Sri Lankan Banks FY17 Report Card

Basel III to Compound Pressures for Sri Lankan Banks

Special Report

References to Banks

NSB: National Savings Bank

BOC: Bank of Ceylon

PB: People's Bank (Sri Lanka)

COMB: Commercial Bank of Ceylon PLC

HNB: Hatton National Bank PLC

Sampath: Sampath Bank PLC

DFCC: DFCC Bank PLC

NDB: National Development Bank PLC

Seylan: Seylan Bank PLC

NTB: Nations Trust Bank PLC

PABC: Pan Asia Banking Corporation PLC

UB: Union Bank of Colombo PLC

Amana: Amana Bank PLC

SDB: SANASA Development Bank PLC

HDFC: Housing Development Finance Corporation Bank Of Sri Lanka

Related Research

Fitch Affirms Nine Sri Lankan Banks (January 2017)

Fitch: Proposal to Raise Capital Floor to Benefit Sri Lanka Bank Sector (November 2016)

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Banking Sector Outlook Negative: Fitch Ratings' outlook on Sri Lankan banks for 2017 remains negative, although the expected deterioration in the operating environment has so far been managed. Challenges stemming from slow economic growth together with deteriorating asset quality and weak internal capital generation could put further pressure on capitalisation levels of banks. The operating environment is a key rating driver for the banking sector as it can affect the vulnerability of the banks' financial profile.

Economic Growth to Slow: Fitch believes the Sri Lankan banking sector faces challenges from a slowdown in economic growth despite the revision of the outlook on the sovereign's rating to 'B+'/Stable from 'B+'/Negative in February 2017. Fitch estimates Sri Lanka's real GDP growth to be just under 5% over 2017-2018, moderately lower than the authorities' estimate of 5.5%-6.0%, as we expect a greater drag on growth from tax hikes as well as slowing credit growth.

Loan Growth to Moderate: Fitch expects loan growth to moderate in 2017 following policy rate hikes in 2016 and early 2017 and a tax hike, which may reduce consumption demand. However, increased credit demand from the state can push growth higher. Loan growth slowed to 17.5% in 2016 from 21.1% in 2015, but remains high in certain sectors such as construction (2016: 17.4% of sector loans and 2015: 16.7%), which could pose risk, if not well managed.

NPLs May Rise: Absolute NPLs among Fitch-rated banks rose 7% in 1Q17, and could see further increase following aggressive lending in 2015/2016 into more susceptible segments such as retail and SME and the effects of the recent floods. However, we do not expect a significant deviation in the sector NPL ratio due to the moderate loan book growth expected.

Capitalisation is a Challenge: Fitch sees capitalisation is a key issue facing the sector, stemming from thin capitalisation across state banks and diminishing capitalisation across most private banks. The state banks' internal capital generation has been weak, with substantial dividend pay-outs to the government. In 2016, the three largest state banks paid 76% of their profits as dividends. Stronger capital buffers are desirable to counterbalance structural balance-sheet issues and to absorb unexpected losses.

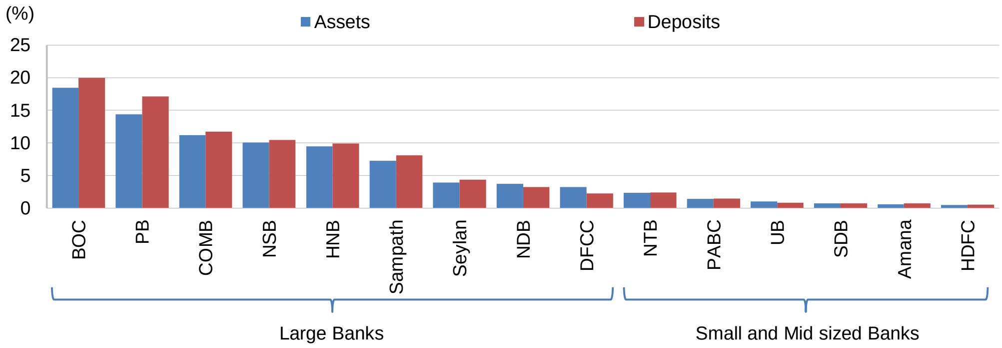
The Central Bank of Sri Lanka has issued local Basel III capital requirements that banks are expected to comply with from 1 July 2017. Whilst we believe that banks are likely to be compliant on the 1 July 2017 requirement, most banks would need to raise capital to meet the new Tier 1 levels by 2019. The new rules also include higher risk weights for foreign-currency lending to the state and gold-backed loans, which the old rules did not have.

