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GULF COOPERATION COUNCIL BANKING PERFORMANCE ANALYSIS – AN EXPLORATORY STUDY

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ABSTRACT

The study focuses on the Middle East Region including the Gulf Cooperation Council (GCC) and the Middle East and North Africa (MENA). GCC's main business is the exploration of oil and which contributes maximum government revenue. It is a two-fold analysis of macroeconomic variables assessing the effects on GCC banks' Key Performance Indicators (KPI). The research methodology employed is descriptive, having a detailed analysis of GCC economy and banking system. The analysis exhibited that the current economic decline is plunging oil prices resulting in the drawdown of revenue from oil companies. These had made a skewing impact on the macroeconomic variables such as GDP, currency pegging, stock market indices and etc. The second part of the analysis is the banking KPIs'. The study has revealed that for most MENA oil exporters, the fiscal adjustment is needed to absorb the unprecedented oil price shock.

KEYWORDS: *Inflation, Macroeconomic Variables, Oil Price Fluctuations*

INTRODUCTION

The study entails the relevance of economic crisis, effects on the banking sector and growth prospects. It focuses on the GCC Countries with the analysis of top performing banking companies. The research is made on the macroeconomic variations that caused by the drawdown in oil prices since 2014 in the Middle East Region. The regulatory authorities expect to stabilize the trend in oil price and creating new means to generate revenue. The GCC countries have open economic systems with free movements of capital and fixed exchange rate arrangements. Since the economy is purely oil dependent, a small decline in oil price makes significant drawdown in the economies of scale. In terms of banking growth, the plunging oil prices stagnate the future deposits from the oil exporters in the economy. This was studied and analyzed to report the effect of decline from banking performances. The scope of monetary policy is limited to primarily regulating short-term liquidity and smoothing out volatility arising from exogenous shocks, while the burden of adjustment falls on fiscal policy.

GCC COUNTRIES BANKING SYSTEM OVERVIEW

The GCC countries have a fairly large number of banks with extensive networks of branches. Banks are also, with few exceptions, financially strong and well capitalized, with total assets ranging between 70 percent of GDP for Saudi Arabia and 280 percent for Oman, levels that are high by international standards. Most of the region's banks were originally branches of major international banks until the mid - 1970s when foreign banks were required to transfer ownership to domestic residents; at present, foreign banks are permitted only minority ownership of local banks. They have recently agreed to permit local banks to establish branches in other GCC member countries. Although private ownership of banks is predominant in many GCC countries, government equity participation in financial institutions is widespread and a large number of banks and specialized financial institutions are fully controlled by the public sector. Moreover, in many cases, private sector ownership tends to be concentrated in a few shareholders. Licensing and foreign ownership restrictions may have resulted in a relatively high degree of banking concentration.

SURVEY OF LITERATURE

Ravichandran, K. and Alkhathlan, K. A. (2010)have confirmed that there is an influence of oil price change on the GCC stock markets return in the long run and oil price changes affecting macroeconomic indicators, especially liquidity and long-term equilibrium linkage among of these markets. The Middle East and Central Asia Department (2016) stated that an additional and substantial deficit-reduction effort is required over the medium term to restore fiscal sustainability and to support the exchange rate pegs. It is essential to have considerate on the private sector which creates much of investments in terms of jobs since the public sector job opportunities are at stake. Kuwait Financial Centre Markaz Research Report (2017) studied the economy and suggested that fiscal consolidation is essential to neutralize degrading oil sectors by freezing the revenue accrued for the past years. The analysis mainly concentrated on the stock market indices and performance with reference to the oil price changes. International Monetary Fund Report (2016) states the reasons for the oil price decline are due to the abundant production from Russia and weak demand in Asia. The review explicitly showed a continuation of the decline in oil prices have given a path to slower growth that led to worsening of external and fiscal balances that stagnated the monetary and financial conditions.

Sturm, M. Strasky, J. Adolf, P. and Peschel, D. (2008) reviews the GCC economy with the global stock market indices proved that the technical progress in energy efficiency remains key to reducing the use of crude oil, in particular, in the automotive sector. Existing oil reserves place GCC countries in a unique position in terms of covering future oil demand. Ernst &Young Report (2016) reviews the impact of the declining oil prices in the real estate, hospitality, and construction sector across the GCC region. It is stated that the negative impacts of the recent plunge in oil prices will affect the real estate, hospitality, and construction sector in the GCC region over the next two years. Kinninmont, J. (2009) encountered the recent boom in oil price has focused world attention on the GCC economies not only as exporters of oil and gas but as investment destinations with major infrastructure projects and financial services sectors. The seizure in global financial markets, the recent fall in the oil prices are all beginning to have an effect on the GCC economies. Guastella, A. and Menghi, A. (2016)

studies that macroeconomic instability is mainly linked to the reduction of oil prices. The reduction in oil price has a negative impact on public finances, thereby creating a significant decline in Government revenue, public spending, current account balance, and international reserves.

Khandelwal, P. Miyajima, K. and Santos, A. (2016) suggests that the GCC bank capital and provisioning have behaved counter cyclically through the cycle. The banks' balance sheets show that the loan loss provisions and capital adequacy ratios are positively correlated with indicators of business and financial cycles. Al-Otaibi, B. and Sylwester, K. (2007) confirm that oil production and sales for the GCC countries comprise larger relative shares of their economies than does oil consumption and imports for most, if not all, oil-importing countries. International Monetary Fund Report (2015) states about GCC banks are well- capitalized, liquid, and profitable at present amidst the oil price reduction, and well-positioned to manage structural systemic risks. Arouri, M. H., and Fouquau, J. (2009) states that there are significant links between the oil price variations and the stock market variables in Qatar, Oman, and UAE. Thus, stock markets in these countries react positively to oil price increases. Alodayni, S. (2016) indicates about the GCC region that the oil price, non-oil GDP, interest rate, stock prices, and housing prices are major determinants of NPLs across GCC banks and the overall financial stability in the region. Credit risk shock tends to propagate disturbances to non-oil GDP, credit growth, and stock prices across GCC economies. Mork, K. A. (1994) The author states that oil price increase spurs inflation and produce recessions, oil price declines dampen inflation. Antonakakis, N., Chatziantoniou, I., Filis, G. (2017) confirms that stock market returns and volatility varies across different time periods and that this time-varying character is aligned with certain developments that take place in the global economy i.e., oil price decline.

Ghosh, A. (2015)confirms that regular stress tests on banks' loan quality that typically underpin scenarios for a rise in NPLs, should take into account the impact of 'micro' or state-level economic conditions on NPLs, that will promote effective cost management in assessing banks financial health. Mensi, W., Hammoudeh, S., Yoon, S., Balcilar, M. (2016)examines the non-linear relationship between stock markets in GCC countries and their country risk ratings as well as with major macroeconomic factors and provides evidence of short-term asymmetry between first-lagged GCC stock returns and the performance of GCC stock markets.

STATEMENT OF THE PROBLEM

It is observed that the analysis about the economy revealed the oil price is plunging since mid-2014 and has been spectacular: prices have fallen nearly 70 percent to about $40 a barrel. This declining trend would have adversely affected the banking sector in terms of deposits growth by oil companies and the net performing assets accretion. The study establishes the relationship between macro-economic variables with reference to banking sector performance. The recent trends in the GCC region are assessed in terms of GDP growth, stock market performances, currency pegging, status on fiscal deficits, current account balances and inflation trends. The research problem identified to be the declining oil prices and its effects on the economy and the banking sector. With respect to the assessment of banking sector performance analysis, different key performance indicators are analyzed to depict the bank growth/decline. The macro-economic variables are the key and drag down in different sectors in the economy.

Objectives

The research is a two-fold analysis of the following:

- To study the macro-economic effects on GCC banks.
- To assess the growth prospects of the banking sector in the GCC region.

