GCC Banks: Solid buffers to weather the storm

Banks are facing major headwinds that have been triggered by the coronavirus pandemic and the steep fall in oil prices. The main challenges could be a possible weakening in asset quality, a fall in NIMs on lower interest rates, and a potential tightening in liquidity, which could affect profitability. We expect higher risk costs in 2020. In contrast, banks in Kuwait, KSA and the UAE exhibit solid asset quality metrics, with strong capitalization levels and liquidity buffers, which will help banks weather the current storm.

Raja Ghoussoub
Senior Economist
+965 2259 5356
rajaghoussoub@nbk.com

Banks are facing major headwinds that have been triggered by the coronavirus pandemic and the consequent lockdowns that have driven economic activity to a standstill. This was aggravated by a steep fall in oil prices, which worsened the outlook even more given oil's preeminent role in the GCC economies. For regional banks, there are three main challenges: (i) a possible weakening in asset quality; (ii) a fall in interest rates and the consequent pressure on banks' net interest margins (NIMs); and (iii) a potential tightening in liquidity.

In addition, banks are having to deal with an expected disruption to their typical role of funding normal business activities, whether corporate or retail. For example, funding business-as-usual working capital requirements, capital spending expenditures, and trade activities will give way, to a certain extent, to lending companies just to keep them afloat and avoid severe employment losses, especially among citizens. On the retail front, blanket deferrals of loan instalments have partially replaced new credit given to purchase real estate or consumer durables. In the note below, we take a close look at the banking sectors in Kuwait, KSA, and the UAE, shedding light on their resilience to the three major headwinds mentioned above, namely a possible worsening of asset quality, NIM pressure, and potential liquidity tightening.

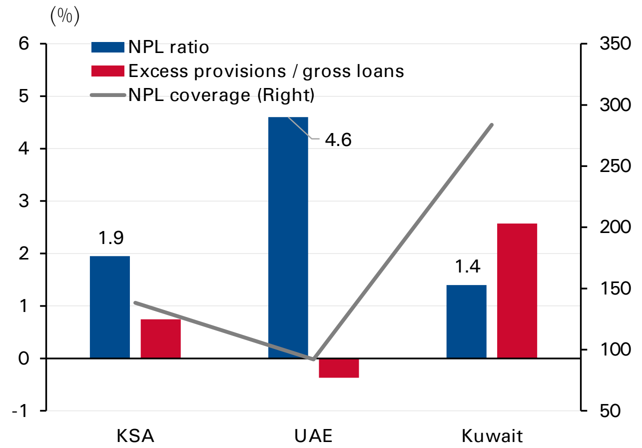
Banks generally have solid asset quality metrics

Generally, asset quality deterioration is the prime reason for bank failures globally. To put things in perspective, GCC banks usually exhibit solid asset quality indicators compared with their global peers. In the GCC, non-performing loan (NPL) ratios of 2% to 3% (and even lower) are common while 4% to 5% ratios are considered relatively "high". In contrast, NPL ratios globally tend to be higher across the credit cycle. The discrepancy in terms of NPL coverage ratios (i.e. provisions divided by NPLs) is much starker with GCC ratios usually in excess of 100% while they tend to be significantly lower globally (for example, averaging less than 50% in the European Union in 2019). In chart 1, we plot the NPL ratios and NPL coverage ratios for the three banking sectors.

