



Building the **wholesale-banking market** in the Gulf States

Despite inherent risks, talent constraints, and the daunting geographic scope of the market, the Gulf Cooperation Council presents fast-growing opportunities in international investment banking.

**Mehmet Darendeli,
Ralph Heidrich, and
Raman Thiagarajan**

A combination of new oil wealth, financial-market liberalization, and changing trade and investment patterns has transformed the outlook for global banking institutions in the six states of the Gulf Cooperation Council (GCC).¹

Retail and private banking have grabbed most of the headlines from the area over the past decade; however, corporate and investment banking represent around 40 percent of total GCC banking revenues (\$11 billion) and seem set to grow by 10 to 20 percent a year over the next decade (Exhibit 1).²

Local opportunities, once scarce, now abound: the Arab Economic Forum, for example, estimates that some \$700 billion worth of capital is likely to be mobilized to finance new infrastructure, oil and gas assets, petrochemicals, and the development of other vital sectors over the next ten years.

Beyond the promise of fast-growing revenue, current market trends are tilting the playing field in favor of global corporate and investment banks. A growing number of local corporations are going global and demanding that their financial advisers have an extensive geographic presence and internationally competitive skills. Local banks do not always have

the experience necessary to offer the sophisticated products and services now demanded by their client base.

Global banks still sitting on the sidelines urgently need to position themselves now in a region that boasts a combined gross domestic product of \$600 billion, double-digit economic-growth rates, and

¹ Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates (UAE).

² McKinsey estimate based on GDP forecasts, announced deals, international benchmarks, and interviews.

banking assets in excess of half a trillion dollars. Likewise, those that have already established a base in the GCC should consider expanding their activities in the near future.

The new landscape

It would clearly be naive to ignore the risks involved in doing business in the Middle East—but these risks are often not what they seem, and what’s more, they must be balanced against the emerging opportunities sparked by new regulatory openness and the demand for international know-how and skill.

Risks

Notwithstanding the obvious political tensions in the region, most regimes in the GCC are domestically stable. The recent

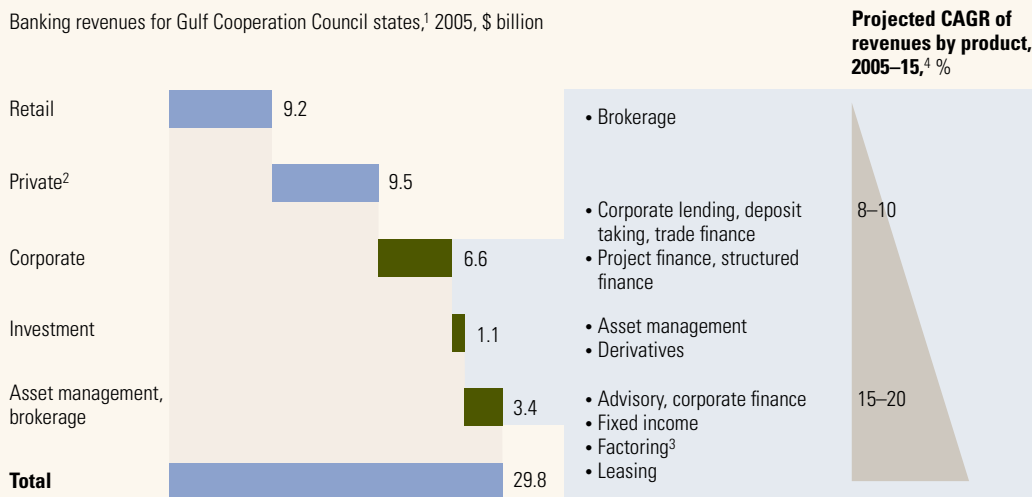
surge in oil prices has been accompanied by a conscious effort to distribute the proceeds more evenly and to build globally competitive industries in preparation for the inevitable day when hydrocarbon wealth will run out.

Equity markets in the region remain volatile, to be sure. After excessive liquidity and irrational exuberance drove markets to new heights in 2005, there was a strong correction in 2006; prices have since remained subdued. Yet GCC investors have learned from that painful experience, and there is a growing sense of maturity in the region’s financial markets.

Oil dependence, of course, is a double-edged sword, and any future oil shock would send macroeconomic ripples

Exhibit 1
Banking in the Middle East

In the Gulf Cooperation Council (GCC) states, corporate and investment banking represent nearly 40 percent of total banking revenues.



¹GCC states: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates (UAE).

²Includes offshore wealth management.

³Lending secured by value of a company’s unpaid invoices.

⁴High-level estimates; assumes 2006 base to account for structural changes related to oil boom and recent corrections in volume of assets under management; CAGR = compound annual growth rate.

