

Expected Impact of US Monetary Policy Tightening on GCC Banks



Executive Summary

The US Federal Reserve is on track to change its monetary policy stance with start of asset purchase taper expected in Q4 2021 and rate hikes starting in 2022/2023. The central banks of GCC countries mostly follow changes in the US Federal Reserve Rate, considering the pegged exchange rate regimes. The last time such rate hike cycle was followed (2015-2019), there were specific set of winners in terms of GCC banks, who witnessed substantial rise in their market capitalization. We conducted a detailed analysis to study how changes in the US monetary policy affects the profitability of GCC banks over the past 13 years (quarterly intervals). The study, conducted using statistical tools such as correlation between policy rates and net interest margins (NIMs) revealed interesting findings. The US Fed is clearly on track to start raising rates sooner rather than later, and we expect GCC central banks to follow suit, thus creating the grounds for changes in GCC banks' profitability trends, with Saudi Arabian banks likely to emerge winners among GCC banks.

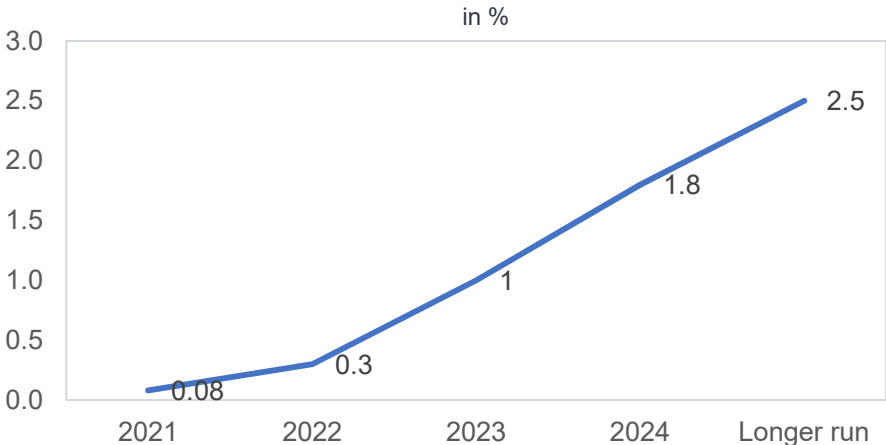
US Federal Reserve expected to change monetary policy stance soon

If Fed raises rates, most GCC central banks would follow suit

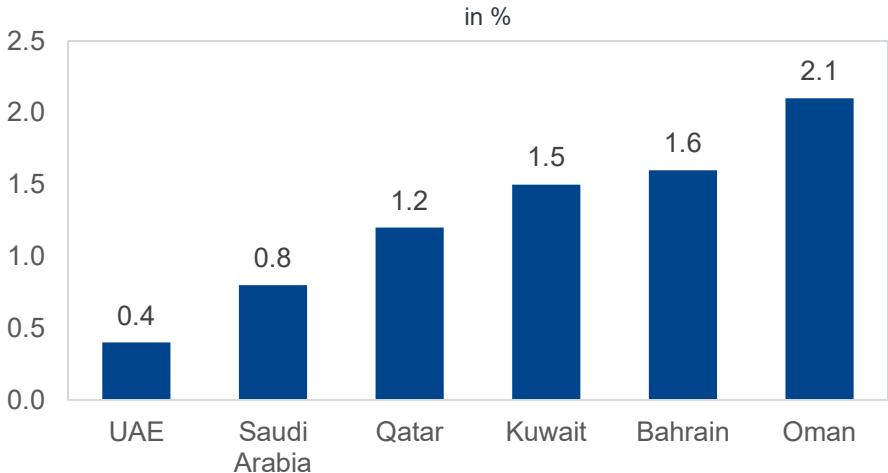
- The US Federal Reserve might tighten monetary policy if economic conditions keep improving and the elevated inflation levels remain steady.
- September 2021 FOMC meeting minutes indicate the Federal Reserve Bank is on track to start tapering bond purchases, which is one step closer to future rate hikes.
- Although the Fed is expected to raise interest rates in late 2022/early 2023, if economic conditions improve faster or inflation remains high, the Fed could change its stance and start raising rates earlier than expected.

- Given the fixed exchange rate regime, the national currencies of GCC countries are pegged to the US dollar, except for the Kuwaiti dinar, which is pegged to a basket of currencies (with the US dollar being the most dominant).
- In the past, GCC banks had followed the Fed's direction in changing policy rates and are expected to do so again.
- In 2015, when the Federal Reserve raised rates after keeping them near zero for seven years, Saudi banks emerged as clear winners as the rise in interest rates had a positive impact on earnings.