 T: (965) 2259 5500, econ@nbk.com,

With an NPL ratio of around 1.4% and NPL coverage in excess of 280% at the end of 2019 as per Moody's, Kuwaiti banks exhibit very solid asset quality indicators. In addition, we also plot a ratio, which we have called excess provisions (i.e. provisions in excess of NPLs) as a share of gross loans. This ratio is particularly useful when the NPL base is low such as in Kuwait and KSA. In such a situation, NPL coverage ratios, on their own, can give a false sense of "security" because an increase in the NPL ratio to even an un-alarming level can result in a steep decrease in NPL coverage ratios; this was actually experienced by some GCC banks in 2008-2009, which saw their coverage ratios tumble to less than 80% from an excess of 300% in a very short period of time. Kuwait stands out in terms of excess provisions to gross loans, recording 2.57% at the end of 2019. This actually means that even if 2.57% of gross loans were to become non-performing, the coverage ratio will remain at 100%. On the other hand, in the UAE the NPL ratio stood at 4.6% in 2019 and coverage slightly less than 100%. The usually high coverage ratios in the GCC are very much an outcome of prudent central bank policies and strict requirements regarding provisioning. For example, the Central Bank of Kuwait (CBK) requires banks to take general provisions amounting to 1% of cash facilities and 0.5% of non-cash facilities. In KSA, it has long been thought that the central bank would like the banks not to be very far from a 150% NPL coverage level.

Chart 1: NPL ratios and NPL coverage ratios

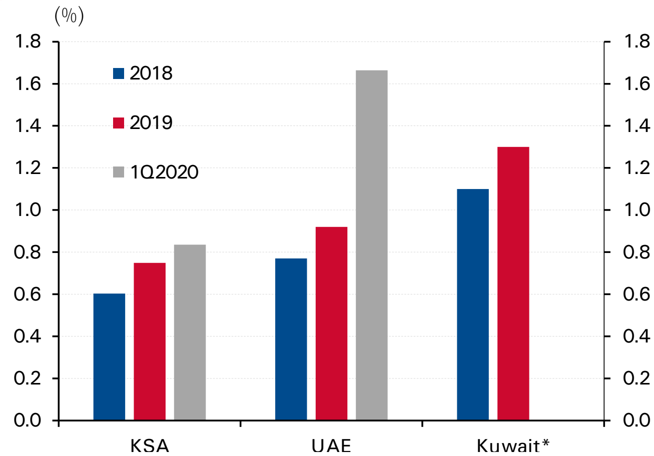


Source: Banks' financials and Moody's; Mar 2020 for KSA, Dec 2019 for UAE & Kuwait

In chart 2, we plot the banks' cost of risk (credit provisioning as a % of average gross loans) since 2018 for the three sectors. We notice that Kuwait's measure has been sticky high (and exceeding its GCC peers) despite the fact that NPL coverage in Kuwait was already at a solid level of 242% at end-2017 as per Moody's. As expected, especially given the requirements of IFRS 9, provisioning increased in 1Q2020 as the economic activity deteriorated and the outlook worsened since the start of the year. The severe contraction in economic activity has been coupled with collapsing oil prices, which is expected to lead to major restraint in government spending in 2020, further exacerbating the economic slowdown. For 2020 as a whole, we expect asset quality to weaken somewhat, leading to higher risk costs. We believe the various stimulus measures undertaken by the respective governments and central banks will lessen somehow the negative impact, but the economic shock is too deep to be completely neutralized by the policy response. Given the unprecedented sudden stop in normal business activities, asset quality stress can possibly emerge from any sector or business activity. However, we highlight below several characteristics for each country that can possibly give some clues about the extent of asset quality deterioration in each respective country.

Kuwaiti banks, as mentioned above, entered this crisis with very solid buffers, but it will be prudent to point out several factors that can possibly impact their asset quality. First, although Kuwaiti banks have a relatively large exposure to the real estate sector, which stood at no less than 53.5% of total domestic credit at the end of April 2020 (23.2% for corporates and 30.3% in personal housing loans), this will not likely pose significant risks given that personal housing loans are mostly given to citizens with de-facto guaranteed jobs. The risk emanating from the corporate sector is of interest given the Kuwaiti authorities' recent announcements of their plans to adjust the country's current demographic makeup which, if implemented in an expedited manner, will lead to a major drop in expatriate numbers and hence a decrease in the overall population level. This will likely have an impact on the real estate market and could potentially impact banks' asset quality if left unchecked, but measures have been already taken to lessen such an impact. In fact, the Governor of the CBK already pointed out that banks need to closely monitor their real estate exposures. Second, the fiscal policy response to the coronavirus in Kuwait has been somehow slower than in KSA and the UAE. This is accentuated by delays to the issuance of a new debt law, which is limiting the government's ability to appropriately deal with the current crisis. At the risk of stating the obvious, the weaker the policy response, the deeper the economic contraction, and hence the higher the likelihood of a worsening in banks' asset quality.

