



# Local Bond Markets as a Cornerstone of Development Strategy

*Economic Note No. 7*



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## Executive Summary

Debt markets represent the leading channel of liquidity for governments, public companies, agencies and financial institutions in many advanced and emerging economies. Developing a local currency fixed income market brings multiple benefits: stable access to capital, diversification of monetary policy instruments, creation of a yield curve for pricing financial assets and tailoring risk management tools.

In most countries, the debt market is born out of the need to finance government expenditures. With time, the yield curve on public debt becomes a reference for private entities such as banks, public utilities and corporations, which are then able to tap the market to fund their investments.

The development of local bond markets requires a strong commitment from governments to implement a proactive debt management programme as well as ensure a large and diversified issuers base. Therefore, a focused issuance programme of government securities is essential to establish benchmark bonds. Governments should also encourage publicly owned companies (especially utilities) to issue similarly structured securities to provide a slate of issuers that enjoy local name recognition, thereby paving the way for private corporations to issue debt. The GCC countries are investing heavily in infrastructure, which according to estimates requires USD2.2 trillion in financing. It is both opportune and desirable to raise this financing through securities backed by future cash flows from the infrastructure services, as is typical of project financing schemes.

Although banks are the obvious buyers of bonds, since government debt is highly attractive for meeting statutory reserve or prudential requirements, authorities should encourage the development of a secondary market among life insurances, asset managers and international institutional investors. To ensure the success of the endeavour, the legal environment needs to be tailored to promote transparency, the seamless and timely flow of information, prevention of insider trading and minimal counterparty risk. As markets develop, issuances further down the credit spectrum will increase and more transparent accounting standards in accordance with International Financial Reporting Standards (IFRS) must be adopted. Another pre-requisite for the development of a healthy bond market is a flexible, interlinked, electronic registry clearing and settlement system.

Building and sustaining a vibrant capital market relies on the commitment of long-term stakeholders. In addition to the government and the central bank, market makers, in their capacity as liquidity providers, are essential to ensure an active secondary market, particularly during a hiatus in primary market issuance. Finally, creating a robust framework for creditor rights and investor protection is necessary to instill investor confidence and maintain the momentum of capital market growth.

# 1. Introduction

Well-functioning and liquid fixed income security markets contribute greatly to the efficiency and stability of financial intermediation and to economic growth in general. The importance of developing domestic bond markets in emerging economies to diversify risks in the financial system has been recognised since the Asian crisis of the late 1990s and has been underscored forcefully as part of an international effort initiated by the G8 in 2007. Market depth and liquidity reduce transaction costs, provide an efficient channel to allocate resources to productive uses and improve risk allocation by all financial intermediaries. A debt market also provides the central bank with tools to effectively conduct its policy by injecting or reducing liquidity.

In the MENA Region, and in particular in the GCC, the growing propensity and need to invest both in private and public projects make an even more compelling case for developing a sophisticated fixed income market. The fact that commercial banks are the primary source of funds in the region, heightens the vulnerability of financial system to mismatch of short term liabilities

(i.e. deposits) and long term risky assets (i.e. loans and mortgages).

Deeper bond markets in local currencies allow small open economies to better absorb volatile capital flows, provide institutional investors with instruments that satisfy their demand for safe and stable long-term yields, reduce financial instability associated with asset price bubbles, and grant a stable source of capital to fund public and private ventures.

Additionally, they enhance market discipline, transparency and accountability because governments, companies, and projects financed through tradable bonds are subject to constant scrutiny by market participants. Intergenerational transfers through social security and pension systems constitute another area where the role of fixed income markets is crucial. In a region where expatriates do not have social security coverage, the natural demand for safe securities is currently met by international asset allocation due to the lack of domestic alternatives.

## 2. Bond and Sukuk Market Development 2003-09

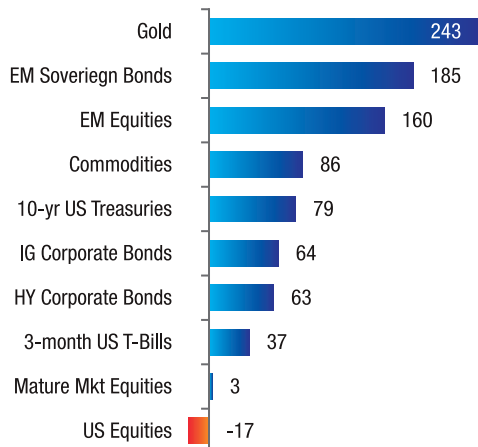
The global financial crisis continues to have notable repercussions on capital markets. Many problems resulting from the crisis are yet to be resolved. Market participants are divided on the outlook: the more forward looking equity markets are heavily betting on a synchronised global recovery. On the other hand, bond markets are comparatively bearish foreseeing a continuation of easy monetary policy - in the form of direct monetary injections or 'quantitative easing' - and weak growth. Having learnt their lessons from the previous crises (East-

Asian, Latin America) where they were left hanging dry with no funding sources, emerging market bonds displayed stronger fundamentals before the crisis and have been (with the exception of Eastern Europe) more resilient than their counterparts in developed markets. (Exhibit 1, left panel)

In this section, we highlight the main characteristics of the MENA region financial markets in comparison with other regions.

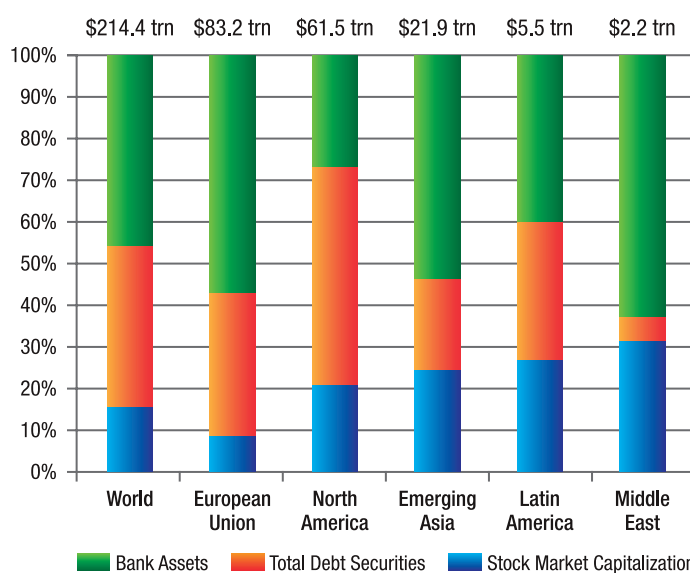
### Exhibit 1 – Comparative Analysis of Selected Markets

10-year returns, July 1999 - July 2009



Source: Capital Flows to Emerging Markets, Sep 2009, Institute of International Finance

Financial Depth Across Regions



Source: IMF Global Financial Stability Report, Oct 2009

Financial depth across the region shows the relatively low dependence of the Middle East on debt securities. According to end-2008 data from the International Monetary Fund, the world capital markets consist of an average 38.9% bond instruments, 15.6% equities and 45.4% bank assets (Exhibit 1, right panel). However, in the Middle East region, the capital market is dominated by bank assets and equities, which together make up

94.4% of finance. Debt securities make up just 5.6% of the Middle Eastern capital markets, according to the IMF<sup>2</sup>. The bond market in the MENA region remains the weakest among the world's regions in terms of financial intermediation. Bond financing is tilted towards sovereign issuers (with the exception of the GCC countries), as opposed to a relatively more balanced distribution in other regions.

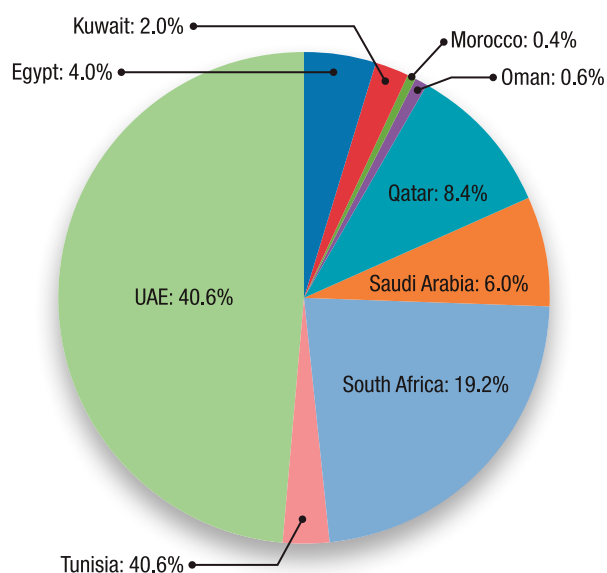
<sup>2</sup> IMF Global Financial Stability Report, October 2009.

