Harmonization of Banking Regulations
A Paper for the GCC First Investment Forum

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I- ECONOMIC AGREEMENT

1) <u>1981 GCC Economic Agreement</u>

It all began with the 1981 Economic Agreement between the GCC member states. The GCC was created on 25 May 1981 by Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

2) <u>Main Objectives: Regional Cooperation and Integration</u>

The main objectives of the GCC Agreement are regional cooperation and integration in all economic, social, and cultural affairs, including trade, industry, investment, finance, transport, communications, and energy.

3) <u>Specific Objectives: Achieve a Common Market</u>

Its specific objectives are to achieve a common market, with equal treatment of GCC citizens in each member country in respect of freedom of movement, work, residence, ownership of real estate, movement of capital, as well as financial and monetary coordination including adoption of a common currency.

4) First Two Decades: Successfully Developing Economic Ties

During the first two decades of the GCC existence, under the 1981 Economic Agreement, Member Sates succeeded in developing their economic ties to bring them closer to full economic integration and economic unity. The Supreme Council, during its annual meetings, adopted several vital resolutions in the economic field that pushed joint economic action great steps ahead. The most important resolutions have been those relating to the GCC customs union, the common market, development integration, and the economic and monetary union.

5) 2001 New GCC Economic Agreement

The new Economic Agreement between the GCC States adopted by the GCC Supreme Council (22nd Session; 31 December 2001) in the City of Muscat, Sultanate of Oman, furthered the objectives achieved by the 1981 agreement, enhancing and strengthening economic ties among Member Sates, and harmonizing their economic, financial and monetary policies, their commercial and industrial laws, as well as their customs regulations, taking into account the new global economic environment.

II- ECONOMIC AND FINANCIAL INTEGRATION

Now what were the salient provisions of the Economic Agreement for achieving Economic and Financial Integration?

Under the Heading of:
1) Trade: Customs Union and International Economic Relations

1- Article One provided for The Customs Union:

Trade between the GCC member States will be conducted within the framework of a customs union

2- Article Two provided for The International Economic Relations:

To secure better terms and more favorable conditions in their international economic relationships, Member States shall draw their policies and conduct economic relations in a collective fashion in dealing with other countries, blocs and regional groupings, as well as other regional and international organizations.

Concerning the:
2) Creation of GCC Common Market:

1- Article Three provided that:

GCC natural and legal citizens shall be accorded, in any Member State, the same treatment accorded to its own citizens, without differentiation or discrimination, in all economic activities, including capital movement.

Regarding the:
3) Economic and Monetary Union:

1- Article Four provided that:

Member States shall undertake, according to a specified timetable, to achieve the requirements of Economic and Monetary Union, which include the achievement of a high level of harmonization between Member States in all economic policies, especially fiscal and monetary policies, banking legislation.

2- Article Five further elaborates that:

Members states shall provide an investment climate characterized by transparency and stability, and take the following steps:

1. Unify all their investment-related laws and regulations.

2. Accord national treatment to all investments owned by GCC natural and legal citizens.

3. Integrate financial markets in Member States, and unify all related legislation and policies.

III- The Question is: What were the achievements in the field of integration of GCC Banking Regulations?

1) Achievement of Economic Nationalization and Equality between GCC Citizens:

1- Permitting the Gulf International Bank to open its branches in the GCC States in accordance with the laws and regulations prevailing in the host Member State.
2- Allowing the national banks of the GCC States to open branches in other Member States in accordance with specific regulations.

2) Approximation and Unification of Procedures and Regulations:

In this area, agreement has been reached on the following:

The Regulation on Adequacy of Capital and Asset Risks; the Regulation on Credit Concentrations and the Monthly Statement of Assets and Liabilities; the Reference-Model Rules for the Classification and Structuring of Demand Appropriations, and the Role of External Auditors, and their Relationship with Monitoring Authorities and the Financial Institutions' Administration in the GCC Banks.

