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RESEARCH PAPERS

Banking and Insurance in the GCC Countries: Is there Regulatory Convergence with the EU?

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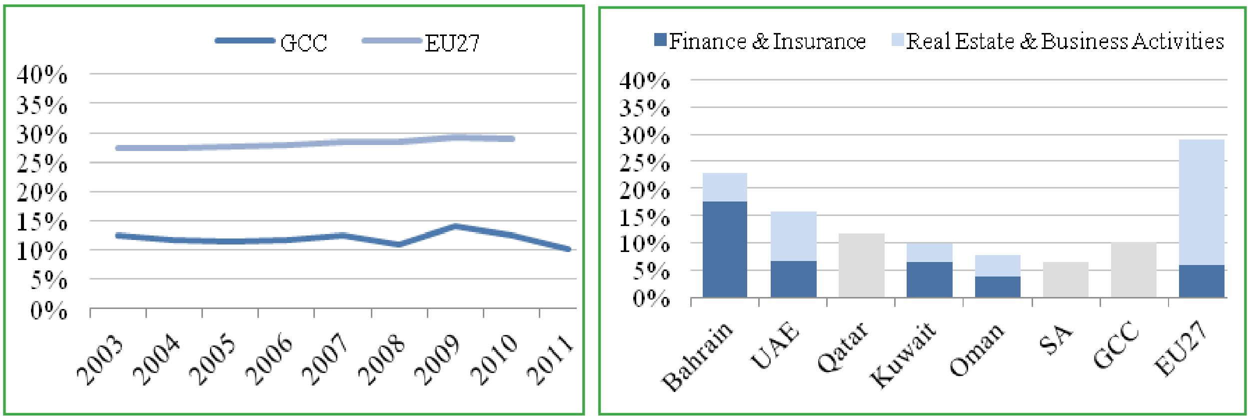
Introduction

The Gulf Cooperation Council (GCC) countries exhibit very similar economic structures, with strong reliance on the hydrocarbon sectors, foreign workers and pegged exchange rates.[1] To reduce their dependency on natural resources that are in the process of being depleted, the GCC countries have made diversification of economic activities their principal long-term policy objective. The GCC countries are therefore trying to develop activities that are closely related to the hydrocarbon sectors or in which they have, or could have, a competitive advantage.

The financial sector has a pivotal role in this strategy of economic diversification. The benefits of financial sector development in the GCC area are twofold. First, the financial sector forms an intermediary that contributes to the collection and efficient allocation of financial resources. Second, the sector itself contributes to the economic development of the GCC countries by means of profits and the creation of employment. To tap this economic potential, the GCC countries have taken the initiative to develop their financial sectors by strengthening the domestic regulatory and supervisory framework, participating directly in financial institutions, and providing grants, subsidies and guarantees.

Fig. 1. Finance, insurance, real estate and business activities (% of GDP)



Note: These figures are for the whole GCC region and the EU27 from 2003 to 2011, and by country for 2011. There was no disaggregated data available for Qatar and Saudi Arabia.

Sources: Gulf Investment Cooperation, Central Bank of Bahrain, Central Bank of Kuwait, Ministry of National Economy Oman, Qatar Central Bank, Saudi Arabian Monetary Agency, UAE National Bureau of Statistics, Eurostat.

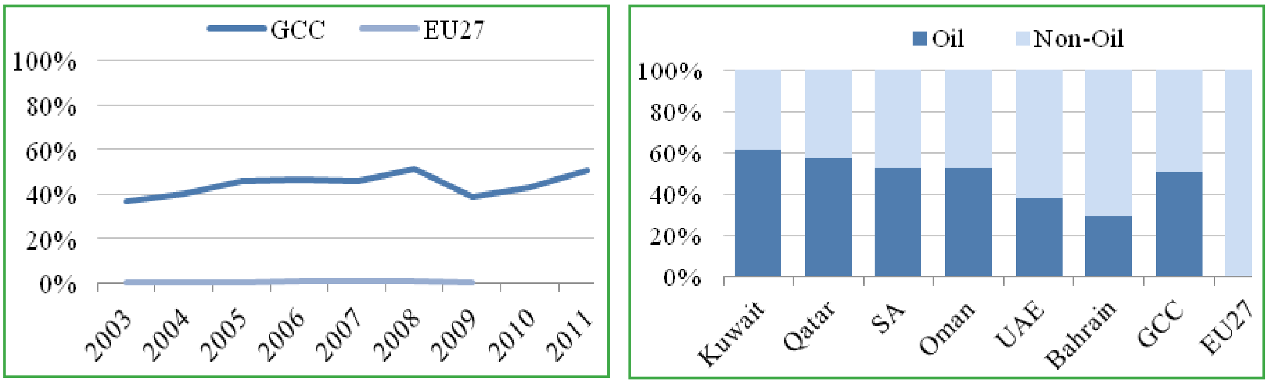
The financial services industry already plays a significant role in the GCC economies. However, its contribution varies substantially between the different countries. Figure 1 shows, for instance, that the financial sector contributes 17.7% to the Bahraini economy, but only 3.9% in Oman. On average, the share of GDP of the financial sectors in the GCC in 2011 was similar to the figure of 5.9% in the 27 Member States of the European Union (the EU27). [2] Since

1 *The GCC is a political and economic union of six states bordering the Persian Gulf, namely Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.*

2 *With the accession of Croatia to the European Union at 1 July 2013 the number of Member States has increased to 28. Since the*

then, the absolute size of the financial sector has remained constant, while the relative size as a percentage of GDP has fluctuated between 10% and 15%. It is important to note that this fluctuation is attributable to variations in total GDP over the past few years. The size of GDP, in turn, follows developments in crude oil and natural gas exploration (see Figure 2).

Fig. 2. Oil exploration



Note: These figures show the contributions of crude oil and natural gas exploration to GDP for the whole GCC region and the EU27 from 2003 to 2011, and by country for 2011.

Sources: Gulf Investment Cooperation, Central Bank of Bahrain, Central Bank of Kuwait, Ministry of National Economy Oman, Qatar Central Bank, Saudi Arabian Monetary Agency, UAE National Bureau of Statistics, Eurostat

The financial sectors in the GCC are dominated by commercial banking. Non-bank financial institutions have a rather limited presence in these countries.

In recent years, access to financial services has improved significantly. However, outside of providing basic banking services for the private and public sectors, it remains relatively underdeveloped. The growth of the GCC banking sectors was partly limited due to stringent regulation and supervision; banks operating in the GCC are restricted in their activities and have to comply with higher capital requirements. Moreover, the banking sectors are often dominated by government-owned banks, with no deposit insurance scheme, and limited possibilities for foreign banks to enter.

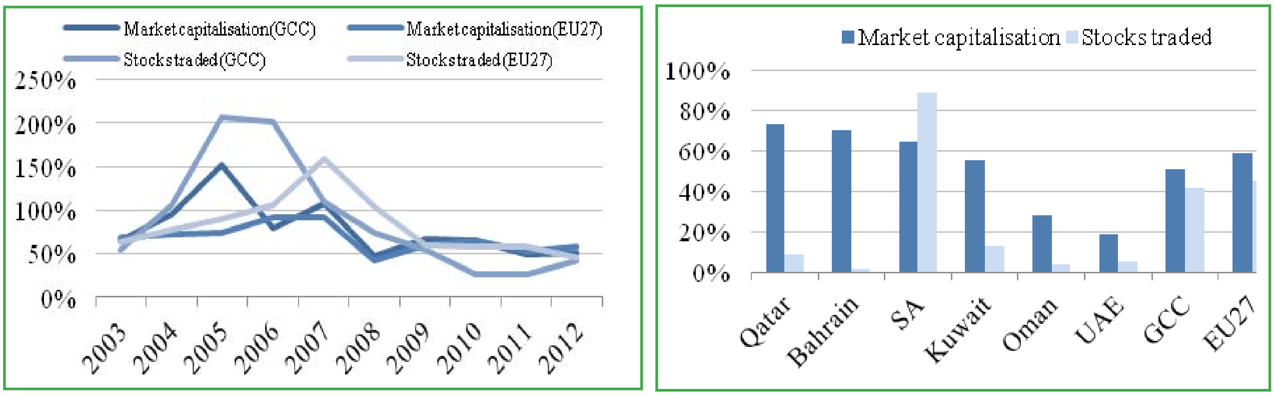
The insurance industry has been booming, with premium income increasing significantly over the past ten years. The absolute size of the industry is, however, still small. The specific nature of the region and the severe lack of skilled labour limit its potential and thus its positive spill-over effects on financial markets and the economy overall. In contrast to the banking sector, fragmentation of the insurance market remains high.

Although stock market capitalisations have grown in recent years, they have been outpaced by economic growth. Equity markets are, however, still mostly underdeveloped, while domestic debt markets are virtually non-existent. Figure 3 shows that in Bahrain, Kuwait, Qatar and Saudi Arabia, listed companies represent a total market value of more than half

accession took place after the period covered in this paper Croatia has not been included in the analyses.

of GDP. This is comparable to the average size of their market value in the EU27. In turn, the equity markets in Oman and Qatar are non-existent. Hence, the main difference between the GCC and EU27 equity markets is in terms of activity. Trading volumes in the GCC countries are substantially lower, with the exception of Saudi Arabia, which has rather deep equity markets. The total value of stocks traded in Saudi Arabia is, for example, only surpassed by the UK among the EU27. The equity and, in a broader sense, the capital markets in the GCC countries are nevertheless still limited in size due to low levels of free float, controls on foreign ownership and limits on inward foreign direct investment (see IMF 2012a).

Fig. 3. Market capitalisation and trade value of listed companies (% of GDP)



Note: These figures are for the whole GCC region and the EU27 from 2003 to 2012, and by country for 2012.
Source: World Bank World Development Indicators.

This paper explores the financial sector (banking and insurance) in the GCC in comparison with the EU, assesses regulatory convergence and provides policy recommendations for future financial partnerships between the two regions.

The first part provides an overview of the banking systems in the GCC countries in comparison with the EU27, and assesses regulatory convergence and integration. The second part analyses the insurance sector in the GCC countries. The paper concludes with some recommendations for the strengthening of EU-GCC cooperation and integration in financial markets.

1. Banking Structure and Regulation in the EU and the GCC: What Degree of Convergence?

The GCC countries have undergone substantial reforms in their financial sectors in recent years. This chapter develops a number of indicators to assess and track the evolution of the adequacy of banking regulations since the early 2000s, using publicly available and comparable surveys for a large sample of countries. To allow for comparison between the EU and the GCC, we have developed measures for the six GCC countries and the EU27. For the purposes of this analysis, the EU has been split in two groups, namely the 15 countries that joined the EU before 2000 (EU15),[3] and the 12 countries that joined after 2000, also called the new Member States (NMS12).[4]

In what follows, a description of the GCC banking sectors is provided. The methods and data used to analyse the convergence between banking regulation in the GCC countries and the EU27 are then described. Finally, quantitative measures are presented and discussed and, based on the results, some conclusions are drawn and policy recommendations made.

1.1. Structure of the banking sector in the GCC

The banking sector in the GCC is dominated by a small number of domestic and foreign commercial banks. However, beyond providing basic banking services for the private and public sectors, the banking sector remains relatively underdeveloped. The absence of deep domestic capital markets and ties with governments are the main obstacles to further development (Cevik and Teksoz 2012). The size of the banking sector in the GCC is, in both absolute and relative terms, much smaller than that of the EU. In turn, the sector's financial soundness and profitability indicators are higher than in the EU.

In the past decade, the total assets of the GCC banks have experienced fast growth, which came to a standstill with the onset of the global financial crisis. Nevertheless, the impact of the crisis on financial stability in the region has been rather limited compared to the EU and the US. After an initial fall in financial soundness and profitability indicators in 2009, a swift recovery followed.

Since the GCC's inception in 1981, the region's countries have pursued ambitious economic and financial integration objectives. While the countries are at different stages of financial market development and monetary policy operations, nominal interest rates have generally tended to converge (Espinoza, Prasad and Williams 2010).[5] For financial integration to progress, however, it is fundamental that regulations converge.

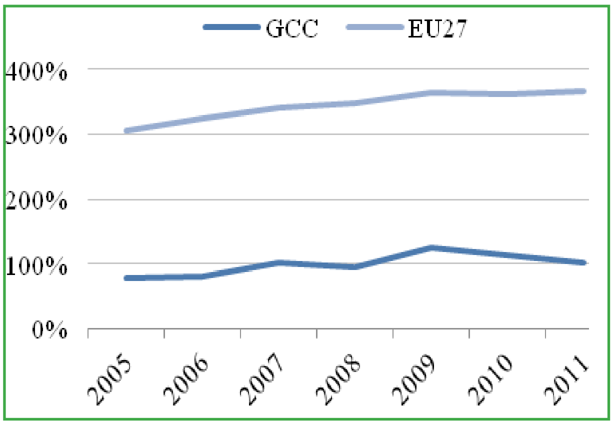
Banks' assets in the GCC countries progressively increased until 2008, and then stabilised soon afterwards. However, the size of the banking sector varies significantly between the GCC countries, with banking sector assets amounting to over double GDP in Bahrain, while they represent only about 70% of GDP in Oman and Saudi Arabia (Figure 4). Bahrain has the largest retail banking sector in the region. The UAE has the second largest banking sector in the GCC, and also one of the least concentrated. The third largest banking sector is in Qatar.

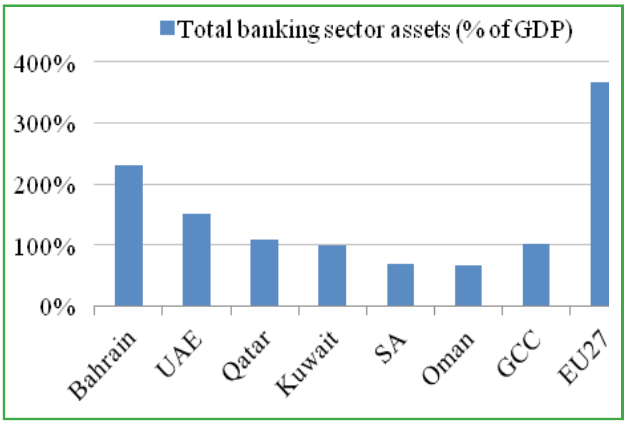
3 The EU15 consists of the following countries that acceded to the EU before 1995: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and the United Kingdom.

4 NMS12 consists of the following twelve countries that acceded to the EU in 2004 or 2007 (as indicated): Bulgaria (2007), Cyprus (2004), the Czech Republic (2004), Estonia (2004), Hungary (2004), Latvia (2004), Lithuania (2004), Malta (2004), Poland (2004), Romania (2007), Slovakia (2004), and Slovenia (2004).

5 Interest rates in the GCC countries have followed US interest rates as a result of credible pegging of most of the GCC countries' currencies to the US dollar, except for the Kuwaiti Dinar, which is pegged to a basket of currencies, including the US dollar.

Fig. 4. Total banking sector assets (% of GDP)





Note: These figures are for the whole GCC region and the EU27 from 2003 to 2011, and by country for 2011.
Source: National authorities, IMF, ECB.

While a significant number of commercial banks in the region are branches of foreign banks, the largest five banks in the GCC countries are domestic. Several studies have shown that the banking sectors in the GCC economies operate under monopolistic competition and are less competitive than in non-oil producing countries (Al-Muharrami, Matthews and Khabari 2006, Turk-Ariss 2009, Anzoategui, Martínez Pería and Rocha 2010). The statistics on bank concentration given in Table 1 show that the concentration of the industry remains high, and that the GCC banking sector is on average more concentrated than the EU banking sector.

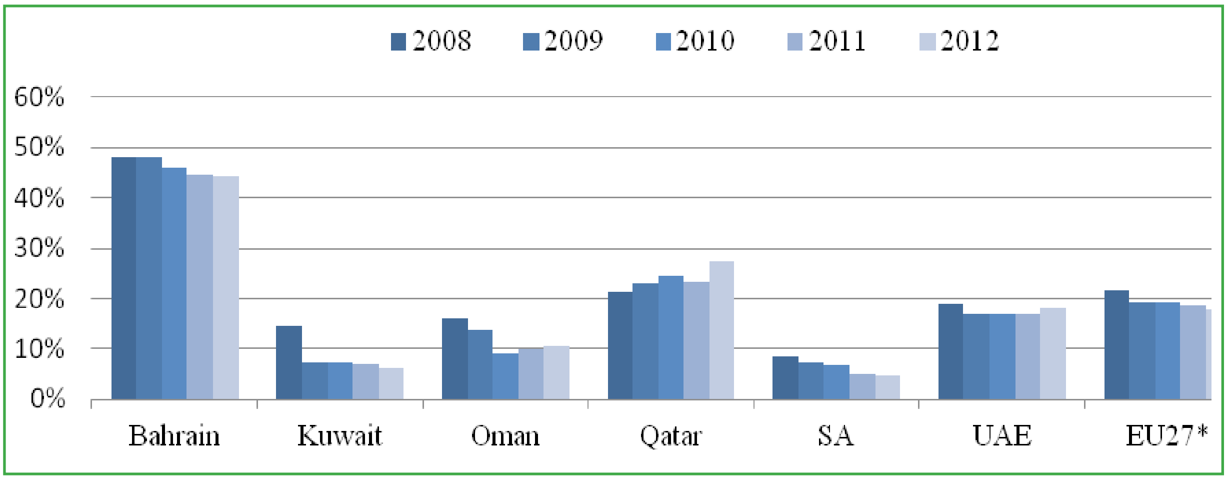
Table 1. Structure of the GCC banking systems

	Concentration ratio (Top 3, 2011)	**Commercial banks (2009)**	**Bank branches (2009)**	**Bank branches per 100,000 adults (2009)**
Bahrain	89	30	414	-
Kuwait	89	21	368	19
Oman	70	17	461	24
Qatar	87	17	254	18
Saudi Arabia	55	23	1,646	9
UAE	61	51	851	15
GCC*	68	159	3,994	12
EU27*	69	8,358	234,077	56

* Regional averages are weighted by total banking assets.
Source: ECB (2010), World Bank (2013)

In comparison to their peers in the EU and the US, banks in the GCC region have limited exposure to sub-prime assets and fewer linkages to the rest of the global financial markets. The operations of the banks are domestically oriented, relying mainly on lending and private deposits. Al-Hassan, Khamis and Oulidi (2010) have shown in their analysis of the items used for funding credit growth in the GCC countries that, while client deposits have been the main contributor, foreign liabilities have played a significant role in explaining the rapid credit growth in the GCC co untries prior to the outbreak of the global financial crisis. Bahrain's banking system emerges as significantly more exposed to external financing than the banks in other GCC countries. However, a large part of the foreign funding in Bahrain comes from regional banks. The Qatari banking system is the only system which has recently significantly increased its share of foreign liabilities.

Fig. 5. Banks' foreign liabilities to total liabilities



* Regional averages are weighted by total banking assets.
Source: National central banks.

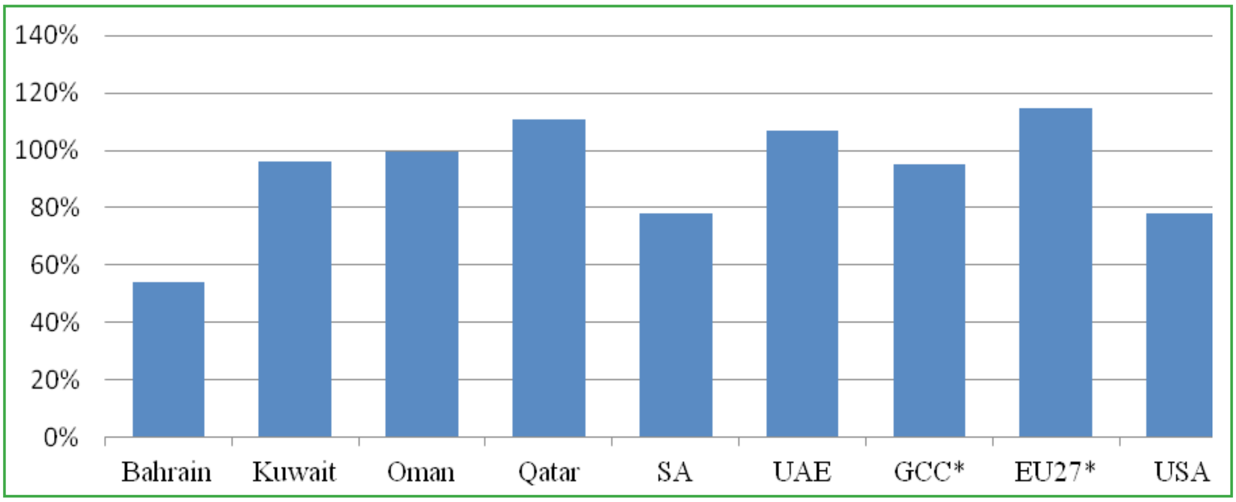
While the domestic focus of the banking systems has shielded the region's countries from the worst effects of the global financial crisis, it has made them vulnerable to other risks, leading to problems such as credit risk concentration. Banks' exposures to the construction and real estate sector continued to be significant in the years following the onset of the financial crisis, with the exceptions of Saudi Arabia and Oman, where less than 10% of loans made by banks go to the sector.

