

## Financial sector development for promoting investment and sustainable growth in Dubai





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**His Highness Sheikh Mohammed Bin Rashid Al Maktoum, Vice President and Prime Minister of the UAE, and Ruler of Dubai**



**His Highness Sheikh Hamdan Bin Mohammed Bin Rashid Al Maktoum,  
Crown Prince of Dubai and Chairman of Dubai Executive Council**





**His Highness Sheikh Maktoum Bin Mohammed Bin Rashid Al Maktoum,  
Deputy Ruler of Dubai**



**His Highness Sheikh Ahmed Bin Saeed Al Maktoum, President of Dubai Civil Aviation and Chairman and Chief Executive of Emirates Airline and Group**



The world's financial landscape has been changed fundamentally over the last few years. Lessons drawn from the global financial crisis point to the pressing need to have an innovative financial architecture that not only acts to provide adequate finance to businesses, but is also effective, timely and predictable that vastly enhances stability, wealth, social well-being, and environment sustainability, helping to secure long-term growth for the local economy.

The recent two decades have confirmed Dubai as a business capital of the UAE, thanks to its outstanding economic growth performance, which has been the result of a deliberated policy aimed at turning the Emirate into a regional financial center at the same development level as Hong Kong or Singapore. This comprehensive development policy aims at integrating Dubai in the world economy and transforming it into an attractive hub for investment and business.

However, in order to sustain its unprecedented economic growth, Dubai's next challenge is to continue to develop its business environment, soft infrastructure and regulatory framework as underpinned by the Dubai Strategic Plan 2021. The aim is to promote the city at the forefront of global competitiveness and innovation, in addition to positioning itself as the global capital of Islamic financing, and meeting the pre-requisites of a successful Expo 2020. This entails, among other factors, fiscal consolidation and budgetary reforms, streamlining the regulatory framework, reforming the labor market and enhancing productive job opportunities for nationals and addressing sector-specific challenges.

Consequently, the Government of Dubai, under the guidance of His Highness Sheikh Mohammed bin Rashid Al Maktoum, Vice President Prime Minister of the UAE and Ruler of Dubai, has fostered the process of financial development in order to transform the Emirate into a regional financial hub with a highly integrated financial system. It has also adopted rational fiscal policies in bar with the federal financial framework. Furthermore, the Government has consolidated the financial institutional framework, with the Dubai International Financial Centre (DIFC) being the center of this scene. The DIFC has been instrumental in connecting the Middle East, Africa and South Asian markets with the developed markets of Europe, Asia and the Americas, by providing the necessary supporting framework.

Moreover, the Government of Dubai has formed the 'Supreme Committee of Fiscal Policy', which is mandated to enhance the financial sustainability in Dubai.

Against this backdrop, this report guides all stakeholders in Dubai's economy, particularly in the financial sector, to consider the critical success factors for their businesses.

Finally, I would like to congratulate Dubai Economic Council (DEC) and Deloitte Corporate Finance Limited for their successful strategic partnership in producing this report.

**Sheikh Ahmed bin Saeed Al Maktoum**

# Foreword

We are delighted to announce the release of the “Financial sector development for promoting investment and sustainable growth in Dubai” report.

The report is being released at an exciting time for Dubai following the recent win of hosting the World Expo 2020 which will ensure the attraction of millions of visitors and promote investment. The World Expo represents a platform for sharing global ideas, innovation and sustainable growth. Additionally, the MSCI announcement earlier this year to upgrade the UAE exchanges to emerging market status has boosted investor confidence and improved market activity. Dubai is an economic and trading leader in the region, diversifying its economy successfully and investing heavily in key industries, such as real estate, infrastructure, financial services and tourism which have contributed to Dubai’s impressive growth rates over the last decade.

Dubai has succeeded in building an impressive physical infrastructure within a short period of time, which has enabled extensive development of a wide range of economic activities. However, in order to sustain its economic growth and competitiveness, Dubai’s next challenge is to continue to develop its soft infrastructure and regulatory framework underpinned by the Dubai Strategic Plan 2015 and the UAE 2021 vision. Financial sector development is one of the key pillars for achieving the three overarching objectives of

the plan: consolidation, sustainability and high productivity growth. Moreover, the recent and potentially transformational initiative of “Dubai as a Capital of Islamic Economy” hinges on turning Dubai into an international hub for conventional and Islamic finance alike.

This report focuses on the key factors that would enable Dubai, as a financial and trading hub, to reach the next level in terms of sustainability and competitiveness, in order to attract investment at the regional and global stage and promote export-oriented growth, especially in skill-intensive SMEs that could generate opportunities for nationals. In addition to financial sector development issues, the report also analyses other related areas of public policies, such as, promoting capital markets, further enhancing the regulatory system, developing the business trading system and increasing the competitiveness of SMEs. Finally, the report makes a number of policy recommendations that would support Dubai’s growth journey.



**H.E. Hani Al Hamli**  
Secretary General  
Dubai Economic Council



**Humphry Hatton**  
CEO, Deloitte Corporate  
Finance Limited, Middle  
East Region

# Acknowledgement

The Dubai Economic Council (DEC) would like to extend its sincere thanks and appreciation to Deloitte Corporate Finance Limited for sharing our vision and subsequently joining us in the conceptualisation, design and writing of this policy report that we hope to maintain as a regular annual report to be jointly produced by the two institutions.

Deloitte availed its international experts, who collaborated with the DEC staff in a cooperative and complementary way that allows the two technical teams to augment their respective comparative advantage. In particular, DEC technical staff brought their expertise on public policy and the macroeconomic issues of Dubai to complement those of Deloitte's operational knowledge of financial markets and benchmark economies.

I would like to extend my gratitude to Her Excellency Sheikha Mona Abdullah Al Moalla, DEC Chief Operating Officer, Strategic Planning and Operations, for her role in creating the motivating work environment for the staff and enabling the timely completion of this report. Dr. Abdulrazak Al Faris, DEC's Chief Economic Counselor, revised the report during its various stages and provided valuable comments.

Special thanks go to the Deloitte technical team: Messrs. Rajeev Patel, Panos Stavropoulos, Ali Bhatti and Mr. David Stark. We are also all grateful to Ms. Isabel Drabble, who took care of logistical and organisational issues, including the design and printing of the report.

We are appreciative to Dubai Statistics Center for providing us with the most updated numbers on Dubai's economy that helped in drawing the most accurate picture of its current position. We are grateful to Dubai Financial Market, HSBC, Emirates Islamic Bank, Dubai FDI at the Dubai Department of Economic Development, Commercial Bank of Dubai, Emirates Investment Bank, Emirates NBD and P Jain School of Global Management for participating at a closed-door seminar aimed at engaging stakeholders and experts to provide their feedbacks to further enhance the report before the launch event. The participants provided important remarks, which contributed substantially to the revision of the draft.

Dr. Ibrahim Elbadawi, Director of Macroeconomics & Forecasting at DEC, supervised all stages of the project and led the DEC team, which includes the project coordinator Ms. Dhuha Fadhel who also contributed to the report; Dr. Ali Al Sadik and Dr. Mohamed Trabelsi for their valuable contributions. Mr. Irfan Al Hassani proofread the original manuscript and provided substantive comments. Mr. Mohamed Al Sayed and Ms. Dana Al Qatawneh helped in the media plan and invitation letters.

Last, but not least, I would also like to express my sincere gratitude to all 'other' DEC and Deloitte staff involved on this project in one way or another. We wish them all continued success and let us keep up the good work.

**Hani R. Al Hamli**  
Secretary General  
Dubai Economic Council

# Executive summary

## I. Purpose of the report

The aim of the report is to identify factors that are likely to attract investment in Dubai by benchmarking against peer regional and international financial and trading hubs that have been successful in attracting investment to unprecedented levels. We have selected Singapore and Hong Kong as benchmark comparators principally due to:

- Their comparability as city economies; and
- Being classified as innovation driven economies comparable to Dubai, thus sharing similarities but at the same time being perceived as more established global leaders.

The report also identifies potential gap limitations and obstacles that could impact Dubai's attractiveness to foreign companies and investors. The report is broadly structured as follows:

- A brief macroeconomic overview of Dubai and economic performance in 2013;
- Dubai's financial and trading performance to date highlighting:
  - Factors that have contributed to achieving high levels of inward foreign investment; and
  - The strong platform that Dubai has built for further growth.

- Promoting investment/benchmarking analysis against Singapore and Hong Kong, identifying key improvement areas that could help Dubai achieve continued high growth rates. This chapter also includes policy recommendations as a result of the benchmarking analysis. The key areas of focus are:
  - Support the creation and growth of start-ups and SMEs;
  - Improving trading capability;
  - Developing the financial services industry;
  - Enhancing capital market activity; and
  - Regulatory framework.

## II. Economic performance overview

Dubai has undergone large scale transformation change over the last decade and is in prime position to significantly grow further as it seeks to capitalise on its current economical, trading and financial success.

Despite the global financial crisis, Dubai has succeeded in transforming its economy into a model for many countries around the world. During the period 1995 - 2003, the economy grew by almost 17% and by a further 12% during the period 2003 - 2008. Also, the emirate's GDP per capita has almost doubled from US\$ 22,752 in 2000 to US\$ 42,133 in 2012. This impressive growth has been achieved through four strategic pillars:

- Diversification of the economy to avoid its dependency on commodity resources aided by expansion in tourism, real estate and trade sectors;
- Expansion in infrastructure and logistics that has developed Dubai further and made it comparable to international standards;
- Development of the financial services sector through the establishment of an integrated system with world markets; and
- Establishment of free zones to increase the attractiveness of the economy for multinational corporations as well as entrepreneurial startups.

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The aim of the report is to identify factors that would continue to develop Dubai into a global leading trading and financial hub and attract further investment

Despite impressive overall performance, Dubai is still facing some challenges in order to enhance its regional competitive position while aspiring to catch up with benchmark and advanced economies. The figure below shows that at the moment, Dubai is ahead of other regional Arab economies, in both current and sustainable competitiveness but still lags behind the benchmark cities and advanced economies. Similarly, other regional economies, such as Qatar, Kuwait and Saudi Arabia are not very far behind Dubai and could pose a challenge to Dubai's regional dominance as a financial and trading hub.

#### Current vs. sustainable competitiveness<sup>1</sup>

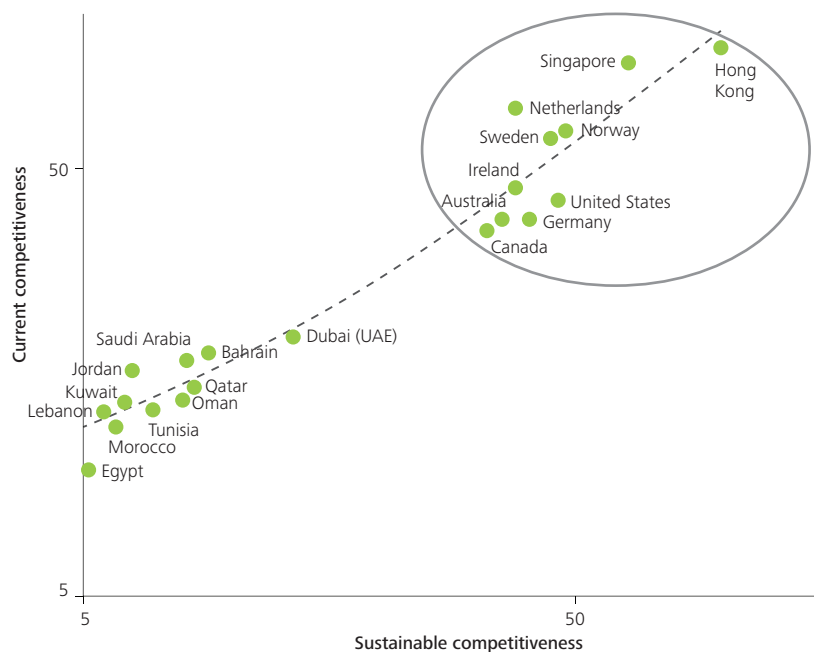
The current competitiveness index (CCI) comprises indicators of the current situation that can be affected by domestic events, external shocks and policy changes in the short to medium term horizon.

The sustainable competitiveness index (SCI) measures the cumulative effects of long run trends in the underlying variables that determine the competitiveness of an economy. These cumulative changes are the result of foundational policies and long term accumulation processes that achieve their impact only in the long run. The sustainable competitiveness index includes components such as; the quality of institutions, human capital formation and technology preparedness.

However, the below figure also suggests that Dubai's goal post should be placed far away from its immediate regional neighbours, so as to catch up with the leaders in overall economic competitiveness, such as the two benchmark city economies of Hong Kong and Singapore.

Dubai is ahead of its regional neighbours in terms of competitiveness, but further opportunities exist to bring its capabilities up to par with leading economies such as Singapore and Hong Kong

Figure 1 - Current vs. sustainable competitiveness (selected countries)<sup>1</sup>

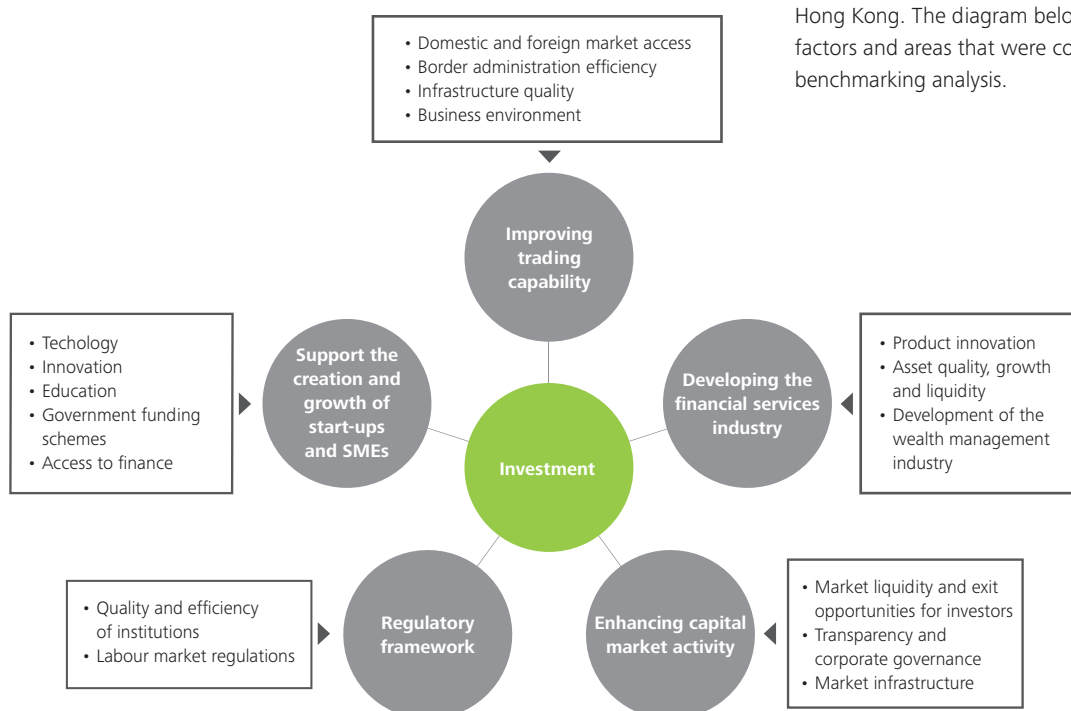


## Further developing Dubai's capabilities in key areas could ultimately attract domestic and foreign investment and support economic growth

### III. Reaching the next level

To foster growth going forward and to achieve its potential, the respective financial, legal and governmental authorities seek to continue to develop Dubai into a global leading financial and trading hub. A core component of this vision is the need to promote domestic and foreign investment in Dubai as a key contributor to economic activity and growth.