**Table 1 - A comparison of International Bonds Outstanding, Q2 2009**

(in USD bn)	Sovereign	Corporate	Financial Institutions	Total
All countries	2113.5	2813.7	20186.2	25881.0
Developed countries	1598.7	2562.8	19503.7	23665.2
Developing countries	477.8	214.0	512.1	1203.9
Africa & Middle East	43.7	35.7	82.3	161.7
Asia & Pacific	57.2	89.8	208.3	355.3
Latin America & Caribbean	206.0	55.5	97.0	358.6
Bahrain	1.1	-	5.1	6.2
Kuwait	-	-	3.2	3.2
Oman	-	-	1.0	1.0
Qatar	4.4	5.9	3.3	13.6
Saudi Arabia	-	1.9	7.8	9.7
United Arab Emirates	8.8	14.4	42.5	65.7

Source: BIS, Quarterly bulletin, Sep '09

**Fig. 1 - International Bonds Outstanding – Africa & Middle East, by country**

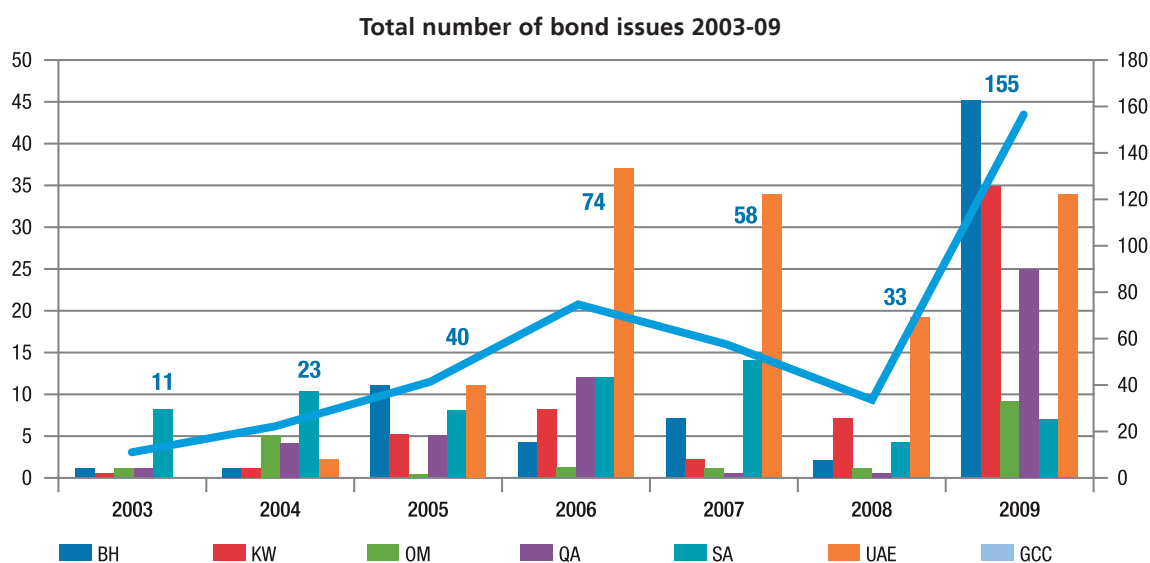


Source: BIS, Quarterly bulletin, Sep '09

Bond financing has been rarely used, in large part, because until very recently, they were deemed unnecessary in a region flush with capital and hydrocarbon wealth. Given the large current account and fiscal surpluses of the oil exporters, funding for large projects were available through the banks and from government coffers. The financial crisis led to a 'sudden stop of capital inflows' and tightened access to liquidity. With banks reluctant to lend and lower energy commodity revenues, the debt market (including Sukuk) has emerged as an attractive financing alternative.

Moreover, the reversal in hot money flows, the losses in the region's equity markets post-Lehman, and the prohibitive cost of long-term borrowing has been a powerful reminder of the vulnerability of relying on external finance. With uncertain sources of external finance in the face of the continued global liquidity crunch, GCC countries are now eagerly tapping the abundant pool of wealth accumulated in the region and the foreign capital looking for relatively safe investment. Hence, activity in the debt market has substantially increased post-crisis to match the governments' commitment to maintain the infrastructure expenditure at a pre-crisis level.

**Fig. 2 – A Country Breakdown of Debt Issuance**



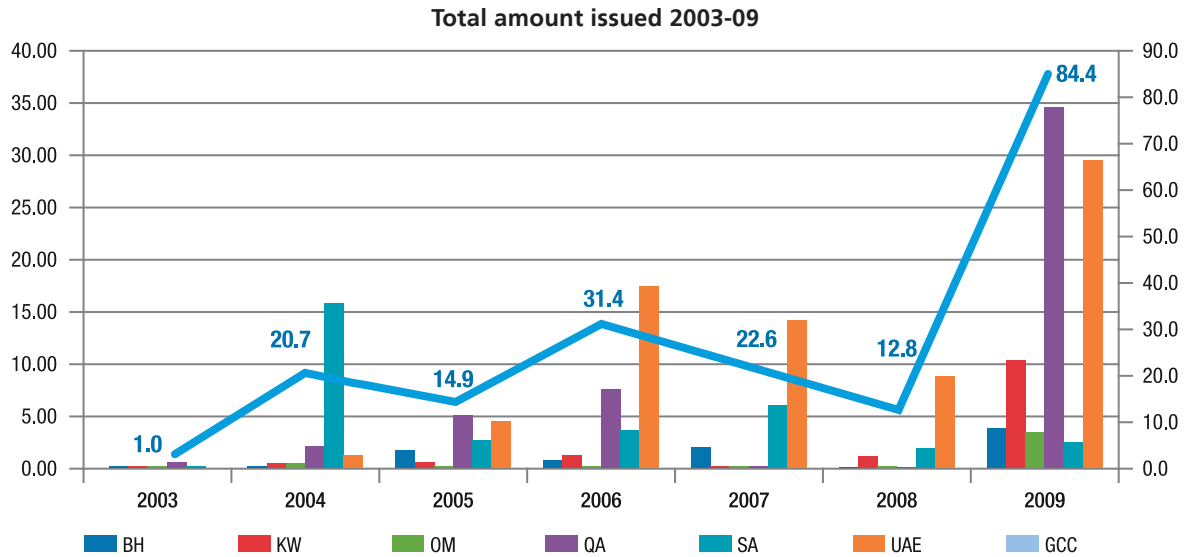
Source: Bloomberg, Reuters, DIFC Economics.

Bond issues have risen dramatically since 2003, but as in the rest of the world, 2008 recorded a dip in the number and size of issues. With the recovery in global bond issuance this year, high-yield corporate borrowers have returned to the market and emerging market external bond issuances have increased (roughly \$85 billion, with sovereigns accounting for about 40% of issuance).

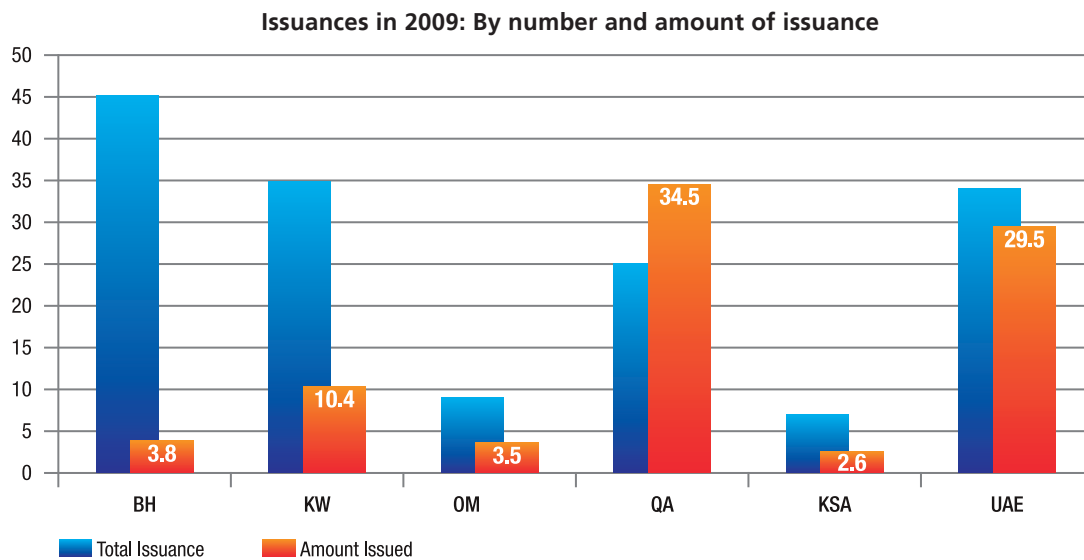
In the GCC, the UAE has been the top issuer since 2006. However, 2009 has seen a large number of issues from Bahrain, Kuwait and Qatar as well. A look at the total issuance in 2009 (till 22nd Nov 09) shows that there was a significant pick-up in issues after the seasonal lull in the Holy Month of Ramadan. Kuwait and Bahrain occupy the top position with regard to number of issues but Qatar ranks the highest in terms of the size of issues (\$34.4 billion).



