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Kuwait

Kuwait's domestic economic conditions have dovetailed with the international crisis to create the perfect storm, reports ***Hugh Miles***.

The Perfect Sandstorm

Initially, many analysts thought the worldwide financial turmoil would sail harmlessly by Kuwait. Then, last October, Kuwait's fourth largest lender unexpectedly revealed massive losses related to derivatives trading. Gulf Bank lost KD375m (US$1.4bn) when the euro fell against the dollar.

"When I heard the news about Gulf Bank I realised that this crisis was not going to pass us by at all," says a source at a leading Islamic investment bank in Kuwait who asked to remain anonymous.

"It was then we realised that in fact the crisis was going to plough right into the middle of the Kuwaiti financial sector. But at that stage no one had any idea about the scale of the problem, because companies stood silent in the face of the crisis, unwilling to share bad news."

The central bank responded quickly, guaranteeing all deposits, but the bad news kept coming. In November, the Kuwait Stock Exchange halted trading in shares of nine firms including the leading Islamic investment bank Investment Dar, until third-quarter financial results had been published. Investors were stunned when Investment Dar, which made headlines in 2007 buying luxury car brand Aston Martin, revealed it needed to secure close to US$1.1bn to refinance debt maturing in 2009.

Shortly afterwards Global Investment House – Kuwait's biggest investment bank and the Emirate's sixth-biggest company – announced it had defaulted on US$200mn of its debt facility and was appointing HSBC to renegotiate with international creditors. Global declined to comment.

Worse than Souk al Manakh

"At this point people just started really panicking. Everyone just wanted to liquidate," comments the investment banker. "People who lived through Souk al Manakh [the Kuwait stock market crash of 1982] and the invasion of Iraq say that this was the worst thing ever to hit Kuwait."

The stock exchange plummeted and a drastic deterioration in asset values ensued. Even the highly respected National Bank of Kuwait, the only Kuwaiti bank to survive the Souk al Manakh financial crisis intact, posted a drop in profits. Confidence in the central bank drained so low one irate investor led his donkey into Kuwait's stock exchange – the second largest by capitalisation in the Arab world and the oldest in the region.

> "The original idea was to bail out companies with good assets." **Sulaiman al Rubaie**

By the end of 2008, with the stock market down 38%, it was clear that without a significant economic stimulus package many of Kuwait's most reputable financial institutions were going to go bankrupt.

"You knew that the situation had reached a disaster level when even the best and cleverest investor had lost 50% of his money," comments Naser al-Nafisi, General Manager at the Al-Joman Center for Economic Consultancy in Kuwait. "The small investors were hit the hardest and they are the majority, but everyone has been hit."

The widely-respected central bank governor, Sheikh Salem Abdulaziz al-Sabah, moved quickly to try and re-establish order, implementing measures aimed at boosting investor confidence, thawing the credit markets and spurring banks to lend to one another again.

Throughout January a rescue plan was hammered out. Draft bills were submitted for debate and an expert committee was assembled with instructions to draw up a list of recommendations to tackle the crisis. Newspapers speculated about the details of the plan, while the financial sector waited nervously, wondering who was going to be bailed out.

"There were various possible solutions," comments Mandagolathur Raghu, senior vice-president of research at the Kuwaiti investment company Markaz. "The Kuwaiti government could bail out some or all of the struggling companies, or it could adopt the US rescue model, whereby each struggling company would be judged on a case-by-case basis. So many companies were involved in the mess they soon realised they had to try to find a common solution to the problem."

Special interests look for bail-out

What aggravated the situation was that many influential parties in Kuwait had a vested interest in seeing the crisis get worse.

"The original idea was to bail out companies with good assets," explains Kuwaiti businessman Sulaiman al Rubaie, "but powerful special interest groups

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want to see the government rescue all companies. Typically these groups are backed by influential merchant families who are very heavily leveraged themselves and with huge ownerships in the Kuwait stock exchange."