Source: Annual reports and Web sites of financial institutions; announced deals; interviews with market experts; McKinsey analysis

throughout the region. Even relatively diverse economies, such as that of Dubai, would be exposed to a substantial correction in real-estate values in the event of a drop in oil prices. However, despite the volatility inherent in the area's financial climate as a result of oil dependence, a global bank's diversified geographic portfolio can provide built-in protection against just such a downturn.

Regulation

The growing opportunities available in the region at this time have been made possible, at least in part, by a new spirit of regulatory openness. Following the success of the United Arab Emirates (UAE) as a liberal marketplace, formerly protectionist economies such as Saudi Arabia's have begun to follow suit. The kingdom's entry into the World Trade Organization (WTO) was accompanied by the signing of free-trade agreements, legal reform, and the establishment of a Capital Markets Authority that serves as the independent regulator of activities related to investment banking and asset management.

Even so, the approach of regional regulators toward foreign players remains somewhat unclear. On the plus side, the recently created Dubai International Financial Centre (DIFC) and the Qatar Financial Centre (QFC) enable foreign banks to participate in wholesale financial services, such as investment banking, asset management, commercial line insurance, and private equity. They cannot do business with retail consumers, however. Since the creation of the DIFC, in September 2004, it has authorized in excess of 50 financial institutions to do business, including leading institutions such as Goldman Sachs, Merrill Lynch,

and Rothschild. Encouragingly, regulators in Kuwait and Saudi Arabia, hoping to increase the level of sophistication among the area's financial institutions, have been issuing new commercial-banking licenses to foreign banks.

On the other hand, it is noteworthy that local rather than international players won all of the licenses announced in early 2006 for eight greenfield banking ventures that account for close to \$20 billion in paid capital across the GCC. Regulators seem to prefer issuing commercial licenses to banks from other GCC states on a reciprocal basis, thereby supporting local institutions in their aspirations for regional expansion. With several states overbanked, it may be some time before regulators issue another wave of commercial-banking licenses to foreign institutions.

Complexity

Despite these concerns, there is still ample room for the know-how and skills of the leading global banks, not least in key areas such as product structuring and risk management. With competition for the business of larger corporate clients increasing, local institutions are developing strategies for tapping into the relatively underserved small and midmarket-enterprise segments; however, even here they need not have it all their own way. Providing efficient and profitable solutions for these clients will remain a challenge for local institutions, creating market openings for larger competitors.

A glance at the 2005 project finance league tables shows that seven out of the top ten book runners were foreign institutions. Even within Islamic banking,



which in 2005 accounted for around 15 percent of GCC wholesale revenues (a proportion that is expected to grow to 25 percent by 2010), international institutions are playing an important role in the more sophisticated product areas. Dubai Islamic Bank, for example, has been bringing in foreign partners such as Barclays Capital to help structure sukuk³ issues in recent years.

Corporations from the Middle East are becoming increasingly global, and local blue-chip companies are naturally more inclined to work with financial-services providers that can support them outside their home countries. DP World, for instance, recently acquired Britain's P&O, in addition to signing agreements in China, Pakistan, and Turkey; Kingdom Hotel Investments operates around the globe; Etisalat and Mobile Telecommunications (MTC) have licenses in 16 and 21 countries, respectively, with each operator serving more than 25 million subscribers.

Capturing the opportunity

Regulators throughout the GCC, especially in Saudi Arabia, are increasingly demanding a local commitment from global

banking institutions. Private bankers selling asset-management products in the kingdom can no longer, for instance, pursue the fly-in-fly-out “suitcase” model and are now required to register with the Capital Markets Authority. The same is true for companies attracted by new corporate- and investment-banking possibilities. To maximize opportunities in the GCC, global institutions must not only work out their overall strategic direction but also first identify the product niches with the greatest potential, find ways to overcome the shortage of talent, determine the scope of their geographic presence, and, finally, consider the best option for market entry.

