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Ratings

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Sharjah Islamic Bank

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Sharjah Islamic Bank

SACP	bbb-	+	Support	+3	+	Additional Factors	0

Anchor	bbb-	
Business Position	Moderate	-1
Capital and Earnings	Strong	+1
Risk Position	Adequate	0
Funding	Average	0
Liquidity	Adequate	

ALAC Support	0
GRE Support	0
Group Support	0
Sovereign Support	+3

Issuer Credit Rating
A-/Negative/A-2

Major Rating Factors

Strengths:	Weaknesses:
• Strong capitalization. • High systemic importance in the United Arab Emirates (UAE). • Strong relationship with the government of Sharjah.	• Sharp economic contraction in the UAE will constrain lending and pressure asset quality indicators. • Sizeable lending exposure to the real estate and construction sectors. • Fragmented banking system with high price competition.

Outlook: Negative

The negative outlook indicates that the worsening operating environment could cause a significant deterioration in Sharjah Islamic Bank's (SIB) asset quality indicators and hamper the bank's profitability.

We could lower the ratings in the next 12-24 months if we observe a significant increase in problem loans (Stage 2 and Stage 3) or if pressure on the bank's operating environment intensifies.

We could revise the outlook to stable in the next 12-24 months if SIB's asset quality deterioration does not exceed our expectation and capitalization remains strong, and risks related to the operating environment recede.

Rationale

The drop in oil prices and impact of COVID-19 will result in reduced profitability and weaker asset quality for Sharjah Islamic Bank, in our opinion. The restrictive measures implemented by the UAE government to contain transmission of COVID-19 will take a toll on sectors, which SIB has significant exposure to, such as real estate, hospitality, trade, and transportation leading to deterioration in the bank's asset quality. Although we expect significant deterioration in certain metrics, we still expect SIB to remain resilient to the weak operating environment and maintain its strong fundamentals.

The rating balances SIB's status as the flagship bank of the Emirate of Sharjah against its moderate, but expanding, franchise outside of Sharjah. Although, we expect the bank's profitability to decline sharply because of higher credit losses, lower intermediation margins, and customer relief measures, we still expect SIB to remain profitable. As of June 30, 2020, SIB's stock of problematic loans (Stage 2 and Stage 3) reached 11.5% of gross loans compared with 10.3% at year-end 2019. We expect the stock of problematic loans to increase to 15%-16% of gross loans and cost of risk to increase to around 120 basis points (bps) by 2021. Among others, the bank has substantial exposure to sectors negatively impacted by COVID-19, in particular to the real estate sector, which will contribute to that increase. However, SIB's strong capitalization provides it with a good buffer against these risks, in our opinion. We expect its risk-adjusted capital (RAC) ratio to decline to around 13%-14% over the next 12-24 months compared with 15.6% at year-end 2019. In our view, SIB's funding and liquidity profiles are on par with domestic peers' and neutral for the ratings.

The rating on SIB is three notches above its intrinsic creditworthiness, given our view of the bank's high systemic importance in the UAE, which we regard as highly supportive of the domestic banking sector.

Anchor: 'bbb-' for banks operating in the UAE

Our starting point for the rating of a commercial bank operating in the UAE is 'bbb-'.

The UAE has a wealthy economy with strong fiscal and external positions. The strength of the government's net asset position has helped counteract the negative impact of lower oil prices on economic growth since late 2015. However, we believe the dual shock of the sharp drop in oil prices and lower economic activity due to COVID-19 will lead to a rise in problem loans and the cost of risk for banks in the UAE in the next 12-24 months. Although UAE banks traditionally operate with healthy profitability metrics, the shift in U.S. Federal Reserve monetary policy toward a more accommodative stance will have negative consequences for banks' margins. In addition, we expect credit losses to increase in 2020-2021, leading to a slump in sector profitability.

Although, we view favorably the Central Bank of UAE's (CBUAE) recently announced Targeted Economic Support Scheme (TESS), which should help to ease the pressure on corporate issuers and small and midsize enterprises, it does not reduce credit risk from the banking system's balance sheet. We also note the relaxation of certain prudential requirements, for example, the cap on real estate exposures and the increase in loan-to-value limits for mortgage lending, and we see some potential risks of slower recognition and disclosure of problematic assets. Public-sector and government depositors provide more than 25% of resident deposits. We expect these entities to withdraw some deposits from the banking system in 2020. However, we do not see any immediate liquidity challenges for the banking sector thanks to proactive measures by the CBUAE to support liquidity in the system, including TESS, reduction in the regulatory capital conservation buffers (CCB), and the relaxation of liquidity buffers for banks.

