ICRA Lanka reaffirms the ratings of Regional Development Bank

October 31, 2019

Summary of rated instruments

Instrument	Rated Amount (LKR Mn)	Rating Action
Issuer rating	N/A	[SL]A (Negative); Reaffirmed
Listed Subordinated Unsecured Redeemable Debenture programme	2,500	[SL]A- (Negative); Reaffirmed
Subordinated Unsecured Redeemable Debenture programme	2,000	[SL]A- (Negative); Reaffirmed

Rating action

ICRA Lanka Limited, subsidiary of ICRA Limited, a group company of Moody's Investors Service, has reaffirmed the issuer rating of Regional Development Bank (RDB or the Bank) at [SL]A (Pronounced S L A) with Negative outlook. ICRA Lanka has also reaffirmed the issue ratings of [SL]A- (Pronounced S L A minus) with Negative outlook on the LKR 2.5 Bn listed subordinated unsecured redeemable debenture programme and the LKR 2.0 Bn subordinated unsecured redeemable debenture programme of the Bank.

Rationale

The ratings reaffirmation takes note of the Government of Sri Lanka (GoSL) ownership (about 91%) of the Bank and, a high likelihood of capital, managerial and operational support from GoSL. The ratings also factor in the strong and established franchise of the Bank with its 268 branches spread across the country which resulted in a high share of lower cost, savings deposit base (39% of the total deposits as of Jun-19). ICRA Lanka further takes note of the Bank's adequate capitalisation profile with Tier I capital adequacy ratio (CAR) at 10.93% as of Jun-19 vis a vis the regulatory threshold of 8.50%. However, the Bank's reported Total CAR was at 12.51% as of Jun-19 compared to the regulatory threshold of 12.50%. The Bank's Total CAR is expected to improve as it raised Tier II complied debt (about USD 15 Mn) in October 2019. This is estimated to improve the Total CAR to about 15%. Further, the Bank's plan to raise Tier II debt (about USD 50 Mn) in the near term is expected to support the Total CAR going forward. ICRA Lanka estimates that RDB would require about LKR 1.0 Bn in Tier I capital and LKR 0.5-1.0 Bn in Tier II capital to maintain adequate CAR (with 2% buffer to Tier I CAR and 1% buffer to Total CAR) and support the envisaged advances growth (10-15%) in CY2020.

The Negative outlook factors in RDB's continued weakness in asset quality, which impacted its earnings profile. The gross NPA ratio (GNPA%) deteriorated significantly during H1CY2019 to 9.15% as of Jun-19 (excluding GNPA of former Lankaputhra Development Bank) vis a vis 5.36% as of Dec-18 (6.77% as of Jun-18) largely because of the unfavourable macro environment. RDB's exposures are largely to agriculture-based customer segments with modest credit history and who are highly susceptible to adverse economic and climatic cycles; given these loans are largely unsecured (not backed with fixed collateral security). ICRA Lanka notes that RDB's profitability indicators contracted (RoA at 0.1%in H1CY2019 vis a vis 0.6% in CY2018 and 0.5% in H1CY2018) largely on account of asset quality related pressures. ICRA Lanka also takes note of the Bank's concentrated deposit profile with top five institutional depositors accounting for about 21% of total deposits as of Jun-19. However, the same has decreased from about 50% as of Mar-18.

Outlook: Negative

The Negative outlook reflects the continued weakness in RDB's asset quality and the earnings profile. The outlook may be revised to 'Stable' in case of a steady improvement in the asset quality indicators, while maintaining a comfortable earnings profile. The ratings may be downgraded in case of a further weakening in capitalization and asset quality profiles, and the overall financial risk profile.

Key rating drivers

Credit strengths

Majority GoSL ownership and strategic importance for rural development; RDB is a state owned Licensed Specialised Bank; with GoSL holding about 91% and Bank of Ceylon (rated [SL]AAA (Negative)), People's Bank and National Savings Bank (rated [SL]AAA (Stable)) holding about 3% each as of Jun-19. In Dec-17, GoSL infused about LKR 2.5 Bn to RDB by issuing treasury bonds to the Bank, increasing the Government's holding to about 87% as of Mar-18 from about 64% as of Mar-17. The government's stake in RDB further increased in Dec-18 to about 91% post the acquisition/merger programme of state owned Lankaputhra Development Bank (LDB) by RDB. RDB issued its shares to the Treasury as LDB's purchase consideration. RDB is involved in extending banking services and facilities to rural communities having limited or no access to formal credit services, making it a key credit delivery channel for these borrower segments.

