



Fitch Downgrades BOC's Foreign Currency IDRs to RD; Maintains National Rating at 'AA-(Ika)'/RWN

Fitch Ratings - Colombo - 24 Jun 2022: Fitch Ratings has downgraded Bank of Ceylon's (BOC) Long- and Short-Term Foreign Currency (FC) Issuer Default Ratings (IDRs) to 'RD' (Restricted Default) from 'CC' and 'C', respectively. Fitch has also downgraded the Viability Rating (VR) to 'f' from 'cc', and removed the ratings from Rating Watch Negative (RWN). The rating actions are in accordance with Fitch's rating definitions.

At the same time, Fitch has maintained BOC's Long-Term Local-Currency (LT LC) IDR of 'CCC' on RWN as well as its National Long Term Rating of 'AA-(Ika)'.

A full list of the rating actions is detailed below.

KEY RATING DRIVERS

Fitch Ratings has been made aware of missed payments on BOC's foreign-currency obligations which underpins our rating action on its LT FC IDR, ST FC IDR and VR. We believe the foreign-currency funding and liquidity profile is highly stretched, and also believe this is exacerbated by the sovereign's debilitated credit profile (Long-Term Foreign-Currency IDR of 'RD' and Long-Term Local-Currency IDR of 'CCC'). Please see "Correction: Fitch Downgrades Sri Lanka to 'RD'".

Local-Currency Ratings Unchanged: BOC's LT LC IDR takes into consideration that the risk of local-currency restrictions being imposed is lower than that of foreign-currency restrictions, should there be any, due to the sovereign having defaulted on its foreign-currency obligations. It reflects our view of the sovereign's current and likely continued access to local-currency funding. The bank has so far maintained access to local-currency liquidity, such as via the Central Bank of Sri Lanka (CBSL).

The RWN on BOC's National-Long Term Rating reflects the RWN on its LT LC IDR and also the potential for the bank's creditworthiness relative to other Sri Lankan national scale ratings to deteriorate, given the potential stress on bank's funding and liquidity, and also its significant exposure to the sovereign and broader public sector that raises its risk profile.

Funding and Liquidity is Weakest Link: BOC's ability to honour its senior, foreign currency obligations has been significantly impeded by the sovereign's worsening credit profile which has limited the bank's access to foreign currency funding and liquidity. We believe that any foreign-currency liquidity flows from the state or the CBSL is unlikely to be forthcoming, given the sovereign's default status and precarious reserve position.

Rupee liquidity has also tightened following the bank's excessive lending to the state in 2021, but we expect local-currency liquidity to be much more manageable than foreign currency, supported by BOC's strong domestic franchise as well as its ability to access the CBSL liquidity.

OE Remains Challenging: The current operating environment (OE) score of 'ccc'/negative reflects the pressure on the Sri Lankan banks' OE and their already stressed credit profiles following the sovereign's default on its foreign-currency obligations. The score also captures the rapid deterioration in the broader macroeconomic environment which has limited BOC's operational flexibility. The negative outlook on the OE score reflects significant near- to medium-term downside risks presented by the weakening sovereign credit profile.

Economic Instability Pressures Business Profile: We have maintained BOC's business profile score at 'ccc'/negative to reflect the vulnerability of the bank to heightened risks in the domestic market, which affects its ability to generate and defend business volume. As such, BOC's business profile score is constrained by our assessment of the OE. The negative outlook captures pressure on the business profile stemming from the OE and, ultimately, the sovereign.

Significant Exposure to Sovereign: We maintain BOC's risk profile score at 'cc'/negative, to reflect BOC's significant exposure to the sovereign's weak credit profile via its loan book exposures, off-balance sheet liabilities, as well as its investment securities making the bank vulnerable to the sovereign's repayment capacity and liquidity position. The negative outlook reflects downside risk to the risk profile from the OE and sovereign.

Asset Quality Weaker than Private Peers: BOC's underlying asset quality is significantly weaker relative to its private counterparts on account of its large exposure to the sovereign and broader public sector, as reflected in the 'cc' score. The score also reflects rising pressure on its non-state loan exposures as corporate and household balance sheets deteriorate significantly amidst worsening macroeconomic conditions. The negative outlook reflects our view of downside risk to the asset-quality score from its exposure to the sovereign and the OE.

Core profitability Under Pressure: We have lowered BOC's earnings and profitability score to 'ccc'/negative from 'ccc+ '/negative, underpinned by our view that the difficult OE is likely to constrain the bank's earnings and profitability. We believe that the sovereign default and ensuing macroeconomic challenges increases the possibility of BOC becoming structurally unprofitable. The negative outlook on the score is due to the downside risk from potential economic fallout.

