بنك الإمارات دبي الوطني
Emirates NBD

Credit Adhoc
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GCC local currency bond market

Background

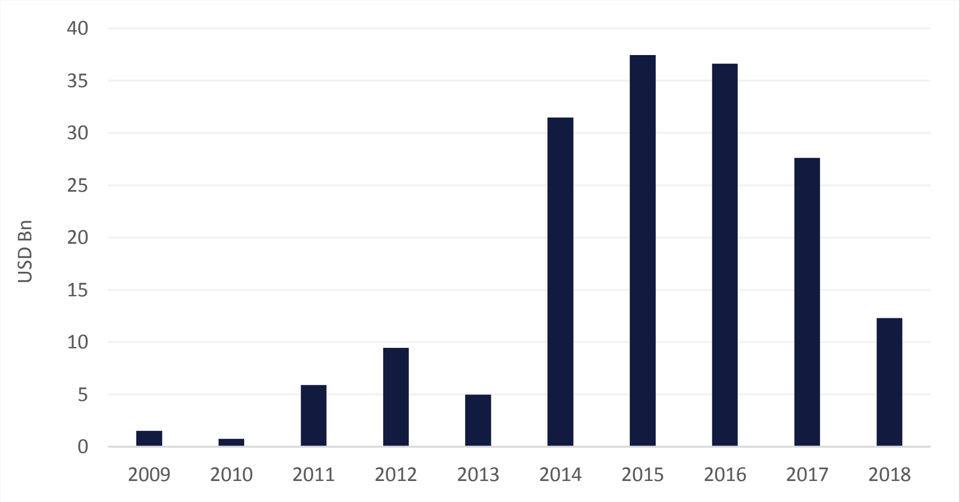
Growth of the GCC debt capital markets in the first decade of this century was relatively stunted as region's need for debt funding was negligible in the face of abundant liquidity ensuing from high oil prices. Since 2014, GCC sovereigns have been experiencing substantial problems in balancing their budgets as oil revenues dropped amid structurally difficult to curtail expenditures. Therefore, tapping the capital markets for funding government budget deficits became the need of the hour, consequently creating the environment for rapid growth of the debt capital markets in the region.

GCC debt markets have traditionally been dominated by USD denominated bonds. However, recently, local governments have made notable advancement for deepening the local currency debt markets (LCY) by creating public debt management units, articulating debt management strategies and launching benchmark issues for building yield curves. There has also been substantial improvement in market infrastructure and regulations.

The incremental push from the regulators in deepening the LCY debt markets is validated by several recent developments such as:

- UAE regulators have allowed sukuk issuance in as small denominations as USD10 million. Also Dubai Financial Market (DFM) in conjunction with NASDAQ Dubai offers electronic trading platform for listed bonds and sukuk in the region.
- As a step to achieve Vision 2030, and in an endeavor to develop the debt instruments market, Saudi Arabia's Capital Market Association (CMA) has approved the listing of debt instruments issued by the KSA Government. Listings began in April 2018. Additional steps underway include establishing a primary dealer system, increasing the flexibility of government debt issuance, and extending the yield curve by issuing shorter and longer-dated bonds.
- While there are foreign ownership limits on stocks, there are no restrictions on foreign investors to buy bonds of GCC issuers.
- Qatar has set up a domestic rating agency called the Middle East Credit Rating Agency.

GCC LCY bonds New Issues



Source: Markit, Emirates NBD Research as of April 2017

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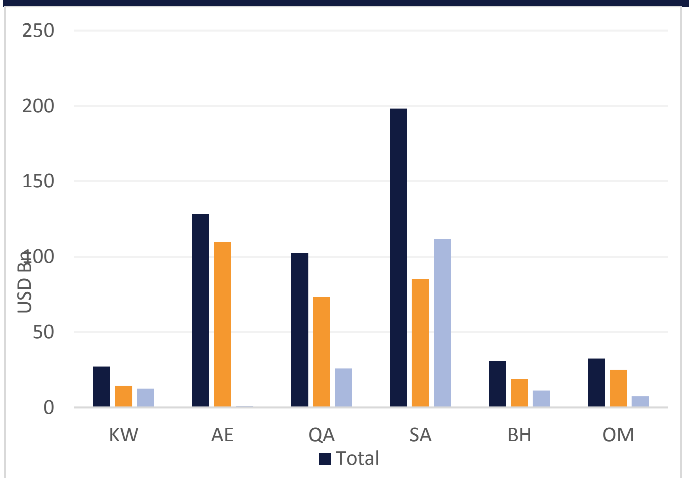
No capital gains tax and minimal withholding tax, if any, in the regional GCC markets makes it attractive for the foreigners to invest here. In addition, the risk of capital controls in the region is considered low relative to other EM markets, further boosting investor confidence.

