

# Analysis of UAE Banking Sector

Ayush Kabra<sup>1</sup>, Maneesha Singh<sup>2</sup>

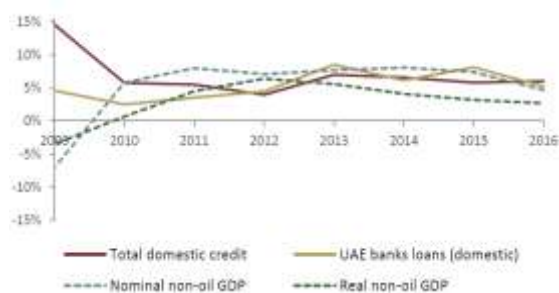
Birla Institute of Science and Technology Dubai Campus, Academic city, Dubai

**Abstract:** The paper aims to give an overview of the banking sector of the United Arab Emirates. The paper aims to give information about the importance of the sector, the major changes that have been made and are planned for future by the Central Bank of UAE, the performance and efficiency of banks in the sector, the operational differences between the conventional and Islamic banks. We also aim to predict a future road for the banking sector, which is the largest in the GCC.

**Keywords:** CAR, ROE, Quarter, GDP

## 1. Macroeconomics of the UAE

The UAE has proven crude oil reserves of 98 billion dollars or about 10% of the total world's reserves. The UAE currently is the seventh largest petroleum producer in the world and the hydrocarbon exports are expected to generate revenue of \$65 billion, about 20% of all the export revenue. The petroleum revenues, which amounted to \$129 billion, have fallen since 2013 due to the decline in oil prices.



In addition to the substantial hydrocarbon economy, the nation is getting to be plainly one of the world's most critical monetary focus and a noteworthy exchanging focus in the Middle East. Interests in non-energy sectors, for example, infrastructure and innovation, keep on providing the UAE with long haul protection against oil value decays and worldwide monetary stagnation. IMF information demonstrates the UAE's genuine total national output impeded from 4.7% development in 2013 to 4.0% out of 2015 because of determinedly low oil costs. The IMF anticipates that UAE's financial development will be to a great extent restricted to 3.5% over the medium term.

As a developing economy, the banking sector makes up the core of the financial system in the UAE. They operate under the rules and regulations of the UAE Central Bank. Under the Federal Law 10, the Central Bank of UAE was established and then it took over the responsibilities of overseeing the financial system of the country.

The non-oil GDP grew 2.7% in 2016. After a negative price correction during the previous two years, the real estate market started to stabilize in 2016. Residential real estate prices remained somewhat unchanged in Dubai and declined a bit in Abu Dhabi. Furthermore, bank real estate lending increased during 2016 for both residential and commercial

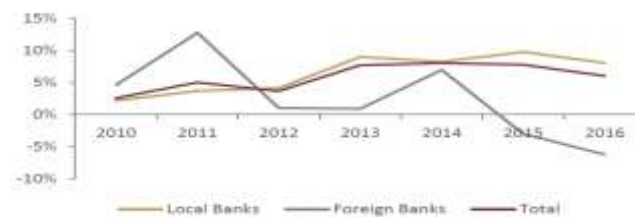
properties, after falling in 2014 and growing in 2015, suggesting a reversal in the real estate market. Financial conditions of the household sector remained stable during 2016. There was a 8% increase in household deposits, while the growth of household loans was 5%. UAE banks' lending to the corporate sector expanded at a stable rate of 6.5% in 2016, while corporate deposits increased by only 0.9%, largely reflecting the decline in deposits from government related entities.

## 2. Macro financial conditions in the UAE

Macro financial conditions in the UAE – measured by the Financial Stability Trend Index (FSTI) – improved during 2016 compared to the previous year, supported by the increase in the oil price, stabilization of the real estate market, and lower market volatility and credit spreads. The improved FSTI also benefited from stronger liquidity conditions and capital adequacy of the UAE banking sector. There are a total 51 banks in the UAE, 28 of which are foreign banks and 23 are national banks.

The banking sector of the UAE is still characterized by a predominant ownership of government and domestic shareholders.

The gross bank assets show a y-o-y growth of 4% while the total investments by banks show a y-o-y growth of 9.3%, in which investment in equities decreased while more investment was made in Debt securities. Bank deposits show a growth of around \$3bn in the national banks while the deposits in the foreign banks showed a mere decrease.



