UAE Banking Sector 2022 Outlook
On The Path To Recovery

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S&P Global
Ratings

Key Takeaways

- We expect the UAE's economic activity will accelerate in 2022 due to higher oil prices, supportive government policies, and normalizing non-oil activity.
- We think further deterioration of banks' asset-quality indicators will remain contained as the economy improves and corporate activity recovers. We expect part of the deterioration will come from deferred exposures once the central bank (CBUAE) lifts support measures and companies in still vulnerable sectors are reclassified.
- Corporates are recovering gradually as economic activity normalizes and the oil price recovers, but sectors such as aviation and hospitality remain vulnerable. The rise in Dubai real estate prices may slow down because the structural oversupply of residential property could challenge the market over the long term.
- The UAE banking sector should benefit from expected interest rate hikes, assuming banks adopt a pragmatic approach for borrowers by not reflecting the rate increase systematically if it could dip borrowers to default.
- Stable and strong capital buffers, good funding profiles, and expected government support should continue to support banks' creditworthiness in 2022.
- We expect the impact of the Russia-Ukraine conflict on the UAE banking system to be limited for now.

Limited Impact Of The Russia-Ukraine Conflict... For Now

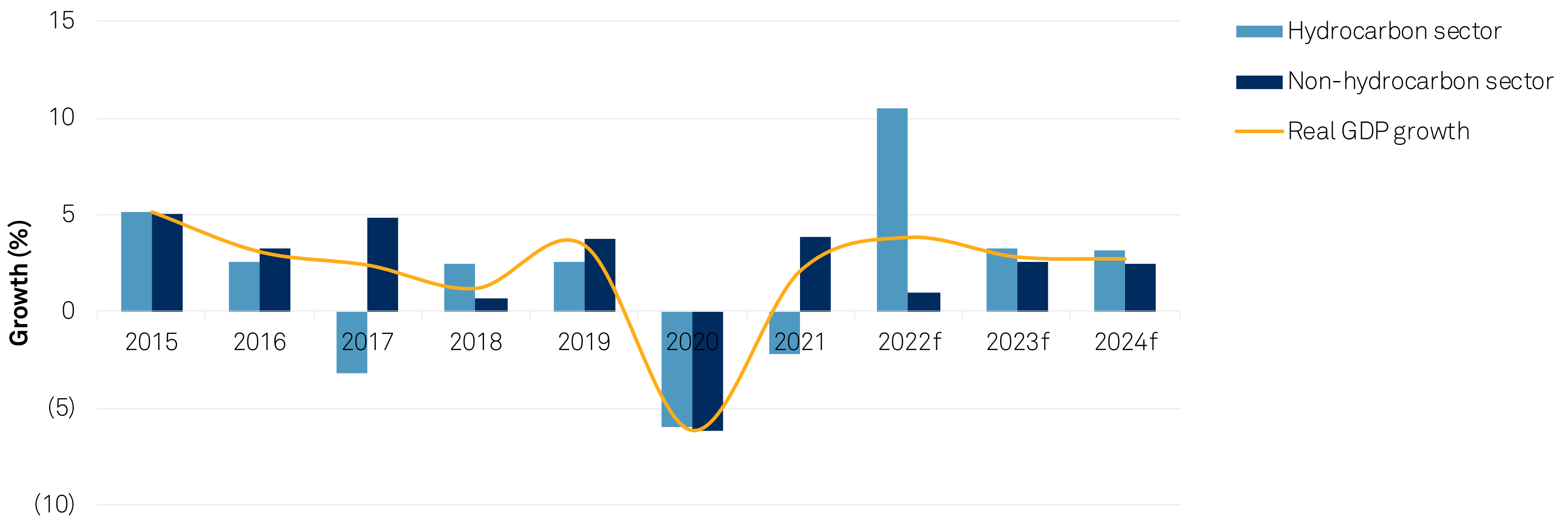
- Direct impact is likely to be limited given banks' limited exposures to Russian and Ukrainian counterparties.
- Indirect impact could materialize through the following channels:
  - Higher oil price, which is likely to further boost confidence and sentiment in the UAE economy. However, we do not expect a major change in the macro-picture of further acceleration of lending.
  - Increased investor risk aversion. Although the UAE banking system operates with a substantial gross external debt position--23% of total assets at Nov. 30, 2021--it has a significant amount of external liquid assets that could be used if banks' access to external funding is restricted. Moreover, we expect the government to support systemically important banks should the need arise.

