

ICRA Lanka revises the issuer rating of State Mortgage and Investment Bank

November 14, 2018

Instrument*	Rated Amount (LKR Mn)	Rating Action
Issuer rating	N/A	Revised to [SL]A- (Negative) from [SL]A (Stable)

Rating action

ICRA Lanka Limited, subsidiary of ICRA Limited, a group company of Moody's Investors Service, has revised the issuer rating of State Mortgage & Investment Bank (SMIB or the Bank) to [SL]A- (pronounced SL A minus) from [SL]A (pronounce SL A). The outlook is revised from stable to negative.

Rationale

The rating revision factors in SMIB's weakening asset quality and modest profitability indicators. The gross NPA ratio, excluding Employees' Provident Fund (EPF) backed loans, has increased to 6.7% in H1CY2018 from 5.7% in CY2016 (6.5% in CY2017). Going forward, with the expected increase in the share of personal loans and unsecured loans, the bank is faced with higher credit risk, considering its modest internal controls, loan origination and monitoring systems. SMIB's profitability, as envisaged, moderated sharply (RoA at 0.8%, provisional, as of Jun-18 and 0.6% Dec-17 vis a vis 1.3% in Dec-16) on account of decline in loan yields, in line with the CBSL recommendation and, the increase in its borrowing costs. ICRA Lanka notes that while the bank's core and total capital adequacy ratios are adequate at 23.9% and 24.7% respectively as of Jun-18, its minimum core capital remained below the minimum requirement (LKR 5 Bn) as in Jan-18. Further, SMIB would have to enhance its core capital to LKR 7.5 Bn by Dec-20 to meet the minimum core capital requirement applicable for Licensed Specialised Banks (LSBs). ICRA Lanka estimates the bank would need about LKR 2.0-2.3 Bn capital infusion to meet the regulatory requirement as the internal generation is likely to remain modest. ICRA Lanka envisages timely capital support from Government of Sri Lanka (GoSL) to meet this requirement. Further, ICRA Lanka notes SMIB's concentrated funding profile and higher ALM mismatches in less than 1 year (at -33% as of Jun-18).

The rating, however, continues to factor in the 100% GoSL ownership in SMIB, which provides a strong likelihood of sovereign support to the Bank, when needed. The rating takes cognizance of the bank's established franchise with its 24 branches across the country, and granular loan portfolio.

Outlook: Negative

The negative outlook reflects SMIB's weakening asset quality and earning profile, and modest internal controls in relation to the business segments in focus, going forward. The outlook may be revised to "Stable" in case of a steady improvement in credit quality and profitability indicators while improving internal controls to make it commensurate with the portfolio's risk profile. The rating may be downgraded in case of a further weakening in asset quality and overall financial risk profile or in case of lower than expected support from GoSL.

Key rating drivers

Credit strengths

100% government ownership provides visibility on timely support; SMIB is a 100% GoSL owned LSB, and the bank has received financial and managerial support from GoSL in the past. The GoSL has appointed three government administrative officers to SMIB's Board representing the Ministry of Finance, Housing and Agriculture. GoSL also infused capital of LKR 250 Mn in 2016 by converting a loan granted by it in the past. ICRA Lanka therefore expects timely support, especially in meeting SMIB's core capital requirement of Rs 7.5 Bn by December 2020.

Established franchise and granular portfolio; 100% state ownership and long-standing presence of the bank has helped it to secure an established depositor base. The bank has 24 branches spread across the country. Top 10 loans accounted for about 1% of the total portfolio as of Jun-18 indicating portfolio granularity and low credit concentration risk.

Credit challenges

Moderate scale of operations; share of unsecured loans to further increase; SMIB is a moderate sized LSB with a total asset base of LKR 43 Bn as of Jun-18. The bank offers personal loans, mortgage loans and EPF loans which accounted for 42%, 27% and 25% respectively of its LKR 33 Bn portfolio as in Jun-18. ICRA Lanka takes note of the increase in the share of unsecured loans in the overall portfolio, as personal loans share has increased to 42% in Jun-18 from 26% in Dec-16 and 17% in Dec-15. As the bank expands its personal loan book further and diversifies to newer products namely SME credit and microfinance, the share of unsecured loans is expected to increase further going forward. SMIB's ability to keep credit quality under control in view of the increased share of unsecured loans would be a key monitorable.

Scope to improve overall risk management systems; ICRA Lanka notes that given SMIB's limited internal controls and monitoring systems; there is scope to improve the same to make it commensurate with the increased business risk. The bank's business risk profile has changed over the period as the portfolio exposure has shifted from secured EPF loans (25% in Jun-18 vis a vis 45% in Dec-15) and mortgage loans (27% in Jun-18 vis a vis 31% in Dec-15) to personal loans (42% in Jun-18 vis a vis 17% in Dec-15), which warrants prudent loan origination and enhanced monitoring.

