



## RATING ACTION COMMENTARY

# Fitch Downgrades National Development Bank's National Rating to 'A(Ika)'; Maintains Watch Negative

Thu 28 Jul, 2022 - 5:45 AM ET

Fitch Ratings - Colombo - 28 Jul 2022: Fitch Ratings has downgraded Sri Lanka-based National Development Bank PLC's (NDB) National Long-Term Rating to 'A(Ika)' from 'A+(Ika)'. Fitch has also downgraded NDB's subordinated debt ratings to 'BBB+(Ika)' from 'A-(Ika)'. The ratings remain on Rating Watch Negative (RWN).

A full list of the rating actions is detailed below.

## KEY RATING DRIVERS

**Capital Buffers Deteriorating:** The downgrade reflects our view that NDB's credit profile has weakened relative to that of similarly rated peers. This is due to the pace of the deterioration in its capital buffers and the limited profitability headroom to absorb credit cost shocks in light of the rising risks to the bank's operating environment.

**RWN Maintained:** The RWN on NDB's National Long-Term Rating reflects the potential for the bank's creditworthiness relative to other entities on the Sri Lankan national rating scale to deteriorate amid the heightened stress on the bank's funding and liquidity and its material exposure to the sovereign via investment in foreign-currency instruments that raises the

risks to its overall credit profile. We believe the acceleration in inflation, depreciation of the local currency and other factors can distort the bank's underlying financial performance in the current operating environment.

**Constrained Foreign-Currency Liquidity:** The sovereign's default on its foreign-currency obligations has exerted significant pressure on NDB's foreign-currency liquidity position, given its large holding of foreign-currency government securities, at 6.5% of assets at end-2021. Access to foreign-currency funding has been severely dampened due to the sovereign's debilitated credit profile, which has caused the bank to rely on limited flows of remittances and export proceeds.

**Highly Vulnerable Capitalisation:** We believe that risks to NDB's capital have increased significantly since our last rating review, despite a capital infusion of LKR9.5 billion in 2Q21. This stems from the possibility that increased provisioning on both loan and non-loan exposures could far outweigh pre-impairment profitability, potentially eroding its equity and capital buffers.

The bank's above-average share of unprovided impaired loans and the potential for a haircut on its foreign-currency government securities that is higher than the amount already factored into its metrics exacerbate the risk on its thin capital buffers. Recently announced regulatory forbearance measures could help the bank to remain compliant with minimum capital ratios on a reported basis.

**Heightened Asset-Quality Pressure:** We expect worsening economic stress to destabilise corporate and household balance sheets further, leading to a marked increase in impaired (Stage 3) loans from the 8.3% estimated in 1Q22 in the near-to-medium term. Still, recently announced concessions for affected borrowers may limit the growth in impaired loans, which we believe could mask true credit quality. The bank's exposure to the government's foreign-currency instruments also adds to its asset-quality woes.

**Deteriorating Profitability:** Fitch expects pressure on NDB's earnings and profitability to intensify in the near-to-medium term as economic conditions continue to deteriorate rapidly. Earnings pressure is already evident in the substantial increase in impairment charges (86% of 1Q22 pre-impairment profit) on its loan and non-loan exposures, which led the bank's core profitability metric - operating profit/risk weighted assets - to decline to 0.7% by end-1Q22 (end-2021: 2.3%).

**Weakening Operating Environment:** Our assessment of Sri Lankan banks' operating environment reflects the pressure on the banks' already stressed credit profile following the

sovereign's default on its foreign-currency obligations. It also captures the rapid deterioration in the broader economy, including increased interest rates, high inflation and acute currency depreciation, which has limited NDB's operational flexibility.

**Instability Weighs on Business Profile:** We believe NDB's business profile, like that of most domestic peers, is highly vulnerable to the intensifying risks in the domestic market as the profile is highly concentrated on the weak and unstable Sri Lankan economy. This could potentially limit the bank's ability to generate and defend business volume while controlling risks.

**High Risk Profile:** NDB's elevated risk profile, similar to local peers, stems from its predominantly domestic exposure with weak credit quality, including project financing, which is reflected in the 'ccc'/negative operating environment score. This is exacerbated by NDB's sizeable exposure to the foreign-currency instruments issued by the government, making the bank vulnerable to the sovereign's repayment capacity and liquidity position.

## **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 the bank'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 the bank'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 obligation
- Fitch's belief the bank 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****SUBORDINATED DEBT**

NDB'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 expectation 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 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**

<b>ENTITY / DEBT</b> ⚡	<b>RATING</b> ⚡	<b>PRIOR</b> ⚡
National Development Bank PLC	Natl LT A(Ika) Rating Watch Negative Downgrade	A+(Ika) Rating Watch Negative
subordinated	Natl LT BBB+(Ika) Rating Watch Negative Downgrade	A-(Ika) Rating Watch Negative

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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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National Development Bank PLC -

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