Changing patterns of financial intermediation: Implications for central bank policy

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Abstract

Within the UAE, banks play a major role in financial intermediation, so that the bank lending channel accounts for a very large portion of the monetary policy transmission mechanism. Securities markets, on the other hand, constitute a relatively new source of funding, thereby playing a relatively minor role. Within this context, the growth of the banking sector over recent years has facilitated financial intermediation and enhanced monetary policy transmission. Similarly, the central bank has proactively dealt with changes in financial intermediation to ensure an efficient and productive financial system that best serves the needs of the UAE.

Keywords: monetary policy, central bank policies, banks and financial institutions

JEL classification: E52, E58, G21

A. The role of banks

1. How did the relative importance of banks and market-based financing change in EMEs over the past decade?

Efficient financial intermediation has helped to support economic growth in the UAE, since the non-oil sectors rely primarily on bank financing.

Securities markets are a relatively new source of financing within the UAE, with equities markets introduced only in the early 2000s (eg the Dubai Financial Market, Abu Dhabi Securities Market). Consequently, capital and debt markets remain relatively shallow, illiquid and dominated by retail investment. Similarly, other sources of funding, such as fixed income debt instruments, meet only a relatively small proportion of the financing needs of UAE corporates and the government. Reflecting the dominance of bank loans, total debt securities issued by resident corporates and the government, and held by banks operating in the UAE reached AED 57.6 billion[1] at the end of 2013, compared with loans granted by banks of AED 1275.5 billion.

2. How has the composition of assets and liabilities of domestic banks changed? What does this imply for the liquidity, maturity and credit risks banks face as well as their credit extension decisions (pricing etc)? In particular, what is the structure of their lending (eg (i) households vs corporates; (ii) fixed vs variable rate; (iii) collateral practices; (iv) domestic vs foreign currency) and how has it changed? How has the degree of competition evolved? And what has been the role of government-owned banks/financial intermediaries?

During the period 2004 through 2009, the total assets of banks operating in the UAE grew by 247.3%: assets of state-owned banks grew by 242.5%, assets of local private banks grew by 396.6%, and assets of foreign-owned banks grew by 180.6%. This increase indicates significant growth in financial intermediation in support of economic activity. At the end of 2009, state-owned banks held 63.0% of total assets in the banking system, compared with 18.9% for foreign banks and 17.9% for private banks

Starting in 2009, the impact of the global financial crisis, combined with the corrections that took place in the domestic real estate and securities markets, led to a slowdown in bank activity. As a result, during the period 2009 to 2013, bank assets grew at a slower pace, by 32.8% for foreign banks, 34.0% for private domestic banks, and by 37.4% for state-owned banks. The slower growth was a function of more stringent oversight and regulation by the central bank and more prudential management by banks of portfolio options and available liquidity.

Banks' total equity (capital and reserves) increased fivefold between the end of 2004 to the end of 2009, reflecting a continued drive to strengthen the capital adequacy ratio, while high profitability led to a large increase in retained earnings. Nonetheless, banks' liquidity and profitability indicators took a turn for the worse at the outset of the international financial crisis, prompting the Central Bank of the UAE, in cooperation with the Ministry of Finance, to make a deposit at banks in the amount

[1] Arab Emirates Dirham (AED) exchange rate: 3.6725 Dirhams per US Dollar.

of AED 50 billion (USD 19.1 billion) to support banks' liquidity. The resulting "subordinated loans" boosted banks' capital and reserves.

During 2004–09, bank loans to the private domestic non-financial corporations grew by 293.1%, compared to 285.1% increase in loans to domestic government and public sector corporations. In the period between end-2009 to end-2013, however, loans to private sector non-financial corporations remained roughly flat, while loans to the government and the public sector grew by 81.6%, which reflects a more prudent banking sector lending strategy towards the private sector, and the leading role of the government and government-related entities (GREs) in the credit market in line with the countercyclical stance of fiscal policy.

Meanwhile, the share of bank loans to domestic households remained in the range of 6–8% during the whole period. This indicates that bank activity in the UAE is geared towards corporates and government sectors, and that there is a potential to further develop retail banking activities in the country.

B. The role of debt securities markets

3. How have international banks' business models (eg centralised vs subsidiary) evolved since the 2008 financial crisis? Does the nature of a bank's business model influence the supply of credit during periods of adverse external shocks?

The business model of foreign retail banks operating in the UAE has remained unchanged, and is limited to the activity of the branches of these banks. Total loans granted by these branches increased steadily to reach AED 201.7 billion at the end of 2013. However, in the light of the growing share of national banks in intermediation, the share of foreign banks in total bank loans decreased from 23.0% at the end of 2004 to 15.8% in 2009, and has remained at this level until the end of 2013.