As at April 2019, total outstanding in the GCC bond market (USD + LCY) is circa equivalent of USD 519 billion excluding short term securities, i.e. securities issued with less than one year to maturity, and T-bills issued by local central banks. Of the total, 63% is issued in USD (USD 327 billion), 33% in local currencies (equivalent of USD 170 billion) and remainder in other currencies such as Euro, JPY, CNH, AUD etc. Saudi bonds account for 38% of the market, followed UAE at 25% and Qatar at 20%.

Though GCC LCY markets have seen material growth in the last five years, the development is uneven across the six nations. As a percentage of GDP, those in Bahrain and Qatar are the largest and relatively the most developed while those in UAE and Kuwait have lagged behind. Of the USD 170 billion in the LCY bond market, Saudi Arabia accounts for 66% (USD 112 billion) while UAE is less than 1% (USD 1.04 billion).

So far issuance in the domestic debt market has remained skewed towards government debt as governments have sizeable funding needs while borrowing needs of large corporates remains limited in the face of slow economic growth in the region. Though capital market borrowings by local corporates has increased, large firms find it cheaper and more convenient to raise money in global capital markets than in the local currency markets.

USD dominates GCC markets



Source: Emirates NBD Research, Bloomberg

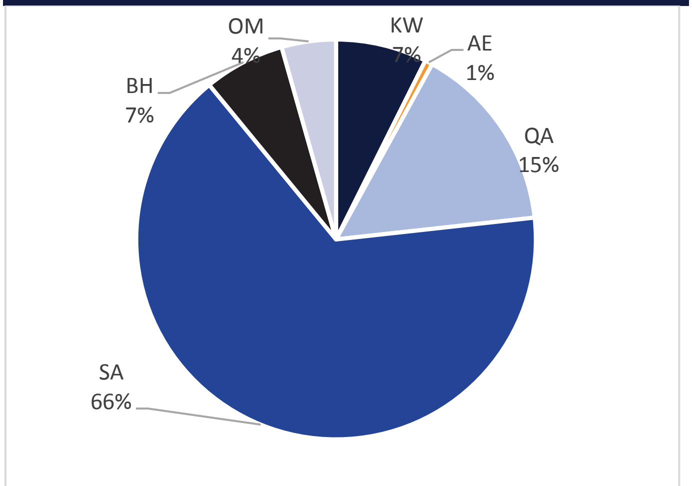
Most issues in the LCY market are unrated but expected to have credit quality better than average found in other emerging economies given their linkage with highly rated governments.

KSA dominates the LCY market

Though as a percentage of GDP, Bahrain has the deepest LCY bond market, in sheer size, the SAR denominated market dwarfs all others in the GCC. This is attributed to several factors as below:

- The KSA is the largest economy in the region, representing circa 47% of the GCC's total GDP followed by the UAE at about 26%.
- In terms of absolute amount, the KSA had and continues to have the largest budget deficit in the region, requiring it to tap bond markets aggressively to fund expenditures.
- The KSA government owned entities that traditionally were funded by the government are now having to rely on capital markets for their funding needs and therefore are increasing their bond/sukuk issuance in the SAR market.
- The KSA government is endeavouring to make government securities available for the banks to be able to park their reserves as they make progress on adoption of Basel III and IFRS 9.

GCC LCY bond market outstanding

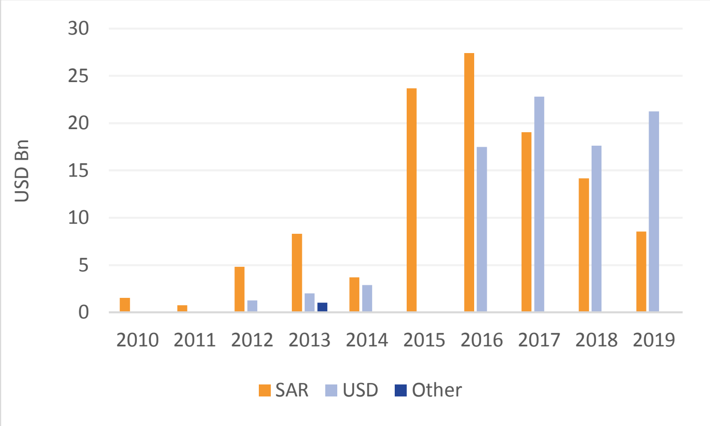


Source: Emirates NBD Research, Bloomberg

In 2015/16, the KSA government funded substantial part of its budget deficit via asset sales, however this trend has now slowed and the government is using debt as a preferred funding source, issuing in excess of circa USD 14 billion per annum in the SAR market.