US Fed Funds Rate Dot Plot Projections (Median)



GCC Country-wise Interbank Rate



Source: Bloomberg, Aranca Analysis; Note: US Fed Dot based on September 2021 projections

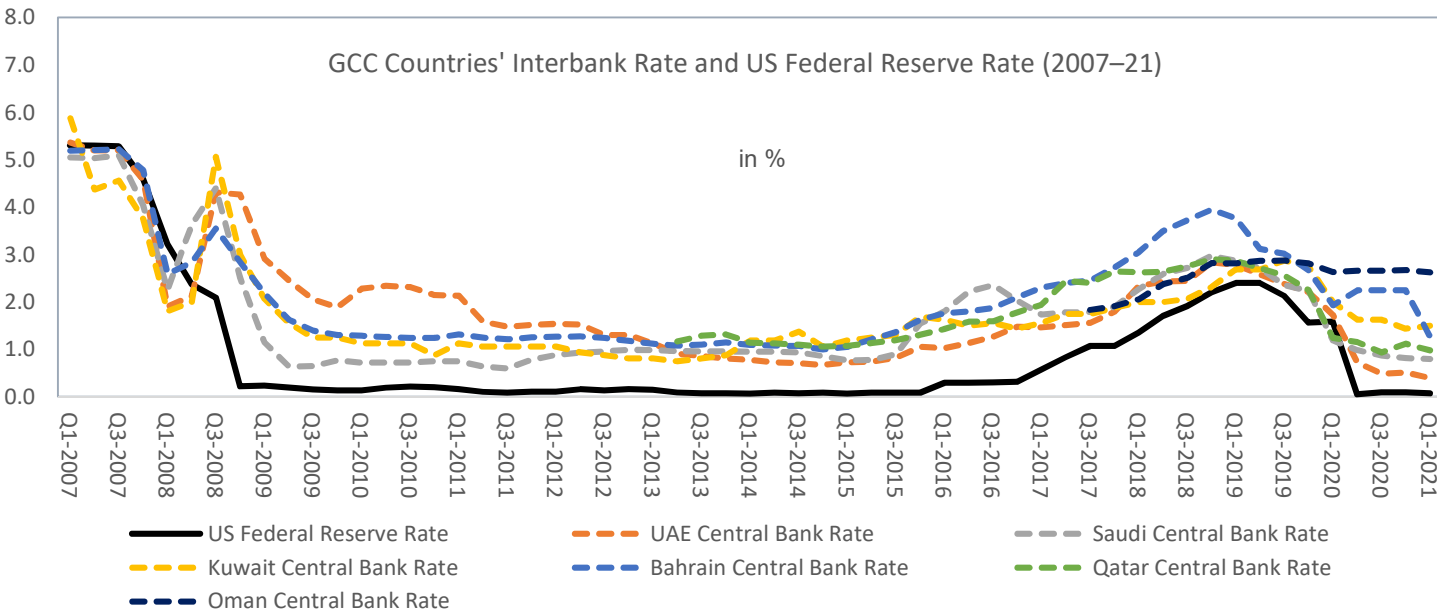
Scope of study conducted to identify relationship between rates and banks' NIM

Detailed analysis of each GCC country's interbank rate and country wise banks' NIM

To examine who would benefit or lose from a rising interest rate scenario, we conducted a detailed analysis of 51⁽¹⁾ GCC banks on the relationship between three-month interbank rates of each GCC country and country wise banks' NIM.

We examined the net interest margin (NIM) variations of each bank for the past 57 quarters⁽²⁾, covering the last 13 years (an entire economic cycle as well as tight and easy monetary policies).

The country wise analysis helps in understanding the lag in the pass-through of changes in benchmark interest rates to banks' net earnings.



Closer scrutiny of the chart indicates GCC countries' three-month interbank rates follow a similar trend as the US Federal reserve rates from 2009 to 2021, except for 2008, where deviations can be seen due to the impact of the global economic crisis.

(1) Alawwal Bank merged with SABB in 2018, Union National Bank merged with ADCB in 2019, Alizz Bank merged with Oman Arab Bank in 2020, Samba Financial Group merged with NCB in 2021

(2) Except Warba Bank (Kuwait), which was formed in 2010

Source: Bloomberg, GCC Bank Filings Aranca Analysis

Study conducted to identify relationship between rates and banks' NIM

GCC central banks track Federal Reserve's rate changes

- ▶ The Federal Reserve increased its benchmark interest rate for the first time since the economic crisis in 2015, and the hike continued until 2Q19.
- ▶ During this period, 5 out of 17 full-fledged Islamic banks recorded more than 50% jump in respective share prices. Emirates Islamic Bank's share price rose sixfold from 2016 to 2017.
- ▶ In 2020, the Federal Reserve announced emergency rate cuts to shelter the economy from the adverse impact of the pandemic.
- ▶ The overnight interest rate that banks pay to borrow from each other witnessed a combined reduction of 1.5% from March 2020 to March 2021.
- ▶ During this period, GCC central banks, such as the Central Bank of the UAE followed suit, with a nearly 1.8% decline in interbank rates. The Saudi Arabian Monetary Authority adapted to the measure by decreasing its benchmark rate by 1.4%, followed by Bank of Bahrain and Qatar Central Bank with almost 1.4% and 1.3% rate reduction, respectively.