S&P Global Ratings acknowledges a high degree of uncertainty about the extent, outcome, and consequences of the military conflict between Russia and Ukraine. Irrespective of the duration of military hostilities, sanctions and related political risks are likely to remain in place for some time. Potential effects could include dislocated commodities markets -- notably for oil and gas -- supply chain disruptions, inflationary pressures, weaker growth, and capital market volatility. As the situation evolves, we will update our assumptions and estimates accordingly. See our macroeconomic and credit updates here: Russia-Ukraine Macro, Market, & Credit Risks. Note that the timing of publication for rating decisions on European issuers is subject to European regulatory requirements.

Increasing Economic Activity

- We have raised our assumption for Brent oil prices to an average of $85 in 2022. Improving economic sentiment and higher hydrocarbon production should lead to accelerated economic growth in UAE.
- Despite the ongoing weakness in the tourism and hospitality sectors, which we think will take longer to recover, we expect nominal GDP to reach pre-pandemic levels supported by activity from the ongoing Expo 2020 in Dubai and a recovering hydrocarbon sector.

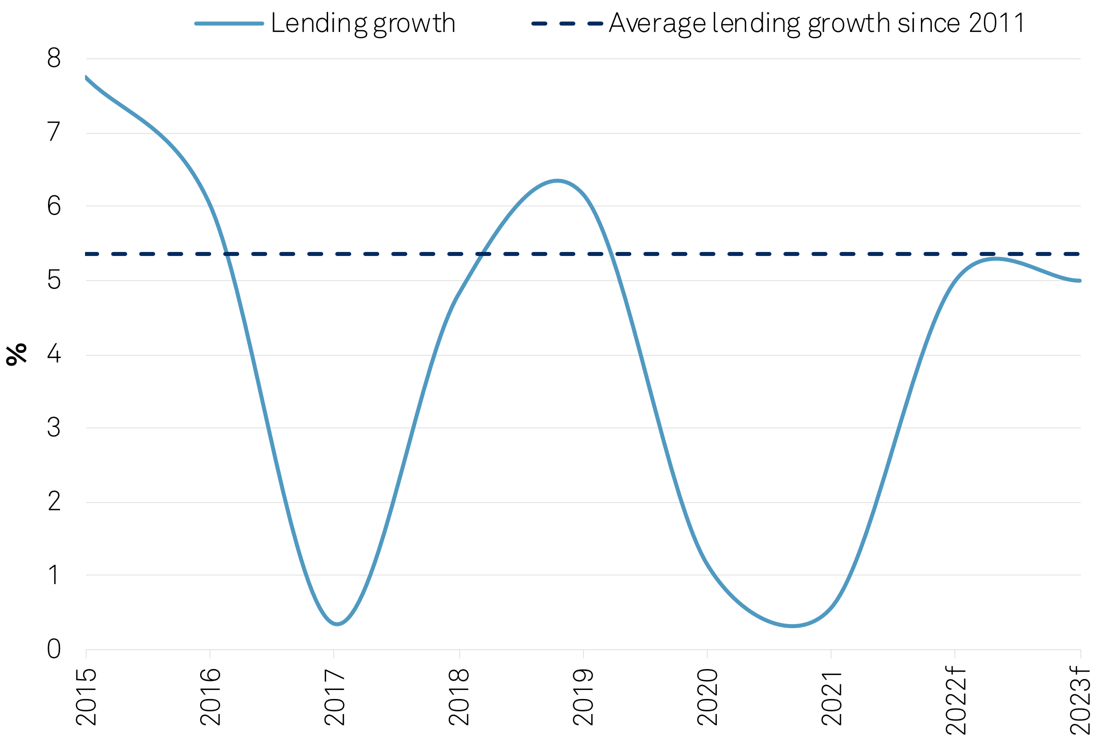
Real GDP To Recover To Pre-Pandemic Levels



f--Forecast. Source: S&P Global Ratings.

