



Fitch Affirms Al Hilal Bank at 'A+'; Downgrades VR to 'b+'

Fitch Ratings-London-03 July 2018: Fitch Ratings has affirmed UAE-based Al Hilal Bank's (AHB) Long- and Short-Term Issuer Default Ratings (IDR) at 'A+' and 'F1', respectively. The rating Outlook is Stable. The Viability Rating (VR) has been downgraded to 'b+' from 'bb-' and removed from Rating Watch Negative (RWN). A full list of rating actions is at the end of this rating action commentary.

The downgrade of the VR reflects deteriorating asset quality, capital ratios that are not commensurate with the bank's risk profile and not supported by sufficient internal capital generation due to weak profitability. It also reflects uncertainties regarding the ability of management to realise their strategy given the bank's tight capital position.

KEY RATING DRIVERS

IDRS, SUPPORT RATING (SR) AND SUPPORT RATING FLOOR (SRF)

AHB's IDRs, SR and SRF are driven by an extremely high probability of support from the UAE and Abu Dhabi authorities if needed. This is based on the bank's full ownership by the Abu Dhabi government, which offsets its lower systemic importance in the UAE.

Fitch's view of support factors in the sovereign's strong capacity to support the banking system, sustained by sovereign wealth funds and recurring revenue mostly from hydrocarbon production, despite lower oil prices, and the moderate size of the UAE banking sector relative to the country's GDP. 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 close ties with and part government ownership links to a number of banks.

AHB's SRF is at Abu Dhabi banks' SRF for domestic systemically important banks (D-SIB) of 'A+'. Abu Dhabi banks' D-SIB SRF is one notch higher than other UAE banks due to Abu Dhabi's superior financial flexibility.

SPV AND SENIOR DEBT

The ratings of senior unsecured debt (Sukuk) issued by AHB's special purpose vehicle (SPV), AHB Sukuk Company Ltd, are in line with the bank's Long -Term IDR because Fitch views the likelihood of default on any senior unsecured

obligation issued by the SPV the same as the likelihood of default of the bank.

VR

AHB's VR reflects the bank's weak asset quality, profitability and capital ratios, which altogether render the bank's repositioning and growth strategy difficult to implement by the recently appointed management team. It also reflects the bank's high single name concentrations and a small domestic franchise. The VR also factors in the adequate funding and liquidity of AHB and, to some extent, its links to the Abu Dhabi government for potential business origination through its ownership by Abu Dhabi Investment Council (ADIC).

AHB's asset quality metrics deteriorated sharply since 2015 with the impairment of two of its largest exposures. The impaired financing ratio (NPF) reached 8.7% at end-2017, well above the peer average of 5.2%. In addition, restructured exposures have increased substantially and the bank's total problem financing (impaired financing, restructured financing, and 90 days past due but not impaired financing) increased to 16.4% of the financing book at end-2017. Despite progress made on resolving its largest impaired financing, Fitch estimates that asset quality is likely to suffer even more from weak historical underwriting standards, and asset quality metrics are likely to come under further pressure. The financing book is highly concentrated by single-name borrowers, well above peer average.

AHB's profitability is below peers', impacted by high impairment charges, weak cost efficiency and low fee income reflecting a fairly undiversified business model. The cost-to-income ratio improved to 58% in 2017 but remains significantly above peers'. Additional efforts by management to reduce the bank's high operating cost base are positive, but a meaningful improvement in the cost-to-income ratio is not expected until revenue generation picks up. Impairment charges absorbed 67% of the bank's pre-impairment operating profit in 2017, resulting in 0.53% operating profits/risk weighted assets (RWAs) ratio, strongly below the sector average of 2.1%. Earnings and profitability come under further pressure from high impairment charges.