Source: Bloomberg, Reuters, Aranca Analysis

Overview of GCC banking sector

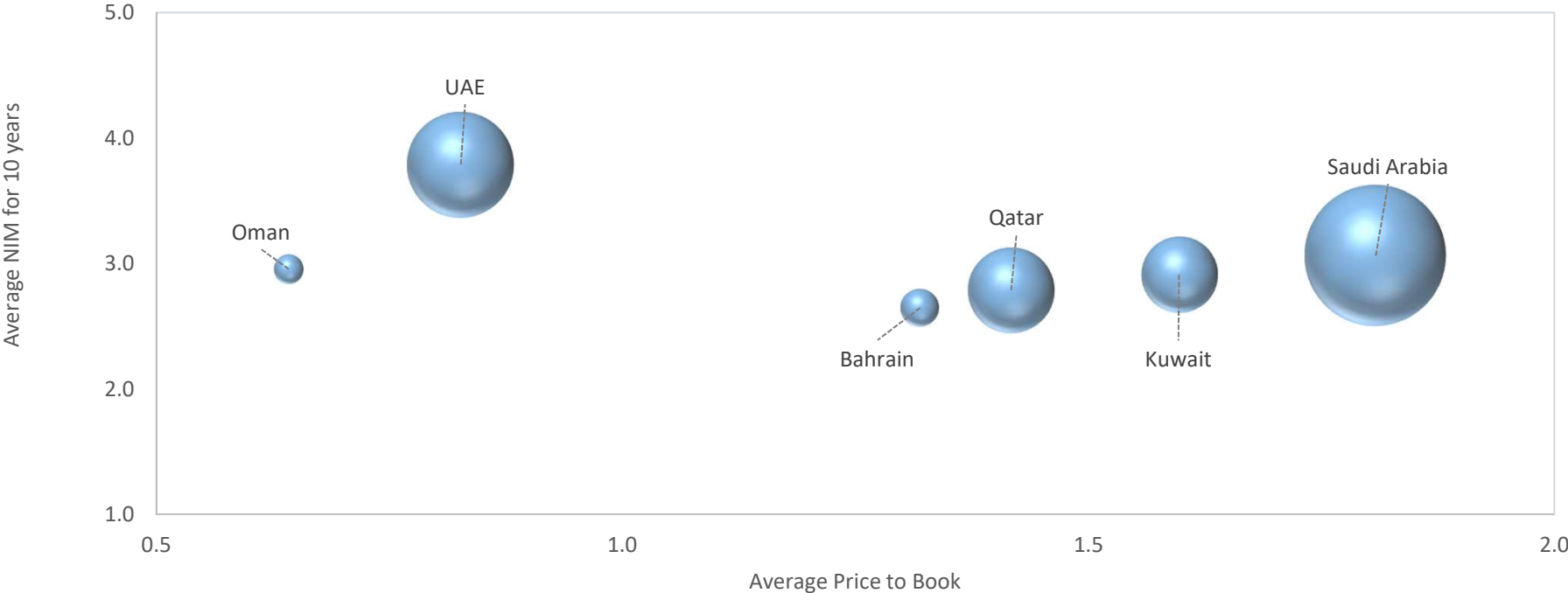
GCC banks' earnings in response to changing Federal Reserve rate

Of the 65 listed banks in the GCC region, the top 10 banks with the highest market capitalization represent 66.5% of total market share and control on average 57.1% of the region's total banking assets. The Saudi banking sector remains largest with total market capitalization of USD222.8 billion, followed by that of the UAE (USD124.8 billion).

The chart below shows a broad comparison of regional GCC banks based on market capitalization, valuation, and profitability.

(Size of the bubble indicates market capitalization)

Regional GCC Banks



Source: Bloomberg, Reuters, Aranca Analysis

Study conducted to identify relationship between rates and bank's NIM

Correlation analysis findings

Country	No. of Banks	No. of Islamic Banks*	Correlation Observed
Saudi Arabia	10	4	Positive
UAE	15	5	Mixed
Qatar	8	4	Negative
Kuwait	10	4	Positive
Oman	5	0	Negative
Bahrain	3	0	Positive

Source: The Asian Banker, Aranca Analysis; Note: * - Islamic banking indicates banking operations based on the principles of Islamic law (Sharia law)

