MOODY'S
INVESTORS SERVICE

CREDIT OPINION
5 November 2019

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Long Term Debt	Withdrawn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.

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Hatton National Bank Ltd.

Update following rating affirmation

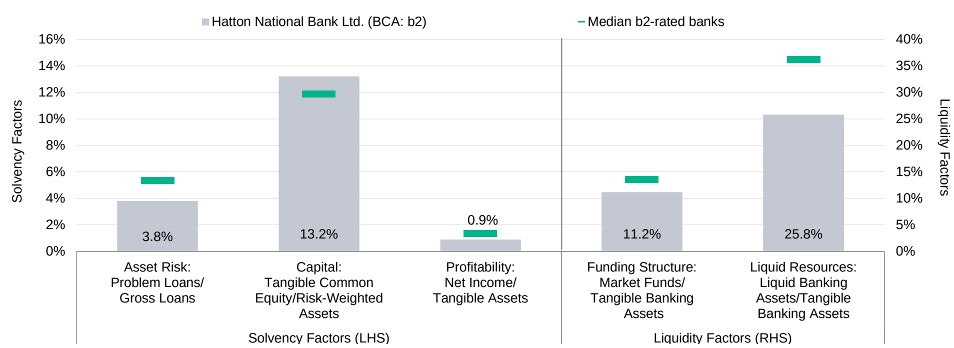
Summary

On 31 October 2019, we affirmed Hatton National Bank Ltd.'s (HNB) long-term local-currency deposit and foreign-currency issuer ratings of B2. We also affirmed the bank's Baseline Credit Assessment (BCA) and Adjusted BCA of b2. The outlook, where applicable, is maintained at stable.

The b2 BCA reflects the deterioration in HNB's asset quality and profitability as a result of weak operating environment. However, these risks are mitigated by its adequate capitalization to absorb unexpected losses, and stable funding and liquidity.

Our assumption of a high probability of support from the Government of Sri Lanka (B2 stable) does not result in any support uplift to HNB's final ratings because its BCA is already at the same level as the sovereign rating.

Exhibit 1
Rating Scorecard - Key financial ratios



Source: Moody's Financial Metrics

Credit strengths

» Good funding and liquidity, supported by a strong deposit franchise

» Stable capitalization

Credit challenges

» Deteriorating asset quality because of the weakening operating environment

» Declining profitability, strained by high credit costs and margin pressure

Outlook

The outlook on HNB's ratings is stable, in line with the stable outlook on the sovereign rating.

Factors that could lead to an upgrade

» HNB's BCA, local-currency deposit and foreign-currency issuer ratings are already at the same level as the Sri Lankan sovereign rating. Given the stable outlook, an upgrade of the BCA and the long-term ratings is unlikely.

» 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 bank's BCA could also be downgraded if there is material deterioration in the solvency factors, such as asset quality or capital. Tighter liquidity and increased reliance on market funding could also lead to a downgrade of the BCA.

Key indicators

Exhibit 2

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

	06-19[2]	12-18[2]	12-17[2]	12-16[3]	12-15[3]	CAGR/Avg.[4]
Total Assets (USD Million)	6,461.2	6,280.0	6,563.9	6,018.3	5,251.9	6.1[5]
Tangible Common Equity (USD Million)	754.4	709.4	759.4	589.9	485.6	13.4[5]
Problem Loans / Gross Loans (%)	--	3.8	2.3	1.8	2.4	2.6[6]
Tangible Common Equity / Risk Weighted Assets (%)	13.2	11.9	12.4	11.1	10.4	11.8[7]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	--	19.6	11.9	11.0	15.5	14.5[6]
Net Interest Margin (%)	5.3	5.2	4.9	4.9	4.6	5.0[6]
PPI / Average RWA (%)	3.1	3.7	3.0	3.1	3.0	3.2[7]
Net Income / Tangible Assets (%)	0.9	1.6	1.5	1.7	1.3	1.4[6]
Cost / Income Ratio (%)	58.2	52.3	56.2	57.3	59.9	56.8[6]
Market Funds / Tangible Banking Assets (%)	9.9	11.2	10.2	13.1	14.5	11.8[6]
Liquid Banking Assets / Tangible Banking Assets (%)	28.7	25.8	28.2	26.9	26.3	27.2[6]
Gross Loans / Due to Customers (%)	95.7	97.1	92.8	95.8	96.7	95.6[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 and company filings

