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Summary:

Arab Banking Corp. B.S.C.

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Summary:

Arab Banking Corp. B.S.C.

Credit Rating: BBB+/Stable/A-2

Rationale

The ratings on Arab Banking Corp. B.S.C. (ABC) reflect the group's strong wholesale customer franchise in the Arab world, high support from principal shareholders, good loan quality, and reduced market risk. Negative rating factors include the lack of a strong core home market, low profitability, a short-term and concentrated wholesale funding profile, and important challenges ahead to the revised group's business strategy. ABC's shareholding structure--dominated by the Kuwait Investment Authority, the Central Bank of Libya, and the Abu Dhabi Investment Authority--is a positive rating factor. The long-term rating on the bank includes a one-notch uplift from its stand-alone credit profile, based on Standard & Poor's Ratings Services' expectation that support from principal shareholders is highly likely in case of need. Shareholders demonstrated their commitment by increasing ABC's capital by $1.1 billion in June 2008. ABC allocated $1.0 billion in provisions for its impaired assets (including $733 million against structured investment vehicles and collateralized debt obligations) which led the bank to report a loss of $880 million for 2008, triggering the need for a capital increase.

ABC's strategic focus is on developing its Arab roots, with a stronger emphasis on the retail segment, with the parent bank and its units now operating as a more cohesive group. The shift toward retail appears ambitious and the group's track record in this segment is short with mixed results. Loan quality is good and on a par with regional peers', with a ratio of nonperforming loans to total loans of 1.9% at year-end 2008. The provisioning policy is conservative.

ABC's core profitability still compares unfavorably with peers', owing to the bank's business mix which lacks a retail franchise and relies on costly wholesale funding that limits interest margins. ABC reported a $32 million net profit in the first quarter of 2009. We do not expect a material improvement in the foreseeable future as business volumes are likely to decline due to the global recession. On the other hand, we believe that the downside risk has lessened considerably now that the bank has derisked its balance sheet.

The parent company's reliance on short-term funding, including repurchase agreements, is significant and a negative rating factor. ABC is using its securities portfolio (about 50% guaranteed by U.S. government agencies). The group also benefits from historically sticky deposits from regional institutions--including its shareholders, governments, and central banks--which we take as a comforting factor.

The large write-downs on the securities portfolio and aforementioned unrealized losses recognized as equity hurt the group's capitalization, but capital subsequently rebounded after the $1.1 billion capital increase. At 8.8% at end-2008, the ratio of adjusted total equity to adjusted assets is adequate and on a par with similarly rated peers' in the Gulf.

Outlook

The stable outlook reflects the substantial decrease in market risks and our expectations that the bank will maintain its adequate asset quality and capitalization. Nevertheless, the bank will find it difficult to increase business diversification in a less benign economic environment. We could lower the ratings if the group's funding and liquidity profile, core profitability, or capitalization show signs of weakening. Although unlikely in the foreseeable future, we could raise the ratings if the group can significantly strengthen its profitability and funding profile, while limiting its risk appetite.

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