

# Operating Environment for Sri Lankan Banks Deteriorates

## Banks' Ratings Under Pressure as Operating Conditions Weaken

### Implied Operating Environment Score

GDP per capita (USD 000)	Ease of doing business (percentile rank)				
	>85	70-85	55-70	40-55	<40
>45	aa	aa	a	a	bbb
35-45	aa	a	a	bbb	bb
15-35	a	bbb	bbb	bb	b
6-15	bbb	bb	bb	b	b
<6	bb	b	b	b (Sri Lanka)	b

Source: Fitch Ratings

### Related Research

[Coronavirus Compounds Sri Lankan Banks' Stresses \(June 2020\)](#)

[Coronavirus Pandemic Pressures Sri Lankan Banks' Ratings \(May 2020\)](#)

[APAC Banking Outlooks Negative as Coronavirus Heightens Risks \(March 2020\)](#)

[Fitch Revises Outlook on 5 Banks, 1 NBFI in Sri Lanka to Negative; Downgrades PLC; Affirms HNB \(January 2020\)](#)

[Fitch Revises Outlook on Sri Lanka to Negative; Affirms at 'B' \(December 2019\)](#)

[Fitch Ratings 2020 Outlook: Asia-Pacific Emerging Market Banks \(December 2019\)](#)

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### Negative Operating Environment Outlook

Fitch Ratings revised down the operating environment (OE) score for Sri Lankan banks to 'b-' from 'b' in May 2020 after the sovereign rating was downgraded to 'B-' in April 2020. The Outlook on Sri Lanka's Long-Term Issuer Default Rating (IDR) is Negative, as is the outlook on the OE score.

The change in the OE score followed a revision in the outlook on the score to negative from stable in January 2020, which came on the heels of a revision in the Outlook on Sri Lanka's 'B' sovereign rating to Negative from Stable in December 2019.

### OE Score Constrained by Sovereign Rating

These actions show that the OE score for banks is usually constrained by the sovereign rating. The OE score change also reflects Fitch's assessment that the risk of doing business in Sri Lanka could rise in the medium term. The current OE assessment factors in the pressure arising from the coronavirus pandemic and the possibility of further risk if the pandemic worsens or lingers.

The assigned OE score is consistent with the implied score for Sri Lankan banks, which is at the lower end of the 'b' range. This reflects a GDP per capita of around USD4,000 and a 48.2 percentile ranking under the World Bank's Ease of Doing Business index for 2019.

Fitch also considers qualitative aspects when assigning the OE score, such as the sovereign rating, macroeconomic stability, size and structure of the economy, economic performance, the level and growth of credit, financial market development, regulatory and legal framework and international operations.

Fitch's Macro Prudential Risk Indicator (MPI) of 2 for Sri Lanka indicates that there is moderate vulnerability to potential stress in the banking system and the broader economy.

### Ratings Also on Negative Outlook

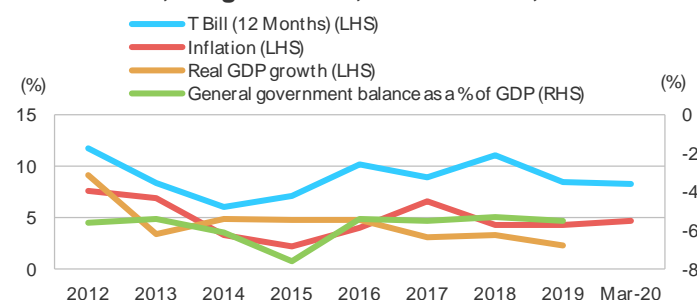
The ratings of the Sri Lankan banks are also on a negative outlook, reflecting the sovereign rating outlook for those that are support-driven and the negative outlook of the OE and some financial profile factors for those that are driven by their standalone profiles.

The OE for Sri Lankan banks has a high influence on the banks' ratings, as it is likely to constrain their intrinsic credit profiles through its effect on financial and non-financial key rating factors, despite regulatory reliefs.

## OE Score Linked to Sovereign Rating

Fitch believes that there is a strong link between the sovereign credit profile and the operating conditions for banks in Sri Lanka. This is because our forecast 1.3% GDP contraction in 2020 will constrain the banks' growth and recovery prospects and the increased risk of sovereign debt distress will limit banks' access to and cost of foreign funding.