Gross Lending Growth Will Accelerate

We Forecast Lending Growth Will Speed Up In 2022



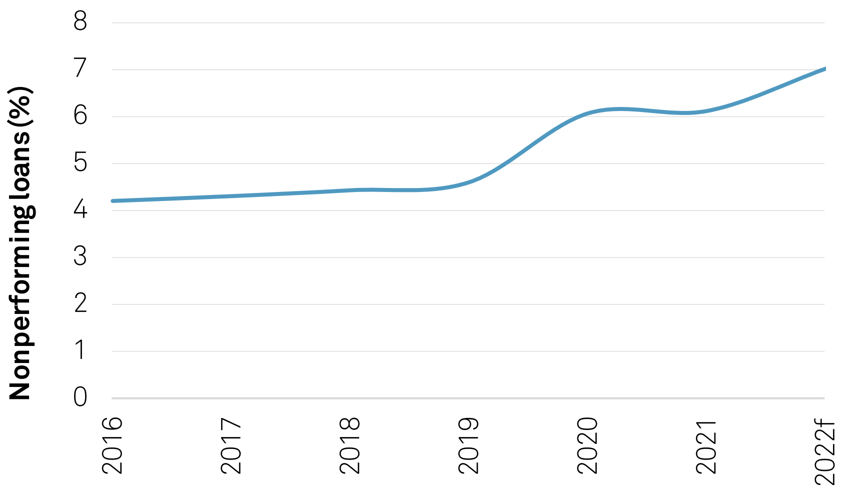
f--Forecast. Source: S&P Global Ratings, Central Bank of UAE.

- We expect the lending growth to accelerate thanks to UAE's economic growth, albeit tempered by the expected increase in rates.
- Lending growth could slow down in the second half of the year once we see a meaningful increase in rates. Residential mortgage loans contributed about 20%-25% of residential real estate demand in Dubai. We expect this demand to slow down once interest rates start increasing.

Asset Quality Deterioration Will Remain Contained

- We expect further increases in problem loans to remain contained as the economy improves and corporate activity recovers.
- We think part of the deterioration will come from deferred exposures once the CBUAE lifts support measures and companies in still vulnerable sectors are reclassified. At year-end 2021, Group 2 exposures contributed to 1.8% of gross loans, and we think some of these exposures could migrate to nonperformance because of higher interest rates.
- Sectors such as real estate, construction, hospitality, consumer-related sectors, and small and midsize enterprises will take longer to recover and will be the chief contributors to new nonperforming loan formation.

Further Increases In Nonperforming Loans Will Be Manageable



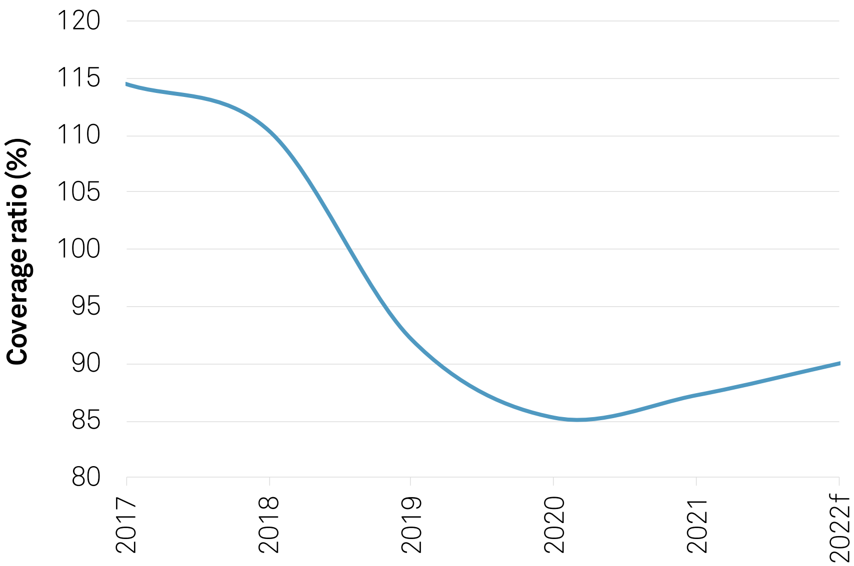
Weighted average nonperforming loans (Stage 3) for the 10 largest UAE banks. f--Forecast. Source: S&P Global Ratings.

