

GCC banks: excess cash and slow credit growth

- Despite the relatively upbeat regional economic outlook, large parts of the GCC banking sector still appear to be struggling. Bank lending remains weak and institutions are holding a large amount of idle cash.
- Banks remain cautious about taking on new risks, while higher provisioning continues to hit profitability. Meanwhile, recent turmoil in global and local equity markets has damaged investment portfolios.⁰¹
- An improvement in banking sector conditions is likely to be moderate and gradual, with banks slowly nursing their balance sheets back to health

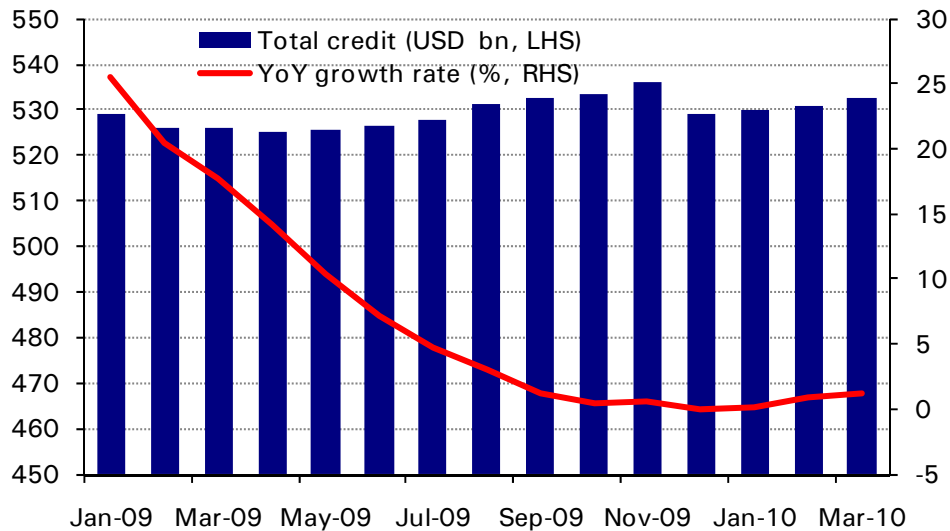
In IBQ's latest GCC Brief: In late 2009, one year following the eruption of the global financial crisis, a widespread consensus emerged that risks facing GCC economies and banks were dissipating and that a solid recovery would be underway. At that time, most major indicators across the region - including oil prices, consumer and business confidence surveys, and equity prices - gave support to that view. Up until now, and despite pressures facing Greece and other highly indebted countries in Europe, the GCC region's positive economic outlook seems unlikely to be significantly derailed and the recovery should stay on track. The GCC economies are expected to post over 4% real growth in 2010, following an estimated 0.5% contraction last year.

In that context, GCC regional banks outperformed in 2009 relative to their peers elsewhere. The anticipated recovery of regional economies, as well as the comfortable levels of liquidity, is supposed to boost the performance of banks in 2010, especially on the lending side, after the sharp slowdown in 2009. Unfortunately, recent data on credit do not support this view and still reflect continued weakness in bank lending as well as in financial results. The banks continue to hold excess idle cash as a result of slow lending activity. This is not only affecting profitability, but also is expected to weigh on growth of the private sector.

Bank lending remains weak

As of March 2010, credit extended by GCC banks to the private sector was up only 1.2% y/y, much slower than the 18% of a year ago. This deceleration took place despite the absence of any new regulatory constraints and despite the reported improvement in overall confidence. Since December of last year, credit growth ranges from a negative 1.1% in Bahrain to +2.7% for Qatar. Though modest, the aggregate growth in GCC credit is at its strongest since October 2009, providing a small sense of potential recovery. Meanwhile, deposits at regional banks rose by an aggregate 5.3% during the same period, as a result of 7% growth in private deposits and a 3.9% drop in government deposits. Accordingly, the simple ratio of loans to total deposits (LDR) dropped by 3 percentage points to 73%, which is well below the regulatory ceilings imposed by a number of countries, ranging from 85% to 100%. It is worth noting though that many countries include government deposits in calculating regulatory LDR measures.