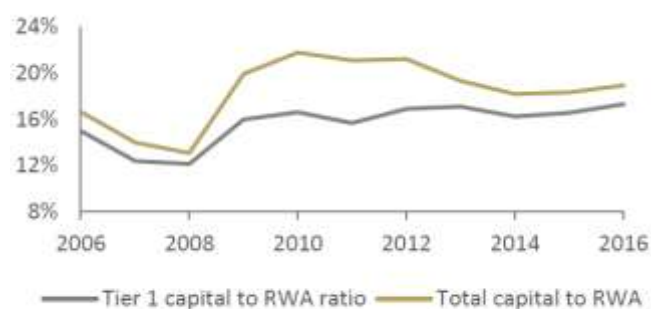
The CAR of the banking sector of UAE increased even more during 2016 to 18.9%. The resilience of the banking sector was also reinforced by strong liquid asset buffers with an eligible liquidity asset ratio around 6 percentage points above the regulatory requirement of Basel III. Decrease in net profits of UAE banks was a rise in provisioning rates due to deteriorating asset quality.

Nonetheless, the UAE banking sector profitability remained stable with the ROE at 10.4%. The profitability of individual banks, however, is highly dependent on the size of the bank, with lower profitability and losses disproportionately affecting the small banks.

UAE banks remain well capitalized with the total capital adequacy ratio rising by 0.6 percentage points to 18.9% and a Tier 1 ratio rising by 0.7 percentage points to 17.3% during 2016.

Islamic bank assets grew by 8.9% in 2016 to 505 billion aed. Assets of the Islamic banks constituted 19.3% of the banking system assets and 21.3% of lending in 2016.

Deposits rose in 2016 by 4.8% (2015: 16.6%) to 349 billion and accounted for 22.3% (2015: 22.6%) of the banking deposits.



The CAR of Islamic banks increased to 17.1% at the end of 2016 and the Tier-1 capital ratio increased to 16.5% in 2016. The return on assets for Islamic banks decreased to 1.4% in 2016(2015: 1.5%), while the return on equity decreased from 10.9% in 2016 (2015:14%). At the end of 2016, there were two small banks with observed capital ratios below 14%. All the big and medium-sized banks had capital adequacy ratios above 15% indicating substantial loss absorption capacity.

### 3. Developments in the UAE

In late 2013 an announcement was made and since then, there has been an excitement widespread in the UAE. The fact is this event will have certain impact on various sectors of UAE economy such as, Real Estate, Tourism, Hospitality, Finance, Banking and Insurance. This will be the first time that the World Expo is staged in the Middle East and North Africa (MENA). Dubai's World Expo is held under the theme of Connecting Minds, Creating the Future, echoing the powerful spirit of partnership and co-operation that has driven the UAE's success in pioneering new paths of development and innovation.

The CAR for the Banking sector before and after the event is enough evidence. The banking sector is increasing continuously after and before the announcement of the event and even after. The growth of this sector very constant and shows upward trend.

The 'Gulf Cooperation Council' (GCC) states are preparing for the introduction of a 'Value Added Tax' (VAT) in the region starting from 1<sup>st</sup> January 2018. The proposed tax will

be on most goods and services with a limited number of specifically exempt or zero rated supplies.

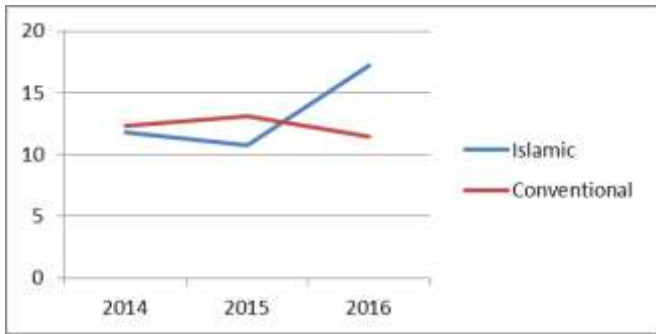
Financial Stability Trend Index- Financial stability is said to be a steady state in which the financial system, performs its functions, such as allocating resources, spreading risk as well as settling payments, and is able to continue to do so in the event of shocks, stress situations and periods of profound structural changes, efficiently. The index improved during 2016 compared to the previous year, supported by the increase in the oil price, stabilization of the real estate market, and lower market volatility and credit spreads. The improved FSTI also benefited from stronger liquidity conditions and capital adequacy of the UAE banking sector. External exposure of UAE national banks increased in 2016 but remained at moderate levels of around 20% of their total balance sheet size. The growth of external assets was driven by non-resident loans and investment in financial securities. External liabilities increased as the national banks attracted more non-resident deposits and capital market funding. Interbank cross-border exposures decreased in 2016. The Central Bank published a Basel III compliant Capital Adequacy Regulation, which is effective from February 1, 2017, including a framework for Domestic Systemically Important Banks, which will further enhance financial stability in the UAE. The Central Bank will continue in its diligent approach to bank regulation and supervision in order to ensure a highly resilient banking system.

