

SECTOR IN-DEPTH

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Contacts

Abdulla AlHammadi, +971.4.237.9693
CFA

AVP-Ratings
abdulla.alhammadi@moody's.com

Diane Soubra +971.4.237.9688
Sr Ratings Associate
diane.soubra@moody's.com

Rodolphe Khaled +971.4.237.9535
Ratings Associate
rodolphe.khaled@moody's.com

Nitish Bhojnagarwala +971.4.237.9563
Exec Dir-Ratings
nitish.bhojnagarwala@moody's.com

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Americas	1-212-553-1653
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Japan	81-3-5408-4100
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Islamic Finance – Gulf Cooperation Council

Structural strengths support Islamic banks amid a more volatile environment

Summary

Despite a more challenging operating environment, GCC Islamic banks' structural strengths will continue to support stronger credit metrics than those of conventional peers. We expect Islamic banks to continue expanding faster, supported by solid demand for Shariah-compliant finance, while higher exposure to the public sector across both their retail and corporate books underpin superior loan quality. Capitalisation and loan-loss reserves remain sound across both banking segments, although Islamic banks are likely to outperform on earnings given their structurally higher margins and lower credit cost.

- » **Structural drivers continue to sustain Islamic finance growth despite a challenging operating environment.** The closure of the Strait of Hormuz is continuing to disrupt exports and supply chains across the region. Non-oil economic growth is likely to weaken in 2026, particularly hampering sectors such as tourism, real estate, construction and logistics, which are confidence-sensitive and dependent on connectivity. Although business activity in the GCC has slowed, Islamic banks will continue to expand faster than conventional peers, supported by the demand for Shariah-compliant products, continued government initiatives and ongoing sector consolidation.
- » **Islamic banks' loan quality remains sounds.** Islamic banks entered 2026 with an aggregate nonperforming financing ratio of 1.75% as of March 2026, against 2.23% for conventional banks, reflecting their greater retail and government-related exposure, while provisioning coverage is broadly in line with conventional peers. High exposure to public-sector employees, with financing backed by salary assignments and collateral should mitigate the impact of weaker operating conditions.
- » **GCC banks' sound capitalisation provides solid loss-absorption buffers.** GCC Islamic banks retain ample capacity to absorb loan quality deterioration and balance sheet growth, supported by solid earnings retention and continued market access through recent Additional Tier 1 capital (AT1) sukuk issuances.
- » **Islamic banks to outperform conventional peers on profitability.** Although conservative provisioning will squeeze earnings across the sector amid geopolitical uncertainty, Islamic banks' stronger margins, lower loan-loss provisions and improved operating efficiency will support stronger bottom-line performance.
- » **Funding remains a key strength for Islamic banks.** GCC Islamic banks' funding and liquidity remain supported by a strong retail deposit base and continued access to sukuk markets. Although Shariah-compliant liquidity management options remain limited, liquidity is generally ample and funding profiles compare favourably with conventional peers.

Structural drivers continue to sustain Islamic finance growth despite a more challenging operating environment

[The Middle East conflict has weighed on operating conditions](#) for GCC banks since late February 2026. The effective closure of the Strait of Hormuz has disrupted commodity exports and supply chains, weakening business and consumer confidence in the non-oil economy where GCC banks extend most of their credit. Earlier de-escalation efforts, including the US - Iran memorandum of understanding, reduced the risk of the most adverse scenarios. However, renewed escalation since late June points to [a slow and uneven path de-escalation](#), keeping a geopolitical risk premium embedded in oil prices and sustaining volatility in energy markets.

The conflict's impact varies across GCC countries. Saudi Arabia and Abu Dhabi can mitigate export disruptions through alternative pipeline infrastructure, while Bahrain, Qatar and Kuwait remain more reliant on the straight. Bahrain is the most vulnerable among these markets, given its limited foreign-exchange reserves and lack of sizeable external buffers.

Under our central scenario, disruption to navigation through the Strait of Hormuz eases gradually, with trade flows and energy supplies normalising into early 2027 as safe passage resumes. We expect Brent crude will remain mostly in the \$90-\$110 per barrel range through 2026 before easing in 2027 (Exhibit 1) toward a medium-term range of \$55-\$75 per barrel.

Exhibit 1

We expect Brent crude to range from \$90-\$110 a barrel through much of 2026
(\$ bbl)



Sources: Energy Information Administration and Moody's Ratings

Elevated energy and transport costs will keep inflation high (Exhibit 2), while a hawkish hold interest rate stance by the US Federal Reserve (Fed) will prolong tighter monetary conditions in the GCC because of the region's US dollar pegs.

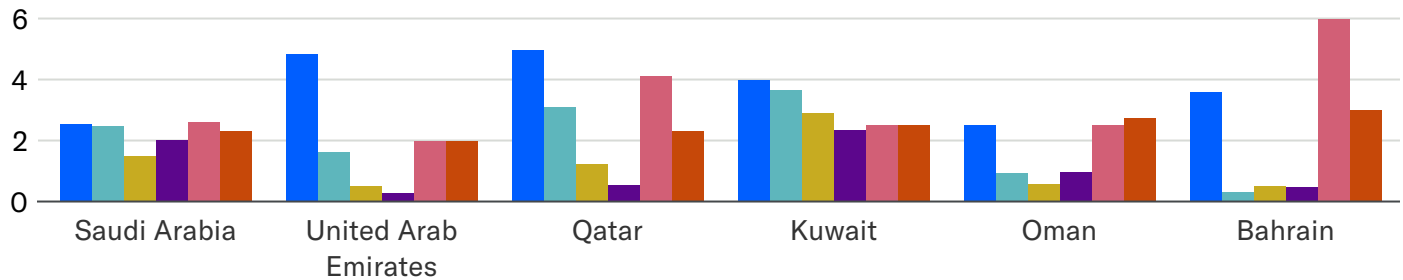
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Exhibit 2

Higher energy prices feed into headline and core inflation as production, transport and utility costs rise

Annual change in consumer prices

■ 2022 ■ 2023 ■ 2024 ■ 2025 ■ 2026F ■ 2027F



Sources: Central banks and Moody's Ratings

We expect non-oil economic growth in the GCC region to slow in 2026 (Exhibit 3), reflecting a reduction in activity in confidence-sensitive sectors that have been central to economic diversification, including tourism, real estate and construction, trade, transportation and logistics.

