



## **Fitch Revises Amana Outlook to Positive; Affirms Five Small and Mid-Sized Sri Lankan Banks**

Fitch Ratings-Colombo-26 June 2018: Fitch Ratings Lanka has revised the Outlook on Amana Bank PLC to Positive from Stable and has affirmed its National Long-Term Rating at 'BB(lka)'. The agency has also affirmed the National Long-Term Rating of Union Bank of Colombo PLC (UB) with a Positive Outlook and the National Long-Term Ratings of Nations Trust Bank PLC (NTB), Pan Asia Banking Corporation PLC (PABC) and SANASA Development Bank PLC (SDB) with a Stable Outlook. 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 has maintained the negative outlook on Sri Lanka's banking sector, as we expect challenging operating conditions to persist in 2H18.

Fitch expects capital raising to remain difficult for small- and mid-sized banks, which are required to meet the higher minimum capital requirement of LKR20 billion by end-2020. Towards this end, PABC and Amana will need to almost double their capital bases, despite already raising capital in 2017. Profitability headwinds are likely to persist in 2018 due to higher credit costs with the implementation of SLFRS 9, weaker asset quality and lower pre-provision buffers relative to larger peers.

The Outlook revision on Amana takes into account our expectation that the bank will continue to improve its financial profile on better profitability metrics and enhanced capital position arising from future capital raising. The bank's rating reflects its small and developing franchise and high-risk appetite that stems from its focus on SME and retail segments, which accounted for 74% of gross loans at end-2017. Amana began operations in 2011 and accounted for 0.6% of banking-sector assets at end-March 2018. It is Sri Lanka's only fully Sharia-compliant bank.

Amana's profitability metrics have consistently improved since the bank became profitable in August 2014, with the exception of 2016, when it was affected by a one-off impairment loss on an equity investment. Its operating profit/risk-weighted assets ratio rose to 2.5% in 1Q18 (2017: 2.1%, 2016: 0.6%) and we see room for further improvement as lending volume increases. This should help offset potentially higher credit costs. The bank's net interest margin (NIM) is the highest among its peer group due to its high share of low-cost current account saving accounts (46% of deposits), which has been sustained despite rising deposit rates.

Amana's capital ratios improved in 2017 following a rights issue that doubled its capital base to LKR10 billion. We expect the bank's Fitch Core Capital (FCC) ratio to moderate to 15%-16% in the medium term, from 21% at end-1Q18, owing to balance sheet growth, but to still remain higher than that of most peers. The bank's capital ratios are well above the regulatory requirements for non-domestic systemically important banks (D-SIB) under Basel III.

Increased defaults from the SME segment amid difficult operating conditions and the seasoning of its loan book saw Amana's asset quality metrics deteriorate through 2017, in line with our expectations for the bank as well as the industry. We believe asset quality pressures are likely to persist, but the risk stemming from increasing non-performing loans (NPL) should be somewhat offset by the bank's enhanced capital buffers following further capital infusions.

UB's rating reflects its higher capitalisation, improving risk profile in terms of a more diversified loan book, but lower profitability relative to higher-rated peers. Fitch expects UB to maintain a more diversified loan book than in the past; corporate, SME and retail loans accounted for 46%, 35% and 19%, respectively, of loans at end-2017. Exposure to the more profitable retail and SME segments could increase in the medium-term, similarly to the trend across peers.

UB has sustained above-industry growth, with loans expanding by 26% in 2017. Fitch expects loan expansion to remain high in the medium-term and believes it could offset enhancements to risk management and pressure asset quality if not managed.

The bank's asset quality is likely to see some pressure through 2018, similar to our expectations for the sector amid a challenging operating environment. UB's reported gross NPL ratio rose to 3.0% at end-March 2018, from 2.7% at end-2017, similar to industry trends. NPLs from its subsidiary, UB Finance Co. Ltd, accounted for 30% of group NPLs and remain a significant drag on group asset quality. Notwithstanding this, Fitch does not expect a significant deviation in UB's asset quality metrics relative to similarly rated peers.

UB's capital position remains stronger than most similarly rated peers. Its Tier 1 and total capital adequacy ratios of 19.3% at end-March 2018 are higher than the 8.5% and 12.5%, respectively, of the end-point minimum regulatory requirement for non-D-SIBs. Fitch believes the bank's stronger capitalisation somewhat compensates for its low reserve coverage of impaired loans.

UB's profitability metrics remains lower than those of similarly rated peers, despite rapid loan expansion. Its increased focus on NIM could support better profitability. The bank's cost/income ratio remains high, but has decreased and we expect this trend to continue as scale efficiencies continue to accrue.

NTB is a mid-sized licensed commercial bank with a modest franchise, accounting for 2.7% of banking-sector assets at end-March 2018. Its ratings reflect its higher-than-peer product concentration, with leasing and credit cards forming 20% and 10%, respectively, of its loan book at end-March 2018, and slight increase in capitalisation. NTB's exposure to the SME segment had risen to 30% by end-March 2018 and Fitch expects the bank to remain largely exposed to the consumer, retail and SME segments in the short to medium term.

NTB's Tier 1 and total capital adequacy ratios of 12.4% and 15.1%, respectively, at end-March 2018 (2017: 10.8% and 13.9%) are above 8.5% and 12.5% end-point minimum regulatory requirement for non D-SIBs. The rights issue of LKR3.2 billion in 1Q18 arrested the decline in NTB's capitalisation.

