

Credit Opinion: National Bank of Fujairah

Global Credit Research - 31 Mar 2014

Fujairah, United Arab Emirates

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	Baa1/P-2
Bank Financial Strength	D+
Baseline Credit Assessment	ba1
Adjusted Baseline Credit Assessment	ba1

Contacts

Analyst	Phone
Christos Theofilou, CFA/Limassol	357.25.586.586
Olivier Panis/Dubai	9714.237.9533
Nitish Bhojnagarwala/DIFC - Dubai	971.42.37.9536
Yves Lemay/London	44.20.7772.5454

Key Indicators

NATIONAL BANK OF FUJAIRAH (Consolidated Financials)[1]

	[2]12-13	[2]12-12	[2]12-11	[3]12-10	[2]12-09	Avg.
Total Assets (AED million)	21,455.4	17,544.6	14,913.4	12,916.6	11,890.9	[4]15.9
Total Assets (USD million)	5,841.4	4,776.6	4,060.2	3,516.5	3,237.2	[4]15.9
Tangible Common Equity (AED million)	2,507.0	2,247.1	2,061.0	1,847.0	1,671.2	[4]10.7
Tangible Common Equity (USD million)	682.5	611.8	561.1	502.9	455.0	[4]10.7
Net Interest Margin (%)	3.1	3.2	3.2	3.0	2.7	[5]3.0
PPI / Average RWA (%)	3.3	3.2	3.0	-	2.8	[6]3.0
Net Income / Average RWA (%)	2.3	2.0	2.1	-	0.9	[6]1.8
(Market Funds - Liquid Assets) / Total Assets (%)	-16.5	-5.9	-2.9	-10.8	-14.4	[5]-10.1
Core Deposits / Average Gross Loans (%)	106.6	94.3	91.0	98.5	95.6	[5]97.2
Tier 1 Ratio (%)	14.4	12.3	12.8	-	14.2	[6]13.4
Tangible Common Equity / RWA (%)	13.6	14.1	14.8	-	14.9	[6]14.4
Cost / Income Ratio (%)	36.6	36.9	39.4	35.6	41.4	[5]38.0
Problem Loans / Gross Loans (%)	4.5	7.6	10.8	11.6	7.5	[5]8.4
Problem Loans / (Equity + Loan Loss Reserves) (%)	17.9	32.4	44.6	43.5	28.8	[5]33.4

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel II; IFRS [3] Basel I; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel II & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

Moody's assigns Baa1 issuer ratings to National Bank of Fujairah (NBF). These ratings are underpinned by the bank's overall standalone credit strength (reflected in a standalone baseline credit assessment or BCA of ba1) and

by our view of the high likelihood of systemic support if needed.

NBF's standalone BCA reflects its (1) small but growing franchise in the United Arab Emirates (UAE, Aa2 stable), supported by an improving risk management framework, (2) solid capitalization metrics underpinned by stable profitability and (3) solid liquidity metrics despite rapid asset growth. These strengths are moderated by (1) NBF's improving, but still relatively weak, asset quality and (2) high balance sheet concentrations.

NBF's Baa1 issuer rating incorporates a high three notches of uplift from the bank's BCA, which reflects Moody's assessment of a high likelihood of UAE government support in the event of need. Moody's view is based on (1) the 40% ownership of Government of Fujairah and 15% of other government related parties and (2) the UAE's strong track record of supporting banks in times of stress.

Rating Drivers

- Small but growing franchise supported by an improving risk management framework
- Solid capitalization underpinned by stable profitability
- Solid liquidity metrics despite rapid asset growth
- Improving but relatively weak asset quality and high balance sheet concentrations

Rating Outlook

All ratings assigned to NBF carry a stable outlook

What Could Change the Rating - Up

Upward pressure on NBF's ratings could develop from a combination of the following: (1) a considerable expansion and diversification of the franchise; (2) a material reduction in the single-name borrower concentration; and/or (3) improved asset quality and capitalization metrics.

What Could Change the Rating - Down

Downwards pressure on NBF's ratings could develop from: (1) material weakening of franchise leading to a decline in profitability; (2) material weakening of financial fundamentals; or (3) significant deterioration in asset quality.

DETAILED RATING CONSIDERATIONS

-- SMALL BUT GROWING FRANCHISE SUPPORTED BY AN IMPROVING RISK MANAGEMENT FRAMEWORK

Established in 1984, National Bank of Fujairah (NBF) is amongst the smallest banks in the UAE holding a 1% market share in terms of assets, loans and deposits. However, the bank has materially grown its balance sheet since 2009 whilst also significantly strengthening its risk management framework following severe stresses experienced during the crisis period.

