
Lebanon	0.19	0.32	0.62	0.39	0.39	0.43	0.39
Morocco	0.27	0.21	0.29	0.30	0.32	0.36	0.29
Oman	0.21	0.22	0.27	0.17	0.41	0.27	0.26
Qatar	0.30	0.56	0.38	0.30	0.53	0.51	0.43
Saudi Arabia	0.33	0.18	0.54	0.37	0.52	0.50	0.41
Tunisia	0.11	0.12	0.15	0.16	0.8	—	0.13
United Arab Emirates	0.26	0.25	0.32	0.25	0.39	0.40	0.31
Mean	0.22	0.25	0.33	0.23	0.36	0.34	0.29

Source: World Bank staff calculations based on data from Bloomberg database.

Note: — = not available.

TABLE 9.5

Portion of Weekly Returns Explained by the Market in Selected World Economies

Ranking portion of weekly returns explained by the market in sample of 40 markets outside the Middle East and North Africa Ranking	Economy	R^2	Ranking	Economy	R^2
1	Canada	0.03	22	India	0.12
3	Ireland	0.04	24	Japan	0.12
5	United Kingdom	0.05	26	Indonesia	0.15
7	Peru	0.05	28	Mexico	0.17
9	Portugal	0.06	30	Italy	0.19
11	United States	0.06	32	Philippines	0.20
13	Denmark	0.06	34	Poland	0.22
15	Colombia	0.08	36	Taiwan, China	0.22
17	Germany	0.08	38	Greece	0.27
19	Netherlands	0.11	40	China	0.29

Source: Alves, Peasnell, and Taylor 2010.

Note: Means were calculated over the 1997–2004 period.

The MENA indicators of price synchronicity seem very high by international comparison, suggesting that the price discovery function is not very effective. They fluctuate over the sample period and spike in periods of crisis, such as 2006 (the local GCC crisis) and 2008 (the global crisis). These fluctuations are expected, as the co-movement of stock prices increases in periods of boom and bust. However, the MENA mean (29 percent) is equal to the mean of the lowest-ranked country in the

international sample, and countries in the region generally fare poorly in this comparison. Admittedly, the methodology has limitations. For example, the R^2 captures factors other than the institutional quality of the equity market. In addition to bubbles and bursts, it could reflect the size and composition of the market and idiosyncratic factors. The high R^2 for countries in the region could partly reflect the large share of financial firms, whose stock prices tend to move together.[5] These possibilities notwithstanding, the differences between countries in the region and other markets are impressive, suggesting weak price discovery.

The combination of strong trading volumes and weak price discovery may reflect the large and active participation of uninformed retail investors and the lack of a well-developed base of private domestic institutional investors. MENA's base of private institutional investors is very small by international comparison (see chapters 3 and 8). Institutional investors are more likely than individual investors to support efficient price discovery by basing investment decisions on fundamental research rather than rumor or sentiment. Institutional investors may also be less likely to be taken in by market manipulation. In 2008, individual investors accounted for 60–80 percent of the value of shares traded in Dubai, Kuwait, Egypt, and Qatar and more than 90 percent in Saudi Arabia (table 9.6). Reactive and only partially informed trading by individuals investing on their own rather than through institutional investors may have contributed to high price synchronicity in the United Arab Emirates, Qatar, and Saudi Arabia. Other empirical research is consistent with this conclusion. For example, after examining the large volume of trading in the Saudi Arabia stock exchange in the past decade, Haddad and Hakim (2008) conclude that such trading was dominated by uninformed retail investors.

Foreign investors seem to have contributed to price discovery, but their presence in MENA is uneven. Relying more on fundamentals and less on rumor, foreign investors may aid price discovery. In many MENA

TABLE 9.6

Percentage of Retail and Institutional Investors in Selected Economies in the Middle East and North Africa, 2008

(percent)

Economy	Retail investors	Institutional investors
Saudi Arabia	91	9
Dubai	80	20
Kuwait	71	29
Egypt, Arab Rep.	66	34
Qatar	62	38

Source: World Bank staff compilation based on data from NCB Capital and EGX.

stock markets, foreign investors account for 30 percent or more of value traded (table 9.7). Foreign participation varies widely in the GCC, ranging from less than 10 percent in Kuwait and Saudi Arabia to 40–50 percent in Bahrain and Dubai. Major GCC markets limit foreign ownership of shares in listed companies, though some countries have been gradually relaxing these barriers. The limited presence of foreign investors in Saudi Arabia may have contributed to high price synchronicity, while trading by better-informed investment companies may have offset Kuwait's nearly as low level of foreign investment and contributed to better price discovery. Conversely, relatively high levels of foreign trading in Bahrain, Egypt, and Tunisia may partly explain the good rankings for price discovery within MENA. Appendix B provides an econometric analysis of the determinants of stock price synchronicity for MENA markets. It suggests that the presence of foreign investors may have reduced price synchronicity (for the original analysis, see Mako, Feyen, and Sourrouille 2011).

Raising Entrepreneurial Finance

Initial public offering (IPO) activity was relatively high in some countries in the region in the precrisis period, although IPOs were concentrated in financial services and infrastructure. IPOs peaked in 2007–08, declining sharply thereafter, as a result of the global financial crisis. During 2006–10, IPOs on MENA stock markets raised US$41.5 billion.[6] However, four GCC states (Saudi Arabia, the United Arab Emirates, Qatar, and Bahrain) accounted for 84 percent of this total. Relative to GDP, amounts raised through IPOs in these countries in 2006–09 exceeded the worldwide

TABLE 9.7

Foreign Investor Share of Value Traded in Selected Markets in the Middle East and North Africa, 2005–08
(percent)

Economy	2005	2006	2007	2008
Abu Dhabi	n.a.	n.a.	n.a.	25.9
Bahrain	52.2	57.7	48.0	47.7
Dubai	n.a.	n.a.	32.0	37.9
Egypt, Arab Rep.	30.3	30.2	31.7	30.0
Jordan	12.8	14.0	22.9	20.8
Kuwait	n.a.	n.a.	n.a.	8.5
Saudi Arabia	n.a.	n.a.	n.a.	4.0
Tunisia	n.a.	n.a.	n.a.	33.0

Source: World Bank staff compilation based on data from NCB Capital and EGX.

Note: n.a. = not applicable.

average (figure 9.8). As an offshore financial center with a large share of financial listings, Bahrain ranks high. Non-GCC markets are noticeably below the worldwide average, with the exception of Jordan. More important, industry and services have accounted for a small share of IPOs: between 2006 and 2010, infrastructure accounted for 58 percent and financial services for 19 percent of total IPO amounts, whereas industry accounted for 15 percent and services 8 percent (Mako, Feyen, and Sourrouille 2011).

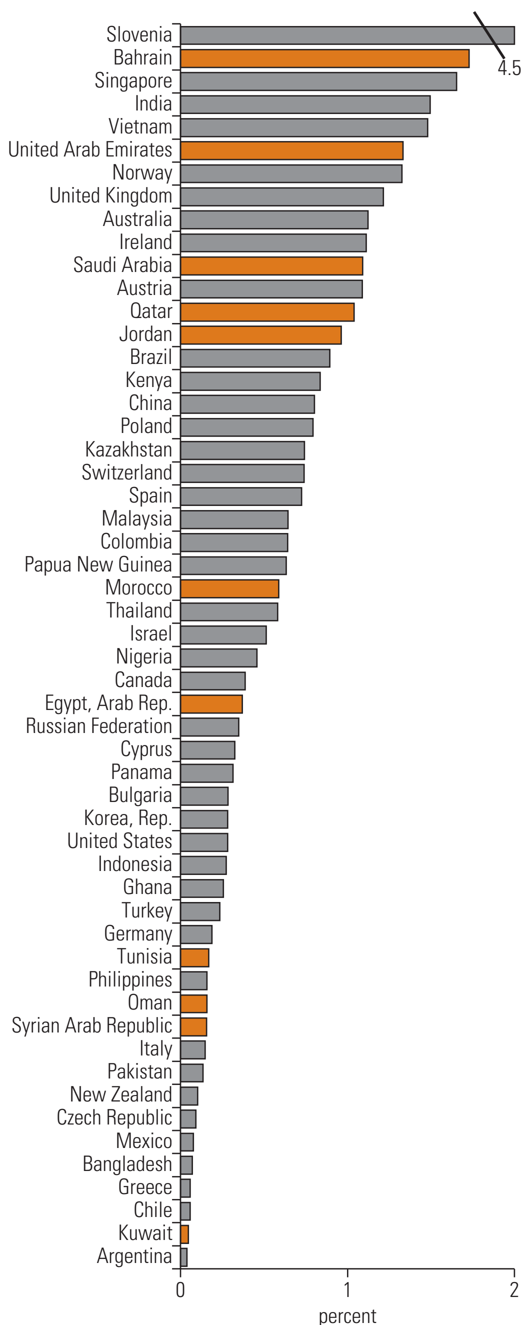
Some countries have tried to facilitate access to equity finance by small and medium enterprises—so far with limited success. In Tunisia, for instance, the stock exchange provides three tiers of listings, with varying listing requirements, to facilitate the listing of different-sized firms. The number of listed firms actually declined slightly, however, from 77 at end-2008 to 76 at end-2009. To encourage small and medium enterprise IPOs in Egypt, in October 2007 the Egyptian Exchange established a separate and distinct board (NILEX) for small and medium enterprise listings. NILEX offers more flexible listing rules on the minimum number of IPO subscribers and issued shares, audits (annual financial statements only), financial history, and listing fees. Despite these changes, as of end-2009, only nine small and medium enterprises had listed on NILEX, and none had raised equity finance through an IPO. Worldwide it has remained difficult to induce small and medium enterprises to raise equity finance through IPOs. As of end-2011, at least 17 small and medium enterprises and at least 1 IPO were listed.

Privatization

Several countries in the region have undertaken significant privatization programs over the past 10–20 years that included IPOs in the local stock market. However, the pricing for many privatization IPOs in the GCC has been highly artificial, undermining development of local markets' capacity to price new issues. Unlike the book-building process followed in other emerging markets, GCC markets have priced IPOs at an arbitrary par value chosen by the government. In order to share hydrocarbon-based wealth with all citizens, GCC governments distributed the equity from state-owned enterprises at deep discounts to market value. Deep discount distributions resulted in massive oversubscriptions, creating the need for a rationing process. There remains a huge potential for many MENA governments to transfer shareholdings in numerous state enterprises to private institutional and retail investors. To avoid retarding the development of the markets' price discovery function, it will be important to follow a more traditional book-building approach to pricing privatization IPOs.

FIGURE 9.8

Initial Public Offerings as a Percentage of GDP in Selected Countries, 2006–09



Source: World Bank staff compilation based on data from the Arab Monetary Fund (AMF) for MENA countries and the World Federation of Exchanges for other countries.

Note: IPO amounts from the AMF and World Federation of Exchanges are identical or reasonably close for Bahrain, Egypt, Saudi Arabia, and the United Arab Emirates. For other MENA countries, World Federation of Exchanges data may include transactions (new listings, secondary offerings) that are not strictly IPOs.

Corporate Governance

The ability of a country's equity market to promote good corporate governance depends on opportunities for shareholders and other stakeholders to be aware of and influence events at listed companies. A 2008 survey of 155 listed companies in 11 countries in the region found that not a single company could claim to follow best practice in corporate governance (IFC and Hawkamah 2008). Surveyed companies lack basics for effective board oversight, such as a sufficient number of independent directors and a separate audit committee with a majority of independent directors that reports to the board. Both internal and external audit practices are underdeveloped in many cases, and financial and other disclosure is spotty. Minority public shareholders may lack ready access to give voice and protect their interests. A 2009 report focusing on corporate governance of MENA banks confirms the need to upgrade boards of directors, improve nonfinancial disclosure, and control conflicts of interest and related-party transactions (OECD, Hawkamah, and UAB 2009).

Notes

1. This section is based on Garcia-Kilroy and Silva (2011).
2. This section is based on Endo (2011).
3. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) defines *sukuks* as certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs, services, or (in the ownership of) the assets of particular projects or special investment activity.
4. This section is based on Mako, Feyen, and Sourrouille (2011).
5. Alves, Peasnell, and Taylor (2010) stress these limitations and the need to account for confounding factors.
6. MENA markets also support some level of secondary public offerings (SPOs) but definitions of SPOs are not uniform in the region. Estimates of SPOs vary widely, perhaps because of differing definitions. Private placement–type SPO transactions may account for 90 percent of SPO proceeds in the region.

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CHAPTER 10

An Agenda for Financial Development with Financial Stability

This concluding chapter proposes an agenda for sustainable financial development in MENA based on the diagnostic presented in the first nine chapters. It identifies and discusses the main components of an agenda that could substantially expand access to finance while preserving financial stability. The chapter highlights the most important policy actions in each area without being exhaustive. More detailed recommendations are provided in the background papers prepared for this report.[1]

Main Elements of the Proposed Agenda

The roadmap is comprehensive, because the lack of access in MENA is a result of a large number of interconnected factors. As discussed in the preceding chapters, the agenda must address the extreme level of loan concentration in the region and create the conditions for a sustainable expansion of access to underserved sectors in all critical areas, including small and medium enterprise, consumer, microfinance, housing, and investment finance. Doing so will require a battery of coherent and mutually reinforcing reforms addressing regulatory and institutional weaknesses in many areas.

The main thrust of the proposed reforms is to enable a stronger engagement of private financial institutions through an improved enabling environment while reserving an important role for the state as an enabler and regulator, as well as a guarantor and provider if market failures persist. The roadmap includes reforms that could improve access to all underserved sectors and reforms that are specific to each sector.

The agenda includes reforms in financial infrastructure and in banking regulation designed to improve competition while preserving the

system's resiliency, as well as reforms to promote the development of nonbanking institutions, markets, and instruments.

The proposed roadmap includes specific recommendations tailored to the initial conditions in each of three main subregions and recommendations that apply to the MENA region as a whole. The number of recommendations that apply to the region as a whole is high because countries across the region face similar challenges in many areas. Table 10.1 organizes the policy recommendations along these lines.

The proposed reform plan starts with recommendations to strengthen financial infrastructure, one of the weakest components of MENA financial systems. Strengthening credit information and creditor rights would not only directly increase access, by reducing creditor risks, but also have an indirect impact, by leveling the playing field for banks of different sizes and promoting bank competition. Reforms in this area have the potential for unblocking lending in many areas, including small and medium enterprise, consumer, microfinance, and housing finance.

The recommendations include regulatory reforms in the banking system designed to enhance competition, as the banking sector will remain the dominant component of MENA's financial systems for the foreseeable future. The structure of MENA's banking systems is evolving in the right direction but not at a sufficient pace to break the access gridlock. In many countries the approach to regulation and supervision may need to be revised in critical areas such as entry regulations, large exposures, and connected lending.

The roadmap also includes reforms designed to diversify MENA's financial systems, creating institutions and instruments that do not exist or are negligible. This component of the agenda does not aim to transform MENA's bank-based systems into market-based systems, something that is neither necessary nor realistic in many cases. However, the negligible size of nonbanking institutions and instruments implies the absence of many essential services, hinders competition in the financial sector, and deprives the banks of instruments to manage their risks and expand access in a sound manner. Therefore, specific reform proposals are put forward for building a base of institutional investors, developing key instruments and markets, and developing alternative sources of small and medium enterprise finance.

In their efforts to diversify MENA's financial systems, policy makers should not avoid addressing apparently intractable "circular challenges." The preceding chapters have shown that the slow development of markets and instruments is partly a result of the absence of institutional investors, whereas the slow development of institutional investors is partly a result of the lack of suitable financial instruments.

Other countries have cut this Gordian knot by making steady progress on all fronts over time, identifying and removing regulatory and institutional barriers where the barriers exist. As shown in the preceding chapters, Morocco provides a relevant example of a middle-income MENA country that has developed a critical mass of institutional investors.

This chapter also includes recommendations for improving the approach to policy interventions, including the use of state banks and guarantee schemes. State banks have played developmental roles in many countries, although their performance in fulfilling these roles has been mixed and uneven across the region. Moreover, countries with state-dominated systems have the lowest levels of financial development and lower economic growth rates than other countries. The agenda recognizes that the state may have a role to play in financial development but that this role must evolve over time. In this regard, critical questions need to be addressed, such as the mandates and governance structures imposed on state institutions and the number and size of institutions required. Other policy interventions aiming to expand access should be better targeted. Credit guarantee schemes offer better perspectives than other interventions, but MENA schemes can be better designed to improve their additionality.

The agenda also emphasizes the potential contribution of foreign institutions and investors, while acknowledging the need to mitigate the risks of their increased participation. The recent crisis has shown that financial openness increases exposure to external shocks. However, the lack of openness can also have a negative impact on the efficiency of the financial system and its capacity to provide access. Countries in the region that are financially closed have been less affected by the recent crisis, but they also have the lowest levels of financial development and have grown more slowly than the other countries in the region. Foreign banks can enhance competition and access, but they have not reached critical size in many countries. Foreign investors can contribute to market development, especially as domestic institutional investors are being built, but their presence is negligible in MENA debt markets and limited in many equity markets. The challenge lies in maximizing the benefits of foreign participation while mitigating its risks.

The financial development roadmap needs to be complemented by a financial stability agenda to ensure that financial systems remain resilient as access is expanded. Some of the proposed reforms may actually reduce some risks, such as concentration risk. Other reforms designed to expand access may imply new risks for the banks. For this reason, it is imperative to ensure that the banks are capable of managing these risks and the

financial system remains resilient. Doing so implies the need for several improvements in bank governance and in the overall architecture of bank regulation and supervision.

Finally, addressing long-standing fiscal constraints would strongly complement the reform agenda. In non-GCC countries, persistent budget deficits contribute to a symbiotic relationship between banks and the government: governments get a stable funding source, and banks gain the margin between their low funding costs and the yields on low-risk government securities. In the GCC, banks provide primarily consumer finance to government employees and project or investment finance to enterprises with well-established connections. In both cases, the existence of a stable and profitable business line with the government blunts the momentum of the reform agenda. Outside the GCC, the agenda entails deficit reduction; within the GCC, it entails diversification, which can be achieved through greater opportunities for banks to broaden access to credit beyond the very narrow focus on nationals in the public sector and large corporations.

First Things First: Strengthening Financial Infrastructure

Strengthening Credit Information Systems

An important strategic decision faced by many countries in the region is whether to upgrade their public credit registries or introduce private credit bureaus. When making this decision, regulators should not underestimate the difficulty of implementing a reform of credit reporting systems. Effective systems require the participation of a wide spectrum of players, including banks, other regulated financial institutions, and unregulated lenders. Microfinance institutions, utilities, retailers, and mobile phone companies should be engaged, implying the collection and management of millions of records and the generation of full credit reports. Effective systems also provide value added services, such as credit scores.

The combination of a public registry and a private bureau may prove an effective solution to expanding the coverage and depth of information in MENA. However, some public registries are aiming to operate like best-practice private bureaus. In particular, the public credit registry established by the Palestine Monetary Authority merits examination. All banks and major microfinance institutions are part of the scheme. The registry provides users with a Web-based online facility for inquiries and data sharing. The credit report is quite complete, more like a private

bureau report, displaying detailed information at the account level. It has also developed a fully automated scoring model that will be available to banks and microfinance institutions.[2]

Countries considering introducing a private credit bureau should develop specific legislation. A customized credit reporting law represents the best legal foundation for information sharing, particularly to clarify consumer rights and the responsibilities of lenders and bureaus. This has been the avenue Jordan and Saudi Arabia have chosen. Other countries, such as the Arab Republic of Egypt and Morocco, have introduced a sound legal basis for credit reporting by regulating their central banks, an approach that may prove feasible in other countries as well. Yet other countries have introduced private bureaus through a code of conduct and consumers' consent. Bahrain and Saudi Arabia adopted this approach, but the Saudi Arabian authorities concluded that a credit information law would provide a more solid basis for credit reporting and passed such a law in 2008.

Legislation on private bureaus should include all the main elements of an effective credit reporting system: submission of data should be mandatory for all regulated entities and cover all loans; all data (positive and negative) should be part of the database; the participation of unregulated entities should be encouraged and maximized (including microfinance institutions); no loan thresholds should be established; the data distributed should be detailed at the account level; historical data (for the previous three to five years) should be provided; inquiries to the bureau should be mandatory before granting credit; and borrower consent and the right to access and challenge information should be established.

Egypt, Morocco, and Saudi Arabia provide examples of effective bureaus. The Saudi bureau has made impressive gains in coverage in recent years. It computed modalities of default in coordination with the commercial banks and the central bank, and has also computed ratings for more than 20,000 small and medium enterprises as part of an effort to promote more small and medium enterprise lending. The Moroccan bureau is younger, but represents an innovative model of a "delegation contract," through which the central bank delegates operation of the public registry service to a private bureau. (Morocco established an innovative "delegation contract," through which the central bank delegates operation of the public registry service to a private bureau.) The two models have stronger and weaker aspects that other countries should examine.

MENA countries should consider creating a national identification number (NID) system, something many countries in the region still lack. These countries should consider the introduction of a NID that is unique,

electronic, and secure and encourage use of this NID for credit reporting purposes.

The legal framework should allow use of "nontraditional data" by private credit bureaus. A huge and critical mass of powerful and predictive information on microfinance institutions, utilities, and similar data (mobile phone users) normally goes unused because of lack of regulation or excessive restrictions. These data are crucial to start building credit histories for potential borrowers who do not have them. Alternative data can bridge the information gap for the millions of people—most of them poor—who lie outside the credit mainstream. Harnessing alternative data is paramount to formalizing the informal economy.

Strengthening Collateral Regimes

The most appropriate way to strengthen creditor rights is to draft a law that regulates every aspect of the chain of secured lending. Countries in the region should move away from the current system of fragmented provisions in different bodies of the law (civil codes, commercial codes, mortgage laws, debt recovery). A number of countries with both civil law systems (Albania, Bosnia and Herzegovina, Cambodia, China, and Romania) and common law systems (Australia, Ghana, India, and New Zealand) have introduced successful reforms in this area following modern principles. The type of legal system should thus not be a deterrent to introducing reforms in this area. The specific law should do the following:

- Be broad in scope.
- Allow broad pools of assets, such as inventories and receivables, and a generic description of the assets accepted as collateral.
- Adopt the "functional approach" to secured transactions, ensuring equal treatment of all types of transactions secured by movable property, such as loans and leases, to avoid hidden liens.
- The creation of security interests in movable property should be simplified, and the law should establish a clear priority scheme for secured lenders. The new law should eliminate cumbersome and unnecessary formalities for the creation of security interests in movable property. It should allow the parties to freely agree on the conditions of the transaction in the credit agreement. Secured creditors should also be able to predict their priorities with respect to other creditors at the moment of granting a loan to a business.

Movable collateral registries should be modernized. The registry plays an essential role, which is to notify parties about the existence of a security

interest in movable property (of existing liens) and establish the priority of secured creditors. Collateral registries in MENA must be centralized in a single database, be electronic and Web based, register notices, be accessible to the public for real-time consultations, cover all types of movable assets, be cost-effective, and ensure the security of all data.

Enforcement must be substantially strengthened, especially through the introduction of effective out-of-court enforcement mechanisms. Weak enforcement of collateral and collection of debts are possibly one of the major impediment to increasing access to credit in MENA. Enforcement is most effective when parties can agree on rights and remedies upon default, including seizure and sale of collateral outside the judicial process. A fast and efficient procedure is particularly important for movable property, which in most cases depreciates rapidly over time. More than 100 countries worldwide have adopted out-of-court enforcement procedures.

A number of out-of-court enforcement mechanisms have proved successful in countries outside the region. The reform of enforcement procedures—in particular, the introduction of out-of-court enforcement—has proved feasible in several countries (box 10.1), frequently

BOX 10.1

Alternative Models for Out-of-Court Enforcement of Collateral

Various alternatives to litigation are available for enforcing the collection of collateral:

- *Public collection agents.* Several countries have created public collection agents that are responsible for seizing the asset with the appropriate executory title or judgment. These agents are usually part of the executive branch (police officers or bailiffs) but are not associated with the courts. Several Eastern European countries have adopted this approach.
- *Private collection agents.* Other jurisdictions have established organized bodies or private enforcement agents. These agents include notaries (Romania), private enforcement officers (Georgia), bailiffs (*huissiers*) (France), receivers (United Kingdom), and financial institutions and housing finance companies (India). These bodies are usually regulated and licensed to prevent abuse.
- *Combination of public and private agents.* Some countries have hybrid systems, in which different agents perform different enforcement functions. In the Slovak Republic, notaries are allowed to enforce mortgages and collateral agreements, and public enforcement agents are used for other enforcement cases.

Source: Alvarez de la Campa 2011.

by introducing private enforcement agents and regulating out-of-court enforcement to prevent abuse.

Finally, the law should provide flexibility for the secured creditor to dispose of the collateral. In many countries in the region, collateral must be sold by court-controlled public auctions, with cumbersome procedures and minimum bids, which may delay the sale and allow the value of the assets to decline. It is preferable to allow the secured creditor to determine the method of sale or simply to allow the secured creditor to take the collateral in satisfaction of the debt.

Strengthening Insolvency Regimes

There is a need to modernize insolvency laws in MENA. In particular, reorganization procedures need to be made more effective and liquidation procedures more efficient and less formalistic and cumbersome. Laws need to be modernized, and the functioning of the judicial system needs to be improved. Specialized courts can be created to deal with insolvency cases. Countries also need to enhance the capacity of professionals involved in the insolvency system, through training, qualification, and supervision to ensure integrity and proper performance of the insolvency administrator function.

Recent experiences suggest that some jurisdictions in the region are ready to implement an out-of-court restructuring scheme. In the wake of the recent financial crisis, both Dubai and Kuwait took steps to enable out-of-court restructuring, in order to prevent the bankruptcy filings of large companies important to their economies. These efforts led to some initially successful restructurings. For countries in which there are significant numbers of corporate entities with multiple institutional creditors, developing such schemes, with rules tailored to a country's needs, may be prudent. In countries in which debtors do not have multiple creditors, developing reliable alternative dispute resolution services may be an effective tool to promote resolution of creditor-debtor disputes and avoid bankruptcy.

Strengthening Bank Competition

Clear arrangements need to be established to promote sound competition in banking systems. In most countries in the region, no authority is responsible for promoting sound competition. As a result, there are no structured analyses of competition in the banking sector (at the aggregate or business line level), and anticompetitive behavior (including actions ensuring that state banks do not have unfair advantages

over private banks) is not addressed. The European Union (EU) experience, with a detailed regime proactively implemented by the European Commission's Competition Directorate General, could provide a useful example of how to assess and suggest improvements in the competitive environment of the financial system. Where they exist, competition authorities should also have a mandate to ensure competition in the financial sector. Coordination with financial supervisors will be needed where the implementation of competition policy can affect financial stability. As many countries in the region do not have competition agencies, a second-best solution would entail giving financial supervisors a mandate to ensure fair competition.

Bank regulators should give greater weight to sound competition when implementing licensing criteria. Surveys of bank regulation suggest that entry regulations in MENA are generally restrictive and that MENA has the largest share of bank license applications denied among emerging regions (Anzoategui, Martinez, Peria and Rocha 2010). Licensing decisions still lie with the ministry of finance in some countries, which considers factors other than soundness (such as the fact that new entrants would not bring new financial services, the system is perceived as overbanked, and national champions could lose market share). Such factors do not justify restricting the entry of reputable banks, which could increase competition, innovation, and access. Bank licensing approaches could be revisited without relaxing the quality of entry. If the banking system proves to be overbanked, the problem is best handled by the exit of weaker banks through well-designed resolution regimes.

