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Qatari Banks' Profitability To Wane In 2016

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Although the drop in hydrocarbon prices and the Qatari government's streamlining of its public investment program are putting the brakes on economic growth, banks' asset quality held generally steady while credit growth remained resilient on the back of strong private sector activity in 2015. Nevertheless, as liquidity in the banking sector tightens further with the rise of local and global interest rates, we expect credit growth will lose some steam.

Standard & Poor's Ratings Services anticipates that operating conditions for Qatari banks will toughen in 2016, denting their profitability. In 2015, the Qatari public sector withdrew some of its deposits from the domestic banking system. We expect more of the same in 2016 and foresee a further squeeze on banks' liquidity. Further trimming of government spending will likely reduce private-sector lending opportunities. At the same time, we think banks will manage their funding profiles more conservatively, which should translate into lower growth. We also expect credit losses will increase given the economic slowdown and the pressure we expect in some sectors, such as contracting.

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Importantly, we foresee some tension on banks' asset quality. Over the past few years, public-sector lending took a back seat, while a visible portion of new lending was in the private sector. We now anticipate increased credit losses in the private sector, particularly given our expectations of slowing real GDP growth to 4.0%-4.5% in 2015-2018 from 6.1% in 2014. In particular, the banks' exposures to contractors are susceptible to losses amid slacker capital spending. Moreover, as in other Gulf Cooperation Council (GCC; Bahrain, Kuwait, Oman, Qatar, United Arab Emirates, and Saudi Arabia) countries, we think a drop in the performance of capital markets could translate into some losses on certain high-net-worth portfolios.

Liquidity Will Continue To Tighten Due To Scarcer Public-Sector Deposits

Generally weak deposit growth will take a toll on liquidity in the banking sector in 2016, in our view. Qatari public-sector entities withdrew some of their deposits from domestic banks in 2015. On Nov. 30, 2015, public-sector deposits had declined by 9.9% year-on-year or 3.3% year-to-date. Consequently, total resident deposits had grown by only 2.3% year-on-year, or 3.0% year-to-date on the same date. The relative weight of public-sector deposits had decreased to 34.8% as of end-November 2015 from 38% at the beginning of the year.

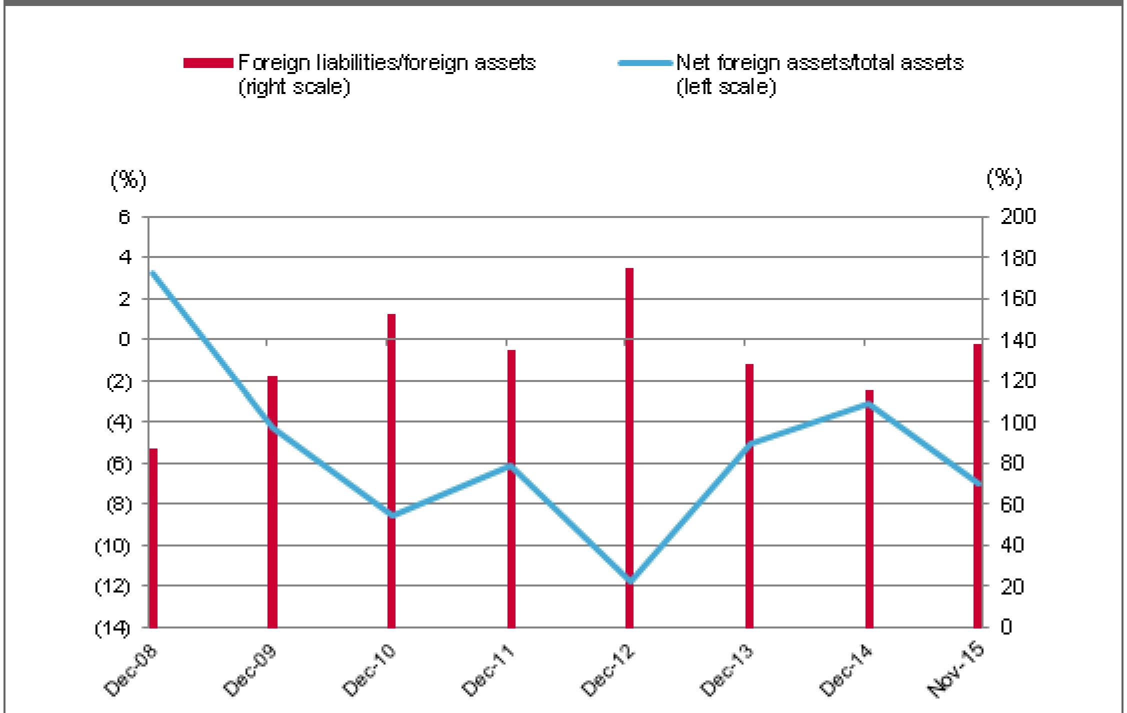
Qatari interest rates already started to increase in 2015 in response to contracting liquidity, and we expect this trend will continue in 2016. On Dec. 16, 2015, the U.S. Federal Reserve raised interest rates for the first time since 2006, and market participants expect further increases this year. Given that the Qatari riyal is pegged to the U.S. dollar, we expect U.S. rate hikes will trigger further increases in domestic interest rates over time.

