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Building Sustainable Capital and Liquidity Positions

*Booz & Company's
Study of Capitalization
and Liquidity Levels of
GCC and Levant Banks*



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EXECUTIVE SUMMARY

Thanks to astute oversight by regulators in Gulf Cooperation Council (GCC)¹ countries and the Levant, banks in these regions came out of the recent financial crisis better than many in Western countries. That does not, however, guarantee future success. Booz & Company recently conducted a study of capitalization and liquidity levels at 64 regional banks. The results were sobering, as many institutions face the prospect of capital and liquidity shortfalls in the near term, particularly as Basel III rules are phased in.

In response, banks must manage their capital and liquidity positions more proactively. This is necessary to comply with Basel III in the short term and satisfy stakeholders' expectations—such as shareholders and rating agencies that increasingly want to see that capital is deployed in the most efficient and profitable way possible. But, more importantly, banks ultimately have to undergo a holistic capital, liquidity, and risk transformation to build a competitive

edge and to fulfill their long-term growth ambitions.

The bottom line is that to meet ambitious growth plans, be globally competitive, satisfy more demanding regulatory and stakeholder standards, and cope with adverse market conditions and poorly performing assets, GCC banks should manage their capital and liquidity more strategically in order to address both short-term as well as long-term imperatives.

KEY HIGHLIGHTS

- The capital shortfall for the GCC and Levant banks under study would increase from about US\$11 billion in total in 2012 to a range of \$12 billion to \$27 billion in 2017, based on possible ratios and various economic scenarios.
- In total, the liquid assets needed to satisfy the 100 percent Liquidity Coverage Ratio (LCR) threshold would range from \$2.7 billion to \$10.5 billion based on the conservative and aggressive scenarios, respectively.
- Among the 64 GCC and Levant banks covered in this study, 16 have relatively strong capital and robust liquidity while 18 have relatively average capital and average liquidity.
- Banks should be proactive in managing short-term objectives (engaging with internal and external stakeholders, revamping data and systems) and long-term objectives (integrating business, risk, capital, and liquidity strategies, effective capital utilization, etc.).

SURVIVING THE FINANCIAL CRISIS

GCC and Levant banks emerged from the financial crisis in better shape than many Western banks, but their liquidity and capital positions should not be taken for granted.

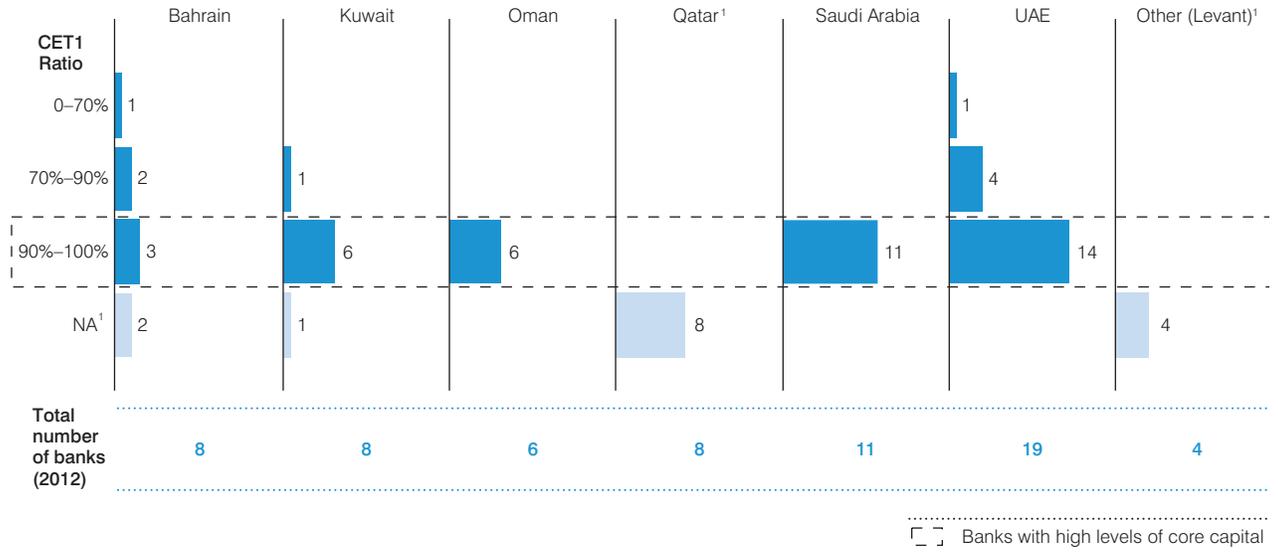
Since the crisis, capital and liquidity support from GCC and Levant regulators has helped keep the banking sector relatively strong. Across the region, governments acted fast to inject liquidity into the system by placing long-term government deposits into banks. In Bahrain, Oman, and Saudi Arabia regulators also lowered interest rates and modified reserve requirements to improve the liquidity situation. To support capital positions, Kuwait and the United Arab Emirates (UAE) made direct capital injections (e.g., Gulf Bank in Kuwait and Emirates NBD in Dubai) and Qatar purchased bank assets.

These measures had the desired effect. In our comprehensive analysis and study of the capital and liquidity positions of regional GCC and Levant banks, we have found that all 64 participating banks meet their capital requirements, and most exceed the minimum capital requirement by 50 percent or more. Many banks in the region also hold very high levels of core capital. For example, all 17 of the banks in Saudi Arabia and Oman hold 90 percent to 100 percent of their capital in the form of core capital (*see Exhibit 1*).

The analysis also revealed that regulators' impact on liquidity has been equally positive. Deposits as a percentage of funding vary from 58 percent in Bahrain to 78 percent in Saudi Arabia. Moreover, according to a conservative liquidity ratio,² the vast majority of GCC and Levant banks (58 out of 64 banks) have moderate to strong liquidity with a ratio of 20 percent or more. For example, in Saudi Arabia, 10 out of the 11 banks we analyzed have ratios of 30 percent or greater, as do the four Levant banks in Jordan and Lebanon we analyzed (*see Exhibit 2*).