Methodology

The research methodology employed is descriptive; includes detailed analysis of the problem for the specified period. The data derived is used to interpret and forecast for strategic decision making. There is a high opinion difference in the movements of oil prices, size of the balance sheets and the assets worth.

Tools for the Analysis

Tools for macroeconomic analysis are listed below:

- GDP growth rate
- Currency Pegging
- Stock market indices of GCC region
- Current account, fiscal deficits and inflation rates

Tools for Banking KPI analysis are listed below:

- Loans growth rate
- NPL Coverage ratio
- Capital Adequacy ratio
- Return on Assets
- Return on Equity
- Cost to Income ratio
- Net Interest Margin
- Earnings Per Share

The aforementioned tools are applied to analyze the bank's performance for the period of 3 years from 2013-14, 2014-15, and 2015-16.

DATA ANALYSIS AND INTERPRETATION

Macroeconomic Variables

GDP Growth rate of GCC Countries: Overall economic activity and sovereign creditworthiness were lagging since the mid of 2016, due to the instable demand for oil and macroeconomic variability. This causes delayed payments for GCC governments creating a huge sum of deficits. The IMF data reflects that the average GDP growth rate for GCC countries was declining from 3.3 percent in the year 2015 to 1.8 percent in 2016. However, the analysts' forecasts for the stronger

GDP growth rate of 2.3 percent in 2017. With the current level of declining economic growth due to lagging demand for oil, the countries will have to find new business ideologies and revenue sources to cope up the forthcoming fiscal deficits.**(Refer Figure 1)**

Reasons for Diminishing Oil Prices: There has been a significant increase in the oil production in the United States; this eventually increased the world oil supply and the prices fall down. The OPEC regulation is another reason for the surplus oil in the economy. Another reason is that the landmark agreement between Iran and group of world powers will allow more Iranian exports eventually adding to the world's oversupply of oil.

Status on Current, Fiscal Balances and Inflation: Inflation is expected to be muted as owing to the peg that most GCC countries have with US Dollar. Reduced government deposits trigger banks to lower the expansion prospects; the financial balance relies on the equilibrium in receipts and payments. The low rate of deposits and creeping credit growth have implication on the fiscal balance and monetary policies. It appears to have increased fiscal deficits due to the shortening deposits and increased spending.**(Refer to Figure 2)**

GCC Countries Currencies against Us Dollar: The currencies are pegged to US Dollar in order to gain financial support and macroeconomic stability. The degrading economic slowdown is expected to affect the currency pegging in terms of increasing the cost of carrying. The heavy dependence on oil revenue is one of the main drawbacks of GCC Countries. Without the dominant pegging to USD, the GCC currencies will be devalued. Maintaining the dollar pegs brings financial stability and certainty to GCC economies amid regional geopolitical tensions.

Bahrain Dirham Pegging against US Dollar: The trend in pegging with US Dollar shows that during July there had been a dip in the Bahrain Dirham with a respective decline in the US Dollar. These are subject to the regulatory framework of the US economy. The year 2016 had the highest currency price during January and June. Trading activities generated the highest revenue when they were priced high with US Dollar.**(Refer Figure 3)**

· Kuwaiti Dinar Pegging against US Dollar: Since 2007 Kuwait pegged its dinar to a basket of international currencies after more than a decade of linking the local currency to the dollar, in a bid to reduce inflationary pressures. The oil-rich emirate had historically pegged the dinar to a basket of currencies before pegging it to the dollar. The year 2016 showed a peak pricing of dinar during February.**(Refer Figure 4)**

Omani Riyal Pegging against US Dollar: Oman is committed to maintaining the peg of its currency against the U.S. dollar despite the drop of oil prices. The plunge of oil prices since mid-2014 has put heavy pressure on Oman's state budget, causing one-year dollar/rial forwards to rise. Devaluing the rial could aid state finances by increasing the local currency value of oil exports. However, it would also raise the cost of the many imports on which Oman depends and could shake investor confidence. There had been an increasing trend in June 2016. (Refer to **Figure 5**)

Qatar Riyal Pegging against US Dollar: The Qatari riyal is associated with U.S dollar that stood as a yardstick for the economy for decades. This pegging has reduced the risks associated with exchange rates that amplify larger reduction of imported inflation that has a significant impact in domestic inflation. The IMF statistics reported April 2016 had the more pricing of rial with reference to US Dollar.**(Refer Figure 6)**

Saudi Riyal Pegging against US Dollar: Saudi Arabia remains committed to pegging the riyal to the dollar. Saudi economy continues to perform well despite the drop in oil prices. The peak pricing of rial during June 2016 resulted in increased revenue in exports. This included using dollars instead of a local currency, to a free float allowing the exchange rate to rise and fall at will. The dollar peg remained the most effective tool for Saudi Arabia**. (Refer Figure 7)**

UAE Dirham Pegging against US Dollar: The UAE will not bow to investors betting low oil prices will force it to drop its currency peg. UAE's dirham will remain pegged to the dollar in 2016, with 41 per cent saying it would "definitely not" be broken. There had been degrading trend in the dirham with the decline in USD prices, but are expected to grow in future, since UAE continues to hold its pegging to US Dollar. **(Refer Figure 8)**

GCC Countries Stock Markets Indices Performance: GCC stock markets are highly affected by oil prices fluctuations. The stock markets are varying in its size, market capitalization. GCC Countries stock markets are considered to be emerging markets with diverse segmentation. The economic globalization has a skewed the stock prices to a stipulated level**.(Refer Figure 9)**

Macroeconomic Variables Attributable to GCC Banks: Factual information explicitly transforms the economic progression level in terms of the macroeconomic variables such as oil price, NPL, Currency pegging. Since the majority of revenue accretion and business reinvestments evolve from the oil exporters, the trends and fluctuations in the oil demand and supply. The effect of this creeping demand for oil has led to the liquidity crisis. The working capital management is one of the major functions of banks since the deposits are made available for advances promptly. Liquidity level falls down beyond the stipulated level. The aggregate credit drops to below average 11.4 percent for the period of 2011 to 2015. The drawdown is expected to continue overcoming five years. The impact of this liquidity crisis is more on Oman and Bahrain, which already lacks in fiscal and external benefits, thereby tightening liquidity in the banking system. **(Refer to Figure 10)**

Non-Oil Augmentation: GCC governments have diversified the efforts in developing more projects on oil prospects, instead of concentration to non-oil sectors and channelizing in order to future-proof their economy from future oil shocks. Governments in the region have agreed to use VAT (Value Added Tax) as a policy tool to supplement their income. Policymakers in the six-nation GCC are aiming to introduce a five percent value-added tax at the start of next year. The GCC, its finances strained by low oil prices, has long planned to adopt the tax in 2018 as a way to increase non-oil revenues. Introduction in all countries may not be feasible because of the complexity of creating the administrative infrastructure to collect the tax and the difficulty of training companies in compliance, in a region where taxation is minimal**.(Refer Figure 11)**

Value Added Tax System: VAT contributes to 20% of World Tax revenues, UAE would be the first country to implement the Value Added Tax system with the rest of the nations following it up by Jan 1^{st}, 2018. Efficiency improvements in the GCC region is an area that has not received as much as attention as it deserves. VAT and taxation reforms are an avenue that is worth considering and highly coordinated effort among various departments. Introducing energy efficiency standards for energy consumption could produce cost savings that could match or even trump the revenues from the introduction of taxation. This has been calculated under the assumption of 90% consumption base is taxed through VAT.