Although Dubai currently surpasses its regional neighbours, there are further opportunities for development to enable it to compete more effectively with other leading global hubs, such as Singapore and Hong Kong. The diagram below summarises the key factors and areas that were considered in the benchmarking analysis.



A summary of the results of the benchmarking analysis is shown in the table below:

Category	Saudi Arabia	Qatar	UAE/Dubai*	Singapore	Hong Kong
<b>Innovation and technology</b>					
Availability of latest technologies	Adequate	Adequate	Well developed	Adequate	Adequate
Global innovation index	Adequate	Adequate	Adequate	Well developed	Well developed
Patent applications per million population	Adequate	Adequate	Adequate	Adequate	n/a
Intellectual property rights protection	Adequate	Adequate	Adequate	Adequate	Well developed
<b>Trading capability</b>					
Domestic and foreign market access	Underdeveloped	Underdeveloped	Underdeveloped	Well developed	Well developed
Border administration	Adequate	Adequate	Adequate	Well developed	Well developed
Transport and communication infrastructure	Adequate	Adequate	Adequate	Well developed	Well developed
Regulatory environment	Adequate	Adequate	Adequate	Well developed	Well developed
<b>Financial services industry</b>					
Availability of financial services index	Adequate	Adequate	Adequate	Well developed	Well developed
Affordability of financial services index	Adequate	Well developed	Adequate	Well developed	Well developed
Soundness of banks index	Adequate	Adequate	Adequate	Well developed	Well developed
<b>Capital markets</b>					
Financing through local equity market	Adequate	Well developed	Adequate	Well developed	Well developed
<b>Regulatory framework</b>					
Quality of institutions*	Adequate	Underdeveloped	Adequate	Adequate	Adequate
Efficiency of institutions*	Adequate	Underdeveloped	Adequate	Well developed	Well developed
Labour market efficiency	Underdeveloped	Adequate	Well developed	Well developed	Well developed

\*Due to limitation on availability of benchmarking data on Dubai, UAE was used as a close benchmark, with the exception of "quality and efficiency of institutions" indicators

Source: Global Competitiveness Report 2014-2015, WEF and Dubai Competitiveness Report 2011-2012, unpublished mimeo, DEC

The above conceptual framework and the summary of the benchmarking results are underpinned by detailed analysis in chapters 1-3. The remainder of this executive summary presents the key policy recommendations associated with the benchmarking results.



#### IV. Key policy recommendations

The set of proposed policy recommendations spans five key areas of government initiatives to:

- 1) Support the creation and growth of start-ups and SMEs;
- 2) Improve trading capability;
- 3) Develop the financial services industry;
- 4) Enhance capital market activity; and
- 5) Formalise the regulatory framework.

##### 1. Support the creation and growth of start-ups and SMEs

Supporting the creation and growth of start-ups and SMEs, through appropriate government schemes, could attract further investment and contribute to economic growth. Dubai has introduced a number of government schemes and initiatives for supporting SMEs, such as the SME 100 programme, but further improvement opportunities exist to promote innovation and growth through:

- The introduction of funding schemes to support SMEs in the adoption of latest technologies;
- The introduction of Government funding, loan schemes and loan guarantee schemes to support SMEs that meet specific criteria with regards to funding of working capital requirements and expansion of facilities;

- The development of a suitable regulatory framework that supports protection of intellectual property rights and other patents;
- The implementation of government training programmes in collaboration with the private sector, to develop the skills of the local workforce and subsequently increase innovation and entrepreneurship;
- Raising awareness amongst the banking community of SME financing requirements and the need for the introduction of more customised financing products could improve access to finance as well as help banks diversify their loan books;
- Enhancing the recently implemented centralised electronic register by the national credit bureau to allow banks to access the credit history of customers of other banks. The aim of the electronic register is to track collateralised assets and loans given to businesses to provide creditors with better information to manage risk. This could assist banks in making lending decisions and ensuring only credit worthy borrowers are extended finance;
- Allowing companies' moveable assets, such as equipment to be used as collateral for financing; and
- Creating a central repository for companies' information to support SME growth by making it easier to complete supplier and customer due diligence. Additionally, this could make it easier for banks to assess SMEs and could lead to improved lending levels.

##### 2. Improve trading capability

Although Dubai surpasses its regional neighbours as a trading centre, there are still opportunities to improve its trading capability:

- Dubai could strengthen trade relationships with key partners, such as China and Africa, to increase the attractiveness of its exports and support investment.

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Supporting the growth of start-ups and SMEs through improving access to finance and government initiatives promoting innovation, improving education levels and use of latest technologies

- Further improvements in logistics capabilities, transparency of customs clearance procedures and investment in telecommunications infrastructure could enhance trading activity;
- Improving further the business environment impacting trading businesses, focusing on easing foreign ownership restrictions, efficiency of settling disputes, bankruptcy regulation and access to trade finance could increase investment further; and
- Developing Dubai's capability as a regional trading hub for halal products, by implementing international best practice trade policies and quality standards.

### 3. Develop the financial services industry

A well-functioning financial services industry is crucial to supporting other industries and consequently economic growth.

The benchmarking analysis identified three key areas that could contribute to developing the financial services industry further, which include:

#### A competitive environment that encourages product innovation

- Develop the derivatives market to improve diversification and risk management opportunities for investors;
- Developing an appropriate infrastructure and regulatory framework to regulate Islamic financial products could significantly contribute to establishing Dubai as a regional Islamic financial centre and further attract investment; and
- Developing Dubai's capability as a regional clearing and settlement centre for Chinese Yuan transactions, could enhance trading and improve market liquidity via increased Yuan denominated deposits in Dubai.

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Further developing Dubai's financial services industry through promoting product innovation, balancing asset quality, growth and liquidity and developing the wealth management industry could support growth of other industries and the economy overall

#### Balance between asset quality, growth and liquidity

Balancing asset quality, growth and liquidity through appropriate regulatory policies is critical for the sustainable growth of the banking sector. The Central Bank of the UAE has introduced a number of measures to ensure the robustness of the banking sector, including:

- New lending restrictions for government related entities (GREs);
- Issuance of Basel III liquidity guidelines; and
- Introduction of caps on mortgages.

#### Developing the wealth management industry

- Increasing liquidity of capital markets through promoting IPOs, introduction of Islamic finance products and further issuance of government bonds at discounted prices, could increase investment opportunities for wealth managers;
- Allowg admission of Real Estate Investment Trusts I and Exchange Traded Funds on the Dubai Financial Market (DFM);

- Allow usage of omnibus account (a trading account between two brokerage firms whereby a number of individual customer accounts of one firm are grouped into a single account) on DFM to attract investment by foreign wealth managers; and
- Enhancement of regulation to introduce rigorous training and minimum qualifications for wealth managers and increased monitoring of wealth manager activity to prevent unethical conduct and practices.

#### **4. Enhance capital market activity**

A well-functioning and liquid capital market encourages investment activity. Dubai's capital markets have historically faced low levels of liquidity and challenges with market infrastructure. Low levels of capital market activity deter potential investors, especially private equity and venture capital firms who look at the capital markets as a potential exit option for their investments. The enhancement of Dubai's capital markets could be achieved by improving market confidence and hence market liquidity, raising awareness of the benefits of listing and further developing the following actions through the market infrastructure.

#### **Improving market liquidity**

- Government wealth funds could increase liquidity by investing more in the local market;
- Introducing a pension state scheme for foreign high skilled workers that meet specific requirements, together with easing retirement visa restrictions, could attract more investment into the local market and support financial stability of capital markets;
- Easing foreign ownership levels of companies listed on the DFM exchange to attract more investors;
- Development of the fixed income industry and enhancement of the bond market could contribute to increased liquidity and improved pricing. For example the recent regulations issued by the UAE's Securities and Commodities Authority relating to issuance of Sukuk and conventional debt in line with best practices could boost issuance levels in the local market.
- Issuing government bonds across a range of maturities could establish a pricing benchmark for companies looking to raise debt in the capital markets. Issuance of discounted government bonds and allowing access to several types of investors could increase liquidity further; and
- Allowing admission of Exchange Traded Funds and Real Estate Investment Trusts on DFM could attract more investors and contribute to increased market liquidity.

#### **Raising awareness of the benefits of listing and adherence to listing requirements**

- Raising awareness amongst listed companies of adhering to listing requirements as well as introducing penalties for non-compliance could improve transparency and investors' confidence; and
- Educating businesses especially SMEs, on IPOs as an alternative financing option and on the importance of adhering to listing requirements, such as corporate governance and reporting, could increase listings

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The enhancement of Dubai's capital market activity could be achieved by improving market confidence and liquidity, raising awareness of the benefits of listing and further developing the market infrastructure

and market liquidity. Similarly, streamlining listing requirements such as minimum listing capitalisation and supporting businesses throughout the process through special government schemes would make listing more attractive.

#### Market infrastructure enhancements

- Implementation of the recently issued regulations to allow short selling and stock lending in DFM within defined parameters, could provide additional market liquidity whilst minimising volatility risk; and
- Allowing overdraft facilities in DFM for foreign investors and extending official trading hours to match international markets could increase market activity.

#### 5. Formalise the regulatory framework

Government regulation is crucial in supporting small and larger enterprises to trade efficiently and become more competitive. Dubai has recorded significant success through implementing a number of modern regulations and institutions over a relatively short period of time, surpassing its regional neighbours with regards to institutional efficiency and quality, however opportunities for further improvement exist.

These include:

- Easing foreign ownership restrictions in selected industries of non-national strategic importance;
- Easing trading restrictions for companies in free zones to support trading in mainland Dubai;
- Easing the criminal implications of bankruptcy and bounced cheques;
- Alignment of arbitration regulation to international standards;
- Dubai could introduce some flexibility along the lines of the proposal recently promoted by the Ministry of Labour. Such measures might include easing

## Aligning the regulatory framework to international standards with respect to bankruptcy regulation, arbitration processes, issuance of visas and easing foreign ownership restrictions in selected industries could attract further investment

retirement visa restrictions and visa extensions from 2-3 years to longer durations as in the case of Singapore where granting 10-year visas has positively influenced the consumption and investment decisions of the migrant population towards the domestic economy;

- Easing restrictions on number of employee visas allowed based on floor space for SMEs;
- Easing restrictions on freelance and part time employment could further attract high skilled human capital;
- Easing the residency rights process and ease of travel within the GCC;
- Allowing issuance of visas for high skilled expatriates that meet specific requirements without the need of a sponsor; and
- Speeding up the enactment of new and amended federal laws that aim to enhance the business environment, including those that encourage foreign direct investment.





# Macroeconomic performance

In 2013, the real growth rate of GDP increased significantly to 4.6% due to improved economic activity in almost all sectors: manufacturing 8.1%; transport 5.6%; and real estate 4.7% and the construction sector 1.3%.

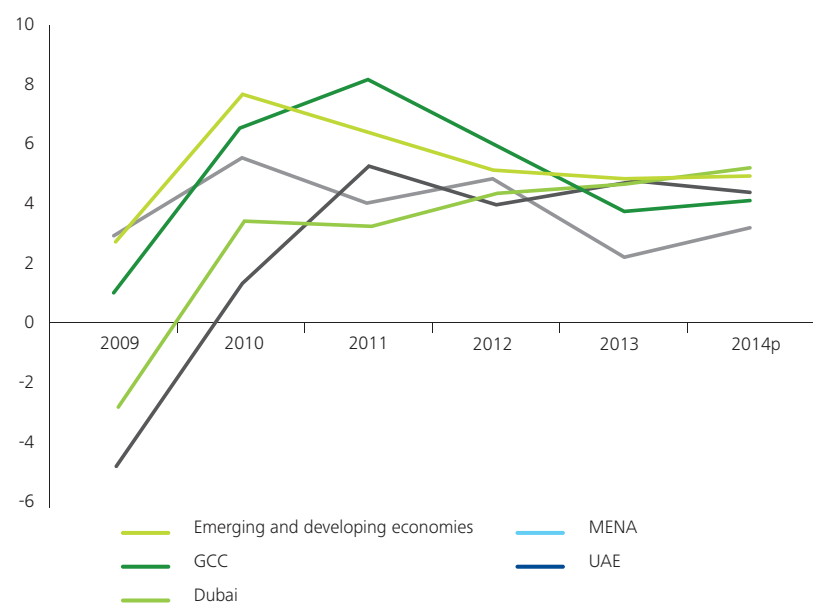
The domestic trade sector, which includes wholesale and retail trade, was the most important contributor to GDP in 2013 with more than 29% of the added value, followed by the transport sector at 14.8% and manufacturing at 13.7%. The real estate sector ranked fourth representing 13.3% of GDP and the financial sector represented 11.2% of GDP.

Dubai's 2014 GDP is estimated to grow at a rate of 5.2%. Meanwhile the first quarter registered a growth rate of 4.2%. This growth in Dubai's GDP is expected to continue over 2014 in spite of the recent decline in the international oil prices. This view is based on the following three factors: first; Dubai's economy is more diversified and is less dependent on oil, second; the expected higher demand for services by GCC countries in Dubai, will not be affected by the decline in the oil prices because of no significant changes in their spending plans due to their high accumulated reserves, and finally; the still high future growth of Dubai's major Asian trade partners.

Furthermore, Dubai's economy has been directly fueled by a growth in the tourism sector and an increasing influx in foreign capital, including from some MENA countries perceived to be experiencing some instability. Dubai's secure environment, political stability, quality of life and outstanding infrastructure have been cited as key factors encouraging visitors and incoming foreign capital.

Dubai represents a preferred visitor destination, with almost 10 million tourists visiting Dubai in 2013 and an average hotel occupancy rate exceeding 80%. The number of hotel rooms and apartments also increased by 3.3% in 2013. As this growth is expected to continue in the coming years and due to the strategic nature of tourism in economic development, the government of Dubai announced its aim to achieve the ambitious target of 20 million tourists by 2020. In terms of capital flows, it is widely believed that the doubling of foreign direct investment (FDI) in UAE to reach nearly US\$10 billion in 2013 has benefited Dubai to a large extent.

