الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency

ECONOMIC & BANKING SECTOR OVERVIEW

United Arab Emirates

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ECONOMIC OVERVIEW

UAE is the second largest Gulf Cooperation Council ("GCC") state[1] in terms of size of the economy. It is a federation of seven Emirates consisting of Dubai, Abu Dhabi, Ajman, Fujairah, Ras al-Khaimah, Sharjah and Umm al-Quwain. With a combined population of about 9m in 2017, UAE's GDP per capita of over US$40,000, positions it as a 'high income' earning country as per the World Bank.

Table 1: Key Economic Indicators - UAE					
Figures as stated	**2015**	**2016**	**2017E**	**2018P**	**2019P**
Population (m)	9.1	9.1	9.1	N.A.	N.A.
Nominal GDP (AED'b)	1,315	1,311	1,405	1,511*	1,570*
Real GDP Growth (%)	3.7	2.7	0.8	2.7	3.1
Hydrocarbon	5.4	2.6	-3.0	-0.3	0.1
Non-hydrocarbon	3.0	2.8	2.5	3.9	4.3
CPI Inflation (%)	4.1	1.6	2.0	3.5	2.5
Current Account % of GDP	4.9	3.7	7.2	5.3	5.1
Fiscal Balance % of GDP	-3.4	-2.5	-1.8	-1.4	-0.8
Total Gross External Debt % of GDP	63.3	66.7	60.3	56.0	54.6

UAE has been reliant on the oil and gas ("O&G") industry historically, which has contributed on an average of about 30% of the overall GDP over 2010-2017 (2017E: 22.3% of GDP), albeit the contribution has been reducing over the last couple of years on account of the economic diversification drive. This is also explained by the fact that UAE holds about 1% of the global O&G proven reserves of 2.8 trillion boe[2] and contributes about 3% of the global O&G production. At the same time, in the downstream O&G sector, UAE's refining capacity stands at about 1.2% of the global capacity at 2017. As such, the downward trajectory of oil prices since 2014 translated into UAE's economic growth receding in line with other O&G exporting countries. Nonetheless, crude prices started moderating since last year, averaging at about US$54.2/bbl[3] in 2017 (2016: US$43.5/bbl), and most recently in 2018 the price levels have surpassed UAE's fiscal break-even price[4] of about US$70/bbl. Similarly, improvement in natural gas prices was also observed in 2017 to US$2.9/mmbtu[5] from US$2.5/mmbtu in 2016.

It may be noteworthy that despite the improvement in oil prices, UAE's real GDP further slowed down to 0.8% in 2017 from 2.7% in 2016 as per government estimates. Lower oil production to comply with OPEC agreement led to real oil GDP to contract by about 3% during the year. This contraction was somewhat contained by the 2.5% growth (albeit slower than 2016 at 2.8%) in non-hydrocarbon sector's resilience on account of UAE's fiscal consolidation and diversification measures that led to employment expansion and higher government spending. General economic improvement in the country's main trading partners also supported UAE's current account balance. For 2018, continuing improvement in O&G prices along with growth in non-hydrocarbon sector activities is expected to provide impetus to growth estimated at 2.7% for the current year.

Each of the Emirates has its own fiscal framework. Post the implementation of fiscal consolidation in 2015 which resulted in government spending cuts, the government adopted an expansionary strategy in 2016 as the non-oil revenue contribution improved. Further, in 2017, the government again switched back to some fiscal tightening despite the uptick in oil prices. At the same time, social safety net measures including social benefits, subsidies and wages were raised from the prior year. Subsidies also included surge in government's transfers to GREs. The country has financed the deficit through withdrawals from sovereign wealth fund, bank borrowings and accessing international capital markets. With the implementation of VAT starting this year, the revenue base is expected to further widen, which may further contribute to reducing the fiscal

[1] Lagging Saudi Arabia at US$683.8b and leading Qatar at US$166.3b at 2017 (Source: IMF – Regional Economic Outlook, May 2018)
[2] Source: BP Statistical Review of World Energy 2018, considering total oil and natural gas proved reserves; boe: barrels of oil equivalent
[3] bbl: barrel; Source: EIA – Brent spot price
[4] As per IMF statistics, UAE's fiscal break-even oil price for 2018 and 2019 is US$71.5/bbl and US$64.8/bbl, respectively
[5] mmbtu: million British thermal units; Source: EIA - Henry Hub natural gas spot price

imbalance over the coming periods.