GCC Banking Key Performance Indicators Analysis

- GCC Banks Earnings growth rate at 5.9% in 2017
- ROE improving at 13.1% YoY
- Impact of oil price fall on GCC Bank growth
- Asset Quality remains solid with the backup of adequate measures undertaken

Economic growth for GCC banks remains projected with a growth rate of 5.9 percent in 2017, along with the constant stabilizing return on equity growth at 13.1 percent as per the current statistics. Since the drag in economic development due to the current oil price falling, it will have a significant impact on the banking sector as well and are expected to continue in 2017 and 2018. Key factors for the development of banking sectors include:

- growth in loan asset growth
- greater margins on interests
- growth rate in commission and fee income and
- Reduction in the loss of loan provision charges

The operational environment causes severely on the GCC banks which will in turn, reducing the credit rates of banks. However, the new rate rises mean that they will have to apply higher interest rates for loans, and will make them more selective. The increase in the rate comes as part of regional governments to raise billion dollars in debt to clear off the deficits that have been swelling by these of falling oil prices.(**Refer Figure 12)**

Loan Growth Rate: The oil price fall impacted on banks growth in terms of:

- · Reduced government deposits.
- · Reduced deposits by oil companies.
- · Spending cuts on infrastructural projects.
- · Disequilibrium in income and expenditures.

The loans growth rate is expected to decline further in 2017 due to the US Fed interest rate hike. Slowing loan growth and deterioration of asset quality is expected to reflect on the GCC bank's profitability in 2017**.(Refer Figure 13)**

NPL Ratio

The debt recovery tends to be declining with the increase in the risk on the cost of assets

- The increased cost of risk is driven by the interest rates hike and increasing borrowing rates amongst banks.
- Degrading asset quality is one of the reasons where there is no accretion to the assets in terms of loans or advances recovery by banks
- It is expected to remain between 3 to 4 percent in 2017**(Refer Figure 14)**

Strategies to ensure the NPL coverage

- Prior warning, identification, and recognition of Non Performing Loans An Agreement for forbearance
- Providing Reserves for contingencies in loan losses
- Secondary assets valuation
- Legal Formalities and recovery of debts
- Consistent Reporting and evaluation of Non Performing Loans its effectiveness.

Capital Adequacy Ratio: Capital Adequacy ratios seek to ensure that there are sufficient funds to meet unforeseen adequacies in funds to prevent from insolvencies. It is required to maintain a minimum capital adequacy ratio in order to cover the risk of being insolvent. It appears to have balance capital resources for the banks accumulated for the period of five years. A lower rate signifies the bank's liquidity position is questionable. The BASEL III specifies the common equity Tier 1 must be at least 7.0 per cent of risk-weighted assets. Tier 1 Capital must be at least 8.5 per cent of RWA - Total Capital, calculated as the sum of Tier 1 Capital and Tier 2 Capital, must be at least 10.5 per cent of RWA.(**Refer Figure 15)**

Return on Assets: Return on assets tends to be moderate though there has been a significant skewing on the growth rate on assets. The return on assets brings out the future investment prospects and the retained earnings accrual to the banks. Emerging banks developments will be in the stack with the current level of progression.**(Refer Figure 16)**

Return on Equity: The current level of progression would slow down the rate on equity since the impact over the last five years shows a drawdown of return growth. The oil price stabilization would amplify the constant growth in ROE. The impact of this slow return is on dividend accretions in future years. The dividend payout and retained profit include the revenue from return on equity**.(Refer Figure 17)**

Cost to Income Ratio: Cost to Income ratio depicts the profitability position of the bank, lower the ratio the more profitable the bank. The trend seems to have to decline but the current economic pressure is expected to bring up the level of CTI. Reasons for the increase in Cost to Income ratio:

- Increasing operating costs.
- Liquidity pressure.
- Working Capital deficiency.
- Reduction in operating income**.(Refer Figure 18))**

Net Interest Margin: Net Interest Margin estimates the operational efficiency of banks in investing its funds and borrowing from the investible funds. The higher the NIM higher will be the banks operating profit. It appears to be moderate in generating interest income from the bank's client and from the borrower of funds. 2017 measures NIM to prevail amidst the economic crisis**.(Refer Figure 19)**

Earnings Per Share: EPS growth likely to have few impacts on the economic trends, the operating profits, net worth and employable funds exhibit stronger growth in returns to the shareholders. Qatar Islamic Bank has the highest growth rate in earnings to the shareholders. The liquidity pressure on banks continue to prevail through 2017, hence it is expected to have a decline in the returns growth**. (Refer Figure 20)**

DISCUSSIONS AND IMPLICATIONS

- The results imply that the actual and projected declines in oil prices and the slowing of GDP growth could lead to an increase in the NPL ratio. Fall in the incremental rate of oil prices reduces the accretion from loans and advances; this will reduce the credit and deposits rates of banks.
- The increase in NPL ratios leads to the solvency risks, that reduces the Capital Adequacy ratios, which implies that the confidentiality in keeping deposits with the banks by customers are reduced.
- The currency dependency on US dollar has kept the inflation at the desired level since the trading prospects are made in USD.
- The countries with largest current account deficits have lost a sizeable amount of foreign exchange reserves, i.e. Bahrain, Oman, and Saudi Arabia.
- Through the research analysis, Middle East economies, their prospective growth factors, current economic condition, methods to overcome the economic growth barriers are studied, analyzed and prepared for the purpose of enhancing knowledge on macroeconomic variables and different banking key performance indicators. With respect to the utility of research into the industry, new means to generate revenue has been selected and implemented plans by the respective regulatory authorities. The revenue generation measures are in terms of taxation and private sector orientation. The study on GCC economy reveals that oil price decline is drawing down the economic prospects of the region.

LIMITATIONS

- The study finds that the countries in GCC, as well as MENA, wholly depend on oil companies, which are state- owned public enterprises. Since the government supports public sector, there is no private sector orientation.
- The study is limited to GCC banks alone.
- The analysis is purely based on secondary data only.
- The currency pegging analysis is made for one year i.e., 2015-2016.
- The current decline in the oil revenue as a result of oil price decline degraded the economic progression. Hence the region has to diversify the economic growth from supporting the oil exporting companies.
- The capital structure of banks is well equipped for the future infrastructure projects, thus bringing stagnancy in the current decline resulting in a liquidity crunch.

CONCLUSIONS

The banking sectors in the GCC countries continue to be well capitalized across the board with capital adequacy ratios well above minimum standards and comfortable leverage ratios by international comparisons. First, there are few GCC countries witnessed rapid credit growth in the oil boom period preceding the financial crisis. Second, there are issues that need to be addressed in relation to banks' asset management practices. Additionally, few GCC banking systems have high exposures to the households. While household lending in the GCC is generally secured by borrowers' salaries and other sources of income, which could pause risks from household defaults. This would result in the prevention of economic degradation and the massive layoffs of the expatriates. Third, liquidity management practices in GCC banks in general needs to be evaluated. Since the GCC banks are maintaining low liquidity levels compared with the international players. Still, GCC banks heavily relies on stable deposits as a main source of funds, whereas they have a very minimal share in bonds financial market; which complicates the banks to manage the maturity mismatches between the assets and liabilities. Furthermore, the increasing dependence of banks on external financing in some GCC countries in recent years has increased banks' vulnerability to external credit conditions. This was demonstrated in the current crisis as banks' liquidity become stagnant and crunched; hence these banks are not able to produce consistent and competent growth in the industry. Stabilization of oil prices, resilient non-oil sectors, and drawdown in the government deposits are the driving forces focusing on the bank's growth rate.