Lending to the government constitutes only a small share of loans in most countries in the region, with the exception of Qatar. The significant and increasing share of loans to the government in Qatar reflects the infrastructure investments the government has decided to make in non-hydrocarbon sectors in order to promote economic diversification. Financing for the government is also on the rise in the UAE, which reflects the state of an emerging market where government-owned enterprises contribute significantly to economic development, meaning that significant amounts of financing are necessarily for government-led projects. The decrease in other countries is in line with the fact that governments have benefitted from rising oil prices in recent years, which has reduced their need for external funding.

Generally, the credit provided by financial institutions is highly concentrated on individuals; 20%-40% of credit is directed to individuals, which is on a similar level to the EU, where loans to individuals makes up about 30% of banks' total credit facilities. The concentration of lending to households has further increased over the past few years. In Oman, personal loans make up the greatest share of commercial banks' credits, and they have been a key profit driver for the Omani banks in the recent period. Again, Qatar proves an exception in this respect, showing a significant decrease in the share of credit directed to individuals. However, household loans in the GCC are generally granted to individuals against salaries, which lowers the risk of lending in this category. Furthermore, GCC governments have started to place restrictions on private lending. In April 2011, for instance, the Qatar Central Bank tightened its limits on personal loans per borrower, and introduced a ceiling on interest rates on salary-assigned and credit card loans, including existing loans.[6] In the UAE, the central bank adopted regulations in February 2011 revising the maximum amount that an individual can borrow and introducing a maximum debt service ratio.[7]

Even though the reversals of foreign deposits reduced the liquidity of the GCC banking sectors, injections by the authorities via central bank deposits and direct placements of government deposits restored liquidity quickly, boosting banks' lending capacity. The loan-to-deposit ratios of GCC banks given in Figure 6 show that, while GCC countries vary significantly in this respect, the average loan-to-deposit ratio for banks in each country is still below the average for EU banks.

Fig. 6. Banks' loan-to-deposit ratios, 2011



* Regional averages are weighted by total banking assets.

Sources: National authorities, ECB, Federal Reserve.

6 *The maximum interest rate that banks can charge on salary-assigned loans is the QCB policy lending rate plus 1.5%, which in April 2011 resulted in a maximum rate of 6.5%. Interest rates on credit card loans were capped at 1% monthly. Possible circumventions of the ceiling have been prevented by a QCB directive from February 2010, which set a ceiling on commissions and fees chargeable on personal accounts and services.*

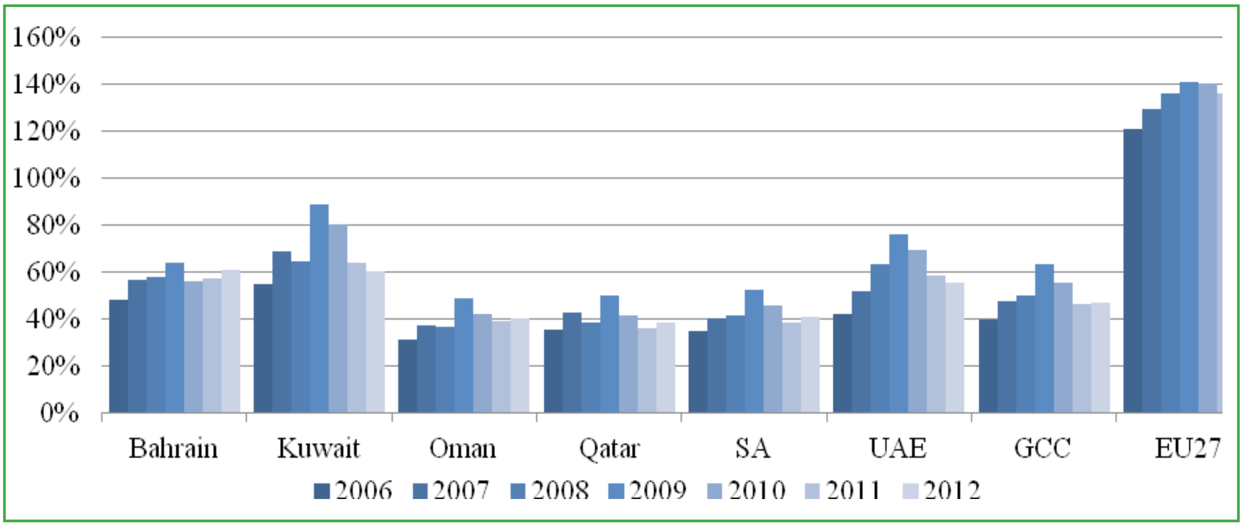
7 *An individual can borrow an amount up to 20 times his monthly income, and the debt service ratio can be 50% of regular income at the most. Terms and conditions for applying for car loans and a minimum salary to qualify for a credit card were also introduced, together with limits on fees, service charges and commissions charged to individual customers.*

The recent years of financial turmoil have had less impact on the GCC countries than on the more mature financial markets as the banks in the GCC region had limited exposure to sub-prime assets and fewer linkages to the rest of the global financial markets. Nevertheless, the vulnerabilities of the GCC banking systems were revealed by the global crisis, in particular the increased reliance on external funding and exposures concentrated in the real estate and construction sectors.

During the years preceding the financial crisis, the region experienced a rapid growth in credit to the private sector. Higher oil prices, increased government spending and non-oil GDP growth spurred business confidence and private sector investment, leading to an increase in the demand for credit.

However, high rates of credit growth during an economic upturn almost invariably lead to higher levels of credit default when economic activity slows down, which increased the vulnerability of the region (Al-Hassan, Khamis and Oulidi 2010). While the favourable macroeconomic environment in the years preceding the financial crisis had been conducive to favourable credit conditions and lower levels of non-performing loans (NPLs), in 2009 NPLs increased sharply and credit stagnated (Espinoza and Prasad 2010). As can be seen in Figure 7, domestic credit to the private sector as a percentage of GDP has been falling steadily since the peak of the financial crisis in 2009 in every country in the region.

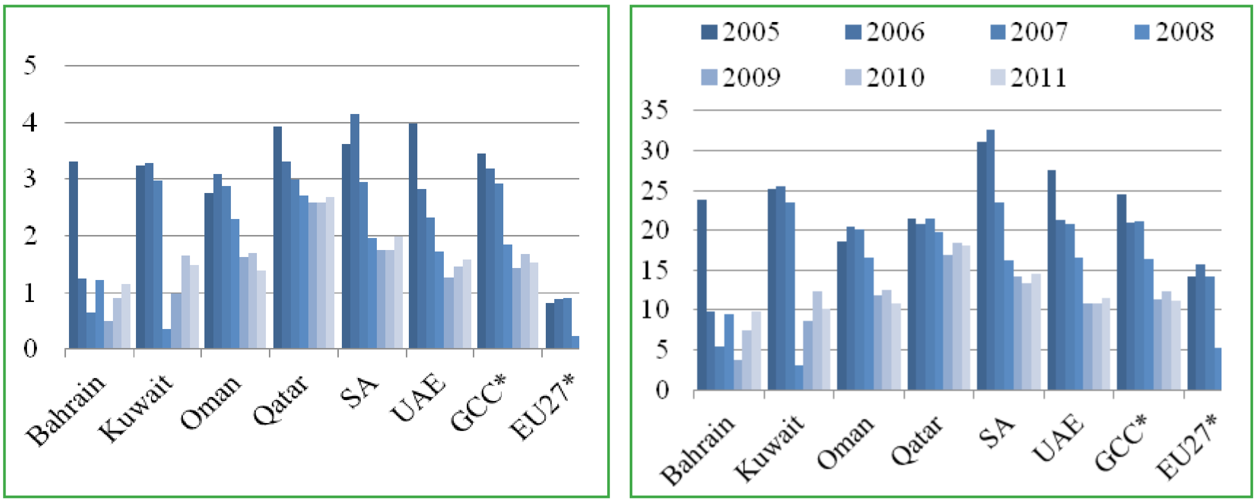
Fig. 7. Domestic credit to the private sector (% of GDP)



Source: World Bank World Development Indicators and national authorities.

The focus of the GCC banking systems on traditional banking operations has secured relatively stable sources of earnings for the banks. Nevertheless, the financial crisis has had an impact on the profitability of GCC banks. The banking sector in Kuwait was the most profitable in the GCC before the crisis, but was also the most affected by it. As can be seen in Figure 8, banks' return-on-asset (ROA) and return-on-equity (ROE) ratios have started to increase again since the peak of the financial crisis in 2008/2009, largely driven by strong credit growth supported by strong government spending. With the economy growing, recoveries on previous loan loss provisions have also boosted the banks' profits. Only Oman and Kuwait experienced decreases in their banks' profitability in 2011. The Qatari banking sector was the least affected by the global crisis, which is reflected in its banks' profitability ratios. The relatively high profitability of Qatari banks through the crisis period also reflects the fact that Qatari banks have the most diversified sources of income within the GCC (Al-Hassan, Khamis and Oulidi 2010).

Fig. 8. Development of bank profitability – ROA (left panel) and ROE (right panel)



*Regional medians.
Source: World Bank (2013) and national authorities.

Banks in the GCC are relatively well capitalised, and the soundness of GCC banking systems has strengthened during recent years. As shown in Table 2 and Subsection 1.2.3., capital adequacy ratios of the banks have increased since 2009. Capital adequacy is above national and international standards in all countries. Non-performing loans as a proportion of total loans have also decreased in every country except for the UAE and Bahrain. While the increase in non-performing loans in Bahrain is not significant, the increase in the UAE is of greater significance, reflecting the problems in the country's real estate sector.

For countries with lower levels of non-performing loans, the provisioning rates are relatively high. The high provisioning rates in Oman are driven by the requirements of the Central Bank of Oman for banks to hold provisions of 1% of performing non-personal loans and 2% of performing personal loans. The low provisioning rate in Kuwait is due to write-offs of bad loans. However, since the onset of the financial crisis, banks in Kuwait have been required to set aside additional "precautionary" provisions (IMF 2012b:18-19). In the UAE, in November 2010 the central bank issued a regulation (No. 28/2010) requiring banks to implement best practices and to recognise default after 90 days, regardless of the ownership of the entities concerned.

Table 2. Bank financial soundness indicators

	Capital adequacy ratio		Non-performing loans (% of gross loans)		Provisioning rate (% of non-performing loans)	
	2009	**2011**	**2009**	**2011**	**2009**	**2011**
Bahrain	19.6	20.3	4.3	4.5	63.9	65.9
Kuwait	16.7	18.5	11.5	7.3	38.3	33.9
Oman	15.5	15.9	2.7	2.4	104.0	120.6
Qatar	16.1	20.6	1.7	1.7	84.5	86.3
Saudi Arabia	16.5	17.3	3.3	2.3	89.8	132.8
UAE	19.9	21.2	4.3	6.2	94.4	67.8
GCC	17.8	19.4	4.5	4.3	83.8	87.5
EU27	13.7	14.3	4.8	6.0	63.9	68.6

Note: Capital adequacy ratio is total regulatory capital divided by risk weighted assets. Provisioning coverage in Saudi Arabia, Oman and Qatar includes general as well as specific provisioning.
Sources: World Bank World Development Indicators and IMF.

While the banks in the region are well capitalised, the crisis continues to strain the banking sector, with the real estate sector in particular putting pressure on it, thereby worsening the banks' asset quality. Due to the persisting high concentrations on the real estate and construction sectors as well as on credit to individuals, international institutions pushed GCC banks to improve the quality of their credit and asset portfolios. Low levels of bond financing have contributed to the maturity mismatches between the assets and liabilities of banks, with limitations resulting from lower market liquidity and funding issues.

As debt securities markets have remained the least developed financial segment in the GCC economies, deepening domestic debt markets is often referred to as a means of enhancing the resilience of these economies. In particular, putting in place the necessary infrastructure and regular placement of government debt to establish a yield curve in order to develop a corporate debt market have generally been proposed as ways of enhancing domestic financing and reducing reliance on foreign financing.

1.2. An assessment of EU-GCC regulatory convergence in the banking sector

The aim of this analysis is to use quantitative measures of regulatory development to assess the degree of convergence of banking regulation in the GCC to international norms. Building on the work of Ayadi et al. (2011) and Ayadi, Arbak and Groen (2013), seven distinct regulatory areas have been identified in order to assess the various aspects of regulatory adequacy. These areas cover the definition of banking, licensing requirements, capital requirements, the independence and powers of supervisors, the presence of safety nets, disclosure and the availability of credit information. Although these provide a broad view of the extent of regulation, several potential areas (i.e. payment and settlement systems, credit guarantee schemes, financial inclusion, etc.) have been excluded from the convergence analyses due to the unavailability of comparable information sources for the sampled countries for at least two consecutive periods. The results of this analysis are used to distil potential areas of EU-GCC cooperation in the banking sector for the purposes of the follow-up to the 2010-2013 Joint Action Programme.

The main source of information for the regulatory adequacy indices are the Bank Regulation and Supervision Surveys (BRSS) developed by Barth, Caprio and Levine (2001) and later revised in 2003, 2007 and 2011.[8] All four surveys are built on official responses to questionnaires that were sent to the national regulatory and supervisory agencies of over 120 countries, most of which were returned.[9] The questions cover a wide variety of areas, including banking activity, entry, capital regulations, supervisory authorities, private monitoring, deposit insurance and external governance.

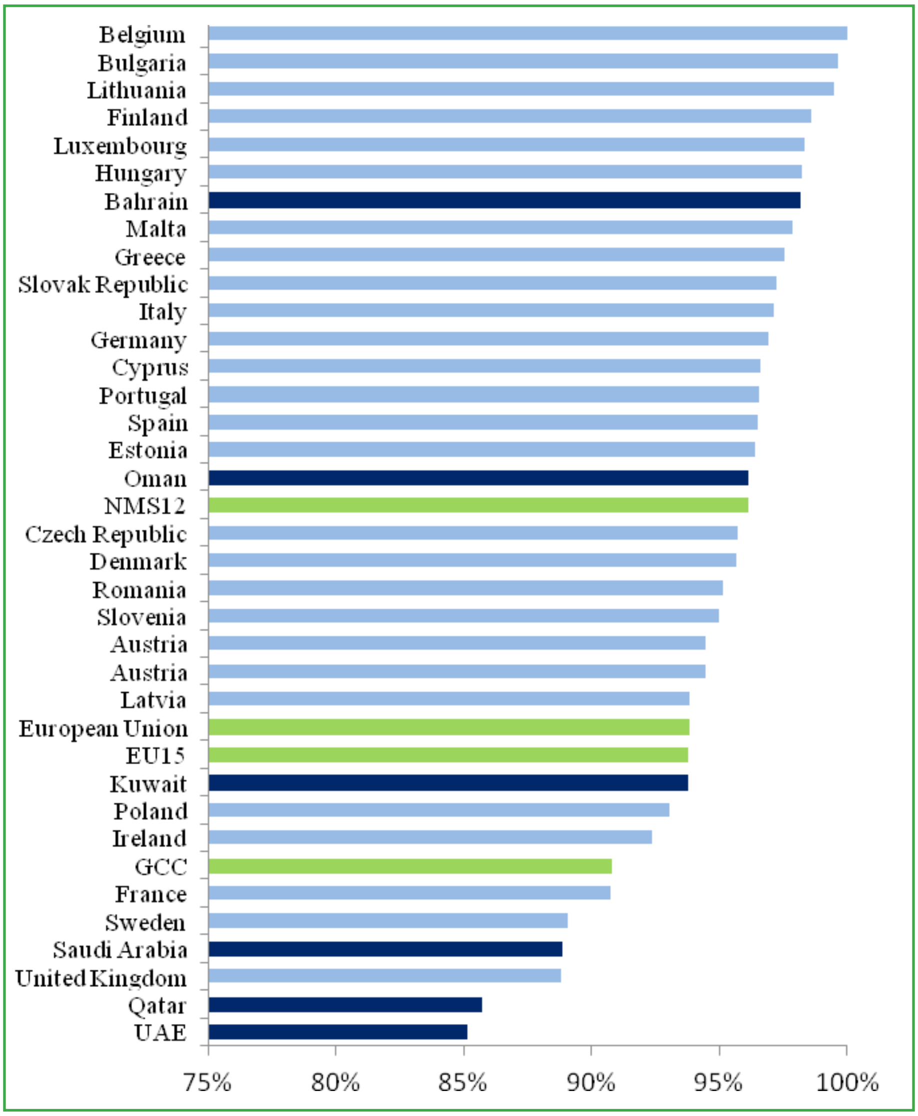
One of the key advantages of the BRSS is that the questionnaires have remained relatively similar over the years, although the later versions cover more areas than the original survey. This particular feature of the datasets has allowed us to make comparisons by building composite indices based on specific answers over time to track the evolution of the different regulatory and supervisory elements.

A key disadvantage of the BRSS is that the number of questions responded to in the 2003, 2007 and 2011 revisions varies from one country to another. For the GCC countries, the aggregate response rates are on average lower than for the entire sample. As shown in Figure 9 the Bahrain regulatory authorities were the most responsive to the survey among the GCC countries, with an average response rate of over 95%. This is followed by Oman and Kuwait, with response rates of around 95%. Three of the six GCC countries – the UAE, Qatar and Saudi Arabia – only achieved response rates of between 85 and 89%, which is well below the average rate for the GCC countries.

8 For discussion of the results and other aspects of the data, see Barth, Caprio and Levine (2006, 2008 and 2012) and the World Bank website: http://go.worldbank.org/SNUSW978P0.

9 The number of countries responding to the survey varied over time. The original survey had 117 country respondents, including a wide range of developed, developing and underdeveloped countries. The later revisions achieved greater participation, with 152 countries responding in 2003, 142 in 2007 and 125 in 2011.

Fig. 9. Average response rates to BRSS



Note: Response rates are averaged over the four surveys and correspond to the number of questions with complete (i.e. excluding empty or partial) answers divided by the total number of questions used to compute the composite indices presented in this paper.
Source: BRSS.

Although the response rates appear high in general, the existence of one single partial or empty answer renders the construction of a relevant composite index dubious since there is no clear way of scoring for missing responses. Moreover, some countries did not respond to all four surveys.[10] To avoid any inconsistencies, empty answers have been scored as zero in the construction of the relevant indices. This approach is in line with Barth, Caprio and Levine (2006 and 2012). The assessment of regulatory convergence is based on the calculation of regional averages, weighted by the total banking assets of each country. This

10 The regulatory authorities of the UAE did not respond to two surveys (2000 and 2007), while those of Qatar (2007), Saudi Arabia (2011), Sweden (2011) and the Czech Republic (2011) did not respond to one survey.

has allowed us to make a sounder judgment of whether the regulatory conditions on both coasts of the Mediterranean are converging.

A second disadvantage of Barth, Caprio and Levine (2001) and its revisions was that the questions did not cover all regulatory and supervisory areas. Two major areas where the surveys lacked depth were the details of deposit insurance guarantee schemes and institutional variables, such as the extent of credit information sharing and creditors' legal rights. In order to fill the gap, several additional sources have been used to supplement the construction of the composite indices, including the deposit insurance database of Demirgüç-Kunt, Karacaovalı and Laeven (2005), the IMF and World Bank's Financial Sector Assessment reports, the World Bank's Doing Business Indicators and the websites of the national authorities.

Seven composite indices have been created using the various data sources identified above. They cover scope restrictions, entry obstacles, capital requirement stringency, supervisory authorities, deposit insurance, private monitoring, and credit information and laws. These areas provide a relatively broad coverage of the quality and evolution of banking regulation and supervision. The composite indices were calculated for each country individually, as well as for GCC countries and the EU27 (EU15 and NMS12) collectively.

The following subsections review and compare the evolution of the regulatory conditions in each of the seven areas listed above.

1.2.1. Area I: Scope restrictions

As is evident from their differing business models across the world, financial institutions are growing increasingly complex and are offering a wider spectrum of products. Some countries restrict banking to a narrow range of activities, such as taking deposits and issuing credit, with little flexibility in debt and asset management, while others provide more flexibility. Regulations typically restrict the extent to which banks may engage in the business of i) securities underwriting, brokering, dealing, and all aspects of the mutual fund industry; ii) insurance underwriting and selling; and iii) real estate investment, development and management.

