Chapter 9

Saudi Arabia's King Abdullah Financial City:

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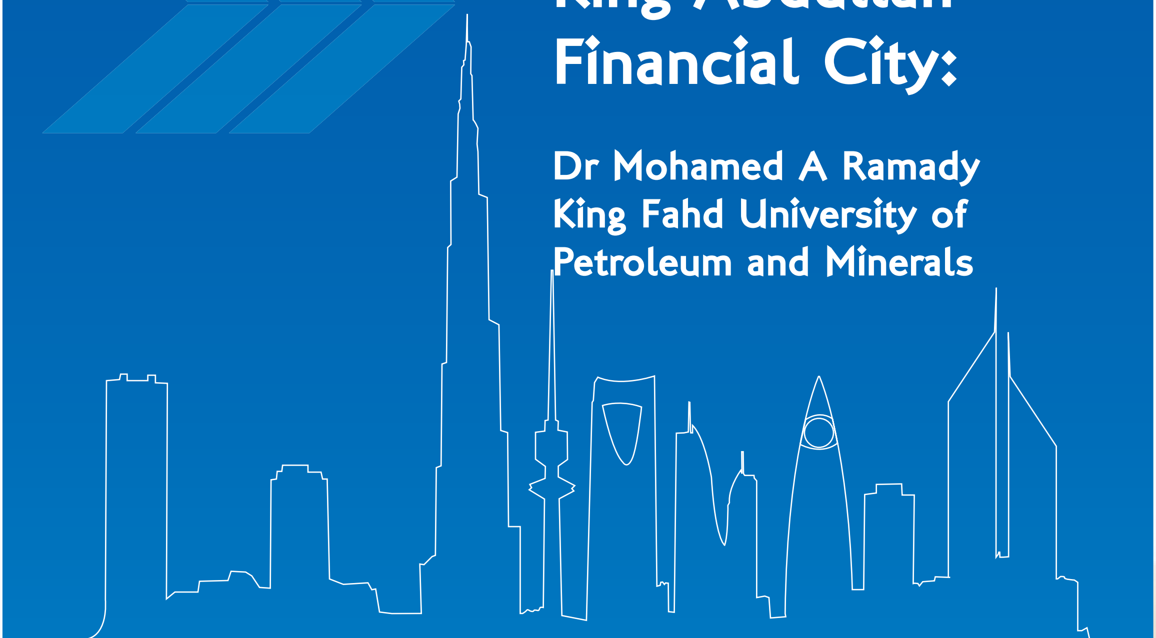

In life, as in chess, forethought wins
Charles Buxton

The Kingdom at centre stage

The Kingdom of Saudi Arabia is staking a serious claim on becoming the region's pre-eminent financial power. Despite the UAE's expressed reservation over the GCC's choice of Riyadh as the location of the long awaited GCC Central Bank, Saudi Arabia has suddenly become the preferred Gulf economy to be doing business with in the long run. While Abu Dhabi and Qatar have built up sizeable overseas investments and diversified their asset portfolios abroad through Sovereign Wealth Funds (SWFs), Saudi Arabia, through its de facto Central Bank, the Saudi Arabian Monetary Agency (SAMA), seems to have laid down a claim for being the most financially prudent regulator in the region in the face of the global financial and credit market turmoil.

For a long while, it seemed that Riyadh would be bypassed by other regional financial centres such as Dubai, Bahrain and more recently Qatar, who are all vying with each other in promoting their particular model of a financial centre. Both international and regional financial players were welcomed to these financial centers and it seemed that the era of financial globalisation and deregulation could do no wrong, while Riyadh with its more insular program watched from the sidelines. The rude awakening call of 2008 and 2009, triggered by the sub-prime tsunami, toxic assets and government bailouts changed basic assumptions around the world, and none more so than in the Gulf. The search was on for a financial and regulatory framework more suited to the region's needs.

Financial markets tumbled and investment banking giants, the so-called masters of the universe, suddenly fell by the wayside like nine pins. The rush was on for asset quality, liquidity and prudent risk management controls. Suddenly Riyadh seemed to be an attractive and safe place to be in, and SAMA's conservative regulatory model was the grudging toast of the region. The question now is whether Saudi Arabia can come out of its self imposed marginalisation and capitalise on this new found admiration to build up a sustainable, long term financial model, which truly adds value to the Kingdom and to the region as a whole.

Financial centres or real estate projects?

