The Future of Bahrain as a Financial Center

by

Abdul Razak Abdulla Hassan Al Qassim

Submitted to the Sloan School of Management
in Partial Fulfillment of
the Requirement of the Degree of
Master of Science in Management

at the
Massachusetts Institute of Technology
May 1994

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The Future of [illegible] as a Regional Financial Center

by

[illegible]

Submitted to the Alfred P. Sloan School of Management
on April [illegible], 199[illegible] in partial fulfillment
of the requirements for the Degree of
Master of Science in Management

ABSTRACT

Recognizing its limited petroleum reserves, the Government of [illegible] in the early seventies, as part of its diversification plans, took the [illegible] [illegible] from [illegible] [illegible] into a regional financial center. [illegible]

The evaluation [illegible] in this study will [illegible] on the [illegible] of competitive advantage of nations for service industries as [illegible] by [illegible]. The study will first analyze the major competitive advantages that led [illegible] to become a financial center in the early seventies. Secondly, it will assess the [illegible] of [illegible] as a financial center in terms of growth, [illegible] portfolio and [illegible] and, accordingly, [illegible] position as a regional and international financial center. Thirdly, I will [illegible] in the form of competitive advantage [illegible]. Finally, a set of recommendations will be presented, covering policy issues for the Government and strategies for the firms in [illegible]. Finally, I will attempt to [illegible] that will [illegible] on a [illegible] scale and the [illegible] global/financial [illegible]

Thesis Supervisor: Professor Donald R. Lessard
Title: Professor of International Management

The Future of Bahrain as a Financial Center

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ABSTRACT

Recognizing its limited petroleum reserves, the Government of Bahrain in the early seventies, as part of its diversification plans, took the initiative to transform Bahrain from a home-based banking center into a regional financial center. The growth of the financial sector in the post 1975 era are attributable mainly to the policy design of the Bahrain Government, strong real growth in the region, and Bahrain's favorable geographic location. The banking industry in Bahrain has played an active role in the development of Gulf countries' economies and banking capabilities. However, during the last few years, banking has witnessed some negative growth patterns. Given the importance of this sector for the economy of Bahrain, this thesis will evaluate the success of Bahrain as a regional financial center and will present some recommendations to reactivate its growth and enhance its prospects.

The evaluation process in this study will focus on the determinants of competitive advantage of nations for service industries as identified by Porter (1991). The study will first analyze the major competitive advantages that led Bahrain to become a financial center in the early seventies. Secondly, it will assess the achievements of Bahrain as a financial center in terms of growth, activity portfolio and market place and, accordingly, determine Bahrain's position as a regional and international financial center. Thirdly, I will outline my conclusions in the form of competitive advantages and disadvantages. Fourthly, two sets of recommendations will be presented, covering policy issues for the Government, and strategies for the firms in Bahrain. Finally, I will attempt to introduce a framework that can be used by firms in Bahrain to determine the scale and the scope of their global alliances' linkage.

Thesis Supervisor: Professor Donald R. Lessard
Title: Professor of International Management.

ACKNOWLEDGEMENTS

I would like to first express my sincere appreciation to Mansour Ali Jama, who has made it possible for me to attend this course. Many thanks and gratitude go to my wife and my children, for their support and patience during this year of hard work. I am deeply in debt, to them all. Special thanks to Professor Donald Leopard, Professor Nigel Cheetal and Tom G. Sharp, for their support and guidance that made valuable contribution to this thesis.

ACKNOWLEDGMENTS

I would like to first express my sincere appreciation to Hassan Ali Juma, who has made it possible for me to attend this course. Many thanks and gratitude go to my wife and my children, for their support and patience during this year of hard work. I am deeply in debt to them all. Special thanks to Professor Donald Lessard, Professor Nazli Choucri and Tony S. Frost, for their support and guidance that made valuable contribution to this thesis.

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The Future of [illegible] Financial Centre

Introduction

[illegible] Bahrain's strategic position in the centre of the Gulf region [illegible] in the past quarter century, its development as a major regional banking and distribution centre. That trend [illegible] resulted from the service sector representing on average about 41 percent of GDP during the period from 1980 to 1991. Most of the growth of the service industry in [illegible] was recorded during the eighties, and it has almost stagnated during the last few years. Given the importance of this sector for the economy of Bahrain, I will attempt in this study to find some evidence to substantiate the growth of the banking industry which is the largest subsector under the services sector.

[illegible] provides the necessary background information about the evolution of the banking industry and its development over the last several years, [illegible] chapter one of this study.[1] Chapter two will provide a brief background [illegible] banking in Bahrain, including the major competitive advantages that led Bahrain to become a financial centre in the area. Achievements of Bahrain as a financial centre in terms of growth, activity, profitability and market share will be discussed in chapter three. Chapter four will focus on the contributions and the role played by Bahrain's financial sector in the development of Bahrain into [illegible] economy. The [illegible] approach in this chapter will focus on the determinants of competitive advantage of nations for service industries as described by Porter (1990). In Chapter five of this study I will attempt to draw some conclusions in the form of competitive advantages and disadvantages of Bahrain as a financial centre. Bahrain's position as a regional and

[1] Chapter one of this study is substantially based on [illegible] ... "Bahrain's Competitive [illegible] in the [illegible] Industry".

The Future of Bahrain as a Financial Center

Introduction

Bahrain's strategic position in the center of the Gulf has facilitated, in the past quarter century, its development as a major regional service and distribution center. The total value added from the service sector represented on average about 43 percent of GDP during the period from 1980 to 1991. Most of the growth of the service industry in Bahrain, was recorded during the eighties, and it has almost stagnated during the last few years. Given the importance of this sector for the economy of Bahrain, I will attempt, in this study, to find some solutions to reactivate the growth of the banking industry which is the largest subsection under the services sector.

I will first provide the necessary background information about the structure of the Bahrain economy and its development over the last several years. This will be covered in Chapter one of this study.* Chapter two will provide a brief background on the history of banking in Bahrain, including the major competitive advantages that led Bahrain to become a financial center at the time. Achievements of Bahrain as a financial center in terms of growth, activity portfolio and market place will be discussed in chapter three. Chapter four will focus on the contributions and the role played by Bahrain's financial center in the development of Bahrain and the Gulf countries' economies and markets. The evaluation process in this chapter will focus on the determinants of competitive advantage of nations for service industries as identified by Porter (1991). In Chapter five of this study I will attempt to draw some conclusions in the form of competitive advantages and disadvantages of Bahrain as a financial center. Bahrain's position as a regional and

* *Chapter one of this study is substantially based on International Monetary Fund's report dated July 1992 on the recent economic development in Bahrain. It is jointly written by the author of this study and Ahmed S. Al Noaimi for his thesis "Bahrain's Competitiveness in the Aluminum Industry".*

international financial center will also be assessed in this chapter. Two sets of recommendations are outlined in chapter six, the first covering policy issues for the Government, and the second covering strategies and directions for the firms in Bahrain. Chapter seven will be devoted to introduce a framework that can be used by firms in Bahrain to determine the scale and the scope of their global alliances.

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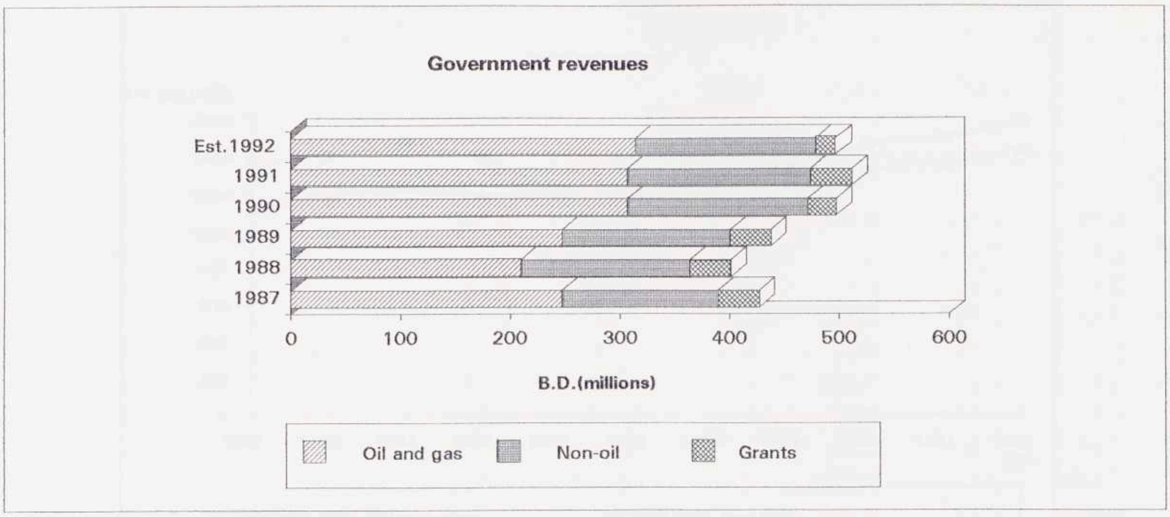
Chapter One
Bahrain Background and Economy

1.1 Introduction

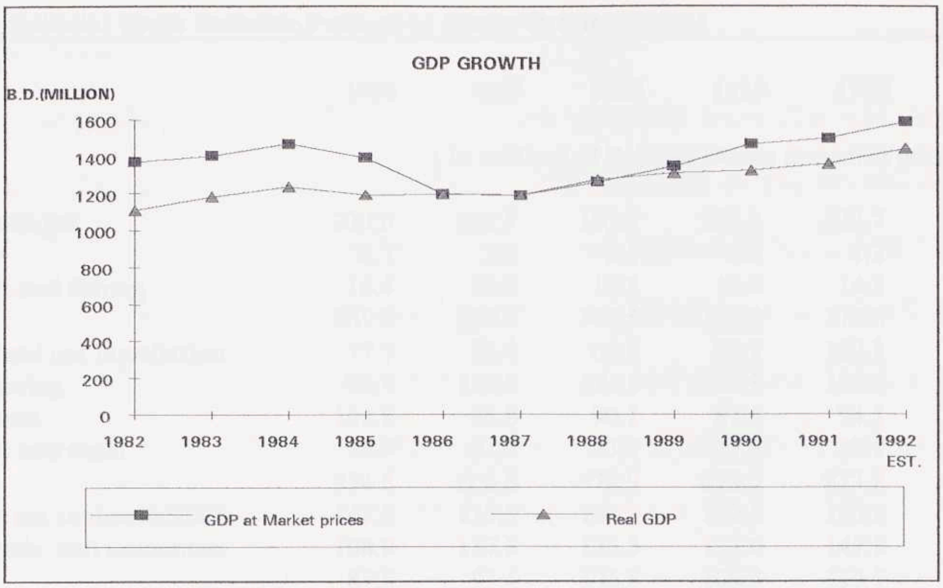
Bahrain is an archipelago consisting of 33 islands in the Arabian Gulf, situated between Saudi Arabia's East coast and Qatar peninsula. The islands cover a total area of 693 square kilometers, making it slightly smaller than Singapore.

Bahrain is an independent sovereign state ruled by the Amir, H. H. Sheikh Isa Bin Salman Al-Khalifa, who succeeded in 1961. The affairs of state are run by the Prime Minister and a Council of Ministers presently comprising 15 members appointed by the Amir. Bahrain is a member of the Gulf Co-operation (GCC), the United Nations, the Arab League, the International Monetary Fund, the World Bank and several other international organizations.

Bahrain is a small open economy with a population of 516,444 as of 1991, with a total employment of 212,070. Expatriate labor comprises about 60 percent of this labor force. The economy of Bahrain is dominated and almost singly driven by the public sector's revenues from oil and gas. Value added generated in the government-owned oil and gas sector, government services, and joint ventures manufacturing enterprises account for over 60 percent of GDP. The sharp increase in government revenues in the 1970s, which was mainly on account of higher oil prices, facilitated rapid progress in establishing an extensive modern infrastructure allowing Bahrain's population to enjoy a relatively high standard of living.



Reserves of onshore oil, estimated at about 150 million barrels, could be exhausted by the end of the century at the present level of production. Recognizing this limited petroleum reserves, the Government, in the early 1970s, initiated economic diversification efforts aimed at utilizing domestic natural gas resources to develop an export-oriented, energy intensive manufacturing sector. At the same time, the diversification plan was aimed at developing Bahrain as an offshore financial center. As a result, the country experienced high rates of real economic growth. Despite rising import levels, the external current account and the overall external position experienced large surpluses, and foreign reserves were accumulated. These trends were maintained through the early 1980s, despite the regional Iraq-Iran conflict, due to continued strong world oil prices and an increase in petroleum exports attributable to Bahrain receiving a half share of the offshore Abu Saafa oil field operated by Saudi Arabia.



The Government's current diversification policy has aimed at expanding existing joint venture projects and encouraging private sector investment in downstream industry. The expansion of Aluminum Bahrain (ALBA) to twice the previous capacity has been the most important of recent projects. The Government policy to privatize non strategic industries, while not progressing rapidly, remains a long-term objective.

1.2 Overall Economic Development

As a result of progress that has been made in the recent past in diversifying Bahrain's economic base, combined with weakened oil prices, the contribution of the crude oil and gas sector to national income declined to about 17 percent over the past five years from about 20 percent in the mid-1980s. The decline was offset by a rise in the share of industry to 23 percent, while services remained relatively stable at 60 percent (Table 1.1). However, the role of oil and gas remains predominant as it is the primary source of government revenue to finance government expenditures which, in turn, are the driving force behind non-oil economic activity. Expenditures have been equivalent to about one half of non-oil GDP in recent years.

Table 1.1 ***Bahrain:*** **Gross Domestic Product by Sector Origin, 1986-91**

	1986	1987	1988	1989	1990	1991
	(In millions of Bahrain Dinars at current prices)					
Crude oil and gas	229.0	222.7	193.7	233.8	322.7	295.4
Quarrying	2.7	2.3	2.3	2.6	1.2	1.1
Agriculture and fishing	16.4	16.0	15.3	15.8	14.3	14.0
Industry	289.8	299.7	348.5	355.2	375.5	364.5
Refining and gas liquefaction	77.7	78.5	60.8	76.9	120.1	114.2
Manufacturing	88.4	112.5	174.4	162.9	132.6	135.6
Construction	102.8	86.8	90.1	87.6	94.1	90.5
Electricity and water	20.9	21.9	23.2	27.8	28.7	24.2
Services	854.5	806.8	878.9	873.0	873.8	952.3
Transport ant communication	147.9	139.9	147.2	152.5	140.2	168.6
Trade, hotels, and restaurants	108.9	117.8	135.5	137.0	147.9	167.6
Trade	87.5	93.4	105.8	109.2	115.7	129.1
Hotels	14.6	17.1	18.8	17.0	19.8	25.8
Restaurants	6.8	7.3	10.9	10.8	12.4	12.7
Banks and insurance	201.8	145.9	169.0	140.0	114.3	129.8
Domestic banks	72.8	68.5	72.8	87.9	77.1	82.8
Offshore banking units	103.9	62.6	89.2	46.8	36.1	43.3
Insurance	25.1	14.8	7.0	5.3	1.1	3.7
Real estate	73.5	68.1	69.6	73.5	78.2	86.5
Government	261.3	271.3	288.0	299.6	314.3	319.2
Other services	61.1	63.8	69.5	70.4	78.9	80.6
Less: Imputed service charge	194.2	155.7	176.0	132.9	120.0	128.8
Total GDP, of which:	1,198.3	1,191.8	1,262.7	1,347.5	1,467.5	1,498.5
Non-oil GDP 1/	891.6	890.6	1,008.2	1,036.8	1,024.7	1,088.9
			(As percent of GDP)			
Crude oil and gas	16.4	16.5	13.50	15.8	20.3	18.2
Quarrying	0.2	0.2	0.2	0.2	0.1	0.1
Agriculture and fishing	1.2	1.2	1.1	1.1	0.9	0.9
Industry	20.8	22.2	24.2	24.0	23.7	22.4
Refining and gas liquefaction	5.6	5.8	4.2	5.2	7.6	7.0
Manufacturing	6.3	8.3	12.1	11.0	8.4	8.3
Construction	7.4	6.4	6.3	5.9	5.9	5.6
Services	61.4	59.9	61.1	59.0	55.0	58.5
Transport and communication	10.6	10.4	10.2	10.3	8.8	10.4
Trade, hotels, and restaurants	7.8	8.7	9.4	9.3	9.3	10.3
Banks and insurance	14.5	10.8	11.7	9.5	7.2	8.0
Domestic banks	5.2	5.1	5.1	5.9	4.9	5.7
Offshore banking units	7.5	4.6	6.2	3.2	2.3	2.7
Government	18.8	20.1	20.0	20.2	19.8	19.6

Source: Ministry of Finance and National Economy and International Monetary Fund Report of July 1992.

