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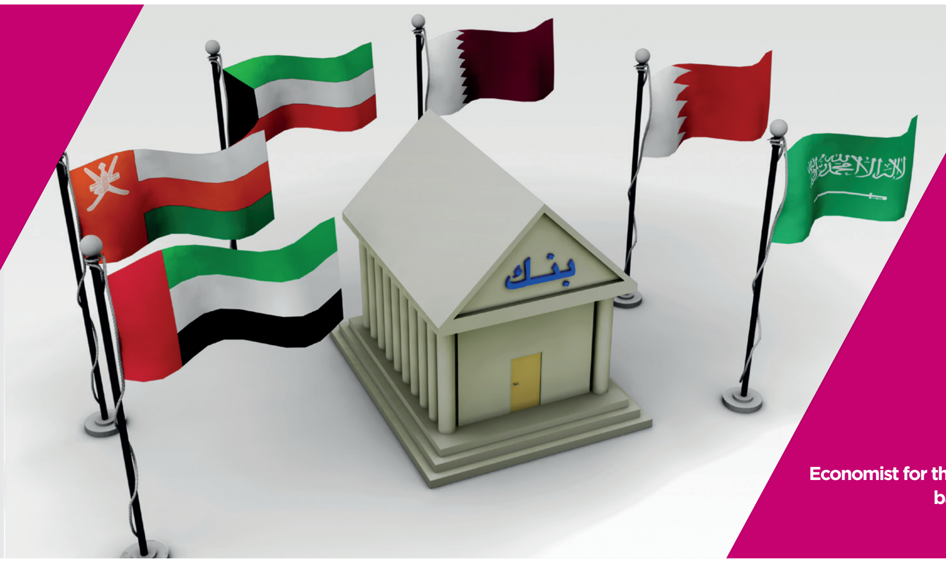


By Seltem Iyigun,
Economist for the Middle East & Turkey,
based in Istanbul, Turkey

GCC: tight financial conditions for businesses feed alternative sources of financing

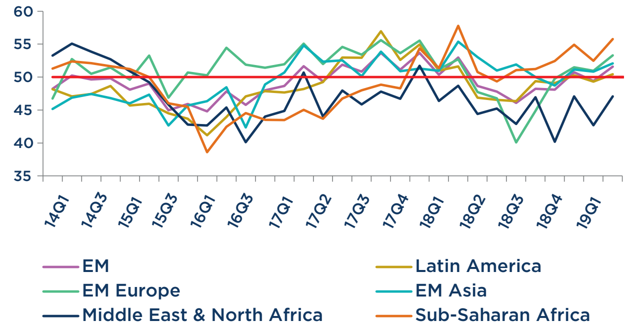
Despite improving economic performances across the Gulf Cooperation Council (GCC), monetary and financial conditions remain tighter than they were before 2015. Access to financing remains one of the key issues for companies, particularly for small- and medium-sized enterprises (SMEs). Loan growth in the region has recovered somewhat thanks to higher oil prices, but it remains below its historical average. The US Federal Reserve's (Fed) policy normalisation is another cause: since the Fed announced its policy normalisation in 2013, central banks across the GCC have increased their policy rates in line with the Fed's exit strategy. These tight bank credit conditions have forced companies to look for alternative financing sources in recent years, e.g. bond and sukuk issuances, trade finance, and initial public offerings. But despite their fast growth, these different sources of financing account for no more than around 5% of usual bank credit. GCC companies are now looking forward to the expected expansionary monetary policy in the United States, which should help them.