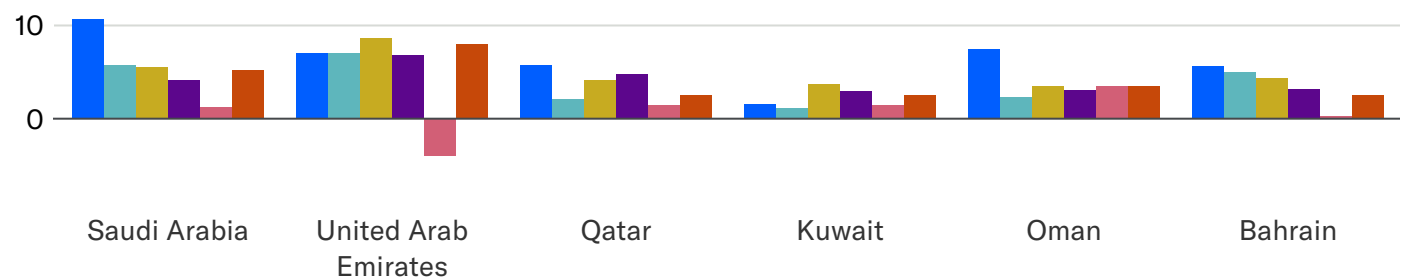
[Despite a more challenging operating environment, GCC banks remain supported by strong capital, liquidity, provisioning buffers and stable funding profiles.](#) These strengths should help both Islamic and conventional banks absorb a deterioration in credit conditions while maintaining broadly sound financial fundamentals.

Exhibit 3

Non-oil economic activity will slow in 2026

Non hydrocarbon real GDP growth (%) actual and forecast

■ 2022 ■ 2023 ■ 2024 ■ 2025 ■ 2026F ■ 2027F



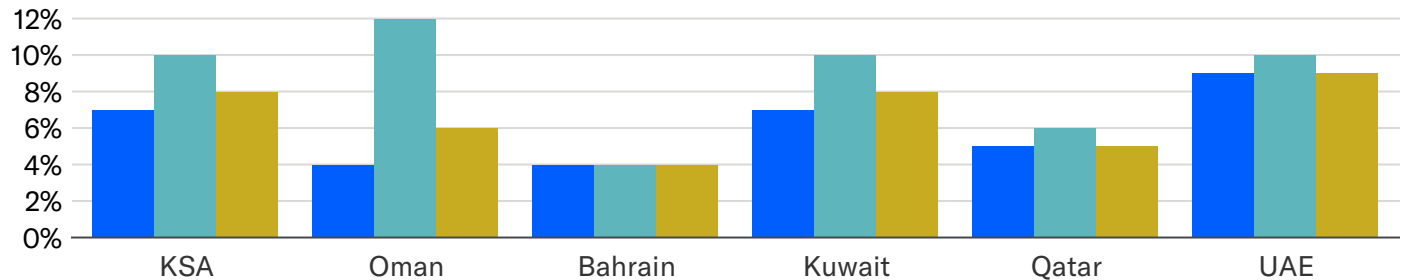
Sources: Central banks and Moody's Ratings

Geopolitical uncertainty and weaker business confidence are also likely to curb credit demand across the GCC in the near term. Nonetheless, we expect Islamic finance to remain one of the fastest-growing segments of the regional banking sector and outpace conventional lending, supported by three structural strengths: strong demand for Shariah-compliant products, government support for Islamic finance development and ongoing sector consolidation. As economic activity gradually recovers under our central scenario, these factors should support faster financing growth from 2027, while we expect economic diversification programmes to continue across the GCC (exhibit 4).

Exhibit 4

GCC Islamic financing growth has continued to outpace conventional peers in most countries Five-year CAGR to end December 2025

■ Conventional banks CAGR ■ Islamic banks CAGR ■ Total CAGR



Sources: Banks' financial statements and Moody's Ratings

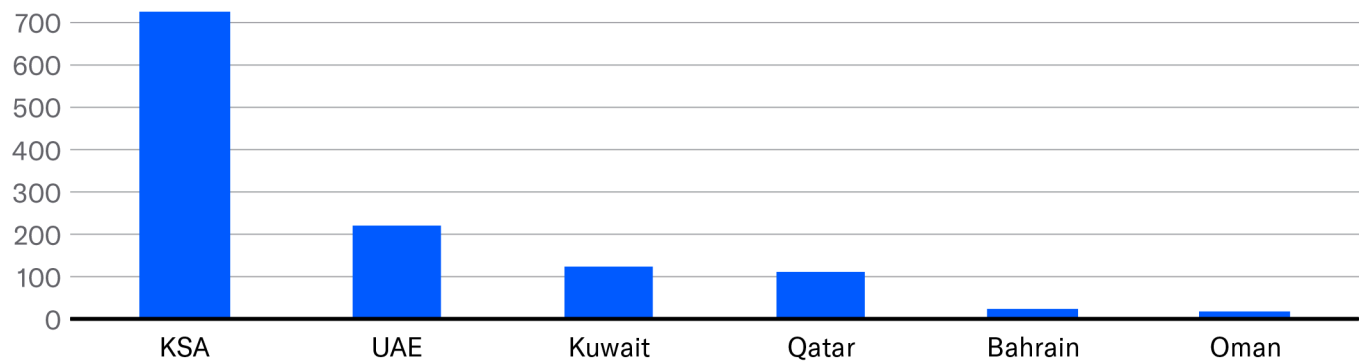
Increasing demand for Shariah-compliant products across retail and corporate segments will continue to support long-term growth, with Islamic banks maintaining significant market shares across GCC banking systems, and leading positions in Saudi Arabia and UAE (Exhibit 5).

