

CREDIT OPINION

28 June 2017

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Long Term Debt	Withdrawn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.

Semiannual Update

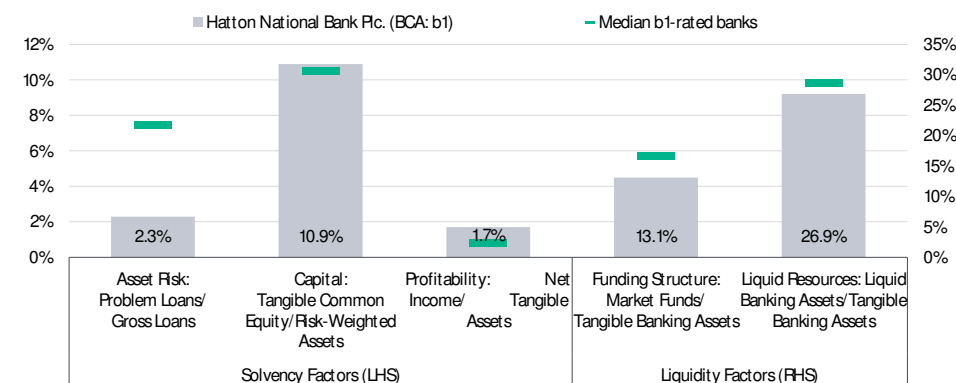
Summary Rating Rationale

Hatton National Bank Ltd.'s (HNB) B1/B2 local and foreign currency ratings are based on the bank's b1 baseline credit assessment (BCA). We also expect a "high" probability of support from the government of Sri Lanka (B1 negative) to the bank in case of need, however such support does not result in any rating uplift because the BCA of the bank is already at the same level as the government rating.

The 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.

Exhibit 1

Rating Scorecard - Key Financial Ratio



Source: Moody's Financial Metrics

Credit Strengths

- » Strong NIM supports healthy profitability levels
- » Core capital buffer will improve after the planned right issue

Credit Challenges

- » Asset quality improved in 2016, but rapid growth could mask asset quality challenges
- » Tight funding and liquidity profiles

Rating Outlook

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

We revised the outlook on the bank's ratings to negative from stable following the revision of the outlook on Sri Lanka's B1 sovereign rating to negative on 20 June 2016.

Factors that Could Lead to an Upgrade

Given the negative outlook, there is currently no 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 BCA.

Key Indicators

Exhibit 2

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

	3-17 ²	12-16 ²	12-15 ²	12-14 ²	12-13 ²	CAGR/Avg. ³
Total Assets (USD million)	6,218	6,018	5,252	4,546	3,998	14.6 ⁴
Tangible Common Equity (USD million)	596	590	486	457	398	13.2 ⁴
Problem Loans / Gross Loans (%)	1.9	1.8	2.4	3.2	3.6	2.6 ⁵
Tangible Common Equity / Risk Weighted Assets (%)	10.9	11.1	10.4	11.9	12.1	11.3 ⁶
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	11.5	11.0	15.5	18.3	21.0	15.5 ⁵
Net Interest Margin (%)	4.8	4.9	4.6	4.9	5.6	4.9 ⁵
PPI / Average RWA (%)	3.1	3.1	3.0	-	-	3.1 ⁶
Net Income / Tangible Assets (%)	1.7	1.7	1.3	1.7	1.5	1.6 ⁵
Cost / Income Ratio (%)	57.9	57.3	59.9	58.9	54.2	57.6 ⁵
Market Funds / Tangible Banking Assets (%)	14.8	13.1	14.5	12.1	9.1	12.7 ⁵
Liquid Banking Assets / Tangible Banking Assets (%)	28.9	26.9	26.3	26.4	25.8	26.8 ⁵
Gross Loans / Due to Customers (%)	98.4	95.8	96.7	97.1	93.7	96.3 ⁵

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

Source: Moody's Financial Metrics

Detailed Rating Considerations

ASSET QUALITY HAS IMPROVED, BUT RAPID GROWTH COULD MASK CREDIT 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 2017, HNB reported a gross bank-only NPL ratio of 1.9%, slightly higher than 1.8% at end-2016 (2015: 2.2%). HNB's NPL ratio compares well with the system-average NPL ratio of 2.6% at end-2016.

