FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Jordan Islamic Bank at 'BB-'; Outlook Negative

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Fitch Ratings - Dubai - 18 Jan 2021: Fitch Ratings has affirmed Jordan Islamic Bank's (JIB) Long-Term Issuer Default Rating (IDR) at 'BB-'. The Outlook is Negative. At the same time, Fitch has affirmed all JIB's other ratings. A full list of rating actions is below.

KEY RATING DRIVERS

IDRS and VIABILITY RATING

JIB's IDRs are driven by its standalone credit profile, as defined by its Viability Rating (VR).

The bank's VR considers its exposure to the weakening domestic operating environment, which heightens pressures on the bank's asset quality and profitability metrics, and only adequate capitalisation. However, it also considers the bank's strong domestic franchise, as the largest Islamic bank in Jordan, and solid funding and liquidity profile.

The Negative Outlook reflects Fitch's assessment that the coronavirus pandemic will continue to put pressure on the bank's asset quality and profitability, and on the domestic operating environment - which already had below-potential GDP growth, high

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unemployment and a difficult regional environment entering the crisis, constraining the country's growth prospects.

Fitch estimates a 3% decline in real GDP in 2020, the country's first economic contraction in three decades, hit by the absence of tourism inflows since mid-March and lockdown measures. Fitch forecasts a fairly weak recovery in 2021 with a growth rate of 1.9% before an acceleration to 2.7% in 2022. The latter is similar to pre-pandemic trends, in which the Jordanian economy was hampered by regional instability and trade disruptions, among other factors.

Fitch believes external assistance from the international donor community, multilateral organizations and bilateral allies will continue over the rating horizon. This will underpin the country's macroeconomic stability despite the challenging economic outlook, particularly with regard to the stability of its foreign-exchange rate peg regime to the US dollar.

The Negative Outlook also reflects that on the Jordanian sovereign rating, which caps the bank's ratings at their current level, given that JIB's operations are concentrated solely in Jordan and the bank is highly exposed to the Jordanian sovereign.

Fitch estimates that the bank's total exposure to the sovereign through financing to government-related entities, holdings of government debt and balances with the Central Bank of Jordan (CBJ) represents 37% of total assets at end-1H20, equivalent to 4x common equity Tier 1 (CET1).

The bank's largest financing (to National Electric Power Company - NEPCO), equal to about 25% of JIB's gross financings or 1.9x CET1, was against a 100% government guarantee. Consequently, there is a close correlation between the bank's credit profile and that of the Jordanian sovereign. The financing book is otherwise well diversified, with the 20 largest single obligors accounting for 6% of financings (or 0.5x CET1).

The VR considers JIB's well-established domestic franchise, as the largest Islamic bank in the country, and as the third-largest bank in Jordan, with a 10% share of banking sector deposits and 13.25% of financing at end-2019. These give it a competitive advantage in deposit collection. The bank is classified as a domestic systemically important bank (D-SIB) by the Central Bank of Jordan (CBJ).

The bank's financing book is well balanced between corporate (52% of gross financing at end-1H20; 25% of gross financings to NEPCO) and retail (48%) customers. Retail is dominated by residential mortgages (32% of gross financing, including Ijara Muntahia Bil Tamleek: 21% of gross financing) predominantly extended to civil servants.

The bank's Stage 3 ratio has remained resilient, supported by strong, above-peer-average financing growth (9.4% in 9M20) and the credit moratorium offered by the CBJ. Asset-quality metrics are also supported by NEPCO financing against a 100% government guarantee and a high share of retail financing to civil servants with salary assignment, which mitigate credit risks.

At end-3Q20 the Stage 3 financing ratio (excluding deferred revenues on profit) was stable at 3.7%. However, Stage 2 financing - concentrated in trade, manufacturing and services, which have proved sensitive to the pandemic - rose to 13% of gross financing (2019: 9.8%), the highest among Fitch-rated domestic peers. The total problem financing generation ratio (defined as the change in Stage 3 and Stage 2 financings plus write-offs) has therefore risen (4.9% in 9M20).