Sizeable capital required for meeting minimum regulatory core capital; SMIB has adequate capital adequacy ratios since its exposures to EPF loans and mortgage loans (25% and 27% in Jun-18) have lower risk weights of 0% and 50% respectively. The bank's core and total CAR stood at 23.4% and 24.7% respectively and the gearing stood at 7.2 times in Jun-18. However, SMIB's core capital stood at LKR 4.8 Bn as of Dec-17, below the minimum requirement of LKR 5 Bn (effective from Jan-16 and SMIB was granted an extension till Jan-18). The same including unaudited profits for CY2017 and H1CY2018 improves to about LKR 5.1 Bn as of Jun-18. In October 2017, CBSL has issued another direction, further increasing the minimum capital of LSBs to LKR 7.5 Bn by Dec-20. Based on ICRA Lanka's estimates, the bank would require external capital support of about LKR 2.0-2.3 Bn to meet the same, as internal generation is expected to be inadequate. However, timely support from GoSL is envisaged to meet the above minimum regulatory requirement.

Weakening asset quality indicators; The bank's gross NPA ratio stood at 20.7% in Jun-18 vis a vis 22.9% in Dec-17 (25.2% in Dec-16). Historically, SMIB recorded lower NPAs during the second quarter of the year as

the claims for previous year's over dues on EPF backed loans are paid during this period by the EPF division of CBSL. EPF loans contribute significantly for the overall high NPA's, as most borrowers expect the bank to recover loan liabilities out of EPF balances. As in June 2018, gross NPA ratio of EPF loans improved to 64.7% from 68.8% in CY2017 (61.5% in CY2016), largely because of the recovery claims received from the EPF department and some early settlement of loans by directly by borrowers through withdrawals from EPF accounts. The gross NPA ratio, excluding EPF loans, increased to 6.7% in Jun-18 from 6.5% in Dec-17 and 5.7% in Dec-16. The increase in gross NPAs in personal loan segment (GNPA% at 5.0% in Jun-18 vis a vis 4.4% in Dec-17 and 3.5% in Dec-16) during the period largely contributed to weaker asset quality in non-EPF loan book. In the mortgage loan category, the GNPA ratio stood high at 8.0% in Jun-18, however improved from 8.5% in Dec-17 (6.3% in Dec-16) as incremental slippages decreased. Going forward, as the non-EPF loan portfolio seasons and as the share of unsecured loans increases, SMIB's ability to keep its asset quality under control would be crucial.

Concentrated deposit profile and sizeable ALM mismatches; SMIB's total borrowings stood at LKR 37 Bn and 93% of it was as deposits (86% FDs, 4% savings and 3% special scheme deposits) as in Jun-18, while borrowings from banks (5%) and refinance loans (1%) accounted for the rest. Top 10 deposits accounted for about 36% of total deposits in Jun-18, indicating a somewhat concentrated deposit profile. SMIB's ALM profile is characterized by significant mismatches in the less than 1-year bucket (33% of total assets in Jun-18), as majority of borrowings are short-term compared to long-term nature of its lending portfolio. While ICRA Lanka notes the healthy deposit renewal rate of about 85-90% and availability of contingent funding lines, it would be crucial for the bank to improve its liquidity profile to offset refinance and interest rate risks.

Modest profitability indicators; SMIB's RoA decreased sharply to 0.6% in CY2017 from 1.3% in CY2016 and the same stood at 0.8% in H1CY2018. This is largely because of contraction in NIM (4.4% in H1CY2018 and 4.3% in CY2017 vis a vis 5.2% in CY2016) as SMIB reduced yields, based on the recommendation of CBSL and, upward re-pricing of its deposits (10.8% in H1CY2018 vis a vis 9.8% in CY2017 and 8.5% in CY2016), which are largely of shorter-term tenures. In addition, the bank's credit cost¹ increased to 0.31% in H1CY2018 and 0.41% in CY2017 from 0.10% in CY2016, largely because of the increased slippages in unsecured personal loans portfolio. Operating expenses (as a proportion of total assets) stood at about 3.0% for H1CY2018, improved from 3.1% in CY2017 and 3.5% in CY2016. Going forward, it is crucial for SMIB to further improve its operating efficiencies and keep borrowings and credit cost under control.

Analytical approach: For arriving at the rating, 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:

The State Mortgage & Investment Bank is a 100% GoSL owned, Licensed Specialized Bank operating with 24 branches. SMIB is one of the five entities in Sri Lanka to offer EPF backed loans. Apart from the above, the bank also offers mortgage backed housing loans, personal loans and leasing facilities to its customers. It commenced operations as the Ceylon State Mortgage Bank (CSMB) in December 1931. SMIB was formed by the State Mortgage & Investment Bank Act No. 13 of 1975, amalgamating CSMB and the Agricultural

¹ provisioning and write off as a proportion of total assets

and Industrial Credit Corporation and commenced its operations from January 1979. In April 1998, the Bank was granted the license to operate as a licensed specialized bank by the CBSL.

In 2017, SMIB reported a PAT of LKR 224 Mn (unaudited) on a total asset base of LKR 42.1 Bn. During 2016, the bank reported a PAT of LKR 436 Mn on a total asset base of LKR 35.3 Bn. The Bank's reported net worth stood at LKR 5.0 Bn as of Dec-17 (LKR 4.9 Bn as of Dec-16). For the six months ended Jun-18, the bank reported a PAT of LKR 161 Mn (un-audited) on a total asset base of LKR 42.7 Bn.

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