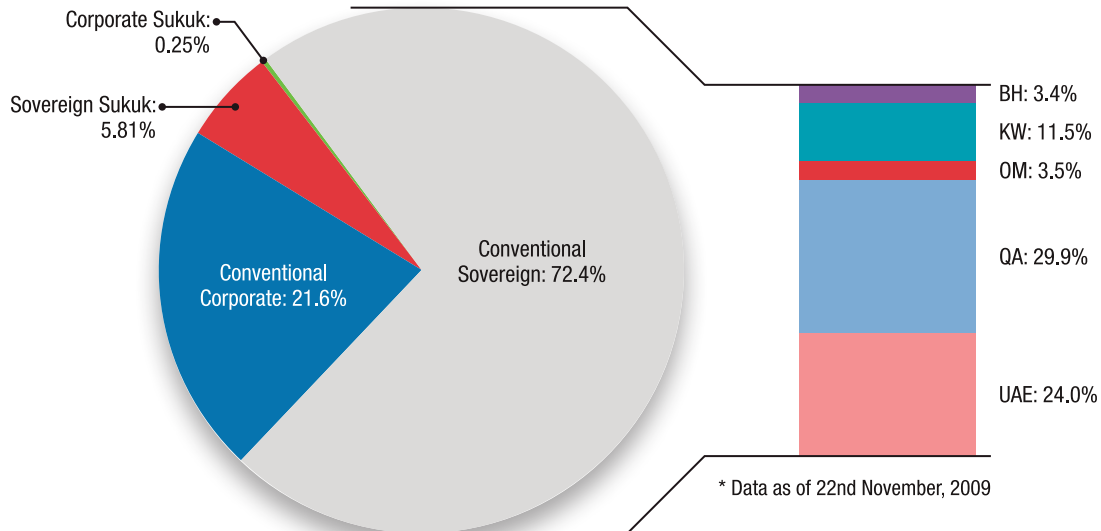
**Fig. 3 - Country Breakdown of New Debt Issued**



**Exhibit 2 – Recent Developments in the GCC Bond Markets**



**Conventional and Sovereign issues formed 72.4% of debt issuance\***



Source: Bloomberg, DIFC Economics.

### The Emergence of the Sukuk Market

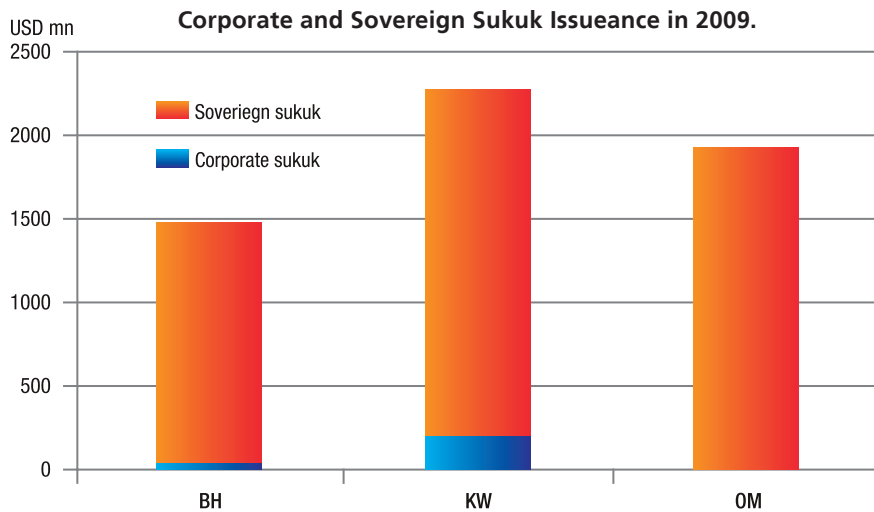
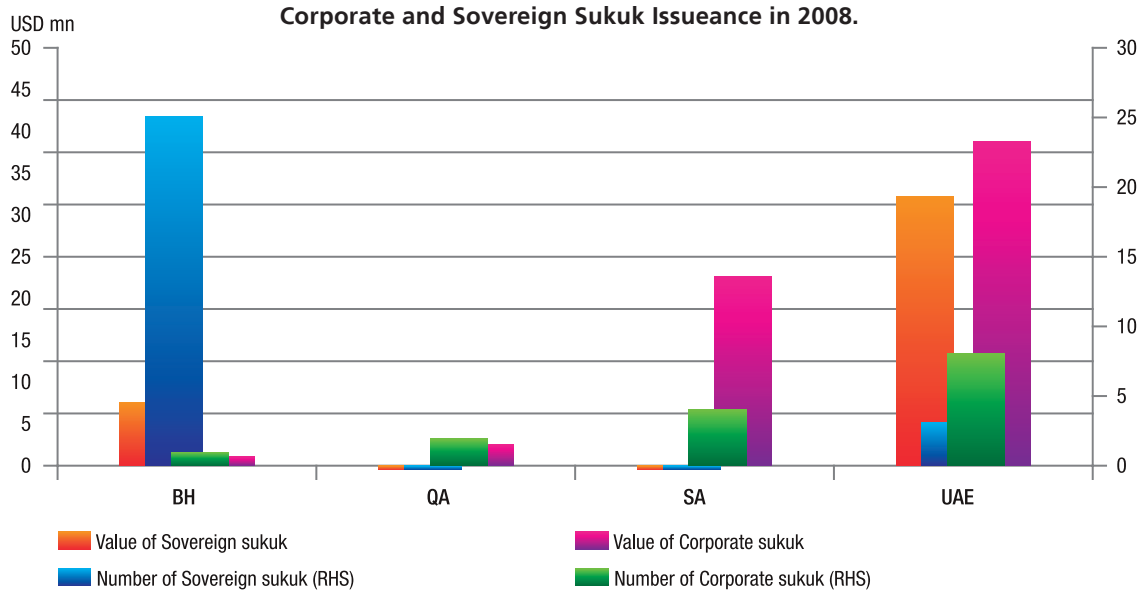
While the financial crisis highlighted the role of Islamic finance and the relative resilience of Islamic Financial Institutions (IFIs), the most striking element was the fast growth of Sukuk, which are wholesale, asset-based capital market securities (Exhibit 2). Although the issuance of Sukuk dampened in 2008 and 2009 compared to 2007, it is expected that it will cross US\$200bn<sup>3</sup> by 2010, spurred by buoyant demand especially from sovereigns, banks, insurance companies and pension funds in both Islamic and non-Islamic countries. Global issuance has historically been primarily in US dollars and concentrated in parts of Asia and the GCC. About half of the issues in value terms originate in Asia (Malaysia and Brunei) and the other half in the GCC and Pakistan. Sovereigns and

government-related issuers are the most common Sukuk issuers this year, due to the various funding programmes amid declining economic activity, fiscal deficits and lower commodity prices.

There has been a significant change in currency of choice for the Sukuk market - the share of US dollar-denominated Sukuk dropped from 85% in 2002 to 10% of issuance in 2008; in the GCC, rumours of de-pegging also led to a shift in currency choice. Though the Malaysian ringgit was the top currency choice in 2009, Sukuk data for the year show that USD denominated Sukuk rose to 20% of total issues, indicating the return of the greenback as one of the main currencies (Exhibit 3).

<sup>3</sup> "Islamic Bond Issuance: What Sovereign Debt Managers Need to Know", IMF Working Paper, July 2008.

### Exhibit 3 – Islamic Bonds Market in 2008 and 2009



Source: IFIS database, DIFC Economics

During the first ten months of 2009, GCC bonds and Sukuk volume reached USD 60.8 billion, a substantial increase from the previous year when the total volume had dropped by about 40%. Overall, Sukuk issues have slowed amid an increase in conventional bond issues (dominated by sovereigns), with the third quarter witnessing a genuine recovery in issuance.

An interesting point to note is that Bahrain dominated the number of Sukuk issues in 2009 (20), though Saudi Arabia raised the maximum value, followed by the UAE (with two issues per country).

### Box 1 - The IFC Sukuk

On 4 November, 2009 the International Finance Corporation, an affiliate of the World Bank, listed an Islamic bond (or Sukuk) on Nasdaq-Dubai, the international exchange located within DIFC. The listed Sukuk called IFC Hilal Sukuk is a dollar-denominated \$100 million issue, Aaa rated, with a five-year maturity.

While this is a symbolic amount compared to some of the mega-Sukuk, the Hilal Sukuk offered by the IFC set a milestone for Islamic Finance and for financial markets in the GCC. This was the first time that a non-Islamic financial institution was issuing a Sharia-compliant security for term funding, a fact all the more important, considering that the IFC has a strong reputation on international markets and impeccable credentials. By issuing a Sukuk, the IFC and the World Bank have recognised Shari'a-compliant finance and securities as bona fide, valid, and acceptable financial instruments. The contractual terms of this IFC Sukuk are established under DIFC law (based on English common law), which is an implicit validation of the fact that DIFC's legal framework is on par with those of other well-established jurisdictions.

Furthermore, the fact that the Hilal Sukuk was arranged by a regional syndicate including Dubai Islamic Bank, Kuwait Finance House, Bahrain, HSBC Amanah, and Liquidity Management House points to the increasing maturity of regional capital markets. With such a high profile precedent, the investment banking community and the legal profession will take notice and have the confidence that every aspect has been thoroughly tested and can be duly replicated.

The IFC Sukuk represents a historic benchmark for all future Shari'a compliant financing operations by sovereign and corporate entities and sets a standard for the entire Islamic finance sector, which has so far been hampered by a lack of standardisation and the absence of uniform rules and structures. The IFC Sukuk listing documents will provide reference documentation for other issuers from the region and internationally, thereby lowering the cost of issuing Sukuk, making them more competitive with conventional debt.

