MOODY'S INVESTORS SERVICE

Credit Opinion: Arab Bank Australia Limited

Global Credit Research - 21 Sep 2010

Sydney, New South Wales, Australia

Ratings

Category	**Moody's Rating**
Outlook	Stable
Bank Deposits	A3/P-1
Bank Financial Strength	D+
Issuer Rating	A3
Senior Unsecured MTN -Dom Curr	(P)A3
Subordinate MTN -Dom Curr	(P)Baa1
ST Issuer Rating	P-1
Other Short Term -Dom Curr	(P)P-1
Parent: Arab Bank PLC	
Outlook	Stable
Bank Deposits -Fgn Curr	Ba3/NP
Bank Deposits -Dom Curr	A3/P-2
Bank Financial Strength	C+

Contacts

Analyst	**Phone**
Daniel Yu/Sydney	612.9270.8198
Marina Ip/Sydney	612.9270.8130
Stephen Long/Hong Kong	852.3758.1306

Key Indicators

Arab Bank Australia Limited (Consolidated Financials)[1]

	[2]**12-09**	[2]**12-08**	[2]**12-07**	[3]**12-06**	**Avg.**
Total Assets (AUD million)	**1,212.62**	**1,342.69**	**870.12**	**873.45**	[4]**11.56**
Tangible Common Equity (AUD million)	**98.32**	**99.27**	**95.59**	**93.89**	[4]**1.55**
Total Assets (USD million)	**1,090.58**	**936.12**	**764.01**	**688.46**	[4]**16.57**
Tangible Common Equity (USD million)	**88.42**	**69.21**	**83.94**	**74.01**	[4]**6.11**
PPI / Avg RWA	**1.28%**	**0.84%**	**0.32%**	**0.65%**	[5]**0.81%**
Net Income / Avg RWA	**-0.04%**	**0.51%**	**0.19%**	**0.48%**	[5]**0.22%**
(Market Funds - Liquid Assets) / Total Assets	**15.63%**	**14.03%**	**17.04%**	**29.04%**	[6]**18.94%**
Core Deposits / Average Gross Loans	**77.82%**	**108.81%**	**81.52%**	**62.52%**	[6]**82.67%**
Tier 1 Ratio	**9.50%**	**10.20%**	**14.30%**	**14.20%**	[5]**11.33%**
Tangible Common Equity / RWA	**10.25%**	**10.53%**	**13.29%**	**13.22%**	[5]**11.36%**
Cost / Income Ratio	**64.25%**	**76.00%**	**90.35%**	**81.52%**	[6]**78.03%**
Problem Loans / Gross Loans	**4.49%**	**2.87%**	**3.06%**	**3.75%**	[6]**3.54%**
Problem Loans / (Equity + Loan Loss Reserves)	**33.69%**	**23.60%**	**21.11%**	**27.07%**	[6]**26.37%**

Source: Moody's

[1] All ratios are adjusted using Moody's standard adjustments [2] Basel II; IFRS [3] Basel I; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] Basel II & IFRS reporting periods have been used for average calculation [6] IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

Moody's assigns a bank financial strength rating (BFSR) of D+ to Arab Bank Australia Limited, which translates into a baseline credit assessment of Baa3. The outlook is Stable.

The rating reflects the bank's niche franchise in the Arabic community in Sydney and Melbourne (and progressive expansion to the broader community, especially in the deposit space), and ample capital ratios for its risk profile.

Besides a small subordinated debt issue to its parent, the bank is totally self-funded with over half of total funding sourced from retail deposits, with the balance sourced from wholesale deposits and government guaranteed issued debt.

However, the rating is constrained by its small market share resulting from strong competition, ongoing margin compression driven by relatively high-cost term deposit funding, concentration risk arising from its smaller customer base, and overweight positions in construction and development finance.

The bank's long-term global local currency (GLC) deposit rating of A3 is based on the very high probability of support from Arab Bank Australia's parent, Arab Bank plc, and the low probability of systemic support, in case of need - which results in a 3 notch lift from the Baa3 baseline credit assessment. The short-term GLC deposit rating is Prime-1.

Support from the parent is highly likely given the shared branding. The parent also has a strong track record of providing support to its subsidiaries and has a very large pool of global liquidity, relative to the size of Arab Bank Australia.

With regards to the prospect for systemic support, Australia is considered a high support country but Arab Bank Australia is viewed as having low systemic importance, due to its small market share.