3) Monetary Union

The GCC States, in the 22nd session of the Supreme Council held in Muscat, Sultanate of Oman, in December 2001, Under the Heading of Time-table for Monetary Union, have taken the following decisions:

1- to assign the Governors of the financial institutions and the central banks with the task of implementing and executing the resolutions of the Supreme Council with regard to approving the American Dollar as the common peg for the currencies of the GCC States before end of the year 2002; The Dollar peg was achieved.
2- to assign the Committee of Governors with the task of identifying and harmonizing the economic benchmarks and standards related to the financial and monetary stability to make the Monetary Union successful. Also, to define these standards, their components, and the method of calculating and deriving them, and to reach an agreement in this regard by no later than the year 2005, thereby

paving the way for the launch of the common currency before January 2010.

The GCC States, in the 26th session held in Riyadh, Kingdom of Saudi Arabia, in December 2005, with regard to the implementation of the timeline for instituting the Monetary Union of the GCC, The Supreme Council endorsed the agreement reached on the financial and monetary standards for economic approximation by the Finance and Economics Committee and the Committee of the Governors of the Monetary Agencies and Central Banks, endorsing five macroeconomic and budgetary convergence criteria for monetary union by 2010, including a cap on budget deficit relative to gross domestic product, the public debt to GDP ratio, inflation rates, and on national interest rates, and adequacy of foreign exchange reserves. The Council directed the two committees to conclude deliberations on how to calculate those standards and percentages, and to submit it during the next session of the Supreme Council.

In the 27th session held in Riyadh, Kingdom of Saudi Arabia, in December 2006, the Supreme Council extended the mandate given to the two committees and directed them to complete the remaining steps and to reach an agreement on the regulations and documentation necessary for the establishment of the Monetary Union and the launch of the single GCC currency in accordance with the timetable.

A common currency is expected to act as a catalyst for stronger integration and deepening of GCC financial markets. It will foster the integration of money markets across the region and lead to a uniform short-term interest rate structure. It is also believed that a monetary union—formed by a single GCC currency—would lead to the formation of the largest and most liquid capital market in the Middle East. It will also contribute to the integration and development of the bond and equity markets and thereby facilitate savings and investments in the region. The single currency would have a long-term impact on major regional banks, as it would encourage greater efficiency in the use of cash.

4) Two major setbacks in 2007 (Kuwait and Oman)

However, with Kuwait's decision to peg its currency to a currency basket instead of the dollar exclusively in May 2007, and the withdrawal of Oman (Oman said in 2007 it would skip the 2010 deadline over concerns that spending targets could constrain economic growth), the planned GCC currency union saw two major setbacks in 2007. Still, its scheduled implementation by 2010 was reconfirmed at the GCC 28th summit in December 2007, despite widespread doubts among experts who deem this unrealistic under present circumstances.

In the 28th session held in Doha, Qatar, in December 2007, GCC leaders declared the launch of the GCC common market in January 2008. The Prime Minister of Qatar further declared that current policy is based on keeping a peg to the dollar noting that the issue has been discussed at the summit. He referred to the absence of any decision to peg to a basket of currencies at present and made clear meantime that the GCC members are deeply concerned with the fluctuations and devaluation of the US Dollar.

The Central Bank of Kuwait Governor reaffirmed that the State of Kuwait fully supports and endorses the GCC common currency project, and shall continue to exert every effort towards its realization. Accordingly, until all technical, legislative and institutional requirements are fulfilled for the establishment of the GCC monetary union and the launch of the common GCC currency, the CBK will continue using the basket of currencies' system for the determination of the KD exchange rate.

UAE central bank governor Sultan Nasser Al-Suweidi said earlier that the GCC was unlikely to have a single currency by 2015.