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APPENDICES

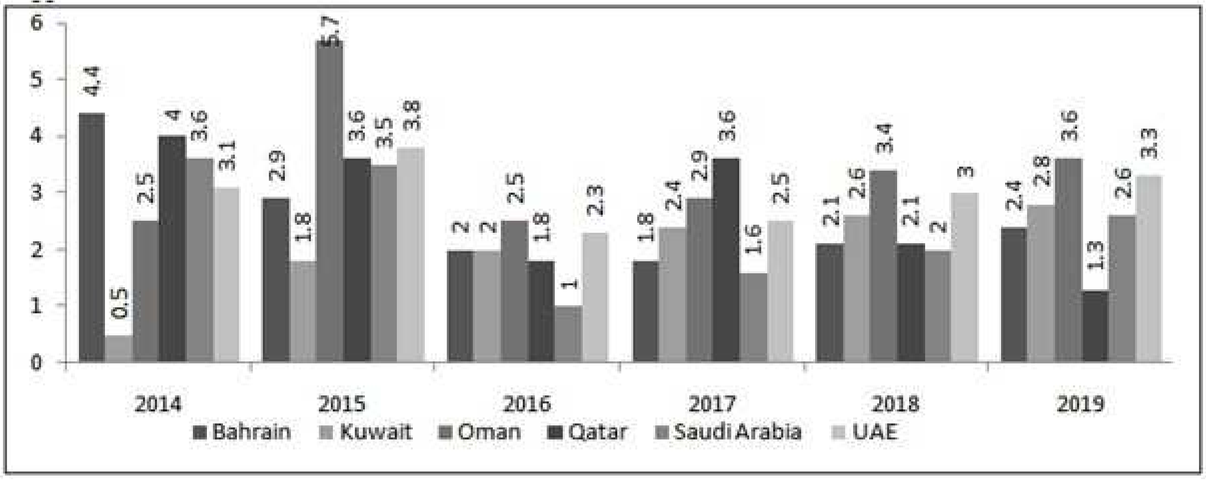

Figure 1: GDP Growth rate of GCC Countries

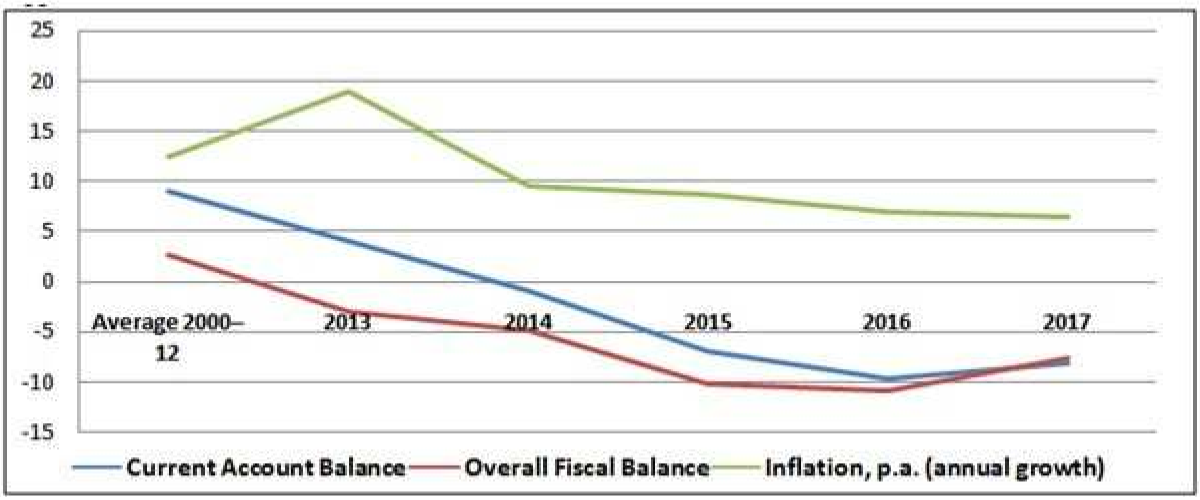

Figure 2: Status on Current, Fiscal and Inflation rates

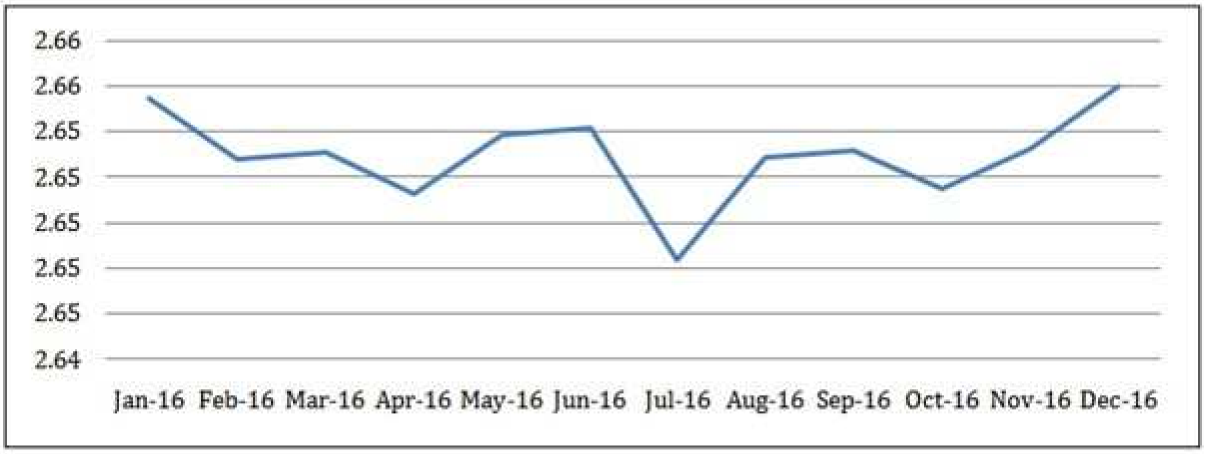

Figure 3: Bahrain Dirham Peggingagainst US Dollar

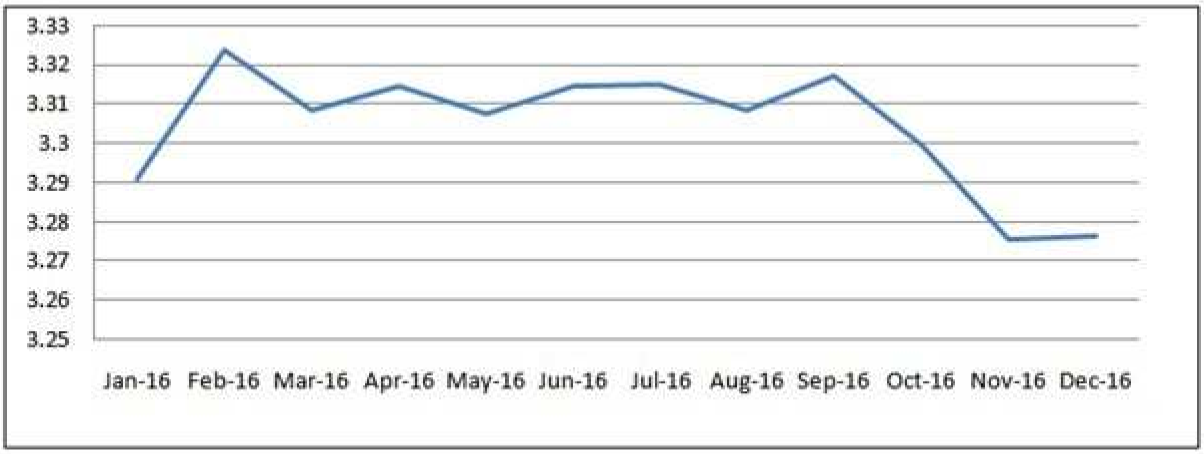

