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CREDIT OPINION
5 July 2016

Update

Rate this Research

**RATINGS**

Hatton National Bank Ltd.

| | |
|---|---|
| Domicile | Sri Lanka |
| Long Term Rating | B2 |
| Type | LT Bank Deposits - Fgn Curr |
| Outlook | Negative |

*Please see the ratings section at the end of this report for more information.The ratings and outlook shown reflect information as of the publication date.*


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# Hatton National Bank Ltd.

## Update Following Rating Action

### Summary Rating Rationale

On 21 June 2016 we affirmed the B1 issuer and local currency deposit ratings of Hatton National Bank Ltd. (HNB). At the same time, we revised the outlook on the bank's ratings to negative from stable.

The negative outlook reflects our revision of the outlook on Sri Lanka's B1 sovereign rating to negative on 20 June 2016.

HNB's B1 ratings are based on the bank's b1 baseline credit assessment (BCA), and our assessment of the very high probability of systemic support from the government of Sri Lanka to the bank in times of need, based on the bank's systemic importance and high market share.

However, our assumption of government support does not result in any uplift to HNB's ratings, because the bank's long-term ratings are at the same level as the government's rating.

HNB's b1 BCA reflects the bank's moderate capital adequacy and healthy profitability. At the same time, the BCA also captures HNB's tight liquidity profile, and the inherent vulnerability of the bank to Sri Lanka's volatile operating environment, which exposes the bank to asset quality pressure.

HNB's capital adequacy is moderate, with a tangible common equity (TCE)/adjusted risk-weighted asset (RWA) of 10.3% at end-March 2016. We incorporate our standard adjustment for RWA, and include a 100% risk weighting for government securities. HNB's TCE ratio is higher when compared to Bank of Ceylon's (B1 negative, b1) 6.1% and Sampath Bank Plc's (B1 negative, b1) 6.8%.

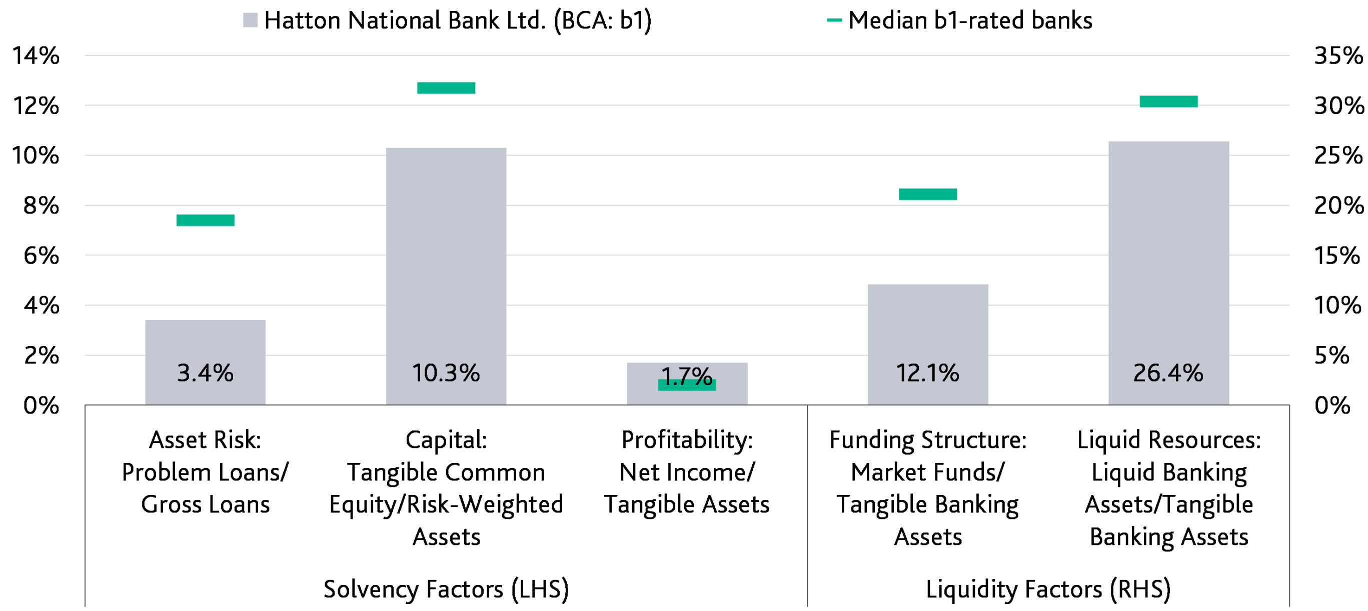
HNB's strong net interest margin (NIM) of 4.5% at end-March 2016 supports the bank's bottom-line profitability. We note that HNB's NIM is higher than the system average of 3.6%. The bank's strong NIM is driven by its high share of cheap customer deposits in the form of current account and savings accounts (CASA), and the higher yields on small- and medium-size enterprise (SME) and retail loans.