Strategic direction

Foreign institutions essentially have two choices when developing business strategies for the GCC: they can either take a product-focused approach or become fully fledged wholesale bankers in the region. Under the product-focused approach, foreign institutions should identify niches where market needs are not being met and establish a presence either on their own via an offshore location in the region or by joining forces with local partners. Macquarie Bank of Australia,

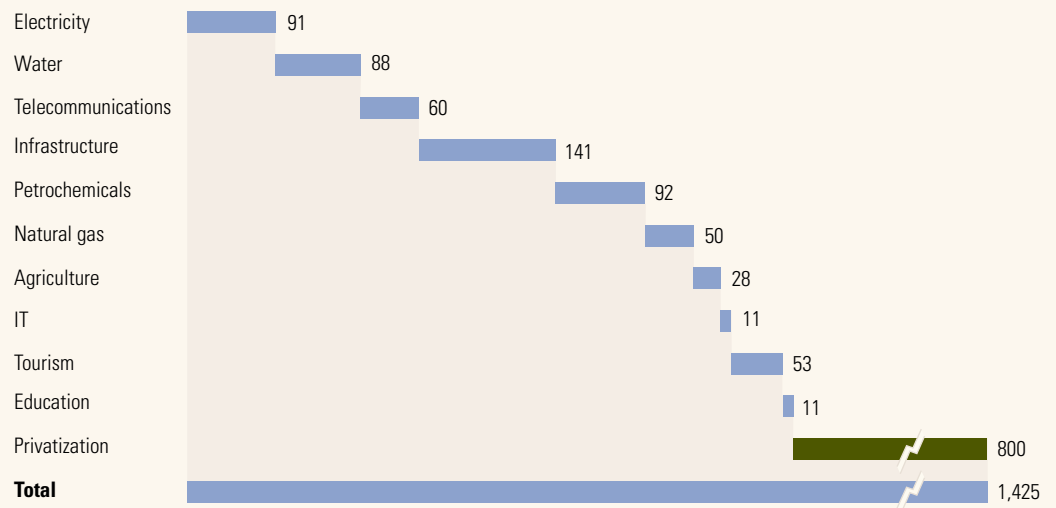
³Sukuk is a hybrid bond structure in which the money loaned (or coinvested) by bondholders is always loaned against asset collateral (usually the asset for which money is being borrowed). Ownership of the asset usually remains with the bondholders, and the borrower buys back its equity in the asset through regular payments.

Exhibit 2

Investing in Saudi Arabia

Over the next 15 years, privatization in Saudi Arabia may provide \$800 billion in investment opportunities.

Investment opportunities in Saudi Arabia, 2005–20, \$ billion



Source: Committee for the Development of International Trade of the Council of Saudi Chambers of Commerce and Industry; *London Times*

for example, has worked with Abu Dhabi Commercial Bank (ADCB) to provide project finance and structured-lending services in the UAE and across the GCC. Likewise, Permal has recently created an asset-management capability through the DIFC to serve a GCC-wide client base.

The fully fledged approach, by contrast, is for institutions that wish to offer a complete range of corporate- and investment-banking services. In our view, the plain-vanilla corporate-banking opportunity is attractive. After all, the ratio of corporate leverage to GDP in the GCC states is just 20 to 30 percent of what it is in developed markets such as the United Kingdom and the United States. And while margins have been under pressure, they are likely to improve thanks

to growing local-financing requirements and the adoption of Basel II guidelines (which will likely encourage the repricing of corporate exposures). Notwithstanding the interest of local institutions, relatively underbanked small and midmarket clients look particularly promising for players with sophisticated credit skills and an appetite for risk.

The fully fledged approach promises a much bigger payoff than the narrower, product-focused one; however, it is obviously much more demanding. Citibank, Deutsche Bank, and HSBC are among those already pursuing that strategy.

Product niches

Several product areas in the Gulf are potentially attractive at the moment, providing opportunities for both

those wishing to focus and those planning to develop a fully fledged operation.

Well-known opportunities include asset management and project finance, where double-digit growth rates are anticipated. These opportunities are already on the radar screens of many global institutions, however, and formerly high margins are slowly falling back in line with international benchmarks.

A recent McKinsey global asset-management survey indicated that 75 percent of the top 30 global asset managers are active in the GCC (although this did not necessarily include an onshore presence) and that two-thirds view the market as a high-growth area for asset management (despite having experienced varying degrees of success so far). Regional banks and boutique asset managers are also active in the region, with institutions such as Global Investment House in Kuwait and EFG Hermes in Egypt expanding to capture revenues from regional asset manufacturing and the distribution (or white labeling) of global funds. While mutual-fund penetration rates are still low in the GCC—close to a third or a quarter of those in established markets—fees and commissions, albeit under pressure, remain relatively high. Typical asset-management fees on equity funds are close to 200 basis points, compared with around 100 to 150 in Germany, Switzerland, and the United Kingdom.

About \$200 billion is expected to be invested in infrastructure, petrochemicals, electricity, desalination, and other major undertakings in the GCC over the next four years, making project finance another

inviting opportunity. That said, margins have already been driven lower thanks to the involvement of new players. Close to 15 percent of recent project finance deals in the region had an element of Islamic finance, the largest so far being the \$850 million Islamic tranche issued by Saudi Basic Industries (Sabic) as part of the \$3.5 billion project-financing deal for its greenfield Yanbu' al Bahr facility. Those entering the market will be able to compete only if they can offer sophisticated skills in Islamic product structuring.

