

Thin Capital Buffers Amid High Risk Appetite Exert Pressure on Sri Lanka's SMBs

Fitch Ratings assesses the ratings of Sri Lanka's small and mid-sized banks (SMBs) as driven mainly by their high risk appetite and modest loss-absorption buffers. Other features are a small franchise, as reflected in a combined market share of 7% of total assets at end-2018 compared with 82% for the nine larger Fitch-rated banks in the country.

Ratings on NTB, PABC, UB, SDB, HDFC and Amana reflect their standalone strength, while CBL's rating captures Fitch's expectation of extraordinary support from its ultimate parent.

Fitch reviewed the ratings of seven Sri Lankan SMBs on 23 May 2019 (please see [Fitch Upgrades Union & Cargills Banks; Affirms 5 Small & Mid-Sized Sri Lanka Banks](#))

What to Watch

Thin Capital Buffers: SMBs' capital buffers are likely to remain thin from aggressive loan growth, muted earnings and lingering credit risks. The median Fitch Core Capital ratio has remained higher than that of larger rated banks, although we view capital buffers as not being commensurate with the high risk appetite. Capital-raising is likely to continue across most SMBs. PABC, HDFC, Amana and CBL need to raise equity capital to meet enhanced regulatory capital requirements by end-2020.

Higher Risk Appetite: SMBs' predominant exposure is to the retail and SME segments, which we believe are more vulnerable to economic cycles. Loan growth at these banks has also been above the sector average, which could continue in the medium term as they pursue scale.

High Asset-Quality Risks: SMBs' relatively high risk appetite, against a backdrop of a more challenging operating environment, exposes these banks to greater asset-quality pressure than their larger counterparts. SMBs' median impaired loans/gross loan ratio (based on SLFRS 9 stage 2 loans) of 7.4% was significantly higher than 3.4% for the larger banks' at end-2018.

Pressure on Operating Profit: SMBs' profitability is likely to remain subdued in the medium term, similar to the banking sector, due to rising credit costs. SMBs' lower median risk-adjusted profitability ratio than that of the larger banks reflects SMBs' higher operating cost structures.

Weaker Funding and Liquidity Profile: SMBs' relatively weak deposit franchises exert pressure on their funding and liquidity profiles. SMBs' median loan/deposit ratio is likely to remain higher versus the larger banks, while their share of CASA remains low at 18.3%.



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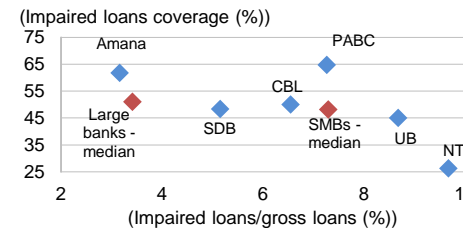
Rated Small and Mid-Sized Banks

| Bank | Rating | Outlook |
|-------|-----------|----------|
| NTB | A(Ika) | Stable |
| CBL | A-(Ika) | Stable |
| PABC | BBB-(Ika) | Stable |
| UB | BBB-(Ika) | Stable |
| SDB | BB+(Ika) | Stable |
| HDFC | BB+(Ika) | Stable |
| Amana | BB(Ika) | Positive |

Source: Fitch Ratings, Fitch Solutions

Asset Quality

Based on SLFRS 9: by end-2018

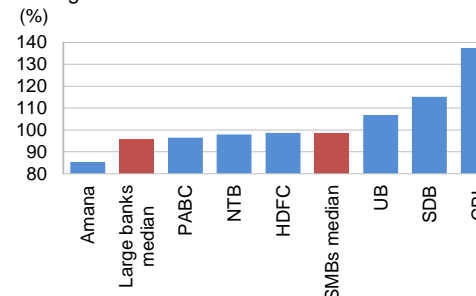


Note: HDFC's impaired loan ratio of 24% and loan coverage ratio of 10% are not shown as the ratios exceed the chart scale

Source: Fitch Ratings, Fitch Solutions, Banks

Loan/Deposit Ratio

Average 2015 - 2018

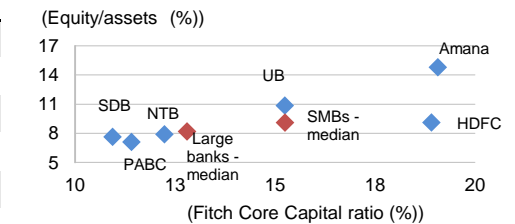


Source: Fitch Ratings, Fitch Solutions, Banks

(Fitch-rated larger banks include Bank of Ceylon, People's Bank, National Savings Bank, Commercial Bank of Ceylon PLC, Hatton National Bank PLC, Sampath Bank PLC, Seylan Bank PLC, DFCC Bank PLC and National Development Bank PLC)

Capitalisation and Leverage

By end-2018

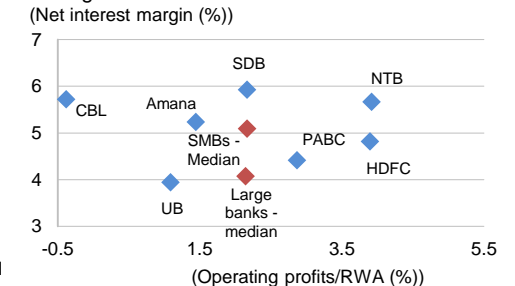


Note: CBL's FCC ratio of 31.6% and Equity/Assets ratio of 31.5% are not shown as those ratios exceed the chart scale

Source: Fitch Ratings, Fitch Solutions, Banks

Profitability

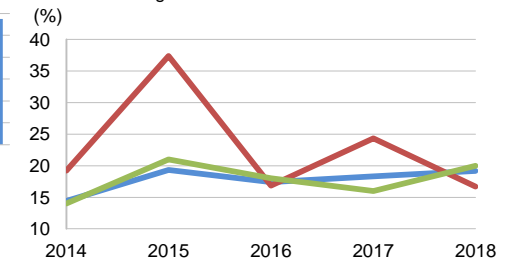
Average 2015 - 2018



Source: Fitch Ratings, Fitch Solutions, Banks

Loan Growth

Average 2015 - 2018



Source: Fitch Ratings, Fitch Solutions, Banks

(Fitch-rated larger banks include Bank of Ceylon, People's Bank, National Savings Bank, Commercial Bank of Ceylon PLC, Hatton National Bank PLC, Sampath Bank PLC, Seylan Bank PLC, DFCC Bank PLC and National Development Bank PLC)

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