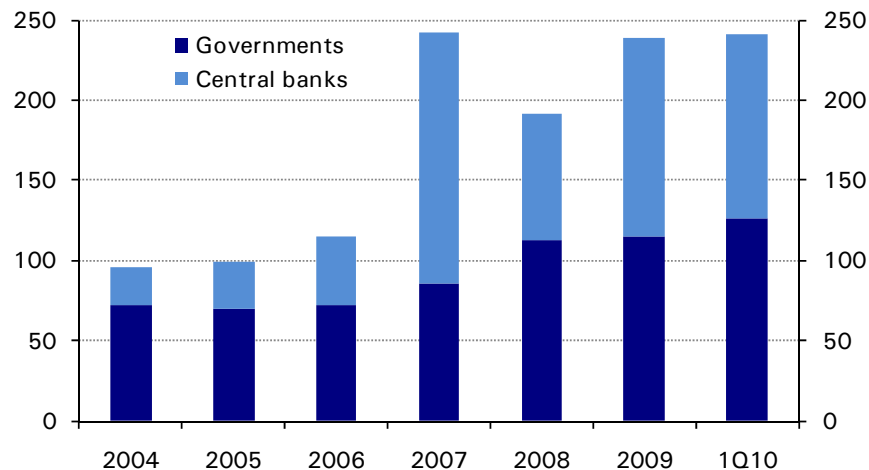
Chart 1: GCC banks-Credit to private sector



Source: GCC central banks

The disappointing growth in credit may signal three things. First, the banking environment remains very risky, forcing regional banks to remain ultra cautious about taking on new risks, competing only for the narrow segment of high quality loans. This behavior makes sense as banks focus on restoring the health of their balance sheets. Second, banks are willing to substitute risky loans for lower risk investments. This is evidenced by the 25% increase in banks' investments in government securities, claims on GCC central banks, and credit to government last year, and another 1.2% during the first quarter of this year. Finally, a decent recovery in bank lending may take longer than originally anticipated and it may not materialize until later this year. As a result, we expect credit to the private sector to expand in the range of 3 to 5 percent this year, down from the 8% we anticipated at the beginning of the year.

Chart 2: GCC banks-Claims on gvts and cntl banks*
(USD bn)



