Middle East And African Banks:
Varied Exposure To Russia-Ukraine Conflict

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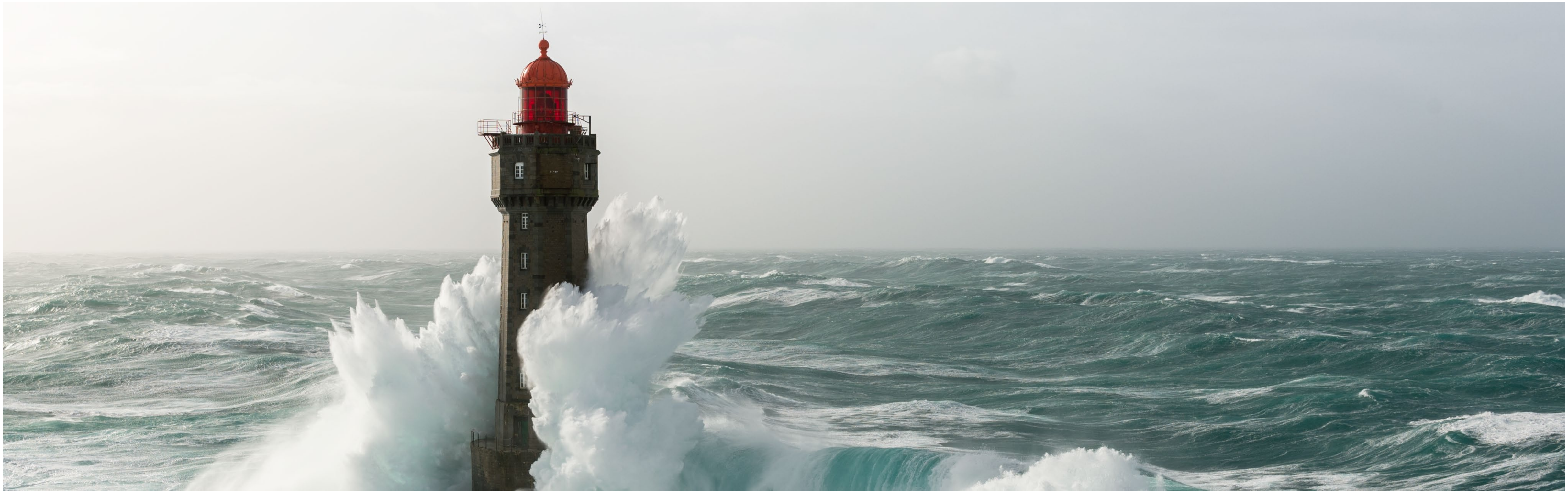

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Key Takeaways

- S&P Global Ratings expects rated banks across the Middle East and Africa to suffer little direct fallout from the Russia-Ukraine conflict due to their limited dealings with Russian and Ukrainian counterparties.
- The Turkish and Tunisian banking sectors are most likely to suffer from negative indirect effects, while we expect Saudi, United Arab Emirates, and South African banks will remain relatively insulated.
- The major indirect effects of the conflict will include:
  - Higher oil prices, which will bolster oil exporting economies and weigh on oil importing countries;
  - Higher food prices, leading to inflationary pressure and current account deficits; and
  - Increased investor risk aversion, which could increase vulnerability for banking systems with substantial net external debt.
- This report focuses on the few emerging markets where we have observed significant vulnerabilities, or where we have received specific investor queries relating to the conflict's effects.

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.

Vulnerability To The Conflict

	Economic and credit growth	Asset quality	Profitability	Funding and liquidity
Egypt	Moderate vulnerability	No or limited vulnerability	Moderate vulnerability	No or limited vulnerability
Nigeria	Moderate vulnerability	No or limited vulnerability	No or limited vulnerability	No or limited vulnerability
Qatar	No or limited vulnerability	No or limited vulnerability	No or limited vulnerability	Significant vulnerability
Saudi Arabia	No or limited vulnerability	No or limited vulnerability	No or limited vulnerability	No or limited vulnerability
South Africa	No or limited vulnerability	No or limited vulnerability	No or limited vulnerability	No or limited vulnerability
Tunisia	Significant vulnerability	Significant vulnerability	Moderate vulnerability	Moderate vulnerability
Turkey	Significant vulnerability	Moderate vulnerability	Moderate vulnerability	Significant vulnerability
United Arab Emirates	No or limited vulnerability	No or limited vulnerability	No or limited vulnerability	No or limited vulnerability