Exhibit 1
GCC Banks Have Adequate Capital

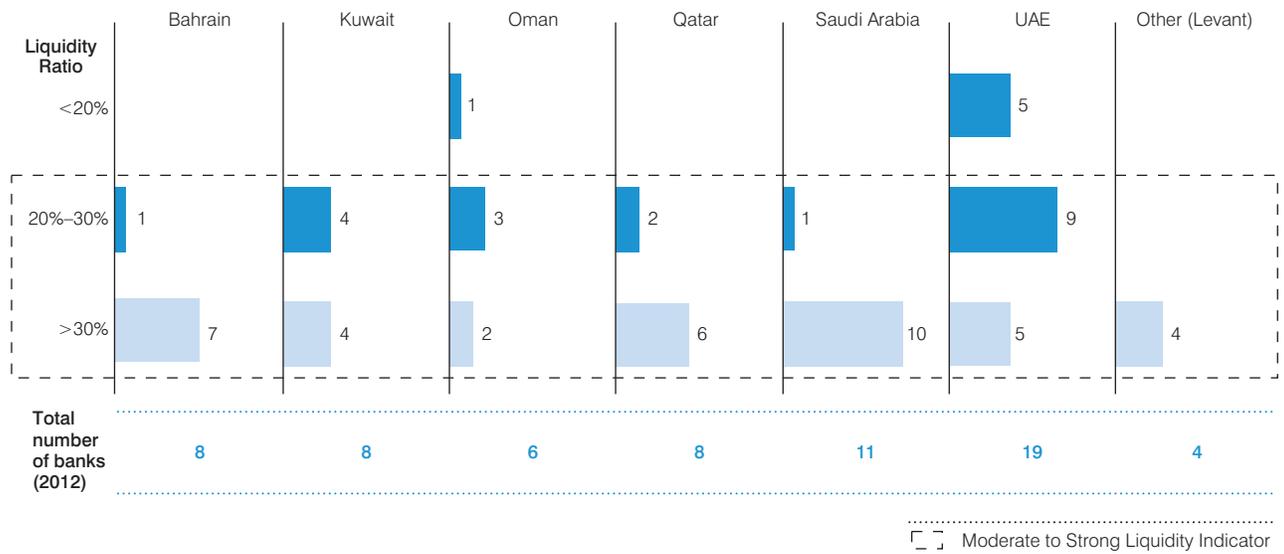
DISTRIBUTION OF BANKS BASED ON % OF CET1 CAPITAL/TOTAL TIER 1 CAPITAL



¹ Detailed Basel II disclosures data is not available for CET1 capital calculation.
 Source: Annual reports; Booz & Company analysis

Exhibit 2
Most Banks Have Adequate Liquidity

DISTRIBUTION OF BANKS BASED ON A SIMPLIFIED LIQUIDITY RATIO¹



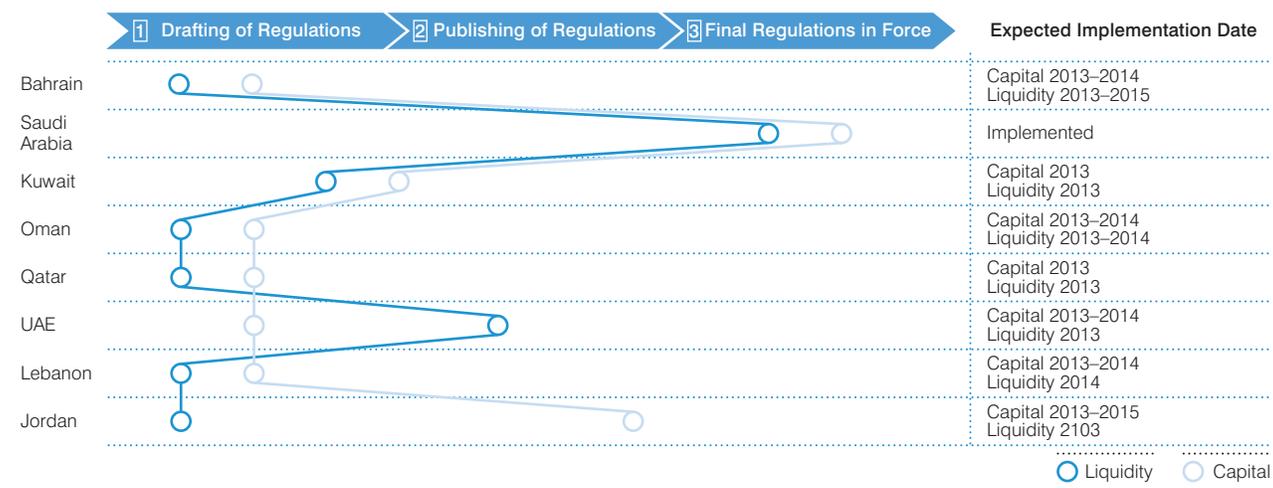
¹ Defined as the ratio of liquid assets to total liabilities, where liquid assets is the sum of cash and central bank reserves, sovereign bills, and bonds due from banks.
 Source: Annual reports; Booz & Company analysis

CAPITAL AND LIQUIDITY POSITIONS AT RISK

Although the governments' capital and liquidity initiatives have helped keep regional banks solvent and strong to date, our study found that many of these banks could face capital and liquidity shortfalls as soon as new Basel III rules are phased in between 2013 and 2018. In response, banks will need to manage their capital and liquidity levels more proactively—and soon (*see Exhibit 3*).

To a large extent, the new capital and liquidity ratios under Basel III have not yet been finalized, but with the implementation phase around the corner, we ran several scenarios based on the most likely new ratios. The findings were noteworthy. Under all reasonable scenarios, many banks in the GCC and Levant may face capital and liquidity shortfalls.

