

## ICRA Lanka reaffirms the issuer rating of Bank of Ceylon

December 19, 2018

Instrument	Rated Amount (LKR Mn)	Rating Action
Issuer rating	N/A	[SL]AAA (Stable); Reaffirmed

### Rating action

ICRA Lanka Limited, subsidiary of ICRA Limited, a group company of Moody's Investors Service, has reaffirmed the issuer rating of Bank of Ceylon (BOC or the Bank) at [SL]AAA (Pronounced SL triple A). The outlook on the rating is stable.

### Rationale

The rating continues to factor in the 100% Government of Sri Lanka (GoSL) ownership, which provides a strong likelihood of sovereign support and, BOC's leading position in the Sri Lankan banking industry. The rating factors in its established franchise, healthy deposit profile and comfortable liquidity position with liquidity coverage ratio (LCR) at 143% as in Sep-18. The rating takes cognizance of the significant shrinkage in the Bank's capital buffers, however, the same is presently over and above the regulatory requirement (tier I and total CAR at 10.0% and 14.0% respectively in Sep-18). Further, BOC would have to comply with enhanced capitalisation requirements under Basel-III, with Tier-I capital ratio at 10.0%<sup>1</sup> and overall capital adequacy ratio (CAR) at 14.0%<sup>1</sup> from January 01, 2019. ICRA Lanka notes that moderation in internal generation and, increase in the risk weighted assets because of weakening asset quality and increased risk weights on some of its other large exposures are likely to exert pressure on BOC's capitalisation profile in the next 1-2 quarters, till it secures commensurate capital from GoSL. Going forward, maintenance of adequate buffers (at least 1%) over and above the minimum capitalisation requirements (Tier-I and overall CAR) would be critical for sustenance of the current rating. ICRA Lanka takes note of the initiatives taken by the Bank to improve its asset risk profile, which could reduce the risk weights on its assets and, expects timely and adequate equity infusion by GoSL to improve its capitalization profile.

The rating also noted the moderation in earnings with return on assets (RoA<sup>2</sup>) at 1.2% in CY2017 (0.9% in 9MCY2018) as compared to 1.5% in CY2016. The rating also noted the weakening asset quality of the Bank as the gross NPA ratio has increased to 4.5% in Sep-18 from 2.9% in Dec-17, as a result of poor performance in agriculture and construction sectors. The above, however exert further pressure on the overall credit profile of the Bank and steady improvement of these indicators would be also be crucial from a rating perspective.

<sup>1</sup> Including capital conservation buffer and capital surcharge on Domestic Systemically Important Banks

<sup>2</sup> RoA based on Profit after tax

## Outlook: Stable

ICRA Lanka believes that BOC will continue to benefit from timely and adequate capital support from GoSL. The outlook may be revised to 'Negative' in case a steady shortfall is observed in BOC's capital buffers over the regulatory requirement or in case of further weakening in the profitability and asset quality indicators.

## Key rating drivers

### Credit strengths

**100% government owned, systemically important bank with long term track record and established franchise:** BOC is a licensed commercial bank, 100% owned by GoSL. The Bank is the largest commercial bank in Sri Lanka with systemic importance, which indicates strong likelihood of the sovereign support. BOC accounts for about 21% of the aggregate advances and about 23% of the aggregate deposits of all licensed commercial banks (LCBs) in Sri Lanka as in Jun-18. The Bank operates 577 branches covering all the regions in Sri Lanka; however, the Western province accounts for about 69% of the total loans of the Bank. BOC's total advances in CY2017 grew by 16% (20% in CY2016) in line with the 16% growth reported by the LCB industry during the same period. During 9MCY2018, advances grew by 16% (YTD, annualized); During the first two quarters, growth was 8-9% (QoQ, annualized) and in the third quarter the Bank reported a robust growth of 28% (QoQ, annualized) which came from the credit to SME sector in compliance with the government's policy to support the sector. The rating factors the Bank's position as one of the key lenders to the GoSL and state-owned entities (SOE), which constituted about 33% of the total portfolio as in Sep-18, as compared to 31% in Dec-17 and 30% in Dec-16; the Bank envisages maintaining an exposure at about 35% to GoSL and SOEs over the medium term.

