Basel III: A silver lining for Middle East banks
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Middle East banks have embarked on a laborious journey to comply with Basel III regulations. In jurisdictions where the regulations have been rolled out, banks have achieved this objective already, while in countries that are still finalizing their local versions, banks are trying to grapple with the implications of these regulations on their profitability, balance sheet, and operations. Although the regulations, in their local form, require a substantial amount of work — and in some cases, such as the new liquidity requirements, address issues that few Middle East banks face — they also represent an opportunity. By calling for higher capital requirements and more stringent definitions of capital, Basel III forces regional banks to take a hard look at their capital allocation and deploy their capital more strategically.

In this fundamental rethink of Middle East approaches to capital and risk, banks will need to instill a new mind-set regarding risk along four dimensions:

• Governance and oversight, requiring a strategic perspective on the bank’s risk profile and risk appetite

• Core risk processes and models, ensuring that decisions within and across lines of business align with the overall risk strategy

• Human capital, ensuring that the people responsible for making day-to-day decisions embrace a new mind-set about risk

• Core risk and management information systems, supporting the data-intensive Basel III reporting requirements from regulators

For forward-looking banks, the Basel III requirements can be much more than an administrative burden and a drag on growth and profitability. Rather, financial institutions should consider the new rules as a catalyst to upgrade their capabilities and as a call for thoughtful, balanced improvements of their risk-return profile. This will benefit the region not just during times of financial crisis or market dislocation, but for decades to come.
Why Basel III matters in the Middle East

When the new Basel III regulations were announced in December 2010, Middle East banks were justified in questioning their fairness and applicability. After all, the new regulations — with more stringent capital definitions, as well as liquidity and leverage restrictions — were formulated in response to the financial crisis that began in 2008. Middle East banks played no role in the subprime crisis, and generally had limited exposure to its root causes. The financial instruments associated with the 2008 blowup, such as mortgage-backed securities, credit default swaps, and other derivatives, are rare in Middle East markets. Why, then, should Middle East banks be penalized by the regulatory reforms originating from major financial markets? Moreover, the whiplash of international regulation is extending beyond Basel III, with new prohibitions on proprietary trading and investment risks. This strikes at the heart of some Arab banks’ activities, such as private equity, public equities, and the somewhat gray areas of Shari’a-compliant financing and investment assets.

Although the magnitude of Basel III’s impact will vary by country, the new rules will put the brakes on Middle East banks’ rapid expansion. Our analysis shows that the Middle East banking sector will experience an average capital shortfall of around 25 percent of total regulatory capital required by 2019, assuming current growth rates. Even with more aggressive growth generating more internal capital, the shortfall would reach no less than 18 percent of total regulatory capital required as per Basel III. In nominal value, for the sample we assessed, this Basel III capital shortfall was estimated at just over US$35 billion in 2019, equal to roughly 25 to 28 percent of the total required capital to ensure no shortfalls across any of the 22 banks we studied in the region (see “Methodology,” page 6).
Forward-thinking leaders will address this shortfall by viewing the new requirements as an opportunity, rather than a penalty. The rapid growth Middle East banks have experienced has been, for some, a mixed blessing. The ability to expand in multiple geographies simultaneously has muted their need to make difficult choices about expanding strategically in their core domestic or regional markets. In some cases, banks have not deployed capital in a rigorous or deliberate manner that properly allocates risk and return levels against capital. The choices that banks will need to make in the light of Basel III will force more careful consideration of their strategic options in the future, and guide them away from underperforming investments that dilute returns and growth.
Methodology

To conduct our analysis, we looked at published annual financial statements from December 2013 (the most recent available) for a sample of 22 banks across Bahrain, Jordan, Kuwait, Lebanon, Oman, Qatar, Saudi Arabia, and the UAE.

We performed balance sheet forecasts under two main scenarios, based on retained earnings and growth in return on assets. We then determined the forecasted Basel III CAR in 2019 and tested it against thresholds based on the fully phased-in limits as outlined by the Basel Committee on Banking Supervision, with CAR of 16 percent for regular banks and 18 percent for (regional) systemically important financial institutions (SIFIs).

For banks with 2019 CARs lower than the minimum thresholds, we quantified the amount of capital required to meet the Basel III CAR requirements. We used this to calculate the impact of increasing the capital base by the required amount on 2019 ROE, assuming that the new capital would need to be invested at the risk-free rate. This yielded an adjusted ROE (AROE) measure that we used to assess the impact of Basel III on banks’ profitability.
To understand how Middle East banks must respond to Basel III, it is important to consider first what impact the new regulations will have. The new requirements cover six areas of reform (see Exhibit 1).