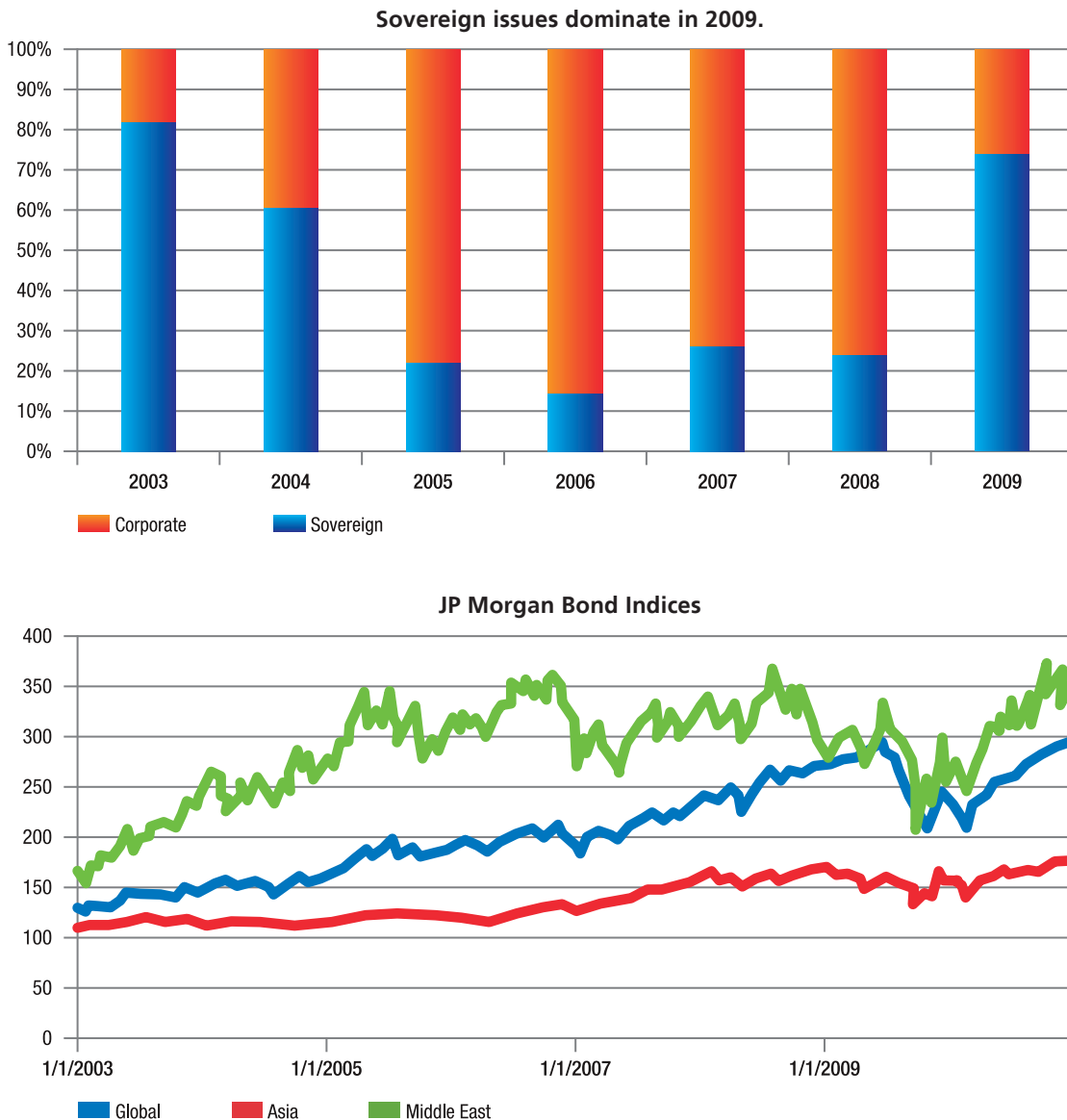
Two additional aspects are noteworthy. First, the Hilal Sukuk will raise funds for IFC infrastructure and health projects in Yemen and Egypt, stressing the ideal suitability of Islamic finance for the financing of tangible, real assets. In a region where the pipeline of infrastructure is estimated at around USD 2.2 trillion over the next years, the IFC has clearly indicated a direction which others would be persuaded to follow. Second, so far, a liquid Sukuk secondary market in the region has struggled to emerge in part because there is a shortage of high quality securities compared to the demand by a host of Islamic institutions (which typically buy and hold most of the supply). The IFC Sukuk displayed a narrow spread with a profit rate of 3.0379%, which highlights regional investor appetite for the issue. Strongly oversubscribed, it will provide a benchmark for pricing sovereign and corporate Sukuk.

## Growth of Sovereign Debt

With global equity markets falling into turmoil following the Lehman bankruptcy, government bonds became increasingly attractive as investors flocked for the security of government-backed paper to the detriment of the corporate sector, which had been more affected by the credit crunch. Nearly all of the recent bond issuances have come from sovereigns whose high

credit ratings make them particularly attractive to international debt buyers. Sovereign issuances hence dominated the market in 2009, with only 21% of total amount issued by corporates, a reversal of recent trends in the region. The only other time this happened in recent years, was in 2003-04 (Exhibit 4).

### Exhibit 4 – Issuance and Performance of Government Bonds



Source: Bloomberg, DIFC Economics.

Sovereign issues by GCC countries received a spirited reception from the world market and international investors, in a sign that risk appetite may be returning. Two recently issued sovereign bonds illustrate this. The Central Bank of Kuwait received KWD 1.26 billion worth of bids for an announced tender of KWD 200 million of one-year treasury bonds, while Abu Dhabi's sub-sovereign bond issue was oversubscribed more than twice as investors offered to buy about USD 7 billion of the bonds. Dubai government also placed USD 1.25 billion sukuk and another AED 2.5 billion floating-rate Islamic note in October. The total debt emission was more than three times oversubscribed.

Finally Qatar issued a total of USD 7 billion in what was the largest emerging market debt operation, covering the maturity spectrum up to 30 years.

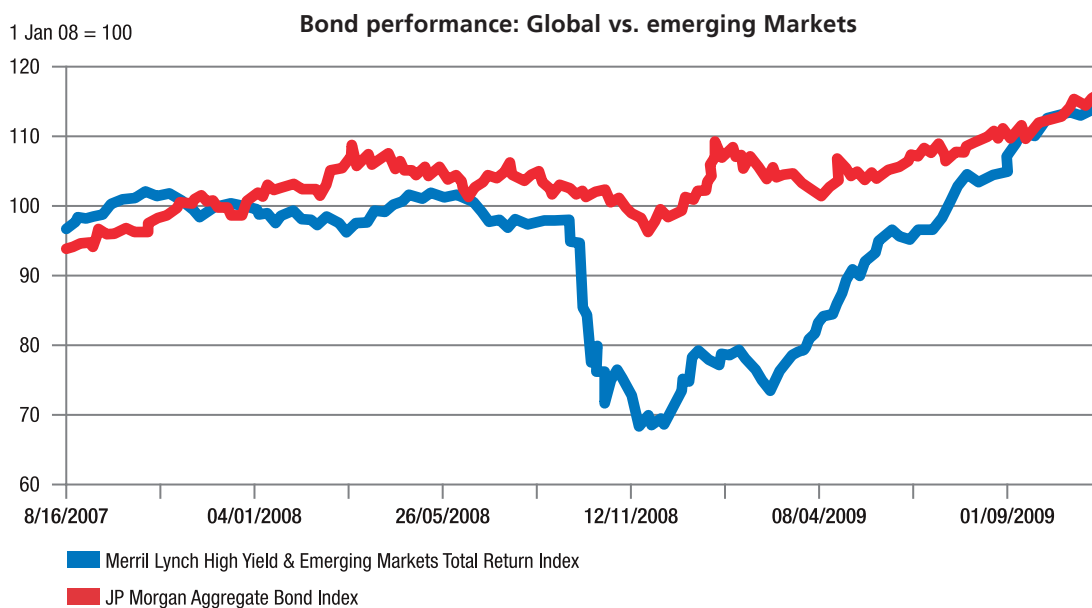
As sovereign bonds are a relatively undeveloped asset in the GCC region, recent sovereign issuances will begin to generate a benchmark yield curve by which other smaller issuers can price their own debt and investors can more accurately weigh risk and value. With a yield curve in place, more issuers will be willing to enter the market and banks and corporations will be encouraged to issue similar securities.

## Bond Returns

Following the crisis, total bond market returns (i.e. the sum of capital gains and interest earned) in the Middle East markets dipped. The impact of the Lehman tsunami on the markets was clearly evident. However, they slowly

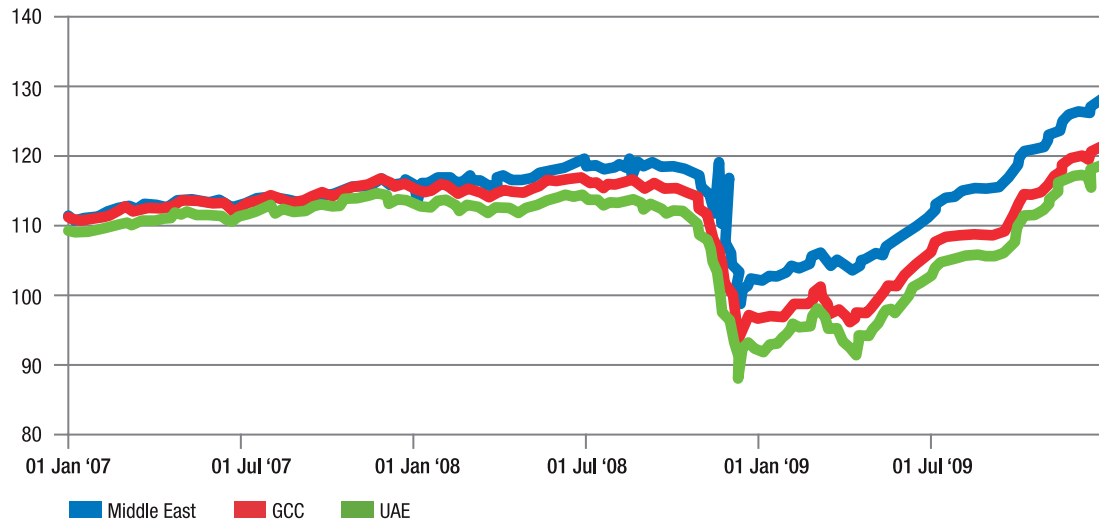
climbed back to their pre-Lehman levels by end-Aug 09. Inflation adjusted returns, which were earlier in the negative range (following high inflation levels) are slowly returning to positive territory (Exhibit 5).

