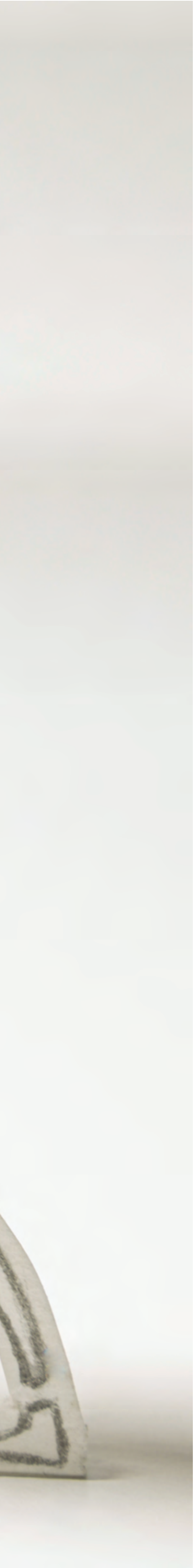

Rethinking the future

Stricter capital requirements and low interest rates are impacting the Gulf region's finance companies that are now seeing the need to re-evaluate their corporate strategy and business model.

Although the United Arab Emirates financial sector's net profits grew by 14 percent in 2013 and has had its credit rating raised from negative to stable by Moody's[1]–a rating that has been maintained for 2014–there are concerns that new regulations to be issued by the Central Bank of the UAE (CBUAE) in line with international best practices such as Basel III, may end up constraining the activities of certain types of financial institutions.

Some are likely to be impacted more than others…

While established banks may have the adequate capital needed to meet the revised requirements, finance companies that are generally independent and primarily focus on lending activities, are likely to face some difficulty in raising the additional capital needed to meet these requirements. Unlike banks, finance companies are often limited by their ability to accept retail deposits, which reduces their overall asset base, thereby restricting their access to "cheap" sources of funding.

A reluctance on the part of some existing shareholders to inject more capital into a given finance company further exacerbates the capital challenge being faced by these institutions.

Revisiting the funding channels

As consumer borrowing increases across the region, a number of finance companies have limited capacity to grow their loan books and, with constraints on their ability to accept deposits as mentioned above, they end up leveraging their existing capital. Once the leverage limits are reached, the finance company then becomes compelled to either maintain its loan book or seek alternative ways to increase its capital base in order to leverage and lend.

A natural option to increase capital is through a shareholder injection. But what about finance companies whose existing shareholders are unwilling to increase their capital? How do such finance companies look to raise funds and what should their strategy be to overcome this funding imperative?

One possibility is for potential tie ups with banks that have excess capital available, with a view to provide the bank with an equity stake in the finance company in return for additional funding. This also allows the acquiring bank to diversify its overall exposure, at the same time providing an alternate source of much needed capital for the finance company.

If one critical aspect of a finance company's business model is to ensure that it continues to have adequate funds to lend, then another would be to have sufficient lending activities to build the revenue stream

This trend is becoming increasingly prevalent in markets such as the Kingdom of Saudi Arabia, where regulations limit direct access to the local market for foreign financial institutions. A leading UAE-based Islamic Bank recently acquired an equity stake in a Saudi-based finance company with a view to gaining access to the Saudi market while at the same time providing this particular finance company with much needed funding to sustain and grow its business in its home market.

Feeling the pinch of low interest rates

If one critical aspect of a finance company's business model is to ensure that it continues to have adequate funds to lend, then another would be to have sufficient lending activities to build the revenue stream. With interest rates close to all-time lows, the return on existing capital for most financial institutions is correspondingly low due to the subsequent reduction in the net interest rate margin. In contrast to established banks that generally offer a broad range of financial products from which they earn their income, the finance companies have been hit much harder, as they have smaller lending books to begin with and offer only a limited range of products. Some finance companies are also finding it increasingly difficult to generate adequate revenues to sustain their existing businesses, let alone turning a profit.

While the problem appears to be relatively straightforward, the solution may not be as simple as it requires a fundamental re-evaluation of the finance company's existing strategy and business model. Finance companies need to start evaluating different options to safeguard future growth and generate enough revenue to sustain their business.

The need to diversify income sources

Finance companies need to find avenues to diversify their income sources away from conventional lending-based activities and towards more fee-based products and services. In fact, some of the largest banks in the

UAE have been proactively diversifying their revenue streams for some time now and have managed to increasingly generate more fee-based income alongside the conventional lending-based income, in certain cases increasing their non-interest income steadily by around 10 percent per annum while interest income increased by 2.5 percent year-on-year over the last four years.

While an increasing number of banks have been proactively seeking ways to diversify their revenue sources and continue to do so, finance companies have generally been slow to respond. It is only now that some finance companies have consciously initiated the process of re-evaluating their corporate strategy and embarked on journeys to diversify their revenue streams.

One example is a prominent UAE-based finance company that was seeking to identify different revenue-generating opportunities that it could potentially consider diversifying into with a view to increasing its fee-based income. At the same time, from the finance company's perspective, it was vital to balance the competing interests of its stakeholders and avoid any risks of cannibalization to its existing product offering that the diversification initiative may bring about.

As such, a comprehensive market analysis was conducted and multiple business opportunities identified for diversification of revenues. Each of these opportunities was systematically evaluated to complement, rather than cannibalize the company's existing product offering, whilst at the same time be relatively easy to integrate within its existing operating model. A detailed financial analysis was also conducted to narrow down a set of four different service offerings which could potentially yield gross profits in excess of 30 percent while limiting the associated increase in total operating costs by just under 5 percent.

The finance companies that make the right strategic choices are likely to be well positioned and continue to benefit from the growth opportunities presented in this region

Better late than never…

With regulators all set to introduce new capital adequacy requirements and interest rates at all-time lows (and projected to potentially dip further), it's a good juncture for finance companies to consider a re-think of their corporate strategy and business model, both in terms of sources of revenue as well as sources of funding. A failure to do so may potentially put the finance company at risk of regulatory noncompliance, associated reputational harm and even a gradual standstill of operations due to a lack of funding and adequate revenues.

The finance companies that make the right strategic choices are likely to be well positioned and continue to benefit from the growth opportunities presented in this region.

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Endnotes

1. Financial Stability Report issued by the Central bank of the UAE in June 2014