ICRA Lanka reaffirms the issue rating of [SL]A- to the proposed Unlisted Subordinated Debentures programme of Regional Development Bank

December 28, 2016

Instrument	Amount	Rating Action
Proposed Unlisted Subordinated Unsecured Redeemable Debenture programme	LKR 3.0 Billion (with the option to increase up to LKR 5.0 Billion)	[SL]A- with stable outlook; Reaffirmed

ICRA Lanka Limited, subsidiary of ICRA Limited, a group company of Moody's Investors Service has reaffirmed the issue rating for the proposed LKR 3.0 billion (with the option to increase up to LKR 5.0 billion) Subordinated Unsecured Redeemable Debenture programme of Regional Development Bank. Terms of the instrument has changed to a private placement, from a listed debenture, which was covered in the ICRA Lanka rationale dated August 05, 2016. Further, ICRA Lanka has an outstanding Issuer rating of [SL]A with a stable outlook for Regional Development Bank (RDB or "the Bank") and Issue rating of [SL]A- with stable outlook for the existing LKR 2.5 Billion Subordinated Unsecured Redeemable Debenture programme currently listed on the Colombo Stock Exchange.

The rating takes note of the state ownership of the bank and a high likelihood of capital, managerial and operational support from the Government of Sri Lanka (GoSL) and other shareholders, if required. The rating also factor in the strong and established franchise of the bank, especially in rural Sri Lanka, with its 265 branches spread across the country. The above has also resulted in a good share (88% of the total debt as on September 30, 2016) of low cost savings deposit base for the bank. The rating also takes cognisance of its currently subdued capital profile (Total capital ratio at 10.5% as in December 31, 2015, 10.1% in September 30, 2016) and moderate profitability indicators (RoA at 0.9% for CY2015; 0.4% for 9M CY2016). The bank's current exposures are largely to customer segments with modest credit history and who are highly susceptible to economic and climatic cycles; further these loans are largely unsecured (not backed with collateral). The rating takes note of the improvement in the asset quality profile of RDB over the recent past (GNPA 4.0% as on December 31, 2015, 4.2% on September 30, 2016 Vis a Vis 7.6% on December 31, 2014) and, its plan to increase the share of secured SME loans going forward vis a vis the microfinance and unsecured micro-credit facilities extended by the bank in the past. The bank envisages a robust 25-30% per annum portfolio growth over the next 3-4 years; ICRA Lanka notes that RDB would require sizeable capital infusion in relation to its current net worth (75% of the current networth over the 3 year period ended December 31, 2018) to maintain a reasonable core capital profile of about 8% as the risk weighted assets expand at CAGR of 25-30% and internal generation is about 6-8%. The rating however takes comfort from the state ownership, 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 activities; thereby providing visibility on timely support from the state. ICRA Lanka further notes that it would be crucial for the bank to broad-base its middle and lower management team and, augment its risk management and internal control systems to manage the envisaged robust portfolio growth with incremental focus on SME financing.

The bank's gross lending portfolio reported a CAGR of 17% over the period 2011-2015. RDB's lending profile has gradually evolved from primarily agriculture financing and pawning to include, housing, and SME financing. The bank's pawning exposure has reduced to 9% as on December 31, 2015 (17% in 2014; 35% in 2013), while the agriculture exposure has reduced to 14% (17% in 2014; 16% in 2013) and the exposure to housing, which is relatively a safer asset class, has increased to 37% as in December 31, 2015 (21% in 2014). Exposure to industry & commercial sector was 23%, while microfinance exposure of the bank was 8-10%. Going forward, the key growth driver for the bank is expected to be SME financing; the bank is expected to direct at least 50% of its loan disbursements for CY2016 towards the SME sector.

