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Industry Report Card:

GCC Banks Should See A More Stable Financial Footing In 2018

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Banks in the Gulf Cooperation Council should breathe a little easier in the year ahead. S&P Global Ratings believes that barring unforeseen events, 2018 will mark the stabilization of the financial profiles and performance of GCC banks, after two years of significant pressure. What's more, GCC banks will have recognized most of the impact of the softer economic cycle on their asset quality by mid-2018. That's except for Qatar, where trends in asset quality will depend on how the boycott of the country evolves. Relatively sluggish economic conditions will also keep lending growth muted, as we do not expect oil prices to rebound significantly.

We think that GCC banks' cost of risk will increase in 2018 because of the adoption of IFRS 9 and the higher amount of restructured and past due but not impaired loans sitting on their balance sheets. However, we also think that the general provisions that GCC banks have accumulated over the years will help a smooth transition to the new accounting standard.

GCC banks' liquidity improved in 2017, and we do not foresee a major change in 2018. Continued debt or sukuk issuance by the GCC governments in 2018 will absorb some of the liquidity without a major change in GCC banks' risk appetite. Finally, we think that GCC banks' profitability will stabilize at a lower level than historically, underpinned by an increased cost of risk and the introduction of value added tax (VAT; some of which banks will pass on to their clients).

Overview

- We believe that GCC banks' financial profiles will start stabilizing from the second half of 2018, absent any materialization of geopolitical risk.
- The three key risks that we foresee for GCC banks, in addition to geopolitical risks, are muted loan growth, a higher cost of risk, and lower profitability.
- Most of our ratings on GCC banks carry a stable outlook. The negative outlooks are on the Qatari banks--where the evolution of the boycott will determine their future creditworthiness--as well as on a few banks in other GCC countries due to idiosyncratic factors.

Supporting the ratings, banks in the GCC continue to display strong capitalization by global standards, albeit with signs of quantitative and qualitative deterioration. Over the past year, we have affirmed most of our ratings on banks in the GCC. We have taken a few negative rating actions, most of them on banks in Bahrain, Oman, and Qatar. Overall, 28% of our rated banks in the GCC currently have a negative outlook. They are concentrated in Qatar, due to the potential effect of the boycott on Qatari banks' funding profiles, asset quality, and profitability, but there are a few banks in other GCC countries where idiosyncratic reasons drive our negative outlook.

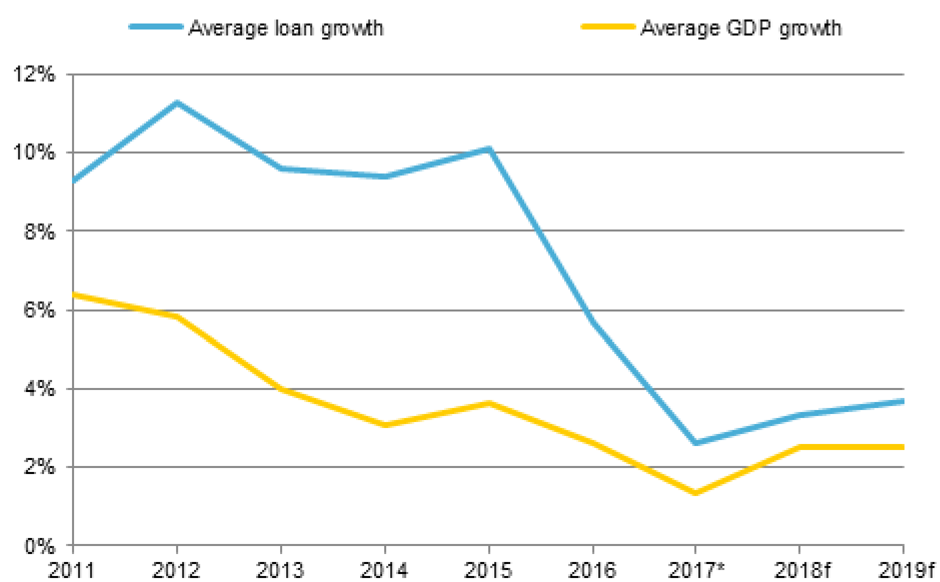
Lending Growth Across The GCC Will Remain Muted

The end of the triple-digit-oil-price era resulted in a significant slowdown of the GCC economies and reduced growth opportunities for their banking systems. We forecast that oil prices will stabilize at about $55 per barrel in 2018 and 2019, and anticipate unweighted average economic growth for the six GCC countries of 2.5% in 2018-2019, or less than half the growth they delivered in 2012.