Significant vulnerability	
Moderate vulnerability	
No or limited vulnerability	

BICRA Analyst: Alessandro Ulliana

Key Considerations | Egypt

– Egypt's banking sector is exposed by the country's significant reliance on staple food imports. Government support could be vital to mitigating damage to the economy.

Economic and credit growth

- **Credit demand and economic stability pressured by stronger inflation**
  - Ukraine and Russia accounted for about 85% of Egypt's wheat imports in 2021.
  - Higher food prices lifted inflation to 8.8% in Feb. 2022, prompting the Central Bank of Egypt (CBE) to increase interest rates -- for the first time in years -- by 1 percentage point.
- **IMF support could help reduce economic uncertainty**
  - Egypt and the IMF recently began discussing a program to alleviate the effects of the higher commodity prices on Egypt's economy.

Asset quality

- **Minimal direct exposure**
  - Rated Egyptian banks have little direct exposure to Russian or Ukrainian counterparties.
  - We do not expect the conflict will have significant direct effects on bank asset-quality indicators.
- **Indirect impact is likely to be contained**
  - The Egyptian pound has depreciated about 15% against the U.S. dollar since the end of February. The depreciation's effect was limited because foreign currency lending accounts for less than 20% of total bank loans, while foreign-denominated loans are usually granted to companies that generate revenues in the same currency.
  - Credit losses could rise as a result of slower economic expansion and surging inflation, while remaining manageable.

Profitability

- **Net interest margin could come under pressure in 2022**
  - The CBE's interest rate increase prompted state-owned banks, which represent about 50% of Egypt's banking sector, to offer one-year, 18% certificate of deposits. That is nearly double the overnight policy rate of 9.25%.
  - The effect on pre-provision income will be determined by the volume of certificates of deposit (CDs) issued, and the extent to which private banks follow state-owned lenders.

Funding and liquidity

- **Ample customer deposit base**
  - Egyptian banks' funding base is primarily composed of domestic retail deposits, where growth has proven resilient even at times of weakened stability.
  - We expect leverage to remain low, with a loan-to-deposit ratio of about 50% over 2022.
- **Net external asset position**
  - Banks' reliance on external funding is limited by their strong deposit base.
  - This is highlighted by their net external asset position, although that position is shrinking.

Key Considerations | Nigeria

– Structural weakness in the Nigerian economy will likely continue to undermine foreign investment inflows despite higher oil prices. Central Bank of Nigeria's (CBN) foreign exchange management is unlikely to derail banks' performance.

Economic and credit growth

- **Higher oil prices insufficient to significantly boost foreign exchange reserves**
  - Exports are underperforming because of weak oil production level and poor infrastructure.
  - Businesses, excluding oil, will continue to suffer from insufficient foreign currency supplies and infrastructure shortcomings.
  - We forecast GDP will increase by about 3% in 2022, after an estimated 3.4% increase in 2021.
- **Portfolio flows slow to return**
  - Global investors and foreign-owned banks continue to face limitations and delays to repatriating investments and dividends.
- **Inflation high at 13% in 2022**
  - Foreign currency shortages and security tensions in the food-producing Middle Belt region could fuel inflationary pressures.

Asset quality

- **Short credit cycles and volatile asset quality, compared with other emerging markets**
  - This reflects economic concentration risks and imbalances stemming from a restrictive foreign exchange regime.
  - We expect credit losses will decline to 1.6% in 2022, while nonperforming loans will gradually fall to the 5% regulatory limit by 2023.

Profitability

- **Continued bank profitability and return on equity above 20% in 2022**
  - We expect banks to continue optimizing nonfunded income from transactional platforms.
  - They are unlikely to improve their cost base materially despite increasing revenue because of the high Asset Management Corp. of Nigeria (AMCON) levy.