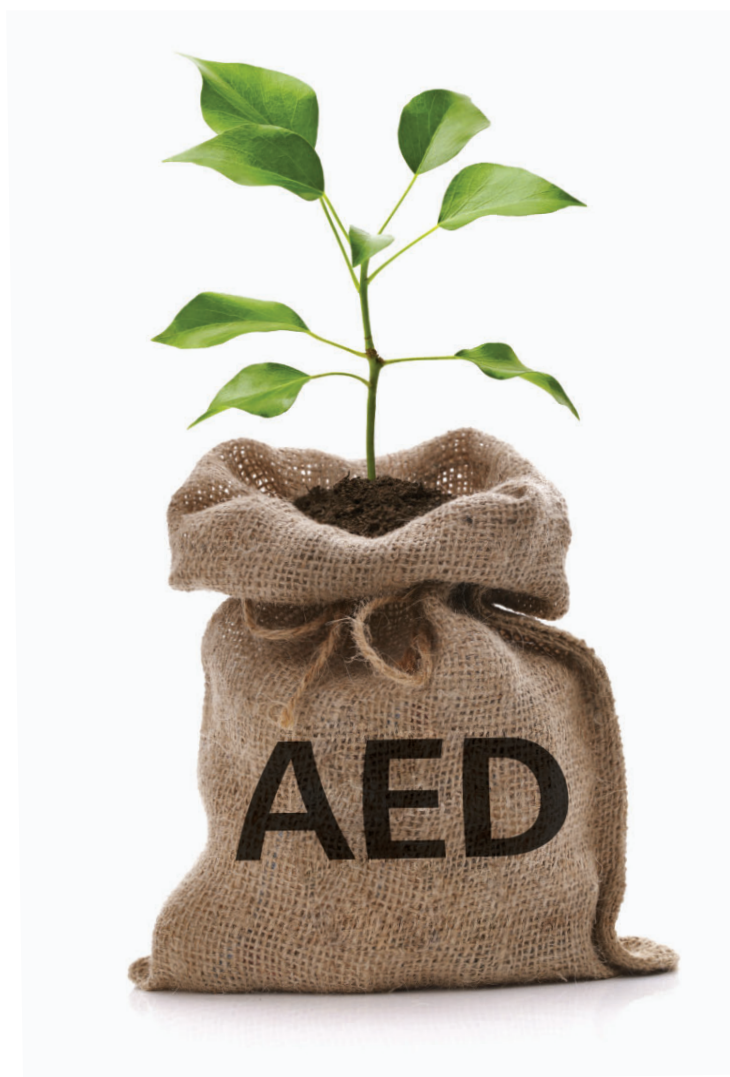
Figure 2 - Real growth rate of GDP (%)<sup>2</sup>



Note: 2014 data are based on projected growth rates.

Dubai witnessed an improvement in economic activity in 2013 as its GDP increased by 4.6%. This growth reflects the strong performance in almost all sectors: manufacturing, transport, and financial services. Dubai's economy has also benefited from a surge in the tourism sector with almost 11 million tourists visiting Dubai in 2013.

Dubai experienced a decreasing inflation rate in the period 2008 - 2012 due to a continuous decline in the average price of water, electricity, gas and fuel

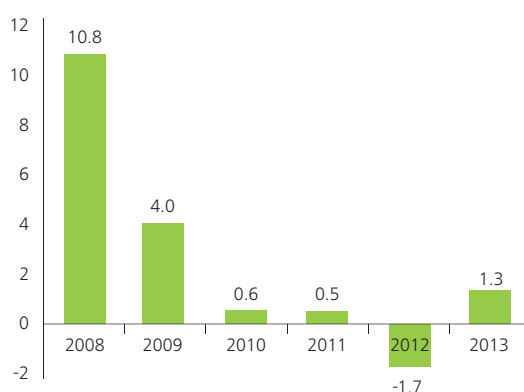


### 1.1 Inflation

In 2013, inflation remained subdued as the CPI index increased by 1.31% which is far lower than the peak registered in 2008 at 10.8%.

The deflation registered in 2013 can be explained by the increase in the average prices of housing, water, electricity, gas and fuel, education, transport and food and beverages.

Figure 3 - Inflation rate (%)<sup>3</sup>





## 1.2 Exchange rate

The UAE has pegged the Dirham to the US Dollar since the late seventies. This strategic policy is expected to ensure stability, boost investment and investor confidence in the economy. The pricing of oil to the US Dollar is another reason which explains the strategic choice. Furthermore, with a country highly dependent on oil revenues, the peg is likely to help fiscal and monetary authorities to stabilise their budgets. The peg regime also encourages economic integration with the rest of the GCC countries and might be considered as a good base for the currency union project; however it should be noted that the UAE has declared its withdrawal from this project.

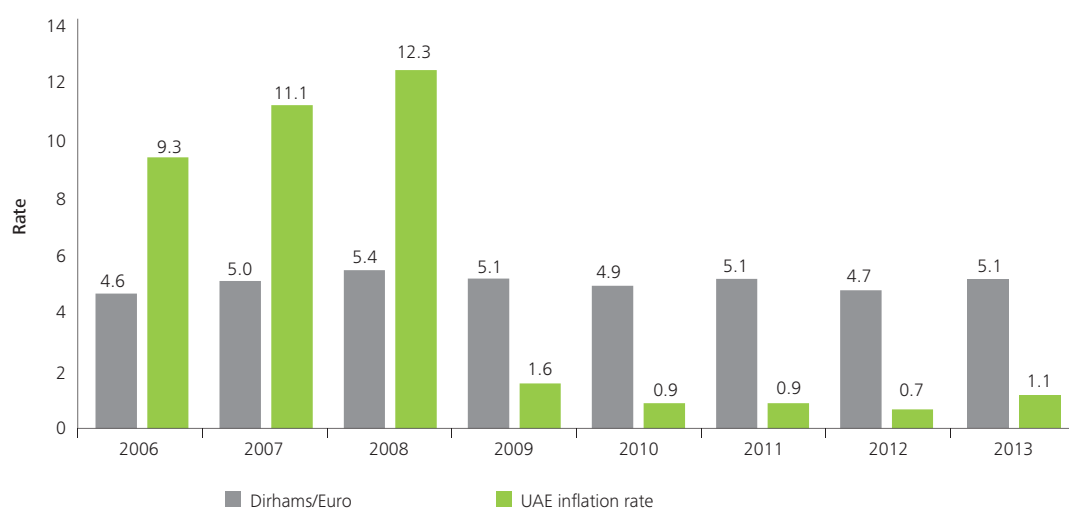
The monetary policy cannot be used as a stabilisation tool given the Dirham exchange rate is fixed at 3.6725 Dirhams per US Dollar with free capital movement. Instead, authorities rely on fiscal policy as an appropriate instrument to stabilise the economy. The resulting UAE monetary policy, which ensures the stability of the Dirham and controls inflation, is influenced to a large extent by the US because of the peg. During the pre-crisis period, the US Dollar experienced significant

depreciation with respect to the Euro, which caused inflationary pressure in the UAE that was reinforced by high growth in local demand fueled by rising oil prices in 2008.

The post crisis period witnessed a major correction in the exchange rate of the US Dollar with respect to the Euro in addition to a significant slowdown in oil price-rises, as well as economic activity in emerging market economies. The result was a progressive appreciation of the Dirham with respect to the Euro and a significant decline in the inflation rate.

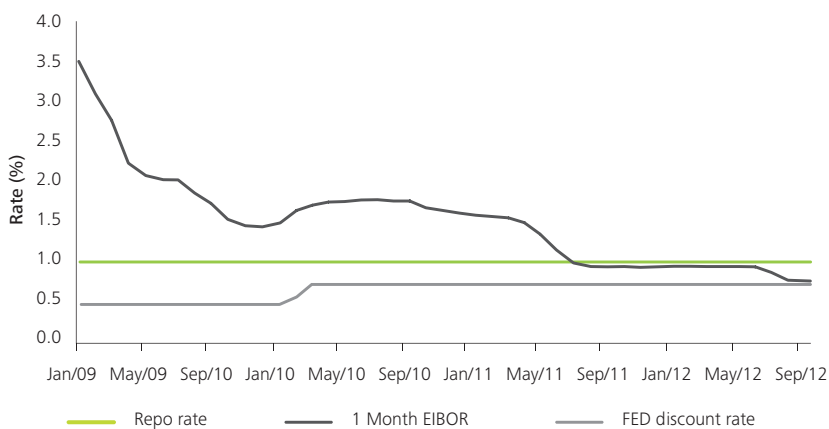
The post crisis period witnessed a progressive appreciation of the Dirham with respect to the Euro and a significant decline in the inflation rate

Figure 4 - The Dirham-Euro rate and domestic inflation in the UAE<sup>4</sup>



## The Central Bank of the UAE manages money supply growth through aligning local interest rates with those prevailing in the US and transactions on certificates of deposit (CDs) with commercial banks

Figure 5 - The dynamics of interest rates in UAE and USA<sup>5</sup>



### 1.3 Interest rates

The Central Bank of the UAE manages money supply growth through aligning local interest rates with those prevailing in the US and transactions on certificates of deposit (CDs) with commercial banks. Specifically, the role of the UAE monetary authority is to reduce the gap between local interest rates and those prevailing in the US. The interest rate for interbank transactions is called the Emirate Interbank Offered Rate (EIBOR). It is the market or reference rate that is used for financial transactions in the UAE between borrowers and lenders. However, as part of the monetary policy, the Central Bank of the UAE uses an interest rate on CDs that is considered as the principal policy rate (or the repo rate) or the benchmark for banks' borrowing from the Central Bank. The rates on the CDs are those used to announce changes in the monetary policy for comparisons with the US rates.

Figure 5 shows the trend of the 1 month EIBOR (1M-EIBOR) against the main UAE policy rate (repo rate) and the US rate represented by the FED discount rate. The chart shows that the repo rate and the US FED rate exhibit a close evolution as a result of the currency peg trajectory. The monetary policy of managing excess liquidity is achieved through the issuance of CDs.

As for the market rate (EIBOR), the chart shows a downward trend from 2009 and subsequent alignment with the policy repo rate in July 2011. This convergence might be accounted for by the conservative behavior of the Dubai/UAE banks to meet new international liquidity requirements introduced by Basel III.

# Dubai's financial and trading performance to date

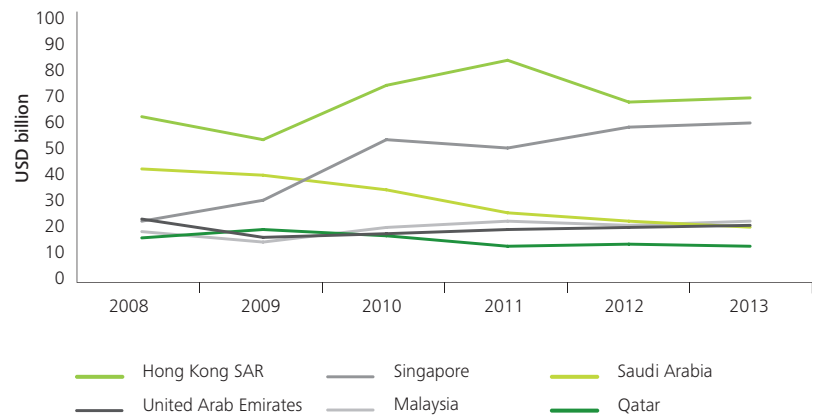
Dubai's eminence as a hub for trade goes back to the era of pearl trade and other trading activities that used to take place along Dubai Creek in the mid-19<sup>th</sup> century. The discovery of oil in the sixties has helped accelerate the economic transformation of the Emirate. However, the leadership of Dubai realised in the 1980s that the oil reserves would run dry within a couple of decades, which prompted the government to engage in significant projects aiming at diversifying the economy of Dubai.

Dubai's market-oriented policies have resulted in considerable diversification of its economy which was once dominated by the oil and gas sectors. From a share of 55% in 1981, oil contributed less than 2% of Dubai's GDP in 2013<sup>6</sup>. Leveraging on its strategic location as a crossroad between Europe, Africa and Asia, Dubai has succeeded in positioning itself as a world centre for trade, finance, logistics, transportation and tourism. Dubai's model was built on attracting FDI through the creation of free zones that offer 100% foreign ownership, free movement of labour, capital and goods, and zero taxation. Dubai has also invested heavily in building state of the art infrastructure and backbone services and developing a business-friendly environment that appeals to investors and businesses alike.

## 2.1 Foreign direct investment

Over the past decade, Dubai (and the UAE) continued to improve its business environment by building infrastructure and enacting business-friendly laws and policies intended to make it competitive in the region. These efforts have resulted in an increase in FDI inflow, which has resulted in Dubai becoming one of the top 15 attractive investment destinations according to a 2013 FDI confidence index<sup>a</sup>. In 2013, the UAE ranked 14<sup>th</sup> among the top destinations preferred by foreign investors.

Figure 6 - FDI Inflows to the UAE and selected economies, 2007-2013<sup>7</sup>



According to figure 6, the flow of FDI into the UAE increased significantly from approximately US\$5.5 billion in 2010 to approximately US\$14.5 billion in 2013 to which Dubai has notably contributed about 90%<sup>8</sup>. According to the UNCTAD statistics, FDI inflows in UAE during 2013 exceeded comparable countries in the region. The figure also shows that Hong Kong and Singapore are highly attractive destinations for foreign investment.

According to data released by the FDI office in Dubai, the flow of FDI to Dubai increased significantly by 26.5% to US\$8 billion in 2012<sup>9</sup>. Several factors contributed to making Dubai an attractive destination for investors:

- World class infrastructure and ports that have helped reduce logistic costs and executing business compared to other economies in the region; and
- Enhanced security, ease of obtaining a trading license compared to other countries in the region and business-friendly policies have also helped attract investors to Dubai. Investors are also allowed to own up to 100% of the enterprises established in the free zones.

<sup>a</sup> This is a popular FDI Index conducted by A.T Kearney, which examines the future prospects of FDI flows, first computed in 1998, and assesses the impact of political, economic and regulatory changes on the FDI intentions and preferences of leaders of top global companies.

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## Dubai attracts the majority of FDI flows into the UAE, backed by world-class infrastructure and logistics, enhanced security, tax-free environment and business-friendly policies

### 2.2 Free zones

In its quest to adopt a diversified growth strategy away from direct oil dependency, the government of Dubai has adopted a policy of encouraging free trade and attracting foreign direct investment through establishing special areas known as free zones. Today, there are 10 main free zones operating in Dubai (23 in total including the branches), hosting approximately 19,000 companies and contributing circa 33% of the total GDP of Dubai<sup>10</sup>.

To attract foreign investment to these free zones, a number of incentives have been introduced including a tax-free environment, duty-free status, 100% foreign ownership of the business, 100% repatriation of capital and profits in addition to simplified administrative procedures (refer to the box above).

