The New Reality of GCC Banking

Are banks in Gulf Cooperation Council countries ready for a paradigm shift? On the downhill side of a growth peak, those who understand and adapt to a new competitive landscape are more likely to be around to enjoy the returns.
The Gulf Cooperation Council (GCC) banking industry has seen a flurry of positive headlines over the past few months. Many banks are reporting year-on-year and quarter-on-quarter improvements in growth, revenues, and profits, and there are clear signs this will continue for the foreseeable future. The financial crisis appears to be firmly in the past.

However, a closer look reveals that the GCC banking market has experienced a fundamental change. The pre-crisis heyday of growth for all GCC countries is gone, leaving behind a more diverse banking landscape. Triggered primarily by macroeconomics, demographics, and regulation, the new landscape is here to stay, and it is having far-reaching consequences on both strategic and operational levels. This paper takes a look at GCC banking performance, examines the factors behind the changes, and explores how banks can tackle this new reality.

A Transformed Market

Four trends are converging to create a banking market that looks quite different from the market before the financial crisis:

**New growth patterns.** GCC banks were in a high-growth mode before the crisis. Between 2006 and 2008, assets were increasing at strong double-digit rates in all GCC countries, from 21 percent in Kuwait to a staggering 46 percent in Qatar, for an average of 29 percent (see figure 1). Post-crisis, growth across the GCC has slowed down. Between 2010 and 2012, asset growth ranged from 3 percent in Bahrain to 20 percent in Qatar, for an average of 10 percent.

![Figure 1: Bank growth across the GCC tumbled after the financial crisis](source: Central bank reports; A.T. Kearney analysis)

While these numbers are still solid by global comparisons, they are far from the industry’s pre-crisis peaks. What’s more, the disparity between GCC countries has widened. For example, before the crisis, growth leader Qatar grew only about twice as fast as the slowest-growing GCC banking market; today, Qatar is growing seven times faster.
Macroeconomics is contributing to the slowdown. Growth in banking assets is highly correlated to growth in GDP. Pre-crisis, assets rose on average four times faster than GDP, signifying increasing banking penetration. After the crisis, assets rose on average just two times faster than GDP. At the same time, GDP growth has slowed in all countries and is expected to remain at these lower levels for the foreseeable future. While relatively low banking penetration in the GCC bodes well for banking assets to once again outpace GDP in the future, it is unlikely to compensate for the lower GDP growth, leading to softer growth prospects.

Regulations are also constraining growth in many GCC markets. Many regulators have traditionally taken a prudent approach, being careful to safeguard the region’s stable and resilient banking industry. The crisis, which brought rising non-performing loans (NPLs) in corporate and retail banking, has certainly reinforced this approach as banks have become more cautious and tightened their lending policies. In the Kingdom of Saudi Arabia (KSA), for example, loan-to-deposit ratios are close to the limits prescribed by the central bank. And the United Arab Emirates (UAE) central bank has introduced a cap on government lending. The new growth paradigm is pushing banks to adapt.

In contrast to the pre-crisis period when corporate banking was the fastest-growing segment, retail banking is now increasing faster in four of the six GCC countries, the exceptions being Qatar and the UAE.

Rise of retail banking. Corporate banking continues to be the most important segment, typically making up a third to half of total assets, three-quarters of total loans, and a third to half of revenues. However, in the wake of the crisis, retail banking is growing faster than corporate banking in four of the six GCC countries, with the exception of Qatar and the UAE. This is in contrast to the pre-crisis period, when GCC retail banking increased faster in only one country, the UAE. Influencing this, again, are demographics coupled with macroeconomics. The GCC’s young population is on the rise and becoming more economically well-off, with GDP per capita steadily rising; demand for retail banking is expected to rise out of these favorable demographics. Banking penetration in some GCC countries, most notably Oman and KSA, is still relatively low, and regulatory moves in some countries may further stimulate retail banking. The mortgage law in KSA and Oman’s new Islamic banking framework are cases in point. Government interventions, such as the push for Saudization in KSA, the support of small and medium-size enterprises (SMEs) in various GCC countries, and the setting up of credit bureaus in Qatar and UAE will also add positive momentum. This rise of retail banking will offer new opportunities in a typically stable business, prompting GCC banks to respond.