Funding and liquidity

- **Good liquidity management despite regulatory headwinds**
  - Banks are relying on balance sheet strength to meet foreign currency obligations.
  - Foreign currency deposits should remain at about 20% of total deposits, providing a hedge against a weaker naira.
  - Banking sector net external debt should average 4.4% of systemwide loans over 2022.
- **A two-speed banking system**
  - Top-tier banks are funded by short-term and cheap customer deposits that reduce funding costs.
  - Lower-tier banks rely on domestic wholesale funding that undermines earnings.

Key Considerations | Qatar

– Risks related to external funding are increasing, although banks have tried to increase the maturity and the stability of nonresident deposits. The government has significant capacity and willingness to provide support if needed.

Economic and credit growth

- **Investment continues ahead of the World Cup in November**
  – The economy is forecast to expand about 4% in 2022, supported by high vaccination rates, the soccer World Cup, and higher hydrocarbon prices.
- **Credit growth will remain strong**
  – We expect small and midsize enterprise and retail credit to increase, despite significant parts of Qatar's infrastructure plan nearing completion.
  – Consecutive years of strong credit expansion have led to material corporate leverage, which could trouble banks if liquidity conditions tighten and disrupt cash flows in struggling sectors.

Asset quality

- **Direct exposure is minimal**
  – Rated Qatari banks have minimal direct exposure to Russian or Ukrainian counterparties.
  – We do not expect to see any significant direct effects of the conflict on their asset quality indicators.
- **Asset quality will remain resilient**
  – Higher oil price supports economic recovery.
  – Hotels and real estate account for nearly one-third of banks' nonperforming loan (NPL) exposure, which we forecast will peak at 3.3% in 2022, up from 2.9% in 2019.

Profitability

- **Credit losses to normalize in the next 12-24 months**
  – We expect credit losses of about 90 basis points (bps) in 2022 compared with 100 bps in 2021 and 2020.
  – Profitability will likely benefit from higher interest rates.

Funding and liquidity

- **Rollover of external liabilities is a risk**
  – Domestic credit growth in 2020 and 2021 was funded by stable domestic deposits, nonresident deposits, and external debt.
  – External funding can be volatile in times of economic or geopolitical instability.
  – The state's capacity and willingness to provide support largely mitigates this risks, as does depositors' often long-term and relationship-based interest in Qatar's economy.
  – We expect Qatari banks' net external debt will contribute to the funding of roughly 45%-46% of domestic loans over the next two years, up from 38% in 2020.

Key Considerations | Saudi Arabia

– The impact of the conflict is likely to be limited. Banking system growth fueled by mortgages, and corporate lending linked to Vision 2030.

Economic and credit growth

- **Higher oil prices improve the economic and fiscal outlook**
  - We expect the Saudi economy to continue its rebound over 2022, supported by higher oil prices and recovering production volumes.
  - The nonoil economy will likely benefit from Vision-2030 projects and related spending.
- **Credit market expansion**
  - Credit market expansion is likely to remain strong, underpinned by mortgage lending and corporate borrowing related to Vision 2030 investments.

Asset quality

- **Direct exposure is minimal**
  - Rated Saudi banks have little direct exposure to Russian or Ukrainian counterparties.
  - We do not expect to see any significant direct effects of the conflict on their asset quality indicators.
- **Asset quality likely stable**
  - Asset quality indicators improved in 2021 as a result of write offs and strong provisioning.
  - The NPL ratio reached 1.7% at year-end 2021, down from 2.1% a year earlier, while provision for NPL coverage improved to 181.1%, up from 165.4%.
  - We expect 2022 to provide stability, supported by increasing lending books and an improving economic environment.

Profitability

- **Higher interest rates support profitability**
  - We calculate an 11.5% increase in net income and 1.1% rise in return on assets for every 100-bps increase in interest rates (parallel shift), based on banks' disclosures.
- **Credit losses likely to return to pre-pandemic levels in the next 12-24 months**
  - Losses fell in 2021, due to the improvement in the macroeconomic environment.
  - Mortgages are mainly secured by salary assignments and are held by employees of the government and government-owned companies; therefore, the risks appear to be contained at this stage.