The vying for the number one financial centre in the Gulf involves a mixture of slick marketing and public relations, financial acumen and a lot of real estate projects thrown together. Sometimes one wonders where one element begins and another end, but this heady cocktail seemed to have worked for some in the Gulf until the reality of the financial market crash in 2008. Suddenly the issue became one of searching for substance and a real economic base to sustain these budding financial centres. For a few years it seemed that Dubai and Bahrain would make all the running – the former attracting a large number of Gulf and international financial players lured by globalisation and the ease of doing business in Dubai, while the latter attracted institutions that preferred to concentrate on the nearby Saudi market and developed a niche in the growing Islamic finance market under the supervision of the Bahrain Central Bank.

The Dubai International Financial (DIFC) seemed the envy of all, with its sophisticated marketing, regulatory friendly regime under the auspices of the Dubai Financial Services Authority (DFSA), as well as the lure of servicing the wider Middle East and Iran. A full range of supporting financial service companies, whether private equity, hedge funds, insurance or investment banks rubbed shoulders and transacted complicated deals to rival the best in New York or London. Added to DIFC's financial pull was the glamour of Dubai's bustling real estate boom, with skyscrapers miraculously going up every week.

What made DIFC attractive were its free zone status and its aim to bridge the "financial space" between Western Europe and East Asia. Financial institutions applied for licences in a whole range of financial services sectors such as investment banking, corporate and private banking, capital markets, including derivatives and commodity trading as well as insurance and re-insurance services. Firms operating out of the 110 acre free zone are eligible for benefits such as zero tax rates on profits, 100% foreign ownership and no restriction on foreign exchange or repatriation of capital. Unlike "offshore" tax havens, the DIFC seemed to boast of a unique advantage over others in the Gulf, in that it was also a fully fledged "onshore" capital market comparable to other leading financial centres such as Hong Kong, London and New York. Dubai seemed unbeatable but others were having a go.

New challengers step in

Bahrain decided to challenge Dubai's role and has conceived its own Bahrain Financial Harbour, on a somewhat more modest scale than Dubai's. Created as a distinctive new architectural landmark to replace the older office space that has served Bahrain's financial services community for years, the financial center includes the Harbour Towers, Harbour Mall and Harbour House, once again combining real estate projects and financial office space, with leisure opportunities thrown in. In its regulatory approach however, Bahrain has decided to complement, rather than take Dubai head on.

Bahrain has adopted a lower, no-nonsense approach and marketed its regulatory oversight strength as a safe banking environment that boasts of a financially skilled and educated local population, good communications and a recognised Islamic finance niche player rivalling that of Malaysia. The attraction of the nearby Saudi market was a big draw. The less frenetic pace of life and business culture of Bahrain has attracted both regional as well as Saudi institutions, who found it convenient and cost effective to penetrate the lucrative Saudi market and yet benefit from the wide range of expertise available in the island Kingdom.

Other Gulf states have also decided to throw their financial hat into the ring. From a sleepy backwater in the Gulf in the 1970s and 1980s, the state of Qatar is today undoubtedly a major Gulf economic tiger, propelled by a self-confidence based on growing revenue surpluses from gas sale. Not to be outdone by the existing financial centres, Qatar established its own Qatar Financial Centre (QFC) as a financial and business hub to tap into the projected $ 140 billion of Qatari led investments over the next five years. Qatar seems to have examined the DIFC model well, as the QFC incorporates some elements of the Dubai model such as the ability to engage in both onshore and offshore business, as well as 100% ownership by foreign companies and full remittance of profits outside Qatar. To ensure international best practice, Qatar is promising to establish an independent judiciary comprising civil and commercial centres and regulatory tribunals, with the QFC Regulatory Authority acting as an independent financial regulator.

King Abdullah Financial District: enter the desert dragon

With new financial centres popping up and others reinventing themselves to attract regional and international clients, the Kingdom of Saudi Arabia has decided to play its hand and develop its own brand of a financial centre, the King Abdullah Financial District (KAFD). The project, once completed, would dwarf others in the Middle East, with a planned site of 1.6 million metres and gross floor area of 3.5 million metres. By comparison, London's Canary Wharf is built over an area of 345,000 metres. The KAFD would house all Saudi state entities dealing with financial matters, including the Capital Market Authority, the Tadawul Stock Exchange as well as the offices of Saudi and foreign financial institutions. Construction has already started and phase one is expected to be completed by 2011.