Basic treasury products, such as interest rate and foreign-exchange derivatives, are also likely to grow in the medium term (starting from a very low base), as corporate clients and the banking sector itself become more sophisticated. Most established foreign institutions already offer these products.

Emerging opportunities in the GCC include investment banking and asset-backed finance, which are both expected to grow rapidly from a small base in the coming years. They therefore represent entry opportunities for foreign institutions that would like to shape these markets.

While advisory and corporate-finance business in the region has been small to date, growing markets suggest that activity in these areas will pick up in the medium to long term. Saudi Arabia still has fewer than 100 listed companies, though it is estimated that the number will double by 2010. Privatization will play a major role as well, with \$800 billion in investment opportunities likely in Saudi Arabia alone over the next 15 years (Exhibit 2). With the recent landmark

merger between two of the largest banks in the UAE—Emirates Bank and National Bank of Dubai—a wave of merger-and-acquisition activity is expected in the financial sector, perhaps rippling through into other industries.

With close to \$12 billion in bonds issued in 2005, up from \$1.5 billion in 2002, the GCC debt market is also growing rapidly. Sukuk structures represented 21 percent of total bond issues in 2005, compared with 13 percent in 2002, and are expanding more quickly than their conventional counterparts, thanks to regional investor preferences and government support for products that comply with Sharia (Islamic

law). Overall, many prerequisites for a healthy bond market—domestic yield curves linked to benchmarks, credible and well-established rating agencies, and a robust network of primary and secondary dealers—are not yet in place. Competition is intensifying, however, and up-front issuance fees fell by 20 percent year-on-year from 2002 to 2005.

Asset-backed financing—in the form of Islamic structures, bill discounting (recourse factoring), and lending to contractors secured by government receivables—is among the existing mainstream corporate-banking activities in the GCC. But leasing and (nonrecourse) factor-

Exhibit 3

Regional targets

Around 75 percent of corporate assets in the Gulf Cooperation Council states are booked in Saudi Arabia and the United Arab Emirates.

Relative size of corporate-banking opportunities in the Gulf Cooperation Council states, 2005, \$ billion

	Corporate deposits	Corporate loans	Trade finance	Corporate-banking revenues ⁴
Saudi Arabia	67	71	32	2.4
United Arab Emirates ¹	65	67	57	2.7
Kuwait	23 ³	23	6	0.7
Qatar	14	12	4	0.4
Bahrain ²	5 ³	4	2	0.2
Oman	5 ³	6	2	0.2

¹Includes foreign banks.

²Excludes offshore-banking units.

³Assumes 50-50 split of corporate and retail deposits.

⁴Estimated revenues from corporate deposits and corporate-lending and trade-finance activities; assumes regional margins of 300 basis points (1 basis point = 0.01 of a % point) on current accounts, 50 on time deposits, 160 on corporate lending, and 165 on trade finance.

Source: Central banks of countries shown; Global Insight; McKinsey analysis

ing have now started to pick up. In the UAE, for example, global players such as HSBC are leading the pack, but local companies such as Emirates Bank are also moving to secure a share of future factoring revenues. Similarly, local specialty institutions, such as Oasis International Leasing and First Leasing Bank (of Bahrain), are taking positions in the region's emerging leasing market.

As capital markets mature, investment banking flourishes, and specialized institutions in mortgage and asset-backed financing emerge in the GCC, the region will more than likely also witness a jump in levels of asset-backed securities in the coming years.

Talent constraints

In the next decade, the GCC needs to create four million additional jobs for its growing population, implying that employment in the private sector must grow roughly four times over. Most of the current labor force in the GCC is made up of expatriates, ranging from around 33 percent in Oman to roughly 50 percent in Saudi Arabia and 90 percent in the UAE. The educational systems of the GCC are struggling to produce local talent with the skills and attitudes required by a modern, productive economy,⁴ and all sectors, including banking, are under growing pressure from governments to employ a greater share of nationals.

A war for local talent has been intensifying across the banking sector in the region. In recent years, the corporate-banking front line in Saudi Arabia has become one of the fiercest battlegrounds, with most players experiencing labor turnover rates as high as 15 to 20 percent despite offer-

ing compensation increases in excess of 10 percent a year.

Successful employers, such as Samba Financial (SAMBA; once a Citibank venture in Saudi Arabia), have traditionally touted their strong professional-development programs as a recruitment and retention tool. In response to recent trends, however, such institutions have also started to adopt long-term incentive structures to secure frontline loyalty. Finding local talent is likely to remain a sizable challenge for new entrants and well-established institutions alike.