Government initiatives also remain supportive. In Saudi Arabia, Vision 2030 is driving mortgage growth and broader development of the financial sector, while the UAE is promoting Islamic banking and sukuk market expansion. In Kuwait, we expect the recently enacted Debt Law to enhance liquidity management and balance-sheet efficiency by expanding the availability of domestic government securities, while the proposed mortgage law should support retail financing growth. Consolidation also remains a key growth driver as institutions pursue greater scale, operating efficiency and stronger market positioning, illustrated by the planned merger of Warba Bank and Gulf Bank in Kuwait. In Oman, recent regulatory reforms requiring a gradual transition toward standalone Islamic banking structures are supporting sector consolidation. Against this backdrop, Bank Nizwa has proposed the acquisition and merger by incorporation of Alizz Islamic Bank, a transaction that would create the country's largest standalone Islamic bank and strengthen the sector's scale and competitiveness.

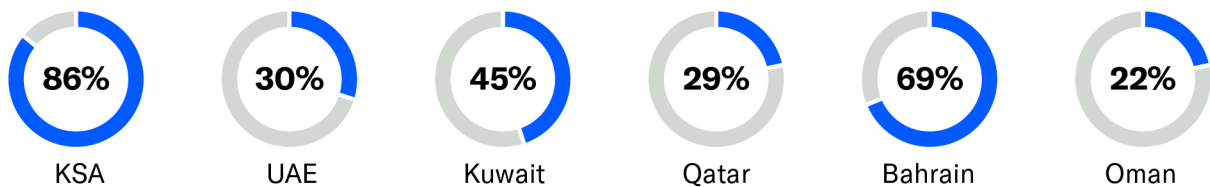
Exhibit 5

Market penetration of Islamic banking is highest in Saudi Arabia

Total Islamic financing (USD Billion)



Market share of Islamic financing



Data as of end 2025

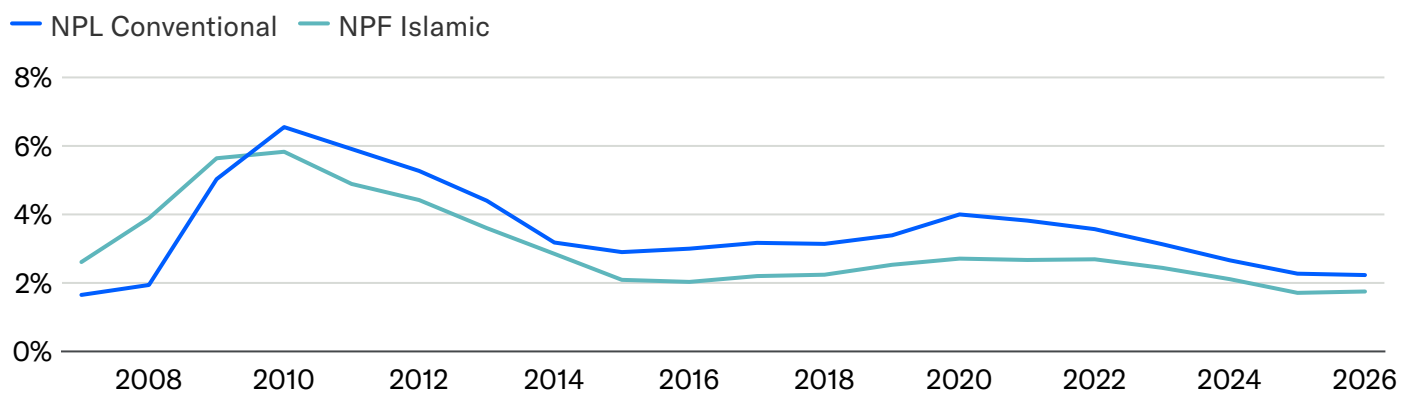
Sources: Banks' financial statements and Moody's Ratings

Islamic banks' loan quality remains sound

We expect GCC Islamic banks' asset quality to remain stronger than conventional peers over the next 12-18 months, although performance will vary across institutions. Islamic banks entered 2026 from a position of relative strength, with an aggregate nonperforming financing ratio of 1.75% as of March 2026 compared with 2.23% for conventional banks (Exhibit 6), reflecting higher retail and government-related exposure.

