Research- Executive Brief

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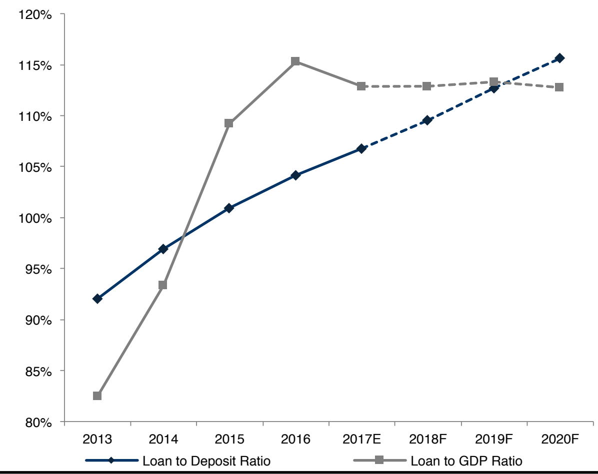
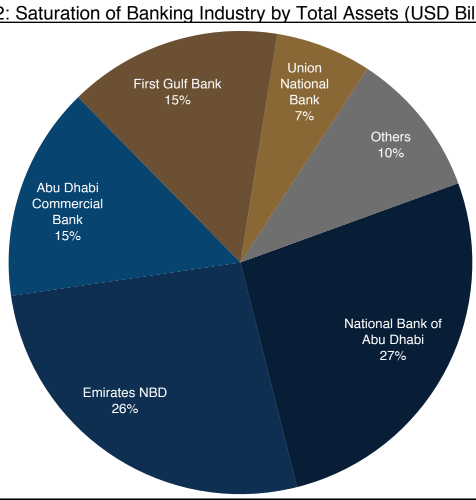
Figure 1: Banking Sector Key Ratios



Source: BMI Research and UAE National Bureau of Statistics, 2017

Figure 2: Saturation of Banking Industry by Total Assets (USD Billions)



Source: Bloomberg, Zawya and IMF, 2017

Headlines

- Investments in infrastructure and mega housing programs are expected to increase loan growth to 7% in 2017, up from 6.7% in 2015
- Tighter liquidity regulations that restrict banks to lend a maximum 100% of its capital base to governments of the federation and their non-commercial entities suppress growth and sector's profitability
- Basel III requirements of banks to hold capital conservation buffer of 2.5% suppress profitability and lower shareholder return expectations
- Merger of NBAD and FGB, which have total assets worth US$114,211 million and US$61,885 million respectively, paves the way for a more competitive market
- Emirates NBD sealing of a $500m acquisition of majority stake in the Egyptian arm of BNP Paribas is a positive step for the banking sector growth externally

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UAE's Banking Industry:
Birth of a Stable & Competitive Market

UAE's banking sector ranks first in the region. With huge investments in infrastructure and mega housing programs, loan growth has been forecasted to reach 7% in 2017, up from 6.7% in 2015. The increase of interest rates coupled with a slowdown in government spending, would however, dampen the increase of loans from banks.

Government Plans Drive Banking growth

Lending to government is an area for tremendous growth. As the government puts in place long-term plans to ramp up to Dubai's selection as the city hosting Expo 2020, this generates financing opportunities as a great amount of infrastructure across the hospitality sector will be required to support such a global event. This provides a steady stream of governmental, as well as international, investments to Dubai that offers opportunities for growth to UAE's banking sector. Furthermore, the large-scale housing program implemented by the government of Abu Dhabi – the construction of around 7000 luxury villas, complemented by amenities, such as mosques, retail malls and schools would require greater financing from banks and other capital markets, thereby increasing the pace of loan growth[2].

Tighter Regulatory Controls Impede Growth Driver

However, new regulations imposed on government loans have limited the profits banks can earn on the credit loan market. As increased government spending on mega projects that eventually reap little or no results could possibly leave banks with loans in default, the UAE Central Bank implemented caps on government lending to shelter banks from systemic risks[8]. A bank in the UAE would only be able to lend 100% of its capital base to governments of the federation and their non-commercial entities, and 25% to individual borrowers[1]. This forces the government related entities (GREs) to borrow from a diversity of sources and places the burden off the banks. No doubt, such regulations bring about stability to the banking system in UAE, but it also dampens the growth potential of lending to government as one of its main growth drivers.

