



## Fitch Assigns Merchant Bank of Sri Lanka & Finance First-Time Rating of 'BBB+(Ika)'; Outlook Stable

Fitch Ratings - Mumbai - 22 Feb 2024: Fitch Ratings has assigned Merchant Bank of Sri Lanka & Finance PLC (MBSL) a first-time National Long-Term Rating of 'BBB+(Ika)'. The Outlook is Stable.

MBSL is 84.5% owned by Bank of Ceylon (BOC, A(Ika)/Stable) and other BOC group entities. BOC is the largest banking group in the country.

### KEY RATING DRIVERS

**Shareholder Support Drives Ratings:** MBSL's rating is driven by our view that the parent, BOC, would provide extraordinary support to MBSL, if required. BOC's ability to support MBSL is reflected in its credit profile, which is underpinned by its standalone strength. We believe that any required support for MBSL would be manageable relative to BOC's financial capacity.

Our support assessment also takes into consideration BOC's majority shareholding in MBSL, increasing product offerings by MBSL that are complementary to those provided by BOC, the parent's oversight of MBSL's policies and strategy through board representation, and the usage of the BOC brand by MBSL in its business operations, which raises reputational risk for BOC should MBSL default.

**Limited Importance to Parent:** MBSL is rated two notches below BOC due to its limited importance to the group. MBSL mainly serves high-yielding, under-banked segments that have limited overlap with BOC's core customer base, but this is partly offset by BOC's focus on increasing merchant banking via MBSL to strengthen group fee-based revenue. MBSL made up 0.8% of BOC's consolidated assets at end-September 2023, and makes negligible contribution to group profitability. MBSL also has considerable management independence and there is limited operational integration between the entities.

**Weak Standalone Profile:** We assess MBSL's standalone credit profile as being weaker than its support-driven rating because of its small franchise with 1.8% market share of sector loans, evolving business model, and weak financial profile, which is reflected in its poor asset-quality metrics, weak profitability and high leverage. MBSL focuses on vehicle leasing, and gold- and property-backed loans. It has a high risk profile stemming from its significant exposure to borrower segments that are highly susceptible to economic and interest rate cycles.

**Stabilising Economic Outlook:** We expect the operating environment for Sri Lankan finance and leasing companies (FLCs) to continue to stabilise following the inflation and interest-rate shocks over the past two years. Easing inflation and interest-rate pressures should provide steadier conditions for FLC sector performance. Some headwinds linger, as higher taxes will continue to weigh on household finances in 2024. Investor confidence

will also take time to recover. Nonetheless, we expect economic activity in Sri Lanka to improve in the financial year ending March 2025 as GDP growth recovers.

**Asset Quality Pressure:** The company's loans that are more than three months past due were high at 25.3% of total loans at end-September 2023 (end-2022: 24.3%) due to its high risk profile. Nonetheless, MBSL's focus on bad debt recovery has resulted in a decline in the non-performing loan ratio from a much higher level in previous years. We expect a pick-up in borrowers' business activity and declining interest rates to aid loan collections in the medium term.

**Weaker Profitability:** MBSL's pre-tax profit/average asset ratio was low at 0.9% in 9M23 and -0.9% in 2022, primarily due to the sharp reduction in its net interest margin and increase in operating costs on lower business volumes. We expect MBSL's profitability to improve in the near to medium term, though it will likely remain weaker than that of peers, as its lending operations pick up, borrowing costs decline, and bad debt recovery improves.

**History of Capital Shortfalls:** MBSL's capital adequacy ratio (CAR) rose to 16.9% (equity Tier 1 ratio at 13.4%) by end-September 2023 from 12.3% (11.7%) at end-2022, and against the regulatory minimum CAR of 12.5%. MBSL suffered significant capital shortfalls in 2020, with CAR at end-2020 of 5.6% below the minimum required 10.5% due to losses. BOC injected equity into MBSL in 2021 to improve its capitalisation. The breaches resulted in the regulator limiting MBSL's deposit and lending balances, which affected its business franchise. The caps were removed after its capital ratios increased.

The recent improvement in CAR was due to significant reduction in total gross loans, an increase in gold loans, which carry lower risk weights, in the lending mix, and an increase in Tier 2 capital. We expect capitalisation pressure to ease in the medium term due to improved profitability prospects.

## **RATING SENSITIVITIES**

### **Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade**

MBSL's rating is sensitive to changes in BOC's credit profile, as reflected in BOC's National Long-Term Rating, as well as Fitch's opinion around BOC's ability and propensity to extend timely extraordinary support. Developments that could lead to a downgrade include:

- meaningful reduction in the parent's ownership, control or influence that could weaken its propensity to support the subsidiary
- notable decline in MBSL's capital buffers, indicating reduced timeliness in financial support to back growth or meet regulatory norms
- insufficient or delayed liquidity support from the parent relative to MBSL's needs, which hinders MBSL's ability to meet its obligations in a timely manner
- sustained weak performance of MBSL that we believe will weaken the parent's propensity to support the subsidiary

- a material increase in size relative to the parent that makes extraordinary support more onerous for the parent.

### Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

An upgrade is less likely in the near term. However, a significantly greater strategic role for MBSL within the BOC group, along with closer integration with BOC across broader functional areas and greater sharing of the BOC brand name besides the operational usage of brand, could be positive for the rating in the long term.

### Date of Relevant Committee

19 February 2024

### 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.

### PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

The rating is linked to rating on the parent, BOC.

#### RATING ACTIONS

ENTITY / DEBT ↕	RATING ↕
<input type="text"/>	<input type="text"/>
Merchant Bank of Sri Lanka & Finance PLC	Natl LT BBB+(lka) ● New Rating

PREVIOUS Page 1 of 1 10 rows NEXT

[VIEW ADDITIONAL RATING DETAILS](#)

This report was prepared by Fitch in English only. The company may prepare or arrange for translated versions of this report. In the event of any inconsistency between the English version and any translated version, the former shall always prevail. Fitch is not responsible for any translated version of this report. Additional information is available on [www.fitchratings.com](http://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 \(pub. 22 Dec 2020\)](#)
- [Non-Bank Financial Institutions Rating Criteria \(pub. 18 Jan 2024\) \(including rating assumption sensitivity\)](#)

## ADDITIONAL DISCLOSURES

- [Solicitation Status](#)
- [Endorsement Policy](#)
- [Potential Conflicts Resulting from Revenue Concentrations](#)

## ENDORSEMENT STATUS

Merchant Bank of Sri Lanka & Finance 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 <https://www.fitchratings.com/rating-definitions-document> details Fitch's rating definitions for each rating s

### 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.