Growth in private-sector lending continued to drop and reached an annualized 2.6% on average in the first nine months of 2017, compared with 5.7% in 2016. In 2018-2019, we expect this situation to continue due to reduced government spending (except in Kuwait). We expect private-sector lending growth to reach 3%-4% in 2018-2019, supported by strategic initiatives such as the Dubai Expo 2020, Saudi Vision 2030, the World Cup 2022 in Qatar, and higher government spending in Kuwait led by Kuwait 2035, a long-term development plan announced in early 2017. A surge in geopolitical risk and ensuing delays of some of these initiatives could severely affect our base-case scenario.

Chart 1

Growth Of GCC Banks' Loan Portfolios Versus GDP Growth



*Annualized. f--Forecast. Source: S&P Global Ratings, GCC Central Banks.

Asset Quality Indicators Are Likely To Stabilize

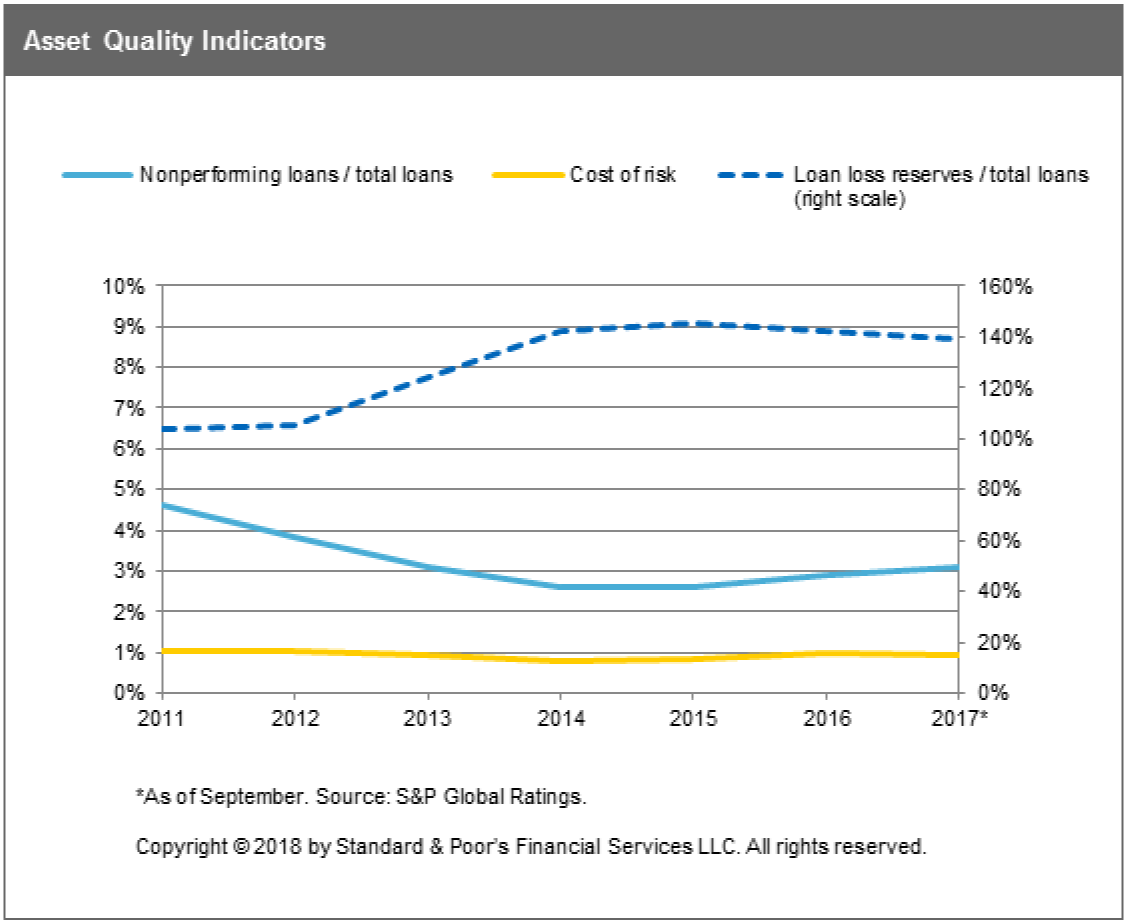
The slowdown in economic activity over the past two years only resulted in a slight increase in nonperforming loans (NPLs). At Sept. 30, 2017, NPLs to total loans for the rated GCC banks reached 3.1%, compared with 2.9% at year-end 2016. However, restructured loans and past due but not impaired loans saw a higher increase, reflecting corporate entities' longer cash flow cycles. We expect NPL ratios to continue to deteriorate in the next six months and then progressively stabilize, mirroring the stabilization of the GCC countries' real economy. Our expectation discounts any unexpected materialization of geopolitical risk or any other shock in the commodities market. Overall, we do not expect the NPL ratio to exceed 5% in the next 12-24 months.