### Exhibit 5 – Comparison of Bond Returns



Source: Bloomberg, Reuters, DIFC Economics

### Bond market returns took a hit post-Lehman



Source: HSBC-DIFX indices, DIFC Economics

### 3. Debt vs. equity markets in MENA

Debt markets represent the leading channel of liquidity for government, public companies, agencies and financial institutions in many advanced economies. Turner (2003) identifies four major reasons that can hinder the development of efficient local currency bond markets:

1. A country with high and variable inflation rate undermines the demand for local currency paper. Macroeconomic stability, with sound monetary and fiscal policies, is necessary for the emergence of bond markets.
2. Interest rate controls; the non-market pricing of loans; and “captive market” arrangements whereby local financial institutions are forced to buy government bonds are all examples of banking and financial distortions that prevent the market pricing of risk and financial securities.
3. Narrowness of the local investor base.
4. Legal, fiscal/tax and regulatory provisions that inhibit active trading by institutional investors.

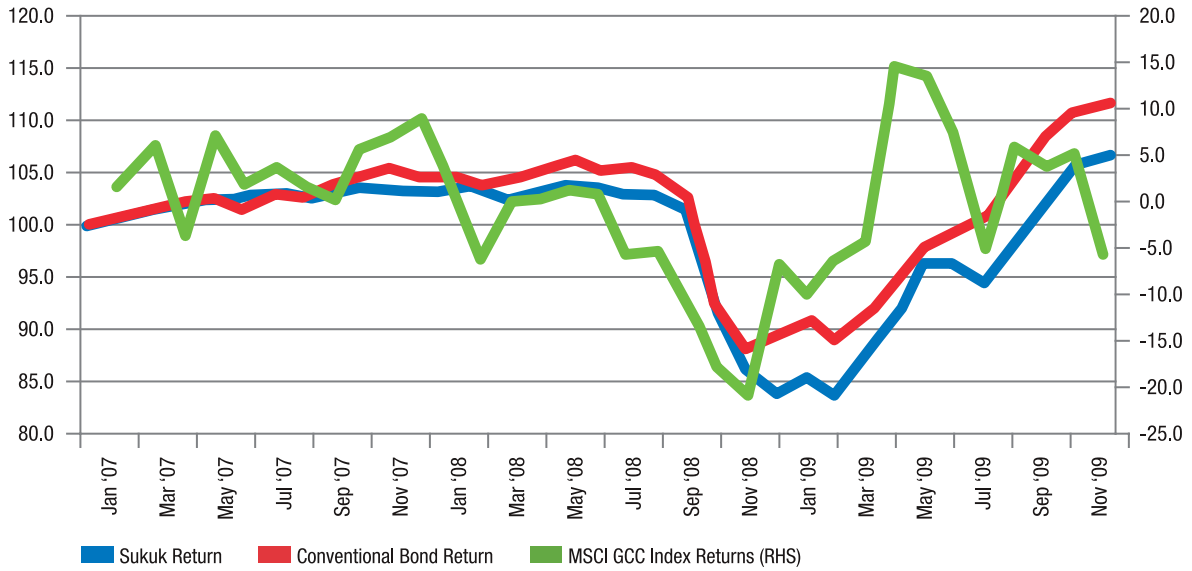
While the GCC economies have generally experienced macroeconomic stability and have followed relatively liberal financial market policies, the last two factors can clearly be identified as barriers. The markets in the MENA region are still underdeveloped, with a lack of breadth, depth and liquidity, a low investor base and the absence of a clear legal and regulatory framework being among the unresolved issues.

The GCC countries also lack additional important ingredients of a well functioning debt capital market: there is little credit rating culture, unsatisfactory market transparency, lack of benchmarks, a dearth of long maturities, lack of a broad spectrum of institutional investors and the absence of a derivative market for managing interest rate and credit risk. Only recently a credit default swap (CDS) OTC market has gained prominence, but it is still in its infancy.

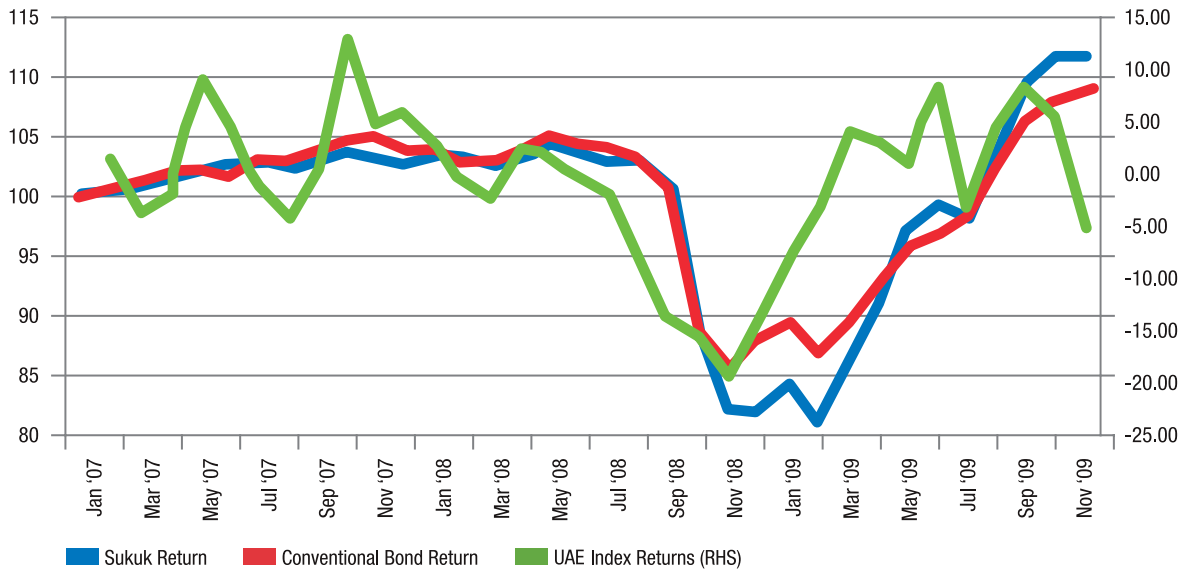


## Exhibit 6 – A Comparison between Debt and Equity markets

GCC Equity market performance better than bonds during crisis, down recently



Return from bonds declined sharper than the volatile UAE equity market



Source: HSBC-DIFX Indices, Bloomberg, DIFC Economics

In recent years, debt markets have been neglected in favour of equity markets and bank lending as a source of finance in the region. This lack of liquidity affected the performance of bonds, which, during the crisis, performed worse than equities both in the GCC and the UAE (Exhibit 6).

From 2004 until the onset of the credit crisis, as observed earlier, new issue volume from the Gulf region increased steadily. For a variety of reasons, secondary activity grew but not in line with the primary market. In other words, investors adhered to a buy and hold strategy.

As a result, many of the positive externalities that should accompany a domestic bond market - market practices, yield curve, market infrastructure, tools for monetary policy and liquidity management, broadened

investor base, credit culture – are merely nascent. In fact, debt markets grew more rapidly in depth and sophistication in places like Latin America, the Far East and South Africa.

As of this date, there is a significant “pipeline” of potential new issuance by companies and projects, which had been put on hold. The appetite, however, for issuers not benefiting from a direct or strong implicit government guarantee is hard to fathom. The recent request by Dubai World to restructure the debt of Nakheel has certainly led to a reconsideration of quasi sovereign risks by market participants. Policy makers across the region are increasingly recognising the need to encourage issuance and develop markets. A joint IMF-AMF Arab Debt Market Development Initiative has begun a concerted regional effort to develop bond markets.

## 4. Importance of Debt Market Development

Common sense and past evidence suggest that a sound credit and debt market strengthen the resilience of economies in the face of a crisis. On the contrary, erratic and haphazard borrowing by public and private institutions (especially in foreign currency and at short maturities) is often associated with financial fragility and ultimately costly financial crises, as demonstrated in the Asian and Russian crises and the recent woes in Dubai.

A deep and liquid domestic government bond market that provides a risk-free benchmark yield curve from which to price other instruments -- including financial derivatives -- helps to reduce the instability emanating from the lack of efficient risk pricing. Above all it provides a tool to hedge risks and carefully plan investment strategies. At present, international asset managers who want to invest in our region do not find suitable securities and therefore capital inflows are severely hampered, curtailing important development opportunities.

Participation by local sophisticated investors has also a supportive and stabilising effect. Given the pool of wealth accumulated in the region, local investors could be relied on to provide liquidity, given that in the current global environment alternative investment opportunities (including safe US government paper) are scarcely attractive. Retail investors in particular would prefer to hold low risk assets denominated in local currency.