In 2017 and 2018, issuance in USD was higher than in SAR, possibly due to the government's endeavor to preserve liquidity in the local banking systems.

KSA new issues : SAR vs USD



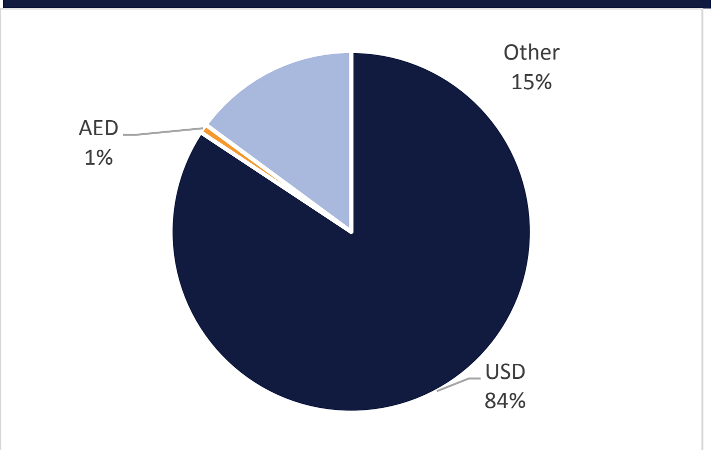
Source: Emirates NBD Research, Markit

Nearly two thirds of SAR issues are in sukuk format compared with only 26% of the USD bonds from Saudi. In terms of credit quality, SAR issues are generally unrated as bulk of them are by either the government or the GREs.

UAE is the late starter

UAE's Dirham denominated market was and still is negligible. The United Arab Emirates is a federation of seven individual emirates that have their own budgets and own finance departments. Until 2017, there was no law facilitating issuance of debt at the federal level which made it difficult to create a risk-free government yield curve. However, the UAE government finalized the Federal Debt Law in 2018 and Emirates Development Bank issued the maiden federal level bond under the new law in early 2019 albeit denominated in USD.

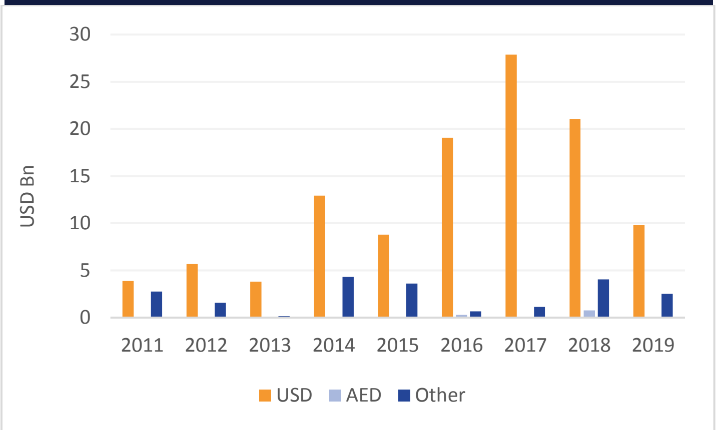
UAE bonds: currency distribution



Source: Emirates NBD Research, Bloomberg

Looking ahead, the federal government plans to establish a Debt Management Office, get a federal level credit rating and have several federal level institutions involved in issuing Dirham denominated debt. The Emirates Development Bank expects to commence issuing in Dirham and then follow through with regular issuance in order to create the benchmark government yield curve.

UAE new issues



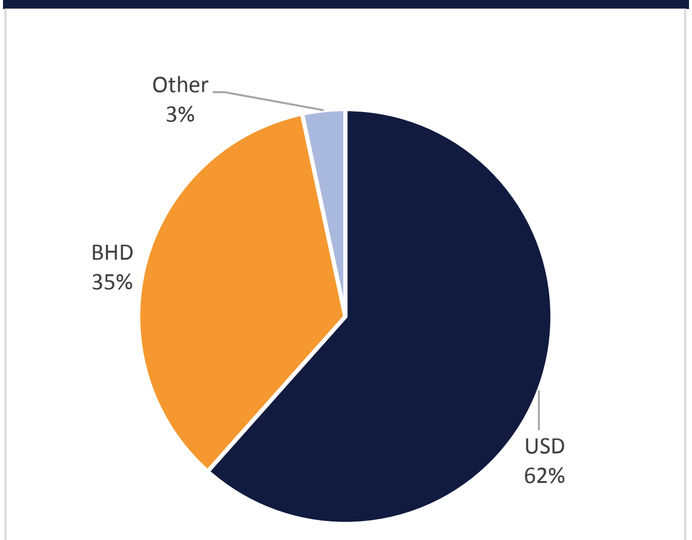
Source: Emirates NBD Research, Bloomberg

Issuers from the UAE have been the most prolific in tapping markets in non-USD G-7 currencies. Nearly 15% of the current outstanding is attributed to other currencies in which Euro, GBP and AUD are the most dominant.