Loan growth is back but remains restrained

Domestic loan growth across the GCC[1] region stood at 9.1% in 2017 and slowed to 4.4% in 2018. Bank loans to the private sector rose by only 1.4% in 2017 due to the low level of hydrocarbon production and the fact that several countries in the region were in recession. (Kuwait, Oman and Saudi Arabia). In 2018, this situation had started to improve slightly, with the annual increase in private sector loans reaching 5%. In line with higher oil prices and stronger growth performances, loans to the private sector across the GCC region are expected to expand a further 5% in 2019 – an improvement, but below the 2013-2015 average of 9%[3]. In the first quarter of 2019, commercial banks' loans to the private sector increased compared to the previous year: 3.1% in Saudi Arabia, 4% in UAE, 12.6% in Qatar, 2% in Oman, and 6.5% in Bahrain. The Institute of International Finance's (IIF) lending survey[2] points to low loan growth in the quarters

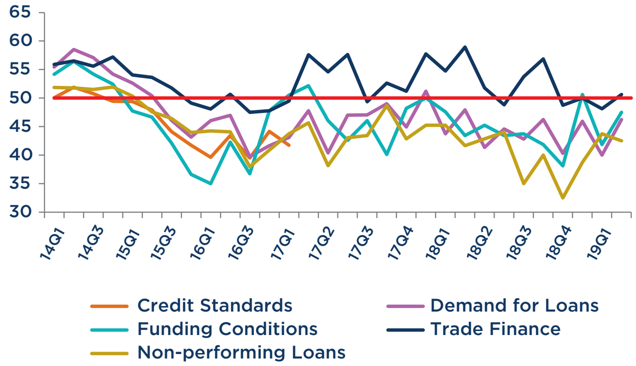
1 - The Gulf Cooperation Council is comprised of Saudi Arabia, Kuwait, the United Arab Emirates, Qatar, Bahrain, and Oman.
2 - The IIF EM Bank Lending Conditions Survey is conducted quarterly among banks in Emerging Asia, Latin America, Emerging Europe, Middle East and North Africa, and Sub-Saharan Africa. The survey contains 26 multiple-choice questions that address five different topics on bank lending. When the index is above 50, it suggests lending conditions are more amenable. When it is below 50, it suggests tighter lending conditions.

CHART 1
IIF EM Bank Lending Conditions Survey (50 = neutral)



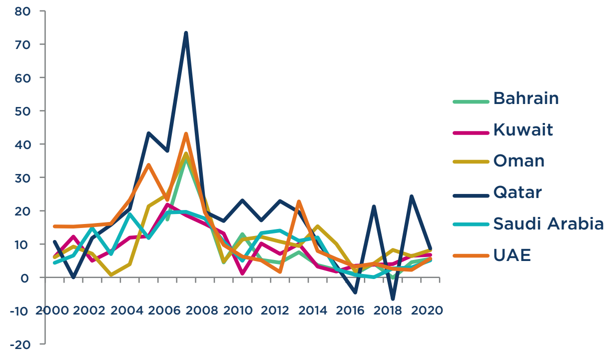
Source: IIF

CHART 2
Lending Conditions Survey Sub-indices for Middle East and North Africa



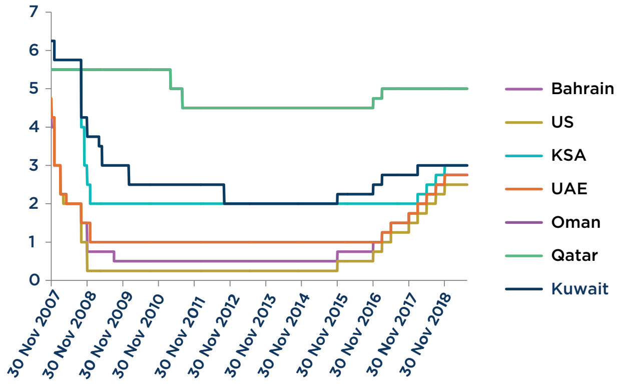
Source: IIF

CHART 3
M2 supply in GCC (YOY, %)



Source: IIF

CHART 4
US Fed fund rates and GCC policy rates (%)



Source: Refinitiv Datastream

ahead: banks continued to tighten credit conditions in the Middle East and North Africa (MENA) region in the first quarter of 2019, despite easing them in the rest of the emerging world **(Chart 1)**. Indeed, the MENA region's score in the survey has been almost constantly below 50[3] since early 2015.