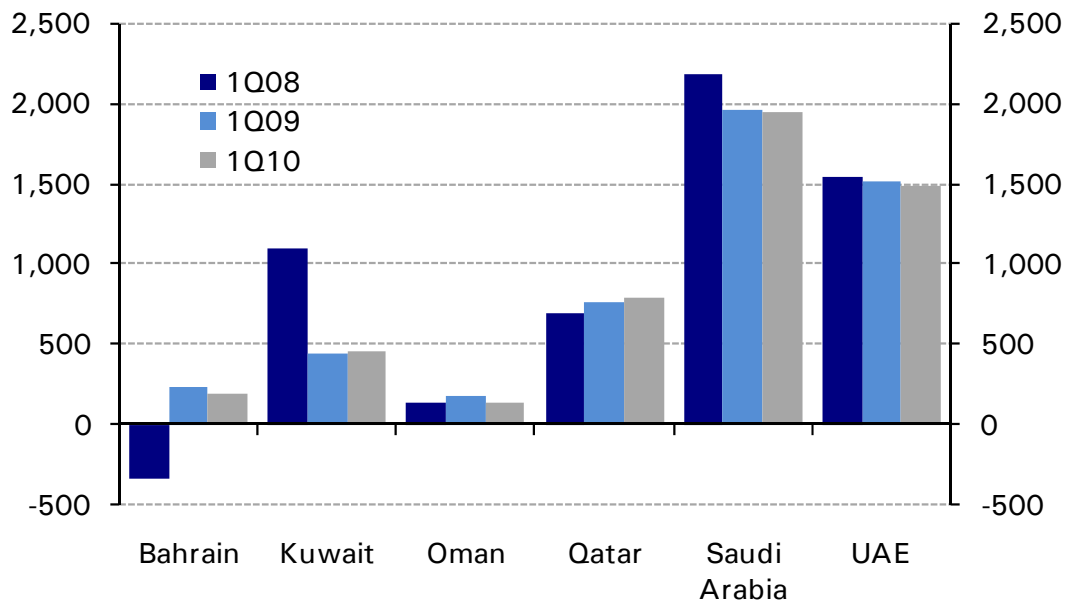
Source: GCC central banks

Note: * Represents banks investments in government securities, credit extended to the public sector, holdings of central banks' CDs or bonds, and deposits with central banks.

Profits continue to suffer

The weak growth in credit has no doubt affected banks profitability across the region. Aggregate profits of the top 60 GCC banks were down 1.9% (y/y) in the first quarter of 2010, totaling USD5 billion. Looking at individual countries, we see a slight increase in profits in Qatar and Kuwait of 3% and 1.8%, respectively. Declines ranged between 0.9% in Saudi Arabia and 25.6% in Oman. Divergence in performance can also be observed at the bank level with 25 banks reporting improved performance, with the remaining 35 banks seeing a deterioration in their profitability. Indeed, banks also differed widely in terms of financial strength, capital, market share, as well as in terms of business model.

Chart 3: GCC banks-Net profits
(USD mn)

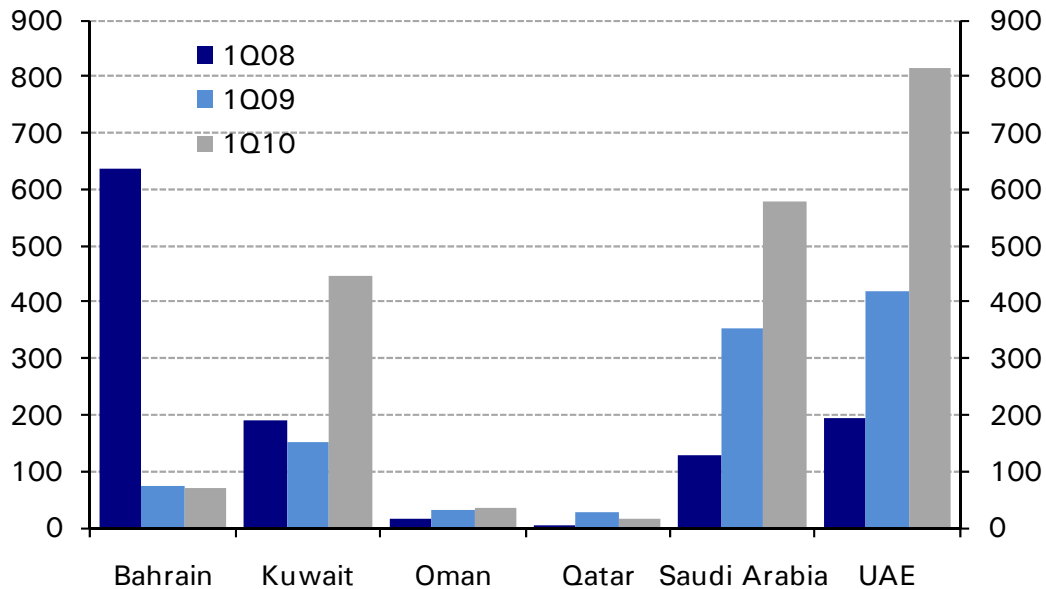


Source: Zawya

The sharp growth in provisioning during the first quarter of this year also played a major role in the drop in profits. Consolidated provisions set aside reached USD2 billion in the first three months of 2010, up 85% y/y. The bulk of these provisions came against non-performing loans, while a smaller portion may have been precautionary or judgmental against unanticipated potential deterioration in the loan portfolios of some banks.