Table 1

Sharjah Islamic Bank--Key Figures					
	--Fiscal year ended Dec. 31--				
(Mil. AED)	**2020***	**2019**	**2018**	**2017**	**2016**
Adjusted assets	52,670	46,390	44,745	38,289	33,539
Customer loans (gross)	30,260	26,261	25,581	22,838	18,105
Adjusted common equity	5,562	5,390	5,174	5,260	4,796
Operating revenues	601	1,220	1,156	1,155	886
Noninterest expenses	269	585	614	556	484
Core earnings	251	538	505	450	174

*Data as of June 30, 2020. AED--UAE dirham.

Business position: Midsized bank with a strong Sharjah footprint

SIB's total assets of UAE dirham (AED) 52.7 billion makes it the fourth-largest Islamic bank in the UAE, with a market share of 7%-8% of UAE Islamic banking system assets as of June 30, 2020. SIB has a very strong relationship with the Sharjah government, which directly and indirectly owns 37.6% of the bank. Thanks to this stable relationship and its Islamic banking status, SIB gets preferential access to important infrastructure projects in the emirate. More than one-third of the bank's lending book comprises financing to the government and government-related entities (GREs). SIB generates about 60% of its total revenue in Sharjah. The bank has been widening its presence in other emirates for the past 10 years. Nevertheless, we anticipate that a substantial portion of its lending and revenue will continue to come from Sharjah in the medium term.

SIB's loan book increased substantially in the first half of 2020, after a muted growth in 2019. Most of the loan growth was driven by exposures to the government of Sharjah and its related entities. As we expect the UAE economy to shrink by 8% and the Sharjah economy to shrink by 6% in 2020, we believe lending growth in the remaining quarters of 2020 will be muted.

Operationally, SIB's response to COVID-19 was swift. The bank activated its business continuity plan smoothly, and reportedly there were no disruptions to its operations.

Table 2

Sharjah Islamic Bank--Business Position					
	--Fiscal year ended Dec. 31--				
(%)	**2020***	**2019**	**2018**	**2017**	**2016**
Total revenues from business line (mil. AED)	601	1,228	1,161	1,183	1,174
Commercial banking/total revenues from business line	48.7	45.6	51.1	61.6	47.9
Retail banking/total revenues from business line	29.4	30.9	26.3	23.8	18.7
Commercial & retail banking/total revenues from business line	78.2	76.5	77.4	85.4	66.6
Other revenues/total revenues from business line	21.8	23.5	22.6	14.6	33.4
Return on average common equity	8.8	9.8	9.4	9.2	9.7

*Data as of June 30, 2020. AED--UAE dirham.

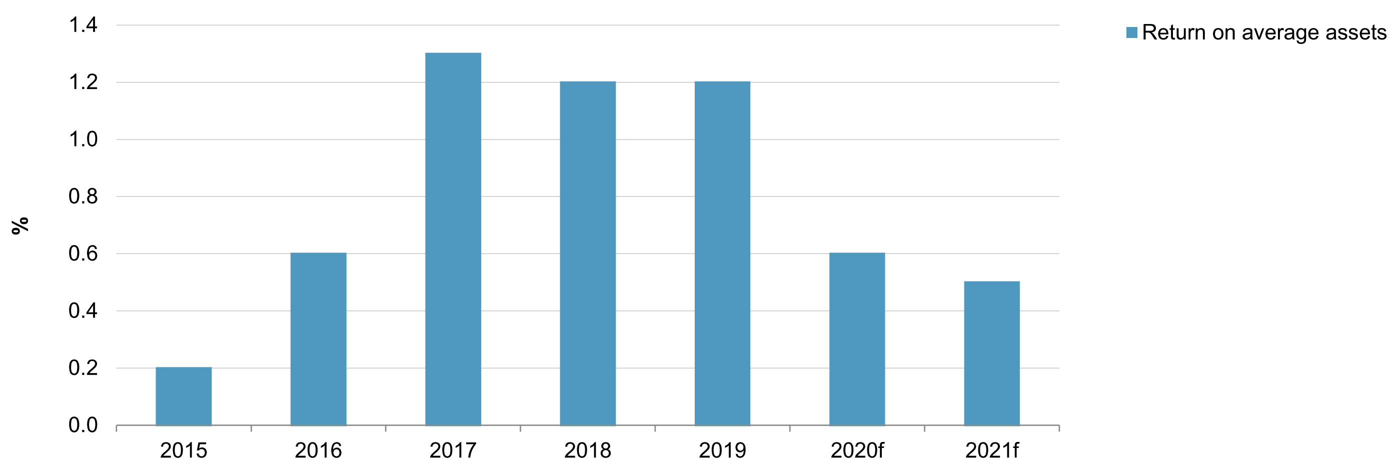
Capital and earnings: Profitability to drop but capitalization will remain strong