Established franchise; RDB has a strong geographic presence in rural Sri Lanka, with a network of 268 island wide branches, serving over 6 million customers (People's Bank: 740, BOC: 627, National Savings Bank: 253). The Bank has strong presences in Western, North-Western, Southern and Sabaragamuwa provinces, which accounted for 18%, 18%, 18% and 13% respectively of its total advances as of Jun-19. The established franchise helped the Bank to secure low-cost deposits, with saving accounts at 39% of the total deposits (34% of the total debt[1]) as of Jun-19.

Adequate capital structure; RDB's Tier I capital adequacy ratio of 10.93% as of Jun-19 (7.92% as of Jun-18 and 10.96% as of Dec-18) was adequately above the regulatory threshold of 8.50%. The Tier I capital improved by about LKR 4.2 Bn in Dec-18, post the acquisition of LDB, by issuance of shares to government for the purchase consideration. However, the Total CAR of 12.51% as of Jun-19 was marginally above the regulatory threshold of 12.50% largely because of the delay in raising proposed Tier II capital (about USD 70 Mn). In October 2019, RDB has received about USD 15 Mn as part of the first tranche of Tier II complied debt from ADB which is estimated to improve the Total CAR to about 15%. ICRA Lanka estimates that RDB may need about LKR 1 Bn in Tier I capital and LKR 0.5-1.0 Bn in Tier II capital to maintain adequate capitalisation (with 2% buffer to Tier I CAR and 1% buffer to Total CAR) and support its growth over the next year (10-15% in CY2020). It is crucial for RDB to raise capital on a timely basis to maintain adequate capitalisation and support the portfolio growth going forward. ICRA Lanka also expects timely capital support from the GoSL, if required.

[1] Deposits and other borrowings

Credit challenges

Weak asset quality indicators; The Bank reported an increase in Gross NPA ratio to 10.25% as of Jun-19 vis a vis 6.77% as of Jun-18 (5.36% as of Dec-18). RDB's GNPA% excluding LDB portfolio was 9.15% as of Jun-19. The GNPA% of the LDB's portfolio was high at around 54% as of Jun-19. Around 90% of LDB's portfolio is asset-backed which is expected to provide comfort in recovery. The gross NPA ratio of development loans (loans to microfinance and SMEs) increased to 12.11% as of Jun-19 from 9.52% as of Jun-18 (7.39% as of Dec-18), while in the non-development loans (housing loans and other consumption loans) GNPA% increased to 5.60% as of Jun-19 from 3.83% as of Jun-18 (3.02% as of Dec-18). Unfavourable economic and macro environment directly impacted loan repayment ability of RDB's vulnerable customer segment. The Bank's lending portfolio includes microfinance and micro-credit exposures to agriculture and related sectors, which is largely unsecured and is susceptible to adverse weather conditions. About 80% of the total advances were with ticket size of less than LKR 1 Mn and, are secured only by personal guarantees. ICRA Lanka expects the Bank's asset quality to remain vulnerable to adverse economic and climatic changes, considering the modest credit profile of the target customer segment. Therefore, maintaining a prudent lending process and undertaking efficient collection and recovery is crucial for keeping the asset quality under control.

Concentrated fixed deposit profile; The fixed deposit (FD) base (about 53% of the total debt) of the Bank is concentrated with large exposures to top five institutional depositors accounting for about 21% of the FD base as of Jun-19. However, the same has decreased from a high of about 50% as of Mar-18. During Mar-18 to Jun-19, the Bank's largest deposit holder has withdrawn close to LKR 26 Bn, resulting in some pressure on the Bank's liquidity during the period. However, the moderate portfolio growth during the period has provided some comfort. While the Bank's ongoing fund-raising programme from ADB in the near term is expected to diversify the funding profile to some extent, ICRA Lanka notes that the same would have to be diversified further for maintaining a comfortable liquidity profile as business expands.

Negative, albeit improving ALM profile; RDB's asset liability management (ALM) profile is characterized by negative cumulative mismatch of 3% for cumulative 12-month time period (as a proportion of total assets) as of Jun-19. The same has improved from about 9% as of Dec-18 largely on account of increase in placement with banks and other short-term investments, because of the moderation in disbursements during the period. As of Jun-19, RDB has contingent bank funding lines of LKR 2.5 Bn from banks, which are unutilized. ICRA Lanka expects timely liquidity support from the shareholders, if required. RDB's liquid asset ratio (LAR) stood at about 28% as of Jun-19 comfortably above the threshold of 20%. The liquidity coverage ratio (LCR) was at about 145% as of Jun-19, above the regulatory threshold of 100% effective since Jan-19.

