FitchRatings

Fitch Affirms Nine Sri Lankan Banks

Fitch Ratings-Singapore/Colombo-11 January 2017: Fitch Ratings has affirmed the Long-Term Issuer Default Ratings (IDRs) of the following Sri Lanka-based banks:
- National Savings Bank (NSB) at 'B+'; Outlook Negative
- Bank of Ceylon (BOC) at 'B+'; Outlook Negative
- DFCC Bank PLC (DFCC) at 'B+'; Outlook Negative

Fitch has also affirmed the National Ratings of the following banks:
- People's Bank (Sri Lanka) (People's Bank) at 'AA+(lka)'; Outlook Stable
- Commercial Bank of Ceylon PLC (CB) at 'AA(lka)'; Outlook Stable
- Hatton National Bank PLC (HNB) at 'AA-(lka)'; Outlook Stable
- National Development Bank PLC's (NDB) at 'A+(lka); Outlook Stable
- Sampath Bank PLC (Sampath) at 'A+(lka)'; Outlook Negative
- Seylan Bank PLC (Seylan) at 'A-(lka)'; Outlook Stable

The rating actions follow Fitch's periodic review of the large banks peer group. A full list of rating actions is included at the end of this commentary.

KEY RATING DRIVERS
IDRS, NATIONAL RATINGS AND SENIOR DEBT

Fitch has revised its sector outlook for Sri Lankan banks to negative from stable. We believe operating conditions have become more challenging, as signalled by the downgrade and Outlook revision on the sovereign rating to 'B+'/Negative in February 2016 from 'BB-'/Stable. Fitch expects rising macroeconomic pressure to strain banks' credit metrics.

Fitch sees capitalisation as a significant issue facing the sector, stemming from thin capitalisation at state banks and diminishing capitalisation at most non-state banks. The Central Bank of Sri Lanka has issued the Basel III capital requirements that banks are expected to comply with from July 2017. Fitch believes most banks will need to raise capital to meet the targets set for 2019, although there may be no immediate issues regarding compliance. Stronger capital buffers are desirable to counterbalance structural balance sheet issues, such as high credit concentration, and absorb unexpected losses.

Sri Lanka's operating environment is a key rating driver for the banking sector. It constrains the Viability Rating of some banks, as it is rare for a Viability Rating to be assigned above the sovereign rating, however well banks score on other factors.

Banks with Long-Term Ratings Driven by Sovereign Support

The IDRs and National Long-Term Ratings of NSB and BOC and the National Long-Term Rating of People's Bank reflect Fitch's expectation of extraordinary support from the sovereign (B+/Negative), albeit constrained by its limited ability.

Fitch sees state support for NSB as stemming from its policy mandate of mobilising retail savings and investing them in government securities. The National Savings Bank Act contains an explicit deposit guarantee and Fitch believes authorities would support, in case of need, the bank's depositors and senior unsecured creditors to maintain confidence and systemic stability. Fitch has not assigned a Viability Rating to NSB, as it is considered to be a policy bank.

Fitch expects support for BOC and People's Bank to stem from their high systemic importance, quasi-sovereign status, role as key lenders to the government and full state-ownership.

The Negative Outlook on the IDRs' of NSB and BOC reflects the Negative Outlook on the sovereign's rating. The Outlook on the two banks' National Long-Term Ratings is Stable, as National Ratings reflect a bank's creditworthiness relative to the best credit in Sri Lanka, and as such, are unlikely to change due to sovereign rating action.

BOC's Viability Rating of 'b+' reflects its thin capitalisation and weak asset quality. This is counterbalanced by its strong domestic funding franchise, which is underpinned by state linkages. Fitch considers state support as BOC's primary rating driver, even though its Viability Rating is at the same level as its Support Rating Floor.

The US dollar senior unsecured notes issued by NSB and BOC are rated at the same level as the banks' Long-Term Foreign-Currency IDRs, as the notes rank equally with other senior unsecured obligations. The notes have a Recovery Rating of 'RR4'.

The National Long-Term Rating of Seylan reflects Fitch's expectation of state support, which is attributable to its state shareholding and higher share of banking sector deposits relative to some peers. Seylan has a lower support-driven rating due to its smaller market share compared with larger peers.

