FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Bank of Bahrain and Kuwait at 'B+'; Outlook Stable

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Fitch Ratings - London - 26 Jul 2021: Fitch Ratings has affirmed Bank of Bahrain and Kuwait B.S.C.'s (BBK) Long-Term Issuer Default Rating (IDR) at 'B+' with Stable Outlook and Viability Rating (VR) at 'b+'. A full list of rating actions is below.

KEY RATING DRIVERS

IDRs and VR

BBK's IDRs are driven by the standalone strength of the bank, as reflected by its VR. BBK's VR is capped by the Bahraini operating environment and, more specifically, the Bahraini sovereign rating of 'B+'. This is, in particular, due to BBK's concentration of operations in Bahrain and a significant exposure to the sovereign. The VR reflects fairly high impaired loans, but also considers the bank's strong domestic franchise, moderate profitability, adequate capital and sound liquidity and funding profile.

BBK is a systemically important bank in Bahrain and has a well-entrenched domestic retail- and corporate-banking franchise, albeit in a small and competitive domestic market. BBK is small relative to its regional peers and has limited competitive advantages compared with more geographically diversified peers. BBK announced its intention to acquire certain assets belonging, directly or indirectly, to Ithmaar Holding B.S.C., which holds 100% ownership of Ithmaar Bank (Islamic bank in Bahrain) in September 2020, but in July 2021, both parties agreed to cease acquisition negotiations.

BBK's impaired (Stage 3) loans ratio increased slightly to 6.3% at end-2020 (end-2019: 5.9%), mainly due to a contraction in the loan book (-7%). The impaired loans ratio improved slightly to 6.2% at end-1Q21 on recoveries. Regulators in Bahrain extended optional payment holidays until end-2021 to reduce the impact of the pandemic on the private sector and individuals. Once deferral period ends, we expect asset-quality metrics at BBK to deteriorate as impairments rise, similar to peers.

BBK's exposures to the vulnerable sectors such as tourism and hotels are small. Exposure to the also vulnerable real- estate sector is moderate at 7% (additional 10% to construction). The bank has some concentration in its loan book to some large project-finance lending. BBK has limited exposure to mortgage loans but a high share of consumer loans, which are mainly extended to stable salaried customers.

Reported Stage 2 exposures were a high 18% of gross loans at end-1Q21 (end-2020: 19%), suggesting the potential for an increase in impaired loans, in line with operating-environment pressures. Total reserve coverage of impaired loans (91% at end-1Q21) is adequate. Specific stage 3 coverage was 64% and stage 2 coverage 8% at end-1Q21.

BBK has a sizeable investment portfolio (35% of total assets or 2.6x equity) mainly consisting of fixed-income securities (about 96% of the investment portfolio). BBK is mainly exposed to the Bahraini government (45% of fixed income), but also has exposure to non-investment grade fixed-income securities (excluding the Bahraini government) equal to about 60% of equity, which we see as a potential vulnerability.

Fitch deems BBK's capital ratios adequate for the weakening operating environment and potential asset-quality problems. Its reported common equity Tier 1 (CET1) ratio was 20.65% at end-1Q21 (end-2020: 20.71%; end-2019: 17.54%). BBK has one-off modification losses of BHD21 million arising from payment holidays provided to customers, which will not be deducted from capital calculations until 2022 and will amortise over three years. Fitch calculates the impact at about 80bp of the CET1 ratio if the modifications were fully implemented at end-1Q21.

The bank's capital ratios benefit from a 0% risk weighting on its sovereign securities and some government-related project-finance loans, similar to other banks in Bahrain. The total capital adequacy ratio (CAR) was 21.75% at end-1Q21, comfortably above the 14%

minimum total regulatory capital requirement for domestically systemically important banks. Pre-impairment operating profit still provides a good buffer against unexpected losses, equal to 3.4% of average gross loans in 1Q21 (annualised). BBK's capital buffers remain exposed to high event risk in a tough operating environment.

BBK's profitability metrics weakened in 2020 due to contracting margins on the back of a lower interest-rate environment. The bank's profitability slightly recovered in 1Q21 (operating profit/risk-weighted assets: 2.4%; 2020: 2.1%; 2019: 2.9%). Profitability could weaken by higher impairment charges, as the bank increases provisions for increased risks once payment holidays end, similar to at peers.

BBK is largely funded by customer deposits, which represented 71% of non-equity funding at end-1Q21. The Fitch-calculated gross loans-to-deposits ratio remained at a healthy 76% at end-1Q21. Despite recent improvements, the deposit base remains concentrated. Nevertheless, these are mainly from Kuwaiti and Bahraini government-related entities given the bank's ownership and are believed to be inelastic. Without shareholder deposits, deposit concentration falls to a more reasonable level.

At end-1Q21, the bank's liquidity coverage ratio and net stable funding ratio were a strong 306% and 133%, respectively. The bank's main wholesale funding consists of deposit from banks (USD832 million), repo facilities (USD1.1 billion evenly distributed by maturities) and bond issuance (USD500 million maturing in 2024). Our base-case expectation is for the currency peg to remain intact and large deposits stable.

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

BBK's SR and SRF reflect a limited probability of support from the Bahraini authorities, if required, because of uncertainties about support ability. BBK's SRF of 'B' is one notch lower than Bahrain's 'B+' Long-Term Foreign-Currency IDR. This reflects Fitch's assessment of the sovereign's weak ability to provide support in foreign currency due to weak reserves and increasing indebtedness.

Our view on support also considers the Bahraini authorities' high propensity to support domestic retail banks including BBK. This considers BBK's systemic importance as a major retail and corporate bank in Bahrain. In addition, the Bahraini government has a 33% stake in BBK via its social insurance organisation, which adds to Fitch's view on the sovereign's propensity to provide support to BBK.

SENIOR DEBT

Senior debt ratings are aligned with BBK's IDRs.

RATING SENSITIVITIES

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

An upgrade of any rating would require an upgrade of the sovereign rating. However, a rating change linked to the sovereign is unlikely in the near future given the Stable Outlook on the sovereign.

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

BBK's Long-Term IDR would be downgraded if the bank's VR is downgraded. This would most likely result from a sovereign downgrade. Downside risk to BBK's VR may also arise from the impact of the pandemic on asset quality, earnings and capitalisation.

A downward revision of the SRF could come from a reduced ability or propensity of the sovereign to support the banking sector or the bank.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions and Covered Bond 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.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY/DEBT	RATING			RECOVERY	PRIOR
Bank of Bahrain and Kuwait B.S.C.	LT IDR	B+ Rating Outlook Stable	Affirmed		B+ Rating Outlook Stable
	ST IDR	B	Affirmed		B
	Viability	b+	Affirmed		b+
	Support	4	Affirmed		4
	Support Floor	B	Affirmed		B
• senior unsecured	LT	B+	Affirmed	RR4	B+

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

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

Bank of Bahrain and Kuwait B.S.C.	UK Issued, EU Endorsed

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