Figure 4: Kuwaiti Dinar Peggingagainst US Dollar

Figure 5: Omani Riyal Peggingagainst US Dollar

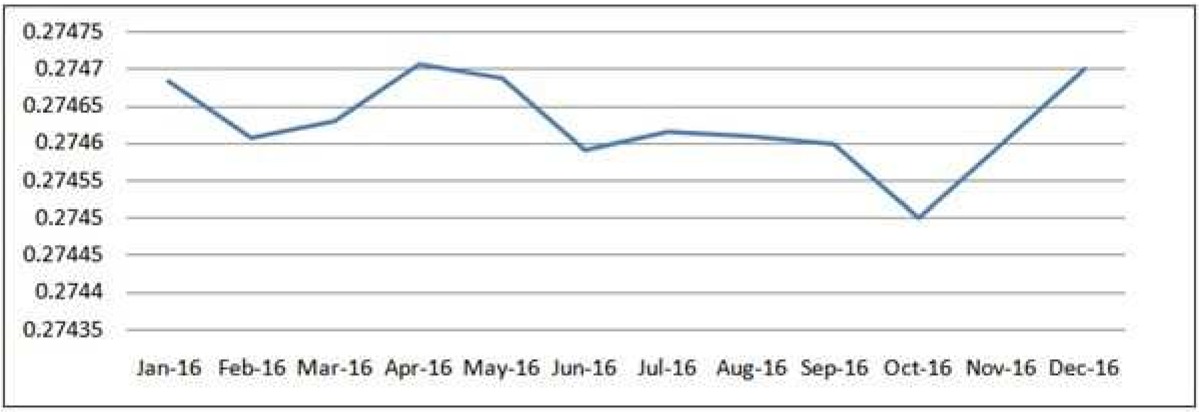

Figure 6: QatarRiyal Pegging against US Dollar

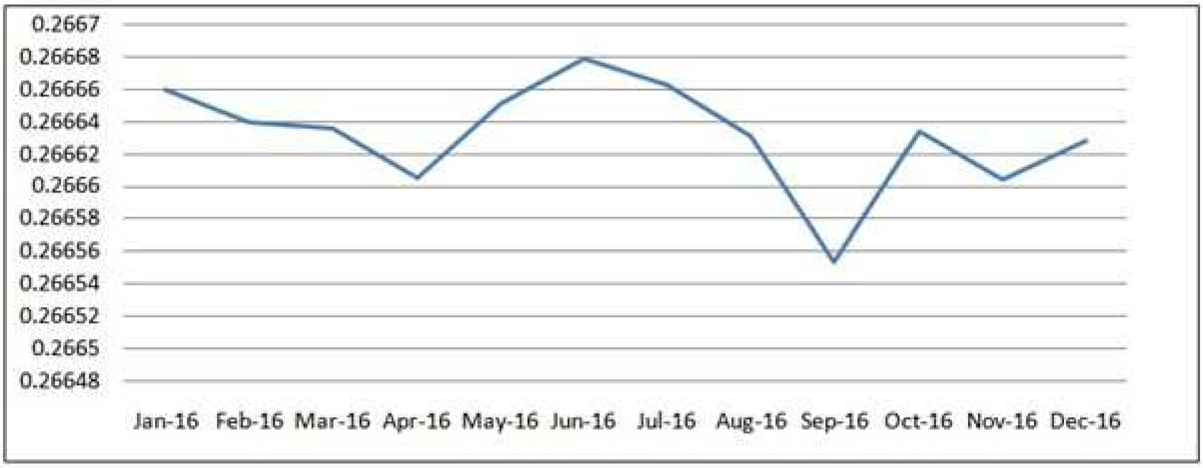

Figure 7: SaudiRiyal against US Dollar

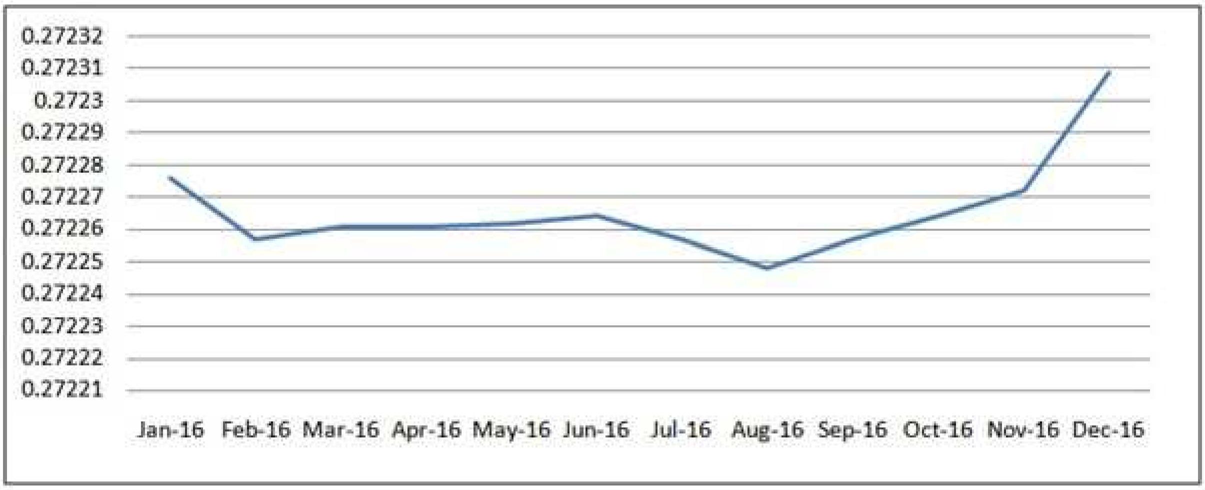

Figure 8: UAE Dirham against USDollar

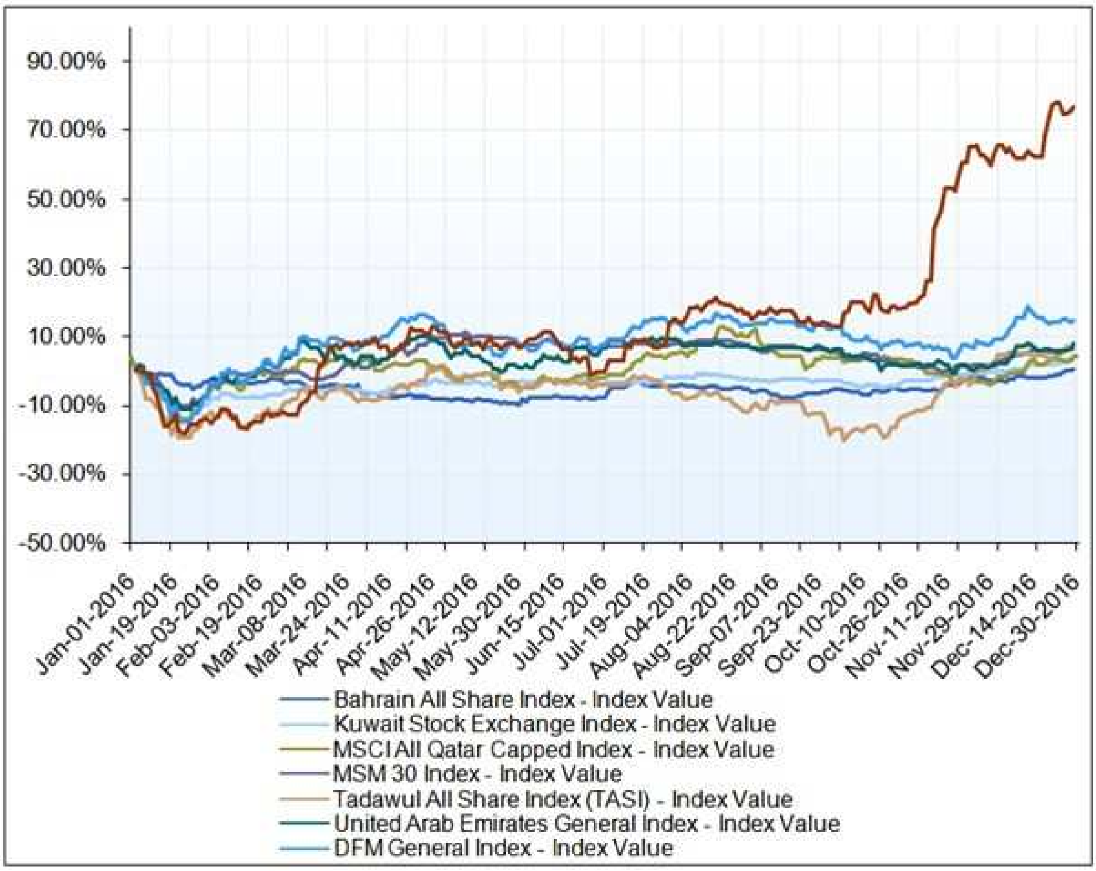

Figure 9: GCC Countries Stock Markets Indices Performance

