

MIDDLE EAST AND NORTH AFRICA REGION
GCC COUNTRY UNIT

Competition in the GCC SME Lending Markets: An Initial Assessment



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Abbreviations and Acronyms

AECB	Al-Etihad Credit Bureau
BCSB	Bank Credit and Statistical Bureau System
BDB	Bahraini Development Bank
C3	Three-bank concentration ratio
C5	Five-bank concentration ratio
CBB	Central Bank of Bahrain
CBK	Central Bank of Kuwait
CBO	Central Bank of Oman
CBUAE	Central Bank of the United Arab Emirates
GCC	Gulf Cooperation Council
ICN	International Competition Network
ITC	Information, Technology and Communication
KSA	Kingdom of Saudi Arabia
KD	Kuwait Dinar
MENA	Middle East and North Africa
NFSD	National Fund for SME Development
ODB	Oman Development Bank
OECD	Organization for Economic Cooperation and Development
PCB	Private Credit Bureau
PCR	Public Credit Registry
QCB	Qatar Central Bank
QDB	Qatar Development Bank
QR	Qatar Dirham
SAMA	Saudi Arabia Monetary Agency
SME	Small and Medium Enterprise
SOE	State-owned Enterprise
SRI	Saudi Arabia Riyal
UAE	United Arab Emirates

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Executive Summary

The countries of the Gulf Cooperation Council (GCC) have articulated a vision for sustainable economic development that highlights the need to diversify the productive base to reduce dependence on the hydrocarbon sector and create more employment opportunities for their young and growing population. Small- and medium-sized enterprises (SMEs) are central to this agenda. The GCC hosts an estimated 675,000 formal SMEs that account for 25 percent of employment. This is significantly below the global average SME employment contribution of 40 percent. While GCC SMEs operate predominantly in the trading and construction sectors, their presence in more valued-added manufacturing sectors remains limited.

Access to finance is one of the main obstacles to the growth of SMEs in GCC economies. Only an estimated 11 percent of SMEs in the GCC have access to credit, and about 40 percent of them identify lack of financial access as a major constraint. Although bank lending is the main source of financing for GCC firms of all sizes, SME lending penetration is very low, with an average of 2 percent of total loans, compared with 13 percent in non-GCC Middle East and North Africa (MENA), for example.

SMEs' limited access to financing reflects the interaction of demand, supply, institutional, regulatory, and other policy factors. Apart from obstacles arising from unfavorable investment climates, SMEs face several nonfinancial barriers related to their own capacities, including a lack of financial

accounts and of reliable credit histories. Banking systems are large, but lending is highly concentrated on large borrowers. Banks perceive SMEs as having a higher credit risk, and therefore demand higher risk premiums or collateral requirements. Financing alternatives outside the banking sector are limited. Policy interventions in recent years have partly mitigated access problems but have not addressed the root causes.

Weak competition in the banking sector is a particular supply-side factor that constrains SMEs' access to bank credit in the GCC.

International experience shows that bank competition promotes access to finance and improves the efficiency of financial intermediation without necessarily eroding the stability of the banking system. However, bank competition in the GCC is among the lowest in the world, largely due to strict entry requirements, restrictions on bank activities, relatively weak credit information systems, and a lack of competition from foreign banks and nonbank financial institutions. This is compounded by a relatively large presence of state-owned banks. Improving bank competition could play a pivotal role in the GCC strategy of economic diversification and increased access to finance for SMEs.

This report draws on fieldwork and available literature to assess competition in the GCC SME lending markets. Governments in all economies play a major role in the banking sector as promoters, owners, regulators and supervisors. Banking regulation is designed to achieve important social and economic goals, and it is generally recognized that greater competition yields positive returns to national economies and consumers. This

initial competition assessment gauges the scale and scope of potential impediments to competition caused by specific rules and regulations as well as by particular components of the institutional framework in the GCC. In particular, this report (i) ranks regulatory and institutional factors under the principle of maximizing the benefits of competition; (ii) highlights alternative arrangements that can meet the desired policy objectives while lowering impediments to competition; and (iii) identifies avenues for a more detailed evaluation.

This report analyzes how some key rules and regulations as well as institutional arrangements for the enforcement of competition law in the GCC may affect competition in the SME lending markets.

Rules and regulations may produce four principal types of negative effects on competition. They may (i) limit the possibility of entry or expansion in a market; (ii) create discriminatory operating conditions amongst market players; (iii) limit business strategy options, either by prohibiting certain competitive actions or by reducing the incentives to compete; and (iv) limit consumers' ability to choose. An effective competition law system underpins a pro-competition regulatory framework, and the implementation of competition policies depends on institutional arrangements. An inappropriate competition law system may exacerbate the competitive distortions introduced by rules and regulations.

The report's main findings follow:

- The state maintains a significant direct and indirect presence in the ownership of banks across all GCC countries.

State-owned banks tend to enjoy important advantages, including access to lower cost of funding and a lower perceived level of risk among investors and depositors, that may negatively affect competition and reduce benefits for SMEs and their customers.

- State-sponsored initiatives launched across GCC countries to bridge the SMEs' financial access gap may interfere with a level playing field in the banking industry. In principle, market failures and imperfections in SME credit markets in the region provide a rationale for direct government intervention. State-sponsored loans at subsidized rates, either through specialized institutions or through commercial banks, and credit guarantee schemes are among the most common measures adopted to address the under-provision of credit to SMEs. While valuable per se, these state-sponsored initiatives potentially distort the level playing field and displace private operators.
- Current bank licensing criteria may potentially stifle competition. GCC rules and regulations outlining the licensing process are not always clear. Clear rules on approval times and the possibility of appealing a rejection are lacking in half of the GCC countries. Some countries have residual restrictions on licenses and branches that limit banks' entry and expansion. More generally, initial capital requirements in the GCC are much higher on average than in comparable countries. This may reduce market contestability and prevent small-scale banks from entering the market.

- Some GCC countries set interest rate ceilings on customer loans, thereby reducing the signaling power of market prices in the allocation of capital resources. While interest rate ceilings may be justified in the absence of competition, in the long run price restrictions suppress market signals and may lead to decreased quantity and quality of loans supplied to SMEs.
 - Credit information coverage varies across GCC countries, and some employ cut-off thresholds for loan reporting. The degree of cross-sectorality and credit data memory also varies. Existing credit information sharing mechanisms provide both positive and negative information about SMEs, but their reliability and timeliness are not assured. Credit information sharing mechanisms appear non-discriminatory, yet the risk of distortion to competition arising from vertical integration is present.
 - Existing regulations appear to constrain SMEs' ability to switch banks to access more suitable financing options. Regulations on early settlement fees are heterogeneous across GCC countries, but suggest that, in general, SMEs incur costs when switching banks. Regardless of their amount, early settlement fees and closing charges introduce significant frictions in the SME lending markets and may impair entry and expansion insofar as they discourage SME borrowers from closing their existing lines of credit and moving to another bank. Safety against bank default is another factor pertaining to customers' choice. Deposit insurance schemes may positively affect switching by influencing customers' perception about banks' riskiness, compensating for reputational effects enjoyed by larger and state-owned banks. Deposit insurance schemes are largely present in the GCC, but their design and implementation vary across countries, with potential negative implications for competition.
 - Competition law systems in the GCC may need strengthening. Although all but one of the GCC countries have adopted explicit rules to protect competition, public awareness of the pro-competition provisions set in the relevant legislation is limited. Criteria for distinguishing between anti-competitive conduct and legitimate behavior are not clearly delineated. State-owned entities and firms subject to state direction and supervision are generally excluded from the application of the competition law. While the banking sector is not explicitly exempted, the applicability of competition law may be obscured by the large presence of state-owned banks, and the fact that banks are subject to public oversight. The independence and authority of institutions overseeing competition may need strengthening. Rules governing merger control are not always clear, and appropriate working relationships between competition authorities and central banks may need to be fostered.
- The findings of this report have several policy implications. This report identifies a number of areas where relevant regulations and institutional frameworks may impede competition in GCC SME lending markets, and require further investigation. Specifically, the report identifies eight broad policy areas where further analytical work is warranted.

Depending on the country context, additional and more specific policy areas would need to be considered.

- **First, governments in the GCC should conduct a detailed assessment of the anticompetitive effects of public ownership in the banking sector.** If an assessment reveals that state-owned banks impede competition, a competitive neutrality principle between state-owned banks and private operators could be enforced. Possible solutions range from privatization to measures aimed at mitigating the likely anticompetitive effects of public ownership, such as (i) reforming the corporate governance and oversight framework of state-owned banks to strengthen transparency and accountability; and (ii) amending all explicit provisions and business practices that could further distort the market.
- **Second, policymakers should consider measures to ensure that state-sponsored initiatives do not distort competition in the banking sector.** In principle, state-sponsored initiatives to support SME's access to finance should be designed in a way to set non-discriminatory participation conditions and establish business relationships between SMEs and banks. Optimal state-sponsored initiatives encourage banks to compete against each other and prospective borrowers to shop around for their preferred credit provider. A full competition assessment of current state-sponsored initiatives aimed at supporting SME financial access is warranted to identify gaps with respect to international best practices.
- **Third, policymakers should review the process through which banks may initiate or expand operations to ensure greater clarity and transparency.** Market contestability could be improved by removing potential obstacles and increasing clarity and transparency in the bank licensing process. Competition prospers when competitors perceive that entry is viable: contestability acts as a disciplining device on banks and mitigates their market power, even if actual entry does not occur.
- **Fourth, GCC governments can consider the potential benefits of introducing a tiered approach to prudential regulation.** Tailoring the application of rules and regulations based on the size, complexity and other characteristics of banking organizations is a useful way to implement a tiered banking regulatory system that encourages entry without exacerbating risks. In particular, revising capital guidelines to encourage entry of small-scale banks may positively affect market contestability in the SME lending markets.
- **Fifth, policymakers in the region should consider regulations limiting banks' strategic options.** For example, interest rate ceilings that suppress interest rates below free-market levels act as focal points and facilitate collusion. As a result, banks may ration credit, which privileges some SME borrowers and leaves most high-risk SMEs unserved. As banks advocate the need for a risk-based approach to lending, understanding the potentially negative impact of interest rate ceilings on competition is especially relevant.

- **Sixth, GCC governments could assess the credit information sharing environment to explore potentially discriminatory access conditions.** Although existing credit bureaus and credit registries appear to be generally well-received among banks, their role could be strengthened. Extending credit information coverage, improving timeliness and reliability of information, promoting regional and international harmonization, and undertaking initiatives aimed at connecting credit history registries with other sources of relevant financial and credit data would produce significant pro-competitive effects.
- **Seventh, governments could increase customers' mobility.** SMEs can stimulate interbank competition by comparing banks and switching if they are not satisfied with their current bank. Reducing switching costs could influence this behavior. GCC governments may therefore consider introducing explicit regulatory provisions that prohibit banks from charging closing fees. GCC governments could also promote knowledge-sharing in this area to develop common practices and tools that improve customers' mobility. Deposit insurance schemes might also be introduced or reformed to improve their coverage and avoid discrimination among banks. Formal deposit insurance schemes may affect switching by influencing customers' perception about banks' risk of default, compensating for reputational effects enjoyed by larger and state-owned operators.

- **Finally, GCC governments could consider further evaluating banking rules, institutions and enforcement of competition policy to improve SMEs' access to financing.** This report finds that the independent of authorities vested with the authority and power to enforce competition law should be strengthened. In the same vein, formal cooperation arrangements between competition authorities and central banks could be established to clarify the division of labor in the area of competition. Legal amendments to expand the scope of the competition law and/or the purview of the competition authority could also be considered. Soft law instruments concerning the definition of the relevant market, the scope of antitrust prohibitions, the criteria to be employed to grant exemptions, and the criteria to assess mergers, could also be considered. Revising the conditions that trigger an obligation to notify mergers is another option. Finally, GCC governments should develop and implement initiatives that increase stakeholders' awareness of the importance of competition among banks and its positive effect on SME access to finance and economic growth.

Table A below summarizes the critical factors potentially limiting competition in the GCC SME lending markets for each country.

Table A1 - Main Factors Potentially Affecting Competition in SME Lending Markets (by Country)

	Bahrain	Kuwait	Oman	Qatar	KSA	UAE
State ownership	The state has a significant stake in two out of three major local banks.	The state directly controls Kuwait Finance House.	The state has important stakes in five major local banks.	The state has important stakes in all five largest local banks. Cross-shareholding linkages exist among banks, which may soften competition.	The state has a share in all five major local banks.	The state holds majority shares in two of the five largest local banks.
State-sponsored initiatives supporting SME access to finance	Tamkeen, the main state-sponsored initiative addressing the under-provision of credit to SME through a credit guarantee scheme, is restricted to Islamic finance only.	The National Fund for SME Development currently collaborates with only a few banks. The experimental phase may have left distortions.	Participation to the credit guarantee scheme provided by the Oman Development Bank is restricted to two banks only.	Not relevant.	Not relevant.	Not relevant.
Licensing criteria	Not relevant.	The licensing process is characterized by areas of discretion and no clear deadlines on approval times. Initial capital requirements are set at a relatively high level. Limitations to foreign ownership apply.	The licensing process is characterized by areas of discretion and no clear deadlines on approval times. Initial capital requirements are set at a relatively high level. Limitations to foreign ownership apply.	Explicit restrictions apply to foreign entry. Initial capital requirements are set at a relatively high level.	The licensing procedures do not include clear deadlines for approval and there is no possibility to appeal a rejection decision.	The maximum number of branches of foreign banks is capped. No deadlines are set for approval and the possibility to appeal a rejection decision is not allowed. Furthermore, important limitations to foreign ownership apply.

<p>Price controls and restrictions on bank activities</p>	<p>Not relevant.</p>	<p>Ceilings on loan interest rates and tenure apply. Restrictions apply to banks with respect to sales of insurance products.</p>	<p>Explicit ceilings on loan interest rates are set.</p>	<p>Ceilings on loan interest rates and tenure apply to consumer loans. Conventional banks are no longer allowed to operate Islamic finance through an Islamic window.</p>	<p>Not relevant.</p>	<p>Not relevant.</p>
<p>Access to credit information</p>	<p>Not relevant.</p>	<p>Lack of accurate credit information on SMEs is a major constraint. Ci-Net, the private credit bureau, cannot collect and disseminate credit information on SMEs, while the facilities offered by the public credit registry do not meet the quality standards necessary for banks to effectively address the information asymmetry in lending markets. Ci-Net member banks may be granted a preferential treatment.</p>	<p>The private credit bureau provides basic information on credit history by SMEs. However, no advanced services – e.g. cross-sectorial information and credit scoring – are offered.</p>	<p>Not relevant.</p>	<p>SIMAH, the private credit bureau, is controlled by a subset of licensed banks. This may raise vertical integration issues and distort competition between member and non-member banks. Credit reports may allow for an excessive degree of transparency, lowering banks' incentives to compete.</p>	<p>Not relevant.</p>

<p>Barriers to customers' mobility</p>	<p>Though kept at relatively low levels, early settlement and termination fees are not capped at zero.</p>	<p>Early settlement fees and termination fees are not capped at zero. This, combined with demand-side issues (e.g. low financial literacy) may negatively affect customers' propensity to shop around. A formal deposit insurance scheme exists, but is not currently operational.</p>	<p>Early settlement fees and termination fees are not capped at zero. This, combined with demand-side issues (e.g. as low financial literacy) may negatively affect customers' propensity to shop around.</p>	<p>Early settlement fees and termination fees are not capped at zero. This, combined with demand-side issues (such as low financial literacy) may negatively affect customers' propensity to shop around. Furthermore, no formal deposit insurance scheme exists.</p>	<p>Early settlement fees and termination fees are not capped at zero. This, combined with demand-side issues (such as low financial literacy) may negatively affect customers' propensity to shop around.</p>	<p>Early settlement fees and termination fees are not capped at zero. Furthermore, no formal deposit insurance scheme exists.</p>
<p>Institutions and enforcement of competition policy</p>	<p>There is no comprehensive competition law and an independent competition authority.</p>	<p>Although the legal framework for competition law enforcement has been set up, the Competition Protection Authority is not fully operational yet.</p>	<p>The Authority for Consumer Protection may not be able to pursue its objectives due to insufficient resources and experience.</p>	<p>The Competition Protection and Anti-Monopoly Committee may lack sufficient legal authority to intervene in the banking sector.</p>	<p>Although the Competition Protection Council is fully operational, no cooperation agreement exist between the Council and SAMA.</p>	<p>The banking sector is explicitly exempted from the application of competition law.</p>

CHAPTER 1 | INTRODUCTION

The countries of the Gulf Cooperation Council (GCC) require growth and vibrancy among small- and medium-sized enterprises (SMEs) to diversify their economies and generate employment.¹ The GCC's current economic model, characterized by a reliance on oil as the main source of export and fiscal revenues, imported, low-wage labor in the private sector, and a concentration of economic activity in the low skilled non-tradable sector, has failed to produce the kind of viable tradable sectors and diversified economies that these countries need going forward. A key challenge for GCC countries is to generate private sector jobs to employ a young and rapidly growing population. In this context, SMEs provide an ideal channel through which GCC countries can foster private sector-led, higher value-added economic growth.

An estimated 675,000 formal SMEs in the region represent a potent source of job creation and economic diversification.² About 90 percent of SMEs are located in the Kingdom of Saudi Arabia (KSA), 5 percent in the United Arab Emirates (UAE), and the rest are spread throughout the remaining GCC countries. In KSA, SMEs comprise 95 percent of registered companies, compared with 90 percent in Oman and Kuwait, and 75 percent in Qatar. On average for the whole GCC, there are 16 SMEs per 1,000 people, accounting for 25 percent of employment.

1. The GCC includes Bahrain, Kuwait, Oman, Qatar, the Kingdom of Saudi Arabia, and the United Arab Emirates.

2. International Finance Corporation (IFC) Enterprise Finance Gap Database.

This is significantly below the global average of 30 SMEs per 1,000 people, accounting for 40 percent of employment. GCC SMEs dominate in the trading and construction sectors, and have room to grow in manufacturing, where they comprise only 5, 12, and 14 percent of total SMEs in the UAE, KSA and Bahrain, respectively (Hertog, 2010).

Limited access to finance is a key obstacle to the growth of SMEs in the GCC economies. Only an estimated 11 percent of GCC SMEs have access to credit, resulting in an estimated credit gap of US\$ 250 billion.³ About 40 percent of SMEs identify lack of financial access as a major or severe constraint. Although bank lending is the main source of financing for firms of all sizes, SME lending penetration is very low in the GCC countries. SME loans in the UAE represent only 4 percent of all lending; in the KSA, Kuwait and Oman, they account for 2 percent of all lending; in Bahrain, 1 percent; and in Qatar, 0.5 percent (Seetharaman, 2015). This compares with an average of 13 percent in non-GCC MENA countries (IMF, 2014).

SMEs' lack of access to finance in the GCC reflects demand, supply, institutional, regulatory, and other factors.⁴ Apart from obstacles arising from unfavorable investment climates, SMEs face several nonfinancial barriers related to their own capacities, including a lack of financial accounts and reliable credit histories. Although banking systems are large, loan concentrations are high, reflecting the focus of banks on large borrowers. Banks perceive SMEs as having higher credit risk, and therefore demand higher risk premiums

3. Ibid.

4. See Rocha et al., 2011; IMF, 2014.

or collateral requirements. Financing alternatives outside the banking sector are limited. Nonbank financial institutions, such as microfinance institutions, leasing companies, and private equity or venture capital firms, remain underdeveloped. Policy interventions in recent years to improve SMEs' financial access have partly mitigated access problems but have not addressed the root causes.

Weak competition in the GCC banking sector particularly constrains SMEs' ability to obtain bank credit.⁵ Theory makes ambiguous predictions regarding the effect of competition on access to finance, especially for firms. On the one hand, competition can reduce the cost of finance and increase the availability of credit, ultimately contributing to stronger economic growth (Besanko and Thakor, 1992; Pagano, 1993; Guzman, 2000; Carbó-Valverde et al., 2009). On the other hand, in the presence of information asymmetries and agency costs, competition can reduce access by making it more difficult for banks to internalize the returns from investing in lending, especially for opaque clients such as SMEs (Rajan, 1992; Petersen and Rajan, 1995). Although the relevant empirical literature does not clarify entirely this ambiguity, more recent evidence based on direct measures of market power as opposed to traditional market structure indicators suggests a significantly positive association between competition and access to finance, including for SMEs (Beck et al., 2004; Claessens and Laeven, 2005; Carbó-Valverde et al., 2009; Love and Martinez-Peria, 2012). These findings are confirmed

5. For a general discussion of competition in the financial sector see, for example, World Bank, 2013, and Claessens, 2009.

for the GCC economies: a background paper prepared for this study provides strong evidence that reducing both market concentration and market power in the banking sector boosts economic growth of financially dependent firms, and this impact is magnified for SMEs (Caggiano and Calice, 2016).