As the UAE has only branches of foreign banks (no foreign subsidiaries), we cannot comment on the impact of the banks' business model on the supply of credit in periods of stress.

As regards wholesale banks, licenses were granted in recent years to allow these banks to collect deposits from corporates only. Currently, the five wholesale banks operating in the UAE are:

Deutsche Bank AG – Abu Dhabi

Industrial & Commercial Bank of China – Abu Dhabi

The Bank of Tokyo – Mitsubishi UFI, Ltd – Abu Dhabi

Korea Exchange Bank – Abu Dhabi

Bank of China Limited – Abu Dhabi

4. What is the structure of the debt held in the form of securities, both sovereign and corporate (size, maturity, fixed/flexible rate, collateral, currency) and how has it evolved? How has the relative importance of domestic and international debt issuance changed?

Banks have increased their holdings of debt securities over time, which grew by 271.5% from 2004 to 2013, reaching AED 135.6 billion. This was mainly due to the issuance of bonds by the governments of Dubai and of Abu Dhabi and their related entities. Nevertheless, it remains significantly lower than loans made to governments and corporates (including government-related corporates), which reached over AED 1 trillion at the end of 2013. It is worthwhile to note that there are no federal government debt securities as the current law does not allow the federal government to borrow.

The smaller share of these securities, relative to cash holdings and deposits at the central bank, reflects the shallow securities markets in the UAE, emphasising the need to develop a domestic market for bonds and Islamic sukuks issued in AED to diversify the range of assets in the banking system and increase the central bank's capacity to manage liquidity.

5. In addition, a major development over the past five years has been the shift of borrowing by EME non-bank corporations away from banks to international debt markets. What are the implications for the financing of firms?

This question does not apply to the UAE since the AED-denominated corporate bond market is not developed.

6. What would be the impact on bank and non-bank corporations' balance sheets of a potential tightening in global financing conditions?

Credit granted by branches of foreign banks operating in the UAE is about 16% of total bank credit at the end of 2013; therefore, any deleveraging by international banks is expected to have only a minor impact in the UAE.

The UAE banking system is liquid with its holding of central bank certificates of deposit, which is demand-driven by banks, amounting to AED 101 billion as at mid-December 2014. We have also seen a limited inflow of non-resident deposits, which remain at around their historical long-term average of 10% of total deposits. As such, we do not expect any significant impact on UAE banks from tightening.

C. Implications for monetary policy

7. What is the share of corporate deposits in total bank deposits? To what extent has it been affected by international debt issuance by non-financial corporations? What other interactions between banks and non-

bank corporations' balance sheets are likely to be important from the viewpoint of monetary and financial stability?

Corporate deposits (including deposits from majority or partially government-owned corporates) represent around 42% of total deposits, reaching AED 543.5 billion at the end of 2013, of which around 53% represented time deposits.

Retail deposits, including those of SMEs and high net worth individuals, reached AED 482 billion at the end of 2013, which represents 37.7% of total deposits.

Non-bank financial corporate (NBFI) deposits reached around AED 75 billion, representing 6% of total deposits as at the end of 2013, of which 24% was demand deposits.

We believe that the increase in debt securities issued by non-financial corporations does not significantly impact the deposits at banks, due to the limited amount of such issuances after 2008 and the fact that the proceeds are being used to redeem existing debt.

8. How have recent changes in financial intermediation affected the transmission mechanism of monetary policy in EMEs (eg size and speed of pass-through of changes in policy rates, responsiveness of overall credit conditions and asset prices, impact on debt service ratios and, through these, on the macroeconomy)?

The UAE operates a pegged exchange rate system, whereby the AED is allowed to trade within a very narrow band around the official rate of 3.672–3.673 USD/AED. Consequently, a key goal of monetary policy within the UAE is to maintain credibility of the currency regime while ensuring monetary stability through adequate provision of liquidity to the banking sector. Given the limitations imposed by the Impossible Trinity, this implies that short-term interest rates within the UAE tend to closely follow the US federal funds rate.

Under these conditions, the main aim of the transmission channel of monetary policy is to manage liquidity in the banking system with a view to influencing bank lending.

With respect to the effect of growing financial intermediation on the transmission mechanism of monetary policy, data limitations make it impossible to quantify this impact in the UAE's case.

The banking sector's growth over time has increased its role in financial intermediation, thereby increasing the effectiveness of the monetary policy transmission mechanism, which aims at managing liquidity in the banking sector. This is particularly important in the UAE given the relatively underdeveloped nature of the capital markets, as characterised by the lack of an AED-denominated yield curve in the absence of an adequate supply of government bonds at varying maturities. Given such limitations and the lack of available funding substitutes for UAE corporates, bank lending plays a very important role in monetary transmission. As such, the UAE banking sector's expansion over the past decade is likely to have strengthened the monetary transmission mechanism over time via credit growth in support of private activity and non-energy output growth.