Our assessment of SIB's capital and earnings reflects the bank's strong level of capitalization. We forecast our RAC ratio for the bank at 13%-14% over the next 12-24 months, compared with 15.6% at the end of 2019. SIB strengthened its capital structure by raising $500 million through the issuance of Tier 1 sukuk in 2019.

We expect the triple shock of a drop in oil prices, less economic activity due to the COVID-19, and lower interest rates will lead to more problem loans and higher cost of risk as well as lower profitability for SIB. Under our base case scenario, we expect the bank's profitability to halve in 2020-2021, with return on assets dropping to about 0.5%-0.6% in 2020-2021, compared with 1.2% in 2019.

Chart 1

Profitability Expected To Decline Substantially



f--Forecast. Source: S&P Global Ratings.

In our RAC forecasts, we specifically assume:

- Lending growth of 9%-10% largely driven by lending to government and GRE entities.
- Net intermediation margin to decline by 30bps-40bps in the low interest rate environment.
- Credit losses to increase to about 100bps-120bps over the next two years, compared with 40bps on average for the past three years.
- Cash dividend of 5% in 2020-2021, similar to 2019, resulting in a dividend payout ratio of 50% in 2020-2021, compared with 26% in 2019.

Our three-year average earnings buffer for SIB stands at 46bps. This means that we expect the bank to generate sufficient earnings to cover its normalized losses. Although the bank's management has the option, we do not expect SIB to defer the payment of the periodic distribution amount of its AT1 sukuk.

Table 3

Sharjah Islamic Bank--Capital And Earnings

	--Fiscal year ended Dec. 31--				
(%)	**2020***	**2019**	**2018**	**2017**	**2016**
Tier 1 capital ratio	20.1	21.6	16.5	19.5	20.4
S&P Global Ratings' RAC ratio before diversification	N/A	15.6	12.1	15.7	17.0
S&P Global Ratings' RAC ratio after diversification	N/A	11.9	9.3	11.1	11.2
Adjusted common equity/total adjusted capital	75.2	75.2	100.0	100.0	100.0
Net interest income/operating revenues	76.9	73.6	51.8	55.1	54.4
Fee income/operating revenues	17.1	15.3	17.2	17.9	19.5
Market-sensitive income/operating revenues	N/A	4.8	25.7	21.7	19.9
Noninterest expenses/operating revenues	44.7	48.0	53.1	48.2	54.6
Preprovision operating income/average assets	1.3	1.4	1.3	1.7	1.3
Core earnings/average managed assets	1.0	1.2	1.2	1.3	0.5

*Data as of June 30, 2020. RAC--Risk-adjusted capital. N/A--Not applicable.

Table 4

Sharjah Islamic Bank--Risk-Adjusted Capital Framework Data

(AED 000s)	**Exposure***	**Basel III RWA**	**Average Basel III RW(%)**	**S&P Global Ratings RWA**	**Average S&P Global Ratings RW (%)**
Credit risk					
Government and central banks	11,278,706	--	--	406,795	4
Institutions and CCPs	10,312,423	--	--	4,863,197	47
Corporate	17,199,657	30,406,780	177	25,846,623	150
Retail	6,608,695	--	--	6,384,839	97
Of which mortgage	648,458	--	--	303,867	47
Other assets†	2,168,994	--	--	3,330,947	154
Total credit risk	47,568,474	30,406,780	64	40,832,400	86
Market Risk					
Equity in the banking book	288,000	--	--	2,674,640	929
Trading book market risk	--	85,650	--	128,475	--
Total market risk	--	85,650	--	2,803,115	--
Operational risk					
Total operational risk	--	2,238,802	--	2,287,226	--
(AED 000s)	**Exposure**	**Basel III RWA**	**Average Basel II RW (%)**	**S&P Global Ratings RWA**	**% of S&P Global Ratings RWA**
Diversification adjustments					
RWA before diversification	--	32,731,232	--	45,922,742	100
Total diversification/ Concentration Adjustments	--	--	--	14,422,206	31
RWA after diversification	--	32,731,232	--	60,344,948	131