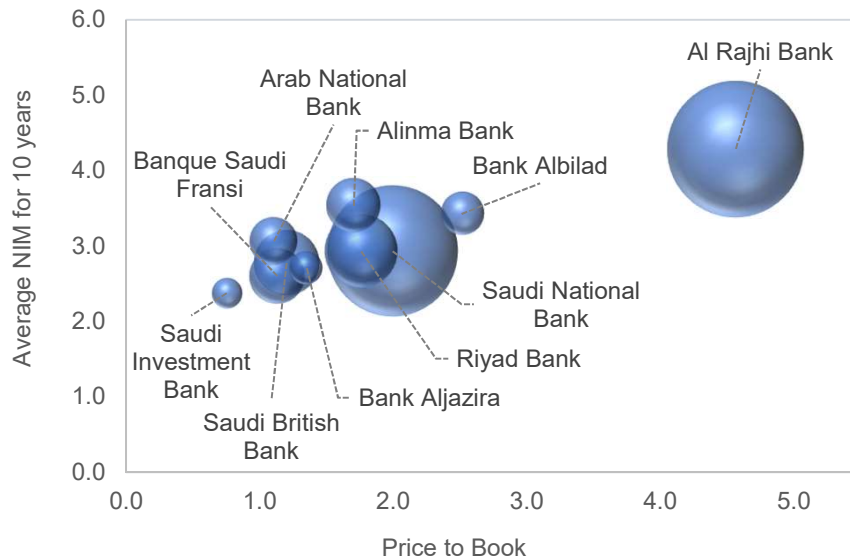
Country wise analysis and observations

Saudi Arabia

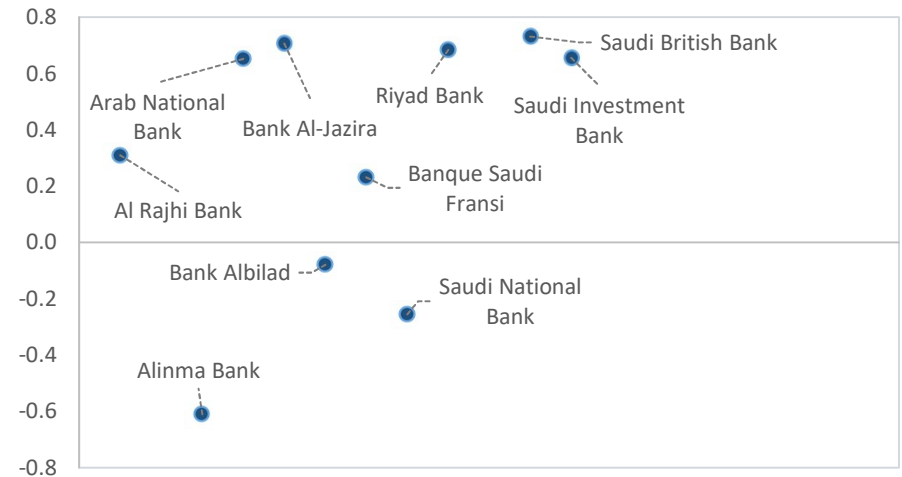
KSA's Al Rajhi Bank is the largest bank in the country with market share of USD72 billion, followed by Saudi National Bank (USD66 billion). Al Rajhi's share price has increased significantly by around 80% in the last five years and has the top spot in terms in profitability and valuation.

Saudi Arabian Banks

(Size of the bubble indicates market capitalization)



Correlation Observed



- Among GCC banks, those in KSA are better positioned as they have a higher positive correlation between NIMs and interbank rates.
- In terms of growth in net interest income (NII) in the past five years, Bank AlBilad topped the list at 133.8%, followed by Alinma Bank (75.2%). Total assets of Bank AlBilad and Alinma Bank increased 78.1% and 49.8%, respectively, from 2016 to 2020. The above chart shows that both banks pass through interest rates with a greater lag.

