



Hatton National Bank

Hatton National Bank PLC

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CIRCULAR TO SHAREHOLDERS

Dear Shareholder/s,

ISSUE OF BASLE III COMPLIANT, TIER 2, LISTED, RATED, UNSECURED, SUBORDINATED, REDEEMABLE 10 YEAR DEBENTURES, WITH A NON-VIABILITY CONVERSION FEATURE TO ORDINARY VOTING SHARES BY THE BANK SOLELY, UPON THE OCCURRENCE OF A TRIGGER EVENT AS DETERMINED BY THE CENTRAL BANK OF SRI LANKA.

The Board of Directors of Hatton National Bank PLC (hereinafter referred to as "the Bank" or "HNB") at its meeting held on 26th November 2020, decided to raise a sum of Rupees Five Billion (LKR 5,000,000,000) by an initial issue of up to Fifty Million (50,000,000) Basle III Compliant, Tier 2, Listed, Rated, Unsecured, Subordinated, Redeemable Debentures, each with a par value of LKR 100/- and to raise a further sum of Rupees Two Billion (LKR 2,000,000,000) by an issue of a further Twenty Million (20,000,000) Debentures (hereinafter collectively called "the Debentures") in the event of an over subscription of the initial issue, at the discretion of the Bank.

As such a maximum amount of Rupees Seven Billion (LKR 7,000,000,000) would be raised by the issue of a maximum of Seventy Million (70,000,000) Debentures each with a par value of LKR 100/-.

The issuance of the BASEL III compliant Tier 2 debentures ("the Debenture Issue") and trading of such Debentures in the secondary market is limited to "Qualified Investors" (please refer section 6 for the definition of Qualified Investor).

THE ABOVE ISSUE IS SUBJECT TO THE APPROVAL OF THE COLOMBO STOCK EXCHANGE (CSE), CENTRAL BANK OF SRI LANKA (CBSL) & ANY OTHER REGULATORY APPROVALS (AS APPLICABLE)

An expected rating of A(EXP)(Ika) for the proposed Debenture issue has been obtained from Fitch Ratings Lanka Ltd.

The final rating for the proposed Debenture Issue will be issued by Fitch Ratings Lanka Ltd., subsequent to the special resolution being passed by the shareholders at the Extraordinary General Meeting (EGM) convened and the final rating will be incorporated in the Prospectus to be issued in respect of the Debenture Issue (hereinafter referred to as the "**Debenture Prospectus**").

This Circular to the Shareholders is issued mainly to inform the shareholders of the requirement for the Bank to seek approval of the shareholders for the issuance of the Subordinated Debentures. In the event of there being a 'Trigger Event' as defined in the Banking Act Direction No. 1 of 2016, the Subordinated Debentures require to be converted into Ordinary Voting Shares of the Bank. This is referred to as 'Non-Viability Conversion' in the said Banking Act Direction. The features of the Debentures and further information in this regard are described in this Circular under section 5.

1. OBJECTIVES OF THE ISSUE

The funds generated from the Debenture Issue will be utilized for the following purposes:

1.1 To refinance the debentures maturing in 2021 and to further strengthen the Tier 2 capital base of the Bank in line with the Basel III accord.

During the year 2021 debentures totaling to approx. Rs 11.5 Bn are due to mature and the funds raised from the Debenture Issue will be utilized to strengthen the Tier II capital of the Bank as required under the BASEL III regulations.

Debenture Objective	Expected utilization of the proceeds(LKR Billion)
To refinance the debenture maturity	4.0
Lending growth	3.0
Total	7.0

The shortfall between the total debenture maturity in 2021 (i.e LKR 11.5 Bn) and debenture proceeds allocated (LKR 4.0 Bn) is expected to be financed by internally generated funds.