Exhibit 3
Basel III Progress Diverges Widely across the Middle East



Source: FSI Survey Basel II, 2.5 and III Implementation, July 2013; BCBS Progress Report on Basel III Implementation, April 2012

Methodology

- The capital analysis was conducted on 64 commercial and Islamic GCC and Levant banks with publicly available capital adequacy data.
- The study was conducted based on the latest data available as of December 2012.
- The liquidity analysis was conducted on 64 commercial and Islamic GCC and Levant banks with publicly available financial statements and accompanying notes.
- For Common Equity Tier 1 (CET1) ratio and leverage ratio calculations, banks were excluded from the sample where detailed Basel II disclosure data enabling the calculation is not available.
- Capital Adequacy Ratio (CAR), CET1 ratio, and leverage ratio were projected for the next five years under a base case and downside scenario using the assumptions based on historical performances at the country and bank level.
- CAR was forecasted using return on assets growth assumptions based on historical performance at country and bank levels. The aggressive scenario assumes a 50 percent slowdown in asset growth compared to the base case.
- LCR was calculated while following Basel III guidelines. Varying levels of haircuts and factors were used to calculate the conservative and aggressive ratios; with shorter haircuts/more severe factors under the aggressive scenario.
- The thresholds against which CAR, CET1 ratio, leverage ratio, and LCR were tested are determined based on the recommended phase-in limits by the Basel Committee on Banking Supervision as follows:
 - CAR thresholds: 13.5 percent, 16 percent, and 18 percent
 - CET1 ratio thresholds: 9.5 percent, 13 percent, and 14.5 percent
 - Leverage ratio threshold: 3 percent
 - LCR thresholds: 60 percent, 80 percent, and 100 percent

CAPITAL RESULTS

Under Basel III, the main capital requirement changes involve improving the quality and quantity of Core Tier 1 and Tier 1 capital, simplifying and reducing Tier 2 capital, eliminating Tier 3 capital, enforcing more stringent criteria for each instrument, and enhancing disclosure.

According to our study the new minimum capital requirements set by the Basel Committee and local regulators will significantly affect banks, including systemically important financial institutions (SIFI).³ Indeed, the new requirements are much more stringent, and they call for meticulous and recurrent capital planning that is integrated into the overall strategy of the banks.

Based on 2012 performance, 15 of the 64 banks could fail to meet a capital requirement of 16 percent, and 29 of the banks could fail to meet a capital requirement of 18 percent.

To get an idea of how banks would perform in the future, we also ran two economic scenarios for 2017: one assuming growth in line with the projected expansion in GDP and another assuming decelerated growth. The results for the downside scenario were sobering. Under the downside scenario, 28 banks could fail to meet the 16 percent capital requirement while 39 institutions could fail to meet the 18 percent capital requirement (see Exhibit 4).

Exhibit 4
Some Banks Will Struggle as New Capital Requirements Thresholds Are Toughened

PERFORMANCE OF BANKS' CAR UNDER DIFFERENT THRESHOLD SCENARIOS

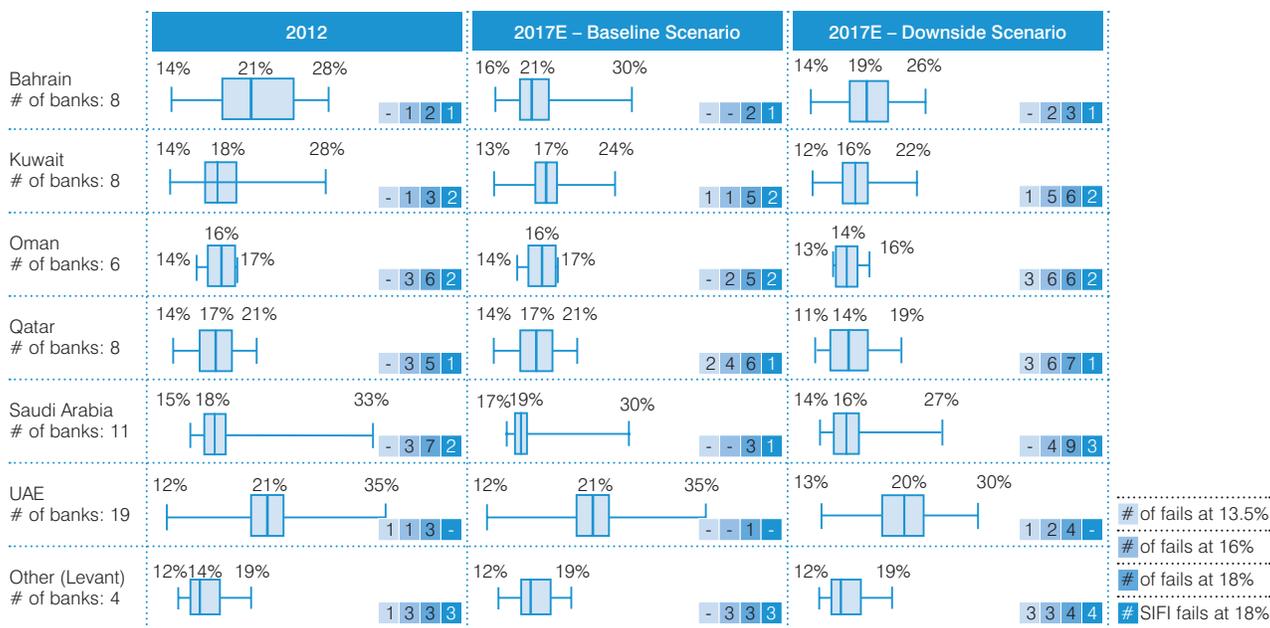
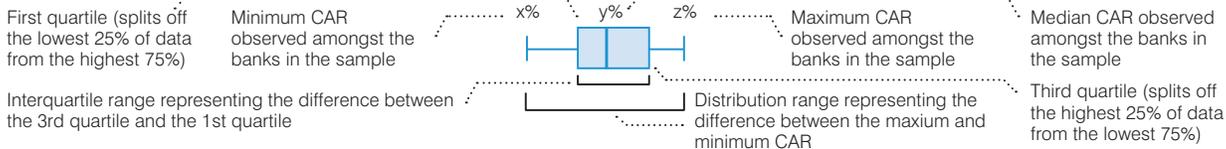


Exhibit legend



Source: Annual reports; Booz & Company analysis

The picture is similar, though somewhat better, when looking at core capital. For instance, based on 2012 performance, two banks could fail to meet a new core capital

requirement of 9.5 percent, 11 could fall short if the level was at 12 percent, and 22 could fail were the level raised to 14.5 percent. In a 2017 downside scenario, 25 banks

could fail to meet the 14.5 percent threshold (*see Exhibit 5*). (No core capital data was available for Qatar or the Levant banks).

