Credit Rating Announcement

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National Bank of Umm Al Qaiwain's Ratings Affirmed with a Stable Outlook

Capital Intelligence Ratings (CI Ratings or CI) today announced that it has affirmed the Long-Term Foreign Currency Rating (LT FCR) and Short-Term Foreign Currency Rating (ST FCR) of National Bank of Umm Al Qaiwain (NBQ) at 'A-' and 'A2', respectively. At the same time, CI Ratings has affirmed NBQ's Bank Standalone Rating (BSR) of 'bbb', Core Financial Strength (CFS) rating of 'bbb-' and Extraordinary Support Level (ESL) of High. The Outlook for the ratings remains Stable.

NBQ's LT FCR is set two notches above the BSR and reflects the Bank's ESL of High. CI expects the Bank to receive extraordinary support from the UAE government (sovereign ratings: 'AA-'/ 'A1+'/ Stable) in case of need. The government has demonstrated such support in the past and in CI's view has the means and willingness to continue to do so in the future. Additionally, NBQ can also expect support from the government of Umm Al Quwain, a founding shareholder.

NBQ's BSR is derived from a CFS rating of 'bbb-' and an Operating Environment Risk Anchor (OPERA) of 'bbb'. The CFS reflects the Bank's long track record of generating strong earnings, solid capital ratios and good liquidity. The principal challenge is the continuing heightened credit risk in the economy owing to the pandemic-led economic disruptions, although this has not seriously impacted the Bank's asset quality, unlike many peer banks. It has however further reduced the Bank's already low risk appetite and delayed its expansion plans. The Bank's undiversified business base and declining market share along with its small balance sheet size also weigh on the CFS. NBQ's high NPLs, low coverage ratio (partly mitigated by a sizeable capital cushion and good collateral cover), customer concentrations in loans and deposits and sector concentration – although declining – in real estate are also considered challenges.

UAE's OPERA reflects the country's continuing dependence on hydrocarbons, although less so than neighbouring countries, with the economic risk partially mitigated by the support of the wealthy emirate of Abu Dhabi. It also reflects the overall sound financial position of the banking sector. However, a prolonged period of Covid-19-led disruptions in the economy would have an adverse impact on local banks.

The Bank has followed a very conservative strategy since 2008 when the global financial crisis led to sizeable asset impairments. Conserving capital and liquidity have been management's main objectives since that year. Thus far, the Bank has been able to overcome the disadvantages of a small customer franchise and limited business diversification to generate good earnings every year. The Bank has also been able to reward its shareholders at a reasonably good rate over the years and maintain solid capital and liquidity ratios. However, its share of the business in the UAE has shrunk and rising competitive pressures in a consolidating banking sector could adversely impact its franchise over the long-term.

NBQ's overall cautious outlook is unlikely to change in the next two years, particularly given the pandemic-led economic disruptions in the country last year. The Bank has steadily shrunk its loan portfolio in recent periods and even if loan disbursals increase in the second half of this year, as economic recovery gains momentum, only modest loan growth is likely for the full year. There is some concentration in the real estate sector due to loans for the construction of property and the value of mortgaged property. However, the book has performed well so far. Customer concentrations are also high but in line with the sector.

The Bank was not as badly affected by the Covid-19 crisis on the asset quality front, as many of the other banks in the country. NPLs rose by just 6% last year (well below growth rates experienced by peer banks) and the 100bp increase in the NPL ratio was partly a reflection of the decline in gross loans. NPLs declined in H1 21. NBQ's Stage 2 loans halved in 2020 and are currently lower than the average for small banks. While customer loans enjoying deferred payment benefits (in line with the central bank guidelines) are at a high level, these are mainly customers who require only temporary support and are therefore not expected to become credit impaired. Only a small group of deferred customer loans (amounting to 2% of gross loans) is likely to migrate to Stage 3. We do not envision any major increase in impairments in the remaining quarters of this year. NBQ's LLR coverage ratio is low compared with the average for the sector; this partly reflects the sizeable amount of collateral available to the Bank. The Bank has traditionally provided loans against security, and it has aggressively pursued the recovery of loans via collateral sales in the courts. While the recovery of collateral value is very slow, the Bank has had a reasonable amount of success and indeed, it is confident of recovering most of its impaired legacy loans. The Bank’s large capital base and its good operating profits provide additional buffers against future asset quality shocks.