We see Qatari banks' asset quality as under increasing pressure. A group of Arab states has been boycotting Qatar since early June 2017, and in our view, this is dampening economic activity, including the real estate and hospitality sectors, which in turn is weakening Qatari banks' asset quality indicators. We see an important correlation between any potential escalation or de-escalation of the boycott measures and deterioration or stabilization of Qatari banks' asset quality.

Elsewhere, the continued decline in real estate prices in the United Arab Emirates (UAE) might reduce the asset quality of Emirati banks, although under our base-case scenario, the deterioration will remain contained. Finally, Saudi banks' NPL formation will continue to depend on the health of the contracting sector. It is too early to tell if the recent shifts in Saudi Arabia's power structures and societal norms will affect Saudi banks' asset quality indicators. However, they could increase the risk of policy mistakes, which in turn would imply higher domestic and geopolitical tensions. At the same time, we consider that these structural reforms could empower Saudi citizens and make Saudi Arabia more attractive to investors over the medium term, as the authorities intend.

On a positive note, rated GCC banks still enjoy strong NPL coverage by provisions, at 139% on Sept. 30, 2017. These provisions will prove helpful as banks move to IFRS 9 in January 2018. While we think that the overall impact of IFRS 9 adoption on GCC banks will be manageable, in our view a higher cost of risk will persist for some time.