Exhibit 5
There Could Be Problems with CET1 Capital

PERFORMANCE OF BANKS' CET1 RATIO UNDER DIFFERENT THRESHOLD SCENARIOS

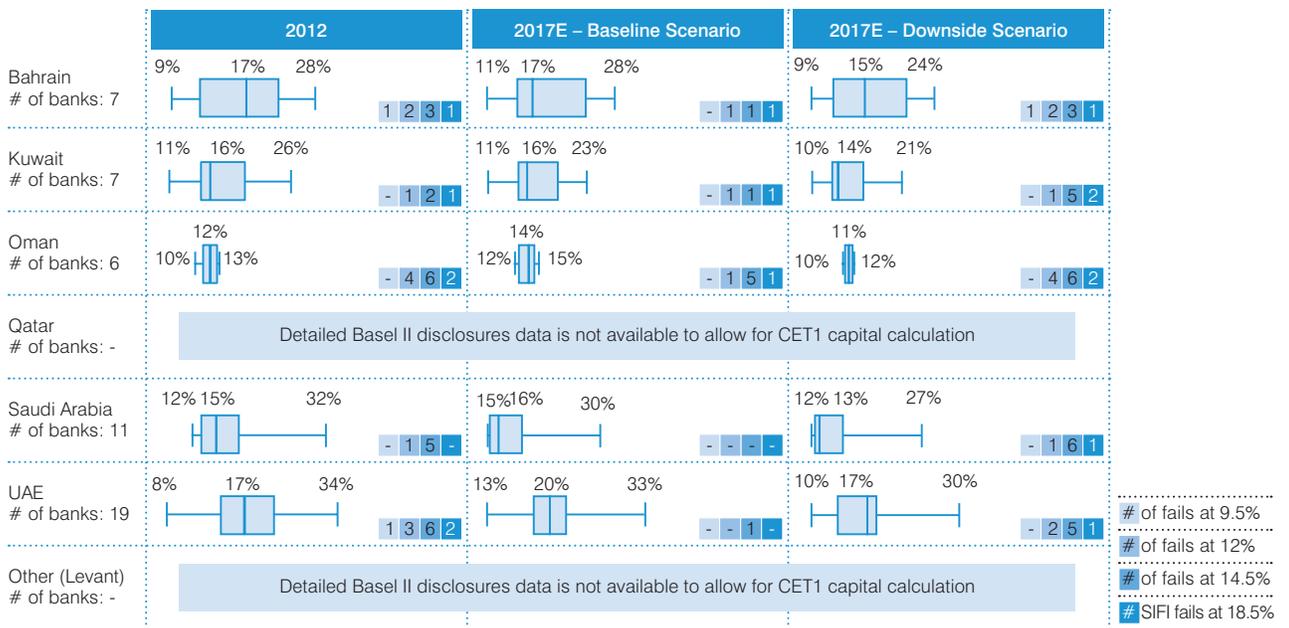
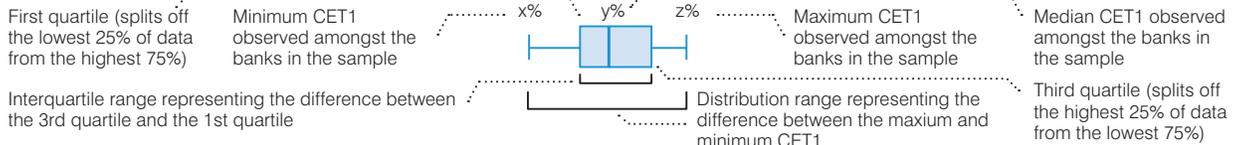


Exhibit legend



Note: Banks with no detailed Basel II disclosures to allow for CET1 capital calculation were excluded from the analysis.
Source: Annual reports; Booz & Company analysis

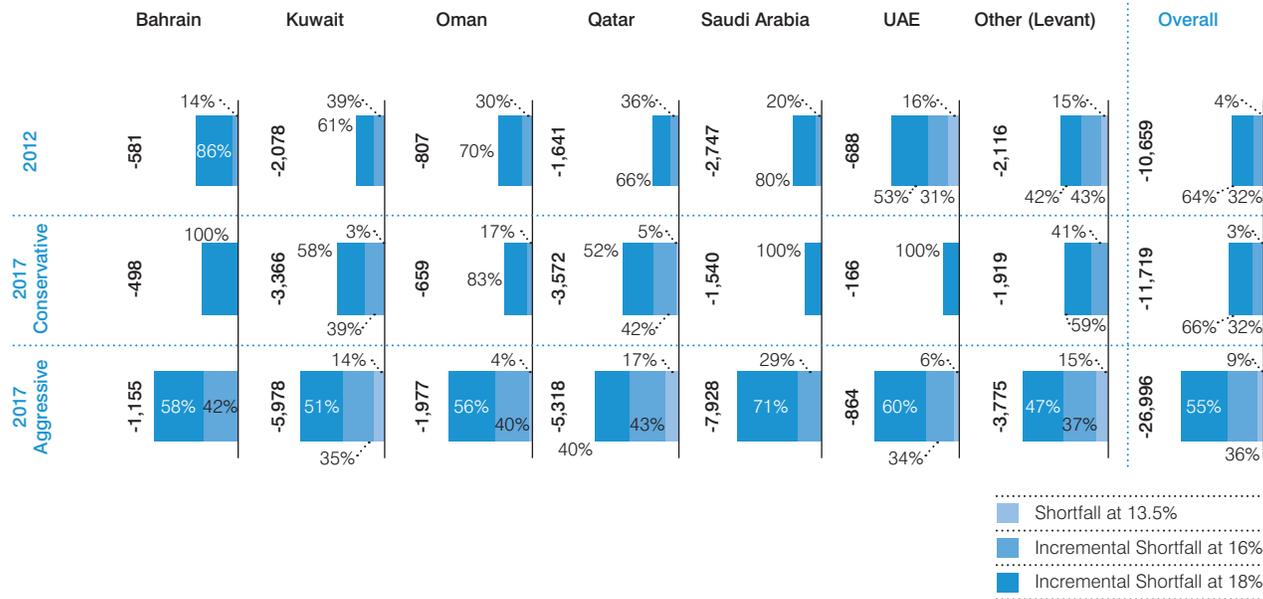
In total, the capital shortfall increases from about \$11 billion in 2012 to a range of \$12 billion to \$27 billion in

