FitchRatings

Fitch Affirms Ratings on 9 Sri Lankan Banks; Outlooks Stable

Fitch Ratings-Singapore/Colombo-28 September 2018: 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 Stable

- Bank of Ceylon (BOC) at 'B+'; Outlook Stable

- DFCC Bank PLC at 'B+'; Outlook Stable

Fitch has also affirmed the National Long-Term Ratings of the following banks:

- NSB at 'AAA(lka)'; Outlook Stable

- BOC at 'AA+(lka)'; Outlook Stable

- DFCC at 'AA-(lka)'; Outlook Stable

- People's Bank (Sri Lanka) 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 (NDB) at 'A+(lka); Outlook Stable

- Sampath Bank PLC at 'A+(lka)'; Outlook Stable

- Seylan Bank PLC at 'A-(lka)'; Outlook Stable

The rating action follows Fitch's periodic review of the large bank peer group. A full list of rating actions is at the end of this commentary.

KEY RATING DRIVERS
IDRS, NATIONAL RATINGS AND SENIOR DEBT

Fitch maintains the negative outlook for the banking sector as operating conditions continue to be difficult against a challenging macroeconomic backdrop, which we expect to continue to pressure bank performance in the short to medium term.

Non-performing loans (NPLs) continued to rise in 1H18 in the aftermath of strong credit growth as indicated by Fitch's Macro Prudential Indicator of 2 for Sri Lanka. There has also been an increase in rescheduled loans across Fitch-rated banks, indicating that pressure on asset quality is likely to extend into 2019.

Sri Lankan banks have been raising capital to meet Basel III regulations that come into effect in full on 1 January 2019. The impact on banks' regulatory capital ratios from the adoption of Sri Lanka Financial Reporting Standards (SLFRS) 9 in 2018 is expected to be modest.

Banks' credit profiles should remain broadly intact, supported by improved capital buffers, although macroeconomic risks will continue to dampen performance, especially on the credit quality front. There could be modest pressure on the ratings of some banks if they fail to maintain sufficient loss-absorption buffers.

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+/Stable).

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

BOC's Viability Rating reflects its thin capitalisation that is counterbalanced by a stronger domestic funding franchise compared with the majority of sector peers. 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 are rated at the same level as the bank's Long-Term Foreign-Currency IDR, as the notes rank equally with other senior unsecured obligations. The notes have a Recovery Rating of 'RR4'.

The Long-Term Rating and the Recovery Rating assigned to BOC's US dollar senior unsecured notes have been withdrawn following the maturity of the notes in April 2018.

Banks with Long-Term Ratings Driven by Intrinsic Strength
The National Long-Term Rating of CB reflects its strong domestic franchise, stable earnings performance and generally stable funding and liquidity profile.

CB's loan mix has not changed significantly despite rapid loan expansion of 21% a year on average since 2015, which exceeded the sector's 18% pace. The bank's asset quality is likely to remain under pressure, following an increase in gross NPL ratio to 2.4% at end-June 2018 from 1.9% at end-2017. Loan loss allowances/gross loans increased to 2.6% from 2.4% over the same period.

CB's LKR10 billion rights issue helped raise its Basel III Tier 1 capital ratio to 12.1% by end-2017. CB's profitability, measured by return on average assets (ROAA), has been fairly stable in the recent four years, although higher impairment charges due to weak asset quality and SLFRS 9 could be a dampener.

CB has an established deposit franchise with current and savings accounts (CASA) making up 38.5% of total deposits at end-June 2018. CB's loans/deposits ratio has been rising (end-June 2018:90.8%; end-2014: 80.1%) on strong loan growth but remains largely comparable to peers.

We expect CB to continue to expand its non-domestic operations beyond Bangladesh after it set up operations in the Maldives and Myanmar recently. With the overseas business likely to remain small, Fitch believes the bank's credit profile would remain primarily linked to the Sri Lankan operating environment.

HNB's rating reflects its strong domestic franchise as the fourth-largest commercial bank in Sri Lanka, its improved capitalisation following an equity infusion and its better-than-average financial profile despite the deterioration in asset quality. This is, however, counterbalanced by a high risk appetite.

HNB's high risk appetite stems from strong balance sheet expansion in the past that has put pressure on the bank's liquidity buffers with loans/deposits ratio staying high at 96% at end-June 2018.