Competition brings about improvements in bank efficiency. There are two views on the direction of causality between competition and efficiency. One view, attributed to Hicks (1935), argues that monopoly power allows banks to relax their efforts and increase their cost base, predicting a positive link from competition to efficiency. The alternative view posits that better managed and more efficient firms can secure larger market shares, leading to more market concentration and less competition. In this case, causality would run from efficiency to competition (Demsetz, 1973). Although studies examining the link between concentration and efficiency find mixed results,⁶ the overwhelming majority of more recent studies employing direct measures of competition conclude that competition enhances bank efficiency.⁷

Competition does not necessarily undermine the stability of the banking sector. Many academics and especially policymakers have stressed the importance of franchise values for banks in maintaining incentives for prudent behavior (Keeley, 1990; Marcus, 1984; Matutes and Vives, 2000). Yet others have highlighted opposite effects where bank competition lowers interest rates

6. See Berger (1995); Goldberg and Rai (1996); and Berger and Hannan (1998), among others.

7. See, for example, Turk-Ariss (2010); Lin et al. (2010); Schaeck and Cihák (2008); Delis and Tsionas (2009); and Demirgüç-Kunt et al. (2004).

in the economy, making borrowers safer and reducing risks to the banking sector (Boyd and De Nicoló, 2005). More recently, some authors have shown that these two contrasting effects can be reconciled in models implying that an intermediate level of competition may be optimal (Martinez-Miera and Repullo, 2010). The extant empirical evidence obtains mixed results related to the relationship between competition and financial stability, although recent studies show that the impact of competition on stability is not linear, and crucially depends on the financial infrastructure of a country, the quality of its prudential regulation and supervision, and overall bank capital adequacy.⁸ Importantly, policy bodies such as the OECD Competition Committee have suggested that to promote banking stability policymakers should design and apply better regulations and supervisory practices rather than limit bank competition (OECD, 2011).

The GCC banking sectors operate under monopolistic competition. Both structural and direct measures of bank market power indicate that the GCC banking systems are among the least competitive in the world. Moreover, comparisons over time indicate that competition has not improved; in many cases, it has actually worsened. This is largely due to stricter entry requirements, restrictions to bank activities, weak credit information systems, and lack of competition from foreign banks and nonbank financial institutions (Al-Muharrami et al., 2006; Anzoategui et al., 2010). This pattern is exacerbated by a relatively large presence

of state-owned banks (see Al-Hassan et al., 2010). The GCC banking sectors continue to be characterized by significant public and quasi-public ownership, though the extent of public ownership varies considerably, ranging between 11 percent in Kuwait to 41 percent in UAE. Moreover, the state intervenes directly in SME credit markets through several state-sponsored initiatives.

Improving bank competition may play a pivotal role in the GCC's strategy to diversify their economies and increase SMEs' access to finance. Greater bank competition can improve the efficiency of financial intermediation without undermining financial stability. GCC governments can shape bank competition through their actions as regulators and enablers of a market-friendly and information environment, ensuring that implementation is supported by sound institutional arrangements. The purpose of this study is to provide insights into the degree of competition in GCC SME lending markets, uncover possible distortions to competition originating from the current regulatory and institutional framework, and suggest further investigative work in a number of policy areas.

SCOPE AND OBJECTIVES OF THE STUDY

SMEs comprise a broad variety of businesses in terms of activity, size and risk profile. They range from small corner shops to locally-established branches of multinationals, and from start-ups and to well-established ventures. OECD economies typically define SMEs using a combination of three metrics:

8. See, for example, Beck et al. (2004) ; Bretschger et al. (2012) ; Schaeck et al. (2009) ; Berger et al. (2009) ; Beck et al. (2006) ; Anginer et al. (2012) ; Jimenez et al. (2013); Uhde and Heimeshoff (2009); and Beck et al. (2013).

number of employees, annual turnover and balance sheet size. Conversely, most GCC countries lack a uniform official definition of SME. Some countries have introduced definitions only recently, and detailed and comparable historical information is not available. For the purpose of analyzing competition in GCC SME lending markets, this study follows as closely as possible the definition of SME adopted by banks in their internal operations. Microenterprises with self-employed persons fall largely outside the scope of this study.

SMEs demand access to three basic services commonly provided by the banking system: savings, borrowing and payments. These basic services are usually referred to as retail banking.⁹ Depending on their size and type of business, SMEs may also require products and services commonly belonging to the area of corporate banking, such as trade finance products (e.g. letters of credit, factoring).¹⁰ The focus of this study at the product level is on both secured and unsecured financing in all possible forms provided by banks to SMEs. Given the generally unsophisticated nature of the GCC's SME sector, as well as the dearth of alternative forms of bank financing such as leasing and factoring, this initial competition assessment focuses implicitly on overdrafts, loans and bank credit lines.

9. Individuals essentially rely on personal current accounts, which encompass several services such as allowing payments to be received and made, providing credit, and holding deposits. SMEs, on the other hand, may use a slightly more complex set of services, such as business current accounts, term deposit accounts, overdrafts, loans, equity and asset financing.

10. Corporate banking encompasses a wider variety of products, from treasury and cash management services to asset management and underwriting.

There are several ways competition may be impeded in a market. Among others, competition distortions may originate from (i) laws, regulations and institutions; (ii) implementation behavior; and (iii) the behavior of market participants. Clear rules are a prerequisite for healthy competition. Laws and regulations can alter market dynamics and prevent or restrict competition among market players. Inadequate governance and institutional arrangements (or their lack thereof) might hamper competition. Implementation behaviors, including the exercise of regulatory, supervisory and sanctioning powers, and the enforcement of laws and regulations, might also negatively influence competition. A typical example is the unequal enforcement of rules in the presence of unaccountable and non-transparent areas of discretion. Another example is how crisis situations, such as failing banks, are handled.¹¹ In addition, firms that are not monitored act in ways that increase their profits but harm society, including collusion, predatory or exclusionary behaviors, abuse of market power and anticompetitive mergers.

This report uses the analytical framework described above to provide an initial assessment of competition in the GCC SME lending markets. Governments in the GCC, like in the rest of the world, play a major role in the banking sector as promoters, owners, regulators and supervisors. GCC governments recognize the importance of banking regulation in achieving social

11. For example, allowing a failing bank to merge with a larger one might be a quick and safe solution to a stability problem, but it could create or strengthen a bank's dominant position, thereby increasing the risk of the bank abusing its position.

and economic goals, but could do more to promote competition in the banking sector to deliver economic benefits. This initial assessment helps to gauge the scale and scope of potential impediments to competition caused by relevant rules and regulations and by the institutional framework. Without compromising the GCC's social and economic policy objectives, this assessment ranks regulatory and institutional options under the principle of maximizing the benefits for competition, highlighting alternative arrangements that can meet the desired policy objectives with potentially less detrimental effect on competition, and paving the way for a more detailed evaluation.

Specific topics explored in this study include (i) restrictions to competition resulting from banking sector rules and regulations; (ii) the exercise of discretion by relevant institutions; and (iii) the role of institutional arrangements for the enforcement of competition law prohibitions and merger control.¹² The report does not provide an in-depth assessment of potentially anticompetitive conduct by market participants. It also does not include an in-depth assessment of the quality of the institutional arrangements for supervision and regulation of the banking sector.¹³ However, it analyzes the main institutional features that could be conducive to anticompetitive behavior.

This initial competition assessment builds on existing studies and utilizes information

collected through desk-based research and in-person stakeholder interviews conducted from June through December 2015. The most relevant secondary sources were reviewed, including existing sectorial studies, periodic analyses and the academic literature. Whenever possible, researchers evaluated primary sources of information, including banking laws, central banks' circulars, notices, and guidelines. In-person interviews helped to complement the sector analysis, validate information collected, and identify critical competition issues. Interviews also helped to uncover gaps in the awareness of competition policy issues stemming from existing regulations and institutional arrangements. Interview participants included representatives of (i) central banks and financial regulators; (ii) commercial banks; (iii) representatives of SMEs (i.e. associations, chambers of commerce); (iv) other relevant institutions, including credit bureaus and specialized institutions supporting SME access to finance; and (v) competition authorities.

While this report aims to serve GCC policymakers responsible for improving SMEs' access to finance through regulation, it considers the interactions of a broad range of actors, including bank regulators and supervisors, competition authorities, and relevant ministries and agencies. The study is also relevant to a broader range of policymakers whose policies and actions influence financial access. Although the report does not directly target banks and financial services providers, it is based on the principle, strongly supported by the empirical evidence, that private financial services

12. Only rules and regulations that specifically apply to the banking sector (and competition laws) are reviewed.

13. Some jurisdictions, such as the United Kingdom, mandate that regulators or supervisory authorities pursue competition policy objectives too.

provision is key to sustainable financial access for SMEs.¹⁴

ANALYTICAL FRAMEWORK¹⁵

Governments play a major role in the banking sector as promoters, owners, regulators and supervisors. Economics provide good reasons for the government to assume an active role in the sector to address market imperfections such as costs and uncertainties associated with (i) acquiring and processing information, (ii) writing and enforcing contracts, and (iii) conducting transactions. These market imperfections may create situations in which the actions of a few people or institutions adversely influence many other people in society. Government intervention in the sector through prudential regulation and direct involvement, such as by supporting state-owned financial institutions and programs, is needed to maintain financial stability, protect consumers and investors and, increasingly, to promote financial access.

Governments face the difficult task of choosing the best form of intervention to achieve intended policy objectives. In recent years, many countries have initiated reforms to improve the quality of regulations and enforcement institutions to minimize the extent to which national economies are subject to command-and-control forms of regulation. Impediments to competition, which can arise from poorly designed or excessively stringent regulations as well as from weak enforcement mechanisms,

can hinder the achievement of efficiency, quality, innovation, financial access and financial stability typically associated with greater competition. This competition assessment reveals the potential constraints to competition caused by some regulations and by the competition law enforcement system. This assessment employs a two-pronged analytical method to evaluate lending competition in the GCC: one that evaluates rules and regulations, including implementation behaviors; and another that assesses the competition law infrastructure, with special focus on the institutional arrangements to enforce competition policy. While rules and regulations analyzed in this report pertain directly to the SME lending markets, the institutional framework has wider ramifications and concerns the way competition policy is enforced in general.

Rules and regulations have the potential to negatively impact competition in four ways. They may:

- (a) limit the possibility of entry or expansion in a market;
- (b) create discriminatory conditions amongst market players;
- (c) limit business strategy options, either by prohibiting certain competitive actions or by reducing the incentives to compete; and
- (d) limit consumer's ability to choose.

These concepts are discussed in detail below.

14. See, for example, World Bank Group (2014b).

15. This study adopts the methodological framework from the OECD (2007; 2010).

Blocking or limiting entry

Blocking or limiting entry is probably the most detrimental competitive distortion. When shielded from potential competition, banks' market power increases. Banks may then have the ability and the incentive to protect their rents (Harbord and Hoehn, 1994). Regulation can significantly alter entry conditions in a market. Restrictive government policies create direct barriers to entry when they set a maximum number of firms that are allowed to enter a certain market or, in the case of the banking market, they do not clearly specify the criteria for issuing a license. In some cases, governments grant exclusive rights to a single firm, thus creating a legal monopoly (Demsetz, 1982).

Granting exclusive rights and fixing the number of licenses completely prevents effective entry. Even if the entrant can circumvent the entry limitation by offering products similar (and substitute) to the one subject to licensing, this would not alleviate concerns with the license regulation since the entrant would be forced to offer less attractive products and could not compete directly with the licensed firms (Lott, 1987). The only form of entry that these regulations allow is entry by acquisition, whereby the new firm enters the market by acquiring one of the licensed firms.¹⁶

Even if the number of licenses is not capped by the existing regulation, the conditions that firms must fulfill to obtain a license may impede, delay or reduce the scope

of entry. For instance, a regulation that imposes a certain minimal initial capital may deter potential suppliers from entering the market. Similarly, licensing provisions that impose significant entry sunk costs limit the possibility of entry (Djankov et al., 2002), such as when a prospective new bank has to fully deploy its ITC infrastructure before obtaining a license to operate.

Rules and regulations may affect entry to the extent they create unclear or conflicting rules or entail an unpredictable and arbitrary enforcement of laws. These circumstances increase the cost of entry, and may particularly influence the decision to enter a foreign market as they increase transaction costs (Djankov et al., 2003). Limitations to entry of foreign firms may also result from restrictive trade policies (Levine, 2006).

High exit costs can also deter entry. Economic agents incorporate the cost of exiting a market or downscaling operations in their ex-ante entry decisions (Siegfried and Evans, 1994). Exit is not easy in banking. Shareholders may exit by selling shares, but a bank must continue operations until its obligations to the depositors can be unwound. Effective resolution regimes for distressed financial institutions may, therefore, have important competitive implications.

Creating discriminatory market conditions

Rules and regulations may create discriminatory conditions among market players by providing a competitive advantage to a subset of firms. This can be the outcome of (i) subsidies and incentive

16. Some regulations may prevent this type of entry if they exclude secondary markets in which licenses can be traded. This would not constitute entry from a competition perspective since the number and relative size and market share of competitors would not change.

policies that are not correctly designed; (ii) uneven enforcement of regulatory provisions; and (iii) regulation designed to be applicable to firms according to subjective criteria rather than the type of service materially provided, causing firms competing in a partially overlapping product and service space to be subject to a different set of rules.

The presence of state-owned enterprises (SOEs) in the market might disadvantage private competitors. The concept of SOE covers a wide range of entities sharing the feature of government control, which can be exerted through various tools such as share ownership, direct assignment of works or simply activities carried out by a government agency. SOEs normally enjoy privileges and immunities that not available to their competitors. These privileges and immunities give them a competitive advantage that may alter the competitive process. State-owned banks, for example, may be perceived as a safer, more stable option, and have access to cheaper deposits (Sappington and Sidak, 2003).

The lack of competitive neutrality potentially alters banks' behaviors. In particular, the lack of competitive neutrality may:

- alter the incentives of firms enjoying a competitive advantage as they do not need to strive to win over competitors. This in turn may induce these firms to adopt less efficient technologies or organizations. Managerial slack reduces the level of productive efficiency and causes significant waste of scarce resources (within-firm effects);
- impede the redistribution of demand from the incumbent, inefficient firms in favor

of more efficient firms if the existing rules shield some firms from competition. This further decreases productivity (between-firms effect);

- incentivize firms in dominant positions to adopt anticompetitive foreclosing strategies that further depress the existing level of competition in the market. These foreclosing strategies may generate short- and long-term effects, such as leading to supra-competitive prices (e.g. service fees and interest rates) in the short and medium terms, and also reducing the incentives of smaller firms to invest in innovative products (e.g. on-line banking, new credit schemes) or production processes (e.g. faster creditworthiness screening, tailored business support) over the long term.

Limit business strategy options and incentives to compete

Regulations may limit businesses' strategy options by (i) constraining players' pricing decisions (e.g. ceilings or floors on interest rates); (ii) setting standards that impede the supply of products or services that would find an adequate demand, given customers' preferences and budget constraints; (iii) limiting banks' freedom to advertise products or choose distribution channels (e.g. internet) that best suit their competitive strategy; (iv) restricting other business tactics that banks might employ to attract customers, for example longer tenure and grace periods when extending loans to SME.

Some regulations do not directly limit the set of strategies that firms can adopt, but reduce their incentives to undertake competitive actions. In some sectors, governments,

rather than adopting a classical command-and-control model of regulation, ask market participants to engage in some form of self-regulation. While this is a more flexible regulatory tool, it entails some concrete competitive risks. The need to exchange views and information on issues pertaining to self-regulation provides firms with the opportunity to engage in collusive behavior, coordinating prices or other strategic and operative choices. Fostering collusion and coordination may also result from rules that force firms to exchange information on sales and prices or that require or encourage firms forming cooperatives or consortia for joint marketing of products.

The exemption of some activities from competition law may significantly reduce or even eliminate competition across firms. In these cases, regulation does not limit businesses' strategy options but increases them, explicitly allowing firms to engage in anti-competitive practices that are prohibited by competition laws in other sectors or to other players (Becker, 2007).

Limit consumers' ability to choose

Regulations may affect consumer decisions in a way that limits their ability to choose among competing suppliers. Consumers play a fundamental role in making markets work well: when consumers are in a position to make informed, well-reasoned choices, firms strive to offer products and services that best meets their needs at the lowest possible price. Underserved demand segments may attract new entrants.

Rules and regulations may confine customers to purchasing some services in a given area

or from some given suppliers, for example when salaries of public employees must be wired through a specific bank. These constraints may disadvantage buyers that purchase different goods or services outside a certain area or from different suppliers (e.g. through state-subsidized incentive schemes or special partnerships). This restriction gives suppliers market power over a specific set of buyers, thereby increasing their ability to raise prices. In these circumstances, firms are less responsive to the competitive pressure that would force them to improve the quality of their offer or increase the variety of goods and services provided (Fishman and Rob, 2003).

Regulations can influence buyers' ability to switch suppliers by intervening on switching costs. The costs associated with switching banks can be too high, in both monetary and non-monetary terms. This may occur by forcing buyers to enter into long-term contracts or requiring them to undergo a complex set of regulatory requirements when they intend to change suppliers (Kim et al., 2003). In the banking sector, for example, early settlement fees on loans and closing charges for current accounts are a typical example of switching costs capable of dampening competition. Similarly, inherent complexity of both the banking products themselves and the associated fees may discourage customers from shopping around for alternatives.

* * *

To develop an understanding of the potential constraints to competition in the GCC SME lending markets of different types of rules and regulations on competition, this study

discusses a set of rules and regulations grouped under the following categories (see Chapter 3):¹⁷

- (a) *State-sponsored initiatives supporting SME access to finance*: rules concerning the participation of market players in state-sponsored programs; features of government schemes.
- (b) *Licensing criteria*: features of the licensing process and extent of discretionary power of the regulator; explicit limitations on new licenses and branching; limitations to ownership; initial capital requirements.
- (c) *Price controls and restrictions on bank activities*: interest rate controls; line-of-business restrictions.
- (d) *Credit sharing information environment*: quality of credit information; accessibility at non-discriminatory conditions; factors that may facilitate anticompetitive behaviors by banks.
- (e) *Customers' mobility and propensity to shop around*: early settlement fees; explicit deposit insurance schemes.

* * *

An effective competition law system underpins a pro-competition regulatory framework. Implementation of competition policies depends on institutional arrangements. An inappropriate competition legal system may exacerbate competitive distortions introduced by rules and regulations. For example, the absence or inadequate enforcement of rules prohibiting

anti-competitive conduct may allow incumbents to (i) erect strategic barriers to entry or expansion; (ii) limit firms' ability to choose the most effective business strategies or curtail their incentive to compete; (iii) disadvantage some market agents; and (iv) create artificial switching costs that restrict the buyers' capacity to select the most convenient offer in the market. The same detrimental effects may stem from the absence of an appropriate merger control regulation.

Banking has traditionally been considered a special sector requiring a different treatment under competition law. Historically, scholars and policymakers believed that prudential regulation and competition law could produce divergent and conflicting effects.¹⁸ Thus, the aims of prudential regulation had to be considered prevalent and inform competition law enforcement of bank activities. This implied exceptions to the general competition rules and specific institutional arrangement for enforcement.

There is now a general consensus that a well-functioning competition legal system is essential to the protection and promotion of healthy competition in the banking sector and does not preclude prudential regulation. While the specificities of banking have to be taken into consideration in the implementation of competition policy, this does not justify a general exemption from competition law prohibitions or a significant shake-up of the institutional arrangement presiding competition policy (ICN, 2005; OECD, 2006).

17. The choice of rules and regulations analyzed in this report reflects the findings of the relevant empirical literature that has investigated the main sources of low bank competition in the GCC. See Al-Muharrami et al., 2006; Anzoategui et al., 2010; and Al-Hassan et al., 2010.

18. See Carletti and Hartmann (2003), Carletti and Vives (2007) and Carletti (2008) for a review of the literature and the policy debate.

Competition law comprises a set of rules concerning the prohibition of anti-competitive behavior. Conduct that distorts or eliminates competition is grouped into two broad categories: (i) anti-competitive agreements and (ii) abuses related to market dominance. Anti-competitive agreements include naked cartels that aim at fixing prices, allocating markets or customers or restricting output. Collusion may also be achieved through facilitating practices, such as the sharing of competitively sensitive information. Other anti-competitive agreements include vertical arrangements, such as exclusive contracts of resale price maintenance that restrain the ability of one of the parties to compete freely in the market. Abusive behavior refers to actions undertaken by a dominant firm or group of firms to exclude rivals. In some jurisdictions, excessive pricing by a dominant firm is considered exploitative abuse.

Competition law also includes the ex-ante control of mergers and acquisitions. The structure of the market may be altered when one firm acquires control over another, or when two previously independent firms form a jointly-controlled new entity. In many jurisdictions, one or both of the parties involved in such operations is obliged to notify a competition authority before undertaking it, when some conditions hold. The competition authority then has the power to block or authorize the merger, subject to some conditions and depending on whether the notified operation is likely to substantially lessen competition. This kind of negative impact on competition can result from three different circumstances:

- The market structure resulting from the merger, together with other relevant market conditions, leads to a collusive equilibrium (coordinated effects).
- The two merging firms gain or strengthen a dominant market position or, even if they do not become dominant, are very close competitors, and their merger would remove an essential competitive constraint and allow the new entity to exert market power unilaterally (unilateral or non-coordinated effects).
- The merger enables the new entity to acquire control of an essential input that might be used strategically to foreclose or marginalize rivals (foreclosure effects).

STRUCTURE OF THE REPORT

This assessment of the competition in the GCC's SME lending markets proceeds as follows:

- Chapter 2 presents the SME banking markets in the GCC by discussing the number and ownership patterns of banks, and evaluating measures of concentration and market power.
- Chapter 3 presents the results of an initial screening of selected areas of regulatory intervention that affect SME lending markets. The analysis concentrates on key areas where restrictions to competition can be identified. The chapter is organized in five sections, each focusing on a specific set of rules and regulations. Each section begins with an explanation of the analytical framework, and proceeds with an evaluation of the current status of

regulation. Each section concludes with a summary of potential policy options.