1.2. 1 Petroleum and Gas

Bahrain's hydrocarbon sector includes production of crude from the onshore Jebel al Dakhan field located in the center of Bahrain, and one half of the production of the offshore Abu Saafa field which is shared with, but operated by, Saudi Arabia. It incorporates, as well, production of natural gas from the Khuff zone, an oil refinery, and a number of downstream industries including a petrochemical plant and a gas liquefaction plant. The major part of the gas output has been used as fuel by energy-intensive industries, such as aluminum and for power generation.

Bahrain's crude oil output has fluctuated over the 1989-91 period within the range of 111,500-117,000 b/d (barrel per day) including the half share in the Abu Saafa field production. Crude oil output of the onshore Jebel al Dukhan field has remained largely unchanged at about 42,000 b/d in the period 1989-91.

Refinery Operations

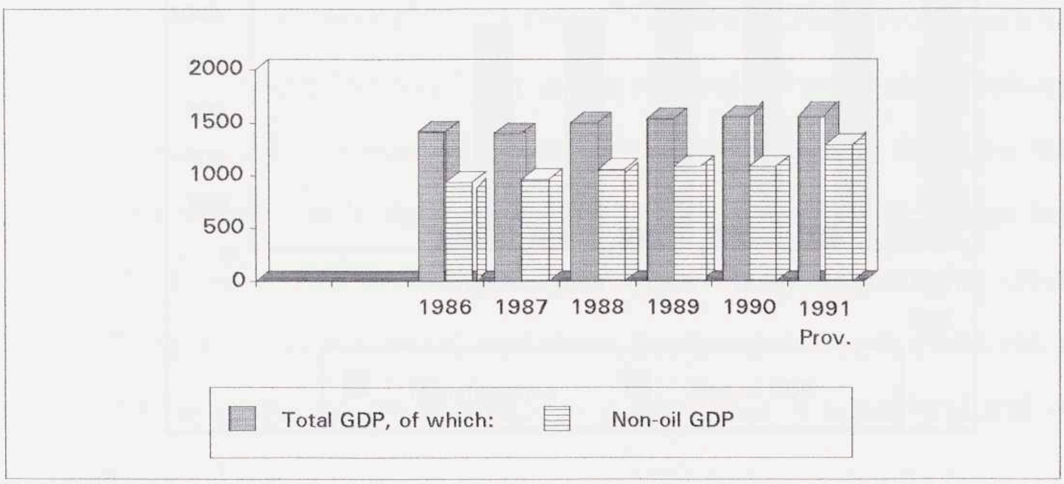
The Bahrain refinery has operated at near full capacity of 250,000 b/d over the past several years. Saudi Arabian light crude, which accounts for 80 percent of crude processed, is transported through a pipeline between the refinery at Sitra and Dhahran in Saudi Arabia. The refinery was established in 1936 with initial refining capacity of 10,000 b/d which has been expanded gradually to the present 250,000 b/d level. The most recent modernization project, to be completed in 1996 at a cost of US $ 500 million, is expected to improve the product mix toward a higher concentration of the lighter distillates, and also produce unleaded gasoline enabling the refinery to improve its profitability. Output consists of a wide range of products including gas oil, fuel oil, naphtha, jet fuel, and gasoline which together account for over 90 percent of the total. Exports are mostly marketed in Japan and Europe and include about 96 percent of the refinery products.

Gas

Given the unfavorable prospects for new oil discoveries and the low level of proven oil reserves, Bahrain has intensified its dependence on gas as a main source of energy. The gas reserves of 9-12 trillion cubic feet are sufficient for 60 years at current production levels. Requirements of industry and power generation, as well as the growing need to inject gas into aging onshore fields for enhanced oil recovery, have led to a 6 percent rise in natural gas production during 1989-91, while production of natural gas liquids (NGLs) increased by 35 percent . Most of the propane and butane is exported to Japan, naphtha is sent to the refinery, while the residue gas is piped to Aluminum Bahrain(ALBA) for use in combination with non-associated gas from the Khuff zone for power generation.

Expansion of capacity of the LPG plant by 100 million cubic feet per day (mmcfd) was completed in 1991 at a cost of US $ 87 million-- Bahrain's share in financing was US $ 65.3 million. The expansion took place in response to increased demand by some downstream industries, such as the urea plant and the polypropylene and methyl tertiary butyl ether (MTBE) plant, both under construction by Gulf Petrochemical Industries Company (GPIC).

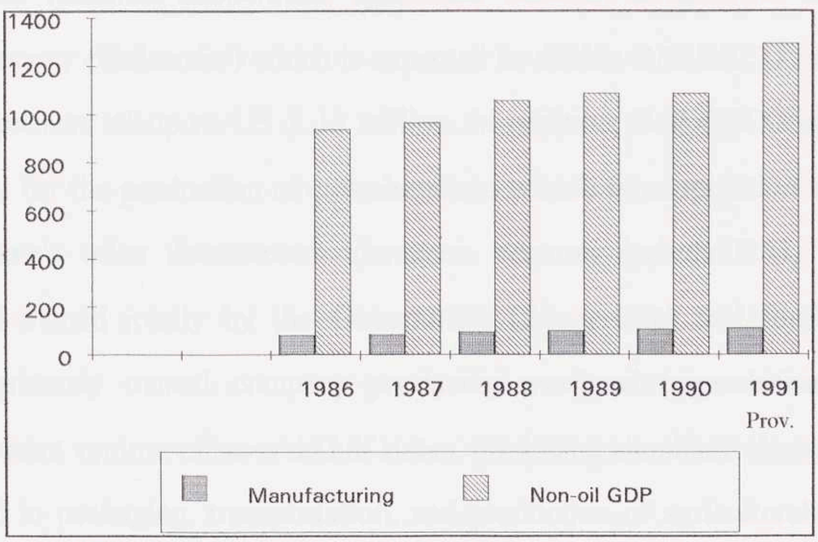
1.2.2 The Non-Oil Economy



Non-Oil Manufacturing Sector

Bahrain's Government has initiated efforts to diversify its industrial base in the 1970s and 1980s by developing export-oriented and energy intensive projects based on cheap domestic energy. The Government launched several projects that included an aluminum smelter and aluminum processing industries, ship repair facilities, a petrochemical plant, and factories for iron and steel fabrication. With the completion of these projects, industrial policy has shifted toward the establishment of downstream industries and providing incentives for small and medium-scale private sector projects. The Government's support for private sector manufacturing has been mostly indirect, through developing an advanced infrastructure, and an exchange and payments system free of restrictions, and a generally liberal expatriate labor policy, and subsidized electricity and water rates.

The role of manufacturing sector in Bahrain's economy increased over the last several years from about 8 percent of GDP in 1987 to about 9 percent of GDP over 1989-91 (Table 1.1). The response of the private sector has been slow as most of the value added generated in this sector originated in activities that are fully or partly owned by the Government.



Bahrain's largest and the most important non-oil industrial project is the ALBA aluminum smelting plant which commenced operations in 1971 as a joint venture between the Government of Bahrain (77 percent); Saudi Arabia Investment Fund, (20 percent); and Breton Investment of the Federal Republic of Germany, (3 percent). After building an initial production capacity of 120,000 tonnes in 1971, ALBA has undertaken several expansion and modernization projects, increasing its capacity to 205,000 tonnes by 1989. The most recent ALBA expansion project was completed in May 1992 bringing ALBA's full capacity to 460 thousand tons per annum.

The marketing of the Bahraini and Saudi shares in ALBA's production is handled by Bahrain Saudi Aluminum Marketing Company (BALCO), which is owned by the Governments of Bahrain and Saudi Arabia. The company's main activity is to market the primary aluminum off take from ALBA and 51 percent of atomized aluminum powder from Bahrain Atomizers International (BAI).

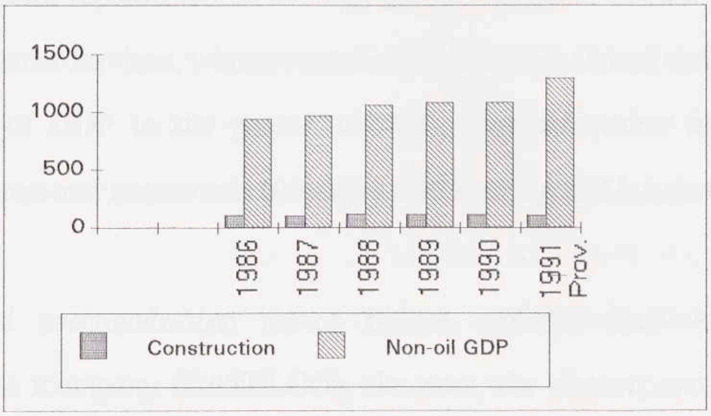
ALBA is also expected to support Bahrain's diversification effort through the potential for downstream industries that it would generate. One of the first of the new downstream ventures is the technical cooperation agreement between BALEXCO and an Italian aluminum company (Finleander) which is expected to double BALEXCO's capacity at an estimated investment of up to US $ 15 million. In addition, BALEXCO has a US $ 25 million project for the production of cast aluminum wheels in cooperation with a Korean partner. Bahrain's other downstream aluminum ventures include BAI, an aluminum powder plant owned jointly by the Government (51 percent) and foreign investors; MIDAL, a privately owned company producing overhead transmission cables; and GARMCO, a joint venture of several Gulf states, producing aluminum sheets and coils for firms engaged in packaging, transportation, and production of agricultural and electrical equipment.

Aside from aluminum-related industries, Bahrain's diversification strategy has included major projects in the iron and steel, petrochemical, and ship repair industries. The Arab Shipbuilding and Repair Yard (ASRY), which commenced operations in 1977 with a dry dock designed to accommodate large vessels of up to 500,000 deadweight (dwt), has benefited from an increase in the dock occupancy rate to about 90 percent in 1989-90 and from a higher repair content per vessel. After a tangible decline in activity in the second half of 1990 as a consequence of the regional crisis, ASRY operations recovered in 1991. ASRY has recently expanded its activities with the new floating dock which was constructed at an estimated cost of US $ 30 million.

The Gulf Petrochemical Industries Company (GPIC), which is owned jointly by the Governments of Bahrain, Kuwait, and Saudi Arabia, commenced production of ammonia and methanol in late 1985. Despite high capacity utilization rates, the fall in world prices for its products has resulted in substantial losses, which were contained below budgeted levels in 1987 through cost reduction measures and a successful rescheduling of bank loans. Following a recovery in prices, the company has reported net profits since the beginning of 1988.

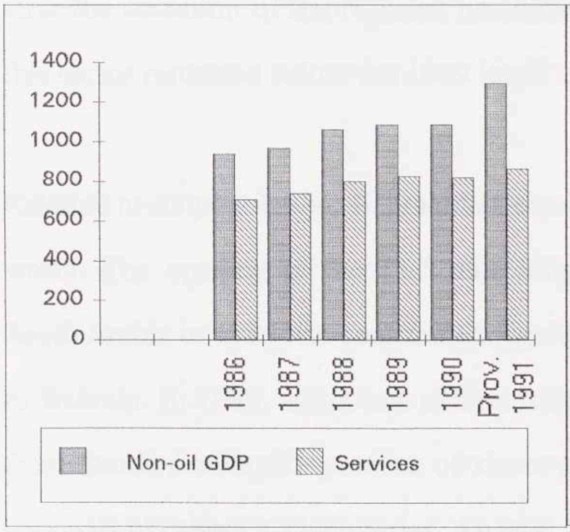
The iron ore palletizing plant of the Arab Iron and Steel Company (AISCO) was started in late 1984 by private shareholders from several Arab countries in the area. It has faced technical and financial problems from the beginning; production was interrupted several times and in 1986 ceased altogether following combined losses of US $ 43 million over the 1985-86 period. In early 1988, all of AISCO's assets were transferred to the Gulf Industrial Investment Company, a subsidiary of Kuwait Petroleum Corporation. The reorganized company resumed production in January 1989 under new ownership.

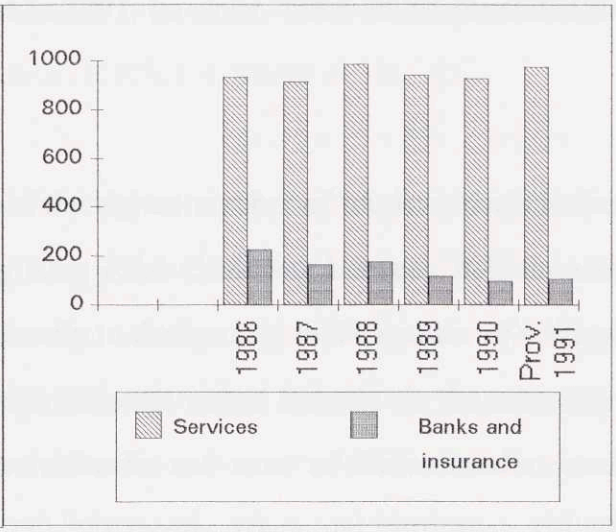
Construction Sector



The construction sector declined by 2.5 percent annually during 1989-91. Most of the decline, about 6 percent, was registered in 1989 as the expansionary phase of 1988 could not be sustained. In 1990, construction activity rebounded mostly in the first half of the year in response to an improved overall demand.

Services Sector





The services sector has a very important role in Bahrain's economy. The total value added from the services sector represented on average about 60 percent of GDP during 1989-91. Apart from government services, whose contribution has been almost stable at the level of about 22 percent of GDP in the period 1989-91, Bahrain's other main services are transport, trade, hotels and restaurants (tourism), and banking and insurance.

The transport and communication sector (which includes Gulf Air, the Bahrain Telecommunications Company (BATELCO), the port, the airport, and the post office) declined by 14.6 percent in 1990 as a result of the regional crises .

After a modest real growth of 1.6 percent in 1989, trade declined to 0.4 percent in 1990 and rebounded to 11.6 percent in 1991 as a result of the resumption of the overall economic activity.

The banking sector, one of the main service subsections, experienced serious decline in 1989 and 1990 as a result of capital outflows, but rebounded substantially immediately after the cessation of the regional hostilities in 1991; however, value added generated in this sector remained below the 1989 level.

Relative to its population, Bahrain has one of the highest number of tourist arrivals in the world. The opening of the 15.5 mile long King Fahd Causeway between Bahrain and Saudi Arabia in 1986 has contributed significantly to the increase in the number of visitors to Bahrain. In 1989, about one million foreign nationals visited Bahrain via the causeway from Saudi Arabia; 85 percent of them were Saudis and most of the remainder were nationals of other GCC countries. Another 250,000, mostly Asians and Europeans, visited Bahrain by air.

1.3 Development Planning and Investment

Since the mid-1970's, Bahrain embarked on a series of steps to diversify its economy. Given the relative abundance of energy resources, shortage of labor, and the limited domestic market, planning was directed toward promoting export-oriented capital and energy-intensive industries and services. By the mid-1980's, Bahrain had achieved rapid progress in diversifying economic activity. Oil refining, aluminum and several ancillary industries were set up, offshore banking flourished, and tourism was active. Planning, however, did not follow a formal integrated approach; it was primarily project oriented.

In 1985 a Strategic Choices Committee (SCC), comprising senior officials of several ministries, was formed to study possible areas of development and the role of the Government in promoting growth. The SCC recommended that greater emphasis be placed on development of downstream activities, selected medium- and small-scale projects producing consumer goods that have an export potential and financed by private capital, both domestic and foreign. The SCC also recommended that the Government refrain from launching new public sector industrial projects. Growth of the industrial sector would be stimulated through incentives to the domestic and foreign private sectors. The SCC would strive to discourage duplication of industrial plants within GCC.

In the financial sector, the SCC recommended the further formation of specialized banks. The recent establishment of an industrial bank was a first step in providing financial services to promote private industry. Furthermore, tapping the financial assets of existing institutions such as the General Organization for Insurance (GOSI) to help finance industrial development would be encouraged. In other services, the SCC recommended that OBUs diversify their services to help sustain their long-term growth. Other services are also being encouraged through continued development of Bahrain's infrastructure base.

