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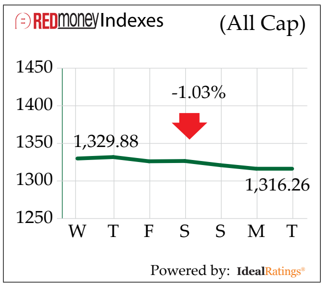

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Qatar: Back in the fold, for better or worse?

After a 3.5-year blockade, diplomatic relations have finally been restored between Qatar and its GCC neighbors. The "unity and stability" Al-Ula Declaration signed at the 41st GCC Summit this month was a welcome step forward, and there is widespread optimism about the benefits of renewed cooperation within the region. But what does it mean for Islamic finance, both in the country and across the region? LAUREN MCAUGHTRY writes.

On the 5th January 2021, Saudi Arabia confirmed that it was lifting its air, land and sea embargo on Qatar, first imposed back in June 2017 — with the UAE, Bahrain and Egypt expected to follow. The deal is believed to have been driven by the efforts of Saudi Crown Prince Mohammed Salman, supported by mediation from Kuwait and the US, and there are also rumors that the peace may have been influenced by the objectives of the incoming Joe Biden administration, as Saudi seeks to distance itself from outgoing US President Donald Trump.

"All the outstanding [issues], whether returning of diplomatic relations, flights, will go back to normal," Saudi Foreign Minister Prince Faisal Farhan told reporters. "It's a very important breakthrough that we believe will contribute very much to the security of all our nations in the region."

It's a diplomatic win — and one that could see Qatar take its place back at the GCC table.

"Lifting of the blockade will positively impact upon the financial and business sectors in Qatar," confirmed Amjad Hussain, a partner at K&L Gates in Qatar. "Regional investors who have been unable to access their Qatar-based business operations will now be looking to pick up where things were left in 2017. We are already seeing a greater level of interest in Qatar from its neighboring countries; especially in financial services, real estate and food sectors. Saudi investors are particularly keen to resume business relations with their Qatari counterparts without delay."


Amjad

But will everything just return to the way it was before? Perhaps not. The world today is a very different place — and Qatar, in particular, has moved on from the blockade in numerous ways that it may not be so keen to relinquish.

A certain resilience

The initial severing of ties certainly had a severe impact on the country: which saw its ratings downgraded, its currency plummet to its lowest level in over a decade, a capital flight of foreign reserves and a fall of over 20% in its equity markets. Market participants were concerned that being cut off from the rest of the GCC would limit Qatar's ability to raise Shariah compliant funds or result in a higher cost of borrowing. Qatari banks were relatively highly exposed to other GCC banks, with some holding about 25% of loans from other GCC markets, and the rift caused initial economic and social chaos, with the government forced to repatriate billions of dollars in overseas deposits to support its financial system through the first few months.

continued on page 3

Qatar: Back in the fold, for better or worse?

Continued from page 1

But the situation recovered surprisingly quickly, as Qatar built new trading ties and turned to alternative allies such as Iran and Turkey to support its supply lines through the crisis.

On the equity side, confidence returned within less than a year. Between June and November 2017, the S&P Qatar Domestic Shariah Index might have dropped 20%, but from a low point on the 30th November the index began to consistently climb again, gaining 44% over the following year to hit a high of 216.4 on the 15th January 2019. The market saw an inevitable drop in the first quarter of 2020 as the COVID-19 pandemic hit, but once again it showed its resilience, and since March it has climbed steadily, gaining over 30% during the rest of 2020 to top 200 again in January 2021.

Nor did its debt capital market see much of a downturn, despite fears that the budget strain could see the country struggle to raise money in the international markets. In fact, in the first half of 2019, Qatar's total Sukuk issuance actually increased by almost a third — while issuance in other GCC states declined, according to data from Moody's Investors Service. S&P Global Ratings also noted increased activity in the Qatari Sukuk market in 2019, identifying Qatar as a key player in the global Islamic bond market. In 2020, Qatari Islamic banks tapped the market numerous times — including two benchmark-sized issuances from Qatar Islamic Bank — and while the sovereign has not yet tapped the Shariah segment, its US$10 billion eurobond in April 2020 attracted US$45 billion-worth of orders, suggesting that investor appetite for Qatari debt has remained strong.