Money supply data in the GCC points to the same dynamic: positive but low growth. The rate at which loans are issued began to increase gradually after 2016 following the recovery in oil prices and growth performances. A good indicator of liquidity conditions is M2 , which includes currency in circulation and saving deposits. In the UAE, the M2[4] money supply rose by 1.7% in April 2019 year-on-year to reach USD 363 billion. In April 2019, M2 rose by 9% YOY in Bahrain.

The Fed's policies and oil prices play an important role in the liquidity conditions of the GCC banking sector. Since the Fed announced its policy normalisation in 2013, central banks across the GCC have followed the Fed's example and increased their policy rates in line with the Fed's exit strategy. The Fed funds rate –reduced to 0-0.25% during the global financial crisis – started to rise again after December 2015. GCC countries (with the exception of Kuwait) follow a fixed exchange rate regime, pegging their currencies to the US dollar. Since 2015, three-month interbank rates rose by nearly 200 basis points in the UAE and Saudi Arabia, 170 bps in Kuwait and 230 bps in Bahrain. Looking ahead, the new direction of the US monetary policy (on the back of softer economic growth in the US) is likely to support credit growth in the GCC[5].

Recovery in oil prices help but volatility is a challenge

Although GCC countries have made significant progress in diversifying their economies outside of oil, it still represents the largest proportion of their budget revenues. As of 2018, hydrocarbon revenues as a percentage of total budget revenues stands at around 70% in Saudi Arabia, 80% in Oman and Bahrain, 60% in Kuwait and Qatar, and 55% in the UAE. The volatility in oil prices represents a challenge for both budget balances and the level of interbank rates. During the 2015-2017 period of falling oil prices, the need for liquidity in the GCC banking system resulted in a steep increase in interbank rates. Indeed, low energy prices push government-related entities to withdraw their deposits from the banking system to support budget deficits. As a result, a lower level of deposits remain in the banking system. Therefore, interbank rates increase, and so funding costs of banks – especially for those that rely on interbank deposits – rise significantly. Currently, the higher level of oil prices represents a security for banks, yet the surrounding volatility is still a risk, especially given some GCC governments' decisions to ease some fiscal austerity measures.

3 - If the score stands below this threshold, it suggests a majority of banks will tighten their credit conditions.
4 - M1 = Currency in Circulation Outside Banks (Currency Issued - Cash at banks) + Monetary Deposits
M2 = M1 + Quasi-Monetary Deposits
M3 = M2 + Government Deposits
Monetary Deposits: all short term deposits on which bank customers can withdraw without prior notice
Quasi-Monetary Deposits: Resident Time and Savings Deposits in Dirham + Resident Deposits in Foreign Currencies (Central bank of UAE)
5 - Given that GCC currencies are pegged to the US dollar, their central banks follow the US Fed's example when making policy actions. As the Fed says it will cut rates, it means GCC central banks will do so as well, leading to an increase in credit volume.

Bank operating conditions seem to have stabilized, yet there are some potential risks. The level of oil prices is a major factor that weighs heavily on the banking outlook. Current oil prices (Brent hovering around USD 65 per barrel) support government spending across the region. Better economic conditions and improved operational environments should contribute to the loan performance of banks in the GCC region. Loan growth is expected to recover, yet remain below its pre-2015 average. If interest rates start falling globally following a likely rate cut from the US Fed, then loan demand will increase further. Funding pressures would ease in line with higher oil prices, while the profitability would improve due to higher interest rates. However, the NPL ratio will continue to represent a challenge due to the lagging effect of previous economic slowdown in the region. GCC banks are also undergoing a strong consolidation, which should help banks overcome the negative impact of subdued loan demand and also increase their profitability. As of May 2019, 20 banks are said to be negotiating mergers and acquisitions, with an estimated USD 1 trillion worth of assets[6].

