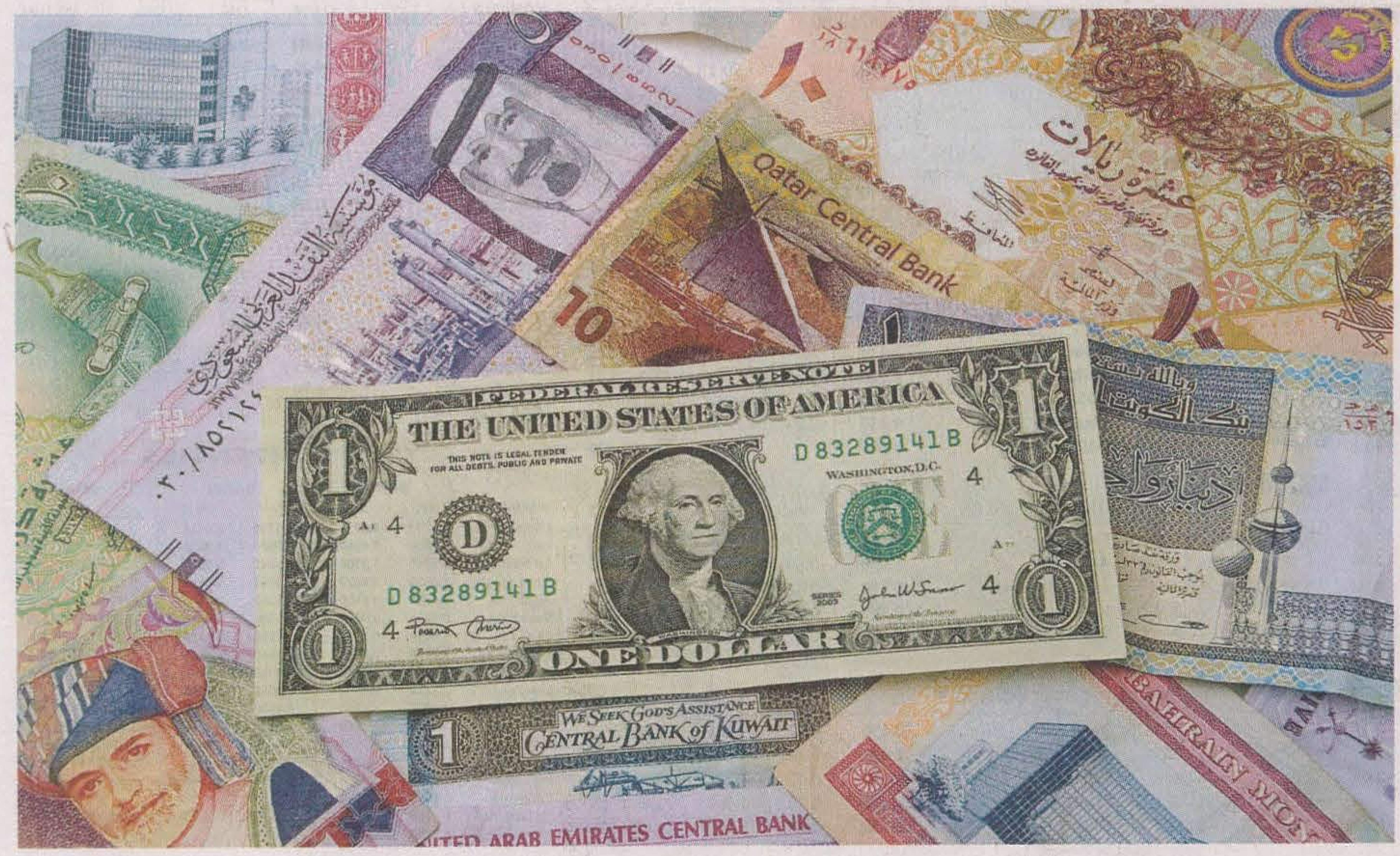
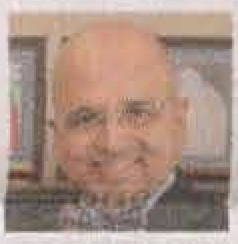