Breakdown Of Loan Portfolio By Sector

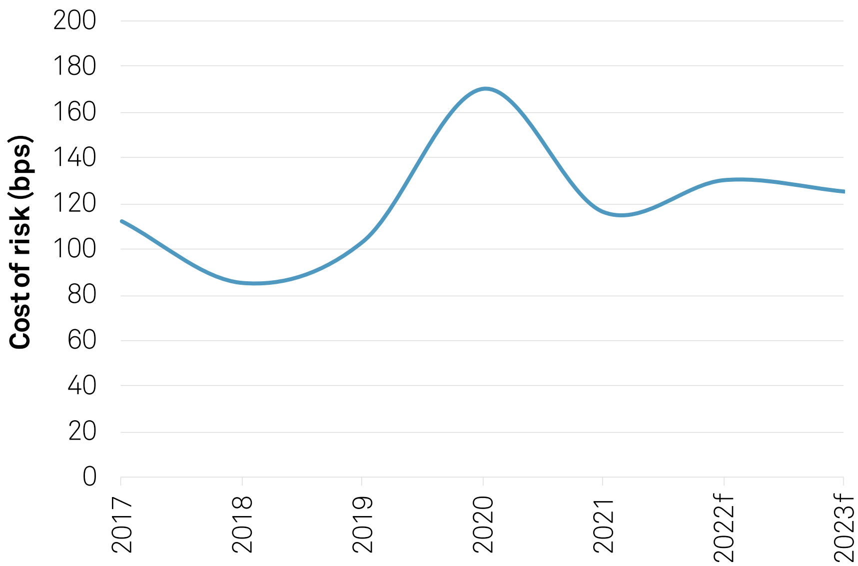
The Cost Of Risk Will Stabilize Despite Rising Interest Rates

- We think an increase in interest rates would only marginally increase the cost of risk. For corporate exposures, we expect banks to adopt a pragmatic approach by not reflecting the full extent of the increase in rates whenever this could dip their clients to nonperformance. For retail customers, stress tests applied by banks to mortgages at inception in relation to an increase in rates, exposure granularity, and salary assignments will act as mitigants.
- We anticipate the coverage ratio will remain below historical levels in 2022.