NTB paid 2017 dividends entirely in the form of scrip, which also supported its capitalisation. Its core capital base is above the minimum LKR20 billion capital requirement for licensed commercial banks applicable from end-2020, in contrast to its small and mid-sized peers. Fitch expects the bank's capitalisation to moderate on rapid loan growth, but for it to retain adequate capital buffers commensurate with its risk profile.

NTB sustained a strong 24.5% increase in loans in 2017, against 16.1% for the sector. Fitch expects loan expansion to remain above the sector in the medium term. The bank's reported gross NPL ratio rose to 2.6% at end-March 2018, from 2.3% at end-2017, mainly due to weakness in consumer and SME loans. This is likely to persist in the short to medium term.

NTB's profitability, as measured by operating profit/risk-weighted assets, is likely to remain stronger than that of peers, supported by better NIMs and improving cost efficiency that should offset higher credit costs stemming from asset-quality pressure and the implementation of SLFRS 9.

PABC's rating reflects potential pressure on the bank's improved capital position from its still-weak asset quality and higher share of unprovisioned NPLs relative to better-rated peers. The bank's Tier 1 ratio improved to 11.4% at end-2017, from 8.4% in 2016, following its LKR2.1 billion rights issue in early 2017, but remains the lowest among this peer group. The rating also reflects earnings pressure from higher impairment charges, both from deteriorating asset quality and SLFRS 9 implementation.

We expect further capital raising to meet regulatory minimum capital requirements. Fitch believes higher capital buffers are warranted, given the bank's higher risk appetite, as seen

through its predominant exposure to retail and SME segments, which, in our view, are susceptible to deteriorating economic conditions.

PABC's asset quality metrics are likely to remain under pressure in 2018 due to difficult operating conditions, which could limit the repayment capacity of the bank's key borrowing segments. Therefore, we do not expect a marked improvement in its NPL ratio, despite focused recovery efforts. PABC's asset quality metrics remain weaker than those of peers, with a reported gross NPL ratio of 4.4% at end-March 2018. This stems from the bank's predominant exposure to retail and SMEs.

SDB's rating captures its high-risk appetite in light of the bank's significant exposure to retail, lower-end SMEs and cooperative segments, which are susceptible to economic and interest-rate cycles. The rating also captures potential pressure on SDB's capitalisation due to the bank's aggressive growth expectation, which compels regular capital infusions to maintain adequate capital buffers commensurate with its risk profile.

The improvement in SDB's FCC ratio to 12.6% at end-2017, from 11.9% at end-2016, was attributable to capital infusions by three strategic investors totalling LKR1.5 billion and better earning retention through scrip dividends. Nevertheless, SDB's FCC ratio declined to 12.2% at end-March 2018 alongside moderate loan growth.

SDB's credit standards have been improved since 2H17, supported through the implementation of systems and processes; the results of which should become visible in the medium term. Nevertheless, SDB's reported gross NPL ratio increased to 2.4% at end-March 2018, from 2.1% at end-2017, due to the seasoning of loans. SDB's loans have expanded rapidly over last several years.

#### DEBT RATINGS

NTB's Basel II Sri Lanka rupee-denominated subordinated debentures and Basel III compliant Tier II Sri Lanka rupee-denominated subordinated debentures are rated one notch below the bank's National Long-Term Rating to reflect their subordinated status relative to senior unsecured creditors. The Basel III compliant debentures contain a non-viability trigger upon the occurrence of a trigger event, as determined by the Monetary Board of Sri Lanka.

PABC's senior debentures carry the same rating as its National Long-Term Rating, as they rank equally with its other unsecured obligations.

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

#### RATING SENSITIVITIES

##### NATIONAL RATINGS

Sustained improvement in Amana's financial profile, characterised by a sustained period of better profitability relative to higher-rated peers, alongside an enhanced franchise, could lead to an upgrade of the bank's National Long-Term Rating. An increase in risk appetite, such as excessive growth above management's forecasts, leading to deterioration in loss-absorption buffers, could put downward pressure on the rating.

UB's rating could be upgraded if the bank is able to manage risks from continued high loan expansion without undermining its capital position and asset quality. Improvement in its financial profile in terms of its profitability could also support an upgrade. Capital impairment risk, stemming from sustained rapid loan expansion and asset-quality deterioration could pressure UB's rating.

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

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

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 moderation of its risk appetite and sustainable asset quality and profitability improvements.

#### DEBT RATINGS

Subordinated debt ratings will move in tandem with NTB and PABC's National Long-Term Ratings. Senior debt ratings will move in tandem with PABC's National Long-Term Rating.

The rating actions are as follows:

##### Amana Bank PLC

National Long-Term Rating affirmed at 'BB(lka)'; Outlook revised to Positive from Stable

##### Union Bank of Colombo PLC

National Long-Term Rating affirmed at 'BB+(lka)'; Positive Outlook

##### Nations Trust Bank PLC

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

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

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

##### Pan Asia Banking Corporation PLC

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

Senior debenture rating affirmed at 'BBB-(lka)'

Subordinated debenture rating affirmed at 'BB+(lka)'

##### SANASA Development Bank PLC

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

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Applicable Criteria

Bank Rating Criteria (pub. 22 Jun 2018)

National Scale Ratings Criteria (pub. 07 Mar 2017)

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