The country's economy now looks both robust and resilient. "A gradual recovery in Qatar — with real GDP growth projected at 2.7% in 2021 — will be supported by increasing gas production and the rebound in domestic demand. The ambitious structural reform agenda underpins Qatar's economic diversification efforts to enhance long-term potential growth," said the IMF in December 2020 following a virtual visit.

Thaddeus Best, an analyst at Moody's, notes that the financial sector is now in a good place. "Qatar's financial system could benefit if lenders and depositors from the blockading GCC sovereigns return. But similarly to trade supply chains, Qatari banks were able to continuously find alternative sources of funding to replace capital outflows after the imposition of the embargo," he said. "Despite the initial shock caused by the outflow of non-resident GCC deposits immediately following the blockage in 2017, the rapid placement of funds in domestic banks by the Qatari authorities, facilitated by the sovereign wealth fund's assets, swiftly stabilized the financial system. By 2019, the stock of non-resident deposits had returned to its pre-boycott level, and loans from European creditors offset the decline in lending from GCC banks. The normalization of relations could support renewed inflows of deposits and cross-border lending from the GCC, potentially reversing the decline witnessed since the dispute, but the relatively high average credit rating for Qatari banks has supported ample access to foreign funding regardless."

New friends

The blockade certainly had the effect of halting cross-border investment into Qatar from most of its neighbors, and there are numerous examples of projects that were abandoned or delayed due to the geopolitical tensions that ensued. But the result of this was not necessarily negative. On an international level, Qatar was forced to seek business partners beyond its traditional Gulf playground, and Qatari businesses began to focus their efforts further afield. Over the past three years, the country has seen a significant spike in investments in the US, Europe and Asia, while there was a substantial uplift in bilateral trade and strengthened relations between Qatar and Turkey.

Qatar also used the blockade period to focus on creating the legal and business infrastructure required to attract international businesses from beyond the Middle East — most notably with expansion of the Qatar Financial Centre, which has seen significant growth in numbers over the past few years to reach over 1,000 companies in 2020. Qatar has established its own mega free zone with the creation of the Free Zones Authority, and passed a set of new regulations based upon global best practice, which have attracted a number of global names and offer an attractive platform for industrial companies to establish their regional base.

Best

"Qatar has realized the importance of diversifying its economic ties and has also focused upon self-sufficiency when it comes to sustaining its future development," said Amjad. "These are systemic changes to Qatar's outlook and are unlikely to change now that the blockade has lifted. The impact of the policy changes has been positive to

continued on page 4

Qatar: Back in the fold, for better or worse?

Continued from page 3

date … Qatar's independent outlook will continue."

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Banking boost

The last few years have also been a strong success story on the Islamic side. Shariah compliant banking asset growth has long outpaced conventional banking in Qatar, with a 21% compound annual growth rate of financings for Islamic banks between 2011 and 2016 compared to 14% for the conventional banks, and overall the sector is healthy. In addition, due to the limited options for managing liquidity, much of the Shariah compliant banks' balance sheets are held in short-term placements or cash — making them more liquid than their conventional counterparts.

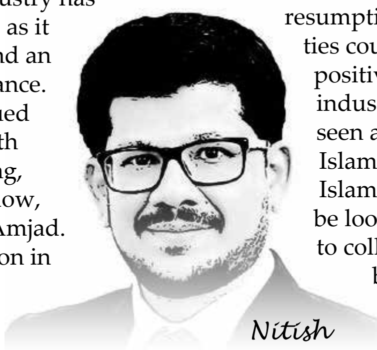
The financing asset market share of Islamic banks in Qatar increased to around 28% as of September 2020 from 25% in December 2018, while on the investment side, Islamic assets under management have doubled over the past five years to US$399 million.

"Qatar's Islamic finance industry has benefited from the blockade as it has led to a consolidation and an increased focus on performance. Banks in Qatar have continued to grow their books and, with greater focus on local lending, the NPL ratios have stayed low, despite COVID-19," noted Amjad. "There has been consolidation in the Shariah advisory space too with the regulators creating a centralized board of advisors. This will help to create standardization across the banks."

Qatar has seen several major Islamic bank consolidations in recent years, starting off with the 2019 deal between Barwa Bank and International Bank of Qatar (IBQ), the country's first-ever bank merger, to create Dukhan Bank, the third-largest Islamic bank and sixth-largest bank overall. In January, this was followed by the announcement of a planned merger between Masraf Al Rayan and Al Khalij Commercial Bank (following the failed 2017 merger between Masraf, IBQ and Barwa Bank).