Strengthening the credit concentration regime may also increase competition, which would broaden access. Credit concentration regimes are primarily prudential tools, but they may also contribute to stronger competition. If supervisors apply stricter limits (on an individual or portfolio basis) or impose additional capital requirements for banks with credit concentration, reflecting an excessive risk appetite, large clients will have more incentives to tap capital markets (either because less bank financing is available or because it becomes more expensive) or to distribute their business among several banks. The regulation and supervision of credit concentration risk is discussed in the last section.

Developing Nonbanking Financial Institutions

Developing the Insurance Sector

Reducing the presence and participation of state-owned insurers would stimulate competition and innovation and contribute to faster development

of the sector. A number of MENA countries, including Algeria, Egypt, Libya, and the Syrian Arab Republic, are still dealing with the legacy of heavy state involvement in the insurance sector and working through the liberalization process. State-owned insurers should undertake full financial and operational independent audits and develop plans for corporatization and eventual privatization.

Expanding the scope of compulsory insurance would accelerate the growth of the sector and generate positive externalities. Making worker's compensation compulsory would both substantially increase premiums and generate a social good. Other classes of insurance that would yield these dual benefits include coverage of liabilities of enterprises that interact with the public, including construction companies and transport providers. Insuring catastrophic risk should also be compulsory, particularly when associated with the exposure of lenders to natural disasters (for example, mortgage lenders). All GCC countries could consider introducing health insurance for expatriates and eventually their domestic populations.

Enforcing compliance of compulsory lines would also stimulate the growth of the industry and generate positive externalities. This is the case of motor third-party liability (MTPL) and contractors all risks insurance. Policy makers must address the causes of limited premiums in MTPL insurance, by introducing more aggressive enforcement measures, addressing understatement of provisions for outstanding claims, and relaxing price controls. Creating an information database is essential for enforcing compliance and combating fraud. Egypt, Saudi Arabia, Syria, and Tunisia are implementing many innovative actions in this area (Lester 2011).

Promoting industry consolidation would remove weak and small players, which generate losses, cause public mistrust, and do not contribute to market development. The traditional approach to consolidation—raising the minimum capital requirement—has not been effective in a capital-rich region like MENA. A more effective approach would require insurers to satisfy stricter fit and proper rules for managers, board directors, and owners, as well as meet minimum efficiency conditions, including maintaining minimum market shares in mandatory lines and operating with a minimum premium retention level of 30–40 percent.

Authorizing the use of *banc-assurance* has the potential to produce a quantum leap in life insurance in MENA, albeit only if appropriate conduct rules are in place. Some countries have followed a careful approach, forbidding banks from accepting commissions from insurers. Others have banned the bundling of bank and insurance products. The handling of long-term insurance classes needs enhanced market conduct

rules, without which consumers might believe they are purchasing a bank-guaranteed product.

Improving consumer protection is essential for reversing the pervasive public mistrust of the insurance sector in MENA countries. An increasing number of countries require that insurers have internal dispute resolution mechanisms; most jurisdictions specify that the insurance supervisor is the next step if resolution cannot be achieved. A few countries have set up alternative dispute resolution procedures, including mediation and arbitration mechanisms. These efforts should continue, in order to build the population's trust.

Tax regimes should be reviewed, especially in the case of the life insurance sector. Turnover taxes applied to life insurance premiums and the *Zakat* wealth tax applied to policyholder funds represent direct penalties on the savings components of life products. For example, Algeria applies a combined value added tax and premium tax of 19 percent to all insurance classes, including life insurance. This factor probably accounts for the absence of life insurance in Algeria. Similarly, a 3.25 percent tax on capitalization policies in Morocco has stopped the development of that market. Other countries, including Egypt, have ceased taxing life insurance premiums.

Regulators must greatly strengthen reporting and disclosure requirements. The lack of basic information on insurers is striking. It reflects both the newness of some insurance markets and supervisors and the desire by economic groups to retain critical information. This attitude is not acceptable for financial institutions collecting funds from the public and taking on contractual liabilities. All insurers should be required to submit information to supervisors in electronic form according to agreed-upon templates, timetables, and definitions.

Supervisors need to be given the resources and independence to act according to the public good rather than the requirements of special interests. One approach is to place the insurance supervisor in the central bank; this may be a next step for a number of supervisors in small countries in the region. An alternative is to establish an independent supervisor with its own funding sources and transparent appointment and removal processes for senior personnel.

Developing risk-based supervision should start with simple solvency requirements. Overly complex risk-based models are not appropriate given the nascent stage of the industry and supervisory capacity. Supplementary general reserve requirements should be based on simple weightings related to asset structures. Given the thin actuarial resources in most countries, a rules-based approach could be adopted for the setting of nonlife claims provisions.

Takaful insurance may be a way to make insurance compatible with religious and cultural traditions, but operationalizing its principles remains a challenge. Given the large number of conservative Muslims in the region and the role of insurance in development, there is much to be said for persevering. However, the current fragmented approach—with its numerous interpretations and hybrid structures, a number of which are replicas of traditional commercial insurance—is not helpful; a more coordinated approach to developing a genuinely acceptable model is needed. Doing so may involve greater centralization of *Sharia* guidance, new structures for capital support required by modern risk-based standards, and innovative approaches to consumer protection.

Enhancing the Contribution of the Pension Sector

The prospects for rapid growth of private pension funds over the next 10–20 years are limited. Rapidly developing this sector would require major structural reforms in public pension systems, entailing the downsizing of benefits to sustainable levels and a robust regulatory framework for private funds. Even when they are implemented aggressively, such reforms take many years to have a significant impact on financial markets. Egypt has already enacted an ambitious systemic reform, which it will implement gradually; its impact on the growth of private pension funds will therefore be slow. Jordan has undertaken parametric reforms but has not yet mandated the creation of private pension funds. GCC countries are planning to expand the coverage of expatriate staff by private pension funds. These funds may contribute to the build-up of an investor base in the region, but they will need a decade or more to reach critical mass.

A more promising path to increase the contribution of public pension funds to capital market development in the current decade entails reforming the large public pension funds, as Jordan, Morocco, and Saudi Arabia have already begun to do. Three major initiatives are required: strengthening fund governance and public disclosure, improving the professionalism of asset management, and creating a pluralistic structure in asset management.

Strengthening fund governance and public disclosure is a major requirement for enhancing the performance of public pension funds. Jordan and Morocco have already adopted greater public disclosure than other MENA countries, although even these countries need to do more. Fund governance should ensure the insulation of boards of directors from political influence. Investment policies and results should be disclosed and subject to external scrutiny by independent experts. In this regard, it is noteworthy that the sovereign wealth funds of countries in the region

score very low in international comparisons of governance and disclosure (see, for example Mitchell, Piggott, and Kumuru 2008).

Increasing the professionalism of asset management requires the appointment of professional boards of directors and the adoption of modern asset allocation strategies. Directors should be experts in the area of fund management or related disciplines. Their appointment should be insulated from political pressure by using selection criteria that privilege technical expertise. Investment policies should aim to achieve risk diversification and maturity and currency matching of assets and liabilities. Investment policies should be free from excessive restrictions and should prevent the use of public pension funds as a captive source of finance for the public sector. Foreign investments should be allowed subject to reasonable limits.

Creating a pluralistic structure in asset management will protect public pension funds and contribute to capital market development. In asset management, a large public pension fund may acquire a dominant position in local markets, distorting market prices and investment decisions. A more pluralistic structure, which would avoid these problems, could take two forms (Vittas, Impavido, and O'Connor 2008):

- *Establishing several competing public sector entities responsible for managing a given fraction of the assets of the public pension fund*. In Sweden, for example, five public buffer funds, each with an independent board of directors, set their own investment policies and compete with the other public buffer funds as well as dozens of private asset managers in the local financial markets.

- *Requiring public pension funds to hire external asset managers through a competitive bidding process and award mandates for different segments of their portfolios*. This more flexible approach is widely used around the world, not only by public pension funds but also by large private corporate funds. Mandates may be terminated at short notice if performance is unsatisfactory. Various safeguards, such as safe external custody of assets and fidelity insurance of asset managers, can be put in place to protect the assets of the public pension fund.

Stimulating the Development of Mutual Funds

The legal framework in some countries in the region does not empower the supervisor to regulate and supervise key activities, such as licensing criteria, net asset value valuation and pricing, and distribution channels. This lack of empowerment can leave many regulatory gaps unaddressed for long periods of time.

Licensing criteria and capital requirements must be strengthened, including stricter fit and proper rules for owners and managers of mutual funds, requirements for the professional qualifications of investment managers, and reasonable minimum capital requirements. Some countries impose minimum net asset requirements for fund managers. Doing so can deter the growth of the industry and should be replaced by risk-based capital requirements.[3]

Valuation and redemption rules should be considerably strengthened. Net asset values should be calculated daily. The sale and redemption of mutual fund shares should be based on forward pricing, to ensure that all fund shareholders are treated equally. By number, only about a third of MENA funds, accounting for 62 percent of assets under management, calculate daily net asset values; some countries still use backward pricing.

Mutual funds should be subject to adequate disclosure rules—the basis for mutual fund regulation. Promotion of any mutual fund should center on a public prospectus that provides investors with relevant information (fund investment strategy, net asset value pricing policy, historical performance, risk/reward summary, fees and expenses) to aid investment decisions. Mutual funds in many MENA countries are not currently providing such information.

Controlling conflict of interest situations is a crucial aspect of investor protection. Examples of conflicts of interest include transactions between a mutual fund and its affiliates (including affiliates of the sponsor or custodian), soft commissions, lending or borrowing to or from affiliates, the purchase of an affiliate's securities, the use of affiliated brokers, and trading by fund managers on their own account. Administrative companies, external custodians, internal control officers, and independent fund directors can protect investors from conflict of interest situations. It would also be useful to establish a code of ethics for investment managers.

Mutual fund development seems to suffer from constraints on distribution channels resulting from bank dominance, limits on foreign managers, and lack of supporting services. Bank dominance of the mutual fund industry may have impeded its development. Encouraging large foreign fund managers to establish local operations could counter this dominance. Consolidating the mutual fund industry could lead to greater economies of scale and lower operating fees; developing supporting services would not only promote higher efficiency but also strengthen investor protection.

The development of mutual funds also requires further development of suitable financial instruments. The two reform agendas are very closely connected and mutually reinforcing: the development of financial instruments

will encourage the growth of mutual funds, and the development of the investor base will encourage more issues by corporations and financial institutions. The agenda for developing financial instruments is discussed below.

Developing Leasing

Strengthening the legal framework for leasing would be best achieved through a specialized leasing law combined with appropriate changes to related pieces of legislation. The definition of leasing needs to be clear, and a fairer balance established between the rights and responsibilities of the parties to a lease. It is important to establish regulations for other forms and types of leasing, such as sale and leaseback and subleasing. In addition, the law should address the following elements:

- *The process for registering leased assets should be strengthened*. One of the first priorities entails the development of registries in which lessors may publicize their interest in the leased asset and protect its ownership rights. Ideally, there should be a unified registry for movable collateral, where all security interests are recorded; lessors' interests in leased assets would be recorded in this registry.
- *Repossession procedures must be substantially improved*. The right of the lessor (owner) to repossess a leased asset expediently should not depend on the type of breach committed by the lessee. Should a leasing agreement be rescinded for any reason or the lessee not exercise his or her right to purchase the leased asset, the lessee must return the asset to the lessor. If the leased asset is not returned, the lessor should have the means to repossess the asset. As noted earlier, countries should consider adopting the nonjudicial repossession procedures that have been adopted outside the region.
- *Tax rules should be clear and neutral, removing the current bias against leasing*. Leasing operations in MENA are subject to harsher tax treatment, which slows the growth of the sector. The income tax treatment of leasing and loans should be similar, as there is little difference between leasing and loan finance. Value added tax rules should clarify that a leasing operation is a financial service, not the sale or rental of a good.
- *Insolvency regimes must clarify the rights of lessors and lessees under bankruptcy*. The consequences of default should be clearer. In particular, lessors' rights under bankruptcy should be preserved, as lessors are a particular class of secured lender; leased assets do not belong to the insolvent company and should be returned to the owner (the lessor).

Developing Factoring and Reverse Factoring

Countries should explore means to develop both factoring and reverse factoring in order to provide alternative financing sources for exporters and small and medium enterprises. Egypt has been trying to develop the factoring industry, by amending the regulations to the Investment Law; setting rules governing factoring activities, licensing, registration requirements, and procedures; and establishing surveillance on financial adequacy, credit risk protection, as well as receivables bookkeeping and collection services (Nasr and Pearce 2011).

Reverse factoring is a more recent and attractive arrangement that would allow small and medium enterprises to receive more financing at lower cost. The scheme relies on the creditworthiness of large buyers rather than that of small and medium enterprises. Reverse factoring has the potential to be an important source of working capital financing for exporters and small and medium enterprises in countries still struggling with poor credit information. It is an ideal source of financing in countries with small, risky suppliers and large buyers. A successful example of reverse factoring is the NAFIN program in Mexico (box 10.2).

Developing Microfinance

Countries in the region should provide a regulatory and supervisory framework that supports wide financial inclusion based on sound risk management and sufficient consumer protection.[4] They are encouraged to develop a national strategy for financial inclusion. Countries that have no clear regulatory and supervisory frameworks should bring microfinance under the umbrella of financial regulatory authorities and develop adequate specialist supervisory capacity. Interest caps should be removed and consumer protection strengthened as access increases, ensuring that customers can make well-informed decisions about how best to manage and use financial services. Prudent innovation that lowers the cost and risk of microfinance services—for example, through mobile phone banking or the use of agents to extend outreach—should be encouraged.

Microfinance institutions should operate under a sound credit information environment, best achieved by integrating microfinance institutions into public credit registries or private credit bureaus, rather than relying only on narrow microfinance information-sharing systems. Sharing borrower information allows microfinance institutions to manage risks more effectively and prevent multiple borrowings and indebtedness, such as in the repayment crisis suffered by Moroccan microcredit providers in recent years. Moreover, by integrating microfinance borrower information into credit bureaus, the coverage and utility of data in

BOX 10.2

Reverse Factoring: The Case of NAFIN, Mexico

Nacional Financiera (NAFIN) Mexico's state-owned development bank, has succeeded in expanding finance to small and medium enterprises since the program's inception in September 2001. As of mid-2004, it had established productive chains with 190 large buyers (about 45 percent in the private sector) and more than 70,000 small and medium enterprises (out of a total of 150,000 participating suppliers). About 20 domestic lenders, including banks and finance companies, participate. As of mid-2004, NAFIN had brokered more than 11 million transactions—98 percent by small and medium enterprises—at a rate of about 4,000 operations per day.

NAFIN uses an electronic platform that provides online factoring services, which further reduces costs and improves security (more than 98 percent of all services are provided electronically). Many small suppliers that participate in the NAFIN program have no other sources of financing. Many had no access to external financing before receiving financing from NAFIN and depended on internal funds and credit from their own suppliers. Suppliers prefer NAFIN financing to bank financing, because banks are slower to make credit decisions and charge higher rates.

The NAFIN program depends on the existence of electronic signature and security laws. Its platform helps prevent fraud, which can occur even in developed countries. As only large buyers are able to enter new receivables, sellers cannot submit fraudulent receivables. Moreover, as the bank is paid directly by the buyer, suppliers cannot embezzle the proceeds.

Source: Klapper 2006.

the bureaus themselves can be improved. Government intervention or encouragement may be needed to ensure that the prices the bureaus charge microfinance institutions are affordable.

Stronger microcredit nongovernmental organizations (NGOs) should have the option of graduating to regulated financial institutions, such as a finance company model. A finance company legal form can provide the necessary clarity for banks and investors on key issues, such as governance, ownership, tax liabilities, and capital base of microfinance institutions, which an NGO license may not. Where regulatory frameworks have been put in place that allow specialized microfinance institutions—such as finance companies regulated by financial regulators—the institutions set up under those frameworks are growing more rapidly than microcredit NGOs and are now a leading driver of growth in MENA microfinance (Sanabel 2010). A finance company model can more effectively tap

commercial bank and microfinance investor sources of finance (both equity and debt), potentially on more favorable terms (lower cost, less collateral required, longer tenors, currency) than an NGO or association model.

Developing Capital Markets

Developing Government Debt Markets outside the Gulf Cooperation Council

Developing a government debt market in MENA requires country-specific strategies addressing weaknesses in each of the main building blocks. This section provides a roadmap for addressing bottlenecks and promoting market development in more advanced non-GCC countries. Most of the recommendations are relevant for GCC countries as well, with some important additional prerequisites discussed below.

Money market reforms

Central banks need to introduce market-friendly intervention instruments and develop a sound repurchase agreement framework. In most countries, excess structural liquidity is not sterilized fully or on a timely basis, because of high costs related to the use of remunerated central bank debt or deposits and difficulties forecasting liquidity. Central banks need to improve liquidity forecasting, develop adequate intervention instruments, and coordinate with the government to improve management of its cash balances. The development of a sound repurchase agreement framework should be a priority, given its multiple benefits for money markets, primary dealers, and the efficiency of monetary operations. Most countries have substitutes to repos with questionable legal and operational reliability. Solving the multiple aspects of repos (accounting, tax, legal) would also require the leadership of the central bank.

Primary market reforms

Governments should aim at consolidating short-term benchmarks in order to build credible long-term references. Doing so would affect mainly countries that have favored risk reduction through issues of longer maturities that are excessively fragmented and lack liquidity. These countries will need to conduct a systematic consolidation of debt in a smaller number of benchmarks. Liability management operations (reopenings, buybacks, and switches) should be employed to support benchmark building.

A balanced maturity structure of outstanding debt should be maintained at all times, with a regular and predictable supply of instruments at

key maturities, so that all points in the yield curve have liquid references. Once the yield curve has been gradually lengthened, governments should maintain a regular issuance flow at all key maturities and avoid opportunistic behavior. Shorter maturities on Treasury bills should be issued in sufficient volume that investors can manage liquidity and not bear all the interest rate risk. Doing so is not inconsistent with attaining a long average maturity, but it does require greater efforts to extend the average maturity over time.

Auction rules and other mechanisms, such as syndications, need to be examined to enhance competition and improve price discovery. Such rules and mechanisms are central to building a reliable yield curve and minimizing price distortions caused by captive demand. Reforms in the primary dealer model can contribute to improved competition in primary markets. Incentives could be introduced to reward better-performing primary dealers.

Secondary market reforms

Enhancements in pretrade and posttrade price dissemination would augment the impact of other building block reforms and support liquidity. Price transparency could be improved by the collection of indicative prices or by standardized methods to collect and publish prices from market makers at a given time each day. Stricter reporting obligations of posttrade prices would support price transparency, which becomes increasingly important as markets develop.

Developing the investor base

The development of government debt markets also requires development of the institutional investor base, including a greater presence of foreign investors. Reforms to build a diversified base of domestic institutional investors may take time in many countries. In the meantime, increased participation of foreign investors on government debt markets would contribute to market development. In many countries, foreign investors are an important source of funding in the medium- and long-term segments and contribute to market liquidity, price discovery, and the transfer of knowledge.

At the same time, governments should be able to prevent an excessive entry of foreign investors into the market and reduce debt market volatility in times of crisis. They should be able to calibrate the entry of foreign investors if needed, by changing auction rules or adjusting primary dealer regulations to reduce incentives for bidding or trading with foreign investors. Placing debt through syndications could also be a powerful alternative to enhance control over the allocation of debt to different classes of investors. Governments should be ready to address price volatility and refinancing risk in times of crisis by preemptively building up cash

reserves and conducting buyback or debt exchange operations. These measures were critical in the policy response of several countries to stabilize local markets during the recent financial crisis (Anderson, Silva, and Velandia-Rubiano 2010). More generally, greater foreign investor participation may imply relaxing foreign exchange and capital account restrictions. These changes need to be carefully sequenced to preserve financial stability.

Developing hedging tools for interest rate and foreign exchange risk would facilitate greater foreign investor participation and help banks manage their balance sheet mismatches. These instruments allow foreign investors to adopt broader investment strategies and more active liquidity management. Interest rate and foreign exchange swaps or other hedging tools are almost nonexistent in MENA.

Developing Government Debt Markets in the Gulf Cooperation Council

The agenda for developing government debt markets in the GCC is more challenging. It includes all the elements cited above plus some additional requirements. Market development in the GCC requires special commitment and overfunding of the budget, given the lack of financing needs. GCC countries have made large debt issues, but they have been sporadic and insufficient to develop a market and build a yield curve. In this regard, GCC countries (and non-GCC oil exporters) must make two key strategic decisions before embarking on efforts to develop the government debt market. The first is whether the use of the U.S. government debt yield curve would suffice for most practical purposes. The second is whether a market should be developed in *sukuk* or conventional bonds, as it may be very costly to build a critical mass of both instruments.

If GCC governments decide to go ahead with their plans to build a government debt yield curve for capital market development objectives, they should examine the experience of other economies. Several economies outside MENA—including Australia; Hong Kong SAR, China; New Zealand; Norway; and Singapore—have made progress in developing a reliable government yield curve through regular debt issues without funding needs. Their experience merits close examination. Debt market development is becoming more pressing in the GCC with the stable funding requirements of the new Basel III framework. If banks continue increasing longer-term lending, many will need to increase the issuance of longer-term liabilities in order to meet the net stable funding ratio requirement.

Developing Private Debt Markets

Corporate bonds

In the absence of a developed government debt market and a solid institutional investor base, the development of corporate bonds is a medium-term agenda for most MENA countries. Countries that wish to develop corporate bonds should refrain from imposing unnecessary restrictions in their company and securities laws. A prospectus for a public offering of corporate debt to both retail and institutional investors should include the same information as a prospectus for a public offering of equities. In the case of private offerings made to institutional or other qualified investors, some derogation in the substance and form of the disclosure is warranted. Successful experiences with market development indicate that it is important to maintain flexibility in primary market regulation of corporate bonds to avoid overregulation of issues targeted at sophisticated investors. In nascent markets where investors are not institutionalized and market intermediaries are unsophisticated, a simple form of nonautomated trading system may be sufficient for the limited secondary trading that would take place.

Mortgage-covered bonds and mortgage-backed securities

Many countries could consider introducing mortgage-covered bonds, which would allow banks to better manage risks associated with growing maturity mismatches and offer a new low-risk and low-cost funding instrument. Covered bonds are issued by originating banks with priority recourse to a pool of high-quality collateral, often composed of mortgage loans. The experience of EU countries shows that these instruments can contribute to sound and low-cost mortgage finance. The global crisis has also highlighted their much stronger resiliency than securitization products, as banks retain the credit on their balance sheet (that is, there is no transfer of credit risk); collateral is of high quality; and access to collateral is monitored by financial supervisors. Morocco is preparing a draft law introducing covered bonds; market consultations have revealed strong support from banks and institutional investors.

Only a few countries should contemplate introducing mortgage-backed securities, and any effort should draw on the lessons of the few existing regional experiences. Securitization can provide new risk management tools for financial institutions and allow them to offload long-term mortgage loans when they face funding constraints. However, the recent global crisis highlighted the risks associated with complex and poorly regulated securitizations. Morocco and Tunisia introduced legislation a decade ago, but few transactions occurred because of many structural weaknesses, including insufficient pools of eligible loans, lack of

housing price indexes, lack of historical data to estimate probabilities of default, and flaws in the securitization chain (conflicts of interest at the loan originator level). More advanced countries may consider this instrument in the coming years, as they build pools of housing loans and meet the preconditions for successful securitizations.

Enhancing the Contribution of Equity Markets

Successful experiences in increasing access to equity markets have invariably entailed efforts to improve disclosure and governance, including the protection of minority shareholders. The increased access to equity markets in the European Union and emerging markets in recent decades was preceded by reforms designed to strengthen disclosure and governance, especially shareholder protection.[5] For example, Brazil adopted international financial reporting standards (IFRS) and other disclosure requirements, provided tag-along rights, required a minimum participation of independent board members, and committed to at least a 25 percent free float. The increase in initial public offerings (IPOs) after the reform was impressive. The investor base, including individual investors, widened. The favorable price and strong protection of minority shareholders encouraged former controlling shareholders (including family groups) to divest and even become minority shareholders in several cases (Santana and others 2008).

Information disclosure requirements should be enhanced and enforced to provide a more secure and attractive environment to investors. Recent corporate governance surveys (IFC and Hawkamah 2008) indicate that at least 23 percent of banks and 42 percent of other listed companies in MENA have not adopted IFRS. There is room for some countries in the region to adopt the modern version of IFRS and require consolidated accounting and reporting for corporate groups. Greater reliance on international audit firms, stricter rules on audit rotation, and use of board audit committees made up of independent directors would raise the reliability of financial reporting. Listed companies also need to improve their nonfinancial disclosures to include management discussion and analysis of financial results in the annual report and to indicate governance standards.[6]

Many jurisdictions need to improve protections for minority shareholders. Necessary measures include implementation of international standards in the area of takeover bids, earlier provision of information to shareholders ahead of annual meetings, and increased liability for chief executive officers (CEOs) and directors, such as greater opportunities for courts to void related-party transactions, award monetary damages, impose fines, and try shareholder lawsuits. Changes are also needed to make it easier for

shareholders to sue listed companies, directors, and CEOs, by improving access to information for shareholder plaintiffs and by facilitating document discovery and examinations of witnesses and defendants at trial. Special efforts should be made to fight insider trading and market abuse.

Free floats need to be raised in a number of markets and companies that are not traded or delisted. Stock exchanges should normally require any listed company to maintain a free float of at least 25 percent, allowing only justified exemptions. Compliance with these free float goals should be promoted, and family-controlled corporations should be encouraged to open up and improve their corporate governance. Thinly traded companies can easily become targets for price manipulation and speculation, which can undermine price discovery and market stability.

There is also scope for additional IPOs of state enterprises and sales of government shareholdings in enterprises that were once 100 percent state owned. The large number of state enterprises in many countries in the region creates the opportunity for new listings. Privatizations usually attract new local and foreign investors, both private and public, on the stock market and have a positive effect on liquidity.

The development of equity markets will depend on the build-up of a domestic institutional investor base and greater participation of foreign investors. Development of domestic institutional investors may take a few years to materialize. In the meantime, it is important to increase participation of foreign investors, as there is some evidence that they have contributed to price discovery (see chapter 9 and appendix B). In this regard, it would be desirable to relax limits on foreign ownership of listed companies, especially in various GCC jurisdictions.

The performance of dedicated small and medium enterprise exchanges in MENA has been disappointing, but there is probably a case for persevering. Further attempts to develop such exchanges may require adoption of several rules:

- The size of qualified small and medium enterprises should not be capped at very low levels, as doing so may have adverse effects on liquidity and discourage the participation of fund managers.
- The public float should have a minimum size, as an excessively low float will also constrain liquidity. Some successful exchanges impose a minimum float of 10 percent combined with commitments of market-making and research by the broker.
- A large minimum number of shareholders may be required to improve liquidity.
- Lock-up periods of 6–12 months or longer during which shareholders with 5 percent or more of shares cannot sell their stake following an

IPO would prevent the early exit of corporate insiders and curtail insider trading.

- Governments may consider tax incentives for small and medium enterprises that go public.

Given the relatively small size of individual MENA economies, it is essential to find ways to facilitate crossborder investment flows, in order to marshal sufficient liquidity to IPOs and share trading. A successful approach will likely involve some combination of the following:

- Common listing rules for small and medium enterprises
- Common standards for IPO prospectuses
- Standardization of accounting, auditing, and nonfinancial disclosure rules
- A common crossborder platform for clearing and settlement of trades
- Promotion of MENA–wide small and medium enterprise funds
- Limits on participation by "nonqualified investors" to investment through adequately regulated and supervised investment funds.

The development of capital markets in the region would benefit from qualitative improvements in the provision of investment services by market professionals. Such improvements could be achieved by enhancing market intermediaries' professionalism and capabilities by setting up professional accreditations for securities analysts; compliance officers; fund managers; and, for the development of futures markets, other market professionals, such as heads of clearing and settlement operations within brokerage firms. Improvement of the business relationship between market intermediaries and their clients would play a very positive role. It could be achieved by the introduction of modern and internationally recognized conduct of business rules applicable to market intermediaries.

