

Clearly, ver

The banking industry in the UAE

The numbers look good, so what, if anything, is ailing the banking sector of one of the strongest economies in the region?

The numbers look good...

Macroeconomics in the UAE

The United Arab Emirates has proven crude oil reserves of around 98 billion barrels (or 10% of the world's reserves) and boasts substantial reserves of natural gas, accounting for approximately 3.2% of world reserves. The bulk of the oil and gas wealth is concentrated in Abu Dhabi, which contributes approximately 90% of the total oil production of the country and holds over 90% gas reserves. Dubai has also become an important financial center in the UAE because of its significant financial and services industries. Together, the two emirates have emerged as two of the most important economies in the region. The other five emirates all have a relatively stable economic and political system and the country has an ambition to emerge as a financial and service sector leader in the Middle East.

The hydrocarbons sector will remain the main engine of growth in the future. Having said that, the UAE federal government - Abu Dhabi in particular - will continue to pursue its diversification program through large-scale

infrastructure investment in transport, tourism, manufacturing, technology and ports. The diversification programs for Abu Dhabi and Dubai will differ, in that Dubai will refocus its efforts on promoting core sectors such as trade and tourism and Abu Dhabi will invest heavily in other large-scale projects.

The economic outlook remains expansionary in the foreseeable future to support the diversification program, which will continue to have a positive impact on the banking sector as the backbone of the economy. While most of the increase in spending is expected to come from Abu Dhabi, other emirates in the UAE will also benefit, especially Dubai, due to the proximity and the involvement of its own banks in Abu Dhabi's Economic Vision 2030 program, the emirate's roadmap for future economic development.

It is expected that the federal budget will remain in surplus through 2012 at an average of 1% of GDP and that the government debt will fall from an estimated 44.6% of GDP in 2010 to 23.9% of GDP in 2014.

... uncertain

Forecast Summary (% , unless otherwise indicated)

	2009 ^a	2010 ^b	2011 ^b	2012 ^b	2013 ^b	2014 ^b
Real GDP growth	-2.7 ^c	2.6	3.5	5.5	5.6	6.0
Oil production ('000b/d)	2,271	2,320	2,400	2,500	2,575	2,675
Crude oil exports (US\$ m)	54,117	56,775	57,822	64,030	63,383	62,731
Consumer price inflation (av.)	1.6	2.2	3.2	4.0	3.5	3.0
Deposit rate	2.8	1.3	2.7	1.6	2.9	4.7
Government balance (% of GDP)	2.6 ^c	1.8	0.7	0.6	-0.9	-2.4
Exports of goods fob (US\$ bn)	192.2	195.5	213.1	238.1	264.7	304.0
Imports of goods fob (US\$ bn)	150.0	159.0	171.8	190.7	215.4	247.7
Current-account balance (US\$ bn)	7.9	3.1	6.4	11.4	8.2	6.7
Current-account balance (% of GDP)	3.2	1.1	2.1	3.1	2.0	1.4
External debt (end-period; US\$ bn)	122.5 ^c	122.7	123.3	123.7	125.9	129.4
External rate Dh: US\$ (av.)	3.67	3.67	3.67	3.67	3.67	3.67
Exchange rate Dh: € (av.)	5.12	4.75	4.37	4.22	4.19	4.19
Exchange rate Dh: ¥100 (av.)	3.92	4.16	4.19	4.23	4.27	4.27

^a Actual. ^b Economist Intelligence Unit forecasts. ^c Economist Intelligence Unit estimates.

... herein lies the problem

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The banking sector in the UAE is quite fragmented, with the market currently being served by 23 domestic banks and 28 foreign banks. Banks incorporated in Abu Dhabi and Dubai hold the lion's share of total domestic assets.

In view of the ambitious outlook of the economy and the expansionist program of the country, is the banking sector able to support the pressure?

The rising cost of domestic deposits in a competitive market and reduced access to the international debt capital market are also major contributors to the challenge in fueling the banking sector with resources to match the ambitious development plans of the country

What is ailing banks in UAE? Are banks going to send alarm signals to the market? Is the problem limited to government-related entities? Is the problem limited to the real estate sector in Dubai? What about the real estate sector in Abu Dhabi? How about family-owned conglomerates and their gearing ratios? What is their impact on the UAE banking sector in view that most of their debt is financed locally? Too many questions remain unanswered and unclear, which makes market observers wonder!