In addition to the provision of a number of incentives in the form of indirect subsidies, such as cheap power, tax exemptions, and subsidized industrial zones, the Government recently introduced several measures to further diversify the economy. New investments in downstream aluminum industry could benefit from annual grants for employment of national labor force. To benefit from the incentive program, new enterprises had to submit feasibility studies that indicated profitability without the grant. The investment environment has also been enhanced by rapidly processing licenses for setting up industries. Restrictions in granting licenses would only apply to over-capacity areas and areas deemed strategic. Foreign ownership of up to 100 percent had been allowed since June of l991. However, to benefit from the trade arrangement within GCC, in addition to a 40 percent value added generated domestically, at least 51 percent ownership is required by GCC nationals. Certain enterprises (a total of nine companies in 1992) had also been supported by a 20 percent temporary protection tariff. The tariff covers only certain products and would be granted for one year; an extension may be granted in some cases. Downstream industries such as aluminum extraction, chemicals, and pharmaceutical products, have benefited from protective tariffs.

To encourage the further movement of the market toward commercial principles in production and trade, the Government initiated steps aimed at privatizing joint-venture enterprises. So far, Government ownership in BALEXCO had been reduced from 80 percent to 20 percent. The Government intends to continue in the direction of reducing its share in a number of other joint-venture projects.

In addition to projects undertaken by the Government to enhance infrastructure and opportunities for downstream industries, the public sector has undertaken a number of joint-venture projects financed from non government sources which are expected to be completed during 1993-96 at an estimated cost of US $ 800 million; the public sector's share is expected to be 50 percent.

1.4 Gulf Regional Issues

Since the establishment of the GCC in 1981, several steps have been taken to integrate the economies of the member countries. Under an agreement reached in 1983, a process of unification of tariff schedules of member countries was initiated. Member countries are allowed to impose tariff duties on goods originating outside the region (and not accorded duty-free access) at rates ranging between 4 percent and 20 percent. However, since 1986, compliance in applying these rates has not been uniform and a new agreement has been reached to implement a unified common external tariff by March 1993. Goods originating in GCC member countries are exempt from import duties provided that at least 40 percent of the value added is produced in the GCC region and that at least 51 percent of the capital of the producing firm is owned by citizens of the GCC member countries. Reflecting this exemption, the opening in 1986 of the causeway linking Bahrain to Saudi Arabia and the increased economic diversification in the region, the share of GCC rose by some threefold to about 10 percent of Bahrain's non-oil imports over the past decade.

Citizens of GCC countries are allowed to purchase and own shares of industrial companies in all the GCC member countries. In addition, free movement of indigenous workers is provided in the GCC region. Citizens of the GCC member countries can also borrow from the specialized credit institution of any member country providing loans are for industrial development and on common terms relating to maturity and charges. Preferential treatment in government purchases has also been accorded to GCC companies (a 10 percent price differential for a national company and a 5 percent price differential for a GCC company).

The Gulf Investment Corporation (GIC) which is aimed at undertaking joint ventures with the private sector (with the GIC participation ranging from 10 percent to 40 percent) became operational in 1986. Since its inception the GIC has invested in various projects in the GCC countries. In addition, a number of projects that are jointly owned by some or all of the GCC states have been established. In Bahrain, the major projects that are jointly owned by Bahrain and one or more GCC states include Gulf Air, ALBA, and BAPCO.

Over the past two years a number of steps have been taken to enhance cooperation among the GCC states in a number of areas. These include arrangements aimed at allowing GCC corporations to open subsidiaries in all member countries, unifying laws pertaining to property rights, and agreeing to establish a development fund to provide financing for projects in Arab countries, with emphasis on the private sector. The authorities stated that the coordination among the GCC monetary authorities to defend declared parities, which was initiated during the regional crisis, continued to operate effectively.

An economic cooperation agreement between the GCC and the EC, concluded in 1988, commits member countries of each group to grant most-favored-nation status to member countries of the other group. Since then, negotiations aimed at creating a free trade area between the GCC and the EC have been underway.

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Chapter Two

History and Evolution Of The Banking Industry

This chapter will be devoted to discuss the country's motives, objectives, competitive advantages, and the strategy adopted by its Government to establish itself as a financial center in the Gulf region in the mid seventies. The discussion will address the following major issues:

- Background on the History of Banking
- Evolution of Bahrain as a Financial Center
    - Policy Design of Bahrain Government
    - Domestic and Regional Demand
    - Location
    - History and Chance.

2.1.0 Background

Prior to the discovery of oil in the Arabian Gulf, the financial systems of the Gulf States were very simple, reflecting the simple structure of these economies. With the exception of Saudi Arabia, all the States shared a common currency, the Indian Rupee. Official banking started in Bahrain, when a branch of the Eastern Bank (now Standard Chartered Bank) opened in 1921. Up to 1960 only three other banks opened their doors: the British Bank of the Middle East in 1944; the Bank of Bahrain (The first Bahraini share holding company, now called National Bank of Bahrain) in 1957; and Arab Bank Ltd. in 1960. These banks proved sufficient to cater to the basic banking needs of the time that consisted of mainly financing the activities of importers, pearl merchants and British trading and shipping Companies based in the Region.

The discovery of oil in 1932 represented a turning point in Bahrain's economic structure and financial system. The most important change was the decline of the traditional occupations in pearl-diving, fishing and agriculture in line with the growth of the oil industry. The oil industry also provided an impetus for active trading, contracting and service sectors. As a result of the considerable improvement in the financial position of the Government and the increased role of foreign employment and trade, the Banking system in Bahrain expanded substantially in terms of type of services provided and number of institutions operating in the country.

Prior to 1973, the Chartered Bank (now Standard Chartered Bank) acted as agent for the Government's Currency Board and was responsible for issuing currency. The Bahrain Currency Decree of 1964 was revoked in 1973 and replaced by the Bahrain Monetary Agency Law. Overall policy, control and supervision of the banking system is now exercised through the Bahrain Monetary Agency. The principal activities of the BMA are:

- To regulate the issue and circulation of Bahrain's currency,
- To maintain foreign exchange reserves at levels adequate to support the currency in circulation and meet the country's external obligations
- To grant new licenses to banking firms and other financial institutions,
- To regulate the types of business banks may or may not conduct,
- To supervise and control the operations of the banking system,
- To stipulate capital, reserve and liquidity requirements,
- To inspect banking institutions and appraise their financial position,
- To control and direct bank credit in accordance with policy objectives,
- To administer a domestic clearing house and,
- To issue treasury bills and bonds on behalf of the Government of Bahrain.

2.2.0 Evolution of Bahrain as a Financial Sector

Strategically located in the center of the Gulf, endowed with sweet water and surrounded by a relatively shallow sea, the island of Bahrain has been an ideal trading post since times immemorial. As the first country in the southern Gulf region to have an oil based economy, Bahrain's economy expanded in the construction, industrial and banking sectors, ahead of its now rich oil based neighboring countries. This time lead, coupled with the Government's early recognition for the need to diversify the country's economic base, allowed Bahrain to gain advantages over the other gulf countries in terms of acquiring high levels of education for its nation, building advanced infrastructure facilities, and transforming from an economy dependent on the primary sector for output and employment, to a fairly modern industrial economy and service center.

The Government of Bahrain came to realize that to place almost exclusive reliance on an asset (i.e. oil) of limited size and of uncertain price and value would not support the pace and sale of development to which it was committed. Therefore as part of its diversification plans, the Government of Bahrain took the initiative to promote growth of the financial sector and to transform Bahrain from a home-based banking center into a regional financial center. The major impetus for growth of the financial sector in Bahrain in the post 1975 era is attributable mainly to the policy design of the Bahrain Government, strong real growth in the region, and Bahrain's favorable geographic location. As we will show, history also played an important role.

2.2.1 Policy Design of the Bahrain Government

Government's Objectives

As part of its diversification plan to convert energy resources into higher value products and move the economy away from its dependence on the primary production of oil, the Government of Bahrain promoted the banking sector to support the pace and scale of its future development plans. Broadly the Government of Bahrain had the following major objectives from this strategic direction:

- Create job opportunities for its citizens, and improve their standard of living.
- Generate higher value added contribution to GDP.
- Establish the Banking industry as a critical support industry for development of other sectors of the economy such as manufacturing, trade and other services related industries.
- Attract foreign investment into the country.
- Upgrade the knowledge and capability level of the domestic and regional financial institutions.
- Enhance the overall financial stability of the country.

In 1975, the Bahrain Monetary Agency invited banks of international standing to establish their regional operations offices in Bahrain for wholesale Banking activities in the region and offered them various fiscal and regulatory incentives as well as other attractions, such as exemption from tax, no restrictions being placed on foreign exchange payments and receipts.

In addition to then existing advanced infrastructure facilities in comparison with other countries in the Arab world, such as good communication system, relatively skilled labor force and excellent port and airport facilities, the Government of Bahrain, also adopted a legal structure that is compatible with international laws and practices. Unlike other Gulf countries which operate under Sharia law that prohibit transactions earning or charging interest, laws in Bahrain accept payment and receipt of interest and recognize international codes of business and practices such as Universal Credit Practices (UCP) for documentary credit.

To protect the soundness and resilience of financial intermediaries and to insulate domestic financial activities from international influences, the Bahrain Government through the Bahrain monetary Agency(BMA) adopted the following broad polices.

Full Commercial Banks (FCBs)

The number of full commercial banks licensed to operate in Bahrain is limited by the BMA, which has stated that the country is adequately served at present and that in the near future no further FCB licenses will be issued.

Offshore Banking Units (OBUs)

In October 1975, the BMA announced that it was prepared to grant licenses to international banks to open offshore Banking units in Bahrain. The basic restriction placed on OBUs by the BMA is that, with some limited exceptions, they are not permitted to deal with companies or individuals resident in Bahrain. However, transactions of all types with other OBUs and other fully licensed commercial and investment banks in Bahrain are permitted, as well as dealing with the BMA in its own name or as agent for the Government. The OBUs are allowed to deal with Government-owned institutions and large corporation in Bahrain after obtaining special permission from the BMA. Offshore Banking Units are required to pay an annual license fee of BD 10,000 (US 26,500) and maintain a separate sets of books in US. Dollars from the Full Commercial Banks (FCBs).The BMA has remained highly selective in granting OBU licenses. The emphasis has been to choose banks from amongst those with a high international standing and from as wide a geographical area as possible to maintain high quality and standards and achieve widely distributed linkage with the international banking community.

Investment Banks

Investment banking was introduced in 1977 in order to accommodate institutions with small balance sheets to participate in traditional investment or merchant banking business, primarily to generate fee income. The investment banks can engage in security business, underwriting, investment advise, and portfolio management. They are permitted to accept inter bank deposits and deposits from non-bank outside Bahrain, subject to a minimum of US$ 50,000 or equivalent in other currencies. Moreover, investment banks can lend only to non-residents. The locally incorporated investment banks are required to maintain a gearing ratio of total assets to capital of 10:1 and liquid assets in excess of 25 percent of their current liabilities.

2.2.2 Domestic and Regional Growth

In the year 1973, the Organization of Petroleum Exporting Countries succeeded in imposing a very large increase in the international price of oil which attracted huge sums of petro-dollars to the Gulf region. As a consequence, extensive development projects were set in train to expand and modernize the infrastructures of the beneficiary states. Given the post- 1973 flow of wealth to the Arab world and the need to efficiently invest and re channel these resources to different countries for different purposes, a growing number of international banks established Offshore Banking Units in Bahrain to conduct regional lending, including syndication loans, and deposit taking activities . The first of these were Citibank and Algemene Bank, and the number of the Offshore Banking Units grew to 67 institutions by the end of 1986. The establishment of the OBU center in Bahrain also attracted large international banks who have chosen Bahrain as a center from which to undertake public relations and promotion work, as well as liaison with other countries in the region. The first of these Representative Offices to establish a presence in Bahrain was Commerzbank AG and the total Representative Offices reached 55 by the end of 1986. Hence, with regional real sector growth and globalisation of markets, financial sector development in Bahrain was also accelerated. By the mid eighties, Bahrain has successfully established itself as a regional financial center in the lending activities with emphasis on loan syndication geared toward project financing and large ticket trade related transactions, as well as on deposit taking in regional and international currencies. Foreign exchange and money market activities were also actively traded within the region.

2.2.3 Location

Bahrain's geographical location with a time zone of GMT + 3 hours make its working hours overlap with Tokyo, Hong Kong, Singapore in the far east and with London, other European Countries and New York in the west. The banking center in Bahrain also fill a time gap of about three to four hours between the close of the Far East and the opening of European markets. This feature of having the highest overlapping time among the major financial centers in the world increase accessibility of banks and customers to variety of investment and trading opportunities and facilitate better distribution of risks in different markets and instruments.

Being close to the major oil producing countries, who are sitting on large sums of wealth, lack the domestic or the regional investment opportunities, and heavily spending on development of their economies, Bahrain is ideally positioned to provide banking and other services required and act as a link between the Gulf states and the rest of the world.

2.2.4 History and Chance

The collapse of the banking industry in Beirut, Lebanon as a result of the civil war, also contributed to Bahrain's emergence as a financial center to the Gulf region. However, the preparation and planning in terms of having the appropriate infrastructure facilities, and the Government's earlier desire to diversify into service industry including banking, were critical to its success. Restrictive policies of other Gulf countries on new entrants in the

Banking sector, and the consequent under representation of international financial institutions in those countries, as well as the relatively better developed domestic banking system in Bahrain, increased the level of motivation for Bahrain to embark on establishing a financial center for the region. As an indication of the higher role of the Banking activities in Bahrain in comparison with other Gulf countries, the following table shows the total assets of the banking industry in each country as a percentage of their GDP in 1974.

Table 2.1 GCC countries' Banks' Total Assets as a percentage of GDP (1974)

U.S. Dollars Million (Exchange Rates at end of period)	Bahrain	Kuwait	Oman	Qater	Saudi Arabia	U.A.E
Total Assets	581	3,365	428	341	2161	2204
GDP	1,079	13,161	1,646	2,000	27,977	7,856
% Total Assets to GDP	54%	26%	26%	17%	8%	28%

* * * * * * *

Chapter Three
Bahrain as a Regional Financial Center

Chapter three will contain analysis of the evolution of Bahrain as a financial center for the region and will assess its progress in terms of growth of its size, product / activity mix, and market penetration. Knowledge and capabilities transformation among the various banking institutions in the country will be carefully evaluated in this chapter.

The offshore Banking Units' activity level, product mix and overall progress have been influenced largely by economic and political developments of the oil producing countries in the Gulf. As we are evaluating the development of Bahrain as a regional financial center, we will focus on the progress of the Offshore Banking Units activities in terms of growth, product mix (activity portfolio) and their overall contribution to the Gulf financial system.

Our discussion of the domestic banking sector will be limited to their regional activities and the impact of the OBUs on their capabilities and market positioning. However, we need first to distinguish between the role of the Domestic Banking institutions and the Offshore Banking Units.

Domestic Banking will be used to refer to banks, whether local institutions or branches of foreign banks, that are domiciled in each Gulf country and permitted to do business with the residents of such country and are fully subject to domestic supervisory, regulatory and monetary-policy controls of that specific country.

Offshore Banking Units will be used to refer to Banks operating in Bahrain to do business outside Bahrain.

3.1.0 Growth

As at end of 1992 the financial services industry in Bahrain comprised 17 full commercial banks, 21 investment banks, 3 specialized banks, 47 offshore banking units, 41 representative offices, 5 foreign exchange and money brokers, 22 money changers and 17 onshore and 44 exempt (offshore) insurance companies. Table 3.1 shows the number of financial institutions in Bahrain classified by type of activity over the period from 1986 up to 1992.

Table 3.1 Financial Service Institutions Operating in Bahrain.

ACTIVITY	1986	1987	1988	1989	1990	1991	1992
Commercial Banks	19	19	19	19	19	17	17
Investment Banks	18	18	19	21	21	21	21
Specialized Banks	2	2	2	2	2	2	3
Offshore Banks	67	67	62	56	52	47	47
Representative Offices	55	58	54	48	48	46	41
Brokers	6	6	6	6	5	4	5
Total	**167**	**170**	**162**	**152**	**147**	**137**	**134**

Source: Bahrain Central Statistics Organization, *statistical abstract*, various issues.

The 47 licensed OBUs at end of 1992 represent a fair cross-section of the world's largest international banks. Arab banks are well represented and the three largest and most active international Arab banks namely; Arab Banking Corporation, Gulf International Bank and Investcop, are incorporated and operating mainly out of Bahrain.