The Masraf/Al Khalij merger will see Qatar create one of the largest Islamic banks in the region, with combined assets of over US$47 billion and direct access to two strategic European cities: London and Paris, opening up even more channels through which Islamic banks in Qatar can access regional and global opportunities.

"Slowing economic growth amid low oil prices are driving banking sector consolidation both in Qatar and the Gulf Cooperation Council states, where Islamic banking has gained momentum and banking penetration increased over the last decade to 46% as of September 2020 from 32% in December 2009," said Nitish Bhojnagarwala, the senior credit officer at Moody's, speaking to IFN. "Customer demand, proactive government legislation and mergers and acquisitions have driven growth in Islamic banking assets and there has been a flurry of acquisitions and consolidations in the past two years. In some cases, Islamic banks are acquiring conventional banks and emerging as the surviving entity, substantially adding to their asset bases."



Nitish

That is not to say that the recent resumption of diplomatic ties could not have its own positive impact on the industry. "Saudi is still seen as a strong market for Islamic finance and Qatari Islamic banks will no doubt be looking for opportunities to collaborate with Saudi banks in the near-term," pointed out Amjad.

So what happens now?

The terms of the deal have not yet been released, but both sides have agreed to wind down hostilities in the media, while it looks as if Saudi Arabia has dropped its demands for Qatar to close media channel Al Jazeera, a major sticking point back in 2017.

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On Qatar's side, it has reportedly agreed to drop the legal cases against the blockaders that it had filed with the International Civil Aviation Organization and the World Trade Organization. But what else will change? In fact, those involved are being relatively cagey about what the deal really entails — and what momentum we might see in the short term. "I'm very optimistic, but of course you always know that following a rift such as the one that we have had … the issue of rebuilding confidence is one that takes time, takes some energy," UAE Minister of State Anwar Gargash told CNN.

It certainly remains a highly sensitive issue, and market participants are reluctant to go on record to discuss possible impact. The Qatar Financial Centre declined to participate in this story, while financial institutions including Qatar Islamic Bank and Dhukhan Bank (formerly Barwa Bank before its merger with IBQ) also chose not to comment when contacted by IFN,

continued on page 5

Qatar: Back in the fold, for better or worse?

Continued from page 4

citing sensitivities. But off the record, some market participants have suggested that Qatar might be a little more cautious about resuming levels of engagement with its Gulf neighbors that might leave it vulnerable to another embargo.

> *I don't see the relationships that have been established by Qatar over the last few years falling away because of the Al-Ula Declaration as Qatari businesses appreciate the support they received during the tough times from their international partners*

"I don't see the relationships that have been established by Qatar over the last few years falling away because of the Al-Ula Declaration as Qatari businesses appreciate the support they received during the tough times from their international partners," commented Amjad. "I think those relationships will continue to thrive but now there will be a further diversity resulting from GCC participants."

Optimistic outlook

Whatever the long-term impact, change is unlikely to happen all at once. "While the reopening of land, air and sea borders will allow the recommencement of cross-border trade, services and travel that have been largely in hiatus since the embargo was imposed in June 2017, the diplomatic thaw is unlikely to have immediate material credit ramifications due to (1) the limited intra-GCC trade linkages and (2) the prolonged duration of the diplomatic spat, which provided Qatar with ample time to build trade and financial ties with new partners outside the GCC in the interim," noted Best. "It will nevertheless have some marginal economic benefits for tourism and trade in the region at a time when both sectors are still reeling from the coronavirus shock … [But] the process of reconciliation between Qatar and Saudi Arabia and its allies is likely to be gradual, and potentially volatile."

That being said, we are living in extraordinary times. And the global pandemic has perhaps forced us to re-evaluate our priorities — at both a personal and a public level. One positive development has been a renewed focus on the importance of regional integration and collaboration. Given the current economic pressures and weak oil prices, these relationships will be crucial as the Gulf region seeks to develop a diversified economic base, with each country focusing on its own areas of strength.

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"Islamic finance has an important role to play in this, as regional businesses accustomed to Shariah compliant solutions expand their horizons," concluded Amjad. "The Al-Ula Declaration has established a strong basis for this collaboration, but the true success of rapprochement will depend upon the effort that is put in by all regional parties to rebuild trust."