Furthermore, given the size of the infrastructure projects under way and planned in the Gulf region (but also in the rest of the Middle East), governments alone cannot be expected to shoulder the financial burden due to fiscal constraints. Thus, there is a need to attract private sector funds. The size of projects planned, under way or completed in Arabia was reported at US\$2.2 trillion according to the MEED Project Tracker (Nov. 2009). In the DIFC region (which covers MENA, the Indian subcontinent, Central Asia and East Africa) an important country with large infrastructure spending

is India; according to the Planning Commission of India, core infrastructure spending is estimated at USD 429 billion during 2008-12, while Goldman Sachs estimates Indian infrastructure spending at USD 1.7 trillion over the coming decade.

Demographics are also an important consideration. Despite a presently youthful population across the GCC region, as the new generation progressively enters the workforce, provisions will need to be made for their ultimate retirement. State-sponsored social security funds are expected to emerge together with a vibrant private sector life insurance and pension fund industry. Consequently, robust demand for longer duration assets to match liability portfolios will arise – a need well served by longer-dated fixed rate bonds. Another area where demographics will be a key driver is housing finance. It would be appropriate to develop a mortgage-backed securities market which, avoiding the shortcomings that led to the sub-prime crisis in America, could allow banks to better manage their exposure to the real estate market. Also, it would be desirable to institute a mortgage guarantee scheme, which could insure against defaults on payments linked to unforeseeable events such as premature death or unemployment.

Once a liquid and deep debt market is established, financial innovation could be sparked to better manage resources.

To summarise the argument, developing debt markets in local currencies would allow to

1. Deal with currency and maturity mismatches
2. Absorb volatile capital flows and reduce financial instability
3. Provide institutional investors instruments that satisfy their demand for safe and stable long term yields

4. Grant a stable source of capital to fund public and private ventures under the constant scrutiny of markets

The development of a bond market will also provide the Central Banks with an effective monetary policy tool. It makes open market operations feasible - buying government securities injects liquidity while selling securities withdraws liquidity. This element will be of paramount importance if the central bank

has to maintain an inflation target without a peg to a major currency. In other words, if the GCC countries will regain monetary independence, they will need a well-developed local currency market to steer the economy via interest rate moves. As a by-product debt market would enhance transparency in pricing and intermediation, facilitating constant monitoring of macro-economic expectations, as well as ensuring disclosure of information and periodic communication regarding public policies.

## 5. Policy Recommendations

The development of a capital market is clearly a multi-faceted undertaking. Embryonic markets need to be created through a carefully structured plan and continuously nurtured in order to achieve critical mass and sustainable growth. This is a complex task often best addressed through an ongoing commitment to periodically review and fine-tune local regulations and market practice with inputs from market participants.

The successful launch of a bond market for long-term instruments requires a holistic approach in enacting complementary policies such as sound fiscal policies, an enabling legal environment, good corporate governance principles, risk management and treasury management systems. The efficiency of bond markets would depend on standards of accounting, auditing and disclosures, institutional infrastructure, and enforcement of contracts.

In the absence of these conditions, a domestic bond market by itself might fail to address the fundamental issues of risk management and pricing of risk. Finally, any programme that requires the government to issue large amounts of securities in the absence of a financing need should be governed by a clearly defined set of principles and objectives, and take into consideration its impact on the sovereign balance sheet.

A government bond market needs to be developed with care and caution so as to ensure that in the process, global risks are not transferred into the domestic economy. It is therefore important that debt management is carried out in close coordination between fiscal and monetary authorities. Drawing from past international experiences of launching bond markets in emerging economies, we recommend the following key steps for governments.

1. A programme of government bond issuance across the maturities spectrum (for example 1, 2, 5, 7, 10 and 30 years), which can provide the building blocks for the interpolation of all points on the yield curve.

2. The issuance programme must be conducted systematically over a number of years with appropriate pre-announcement of auction dates, size of the issue, characteristics of the securities, primary dealers, and secondary market listings. The calendar interval should be conveniently spaced with three objectives in mind: a) creation of a critical mass of tradable paper; b) avoiding the drying up of longer dated maturities and the detachment of the yield curve from its canonical focal points over the long term and finally c) preventing concentrated refinancing activity from putting a strain on the market's absorptive capacity.
3. Issuance must be large and liquid enough to be traded actively by a number of agents while their features (coupons, legal obligations, transaction costs, custody fees etc.) ought to maintain consistency across maturities to favour comparability and tradability.
4. The primary market could be activated quite simply through an auction mechanism once the Authorities establish a Primary Dealer system to ensure participation in auctions and distribution of Treasuries. A dialogue with primary dealers will be required in order for market information to be exchanged amongst participants and with the authorities. Essentially, the Primary Dealers commit to a minimum uptake of securities in each fiscal year.

It would be wise to maintain a degree of simplicity and standardisation, at least initially, for example issuing zero coupon bills at shorter maturities and bonds carrying semi-annual coupons for longer maturities. This would make it easier to lay the foundation of a yield curve and attract retail investors.

Islamic debt is another opportunity particularly accessible to the GCC states due to its local market place. A full discussion on this topic is beyond the

scope of this paper. However, it should be stressed that there is clearly much to be gained from the development of a Shari'a compliant Islamic capital market in conjunction with a conventional one.

When a government commits to the development of a bond market it does so as a catalyst, as an issuer, regulator and coordinator. Typically, there is a high-level Debt Market Policy Steering Committee that

includes government as issuer, financial market regulator(s) and the monetary authority. In any case, the first priority has to be to work out the relative roles and responsibilities of the official entities. If this is not clear from early on, the market may be set for severe setbacks later on. It would also be desirable to enact a law on public debt issuance and to set up a unit in charge of public debt management, which would devise the strategy and implement it.

## 5.1 The Role of the Central Bank

The Central Bank has a special interest in the existence and functioning of the debt market and therefore should be closely involved in or even lead efforts to develop it. This interest arises from its various roles.

In many instances, the Central Bank is the designated fiscal agent of the government. In this role, the Central Bank will likely physically conduct the sale of securities, either via auction or another process. As fiscal agent, it may also maintain and operate the securities depository, especially for direct government instruments. In this respect, a Central Bank acts at the direction of the government and may even charge fees for its operations as would a commercial bank.

The Central Bank's role as monetary authority is somewhat different and has to be conducted separately from its role as fiscal agent. In this role, the Central Bank may be operating in the market to inject or withdraw funds using market mechanisms. In this role, the Central Bank may well come into conflict with national or other sovereign financial managers who may seek to fulfill different short-term objectives.

As regulator of the banking system, the Central Bank has an incentive to be involved in market development as the creation of a liquid yield curve will allow banks to price their assets more accurately thereby enabling better systemic risk identification.

The case for the involvement of a Central Bank in corporate debt or project markets is less direct. Typically a Central Bank will not provide agency services for anyone other than the sovereign Treasury, though there are a few exceptions. As monetary authorities, central banks have not historically accepted non-sovereign paper as collateral. However, the financial crisis has dramatically (though possibly temporarily) dampened this aversion to riskier collateral and so to an extent central banks are playing a role even in corporate debt market liquidity.

The Central Bank could give a boost to the market if the banks were required to hold a minimum percentage of their statutory liquid reserves in government paper. The instruments should be made exempt from loan to deposit ratios (LDR) ratios and should be zero-weighted for capital adequacy purposes.

Furthermore, the repo (repurchase) market could be established to facilitate open market operations and to facilitate banks / participants to manage their own liquidity flows. Currently, if a bank has a surplus of short-term liquidity, it can only lend "clean" to other banks; however, due to capital and credit constraints, this is not a very effective tool. On the contrary, by lending through a reverse repo, the capital and credit constraints would be reduced to a fraction of clean lending.

## 5.2 The Role of Ministries

The ministry that is critical to the development of the bond and Sukuk market is the Ministry of Finance (MoF), due to its role as developer and executor of the state budget and sovereign borrower for the country. In a federal environment such as the UAE, much of what is said about the Ministry of Finance can be mutatis mutandis applied to the Department of Finance of each Emirate.

Ministries of Finance should publicly adopt market development as a national policy priority. The MoF can develop consensus both within and outside the government to establish a development policy and strategy for bond market. Considering the critical importance of bond market development for the economy, a high-level coordination committee led by the MoF (the Debt Market Policy Steering Committee mentioned above) could spearhead the market development process.

Practically, MOFs need to commit to maintaining borrowing practices that support market development in the long term. This commitment will likely entail short-term costs that will have to be explained to the highest authorities and to other stakeholders. As a benchmark issuer, the government can standardise its structures and commit to regular issuance practices.

The fiscal authorities will also have to consider how important projects will be funded, even if they are not typically the subject of direct government funding. Choices made on how to fund projects – domestically, internationally, bond or loan market and so on - will impact profoundly the level of market development.

## 6. Role of DIFC in Debt Market Development

A liquid and deep debt market requires a state of the art infrastructure. NASDAQ Dubai is a fully integrated electronic regional securities exchange that operates to international standards and is strategically located in the Dubai International Financial Centre (DIFC). Since its launch in September 2005, NASDAQ Dubai has sought to match the best global standards in regulation of issuers and post listing disclosures in

order to promote transparency. The exchange has issuers spanning five continents and its membership base bridges international institutional investment and regional retail liquidity. Currently, NASDAQ Dubai is the only exchange in the region with a wide product range listed including Equities, Derivatives, Structured Products, Bonds/Sukuk and Exchange Traded Commodities.