The rapid growth experienced by the OBUs during late seventies and early eighties, came as a result of the economic boom in the region during that period. All GCC countries spent heavily on development projects during this time. The slow growth rates during mid to late eighties reflected the sluggish economic activities of the region which was caused by lower oil prices. The total assets of the OBUs which has peaked at U.S. $ 73 billion at the end of 1989, witnessed a sharp reduction in the following two years as a result of the

Gulf War. However, with the Gulf war receding into history, the confidence of the international financial community in the region is returning. This is evidenced by the recovery of growth in the total assets of the OBUs from US$ 53 billion in 1991 to US $ 61 billion in September 1993. Table 3.2 summarize OBUs consolidated Balance sheet structure and growth.

Table 3.2 Offshore Banking units, Consolidated Balance Sheet (percentage)

	1980	1985	1990	1993*
Total Assets(U.S. Dollars Million)	37,466	56,805	59,863	60,933
Growth rate		52%	5%	2%
Assets (Percentage)				
Loans to Non-Banks	22%	28%	16%	27%
Inter bank Funds	72%	68%	79%	65%
-Commercial Banks in Bahrain	*1%*	*1%*	*1%*	*0%*
-Other OBUs	*18%*	*13%*	*4%*	*4%*
-Outside Bahrain	*53%*	*54%*	*74%*	*61%*
Other Assets	6%	4%	5%	8%
Assets = Liabilities	100%	100%	100%	100%
Liabilities (percentage)				
Deposits of Non-Banks	23%	23%	29%	31%
Inter bank Funds	72%	68%	63%	58%
- Commercial Banks in Bahrain	*1%*	*2%*	*1%*	*1%*
- Other OBUs	*18%*	*13%*	*4%*	*4%*
- Outside Bahrain	*53%*	*53%*	*58%*	*53%*
Other Liabilities	5%	9%	8%	11%

* September 30, 1993 Source: Bahrain Monetary Agency, *Statistical Bulletin*

As can be seen from Table 3.3 shown below, the OBUs have become a significant power in the Gulf region banking sector. Total asset of the Offshore Banking Units represented 31 percent of the total banks' assets of the Gulf Cooperation Council (GCC) countries at the end of 1992, almost equal to Saudi Arabia's Banking system.

Given Bahrain's limited resources, its small size economy and low level of population, Bahrain's ability to attract such sizable demand of banking business is a good indication of its competitiveness in the region. Bahrain is one of the smallest economies among the

GCC countries, its government annual revenue is only around 9 percent of the Saudi Arabia's revenues and in terms of population, Bahrain is about 4 percent of the Saudis population.

Table 3.3 GCC Countries Deposit Money Banks as of end of 1992

U.S. Dollars Million	Bahrain	Kuwait	Oman	Qater	Saudi	UAE	Total	OBUs*	Total
Assets									
Reserves	311	155	187	149	2844	2306	5953		5953
Foreign Assets	2673	4381	533	2065	28403	18497	56551	50427	106978
Claims on central Government	372	16254	497	0	0	3331	20454		20454
Claims on Private Sectors	1370	2702	2679	3092	23287	15229	48359	13929	62288
Other (net)	380	0	0	0	13036	0	13416		13416
Total	**5106**	**23492**	**3896**	**5306**	**67570**	**39363**	**144733**	**64356**	**209089**
Liabilities									
Demand Deposits	670	2157	536	600	22414	2689	29067		29067
Time and Savings Deposits	2170	14040	2187	3091	24774	14854	61117	15907	77024
Foreign Liabilities	888	1857	107	338	8668	7158	19015	44276	63291
Central Government Deposit	963	215	362	256	393	3089	5277		5277
Capital Accounts	415	2597	336	599	11322	4587	19855		19855
Inter bank- local in Bahrain	0	0	0	0	0	0	0	3198	3198
Other (net)	0	2626	369	421	0	6985	10402	975	11377
Total	**5106**	**23492**	**3896**	**5306**	**67570**	**39363**	**144733**	**64356**	**209089**

* Offshore Banks In Bahrain   Foreign Exchange Rates at end of period.
Source: International Financial Statistics, January 1994 and Bahrain Monetary Agency Bulletin

3.2.0 Activity Portfolio

The activity mix of the OBUs was affected by two major factors. First, it responded to the demand pattern as was shaped by the changing economic activities of the region. Second, it was influenced by the ability of the domestic banking institutions to enhance their capabilities in various banking activities. The typical pattern is, the OBUs would introduce a product or a service that is needed in the market and as the domestic banking institutions enhanced their ability to handle this sort of product, the OBUs will move higher on value added chain for such product. Figure 3.1 shows the changing pattern in the OBUs activity mix during the 1970s, the 1980s, the present and the anticipated future trends. Figure 3.2 illustrates the change in the capabilities of the domestic banking institutions in the GCC countries for the same period.

Figure 3.1 OBUs' Activity Portfolio

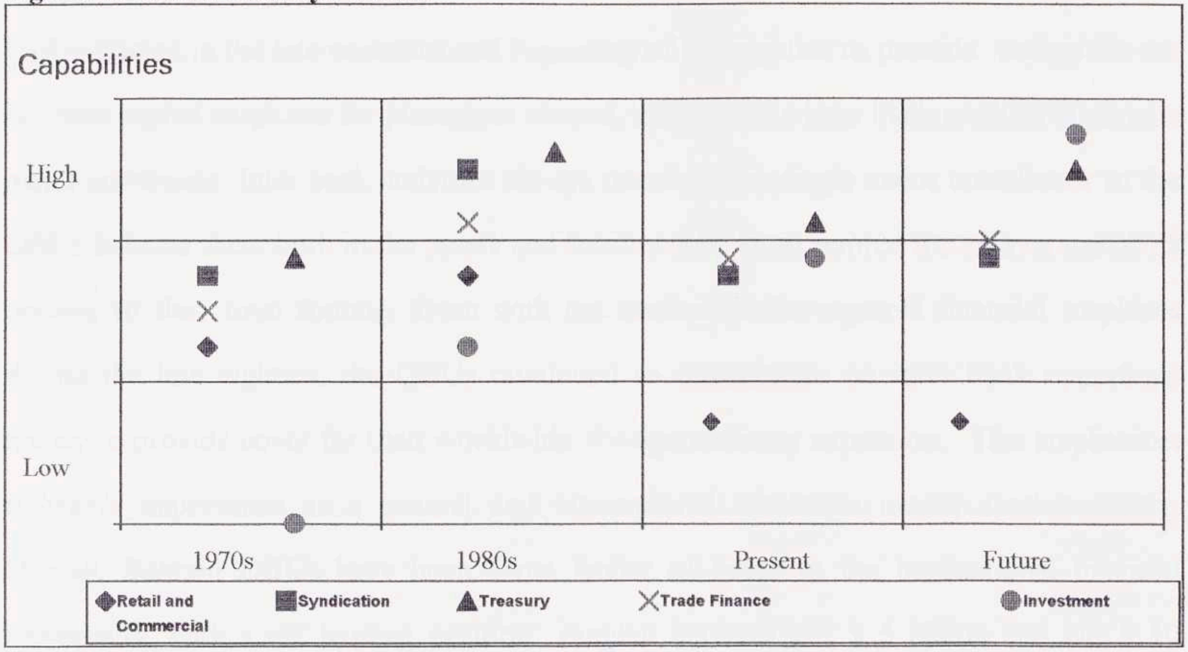
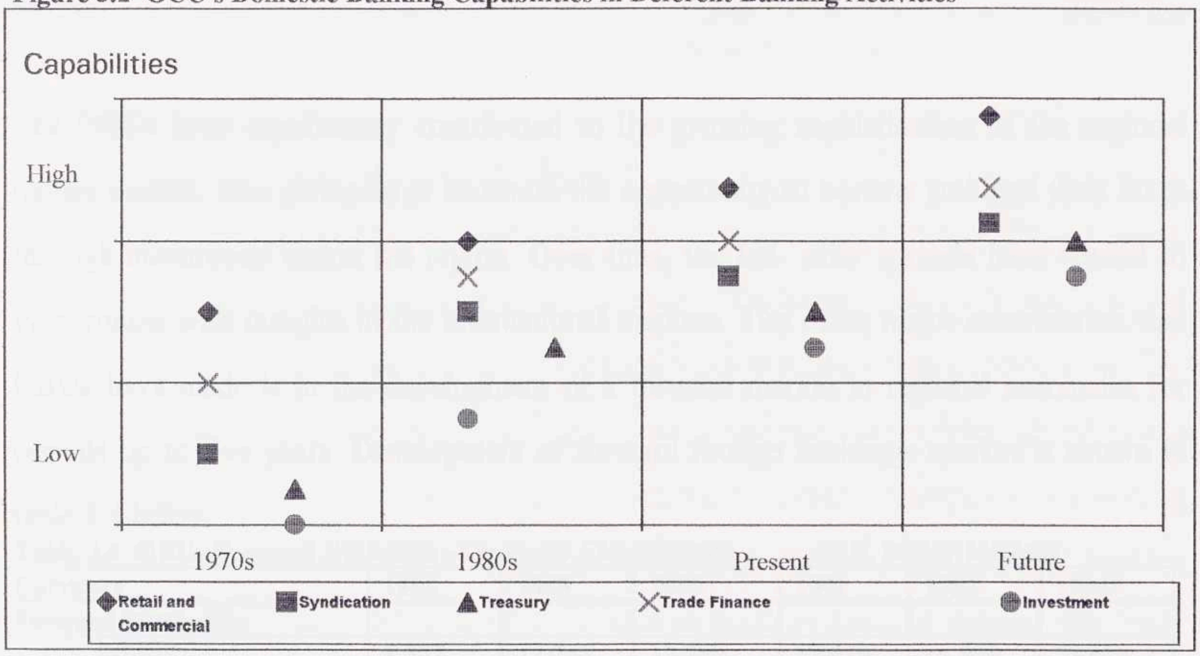


Figure 3.2 GCC's Domestic Banking Capabilities in Deferent Banking Activities



Despite the highly competitive environment in the domestic market in each of the GCC countries, the offshore banking units in many ways complemented the domestic banking systems and positively contributed toward development and expansion of their market place in the following major fields:

3.2.1 Treasury

OBUs started in the late seventies and beginning of the eighties to provide outlets for the regional capital surpluses for placement abroad, mainly in the inter bank markets in various major currencies. Inter bank activities always remained the single major contributor to the OBUs balance sheet both in the assets and liability side. It accounted for an average of 75 percent of the total footing. Even with the decline in the regional financial surpluses during the late eighties, the OBUs continued to concentrate on inter bank operations mainly to provide cover for their worldwide foreign currency exposures. This emphasizes Bahrain's importance as a general and international wholesale money market center. Overall, Bahrain OBUs have been a net lender of funds to the international financial community; with a net lending position ranging between US $ 5 billion and US $ 10 billion.

The OBUs have significantly contributed to the growing sophistication of the regional money market, thus giving large investors the opportunity to borrow and lend their funds through institutions within the region. Over time, the bid- offer spreads have tended to synchronize with margins in the international markets. The other major contribution that OBUs have made is in the development of a forward market in regional currencies for periods up to five years. Development of forward foreign exchange market is shown in table 3.4 below.

Table 3.4 OBUs Forward Exchange - Currency Classification (U.S. Dollar Million)

Currency	1980	1985	1990	1991	1992	1993*
Forward Purchases:						
U.S. Dollars	3,557	12,743	13,380	12,039	16,809	21,673
Regional Currencies	1,839	10,638	6,983	7,034	10,958	11,833
Others	3,402	5,922	6,947	6,543	9,615	13,250
Total	8,798	29,303	27,310	25,616	37,382	46,756
Forward Sales						
U.S. Dollars	4,978	16,212	13,575	13,542	19,889	24,935
Regional Currencies	827	7,553	6,435	6,626	10,027	11,448
Others	2,993	5538	7,300	5,448	7,466	10,373

* September 30, 1993 Source: Bahrain Monetary Agency, *Statistical Bulletin*

The OBUs have substantially helped in upgrading the knowledge and products' capabilities of the banking system in the region. Over the last three decades, the banking system in Bahrain have gained high level of sophistication and largely expand their product range by working closely with the OBUs. The progress of treasury related activities in the domestic banking institutions is summarized in table 3.5 below. The table also highlights the future Products/activities' requirement based on market demand. Similar Tables will be presented for other business segments, under their respective sections in this chapter..

Table 3.5 Development of Domestic Banking Products' Capabilities in Treasury Business Segment

Activity	1970s	1980s	Present	Future
Treasury	-Spot Foreign Exchange to cover own account and trade Transactions. -Inter Bank Placement and Borrowings.	-Forward Foreign Exchange. -Foreign Exchange Trading. -Inter Bank Gapping. -Swaps	-Margin Accounts. -Certificate of Deposits. -Floating Rate Notes. -Participating in Domestic Treasury Bills. -U.S. Treasury Bills And Gilt Trading. -Interest Rate Swap.	-System Trading. -Derivatives, Options and Futures. -Hedging instruments. -Forward Rate Agreements. -Portfolio Management -Regional Govt. Securities Trading.

3.2.2 Syndication (including Project Finance)

Syndication Facilities played an important role in the development of the OBUs business mix. The OBUs were instrumental in financing most of the infrastructure and development projects in the Gulf through syndicated facilities in foreign and regional currencies. The OBUs were actively involved in arranging, lead managing, performing advisory and agency roles and participated along with the domestic banking institutions in risk sharing of such transactions. The close coordination between OBUs and domestic banking institutions in the deferent Gulf countries, created an excellent network linkage that made it possible for the regional banks to successfully finance a vast number of large ticket syndication transactions. Many OBUs have also participated in international loan syndication activities and some have acted as syndicate leaders or co-managers. Total non-bank assets of the OBUs averaged at 25 percent of total assets with a peak of around 30 percent of assets at the end of 1984 and lowest point of 16 percent in 1990. Progress of the products' capabilities in syndication business segment for the domestic banking institutions is shown in the following table.

Table 3.6 Development of Domestic Banking Products' Capabilities in the Syndication Business Segment

Activity	1970s	1980s	Present	Future
Syndication and Project Finance	-Participant Role.	-Manager and Co-Manger Role. -Multi-Currency Deals. -Some Agency Role.	-Co-Lead Manager Role. -Documentation and Agency Role. -Arranger's Role.	-Lead Manager Role. -Advisory and Arranger Role. -Issuing Bank Role.

3.2.3 Retail and Commercial

Retail and Commercial banking is used here to refer to the conventional banking activities such as Lending facilities, Deposits taking and Remittances transactions that are directly provided by the domestic banking institutions to the domestic consumers, companies and Government customers.

In their early days, the OBUs started their business in the Gulf region by soliciting direct relationships with some of the large corporations mainly in Saudi Arabia and Kuwait. Their focus was on short-term, self-liquidating receivable and inventory financing. With the slowdown in the business activities in the region and the greater emphasis placed by domestic banking institutions on their local markets, the OBUs could not sustain their competitive advantage and gradually pushed out of this sector of the market with the exception of deposit mobilization in which the OBUs are still visible. The OBUs' pricing advantage for foreign currency deposits is attributed to non payment of reserve and more active trading capabilities in the worldwide markets than the domestic banking institutions. Non-Bank Deposits constituted around 27 percent of the total liabilities of the OBUs over the last decade. The development of product/activity's capability in retail and commercial banking activities is presented below in table 3.7.

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Table 3.7 Development of Domestic Banking Products' Capabilities in Retail & Commercial Business Segment.

Activity	1970s	1980s	Present	Future
Retail & Commercial	-Short to Medium term Loans and Advances. -Current, Saving and up to one year Time Deposits. -Remittances.	-Long Term, Multi-Currency Financing. -Personal Loans. -Regional Financing and Deposit Taking. -One on One Project Financing Deals. -Credit Cards.	-Specialized Financing. -Consumer Financing. -Suppliers Financing. -Multi-Interest Rate Deposit and Financing. -Cash Management. -ATMs. -Voice Response.	-Leasing. -Commercial Papers. -Home Banking. -Mortgage Loans. -One-stop-Banking, including Insurance and Travel. -Corporate Finance.

3.2.4 Trade Finance

Similar to Retail and Commercial activities, the OBUs were actively involved in direct trade financing transactions for large regional corporations. On the other hand, as part of the syndicated facilities, the OBUs were also involved in arranging export financing facilities as well as pre-export and supply-contract financing for major development projects in the region. Despite the increasing penetration of the domestic banking institutions in this field, the OBUs will continue to be competitive in areas such as structuring and arranging risk sharing trade transactions, Commercial Papers (issuance and trading), and trade finance advisory services.