Scope for improvement in internal controls; ICRA Lanka notes that given RDB's limited internal controls and monitoring systems, there is scope to improve the same to make it commensurate with the current business risk profile. RDB's portfolio was at LKR 137.4 Bn as of Jun-19 with exposure to development loans (loans to microfinance and SMEs) at 54% and non-development loans (housing loans and other consumption loans) at 44%. The remaining balance of about 2% comprised of LDB portfolio. The Bank expects to increase the lending for microfinance and SMEs (development loans) to about 70% going forward, which demand comprehensive credit evaluation practices. Further, considering the recent escalation in NPAs, the Bank needs to strengthen its collection and recovery functions to maintain healthy asset quality indicators.

Contraction in profitability indicators; The Bank's RoA moderated to 0.1% (annualised) in H1CY2019 vis a vis 0.5% in H1CY2018 (0.6% in CY2018). The moderation in profitability was largely on account of increase in credit provisioning costs. RDB's provisioning costs (as a percentage of total assets) increased to 1.4% in H1CY2019 vis a vis 0.7% in H1CY2018 (0.8% in CY2018) because of the increased slippages in the portfolio. The Bank's net interest margin (NIM) was at 6.6% in H1CY2019 and H1CY2018 (6.9% in CY2018). Operating costs (as a proportion of average assets) decreased over the period to 5.0% in H1CY2019 from 5.2% in H1CY2018 (5.4% in CY2018). However, the operating cost is expected to increase going forward with the increase in staff related costs because of absorption of LDB's staff (about 100) and new recruitments (about 300). It is crucial for RDB to keep credit costs and operational costs under control so as to generate adequate profitability going forward.

Analytical approach: For arriving at the ratings, ICRA Lanka has applied its rating methodologies as indicated below.
Links to applicable criteria: **ICRA Lanka's Credit Rating Methodology for Banks**

About the Bank:

Regional Development Bank (RDB) was established in May 2010 by merging six provincial banks, to form a national level rural development bank. RDB was established under the Pradeshiya Sanwardhana Bank Act No.41 of 2008, as a fully state-owned national level Bank with the long-term objective of improving the living standards of the rural masses by providing them accessible and affordable financial services. The Bank is 91% owned by the GoSL and the balance 9% is equally owned by the three state owned banks, namely, Bank of Ceylon, People's Bank and National Savings Bank.

In CY2018, RDB reported a profit after tax (PAT) of LKR 1,074 Mn (LKR 1,284 Mn in CY2017) on a total asset base of LKR 177 Bn (LKR 169 Bn as of Dec-17). For the six months ended Jun-19, the Bank reported a PAT of LKR 79 Mn (un-audited) on a total asset base of LKR 188 Bn.

Key financial indicators (audited)

LKR Mn	CY2017	CY2018	6MCY2018 (Unaudited)	6MCY2019 (Unaudited)
Net Interest Income	9,675	11,906	5,607	5,985
Profit after Tax	1,284	1,074	459	79
Net worth	9,613	14,710	10,072	14,806
Loans and Advances	127,509	133,433	133,072	132,241
Total Assets	169,259	176,937	171,344	187,882
Return on Equity	16.45%	8.83%	9.33%	1.07%
Return on Assets	0.86%	0.62%	0.54%	0.09%
Gross NPA	3.27%	5.36%	6.77%	10.25%
Capital Adequacy Ratio	12.57%	13.00%	10.63%	12.51%
Gearing (times)	16.2	10.7	15.3	11.2

Rating history for last three years:

Instrument	Current Rating (CY2019)			Chronology of Rating History for the past 3 years			
	Type	Amount Rated (LKR Mn)	Amount Outstanding (LKR Mn)	Date & Rating in CY2019	Date & Rating in CY2018	Date & Rating in CY2017	Date & Rating in CY2016
				Oct-19	Aug-18	Feb-18	Aug-16
Issuer rating	N/A	N/A	N/A	[SL]A (Negative)	[SL]A (Negative)	[SL]A (Stable)	[SL]A (Stable)
Issue rating	Listed Subordinated Unsecured Redeemable Debenture programme	2,500	2,500	[SL]A- (Negative)	[SL]A- (Negative)	[SL]A- (Stable)	[SL]A- (Stable)
Issue rating	Subordinated Unsecured Redeemable Debenture programme	2,000	2,000	[SL]A- (Negative)	[SL]A- (Negative)	[SL]A- (Stable)	[SL]A- (Stable)

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