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Credit FAQ:

A Sharp Increase In Geopolitical Risk Could See GCC Banks Require Sovereign Support

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Key Takeaways

- GCC banking systems should be able to absorb foreign funding outflows without government support in a hypothetical modest stress scenario.
- However, in our more severe hypothetical stress scenario, we see potential funding gaps in all banking systems aside from Kuwait's, with Qatari and Bahraini banks requiring the most support as a proportion of GDP.
- Most GCC governments possess sufficient liquid assets and foreign exchange reserves to support banks under our hypothetical stress scenarios, but such support could weigh on some sovereigns' fiscal and external profiles.

Tensions between the U.S. and Iran have increased, but S&P Global Ratings has not changed any bank or sovereign ratings or outlooks in the Gulf Cooperation Council (GCC). This is because, in our base case, we do not expect direct military conflict between the two countries or their regional allies. Furthermore, we expect the Strait of Hormuz to remain open to the global oil trade. For more details about these assumptions see Appendix and "Credit FAQ: How U.S.-Iran Tensions Might Affect Gulf Sovereign Ratings," published June 11, 2019, on RatingsDirect.

If the strait were blocked (even for a few days), or if there is a significant escalation in tensions between allies of either the U.S. or Iran that could affect Gulf countries, the potential related loss of investor confidence could weigh on the ratings of GCC banks and sovereigns.

Against this backdrop, investors are asking us about the potential implications for banks and sovereigns in the GCC. Here, we respond to such questions and present some bank-funding-related hypothetical stress test scenarios. We exclude potential second-round effects on banks' asset quality or capitalization. Nevertheless, we think these could be significant if tensions were to increase materially.

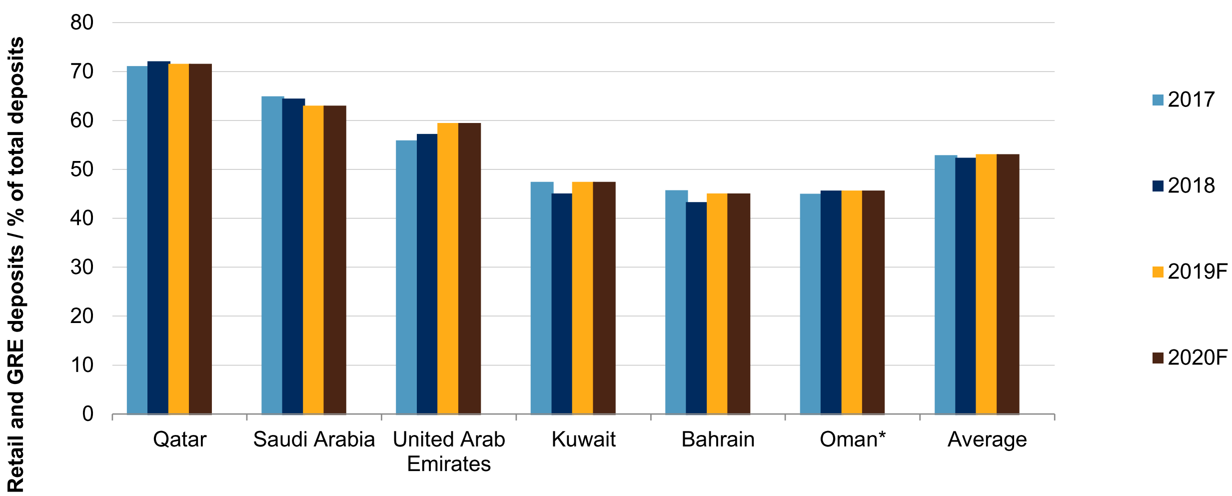
What are the main characteristics of GCC banking systems' funding profiles?

For most banking systems in the GCC, strong customer bases support their systemwide funding profiles. At year-end 2018, the loan-to-deposit ratio reached 99% on average for the six GCC countries. Moreover, about 52% of deposits came from retail customers and government-related entities (GRE) at the same date (see chart 1). Qatar had the biggest share of retail and GRE deposits at about 70% and Bahrain and Oman had the lowest at about 45% at year-end 2018.