Table 4

Sharjah Islamic Bank--Risk-Adjusted Capital Framework Data (cont.)				
(AED 000s)	**Tier 1 capital**	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global Ratings RAC ratio (%)**
Capital ratio				
Capital ratio before adjustments	7,080,521	21.63	7,168,446	15.61
Capital ratio after adjustments‡	7,080,521	21.63	7,168,446	11.88

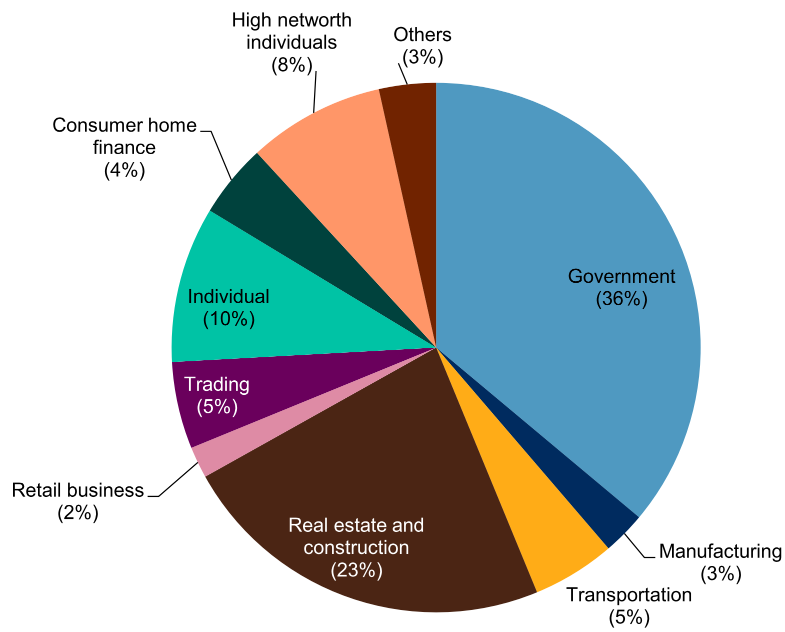
*Exposure at default. §Securitization Exposure includes the securitization tranches deducted from capital in the regulatory framework. †Exposure and S&P Global Ratings' risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. ‡Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). CCP--Central counterparty. RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. AED--UAE dirham. Sources: Company data as of 'Dec. 31 2019', S&P Global Ratings.

Risk position: High exposure to the real estate sector will derive higher credit losses

We expect SIB's asset quality to deteriorate in 2020-21, with new credit losses increasing significantly to 100bps-120bps of gross loans, as a result of the economic shock induced by COVID-19 and the oil price drop. We think the bank's stock of problematic loans (Stage 2 and Stage 3 loans) will increase to 15%-16%, up from 11.5% at June 30, 2020, spurred by substantial exposure to sectors negatively impacted by COVID-19, including high net worth individuals, real estate, trading, and transportation. Loans to these sectors make up about 45% of SIB's gross loans. Reportedly, SIB has a good collateral coverage against the real estate portfolio, which also explains why its coverage ratio tends to be lower than other banks' in the system. Also, we take comfort from the fact that 37% of SIB's lending is to Sharjah's public sector, which we view as being of stronger credit quality relative to the private sector. Therefore, while significant risk exposures exist, we view these factors as potential mitigants to a more severe deterioration in asset quality. In addition, SIB has sufficient capital buffers to withstand the current deteriorating economic environment.

