Islamic International Rating Agency

IIRA upgrades ratings of Bank of Khartoum

Manama, March 20, 2023 – Islamic International Rating Agency (IIRA) has upgraded ratings of Bank of Khartoum (‘BoK’ or 'the Bank') to ‘AA-(sd)/A1(sd)’ (Double A Minus / A One) from ‘A+(sd)/A1(sd)’ (Single A Plus/ A One) while revising the outlook on the ratings to ‘Stable’ from ‘Negative’. Rating action was triggered mainly on account of improvement in capitalization indicators, consistent decline in impairments over a timeline along with increasing provisioning buffers, and an improvement in core profitability indicators.

With 128 branches, BoK has the largest branch network in Sudan. The Bank has a strong franchise value, both domestically and across the Middle East Region, with presence in the Gulf. Having the widest retail network enables the Bank to attract deposits at the lowest cost of funding in the industry and has given the Bank a market share of around 34%, having generally been on an uptrend over the past few years. While accelerated growth in financings has been noted, spare liquidity has continued to accumulate with limitations to deployment opportunities.

Within the financing portfolio, increasing weight of government exposures was evident. A gradually developing sovereign sukuk portfolio is also a favorable development. In 2021 and continuing in H1’22, gross non-performance has declined, while provision cover has strengthened notably. The inflow of new NPFs was quite limited, which compounded with part repayments from two legacy NPFs, collectively accounting for over 90% of non-performing exposures, has brought gross non-performance lower. Overall, IIRA notes the significant improvemet in asset quality profile of the Bank both on gross and net basis, with sizable buildup of provision buffers from 2021 onwards.

The combined effect of higher proportion of cash assets and increasing sovereign exposures has curbed the growth in risk assets. The Bank’s Capital Adequacy Ratio improved to 14.3% from 12.9% as growth in regulatory capital exceeded risk assets growth. Meanwhile, tier 1 capital retreated to 7.1% from 7.6% with most of the improvement in capital buffers stemming from supplementary capital, and driven by revaluation reserves. The reported CAR declined to 12% as of June 2022, however, IIRA estimates that the underlying CAR was around 15.5% owing to internal capital generation, as reported indicator excludes interim profit generation from regulatory capital. Moreover, the bank has sizable unrealized gains which represent a potential source of additional capital given that it can be partly realized to enhance tier-1 capital. Increased tier-1 capital also increases eligibility of additional tier-2 capital, providing further room for growth, if needed.

In addition to the significant increase in BoK’s reported net income, buoyed by the SDG37.1bn FCY revaluation gain, core operating earnings[1] also depicted significant improvement to SDG6.6bn in the year 2021, up from only SDG0.6bn for the prior year. Improvement in margin and fee income, more than

[1]Before tax and provisions and excluding the FCY revaluation gain

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compensated for surging operating costs, which rose above inflation and peers, as the Bank has a relatively higher FCY-indexed cost component. Uptrend in profitability indicators was carried onto 2022 due to further improvement in spread income, fee income, and foreign currency trading gains, whereas growth in operating expense base moderated, given base effect as well as relative tapering down of inflation.

The Bank's fiduciary score was maintained at '71-75' and reflecting adequate fiduciary standards wherein rights of various stakeholders are adequately defined and protected. While the independent representation at Board of Directors is in line with local regulations, it lags best practices recommendation of one-third. The Bank has experienced instability at key management positions, which will be monitored going forward. The absence of a Shari'a Supervisory Board, while acceptable under local regulations, is a departure from best practices. The Shari'a control department supervises daily operations and is adequately empowered to do so. Given the strong local Shari'a-compliant banking environment and the high involvement of Higher Shari'a Commission of Control on Banks and Financial Institutions, particularly in product approval, the supervisory mechanism is considered adequate; notwithstanding, independent control of the internal Shari'a Board may more effectively guide the Bank's operations and provide urgent support.

In the absence of regulatory directive on matters pertaining to the sector's commitment to ESG initiatives, we have not yet seen notable progress in the Bank in terms of addressing climate change risks within the portfolio, as yet. Assigned ratings however have not been affected by this assessment.

For further information on this rating announcement, please contact us at iira@iirating.com

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