The Bank has in total LKR 4.0 Bn worth debenture maturities in September and November 2021. At the same time the amount allocated for lending is marginal and the Bank expects to utilize debenture proceeds within 12 months from the date of allotment

The requirements for minimum capital as per Basel III guidelines based Banking Act Direction No.1 of 2016 and Direction No. 11 of 2019 issued by the Central Bank of Sri Lanka (CBSL) are as follows;

Components of Capital	BASEL III Minimum Regulatory Requirement		
	To be maintained by Non-DSIBs	To be maintained by D-SIBs	Applicable to HNB
Common Equity Tier I including Capital Conservation Buffer	7.00%	7.00%+HLA **	8.50%
Total Tier I including Capital Conservation Buffer	8.50%	8.50%+HLA **	9.50%
Total Capital Ratio Including Capital Conservation Buffer	12.50%	12.50%+HLA **	13.50%

Note: In order to minimise the impact of COVID 19 on the banking sector in April 2020, the Central Bank of Sri Lanka permitted the licensed commercial banks to drawdown the Capital Conservation Buffer up to 100bps.

As a domestic systemically important bank the high loss absorbency (HLA) applicable to HNB is 100bps higher than that for a licensed commercial bank.

Banks Capital Adequacy Ratio (CAR) under BASEL III

The Bank has complied with the CBSL BASEL III minimum capital adequacy requirement as at 31st December 2020 with a Tier I capital adequacy ratio of 14.73% and total capital adequacy ratio of 17.98%.

The projected ratios taking into account the intended proceeds of Debenture Issue computed under BASEL III will be as follows:

Components	As at 31 st December 2020	Temporary Regulatory Requirement As at December 2020	With LKR 5 Bn in new Debentures	With LKR 7 Bn in new Debentures
Total Tier I capital with buffers (CCB & Surcharge on D-SIB)	14.73%	8.50%	14.73%	14.73%
Total Capital Ratio (Tier I + Tier 2) with buffers (CCB & Surcharge on D-SIB)	17.98%	12.50%	18.61%	18.86%

Tier II capital adequacy ratios move in relation to the risk-weighted assets and total capital of the bank which include qualified Tier II instruments, it's prudent for the bank to maintain an additional buffer above the minimum capital adequacy ratios specified by CBSL so that the Bank doesn't fall below the minimum requirements in the event of fluctuations (i.e: maturity of a BASEL III compliant Tier II instrument) that may arise in the ordinary course of business.

In order for the Debentures to be recognized as Tier II Capital of the Bank under BASEL III as detailed in the Banking Act Direction No. 1 of 2016 issued by the Central Bank of Sri Lanka, the Debentures are required to have the following minimum features:

- Issued and fully paid-in cash
- Subordinated to the claims of depositors and general creditors
- Neither secured nor covered by a guarantee or any other arrangement that legally or economically enhances the seniority of the claim above the depositors and general creditors of the Bank
- Prior approval of the Monetary Board is required for inclusion of capital instruments/term debt in Tier II Capital
- Listed on a recognized Stock Exchange
- The total approved Tier II Capital instruments/term debt shall not exceed 50 per cent of total Common Equity Tier I Capital
- Redeemable
- Of a minimum original maturity of at least 5 years
- Having an option where, in the event the Monetary Board of the Central Bank of Sri Lanka deeming it appropriate that the Debentures being converted into ordinary shares of the Bank (ranking equal and *pari passu* with the existing ordinary shares of the Bank) through issuance of new shares to cover the total outstanding under the Debentures is in the best interest of the Bank, directs the Bank to convert the Debentures into ordinary shares of the Bank (ranking equal and *pari passu* with the existing ordinary shares of the Bank) through issuance of new shares to cover the total outstanding under the Debentures (the Trigger Event referred to in section 5)
- Neither Bank nor a banking group over which the Bank exercises control or significant influence will purchase the instrument and the Bank will not directly or indirectly fund the purchase of the instrument.

1.2 Support the Bank's balance sheet growth

Funds generated through the Debenture Issue will also be used to support the lending activities of the Bank as part of its normal course of business.

The proceeds from the Issue will be added to the Bank's pool of funds. This pool is available for on-lending to all parties. Transactions with related parties will be carried out in compliance with all applicable Statutes, Directions, Regulations and CSE Listing Rules.

It is the understanding of the Bank that the entire quantum of funds would be utilized within a period of 12 months from the date of allotment of the Debentures. In the interim period these funds will be invested in Government Securities at zero credit risk at the current market rates, which would generate a return at the rate of approximately 4.50% -5%.