### GDP Growth, Budget Deficits, Interest Rates, Inflation



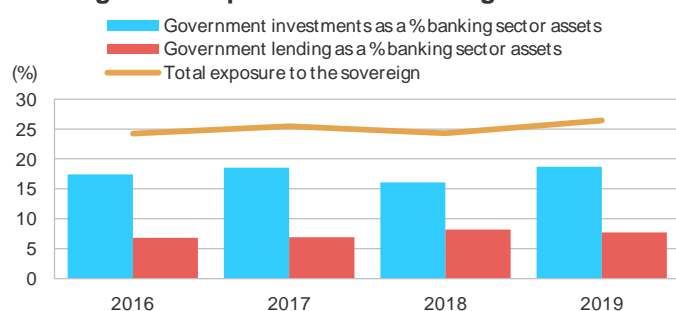
Source: Fitch Ratings, Central Bank of Sri Lanka

### Banks Have Direct Sovereign Exposure

Sri Lankan commercial banks also have significant exposure to the state mostly through investments in government securities. Total exposure was over 25% at end-2019. This underscores our view that it is unlikely that a domestic bank would be rated above the sovereign rating.

We believe that should the sovereign credit profile deteriorate further, the operating environment will also worsen, including weakening of public- and private-sector balance sheets, funding market dislocations and macroeconomic volatility

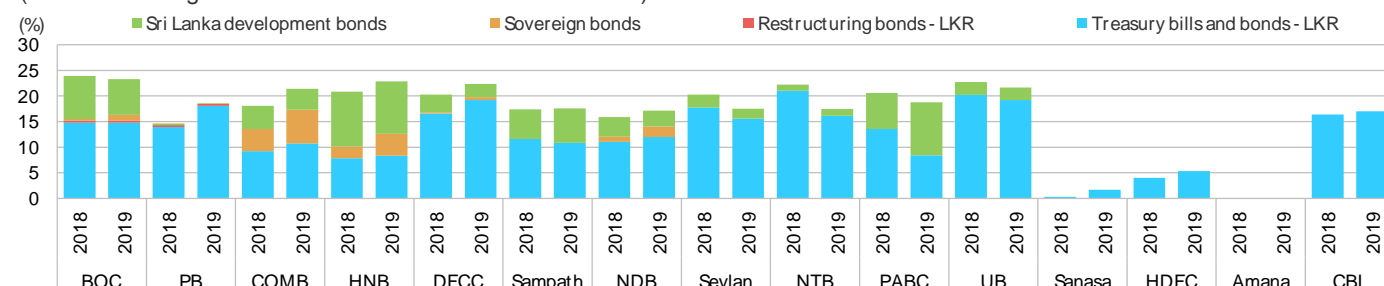
### Banking Sector Exposure to the Sovereign



Source: Fitch Ratings, Central Bank of Sri Lanka

### Banks' Exposure to Government

(Investments in government securities as a % of total assets)

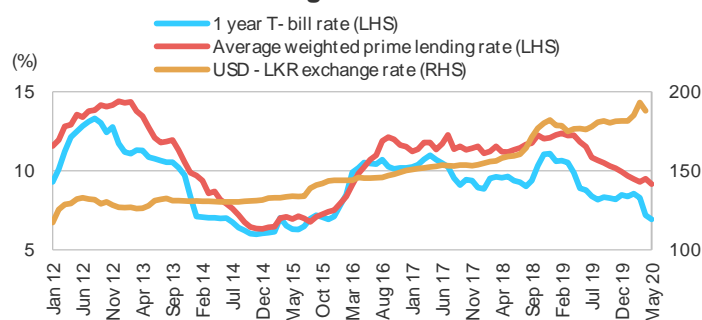


Source: Fitch Ratings, Banks

## Economy Vulnerable to Shocks

Fitch believes that the Sri Lankan economy is more susceptible to negative shocks after having previously experienced significant volatility in economic variables, such as interest rates and exchange rates in times of stress.