Although the development of the domestic banking product/activity's capabilities for this business segment has been progressing at a lower pace than other business segments, the banks in Bahrain are heavily targeting the trade finance business segment for their future growth objectives.

Table 3.8 Development of Domestic Banking Products' Capabilities in the Trade Finance Business Segment.

Activity	1970s	1980s	Present	Future
Trade Finance	-Issuance of Letter of Credits (L/Cs) and Letter of Guarantee(L/G) -Collections	-Export Credits. -Trust Receipts.	-Pre Export and Pre Import Financing. -Risk Sharing. -Commodity Trading.	-Structure Deals/Cross Border Transactions. -Commercial Papers. -Advisory Service. -Trade Exposure Trading.

3.2.5 Investments

Despite the dominant concentration of foreign assets in both the OBUs and the domestic banking balance sheets, investment banking was a late comer to the Gulf regional market. Virtually, all excess liquid assets were placed in short term inter bank placements in the European and US markets. Prior to the late eighties most of the investment activities by GCC Governments, cash rich institutions, and high net worth individuals were bypassing the Gulf financial market and were directly handled by international financial institutions in the major European and U.S.A markets. The OBUs and some large domestic banking institutions in the Gulf area started in the late eighties to participate in direct investment for their own accounts in the world's major capital markets and at the same time, acted as sales and administrative agents for some of the international investment houses offering various type of unit trusts, funds, and portfolio management.

The Banking system in Bahrain is under increasing pressure to expedite their investment banking capabilities to meet the growing market demand in the region. Banks are increasingly focusing on this business segment for their future growth. Despite the high level of product and market sophistication required in this business segment, banking institutions in Bahrain were able to come a long way in the development of their capabilities(table 3.9). However, the future capability requirements, in this fast changing market environment, will continue to provide banks in Bahrain with a challenging task to achieve.

Table 3.9 Development of Domestic Banking Products' Capabilities in the Investment Business Segment

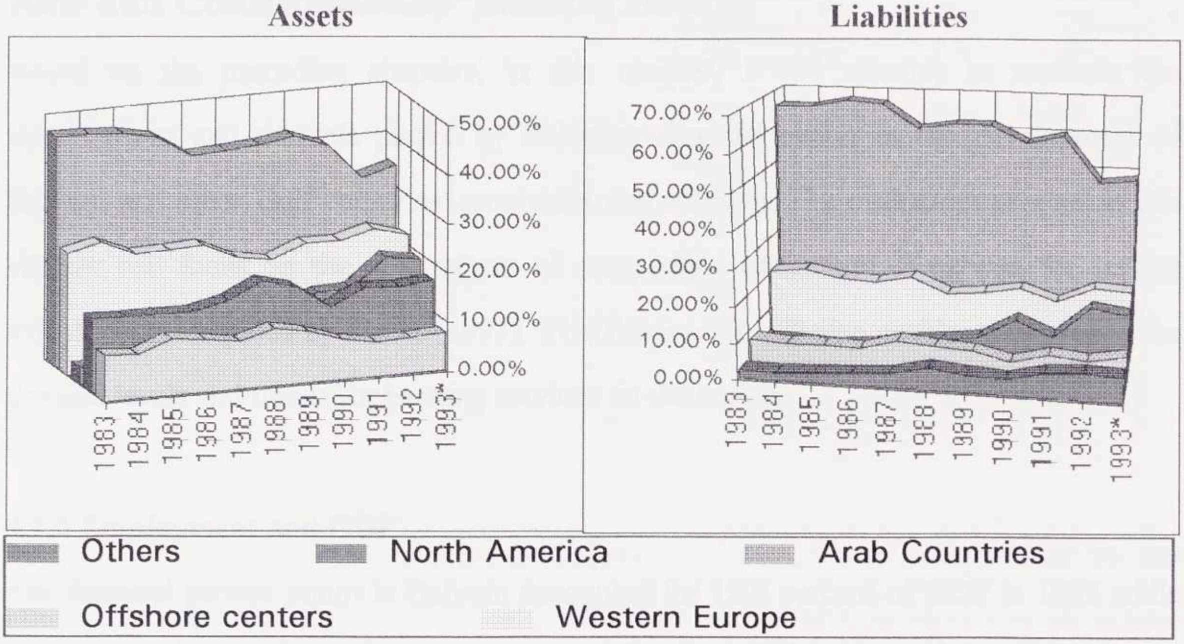
Activity	1970s	1980s	Present	Future
Investment		-Direct Investment in domestic equity for own account. -Sales Agent for International Investment Houses	-Fixed Income Securities Trading and Investment for own account. -Commodity Trading. -Administrative and Sale Agent. -Outside-Managed funds and portfolios.	-Assets/Mortgage backed Securities. -Trading in derivatives and hedging. -Advisory Services. -In-house-Managed funds and portfolios. -Real Estate. -Regional Funds and portfolios.

3.3.0 Market Place

The type of business provided by the OBUs varied; some are marketing and administration centers for the area, others provide international wholesale banking services for clients in the Gulf or are wholesale fund gathering centers for their Head Offices. Other OBUs are arms of local banks with regional retail business. Some banks have followed large domestic and multinational customers to the Gulf. Some Arab-owned banks use Bahrain as a base for a major international presence. Bahrain has always essentially been a transactions center rather than a booking center, and within the overall growth of the market in recent years, Arab banks have played a major role.

The major users of the OBUs' services in Bahrain have continued to be residents of the Arab countries in terms of providing and usage of funds. Their contribution to the funding of the OBUs averaged around 60 percent of the total footing of all banks in the period from end of 1983 to end of September, 1993. Arab country residents' usage of fund averaged at 42 percent for the same period, leaving a net positive funding position for the OBUs of 18 percent of their total assets. Western Europe comes in the second place with an a average of 19 percent of total assets in the funding side and 23 percent usage of fund. The OBUs' activities within North America have shown gradual growth during the last five years. Their share of business increased from 7 percent in 1988 to 19 percent contribution in the assets side and 17 percent in the liabilities in 1993. Figure 3.3 illustrates the OBUs' assets and liabilities distribution for the period from the end of 1983 to the end of September 1993.

Figure 3.3 Geographical Distribution



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Chapter Four
Role and Contribution of Banking Sector

Based on the preceding chapters, in this chapter, I will attempt to evaluate the contributions and the role played by Bahrain's financial center in the development of Bahrain and other Gulf countries' economies and markets. The evaluation process in this chapter will focus on the determinant of competitive advantage of nations for service industries as identified by Proter (1991). This framework will also enable us to assess the demand levels and trends for banking services in the region.

4.1.0 Employment and GDP

The financial service sector in Bahrain accounted for 12.9 percent of GDP in 1992 while the Banking industry's employment accounted for about 2.5 percent of the total working force in Bahrain. National working force reached 70 percent, leaving the remaining 30 percent for expatriates, who are mostly in the professional and technical occupation groups. Locally incorporated banks in Bahrain maintain high level of Bahriani staff in the clerical, middle management and senior management levels. The Bahraini-national staff in these banks would be around 85-90 percent.

Human resources has always been one of the main success factors for development of Bahrain over the years. Skills have moved from being almost totally pearl diving and agriculturally oriented work force to heavily concentrated oil industry employment pattern and later on, diversifying into trade, manufacturing and service oriented labor force. This has not only generated a fairly diversified human recourses skills, but more importantly, helped in building a relaxed atmosphere and creating a multiple culture environment for working and living together in this small island. The shift in the pattern of employment for the period from 1971 to 1991, can be clearly seen from the working population statistics shown below in table 4.1

Table 4.1 Working Population (15 years +) by major economic Activity

Economic Activity	Work force		% of Total		% Bahraini	
	1971	1991	1971	1991	1971	1991
Agriculture and Fishing	3,990	5,108	7%	2%	75%	39%
Mining, Quarrying, and Manufacturing	8,464	30,256	14%	14%	66%	30%
Construction	10,404	26,738	17%	13%	54%	8%
Trade	7,706	29,961	13%	14%	63%	23%
Transport & Communication	7,743	13,789	13%	7%	65%	60%
Financing, Insurance, Real Estate & Business Services	1,084	17,256	2%	8%	68%	34%
Government		40,952		19%		65%
Others	20,199	48,010	34%	23%	62%	34%
Total	59,590	212,070	100%	100%	63%	36%

Source: Central statistics Organization.

Bahrain's abilities to attract foreign skilled and unskilled labors is confirmed by the willingness of these large numbers and well diversified foreign resources to accept working in the island at reasonable cost. The Government and the people of Bahrain are will aware of the importance of the expatriate community to the development of their country and spare no efforts to provide them with a reasonable and comfortable living conditions. Nevertheless, training and development of its national human resources has always remained in the top of their priority list. The high standard formal education system, variety of vocational training institutions and the extensive in-house training programs performed by firms in Bahrain, are all geared to upgrade the nation working force to meet the challenges of the future.

The long history of banking in Bahrain, that started back in 1921 generated experienced national human resources in the conventional commercial banking activities at all levels. The emergence of the OBUs and their heavily involvement in the inter bank activities, also helped in acquiring knowledge in managing foreign exchange and money market portfolios. With the exception of very few highly technical and sophisticated functions, the

Bahraini labor force in the domestic banking feild, is presently in excess of the demand and there is evidence of expatriation of labor to other Gulf countries.

4.2.0 Banking Sector as a Support for other Industries

One of the main objectives of the Government of Bahrain is to establish the banking sector as a critical support industry for development of other sectors of the economy such as manufacturing, trade and other service related industries. This objective was successfully achieved and the combination of the OBUs and the domestic banking system were essential in financing green field and expansion projects in various sectors of the economy. Financing of Aluminum Bahrain's latest expansion project of U.S. $ 1.45 billion that was arranged, lead managed, and financed by major OBUs and regional domestic banks, is a good example of such success.

The sectoral distribution of bank credit in Bahrain, underwent some changes in the recent years (Table 4.2). Personal loans grew in importance with the ratio to commercial bank credit rising from 23 percent in 1986 to 33 percent in September 1993. The ratio of manufacturing loans to commercial bank credit also rose from 12 percent in 1986 to 20 percent in 1993. The growth in the share of personal and manufacturing loans was achieved mainly at the expense of loans in the construction area. Reflecting the regional slowdown and the completion of a major part of infrastructure projects. Construction loans' share fell from 26 percent in 1986 to 13 percent in 1993.

The share of the Bahraini registered commercial banks in total credit stream has been gradually increasing from 61 percent in 1987 to 68 percent in 1993. This was mainly as a result of change of strategies of the locally incorporated commercial banks to become more aggressive for domestic business to compensate for the low yield on foreign assets and improved learning capability of the domestic Banking sector to handle large-ticket and sophisticated syndication facilities.

Table 4.2 Bahrain's Commercial bank lending by major economic sector (Percentages)

End of Period	**1986**	**1987**	**1988**	**1989**	**1990**	**1991**	**1992**	**1993***
Trade	21.4	16.0	19.5	17.6	17.6	19.9	19.8	20.0
Construction	25.9	20.4	26.4	21.5	15.6	15.4	13.0	13.0
Manufacturing	11.9	9.8	12.5	14.0	17.5	19.1	20.2	19.5
Transport	1.6	2.5	4.0	5.3	10.0	5.1	2.4	1.6
Personal	22.5	22.7	22.9	27.3	28.7	28.1	32.1	33.0
Government	10.8	23.8	10.1	7.5	1.9	2.5	2.7	4.1
Other	5.9	4.8	4.6	6.8	8.6	10.0	9.7	8.8
Total	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**
Market Share								
Bahraini Banks		61.3	57.7	66.9	69.9	65.2	68.3	
Foreign Banks		38.7	42.3	33.1	30.1	34.8	31.7	
Total		**100**	**100**	**100**	**100**	**100**	**100**	

* As at September 30,1993 Source: Bahrain Monetary Agency, *Statistical Bulletin, various years.*

4.3.0 Knowledge Resources

As far as accessibility to knowledge and information, banks in Bahrain are supported by The Bahrain Monetary Agency's economic research department, The Institute for Researches and Studies and The Central Statistics Organization. The Bankers' Society of Bahrain provides a healthy channel of communication between the Bahrain Monetary Agency and the banking community through their monthly meeting with the Governor to discuss matters affecting the banking industry in Bahrain. The information facilities in Bahrain is equivalent to any world financial center, in addition to the local and international newspapers and magazines the following facilities are readily available:

- Direct line facilities with firms of foreign exchange, money market and capital market brokers.
- Reuters information and dealing networks.
- All other major information networks (AP-DJ-Telerate, CNN, BBC, Bloomberg, etc.)
- Direct link with credit rating and risk analyzing institutions around the world.

Automation of banking services in Bahrain is well advanced and continues to race to catch up with the fast changing development in the world banking industry. All most all commercial banks are computerized with on- line facilities linking all their branches to main frame systems where customers can conduct their operations at any branch without any delays or time lags. 24- hours service is provided via the Automated tellers machines(ATM) which are widely distributed and well- accepted by the clients. Home Banking is in progress and major steps toward achieving this advanced banking facilities, such as voice response and cash management systems, are already available to customers. The Bahrain Monetary Agency who has recently lunched an automated clearing system, is presently working with the Banker's Society to introduce a shared Automatic Teller Machine (ATM) network for banks in Bahrain and the Gulf area.

4.4.0 Transfer of Knowledge and Capability

As can be seen from the above, the OBUs have significantly contributed in upgrading knowledge and level of capabilities of the domestic banking institutions in the region and enhanced the value added chain of various products and services. The annual reports of the major GCC's domestic banks at the end of 1993, indicated an increased investment in sophisticated technology such as automated teller machines, home banking and information and decision making support systems.

Despite the highly competitive environment in the domestic market in each of the GCC countries, the offshore banking units operating in Bahrain are successfully penetrating these markets through differentiated range of product and services. The OBUs are complementing the existing banking systems and positively contributing toward development and expansion of their market place. Through their concentration on large ticket and complicated financing transactions, which normally must be syndicated among a large number of banks, the OBUs are not only opening the domestic market in each country to other GCC banks, they are also attracting foreign investments to the region, via involvement of international banks in such deals. At the same time, the OBUs are contributing to promote the credibility and the acceptability of the gulf regional credit, economical, and financial risks' perception in the global financial markets.

The active money market inter bank business of the OBUs, which accounted for between 60-65 percent of their total assets and liabilities in September 1993 and the relatively high foreign exchange activities, in the regional and major international currencies, are other fields where the added value are substantial in terms of recycling of capital resources among the regional banks and improving the liquidity level in the system.

The Banking center in Bahrain is playing an active role in managing the regional foreign assets and generating foreign capital for the region. As at the end of 1992, about 71 percent ($ 45.2 billion) of the foreign liabilities of the regional banking system is on the hand of banks operating in Bahrain, and 50 percent ($ 53.1 billion) of the foreign assets of the GCC countries' banking system is also under their control (Table 3.3 on page 37).

4.5.0 Capital Resources

One of the essential determinants for establishing a successful financial center is the political, economical and financial stability of the host country and the overall country risk acceptability in the global market. Despite its small size and limited resources, Bahrain has always been highly rated by respectable professional rating institutions. According to the latest IBC Int'l Country Risk Guide, Bahrain has further improved its ranking from being the 35th best country in the world in 1992 to 24th position in 1993. As can be seen from the following table, Bahrain is well positioned among the major financial centers in the world and ahead of all the Gulf and the Arab countries. This will not only makes Bahrain the ideal Banking center for the Middle East, but will at the same time expand its capacity to attract capital and improve its global competitive position.

Table 4.3 Comparative Country Risk Composite Political, Financial and Economic risk Rating

Country	As of 11/1993		As of 11/1992	
	Rating	Rank	Rating	Rank
Switzerland	91.0	1	89.5	2
Luxembourg	90.0	2	90.0	1
Singapore	84.0	10	82.0	13
United States of America	83.5	12	81.5	14
United Kingdom	79.0	24	79.5	22
Bahrain	**78.0**	**28**	**72.5**	**35**
Kuwait	78.0	28	69.5	46
Hong Kong	77.5	30	76.0	28
Saudi Arabia	76.5	32	75.0	31
Qater	76.0	33	71.0	44
Oman	75.0	36	73.5	33
United Arab Emirates	74.5	38	72.0	37

Source: 1993 IBC Int'l Country Risk Guide, November 1, 1993

In addition to the strong support provided by the Gulf countries' Central banking authorities during the Gulf war, the OBUs' support and commitment to the region were instrumental in enabling the banking system in the Gulf to cope with the consequences of the Gulf crisis during 1989 and 1990. At the end of 1992 the total asset of GCC's commercial banks was about 14 percent higher than 1988 levels.