2. BENEFITS OF THE DEBENTURE ISSUE TO THE BANK

The Issuance of proposed BASEL III compliant Debenture issue will result in the following benefits:

- Refinance maturing debentures and further strengthen the capital adequacy ratios of the Bank.
- Enable expansion of the lending book
- To lock in interest rates for 10 years and improve the overall cost of capital of the Bank
- Reduce maturity mismatches in the assets and liabilities portfolios of the Bank.
- Upon the occurrence of a Trigger Event, any outstanding balance of these Debentures including the total par value of the Debentures and Debenture Interest accrued and unpaid as at that date will be converted to Ordinary Voting Shares of the Bank. As a result, the non-viability conversion has the effect of acting as a buffer by reducing outstanding claims from liability holders (Debenture holders) in the event of an occurrence of a Trigger Event.
- Voting rights of existing Ordinary Voting Shareholders are not altered as long as the Non-viability conversion Debentures are not converted into Ordinary Voting Shares of the Bank, and to the extent that a Trigger Event does not occur the issuance of these Debentures is a suitable instrument to improve capital adequacy and fund growth without resorting to a new issue of equity.

3. DISCLOSURE IN THE INTERIM FINANCIAL STATEMENTS & THE ANNUAL REPORT

The utilization of the proceeds of the Debenture Issue will be disclosed in the Annual Report and the Interim Financial Statements from the allotment Date and until the objectives of the Debenture Issue are achieved. The Bank has utilized the proceeds of all previous Debenture Issues towards achieving the objectives of the respective Issues. Further information and relevant disclosures on utilization of proceeds will be more fully disclosed in the Prospectus.

4. SPECIFIC RISKS RELATING TO OBJECTIVES OF THE DEBENTURE ISSUE

The Bank's total assets and liabilities stood at LKR 1,291.85 Bn and LKR 1,157.85 Bn respectively as at the end of December 2020, compared to maximum size of the proposed debenture issue LKR 7 Bn. Hence, the dependence of proceeds of the Issue to achieve the objectives of the Issue, being settlement of LKR 4 Bn in maturing debentures and utilization of LKR 3 Bn to finance loan growth is marginal, as the Bank in the ordinary course of business has access to multiple sources of funds. It is the understanding of the Bank that the entire quantum of funds would be utilized within a period of 12 months from the date of allotment of the Debentures.

There are no significant risk factors that may lead to the non-achievement of the objective of refinancing of the debenture maturity as the bank is well liquid /capitalized and has access to alternative sources of funds.

The Bank's portfolio of gross loans and advances recorded a growth of LKR 42.6 Bn for 2020, despite the challenging operating environment. Therefore, there is no specific risk factor that may lead to non-achievement of expansion targets pertaining to the Bank's loans and advances portfolio within the specified time line via the proceeds of the Issue up to a maximum of LKR 7 Bn, of which LKR 3 Bn is to be allocated for financing loan growth. However, in the highly unlikely event of the Bank failing to lend these funds due to an unforeseen reason, these funds would be invested in Government Securities at zero risk at the current market rates.

In the event the Debenture Issue is not fully subscribed or if the timelines are changed if thought fit by the Bank, no further shareholder approval will need to be sought.

5. OCCURRENCE OF THE TRIGGER EVENT

A 'Trigger Event' is determined by and at the sole discretion of the Monetary Board of the Central Bank of Sri Lanka, and is defined in the Banking Act Direction No. 1 of 2016 of Web Based Return Code 20.2.3.1.1.1. (10) (iii) (a & b) as a point /event which is the earlier of;

(a) "A decision that a write-down, without which the Bank would become non-viable, is necessary, as determined by the Monetary Board, **OR**

(b) The decision to make a public sector injection of capital, or equivalent support, without which the Bank would become non-viable, as determined by the Monetary Board."