Chart 2: Cost of Risk



Source: Banks' financials and Moody's *unavailable for 1Q2020

UAE banks are more sensitive to the economic shock given the relative importance of the non-oil sector

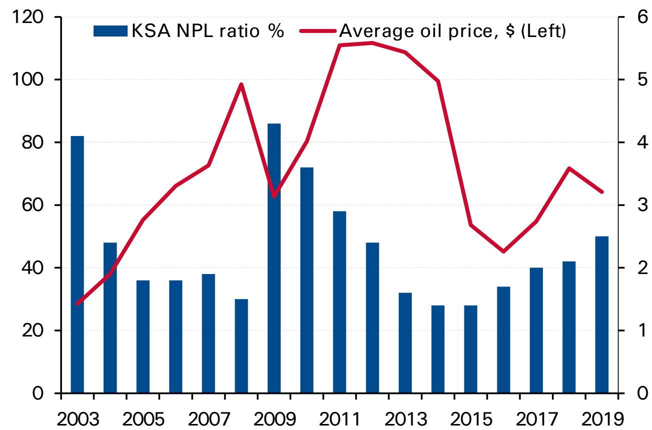
In the UAE, asset quality indicators tend to be weaker than in Kuwait and KSA. Given the current sharp shock to non-oil activities, UAE banks could face more risks than in Kuwait and KSA in terms of asset quality weakening given the significantly higher proportion of non-oil GDP in the total, which stood at 70% in 2019. The most affected sectors, especially in Dubai, are the tourism, transportation, and wholesale & retail trade industries given the emirate's high dependence on tourists and the fact that it is a major trade hub. In fact, the overall services sector, which accounts for a whopping 80% of Dubai's economy, is the most affected in the current environment. We roughly estimate the exposure to these sectors at around 25% of banks' total credit. The sharp increase in the UAE banks' cost of risk in 1Q2020 to around 166 bps compared with 92 bps in 2019 is testimony to the banks' high susceptibility to a worsening asset quality in 2020. Another important pressure point for UAE banks is the sizable exposure to the real estate sector (roughly estimated at more than 25% of total credit) which has been under pressure for several years now. This pressure is expected to intensify given sharp expatriate job losses in a country where expats account for around 88% of the total population. On the flip side, the UAE seems to have been more successful, so far, than its GCC peers in terms of containing the coronavirus, implementing a strategy of wide-scale mass testing. Obviously, the sooner the virus is contained, the quicker the return to normal business activities, and hence the lower the impact on economic growth and banks' asset quality stress.

There is a relatively strong relation between oil prices and banks' NPL ratios in KSA

As for KSA, it is interesting to note the relatively strong relation between oil prices and NPL ratios as seen in chart 3 (this relation also holds for UAE and Kuwait, but it manifests itself in a stronger way in KSA). In our view, this is expected given that the oil price is still, despite the diversification efforts, the main barometer of government spending and economic growth in the GCC. We note the improving trend in the NPL ratio between 2003 and 2008 as oil prices were increasing (and non-oil growth averaged 8.4%), but that ended in soaring NPLs in 2009 after oil prices crashed in the second half of 2008. Between 2010 and 2014, when oil prices averaged between $80 and $100, the NPL ratio fell to around 1.4% from over 4%, to start inching up again in the following years as oil prices averaged a relatively low $50 between 2015 and 2017.

Given where oil prices are currently and given the severe economic shock, NPL ratios and risk costs are expected to trend upwards in KSA as elsewhere in the GCC. For example, the two largest banks, NCB and Al Rajhi, have mentioned that their risk costs will increase by 30-50 bps and 10-30 bps, respectively, to stand at 80-100 bps in 2020. One historical pressure point in KSA was the exposure to the building and construction sector. However, credit to that sector has now fallen to around 6% after being close to 10% previously. Another factor worth highlighting is mortgage lending, which has been increasing very fast, accounting for 50% of the total increase in credit in the last year and a half. The risk from that segment should be relatively contained in the short term given that it is driven by citizens working mostly in the public sector. However, an ongoing increase in the concentration of that exposure coupled with continued pressure on real estate prices, as is the case now, could be a source of risk in the future.