HNB's NPL ratio deteriorated to 2.9% in 1H18 (end-2017: 2.3%) after non-payment on one large loan facility (0.5% of gross loans) in 2017. HNB wrote off LKR3 billion of NPLs (0.5% of gross loans) in 4Q17, which explains the quarterly decline in NPL ratio to 2.3% from 2.6% at end-3Q17. We expect asset-quality pressure to persist in the short to medium term.

DFCC's Viability Rating and National Long-Term Rating capture its developing commercial banking franchise, relatively weak asset quality and earnings, and our expectation that DFCC would maintain higher capital buffers than similarly rated peers.

DFCC's Fitch Core Capital ratio remains one of the highest among its larger peers, although it has declined due to strong loan growth and substantial mark-to-market losses for its stake in CB. We expect the bank to shore up its capital buffers in the medium term.

We expect DFCC's asset quality to remain under pressure in the short to medium term with incremental risks stemming from its rapidly expanding commercial loans.

DFCC's ROAA has been volatile in recent years, particularly since the merger with DFCC Vardhana Bank PLC. The bank's ROAA was over 2% prior to the merger, but declined to a little over 1% in recent three years despite a one-off gain from the sale of shares in CB in 2017 and in Nations Trust Bank PLC in the financial year ended March 2015. DFCC's earnings are also dependent on the dividend income from CB, which accounts for 13%-16% of net profit.

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

Sampath's rating incorporates its evolving franchise, high risk appetite and improving, but lower-than-peers' capitalisation.

Fitch expects Sampath to maintain adequate buffers above the Basel III minimum regulatory requirements. Its Tier 1 ratio improved to 12% in end-June 2018 after it raised LKR12.5 billion in April 2018 and LKR7.6 billion in December 2017 via rights issues, and retained 2017 profit of LKR12.7 billion by issuing a scrip dividend.

Sampath's high risk appetite is evident as its loans have expanded faster than the sector average, and its higher loan concentration in the consumer/retail and SME/mid-sized corporate segments. Fitch expects the growth to remain strong in the medium term despite strong loan growth of 24% in 2017 and 10% in the six months to end-June 2018.

Sampath's reported gross NPL ratio increased to 3.0% at end-June 2018 from 1.6% at end-2017. Asset quality pressure may persist due to the bank's exposure to the more susceptible customer segments.

NDB's National Long-Term Rating reflects its developing franchise, satisfactory asset quality and declining capitalisation. NDB's Tier 1 ratio fell to 9.8% at end-June 2018 due to strong loan expansion and is likely to continue to slide given the bank's growth aspirations. The bank could face greater capital pressures as its asset base approaches the LKR500 billion mark (end-June 2018: LKR421.9 billion), which will require the bank to comply with an additional regulatory capital buffer of 1.5% imposed on domestic systemically important banks (D-SIBs). For now, the announced LKR6.2 billion rights issue, which is due by the year's end, should help it meet the Basel III minimum regulatory capital requirements.

NDB is increasing exposure to the retail and SME segments which, alongside greater focus on rupee-based lending, should drive net interest margin higher, but potential upside is likely to be constrained by the bank's weak deposit franchise. Higher exposure to retail and SME customers, which are more vulnerable to economic changes, could pressure asset quality, especially since loan growth has been rapid in recent years.

Seylan's National Long-Term Rating reflects its modest franchise and weaker-than-peers asset quality. The bank's reported NPL ratio increased to 5.5% at end-June 2018, from 4.4% at end-2017. It also has low allowance coverage.

Fitch expects Seylan to become a D-SIB by mid-2019 once its assets reach LKR500 billion. Seylan may need to raise new capital as internal capital generation is not likely to be sufficient for the bank to meet the higher capital requirements after it crosses that mark.

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

SUPPORT RATING AND SUPPORT RATING FLOOR
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.

The Support Rating and Support Rating Floor of privately owned DFCC reflect its relatively lower systemic importance, in Fitch's view.

SUBORDINATED DEBT
The old-style Basel II Sri Lanka rupee-denominated subordinated debt of BOC, CB, HNB, DFCC, NDB, Sampath and Seylan and the Basel III compliant Tier 2 Sri Lanka rupee-denominated subordinated debt of BOC, Sampath, Seylan, DFCC and CB are rated one notch below their National Long-Term Ratings to reflect the subordination to senior unsecured creditors. The Basel III compliant debentures include a non-viability trigger upon the occurrence of a trigger event, as determined by the Monetary Board of Sri Lanka.