The mega project is estimated to cost around $ 60 billion when completed, but given that it is an integrated socio-economic project the final cost could end up higher as KAFD will also become a community hub. The recent announcement by the Saudi Government that it is considering the introduction of a "Fannie Mae" type of government owned mortgage guarantee institution comes at an opportune time for those considering financing such mega projects, as they could issue asset backed Sukuk and sell them to the Government's proposed "Fannie Mae". The Government in turn is planning to sell these asset backed Sukuk to Saudi and international investors to add depth to the Saudi capital market, which opened up to institutional bond sales in June 2009. The approval of the Saudi Mortgage Law will add impetus and credibility to any "Fannie Mae" Government purchases of mortgage-backed assets.

The KAFD differs from other Gulf financial centres in many respects. It is not only a financial centre, attracting all those operating in this sector and their ancillary support companies, but is planned to be an ambitious social-economic project that will add value to the domestic economy in the first instance. The pace of economic diversification has quickened in the Kingdom since the succession of King Abdullah in 2005, with the aim of increasing employment opportunities for its young population, where around 65% of the population are under the age of 30 years.

GCC Countries Macro Economic Indicator 2008 ($ Billions)

Indicator	KSA	Qatar	UAE	Bahrain	Oman	Kuwait
GDP (nominal)	466	90	272	20	51	136
Real GDP Growth (%)	4.2%	19.6%	6.8%	5.4%	6.4%	5.6%
CPI (% change)	9.9%	16.0%	14.0%	5.5%	12.0%	9.7%
Population (million)	26.0	1.2	4.7	0.8	2.7	3.0
Foreign Currency 2009 debt repayment ($ billion)	2.9	5.6	23.1	3.5	0.5	4.4
Gross External Debt 2008 ($ billion)	76	43	152	30	12	46

Sources: Central Banks, IIF, IMF

Table 1

The decision to promote Riyadh as a major financial district is part of the new found sense of self-confidence in the Kingdom about its regional and international role, based on holding a quarter of the world's proved oil reserves . Saudi Arabia is truly the world's energy warehouse. With the largest economy in the Middle East and a Gross Domestic Product of around $ 446 billion in 2008, it dwarfs all the other Middle East economies as illustrated in Table 1 above.

It must be noted that, with the exception of the UAE, most GCC countries have no sovereign debt and this is particularly so for Saudi Arabia and Kuwait. The figures in Table 1 are used for benchmarking purposes only and are based on quasi-government entity borrowings. The decision to locate the proposed GCC Central Bank in Riyadh following the GCC Summit in May 2009 was another indication of the Kingdom's acknowledged economic status, not withstanding the UAE's "reservation" about the decision.

GCC monetary union: to be or not to be?

Saudi credentials to host the central bank are impressive. As noted, the Kingdom has the largest economy within the GCC, and its wholehearted support is essential if monetary policy and integration is to have any chance of success. The same applied to the establishment of the European Central Bank (ECB), which eventually was hosted in Frankfurt. Just like Saudi Arabia, the German economy dwarfed the other economies in the Eurozone, and the Germans made it clear that their support for subsidising weaker Eurozone economies would come only at the price of the ECB being located in Germany. So now that Saudi Arabia has the central bank, will it do the equivalent and take the lead in resolving the challenge that faces the GCC itself? In other words, will it push ahead and maintain momentum towards monetary union? If this happens, it will significantly raise Riyadh's status as the region's financial capital.

Despite the announced or unannounced reservations of the other GCC members, what SAMA will bring to the table is its undoubtedly mature and conservative banking regulation and supervision model and experience. The Saudi economy and the Saudi banking system has been relatively unscathed by the current crisis, with comparatively fewer projects cancelled or delayed. There has been no downgrading of Saudi banks' credit standing, and foreign direct investment continues to flow to the Kingdom. All these are public facts.

That said, SAMA has always been loathe granting approval for fancy structured-investment banking products and services, and has applied a "fit and proper" central banking supervision approach. This sometimes projected Riyadh as out of step with world financial-market developments, and somewhat more insular than other Gulf economies. The battering that investment banking has taken, and the industry's return to basics, seems to have proved Saudi Arabia right in the short term. But crises eventually pass and memories fade. Over time, markets adjust and new products and services evolve and the question will then arise whether SAMA should adapt or remain conservative and be bypassed by other financial centres? This could be the basis of the UAE's "reservation", a feeling that a more nimble and adaptable regulatory environment is needed to meet future challenges. Only time will tell which model will prevail, but what is certain is that there are thorny problems and questions that need more immediate answers.