Minimum Capital May Increase: The Sri Lankan government in 2016 proposed an increase in the minimum capital of licensed commercial banks to LKR20 billion from LKR10 billion, and that of licensed specialised banks to LKR7.5 billion from LKR5 billion. Six small and mid-sized banks rated by Fitch did not meet this requirement based on reported core capital as of end-2016.

Profitability May Decline: Sector profitability may decline as net interest margins (NIMs) are likely to narrow due to higher funding costs, which could outpace the rise in lending rates due to higher funding costs. This could be compounded by an increase in credit costs if asset quality were to worsen alongside the implementation of IFRS 9 due in early 2018.

- Fitch-rated banks account for around 88% of the sector's assets.
- Fitch-rated state banks' market share had declined to 43% by end-2016 from 47% in 2013 due to aggressive growth by private banks.

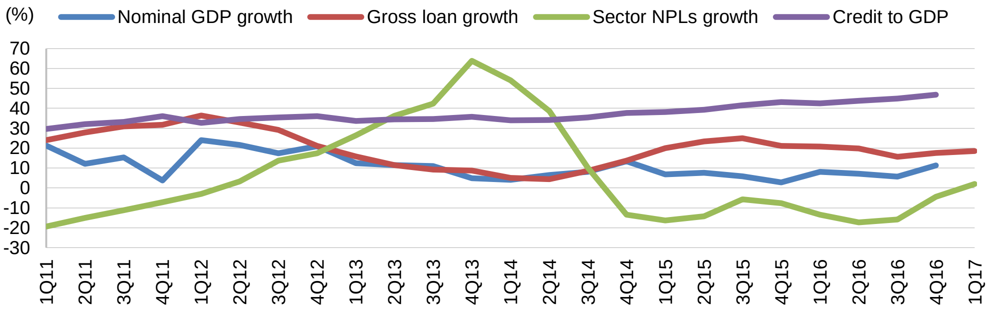
Market Share by Assets and Deposit Sizes at End-2016



Source: Banks; Central Bank of Sri Lanka (CBSL); Banks arranged in descending order of asset size

- Loan growth has been high despite contractionary monetary policy.
- Credit-to-GDP is one of the lowest in the region.

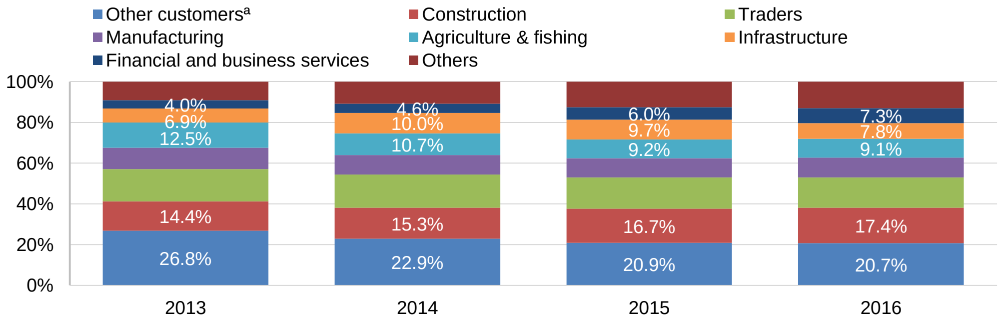
Banking Sector Loan Growth - YoY Trend



Source: Central Bank of Sri Lanka (CBSL), Banks
Nominal GDP for 1Q17 is not available

- Banks have growing exposure to the construction (sub-sector housing) and financial and business services (lending to leasing companies) sectors.
- State banks account for around 75% of the housing exposure.