1 The share of corporate banking assets and loans is much higher than in more developed economies, highlighting the limited role of capital markets in financing GCC corporations. Treasury assets, the third main banking business, have also seen a drop in growth rates across the GCC, except in Oman.
More-demanding customers. Despite some dramatic recent changes, banking practices in the GCC can still sometimes appear to be from a bygone era, often more closely resembling a government office than a modern services industry (for example, taking a ticket to get in line in a branch). However, given GCC demographics and economic development, customers’ needs are evolving fast. Consider the advent of digital natives, a younger generation of customers that are now up to 30 years old. Though not yet the strongest group financially, digital natives are technologically savvy, use the latest gadgets, are demanding, and make up more than half of the population in many GCC countries. They are typically better connected, more informed, less loyal to companies or institutions, and expect the best of both digital and traditional worlds. Some banks are already adapting their branch formats, channel mix, and digital offerings to suit these customers. At the same time, new personal financial comparison websites are providing transparency on prices for retail banking products and services. Several of these sites are active in the UAE, with the first ones expanding into other GCC countries, including KSA and Kuwait.

In corporate banking, finance departments are becoming more sophisticated, thanks in part to investor demands. And it is becoming more difficult for corporations to finance growth through bank loans because of bank limits and risk-averse behavior. As international investors are attracted by the growth prospects of many GCC firms, more GCC businesses are turning to capital markets for financing. We expect competition in corporate banking to eventually increase as businesses depend less on banks for loans.

Profitability under pressure. Compared to global benchmarks, especially in developed markets, GCC banks continue to be highly profitable with an average cost-to-income ratio of 41 percent. However, this ratio has deteriorated since the crisis from a GCC average of 29 percent in 2006 (see figure 2). A similar trend can be observed for return on assets, which has declined from a GCC average of 3.1 percent in 2006 to 1.7 percent in 2012 (see figure 3 on page 5). Many GCC banks are taking a hit as costs rise and income drops.

![Cost-to-income ratio](image)

**Figure 2**

GCC banks are taking a hit as costs rise and income drops

<table>
<thead>
<tr>
<th>Country</th>
<th>2006</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>GCC</td>
<td>29%</td>
<td>41%</td>
</tr>
<tr>
<td>Bahrain</td>
<td>41%</td>
<td>26%</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>46%</td>
<td>46%</td>
</tr>
<tr>
<td>Kuwait</td>
<td>46%</td>
<td>45%</td>
</tr>
<tr>
<td>Oman</td>
<td>42%</td>
<td>30%</td>
</tr>
<tr>
<td>Qatar</td>
<td>25%</td>
<td>31%</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>36%</td>
<td>36%</td>
</tr>
</tbody>
</table>

1 Cost-to-income ratio is operating expenses divided by operating income.
Sources: Annual reports for 57 leading banks across the GCC; A.T. Kearney analysis

2 For a closer look at the needs of digital natives and the impact on financial services, see “Inside Tomorrow’s Retail Bank” at www.atkearney.com.
factors are to blame. During the crisis, NPLs rose dramatically across the GCC, dealing a blow to profitability. The situation has largely improved, but some banks continue to face challenges with asset quality. For example, provisions for impairments showed an overall increase in Bahrain, Kuwait, and KSA in 2012, and net interest margins have declined in several GCC countries, such as KSA and Qatar. Given the issues around asset quality, some banks have opted to build up a lower-yielding investment book rather than take on risky loans, while others face pressure on the funding side, leading to higher funding costs.

Figure 3
A drop in return on assets is cutting into GCC bank profits

Return on assets¹

![Graph showing return on assets for GCC banks from 2006 to 2012](image)

<table>
<thead>
<tr>
<th>Country</th>
<th>2006</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>GCC</td>
<td>3.1%</td>
<td>1.7%</td>
</tr>
<tr>
<td>Bahrain</td>
<td>1.5%</td>
<td>0.9%</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>4.3%</td>
<td>2.1%</td>
</tr>
<tr>
<td>Kuwait</td>
<td>3.0%</td>
<td>1.1%</td>
</tr>
<tr>
<td>Oman</td>
<td>2.4%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Qatar</td>
<td>3.5%</td>
<td>2.6%</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>2.3%</td>
<td>1.4%</td>
</tr>
</tbody>
</table>

¹Return on assets is net profit divided by total assets.
Sources: Annual reports for 57 leading banks across the GCC; A.T. Kearney analysis

Other factors will continue to put pressure on profitability. Regulators are adopting more measures on fees and rates—capping or prohibiting them—especially in retail banking. In KSA, where loan-to-deposit ratios of many banks are close to the limits prescribed by SAMA, competition for deposits is expected to intensify. Wholesale funding rates may also increase over the next few years, as central banks globally move away from quantitative easing. In addition, many banks are compelled to upgrade their infrastructures, especially IT systems, to keep pace with competition and customer needs, which may lead to increased operating expenses. The pressure on profitability is here for the foreseeable future and will require banks to adapt.