Source: Bloomberg, Reuters, Aranca Analysis

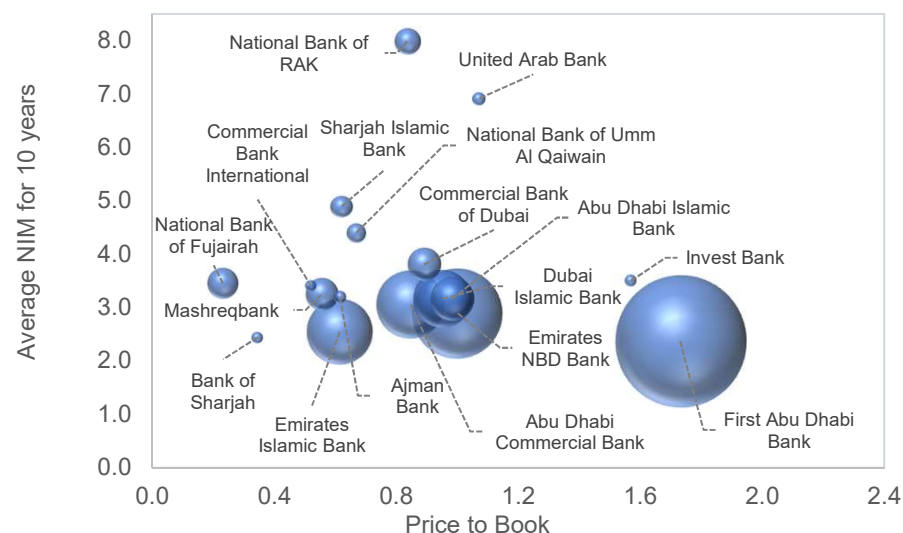
Country wise analysis and observations

United Arab Emirates

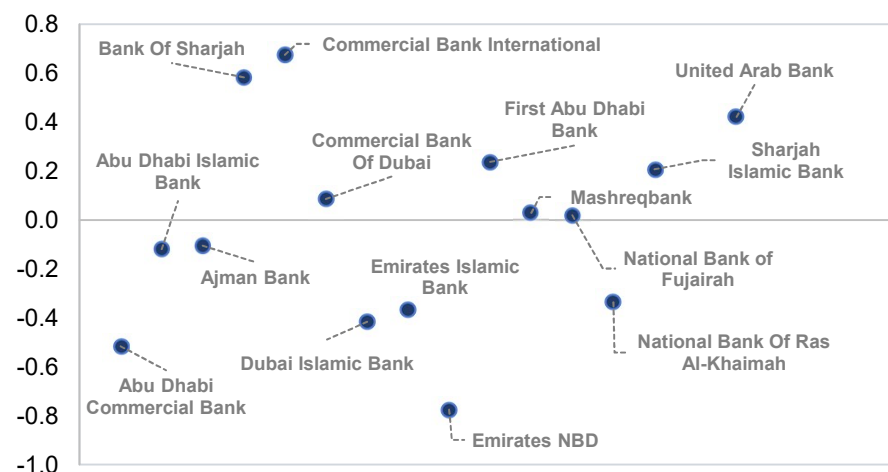
First Abu Dhabi Bank (FAB) is UAE's leading bank in terms of market share as well as valuation. Market capitalization of FAB stands at USD48 billion followed by Emirates NBD with share of USD22 billion. FAB's price to book ratio remains highest at 1.73x. In terms of profitability, National Bank of Ras Al Khaimah leads with 10 year average NIM of 7.9%.

UAE Banks

(Size of the bubble indicates market capitalization)



Correlation Observed



- A mixed correlation can be seen in the UAE, where 8 out of 15 banks represent a positive correlation, while the remaining 7 show a negative correlation. Excluding the year 2020 from correlation analysis, 10 of the 15 banks denote a negative correlation; this indicates that changes in NIMs would not be highly sensitive to those in interbank rates.
- Sharjah Islamic Bank represents the highest increase in NII with more than 100% growth in the past five years, closely followed by First Abu Dhabi Bank (FAB: ~93%). On the other hand, FAB's assets rose exponentially by 310.3%, followed by an increase of 65.5% in Dubai Islamic Bank's assets.

Source: Bloomberg, Reuters, Aranca Analysis

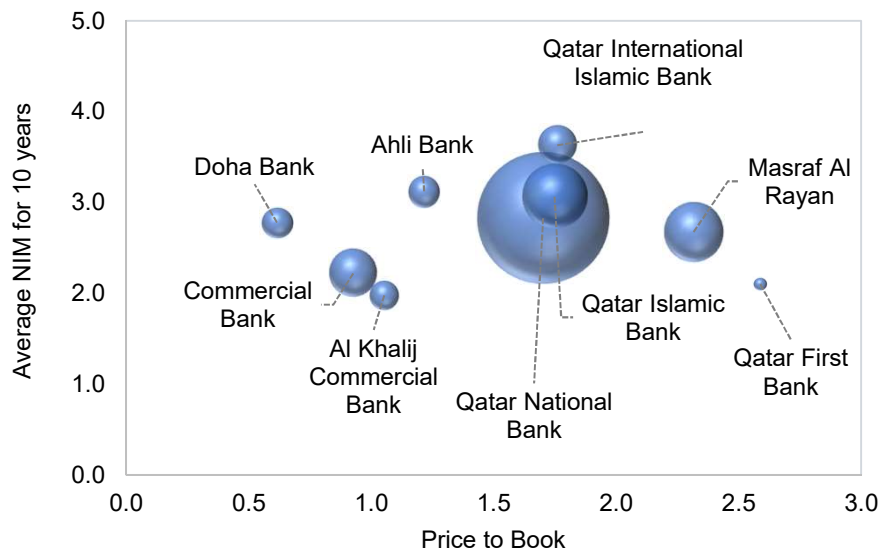
Country wise analysis and observations

Qatar

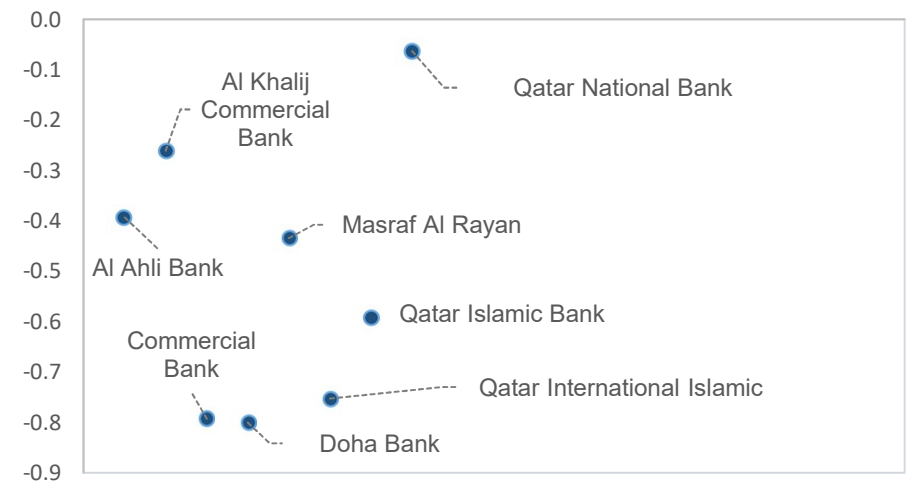
Qatar National Bank is the largest bank with market share of USD45 billion, it is one of the four full fledged Islamic Banks in Qatar. Qatar First Bank is the only small-cap bank in the country with highest price to book ratio of 2.6x

Qatari Banks

(Size of the bubble indicates market capitalization)



Correlation Observed



- A higher negative correlation can be observed in Qatar. The country's largest bank, Qatar National Bank, recorded a 57.7% turnaround in NII in the last five years, meanwhile Qatar International Islamic Bank's asset base expanded 44.1%.
- Qatar Islamic Bank recorded the biggest increase of 64.7% in share price from 2016 to 2020.