- Chapter 4 evaluates the effectiveness of competition laws in the GCC countries. Emphasis is given to the scope of competition law prohibitions as they apply to the banking sector; the proper application of criteria to potentially anti-competitive conduct; the identification of well-defined efficiency criteria to grant exemptions; the degree of independence of the institution entrusted with the power to enforce competition law and its relation with the central bank; the adequacy of competition authority's investigative and sanction powers and the existence of a leniency program; and the existence of a merger control regulation.
- Chapter 5 concludes by highlighting areas where further analytical work may be warranted.

CHAPTER 2 | SME BANKING IN THE GCC COUNTRIES

NUMBER OF BANKS

Outside of Bahrain and UAE, all GCC countries are characterized by a relatively low number of active banks.

- **Bahrain:** As of July 2015, Bahrain hosted 28 licensed retail banks, including 13 locally incorporated banks and 15 branches of foreign banks.¹⁹ Both conventional and Islamic banks operate in the country. The total size of the retail banking sector is expanding. However, no new retail banks have entered the market for several years and no inquiries by prospective entrants have been registered recently. The Central Bank of Bahrain (CBB) seems to be in favor of possible consolidation in the sector. The three largest banks (Ahli United Bank of Bahrain, Bank of Bahrain and Kuwait and Ithmaar Bank) are domestic.²⁰
- **Kuwait:** There are 10 domestic commercial banks (five conventional and five Islamic banks), one specialized bank (Industrial Bank of Kuwait) and 12 foreign bank branches (including one foreign Islamic bank branch). Both the number of branches of foreign banks in Kuwait and

their operations are very limited. Since March 2014, the Central Bank of Kuwait (CBK) has permitted foreign banks to operate multiple branches (previously limited to a single outlet), but the effects of foreign banks' expansion have not yet materialized.

- **Oman:** At the end of 2014, there were 16 commercial banks, including seven locally incorporated institutions and 9 branches of foreign banks. Two of the licensed banks are specialized credit institutions (Oman Housing Bank and Oman Development Bank).²¹ In 2012, banks already active were allowed to offer Islamic banking services. Two banks have started full-fledged operations based on Islamic banking principles, while six banks have established windows for practicing Islamic banking. The latest entrant in the market, Bank Sohar, was licensed in 2006. In 2013, two active banks (HSBC and Oman International Bank) merged, and other consolidation processes are expected in the near future. The two banks with the largest branch networks, Bank Muscat and HSBC Bank, are domestically owned.
- **Qatar:** There are currently 11 domestic banks and seven branches of foreign commercial banks.²² The 11 domestic banks consist of 10 commercial banks, comprising six conventional banks and four Islamic banks. There is one bank (Qatar Development Bank) focusing on SMEs.

19. CBB Register, available at <http://www.cbb.gov.bh/assets/CBB%20Register/CBL-July2015.pdf>, retrieved on 15 December 2015.

20. Ahli United Bank of Bahrain and Bank of Bahrain and Kuwait are conventional banks; Ithmaar Bank is an Islamic bank.

21. Oman Housing Bank provides soft financing mainly to low and middle-income nationals to build or purchase residential property, whereas Oman Development Bank caters to private sector investors focusing on small projects.

22. See directory, available at http://www.qcb.gov.qa/English/SupervisionApproach/LicensingAndRegistration/Documents/Banks_Directory_Dec2014_En.pdf, retrieved on 15 December 2015.

In 2011, the Qatar Central Bank (QCB) stipulated that conventional banks would have to cease offering Islamic banking services by the end of year. No new bank licenses have been granted in recent years.²³ QCB does not actively encourage new entrants, but exceptions are possible on a reciprocity base and few inquiries by prospective entrants have been registered. The three largest banks active in Qatar (Qatar National Bank, Commercial Bank of Qatar and Qatar Islamic Bank) are domestically owned.

- **KSA:** only 12 locally incorporated commercial banks operate in the KSA, whose population stands at about 29 million. Since 2005, the Saudi Arabia Monetary Agency (SAMA) has gradually granted 12 licenses to foreign banks to establish a branch in the country. However, foreign branches remain niche players.
- **UAE:** In 2015, a total of 46 commercial banks operated in the country, of which 22 are locally incorporated, and the rest are foreign branches.²⁴ Foreign banks are generally permitted to operate a maximum of eight branches, but exemptions are possible subject to special permission.

OWNERSHIP STRUCTURE

Banks' ownership structure in the GCC countries is characterized by the direct and indirect control of the state.²⁵

23. Barwa Bank was established in Qatar in 2009. See http://www.qcb.gov.qa/English/SupervisionApproach/LicensingAndRegistration/Documents/Registered_Banks_Dec2014_En.pdf

24. See http://www.centralbank.ae/en/index.php?option=com_content&view=article&id=149&Itemid=97, last accessed on December 2015.

25. All data refers to December 2015.

- **Bahrain:** The government has a significant stake in two of the three major banks. The Social Insurance Organization²⁶ and the Pension Fund Commission of Bahrain have a 13.3 percent and 18.8 percent stake in the second largest bank of Bahrain (Bank of Bahrain and Kuwait), respectively while the Kuwait Investment Authority owns 18.7 percent. Ithmaar Bank – the third largest bank – has 25.4 percent in Bank of Bahrain and Kuwait. The Bahraini Ministry of Finance has a minority stake in Ithmaar Bank (1.38 percent), whose majority shareholder (45.7 percent) is the Dar Al Maal Al-Islami Trust, an Islamic holding company founded by Saudi Prince Al Faisal. Ahli United Bank is owned by the government of Kuwait (22.7 percent of shares) and by the Bahrain Pension Fund (9.7 percent).
- **Kuwait:** Compared to other GCC countries, state ownership in the banking sector appears to be less pervasive. There is one bank – Kuwait Finance House – which is controlled by the government through a combination of direct (10.5 percent of total shares) and indirect shares (other public institutions and authorities hold a 38.4 percent stake).
- **Oman:** The government holds significant shares in five major banks. The government directly owns 23.6 percent shares of Bank Muscat, the largest bank of Oman. Another 14.8 percent is controlled by various pension funds and the Authority for Social Insurance. A 24.8 percent stake

26. The Social Insurance Organization is the official authority responsible for providing social insurance services to all individuals covered by Pension Civil Law and Social Insurance Law in the Kingdom of Bahrain.

in the National Bank of Oman is also indirectly attributable to the government. Qatar Commercial Bank controls 34.9 percent of National Bank of Oman's shares. A 26.8 percent of total shares of Bank Dhofar are indirectly controlled by the government (through pension funds and Public Authority for Social Insurance). The government also owns a 12.3 percent share in Bank Sohar.

- **Qatar:** The government holds large stakes in all five largest local banks in the country. The Qatar Holding LLC (a public global investment house established in 2006 by the Qatar Investment Authority) holds the largest share in Qatar Commercial Bank (16.7 percent) and in Doha Bank (16.7 percent). The Qatar Investment Authority holds 50 percent of Qatar National Bank and 17.4 percent (largest share) of Qatar Islamic Bank. Finally, Masraf Bank is controlled by the Qatar Holding LLC (11.9 percent), Government of Qatar (9.3 percent), Qatar Foundation (3.6 percent) and Qatar National Bank (3.3 percent). According to stakeholder interviews, major Qatari banks have cross-shareholding linkages.
- **KSA:** The government has shares in all five largest banks. Of particular mention are the National Commercial Bank, owned through the Public Investment Fund (44.3 percent of shares) and the Public Pension Agency (10 percent); and Bank Riyadh, of which the Public Investment Fund owns 21.8 percent while another 9.2 percent is owned by the Public Pension Agency.
- **UAE:** The government holds majority shares in two of the five largest banks,

namely National Bank of Abu Dhabi (41.2 percent of shares) and Abu Dhabi Commercial Bank (38.4 percent of shares). Emirates National Bank is owned by the Investment Corporation of Abu Dhabi (38.6 percent of shares), while the Dubai Islamic Bank is owned by the Investment Corporation of Dubai (a sovereign wealth fund owned by the government of Dubai). First Gulf Bank shares, instead, are dispersed among several private companies.

State-owned banks might benefit from preferential treatment. Compared to privately-owned banks, state-owned banks in general benefit from a lower cost of funding (a cost advantage) as a result of their special relationship with other state-owned companies, and a lower perceived level of risk among investors and depositors. Hence, the presence of state-controlled entities in the market can distort the playing field. A full assessment of the impact of state-owned banks on competition may be warranted to ensure that a competitive neutrality principle between state-owned banks and private operators is in place and operational. If not, possible solutions to mitigate the potential anticompetitive effects of public ownership range from privatization to a set of measures aimed at, including:

- reforming the corporate governance and oversight framework of state-owned banks to strengthen transparency and accountability, and ultimately level the playing field;²⁷
- designing and implementing government-sponsored initiatives (see Chapter 3.A)

27. See, for example, World Bank Group (2014a).

capable of alleviating the problem of higher cost of capital for non-SOEs;

- introducing a formal deposit insurance scheme (discussed in chapter 3.E) insofar as it may contribute to increase customers' confidence in non-SOEs; and
- amending all explicit provisions and influencing business practices that, combined with the presence of SOEs, could further distort the market. For example, in some GCC countries public employees are mandated to receive their salaries through a specific bank, usually a state-owned bank.

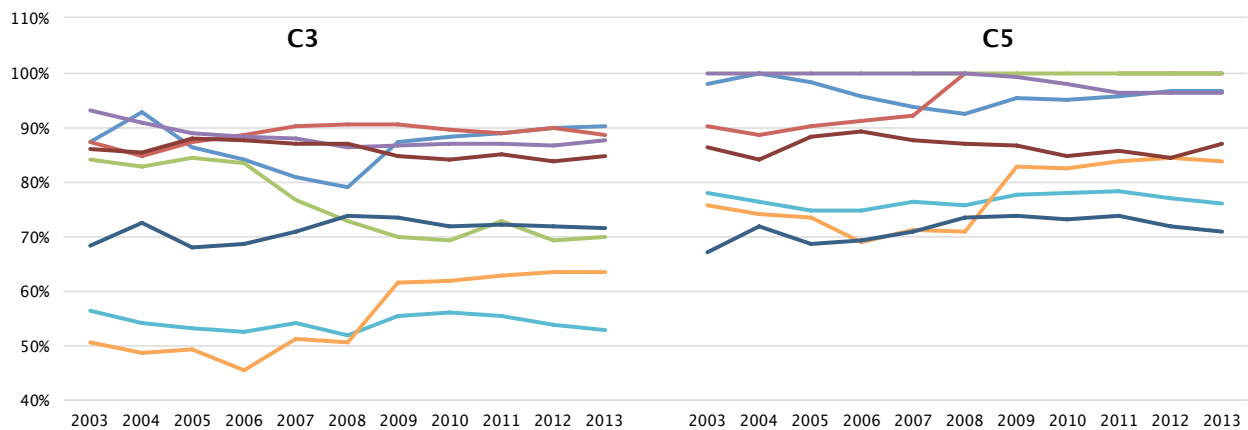
Cross-ownership linkages among banks may also weaken incentives to compete. The effects of cross-ownership on competition have been widely investigated in the economic literature: cross-ownership can

move the market equilibrium closer to the monopoly solution, even when cross-ownership does not involve controlling positions (Spiegel and Gilo, 2003; Gilo, 2000; O'Brien and Salop, 2000; Maxwell et al., 1999).²⁸ A detailed assessment of the potential competitive distortions introduced by this practice, which is present in particular in Qatar, may be warranted.

MARKET CONCENTRATION

Banking sectors in all GCC countries are characterized by high levels of market concentration. Figure 1 below shows the evolution of 3-bank (C3) and 5-bank (C5) concentration ratios for each GCC country over the period 2003 to 2013, benchmarking it against OECD and non-GCC MENA.²⁹

FIGURE 1: Banking Sectors in the GCC: CR3 and CR5, 2003-2013



Source: Global Financial Development Database, World Bank

28. Empirical research confirms these theoretical findings: for example, Trivieri (2007) analyzes the Italian banking market in the period 1996–2000 and finds that banks involved in cross-ownership compete less aggressively than other national credit institutions.

29. C_k is computed as the sum of the market share of the k largest firms. Hence, C3 is the sum of the market share of the three largest banks, whereas C5 is the sum of the five largest ones.

Ratios are computed considering market shares in terms of total assets in the banking sector, hence they are not specific to SME banking operations. Specific information for SME banking is not publicly available. However, in-person interviews indicated that a significant portion of financing to SMEs come mostly from large local banks. Thus, concentration in SME lending markets is likely to be higher than what is observed for the banking sector as a whole. Country-specific details follow below.

- *Bahrain*: Both C3 and C5 are well above the OECD average. In recent years, C3 has come closer to the MENA average yet C5 has remained considerably higher.
- *Kuwait*: The country shows very high and stable C3 and C5 indexes, which are above the OECD average. C3 was close to MENA level, while C5 has progressively increased since 2008.
- *Oman*: Notwithstanding a reduction of C3 from 83.3 percent in 2006 to 69.8 percent

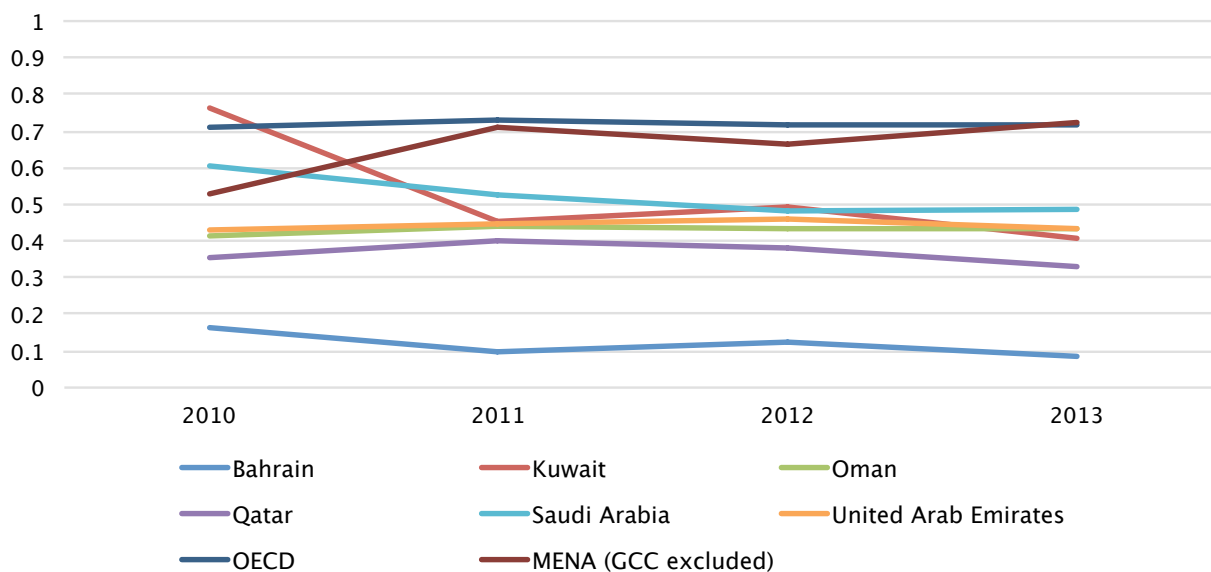
in 2013, C5 continues to be very high and above both the OECD and the MENA average.

- *Qatar* has the highest concentration ratios, with C3 and C5 around 90 percent and 100 percent, respectively, in 2013.
- *KSA* shows stable C3 and C5 indexes. C3 is lower than the OECD average (76.0 percent vs. 70.8 percent in 2013), whereas C5 is slightly above it.
- *UAE* has seen an increase in both C3 and C5 starting in 2009. C5 is now 83.6 percent, standing above the OECD average (70.8 percent) and close to MENA's (86.9 percent).

MARKET POWER

Banking sectors in the GCC economies operate under monopolistic competition. Non-structural and direct measures of market power, such as the H-Statistic and the Lerner

FIGURE 2: Banking Sectors in the GCC: H-statistic, 2010 - 2013



Source: Global Financial Development Database, World Bank

index (see below) computed on bank-level data, indicate that GCC banking systems have relatively low levels of contestability. Comparisons over time indicate that competition has not improved and in many cases has actually worsened.

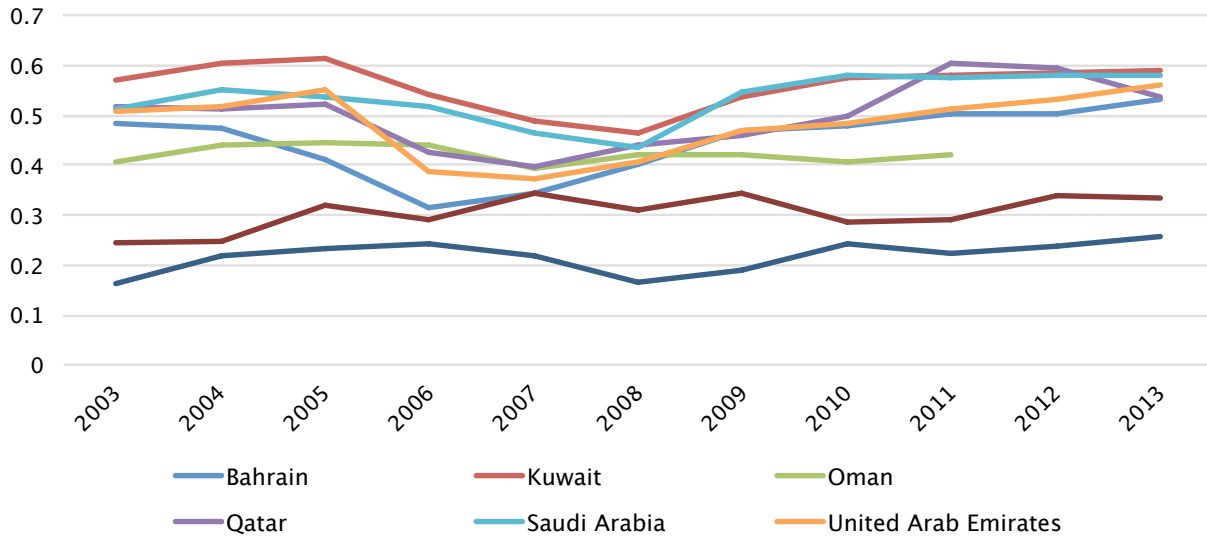
H-statistics calculated for the GCC countries are significantly lower than the OECD and MENA benchmarks.³⁰ Figure 2 compares the H-Statistic for the banking sector in each of the six GCC countries to the OECD average and the average for MENA countries (GCC region excluded) during the period 2010 to 2013. None of the GCC countries shows an H-Statistic close to 1, which would signal perfect competition. Both OECD and MENA averages – used as a benchmark – are significantly closer to 1. No sign of improvement of this metric can be identified for GCC countries.

Lerner indexes in the GCC countries are significantly and persistently higher than the OECD and MENA benchmarks and show a more prominent increasing trend.³¹ Figure 3 below presents the evolution of the Lerner index over the period 2003-2013 for the six GCC countries, and benchmarks it against the average value measured in the OECD and in the MENA countries (GCC region excluded). As the figure indicates, for all GCC countries the Lerner Index is well above the competitive level (zero), and has increased in recent years. Moreover, banking sectors in all GCC countries appear to illustrate a trend of increasing market power that is stronger than the similar trend observed in the OECD and the MENA region. Qatar, the only country showing a trend inversion in 2011, still ranks high in terms of banks' market power as measured by the Lerner index.

30. The Panzar-Rosse indicator (Panzar and Rosse, 1977, 1982, 1987), often called H-Statistic, is one of the most widely applied indicators of competition in the banking sector. It measures the elasticity of banks' revenues relative to input prices. Under perfect competition, an increase in input prices raises both marginal costs and total revenues by the same amount, hence the H-statistic equals 1. Under monopoly, an increase in input prices results in a rise in marginal costs, a fall in output, and a decline in revenues, leading to an H-statistic less than or equal to 0. When the H-statistic is between 0 and 1, the system operates under monopolistic competition. However, it is also possible for the H-stat to be greater than 1 in some oligopolistic markets.

31. The Lerner Index (Lerner, 1934) is a popular measure of market power in empirical research. The level of market power of a firm is measured by the difference between the firm's price and its marginal cost normalized by prices. The index ranges from a low of 0 to a high of 1. Under perfect competition (no market power), firms price at marginal costs and the index is equal to zero. Higher values imply greater market power. The Lerner Index has been in use since the mid-1930s. However, because of the difficulty in assessing marginal costs, its application to the banking sector is relatively recent (Florian, 2014). Furthermore, it is important to note that the use of the Lerner Index in banking poses some problems. For example, typically it is calculated without consideration for risk. Both the Lerner Index and market concentration are endogenous and determined by more fundamental variables, such as entry conditions and the degree of product differentiation.

FIGURE 3: Banking Sectors in the GCC: Lerner index, 2003 - 2013



Source: Global Financial Development Database, World Bank

CHAPTER 3 | ASSESSMENT OF RULES AND REGULATIONS

STATE-SPONSORED INITIATIVES

State-led initiatives to bridge the financial access gap of SMEs may have important implications for competition in the banking sector. To foster competition, state interventions should be designed in a way to minimize distortions to a level playing field and to avoid displacing private operators. In principle, it is advisable to design these initiatives to facilitate the establishment of business relationships between SMEs and commercial banks.