The independence and empowerment of capital market supervisors should be strengthened. The majority of capital market authority board members should be independent and have financial sector experience. The regulator should have the technical and financial means to carry out its missions. It should have its own funding and not rely exclusively on annual appropriations from the government budget. Its salaries should be high enough to attract and retain qualified staff. The capital market authority should have the authority to impose heavy penalties on registrants and issuers and rapidly bring cases before a public prosecutor and courts for further civil and criminal penalties.

Improving the Provision of Long-Term Finance

Housing Finance

Given the nascent stage of housing finance in MENA, enhancing its availability requires a package of reforms, some of them very basic. Developing housing finance involves developing long-term lending, preferably at fixed rates, to spread the cost of a large investment and make housing affordable to households, as well as a robust system to secure lending that would otherwise remain short term and hence restricted to small amounts.

The authorities could introduce several measures to improve the transparency of real estate markets. Reducing registration costs would encourage the formalization of transactions. Countries in the region need to develop housing price indexes, using in particular the information in land registries, and create real estate market observatories, including indicators of market equilibrium, such as ongoing and future delivery of new units, vacancy rates, and the speed of sale of new developments. Strengthening housing demand analyses by building databases with income distributions is necessary for well-targeted housing and subsidy policies. Guidelines for appraising assets need to be strengthened.

To accurately manage and price risks, policy makers, regulators, lenders, guarantors, and investors must have the capacity to monitor mortgage lending. This will require improving the supply of data on mortgage lending by breaking down mortgages for residential, developer, and commercial properties; tracking new lending by vintages; and monitoring loan-to-value ratios, debt service coverage ratios, and nonperforming loans by annual cohorts.

Strengthening the prudential framework for housing finance demands an extensive reform agenda. Banks should conduct affordability assessments for housing loans, especially for low-income groups, and impose and monitor simple debt service–to-income ratios. Standards—including prior savings requirement, centralization of risk analyses by credit registries, and economic surveys—should be developed for lending to informal sector households. A prudential framework should be designed for commercial real estate and developer finance. It is worth considering introducing portfolio-level prudential norms, including diversification standards more relevant and precise than a simple cap on total real estate finance. Lenders should be required to conduct stress tests at origination on certain types of loans, such as floating rate or foreign currency–denominated mortgages. Stress tests should be conducted periodically to assess the impact of financial or real estate market shocks on mortgage portfolios.

Regulators should systematically develop a set of countercyclical prudential measures, including the adjustment of parameters such as

debt service–to–income ratios, loan-to-value ratios, differentiated risk weights, and provisioning requirements for different loan types to the context prevailing in real estate markets. The timeliness of such adjustments is of the essence to fight asset price bubbles; the efficiency of these adjustments requires a reliable real estate information system. These issues are discussed in more detail in the last section of this chapter.

Long-term funding instruments and/or mechanisms need to be developed. The type of instrument or arrangement depends on the market capacity and acceptance. For example, central mortgage refinance companies such as those established in Egypt and Jordan are well suited to markets in the early stages of development and limited loan origination, small lenders, and investor demand restricted to simple bonds. As the market develops, regulators should consider developing long-term funding instruments such as mortgage-covered bonds and mortgage-backed securities (see the earlier discussion on long-term funding instruments).

Finally, expanding access to housing in MENA will also require addressing a number of non-financial constraints, particularly the availability and affordability of land and the effective management of land resources. In this regard, it is important that MENA governments allocate more efficiently the large tracks of land they own themselves, promote orderly and efficient urban expansion through adequate planning (relevant examples include the new towns and projects developed in Egypt, Saudia Arabia, and Tunisia), and curb speculative investments in land through adequate regulatory or tax measures.

Investment Finance

State support to investment finance may be needed for some time in many countries, particularly in the case of infrastructure. However, the involvement of state banks in long-term lending raises the question of how to ensure a good selection of projects and prevent the accumulation of nonperforming loans that has characterized lending by state banks in some countries. An agenda of state bank restructuring, mandates, and governance is associated with this question. Greater private bank participation in long-term lending would be welcome, as it would improve the selection of investment projects and reduce credit risk, but it would imply the generation of interest and liquidity risks borne by the borrower, the lender, or both.

The agenda for increasing the engagement of private banks in long-term lending finance may have to combine prudential elements with well-designed guarantees. Regulators must monitor the evolution of maturity mismatches and banks' exposure to interest rate and liquidity risk, standing

ready to impose capital charges or require the banks to issue some medium- to long-term debt, depending on the particular situation. Governments may also consider introducing liquidity/rollover guarantees on medium-term corporate or private bank bond issues to finance investment, which could help jump-start the bond market and generate better outcomes than direct investment lending by state banks.

The GCC financial centers provide one option for deepening investment finance in MENA. The financial centers (in Bahrain, Dubai, and Qatar) have already gained significant investment finance capacity. Bahrain leads the region in syndicated lending and crossborder banking; Dubai has created a corporate bond market. The three centers also have access to significant advisory capacity for such deals. The flexibility offered by the structures of financial center ownership also provides a platform for crossborder banking, which is still in its infancy. More crossborder investment lending by financial centers would facilitate closer link between the pools of wealth in the GCC and the significant investment needs of the rest of the region.

Improving the Effectiveness of Policy Interventions

State Banks

State banks may still be needed in some countries to improve access to finance to underserved sectors, such as small and medium enterprises, and to reach populations in remote areas. They have had a mixed record in fulfilling their mandates, however, and their interventions have frequently entailed significant costs. The central policy question is, then, how to maximize the potential benefits of state bank interventions and minimize the potential costs. The answer needs to be tailored to country conditions.

There is scope for substantially reducing the market share of state banks in countries where they still dominate financial intermediation (Algeria, Iraq, Libya, and Syria). The policy objectives that may justify the presence of state banks could be met with fewer state banks holding a smaller market share. It is easier to clarify policy mandates and monitor the performance of state banks when their number is small and there is a critical mass of private banks providing a benchmark for performance. Egypt has made progress in reducing the share of state banks; Syria has been making reasonable progress more recently, although the restructuring of state banks remains an ongoing challenge.

Countries that substantially reduce the share of their state banks should implement coherent programs that also include restructuring of state enterprises. The experience of Central Europe in the 1990s is

arguably the most relevant experience for MENA countries. State bank and state enterprise restructuring and privatization programs were conducted in parallel, to make sure that the banking system would have viable clients with solid growth prospects and that unviable state enterprises generating continuous losses would not contaminate the state banks again with new nonperforming loans.[7]

There is also scope for clarifying the mandates, improving the governance structures, and strengthening the operational efficiency of most state banks in MENA. Achieving these results and sustaining them over time is not a trivial task but should remain a key objective for MENA policy makers if the decision is made to preserve a role for these banks. Although state banks may not be able to achieve the same levels of profitability as private banks as a result of their policy mandates, they could meet their mandates more effectively if they were allowed to operate independently, reduce the excessive employment of low-skilled personnel, and recruit better-trained staff able to adopt better lending and risk management technologies. The last section of this chapter discusses further the corporate governance challenges of state banks.

Policy makers could examine the cases of state banks that have operated with clear mandates and governance structures and that aim at addressing market failures.[8] For example, the Canadian Business Development Bank (BDC) was created by a law that stipulates a clear mandate (small and medium enterprise development), clarifies that the bank cannot compete with the private sector and imposes a minimum level of profitability (the return on equity should not be lower than the government's cost of capital), and provides governance rules to insulate the bank from political pressures. (Scott 2007 and Rudolph 2009 review governance requirements for state banks.)

Some state banks in the region that operate with clear policy mandates merit further analysis and consideration by MENA policy makers:

- The Egyptian Principal Bank for Development and Agricultural Credit (PDBAC) has been subject to a restructuring program that shows promising results. It is receiving assistance from the Dutch Rabobank to use that institution's large branch network and expand access to finance in remote areas.

- The new Postal Bank in Morocco is building on the strengths of the post office as the only institution licensed to specifically serve the low-income and rural population. It is expected to substantially expand access to finance in remote areas in the coming years.

- The Crédit Populaire du Maroc has operated reasonably well in the field of small and medium enterprise finance, as a result of good

penetration in communities and governance structures that have isolated management from undue political pressure (box 10.3).

- The Saudi Industrial Development Fund is a well-managed state institution providing long-term finance to manufacturing companies, including small and medium enterprises. It has been able to preserve the quality of its portfolio as a result of its operational independence, the quality of its staff, and aggressive monitoring procedures.

BOX 10.3

Effective Implementation of State Bank Mandates: The Case of Crédit Populaire du Maroc

The Crédit Populaire du Maroc (CPM) has been successful in serving small and medium enterprises thanks to its proximity to clients and a unique governance structure adapted from the French Banques Populaires. CPM is one of the two largest banking groups in Morocco, controlling about a quarter of banking assets. In recent years, small and medium enterprise finance has been a significant contributor to the group's profits, thanks to reasonable credit quality, effective pricing, and a cheap funding base.

A specific law (Law 12/96) lays out the foundations for effective governance by clearly defining the CPM's mandate and establishing checks and balances between the head office and its cooperative members. The CPM group includes a listed joint stock bank (Banque Centrale Populaire) and 10 regional cooperative banks (Banques Populaires Régionales), responsible for most retail activities, including small and medium enterprise finance.

A reform implemented in 2000 enhanced the regional dimension of the group, even if the state remains a key stakeholder. The risk of political interference is further reduced by the fact that each of the members of the CPM group and the group as a whole are supervised by an independent central bank.

Banques Populaires Régionales are medium-size regional institutions owned by their customers and run by experienced professionals. They maintain strong ties to their regional communities, from which most of their directors come. Regional boards of directors play a key role in defining their strategies and products. Credit committees ensure sound credit origination and effective portfolio monitoring.

Group mechanisms provide checks and balances: the largest transactions (including those to related parties) must be approved at the group level, group teams conduct regular monitoring of portfolio performance and in-depth audits, and senior management is vetted (and dismissed) at the group level. Economies of scale are achieved by developing systems at the group level (for example, for Basel II implementation) while making sure they are tailored to local needs.

Credit Guarantee Schemes

Credit guarantee schemes offer the best perspectives for improving the targeting of policy interventions promoting small and medium enterprise finance, but there is scope for improving the design of most schemes. Some schemes should consider tightening their eligibility criteria, to improve targeting (reducing the ceiling on firm and loan size). Most schemes should consider slightly reducing their coverage ratios to levels closer to international standards and linking both coverage ratios and fees more closely to risk. In some countries, guarantee schemes could play a more proactive role in capacity building, including training of banks in small and medium enterprise lending and risk management, and of small and medium enterprises in the development of project proposals, loan applications, and financial reporting. These schemes should conduct systematic assessments of outreach and additionality. This comprehensive review should be conducted on a regular basis, using appropriate analytical tools, including a small and medium enterprise survey and a banking survey. One of the best practices to consider is the comprehensive review conducted in Canada every five years by the Small Business Financing Program. (Saadani, Arvai, and Rocha [2011] provide further details on the design of guarantee schemes and recommendations for improvements.)

The Financial Stability Agenda

Strengthening Microprudential Regulation and Supervision

Implementing effective risk-based supervision remains a challenge in MENA. A transition from compliance to risk-based supervision needs to be completed in the most advanced countries and initiated in others. Risk-based supervision requires a "cultural" transition from focusing on regulatory compliance to understanding and assessing banking groups' risk profiles and strategies and taking appropriate supervisory actions in response. This transition generally calls for new supervisory methodologies, allowing for risk prioritization of on-site inspections and structured off-site risk analyses; a better understanding of the environment banks operate in; new staff with market experience; close dialogue with banks' managers and directors; and effective coordination between off- and on-site supervision. A prompt corrective action framework should accompany such efforts to introduce risk-based supervision, in order to ensure timely supervisory intervention when needed (only a few countries in the region have already done so).

Credit concentration is a regional feature that reflects economic structures to some extent, but it needs to be gradually reduced to ensure

banks' resiliency. Although the largest borrowers are often well known and considered low risk (often leading to "name lending"), some large groups failed in the recent crisis. Disclosure is at best limited to some of a group's entities, which makes it difficult to identify all group members and monitor their links. In some cases, corporate and personal assets have not been separated. A stricter definition and enforcement of the large-exposure (and related-party) regime could help reduce risks associated with credit concentration.

Supervisors should leverage the introduction of risk-based approaches to reduce the concentration of credit portfolios. They should initiate the gradual reduction of maximum credit concentration limits and proactively implement supervisory actions against outliers. Banks exposed to high credit concentration risk should ultimately be subject to additional capital requirements. These actions would improve the resiliency of such banks and affect their pricing policy, thereby also creating incentives for the largest corporations to distribute their banking business and find alternative sources of finance.

Banks' exposures to maturity mismatches seem to be growing, requiring closer monitoring and supervisory action in some cases. MENA banks have so far enjoyed cheap and stable funding, thanks to sizable customer deposits kept captive by the lack of alternative investment opportunities. When expanding housing and investment finance, such activities require banks to have well-articulated asset and liability management frameworks to avoid excessive liquidity, interest rate, and counterparty risks. Such requirements still need to be introduced in many countries, and most supervisors need to build their capacity to assess asset and liability management frameworks.

Capital requirements should better reflect individual institutions' risk profiles as well as macro risks. All supervisors need to be empowered to require individual institutions to hold capital adequacy ratios above the minimum level and use such powers when needed.[9] This requires that progress be made in risk-based supervision to define and justify such additional capital requirements. Supervisors should also consider introducing a capital conservation buffer in the manner of Basel III when justified by the macroenvironment and enhance supervision for banks operating close to such new minimum requirements.

Well-designed product regulation needs to accompany gains in access to finance. Supervisors should consider introducing limits to debt service–to–income ratios (for example, 30–40 percent) and loan-to-value ratios (for example, 70–80 percent) for mortgage loans; banning excessively risky products (for example, loans with teaser rates); regulating floating rate loans by requiring transparent and regularly published reference rates; smoothing changes in the reference rate and introducing caps on

short-term rate changes; and requiring that banks communicate detailed and standardized information to their customers, which facilitates comparisons across banks and could increase competition.

As banking groups and conglomerates develop, consolidated supervision needs to be significantly strengthened. Financial conglomeration is not yet a critical issue in many MENA countries, but it will increasingly become a regulatory concern as financial systems diversify. This calls for detailed standards for both accounting and prudential purposes and the ability of supervisors to assess links within financial groups and impose necessary requirements, such as capital adequacy requirements to avoid double-gearing, excessive exposure, and internal control requirements at the conglomerate level. Cooperation and the exchange of information among different sector or national supervisors need to be built for the supervision of individual institutions.

The regulation and supervision of Islamic banking has its own unique challenges. Detailed recommendations on Islamic finance are beyond the scope of this report. Box 10.4 lists some of the most important challenges facing the industry.

Revising Deposit Insurance and Resolution Mechanisms

The reliance on implicit deposit insurance schemes offering de facto full guarantees has undermined market discipline in MENA. Most countries in the region had implicit but effectively full deposit guarantees before the global financial crisis; some transformed these into explicit blanket guarantees during the crisis. It is sometimes argued that implicit systems generate less moral hazard, because they have an element of ambiguity. This argument does not apply to countries in MENA, where implicit schemes have always been understood as blanket guarantees in a region where banks are not allowed to fail. These expectations create incentive problems by rewarding risky banks and placing a heavy burden on supervision. In addition, with the recent announcement of explicit guarantees, depositors and banks expect the introduction of explicit blanket guarantees in any future crisis. Such guarantees increase moral hazard and may lead to riskier financial systems without a commitment for limited coverage systems in the future.

Countries are advised to introduce explicit, limited-coverage deposit insurance systems. To be credible, a deposit insurance system needs to be properly designed, well implemented, and understood by the public. It can contribute to the stability of a country's financial system if it is part of a well-designed safety net. The few explicit deposit insurance systems in MENA may not require overhauls, as their main design features are largely in line with the core principles developed by the International Association of Deposit Insurers. However, many countries will need to

BOX 10.4

Main Challenges in Islamic Banking

Some of the major challenges that Islamic banking faces are very similar to those of conventional finance; others are unique to Islamic finance. The most significant challenges are in the areas of regulation, supervision, and international harmonization; risk management; innovation and financial diversification; and human resources. Consumer protection and financial literacy in Islamic finance are emerging areas for regulators.

Enhanced international harmonization and cooperation would facilitate faster growth of the Islamic financial industry. The multiplicity of *Sharia* boards and judgments across jurisdictions impede the homogeneity of products and create uncertainty for clients and investors about the crossborder acceptability of *Sharia* rulings. Although Islamic finance is becoming increasingly internationalized, it remains a collection of segmented, weakly coordinated local operations. As the industry has great potential to facilitate crossborder capital flows and financial integration, efforts are needed to resolve or at least mitigate the uncertainty regarding the acceptance of *Sharia* rulings. More international cooperation is needed by home and host regulators and standard setters. The legal and regulatory framework of Islamic finance needs further work to make it consistent with international practices while maintaining the unique features of Islamic finance and not compromising *Sharia* principles.

As in conventional finance, there needs to be an integrated crisis management framework in Islamic finance to ensure that any emerging crisis in the Islamic financial system will be managed. Such a framework involves having in place mechanisms and vehicles to address short-term liquidity problems, remove troubled assets from the balance sheets of financial institutions, and resolve solvency issues. An adequate crisis management framework also raises the issue of designing *Sharia*-compliant deposit insurance systems.

Source: Ali 2011.

revise their funding policies and coverage limits. Other areas that require attention include operational independence and governance structures.

Explicit deposit insurance systems should be introduced only under stable economic and financial conditions. The number and types of deposit-taking institutions will have design implications for an insurance system. In particular, the large presence of state and Islamic banks will pose some challenges to the introduction of explicit schemes. Deposits of state banks are generally perceived as having a full government guarantee. Islamic banks may require different arrangements. Within the region, crossborder coordination and cooperation in transitioning needs

to be enhanced to avoid negative spillovers. Differences in income levels and financial structures across economies will eventually lead to differences in the coverage limit, scope, and other design elements, but the coverage levels in neighboring countries should be taken into account by any country considering changes to its deposit insurance system. (Al-Jafari and Walker [2011] provide a more detailed assessment of safety nets in MENA.)

Special resolution regimes empower authorities to temporarily continue the core operations of an institution (possibly after transferring assets and liabilities to a bridge bank); have shareholders absorb losses, pay off senior creditors only at estimated recovery value, and change management, in order to minimize moral hazard; and provide the conservator with adequate flexibility to minimize damage to the economy and cost to taxpayers. Adoption of such regimes is necessary to provide flexible crisis management and resolution tools. It could usefully accompany any transition to explicit deposit insurance. Countries in the region should follow suit on recent initiatives to introduce special resolution regimes to send a welcome signal that financial institutions cannot be expected to be rescued at no cost to them after they take excessive risks. (For more details, see BCBS 2010; Bierley 2009; Cihák and Erlend 2009; and Cohen and Goldstein 2009.)

Strengthening Corporate Governance of Banks[10]

Concentrated banking sector ownership in MENA makes strong corporate governance all the more important. The ownership structure implies that there is a need for clearer delineation of the key functions of ownership, oversight, and management; enhanced independence and role of the board; and further deployment of effective and independent risk management. In many instances, even when ownership and affiliations are known to the regulator and the public, more efforts are needed to identify the ultimate beneficial owners. Appreciation and ownership of corporate governance could be substantially enhanced by the local development and adoption of a corporate governance code, which could be given legal status by requiring compliance with relevant laws, regulations, or both.

More professional and independent boards of directors are essential for good governance. Boards need to provide more strategic guidance and define risk appetite and controls. They need more diversified composition, including a larger representation of independent board members, enhanced mix of relevant experience, and more formalized nomination procedures. Small countries with a small pool of qualified board members will have to rely more heavily on board members from abroad. Formalized

succession planning for both board members and key executive management is needed. In the event that the chairman of the board and CEO positions are not separate, evolving best practice encourages the appointment of a senior representative (independent) director as the lead interface to the chairman or CEO.

The roles of board committees should be clearly defined. The key tasks of the audit committee and the risk committee should be conducted by independent directors with clear delineations of lines of authority and control. Key strategic and risk decisions should be made by the full board or the risk committee followed by full board briefing. The responsibilities of each committee reflect two different aspects of bank operations. Audit and financial integrity issues have more static perspectives; risk issues require more prospective and strategic perspectives. The trend internationally is to separate these two critical tasks so that adequate time and resources can be allocated to each.

Risk management needs to be strengthened in most MENA banks. Few banks have chief risk officers (CROs). Those that do may not give them sufficient organizational stature, authority, or independent communication channels to alert the board to existing or building risks the bank may be facing. The board should be sufficiently involved in selecting and determining the compensation of the CRO; if it is not, the CRO's observations and concerns become overly subservient to business appetites and objectives. Most risk functions in the region lack the budget and staff needed for the size and complexity of bank activities; they require clearer and more independent reporting lines to the board and management.

Significant improvements in transparency and disclosure have been made, but both areas, in particular nonfinancial disclosure, need to be enhanced. Although the framework for disclosure has been improved, more needs to be done with regard to application and enforcement. Nonfinancial disclosure needs further upgrading, in particular in the areas of ownership, including ultimate or controlling ownership; nonexecutive board membership; the qualifications of board members and executives; board member attendance at board and board committee meetings; and remuneration schemes and compensation packages.

Surveillance of banks' financial statements, quality, and integrity needs to be more active. Rectifying inaccurate statement of banks' financial positions will require further enhancement of regulatory resources, including budgets and skills. In some instances, it will also require enhancement of enforcement legislation, as well as market regulators to demonstrate the political willingness to apply the legal tools at their disposal and to further improve monitoring and surveillance. It will require market players, such as smaller investors, rating agencies,

and industry associations, to continue to actively review, critique, and demand greater disclosures. Last and perhaps most crucially, it will require recognition by the banks themselves of the long-term rewards of greater transparency.

State banks should be subject to additional governance requirements. Mandates, ownership arrangements, and performance criteria should be made transparent, as should the performance of the institution. State banks should not operate with undue influence from the government or politicians over and above their disclosed public mandate; they should have in place clearly enumerated conflict of interest policies. Board member nomination and selection should follow an objective and standardized process. Board member composition should incorporate a mix of relevant skills and experience and should not be limited to public servants. State-owned institutions should be regulated and supervised like private sector banks. (Scott [2007] and Rudolph [2009] provide a more detailed discussion of the governance challenges of public banks.)

Introducing Macroprudential Regulation and Supervision

Extension of the perimeter of prudential regulation will be increasingly important in MENA. As financial systems become more diverse and complex, the current focus on banking sector regulation and supervision will prove inadequate. International experience shows that regulation of banks has proved to be an insufficient instrument to capture systemic risks. Market discipline and self-regulation cannot be expected to curtail risk taking by lightly regulated and unregulated institutions (Carvajal and others 2009). These considerations argue for the allocation of more resources for regulatory authorities of nonbank financial institutions.

Coordination by oversight authorities is essential. In most MENA countries, banking supervision is under the central bank; a number of oversight arrangements exist for nonbank financial institutions. Although there is no “one size fits all” solution to the architecture of financial supervision, continuous coordination and cooperation among authorities is vital in any arrangement to monitor interlinks within the financial sector and with the nonfinancial sector. Coordination is also essential to prevent regulatory arbitrage, an increasing risk as MENA financial systems become more diverse and complex.

Crisis simulation exercises should be undertaken to identify where existing arrangements need to be strengthened and cooperation by financial sector authorities fostered. Such simulations typically gather key public decision makers to experience a plausible crisis scenario and identify areas where improvements are needed, such as availability of information

and analytical frameworks to make decisions, public communication, or assessment of possible responses under tight time constraints. Very few countries in the region have undertaken such exercises, which are now a key component of the financial stability frameworks in the European Union and the United States.

Countries are advised to strengthen macroprudential oversight. Several GCC countries are already using a variety of the macroprudential tools advocated in regulatory reform proposals, including limits on debt service coverage ratios, loan-to-value and loan-to-deposit ratios, and, in some cases, sectoral concentration. Given the undiversified nature of these economies and their heavy reliance on hydrocarbon revenues, which lead to sharp cycles, consideration could be given to complementing these initiatives with dynamic provisioning; increased capital requirements for particular exposures, such as real estate; and limiting of dividend payments in good times to help build up capital buffers.

Several non-GCC countries would also benefit from more active use of macroprudential tools. Although most of these countries are not yet ready to adopt more sophisticated risk measurement methodologies, a gradual increase in capital buffers and the adoption of more basic macroprudential instruments would help them limit the build-up of systemic risk. These instruments could include caps on debt-service coverage ratios, loan-to-value ratios, and loan-to-deposit ratios, as well as quantitative limits to growth of individual types of exposures. Most of these measures would not hinder credit recovery, because these ratios are currently at low levels, but they would help regulators contain risk after credit activity recovers fully.

Countries are encouraged to conduct regular macroprudential assessments and to prepare and publish financial stability reports. To date, only Bahrain and Qatar have published such reports. These reports could improve the transparency of risk recognition in the financial system and facilitate broad communication with the financial community. Stress testing should also become an integral part of MENA supervisors' systemic surveillance of the financial sector. These activities could best be achieved by setting up macroprudential units within the supervisory agencies and ensuring a diverse skills mix of staff.

Preparing the Preconditions for Successful Financial Integration

A greater presence of foreign institutions and foreign investors would increase efficiency and access, but financial integration—regional or global—requires careful planning and the capacity to manage the associated

risks. Financial integration would need to be preceded by efforts to upgrade and harmonize financial infrastructure and financial regulation, build supervisory capacity, and strengthen supervisory coordination. These steps have just started being addressed in the area of financial infrastructure.

Ongoing efforts to strengthen and harmonize financial infrastructure are commendable and should be pursued further. The World Bank and the Arab Monetary Fund (AMF) launched the Arab Payment and Securities Settlement Initiative (API) in 2005, with the objective of supporting reforms in payment, remittances, and securities settlement systems in the Arab world. The API is conducted in cooperation with the International Monetary Fund (IMF). In 2010, the Arab central bank governors endorsed a feasibility study on Arab payment system integration; implementation was scheduled to begin in 2011. This critical step will pave the way for further integration efforts. A similar joint program by the World Bank Group and the AMF—the Arab Credit Reporting Initiative (ACRI)—is playing an important role in improving the quality of credit information in MENA. A new joint program of the World Bank Group and the AMF, addressing the problem of weak creditor rights, is expected to be launched in 2011. It will include the development of a model law to serve as a basis for legal reforms of secured transactions in the region. These initiatives may pave the way for more crossborder lending and investment in the future.

Further integration steps should be preceded by efforts to measure crossborder financial flows and identify the regulatory obstacles to further financial integration, as well as efforts to upgrade and harmonize financial regulation. The AMF and the World Bank have designed a new survey designed to measure the volume of crossborder flows and identify regulatory constraints in banking, debt, and equity markets. This important initiative should be fully implemented, as it will provide the information required for further integration efforts. Ongoing joint efforts to survey the quality of banking regulation should be fully implemented, as they will provide the basis for future efforts to strengthen and harmonize financial regulation and supervision. The AMF is well placed to play a pivotal role in these efforts, in association with the World Bank and the IMF.

