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Syria quickens the pace of financial sector reform

by Nick Lord

The country's banking reforms are going well and attracting regional interest. But western banking groups remain largely excluded because of Bush-era sanctions. Are they missing out on an incipient boom market? Nick Lord reports from Damascus.

BATOUL RIDA LEANS forward in her seat. "It has been so exciting," she enthuses."Five years ago there was nothing here. It was virgin territory." Rida, resplendent in a turquoise headscarf, is a splash of colour in the otherwise utilitarian offices of the Central Bank of Syria. She is employed by GTZ, a German technological cooperation company, and is seconded to the central bank as a reform expert.

For Rida and other reform-minded Syrians, the changes to the country's banking system are perhaps the most visible evidence of the economic changes in the years since president Bashar Al-Asad took over from his father. Five years since they started, the banking reforms have recently moved to a new level of intent.

In mid-January, the central bank increased the limit on foreign stakes in privately owned Syrian banks to 60% from the previous 49%. Foreign groups can now take majority control, albeit with a 40% stake owned by Syrian nationals. The previous limit of 49% is thought to have dissuaded many international groups from investing.

Privately owned banks in Syria were authorized in 2001, shortly after Asad took power. Allowing private ownership was one of the key moves in trying to free up the economy from its state-controlled, Baathist past. To date, 12 private banks have opened. These are in addition to six state-owned banks and three Islamic banks.

Initially the focus was on commercial and retail banking, but at the end of July the president issued legislative decree number 56, which allowed for the creation of investment banks. These can also have up to 60% foreign ownership but individuals are allowed no more than 5% of any institution. These banks will largely be active in the equity markets after the establishment of the Damascus Securities Exchange last year.

While the increased ownership levels have been well received, controversy surrounds the increase in capital requirements that are concurrently being imposed on the commercial banks and the investment banks. The minimum capital requirement for commercial banks has been increased from $30 million to $200 million ($300 million for Islamic banks). While the banks have until 2012 to make the increase, many are already complaining.

"The new capital requirements are a challenge for existing and for new banks," says Omar Al Ghraoui, general manager of Bemo Saudi Fransi Finance in Damascus. "A good portion of the banks operating here already suffer from excess liquidity."

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The capital requirements for investment banks are even more onerous. Initial reports suggested that newly incorporated investment banks would be required to have S£20 billion ($435 million) in capital at the local branch. Given that this would automatically prevent any single bank opening up, the requirement was then translated to a global capital base. Even so it is a large amount. None of the standalone investment banks from the region have such sums. And so it is a way to ensure that only the strongest banks will apply. The government is unapologetic about its desire to get the biggest banks – both commercial and investment – into the country.

All of the banks that have set up in the country have connections to the region, notably Lebanon. Banque Bemo Saudi Fransi (BBSF) was the first private bank to open. It is a joint venture between Banque Bemo of Lebanon and Banque Saudi Fransi of Saudi Arabia along with what are called "prime investors from Syria and Saudi family groups of Syrian origin". Other private banks with foreign participation that have entered the market include Arab Bank from Jordan, and Byblos Bank and Bank Audi from Lebanon.

New banks are applying for banking licences. Sources within Syria confirm that three Gulf banks are vgoing through the approval process: National Bank of Kuwait, Abu Dhabi National Bank and Global Finance House.

Also understood to be applying are some of Turkey's state-owned banks. Isbank has applied for a licence to open a representative office, as have Vakifbank and Ziraat Bank. All three are state-controlled banks and so their actions are a reflection of the Turkish government's desire to strengthen its ties with Syria. Notably absent are Turkey's private-sector banks; Akbank, the joint venture between Citi and the Sabanci family, has denied earlier reports that it has applied for a licence.

Sources suggest that initially the Turkish private banks were going to apply to open up fully fledged subsidiaries in Syria but have been put off by the ownership restrictions and the high capitalization costs. Nevertheless, Rida at GTZ confirms that new licence applications are being assessed by the central bank and will be awarded by the end of the year.

Good returns on capital?

For the new banks and the ones already in place, the problem with raising new capital is not one of fund raising per se; most come from large groups where an extra $100 million or $200 million is immaterial. The concern is rather the returns they can make from the capital.

Syria lacks product. On the retail side most activity is concentrated in consumer finance for auto loans and credit cards. Banks can lend at a fixed rate of 6%. However, with a lack of central credit checking bureaux, this lending is restricted to people in professions such as doctors who are thought to have the necessary income to be good borrowers. New laws are being prepared that will allow mortgages and leasing, which are absent at present.

BBSF is a case in point. It has a loan-to-deposit ratio of 35% and almost 50% of its deposits are in foreign currency, which it cannot lend out in either retail or commercial business. Even so, the bank is doing well. With $2 billion in assets it is the largest private bank in the country. Last year it made S£661 million in profits, making it Syria's second most profitable bank. Over the past two years it has been adding eight to 10 branches a year, bringing its network to 36 branches, the largest of any private bank in Syria.