Optimal state-sponsored initiatives encourage banks to compete against each other, and prospective borrowers to shop around for their preferred credit provider. Competitive mechanisms perform best when the credit risk of a project applying to a support scheme is assessed by the bank that will grant the credit. If this is the case, different banks may be able to offer different conditions according to their risk appetite. Similarly – from a competition policy perspective – caps on interest rates are to be preferred to fixed interest rates to ensure that banks can go below suggested interest rates if willing to do so. Furthermore, it would be advisable for competition authorities to closely monitor the market so that state-sponsored initiatives do not contribute to the creation of focal point for banks to coordinate their behaviors.

Many state-sponsored initiatives have been launched across GCC countries. Some of

them focus on startups and early stage finance, a segment of the market that banks do not typically serve due to its inherent riskiness. Many initiatives, however, are open to established businesses. Direct loans at subsidized rates, either through specialized institutions or through commercial banks, and credit guarantee schemes are among the most adopted measures to address the under-provision of credit to SMEs.

The main provisions regulating the most important support schemes for SMEs are assessed below on the basis of the analytical framework presented in Chapter 1. To identify possible negative effects on competition, this section focuses on

- *rules concerning banks' participation in the initiative*, insofar as they may create discriminatory conditions amongst market players; and
- *specific features of each scheme*, which may unduly restrict banks' business strategy options, soften their incentives to compete, or restrict SMEs' ability to shop around.

The current status of state-sponsored initiatives

Table 1 summarizes the main state-sponsored initiatives aimed at improving financial access for SMEs in each GCC country.

In Bahrain, the most important state-sponsored initiative addressing the under-provision of credit to SMEs is Tamkeen. Tamkeen was set up in 2006 and supports SMEs in accessing credit by means of a program confined to Islamic banks only. The program offers SMEs a 50 percent subsidy on

Table 1: Main State-Sponsored Initiatives in the GCC

	Bahrain	Kuwait	Oman	Qatar	KSA	UAE
Name	Tamkeen ³²	National Fund for SME Development ³³	Oman Development Bank; ³⁴ Riyada	Qatar Development Bank ³⁵	KAFALAH ³⁶	Khalifa Fund; ³⁷ Dubai SME ³⁸
Type	Islamic	Conventional	Conventional	Conventional	Islamic	Conventional
Direct financing	Yes, between BHD 5,000-250,000	Yes, up to 80 percent of projects value (max KD 500,000 per company)	Yes, up to 1 million OMR per loan (ODB)	n/a...	n/a	Yes
Credit guarantee scheme	Up to 50 percent of the principal	n/a	Yes, up to 50 percent of the principal	Yes, up to 80 percent of the principal (case by case assessment and portfolio program)	Yes, up to 80 percent of the principal	Yes
Participation requirements	Open, but mostly partners BDB	Currently a few banks	Selected banks (currently 2 banks, will increase to 5)	Open, all active banks	Open, all active banks	Selected banks

Source: Elaboration based on publicly available data and stakeholder interviews

the profit rate charged by the bank providing the loan, and guarantees the bank 50 percent of the principal. Bahrain Development Bank (BDB) is the most important partner of Tamkeen.

In Kuwait, the government is actively trying to improve SMEs' access to finance through the recently established National Fund for SME Development (NFSD). To this purpose, NFSD has been endowed with KD 2 billion

(about US\$ 6.5 billion) to be used both to extend direct credit to selected SMEs and for training initiatives. After an experimental phase where NFSD collaborated with one bank only, it now partners with a few domestic commercial banks. The project is restricted to existing SMEs that are 100 percent Kuwaiti-owned, which can approach either NFSD or the partner banks to take part in the scheme. NFSD can support projects up to a pre-defined size and directly finance up to 80 percent of the project value at a flat two percent interest rate, while the remaining part is financed by the partner bank at a "market" rate. According to information collected, NSFSD operates by directly transferring funds to the bank account of

32. See <http://www.tamkeen.bh/en/>

33. See <http://nationalfund.gov.kw/en/>

34. See <http://www.oddb.com.om/>

35. See <http://www.qdb.qa/English/Pages/default.aspx>

36. See <http://www.sidf.gov.sa/en/Achievements/Pages/SmallandMediumEnterprises.aspx>

37. See <http://www.kfgateway.com/en>

38. See <http://www.sme.ae/English/pages/default.aspx>

the SME borrower, thus *de facto* granting relatively cheap liquidity to the commercial bank, which finances the remaining 20 percent of the project, while retaining credit risk on its books.

Oman has established several concurrent initiatives to improve access to finance for SMEs, and there is an ongoing effort to harmonize them. Among state-led support initiatives, the Oman Development Bank (ODB) plays an important role. ODB is a licensed government institution with the specific mandate to support SMEs. According to stakeholder interviews, ODB's operations are heavily regulated. In particular, ODB can directly extend subsidized loans and offer working capital facilities within pre-specified limits. At the same time, ODB can partner with other commercial banks and offer credit guarantees on their SME credit facilities. Currently, ODB is offering its guarantee scheme through two partner banks only. According to information collected, there is another SME credit guarantee program operating in Oman, managed by the Public Authority for Small and Medium Enterprises Development (Riyada). The latter program seems to enjoy a wider acceptance due to more favorable financial terms and the existence of a longer moratorium period than the original ODB scheme. Riyada also manages a direct lending scheme.

In Qatar, the Qatar Development Bank (QDB) is the most important initiative undertaken by the government to reduce the SME financial access gap. QDB's main tool is a partial credit guarantee scheme. Within this scheme, QDB offers banks a guarantee on up to 80 percent of the principal of approved SME loans. In exchange for the guarantee, banks partaking

in the scheme cannot charge an interest rate higher than seven percent. Eligibility criteria and the main features of the scheme are clearly detailed. QDB does not deal directly with prospective borrowers, but encourages SMEs to shop around for their preferred bank. Participation in the scheme is open to all banks, and the process to enter into the framework agreement with the QDB seems transparent and objective. The approval of projects submitted by partner banks under the portfolio scheme is automatic up to a pre-agreed total exposure ceiling, provided that eligibility criteria are met.

In KSA, the Kafalah Guarantee Program is the main vehicle aimed to improve SMEs' access to finance. This is a public-private partnership SME credit guarantee scheme spearheaded by the Saudi Industrial Development Fund (SIDF), a specialized state-owned bank backed by the Ministry of Commerce, to promote economic growth and SMEs' access to finance within KSA in partnership with commercial banks. Under the Kafalah Guarantee Program, commercial banks are guaranteed 80 percent of the loan principal for tenures up to seven years. Unlike the homologous initiatives in other GCC countries, there is no set cap on the profit rate. Stakeholder interviews indicate that participation is open to all banks that meet certain requirements and agree to an injection of capital into the program. Banks are willing to participate to benefit from a reputational element while actual usage of the program varies among institutions. The Kafalah Guarantee Program has been operating for the past ten years. Its governance structure is currently undergoing major reforms.

In UAE, different Emirates have devised their own initiatives to support SMEs. In Abu Dhabi, the Khalifa Fund supports SMEs mainly through direct lending, for which it has credit administration agreements with a limited number of banks. The Khalifa Fund also operates a credit guarantee scheme with a cap on the interest rate. In Dubai, the Dubai SME offers a similar guarantee scheme.

Possible policy improvements

Initiatives to enhance access to finance for SMEs are reported to be successful in Bahrain; however, introducing funding programs for conventional banks could stimulate competition with Islamic banks to the benefit of SMEs. According to stakeholder interviews, Tamkeen is currently helping reduce the financial gap by SMEs. Nonetheless, access to Tamkeen programs is limited to Islamic banks only. As some products are offered by both conventional and Islamic banks, this may alter the level playing field in the market and decrease the possibility for SMEs to select their preferred bank. Furthermore, the 50 percent subsidy of the profit rates charged by banks might reduce the incentive for SMEs to shop around, thus reducing competitive pressure on banks, and lead to higher prices. A detailed assessment of the Tamkeen and whether its current design and implementation negatively impact competition may be warranted.

The main state-sponsored supporting initiative in Kuwait would benefit from active participation of more commercial banks to avoid a negative impact on competition.

The experimental phase during which NFSD entered into a framework agreement with just one bank, Gulf Bank, was highly critical from a competition point of view. However, Gulf Bank did not compete with any other bank to win potential clients asking for support from NFSD for some time. The first-mover advantage that Gulf Bank has gained could have long-lasting anticompetitive effects. The recent extension of the program to other domestic banks represents an important step to help level the playing field, yet distortions may still be present as a result of the design of the experimental phase.

Similarly, in Oman, extending partnerships with ODB to other commercial banks could improve competition. Clarifying the role and the functions of the ODB is also advisable. As in Kuwait, the existence of a framework agreement between one of the main state-led supporting initiatives and selected commercial banks is highly critical from a competition perspective. Current plans to extend partnership to five banks might be insufficient to ensure a level playing field between all banking institutions. To foster banks' participation in the agreement and avoid displacing private operators, it is particularly important to set clear, transparent and objective eligibility rules. In addition, the role of ODB in the sector appears ambiguous as it both competes and partners with commercial banks. Clarifying its mandate and adopting a more coherent corporate governance framework could improve its effectiveness.

The scheme provided by QDB has many desirable features; however, extending the scheme to more banks and lifting the cap on interest rates might further improve

competition among banks. Through its credit guarantee program, QDB provides the right incentives to SMEs to shop around. The application process to the scheme is transparent and the criteria objective, making the risk of potential discrimination unlikely. However, as in other GCC countries, the scheme is currently open only to a small subset of partner banks, and the total maximum allowance guaranteed differs among banks. This situation may have discriminatory effects that might limit the ability of some banks to compete. Therefore, it would be advisable to extend the scheme to other banks and reduce the risk of coordination among banks.

LICENSING CRITERIA

This section discusses licensing regulations in the GCC SME banking sectors, screening for possible sources of competitive concern. Financial institutions must go through a relatively complex procedure to obtain a license to provide banking services. This is justified on both financial stability and consumer protection grounds. The procedure is usually regulated by the central bank or financial regulator and encompasses a variety of steps.³⁹ As discussed in the analytical framework, bank licensing criteria may raise

39. Licensing criteria constitute one of the Core Principles for Effective Banking Supervision (Principle 5) issued by the Basel Committee on Banking Supervision, which represent the minimum standard for a sound prudential regulation and supervision of banks. Principle 5 states that the licensing authority has the power to set criteria and that at the minimum the licensing process should assess the ownership structure and governance of a bank, its strategic and operational plans, internal controls, risk management and financial projections. An initial capital amount is also stipulated for all banks. See Basel Committee on banking Supervision (2012).

various competition problems. In particular, such regulations can limit entry for deserving institutions, i.e. those who pass the “fit and proper” test, create an uneven playing field or limit firms’ business options.

A transparent licensing process minimizes possible distortions to competition. The process should clarify all phases of the licensing procedure, including a detailed timeline of the application process and explicit requirements to provide feedback to unsuccessful applicants. The possibility to appeal the decision of the licensing authority in case of rejection further improves the predictability of the licensing process and reduces the scope for discriminatory decisions (Carletti and Vives, 2007). The process is also improved by avoiding specific bans that discriminate among different types of banks and preclude their entry.

Regulations that set limits on new licenses and branching may create explicit barriers to entry and expansion. For instance, setting different requirements for a license according to the bank’s type can alter the level playing field and prevent entry in the market. Limitations on branching, both in terms of complexity of the procedure and number of branches, also constitute barriers to expansion.

Limitations on banks’ structure and ownership may pose further barriers to entry. Different forms of establishments may have stricter requirements that impose high costs on some categories of banks and prevent their entry in the market, or force prospective entrants to consider a limited set of business strategy options. Similarly, foreign entry may occur through acquisition of an established

bank and its brand. However, this option may not be available if explicit limits on ownership by foreign entities are in place.

Banks must comply with minimum initial equity capital requirements to start operations. However, requirements that are too high may create unsustainable up-front costs for potential entrants and negatively affect the capacity of firms to compete in the market.⁴⁰

The following section delineates in more detail the possible constraints to competition introduced by licensing criteria in the GCC and provides options on how to successfully reduce those obstacles. It addresses the following aspects:

- characteristics of the licensing process;
- explicit limitations on new licenses and branching;
- limitations to ownership; and
- initial capital requirements.

Current status of licensing criteria

In all GCC countries, central banks are essentially responsible for the licensing process. In Bahrain, Oman, Qatar and UAE, the central bank is the only institution responsible for the licensing process. In Kuwait, the central bank is in charge of the process together with the Ministry of Finance, which exercises a formal role. In KSA, SAMA is responsible for the process together with the Council of Ministers and the Ministry of Finance.

40. See Neuberger (1998).

Rules and regulations describing the licensing process are clear in Bahrain and Oman, while there are difficulties in identifying relevant information for the other GCC countries. A clear licensing process needs detailed rules regarding at least the following aspects: (i) timing of the application and possibility to appeal rejections; (ii) amount of licensing fees; (iii) procedure for opening branches; (iv) explicit restrictions; (v) legal form to be adopted; and (vi) initial capital amounts. In Bahrain and Oman, these aspects are described adequately within the CBB Law and Rulebook and the CBO Law, respectively.⁴¹ These sources provide detailed information on the licensing process and can be easily consulted online. In Kuwait, the CBK Law specifies legal form and capital requirements, while a CBK Circular describes information on branches and restrictions.⁴² In Qatar, the QCB Law lacks information on branches and licensing fees, while capital requirements are specified in the license application form. In addition, the QCB Law is not available on the QCB website.⁴³ Regarding KSA and UAE, the whole description of the licensing process is inadequately detailed.⁴⁴

41. CBB Law and Rulebook available at <http://cbb.complinet.com/cbb/microsite/>, retrieved on 4 December 2015. CBO Law available at <http://www.cbo-oman.org/>, retrieved on 4 December 2015.

42. CBK Law and CBK Circular available at <http://www.cbk.gov.kw/en/legislation-and-regulation/cbk-law/Law-intro.jsp> and <http://www.cbk.gov.kw/en/images/section-3-10-2734-2.pdf>.

43. The QCB Law can be found at <http://www.almeezan.qa/LawPage.aspx?id=4782&language=en>.

44. The lack of transparency in the licensing application process in KSA is also highlighted in a recent report by the IMF (2013). For KSA, see SAMA Banking Control Law available at <http://www.sama.gov.sa/en-US/Laws/Pages/BankingLaws.aspx>. For the UAE, see the Union Law No. (10) concerning the Central Bank, the Monetary System and Organization of Banking available at <http://centralbank.ae/pdf/OffGazetteB.pdf>.

Consistent with a transparent licensing process, there are rules on both approval time and the possibility of appealing a rejection in Bahrain, Oman and Qatar, whereas in Kuwait, KSA and UAE, these rules are lacking. Table 2 summarizes these rules. In Bahrain and Qatar, the Governor of the central bank must issue a decision within 60 days after the submission of the required documents by the applicant. In Oman, the same decision has to be issued within 120 days. Then, if the central bank rejects the application, it shall notify the applicant of the reasons for the refusal and the period of time to appeal the decision. In this respect, Qatar provides a clear written deadline (15 days from the date of notification). In Kuwait, the approval time is not specified by the CBK Law. Nevertheless, stakeholder interviews report that rejections by the CBK can be appealed before an administrative court.

Table 2: Approval Time and Possibility to Appeal a Rejection Decision

Country	Approval time	Possibility to appeal a rejection decision
Bahrain	60 days	Yes
Kuwait	N/A	Yes
Oman	120 days	Yes
Qatar	60 days	Yes
Saudi Arabia	N/A	No
UAE	N/A	No

Source: Elaboration based on central banks' data and stakeholder interviews

In some cases, limitations on new licenses and branching have been lifted; however, restrictions for foreign banks still apply in Qatar and UAE. In most cases, the procedures to open a branch are similar to those to issue a first-time license. For example, in Kuwait an "economic feasibility study" has to be submitted to CBK both when applying for a bank license and when opening a branch. In Bahrain and Oman, the opening of new branches is not subject to a new licensing procedure.^{45,46} In KSA, the Law does not impose limits on branches for either national or foreign banks.⁴⁷ Qatar and UAE employ the following exceptions with regard to foreign banks:

- **Qatar:** QCB explicitly prohibits foreign investors from entering the banking sector. There are seven foreign banks registered in Qatar that entered the market between the 1950s and the 1970s.⁴⁸ Currently, foreign banks may obtain licenses to undertake offshore operations within the Qatar Financial Center. However, such operations are typically outside the area of SME banking.
- **UAE:** The Central Bank of the UAE (CBUAE) sets specific limits on foreign banks expansion. In particular, foreign banks can open a maximum of two

45. According to the Rulebook issued by CBB, conventional banks can operate Islamic windows without requesting a separate license. CBB Rulebook, Volume 1, Part A, High Level Standards, LR Licensing Requirements, LR-1 Requirements to Hold a License, LR-1.4 General Requirements for All Conventional Banks, LR 1.4.1.

46. Stakeholders reported that CBO has encouraged creation of national branch networks over the last years.

47. However, Art 11 of the Saudi Banking Control Law states that national banks need the approval of SAMA to open a new branch. Saudi Banking Control Law available at <http://www.sama.gov.sa/en-US/Laws/Pages/BankingLaws.aspx>, retrieved on 4 December 2015.

48. See Muharrami (2009).

branches per Emirate, with exceptions granted on a case by case basis, mainly after mergers. Alternatively, foreign banks can also be established within the Dubai International Finance Center, where they are regulated by the Dubai Financial Service Authority. However, these banks focus on corporate services and they only cater to a minority of SMEs, often subsidiaries of international companies.

With respect to the bank's ownership structure, there are limits on foreign ownership in Kuwait, Oman and UAE. CBK sets limits on foreign ownership of domestic banks, whereas commercial banks must have a minimum national shareholding of 49 percent. Exemptions are possible: in Kuwait, foreign banks may be authorized to

own up to 100 percent of business entities in the banking, corporate investments and exchange sectors, provided that a license is issued by the Kuwaiti Ministry of Commerce and Industry.⁴⁹ However, the criteria for issuing a license are not always clear and transparent, increasing the risk that discretionary power may distort the level playing field. Similarly, in Oman the relevant Ministry may increase the maximum equity share held by non-nationals to 70 percent.⁵⁰ Finally, UAE laws impose a minimum of 60 percent of national shareholding for commercial banks. An exemption is granted to other GCC banks, which are allowed to acquire controlling stakes in UAE banks and financial institutions.⁵¹

49. See Law No. 8 Regulating Foreign Capital Direct Investment in Kuwait (22 April 2001), available at http://www.kuwaitemb-australia.com/files/direct_investment.pdf, retrieved on 25 November 2015.

50. See Royal Decree No. 56/2003 amending the law of the foreign capital investment issued by Royal Decree No. 102/94, available at <http://www.chamberoman.com/En/Content.aspx?SecNo=54#2>, retrieved on 25 November 2015.

51. See Putnis (2014).

Table 3: Initial Capital Requirements (Values in US\$, Millions)

Country	Conventional domestic bank	Islamic bank	Foreign bank
Bahrain ⁵²	\$ 53	-	-
Kuwait ⁵³	\$ 246	\$ 246	\$ 49
Oman ⁵⁴	\$ 249	\$ 249	\$ 51
Qatar ⁵⁵	\$ 275	-	\$ 275
KSA ⁵⁶	\$ 0.66	\$ 0.66	-
UAE ⁵⁷	\$ 27	-	\$ 50

Source: Elaboration based on central banks' data and stakeholder interviews

Most GCC countries have high initial capital requirements and generally apply distinct conditions to domestic and foreign banks. Table 3 shows these requirements according

to bank type. With the notable exception of KSA, initial minimum capital requirements are on average higher in the GCC countries than in MENA and OECD countries. Figure 4 compares initial minimum capital amounts for conventional domestic banks in the GCC countries with MENA and OECD averages.⁵⁸ Oman, Bahrain, Kuwait, Qatar and UAE show higher requirements than MENA and OECD averages, with KSA's requirements lower. Kuwait, Oman and Qatar have by far the highest initial capital requirements amounting to US\$246 million, US\$249 million and US\$275 million, respectively.⁵⁹

52. See CBB Rulebook, Volume 1, Part A, High Level Standards, LR-2.5 Condition 5: Financial Resources, LR-2.5.1., available at http://cbb.complinet.com/cbb/display/display.html?rbid=1820&element_id=4220, retrieved on December 4, 2015.

53. See CBK Law No. 32/1968, Chap. 3: Organization of Banking Business, Sec. 1: Establishment of Banks, Article 57, available at <http://www.cbk.gov.kw/en/legislation-and-regulation/cbk-law/chapter-three.jsp>, retrieved on December 4, 2015.

54. The values for Oman in the table are retrieved from an interview with CBO officials. The Omani law states that capital requirements for domestic and foreign banks amount to US\$51 and US\$7.8 million respectively. See Oman Banking Law, Chapter 3 on Financial Requirements of Licensed Banks, Article 60 available at <http://www.cbo-oman.org/>, retrieved on December 4, 2015.

