

ICRA Lanka revises outlook on the issuer rating of Bank of Ceylon to Negative

October 18, 2019

Instrument	Rated Amount (LKR Mn)	Rating Action
Issuer rating	N/A	Issuer rating of [SL]AAA Reaffirmed; Outlook revised to Negative from Stable

Rating action

ICRA Lanka Limited, subsidiary of ICRA Limited, a group company of Moody's Investors Service, has reaffirmed the issuer rating of Bank of Ceylon (BOC or the Bank) at [SL]AAA (pronounced SL triple A). The outlook on the rating is revised to Negative from Stable.

Rationale

The revision in outlook factors in BOC's moderate capitalisation levels with steady decline in capital buffers and weakening asset quality which impacted its earnings profile. The Bank reported a Core Capital Ratio of 10.73% and Total Capital Adequacy Ratio of 15.48% in Jun-19 as compared to the regulatory requirement of 10.00%¹ and 14.00%, respectively. However, ICRA Lanka noted the gradual decline in the Bank's capital buffers due to moderation in internal generation mainly because of weak asset quality. With less than 1% buffer over the regulatory capital requirements, the ability of the Bank to absorb any further asset quality shocks remains low. ICRA Lanka however expects timely and adequate equity infusion by the Government of Sri Lanka (GoSL) to maintain the capitalization profile. The rating continues to factor in the 100% Government of Sri Lanka ownership, which provides a strong likelihood of sovereign support and BOC's leading position in the Sri Lankan banking industry.

The Bank's asset quality deteriorated with gross NPA ratio increasing to 5.34% in H1CY2019 as of Jun-19 vis-à-vis 3.62% as of Dec-18 due to weak macroeconomic conditions in the given period. The rating factors in its established franchise, healthy deposit profile and comfortable liquidity position with liquidity coverage ratio (LCR) at 199.76% as in Jun-19. The rating also noted the moderation in earnings profile with return on assets (RoA²) at 0.92% in CY2018 (0.62% in 6MCY2019) as compared to 1.18% in CY2017. The above, however exert further pressure on the overall credit profile of the Bank and steady improvement of these indicators would be crucial from a rating perspective.

Outlook: Negative

The Negative outlook reflects the shortfall in BOC's capital buffers over the regulatory requirement coupled with weakening of the asset quality and profitability indicators. ICRA Lanka believes that BOC will continue to benefit from timely and adequate capital support from GoSL. The outlook may be revised to 'Stable' in case of a steady maintenance of the capital buffers above regulatory capital requirement, improvement in the asset quality profile, while maintaining a comfortable earnings profile.

¹ Including capital conservation buffer and capital surcharge on Domestic Systemically Important Bank

² RoA based on Profit after tax

Key rating drivers

Credit strengths

100% government owned, systemically important bank with long term track record and established franchise; BOC is a licensed commercial bank, 100% owned by the GoSL. The Bank is the largest commercial bank in Sri Lanka with systemic importance, which provides strong likelihood of sovereign support. BOC accounts for about 21% of the aggregate advances and about 24% of the aggregate deposits of all licensed commercial banks (LCBs) in Sri Lanka as on June 30, 2019. The Bank operates with 579 branches covering all the regions in Sri Lanka; however, the Western province accounted for around 70% of the total loans of the Bank as of Jun-19. BOC's total net advances grew by 23% YoY in CY2018 (16% in CY2017) which was higher than the 20% growth reported by the LCB industry during the same period. The high growth was mainly supported by lending to government entities related to infrastructure development projects. During 6MCY2019, net advances grew by 18% YoY, driven by growth in lending to the Government and State-Owned Enterprises (SOEs). The rating factors the Bank's position as one of the key lenders to the GoSL and SOEs, which accounted for about 31% of the total portfolio as in Jun-19 (~34% in December 2018 and ~30% in June 2018); the Bank expects to maintain the exposure at the present level.