The composite indicator used in this area to assess the extent of restrictions imposed on banking activity is based on the Banking Activity Restrictiveness Index in BRSS.[11] The surveys provide measures for the degree of restrictiveness for each of the following four categories, ranging from unrestricted (1 point) and mostly permitted (2 points), to too restricted (3 points) and fully prohibited (4 points). The Banking Activity Restrictiveness Index totals the scores for each category to come up with a measure of the extent to which banks are

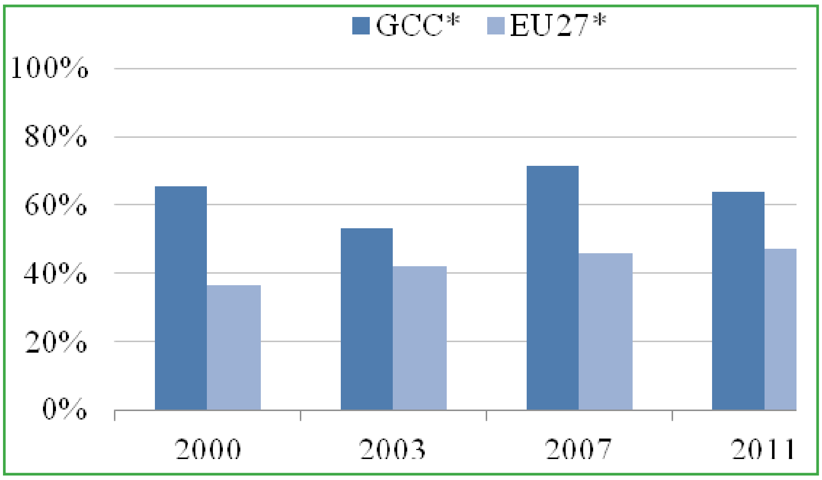
11 The Banking Activity Restrictiveness Index is constructed by adding up the scores for the World Bank Guide (WBG) questions 4.1-4.3, as detailed in Appendix 2 to Barth, Caprio and Levine (2006).

restricted, with a maximum restrictiveness score of 12 points where no activity other than narrow banking is allowed.

The results summarised in Table 3 show that the regulators in the GCC countries impose more restrictions than in the EU27 in general. Hence, banks in NMS12 face similar restrictions in their activities to those encountered by their peers in the GCC countries, whereas banks in the EU15 have more freedom. A deeper analysis of the survey results (not included here) shows that most of the GCC and EU27 regulators impose some form of restriction on insurance activities and real estate activities, while there are no restrictions on securities activities. The GCC countries are, however, much more stringent on real estate activities (real estate investment, development, and management). In all GCC countries, except Bahrain and Kuwait, real estate activities are prohibited for banks.

The figures show no clear convergence tendency when the regional weighted averages of the GCC countries and the EU27 are considered. The difference between the GCC and EU27 weighted averages has moved up and down over time, despite the fact that the EU27 average has increased gradually. The changing composition of the GCC sample, as well as the restrictions on real estate activities in Kuwait and Qatar, are the main reasons for the volatility in the GCC average. The level of restrictions on bank activities in the GCC has nevertheless remained above the EU27. This might change as a result of the new banking reforms that are moving the EU27 towards greater restrictions on banking activities following the financial crisis.[12]

Table 3. Banking activity restrictiveness (% of maximum score)



12 *In 2012, Commissioner Barnier nominated a group of experts, chaired by Erkki Liikanen, to examine the need for reform in the structure of the EU banking sector. In the final report published in October 2012, the experts advised the European Commission, among other things, to curb investment banking activities.*

Table 3. Banking activity restrictiveness (% of maximum score) (continued)

	2000	2003	2007	2011
Bahrain	67	67	67	50
Kuwait	58	42	67	33
Oman	83	75	67	67
Qatar	67	25	-	67
Saudi Arabia	67	67	75	-
UAE	-	42	-	75
GCC*	66	53	72	64
EU15*	36	42	45	47
NMS12*	55	62	65	64
EU27*	36	42	46	47
AVG	36	42	46	47
STDEV	13	12	17	15

Note: Higher values represent more restrictive rules, as a share of a maximum score of 12 points.
* Regional averages are weighted by total banking assets. See Table A.1. for the scores of the individual EU Member States.
Source: BRSS.

1.2.2. Area II: Entry obstacles

The competitive conditions in a country depend crucially on the regulatory structure, in particular on conditions that might hinder or prevent entry into the banking sector by domestic or foreign banks. In some countries, obstacles may take the form of excessive licensing or entry requirements, which are applicable to both domestic and foreign banks. In others, governments may restrict foreign entry as part of a deliberate policy choice, either explicitly through setting limits on ownership or, more importantly, by rejecting foreign applications in a disproportionate manner.[13] Finally, a banking sector that is predominantly state-owned may be disadvantageous for the development of privately-owned banks.

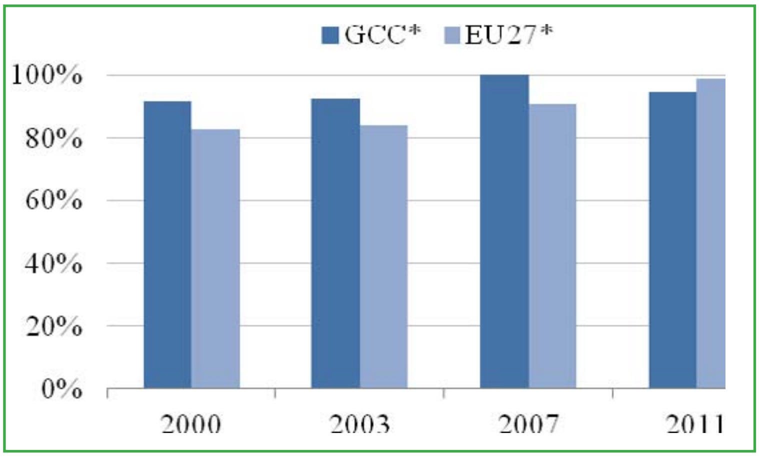
Three indicators are utilised to construct the composite index assessing the impact of entry obstacles.

The first indicators that can be used to measure the extent to which the regulatory structure obstructs entry are legal licensing requirements, which can hamper entry by making procedures unnecessarily cumbersome. The relevant measure is based on the set of requirements for a licensing application to be considered valid. The index is built on the

13 Rejections of domestic banks are not considered here as they are more likely to arise from prudential concerns, including funding deficiencies or other financial problems, which are common place for home-grown banks in countries with less developed financial systems that have limited access to external capital.

total number of required documents, including i) draft by-laws; ii) an organisational chart; iii) financial projections; iv) financial information on potential shareholders; v) the background of directors; vi) the background of managers; vii) details of funding sources; and viii) the intended market differentiation.[14]

Table 4. Entry into banking requirements (% of maximum score)



	2000	2003	2007	2011
Bahrain	100	100	100	100
Kuwait	63	75	100	100
Oman	100	100	100	100
Qatar	100	50	-	75
Saudi Arabia	100	100	100	-
UAE	-	100	-	100
GCC*	92	93	100	95
EU15*	83	84	91	99
NMS12*	95	93	93	96
EU27*	83	84	91	99
AVG	83	84	91	99
STDEV	24	23	11	4

Note: Higher values represent more restrictive access, as a share of a maximum score of 8 points.
* Regional averages are weighted by total banking assets. See Table A.2. for the scores of the individual EU Member States.
Source: BRSS.

Table 4 shows that most GCC countries impose similar levels of stringency in terms of entry requirements to the EU27 countries. In particular, all of the eight requirements listed above are commonplace in four of the five GCC countries for which the latest survey has been filled out. As for the EU27, almost all countries require all of the eight documents. Only Austria,

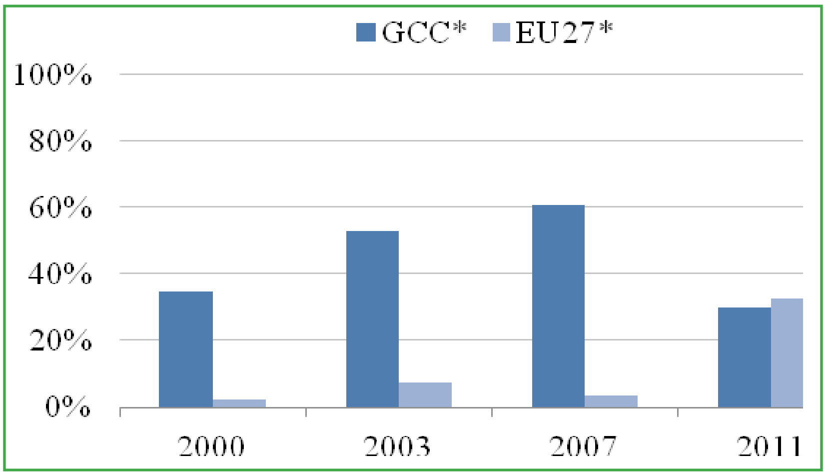
14 The entry into banking requirements index is constructed by adding up the scores for WBG questions 1.8.1-1.8.8, as detailed in Appendix 2 to Barth, Caprio and Levine (2006).

Belgium, Greece, Poland and Portugal do not legally require banks to provide information on the background of future managers. These results show that most countries across the GCC and the EU require similar documents for licensing. This might mean that these figures give an incomplete picture of the obstacles faced by potential entrants. To get a more complete picture, foreign banking application rejections and government ownership in banking are considered.

The second index considers the more discretionary power that authorities exert in allowing or rejecting entry. More specifically, the index is based on the fraction of foreign banking licensing applications that were rejected during the five–year period starting from the day the questionnaire was conducted.[15]

Table 5 very clearly shows that foreign banking application denials are commonplace in the GCC countries, which is in stark contrast with the EU27, where such denials are rare. In particular, over 70% of foreign banking licensing applications between 2001 and 2005 were denied in Oman (three out of four applications) and Kuwait (ten out of 14). More recently, the Kuwaiti authorities denied almost half of foreign licensing applications (seven out of 16) in the five years to 2011. The Bahraini authorities denied about a fifth of foreign applications (two out of nine) over the same period. These results show signs of convergence between the GCC countries and the EU27. However, the picture is slightly blurred due to the missing information for Qatar, Saudi Arabia and the UAE in relation to 2007.

Table 5. Percentage of foreign applications denied



15 *Share of foreign denials is addressed by WBG question 1.10, as detailed in Appendices 1 and 2 to Barth, Caprio and Levine (2006).*

Table 5. Percentage of foreign applications denied (continued)

	2000	2003	2007	2011
Bahrain	0	10	24	22
Kuwait	100**	100**	71	44
Oman	100**	100**	75	0
Qatar	100**	-	-	100**
Saudi Arabia	0	0	-	-
UAE	-	100**	-	0
GCC*	35	53	60	30
EU15*	2	7	3	33
NMS12*	13	16	15	8
EU27*	2	8	3	32
AVG	2	9	4	32
STDEV	19	37	22	51

* Regional averages are weighted by total banking assets. See Table A.3. for the scores of the individual EU Member States.
** 100% if no foreign application was registered. No applications can indicate that it is not possible to enter the market, or that the market is saturated. As already mentioned, in most GCC countries it is impossible to enter the banking sector. The countries without foreign applications are therefore rewarded with the highest possible percentage of foreign denials.
Source: BRSS.

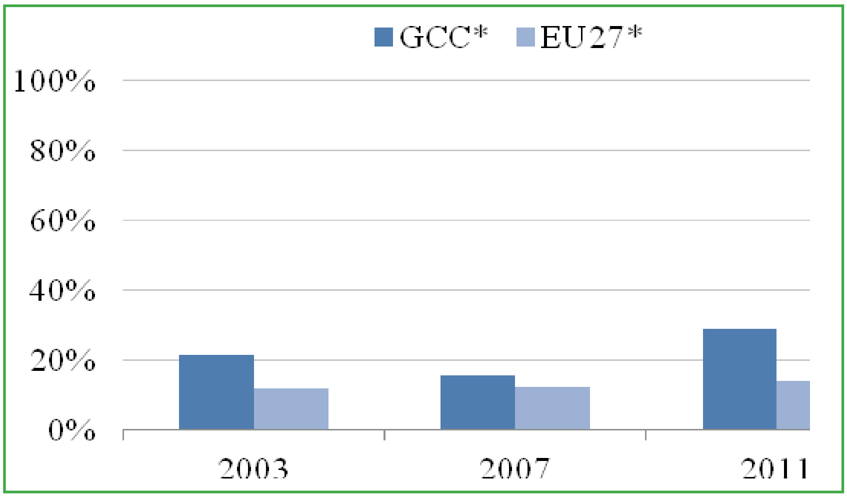
The third and final indicator for entry obstacles relates to the dominance of government-controlled banking. State-owned banks often enjoy implicit or explicit state guarantees, have access to public funding, and are possibly subject to less strict or more flexible rules, which creates a disadvantage for potential entrants and more generally undermines healthy competition (Barth, Caprio and Levine 2004). The index is a simple measure of the market power of state-owned banks, where market power is expressed as a percentage of total banking assets, and a bank is considered to be state-owned if the government holds more than 50% of the equity.[16] The relevant data are only available for the surveys conducted from 2003 onwards.

Table 6 shows significant differences between the GCC and EU27 averages, as well as between the individual countries within the regions. In Qatar, Saudi Arabia and the UAE, the governments hold majority stakes in banks which control between 20% and 49% of total domestic banking assets. In addition to the majority holdings, most governments also have minority interests in commercial banks. These minority holdings can be substantial: Bahrain, for instance, holds 49% of the shares of the National Bank of Bahrain (one of the largest commercial banks in the country). Turning to the EU27, the capital injections to banks made

16 Share of government-controlled banks is addressed by WBG question 3.8.1, as detailed in Appendix 1 to Barth, Caprio and Levine (2006).

during the financial crisis have increased the number of banks controlled by governments. During the crisis, the share of the banking sector owned by the government in Austria, Latvia, Netherlands, Slovenia and the UK increased substantially.

Table 6. Market share of government-controlled banks (% of total assets)



	2003	2007	2011
Bahrain	0	1	0
Kuwait	0	-	0
Oman	0	0	0
Qatar	46	-	43
Saudi Arabia	21	20	20
UAE	35	-	49
GCC*	21	16	29
EU15*	12	12	14
NMS12*	12	8	12
EU27*	12	12	14
AVG	12	12	15
STDEV	20	21	15

Note: Figures represent the share of banks with at least 50% state ownership.
* Regional averages are weighted by total banking assets. See Table A.4. for the scores of the individual EU Member States.
Source: BRSS.

Put together, the three indices provide a contrasting picture of the sampled countries in terms of entry obstacles. The set of documents needed for a valid licensing application are, to a large extent, similar in both the GCC countries and the EU27. These requirements are most likely used to ensure that only 'fit and proper' undertakings are allowed to operate as banks. Only Qatar and five out of 27 EU countries can be distinguished in this respect as having fewer licensing requirements. Turning to less official controls that the authorities exert over the banking sector, foreign entry denials are disproportionally high in some of the GCC countries, particularly in Kuwait and Oman. The state also maintains a substantial direct control over the banking sector in most of the countries in the region, with state-owned banks accounting for half of banking sector activities in Qatar and the UAE. In short, although the official entry conditions appear comparable, there are significant and persistent obstacles to entry that can curtail competition in the GCC countries' banking sectors, possibly emanating from official practices and political interference.

1.2.3. Area III: Capital requirement stringency

One of the common aims of bank regulation is ensuring that banks operate soundly. Regulatory capital requirements are an important part of this. They determine the minimum amount of capital a bank should hold relative to its total assets (or risk-weighted assets).

Comparing capital ratios represents a first step towards understanding how sound a banking sector is. The capital ratios in the GCC countries are clearly higher than in the EU27, as shown in Table 7. First of all, all the GCC countries have maintained a total capital ratio of between 10% and 20%. The capital position of banks in the GCC countries deteriorated from 20.6% in 2000 to 16.4% in 2007. In recent years, the capital ratio improved, reaching 19.4% in 2011. The capital ratios of banks in the EU27 increased after the explosion of the financial crisis in the summer of 2008. Supervisors like the EBA de facto required systemically important banks to hold more capital, while at the same time capital markets tend to push banks to hold higher capital cushions in times of economic uncertainty.

Table 7. Regulatory capital ratios (% of risk-weighted assets)

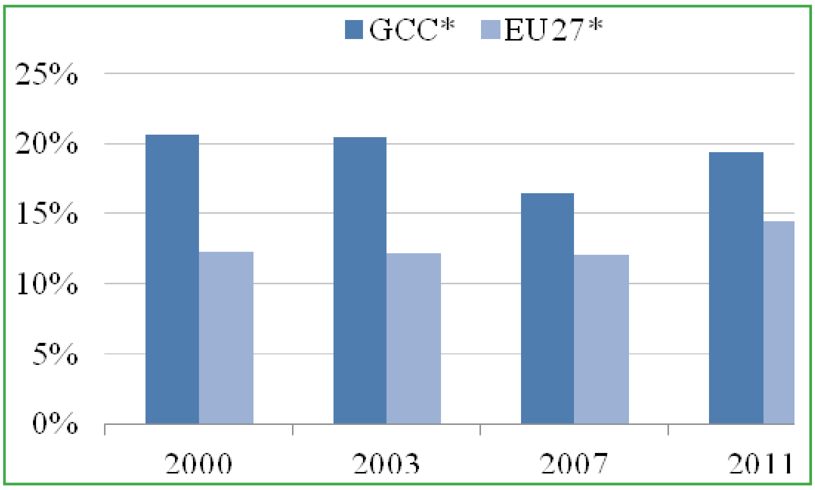


Table 7. Regulatory capital ratios (% of risk-weighted assets) (continued)

	2000	2003	2007	2011
Bahrain	21	21	23	20
Kuwait	22	23	17	19
Oman	19	16	18	16
Qatar	-	-	-	21
Saudi Arabia	21	20	18	17
UAE	20	20	14	21
GCC*	21	20	16	19
EU15*	12	12	12	14
NMS12*	14	16	14	14
EU27*	12	12	12	14
AVG	12	12	12	15
STDEV	2	2	1	2

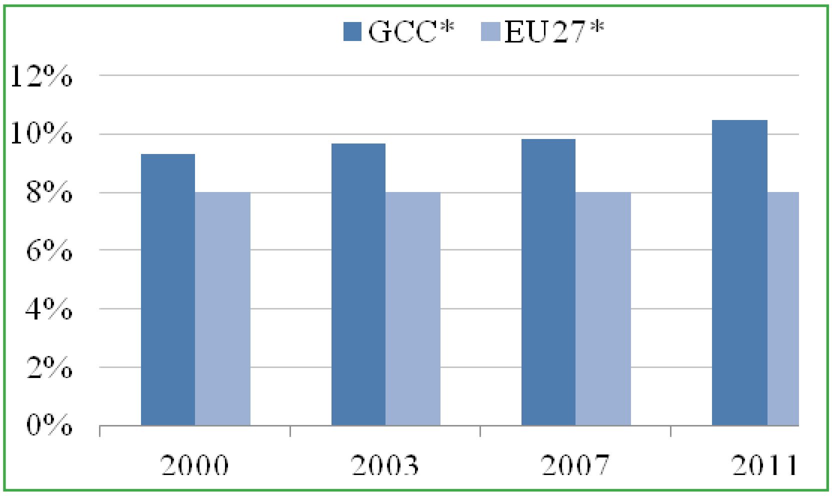
Note: Figures represent the share of total capital in risk-weighted assets using the 1988 Basle Accord definitions.
* Regional averages are weighted by total banking assets. See Table A.5. for the scores of the individual EU Member States.
Sources: BRSS and IMF Global Financial Stability Reports.

The GCC countries' banks appear to be better capitalised than their EU27 counterparts. Does this reflect the level and/or stringency of capital requirements, or a lower appetite for risk? In other words, is it the regulations that make the banks sounder, or are the banks simply not willing to take too many risks? To answer this important question, it is necessary to look deeper into the level of the minimum capital ratios and the other rules.

Table 8 shows that the minimum capital requirements for banks in the GCC countries are above those for the EU27 banks. All EU27 countries, except Bulgaria and Estonia, require their banks to have a minimum total capital of at least 8% of risk-weighted assets, in line with the minimum capital standards imposed by the Basel I and Basel II agreements.[17] Of the GCC countries, all but Saudi Arabia impose higher minimum regulatory capital requirements. These remained stable during the sample period, with only Qatar and the UAE increasing their minimum capital requirements. There is therefore no noticeable convergence between the minimum regulatory capital ratios in the GCC countries and the EU27.

17 For more information on the status of the implementation of Basel II, 2.5 and Basel III in the EU, see BCBS (2013) and FSI (2013).