Adequately capitalized and relatively under leveraged banks operating in Bahrain add to their potential to raise funds in the international financial markets. In comparison with the widely accepted industry norm leverage ratio of between 15 to 20 times of capital to total liabilities, the total commercial banking industry in Bahrain was enjoying a leverage of 12 times at the end of 1992. Likewise, the OBUs' consolidated balance sheet is concentrated in Inter bank assets outside Bahrain with a net lending position of between US$ 5 billion and US$ 10 billion. The existence of branches of major North American, European, And Japanese banks among the banking institutions in Bahrain, widens the capital base and enhances the range of products and services of the center.

Although raising capital is not yet a problem to the banking firms operating in Bahrain, the future expansion plans of the locally incorporated commercial banks might put pressure for higher fund raising capabilities or need longer deposit maturity profiles. Given the fact that these banks are presently having no branches in the major financial centers of the world, we feel it is imperative to spread their operation locations to cover these financial centers either through expanding their branch network or establishing wholly or partly owned subsidiaries. The later route is preferable, as it will mitigate some of the concerns about the Gulf region's political risk.

4.6.0 Demand Condition

4.6.1 Commercial Banking

Banks in the various Gulf countries are reporting good results for 1993, showing both higher assets and larger profits. Financial institutions have benefited from the upturn in business specially in rising trade flows, extending loans to government and public sector institutions, as well as a surge in consumer finance.

Financing of local projects looks set to become big business in the coming few years. The policy of Gulf governments is to use revenues from traditional hydrocarbon resources to meet the social and economic requirements of their citizens, pay for defense and security expenses and maintain infrastructural development. Where the viability of projects can easily be assessed by the commercial potential of their products and the burden to provide finance will be shifted to equity participants, domestic and international financial markets and even contractors. In this way governments will be able to reduce their accumulating budget deficits (table 4.4) and/ or expand their borrowing capabilities.

Table 4.4 GCC Countries Public Finance for the year 1991/1992

U.S.Dollars million	Bahrain	Kuwait	Oman	Qater	Saudi Arabia	U.A.E	Total
Revenues	3503	2874	4302	2318	40320	4331	57648
Expenditures	4386	20396	5095	3216	48331	4713	86137
Surplus/Deficit	**-883**	**-17522**	**-793**	**-898**	**-8011**	**-382**	**-28489**
Exchange Rates($)	2.6596	3.3036	2.6008	0.2747	0.267	0.2724	
% deficit to revenues	25%	610%	18%	39%	20%	9%	49%

Source: National Commercial Bank, The NCB Economist, January and February 1992.

State owned development funds offering subsidized loans are no longer the main stay of Gulf project finance. Increasingly, expansion of public sector companies and autonomous government bodies must be commercially justified and financed from the firms' own resources, cash flow and/or borrowing against reasonable projection of future income. The privatization plans of the publicly owned companies in the region will need great deal of fund raising. The private sector is following a similar course, borrowing from banks for financing green field plants or expansion of existing facilities.

4.6.2 Investment Banking

According to the Bank of England Quarterly Bulletins, OPEC countries accumulated foreign asset estimated around U.S. $ 466 billion by mid 1989. The GCC countries alone are believed to account for around 75 percent of this amount or U.S. $ 350 billion. It is estimated that the private sectors investments constitute around U.S. $ 150 billion of the reported overseas assets, leaving a balance of U.S. $ 500 billion accrued by the public sectors. Close to 35 percent of GCC foreign assets ($ 122 billion) were invested in the EC countries, 14.5 percent ($ 50.5 billion) in the US, 15.9 percent ($ 55.6 billion) in the other OECD countries mainly Japan, Canada and the Far East, 12.8 percent ($ 44.6 billion) placement with less developed countries, mainly in the Arab region and 7.8 percent ($ 27 billion) in liquid foreign reserves and gold with the IMF and the World Bank. The following table shows the foreign assets of GCC countries in 1983 and 1989.

Table 4.5 Foreign Assets of GCC Countries* (U.S. Dollar Billion)

	1983		1989	
	Amount	%	Amount	%
EC	86.0	28.1	121.8	35.0
U.S.A	64.6	21.1	50.5	14.5
Other OECD Countries	51.7	16.9	55.6	15.9
Offshore Centers Bank Deposits	27.5	8.9	40.2	11.2
Placements With Less Developed Countries	43.5	14.2	44.6	12.8
Credit to Non-Banks	5.8	1.9	9.7	2.8
IMF and World Bank	27.1	8.9	27.0	7.8
Total	306.2	100.0	349.4	100.0

* GCC countries are taken to constitute 75% of total foreign assets of OPEC.
Source: Gulf Economic and Financial Report, February 1990, Gulf International Bank.

Distribution of Assets

42.0 percent	U.S. $ 146.0 billion	In form of Bank Deposits
14.8 percent	U.S. $ 52.0 billion	Government Securities mainly U.S.A.
7.7 percent	U.S. $ 27.0 billion	Foreign Reserve, Gold, SDR etc..
19.7 percent	U.S. $ 68.8 billion	Equity Holdings (Corporate Bond, stocks and Properties).
15.8 percent	U.S. $ 56.2 billion	Direct long term Credit to Non-Bank and Loans to developing countries.
100 percent	U.S. $ 350 billion	

There are three broad groups of Gulf private investors: institutions, the high net worth individuals and the less wealthy investors and we estimate between 60 to 70 percent (US $228 billion) of this US $ 350 billion are directly placed outside the regional banking system. The result of a sample survey carried out in 1990 by the Gulf International Bank , investment priorities, trends and patterns of high net worth individuals in the various Gulf countries ranked equity as the highest priority with clear bias towards local stock markets followed respectively by stock markets of US, Germany, Japan , and the UK. Bank deposits ranked the second with US Dollar deposit being dominant, followed by deposits in the respective Gulf currencies and sterling deposits. Real estate ranks third among preferred Gulf investment outlets and is definite first if we only consider the domestic markets. Internationally, real estate in the US rank highest with UK second and other European markets mainly France and Spain. Bonds come next with US dollar first followed by sterling , Deusche marks and yen. Precious metals come next followed by financial instruments such as options, futures and margin trading.

Given the large amount of GCCs' foreign investment, continuously increasing customers' deposits base and the prevailing low interest rates for all major currencies in the world, investment banking offers tremendous growth potential in the Gulf region.

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Chapter Five
Conclusions

In this chapter, I will draw some conclusions in form of competitive advantages and disadvantages of Bahrain as a financial center and will continue to use Porter's model to determine Bahrain's position as a regional and international financial center. Toward the end of this chapter, I will summarize the findings of this study and highlight the challenges for the future. Recommendations will be presented in the next chapter.

5.1.0 Competitive Advantage

- Factors of production such as human, physical, knowledge, capital and infrastructure resources played a very important role in the development of Bahrain as a regional financial center. As a first country in the southern Gulf region to have an oil based economy, Bahrain's economy expanded in the construction, industrial and banking sectors, ahead of its, now rich oil based neighboring countries. This time lead, coupled with its Government early recognition for the need to diversify the country's economic base, allowed Bahrain to create advantages over the other gulf countries. Bahrain's advantages were (1) acquiring high level of education for its nation, (2) building advanced infrastructure facilities, (3) developing skilled labor among their nationals, (4) creating the appropriate atmosphere and lifestyle to attract foreign talent into the country and (5) more importantly, establishing the suitable legal system and structure that is compatible with the international legal laws and standards.

- The financial center in Bahrain represents a fair cross-section of the world's largest international banks. The existence of the three largest regionally owned financial institutions (Gulf International Bank, Arab Banking Corporation and Invescorp) and a wide number of branches of major North American, European and Japanese banks among the banking institutions in Bahrain, provide diversity in type of activity, increase risk acceptance and distribution capabilities that allowed a wider access to business opportunities and enhanced their knowledge transfer capabilities.

- Bahrain's early entrance in establishing a financial center for the region, its strong determination and heavy Government's support, strengthen its capability and helped a great deal, in establishing itself as a dominant and active financial center in the region. Bahrain's positioning was also facilitated by its proximity to the two largest markets in the region, namely Saudi Arabia and Kuwait and the culture similarity between Bahrain and other Gulf countries. The financial center in Bahrain now controls about one third of the GCC's Banking Assets and about 71 percent of their foreign assets.

- Bahrain enjoys an excellent country risk rating as measured by IBC Int'l Country Risk Guide in terms of its Political, Economical and Financial risks and is viewed as one of the best risks in the Arab world. This fact combined with the existence of healthy domestic financial institutions and a wide representation of large global financial institutions in the country, enhance Bahrain's ability to attract foreign investment to this small island.

- The demand for banking services in the region will continue to grow mainly in four major fields; ***Treasury, Syndication(including project finance), Trade Finance and Investment Management (e.g. Private and Institutional Investments)***. Given the sophisticated nature of these businesses, the large size and amount of the transactions and the relatively long lag times required for the regional local banks to develop their technological infrastructure facilities to the level of the international investment institutions, the OBUs will continue to play a major role. During the transformation process, and even after that, in linking the domestic banking institutions in the Gulf to the rest of the world. The change in the pattern of demands will put pressure on all banks operating in the region, including the OBUs not only to efficiently deliver the latest financing and investment instruments from abroad, but also to develop regionally customized instruments and products. This will call on institutions to pioneer development of secondary markets for such instruments to meet the increasing customers' demands for liquidity and flexibility in their financing and investments portfolios. Despite the highly competitive banking business conditions in the region, the Offshore Banking Units in Bahrain will continue to fill gaps in these markets in the following areas:

Treasury Activities

Given the limited geographical distribution of the Gulf domestic banking institutions and their relatively small activity base, their access to the major world foreign exchange and money markets and their ability to sustain the required critical mass volume level to effectively manage the widely diversified product range in this field, will always remain short of being totally fulfilled. ***The OBUs' contribution in acting as a link between the region and other major financial centers will continue to be essential in areas such as Correspondent Banking, Trading in Derivatives, Options, Futures and other Hedging Instruments, as well as Foreign Exchange and Money Markets Portfolio Management.*** The Domestic Banking Institutions will keep on working with the OBUs, specially the branches of major international banks, to execute such deals for their account and/or on behalf of their customers. In-house managed portfolios will be developed by some of the domestic banking institutions, however the execution process will mainly be done through the OBUs.

Syndication (including Project Finance)

The shift in the Governments' policies of the GCC countries to focus on social requirements, maintenance of infrastructure and defense expenditures together with the pressure on their revenues which are suffering from low oil prices, is forcing such Governments towards privatization. Privatization plans include selling to the regional private sector investors some of the existing Government-owned strategic institutions, including manufacturing companies, power, water and other utilities facilities, as well as encouraging establishment of privately-owned new projects. This fact coupled with the general upturn in the business conditions in the region, are boosting the need for syndication banking facilities in the region that is beyond the capabilities of the domestic banking institutions.

The OBUs role will be more required in performing ***Advisory, Arranger and Lead Manager functions*** for the large financing packages where they can draw on their international experience and network capabilities. As almost all major projects undertaken in the region, are based on transfer of technology from other part of the world and a large component of their cost are normally supply of equipment and/or outside contractor bills, the OBUs will continue to play an important role in arranging ***Export Financing, Foreign Exchange Hedging, Contractor Financing and acting as Issuing Banks for the Letters of Guarantee*** to support such deals. The domestic banking institutions will continue to take major roles in jointly bedding with the OBUs for such deals to undertake more of the marketing, administrative, public relation functions and provide funding sources.

Retail and Commercial

The GCC's banking system consist of relatively high proportion of private deposits. The ratio of private sector deposits to total liabilities of 62 percent in 1992 (U.S. $ 106 billion) remained high in comparison with Japan (65 percent) and Germany (38 percent) and other European countries. Given this high level of deposit base and the fact that there was about another U.S. $ 146 billion (in 1989) of foreign assets of GCC countries and citizens in form of bank deposits outside the regional banking system, the OBUs, specially the branches of foreign banks will be better positioned in the region to service and/or route such funds to their respective branches in other part of the world. Due to a desire of diversity of risk, GCC depositors will always hold a large portion of their deposits (our estimate is up to 30 percent or U.S. $ 75 billion) outside the region and will definitely feel more comfortable dealing with representatives that are located nearby. Thus, ***Foreign Currency Deposit taking*** will remain an area of interest for the OBUs.

Trade Finance

Trade is an important cornerstone of the GCCs' economies which are on one hand, almost singly driven by oil revenues and on the other hand, are far from being self sufficient. Almost everything is imported from outside the region. According to the International Monetary Fund (IMF), International Financial Statistics, December 1993 issue, the total exports of the GCC countries in 1992 was approximately U.S. $ 82 billion and total imports was around U.S. $ 64 billion. The Domestic banking institutions in the region are mostly financing such deals through issuance of letters of credits and acceptance of collections documents directly between suppliers and buyers. While large ticket-transactions such as Oil financing are almost entirely handled by Governments and Government agencies in the region. The increasing financing requirements of the private sector institutions and Governments of the region will require banks to endorse Commercial paper risks and will encourage Trading of such instruments among the banking institutions in the region. In addition to ***creating a market for regional Commercial Papers, the OBUs will be able to arrange and structure Cross-border trade transactions between different parts of the world and use their regional network linkages to obtain risk-sharing partners from the Gulf region.***

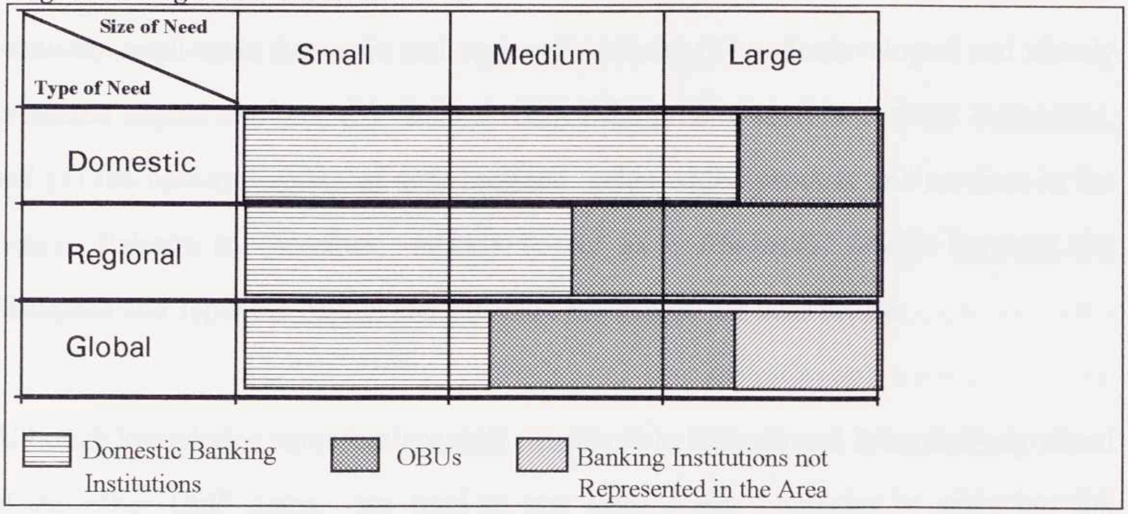
Investment

Given the large sums of existing investment portfolios and the increasing private deposit base in the regional banking systems, the need for investment and private banking services is magnified. The clear preference of Gulf investors toward regional markets investment opportunities, as indicated in the above mentioned survey, will expand the need for investment services to include introduction of domestic freely tradable investment instruments which is presently under developed. Although the investment banks in Bahrain, many OBUs and more recently few commercial banks are acting as sale agents for non-regional based investment institutions and in some cases delivering outside managed portfolios and funds to their clients, they will not be able effectively compete unless they build in-house fund management capabilities and track records.