Central banks in the region do not disclose the percentage of deposits from expatriate clients. The structure of regional populations is clearly biased toward foreign workers (see table 1). However, where they deposit their income is more complex. A significant proportion of foreign workers remit their wages and keep minimal funds in domestic banks. We estimate that expat deposits account for about 30% of total domestic deposits in Qatar and the United Arab Emirates (UAE). This ratio is higher than our estimate for other GCC countries (10%), due to the larger percentage of expatriates in the Qatari and UAE populations. These estimates impact our stress scenarios below.

Chart 1

Retail And GRE Deposits Underpin The Funding Profiles Of GCC Banking Systems



*S&P Global Ratings estimate. GCC--Gulf Cooperation Council. GRE--Government-related entity. F--Forecast.
Source: S&P Global Ratings and central banks. Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

Table 1

The Large Expat Populations In Some GCC Countries Could Affect Deposits

	Expatriate population (%)*	Private sector domestic deposits (bil. $)§	Private sector domestic deposits (GDP %)§
Saudi Arabia	38	353	47%
Qatar	85	97	51%

Table 1

The Large Expat Populations In Some GCC Countries Could Affect Deposits (cont.)

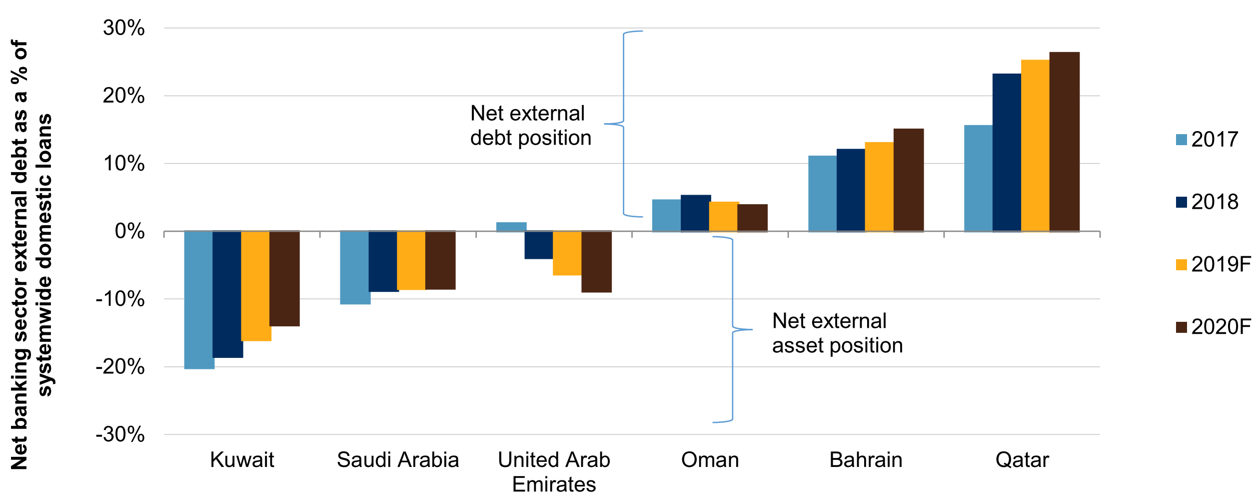
	Expatriate population (%)*	Private sector domestic deposits (bil. $)§	Private sector domestic deposits (GDP %)§
UAE	85	294	72%
Kuwait	70	121	94%
Oman	43	38	49%
Bahrain	54	34	86%

*Sources: For Saudi Arabia, General Authority for Statistics; for Qatar, estimate based on Planning and Statistics Authority data, Labor Force Survey; for the UAE, estimate compiled from Statistics Center - Abu Dhabi, Dubai Statistics Center, and 2015 Sharjah census; for Kuwait, Public Authority for Civil Information, statistical reports; for Oman, National Centre For Statistics & Information; for Bahrain, Central Bank of Bahrain quarterly statistical bulletin. §Data from central banks and excludes GRE and government deposits where available, which we assume would remain in domestic banks under these stress scenarios.

The other key feature of the GCC banking system is that, except for Qatar and to a lesser extent Bahrain, total external debt is relatively limited. Indeed, three out of the six countries are in net external asset positions (see chart 2) ranging from about 20% of systemwide loans for Kuwait to about 4% for the UAE at year-end 2018. We believe the Qatari banking system's high dependence on external debt is a source of risk and one of the main factors underpinning our negative industry risk assessment on Qatar. A closer look at the composition of this external debt shows 48% from interbank deposits, 38% from customer deposits, and 14% from other instruments. Oman has a small net external debt position.