The Stage 3 gross credit risk ratio (including financing, investments, interbank and central bank placements and off-balance-sheet items; Fitch calculation) has also risen (end-1H20: 2.9%), but remains adequate.

We expect further pressure on financing quality in 2021-2022 and that the Stage 3 financing ratio will moderately increase by end-2022 due to the weak economic recovery, challenging employment conditions and the end of the credit moratorium period at end-2021.

Total reserve coverage of Stage 3 financing (95% at end-3Q20) is towards the lower end of Fitch-rated domestic peers, but higher than the sector average. Reserve coverage of Stage 3 financings is likely to weaken only moderately, remaining at over 90%. However, total reserve coverage should be considered in light of the bank's level of Stage 2 financings, reserves against which are low (3.5% at end-3Q20).

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Fitch's core metric, annualised operating profit/risk-weighted assets (RWAs; after deducting operating expenses and impairment charges), was resilient in 9M20 compared with domestic peers at a solid 4.8%, having declined just 30bp. The bank has consistently outperformed peers on this measure, partly reflecting its lower-risk weighted asset density as an Islamic bank. However, in 9M20 operating profitability was also supported by its use of surplus investment risk fund reserves (accounted for under liabilities) to cover expected credit losses.

In 9M20 the bank used JOD13.6 million, out of a total available JOD30 million, surplus investment risk fund reserves to cover its expected credit losses, neutralising the impact on profitability of additional impairments. Financing impairments were equal to just 1% of pre-impairment operating profit in 9M20.

However, Fitch-calculated net financing margins (NFMs) tightened further in 9M20, to 3.6% from 4% in 2019, due to the declining profit rate environment and the ensuing lower yields on its largest exposure to NEPCO. We expect Fitch's core profitability metric to remain below pre-pandemic levels in 2021, albeit still at acceptable levels, due to lower profit rates, rising credit risk and fewer business opportunities.

The bank's annualised pre-impairment operating profitability remained acceptable at 2.8% of gross financing in 9M20, giving the bank a reasonable cushion to absorb potential credit losses through the income statement (after using the investment risk fund) before hitting capital.

Capitalisation is supported by the bank's reasonable internal capital generation and adequate Stage 3 financing reserves coverage. In addition, outstanding surplus investment risk fund reserves were equal to an additional 0.5% of gross financings at end-3Q20.

However, JIB's capital buffers are only adequate given the bank's risk profile, high exposure to sovereign risks and the low risk weightings applicable in its regulatory capital calculations. The CET1 ratio declined by 110bp to 22.9% at end-3Q20 due to financing growth. The capital adequacy ratio was 23.2%, well above the minimum regulatory requirement of 12.5%.

The bank's regulatory capital ratios are much higher than at domestic peers as they benefit from a 0% risk weighting on local-currency financing to NEPCO and cash balances with the CBJ. These were equal to a combined total of about 36% of total assets at end-3Q20.

In addition, as an Islamic bank it benefits from lower RWAs under CBJ instructions based on IFSB standards for Islamic banks. JIB applies an alpha factor of 30% when calculating credit RWAs funded by unrestricted investment accounts. This means only 30% of the credit RWAs financed by such deposits feed into its regulatory RWA calculation.

JIB's tangible leverage ratio (9.7% at end-3Q20) is therefore lower than Fitch-rated domestic peers highlighting lower absorption buffers. However, this is common among Islamic banks as investment accounts considered as quasi-equity represent a large part of their funding (about 67% of JIB's customer deposits at end-3Q20).

JIB's funding and liquidity profile is solid, underpinned by a resilient and granular customer deposit base supported by its good domestic franchise. Retail deposits accounted for 87% of the deposit base at end-3Q20, resulting in a low depositor concentration, with the 20 largest depositors accounting for only 4% of the total at end-1H20. The existence of a deposit insurance scheme in Jordan guaranteeing customer deposits (including sharia compliant) up to JOD50,000 supports the stability of the bank's funding base, in our view.

