Money and banking

UAE: Banking sector could become more supportive of growth this year

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- **Conditions in the banking sector are showing signs of improvement, suggesting that the sector could become steadily more supportive of the macroeconomic climate through 2018.**
- **Liquidity conditions have improved, credit demand is rising and banks may be more prepared to lend. This should help counter the drag on lending from higher interest rates and a still-weak property sector.**

Credit growth decelerated in 2017, despite improving economy

Headline credit and deposit growth have moved in opposite directions for most of the past 2-3 years, sending mixed signals on the health of the monetary sector. Although there are still forces pulling in both directions, the banking system now looks better adjusted to the new, lower oil price climate and could become more supportive of economic growth this year.

On the one hand, credit conditions remain disappointingly weak. Since peaking at 11% y/y in mid-2015, credit growth has been in more or less consistent decline, standing close to multi-year lows at just 0.5% y/y in January 2018. (Chart 1. The current figure would likely be slightly higher once an adjustment is made for an accounting change last August.) This is the lowest in the Gulf region, other than Saudi Arabia, where economic growth is weaker.

A number of factors explain the slowdown. The plunge in oil prices in mid-2014 triggered a moderation in non-oil economic growth from 5% per year on average in 2013-14 to 3% in 2015-17, as well as a downturn in the key real estate market – both of which affected credit demand. Banks tightened lending criteria in response to slower deposit growth and a tougher funding climate, while new regulations to cap mortgage loans were also in effect. Finally, the policy repo rate has been increased four times following hikes by the US Fed, contributing to tighter liquidity and pushing market interest rates higher. (Chart 2.)

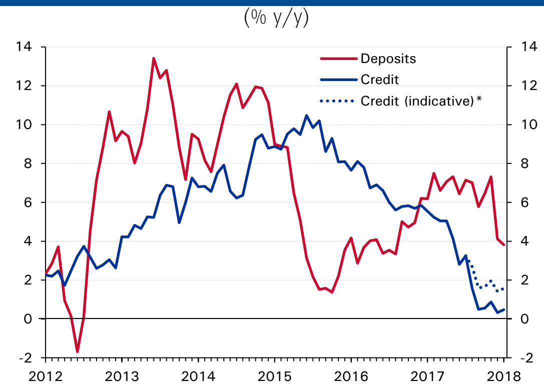
Latest sectoral figures (December 2017) show that lending growth is negative across a range of sectors, including the finance, personal (including mortgages) and trade sectors, the latter two reflecting weak conditions in the consumer sector affected by subsidy cuts and a soft labor market. (Chart 3.) By contrast, lending to construction remains robust, helped by project-related activity ahead of the Dubai Expo and the rising supply of new property developments.

Deposit growth recovers as oil prices rise

On the deposit side, however, things are looking better. After slumping to just 2% y/y in mid-2015, deposit growth has staged a steady recovery, rising to 4% in 2016, then 7% last year (though the latest figures are weaker, partly on base effects). (Chart 1.) But even here, the underlying picture is mixed. As chart 4 shows, the pick-up in deposit growth has been driven exclusively by government deposits, which have surged over the past year helped by rising oil revenues and two large sovereign debt issues by Abu Dhabi in 2016 and 2017. Private deposit growth has remained weak, and in fact decelerated in 2016 and 2017.

Chart 1: UAE bank credit and deposits

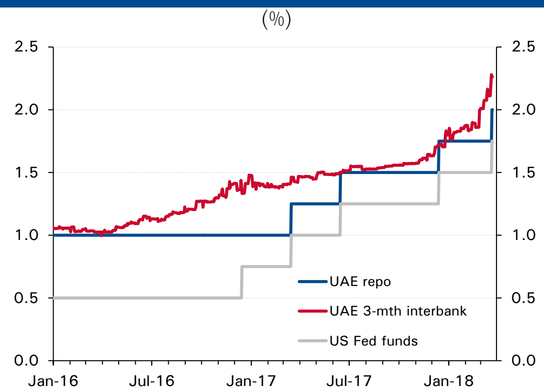
(% y/y)



Source: Thomson Reuters Datastream / NBK
* NBK estimate following accounting change in August 2017

Chart 2: Interest rates

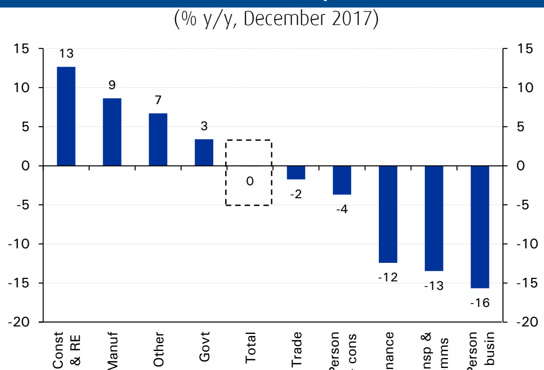
(%)



Source: Thomson Reuters Datastream

Chart 3: Credit by sector

(% y/y, December 2017)



Source: CBUAE Note: Credit figures are gross of provisions

Although nuanced by sector, stronger overall deposit growth has at least improved the funding picture for banks. The ratio of liquid-to-total assets fell to 14% in 3Q 2015 following the fall in oil prices, but recovered to above 18% by end-2017. This provides banks with better cover for short-term deposit flows. Meanwhile, the loans-to-stable resources ratio fell from above 88% in 3Q 2015 to below 85% at the end of last year, giving banks greater scope to lend.

