# Rebound or Mirage?

Signs of a revival in Gulf banking are sprouting even as the cost of bad debts continues to grow.

By Mark Townsend
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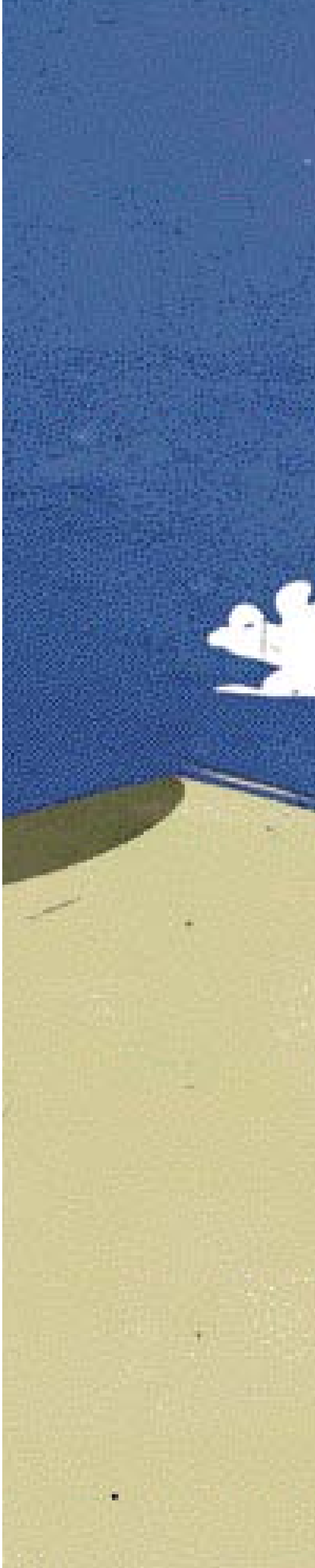
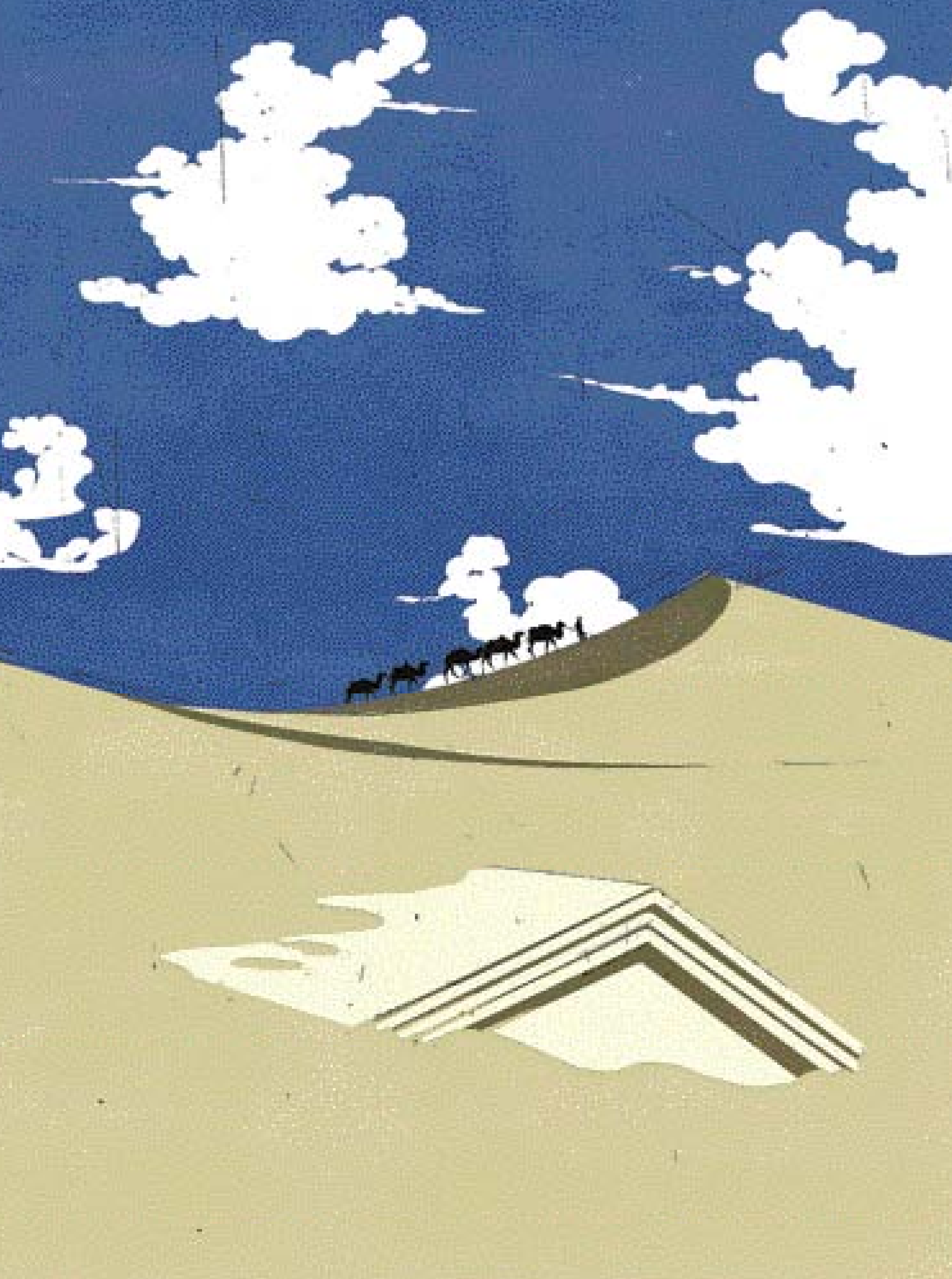
A little more than a year ago, Gulf policymakers and many investors were confident that the region's banks would remain largely immune from the global financial crisis. Today market perceptions of the Gulf banking sector have worsened dramatically following a record corporate default in Saudi Arabia and the prospect of a restructuring of the massive debts of Dubai World, the emirate's flagship holding company.