#### Common set of incentives offered by DFZs<sup>11</sup>

- No custom duties
- No quotas
- No foreign exchange controls
- No restrictions on capital and profit repatriation
- Long term corporate and personal tax holidays
- Streamlined labour procedures
- 100% foreign ownership possible
- Simple procedures and minimal legislation
- Low bureaucracy
- Competitive land rates with long term renewable leases

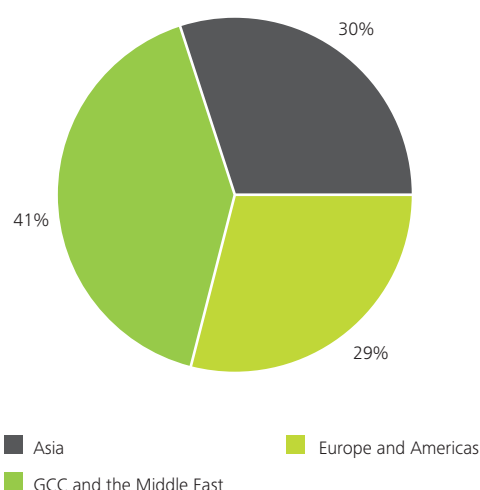
There are a number of free zones in Dubai, most notably the Jebel Ali Free Zone (JAFZA), Dubai Airport Free Zone (DAFZ) and Dubai International Financial Centre (DIFC). The following section provides a brief overview of these free zones.

#### a) Jebel Ali Free Zone (JAFZA)

Jebel Ali Free Zone (JAFZA) is considered to be the most prominent zone among the group of Global Economic Zones that belong to Dubai World. JAFZA's location has helped attract companies and global brands, seeking to take advantage of its strategic location, to facilitate and accelerate the transfer of goods to different parts of the world.

The total number of companies operating in JAFZA was 7,300 by the end of 2013. JAFZA attracted 613 new companies in 2013, of which c.30% were coming from developed and developing economies of Asia, as it is displayed in figure 7. In terms of countries, the largest number of foreign investors came from India and China.

**Figure 7 - Percentage of new companies that joined JAFZA in 2013 based on country of origin**



Trade volumes of the operating companies in JAFZA were estimated to be approximately AED330.5 billion in 2013. In addition, JAFZA contributes more than half of Dubai's exports.

#### **b) Dubai Airport Free Zone (DAFZ)**

The Dubai Airport Free Zone (DAFZ) was founded in 1996 as part of the government's strategy, which aims to support economic development and attract investment. In 2012, DAFZ was ranked the Top Free Zone in the World by the Financial Times' FDI Magazine. DAFZ was also ranked first in the Middle East and North Africa in 2011, 2012 and 2013.<sup>12</sup>

DAFZ provides all the necessary facilities to enable multinational companies to establish their regional offices and to help them benefit from its access to neighbouring markets that attract nearly two billion consumers.

Today DAFZ embraces 1,600 companies around the world, from a large number of key industrial sectors, such as aviation, shipping and logistics, information technology and telecommunications, pharmaceuticals, engineering, food and beverage, jewelry and cosmetics. Some global brands have even established their regional headquarters in DAFZ.

#### **c) Dubai International Financial Centre (DIFC)**

Dubai International Financial Centre (DIFC) was established in 2004 as a free zone specialising in providing financial services to serve as an attractive gateway for foreign investors looking for investment opportunities in the region. DIFC enjoys a strategic location, independent jurisdiction, unique tax system and a distinctive infrastructure in line with international standards making it an attractive destination for leading global companies. By the end of 2013, there were 10392 companies operating in DIFC, an increase of 14% from the previous year<sup>13</sup>.

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## Free zones have contributed significantly to the growth of Dubai's economy as they attract more FDIs though a common set of incentives including a tax-free environment and 100% foreign ownership of business

A number of leading international companies from sectors such as banking, capital markets, insurance and wealth management and professional services are based in the DIFC. There are also several international and regional companies from the fast-moving consumer goods (FMCG), petrochemical and technological industries that also operate in the DIFC.

According to a study conducted by an economic team at the DIFC, the total value added (equivalent to GDP) achieved by DIFC in 2011 was approximately US\$3.1 billion, an increase of 7% compared to the previous year. Financial intermediation activities contributed about 70% of the added value of DIFC while the remaining 30% was generated through business services and public administration<sup>14</sup>.

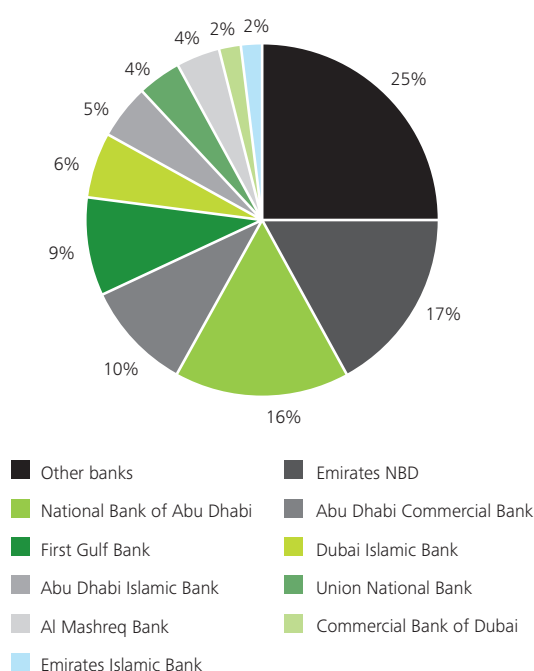
DIFC has contributed to the development of Dubai as a global financial centre. Dubai jumped from 8<sup>th</sup> to 6<sup>th</sup> place in the 2012 ranking of global financial centres according to "The Banker" magazine. Dubai has also risen from 29<sup>th</sup> to 17<sup>th</sup> in the September 2014 Global Financial Centres Index and it is now classified as a "Global Centre" compared to its previous classification as a "Transnational Centre"<sup>13</sup>.

### 2.3 The financial sector in Dubai

The financial sector has played an important role in transforming Dubai into an attractive regional destination for financial activities. The sector is divided between main Dubai and the Dubai International Financial Centre (DIFC). The internal banking activities are concentrated in main Dubai where 28 national and foreign banks operate and provide corporate and consumer financing. Three banks are offering a full range of Sharia-compliant banking services, while several conventional and foreign banks have opened Islamic banking windows to meet the growing demand in the market.

The capital market in main Dubai is represented by the Dubai Financial Market (DFM), which serves as a stock exchange for the trading of equities and bonds issued by public shareholding companies. Whereas in the DIFC, the Dubai International Financial Exchange (DIFX) (also called Nasdaq Dubai) is the stock market for the free zone and it is open to foreign investment providing a comprehensive framework for trading of bonds, equities and derivatives. It is also considered as one of the most important and liquid exchange for Islamic securities (Sukuks) worldwide.

**Figure 8 - Market shares of banks in UAE in terms of assets in 2013<sup>15</sup>**



#### a) The banking sector

The banking sector makes up the core of the financial activity in the UAE and it operates under the rules and regulations of the Central Bank of the UAE. By 2013, the total number of licensed banks operating in UAE was 51, of which 23 were national banks and 28 were foreign. The total size of assets amounted to AED2,025.8 billion by the end of 2013, equivalent to

137% of UAE's nominal GDP. The sector is quite concentrated, with 10 of the banks accounting for approximately 75% of the total banking assets in 2013 while for the remaining 44 banks the total share was below 25% (figure 8).

#### b) Capital markets

Since its creation, the capital markets sector has played a substantial role in transforming Dubai into a regional financial hub. The sector has two stock exchanges trading primarily bonds and equities: Dubai Financial Market (DFM); and Nasdaq Dubai.

Dubai financial market (DFM) began its operations in 2000 as a market for trading securities and bonds issued by public joint stock companies in addition to government and public entities. In 2005, DFM became a public joint stock company and in March 2007, began to trade its shares. Despite the improvements achieved in this sector, the market for fixed-income securities is still not well-developed as the value of traded debt instruments with respect to the exchange total market capitalisation stands at less than 1%. In fact, with the exception of "Sukuks," the listings in traditional corporate bonds are low.

On the other hand, the Dubai Financial Exchange (Nasdaq Dubai) provides a platform through which investors can access regional and international investments. In July 2010, Nasdaq Dubai outsourced its trading of equities to Dubai Financial Market. Nasdaq Dubai is located in the DIFC and is regulated by the Dubai Financial Services Authority.





# Promoting investment

## Benchmarking analysis

### 3.1 Overview

This chapter analyses the key factors at a micro and macroeconomic level that could attract investment in Dubai and what more can be done to catch up with other global economic leaders. A benchmarking analysis was conducted comparing Dubai against other global trading and financial hubs in order to identify gaps and improvement opportunities. Because Dubai is considered as the leading trading and financial hub in the region, the benchmarking analysis focuses on global trading and financial hubs. Singapore and Hong Kong were selected as the benchmarks as they are classified as innovation driven economies, sharing many similarities with Dubai, whilst being perceived as more established global players.

According to the 2014 to 2015 Global Competitiveness Index, published by the World Economic Forum, Singapore and Hong Kong are classified as innovation

driven economies with UAE being classified as making the transition from an efficiency driven to an innovation driven economy. UAE ranked 12<sup>th</sup> out of 144 countries, while Singapore and Hong Kong ranked 2<sup>nd</sup> and 7<sup>th</sup> respectively. Innovation driven economies are considered to have reached an advanced stage of economic development where business sophistication and innovation are the key factors contributing to the economy's development<sup>16</sup>.

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Attracting domestic and foreign investment is a key contributor to economic activity as measured by Gross Domestic Product (GDP)

#### Benchmarking analysis using Global Competitiveness Indices

There are several global competitiveness reports published annually by different institutions around the world aiming to assess various metrics to determine performance of a country relative to the rest of the world. Most notable reports include the Global Competitiveness Report published by the World Economic Forum (WEF) and the World Bank's Doing Business Report. These reports differ in their structure, sample of countries used and methodology. As a result, their country rankings tend to differ.

The WEF Global Competitiveness Report makes use of over 110 variables coming from the Executive Opinion Survey as well as publicly available sources.

These variables are organised into 12 pillars of competitiveness that are divided into 3 groups: Basic Requirements (institutions, infrastructure, macroeconomic stability, health and primary education), Efficiency Enhancers (higher education and training, goods market efficacy, financial market sophistication, technological readiness, and market size), and Innovation and Sophistication factors (business sophistication, and innovation). The countries are grouped into three stages of development based on their GDP per capita. Least developed countries are thought to be factor driven, middle income countries are efficiency driven while developed countries are innovation-driven.

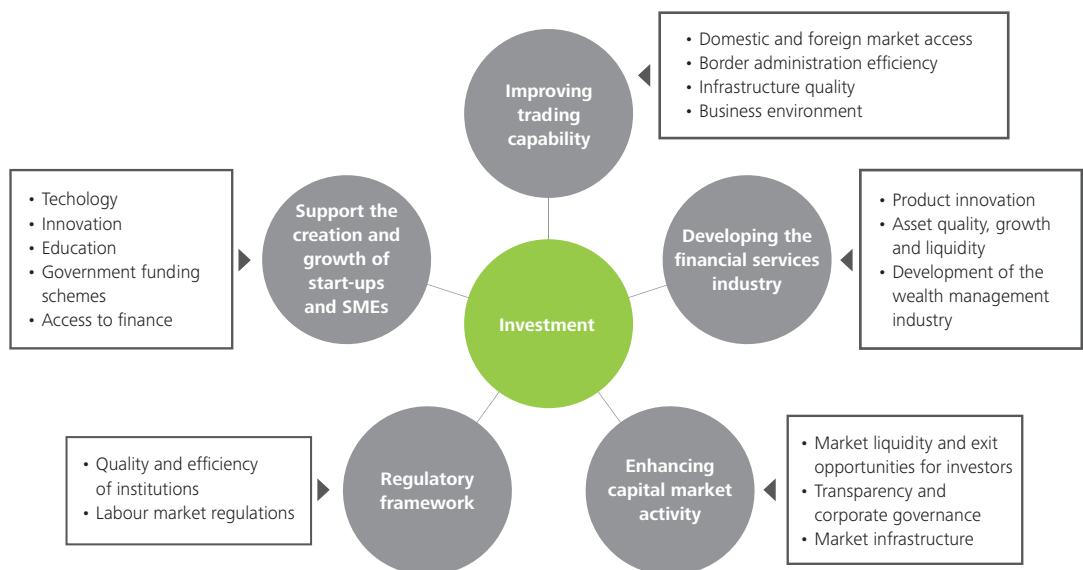
On the other hand, the World Bank's Doing Business Report assesses regulations that affect small and medium sized businesses and produces rankings for approximately 189 countries. The report contains quantitative indicators of regulations affecting 11 areas of the life of a business, which include starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, resolving insolvency and employing workers.

Though the WEF Global Competitiveness Report covers merely 149 countries, it assesses a wider and more elaborate set of indicators including institutions, infrastructure, macroeconomic stability, soft skills, technological readiness and other

indicators. While the World Bank's Doing Business Report covers a wider sample of countries (189), it is mainly focused on the cost to small and medium sized firms of business regulations. Therefore, for the purpose of undertaking the benchmarking analysis in this report, the WEF Global Competitiveness Index provides the best measure among the currently available global competitiveness indices.

Moreover, the estimated correlation coefficient between the normalized rankings of the WEF Global Competitiveness report and the World Bank's Doing Business Report published in 2013 was found to be high (about 0.85) suggesting that despite the differences in the samples and methodologies used, the rankings of countries across the two indices are not substantially different.

**Figure 9 - Key factors contributing to attracting investment**



### 3.2 Supporting the creation and growth of start-ups and SMEs

SMEs comprise 95% of all businesses in Dubai and contribute 40% of Dubai's nominal GDP<sup>17</sup>. Supporting the creation of start-ups and growth of SMEs contributes to increased innovation, national competitiveness, investment and economic growth. As SMEs grow, further capital investment is required. Additionally as SMEs become more competitive, they attract domestic and foreign investors looking for investment opportunities.

Through appropriate initiatives governments can:

- Support the creation of start-ups and SMEs;
- Support start-ups and SMEs to grow into larger more successful businesses;
- Attract foreign skilled human capital, which start-ups and SMEs can use to improve competitiveness; and
- Attract domestic and foreign investors who want to invest in Dubai's start-ups and SMEs.

This section focuses on the key factors that promote entrepreneurship, supporting SMEs to grow and attract investment. Government sponsored initiatives and programmes focusing on factors, such as financing, technology, education and innovation are crucial towards ensuring collaboration with the private sector and further supporting SME growth.

#### Dubai SME agency

Dubai SME is one of the agencies that has been introduced by the government of Dubai to support the growth of the SME sector. The agency that was incorporated into the Department of Economic Development in 2002 has been providing programmes and initiatives that are focused on policy development and advocacy, training and capability development, incubation, and access to finance and markets.