Domestic credit in Qatar had grown by 17% year on year as of Nov. 30, 2015, visibly outpacing deposit growth. At the same time, the loan-to-deposit ratio in the domestic market had increased to 114.8% by end-November 2015, up from 100.4% one year earlier. We note that Qatar has the highest loan-to-deposit ratio among the six GCC banking markets.

In an environment of weak domestic deposit funding growth, Qatari banks' funding from abroad has increased visibly.

For example, since November 2014, non-resident deposits increased by 50.9%, while overall foreign liabilities climbed by 38% to reach Qatari riyal (QAR) 282.2 billion (US$77.5 billion). Consequently, the net foreign liability position of the banking system is now QAR76.94 billion ($21.14 billion) or about 7% of the system's asset base, up from 0.3% on Nov. 30, 2014 (see chart 1). We expect the role of funding from overseas will continue to increase in 2016.

Chart 1



Qatari Banks' Reliance On Foreign Funding

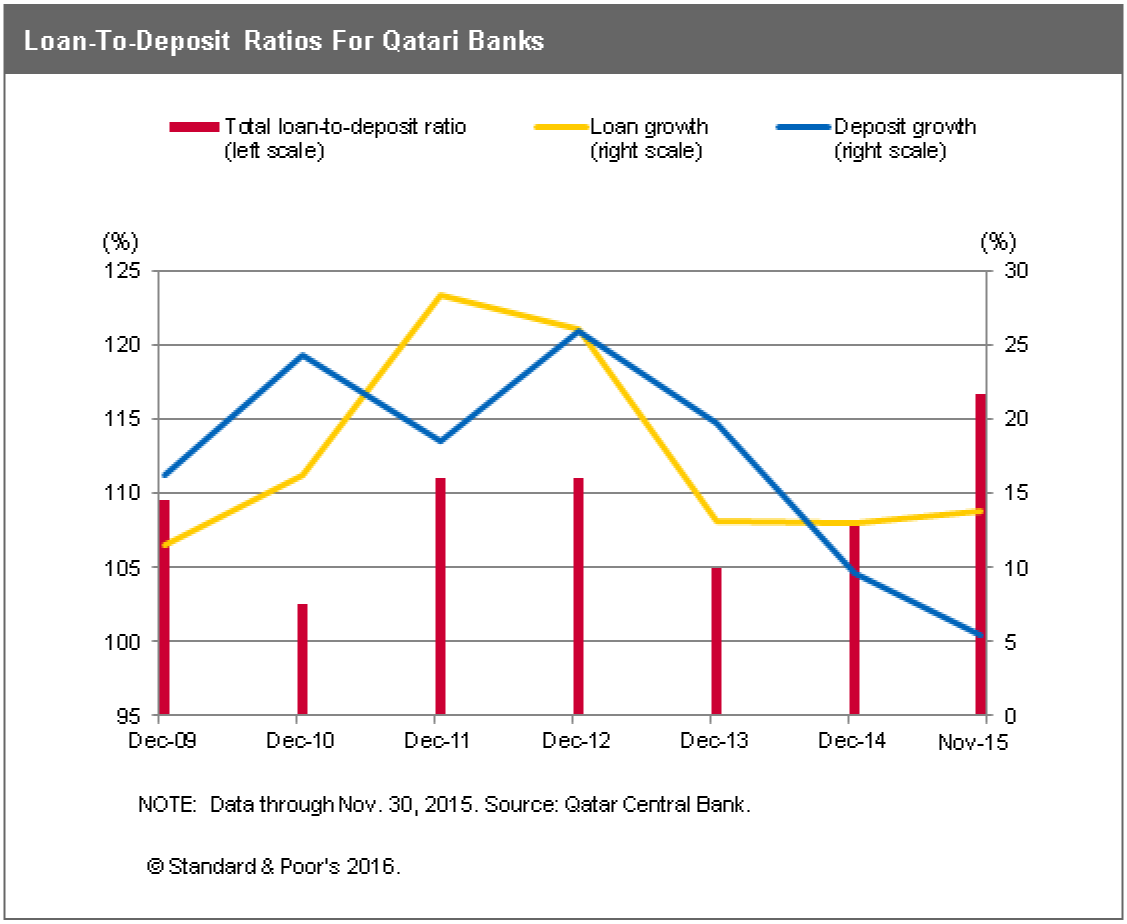
Note: Data through Nov. 30, 2015. Source: Qatar Central Bank.