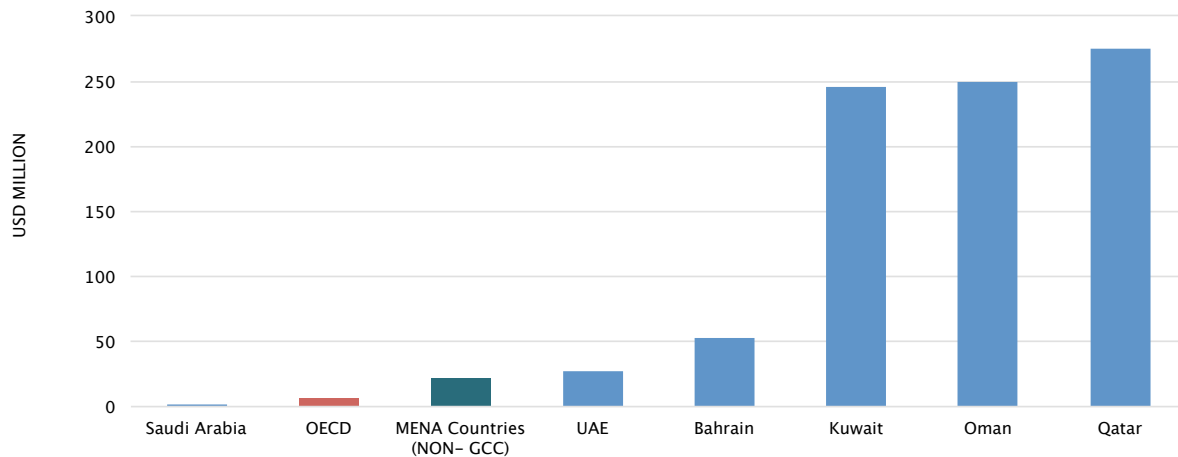
55. See the License Application Form – National Bank and foreign branch available at <http://www.qcb.gov.qa/English/Legislation/Instructions/Documents/BankInstructions/2013/13-025-01.pdf>, retrieved on 4 December 2015.

56. See Banking Control Law, Article 3, page 2 available at <http://www.sama.gov.sa/en-US/Laws/Pages/BankingLaws.aspx>, retrieved on 4 December 2015.

57. The values for the UAE in the table are retrieved from an interview to the CBUAE. The UAE law states that capital requirements for domestic banks amount to US\$10 million, but the CBUAE has reported to encourage a much higher minimum paid-up capital. See Union Law No. (10) concerning the Central Bank, the Monetary System and Organization of Banking, articles 79 and 80, available at <http://centralbank.ae/pdf/OffGazetteB.pdf>, retrieved on December 4, 2015.

58. MENA countries in the figure do not include Jordan, Gaza-West Bank and Syria where information is lacking. Statistics on MENA exclude the six GCC countries. OECD countries in the figure account for all OECD but Australia, New Zealand and the USA, and the base limit imposed by the European Central Bank (ECB) is taken as a standard for EU countries.

59. For Kuwait, see CBK Law No. 32/1968, Chapter 3: Organization of Banking Business, Section 1: Establishment of Banks, Article 57, available at <http://www.cbk.gov.kw/en/legislation-and-regulation/cbk-law/chapter-three.jsp>, retrieved on November 25, 2015. For Qatar, see the License Application Form – National Bank and foreign branch available at <http://www.qcb.gov.qa/English/Legislation/Instructions/Documents/BankInstructions/2013/13-025-01.pdf>, retrieved on November 25, 2015.

FIGURE 4: Minimum Initial Capital Requirements for Conventional Domestic Banks

Source: Elaboration on central banks' data

Options for improving the licensing system

Introducing a clear timeline for both the approval time for an application and the possibility to appeal a rejection decision may increase transparency in the licensing process and enhance competition. As discussed, uncertainty in the approval process may discourage potential applicants from entering the banking sector, particularly small-scale banks that are subject to greater constraints. The central banks of Bahrain, Oman and Qatar set clear rules for the timing of the application process. Moreover, the possibility to appeal the rejection of the central bank lowers the risk of discrimination among applicants. Therefore, it would be advisable to apply similar rules in Kuwait, KSA and UAE as well.

As a general rule and subject to maintaining financial stability, it might be appropriate to explore lifting existing restrictions on licenses and branches in order to increase market contestability. Restrictions on

licenses can be considered limits to entry or expansion. Restrictions on branches can be considered limits to expansion that reduce the competitive pressure exerted on larger banks. Such limits reduce competitive pressure and allow existing operators to enjoy a higher degree of market power. Contestable markets, instead, promote competitive market outcomes, even in the absence of actual entry.

Lifting foreign entry restrictions in Qatar and UAE might improve competition and assure efficient entry in the SME banking industry. In Qatar and UAE, important restrictions to entry and expansion remain. In particular, foreign banks are prevented from entering the market or to take advantage of all potential business opportunities. These limitations are not offset by the presence of offshore centers in both countries. In UAE, for instance, competitive pressure by banks established within the Dubai International Finance Center does not appear to be relevant to the SME segment. The same holds for the Qatar Financial Center.

Therefore, restrictions in Qatar and UAE may be lifted to increase contestability in the market. Central banks can implement other measures, such as clarifying the rules for granting exceptions to the maximum limit on the number of foreign branches. This would enhance the transparency of the process, and in turn benefit competition, reducing the risk for discrimination.

A tiered approach to prudential regulation can also increase market contestability. As discussed, initial capital requirements in the GCC, especially in Kuwait, Oman and Qatar, are much higher on average in the GCC countries than in MENA and OECD countries. Tailoring the application of generally applicable rules and regulations based on the size, complexity and possibly other characteristics of banking organizations is a useful way to implement a tiered banking system, where entrance is encouraged without exacerbating system risks. Revising capital guidelines to encourage the entry of small-scale banks could particularly improve contestability in the SME banking markets, given the comparative advantage that small banks may enjoy in serving local markets and individual borrowers.

PRICE CONTROLS AND RESTRICTIONS ON BANK ACTIVITIES

All forms of price controls may alter competition in the banking industry. Price controls can involve interest rate floors or ceilings as well as caps on fees and commissions. Setting interest rate caps can be a tool to provide support to a specific

industry or segment of the economy. Governments may also use interest rate caps to protect consumers from usury. However, these forms of price control may suppress market signals or decrease the quantity or quality of services supplied to SMEs. For example, in the case of price ceilings, the least creditworthy borrowers would not be served.⁶⁰ Explicit caps may also act as focal points and facilitate coordination among banks (Knittel and Stango, 1987).⁶¹

Relevant rules and regulations typically define banks' permissible activities and their supervision. As part of their operations, commercial banks routinely set interest rates, lend to various sectors of the economy and offer a wide range of products. These activities can vary according to a bank's chosen business model and strategy. Overly strict regulation on bank activities can limit banks' business options.

Line of business restrictions may be detrimental for competition. In addition to banking products, commercial banks' offering may include insurance, securities, and other financial services. There might be several reasons to restrict such activities. For instance, allowing banks to differentiate their lines of business may increase the possibility for conflicts of interest (Walter, 1985), raise the risk of moral hazard (Boyd et al., 1998), and make banks too complex to monitor (Barth et al., 2006). Furthermore, cross-selling can lead to bundling of different products, a practice that incumbent banks may eventually use to exclude smaller

60. Lending to SMEs, given their higher riskiness, naturally advocates for a risk-based approach.

61. Rey and Tirole (2013) suggest that price caps may increase the risk for collusion by providing focal points.

players from competition.⁶² However, overly-restrictive regulation is not always optimal. Barth et al. (2006) find that restricting bank activities is negatively associated with bank development and stability. Claessens and Klingebiel (2001) show that when markets are sufficiently contestable, a wider scope for financial services provision by financial institutions is pro-competition.

Current status of price control and activity regulations

The central banks of Kuwait, Oman and Qatar set interest rate ceilings on customers' loans, while no specific rules seem to be present for other GCC countries. Country-specific details follow, below:

- *Bahrain*: There are not general interest rate ceilings. According to stakeholder interviews, CBB has lifted most of the price regulations previously in force.
- *Kuwait*: CBK sets the discount rate and ensures that certain rates on both short and long term loans do not exceed it. Stakeholders interviews indicate that the maximum interest rate currently applicable is the CBK discount rate plus 2.5 percent and plus 4 percent for short and long term loans, respectively.

- *Oman*: According to stakeholder interviews, commercial banks can set interest rates freely in Oman, with one notable exception: CBO fixes a ceiling on personal and housing loans to 6 percent.⁶³ This ceiling has been gradually lowered over time (it was 8.5 percent in 2008).⁶⁴
- *Qatar*: Stakeholder interviews suggest that rates on loans usually range between 8 and 10 percent, but can go as high as 18 to 20 percent for cash advances. QCB sets an interest rate ceiling on personal loans against salary (currently at 6 percent) and on credit cards (12 percent). Moreover, the QCB Law prevents banks from extending the maturity of these loans by more than one year.
- *KSA*: Stakeholder interviews indicate that no caps on interest rates apply to SMEs and the corporate segment. Moreover, all fees, costs and administrative charges that the creditor has to recover from the borrower must not exceed the equivalent of 1 percent of the amount of financing or SRI 5,000 (US\$1,333), whichever is lower.⁶⁵
- *UAE*: Information from stakeholder interviews suggests that commercial banks do not face caps on interest rates chargeable to SMEs.

Rules and regulations in all GCC countries except Kuwait do not impose restrictions on

62. For example, a bank with market power in banking products (service A) and facing actual or potential competition in insurance products (service B) prices an A-B bundle in a way that makes it impossible for equally efficient one-service rivals selling service B to compete. See Nalebuff (2005) and Heidhues (2007) for more details on "exclusionary bundling".

63. CBO Circular of 2 October 2013 available at <http://www.cbo-oman.org/circulars/2013/bm1112.pdf>

64. CBO Circular of 4 April 2012 available at http://www.cbo-oman.org/circulars/BM_1093.pdf

65. Regulations for Consumer Financing, Section 2, Article 9, available at [http://www.sama.gov.sa/en-US/Laws/BankingRules/Regulations percent20for percent20Consumer percent20Finance percent20- percent20Final percent20 percent2030-6-2014.pdf](http://www.sama.gov.sa/en-US/Laws/BankingRules/Regulations%20for%20Consumer%20Finance%20-%20Final%2030-6-2014.pdf)

particular lines of business of commercial banks. These banks can generally offer both financial and insurance services, with some rules specific to the country in which they operate. An exception is Kuwait, where there are significant restrictions on cross-selling of products. The most relevant aspects detailed per country follow:

- *Bahrain*: CBB does not restrict Bahraini banks from offering financial and insurance products.⁶⁶ Among the services regulated for conventional bank licensees, the CBB Law includes dealing with financial instruments and operating collective investment undertakings. Insurance sold through banks known as Bancassurance is growing considerably, and Bancassurance partnerships have flourished.
- *Kuwait*: As reported in stakeholder interviews, Kuwait imposes a number of restrictions on bank activities and CBK can exercise significant discretion regarding banks' ability to implement a competitive strategy. For instance, relevant stakeholders indicate that banks cannot sell insurance products.⁶⁷ CBK must also previously approve any new fee a bank wants to charge, regardless of its amount.
- *Oman*: CBO allows banks to undertake several line of business activities.⁶⁸

Licensed banks can act as insurance agents (but not as brokers) through the Bancassurance arrangement⁶⁹ and sell basic insurance products such as life and general insurance.⁷⁰ As a rule, banks may partner with a maximum of two insurance companies, one for life insurance and one for general insurance, and they cannot sell the same line of products of two distinct insurance companies.

- *Qatar*: QCB does not restrict Qatari banks from offering both financial and insurance products. The Instructions on Supervision and Control issued by QCB provide banks with rules and limits on multiple business lines.⁷¹ With respect to financial products, banks can issue and manage investment accounts; market the units of investment in mutual funds and portfolios; apply for a license to establish investment mutual funds; and sell foreign companies' stock to domestic customers. With respect to insurance products, banks can sell such products on behalf of insurance companies outside Qatar provided they include the activity of marketing insurance in their Art. of association and obtain the approval from the Ministry of Economy and Commerce. Both national and foreign banks should include the insurance activity in their commercial register in Qatar.

66. CBB Rulebook, Volume 1, LR-1.3 on definition of regulated banking services http://cbb.complinet.com/cbb/display/display.html?rbid=1820&element_id=4220

67. Nonetheless, it is reported that sometimes banks can provide insurance tied to financial products upon customer's request.

68. Art 5 of Oman Banking Law. Available at http://www.cbo-oman.org/info_law.htm

69. Circular MB 971 of 9 May 2004. Available at http://www.cbo-oman.org/circulars/Crclrs_1till932.pdf page 535.

70. Guidelines issued by the Ministry of Commerce and Industry Regarding the Sale of Insurance Products by Banks". Available at http://www.cbo-oman.org/circulars/Crclrs_1till932.pdf page 537.

71. See Instructions of Supervision and control Part (VII), available at <http://www.qcb.gov.qa/English/Legislation/Instructions/Documents/BankInstructions/2013/07-04.pdf>, retrieved on October 1, 2015.

- **KSA:** According to available information and stakeholder interviews, SAMA does not significantly restrict the activities of Saudi banks, but financial services other than banking remain relatively limited.
- **UAE:** According to available information and stakeholder interviews, CBUAE does not seem to prevent banks from engaging in non-banking financial services and market, for example, financial and insurance products.

Some evidence suggests that the development of Islamic banking can boost competition and financial inclusion. Surveys indicate that 23 to 24 percent of the adult population in KSA cite religious reasons for not having a bank account (although this share is negligible in the other GCC countries).⁷² Islamic banking is found to be positively related to financial inclusion: while Arab countries in general tend to exhibit lower levels of financial inclusion, Islamic banking is associated with a lower incidence of self-exclusion and with a lower share of firms citing access to finance as a significant obstacle (World Bank Group, 2014b).

Islamic banks are distinguished by the presence of a Sharia Board, and operate on the basis of the Islamic business law. They use Sharia-compliant contracts for their business. These banks contribute to the diversification of the banking offer. According to stakeholder interviews, there is some degree of substitutability between products offered by conventional and Islamic banks and the two groups may exercise a competitive pressure on each

other. Generally, in the GCC countries there is the possibility for conventional banks to offer Islamic products or to open Islamic “windows”, with one notable exception. In Qatar, QCB has recently decided to close the “Islamic banking windows” of commercial banks. Since 2011, therefore, there are few banks exclusively licensed to practice Islamic banking activities in Qatar, and the main ones are the Qatar Islamic Bank, the Masraf Al Rayan Bank and the Qatar International Islamic Bank.

Options for easing price controls and activity restrictions

Governments may consider removing restrictions on interest rate ceilings where present to reduce the risk that SMEs are underserved. Some GCC countries set ceilings to hold interest rates below their free-market levels. Banks consequently may ration credit, privileging some borrowers and leaving most high-risk borrowers unserved. The removal of interest rate ceilings is especially relevant for SMEs, as banks advocate the need for a risk-based approach to lending. The most relevant issues and recommendations at the country level are described below:

- **Kuwait:** CBK might rule out ceilings on both short- and long-term loans. Interest rates ceilings may create allocative inefficiencies and contribute to the under provision of credit to SMEs. Existing restrictions on loan tenure aggravate the situation and might be waived too.
- **Oman:** CBO might progressively reduce till complete elimination the ceiling on personal loans.

72. Global Findex Database.

- **Qatar:** QCB might gradually eliminate caps on interest rates (depending on the type of loan), factoring in financial stability. Although they serve to reduce potential rates' volatility, these caps can unnecessarily limit banks' strategy options, negatively effecting competition.

Lifting line of business restrictions in Kuwait might improve market competition by attracting new banks. CBK imposes limitations to business strategy options that may undermine competition. It is advisable to lift such limitations to stimulate entrance of new competitors in the long term. In addition, to prevent the risk of exclusionary bundling and other anticompetitive practices by incumbent banks, it is advisable to strengthen the role and monitoring activities of competition authorities (see Chapter 4).

Allowing conventional banks in Qatar to open Islamic banking windows may increase entry and diversification in the SME banking industry. Since conventional and Islamic products can be considered substitute, the decision of the QCB to close such windows may constitute a barrier to expansion. Further research may be needed to understand the level of competitive pressure that conventional banks exert on Islamic ones.

Enforcement of competition law is critical to prevent the bundling of practices that deters competition. Bundling practices may affect consumers' ability to assess products' costs and features, thus hampering switching⁷³

and foreclosing entry.⁷⁴ Existing banks are more likely to adopt bundling practices. In addition, the fact that some products act as a gateway for others, as for example are accounts for loans, may exacerbate the negative effect of bundling on firms' entry (Koderisch et al., 2007).

ACCESS TO CREDIT INFORMATION

Accurate information about a customer's financial situation enables banks to extend credit effectively to customers. Information asymmetry in credit markets can lead to the well-known problems of adverse selection and moral hazard. In the absence of accurate information about potential customers' risk profiles, banks may be forced to use less reliable information, resulting in credit being over- or under-provided. As a result, providers may cease to offer certain products to customers for whom they cannot accurately assess risk. Quality, reliability and accessibility of credit information among active banks and for prospective entrants significantly affects how competition unfolds in the banking market.

Credit information sharing mechanisms such as private credit bureaus (PCBs) and public credit registries (PCRs) can help to lower barriers to entry and level the playing field. The longer a firm operates in a market, the more it may improve its knowledge about borrowers' creditworthiness.⁷⁵ Incumbents are at an advantage in mitigating adverse selection, while challenger banks face a

73. See, among others, Kühn et al. (2005), and Prince and Greenstein (2014)

74. See Nalebuff (2004).

75. See, for example, Stiglitz and Weiss (1981) and Bonaccorsi di Patti and Dell'Araccia (2001).

higher risk of supplying less creditworthy borrowers. This may deter entry and limit appetite for expansion. Equally important, the information advantage on borrowers' behaviors may allow incumbents to cross-subsidize between new and existing clients, as well as between less and more creditworthy ones.⁷⁶ Credit information sharing mechanisms such as PCBs and PCRs may mitigate incumbents' advantage and lower barriers to entry and expansion. PCBs and PCRs can also lower entry barriers by increasing borrowers' incentives to repay debts⁷⁷ and compensating for poorly performing legal systems, for example.⁷⁸

Widespread availability of high quality information on borrowers' credit history can positively affect competition by improving both banks' commercial strategy options and buyers' ability to choose. Credit information sharing mechanisms may reduce the costs banks face in establishing a new relationship.⁷⁹ In particular, PCBs and PCRs may increase competition for the

acquisition of creditworthy borrowers with a long track record.⁸⁰ Furthermore, when credit information is readily available, banks may compete by developing products that better meet the needs of prospective clients.⁸¹ Customers may benefit insofar as credit information sharing schemes mitigate applicants' credibility problems in conveying their creditworthiness to potential lenders (Watt, 1977).⁸²

Open, non-discriminatory access to PCBs and PCRs is a necessary condition for pro-competitive effects to materialize. PCBs and PCRs operate through a network arrangement and are natural monopolies; economies of scale and scope make them not easily replicable by new entrants.⁸³ Access must not be restricted and not conditional on the basis, for example, of banks' prevailing ownership (i.e. public or private), nationality (i.e. local or foreigner), or status (i.e. existing or new entrant).⁸⁴ In particular, vertical integration between banks and PCBs may increase the risk of discriminatory access conditions to credit information, whereby shareholders are granted more favorable terms. Furthermore,

76. Since new entrants do not have the same informational endowment of incumbents, as well as the same cost and customer structure, they cannot compete with firms pricing below costs (Petersen and Rajan 1995).

77. PCBs and PCRs act as a discipline device insofar as they increase the cost of insolvency by affecting borrowers' ability to access credit in the future (Padilla and Pagano, 2000). This, in turn, increases debt repayment (Jappelli and Pagano, 2006) and reduces adverse selection, which would positively impact challenger banks.

78. The inefficiency of courts in enforcing creditors' rights may reduce the scope for entry and expansion in the market (La Porta et al., 1997). By mitigating ex-ante lenders' information asymmetry on borrowers' creditworthiness, PCBs and PCRs may act as a substitute for weak enforcement mechanisms and mitigate entry deterrence (Brown et al., 2009).

79. See Klemperer (1995). However, while a borrower may provide evidence of a good payment history, it is almost impossible for lenders to verify whether it hides less favorable information.

80. See Jaffee and Russell (1976); Diamond (1989) and Gehrig and Stenbacka (2007).

81. Consumers would switch towards products that create value for them. See Jappelli and Pagano (1999).

82. Absent credit information infrastructures, it is unlikely that lenders entering in a new relationship can overcome rivals' conflict of interests in providing relevant information (Padilla and Pagano, 1997).

83. The more sources connected to the network, the greater the data coverage. Scale and scope economies affect credit information coverage and, in turn, its relevance. Open access to PCRs would be advisable (Ferretti, 2015).

84. Jappelli and Pagano (2002).

vertical integration may give rise to foreclosure⁸⁵ or exploitative abuses.⁸⁶

Information sharing on banks' commercial strategies may promote collusive practices. PCBs and PCRs store information on borrowers' credit history, including loans and other financial facilities. Disclosure of commercially sensitive information (e.g. interest rates and tenures applied) to competitors may facilitate collusion. Greater transparency supports collusive practices by facilitating the detection of cartels' deviations (Gehrig and Stenbacka, 2001; Odudu, 2011).