Since its establishment, Dubai SME has embarked on a number of initiatives aiming to promote the entrepreneurial sector, such as the Dubai SME 100 programme and Intelraq programme. Dubai SME has also commissioned Hawkamah, the Dubai based institute for corporate governance, to draft the "Corporate Governance Code for Small and Medium Enterprises" to provide SMEs with a set of recommendations, and a benchmark of best practices on the areas in which SMEs should develop as they grow.

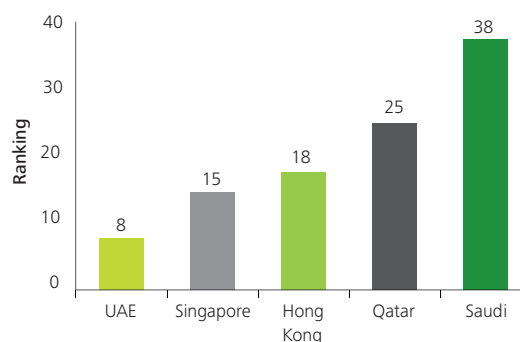
## Government initiatives to support innovation, use of latest technologies and education would be crucial to improving SME competitiveness

One of the key challenges that SMEs and start-ups currently face is access to finance. Investors are typically unconvinced of the SMEs' / start-ups' ability to guarantee a return and are also discouraged by cultural resistance to embrace the concept of corporate governance in the region, and limited financial reporting data. Dubai SME recently launched SME governance guidelines, however in the absence of a Corporate Governance "best practice" code for larger businesses, there is little incentive for SMEs to follow these guidelines.

### 3.2.1 Government initiatives to support start-ups and SMEs

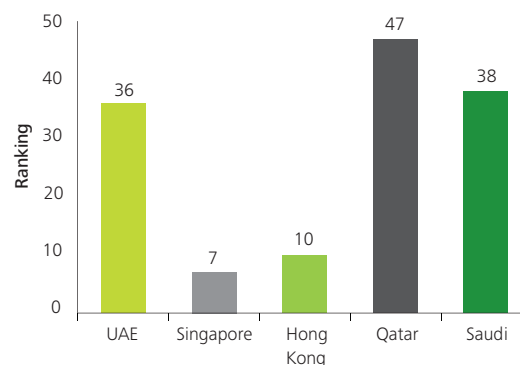
The use of latest technologies can improve SME competitiveness, which can attract further foreign investment. The UAE ranks 8<sup>th</sup> at the "Availability of latest technologies" indicator of the 2014-2015 Global Competitiveness Index, while Singapore and Hong Kong rank 15<sup>th</sup> and 18<sup>th</sup> respectively (see figure 10).

Figure 10 - Availability of latest technologies<sup>16</sup>



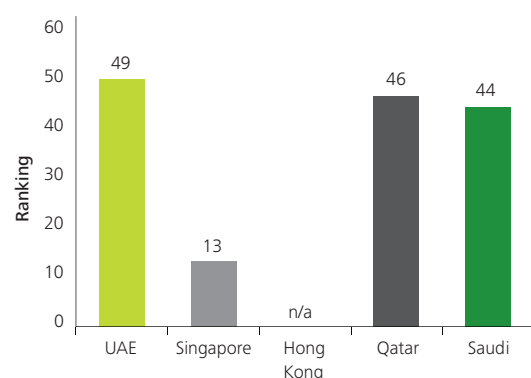
Promoting innovation is key in supporting businesses and entrepreneurs to generate new, efficient and competitive technologies. The UAE ranks 36<sup>th</sup> out of 144 countries in the Global Innovation Index, with Singapore and Hong Kong ranking 7<sup>th</sup> and 10<sup>th</sup> respectively. The Global Innovation Index measures the capability of a nation to innovate as a driver of economic growth (see figure 11).

Figure 11 - Global Innovation Index<sup>18</sup>



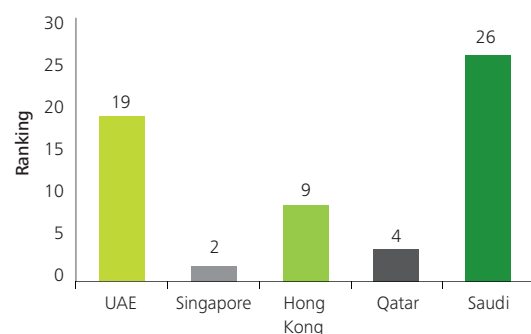
An additional measure of innovation is the number of patent applications in a nation. UAE ranks 49<sup>th</sup> out of 144 countries in the “Patent applications per million population” indicator, while Singapore ranks at 13<sup>th</sup> (see figure 12).

**Figure 12 - Patent applications per million population<sup>16</sup>**



A prerequisite for encouraging innovation and patent creation is for a suitable regulatory framework to be in place, to protect intellectual property rights. UAE ranks 19<sup>th</sup> in the “Intellectual property rights protection” indicator, while Singapore and Hong Kong rank 2<sup>nd</sup> and 9<sup>th</sup> respectively (see figure 13).

**Figure 13 - Intellectual property rights protection<sup>16</sup>**



## Enhancing the regulatory framework to support protection of intellectual property rights is key to encouraging innovation

Dubai has successfully identified the economic importance of supporting SMEs to grow by introducing various initiatives, such as the “Dubai SMEs 100” programme. The programme evaluates Dubai’s top 100 SMEs and assists them by offering them access to special government programmes, to allow further investment in innovation and human capital. The programme assesses the performance of SMEs in Dubai and lists the top 100 in terms of corporate excellence, international orientation, human capital development, innovation, financial soundness and growth performance<sup>19</sup>. Additional objectives of the programme include raising awareness of the importance of growing SMEs, encouraging sharing of best practices and marketing Dubai’s SMEs to investors.

The Dubai SME agency also offers a variety of services to support Dubai based SMEs and start-ups to grow. For example the Dubai Intelraq programme, which is one of the agency’s initiatives, supports UAE nationals to set up their own business operating from home. Under the programme start-ups receive training and support, such as marketing, financing, licensing and legal advice<sup>20</sup>.



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Government funding schemes and collaboration with the private sector are crucial in supporting SME and start-up growth. Supporting innovation, usage of latest technologies, information sharing and improving education levels are key success factors.

#### **Recommendations**

Dubai should promote the use of innovative technologies to further support SME businesses to become more competitive and attract investment. This could be accomplished by introducing funding schemes for the adoption of latest technologies. For example, Singapore's Local Enterprise Technical Assistance Scheme (LETAS) supports IT upgrade projects for SMEs by partially financing the cost of operational and technological roadmaps, quality management systems and consultancy services<sup>21</sup>. Hong Kong's Innovation and Technology Fund offers four different funding schemes to support SMEs with technology upgrades and research and development activities. To promote innovation amongst SMEs, Dubai could also make improvements in its regulatory framework to strengthen the protection of intellectual property rights.

In addition, further government funding and loan schemes could be introduced for SMEs meeting specific criteria to support growth. Hong Kong offers various funding schemes for SMEs, such as the SME Loan Guarantee Scheme, which guarantees a portion of the loan provided by a financing institution for funding of working capital requirements, expansion of facilities and acquisition of machinery.

Singapore offers a number of support funding programmes for start-ups and SMEs at their early stage of development. Some of the initiatives include the Local Enterprise Finance Scheme (LEFS) where the government provides loans to SMEs for upgrading and expanding machinery and the "SPRING SEEDS" scheme, where government agencies co-invest in local startups. Additional initiatives include the "Entrepass" scheme where an employment pass is given to foreign entrepreneurs as an incentive to stay in Singapore and operate their business<sup>22</sup>.

Improving the education level and skills of the local workforce could lead to increased innovation and entrepreneurship, which could support the creation of start-ups and allow Dubai's SMEs to become more competitive. Dubai could introduce government training programmes by collaborating with education institutes and corporates. For instance, Singapore has unveiled a host of initiatives, such as LINK (Leadership Initiative, Network & Knowledge) where the aim is to design and implement executive talent and leadership development programmes in collaboration with universities and corporates<sup>23</sup>.



Most SMEs choose to register in a free zone due to the perceived administrative burden of finding local sponsorship. The Dubai government could act as an interim local partner for a fixed period of time, to assist newly established foreign SMEs with setting up and operating in Dubai. Following the fixed period of time a local partner could then be allocated to the SME. Dubai and Abu Dhabi have already taken steps to encourage more British SMEs to invest in UAE. In April 2014 the Dubai Department of Economic Development in collaboration with British authorities launched the first British centre in Dubai that will provide support to new British SMEs that want to establish operations in the UAE. An additional British centre in Abu Dhabi is scheduled for launch later this year. The centres will also act as a local interim partner for a period of 12 months as well as support SMEs with finding affordable office space<sup>24</sup>.

Additionally, Dubai could create a central repository for company information, such as trade licenses, director details, statutory accounts, etc. This may support SME growth by making it easier to complete supplier and customer due diligence and understanding their competitors and market better.

### 3.2.2 SME access to financing

Attracting investment into the SME sector can be achieved through improved access to financing. At present, SMEs receive less than 4% of total bank loans issued across the UAE as opposed to 13% in non-GCC MENA countries<sup>25</sup>. Hurdles in the existing banking sector that hinder lending to SMEs include:

- Perceived riskiness of SMEs by lending institutions because of high bankruptcy rates;
- Failure to meet lending institutes' loan criteria;
- Lack of adequate collateral;
- Weaknesses in the existing bankruptcy law; and
- Effectiveness of national credit bureau in providing increased transparency of loans given to minimise lending risk.

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Tailoring banking products to meet SME needs, improving the national credit bureau and allowing companies' moveable assets, such as equipment to be used as collateral for financing would all strengthen the competitive edge of SMEs in Dubai and facilitate their survival under a changing business environment



According to the Executive Opinion Survey conducted by Dubai Economic Council in 2011/2012, approximately 80% of the firms surveyed indicated they obtain funding mainly from sources other than commercial banks, while only 20% have access to bank financing. Additionally 70% of respondents noted that it is not easy to obtain loans from the banking sector.

#### Recommendations

- The products provided to SMEs are limited and generic. Banks tend to consolidate all SMEs into one segment and provide them with the same products. Banks should be encouraged to look at the SME sector as an opportunity to diversify from concentrated lending thereby improving access to finance and increasing investors' confidence;
- The UAE should look to enhance the national credit bureau to assist banks in making lending decisions. The Al Etihad Credit Bureau recently implemented a centralised register to capture businesses' loan positions and payment history, with the first credit reports issued in September 2014. The system could be improved by allowing banks to access the credit history of customers of other banks. The implementation of a well regulated electronic collateral register to track collateralised assets and

loan balances of companies aims to provide transparency and reduce the cost of borrowing for businesses, as creditors will have better information to make decisions. This could mitigate lending risk and be an essential step in ensuring only credit worthy borrowers are extended finance.

- The lack of adequate collateral held by SMEs could be addressed with the finalisation and implementation of a secured lending law, currently being developed by the Ministry of Finance and the International Finance Corporation (IFC) that allows companies to register movable assets as collateral for loan guarantees (i.e. the creation of "floating charges"); and
- An implementation of a central repository holding company information would make it easier for banks to assess SMEs and could lead to improved lending levels.

#### 3.3 Improve trading capability

Establishing appropriate infrastructure, logistics services and regulation can support businesses to produce and trade efficiently, leading to improved competitiveness and increased investor interest. Developing the right infrastructure, such as modernised telecommunications, reliable energy networks, logistics and transport facilities is crucial in supporting trade. Additionally, the existence of appropriate trading policies and procedures can support businesses further by reducing trading cost and time. Having in place the right urban infrastructure, such as hospitals and schools, can also contribute significantly to attracting highly skilled human capital.

One of the key segments in Dubai's Strategic Plan 2021 is trade and logistics. Dubai has already successfully invested in several large scale infrastructure projects to attract investment, human capital and stimulate trade.

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Government regulation, infrastructure, efficient customs administration procedures and appropriate trade policies, contribute to company competitiveness in the production and trading of goods and services

This has included the construction of key free zones, such as the Jebel Ali Port, one of the ten largest and busiest sea ports in the world, and Al Maktoum International Airport one of the largest cargo and commercial airports in the world.

The UAE ranked 16<sup>th</sup> out of 138 countries in the 2014 Enabling Trade Index published by the World Economic Forum. Singapore and Hong Kong ranked 1<sup>st</sup> and 2<sup>nd</sup> respectively<sup>26</sup>. The Enabling Trade index measures a nation's capabilities (institutions, policies and services) in facilitating the flow of goods over borders. The index takes into consideration four main factors for enabling trade:

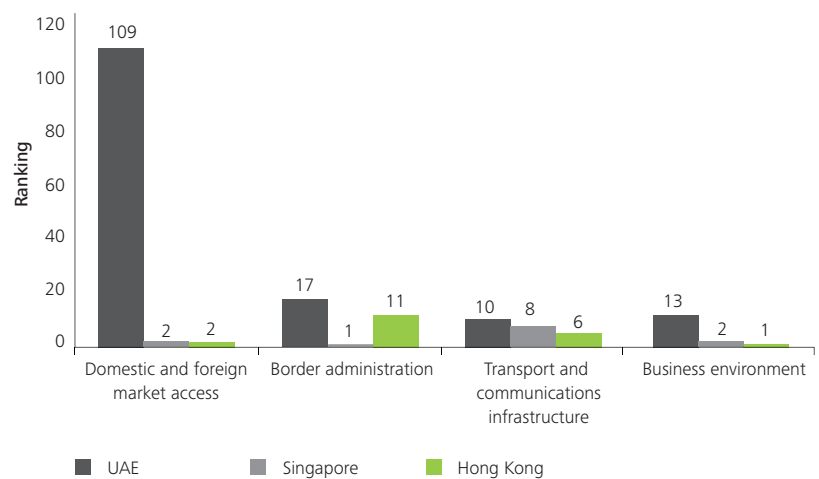
- The "domestic and foreign market access" sub-index assesses the effectiveness of a country's tariff regime and barriers on imports as well as barriers faced by a country's exporters in other foreign markets.
- The "border administration" sub-index assesses the effectiveness of a country's policy framework in supporting the trade of imported and exported goods;
- The "transport and communications infrastructure" sub-index assesses the level of infrastructure supporting the movement of imported and exported goods; and
- The "operating environment" sub-index assesses the effectiveness of the regulatory framework in supporting the importers and exporters of a country to conduct business.

A similar index, the "Logistics Performance" index, issued by the World Bank in 2014 ranked UAE 27<sup>th</sup> out of 160 countries, with Singapore and Hong Kong ranking 5<sup>th</sup> and 15<sup>th</sup> respectively<sup>27</sup>.

The figure opposite shows a benchmarking of UAE, Singapore and Hong Kong against the four factors of the "Enabling Trade" index.