Healthy deposit profile with CASA ratio above the systemic level; BOC reported a healthy deposit profile with total deposit growth of 13% YoY, which was above the industry average growth of 10% YoY as in June 2019. The Bank has a comfortable mix of both foreign and local deposits, aided by the Bank's well-established branch network and dominant position in the remittance business. However, the Bank's CASA³ ratio moderated to 34% as in Dec-18 from 37% as in Dec-17, although it remained above the systemic levels of 32% and 34% in the same period. During 6MCY2019, the Bank reported a CASA ratio of 33% as compared to the system average of 31%.

Comfortable liquidity position; The Bank's liquidity profile remained comfortable as a result of lower credit growth and higher deposit growth which mainly resulted in positive cumulative short term (less than 12 months) maturity mismatch (1.71% in Jun-19). The Liquidity Coverage Ratio (All Currencies) was comfortably maintained at 132% (regulatory requirement 100%) and Liquid Asset Ratio (Domestic Currency) stood at 27% (regulatory requirement 20%) in Jun-19.

Credit challenges

Weakening asset quality; BOC reported a gross NPA of 5.34% as of Jun-19 as compared to system average of 4.78% in the same period. The Bank's Gross NPA ratio witnessed a sharp increase in Jun-19 as compared to the Gross NPA of 3.62% as in Dec-18 and 4.50% as in Jun-18. The Gross NPA increased as a result of rise in fresh slippages to 7.68% in the quarter ended Jun-19 as compared to 4.79% reported in the quarter ended Jun-18. BOC's asset quality deteriorated since 2018 mainly as a result of poor performance in construction and agriculture sectors which affected the corporate and SME portfolios of the Bank. The Bank has taken measures to recover the NPAs by expediting legal actions and restructuring the facilities. The Net NPA ratio of the Bank was 1.92% as compared to system average of 3.00% as of Jun-19. Net NPA ratio of the Bank was lower than the system as a result of its high provision coverage ratio of 64.09% as compared to the system average of 48.51% as in Jun-19. ICRA Lanka noted that the provision coverage ratio has gradually decreased from 76.00% as in Dec-18 and 87.94% in Dec-17. A deterioration in the

³ Current Account Savings Account Ratio

Bank's asset quality has increased its solvency ratio (Net NPA/ Networth) to 22.07% as in Jun-19, as compared to 10.62% in Dec-18 (18.57% in Jun-18). However, the Bank's solvency ratio was better as compared to Licensed Commercial Banking sector average of 31.38% as in Jun-19.

Moderate capitalization levels; The common equity tier I including capital conservation buffer ratio of BOC was 10.73% (regulatory requirement 10.00%) and capital adequacy ratio (CAR) was 15.48% (regulatory requirement 14.00%) as in Jun-19. ICRA Lanka noted that the Bank continues to have only a minimal buffer of less than 1% over the Tier I regulatory requirement of 10.0%. A significant first day net adjustment of LKR 7.4 Bn was made to BOC's capital because of SLFRS-9 transition, impact of which would be spread over four years starting 2018 for capital adequacy computation, as per the CBSL directions. The Bank, in view of the above and moderation in its internal generation is expected to cap its dividend payments to conserve capital for meeting the enhanced capital requirement from 2019. ICRA Lanka estimates that BOC would require significant additional capital of LKR 15-18 Bn to maintain tier-I capital with a 1% capital buffer over the regulatory requirement over the next two years, assuming a 7.5%-10.0% growth in Risk Weighted Assets (RWA). The Bank would also have to raise commensurate Tier-II capital for meeting the overall CAR requirement. BOC received LKR 20 Bn as equity capital from GoSL during 2014 to 2018 and, ICRA Lanka expects timely capital support from GoSL in future due to the systemic importance of the Bank. Going forward, maintenance of adequate buffers (at least 1%) over and above the minimum capitalisation requirements (Tier-I and overall CAR) would be critical from a rating perspective.