AHB's current capital ratios are not commensurate with the bank's asset quality and high balance sheet concentration. Capital ratios have been on a declining trend since 2014, impacted by high impairment charges on the two large impaired exposures and on the SME portfolio. The bank's FCC/RWAs increased slightly to 10% at end-2017 owing to lower RWAs but remains well below the sector average of 14.8%. The regulatory Tier one capital ratio was higher yoy at 15.3%, supported by Sukuk issuance. Unreserved problem financing represented a significant portion of the bank's FCC at end-2017. The planned capital injection in 2018 is not expected to result in an improvement in capital ratios as the additional capital would broadly be neutralised by the implementation of IFRS-9.

AHB's liquidity position is comfortable, with liquid assets covering 18% of total deposits at end-2017. The financing-to-deposits ratio was down at 99% at end-2017 due to a contracting financing book. We do not expect the ratio to increase materially as financing book growth should remain in the low single digits in 2018. The 20 largest depositors account for a significant portion of the total deposit base and are largely related to the Abu Dhabi government and government-related enterprises given the bank's ownership and close ties with the government.

The bank's strategy focuses on conservative underwriting standards, steady balance sheet growth, deleveraging and capital ratios preservation, higher liquidity, further diversification of the funding base, and reducing the cost base. Expanding the bank's franchise, notably by building up on its links with the Abu Dhabi government and taking advantage of a growing Islamic finance market, would consume capital and is therefore unlikely to materialise in the short-term despite the bank's experienced management team.

In assessing AHB's ratings, we considered important differences between Islamic and conventional banks. These factors include closer analysis of regulatory oversight, disclosure, accounting standards and corporate governance. Islamic banks' 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

IDRS, SR AND SRF

AHB's IDRs, SR and SRF are sensitive to a change in Fitch's view of the creditworthiness of the UAE and Abu Dhabi authorities and on their propensity to support the banking system or the bank.

SPV AND SENIOR DEBT

The Sukuk issued via AHB Sukuk Company Limited are rated in line with AHB's IDRs and their ratings are therefore subject to the same sensitivities as the IDRs.

VR

AHB's VR remains sensitive to further deterioration in asset quality, capitalisation and profitability. Upside is currently limited unless the bank manages to strengthen its capital ratios significantly and establishes a solid track record of improvement in asset quality metrics.

The rating actions are as follows:

Al Hilal Bank PJSC

Long-Term IDR affirmed at 'A+'; Outlook Stable

Short-Term IDR affirmed at 'F1'

Viability Rating downgraded to 'b+' from 'bb-'; removed from RWN
Support Rating affirmed at '1'
Support Rating Floor affirmed at 'A+'

AHB Sukuk Company Limited:

Trust certificate issuance programme affirmed at 'A+'/'F1'
Senior unsecured certificates affirmed at 'A+'

CRITERIA VARIATION:

Under Fitch's Global Bank Rating Criteria, Fitch's SRFs are based on the ability and propensity of the government to provide support. Within the UAE, Fitch assesses the potential for support at federal level as Fitch believes that support would be forthcoming from the UAE authorities acting together. However, in respect of Abu Dhabi, Fitch has varied the criteria to reflect the superior financial flexibility of the Abu Dhabi authorities. As such, the SRFs for banks in Abu Dhabi are based on Fitch's assessment of the ability and propensity of the Abu Dhabi authorities to provide support in its own right. This results in a one notch higher SRF for Abu Dhabi banks (compared with other UAE banks), and results in a one-notch higher rating for the bank.

Contact:

Redmond Ramsdale
Senior Director
+44 20 3530 1836
Fitch Ratings Limited
30 North Colonnade
London E14 5GN

Secondary Analyst
Zeinab Abdala
Director
+971 4 424 1210

Committee Chairperson
Artur Szeski
Senior Director
+48 22 338 6292

Media Relations: Peter Fitzpatrick, London, Tel: +44 20 3530 1103, Email:
peter.fitzpatrick@fitchratings.com

Additional information is available on www.fitchratings.com

Applicable Criteria

Bank Rating Criteria (pub. 22 Jun 2018)

(<https://www.fitchratings.com/site/re/10034713>)

Sukuk Rating Criteria (pub. 14 Aug 2017)

(<https://www.fitchratings.com/site/re/902221>)

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