The improvement in HNB's NPL ratio was related to recoveries in some large corporate NPLs, as well as to the rapid year-over-year credit growth of 20% over the 12 months ending 31 March 2017. HNB's rapid loan growth makes a large part of its loan book unseasoned, whereby increasing its asset risk. We note, however, that HNB's loan growth is in-line with the banking system (2016: 18%).

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

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

The bank's provisioning—including reserves for interest in suspense—stood at a good 101% at end-March 2017.

In 2016, the bank also restructured 1.4% of its loans (2015 : 1.1%), without classifying those as NPLs.

The bank demonstrates elevated single-party concentrations in its loan book, which increase the risk of asset quality swings if some of its large borrowers default. The top-20 corporate borrowers make up around 190% of the bank's TCE.

STRONG NIM SUPPORTS HEALTHY PROFITABILITY

We assign a baa3 score for profitability, reflecting the bank's high return on assets (ROAs) and earnings quality. ROA was healthy at 1.7% over the three months ending 31 March 2017. We expect profitability to remain stable in the next 12-18 months.

The bank reported a stable NIM of 4.8% in Q1 2017, in line with 4.9% for 2016. HNB's margin is higher than system-average (3.6%), and is 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.

Credit costs (provisions/loans) have been elevated in the last two quarters, at 27 bps in Q1 2017 and 16 bps in Q4 2016, reflecting modest asset quality challenges. Q2 2017 could also be heavy on provisions, as adverse weather conditions in Sri Lanka have the potential to lead to higher losses on agriculture loans (9% of gross loans at YE2016).

CAPITAL BUFFER IS MODEST

We assign a b1 score for capital, based on risk weighted capitalization.

HNB's capital adequacy is moderate, with a TCE/adjusted RWA of 10.9% at end-March 2017. We incorporate our standard adjustment for RWA, and include a 100% risk weighting for government securities.

In April 2017 the bank announced its intention to raise LKR15 billion (approx. USD97 million) by way of rights issuance. The planned rights issue will increase HNB's capital buffer in light of the Basel 3 implementation in Sri Lanka in June 2017, and will support its credit growth strategy, a credit positive. We estimate that the capital raise will increase HNB's Tier 1 capital ratio to 12.9%, well above the 10% (include 1.5% D-SIB buffer) minimum Tier 1 required by end-2019.

The bank expects to complete the capital raising exercise in July 2017, after receiving approval from the Colombo Stock Exchange and HNB's shareholders.

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 operates with a high loans-to-deposits ratio (LDR) of 98% at Q1 2017.

Higher loan growth relative to deposit growth is a feature of the system, where savings are below investment levels. Such a situation leads to tight liquidity conditions in the banking system.

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

Liquid assets made up around 26% of total assets at end-March 2017. We assign b1 score for liquidity.

MACRO PROFILE: MODERATE-

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 deficit.

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.

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 2016. 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.

Macro Factors

Weighted Macro Profile	Moderate	100%
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Factor	Historic Ratio	Macro Adjusted Score	Credit Trend	Assigned Score	Key driver #1	Key driver #2
Solvency						
Asset Risk						
Problem Loans / Gross Loans	2.3%	baa3	← →	ba3	Unseasoned risk	Single name concentration
Capital						
TCE / RWA	10.9%	ba3	↓	b1	Expected trend	
Profitability						
Net Income / Tangible Assets	1.7%	baa3	← →	baa3	Expected trend	
Combined Solvency Score		ba1		ba3		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	13.1%	baa3	← →	ba1	Expected trend	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	26.9%	ba1	← →	b1	Asset encumbrance	Expected trend
Combined Liquidity Score		baa3		ba2		
Financial Profile						
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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