FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Sharjah Islamic Bank at 'BBB+'; Outlook Stable

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Fitch Ratings - London - 28 May 2020: Fitch Ratings has affirmed UAE-based Sharjah Islamic Bank's (SIB) Long-Term Issuer Default Rating (IDR) at 'BBB+' with a Stable Outlook and Viability Rating (VR) at 'bb+'. A full list of rating actions is below.

KEY RATING DRIVERS

IDRs, SUPPORT RATING (SR) and SUPPORT RATING FLOOR (SRF)

SIB's IDRs, SR and SRF reflect a high probability of support available to the bank from the UAE authorities if needed.

Fitch's view of support factors in the sovereign's strong ability to support the banking system, sustained by sovereign wealth funds and recurring revenue, mostly from hydrocarbon production, despite lower oil prices. Fitch also expects high willingness from the authorities to support the banking sector, which has been demonstrated by the UAE authorities' long track record of supporting domestic banks, and is also underlined by partial government ownership of some banks.

SIB's SRF is two notches below the UAE Domestic Systemically Important Banks' (D-SIB) SRF of 'A', reflecting Fitch's view that SIB is of moderate systemic importance based on its approximate 1.5% market share of total assets in the UAE banking sector at end-2019.

SIB's Short-Term IDR of 'F2' is the lower of the two options corresponding to a 'BBB+' Long-Term IDR as described in our rating criteria. This is because a significant proportion of UAE banking sector funding is related to the government and stress on banks would likely come at a time when the sovereign itself is experiencing some form of stress. Fitch judges this "wrong-way" risk as high in the UAE, and this is reflected in the choice of Short-Term IDR, which primarily reflects SIB's liquidity and funding profile.

SPV AND SENIOR DEBT

The rating of the senior unsecured notes issued under the bank's trust certificate issuance programme through SPV SIB Sukuk Company III Limited (100%-owned subsidiary) is in line with the bank's Long-Term IDRs because Fitch views the likelihood of default on senior unsecured obligations issued by the SPV as being the same as that of the bank.

VR

SIB's VR reflects the bank's modest franchise, satisfactory asset-quality metrics, only adequate capital ratios given high concentrations on both sides of the balance sheet and below peers' profitability. It also reflects acceptable management and strategy, a fairly conservative risk appetite, and sound funding and liquidity.

The VR remains constrained by the bank's modest franchise, although SIB benefits from its close ties to the Sharjah government. SIB's market share is approximately 1.5% of both UAE banking-system assets and deposits, which limits the bank's pricing power and competitive advantage.

SIB's financing book is characterised by high obligor and sector concentrations, exposing the bank to event risk. Related-party financing is large, although predominantly to the Sharjah government and related government projects, particularly infrastructure. The stage 3 financing ratio declined to 4.9% at end-1Q20 from 5.5% at end-2018, supported by write-offs and financing growth, which compares favourably with domestic peers'. Accordingly, financing loss coverage of stage 3 financing declined to 78% at end-1Q20 from 104% at end-2019.

Stage 2 financing represented a further 6% of gross financing at end-1Q20 and is concentrated in the real-estate and services sectors. The total potential problem financing ratio (which includes stage 2 and stage 3 financing) was 10.9% at end-1Q20, although total reserve coverage was satisfactory at 35%. We expect problem financing to increase over our 18-to-24 month rating horizon given the weaker economic and business environment driven by the COVID-19 outbreak and lower oil prices.

Measures announced in March 2020 allowing a broad range of customers to defer their financing servicing commitments and encouraging banks to restructure financing where necessary will slow the need to recognise impaired financing in the near-term. However, borrowers' ability to recover and maintain or resume debt servicing payments will depend, to a large extent, on the duration of lockdown measures in the UAE, travel restrictions and global economic trends.

Earnings and profitability metrics had been improving prior to the COVID-19 outbreak, but remained below domestic peers'. SIB's profitability metrics improved in 2019, supported by higher net financing margins (NFMs), non-profit revenues and declining operating expenses. However, a combination of lower-risk, lower-yielding assets and comparatively weak cost efficiency explains SIB's below-average overall profitability, which we expect to persist. Weaker asset-quality metrics, resulting in higher financing impairment charges (FICs), and lower business volumes will further weigh on profitability metrics.