Table 8. Minimum regulatory capital ratios (% of risk-weighted assets)



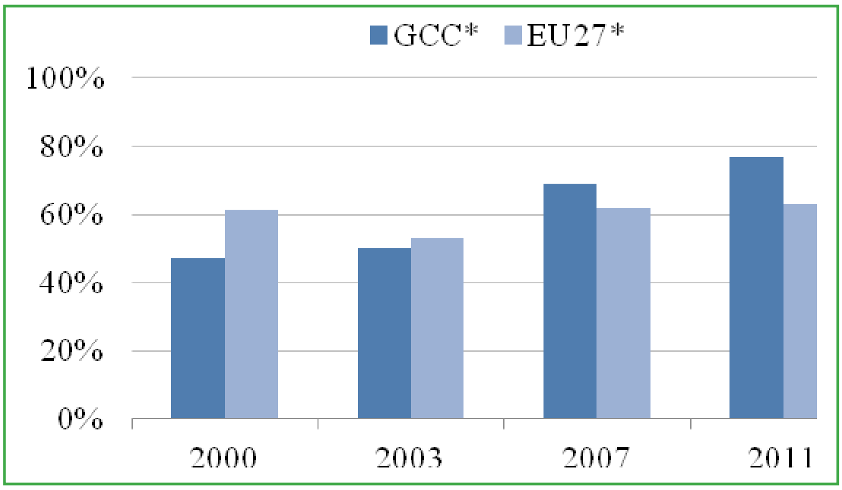
	2000	2003	2007	2011
Bahrain**	12	12	12	12
Kuwait	12	12	12	12
Oman	12	12	12	12
Qatar	8	10	10	10
Saudi Arabia	8	8	8	8
UAE	-	10	10	12
GCC*	9	10	10	10
EU15*	8	8	8	8
NMS12*	8	8	9	8
EU27*	8	8	8	8
AVG	8	8	8	8
STDEV	0	0	0	1

Note: Figures represent the share of total capital in risk-weighted assets using the 1988 Basle Accord definitions.
* Regional averages are weighted by total banking assets. See Table A.6. for the scores of the individual EU member states.
** Bahrain has an unadjusted regulatory leverage ratio in addition to the risk-adjusted regulatory capital ratio.
Sources: BRSS and national authorities.

There are different ways of measuring the stringency of capital requirements. The index used here gives consideration to the types of capital allowed, the risk weights applied, and whether the minimum capital ratios vary with risk. More specifically, the capital stringency index aims to determine the extent to which capital requirements restrict leverage potential and risky behaviour, taking account inter alia of i) whether the minimum capital-to-asset requirements are in line with 1988 Basel Accord definitions; ii) whether the minimum ratio varies with the bank's credit risk or iii) market risk; and whether the value of iv) unrealised loan losses, v) unrealised security losses or vi) foreign exchange losses are deducted from regulatory capital. Additionally, the index aims to measure restrictions imposed on the source of regulatory capital, such as vii) whether these funds are verified by regulatory authorities; and whether viii) cash and government securities, or more generally ix) non-borrowed funds are the only forms of capital allowed for initial disbursements and subsequent injections.[18] Hence, the index composed for 2011 does not include whether the value of iv) unrealised loan losses and vi) foreign exchange losses are deducted from regulatory capital. A greater number of affirmative responses to these questions leads to a higher stringency score.

Table 9 presents a comparison of the stringency of capital requirements for the countries in our sample. A quick glance through the figures reveals that capital requirements have become more stringent in most countries in the sample. More and more GCC countries are implementing legislation to align their capital requirements with the Basel II capital standards. All the GCC countries have adopted legislation that allows banks to vary their minimum capital requirements depending on banks' individual credit and market risk. The implementation of this legislation led to a jump in capital stringency between 2003 and 2011. Among the EU27 countries, most have imposed capital requirements that are as stringent as the GCC countries. However, eight of the EU27 countries have less stringent capital measures, mostly because the authorities in these countries allow the banks to use assets other than cash or government securities for capital injections. Looking at these results, it is hard to say that there is convergence, although both the GCC and EU27 countries have become more stringent.

Table 9. Stringency of capital requirements (% of maximum score)



18 *The stringency of capital requirements index is addressed by WBG questions 3.1.1, 3.2, 3.3, 3.9.1, 3.9.2, 3.9.3, and 1.5-1.7. The calculation of the index is detailed in Appendix 2 to Barth, Caprio and Levine (2006:337-338). One question (WBG 3.7), on the fraction of revaluation gains allowed as part of capital, has been omitted from the calculation of the index since responses were not available for most countries in our sample.*

Table 9. Stringency of capital requirements (% of maximum score) (continued)

	2000	2003	2007	2011
Bahrain	22	56	67	71
Kuwait	78	67	78	86
Oman	56	56	56	71
Qatar	78	33	-	86
Saudi Arabia	33	33	67	-
UAE	-	67	-	71
GCC*	47	50	69	77
EU15*	62	53	62	63
NMS12*	43	46	45	71
EU27*	61	53	62	63
AVG	61	53	62	63
STDEV	15	22	21	15

Note: Higher values represent greater stringency, as a share of a maximum score of 9 points for 2000, 2003 and 2007, and 7 points for 2011.
* Regional averages are weighted by total banking assets. See Table A.7. for the scores of the individual EU Member States.
Source: BRSS.

To sum up, most of the banks in the GCC countries need to comply with higher capital requirements than their peers in the EU27. This is reflected in the average capital ratios, which are significantly higher in almost all GCC countries. There are, however, also differences between the GCC countries and the EU Member States in the actual capital ratios that are independent of the minimum capital standards. Moreover, the capital requirements in the GCC countries are more stringent than those in the EU27.

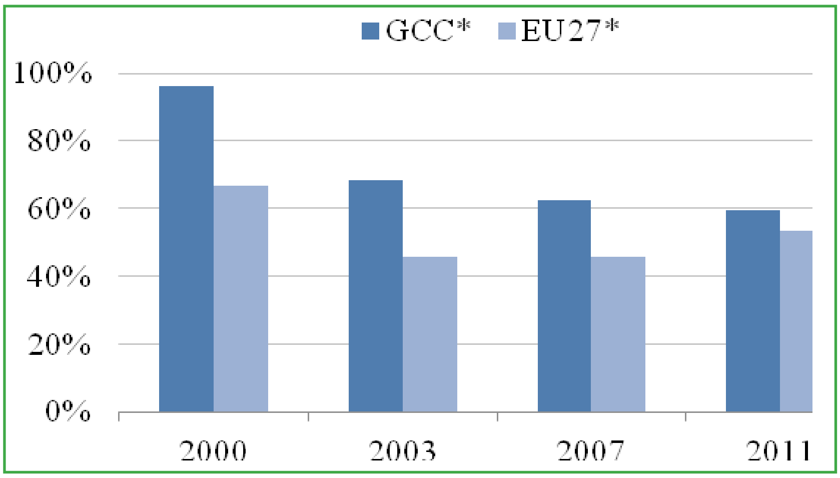
1.2.4. Area IV: Supervisory authorities

A key issue in the effectiveness of banking regulation is whether the supervisory authorities have the powers necessary to apply measures to discipline or, in the extreme, resolve banks that violate the rules or engage in imprudent activities. In most countries, the supervisors take prompt corrective action against a bank if its capital falls below the minimum required level. If the deterioration of the bank continues, the supervisor must have the ability to resolve the bank before it becomes insolvent, thereby posing a systemic threat. To be effective, supervisors need access to reliable and frequently-updated information on the condition of banks. Judicial systems often allow the courts to intervene by diminishing, postponing or reversing illegitimate supervisory actions; however, this should not undermine the supervisor's chief responsibility for protecting and ensuring the orderly functioning of the banking market. These aspects of the supervisory system should be in line with regulatory priorities, and should not be subject to political patronage. In short, supervisors should have the authority to discipline potentially troubled banks and resolve problems while remaining independent from political influence.

Two indices on the power and independence of supervisory authorities have been used to measure the strength of the supervisory system.

The first index measures the official power of the supervisor to take specific action to correct or prevent problems. The relevant questions include the ability of supervisors to i) meet external auditors without approval of the bank; ii) communicate directly with auditors regarding illicit activities undertaken by the bank's management or directors; iii) receive disclosure of off-balance sheet items; iv) take legal action against negligent auditors; v) change the organisational structure of troubled banks; vi) order management or directors to cover losses; and suspend vii) dividend distributions, viii) bonuses, and ix) management fees. Additionally, in the 2003, 2007 and 2011 surveys, additional questions on troubled banks were also asked regarding the supervisors' ability to x) declare insolvency; xi) suspend ownership rights; xii) supersede shareholder rights; and fire or hire xiii) management, or xiv) directors. The 2011 survey did not include questions on the supervisors' power to suspend ix) management fee distribution and xi) ownership rights, as well as xiv) to remove or replace directors.[19] An affirmative answer to any of these questions indicates greater supervisory power. Some of these powers may only be exercisable by some supervisory-like institutions, such as depository insurance agencies or bank restructuring agencies, as part of which supervisors hold more moderate powers.[20] In other cases, the courts or the government may be involved, which would serve to undermine the power of the supervisors.

Table 10. Official supervisory power (% of maximum score)



19 The official supervisory power index is addressed by WBG questions 5.5-5.7, 6.1, 10.4, 11.2, 11.3.1-11.3.3, 11.6, 11.7, and 11.9.1-11.9.3. The calculation of the index is detailed in Appendix 2 to Barth, Caprio and Levine (2006:339-342).

20 In these cases, the aggregate score has been augmented by 0.5 points only; for more details, see the calculation of the index detailed in Appendix 2 to Barth, Caprio and Levine (2006:339-342).

Table 10. Official supervisory power (% of maximum score) (continued)

	2000	2003	2007	2011
Bahrain	100	74	66	64
Kuwait	89	53	47	64
Oman	89	71	63	71
Qatar	89	53	-	57
Saudi Arabia	100	74	68	-
UAE	-	74	-	57
GCC*	96	69	62	60
EU15*	66	45	45	53
NMS12*	83	52	59	67
EU27*	67	46	46	53
AVG	67	46	46	53
STDEV	18	14	9	16

Note: Higher values represent greater supervisory power, as a share of a maximum score of 9 points for 2000, 19 points for 2003 and 2007, and 14 points for 2011.
* Regional averages are weighted by total banking assets. See Table A.8. for the scores of the individual EU Member States.
Source: BRSS.

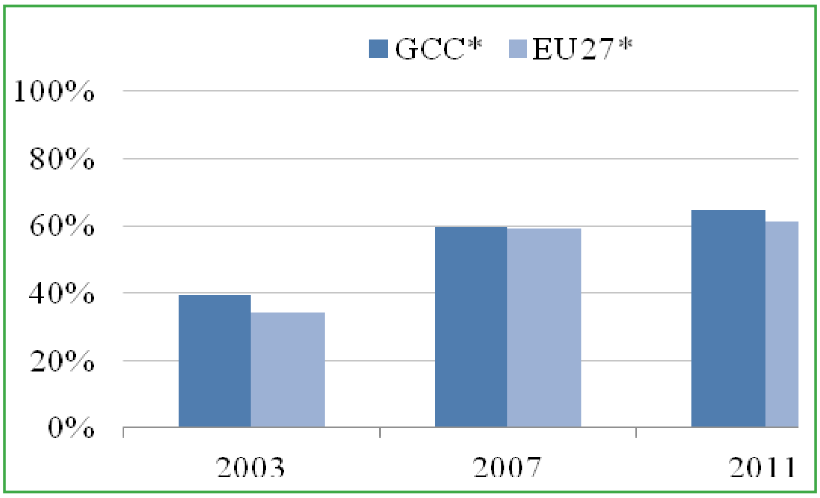
Table 10 shows that the supervisory powers of the authorities in the GCC countries and the EU27 have clearly converged; regulatory power in the GCC countries is declining, whereas since 2000 it has gradually increased in the EU27. However, the GCC countries' supervisory authorities still have more power than their EU27 counterparts, excluding the NMS12. In Oman, the official supervisor is allowed to intervene directly in all the issues listed above, except in order to declare a bank insolvent. In contrast, the official supervisors in Qatar and UAE have more elementary tools. They have, for instance, the power to meet external auditors without the approval of the bank, but are not allowed to supersede shareholders' rights, nor to remove or replace management. Moreover, as in all GCC countries excluding Kuwait, the official supervisor does not have the authority to declare a bank insolvent.

The second index for assessing supervisory authority looks at the general independence of the supervisor from political influence. For this index, the following three questions from the BRSS have been considered: i) Are supervisory bodies accountable only to a legislative body? ii) Are supervisors legally liable for actions committed in exercising their duties? iii) Does the head of the agency have a fixed term? The level of independence is determined by counting affirmative answers to questions (i) and (iii), and negative answers to (ii). The questions needed to construct the index were only included in the BRSS surveys from 2003 onwards.[21]

21 Independence from political interference index is addressed by WBG questions 12.2, 12.10, and 12.2.2. The calculation of the index is slightly different from the specification in Appendix 2 to Barth, Caprio and Levine (2006:349-350), in that, in order to score a point under question 12.2, the supervisory bodies have to be accountable to no-one other than a legislative body, such as Parliament or Congress.

Table 11 shows that the GCC countries and the EU27 are increasing the independence of their supervisory authorities at similar speeds, and that they are currently at similar levels. The GCC countries show a harmonious picture. In the GCC countries, none of the authorities is accountable only to a legislative body, and none is legally liable for its actions. Moreover, all heads of the supervisory agencies are nominated for a fixed term, except in Oman. Turning to the EU27, the picture becomes more diffuse. The supervisory authorities in just over half of the Member States are accountable only to a legislative body. In five Member States, including Italy and four belonging to the NMS12, the supervisory authorities can be held legally liable for their actions. Only in four of the 27 Member States are the heads of the supervisory agencies not nominated for a fixed term.

Table 11. Independence from political interference (% of maximum score)



	2003	2007	2011
Bahrain	33	33	67
Kuwait	67	67	67
Oman	33	0	33
Qatar	33	-	67
Saudi Arabia	33	67	-
UAE	33	-	67
GCC*	39	60	65
EU15*	34	59	61
NMS12*	50	75	81
EU27*	34	59	61
AVG	34	59	61
STDEV	18	29	33

Note: Higher values represent more independence, as a share of a maximum score of 3 points.
* Regional averages are weighted by total banking assets. See Table A.9. for the scores of the individual EU Member States.
Source: BRSS.

When combined, the two indices for supervisory authority clearly show convergence.[22] The difference in supervisory power between the two regions has declined, while the difference in independence has remained more or less constant. Overall, the strength of both regions has increased. The GCC countries' supervisors have become more independent, whereas the EU27 supervisors have gained both more power and more independence. When the individual countries are considered, only limited differences are noticeable. The GCC countries, for instance, are almost all within three percentage points of each other. Oman is the only exception, with a substantially lower score due to the limited independence of its supervisory authorities.

1.2.5. Area V: Deposit insurance

Deposit insurance systems are among the key elements of a country's financial safety net, being designed to prevent disruptions to financial markets and the economy. By protecting depositors, deposit insurance schemes provide confidence to relatively small depositors, and contribute to preventing bank runs. At the same time, they may introduce moral hazard by diminishing depositors' incentives to monitor and screen banks, while also amplifying the incentives of shareholders in banks to engage in excessive risk-taking. The moral hazard problem implies that banks have incentives to take on risk that can be shifted to a deposit insurance scheme or, ultimately, to taxpayers.

Efforts are being made across the world to mitigate the moral hazard problems arising from deposit guarantee schemes.[23] First, coverage matters. In some countries, aside from limits on the total amount, co-insurance is imposed to ensure that depositors bear some part of the costs.[24] Second, the use of risk-adjusted premiums may also serve to better internalise the costs of the risks taken. Third, the way that deposit insurance schemes are funded also matters. For example, when the government is explicitly or implicitly involved in providing the necessary funds, moral hazard may be attenuated, especially in countries where the government has ample resources. In turn, when the system is backed with funds provided by banks, moral hazard can be limited by the understanding that the amount of the guarantee is restricted to pooled reserves.

Looking at the existing deposit guarantee schemes presented in Table 12, there are clear differences between the GCC countries and the EU27. The revised EU Deposit Insurance Directive requires Member States to maintain deposit insurance with a coverage limit of at least €100,000, raised from a minimum of €20,000 in the aftermath of the financial crisis.[25]

22 The supervisory authority score is a multiplication of the official supervisory power index and the independence from political interference index.

23 See Kane (2000) and Demirgüç-Kunt et al. (2005) for a review of the potential effects and key design features of deposit insurance schemes.

24 Empirical evidence shows that coverage limits and co-insurance practices serve to substantially reduce the likelihood of bank failure (Demirgüç-Kunt and Detragiache 2002).

25 Directive 2009/14/EC, which amended the Deposit Guarantee Directive (Directive 94/19/EC). The minimum amount of €100,000 has been in force as of 31 December 2010.

Most of the countries in the EU27 have chosen to set this base amount as their coverage limit, representing between 1.5 and 9.5 times the average annual income per capita figure. About three-quarters of schemes are ex ante or partially ex ante (hybrid) funded. The remaining six countries have an ex post funding structure. The levels of ex ante/hybrid funds display substantial variation, with a low of 0.3% of eligible deposits in Ireland, and a high of 3.1% of eligible deposits in Bulgaria.

Tuning to the GCC countries, Kuwait, Qatar, Saudi Arabia and the UAE have no schemes in place. The coverage limits of the schemes in Bahrain and Oman represent one to two times average annual income, pointing to a much lower level of protection afforded than in almost all EU27 countries. Moreover, the deposit guarantee scheme in Bahrain only covers a maximum of 75% of eligible deposits.

Table 12. Deposit guarantee schemes in the GCC, latest available figures

	Est. date	Coverage limit		Funding (Public or banks)	Co-insurance	Risk-based premiums	Ex post/ex ante	Coverage ratio**
		€ (current)	(% of GDP per capita in 2012, PPP)					
GCC								
Bahrain***	1994	40,241	225%	Banks	Yes	No	Ex post	-
Kuwait	-	-	-	-	-	-	-	-
Oman	1995	39,417	181%	Both	No	No	Ex ante	-
Qatar	-	-	-	-	-	-	-	-
Saudi Arabia	-	-	-	-	-	-	-	-
UAE	-	-	-	-	-	-	-	-
EU27								
EU15								
Austria	1979	100,000	330%	Both	No*	No	Ex post	0.0%
Belgium	1985	100,000	359%	Banks	No*	No	Ex ante	0.4%
Denmark	1987	100,523	342%	Banks	No*	No	Ex ante	0.5%
Finland	1969	100,000	372%	Banks	No*	Yes	Ex ante	0.6%
France	1980	100,000	363%	Banks	No*	Yes	Hybrid	0.1%
Germany	1966	100,000	352%	Banks	No*	Yes	Ex ante	-
Greece	1995	100,000	515%	Banks	No*	Yes	Ex ante	1.7%
Ireland	1989	100,000	334%	Banks	No*	No	Hybrid	0.3%
Italy	1987	103,291	428%	Banks	No*	Yes	Ex post	-
Luxembourg	1989	100,000	156%	Banks	No*	No	Ex post	-
Netherlands	1979	100,000	325%	Both	No*	No	Ex post	-
Portugal	1992	100,000	561%	Banks	No*	Yes	Ex ante	1.1%
Spain	1977	100,000	424%	Banks	No*	No	Hybrid	0.6%
Sweden	1996	100,000	336%	Both	No*	No	Ex ante	0.7%
UK	1982	104,610	408%	Banks	No*	No	Ex post	-

Table 12. Deposit guarantee schemes in the GCC, latest available figures (continued)

	Est. date	Coverage limit		Funding (Public or banks)	Co-insurance	Risk-based premiums	Ex post/ex ante	Coverage ratio**
		€ (current)	(% of GDP per capita in 2012, PPP)					
NMS12								
Bulgaria	1999	100,215	941%	Banks	No*	No	Hybrid	3.1%
Cyprus	2000	100,000	479%	Banks	No*	No	Hybrid	0.3%
Czech Republic	1994	100,000	531%	Banks	No*	No	Hybrid	0.6%
Estonia	1998	100,000	633%	Banks	No*	No	Ex ante	2.3%
Hungary	1993	100,000	643%	Banks	No*	Yes	Hybrid	0.0%
Latvia	1998	100,000	792%	Banks	No*	Yes	Hybrid	1.0%
Lithuania	1996	100,000	685%	Banks	No*	No	Hybrid	2.0%
Malta	2003	100,000	494%	Banks	No*	No	Ex ante	0.4%
Poland	1995	100,000	655%	Banks	No*	No	Ex ante	0.6%
Romania	1996	100,000	919%	Banks	No*	No	Ex ante	1.8%
Slovakia	1996	100,000	582%	Banks	No*	No	Ex ante	1.6%
Slovenia	1991	100,000	516%	Both	No*	No	Ex post	-

* Co-insurance was abolished by Directive 2009/14/EC.