Source: Bloomberg, Reuters, Aranca Analysis

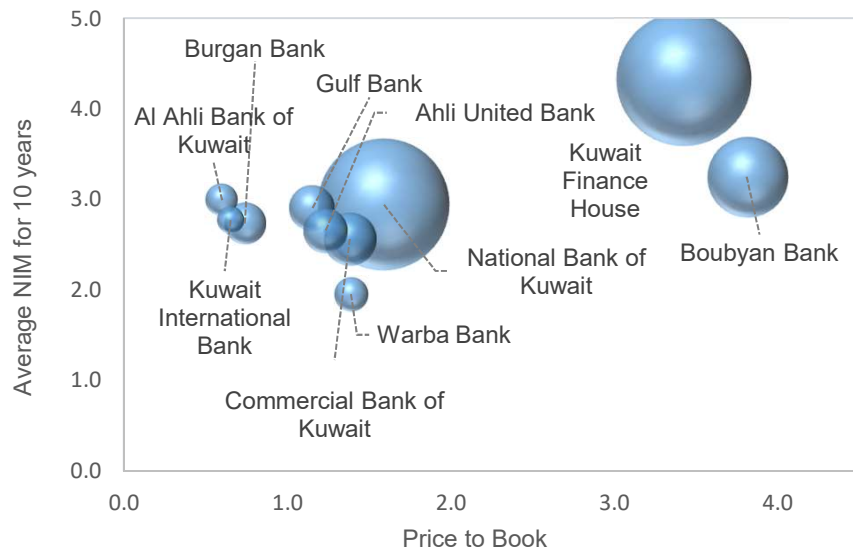
Country wise analysis and observations

Kuwait

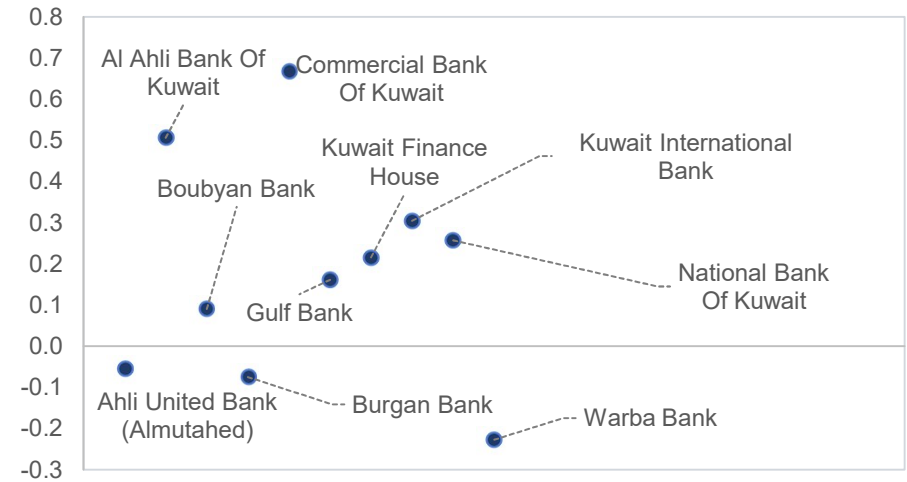
Kuwait Finance House (KFH) is currently the leading bank with USD21 billion in market capitalization followed closely by National Bank of Kuwait (USD20 billion). Boubyan Bank which is Kuwait's third largest bank has the highest price to book ratio of 3.81x in the sector

Kuwaiti Banks

(Size of the bubble indicates market capitalization)



Correlation Observed



- Of the total 10 banks, 7 indicate a positive correlation between changes in interbank rates and their corresponding effect on NIMs. Kuwait Finance House's share price jumped 101.6% and NII went up 42.0% in the past five years.
- A closer look at the financials suggests Warba Bank's NII increased by more than 150% during this period.