Banks report improved profitability in 2017

Against this backdrop, banks' financial results for last year were encouraging. Net profit at the five largest banks rose 6% in 2017. This rises to 12% if the merger-affected profits at the largest bank, First Abu Dhabi Bank (previously National Bank of Abu Dhabi and First Gulf Bank), are excluded. Profits were supported by rising net interest income, with higher interest rates helping to offset the impact on revenues of slow lending growth. Banks also pursued cost-cutting measures, though expenses are being pushed higher by investments in technology and in the case of FAB integration costs relating to the merger. Finally, the rise in impairment costs triggered by the 2014 oil price crash (particularly for SMEs) may be abating.

Monetary climate should see gradual improvement this year

Although there are pressures in both directions and a major upswing looks unlikely, monetary trends could improve through 2018. One factor is that sentiment seems to be improving. The central bank's credit survey shows that the pace of tightening in bank credit standards has consistently eased in recent quarters – and is expected to moderate further in 1Q 18. (Chart 5.) This could herald better access to credit, including for SMEs, reflecting greater confidence in the economic outlook.

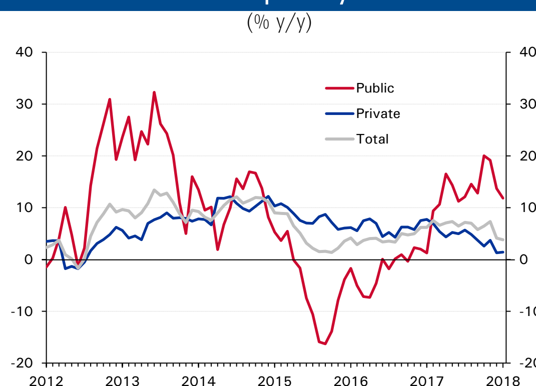
Another positive is that liquidity conditions at present look well-supported. The rise in oil prices to above $60/bbl has been backed by a supply agreement among key producers that has been extended until at least end-2018. This will help deposits and reduce the government's borrowing requirement. Indeed, central bank issuance of certificates of deposit rose 25% y/y in December, a sign that it is now looking to remove excess liquidity from the system.

Finally, the pick-up in non-oil growth forecast for this year (3.7% versus an estimated 3.3% in 2017) should itself help the banking system, including by shrinking non-performing loans and supporting credit growth: the central bank's survey shows credit demand gradually recovering, with the construction and property sectors strongest. (Chart 5.) Faster growth could also help reverse the slowdown in private deposit growth.

Although the overall picture looks more positive, other factors will continue to weigh on the banking sector. Weakness in property prices is likely to persist through the rest of this year (see our recent report, "Stronger economy unlikely to lead to a rapid rise in property prices"), exerting downward pressure on mortgage lending and presenting ongoing credit risk. Meanwhile, interest rates in both the US and the UAE (linked via the exchange rate peg) are set to rise at least twice more this year. This could lead to some retightening of liquidity conditions.

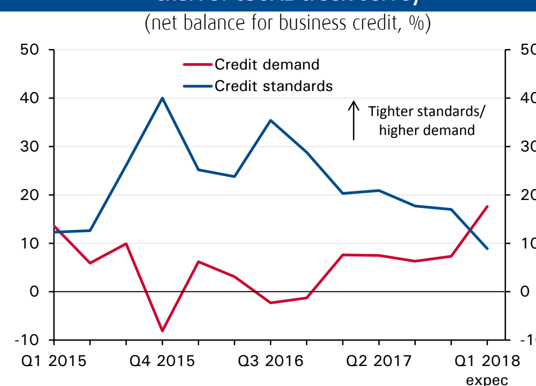
Finally, although credit rating agencies consider the banking system overall as solid and well-supported (large banks already meet Basel III capital thresholds, for example), they also point to ongoing structural challenges that will affect growth and performance. These include high loan concentrations (including to government-related firms) and limited transparency at some large corporate borrowers.

Chart 4: Deposits by sector
(% y/y)



Source: Thomson Reuters Datastream

Chart 5: CBUAE credit survey
(net balance for business credit, %)



Source: CBUAE

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