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CREDIT OPINION
23 May 2019

Update

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RATINGS

**Hatton National Bank Ltd.**

| | |
|---|---|
| Domicile | Sri Lanka |
| Long Term CRR | B1 |
| Type | LT Counterparty Risk Rating - Fgn Curr |
| Outlook | Not Assigned |
| Long Term Debt | Withdrawn |
| Type | Senior Unsecured - Fgn Curr |
| Outlook | Not Assigned |
| Long Term Deposit | B3 |
| Type | LT Bank Deposits - Fgn Curr |
| Outlook | Stable |

*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 to credit analysis

## Summary

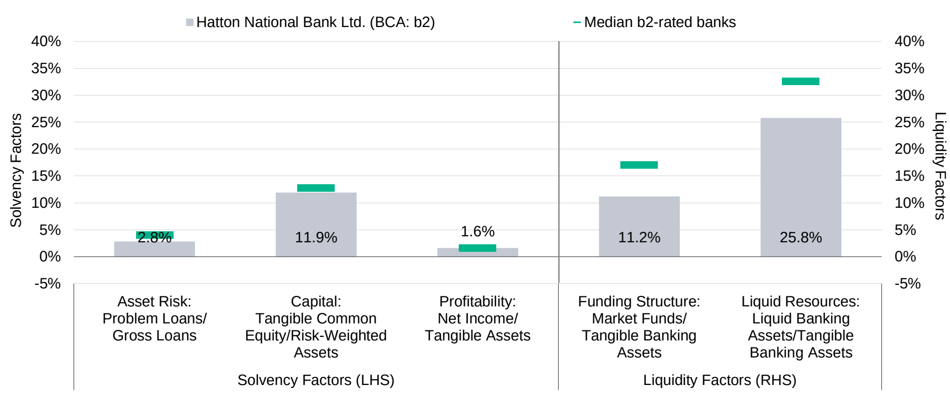
Hatton National Bank Ltd.'s (HNB) long-term local-currency deposit rating of B2 is in line with the Government of Sri Lanka's rating (B2 stable). The bank's Baseline Credit Assessment (BCA) and Adjusted BCA are positioned at b2 and incorporate zero notches of government support because they are constrained by Sri Lanka's sovereign rating. The outlook, where applicable, is stable.

The b2 BCA reflects our expectation that the country's weak operating environment, in addition to years of strong credit growth, will strain the bank's asset quality. The BCA also takes into account the bank's healthy profitability, although balanced by a slight weakening in capital.

HNB's BCA and Adjusted BCA of b2 are constrained by Sri Lanka's sovereign rating.

Exhibit 1

**Rating Scorecard - Key financial ratios**




*Source: Moody's Financial Metrics*

## Credit strengths

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

## Credit challenges

» Deteriorating asset quality, which will be further affected by the weakening operating environment

» Tight funding driven by a high loan-to-deposit ratio (LDR)

## Outlook

The outlook on HNB's ratings is stable, in line with the sovereign outlook. The sovereign outlook is stable on account of our expectation that the government will remain broadly focused on implementing important fiscal, monetary and economic reforms.

## Factors that could lead to an upgrade

» HNB's standalone credit profile, local-currency deposit rating and foreign-currency issuer rating are already at the same level as those of the Sri Lankan government. Hence, there will not be any upward pressure on the ratings unless there is an upgrade of the sovereign rating.

» The long-term foreign-currency deposit rating of B3 is capped by Sri Lanka's foreign-currency deposit ceiling of B3.

## Factors that could lead to a downgrade

» A downgrade of the sovereign rating will lead to a downgrade of the bank's long-term ratings.

» The BCA and deposit ratings could also be downgraded if there is material deterioration in the solvency factors, such as asset quality or capital because of higher loan impairment provisions. Tighter liquidity and an increased reliance on market funding could strain the bank's BCA.