Exhibit 6

Nonperforming loan ratios have generally been improving



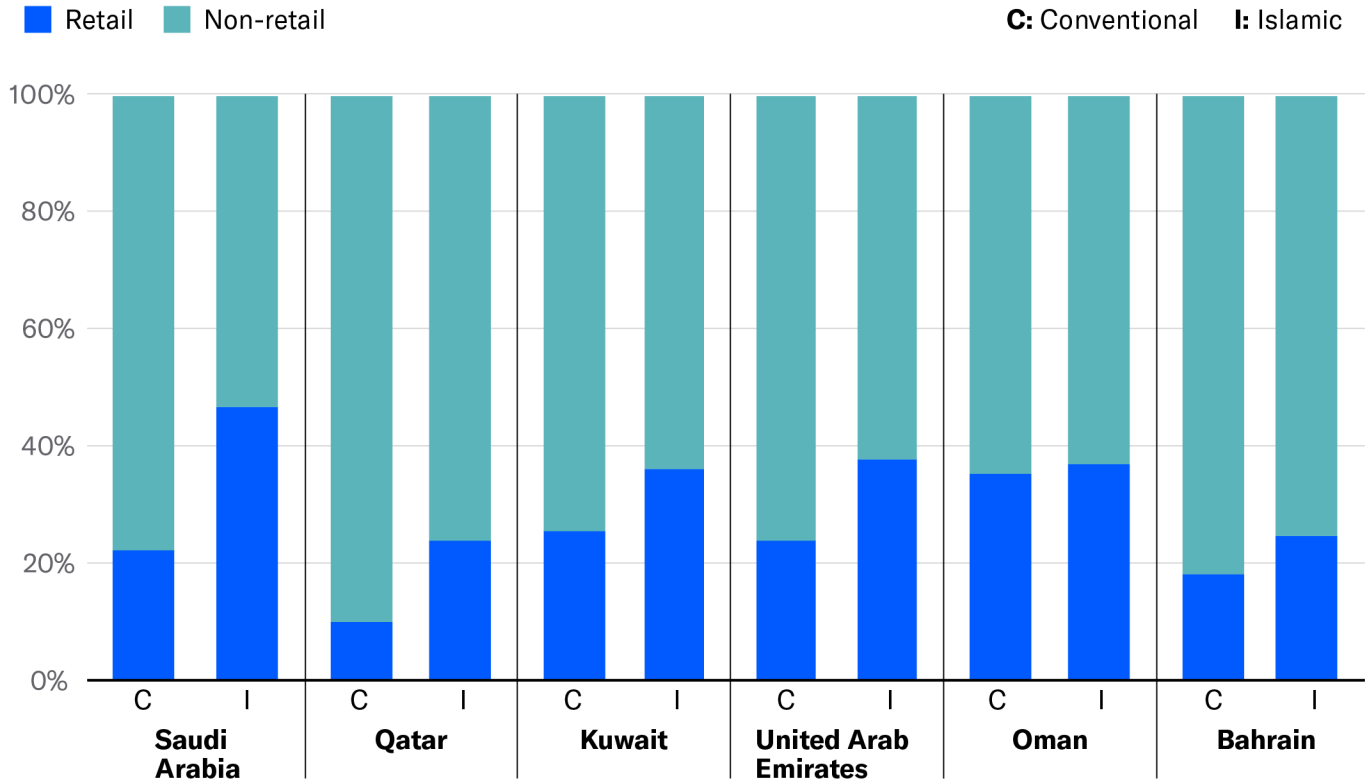
Ratios are asset-weighted averages. 2026 figures as of March 2026. Islamic banks' figures exclude Islamic windows of conventional banks.

Sources: Bank's financial statements and Moody's Ratings

Although weaker operating conditions may lead to some deterioration in the retail book, Islamic banks remain predominantly lending to public-sector employees, with financings often supported by salary assignments and collateral (exhibit 7). Concentration risk remains a key credit consideration for banks with sizeable corporate sector portfolios, which tend to be more exposed to single borrowers and individual sectors. As a result, institutions with a significant focus on more vulnerable sectors, including construction, are likely to face a greater decline in loan quality in a weaker operating environment.

Exhibit 7

Islamic banks' greater exposure to retail lending supports loan quality
As of December 2025



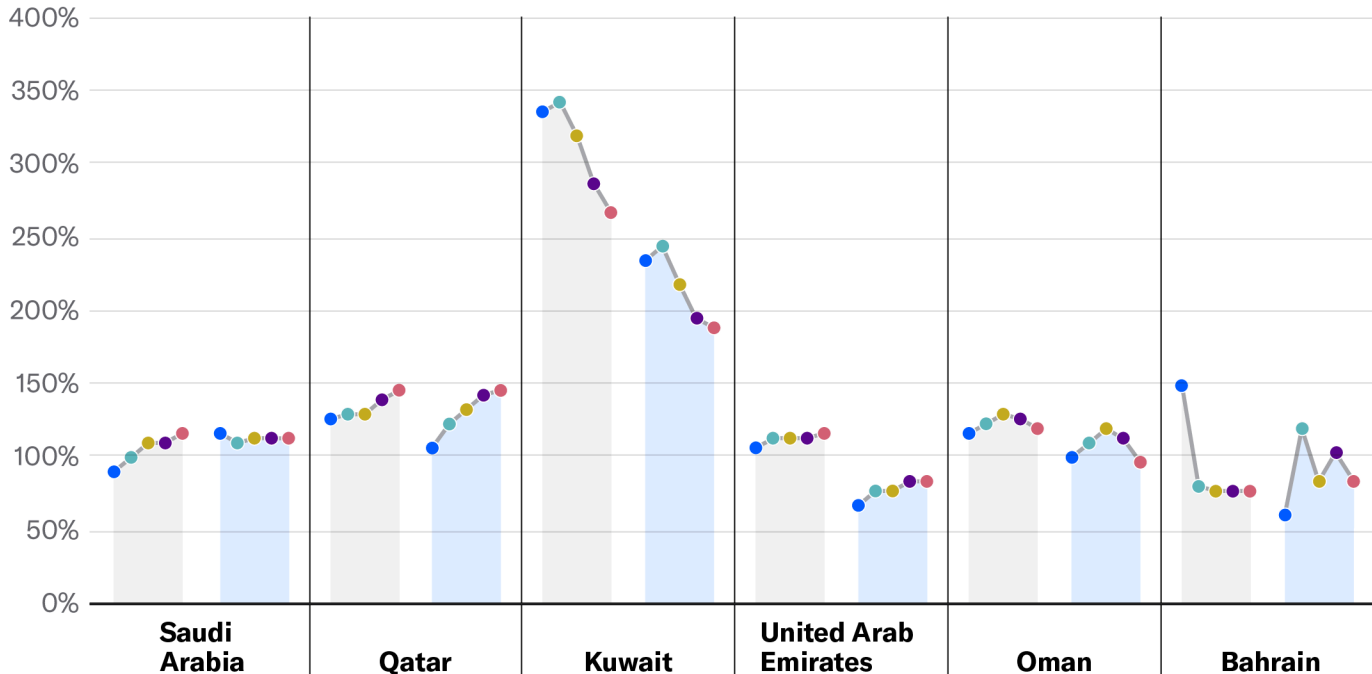
Source: Banks' financial statements and Moody's Ratings