5) Common Market

In the 28th session held in Doha, Qatar, in December 2007, GCC leaders declared the launch of the GCC common market in January 2008. The launch of the GCC common market is just the beginning, and it will take some time before we come to see its full realization. But the economic bloc, no doubt, will lead to greater capital mobility. But for all of this to happen, the GCC should first move towards harmonizing the rules and regulations relating to investments, real estate, among others, across the board. The 2010 deadline for the monetary union also seems ambitious as there are issues like common monetary tools, common monetary goals, currency conversion criteria, etc that need to be sorted out first.

6) Model Laws and Documents

The Following Model Laws and Documents were approved:

Monthly Statement of Assets and Liabilities	Fifth Meeting of the Governors of Monetary Institutions & Central Banks Muscat , 6-7	For guidance

	May 1986	
Law on the Centralization of Risks	Seventh Meeting of the Committee of Governors of Monetary Institutions &Central Banks Abu Dhabi 25-26 January 1986	For guidance
Law on Adequacy of Capital , Asset Risks, and the Law on Credit Concentrations in the GCC Banks	Committee of Governors of Monetary Institutions and Central Banks Abu Dhabi, 10 April 1993	For guidance

IV- What are the future plans on the roadmap for Monetary Union and Full Economic Integration?

1) Gulf Monetary Council and Gulf Central Bank

Various important stages in the lead-up to the desired goal of achieving a common currency still await completion. The GCC has yet to establish a common central bank, which is vital for regulating a common currency and a monetary union. There is also the task of ironing out a governing mechanism for the bank and for forging an agreement on the respective roles of various member countries in the new arrangement. There has to be a framework for resolving differences on fiscal policies. Other important issues that need to be ironed out include the formulation and ratification of various related legislation and the streamlining of disparate regulations among member states.

1- However, it is noteworthy that significant progress is being made on the aforementioned challenges. A decision to establish a Gulf monetary council in preparation for the establishment of a joint central bank and later a single Gulf currency was agreed upon in 2006 by central bank governors. Operations for the proposed council would begin in 2008.

The Plan is to:

- Set-up a Gulf Monetary Council (GMC) in 2008 and a Gulf Central Bank (GCB) in the course of 2009

- Introduce a single currency on 1 January 2010

2) The GMC Objectives:

1- preparation for the realization of Monetary Union

2- preparation for the changeover to the single currency, and in particular for the establishment of the GCB and its analytical and operational capabilities

3) The GCB Objectives:

1- The primary objective of the GCB would be to ensure price stability in the single currency area.

2- Also, contribute to the achievement of the common objectives as laid down in the current GCC Charter and related agreements.

4) The GCB Tasks

1- define the monetary and exchange rate policy of the single currency area

2- ensure the consistent implementation of the monetary and exchange rate policy of the single currency area

3- hold, manage and control the foreign reserves of the single currency area

4- issue banknotes and coins denominated in the single currency

5- promote the smooth operation of the market infrastructure for the clearing and settlement of payments and securities transactions within the single currency area

6- The GCB would also exercise specific powers in the area of prudential supervision and financial stability (harmonization of policies)

7- Advisory role to GCC and national governments on draft legislation

5) Independence, accountability and transparency

The GCB will be:

1- Independent from governments and other bodies

2- Accountable to GCC political bodies

3- GCB will have Different publications to explain policies

6) Why the GCB?

1- The power to formulate monetary policy in a monetary union is transferred to the supranational level

2- This implies centralized decision-making (not merely coordination of national policies)

Therefore, the GMC will have to be transformed into the GCB, a genuine fully-fledged central bank.

V- Overall Assessment of Economic Integration

1) Basic Elements of Economic Integration have progressed at a brisk rate

It should be noted here that the basic elements of economic integration such as the GCC Customs Union, the GCC Common Market, the GCC Monetary Union and the harmonizing of policies have progressed at a brisk rate.