Sizable provisioning was more apparent in the UAE, Saudi Arabia, and Kuwait. Each of these faced country-specific challenges that necessitated the buildup of extra provisions. In the UAE, for example, the Dubai World debt problems played a major role, while the repercussions from the defaults of Saad and Al-Gosaibi conglomerates pressured Saudi banks. In Kuwait, investment companies were an issue and the central bank (CBK) has just issued new regulatory measures for them. While there may still be a need for regional banks to set aside more provisions, we expect these to be smaller.

Chart 4: GCC banks-Provisions
(USD mn)

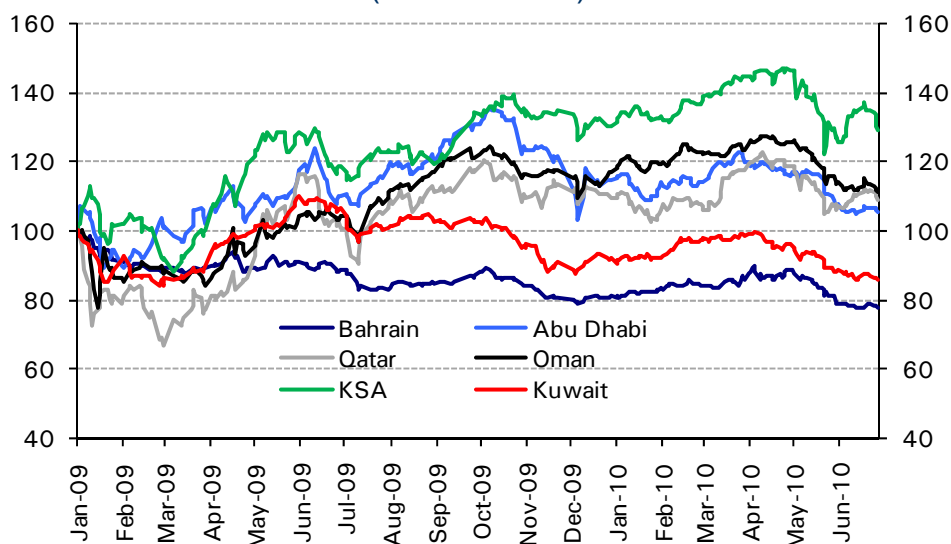


Source: Zawya

Further pressure from stock and real estate markets

The first quarter of 2010 was a good month for all equity markets in the region, despite the high volatility. The markets benefitted from positive sentiment, high oil prices, and the huge injection of liquidity by most GCC governments to stimulate their economies. The stock market indices were up between 5% in Oman and 11% in Saudi Arabia in the first quarter. On a y/y basis, such gains reach 53% in Qatar, 45% in both Saudi Arabia and Oman, and 12% in Kuwait.

Chart 5: GCC equities-Daily performance
(2009 rebased)



Source: Zawya

More recently, however, the negative news from Greece and the worries about a wider contagion across Europe and beyond, have had a severe impact on regional equity markets and have wiped out all the year's gains. Losses during the second quarter ranged between 8% in Qatar to 13% in Kuwait and 14% in Abu Dhabi. Renewed turmoil in financial markets is expected to weigh negatively on sentiment.

Similar weakness is noted in most regional real estate markets. With the exception of Saudi Arabia, real estate markets did not reflect the improvement in economic conditions. Indeed, further deterioration in the UAE real estate market is possible this year, though at a much lower pace than last year.

Improvements in both household and corporate net asset positions are likely to remain subdued, unless a major improvement takes place in equity and real estate markets, which is not very likely in the near term. Similarly, the investment portfolios of banks may continue to show weak performance this year.

The IBQ report concluded: GCC banks enjoy a surplus of cash and other liquid assets, but not too many sound investment or lending opportunities, at least for now. In line with the economic recovery, improvement for the banks is likely to be moderate and gradual, while at the same time providing banks with an opportunity to nurse their balance sheets back to health. □