### The Asset Classes traded on NASDAQ Dubai



A sovereign or a corporate, domestic or foreign, issuer can list on NASDAQ Dubai through a debt issuance programme. The application covers the maximum number of securities that may be issued under the programme. The NASDAQ Dubai Listing Authority approves the programme, which is valid for 12 months. Subsequent tranches can be easily issued and listed.

Through NASDAQ Dubai, the DIFC has put in place a financial platform incorporating international best practice and characteristics:

- The market infrastructure covers not only the trading platform or the settlement system, but encompasses many sides, above all the legal system and the regulatory environment and includes requirements for price and market data publication, equal access clearing and custody.
- A sound legal and regulatory infrastructure incorporating international best practices

provides incentives for financial institutions to conduct business in a developing financial market. This feeds upon itself as financial clusters form, to create a sustainable market place with a ready talent pool of financial professionals.

- The legal environment is tailored to promote a sophisticated market where transparency and disclosure are predominant criteria for issuers, with timely flow of information. The BASICS II, a study conducted jointly by the Hawkamah Institute of Corporate Governance and the National Investor found that companies listed on the Nasdaq Dubai scored 31% higher than the average GCC score; Nasdaq Dubai also showed the highest levels of disclosure among all GCC exchanges.
- The insolvency and creditor rights regime is in line with best practice. Hawkamah, in collaboration with the World Bank, OECD

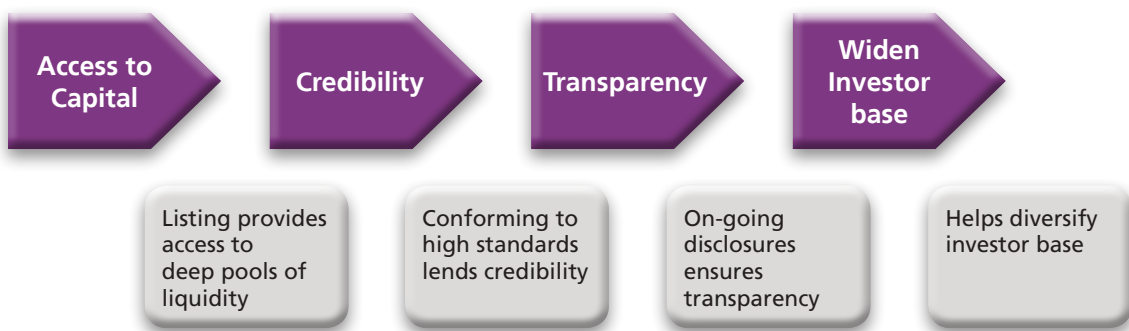


and INSOL International recently published a study of insolvency regimes in the MENA region. The results of this study highlighted the DIFC insolvency framework ((based on the “common law” and with the additional advantage of being “purpose-built”) as the most robust and highest rated in the region, with standards above the OECD average. Although it has not been tested in a high profile case, it has been adopted by the Government of Dubai as the legal framework to be applied

for any bankruptcy claim brought against Dubai World.

Equally important are the enforcement mechanisms that need to be tailored to the specific characteristics of the market and assigned to regulators perceived to be independent from outside influence and with a long-standing experience in international markets. Similarly, unequivocal transparency and disclosure standards are key elements to guide pricing and transactions and to prevent abuses such as insider trading.

### Sound Market Characteristics



Empirical evidence suggests that financial markets have a preference for a common law framework because it has been adopted by practitioners as the equivalent of an international legal standard. Therefore market participants and compliance officers tend to be more familiar and comfortable with the contractual obligations stemming from a common law jurisdiction.

Finally, a great deal has been written about how to

promote secondary market liquidity and the Gulf region can benefit from experiences elsewhere. Liquidity is both a cause and an effect of other characteristics of a market – success in one aspect will breed success in others. Experienced professionals know that secondary market liquidity is considerably more difficult to achieve than placement of debt instruments with investors. It requires sustained cooperation among stakeholders and a regulatory and legal framework, which abides to best international practices.

## 7. GCC Debt Market in the Global Context

The development of a bond market in the GCC will also have profound implications for the global financial markets and, with time, might come to represent a key component of the new emerging international financial architecture.

Over the past decade, local currency markets in emerging countries have had a stabilising effect on domestic economies and cyclical fluctuations. However, in 2008 they were not able to escape the contagion from the global financial crisis. After the Lehman bankruptcy, they were hit by a wave of fire sales which were not justified on the basis of their macroeconomic fundamentals and the often virtuous macroeconomic policy mix pursued since the crises (from South East Asia to Russia) in the second half of the 1990s.

It is true that the memories of the past capital flights and currency devaluations were always kept alive, ready to be re-ignited when tensions on global markets stirred a bout of risk aversion. But in 2008, the main contagion mechanism worked through the repo market. The main emerging markets bonds took a hit because their worthiness as collateral in the repo market was perceived as inadequate especially for securities with B ratings and their spreads widened between 250 and 350 bp. Only in a few countries, such as Chile or Korea, with ratings above A, was the impact on the spreads minimal.

Essentially this episode demonstrates that international markets need a new asset class in emerging market debt with a low risk profile. Market participants would welcome an asset class that displays lower correlation with shocks and can act as an anchor for the international financial system. The GCC bond market would be ideal in this sense because its securities would be backed directly or indirectly by the region's vast energy commodities reserves, accumulated private and public wealth and political stability. Furthermore the value of the GCC fixed income securities would be underpinned by a series of forward looking fundamentals such as endogenous growth capacity reinforced by the ongoing diversification process, the shift of the epicenter of the world economy and trade patterns towards Asia and Pacific, closer South-South financial links and a talent pool which is increasingly attracted outside the mature economies. The more risk averse and unleveraged market participants such as pension funds could find a safe haven in the GCC securities to hedge against episode of extreme risk aversion and uncertainty.

These benefits could be greatly strengthened by the launch of a common currency in the Gulf, which would emerge as one of the five most important currencies and enable global asset managers and central banks to attract massive capital inflows.

## 8. Summary and Conclusions

The development of local currency debt markets can be viewed as an investment in the economy, similarly to any other public investment (e.g. in infrastructure, health, education, etc...). An active, resilient debt market allows governments to efficiently and cheaply raise the funds required to finance operating and development expenditure needs. Even in the absence of a pressing need to borrow by the government, the creation of a debt market is a key milestone on the road to develop an advanced economy. A mature and liquid debt market can improve resource allocation by channeling savings into domestic investments and can diversify the choices available to both retail and institutional investors.

In addition, debt securities provide an instrument for the banking system to manage liquidity and risk in an effective manner; and allow the central bank to control liquidity by smoothly injecting and withdrawing liquidity from the economy. Diversification of financing and investment options contributes to the stability of financial markets and to greater corporate and government transparency.

The GCC region would not be starting from scratch. Indeed, the corporate debt market is going through a revival and the sovereign debt market –conventional and Sukuk- is re-emerging strongly after the crisis in 2009.

Proactive efforts on the part of the government authorities, regulatory bodies and market participants are essential for creating an environment conducive to the development of a deep and liquid debt market. An initiative to provide both a foundation for future development and to show the market that GCC member

states are serious about developing capital markets, would be a programme of regular local currency government bond issuance. This should entail direct government obligations, rather than quasi-sovereign or State-Owned-Enterprise issuance, across the full term structure in order to develop a quasi risk-free benchmark yield curve.

Money markets and financial derivative markets should be developed alongside the debt capital markets to facilitate liquidity management by both central banks and investors.

A credit culture should be nurtured to encourage the bank disintermediation process, which will allow a corporate bond market to develop on the foundations laid by the aforementioned government bond market development. Last but not least, it is vital that regulatory authorities remain cognizant of the need to nurture markets through provisions conducive to an efficient and market-friendly regulatory environment. If this is achieved, we can look forward to broader and deeper markets capital markets in the GCC region located primarily in Dubai.

At present, there is an abundance of onshore liquidity that is currently forced to look beyond the boundaries of the GCC for investment opportunities, typically in G3 currencies. Simultaneously, there is a need for local funding that is met in the US dollar market due to the absence of ready domestic funding by a constrained banking sector. Marry the two needs and we have the demand and supply sides of the equation for a local currency debt capital market.