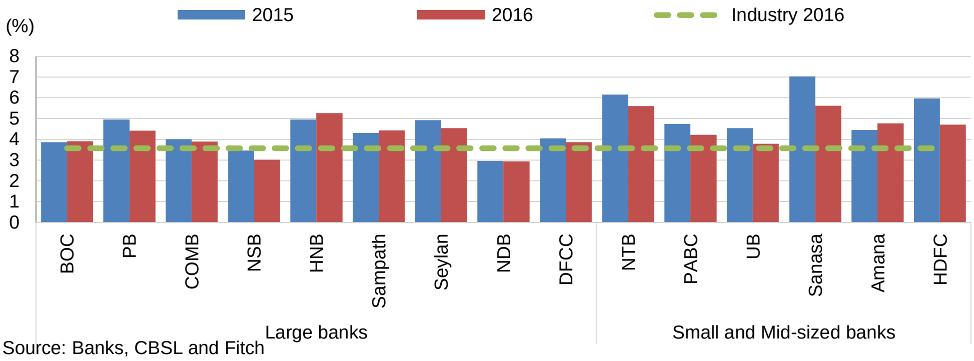
Sri Lankan Banks: Sector-Wise Exposure



[a] Other Customers include pawning, credit card and direct lending to the Government of SL
Source: Banks; Fitch

- NIMs have come under pressure due to increased share of term deposits.
- Yields are supported by growing exposure to the SME and retail segments.

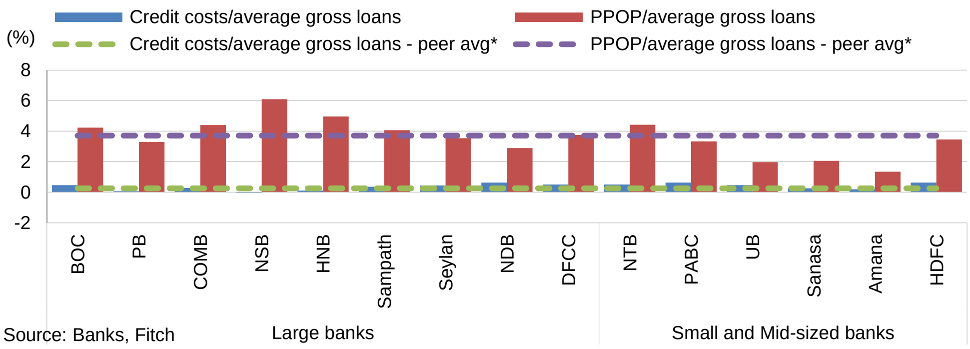
Profitability Indicators - Net Interest Margin (NIM)



Source: Banks, CBSL and Fitch

- Credit costs expected to increase due to asset quality pressures and the implementation of IFRS 9.
- Most banks' pre-provision operating profit (PPOP) buffers are satisfactory.

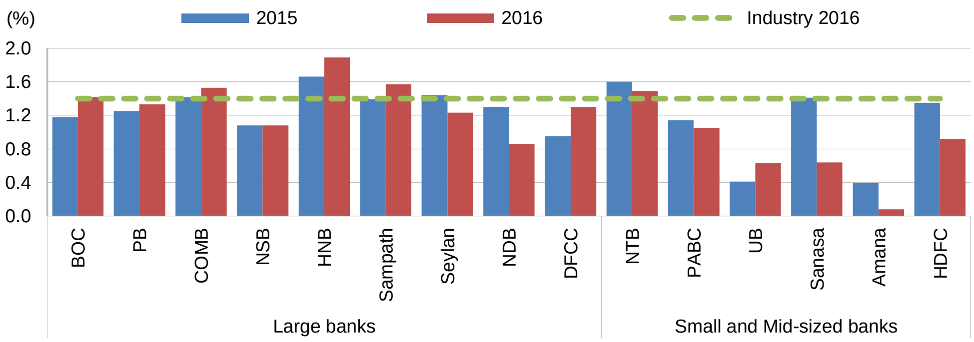
Profitability Indicators - PPOP vs. Credit Costs at End-2016



Source: Banks, Fitch
* Peer average is calculated as the asset weighted average of the 15 banks

- Higher credit costs, weaker NIMs and higher taxes are key challenges amid lower growth.

