

ICRA Lanka reaffirms the issuer rating of Sri Lanka Savings Bank

February 16, 2018

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 takes note of the possible 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 71% in Sep-17. However, SLSB would have to enhance its core capital to LKR 7.5 Bn by Dec-20 from LKR 4.3 Bn in Sep-17 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 13% in the active portfolio (i.e. excluding the legacy PSDB¹ portfolio) as of Sep-17. 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 10.2 Bn as of Sep-17. Going forward, SLSB's ability to report healthy profitability indicators would be crucial as the low-cost deposits (about 53% of funding profile in Sep-17) get redeemed and the lending portfolio expands. In CY2016, SLSB's profitability was largely because of its investment income (about 67% of total interest income) earned on the back of the low-cost deposits available with the bank; these deposits have to be repaid to the PSDB deposit holders (about LKR 2.2 Bn) starting from Dec-17.

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 372 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 which is also highlighted by the bank's auditor, the Auditor General's Department. 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 10.2 Bn and LKR 4.0 Bn respectively as of September 2017. The bank has only 4 branches, including head office. The asset base is characterised by investments accounting for 65% as of September 2017, part of which would be to facilitate repayment of deposit holders (about LKR 2.2 Bn) of failed Pramuka Savings and Development bank (PSDB). The lending portfolio consists of exposures to microfinance bulk lending, consumer loans, leasing and HP, and micro SME loans which accounted for 32%, 18%, 13% and 11% respectively as of September 2017. The legacy portfolio inherited from PSDB accounted for 26% of the total lending portfolio. The bank presently has been advised by GoSL to refrain from taking any significant business decisions pending acquisition by NSB.

Exposure to riskier asset classes resulted in weaker 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 lendings which accounted for about 83% of the active portfolio (excluding PSDB portfolio), and stood at LKR 2.9 Bn as of September 2017. Further, SLSB has considerable loan concentration in bulk microfinance segment with top 10 microfinance borrowers representing close to 26% of the total active loan portfolio. The bank reported a high gross NPA ratio of 35.6% as of September 2017 (34.5% as of December 2016). The asset quality is affected by the legacy portfolio taken over from PSDB (LKR 1.0 Bn as of September 2017), which is almost entirely non-performing and is fully provided for. The gross NPA ratio of the active portfolio was 12.83% as of September 2017 vis-a-vis 13.22% as of December 2016. The micro enterprise segment recorded the highest GNPA of 29.1% as of September 2017 (32.0% in Dec-16) largely because of inadequate loan appraisals at branch level. In the bulk microfinance lending category also, the gross NPA stood high at 13.0% in September 2017 (14.5% in Dec-16) mainly because of 2 accounts amounting to about LKR 87 Mn becoming NPAs. The gross NPA of leasing and HP, and consumer loans categories were relatively low at 8.9% and 4.9% respectively as of September 2017, however, it is higher than peers.

Profitability supported by low leverage and investment income; ability to grow the lending portfolio is crucial for increment profitability- SLSB's healthy level of NIM (about 7.8% in Dec-16) was supported by the modest cost of borrowings and good investment income. The bank reported a RoA of 6.5% and 6.6% in CY2016 and 9MCY2017 respectively. About 50% of the borrowing profile of the bank consisted of PSDB

deposits and the interest cost for majority of it (about 43% as on Sep-17) was capped at 5%. SLSB's investment portfolio represented about 65% and 67% of total assets base and interest income respectively as of December 2016. The repayment of PSDB deposit holders of about LKR 2.2 Bn is expected from the liquidation of investment portfolio and is estimated to reduce the investment portfolio by about 33% and will impact earnings. Therefore, SLSB's ability to expand its lending portfolio while keeping borrowing cost under control would be crucial for maintaining a healthy profitability level going forward.

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. Subsequently, in 2011, the articles of the bank were amended to enable SLSB to commence its own lending operations.

In CY2016, SLSB reported a PAT of LKR 615 Mn (un-audited) on a total asset base of LKR 9.7 Bn. During CY2015, the bank reported a PAT of LKR 432 Mn on a total asset base of LKR 9.2 Bn. The Bank's net worth as in Dec-16 stood at LKR 4.3 Bn (adjusted for revaluation).

For the nine months ended Sep-17, the bank reported a PAT of LKR 493 Mn (un-audited) on a total asset base of LKR 10.2 Bn.

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