الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency

ECONOMIC & FINANCIAL SECTOR OVERVIEW

United Arab Emirates (UAE)

August, 2021

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FINANCIAL SECTOR OVERVIEW: UAE

United Arab Emirates ('UAE' or 'the Country') economy had been impacted from double shocks of sharply lower oil prices and lower economic and touristic activity in 2020. Consequently, real GDP contracted by 6.1% with real non-hydrocarbon GDP also declining by 6.2%. In 2020, current account surplus has decreased to AED77.1bn (2019: AED137.1bn) or 5.9% of GDP down from 8.9% in the prior year. This was in tandem with the AED 66.6bn drop in trade balance stemming from average oil prices declining by over 33%. For 2021 and 2022, CBUAE foresees real total GDP to recover, and expected to grow by 2.4% and 3.8%, respectively, and non-hydrocarbon real GDP to grow by 3.8% and 3.9%, respectively.

The UAE oil production declined by 9.1% in 2020, in line with the agreement by OPEC+ to stabilize oil prices. In Q1'21, UAE's oil production fell by 17.6% YoY, while increasing by 4.3% Q-o-Q, in line with the agreement of OPEC+. Real oil GDP is projected to contract in 2021 by 1.0%, corresponding to an average oil production of 2.75 mb/d for the year as a whole.

UAE has been executing one of the most efficient vaccination campaigns with around two thirds of total population having received double doses of vaccines as of June 2021. Given the relatively strong pace of vaccinations, better than expected oil prices, wide ranging support packages by the government and prospects of DUBAI Expo scheduled from October 2021 until April 2022, UAE shall post growth rates comfortably stronger than IMF forecast of 1.3% for the year and closer to the CBUAE forecast.

Non-hydrocarbon real GDP growth is expected to be driven by higher fiscal spending, pick up in credit and employment, relative stabilization of the real estate market with recovery in confidence and the Dubai EXPO in 2021 - 2022. Acceleration in 2022 is foreseen on grounds of continued fiscal spending and credit growth, strong improvement in employment and recovered business sentiment and the Dubai EXPO. In addition, UAE is forecasted to benefit from Qatar's hosting of FIFA 2022 World Cup as a major tourism, transit and trade hub in the region.

In March 2021, an Industrial Strategy "Operation 300bn" was launched with the aim of more than doubling the size of the sector over the next decade to AED 300bn from current levels of AED133bn. Under this initiative, Ministry of Industry and Advanced Technology will support more than 13,500 SMEs by 2031. Currently, over 33,000 industrial enterprises operate in the UAE, comprising 95% of small and medium-sized businesses. The spending on research and development in the industrial sector will increase from 1.3% of GDP to 2% over the course of years reaching AED57bn nominally in the year 2031. Additional financing will be made available to support SMEs in the industrial sector and the strategy will focus on developing new high-tech industries including biotech, meditech, pharmaceuticals, clean energy and space technology. The strategy is expected to reduce UAE's reliance on imports over time.

Real estate market continued to be under pressure but depicts initial signs of recovery in some areas. Accordingly, residential property prices in Dubai decreased on average by 5.5% Y-o-Y in Q1'21[1] and rents declined by 4.3% YoY. Therefore, implied rental yield in Dubai moved to 6.7% in Q1 2021, down from 6.9% in the previous quarter. On the other hand, the average price in the Abu Dhabi housing market increased for a third consecutive quarter in Q1 2021, denoting also the first Y-o-Y increase for more than five years of 0.9%.

As has been the case for the last two years, inflation remained in negative territory in 2020 with consumer prices declining 2.1% over a 1.9% decline in 2019. Lower CPI mainly reflects weakness in prices of rent and utilities comprising 34% weight in the consumption basket, lower oil price causing decline in fuel costs and Nominal Effective Exchange Rate appreciation of the Dirham. In Q1'21, CPI remained in the negative territory at -1.7% YoY as tradable and non-tradable inflation remained at -0.5% and -2.3%, respectively. CBUAE forecasts the average CPI inflation for 2021 to remain at about -0.3%, with negative inflation during the first half due to pressure on prices in the real estate market and a degree of uncertainty persisting in the economic environment. Meanwhile, CPI is expected to move into positive territory in H2'21.