## Key indicators

Exhibit 2

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

| | 12-18[2] | 12-17[2] | 12-16[3] | 12-15[3] | 12-14[3] | CAGR/Avg.[4] |
|---|---|---|---|---|---|---|
| Total Assets (USD Million) | 6,280.0 | 6,563.9 | 6,018.3 | 5,251.9 | 4,546.4 | 8.4[5] |
| Tangible Common Equity (USD Million) | 709.4 | 759.4 | 589.9 | 485.6 | 457.4 | 11.6[5] |
| Problem Loans / Gross Loans (%) | 2.8 | 2.3 | 1.8 | 2.4 | 3.2 | 2.5[6] |
| Tangible Common Equity / Risk Weighted Assets (%) | 11.9 | 12.4 | 11.1 | 10.4 | 11.9 | 11.5[7] |
| Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%) | 14.3 | 11.9 | 11.0 | 15.5 | 18.3 | 14.2[6] |
| Net Interest Margin (%) | 5.2 | 4.9 | 4.9 | 4.6 | 4.9 | 4.9[6] |
| PPI / Average RWA (%) | 3.7 | 3.0 | 3.1 | 3.0 | 3.4 | 3.3[7] |
| Net Income / Tangible Assets (%) | 1.6 | 1.5 | 1.7 | 1.3 | 1.7 | 1.6[6] |
| Cost / Income Ratio (%) | 52.3 | 56.2 | 57.3 | 59.9 | 58.9 | 56.9[6] |
| Market Funds / Tangible Banking Assets (%) | 11.2 | 10.2 | 13.1 | 14.5 | 12.1 | 12.2[6] |
| Liquid Banking Assets / Tangible Banking Assets (%) | 25.8 | 28.2 | 26.9 | 26.3 | 26.4 | 26.7[6] |
| Gross Loans / Due to Customers (%) | 97.1 | 92.8 | 95.8 | 96.7 | 97.1 | 95.9[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.

*Sources: Moody's Investors Service, company filings*

## 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 (SMEs), and medium-sized to large corporate and financial institutions. The bank also offers Islamic banking products and services.

As of 31 December 2018, HNB held market shares of 10% in terms of gross loans and deposits. As of the same date, the bank reported a consolidated asset base of LKR1.1 trillion ($6.3 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

### Asset risks are increasing amid deteriorating macroeconomic conditions

We expect HNB's asset quality to deteriorate further in 2019, driven by slowing macroeconomic conditions and weakness in the tourism sector, which accounts for a significant share of the country's GDP. As of year-end 2018, direct loans for tourism represented about 4% of HNB's gross loans, but we expect the indirect exposure, including the suppliers and contractors as well as retail customers, to be much higher.

To aid the tourism sector, Sri Lankan banks will grant a one-year moratorium for capital and interest repayments to all registered travel and tourism businesses until March 2020. Reduced capital and interest rates during the moratorium period will be converted into a term loan, and the repayments, starting July 2020, will be charged a concessionary rate.

The moratorium will insulate HNB from asset-quality stress in its tourism-related loan exposures over the next one year. However, we expect higher NPL formation thereafter if the revenue of the tourist operators does not increase sufficiently to cover the higher debt repayments after the debt moratorium ends.

As of the end of March 2019, HNB's gross nonperforming loan (NPL) ratio increased to 4.6% of gross loans (on a bank-only basis) from 2.7% as of a year ago. In addition, restructured loans, not classified as NPLs, made up 0.6% of its loans (2017: 1.2%) as of December 2018.

The increase in HNB's NPL ratio was largely driven by the retail and SME segment because of the challenging operating conditions in the country.

HNB's previously healthy loan-loss coverage also deteriorated in the first quarter of 2019 due to the significant spike in NPLs. The bank's loan-loss coverage ratio declined to 77% as of 31 March 2019, from 111% at the end of December 2018. This is credit negative for the bank as it now has lower loss-absorbing buffers to take haircuts on its NPLs.

HNB's assigned Asset Quality score of b2 also reflects the risks of slowing macroeconomic conditions and elevated single-party concentrations in the loan book, which increases the risk of asset-quality swings if some of the bank's large borrowers default. HNB's largest borrowers are the Sri Lankan government and the diversified local conglomerates.

### Capitalization to further moderate because of high loan growth

HNB's capital is likely to further moderate because of high loan growth. Under Basel III norms, HNB reported a Tier 1 capital ratio of 12.6% as of the end of March 2019, compared with 12.8% a year earlier.