Chart 3: NPL ratios in KSA versus average Brent oil prices

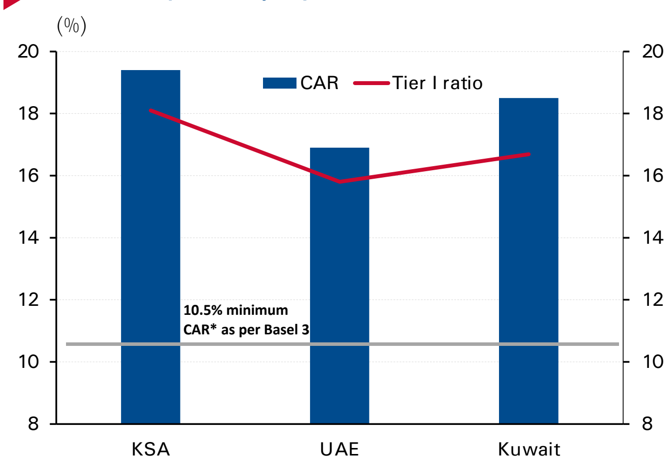


Source: Moody's and NBK

Capitalization levels are high, offering a good cushion in the face of the lower expected profitability

On top of their generally good asset quality indicators, GCC banks exhibit very solid capital adequacy ratios that are way higher than the minimum requirements of Basel 3 as seen in chart 4. In fact, the regulators in the GCC have imposed higher minimum requirements than those prescribed by Basel 3, in addition to extra buffers such as the countercyclical buffer and the domestic systemically important banks (D-SIB) buffer. In the wake of the coronavirus pandemic, the central banks

Chart 4: Capital adequacy ratios



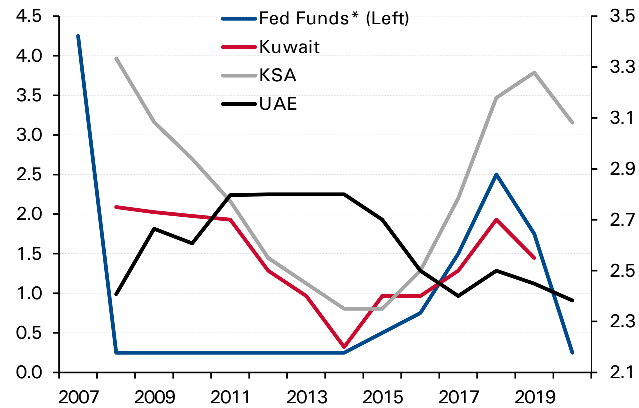
Source: Central bank data *including only the capital conservation buffer in Kuwait and UAE relaxed, fully or partially, some of the required buffers such as the capital conservation buffer and the D-SIB, which have widened the banks' lending capacity. We note that credit growth in this environment is not expected to be strong, putting less pressure on capital consumption. Overall, we think the GCC banking sectors as a whole are in a comfortable position when it comes to capital adequacy, although on an individual bank level, some of them may need to boost their capital bases especially if the current weak environment drags on.

Lower interest rates are expected to put pressure on banks' NIMs

We now move to the second headwind, which is lower NIMs on the back of a drop in interest rates. For a historical perspective, we plot the sectors' NIM and the upper bound of the Federal Funds target rate (FF) since 2007 (Chart 5).