### 4. Research Methodology

The data was collected from banks for the past 3 years that is for the years 2014, 2014 and 2016 and were compared. The analysis (empirical) in this project is based on a panel data comprising of a sample of 7 banks, out of the 51 banks out of which 23 are national and 28 are Islamic banks. The above stated time period of research will help in knowing the trend of the industry and help in shaping the forward expectations of the people. The sample was limited by availability of data on relevant information on banks especially variables that are used to assess banks soundness (such as capital adequacy ratio, non-performing loans to total gross loans and return on assets). As for the bank-specific characteristics, we make use of data obtained from these banks' annual financial results such as total assets, deposits, gross loans, interest margin, nonperforming loan and bank's exposure to real estate. In addition, to measure banks financial soundness, we use the same financial ratio calculations as capital adequacy ratio, the return on equity (ROE) and return on assets (ROA) to measure bank profitability.

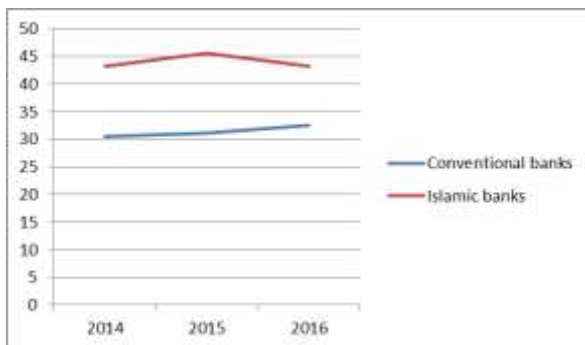
### 5. Research and Analysis

**Return on Equity (ROE)-** ROE is a true bottom-line profitability metric, comparing the profit available to shareholders to the capital provided or owned by shareholders. In a conceptual sense, equity investors care most about the profitability measure.



From the graph it is evident that conventional banks just had a momentary upper hand at the ratio but soon Islamic Banks took over and their returns on equity have been increasing ever since this shows that Islamic banks are in a better position and will be able to raise money more easily for their growth. Conventional banks had an average ROE of 12.31%, 13.1% and 11.46% in 2014, 2015 and 2016 respectively while the Islamic banks had an average ROE of 11.8%, 10.8% and 17.2% in 2014, 2015 and 2016 respectively.

The Cost Income ratio- Cost to income ratio is an important parameter to determine the profitability of the bank. The ratio gives a perspective on how efficiently the bank is running. The more less is the ratio, the more profitable the bank is.

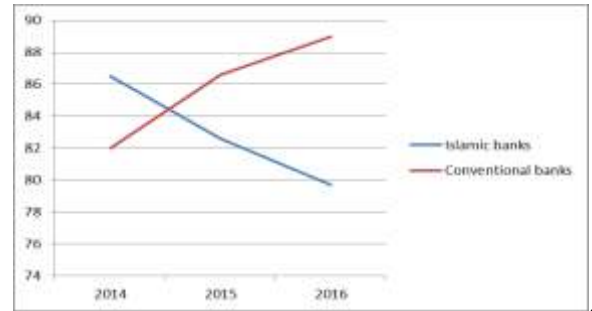


The graph clearly shows that Islamic banks have had a much larger cost to income ratio than the conventional banks. It means that the costs are rising at a higher rate than income, which suggests that the conventional banks lost significant business during the period and were struggling hard to meet their operating costs with their reduced income. The Cost income ratio of Islamic banks was relatively stable which shows that they were in a better position to handle any crisis and hence more reliable.