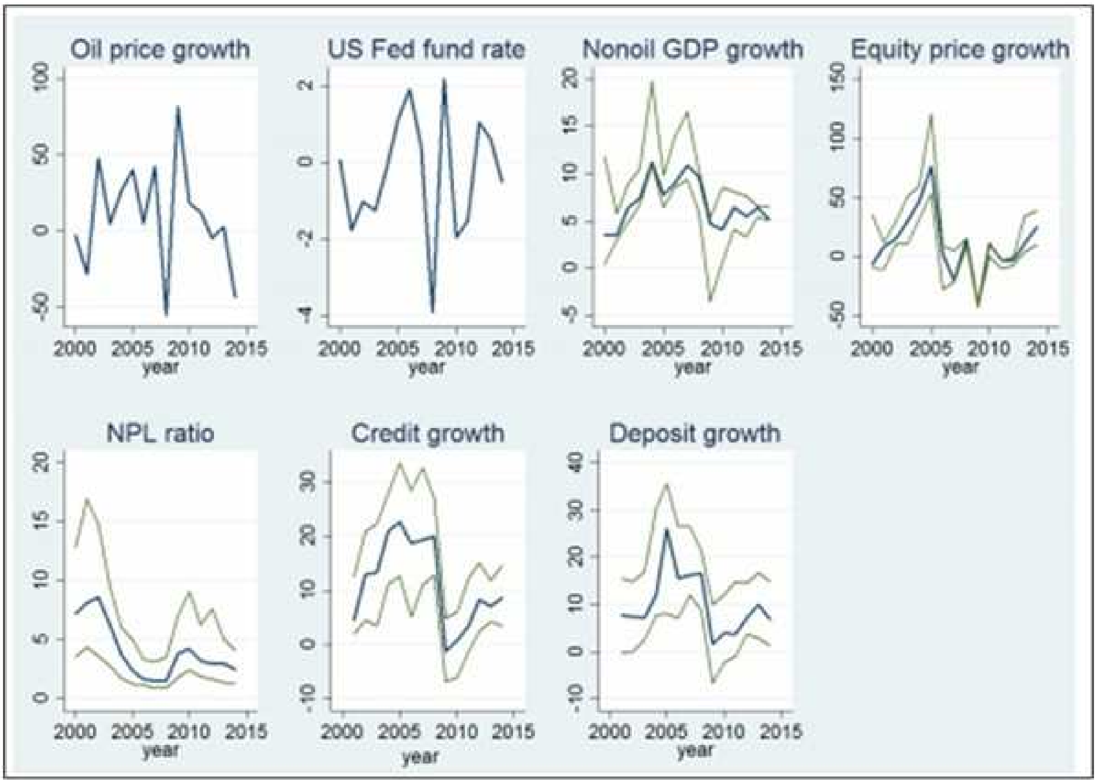

Figure 10: MacroeconomicVariables Attributable To GCC Banks

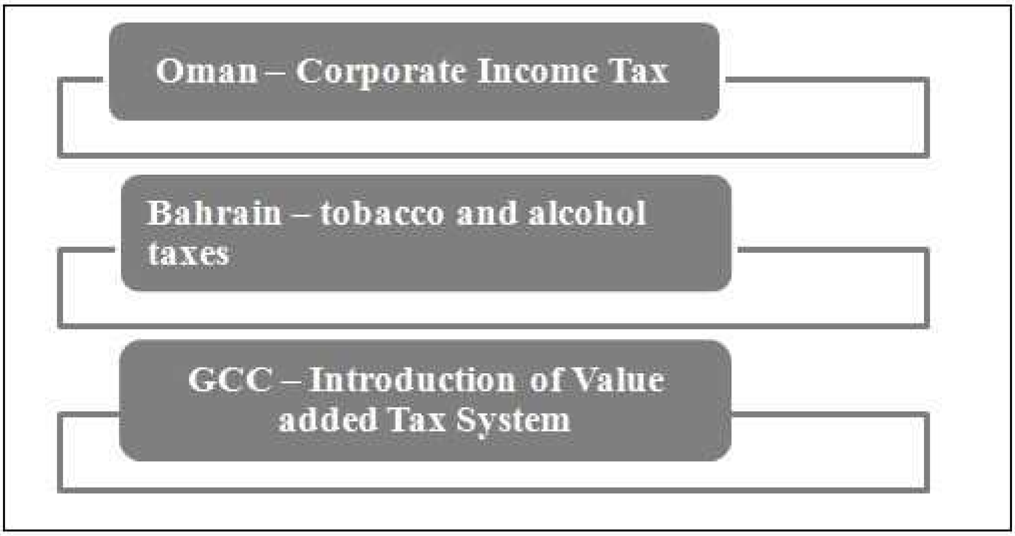

Figure 11: Non Oil Augmentation

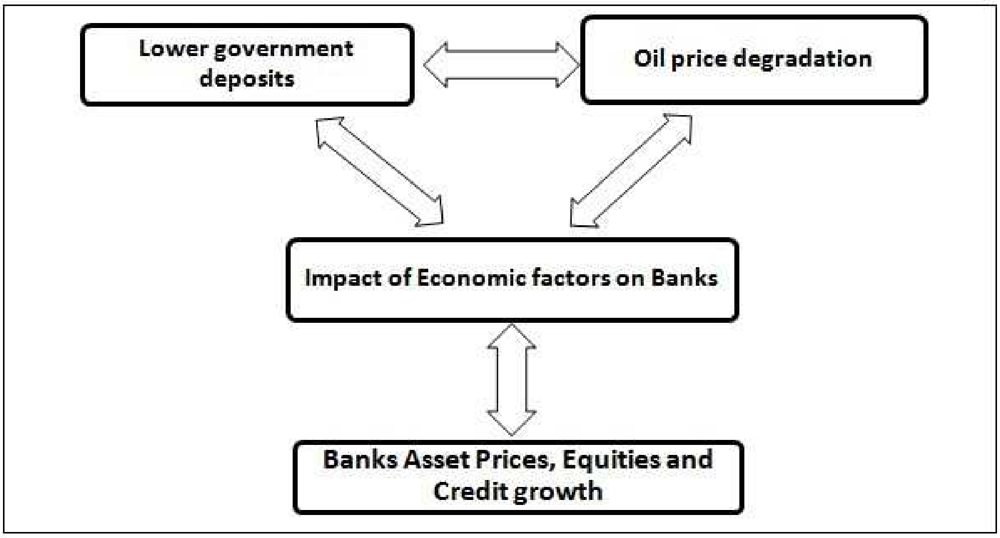

Figure 12: GCC Banking System Overview

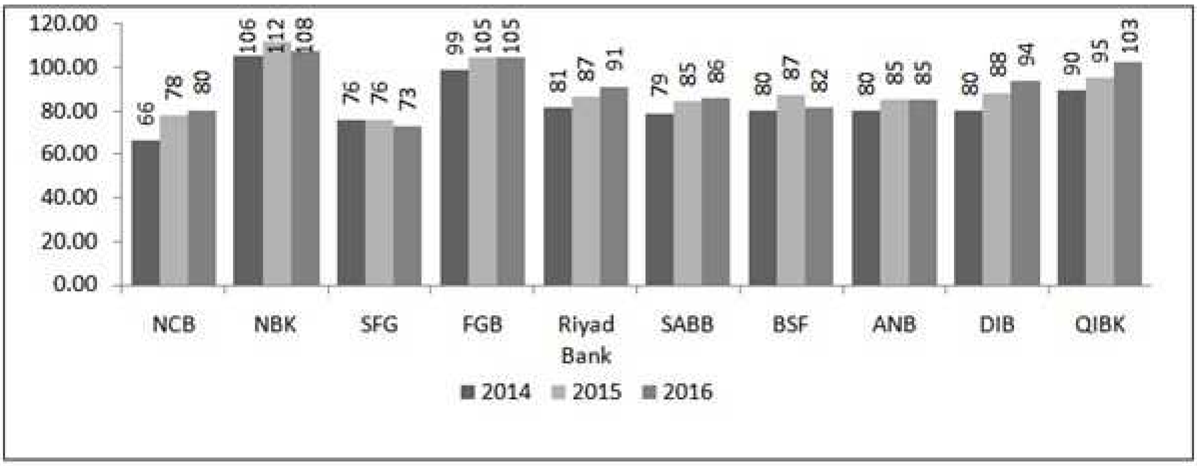

Figure 13: Loan Growth Rate (For the Financial YearEnding 2014, 2015, 2016)