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"These groups tried to push the government into a corner so it had to rescue everyone with a huge crazy bail-out. They wanted the situation to get worse so that there was no solution for the government except drastically to inject a vast amount of capital into the economy, to help all companies both good and bad."

Other MPs argued that it was not just immoral to use public funds to bail out wealthy merchant families and financial institutions: it also made bad business sense. The current government's savings are in large part invested in an international portfolio that, like all the Gulf Sovereign Wealth Funds, has recently seen billions of dollars wiped off its value.

"The government can of course pay but it would require liquidating its Future Generations' Fund at a very bad time and the money is not going to be coming back again. Bailing people out who made very stupid decisions is like throwing money into a garbage can," comments Al- .

Some MPs and many ordinary citizens wanted to tie the economic rescue package to a long-standing plan to annul all citizens' personal loans, as the previous Emir Jaber Al-Ahmed Al Sabah did after Kuwait's liberation in 1991.

"People were trying to write off their personal loans and they thought this was their opportunity to have both these two plans passed as law – the central bank rescue plan and their plan – otherwise they threatened to destroy the central bank proposal," explains Al-Nafisi.

Unusually in the Gulf, Kuwait's parliament has the right to approve all bills and major business deals and with so many different interest groups all pushing their own agendas, the decision making process seized up.

"The central bank tried to implement some sensible measures but it was consistently blocked or ignored either by the executive branch or by parliament or by special interest groups," says Al-Rubaie. "For example they thought that they could introduce a type of convertible bond to buy all the loans from the investment companies, guaranteed by the government, before being converted into equity. But in Kuwait we are not allowed to have convertible bonds."

Nearing a deal

Finally, at the start of February, details of the multi-billion dollar stimulus plan appeared in the local press. It targets the financial sector holistically, aiming to unfreeze the financial log-jam and encourage inter-bank lending again. Company loans will be issued to select investment companies in exchange for a secured asset as a guarantee with an option to buy back later at the same price. Banks will have their existing asset portfolio guaranteed by the state and be able to grant cash-strapped local companies approximately KD4bn (US$13.8bn) of fresh credit, half of which will be underwritten by the central bank.

"The central bank plan will limit further bankruptcies and it will help the financial system to lend to some companies who have troubles. Without the plan, a minimum of 30 companies would have gone bankrupt," says al-Nafisi.

"This plan is not a blank cheque," says Raghu. "There are a lot of conditions and performance measures written into the legislation. For example it talks about the role of outside consultants in evaluating the prospects of a company before they become eligible to seek assistance. The CBK will give bonds for assets and work out the re-purchase programme accordingly, but terms can run for as long as 15 years."

The devil is in the details, and they are still being hotly debated behind closed doors. The final legislation may end up looking very different to the draft published so far, by the time it has been debated by all stakeholders and enshrined in law.

The central bank is unlikely to be entertaining any applications from needy companies until the first week of March, at the earliest.

"Obviously they will try to short-circuit many things to get this plan passed into law quickly as this stimulus package is designed on an emergency basis to rescue the economy," says Raghu. "I don't expect any delays in implementation but what I do expect is more confusion among politicians on the broader debate as to whether they should use public money to rescue private companies."

Meanwhile Kuwait's macro-economic outlook remains uncertain. The government has already poured liquidity into the finance sector but still no one is willing to accept credit, and the crisis has now spread into every sector of the Kuwaiti economy, from industry and training to retail and services. New products are being shelved and recent hires are being sent back home Salaries have been reduced across the board. There have been deep job cuts in the investment sector and "job rationalisation" in many of the merchant family companies.

Even the most prestigious Kuwaiti financial institutions have sustained losses of more than 50% of their value and many reputable companies now have shares trading at under the book value of 100 fils. Gulf Bank, Investment Dar and Global Investment House are all still operating, but rumours of bankruptcy and mergers swirl around on a daily basis. Kuwait's First Investment Co and Gulf Investment House were the latest to join forces on February 3 and analysts expect more such mergers

before the crisis is over, especially in the fragmented investment sector. Kuwait has over 90 investment banks that together make up more than half the country's listed companies.