Loss of Financing Power

These regulations have an adverse effect in the financing power of UAE banks. Loan to GDP (LTG) ratio is at 111.56% high, but is forecasted to fall in the future. Given that the banking industry of UAE is the first in rankings within the Gulf Cooperation Council, its high LTG ratio means that it has high financial resources to support its private and public sectors, hence allowing greater opportunity for the economy to grow. In comparison to the regions, with Saudi Arabia and Kuwait having a LTG of 143.3% and 106.4% respectively, UAE's banking industry is in a good position. The falling LTG ratio, however, signifies credit growth is restricted in a slowly recovering economy- with the recovery of oil prices boosting government spending (See Figure 1). This could result in a slower recovery for the private sector.

Global Liquidity Standards Alignment

This issue of liquidity has been duly recognized by the Central Bank of the UAE as it began to implement the Basel III regulations. Loan to deposit (LTD) ratio is at an alarming 104.46%, and rising. The ideal LTD ratio is between 80% to 90% to ensure that banks are growing at an optimal rate. The abnormally high LTD could be due to the real interest rate of which banks pay on-time deposits are at a -0.5% after inflation adjustments. Moreover, given that the Dirham is pegged to the US dollar and interest rates by the Federal Reserve have only increased by a negligible 0.25% over the past year, consumers are more hesitant to save[4] (See Figure 1). The high LTD ratio is a cause for concern as the local banks may not have enough liquidity to cover any unforeseen fund requirements. They are at a higher risk of being required to repay its borrowed funds under the constraints of not being able to have sufficient funds to pay them back.

By ensuring that banks have sufficient liquidity coverage ratio and net stable funding ratio (long-term structural ratio designed to address liquidity mismatches), this ensures that UAE banks have the absorptive capacity to take on economic shocks and are not delving into short-term interbank lending as a major source of funding[3]. However, the implementation of the Basel III has not been without pressures. As banks are required to hold a capital conservation buffer (capital built up outside periods of stress which can be drawn down as losses are incurred) of 2.5%, profitability and shareholder return expectations have gone down[6]. Greater competition would also arise in sourcing for more stable funds, deposits and savings accounts to satisfy liquidity rules.

Competitive Landscape Heats Up

The banking industry of UAE consists of 23 national banks operating 864 branches and 28 foreign banks with 169 branches in the country (See Figure 2). Research done by Lafferty Group shows that the UAE population has a bankable population of 3.5 million against a total population of around 9.5 million[7]. This emphasizes the level of saturation within the banking industry. However, there has been little consolidation achieved over the past due to the variety of interests held by investors.

One of the recent shocks within the industry has been the prospective merger of two mammoth banks - NBAD and FGB. The merger will provide savings in operating costs and stability against fluctuating oil prices, that causes liquidity fluctuations. The resultant bank will also be better equipped to serve the various needs of its customers- combining the strengths of FGB, which is its market-leading consumer banking business and dynamic credit card offerings, with international connectivity, customer-driven wholesale banking and reputed capital markets advisory of NBAD. This merger will increase the level of competition in the industry. Due to the resultant economies of scale of the merger which would lower funding costs and operating costs incurred by the bank, loan prices will fall and credit growth could be further enhanced[9]. Therefore, with the exemption of the banking sector from the applicability of competition laws, smaller banks will ultimately be threatened for their survival in the overbanked market.

Growth taking place locally and abroad

Presently, growth is taking place via overseas acquisitions or expansions, typically in countries with less mature banking sectors. For example, in 2013 Emirates NBD completed a $500 million acquisition of a majority stake in the Egyptian arm of BNP Paribas. For the banks, some of which qualify as GRE(s) themselves, the process is slow but shows signs of progress. Emirates NBD, the largest single creditor to the largest single debtor, Dubai World, changed the conglomerate's loan status from non-performing to performing in the fourth quarter of 2014, which was followed by a $14.6bn debt restructuring agreement in early 2015. As of June 2014, Emirates NBD's total sovereign debt exposure was Dh98.6bn ($26.8bn), or about 40% of its total loans.

The privatization of former state-owned enterprises would continue at some point, despite slow progress over the past decade. This will increase the number of opportunities for both commercial banks and investment banking as firms become more profit-driven. The future of banking industry indeed is poised to grow, in both the overseas market, as well as locally. More importantly, the industry will be positioned better as oil prices stabilize and better regulatory controls are put in place to safeguard investor interests.

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