Exhibit 1
Basel III specifies six areas for reform

Main Areas of Reform in Basel III
1. **Definition of capital:** The new regulations increase the quality, consistency, and transparency of the capital base to help banks better absorb shocks and to mitigate the risk of insolvency.

2. **Countercyclical buffers:** Such buffers, which are built during periods of credit growth and released during downturns, protect banks from business cycle fluctuations and stress events.

3. **Enhanced credit risk coverage:** Basel III strengthens capital requirements and enhances management requirements of counterparty credit risk.

4. **New leverage ratio:** Banks are more limited in how much leverage they can accumulate on their balance sheets after the events of 2008.

5. **New liquidity standards:** The new rules aim to improve the banking sector’s ability to absorb shocks arising from financial and economic stress, thus reducing the risks of bank runs and contagion spreading across the financial markets and into the overall economy.

6. **General risk guidelines:** Tighter guidelines call for the designation of SIFIs, enhanced governance standards, and reduced reliance on external ratings.

The new liquidity standards have received the lion’s share of attention, because they are new to Basel requirements. These requirements place greater emphasis on banks holding high-quality liquid assets such as government debt. It may be the case that Middle East debt markets are just not consistently deep enough to provide that sort of liquidity. Additionally, although Middle East central banks have never failed to step in to provide liquidity during times of stress, counterparties — especially foreign — may become far less tolerant of banks that rely on implicit support rather than real balance-sheet liquidity. Overall, however, our analysis of the impact of this ratio on Middle East banks shows it is less significant than for their U.S. or European counterparts.

For Middle East banks, the biggest changes will come from the redefined capital requirements. The minimum CAR is expected to fall to anywhere between 15 and 18 percent, with SIFIs at the high end of that range. The higher requirements, combined with more stringent definitions of capital, mean that Middle East banks will need to raise substantially more capital if they want to continue on their current growth trajectory — or make some tough decisions about where they want to grow and where they can rein in growth.
Our analysis of 22 banks in the Gulf Cooperation Council (GCC)¹ and the Levant (Jordan and Lebanon) found that by 2019, Middle East banks which do not address the new capital requirements will find themselves with capital adequacy ratios ranging from shortfalls of -10.4 percent to excesses of +10.5 percent of Basel III minimums (see Exhibit 2, page 10). Fast-growing players in Qatar, Kuwait, and the Levant will be the hardest hit, as any growth in assets requires accompanying growth in Tier 1 capital to meet new standards. By contrast, countries that have witnessed relatively slower growth in recent years — including Bahrain, Saudi Arabia, and the United Arab Emirates (UAE) — will have little difficulty meeting or even exceeding required CAR if they continue along that trajectory. However, the new capital requirements will hinder their growth if they want to ramp up regional and international expansion; therefore, they too would need to rethink their business and asset mix with an eye to strategic capital requirements.

Banks with the greatest potential capital shortfalls as a result of not thoughtfully addressing Basel III requirements could see corresponding declines in return on average equity (ROE). Even the most aggressive growth scenarios estimate substantial drops in ROE (see Exhibit 3, page 11).


Exhibit 2
Estimates of CAR impact vary across the region


Note: Each double bar represents one bank.
Source: Sample banks’ annual financial statements; Strategy& analysis
### Exhibit 3
Capital shortfalls as a percentage of regulatory capital will translate into severe declines in profitability

<table>
<thead>
<tr>
<th></th>
<th>2019 capital shortfall as a % of regulatory capital</th>
<th>Impact on ROE(^1) – base growth case</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qatar(^2)</td>
<td>71.7%, 50.1%</td>
<td>14.0%, 4.7%, -24.9%</td>
</tr>
<tr>
<td>Kuwait(^2)</td>
<td>58.5%, 51.0%</td>
<td>7.2%, 2.3%, -24.4%</td>
</tr>
<tr>
<td>Levant(^3)</td>
<td>33.5%, 29.6%</td>
<td>7.6%, 1.6%, -16.9%</td>
</tr>
<tr>
<td>Oman(^3)</td>
<td>14.6%, 12.5%</td>
<td>9.9%, 1.0%, -9.5%</td>
</tr>
<tr>
<td>Saudi Arabia(^2)</td>
<td>7.2%</td>
<td>15.5%, 0.8%, -4.8%</td>
</tr>
<tr>
<td>Bahrain(^2)</td>
<td>3.9%</td>
<td>11.9%, 0.3%, -2.7%</td>
</tr>
<tr>
<td>UAE(^4)</td>
<td>2.5%, 1.4%</td>
<td>10.7%, 0.2%, -1.6%</td>
</tr>
<tr>
<td>Overall average</td>
<td>24.9%, 17.9%</td>
<td>11.7%, 1.8%, -13.3%</td>
</tr>
</tbody>
</table>

- Base growth case
- Aggressive growth case
- Status quo ROE, base case
- ROE adjustment

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\(^1\) ROE = Return on equity.
\(^2\) Three banks reviewed.
\(^3\) Two banks reviewed.
\(^4\) Five banks reviewed.