The bank's long- and short-term GLC issuer ratings - which address the risk of senior non-deposit obligations - and its senior debt ratings are also A3/Prime-1, reflecting the same support considerations as the deposit ratings.

Thus the deposit and debt ratings of Arab Bank Australia incorporate four main elements: (1) the bank's BFSR of D+, which addresses its stand-alone credit profile, (2) Moody's assessment of a very high probability of support from its parent (a component of joint default analysis, referred to as JDA), (3) Moody's assessment of a low probability of systemic support in Australia (also a component of JDA) and (4) the seniority of its deposits and other obligations.

The bank's foreign currency obligations are rated the same as its local currency obligations. Australia's sovereign ceilings for deposits and debt are at Aaa, and therefore do not constrain the bank's foreign currency ratings.

Credit Strengths

[1] Credit enhancement provided by strong relationship with parent

[2] Well established niche franchise

[3] Ample capital ratios, with all profits retained to support the local franchise

Credit Challenges

[1] Borrower concentration high on a global scale due to single large exposures to the property development and construction sector, as a percentage of pre-provision profit

[2] Risk-adjusted profitability impacted by competitive deposit pricing and impairment expense

[3] Maintaining retail deposit growth

[4] Asset quality under pressure in a weaker economic climate

Rating Outlook

The outlook for Arab Bank Australia's BFSR is Stable. Maintaining risk-adjusted profitability remains a challenge, as competition continues to pressure margins, particularly in retail deposits. The outlook also incorporates the bank's strong retail deposit raising capabilities and sound capital levels which should ensure the bank maintains its credit profile in line with the assigned ratings.

The stable outlook for Arab Bank Australia's deposit and debt ratings reflects our expectation that it will continue to enjoy strong support from Arab Bank plc if required. It also incorporates our expectation that the potential for systemic support will continue to be low due to the bank being a small foreign-owned bank.

What Could Change the Rating - Up

Given the challenging economic environment, an upgrade to Arab Bank Australia's rating is not considered likely in the near-term.

What Could Change the Rating - Down

BFSR

A combination of the following could trigger a downgrade

[1] A decline in the bank's Tier 1 % to below 8.5% as a result of an increase in asset impairment, rapid asset growth, or dividend upstreaming to its parent

[2] A significant fall in the proportion of customer deposit funding resulting in greater wholesale funding reliance

[3] A significant rise in problem loans (defined as non-accrual loans and 90 days past due loans) as a percentage of pre-provision profit or as a percentage of shareholders equity and loan loss reserves

Deposits & Debt

[1] A downgrade of Arab Bank Australia's BFSR

[2] A downgrade of its parent's BFSR

[3] A lower systemic support assumption

Recent Results

For FY2009, Arab Bank Australia reported net loss of A$0.41million, compared to a profit of A$4.8million in FY2008. The result was impacted by a significant loan impairment charge of A$10.9m, relating to an exposure to a Bahraini Bank. The charge was for 100% of the exposure. Excluding bad debt expense, pre-provision profits rose 74% to A$12.2m.

Interest income declined 16% in FY2009, although this was offset by an even greater 27% fall in interest expense - leading to a 21% rise in net interest income.

Total assets were A$1.213billion, down 10% from FY2008, with cash balances falling 90% to A$11.4million. Total liabilities were 11% lower, driven by a 20% decline in total deposits.

The Tier 1 capital ratio stood at 9.5% at FY2009, compared to 10.2% at FY2008.

DETAILED RATING CONSIDERATIONS

Detailed rating considerations for Arab Bank Australia's currently assigned ratings are as follows:

Bank Financial Strength Rating

Moody's assigns a BFSR of D+ to Arab Bank Australia. The BFSR scorecard outcome of C-, based on the FY2009 two year average, is one notch above the bank's current assigned rating. Moody's rating analysis revealed a number of factors that were hard to capture in the scorecard by nature of its inputs and definitions. In particular, the bank's small franchise and vulnerability single large exposures are viewed as more consistent with a D+ rating.

Qualitative Rating Factors (50%)

Factor 1: Franchise Value

Trend: Neutral

Arab Bank Australia is a subsidiary of Arab Bank plc, which has extensive international operations. In Australia, the bank currently has 10 branches located in Australia's two largest cities, Sydney and Melbourne.