Conventional banks had an average Cost to income percentage of 30.5%, 31.2% and 32.5% in 2014, 2015 and 2016 respectively while the Islamic banks had an average ROE of 43.3%, 45.6% and 43.3% in 2014, 2015 and 2016 respectively

**Loan to deposit ratio (LDR)-** The loan-to-deposit ratio (LDR) is a commonly used statistic for assessing a bank's liquidity by dividing the bank's total loans by its total deposits. This number is expressed as a percentage. If the ratio is lower than one, the bank relied on its own deposits to make loans to its customers, without any outside borrowing. If on the other hand, the ratio is greater than one,

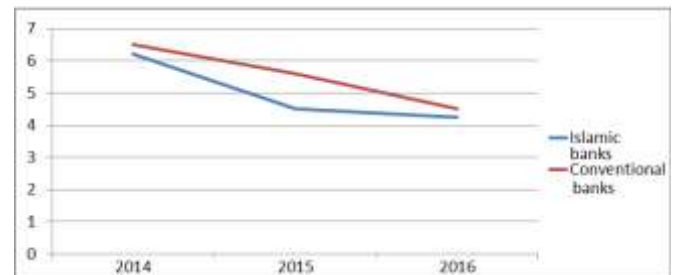
the bank borrowed money which it re-loaned at higher rates, rather than relying entirely on its own deposits.



The graph shows that midway through 2014, conventional banks overtook the Islamic banks due to higher loan to deposit ratio and then the ratio for conventional banks just grew while for the Islamic banks, it's been quite the opposite. Among the conventional banks, Emirates NBD had the highest loan to deposit ratio at 95.24% in 2014, 94.4% in 2015 and 93.2% in 2016.

Conventional banks had an average LDR of 82%, 86.6% and 89% in 2014, 2015 and 2016 respectively while the Islamic banks had an average LDR of 86.5%, 82.6% and 79.7% in 2014, 2015 and 2016 respectively.

**Non-Performing loans-** Non-performing loan (NPL) is the sum of borrowed money upon which the debtor has not made his scheduled payments for at least 90 days. A nonperforming loan is either in default or close to being in default.



The graph shows that conventional banks have always had greater non-performing loans as compared to their Islamic counterparts.

The UAE Banks' nonperforming loan to total gross loans (%) remains at 5.3% as compared to the world average of 3.925%.

Emirates NBD bank had recorded the highest Non-performing Loans ratio in 2016 at 6.4% among its peers for all the three years. It had made a continued effort to lower it down since.

Conventional banks had an average NPL of 6.5%, 5.5% and 4.5% in 2014, 2015 and 2016 respectively while the Islamic banks had an average NPL of 6.2%, 4.5% and 4.25% in 2014, 2015 and 2016 respectively.

**Table 1 - Monetary Developments in the UAE**  
 (In Billions Dirhams - End of Period)

	2016								2017						
	First Quarter		Second Quarter		Third Quarter		Fourth Quarter		First Quarter		Second Quarter		Third Quarter*		
	Amount	Quarterly Change (%)	Amount	Quarterly Change (%)	Amount	Quarterly Change (%)	Amount	Quarterly Change (%)	Amount	Quarterly Change (%)	Amount	Quarterly Change (%)	Amount	Change (%)	
														Quarterly	Annual
<b>Money Supply (M<sub>1</sub>)</b>	490.3	7.3%	481.0	-1.9%	472.5	-1.8%	474.1	0.3%	504.4	6.4%	507.1	0.5%	488.9	-3.6%	3.5%
<b>Money Supply (M<sub>2</sub>)</b>	1218.4	2.7%	1180.4	-3.1%	1200.2	1.7%	1225.5	2.1%	1272.2	3.8%	1267.1	-0.4%	1257.2	-0.8%	4.7%
<b>Money Supply (M<sub>3</sub>)</b>	1373.8	2.3%	1364.8	-0.7%	1368.6	0.3%	1411.4	3.1%	1465.8	3.9%	1463.1	-0.2%	1458.0	-0.3%	6.5%

*Source- Data received from banks operating in the UAE*

**M<sub>1</sub>** = Currency in Circulation Outside Banks (Currency Issued - Cash at banks) + Monetary Deposits  
**M<sub>2</sub>** = M<sub>1</sub> + Quasi-Monetary Deposits  
**M<sub>3</sub>** = M<sub>2</sub> + Government Deposits

Money Supply (M<sub>1</sub>), which includes the Currency in Circulation outside Banks (Currency Issued - Cash at banks) in addition to the monetary Deposits have decreased by 3.6% during Q3 of 2017, compared to a 1.8% reduction during the same period last year.