Nonetheless, strong reserves provide a buffer against any deterioration in loan quality. Across the GCC, both Islamic and conventional banks maintain problem financing coverage ratios that generally exceed 100%, reflecting conservative provisioning practices and ample loss-absorption capacity (exhibit 8).

Exhibit 8

Islamic banks' provisioning mainly exceeds problem financings

● 2022 ● 2023 ● 2024 ● 2025 ● 2026 Q1 ■ Conventional ■ Islamic



Ratios are asset-weighted averages. Islamic banks' figures exclude Islamic windows of conventional banks.

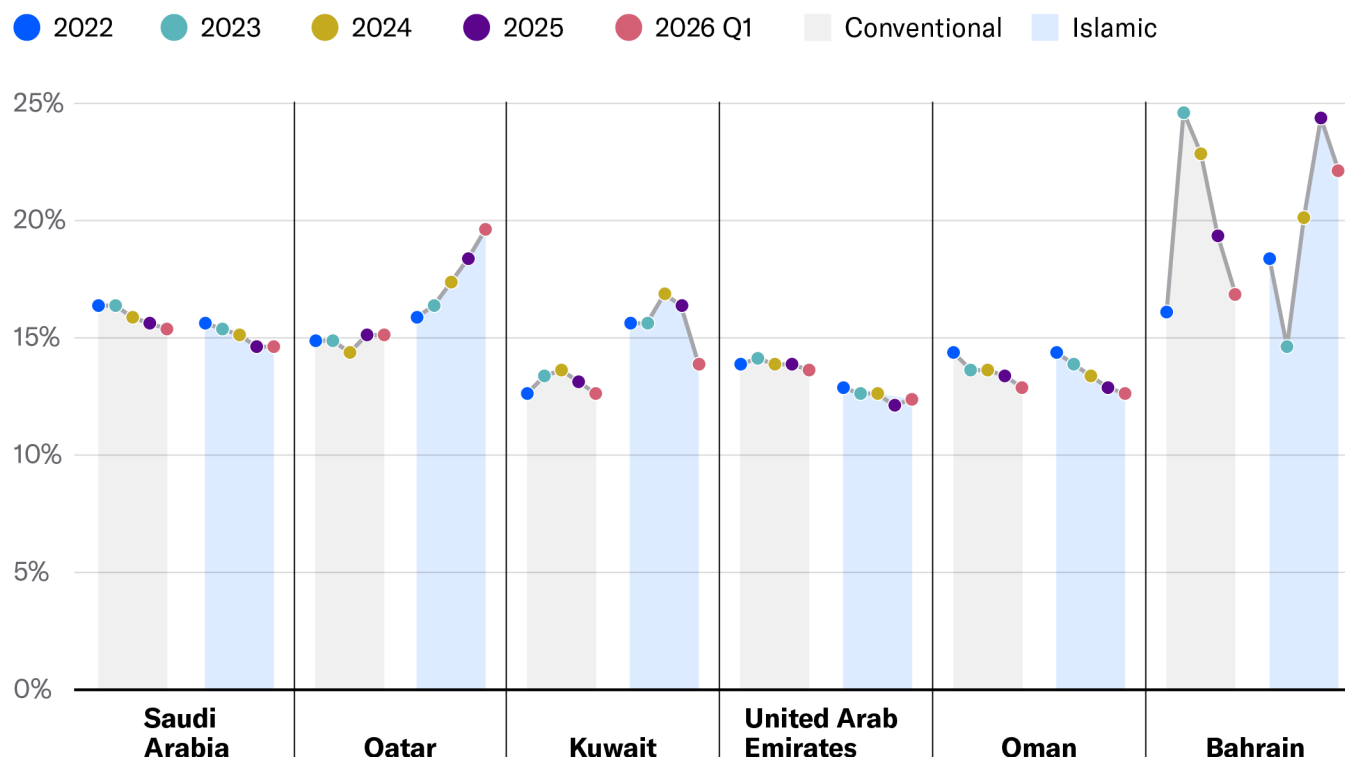
Sources: Banks' financial statements, central banks and Moody's Ratings

GCC banks' sound capitalisation provides solid loss-absorption buffers

Islamic banks maintain significant balance sheet capacity to absorb a potential deterioration in asset quality and support future growth. Reported Common Equity Tier 1 (CET1) ratios exceed those of conventional peers in several key markets, including Qatar, Kuwait and Bahrain, as of March 2026 (exhibit 9). Solid earnings retention and capital generation have further supported balance-sheet strength.