The following section assesses the impact of PCBs and PCRs on competition in the GCC SME lending markets. The section addresses the following aspects: (i) quality of credit information; (ii) accessibility at non-discriminatory conditions; and (iii) factors that may facilitate anticompetitive behaviors by banks. To this purpose, the analysis considers the following dimensions:

- *coverage*, i.e. whether both SMEs and individuals are covered, and to what extent;⁸⁷
- *dosage of positive and negative information*;⁸⁸
- *cross-sectorality*, i.e. whether information on borrowers' creditworthiness from other

85. Raising rivals' costs in the downstream market is an example of anticompetitive practices aimed at excluding competitors by preventing them from accessing an input or by creating a cost disadvantage for them (Giannetti et al., 2010).

86. PCB's shareholders may exploit their market power when commercializing access to credit information to other members, for example by setting reports' or ratings' prices at supra-competitive levels (Vickers, 2005).

87. The application of cut-off thresholds for loan reporting can greatly reduce coverage (Bertola et al., 2006).

88. Positive information refers to the provision of records about creditworthy borrowers in addition to those of bad payers.

financial institutions, retailers or utilities is collected and reported;⁸⁹

- *memory*, i.e. the time span covered by credit information reports;⁹⁰
- *accuracy of collected data* (including frequency of database updates);^{91,92}
- *conditional access to credit information*, i.e. restricting access on the basis of discriminatory conditions such as applicants' nationality (local or foreigner), ownership structure (private or public), or status (new or existing);
- *discriminatory membership or usage costs*, i.e. the application of differentiated costs to obtain PCBs' membership or exploit credit information, with respect to applicants' nationality, prevailing ownership structure, status;
- *vertical integration* (between credit information infrastructures and banks);
- *practices facilitating collusion*, i.e. whether the scope of credit information is such to promote potential collusive practices aimed at restricting competition in the banking sector.

89. Information variety may improve the estimation of borrowers' likelihood of insolvency (Hainz, 2011).

90. Credit information infrastructures with long-lasting memory promote entry by alleviating adverse selection by allowing for a more exhaustive assessment of prospective clients' creditworthiness and by acting as a discipline device and increasing borrowers' incentive to repay. Since switching is driven by creditors with a good and long track-record, longer memory also promote competition by supporting borrowers' mobility.

91. PCRs and PCBs should be subject to frequent, even real time, updates to ensure that the information provided is representative of the ability of borrowers to repay debts.

92. The possibility to identify individuals and SMEs unambiguously is a relevant determinant of accuracy. For example, in developing and emerging economies, single SME ID numbers or VAT numbers do not exist and most SMEs operate informally, making it difficult to link available information to them (World Bank, 2014).

The current credit information sharing infrastructure

All GCC countries have credit sharing information mechanisms in place. With the exception of Kuwait, where both a PCB and a PCR operate, all other GCC countries have either a PCB or a PCR. Oman, Qatar and UAE established a PCR under the respective central banks. Bahrain and KSA have a PCB,

with the central bank playing an oversight role in both countries. Central banks' representatives sit on the board of both PCBs and PCRs in Bahrain, Kuwait, and KSA. In Kuwait and UAE, the Ministry of Commerce and Industry and the Ministry of Finance, respectively, have concurrent supervisory powers. Table 4 below summarizes the governance features of credit sharing information schemes in the GCC countries.

Table 4: Institutional Framework of PCBs and PCRs in the GCC Countries

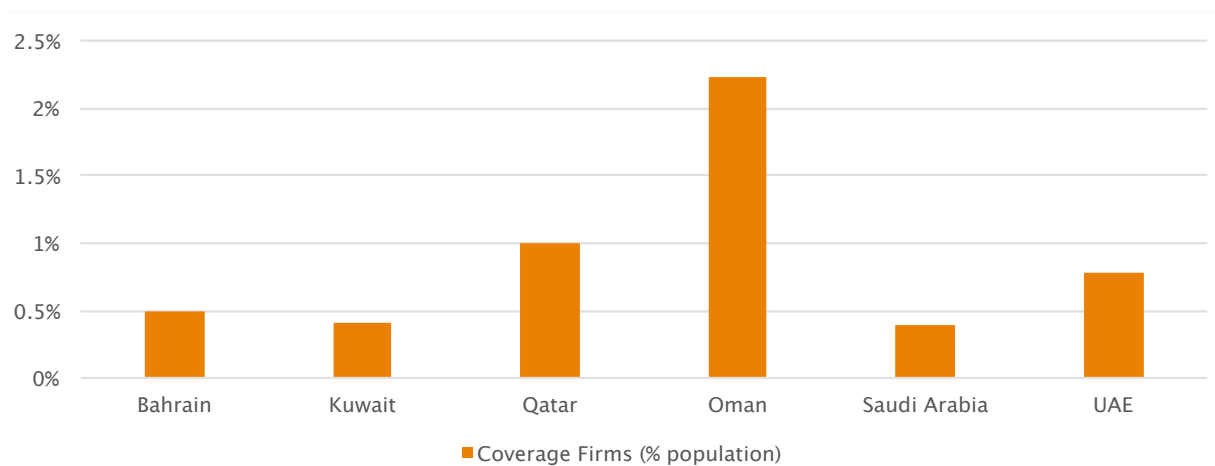
	Bahrain	Kuwait	Oman	Qatar	KSA	UAE
Type	Private Credit Bureau	Private Credit Bureau Public Credit Registry	Public Credit Registry	Public Credit Registry	Private Credit Bureau	Public Credit Registry
Name	Benefit Company	Credit Information Network of Kuwait (Ci-Net) CBK	Bank Credit and Statistical Bureau System	Qatar Credit Bureau	SIMAH	Al Ethiad Credit Bureau (AECB)
Ownership structure	Privately-owned by fourteen banks	Ci-Net is owned by CBK and a consortium of 14 banks and other financial institutions	State-owned	State-owned	Privately-owned by ten local banks	State-owned
Legal framework	Bahrain Credit Reference Bureau Code of Practice	Emir Decree No 2 of 2011	New regulation BM/ bG/ 53/9/2011	Decision No 5 of 2008	Credit information law 2009 under Royal Decree No. M/37	Federal Decree Law No. 6 of 2010
Supervisory Power	CBB	CBK	CBO	Qatar Central Bank	SAMA	CBUAE Ministry of Finance
Role of Central Bank	CBA licenses the PCB Reps of CFF sit on the board	CBK representative chairs the board of Ci-Net	CBO controls the PCR	QCB controls the PCR	SAMA's reps sit in the board of the PCB	AECB directly reports to the Board of Directors of CBUAE

Source: Elaboration on publicly available data and stakeholder interviews

Credit information coverage appears to be significantly heterogeneous across countries and cut-off thresholds apply in some cases. In general, PCBs and PCRs collect and provide information on both SMEs and individuals, irrespective of the size of the credit facility. The heterogeneity of information

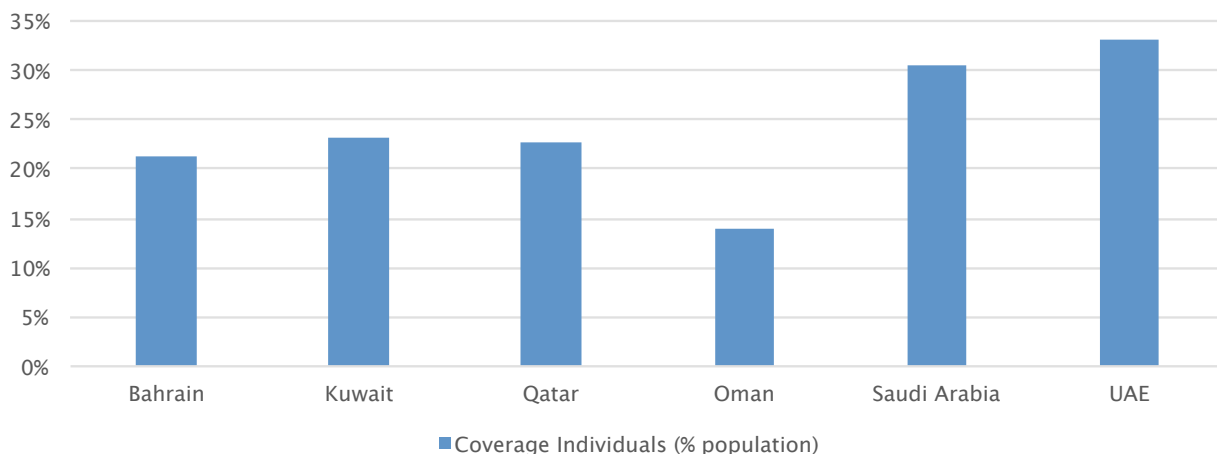
infrastructures across GCC countries (Figure 5 and Figure 6) and with respect to possible benchmarks such as OECD and MENA countries (Figure 7) may be explained by the diverse and overall recent maturity of the various PCBs and PCRs in the region, as well as by the following country-specific elements:

FIGURE 5: Percentage of Firms (over Total Population) Covered by PCBs and PCRs in the GCC



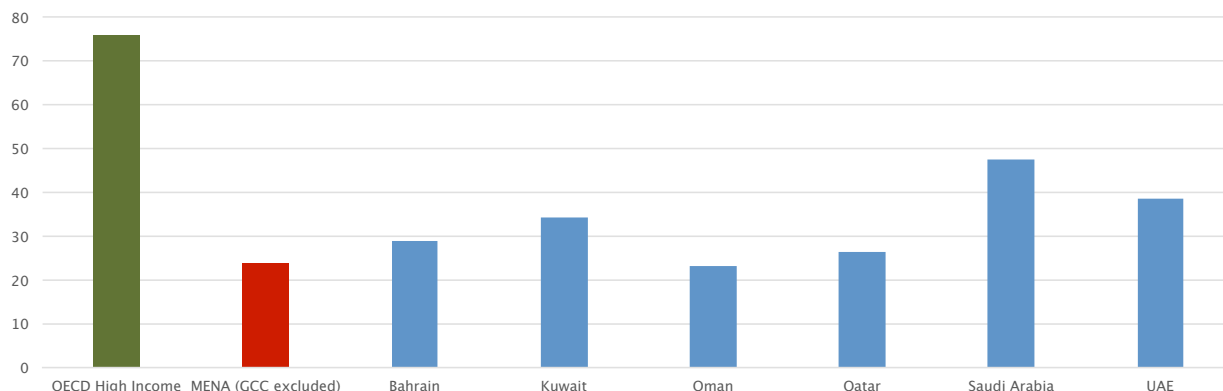
Source: World Bank. Doing Business Indicators, 2016

FIGURE 6: Percentage of Individuals (over Total Population) Covered by PCRs and PCBs in the GCC



Source: World Bank. Doing Business Indicators, 2016

FIGURE 7: Percentage of Firms and Individuals (over Total Population) Covered by PCBs and PCRs in the GCC, MENA (GCC Countries Excluded) and OECD Countries



Source: World Bank. Doing Business Indicators, 2016

- **Kuwait:** The PCR collects data about both individuals and SMEs, but only for facilities exceeding an amount equivalent to US\$46,000. The PCB, instead collects data on individuals only.
- **UAE:** The PCR cannot provide information when aggregate exposure is greater than an amount equivalent to US\$4 million. Interviews reveal that this threshold is considered low for the UAE context and may exclude a significant number of SMEs from the reporting system.
- **Qatar:** A threshold applied though it was removed in 2012.

Credit sharing information schemes provide extensive and detailed credit reports covering both positive and negative information. Details for each country are provided below:

- **Bahrain:** Benefit Company provides information for five product categories: loans, credit cards, charge cards, overdraft limits and mortgages. In 2008, the Bureau Scorecard Service was launched – a service

that assigns a creditworthiness score to individuals and companies.

- **Kuwait:** The PCR of Kuwait represents an exception insofar as it only provides negative data. On the other hand, Ci-Net, the PCB, provides information on the amount, type and tenure of loans provided as well about the conditions of financing products other than loans. Data on ongoing legal disputes, individuals' incomes and companies' shareholders and related entities are also collected. Non-performing loans are recorded into a separate database. The PCB does not provide, however, scoring services on borrowers' creditworthiness.
- **Oman:** The Bank Credit and Statistical Bureau System mainly collects data about individuals and SMEs' credit history. Inquiries on credit information are also recorded. For individuals, the PCR also collects employment history. Scoring services about borrowers' creditworthiness are not supplied. However, interviews reveal that a scoring service exists and it is

shared only with CBO. For nonperforming loans, the lender's name is also provided.

- *Qatar:* The Qatar Credit Bureau provides information with respect to both SMEs and individuals. Positive and negative information is collected only with respect to loans. Conversely, according to interviews, deposits and transfers are not covered.
- *KSA:* SIMAH collects data about firms' and individuals' credit and payment history, national security number, and accounts. Inquiries on credit information are also recorded. The PCB does not offer scoring services about borrowers' creditworthiness. However, interviews point out that this is in the pipeline. According to available information, the lender's name is also reported, allowing the identification of individual banks extending each credit facility (a feature discouraged by international best practices due to the associated risk of collusion). Bespoke reports can be produced based on applicants' requests.
- *UAE:* Al Ethiad Credit Bureau develops simplified and full credit information reports for both individuals and corporates. The simplified report contains information on credit score, total outstanding balance, total overdue, number of default contract, summary of number of credit facilities requested, active, rejected or closed and a summary of all active contracts belong or related to the subject. The full report also contains details about payment history for each credit facility and applications with lending institutions. The PCR does not

provide a rating service on borrowers' creditworthiness. However, interviews revealed that a scoring service is planned to be implemented in 2016.

The degree of cross-sectorality and credit data memory varies across the GCC countries. Country-specific details are provided below:

- *Bahrain:* Benefit Company collects information from retailers, utilities and other non-bank financial institutions. Negative payment records are stored for five years.
- *Kuwait:* PCR and PCB store data on SMEs and individuals forever and for five years, respectively. Ci-Net complements information collection, including from retailers, utilities and other non-bank financial institutions
- *Oman:* The PCR provides data only for banks. Credit history reports cover the past two years, while information is kept in the record for ten years.
- *Qatar:* Currently, the PCR only provides data for credit facilities by banks. It is planning to start collecting information from retailers and utilities in the near future. Qatar credit data covers the last three years.
- *KSA:* SIMAH collects data from telecoms, car rental, insurance, and other financial companies. SIMAH's credit reports provide data for two years.
- *UAE:* AECB collects data from telecoms companies. There is a plan to increase information coverage to tax records and utilities in next years. AECB credit reports

provide data for two years, while negative files are kept for five years.

Interviews with relevant stakeholders suggest there is an opportunity to analyze more closely the reliability and timeliness of credit information. Records of the Qatar Credit Bureau are updated every three months. In UAE, credit information is updated on a monthly basis and CBUAE plans to increase the frequency of information update. In Kuwait and UAE, some banks are concerned about the exhaustiveness of the data provided by the PCR, while in Oman, banks emphasize the importance of scoring services on borrowers' creditworthiness. Since up-to-date credit data is crucial to mitigate adverse selection, real-time updates may be appropriate.

PCBs and PCRs in the GCC countries appear to abide to a general obligation of non-discrimination, however currently available information does not completely prevent the risk of distortions to competition. Both types of credit information sharing schemes generally grant members' access at "transparent and non-discriminatory conditions". However, all PCBs are vertically integrated with banks. In principle, vertical integration may generate an uneven playing field and lead to foreclosing practices.⁹³ Furthermore, information on access conditions (including in some cases information on fees levied) could not always be retrieved. Country-specific information is presented below:

93. A typical example would be the imposition of differentiated fees for owners and regular members. However, the imposition of equal but very high fees may distort competition. Banks that own a share in the PCB will be able to recoup part of the cost incurred for accessing information (for example through dividends), while competitors would carry the entire burden.

- *Bahrain*: The PCB is owned and operated by fourteen banks.⁹⁴ Each member of Benefit Company has the right to access credit information at fair and identical conditions. Auditing and firewalling mechanisms are reportedly in place to prevent shareholder banks from accessing commercially sensible information on their competitors. An annual flat fee, equal for all applicants, applies to access credit information. The value of the usage fee varies according to the scope of the required credit information (though shareholders and other members pay the same fee). Products concerning corporates' or individuals' credit information are sold at the equivalent of US\$2,600 and reports on both firms and individuals at US\$5,300.
- *Kuwait*: Ci-Net (the PCB) is controlled by a consortium of banks and other financial institutions, together with CBK. Ci-Net provides credit information to its members contingent on the payment of membership and usage fees that are not publicly available. Usage fees are lower for Ci-Net shareholders. Credit information is fully disclosed only when related to applicants' clients. Inquiries on rivals' clients give only access to aggregate exposure. Limited information is available on access conditions and commercial practices.
- *Oman*: All licensed banks under the OCB's supervision can access the PCR conditional on payment of membership and usage

94. Member banks include non-shareholders. Participation to the PCB is mandatory in Bahrain and all request for credit facilities must be reported to the credit bureau.

fees. Interviews reveal that usage fees approximate US\$7,000.

- **Qatar:** Access to Qatar Credit Bureau is open for all its members upon payment of a membership and usage fee. Interviews point out that these fees apply uniformly within the banking sector but may differ with respect to other sectors. Fees are not publicly disclosed.
- **KSA:** The PCB is controlled by 10 national banks. Credit information is available to all members within KSA, including non-shareholders. Membership and usage fees apply. The latter may vary according to the applicants' requests. However, usage and membership fees are not disclosed and limited information is available on access conditions and commercial practices.
- **UAE:** The PCR applies a yearly subscription fee for all the licensed and supervised banks having the right to access credit information. This fee is approximately US\$5,400. A variable fee for inquiries also applies and varies according to applicants' inquiries. Short reports cost US\$19 for individuals and US\$40 for corporates. The cost of long reports varies from US\$39 for individuals to US\$149 for corporates.

Options for improving access to credit information

Stakeholder interviews indicate that cross-country cooperation on credit information harmonization could help to overcome the observed heterogeneity in PCB and PCR coverage, improve and harmonize PCB and PCR standards, and boost competition. Credit information coverage seems to vary

significantly across GCC countries. Cut-off amounts with respect to loan reporting may exacerbate such heterogeneity.

Generally, GCC credit sharing information mechanisms provide for a good level of cross-sectorality of PCBs and PCRs. However, the extent to which different sectors are considered by PCBs and PCRs varies across countries. Since an increase in cross-sectorality positively impacts competition, GCC countries could consider sharing knowledge to foster the emergence of more extensive cross-sectorality.

Credit information memory might be extended as PCBs and PCRs mature. With few exceptions, PCBs and PCRs generally store credit information for a time-span ranging from two to five years at most. Since pro-competitive effects grow as credit information memory increases, it might be beneficial to consider an extension of PCBs' and PCRs' depth where needed.

Improvement to the reliability of credit information might benefit most GCC countries. The quality of credit information could be complemented with up-to-date evidence on borrowers' creditworthiness, which would have a positive spillover effect on competition. However, most GCC countries seem to have difficulty collecting evidence regarding credit information updates. Where available, evidence on update frequency suggests room for improvement. To this aim, it might be beneficial to improve transparency on evidence pertaining to update frequency, and to foster knowledge sharing to promote best practices across the region.

Apparently discriminatory access conditions to credit information may warrant further scrutiny. Most PCBs and PCRs make credit information available at non-discriminatory conditions. However, apparently discriminatory rules seem to apply in some countries. The lack of disclosure of access fees, lower usage fees for PCBs' shareholders, information granularity varying according to the membership status, and information released only to domestic members are examples of rules that could distort the playing field. GCC governments may consider eliminating discrimination on access conditions between shareholders and other operators.

There are potential concerns about market power exercise with respect to PCB products that are sold at prices unlikely to reflect production costs. An example is the supply of reports covering both individuals and firms at a price that is twice that applying for reports entailing only firms or individuals.

Linking information on individuals and companies appears particularly important for SMEs. Since it seems unlikely that production costs increase proportionally with the scope of reports, it might be worth providing additional evidence as to whether such practices hinder competition.

Where PCBs are in place, mitigating remedies for vertical integration might help to avoid potential anticompetitive effects. Vertical integration between banks and PCBs could promote foreclosure practices that result in an uneven playing field among market actors. This effect might be amplified in the presence of discriminatory access conditions to PCBs. Thus, governments may want to consider potential remedies that

mitigate the risk of anticompetitive effects arising from vertical integration. Chinese walls are examples of remedies that might be taken into consideration.

Enforcement of competition law is critical to deterring collusive practices that may arise from information sharing. In light of potential anticompetitive behaviors, the design of PCBs and PCRs should carefully address information scope to balance adequately pro- and anti-competitive effects. However, ex-ante regulation of PCBs and PCRs is not sufficient to prevent information sharing from promoting collusive practices. Independent antitrust authorities and effective competition law enforcement shall complement the design of PCBs and PCRs to deter potential collusive practices to the detriment of competition (Porter, 2005).

BARRIERS TO CUSTOMERS' MOBILITY

The ability of customers to switch among suppliers is crucial to foster healthy competition amongst banks. Laws and regulations may raise barriers to switching, or fail to remove existing ones. Switching costs – both monetary and non-monetary – are a typical barrier that can weaken the effectiveness of consumers' competitive pressure on firms (Klemperer, 1995). This section examines whether and to what extent banking sector regulation affect SMEs' mobility in the GCC. The analysis focuses on some of the most relevant dimensions of switching from the consumer perspective.

Customers' inertia coupled with the presence of strong incumbents may limit

entry and expansion and negatively impact competition. Consumers' inertia is expected to increase with effective and perceived switching costs (Farrell and Klemperer, 2007). Borrowers' inactivity may lead to incumbents' exercise of market power that, in turn, may ease cross-subsidization practices between existing and prospective customers (Campbell et al., 2011). Excessive pricing for back-book customers allows attracting new ones by pricing below costs. Since challenger banks face different cost and customer structures with respect to incumbents', cross-subsidization may deter firms' entry and expansion.