Revisiting Time-Tested Strategies

Some common threads can be seen in the region’s changing dynamics. Profitability has come under pressure, customers are becoming more demanding, and retail banking is becoming more important. However, growth prospects differ markedly among countries: KSA, Oman, and Qatar have better prospects than Bahrain, Kuwait, and UAE, given the projected GDP growth, banking penetration, and competitive environments.

³ SAMA is Saudi Arabian Monetary Agency.
So how can players across the region thrive in this new environment? The answer lies in differentiating—whether that means focusing on a niche, assuming cost leadership, or tailoring the customer experience with products and services. Because of their differences, each country deserves specific consideration:

**KSA: managing domestic expansion.** This market combines good economic growth prospects—GDP growth is expected to reach 4.7 percent over the next few years—with a relatively low banking penetration of 74 percent. The key for Saudi banks is managing domestic expansion, in particular strengthening the physical network—both branches and ATMs—and broadening products and services by tapping into opportunities such as mortgages and more sophisticated auto financing. Direct banking is another option, as online banking provides opportunities to gain customers more quickly than by setting up new branches. The country also has the scale to offer opportunities for niche positioning, such as an SME banking specialist. And while domestic growth prospects are good for now, internationalization offers opportunities that many banks could pursue from a position of strength.

The key for Saudi banks is managing domestic expansion and broadening products and services by **tapping into opportunities such as mortgages and more sophisticated auto financing.**

**UAE: consolidation and internationalization.** Growth prospects here are weaker, despite a projected 4.8 percent rise in GDP over the next few years. This is because of high (135 percent) banking penetration and an overbanked market, with the top four players holding 54 percent of the market and the remaining 47 sharing the other half. Clearly, there is room for consolidation. In fact, the UAE has already seen some mergers and acquisitions, with the merger of Emirates Bank and National Bank of Dubai to create Emirates NBD being the best-known example. Others include Emirates NBD’s merger with Dubai Bank and Abu Dhabi Commercial Bank’s acquisition of Royal Bank of Scotland’s UAE retail banking business. Clearly, further consolidation will require clearing hurdles such as the ownership structure, with governments and founding families owning significant stakes in many GCC banks. Regional expansion is another option. For some, this may mean deeper penetration of neighboring emirates while bigger players should consider broadening their international footprints.

**Qatar: avoiding complacency.** Qatar has the best growth prospects, thanks to the government’s plan to make substantial investments in infrastructure. The biggest strategic risk will be failing to take advantage of the possibilities. International expansion also deserves a deeper look, as the domestic market is relatively small and offers limited potential to diversify risks. Qatar National Bank has been very active, with acquisitions in Egypt (100 percent stake in National Société Générale Bank), UAE (24 percent stake in Commercial Bank International), Libya (49 percent), and others.

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⁴ For a closer look at the online banking opportunity, see “Online Banking in the GCC” at www.atkearney.com.
percent stake in Bank of Commerce and Development), Iraq (28 percent stake in Al Mansour Bank), and Morocco (majority stake in Union Marocaine des Banques). Others could be missing a window of opportunity.

**Kuwait: internationalization and diversification.** The prospects here are weaker, with some upside potential if the Kuwait Development Plan is fully brought to bear. Kuwait has a projected GDP growth of 4.5 percent over the next few years, has a relatively high banking penetration of 93 percent, and is the most concentrated market with the top four players holding more than 90 percent of the market. Moreover, the market, especially retail banking, is tightly regulated, which limits leeway in products and pricing. Kuwaiti banks should therefore continue to explore international expansion opportunities. In fact, several players are already active internationally, including the National Bank of Kuwait (NBK), Burgan Bank, and Kuwait Finance House. Diversification is another option, as seen when NBK entered Islamic banking through its stake in Boubyan.

In this new environment, **players will thrive by differentiating**—whether that means focusing on a niche, assuming cost leadership, or tailoring the customer experience with products and services.