Fitch believes Seylan's standalone financial strength has improved, reaching the same level as it support-driven rating. However, Seylan's asset quality remains weaker against peers despite its reported gross non-performing loan ratio improving to 5.12% at end-3Q16, from a peak of 29.7% at end-2009. Further, Seylan's reserve coverage is significantly weaker than higher-rated peers.

Seylan's Sri Lanka rupee-denominated senior debt is rated at the same level as its National Long-Term Rating, as the debentures rank equally with other senior unsecured obligations

Banks with Long-Term Ratings Driven by Intrinsic Strength

The National Long-Term Rating of CB reflects its measured risk appetite relative to peers, strong funding profile as seen through a sustained high share of current and savings deposits (45% at 3Q16), solid franchise and sound performance. The ratings reflect Fitch's expectation that CB's non-domestic operations will remain small, even though the bank has been expanding its international presence.

The National Long-Term Rating of HNB reflects its strong domestic franchise, satisfactory capitalisation and improving financial profile. This is counterbalanced by a higher risk appetite relative to better-rated peers. HNB's risk appetite, as seen from its historically above-industry loan growth of 25.5% in 2015 versus the industry's 21.1% (2014: 14.0% versus the industry's 13.7%), has put pressure on its funding, liquidity and capitalisation.

DFCC's Viability Rating captures its developing commercial banking franchise alongside its core project financing business and still-high capitalisation levels (end-3Q16: Fitch Core Capital (FCC) ratio of 22.6%). The Negative Outlook on DFCC's IDR reflects the probable adverse effect on the bank's credit profile from the sovereign's deteriorating credit profile and increasing risks in the domestic operating environment. Fitch maintains the Negative Outlook on DFCC's National Long-Term Rating due to its declining capital buffers from weaker asset quality, below-average internal capital generation and high loan growth, relative to peers.

DFCC's US dollar notes are rated at the same level as its Long-Term Foreign-Currency IDR. The notes have a Recovery Rating of 'RR4'.

The National Long-Term Rating of Sampath reflects its lower capitalisation and higher risk appetite relative to peers, which counterbalance its growing franchise and satisfactory asset quality. Sampath's gross loan growth of 15.3% in 9M16 continues to outpace the industry's 10.3% growth (Sampath 2015: 24.2%, industry 2015: 21.1%). Fitch expects capitalisation to further weaken in the absence of capital injections, as the bank's retained earnings are insufficient to sustain its capitalisation - especially in the light of higher capital requirements. The bank's regulatory Tier 1 capital ratio continued to deteriorate and stood at 7.8% by end-9M16, from 8% at end-2015 (2013: 10.1%).

NDB's ratings reflect its satisfactory asset quality, weaker franchise and lower capitalisation (end-3Q16: FCC ratio of 12.4%) relative to higher-rated peers. Fitch's believes the bank's higher risk appetite could dilute the benefit of any possible capital infusions.

HNB's and DFCC's Sri Lanka rupee-denominated senior debt is rated at the same level as their National Long-Term Rating, as the debentures rank equally with other senior unsecured obligations.

SUPPORT RATING AND SUPPORT RATING FLOOR
The Support Rating and Support Rating Floor of privately-owned DFCC reflect its relative lower systemic importance, in Fitch's view.

The Support Ratings and Support Rating Floors of NSB and BOC reflect the state's ability and propensity to provide support to the banks given their high importance to the state and high systemic importance.

SUBORDINATED DEBT
The old-style Basel II Sri Lanka rupee-denominated subordinated debt of BOC, CB, HNB, DFCC, Sampath, NDB and Seylan is rated one notch below their National Long-Term Ratings to reflect the subordination to senior unsecured creditors.

RATING SENSITIVITIES
IDRS, NATIONAL RATINGS AND SENIOR DEBT
The banks' credit profiles are sensitive to changes in the operating environment. Negative rating action could also result from pressure on bank credit profiles through an increase in risk appetite, such as sustained rapid loan expansion or rising exposure to more susceptible segments, unless this is counterbalanced through higher capital buffers and stronger risk management.

