

## ICRA Lanka reaffirms the ratings of Regional Development Bank

April 03, 2018

### Summary of rated instruments

Instrument*	Rated Amount (LKR Mn)	Rating Action
Issuer rating	N/A	[SL]A (Stable); Reaffirmed
Listed Subordinated Unsecured Redeemable Debenture programme	LKR 2,500 Mn	[SL]A- (Stable); Reaffirmed
Subordinated Unsecured Redeemable Debenture programme	LKR 2,000 Mn	[SL]A- (Stable); Reaffirmed
Subordinated Unsecured Redeemable Debenture programme	LKR 1,000 Mn*	[SL]A- (Stable); Withdrawn

\*Remaining part of the originally rated limit of LKR 3,000 Mn (with an option of going up to LKR 5,000 Mn); RDB raised of Rs 2,000 Mn Subordinated Unsecured Redeemable Debentures, out of the originally rated limit, in August 2016

### Rating action

ICRA Lanka Limited, subsidiary of ICRA Limited, a group company of Moody's Investors Service, has reaffirmed the issuer rating of [SL]A (Pronounced SL A) with a stable outlook assigned to Regional Development Bank (RDB or the Bank). ICRA Lanka has also reaffirmed the [SL]A- (Pronounced SL A minus) with a stable outlook assigned to the LKR 2.5 Bn listed subordinated unsecured redeemable debenture programme and the LKR 2.0 Bn subordinated unsecured redeemable debenture programme of the Bank. ICRA Lanka has also withdrawn the [SL]A- (Pronounced SL A minus) with a stable outlook assigned to the LKR 1.0 Bn \* subordinated unsecured redeemable debenture programme, at the request of the Bank, as it does not intend to make further issuance out of the originally rated limit.

### Rationale

The ratings take note of the Government of Sri Lanka (GoSL) ownership (87.25%) of the Bank and, a high likelihood of capital, managerial and operational support from GoSL and other shareholders, if required. The ratings also factor in the strong and established franchise of the bank, especially in rural Sri Lanka, with its 268 branches spread across the country. The above has also resulted in a good share (32% of the total borrowings as at Dec-17) of lower cost savings deposit base for the Bank.

The ratings however take cognisance of its subdued capital profile (Tier-I capital ratio of 8.45% <sup>1</sup>provisional, as in Dec-17 as against the Basel-III Tier-I capital requirement of 7.9% as on Jan 01, 2018) and, its moderate profitability indicators (RoA at 0.67% for 6MFY2018, provisional, and 0.54% in FY2017). The bank's current exposures are largely to customer segments with modest credit history and who are highly susceptible to adverse economic and climatic cycles; further these loans are largely unsecured (not backed with fixed collateral security). The asset quality of the bank weakened, with gross NPAs increasing to 3.20% in Dec-17 as compared with 2.82% in Dec-16 because of the adverse weather conditions that prevailed in 2017. The bank envisages a 20% per annum portfolio growth during the period 2019-2020; ICRA Lanka notes that

<sup>1</sup> Estimated, including profits for CY2017

RDB would require about LKR 6-7 Bn capital infusion to maintain an adequate Tier-1 ratio of about 9.5% (buffer of 1.0% over the minimum requirement of 8.5% from January 01 ,2019), considering the relatively moderate internal generation of about 8-10%. ICRA Lanka also takes note of the proposed share-swap acquisition and merger of Lankaputhra Development Bank (LDB) with RDB that would improve the capital of the Bank, considering the favourable capital profile of LDB. The ratings continue to draw comfort from GoSL's majority ownership in the Bank, which along with RDB's focus to extend credit facilities to the rural population makes it a crucial channel for GoSL to undertake regional development; thereby providing visibility on timely capital support, if required.

### Outlook: Stable

ICRA Lanka believes that RDB would continue to get GoSL's support and meet regulatory capital requirements in a timely manner, while expanding its portfolio at the envisaged pace. The outlook may be revised to 'Positive' in case of significant improvement in the capitalisation and earnings of the Bank. The outlook may be revised to 'Negative' in case of a considerable weakening in the capital profile or a significant deterioration in the asset quality and earnings profile.

### Key rating drivers

#### Credit strengths

**Majority GoSL ownership and strategic importance for rural development:** RDB is a state owned Licensed Specialised Bank; with GoSL holding 87.25% and Bank of Ceylon, People's Bank and National Savings Bank holding 4.25% each. RDB is involved in extending banking services and facilities to rural communities having limited or no access to formal credit services, making it a key credit delivery system for these borrower segments. The bank has strong presence in Western, North- Western, Southern and Sabaragamuwa provinces, which accounted for 19%, 19%, 16% and 12% respectively of the total advances as of Dec-17.