2017 based on possible ratios and various economic scenarios (see Exhibit 6). As a result, once these new requirements

are set, the shortfall in the availability of excess capital that banks can use to meet their growth plans will be substantial.

Exhibit 6
The Total Capital Shortfall More Than Doubles to Satisfy the Different Thresholds

CAPITAL SHORTFALL BY COUNTRY AND OVERALL
(US\$MILLIONS, 2012, 2017, % OF SHORTFALL BY THRESHOLD)



Source: Annual reports; Booz & Company analysis

LIQUIDITY RESULTS

On the liquidity side, Basel III introduces two new ratios to improve the banking sector's ability to absorb shocks arising from financial and economic stress, thus reducing the risk of spillover from the financial sector to the real economy.

- *The Liquidity Coverage Ratio* (LCR) promotes short-term resilience of a bank's liquidity risk profile by ensuring the bank has sufficient high-quality liquid assets to survive a significant stress scenario lasting for one month.
- *The Net Stable Funding Ratio* (NSFR) promotes resilience over a longer time horizon by creating additional incentives for banks to fund their activities continuously with more stable sources of finance.

These two new ratios pose a number of structural challenges for GCC banks. Banks with the wrong funding composition or balance sheet maturity profiles could struggle to meet the new requirements on time. Some also lack access to stable funding due to limited local retail deposits and sovereign debt instruments, and Islamic banks in particular often have limited access to liquid assets.

There is also a serious operational challenge. Many banks lack the data

and flexible IT systems necessary to compute LCR and NSFR ratios, which require, among other inputs, detailed breakdown of portfolios and historical data analysis at the group level as well as across subsidiaries.

As with the capital requirement, the liquidity requirement will be introduced in phases from 2013 to 2018. Similarly, we studied GCC and Levant banks to gauge how prepared they are to cope with the new liquidity requirements. Overall, the banks fared slightly better than with capital requirements, but many banks are still at risk.

We ran two scenarios for the liquidity coverage ratio, a conservative one and a more aggressive one. Using Basel III guidelines, we used various haircut levels and other factors to set the conservative and aggressive ratios. We then tested each bank's ability to meet LCR requirements as they are gradually implemented from 60 percent to 80 percent to 100 percent. The different assumptions had an important impact on the number of banks that would potentially fail to meet the threshold, underscoring the need for banks to build greater resiliency measures into their liquidity management. For instance, under the conservative scenario, based on 2012 data, seven of the 64 banks failed at 100 per-

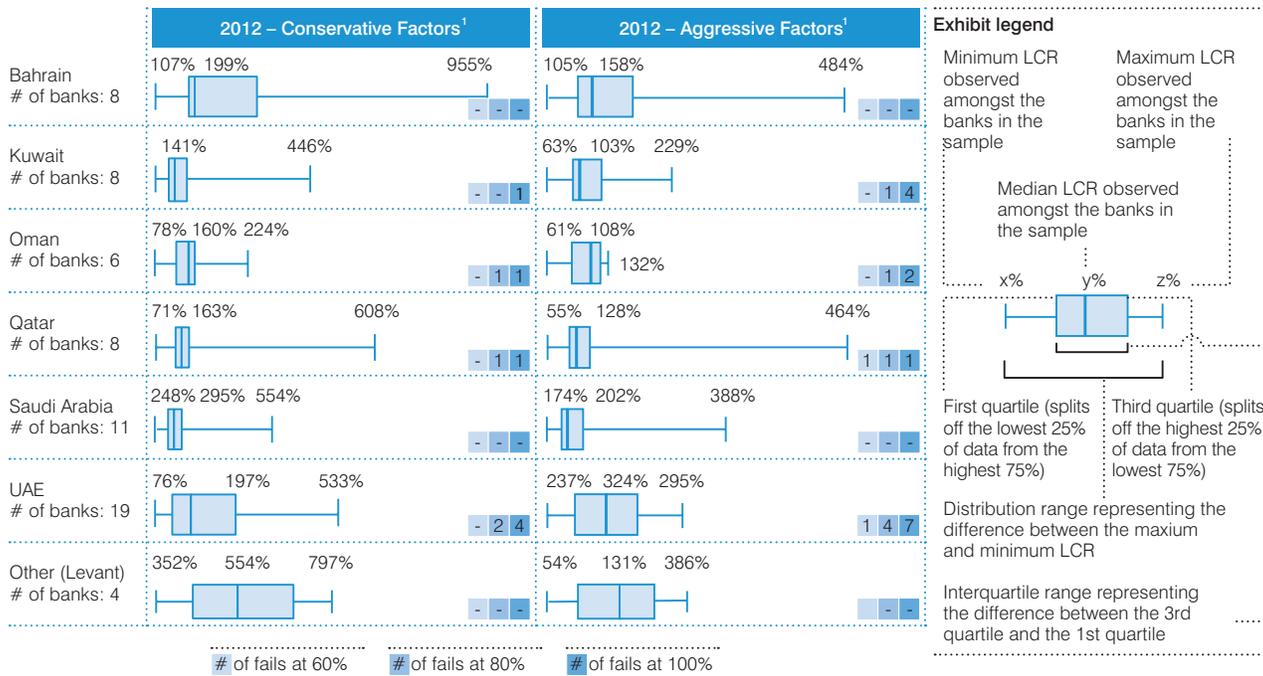
cent implementation; that number doubled to 14 using the aggressive assumption (see Exhibit 7).