After averaging around USD41.7 per barrel in the year 2020, crude prices are expected to rebound to average USD65.2 per barrel[2] in 2021 before dropping to its USD60.5 per barrel in 2022. Similar to other GCC countries, UAE has been taking

[1] CBUAE Q1 2021Quarterly Economic Review
[2] https://www.eia.gov/outlooks/steo/report/prices.php

steps to promote sustainable growth and reduce dependence on oil revenues.

Comprehensive support packages have been announced by the Federal Government and local governments amounting to AED27.5bn in fiscal measures. These measures include reducing various government fees and accelerating existing infrastructure projects, additional water and electricity subsidies and simplifying business procedures.

Economic activity has been gaining momentum recently as evidenced by Dubai PMI which rose to 53.5 in April 2021 from 51.0 in March and reached its highest level since November 2019. New business activity grew at the fastest rate in over a year, and the employment component of the PMI moved back into expansion territory at 50.6, although the rate of job growth was still rather muted.

Banking Sector Review

With an aggregate asset base of AED 3,188bn, the Banking System of UAE corresponds to 240% of nominal GDP; 8 of the 58 banks are Islamic Banks holding 18.9% share in total assets (2019: 18.6%). Following the recent mergers, the concentration of the UAE Banking Sector increased further with the share of largest 4 banks in terms of assets and deposits increased to 72.7% and 77.6% respectively at the end of year 2020 (2019: 75.7% and 69.4%; 2018: 60.9% and 65.3%).

Table 1: Snapshot of the UAE Banking Sector (%)[3]

Amounts in AED'bn, unless otherwise stated	Overall Banking			Islamic Banking ("IB")		
	2018	2019	2020	2018	2019	2020
Gross Assets	2,869	3,086	3,188	583	572	601
Gross Financings	1656.2	1758.6	1779.0	373.4	366.4	391.8
Deposits	1,756	1,870	1,885	402	402	410
Eligible Liquid Assets Ratio ("ELAR") (%)	17.5	18.1	17.0	19.6	19.8	19.7
Total CAR (%)	17.5	17.7	18.2	17.3	17.9	20.0
Tier 1 Ratio (%)	16.2	16.5	17.1	16.2	16.8	18.8
CET 1 Capital Ratio (%)	14.3	14.7	14.9	12.7	13.4	14.6

The Central Bank of the UAE ("CBUAE") has lowered the policy rate twice by a combined 125bps in 2020. In addition, CBUAE has announced a comprehensive package of measures amounting to AED 256bn (20% of GDP) comprising reduction in required reserves; providing zero-interest rate collateralized loans to banks; allowing banks to defer loan repayments; permitting the use of excess capital buffers; increase in LTV for first time home buyers; increasing the limit on banks' exposure to the real estate sector from 20% to 30% of risk-weighted assets, and reducing the provisioning requirements for SME credits among others.

CBUAE later extended the deadline for the forbearance measures until the end of June 2021. The Central Bank also relaxed the Net Stable Funding Ratio ("NSFR") and the Advances to Stable Resources Ratio effective through end-2021 to support the banks' lending to the economy.

In April 2021, CBUAE announced that banks will continue to be eligible to access the collateralized AED 50 bn zero-cost liquidity facility up to 30 June 2022 to provide new loans and financing to individuals, SMEs, and other private corporates affected by Covid-19 repercussions. The financing provided by the CBUAE for loan deferrals under the TESS scheme will be extended until the end of 2021. According to the Annual Report of CBUAE, the TESS (Targeted Economic Support Scheme) loan deferral program directly helped over 10,000 SMEs, 1,700 other private companies, and 310,000 individuals in the UAE.