** The current EU27 coverage ratios are calculated as the ratio of ex ante collected funds and eligible deposits using published figures for 2007-8.

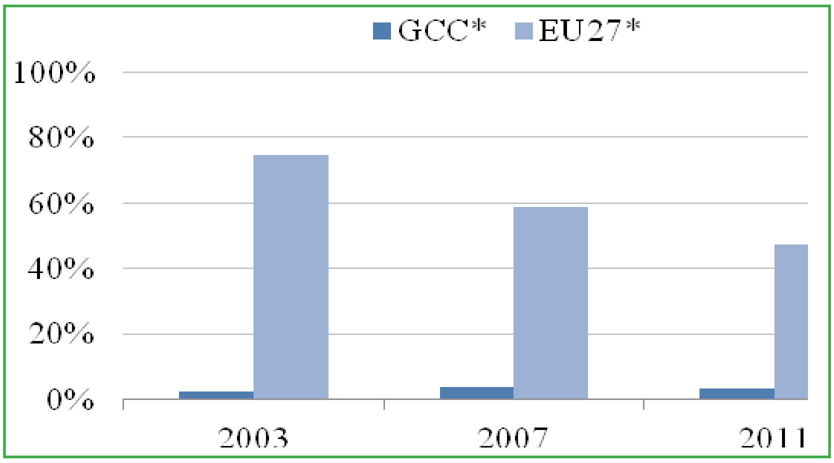
*** The Bahrain Deposit Protection Scheme covers up to 15,000 BHD (approximately 40,000 EUR) and no more than 75% of eligible deposits. Moreover, the total pay-out in a single year is limited to 25 million BHD. It is foreseen to revise the Deposit Protection Scheme to make it an ex ante funded system.

Sources: European Commission (2010), World Bank, Central Bank of Bahrain and Central Bank of Oman.

The deposit insurance scheme index identifies the level of compliance with standards that are thought to mitigate the moral hazard problem. For countries with an explicit system, three issues are relevant: i) whether a co-insurance discount is applicable to pay-outs; ii) whether premiums are risk-adjusted; and iii) whether only banks take a primary role.[26] A point is scored for an affirmative answer to each one of these questions. A score of zero has been assigned to countries where no explicit system exists, since in those cases the government is assumed to provide implicit guarantees, which implies that banks have a greater incentive to take risks.[27] The BRSS surveys have included the questions necessary to construct the index from 2003 onwards.

Table 13 shows that moral hazard due to implicit guarantees are more of a threat in the GCC countries. For the most part, this is due to the absence of explicit deposit guarantee schemes in Kuwait, Qatar, Saudi Arabia and the UAE. A poorly-designed scheme can invite additional risks, and may be no better than a system with no scheme at all. The Omani scheme, for instance, might amplify the risk of moral hazard. Although it has an explicit deposit guarantee scheme, it does not give a better score. In addition to the facts that there is no co-insurance and that the premium is not risk-based, the central bank contributes one-third of funds. The remaining GCC deposit guarantee scheme, that of Bahrain, gives positive answers to two of the questions outlined above, but does not require banks to pay a risk-based premium.

Table 13. Deposit insurance index (% of maximum score)



26 The calculation of the deposit insurance scheme index follows the format detailed in Barth, Caprio and Levine (2006:354), except that a score of zero has been assigned to countries with no explicit insurance scheme.

27 Gropp and Vesala (2004) show that credible implicit guarantees operating by means of an expectation of public intervention at times of distress can aggravate the moral hazard problem when compared to explicit deposit guarantee schemes. As the authors note, the key issue is whether the institutional and fiscal conditions make the inherent guarantees credible. It is assumed here that the four countries with no explicit systems – Kuwait, Qatar, Saudi Arabia and United Arab Emirates – have ample fiscal resources and the necessary institutional framework to make such guarantees credible.

Table 13. Deposit insurance index (% of maximum score) (continued)

	2003	2007	2011
Bahrain	67	67	67
Kuwait	0	0	0
Oman	0	0	0
Qatar	0	0	0
Saudi Arabia	0	0	0
UAE	0	0	0
GCC*	2	4	3
EU15*	75	59	48
NMS12*	66	58	37
EU27*	75	59	48
AVG	74	58	47
STDEV	29	19	24

Note: Higher values represent more restrictive rules, as a share of a maximum score of 3 points.
* Regional averages are weighted by total banking assets. See Table A.10. for the scores of the individual EU Member States.
Sources: BRSS, European Commission (2010), World Bank, Central Bank of Bahrain and Central Bank of Oman.

All EU Member States have an explicit deposit guarantee scheme. However, this does not mean that there is no moral hazard. In almost 20% of Member States, banks are not exclusively responsible for funding, and just over 70% of Member States do not have a risk-based contribution. Yet, no Member State requires small depositors to absorb part of the losses. This is a consequence of an amendment adopted in 2009 that de facto abolished co-insurance in the EU. In 2007, almost half of the EU27 still allowed up to 10% of losses to be shared with covered depositors. This change in regulation is reflected in an increase in the risk of moral hazard.

In the aftermath of the financial crisis, deposit guarantee schemes in the EU might be further harmonised. In 2010, the European Commission adopted a proposal foreseeing a risk-based bank-funded deposit guarantee scheme. However, the legislative act has not been adopted, since the European Parliament and the Council have not been able to agree on the final terms.

These results, however, should be interpreted with care. As the recent financial crisis has shown, when a run on a bank has the potential to create broader panic, governments and central banks are likely to step in to stop it, notwithstanding the type of explicit arrangements in place.[28] One may wonder, quite justifiably, whether any given arrangement really does mitigate moral hazard when it may so easily be replaced with limitless state support.

28 This was amply demonstrated during the Northern Rock crash of 2007, when the UK Treasury extended the existing guarantees on bank deposits – with a maximum payout of £31,700 at the time – to cover all deposits.

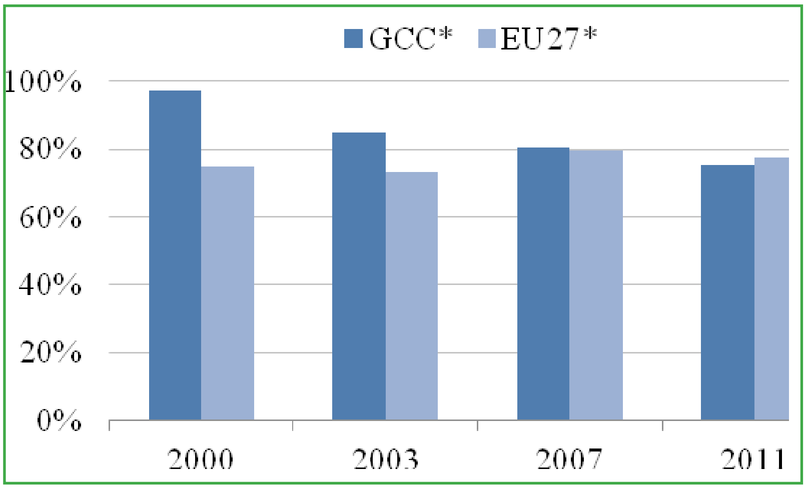
1.2.6. Area VI: Private monitoring

Most of the regulatory factors considered in this paper relate to the rules and standards set out by regulators, which are used to distinguish between acceptable and unsound behaviour. Regulatory principles are often well-defined, calling for compliance with specific rules or standards. However, market forces and investors may also be crucial in shaping decisions and, in particular, restraining risky behaviour. Debtors or stockholders use available information to assess a bank's condition and indirectly influence the management by withdrawing funds, which has an impact on the borrowing costs of banks.

The availability of reliable and timely information to investors is at the core of market disciple. The private monitoring index is therefore based on the survey responses to a number of questions on disclosure rules and standards, including whether: i) a certified audit is required; all of the top ten banks are rated by ii) domestic or iii) international credit rating agencies; income standards include accrued though unpaid interest on iv) performing or v) non-performing loans; vi) banks are required to produce consolidated accounts; vii) directors are liable for erroneous or misleading reporting; viii) subordinated debt is allowable or required as part of capital; ix) off-balance items are disclosed to the public; x) banks are required to disclose risk management procedures; and xi) supervisors are required to make enforcement action public.[29] The private monitoring score increases with each affirmative answer to each of these questions.

Table 14 shows a clear convergence between the GCC countries and the EU27. The initial disparities between both regions have diminished in the past decade; private monitoring in the GCC countries has gradually decreased, whereas it has remained constant in the EU27.

Table 14. Private monitoring (% of maximum score)



29 *The private monitoring index is addressed by WBG questions 3.5-6, 5.1, 5.3, 10.1, 10.1.1, 10.3, 10.4.1, 10.5, 10.6, 10.7.1-2, and 11.1.1. The calculation of the index is slightly different from the specification in Appendix 2 to Barth, Caprio and Levine (2006:350-352), in that it excludes a question on the presence of explicit deposit insurance, which is covered by another index.*

Table 14. Private monitoring (% of maximum score) (continued)

	2000	2003	2007	2011
Bahrain	89	64	82	91
Kuwait	100	91	82	82
Oman	89	82	55	64
Qatar	78	73	-	73
Saudi Arabia	100	82	82	-
UAE	-	91	-	73
GCC*	97	85	80	75
EU15*	75	73	80	77
NMS12*	67	69	69	75
EU27*	75	73	80	77
AVG	75	73	80	77
STDEV	12	13	10	11

Note: Higher values represent greater monitoring, as a share of a maximum score of 9 points for 2000, and 11 points for 2003, 2007 and 2011.
* Regional averages are weighted by total banking assets. See Table A.11. for the scores of the individual EU Member States.
Source: BRSS.

There are broad similarities between the GCC countries and the EU27 at the regional level, although there are differences between the levels of private monitoring in the individual countries. The share of the top ten banks that are rated by (international or domestic) credit rating agencies varies widely, for instance. In the EU27 countries, about 30% of the top ten banks are rated by an international rating agency, and only in Greece, France and Poland are all top ten banks are rated by a domestic rating agency. In none of the GCC countries are all top ten banks rated by a domestic rating agency, but in half of them the top ten banks are rated by international agencies. The differences between countries are, in some cases, due to the inherent structure of the market.

Another common issue, especially more recently, is the exclusion of accrued (though unpaid) interest from income statements, which allows banks undue flexibility in determining their earnings. Finally, according to the 2011 BRSS survey, bank regulators/supervisors in Bahrain, Cyprus, Denmark, Hungary, Ireland, the Netherlands, Poland, Slovakia, and the UK are required to make their risk management procedures public.

These results show that the regulatory structures of the GCC countries have converged with those of the EU27, and that there are broad similarities between the regions. For example, a certified audit is compulsory in all of the sample countries, and accounting rules exhibit similarities in most of the countries.

1.2.7. Area VII: Credit information and laws

Access to information and creditor protection laws are crucial for ensuring the smooth operation of credit markets. Economic theory suggests that two factors in particular limit the amount of credit that financial institutions will lend to potential borrowers. On the one hand, credit conditions are clearly influenced by the ability of creditors to enforce contracts, require repayment, claim collateral and possibly gain control over receivables. The easier these actions, the more likely lenders are to make loans. On the other hand, lenders would like to have access to accurate information on potential borrowers, such as credit histories, other lenders and other banking transactions.

Theoretical models suggest that an operational information-sharing infrastructure can reduce adverse selection in credit markets and facilitate access to credit, especially among more opaque borrowers such as small and medium-size enterprises (SMEs) (Pagano and Jappelli 1993). When such information is available, creditors can make a better judgement of the creditworthiness of borrowers. Other studies have documented the importance of creditors' rights to the availability of credit (La Porta, Lopez-de-Silanes and Shleifer 1998, Levine 1998). Recent studies have confirmed these views with increasingly convincing evidence that both credit information mechanisms and creditors' rights have a non-trivial impact on the flow of credit and financial development (Jappelli and Pagano 2002, Djankov, McLiesh and Shleifer 2007, Haselmann, Pistor and Vig 2010).

The credit information and laws indices developed in this subsection are based on the Getting Credit methodology developed in the World Bank's Doing Business surveys.[30] The relevant area covers the legal rights of borrowers and lenders with respect to secured transactions and the extent of credit information sharing. Two sets of indicators are used for these purposes.

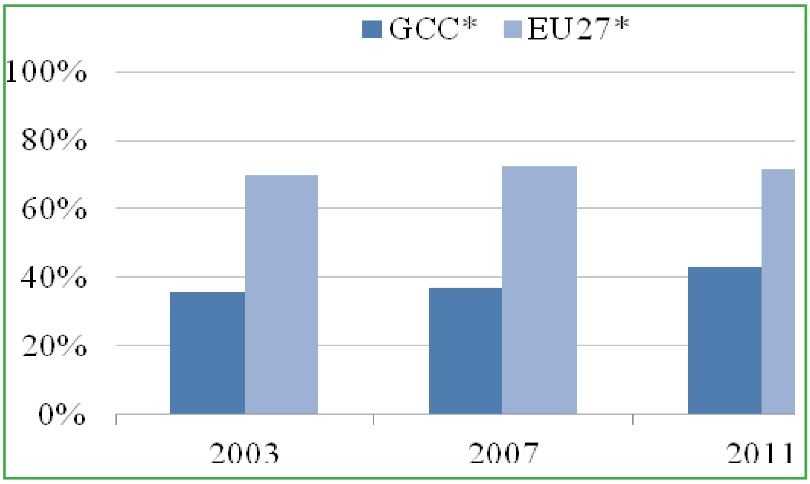
The first set describes how well collateral and bankruptcy laws facilitate lending, covering: i) the ability to use moveable assets while keeping possession of assets; the ability to obtain non-possessory security rights in ii) a single or iii) all moveable asset classes without requiring a specific description of the collateral; iv) the extension of security rights to future or after-acquired assets; v) the ability to secure all types of debts and obligations via a general description; vi) the availability of a collateral registry; the ability of secured creditors to obtain priority without exception in the case of vii) defaults, viii) liquidations, and ix) restructuring; and x) the possibility of out-of-court agreements on collateral enforcement. An affirmative answer to any of these questions adds to the relevant score.[31]

30 First started in 2003, the World Bank's Doing Business surveys cover over 180 countries, providing a snapshot of regulatory and legal conditions and their effects on businesses, especially SMEs. Each year, the surveys are sent out to a large number of local experts specialising in different fields, including lawyers, consultants, officials and other professionals who are in close contact with the legal and regulatory structures of the countries covered. The results of the surveys are available at http://www.doingbusiness.org

31 See the World Bank's Doing Business website for further details of the methodology: http://www.doingbusiness.org/methodology/getting-credit.

Table 15 shows that the legal rights granted to creditors are fewer in the GCC countries; security rights to future or after-acquired assets can be extended only in the UAE, and the possibility to obtain possessory security rights in a single or all moveable asset classes without a specific description of the collateral is only provided for in Saudi Arabia, Kuwait and the UAE. In contrast, this is much more common in the EU27 countries, while the UK and Latvia provided affirmative answers to all questions.

Table 15. Strength of legal rights (% of maximum score)



	2003	2007	2011
Bahrain	-	40	40
Kuwait	40	40	40
Oman	40	40	40
Qatar	40	40	40
Saudi Arabia	30	30	50
UAE	40	40	40
GCC*	36	37	43
EU15*	70	72	71
NMS12*	75	75	77
EU27*	70	73	72
AVG	69	72	71
STDEV	27	22	23

Note: Higher values represent stronger rights, as a share of a maximum score of 10 points.
* Regional averages are weighted by total banking assets. See Table A.12. for the scores of the individual EU Member States.
Source: World Bank Doing Business surveys.

The second index measures the availability, coverage and depth of credit information provided through either public credit registries or private credit bureaus. The relevant questions relate to: i) the collection of both positive and negative information; ii) the collection of data on both firms and individuals; iii) the collection of data from retailers and utility companies; iv) the availability of a credit history for at least two years; v) the availability of data on small loans (i.e. less than 1% of annual income); and vi) the ability of borrowers to access their credit history. As above, an affirmative answer to any one of these questions adds a score to the credit information index.

Table 16 clearly shows that the GCC countries have progressively closed the gap with the EU27 in terms of the depth of credit information. The average score of the GCC countries is almost as high as that of their EU27 counterparts. In recent years, the credit bureaus in Oman, Qatar, Saudi Arabia and the UAE have substantially improved their provision of information. In the recent Doing Business surveys, Saudi Arabia even satisfied all six criteria, while the credit bureaus in Oman and the UAE only fail to distribute credit information from non-financial institutions. The Qatari public credit bureau does not provide credit information from non-financial institutions, and there is no legal guarantee that borrowers can inspect their data. In addition to the absence of such a guarantee, the private credit bureau in Kuwait only provides credit information on customers. The private credit bureau in Bahrain neither guarantees borrowers the possibility to inspect their credit profile nor provides credit information from firms or non-financial institutions.

Table 16. Depth of credit information (% of maximum score)

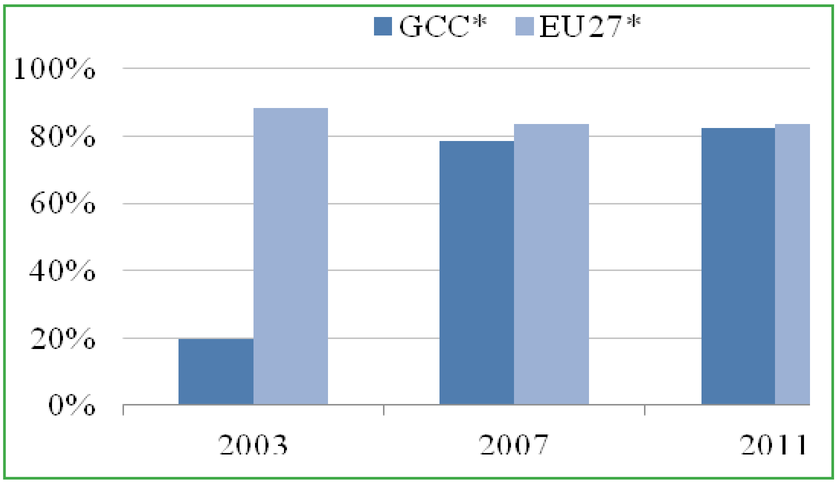


Table 16. Depth of credit information (% of maximum score) (continued)

	2003	2007	2011
Bahrain	-	50	50
Kuwait	50	67	67
Oman	-	33	83
Qatar	0	33	67
Saudi Arabia	0	100	100
UAE	33	83	83
GCC*	20	78	82
EU15*	89	84	84
NMS12*	66	73	75
EU27*	89	84	84
AVG	88	84	83
STDEV	18	22	21

Note: Higher values represent deeper information, as a share of a maximum score of 6 points.
* Regional averages are weighted by total banking assets. See Table A.13. for the scores of the individual EU

Member States.
Source: World Bank Doing Business surveys.

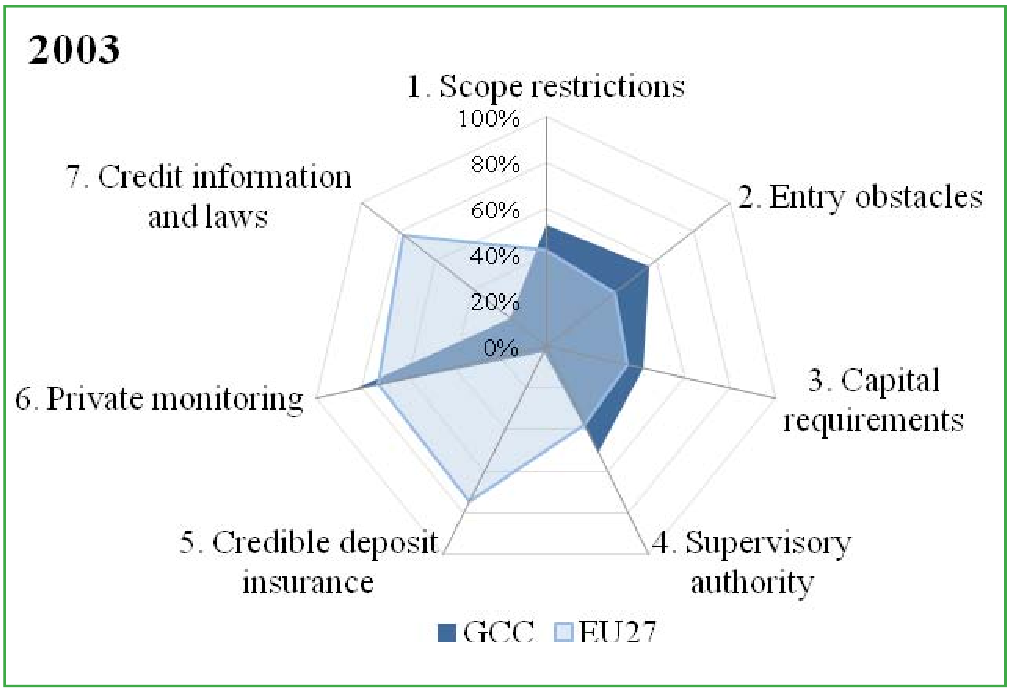
The large majority of the EU27 countries report similar scores to those of the GCC countries, with Cyprus, Luxembourg and Malta the only clear exceptions. In Cyprus, the private credit bureau only meets two criteria, and in Luxembourg and Malta there are no credit bureaus at all. More broadly, the other EU27 countries comply with almost all the criteria. Like many of their GCC counterparts, the credit registries in two-thirds of the EU27 countries do not collect information from retailers or utility companies. Moreover, in almost half of the EU27 countries, the credit bureaus do not provide both positive and negative information and/or distribute a credit history of more than two years. Finally, in contrast to the GCC countries, all credit registries in the EU27 are legally obliged to offer borrowers the possibility to inspect their data.