### Interest Rate and Exchange Rate Movement

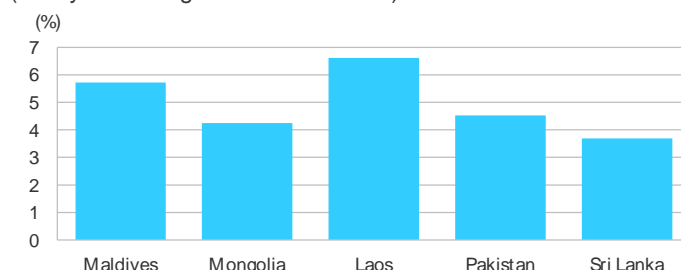


Source: Fitch Ratings, Central Bank of Sri Lanka

Sri Lanka's five-year average real GDP growth is below the median for 'B' rated countries. The economy grew by 2.3% in 2019, slower than the 3.2% in 2018, mainly due to weak growth in the services sector after the April 2019 Easter attacks. Private-sector credit, which grew by 16% in 2018, expanded by only 3.9% in 2019.

### Real GDP Growth

(Five-year average over 2015 - 2019)



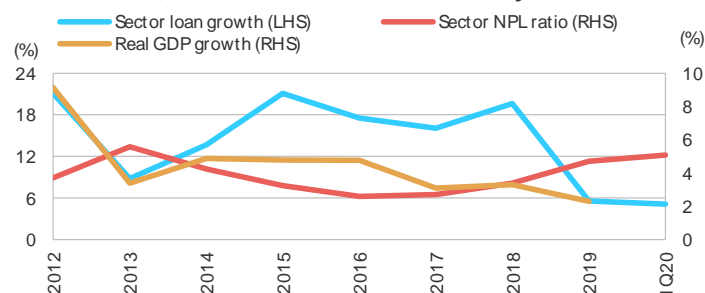
Source: Fitch Ratings

### Lending, Asset Quality Affected by Economic Slowdown

As a result, lending by Sri Lankan banks has grown more slowly and asset quality has deteriorated. Loan growth picked up in the last quarter of 2019 to 5.6%, after a contraction in the first half of 2019, but remained below the 17.5% average over 2015-2018. Loan growth was 5.1% in the first quarter of 2020, but we expect loan growth in the rest of 2020 to be muted due to the pandemic.

The sector's non-performing loan (NPL) ratio continued to rise rapidly and reached 4.7% by end-2019 and 5.1% by end-March 2020. We expect the accumulation of potential credit stress, even though the banks are likely to report a lower stock of NPLs and Stage 3 loans in the near term than might otherwise have been the case due to relief measures.

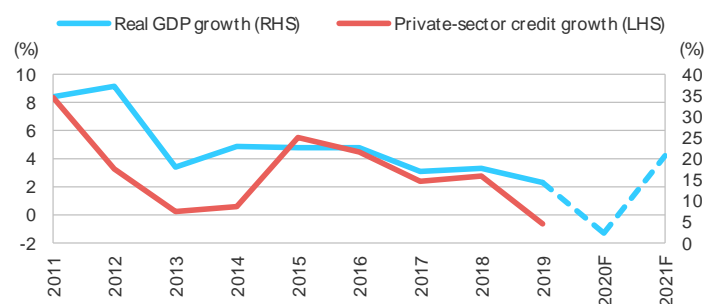
### GDP Growth, Loan Growth and Asset Quality



Source: Fitch Ratings, Central Bank of Sri Lanka

Fitch forecasts real GDP to contract by 1.3% in 2020, reversing from growth of 2.3% in 2019, due to the pandemic and related containment measures. We forecast real GDP growth of 4.2% for Sri Lanka in 2021, assuming a gradual recovery in tourism receipts beginning in late 2020. However, growth prospects will depend in part on how the pandemic develops in Sri Lanka and globally.

### Real GDP Growth and Private-Sector Credit Growth



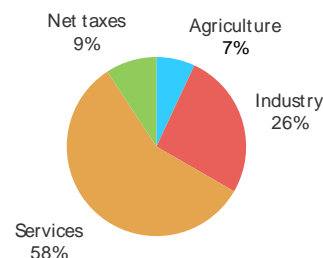
Source: Fitch Ratings, Central Bank of Sri Lanka

The Central Bank of Sri Lanka (CBSL) has taken steps to support economic growth since 2019 through reductions in policy rates, a lending rate cap and a deposit rate cap. It also announced several relief measures aimed at supporting businesses and individuals affected by the coronavirus pandemic, as well as the banking sector, which acts as the intermediary.

## Small, Concentrated Economy

Sri Lanka's economy is small and fairly concentrated, with high dependency on a few sectors, including agriculture, which is reliant on climate and other external factors. This increases the risk of economic volatility and provides banks fewer opportunities to diversify their risk exposures.

