

Difficult Operating Conditions Continue to Stifle Sri Lankan Banks' Performance in 2019

Operating Environment Key: Fitch Ratings' expectation of continued pressure on banks' financial profiles due to the challenging operating environment – as reflected in our negative outlook on the sector – is being borne out in their results. Heightened risks, largely on the macro front, are being manifested in the form of a sharp rise in non-performing loans (NPLs). The operating environment is of high importance to the ratings of Sri Lankan banks, and acts as a constraint on the Viability Ratings of some banks.

Slower Loan Growth: Our expectation is for loan growth to decelerate in 2019 (down by 0.4% in 1Q19) on muted private-sector credit demand. Loan growth remained subdued through 9M18 at 13%, but closed at 19.6% for 2018, due largely to increased state borrowings. Three large state banks contributed about half of the incremental lending in 2018 (2017: 42%).

NPLs Rising: We expect asset-quality pressures to linger in 2019, as seen in the increasing share of restructured loans across Fitch-rated banks. Sector NPLs grew by 64% in 2018 – the sharpest increase since the pawning debacle in 2013 – driving the sector NPL ratio to 3.4% (2017: 2.5%). This trend continued in 1Q19, with the sector NPL ratio rising further to 4.2% broadly in line with our expectations for 2019. The adoption of SLFRS 9 saw loan-loss allowances/gross loans increase to 3.7% (2017: 3%).

Profits Subdued: Pressure on profitability is likely to remain in 2019 from rising credit costs, with SLFRS 9 implementation and weaker asset quality. In addition, the debt-recovery levy imposed in late 2018 should push effective tax rates for the Fitch-rated banks even higher (2018: 49%, 2017: 44%), squeezing profits further. Sector net profit declined by 9% in 2018 (the first time since 2013) as impairment charges more than doubled. This trend continued into 1Q19, with sector ROA declining from 1.1% in 2018 to 0.9%, lower than our expectations.

Ongoing Capitalisation Pressures: Weaker earnings and asset-quality stress will add to capitalisation pressures despite the capital injections made ahead of Basel III implementation. Capital-raising plans could face execution risks, with recent rights issues of banks being significantly undersubscribed.

Tighter Liquidity; Stable Funding: The loans/deposits ratio edged up to 91% during 2018 but dipped marginally to 89% in 1Q19 as loans contracted. The funding profiles of banks are fairly stable as deposits remain the main source of funding (2018: 84% of funding).



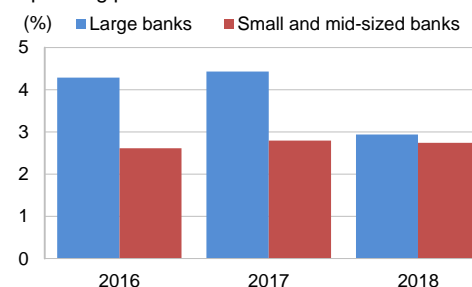
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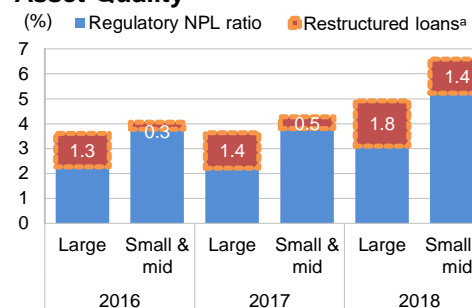
Earnings & Profitability

Operating profits/RWA



Source: Fitch Ratings, Banks

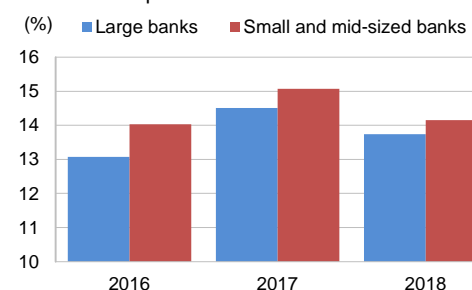
Asset Quality



^a As a % of gross loans
Source: Fitch Ratings, Banks

Capitalisation

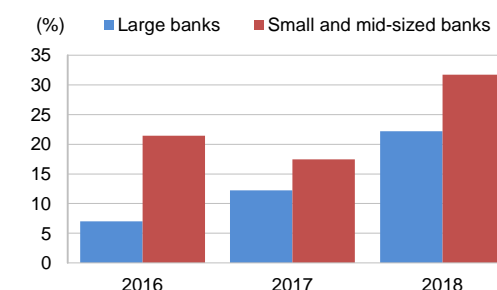
Fitch Core Capital ratio



Source: Fitch Ratings, Banks

Earnings & Profitability

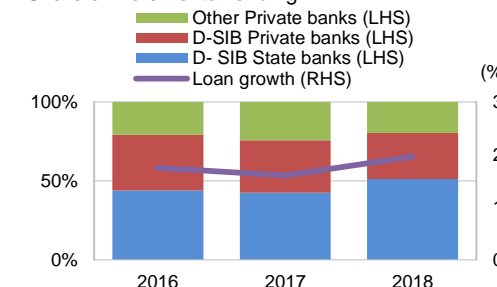
Credit costs/PPOP



Source: Fitch Ratings, Banks

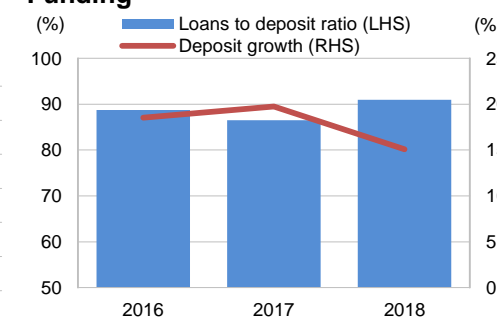
Loan Growth

Share of incremental lending



Source: Fitch Ratings, Banks

Funding



Source: Fitch Ratings, Banks

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