Source: Bloomberg, Reuters, Aranca Analysis

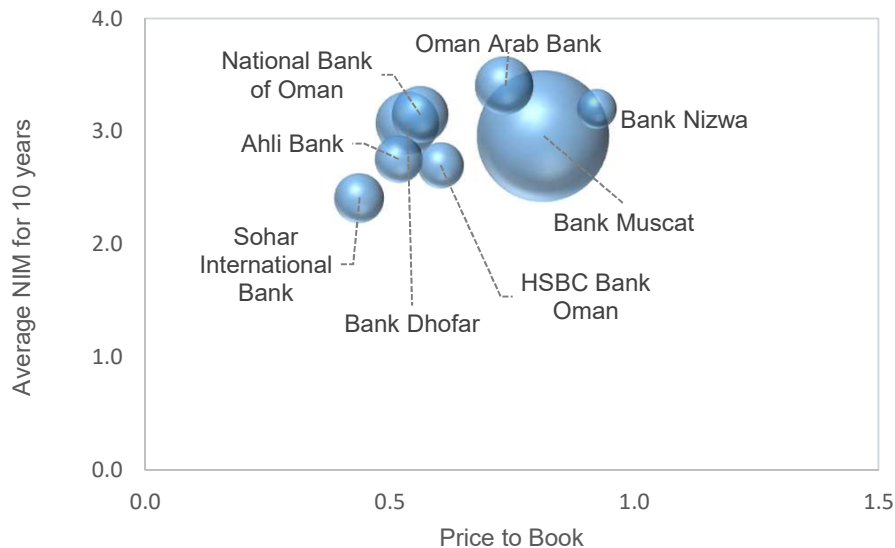
Country wise analysis and observations

Oman

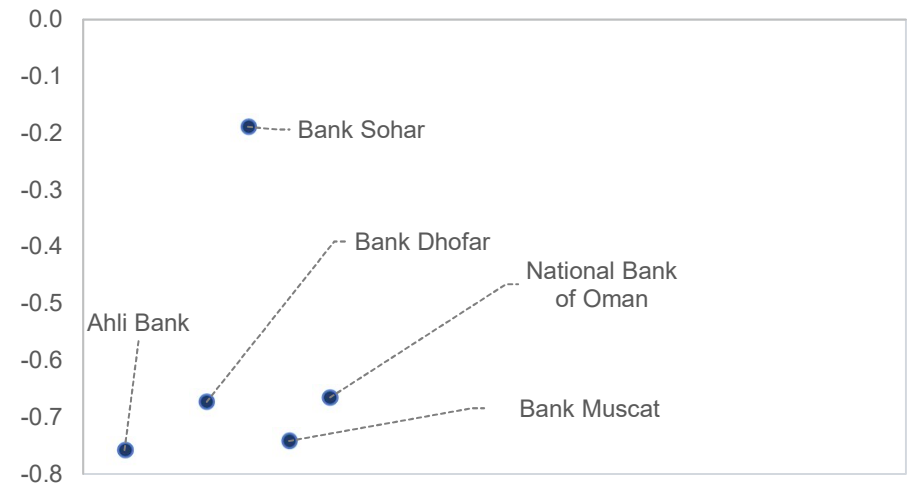
Bank Muscat in Oman is the largest bank with market capitalization of USD4billion and controls 37.2% of total assets held by all listed Omani Banks. Although on observing the chart, Oman Arab Bank's average NIM stands at 3.4% which is also the highest among rest of the Omani Banks

Omani Banks

(Size of the bubble indicates market capitalization)



Correlation Observed



- All banks that were part of the study showed a negative correlation between interbank rates and NIMs.
- This suggests that banks in Oman pass through interest rates to customers with a greater lag. Ahli Bank's NII grew 34.3% in the last five years.