Note: From 2018 onward, problem loans are based on Stage 3 loans under the SLFRS 9 accounting standards. Before 2018, problem loans are based on gross nonperforming loans. Ratios relating to problem loans for 30 June 2019 are not shown because Stage 3 loans data for interim periods are not publicly available.

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 30 June 2019, HNB held market shares of 10% in terms of gross loans and 9% in terms of deposits. As of the same date, the bank reported a consolidated asset base of LKR1.1 trillion ($6.5 billion).

Please see Issuer Profile for more information on the issuer, and see Banking System Profile: Sri Lanka for more details on the banking system.

Detailed credit considerations

Asset risks are increasing amid deteriorating macroeconomic conditions

HNB's assigned Asset Quality score of caa1 reflects our expectation that the bank's asset quality will remain weak over the next few quarters, given the sluggish economic recovery.

As of the end of June 2019, HNB's gross nonperforming loan (NPL) ratio increased to 4.7% of gross loans (on a bank-only basis) from 2.8% as of a year-end 2018. In addition, restructured loans, not classified as NPLs, made up 0.6% of its loans as of year-end 2018 (2017: 1.2%).

The deterioration in the bank's asset quality was largely driven by weaknesses in the agriculture and construction sectors and dampened consumer sentiment, against the backdrop of a challenging operating environment.

We also incorporate downside risks to HNB's asset quality arising from the tourism-related loans that are under a debt moratorium. As of the end of June 2019, direct loans for tourism represented about 6% 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 granted 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 for accumulated interest, starting July 2020, will be charged a concessionary rate.

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

HNB's previously healthy loan-loss coverage also deteriorated in the first half of 2019 because of the significant spike in NPLs. The bank's loan-loss coverage ratio declined to 84% as of the end of June 2019, from 111% as of year-end 2018. This is credit negative for the bank as it now has lower loss-absorbing buffers to take haircuts on its NPLs.

Borrower concentration is a structural feature of the Sri Lankan banking system. HNB's single-party concentrations in the loan book are elevated, which increases the risk of asset-quality swings if any of the bank's large borrowers default. HNB's largest borrowers are the Sri Lankan government and the diversified local conglomerates.

Capitalization to remain stable because of slow loan growth

We expect HNB's capitalization to remain broadly stable because weaker internal capital generation will be balanced by muted loan growth.

Under Basel III norms, HNB reported a Common Equity Tier 1 (CET1) capital ratio of 13.0% as of the end of June 2019, compared with 12.8% as of year-end 2018.

HNB's consolidated Tier 1 capital ratio and total capital ratio of 13.0% and 15.6%, respectively, as of the end of June 2019, are comfortably above the minimum requirements of 10% and 14%, respectively, under Basel III.

We expect HNB's credit growth to remain low in 2019, supporting its capitalization. In line with the industry trend, HNB's annualized loan growth contracted by 4% in the first half of 2019 compared with 19% in 2018, as the bank focused on NPL management while taking a more cautious approach with lending amid growing asset risks.

We assign a Capital score of b1 to consider additional regulatory deductions to the bank's insurance subsidiaries and reflect that some of the bank's capital may not be fully fungible.

Declining profitability, strained by high credit costs and margin pressure

HNB's return on assets (ROA) declined materially to 0.9% on an annualized basis in the first half of 2019 from 1.8% in same period a year ago, because of a spike in credit costs and higher effective tax rates. We expect the bank's profitability to remain under pressure due to high credit costs and narrower margins.