BHD market growing faster than USD in Bahrain

Bahrain's financial markets are the deepest as a percentage of GDP. Total bond market outstanding is roughly 77% of GDP and the local currency market is roughly 28% of GDP.

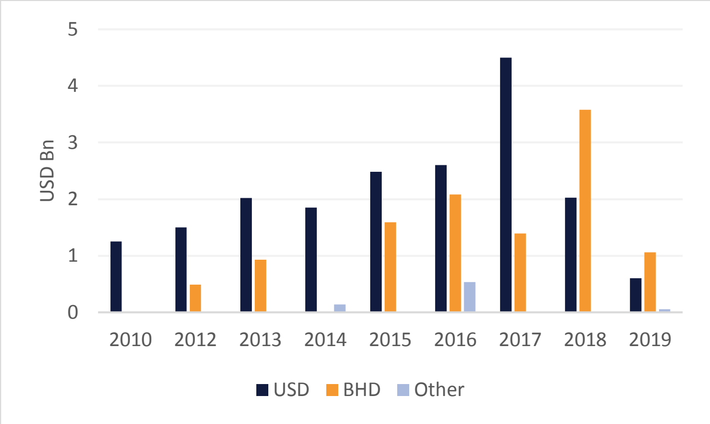
Bahrain bonds: currency distribution



Source: Markit, Emirates NBD Research

Bahrain's fiscal budget deficits began before the oil price decline in 2014 mainly as a consequences of increased government expenditure in the aftermath of the Arab spring in 2011. Therefore Bahrain has been an active issuer of bonds for most of this decade.

BHD issues picking up pace

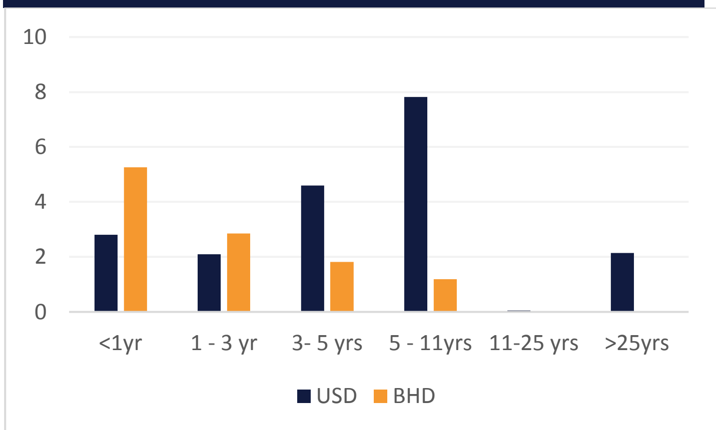


Source: Emirates NBD Research, Markit

With continuous downgrade of its credit rating in the recent past, Bahrain's access to international bond market has become prohibitively expensive, thereby incentivizing the government to issue more in the local BHD market. Consequently total issuance in BHD has begun to dwarf the USD issuance.

We note that circa 96% of the current BHD issues mature in less than five years which could prove challenging to refinance should the Bahrain sovereign continue to rely excessively on BHD market.

Short maturity of the BHD market



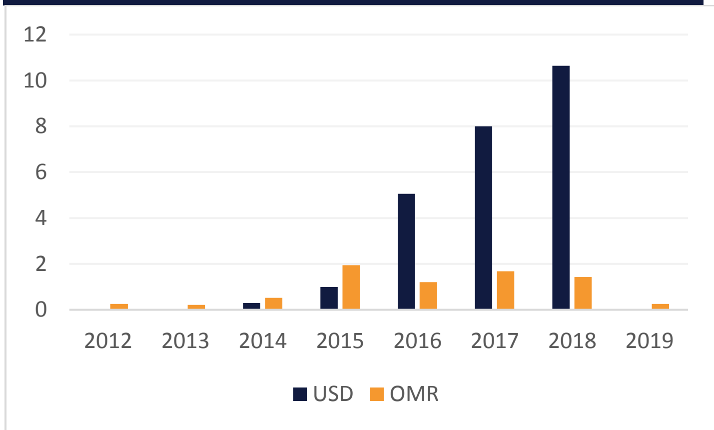
Source: Emirates NBD Research, Markit

Nearly 80% of Bahrain's bond market is attributed to bonds issued by the government and government owned entities.

