ICRA Lanka revises outlook on the ratings of Regional Development Bank to negative

September 14, 2018

Summary of rated instruments

Instrument*	Rated Amount (LKR Mn)	Rating Action
Issuer rating	N/A	Issuer rating of [SL]A reaffirmed; Outlook revised to Negative from Stable
Listed Subordinated Unsecured Redeemable Debenture programme	LKR 2,500 Mn	Issue rating of [SL]A- reaffirmed; Outlook revised to Negative from Stable
Subordinated Unsecured Redeemable Debenture programme	LKR 2,000 Mn	Issue rating of [SL]A- reaffirmed; Outlook revised to Negative from Stable

Rating action

ICRA Lanka Limited, subsidiary of ICRA Limited, a group company of Moody's Investors Service, has reaffirmed the issuer rating of Regional Development Bank (RDB or the Bank) at [SL]A (Pronounced SL A) while revising the outlook to negative from stable. ICRA Lanka has also reaffirmed the issue rating of [SL]A- (Pronounced SL A minus) on 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, while revising the outlook of the two ratings to negative from stable.

Rationale

The revisions in the outlook factor in RDB's weakening asset quality, which impacted its earnings profile. The gross NPA ratio deteriorated significantly during H1CY2018 to 6.77% as of Jun-18 vis a vis 3.27% as of Dec-17 because of adverse weather conditions and unfavourable economic environment. RDB's exposures are largely to agriculture-based customer segments with modest credit history and who are highly susceptible to adverse economic and climatic cycles; given these loans are largely unsecured (not backed with fixed collateral security). ICRA Lanka notes that RDB's profitability indicators are expected to contract, going forward, largely on account of asset quality related pressures. ICRA Lanka also takes note of the bank's concentrated deposit profile (top five institutional depositors accounting for 50% of the total deposits as on March 2018) and, the non-renewal of some deposits by a large depositor in Q2CY2018 and further withdrawals in H2CY2018; ability to manage liquidity in view of the above would also be a monitorable.

ICRA Lanka further takes note of the pressure in the capitalisation profile on account of the robust growth in the past and the delay in the merger of Lankaputra Development Bank (LDB). As of Jun-18, the tier I capital ratio was at 7.92%, marginally above the regulatory threshold of 7.88% and total capital ratio was at 10.63% which was below the threshold of 11.88%. ICRA Lanka notes that RDB would require about LKR 6-7 Bn[1] capital infusion till CY2020 to maintain an adequate Tier-1 ratio of about 10.5% (buffer of 2.0% over the minimum requirement of 8.5% from January 01 ,2019), considering the internal generation of about 10%. ICRA Lanka also takes note of the proposed share-swap acquisition and merger of LDB with RDB and

[1] About LKR 1-2Bn, if adjusted for the merger with LDB

proposed tier II complied debt raising from a multinational institution that would improve the capital of the Bank.

The ratings, however continue to 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. The ratings also factor in the strong and established franchise of the bank with its 268 branches spread across the country which resulted in a good share of lower cost savings deposit base (37% of the total borrowings as of Jun-18) for the Bank.

Outlook: Negative

The negative outlook reflects the deterioration in RDB's asset quality and expected impact on the bank's earnings. The outlook may be revised to 'Stable' in case of a steady improvement in the asset quality indicators while maintaining a comfortable earnings profile. The ratings may be downgraded in case of a further weakening in capitalization and asset quality profile, and the overall financial risk 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.

Established franchise; RDB has a strong geographic presence in rural Sri Lanka, with a network of 268 island wide branches, serving over 6 million customers (National Savings Bank: 253, People's Bank: 740, BOC: 627). The bank has strong presence in Western, North-Western, Southern and Sabaragamuwa provinces, which accounted for 19%, 19%, 16% and 12% respectively of its total advances as of Dec-17. The established franchise helped the bank to secure low-cost deposits, with saving accounts at 37% of the total deposits (33% of the total debt[2]) as of Jun-18.

Credit challenges

Weakened asset quality indicators - The bank reported an increase in Gross NPA ratio to 6.77% in Jun-18 vis a vis 3.27% in Dec-17. The gross NPA ratio of development loans (loans to microfinance and SMEs) increased to 9.52% in Jun-18 from 4.96% in Dec-17 (5.18% in Dec-16) while in the non-development loans (housing loans and other consumption loans) GNPA ratio increased to 3.83% (Jun-18) from 1.59% (Dec-17). Adverse weather conditions and unfavourable economic environment directly impacted loan repayment ability of the agriculture-based borrowers. RDB is exposed to borrower segments having modest credit history. The Bank's lending portfolio includes microfinance and micro-credit exposures to agriculture and related sectors, which is largely unsecured and is susceptible to adverse weather conditions. About 90% of the advances were with ticket size of less than LKR 500,000 and, are secured only by personal guarantees. ICRA Lanka expects the bank's asset quality to remain vulnerable to adverse economic and climatic

[2] Deposits and other borrowings

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.