Significant Pressure on Capital: We maintain capitalisation and leverage score at 'ccc'/negative, as we believe that capital deficiencies may arise in a very likely scenario that the bank has to absorb a haircut on its foreign-currency government securities exposure, thus requiring a capital injection. This is in conjunction with the heightened constraints on accessing capital, given the sovereign's weak ability to provide support. The negative outlook reflects downside risk to capitalisation and leverage in a scenario of increased sovereign stress, particularly on local currency.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

The LT IDR, ST IDR and VR are already at the lowest level and thus have no downside risk.

We expect to resolve the RWN on BOC's LT LC IDR and national rating when the impact on the bank's credit profile becomes more apparent, which may take longer than six months. Potential triggers that could lead to a downgrade include:

- funding stress that impedes bank's repayment ability in local currency
- significant banking-sector intervention by authorities that constrain banks' ability to service their local currency obligations
- a temporary negotiated waiver or standstill agreement following a payment default on a large local-currency financial obligation
- where Fitch believes a bank has entered into a grace or cure period following non-payment of a large local current financial obligation.

GOVERNMENT SUPPORT RATING

The rating is already at its lowest level, and thus has no downside risk.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

The LT IDR, ST IDR and VR are unlikely to be upgraded until Fitch believes that BOC is able to meet its foreign-currency obligations in full and in a timely manner - as evident from a material improvement in its foreign-currency funding and liquidity position. We believe any upgrade to the ratings would likely be tied to the trajectory of Sri Lanka's sovereign rating - given BOC's large exposure to the latter - while also taking into consideration other weaknesses in the bank's credit profile and performance challenges that domestic banks are facing.

There is limited scope for upward rating action on the LT LC IDR and National Rating in light of the RWN, and the negative outlook we have on all rating factors.

GOVERNMENT SUPPORT RATING

The Government Support Rating is constrained by the sovereign rating. An upward revision is possible, provided the sovereign's ability to provide support significantly improves. However, this appears unlikely in the near to medium term.

OTHER DEBT AND ISSUER RATINGS: KEY RATING DRIVERS

The RWN on the subordinated debt stems from the RWN on the National Long-Term Rating. The Basel II Sri Lankan rupee-denominated subordinated debt of BOC is rated

two notches below its National Long-Term Rating, in line with Fitch's baseline notching for loss severity for this type of debt and our expectations of poor recovery.

OTHER DEBT AND ISSUER RATINGS: RATING SENSITIVITIES

BOC's subordinated debt rating will move in tandem with the National-Long Term Rating.

VR ADJUSTMENTS

The assigned VR is below the implied VR, reflecting a negative adjustment from the weakest link of BOC's funding and liquidity, which has a greater impact on the VR than what the weighting suggests.

BOC has a 1.78% equity stake in Fitch Ratings Lanka Ltd. No shareholder other than Fitch, Inc. is involved in the day-to-day rating operations of, or credit reviews undertaken by, Fitch Ratings Lanka Ltd.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Bank of Ceylon has an ESG Relevance Score of '4' for Governance Structure due to ownership concentration, with a 100% state shareholding and several related-party transactions with the state and state-owned entities, which has a negative impact on the credit profile, and is relevant to the rating in conjunction with other factors.

Bank of Ceylon has an ESG Relevance Score of '4' for Financial Transparency. It reflects our view that the recent regulatory forbearance measured announced by the Central Bank of Sri Lanka could distort the true solvency and liquidity position of the bank thereby limiting financial transparency.

RATING ACTIONS

ENTITY / DEBT ↕	RATING ↕	PRIOR ↕
<input type="text"/>	<input type="text"/>	<input type="text"/>
Bank of Ceylon	LT IDR RD Downgrade	CC ↕
	ST IDR RD Downgrade	C
	LC LT IDR CCC ↕ Rating Watch Maintained	CCC ↕
	Nat'l LT AA-(Ika) ↕ Rating Watch Maintained	AA-(Ika) ↕
	Viability f Downgrade	cc ↕
	Government Support ns Affirmed	ns
subordinated	Nat'l LT A(Ika) ↕ Rating Watch Maintained	A(Ika) ↕

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[VIEW ADDITIONAL RATING DETAILS](#)

Additional information is available on www.fitchratings.com

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APPLICABLE CRITERIA

- [National Scale Rating Criteria \(pub. 22 Dec 2020\)](#)
- [Bank Rating Criteria \(pub. 13 Nov 2021\) \(including rating assumption sensitivity\)](#)

ADDITIONAL DISCLOSURES

- [Dodd-Frank Rating Information Disclosure Form](#)
- [Solicitation Status](#)
- [Endorsement Policy](#)

ENDORSEMENT STATUS

Bank of Ceylon EU Endorsed, UK Endorsed

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