Credit costs, measured by loan-loss provisions as a percentage of average gross loans, rose to 1.8% in the first half of 2019 from 0.7% in same period a year ago. The increase in credit costs was driven by weaker asset quality and the adoption of Sri Lanka Financial Reporting Standards 9 (SLFRS 9) requirements.

Historically, HNB's net interest margin (NIM) has been strong, benefiting from 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 (CASA) deposits. The bank's NIM was 5.3% in the first half of 2019, slightly higher than 5.0% in the same period a year ago.

We expect some moderation in HNB's NIM over the next few quarters because the central bank's mandated cut to the lending rate will add pressure to the margin. In addition, NIM will likely narrow from the interest moratorium on tourism-related loans. Because of the interest moratorium, we expect HNB to record lower interest income on the affected loans in the next few quarters.

We assign a b2 score for Profitability to reflect the weakening profitability, which is depressed by elevated credit costs and margin pressure.

A tight funding position, although balanced by healthy liquidity

We assign a b1 score to HNB's Funding Structure to reflect its modest reliance on market funds and the weakness in the bank's overall funding structure. The bank's market funds accounted for 10% of tangible assets as of the end of June 2019 (2018: 11%).

The bank operated with a high loan-to-deposit ratio (LDR) of 95% as of the end of June 2019, marginally lower than 96% as of year-end 2018. We expect its LDR to ease because of muted loan growth.

The high LDR is somewhat balanced by HNB's high share of CASA deposits, which stood at 34% of customer deposits as of the end of June 2019.

The bank had a healthy all-currency liquidity coverage ratio of 119% (bank level) as of the end of June 2019.

Liquid assets made up around 29% of tangible assets as of the end of June 2019, mainly in the form of government securities. We assign a b1 score for Liquidity because some liquid assets are typically pledged under repo deals, slightly reducing its unencumbered liquid assets/tangible assets to around 24%, compared with 26% as of year-end 2018.

HNB's BCA reflects 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 the fact 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 downside risks to asset quality from the historically rapid credit growth in Sri Lanka. Loans grew at a compound annual growth rate of 18% between December 2015 and December 2018.

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 87% as of the end of June 2019.

Environment, social and governance considerations

HNB and the other Sri Lankan banks are vulnerable to climate change risks arising from weather-related disruptions to the economy, given their lending exposure and the economy's reliance on the agriculture and fishing sectors. We incorporate this consideration in our assessment of the bank's asset quality. See our Environmental risks heat map for further information.

The most relevant social risks for banks arise from the way they interact with their customers. Social risks are particularly high in the area of data security and customer privacy, which is partly mitigated by sizable technology investments and banks' long track record of handling sensitive client data. Fines and reputational damage because of product mis-selling or other types of misconduct is a further social risk. Social trends are also relevant in a number of areas, such as shifting customer preferences toward digital banking services, increasing information technology cost, aging population concerns in several countries impacting demand for financial services or socially driven policy agendas that may translate into regulations that affect banks' revenue base. Overall, we consider banks to face moderate social risks. See our social risks heat map for further information.

Governance is highly relevant for HNB, as it is to all entities in the banking industry, and governance risks are largely internal rather than externally driven. We do not have any particular governance concern for HNB, and do not apply any corporate behavior adjustment to the bank. We view the bank's risk management framework as consistent and commensurate with its risk appetite. Corporate governance remains a key credit consideration and requires ongoing monitoring. See this report for more details on how we assess governance risk.

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 sizable market share of around 9% of system deposits as of the end of June 2019. However, this support assumption does not result in any rating uplift for HNB because its BCA is already at the same level as the B2 sovereign rating.

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

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	3.8%	ba3	↓↓	caa1	Quality of assets	Single name concentration
Capital						
Tangible Common Equity / Risk Weighted Assets (Basel III - transitional phase-in)	13.2%	ba3	↓	b1	Capital fungibility	Expected trend
Profitability						
Net Income / Tangible Assets	0.9%	b1	↓	b2	Return on assets	Expected trend
Combined Solvency Score		ba3		b2		
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				b2		
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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Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

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