In total, the liquid assets needed to satisfy the 100 percent LCR threshold range from \$2.7 billion

to \$10.5 billion based on the conservative and aggressive scenarios (see Exhibit 8).

Exhibit 7
As the New Liquidity Regulations Are Introduced, Some Banks Could Face Challenges in Meeting These Requirements

PERFORMANCE OF BANKS' LCR UNDER DIFFERENT THRESHOLD SCENARIOS

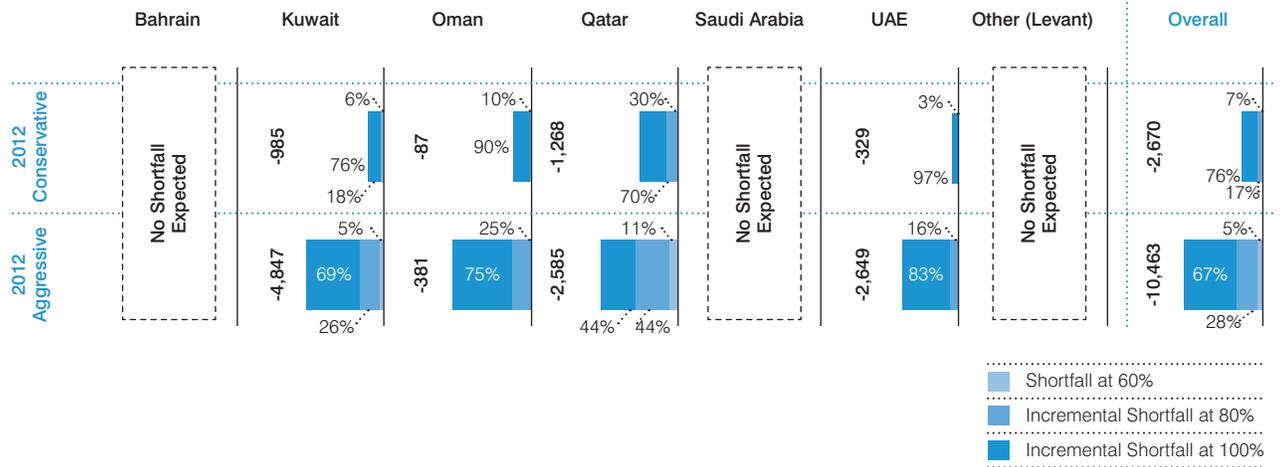


¹ Assumptions were made on the different factors for the LCR items as suggested by Basel criteria.
Source: Annual reports; Booz & Company analysis

Exhibit 8

Total Assets to Be Converted to High Liquid Assets to Satisfy LCR Thresholds Range between \$2.7 Billion and \$10.5 Billion

HQLA SHORTFALL BY COUNTRY AND OVERALL
(US\$MILLIONS, 2012, % OF SHORTFALL BY THRESHOLD)



Source: Annual reports; Booz & Company analysis

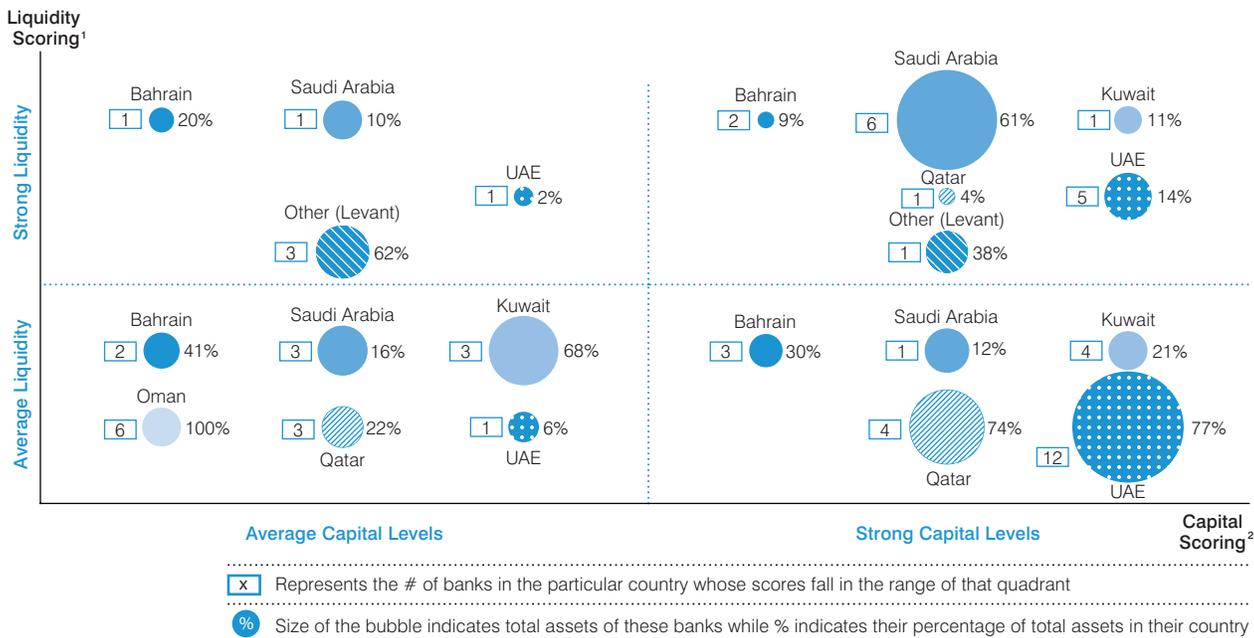
What emerges from our capital and liquidity study and the subsequent analysis is that a wide spectrum of preparedness exists among GCC banks. Among the 64 GCC

and Levant banks studied, 16 have relatively strong capital and liquidity whereas 18 have relatively average capital and liquidity positions (see Exhibit 9). Our

analysis also covered leverage ratios, but these posed no problem for any GCC bank due to high Tier 1 capital levels and limited off-balance-sheet exposures (see Exhibit 10).