## Enhancing Dubai's capabilities to support trade could improve SMEs competitiveness and enable further growth of SMEs

Figure 14 - Benchmarking of Enabling Trade Index's factors<sup>26</sup>



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India and China are Dubai's largest trading partners with an estimated foreign trade activity of AED81 billion and AED63 billion respectively. Strengthening trade and investment protection agreements with key trading nations could help eliminate some of the investment barriers.

#### 3.3.1 Domestic and foreign market access

UAE's trade policy is considered relatively restrictive, mainly due to high tariffs that UAE exports face in destination markets and higher tariffs applied to imports:

- UAE ranks 126<sup>th</sup> in the "Tariffs faced %" indicator of the Enabling Trade index, while Singapore and Hong Kong rank 5<sup>th</sup> and 134<sup>th</sup>. The "Tariffs faced %" indicator measures the weighted average of tariffs applied abroad on a country's exported products<sup>26</sup>.
- UAE scores 53<sup>rd</sup> in the "Tariff rate %" indicator of the Enabling Trade index, while Singapore and Hong Kong rank 3<sup>rd</sup> and 1<sup>st</sup>. The "Tariff rate %" indicator measures the weighted average of custom duties applied on imported goods<sup>26</sup>.

India and China represent two of the largest trade partners for Dubai. In the first half of 2013 India represented the top trading partner with a foreign trade value of AED81 billion, while China came second with a value of foreign trade at AED63 billion<sup>28</sup>.

The depreciation of the Indian rupee in 2013 has led to a significant amount of funds flowing out of UAE into India. India has introduced a number of policies to tackle the fall of the rupee by trying to limit the supply of the rupee in the markets. The reserve bank of India has introduced a cap on outward investment, which could affect Dubai's real estate market and also increased tariffs on imported gold. The highest portion of foreign investment in Dubai's real estate market came from India, at a value of AED 5.53 billion<sup>29</sup>.

Additionally, Dubai represents the top exporter for gold to India, with exports of gold and jewelry standing at US\$21 billion in the first half of 2013. Dubai Gold trading exports decreased by 60% over the last few months of 2013 following the increase in tariffs introduced by India in early 2013<sup>30</sup>.

#### Recommendations

Dubai could strengthen trade and investment relationships with key trading partners, such as India, China and Africa to increase trading and investment levels.

China and the UAE have a bilateral trade and investment protection agreement in place, however there are opportunities for enhancing trade and investment activities further by making Dubai a clearing and settlement centre for Chinese Yuan transactions. This is discussed in more detail in section 3.4.1.

### 3.3.2 Border administration

Border administration and clearance of goods in the UAE is considered more difficult compared to Singapore and Hong Kong due to:

- Lower efficiency of customs administration procedures. UAE ranks 25<sup>th</sup> in the “efficiency of clearance process” indicator, while Singapore and Hong Kong rank 3<sup>rd</sup> and 17<sup>th</sup> respectively<sup>26</sup>; and
- More days required to import goods, with a larger number of documents required and higher costs. UAE ranks 10<sup>th</sup> in the “no. of days to import” indicator, while Singapore and Hong Kong rank 1<sup>st</sup> and 2<sup>nd</sup> respectively.<sup>26</sup> UAE ranks 27<sup>th</sup> in the “no. of documents required to import” indicator, while Singapore and Hong Kong both rank 3<sup>rd</sup>.
- Higher costs to export from the UAE. UAE ranks 16<sup>th</sup> in the “cost to export” indicator, while Singapore and Hong Kong rank 2<sup>nd</sup> and 4<sup>th</sup> respectively.

#### Recommendations

To increase trading activity and attract investment, Dubai could improve its logistics capabilities and become more transparent and efficient regarding customs clearance procedures.

### 3.3.3 Transport and communications infrastructure

The UAE ranks lower in the “Transport and Communications Infrastructure” index compared to Hong Kong and Singapore mainly due to:

- Lower availability and quality of transport infrastructure. UAE’s quality road infrastructure and trans-shipment connectivity is considered less developed compared to Hong Kong and Singapore<sup>26</sup>;

## Improving Dubai’s logistics capabilities and further enhancing transparency of customs clearance procedures could increase trading activity and attract investment

- Lower availability and quality of transport services. UAE ranks lower in key areas, such as ease and affordability of arranging competitively priced shipments, logistics industry competence, tracking and tracing ability of shipments and postal efficiency<sup>26</sup>; and
- Lower availability and usage of information and communications technology. Fewer companies in the UAE use the internet to facilitate business operations, such as buying and selling goods and interacting with suppliers and customers<sup>26</sup>.

#### Recommendations

Additional government investment in logistics services and telecommunications infrastructure could enhance trading activity, making it faster and easier for businesses to trade. Enhancing infrastructure, such as developing a rail network connecting Dubai with other Emirates and also other GCC countries could increase trading activity and investment further.

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## Developing the appropriate capabilities to accommodate halal industries, such as food, medicine and cosmetics could attract further investment and contribute to increased trading and economic activity

### 3.3.4 Business environment

The business environment for importers and exporters is considered more restrictive in the UAE due to:

- Lower protection of property rights and intellectual property. UAE ranks 21<sup>st</sup> in the “Property rights” indicator, while Singapore and Hong Kong rank 2<sup>nd</sup> and 8<sup>th</sup> respectively<sup>26</sup>;
- Higher barriers to foreign investment. The “Openness to foreign participation” indicator ranks UAE 14<sup>th</sup>, while Singapore and Hong Kong are ranked 3<sup>rd</sup> and 2<sup>nd</sup> respectively<sup>26</sup>;
- Higher difficulty for companies to obtain trade finance at affordable cost. UAE ranks 11<sup>th</sup> in the “Availability of trade finance” indicator, compared to Singapore 12<sup>th</sup> and Hong Kong 1<sup>st</sup> (26); and
- Lower efficiency in settling disputes, lower levels of transparency of policy making and complexity of governmental administrative requirements. The UAE ranks 20<sup>th</sup> in the “Government efficiency and accountability of public institutions” indicator compared to Singapore 1<sup>st</sup> and Hong Kong 2<sup>nd</sup> (26).

### Recommendations

There are a number of factors that would contribute to a less restrictive business trading environment:

- Improving the efficiency of settling disputes;
- Improving bankruptcy regulation to support companies in financial distress;
- Easing foreign ownership regulations;
- Improving access of trade finance to businesses;
- Increasing protection of property and intellectual property rights; and
- Clearing the complexity surrounding governmental administrative requirements.

An additional opportunity for Dubai to diversify its trading economy and attract further investment is developing the capability to accommodate halal industries. Halal industries are industries that follow Sharia’a principals as part of their economic development. On the 9<sup>th</sup> of January 2013, His Highness Sheikh Mohammad Bin Rashid Al Maktoum, Vice-President and Prime Minister of the UAE and Ruler of Dubai, announced the “Dubai: Capital of Islamic Economy” initiative, which is aimed at transforming the Emirate’s economy into a comprehensive platform of Islamic financial services and “halal” industries. Trade of halal products is expected to more than double and grow to US\$8.4 billion by 2020, according to government estimates, representing a significant opportunity for the economy<sup>31</sup>.

As part of developing a halal trading hub within Dubai, the Emirate will need to implement appropriate trade policies, commercial laws, quality standards and provide the trading infrastructure to support halal industries, such as food, medicine and cosmetics. Cooperation with other global leading Islamic financial hubs, such as Malaysia will be imperative to support standardisation of practices and regulations, sharing of knowledge and linking successfully to the international supply chain.

### 3.4 Develop the financial services industry

One of the key markets in developing nations is the financial services industry, the development of which supports the investment, growth and trading activities of almost all industries. According to data released from the Dubai Statistics Centre, the financial services industry accounts for approximately 68% of all inward UAE FDI<sup>32</sup>.

This highlights the importance of how a growing, competitive and developed financial services industry, which in the UAE is dominated by the banking sector, has the potential to encourage and contribute to greater levels of investment. A fully functional banking sector within the UAE requires:

- A competitive environment that pushes product innovation;
- A balance between asset quality, asset growth and liquidity; and
- A strong regulatory framework.

#### 3.4.1 A competitive environment that pushes product innovation

According to the Central Bank of the UAE, there are 23 local banks and 28 foreign lenders operating in Dubai at present<sup>33</sup>. The number of banks has remained relatively stable for a number of years largely due to regulatory constraints set on foreign banks, such as restrictions on the number of branches they are permitted to operate. Other global leading financial hubs have set similar constraints upon foreign banks. In Singapore, foreign banks face restrictions in terms of the number of ATMs and branches they can operate.

## Further development of Dubai's financial services industry would contribute to the growth of other industries and encourage increased levels of investment

The constraints set on foreign banks may have led to a less competitive banking sector in the UAE, thereby discouraging product innovation and increasing prices. In order for the banking industry to grow and encourage investment in Dubai, appropriate and affordable banking products need to be available to satisfy customer needs and build investor confidence.

For instance, there may be an opportunity to further develop Islamic banking products to cater for the increased appetite for Islamic finance products internationally. The Islamic banking sector in the MENA region alone is expected to double in size and grow to US\$990 billion by 2015<sup>34</sup>.

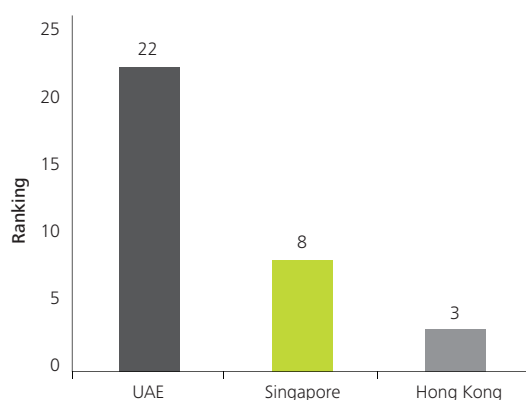
The two indices illustrated on the right highlight opportunities for the UAE banking sector to further development in terms of availability and affordability of products.

## Establishing Dubai as a regional clearing and settlement centre for the Chinese Yuan currency could attract further investment and increase liquidity in the market

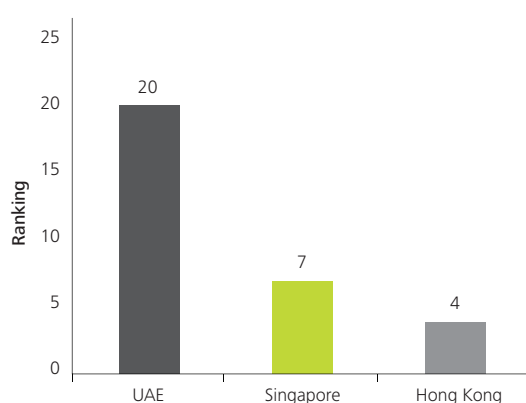
The availability of financial services index, which measures the variety of financial products and services offered to businesses, ranks the UAE at 22<sup>nd</sup> compared to Singapore 8<sup>th</sup> and Hong Kong 3<sup>rd</sup>.

The affordability of financial services index, an indicator that measures the provision of financial services at affordable prices, ranks the UAE 20<sup>th</sup> compared to Singapore 7<sup>th</sup> and Hong Kong 4<sup>th</sup>. The banking sectors in Singapore and Hong Kong face similar restrictions to the UAE, but they rank higher in the two indices due to higher savings rates.

**Figure 15 - Availability of Financial Services Index<sup>16</sup>**



**Figure 16 - Affordability of Financial Services Index<sup>16</sup>**



### Recommendations

China represents the second largest trading partner for UAE after India. From 2002 to 2012 trade between the two nations increased from US\$3.12 billion to US\$15.6 billion representing a growth of 400%<sup>35</sup>. Over the last few years, UAE and China have been co-operating to strengthen their trading and investment relationship. According to senior officials in the DIFC, Dubai could draw further investment by becoming an offshore trading centre in the GCC for the Chinese Yuan currency and providing a gateway to Africa for Chinese companies that want to establish a presence in Dubai. It is estimated that about 60% of China's trade to Africa and Europe passes through Dubai. When exporting goods from China to Dubai and then Africa, the currencies involved in settling trading transactions is the Chinese Yuan, Dollar and the local African currency. By establishing Dubai as a settlement centre for Chinese Yuan transactions, only two currencies will be used for these transactions, the Chinese Yuan and the local African currency, which will ultimately eliminate the Dollar currency exchange and related costs.



Singapore, Taiwan and Hong Kong have all established themselves as Yuan trading and settlement centres, with London, Paris and Frankfurt also currently developing similar capabilities. Several banks in Dubai, such as Standard Chartered, HSBC and Mashreq have started offering current accounts and banking services denominated in Yuan. Additional benefits include currency hedging for Chinese exporters, by eliminating any fluctuations in the exchange rate between the Dollar and the Yuan. Currently, the amount of trades settled in Yuan are only around 4% of the total trades between China and UAE, however a large increase is anticipated over the next couple of years as demand and trading activity is expected to increase<sup>36</sup>.

Establishing Dubai as a regional settlement centre for Yuan transactions could also result in additional liquidity for the Emirate from increased Yuan denominated deposits in Dubai. DIFC could play a leading role acting as a clearing hub for Yuan settlements as well as providing related financial services. Changes in UAE's Central Bank regulatory framework would be necessary to allow Dubai to become a Yuan clearing centre. Another market segment that has yet to be developed is the derivative market. Derivative products in the UAE are considered to be simple in nature as compared to other more mature markets. The development of derivative instruments, such as securitisation products, may bring benefits in terms of better diversification and risk management opportunities for investors.

Housing finance is a key area with considerable growth potential. As the young working age population in Dubai is anticipated to increase, demand for mortgages is also likely to increase. Meeting this demand together with managing risk will be critical for the economy. The recent introduction of mortgage cap regulation by the UAE Central Bank aims to protect the sector.

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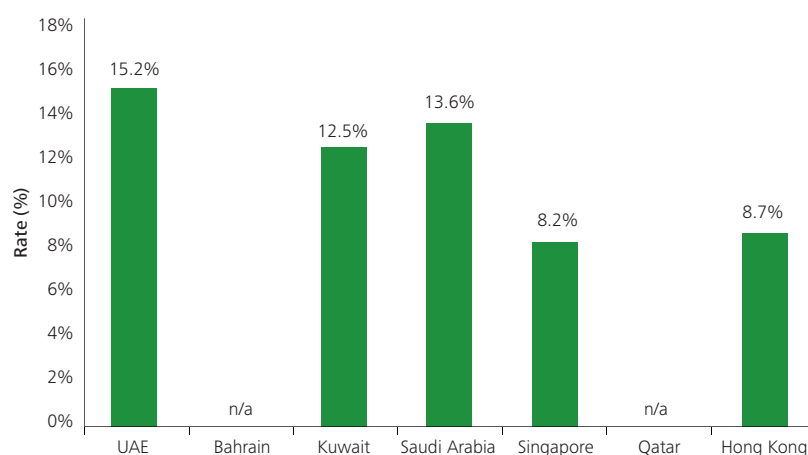
## Developing Dubai's Islamic banking sector could contribute to further investment and liquidity

Given the potential growth opportunities within the Islamic banking sector and Nasdaq Dubai's position as one of the biggest Sukuk markets in the world, the UAE could look to design and implement a regulatory framework that facilitates growth and investment in the sector. Close co-operation with established global Islamic hubs, such as Malaysia will be crucial for ensuring standardisation of Islamic products and procedures. DIFC and DFSA have already initiated steps towards providing the necessary infrastructure and regulation to develop Dubai into a global Islamic financial hub by introducing a set of laws, regulated through the Independent Islamic Finance Regulatory Regime.