HNB's asset quality improved in 2015, and also during the quarter ended 31 March 2016. Specifically, the bank's nonperforming loan (NPL) ratio—at a non-consolidated bank level—registered 2.4% at end-March 2016, down from 3.2% at end-2014. However, we are concerned that the rapid 25% credit growth in 2015 might be masking asset quality challenges.

While HNB's NPL ratio is lower than the system average of 3.1%, the bank's asset quality is exposed to single-party concentration risk and historic volatility in credit costs.

HNB's liquidity is tight, with a gross loans-to-deposits ratio (LDR) of 99% at end-March 2016, which is higher than the 88% for the banking system.

Exhibit 1
**Rating Scorecard - Key Financial Ratios**




*Source: Moody's Financial Metrics*

## Credit Strengths

» Strong NIM supports healthy profitability levels

» Capital buffer, while modest, is higher when compared to domestic peers

## Credit Challenges

» Asset quality improved in 2015, but rapid growth could mask asset quality challenges

» Tight funding and liquidity profiles

## Rating Outlook

The ratings outlook is negative.

## Factors that Could Lead to an Upgrade

Given the revision of the outlook for Sri Lanka's sovereign rating to negative from stable, it is unlikely that the long-term credit ratings of the three Sri Lankan banks that we rate will be upgraded, because the banks' long-term ratings are positioned at the same B1 rating level as Sri Lanka's sovereign rating.

## Factors that Could Lead to a Downgrade

A downgrade of Sri Lanka's sovereign rating will result in a downgrade of the long-term credit ratings of HNB.

HNB's BCA could be lowered if there is a material deterioration in solvency factors, such as asset quality, profitability and capital. Tighter liquidity and an increased reliance on market funding will also be negative for the BCA.

## Key Indicators

Exhibit 2

**Hatton National Bank Ltd. (Consolidated Financials) [1]**

| | 3-16[2] | 12-15[2] | 12-14[2] | 12-13[2] | 12-12[2] | Avg. |
|---|---|---|---|---|---|---|
| Total Assets (USD million) | 5,429.7 | 5,251.9 | 4,546.4 | 3,997.6 | 3,597.9 | 10.8[3] |
| Tangible Common Equity (USD million) | 491.1 | 485.6 | 457.4 | 398.0 | 377.5 | 6.8[3] |
| Problem Loans / Gross Loans (%) | 2.4 | 2.4 | 3.2 | 3.6 | 4.2 | 3.2[4] |
| Tangible Common Equity / Risk Weighted Assets (%) | 10.3 | 10.4 | 11.9 | 12.1 | 13.4 | 11.6[5] |
| Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%) | 15.5 | 15.5 | 18.3 | 21.0 | 23.3 | 18.7[4] |
| Net Interest Margin (%) | 4.5 | 4.6 | 4.9 | 5.6 | 5.6 | 5.0[4] |
| PPI / Average RWA (%) | 2.9 | 3.0 | - | - | 3.4 | 3.1[5] |
| Net Income / Tangible Assets (%) | 1.8 | 1.4 | 1.7 | 1.5 | 1.8 | 1.6[4] |
| Cost / Income Ratio (%) | 58.7 | 59.9 | 58.9 | 54.2 | 60.2 | 58.4[4] |
| Market Funds / Tangible Banking Assets (%) | 16.6 | 14.5 | 12.1 | 9.1 | 8.1 | 12.1[4] |
| Liquid Banking Assets / Tangible Banking Assets (%) | 16.6 | 26.3 | 26.4 | 25.8 | 26.6 | 24.3[4] |
| Gross loans / Due to customers (%) | 99.0 | 96.7 | 97.1 | 93.7 | 90.7 | 95.5[4] |

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel II; IFRS [3] Compound Annual Growth Rate based on IFRS reporting periods [4] IFRS reporting periods have been used for average calculation [5] Basel II & IFRS reporting periods have been used for average calculation

*Source: Moody's Financial Metrics*

## Detailed Rating Considerations

1. ASSET QUALITY HAS IMPROVED, BUT RAPID GROWTH COULD MASK ASSET QUALITY CHALLENGES

We assign an adjusted ba3 score for asset risk, to reflect HNB's unseasoned risk and the single-name concentrations in its loan book.

At end-March 2016, HNB reported a gross bank-only NPL ratio of 2.4%, which was lower than the 3.2% seen at end-2014. HNB's NPL ratio compares well with the system-average NPL ratio of 3.1%.