The investment services required for the region can be divided into two major categories, one is providing access to the regional clients to the global capital and other financial markets and the other, developing regional investment instruments through adoption of features and technologies to meet local requirements. The OBUs services will be critical for both options. Based on their large international branch network and their direct access to global capital markets, the OBUs are better positioned to deliver international investment opportunities to the domestic banking institutions and the regional customers. By working jointly with the domestic banking institutions, the OBUs will achieve better penetration to the markets. Together, they will be able to gradually adopt such product to meet local requirements. ***Securities, Equities and Derivatives Trading Services as well as Portfolio and Fund Management Capabilities, including Custodian Services in the major international markets such as U.S.A., European, Japanese and other Asian markets, are among the major investment products demanded in the area.*** Domestic banking institutions will have to focus on Marketing, Administration and advisory functions.

- The primary market place for the OBUs will remain to be the Arab Countries, with heavy concentration on the Arabian Gulf large corporations and the domestic banking institutions, as their major client base. The different banking institutions whether Domestic, OBUs and/or other financial institutions that are not represented in the area, will have to satisfy the domestic customers' needs through their in-house capabilities or importation of the appropriate products or services from outside sources. There will be very limited non-regional banking based transactions (such as non-regional deals to non-regional customers). Figure 5.1 illustrates the various customers needs by type and size in the Gulf and the type of banking institutions that will be used to satisfy such need.

Figure 5.1 Regional Customers' Needs



5.2.0 Competitive Disadvantage

- Despite the reasonable success of Bahrain as a regional financial center, its small size economy, low level of population, and its limited resources, will remain as one of the major obstacle for future development. As one of the smallest economies among the GCC countries, Bahrain's ability to exercise political and economic power in the region will be limited. Bahrain will have little influence to defend and/or protect its goals and objectives. Beside, the relatively low level of domestic demand in Bahrain for large financial requirements, in comparison with Saudi Arabia and Kuwait, will not only increase its vulnerability to any sort of protectionism measures that may be taken by other Gulf countries to prevent OBUs' access to their markets, but will also hinder, to some extent, growth and development potential of its domestic banking institutions. Relaxation measures by other GCC countries, to allow foreign financial institutions to operate in their countries, will also have some negative impact on the prospect of the financial center in Bahrain.

- Bahrain's potential to transform itself into a global financial center, is far from reality. The region offers few opportunities, and little incentives for foreign investors to access the financial and the capital markets in these countries, due to (1) the relatively small scale domestic and regional markets, (2) underdeveloped and closely protected capital markets, (3) limited role of the private sectors in these economies, and (4) the non-availability of differentiated value-added product and services in the region. Bahrain is, therefore, unlikely to act as a ***Financial bridge*** between the European and Japanese capital and financial markets in the near future.

- Although knowledge resources are well structured in Bahrain and it is relatively ahead of the other Gulf states, we tend to see some major obstacles in achieving full efficiency in this area. The overreliance of the education and research systems on Government support and directions tend to produce inadequate or unmatched end products for the business community. With the exception of The Bahrain Institute of Banking and Finance, which has, so far, concentrated on providing basic banking training programs, the commitment of the banking community toward training has been unorganized and unfocused. To meet future challenges, the firms in the banking community will need to invest in building expertise in the future requirement of the industry and reduce reliance on foreign forces in the technical side. These institutions will also be required to realize the importance of the research and development field in their industry and allocate adequate resources to this function in order to differentiate their products and services from global competition.

- Despite the positively perceived risk rating of Bahrain in the global markets, the domestic and/or the regionally focused business strategies of the domestic institutions in the Gulf, will tend to restrict growth potential and limit the abilities of the domestic financial institutions to attract foreign capital resources once needed. The limited branches or other sort of representation of the Gulf domestic banking institutions in the world major financial and trade centers, is a good example of their domestic or regional oriented strategies.

5.3.0 Summary of the Conclusions

To summarize our findings I have attempted, in Figure 5.2 below, to separately measure Bahrain's positioning as Regional and Global Financial Center, using as a guide the major determinants of national competitive advantage in service industries as quoted by Michael E. Porter in his book, The Competitive Advantage of Nations. Figure 5.2 lists the relevant determinants of competitive advantage, and describes Bahrain's advantage or disadvantage in each determinant. This analysis is based on the discussions and findings in the preceding chapters of this study as well as my 25 years of experience and knowledge in the field.

Figure 5.2 Bahrain's Competitive Advantage Positioning as a Regional and Global Financial Center

Factors and Justifications	**Weak**	**Medium**	**Strong**
Physical Resources - Fill a time Gap between Far East and European Markets. - Close to the rich Arab oil-producing countries. - Language skills of its Citizens - Ability to interact easily with many different cultures.			+ x
Human Resources - Skilled local personnel - Ability to attract foreign talents. - Good working conditions and lifestyle. - job security for expatriates need to be enhanced.		+	x
Knowledge Resources - High standard Universities and other training institutions. - Low investment in R&D at industry and firms levels. - Good access to global market information.		+	x
Capital Resources - Excellent country risk rating and stable political environment. - Healthy Financial Institutions, wide representation of global banks. - Domestically focused business strategies and low global outlets.		+	x
Infrastructure - Advanced communication and transportation facilities. - Acceptable legal structure.		+	x
Size of Home Demand - Domestic market is medium vs. other Gulf countries. - OBUs are dominant in the regional market. - Domestic and Regional markets are small vs. Global markets.	+	x	
Structure of Home Demand - Reasonably sophisticated home and regional demand level. - Highly competitive and widely diversified.	+	x	
Pattern and Trends of Home Demands - High growth potential. - Increasing need for new products and services. - Demand characteristics favor personal attentiveness.		+	x
Access to Demand - Early mover advantage and social and culture similarity. - Location near buyers. - Customers prefer to deal with regional institutions. - Mobile demand. Easy to be captured by other financial centers. - Little control on protection and other measures by other gulf states.		+	x
Related and Supporting Industries - Presence of international Audit, legal and consultant firms. - Wide base of trading and manufacturing firms. - Use of advanced imported technologies in such firms.	+		x
Firms Strategy, Structure and Rivalry - Prestige of the financial service industry in Bahrain and the region. - Highly competitive domestic and regional financial markets. - Use of technology and service automation to reduce cost. - Easy to start new firms. - Relatively small size of regional institutions. - Domestically oriented business strategies of the local banks.	+	x	
Government - Flexibility and heavy support by Bahrain Government to Banks. - Easy access to Government officials. - Strong planning and reasonable level of investment in the future. - Small size and limited power to influence GCC's future directions.		+	x

x Bahrain as a Regional Financial Center **+ Bahrain as a Global Financial Center**

In summary, Bahrain enjoys an overall strong position as a **Regional Financial Center** for the Gulf and the Arab world, but a weak to medium position as a **Global Financial Center**. Despite the small size of the home demand, locally oriented business strategies of its domestic banking institutions and the low influence of the Government to protect its position in this field, Bahrain has managed, so far, to succeed as a regional financial center. By adopting an externally focused and open economic strategy and policy design, whether for choice or necessity reasons, the Government of Bahrain was able to use its small size disadvantage to the country's and its nation's favor. Capitalizing on their strengths: (1) advanced infrastructure facilities; (2) strategic location; (3) better educated human resources in comparison with other Gulf countries (4) relatively cosmopolitan population base; Bahrain has positioned itself ahead of its neighboring countries in terms of capabilities, competitiveness and attractiveness as a regional financial center.

The Government of Bahrain has rightly recognized the importance of having foreign banking institutions and expatriate human resources talent in the country. As such Bahrain has created the appropriate social, business and legal environment to attract and maintain such resources. Unlike other Gulf countries, Bahrain has ruled out any option to nationalize or merge foreign institutions. To the contrary, Bahrain provides all institutions, whether locally incorporated or foreign, with equal business opportunities in the country. As a result of providing this healthy business environment, the domestic banking firms in Bahrain were able to develop high level of capabilities and the OBUs are continuously under pressure to move higher in the value chain of their products and services. This sort of accumulation of capabilities in the banking system in Bahrain has allowed Bahrain to, so far, sustain its competitive advantage over other Gulf countries.

However, with today's growing trend toward globalization of banking services and volatile world oil prices, which is putting increasing pressure on other Gulf countries to diversify their economic base, Bahrain's position as a regional and/or global financial center is becoming more vulnerable to outside competition. Such competition can either come from (1) Other Gulf States such as Dubai and\or Kuwait, who may decide to deploy their superior size and financial resources to establish regional financial centers in their home countries or (2) Other Financial Centers in the world through offering a wider range of products and services and/or more competitive terms and conditions to regional customers.

In order to sustain its present favorable position as a regional financial center, Bahrain will need to expand its open economic strategy and to strengthen the breadth and depth of their knowledge and learning capability's gaps. This will call on the Government and firms in Bahrain to place greater emphasis on attracting foreign investments into the country, and increasing level of Bahrain's investment in foreign institutions. Their objectives for such measures will be (1) expanding the domestic market opportunities (2) diversifying their source of revenue and (3) more importantly, strengthening their global alliances network which is very essential to sustain Bahrain's learning and capability gaps over other countries in the Gulf. Detailed recommendations are presented in the following chapter.

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Chapter Six

Recommendations

Based on the review of the factors selected for this study and the conclusions presented in the preceding section, I can recommend some key objectives to strengthen the position of Bahrain as a regional financial center and improve its competitiveness as a global financial center in the near future:

6.1.0 Major Objectives

Bahrain's policy direction should focus on expanding the country's outward looking and open economic and management strategy. Their main objective should be centered around strengthening domestic demand for banking services and continue to upgrade, at a faster pace, the financial services industry's capability and product range. The increased level of financial services' depth and breadth can be achieved by pursuing the following recommended main objectives:

- Promote Bahrain as a regional base for foreign investment from all nationalities in the manufacturing, trading and services industries.

- Adopt an aggressive investment plan by firms in Bahrain and to a lesser extent, by the Government, aimed at acquiring direct ownership in regional and global strategic businesses.

- Allocate funds and other resources for research and development functions.

- Make changes as necessary in the rules and regulations governing foreign investment, business conditions, working environment and create incentives to achieve the above mentioned objectives.

6.2.0 Actions

In order to achieve these objectives, two set of actions are recommended. The first set relates to the Government and its agencies and the second set of actions is geared toward firms and more specifically, financial institutions in Bahrain.

6.2.1 Government of Bahrain

- To overcome the major competitive disadvantage of Bahrain - the small size of its institutions and home market,- the Government of Bahrain has to expedite its privatization plan and permit foreign investors to participate in a wider range of domestic companies and institutions. Given the restrictive policies of the neighboring Gulf States for foreign investments, the domestic firms, which enjoy more freedom and access to these markets, will provide foreign investors with a an ideal vehicle to penetrate such markets. This at the same time, will allow the domestic institutions in Bahrain to have stronger alliances for doing business outside the region. Their strategy can be focused on attracting regional investments into the country and increase level of commitment of the region to Bahrain as a financial center. The risk of losing control over the direction and the future of these companies, can be eliminated by limiting foreign investment portion to a manageable level, but yet attractive to foreign investors.

  Allowing foreign investors to invest in the domestic market, including ownership of land and property development, will attract a large amount of foreign labors' savings to be recycled in the local economy, instead of instantly leaving to their home countries, as the case is at the present time. This will not only increase the level of commitment of the labor force, but it will also contribute to the development of the domestic stock exchange and eventually expand overall demand in the country.

- To reduce the level of vulnerability facing Bahrain's financial center from over reliance on domestic and regional markets, Government of Bahrain should encourage its financial institutions and other firms to invest in viable regional and global business ventures. Such measures will allow domestic institutions to diversify their business base, expand their global network and alliances linkage, upgrade their level of services, and improve their learning curves and technology transfer capabilities. As a motive to speed up the process, Government of Bahrain may take the lead in investing directly or though its agencies in foreign ventures by using part of the funds raised from implementing their privatization plan. This will not only send a positive signal to the domestic institutions to follow suit, but will also increase the level of reciprocity among foreign investors to invest in Bahrain and will increase their commitment to the region.

- As a consequence of the above two recommendations, Bahrain will be able to develop its stock exchange market to include regional and some global companies.

- To reduce overdependence of firms in Bahrain on imported technologies and improve their abilities to create differentiated products and services, that are more suitable to the regional needs, investment in Research and Development functions at the industry and/or firms' levels, is very essential. In addition to encouraging firms to allocate resources to this important function, Government of Bahrain should direct Universities, Research and professional institutions, which are all owned by the Government, to focus on business related issues and work closely with firms to determine their priorities.

- As part of their implementation plans and in addition to establishing the appropriate legal and business conditions, Bahrain must ensure that the level of taxes, fees and government charges does not discourage businesses from setting up in Bahrain. We acknowledge that any such decision has to be balanced against the wider economic needs of Bahrain, but I believe that business competitiveness is one factor to be given importance in that overall judgment.

- The resultant strategic plans, once finalized, must be effectively communicated to regional and international markets by establishing a professionally planned and coordinated promotional campaign to establish a worldwide awareness of Bahrain and the attractions of Bahrain as a place to do business. To assist foreign investors, factual brochures explaining regulations and procedures must be prepared. This will give confidence to foreign businessmen by diminishing fears of the arbitrary application of regulations.

6.2.2 Financial Institutions

- The Domestic Banking institutions in Bahrain will need to widen their strategic focus and put more emphasis on regional and international markets. Their expansion plans in the region can be achieved through (1) Acquiring shares in some of the successful regional financial institutions in other Gulf countries, (2) Closely coordinating their business strategies with other banks in the region (3) Increasing their representation in the region either through opening branches, representative offices and/or forming joint ventures, and (4) Combination of all the above mentioned approaches.

- International business development need to be carefully handled and planned. Given the relatively small size of the individual domestic institutions in the Gulf, compared to the large international banks, a separate bank by bank expansion into the global market might not be effective in facing the global competition and achieving the desired impact in such large markets. As such, a coordinated approach among two or three Bahraini banking institutions or even Gulf wide institutions should be considered. Alternatively, consortium banking institutions can be formed among Bahraini Banks, Regional Banks and some International Banks in different part of the world. Selection of the appropriate location for international expansion will need to be carefully studied. Preference should be given to high growth potential areas, trade partner countries, suppliers and places with whom domestic and regional customers' banking and investment needs reside.

- To support their future expansion plans, establish the appropriate image, enhance the awareness level and promote their attractiveness among foreign investors, the major domestic banking institutions in Bahrain will need to approach the international capital markets in major financial centers for raising long term funding and capital resources, rather than domestic or regional markets. This can be achieved through issuance of long-term bonds, preference shares and/or equity funds, in major international currencies, in the New York and/or the London markets. By doing so, the gulf financial institutions will be subject to the global institutional rating systems which will put them closer to the reach of foreign investors.

- Continue to expand their products range, enhance level of customer's service and pursue cost reduction measures through more use of technology in product development and automation of their services. As per our discussions in the previous chapters, the financial institutions in Bahrain will need to focus on the products and services listed in **Tables 3.5 to 3.9** under present and future columns, in chapter three of this study.

- Allocation of funds and other resources to Research and Product Development is becoming more and more important to sustain competitive advantage of institutions.

Research and Product Development functions for banking institutions in Bahrain should be geared toward introduction of appropriate Products and Services as well as adoption of global products' feature and services' technology to the domestic and region markets. In carrying out this function, banks can consider partly out sourcing such service to domestic, regional and international universities, Bahrain Institute of Banking and Finance and/or some consultant firms.

- Human resources development and training are areas with vast room for improvements in the banking sectors in Bahrain. The Bahrain Institute of Banking and Finance need to work more closely with the banking community in Bahrain to upgrade their existing training programs, in order to develop specialized skills required in the banking field. Bahrain Institute of Banking and Finance is required to expand its mission and objectives to undertake research tasks in the banking and finance filed in coordination with advanced worldwide universities and research centers. The training process at the firms level should also be more focused and geared toward career development of their employees rather than providing fragmented basic course that are designed to enhance the participants' skills in specific functional task. The aim of the banking community in Bahrain, including The Bahrain Monetary Agency and The Bahrain Institute of Banking and Finance should be to develop Bahrain as a Regional Training Center for Banking and Finance.

- The change in the strategies of the banks in Bahrain, is expected to put more pressure on the institutions to obtain new skills geared toward merchant and investment banking activities. Apart from training and retaining of the their work forces, banks will be compelled to go beyond their normal remuneration packages to attract the highly talented expertise. The challenge is more for the locally incorporated or regional institutions, as the branches of foreign banks can always draw on the resources of their global networks. The highly demanded and extravagantly paid investment specialists will need great incentives to leave the Wall Street or London centers to come and work in Bahrain. Demand for career advancement opportunities and job security may calls for abolishment of the short-term contract recruitment practice presently applied. Banks will be under pressure to provide profit sharing and ownership stake to employees, including expatriates. This will requires a change in the mentality of the local owners to accept them as partners. More open policies toward immigration and citizenship regulations such as granting passports to professionals and major investors, are to be considered as part of the measures to be taken to attract foreign talents.

