23 May 2019 | Upgrade

Fitch Upgrades Union & Cargills Banks; Affirms 5 Small & Mid-Sized Sri Lanka Banks

Fitch Ratings-Colombo-23 May 2019: Fitch Ratings Lanka has upgraded the National Long-Term Ratings of Union Bank of Colombo PLC (UB) to 'BBB-(lka)' from 'BB+(lka)' and of Cargills Bank Ltd (CBL) to 'A-(lka)' from 'BB(lka)'. The Outlooks are Stable.

The agency has also affirmed the National Long-Term Ratings of Amana Bank PLC, Nations Trust Bank PLC (NTB), Pan Asia Banking Corporation PLC (PABC), SANASA Development Bank PLC (SDB) and Housing Development Finance Corporation Bank of Sri Lanka (HDFC).

A full list of rating actions is at the end of this commentary.

KEY RATING DRIVERS

NATIONAL RATINGS

The rating actions follow Fitch's periodic review of Sri Lanka's small and mid-sized bank peer group. The agency maintains the negative outlook on Sri Lanka's banking sector, as we expect challenging operating conditions to persist in 2019.

Fitch expects the banks' ratings to be weighed down by their high-risk appetites as they pursue above-sector loan expansion in the medium term, which will pressure their already-thin capital buffers. The ratings also take into account these banks' small franchises.

Fitch expects credit risks to linger in 2019 due to the banks' exposure to the more susceptible customer segments at a time when the country faces domestic and external challenges. The banks' profitability metrics are likely to remain weak owing to high impairment losses and effective taxes. PABC, HDFC, Amana and CBL need to raise equity to meet the enhanced capital requirements by end-2020; capital raising could be more difficult for these banks than for larger peers.

UB

The upgrade of UB's rating reflects its risk profile, which has improved in the previous few years, as indicated by a more diversified loan book, increased profitability and higher-than-average capitalisation. The rating also takes into account the bank's small franchise and still-high exposure to vulnerable customer segments.

The bank's loan composition has become more diversified, with corporate, SME and retail loans accounting for 48%, 33% and 19%, respectively, of total loans at end-2018. Loan growth slowed to 6% in 2018, but we believe loan momentum could re-accelerate in the medium term.

UB's reported gross non-performing loan (NPL) ratio rose to 3.7% in 2018 (2017: 2.7%), with its subsidiary - UB Finance Co. Ltd - which contributes about one-third of group NPLs, remaining a significant drag on group asset quality.

UB's capital position in terms of its Fitch Core Capital ratio of 15.4% at end-2018 is stronger than that of similarly rated peers. We believe UB would be able to sustain comfortable capital buffers and meet regulatory minimum capital requirements with access to capital from major shareholder - Culture Financial Holdings, an affiliate of Texas Pacific Group, has 70% in UB - through the exercise of warrants if required.

UB's profitability metrics improved in 2018, with operating profit/risk-weighted assets rising to 1.5% (2017: 1.1%, 2016: 1.1%, 2015: 0.6%), aided by better net interest margins which helped offset high impairment costs. We expect the improving trend to continue in 2019, albeit slowly, in light of the still-challenging operating environment.

CBL

The multiple-notch upgrade of CBL's rating follows Fitch's assessment of support from its ultimate parent, CT Holdings PLC (CTH), and our expectation that the bank is likely to receive extraordinary support from its ultimate parent, if needed.

Our assessment takes into account operational integration, as seen through the use of Cargills Food City outlets to expand the bank's operations, shared brand name and a capital infusion of LKR5.8 billion by the group in 2016. However, we believe support from the parent could be constrained by the bank's large size, as its assets represent 130% of group equity. Furthermore, the regulator has restricted the parent's voting rights to 30% despite its majority 53% effective stake in CBL.

CTH is a large local conglomerate with businesses in retail and wholesale distribution, fast-moving consumer goods and real estate. The group's leading supermarket chain benefits the bank through the strong 'Cargills' brand and group synergies, with the latter likely to improve over the long term.

CBL's intrinsic financial strength is considerably weaker than the support assessment.

NTB

NTB's ratings reflect its higher-than-peer product concentration, with leasing and credit cards forming 20% and 11%, respectively, of its loan book, and modest franchise, with 2.8% of system assets at end-2018.