Inflation eased off during 2016 in the UAE; however there was a slight uptick in average CPI inflation to about 2% in 2017 from ~1.6% in 2016, on account of implementation of excise tax on beverages and tobacco, imported inflation and recovery in domestic demand. Further, with the implementation of VAT @ 5% starting this year, average CPI rose to 4.2% in Q1'18 compared to 2.7% in the corresponding prior year period. However, it should be noted that over 2016-2017, low rental and housing costs have also contributed towards the decline in the inflationary pressure in the country. Any reversal in the rental and housing cost trend may further add to the inflation going forward.

Liquidity in the economy has generally improved over the last two years with growth in money supply. This is also evidenced in the narrowing money market spreads, AED-US$ forward points and credit market spreads, implying restored investor confidence in UAE's economy and financial system. Owing to the dollar peg, CBUAE's monetary policy decisions are closely aligned with the direction of Fed rate in the U.S. As such, the central bank's benchmark interest rate on issuance of certificate of deposits ("CDs") has been raised thrice[6] in 2017 and twice so far in 2018[7], each by 25bps. In conjunction, the central bank has also raised the repo rate applicable to banks' borrowing of short-term liquidity from the central bank against their holdings of CDs to 2.25% at June 2018 from 1.75% at end-2017. Concurrently, the Emirates interbank offer rate ("EIBOR") has also shown an upward trend, and most recent 3-month EIBOR stood at 2.57% at July 2018. Over the coming quarters, further anticipated Fed rate increases may likely put pressure on the banking system spreads.

BANKING SECTOR OVERVIEW:

The banking system in UAE comprised 61 operating banks at March 2018, with 22 national, 27 foreign and 12 wholesale banks. Collectively, the banking system manages a delivery network of 842 branches and 5,274 ATMs in the country. [9]Within the industry, there are about 8 Islamic banks and 26 Islamic windows set up by conventional banks, the assets[10] of which altogether account for about 21% of aggregate banking assets at end-Q1'18. In the overall context, the 3 largest banks represented about 48%[11] of the total banking sector assets at end-2017. Moreover, aggregate assets of these large banks represented about 92% of the nominal GDP and 113% of the nominal non-oil GDP at 2017[12], indicating both concentration and systemic risk in the country in the event of any stress in the financial sector.

Table 2: UAE – Overall Banking & Islamic Banking Indicators

Amounts in AED'b, unless otherwise stated	**Overall Banking**			**IB**		
	2016	**2017**	**Q1'18**	**2016**	**2017**	**Q1'18**
Gross Assets	2,593	2,694	2,718	506	550	559
Gross Financings	1,554	1,580	1,608	335	354	358
Deposits	1,563	1,627	1,662	349	384	396
Eligible Liquid Assets Ratio ("ELAR") (%)[8]	16.2	18.3	17.4	16.8	20.0	20.2
NPFs Ratio (%)	6.4%	6.7%	N.A.	7.6%	6.3%	N.A.
RoA (%)	1.4%	1.5%	N.A.	1.5%	1.7%	N.A.
Total CAR (%)	18.9	18.1	17.5	17.1	16.4	15.8
Tier 1 Ratio (%)	17.3	16.6	16.0	16.5	15.3	14.6
CET 1 Capital Ratio (%)	N.A.	14.6	13.9	N.A.	11.4	10.9

(Source: CBUAE – UAE banking indicators; Financial Stability Report 2017; N.A. – not available)