Chart 2

Qatari Banks Have The Highest Net External Debt In The GCC



GCC--Gulf Cooperation Council. F--Forecast. Source: S&P Global Ratings and central banks.

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How might rising geopolitical risk affect GCC banks?

Geopolitical risk has been part of daily life for GCC citizens and corporates for several decades. However, over the past three years, and particularly in recent months, geopolitical risk has risen, in our opinion. We conducted the two hypothetical stress scenarios, set out below, based on a relatively simple set of assumptions to try to assess the potential effect of a confidence shock on GCC banking systems. We assumed in these hypothetical scenarios that a relatively high proportion of expat deposits would leave the system, outlining a peculiarity of GCC banks versus nonregional peers.

The main purpose of this exercise is to try to highlight the banking systems that could potentially be the most affected by an escalation in tensions. However, we consider only funding positions in these hypothetical scenarios and do not include the impact on asset quality or capital considerations. We aligned our hypothetical scenarios with those published by S&P Global Ratings' sovereign practice (see Appendix and Related Research for the narratives of the two scenarios) and applied a related set of assumptions for each hypothetical stress scenario.

Our Hypothetical Scenarios

Hypothetical scenario 1	Hypothetical scenario 2
Under this hypothetical scenario, we assume that 25% of total foreign interbank deposits and 40% of foreign customer deposits would leave the GCC countries. Our assumption is underpinned by our view that the impact would be about 1.5x that observed during the boycott of Qatar (see below "What level of government support might GCC banks receive?"). We also assume in this hypothetical scenario that 30% of expat deposits would be transferred abroad--equivalent to an estimated 9% of total deposits for the UAE and Qatar and an estimated 3% of total deposits for the other countries. This ratio is lower than our assumption for nonresident customer deposits given the greater interest expatriates have in their host economies (including financial obligations and investments). Although banks in the GCC generally place most of their money with highly rated counterparties, we assume that it would not be possible for them to liquidate all assets in a timely manner and they would not be available in full to plug the flight of liabilities. Therefore we apply a 5% haircut on interbank deposits and 10% haircut on investment portfolios. We also assume in this hypothetical scenario that only 5% of the lending book to nonresident clients matures and is not renewed.	Under this hypothetical scenario, we assume 2.5x the magnitude of the Qatar boycott, or outflows of 45% of interbank deposits and 70% of foreign customer deposits. For expat deposits, we assume that 70% would be transferred abroad--equivalent to an estimated 21% of total deposits for the UAE and Qatar and an estimated 7% of total deposits for the other countries. We believe that, under this hypothetical scenario, expats would consider their options and prepare for a longer absence from the region. Furthermore, we assume that 10% of other foreign funding (mostly bonds and other long-term instruments) matures and is not renewed. Although banks in the GCC generally place most of their money with highly rated counterparties, we assume a 10% haircut on interbank deposits and a 20% haircut on investment portfolios under this hypothetical scenario. We assume no additional repayment from foreign lending.