Chart 2

High Exposure To Real Estate And Construction Sectors

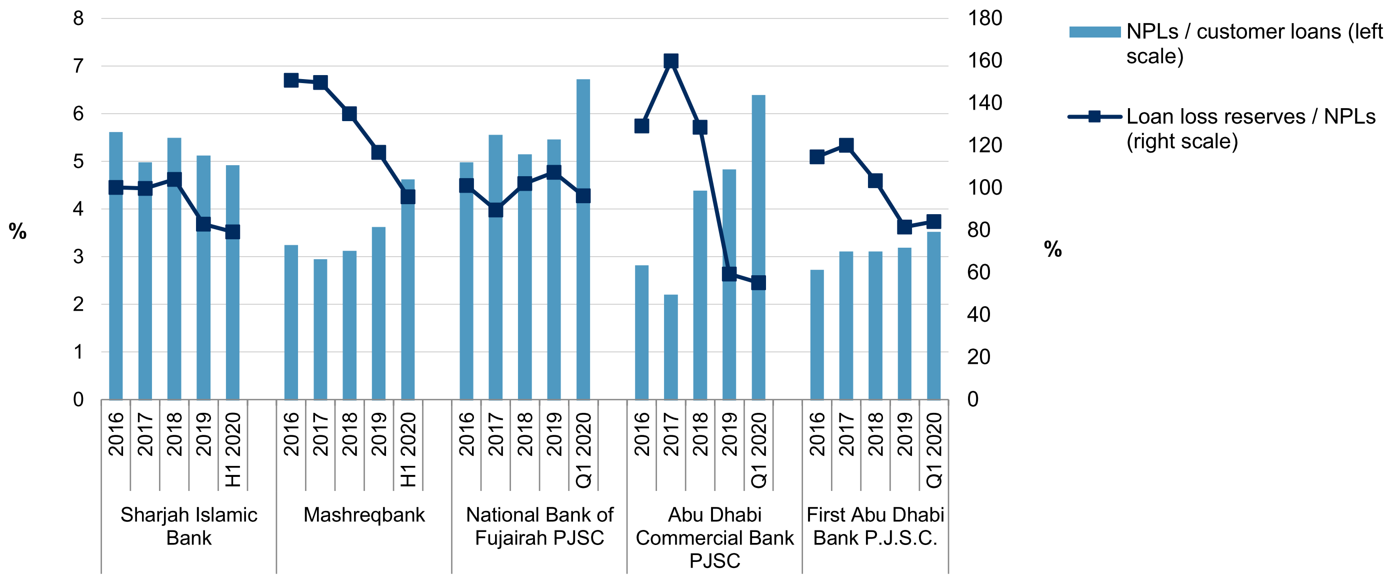


Source: S&P Global Ratings.

Similar to other Gulf Cooperation Council (GCC) banks, another source of risk for SIB lies in high single-party concentration. The 20-largest funded and unfunded corporate gross credit exposures represented 23% of the bank's loan book as of year-end 2019. Some of these are large corporates and conglomerate groups in the UAE, which somewhat mitigates risks.