Borrowers' propensity to switch suppliers is closely related to their ability to access and assess products' features and costs. Relevant information concerning products' features and charges must be easily available at no cost. To this aim, best practices suggest that banks shall communicate relevant information – such as interest rates, installment rate conditions, early settlement fees and ancillary fees – clearly and timely to customers (OECD, 2011b).

Early settlement fees may prevent entry and expansion by discouraging borrowers from terminating their lending contract. Fees to close a loan or a line of credit may prevent borrowers from shopping around and switching to alternative suppliers (Anderson and Renault, 1999). If so, entry and expansion may be inhibited due to the difficulty to compete for customers (Nilssen, 1992). Indeed, new entrants may be discouraged by the fact that although they can offer more valuable services, the disbursement of early settlement fees may dissuade borrowers from abandoning their current lender (Klemperer,

1987). To address these potential competitive concerns, the following dimensions are examined with respect to rules and practices pertaining to early settlement fees:

- *existence and extent*: i.e. whether early settlement fees apply, and to what extent, in case borrowers decide to close their line of credit;
- *communication*: i.e., how early settlement fees are disclosed to borrowers; and
- *ceilings*: i.e. whether regulation imposes a cap to the amount of early settlement fees that may apply in case borrowers decide to switch to an alternative bank.

The presence of well-designed deposit insurance schemes may encourage competition in the banking sector.⁹⁵ Bank safety is a relevant dimension for consumers' choice (Jagelaviciene et al., 2006). Deposit insurance schemes may affect switching by influencing customers' perception about banks' risk of default, compensating for reputational effects.⁹⁶ In particular, they may reduce consumers' biases by mitigating the perception that large and/or state-owned incumbents offer stronger guarantees in case of default. Thus, the presence of a formal guarantee on deposits may positively

95. Increased rivalry for deposits induced by deposit insurance may be excessive in some circumstances. Excessive competition may occur because of the externality of a social cost of failure (Matutes and Vives, 2000b) or because deposit insurance allows weak institutions to bid for deposits aggressively and induces sounder competitor to respond in kind on the face of strategic complementarity of deposit rate competition (Matutes and Vives, 1996). This would create increased systemic risk. However, considering the current level of competition in the GCC countries and the relative stability of the banking systems, introducing deposit insurance schemes appears desirable. In any case, insurance premiums should be risk-based in order to prevent too much risk taking (Matutes and Vives, 2000b).

96. See, among others, Fombrun and Shanley (1990), Kim and Choi (2003), and Bijlsma and Van der Wiel (2015).

contribute to the creation of a more level playing field, provided that the scheme does not directly or indirectly favor some banks (e.g. national banks) over others (e.g. foreign banks) and does not impose a too onerous cost that deters entry or expansion (Beck, 2002).⁹⁷ With respect to deposit insurance schemes, the following dimensions are assessed:

- *existence*: i.e. whether explicit deposit insurance schemes exist to protect consumers' money in case of banks' default;
- *participation*: i.e. rules affecting banks' participation and funding requirements with respect to deposit insurance schemes; and
- *coverage*: i.e. the scope of deposit insurance schemes in terms of indemnification provided with respect to deposits' amount and products' characteristics.

Current status of early settlement fees and explicit deposit insurance schemes

Regulation on early settlement fees for SME loans is heterogeneous across the GCC countries. Interviews with relevant stakeholders and desk research revealed that the level of adoption of early settlement fees by banks varies widely across the GCC countries. The same observation applies to the heterogeneity of regulatory provisions addressing early settlement fees and related

disclosure obligation. Country-specific details are provided below:

- *Bahrain*: There are no specific regulatory provisions on fees applicable to SMEs in the event they terminate a line of credit with their bank. According to stakeholders interviewed, switching costs are relatively low; however early settlement is infrequent among SMEs. Conversely, switching costs appear regulated with respect to individuals, with CBB ruling on caps and disclosure of early settlement fees.⁹⁸
- *Kuwait*: Stakeholder interviews revealed that in general no early settlement fees are levied on SMEs closing their lines of credit earlier. Any new fee introduced by a bank (including any fee related to customers switching) shall be disclosed and justified before CBK, which is responsible for approving or rejecting its introduction. Furthermore, banks are required to clearly specify to consumers all the charges related to a purchased product.⁹⁹
- *KSA*: According to the information retrieved during interviews, Saudi banks can apply early settlement fees to SMEs. In fact, fees charged appear to be extremely heterogeneous. In some circumstances, banks may charge up to the entire nominal value of the loan, or a variable amount proportional to the residual loan duration and unamortized portion. There are provisions mandating disclosure

97. The larger the population of banks contributing to the deposit insurance scheme and the broader the perimeter of the provided insurance, the stronger the effect on customers' switching and the development of a level playing field amongst firms (Shy et al., 2014).

98. CBB Rulebook, Volume 1, Part A, Business Standard, CM-8.6.2. Available at: http://cbb.complinet.com/cbb/display/display.html?rbid=1820&element_id=4606.

99. CBK's circular issued on October 16, 2006. Available at: <http://www.cbk.gov.kw/en/images/section-15-10-2750-1.pdf>.

to customers of all fees related to a purchased product.¹⁰⁰

- *Oman, Qatar, and UAE:* Like Bahrain, specific rules on early settlement fees for SMEs (or companies) do not appear to exist. However, early settlement fees for individuals are regulated and central banks mandate the scope of early settlement fees and impose ceilings. No specific disclosure requirements to individuals about early settlement fees appear to be present.

The development of deposit insurance schemes has varied across GCC countries. Deposit insurance schemes exist, or existed in the past, in most GCC countries. Their governance generally shows different arrangements:

- *Bahrain:* A deposit insurance scheme, the so-called Compensation Scheme, was established in 1993 and was recently amended by a 2010 resolution of CBB.¹⁰¹ The new scheme relies on ex-ante funding, as did previous deposit insurance scheme.
- *Kuwait:* Currently, the country has no formal deposit insurance scheme in place. However, the government fully guarantees all types of deposits in local banks.¹⁰²

100. SAMA, Banking Consumer Protection Principle, article 8 – June 2013. Available at: <http://www.sama.gov.sa/en-US/Laws/ConsumerProtectionRules/Banking%20Consumer%20Protection%20Principles.pdf>.

101. CBB Resolution No 34/2010 <http://www.cbb.gov.bh/assets/Consultations/Regulation%20in%20respect%20of%20protecting%20Deposits%20and%20Unrestricted%20Investment%20Accounts%20E.pdf> and CBB Volume 1, Part A, CP module. Available at: http://cbb.complinet.com/cbb/display/display.html?rbid=1820&element_id=4220.

102. Law No. 30/2008 published in the Kuwait Gazette on 3-11-2008 (Appendix No. 895).

- *Oman:* The government established the Bank Deposits Insurance Scheme in 1995.¹⁰³ According to relevant stakeholder interviews and desk research, amendments to the scheme were introduced in 2000 and in 2010 to incorporate best practices.
- *Qatar:* Qatar does not have a deposit insurance scheme but is planning to introduce one. Interviews also revealed that the government is planning to adopt an Islamic deposit insurance framework based on Sharia principles to address the increasing scale of operations of Islamic banks. Given the implicit guarantee offered to borrowers by government ownership in banks, stakeholders also indicated that market operators do not consider deposit insurance schemes to be relevant for credit to SMEs.
- *KSA:* SAMA introduced a deposit insurance scheme, the so-called Saudi Arabian Deposit Protection Fund, in 2015.
- *UAE:* UAE does not have a deposit insurance scheme. In response to the recent global financial crisis, an implicit deposit insurance scheme was implemented temporarily from 2008 to 2012.

In countries where a deposit insurance scheme is adopted, participation and funding involve a variety of arrangements:

103. Royal Decree 09/95 and Regulation BM/REG/39/5/95. Available at: http://www.cbo-oman.org/circulars/Crclrs_1till932.pdf.

- *Bahrain*: The Compensation Scheme is open to domestic and foreign banks (both local subsidiaries and branches). The scheme relies on two sources of funding: the Conventional Banks Fund and the Islamic Banks Fund. Both funds involve a non-refundable contribution for an aggregate amount of US\$158.9 million and US\$52.9 million, respectively. In both cases, banks shall provide their contribution over a period of fifteen years in proportion to the size of their eligible deposit accounts.
- *Oman*: Participation to the scheme is mandatory for all licensed banks, both local and foreign, operating in the Sultanate. Both CBO and licensed banks provided the initial capital for the scheme, which amounts to US\$13 million. Each year, licensed banks contribute to the fund for an amount equal to 0.05 percent of the total value of their eligible deposits. CBO contributes half of the total premiums paid by member banks each year.
- *KSA*: The Saudi Arabian Deposit Protection Fund, introduced in 2015, is funded by a special fund capitalized for this purpose.

Where deposit insurance schemes are implemented, they often offer a limited coverage in case of banks' default. The most relevant aspects are detailed per country:

- *Bahrain*: The Compensation Scheme protects all types of deposit accounts held by foreign and local banks regardless of the currency. In case of default, insurance will cover up to the equivalent of US\$39,000 per account.
- *Oman*: The Bank Deposits Insurance Scheme offers limited coverage to depositors for a compensation up to the

equivalent of US\$52,000. The insurance applies independently from banking products' characteristics.

- *KSA*: The recently adopted Deposit Protection Fund covers bank deposits up to an amount equivalent to approximately US\$53,000. Insurance covers deposit accounts independently of their characteristics.

Options for improving customers' mobility

Where rules and regulations exist, they reveal that SMEs should pay to switch to another bank. However, best practices suggest that no early settlement fees should be levied (UK Department for Business, Innovation and Skills, 2015). Positive early settlement fees, though relatively low, may exacerbate at the margin transactional costs and represent a psychological barrier to switch (Dubé et al., 2009). Best practices may be valuable references to review and reform current arrangements for early settlement fees.

Rules on early settlement fees concerning personal loans may offer a benchmark for the development of a specific regulatory framework for SMEs. Early settlement fees for personal loans seem to be regulated in detail in most GCC countries. Such rules may represent a further stimulus for the development of best practices concerning SMEs' switching procedures. Ceilings on early settlement fees for personal loans is an example of regulation whose adoption should be carefully considered in the light of its potential anticompetitive effects. Conversely, ex-ante disclosure to individuals

about products' fees is a best practice that could be adopted to foster SMEs' mobility.

Knowledge-sharing across GCC countries to address differentiated arrangements for SMEs' early settlement fees may be strengthened based on international best practices. International practices provide a source of stimulus for the development of innovative and effective practices for consumers' switching, such as the development of price comparison

websites, the employment of sophisticated communication practices, and the adoption of more advanced analytical frameworks.

The adoption of explicit deposit insurance schemes could be encouraged. The introduction of a deposit guarantee scheme may improve conditions for competition, provided that the deposit guarantee scheme is well designed and does not directly or indirectly favor some banks (e.g. national banks) over others (e.g. foreign banks).

CHAPTER 4 | ASSESSMENT OF THE COMPETITION LAWS

AN EFFECTIVE COMPETITION LAW SYSTEM

There is a general consensus in academic and policy circles that full application of competition law in the banking sector by a national competition authority is desirable and is compatible with effective prudential regulation.¹⁰⁴ Generic legislation, which applies to a large number of firms with different interests, tends to exhibit greater stability and avoids the tendency for regulation to operate for the benefit of the regulated industry. In contrast, selective competition rules encourage sectoral lobbying and are more vulnerable to industry capture.¹⁰⁵

Competition law enforcement should be in the hands of an independent authority that has a clear and coherent mandate; is explicitly mandated to protect competition; is shielded from political and economic influence; and is separated from the financial regulator.¹⁰⁶ Separation from prudential oversight does not mean that the financial regulator would have no say in competition: the prudential authority could have some

rights in any specific decision, most obviously in bank merger reviews, or policy changes. Moreover, should technical expertise be necessary for competition decisions, this could be addressed through formal or informal consultations of the financial regulator by the competition authority. Clearer separation would address some of the factors that could impede effective competition policy in the banking sector.

The efficacy of a generally-applicable competition law requires a proper blend of flexibility and strictness.¹⁰⁷ Rules concerning firms' conduct typically prohibit anti-competitive agreements and abuses of dominance. These categories are very broad. Hence, competition law enforcers must have the ability to differentiate behaviors that are likely to distort competition from those that firms undertake for efficiency reasons. Rules that are too rigid and prohibit certain conducts (e.g. below-cost pricing) without requiring a thorough analysis of the specific legal and economic context may dampen competition. Competition authorities should have the possibility of applying a rule of reason to most potential antitrust infringements and guarantee the parties the right to prove that their strategies are motivated by efficiency justifications. At the same time, hard-core anti-competitive agreements, such as price-fixing or bid-rigging, should be pursued firmly.

Exemptions to competition law prohibitions should be objectively justified and granted

104. For a discussion see, for example, Carletti and Hartmann (2003); ICN (2005); Claessens (2009); Vickers (2010); and OECD (2011).

105. See Becker (1976, 1983); Laffont and Tirole (1991); Posner (1988, 1974) Stigler (1971).

106. For a discussion of the importance of having a competition authority that is independent from the government see, for example, Høj (2007); Oliveira et al. (2005); Rey (2003); Voigt (2006).

107. The importance of this as well as of other features of an effective competition policy regime discussed in this section are elaborated in Buccirosi et al., (2009; 2011) and in the literature therein cited.

only if the exempted conduct benefits consumers in ways that offset the negative consequences of a lower degree of competition. Some conduct that restricts competition, especially agreements, might be necessary to improve the production or distribution of goods or to promote technical or economic progress. Hence, they might be exempted.

Competition authorities must be endowed with adequate investigative powers to uncover anticompetitive behavior. Competition law infringements, especially cartels, can be very difficult to detect and to prove. Conspirators employ sophisticated methods to reach and execute coordination and to conceal evidence of their wrongdoing. A competition authority can defy cartels only if it has the power to inspect the companies' premises and to obtain relevant information from market participants.

Competition law enforcement must be coupled with an effective sanction policy. The main purpose of competition law is to deter anti-competitive conduct. Firms are rational decision makers. They refrain from committing an antitrust infringement only if the expected negative consequences of the illegal conduct outweigh the expected profits. Antitrust sanctions have to be sufficiently harsh to tip the balance in favor of compliance, but it is also important to ensure that expected sanctions are proportional to the social harm caused by the anti-competitive behavior.¹⁰⁸

Sanctions can be used strategically to fight cartels through the adoption of leniency programs. Leniency programs grant a sanction reduction, up to immunity, to firms that cooperate with a competition authority by disclosing an undetected cartel or by providing evidence that can be used to successfully prosecute it. Such programs have proved effective in fighting cartels. However, they can be counterproductive if not well-designed. An effective leniency program requires a generous treatment only for the first leniency applicant and a clear and predictable application of the more favorable treatment to the applicants (Buccirossi and Spagnolo, 2006, 2007; Spagnolo, 2004).

Merger control regulation should guarantee that competition authorities are promptly informed of operations that might alter competition. Mergers and acquisitions could have anticompetitive effects by making it profitable for a leading firm to exercise power unilaterally, or by increasing the likelihood that firms in a market could successfully maintain a collusive outcome. In the case of SME lending markets, the question for antitrust analysis is whether as a result of a merger banks are likely to raise prices with respect to small business loans. Merging parties should have an ex-ante obligation to notify a merger. This obligation must arise when some objective conditions are satisfied. International best practices indicate that these conditions may refer to the turnover of the merging parties, or total assets in the case of banks.¹⁰⁹

108. See Connor, (2006) and Landes, (1983) for a discussion of this topic.

109. See, for example, Buccirossi et al. (2014), and Gonzalez and Benitez (2009) for a discussion.

This chapter assesses the effectiveness of the competition law system in the GCC countries by considering the following elements:

- The scope of competition law prohibitions as applicable to the banking sector
- Proper application of per se and rule of reason criteria to potential anticompetitive conducts
- Identification of well-defined efficiency criteria to grant exemptions
- Independence of the institution entrusted with the power of enforcing competition law and its relation with the central bank
- Adequacy of the investigative and sanction powers attributed to the competition authority and the existence of a leniency program
- Existence of an obligation to notify mergers between banks, the conditions that trigger this obligation and the criteria adopted to assess the competitive effects of a notified merger

COMPETITION LAW REGIMES IN THE GCC COUNTRIES

Existence and scope of competition law

All the GCC countries except Bahrain have enacted a competition law. KSA was the first country in the region to adopt a competition law in 2004, and amended it in 2014.¹¹⁰ Other countries followed suit:

Qatar in 2006, Kuwait in 2007, UAE in 2012 and, most recently, Oman in 2014. In Bahrain some competition-related provisions are set in Law No. 35/2012, which contains a number of consumer protection measures. Table 5 summarizes the main elements of the national competition laws in the GCC. It reports the reference number of the legal source, the denomination of the institution authorized to enforce its provisions, and the Art.s that discipline the main competition-related issues.

Stakeholder interviews reveal weak enforcement of competition laws across GCC countries. Parties interviewed, including the competition authorities, reported no enforcement activity in the banking sector. Banks' representatives showed little awareness of the prohibitions set in the competition law and of the existence of an ex-ante merger control regime. For instance, many market participants reported that mergers among banks can be scrutinized only by the central bank or by other sectoral regulators. None mentioned a notification obligation to the competition authority despite the presence of one. Hence, although the relevant provisions have been formally set, they seem insufficient to effectively prevent anti-competitive conduct and to discipline structural changes that may hinder competition. This state of affairs may be due to limited capacity at relevant institutions, the existence of large segments of economic activities that are subtracted from the application of the law, or to insufficient independence of the competition authority vis-à-vis economic and political interests.

110. As of October 2015, further amendments are being discussed.

Table 5: Competition Law in the GCC

Country	Source	Competition Authority	Agreements	Abuses	Merger
Bahrain	Law No. 35/2012	Directorate of Consumer Protection	Art. 13	Art. 14	-
Kuwait	Law No. 10/ 2007	Competition Protection Authority	Art. 4	Art.4	Art. 8
Oman	Royal Decree No. 67/2014	Authority for Consumer Protection	Art. 8 Art. 9	Art. 10	Art. 11
Qatar	Law No. 19/2006	Competition Protection and Anti-Monopoly Committee	Art. 3	Art. 4	Art. 10
KSA	Royal Decree No. M25/2004 (amended with Royal Decree No. 24/M 2014)	Competition Protection Council	Art. 4	Art. 5 (see also Art. 4)	Art. 6
UAE	Federal Law No. 4/2012	Competition Regulation Committee	Art. 5	Art. 6	Art. 9, 10, 11

Source: Elaboration on publicly available data and stakeholder interviews

Lack of enforcement activity impedes the identification of criteria needed to distinguish between anti-competitive conduct and legitimate behavior. The wording used to define prohibitions set in the relevant laws is insufficient to identify precisely which conduct is considered illegal and under which circumstances. This is a feature common to all competition legislations across the world. Hence, in all jurisdictions the exact scope of the prohibitions is mainly delineated through case law. The proper interpretation of competition rules can be further enhanced through the adoption of soft law instruments, such as notices and guidelines. Currently, it appears that these sources of guidance are lacking in the GCC, creating uncertainty. This uncertainty is exacerbated by the fact that substantive

rules contain instances of prohibited conduct that are not aligned with international best practices.

Exclusions and exemptions

GCC competition laws frequently exclude from their application a large number of business operations and/or companies. These exclusions may significantly hinder the generally positive impact of competition on the economy.

- *Bahrain*: Relevant legislation excludes from its application medicines, health related goods and services, as well as professional services concerning medicines, engineering, law, accounting and insurance (Art. 1).

- *Kuwait*: Art. 6 declares that the competition law does not apply to facilities and projects owned and managed by the state. It also excludes activities designed to facilitate economic activities, such as cooperation among companies in laying down standard specifications, and the collection and exchange of statistics and information about a particular activity.
- *Oman*: The provisions of the competition law are not applicable to the activities relevant to the public facilities fully owned or controlled by the Sultanate of Oman (Art. 4).
- *Qatar*: Art. 6 declares that the provisions of the Competition Act do not apply to sovereign ventures of the state, or acts of institutions, authorities, companies and entities directed or supervised by the state.
- *KSA*: Art. 3 of the Competition Act establishes that the provisions of the Law apply to all firms working in Saudi markets except public corporations and wholly state-owned companies.
- *UAE*: The competition law excludes from its application conduct and activities carried out by state-owned establishments and by any institution that has been granted an exception by the government. The government also has the right to exempt entire sectors, activities and businesses as it deems fit from time to time. Currently, the financial sector is among the excluded sectors (Art. 4 and Annex).

While the banking sector is not explicitly excluded from the application of national competition laws (with the exception of

UAE), the general exemption granted to SOEs and entities subject to state direction or supervision may affect competition in the SME banking sector. Chapter 2 showed that all GCC governments have direct or indirect control of a large number of banks. Moreover, the central bank oversees all banks in all the GCC countries. Great uncertainty exists on whether banks, especially those owned or controlled by the state, are subject to the provisions of national competition laws. This uncertainty was confirmed in interviews with stakeholders.

Rules concerning exemptions to antitrust prohibitions are not always objectively identified and related to the achievement of efficiency-related objectives. The competition authority is not often entrusted with power to grant an exemption. Country-specific criteria set in the competition laws to grant an exemption to the antitrust prohibitions and the authority empowered to do it are summarized below.