Loan Growth Will Ease

We expect loan growth will moderate over the next 18-24 months. The banking system's loan-to-deposit ratio (including both domestic and foreign exposures) rose to 116.8% on Nov. 30, 2015, up from 103.4% one year earlier (see chart 2), as lending continued to grow faster than deposits. Given our expectations for continued slow deposit growth and the banking sector's already high loan-to-deposit ratio, we anticipate that banks will manage credit growth more conservatively.

We note that Qatari banks' annual lending had grown by 19.4% on Nov. 30, 2015, largely on a 23.6% jump in loans to the private sector. Public-sector lending was up by just 6.8% in the same period because of the government's streamlining of project execution.

Chart 2



Credit Losses May Increase Given The Growth In Private-Sector Loans

Although Qatari banks continue to operate with some of the best asset quality metrics in the GCC, we think some deterioration over the next few years is likely. The expansion of credit in the domestic economy has been elevated in our view, as bank loans to the private sector grew at a compound annual growth rate of 17.6% between Nov. 30, 2010, and Nov. 30, 2015. Largely supported by government spending under the Qatar National Vision 2030 program, the high private-sector loan growth may have exacerbated credit risk in some segments (such as construction), because the Qatari economy's diversification across sectors remains narrow.

In particular, we view the contracting sector as a potential risk area. We think the government's slowing infrastructure spending exacerbates the potential for increased credit losses. The competition in contracting is stiff, often creating cost overruns that lead to legal disputes between numerous market participants and, therefore, delays in cash flow generation. These have penalized banks' asset quality in the recent past. As a result, some of the banks we rate have seen loans overdue for less than 90 days averaging 6% to 7% of gross loans over the past five years. In times of weakening fiscal balances, we expect government authorities will be increasingly careful with capital spending. Consequently, banks may suffer increased payment delays from exposures in contracting. As of Nov. 30, 2015, real estate and construction accounted for one-fifth of total loans and 1.1x of the equity base of the banks.

For the Qatari banks we rate, the ratio of nonperforming loans to total loans stood at 1.8% as of Dec. 31, 2015, down from 2.0% at year-end 2014. Over the coming quarters, we expect that some acceleration in the formation of nonperforming loans will trigger increased credit losses, as banks aim to maintain stable loan loss coverage levels.

We Project A Slowdown In Net Income Growth In 2016

We think growth in banks' net income will visibly slacken, in line with our expectations for sluggish revenue growth, owing to slower lending growth and our projection that credit losses will increase because of lower recoveries and gradual asset quality deterioration.