NBQ has delivered good earnings ratios over the last several years due to its wide margins and low operating cost base. Its low interest expense base is a major strength, and this is partly attributed to the fact that capital funds a large proportion of its balance sheet. Although operating income declined last year, with the fall in interest rates and lower loan volumes impacting net interest income (NII), it continued to be good. Operating profitability also declined in 2020 but remained high. High provision charges halved net profit last year and ROAA fell, although it was still at an acceptable level. Although operating profits continued to fall in H1 21 over the corresponding period of the previous year, reflecting lower NII and fee income, ROAA strengthened due to significantly lower impairment charges. The Bank’s income is not diversified since it is dependent on corporate banking activities, both on the assets and liabilities side of the balance sheet. CI expects income levels to rise in the second half of this year as economic recovery gains momentum.

NBQ’s high capital base supports its overall strong liquidity. Deposits have declined in recent periods in line with the contraction in lending, but CASA levels have increased, and key liquidity ratios continue to be strong. In common with most banks, there is some customer concentration in the deposit base. However the major funding sources, including related parties, have proved to be stable in stressed conditions in the past.

The Bank is very strongly capitalised, and its key ratios are the best in the industry. Capital is also not at risk due to unprovided NPLs. NBQ has paid generous dividends in recent years but despite that its capital has grown at a reasonable pace every year, reflecting good comprehensive income. NBQ’s capital ratios are expected to stay strong given its low and conservative risk appetite and strong earnings.

Rating Outlook

The Stable Outlook reflects our expectation that the ratings will not change over the next 12 months. The economic disruptions due to Covid-19 have had an adverse impact on the financial position of nearly all banks in the country. However, NBQ has been less impacted than many peer banks by the crisis and we believe that there is high probability that its standalone credit profile will strengthen to pre-crisis levels in the recovery phase of the business cycle. NPLs could rise due to the lingering adverse effects of the crisis but we expect this to be manageable.

Rating Dynamics: Upside Scenario

An upgrade over the next 12 months appears remote at this stage since this would require an improvement in the Bank’s standalone profile. This could come from a significant improvement in asset quality, lower customer concentrations and a substantially larger balance sheet.

Rating Dynamics: Downside Scenario

A one-notch downgrade of the LT FCR would be possible in the event of a deterioration in the Bank’s credit profile. This could be caused by a significant weakening of asset quality or profitability that the Bank may not be able to correct in a reasonable period.

Ratings

Foreign Currency		Outlook	BSR	Outlook	CFS	ESL	OPERA
LT	ST	LT FC		BSR			
A-	A2	Stable	bbb	Stable	bbb-	High	bbb

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About the Ratings

The credit ratings have been issued by Capital Intelligence Ratings Ltd, P.O. Box 53585, Limassol 3303, Cyprus.

The following information sources were used to prepare the credit ratings: public information and information provided by the rated entity. Financial data and metrics have been derived by CI from the rated entity's audited financial statements for FY 2017-20 and H1 2021. CI may also have relied upon non-public financial information provided by the rated entity and may also have used financial information from credible, independent third-party data providers. CI considers the quality of information available on the rated entity to be satisfactory for the purposes of assigning and maintaining credit ratings. CI does not audit or independently verify information received during the rating process.

The principal methodology used to determine the ratings is the Bank Rating Methodology, dated 3 April 2019 (see www.ciratings.com/page/rating-methodologies/bank-ratings). Information on rating scales and definitions, the time horizon of rating outlooks, and the definition of default can be found at www.ciratings.com/page/our-policies-procedures. Historical performance data, including default rates, are available from a central repository established by ESMA (CEREP) at http://cerep.esma.europa.eu

This rating action follows a scheduled periodic (annual) review of the rated entity. Ratings on the entity were first released in August 1994. The ratings were last updated in September 2020. The ratings and rating outlook were disclosed to the rated entity prior to publication and were not amended following that disclosure. The ratings have been assigned or maintained at the request of the rated entity or a related third party.

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