The Coverage Ratio Will Remain Below Historical Levels



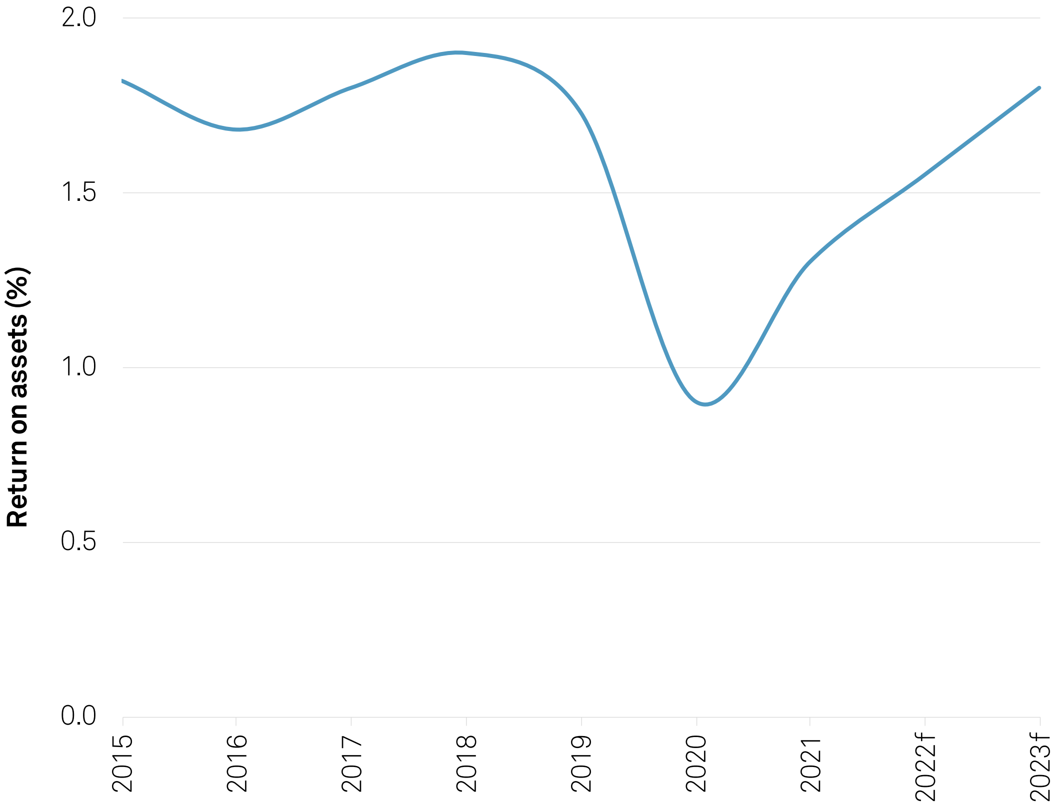
The Cost Of Risk Will Stabilize In 2022



Weighted average coverage ratio and cost of risk for 10 largest UAE banks. bps--Basis points. f--Forecast. Source: S&P Global Ratings.

Increase In Interest Rates Will Support Profitability

UAE Banks' Profitability Will Benefit From The Expected Increase In Interest Rates



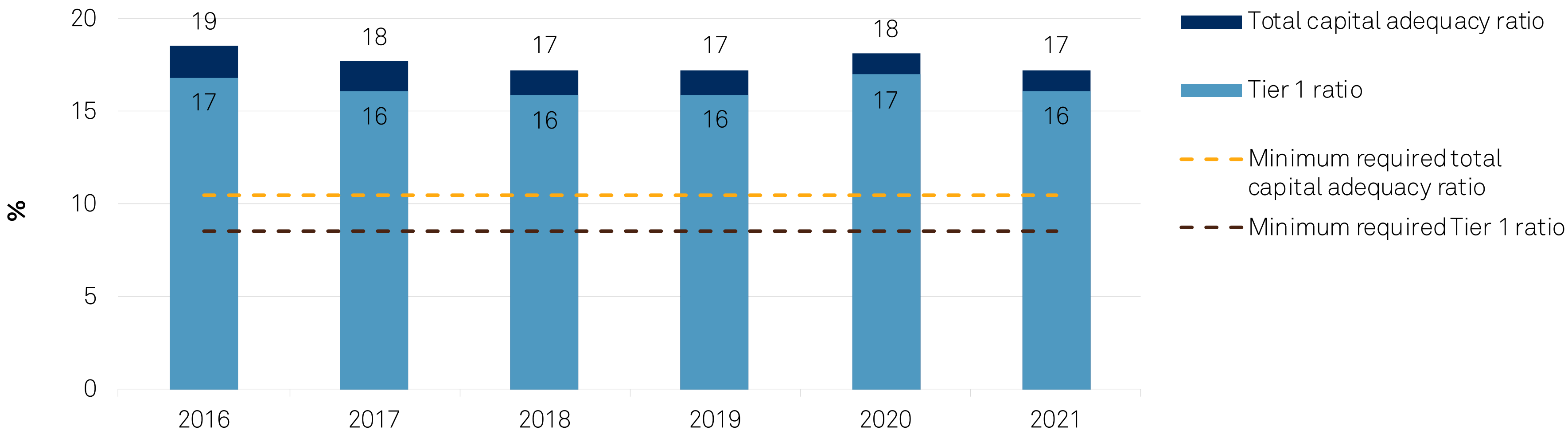
Source: S&P Global Ratings.

- We expect the CBUAE will mirror the Federal Reserve's planned interest rate hikes, which would benefit banks in the UAE.
- We calculate a 15% increase in net income and 1.4% rise in return on assets for every 100-basis-points increase (parallel shift) based on the top 10 banks' disclosures.
- We expect the cost of risk to stabilize, so we think UAE banks' profitability will keep improving, reaching pre-pandemic levels by 2023.
- Cost-reduction initiatives have been at the top of banks' management agendas. Reducing real estate footprints, relocating staff to lower-cost areas, and taking advantage of digitalization will remain among their action plans.