[6] *March, June and December*
[7] *March and June*
[8] *As per CBUAE definition, ELAR = Total Banks' Eligible Liquid Assets (including cash, liquid assets at the Central Bank and eligible bonds or sukuk as prescribed by regulation 33/2015 & Basel Principles but excluding interbank positions) / Total Assets*
[9] *UNSTATS – Presentation on Islamic Banking in the UAE (workshop on Islamic Finance in National Accounts), Oct. 2017*
[10] *For IB*
[11] *Source: CBUAE – Financial Stability Report 2017*
[12] *CBUAE's Financial Stability Report 2017*

As UAE made efforts to diversify economically, the sector has also witnessed consolidation of 2 major banks and reduction in the physical banking channels of distribution for attaining cost efficiency. A general year-over-year ("YoY") slowdown was observed in the overall banking sector vis-à-vis assets, deposits and financings during 2017. On the other hand, growth in IB assets over 2017 and through Q1'18, was in line with the previous year, primarily driven by faster growth in deposits. CBUAE's quarterly credit sentiment surveys for 2017 and following Q1'18 indicate moderate growth in demand for corporate loans while demand for retail loans have either remained flat or weakened.

It is noteworthy that most of the increase in corporate financings was led by real estate sector, while financings to Government Related Entities ("GREs") showcased contraction during this period. As such, real estate exposure for the UAE banking sector increased to 19.9% in 2017 from 16.4% a year ago, which may be a cause of concern for the sector particularly in the light of existing oversupply, weakening demand and subdued prices.

Nonetheless, UAE banking sector remained healthy in Q1'18 with adequate capitalization and strong profitability metrics. With stable sources of funding and slower financings growth, asset allocation strategy shifted towards liquid assets in UAE. In the overall industry context, slight deterioration in asset quality was observed in 2017, while impairments remained contained in Islamic banks. At the same time, such impaired financings were adequately provided for with provisioning coverage in excess of 100%[13]. Further, the banking sector resilience was also captured in the 2017 regulatory stress test conducted by CBUAE that yielded satisfactory results.

In terms of regulatory developments, in 2017 CBUAE issued the UAE Basel III capital standard and IFRS 9 guidance note. While IFRS 9 has already been rolled out, the central bank expects to fully implement Basel III capital framework in phases until 2019. Similarly, further Basel III standards (Pillar 2 and 3) are likely in the pipeline to be published by the end of 2018. During 2016-2017, the central bank also designated 4 D-SIBs based on the criteria recommendations of Basel Committee on Banking Supervision ("BCBS"). As such, designated D-SIBs are subject to stringent capital requirements that shall be tightened over the transitional period until 2019. A snapshot of the minimum transitional arrangement in terms of minimum capital and capital buffer requirements in UAE is provided in Table 5.