By all indication however, the withdrawal of the UAE from the planned GCC monetary union does not seem to have derailed Riyadh's commitment to proceed with the plan, although emphasis will now be on a broader monetary union rather than a unified currency. The lessons of history and other unified currency blocks plays a role, and the European Union (EU) model could be a template for the GCC. In Europe, Germany played a central role in the formation of the union and, as a price, it insisted that the European Central Bank be located in Frankfurt while the Maastricht Treaty allowed EU member states the option to "opt out" of the common currency. Britain did that, and yet remained in the EU. The same model could apply to the GCC, with the UAE and Oman "opting out" of the common currency, but remaining in the broader monetary union. For the GCC's common currency to evolve, there are a host of questions that need to be addressed.

Will the common currency be pegged solely to the US dollar or to a basket of currencies? Will the pegged rate be within a narrow or wider band - the first causing the currency to be overvalued in times of oil trade surpluses, the latter inviting speculative pressures in exchange markets. The main argument for pegging to a basket of currencies is that this will afford members of the bloc some degree of independence in setting their own monetary policies to deal with local inflationary or deflationary conditions, rather than being tied to the policies of the US

Federal Reserve. Saudi Arabia has already come out strongly to state that SAMA will continue to support a dollar peg, which might put it at odds with others in the GCC.

GCC countries are also a diverse lot. Not all are overwhelmingly oil-based economies, with Bahrain and Dubai in the UAE moving towards diversifying their economies through property development, tourism and financial services. And inflation levels vary across the region. Each country currently has a separate central bank and it is not yet clear whether they will adopt the EU model of having its central bank set monetary policy for all nations using the single currency, or allows Gulf nations to exercise sovereign decision-making concerning domestic monetary policy. Yet the latter would appear problematic, of course, giving rise to arbitrage opportunities of borrowing cheap in one country to earn higher rates in another.

The establishment of an interim "monetary council" seems to suggest a weaker federation, and this is probably intentional to allow the bloc to figure out the final powers of a GCC central bank. A monetary council would try to set out agreed upon parameters for less contentious issues, such as bank supervision, capitalisation, risk management processes and internal controls.

This is where the experience of SAMA and Saudi Arabia's conservative policies finally prevailed, and handed Riyadh the coveted prize of the GCC central bank location. These issues are more important than trying to guess by what name the common currency might carry, which is presumably the next GCC milestone. And these are the issues Saudi Arabia must take the lead on now that it has been established as the headquarters for the central bank, and which can provide a viable regulatory platform that could be incorporated into the planned KAFD financial centre.

The establishment of the GCC Central Bank in Riyadh and the emergence of KAFD as a new powerful financial centre, albeit a mixture of socio-economic factors, will provide Saudi Arabia with a unique opportunity to establish new international strategic alliances and joint ventures with leading financial institutions in the capital and stock market sectors. It is not inconceivable that leading stock markets might decide to form strategic alliances for dual listing and trading in KAFD to take advantage of the emerging Saudi capital market and large financing needs for the demand led Saudi residential construction sector and planned mega cities, with an estimated combined investment need of over $ 1.5 trillion in the next 15 years.

While hosting the GCC Central Bank will give the Kingdom some regional and international political gravitas and international stature, along with its membership at the high table of the G20 leading world economies, it is the pace and direction of the domestic economy that are of more concern. If the current pace of economic diversification and development bears fruition over the next few years they will undoubtedly ensure that Riyadh's dream of establishing a new model regional financial centre becomes a vibrant reality and not just another desert mirage.

Saudi economic cities take shape

Compared with some other Arab economies hard hit by the global financial downturn, there is a mood of quiet optimism in Saudi Arabia and consumer confidence indexes reveal that Saudi citizens believe they will not be as badly affected as other countries worldwide. This sense of self-confidence seems to be sustained by some bolder strategic economic and social reforms implemented by King Abdullah, whether in the judiciary, educational or economic fabric of society. Buoyed by several years of budget surpluses, the Kingdom has embarked on structural economic reforms in both capital infrastructure and human capital development and the planned KAFD is manifestation of this mood of self confidence.

A key element of this strategy has been a reinvigorated regional economic diversification and more equitable wealth creation for all its citizens. This has been translated into the launching of special economic zones, or economic cities and KAFD is one such specialised initiative. As of 2009, the following economic cities have been launched with two more economic cities expected in Tabuk and Dammam. Table 2 below summarises the main features of the mega projects under way.