Exhibit 9

Islamic banks' core capital ratios are robust and broadly in line with conventional peers



Ratios are asset-weighted averages. Islamic banks' figures exclude Islamic windows of conventional banks.

Sources: Banks' financial statements and Moody's Ratings

Both conventional and Islamic banks have continued to reinforce their capital buffers through AT1 issuance, including [Bank AlJazira](#) (A3 stable, baa3) SAR1.5billion (\$390 million) issuance in March 2026, [Kuwait Finance House](#) (A2 stable, baa3)'s KWD200 million (\$650 million) AT1 Mudaraba sukuk issuance in May 2026, [Saudi Investment Bank](#)'s (A2 stable, baa2) SAR1.85 billion (\$493 million) AT1 sukuk in May 2026 and [Riyad Bank](#) (A1 stable, baa1)'s SAR10 billion (\$2.7 billion) AT1 sukuk issuance in August 2026. These transactions highlight continued investor appetite for GCC banks' capital instruments and banks' ability to raise capital despite heightened regional volatility.

In some GCC jurisdictions, Islamic banks also benefit from the application of the regulatory alpha factor, which lowers risk-weighted assets for certain assets and which could overstate reported capital ratios. Nevertheless, we view capitalisation across GCC Islamic banking systems as broadly sound and credit-supportive.

Islamic banks to outperform conventional peers on profitability

Islamic banks will likely remain more profitable than conventional peers. Although conservative provisioning will squeeze earnings across the sector amid geopolitical uncertainty, Islamic banks' structurally stronger margins, lower loan-loss provisions and improved operating efficiency will support stronger bottom-line performance.

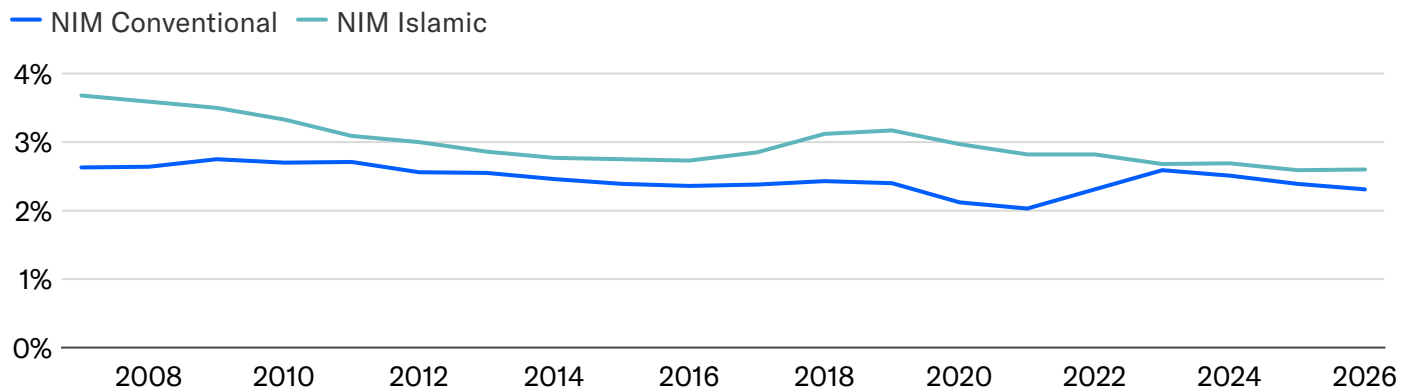
Islamic banks have historically maintained a margin advantage over conventional peers, although the gap narrowed in 2023-24 as conventional banks benefited more from rising interest rates (exhibit 10). The predominantly floating-rate nature of conventional banks' loan books allowed asset yields to reprice more rapidly during the tightening cycle, supporting margin expansion. The convergence was particularly evident in Saudi Arabia, where competition for funding drove up funding costs across both banking segments (exhibit 11). Nevertheless, Islamic banks maintained stronger margins throughout the tightening cycle, supported by robust financing growth at higher rates.

As the rate cycle began to reverse, conventional banks faced a faster repricing of asset yields, while Islamic banks are benefitting from the resilience of fixed-rate retail financings originated during the period of elevated rates. With policy rates expected to remain steady, assuming continuous policy alignment with the Fed, Islamic banks' stable base of retail low-cost current and savings account should continue to provide a funding cost advantage, reinforcing their structural margin strength relative to conventional banks.