Capitalization Remains Strong

- Despite lower profitability in 2020-2021, strong capital buffers supported the banking sector. With the anticipated increase in profitability, we expect banks to further strengthen their capital buffers.
- We think banks will start paying dividends at pre-pandemic levels from 2022, as profitability improves.
- Some banks have raised additional capital in the form of Tier 1 instruments over the past couple of years to benefit from existing rates.
- Quality of capital is still good, with a modest--albeit increasing--contribution of hybrid instruments. Additional Tier 1 instruments as a proportion of total adjusted capital increased to 13.8% in 2021 from 12.9% in 2017.

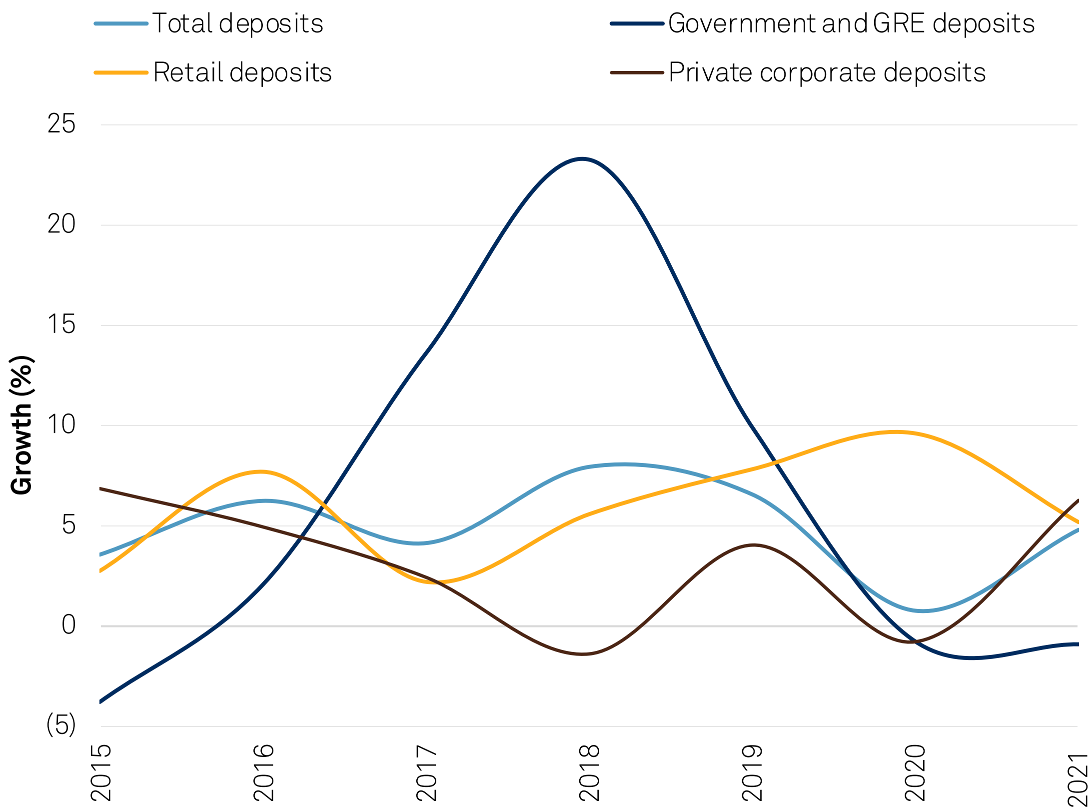
UAE Banks Have Strong Capital Positions



Sources: S&P Global Ratings, Central Bank of UAE.