OMR market evolution

Oman government's reliance on debt capital markets has increased substantially over the last five years. Coming from a low base, Oman sovereign's total debt to GDP has reached circa 40% and expected to continue to increase. Currently 77% of the market is denominated in the USD and 23% in OMR. Of the OMR bonds, 96% are issued by the government.

New Issues in Oman; OMR vs USD



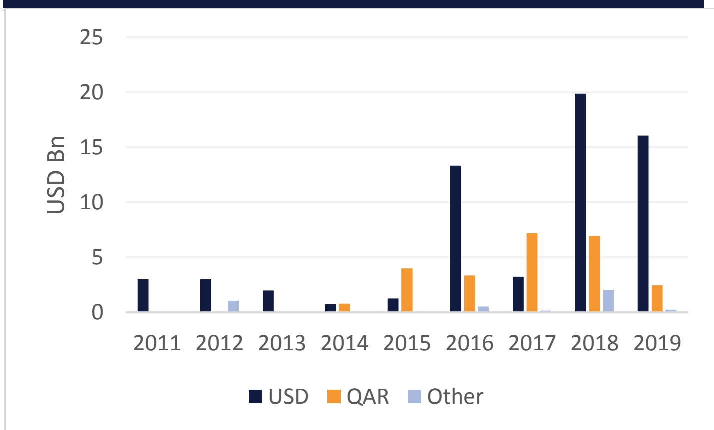
Source: Emirates NBD Research, Bloomberg

OMR new issues have remained range-bound around the equivalent of cikrca USD 1.3 billion per annum compared with average circa USD 5 billion in the USD market by the government per annum. This is because the government has relied more on the USD funding than in OMR in order to preserve liquidity in the local banking system for the corporate sector.

QAR market is the second largest in the GCC

Qatar's bond market outstanding is around USD 107 billion comprising of 71% in USD bonds, 25% in QAR bonds and 4% in other currencies. Current QAR outstanding of circa USD 26 billion equivalent is entirely from the government.

New issues in QATAR

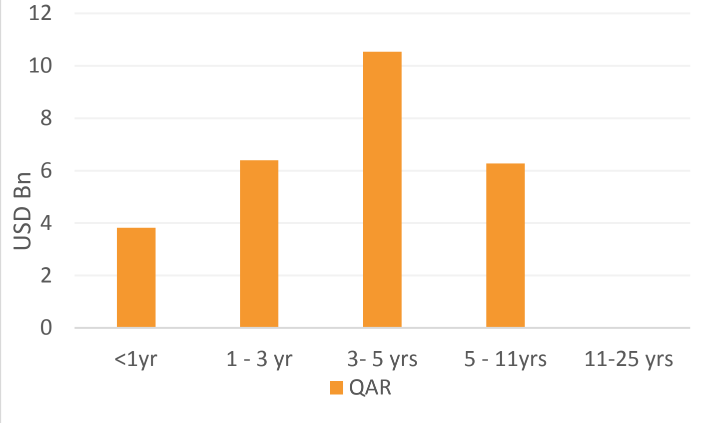


Source: Emirates NBD Research, Bloomberg

Leverage in Qatar's banking system is higher than other GCC with average loan-to-deposit ratio being higher than 110%. Consequently, Qatari banks are active issuers in the bond market.

However, almost all of Qatari bank's bonds issuance is in non-QAR currency, mostly in USD and more recently in CNY.

QATAR LCY bonds maturity

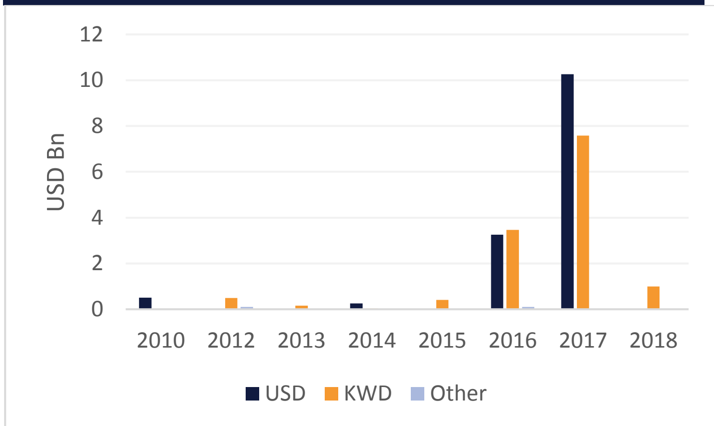


Source: Emirates NBD Research, Bloomberg

KWD market

Though Kuwait does not have vital need to fund budget deficits via debt, it has chosen to opportunistically issue bonds in order to deepen its capital markets. With no pressing agenda, the development of USD and KWD markets has kept pace with each other. Current KWD denominated bond outstanding of circa USD 13.3 billion is comparable with USD denominated issues of circa USD 14.7 billion.

