FitchRatings

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

Fitch Ratings - Colombo - 11 Jul 2022: Fitch Ratings has maintained Hatton National Bank PLC's (HNB) National Long-Term Rating of 'AA-(lka)' on Rating Watch Negative (RWN). Fitch has also maintained HNB's senior and subordinated debt ratings of 'AA-(lka)' and 'A(lka)', respectively, on RWN.

KEY RATING DRIVERS

RWN Maintained: The RWN on HNB's National-Long Term Rating reflects the 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 Liquidity: We believe HNB's foreign-currency funding and liquidity position is prone to sudden changes amid already weak creditor sentiment, similar to peers. HNB's access to foreign-currency funding is severely limited given the sovereign's stretched credit profile, while the bank's foreign-currency liquidity has been significantly impeded by the sovereign's default on its foreign-currency debt given the bank's large holding of foreign-currency government securities.

Weakening Operating Environment: Our assessment of Sri Lankan banks' operating environment (OE) reflects the pressure on the Sri Lankan 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 HNB's operational flexibility.

Increased Pressure on Asset Quality: Fitch expects the worsening OE to destabilise corporate and household balance sheets, leading to a marked increase in impaired (stage 3) loans in the near to medium term. Recently announced concessions for affected borrowers may limit the growth in impaired loans, which we believe could mask the true credit quality of the bank. HNB's large exposure to foreign-currency government instruments adds to its asset-quality woes. At end-2021, impaired loans accounted for 5% of total assets, with another 11% of assets in foreign-currency government securities.

High Risk Profile: HNB's elevated risk profile, similar to local peers, stems from its large exposure to high-risk customer segments with weak credit quality as reflected in the 'ccc'/negative OE score. This is exacerbated by HNB's large exposure to foreign-currency instruments issued by the government, which made up 11% of its assets at end-2021, making the bank vulnerable to the sovereign's repayment capacity and liquidity position.

Core Profitability Under Pressure: We believe that the sovereign default and macroeconomic challenges could adversely affect HNB's earnings and profitability in the near to medium. Earnings pressure is already evident in the substantial increase in impairment charges (62% of 1Q22 pre-impairment profits) on account of loan and non-loan exposures. However, the exchange gains from its foreign-currency denominated assets have partly mitigated the increased credit costs.

Heightened Capital Impairment Risks: We believe that capital deficiencies could arise in a very likely scenario that the bank has to absorb a haircut on its foreign-currency government securities. Weak internal capital generation, mark-to-market losses and loan-quality deterioration combined with bloated risk-weighted assets from the rupee's sustained depreciation will exert significant pressure on the bank's capitalisation metrics in the near term, in our view.

Economic Instability Undermines Business Profile: We believe that HNB's business profile is highly vulnerable to the intensifying risks in the domestic market, which could limit the bank's ability to generate and defend business volume. HNB's business profile could be differentiated by its superior domestic franchise as the fourth-largest commercial bank in Sri Lanka, with 8% of sector assets at end-2021, if the macroeconomic environment regains a higher level of stability.

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 issuer's credit profiles becomes more apparent, which may take more than six months. Developments that could lead to a multiple-notch downgrade include:

- funding stress that impedes HNB'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 HNB 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

SENIOR DEBT

HNB's outstanding senior unsecured debentures are rated at the same level as its National Long-Term Rating in accordance with Fitch's criteria. This is because the debt ranks equally with the claims of the bank's other senior unsecured creditors.

SUBORDINATED DEBT

HNB's Basel II- and Basel III-compliant Sri Lankan rupee subordinated debt is rated two notches below the National Long-Term Rating anchor. This reflects Fitch's baseline notching for loss severity for this type of debt and our expectations of poor recoveries. There is no additional notching for non-performance risks, as the notes do not incorporate going-concern loss-absorption features.

OTHER DEBT AND ISSUER RATINGS: RATING SENSITIVITIES

The senior and subordinated debt ratings will move in tandem with the bank's 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.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Hatton National Bank PLC	Natl LT	AA-(lka)	Rating Watch Maintained	AA-(lka)
senior unsecured	Natl LT	AA-(lka)	Rating Watch Maintained	AA-(lka)
subordinated	Natl LT	A(lka)	Rating Watch Maintained	A(lka)

PREVIOUS Page 1 of 1 10 rows NEXT

VIEW ADDITIONAL RATING DETAILS

Additional information is available on www.fitchratings.com

PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer's available public disclosure.

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

Hatton National Bank PLC -

DISCLAIMER & DISCLOSURES

All Fitch Ratings (Fitch) credit ratings are subject to certain limitations and disclaimers. Please read these limitations and disclaimers by following this link: https://www.fitchratings.com/understandingcreditratings. In addition, the following

READ MORE

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained by Fitch at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

ENDORSEMENT POLICY

Fitch's international credit ratings produced outside the EU or the UK, as the case may be, are endorsed for use by regulated entities within the EU or the UK, respectively, for regulatory purposes, pursuant to the terms of the EU CRA Regulation or the UK Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, as the case may be. Fitch's approach to endorsement in the EU and the UK can be found on Fitch's Regulatory Affairs page on Fitch's website. The endorsement status of international credit ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.