Its main activities are concentrated in the corporate and commercial banking businesses, which represent altogether 91% of its net income and 66% of its assets, whilst the Retail operations contribute only marginally to the operating profit, total assets and deposits. There is very limited geographical asset diversification as 98% of funded and unfunded exposure is located in UAE, hence the recent growth in balance sheet has benefited from the improving operating environment of the UAE.

Pre-crisis, NBF had a sizeable investment portfolio, which led to a net loss of AED50m in 2008, and also suffered further asset quality deterioration from the impairment of several large Dubai-based corporate exposures. A new, stronger management team was put in place in 2009 and refocused NBF towards its core strengths in corporate and commercial banking, particularly in the fast growing and resilient trade finance area. This focus has resulted in high loan growth (albeit from a low base) of 16% CAGR between 2009 and 2013, compared to UAE average of 4% over the same period. Going forward, asset growth is expected to remain in line with recent years with exposure to the same business segments, however the bank is also seeking to develop a retail franchise particularly for the local customer base.

Since 2009, NBF has also strengthened its risk management framework through enhanced infrastructure

combined with stricter controls and processes. This is additionally coupled with a more conservative risk culture that focuses on continuous monitoring and management of key identified risks, these ongoing developments bring NBF's risk management on par with other - sometimes larger - UAE banks and provide a foundation for balanced future growth.

-- SOLID CAPITALIZATION UNDERPINNED BY STABLE PROFITABILITY

We consider that NBF has built up solid capital buffers in recent years, reflecting its stable profitability and retention policies. This places the bank on a solid foundation for future growth. NBF's income structure benefits from a significant fee and commission contribution of 25% of net operating revenues compared to 19% UAE average. This is increasingly driven by the provision of treasury services to its corporate clients and the profitable trade finance focus of the bank, which has supported consistent and healthy net interest margins around 3% over the last four years, above the 2.8% UAE average. Besides the success of the cross-selling strategy of NBF in recent years, the bank's focus on productivity and cost control have also contributed to the steady improvement of the cost to income ratio from 41.4% in 2009 to 36.6% as of year-end 2013 in line with UAE average.

With consistent profit retention in excess of 60%, NBF generates significant internal capital that, combined with the issuance of AED 500m Tier 1 perpetual notes in 2013, has strengthened its Tier 1 ratio, currently 14.4% as of year-end 2013 (12.3% in 2012). Despite being below UAE average of around 16%, Tier 1 capital ratio remains well above the 13% median for global banks with same BCA. We expect that this metric will remain stable despite the planned loan growth and also note that the bank's capitalization metrics remain resilient under Moody's adverse scenario analysis.

-- SOLID LIQUIDITY METRICS DESPITE RAPID ASSET GROWTH

Despite experiencing rapid asset growth since 2009, NBF has gradually improved its liquidity risk profile and developed solid liquidity buffers that are in line with its UAE peers, thanks to the implementation of a very conservative liquidity risk management and deposit gathering capabilities.

The bank has built various layers of liquidity buffers, such as AED 3.9 billion of cash (18% of total assets) with the UAE central bank, AED 1.4 billion of cash and placements with various banks and high-quality securities investments representing 3% of total assets. Liquid assets therefore increased to a sound 27% of total assets from 20% over the same period.

Demonstrating the capacity of the bank to attract deposits in excess of the asset growth, the net loans to deposits ratio has decreased from 113% in 2011 to 96% in 2013 and is now in line with local peers. Customer deposits now fund 70% of total assets as of year-end 2013, compared with 62% in 2011, 77% of which are term deposits that - when coupled with the short-term nature of its trade financing book - help reduce the sizable asset-liability maturity mismatch prevalent across all GCC banks.

Going forward, even if sources of liquidity are expected to be diversified, loan growth should continue being mainly funded through customer deposits and liquidity metrics should remain stable and within the liquidity risk management framework defined today by the bank.

--IMPROVING BUT RELATIVELY WEAK ASSET QUALITY AND HIGH BALANCE SHEET CONCENTRATIONS

Although NBF's asset quality and concentration levels have materially improved since 2011 and are expected to remain on an improving trend, they are still both weaker than global peers with BCAs of ba1.

Despite its recent economic growth, the Emirate of Fujairah, which represents only 1% of the UAE's GDP, constitutes less than 15% of NBF's activities, with the bulk of the balance sheet growth originating in Dubai. As a result, and in line with some other UAE banks, NBF was exposed to troubled Dubai government related entities, causing asset quality to deteriorate rapidly between 2008 and 2010, with the non-performing loan ratio (NPL) peaking at 11.6% in 2010.

