FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades Bank of Bahrain and Kuwait to 'B+'; Outlook Stable

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Fitch Ratings - London - 09 Sep 2020: Fitch Ratings has downgraded Bank of Bahrain and Kuwait B.S.C.'s (BBK) Long-Term Issuer Default Rating (IDR) to 'B+' from 'BB-'. The Outlook is Stable. Fitch has also downgraded BBK's Viability Rating (VR) to 'b+' from 'bb-' and revised the Support Rating Floor (SRF) to 'B' from 'BB-'. A full list of rating actions is below.

The rating actions follow the downgrade of the Bahraini sovereign rating (see 'Fitch Downgrades Bahrain to 'B+'; Outlook Stable' dated 14 August 2020 on www.fitchratings.com).

The downgrade reflects increased pressure on the bank's standalone profile from the weakened operating environment and, more specifically, the sovereign downgrade. The downward revision of the SRF reflects the sovereign's weaker ability to support as reflected by its lower foreign-currency (FC) reserves and higher debt levels.

In accordance with Fitch's policies, the issuer appealed and provided additional information to Fitch. The rating action is different to the original rating committee outcome.

KEY RATING DRIVERS

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 sovereign rating. BBK is an important retail bank in Bahrain with a significant exposure to the sovereign and domestic operating environment. The VR considers BBK's concentration of operations in the challenging operating environment in Bahrain, the weakening of the bank's asset quality, a strong domestic franchise, moderate profitability, adequate capital and liquidity and funding profile.

BBK has a good franchise in Bahrain; however, it is reliant on a small and competitive domestic operating environment. BBK is small relative to its regional peers and has limited competitive advantages compared with more geographically diversified peers. Nevertheless, BBK has a well-entrenched domestic retail and corporate banking franchise.

BBK's impaired loans ratio increased slightly to 6.3% at end-1H20 (end-2019: 5.9%), mainly due to a contraction in the loan book (-4% year to date). Regulators in Bahrain and Kuwait mandated banks to defer loan payments for six months until September due to the impact of the pandemic. After payment holidays, we expect asset-quality metrics at BBK to deteriorate as impairments rise, similar to peers.

BBK's exposures to the directly impacted sectors such as tourism and hotels are small. The bank has some concentration in its loan book and is exposed 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 payroll customers, which in turn mitigates risks.

Reported Stage 2 exposures were a high 15% of gross loans at end-1H20, suggesting the potential for an increase in non-performing loans (NPLs), in line with operating environment pressures. BBK has increased its total reserve coverage to an adequate 101% of impaired loans at end-1H20 (99% at end-2019). Stage 3 coverage was at 74% and stage 2 coverage was 8% at-end-1H20. BBK has a sizeable investment portfolio (34% of total assets or 3.1x equity) with an exposure to non-investment grade fixed-income securities (excluding Bahrain and mainly to sovereign or quasi sovereign) equal to about 40% of equity, which we consider a potential vulnerability.

Fitch deems BBK's capital ratios adequate for the weakening operating environment and potentially asset-quality problems. Its reported CET1 ratio was 17.5% at end-1H20, slightly down on end-2019's level. The bank's capital ratios were hit by marked-to-market securities losses in 1H20 (BHD64 million loss or about -300bp of CET1 ratio), and as a result the equity/assets ratio fell to 11% at end-1H20 (end-2019: 14.1%).

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 18.6% at end-1H20, comfortably above the 14% minimum total regulatory capital requirement. Pre-impairment operating profit still provides a good buffer against unexpected losses, equal to 3.8% of average gross loans in 1H20 (annualised). BBK's capital buffers remain exposed to high event risk in a weakened operating environment.

BBK's profitability metrics weakened in 1H20 due to contracting margins on the back of a lower interest-rate environment. Profitability could weaken further by higher impairment charges, as the bank increases provisions for increased risks after the end of payment holidays, similar to peers.

BBK is largely funded by customer deposits, which represented 70% of non-equity funding at end-1H20. The Fitch-calculated gross loans-to-deposits ratio fell significantly to 72% at end-1H20. The bank has not faced deposit outflows and even managed to increase its deposit base despite contraction in its loan book. The deposit base is concentrated though improved recently. These are mainly from Kuwaiti and Bahraini government-related entities given the bank's ownership and are believed to be sticky. Without shareholder deposits, the deposit concentration ratio falls to a more reasonable level.

Overall the bank has comfortable liquidity - comprising cash, central bank placements (excluding mandatory deposits) and interbank placements - covering 33% of deposits. The bank's main wholesale funding consists of deposit from banks, repo facilities (USD1 billion evenly distributed by maturities) and bond issuance (USD500 million maturing in 2024). Our base-case expectation is that the currency peg remains intact and large deposits remain stable.

SUPPORT RATING AND SUPPORT RATING FLOOR

BBK's Support Rating (SR) and SRF reflect a limited probability of support from the Bahraini authorities, if required, because of uncertainties about support ability. BBK's SR has been downgraded to '4' from '3' and the SRF revised downwards by two notches to 'B', one notch lower than Bahrain's 'B+' Long-Term Foreign-Currency IDR. This reflects Fitch's assessment of the sovereign's reduced ability to provide support in FC due to weak reserves and increasing indebtedness.

Our view on support also considers the Bahraini authorities' high propensity to support domestic commercial 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 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.

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.

A rating change linked to the sovereign is unlikely in the near future given the Stable Outlook on the sovereign.

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]

LIQUIDITY AND DEBT STRUCTURE

SENIOR DEBT

The senior debt ratings are sensitive to the same considerations that might affect the bank's Long-Term IDR.

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

The SR and the SRF are driven by sovereign rating.

ESG CONSIDERATIONS

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			RECOVERY	PRIOR
Bank of Bahrain and Kuwait B.S.C.	LT IDR	B+ Rating Outlook Stable	Downgrade		BB- Rating Outlook Stable

ENTITY/DEBT	RATING			RECOVERY	PRIOR
	ST IDR	B	Af fir		B

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Ahmet Kilinc
Director
Primary Rating Analyst
+44 20 3530 1272
Fitch Ratings Ltd
30 North Colonnade, Canary Wharf London E14 5GN

Tim Slater
Senior Analyst
Secondary Rating Analyst
+44 20 3530 1791

James Watson
Managing Director
Committee Chairperson
+7 495 956 6657

MEDIA CONTACTS

Louisa Williams
London
+44 20 3530 2452
louisa.williams@thefitchgroup.com

Additional information is available on www.fitchratings.com

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

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Banks Middle East Asia-Pacific Bahrain