

ICRA Lanka reaffirms the issuer rating of Sri Lanka Savings Bank

December 20, 2018

Instrument*	Rated Amount (LKR Mn)	Rating Action
Issuer rating	N/A	[SL]BBB- (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 [SL]BBB- (Pronounced SL triple B minus) with a stable outlook for Sri Lanka Savings Bank (SLSB or the Bank).

Rationale

The reaffirmation of the rating takes note of the 100% Government of Sri Lanka (GoSL) ownership in SLSB, which provides a strong likelihood of sovereign support to the Bank, when needed. ICRA Lanka also takes note of the expected acquisition of the Bank by National Savings Bank (NSB) over the medium term. The Bank has a comfortable capital structure characterised by a core capital ratio of about 90% in Sep-18. However, SLSB would have to enhance its core capital to LKR 7.5 Bn by Dec-20 from about LKR 5.7 Bn in Sep-18 to meet the minimum core capital requirement for Licensed Specialised Banks (LSBs). ICRA Lanka expects timely capital support from GoSL or NSB, if acquired, to meet the regulatory capital requirement. The rating takes cognizance of SLSB's currently inadequate internal controls, processes and systems to effectively manage the risky market segments serviced by the Bank; namely microfinance, micro and small-scale enterprise, and retail credit. This is evident from the Bank's weak asset quality indicators with gross NPA ratio of about 15.5% in the active portfolio (i.e. excluding the legacy PSDB¹ portfolio) as of Sep-18. The rating takes note of the relatively weak franchise of the Bank with only 4 branches and a modest total asset base of about LKR 9.4 Bn as of Sep-18. SLSB's profitability is expected to be supported by its investment income (about 62% of total interest income in 9MCY2018) and its low leverage. Going forward, SLSB's ability to report healthy profitability indicators would be crucial as the lending portfolio expands and leverage increases. Between Dec-17 and Sep-18 period, the Bank has repaid about LKR 1.5 Bn of PSDB debentures which matured on December 03, 2017.

Outlook: Stable

The outlook may be revised to "Positive" depending on the successful acquisition by NSB and improvement in the Bank's overall risk management and internal controls. The outlook may be revised to "Negative" in case of lack of timely capital support from GoSL or a significant deterioration in the earnings, capital or asset quality profile of the Bank.

Credit strengths

100% government ownership, possible acquisition by NSB; SLS bank is a 100% GoSL owned LSB, with focus on microfinance, micro SME and retail credit. The Bank has received financial and managerial support from GoSL in the past and, ICRA Lanka envisages timely support in the future also. GoSL has demonstrated

¹ Pramukha Savings and Development Bank

support and assistance through LKR 500 Mn initial capital infusion in 2006, merger of National Development Trust Fund (NDTF) to address capital shortage in 2010, and LKR 362 Mn capital infusion in 2017 to meet the capital requirement of LKR 5 Bn. Further, GoSL has proposed an acquisition of SLSB by National Savings Bank (NSB), which is expected to be completed in the near to medium term. ICRA Lanka expects, timely support to SLSB from GoSL or from NSB, if acquired, for meeting its core capital requirement of LKR 7.5 Bn by Dec-20.

Credit challenges

Weak internal controls, processes and systems; ICRA Lanka notes there is substantial scope to improve SLSB's internal controls, processes and systems to adequately manage the underlying risks of dealing with the key target lending segments; microfinance, consumer loans and leasing. Further, SLSB has significant limitations with the adequacy of competent human resources to carry out its operations. ICRA Lanka however expects this to be addressed post acquisition by NSB, and this would remain a key monitorable from a rating perspective.