Liquidity and government support

Funding and liquidity pressures remain on the banking system, with the average loan/deposit ratio for some major banks above 100% and in some cases above 120%. The rising cost of domestic deposits in a competitive market and reduced access to the international debt capital market are also major contributors to the challenge in fueling the banking sector with resources to match the ambitious development plans of the country. Federal liquidity support measures greatly helped to stabilize the banking

system in 2009. Over and above the federal support to UAE banks, the Abu Dhabi-based banks had received Tier 1 capital funding amounting to AED 16 billion, distributed among the four major banks, which contributed to liquidity in the sector.

Capital adequacy ratios of UAE banks strengthened in 2009 following government actions and greater retentions of net income by the banks and, in some cases, lower risk-weighted assets. The average regulatory Tier 1 and total capital ratios were maintained at significantly above the regulatory requirements, in some instances exceeding 20%, which will eventually strengthen the ability of banks to absorb higher non-performing loans (NPL) over the next 12 to 24 months.

Asset quality

Asset quality deteriorated significantly in 2009 and the trend continued in 2010 with average NPL to gross loans ratio of banks increasing to 4.3% in 2009 from 1.7% at end-2008. These figures do not include the troubled debt of Dubai World, which have been reported in the 2010 financial statements, so these numbers will likely continue to rise.

It is worth noting that these ratios may not reflect the real quality of the loans portfolio given the high levels of restructured and rescheduled loans and those past due, but not impaired, reported by banks in accordance with International Financial Reporting Standards. These same ratios, reported by foreign banks operating in the UAE, were higher in 2009, which is considered a better indication given the stringent provisioning requirements of those banks.

As loan books stagnate in 2010 and into 2011, the ratio of NPL to gross loans is expected to increase for all banks as problematic assets surface in the banking

system. The deterioration in the asset quality of banks will increase the impairment charge and will put pressure on the profitability of banks, which might cause an increase in the cost of funding on debtors as a compensation mechanism to sustain profitability. That, in turn, will have a direct impact on the profitability of debtors and their ability to meet their obligations as per original terms and conditions - hence, it is a vicious circle.

Profitability

The UAE banking sector's profitability suffered in 2009 as the global economic crisis impacted the region more significantly and year-on-year comparatives in Q1 2010 were generally disappointing, although core interest and fee revenues are holding up relatively well. Impairment charges are still rising in both, retail and corporate portfolios. With Dubai World and other GREs and the remainder of the troubled Saudi corporate exposures to provide for, sector profitability in 2010 is unlikely to be any better compared to 2009 levels. Not surprisingly, profits are expected to stagnate, or at least not decline, for some banks as a result of the key factors mentioned above. Increase in the cost of funding will put pressure on net interest margins. The decline in trade finance, IPO business and other operating income will have similar negative impact on fee and commission income which will eventually impact banks' profitability. Stagnation in loans and advances growth as a result of higher funding cost and/or lower customer demand will also impact banks' profitability.

In such a competitive market, it is vital for banks to understand how customers and market sectors contribute towards profitability, and to what extent relationships with particular customers are profitable. More focus on client satisfaction, quality of service and innovation in products offered, will lead to the creation of new categories of interest income, charges, commissions and possibly FX-related profit.

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Conclusion

The challenges facing the UAE banking sector are expected to continue for the coming 18 to 24 months, with the property markets in all seven emirates, especially Dubai, Abu Dhabi and Sharjah, continuing to show a negative trend in prices and yields generated from rentals. The challenges of the real estate market will in turn, negatively impact contractors, building material suppliers, smaller developers and the high-net individuals with exposure to these sectors. Faced with the economic downturn, a number of privately-owned companies, including family conglomerates, will eventually engage in restructuring their original loans and advances with longer tenures and possibly cheaper rates. The rising level of renegotiated loans might trigger other factors, such as an increase in the ratio of non-performing loans, which may alarm market observers and banks valuers as they may, in turn, have an adverse effect on banks' profitability.

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