Geographic scope

Most of the money to be made in GCC corporate banking is in Saudi Arabia, so any bank with an ambition to follow the fully fledged approach must include the kingdom as part of its plan. Around 75 percent of corporate assets in the GCC are booked in Saudi Arabia and the UAE, with the former accounting for around 40 percent of the total (Exhibit 3). Moreover, a sizable portion of the corporate assets in the UAE originates from Saudi corporations.

New entrants taking the fully fledged approach are more likely to succeed with a targeted effort rather than by trying to develop a regional presence all at once. The six regional markets, after all, have very different geographic, demographic, and economic profiles. While the UAE's economy is driven by, among other things, real estate, tourism, and trade, the Saudi economy is predominantly oil dependent. The underlying regulatory frameworks and legal infrastructures also vary from state to state. Success as a fully fledged wholesale bank across the GCC requires

⁴Michael Barber, Mona Mourshed, and Fenton Whelan, "Improving education in the Gulf," *The McKinsey Quarterly*, Web exclusive, March 2007.

fulfilling different requirements and tackling different priorities in each market. In addition, it will not be feasible to build the key relationships with conglomerates, corporations, and wealthy families without a strong local presence.

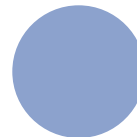
To move the needle, global banks taking the product-focused route need a pan-GCC approach, with a footprint that covers Saudi Arabia and the UAE at the very least. Only in this way will the initiative be deemed a worthwhile expansion effort by the decision makers in a global bank. However, foreign institutions should not limit themselves to a comprehensive Gulf platform based only on a presence in these two states. On the contrary, it should be understood that a pan-GCC operation is necessary to build a wider presence in the Middle East and North Africa in the future. A strong footing in the GCC will also help build an institution's Islamic-banking skills and credibility in the Muslim world as a

whole, which can be leveraged in regions extending as far away as East Asia.

Market entry options

Since capital markets in the region are relatively underdeveloped and most of the demand at this time is for plain-vanilla lending, a full corporate- and investment-banking presence in the GCC is bound to be capital intensive. However, the biggest challenge will be the up-front cost of market entry.

There are two fully fledged market entry options. The first is to set up a green-field operation with a new license. Unfortunately, aspirants may have a long wait if they plan to enter the market in this fashion, since regulators tend to pause before approving new licenses in order to allow the holders of recently issued ones to establish themselves. A second option would be to buy an established bank along with its license, customer relationships, and talent. The hurdles here



are high valuations and a lack of available sellers. The most viable course may be to buy a relatively small franchise, though only a handful of attractive opportunities remain.

Foreign banks considering the product-focused approach should examine the partnership possibilities. Local institutions still have the ability to open doors to the offices of the CEOs and CFOs in the region. But they are increasingly inclined to form partnerships with global banks whose brand recognition, product expertise, and risk-management skills will help them defend their client bases against strong competition from global incumbents such as BNP Paribas, Citibank, Deutsche Bank, and HSBC.

In building these alliances, foreign banks need to be aware of the cultural differences between Wall Street and the traditional commercial bankers of the Gulf States. However, commitment and foresight on both sides will help overcome these challenges. Leading local banks in the GCC have already started to form partnerships with specialized foreign partners. NCB Capital, for example, is negotiating with Goldman Sachs to engage

in a broad range of activities, including investment banking and principal investing, while ADCB has built a partnership with Macquarie to tap into project finance and treasury opportunities in the region. Foreign institutions keen to pursue the partnership route need to move fast, as many local banks are already being targeted in the corporate- and investment-banking arena.

The large and fast-growing Middle East corporate and investment-banking market is an attractive one for global institutions. The risks cannot be discounted, but the opportunities over the next five to ten years look attractive. The few available acquisition and partnership possibilities are disappearing quickly as local players and Western first movers position themselves to build strong franchises. Global players without a presence in the region need to act quickly. **MoCIB**

The authors wish to acknowledge the contributions of Xavier Jopart, as well as those of Saleh Al-Ateeqi, Philipp Harle, Hans-Martin Stockmeier, Thibault Surer, and Ozgur Tanrikulu.

Mehmet Darendeli (Mehmet_Darendeli@McKinsey.com) is an associate principal and **Raman Thiagarajan** (Raman_Thiagarajan@McKinsey.com) is a consultant in McKinsey's Dubai office; **Ralph Heidrich** (Ralph_Heidrich@McKinsey.com) is a principal in the London office. Copyright © 2007 McKinsey & Company. All rights reserved.