With a strong franchise position within the Arabic community in Australia, Arab Bank Australia focuses on establishing relationship banking connections with its customers. Whilst a substantial portion of its lending book continues to be towards this group, the bank has been able to diversify and grow its customer base outside this segment on the deposit side, with a large proportion of its deposit customers outside this group.

The bank is facing challenges to its franchise (i) strong retail deposit competition (ii) slowing housing market in NSW and VIC, where the majority of the bank's customers are located, is also impacting property development and construction. Home loan market share has steadily declined over the past two years while the bank's share of customer deposit have declined since peaking at the start of 2009.

Referencing the scorecard, Arab bank Australia's overall franchise score of D accurately reflects the challenges to its business.

Factor 2: Risk Positioning

Trend: Neutral

Arab Bank Australia's risk positioning is supported by its controls and processes adopted under a risk management framework originated by the Arab Bank group. Its control framework is becoming more complex as the bank matures.

With reference to the scorecard, Arab Bank Australia continues to have very high borrower concentration levels relative to pre-provision income or Tier 1, resulting in a subfactor score of E. This is mostly related to large property development and construction exposures.

In common with other Australian banks, Arab Bank Australia has very low levels of market risk.

Referencing the scorecard, the overall risk score of D is in line with the bank's rating.

Factor 3: Regulatory Environment

Trend: Neutral

All Australian banks are subject to the same score on regulatory environment. This factor does not address bank specific issues; instead, it evaluates whether regulatory bodies are independent and credible, demonstrate enforcement powers and adhere to global standards of best practices for risk control. Moody's views the Australian regulatory environment as a positive factor that provides a strong underpinning to Australian bank ratings. Please refer to Moody's Banking System Outlook for Australia to obtain a detailed discussion on the Regulatory Environment.

Factor 4: Operating Environment

Trend: Neutral

This factor is also common to all Australian banks. Moody's assigns an A- for the overall operating environment. Economic volatility is low - although not the lowest amongst developed countries - and the country has a strong legal system with good enforceability of creditor claims. We see these factors as supporting average bank asset quality and profitability over economic cycles. Please refer to Moody's Banking System Outlook for Australia to obtain a detailed discussion on the Operating Environment.

Quantitative Rating Factors (50%)

Factor 5: Profitability

Trend: Neutral

After showing improvement in FY2008, Arab Bank Australia reported a loss in FY2009 as a result of bad debt provisions raised against a single large exposure to a Bahraini Bank. Whilst it is possible that the bank may recover some of this exposure, Arab Bank Australia has taken a conservative approach by providing for the full amount of the loan. Excluding provisions, the bank's risk adjusted profitability (measured as pre-provision, pre-tax profit as a percentage of average risk-weighted assets) improved to 1.28% from 0.84% in FY2008 and 0.32% in FY2007.

Whilst lending growth has recovered, generating new lending volumes, the bank has been able to reduce the slide in interest margins, assisted by reducing the reliance on higher cost deposits and the re-pricing of risk by most lending institutions in Australia.

Although the rate of decline has slowed, margin compression will continue to be a challenge as funding costs remain high, as a result of strong retail deposit competition. This is evident in the bank's net interest margin, which has fallen from 2.59% in FY2007, to 2.41% in FY2008, and 2.36% in FY2009

On a pre-provision profit to average risk-weighted assets basis, the bank's profitability is at its D rating level. The bank's net income to average risk-weighted assets are below the expected range for its rating. However, this is driven by the reported loss in FY2009 and is expected to improve in FY2010.

Factor 6: Liquidity

Trend: Weakening

After growing 47% in FY2008, retail deposits declined 21% in FY2009, as competition for deposits remained intense. Arab Bank Australia also sought to diversify its funding base by issuing A$200m of 3 year, Government guaranteed wholesale debt. This allowed the bank to lock-in longer term funding and alleviate some of the pressure to compete fiercely for deposits

As a result of the debt issuance and decline in deposit growth, retail deposits comprise just over half of total funding, compared to 70% during the peak of the crisis. Whilst accessing term funding does diversify the bank's funding sources, a continued decline in the portion of retail funding due to insufficient retail deposit growth or increased reliance on wholesale funding could place negative pressure on the rating.

We do note that the bank continues to focus on growing its customer base outside its niche market through its flagship deposit products, which are well received by the market. Arab Bank Australia recently introduced a new online savings product which is popular amongst self managed superannuation customers, which will add another channel for the bank to attract deposits from. In the past, the bank has also been successful in attracting deposits through marketing campaigns targeting term deposits.