Concentrated fixed deposit profile- The fixed deposit (FD) base (about 56% of the total debt[3]) of the bank is concentrated with large exposures to top 5 institutional depositors (about 50% of FD base as of Mar-18). During Q2CY2018, bank faced some pressure on liquidity because of non-renewal of deposits amounting to about LKR 12.5 Bn (about 14% of total deposits as of Mar-18) by its largest depositor, further withdrawals, to the extent of LKR 7.0 Bn is envisaged in H2CY2018. As of Jun-18, RDB had contingent bank funding lines worth of LKR 2.5 Bn, which are unutilized and the bank is expected to raise further funds from other banks and Institutions, if required. ICRA Lanka expects timely liquidity support from the shareholders and notes that the bank would have to diversify its liability profile for maintaining a comfortable liquidity profile, as business expands.

Subdued capital position; The bank's capital position weakened during H1CY2018. The bank's core capital ratio was at 7.92% as of Jun-18, marginally above the regulatory requirement of 7.88% and total capital adequacy ratio was at 10.63%, which is below the regulatory requirement of 11.88%. As an immediate measure, the bank has slowed down its portfolio growth. ICRA Lanka expects the acquisition and merger of Lankaputhra Development Bank (which had a net worth of LKR 5.2 Bn as of Dec-17 and core CAR at 83.32%) and ongoing tier II fund raising initiatives (about LKR 13.0 Bn) to address the shortfall in capitalization. ICRA Lanka also expects timely capital support from GOSL, if required.

Scope for improvement in internal controls- ICRA Lanka notes that given RDB's limited internal controls and monitoring systems and there is scope to improve the same to make it commensurate with the current business risk profile. Further, considering the recent escalation in NPAs, the bank needs to strengthen its collection and recovery functions to maintain healthy asset quality indicators.

Expected contraction in profitability indicators- The bank's RoA (on PBT) moderated to 1.2% (annualised) for Q1CY2018 vis a vis 1.5% in CY2017 (1.1% in CY2016) and this is expected to further come down to about 1.0% for CY2018 because of moderation in the lending spreads and the expected increase in provision related costs and operating costs. The bank has shifted its product focus to financing development loans which have relatively lower yields and is expected to face higher credit losses as the asset quality has weakened. Operational costs (as a proportion of average assets) decreased over the period to 5.0% as of Mar-18 (5.3% in Dec-17 and 6.1% in Dec-16). The same is however is expected to increase in CY2018 with the increase in staff cost because of new recruitments and salary increments.

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 Bank:

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

[3] Deposits+other borrowings

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 CY2017, RDB reported a PAT of LKR 1,284 Mn on a total asset base of LKR 169 Bn. In CY2016, the bank reported a PAT of LKR 641 Mn on a total asset base of LKR 130 Bn. The bank's net worth as of Dec-17 stood at LKR 9.6 Bn (LKR 6.0 Bn as of Dec-16).

For the three months ended Mar-18, the bank reported a PAT of LKR 271 Mn (un-audited) on a total asset base of LKR 174 Bn.

Key financial indicators (audited)

	CY2016	CY2017	3MCY2018 (Unaudited)
Net Interest Income	7,616	9,676	2,665
Profit after Tax	641	1,284	271
Net worth	5,999	9,613	9,884
Loans and Advances	105,654	127,509	130,691
Total Assets	130,914	169,259	174,091
Return on Equity	11.04%	16.45%	11.11%
Return on Assets	0.54%	0.86%	0.63%
Gross NPA	2.86%	3.27%	5.85%
Capital Adequacy Ratio	9.27%	12.57%	11.40%
Gearing (times)	20.3	16.2	15.9

Rating history for last three years:

	Current Rating (CY2018)				Chronology of Rating History for the past 3 years		
Instrument	**Type**	**Amount Rated (LKR Mn)**	**Amount Outstanding (LKR Mn)**	**Date & Rating in CY2018 Aug 2018**	**Date & Rating in CY2017 Feb 2018**	**Date & Rating in CY2016 Aug 2016**	**Date & Rating in CY2015 -**
Issuer rating	N/A	N/A	N/A	**[SL]A (Negative)**	**[SL]A (Stable)**	**[SL]A (Stable)**	**N/A**
Issue rating	Listed Subordinated Unsecured Redeemable Debenture programme	2,500	**2,500**	**[SL]A- (Negative)**	**[SL]A- (Stable)**	**[SL]A- (Stable)**	**N/A**
Issue rating	Subordinated Unsecured Redeemable Debenture programme	2,000	**2,000**	**[SL]A- (Negative)**	**[SL]A- (Stable)**	**[SL]A- (Stable)**	**N/A**

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