RATING ACTION COMMENTARY

Fitch Affirms National Development Bank at 'A+(lka)'/Stable

Wed 05 Aug, 2020 - 4:37 AM ET

Fitch Ratings - Colombo - 05 Aug 2020: Fitch Ratings Lanka has affirmed National Development Bank PLC's (NDB) National Long-Term Rating at 'A+(lka)'. The Outlook is Stable.

KEY RATING DRIVERS

NATIONAL RATING

NDB’s National Long-Term Rating reflects its modest franchise and more balanced business model but thinner capitalisation relative to similarly rated peers.
The operating environment in Sri Lanka remains challenging amid our expectation GDP will contract 1.3% in 2020 due to the impact of the coronavirus pandemic. We forecast GDP growth of 4.2% for Sri Lanka in 2021, although growth prospects will depend in part on how the pandemic develops in the country and globally. We maintained the outlook on the operating environment at negative to reflect the possibility of further risks should the effects of the pandemic be more pronounced or persist. The operating environment for Sri Lankan banks has a high influence on their ratings, as it is likely to constrain their intrinsic credit profiles through its effect on financial and non-financial key rating factors.

We expect NDB’s asset quality to come under pressure in the near-to-medium term amid our expectations for a challenging operating environment. Exposure to corporates is likely to continue dominating its loan book in the medium term amid the increasingly challenging operating environment, despite its plan to increase its exposure to SME and retail customer segments. Project lending, which accounted for 24% of total loans at end-2019, is likely to remain an integral component of its loan book. NDB’s impaired-loan ratio based on stage 3 loans decreased to 6.9% by end-2019, from 7.7% at end-2018, due to the minimal increase in stage 3 loans and above-sector loan expansion. Underlying asset-quality stress is likely to build amid the economic shock, despite the regulatory relief in the form of a moratorium for affected customers that has to a large extent halted the recognition of credit impairment.

We expect pressure on income generation and higher credit costs from the impact of the pandemic on the operating environment to depress NDB’s earnings and profitability. Operating profit/risk-weighted assets decreased to 2.4% in 1Q20 from 2.6% in 2019 largely due to a sharp increase in loan-impairment charges.

NDB’s capital ratios have been progressively declining as a result of the large increase in loans. Its common equity Tier 1 ratio stood at 9.9% at end-1Q20 and could remain lower than that of similarly rated peers that are likely to sustain riskier business models in the medium term. The bank is likely to manage its capital position in 2020 through profit retention. NDB has to maintain a minimum Tier 1 ratio of 8.5% and total capital ratio of 12.5%. The bank is not considered a domestic systemically important bank even though it exceeded LKR500 billion in assets, which means it does not have to maintain additional buffers.

NDB’s exposure to project lending and its appetite for loan expansion have kept its loan/deposit ratio at over 100%. The central bank’s accommodative stance has supported NDB’s Sri Lankan rupee liquidity position but it could face
challenges in its access to - and pricing of - foreign-currency funding due to the sovereign's deteriorating credit profile.

SUBORDINATED DEBT

NDB’s outstanding and proposed Sri Lankan rupee-denominated 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.

RATING SENSITIVITIES

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

The prospect of an upgrade appears unlikely in the near term due to the deteriorating operating environment. An upgrade of NDB's rating in the medium term would stem from an improvement of its credit profile relative to the rated universe of Sri Lankan entities. A much stronger franchise and financial profile, in particular higher capital buffers that can absorb risks related to the operating environment, would be consistent with positive rating action.

NDB’s subordinated debt would be upgraded if the bank’s National Long-Term Rating is upgraded.

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

NDB’s rating would be downgraded if there were to be deterioration in its financial profile relative to the universe of rated entities in Sri Lanka, in particular its capital buffers, or increased risk appetite through aggressive loan growth or higher exposure to riskier customer segments.

NDB’s subordinated debt would be downgraded if the bank’s National Long-Term Rating is downgraded.
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

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<td>A+(lka) Rating Outlook Stable Affirmed</td>
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VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Bank Rating Criteria (pub. 28 Feb 2020) (including rating assumption sensitivity)
National Scale Rating Criteria (pub. 08 Jun 2020)

ADDITIONAL DISCLOSURES

ENDORSEMENT STATUS

National Development Bank PLC

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