To preserve financial stability, any capital account liberalization measures have to be country specific and carefully sequenced, and they must take account of recent emerging market experience with excessive inflows and outflows. Greater participation of foreign strategic and portfolio investors would bring benefits in many areas, including stronger competition, greater transfer of know-how, better risk management, and

improved liquidity and price discovery. However, foreign investors may also import volatility through links with international markets. Therefore, policy makers and regulators must be able to control the exposure of institutions and markets to crisis and mitigate the impact of crises when they do occur. Foreign borrowings by banks should be strictly regulated to prevent exposure to shocks and sudden stops, the participation of foreign investors in debt markets should be calibrated to prevent excessive exposure to volatility, and large sellouts should be absorbed through appropriate reserves. More generally, capital account liberalization needs to be carefully sequenced and the experience of other emerging markets in curtailing excessive inflows and outflows studied. Adoption of macroprudential instruments and oversight would also help MENA regulators mitigate the impact of external shocks.

Notes

1. All background papers are available at http://www.worldbank.org/mna.
2. This model may be particularly relevant to countries that cannot attract private credit bureaus because of lack of credit penetration and very weak legal and institutional frameworks.
3. Chile imposed net asset requirements or reserve requirements on fund managers for the private and open pension fund industry; pension fund regulators in many countries in Latin America and Central Europe copied these requirements. This regulation may be justified in the case of mandatory private open pension funds, which offer return guarantees, but not for voluntary mutual funds, which do not offer return guarantees.
4. This section draws on Pearce (2010).
5. Rajan and Zingales (2002) discuss the EU case between 1980 and 2000; Santana and others (2008) discuss the case of Brazil and other merging countries in the 2000s.
6. Christensen, Hail, and Leuz (2010) show that the stricter implementation of two EU directives increased market liquidity and decreased the cost of capital for issuing firms. The market abuse directive deals with insider trading; the transparency directive deals with financial reporting and disclosure.
7. A World Bank study (2000) examines the case of the Czech Republic and provides general lessons for other Central European countries.
8. Rudolph (2009) and Scott (2007) review the experiences of well-managed state banks and the legal structures and safeguards that must be put in place to ensure reasonable operational and financial performance.
9. For instance, the zero risk weight of claims in domestic currency on the sovereign can sometimes underestimate the capital that banks should keep to cover their real risks. Under a risk-based approach, this risk should be taken into account, leading to additional capital requirements when material risks exist.
10. This section is based on Hawkamah, OECD, and UAB (2010), and in-depth bank governance assessments conducted by the World Bank in several MENA countries.

TABLE 10.1

Roadmap for Increasing Financial Access While Maintaining Financial Stability

<table>
<tr><th>Area</th><th>GCC economies</th><th>Non-GCC economies with private-led systems</th><th>Non-GCC economies with state-led systems</th></tr>
<tr><td colspan="4">1. Financial infrastructure</td></tr>
<tr><td>Credit information systems</td><td>• For countries with existing private credit bureaus, make reporting and consultation mandatory for regulated entities (as applicable).</td><td>• Introduce private credit bureaus, preferably with specific law; require reporting and consultation; consider Moroccan model of delegated management.
• Alternatively, upgrade public credit registries (following the model of the West Bank and Gaza). This option may be optimal for lower-income countries with limited credit penetration.
• For countries with existing private credit bureaus, make reporting and consultation mandatory for regulated entities (as applicable).</td><td>• Initially, upgrade public credit registries to operate as best-practice private credit bureaus (following the model of the West Bank and Gaza).
• In the medium term, consider introducing a complementary private credit bureau model or shifting to a Moroccan model of delegated private credit bureau management by the Central Bank.</td></tr>
<tr><td></td><td colspan="3">• Introduce National Identification Number system.
• Encourage inclusion of microfinance institutions and expansion of number of unregulated reporting entities.
• Encourage use of nontraditional data.
• Encourage provision of value added services, such as credit scores and ratings of small and medium enterprises.</td></tr>
<tr><td>Collateral and Insolvency regimes</td><td colspan="3">• Overhaul collateral regimes through new, specific modern law on secured lending.
• Create unified electronic registry for movable collateral.
• Introduce out-of-court enforcement procedures with public or certified private collection agents, or both.
• Modernize insolvency laws to allow for reorganization as well as more efficient liquidation procedures.
• Enhance the capacity of courts and professionals involved in the insolvency system through adequate training, qualification, and supervision.</td></tr>
<tr><td colspan="4">2. Bank competition</td></tr>
<tr><td></td><td>• Introduce clear mandates, governance, and performance criteria for state banks.</td><td>• Consider further restructuring/privatization of state banks where their market share is still excessive and they hinder competition.
• Ensure a coherent reform program following the Central European transition model, including the parallel restructuring/privatization of state banks and state enterprises.
• Introduce clear mandates, governance structures, and performance criteria for remaining state banks.</td><td>• Reduce market share of state banks to below 50 percent of bank assets through new entry and restructuring/privatization.
• Ensure a coherent reform program following the Central European transition model, including the parallel restructuring/privatization of state banks and state enterprises.
• Introduce clear mandates, governance structures, and performance criteria for remaining state banks.</td></tr>
</table>

	• Revise licensing rules and procedures that bar entry of reputable banks, emphasizing fit and proper rules. • Revise rules and implementation of large exposure/connected lending regime to reduce loan concentration. • Introduce competition agency, or empower bank supervisor to address competition issues.		
3. *Nonbank financial institutions*			
Insurance	• Consider introducing mandatory health insurance for expatriates (as applicable).	• Egypt, Arab Rep.: Complete the restructuring and privatization of state insurers.	• Substantially reduce the market share of state insurers through new entry and restructuring/privatization of state insurers.
	• Make worker's compensation, construction, transportation, and catastrophic insurance mandatory for mortgage lenders. • Enforce existing mandatory lines (motor third-party liability [MTPL]), and address understatement of claims and price controls on MTPL. • Authorize use of *banc-assurance* with proper market conduct/consumer protection regulations (as applicable). • Strengthen reporting and disclosure requirements. • Review tax regime for life products. Exempt contributions and investment income tax benefits. • Operationalize *takaful* insurance, preferably with greater centralization of *Sharia* guidance. • Create independent insurance supervisor (as applicable).		
Pension sector	• Strengthen public fund governance and disclosure, including investment policies. • Introduce pluralistic/decentralized asset management structures to enhance efficiency and contribute to capital market development. • Introduce pension coverage for expatriates with supportive tax regime and private defined-contribution funds.	• For countries with public pension funds (Jordan, Morocco), strengthen governance and disclosure, including disclosure of investment policies; introduce pluralistic/decentralized asset management structures to enhance efficiency and contribute to capital market development. • For countries with private schemes (Egypt, Arab. Rep.; Jordan), introduce supportive tax regime and sound regulatory frameworks for private funds.	
Mutual funds	• Strengthen fit and proper rules for owners and managers of mutual fund management companies. • Strengthen professional requirements/certification of asset managers. • Ensure asset segregation and legal separation of mutual funds from bank sponsors. • Strengthen valuation and redemption rules, with daily net asset value valuation and forward pricing. • Strengthen disclosure rules, by requiring that prospectuses include investment policy, net asset value pricing policy, historical performance, and fees and expenses. • Eliminate net asset requirements for fund managers, and introduce risk-based capital requirements. • Strengthen and enforce conflict of interest rules. • Establish code of ethics for investment managers and brokers. • Encourage entry of nonbank fund managers.		

(Table continues on the following pages.)

TABLE 10.1 (continued)

Area	GCC economies	Non-GCC economies with private-led systems	Non-GCC economies with state-led systems
Leasing and factoring	• Consider introduction of reverse factoring platform to promote further small and medium enterprise finance. • Introduce specific leasing legislation that clarifies rights and obligations of parties to lease contract and strengthens repossession of leased assets. Include leased assets in the unified registry for movable collateral (as applicable). Clarify rights of lessors in bankruptcy.		
4. Small and medium enterprise finance			
	• Strengthen financial infrastructure. • Strengthen banking competition. • Improve the regulatory and institutional framework for leasing and factoring. • For countries with very small or nonexistent credit guarantee schemes, consider introducing well-designed and targeted schemes. • For countries making use of state banks to finance small and medium enterprises, strengthen governance, as well as lending and risk management capacity, through dedicated small and medium enterprise units.		
5. Microfinance			
	• Not relevant	• Develop a national financial inclusion strategy. • Develop specific law for microfinance institutions. • Submit microfinance institutions to financial supervision. • Integrate microfinance institutions into the national public credit registry or private credit bureau. • Allow stronger microfinance institutions to adopt finance company legal structure.	
6. Fixed-income instruments and markets			
Development of the government debt market	• Consider the fundamental decision to develop the local market, and build a reliable benchmark yield curve where there are no financing needs. Examine relevant cases (for example, Hong Kong SAR, China; New Zealand; Norway; and Singapore). • Develop the five key building blocks of a government debt market. In particular, gradually lengthen the yield curve and maintain a regular issuance flow at all key maturities, avoiding opportunistic behavior. • Make a fundamental decision to issue and build a critical mass of government debt in conventional debt or *sukuk* markets.	• Develop the five key building blocks of a government debt market. In particular, gradually lengthen the yield curve and maintain a regular issuance flow at all key maturities, avoiding opportunistic behavior. • Allow participation of foreign investors while mitigating risks of excessive presence and volatility through primary dealer rules, syndications, and reserve buffers.	• Develop the local market, and build a reliable benchmark yield curve where there are no financing needs. Examine relevant cases (for example, Hong Kong SAR, China; New Zealand; Norway; and Singapore). • Develop the five key building blocks of a government debt market. In particular, gradually lengthen the yield curve and maintain a regular issuance flow at all key maturities, avoiding opportunistic behavior. • Allow the participation of foreign investors while mitigating risks of excessive presence and volatility through primary dealer rules, syndications, and reserve buffers.

Development of private fixed income instruments	• Develop enabling legislation for mortgage-covered bonds.	• For more financially developed countries, develop enabling legislation for mortgage-covered bonds. • For more financially developed countries with critical mass of housing loans, create conditions for future sound securitizations.	
7. Equity market			
	• Consider additional initial public offerings of state enterprises. • Enforce minimum free float of 25 percent. • Enforce full adoption of international financial reporting standards, including consolidated version for corporate groups. • Strengthen nonfinancial disclosure. • Strengthen protection of minority shareholders, especially international standards in takeover bids, proxy/cumulative voting, information ahead of general assemblies, liabilities for directors and management. • Introduce professional accreditations for securities analysts, compliance officers, and fund managers .		• Consider initial public offerings of state enterprises.
8. Housing finance			
	• Improve infrastructure for housing finance (cadastres, titling, credit information, collateral regime for fixed assets). • Improve transparency of real estate markets by introducing housing price indexes and real estate market observatories. • Enhance capacity to monitor mortgage lending through build-up of statistical base, showing for each cohort mortgage types, debt-service coverage ratios, loan-to-value ratios, nonperforming loans. • Strengthen the prudential framework for housing loans. • Consider introducing a mortgage refinance facility. • Prepare/introduce legislation on covered bonds. • Introduce countercyclical prudential measures (see section on macroprudential regulation below). • Develop regulatory or tax mechanisms to curb excessive speculative investments, especially on land.		
9. Financial stability			
Microprudential regulation and supervision	• Strengthen consolidated supervision as banking groups and conglomerates develop. • Strengthen definition and enforcement of large-exposure and related-party regime to reduce risks associated with credit concentration. • Require banks to have well-articulated asset and liability management frameworks to avoid excessive liquidity as well as interest rate and counterparty risks when expanding housing and investment finance (long-term lending). • Empower supervisors to require individual institutions to hold capital adequacy ratios above the minimum level, and effectively use such powers when needed. • To accompany gains in access to finance, implement well-designed product regulation, including regulation of terms and transparency of floating rate loans, banning excessively risky products. • Strengthen independence of financial supervision.		

(Table continues on the following pages.)

TABLE 10.1 (continued)

<table>
<tr><th>Area</th><th>GCC economies</th><th>Non-GCC economies with private-led systems</th><th>Non-GCC economies with state-led systems</th></tr>
<tr><td>Deposit insurance and bank resolution mechanisms</td><td colspan="3">• Revise explicit deposit insurance systems to be compliant with the core principles of the International Association of Deposit Insurers.
• Introduce explicit, limited-coverage deposit insurance systems, as applicable. Enhance crossborder coordination and cooperation in transitioning countries in order to avoid negative spillovers.
• Adopt special resolution regimes to provide flexible crisis management and resolution tools. Such regimes could usefully accompany any transition to explicit deposit insurance.</td></tr>
<tr><td>Bank governance</td><td colspan="3">• Ensure clearer delineation of the key functions of ownership, oversight, and management.
• Ensure more professional and independent boards of directors, with more diversified composition, including larger representation of independent members, enhanced mix of relevant experience, and more formalized nomination procedures.
• Clearly define the roles of board committees, including audit and risk management committees.
• Strengthen the risk management function; introduce a chief risk officer.
• Enhance transparency and disclosure, in particular nonfinancial disclosure.
• Enhance surveillance of quality and integrity of banks' financial statements.
• Strengthen the governance requirements of state-owned banks. Make mandates, ownership arrangements, and performance criteria transparent. Introduce clearly enumerated conflict of interest policies.</td></tr>
<tr><td>Macroprudential oversight</td><td>• Consider dynamic provisioning and increased capital requirements for particular exposures, such as real estate.</td><td colspan="2">• Consider caps on debt-service coverage ratios, loan-to-value ratios, and loan-to-deposit ratios, as well as quantitative limits to growth of individual types of exposures.</td></tr>
<tr><td></td><td colspan="3">• Coordinate among regulatory authorities to avoid regulatory arbitrage.
• Conduct crisis simulation/management exercises.
• Conduct regular macroprudential assessments and publish financial stability reports.
• Mitigate risk of excess volatility as a result of increased global integration by appropriately chosen capital account measures.</td></tr>
</table>

Source: World Bank staff.

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APPENDIX A

Statistical Benchmarking

This appendix contrasts the benchmarking techniques used in chapter 3 with a different set of techniques. It then describes the results obtained by the two techniques.

Benchmarking Technique Used in Chapter 3

The benchmarking methodology used in chapter 3 takes into account the most important nonpolicy factors affecting financial sector development and excludes policy-driven factors. The statistical benchmark determines the level at which a country's financial system would be expected to perform in a policy-neutral environment. Deviations from the statistical benchmark can therefore be attributed, at least in part, to the quality of the country's policies, which is directly comparable across countries (see Beck and others 2006).

The figures in chapter 3 show the actual value of the financial indicator against a predicted value based on benchmark controls for per capita income, population, population density, the age dependency ratio, inflation, and a dummy measuring whether the country is an oil exporter. Economic development clearly affects financial development, as a result of both demand effects (the demand for financial assets and services increases with income) and supply effects (larger, richer economies can achieve economies of scale and benefit from more competition and better infrastructure). Financial sector development is also affected by a country's population size and density. Countries with larger populations can have deeper and more efficient financial systems (scale effect), and financial services can be provided at a lower cost in countries with higher population density (network effect). The proportion of the nonworking population in the labor force is likely to affect savings, asset accumulation, demand for insurance, and lending patterns influencing financial development. Oil exporters may have smaller financial sectors than other

countries at similar levels of income, reflecting the fact that oil revenues can boost gross domestic product (GDP) without a proportional increase in economic and financial activity. Inflation reduces the real return on financial instruments and the relevant ratios to GDP.

The benchmarking methodology represents a significant improvement over simple comparisons with peer groups, regional averages, or predicted values controlling only for per capita income, but its limitations must be taken into account. For example, the inclusion of per capita income as an explanatory variable can create endogeneity problems, because it can be argued that economic development is itself influenced by financial development. However, Beck and others (2006) point out that the strength of the impact of financial development on economic growth increases as the time horizon increases. Financial development has a supply-side impact on economic growth over the medium term; in contrast, the relationship between per capita income and financial development is largely demand driven and shorter term. Therefore, as long as the impact of financial development is lagged (such that policy improvements affect financial development before financial development affects economic development), policy will not be fully captured by the per capita term and remain at least partially embedded in the residual. The residual from a regression that does not account for policy thus captures the quality of a country's policies and can be used for cross-country comparisons.

Inflation is another control variable that is potentially endogenous in some of the estimated equations, such as the equation for deposits and loans to GDP. Ideally, inflation should be instrumentalized in some of the regressions, but instrumentalizing it would complicate the exercise. There is a difficult trade-off between omitting an important variable and including it without instrumental variables. Given its potential impact on the demand for financial assets, inflation is included in this exercise.

Possibly one of the greatest limitations of this methodology is the omission of some important nonpolicy variables in some of the regressions. For example, the regression on deposits to GDP does not control for workers' remittances and financial openness, which, as the literature shows, can influence the ratio of deposits to GDP (see Aggarwal, Demirgüç-Kunt, and Martinez Peria 2006). That Lebanon, with its very large deposit base, is an outlier in this regression is explained in part by the omitted variables mentioned above (see chapter 3). The residuals probably reflect important omitted nonpolicy variables, not the quality of policy, and therefore have to be interpreted accordingly. In other regressions, such as insurance assets to GDP, the problem of omitted variables is probably less severe. Hence, the large residual in Morocco primarily reflects better policies leading to better outcomes (see chapter 3).

Benchmarking Technique Used in This Appendix

The benchmarking methodology used here is both similar to and different from the approach used in chapter 3. In both exercises, the independent and dependent variables are log transformed and the statistical benchmarks defined as the predicted values of the equations.

The first difference between the two exercises lies in the estimation method used. The estimates reported here are based on median quantile regressions, not ordinary least squares regressions, as in chapter 3.[1] Quantile regressions reduce the impact of outliers; they can also be used to obtain expected values of other percentiles (graphs show the 25th and 75th percentiles). The second difference between the approaches lies in the regression model used for estimation: the model in chapter 3 includes inflation as an additional explanatory variable.

Different Benchmarking Techniques, Very Similar Results

The results are very similar regardless of the benchmarking technique employed. For bank deposits and credit, both benchmarking exercises show that countries in the Gulf Cooperation Council (GCC) are close to their predicted values (figures A.1 and A.2). The sole exception is Qatar, which lies below the lowest percentile for both deposits and loans. In the non-GCC private-led group (figure A.3), the Arab Republic of Egypt, Lebanon, and Jordan have large deposit ratios that lie above the expected level of their 75th percentile. Morocco, Tunisia, and the Republic of Yemen—where deposit ratios are lower than in the other countries in the group—still compare well with other economies.

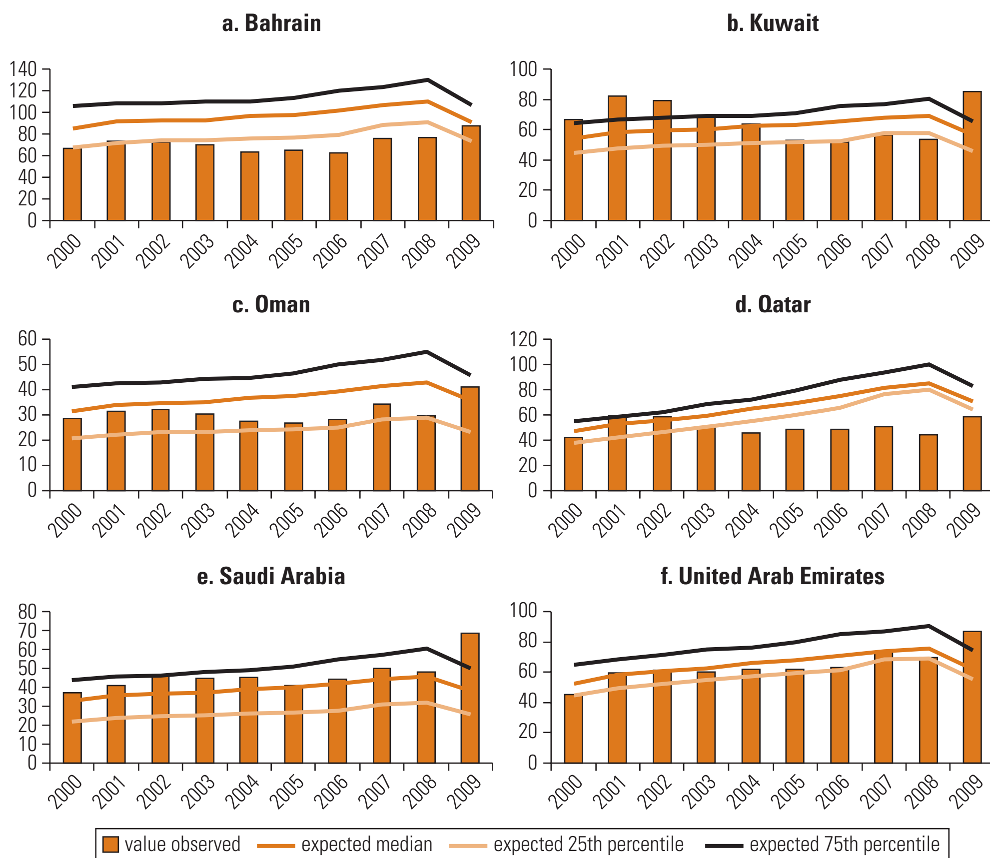
As in chapter 3, countries outside the GCC with financial systems led by the private sector compare well with other countries in terms of private credit, albeit less so than in the case of deposits (figure A.4). The difference reflects the fact that part of the deposit base is used to finance the government, resulting in less credit to the private sector. Also as in chapter 3, the deposit ratio in countries outside the GCC with financial systems led by the state is generally in line with the levels predicted by their per capita income, demographic profiles, and other characteristics (figure A.5). As in chapter 3, private credit ratios for these countries do not benchmark as well (figure A.6).

In line with the results in chapter 3, the analysis here shows that countries in the region compare well in equity market capitalization (figures A.7, A.8, and A.9). Most MENA countries in both GCC and non-GCC private-led groups have market capitalization ratios that are within the range predicted by the model or at least at the lowest expected percentile. An exception is the United Arab Emirates, where market capitalization has been below the lowest percentile in recent years.

FIGURE A.1

Domestic Bank Deposits as a Percentage of GDP in the Gulf Cooperation Council, 2000–09

(percentage of GDP)



Source: World Bank 2011.

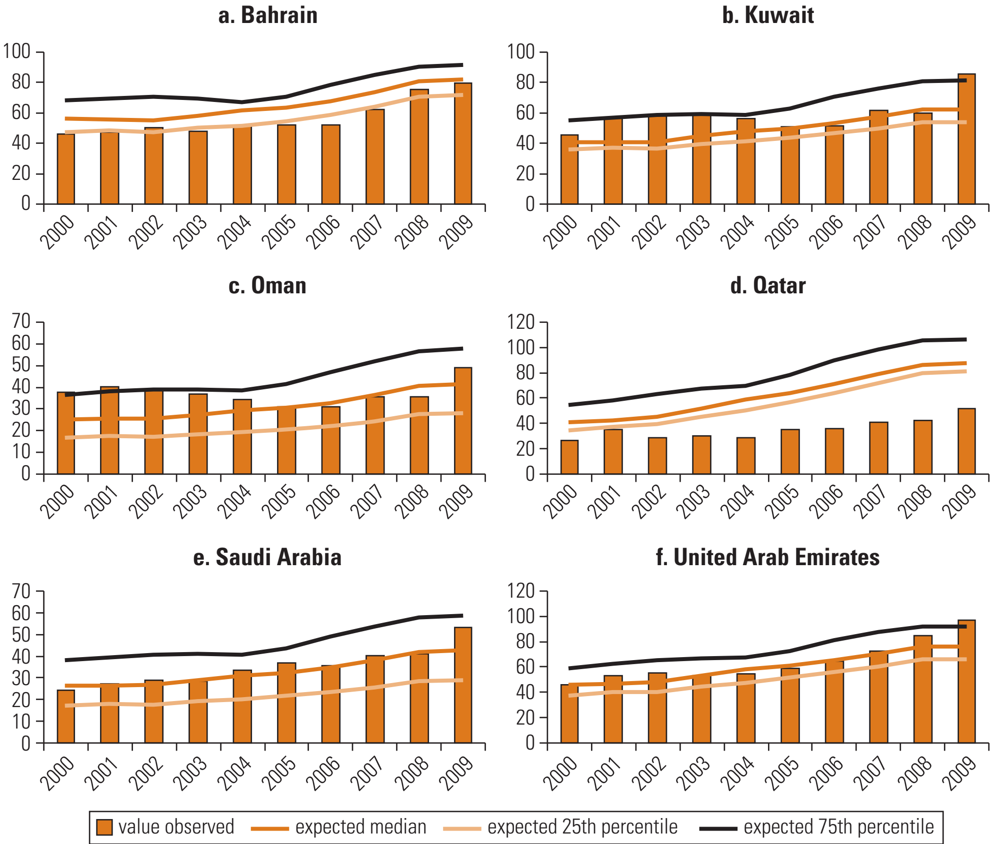
A similar picture exists for stock market turnover ratios: values are well within the range predicted by per capita income, demographic profiles, and other characteristics. The two exceptions are Qatar and the United Arab Emirates, both of which have low turnover ratios. Equity market data for state-led economies are not available (figures A.10, A.11, and A.12).

As in chapter 3, the analysis here shows that the average ratio of insurance assets and premiums to GDP is low, especially in the GCC region. Bahrain has a more developed insurance sector, with actual assets higher than the predicted median value. Other GCC countries have very small insurance sectors and generally fall below their expected median values

FIGURE A.2

Private Credit as a Percentage of GDP in the Gulf Cooperation Council, 2000–09

(percentage of GDP)



Source: World Bank 2011.

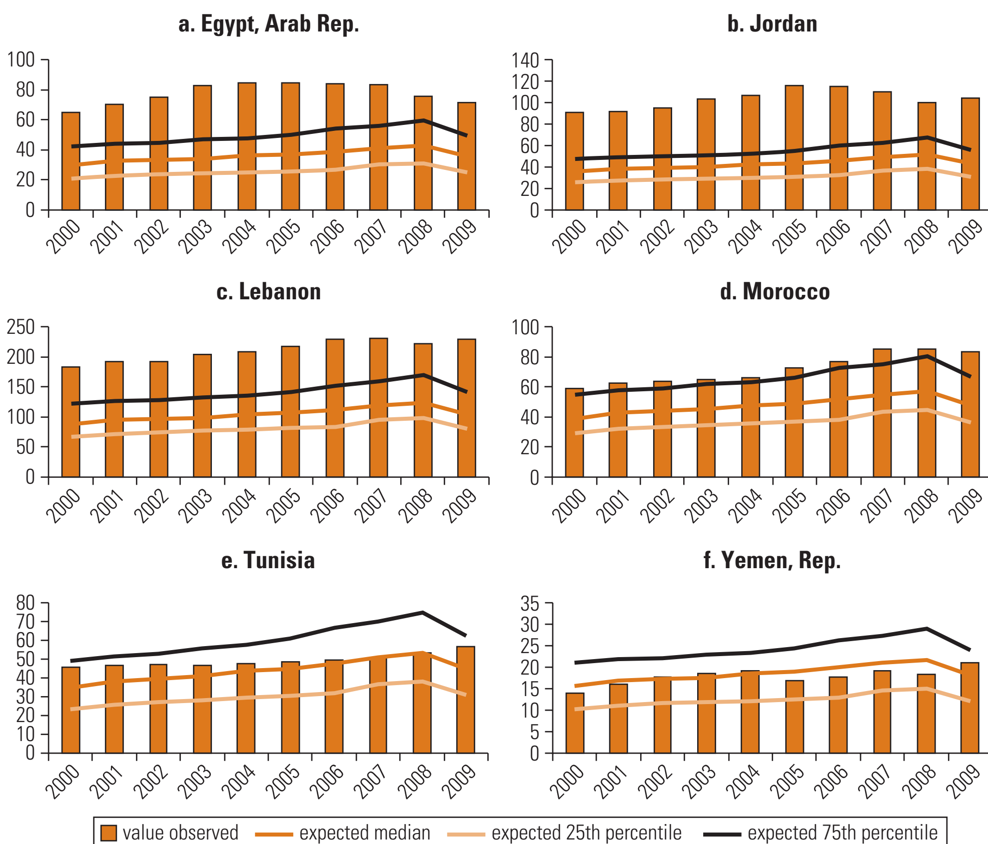
(figure A.13). In economies outside the GCC led by the private sector (figure A.14), Morocco is a clear exception, with total assets that are well above the levels predicted by its income level and demographic profile (the same result is shown in chapter 3). All other countries in the group are either at or below the lowest expected percentile. Algeria is the only state-led economy for which data on insurance assets to GDP are available; it lies below its predicted 25th percentile, implying an undeveloped insurance sector (figure A.15).

