MOODY'S
INVESTORS SERVICE

Rating Action: Moody's assigns a Aa3 deposit rating to Al Rayan Bank PLC; outlook negative

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London, 01 November 2017 -- Moody's Investors Service (Moody's) has today assigned a baa2 baseline credit assessment (BCA), an a2 adjusted BCA, Aa3/Prime-1 deposit ratings, as well as a Counterparty Risk Assessment (CR Assessment) of Aa3(cr)/Prime-1(cr) to Al Rayan Bank PLC (ARB). The outlook on the long-term deposit rating is negative.

ARB's baa2 BCA reflects the bank's: (1) sound asset quality profile in both its secured and unsecured portfolios; (2) Moody's expectation that capitalisation; and (3) levels of liquid resources will remain robust. These strengths are balanced against ARB's: (1) rapid growth in financing, which could result in an asset quality deterioration in a downturn; (2) limited operating history and evolving business model; (3) modest, albeit improving profitability ; and (4) lack of access to market funding and high reliance on funding from Qatar Central Bank and Qatar Investment Authority.

The long-term deposit ratings are underpinned by: (1) the bank's a2 adjusted BCA which reflects Moody's view that ARB benefits from a very high probability of support from its parent Masraf Al Rayan (Q.S.C.) (Masraf, A1 negative); (2) the results of Moody's Advanced Loss Given Failure (LGF) analysis, reflecting the agency's view that the bank's junior depositors would face very low loss-given-failure, leading to two notches of uplift from the adjusted BCA; and (3) a low expectation of government support.

The outlook on the long-term deposit rating is negative, and is aligned with the negative outlook assigned to the ratings of ARB's immediate parent, Masraf. Masraf's negative outlook is driven by (i) Moody's expectation that the downside risk of a prolongation of the dispute between Qatar and a group of peer countries could lead to some outflows of external funding, which would reduce Masraf's liquidity buffers, while domestic funding sources remain tight due to current oil prices ; and (ii) the weakening capacity of the government of Qatar to provide support in case of need, as implied by the negative outlook on its Aa3 government bond rating.

RATINGS RATIONALE

RATINGS RATIONALE - BCA

Established in 2004 as Islamic Bank of Britain, the first wholly Sharia-compliant UK bank, ARB was renamed in 2014 following their acquisition by Masraf, the second largest bank in Qatar. The growth strategy which was implemented following the takeover led to a compound annual growth rate of 49% between 2013 and 2016, with total assets amounting to GBP1,436 million at YE 2016 compared to GBP368 million at YE 2013. ARB focuses on three business segments: (i) the retail business is mostly composed of Home Purchase Plans (HPP) and Buy-to-Let Home Purchase Plan (BTLPP) products, which adhere to Sharia principles; (ii) the commercial property finance portfolio, which covers large residential investment private rental sector (PRS) schemes, mixed used industrial warehouses, student property as well as prime offices, and (iii) the GCC segment which offers private banking services to high net worth GCC customers, including real estate finance and day-today banking services.

ARB have improved their asset risk track record since the financial crisis, by moving out of unsecured financing where they had incurred some losses, into secured financing. Whilst Moody's recognises that since the shift into secured financing ARB have reduced non-performing financings and maintain conservative underwriting standards, their asset growth has been significant, albeit from a small base over the past two years. Although reflective of the customer base, financing is concentrated in the south east of England, particularly London, for which HPP financing equates to 44% of overall HPP financing. In addition, ARB have large average financings of GBP1 million outstanding to GCC customers accounting for 20% of the book, increasing concentration in London further, as well as reducing the granularity of the overall financing book.

Profitability had been largely negative up until 2014, driven historically by losses made from financing, but also the high cost base maintained by ARB. Cost-to-income has reduced to 72%, but still remains above peers. This has been driven by costs such as opening a branch in Knightsbridge, a key area for GCC customers. Moody's expects profitability to increase going forward, as costs are reduced, rental rates increase and the cost of funding reduces, through a Sukuk issuance and a reduced reliance on more expensive retail deposits. ARB are also looking to move into higher margin SME financing, further aiding profitability.

ARB's tier 1 capital is predominantly made up of common equity, reflecting retained earnings from prior periods. Capitalisation remains solid at 17.7% (31 December 2016), though this is required to support the continued financing growth and expansion of the bank. ARB use the standardised approach to risk weighting assets and have adequate capital to meet their growth plans, without the further need for a capital injection. However, if asset risk were to deteriorate through lower underwriting standards, or a deterioration in the UK macro environment, additional capital may be required or reduced financing growth would have to take place.

ARB have limited access to wholesale funding, given their requirement to comply to Sharia principles and not pay interest. Given this, they are highly reliant on the Qatar Investment Authority (QIA) and Qatar Central Bank (QCB) for funding, to which ARB have drawn three-month rolling contracts of $50 million and $75 million respectively. Given the lack of market access, ARB offer very competitive retail profit rates, attracting mainly non-Muslim retail deposits through attractive profit rates on the best buy tables. However, this increases the overall cost of funding, reducing margins and negatively impacting profitability.

Moody's views liquidity as a strength for the bank, with above average liquid banking assets to tangible banking assets maintained compared with peers. Liquidity is largely made up of cash on demand and short-term commodity Murabaha and Wakala transactions.

RATINGS RATIONALE -- ADJUSTED BCA

Given the strategic importance of ARB to its parent Masraf, allowing GCC customers to have access to private banking services in the UK, Moody's expects the probability of support from Masraf to be very high. The parent has representation on ARB's board and is active in the development of its forward looking strategy. Moody's uses the parent's supported rating of A1, as the basis for deriving support to ARB. This is based on Moody's expectation that ARB would be supported in case of need, due to the interconnectedness of the bank with its parent, its operating under the same brand name, the 38% ownership (on a look-through basis) by Qatar Holding and relatively modest size. As a result Moody's assigns three notches of support to the bca of baa2, to arrive at an adjusted BCA of a2.

RATINGS RATIONALE -- LOSS GIVEN FAILURE

Moody's applies the Advanced LGF analysis to ARB because it is domiciled in the UK, which Moody's considers has an operational resolution regime, following the implementation of the EU Bank Recovery and Resolution Directive (BRRD). Under these assumptions, ARB's deposits are likely to face very low loss-given-failure, due to the loss absorption provided by the volume of deposits themselves. This results in a PRA for ARB's deposits of aa3, two notches above the a2 adjusted BCA.

The CR Assessment is positioned at Aa3(cr)/Prime-1(cr), in line with the country ceiling of Qatar. The CR Assessment is two notches above the adjusted BCA of a2, based on the cushion against default provided to the senior obligations represented by the CR Assessment by more subordinated instruments, i.e. bail-in-able funding and deposits.

WHAT COULD CHANGE THE RATING UP / DOWN

An upgrade of the bank's BCA could be triggered by the establishment of a stabilized asset quality profile as the financing book continues to grow. An upgrade to the BCA could also arise should profitability metrics improve.

A downgrade of ARB's BCA could be driven by a material deterioration in the bank's asset quality or demonstration of a materially more aggressive risk appetite in its financing book. Negative pressure could also arise from significant deterioration in the bank's profitability metrics, capitalisation and liquidity metrics.

A downgrade of ARB's deposit ratings could be driven by a downgrade of its immediate parent's rating.

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Banks published in September 2017. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

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