**Healthy deposit profile with comfortable liquidity position:** BOC reported a healthy deposit profile with a comfortable mix of both foreign and local deposits, aided by the Bank's well-established branch network and dominant position in the remittance business. However, the Bank's CASA indicator moderated quite sharply in relation to peers to 35.0% in Jun-18 (37.3% in Dec-17 from 43.3% in Dec-16) because of the high yields available for shorter tenure deposits; however, it remained in line with the systemic levels (35.7% Jun-18 and 36.6% in Dec-17). During CY2017, the deposit base grew by 23% and for the 6 months ended Jun-18, the deposit base grew by 9% (YTD, annualized) to about LKR 1,617 Bn.

### Credit challenges

**Weakening asset quality:** BOC's asset quality deteriorated in 9MCY2018 as a result of poor performance in construction and agriculture sectors. The Bank's gross NPA ratio increased from 2.9% in Dec-17 to 4.5% in Sep-18 as compared to 2.9% gross NPA ratio reported in Dec-16. The Bank has taken action to regularise the NPA facilities and to prevent further slippages by conducting recovery clinics to retail customers and maintaining continuous dialogue with the corporates. ICRA Lanka noted that the solvency ratio<sup>3</sup> of the Bank has increased from 3.8% in Dec-17 to 13.1% in Sep-18 as a result of deteriorating asset quality.

**Subdued capitalization levels:** As in Sep-18, BOC's Tier-I capital adequacy ratio was 10.0% (regulatory requirement 7.375%) and total CAR was 14.0% (regulatory requirement 12.875%). LCBs are required to

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<sup>3</sup> Net NPA/ Networth

achieve a Tier-I CAR of 10.0% and total CAR of 14.0% by Jan-19 as per the Basel III requirement. Further, ICRA Lanka expects a significant first day adjustment to BOC's capital because of SLFRS-9 transition, impact of which would be spread over three years starting 2019 for capital adequacy computation, as per the CBSL directions. The Bank, in view of the above and moderation in its internal generation is expected to slow-down loan growth and focus on secured asset classes such as mortgage loans and pawning to improve the capitalisation in the near term. BOC is also expected to cap its dividend payments to conserve capital for meeting the enhanced capital requirement from Jan-19. ICRA Lanka estimates that BOC would require significant additional capital to maintain tier-I capital with a 1% capital buffer over the regulatory requirement over the next two years, assuming a 16-18% growth in Risk Weighted Assets (RWA). The Bank would also have to raise commensurate Tier-II capital for meeting the overall CAR requirement. BOC received LKR 5 Bn as equity capital from GoSL each in 2017 and 2018 and, ICRA Lanka expects timely capital support from GoSL in future also due to the systemic importance of the Bank. Going forward, maintenance of adequate buffers (at least 1%) over and above the minimum capitalisation requirements (Tier-I and overall CAR) would be critical from a rating perspective.

**Declining profitability indicators;** The Bank's ROA<sup>4</sup> moderated to 1.2% in CY2017 as compared to 1.5% in CY2016 because of increase in cost of funds and credit cost. During the latest nine months ended Sep-18, it further moderated to 0.9%. The cost of funds of the Bank increased with the moderation in CASA ratio; savings deposits shifted to term deposits due to the increase in the systemic rates, while the credit cost increased as result of sharp increase in the NPAs. The Bank expects an incremental impact of 25% to 35% on the credit cost with the implementation of SLFRS9 in 2019. ICRA Lanka notes that significant improvement in the interest margins and control on credit cost would be crucial to maintain a healthy earnings profile over the medium term.

**Analytical approach:** For arriving at the ratings, ICRA has applied its rating methodologies as indicated below.

**Links to applicable criteria:** [ICRA Lanka's Credit Rating Methodology for Banks](#)

### **About the entity:**

BOC is the largest licensed commercial bank in Sri Lanka; 100% owned by the Government of Sri Lanka. The Bank with assets of over LKR 1.98 trillion accounts for approximately 21% of the total banking sector assets as of Jun-18. BOC was incorporated in August 1939 under the Bank of Ceylon Ordinance No. 53 of 1938. Currently, BOC operates over 577 branches including 3 overseas branches in Maldives, Chennai and Seychelles. The Bank also operates a subsidiary in UK – Bank of Ceylon (UK) Limited. The BOC group has 10 subsidiaries and 4 associate companies that are involved in NBFIs operations, property development and leisure.

During the CY2017, BOC reported a PAT of LKR 21,312 Mn on a total asset base of LKR 1,952 Bn as compared to a PAT of LKR 24,791 Mn on a total asset base of LKR 1,669 Bn in the previous financial year. For 9MCY2018, BOC reported a PAT of LKR 13,029 Mn on a total asset base LKR 2,099 Bn.

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<sup>4</sup> ROA based on profit after tax

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