Funding and liquidity

- **Customer deposit base offers support**
  - A significant amount of core customer deposits is short term or on-demand, and unremunerated.
  - It remains to be seen what proportion will migrate to remunerated products.
- **The banking sector is in an overall net external asset position**
  - Limited reliance on external funding due to a large domestic deposit base, and historically small overseas operations.

Key Considerations | South Africa

– Among key emerging markets, South Africa's banking system is likely to be one of the least affected by the conflict. The country's economic reforms are taking shape, and banking sector performance has recovered quicker than anticipated.

Economic and credit growth

- **Positive commodity cycle insufficient to support growth forecast**
– We revised downward our real GDP growth forecast for 2022 to 1.9%, well below the 4.9% in 2021.
- **Business confidence better, but still weak**
– Corporate financing demand could remain capped by geopolitical risks.
– Government reform agenda progress is positive for sentiment.
- **Credit conditions likely tighter in 2022**
– The South African Reserve Bank (SARB) raised its benchmark rate in March 2022.
– Domestic lending rose about 4.5% in 2021, led by retail lending.
– We expect credit growth will remain muted in 2022.

Asset quality

- **Household leverage and affordability metrics improved in 2021**
– Higher inflation will likely spur a 50bps-100bps increase in household leverage, defined as household debt to disposable income, which had been stable at about 68%.
- **Credit losses nearly halved in 2021**
– Credit losses were about 1.2% of total loans over 2021, down from 2.1% in 2020.
– Losses are likely to remain slightly higher than their historical and normalized level of about 0.8% over 2017-2019.
– We forecast that credit losses will average 1% in 2022-2024, the NPL ratio will continue to improve to below 4% by 2023, down from about 4.5% in 2021.

Profitability

- **Earnings likely to recover to pre-pandemic levels**
– Lower impairment charges and higher interest rates will support net interest margins and earnings.
– We expect return on equity to reach 16% in 2022, after improving to 14% in 2021.
– Return on assets is expected rise to 1.3% in 2022, from 1% in 2021.
– Banks resumed dividend payments in 2021 on the back of resilient earnings in 2020.

Funding and liquidity

- **Banks operate in a closed rand system**
– In a crisis, exchange controls help maintain rand liquidity.
– Banks are not exposed to external refinancing risks.

Key Considerations | Tunisia

– Increasing commodity prices are likely to add to the country's high fragility.

Economic and credit growth

- **Facing a large twin deficit**
  - Negotiations with the IMF have been ongoing for a year.
  - Domestic fuel and food subsidies will increase external financing needs at a time when the market is tight.
  - A sluggish recovery from the pandemic and political uncertainty are weighing on sentiment.
- **Sovereign risk and inflationary pressure**
  - Elevated sovereign risk could materially harm banks' financial and business profiles.
  - We expect retail lending to only increase 2% in 2022. Inflationary pressure and economic policy uncertainty will weigh on the recovery.

Asset quality

- **Direct exposure is minimal**
  - Rated Tunisian banks have minimal direct exposure to Russian or Ukrainian counterparties.
  - We do not expect to see any significant direct effects of the conflict on their asset quality indicators.
- **Indirect effects cloud the future**
  - Higher oil and food prices are likely to weaken the country's already limited capacity to meet its financial obligations.
  - An IMF program might be contingent on important reforms of state-owned enterprises. Public sector exposure was 16.5% of banks' total assets at year-end 2020.
  - We expect the NPL ratio to reach 13% in 2022.

Profitability

- **Credit losses will remain high over the next 12-24 months**
  - We expect credit losses of about 150 bps in 2022, compared with 140 bps in 2020.
- **Capitalization under pressure**
  - Muted revenues amid sluggish economic activity, high credit losses, and increasing costs will put pressure on bank capital ratios.

Funding and liquidity

- **Limited reliance on external funding.**
  - Net external debt accounted for less than 14% of domestic loans in 2021 and primarily comprised deposits from offshore companies, Tunisian expatriates, and credit lines from multilateral lending institutions.
  - Banks continue to depend on Central Bank of Tunisia financing due to the small local capital market and an insufficient local deposit base.