As seen, Saudi banks have been more sensitive to changing interest rates with their NIM falling from a high of 3.3% in 2008 to around 2.35% in 2014 as the FF dropped from 4.5% to 0.25%. On the upside, their NIMs rallied from around 2.35% in 2015 to 3.3% in 2019 as the FF was on an uptrend starting at 0.25% at the end of 2014 and reaching 2.5% at the end of 2018, before starting to decrease again in August 2019. In 1Q2020, the NIM in KSA dropped by around 20 bps compared with 2019 (versus around 7 bps fall in the UAE NIM) as the FF was slashed from 2.5% in July 2019 to 0.25% in mid-March 2020. The main reason for this NIM dynamic in KSA is the structurally-high level of non-interest bearing (NIB) deposits in the banking sector, which stood at around 70% of total local-currency deposits, significantly higher than in the UAE and Kuwait (Chart 6).

Chart 5: Net interest margins versus the Federal Funds target rate
(%)

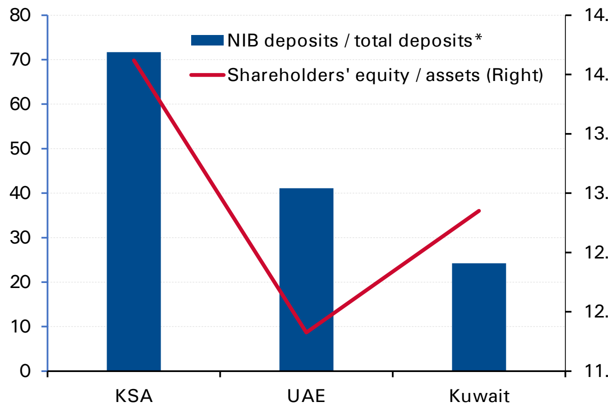


Source: Banks' financials, Moody's, and NBK *upper bound

This naturally results in a reduction in the NIM when interest rates fall and in an improvement in the NIM when interest rates increase. Another factor, though much less important, is the higher capitalization of Saudi banks as measured by shareholders' equity to assets, which will effectively impact the NIM in the same manner as NIB deposits do. Going forward, we expect the NIM in KSA to fall further as asset yields gradually reprice lower driven by reduced benchmark rates. We note that the country's largest banks expect their NIMs to fall by anything between 10 to 70 bps in 2020. On the other hand, given the currently higher credit risks, banks in KSA as well as elsewhere might attempt to reprice spreads (the difference between loan yields and benchmark interbank rates) upwards, which will lessen the reduction in NIMs to a certain extent. The NIM in the UAE is more stable than in KSA as seen in chart 5. The sharp increase in the NIM in 2009 when the FF had dropped to nearly zero was driven by aggressive upward repricing of loan spreads in the wake of the global financial crisis, which had a significant impact on the UAE banking sector. The downward trend in the NIM in 2015-2017 was driven by asset yields not keeping up with the increase in funding costs.

In Kuwait, there are additional factors that impact the NIM such as the KD's peg to a basket of currencies, which gives the CBK more flexibility in terms of monetary policy and setting interest rates. Hence, while the central banks in KSA and the UAE tend to consistently follow the Federal Reserve in changing interest rates, this is not always the case for the CBK. For example, the Fed has slashed interest rates by a cumulative 2.25% since August 2019, while the CBK reduced rates by only 1.5%, which, all else equal, puts Kuwaiti banks in a better position currently versus its GCC peers. Another aspect of the Kuwaiti banking sector is that the pricing of loans does not follow the customary process of charging a spread above respective interbank rates, but loan yields are priced off the main policy interest rate, which is the discount rate. In effect, this results in a more direct impact on loan yields whenever the discount rate changes irrespective of the behavior of interbank rates (KIBOR). A third important factor is that the pricing of loans and deposits is regulated given the imposition of loan spread caps and deposit cost floors, which reduces to a certain extent the differences among banks in terms of pricing. As for NIB deposits, these constitute a smaller share of domestic currency deposits in Kuwait (around 24%) compared with KSA and UAE. The impact of that, and all else equal, is that Kuwaiti banks should see less variation in their NIM than their GCC peers, given a change in benchmark interest rates.