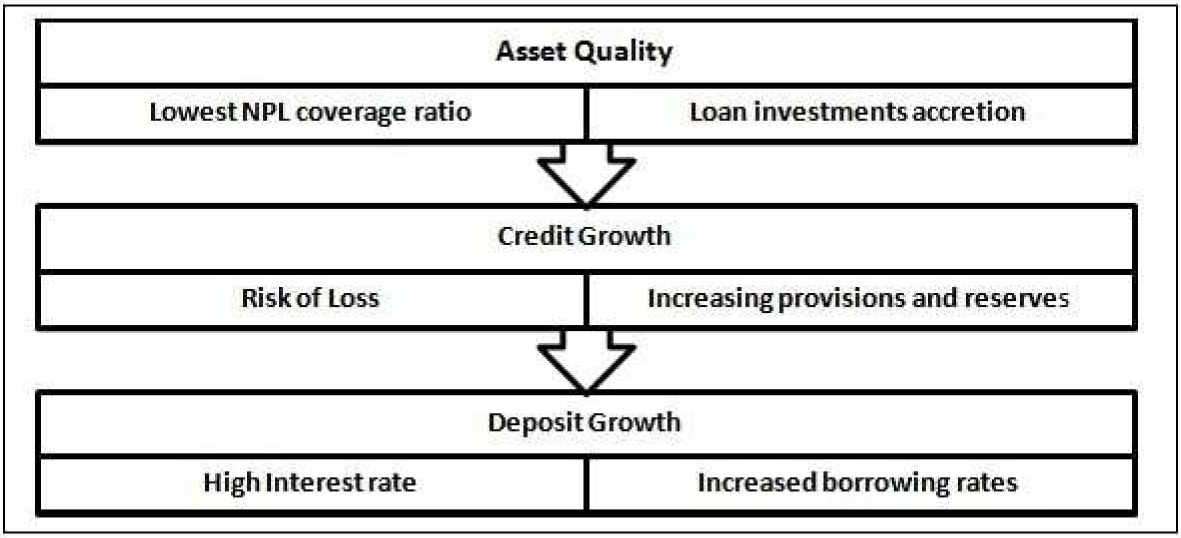

Figure 14: Challenging Constituents on GCC Bank growth

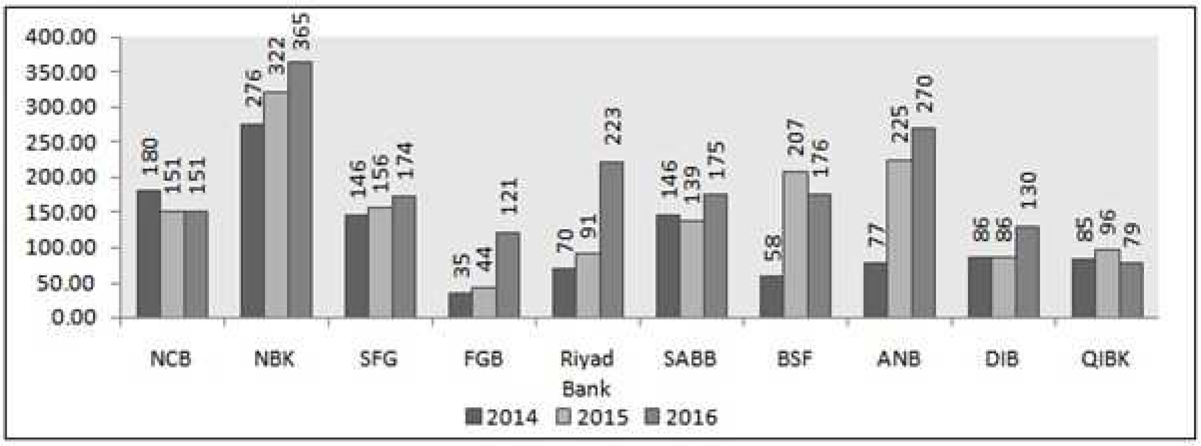

Figure 15: NPL Ratio (For the Financial YearEnding 2014, 2015, 2016)

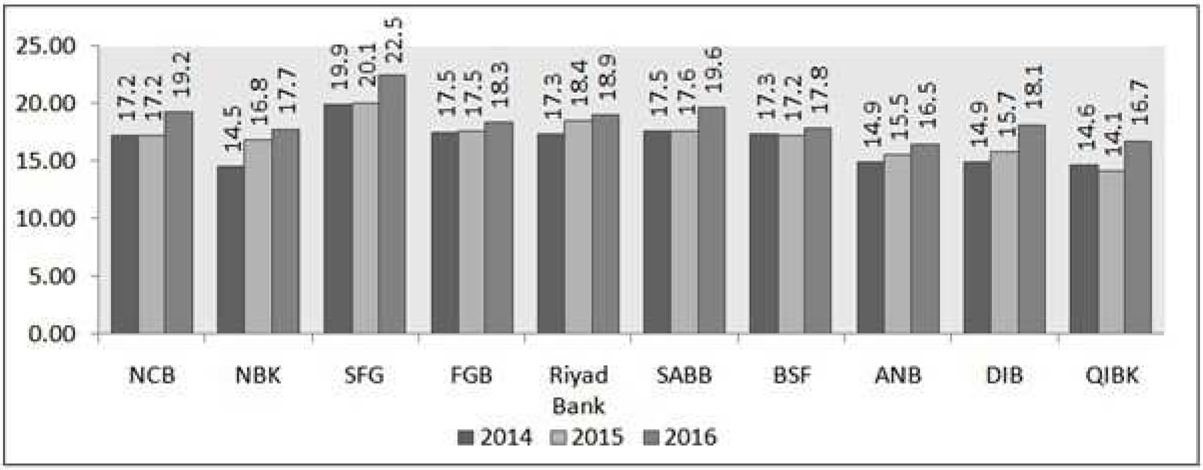

Figure 16: Capital Adequacy Ratio (For the Financial Year Ending 2014, 2015, 2016)

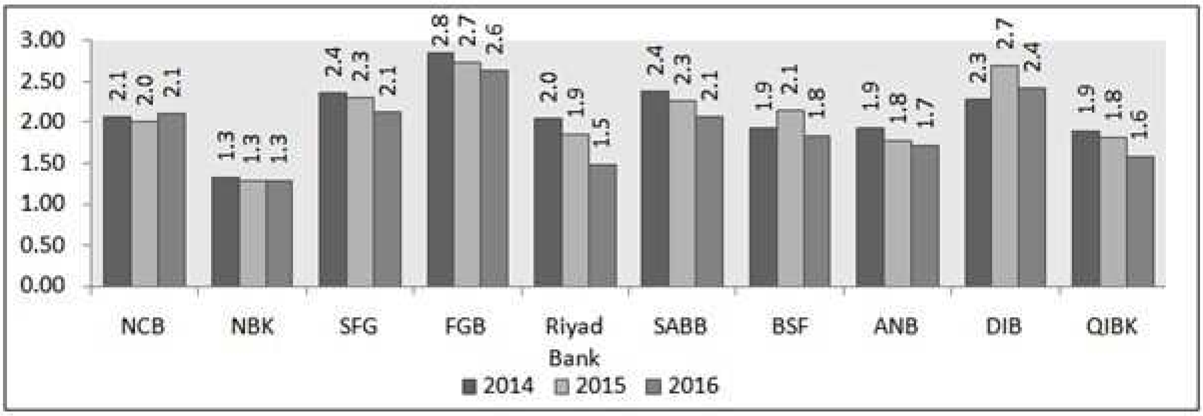

Figure 17: Returnon Assets (For the Financial Year Ending 2014, 2015, 2016)