Total assets expanded by 3.4% in the year 2020 and then retreated 0.6% in the first 4 months of the current year. Financings comprised around 56% of assets (2019: 57%) and depicted an annual growth rate of 1.2% in the year 2020, falling by 0.9% mostly reflected in foreign credits declining by 9.3%. Financings to Governments and GREs made up 26.5% of total financings of the system, slightly up from 25.2% in the previous year. Within total credits, construction and real estate sector

[3] *CBUAE 2020 Annual Report and Core Financial Soundness Indicators for March 2021*

constitute around 21% followed by 20% in personal loans for consumption. Just below 90% of total credits are extended domestically.

Credit Sentiment Survey of the (CBUAE) for Q1'21 demonstrated a positive outlook for the upcoming quarter, expecting an increase in demand for loans from both consumers and businesses. Credit standards for business and personal loans are expected to soften further relative to the March quarter.

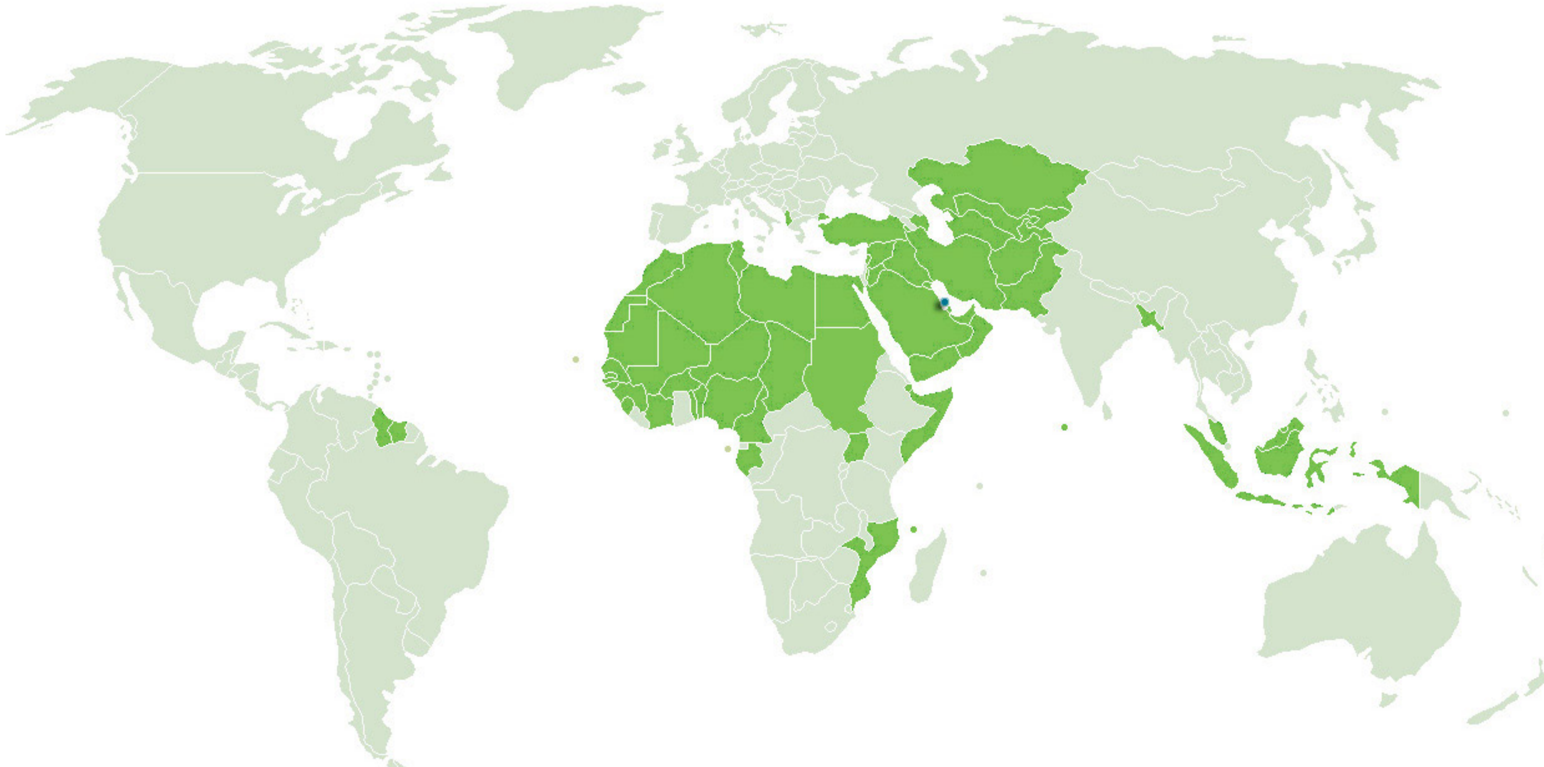
Deposit base grew 0.8% in the year 2020 to AED1.9bn as private deposits and Government-related Entity ("GRE") deposits increased 4% and 3.9% respectively whereas government deposits contracted 4.6%. High reliance on government deposits was deemed to be a risk for the sector, however, despite the sharp decline in oil prices government deposits did not decrease materially.