NTB's high-risk appetite is characterised by its exposure to the susceptible consumer, retail and SME segments, and sustained strong loan growth of 20% in 2018 (2017: 24%, 2016: 23%). We expect the bank's loan momentum to remain strong in the medium term.

Fitch expects the bank's capitalisation to moderate on rapid loan growth, but for the bank to retain adequate capital buffers commensurate with its risk profile. Profitability, as measured by operating profit/risk-weighted assets, is likely to remain stronger than that of similarly rated peers due to better net interest margins stemming from NTB's exposure to high-margin loans.

PABC

PABC's rating reflects pressure on the bank's capital due to downside risks from asset quality and earnings. The ratings also reflect PABC's high-risk appetite, as seen through its predominant exposure to the retail and SME segments, which accounted for 51% and 33%, respectively, of total loans.

PABC's Fitch Core Capital ratio of 11.4% at end-2018 was one of the lowest in the peer group and is further affected by still-high unprovisioned NPLs relative to peers. The bank's total capital ratio of 13.3% was not much higher than the minimum regulatory requirement of 12.5% for non domestic-systemically important banks. We believe the bank would need to raise at least LKR6.5 billion in equity to meet the regulatory minimum capital requirement of LKR20 billion, as we believe earning retention alone will not be sufficient.

PABC's asset quality remains weaker than that of peers, with a reported gross NPL ratio of 5.4% at end-2018, reflecting its predominant exposure to vulnerable segments.

SDB

SDB's rating reflects its weak capital buffers, high-risk appetite and small franchise.

Fitch believes it would be challenging for the bank to maintain adequate capital buffers that are commensurate with its risk appetite in light of its weak profitability and in the absence of sufficient capital infusions. The bank aims to maintain strong loan expansion in the medium-term after a rapid 24% CAGR over 2014-2018.

SDB's Tier 1 and total capital ratios declined to 11.0% and 12.5%, respectively, by end-2018. The planned Basel III-compliant local-currency subordinated debt worth an equivalent USD10 million should help relieve short-term pressure on the bank's total capital ratio, which was at the regulatory minimum.

SDB's profitability, as measured by operating profit/risk-weighted assets, has weakened in the last three years (2018: 1.7%, 2017: 1.9%, 2016: 2.0%), burdened by rising credit costs and a high operating-cost structure.

SDB's reported gross NPL ratio increased to 2.6% in 2018, from 2.1% in 2017, but remains better than that of most similarly rated peers. Nevertheless, the bank's increased appetite for large ticket-size SME lending could pose asset-quality risk if the weak operating conditions are prolonged.

HDFC
HDFC's rating reflects the bank's high-risk appetite, limited access to capital markets and weaker-than-average asset quality and profitability owing to its large exposure to low- and middle-income customers, who are susceptible to economic and interest-rate cycles.

HDFC's Fitch Core Capital ratio improved to 18.9% in 2018, helped by capital retention. Nevertheless, we regard the bank's capitalisation profile as weak in light of its substantial unprovisioned NPLs and limited capital market access. We believe the bank will need to raise around LKR2.7 billion to meet the LKR7.5 billion enhanced minimum capital requirement by end-2020.

Amana
Amana's rating reflects its small and developing franchise and high-risk appetite that stems from its focus on the SME and retail segments, which collectively formed 70% of gross advances at end-2018. Amana, which constituted 0.7% of system assets at end-2018 (2017: 0.6%), is Sri Lanka's only fully Sharia-compliant bank. The Positive Outlook on Amana's rating reflects our expectation of continued improvement in its profitability and capitalisation metrics.

We expect Amana's profitability as measured by operating profit/risk-weighted assets, to be supported by its strong net interest margin due to its high share of current and savings accounts in its deposit base (2018: 41% of deposits).

Amana's capitalisation remains healthy, with a Fitch Core Capital ratio of 19% at end-2018 (2017:

22%) following a capital infusion in 2017. We estimate that the bank would require another equity infusion of around LKR8 billion to meet the minimum regulatory capital requirement by end-2020.