**Established franchise provides access to lower cost deposits:** RDB has a strong geographic presence in rural Sri Lanka, with a network of 268 branches and catering to over 6 million customers. Through its established franchise, the bank has created a good deposit base. As of Dec-17, the bank reported a total deposit base of LKR 135.5 Bn, with share of saving deposits at 32% of the total borrowings. About 90% of the total borrowings were in the form deposits (fixed +savings) as in Dec-17.

#### Credit challenges

**Modest borrower credit profile and unsecured nature of loans increases portfolio vulnerability:** RDB is exposed to borrower segments having modest credit history. The Bank's lending portfolio includes microfinance and micro-credit exposure to agriculture and related sectors, which is largely unsecured and is susceptible to adverse weather conditions. About 90% of the advances were <LKR 500,000 and, are secured only by personal guarantees. Gross NPAs increased to 4.19% in Sep-17 as compared to 2.82% in Dec-16 as adverse weather conditions, which prevailed during 9MCY2017 impacted the loan repayment ability of the borrowers. The bank was able to arrest the delinquency during the last quarter of 2017 by tightening the collection and recovery activities. As a result, the bank's gross NPAs moderated to 3.2% (provisional) in Dec-17. ICRA Lanka expects the Bank's asset quality to remain vulnerable to adverse economic and climatic changes, considering the modest credit profile of the target customer segment. Therefore, maintaining a prudent lending process and undertaking efficient collection and recovery is crucial for keeping the asset quality under control.

**Subdued capital position; timely GoSL support envisaged:** The Bank's capital position weakened with the aggressive portfolio growth reported in CY2016. As a result, the Bank's total capital adequacy ratio (CAR) weakened to 9.29% in Dec-16 from 11.34% in Dec-15 (Basel III regulatory requirement was 11.25% from Jan 01,2017). In Dec-17, GoSL infused LKR 2.5 Bn; this along with the profits for CY2017 is expected to improve total CAR to 12.19%<sup>2</sup> as against the minimum requirement of 11.875% as on January 01, 2018. ICRA Lanka expects further improvement in the capital with the acquisition and merger of Lankaputhra Development Bank, which had a networth of LKR 5,094 Mn (provisional) in Sep-17 and a modest leverage of 0.77 times (provisional).

**Moderate profitability indicators:** The Bank's profitability indicators are quite depressed on account of the high operating cost structure, which is involved in serving a geographically dispersed customer base. NIM of the bank was about 6.41% in CY2016, while the operating expenses in relation to the total assets stood at 6.05% in CY2016. During the latest 9 months, NIM decreased to 6.06% on account of the increase in the systemic interest rates. The Bank however has taken action to improve its operating efficiency; as a result, the operating expense ratio decreased to 4.99% in 9MCY2017 from 6.05% in CY2016. RDB's credit cost nevertheless increased to 0.36% in 9MCY2017 (-0.02% in CY2016) on account of higher delinquencies reported in the period and upward revision of loss given default rates. ICRA Lanka expects credit cost in CY2017 and CY2018 to remain at elevated levels because of the upward revision of loss given default rates. The Bank's ROA marginally improved to 0.67% in 9MCY2017 and 0.54% in CY2016 (0.53% in CY2015), mainly due to improvements in operational efficiencies. The Bank's ability to further improve its operational efficiencies and control credit cost would be crucial for incremental profitability.

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

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

### **About the company:**

Regional Development Bank (RDB) was established in May 2010 by merging six provincial banks, to form a national level rural development bank. RDB was established under the Pradeshiya Sanwardhana Bank Act No.41 of 2008 as a fully state-owned national level bank with the long-term objective of improving the living standards of the rural masses by providing them accessible and affordable financial services.

The Bank is 87.25% directly owned by the GoSL and the balance 12.75% is equally owned by the three state owned banks, namely, Bank of Ceylon, People's Bank and National Savings bank.

In CY2016, RDB reported a PAT of LKR 641 Mn (audited) on a total asset base of LKR 130 Bn. During CY2015, the bank reported a PAT of LKR 529 Mn on a total asset base of LKR 106 Bn. The Bank's net worth as at Dec-16 stood at LKR 5.9 Bn.

For the nine months ended Sep-17, the bank reported a PAT of LKR 725 Mn (un-audited) on a total asset base of LKR 158 Bn.

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<sup>2</sup> Estimated, including profits for CY2017

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