Chart 6: NIB deposits to total deposits & shareholders' equity-to-assets ratio (March 2020)
(%)



Source: Central bank data *excluding FX deposits in KSA/Kuwait & government deposits in UAE

An important factor that will have an impact on NIMs in the current environment is the deferral of loan instalments for certain borrowers in the three GCC countries. The more extensive the deferrals will be (in terms of volumes and number of months) the higher the expected impact on the NIM. On the other hand, the higher the compensating support that the banks will receive from the central banks and governments, for example in terms of providing free-funding, the more the NIM impact will be lessened. One factor that might complicate matters more is different accounting treatments by the banks, which might blur the NIM impact comparison among those banks.

Liquidity may tighten but banks have solid buffers and some central banks eased liquidity requirements

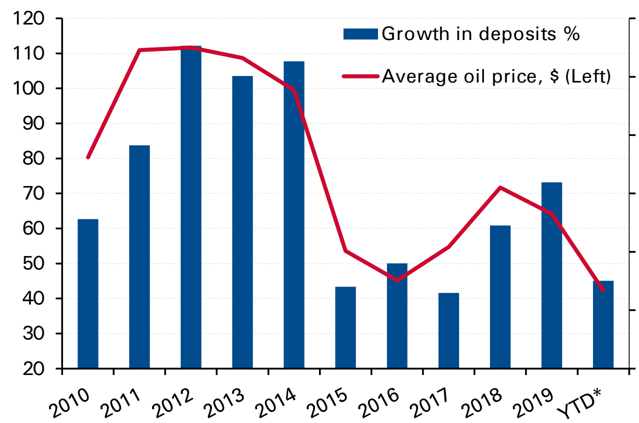
In addition to the general level of interest rates, funding pressures are a very important determinant of the NIM, which brings us to the third challenge facing GCC banks that is a potential worsening of liquidity. Factors that could lead to a tighter liquidity situation include the current economic contraction, possible reduction in government spending, blanket deferral of loan repayments, and lower oil prices. In contrast, there are several factors that should ease the liquidity situation such as the stimulus measures taken by some central banks, especially measures that entail depositing funds at the banks. Of profound importance is the relaxation of some prudential liquidity requirements as has happened in Kuwait and the UAE, which released significant liquidity into the system and expanded banks' lending capacity by a wide margin. The CBK in early April lowered the minimum "reserve ratio" from 18% to 15%, increased the maximum loans-to-deposits ratio from 90% to 100%, and dropped the minimum liquidity coverage ratio (LCR) and the minimum net stable funding ratio (NSFR) from 100% to 80%. In the UAE, the central bank reduced the minimum LCR from 100% to 70% and dropped the reserve requirement on demand deposits from 14% to 7%, among other measures.

Of prime importance to banks' funding profiles in the GCC is the oil price level, which is the main determinant of government spending which, in turn, remains the key driver of non-oil GDP growth. In chart 7, we plot the oil price versus the combined growth in deposits for the three GCC banking sectors, whereby the strength of the impact that oil prices have on deposit growth can be seen.

Given where oil prices are currently and their outlook in the short term, deposit growth is expected to be under pressure in 2020, which will not be helpful for banks' funding and liquidity profiles.

To gauge the trend in liquidity so far this year, we plot the banks' simple loans-to-deposits ratio, which has barely moved year-to-date (Chart 8). In fact, the regulatory loans-to-deposits ratio in KSA (where borrowings are added to deposits) stood at less than 77% at the end of May 2020, significantly below the maximum allowed level of 90%. In the UAE, the regulatory variant of the loans-to-deposits ratio stood at 81.5% at the end of April, lower than the maximum allowed level of 100% by a wide margin.

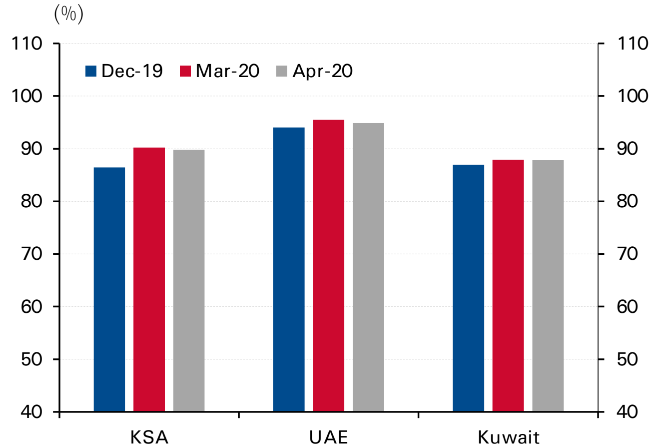
Chart 7: Deposit growth in KSA, UAE and Kuwait versus average Brent oil prices