The real picture is more nuanced than either of those views would suggest. Gulf economies are suffering from their own debt binge during the boom years, and for many banks, nonperforming loans are continuing to mount. Worst hit are financial institutions in the United Arab Emirates, which have the biggest exposure to Dubai World, and in Kuwait and Bahrain, where many firms overextended themselves by investing in real estate and other illiquid assets, bankers and analysts say. By contrast, banks in Saudi Arabia and Qatar are benefiting from stronger domestic economies and more-aggressive government intervention to deal with bad assets.





The result is a two-tiered market, with stronger banks already beginning to post profit gains while weaker institutions grapple with problem loans. "We see a growing disparity in credit quality among banks in the Gulf, between the stronger Saudi and Qatari banks on the one hand and the relatively weaker Dubai, Kuwaiti and Bahraini investment banks on the other," analysts at Standard & Poor's wrote in a recent report. The agency, which has lowered its ratings on a number of Gulf banks over the past year, maintains a negative outlook on about a third of the 30 banks it rates in the region.

Notwithstanding their differences, banks across the Gulf stand to get a boost from a rapidly improving economy. The rebound in world oil prices to more than $80 a barrel, a by-product of strong growth in China and other emerging markets, is fueling a robust economic recovery. Growth in the Middle East and North Africa, which fell by more than half as a result of the crisis, to 2.4 percent in 2009, should pick up to 4.5 percent this year, according to the International Monetary Fund. That kind of economic buoyancy will help banks work off the excesses of recent years.

Such excesses abound. Fed by strong oil prices and abundant global liquidity earlier this decade, credit growth across the Gulf averaged a dizzying 23 percent a year from 2003 through 2008, according to the IMF. Among Gulf banks rated by S&P, nonperforming loans had surged to 5.4 percent of all loans by the end of September 2009, compared with 2.7 percent at the start of the year, and the volume of troubled loans is likely to remain high for some time. "We expect asset quality to bottom within the next few quarters before starting to improve, and this assumes the economic recovery goes along with our expectations," says Mohamed Damak, a credit analyst at S&P in Paris.

Although the credit boom swept the region, it reached its fullest flowering in the UAE. The transformation of Dubai from a small desert trading outpost into a global financial services and tourism center was based on borrowed money. UAE banks pursued an aggressive credit expansion strategy that generated an estimated $100 billion of loans above the underlying trend rate of credit growth — one of the biggest lending explosions in emerging markets, according to the IMF. The agency estimates that Dubai's debt alone amounts to some $109 billion, or about 130 percent of GDP.