Upon the occurrence of the Trigger Event, the non-viability conversion option will be invoked and the Bank shall be required and entitled to issue and within twenty (20) days to allot ordinary voting shares of the Bank ranking equal and *pari-passu* with the existing Ordinary Voting Shares to the Debenture Holders up to the outstanding balance of such Debentures including the total par value of the Debentures and unpaid accrued Debenture Interest at an issue **price for such Ordinary Voting Shares which will be based on the Volume Weighted Average Price (VWAP) of an Ordinary Voting Share of the Bank during the three month (03) period, immediately preceding the date of the Trigger Event.** The calculation of the VWAP would be based on the simple average of the daily VWAP of an Ordinary Voting Share as published by the Colombo Stock Exchange during the said 3 month period. In the event of any Debenture Holder being entitled to a fractional allotment of an Ordinary Voting Share on such issuance and allotment, the Bank shall settle such sums in cash, based on the issue price of such ordinary voting share within fourteen (14) market days from the date of allotment of the said Ordinary Voting Shares.

Averaging out of the VWAP over a period of 3 months preceding the Trigger Event as opposed to a shorter window closer to the Trigger Event, is aimed at smoothening out changes in ordinary voting share price movements thus minimizing the extent of the dilution impact of the conversion.

However, if there is an issuance of Ordinary Voting Shares to the Debenture Holders upon the occurrence of the Trigger Event, a Debenture Holder would cease to be a Debenture Holder and would become a shareholder of the Bank to the extent of such issuance and will rank equal and *pari passu* with existing Ordinary Shareholders with voting rights after the date of allotment of new shares to such ordinary shareholders with voting rights (i.e. the previous Debenture Holders). In the event of the conversion, the shares will be allotted to the respective Debenture Holders in accordance with the applicable laws and regulations as guided by the instructions of the Monetary Board of the Central Bank of Sri Lanka with regard to the application of the Single Holder Limit.

The Ordinary Shares (with voting rights) arising from the conversion of Debentures will be listed in the CSE.

In the event of the Debenture Holders becoming ordinary shareholders (with voting rights) of the Bank due to the occurrence of the Trigger Event, they would be entitled to exercise such rights as are exercisable by the other shareholders of the Bank holding ordinary voting shares. In the event of conversion to ordinary voting shares, there would be a dilution of the existing shareholding percentage held by the current shareholders as at the date of allotment of Debentures, however the extent of dilution will be dependent on several factors that cannot be determined at this point, due to the following;

- (a) The number of ordinary voting shares to be issued resulting from such conversion will be determined by the 'conversion price' at the 'Trigger point' as detailed above.
- (b) The extent of dilution of existing shareholders will need to be determined by how many shares are in issue at the time of such conversion. Such a number can vary due to issuance of new shares by way of scrip dividends, capitalization of reserves or rights issues during the tenure of the subject Debenture.

In the event the conversion price based on the above VWAP formula at the time of the Trigger Event is low, this would result in a comparatively higher number of ordinary voting shares (with voting rights) being required to be issued by the Bank which would further dilute the holding percentage of current shareholders as at the date of allotment of Debentures. On the contrary, if a higher VWAP prevails at the time of a Trigger Event, this would result in comparatively low number of ordinary shares (with voting rights) requiring to be issued which would lead to a lesser degree of dilution in the holding percentage of existing shareholders.

In the event of there being a likelihood of an occurrence of a 'Trigger event', then the existing shareholders will be first called upon to bring in additional capital (subject to CSE & SEC approval as applicable), and only, **if they are unable to infuse fresh capital, (i.e.; Tier I Capital) will the proposed Debentures get converted to ordinary voting share capital (Tier I capital) upon the determination of the non-viability point by the Monetary Board of Central Bank of Sri Lanka.**

Reduction of the Debenture liability of the Bank will reduce the strain on the assets of the Bank in the event of liquidation. i.e. more assets leftover for distribution to the shareholders though on a diluted basis with the inclusion of newly converted Debenture Holders (existing shareholders plus newly converted shareholders).

With the reduction of the interest bearing liabilities as stated above, the financing cost will reduce and improve the bottom line of the Bank.

The Bank on receipt of a Trigger Event notification from the Central Bank of Sri Lanka will immediately make a market announcement of the same and further announce the "price" and "dates" (i.e. Trigger Event date, date of allotment) pertaining to such conversion of Debentures to ordinary voting shares.