The improvement in HNB's NPL ratio was related to both write-offs and recoveries in some large corporate NPLs, as well as to the rapid year-over-year credit growth of 26% at end-March 2016. HNB's credit growth exceeded that of the banking system (21% growth), a situation which we view as negative, because it could mask asset quality challenges.

Credit growth in 2015 (+ 25%) was concentrated in the bank's financial and business services segment (+37%), manufacturing (+27%) and construction (+26%). These sectors constituted 40% of total loans at end-2015.

The bank does not disclose its consolidated NPL ratio, but we consider it to be close to the bank-only ratio. The bank's provisioning—including reserves for interest in suspense—stood at a good 89% at end-March 2016.

In 2015, the bank increased its loan restructuring activities, with newly restructured loans amounting to 1.1% of gross loans. The outstanding stock of standard restructured loans made up around 3% of gross loans at end-March 2016. These loans are not classified as NPLs.

The bank also demonstrates large single-party concentrations in its loan book, which increase the risk of asset quality swings if some of its large borrowers default. At end-2015, the top-20 borrowers made up 370% of the bank's TCE. This ratio decreases to 312% if we exclude one large government-guaranteed transaction.

2. STRONG NIM SUPPORTS HEALTHY PROFITABILITY LEVELS

We assign a baa3 score for profitability, reflecting the bank's high return on assets (ROAs) and earnings quality.

The bank reported a strong NIM of 4.5% for the three months ended 31 March 2016, somewhat lower than the 4.7% for the same period in 2015. HNB's margins are higher when compared to the system average of around 3.6% for the January-March quarter of 2016, and are supported by higher yields on its SME and retail loans, as well as a lower cost of funding due to its high reliance on CASA deposits.

The bank's ROA (net income/tangible assets) was healthy at 1.4% for 2015, slightly lower than the 1.7% registered in 2014, as a result of margin compression. We expect profitability to remain stable over the next 12-18 months.

3. CAPITAL BUFFER, WHILE MODEST, IS HIGHER WHEN COMPARED TO DOMESTIC PEERS

We assign a b2 score for capital to reflect the likely decline in capitalization, due to high credit growth.

HNB's capital adequacy is moderate, with a TCE/adjusted RWA of 10.3% at end-March 2016. We incorporate our standard adjustment for RWA, and include a 100% risk weighting for government securities.

HNB's TCE ratio is higher when compared to Bank of Ceylon's (B1 negative, b1) 6.1% and Sampath Bank Plc's (B1 negative, b1) 6.8%.

4. TIGHT FUNDING AND LIQUIDITY POSITION SUPPORTED BY STRONG DEPOSIT FRANCHISE

We assign a ba1 score to the bank's funding structure. Because of rapid credit growth, the bank showed an increased reliance on market funds to 17% of tangible banking assets at end-March 2016 from 12% at end-2014. Consequently, HNB's gross loans-to-deposits increased to 99% from 97% for the same period.

Higher loan growth relative to deposit growth is a feature of a system, given the significant investment to savings gap – where savings are below investment levels – as such the recent high levels of system loan growth ( 21% year-over-year at end-March 2016) has led to tightened liquidity for the system as a whole. However Hatton's recent loan growth (2012-2015 CAGR of 19% ) has been higher than that of the system (2012-2015 CAGR of 14% ) leading to the LDR of 99% being significantly higher than the 88% system LDR at end-March 2016 .

To some extent, the high LDR is somewhat balanced by HNB's high share of CASA deposits. Such deposits were stable at 41% of customer deposits at end-March 2016. Still, the rapid credit growth is likely to exert further negative pressure on the LDR.

Even though deposit growth grew year-over-year by 22% ( higher than the system deposit growth of 17%) this was still lower than 25% loan growth at end-March 2016, leading to continued tightening of liquidity.

Liquid assets made up around 17% of total assets at end-March 2016, a decrease from 26% at end-2014. We also note that repo funding (liabilities) increased materially in early 2016, leading to the encumbrance of some liquid assets.

Overall, we assign a b1 score for liquidity.

HNB'S BCA IS SUPPORTED BY SRI LANKA'S MODERATE- MACRO PROFILE

HNB operates in Sri Lanka, a country with a Moderate- Macro Profile. The Macro Profile reflects the deteriorating operating environment for Sri Lankan banks, as a result of the country's weakened institutional strength, given that economic and policy reforms might not be realized, and the fact that Sri Lanka faces heightened external vulnerabilities as it continues to rely on external debt to fund its current account deficits.

We expect challenges in implementing some of the fiscal policy measures and other structural reforms planned under the International Monetary Fund's Extended Fund Facility. Sri Lanka has a mixed record on the effective implementation of policy reforms. For example, the budget deficit widened markedly in 2015 to 7.4% of GDP compared with the 4.4% targeted in the budget.