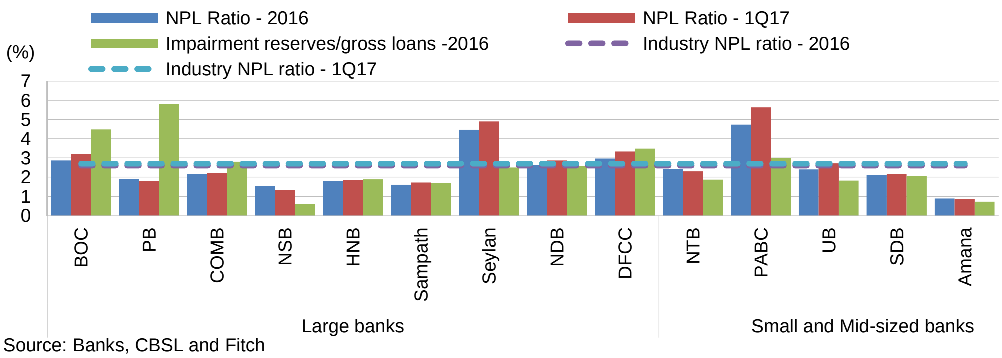
Profitability Indicators - ROA



Source: Banks, CBSL and Fitch

- Pressure on asset quality expected.
- Share of special mentioned NPLs increased from 12.6% in 2015 to 17.4% at end-1Q17.
- Industry NPLs increased 7% during 1Q17.

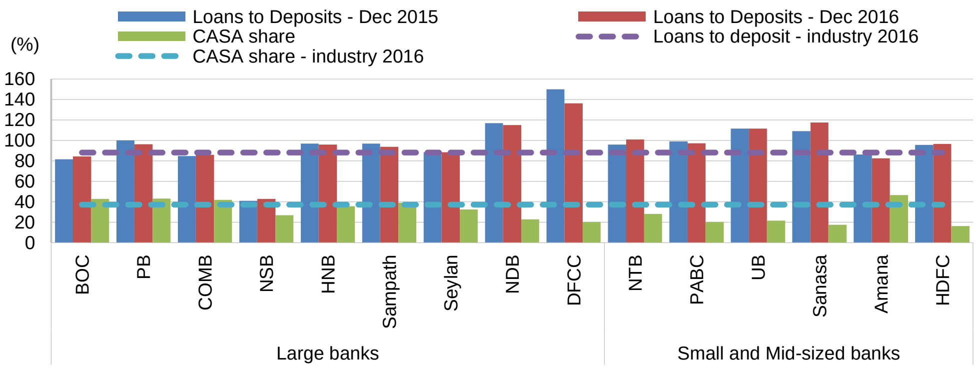
Asset Quality Indicators



Source: Banks, CBSL and Fitch

- The share of current and savings accounts (CASA) in the banks' total deposits declined as term deposits grew sharply.
- Liquidity levels remain stretched as loans-to-deposit ratios increase.

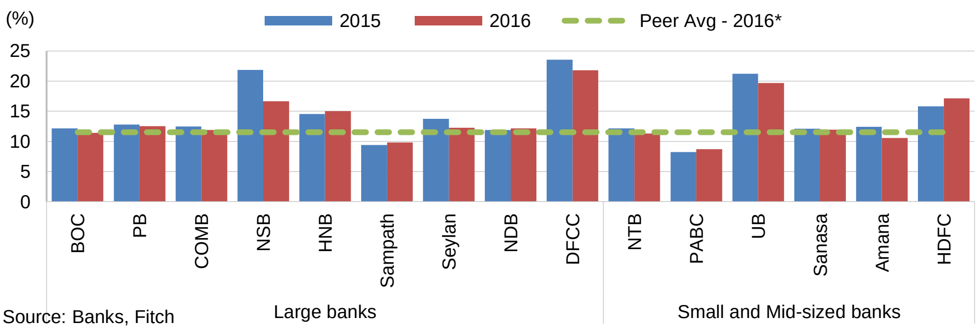
Funding Indicators



Source: Banks, CBSL and Fitch

- Weakening capital buffers across the sector following rapid growth.
- Two of the large banks have already announced capital-raising plans ahead of Basel III implementation.