The bank's gross financing/customer deposits ratio increased to 81% at end-3Q20 from 78% at end-2019 due to high financing growth. The bank has a good cushion of liquid assets with Basel III High-Quality Liquid Assets covering 19% of customer deposits at end-9M20. This supports its strong Liquidity Coverage Ratio of 216.5% at end-3Q20. The net stable funding ratio was 138% at end-3Q20.

In assessing JIB's ratings, we consider important differences between Islamic and conventional banks. These factors include closer analysis of regulatory oversight, disclosure, accounting standards and corporate governance. Islamic banks' ratings do not express an opinion on the bank's compliance with sharia. Fitch will assess non-compliance with sharia if it has credit implications.

SUPPORT RATING AND SUPPORT RATING FLOOR

Fitch considers JIB as a D-SIB and its Support Rating Floor (SRF) is at the country D-SIB SRF of 'B+'. This considers JIB's market position as the third-largest bank and largest Islamic bank in Jordan and with 10% and 8% shares of total banking sector deposits and financing respectively.

JIB's Support Rating of '4' and SRF reflect a limited probability of support from the Jordanian sovereign due to constraints on its ability to provide support, given its weak financial flexibility. However, we believe the willingness of the Jordanian authorities to provide support would be high given JIB's systemic importance and the banking sector's importance to the economy and to the country's development plans.

RATING SENSITIVITIES

JIB's Long-Term IDR will move in line with its VR.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- JIB's ratings are primarily sensitive to deterioration in the bank's domestic operating environment, and material weakening in asset quality and profitability.

- A material deterioration in asset quality as evidenced by an increase in the problem financings ratio defined as the sum of stage 2 and stage 3 financings, could lead to a VR downgrade, particularly if this puts pressure on capitalisation.

- A material weakening in JIB's profitability, or if the bank's operating profit/total assets ratio falls below 0.5%, could also put pressure on the VR, especially if pre-impairment operating profit is not sufficient to shield capital buffers from asset-quality deterioration.

- A material weakening in capital or fall in the equity/total assets ratio to around 5% could also lead to a downgrade of the VR.

- As JIB did not meet Fitch's criteria to be rated above the sovereign given its significant exposure to the domestic economy and to the sovereign, its ratings are sensitive to a downgrade of the Jordanian sovereign.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- The Outlook on JIB's Long-Term IDR could be revised to Stable if: the impact of the pandemic on its markets is short, the recovery swift and the impact on the bank's financial metrics moderate; and the Outlook on the Jordanian sovereign is revised to Stable.

- An upgrade of JIB's ratings would require an upgrade of the Jordanian sovereign, which is unlikely at present given the Negative Outlook.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579]

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Jordan Islamic Bank: Governance Structure: 4

As an Islamic bank JIB needs to ensure compliance of its entire operations and activities with sharia principles and rules. This entails additional costs, processes, disclosures, regulations, reporting and a sharia audit. This results in a Governance Structure relevance score of '4' for the bank (in contrast to a typical ESG relevance score of '3' for comparable conventional banks), which has a negative impact on the bank's credit profile in combination with other factors.

In addition, Islamic banks have an Exposure to Social Impacts ESG Relevance Score of '3' (in contrast to a typical ESG Relevance Score of '2' for comparable conventional banks), which reflects that Islamic banks have certain sharia limitations embedded in their operations and obligations, although this only has a minimal credit impact on the entities.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit neutral or have only a minimal credit impact on JIB, either due to their nature or the way in which they are being managed by JIB. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

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RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Jordan Islamic Bank	LT IDR	BB- Rating Outlook Negative	Affirmed	BB- Rating Outlook Negative
	ST IDR	B	Affirmed	B

ENTITY/DEBT	RATING			PRIOR
	Viability	bb-	Affirmed	bb-
	Support	4	Affirmed	4
	Support Floor	B+	Affirmed	B+

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

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Bank Rating Criteria (pub. 28 Feb 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

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Islamic Finance Middle East Jordan