Exhibit 9
A Wide Spectrum of Preparedness Exists Among Middle East Banks

BANK SCORES ON CAPITAL AND LIQUIDITY INDICATORS



¹ Liquidity Scoring is based on the weighted average of the score of the bank on the two LCRs (conservative & aggressive factors – each 40%) and the simplified liquidity ratio (20%).

² Capital Scoring is based on the weighted average of the score of the bank on CAR (50%), CET1 (30%), and on leverage ratio (20%).

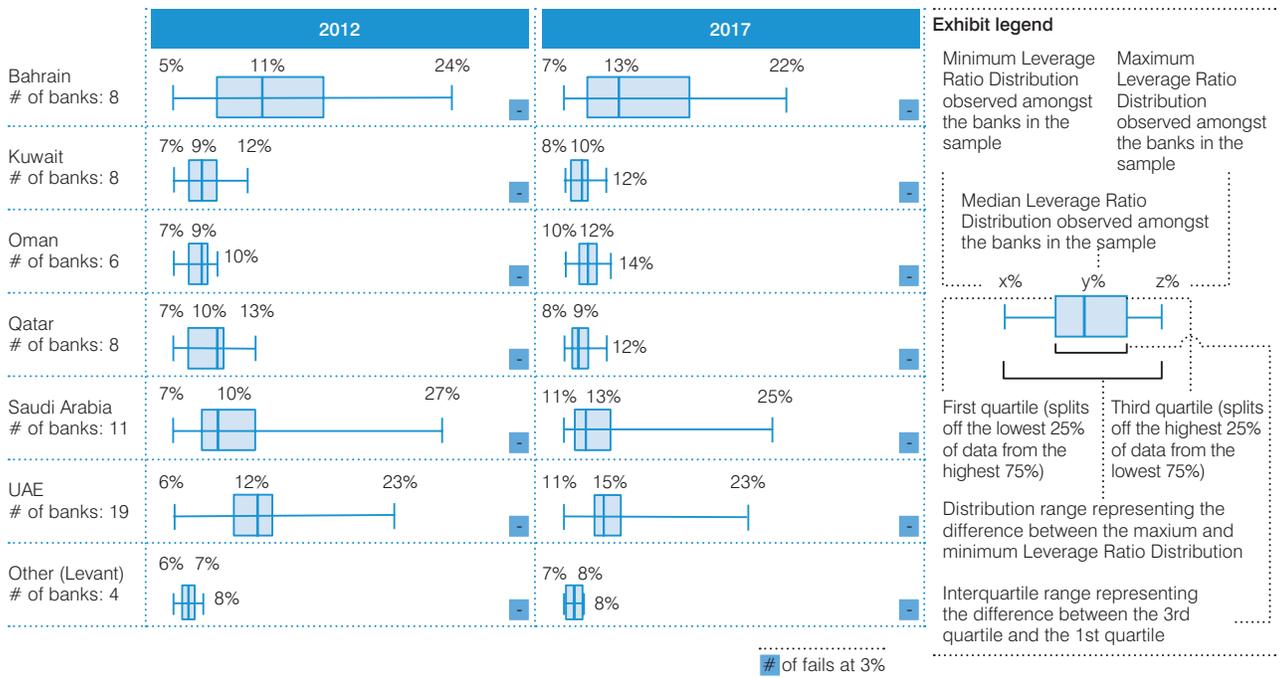
Note: Scores are determined based on the position of the bank's indicator with respect to other banks, after removing the effect of outliers. Banks with no CET1 indicator were assigned a score in line with their CAR score.

Source: Annual reports; Booz & Company analysis

Exhibit 10

Banks Perform Better on Leverage Ratios Because of Strong Tier 1 Levels and Limited Off-Balance-Sheet Exposures

PERFORMANCE OF BANKS' LEVERAGE RATIO BASEL III DEFINED THRESHOLD



Source: Annual reports; Booz & Company analysis

GCC BANKS MUST BECOME MORE PROACTIVE

To avoid these shortfalls, GCC banks must begin to manage capital and liquidity ratios more proactively and rely less on reactive “helping hand” measures from their governments and regulators. There are four primary reasons why they must pursue this more proactive approach.

- **Tighter Regulatory Requirements:** primarily linked to the Basel Committee’s new capital and liquidity guidelines, known as Basel III. The new regulatory changes will raise the bar for banks in terms of capital, leverage, and liquidity. Creating additional capital and liquidity buffers will reduce the amount of free capital and liquidity available for growth plans, making careful management of free capital and liquidity all the more vital.
- **Developing International Expansion Plans:** Increasingly banks will seek cross-border growth opportunities. However, these expansion plans pose a number of challenges: capital is becoming more expensive; funding is more complex and needs to be streamlined; and dealing with multiple regulatory jurisdictions is complicated.
- **Increasing Stakeholder Awareness:** Shareholders are increasingly concerned about how capital and liquidity are being deployed. They want a healthy risk-adjusted return on capital (RAROC) and are pressing management to optimize current capital and liquidity before

asking for new injections of equity. Likewise, regulators and rating agencies are taking a greater interest in how banks deploy their capital and keep their liquidity ratios healthy. In response, banks need to be transparent about capital needs, avoid burning capital, and make sure RAROC is satisfactory.

- **Degradation of Legacy Assets:** Loans and investments dating from the financial crisis continue to deteriorate, weighing on banks’ ability to generate capital internally (through retained earnings) and to build up their capital and liquidity buffers. These legacy assets will remain a significant problem for some banks in the short term to mid-term.

The bottom line is that surviving the financial crisis is no guarantee of future success. To meet ambitious growth plans, be globally competitive, satisfy demanding regulatory and stakeholder standards, and cope with adverse market conditions and poorly performing assets, GCC banks must manage their capital and liquidity more proactively.

Short-Term Focus on Compliance with Basel III

In the short term, banks should prepare themselves to ensure compliance with Basel III by implementing various mechanisms, including:

- **Assess the impact of the new regulations.** The new Basel III standards are changing the way capital and liquidity are assessed and computed. However, beyond considering the various thresholds for capital adequacy and liquidity ratios, banks should carefully assess other issues addressed by the new standards, including the treatment of minority interests and investments in unconsolidated and associated financial entities.