Banks with Long-Term Ratings Driven by Sovereign Support

Changes to the sovereign rating or perception of state support to NSB and BOC could result in a change in their Support Rating Floors. Fitch may downgrade NSB's National Long-Term Rating if there is a reduced expectation of state support through, for instance, the removal of preferential support, or a substantial change in NSB's policy role or deviation from mandated core activities indicating its reduced importance to the state. A downgrade of BOC's Issuer Default Ratings (IDR) would most likely result from the sovereign's weakened ability to support the bank manifested through a lower sovereign rating. Visible demonstration of preferential support for BOC and People's Bank in the form of an explicit guarantee may be instrumental to an upgrade of their National Long-Term Ratings.

NSB's and BOC's senior debt ratings are sensitive to changes in the banks' Long-Term IDRs. The two banks' Recovery Ratings are sensitive to Fitch's assessment of potential recoveries for creditors in case of default or non-performance.

BOC's Viability Rating may come under pressure if there is a continued decline in capitalisation through a surge in lending or further decline in asset quality alongside high dividend payouts. Further deterioration in the operating environment, reflected in a decline of BOC's key credit metrics, could negatively affect its Viability Rating.

A downgrade of Seylan's rating could result from a reassessment of state support and large reversal in recent asset quality improvements, together with a weakening financial profile. In the absence of changes to Fitch's support assessment, an upgrade of Seylan's rating would be contingent on further improvements in its standalone profile through improved asset quality and provisioning, mainly stemming from recovery of legacy non-performing loans, while maintaining its other credit metrics in line with higher-rated peers.

Seylan's senior debt ratings will move in tandem with its National Long-Term Rating.

Banks with Long-Term Ratings Driven by Intrinsic Strength

Enhanced loss absorption buffers against a volatile operating environment could be positive for CB's National Long-Term rating. The bank's ratings could be downgraded if its ability to withstand cyclical asset quality deterioration declines due to lower earnings and capitalisation. In addition, any marked weakening in its deposit franchise and deviation from its measured risk appetite, both viewed by Fitch as key factors that differentiate CB from its lower-rated peers, would be negative.

An upgrade of HNB's National Long-Term Rating is contingent on the bank achieving sustained improvements in its financial profile, particularly in its funding, and a moderation of its risk appetite. A rating downgrade could result from a significant increase in risk-taking and operating environment-related risks, unless sufficiently mitigated through capital and financial performance. Further weakening of HNB's liquidity position could also negatively affect its rating.

The Outlook on DFCC's National Long-Term Rating may be revised to Stable if the bank can sustain capital buffers to sufficiently cushion its weaker asset-quality amid higher operating environment-related risks. Fitch expects the bank to maintain higher capitalisation to offset the risk stemming from its project finance portfolio - a core business for DFCC since inception.

DFCC's IDRs and National Long-Term Rating could be downgraded if there is sustained deterioration in its capitalisation, particularly if its asset quality were to also simultaneously deteriorate. The ratings can also come under pressure if there is further weakening of the operating environment. DFCC's Recovery Rating is sensitive to Fitch's assessment of potential recoveries for creditors in case of default or non-performance.

The Outlook on Sampath could be revised to Stable if it can fundamentally improve its capital buffers commensurate with its risk profile. Sampath's ratings could be downgraded if there is a sustained decline in capitalisation, increase in risk-taking or a sharp decline in asset quality.

NDB's National Long-Term Rating may be downgraded if the bank cannot sustain its capitalisation at a level commensurate with its risk profile. An upgrade could result from NDB's ability to sustain a sufficient capital buffer that can counterbalance weaknesses in its credit profile.

The assigned senior debt ratings will move in tandem with the banks' National Long-Term Rating.

SUPPORT RATING AND SUPPORT RATING FLOOR

Reduced propensity of the state to support systemically important banks could result in a downgrade in the assigned Support Ratings and Support Rating Floors, but Fitch sees this to be unlikely in the medium-term. A change in the sovereign's ratings could also lead to a change in the banks' Support Ratings and Support Rating Floors.

SUBORDINATED DEBT
The assigned subordinated debt ratings will move in tandem with the banks' National Long-Term Rating.