Companies opting for alternative sources of financing

According to the IMF's Financial and Monetary Conditions Indices (FMCI) in GCC countries[7], the main drivers of tighter financial and monetary conditions were declines in real estate (Qatar and UAE), falling equity prices (Bahrain, Dubai and Oman) and lower domestic liquidity growth. The latter is also related to pressures from tighter global financial conditions, which caused net capital outflows from some countries of the region. For example, in 2018, net capital outflows exiting Saudi Arabia stood at USD 70.7 billion[8].

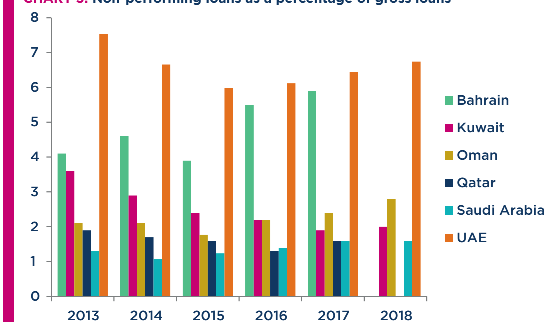
Gradual and subdued loan growth and tighter liquidity conditions compared with the pre-2015 period have increased the importance of other financing sources for companies. Bond and sukuk[9] issuance is a part of this alternative financing[10]. Saudi Aramco raised USD 12 billion in its debut international bond in April 2019, receiving more than USD 100 billion in orders; while Saudi Telecom issued USD 1.25 billion in international sukuk in May 2019, attracting USD 4.5 billion in orders. More issuers of this type are expected to tap capital markets in order to diversify their funding base. According to figures from the Bank of International Settlements, total outstanding international debt securities issued by non-financial corporations in the GCC region (except Bahrain) stood at USD 53 billion as of the fourth quarter of 2018, compared with total bank claims on the private sector estimated at nearly USD 1.100 billion as of 2018[11].

The GCC debt market does face some challenges. The continuing infrastructure and construction projects remain vital, as they are an important pillar of economic diversification and support project financing requirements, hence the borrowing from the debt

Specific drivers of the banking sector, by country

- In **Bahrain**, the USD 10 billion support package provided by Saudi Arabia, the UAE, and Kuwait is expected to stabilise liquidity conditions for banks and support loan growth. However, weakness in government accounts and subdued recovery in non-oil sectors may impact the asset quality of Bahraini banks, as they are largely exposed to the domestic economy.
- In **Oman**, weak economic growth is expected to weigh on the banking sector. Nevertheless, an increase in government capital expenditure would sustain loan growth. Additionally, Bahrain and Oman are still suffering from elevated fiscal and external deficits, so fiscal pressures would continue to weigh on banks. Therefore, although increased government spending and better economic conditions are positive for banks, the outlook remains more challenging compared with other countries in the region.
- **Kuwait**'s government spending to diversify the economy away from oil and recovery in economic growth is expected to contribute positively to the banking sector. Government deposits account for no more than 13% of total deposits, i.e. lower than in Oman (34%), Qatar (30%) and Saudi Arabia (20%).
- In the **UAE**, decline in real estate prices and payment delays in the construction sector are expected to continue, and therefore impact non-performing loans, which are expected to stand at 6% of total loans by the end of 2019. Loan growth, higher interest rates, and economic expansion backed by the government's stimulus programme ahead of Expo 2020 are expected to contribute to higher profitability by increasing net interest margins. Furthermore, in June 2018, Abu Dhabi unveiled in June 2018 a USD 13.6 billion stimulus programme.
- In **Qatar**, bank liabilities have stabilized with a gradual return of foreign deposits after the blockade. In Q1 2019, non-resident deposits rose by 20% YOY. However, most of the external funding has a maturity of up to one year, which makes them quite volatile as a source of funding and vulnerable to risk averse investors.
- In **Saudi Arabia**, gradually rising public deposits are helping to improve liquidity conditions in the banking sector. However, any decline in oil prices may restrain the expansionary fiscal policy of the government, which in turn may reduce commercial loan growth.