Modest Deposit Growth Will Continue

Deposit Growth Improved In 2021



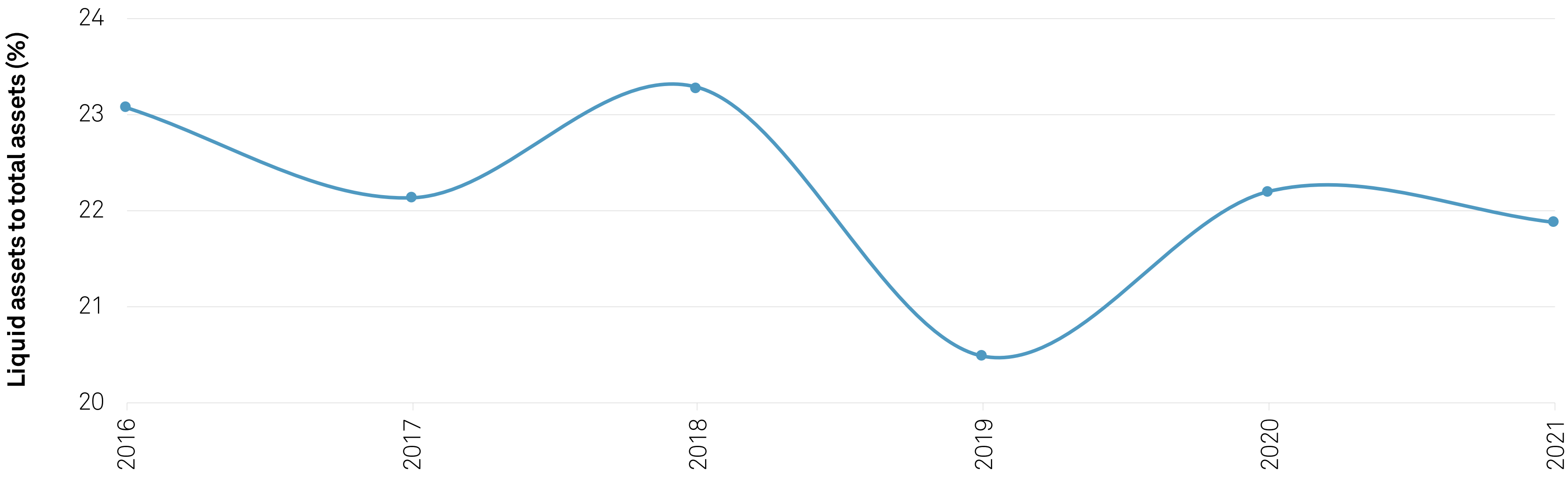
Data until November 2021, annualized for full year. GRE--Government-related entity.
Source: S&P Global Ratings, Central Bank of UAE.

- UAE banks' funding structures benefit from strong core-customer deposit bases and limited reliance on external funding.
- Overall deposit growth improved in 2021 because private corporates and retail depositors prioritized saving over spending in a still challenging operating environment.
- We expect modest deposit growth to continue in 2022 as the economic environment improves, leading to stronger cash flow generation from corporates, which will translate into higher banking sector deposits.
- The higher interest rate environment means a higher return on deposits, which could further accelerate deposit growth.
- The cost of funding will inevitably rise as some deposits migrate to interest-bearing products from no- or low-interest-bearing products.

Liquidity Is Not An Issue For Now

- UAE banks benefited from a UAE dirham 50 billion free liquidity injection from the CBUAE and a relaxation of regulatory liquidity ratios in 2020-2021.
- As of year-end 2021, almost one quarter of UAE banks' assets were liquid.
- This could change if geopolitical risks translate into difficult funding conditions, which is not our base-case scenario for 2022.

UAE Banks Have Ample Liquidity On Their Balance Sheet



Liquid assets include cash and balances with central bank and interbank deposits. Calculated for 10 largest banks in UAE. f--Forecast. Source: S&P Global Ratings.

Our UAE Bank Ratings

- Despite a challenging external environment, our rating and outlook distribution shows that UAE banks are on a stable path heading into 2022.
- This reflects improving economy and banks' recovery from a low base set in 2020 when the pandemic began.

	Issuer Credit Rating
First Abu Dhabi Bank	AA-/Stable/A-1+
Abu Dhabi Commercial Bank	A/Stable/A-1
Mashreq Bank	A-/Stable/A-2
Sharjah Islamic Bank	A-/Stable/A-2
National Bank of Fujairah	BBB/Stable/A-2

Ratings as of Feb. 21, 2022.

Related Research

- When Rates Rise: UAE Banks Will Benefit From Higher Interest Rates, Feb. 15, 2022
- The Introduction Of Corporate Tax In The UAE Will Benefit Government Revenue Diversity Without Overburdening Companies, Banks, Or Insurers, Feb. 7, 2022
- Ratings On Five UAE Banks Affirmed Under Revised Criteria; Outlooks Stable, Jan. 20, 2022
- GCC Banking Sector Outlook: On The Recovery Path In 2022, Jan. 11, 2022
- Banking Industry Country Risk Assessment, United Arab Emirates, April 15, 2021

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