Chart 3

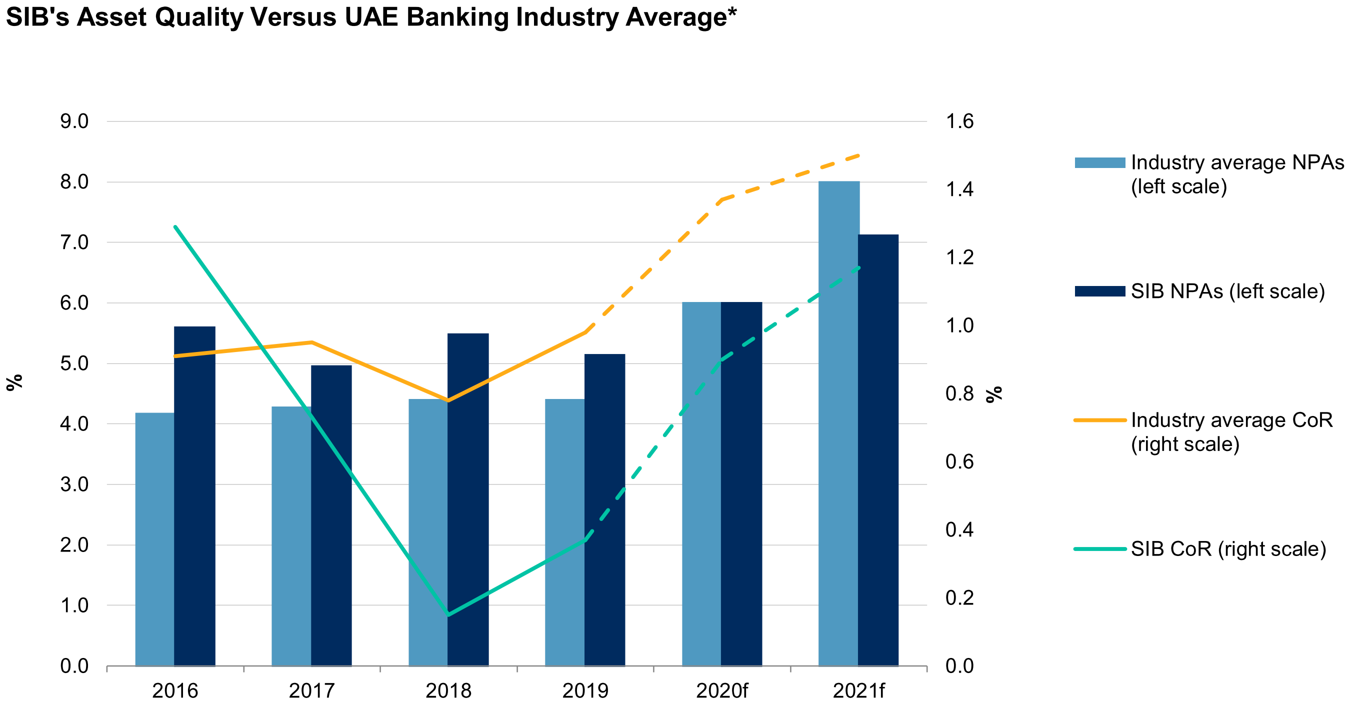
Top-Tier UAE Bank's Asset Quality Metrics



H--Half. Q--Quarter. NPL--Nonpeforming loans. UAE--United Arab Emirates. Source: S&P Global Ratings.

We expect that COVID-19's full impact on the UAE economy will only gradually become clear. Official support mechanisms, coupled with regulatory forbearance, will also affect the extent to which asset quality deterioration is recognized in 2020. Under our base case scenario, we expect asset quality to deteriorate across the entire banking system, leading to NPLs increasing to 8% and cost of risk reaching 150bps by 2021 among sample UAE banks (see "Banking Industry Country Risk Assessment: United Arab Emirates," published on May 20, 2020). We expect SIB's NPLs and cost of risk will increase in line with the industry average.

Chart 4



*UAE banking industry based on a sample of the 10 largest banks. UAE--United Arab Emirates. NPA--Nonperforming asset. f--Forecast. Source: S&P Global Ratings.

Table 5

Sharjah Islamic Bank--Risk Position					
	--Fiscal year ended Dec. 31--				
(%)	**2020***	**2019**	**2018**	**2017**	**2016**
Growth in customer loans§	30.5	2.7	12.0	26.1	5.1
Total diversification adjustment/S&P Global Ratings' RWA before diversification	N/A	31.4	29.8	42.0	39.0
Total managed assets/adjusted common equity (x)	9.5	8.6	8.6	7.3	7.0
New loan loss provisions/average customer loans	0.6	0.4	0.2	0.7	1.3
Net charge-offs/average customer loans	N.M.	1.6	(0.1)	(0.3)	0.2
Gross nonperforming assets/customer loans + other real estate owned	4.9	5.1	5.5	5.0	5.6
Loan loss reserves/gross nonperforming assets	79.2	82.8	104.0	99.8	100.1

*Data as of June 30, 2020. §2020Figures are annualized. RWA--Risk-weighted assets. N/A--Not applicable. N.M.--Not meaningful.

Funding and liquidity: Satisfactory and neutral for the rating

SIB's funding profile is in line with its domestic peers. Although the bank funds itself predominantly from domestic customer deposits, it is also an active issuer in the sukuk market. In order to diversify its funding base, the bank recently issued $500 million in five-year U.S. dollar denominated sukuk.

As of June 30, 2020, SIB's loan-to-deposit ratio stood at 90% and the ratio of stable funding resources to funding needs was a healthy 109%. SIB enjoys steady access to deposits from the government of Sharjah and its cash-rich related entities, thanks to its privileged relationship. Like most banks in the GCC, SIB exhibits funding concentrations. Its ratio of top-20 depositors to total deposits remained high at 36% at year-end 2019, and mainly comprised deposits from government and public-sector entities.