Source: Sample banks’ annual financial statements; Strategy& analysis
Starting a conversation with regulators

The implementation of Basel III regulations will have a substantial and lasting impact on the banking sector’s capital and liquidity positions, as well as its profitability. Putting the new standards in place will also involve a significant measure of implementation complexity from a technology and processes perspective. Banks can head off potential problems and ease the path into Basel III compliance by engaging early and often with regulators.

Working through central banks, which should manage the data-gathering process using clear and standard templates, banks should ask their regulators to run a quantitative impact study to assess the impact of Basel III on their overall local market. With that information in hand, regulators can consider tailoring regulations to the unique needs of the local banking sector.

Banks should advocate three measures:

- Phased-in capital and liquidity requirements to avoid a major and abrupt impact on profitability and efficiency
- Sufficient amounts of time for clarifications, discussions, and feedback during the quantitative impact study
- Reduced complexity of data requirements to avoid unnecessarily cumbersome data collection

Although there is no question that Basel III will have a substantial impact on banks, these special measures by local regulators could reduce the disruption to banks’ operations while the new regulations go live.
**Rebalancing capital and income**

As the leaders of Middle East banks consult with their boards and review their strategic direction in light of new capital requirements, they must consider three options to avoid the capital shortfalls that would leave them in breach of Basel III requirements. In all cases, banks will need to make careful choices about where and how to grow in the future.

**Option 1: Reduce capital and maintain income**

In this approach, banks divest underperforming, capital-consuming investments; this requires them to generate hard-to-earn fee income to compensate for the lost revenue from these assets, just to keep their income at the same level. From a profitability perspective, this may entail taking a harder look at the cost and efficiency side, as well, namely reducing overhead, optimizing the real estate strategy, or rationalizing the IT spend and architecture. Alternatively, maintaining income levels would necessitate wider margins and increased prices on assets, which could prove difficult and lead to business flight. Theoretically, reducing capital is one way to maintain their ROE, but it is probably the least likely strategic option banks will pursue. Although it relieves senior management from the pressure of raising new capital, shareholders are unlikely to agree to a strategy that in essence calls for lower growth in the interest of complying with tighter capital restrictions.

**Option 2: Maintain capital and grow income**

This option requires banks to generate even more revenue without adding assets to the balance sheet. This option is more acceptable to shareholders, but still challenging. Profit expansion would need to come from higher pricing, wider margins, and even greater fee income. This might include, for instance, wealth management or transaction banking fees, and faster growth in high-margin businesses such as affluent banking or SME business banking. Under this option, banks will need a rigorous approach to profitability and efficiency to grow their income without corresponding increases in risky assets and capital. In particular, they will need to develop capabilities around risk pricing and fund transfer pricing, and to invest in advanced risk and data systems supporting organizational and governance processes.
Option 3: Grow capital and grow income

For many banks, this is the option that will address the aspirations of regional shareholders, boards, and management teams: an aggressive attempt to grow the overall balance sheet by growing capital, raising funds, and growing income. Like options 1 and 2, it will demand greater revenue generation and a rethinking of the business and asset mix, as well as a serious review and realignment of the bank’s operating models. Like option 2, it will require new capabilities and systems around risk and capital management. For example, banks must be able to determine: Would a significant new investment in expanding the branch network make sense to boost retail and SME volumes, or would capital be best directed toward new digital channels and offerings focused on an enhanced experience, efficient service delivery, and cheaper client acquisition?

Inevitably, option 3 has unique requirements and cannot be pursued with the same exuberance of the past days of Basel I/II. Banks will have to rethink their dividend policy and pay-out ratios to maximize organic capital growth. They will also have to consider raising capital through innovative instruments, such as convertible bonds or contingent convertibles, although such operations may be harder to execute in today’s Middle East capital and debt markets environment.
Beyond Basel III: Instilling a strategic risk mind-set

Regardless of which option Middle East banks choose for their path forward, they are entering a new era of accountability. Without a fundamental rethinking of their approaches to capital and risk, banks may fall afoul of Basel III requirements. Still, rather than feeling restricted by the new regulations, banks could view Basel III as an opportunity to deploy their capital more strategically. In doing so, they will make choices that better support organic and inorganic growth for years to come.

Many banks are willing, even eager, to move in this direction but struggle to instill a new mind-set and culture across their organization. In order to support banks through this challenging transition, we recommend a top-down approach that moves through four stages.