However, it is unlikely that a 'Trigger Event' would occur given the high credit rating of the Bank (i.e. AA- (Ika)/Stable by Fitch Ratings Lanka Ltd.) and resilient performance demonstrated by the Bank during unprecedented times.

6. QUALIFIED INVESTOR

'Qualified Investor' shall mean,

- a commercial bank licensed by the Central Bank of Sri Lanka in terms of the Banking Act No. 30 of 1988 (as amended);
- a specialized bank licensed by the Central Bank of Sri Lanka in terms of the Banking Act No. 30 of 1988 (as amended);
- a mutual fund, pension fund, Employee Provident Fund or any other similar pooled fund;
- a venture capital fund/company and private equity company;
- a finance company licensed by the Central Bank of Sri Lanka in terms of the Finance Business Act No. 42 of 2011(as amended);
- a company licensed by the Central Bank of Sri Lanka to carry on finance leasing business under the Finance Leasing Act No. 56 of 2000 (as amended);
- a company licensed by the Insurance Board of Sri Lanka to carry on insurance business in terms of the Regulation of Insurance Industry Act No. 43 of 2000 (as amended);
- a corporate (listed or unlisted) which does not fall under the above categories and is incorporated under the Companies Act No. 7 of 2007;
- an investment trust or investment company;
- a non-resident institutional investor; and,
- an individual with a minimum initial investment of LKR. 5,000,000/-.

7. IMPACT OF COVID 19 ON THE BANK AND ITS BUSINESS OPERATIONS

The substantial monetary loosening adopted by the Central Bank of Sri Lanka (CBSL) in 2020 as a response to revive the economy battered by COVID 19 saw the Average Weighted Prime Lending Rate declining by a considerable 400 bps. This had an impact on our net interest income which declined by 9% Year on Year (YoY). Despite a low rate regime the demand for credit was low as the environment in 2020 was underpinned by uncertainty. Hence the Bank focused upon asset quality and a cautious approach until improvement in operating environment in 2021 and beyond which is expected to present more conducive conditions for credit growth. Furthermore close to 40% of the loan book as per CBSL guidelines was also under moratoriums during the year albeit same declining to approximately 15% by year end. HNB also disbursed LKR 24 Bn via CBSL Re Finance schemes as COVID relief funding.

The loan book (gross) grew by 5.5% YoY during 2020. The Bank was able to bring down Gross Non Performing Asset (NPA) ratio to 4.3% from 5.9% in 2020. The regularization of an overdue exposure to a State Owned Entity (SOE) also contributed significantly towards NPA reduction.

Despite the improvements in the NPA ratio the Bank made prudent provisions taking in to consideration factors such as elevated risks in certain sectors and the deterioration in economic conditions. Furthermore, the Bank recognised substantial impairment charges on account of its investments in dollar denominated government securities due to the sovereign downgrade by rating agencies. These factors resulted in impairment charges increasing by 58% to LKR 15.3Bn for the year ended December 2020.

On the funding side of the balance sheet, contrary to initial pandemic induced expectations for low levels of liquidity and cash flow, the Bank was able to mobilize low cost Current and Savings Accounts (CASA) and maintained liquidity at levels well above regulatory requirements during 2020.

In terms of HNB response to the breakout of the pandemic, the Bank set up a high level COVID task force even prior to cases being reported locally in March 2020 to assess impact and response. HNB operated selected branches and critical departments throughout curfew periods covering the entire Island. Departments and branches, as they were during the first wave of the pandemic, continue to be supplied with Personal Protective Equipment, Sanitizers, Masks, Gloves, Infra-red thermometers etc. in order that the Bank minimizes the possibility of staff, clients and stakeholders contracting the virus at its branches. Staff members carrying out non critical functions were rapidly equipped with 'Work From Home' capabilities, most of whom continue to work from home owing to the 2nd wave of the pandemic. Efforts were also made to ensure that transport facilities were provided to staff members during lockdown and those who continue to commute to or from isolated areas.