The bank has a relatively liquid balance sheet. As of June 30, 2020, 21% of its assets comprised cash and money market instruments, while another 15% came from the securities portfolio, largely composed of highly rated government and quasi-government sukuk. Broad liquid assets covered short-term wholesale funding needs by 2.1x and net broad liquid assets covered 15% of short-term customer deposits as of June 30, 2020.

Table 6

Sharjah Islamic Bank--Funding And Liquidity					
	--Fiscal year ended Dec. 31--				
(%)	**2020***	**2019**	**2018**	**2017**	**2016**
Core deposits/funding base	72.8	72.0	68.7	70.0	66.2
Customer loans (net)/customer deposits	90.2	92.1	91.2	97.3	93.2
Long-term funding ratio	91.9	88.7	89.2	93.3	91.8
Stable funding ratio	108.9	107.2	106.1	106.4	124.8
Short-term wholesale funding/funding base	9.5	13.5	12.3	7.9	9.6
Broad liquid assets/short-term wholesale funding (x)	2.1	1.7	1.7	2.2	3.6
Net broad liquid assets/short-term customer deposits	15.0	13.7	12.2	13.9	38.3
Short-term wholesale funding/total wholesale funding	30.4	41.2	39.4	26.3	28.5
Narrow liquid assets/3-month wholesale funding (x)	2.7	2.6	2.5	2.1	3.5

*Data as of June 30, 2020. Source: S&P Global Ratings.

Support: High systemic importance in a highly supportive country

The issuer credit rating on Sharjah Islamic Bank is three notches higher than its stand-alone credit profile, reflecting our view of a high likelihood of extraordinary government support for SIB if needed. This is in line with the bank's high systemic importance in the UAE. SIB is the fourth-largest Islamic bank in the UAE, with a market share of 7%-8% in terms of Islamic loans and deposits. The assessment also reflects the bank's strong relationship with the government of Sharjah, which owns 37.6% of SIB. We also consider the UAE authorities as highly supportive toward their banking system, with a strong track record of support provision.

Ratings above the sovereign

We apply the sovereign stress test for SIB at the UAE level and not at the level of Sharjah, where the bank has material exposure. This is because we view the UAE as the relevant level of jurisdiction for banks (see "Guidance | Criteria | Financial Institutions | General: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions", published Feb. 13, 2019 on Ratings Direct).

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- General Criteria: Group Rating Methodology, July 1, 2019
- Guidance | Criteria | Financial Institutions | General: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Feb. 13, 2019
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Methodology For Rating Sukuk, Jan. 19, 2015
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Global Banks Outlook Midyear 2020: A Series Of Reports Look At The Profound Implications Of The COVID-19 Shock, July 9, 2020
- Islamic Finance 2020-2021: COVID-19 Offers An Opportunity For Transformative Developments, June 15, 2020
- How COVID-19 Is Affecting Bank Ratings: June 2020 Update, June 11, 2020
- Banking Industry Country Risk Assessment: United Arab Emirates, May 20, 2020
- Research Update: Sharjah Outlook Revised To Negative On Increasing Macroeconomic Risks; 'BBB/A-2' Ratings Affirmed, April 24, 2020
- Industry Report Card: GCC Banks Face An Earnings Shock From The Oil Price Drop And COVID-19 Pandemic, April 6, 2020
- Outlooks On Five UAE Banks Revised To Negative On Deteriorating Operating Environment, March 26, 2020
- Guidance | Criteria | Financial Institutions | General: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Feb. 13, 2019

Anchor Matrix

Industry Risk	Economic Risk									
	1	2	3	4	**5**	6	7	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	a-	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	**bbb-**	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of August 18, 2020)*

Sharjah Islamic Bank	
Issuer Credit Rating	A-/Negative/A-2
Issuer Credit Ratings History	
26-Mar-2020	A-/Negative/A-2
27-May-2019	A-/Stable/A-2
21-Apr-2011	BBB+/Stable/A-2
Sovereign Rating	
Sharjah (Emirate of)	BBB/Negative/A-2
Related Entities	
SIB Sukuk Co. III Ltd.	
Senior Unsecured	A-

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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