In terms of the asset quality, there was a noticeable increase in gross NPL ratios in the three years, from 2011-2014 (GNPA 2012-4.2%, 2013-7.1%, 2014-7.6%), mainly due to pawning related loan delinquencies and poor recovery in the microfinance segment. However, the same has improved during CY2015 to 4.0% (4.2% as on September 30, 2016). ICRA Lanka is cognisant of the inherent risk involved in the market segments that RDB operates in, due to the modest credit profile of the borrowers. The NPLs are quite high in the microfinance portfolio of the bank; gross NPL ratio was at 10.4% as in March 31, 2016. The high NPL levels in microfinance were on account of the modest internal controls and collection efforts at the field level. The bank is actively taking measures to improve recoveries by augmenting its processes and collection efficiency. The NPL in the remaining portfolio of the bank was relatively moderate at 5.3%. ICRA Lanka notes that the provision cover ratio of the bank is below average at 20% in CY2015 and 24% in CY2014.

The capital position of the bank is subdued with the Tier 1 CAR as on September 30, 2016 being at 7.2% (December 31, 2015 – 7.6%) and the total CAR was marginally above the regulatory minimum, at 10.1% (December 31, 2015 – 10.5%). Over the last 4 years from CY2011 to CY2015 asset base of RDB had grown by 16% (CAGR), and the bank is estimated to grow its loan portfolio at a rate of 25-30% (CAGR) over the next 3 years. This envisaged robust growth would exert pressure on the capital position of RDB, given the expected modest internal generation. RDB would require sizeable capital in relation to its current networth (76% of the current networth over the 3 year period ending December 31, 2018) to maintain a reasonable core capital profile of about 8% as the risk weighted assets expand at CAGR of 25-30% and internal generation is about 6-8%. The proposed LKR 3.0 billion unsecured subordinate debenture issue would support the total CAR in the near to medium term.

RDB is primarily dependent on public deposits for its funding, where deposits accounted for about 88% of the total debt (borrowings + deposits) of the bank as on September 30, 2015 (December 31, 2015 – 90%). Of the total deposits, a high proportion of over 42% is represented by savings deposits. The liquidity risk stemming from reliance on public deposits is offset to an extent by the high renewal rate (approximately 90%) and its quite granular deposit profile. The liquidity position of the bank is further strengthened by the access to funding lines from the three state owned banks who are also the shareholders of RDB.

The bank's profitability indicators are quite depressed on account of the moderate spread coupled with a high operating cost structure, which involved in serving a geographically dispersed customer base. NIM of the bank was about 6.6% in CY2015 and 6.0% in 9M CY2016 (CY2014 - 6.2%), while the operating expenses in relation to the total assets stood at 6.1% in CY2015 and 5.6% in 9M CY2016 (CY2014- 6.2%). ROA (after tax) of the bank, which stood at about 0.3-0.4% during 2013-2014, improved to 0.9% in CY2015 (CY2014 – 0.4%), mainly due to provision reversals; the same was recorded at 0.4% in 9M CY2016. Going forward, ICRA Lanka expects the profitability of the bank to witness some pressure in the short-medium term as the systemic interest rates are on an upward trajectory; the bank's earnings profile would also be affected, if it undertakes state directed financing at lower rates, as in the past. Ability of the bank to optimise its operating cost structure and keep its credit cost under control would be crucial for maintaining a good risk adjusted return going forward.

Bank Profile

Regional Development Bank (RDB) was established in May 2010 by merging six provincial banks, to form a national level development bank. The 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 64% directly owned by the GoSL and the balance 36% is equally owned by the three state owned banks, namely, Bank of Ceylon, People's Bank and National Savings bank.

Recent Results

For the financial year ended December 31, 2015, RDB reported a profit after tax of LKR 882 Million (LKR 343 Million in 2014) with a total asset base of LKR 107 Billion (LKR 92 Billion in 2014). The bank had a reported net worth of LKR 6.2 Billion as on December 31, 2015, up from LKR 5.4 Billion in December 31, 2014.

In the nine months ended September 30, 2016, the bank reported a net profit of LKR 342 Million, with a total asset base of LKR 126 Billion. The reported net worth as on September 30, 2016 was LKR 6.4 Billion.

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