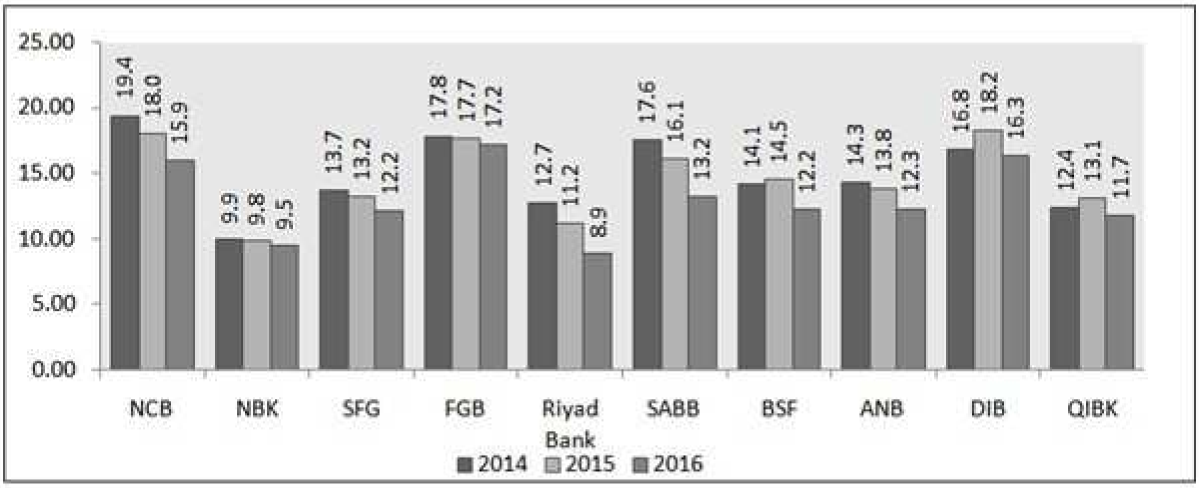

Figure 18: Returnon Equity (For the Financial YearEnding 2014, 2015, 2016)

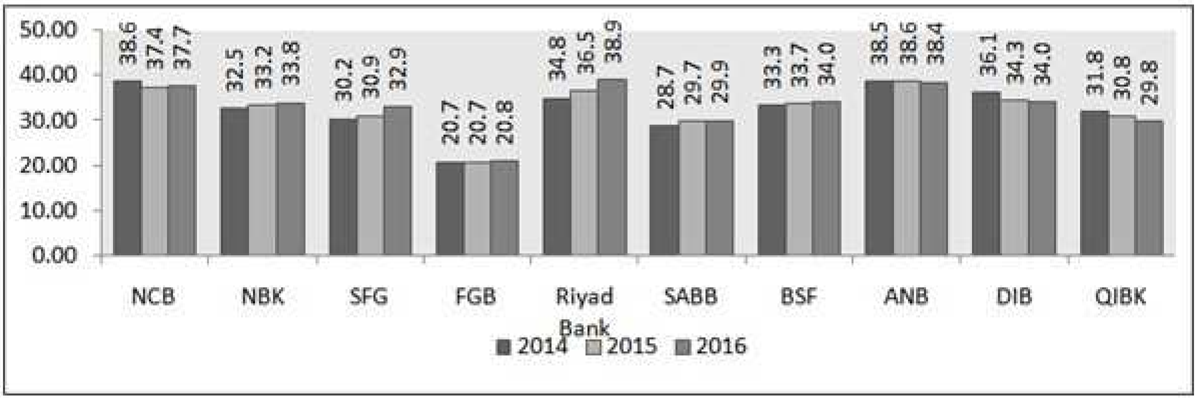

Figure 19: Cost to Income Ratio (For the Financial Year Ending 2014, 2015, 2016)

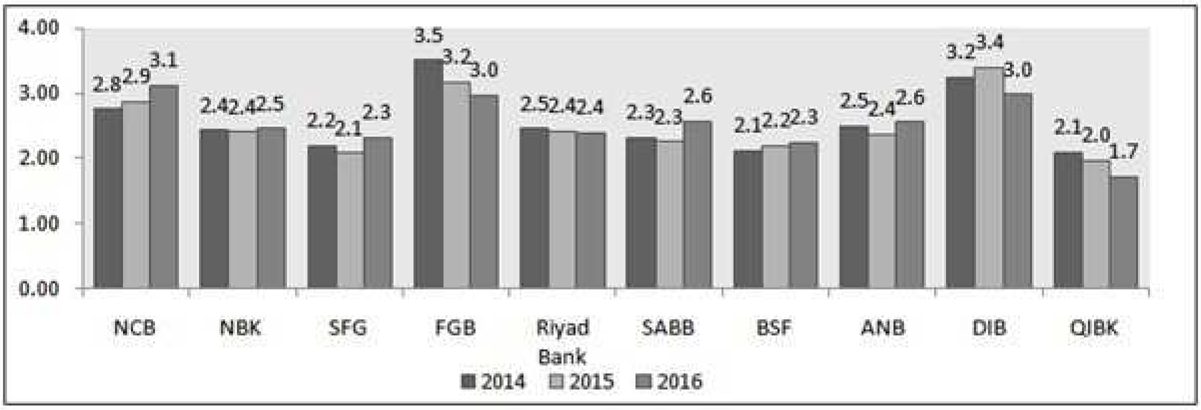

Figure 20: Net Interest Margin (For the Financial Year Ending 2014, 2015,2016)

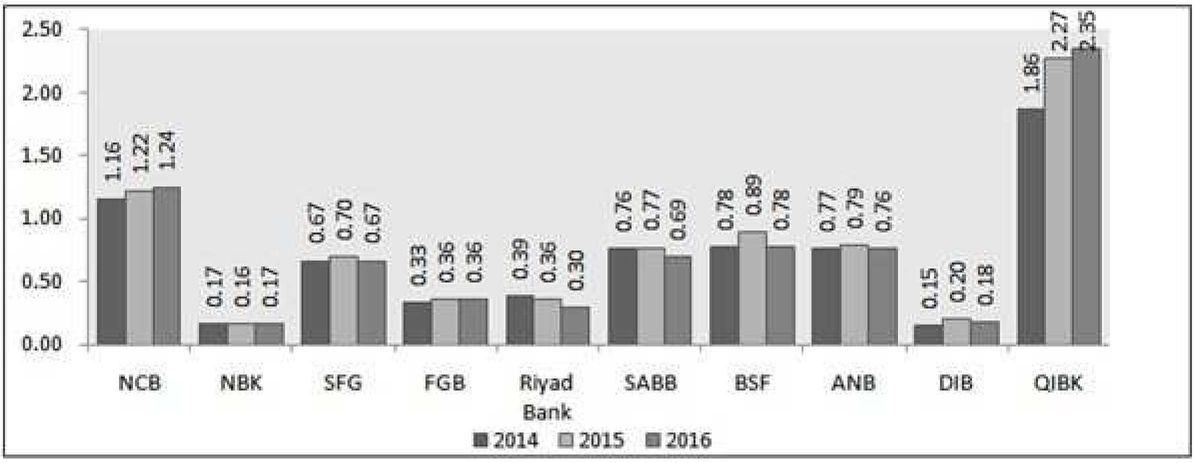

Figure 21: Earnings Per Share (For the Financial Year Ending 2014, 2015,2016)