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CREDIT OPINION
15 January 2018

Update

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RATINGS

Hatton National Bank Ltd.

Domicile	Sri Lanka
Long Term Debt	Withdrawn
Type	Senior Unsecured - Fgn Curr
Outlook	Not Assigned
Long Term Deposit	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 affirmation, outlook remains negative

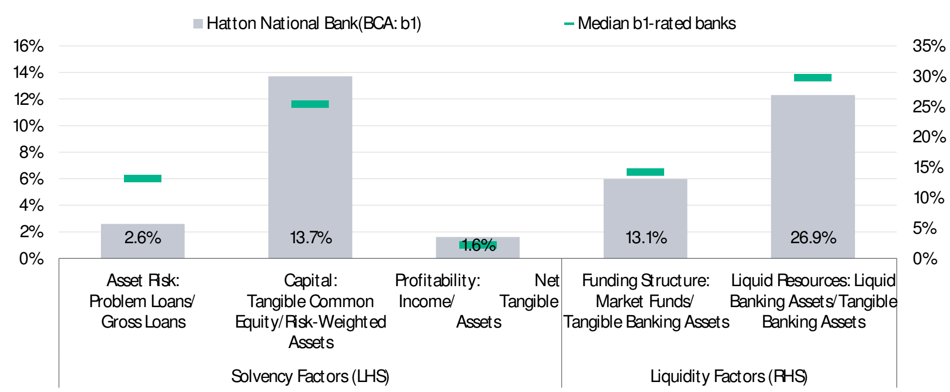
Summary

On 13 December 2017, we affirmed Hatton National Bank Ltd.'s (HNB) local-currency deposit, issuer and foreign-currency senior unsecured debt ratings at B1, in line with the Government of Sri Lanka's rating (B1 negative). We also affirmed the bank's Baseline Credit Assessment (BCA) of b1 and its foreign-currency deposit rating at B2. The outlook on the bank's deposit and issuer ratings remains negative, in line with that of the Sri Lankan government.

The b1 BCA reflects the bank's good and improved capital adequacy, and healthy profitability. At the same time, the BCA also captures HNB's tight funding profile and mildly weakened asset quality. HNB's b1 BCA is capped by the B1 sovereign rating.

Exhibit 1

Key financial ratios for HNB and global b1 banks



Source: Moody's Financial Metrics

Credit strengths

» Strong net interest margin (NIM), which supports healthy profitability levels

» Improved core capital buffer after the recent rights issue

Credit challenges

» A deterioration in asset quality, given that agricultural loan book has been hurt by adverse weather conditions

» Tight funding profile

Rating outlook

The rating outlook is negative because the outlook on the sovereign rating is negative.

Factors that could lead to an upgrade

» Given the negative outlook, there is little upside potential for HNB's ratings.

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 bank's BCA.

Key indicators

Exhibit 2

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

	9-17[2]	12-16[3]	12-15[3]	12-14[3]	12-13[3]	CAGR/Avg.[4]
Total Assets (USD million)	6,556	6,018	5,252	4,546	3,998	14.1[5]
Tangible Common Equity (USD million)	739	590	486	457	398	18.0[5]
Problem Loans / Gross Loans (%)	2.6	1.8	2.4	3.2	3.6	2.7[6]
Tangible Common Equity / Risk Weighted Assets (%)	13.7	11.1	10.4	11.9	12.1	13.7[7]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	13.7	11.0	15.5	18.3	21.0	15.9[6]
Net Interest Margin (%)	4.9	4.9	4.6	4.9	5.6	5.0[6]
PPI / Average RWA (%)	3.2	3.1	3.0	3.4	3.9	3.2[7]
Net Income / Tangible Assets (%)	1.6	1.7	1.3	1.7	1.5	1.5[6]
Cost / Income Ratio (%)	56.8	57.3	59.9	58.9	54.2	57.4[6]
Market Funds / Tangible Banking Assets (%)	10.6	13.1	14.5	12.1	9.1	11.9[6]
Liquid Banking Assets / Tangible Banking Assets (%)	31.5	26.9	26.3	26.4	25.8	27.4[6]
Gross Loans / Due to Customers (%)	91.5	95.8	96.7	97.1	93.7	95.0[6]

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; IFRS [3] Basel II; IFRS [4] May include rounding differences due to scale of reported amounts [5] Compound Annual Growth Rate (%) based on time period presented for the latest accounting regime [6] Simple average of periods presented for the latest accounting regime. [7] Simple average of Basel III periods presented

Source: Moody's Financial Metrics

Profile

Hatton National Bank Ltd. (HNB) is a privately owned commercial bank based in Sri Lanka. The bank provides a wide range of products and services — including personal and corporate banking; developmental, lease and mortgage financing; and bancassurance products and services — to individuals, small and medium-sized enterprises, and medium-sized to large corporate and financial institutions. The bank also offers Islamic banking products and services.