DEBT RATINGS

NTB's Basel II Sri Lanka rupee-denominated subordinated debentures and Basel III-compliant Tier 2 Sri Lanka rupee-denominated subordinated debentures are rated one notch below the bank's National Long-Term Rating to reflect their subordinated status and higher loss-severity risks relative to senior unsecured instruments. The Basel III-compliant debentures would convert to equity upon the occurrence of a trigger event, as determined by the Monetary Board of Sri Lanka.

PABC and HDFC's senior debentures carry the same rating as their National Long-Term Ratings, as they rank equally with their other unsecured obligations.

PABC's Basel II Sri Lanka rupee-denominated subordinated debentures are rated one notch below its National Long-Term Rating to reflect the notes' subordination to senior unsecured creditors.

RATING SENSITIVITIES

NATIONAL RATINGS

UB

Capital impairment risk, stemming from sustained rapid loan expansion and asset-quality deterioration, could pressure UB's rating. We do not see any near-term upside to the rating given downside risks to capitalisation, asset quality and profitability.

CBL

CBL's rating is sensitive to changes in CTH's credit profile. CBL's rating is also sensitive to a change in Fitch's opinion around the ability or propensity of CTH to extend extraordinary support in a timely manner. CBL's rating could be downgraded if growth of the bank's balance sheet significantly exceeds that of CTH, which has the effect of diminishing the parent's ability to provide support. A significant dilution of CTH's ownership that reduces the parent's propensity to provide support to the bank could also trigger a negative rating action.

NTB

Increased capital impairment risk through sustained rapid loan expansion or asset-quality deterioration could result in a downgrade of NTB's rating. An upgrade is contingent on lower product concentration, higher capitalisation and a more stable funding profile, alongside progress in building a stronger franchise.

PABC

PABC's rating would be downgraded if loss-absorption buffers were to deteriorate, either through a greater share of unprovisioned NPLs, aggressive loan growth or weaker earnings. We do not see any near-term upside for PABC's rating, as the bank may face difficulty in sustaining adequate capital buffers.

SDB

SDB's rating could be downgraded if there is a continued deterioration in capitalisation, either through aggressive loan growth or greater unprovisioned NPLs. An upgrade would be contingent on sustaining better capital buffers, moderation of risk appetite and sustainable asset quality and profitability improvements.

HDFC

HDFC's rating could be downgraded if capitalisation were to deteriorate for a sustained period, either through aggressive loan growth or higher unprovisioned NPLs. An upgrade would be contingent on moderation of risk appetite and a sustained improvement in asset quality and profitability.

Amana

Sustained improvement in Amana's financial profile, characterised by better profitability and capitalisation, alongside an enhanced franchise, could lead to an upgrade of the bank's National Long-Term Rating. Increased risk appetite, such as through excessive growth that deteriorates loss-absorption buffers, could put downward pressure on the rating.

DEBT RATINGS

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

The rating actions are as follows:

Union Bank of Colombo PLC

National Long-Term Rating upgraded to 'BBB-(lka)' from 'BB+(lka)'; Outlook Stable

Cargills Bank Ltd

National Long-Term Rating upgraded to 'A-(lka)' from 'BB(lka)'; Outlook Stable

Nations Trust Bank PLC

National Long-Term Rating affirmed at 'A(lka)'; Outlook Stable

Basel II-compliant subordinated debentures affirmed at 'A-(lka)'

Basel III-compliant subordinated debentures affirmed at 'A-(lka)'
Proposed Basel III-compliant subordinated debentures affirmed at 'A-(lka)(EXP)'

Pan Asia Banking Corporation PLC
National Long-Term Rating affirmed at 'BBB-(lka)'; Outlook Stable
Senior debenture rating affirmed at 'BBB-(lka)'
Basel II-compliant subordinated debenture rating affirmed at 'BB+(lka)'

SANASA Development Bank PLC
National Long-Term Rating affirmed at 'BB+(lka)'; Outlook Stable

Housing Development Finance Corporation Bank of Sri Lanka
National Long-Term Rating affirmed at 'BB+(lka)'; Outlook Stable
Senior debenture rating affirmed at 'BB+(lka)

Amana Bank PLC
National Long-Term Rating affirmed at 'BB(lka)'; Outlook Positive

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Applicable Criteria

[Bank Rating Criteria (pub. 12 Oct 2018)]
[National Scale Ratings Criteria (pub. 18 Jul 2018)]

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