



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

Fitch Ratings - Colombo - 11 Jul 2022: Fitch Ratings has maintained People's Bank's (Sri Lanka) (PB) National Long-Term Rating of 'AA-(lka)' on Rating Watch Negative (RWN).

KEY RATING DRIVERS

RWN Maintained: The RWN on PB'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 stress on bank's funding and liquidity, and also its significant exposure to the sovereign via foreign-currency lending and, to a lesser extent the 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 Profile: Tight foreign-currency liquidity in the financial system continues to weigh on PB's ability to service its foreign-currency obligations, including off-balance-sheet trade finance liabilities, in a timely manner. We also believe that the weakened sovereign credit profile has constrained the access of state banks, including PB, to foreign-currency funding in the near-to-medium term.

PB's foreign-currency loan/deposit ratio of 186% at end-1Q22 is significantly higher than the median of 74% for 'AA-(lka)' rated peers, reflecting the bank's heavy reliance on wholesale funding to support government and state-owned enterprises' (SOE) foreign-currency funding needs. PB's local-currency liquidity is stable (local-currency loan/deposit ratio of 79.7% at end-1Q22), supported by muted loan growth and access to the Central Bank of Sri Lanka's (CBSL) liquidity window.

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 PB's operational flexibility.

High Pressure on Asset Quality: We expect PB's impaired-loan ratio to rise in 2022 and 2023, similar to the sector, due to the worsening OE. While recently announced concessions for affected borrowers could limit the growth in impaired loans, we believe it could mask the true credit quality of the bank. We believe that PB is unlikely to be able to sustain the fall in its impaired-loan ratio, based on SLFRS 9 stage 3 loans/gross loans, to 8.7% by end-2021 from 9.5% at end-2020. PB's loan-loss provisions cover 62% of impaired loans, higher than the average of 54% over 2018-2020, but low relative to larger private peers.

High Risk Appetite: PB's high risk profile is reflected in its significant exposure to the weakened Sri Lankan sovereign, which has defaulted on its foreign-currency obligations. Its sizeable non-state exposure, including retail and SME customers, also raises the bank's risk profile as we believe that these segments are more vulnerable in the current economic downturn. The government and SOEs accounted for nearly half PB's loan book at end-2021, indicating high concentration risk and PB's dependence on the state's financial profile.

Pressure on Probability: An increase in credit costs, contraction in net interest income, muted loan growth and increased taxation are likely to squeeze PB's earnings and profitability, as with peers. Rising inflation could also increase the bank's operating costs. PB's operating profit/risk-weighted asset (RWA) ratio rose to 4.8% by end-1Q22 from 4.3% at end-2021, as interest income grew faster than interest expenses. However, we believe this is unlikely to be sustained for the rest of 2022 as we expect a sharp increase in credit costs and deposit rates to be repriced upwards amid fierce competition for liquidity.

Capitalisation Vulnerable: We believe that PB's capitalisation is highly vulnerable to even moderate asset-quality shocks, particularly if it has to absorb credit losses from its foreign-currency exposure to government and SOEs loans. PB's capital ratios are masked by its low risk density (RWA/total assets of around 38%), benefiting from low risk-weights for government exposures. PB's common equity Tier 1 (CET1) ratio fell to 11.6% by end-1Q22, in line with 'AA-(lka)' peer median, from 13.0% at end-2021 due partly to increased RWA as the rupee depreciation expanded the foreign-currency asset base.

Strong Domestic Franchise: PB's business profile is differentiated by its superior domestic franchise as the second-largest commercial bank in Sri Lanka, accounting for 17.4% of sector assets and 18.8% of sector deposits at end-2021. The bank is of high systemic importance because of its size, quasi-sovereign status, role as key lender to government and full state ownership. However, we believe that PB's business profile is highly vulnerable to the intensifying risks in the domestic market, similar to peers, which could 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 PB'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 PB's repayment ability
- significant banking-sector intervention by authorities that constrain PB'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 PB 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.

PB 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.

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 ↕	
People's Bank (Sri Lanka)	Natl LT	AA-(lka) ↕	Rating Watch Maintained	AA-(lka) ↕
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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

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ENDORSEMENT STATUS

People's Bank (Sri Lanka) -

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