The struggle in capital markets on account of low oil prices have increased the market risk on investment books. – *Bloomberg*

Strengthen enterprise risk management in GCC

Global financial system may face an unprecedented adjustment in response to possible Fed rate hike in Dec



R. SEETHARAMAN
Doha Dateline

IT IS IMPORTANT when assessing GCC banks' risk profile, to recognise its dependence on developments on oil sector. Its dependence on oil led to credit portfolios that have large correlations with government expenditures, which in turn are correlated with oil developments. As a result, banks' portfolios do not benefit as much from the potential diversification that lending to different sectors of the economy would usually provide.

Rather, most sectors are ultimately driven by government spending. The contract financing risks on projects may increase if there are delay in funding by government. The geographic distribution of banks' credit exposures is also concentrated in the GCC region contributing to the oil exposure of banks. Consequently, GCC banks' net income is highly correlated with oil-driven fiscal developments. This implies that the oil price is a significant risk factor driving credit default and with low oil prices the risk of credit default by counterparties has increased.

Fiscal spending in infrastructure and investment projects fuels bank credit to public sector entities or private contractors. With fiscal spending expected to be more pragmatic, lending and risk evaluation parameters to such sectors should be revisited.

The credit evaluation process should be enhanced in the light of changing market dynamics and the recovery mechanism from customers should be more robust. The slowdown in economic cycle should be correlated to the slowdown in business activities and liquidity scenario.

The major asset class in GCC banks' gross exposure consists of claims on corporates. A significant share of claims on corporates, sovereigns and public sector entities in gross exposures is due to the economic and corporate structure in GCC countries with oil driving most of the economic activity and the interconnectedness between financial, industrial, and commercial private and public sector groups.

The lending to large and connected private and public sector groups could increase concentration risks to these groups and sometimes represent a large percentage of bank capital and may have the potential to impair bank solvency in the event of default.

Bank credit for personal lending is importantly driven by public sector wages and oil developments. Fiscal spending on public sector wages fuels bank credit for personal and housing purposes as banks are able to deduct loan payments directly from government employees' paychecks. Any significant realignment of staff in public and private sector entities could increase the default risk on retail loans.

There has been a shift in the bank loan market as banks are becoming more cautious and selective. In the initial phase, the loan growth slowdown will be more pronounced in the small and medium enterprises (SME) segment, and with the persistence in oil decline, the squeeze is expected to extend to both loan demand and supply across all segments.

GCC banks use credit risk mitigation to reduce their gross exposures and the impact on capital. Some of the credit risk mitigation techniques include netting arrangements, financial and real estate collateral, and bank guarantees which as a way to reduce the impact of gross exposures on capital requirements. Credit exposure to the government sector is important for Saudi Arabia and some of the Qatar and UAE banks. Exposure to financial institutions is important in Bahrain's banks and some banks in Kuwait, Qatar and the UAE. Personal credit is most relevant in Oman and relatively high concentration in real estate/construction is present in some banks in Kuwait, Oman, Qatar and the UAE.

The struggle in GCC capital markets on account of low oil prices have also increased the market risk on investment books. Federal Reserve looks set to begin the gradual process of tightening monetary policy, the global financial system faces an unprecedented adjustment as risk premiums "normalise" from historically low levels alongside rising policy rates and a modest cyclical recovery.

As the Federal Reserve begins to normalise its monetary policy, a smooth implementation will be critical to avoid disruptions of market liquidity. The liquidity conditions which had remained difficult on account of low oil prices may further get impacted if GCC monetary policies follow monetary tightening in response to Fed rate hike.

GCC banks need to conduct liquidity stress testing taking into account the systemic effects of market illiquidity arising from above factors. GCC banks also need to strengthen its enterprise risk management to address the various challenges arising from economic slowdown.

The writer is Group CEO of Doha Bank. Views expressed by him are his own and do not reflect the newspaper's policy.