The non–life insurance sector is somewhat more developed than the life sector in MENA, as shown by the ratios of insurance premiums to GDP. GCC countries with relatively high life insurance premium ratios

FIGURE A.3

Domestic Bank Deposits as a Percentage of GDP in Private-Led Financial Systems outside the Gulf Cooperation Council, 2000–09

(percentage of GDP)



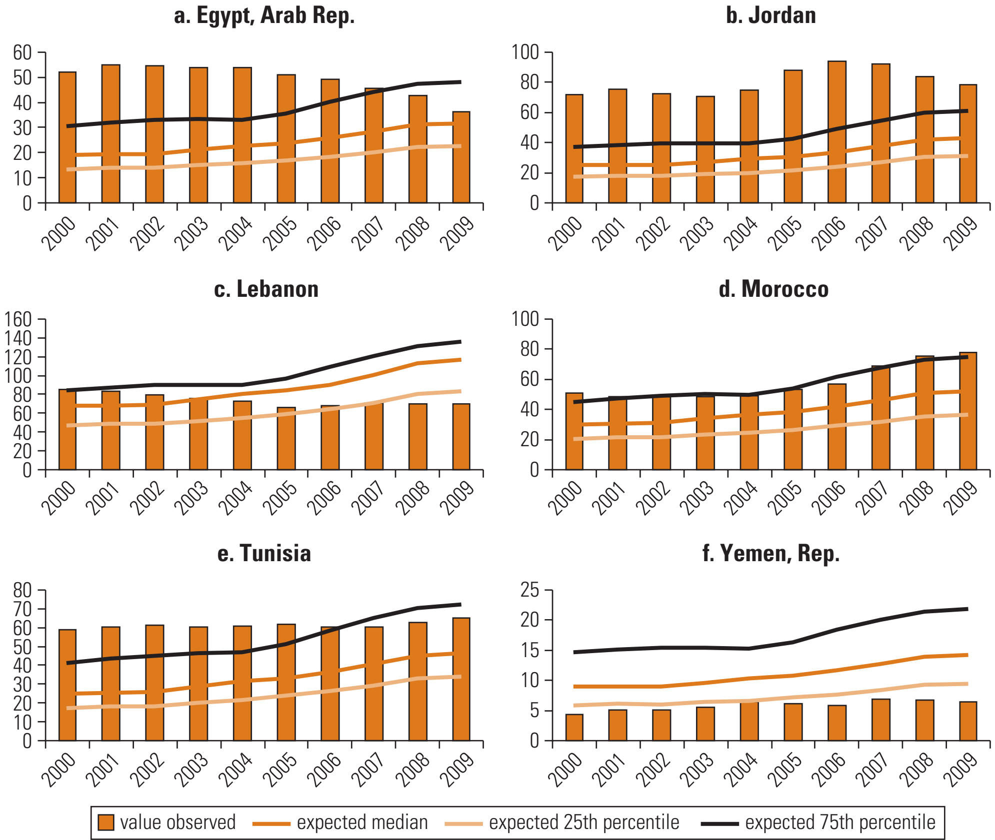
Source: World Bank 2011.

include Bahrain, Oman, and the United Arab Emirates, all of which perform above their predicted 25th percentile (figure A.16). For non–life insurance premium ratios, Bahrain and the United Arab Emirates lead the region, with actual values above their predicted median (figure A.17). Among private-led non-GCC countries, Morocco is the exception, with premium ratios higher than the predicted median (figure A.18). For non–life insurance premiums, Jordan, Morocco, and Tunisia display actual values that are at or higher than their predicted 75th percentile (figure A.19). State-led economies severely lag their expected performance in the life insurance sector (figure A.20). Although they perform

FIGURE A.4

Private Credit as a Percentage of GDP in Private-Led Financial Systems outside the Gulf Cooperation Council, 2000–09

(percentage of GDP)



Source: World Bank 2011.

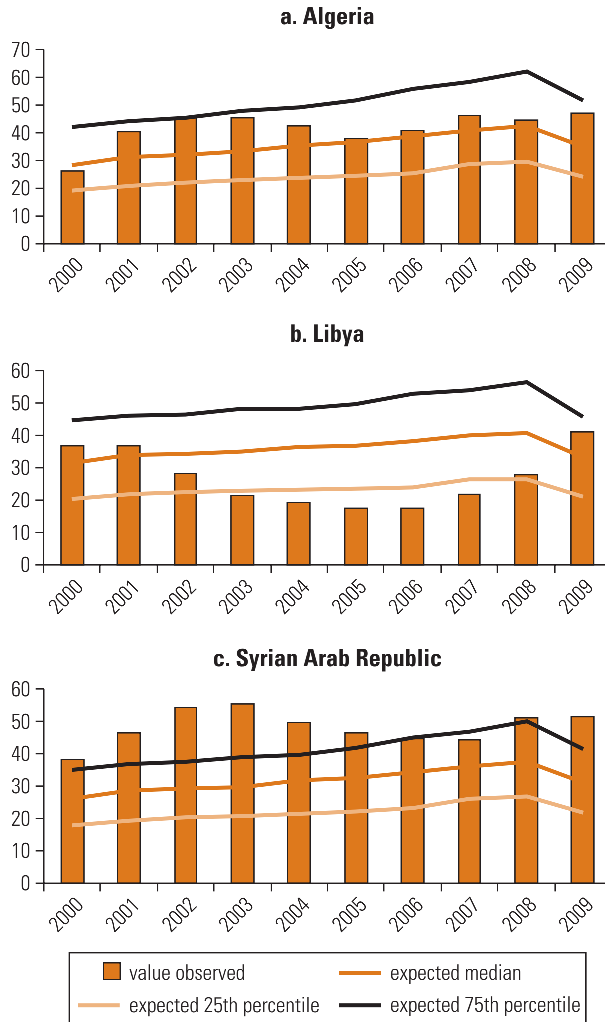
relatively well in the non–life insurance sector, they still perform worse than predicted (figure A.21).

Like chapter 3, the analysis here finds the mutual fund sector to be undeveloped in MENA. Most GCC countries are at or below the lowest predicted percentile (Bahrain's actual value is above its predicted 25th percentile, but it has only one data point) (figure A.22). In non-GCC private-led countries, Morocco and Tunisia have actual values that are higher than the levels predicted by their per capita income, demographic profiles, and other characteristics (figure A.23). Data for state-led countries are not available; only predicted values are therefore shown (figure A.24).

FIGURE A.5

Domestic Bank Deposits as a Percentage of GDP in State-Led Financial Systems outside the Gulf Cooperation Council, 2000–09

(percentage of GDP)

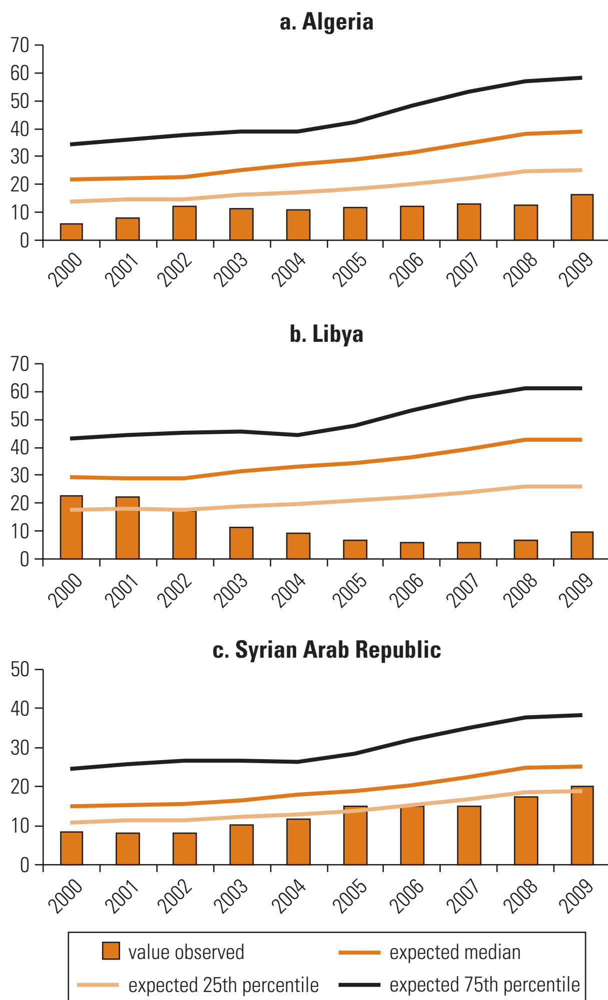


Source: World Bank 2011.

FIGURE A.6

Private Credit as a Percentage of GDP in State-Led Financial Systems outside the Gulf Cooperation Council, 2000–09

(percentage of GDP)

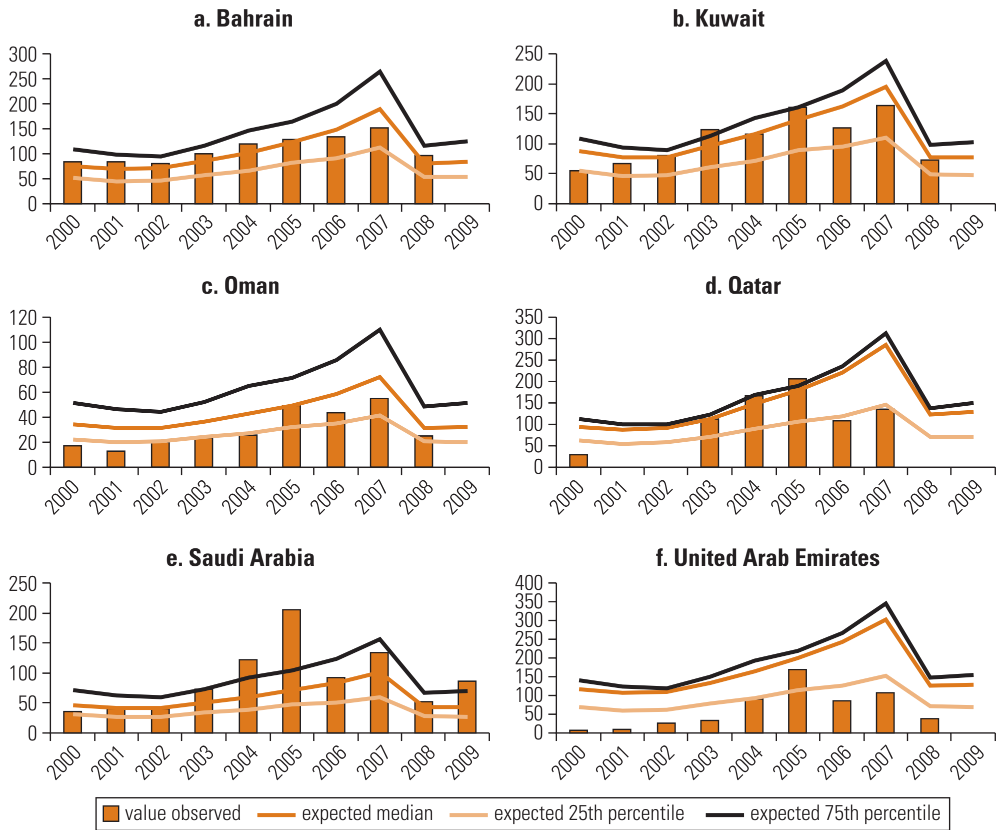


Source: World Bank 2011.

FIGURE A.7

Stock Market Capitalization as a Percentage of GDP in the Gulf Cooperation Council, 2000–09

(percentage of GDP)

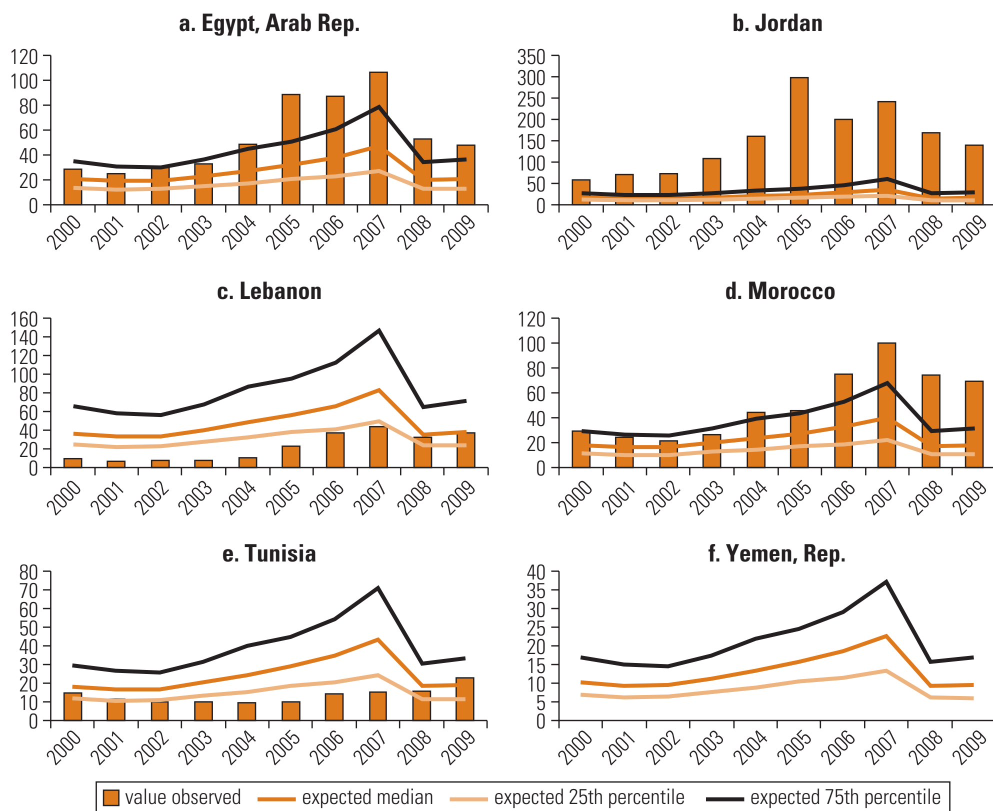


Source: World Bank 2011.

FIGURE A.8

Stock Market Capitalization as a Percentage of GDP in Private-Led Financial Systems outside the Gulf Cooperation Council, 2000–09

(percentage of GDP)

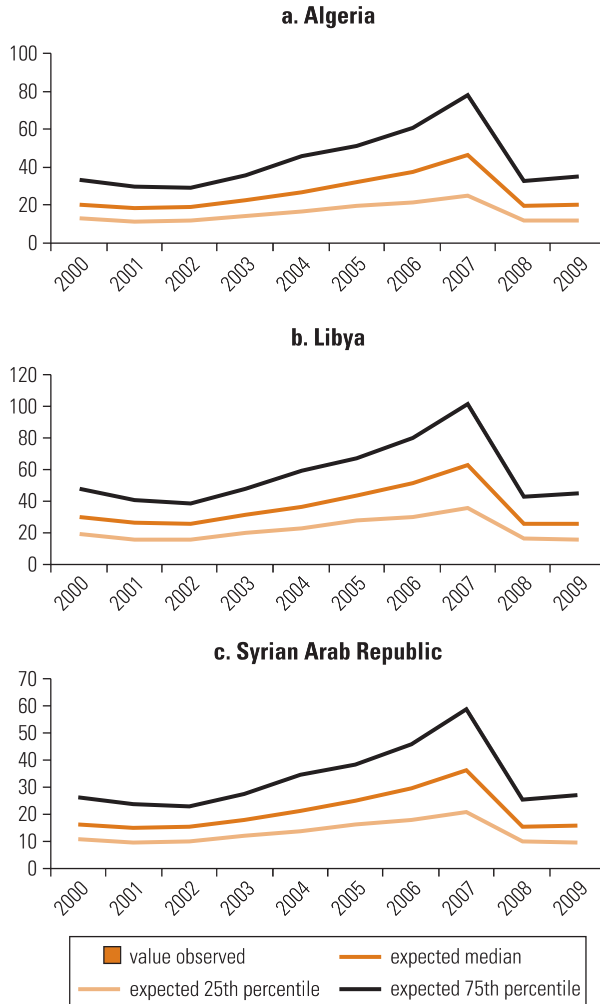


Source: World Bank 2011.

FIGURE A.9

Stock Market Capitalization as a Percentage of GDP in State-Led Financial Systems outside the Gulf Cooperation Council, 2000–09

(percentage of GDP)

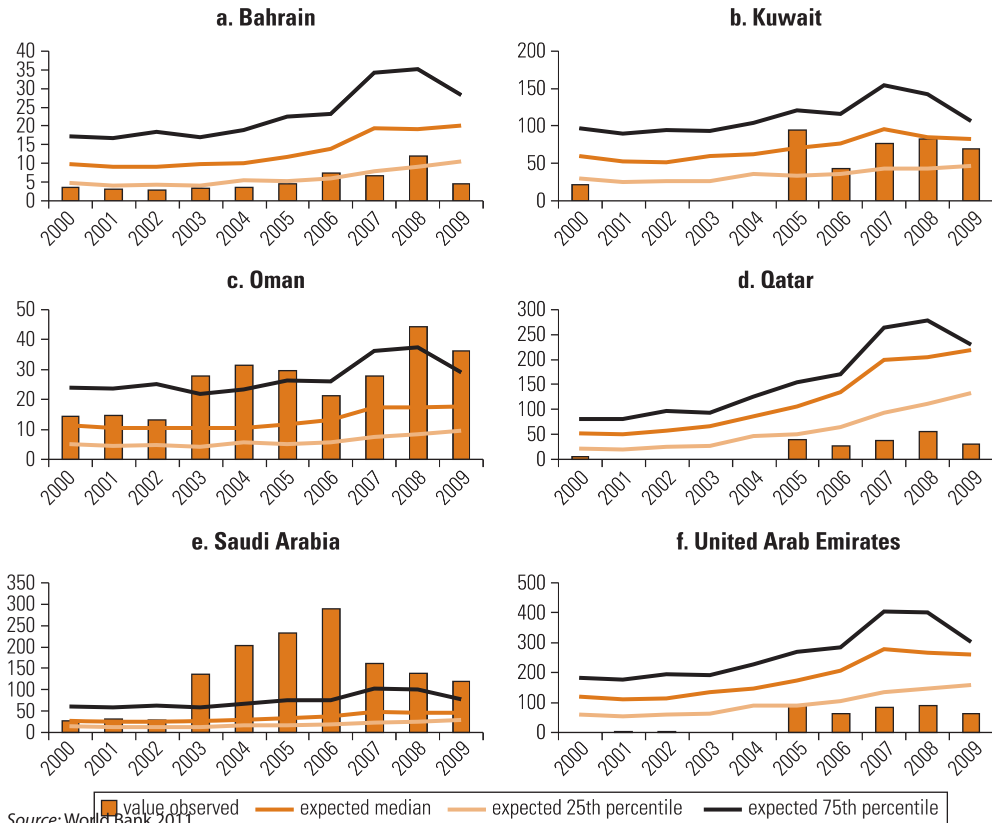


Source: World Bank 2011.

FIGURE A.10

Stock Market Turnover Ratio in the Gulf Cooperation Council, 2000–09

(turnover/market capitalization)

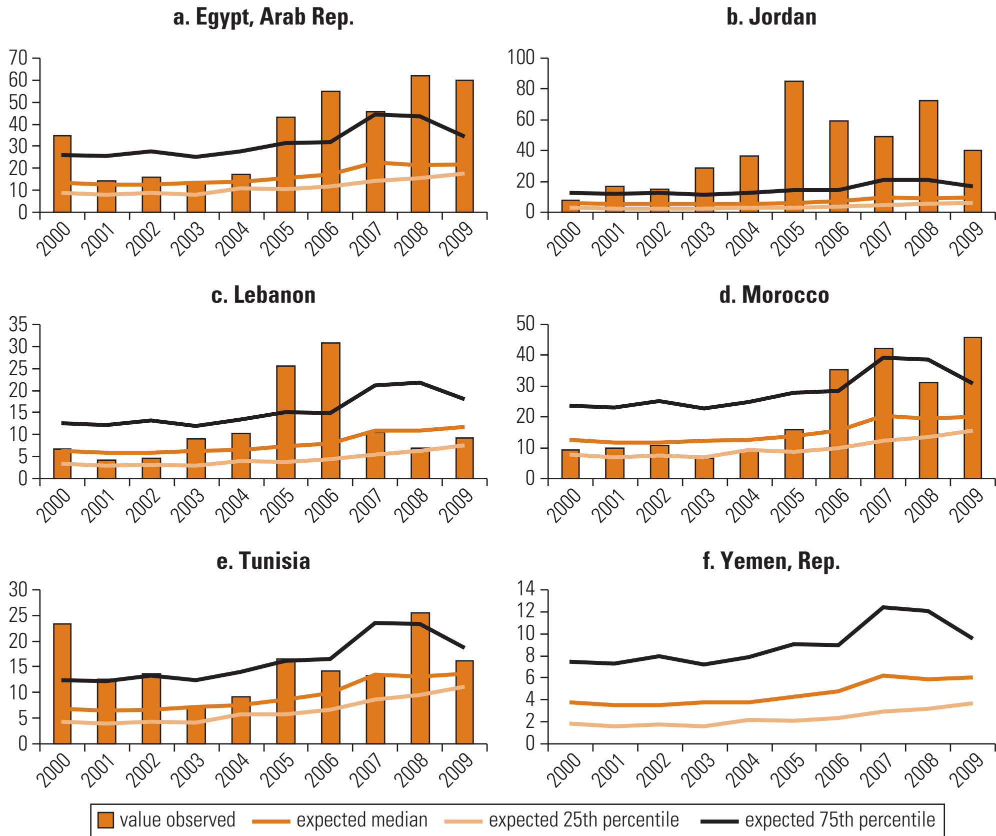


Source: World Bank 2011.

FIGURE A.11

Stock Market Turnover Ratio in Private-Led Financial Systems outside the Gulf Cooperation Council, 2000–09

(turnover/market capitalization)

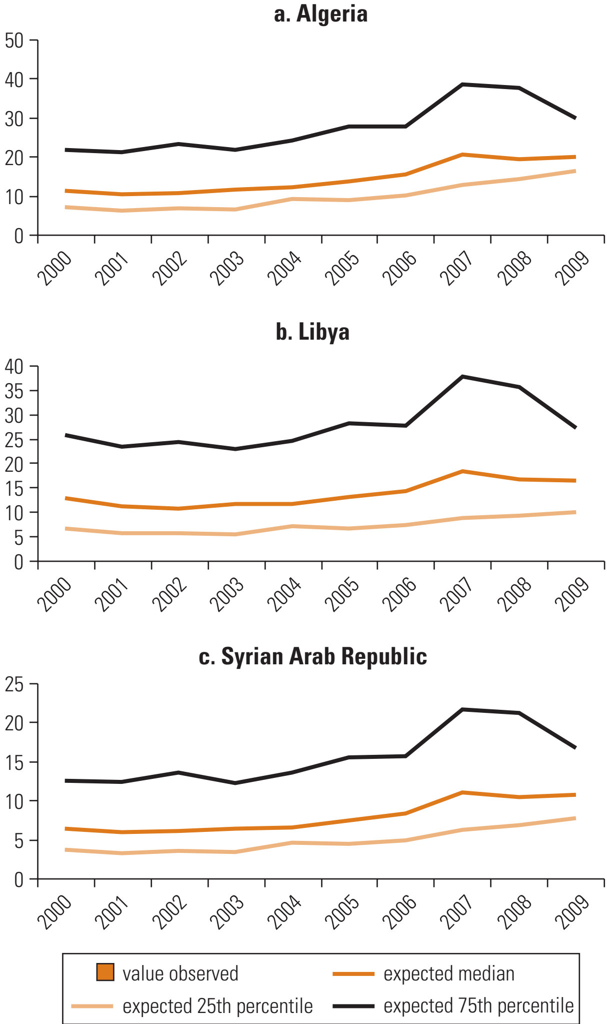


Source: World Bank 2011.

FIGURE A.12

Stock Market Turnover Ratio in State-Led Financial Systems outside the Gulf Cooperation Council, 2000–09

(turnover/market capitalization)

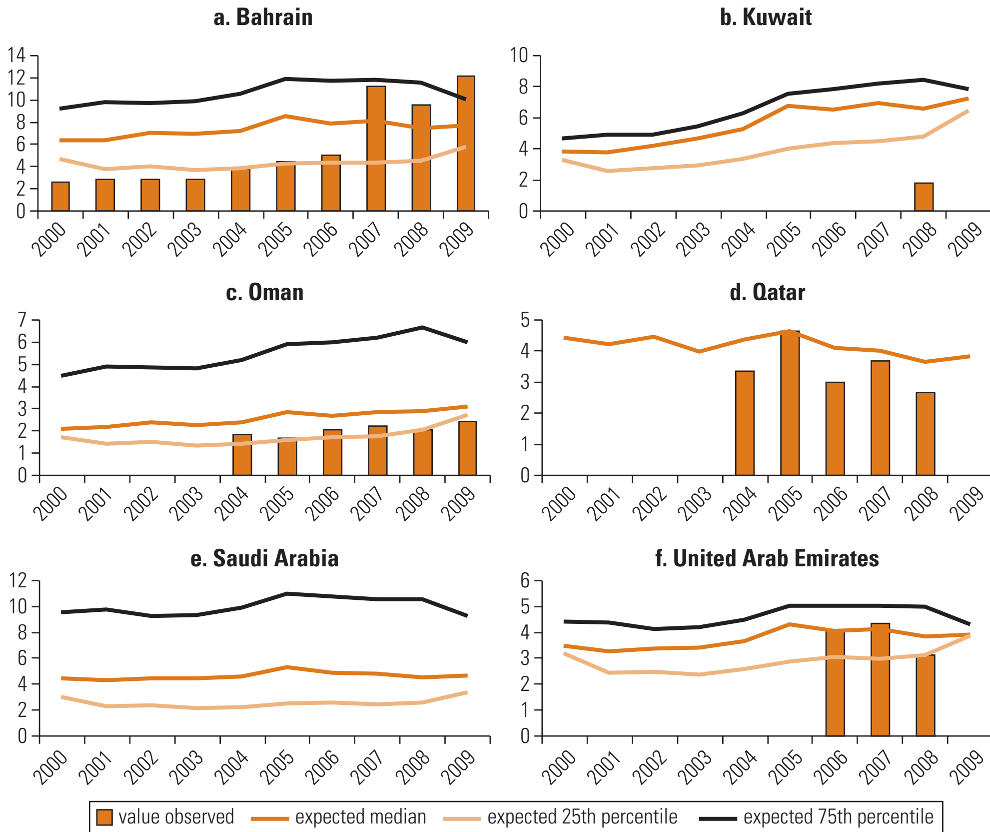


Source: World Bank 2011.

