



RATING ACTION COMMENTARY

Fitch Affirms National Development Bank at 'A+(Ika)'; Outlook Stable

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Fitch Ratings - Colombo - 03 Aug 2021: Fitch Ratings has affirmed National Development Bank PLC's (NDB) National Long-Term Rating at 'A+(Ika)'. The Outlook is Stable. At the same time Fitch has affirmed the bank's outstanding subordinated debt at 'A-(Ika)'.

KEY RATING DRIVERS

NDB's National Long-Term Rating is driven by its intrinsic credit profile and reflects its modest franchise and weaker financial profile relative to higher-rated peers. This is despite the recent capital infusion that bolstered NDB's deteriorating capitalisation.

Our assessment of the operating environment for Sri Lankan banks reflects the risk of doing banking business due to the sovereign's credit profile (CCC) and the impact of the coronavirus pandemic. Sri Lanka's economy contracted by 3.6% in 2020, and we expect GDP growth of 3.8% in 2021. Our forecasts are subject to a high degree of uncertainty as they depend on the path of the pandemic.

The outlook on the operating environment assessment remains negative due to the potential for deterioration in the sovereign credit profile and pressure on domestic

operating conditions beyond our expectation independent of changes in the sovereign rating. The operating environment for Sri Lankan banks has a high influence on banks' ratings, as it is likely to constrain their intrinsic credit profiles through its effect on financial and non-financial key rating factors.

We expect pressure on NDB's asset quality to persist in the near to medium term, stemming from our assessment of the operating environment. Its impaired-loan ratio based on stage 3 loans rose to 8.3% by end-2020 from 6.9% at end-2019. Pressure on impaired loans is likely to manifest across an extended period due to relief measures that halted the recognition of credit impairments and ongoing discretionary restructuring. NDB's loan-loss allowances increased to 4.3% of gross loans by end-1Q21 and 4.0% by end-2020 from 3.1% at end-2019 in recognition of asset quality risks.

We expect NDB's earnings and profitability to remain under pressure from high credit costs despite the potential for improved pre-provision profit buffers. Operating profit/risk-weighted assets decreased to 2.2% in 2020 from 2.6% in 2019 alongside a sharp increase in impairment charges that consumed 43% of pre-impairment profits in 2020, before rebounding to 3.3% in 1Q21. NDB's net interest margins could remain thin due to its sustained focus on corporates and a smaller base of lower-cost current and savings deposits. Profitability could be supported through improved cost efficiencies and increased focus on non-interest income.

The capital infusion of LKR9.5 billion from a rights issue and private placement in 2Q21 lifted NDB's common equity Tier 1 (CET1) ratio to 10.8% by end-1H21 from 9.7% at end-2020. The ratio has been declining as a result of the strong increase in loans (CAGR of 17% over 2017-2020) alongside the bank's pursuit of enhancing its asset base and market position. Medium-term capitalisation hinges on the pace of expansion as NDB seeks to cross LKR1 trillion in assets in 2025, after reaching LKR500 billion in assets in 2019 ahead of its 2020 target.

NDB's loan/deposit ratio decreased to an average of 99% over 2017-2020 from 105% over 2016-2019. Its exposure to project lending (24% of gross loans) that is financed through non-deposit funding sources and its appetite for loan expansion could result in the loan/deposit ratio remaining high in the medium term relative to higher-rated peers. The share of foreign currency funding is significant, exposing the bank to challenges in access to - and pricing of - foreign-currency funding due to the sovereign's credit profile.

SUBORDINATED DEBT

NDB's 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 our assessment of the sovereign's credit profile and the operating environment. An upgrade of NDB's rating in the medium term is contingent upon the bank's credit profile improving relative to the universe of Sri Lankan entities rated on the National Rating scale. This could be through a much stronger franchise and financial profile, in particular higher capital buffers that can absorb risks related to the operating environment.

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 is most likely to be downgraded if there was increased risk appetite that could erode its capital buffers. Pressure on NDB's National Rating also could stem from a deterioration in Sri Lanka's sovereign rating, constraining NDB's standalone credit profile, particularly the operating environment. Operating conditions are likely to deteriorate significantly in such a scenario, resulting in heightened risk for NDB's financial profile. Weaker assessment of the operating environment independent of changes in the sovereign rating, or a deterioration in credit metrics past our base-case expectations relative to peers, would also lead to increased pressure NDB's National Rating.

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

ENTITY/DEBT	RATING			PRIOR
National Development Bank PLC	Natl LT	A+(lka) Rating Outlook Stable	Affirmed	A+ (lka) Rating Outlook Stable
● subordinated	Natl LT	A-(lka)	Affirmed	A-(lka)

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Additional information is available on www.fitchratings.com**APPLICABLE CRITERIA**[Bank Rating Criteria \(pub. 29 Feb 2020\) \(including rating assumption sensitivity\)](#)[National Scale Rating Criteria \(pub. 22 Dec 2020\)](#)**ADDITIONAL DISCLOSURES**[Solicitation Status](#)[Endorsement Policy](#)**ENDORSEMENT STATUS**

National Development Bank PLC -

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