Chart 2

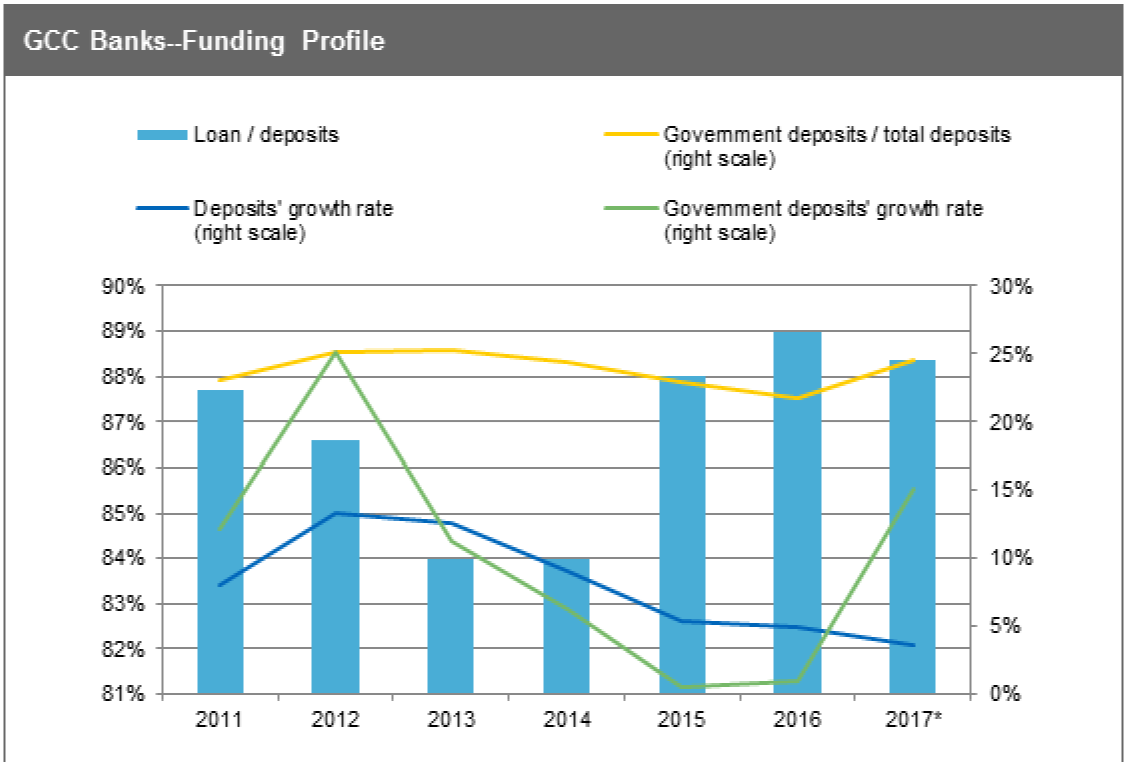


Funding Is Improving; Deployment Of Liquidity Is The New Theme

Growth in customer deposits slowed to 3.5% in the first nine months of 2017, compared to 5.0% in 2016. Qatar was the outlier, as Qatari bank deposits grew by 10%, underpinned by a significant jump in government deposits of 57% during the first nine months of 2017. The Qatari banking system experienced significant outflows of foreign deposits in the aftermath of the boycott--$21 billion at Sept. 30, 2017. However, an injection of $39 billion by the government and its related entities more than compensated for the outflow. While we think that the outflows will continue as foreign deposits, particularly from the boycotting countries, continue to mature, we expect that it will be in an orderly fashion. Under our base-case scenario, we exclude significant outflows from Asian and European countries, which in our opinion only a large-scale geopolitical event could trigger. We also take comfort from our expectation of sufficient extraordinary government support to the Qatari banking system as needed. Elsewhere in the GCC, government deposits are growing again, accelerating in the UAE and Saudi Arabia, but decelerating in Kuwait due to increased government spending.

We view the GCC banks' funding profiles as satisfactory. Funding is dominated by core customer deposits, and the use of wholesale funding remains limited, except for a few large and sophisticated issuers. The GCC banking system's loan-to-deposit ratio averaged 88.3% on Sept. 30, 2017, compared with 89% at year-end 2016, ranging from a high 112.2% for Qatar to a low 50.1% for Bahraini retail banks (see chart 3).