Source: Central bank data and NBK *annualized

Chart 8: Simple loans-to-deposits ratios

(%)



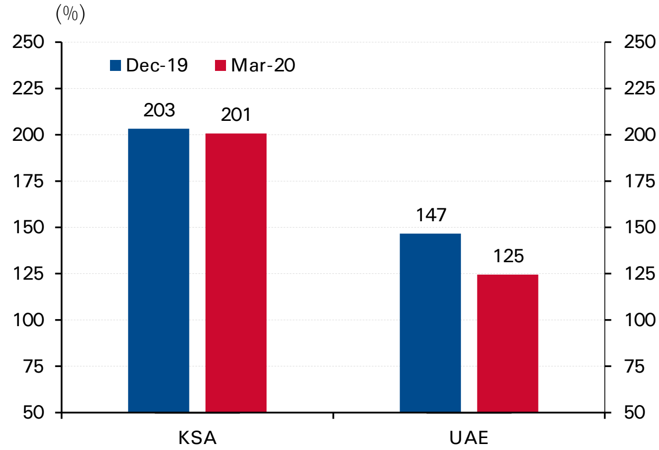
Source: Central bank data

We also looked at another common measure of liquidity, which is the liquid assets-to-total assets ratio. For simplicity, we used a broad definition of liquid assets, which includes cash, deposits at central banks, due from banks, and all investments. The three banking sectors have ratios that are in excess of 30% (with Kuwait the highest at 37%) and these ratios have been broadly stable so far this year, indicating solid liquidity positions.

The two metrics above are traditional measures of banks' liquidity, so we complemented them by incorporating the LCR of Basel 3. The weighted average LCR of the largest banks in KSA and UAE is plotted in chart 9. As seen, there was a material decrease in the UAE, but that cannot be decoupled from the fact that the minimum LCR requirement was slashed from 100% to 70%. In KSA, there was only a minor drop in the LCR in 1Q2020 to 201% (minimum requirement of 100%), which was lower than a 6% decrease in the NSFR that stood at 123% at the end of March 2020 versus a 100% minimum requirement.

To sum, as per the metrics above, the three banking sectors enjoy good liquidity, which is very strong in Kuwait, and that liquidity hadn't shown a systemic deterioration by April 2020. This observation applies to the three sectors as a whole, but not necessarily to each and every bank. For example, In the UAE, some banks mentioned that liquidity tightened for some time in March before easing off in April. Finally, given that the operating environment began souring in earnest in March it was probably still a bit early for a systemic tightness in liquidity to appear in April, if at all, especially given the central banks' measures that were taken early on.

Chart 9: Weighted average LCR



Source: Banks' investor presentations and Basel 3 disclosures

To conclude, higher loan provisioning and lower NIMs will pressure banks' profitability in 2020. Furthermore, if liquidity tightens then cost of funding will increase, which will put further stress on NIMs and hurt profitability even more. The latter is also expected to suffer from muted fee income on the back of weak projected credit growth. On the other hand, banks, especially in Kuwait followed by KSA, exhibited solid asset quality metrics, while capitalization levels are particularly solid across the board and liquidity buffers are strong, which will help banks to weather the current storm.