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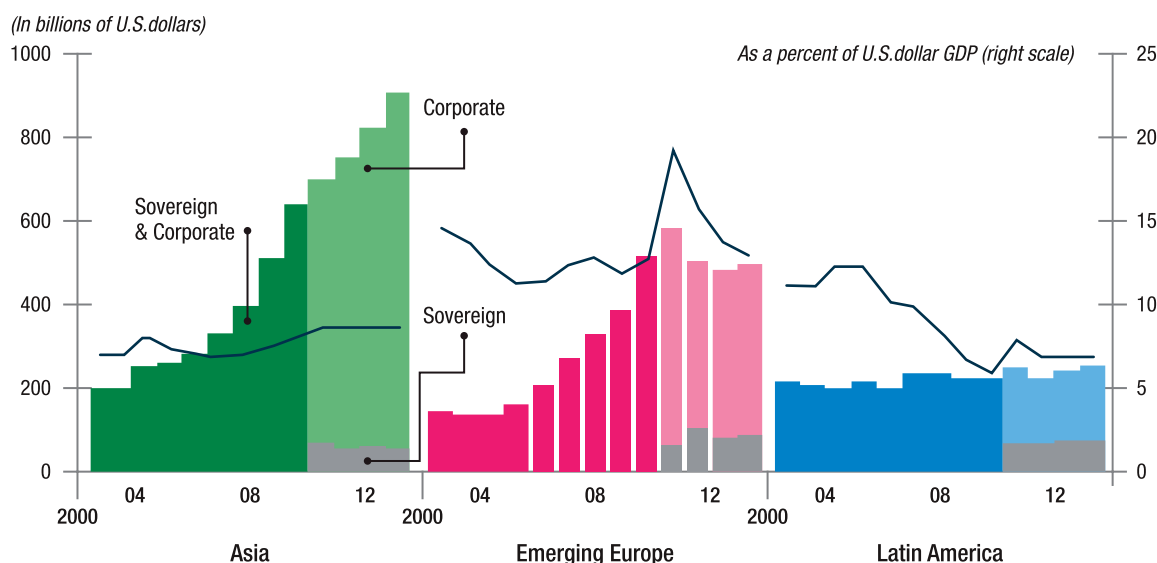
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## Appendix – A look at the future

Essentially fixed income securities markets allow a wider diversification in the supply of funding for the public and the private sector, thereby offering protection from sudden withdraw of capital or inability to access funds at times of financial stress. This need is evident when we look at the picture below, which depicts the refinancing need of the main emerging

economies. Over the next few years, there will be fierce competition for capital and only the countries with well developed financial structures will be able to gain the trust of investors. The others will pay a sizeable spread or possibly could struggle to meet their obligations.

**Fig. A1 - External Debt Refinancing Needs in Emerging Markets**



Sources: Bloomberg L.P.; IMF, International Financial Statistics and World Economic Outlook databases; and IMF staff estimates

Note: Amortization of medium- and long-term debt on the year and short-term debt outstanding at the end of previous year. Corporate debt includes financials.

The outlook for the new issuance of Sukuk, which has the potential for fast growth performance over

2010, is encouraging. Table A1 reports the pipeline of possible issuance in the foreseeable future.

**Table A1 - List of announced and rumored Sukuk issuances in the GCC**

Status	Issuer	Sukuk Name	Sukuk Structure	Country	Currency	Issue Size(\$)	Tenor
Announced	Tamweel	Tamweel Convertible Sukuk II	Ijarah	UAE	AED	299.5M	-
Announced	First Investment Company	First Investment Company Sukuk	Ijarah	Kuwait	USD	200.0M	-
Announced	Limitless	Limitless Sukuk	Unknown	UAE	-	-	-
Announced	Saudi Hollandi Bank	Saudi Hollandi Bank Sukuk (Tranche 2)	Modarabah	KSA	SAR	193.6M	-
Announced	Al Oula Development Company	Al Oula Sukuk	Ijarah	KSA	SAR	801.1M	-
Announced	Abraaj Capital	Abraaj EFC Sukuk	Ijarah	UAE	USD	400.0M	10 years
Announced	Amlak Finance	Amlak Finance Second Sukuk	Ijarah	UAE	USD	260.0M	-
Announced	A'ayan Leasing and Investment Company	A'ayan Leasing and Investment Second Sukuk	Ijarah	Kuwait	USD	200.0M - 250.0M	-
Announced	Kuwait Commercial Markets Complex Company	KCMCC Second Sukuk	Ijarah	Kuwait	KWD	101.7M	-
Announced	Abu Dhabi National Insurance Company	ADNIC Sukuk	Ijarah	UAE	AED	272.3M	-
Announced	Al Safwa Group Holding Company	Al Safwa Group Sukuk	Ijarah	Kuwait	USD	150.0M	-
Announced	National Real Estate Company	NREC Sukuk	Ijarah	Kuwait	-	-	-
Announced	Abu Dhabi National Energy Company	Taqa Malaysian Sukuk	Unknown	UAE	MYR	-	-
Announced	Al Salaam Bank - Bahrain	Al Salaam Bank - Bahrain Sukuk	Manfa'a	Bahrain	BHD	227.3M	-
Announced	Government of Kuwait	Kuwait Sovereign Sukuk	Unknown	Kuwait	-	-	-
Announced	Manara Developments Company	Manara Developments Sukuk	Ijarah	Bahrain	-	-	-
Announced	Al Intiaz Investment Company	Al-Intiaz Sukuk	Ijarah	Kuwait	USD	75.0M - 150.0M	3 years
Announced	Jabal Omar Development Company	Jabal Omar Sukuk	Unknown	KSA	-	3031 M	-
Announced	Emaar Sukuk Limited	Emaar Sukuk Limited	Ijarah	UAE	USD	2,000.0M	-
Announced	DAMAC Kuwaiti Holding Company	Damac Kuwaiti Holding Company Sukuk	Unknown	Kuwait	-	-	-
Announced	Albaraka Banking Group	Albaraka Banking Group Sukuk	Ijarah	Bahrain	USD	250.0M	-
Announced	Qatar Central Bank	Qatar Sovereign Sukuk	Ijarah	Qatar	-	-	-
Announced	Amlak Finance	Amlak Finance Non-convertible Sukuk	Ijarah	UAE	AED	816.8M	3 to 5 years
Announced	Dar Al Dhabi Holding Company	Dar Al Dhabi Sukuk	Unknown	Kuwait	KWD	339.0M	-
Announced	Unicorn Investment Bank	Unicorn Investment Bank Sukuk	Ijarah	Bahrain	-	245.0M	-
Announced	DB Sukuk Company (DBSC)	Dubai Bank Sukuk (Tranche 1)	Ijarah	UAE	USD	500.0M	-
Announced	Amlak Finance	Amlak Finance Convertible Sukuk	Ijarah	UAE	AED	490.1M	3 to 5 years
Announced	ETA Star Property Developers	ETA Star Sukuk	Ijarah	UAE	USD	150.0M - 200.0M	-
Announced	Abu Dhabi Islamic Bank	ADIB Tier 1 Sukuk	Ijarah	UAE	AED	544.5M	5 years
Announced	The Investment Dar Company	The Investment Dar Sukuk 2	Ijarah	Kuwait	USD	500.0M	-
Announced	Ektitab Holding Company	Ektitab Sukuk	Unknown	Kuwait	-	150.0M - 200.0M	-
Announced	Central Bank of Bahrain	Bahrain Domestic Sukuk	Unknown	Bahrain	BHD	530.4M	-
Announced	Islamic Development Bank	Islamic Development Bank Sukuk	Unknown	KSA	USD	500.0M - 1,000.0M	3 to 5 years
Rumoured	Mubadala Development Company	Mubadala Sukuk	Unknown	UAE	-	-	-
Rumoured	Qatar Islamic Bank	QIB Sukuk	Unknown	Qatar	-	-	-
Rumoured	Dubai Pearl	Dubai Pearl Sukuk	Unknown	UAE	-	-	-
Rumoured	Tourism Development and Investment Company	TDIC Sukuk	Unknown	UAE	-	-	-
Rumoured	Mobile Telecommunications Company	Zain Sukuk	Unknown	Kuwait	-	-	-
Rumoured	Bahrain Muntalakat Holding Company	Muntalakat Sukuk	Unknown	Bahrain	-	-	-
Rumoured	Saudi Telecom	Saudi Telecom Sukuk	Ijarah	KSA	-	-	-
Rumoured	Bukhatir Investments	Bukhatir Investments Second Sukuk	Ijarah	UAE	USD	200.0M	-
Rumoured	Salam Bounian Development Company	Salam Bounian Second Sukuk	Ijarah	Qatar	-	-	-
Rumoured	First Energy Bank	First Energy Bank Sukuk	Unknown	Bahrain	-	-	-
Rumoured	Bank Al Jazira	Bank Al Jazira Sukuk	Ijarah	KSA	-	-	-
Rumoured	RAK Ceramics	RAK Ceramic Sukuk	Ijarah	UAE	-	-	-
Rumoured	Dubai Electricity and Water Authority	DEWA Sukuk II	Ijarah	UAE	-	-	-
Rumoured	Kingdom Installment Company	Kingdom Holding Company Sukuk	Unknown	KSA	-	-	-
Rumoured	Al Rayan Investment Company	Al Rayan Investments Sukuk	Unknown	UAE	-	-	-
Rumoured	Abu Dhabi Airports Company	Abu Dhabi Airports Sukuk	Unknown	UAE	-	-	-
Rumoured	National Industries Group Holding	NIG Sukuk II	Ijarah	Kuwait	-	-	-
Rumoured	RAK Properties	RAK Properties Sukuk	Unknown	UAE	USD	-	-
Rumoured	Abu Dhabi Commercial Bank	ADCB Malaysian Sukuk	Ijarah	UAE	MYR	85.9M	3 years
Rumoured	Union Properties	Union Properties Sukuk	Unknown	UAE	-	-	-
Rumoured	Allianz Takaful	Allianz Takaful Sukuk	Unknown	Bahrain	-	-	-
Rumoured	Sakana Holistic Housing Solutions	Sakana Sukuk	Unknown	Bahrain	USD	50.0M	-
Rumoured	Qatar Real Estate Investment Company	Qatar Real Estate Investment Company Second Sukuk	Ijarah	Qatar	-	-	-
Rumoured	First Gulf Bank	First Gulf Bank Sukuk	Ijarah	UAE	USD	-	-
Rumoured	Abu Dhabi Ports Company	Abu Dhabi Ports Company Sukuk	Ijarah	UAE	-	-	-

Source: Zawya Investor.





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