RATING SENSITIVITIES
IDRS, NATIONAL RATINGS AND SENIOR DEBT RATINGS

Banks with Long-Term Ratings Driven by Sovereign Support
Any change in Sri Lanka's sovereign rating or the perception of state support to NSB, BOC, and People's Bank could result in a change in their IDRs and National Ratings.

A reduced expectation of state support through, for instance, the removal of preferential support extended to NSB or a substantial change in its policy role or deviation from mandated core activities, indicating its reduced importance to the government, could result in a downgrade of NSB's ratings. However, this is not our base case scenario.

A downgrade of BOC's IDRs and National Long-Term Rating would most likely result from the sovereign's weakened ability to support the bank, manifested through a lower sovereign rating.

BOC's Viability Rating may come under pressure if there is a continued decline in capitalisation through a surge in lending or high dividends. Further deterioration in the operating environment, leading to deterioration of BOC's key credit metrics, could trigger a negative rating action.

NSB's senior debt rating is sensitive to changes in the bank's Long-Term IDRs. The Recovery Rating on the bank's notes is sensitive to Fitch's assessment of potential recoveries for creditors in case of default or non-performance.

Banks with Long-Term Ratings Driven by Intrinsic Strength
Enhanced loss-absorption buffers could be positive for CB's National Long-Term Rating. The bank's rating could be downgraded on weakened loss-absorption buffers.

An upgrade of HNB's National Long-Term Rating is contingent on the bank sustaining improvement in its financial profile, particularly in its funding, and moderating its risk appetite. A rating downgrade could result from a significant increase in risk-taking and operating environment-related risks that could materially weaken capital buffers.

Capitalisation is an important driver on DFCC's Viability Rating. An inability to replenish its capital buffers to a level that is commensurate with its risk profile could pressure the bank's IDRs and National Long-Term Rating. Fitch sees limited upside for the bank's ratings due to its weak franchise.

The ratings on DFCC's notes are expected to move in tandem with changes to its IDRs. The Recovery Rating is sensitive to Fitch's assessment of potential recoveries for creditors in case of default or non-performance.

Failure to maintain capital buffers commensurate with its risk profile could put pressure on Sampath's rating. Conversely, Sampath's ratings could be upgraded if the bank significantly strengthens its capitalisation and at the same time restrains its growth trajectory.

NDB's National Long-Term Rating could be downgraded if the bank cannot sustain its capitalisation at a level commensurate with its risk profile. A significant improvement in its capital buffers along with a moderation in its risk appetite could be a rating positive, although Fitch does not expect this to happen in the medium term.

A downgrade of Seylan's National Long-Term Rating could come from a reassessment of state support and a significant deterioration in its credit profile. An upgrade of Seylan's rating would be contingent on improvements in its standalone profile through better asset quality and a financial profile similar to higher-rated peers.

The banks' senior debt and subordinated debt ratings will move in tandem with the banks' National Long-Term Ratings.

SUPPORT RATING AND SUPPORT RATING FLOOR
Lower propensity of the state to support systemically important banks could result in a downgrade in the banks' Support Ratings and Support Rating Floors, but Fitch sees this to be unlikely in the medium term. A change in the sovereign rating could also change the banks' Support Ratings and Support Rating Floors.

The rating actions are as follows:

National Savings Bank:
Long-Term Foreign-Currency IDR affirmed at 'B+'; Stable Outlook
Long-Term Local Currency IDR affirmed at 'B+'; Stable 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+'; Stable Outlook
Long-Term Local-Currency IDR affirmed at 'B+'; Stable 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+'
Basel II compliant Sri Lanka rupee-denominated subordinated debentures affirmed at 'AA(lka)'
Proposed Basel III compliant Sri Lanka rupee-denominated subordinated debentures affirmed at 'AA(lka)'

DFCC Bank PLC:
Long-Term Foreign-Currency IDR affirmed at 'B+'; Stable Outlook
Long-Term Local-Currency IDR affirmed at 'B+'; Stable 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 '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)'
Basel III compliant Sri Lanka rupee-denominated subordinated debentures affirmed at 'A+(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)'
Basel III compliant Sri Lanka rupee-denominated 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)'

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

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

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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.

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Additional information is available on www.fitchratings.com

Applicable Criteria

Bank Rating Criteria (pub. 22 Jun 2018) (https://www.fitchratings.com/site/re/10034713)
National Scale Ratings Criteria (pub. 18 Jul 2018) (https://www.fitchratings.com/site/re/10038626)

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