- **Engage internal and external stakeholders.** Banks must secure buy-in from all stakeholders involved in Basel III implementation to align all their common objectives (business versus risk management), minimize conflicts, and secure a successful implementation. This includes assigning the right people or appointing a committee to oversee and lead the implementation efforts and ensure accountability.
- **Be proactive with regulators.** Banks need to develop an internal Quantitative Impact Study to assess the impact on capital, leverage, and liquidity under multiple scenarios—and do so before regulators require it. They should continue to consult with regulators often to help shape regulatory outcomes on Basel III. Regulators must ensure progressive rollout of the new regulations to allow the banks the necessary time to be well-prepared for the full implementation of Basel III.
- **Revamp process, prepare data and system integration.** Implementing the new standards will entail: substantial investment in data management and IT system upgrades for streamlined and timely data collection/preparation; group-wide data coverage and integration with various subsidiaries; comprehensive review and redesign of reporting processes for reporting at multiple levels (group, stand-alone, and subsidiaries); and extensive people training and project management to meet deadlines.

Long-Term Focus on Five Strategic Imperatives

Beyond preparing for the new Basel III regulatory changes, banks should engage in a holistic capital, liquidity, and risk transformation to secure a competitive edge and fulfill their growth ambitions at home and overseas. Ultimately, the new

long-term focus on capital, liquidity, and funding renders the availability of such resources more expensive and scarce. In this environment, it is vital that banks adjust the way they do business to optimize the use of capital and liquidity and ensure that strategies are aligned at the business, risk, capital, and funding levels. Each bank's ability to tackle these issues depends on where it currently stands in terms of risk and finance capabilities; capital, liquidity, and balance sheet management practices; data quality; as well as human and financial resources. Nonetheless, all banks need to follow five strategic imperatives.

1. *Integrate Bank-Wide Risk, Capital Planning, and Funding Management Strategies*

- Integrate risk, capital, and funding management strategies, keeping in mind the capital and funding needed and the expected risk-return profile of the strategic plan.
- Maximize value creation by striking the right balance between the strategic objectives, risk appetite, and capital and funding availabilities.
- Ensure integration and internal alignment among stakeholders by elevating the endeavor to the board and management levels.
- Define a holistic risk appetite framework with agreed-upon metrics and enforceable limits.

2. *Utilize Capital Effectively and Efficiently*

- Identify the capital gap—the difference between capital availability and capital requirements—and identify internal and external

sources for capital-raising initiatives; consolidate these findings into a holistic capital plan.

- Define and implement a capital allocation mechanism to utilize capital effectively. This includes screening all business opportunities to make sure the risk-return profile is in line with the bank's guidelines, allocating capital only where risk-return profiles are optimal, and being transparent about risk-return performance and capital consumption.

3. *Enhance Funding and Liquidity Management*

- Identify the funding gap—the difference between funding availability and funding requirements—and identify sources of funding to bridge the gap; consolidate these findings into a holistic funding plan.
- Establish a centralized, consolidated, timely view of the bank's liquidity positions to understand all liquidity needs and sources to avoid unexpected shortfalls or other liquidity surprises.
- Monitor liquidity frequently to avoid problems and continue to meet liquidity requirements (LCR, NSFR, and others).
- Manage liquidity across different business units and subsidiaries by creating fund transfer pricing capabilities.

4. *Integrate Risk Governance with the Organization, Culture, and Processes*

- Articulate and tailor risk processes, policies, and procedures. This includes: defining end-to-end risk

processes; assigning clear roles and responsibilities; and embedding the processes in policies and procedure manuals.

- Require that senior management make strong, visible, and consistent commitments to risk management to strengthen the bank's risk culture.
 - Apply three lines of defense throughout the bank to improve risk governance: business units allocate capital only where risk-return profiles are optimal; the bank's risk management function monitors risk taking and the risk profile; and internal/external audits make sure that risk policies and standards are being adhered to.
- ### 5. *Invest in Reporting, Solutions, Data, and IT Infrastructure*
- Produce insightful reports and dashboards to support senior management and board decision making.
 - Create transparency around performance and risk-adjusted profitability at the group and subsidiary levels to improve measurement and increase accountability.
 - Invest in next-generation models and solutions for better analyses and decision making. Include stress-testing solutions, capital planning and allocation models, funding planning, fund transfer pricing, etc.
 - Guarantee the availability, consistency, and quality of the data (e.g., streamlined and timely data collection, group-wide data coverage and integration, historical data extraction, etc.) as well as the necessary IT systems.

CONCLUSION

Basel III compliance, while important in the short term, is not the only reason for managing capital and liquidity more proactively. Longer term, banks must also engage in a holistic capital, liquidity, and risk transformation. The reasons to do so are compelling. Those whose growth ambitions lie overseas may find even tougher capital and liquidity requirements in these for-

eign markets. Moreover, to improve RAROC and continue to attract shareholder backing, banks need to deploy capital in the most productive ways possible. Ultimately, more proactive management and strategic integration of capital and liquidity is necessary if GCC banks are to fulfill their growth ambitions and compete on the global stage.

Endnotes

¹ The GCC countries are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

² The ratio of liquid assets to total liabilities, where liquid assets is the sum of cash and central bank reserves, sovereign bills, and bonds due from banks.

³ SIFIs are banks whose failure could have a material impact on the domestic financial system and economy, regardless of the risk of that failure occurring. We define these banks as those with assets representing at least 50 percent of the total domestic banking assets.

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George Haimari is a partner with Booz & Company in Dubai and a member of the firm's financial services practice. He co-leads the firm's advisory work for central banking and risk, capital, and liquidity management across the Middle East and North Africa region and has more than 18 years of management consulting and banking experience. He has extensive experience in regulatory frameworks, banking supervision, risk management, and large-scale transformation programs.

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We believe passionately that essential advantage lies within and that a few differentiating capabilities drive any organization's identity and success. We work with our clients to discover and build those capabilities that give them the right to win in their chosen markets.

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