**Oman: diversification.** Although less wealthy than several other GCC states, Oman has good growth prospects in its domestic banking market, due to sound social and economic government spending. GDP is projected to grow at 5.1 percent over the next few years, and the country has the lowest banking penetration in the region. Given the strong retail banking orientation of Omani banks, tightening retail banking regulation, and increasing competition with the emergence of two new Islamic banks (Al Izz Islamic and Bank Nizwa), growth will likely be driven more by corporate banking than by retail banking. As a consequence, Omani banks may benefit from diversification opportunities—for example, moving into Islamic banking for conventional banks or into more corporate banking segments for strongly retail-oriented players.

**Bahrain: consolidation and internationalization.** This market has faced challenging times, with political and social unrest in the wake of the Arab Spring prolonging and adding to the financial crisis. Domestic banking growth prospects are weaker here than in some other GCC countries, with a projected GDP growth of 4.2 percent and banking penetration of 182 percent. At the same time, it is a rather overbanked market, with 30 competing retail banks, a dozen of which are locally incorporated, while the rest are branches of international banks. Clearly, there is room for consolidation, and some banks are already moving in that direction, as demonstrated by the National Bank of Bahrain’s desire to acquire a 40 percent stake in Bahrain Islamic Bank. International expansion should also be considered, given that domestic growth is limited, following the example of more than 70 wholesale banks that already focus on foreign business.

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5 Retail loans account for roughly 40 percent of total loans, markedly higher than the typical GCC share of 20 to 25 percent.
6 Excludes foreign assets
Tackling the Fundamentals

Regardless of the strategic direction a bank takes, operational improvements are necessary to address changing client needs and margin pressures. Four areas will be essential to a successful strategy:

**Customer focus.** The number of banking products and revenue per customer in the GCC remains relatively low compared to developed markets (see figure 4). Although customer satisfaction is essential to increasing a bank’s share of wallet, studies show that GCC banks generally do not rank customer satisfaction among their highest priorities. Improving customer service begins with aligning your brand promise with every aspect of the organization, from your people and culture to performance metrics, processes, and infrastructure. As competition intensifies, a more sophisticated, customer-centric sales approach is needed—from reorganizing the sales force (shifting from a product focus to a customer focus) and improving sales techniques and skills to launching multichannel offerings. Such changes will help keep costs down, allow for tapping into underserved customer segments (such as SMEs) and better address evolving customer needs, in particular for digital natives. A single view of the customer across all channels is paramount. And it is wise to never underestimate the value of partnerships to improve products and services in areas that have been a struggle, such as SME banking and wealth management.

**Operational efficiency.** Many processes are still done manually and involve a multitude of documents and layer upon layer of decision makers. Redesigning these processes can yield substantial efficiency improvements, in some cases cutting resource requirements in half. Yet while automation is important, it is not always necessary, particularly given the region’s low labor costs. Therefore, we recommend targeted IT investments, aligning the entire organization, and streamlining the structure—all of which can significantly improve efficiency.
Outsourcing and offshoring can help centralize business processes, improve service levels, and increase control. Several regional banks have already successfully offshored simpler functions to India and Egypt. And a structured approach to procurement, one that analyzes spending and identifies savings, can reduce costs by as much as 30 percent in some categories.

**Risk management.** Managing risks remains a priority despite all the efforts made following the crisis. For example, many GCC banks still consider lending to salary account holders to be secure because loan payments are typically deducted as soon as a salary transfer is made and before the customer can spend the money. The rise of credit bureaus, along with more sophisticated regulatory frameworks, such as guidelines for repossessing mortgaged real estate, will help in the development of more sophisticated risk management approaches.

**Performance management.** Improving performance requires properly rewarding high achievers. Rewards can be in the form of financial compensation, career progression, and other acknowledgements, such as tried-and-proven employee of the month awards. A properly structured incentive system can become a powerful tool for retaining staff, particularly in the front office, where turnover is notoriously high. The key is linking rewards directly to performance measures, defined at the employee level, to ensure that hard-won improvements are sustained.

**Thriving in the New World**

The GCC’s new banking landscape is here to stay. To survive, fundamental operational changes can have an immediate impact on meeting customers’ needs and take some of the pressure off profits. But to flourish and capture long-term advantage, it is necessary to stand apart from the crowd. While each GCC country warrants some specific strategic considerations, there is one common theme across all markets: Banks that differentiate their products and services are more valuable in the eyes of today’s increasingly demanding customers.

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