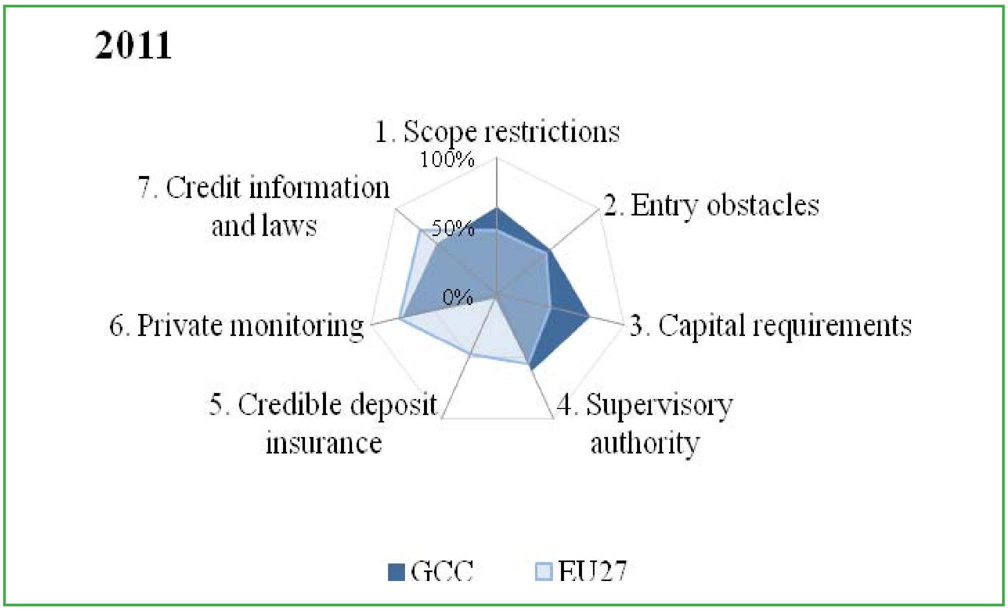
To sum up, the figures above show that substantial reforms in recent years have clearly helped the GCC countries to close the gap with the EU27 in terms of the use of credit information. The same cannot be said concerning the strength of legal rights; the EU27 average here is clearly higher than that of the GCC countries.

1.2.8. Results

The previous subsections reviewed the quality of the regulatory and supervisory structures of the GCC countries and the EU27, and their level of convergence. The assessment included seven dimensions: the scope of banking; entry obstacles; the stringency of capital requirements; the power and independence of the supervisory authorities; incentives provided by deposit insurance schemes; private monitoring; and creditors' rights and access to information. Figure 10 and Table 17 summarise the key weaknesses that distinguish the GCC countries from the EU27.

Fig. 10. Regulatory standards in the EU and the GCC





Note: The figures above sum the GCC and EU27 weighted averages for the regulatory indices in each of the seven areas discussed in Subsection 1.2.7.

The collective assessment of the convergence of the regulatory and supervisory structures of the GCC countries with EU27 standards gives a mixed picture. Despite some improvements, key weaknesses remain in deposit insurance, entry obstacles and the strength of legal rights. Other disparities have also become more apparent, especially as regards capital requirements.

The deposit insurance index has failed to improve in recent years as the authorities in Kuwait, Qatar, Saudi Arabia and the UAE have chosen not to put in place an explicit insurance scheme. Implicit schemes may enhance risk-taking through a blanket government guarantee for the leading institutions. Moreover, no effort has been made in Oman to align banks' incentives by implementing risk-based premiums or co-insurance schemes, which would help to internalise some of the costs to deposit guarantee schemes of excessive risk-taking.

Another major issue, the presence of entry obstacles, continues to be a key weakness of the regulatory structures of the GCC region. Although the licensing requirements exhibit similarities in both the GCC countries and the EU27, other indicators point to substantial barriers to entry. Government ownership, which is widespread in the region, gives undue advantages to incumbent banks and restricts entry incentives. In Qatar and the UAE, as well as to some extent in Saudi Arabia, government ownership remains significant. Although government ownership may have some benefits, the authorities have to ensure that roles are well-defined within a national strategy with clear objectives and instruments, and that it does not become an obstacle to the development of the financial system.[32] The rates of foreign denials are also high, further supporting the idea of substantial entry barriers and competitive advantages enjoyed by domestic incumbent banks.

32 Rocha et al. (2010) note the essential role that public banks play in the region by providing financing to SMEs. The authors note that private banks are unable to fill this gap largely due to the generally weak quality of financial infrastructure, including the availability and reliability of information on potential borrowers.

Table 17. Key regulatory weaknesses in the GCC

	Description	General remarks	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE
AREA I. Scope REstrictions	Restrictions on or prohibition of various activities	Slightly more stringent than EU27 standards	Insurance activities prohibited	Some restrictions on insurance activities	Insurance activities restricted; real estate activities prohibited	Some restrictions on securities trading & insurance activities; real estate activities prohibited	Some restrictions on securities trading; insurance restricted; real estate activities prohibited	Insurance & real estate activities prohibited
AREA II. Entry obstacles	Licensing, foreign entry & presence of public banks	Below EU27 standards due to foreign denials & the role of government	Foreign denials	Foreign denials		No foreign applications, Public banks represent >40% of banking activity	Public banks represent about 20% of banking activity	Public banks represent almost 50% of banking activity
AREA III. Capital Requirements	Extent to which capital requirements restrict risks	More stringent and higher minimum capital requirements than the EU27	Borrowed funds can be used to disburse initial capital		Borrowed funds can be used to disburse initial capital			
AREA IV. Supervisory authorities	Ability of supervisors to prevent & correct problems	Supervisors have slightly more power and independence than in the EU27	Some potential for interference	Some potential for interference	High potential for political interference	Some potential for interference	Some potential for interference	Some potential for interference
AREA V. Deposit insurance	Presence of an explicit scheme & mitigation of moral hazard	Below EU27 standards due to implicit insurance & adverse incentives	No co-insurance or risk-adjusted premiums	No explicit deposit insurance scheme	No co-insurance or risk-adjusted premiums; co-funded	No explicit deposit insurance scheme	No explicit deposit insurance scheme	No explicit deposit insurance scheme
AREA VI. Private monitoring	Availability of reliable & timely information to investors	Similar to the EU27		No disclosure of enforcement action	Flexibility in accounting rules, no disclosure of enforcement action	No disclosure of enforcement action	No public disclosure of risk management	No disclosure of enforcement action
AREA VII. Credit info. & laws	Ability of legal & information systems to facilitate lending	Below EU27 standards due to deficient legal rights	Limited legal rights for creditors; no public credit register, private register has limited coverage and borrowers have no access to it	Limited legal rights for creditors; no public credit register, private register has limited coverage and borrowers have no access to it	Limited legal rights for creditors; no private credit register & public register has no information on credit distributed by non-financials	Limited legal rights for creditors; no private credit register, public register has limited coverage and borrowers have no access to it	Limited legal rights for creditors; no public credit register	Limited legal rights for creditors; no information on credit distributed by non-financials

In addition to the two key weaknesses summarised above, the GCC countries fall short in terms of legal rights. Less stringent legal rights reduce the ability of creditors to enforce contracts, require repayment, claim collateral and gain control of receivables, making it less attractive to make loans.

The GCC countries have implemented a number of reforms to improve the availability and use of credit information by financial institutions. Qatar and Saudi Arabia have established public and private credit bureaus respectively in recent years. Moreover, while the score of the private credit bureau in Bahrain has remained unchanged, the private credit bureaus in Kuwait, the public bureau in Oman and the private as well as public bureaus in the UAE have all improved the depth of credit information. The GCC countries have thus almost closed the gap with the EU27. Although the literature provides little guidance, private credit bureaus have improved access to new technologies and know-how to ensure that information-sharing mechanisms work effectively. The countries in the GCC region should continue to monitor developments and spearhead innovative systems to use the stock of information and infrastructure already set up by the public systems.

Finally, there is a large difference in the strength and level of capital requirements between the GCC and the EU27. All of the GCC countries, except Saudi Arabia, require banks to hold more capital than the 8% minimum required under the Basel accords. The implementation of Basel II in the GCC countries is reflected in rising capital stringency scores. Increasing the levels of and strengthening capital requirements has an ambiguous effect. On the one hand, bank efficiency is decreased due to an increase in the cost of capital. On the other hand, the higher loss absorption capacity enhances financial stability. The Basel II minimum requirements proved to be insufficient to safeguard global financial stability during the financial crisis in 2008-9. Under the new Basel III Accord, the balance therefore shifts to higher minimum requirements. Since these accords will also be implemented by the EU27, the capital requirements in the two regions are expected to converge soon.

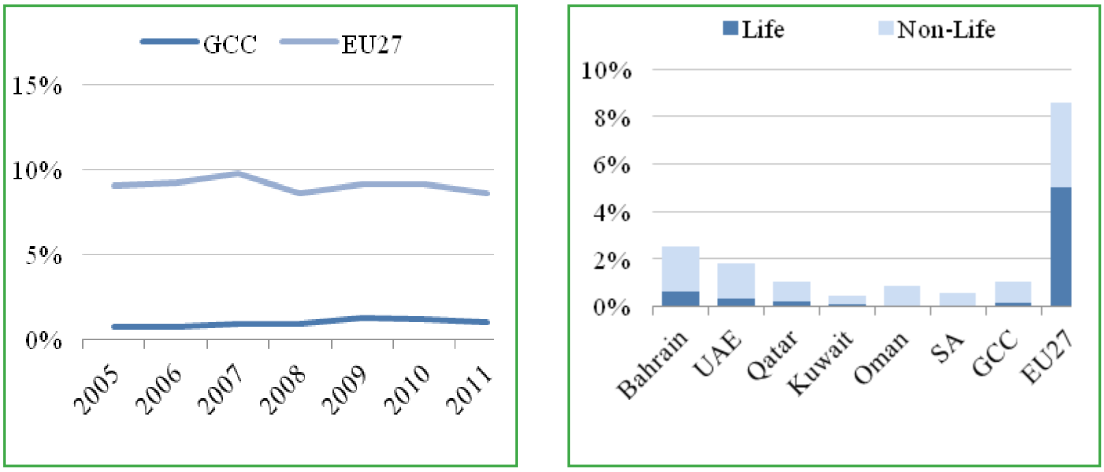
2. Overview of the Structure and Regulation of the Insurance Sector in the GCC Countries

In high-income, natural resource-oriented economies like the GCC countries, a developed insurance sector is a prerequisite for a robust and diversified economy. It removes tail risks from businesses and enhances risk allocation. If premiums are retained domestically, further expansion of the sector can also provide financial markets with attractive and diverse assets and decrease the overall risk premiums on credit thanks to collateral and default insurance products. In many respects, the need for developed insurance markets is in line with the long-term goals of the GCC. The general recurrent picture of the GCC countries' insurance industries, however, is one of insufficiently regulated markets with extremely low penetration rates and high growth potential. At a closer look, this depiction becomes too simplistic, since it ignores recent developments, competition-related issues and the challenges of future regulatory and enforcement adjustment, as well as the potential structural limits of the regional insurance markets. In terms of convergence with the mature insurance markets of the EU27, a set of structural, regulatory and cultural challenges exists which is unlikely to disappear in the medium term.

2.1. Development of the insurance industry in the GCC

With an annual increase of approximately 20%, insurance premiums have been growing faster than GDP and populations in the past eight years, effectively increasing penetration and density levels, although the expansion of insurance markets in terms of premiums can be misleading considering the extremely low base and the virtual non-existence of domestically-based insurers at the turn of the century. What appears to be solid growth could also be interpreted as a very steady catch-up with countries with comparable incomes (Figure 11).

Fig. 11. Insurance premiums in the EU and the GCC (ratio of total premiums to GDP)



Note: Numbers for Bahrain in 2005 and 2006 and Qatar in 2008 and 2009 are estimates. Penetration levels denote the ratio of total premiums to GDP.
Sources: Swiss Re, CEPS.

Although insurance densities (premiums per capita) in the GCC countries are higher than in other emerging economies[33] and are, on average, comparable with the NMS12, they remain extremely low relative to the EU15, reflecting an extremely low insurance penetration (the ratio of premiums to GDP). The entire insurance market of the GCC countries is lower than that of Portugal and between five to six time times lower than that of Spain, with a similar population size. When compared to countries with developed mandatory private insurance policies, the contrast is even more striking. For example, in the Netherlands – with a population of roughly one third of the GCC region – the overall volume of insurance premiums is more than seven times higher (Seiler, Staib and Puttaiah 2013). The insurance sector is also unevenly distributed within the GCC region, with the two major markets in

33 Latin America, Central and Eastern Europe, South and East Asia, the Middle East (excluding Israel) and Central Asia, Turkey, and Africa.

the region (UAE and Saudi Arabia) together generating approximately 80% of all insurance premiums. The concentration of life insurance business is even higher, with the UAE being the only major player.

Recent high GDP growth has been one of the most important factors determining the perceived potential of insurance markets in the region (Garbois and Pock 2010), but other characteristics of the GCC countries also point to a significant potential for future growth. The demographic composition and future dynamics of the market – most importantly, the proportion of the pre-active population about to enter the labour market – is exceptionally high when compared to other high-income countries. The majority of the region's population is younger than 25 and is set to remain so until at least 2020. The population is set to grow by 12 million – or 29% – between 2010 and 2020 (EIU 2009:5). As the young population is expected to enter labour markets with an enhanced understanding of financial products, growth rates are likely to accelerate in the upcoming years.

Governments across the GCC region are also implementing spending programmes to support infrastructure development. Saudi Arabia, Kuwait and Qatar have large-scale medium-term development programmes focusing on economic diversification. Due to the existence of national insurance or large captive schemes dealing with the risks related to the oil industry and many auxiliary (mostly engineering) services, economic diversification as well as privatisation are crucial drivers of general-access insurance markets in the GCC countries, although with little prospect of increasing life insurance rates.

Table 18. Distribution of insurance markets

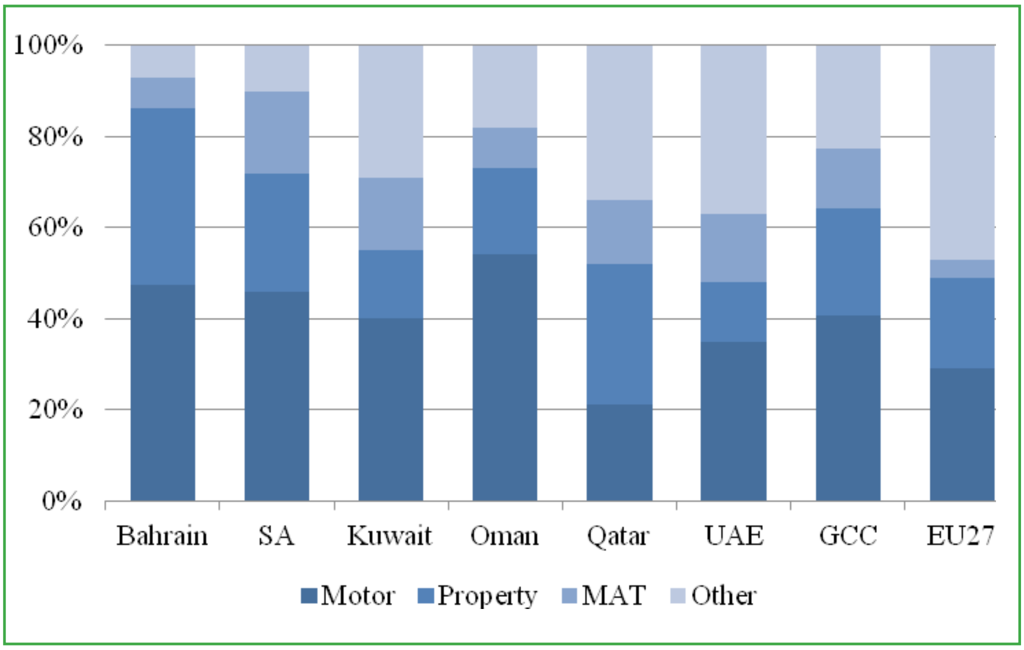
	Insurance premiums (millions, 2011)			Insurance penetration (premiums to GDP, 2011)			Insurance density (per capita, 2011)		
	Total	**Life**	**Non-life**	**Total**	**Life**	**Non-life**	**Total**	**Life**	**Non-life**
Bahrain	416	106	310	2.41%	0.62%	1.80%	414	106	308
Kuwait	583	133	450	0.52%	0.12%	0.40%	290	66	224
Oman	551	108	443	1.14%	0.22%	0.92%	274	54	220
Qatar	691	39	652	0.53%	0.03%	0.50%	534	30	504
Saudi Arabia	3,571	208	3,364	0.86%	0.05%	0.81%	177	10	167
UAE	4,771	881	3,890	1.81%	0.33%	1.48%	1,384	255	1,128
GCC	**10,583**	**1,474**	**9,109**	**1.07%**	**0.15%**	**0.92%**	**353**	**49**	**304**
EU15	1,043,487	618,283	425,203	8.97%	5.31%	3.65%	2,652	1,570	1,082
NMS12	32,192	14,193	17,999	3.25%	1.43%	1.82%	333	147	186
EU27	**1,075,679**	**632,476**	**443,202**	**8.52%**	**5.01%**	**3.51%**	**2,165**	**1,273**	**892**

Sources: Swiss Re and CEPS.

Despite the large number of positive factors in favour of growth in the region, there are also specific reasons for scepticism concerning the long-term potential of the GCC countries' insurance markets. Savings rates are extremely high in the region, and many households retain large asset buffers and therefore feel low incentives to insure their lives and property. This could be a major hindrance to the long-term development of insurance markets, as there appears to be a trade-off between savings and insurance (Besley 1995). The region is also away from major hurricane and earthquake areas, with the exception of Oman as regards the former. Weather extremes are also very rare. There may therefore be natural and cultural limits to the perceived need for insurance due to the low natural and political extremes of the GCC countries (in contrast to other MENA countries). Moreover, changing the approach towards insurance and overall awareness could take generations.

One of the particular and potentially important idiosyncrasies of the GCC countries' insurance markets is the low share of life insurance. While non-life insurance penetration is almost comparable to NMS12 (Table 12), life insurance has been, until recently, virtually non-existent in some GCC countries. This is in a stark contrast to the rest of the world, where life insurance clearly dominates. The non-life insurance sector tends also to be dominated by motor insurance, which is the only insurance line which is compulsory across the region. The dominance of motor insurance is even more important when the lower premiums for life insurance are taken into account. When compared to the EU27, the major difference in non-life insurance composition is the relatively lower development of insurance lines related to general liability, accident and legal expenses ("Other" in Figure 12).

Fig. 12. Non-life insurance by type



Note: MAT refers to approved marine, aviation and transit insurance.
Sources: World Bank, Insurance Europe.

Another, and maybe the most important, characteristic of the GCC countries' insurance markets is the persistently high cession rates. Although the markets could have not developed at such a pace without the involvement of reinsurers (Jeffrey 2012), retention rates are strikingly low compared to the rest of the world. On average, the GCC markets cede 46% of their premiums (compared with 8% in the rest of the world). Cession rates in all GCC countries exceed 40%, and even exceed 50% in Qatar and Oman (Ballantine 2012).