As of 30 September 2017, HNB held domestic market shares of 10.0% in terms of assets, 10.6% in terms of loans and 10.0% in terms of deposits. As of the same date, the bank reported a consolidated asset base of LKR1,003.8 billion ($6.0 billion).

Please refer to the Issuer Profile for more information.

For more details on the banking system, see Banking System Profile: Sri Lanka.

Detailed credit considerations

Improved capital buffer

We assign a ba2 score for capital, based on risk-weighted capitalization.

HNB's capital adequacy is moderate, with tangible common equity (TCE)/adjusted risk-weighted assets (RWA) (TCE ratio) of 13.7% as of the end of September 2017. We incorporate our standard adjustment for RWA and include a 100% risk weighting for government securities that are rated B1.

The capital score reflects HNB's Q3 2017 rights issue for LKR14.5 billion (around $100 million). The capital increase was in line with the July 2017 implementation of Basel III rules in Sri Lanka. Following the increase, the bank's TCE ratio went up to 13.7% in Q3 2017 from 11% in Q2. We expect the bank's TCE ratio to normalize at around 12.5%, which corresponds to a ba2 score.

The new IFRS9 accounting standard was implemented in Sri Lanka on 1 January 2018. HNB has not communicated the impact analysis on its capital ratios; we expectation a mildly negative pressure on capital.

Asset quality has deteriorated amid adverse weather conditions

We assign a b1 score for asset risk, to reflect HNB's unseasoned risk and the single-name concentrations in its loan book.

As of the end of September 2017, HNB reported a gross bank-only nonperforming loan (NPL) ratio of 2.6%, slightly higher than the 1.8% as of year-end 2016 (2015: 2.2%). In 2016, the bank also restructured 1.6% of its loans (2015: 1.1%) without classifying them as NPLs; more recent data on restructured loans is not available.

In our view, the increase in HNB's NPL ratio was because of adverse weather conditions in Sri Lanka in early 2017, which led to higher losses on agriculture loans. A sizable portion of the bank's loan book is committed to agricultural activities (year-end 2016: 9% of gross loans).

We view as negative that the bank's NPL coverage decreased to 75% as of the end of September 2017, from 100% in 2016.

We also adjust the b1 score to account for rapid loan growth, which stood at 15% as of September 2017 YoY. However, loan growth has been slowing down in recent quarters, which should decrease asset risk.

While loan growth was broad-based, some of the largest contributors to growth were the construction segment (2016: 8% of gross loans) and trading (20%).

We also adjust the score further downward to account for elevated single-party concentrations in HNB's loan book, which increases the risk of asset-quality swings if some of the bank's large borrowers default. HNB's largest borrowers are diversified local conglomerates.

Strong NIM supports healthy profitability

We assign a ba1 score for profitability, reflecting the bank's high return on assets and earnings quality. The bank's return on assets was healthy at 1.6% over the nine months ended 30 September 2017. We expect profitability to remain stable in the next 12-18 months.

The bank reported a stable NIM of 4.9% for 9M 2017. HNB's margin is higher than the system average (3.6%) and is supported by higher yields on the bank's small and medium-sized enterprise and retail loans, as well as a lower cost of funding owing to its high reliance on current account and savings account deposits (CASA).

Credit costs (provisions/loans) have been elevated, at 58 basis points (bps) in Q3 2017 and 68 bps in Q2, reflecting a modest asset-quality deterioration.

Tight funding position; good liquidity profile

We assign a ba2 score to the bank's funding structure to reflect its 13.1% market funds ratio. However, we consider that the overall funding structure has some weaknesses, because the bank operated with a high gross loans/deposits ratio (LDR) of 91% at Q3 2017 – which is nevertheless an improvement from 95% in 2016.

To some extent, the high LDR is somewhat balanced by HNB's high share of current account and savings account deposits. These deposits were stable at 38% of customer deposits as of the end of September 2017. We expect some moderation in loan growth amid higher policy rates and increased reserve ratio.