The rating actions are as follows:

National Savings Bank:
Long-Term Foreign-Currency IDR affirmed at 'B+'; Negative Outlook
Long-Term Local Currency IDR affirmed at 'B+'; Negative Outlook

Short-Term Foreign-Currency IDR affirmed at 'B'
National Long-Term Rating affirmed at 'AAA(lka)'; Stable Outlook
Support Rating affirmed at '4'
Support Rating Floor affirmed at 'B+'
US dollar senior unsecured notes affirmed at 'B+'; Recovery Rating at 'RR4'

Bank of Ceylon:
Long-Term Foreign-Currency IDR affirmed at 'B+'; Negative Outlook
Long-Term Local-Currency IDR affirmed at 'B+'; Negative Outlook
Short-Term Foreign-Currency IDR affirmed at 'B'
National Long-Term Rating affirmed at 'AA+(lka)'; Stable Outlook
Viability Rating affirmed at 'b+'
Support Rating affirmed at '4'
Support Rating Floor affirmed at 'B+'
US dollar senior unsecured notes affirmed at 'B+'; Recovery Rating at 'RR4'
Basel II compliant Sri Lanka rupee-denominated subordinated debentures affirmed at 'AA(lka)'

People's Bank (Sri Lanka):
National Long-Term Rating affirmed at 'AA+(lka)'; Outlook Stable

Commercial Bank of Ceylon PLC:
National Long-Term Rating affirmed at 'AA(lka)'; Stable Outlook
Basel II compliant outstanding subordinated debentures affirmed at 'AA-(lka)'

Hatton National Bank PLC:
National Long-Term Rating affirmed at 'AA-(lka)'; Stable Outlook
Sri Lanka rupee-denominated senior unsecured debentures affirmed at 'AA-(lka)'
Basel II compliant outstanding subordinated debentures affirmed at 'A+(lka)'

DFCC Bank PLC:
Long-Term Foreign-Currency IDR affirmed at 'B+'; Negative Outlook
Long-Term Local-Currency IDR affirmed at 'B+'; Negative Outlook
Short-Term Foreign-Currency IDR affirmed at 'B'
National Long-Term Rating affirmed at 'AA-(lka)'; Negative Outlook
Viability Rating affirmed at 'b+'
Support Rating affirmed at '5'
Support Rating Floor affirmed at 'B-'
US dollar senior unsecured notes affirmed at 'B+'; Recovery Rating at 'RR4'
Sri Lanka rupee-denominated senior unsecured debentures affirmed at 'AA-(lka)'
Basel II compliant Sri Lanka rupee-denominated subordinated debentures affirmed at 'A+(lka)''

Sampath Bank PLC:
National Long-Term Rating affirmed at 'A+(lka)'; Negative Outlook
Basel II compliant outstanding subordinated debentures affirmed at 'A(lka)'

National Development Bank PLC:
National Long-Term Rating affirmed at 'A+(lka)'; Stable Outlook
Basel II compliant subordinated debentures affirmed at 'A(lka)'

Seylan Bank PLC:
National Long-Term Rating affirmed at 'A-(lka)'; Stable Outlook
Sri Lanka rupee-denominated senior unsecured debentures affirmed at 'A-(lka)'
Basel II compliant subordinated debentures affirmed at 'BBB+(lka)'
Proposed Sri Lanka rupee-denominated senior unsecured debentures affirmed at 'A-(EXP)(lka)'

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NDB, DFCC, Sampath, BOC, People's Bank, CB and HNB each have a 1.78% equity stake in Fitch Ratings Lanka Ltd. No shareholder other than Fitch, Inc. is involved in the day-to-day rating operations of, or credit reviews undertaken by, Fitch Ratings Lanka Ltd.

Note to editors: Fitch's National ratings provide a relative measure of creditworthiness for rated entities in countries with relatively low international sovereign ratings and where there is demand for such ratings. The best risk within a country is rated 'AAA' and other credits are rated only relative to this risk. National ratings are designed for use mainly by local investors in local markets and are signified by the addition of an identifier for the country concerned, such as 'AAA(lka)' for National ratings in Sri Lanka. Specific letter grades are not therefore internationally comparable.

Additional information is available on www.fitchratings.com

Applicable Criteria
Global Bank Rating Criteria (pub. 25 Nov 2016)
National Scale Ratings Criteria (pub. 30 Oct 2013)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form
Solicitation Status
Endorsement Policy