Between 2010 and 2015, rated banks' return on average assets narrowed to 1.9% from 2.7%, or about 80 basis points (bps). This mainly followed a visible contraction in net interest margins, to 2.6% in 2015, from 3.5% in 2010, because banks were fiercely competing against each other in the loan market. Credit losses have averaged about 40 bps over the past five years, and we anticipate a gradual but visible increase from 2016, together with our assumption of a slowdown in lending and revenue growth. Consequently, we expect the return-on-average-asset ratio will gradually decline between 2016 and 2018, to about 1.5% (see table 1).

Table 1

Revenue Generation Breakdown For Qatari Banks

(%)	2010	2011	2012	2013	2014	2015
Net interest income to average earning assets	3.5	3.5	3.0	3.0	2.8	2.6
Average earning assets to average assets	83.8	87.8	92.4	91.5	90.9	91.5
Net interest income to average assets	2.9	3.0	2.8	2.8	2.6	2.4
Fee income to average assets	0.7	0.6	0.5	0.5	0.5	0.5
Other noninterest income to average assets	0.5	0.4	0.4	0.4	0.4	0.3
Operating revenues to average assets	4.0	4.1	3.7	3.7	3.5	3.2
Operating cost to average assets	0.9	0.9	0.9	1.0	0.9	0.9
Credit losses to average assets	0.4	0.4	0.4	0.5	0.4	0.3
Other items to average assets	0.0	0.0	(0.0)	(0.1)	(0.1)	(0.1)
Return on average assets	2.7	2.8	2.4	2.2	2.1	1.9
Average equity to average assets	14.1	14.9	15.1	14.0	13.3	12.8
Return on average equity	19.4	18.5	16.1	15.4	15.6	15.2

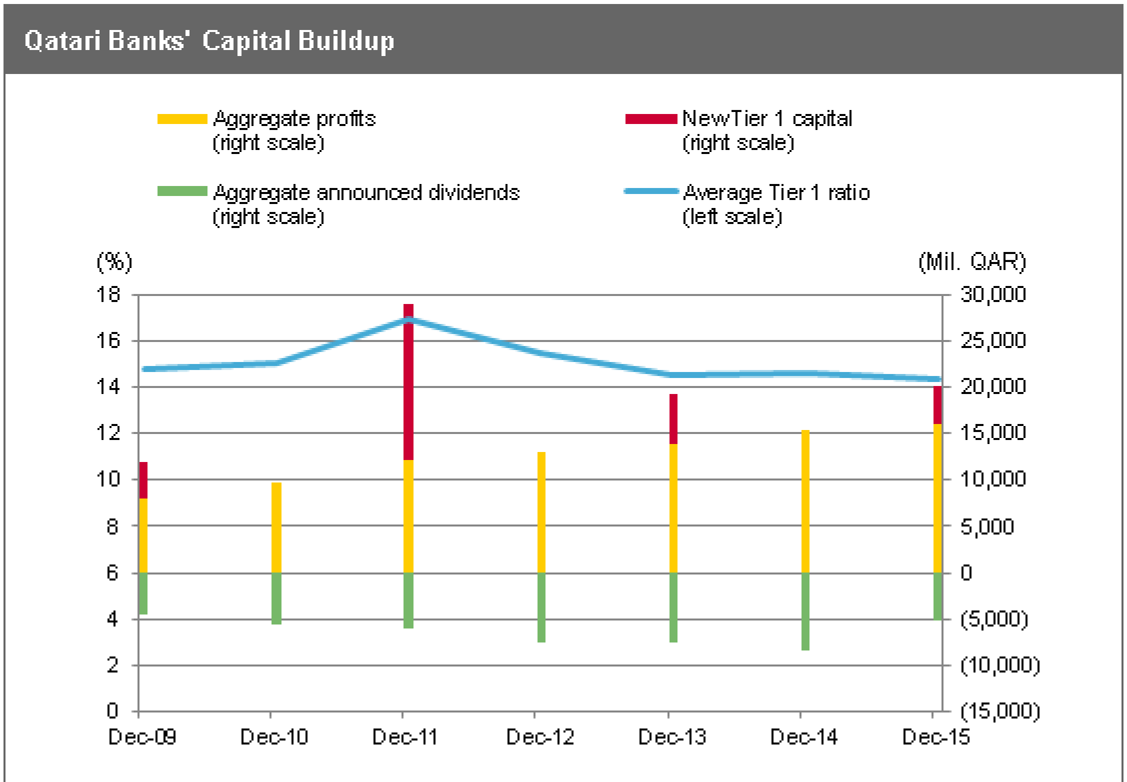
Source: Rated banks' financial statements.