But the bank needs to find ways to put its large deposit base to work. "We need to get proper investment vehicles," says Al Ghraoui. "We have been promised these, but they haven't materialized yet."

Most glaring is the lack of a government bond market. Under the terms of the latest five-year plan, 10% of the government's budget is scheduled to be raised through bonds. But these have not yet been issued. The finance ministry is dragging its feet. It reportedly feels that it should not have to pay for the money it spends: it has always had free tax revenues to spend. It is unclear why it is not fulfilling its obligations to the five-year plan. The ministry declined to comment for this article.

The central bank is taking a more active approach. Central bank governor Adib Mayaleh says that if the finance ministry fails to issue bonds, the central bank will start to issue certificates of deposit under its own name. This will provide a benchmark of sorts, as well as giving investors in the CDs a return. At the moment the central bank pays zero for funds that state and private-sector banks are obliged to deposit with it.

The central bank has undertaken some exercises in creating a market price for government debt, in turn creating product. This year it ran an auction on behalf of Syrian Airlines for €45 million in finance to purchase new aircraft. This exercise involved local banks offering an average price of 2.12% for one-year money, in euros. The winning bid came from state-owned Commercial Bank of Syria, which bid a mere 1.2% for the facility.

In local currency, the central bank undertook a similar exercise for a one-year crop-finance facility. This auction was won with a bid of 3.5% for S£46 billion from a group of private and government banks.

The fact is that Syria needs a lot of investment. The five-year plan calls for a large spending programme, especially in infrastructure. The authorities say that most of this has to come from the private sector. It is therefore incumbent on the government to create the market mechanisms that allow for this capital to be deployed efficiently. At the moment, the contradictions inherent in the system prevent this from happening.

Rida and Mayaleh at the central bank do not deny that the increased capital requirements being imposed on the banks are linked to the government's need for infrastructure finance. Sources also suggest that this is why the finance ministry is prevaricating on issuing bonds: it is forcing the banks to increase their capital and then not giving them anything apart from infrastructure projects to finance. This smacks of a return to the state-directed economy that the government is meant to be abandoning.

Little from the west

Despite the success of some of the early regional entrants, banks from the west are mostly absent from the Syrian market. Some French banks have indirect exposure, through their investments in Lebanese banks, which in turn have set up Syrian subsidiaries. But rows of gleaming HSBC ATMs or application forms for Citi credit cards – ubiquitous in most emerging markets – are absent.

The size of the market is one possible explanation, as are the inherent contradictions that beset Syrian banking. But at root are the sanctions that Syria faces from the US government, some of which are targeted on named individuals. There is also a specific sanction against dealing with Commercial Bank of Syria (CBoS), the largest state-owned bank.

The danger of unwittingly doing business with a named individual is as great as the difficulty in not doing business with CBoS. As a result, western banks have not even tried to enter the market. Spokesmen for HSBC and Citibank say that they are well aware of the recent moves to open the banking system but still they have no plans to invest.

Are these banks missing out on a boom that will pass them by before they are allowed in? Certainly the numbers that existing banks are posting look impressive.

"All the new banks in Syria have been profitable from day one," says Bisher Hashem, a founding director of Syria Rising, an investment company that is looking to raise the first western-style private equity fund to invest in Syria. "Although the returns of the banks will be reduced from 100% a year to 50% a year [due to capital requirement increases and new competition]", Syria Rising will not be investing in the financial services industry, although it is a member of the industry itself.

Contradictions

Another entrant to the market is EFG Hermes, the Egyptian investment banking group that is one of the most important players in the MENA region. Hazem Badran runs EFG Hermes Syria, which is in the process of setting up operations. It wants to offer a full suite of investment banking business, from IPOs and research to trading and asset management. Like Syria Rising, it is aiming to raise a private equity fund, with an initial size targeted at $300 million. The first $30 million will come from the company itself.

Badran points to one of the other internal contradictions that hampers the development of the financial services industry. According to the labour ministry, there is a 3% limit on foreign workers in a company's workforce. This restricts banks' and brokerages' expansion into new products. "The government does want to see the financial services sector grow," says Badran. "But it requires talent that is not available in markets that are just opening up."

Other changes to the tax laws and laws covering securities issues such as IPOs also need to be changed. At the moment most financial institutions are working through exemptions to these laws, which does not lead to a strong and stable market. "A lot of the laws in place today will make people shy away," admits Badran. "But my experience tells me that the government will change them and they definitely want to be cooperative."

Those banks with the capital to deploy and the stomach to deal with internal contradictions will find Syria a remarkably welcoming market. Led by the central bank, there is a willingness to open up. The first private banks have made good money and the next wave are likely to enjoy similar success. But history and politics may keep the big western banks away from Syria for some time to come. Within that window, the regional players could sew up the market.