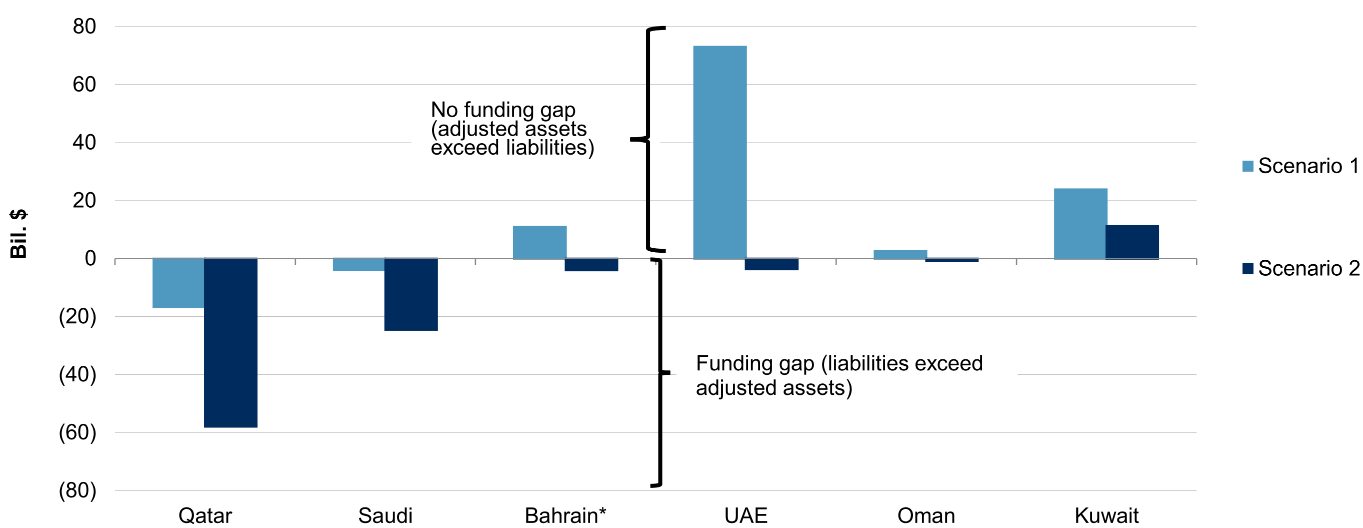
Hypothetical scenario 2 would see all systems aside from Kuwait require government or central bank support

Under the first hypothetical scenario, we would expect that most GCC countries would display strong resilience and would be able to finance outflows using their own internal sources or by liquidating their own external assets. We estimate Qatari and Saudi banks would require $17 billion (9% of GDP) and $4 billion (0.5% of GDP) of funding support from their governments respectively (see chart 3). Qatar's position is explained by the substantial net external liabilities of its banks. In Saudi Arabia's case, the estimated funding support is due to its large local deposit base, on which our estimates of expatriate deposit withdrawals are applied. The UAE displays a comfortable surplus underpinned by the conservative management of external debt.

Under our second hypothetical scenario, which we view as highly unlikely to occur, all systems aside from Kuwait would have a funding gap and would require government or central bank support. Qatar would require almost $59 billion (30% of GDP), Bahrain $4 billion (10% of GDP), and Saudi Arabia almost $25 billion (3% of GDP), while the other countries' funding gaps would be smaller.

Chart 3

Qatar And Saudi Would See The Highest Nominal Hypothetical Stress Funding Gaps



*Bahrain test conducted on the retail banking system only. GCC--Gulf Cooperation Council.
Source: S&P Global Ratings calculations.
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We note that there are many variables to consider when trying to gauge the effect of a confidence shock, depending on individual views of how tensions might escalate. We have calculated heat maps for each GCC country, which show the potential funding gap created in each system using variable stress scenarios that depend on private sector domestic deposit withdrawals and nonresident and interbank liability withdrawals. These situations are purely hypothetical, but we think they can help investors understand the full extent of the funding shortfall in case of severe stress (see Appendix for the tables).

What level of government support might GCC banks receive?

We assess four of the six GCC governments as highly supportive of their banking systems. The ability to provide this support is underpinned by the substantial liquid assets available to GCC governments, aside from Bahrain and Oman, and their very strong track record of support in case of need. The most recent demonstration of this support was seen at the start of the Qatar boycott in 2017. This triggered outflows of $23 billion but they were more than offset by an injection of $43 billion (22% of GDP), by the government, related entities, and the Qatar Central Bank. Foreign deposits have since returned to pre-boycott levels.

How would the support for banking systems affect sovereigns?

Table 2 shows our estimates of government liquid assets that could be deployed to support banks in GCC countries. We also consider that foreign exchange reserves could be used to support banks and offset the withdrawal of external liabilities, as was the case in Qatar during the 2017 boycott. We estimate that authorities possess sufficient resources to support their banks under our hypothetical stress scenarios. However, deploying these assets would be a drain on government assets and could weigh on our sovereign fiscal and external assessments, putting downward pressure on the ratings. Governments could also move to shore up confidence in banks by deploying funds in addition to any potential shortfall, further pressuring liquid assets. Bahraini and Qatari banking systems have the largest potential funding requirements as a proportion of GDP under hypothetical scenario 2.