Declining profitability indicators; The Bank's yield on advances moderated to 11.23% in CY2018 as compared to 11.55% in CY2017 due to its volume driven expansion strategy and increased lending to GoSL & SOEs, which are relatively low yielding. The cost of interest-bearing funds reduced to 6.60% in CY2018 as compared to 6.74% in CY2017 mainly due to Bank's high CASA ratio of 34.14% as compared to system average of 31.97% as in Dec-18. As a result, the Bank's margins moderated to 3.11% in CY2018 as compared to 3.22% in CY2017. Further, the cost to income ratio ⁴of the Bank was 49.29% in H1CY2019 as compared to 47.27% in CY2018 (47.38% in H1CY2018). The Bank's operating expenses to total assets ratio remained range bounded to 1.9-2.0% since 2017. The Credit Cost increased to 0.92% in H1CY2019 as compared to 0.71% in CY2018 (0.72% in H1CY2018) as a result of sharp increase in slippages during the same period. BOC's, RoA moderated to 0.62% in H1CY2019 and 0.92% in CY2018 as compared to 0.78% in H1CY2018. ICRA Lanka noted that the Bank's ROA remained lower than the system average of 0.88% in H1CY2019 and 1.14% in CY2018. A moderation in the margins, rise in credit cost and new regulatory levies imposed by the government resulted in a decline in the Bank's RoA. Further weakening of the asset quality would exert pressure on profitability of the Bank. ICRA Lanka notes that significant improvement in the interest margins and control on credit cost would be crucial to maintain a healthy earnings profile over the medium term.

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

About the entity:

BOC is the largest licensed commercial bank in Sri Lanka; 100% owned by the Government of Sri Lanka. The Bank with assets of over LKR 2.23 trillion accounts for approximately 21% of the total banking sector assets as of Jun-19. BOC was incorporated in August 1939 under the Bank of Ceylon Ordinance No. 53 of

⁴ Operating expenses include VAT, NBT and Debt Servicing Levy

1938. Currently, BOC operates with over 579 branches including 3 overseas branches in Maldives, Chennai and Seychelles. The Bank also operates a subsidiary in the UK – Bank of Ceylon (UK) Limited. The BOC group has 10 subsidiaries and 4 associate companies that are involved in NBFI operations, property development and leisure.

During the CY2018, BOC reported profit after tax (PAT) of LKR 19,479 Mn on a total asset base of LKR 2,268 Bn as compared to a PAT of LKR 21,312 Mn on a total asset base of LKR 1,952 Bn in the previous financial year. For 6MCY2019, BOC reported a PAT of LKR 6,948 Mn on a total asset base LKR 2,233 Bn.

Key financial indicators

LKR Mn	CY2017	CY2018	6MCY2018	6MCY2019
Net Interest Income	58,356	65,558	29,484	38,455
Profit after Tax	21,312	19,479	6,637	6,948
Net worth (adjusted for revaluation reserves)	99,189	109,744	108,388	116,008
Loans and Advances	1,163,161	1,429,107	1,208,724	1,409,513
Total Assets	1,951,804	2,268,154	1,986,674	2,233,346
Return on Equity	20.89%	16.75%	13.47%	11.16%
Return on Assets (based on PAT)	1.18%	0.92%	0.78%	0.62%
Gross NPA	2.85%	3.62%	4.50%	5.34%
Net NPA	0.34%	0.87%	1.73%	1.92%
Capital Adequacy Ratio (BASEL III)	14.59%	14.58%	13.66%	15.48%
Gearing (times)	16.32	17.44	15.86	16.27

Rating history for last three years:

Chronology of Rating History for the past 3 years						
Instrument	Type	Amount Rated (LKR Mn)	Date & Rating CY2019 Oct-19	Date & Rating CY2018 Dec-18	Date & Rating in CY2017 Oct-17	Date & Rating in CY2016 Sep-16
Issuer rating	N/A	N/A	[SL]AAA (Negative)	[SL]AAA (Stable)	[SL]AAA (Stable)	[SL]AAA (Stable)

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