Saudi Economic Cities: Major Characteristics

Characteristic	Kind Abdullah Economic City	Prince Abdulaziz bin Musaed Economic City	Knowledge Economic City	Jazan Economic City
Location	Rabigh, Red Sea Coast, North of Jeddah	Hail, Northern Saudi Arabia	Madinah	Jazan, Southern Saudi Arabia
Project size ($ Billion)	$ 80 Billion	$ 23 Billion	$ 7 Billion	$ 30 Billion
Project Area Sq. m.	168 Million	156 Million	8 Million	110 Million
Project Details	Largest Saudi private sector development 260,000 apartments and 56,000 villas To generate 1 million new jobs Promoting energy and transportation related industries Sea port of 13.8 million Sq. m. handling 300,000 pilgrims	30,000 residential units 180,000 residents New airport 250,000 new jobs Agro industry and mineral exploitation services	Focus on knowledge based industries 30,000 housing unit. 20,000 new jobs 150,000 residents 4000 multi purpose commercial units Hotels	Heavy industries (aluminium, refinery, steel, power) Secondary industries (Fisheries, pharmaceuticals, tech parks) 500,000 new jobs.
Expected completion date	2020	2018	2020	2013 Phase 1 2023 Phase 2 2037 completion

Source: SAGIA

Table 2

By 2020, it is expected that the major phases of the economic cities will have been completed and the forecasted impact on the Saudi economy are for reaching. According to the Saudi Arabia General Investment Authority (SAGIA) some 1.3 million new jobs will be created, with the economic cities adding $ 150 billion to the Saudi GDP. They will attract over $ 100 billion of new investments domestically and from abroad, and their population will be three times that of Dubai, with an area four times that of Hong Kong. The Government of Saudi Arabia is forecasting that a staggering $ 800 billion will be invested in these economic zones and other mega projects including those by Saudi Aramco and SABIC over the next 20 years. No other country in the Middle East can match such grand project expenditures, which upon completion, will unleash Saudi Arabia as one of the major economic power houses of the world in league with India, China and Brazil as the undisputed leaders of the developing world. What is of more significance for Saudi Arabia, is the potential for the direct and indirect multiplier effect of these mega projects on secondary local industries and job creation in the wider Saudi economy.

KAFD: adding a total value package

The goal of the Saudi authorities seems clear, if somewhat ambitious: to turn Riyadh into a major centre for financial services on a global level. While it might take time to develop a truly global financial centre, as this often requires more than financial institutions office being relocated along with their regulators, but rather a whole range of support services and institutions being in place. These range from legal, accountancy, telecommunications, administrative and finance orientated education institutions, as well as a flexible and competent workforce to operate in these sectors. This takes time and is the reason why cities such as London for example, have remained pre-eminent over other contenders as the British capital can provide the full range of support services to its financial services sector.

KAFD understands the need to take a long term approach and the planning for the Riyadh financial district offers an integrated plan that is somewhat different from the other Gulf financial centres. According to the master plan, by the time KAFD is completed by 2015 it will offer a wide mix of offices, residential, educational, sports and cultural facilities with significant areas for the public realm in an attractive and eco-friendly landscape. The heart of the financial district will be the transformation of the Arabian Wadi Hanifa – the oasis riverbed – that transverses the area. The Wadi will become a pedestrian public space with retail outlets and cultural attractions. The Wadi will be accessible and linked to all the KAFD districts' public plazas and buildings by a network of fully integrated public transport system built around a monorail system, remote parking facilities for 40,000 cars and an integrated skywalk system. KAFD will constitute a new "mini city" in Riyadh in which both the public and financial world's activities creates a "City life" concept for 55,000 new workplaces. To ensure that the Saudi financial sector is well served by a professional and educated local work force, the KAFD will also open a financial academy for 5,000 students to improve the required skills, training and capabilities of future Saudi entrants. The project is expected to create some 43,000 new and high value jobs for the Kingdom.

Conclusion

The global financial crises of 2008 and 2009 was a wakeup call for many countries to re-examine their current financial operating models, and none more so than in the Arabian Gulf with the mushrooming of competing financial centres. The onset of de-regulation and globalisation has undoubtedly benefited many financial centres around the world. At the same time, globalisation implies that financial players are free to pack bag and relocate to competing centres that offer even more competitive attractions, incentives or market opportunities. Financial centres are then faced by two stark choices: either build up their financial centres to support their domestic economy and grow at a pace commensurate with internal development, or attract foreign financial institutions to relocate through incentives and hope that the local financial hub does not become "infected" by any international financial crises and the exodus of their high profile prestige tenants in times of uncertainty. The Saudi model is of the first kind and the Kingdom feels comfortable and maybe vindicated that its KAFD model will prevail in the long run, as it is built the on fundamental economic strengths of the Saudi economy, and its financing needs over the next few decades.