Cession rates at these levels are both a symptom of a deficient market and a reason for its low potential. Low retention rates mean that along with ceded risks, margins and profitability are also passed on to global reinsurance players. The bulk of the industry in the region could therefore be considered to be operating as sophisticated brokers, rather than fully-fledged insurers (Lester 2011). It also paints a rather negative picture of the region's capacity to deal with risks internally. Actuary and underwriting capacity in the region appears, on average, to be unable to compete with foreign players due to cost effectiveness and limited skill availability. It is therefore more rational for companies to cede their premiums and act effectively as brokers for insurance deals. This, however, raises problems of risk-allocation in the market, since there is less incentive for correct underwriting. It also prevents insurance markets from serving as financial diversifiers, limiting the positive externalities of insurance penetration, most importantly in respect to other sectors of the financial markets.

Another reason for high cession rates is the ongoing struggle for market share. Many companies are not keen to invest in the short term to develop their actuarial and underwriting capacity lest they compromise their immediate market position. Some commercial insurers therefore cede up to 90% of their commercial portfolios. Low retention rates are also linked to the fact that non-life lines prevail in the region, as life insurance tends to have higher retention rates. Overall, it can be assumed that profitability in the region will remain low until underwriting becomes cost-efficient and retention rates rise, but dependence on reinsurers is unlikely to decrease soon, unless there is market consolidation or an abrupt rise in the availability of highly-skilled individuals (Elmahy 2012).

The great potential for growth has naturally attracted a large set of domestic and international players. An increasing number of foreign insurers have registered with the local authorities over the past five years, sometimes despite elevated entry expenses. By 2011, approximately 180 insurance players were competing for a market of less than €11 billion (Alpen Capital 2011). Although it is not high in absolute terms, considering the nominal amount of premiums, the number of insurance players in the region is relatively high, and is a matter of concern for both regulators and businesses. The only insurance market in the GCC countries that appears to be relatively consolidated is that of Qatar, where only nine insurers were operating as of 2010. This is in contrast to the UAE, with 57 insurers, and the other GCC countries, with between 23 and 36 registered insurers (Table 19).

Table 19. Number of active insurers (excluding reinsurers), 2010

	Total	Life	Non-life	Composite	Concentration ratio (top 3)
Bahrain	36	3	29	4	29%
Kuwait	29	2	14	13	-
Oman	23	2	12	9	22%
Qatar	9	0	6	3	65%
Saudi Arabia	26	-	-	-	53%
UAE	57	-	-	-	21%
GCC (average)	**30**	**2**	**15**	**7**	**34%**
EU27 (average)	-	43	106	-	56%

Notes: *Weighted by premiums. **Top five concentration.
Sources: Insurance Europe, Alpen Capital.

The high level of competition in the market has led to aggressive pricing. To compensate for this, insurers tend to be rather under-capitalised, raising doubts about their overall solvency. The under-pricing also induces losses or very low margins. As mentioned above, companies subsequently lack resources for further investment or the creation of appropriate underwriting and actuarial capacities within the region. This leads to high cession rates, effectively causing a flight of potential profit margins abroad (Karakuyu 2012). In order to force rationalisation upon the markets, some jurisdictions have adopted temporary moratoria on granting new licences (such as the UAE since 2008), or limitations on foreign direct ownership for markets outside the financial centres; while Saudi Arabia and Oman limit foreign ownership of insurance companies to 25% and 70% respectively, Qatar and Kuwait forbid foreign shareholding in local insurance companies operating outside the financial centres (Nader 2011), which clearly discourages the entry of multinationals into domestic markets (Cashin 2012).

Today, most operators agree that consolidation of the markets is required to stabilise the profitability of the sector and to avoid inclusion of volatile or high-risk assets in insurers' portfolios and over-dependence on reinsurance (Schanz, Alms & Co 2012). Big global players are already present in the region, and if risk-based solvency rules were to be imposed upon the markets, those players would likely be the winners, due to their asset management and actuarial capacities (Alpen Capital 2011). If a balanced and non-monopolistic market were created, this would induce economies of scale and lead to the creation of more stable companies and larger and more conservative portfolios to hedge against losses. Such consolidation would be likely to proceed through mergers and acquisitions. It is less clear, however, when it might occur.

The limited supply of skilled labour is yet another important issue confronting the GCC countries. The skills necessary for the industry to operate in advanced global markets have had little time to develop due to the recent expansion of insurance markets. The need for skilled labour has been especially urgent in the case of high-end professions, such as actuaries, underwriters and claims professionals. Although this gap has been filled quite successfully by the expatriate community (as in many other industries), there is a chronic shortage of readily available skilled labour, and most importantly local labour (Lester 2011). The most flagrant shortages concern skilled personnel for underwriting and portfolio management, making it difficult to retain premiums in primary insurance, and having a huge impact on the profitability of the industry.

The industry is not the only one suffering from a scarcity of skilled labour. Shortages have been also acute in the regulatory and supervisory authorities. The competitive and diverse markets in the GCC region are often more difficult to supervise than mature and consolidated markets. More competent and highly skilled and technical employees are thus necessary to enable the authorities to exercise effective regulation and supervision (Cashin 2012). Insurance supervision is specifically affected by the lack of insurance professionals; many supervisors have a banking or general finance background, which causes flaws in communication and enforcement. To tackle the situation, some countries, such as Qatar, have established subsidised centres to develop the relevant financial skills, but high-skilled insurance professionals take years to train, and even more time will be required to produce a stream of new graduates every year. Although the establishment of training centres is essential for the future development of the markets, the GCC countries are destined to remain heavily dependent on expatriates in the short and medium term.

Another hindrance to convergence of insurance levels is the still relatively low development of culturally specific insurance lines. Since standard insurance products are mostly prohibited under sharia, the development of takaful insurance business models is considered essential for the expansion of insurance business in the GCC region, most importantly in relation to life insurance. Sharia compliance is an important means of building awareness in the GCC region and of developing a high-growth regional hub for the rest of the MENA region. It also presents an opportunity to host high savings of GCC residents. Takaful insurance is expanding quickly, and has registered above-average growth over the past few years (when compared to other financial markets, GDP or even standard insurance premiums), with an annual growth rate of 45% between 2004 and 2009 (Alpen Capital 2011). As in the general insurance business, however, such growth rates should be viewed with the utmost precaution, due to the extremely small initial base. The generally accepted takaful model has also recently seen several development hiccups. In 2012, takaful growth slowed down across the GCC region (Papp 2012), partly due to new constraints imposed upon the business by regulators in order to increase consumer confidence in such products (see the following Section). The cultural understanding of insurance products remains poor, and consumer confidence in these products is proportionately weak. The large numbers of multinational players have broadly similar return-on-investment requirements from takaful insurance as from ordinary lines of insurance. This creates an effective gap between insurers and their clients, which could become an obstacle to the future development of the industry (MEIR 2013).

Another prominent issue in relation to the development of the GCC countries' insurance markets is the captive insurance industry. There are currently ten companies operating as captives in the GCC region, mostly state-owned or private oil producers. The emergence of captives was driven in the first place by the inability of local insurance markets to meet the needs of large businesses. More recently, the development of captive regulation has become part of the strategy to increase the domestic-based financial environment, in which companies can develop their activities in order to support a diversified economy. At the moment, the existence of captive insurance is an important obstacle to the growth of an open insurance market, since what are by far the largest companies in the region manage portfolios on the corporate level and thus remain outside the potential client pool. Before the development of the insurance markets in the GCC region in the mid-2000s, most large companies using captives operated in offshore locations, generating no particular need for local captives. The liability of the state for risks and losses had also made insurance schemes redundant in many cases. Recent privatisation has increased the scope of the captive business, however, and is likely to increase it further in the future (Ali 2013).

To sum up, all statements about the insurance market in the GCC region have to be made with the utmost precaution. The potential for growth is indeed great if we consider the EU27 or other emerging markets as benchmarks. However, high premium growth rates have been driven in the past by the extremely low initial base as well as by exceptional GDP growth linked to oil prices. It is unclear whether such a development can continue, and whether the GCC market overall has the same potential for insurers as currently mature insurance markets.

Until now, the market has generated losses or extremely low margins. The overall profitability and macro-financial stability of the sector suffers from high competition, under-pricing and high cession rates. Indeed, the future prospects for the GCC market could be even bleaker. Muslim countries are generally prone to lower insurance penetration due to cultural specifics. As is shown in the following Section, even sharia-compliant takaful insurance is legally and religiously controversial.

Overall, although future growth potential is still high, it is probably significantly lower than current insurance penetration levels in the EU27 due to high savings rates, lower extremes in meteorological conditions and a generally lower cultural propensity to insure ordinary skills. The long-term potential of the GCC market may therefore be lower than is expected by current local insurers. There is, nonetheless, still a case for regulatory advancement towards convergence to make the market more efficient and stable, and to serve the interests of policy-holders and the overall economy. In order to succeed in this endeavour, further regulatory changes have to be considered.

2.2. What degree of convergence to international regulatory standards?

Income and wealth are often quoted as among the main determinants of insurance market potential. Insurance in the GCC region nonetheless clearly shows that culture, macro-financial stability and the regulatory framework are also important, as underlying macroeconomic indicators, to the development of the industry (Elmahy 2012). Until recently, the local industry was highly unregulated, with the relative exception of Bahrain, which served until the early 2000s as an insurance hub for the modest demand of the GCC region.

Over the past ten years, a set of changes across the region has transformed insurance regulation into, in some cases, a comprehensive regulatory framework which tries to comply with international standards and to adopt best practices, often following the model of the EU27. The Central Bank of Bahrain, the Saudi Arabian Monetary Agency (SAMA), the Qatar Financial Center Regulatory Authority (QFCRA), the Dubai Financial Services Authority (DFSA), and the Oman Capital Market Authority (OCMA) have been fairly determined in advancing their regulatory reforms and enforcing insurance laws. All GCC countries, with the exception of Kuwait, have joined the International Association of Insurance Supervisors (IAIS) in the past five years, while the UAE and Qatar have taken a step further by becoming signatories to the IAIS's Multilateral Memorandum of Understanding (MMoU). These last two countries have also made policy commitments towards future best practice. The most significant progress on the regulatory side in recent years has been in terms of determining clear rules on market access, non-weighted capital requirements, and taxation, and in terms of regulating proprietary structures. Progress has been made on the supervisory side, particularly as regards risk management and governance, but only to a limited extent.

Enforcement inefficiency, supervisory capacity and legal clarity remain underlying issues, however (Cashin 2012). The bulk of the current critique addresses the absence of market-consistent solvency rules and effective governance and risk management requirements. Clear and non-discriminatory reporting and consumer protection are also matters for concern. The most serious hurdle in implementing advanced international standards has been the inability of local regulators to be at the forefront of future regulatory frameworks, such as the EU's Solvency II or the Swiss Solvency Test (SST). The development of insurance regulation has also varied across the region.

Although the GCC insurance sectors continued to grow during the crisis, their dependence on equity and real estate assets, as well as their relative undercapitalisation when compared to global standards, exposed the fragility of the industry (Alpen Capital 2011). Such asset volatility in insurers' portfolios is mostly attributable to premium-based liability rules and non-risk-weighted capital requirements. This clearly undermines the solvency and growth prospects for the sector. Returns on investments are correspondingly as unstable as insurers' undertakings and assets. As a reaction to the crisis, insurers are now more likely to include debt-related securities as part of their capital requirements. A risk-based solvency (RBS) framework would, however, move the whole industry in a coordinated way towards more stable assets without putting asymmetrical strain on responsible insurers only. In its 2012 updated Insurance Core Principles, the IAIS requires signatories to apply a total balance sheet approach and RBS requirements. Although the IAIS does not stipulate the concrete format , the GCC countries now have three years to apply the RBS model.

Currently, overall valuation regimes for liabilities are risk-based only in Qatar and the UAE, where they are built on the US rather than the EU (Solvency II) or Swiss (SST) model. Other GCC countries follow simple premium-based liability, roughly comparable to Solvency I principles, with few effective requirements along the lines of the total balance sheet approach. The risk-based capital (asset side) requirements of the region are also largely undeveloped, and are based on unspecified internal models evaluated by the respective supervisors. Little legal attention has been given to the matter, and no deterministic models are offered by the regulatory authorities to domestic insurers. This does not allow external players or observers to quantify the solvency of the market, due to large supervisory discretion in the form of such internal models.

Nonetheless, most businesses expect regulators to focus on RBS and supervisors to pay more attention than in the past to capital adequacy, setting clear solvency margins and risk-based capital requirements and ultimately preparing for more robust frameworks such as the EU's Solvency II (Elmahy 2012). This could lead to more risk-adequate underwriting and, ultimately, more risk and premium retention in the long term, albeit with medium-term costs. Indeed, Solvency II is often quoted as the benchmark to which the GCC countries are likely to evolve in the three-year period stipulated by the IAIS (Schanz 2012). Solvency II is a fully RBS framework, and adopts economic perspectives in asset and liability valuation on a strictly market-consistent basis. This could be a challenge for the volatile GCC markets, although a move towards less volatile assets to avoid market risks would be necessary after the introduction of any similar framework. Solvency II not only requires a valuation of additional risk types (operational and market risk), but also stipulates the need to establish an internal risk management framework with the capacity to identify, measure and manage all risks. In terms of solvency capital determination, contrary to the general practice of the GCC, Solvency II would require the fulfilment of criteria from a standard deterministic formula, thus reducing the discretion of the regulator. Such regulatory adjustment could have major consequences for the structure of the GCC insurance markets. Since Solvency II has not yet come into force, its effects on the GCC region can only be estimated from observation of the enforcement of a similar framework, e.g. the SST as implemented in Switzerland. On balance, insurers have become more conservative in Switzerland, increasing capital and reducing risk, mostly due to a move towards government bonds and other less risky assets and, in some cases, even abandoning some high-risk underwritings (Schanz 2012).

High-quality underwriting and actuarial skills require significant resources, and the GCC's unconsolidated markets are a major obstacle to upgrading legislation to RBS due to the possible vested interests of currently under-capitalised insurers. In countries with a relatively high level of market consolidation, such as Qatar, the introduction of risk-based solvency is however likely to generate fewer mergers and acquisitions as well as a more modest increase in cession rates. The implementation of RBS rules could therefore pose problems to some businesses in the region and would have a highly asymmetrical impact on the industry. It is unavoidable in the long term in order to stabilise the volatile assets of GCC insurers and to consolidate the market. While Solvency II is a relevant regulatory framework for global insurance markets, it is not clear that the GCC region is ready to implement such demanding regulation, nor generally to what extent regions with such a short history of insurance development and markets as unconsolidated as those in the GCC are ready for such a framework to become a benchmark. The ultimate trade-off that local authorities face is phasing catch-up with the implementation of risk-based regulatory standards; either regulatory authorities wait for the market to clear and consolidate and let the winners cope with more stringent requirements, or they effectively force the whole market into consolidation by the implementation of RBS rules and limits on cession rates.

Although nominal regulation and its implementation has been the focal point of analyses of the GCC insurance markets as well as of business, the effectiveness of enforcement remains an area of concern, mostly due to the lack of reliable and official information on enforcement efficiency. The biggest pressure on improving enforcement has come from multinational insurance players, which fear the role of insiders, while their business model is clearly based on stable and highly enforceable regulatory frameworks. The region has recently been subject to recommendations on the development of more stringent supervisory and enforcement capacities in regulatory bodies due to their perceived inefficiencies and high discretion. There is a belief among international organisations and market players that even state-of-the-art regulation can be unevenly and non-transparently enforced, causing market distortions by incentivising market players to circumvent nominal regulation to gain competitive advantage.

Feeble enforcement also feeds consumer mistrust, further undermining insurance development in the region. In the case of lenience or arbitrary dealings, policy-holders are not properly protected, and the probability of ensuing insolvencies or a rise in uncovered underwritings increases. As stipulated by the IAIS Insurance Core Principle 11, corrective sanctions must be enforceable and based on objective criteria, something that many businesses present in the GCC region doubt is the case. Some authorities have already identified enforcement as an important issue. The DFSA, together with the QFCRA, has demonstrated a willingness to exercise enforcement powers following the regulatory model of the EU27, and to increase supervisory staff capacity to gain credibility in the markets (Cashin 2012).

Supervisory capacity is tightly linked to the reporting system, which is an important part of the Solvency II framework. Along with risk-based solvency, the World Bank has identified weak financial reporting – mostly the inability to obtain consistent, accurate and timely statistical information – as one of the major problems of the GCC region's insurance regulation, and has underlined the strengthening of reporting and disclosure as a prerequisite of sound regulatory enforcement (Lester 2011).

Among specific insurance types, takaful insurance regulation has been expanding in the region, with virtually all GCC countries establishing a regulatory framework for sharia-compliant insurance, mostly modelled as mutual insurance funds under the takaful model. Although the recent expansion of the takaful market has been extensive, investment in takaful business is not without regulatory challenges, such as the need to avoid direct allusions to speculative or excessive risk-taking, as well as the issues raised by profit generation and returns on the investments of foreign investors. As consequence of the regulatory problems, the takaful markets saw a slowdown in 2012.

The recent expansion of takaful regulation has clearly exposed the conflict between the benevolent and charitable nature of takaful on the one side, and its commercial dimension on the other (Papp 2012). Despite the consolidation efforts made by the Islamic Financial Services Board (IFSB), concrete definitions of takaful vary between scholars and jurisdictions, making enforcement difficult and leading to the risk of void contracts (Dingwall and Schneider 2013). The market is therefore fragmented, and insurers struggle to find sharia-compliant counterparties. Unless there is a broad and unique understanding of sharia compliance by all legislators, there will be counterparty risks and asset costs which are significantly higher than in ordinary insurance, putting pressure on pricing and subsequently on the possible expansion of the whole industry. From a legal perspective, the issue can provoke the sort of extreme reaction seen in Saudi Arabia, where the regulatory authority decided to ban current takaful business to protect policy-holders from disputed sharia compliance. Due to the great potential of the takaful model, the market has, nevertheless, good growth potential, and is likely to overcome the regulatory hurdles, since it is most probably the only way to increase life insurance penetration levels in the region to rates seen in more mature markets. Businesses simply have to find ways to align sharia compliance to the interests of commercial shareholders, and the IFSB must act credibly to find a common, culturally acceptable solution (Papp 2012).

As much as takaful business insurance is an example of partial regulatory failure to support an insurance line with great potential, the captive business is an example of regulatory success in attracting and promoting a potentially beneficial industry. Since underwriting issues are secondary in captives and assets are part of the company's larger portfolio, insurance in captives has been largely seen as efficient and uncontroversial. Before the development of the insurance markets in the GCC region in the mid-2000s, most large companies using captives operated in offshore locations. Almost immediately after the establishment of the relevant regulation, companies moved their operations to domestic markets (Ali 2013). This underlines the essential role of regulation in the development of regional insurance industries and in promoting convergence with other mature insurance markets.

Insurance regulation can also easily be affected by the development of other financial products and regulation. The overall development of financial regulation, especially in asset markets, would boost the potential pool for insurance businesses, and could decrease the high regional cession rates. A clear legal mortgage framework or the establishment of rules for private pension schemes (as well as the sector's privatisation) would also increase the currently low levels of life insurance.

Nonetheless, compulsory insurance represents by far the best prospect for expanding domestic insurance markets. The establishment of compulsory insurance across the region has been evaluated as one of the biggest drivers of insurance growth in the region (Anthony 2012), most significantly in motor insurance and, in some countries, health insurance for expatriates or liability insurance in the engineering and medical professions (Ballantine 2012). Scope therefore exists in compulsory insurance for professional liability insurance in other professions, as well as for more extensive insurance for healthcare going beyond state welfare provisions. State-funded health insurance for public workers, private pension insurance schemes and major risk schemes have also been depicted as ways of boosting insurance (Elmahy 2012). Such new legal insurance requirements should, however, go hand in hand with the development of underwriting capacities, so that risk is priced in a sound way within the economy and does not increase moral hazard. Local authorities should also pay attention to the efficiencies of specific mandatory insurance schemes, and carefully study their positive externalities, so as to avoid falling into the net of insurers' vested interests by putting in place more compulsory insurance schemes with little or no benefit to the economy.

Although the size of the regional industries remains limited, some jurisdictions are developing projects to harvest future growth by becoming regional hubs. At least two local financial centres aspire to transform themselves into regional insurance hubs, namely the Bahrain Central Bank and the Qatar Financial Centre Authority (QFCA), which are working in parallel to establish a natural common law-based jurisdiction to serve as a regional hub for insurance, captive insurance and reinsurance (FTSE Global Markets 2012). While Bahrain historically has a more favourable position, the QFCA has been more active in perspicuously addressing the potential of reinsurance markets as a consequence of current high cession rates. As part of its Strategic Focus of 2010, the QCFA implemented special tax concessions for reinsurers and allowed full foreign ownership of reinsurance companies, thus attracting major global companies to a region with otherwise strict limits on foreign ownership. Although more than purely regulatory changes are needed, the potential of such special jurisdictions, especially in reinsurance, is vast. The GCC is not the only area of the Middle East with very low density and penetration levels. Other countries of the MENA region are – with some exceptions – equally significantly undersized. Building up regulation enabling the establishment of regional insurance hubs is therefore in line with attempts by the GCC countries to diversify their economies towards export-oriented services.