**Governance and oversight:** A senior management committee, typically an asset-liability committee (ALCO) or a variation of it, is responsible for ensuring the bank meets Basel III requirements and takes a strategic perspective on capital allocation. That perspective should be informed by the risk profile and risk appetite of the bank — as determined by the board of directors — and it will trickle down into every decision-making process to drive growth targets for each of the business lines. It should also shape key decisions about regional and international expansion, corporate/legal structure, and any strategic investment. The committee should include representatives from departments including finance, risk management, treasury, and the various business lines. It would often also be reinforced by subcommittees of the board. This ensures buy-in across the business and makes each department a stakeholder in the campaign to impart a new risk mind-set.

**Core risk processes and models:** To operationalize the strategic approach to capital allocation across the business, banks must review their policies and processes to ensure that decisions within each line of business align with the overall risk strategy. A rigorous process that can provide justification for budget management is important because individual business lines are likely to feel budget impacts from a revised...
approach to capital. Additionally, banks will need to enhance their internal risk models and frameworks to assess the impact of decisions on capital and the balance sheet. Simply put, these models prevent business lines from growing beyond their means in terms of capital, if they are not congruent with the new Basel III requirements. Finally, banks must revisit and refresh their investment process and deployment of capital to ensure they support income without severely affecting rates of return.

Human capital: Strategic direction and strong processes will not be enough if the people responsible for making day-to-day decisions have not embraced a new risk mind-set. Banks will need to conduct Basel III training and ongoing coaching for all staff close to the risk process. They will need to communicate the importance of capital planning and allocation, and back up those communications with appropriate incentives. Finally, they will need to establish a clear chain of risk ownership and accountability, balancing both the business and risk sides.

Core risk and management information systems: Underpinning the whole approach to risk are advanced risk systems and data-integration technologies. Banks should start by ensuring that their data quality is robust enough to support data-intensive risk systems, as well as Basel III reporting requirements from regulators. It goes without saying that Basel II systems need to be updated to generate Basel III-ready reports, including liquidity coverage and net stable funding ratios.
Client example

It is instructive to look at the example of one bank in the GCC and how it benefitted from the strictures of Basel III. In considering the bank's strategic options, the board and senior management recognized immediately that they would need an aggressive approach to growth: The bank had strategic assets around the world, including growth markets such as Malaysia that were hard to divest relatively quickly, even with quite mediocre levels of return. Therefore, the bank was under time pressure to raise capital, and put together a capital plan. Under the plan, the bank issued equity improving the CAR position, but the issue size was not large enough.

In parallel, while the bank was addressing short-term needs to improve the capital position, it also took a long-term look at its approach to capital allocation. It formulated a plan to reduce exposures to various strategic investments (thus reducing strain on Tier 1 capital) over a period of 12 to 18 months. The bank also took steps to improve the quality of its credit portfolio by reducing risk-weighted assets, and developed better capabilities around risk pricing and fund transfer pricing to make more strategic investments in the future. In less than one year, the bank:

- increased regulatory capital by 20 percent
- increased return on equity from 8.8 percent to 10 percent, despite the capital injection
- realized over 95 percent of its four-year CAR target, improving CAR by more than 3 percentage points.

With a new capital allocation framework in place, the bank had to ensure that this new approach to risk was integrated within each business unit. Analysis of each unit's risk weights and income targets determined its risk-adjusted profitability, allowing the bank to channel capital toward business units that were expected to provide the highest return within acceptable risk ranges. Some units were identified as areas for growth and expansion, whereas underperforming units were tagged to receive less capital and were instructed to adjust their growth targets to accommodate the high performers. This capital reallocation gave all business units incentive to reduce their risk and start exploring various ways to get in shape and increase their profitability by relying less on capital-driven growth from high-risk assets.
Although every bank in the region is responding to the new Basel III regulations, some will be doing so under duress. Middle East bankers, who attribute the latest financial crisis to irrationally exuberant Western bankers who claimed to have found a way to banish risk when in fact all they had done was lose track of it, have to wonder: What could these regulations do for them besides impede their growth ambitions?

For those banks that feel Basel III regulations are a punishment rather than an opportunity, consider the following: Basel III is not a regulatory penalty. Rather, it presents an opportunity for Middle East banks and regulators to embrace new rules and improve the banks’ asset quality and risk-return profiles. It will encourage a strategic approach to decisions about businesses, asset choices, and growth, allocating capital toward opportunities that fit the bank’s actual risk and return profiles. At the same time this will strengthen investors’, and clients’, confidence in Middle East banks and lead to profitable and well-managed growth in the financial services sector.
The Gulf Cooperation Council countries are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.
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