The bank's adjusted tangible common equity (TCE)/adjusted risk-weighted assets (RWA) or TCE ratio was 11.9% as of the end of December 2018. The TCE ratio incorporates our standard adjustment for RWA, which adds an additional 100% risk weighting for government securities that are rated B2.

We expect HNB's credit growth to somewhat slowdown to about 15% in 2019, as against 19% growth in 2018. As a result, we expect the bank's TCE/RWA to somewhat moderate to about 11.0% - 11.5% by year-end 2019. In addition, our Capital score considers additional regulatory deductions to the bank's insurance subsidiaries.

We assign a Capital score of b1 to incorporate our expectation of a further moderation in the bank's capital.

### Strong NIM supports healthy profitability, although partially offset by rising credit costs

We assign a ba3 score for Profitability, reflecting the bank's high return on assets and earnings quality. The bank's return on assets (ROA) was healthy at 1.6% in 2018, which improved from 1.5% in 2017. In the latest quarter ended March 2019, ROA however declined to 1.2% on an annualized basis, compared to 2.6% in the same period a year ago, reflecting the rise in credit costs.

While core profitability will remain stable over the next 12-18 months, higher credit costs will moderately affect bottom-line profitability. Credit costs (loan-loss provisions/average gross loans) were 1.2% in 2018, higher than the 0.5% in 2017, and we expect the level to increase further, given the challenging domestic operating conditions. Annualized credit costs in the latest quarter ended 31 March 2019 deteriorated to 2.1%, compared to 0.6% in the same period a year ago.

The bank reported a slightly improved NIM of 5.2% in 2018, compared with 4.9% in 2017. HNB's NIM was higher than the system average of 3.7% in 2018, which is because of higher yields on the bank's SME and retail loans, as well as a lower cost of funding because of its high reliance on current account and savings account deposits. In the latest first quarter 2019 results, HNB's NIM moderated slightly to 4.8% on an annualized basis, reflecting the challenges in the broader economy.

We expect some moderation in HNB's NIM, given the one-year moratorium provided by banks for capital and interest repayments to all registered travel and tourism businesses until March 2020. Because of the interest moratorium, we expect HNB to record lower interest income on the affected loans over the next year.

### A tight funding position, although balanced by healthy liquidity

We assign a b1 score to the bank's Funding Structure to reflect its 11% market funds ratio and the weakness in the bank's overall funding structure. The bank operated with a high gross LDR of 97% as of the end March 2019, which deteriorated from 95% a year earlier.

The high LDR is somewhat balanced by HNB's high share of current account and savings account deposits. These deposits were stable at 29% of customer deposits as of the end of March 2019. In addition, we expect some moderation in loan growth amid higher policy rates and an increased reserve ratio.

Liquid assets made up around 26% of tangible assets as of the end of December 2018. We assign a b1 score for Liquidity because some liquid assets are typically pledged under repo deals.

The bank had a healthy liquidity coverage ratio of 116% (on an all-currency basis) as of the end of March 2019.

### BCA constrained by Sri Lanka's Weak Macro Profile

HNB operates mainly 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, largely concentrated in the housing and construction segments.

We maintained the one-notch negative adjustment to the credit conditions scores to reflect the rapid credit growth in Sri Lanka over the three years ended December 2018. Loans grew at a compound annual growth rate of 18% between December 2015 and December 2018.

Because Sri Lanka is an underpenetrated banking market, strong credit growth in itself is not necessarily a cause for concern. However, the current episode of strong credit growth has occurred against a backdrop of moderating economic growth. Thus, the credit growth multiplier (credit growth/nominal GDP growth) averaged around 2x between December 2015 and December 2018. In addition, credit growth has largely been concentrated in the construction segment. The negative adjustment to credit conditions reflects our concern that the divergence between credit growth and the underlying economic conditions may be unsustainable, and that the rapid growth in the construction segment may lead to a seasoning of loans.

We expect funding and liquidity conditions to remain stable in 2019. Sri Lankan banks are primarily deposit funded, and we expect loan and deposit growth rates to be in tandem over the next 12-18 months. The system LDR stood at 91% as of the end of December 2018.