In the event of identified COVID positive cases among staff members or close contacts of staff members, all guidelines have been adhered to in directing such staff towards quarantine procedures followed by temporary closure of relevant branches, disinfection and sanitization protocols. Apart from keeping branches open we also dispatched mobile ATMs across the country, providing HNB customers as well as other Bank customers a means of withdrawing cash to pay for daily essentials.

Focus then shifted to integrating the digital banking suite into the contactless transactions mechanism advocated by the state during the first wave of the pandemic. As such the Bank's digital propositions such as the branded payment app HNB SOLO, Mobile Point of Sale (POS), Internet Payment Gateways, e-commerce facilitation for Small and Medium Enterprises (SMEs), Payment Cards, etc. were highly sought and witnessed unprecedented volume increases during 2020.

8. REDMPTION OF DEBENTURES

The proposed Debentures will be redeemed at maturity and the principal sum and unpaid accrued interest (if any) payable on the redemption of Debentures will be paid not later than three (03) Market days from the date of redemption, unless a 'Trigger Event' occurs as detailed above.

9. EXTRAORDINARY GENERAL MEETING

Pre-emptive Subscription Rights and Risks associated with Debentures

The Bank's intention is to obtain Shareholder approval for the issuance of Ordinary Voting Shares which may be required to be issued in the event of the Monetary Board of Central Bank of Sri Lanka instructing the Bank to exercise the convertible feature attached to these Debentures (the occurrence of the Trigger Event) and to waive the pre-emptive rights of the existing Ordinary Voting and Non-Voting Shareholders.

As per rule No.2.2.1.(l) of the Listing Rules of the Colombo Stock Exchange and the Articles of Association of the Bank, the Bank is required to obtain the approval of the shareholders for the proposed Debenture Issue by way of a special resolution. Further, it will also be necessary to obtain, by way of a duly passed special resolution, the approval of the shareholders (both Voting and Non-Voting) for the proposed ordinary voting share issue which arises pursuant to the conversion of debentures, which may affect the rights attached to the Bank's existing Ordinary and Non-Voting shares, in compliance with Section 99 of the Companies Act No. 7 of 2007.

Therefore, an Extraordinary General Meeting of the Bank is being convened in accordance with the Notice of Meeting attached hereto, for the purpose of passing the special resolutions set out therein.

Shareholders who are unable to attend the meeting in person are kindly requested to complete the enclosed Form of Proxy (in accordance with the instructions specified therein) and deposit it at the Registered Office of the Bank not less than 24 hours before the time appointed for the meeting.

10. NOTE TO SHAREHOLDERS

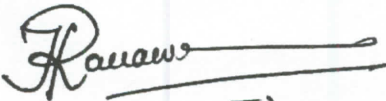
In the current circumstances due to the Covid-19 pandemic, shareholders are strongly encouraged to opt to duly complete the Form of Proxy clearly setting out their preference of vote in the Form of Proxy and to appoint one of the independent directors of the Bank to act on their behalf in order that each shareholder's vote may be identified and recorded as if such shareholder were present at the meeting.

This option is being proposed to all shareholders in the best interest of protecting society against the spread of covid-19 and with a view to maintaining social distancing at the EGM, as advised by the authorities.

The Bank will be taking steps to extend an opportunity to shareholders who wish to connect the EGM via digital means through Microsoft Teams meeting platform or similar methods and such shareholders are requested to forward their e-mail address to the Company Secretary (Thushari.Ranaweera@hnb.lk) or to info@hnb.lk no later than 24 hours prior to the time fixed for the meeting to enable the Bank to share login information for the meeting.

In the event shareholders prefer to physically attend the meeting, the Bank has taken steps to accommodate the required number of shareholders sufficient to meet the quorum (in order that the maximum number present, including the presence of relevant officers of the Bank will be in line with the directives issued by the Health Authorities). Please refer to the Notice of Meeting for details. Whilst the Bank takes all required steps to ensure health and safety measures within the premises, the Bank cannot take responsibility for any negligence by individuals who arrive at the location.

By Order of the Board
Hatton National BANK PLC



K A L Thushari Ranaweera (Mrs)
Deputy General Manger (Legal / Board Secretary)
Colombo, Sri Lanka

05th March 2021