Head Office

Kuwait
National Bank of Kuwait SAKP
Abdullah Al-Ahmed Street
P.O. Box 95, Safat 13001
Kuwait City, Kuwait
Tel: +965 2242 2011
Fax: +965 2259 5804
Telex: 22043-22451 NATBANK
www.nbk.com

International Network

Bahrain
National Bank of Kuwait SAKP
Zain Branch
Zain Tower, Building 401, Road 2806
Seef Area 428, P. O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

National Bank of Kuwait SAKP
Bahrain Head Office
GB Corp Tower
Block 346, Road 4626
Building 1411
P.O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

United Arab Emirates
National Bank of Kuwait SAKP
Dubai Branch
Latifa Tower, Sheikh Zayed Road
Next to Crown Plaza
P.O.Box 9293, Dubai, U.A.E
Tel: +971 4 3161600
Fax: +971 4 3888588

National Bank of Kuwait SAKP
Abu Dhabi Branch
Sheikh Rashed Bin Saeed
Al Maktoom, (Old Airport Road)
P.O.Box 113567,Abu Dhabi, U.A.E
Tel: +971 2 4199 555
Fax: +971 2 2222 477

Saudi Arabia
National Bank of Kuwait SAKP
Jeddah Branch
Al Khalidiah District,
Al Mukmal Tower, Jeddah
P.O Box: 15385 Jeddah 21444
Kingdom of Saudi Arabia
Tel: +966 2 603 6300
Fax: +966 2 603 6318

Jordan
National Bank of Kuwait SAKP
Amman Branch
Shareef Abdul Hamid Sharaf St
P.O. Box 941297, Shmeisani,
Amman 11194, Jordan
Tel: +962 6 580 0400
Fax: +962 6 580 0441

Lebanon
National Bank of Kuwait
(Lebanon) SAL
BAC Building, Justinien Street, Sanayeh
P.O. Box 11-5727, Riad El-Solh
Beirut 1107 2200, Lebanon
Tel: +961 1 759700
Fax: +961 1 747866

Iraq
Credit Bank of Iraq
Street 9, Building 187
Sadoon Street, District 102
P.O. Box 3420, Baghdad, Iraq
Tel: +964 1 7182198/7191944
+964 1 7188406/7171673
Fax: +964 1 7170156

Egypt
National Bank of Kuwait - Egypt
Plot 155, City Center, First Sector
5th Settlement, New Cairo, Egypt
Tel: +20 2 26149300
Fax: +20 2 26133978

United States of America
National Bank of Kuwait SAKP
New York Branch
299 Park Avenue
New York, NY 10171, USA
Tel: +1 212 303 9800
Fax: +1 212 319 8269

United Kingdom
National Bank of Kuwait
(International) Plc
Head Office, 13 George Street
London W1U 3QJ, UK
Tel: +44 20 7224 2277
Fax: +44 20 7224 2101

National Bank of Kuwait
(International) Plc
Portman Square Branch
7 Portman Square
London W1H 6NA, UK
Tel: +44 20 7224 2277
Fax: +44 20 7486 3877

France
National Bank of Kuwait
(International) Plc
Paris Branch
90 Avenue des Champs-Elysees
75008 Paris, France
Tel: +33 1 5659 8600
Fax: +33 1 5659 8623

Singapore
National Bank of Kuwait SAKP
Singapore Branch
9 Raffles Place # 44-01, Republic Plaza
Singapore 048619
Tel: +65 6222 5348
Fax: +65 6224 5438

China
National Bank of Kuwait SAKP
Shanghai Office
Suite 1003, 10th Floor, Azia Center
1233 Lujiazui Ring Road
Shanghai 200120, China
Tel: +86 21 6888 1092
Fax: +86 21 5047 1011

NBK Capital

Kuwait
NBK Capital
38th Floor, Arraya II Building, Block 6
Shuhada'a street, Sharq
PO Box 4950, Safat, 13050
Kuwait
Tel: +965 2224 6900
Fax: +965 2224 6904 / 5

United Arab Emirates
NBK Capital Limited - UAE
Precinct Building 3, Office 404
Dubai International Financial Center
Sheikh Zayed Road
P.O. Box 506506, Dubai
UAE
Tel: +971 4 365 2800
Fax: +971 4 365 2805

Associates

Turkey
Turkish Bank
Valikonagl CAD. 7
Nisantasi, P.O. Box. 34371
Istanbul, Turkey
Tel: +90 212 373 6373
Fax: +90 212 225 0353