### 3.4.2 Balance between asset quality, asset growth and liquidity

During the crisis in 2008 the UAE and Dubai became less attractive as an investment hub to the world markets, with foreign funds being moved to more secure alternatives. This highlighted the need for greater diversification, improved credit quality and prudent bank lending. In order for the UAE banking industry to be successful there needs to be a sustainable balance between asset quality, asset growth and liquidity.

**Figure 17 - Capital adequacy ratios (2014)**

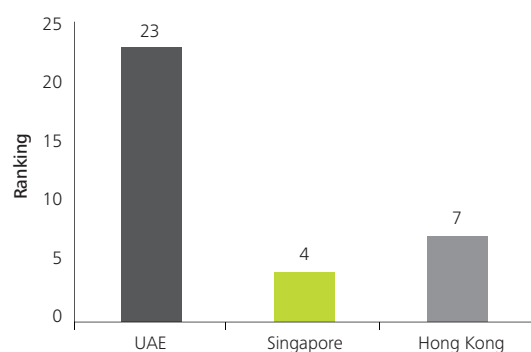


In terms of capital adequacy the UAE is performing exceptionally well. In 2014, the UAE achieved the highest capital adequacy ratio compared to Kuwait and Saudi Arabia and also outperformed Singapore and Hong Kong. The capital adequacy ratio is a measure of a bank's capital (e.g. shareholders' paid up capital, reserves, etc.) to its risk weighted assets (e.g. loans, investments, etc.).

The ratio is usually tracked by national banks to ensure that a bank has adequate capital in case it needs to absorb an amount of loss. According to international standards, a ratio of 8% and above indicates that a bank is adequately capitalised.

However, despite being highly capitalised, the "Soundness of banks" index as per the 2014/2015 World Competitiveness Report highlights that UAE ranks 23<sup>rd</sup> out of 144 countries, while Singapore and Hong Kong rank 4<sup>th</sup> and 7<sup>th</sup> respectively.

**Figure 18 - Soundness of Banks Index<sup>16</sup>**



The UAE's ranking can be explained by:

- **Asset quality:** Compared to both Hong Kong (0.95%) and Singapore (1.3%) the UAE has a significantly higher Non-Performing Loan (NPL) ratio (8.4%)<sup>39</sup>. The high ratio is driven by the lending practices and trends of banks in the region during the years leading up to the economic downturn in 2009. Most UAE banks had a high proportion of lending concentrated within certain cyclical industries, such as real estate, construction and hospitality and also certain corporate types (e.g. Government, semi-Government and family businesses).
- **Asset growth:** UAE banks have witnessed slower credit growth in the past few years, with an average increase in total assets of 5.6% between 2010 and 2012, compared to average growth rates of 10% in both Hong Kong and Singapore<sup>39</sup>. Post financial crisis, UAE banks have focused on ensuring that they maintain liquidity requirements and therefore have not looked to increase their loan books.

- **Liquidity:** During the financial crisis, UAE banks faced a liquidity squeeze with the Central Bank of the UAE injecting AED120 billion into local bank recapitalisation policies whilst the Finance Ministry poured AED50 billion into bank deposits to boost liquidity. Consequently, although UAE banks have been able to maintain sound loans-to-deposits ratios that compare favourably with both Hong Kong and Singapore liquidity concerns have reduced the risk appetite of lending institutions limiting the potential growth in the sector.

#### Recommendations

- The role and support offered by the Central Bank of the UAE and other regulatory bodies underpin the growth prospects of the UAE banking system and its attractiveness to foreign investors. Throughout the financial crisis the Central Bank of the UAE intervened and actively addressed the risk profile and asset quality of UAE banks. The UAE banking strategy going forward could look to address the balance between asset quality, asset growth and liquidity through a strong regulatory framework in order to maintain investors' confidence and encourage investment into Dubai.
- The Central Bank of the UAE has already introduced a number of measures that enforce the pivotal role it continues to have in ensuring sustainable growth within the industry. For instance:
  - New lending restrictions to GREs came into effect in December 2013 according to which UAE banks are not be permitted to lend sums exceeding 100% of their capital to governments and their related companies or more than 25% of their capital base to an individual borrower;

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Balancing asset quality, asset growth and liquidity could contribute to improving the banks' balance sheets and ultimately the soundness of the banking sector as a whole

- Currently finalising regulations on liquidity in line with Basel III requirements. The implementation was due to commence in January 2013, but has been postponed until further consideration of the requirements of the regulations;
- Implemented a cap on the maximum loan amount that can be borrowed to buy a property by expatriates and Emiratis; and
- Signing of an Intergovernmental Agreement (IGA) with the United States in order to facilitate compliance with the Foreign Account Tax Compliance Act (FATCA), a US law designed to carefully monitor the financial transactions of US persons with non-US financial assets.

#### 3.4.3 Development of the wealth management industry

Although the banking sector is the single biggest driver of investment within the UAE financial services industry, investment opportunities exist across the industry as a whole particularly in the area of wealth management.

High net worth individuals are a significant source of investment and liquidity. According to Government statistics, the UAE has 53,800 residents considered as rich and 775 residents as ultra-rich.

Key areas for a leading wealth management centre include:

- A robust business environment (e.g. capital market activity and maturity);
- Provider capability (e.g. high quality of human capital, wealth management service quality, and efficiency of wealth management institutes);
- Monetary, financial and political stability; and
- Tax and regulation (e.g. regulation of exchanges and investor rights protection).

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Developing Dubai's wealth management industry could contribute to increased investment. Key success factors would be improving capital markets' liquidity, developing the wealth management provider capability and regulation of the exchanges to accommodate various funds and attract investors.

DIFC has made significant improvements in accommodating asset management companies as well as funds, through the introduction of a robust regulatory framework and appropriate infrastructure. However, at present the UAE has been unable to tap into the full potential of this source of investment.

#### **Recommendations**

Developing the wealth management industry in Dubai could further lead to attracting investment. The areas that could be enhanced include: capital market liquidity, wealth management provider capability and the regulation of exchanges.

Improving capital market liquidity could increase investment opportunities for wealth managers which could be achieved through:

- Supporting SMEs to list on Dubai's exchanges;
- Issuance of additional government bonds and listing additional government entities; and
- Establishing an Islamic finance capability to increase availability of Islamic financial products.

Developing wealth management provider capability could be achieved by:

- Restricting market access to wealth managers who meet specific requirements (e.g. minimum years of experience, qualification, and other credentials);
- Introducing wealth management training programmes in collaboration with the regulators, DIFC and the private sector to improve wealth managers' skills and breadth of services offered to customers; and
- Regulators allowing for a wide range of services to be offered by wealth managers including offering of customised products and access to Islamic products.

Enhancing the exchange's regulation could include the following areas:

- DFM could allow admission of Exchange Traded Funds (ETFs) and Real Estate Investment Trusts (REITs);
- DFM could also follow Nasdaq Dubai and introduce omnibus accounts, to increase brokers' access to Dubai's local exchange; and
- Improved monitoring of wealth management activity to identify and prevent unethical conduct (e.g. wealth managers misstating portfolio positions and issuing false information). The UAE's Securities and Commodities Authority (SCA) recently implemented a set of new regulations which provide greater protection for investors.

### 3.5 Enhance capital market activity

A fully functioning capital market supports the economic growth of a country whilst also encouraging investment primarily by allowing investors greater access to capital and exit route opportunities. UAE's recent upgrade by the MSCI to "Emerging Market" status, is the result of infrastructure improvements in UAE's capital markets, however opportunities for further improvements exist to address:

- A lack of liquidity and limited exit route opportunities;
- Limited corporate transparency and a cultural resistance to embrace the concept of corporate governance, thus limiting listing opportunities; and
- Market infrastructure capability.

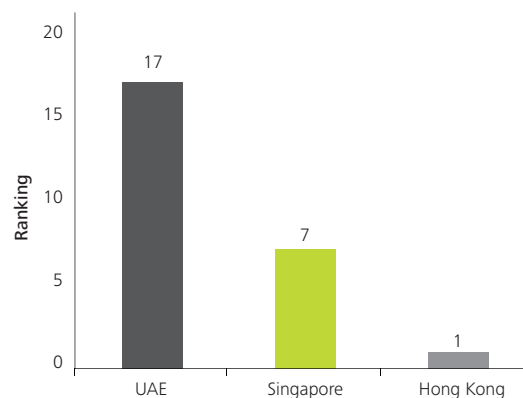
#### 3.5.1 Lack of liquidity and limited exit route opportunities

Over the past few years, capital markets in Dubai have suffered from a lack of new listings, low trade activity and sharp price fluctuations. Neither the DFM nor Nasdaq Dubai has had an IPO since 2009, the last one

being Drake & Scull International which listed on the DFM in November 2009. However, in 2014 IPO activity has picked up with Emirates REIT listing on Nasdaq Dubai and Marka PJSC listing on DFM.

The historic lack of liquidity in the capital markets also limits fundraising options for corporates. The "Financing through local equity market" index as shown opposite measures the ease at which corporates can raise finance through their local stock market. The UAE is ranked 17<sup>th</sup> while Singapore ranked 7<sup>th</sup> and Hong Kong 1<sup>st</sup>.













Figure 19 - Financing through local equity markets<sup>16</sup>



The lack of liquidity in DFM and Nasdaq Dubai can be explained by a lack of investable corporates but also partly due to limited investment from Government funds and institutional investors. Furthermore, regulations limiting foreign ownership of companies' registered on DFM to less than 50% discourage foreign funds from investing in Dubai thus limiting liquidity and investment exit options.

## The lack of liquidity in Dubai's capital markets limits exit routes for investors and deters potential investors such as Private Equity and Venture Capital firms

**Figure 20 - What do you see as the biggest challenges and barriers to growth for the MENA private equity industry to overcome?**

Shortages of quality investment opportunities 	Oversupply of capital/competition 	Exit opportunities/ability to exit 	Market regulation 
Governance/transparency 	Human capital deficiencies 	Fund raising 	Foreign ownership 
Valuation gap 	Length of transaction process 	Lack of dept finance 	Legal framework variances 

In addition, the lack of capital market liquidity limits exit routes for investors and so deters potential investment from a range of investors including private equity and venture capital funds.

The 2013 Deloitte Private Equity confidence survey illustrates what Investment Funds perceive as the barriers to growth for Private equity in the MENA region (see figure 20).

### Recommendations

Investment by sovereign wealth funds in local markets could increase liquidity and consequently lead to more representative security pricing. Currently local wealth funds seem more interested in investing abroad than in local exchange markets. Injecting sovereign funds into local capital markets may improve liquidity thus encouraging private institutional investors to invest in the market, in turn leading to higher trading volumes in the securities market.

The establishment of pension funds and other long-term institutional investors can support sustainable growth and financial stability of capital markets. Since their investment capacity is relatively high, institutional investors can correct stock market inefficiencies, such as speculative actions, thereby stabilising the market in the long run. In successful stock exchanges around the world, pension funds represent a main investor.

Furthermore, introducing a state pension scheme for high skilled foreign workers that meet specific criteria, in combination with easing retirement visa restrictions, could result in more expatriates staying in the Emirate longer and investing their savings within the local market rather than abroad. Singapore and Hong Kong have introduced state pension schemes for expatriates with the aim of retaining human capital and savings within the country. Hong Kong's Mandatory Provident

fund extends to expatriates who are given permission to work in Hong Kong more than 13 months while Singapore's Central Provident fund extends only to expatriates with permanent residency. According to the World Bank, around 40% of UAE's foreign workers' salaries were sent out of the UAE in 2011, representing an estimated AED41.2 billion<sup>41</sup>.

The government could boost market liquidity by listing certain government run corporates. This could create more investment opportunities and may set the tone to encourage other privately owned companies to follow.

Development of the fixed income markets may inject further liquidity. The debt markets in the UAE are small and relatively inactive compared to international counterparts. The UAE could enhance the local currency bond market to ease liquidity constraints and funding costs facing local businesses, by issuing government bonds across a range of maturities, thus creating a risk free yield curve that could serve as a pricing benchmark for other companies looking to raise debt. Issuance of discounted government bonds and allowing access to several types of investors could increase liquidity further. NASDAQ Dubai has already taken steps to address the lack of liquidity in debt markets by introducing a fixed income trading platform, which allows institutional and professional investors to move away from an Over The Counter "OTC" basis of trading and access an automated system that is regulated, transparent and increases trade flows.

Further development and implementation of the regulations relating to issuance of sukuk and conventional debt in DFM. The SCA has already drafted a set of regulations to ensure listing of debt in line with best practices with the objective of boosting sukuk and conventional debt issuance levels in the local market.

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Sovereign wealth funds and the establishment of pension funds could support an increase in market liquidity. Developing the fixed income market further and establishing the right infrastructure to accommodate Mutual Funds, Exchange Traded Funds and Real Estate Investment Trusts could also contribute to increased market liquidity.

The fund industry could also bring additional liquidity to Dubai's exchanges by attracting additional investors. Establishing an appropriate infrastructure is key to allowing admission and attracting Mutual Funds, Exchange Traded Funds (ETFs) and Real Estate Investment Trusts (REITs). Nasdaq Dubai currently accommodates such funds to offer investors additional investment opportunities. DFM already accommodates mutual funds and has established the platform to introduce ETFs however these have not been admitted yet. DFM could possibly increase liquidity by accommodating ETFs and REITs.

### 3.5.2 Transparency and corporate governance

Investors reason that the region lacks an established capital market practice given the lack of IPOs and low trading volumes. Many corporates find it difficult to understand, interpret and comply with the required listing rules and regulations, which results in a high level of uncertainty for investors.

Companies in the region, many of which are family owned, could have better access to the capital markets should they opted to list in the exchange and thus commit to higher level of disclosure and transparency required by Exchange regulators. The concept of corporate governance needs to be fully embraced in the region, especially compared to developed markets, such as London, Singapore or Hong Kong.

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Educating SMEs on the benefits of listing on Dubai's stock exchanges and supporting them through the process could provide an additional source of financing and also increase market liquidity. Easing minimum capitalisation requirements and educating SMEs on the benefits of corporate governance and the required reporting requirements of a listing would be important to attract SMEs to follow an IPO.