Kuwait



Source: Emirates NBD Research, Bloomberg

Kuwait government and GRE related issues account for circa 78% of KWD denominated bonds with remainder coming from the banks and financial institutions. . Though there is a reasonable spread of government bonds across maturity tenures creating an effective risk-free curve, no corporate in Kuwait has tapped the KWD market for bonds yet.

Outlook is positive

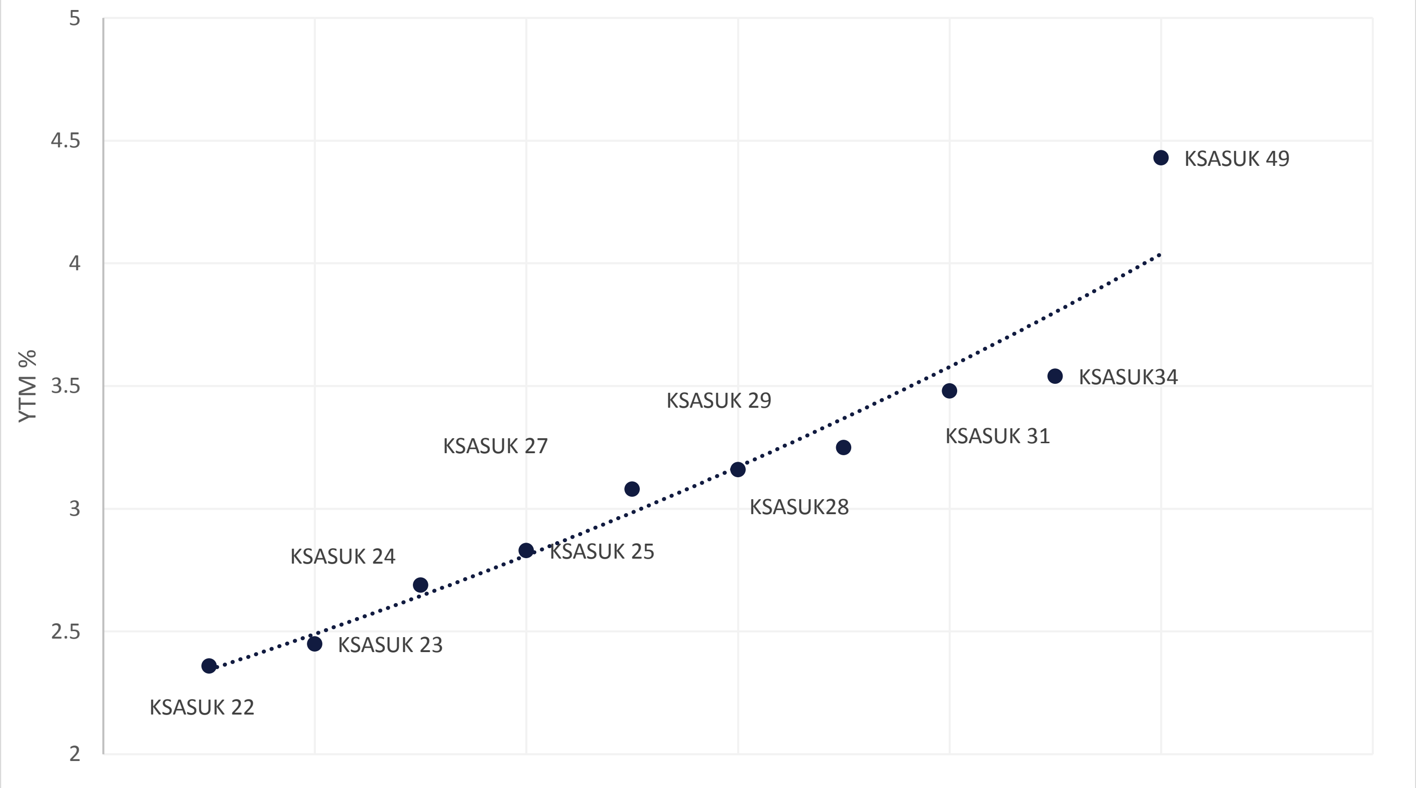
GCC LCY bond markets have more than doubled in the last five years and while the pace of growth may slow we expect them to continue registering strong growth.