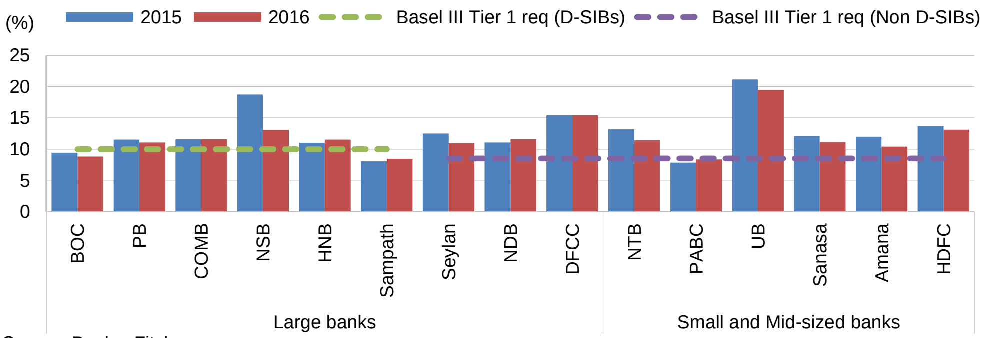
Capitalisation Indicators - Fitch Core Capital Ratio



Source: Banks, Fitch
* Peer average is calculated as the asset weighted average of the 15 banks

- No immediate concerns regarding Basel III compliance which comes into effect on 01.07.2017

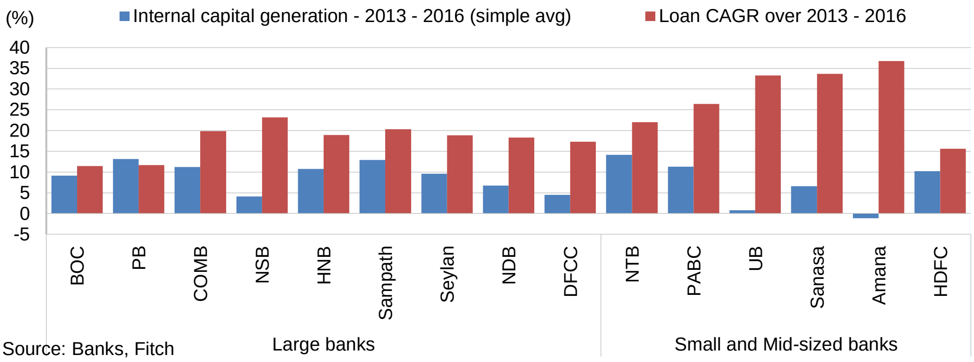
Capitalisation Indicators - Tier 1 Capital Ratio - Group Level



Source: Banks, Fitch

- State banks paid nearly 76% of their total profit for 2016 as dividends.
- Lower cash dividend payout at large private banks have improved earnings retention.

Capitalisation Indicators - Internal Capital Generation vs. Growth



Source: Banks, Fitch

Annex

Issuer Ratings

Issuer	International Ratings	National Ratings
National Savings Bank	B+/Stable	AAA(lka)/Stable
Bank of Ceylon	B+/Stable	AA+(lka)/Stable
People's Bank		AA+(lka)/Stable
Commercial Bank of Ceylon PLC		AA(lka)/Stable
Hatton National Bank PLC		AA-(lka)/Stable
DFCC Bank PLC	B+/Negative	AA-(lka)/Negative
Sampath Bank PLC		A+(lka)/Negative
National Development Bank PLC		A+(lka)/Stable
Nations Trust Bank PLC		A(lka)/Stable
Seylan Bank PLC		A-(lka)/Stable
Housing Development Finance Corporation Bank Of Sri Lanka		BBB(lka)/Stable
Pan Asia Banking Corporation PLC		BBB-(lka)/Stable
Union Bank of Colombo PLC		BB+(lka)/Positive
SANASA Development Bank PLC		BB+(lka)/Stable
Amana Bank PLC		BB(lka)/Stable

Source: Fitch