MOODY'S
INVESTORS SERVICE

CREDIT OPINION
28 November 2018

Update

Rate this Research

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Long Term Debt	Withdrawn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.

Contacts

Alka Anbarasu +65.6398.3712
VP-Sr Credit Officer
alka.anbarasu@moodys.com

Tengfu Li +65.6311.2630
Analyst
tengfu.li@moodys.com

Komaresan Subramanian +65.6311.2602
Associate Analyst
komaresan.subramanian@moodys.com

Graeme Knowd +81.3.5408.4149
MD-Banking
graeme.knowd@moodys.com

Hatton National Bank Ltd.

Update to credit analysis following rating downgrade

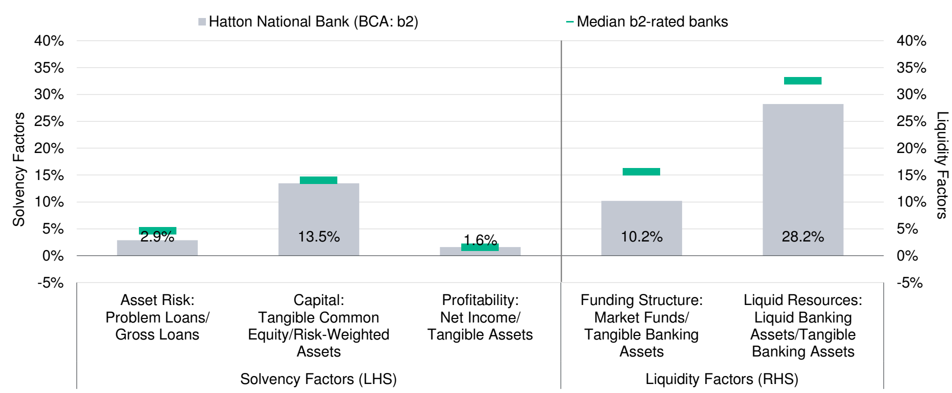
Summary

On 20 November 2018, we downgraded Hatton National Bank Ltd.'s (HNB) long-term local-currency deposit rating to B2, in line with the Government of Sri Lanka's rating (B2 stable). The long-term foreign-currency deposit rating was also downgraded to B3. Furthermore, we downgraded the bank's Baseline Credit Assessment (BCA) and Adjusted BCA to b2. The outlook has been changed to stable, in line with the outlook on the sovereign rating.

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

The b2 BCA reflects our expectation that the recent political and financial market developments in Sri Lanka will weigh on the country's already-weak GDP growth. After years of strong credit growth, the weakening operating environment will strain the banks' asset quality and profitability. The BCA also takes into account the bank's improved capital adequacy and healthy profitability, in addition to its tight funding profile and weakening asset quality.

Exhibit 1
Rating Scorecard - Key financial ratios



Source: Moody's Financial Metrics

Credit strengths

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

» Improvement in the bank's core capital, following the rights issue completed in October 2017

Credit challenges

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

» A tight funding profile

Outlook

The rating outlook is stable, in line with the sovereign outlook. The sovereign outlook is stable on account on Moody's expectation that any future government will remain broadly focused on implementing important fiscal, monetary and economic reforms that would strengthen the credit profile over the medium term.

Factors that could lead to an upgrade

» The bank'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 to 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 BCAs 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 BCAs.

Key indicators

Exhibit 2
Hatton National Bank Ltd. (Consolidated Financials) [1]

	6-18[2]	12-17[2]	12-16[3]	12-15[3]	12-14[3]	CAGR/Avg.[4]
Total Assets (USD million)	6,664	6,564	6,018	5,252	4,546	11.5[5]
Tangible Common Equity (USD million)	777	759	590	486	457	16.4[5]
Problem Loans / Gross Loans (%)	2.9	2.3	1.8	2.4	3.2	2.5[6]
Tangible Common Equity / Risk Weighted Assets (%)	13.5	12.4	11.1	10.4	11.9	13.0[7]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	15.5	11.9	11.0	15.5	18.3	14.4[6]
Net Interest Margin (%)	5.0	4.9	4.9	4.6	4.9	4.8[6]
PPI / Average RWA (%)	3.6	3.0	3.1	3.0	3.4	3.3[7]
Net Income / Tangible Assets (%)	1.8	1.5	1.7	1.3	1.7	1.6[6]
Cost / Income Ratio (%)	53.0	56.2	57.3	59.9	58.9	57.1[6]
Market Funds / Tangible Banking Assets (%)	9.9	10.2	13.1	14.5	12.1	12.0[6]
Liquid Banking Assets / Tangible Banking Assets (%)	27.3	28.2	26.9	26.3	26.4	27.0[6]
Gross Loans / Due to Customers (%)	96.0	92.8	95.8	96.7	97.1	95.7[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 2018, HNB held domestic market shares of 10% in terms of gross loans and deposits. As of the same date, the bank reported a consolidated asset base of LKR1,090 billion ($6.4 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 capitalization to provide support against risks

HNB's capital profile has improved after the rights issue of LKR14.5 billion (around $100 million) completed in October 2017. Under Basel III norms, the bank's Common Equity Tier 1 capital ratio stood at 13.25% as of the end of September 2018 compared with 13.07% a year earlier.

The bank's adjusted tangible common equity (TCE)/adjusted risk-weighted assets (RWA) or TCE ratio was 13.4% as of the end of September 2018. We incorporate our standard adjustment for RWA and include a 100% risk weighting for government securities that are rated B1.

Given the strong credit growth of around 15%, we expect the bank's TCE/RWA to somewhat moderate to 12.0%-12.5% by year-end 2019, corresponding to a ba3 Capital score. However, we adjust the score down by one notch to b1 to account for regulatory deductions taken on the bank's insurance subsidiaries.