CHART 5: Non-performing loans as a percentage of gross loans



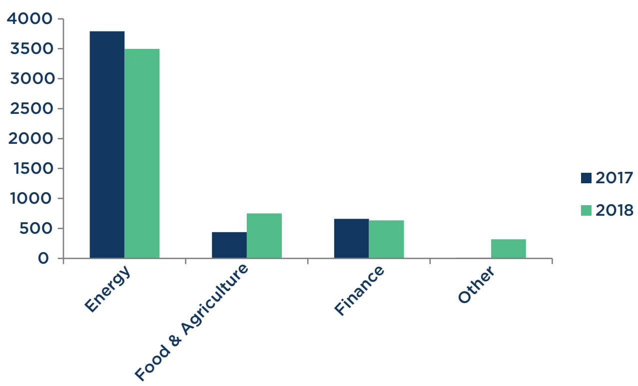
Source: IIF

6 - Nearly $1t GCC bank mergers under way, *Khaleej Times, May 21, 2019.*
7 - Regional Economic Outlook Update, *April 2019, IMF;*
8 - IIF Capital Flows Tracker, Flows Decline Amid Rising Trade Tensions, *May 31, 2019.*
9 - *A sukuk is an Islamic financial certificate similar to a bond, complying with Islamic religious law, Sharia. It is issued by a government or a company, and backed by an asset.*
10 - 2018 in review – how the GCC outperformed peers in bond markets by Anita Yadav, *GBSA, 18 December 2018.*
11 - *IIF Database: GCC, 04/2019.*

markets. Nevertheless, the increasing openness of international capital markets and the rising knowledge of financial instruments are helping GCC countries to improve their transparency, which allows bond and sukuk issues to attract a higher number of international investors.

Initial public offerings (IPOs) made a slow start in 2019, with only one IPO — Al Moammar Information IPO on Tadawul — offering 4.8 million shares, accounting for 30% of its capital (estimated at approximately USD 43 million. In the first quarter of 2018, there were four listings, amounting to USD 430 million[12]. As investors' business confidence for the region improves on the back of higher oil prices, higher growth, and economic diversification efforts, the number of IPOs in the upcoming period is expected to increase. Indeed, the value of total IPOs in GCC rose to USD 2.2 billion in 2018, compared with USD 702 million in 2013. However, this is lower than the value of total IPOs in 2017 (USD 3.3 billion). This is due to several factors, such as weaker-than-expected global economic growth prospects, geopolitical uncertainties, and trade wars.

CHART 6
International Islamic Trade Finance Corporation Approvals by Type of Sector (USD million)



Source: IFTC

Trade finance is also gradually becoming a more preferable option for companies facilitate their international transactions[13]. According to Saudi Arabia-based Islamic Trade Finance Corporation, in 2018, total trade finance approvals rose by 6.1% from the previous year, rising to USD 5.2 billion from USD 4.9 billion. Disbursements rose by 32.3% year-on-year, reaching USD 4.5 billion[14]. Higher oil prices is a factor that contributes to rising demand for disbursements and approvals. Trade finance is a particularly attractive option for SMEs, as they face several challenges when applying for bank loans: banks require a lot of information regarding documents such as balance sheets, income statements, products, etc. that not all SMEs are able to provide. In addition, there is a restrained skilled workforce. Banks' financing tends to be focused on large companies, with only 4.5% of total loans going to SMEs. This is mainly due to the limited business diversification of SMEs, which results in a greater risk of bankruptcy. Furthermore, GCC banks with good ratings and inexpensive deposits are less concerned with financing SMEs. As a result, in the UAE, nearly 70% of loan requests from SMEs are rejected, compared with 20% in the UK[15].

12 - GCC Capital Markets Watch Q1 2019, *PwC.*
13 - *Islamic trade finance is a process that allows companies to find financing solutions within the framework of Shariah principles.*
14 - ITFC Annual Report, *2018.*
15 - How Developed and Inclusive are Financial Systems in the GCC?, *IMF.*

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COFACE SA
1, place Costes et Bellonte
92270 Bois-Colombes
France
www.coface.com

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