Exhibit 10

Historically, GCC Islamic banks have maintained a margin advantage

Net interest/profit margin

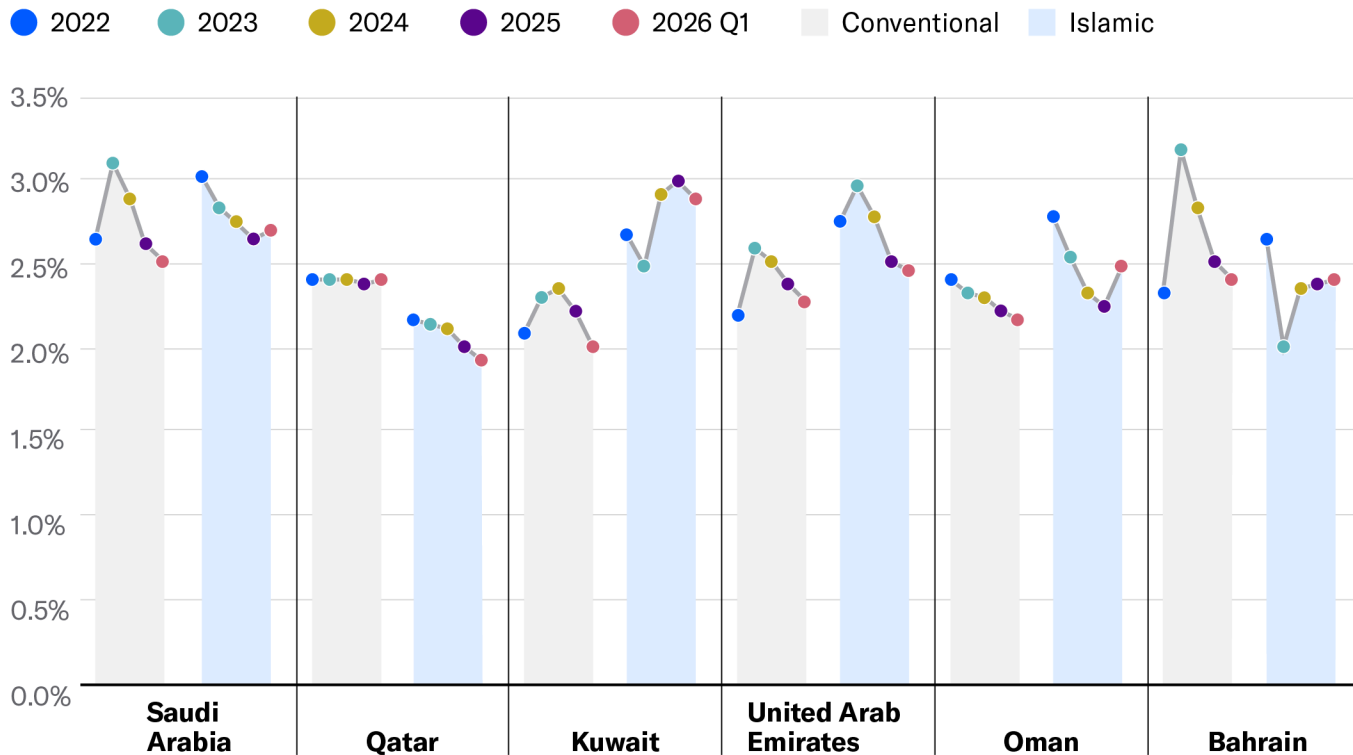


Ratios are asset-weighted averages. 2026 figures as of March 2026. Islamic banks' figures exclude Islamic windows of conventional banks.

Sources: Banks' financial statements and Moody's Ratings

Exhibit 11

GCC Islamic banks' margins are generally higher than conventional peers, but have narrowed in Saudi Arabia
Net interest/profit margin

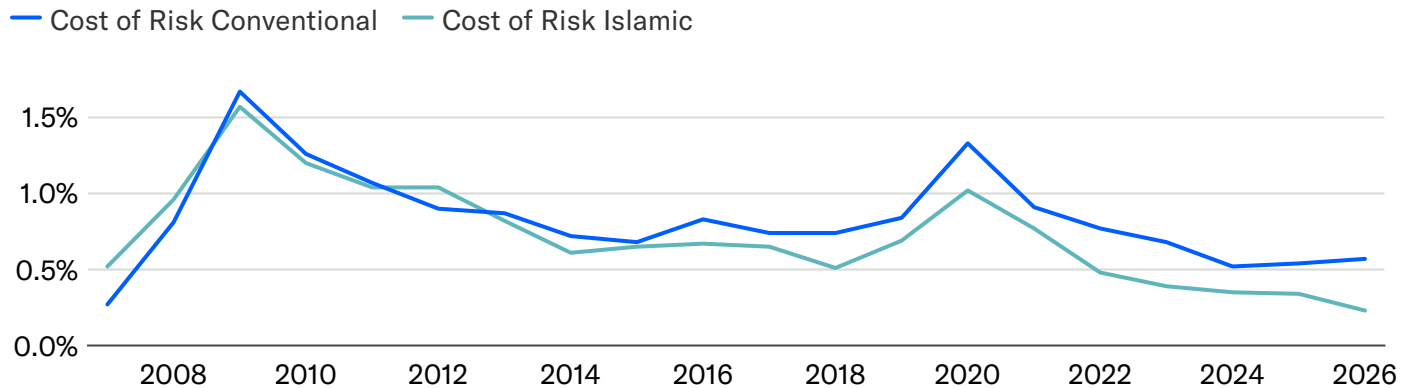


Ratios are asset-weighted averages. Islamic banks' figures exclude Islamic windows of conventional banks.
Sources: Banks' financial statements and Moody's Ratings

We expect both Islamic and conventional banks' loan-loss provisioning costs to remain high for the rest of the year, although manageable, as banks maintain conservative practices and continue to incorporate geopolitical risks into their forward-looking models. However, Islamic banks have historically reported lower cost of risk than conventional peers, including during periods of weaker operating environments such as the pandemic, reflecting their generally stronger asset quality (exhibit 12). As a result, lower provisioning costs should continue to support earnings and underpin stronger bottom-line profitability relative to conventional banks.