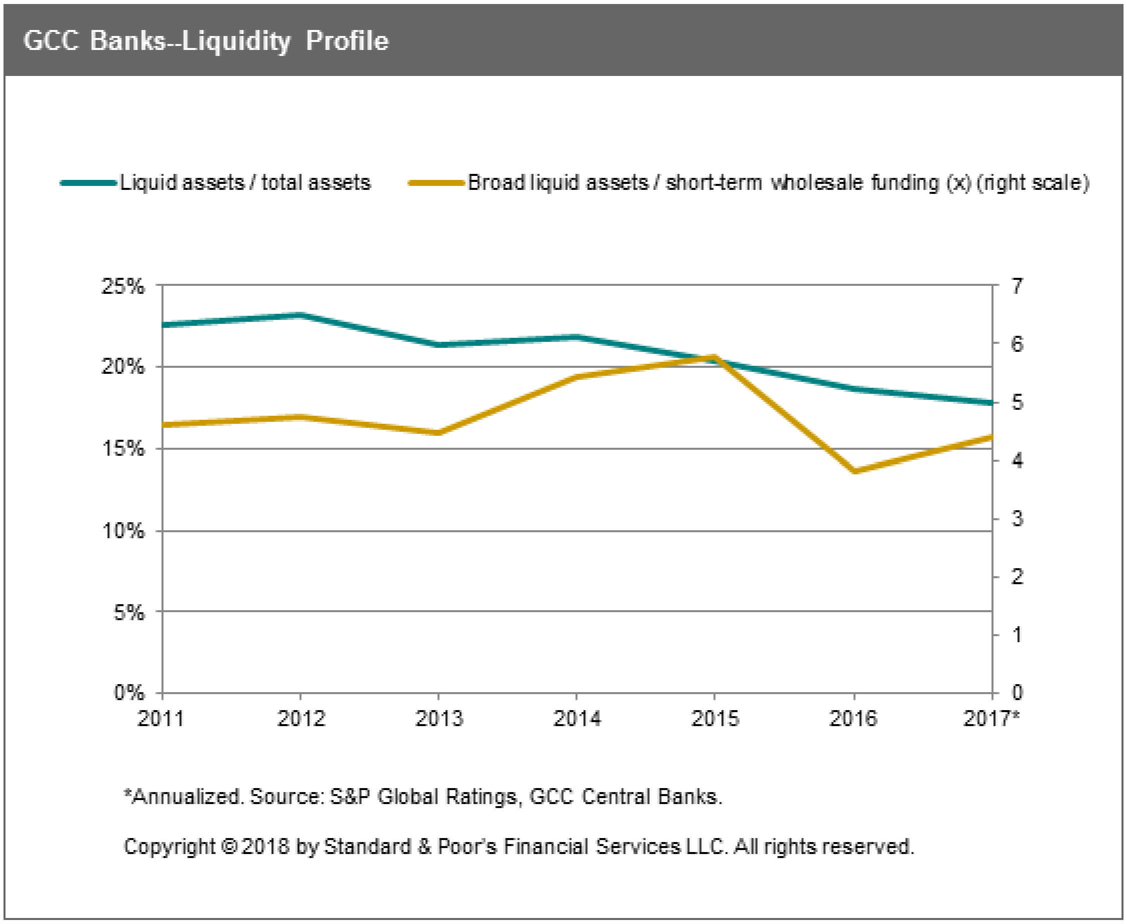
Chart 3



*As of September. Source: S&P Global Ratings.

Loan-to-deposit ratios have been on an improving trend over the past 12 months, meaning that deployment rather than lack of liquidity is the new theme. The ratio of cash and money market instruments to total assets dropped slightly in the same period, as government debt issuances attracted local and regional banks' liquidity. In the context of muted economic activity and loan growth, we think that government issuances will continue to attract local and regional banking systems' attention. As at Sept. 30, 2017, the coverage of short-term wholesale funding by broad liquid assets stood at about 4.4x on average for rated GCC banks, compared with 3.8x at year-end 2016.

Chart 4



Profitability Will Plateau, But At A Lower Level Than Historically

The first nine months of 2017 saw a slight improvement in rated GCC banks' profitability, but we don't think this situation will last (see chart 5). Some of the improvement is due to increasing amounts of earnings-generating assets and slightly higher interest margins. Banks have deployed their excess liquidity in government bonds, which earn more than either deposits with central banks or cash.

At the same time, improving local liquidity and the increase in the Federal Reserve's interest rates--which local authorities (with the exception of Kuwait) mirrored--led to a slightly higher average interest margin in 2017. A more aggressive approach toward costs also helped, with the average cost-to-income ratio reducing to 36.2% on Sept. 30, 2017, compared with 38.7% in 2016. Finally, the increase in the annualized cost of risk was contained at 1.2% for rated GCC banks, compared with 1.0% in 2016.

Overall, we don't think that the improvement in profitability will last because:

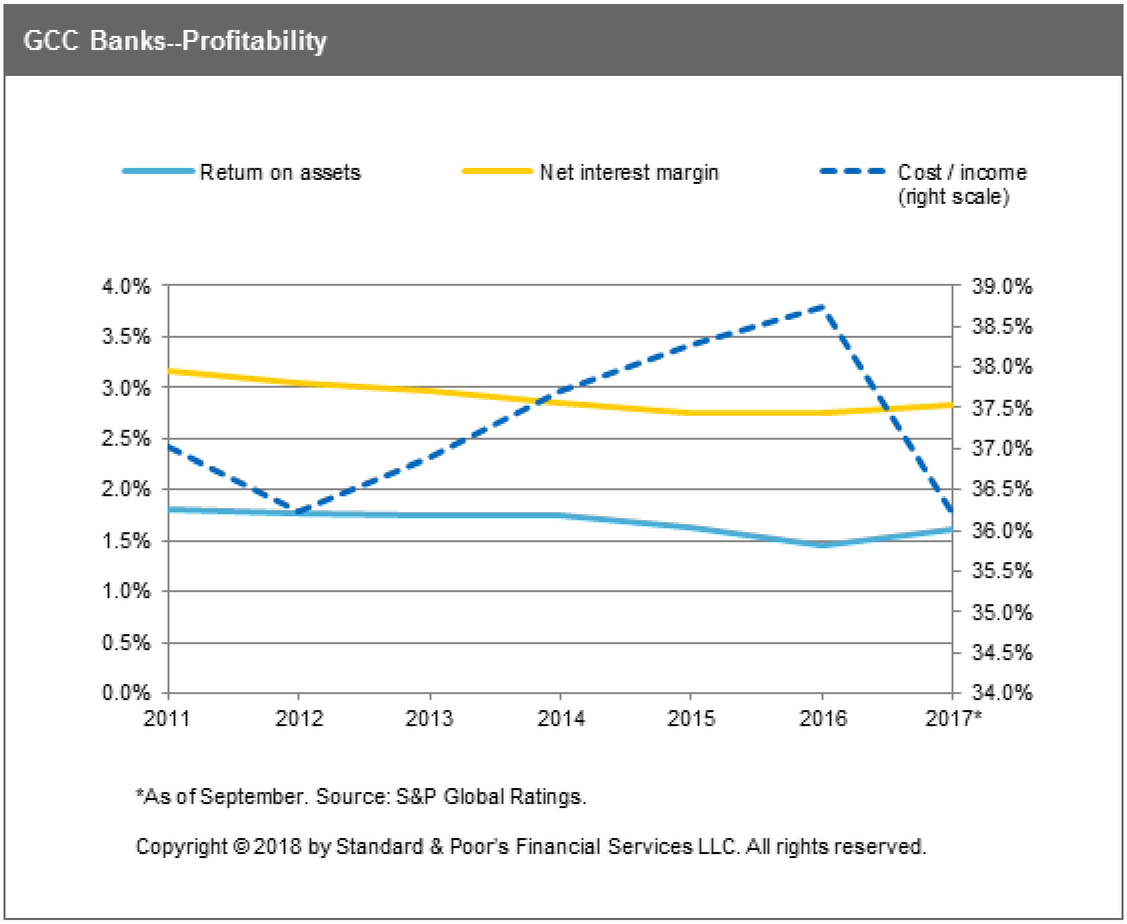
- Loan growth will remain muted. Banks will continue prioritizing quality over quantity and shy away from lucrative but higher-risk exposures, especially as IFRS 9 requires lifetime provisioning for exposures with deteriorating credit

quality or repayment issues.
- The cost of risk will continue to increase and stabilize at a higher level. Restructured loans and past due but not impaired loans that will slip into nonperforming categories in the last quarter of 2017 and new IFRS 9 provisions are likely to push the cost of risk higher for longer.
- Operating costs are likely to increase because of the introduction of VAT, although we are of the view that banks will pass some of its impact on to end users.
- While banks continue to benefit from a large amount of noninterest-bearing deposits, we anticipate that some corporate depositors will seek to improve their profitability by switching to remunerated products when interest rates start to rise.

All in all, we expect revenue growth to decelerate and banks to continue cutting costs where possible. Collaboration with fintech companies and the use of technology for low added-value transactions, such as money transfer and payments, could offer some opportunities in this space.

The decline in profitability since with the triple-digit-oil-price era has reignited the debate on consolidation, especially with the merger of First Gulf Bank and National Bank of Abu Dhabi to form First Abu Dhabi Bank in 2017. We continue to believe that consolidation, although necessary in some overbanked markets, will remain the exception rather than the new norm. The market share of the five largest banks is around 60% in the UAE and Saudi Arabia and is even higher in Qatar and Kuwait. However, the limited number of small banks, with the exception of the UAE, limits consolidation opportunities. Additionally, the ownership structure of many banks in the GCC, characterized by control by prominent families or regional governments, underpins our view.