2) Actual Implementation on the national levels of Model and Key Laws still lags

Article 5 of the 2001 Economic Agreement calls for the creation of an “investment climate characterized by stability and transparency”, including the complete integration of capital markets in the region. To achieve this goal, member states committed themselves to harmonizing their regulations regarding investment, banking and financial markets, to eliminating all discriminatory regulations regarding the trading and ownership of assets, and thereby effectively to removing all barriers to cross-border banking services and investment.

However the implementation of key laws and regulatory frameworks needed to bring member states in line with each other had yet to happen. Although the GCC has already achieved consensus on a vast number of laws on a guidance basis, their actual implementation on the national levels still lags behind and detailed specifications and unified regulatory frameworks are absent in many cases.

3) Public Awareness needs to increase

More importantly, public awareness about the possibilities of the common market would need to increase. Besides specific media campaigns, the website of the GCC and other information outlets could be improved, and cooperation with non-governmental bodies like chambers of commerce strengthened. Only with well-oiled feedback loops, will the GCC be able to monitor the grade of actual implementation. It will, of course, also require the capability to enforce it if need be.

4) A Major Empowerment of Centralized GCC Institutions is also warranted

A major empowerment of centralized GCC institutions is also warranted. It is not enough to meet once or twice a year to decide important issues, the establishment of a common market needs day-to-day decision making by administrations with corresponding institutional capabilities. The EU has the European Commission, the Council of the EU, the European Parliament and the court of justice to deal with such matters; in the GCC, no such institution exists thus far.

5) The Number of Banks operating across GCC countries is still very limited

The number of banks operating across GCC countries is still very limited, although all member countries allow in principle the establishment of banks from other GCC countries on their territory. This may be due to the fact that the equal treatment principle has not yet been implemented completely in national banking and commercial legislation. Furthermore, while basic harmonization has been achieved, legislation in the areas of banking regulation and supervision continues to display differences across countries, complicating the establishment of cross-border branches by GCC banks.

VI- LESSONS TO BE LEARNED

1) Review of Banking Regulations in light of New International Trends

GCC states may benefit from a review of their banking laws and regulations with a view to identifying the extent to which new trends may be properly reflected in them.

A Successful:

1- modernisation of banking laws and regulations
2- harmonisation of such laws and regulations
3- adoption of similar supervisory standards in the GCC countries
4- close cooperation among the GCC central banks and other supervisory authorities

This would no doubt strengthen financial integration among these countries and allow them to reap the benefits of such integration in terms of increased real investment, trade and competition.

2) The cross-country experience of International Institutions

The cross-country experience of international institutions such as the IMF, the World Bank and the Bank for International Settlements may be a good source to draw on in this review process.

3) Deregulation

There is a growing trend toward relying more on the private marketplace and less on government rule-making in order to regulate global banking.

It should be emphasized that authorities in numerous countries are rethinking their basic approach to the supervision of financial institutions generally. They are relying less on rigorous rule-based methodologies, which tend to run counter to the principles of deregulation, and are focusing more on management practices and Corporate Governance. They are specifying more clearly the responsibilities of financial market participants for the sound operation of financial institutions, and are attempting to hold these parties accountable for their performance. Thus, in recent years, many supervisory agencies have articulated more clearly the duties and responsibilities of directors and managers, adopted minimum standards applicable to external auditors, and expanded public disclosure of information regarding financial institutions.

4) GCC Approach to Basel II

Basel II is the second of the Basel Accords which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. The purpose of Basel II, which was initially published in June 2004 (updated November 2005), is to create an international standard that banking regulators can use when creating regulations about capital requirements/or how much capital banks need to put aside to guard against the types of financial and operational risks banks face. (Such an international standard helps protect the international financial system from the types of problems that might arise should a major bank or a series of banks collapse. In practice, Basel II attempts to accomplish this by setting up rigorous risk and capital management requirements designed to ensure that a bank holds capital reserves appropriate to the risk the bank exposes itself to through its lending and investment practices).

In providing a wide range of approaches, Basel II introduces regulatory capital requirements that capture risks more fully and are sensitive to the differing complexity of international banks.