Source: Bloomberg, Reuters, Aranca Analysis

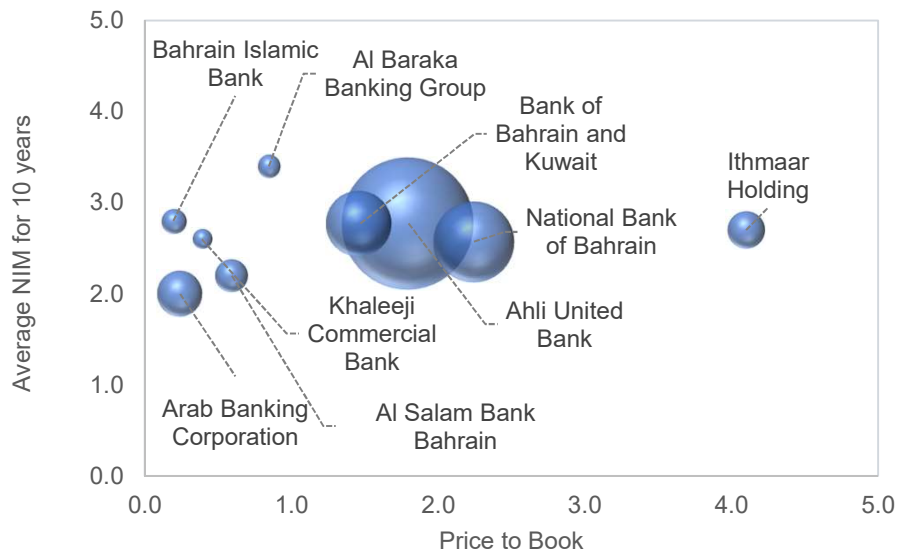
Country wise analysis and observations

Bahrain

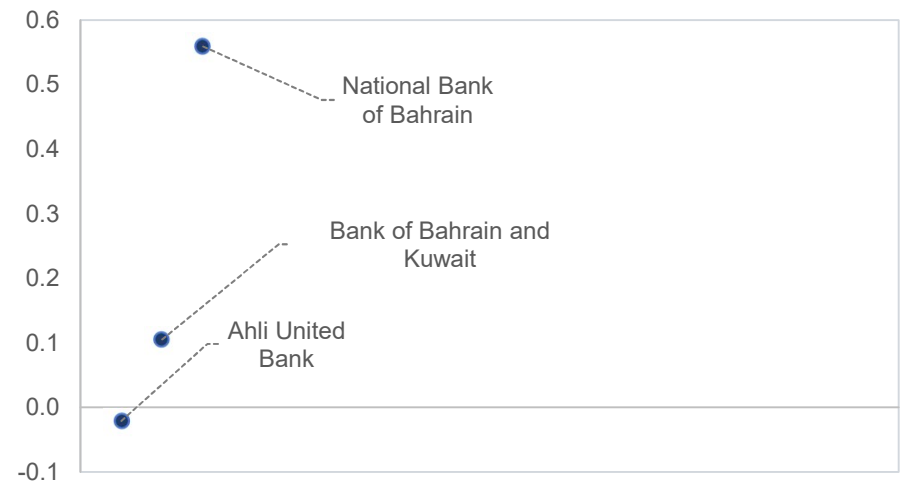
The largest bank in the country Ahli United Bank (AUB) has highest asset base of USD40 billion and is valued at 2.8x price to book multiple. AUB's market capitalization stands at USD7 billion followed by that of National Bank of Bahrain (USD3 billion)

Bahraini Banks

(Size of the bubble indicates market capitalization)



Correlation Observed



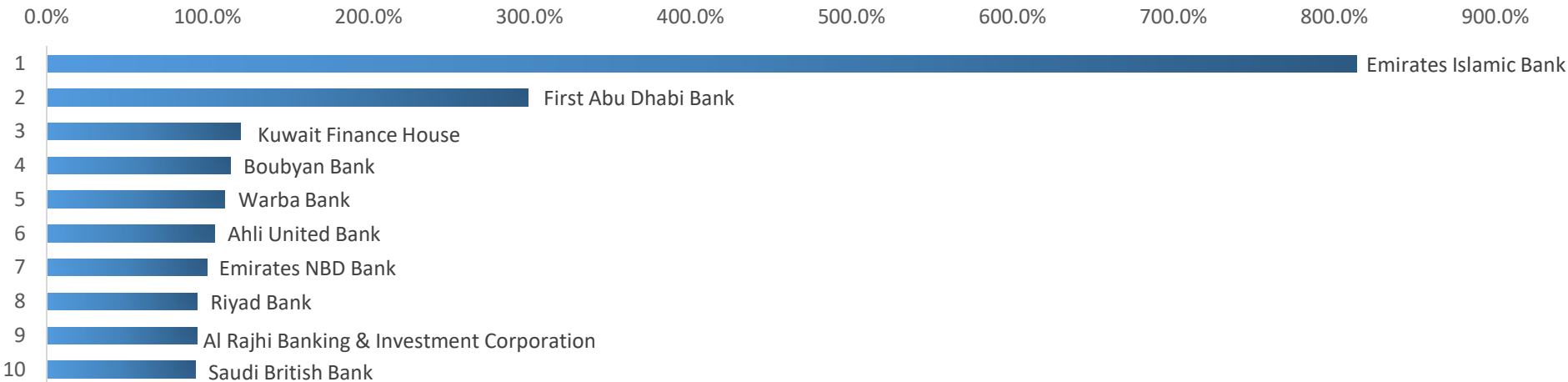
- The analysis includes the three largest banks in Bahrain. Two of them denote a positive correlation, while Ahli United Bank has a slightly negative correlation of 0.02.
- National Bank of Bahrain's NII improved 74.5% over the last five years. All three banks saw an increase in share price during this period: Ahli United Bank (66.0%), Bank of Bahrain and Kuwait (43.0%), and National Bank of Kuwait (27.7%).

Source: Bloomberg, Reuters, Aranca Analysis

GCC banks see increased market capitalization during 2015–19 when Fed raises benchmark rates

Increase in Market Capitalization from 2015 to 2019

Percentage Increase



- According to Islamic Financial Services Industry’s report, Saudi banks’ share of Islamic banking to total banking assets remains at 68.0%, the largest of all GCC nations.
- This implies that Saudi banks pass through the interest rate to their loan customers with a lesser lag, incurring only minimal interest costs. Over the five-year period, NII of KSA’s prominent Islamic Bank Al Rajhi climbed 65.0% while its market capitalization increased 93.6%.
- The Federal Reserve’s upcoming stance on monetary policy would be an interesting point of determination whether the change in rates would affect profitability of GCC banks with a similar tendency observed between 2015 and 2019.

Source: Islamic Financial Services Industry’s Stability Report August 2021, Reuters, Aranca Analysis

Conclusion

The correlation study conducted employing statistical methods such as the correlation between policy rates and net interest margins (NIMs) for the past 13 years (on quarterly intervals) shows that Islamic banks enjoy an advantage over traditional banks during rate hike cycles. This is largely due to the low cost of deposits charged by Islamic banks vis-à-vis traditional banks. During rate hikes, therefore, traditional banks need to pass on the increase in cost to depositors, which may not always be offset by a rise in lending rates (owing to competitive pressures). For the Saudi Arabian banking sector, given its relatively large size and due to the higher share of Islamic banks in this space compared to traditional banks, the correlation between policy rate hikes and NIM (equivalent) expansion during the last rate hike cycle from 2015 to 2019 is positive. For the banking sector in rest of the GCC countries, except Kuwait and Bahrain, correlation is either mixed or negative.



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