- *Bahrain*: The consumer protection law does not envisage exemptions to the antitrust prohibitions.
- *Kuwait*: The competition authority may, upon a request by the interested parties, allow certain practices, agreements, contracts and decisions that might restrict competition when the expected benefit to consumers exceeds the negative effects of restricting competition (Art. 5). This provision seems in line with good practices; however, it must be noted that it concerns both agreements and abuses of dominance.
- *Oman*: The competition authority has broad powers of exemption that might

cover entire businesses. Although an exemption formally requires the existence of potential consumer benefits, it can be granted to pursue objectives that may be at odds with efficiency purposes, such as the development of SMEs or the unification of the terms and conditions governing trade, delivery of commodities and payments (Art. 5).

- *Qatar*: Certain bids, agreements or contracts that limit competition may be exempted from the scope of the substantive prohibitions, when it is in the interest of the consumer. The power to grant these exemptions is in the hands of the Minister of Business and Trade (Art. 5).
 - *KSA*: The Competition Protection Council may choose not to apply the competition law prohibitions to practices and agreements in violation of competition if the expected benefits of such practices and agreements to firms and consumers exceed the negative effects of restricting competition (Art. 4);
 - *UAE*: The Minister of the Economy, following a recommendation of the Competition Regulation Committee, and upon a request from the parties, can exempt a party or parties from the restrictive agreements or practices related to a dominant market position from abiding by the substantive antitrust rules, provided that the parties can prove such restrictive agreements or practices related to a dominant position will strengthen economic development, improve the performance and competitiveness of firms, develop production and distribution systems, or realize specific benefits for consumers (Art. 7).
- Independence of competition authorities and cooperation with central banks**
- Many GCC competition authorities lack sufficient independence, which could hamper their ability to conduct balanced case reviews. We describe the relationship between the competition authority and the government in each country below.
- *Bahrain*: The Consumer Protection Authority is a Directorate of the Ministry of Commerce.
 - *Kuwait*: The Competition Protection Authority is formally independent, however it is affiliated to the Ministry of Commerce and Industry.
 - *Oman*: According to Art. 1 of Royal Decree No. 26/2011 the Authority for Consumer Protection has a legal persona and enjoys financial and administrative autonomy. However, Art. 1 of the Royal Decree No. 53/2011 establishes that the Authority is attached to the Council of Ministers.
 - *Qatar*: The Competition Protection and Anti-Monopoly Committee is tantamount to a government department, directly reporting to the Ministry of Economy and Commerce. The Committee is constituted by decision of the Prime Minister, at the proposal of the Minister of Business and Trade.
 - *KSA*: Art. 8 of the competition law qualifies the Competition Protection Council as “independent”. However, the Competition Protection Council is chaired by the Minister of Commerce and Industry, is located in the same Ministry, and is comprised of representatives of various ministries and the business community.

- *UAE*: The Competition Regulation Committee is chaired by the Undersecretary of the Ministry of Economy. The Council of Ministries determines the membership of the Committee, regulates its working arrangements and sets the remuneration of its members.

Information based on interviews indicates that a working relationship between the competition authorities with the corresponding central banks is lacking in the GCC countries. In many countries, competition authorities and sectoral regulators frequently enter into a memorandum of understanding to cooperate and exchange information. This form of cooperation enables the central bank and the competition authority to avoid overlapping responsibilities and conduct, and to execute their respective duties more efficiently. Cooperation may need to be reinforced, particularly in the assessment of mergers, since a higher degree of concentration may simultaneously hinder competition and financial access as well as financial stability and overall efficiency.

Investigative powers, sanction policy and leniency program

Competition authorities in GCC countries seem to have sufficient investigative powers to effectively perform their functions. The power of each country's competition authority to collect evidence and ascertain infringements is summarized below.

- *Bahrain*: Art. 17 of the relevant legislation provides that officers of the Directorate of Consumer Protection, designated by the Minister, have the power to inspect relevant premises.
- *Kuwait*: The Competition Protection Authority has the power to receive notices, applications and complaints; undertake investigation and search actions; collect evidence; and investigate agreements, contracts and practices that are harmful to competition (Art. 10).
- *Oman*: The Authority for Consumer Protection's personnel is entrusted with power to scrutinize and audit all relevant acts (Art. 13) and to access relevant premises and gather information required in the investigation process (Art. 14).
- *Qatar*: Art. 9 of the competition law authorizes the Committee to enter the places of business and facilities of an offender in order to search and examine documents and registers.
- *KSA*: Art. 11 establishes that the employees of the Competition Protection Council have the capacity of judicial control, and may review all records, files and documents of the firms concerned that are relevant to the complaint, and can obtain copies of relevant information.
- *UAE*: The competition law does not specify the investigative powers attributed to the Competition Regulation Committee.

Sanctions and penalties applicable to antitrust infringements vary significantly across GCC countries. Both pecuniary and criminal sanctions are envisaged to punish infringers as summarized below.

- *Bahrain*: A prison sentence for a period of no more than five years and a fine not exceeding BD 5,000 (US\$13,200), or either penalty, can be inflicted upon anyone who violates the consumer protection law provisions (Art. 21).

- **Kuwait:** Art. 19 sets a fine not exceeding the larger of KD 100,000 Dinars (US\$329,000) or an amount equal to the value of the illegitimate gains achieved for violations of Art. 4.
- **Oman:** According to Art. 19, whoever violates the substantive competition provisions stated under the law shall be imprisoned for a term not less than three months and not exceeding three years and with a fine equal to what was gained thereby in terms of profits from selling the products subject of the violation, or any of the aforementioned penalties plus a rate not less than 5 percent and not exceeding 10 percent of the total annual sales of the products subject of the violation, and that were gained by the violator during the last fiscal year.
- **Qatar:** Art. 17 provides that anyone committing an antitrust infringement shall be fined not less than QR 100,000 (US\$27,360) and not more than QR 5 million (US\$1,368,000). In all cases, the Courts shall undertake to confiscate the profits resulting from the contravention, and any other profits the offender may have obtained by means of unlawful competition.
- **KSA:** According to Art. 12 each violation of the provisions of the competition law shall be subject to a fine not exceeding 10 percent of the total turnover or not exceeding SRI 10 million (US\$2,656,000). The law also establishes the right of the victims of an antitrust infringement to obtain a full compensation; in this respect the infringers shall reimburse all profits achieved as a result of the violation;
- **UAE:** Art. 16 provides that whoever violates the provisions of both Artt. 5 and 6, shall pay a fine of minimum Dh 500,000 (US\$135,600) and maximum AED 5 million (US\$1,356,000).

The level of pecuniary sanctions seems largely inadequate to deter potential violators. Although in most cases the fine is coupled with the disgorgement of the illicit profits, the overall expected sanction appears significantly below the gains that firms can obtain from undertaking anti-competitive conduct, especially when engaging in explicit collusion. For instance, in Kuwait de facto the illicit gains constitute the maximum sanction an infringer may be called to pay. Criminal sanctions can be an effective deterrent in Bahrain and Oman. However, they seem appropriate only for hard-core cartels. For other antitrust infringements, such harsh punishments may induce firms to adopt an excessive prudential attitude and forego efficient strategies fearing that they may misjudged as anti-competitive.

Leniency programs have not been adopted in GCC competition law systems. In Oman, Qatar and UAE, the law prescribes a minimum sanction, which prevents the implementation of a leniency program that generously treats the first firm that cooperates with the authority to the existence of a secret cartel. In all the other countries, the adoption of a leniency program does not seem to require an amendment of the law.

Merger control regime

A merger control regime exists in all GCC countries with the exception of Bahrain. Firms that intend to conduct a merger or an acquisition are obliged to notify the competition authority. As already pointed out, it is not clear whether this obligation applies also to banks since they are subject to the supervisory power of the central bank.

In any event, the conditions triggering this obligation are not objectively defined. In most cases the obligation exists only if the new entity resulting from the merger acquires a dominant position, and this position is ascertained considering only market shares, which is not best practice. In particular:

- *Kuwait*: Art. 1 defines control (equivalent to dominant position) as a condition in which a person or group of persons acting together directly or indirectly control the market for products by acquiring more than 35 percent of the volume of the relevant market.
- *Oman*: “Domination” is defined as the ability demonstrated by any individual or a group of people directly or indirectly cooperating in the control over the concerned market, which means acquiring a rate exceeding 35 percent of the volume of a particular market (Art. 1).
- *KSA*: Art. 2 defines “domination” as a situation whereby a firm or a group of firms are able to influence the market prevailing price by controlling a certain percentage of the total supply of a commodity or service in the relevant industry. The regulations shall specify this percentage according to specific criteria, which include

the market structure, the ease with which other firms enter the market, and any other criteria determined by the Council.

The only exceptions where the notion of dominance is related more directly to that of market power are Qatar and UAE:

- *Qatar*: Art. 1 defines “control” or “dominance” as the power of a person, or group of persons acting together, to dominate the market and effectively to influence prices and the volume of products on offer, while their competitors have no power to prevent this.
- *UAE*: Art. 1 defines a “dominant position” as a position whereby any establishment can, by itself or in collaboration with other establishments, control or affect the relevant market.

None of the competition laws in GCC countries clarify the criteria that the competition authority must use to assess the competitive effects of a proposed merger, or the type of decisions it can make in response to an assessment. In some cases, it seems that the competition authority can only approve or block the merger depending on whether a predefined market share threshold is passed. Competition authorities seem to lack the power to approve the merger imposing specific conditions and obligation. The only exception is UAE, where the law explicitly admits this possibility. The main relevant provisions in each country are summarized below.

- *Kuwait*: Art. 8 provides that individuals or juridical persons who wish to acquire assets, property rights, or benefits; to form unions, amalgamations, mergers; or combine the management of two or

more persons in such manner as to lead to control or to increasing the existing control of a particular market, shall notify the Authority. The latter shall examine the notice and make a decision based on the analysis of the costs and benefits of the merger process.

- *Oman*: Any entity that acts in a way resulting in concentration of assets of more than 50 percent of the relevant market shall submit a written request to the Authority, which shall decide on the request within a period not exceeding ninety days (Art. 19).
- *Qatar*: Art. 10 provides that persons who wish to acquire assets or rights of ownership or use, to buy shares, to set up mergers or unite bodies run by two or more juridical persons, in such a way as to control or dominate the market, must notify the Committee. The Committee shall examine the notification and issue a decision within a period not exceeding ninety days from the date of receiving the notification.
- *KSA*: Firms involved in merger operations or firms desiring to acquire assets, proprietary rights, usufructs or shares, which cause them to be in a dominating position, shall notify the Council in writing at least sixty days prior to completion of the same. The Council may review all necessary information prior to deciding to approve or reject the notification (Art. 6).
- *UAE*: Art. 9 provides that to achieve the economic concentration operations in which the overall share of the establishments exceeds the proportion of the overall transactions in the relevant

market, and which may create or promote a dominant position, the relevant establishment shall submit a request for approval to the Ministry at least thirty days before the date of the operation.

OPTIONS FOR IMPROVING COMPETITION LAW SYSTEMS

Competition law systems in the GCC countries could be significantly improved. Although all the GCC countries have introduced formal rules aimed at protecting competition, the current enforcement systems have yielded limited expected benefits. It is important to ensure the creation of truly independent competition authorities, as well as to substantially reduce the scope of activities excluded from the application of competition law and/or from the purview of the competition authority.

To improve prospects for competition in SME banking, GCC governments are advised to delineate clearly the roles and responsibilities of the competition authority and the central bank. Competition authorities would be the only institution responsible for the enforcement of competition rules in banking, including granting exemptions and scrutinizing mergers; central banks would contribute to the enforcement activity via consultation.

An effective competition law minimizes the scope for preferential treatment and discretion towards specific banks and financial institutions. Competition law should treat banks controlled by the state, as well as any other state-controlled economic initiative, the same as all private entities.

Specific rules for exemptions may require two conditions: first, these sectors subject to exemption form a well-defined and closed list; second, the legal monopolist could be still subject to the provisions of competition law when it operates in any other sector even if economically related to the excluded one.

Competition authorities might also consider the adoption of soft law instruments to clarify the scope of the law and the criteria employed for its enforcement. Competition law is more effective if firms incorporate in their decisions the limits set in the law's substantive provisions. Hence, it is important for firms to correctly anticipate which conduct would be considered anti-competitive. A clear ex-ante definition of the criteria that guide a competition assessment help prevent manipulations and provide firms and their legal counsels with an information that is indispensable to defend themselves against allegations considered unfounded. Hence, competition authorities in the GCC might issue guidelines on the following topics:

- The delimitation of relevant markets: this is a crucial step in many competition assessments and vital to the extent that the application of some provisions require the calculation of market shares
- The interpretation of the substantive provisions concerning agreements and abuses of dominance defining the applicable theories of competitive harm: in particular, it is important to clearly distinguish vertical and horizontal agreements and, among the latter, between hard-core restrictions and other cooperation and specialization agreements

- The economic criteria that a competition authority adopts to decide on an application for an exemption, and the potentially anti-competitive practices that benefit from such an exemption (e.g. clarifying that cartels can never be exempted)
- The economic criteria that the competition authority adopts to assess a notified merger and to identify necessary remedies, if any: the guidelines may spell out the different criteria to be adopted for horizontal, vertical and conglomerate mergers and the theories of competitive harm applicable to them.

The success of a competition policy depends in part on deterring potential infringements; expected sanctions should be adequate and proportional to the potential social harm caused by anti-competitive conduct. Competition authorities might consider developing a more structured sanction policy that allows them and the courts to contemplate all relevant factors when deciding on the type and amount of the sanction to be inflicted. This policy may be divulged to all interested parties both to improve transparency and to dissuade firms from undertaking illegal behavior. Competition authorities may improve the effectiveness of their sanction policy by introducing a leniency program which, as revealed by experience in other jurisdictions, is a powerful tool to fight secret cartels.

Policymakers might consider amending merger control regulation by setting objective conditions that trigger the

obligation to notify a concentration. Notification thresholds based on objective metrics tend to be preferred according to international best practices (ICN, 2002). Parties' turnover or asset values do not require subjective calculations and are usually easily collected by the merging parties. When thresholds are based on these objective criteria, they can vary according to type required. Pre-merger notification thresholds can be based on the world-wide turnover of the merging parties, on the aggregate domestic turnover or both (total assets in the case of banks).¹¹¹ Some countries further require that the turnover of the target firm must exceed a certain threshold. The actual level of the thresholds is important. If thresholds are set too high,

a number of potentially anticompetitive mergers may not undergo a screening by the competition authority. The subsequent merger could be detrimental to consumer welfare, for example by resulting in higher prices, lower quality, or decreasing innovation. On the other hand, if thresholds are not high enough, there might be an excessive number of notifications, imposing unnecessary transaction costs on both the merging parties and the competition authority. The optimal pre-merger notification thresholds can be defined by minimizing the sum of the actual costs imposed on the competition authority and the parties when a merger has to undergo an ex-ante review and the expected opportunity cost of a non-notified merger with anti-competitive effects.

111. The aggregate turnover of the merging parties is defined as the turnover of all merging firms, that is the combined turnover of the acquiring group plus the turnover of the acquired firm.

CHAPTER 5 | WHERE DO WE GO FROM HERE?

This study has investigated competition in the SME lending markets in the GCC countries by scrutinizing potential impediments to competition arising from relevant rules and regulations imposed by the government. Rules and regulations may (i) limit the possibility of entry or expansion in the market; (ii) create discriminatory conditions among market players; (iii) limit banks' business strategy options; and (iv) constrain SMEs' ability to choose. The study has also examined the quality of the competition law system in the GCC countries. Inappropriate competition law systems may exacerbate the competitive distortions potentially introduced by rules and regulations.

SMEs are central to economic diversification and employment generation in the GCC. Most of the external financing SMEs need to grow, invest and innovate is expected to come from banks, which dominate financial intermediation in the GCC. Yet SME bank lending penetration in the region remains only 2 percent of total loans on average, compared for example to 13 percent in non-GCC MENA countries, and it is hindering the growth and development of the SME segment.

Limited SME financial access outcomes in the GCC reflect the interaction of demand, supply, institutional, regulatory, and other policy factors. Apart from obstacles arising from unfavorable investment climates, SMEs face several nonfinancial barriers related

to their own capacities, including a lack of financial accounts and reliable credit histories. Banking systems are extensive, but the high concentration of loans reflects banks' focus on large borrowers. Banks perceive SMEs as higher credit risk, and demand higher risk premiums or collateral requirements. Financing alternatives outside the banking sector are limited. Policy interventions in recent years have partly mitigated access problems but have not addressed the root causes.

One particular supply-side factor constraining SMEs' ability to obtain more bank credit in the GCC is weak competition in the banking sector. Research shows that bank competition in the GCC is among the lowest in the world, largely due to stricter entry requirements, restrictions to bank activities, relatively weak credit information systems, and lack of competition from foreign banks and nonbank financial institutions. This pattern is exacerbated by a relatively large presence of state-owned banks. Given the growing body of evidence showing that bank competition promotes access to finance and improves the efficiency of financial intermediation while not necessarily eroding the stability of the system, improving bank competition could play a pivotal role in the GCC strategy of economic diversification and increased access to finance for SMEs.

In conclusion, this assessment identifies eight broad policy areas where relevant regulations and the institutional framework may impede competition in the GCC's SME lending markets, and where additional investigative work may be warranted depending on the country context. These areas are described below.

- **First, governments in the GCC could consider assessing the anticompetitive effects of public ownership in the banking sector.** Should this test give positive evidence, a competitive neutrality principle between state-owned banks and private operators could be enforced. Possible solutions range from privatization to a set of measures aimed at mitigating the likely anticompetitive effects of public ownership, such as (i) reforming the corporate governance and oversight framework of state-owned banks to strengthen transparency and accountability; and (ii) amending all explicit provisions and influencing business practices that could further distort the market.
- **Second, policymakers might ensure that state-sponsored initiatives do not distort competition in the banking sector.** In principle, it is advisable to design state-sponsored initiatives in a way that non-discriminatory participation conditions are set and that business relationships between SMEs and banks are established. Optimal state-sponsored initiatives encourage banks to compete against each other and prospective borrowers to shop around for their preferred credit provider. A full competition assessment of current state-sponsored initiatives aimed at supporting SME financial access would be warranted to identify gaps with respect to international best practices.
- **Third, policymakers could review the process through which banks are allowed to start or expand their operations to ensure greater clarity and transparency.** Market contestability in principle could be improved by removing potential obstacles and increasing clarity and transparency in the bank licensing process. To reap the benefits of competition, it is important to create a clear perception that entry is possible: contestability would act as a disciplining device on banks and mitigate their market power, even if actual entry does not occur.
- **Fourth, governments in the GCC could look at the potential benefits from introducing a tiered approach to prudential regulation.** Tailoring the application of relevant rules and regulations based on the size, complexity and possibly other characteristics of banking organizations is a useful way to implement a tiered banking system, where entrance is encouraged without exacerbating risks in the system. Revising capital guidelines to encourage entry of small-scale banks, in particular, may positively affect market contestability in the SME lending markets.
- **Fifth, policymakers in the region might investigate potential regulatory restrictions limiting banks' strategic options.** For example, interest rate ceilings may hold interest rates below their free-market levels and act as focal points, facilitating collusion. As a result, banks may ration credit, privileging some SME borrowers and leaving most high-risk SMEs unserved. As banks advocate the need for a risk-based approach to lending, understanding the potentially negative impact of interest rate ceilings on competition is especially relevant.

- **Sixth, it might be appropriate to undertake an in-depth assessment of the credit information environment to explore possible risks of discriminatory access conditions.** Although existing credit bureaus and credit registries appear to be generally well-received among banks, their role could be strengthened. Important pro-competitive effects might derive from extending coverage, improving timeliness and reliability of information, promoting international harmonization, and undertaking initiatives aimed at connecting credit history registries with other sources of relevant financial and credit data.
- **Seventh, governments could increase customers' mobility.** SMEs can increase competition among banks by comparing their products and services and switching if they are not satisfied with their current bank. Reducing switching costs might contribute to this. Explicit regulatory provisions preventing the application of any closing fee may help to lower switching costs. Knowledge sharing in this area across GCC countries would help to develop common practices and tools to improve customers' mobility. Deposit insurance schemes might also be introduced where they do not currently exist or reformed where they have been established to improve their coverage and avoid discrimination among banks. Formal deposit insurance schemes may affect switching by influencing customers' perception about banks' risk of default, compensating for reputational effects enjoyed by larger and state-owned operators.
- **Finally, additional investigative work might be beneficial in the area of rules, institutions and enforcement of competition policy.** The findings of this initial competition assessment suggest that the role and independence of the authority entrusted with the power to enforce competition law could be strengthened. To this end, formal cooperation arrangements between competition authorities and central banks to clarify the division of labor in the area of competition could be considered. Legal amendments might be introduced to reduce the areas of activity currently excluded from the application of competition law and/or from the purview of the competition authority. Moreover, soft law instruments concerning the definition of the relevant market, the scope of antitrust prohibitions, the criteria to be employed to grant exemptions, and the criteria to assess mergers might be introduced along with a more refined sanction policy and well-designed leniency programs. Revising the conditions that trigger an obligation to notify mergers might also be an option. Finally, policymakers could consider developing and implementing advocacy initiatives that increase stakeholders' awareness of the importance of competition among banks and its positive effect on SME access to finance and economic growth.

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