That said, there are substantial challenges as below that hinder market growth:

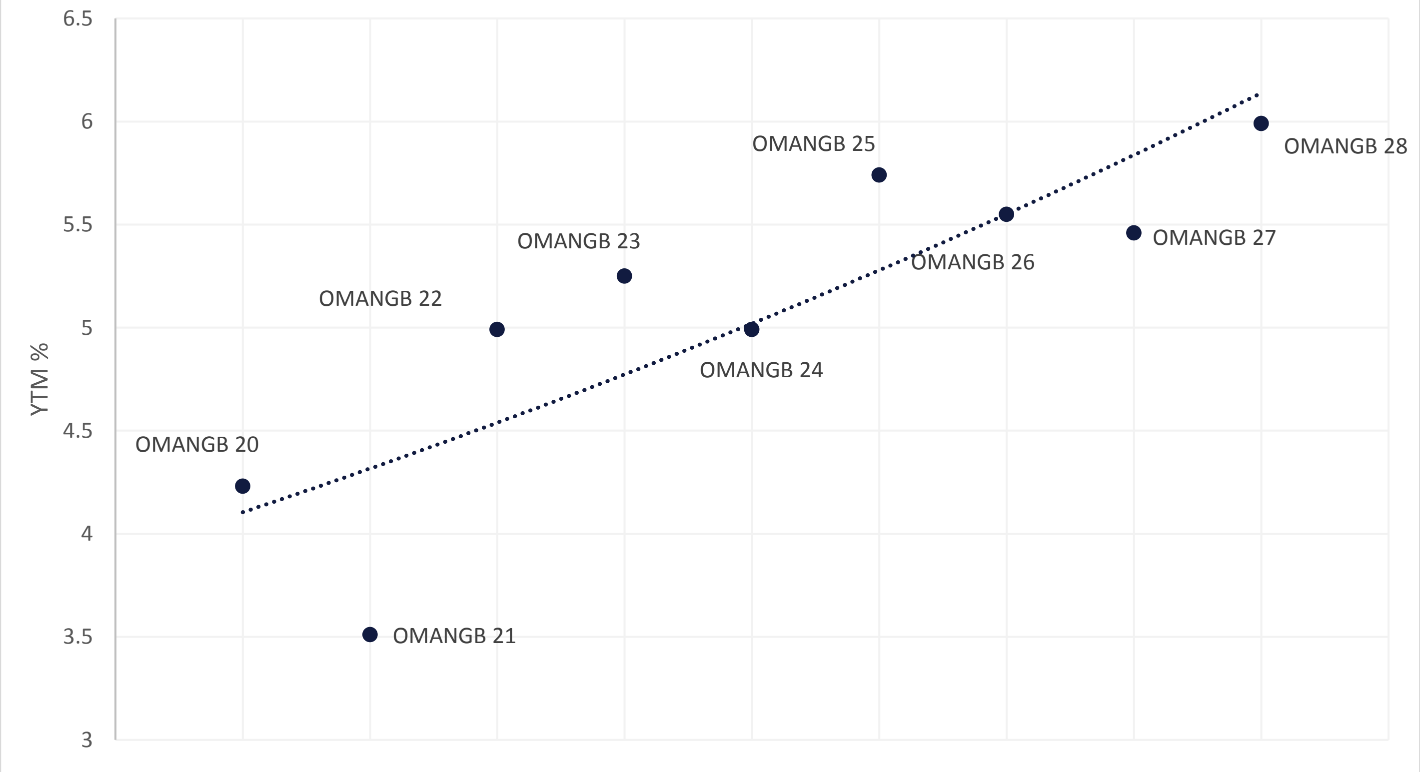
- Local settlement: Ownership of local currency bonds and trading in them is a bit complex as clearing happens through local exchanges and clearing systems. Also low liquidity and high volatility together with a lack of hedging instruments discourages foreign investors from engaging in the GCC LCY market.
- Bank dominance: With total assets at about $2.9 trillion (around 196 percent of GDP), relative to GDP, GCC banking systems are somewhat bigger than average in other emerging market economies and provide fierce competition to the bond market.
- Lack of large independent corporates: Most large corporates in the GCC are government owned or government linked that traditionally get funded directly or indirectly from the government. There are few independent corporate that need external debt funding.
- Lack of diverse investor base: Pension and Insurance industry in the region is small. Government employee pension funds invest a substantial part of their money overseas.
- Buy to hold mentality of GCC investors particular with sharia's prohibition on speculation hinders activity in the secondary market.
- Embryonic legal and regulatory framework in the region reduces investor comfort and limits their participation in the bond market.
- Corporate disclosure appears adequate, however availability of independent research is inadequate.
- Price transparency is weak and transactions costs in the region are higher than average of other EM economies.
- Though currencies in the region are pegged, investors lack instruments to hedge interest rate or corporate default risks which reduces appetite for owning and trading in LCY bonds.
- Lack of asset backed market: GCC bond market is reasonably vanilla and lacks heterogeneity in products.