Since 2011, the reported NPL ratio has declined materially to 4.6% in 2013 (excluding some government related restructuring), which compares to Moody's UAE reported average of 7.8% (UAE average is around 9% when it includes large government related restructurings that Moody's considers impaired) and to the 3% median of global banks with a ba1 BCA. Some government related restructurings were reclassified to the performing loans in 2011, but Moody's still considers them as non-commercial restructuring due to their non-commercial coupon rates and bullet maturity profile. For further information on Moody's views on the reclassification of large restructurings please refer to our published report on the July 16, 2012 "UAE Banks: Problem-Loan Reporting in the Context to

Local Restructurings". The NPL reduction is driven primarily through a combination of write-offs, restructurings and loan growth and we expect problem loan levels to continue to decline in line with loan growth and the improved operating environment.

The improvement in risk management, coupled with the fast growth experienced over recent years has also resulted in a reduction in both asset and deposit concentration levels below UAE average, even if those are still high relative to global medians. Related party deposits have materially increased by 22% in 2013 (representing 27% of total customer deposits), which leave the institution more vulnerable to event risks, although they have historical proven stable and the bank is implementing a number of internal caps aimed at reducing such risks. NBF has also posted a significant improvement in the coverage ratio to 118%, well above local average and global peers, which again stems from NBF's commitment to dedicate part of the current profitability to reserves.

Global Local Currency Deposit Rating (Joint Default Analysis)

NBF's Baa1 issuer rating incorporates a high three notches of uplift from its ba1 standalone BCA. This reflects Moody's assessment of a high likelihood of systemic (government) support in case of need. The rating agency bases this view on (1) the 40% ownership of Government of Fujairah and 15% of other government related parties and (2) the UAE's strong track record of supporting banks in times of stress.

NOTE ON DATA

Unless noted otherwise, data in this report is sourced from the bank's published financial statements and our Banking Financial Metrics. All figures are based on our own chart of account and are adjusted for analytical purposes.

ABOUT MOODY'S BANK RATINGS

Bank Financial Strength Rating

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. BFSRs do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honor its domestic or foreign currency obligations. Factors considered in the assignment of BFSRs include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although BFSRs exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the BFSR as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, they are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, which includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of external elements of support into the bank's Baseline Risk Assessment. In calculating the Global Local Currency Deposit rating for a bank, the JDA methodology also factors in the rating of the support provider, in the form of the local currency deposit ceiling for a country, Moody's assessment of the probability of systemic support for the bank in the event of a stress situation and the degree of dependence between the issuer rating and the Local Currency Deposit Ceiling.

National Scale Ratings

National scale ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. A Aaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each

other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could affect all issuers, even those that receive the highest ratings on the National Scale.

Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt ratings may also be constrained by the country ceiling for foreign currency bonds and notes; however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

About Moody's Bank Financial Strength Scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating Factors

NATIONAL BANK OF FUJAIRAH

Rating Factors [1]	A	B	C	D	E	Total Score	Trend
Qualitative Factors (70%)						D	
Factor: Franchise Value						E+	
Market share and sustainability					x		
Geographical diversification				x			
Earnings stability					x		
Earnings Diversification [2]							
Factor: Risk Positioning						D	
Corporate Governance [2]				x			
- Ownership and Organizational Complexity				x			
- Key Man Risk							
- Insider and Related-Party Risks				x			
Controls and Risk Management			x				
- Risk Management				x			
- Controls		x					
Financial Reporting Transparency			x				
- Global Comparability	x						
- Frequency and Timeliness	x						
- Quality of Financial Information				x			
Credit Risk Concentration				x			
- Borrower Concentration	--	--	--	--	--		
- Industry Concentration			x				
Liquidity Management				x			

Market Risk Appetite	x						
Factor: Operating Environment						D	
Economic Stability					x		
Integrity and Corruption			x				
Legal System				x			
Financial Factors (30%)						C+	
Factor: Profitability						B+	
PPI % Average RWA (Basel II)		3.13%					
Net Income % Average RWA (Basel II)	2.14%						
Factor: Liquidity						C	
(Market Funds - Liquid Assets) % Total Assets		-8.42%					
Liquidity Management				x			
Factor: Capital Adequacy						A	
Tier 1 Ratio (%) (Basel II)	13.17%						
Tangible Common Equity % RWA (Basel II)	14.19%						
Factor: Efficiency						A	
Cost / Income Ratio	37.63%						
Factor: Asset Quality						D	
Problem Loans % Gross Loans				7.68%			
Problem Loans % (Equity + LLR)				31.64%			
Lowest Combined Financial Factor Score (9%)						D	
<i>Economic Insolvency Override</i>						Neutral	
Aggregate BFSR Score						D+	
Aggregate BCA Score						baa3/ba1	
Assigned BFSR						D+	
Assigned BCA						ba1	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.

[2] - A blank score under Earnings Diversification or Corporate Governance indicates the risk is neutral.



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