



Fitch Maintains Commercial Bank of Ceylon's 'AA-(lka)' National Rating on Watch Negative

Fitch Ratings - Colombo - 11 Jul 2022: Fitch Ratings has maintained Commercial Bank of Ceylon PLC's (COMB) National Long-Term Rating of 'AA-(lka)' on Rating Watch Negative (RWN). Fitch also has maintained the 'A(lka)' ratings on COMB's subordinated debt on RWN.

KEY RATING DRIVERS

RWN Maintained: The RWN on COMB's National Long-Term Rating reflects potential for the bank's creditworthiness relative to other entities on the Sri Lankan national ratings scale to deteriorate, given the heightened stress on the bank's funding and liquidity, and its significant exposure to the sovereign via investment in foreign-currency instruments that raises risks to its overall credit profile. We believe that the sharp rise in inflation, depreciation of the local currency and other factors can distort the bank's underlying financial performance in the current operating environment.

Weak Foreign-Currency Funding: We believe the weak foreign-currency liquidity in the system is likely to affect COMB's funding and liquidity profile in the medium term, as with other banks. This is despite COMB's reported overall loan-to-deposit ratio of 72.0% at end-1Q22 (2021: 74.4%) and foreign-currency loan-to-deposit ratio of 62.1% (2021: 66.1%).

We expect COMB to bolster its liquidity, supported by low credit growth. Excluding its investments in Sri Lanka Sovereign Bonds, its all-currency liquidity coverage ratio (at bank level) is lower than the reported 189.3% at end-1Q22, but comfortably above the new regulatory minimum of 90%.

Weakening Operating Environment: Our assessment of Sri Lankan banks' operating environment (OE) reflects the pressure on the banks' already stressed credit profiles following the sovereign's default on its foreign-currency obligations. It also captures the rapid deterioration in the broader macroeconomic environment, including increased interest rates, high inflation and acute currency depreciation, which has limited COMB's operational flexibility.

High Asset-Quality Pressure: We expect the OE to weigh on COMB's asset quality, similar to its peers, in 2022 and 2023. A prolonged economic downturn will weaken household and corporate balance sheets, raising COMB's impaired-loan ratio, as measured by SLFRS 9 stage 3 loans/gross loans, for an extended period. A recently announced moratorium for affected borrowers may limit the rise in impaired loans, which we believe will mask the bank's true credit quality.

COMB's impaired-loan ratio decreased to 7.4% by end-2021 (Fitch-rated large bank median 8.1%) from 10.9% at end-2020 due mainly to a change in the stage assessment criteria for individually impaired facilities at the bank. Loan-loss allowance covered

around 81% of impaired loans at end-2021, up from 50% at end-2020, due to a reduction in stage 3 loans following the reassessment.

Investment in Foreign-Currency Government Securities: Our assessment of COMB's risk profile factors in its investment in foreign-currency government securities, which are currently in default. COMB has the second-largest exposure among domestic banks to these securities in the form of Sri Lanka Development Bonds (3.1% of total assets at end-2021) and Sri Lanka Sovereign Bonds (4.9% of total assets), exposing the bank's capital to restructuring of these instruments. However, this risk is mitigated by COMB's increased provisioning for these securities in the last few quarters.

High Pressure on Profitability: COMB's operating profit/risk-weighted asset (RWA) ratio rose to 5.8% by end-1Q22 from 3.4% at end-2021, buoyed by gains on its foreign-currency assets on the rupee's sharp depreciation. This increase is likely to be short-lived as we expect pressure on COMB's earnings and profitability from interest-margin contraction amid rising interest rates, slow loan-book growth and higher credit costs. In addition, high inflation is likely to raise the bank's operating costs, while increased taxes will hurt the bank's bottom line in the medium term.

Capital Buffers Under Stress: COMB's common equity Tier 1 (CET1) ratio fell to 9.9% by end-1Q22 (end-2021: 12.1%), as RWA rose on the impact of the rupee's depreciation on its foreign-currency assets and mark-to-market losses on government securities. COMB's high share of investment in distressed government securities also puts pressure on its capitalisation in the medium term. The Tier 1 capital ratio, which is same as the CET 1 ratio, was only slightly above the regulatory minimum of 9.0% at end-1Q22, but COMB can draw down its capital conservation buffer as part of regulatory forbearance.

Strong Domestic Franchise: COMB's business profile is differentiated by its superior domestic franchise as the third-largest commercial bank in Sri Lanka, with an asset base of LKR2.2 trillion (USD7.6 billion) at end-March 2022, or around 12% of system assets. The Central Bank of Sri Lanka designates COMB as one of two "Bucket 2" domestic systemically important banks (D-SIB). However, we believe that COMB's business profile is highly vulnerable to the intensifying risks in the domestic market, similar to peers, which may limit the bank's ability to generate and defend business volumes.

RATING SENSITIVITIES

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

The RWN reflects rising risks to the bank's rating from funding stresses, which could lead to a multiple-notch downgrade. We expect to resolve the RWN once the impact on the issuer's credit profile becomes more apparent, which may take more than six months. Developments that could lead to a multiple-notch downgrade include:

- funding stress that impedes COMB's repayment ability
- significant banking-sector intervention by authorities that constrains the bank's ability to service its obligations

- a temporary negotiated waiver or standstill agreement following a payment default on a large financial obligation

- Fitch's belief that COMB has entered into a grace or cure period following non-payment of a large financial obligation.

A downgrade of the sovereign's Long-Term Local-Currency Issuer Default Rating (CCC) could also lead to a downgrade of the bank's rating.

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

There is limited scope for upward rating action given the RWN.

OTHER DEBT AND ISSUER RATINGS: KEY RATING DRIVERS

SUBORDINATED DEBT

The RWN on the subordinated debt stems from the RWN on the corresponding National Long-Term Rating. Sri Lanka rupee-denominated subordinated debt, where applicable, is rated two notches below a bank's National Long-Term Rating, in line with our baseline notching for loss severity for this type of debt and our expectations of poor recovery.

OTHER DEBT AND ISSUER RATINGS: RATING SENSITIVITIES

The ratings on the subordinated debt will move in tandem with the National Long-Term Rating.

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

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY / DEBT ↕	RATING ↕			PRIOR ↕
<input type="text"/>	<input type="text"/>			<input type="text"/>
Commercial Bank of Ceylon PLC	Natl LT	AA-(lka) ⬇	Rating Watch Maintained	AA-(lka) ⬇
subordinated	Natl LT	A(lka) ⬇	Rating Watch Maintained	A(lka) ⬇

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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

- [Solicitation Status](#)
- [Endorsement Policy](#)

ENDORSEMENT STATUS

Commercial Bank of Ceylon PLC -

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