## 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 December 2018. However, this does not result in any rating uplift for HNB because the B2 rating of the Sri Lankan sovereign is at the same level as HNB's BCA.

HNB's B3 foreign-currency deposit rating is one notch lower than the bank's local-currency deposit rating of B2 because the B3 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, 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 B1(cr)/NP(cr)

The CR Assessment, before government support, is positioned one notch above the Adjusted BCA of b2. 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 B2.

### Counterparty Risk Ratings (CRRs)

CRRs are opinions of the ability of entities to honor the uncollateralized portion of non-debt counterparty financial liabilities (CRR liabilities) and also reflect the expected financial losses in the event such liabilities are not honored. CRRs are distinct from ratings assigned to senior unsecured debt instruments and from issuer ratings because they reflect that, in a resolution, CRR liabilities might benefit from preferential treatment compared with senior unsecured debt. Examples of CRR liabilities include the uncollateralized portion of payables arising from derivatives transactions and the uncollateralized portion of liabilities under sale and repurchase agreements

**HNB's CRRs are positioned at B1/NP**

We consider Sri Lanka a jurisdiction with a nonoperational resolution regime. For nonoperational resolution regime countries, the starting point for the CRR is one notch above the bank's Adjusted BCA, to which we then typically add the same notches of government support uplift as applied to the CR Assessment.

## Methodology and scorecard

### About Moody's Bank Scorecard

Our scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The scorecard output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

## Rating methodology and scorecard factors

Exhibit 3

**Rating Factors**

**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 | 2.8% | ba3 | ↓ | b2 | Loan growth | Single name concentration |
| Capital | | | | | | |
| Tangible Common Equity / Risk Weighted Assets (Basel III - transitional phase-in) | 11.9% | b1 | ←→ | b1 | Capital fungibility | Expected trend |
| Profitability | | | | | | |
| Net Income / Tangible Assets | 1.6% | ba2 | ↓ | ba3 | Return on assets | Expected trend |
| Combined Solvency Score | | ba3 | | b1 | | |
| Liquidity | | | | | | |
| Funding Structure | | | | | | |
| Market Funds / Tangible Banking Assets | 11.2% | ba3 | ←→ | b1 | Extent of market funding reliance | |
| Liquid Resources | | | | | | |
| Liquid Banking Assets / Tangible Banking Assets | 25.8% | ba3 | ←→ | b1 | Asset encumbrance | Expected trend |
| Combined Liquidity Score | | ba3 | | b1 | | |
| Financial Profile | | | | b1 | | |
| Qualitative Adjustments | | | | Adjustment | | |
| Business Diversification | | | | 0 | | |
| Opacity and Complexity | | | | 0 | | |
| Corporate Behavior | | | | 0 | | |
| Total Qualitative Adjustments | | | | 0 | | |
| Sovereign or Affiliate constraint | | | | B2 | | |
| Scorecard Calculated BCA range | | | | b1 - b3 | | |
| Assigned BCA | | | | b2 | | |
| Affiliate Support notching | | | | 0 | | |
| Adjusted BCA | | | | b2 | | |

| **Instrument Class** | **Loss Given Failure notching** | **Additional notching** | **Preliminary Rating Assessment** | **Government Support notching** | **Local Currency rating** | **Foreign Currency rating** |
|---|---|---|---|---|---|---|
| Counterparty Risk Rating | 1 | 0 | b1 | 0 | B1 | B1 |
| Counterparty Risk Assessment | 1 | 0 | b1(cr) | 0 | B1(cr) | |
| Deposits | 0 | 0 | b2 | 0 | B2 | B3 |

[1] Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.
*Source: Moody's Investors Service*

## Ratings

Exhibit 4

| Category | Moody's Rating |
|---|---|
| **HATTON NATIONAL BANK LTD.** | |
| Outlook | Stable |
| Counterparty Risk Rating | B1/NP |
| Bank Deposits -Fgn Curr | B3/NP |
| Bank Deposits -Dom Curr | B2/NP |
| Baseline Credit Assessment | b2 |
| Adjusted Baseline Credit Assessment | b2 |
| Counterparty Risk Assessment | B1(cr)/NP(cr) |
| Issuer Rating | B2 |

*Source: Moody's Investors Service*

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