FIGURE A.13

Insurance Company Assets as a Percentage of GDP in the Gulf Cooperation Council, 2000–09

(percentage of GDP)

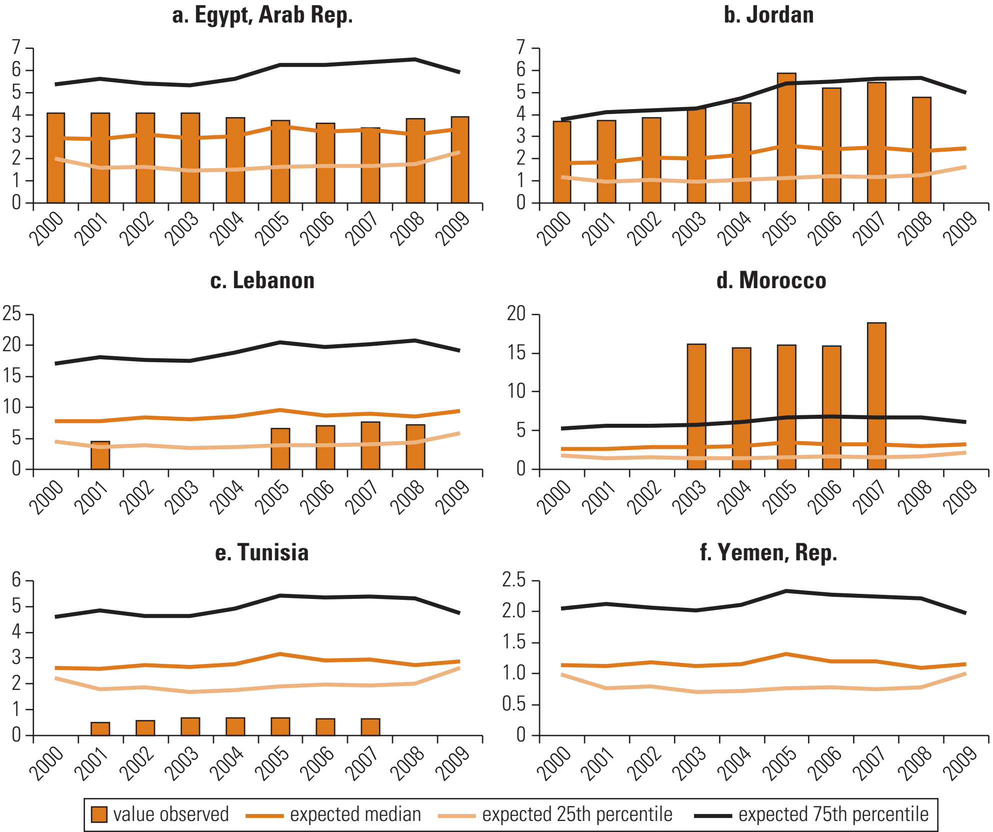


Source: World Bank 2011.

FIGURE A.14

Insurance Company Assets as a Percentage of GDP in Private-Led Financial Systems outside the Gulf Cooperation Council, 2000–09

(percentage of GDP)

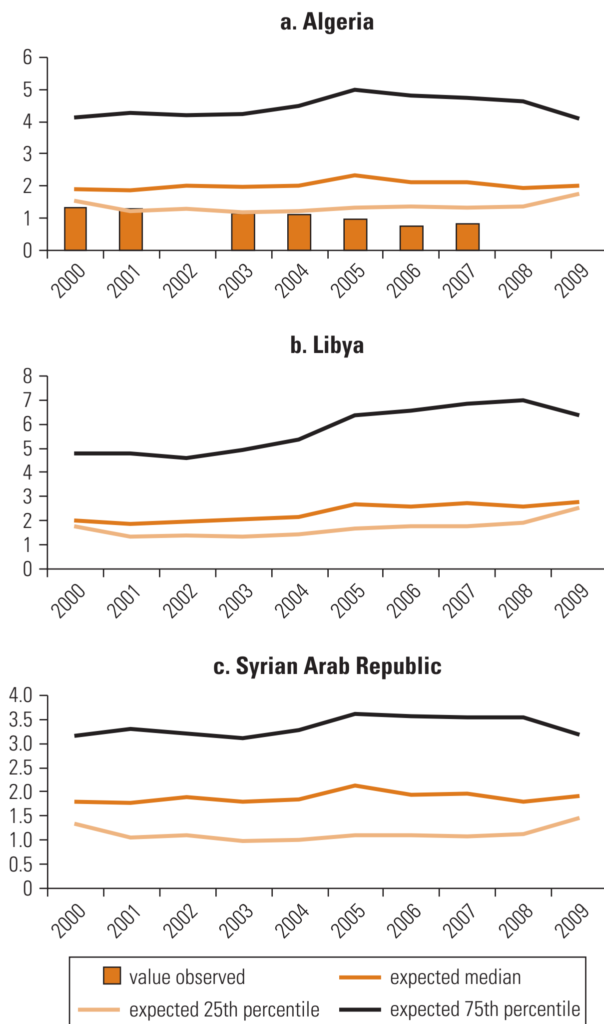


Source: World Bank 2011.

FIGURE A.15

Insurance Company Assets as a Percentage of GDP in State-Led Financial Systems outside the Gulf Cooperation Council, 2000–09

(percentage of GDP)

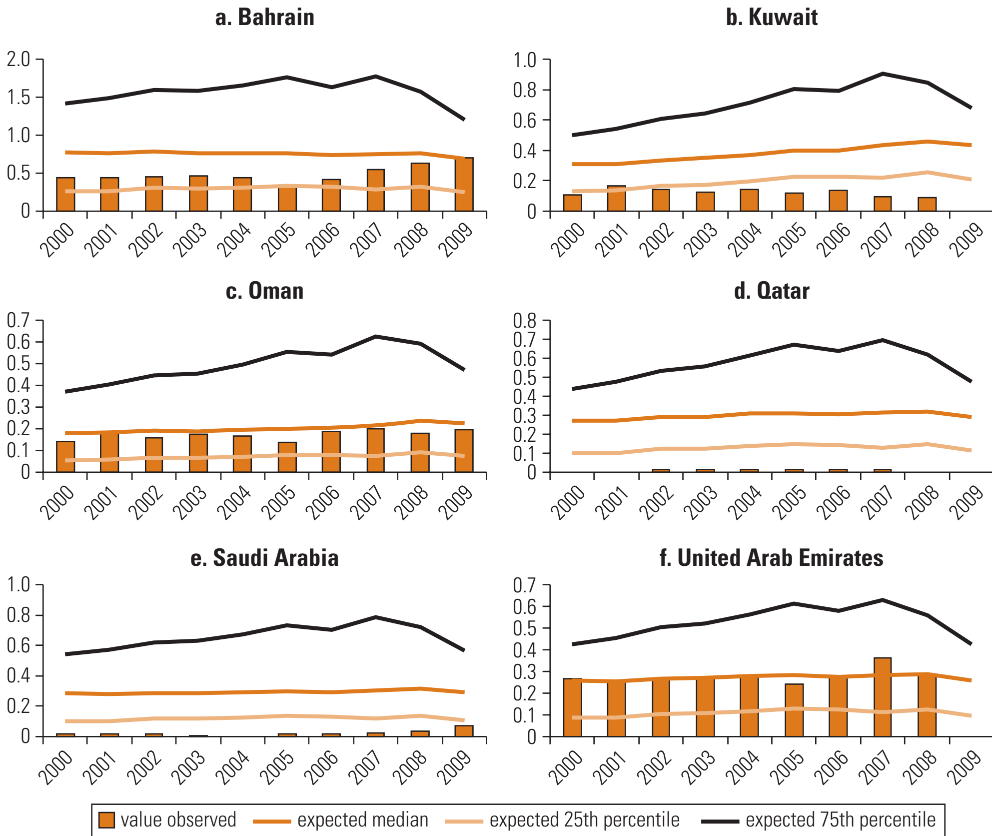


Source: World Bank 2011.

FIGURE A.16

Life Insurance Premiums as a Percentage of GDP in the Gulf Cooperation Council, 2000–09

(percentage of GDP)

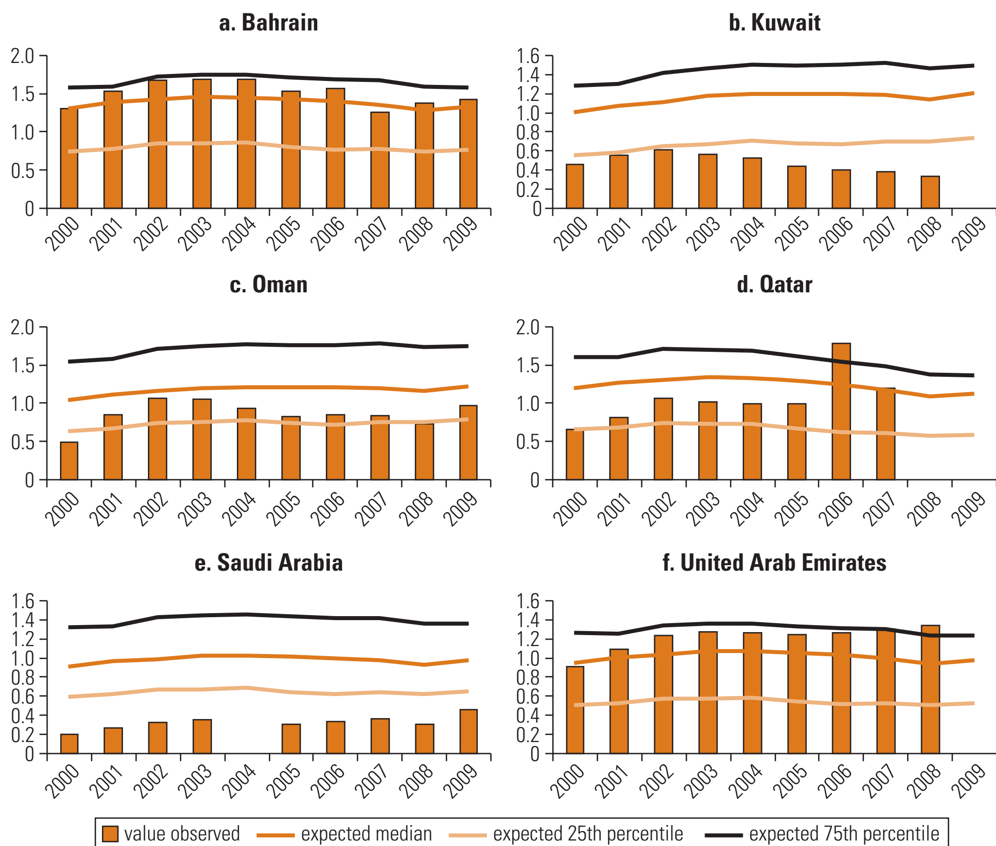


Source: World Bank 2011.

FIGURE A.17

Non–life Insurance Premiums as a Percentage of GDP in the Gulf Cooperation Council, 2000–09

(percentage of GDP)

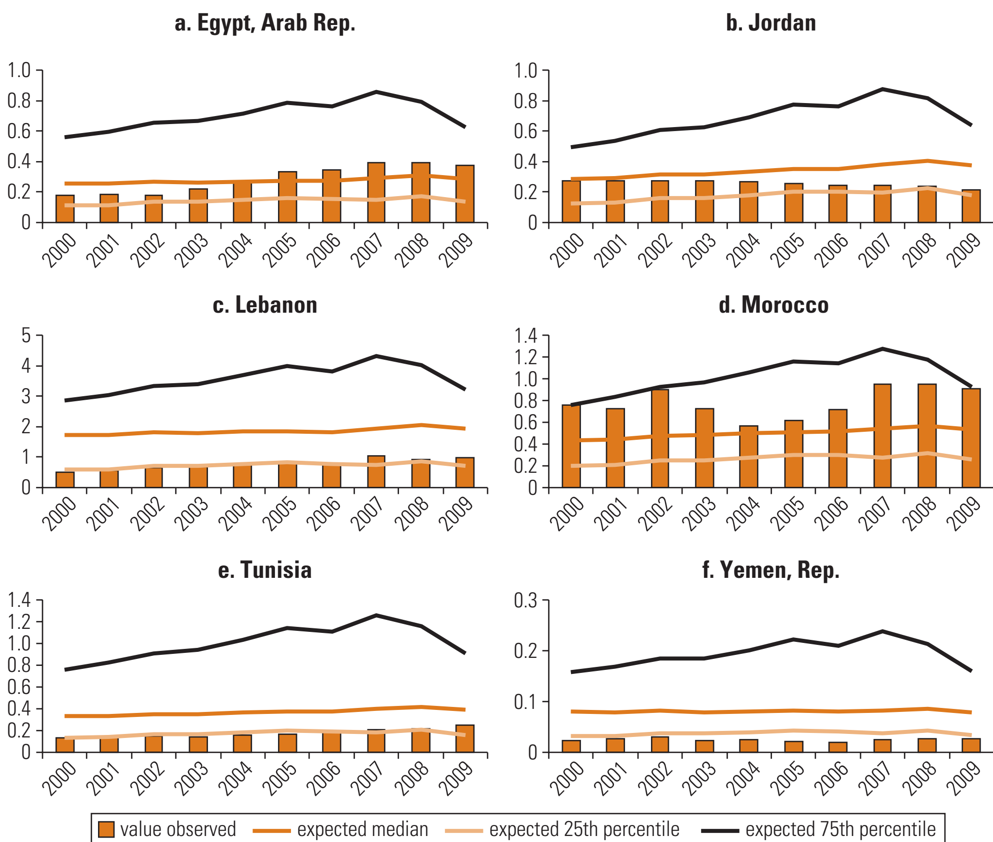


Source: World Bank 2011.

FIGURE A.18

Life Insurance Premiums as a Percentage of GDP in Private-Led Financial Systems outside the Gulf Cooperation Council, 2000–09

(percentage of GDP)

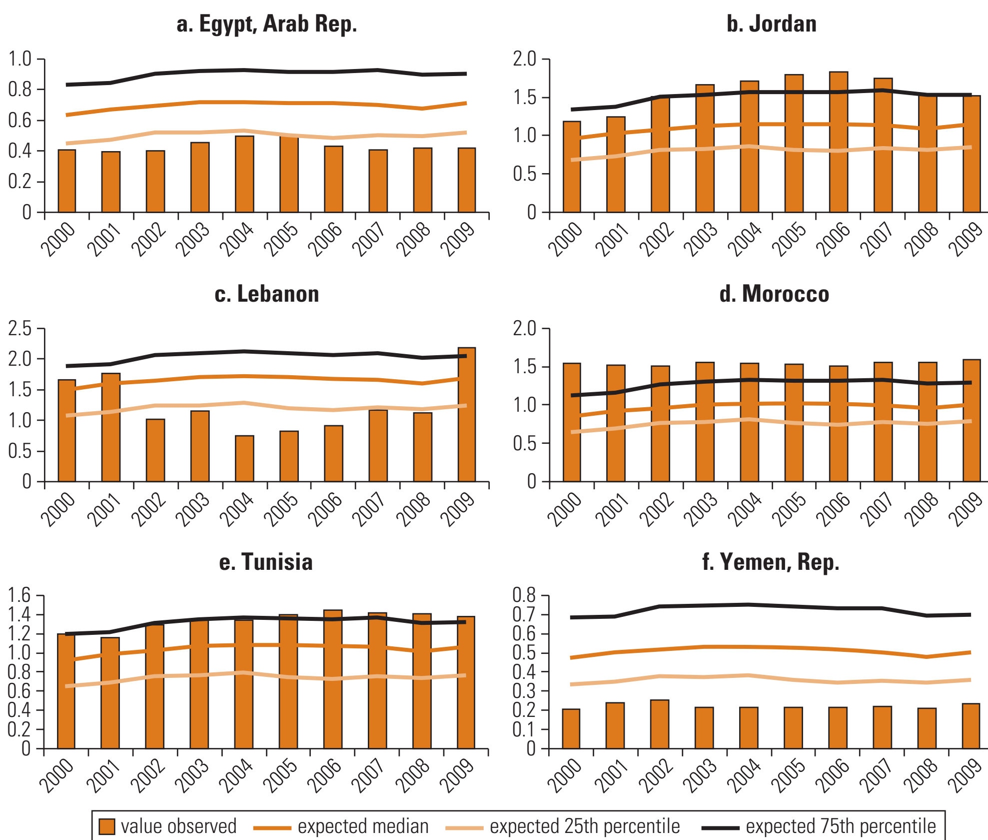


Source: World Bank 2011.

FIGURE A.19

Non–life Insurance Premiums as a Percentage of GDP in Private-Led Financial Systems outside the Gulf Cooperation Council, 2000–09

(percentage of GDP)

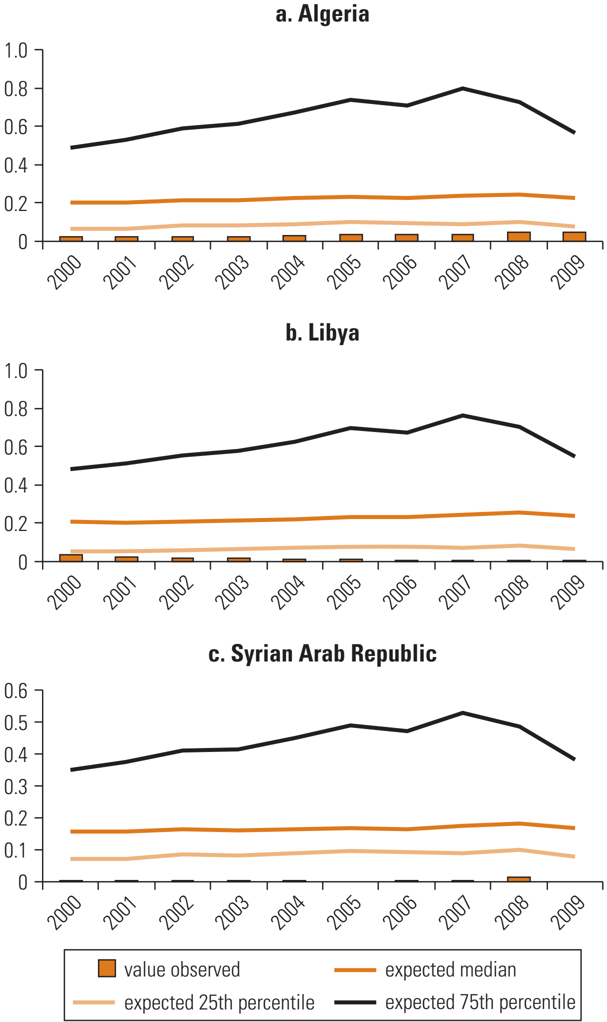


Source: World Bank 2011.

FIGURE A.20

Life Insurance Premiums as a Percentage of GDP in State-Led Financial Systems outside the Gulf Cooperation Council, 2000–09

(percentage of GDP)

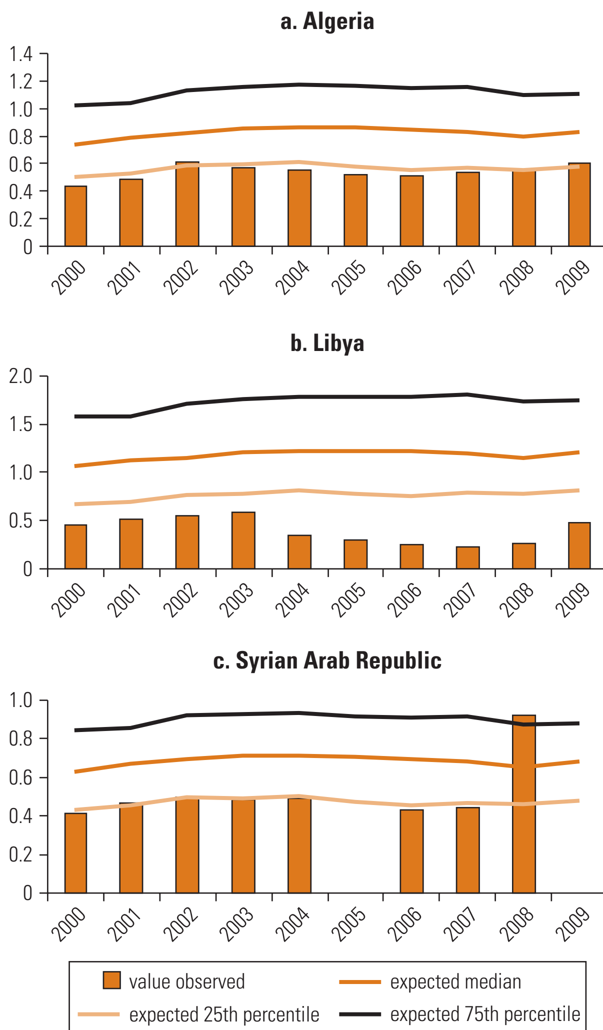


Source: World Bank 2011.

FIGURE A.21

Non–life Insurance Premiums as a Percentage of GDP in State-Led Financial Systems outside the Gulf Cooperation Council, 2000–09

(percentage of GDP)

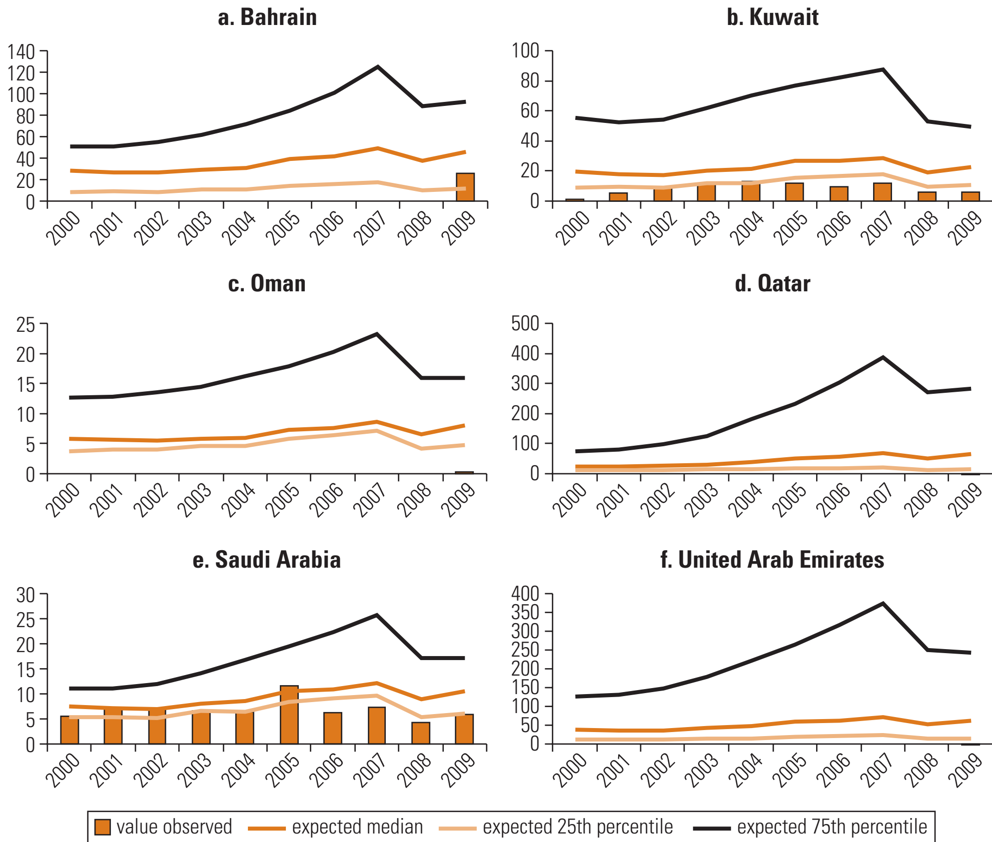


Source: World Bank 2011.

FIGURE A.22

Mutual Fund Assets as a Percentage of GDP in the Gulf Cooperation Council, 2000–09

(percentage of GDP)

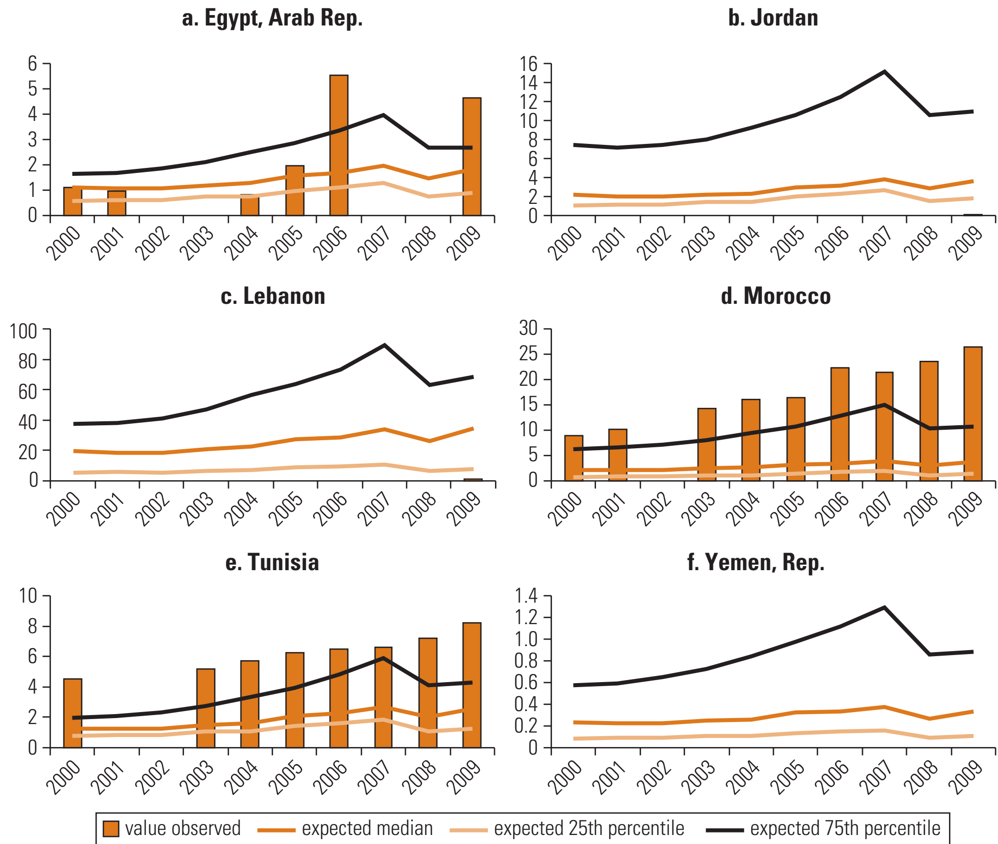


Source: World Bank 2011.

FIGURE A.23

Mutual Fund Assets as a Percentage of GDP in Private-Led Financial Systems outside the Gulf Cooperation Council, 2000–09

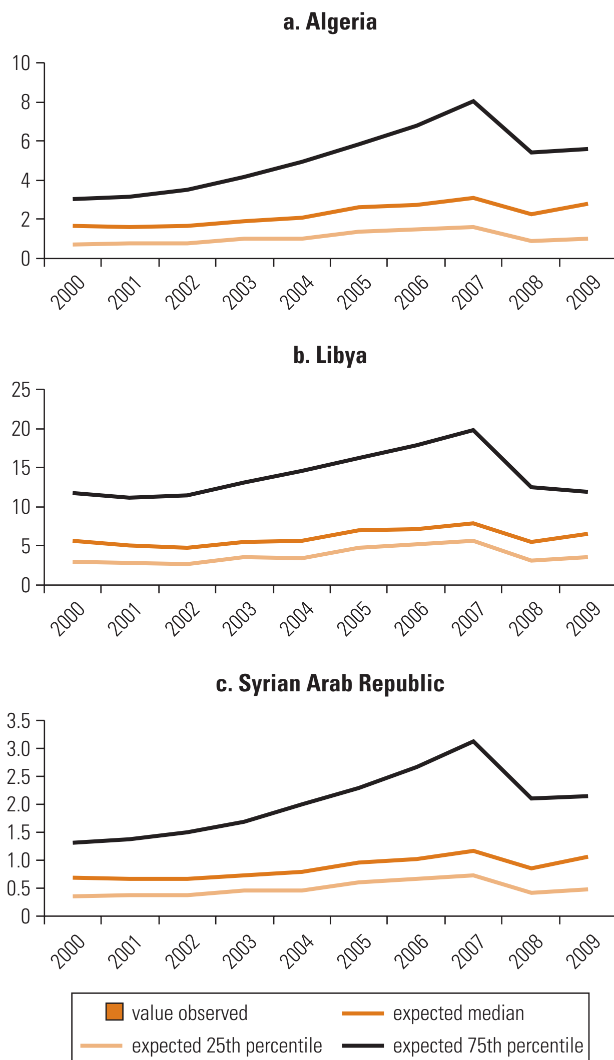
(percentage of GDP)



Source: World Bank 2011.