Chart 5



Capitalization Is Strong And We Expect It To Remain So

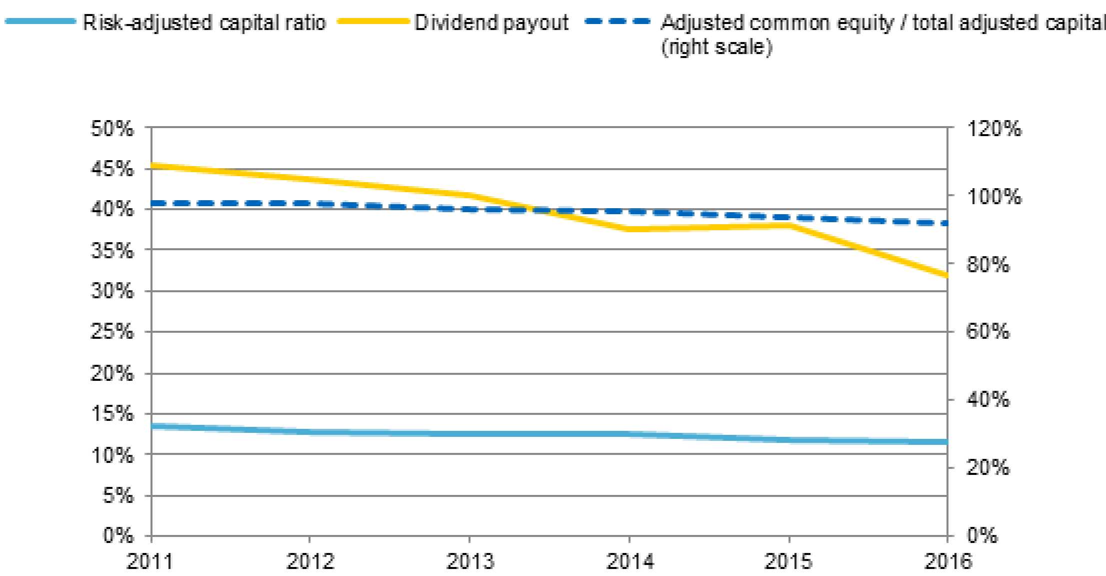
GCC banks continue to display strong capitalization by international standards, with an unweighted average S&P Global Ratings risk-adjusted capital (RAC) ratio of 11.5% at year-end 2016. We note, however, that capitalization has dropped over the past three years, from an average of 12.5% at year-end 2013, as previous lending growth has not been matched by additional capital raisings or conservative dividend payout ratios (see chart 6). This was most evident in Saudi Arabia in 2017, with banks hiking their interim dividends substantially due to a lack of growth prospects coupled with stabilization of liquidity.

Also partly underpinning the drop in capitalization are the new RAC methodology that we implemented in 2017--which increased our risk weights for certain higher-risk exposures--and our downward revision of some of the parameters we use in the calculation (such as sovereign ratings or Banking Industry and Country Risk Assessment scores) over the past couple of years.

Over the past few years, few banks have issued hybrid instruments. That's mainly because core equity has become more expensive in relative terms, given the favorable liquidity conditions. As shareholders and other investors are less willing to inject core capital into banks and more interested in getting a continuous and predefined income stream from hybrid instruments, we expect the quality of capital to continue weakening. However, this trend has not yet reached the point where we would see it as having a negative impact on our assessment of the quality of capital.

Chart 6

GCC Banks--Capitalization



Source: S&P Global Ratings.