To sum up, the main hindrance to the implementation of market-consistent valuation rules has been the market itself, most importantly the limited supply of high-level skills. The rather weak governance requirements have also been a consequence of the restricted managerial capacity of the region. The very high cession rates are not yet directly linked to the complexity of the regulation; they are rather determined by the lack of such skills.

Enhancing the shift in the regulatory paradigm from simple premium-based requirements and non-weighted assets towards RBD and a total balance sheet approach could put further strains on the market, increasing the already high reinsurance rates or requiring more foreign involvement in the medium term. It is therefore likely that regulators and supervisors are being cautious about the possible impact of such rules, and are setting the regulatory agenda accordingly. In this respect, the introduction of RBS clearly clashes with the internal goals of local authorities.

Conclusions

This paper has reviewed the current structure of the banking and insurance sectors in the GCC countries in comparison with the EU27. Convergence and integration of the regulatory frameworks in the GCC countries and the EU27 has also been assessed.

The banking sectors in the GCC region are dominated by a small number of commercial banks, both locally incorporated banks and the branches of foreign banks. Relative to the sizes of the population of the GCC countries, the banking systems are widely present, and access to financial services has improved significantly with payment networks connected throughout the region. However, beyond providing basic banking services to the private and public sectors, the banking systems remain relatively underdeveloped. The absence of deep domestic capital markets and tied relations with governments are the main obstacles to further development.

The analysis of regulatory convergence shows substantial improvements in credit information in the GCC countries. However, the region still suffers from key weaknesses in deposit insurance, entry obstacles and the strength of legal rights. In particular, deposit insurance systems in many GCC countries are not explicit, which could lead to uncertainties over the provision of support to banks in case of default. Another persistent issue is the presence of entry obstacles, in particular signs of substantial barriers to entry and continued government ownership of banks. The comparison of regulatory systems also highlights the fact that the GCC countries have not been able to catch up in terms of creditor protection. However, substantial improvement in credit information has occurred since 2003, in particular through the establishment of private credit bureaus with a broad coverage.

Despite the significant development of insurance regulation, the potential for convergence, most notably through the risk-based requirements of Solvency II, remains high. The GCC region has much to gain from applying such rules, as they would ensure a greater degree of solvency of the insurance sector and increase trust of policy-holders and investors. This advanced and complex regulatory framework, designed for the mature insurance markets of the EU27, is, however, rather demanding for the GCC's young insurance industries, and its implementation could be further postponed due to concerns about the sustainability of the current domestic industry and its structural shortcomings.

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Annexes

Table A.1. Bank activity restrictiveness (% of maximum score)

	2000	2003	2007	2011
Bahrain	67	67	67	50
Kuwait	58	42	67	33
Oman	83	75	67	67
Qatar	67	25	-	67
Saudi Arabia	67	67	75	-
UAE	-	42	-	75
GCC*	66	53	72	64
Austria	33	42	42	33
Belgium	58	58	42	42
Denmark	42	58	58	58
Finland	42	50	58	42
France	33	33	58	67
Germany	25	42	42	42
Greece	58	67	50	50
Ireland	50	42	42	33
Italy	58	67	75	58
Luxembourg	33	25	58	58
Netherlands	33	42	42	42
Portugal	50	58	75	42
Spain	50	42	42	42
Sweden	50	58	67	-
UK	33	33	25	33
EU15*	36	42	45	47
Bulgaria	67	58	58	42
Cyprus	42	67	67	58
Czech Republic	42	75	75	-
Estonia	50	25	50	50
Hungary	50	67	75	42
Latvia	50	42	50	42
Lithuania	58	50	75	50
Malta	58	67	67	67
Poland	67	50	58	92
Romania	83	75	67	33
Slovakia	58	67	58	75
Slovenia	50	67	67	50
NMS12*	55	62	65	64
EU27*	36	42	46	47
AVG	36	42	46	47
STDEV	13	12	17	15

* Regional averages are weighted by total banking assets.

Source: BRSS.

Table A.2. Entry into banking requirements (% of maximum score)

	2000	2003	2007	2011
Bahrain	100	100	100	100
Kuwait	63	75	100	100
Oman	100	100	100	100
Qatar	100	50	-	75
Saudi Arabia	100	100	100	-
UAE	-	100	-	100
GCC*	92	93	100	95
Austria	100	100	100	88
Belgium	100	100	100	88
Denmark	100	100	100	100
Finland	25	75	88	100
France	75	75	88	100
Germany	50	63	75	100
Greece	100	88	88	88
Ireland	88	0	100	100
Italy	100	100	100	100
Luxembourg	100	100	100	100
Netherlands	100	100	88	100
Portugal	88	88	88	88
Spain	100	100	88	100
Sweden	100	100	75	-
UK	100	100	100	100
EU15*	83	84	91	99
Bulgaria	100	100	100	100
Cyprus	100	75	38	100
Czech Republic	100	100	100	-
Estonia	100	100	100	100
Hungary	88	100	100	100
Latvia	75	100	100	100
Lithuania	100	100	100	100
Malta	100	100	100	100
Poland	88	88	100	88
Romania	100	100	88	100
Slovakia	100	100	100	100
Slovenia	100	88	100	100
NMS12*	95	93	93	96
EU27*	83	84	91	99
AVG	83	84	91	99
STDEV	24	23	11	4

* Regional averages are weighted by total banking assets.
Source: BRSS.

Table A.3. Share of foreign applications denied

	2000	2003	2007	2011
Bahrain	0	10	24	22
Kuwait	100**	100**	71	44
Oman	100**	100**	75	0
Qatar	100**	-	-	100**
Saudi Arabia	0	0	-	-
UAE	-	100**	-	0
GCC*	35	53	60	30
Austria	20	-	-	100**
Belgium	0	0	0	100**
Denmark	0	-	0	100**
Finland	100**	100	0	0
France	-	-	0	0
Germany	0	-	0	100**
Greece	0	14	0	0
Ireland	0	0	0	0
Italy	0	13	3	9
Luxembourg	0	0	0	0
Netherlands	0	0	0	100**
Portugal	0	0	0	0
Spain	0	7	0	0
Sweden	0	0	100**	-
UK	-	-	-	0
EU15*	2	7	3	33
Bulgaria	0	0	0	0
Cyprus	0	0	0	20
Czech Republic	-	0	25	-
Estonia	100**	100**	-	100**
Hungary	0	0	4	0
Latvia	0	25	100**	6
Lithuania	0	20	0	100**
Malta	0	0	0	0
Poland	0	0	0	0
Romania	25	-	0	6
Slovakia	50	100**	100**	0
Slovenia	0	0	0	0
NMS12*	13	16	15	8
EU27*	2	8	3	32
AVG	2	9	4	32
STDEV	19	37	22	51

* Regional averages are weighted by total banking assets.
** 100% if no foreign applications were registered.
Source: BRSS.

Table A.4. Market share of government-controlled banks (% of total assets)

	2003	2007	2011
Bahrain	0	1	0
Kuwait	0	-	0
Oman	0	0	0
Qatar	46	-	43
Saudi Arabia	21	20	20
UAE	35	-	49
GCC*	21	16	29
Austria	0	0	12
Belgium	0	0	0
Denmark	0	0	1
Finland	0	0	0
France	0	0	2
Germany	42	40	32
Greece	23	-	11
Ireland	-	-	21
Italy	10	9	0
Luxembourg	5	5	5
Netherlands	4	5	14
Portugal	23	25	23
Spain	0	0	0
Sweden	0	0	-
UK	0	-	26
EU15*	12	12	14
Bulgaria	18	0	3
Cyprus	4	3	1
Czech Republic	4	2	-
Estonia	0	0	0
Hungary	9	0	4
Latvia	3	4	16
Lithuania	12	0	0
Malta	0	0	0
Poland	24	20	22
Romania	42	-	8
Slovakia	4	1	1
Slovenia	12	18	51
NMS12*	12	8	12
EU27*	12	12	14
AVG	12	12	15
STDEV	20	21	15

* Regional averages are weighted by total banking assets.

Source: BRSS.

Table A.5. Regulatory capital ratio (% of risk-weighted assets)

	2000	2003	2007	2011
Bahrain	21	21	23	-
Kuwait	22	23	17	19
Oman	19	16	18	-
Qatar	-	-	-	16
Saudi Arabia	21	20	18	-
UAE	20	20	14	-
GCC*	21	20	16	17
Austria	13	15	15	13
Belgium	11	13	12	18
Denmark	12	10	14	18
Finland	12	11	17	14
France	12	12	12	12
Germany	11	11	12	16
Greece	11	14	13	12
Ireland	13	14	11	14
Italy	13	11	11	12
Luxembourg	13	13	15	18
Netherlands	11	12	12	14
Portugal	12	10	11	10
Spain	13	13	12	12
Sweden	15	20	10	-
UK	13	13	13	16
EU15*	12	12	12	14
Bulgaria	36	31	15	17
Cyprus	10	14	-	12
Czech Republic	11	15	12	-
Estonia	16	15	12	22
Hungary	17	16	11	17
Latvia	16	14	10	15
Lithuania	22	16	10	16
Malta	15	18	21	-
Poland	14	15	15	14
Romania	14	29	21	15
Slovakia	13	13	15	13
Slovenia	15	12	11	11
NMS12*	14	16	14	14
EU27*	12	12	12	14
AVG	12	12	12	14
STDEV	2	2	1	2

* Regional averages are weighted by total banking assets.

Sources: BRSS and IMF Global Financial Stability Reports.

Table A.6. Minimum regulatory capital ratio (% of risk-weighted assets)

	2000	2003	2007	2011
Bahrain	12	12	12	12
Kuwait	12	12	12	12
Oman	12	12	12	12
Qatar	8	10	10	10
Saudi Arabia	8	8	8	8
UAE	-	10	10	12
GCC*	9	10	10	10
Austria	8	8	8	8
Belgium	8	8	8	8
Denmark	8	8	8	8
Finland	8	8	8	8
France	8	8	8	8
Germany	8	8	8	8
Greece	8	8	8	8
Ireland	8	8	8	8
Italy	8	8	8	8
Luxembourg	8	8	8	8
Netherlands	8	8	8	8
Portugal	8	8	8	8
Spain	8	8	8	8
Sweden	8	8	8	8
UK	8	8	8	8
EU15*	8	8	8	8
Bulgaria	12	12	12	12
Cyprus	8	10	10	8
Czech Republic	8	8	8	8
Estonia	10	10	10	10
Hungary	8	8	8	8
Latvia	10	10	8	8
Lithuania	10	10	8	8
Malta	8	8	8	8
Poland	8	8	8	8
Romania	8	8	12	8
Slovakia	8	8	8	8
Slovenia	8	8	8	8
NMS12*	8	8	9	8
EU27*	8	8	8	8
AVG	8	8	8	8
STDEV	0	0	0	1

* Regional averages are weighted by total banking assets.

Sources: BRSS and IMF Global Financial Stability Reports.

Table A.7. Capital stringency (% of maximum score)

	2000	2003	2007	2011
Bahrain	22	56	67	57
Kuwait	78	67	78	86
Oman	56	56	56	71
Qatar	78	33	-	86
Saudi Arabia	33	33	67	-
UAE	-	67	-	71
GCC*	47	50	69	76
Austria	89	89	67	57
Belgium	78	44	22	86
Denmark	89	89	33	43
Finland	44	44	56	57
France	56	22	89	71
Germany	67	67	56	71
Greece	33	56	33	57
Ireland	67	56	44	86
Italy	44	33	33	57
Luxembourg	56	56	56	71
Netherlands	44	56	44	71
Portugal	44	67	78	57
Spain	78	89	89	71
Sweden	11	11	44	-
UK	67	56	67	43
EU15*	62	53	62	63
Bulgaria	33	67	67	71
Cyprus	11	44	67	86
Czech Republic	33	56	33	-
Estonia	78	22	44	86
Hungary	67	33	89	57
Latvia	11	56	44	86
Lithuania	33	33	22	71
Malta	67	56	56	57
Poland	44	33	22	71
Romania	33	33	56	71
Slovakia	44	67	22	57
Slovenia	78	89	56	71
NMS12*	43	46	45	71
EU27*	61	53	62	63
AVG	61	53	62	63
STDEV	15	22	21	15

* Regional averages are weighted by total banking assets.

Sources: BRSS and IMF Global Financial Stability Reports.

Table A.8. Official supervisory power (% of maximum score)

	2000	2003	2007	2011
Bahrain	100	74	66	64
Kuwait	89	53	47	64
Oman	89	71	63	71
Qatar	89	53	-	57
Saudi Arabia	100	74	68	-
UAE	-	74	-	57
GCC*	96	69	62	60
Austria	100	68	53	64
Belgium	89	53	58	64
Denmark	56	47	53	64
Finland	67	32	47	43
France	67	37	45	57
Germany	67	42	42	57
Greece	56	63	53	39
Ireland	56	58	63	50
Italy	33	26	37	71
Luxembourg	100	68	53	71
Netherlands	44	21	37	64
Portugal	67	74	74	71
Spain	44	47	61	57
Sweden	44	42	26	-
UK	78	58	42	29
EU15*	66	45	45	53
Bulgaria	78	58	58	57
Cyprus	100	42	63	64
Czech Republic	89	37	53	-
Estonia	89	74	68	71
Hungary	100	74	76	71
Latvia	56	68	53	64
Lithuania	44	58	76	64
Malta	67	74	74	71
Poland	67	37	47	64
Romania	44	47	47	71
Slovakia	100	74	68	64
Slovenia	100	63	68	79
NMS12*	83	52	59	67
EU27*	67	46	46	53
AVG	67	46	46	53
STDEV	18	14	9	16

* Regional averages are weighted by total banking assets.

Source: BRSS.

Table A.9. Independence from political interference (% of maximum score)

	2003	2007	2011
Bahrain	33	33	67
Kuwait	67	67	67
Oman	33	0	33
Qatar	33	-	67
Saudi Arabia	33	67	-
UAE	33	-	67
GCC*	39	60	65
Austria	67	33	67
Belgium	33	67	67
Denmark	0	67	67
Finland	67	67	100
France	33	33	100
Germany	33	33	33
Greece	67	33	67
Ireland	67	67	100
Italy	0	33	33
Luxembourg	67	67	67
Netherlands	33	67	67
Portugal	67	67	100
Spain	33	67	100
Sweden	67	67	-
UK	33	100	33
EU15*	34	59	61
Bulgaria	100	100	100
Cyprus	67	100	100
Czech Republic	67	67	-
Estonia	100	67	67
Hungary	67	67	100
Latvia	100	100	33
Lithuania	33	67	33
Malta	100	67	67
Poland	0	67	67
Romania	67	100	100
Slovakia	33	33	100
Slovenia	33	100	67
NMS12*	50	75	81
EU27*	34	59	61
AVG	34	59	61
STDEV	18	29	33

* Regional averages are weighted by total banking assets.

Source: BRSS.

Table A.10. Deposit insurance index (% of maximum score)

	2003	2007	2011
Bahrain	67	67	67
Kuwait	0	0	0
Oman	0	0	0
Qatar	0	0	0
Saudi Arabia	0	0	0
UAE	0	0	0
GCC*	2	4	3
Austria	67	33	0
Belgium	100	67	33
Denmark	33	33	33
Finland	67	67	67
France	100	67	67
Germany	100	67	67
Greece	33	33	67
Ireland	67	67	33
Italy	67	67	67
Luxembourg	33	33	33
Netherlands	33	33	0
Portugal	100	100	67
Spain	33	33	33
Sweden	33	0	-
UK	67	67	33
EU15*	75	59	48
Bulgaria	33	33	33
Cyprus	67	33	33
Czech Republic	67	67	-
Estonia	33	67	33
Hungary	100	100	67
Latvia	33	0	67
Lithuania	33	67	33
Malta	67	33	33
Poland	67	67	33
Romania	33	33	33
Slovakia	67	67	33
Slovenia	67	33	0
NMS12*	66	58	37
EU27*	75	59	48
AVG	74	58	47
STDEV	29	19	24

* Regional averages are weighted by total banking assets.

Sources: BRSS, European Commission (2010), World Bank, Central Bank of Bahrain and Central Bank of Oman.

Table A.11. Private monitoring (% of maximum score)

	2000	2003	2007	2011
Bahrain	89	64	82	91
Kuwait	100	91	82	82
Oman	89	82	55	64
Qatar	78	73	-	73
Saudi Arabia	100	82	82	-
UAE	-	91	-	73
GCC*	97	85	80	75
Austria	56	55	55	73
Belgium	67	64	64	73
Denmark	78	73	82	73
Finland	100	82	73	64
France	67	55	73	91
Germany	67	73	82	64
Greece	67	64	82	73
Ireland	78	82	82	91
Italy	67	73	73	73
Luxembourg	78	73	64	73
Netherlands	78	73	91	73
Portugal	89	55	64	55
Spain	89	73	82	82
Sweden	67	64	64	-
UK	89	91	91	82
EU15*	75	73	80	77
Bulgaria	78	64	64	73
Cyprus	67	73	73	82
Czech Republic	56	73	64	-
Estonia	78	73	64	64
Hungary	56	82	82	73
Latvia	56	73	73	64
Lithuania	78	64	82	64
Malta	89	73	73	73
Poland	78	64	73	82
Romania	67	55	55	64
Slovakia	56	64	45	73
Slovenia	67	73	73	64
NMS12*	67	69	69	75
EU27*	75	73	80	77
AVG	75	73	80	77
STDEV	12	13	10	11

* Regional averages are weighted by total banking assets.
Source: BRSS.

Table A.12. Strength of legal rights (% of maximum score)

	2003	2007	2011
Bahrain	-	40	40
Kuwait	40	40	40
Oman	40	40	40
Qatar	40	40	40
Saudi Arabia	30	30	50
UAE	40	40	40
GCC*	36	37	43
Austria	70	70	70
Belgium	60	60	60
Denmark	80	90	90
Finland	80	80	80
France	40	70	70
Germany	80	70	70
Greece	40	40	40
Ireland	90	90	90
Italy	30	30	30
Luxembourg	-	50	50
Netherlands	60	60	60
Portugal	30	30	30
Spain	60	60	60
Sweden	60	70	80
UK	100	100	100
EU15*	70	72	71
Bulgaria	80	80	80
Cyprus	-	90	90
Czech Republic	70	60	60
Estonia	60	60	70
Hungary	70	70	70
Latvia	100	100	100
Lithuania	50	50	50
Malta	-	-	30
Poland	80	80	90
Romania	80	90	90
Slovakia	90	90	90
Slovenia	50	40	40
NMS12*	75	75	77
EU27*	70	73	72
AVG	69	72	71
STDEV	27	22	23

* Regional averages are weighted by total banking assets.

Source: World Bank Doing Business surveys.

Table A.13. Depth of credit information (% of maximum score)

	2003	2007	2011
Bahrain	-	50	50
Kuwait	50	67	67
Oman	-	33	83
Qatar	0	33	67
Saudi Arabia	0	100	100
UAE	33	83	83
GCC*	20	78	82
Austria	100	100	100
Belgium	67	67	67
Denmark	67	67	67
Finland	67	67	67
France	67	67	67
Germany	100	100	100
Greece	67	67	83
Ireland	83	83	83
Italy	100	83	83
Luxembourg	-	0	0
Netherlands	83	83	83
Portugal	83	83	83
Spain	83	83	83
Sweden	67	67	67
UK	100	100	100
EU15*	89	84	84
Bulgaria	50	100	67
Cyprus	-	0	33
Czech Republic	67	83	83
Estonia	83	83	83
Hungary	83	83	67
Latvia	33	67	83
Lithuania	50	100	100
Malta	-	-	0
Poland	67	83	100
Romania	67	83	83
Slovakia	50	67	67
Slovenia	50	67	67
NMS12*	66	73	75
EU27*	89	84	84
AVG	88	84	83
STDEV	18	22	21

* Regional averages are weighted by total banking assets.

Source: World Bank Doing Business surveys.

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ABOUT SHARAKA

Sharaka is a two-year project implemented by a consortium led by Istituto Affari Internazionali (IAI).

The project, partially funded by the European Commission, explores ways to promote relations between the EU and the Gulf Cooperation Council (GCC), through the implementation of policy-oriented research, outreach, training and dissemination activities. The overall project aim is to strengthen understanding and cooperation between the EU and the GCC, with particular attention to the strategic areas identified in the Joint Action Programme of 2010, such as trade and finance, energy, maritime security, media and higher education.

For more information visit www.sharaka.eu