Liquid assets made up around 32% of tangible assets as of the end of September 2017. We assign a ba3 score for liquidity because some liquid assets are typically pledged under repo deals.

The bank runs healthy liquidity coverage ratios (LCRs) of 170%/110% for local currency /all currency as of Q3 2017 (bank-level).

BCA pressured by Sri Lanka's Weak+ Macro Profile

HNB operates in Sri Lanka, a country with a Weak+ Macro Profile. The Weak+ Macro Profile reflects the deteriorating operating environment for Sri Lankan banks as a result of (1) weakened institutional strength, given that economic and policy reforms might not be realized; (2) heightened external vulnerabilities because Sri Lanka continues to rely on external debt to fund its current account deficit; and (3) high loan growth over the last two years, driven by a loosening of underwriting standards.

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 track record in the effective implementation of policy reforms in the past.

The budget deficit was significant at 5.4% of the GDP in 2016. External vulnerabilities are 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, largely denominated in foreign currencies.

The Credit Conditions score was adjusted downward by one notch in December 2017 to reflect rapid credit growth in Sri Lanka over the three years ended September 2017, growing at a compound annual growth rate of 20%. Because Sri Lanka is an under-penetrated banking market, strong credit growth in itself is not necessarily a cause for concern. However, the current episode of strong credit growth has come against a backdrop of moderating economic growth. Thus, the credit growth multiplier (credit growth/nominal GDP growth) has increased rapidly to around 2x over the three years ended 2016. The negative adjustment to credit conditions reflects our concern that the divergence between credit growth and the underlying economic conditions may be unsustainable.

Funding and liquidity conditions will remain balanced and stable in 2018. 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 LDR was a healthy 87% as of the end of September 2017.

Support and structural considerations

Government support considerations

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 10% of system deposits as of the end of September 2017. 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 the foreign-currency deposit ceiling.

Counterparty Risk (CR) Assessment

CR Assessments are opinions of how counterparty obligations are likely to be treated if a bank fails, and are distinct from debt and deposit ratings in that they (1) consider only the risk of default rather than both the likelihood of default and the expected financial loss suffered in the event of default, and (2) apply to counterparty obligations and contractual commitments rather than debt or deposit instruments. The CR Assessment is an opinion of the counterparty risk related to a bank's covered bonds, contractual performance obligations (servicing), derivatives (for example, swaps), letters of credit, guarantees and liquidity facilities.

HNB's CR Assessment is positioned at Ba3(cr)/NP(cr)

The CR Assessment, prior to government support, is positioned one notch above the Adjusted BCA of b1. We then assign government support assumptions, in line with our support assumptions on deposits and senior unsecured debt. Such assignments reflect our view that any support provided by governmental authorities to a bank, which benefits senior unsecured debt or deposits, is very likely to benefit operating activities and obligations reflected by the CR Assessment. Such a view is consistent with our belief that governments are likely to maintain the banks' operations as a going concern to reduce contagion and preserve the banks' critical function. The CR Assessment for HNB is one notch above the sovereign rating of B1.

Rating methodology and scorecard factors

Exhibit 3

Hatton National Bank Ltd.

Macro Factors		
Weighted Macro Profile	**Weak +**	**100%**

Factor	**Historic Ratio**	**Macro Adjusted Score**	**Credit Trend**	**Assigned Score**	**Key driver #1**	**Key driver #2**
Solvency						
Asset Risk						
Problem Loans / Gross Loans	2.6%	ba2	↓↓	b1	Loan growth	Single name concentration
Capital						
TCE / RWA	13.7%	ba2	↓	ba2	Risk-weighted capitalisation	Expected trend
Profitability						
Net Income / Tangible Assets	1.6%	ba1	←→	ba1	Return on assets	Expected trend
Combined Solvency Score		ba2		ba3		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	13.1%	ba2	←→	ba2	Extent of market funding reliance	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	26.9%	ba2	←→	ba3	Asset encumbrance	Expected trend
Combined Liquidity Score		ba2		ba2		
Financial Profile				ba3		
Business Diversification				0		
Opacity and Complexity				0		
Corporate Behavior				0		
Total Qualitative Adjustments				0		
Sovereign or Affiliate constraint:				B1		
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
Senior unsecured bank debt	0	0	b1	--	--	B1

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

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