Access to the wholesale deposit market continues, through the bank's combined ECD, TD and MTN debt programme.

The bank liquidity levels have been built up during the crisis and are considered sound. The bank invests in a mix of short term securities issued by Australian banks as well as a portion of government guaranteed securities with longer-dated maturities.

Factor 7: Capital Adequacy

Trend: Weakening

Arab Bank Australia's regulatory ratios declined for the second straight year in FY2009. Tier 1 % declined to 9.5%, from 10.2% in FY2008 and 14.3% in FY2007. The fall was partly driven by growth in risk-weighted assets as a result of increases in the bank's off-balance sheet risk weighted credit exposures and operational risk charges. We note that although declining, the bank's capital levels are sound and are commensurate to its risk profile.

The bank's Tier 1 capital was reduced by A$4.2million, of which A$3.2million related to an increase in deductions for intangibles, resulting from a one off provision raised against an exposure to a Bahraini Bank.

Any changes in the loan mix towards construction/development and commercial lending will likely see a disproportionate rise in risk-weighted assets which may have the effect of reducing the bank's capital ratios further. Furthermore, loan growth is expected to improve after remaining stable in FY2009, which will place downward pressure on capital ratios if profitability, and hence internal capital generation, does not improve. However, for now the bank's capital ratios remain well above regulatory minimums.

Arab Bank Australia currently has A$50million in subordinated debt from its parent, which qualifies as Tier 2 capital for regulatory purposes. During FY2009, the bank received A$25million from its parent to cover risk weighted asset growth.

Arab Bank Australia's present dividend policy means that all profits are retained in the business to support further growth. With reference to the scorecard, this has resulted in the bank holding a sound level of equity (most of which is core capital) which results in a subfactor score of B+.

Factor 8: Efficiency

Trend: Neutral

The bank's cost to income ratio is reflective of its size and niche franchise. Overall, expense management has been sound, with the bank reporting flat growth for the second straight year in FY2009.

The bank's cost to income ratio improved to 64.25% in FY2009 from 76% in FY2008 driven by higher operating income, which places the bank in the efficiency subfactor score of D.

To move into the higher subfactor score of C, the bank would need to improve its cost to income ratio below 65%.

Factor 9: Asset Quality

Trend: Weakening

Arab Bank Australia's reported asset quality ratios worsened sharply in FY2009, as a result of a single trade finance exposure to a Bahraini Bank which defaulted on payment. Although a proposed settlement is possible, Arab Bank Australia has taken a conservative approach by provisioning for the full exposure amount.

As previously noted, for a bank of its size, Arab Bank Australia is vulnerable to single large exposures, which have the ability to make a noticeable impact to its asset quality ratios.

Driven by this single exposure, non-performing loans (defined as non-accrual loans plus 90 day past due loans) increased sharply to 4.49% of gross loans in FY2009, from 2.87% in FY2008. Excluding this exposure, non-performing loans were 3.28% of gross loans.

Charges for debt provisions continued to increase in FY2009. Excluding the A$10.9million provision taken for the single large exposure, the bank reported provisions of A$1.35million specific and A$476k collective, compared to A$759k specific and A$135k collective in FY2008. However, we note that the bank does have sound credit underwriting standards, with very low loan losses to date

With reference to the scorecard, Arab Bank Australia is within the subfactor score of C when measured by either non-performing loans as a percentage of gross loans or non-performing loans as a percentage of shareholders equity and loan-loss reserves.

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's JDA analysis is used to assess the potential for systemic support during normal market conditions. Moody's will continue to incorporate this approach into its ratings of bank obligations that are not covered by the Australian government's guarantee Scheme for Large Deposits and Wholesale Funding. Guaranteed obligations will be assigned separate "backed" ratings where appropriate.

We view Australia as a high support country. Please refer to Moody's Banking System Outlook for Australia for a fuller discussion of systemic support and the government guarantee scheme.

Moody's assigns a global local currency (GLC) deposit rating of A3 to Arab Bank Australia Limited.

The GLC deposit rating is supported by the bank's Baseline Credit Assessment of Baa3, as well as the A3 Baseline Credit Assessment of its parent, Arab Bank plc, and the Aaa local-currency deposit ceiling (LCDC) in Australia. The bank receives a 3 notch uplift from its Baseline Credit Assessment, bringing the GLC deposit rating to A3.