Exhibit 12

GCC Islamic banks' cost of risk remains lower compared with conventional peers Provisioning charges to gross loans

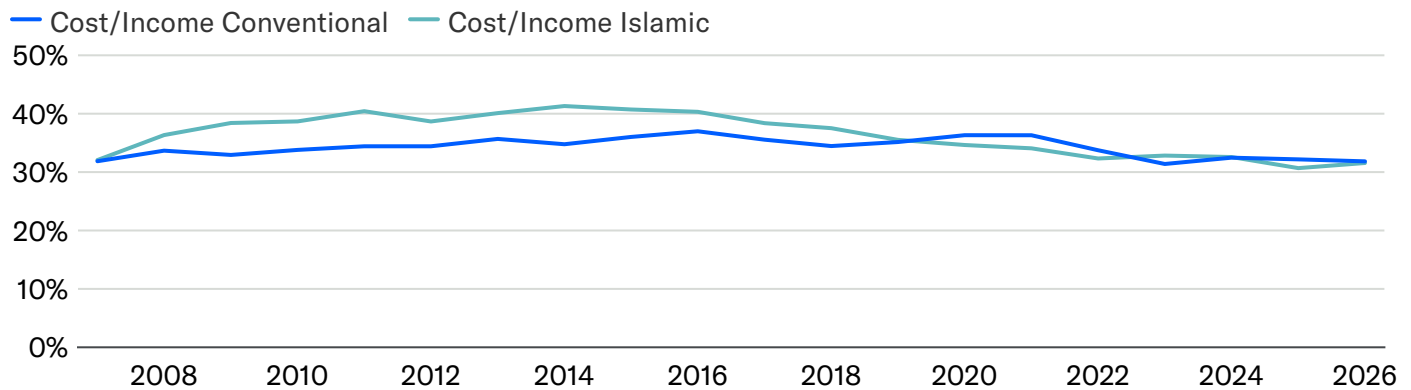


Ratios are asset-weighted averages. 2026 figures as of March 2026. Islamic banks' figures exclude Islamic windows of conventional banks.
Source: Banks' financial statements and Moody's Ratings

Additionally, Islamic banks have significantly improved their cost structures in recent years through digitalisation and branch rationalisation, with cost efficiency metrics now broadly comparable to those of conventional banks (exhibit 13).

Exhibit 13

GCC Islamic banks' efficiency is aligned with conventional peers Cost to income ratio



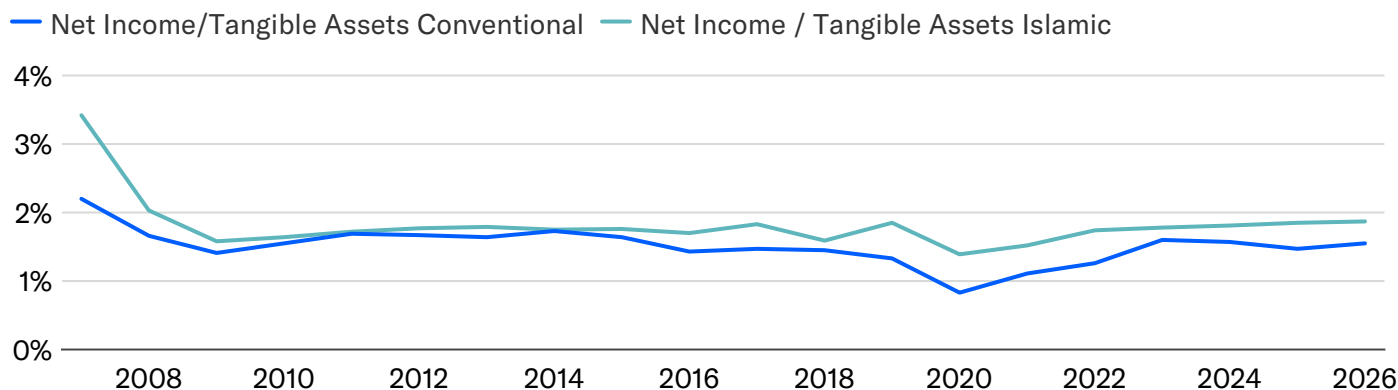
Ratios are asset-weighted averages. 2026 figures as of March 2026. Islamic banks' figures exclude Islamic windows of conventional banks.
Sources: Banks' financial statements and Moody's Ratings

Despite more challenging operating conditions, structurally higher margins and lower loan-loss provisioning costs compared with conventional banks, as well as improved operating efficiency, will continue to support bottom line profitability for Islamic banks (exhibit 14)

Exhibit 14

GCC Islamic banks' net profitability will continue to outpace conventional peers

Net income to tangible assets



Ratios are asset-weighted averages. 2026 figures as of March 2026. Islamic banks' figures exclude Islamic windows of conventional banks.

Source: Banks' financial statements and Moody's Ratings

Funding remains a key strength for Islamic banks

We expect Islamic banks funding and liquidity to remain broadly sound, but with a greater reliance on capital markets in some countries. A key strength of Islamic banks is their generally higher share of retail deposits compared with conventional peers. These deposits are typically more stable through periods of economic stress, which reduces refinancing risks. Islamic deposits have also generally grown faster than conventional deposits in several GCC countries in recent years, supporting balance-sheet expansion.

Despite ongoing geopolitical uncertainty, Islamic banks have also demonstrated sustained access to capital markets through regular sukuk issuance, supporting funding diversification and maturity management. Recent examples include [Qatar Islamic Bank's](#) (A1 stable, baa2) \$750 million senior unsecured sukuk issued in February 2026 and Emirates Islamic's \$500 million sustainability-linked sukuk issued in June 2026. While retail deposits are likely to remain the cornerstone of banks' funding, reliance on wholesale markets may increase.

Liquidity remains ample in most countries, supported by strong deposit franchises. However, Islamic banks still face structural constraints in deploying excess liquidity because of the limited availability of Shariah-compliant liquidity-management instruments and high-quality liquid assets. While this could reduce balance-sheet flexibility relative to conventional peers, ongoing government sukuk issuance and regulatory initiatives — including Kuwait's Debt Law and efforts to deepen sukuk markets in the UAE and Saudi Arabia — should gradually expand the investment opportunities and improve liquidity management options.

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