FIGURE A.24

Mutual Fund Assets as a Percentage of GDP in State-Led Financial Systems outside the Gulf Cooperation Council, 2000–09



Source: World Bank 2011.

Note

1. Median quantile regressions produce expected medians based on minimizing the sum of absolute values of residuals, while ordinary least squares produces an expected mean, based on minimizing the sum of squared residuals.

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APPENDIX B

Stock Price Synchronicity

Market capitalization as a percentage of gross domestic product (GDP) tends to be large in MENA. In many cases, however, it cloaks thin public floats that leave companies under family or state shareholder control. Trading on many MENA stock markets is extensive, but much of it seems to be driven by individuals and retail investor speculation rather than fundamental equity research and institutional investors. Even in terms of turnover, countries in the region rank high compared with other countries, but high turnover does not translate into effective price discovery.

Stock returns reflect new market-level and firm-level information. The extent to which stock returns move together therefore depends on the relative amounts of market- and firm-level information. Other factors being equal, markets that operate in an institutionally sound environment with proper investor protection and better accounting transparency produce more firm-specific information and therefore exhibit more asynchronous price movements.[1]

Two measures of stock price synchronicity are used to assess the quality of price. The simplest conceptual measure is to count the number of stocks that move in the same direction during a given time period. This measure, which is calculated on a weekly basis and lies between 50 and 100 percent, is calculated as follows for country *c* at time *t*:

$$CO-MOVE_{c,t} = \frac{\max[\#\mathrm{UP}_{c,t}, \#\mathrm{DOWN}_{c,t}]}{\#\mathrm{UP}_{c.t} + \#\mathrm{DOWN}_{c.t}}.$$

The second measure takes into account the portion of stock returns explained by the market (R^2). This synchronicity measure uses stock-level regression analysis by estimating the following model for each stock s in country *c* in period *t*:

$$r_{s,c,t} = \alpha + \beta r_{m,t} + \varepsilon_{s,c,t},$$

where $r_{s,c,t}$ represents the individual stock return and $r_{m,t}$ represents the market return. A high R^2 suggests a high degree of price synchronicity.

Table B.1 shows the correlations of measures of market liquidity, synchronicity, and size. The most important result is the high correlation (0.73) between the two price synchronicity measures. This result is expected, as these indicators conceptually represent the same phenomenon. The liquidity measures show moderate intercorrelations, indicating that the individual metrics capture different aspects of liquidity. Market capitalization and the number of firms are positively correlated. The correlation results also highlight that larger markets tend to be more liquid and exhibit less synchronicity. By construction, synchronicity measures exhibit some negative correlation with liquidity, as a high proportion of zero-trading days reduces price synchronicity. Also by construction, synchronicity measures are inherently linked to the number of firms.

Table B.2 shows the results of a regression analysis conducted to examine the drivers of stock price synchronicity, using the co-movement measure. As the measure is bounded between 0.5 and 1, a standard logistic transformation is applied. One of the main results from this analysis suggests that foreign participation contributes to improvements in price synchronicity. After controlling for foreign participation, the main variable is captured by the ratio of gross portfolio equity liabilities to GDP (defined simply as the portfolio of foreign liabilities to total GDP).

To correct for biases arising from market size, the regressions include the number of firms, but the variable is not significant in any

TABLE B.1

Correlations of Market Liquidity, Synchronicity, and Size

Measure	Zero-return days	Value traded top 10	Turnover	Co-move	R^2	Number of firms
Liquidity						
Zero-return days	1.00					
Value traded top 10	0.42	1.00				
Turnover	–0.60	–0.53	1.00			
Synchronicity						
Co-move	–0.32	0.06	0.32	1.00		
R^2	–0.16	0.15	0.33	0.73	1.00	
Size						
Number of firms	–0.21	–0.68	0.31	–0.13	–0.25	1.00
Market cap	–0.31	–0.24	0.27	–0.10	–0.24	0.43

Source: World Bank staff calculations.

Note: Results are based on annual data from 2004 to 2009.

TABLE B.2

Determinants of Stock Price Synchronicity

Variable	(1) Logistic co-move	(2) Logistic co-move	(3) Logistic co-move	(4) Logistic co-move	(5) Logistic R^2
Number of firms	−9.63e−05	−0.0012	0.0016	0.0005	0.0011
	(−0.0578)	(−0.781)	(0.870)	(0.335)	(0.512)
Gross portfolio equity liabilities/GDP	−0.0112*	−0.008**	−0.0118**	−0.009**	−0.0088
	(−1.990)	(−2.485)	(−2.733)	(−3.167)	(−1.793)
Exchange rate (local currency units per $)	0.645***	0.681***	0.658***	0.820***	0.428*
	(5.330)	(5.484)	(4.012)	(5.367)	(2.218)
Industry Herfindahl index			0.700	−0.208	
			(1.097)	(−0.421)	
Log GDP per capita			0.207	0.0527	
			(1.563)	(0.654)	
Stock market turnover		0.0038***		0.0039***	
		(6.440)		(4.472)	
Constant	−0.593**	−0.730***	−2.803*	−1.281	−1.105***
	(−3.073)	(−3.556)	(−2.072)	(−1.575)	(−3.579)
Observations	53	50	41	38	53
R^2	0.408	0.589	0.581	0.710	0.098

Source: World Bank staff calculations.

Note: Dependent variable is the logistic transformation of the co-movement measure ln((Co-move – 0.5)/(1– Co-move)) and the R^2 measure ln((R^2)/(1– R^2)). Regressions use pooled ordinary least squares on annual data for 2004–09. The Herfindahl index is defined as the sum of squared shares in annual GDP of the agriculture, industry, manufacturing, and service sectors. In all regressions, robust *t*-values clustered at the country level are given in parentheses.
* significant at the 10% level; ** significant at the 5% level; *** significant at the 1% level.

of the regressions, suggesting that larger markets do not exhibit greater synchronicity. However, the ratio of portfolio equity liabilities to GDP and the exchange rate, both measures of foreign stock market participation, are significant in all regressions except regression 5, which uses the R^2 measure of price synchronicity; foreign participation has a p-value of 0.104. Overall, the results suggest that more foreign participation and a weaker currency relative to the dollar induce greater synchronicity (lower values). These results persist even after controlling for stock market turnover (regression 2), industry composition and GDP per capita (regressions 3 and 4), and, albeit weakly, use of R^2 as a dependent variable (regression 5).

Note

1. The number of firms in the market or the level of diversification in the economy can also drive synchronicity (better-functioning markets may have more listings). Alternatively, by the law of large numbers, when many stocks co-move randomly, both the R^2 and the co-move measures will be biased toward

lower values. Follow-up regression analysis will attempt to control for this bias. See also Morck, Yeung, and Yu (2000).

Reference

Morck, R., B. Yeung, and W. Yu. 2000. "The Information Content of Stock Markets: Why Do Emerging Markets have Synchronous Stock Price Movements?" *Journal of Financial Economics* 58 (1–2): 215–60.

APPENDIX C

Statistical Appendix

This appendix presents financial sector indicators for economies in the region over time and relative to other regions.

TABLE C.1

Domestic Bank Deposits as a Percentage of GDP, by Economy and by Region, 2000–09

(percentage of GDP)

Economy	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Algeria	26.1	40.6	45.4	45.2	42.4	37.8	40.9	46.1	44.6	47.2
Bahrain	67.1	73.5	72.4	69.9	63.0	64.6	62.8	76.1	76.9	87.2
Egypt, Arab Rep.	64.7	70.1	74.7	82.6	84.4	84.3	83.9	83.2	75.6	71.2
Jordan	90.5	92.0	94.9	103.3	107.0	116.2	114.8	110.2	100.4	104.0
Kuwait	67.0	82.3	79.4	69.4	63.7	53.0	51.8	56.3	53.4	85.4
Lebanon	182.9	192.6	192.1	204.1	207.8	217.4	228.7	230.3	221.4	229.4
Libya	36.9	36.7	28.2	21.4	19.4	17.6	17.4	21.9	27.8	41.2
Morocco	59.2	62.2	63.5	65.0	66.3	72.6	77.0	85.0	84.8	83.4
Oman	28.4	31.5	32.1	30.5	27.6	26.8	28.1	34.4	29.8	41.0
Qatar	41.9	59.6	58.8	50.9	45.7	48.5	48.2	50.8	44.3	58.5
Saudi Arabia	37.4	41.1	46.5	44.5	45.3	41.0	44.3	50.2	48.0	68.7
Syrian Arab Republic	38.3	46.5	54.4	55.4	49.8	46.6	44.6	44.3	51.2	51.4
Tunisia	45.6	46.9	47.0	46.8	47.5	48.6	49.6	51.0	53.3	56.6
United Arab Emirates	45.1	59.4	61.4	60.0	62.0	61.9	63.0	74.0	69.4	86.9
West Bank and Gaza	19.9	23.0	22.9	23.4	21.6	20.2	—	—	—	—
Yemen, Rep.	13.9	15.9	17.6	18.6	19.2	16.9	17.7	19.1	18.4	21.1
Central Europe	35.0	39.4	39.3	38.7	39.9	43.2	46.2	47.5	47.4	50.8
East Asia and Pacific	49.7	51.7	53.0	54.6	55.1	55.4	56.6	59.5	57.9	70.0
Eastern Europe and Central Asia	13.4	15.0	15.9	17.6	19.8	21.9	25.4	29.2	28.6	34.1
High income	89.6	96.7	96.3	97.9	98.9	104.8	110.2	114.9	120.8	123.4
Latin America and Caribbean	38.1	39.9	41.7	42.4	42.8	41.9	43.2	44.6	44.2	47.5
Middle East and North Africa	54.1	60.9	62.0	61.9	60.8	60.9	64.9	68.8	66.6	75.5
South Asia	35.1	38.4	40.7	42.5	44.1	45.5	47.7	50.9	51.4	55.6
Sub-Saharan Africa	24.1	24.5	25.8	27.0	26.3	26.1	28.6	29.7	30.6	33.0

Source: IMF 2011b.

Note: — = Not available.

TABLE C.2

Private Credit as a Percentage of GDP, by Economy and by Region, 2000–09
(percentage of GDP)

Economy and region	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Algeria	5.9	8.0	12.2	11.2	11.0	11.8	12.1	12.9	12.7	16.2
Bahrain	46.1	47.3	50.3	47.9	51.4	51.8	52.4	62.5	75.4	79.6
Egypt, Arab Rep.	52.0	54.9	54.7	53.9	54.0	51.2	49.3	45.5	42.8	36.2
Jordan	71.9	75.5	72.5	70.6	74.6	87.9	94.2	92.0	83.6	78.4
Kuwait	45.4	56.6	58.3	59.5	56.4	50.9	51.2	61.6	60.1	85.4
Lebanon	85.5	83.4	79.4	75.4	73.1	66.1	68.3	70.8	70.4	70.3
Libya	22.7	22.3	17.2	11.5	9.2	6.8	6.0	5.7	6.6	9.8
Morocco	50.7	48.8	48.3	48.7	49.2	53.3	56.9	68.8	75.5	78.0
Oman	37.6	40.2	39.1	36.9	34.3	30.8	31.1	35.7	35.5	49.0
Qatar	26.8	34.9	28.6	30.0	29.0	34.9	36.2	41.0	42.5	51.5
Saudi Arabia	24.4	27.3	29.1	28.4	33.4	36.9	35.6	40.1	41.2	53.0
Syrian Arab Republic	8.5	8.1	8.2	10.2	11.7	14.9	14.9	15.1	17.5	20.0
Tunisia	59.0	60.6	61.2	60.6	61.0	61.6	60.5	60.2	62.7	65.1
United Arab Emirates	46.2	53.2	55.3	53.0	54.5	58.6	64.3	72.7	84.6	97.2
West Bank and Gaza	5.5	6.1	6.4	6.0	6.6	7.5	—	—	—	—
Yemen, Rep.	4.3	5.0	5.1	5.5	6.4	6.1	5.8	6.9	6.7	6.5
Central Europe	27.5	27.4	29.2	32.4	36.8	43.8	51.2	58.9	63.5	56.7
East Asia and Pacific	43.5	42.6	43.4	44.3	44.8	45.2	45.4	48.6	50.2	59.7
Eastern Europe and Central Asia	15.0	13.7	13.8	15.5	17.8	21.2	25.7	33.2	38.5	41.0
High income	99.3	104.5	104.1	107.1	110.7	120.4	130.0	137.7	140.9	143.7
Latin America and Caribbean	36.7	36.2	36.3	33.9	32.9	33.5	35.4	38.3	39.7	40.2
Middle East and North Africa	37.0	39.5	39.1	38.1	38.5	39.4	42.6	46.1	47.9	53.1
South Asia	26.9	27.1	27.6	28.7	31.3	33.6	36.5	39.0	40.6	44.2
Sub-Saharan Africa	15.8	15.8	15.9	17.0	16.7	17.2	18.6	19.9	21.5	22.7

Source: IMF 2011b.

Note: — = not available.

TABLE C.3

Asset Shares of Banks, by Ownership and Country Group, 2001–08
(percent)

Region	2001	2002	2003	2004	2005	2006	2007	2008
Middle East and North Africa								
State banks	41	39	37	38	36	34	34	33
Private banks	59	61	63	62	64	66	66	67
Domestic	42	43	44	44	46	47	47	47
Foreign	18	18	19	18	18	20	19	20
International	8	8	8	8	8	9	9	10
Regional	10	10	10	10	10	10	10	10
Listed banks	56	58	64	66	70	75	76	78
Private	49	50	53	53	55	60	60	61
State	7	8	11	13	15	15	16	17

(Table continues on the following page.)

TABLE C.3 (continued)

Region	2001	2002	2003	2004	2005	2006	2007	2008
Gulf Cooperation Council (GCC)								
State banks	28	28	28	27	28	27	28	28
Private banks	72	72	72	73	72	73	72	72
Domestic	47	46	47	49	48	51	52	52
Foreign	26	26	25	24	23	22	20	20
International	12	12	12	11	10	9	8	9
Regional	13	14	13	13	13	13	12	11
Listed banks	79	79	84	85	86	89	89	90
Private	66	65	67	68	67	69	68	68
State	13	14	17	17	20	20	21	22
Non-GCC								
State banks	56	53	50	52	47	43	43	41
Private banks	44	47	50	48	53	57	57	59
Domestic	36	38	40	38	42	41	38	39
Foreign	8	9	10	10	11	16	19	20
International	3	3	4	4	5	9	12	12
Regional	5	6	6	6	6	7	7	8
Listed banks	29	31	37	41	45	52	54	56
Private	29	31	33	32	38	45	46	48
State	0	0	4	8	7	7	7	7
Non-GCC, private led								
State banks	42	40	39	37	35	30	29	29
Private banks	58	60	61	63	65	70	71	71
Domestic	47	49	49	51	52	52	49	48
Foreign	10	11	12	12	13	18	22	22
International	4	4	5	5	6	11	15	14
Regional	7	7	7	7	7	7	7	8
Listed banks	39	39	46	53	55	65	67	66
Private	39	39	41	42	46	56	58	58
State	0	0	5	11	9	9	8	8
Non-GCC state led								
State banks	98	98	97	96	92	90	90	86
Private banks	2	2	3	4	8	10	10	14
Domestic	1	1	1	1	1	2	2	2
Foreign	1	1	2	3	6	8	9	13
International	0	0	1	1	2	3	3	4
Regional	1	1	1	2	4	6	6	9
Listed banks	0	1	2	3	5	6	12	14
Private	0	1	2	3	5	6	7	11
State	—	—	—	—	—	—	5	3

Source: Bankscope 2011.

Note: — = not available.

TABLE C.4

Number of Banks in the Middle East and North Africa, 2001–08

Region	2001	2002	2003	2004	2005	2006	2007	2008
Middle East and North Africa								
Total Banks	128	135	144	151	158	169	183	172
State Banks	25	24	27	28	27	26	28	26
Private Banks	103	111	117	123	131	143	155	146
Private Domestic	69	73	76	80	83	89	96	86
Private Foreign	34	38	41	43	48	54	59	60
Private Foreign International	11	11	15	14	15	18	20	19
Private Foreign Regional	23	27	26	29	33	36	39	41
Listed Banks	73	77	93	95	103	116	126	125
Listed Private Banks	66	70	82	83	91	104	113	112
Listed State Banks	7	7	11	12	12	12	13	13
GCC								
Total Banks	48	51	52	54	57	61	66	66
State Banks	9	10	10	10	10	10	10	10
Private Banks	39	41	42	44	47	51	56	56
Private Domestic	27	28	29	31	33	37	41	41
Private Foreign	12	13	13	13	14	14	15	15
Private Foreign International	3	3	3	3	3	3	3	3
Private Foreign Regional	9	10	10	10	11	11	12	12
Listed Banks	39	41	47	49	51	56	59	60
Listed Private Banks	32	34	39	41	43	48	51	52
Listed State Banks	7	7	8	8	8	8	8	8
Non-GCC								
Total Banks	80	84	92	97	101	108	117	106
State Banks	16	14	17	18	17	16	18	16
Private Banks	64	70	75	79	84	92	99	90
Private Domestic	42	45	47	49	50	52	55	45
Private Foreign	22	25	28	30	34	40	44	45
Private Foreign International	8	8	12	11	12	15	17	16
Private Foreign Regional	14	17	16	19	22	25	27	29
Listed Banks	34	36	46	46	52	60	67	65
Listed Private Banks	34	36	43	42	48	56	62	60
Listed State Banks	0	0	3	4	4	4	5	5
Non-GCC, private-led								
Total Banks	68	74	80	78	80	84	90	82
State Banks	7	7	10	10	10	9	10	10
Private Banks	61	67	70	68	70	75	80	72
Private Domestic	41	44	46	47	47	49	51	43
Private Foreign	20	23	24	21	23	26	29	29
Private Foreign International	8	8	9	8	9	12	14	13
Private Foreign Regional	12	15	15	13	14	14	15	16
Listed Banks	33	35	42	40	44	51	55	52
Listed Private Banks	33	35	39	36	40	47	51	48
Listed State Banks	0	0	3	4	4	4	4	4
Non-GCC, state-led								
Total Banks	12	10	12	19	21	24	27	24
State Banks	9	7	7	8	7	7	8	6

(Table continues on the following page.)

TABLE C.4 (continued)

Region	2001	2002	2003	2004	2005	2006	2007	2008
Private Banks	3	3	5	11	14	17	19	18
Private Domestic	1	1	1	2	3	3	4	2
Private Foreign	2	2	4	9	11	14	15	16
Private Foreign International	0	0	3	3	3	3	3	3
Private Foreign Regional	2	2	1	6	8	11	12	13
Listed Banks	1	1	4	6	8	9	12	13
Listed Private Banks	1	1	4	6	8	9	11	12
Listed State Banks	0	0	0	0	0	0	1	1

Source: Bankscope 2011.

TABLE C.5

Number of Depositors with Commercial Bank Accounts per 1,000 Adults, by Economy and by Region, 2004–09

Economy and region	2004	2005	2006	2007	2008	2009
Algeria	345.4	343.6	352.6	360.9	371.2	385.3
Bahrain	—	—	—	—	—	—
Egypt, Arab Rep.	—	—	—	—	—	—
Jordan	—	—	—	—	—	—
Kuwait	—	—	—	—	—	—
Lebanon	—	742.1	761.0	780.4	829.8	885.4
Libya	—	—	—	—	—	—
Morocco	197.5	301.5	335.4	378.2	407.2	—
Oman	—	—	—	—	—	1042.4
Qatar	623.7	671.7	687.5	685.2	711.0	766.4
Saudi Arabia	411.3	479.9	571.7	620.0	714.0	809.3
Syrian Arab Republic	—	—	—	—	255.0	236.1
Tunisia	—	—	—	—	—	—
United Arab Emirates	—	—	—	—	—	—
West Bank and Gaza	—	—	—	—	—	561.0
Yemen, Rep.	44.0	54.0	63.8	68.0	79.3	98.6
Central Europe	859.3	1,044.6	1,096.9	1,154.3	1,286.2	1,398.6
East Asia and Pacific	1,044.7	691.1	749.1	812.4	760.1	769.6
Eastern Europe and Central Asia	471.2	910.8	1,012.1	1,110.6	1,173.0	1,018.4
High income	2,382.6	2,332.4	2,347.3	2,166.1	2,413.9	2,460.2
Latin America and the Caribbean	594.8	579.9	650.0	713.7	781.4	835.2
Middle East and North Africa	324.4	432.2	462.0	482.1	481.1	598.1
South Asia	342.7	349.3	372.7	390.4	415.3	259.2
Sub-Saharan Africa	204.6	233.9	232.2	246.5	297.2	338.3

Source: IMF 2011a.

Note: — = not available.

TABLE C.6

Number of Borrowers from Commercial Banks per 1,000 Adults, by Economy and by Region, 2004–09

Economy and region	2004	2005	2006	2007	2008	2009
Algeria	26.3	25.8	25.0	25.2	26.4	25.6
Bahrain	—	—	—	—	—	—
Egypt, Arab Rep.	—	—	—	—	—	—
Jordan	—	—	—	—	—	—
Kuwait	—	—	—	—	—	—
Lebanon	—	174.9	196.6	218.1	248.2	280.0
Libya	—	—	—	—	—	—
Morocco	—	—	—	—	—	—
Oman	—	—	—	—	—	412.8
Qatar	307.9	314.4	327.0	354.3	361.2	387.3
Saudi Arabia	93.4	113.6	142.6	155.9	184.4	187.3
Syrian Arab Republic	—	—	—	—	65.3	74.4
Tunisia	75.5	86.5	118.9	126.3	139.7	153.0
United Arab Emirates	—	—	—	—	—	—
West Bank and Gaza	—	—	—	—	—	70.3
Yemen, Rep.	—	—	—	—	—	—
Central Europe	504.3	436.4	427.9	523.6	447.7	447.4
East Asia and Pacific	167.1	159.5	179.7	187.5	235.5	212.3
Eastern Europe and Central Asia	34.0	48.4	64.1	114.3	174.1	146.7
High income	437.3	501.6	527.2	517.9	555.1	516.4
Latin America and the Caribbean	118.7	159.8	171.9	194.9	217.6	229.6
Middle East and North Africa	125.7	143.3	161.9	177.1	171.1	189.2
South Asia	86.0	93.5	74.3	80.3	82.6	53.4
Sub-Saharan Africa	52.2	150.3	146.2	159.7	165.3	174.0

Source: IMF 2011a.

Note: — = not available.

TABLE C.7

Number of Commercial Bank Deposits and Loan Accounts per 1,000 Adults, by Economy, and by Region 2008–09

	Deposits		Loans	
Economy and region	2008	2009	2008	2009
Algeria	683.0	736.6	—	—
Bahrain	—	—	—	—
Egypt, Arab Rep.	—	—	—	—
Jordan	814.2	898.8	160.5	200.6
Kuwait	—	—	—	—
Lebanon	1,310.4	1,372.0	—	519.9
Libya	—	—	—	—
Morocco	277.4	265.3	—	—
Oman	—	1,042.6	—	412.8
Qatar	—	—	—	—
Saudi Arabia	—	—	—	—
Syrian Arab Republic	157.4	191.5	23.3	72.9

(Table continues on the following page.)

TABLE C.7 (continued)

Economy and region	Deposits		Loans	
	2008	2009	2008	2009
Tunisia	672.0	639.7	175.8	193.5
United Arab Emirates	—	1,750.6	—	—
West Bank and Gaza	—	—	—	—
Yemen, Rep.	105.7	103.9	5.7	8.3
Central Europe	1,791.4	1,985.0	548.7	525.4
East Asia and Pacific	1,122.8	1,116.9	345.1	343.9
Eastern Europe and Central Asia	992.3	931.4	329.1	235.0
High income	2,437.2	2,385.2	831.6	764.7
Latin America and the Caribbean	823.9	970.7	315.4	356.1
Middle East and North Africa	574.3	777.9	91.3	234.7
South Asia	608.5	796.3	147.7	71.2
Sub-Saharan Africa	365.9	342.3	99.5	98.3

Source: World Bank 2011a.

Note: — = not available.

TABLE C.8

Number of Listed Companies on Stock Market, by Economy and by Region, 2000–09

Economy and region	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Algeria	—	—	—	—	—	—	—	—	1	1
Bahrain	42	42	42	42	42	47	49	43	45	49
Egypt, Arab Rep.	1076	1110	1148	967	792	744	603	435	373	305
Jordan	163	161	158	161	192	201	227	245	262	272
Kuwait	77	78	85	97	113	143	163	181	202	207
Lebanon	12	12	13	13	13	11	11	11	11	11
Libya	—	—	—	—	—	—	—	—	—	—
Morocco	53	55	55	53	52	56	65	74	77	78
Oman	131	91	96	96	96	96	124	125	127	127
Qatar	22	—	—	—	29	31	36	40	42	48
Saudi Arabia	75	76	68	70	73	77	86	111	127	127
Syrian Arab Republic	—	—	—	—	—	—	—	—	—	14
Tunisia	44	46	47	46	44	46	48	50	49	49
United Arab Emirates	54	12	24	30	50	79	81	90	96	95
West Bank and Gaza	24	24	27	27	27	28	33	35	—	—
Yemen, Rep.	—	—	—	—	—	—	—	—	—	—
Central Europe	627	582	536	505	469	440	336	323	295	288
East Asia and Pacific	532	473	496	403	424	437	453	467	538	632
Eastern Europe and Central Asia	97	95	120	203	169	231	247	313	119	324
High income	832	790	948	952	966	1,003	1,010	1,031	1,066	944
Latin America and the Caribbean	119	107	102	94	92	94	94	98	112	98
Middle East and North Africa	148	155	160	146	127	130	127	120	118	106
South Asia	1,454	1,426	1,387	1,382	1,200	1,210	1,218	1,240	1,249	1,243
Sub-Saharan Africa	93	79	72	65	64	64	64	76	72	83

Source: World Bank 2011c.

Note: — = not available.

TABLE C.9

Stock Market Capitalization as a Percentage of GDP, by Economy and by Region, 2000–09

(percentage of GDP)

Economy and region	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Algeria	—	—	—	—	—	—	—	—	0.06	—
Bahrain	83.1	83.2	80.7	99.5	120.3	129.0	133.2	152.3	96.7	82.2
Egypt, Arab Rep.	28.8	24.9	29.7	32.6	48.9	88.8	87.0	106.8	52.7	47.8
Jordan	58.4	70.3	73.9	107.5	161.1	298.0	200.3	242.4	169.0	139.8
Kuwait	55.1	66.5	80.5	124.1	116.7	161.0	127.0	163.9	72.4	—
Lebanon	9.2	7.0	7.3	7.5	10.7	22.5	36.9	43.3	32.3	37.4
Libya	—	—	—	—	—	—	—	—	—	—
Morocco	29.4	24.1	21.3	26.4	44.0	45.7	75.2	100.4	74.0	69.2
Oman	17.4	13.1	19.9	23.3	25.6	49.4	43.9	55.0	24.7	37.5
Qatar	29.0	—	—	113.5	166.9	205.6	108.4	134.4	107.4	89.4
Saudi Arabia	35.6	40.0	39.7	73.3	122.3	204.7	91.7	134.1	51.9	86.3
Syrian Arab Republic	—	—	—	—	—	—	—	—	—	2.5
Tunisia	14.5	11.5	10.1	9.9	9.4	9.9	14.4	15.0	15.6	23.1
United Arab Emirates	8.1	8.4	27.1	34.3	90.5	169.6	84.8	108.2	37.4	47.6
West Bank and Gaza	18.6	21.7	20.3	20.7	30.4	111.1	—	—	—	—
Yemen, Rep.	—	—	—	—	—	—	—	—	—	—
Central Europe	15.0	13.1	14.7	17.8	24.4	24.6	32.9	41.5	15.1	21.2
East Asia and Pacific	37.9	41.6	40.9	46.7	46.2	43.7	62.4	76.4	33.6	57.5
Eastern Europe and Central Asia	4.3	4.8	7.0	10.3	11.1	17.8	30.3	43.3	12.5	23.1
High income	101.7	85.2	69.5	86.2	93.4	99.8	119.6	128.3	55.0	75.4
Latin America and the Caribbean	25.4	27.1	27.8	27.1	32.7	34.3	36.9	47.8	29.7	41.1
Middle East and North Africa	32.3	33.7	37.3	56.0	78.9	124.6	91.2	114.2	61.2	60.3
South Asia	12.9	9.9	11.8	18.3	23.7	30.6	35.0	55.5	25.0	36.2
Sub-Saharan Africa	24.0	19.1	24.8	25.9	30.2	32.0	41.2	60.9	40.6	55.4

Source: World Bank 2011c.