Nevrtheless, government efforts towards factors such as creation of risk-free yield curves, allowing foreign issuers to issue in GCC currencies, promoting repo market in LCY bonds etc are expected to continue providing a strong platform for growth.

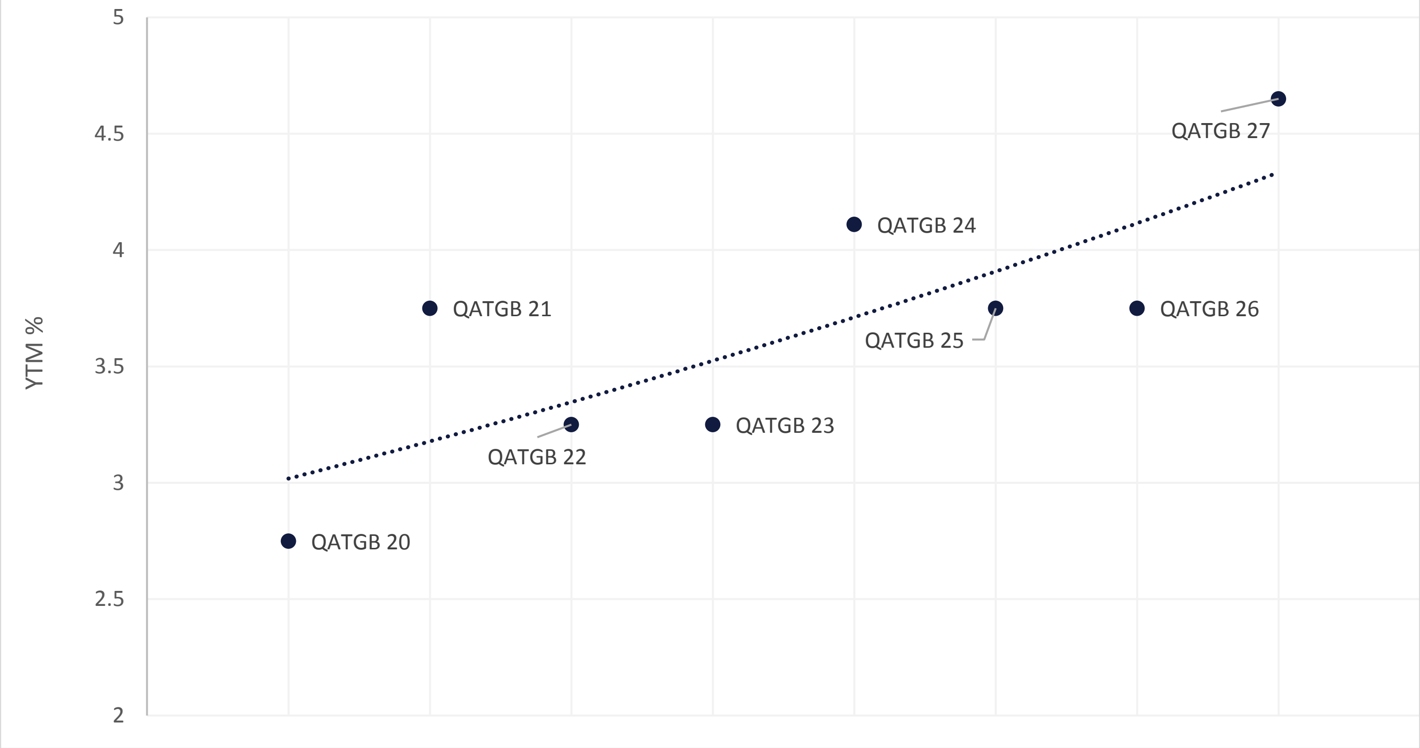
KSA SAR Sovereign Yield Curve



Oman OMR Sovereign Yield Curve



Qatar QAR Sovereign Yield Curve



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