Rated Banks Are Trimming Dividends

The Qatari banks we rate have generally reduced their dividend payout ratios for 2015 earnings, in part to prepare for the now more challenging operating environment. Domestic banks continue to maintain strong capitalization with an average Tier I ratio above 14% (see chart 3). Looking ahead, because Basel III guidelines require banks to hold countercyclical and Domestic Systemically Important Bank (DSIB) buffers, we anticipate that banks will increase earnings retention so as to keep enough capital amid rising funding costs and credit losses.

Despite strong profit generation and several rounds of new capital raising (in the form of both common stock and perpetual notes eligible as Tier 1 capital under Basel III), the average Tier 1 capital ratio for the banks we rate has stagnated over the past few years. A first reason lies in the banks' high pace of growth, as reflected by a five-year compound average growth rate of 20% in their regulatory risk-weighted assets between 2010 and 2015. The banks' high dividend payout ratios have also contributed to this stagnation. On average, rated banks in Qatar have returned about one-half of their profits to shareholders over the past five years.

Chart 3



QAR--Qatari riyal. Source: Rated banks' financial statements.

In the coming years, we expect rated banks' capital ratios will stand comfortably above minimum requirements under Basel III standards. Still, we think the operating conditions we foresee may make it difficult for banks to maintain high dividend payout ratios while at the same time adhering to more demanding capital requirements over the next four years.

Table 2

Standard & Poor's Rated Banks And Their Total Assets In Qatar

	Issuer credit rating	Asset base on Dec. 31, 2015 (bil. US$)
Qatar National Bank	A+/Stable/A-1	148.1

Table 2

Standard & Poor's Rated Banks And Their Total Assets In Qatar (cont.)		
Qatar Islamic Bank (S.A.Q)	A-/Stable/A-2	34.9
The Commercial Bank of Qatar	A-/Negative/A-2	33.9
Doha Bank Q.S.C.	A-/Stable/A-2	22.9

Ratings as of Feb. 2, 2016.

Table 3

Key Metrics For Standard & Poor's Rated Banks In Qatar

(%)	2010	2011	2012	2013	2014	2015
Asset growth	19.6	25.9	18.7	21.8	10.4	12.8
Net loan growth	16.8	34.0	26.7	24.1	11.4	17.1
Revenue growth	13.5	24.7	10.8	19.7	9.7	2.7
Net income growth	20.4	24.3	7.5	6.5	11.4	4.7
Nonperforming loans to gross loans	1.7	1.4	1.5	2.0	2.0	1.8
Loan loss reserves to nonperforming loans	99.1	104.5	102.6	102.2	107.8	106.9
Credit losses to average assets	0.4	0.4	0.4	0.5	0.4	0.3
Cash, money market and securities to total assets	37.0	34.5	30.8	28.6	28.1	25.8
Return on average assets	2.7	2.8	2.4	2.2	2.1	1.9

Source: Rated banks' financial statements.

Related Criteria And Research

- Saudi Banks: A Tough Year's Ahead, With Risks To Growth And Asset Quality, Jan. 20, 2016
- UAE Banks: Earnings To Decline in 2016 As Operating Conditions Weaken, Jan. 11, 2016
- Gulf Banks: After Solid First-Half Results, Earnings Are Set To Slide, Oct. 1, 2015
- Credit FAQ: Assessing The Effects Of The Saudi Government's Debt Issuance Program On The Domestic Banking, Sept. 2, 2015
- Gulf-Based Islamic Banks Grapple With Weakening Regional Economies, Aug. 12, 2015
- Banking Industry Country Risk Assessment: Qatar, May 19, 2015

We have determined, based solely on the developments described herein, that no rating actions are currently warranted. Only a rating committee may determine a rating action and, as these developments were not viewed as material to the ratings, neither they nor this report were reviewed by a rating committee.

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