- To succeed, banking institutions in Bahrain will also, in addition to the above mentioned measures, be required to review their management style and organization structure. They will need to flatten the organization structure to eliminate bureaucracies, speed up decision making process by delegating authorities to people who are closer to customers and create an appropriate environment for learning and managing change. Introducing lean processes via automation and out sourcing, cost, turn-around time and time-to-market will be substantially reduced. Selection of their new recruits and their training polices and procedures will have to be reviewed to be more accommodative to attract, develop and maintain entrepreneurial skills in the organization.

Bahrain's ability to effectively implement and manage the above mentioned recommendations will remain to be one of the critical elements for success. In pursuing these objectives, the banking system, in its totality- including the government, the domestic banking institutions, and the OBUs-, must be fully aware and committed to work together to sustain and to develop their major competitive advantages.

They will need to share a vision to further develop their financial center's superior product knowledge and global markets reach capabilities, which can only be achieved through appropriately positioning of themselves in the global financial services' map. Their strategies, which should be entirely based on present and future trends of customers' need, will have to carefully consider: (1) which of the demanded services can be delivered based on the existing domestic capabilities: (2) what are the additional capabilities required; (3) what is the most effective way to capture these capabilities.

This will make it mandatory for banking firms in Bahrain to expand their association and alliances' ties with global financial institutions in different parts of the world to further expand their product knowledge and widen their access to global markets. Given the importance of such functions, I have made an attempt in the following chapter to introduce a framework that can hopefully be used for selection of the appropriate alliances' strategy.

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Chapter Seven

Framework for Selection of Alliances Strategy

As illustrated in the previous chapters, Bahrain's main core competence lies in its ability to provide and maintain a superior level of product knowledge and wider access to global financial markets within its banking system, than other Gulf countries. This was achieved through market forces dynamics, where competition from OBUs has been forcing domestic banking institutions to increase their learning process and to expand their product range. On the other hand, the OBUs were constantly under pressure to introduce new capabilities to remain competitive in the regional markets. Each capitalizing on its major strengths (being knowledge of domestic markets for local institutions, and higher level of products' sophistication and access to global market for the OBUs), the two banking systems were able to transfer knowledge and resources between themselves, and ultimately complement each other. This was made possible through their constant interaction, and their mutual understanding of the importance of the other party's strengths and capabilities.

Together, the OBUs and the domestic banking institutions were able to offer to the regional customers better products' knowledge, wider reach to global markets and stronger relationship. Such capabilities, that made it possible for the financial center in Bahrain to competitively meet a large portion of the regional customers' need, are still beyond the scope of any of the domestic banking systems in other gulf countries.

The combined knowledge and resources of the OBUs and the domestic banking institutions, has deepen the reach of the banking system in Bahrain into the global markets and widen its access to sophisticated products' capabilities. This has enabled Bahrain to achieve a differentiated positioning for itself in comparison with the other banking systems in the gulf region.

The increasing trend toward globalization of the banking services in the world, coupled with the emergence of an advanced economic development era in the gulf, is reshaping the demand pattern for banking services in the region. Customers' needs are becoming more sophisticated and more price sensitive, to a level where the domestic banking firms in Bahrain will not be able to cater to such needs based on their own capabilities. As these products and services are deeply embodied in the global markets, banking firms in Bahrain will need to widen their integration in the global market by amalgamating their strengths, (using their knowledge of their domestic markets) with the technical and markets access capabilities of foreign institutions in other parts of the world. This will call for a larger scale and scope of associations and alliances relationships, that will allow the banking institutions in Bahrain to effectively and profitably bridge their capability gaps and gradually acquire higher value added in the chain of the product and services required in the region.

Selection of the appropriate alliances' strategy for banking firms in Bahrain has to be aimed at delivering the appropriate range of product and services to their regional customers at the most cost effective and in the most efficient manner. In doing so, banks in Bahrain will have to expand their reach into the global financial markets in order to capture higher product' and market capabilities. The key for their success will be in how and who to select as their major partners, alliances and business associates in the different fields of services, through which firms and ultimately, the financial center as a whole will be able to ideally position itself to pool the necessary capabilities and competitively meet customers' need and want.

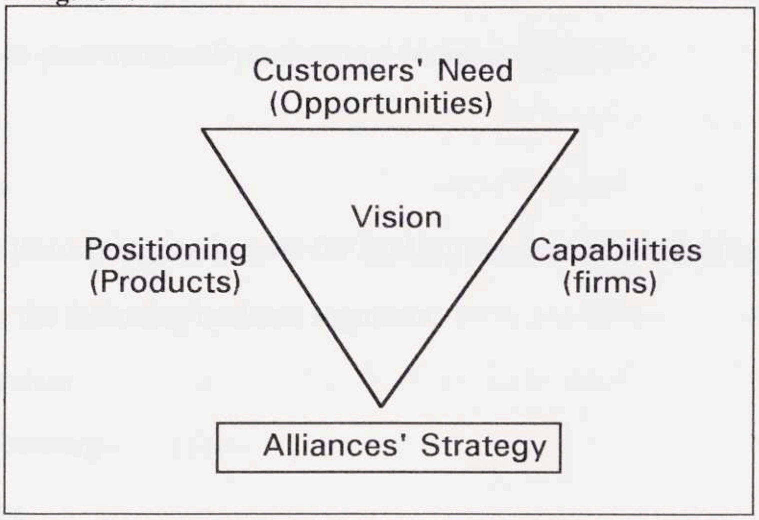
Although it is beyond the scope of this study to go into detailed implantation plans, I see the ability of Bahrain's Government and its financial institutions to select the appropriate association and alliances linkages, as a critical factor that needs careful consideration for all parties concerned. Therefore, I will introduce, in the remaining part of this chapter a framework, which will hopefully be useful to determine the appropriate alliances strategy for various types of businesses and activities demanded by customers.

7.1 Recommended Framework

The recommended framework starts by identifying customers' need, including the future trends in the demand pattern *(opportunities)*, which will be used as a base to determine the rang of products and services required to satisfy such needs. After deciding the rang of product and services, two sets of micro analyses will be needed to find out: (1) what product's functions are within the abilities and reach of the local banking institutions, (2) what are the functions that can be developed or easily imported, and (3) which of the functions will always remain beyond their reach.

On one hand, we will look at the ***position*** of the various functions of each product, by assessing how deeply these functions are integrated in the global financial market. On the other hand, the domestic banking institutions' ***capabilities*** to efficiently and profitably deliver the various functions of each product to the end customers, will be evaluated. At the end of this analysis and based on their positioning against the various functions, the banking institutions in Bahrain will be able to decide the scope and the scale of their alliances ties. The overall concept for the recommended framework is diagrammatically illustrated in figure 7.1 below:

Figure 7.1



In determining the product positioning and the institutions capabilities, we will need to go through the following stages of analysis:

1. Identify customers' need.
2. Segment the need by major **business** groups such as Treasury, Investment, Trade Finance, and Syndication.)
3. Determine the different type of **activities** under each group of business. For example for Investment Business; Derivatives, Securities, Equities, and Commodities.
4. Identify the **functions** required for each type of activity such as Product development, Trading, Advisory, Reporting, and Marketing.)
5. Finally, we will plot each of the **functions** on the proposed diagram (figure 7.2). The vertical axis is capturing the extent to which the function can be thought of as globally integrated, and the extent to which the function is embedded in the local markets. The horizontal axis is capturing the scale of local firms execution and cost effectiveness capabilities for each function. This will help us to arrive at:
   - Where are the areas of strengths and weaknesses of the local institutions' capabilities. (whether a function exhibit global scale of economies or whether knowledge/capabilities are globally dispersed).

- What are the scope and scale of associations or alliances linkages required (if any) to penetrate each product and business segment.

7.2 Application

As concluded in this study, the demand for banking services in the Gulf region is expected to be focused on the following business segments:

- Treasury Services
- Investment Banking
- Trade Finance
- Syndication

To demonstrate the application of the analysis process for the recommended framework, let us arbitrarily pick investment banking segment, as an example.

First, we need to asses the positioning of the investment banking segment in its totality in comparison with other business segments. Investment banking is a widely diversified field in terms of range of products and the geographical distribution of products' and markets' knowledge. The high level of volatility in its markets and prices, puts investment banking risk profile in the front of all other business segments. As such, investment banking operates as a global product segment and ranked low against the effectiveness of local firms capabilities. As can be seen from figure 7.2 under **business** category, investment banking is positioned in the far left at the top end of the chart.

Secondly, we will look at the different types of investment activities that are required by our customers and in the same manner, assess the positioning of each activity in comparison to the rest. This sort of analysis will help us determining the areas of strengths and weaknesses of the local institutions. In figure 7.2 under **Activity** category, all the anticipated activities are shown with their relative position. For example, portfolio management is placed as a globally integrated activity and far from the capabilities of local firms, because of its diversified nature and the fact that it can include many of the other activities (if not all) such as derivatives, equities, securities, and foreign exchange. On the other hand, foreign exchange and money market activities are positioned as fairly domestic and close to the reach of the capabilities of local firms, due to the long experience of the local firms in these fields, and the availability of sufficient number of counterparts (other banks) within the domestic market.

To illustrate the third stage of the analysis, let us take the **security** activity, which is almost in the middle of the activity chart, and break it down to the various **functions** that are required to launch such activity to our end customers. As can be seen from figure 7.2 under function category, the banking firms in Bahrain are independent and capable of performing the marketing function for the security activity, but weak in product development and managing diversified portfolios.

At the end of this stage of our analysis, firms will have a fair idea of : (1) what are the functions that can be delivered based on their own capabilities, (2) what are the functions that will be more cost effective and efficiently delivered through market sources, and (3) what are the functions that will need alliances and other sort of formal relationships with other institutions in the global financial market. This can be derived by doing a Quadrant Analysis for the function chart as shown in figure 7.3. Functions appearing in quadrant 1, are areas that require long term alliances' relationships. Quadrant 2 will show the functions for which the knowledge should be developed over time by local firms in Bahrain. Functions falling within quadrant 3 are to be handled through market sources (out sourcing). In quadrant 4, we will be left with the functions which are within the domain of local firms.

Figure 7.2

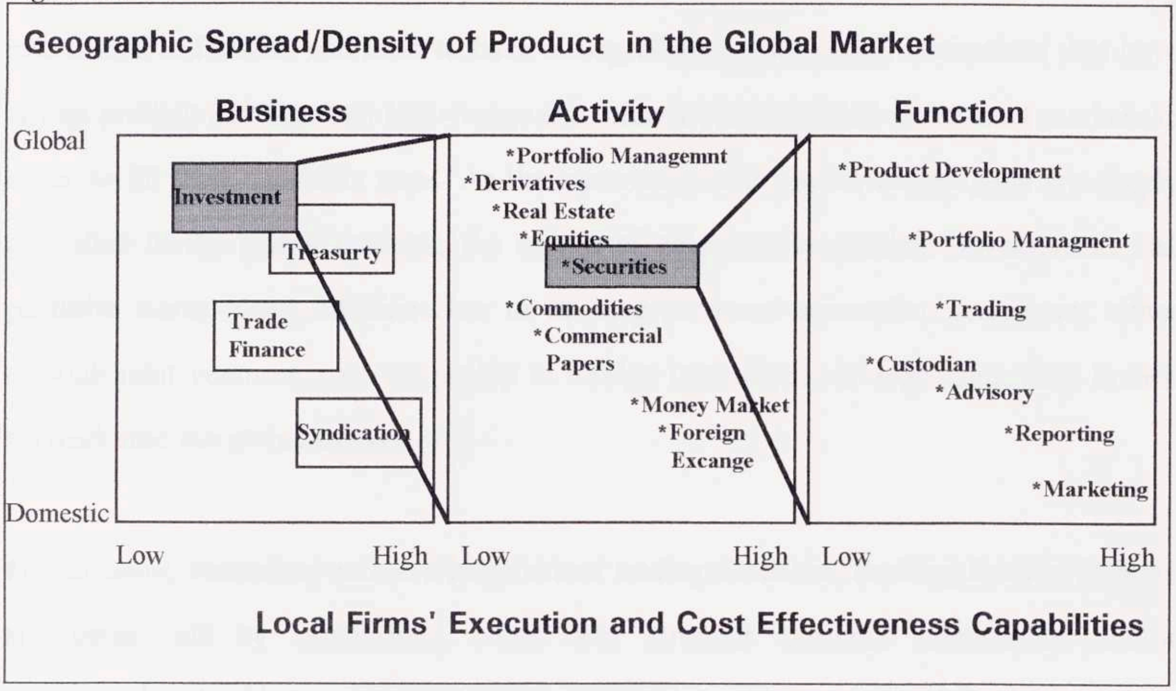
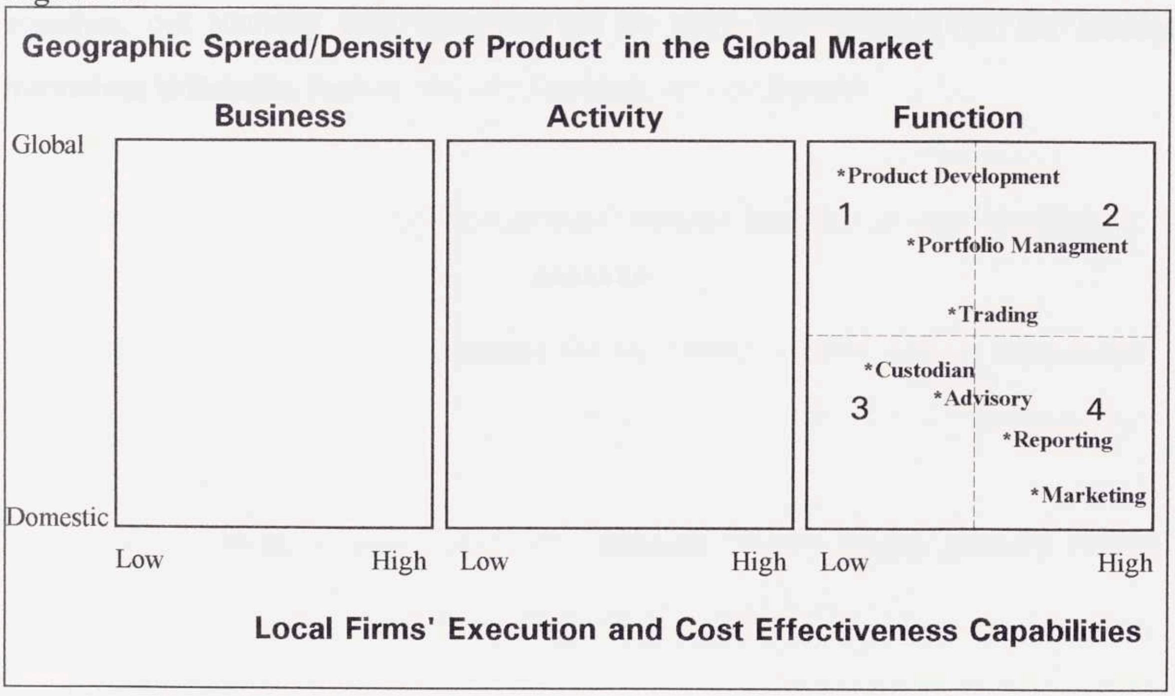


Figure 7.3



As a result of the above mentioned analysis process, we can conclude that the banking institutions in Bahrain will need to have strong alliance with global institutions that have strong product development knowledge and wide access to global investment markets in order to fill their capability gaps. As the knowledge and market access gaps are deeply embodied in the global markets, the nature of alliances for product development and portfolio management functions has to be long-term and somewhat permanent, either through joint ventures, part ownership in foreign institutions, or expanding their branch network into the global market.

For advisory, custodian, and to a large extent trading functions, banking firms in Bahrain are better off by establishing wider and stronger business relationship and/or correspondent banking arrangements with various global institutions in deferent part of the world. Given the large amount of investment required in these field, the low anticipated value added, and the price and the service advantage of dealing with more than one suppliers, out sourcing such functions will be more cost effective for the banking institutions in Bahrain.

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