Modest scale of operations and limited franchise; SLSB is a modest sized LSB with a total asset base and a gross lending portfolio of LKR 9.4 Bn and LKR 4.0 Bn respectively as of Sep-18. The Bank has only 4 branches, including head office. The asset base is characterised by investments accounting for 64% as of Sep-18 (63% in Dec-17 and 65% in Dec-16). Historically, SLSB has maintained a high proportion of investments in order to facilitate repayment of the deposit holders of failed Pramuka Savings and Development bank (PSDB). Since vesting of PSDB's liabilities, SLSB has paid out about LKR 2.8 Bn (including interest on PSDB debentures) and there is a remaining unclaimed balance of about LKR 600 Mn (including interest) as of Sep-18. During 9MCY2018, the Bank has continued to maintain its high exposure to investments as it refrained from taking any significant business decisions pending acquisition by NSB. The lending portfolio consists of exposures to microfinance bulk lending, consumer loans, leasing and HP, and micro SME loans which accounted for 33%, 15%, 13% and 13% respectively as of Sep-18. The legacy portfolio inherited from PSDB accounted for 26% of the total lending portfolio.

Exposure to riskier asset classes resulted in weak asset quality; ICRA Lanka notes that SLSB's portfolio is exposed to vulnerable customer segments through microfinance bulk loans to microfinance institutions, consumer loans and micro-scale enterprise lending, which accounted for about 82% of the active portfolio (excluding PSDB portfolio), and stood at LKR 2.4 Bn as of Sep-18. Further, SLSB has considerable loan concentration in bulk microfinance segment with top 10 microfinance borrowers representing close to 25% of the total active loan portfolio. The Bank reported a high gross NPA ratio of 37.3% as of Sep-18 (33.0% as of Dec-17). The asset quality is affected by the legacy portfolio taken over from PSDB (LKR 1.0 Bn as of Sep-18), which is almost entirely non-performing and is fully provided. The gross NPA ratio of the active portfolio increased to 15.5% as of Sep-18 vis-a-vis 11.2% as of Dec-17, largely because of increased slippages in the microfinance bulk lending product. The GNPA ratio of microfinance bulk lending increased sharply to 16.5% from 9.5% during the period because of challenges faced by the country's microfinance industry over the period. The micro enterprise segment recorded the highest GNPA of 29.3% as of Sep-18 (28.6% in Dec-17) largely because of weak loan assessment process followed at the branch level. The gross NPA of leasing and HP, and consumer loans categories were relatively low at 8.8% and 6.8% respectively as of Sep-18 (7.5% and 5.4% respectively in Dec-17), which also is higher than peers.

Profitability is expected to be supported largely by investment income until the acquisition program concludes; SLSB's healthy level of NIM and RoA (about 9.7% and 5.7% respectively in Sep-18) was supported by the modest cost of borrowings and low leverage (gearing at 0.54 times in Sep-18). The Bank's cost of borrowing has reduced from 3.9% in Dec-17 to 3.3% in Sep-18, largely because of repayment of PSDB debentures (about LKR 1.5 Bn) during the period. Further, SLSB received an equity infusion of LKR 362 Mn

in Dec-17. SLSB's investments accounted for about 64% of total assets base and 62% of the interest income as of the 9-month period ended Sep-18. Pending the acquisition by NSB, ICRA Lanka expects the Bank's borrowings to remain modest and investment income to mainly support the profitability of the Bank.

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 company:

The Sri Lanka Savings Bank was established in July 2006 as a state owned licensed specialized bank, with the primary objective of taking over the assets and liabilities of Pramukha Savings and Development Bank (PSDB). In 2010, with state intervention, National Development Trust Fund (NDTF) was merged with SLSB to meet the capital deficiency of the Bank. Until 2011, SLSB was only authorised to recover the PSDB portfolio and pay-off its deposit holders. Subsequently, in 2011, the articles of the Bank were amended to enable SLSB to commence its own lending operations.

In CY2017, SLSB reported a PAT of LKR 603 Mn on a total asset base of LKR 9.5 Bn. During CY2016, the Bank reported a PAT of LKR 600 Mn on a total asset base of LKR 9.7 Bn. The Bank's net worth as in Dec-17 stood at LKR 4.8 Bn (adjusted for revaluation).

For the 9-months ended Sep-18, the Bank reported a PAT of LKR 327 Mn (un-audited) on a total asset base of LKR 9.4 Bn.

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