Much attention has focused on the problems of Dubai World, which controls the troubled property developer Nahkeel, among other entities. The company narrowly avoided default in December when the government of Abu Dhabi, Dubai's oil-rich neighbor, provided $5 billion in financial support. Also that month, S&P lowered its long-term ratings on Emirates Bank International, Mashreqbank and National Bank of Dubai, a subsidiary of Emirates NBD, by two notches, to BBB, and cut its rating on Dubai Islamic Bank by two notches, to BBB–, citing those institutions' exposure to government-related entities in Dubai. In a sign of the sensitivity of the move, Emirates NBD, the country's largest bank by assets, discontinued the use of S&P for rating its subsidiaries after the downgrade.

Signs of progress on the restructuring of some $24 billion of Dubai World's debt have raised hopes of a turnaround. In March the Dubai government pledged to inject $9.5 billion as part of a deal that would repay banks and bondholders in full but extend maturities and lower interest rates on some of the company's obligations. The proposed terms were more generous than many creditors had feared, sparking a rally in bank stocks and a narrowing of credit default swap spreads. The company hopes to reach agreement with creditors on the package in the second quarter.

Still, with UAE banks estimated to have as much as $15 billion of exposure to Dubai World and with credit problems growing in other sectors, few analysts expect a quick recovery by the banks. "UAE banks have reported NPLs of about 4 percent, while Saudi and Qatar are around 2.5 percent," says Tamer Bazzari, chief executive of Rasmala Investment Bank in Dubai. "There is an expectation that the UAE NPL figures need to adjust higher, given their exposure to distressed debt and real estate." Tighter liquidity conditions are also squeezing the country's banks, relative to Saudi and Qatari institutions, Bazzari adds. One-month interbank rates have averaged nearly 2 percent in the UAE recently, compared with well below 1 percent in Saudi Arabia and Qatar.

First-quarter earnings by local banks have produced some signs of improvement. The National Bank of Abu Dhabi reported that net income rose by 34 percent in the first quarter from a year earlier, to 1.03 billion dirhams ($281 million). The bank sold $750 million worth of five-year bonds in March, making it the first UAE firm to borrow on the capital markets since Dubai World announced its intention to restructure its debt. Emirates NBD, however, posted a 12 percent decline in earnings in the period, to 1.11 billion dirhams. The Dubai-based bank boosted provisions for loan impairments by 20 percent, to 555 million dirhams; nonperforming loans rose to 2.63 percent of overall lending from 2.36 percent in the preceeding quarter, and the bank predicted that the ratio would peak at roughly 3 percent this year. Similarly, Abu Dhabi Commercial Bank reported a 36 percent decline in first-quarter earnings, to 225 million dirhams, after more than doubling its bad-debt provisions, to 681 million dirhams. The bank has $2.7 billion in outstanding loans to Dubai World.

UAE banks are hoping that a successful restructuring of Dubai World will calm market concerns and reduce their funding costs. Both Emirates NBD and Abu Dhabi Commercial Bank have medium-term note programs coming due later this year. ADCB's $849 million in notes due June 28 were recently yielding a spread of 726 basis points over the London interbank offered rate, while Emirates NBD's $750 million of notes due December 6 were trading at a spread of 532 basis points.

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Debt problems are hardly unique to Dubai and the UAE. Two big family-owned Saudi companies, Saad Group and Ahmad Hamad Algosaibi & Brothers, defaulted on some $22 billion in debts last year. The development hit banks across the Gulf, which have an estimated combined exposure to the two companies of $9.6 billion. Prompt action by the Saudi Arabian Monetary Agency has helped contain the problem at home, though "when the Saad/Algosaibi news broke, the central bank immediately froze their assets and forced banks to provide full disclosure on their provisioning," says Rasmala's Bazzari.

Saudi banks boosted their bad-debt provisions by 10.9 billion riyals ($2.9 billion) last year and are likely to continue to build reserves this year, albeit at a slower pace, analysts say. "Total provisions as a proportion of bad loans are below 100 percent, compared with an average for the previous five years of over 160 percent, so there is still likely to be a significant amount of additional funds set aside in 2010," says Paul Gamble, head of research at Jadwa Investment in Riyadh. Meanwhile, lending volumes have declined as many banks have tightened their scrutiny of potential borrowers in the wake of the Saad/Algosaibi default. If the decline in credit is sustained, it could quickly put pressure on the corporate sector. Most bank credit is short-term, with 75 percent having a maturity of less than three years, estimates Jadwa.