External vulnerabilities represent key concerns, because weak levels of foreign direct investment have led to Sri Lanka being reliant on debt to finance its large current account deficit and to supplement its official reserves to meet external payment requirements, which are largely denominated in foreign currencies.

Gross foreign currency reserves fell to $4.7 billion in May 2016 from $6.5 billion in November 2015 and only partially cover external debt due for the rest of 2016.

At end-2015, year-over-year credit growth was at 21%, supported by an accommodative monetary policy and an uptick in domestic demand. Sri Lanka's level of private sector credit to GDP is modest, and is well below the 90% recorded for countries with Moderate Macro Profiles. The three-year (2012-2015) change in private sector credit/GDP registered 6%, indicating that the pace of credit growth has not been excessive.

Funding and liquidity conditions will remain balanced and stable in 2016. Sri Lankan banks are primarily deposit funded, and we expect loan growth and deposit growth rates to be broadly in line over the next 12-18 months. The system's loan-to-deposits increased to 91% at end-March 2016 versus 83% at end-2014.

## Notching Considerations

AFFILIATE SUPPORT

HNB's ratings do not benefit from affiliate support.

PUBLIC SUPPORT

We view the probability of public support for HNB in times of stress as high. HNB is a private sector bank with a large market share of around 9% of system deposits in 2015. However, this does not result in any rating uplift for HNB, because the B1 rating of the Sri Lankan sovereign is at the same level as HNB's BCA.

HNB's B2 foreign currency deposit rating is one notch lower than the bank's local currency deposit rating of B1, because the B2 rating is constrained by foreign currency deposit ceiling.

## Rating Methodology and Scorecard Factors

Exhibit 3

**Hatton National Bank Ltd.**

| Factor | Historic Ratio | Macro Adjusted Score | Credit Trend | Assigned Score | Key driver #1 | Key driver #2 |
|---|---|---|---|---|---|---|
| **Macro Factors** | | | | | | |
| **Weighted Macro Profile** | **Moderate -** | **100%** | | | | |
| **Financial Profile** | | | | | | |
| **Solvency** | | | | | | |
| **Asset Risk** | | | | | | |
| **Problem Loans / Gross Loans** | 2.9% | baa3 | ←→ | ba3 | Unseasoned risk | Single name concentration |
| **Capital** | | | | | | |
| **TCE / RWA** | 10.3% | b1 | ←→ | b2 | Expected trend | |
| **Profitability** | | | | | | |
| **Net Income / Tangible Assets** | 1.6% | baa3 | ↓ | baa3 | Expected trend | |
| **Combined Solvency Score** | | ba2 | | ba3 | | |
| **Liquidity** | | | | | | |
| **Funding Structure** | | | | | | |
| **Market Funds / Tangible Banking Assets** | 14.5% | baa3 | ←→ | ba1 | Expected trend | |
| **Liquid Resources** | | | | | | |
| **Liquid Banking Assets / Tangible Banking Assets** | 26.3% | ba1 | ←→ | b1 | Asset encumbrance | Expected trend |
| **Combined Liquidity Score** | | baa3 | | ba2 | | |
| **Financial Profile** | | | | ba3 | | |
| **Business Diversification** | | | | 0 | | |
| **Opacity and Complexity** | | | | 0 | | |
| **Corporate Behavior** | | | | 0 | | |
| **Total Qualitative Adjustments** | | | | 0 | | |
| **Sovereign or Affiliate constraint:** | | | | | | |
| **Scorecard Calculated BCA range** | | | | ba3-b2 | | |
| **Assigned BCA** | | | | b1 | | |
| **Affiliate Support notching** | | | | 0 | | |
| **Adjusted BCA** | | | | b1 | | |

| Instrument Class | Loss Given Failure notching | Additional notching | Preliminary Rating Assessment | Government Support notching | Local Currency rating | Foreign Currency rating |
|---|---|---|---|---|---|---|
| Counterparty Risk Assessment | 1 | 0 | ba3 (cr) | -- | Ba3 (cr) | -- |
| Deposits | 0 | 0 | b1 | -- | B1 | B2 |

*Source: Moody's Financial Metrics*

## Ratings

Exhibit 4

| Category | Moody's Rating |
|---|---|
| **HATTON NATIONAL BANK LTD.** | |
| Outlook | Negative |
| Bank Deposits -Fgn Curr | B2/NP |
| Bank Deposits -Dom Curr | B1/NP |
| Baseline Credit Assessment | b1 |
| Adjusted Baseline Credit Assessment | b1 |
| Counterparty Risk Assessment | Ba3(cr)/NP(cr) |
| Issuer Rating | B1 |

*Source: Moody's Investors Service*

REPORT NUMBER 1032796

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