Key Considerations | Turkey

– The conflict is likely to be significantly negative for Turkey's banking sector due to effects on the economy, inflation, and refinancing channels.

Economic and credit growth

- **Oil and commodity price hikes**
  - Inflation is expected to average 55% in 2022, boosted by higher oil and commodities prices.
- **Trade and tourism decline will weigh**
  - Russians and Ukrainians accounted for about 27% of Turkey's foreign arrivals last year.
  - In 2021, About 4% of Turkish exports were to Russia and Ukraine, which were also the source of 12.3% of imports.
- **Lira under pressure**
  - The conflict's effects risk destabilizing the lira, despite some support from the foreign exchange-protected deposit scheme and central bank interventions.
- **Credit growth likely to increase**
  - We expect lending to expand in nominal terms, driven by deeply negative real rates and public sector banks' commercial policy.

Asset quality

- **Pressure on credit losses**
  - Credit losses could rise as a result of slower economic expansion (with a real GDP increase of only 2.4%), and surging inflation.
  - We expect the cost of risk to continue increase to over 320 bps on average in 2022-2023.

Profitability

- **Bank profitability will weaken**
  - Higher inflation is positive for bank revenues, increasing gains from consumer price index-linked securities.
  - That will likely be offset by increased provisioning needs and a deeply negative real interest rate, which will weaken profitability in real terms.
- **Capitalization under pressure**
  - Turkish banks' risk-weighted assets will continue to increase, and capital ratios will erode, due to high nominal lending expansion and a weaker lira.

Funding and liquidity

- **Rising capital market costs**
  - We expect banks to be able to rollover most of their external debt, especially their syndicated loans, but the cost is likely to continue rising.
  - External debt was about 19% of total assets as of Sept. 30, 2021.
  - Banks have sufficient foreign currency liquidity to handle lower rollover rates, but most of it is either with the central bank or in government securities, which could restrict availability in a severe stress scenario.
- **Deposit dollarization might pick-up again**
  - The transfer of lira deposits into dollar accounts, known as dollarization, could return along with concerns over unconventional monetary policy and persistently rising inflation.

Key Considerations | United Arab Emirates

– The conflict will have a limited effect on the UAE's banking sector, for now. The government has significant capacity and willingness to provide support if needed.

Economic and credit growth

- **Oil price increase will boost economic confidence**
  - Higher oil revenues should accelerate the UAE's economic growth.
  - Ongoing weakness in the tourism and hospitality sectors will take longer to recover.
  - We expect real GDP to increase 3.8% in 2022.
- **Credit growth**
  - Lending growth is likely to accelerate, underpinned by the UAE's economic growth.

Asset quality

- **Direct exposure is minimal**
  - Rated UAE banks have minimal direct exposure to Russian or Ukrainian counterparties
  - We do not expect to see any significant direct effects of the conflict on their asset quality indicators.
- **Asset quality deterioration contained**
  - Problem loans growth is likely to be limited by economic improvement and recovering corporate activity.
  - Real estate, construction, hospitality, and consumer-related sectors, as well as small- and midsize-enterprises, will take longer to recover and will be the chief contributors to new NPLs
  - We forecast the NPL ratio will peak at 7.0% in 2022, up from 6.1% in 2021.

Profitability

- **Higher interest rates will support profitability**
  - Net income will increase 15%, and return on assets will increase 1.4%, for every 100 bps increase in interest rates, according to our calculations based on the top 10 banks' disclosures.
- **Credit losses will normalize in the next 12-24 months:**
  - An increase in interest rates is likely to only marginally increase the cost of risk (COR).
  - We expect COR to stabilize at about 120 bps-130 bps in 2022-2023, helping UAE banks' profitability to return to pre-pandemic levels by 2023.

Funding and liquidity

- **Liquid external assets provide comfort**
  - The UAE banking system operates with a substantial gross external debt position, equal to about 23% of total assets at Nov. 30, 2021.
  - A significant amount of those external assets are liquid and could be used if banks' access to external funding is restricted.
  - Bank funding structures also benefit from strong core-customer deposit bases and the government's strong capacity and willingness to support systemically-important banks, if needed.

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