Moody's expects a very high level of parental support from Arab Bank plc based on the following: (1) shared branding (2) the bank's small size means that providing assistance would not create a financial strain on the group (3) the parent has a strong track record of providing support to its subsidiaries.

The probability of systemic support in the event of a stress situation is judged to be low. This is based on Arab Bank Australia's national market share and relative importance to the country's banking system. Arab Bank Australia held market shares of less than 1% total deposits (excluding CDs and from financial corporations) and total loans at June 2010 (APRA data).

Additionally, the regulator's own Probability And Impact Rating System - which measures the systemic impact of the failure of an individual institution - uses asset size as a major input. Arab Bank Australia's relatively small asset size suggests it would score relatively low on this metric.

Although the Australian government has made it clear that support will be available to foreign banks as much as domestic banks during the crisis period, we believe that once market conditions have stabilised, the regulator may look to Arab Bank Australia's parent to be the primary source of support in case of need.

Foreign Currency Deposit Rating

The Foreign Currency Deposit ratings of Arab Bank Australia are unconstrained because Australia has a country ceiling of Aaa.

Foreign Currency Debt Rating

The Foreign Currency Debt ratings of Arab Bank Australia are unconstrained because Australia has a country ceiling of Aaa.

ABOUT MOODY'S BANK RATINGS

Bank Financial Strength Rating

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. Bank Financial Strength Ratings do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honor its domestic or foreign currency obligations. Factors considered in the assignment of Bank Financial Strength Ratings include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although Bank Financial Strength Ratings exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the Bank Financial Strength Rating as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, Moody's Bank Deposit Ratings are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, and includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of external elements of support into the bank's Baseline Risk Assessment. In calculating the GLC rating for a bank, the JDA methodology also factors in the rating of the support provider, in the form of the local currency deposit ceiling for a country, Moody's assessment of the probability of government support for the bank in case a stress situation occurs and the degree of dependence between the issuer rating and the LCDC.

National Scale Rating

National scale ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. An Aaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could affect all issuers, even those that receive the highest ratings on the National Scale.

Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to a high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be reminded that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt obligations may also be constrained by the country ceiling for foreign currency bonds and notes, however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

About Moody's Bank Financial Strength Scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating Factors

Arab Bank Australia Limited

Rating Factors [1]	**A**	**B**	**C**	**D**	**E**	**Total Score**	**Trend**
Qualitative Factors (50%)						**C**	
Factor: Franchise Value						**D**	**Neutral**
Market Share and Sustainability				**x**			
Geographical Diversification				**x**			
Earnings Stability				**x**			
Earnings Diversification [2]							
Factor: Risk Positioning						**C-**	**Neutral**
Corporate Governance [2]							
- Ownership and Organizational Complexity							
- Key Man Risk							
- Insider and Related-Party Risks							
Controls and Risk Management			**x**				
- Risk Management				x			
- Controls	x						
Financial Reporting Transparency			**x**				
- Global Comparability	x						
- Frequency and Timeliness				x			
- Quality of Financial Information			x				
Credit Risk Concentration					**x**		
- Borrower Concentration					x		
- Industry Concentration			x				
Liquidity Management			**x**				
Market Risk Appetite	**x**						
Factor: Operating Environment						**A**	**Neutral**

Economic Stability	**x**						
Integrity and Corruption	**x**						
Legal System	**x**						
Financial Factors (50%)						**D+**	
Factor: Profitability						**E+**	**Neutral**
PPI / Average RWA - Basel II				1.06%			
Net Income / Average RWA - Basel II					0.22%		
Factor: Liquidity						**C-**	**Weakening**
(Mkt funds-Liquid Assets) / Total Assets				14.83%			
Liquidity Management			x				
Factor: Capital Adequacy						**B+**	**Weakening**
Tier 1 Ratio - Basel II		9.85%					
Tangible Common Equity / RWA - Basel II	10.39%						
Factor: Efficiency						**D**	**Neutral**
Cost / Income Ratio				70.13%			
Factor: Asset Quality						**C**	**Weakening**
Problem Loans / Gross Loans			3.68%				
Problem Loans / (Equity + LLR)			28.65%				
Lowest Combined Score (15%)						**D-**	
Economic Insolvency Override						**Neutral**	
Aggregate Score						**C-**	
Assigned BFSR						**D+**	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non public information [2] - A blank score under Earnings diversification or Corporate Governance indicates the risk is neutral