Table 2

GCC Government Support Of Banks/GDP %

	Kuwait	UAE*	Qatar	Saudi Arabia	Oman	Bahrain
Govt. liquid asset estimates	478	145	139	88	53	20
Scenario 1 funding gap (where negative)	0	0	(9)	(1)	0	0
Scenario 2 funding gap	0	(1)	(30)	(3)	(1)	(10)
Govt. liquid assets after Scenario 2	478	144	109	85	52	10

*Includes S&P Global Ratings' estimates of Abu Dhabi's government liquid assets. GCC--Gulf Cooperation Council. Source: S&P Global Ratings.

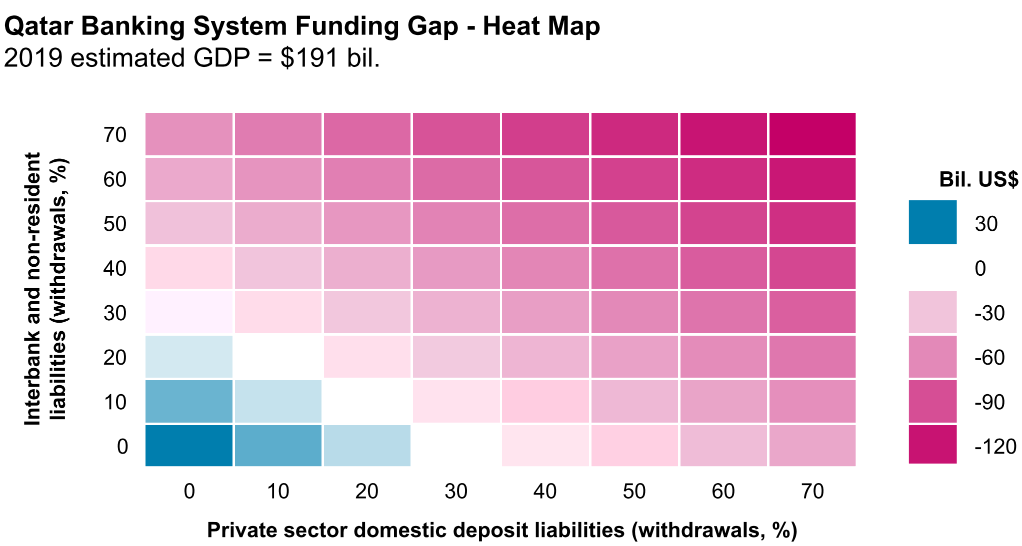
Appendix

Hypothetical scenario 1: Unlikely at this stage	Hypothetical scenario 2: Highly unlikely at this stage
Under hypothetical scenario 1, we envision credible threats to block the strait or even a blockage put in place for a few days. As in the past, when closure threats were made by Iran, we believe international pressure would quickly be brought to bear or, alternatively, a military skirmish. Either way, due to the strait's international significance, we would expect the threats to subside and any blockage to be resolved relatively quickly. The Strait of Hormuz is a critical shipping route for almost one-third of the world's seaborne crude oil supplies. The vast majority of hydrocarbon exports from Saudi Arabia, Qatar (LNG), Abu Dhabi, Kuwait, Iraq, and Bahrain pass through the strait. Oman, being outside the strait, would not have its non-Gulf exports physically blocked by a closure.	Under hypothetical scenario 2, we envision the Strait of Hormuz being closed for an extended period.

Heat maps

We base the following heat maps on the same assumptions as in hypothetical scenario 1. This means we assume a 5% haircut on interbank assets, a 10% haircut on external securities, and give credit for 5% of external loans.

Chart 4



Source: S&P Global Ratings.

