Treasury Developments in the Middle East

Dennis Cox, Risk Reward - 20 Jan 2011

The challenges still facing the global economy are magnified in the Middle East, where the changing market has not been matched by a skills increase in treasury.

Globally the financial world is going through a major shift. The days of continually declining interest rates and year-on-year growth are behind us and we are looking forward to a new environment, which is likely to see increasing interest rates and inflation. For treasurers and risk managers worldwide this will provide an interesting challenge, but this challenge will be even more extreme in the Middle East.

The peak of interest rates was in the period 1980-1982. You only have to picture what changes have occurred since then to imagine the issue. Islamic finance, as we now understand it, really only started in the 1980s. Gross domestic product (GDP) (current prices) for United Arab Emirates (UAE) in 1980 was US$29.626bn. It is now closer to US$270bn. It is only prior to 1982 that we had an environment of generally rising interest rates, a challenge that modern Islamic finance has not had to face.

The challenge then for both banks and companies in the Middle East are how to deal with a changed market environment together with an increase in size in an absence of experience and often skills. The non-Islamic banks and companies will be seeking to tie in borrowings to low interest rates by taking fixed income positions which they will hope to fund efficiently as interest rates rise. The question is whether these firms have the necessary information and further, the leadership and vision that is really required to meet these challenges.

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The Issues for Banks in the Middle East

Many banks in the Middle East are still extremely liquid, a result of the flow of petrodollars into their economies. Oil is currently at a relatively high price (around US$90 per barrel) with some people anticipating that this will increase to US$150 by the end of the year. While I can perceive a scenario that would result in such a rise, the more likely scenario is that the price at the year-end will actually be lower than the current price at around US$70. Generally reasonable liquidity could be expected to still be available at the year end - a challenge many banks would love to face.

There are firms in the Middle East with treasury functions as developed and sophisticated as any that might exist in the developed world. They have detailed information enabling them to work efficiently and a combination of local and expatriate staff capable of efficiently running treasury activity. And then there are the other firms. These have little financial information and, in particular, no behavioural analysis. Many firms (including banks) have only contractual information available, rather than the behavioural data that they need to enable decisions to be made.

Asset-liability committees (ALCOs) are often poorly staffed, with members having limited experience of the products available internationally or the risks inherent within treasury functions. The committees rarely report to risk management committees or directors and instead report directly to a chief executive officer (CEO) or finance director. The paucity of information is often not recognised and accordingly the failure to hedge risks is an obvious consequence.

Interestingly, many of these same firms have acquired advanced treasury systems and risk management software, although much of it is poorly-used and often unsuitable. Why, then, does this problem exist? Often for the banks there is the issue of their central banking systems, which are frequently suitable for accounting and transaction reporting, but do not efficiently facilitate treasury activity. These treasury systems are then bolted on, resulting in significant reconciliation issues and increasing uncertainty. Add to this the often-limited local skills and policies to increase the percentage of local staff employed, and the issue becomes even clearer.

Consequently the type of instrument used is simplified, with many risks effectively going unhedged, although this trend is likely to continue to develop in the other markets as well consequent to regulatory change.

The knowledge of ISDA documentation is often weak in the Middle East, with transactions being contracted without such documents being in place or perhaps "subject to International Swaps and Derivatives Association (ISDA) rules" which really means without ISDA. Little of this has, to date, been tested in the courts, so risk does remain that additional uncertainty could result.

Treasury Issues in Islamic Finance

The tenants of Islamic finance vary from country to country, even within the Middle East, and more so in international markets. However the principle that interest is prohibited ('riba') of course does not make the problem go away. Banks and companies are funded by a combination of borrowing, deposits and capital, much of which effectively carries interest rate risk.

The problem for the treasurer in Islamic finance is that many of the instruments that a traditional treasurer would use, interest rate swaps and options, for example, are effectively unavailable to them. While Malaysian Islamic finance is slowly coming to grips with this issue, the same cannot be said for many of the banks in the Middle East. Accordingly, these treasurers are able to undertake money market activities and then use forward contracts, but little else. However these are the same banks that have what might be termed 'excess liquidity' with good lending opportunities remaining relatively scarce.

Of course, many of these banks have a high percentage of so-called 'core deposits' on which their long-term survival can be relied. The question for the treasurer is at what stage would the funds start to move to an interest earning account rather than one that pays a token or no interest at all? This would exacerbate the funding gap and could restrict a firm's ability to succeed.

It is important to recognise that an Islamic bank has significant difficulties in seeking to chase outstanding loan payments. Given that any additional charge must be given to charity and that pressure should not be exerted if the customer has the willingness but not the ability to make repayment, then there is limited incentive for a customer to make repayment on time, that is, other than moral pressure. If interest rates rise, the banks will be unable to justify an increase in rates due to the riba rulings. This is likely to mean that these loans will remain at what is in effect a below market price while the true cost of funding increases - impacting both margins and the long term survival of institutions.

It is believed that the majority of borrowing clients would renegotiate upwards if asked and if permitted by the relevant Shariah committee. What we expect to see is facilities being redeemed and new facilities provided over longer terms at higher rates. This will be combined with a move to greater use of leasing-style ijara contracts with their two-tier contract structure (capital repayment and rental). Since the rental can be reviewed six monthly or annually it effectively mitigates some of the interest rate risk.

Perhaps due to the level of excess liquidity that has been available, these banks neither use nor offer advanced treasury instruments to their clients and consequently risks remain unhedged. Some of these firms also restrict their use of insurance, again citing Shariah concerns, removing another series of products.

What is available is the sukuk or Islamic bond market. While this has been a source of liquidity, there are still a variety of Shariah issues to deal with and convergence appears a long way off. The sukuk does enable a firm to transform its balance sheet through using such secured bonds and some treasurers are active in this market.

The Key Challenges

It is important for the banks and companies in the Middle East to recognise that the days of declining interest rates are over. While lending fixed long-term that is funded short-term without the ability to reset rates is likely to be a problem, the levels of liquidity in this market are likely to mitigate the impact of this problem. The reliance on core deposits is, however, likely to be questionable and some reduction in excess liquidity could be anticipated. This will be combined with the paucity of skills and product and the limited information available. There are clear needs for board-led direction of treasury strategy supplemented by developing innovative and appropriate solutions to the challenges faced. However, when you are making a good return, the argument that you could reduce risk and make even more money does not have quite the weight that it should.

We suggest that other parts of the world are likely to suffer similar problems. The development of central counterparties for over-the-counter (OTC) derivatives will increase costs in this important market. Our expectation is that some firms will seek to innovate developing alternative non-derivative solutions that are more cost efficient. Many treasurers appear to be working under the misapprehension that changing the rules will not change the market.

History shows that this is not the case. The concern is that the risks of rising interest rates will not be grasped effectively by some institutions. Remember that if you have a floating rate loan and rates rise, you go bust. But if you have a fixed rate loan and rates rise, the bank goes bust. The yield curve is clearly showing that interest rates are likely to rise. The only question is when and how fast; and which banks will have failed to address this issue.