### Recommendations

Currently, investors in the region consider that the regulatory framework is still immature and undeveloped. Regulation in more developed markets such as Singapore and Hong Kong can be used as a benchmark.

Regulators need to raise management team and investor awareness around the importance of corporate governance and other listing regulations in creating a transparent business environment. Investors could look at corporate governance as a way to ensure transparency and good business practice. Management teams could also realise the added value from abiding by regulations, which could lead to improving investors' confidence and increasing access to sources.

Educating corporates on the benefits of IPOs as an alternative source of funding and supporting them through the IPO process could also increase market liquidity. Most businesses are reluctant to list due to corporate governance and mandatory reporting requirements required by exchanges. In 2012, Nasdaq Dubai signed in 2012 a memorandum of understanding with the Dubai SME agency in an effort to educate SMEs on the benefits of an IPO and support them through the process.

Currently, listing requirements on Nasdaq Dubai are for a minimum of 25% of capital to be floated and the company must have a minimum market capitalisation of at least (US\$10 million). Nasdaq Dubai eased listing requirements in 2012 in an effort to increase listings and liquidity, by reducing the minimum capitalisation requirement from US\$50 million to US\$10 million. DFM's capitalisation requirements is AED25 million for local companies with not less than 35% of shareholder equity to be listed and AED40 million for foreign companies. Easing minimum listing capitalisation requirements could attract more corporates, especially SMEs, to list on Dubai's stock exchanges.



### 3.5.3 Market infrastructure

Having a sound market infrastructure in place is one of the most critical factors in capital market development and is especially important given the UAE's recent upgrade by the MSCI to "Emerging Market" status. The main factor that contributed to this achievement was the improvement of the Delivery Versus Payment (DVP) model for settling trades, by introducing a buyer cash compensation programme. The DVP model allows delivery of shares at the same time as payments are received. The buyer cash compensation programme compensates buyers if the shares they buy are not delivered, which further reduces counterparty risk.

The upgraded status will open the UAE exchanges to increased global investment flows, increasing the depth and liquidity of the markets. Share prices in the DFM rose by 1.6% on the day of announcement<sup>42</sup>.

However, despite this upgrade, according to the MSCI, the UAE's clearing and settlement, stock lending, and short selling infrastructure still needs development.

#### Recommendations

The UAE's Securities and Commodities Authority (SCA) recently issued a set of rules to allow for short selling transactions and market making, but implementation has not yet commenced. Continued advancement of market infrastructure through the implementation of regulations allowing short selling and stock lending could ultimately provide greater liquidity and depth in the capital markets, thus improving investor confidence. Further opportunities for improvement of the Dubai and Abu Dhabi exchanges exist to enable UAE to reach "developed" market status. These include allowing overdraft facilities for foreign investors, extending official trading days to match international standards and making omnibus accounts available.

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Further improvements to the DFM stock exchange's infrastructure, such as allowing overdraft facilities for foreign investors, allowing short selling of stocks and market making activities, extending official trading hours and the introduction of omnibus accounts to allow access to foreign brokers, could attract further investors in Dubai's capital markets

An omnibus account is a trading and clearing account between two brokers whereby a number of individual customer accounts of one firm are grouped into a single account. For example, this allows a foreign broker to invest in a local market (e.g. Dubai) without registering with Dubai's exchanges, by placing orders through the local broker who is registered with the local exchanges. Many countries, such as the US put restrictions on brokers. For example, US regulations require that customer funds be invested through a broker registered with the US Commodities Futures Trading Commission. Customers who want to invest in markets abroad can only use a foreign broker who has registered with the US Commodities Futures Trading Commission or through a broker in a recognised foreign exchange that has demonstrated a similar regulatory system to the US.

Brokers in foreign exchanges that do not meet US regulations cannot market their products to US investors. An omnibus account resolves this issue by allowing a US registered broker to invest and pass customer orders to a foreign broker who is registered with a foreign exchange.

### 3.6 Regulatory framework

An effective regulatory framework plays a critical role in supporting companies to trade efficiently, grow and become more competitive. Regulation also plays an important role in citizens' and residents' quality of life in the form of promoting freedom and protection of rights. This section identifies some of the key regulatory factors that support businesses and individuals and contribute to attracting investment. Protection of businesses' and individuals' rights, transparency and efficiency in legal procedures, investment and labour market laws are analysed to identify Dubai's next steps in order to catching up with global centres like Hong Kong and Singapore.

An effective regulatory framework is critical in supporting companies to become more competitive and grow, protecting individuals' rights and attracting investment

#### 3.6.1 Quality and efficiency of institutions

Dubai ranks highly in the "Quality of institutions" indicator of the Dubai Competitiveness report 2011/2012 published by the Dubai Economic Council. Over a relatively short period of time, Dubai has successfully introduced a number of government institutions and regulations. Dubai clearly outperforms

other regional nations, such as Qatar and Saudi Arabia, but when compared to global leaders, such as Singapore and Hong Kong there are still areas for improvement.

The "Quality of institutions" indicator measures the strength of legal rights, such as protection for borrowers and lenders, property rights, absence of corruption, quality of regulation of institutions, government effectiveness and political stability. Dubai's high ranking can be attributed to its success in establishing credible governance structures, institutions and modern market regulations.

Figure 21 - Quality of Institutions<sup>1</sup>

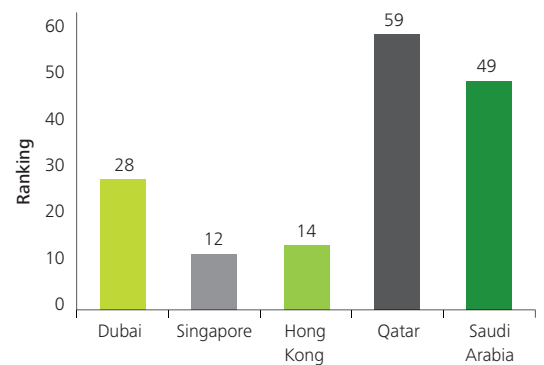
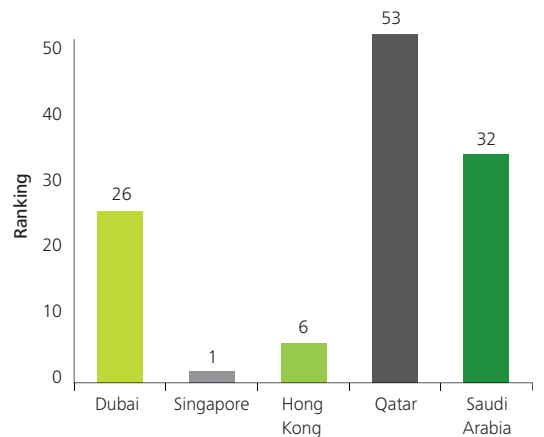


Figure 22 - Efficiency of institutions<sup>1</sup>



According to the Executive Opinion survey conducted by the Dubai Economic Council in 2011/2012, only 54% of the firm executives interviewed rated the transparency of economic policies and the availability of information as “high” or “very high.” Approximately 63% of the respondents of the survey rated Dubai’s administrative system and government institutions in dealing with businesses as “good” or “very good”<sup>1</sup>.

In the “Efficiency of institutions” indicator of the Dubai Competitiveness Report 2011/2012, published by the Dubai Economic Council, Dubai again leads other regional nations, such as Qatar and Saudi Arabia. The “Efficiency of institutions” indicator considers factors such as, the ease of doing business, procedures required to import goods, enforcement of contracts, registering a property and burden of customs procedures. Dubai’s lower ranking compared to leading centres, such as Singapore and Hong Kong is mainly due to higher bureaucracy levels.

At present there are opportunities to further develop bankruptcy and collateral laws to improve protection of troubled businesses and creditors, deterring investment in start-ups and SMEs. UAE ranks low compared to Hong Kong and Singapore due to existing bankruptcy law procedures not meeting international standards. Current regulations are perceived weak for supporting businesses struggling to make payments and to stay afloat, with bankruptcy cases and bounced cheques sometimes carrying criminal implications.

The UAE is currently assessing the implementation of a new bankruptcy law, which follows international standards and removes the criminal implications of bankrupt companies. Under the new draft law,

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## Alignment of regulation to international arbitration standards, improving transparency, removing the criminal implication of bankruptcy and easing foreign ownership laws in selected industries could all contribute to attracting additional investment

companies will be able to apply for support and protection before defaulting. The new bankruptcy system is designed to safeguard viable companies but also support creditors in recovering their funds and assets.

Protection of minority investors is also key to attracting foreign investors in Dubai especially for the SME sector, considering the existing foreign ownership law.

Foreign owners often sign a side agreement with the UAE national partner, where it is usually agreed that the local partner will maintain majority ownership of the company for a fixed fee and the foreigner will be responsible for the daily operations of the business. Side agreements however, do not cover succession planning and considerable ownership risk exists if either partner passes away.

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## Dubai has the opportunity to improve further in areas, such as quality and efficiency of institutions to reach global leaders

### Recommendations

Dubai has the opportunity to improve further in areas such as quality and efficiency of institutions to reach other global leaders. Alignment of regulation to international arbitration standards could improve Dubai's efficiency in settling disputes. Providing further visibility of proposed changes in regulations with indicative timelines of implementation could improve investors' confidence and increase investment. Dubai is currently establishing a new legal framework to allow for increased transparency and alignment to international regulatory standards.

New insolvency regulation is required to help nurture a "rescue" culture in the region. At present, indebted businesses are often forced to close with the notion of bankruptcy carrying a negative stigma as owners fear the risk of criminal prosecution. Removing the criminal implications of bankruptcy and bounced cheques, for businesses which have failed due to commercial reasons and not for fraudulent activities, could improve Dubai's ranking in the legal rights index. This change could further attract high skilled foreign human capital and investment in start-ups, SMEs and larger businesses. Steps have already been taken in this regard with bankruptcy of Emirati nationals decriminalised.

Additional steps have been taken by the UAE government to make it easier to start a business. In 2010, it abolished the minimum capital requirements and simplified registration documentation, as well as further streamlining documentation with the Department of Economic Development in 2012.

Foreign ownership laws could be amended to allow for majority foreign ownership of companies in selected industries. Singapore, as well as many other nations, restricts majority foreign ownership in selected industries of strategic national importance. For example, Singapore restricts foreign ownership of companies in the media sector to 49%, although some exceptions are allowed. Hong Kong does not generally set any foreign majority ownership restrictions, although some restrictions exist on the voting control rights for non-Hong Kong residents in the media sector. Such regulation changes could further attract foreign human capital and investment in start-ups and SMEs, potentially increasing foreign direct investment by 15%<sup>43</sup>.

Additionally, the current laws around trading restrictions for companies registered in free zones could be amended to make it easier for companies to trade outside the free zones. Finally, passing legislation that will address side agreements and business succession planning could further improve investor confidence.

### 3.6.2 Labour market regulations

Labour market regulations that ease the movement of labour contribute to attracting skilled human capital that local businesses can use to further innovate, improve and grow. The UAE currently ranks 8<sup>th</sup> in the "Labour market efficiency" indicator of the 2012/2013 Global Competitiveness Index, while Singapore and Hong Kong rank 2<sup>nd</sup> and 3<sup>rd</sup> respectively (see figure 23). The

indicator measures the efficiency and flexibility of the labour market considering factors, such as labour-employer cooperation levels, wage determination process, hiring and firing practices, women in labour force, level of pay related to productivity, retention and attraction of talented people.

Bahrain, which was once a leading financial and trading hub in the region, ranks 26<sup>th</sup> in terms of labour market efficiency. The UAE has managed to surpass Bahrain, demonstrating the success of UAE in implementing policies and procedures to establish an efficient labour market, however additional improvement opportunities exist, especially with regards to continued development of the Emiratisation programme.

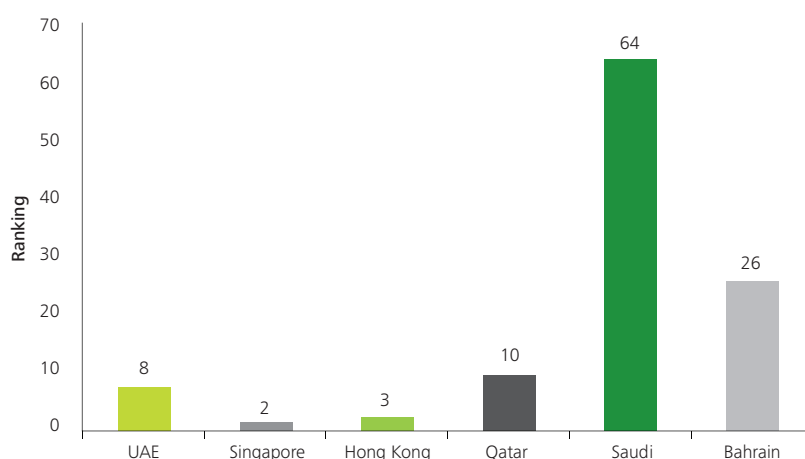
Current UAE regulations limits the amount of employee visas based on the office floor space that SME businesses occupy. For SMEs willing to expand their teams, having to move to a larger office space could be prohibitively expensive considering current market rent increases.

Additionally, there are some restrictions regarding movement of labour, where for example, some employees are given a ban on working for six months after completion of their employment contract. Additional restrictions apply for employees who want to start their own business or engage in freelance work, where they are required to get a no objection certificate from their sponsor as well as apply for a part time work permit<sup>44</sup>.

#### Recommendations

Dubai could introduce some flexibility along the lines of the proposal that has recently been promoted by the Ministry of Labour. Such measures might include easing

**Figure 23 - Labour market efficiency<sup>16</sup>**



retirement visa restrictions and visa extensions from 2-3 years to longer durations as in the case of Singapore, where granting 10-year visas has positively influenced the consumption and investment decisions of the migrant population towards the domestic economy. In addition, it could allow the issuance of visas for high skilled expatriates that meet specific requirements without the need of a sponsor, making it easier to undertake part time or temporary work or other business activities. Easing restrictions on labour could attract more high skilled human capital in Dubai, support the transfer of specialised knowledge to local businesses and promote creation of start-ups. Additionally, the current regulation around limiting the number of visas based on occupied floor space could be reassessed and potentially considered as a guide, to make it easier for growing SMEs to hire more foreign employees.

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Over the last 10 years of its experience, the Council put forward several initiatives and policy recommendations that contributed significantly in enhancing the economic decision making in the emirate.

The Council is considered to be the first advisory body in the Emirate of Dubai and the UAE. Its membership includes some of the leaders of local business communities belonging to the private sector, who contribute significantly to the economic activity in Dubai, in addition to representatives of some government departments concerned. This unique combination of its membership enables the Council to employ the insights, experiences and visions of its members in a way that enhances the economic development process of Dubai and achieve Dubai Government's vision in consolidating the business community's role in enhancing sustainable economic development process in Dubai and the UAE.

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