Note: — Not available.

TABLE C.10

Stock Market Turnover as a Percentage of GDP, by Economy and by Region, 2000–09

(percentage of GDP)

Economy and region	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Algeria	—	—	—	—	—	—	—	—	—	—
Bahrain	3.1	2.5	2.5	2.8	3.7	5.3	9.0	8.8	13.5	4.2
Egypt, Arab Rep.	11.1	4.0	2.9	4.0	7.1	28.3	44.2	40.7	42.8	28.0
Jordan	4.9	10.4	14.0	25.6	46.7	188.5	135.1	102.5	132.0	59.9
Kuwait	11.2	32.8	56.8	110.1	81.8	116.4	55.0	105.2	82.9	—
Lebanon	0.7	0.3	0.6	0.7	0.9	4.2	9.1	4.0	2.4	3.0
Libya	—	—	—	—	—	—	—	—	—	—
Morocco	3.0	2.6	1.5	1.4	2.9	7.0	20.6	34.9	24.7	32.4
Oman	2.8	2.2	2.6	5.8	7.2	10.4	9.0	13.0	13.9	12.6
Qatar	1.3	—	—	—	—	66.1	36.2	42.1	43.5	25.9
Saudi Arabia	9.2	12.1	18.9	74.1	188.9	349.7	393.4	177.0	110.4	91.3

(Table continues on the following page.)

TABLE C.10 (continued)

Economy and region	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Syrian Arab Republic	—	—	—	—	—	—	—	—	—	—
Tunisia	3.2	1.6	1.1	0.7	0.8	1.6	1.7	1.8	3.7	3.2
United Arab Emirates	0.2	0.2	0.5	1.1	4.3	107.6	69.2	72.4	55.4	28.5
West Bank and Gaza	4.6	2.3	1.6	1.9	5.6	52.2	—	—	—	—
Yemen, Rep.	—	—	—	—	—	—	—	—	—	—
Central Europe	10.9	6.2	5.5	5.9	7.7	11.6	11.5	14.0	8.5	7.7
East Asia and Pacific	27.0	14.0	14.1	16.9	18.9	15.0	19.7	51.6	30.0	44.0
Eastern Europe and Central Asia	1.8	1.3	1.6	2.5	3.3	3.0	7.1	8.8	4.7	6.3
High income	92.4	76.1	68.2	60.1	69.3	83.5	108.9	145.0	99.1	71.9
Latin America and the Caribbean	3.4	2.0	1.9	2.0	3.1	3.8	4.4	9.1	9.3	7.7
Middle East and North Africa	4.6	5.9	8.6	19.0	29.2	78.1	70.3	53.9	46.9	28.2
South Asia	31.7	14.5	15.7	26.5	26.6	37.5	34.4	34.3	27.3	22.8
Sub-Saharan Africa	5.8	5.5	6.2	5.2	6.3	6.9	10.2	19.1	18.7	16.3

Source: World Bank 2011c.

Note: — = not available.

TABLE C.11

Stock Market Turnover Ratio, by Economy and by Region, 2000–09

(turnover/market capitalization)

Economy and region	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Algeria	—	—	—	—	—	—	—	—	—	—
Bahrain	3.6	3.0	3.0	3.3	3.6	4.6	7.4	6.6	12.0	4.5
Egypt, Arab Rep.	34.7	14.2	16.1	13.7	17.3	43.0	54.8	45.6	61.9	60.1
Jordan	7.7	16.6	14.8	28.9	36.3	85.0	59.5	49.1	72.7	40.3
Kuwait	21.3	49.3	70.6	88.7	70.1	94.3	43.2	76.2	83.2	68.9
Lebanon	6.7	4.1	4.7	9.0	10.3	25.5	30.8	10.4	6.9	9.3
Libya	—	—	—	—	—	—	—	—	—	—
Morocco	9.2	10.0	10.7	6.5	9.1	15.9	35.3	42.1	31.1	45.7
Oman	14.2	14.6	13.0	27.7	31.5	29.8	21.1	27.7	44.2	36.2
Qatar	4.5	—	—	—	—	40.0	27.6	38.1	56.1	31.1
Saudi Arabia	27.1	31.7	30.4	137.0	204.1	231.7	288.4	161.5	137.8	119.3
Syrian Arab Republic	—	—	—	—	—	—	—	—	—	—
Tunisia	23.3	12.6	13.7	7.2	9.2	16.5	14.3	13.3	25.5	16.2
United Arab Emirates	2.5	3.9	3.4	3.2	4.8	89.6	62.1	82.8	89.9	63.4
West Bank and Gaza	24.7	10.0	10.3	1.7	18.4	89.1	29.7	31.3	—	—
Yemen, Rep.	—	—	—	—	—	—	—	—	—	—
Central Europe	56.6	43.7	50.2	36.9	38.6	43.9	37.3	40.3	37.6	33.1
East Asia and Pacific	61.0	50.8	51.6	40.0	59.9	33.2	34.1	62.4	51.2	75.9
Eastern Europe and Central Asia	28.3	18.1	27.2	37.1	86.9	33.3	33.7	33.2	20.0	26.8
High income	88.6	88.9	98.6	86.0	83.5	91.3	105.6	129.2	130.6	101.5
Latin America and the Caribbean	13.7	7.6	7.4	6.9	14.0	10.8	9.9	14.0	18.3	18.0
Middle East and North Africa	15.0	15.5	17.3	29.7	37.7	63.7	56.2	48.7	56.5	45.0
South Asia	173.6	124.1	138.5	173.5	123.1	105.7	83.5	73.8	72.6	86.7
Sub-Saharan Africa	7.9	9.6	13.6	8.9	10.8	6.8	8.2	13.1	14.4	11.3

Source: World Bank 2011c.

Note: — = not available.

TABLE C.12

Zero-Return Trading Days as a Percentage of Total Trading Days, by Economy, 2004–09

(percent)

Economy and region	2004	2005	2006	2007	2008	2009
Algeria	—	—	—	—	—	—
Bahrain	77	70	74	71	72	79
Egypt, Arab Rep.	64	55	50	37	33	24
Jordan	49	34	31	34	31	39
Kuwait	50	41	48	47	45	49
Lebanon	79	82	73	78	74	75
Libya	—	—	—	—	—	—
Morocco	55	49	38	30	30	38
Oman	73	70	69	72	64	65
Qatar	27	13	10	15	14	19
Saudi Arabia	11	4	4	12	11	10
Syrian Arab Republic	—	—	—	—	—	—
Tunisia	58	54	46	45	36	35
United Arab Emirates	5	42	40	37	36	45
West Bank and Gaza	—	—	—	—	—	—
Yemen, Rep.	—	—	—	—	—	—

Source: World Bank staff calculations based on data from Bloomberg database.

Note: — = not available.

TABLE C.13

Average Weekly Co-Movement of Stocks, by Economy, 2004–09

(percentage)

Economy and region	2004	2005	2006	2007	2008	2009
Algeria	—	—	—	—	—	—
Bahrain	66	65	65	62	66	65
Egypt, Arab Rep.	62	70	69	64	73	74
Jordan	66	63	64	60	63	60
Kuwait	62	61	69	59	67	68
Lebanon	82	79	78	76	77	70
Libya	—	—	—	—	—	—
Morocco	65	67	68	66	65	61
Oman	65	67	69	65	73	70
Qatar	68	76	74	71	72	75
Saudi Arabia	72	73	78	77	79	76
Syrian Arab Republic	—	—	—	—	—	—
Tunisia	60	60	61	63	63	63
United Arab Emirates	68	65	70	68	69	72
West Bank and Gaza	—	—	—	—	—	—
Yemen, Rep.	—	—	—	—	—	—

Source: World Bank staff calculations based on data from Bloomberg database.

Note: — = not available.

TABLE C.14

Portion of Biweekly Returns Explained by Market, by Economy, 2004–09
(percentage)

Economy and region	2004	2005	2006	2007	2008	2009
Algeria	—	—	—	—	—	—
Bahrain	15	21	22	16	25	18
Egypt, Arab Rep.	17	26	30	12	41	27
Jordan	27	23	26	14	30	16
Kuwait	21	14	31	16	37	32
Lebanon	19	32	62	39	39	43
Libya	—	—	—	—	—	—
Morocco	27	21	29	30	32	36
Oman	21	22	27	17	41	27
Qatar	30	56	38	30	53	51
Saudi Arabia	33	18	54	37	52	50
Syrian Arab Republic	—	—	—	—	—	—
Tunisia	11	12	15	16	8	—
United Arab Emirates	26	25	32	25	39	40
West Bank and Gaza	—	—	—	—	—	—
Yemen, Rep.	—	—	—	—	—	—

Source: World Bank staff calculations based on data from Bloomberg database.

Note: — = not available.

TABLE C.15

Insurance Company Assets as a Percentage of GDP, by Economy and by Region, 2000–09
(percentage of GDP)

Economy and region	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Algeria	1.3	1.3	—	1.1	1.1	1.0	0.8	0.8	0.8	—
Bahrain	2.6	2.8	2.8	2.8	3.8	4.5	5.0	11.3	9.5	12.2
Egypt, Arab Rep.	4.1	4.1	4.1	4.1	3.8	3.7	3.6	3.4	3.8	3.9
Jordan	3.7	3.7	3.8	4.3	4.5	5.9	5.2	5.4	4.8	—
Kuwait	—	—	—	—	—	—	—	—	1.8	—
Lebanon	—	4.5	—	—	—	6.6	7.0	7.6	7.2	—
Libya	—	—	—	—	—	—	—	—	—	—
Morocco	—	—	—	16.1	15.7	16.1	15.9	19.0	17.9	—
Oman	—	—	—	—	1.8	1.7	2.1	2.2	2.0	2.4
Qatar	—	—	—	—	3.4	4.6	3.0	3.7	2.7	—
Saudi Arabia	—	—	—	—	—	—	—	—	0.8	—
Syrian Arab Republic	—	—	—	—	—	—	—	—	—	—
Tunisia	—	0.5	0.6	0.7	0.7	0.7	0.7	0.6	0.6	—
United Arab Emirates	—	—	—	—	—	—	4.1	4.4	3.1	—
West Bank and Gaza	—	—	—	—	—	—	—	—	—	—
Yemen, Rep.	—	—	—	—	—	—	—	—	—	—

(Table continues on the following page.)

TABLE C.15 (continued)

Economy and region	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Central Europe	4.1	3.7	3.6	3.7	4.0	4.4	5.2	5.6	5.1	5.6
East Asia and Pacific	—	2.2	8.5	9.2	9.0	8.4	8.8	8.7	8.8	8.8
Eastern Europe and Central Asia	—	—	1.9	1.8	1.3	2.1	1.6	1.8	1.6	2.8
High income	44.2	42.5	41.2	43.6	46.0	49.9	51.6	51.9	45.0	49.1
Latin America and the Caribbean	4.3	3.7	3.9	4.6	4.7	4.7	4.4	4.5	4.9	6.1
Middle East and North Africa	2.9	2.8	2.8	4.9	4.4	5.0	4.7	5.8	4.4	6.2
South Asia	2.8	1.3	2.7	0.8	5.6	6.5	5.5	6.8	6.4	10.4
Sub-Saharan Africa	10.2	7.7	8.2	6.2	6.5	6.4	6.1	1.6	4.3	27.7

Source: Axco 2011.

Note: — = not available.

TABLE C.16

Life Insurance Premiums as a Percentage of GDP, by Economy and by Region, 2000–09

(percentage of GDP)

Economy and region	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Algeria	0	0	0	0	0	0	0	0	0	0
Bahrain	0.4	0.4	0.4	0.5	0.4	0.3	0.4	0.5	0.6	0.7
Egypt, Arab Rep.	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.4	0.4	0.4
Jordan	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2
Kuwait	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	—
Lebanon	0.5	0.6	0.6	0.7	0.8	0.8	0.8	1.1	0.9	1.0
Libya	0	0	0	0	0	0	0	0	0	0
Morocco	0.8	0.7	0.9	0.7	0.6	0.6	0.7	1.0	1.0	0.9
Oman	0.1	0.2	0.2	0.2	0.2	0.1	0.2	0.2	0.2	0.2
Qatar	—	—	0	0	0	0	0	0	—	—
Saudi Arabia	0	0	0	0	—	0	0	0	0	0.1
Syrian Arab Republic	0	0	0	0	0	—	0	0	0	—
Tunisia	0.1	0.1	0.2	0.1	0.2	0.2	0.2	0.2	0.2	0.3
United Arab Emirates	0.3	0.3	0.3	0.3	0.3	0.2	0.3	0.4	0.3	—
West Bank and Gaza	—	—	—	—	—	—	—	—	—	—
Yemen, Rep.	0	0	0	0	0	0	0	0	0	0
Central Europe	0.6	0.6	0.7	0.7	0.7	0.8	0.9	1.0	1.0	1.0
East Asia and Pacific	0.8	1.0	1.1	1.2	1.2	1.1	1.2	1.2	1.2	1.3
Eastern Europe and Central Asia	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
High income	4.5	4.4	4.3	4.2	4.3	4.5	4.5	4.8	4.5	4.5
Latin America and the Caribbean	0.7	1.2	1.1	1.4	1.5	1.3	1.2	1.0	0.7	0.6
Middle East and North Africa	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.3
South Asia	0.5	0.6	0.7	0.7	0.8	0.8	0.9	1.2	1.2	1.3
Sub-Saharan Africa	0.9	0.8	0.9	0.8	0.8	0.8	0.8	0.9	0.9	1.5

Source: Axco 2011.

Note: — = not available.

TABLE C.17

Non–life Insurance Premiums as a Percentage of GDP, by Economy and by Region, 2000–09

(percentage of GDP)

Economy and region	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Algeria	0.4	0.5	0.6	0.6	0.6	0.5	0.5	0.5	0.6	0.6
Bahrain	1.3	1.5	1.7	1.7	1.7	1.5	1.6	1.3	1.4	1.4
Egypt, Arab Rep.	0.4	0.4	0.4	0.5	0.5	0.5	0.4	0.4	0.4	0.4
Jordan	1.2	1.2	1.5	1.7	1.7	1.8	1.8	1.7	1.5	1.5
Kuwait	0.5	0.6	0.6	0.6	0.5	0.4	0.4	0.4	0.3	0.3
Lebanon	1.7	1.8	1.0	1.1	0.7	0.8	0.9	1.2	1.1	2.2
Libya	0.5	0.5	0.5	0.6	0.4	0.3	0.3	0.2	0.3	0.5
Morocco	1.6	1.5	1.5	1.6	1.5	1.5	1.5	1.6	1.6	1.5
Oman	0.5	0.9	1.1	1.1	0.9	0.8	0.9	0.8	0.7	1.0
Qatar	0.7	0.8	1.1	1.0	1.0	1.0	1.8	1.2	0.7	—
Saudi Arabia	0.2	0.3	0.3	0.4	—	0.3	0.3	0.4	0.3	0.5
Syrian Arab Republic	0.4	0.5	0.5	0.5	0.5	—	0.4	0.4	0.9	—
Tunisia	1.2	1.2	1.3	1.3	1.3	1.4	1.4	1.4	1.4	1.4
United Arab Emirates	0.9	1.1	1.2	1.3	1.3	1.2	1.3	1.3	1.3	—
West Bank and Gaza	—	—	—	—	—	—	—	—	—	—
Yemen, Rep.	0.2	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Central Europe	1.4	1.4	1.5	1.6	1.6	1.6	1.6	1.6	1.6	1.6
East Asia and Pacific	0.7	0.7	0.8	0.8	0.8	0.8	0.8	0.8	0.9	0.9
Eastern Europe and Central Asia	0.7	0.8	0.9	0.9	1.1	0.9	0.8	0.8	0.9	0.9
High income	2.0	2.1	2.2	2.3	2.2	2.2	2.2	2.1	2.2	2.2
Latin America and the Caribbean	1.3	1.5	1.7	1.5	1.5	1.4	1.5	1.5	1.4	1.4
Middle East and North Africa	0.8	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	1.0
South Asia	0.4	0.4	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Sub-Saharan Africa	0.7	0.7	0.8	0.8	0.8	0.9	0.8	0.8	0.8	1.0

Source: Axco 2011.

Note: — = not available.

TABLE C.18

Mutual Funds Assets as a Percentage of GDP, by Economy and by Region, 2000–09

(percentage of GDP)

Economy and region	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Algeria	0	0	0	0	0	0	0	0	0	0
Bahrain	—	—	—	—	—	—	—	—	—	25.5
Egypt, Arab Rep.	1.1	1.0	—	—	0.8	2.0	5.5	—	—	4.6
Jordan	—	—	—	—	—	—	—	—	—	0.1
Kuwait	1.1	5.6	8.8	11.8	13.4	12.2	9.6	12.1	5.7	5.7
Lebanon	—	—	—	—	—	—	—	—	—	1.0
Libya	0	0	0	0	0	0	0	0	0	0

(Table continues on the following page.)

TABLE C.18 (continued)

Economy and region	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Morocco	9.0	10.2	15.6	14.2	16.0	16.4	22.4	21.4	23.5	26.4
Oman	—	—	—	—	—	—	—	—	—	0.4
Qatar	—	—	—	—	—	—	—	—	—	0.1
Saudi Arabia	5.5	7.3	6.9	6.7	6.4	11.6	6.3	7.3	4.2	5.8
Syrian Arab Republic	0	0	0	0	0	0	0	0	0	0
Tunisia	4.5	—	—	5.2	5.7	6.3	6.5	6.6	7.2	8.2
United Arab Emirates	—	—	—	—	—	—	—	—	—	0.3
West Bank and Gaza	0	0	0	0	0	0	0	0	0	0
Yemen, Rep.	0	0	0	0	0	0	0	0	0	0
Central Europe	1.7	2.0	2.7	2.9	3.6	4.2	5.1	6.3	3.8	5.2
East Asia and Pacific	4.5	5.1	8.3	10.7	7.6	12.0	8.8	14.9	10.1	14.7
Eastern Europe and Central Asia	0.1	0.1	0.1	0.2	0.2	0.3	0.5	0.7	0.1	0.3
High income	192.9	188.9	179.9	186.5	201.7	214.9	253.0	266.9	175.0	244.8
Latin America and the Caribbean	6.7	6.5	8.2	11.7	10.5	9.4	9.4	9.5	8.9	12.0
Middle East and North Africa	2.1	2.7	3.9	4.2	4.2	4.9	5.0	5.3	4.5	4.9
South Asia	1.8	1.9	1.7	2.6	1.6	4.8	3.2	8.8	5.2	9.9
Sub-Saharan Africa	12.7	12.3	18.9	11.0	8.8	26.5	29.9	33.3	25.1	37.2

Source: World Bank 2011b.

Note: — = not available.

TABLE C.19

Assets under Management, by Type of Fund and Economy, 2009

(US$ millions)

Economy and region	Equity	Fixed income	Short term	Hybrid	Total
Algeria	0	0	0	0	0
Bahrain	885	318	0	5	1,208
Egypt, Arab Rep.	492	31	7,869	343	8,735
Jordan	0	0	0	17	17
Kuwait	4,143	512	824	35	5,514
Lebanon	0	240	0	112	352
Libya	0	0	0	0	0
Morocco	2,267	11,705	6,685	842	21,499
Oman	191	0	0	0	191
Qatar	122	0	0	0	122
Saudi Arabia	5,278	47	15,721	418	21,464
Syrian Arab Republic	0	0	0	0	0
Tunisia	235	2,555	0	99	2,889
United Arab Emirates	729	42	9	5	785
West Bank and Gaza	0	0	0	0	0
Yemen, Rep.	0	0	0	0	0

Source: World Bank staff calculations based on data from Zawya 2011 and local stock exchanges.

TABLE C.20

Leasing as a Percentage of GDP, by Economy and by Region, 2005–08

(percentage of GDP)

Economy and region	2005	2006	2007	2008
Algeria	—	0.2	—	—
Bahrain	—	1.5	—	—
Egypt, Arab Rep.	0.4	0.4	0.4	0.4
Jordan	—	—	—	1.1
Kuwait	—	—	1.5	—
Lebanon	0.3	—	—	—
Libya	0	0	0	0
Morocco	1.5	1.4	2.0	1.9
Oman	—	—	1.2	—
Qatar	—	—	1.1	—
Saudi Arabia	—	—	0.3	—
Syrian Arab Republic	0	0	0	0
Tunisia	2.0	—	—	—
United Arab Emirates	1.8	—	—	—
West Bank and Gaza	—	—	—	0
Yemen, Rep.	—	—	—	0
Central Europe	2.9	4.1	4.8	3.6
East Asia and Pacific	0.3	0.2	0.2	0.5
Eastern Europe and Central Asia	1.1	0.7	3.3	2.0
High income	1.4	1.5	1.7	1.4
Latin America and the Caribbean	0.9	1.0	1.4	1.2
Middle East and North Africa	0.9	0.6	0.8	0.5
South Asia	1.5	2.8	—	—
Sub-Saharan Africa	1.7	2.2	1.3	1.5

Source: World Bank staff compilation based on data from White Clarke 2010 and World Bank 2010.

Note: — = not available.

TABLE C.21

Factoring as a Percentage of GDP, by Economy and by Region, 2002–09

(percentage of GDP)

Economy and region	2002	2003	2004	2005	2006	2007	2008	2009
Algeria	0	0	0	0	0	0	0	0
Bahrain	—	—	—	—	—	—	—	—
Egypt, Arab Rep.	0	0	0	0	0	0.02	0.05	0.08
Jordan	0	0	0	0	0	0	0	0.26
Kuwait	—	—	—	—	—	—	—	—
Lebanon	0.11	0.20	0.24	0.35	0.53	0.96	2.01	1.77
Libya	—	—	—	—	—	—	—	—
Morocco	0.43	0.36	0.65	0.90	0.84	1.20	1.46	1.40
Oman	0.14	0.05	0.04	0	0.02	0.02	0	—

(Table continues on the following page.)

TABLE C.21 (continued)

Economy and region	2002	2003	2004	2005	2006	2007	2008	2009
Qatar	0	0	0	0	0	0	0	0.03
Saudi Arabia	0.05	0.03	0	0	0	0	0	—
Syrian Arab Republic	0	0	0	0	0	0	0	0
Tunisia	0.68	0.95	0.81	0.98	1.10	0.95	0.91	0.97
United Arab Emirates	0	0.05	0.18	0.41	0.62	0.23	1.07	1.04
West Bank and Gaza	—	—	—	—	—	—	—	—
Yemen, Rep.	—	—	—	—	—	—	—	—
Central Europe	3.5	3.6	5.0	3.6	4.1	3.8	4.1	3.7
East Asia and Pacific	0.3	0.4	0.4	0.4	0.5	0.6	0.7	0.9
Europe and Central Asia	0.0	0.0	0.1	0.2	0.6	0.8	0.9	0.8
High income	3.6	3.6	3.9	4.5	4.6	4.9	4.9	5.2
Latin America and the Caribbean	1.0	1.2	1.3	1.7	2.0	2.4	2.4	2.6
Middle East and North Africa	0.1	0.1	0.2	0.2	0.3	0.3	0.5	0.6
South Asia	0.4	0.5	0.5	0.7	0.7	0.8	0.5	0.3
Sub-Saharan Africa	5.0	3.7	4.1	2.9	3.8	4.7	6.4	6.6

Source: World Bank staff compilation based on data from FactorsChain International and World Bank 2011c.

Note: — = not available.

TABLE C.22

Loan Portfolio of Microcredit Institutions as a Percentage of GDP, by Economy, 2005–09

(percentage of GDP)

Economy	2005	2006	2007	2008	2009
Algeria	—	—	—	—	—
Bahrain	0.01	0	0	0	0
Egypt, Arab Rep.	0.21	0.23	0.21	0.20	0.20
Jordan	0.52	0.53	0.49	0.56	0.53
Kuwait	0	0	0	0	0
Lebanon	0.18	0.17	0.18	0.17	0.18
Libya	—	—	—	—	—
Morocco	0.27	0.64	0.96	0.79	0.67
Oman	0	0	0	0	0
Qatar	0	0	0	0	0
Saudi Arabia	0	0	0	0	0
Syrian Arab Republic	0.23	0.20	0.18	0.03	0.04
Tunisia	0.27	0.27	0.26	0.26	0.28
United Arab Emirates	0	0	0	0	0
West Bank and Gaza	0.91	—	—	—	—
Yemen, Rep.	0.03	0.03	0.02	0.02	0.03

Source: Sanabel.

Note: — = not available.

TABLE C.23

Loan Portfolio of Microcredit Institutions as a Percentage of Total Bank Credit, by Economy, 2005–09

(percentage of total bank credit)

Economy	2005	2006	2007	2008	2009
Algeria	—	—	—	—	—
Bahrain	0.01	0.01	0.01	0	0
Egypt, Arab Rep.	0.41	0.46	0.46	0.47	0.55
Jordan	0.60	0.57	0.53	0.67	0.68
Kuwait	0	0	0	0	0
Lebanon	0.27	0.25	0.25	0.24	0.25
Libya	—	—	—	—	—
Morocco	0.52	1.13	1.40	1.04	0.86
Oman	0	0	0	0	0
Qatar	0	0	0	0	0
Saudi Arabia	0	0	0	0	0
Syrian Arab Republic	1.54	1.37	1.16	0.19	0.19
Tunisia	0.44	0.45	0.44	0.41	0.44
United Arab Emirates	0	0	0	0	0
West Bank and Gaza	—	—	—	—	—
Yemen, Rep.	0.46	0.52	0.30	0.34	0.46

Source: World Bank staff calculations based on data from Sanabel and World Bank 2011b.

Note: — = not available.

TABLE C.24

Active Microcredit Borrowers as a Percentage of Working-Age Population, by Economy, 2006–08

(percentage of working age population)

Economy	2006	2007	2008
Algeria	—	—	—
Bahrain	—	—	—
Egypt, Arab Rep.	1.1	1.3	1.7
Jordan	2.2	3.1	3.8
Kuwait	0	0	0
Lebanon	0.5	0.6	0.8
Libya	—	—	—
Morocco	4.9	6.5	6.0
Oman	0	0	0
Qatar	0	0	0
Saudi Arabia	0	0	0
Syrian Arab Republic	0.1	0.1	0.2
Tunisia	0.6	0.9	1.3
United Arab Emirates	0	0	0
West Bank and Gaza	1.4	1.2	1.7
Yemen, Rep.	0.2	0.2	0.2

Source: World Bank staff calculations based on data from Microfinance Information Exchange (MIX).

Note: — = not available.

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