The GCC Central Banks have been working together to establish a unified approach, wherever possible, to National Discretions in implementing Basel II.

GCC Central Banks published lists of National Discretions focusing on the Standardized Approaches to credit risk and operational risk.

The UAE Central Bank for example in August 2006, issued to all banks its Notice 3735/2006 'Basel II Implementation in the UAE' outlining the expectations of the UAE Central Bank from the banks. UAECB further published in March 2007 Guidelines for Banks on National Discretions, Standardized Approaches and Credit and Operational Risk.

(In June 2004 (updated November 2005), the Basel Committee on Banking Supervision ("Basel Committee") issued the "International Convergence of Capital Measurement and Capital Standards" Revised Framework referred to as Basel II, and re-issued a "Comprehensive Version" in June 2006).

5) Banking supervision for Banks with cross-border activities: Consolidated Supervision

With the creation of the GCC Common Market, the region will witness the formation of cross-country financial and banking conglomerates (By "financial conglomerates", I mean a group of legal entities, mainly engaged in financial services activities that are related by ownership and/or control, which may be located in different countries within the GCC).

This will pose a challenge to the supervisory role of central banks.

The International Trend is that supervision of financial conglomerates is increasingly becoming consolidated supervision.

In principle, there are two fundamental regulatory alternatives for addressing financial conglomerates:

a) consolidated regulation, where regulation is extended to all group members engaged in financial agency, and
b) separate regulation, where the focus of regulation is the individual regulated entity.

Two groups of countries are devoting substantial attention to this subject: the countries which comprise the European Community, and the member countries of the Basle Committee on Banking Supervision. In both groups, the preference has been for a form of consolidated supervision.

The concept of "consolidation" is operative on three different levels: prudential regulation, accounting, and supervision.

A) <u>The Basle Committee's Trend</u>

The Basle Committee's four minimum standards for the consolidated supervision of international banking groups, issued in 1992, are worth recalling in this respect:

(1)All such banks should be supervised by a home country authority that capably performs consolidated supervision (i.e., an authority which has the capacity to receive and assess all relevant information from the banking group, to prevent corporate structures that undermine effective supervision, and to prevent the group from creating foreign banking establishments in particular jurisdictions, e.g., because the host country supervision would not be adequate).

(2) The creation of a cross-border banking establishment should receive the prior consent of both the host country supervisory authority and the home country authority (of the bank or, if different, of the banking group).

(3) Supervisory authorities should possess the right to gather information from the cross-border banking establishments of the banks or banking groups for which they are the home country supervisor.

(4) If a host country authority determines that any one of the foregoing minimum standards is not met to its satisfaction, that authority could impose restrictive measures necessary to satisfy its prudential concerns consistent with these minimum standards, including the prohibition of the creation of banking establishments.

B) European Union Trend

Aside from consolidated supervision, another mechanism of regulating banks with cross-border activities is the method of mutual recognition of bank authorizations and activities, as it has been adopted by the European Union member states under European Community Directives.

The so-called home country supervision and single license model, which had been implemented in all EU member states by January 1993, allow financial institutions to operate throughout the EU countries through branches which are subject to the supervision only of the member state in which their headquarters are registered. It is therefore no longer required that banks from one member state establish subsidiaries with their own separate endowment capital when they wish to provide banking services in the other member states.

Of course the introduction of the concept of home country supervision and single license in the EU countries had not been possible without a complementary minimal harmonization of national banking regulations and supervisory standards. EU legislation harmonizing banking regulations and supervisory standards includes, Directives on the financial institutions' own funds, their solvency ratio, and the control of large exposures of the institutions to a client or a group of connection clients.

VII- HOPEFUL NOTE

Last but not least, we end this presentation on a hopeful note.

We hope that the success of the GCC countries' in achieving a high degree of financial integration among their countries could also provide the example for greater financial and economic integration for the benefit of the Arab region as a whole.