9. How has financial intermediation changed the sensitivity to global monetary and financial conditions?

Financial intermediation in the context of a growing banking sector that is well integrated with the global capital market has increased the sensitivity and vulnerability of the financial system and, in turn, that of the real economy to global monetary and financial conditions. This exposure increases the role of monetary policy in managing banking system liquidity to ensure efficient intermediation and prevent overheating. As evident during the global financial crisis, banks' liquidity suffered a severe setback, which called for the intervention of the monetary authority to ease liquidity constraints. Further, oversight prudential measures should be in place and closely monitored to ensure the soundness of the financial system. Against the backdrop of limited exchange rate flexibility and scope for adjusting the policy rate to stem the risk of financial flows, prudential measures need to be taken to counter the risk of a bubble building up, mitigate financial vulnerability and align banking resources with objectives to sustain growth in a diversified economy.

10. How should monetary policy adapt to the changes in financial intermediation? For instance, to what extent should it react to sharp changes in risk premium in EME debt markets (through interest rate and/or balance sheet measures) and respond to broader vulnerabilities?

Given the potential for changes in financial intermediation to impact the transmission mechanism of monetary policy, policymakers should take into account the capacity and efficiency of the banking system when setting policy. With respect to the UAE, this involves maintaining the credibility of the exchange rate peg through the maintenance of adequate liquid foreign reserves. At the same time, ensuring effective tools in the form of standing facilities and open market operations are required to drain and inject liquidity when the need arises. Such tools should be sufficiently flexible to respond to emerging needs as they arise.

The UAE appears to be well equipped to deal with sharp changes in financial intermediation and to withstand vulnerability in the banking system. The credibility of the exchange rate peg is supported by available foreign reserves accounting for well over 100% of the monetary base. Moreover, the central bank can issue certificates of deposits to absorb excess liquidity at banks. Further, a number of standing facilities (such as the repo, swaps and interim marginal lending facilities) are held ready to inject emergency liquidity during times of crisis.

In the event of a sharp increase in the credit risk premium, policy intervention is warranted to monitor credit growth and ease liquidity constraints. With the increasing importance of financial intermediation, tighter oversight over the financial system is needed to ensure stability. In addition, further development of the debt market would help the monetary authority manage liquidity effectively and increase its capacity to respond to broader vulnerabilities.

In support of these goals, the central bank has injected capital to increase capital adequacy ratios in order to increase confidence and liquidity in the banking sector and counter the cyclical downturn. Subsequently, the central bank has enforced thresholds to stem mortgage lending risks and the risk of a real estate bubble by enforcing a loan-to-value (LVT) ratio of 80% for first purchases of less than AED 5 million by UAE nationals and 75% LTV for expatriates, while the debt-service-

to-income ratio was fixed at 50% of borrower's gross salary and any regular income from a defined and specific source.

These guidelines, along with the cap on lending to stable resources of banks (currently set at 100%), can be applied by the central bank as a countercyclical tool to ensure effective intermediation while safeguarding financial stability.

The use of macroprudential policies could be further enhanced to increase the scope for meeting the goals of monetary stability, providing the central bank with further tools to manage liquidity and credit growth as it continues to abide by the constraints of the fixed peg of the exchange rate of the AED to the US dollar.

11. To what extent do macroprudential policies influence the transmission mechanism of monetary policy? How far do they complement or substitute for interest rate policies?

The UAE has a fixed exchange rate regime. As such, the use of monetary policy is limited.

The macroprudential tools available in the UAE are basically the same as the micro supervision tools: capital adequacy ratios, reserve requirements and liquidity ratios for banks. However, these tools are not explicitly used to stem cyclical pressures.

The transmission of monetary policy could be enhanced via the use of prudential policies which aim at releasing more liquidity during cyclical downturns and at restraining overheating and the possibility of bubble formation, particularly in the real estate sector, which was hard hit during the global financial crisis.

Macroprudential tools could complement the use of monetary policy tools (such as standing facilities and liquidity draining facilities) in achieving the goals of monetary stability. It should also be noted that the use of macroprudential tools should not be seen as a panacea to imbalances as they emerge, but rather as tools that strengthen the ability of the financial system to cope with external pressures and looming crises.

More importantly in the context of the UAE, the use of macroprudential policies should complement interest rate policies, providing the central bank with further tools to manage liquidity and credit growth, where interest rate policies are constrained by lack of independent monetary policy in the context of a pegged exchange rate regime. This is a relatively new area and the use of macroprudential tools to lean against the cycle requires further practical evidence in order to achieve the correct calibration of such tools.