Since January 2018, SLFRS 9 (Sri Lanka's equivalent of IFRS 9) has been implemented in Sri Lanka. However, the Institute of Chartered Accountants of Sri Lanka has given the banks time till end of the year to incorporate the impact of SLFRS 9.

Based on HNB's estimates as of the end of September 2018, the implementation of SLFRS 9 will result in an increase of 36%-12% in its loss allowances, translating into a reduction of 60-70 basis points (bps) in its total capital adequacy ratio. We expect a similar impact on the bank's Common Equity Tier 1 ratio.

Nevertheless, we expect the impact of SLFRS 9 on the capital position to be spread over a three- to five-year period and, as such, the immediate impact will be fairly limited.

Asset quality has deteriorated amid adverse weather conditions and default of one large corporate exposure

As of the end of September 2018, HNB reported a gross nonperforming loan (NPL) ratio of 3.1% (on a bank-only basis), higher than the 2.3% as of December 2017 and 1.8% as of December 2016. In addition, restructured loans, not classified as NPLs, made up 1.2% of its loans (2016: 1.6%) as of December 2017.

The increase in HNB's NPL ratio was because of the default of one large corporate borrower. In addition, adverse weather conditions in Sri Lanka in early 2017 led to a higher share of problem loans in the bank's agriculture-related loans. A sizable portion of the bank's loan book is committed to agricultural activities (year-end 2017: 9% of gross loans).

As a result of the increase in NPLs, the bank's loan-loss coverage decreased to 66% as of the end of September 2018 from 77% as of September 2017.

Apart from the default of the large corporate exposure, we expect part of the asset-quality deterioration to be because of the rapid annual loan growth of 21% during 2014-16. Nevertheless, loan growth has slowed down in recent quarters, with a growth of 9% in 2017 and 15% for the 12 months ended 30 September 2018, which will provide some buffer against future risks.

We also adjust the bank's Asset Quality score to b2 to reflect the elevated single-party concentrations in the loan book, which increase the risk of asset-quality swings if some of the bank's large borrowers default, as reflected by the recent increase in the bank's NPLs. HNB's largest borrowers are the Sri Lankan government and the diversified local conglomerates.

Strong NIM supports healthy profitability, although elevated credit costs will drag profitability

We assign a ba3 score for Profitability, reflecting the bank's high return on assets and earnings quality. The bank's return on assets was healthy at 1.7% in 2017 and 1.8% for the first nine months of 2018 (annualized).

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) was 78 bps over the 12 months ended 30 September 2018, higher than the multiyear low of 9 bps in 2016.

The bank reported a stable NIM of 5.0% in the nine months of 2018. HNB's margin is higher than the system average (3.7%, first six months of 2018) 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 because of its high reliance on current-account and savings account deposits.

A tight funding position and a good liquidity profile

We assign a b2 score to the bank's Funding Structure to reflect its 9% market funding ratio and weakness in the bank's overall funding structure. The bank operated with a high gross loan-to-deposit ratio (LDR) of 95% as of the end of September 2018, although lower than the 91% 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 34% of customer deposits as of the end of September 2018. In addition, we expect some moderation in loan growth amid higher policy rates and an increased reserve ratio.

Liquid assets made up around 27% of tangible assets as of the end of September 2018. We assign a b1 score for Liquidity because some liquid assets are typically pledged under repo deals.

The bank had healthy liquidity coverage ratios of 109.6% (on an all-currency basis) as of the end of September 2018 (on a bank level).

BCA constrained by Sri Lanka's Weak Macro Profile

HNB operates mainly in Sri Lanka, a country with a Weak Macro Profile. We lowered the Macro Profile on 20 November 2018 to reflect the weakening operating environment. We expect that the recent political and financial market developments in Sri Lanka will weigh on the country's already-weak GDP growth.

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 expect challenges in implementing some of the fiscal policy measures and other structural reforms planned under the International Monetary Fund's (IMF) Extended Fund Facility. The political situation has also resulted in delay to the disbursements planned under the IMF program. A prolonged pause in the IMF program, associated with uncertainty about the direction of policy, would likely undermine investors' confidence, exacerbating the tightening in financing conditions.

We maintained the one-notch negative adjustment on the credit conditions scores to reflect rapid credit growth in Sri Lanka over the three years ended June 2018. Loans grew at a compound annual growth rate of 18% between September 2015 and September 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 come against a backdrop of moderating economic growth. Thus, the credit growth multiplier (credit growth/nominal GDP growth) averaged around 2x between September 2015 and September 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 a healthy 87% as of the end of June 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 September 2017. 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.

Rating methodology and scorecard factors

Exhibit 3

Hatton National Bank Ltd.

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

Factor	**Historic Ratio**	**Initial Score**	**Expected Trend**	**Assigned Score**	**Key driver #1**	**Key driver #2**
Solvency						
Asset Risk						
Problem Loans / Gross Loans	2.9%	ba3	←→	b2	Loan growth	Single name concentration
Capital						
TCE / RWA	13.5%	ba3	←→	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	10.2%	ba3	←→	b1	Extent of market funding reliance	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	28.2%	ba3	←→	b1	Asset encumbrance	Expected trend
Combined Liquidity Score		ba3		b1		
Financial Profile				b1		
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	--	B1	B1
Counterparty Risk Assessment	1	0	b1 (cr)	--	B1 (cr)	--
Deposits	0	0	b2	--	B2	B3
Senior unsecured bank debt	0	0	b2	--	--	B2

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

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

REPORT NUMBER 1150951

MOODY'S
INVESTORS SERVICE