SIB's capital ratios have fallen in recent years from previously high levels. The bank's Common Equity Tier 1 (CET1) ratio, our core capital metric, fell to 14.9% at end-1Q20 from 20.4% at end-2016. This was driven by a combination of regulatory changes (Basel III transition and IFRS 9 implementation) and high financing growth. SIB's total capital adequacy ratio (CAR) improved to 21.1% at end-1Q20 from 17.8% at end-2018 following a USD500 million (AED1.8 billion) additional tier 1 (AT1) sukuk issuance in 2019. As a result, SIB's regulatory capital ratios remain well above minimum regulatory requirements, although Fitch views these as only adequate in light of the bank's concentrated balance sheet and modest internal capital generation.

SIB is largely funded by stable customer deposits, which accounted for about 74% of total non-equity funding at end-1Q20. Customer deposits are concentrated but have historically been stable; 37% are from sovereign and government-related entities. SIB complements its deposit funding with sukuk issuance and has demonstrated good access to capital markets when required.

SIB's financing/customer deposits ratio improved to 93% at end-1Q20 from 103% at end-2017 but remains high relative to peers' which is indicative of a more diversified funding profile than some peers'. SIB maintains a reasonable cushion of net liquid assets (cash and cash equivalents, net short-term interbank placements and liquid securities), which represented 12% of total assets and covered 21% of customer deposits at end-2019.

In assessing SIB's ratings, Fitch considers important differences between Islamic and conventional banks. These factors include closer analysis of regulatory oversight, disclosure, accounting standards and corporate governance, as applicable. An Islamic bank's ratings do not express an opinion on the bank's compliance with sharia. Fitch will assess non-compliance with sharia if it has credit implications.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

-SIB's IDRs, SR and SRF are sensitive to a change in Fitch's view of the creditworthiness of the UAE authorities and on their propensity to support the banking system or the bank. A negative reassessment of sovereign creditworthiness would trigger a negative rating action on the bank's IDRs.

-Pressure on SIB's VR could result from deterioration in asset quality, especially increasing stage 2 and stage 3 financing as a share of gross financing if this affects the bank's profitability and leads to an erosion of the bank's core capital ratios.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

-Given our existing view of the high creditworthiness of the UAE and high propensity to support the banking system and the bank, a positive rating action on the bank's Long-Term IDR is unlikely. However, a significantly higher market share could be positive for the ratings if this strengthens our view of the bank's systemic importance in the UAE.

-An expansion in the bank's domestic franchise and/or a sustained improvement in the bank's asset quality and profitability metrics could lead to an upgrade of the VR but this is unlikely in the short-term.

The rating of the senior unsecured notes issued under the bank's trust certificate issuance programme through SPV SIB Sukuk Company III Limited is subject to the same sensitivities as the bank's IDRs.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

SIB's IDRs, SR and SRF reflect a high probability of support available to the bank from the UAE authorities if needed.

ESG CONSIDERATIONS

All Islamic banks need to ensure compliance of their entire operations and activities with sharia principles and rules. This entails additional costs, processes, disclosures, regulations, reporting and sharia audit. This results in a governance structure relevance score of '4' (in contrast to a typical relevance influence score of '3' for comparable conventional banks).

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a

minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING		
Sharjah Islamic Bank PJSC	LT IDR	BBB+	Affirmed
	ST IDR	F2	Affirmed
	Viability	bb+	Affirmed
	Support	2	Affirmed
	Support Floor	BBB+	Affirmed
SIB Sukuk Company III Limited			

VIEW ADDITIONAL RATING DETAILS

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Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Sukuk Rating Criteria (pub. 22 Jul 2019)

Bank Rating Criteria (pub. 28 Feb 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Sharjah Islamic Bank PJSC	EU Issued
SIB Sukuk Company III Limited	EU Issued

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