Table 3: UAE – Minimum Transitional Arrangement

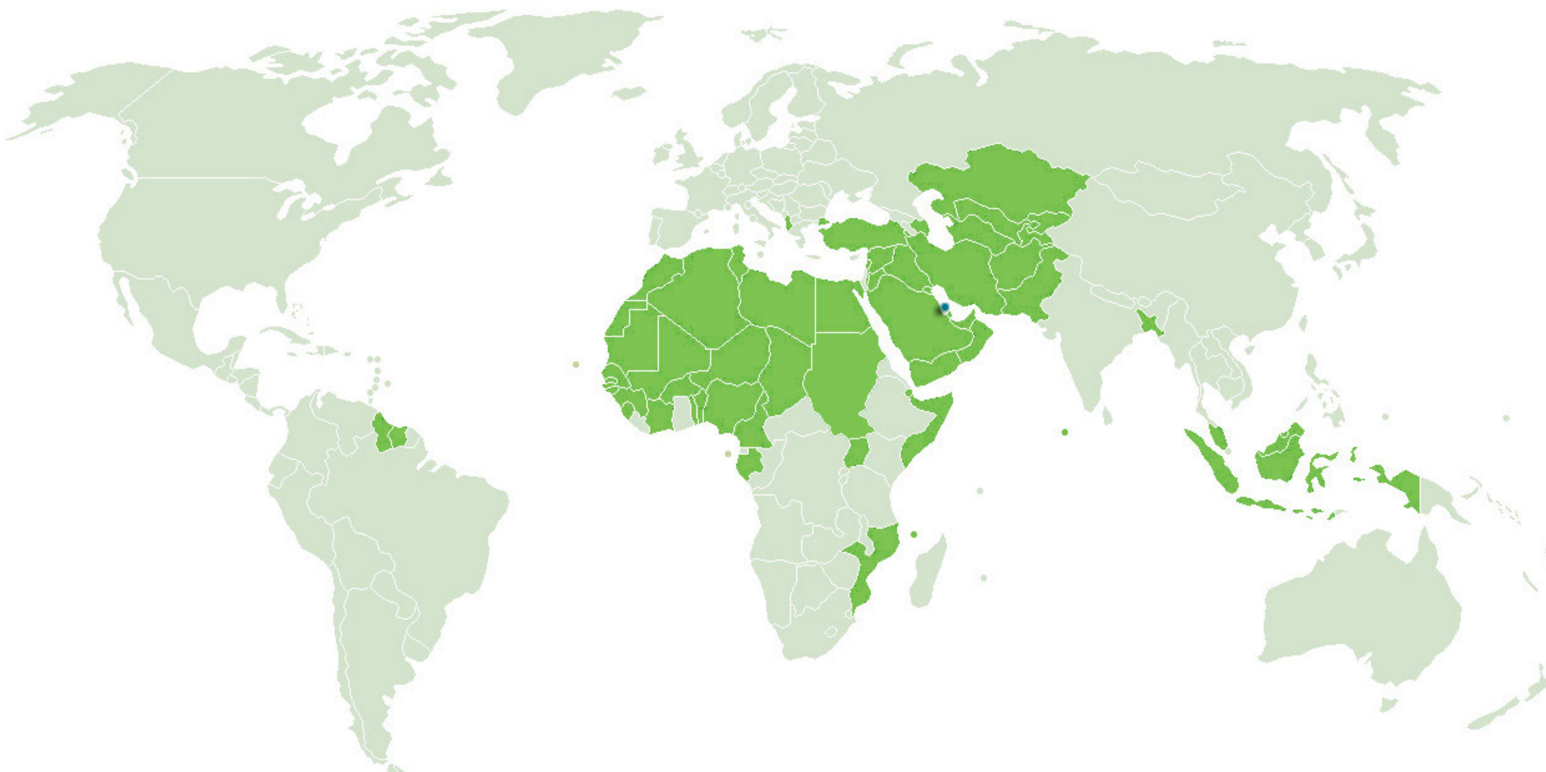
Figures as stated		2017	2018	2019
Min. CET 1 Ratio (%)		7.0	7.0	7.0
Min. Tier 1 Ratio (%)		8.5	8.5	8.5
Min. CAR (%)		10.5	10.5	10.5
Capital Conservation Buffer (%)[14]		1.25	1.875	2.5
D-SIBs Buffer (% of individual capital surcharge)	Additional CET 1 Capital			
		(50%)	(75%)	(100%)
	DIB, ADCB (bucket 1)	0.25	0.375	0.5
	ENBD, FAB (bucket 3)	0.75	1.125	*1.5*

(Source: CBUAE –Financial Stability Report 2017)

In addition, the central bank has finalized new risk management and country and transfer risk regulations during this year. Furthermore under its 5-year 2017-2021 strategy, CBUAE has also been developing macro-prudential policy framework aligned with international best practices. Other major regulatory developments were in the areas of corporate governance ("CG"), internal controls, financial reporting and external audit, outsourcing, dormant accounts, supervisory cooperation and coordination, micro and SME financings, loan-based crowd funding and Islamic finance.

The regulatory framework for IB is still evolving. Islamic banks are governed under the federal law no. 6 promulgated in 1985. Further, in 2016 the country established central Shari'a board – "Higher Shari'a Authority" to bring uniformity in IB practices with central supervision and guidance to financial institutions.

[13] *Including both specific and general provisions*
[14] *Including both specific and general provisions*



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