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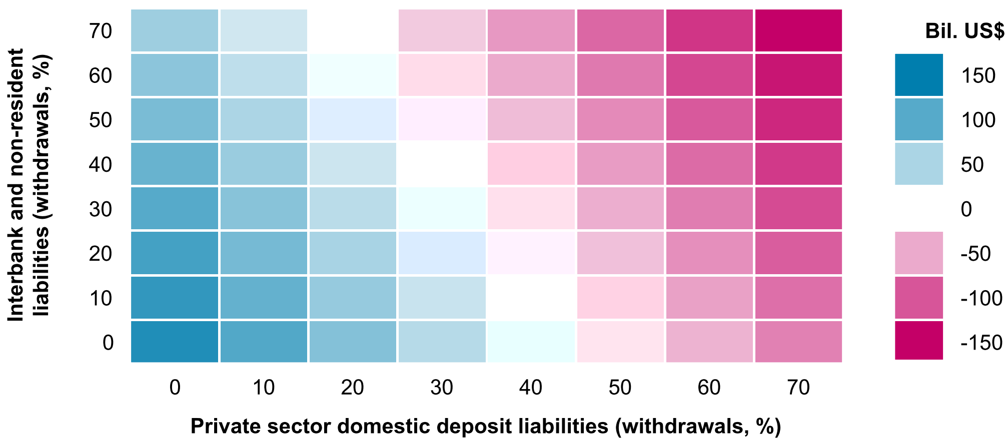
Chart 5

UAE Banking System Funding Gap - Heat Map
2019 estimated GDP = $407 bil.



Source: S&P Global Ratings.
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Chart 6

Saudi Arabia Banking System Funding Gap - Heat Map
2019 estimated GDP = $750 bil.

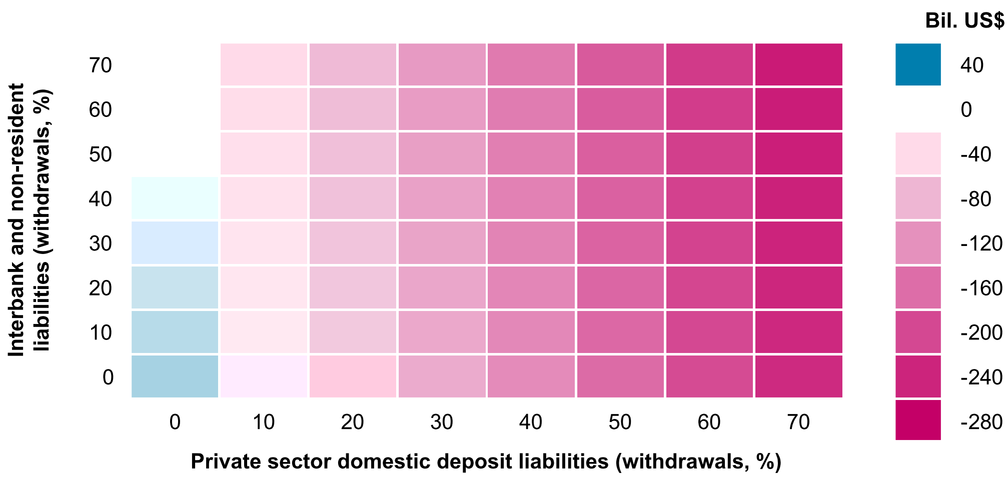

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Chart 7

Kuwait Banking System Funding Gap - Heat Map
2019 estimated GDP = $129 bil.

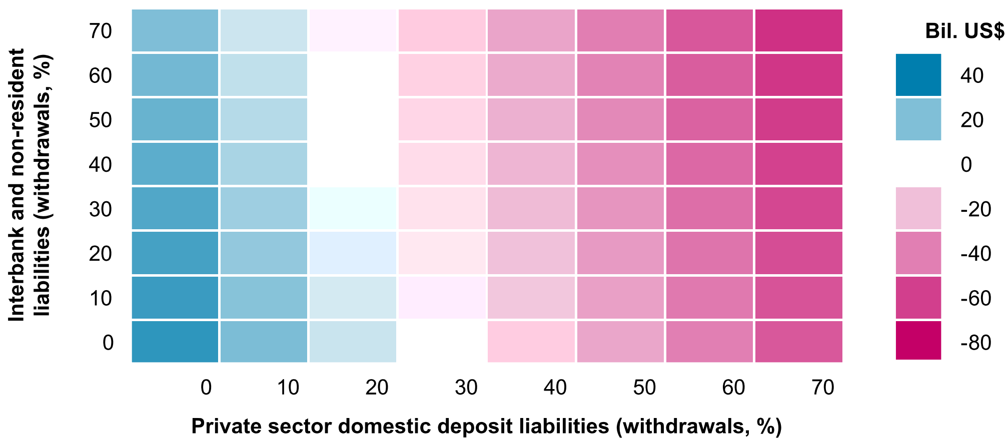

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Chart 8

Oman Banking System Funding Gap - Heat Map
2019 estimated GDP = $78 bil.