As of April 2021, Ytd deposits base contracted 0.4%. Government and GRE deposits constituted 27% of total deposits base versus 28.5% in April 2020. Gross advances to deposits ratio for the system remained healthy at 94.4% in December 2020. Capital buffers remained intact with total Capital Adequacy Ratio ("CAR") and Tier-1 CAR increasing to 17.9% (2019: 17.7%) and Common Equity Tier 1 ("CET1") holding steady at 14.7% (2019: 14.7%) at the end of Q1'21.

Contraction in the economic activity as well as few high-profile defaults inflated the impairments in the Sector with aggregate non-performance reaching 8.2% at the end of 2020, up from 6.5% in the previous year. The deterioration in asset quality was driven mainly by the corporate segment, within which tourism and services were hardest hit. Gross Non-Performing Financings ("NPF") during the year grew by 27.5% whereas the gross financing growth was limited to 1%. Provisioning coverage ratio for stage-3 financings inched down to 58.7% (2019: 62.5%) with net impairments corresponding to 14% of capital base from 10.2% at the end of 2019. At end March 2021, NPF indicators rose further slightly to 8.3%.

Average yields on credits dropped by around 120bps to 3.8% whereas the reduction in cost of deposits was limited to 60bps resulting in lower spreads which pressured the profitability of UAE banks. In Q1'2021, deposit costs and credit yields retreated at similar rates by around 10bps each compared to full year 2020. The aggregate net profit of the UAE banking system declined by 55.1% YoY in 2020 as weaker margins and subdued business activity weighed on operating income (down 14.7% YoY) whereas the higher net impairment charges (up 61.8% YoY) stemming from the COVID-19 pandemic pulled down the net earnings. Consequently, return on assets has contracted to 0.7% from 1.6%. Despite the improvement in the UAE banking system's operating expenses in 2020 (down 6.7% YoY) with cost efficiency measures introduced by banks amid the pandemic, the cost-to-income ratio, increased by 3.2pps reaching 37%.

In 2021, profitability of the sector could be supported by improving business growth, better non-spread incomes, further efficiency gains and lower provisions as the buffers were mainly proactively built in the year 2020. Overall, stress tests indicate that the UAE banking system has adequate buffers to navigate the sizable shocks of 2020. According to the Financial Stability Report of CBUAE latest stress tests depict 243bps decline in UAE Banking Sector's aggregate CET1 to 11.6% from 14% even in the most adverse scenario. Nevertheless, there could be uneven repercussions of Covid-19 shock among various economic sectors and asset quality trends need to be monitored closely.



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