Yet with the economy rebounding strongly thanks to higher oil prices and with ample liquidity keeping funding costs low, Saudi banks are strongly positioned and should be able to take higher provisions in their stride. National Commercial Bank, the largest Saudi lender by assets, posted a 35 percent increase in net income in the latest quarter, to 1.41 billion riyals, while Riyad Bank reported a 55 percent jump in earnings, to 684 million riyals. By contrast, earnings at Samba Financial Group, the country's second-largest lender by market capitalization, slipped 4.8 percent, to 1.21 billion riyals,

**before starting to improve, with our expectations."**

while profits dropped 3.6 percent at Banque Saudi Fransi, owned 31 percent by France's Crédit Agricole CIB, and 19 percent at Saudi Hollandi Bank, in which the U.K.'s Royal Bank of Scotland Group owns a minority stake. Overall, Saudi banks continue to enjoy lower funding costs than most of their regional rivals. Saudi Fransi recently raised $650 million with a five-year bond issue priced to yield 175 basis points above midswaps.

In Qatar banks have benefited from relatively limited exposure to Dubai World, Saad and Algosaibi, as well as timely intervention by the authorities to counteract a sharp drop in local property and stock prices. Qatari real estate values have plunged by between 40 and 70 percent, and the benchmark stock index fell 31 percent last year as the global financial crisis and regional debt problems hit the local economy. The government has provided support through its sovereign wealth fund, the Qatar Investment Authority, which has committed to taking stakes of between 10 and 20 percent in the country's banks. The QIA has invested nearly $6 billion in seven banks: Ahli Bank, Al Khaliji Commercial Bank, Commercial Bank of Qatar, Doha Bank, Qatar International Islamic Bank, Qatar Islamic Bank and Qatar National Bank. Bank earnings in Qatar have been a mixed bag so far. Qatar Islamic Bank, the country's second-biggest lender by market value, reported a 14.3 percent drop in first-quarter earnings, to 300 million rials ($82 million), and Commercial Bank of Qatar posted a 36.7 percent fall, to 410 million rials, but Qatar National Bank posted a 25 percent rise in earnings, to 1.27 billion rials, thanks to increased lending and Islamic banking activities.

"Qatar still has serious issues of transparency and governance," says Ghanem Nuseibeh, co-founder and partner of London-based consulting firm Cornerstone Global Associates. But given the government's deep pockets, he adds, "the weaknesses in Qatari banks are unlikely to be exposed." According to Deepak Tolani, vice president of equity research at Al Mal Capital in Dubai, the Qatari support measures underscore the fact that "connections to government and agencies — not only ownership but ability to attract cheap deposits and deal flow" remain a key distinguishing factor among Gulf banks.

Elsewhere in the region, lenders in Kuwait and Bahrain continue to struggle with a steep rise in bad debts. "In Kuwait and Bahrain the combination of chasing high yields, low borrowing costs and little regulatory oversight allowed [the] setting up of leveraged investment vehicles, which were turning around and investing in the high-flying real estate sector in the Gulf," notes Tolani. S&P recently reduced its long-term debt rating on Commercial Bank of Kuwait by one notch, to BBB, citing deteriorating asset quality. It noted that nonperforming loans had surged to 17 percent by the end of 2009 from less than 5 percent a year earlier.

A key market test could come soon if Bahrain-based Gulf International Bank goes ahead with plans to issue bonds. The bank, which suffered $1.1 billion of impairments on investments in advanced economies, is expected to borrow as much as $800 million through a five-year note program. The bank had to postpone a planned debt offering in the immediate aftermath of Dubai World's debt restructuring announcement late last year.

To be sure, Gulf banks face no shortage of risks in the near term. Poor corporate governance standards and a lack of transparency could be hiding more problems like Saad and Algosaibi, analysts say, while a dip in the global economy could hit oil prices and undermine the regional recovery. "If this happens," cautions Nuseibeh, "expect Dubai-like problems emerging from other places."

Still, most Gulf lenders are coping with their troubled loan books, and they continue to boast capital adequacy ratios in excess of international requirements. With signs of a turnaround at some institutions, hopes are growing that the worst is over. "Overall, we think that the Gulf banking systems resisted quite well the financial and economic crises, compared with other emerging markets," says S&P's Damak.

For a region that sent tremors through global markets late last year when the extent of Dubai World's debt woes first became apparent, that is a welcome expression of confidence. ••

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