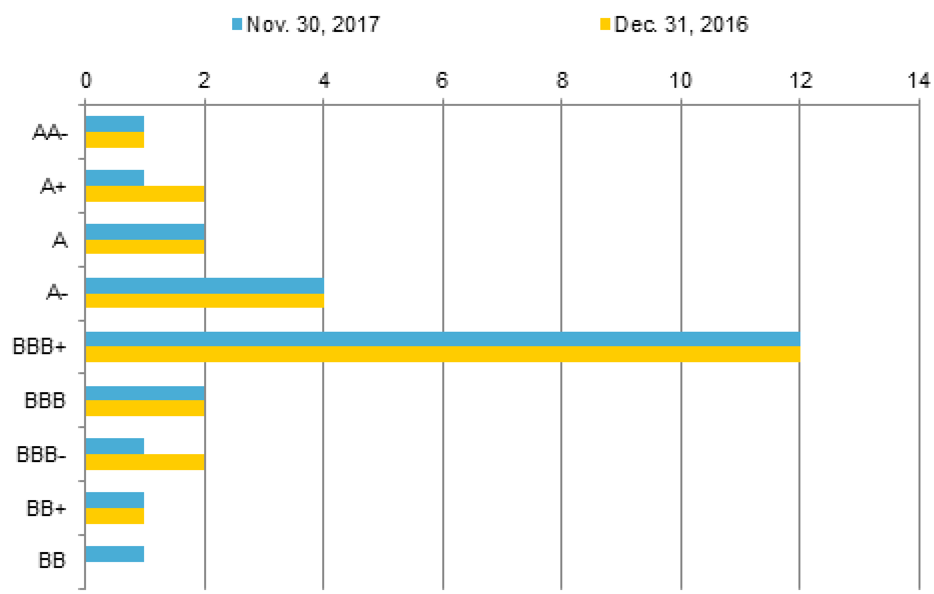
Additional loss-absorbing-capacity instruments and resolution regimes are absent in the GCC, but might develop in the future. For the time being, we continue to see the governments of four out of the six GCC countries as highly supportive of their banking systems, and we expect them to intervene to prevent problems at systemically important banks. We assess the likelihood of government support as uncertain in Bahrain and we view the authorities as supportive in Oman. In both countries, we think that the government's capacity to extend support to its banking system has diminished over time. If and when resolution regimes are implemented in the GCC, we might revise our view on government support.

Our Bank Ratings In The GCC Countries

We currently rate 25 banks in the GCC countries. The average long-term rating on this cohort of banks stood at 'BBB+' at Dec. 31, 2017, the same level as last year. This is in keeping with our outlook distribution, where 68% of outlooks are stable. At Dec. 31, 2017, 28% of our rated GCC banks had negative outlooks, more than half of which are on banks in Qatar. Our negative outlooks on Qatari banks are due to the potential negative impact of the boycott on the government's creditworthiness and capacity to support its banking system, and the pressure on Qatari banks' funding profiles, asset quality, and profitability indicators. Idiosyncratic reasons explain the negative outlooks on a few banks in other GCC countries.

Chart 7

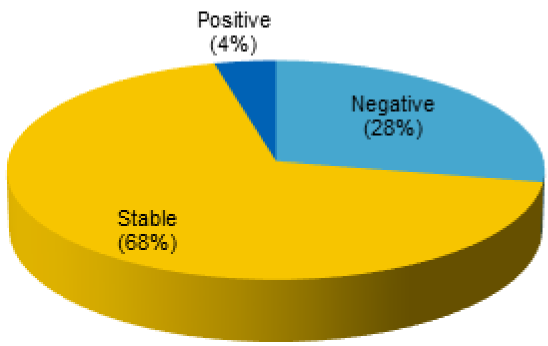
GCC Banks--Rating Distribution



Source: S&P Global Ratings.

Chart 8

GCC Banks--Outlook Distribution (Dec. 31, 2017)



Source: S&P Global Ratings.

Related Research

- Capitalization At Gulf Banks Is One Of The Main Strengths Supporting Their Ratings, Oct. 25, 2017
- The Future Of Banking: Could Fintech Disrupt Gulf Cooperation Council Banks' Business Models?, Oct. 16, 2017
- Qatari Banks Outlooks Revised To Negative Following Sovereign Action; Ratings Affirmed, Sept. 11, 2017
- Credit FAQ: How Recent Developments In Qatar Affect The Banking System, June 9, 2017
- The Overall Effect Of IFRS 9 On Rated Gulf Cooperation Council Banks' Financial Profiles Will Be Manageable, May 29, 2017

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