On a year-on-year basis, there was an increase of 3.5% M<sub>1</sub>, reaching AED 488.9 billion. Money Supply M<sub>2</sub> (M<sub>1</sub> in addition to the quasi monetary deposits (Resident Time and Savings Deposits in Dirham plus Resident Deposits in Foreign Currencies)), decreased by 0.8% during the third quarter of 2017 while there was an increase of 1.7% during the third quarter in 2016

On a year-on-year basis, there was a 4.7% increase in M<sub>2</sub>, reaching AED 1257.2 billion. Consequently, Money Supply M<sub>3</sub> (M<sub>2</sub> plus government deposits at banks and at the Central Bank) also decreased by 0.3% during the third quarter of 2017 as compared.

M<sub>3</sub>, reached AED 1458 billion. Generally, M<sub>2</sub>, the median monetary supply is considered the best indicator for the availability of liquidity in an economy. It comprises of the currency in circulation outside banks, in addition to various deposits of all the resident sectors except the government sector in the UAE. Statistics show that at the end of the Q3 of 2017, M<sub>2</sub> increased considerably in comparison to its value at the end of Q3 of 2016.

At the end of the third quarter of 2017 total assets of banks operating in the UAE decreased by 0.4%, reaching AED 2643.2 billion. During the period between September 2016 and September 2017, the total assets of banks operating in the UAE increased by 3.7%.

By the end of the third quarter of 2017, total deposits customers with banks operating in the UAE reached AED 1595.8 billion. Resident deposits decreased by 0.1%, reaching AED 1407.5 billion at the end of the third quarter of

2017, compared to an increase of 0.4% at the end of the third quarter of 2016 reaching AED 1321.8 billion. Aggregate Capital and Reserves of banks operating in the UAE increased by 8.1%, reaching to AED 327.1 billion at the end of the third quarter of 2017.

The total Capital Adequacy Ratios increased during 2017, remaining well above the 12% Capital Adequacy and 8% Tier1 ratios. Capital adequacy ratios measure the amount of a bank's capital expressed as a percentage of its risk weighted credit exposures. A high capital adequacy ratio provides protection to depositors and promotes the stability and efficiency of the financial system of an economy.

## 6. Conclusion

Economic growth is speculated to strengthen in the years to come with firming oil prices and other growth indicators. Non-oil growth is projected to rise to 3.3% in 2017 from 2.7% in 2016, reflecting increased domestic public investment and a pickup in global trade.

According to the inflation statistics from the IMF, consumer price inflation in the UAE lowered to 1.8 per cent from 4.1 per cent in 2015, showing lesser domestic demand and decreasing rents. Despite the introduction of VAT the IMF projects an annual average inflation of 2.9 per cent in 2018 and 2.5 per cent in 2019.

The UAE's banking sector outlook remains stable reflecting economic resilience, strong capitalization, stable funding and liquidity conditions.

Non-oil activity including government spending in Dubai and robust economic activity in trade and financial services is expected to support growth in the UAE economy. The infrastructure sector is seen to be well giving in for the growth. Non-oil gross domestic product cooled during 2016, largely reflecting constrained public-sector spending. Weaker credit growth in 2017 shows slower economic growth and

business activity in response to the limited public spending, together with a technical reduction in the system balance sheet following the merger between First Gulf Bank and National Bank of Abu Dhabi, concluded in March 2017 to create First Abu Dhabi Bank (FAB). Given FAB's large market share (23.5 per cent in terms of assets in June, the adjustment in its consolidated size impacts system growth in 2017. Capital levels will remain strong over the next 12 to 18 months for the UAE's banks, with system-wide tangible common equity at between 14 per cent and 16 per cent of risk-weighted assets. The UAE banking sector is expected to be primarily deposit-funded, with a fair recourse to more volatile market funding. Stable oil prices and international bond issuances are seen to continue to support funding and liquidity conditions in the country.

## 7. Future Scope

Only 7 banks had been taken for analysis. The research could be more statically stable by increasing the sample size of the data collected.

Moreover, elementary softwares were used for analysis, while the data could be interpreted differently and efficiently by using more sophisticated tools.

The research time span could also be increased, leading to a better forecast.

Unfortunately, due to time and resource constrains the above-mentioned reasons couldn't be rectified.

## References

- [1] Financial Stability Report 2016, Central Bank of the UAE
- [2] UAE Monetary Developments, Central Bank of the UAE
- [3] M. Kabir Hassan, Abdel-Hameed M. Bashir," Determinants of Islamic Banking Profitability"

## Author Profile



**Ayush Kabra** is a third year undergraduate of Mechanical Engineering in the Bits Pilani Dubai Campus. He has a strong interest in economics and financial markets.