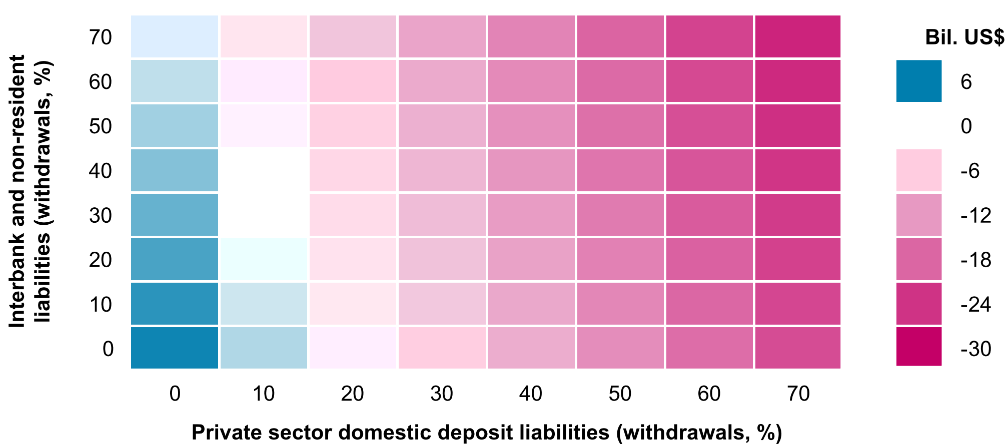

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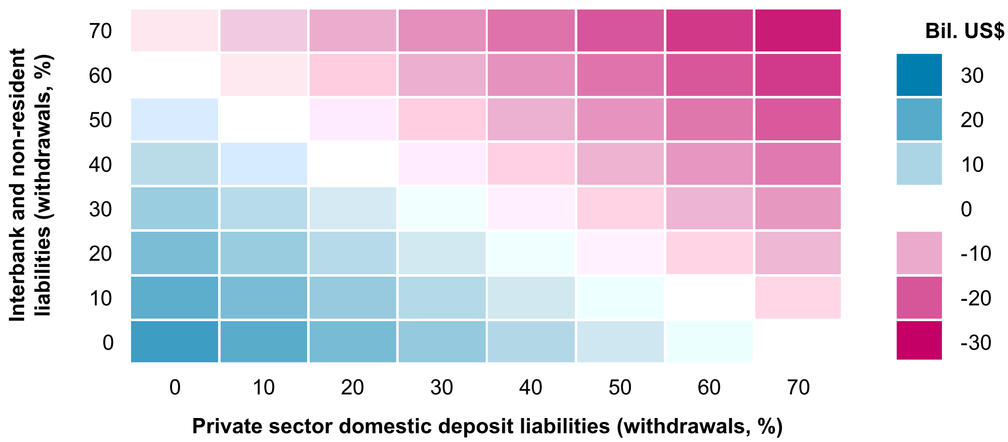
Chart 9

Bahrain Banking System Funding Gap - Heat Map
2019 estimated GDP = $40 bil.



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Related Research

- Credit FAQ: How U.S.-Iran Tensions Might Affect Gulf Sovereign Ratings, June 11, 2019
- Banking Industry Country Risk Assessment: Qatar, April 16, 2019
- Banking Industry Country Risk Assessment: Oman, Feb. 19, 2019
- Banking Industry Country Risk Assessment: Kuwait, Dec. 20, 2018
- Banking Industry Country Risk Assessment: Bahrain, Oct. 17, 2018
- Government Liquid Assets And Sovereign Ratings: Size Matters, Aug. 27, 2018
- Banking Industry Country Risk Assessment: Saudi Arabia, July 11, 2018
- Credit FAQ: How Recent Developments In Qatar Affect The Banking System, June 9, 2017
- Research Update: Qatar Long-Term Rating Lowered To 'AA-'; On Watch Negative After Six Arab Countries Sever Ties, June 7, 2017

This report does not constitute a rating action.

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