### Real GDP Composition - 2019

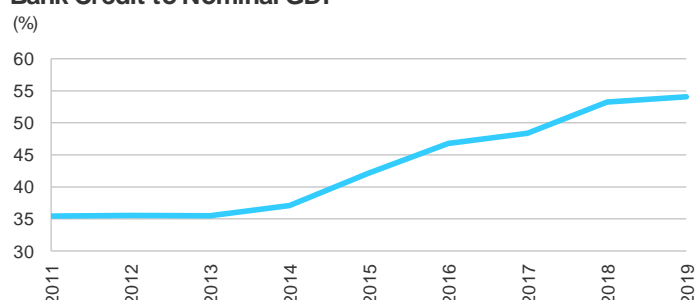


Source: Fitch Ratings, Central Bank of Sri Lanka

## Modest Level of Credit

The level of credit relative to GDP in Sri Lanka has been rising, but remains close to that of some Asia-Pacific peers with bank credit equivalent to around 54% of GDP at end-2019 (India: 49.5%, Indonesia: 35.5%, Philippines: 55.3%, and Thailand: 76%). Private credit was 49.8% of GDP at end-2019, which was the highest among 'B' rated Asia-Pacific peers.

### Bank Credit to Nominal GDP



Source: Fitch Ratings, Central Bank of Sri Lanka

## Six Banks Dominate Industry

The Sri Lankan banking system is concentrated with the six largest domestic banks accounting for 71% of banking sector assets at end-2019. There are 32 banks operating in Sri Lanka. In terms of size, the banking sector dominates the financial system, with its assets accounting for 82.3% of GDP at end-2019. The Banking System Indicator (BSI), which indicates the intrinsic strength of the banking system and is a category score for the system average Viability Rating (VR), stood at 'b'. Please see the Peer Comparison for EM Banking Systems table below for BSI scores.

Sri Lanka has in place institutional frameworks, such as a credit information bureau and deposit insurance scheme, which support banks and finance and leasing companies. Capital markets in Sri Lanka, in terms of both equity and debt, are not deep or liquid, with bank lending continuing to be the main source of external finance for corporates.

## Regulatory and Legal Frameworks Still Developing

Fitch sees regulatory and legal frameworks related to the financial sector as still developing, although they are more advanced than in some emerging-market peers. Sri Lanka has made progress

towards the adoption of global regulatory frameworks, such as Basel III (full implementation of capital and liquidity standards in 2019) and SLFRS 9 (implemented in 2018). The CBSL also expects to enact a new Banking Act in 2021 that could include provisions relating to improving resolution, enforcement and supervisory actions.

The CBSL has been broadly effective as a regulator and supervisor, although there have been instances of forbearance in relation to enforcement of regulation. However, the CBSL has recently been more proactive, particularly in addressing weaknesses among licenced finance companies by cancelling the licences of failed finance companies.

We view creditor protection in Sri Lanka as weak because there can be legal impediments to the resolution of impaired assets through the recovery of collateral.

## Limited International Operations

Sri Lankan banks have limited offshore operations (either through foreign branches or subsidiaries or through transactions booked on their balance sheets). Lending outside the country through banks and their branches accounted for about 4% of loans of Fitch-rated banks at end-2019.

Certain Sri Lankan banks have a larger share of earnings and assets from international operations, such as Commercial Bank of Ceylon PLC (2019: 15% of total operating income; 16% of assets), but this has not reached the level where Fitch will typically derive the OE score by calculating a weighted average of the scores (with weightings based on risk/asset exposures) for the countries in which the banks do business.

## Peer Comparison For EM Banking Systems

Country	Sovereign Rating	Ease of doing business (percentile rank)	GDP per capita (USD 000)	Implied OE score	Actual OE score/outlook	Banking system indicator	Macro prudential indicator
Malaysia	A-	94.2	11.4	bbb	bbb/stable	bbb	1
Thailand	BBB+	89.5	8.0	bbb	bbb/stable	bbb	1
Indonesia	BBB	62.0	4.1	b	bb+/stable	bb	1
Philippines	BBB	50.3	3.4	b	bb+/stable	bb	1
India	BBB-	67.2	2.1	b	bb/negative	bb	1
Vietnam	BB	63.5	3.5	b	b+/stable	b	2
Mongolia	B	57.7	4.3	b	b/stable	b	1
Sri Lanka	B-	48.2	3.9	b	b-/negative	b	2

Source: Fitch Ratings

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