"The draft law explicitly states that banks and investment companies seeking assistance should agree to a merger proposal if it is proposed by CBK. I expect many more consolidations and mergers, but who will join forces with who remains an open question," says Raghu.

Why was Kuwait badly hit?

The Emirate was already experiencing a liquidity crisis and depreciating real estate prices when the credit crisis struck, but analysts believe the key drivers of the crisis to be an overly large investment sector, lax regulation and a lack of transparency, all compounded by bitter political infighting.

"The problem was that many investment companies had taken out short-term loans from local and regional banks, which they had used to buy long-term investments. Heavily dependent on short-term debt and with few illiquid assets, when the crisis struck they defaulted," says Raghu. "Many of Kuwait's investment companies had balance-sheet structures that might have worked in normal circumstances but were not able to handle the extraordinary circumstances of the credit crisis."

"The bubble exploded because of a cocktail of international and local issues, but 80% of the problem is local," says al-Nafisi. "The root cause was that there is no transparency or developed financial regulation, no official control and no serious punishment for the people who violate the current laws. We knew there was a serious threat to the financial system in Kuwait, especially related to the stock exchange, but no one took any serious action. I hope the door is open to punishment for those responsible in the future but I am not optimistic."

"This crisis was primarily the responsibility of the government, the stock exchange management and the Ministry of Trade and Commerce," Nafisi continues. "Besides governmental institutions, we can blame the listed companies especially the investment companies, the speculators and also the media, especially the daily newspapers which are paid to make the market seem wonderful when in fact the opposite is true."

Many commentators agree the authorities could have acted months sooner. The central banks in other GCC markets do not permit such huge mismatches between assets and liabilities, and despite a similar slide in the bourse in 2006 no capital markets authority was ever put in place.

To compound the problem, oil is hovering dangerously close to the break-even price needed to balance the budget. Despite attempts to diversify, Kuwait's energy sector still contributes more than 40% of the national GDP. All public spending is now under review and in December the Kuwaiti parliament scrapped a US$17bn deal with Dow Chemical, dealing another blow to the Emirate's reputation as an easy place to do business. Kuwait

Kuwait Stock Exchange

has failed to implement any major new projects since 1991.

If the oil price bounces back up to US$50 or US$60 a barrel soon, analysts believe public spending will soon be able to resume as before, but if the oil price remains at a lower threshold for an extended period, a further contraction in spending looks inevitable.

"This is the third disaster to have struck Kuwait in three decades," commented Al-Nafisi. "Souk al Manakh was a disaster, the invasion was another and this is the third. Every few years there are financial crises in Kuwait because there is no serious punishment and no serious efforts to improve the laws. Each disaster has its own story and its own causes and consequences and every time the state fund pays out billions to rescue the economy. Unfortunately this is the way they manage our state."

Certainly this crisis has posed unprecedented challenges, which is why Kuwait's response has been marked by trial and error like everywhere else around the world. Although the long-term economic prosperity and stability of the state are not likely to be affected, analysts are divided as to whether any positive lessons are likely to be learned.

"I expect we will see, after years of inactivity, a lot of regulatory streamlining being introduced especially in the capital markets," comments Raghu. "Kuwait will definitely go ahead and overhaul their regulatory mechanism which has been pending for decades now and that will be great news for the region. I am very bullish in the medium to long term, but in the short term I would just sit on the wall and watch."

Not everyone agrees. "This crisis is really a tragedy," says Al-Nafisi, "but when it is over they will forget everything and await another crisis. This is the general routine in our country. When there is a problem it is only a matter of time before it happens again as there are no procedures or measures in place to stop this happening again in the future. This is the painful fact."