

## ICRA Lanka revises the ratings of Regional Development Bank

September 29, 2020

### Summary of Rated Instruments

Instrument	Rated Amount (LKR Mn)	Outstanding Amount (LKR Mn)	Rating Action
Issuer rating	N/A	N/A	Revised to [SL]A- (Negative) from [SL]A (Negative)
Subordinated Unsecured Redeemable Debenture programme	2,000	2,000	Revised to [SL]BBB+ (Negative) from [SL]A- (Negative)
Subordinated Unsecured Redeemable Debenture programme	2,500	-	[SL]A- with Negative outlook; Withdrawn

### Rating action

ICRA Lanka Limited has revised the issuer rating of Regional Development Bank (RDB or the Bank) to [SL]A- (Pronounced S L A minus) with Negative outlook from [SL]A (Pronounced S L A) with Negative outlook. ICRA Lanka has also revised the issue rating to [SL]BBB+ (Pronounced S L triple B plus) with Negative outlook from [SL]A- (Pronounced S L A minus) with Negative outlook for the LKR 2.0 Bn subordinated unsecured redeemable debenture programme of the Bank. ICRA Lanka has also withdrawn the issue rating of [SL]A- (Pronounced S L A minus) with Negative outlook on the LKR 2.5 Bn subordinated unsecured redeemable debenture programme of the Bank, as the said debenture is fully redeemed.

### Rationale

The rating revision factors the sharp deterioration of asset quality indicators of the Bank, where gross NPA ratio increased to 9.6% in December 2019, from about 5.4% in December 2018, and the same has increased further in March 2020 to about 12% and to about 11.5% in June 2020. However, ICRA Lanka notes that the Easter events in April 2019 and the challenging macro conditions that ensued has largely contributed to the asset quality deterioration, as the Bank is primarily serving relatively weaker segments of the economy. Further, the COVID-19 pandemic outbreak and the lockdown have further impacted the asset quality in Q2 CY2020. The rating also factors the moderation of overall profitability of the Bank, largely due to higher credits cost and lower loan growth during the period. PAT for CY2019 has come down sharply to about LKR 500Mn from LKR 1,074Mn in CY2018; the Bank reported a marginal PAT of LKR 44Mn for Q1 CY2020.

However, the ratings continue to factor the Government of Sri Lanka's (GoSL) ownership (about 91%) of the Bank and the continued capital, managerial, and operational support. The ratings also factor in the strong and established franchise of the Bank with its 276 branches spread across the island, and its good deposit franchise. ICRA Lanka further takes note of the Bank's adequate capitalization profile with Tier I capital adequacy ratio (CAR) at about 10.5% compared to the regulatory minimum of 8.5%.

### 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, People's Bank, and National Savings Bank holding about 3% each. The GoSL has demonstrated a good track record of providing both capital and managerial support for the Bank. In December 2017, the GoSL infused about LKR 2.5 Bn to RDB by issuing treasury bonds to RDB. Again in December 2018, the GoSL helped the Bank further improve its capital base by facilitating the acquisition of Lankaputhra Development Bank (LDB); the acquisition added about LKR 4.2Bn to the capital base of RDB, while adding about LKR 6 Bn in liquid investments. Also, the GoSL has offered a sovereign guarantee for the recent USD 25 Mn development loan from the ADB. ICRA Lanka expects the state support for the RDB to continue going forward also, due to the strategic importance of the Bank.

**Established franchise:** RDB has a strong geographic presence in rural Sri Lanka, with a network of 276 islandwide branches, serving over 6 million customers (National Savings Bank: 253, People's Bank: 740, BOC: 627 branches). As in March 2020, the Bank had a gross portfolio of about LKR 143 Bn spread across multiple regions of the island. Colombo centric western province contributed to about 18% of the total portfolio, while the balance was coming from more rural regions such as Northwestern, Southern, and Sabaragamuwa Provinces. Island-wide presence enables the Bank to maintain a good deposit base with close to 40% of total deposits being low-cost savings accounts. Also, RDB is a beneficiary of several refinancing schemes aimed at promoting rural economic development.

**Adequate capital structure supported by regular capital support from GoSL:** As in March 2020, the core capital base of RDB stood at about LKR 14 Bn, compared to the regulatory minimum of LKR 7.5 Bn for licensed specialized banks. Bank's capital base has improved over the last 3 years due to successive capital enhancement initiatives backed by the GoSL. As in March 2020, risk-weighted core capital adequacy ratio of RDB stood at about 10.5% compared to the regulatory minimum of 8.5%. While the Total capital adequacy ratio stood at about 15.7% (regulatory minimum - 12.5%), following the USD 25 Mn Tier II long term loan from ADB. As in March 2020, gearing increased to about 11.8 times, compared to 11.5 times as in December 2019 and 10.7 times in December 2018. Going forward also, ICRA Lanka expects the Bank to maintain an adequate capitalization profile, backed by the continued support from the GoSL.

### Credit challenges

**Sharp deterioration of asset quality indicators:** Asset quality indicators of RDB have gradually deteriorated since CY2017, and the same has deteriorated sharply since the Easter events in April 2019 and the recent pandemic outbreak. Gross NPA ratio increased to 9.6% in December 2019, from about 5.4% in December 2018, largely due to the impact of Easter events in April 2019. The same has increased further in March 2020 to about 12% and to about 11.5% in June 2020, with the pandemic induced lockdown that was enforced on March 15, 2020. ICRA Lanka notes that RDB's portfolio is vulnerable to macro challenges and climate cycles, as the Bank is primarily catering to vulnerable segments such as Micro-SMEs, Agri farmers, and self-employed. RDB's gross NPA, excluding the LDB portfolio, stood at about 11% as in March 2020, vis-à-vis 8.5% in December 2019 and 5.4% in December 2018. As in March 2020, the NPA provision coverage

of RDB stood at about 48%, compared to the industry average of about 35%. The Bank's ability to control incremental slippages and improve overall asset quality will be a key monitorable, going forward.

**Scope for improvement in internal controls and systems:** ICRA Lanka notes that given RDB's exposure to relatively weaker economic segments and due to its island-wide presence (including the rural regions), there is scope to improve its internal controls and systems. Further, RDB carries a very granular portfolio (LKR 143 Bn as in March 2020), where over 80% of all the facilities are less than LKR 1Mn in ticket size. ICRA Lanka notes that lack of resources (both human and systems) at operational levels have contributed to the weakening of asset quality over the last 2 – 3 years. Going forward, it will be crucial for the Bank to improve its internal controls and systems, given the higher risk profile of its portfolio.

**Contraction of profitability indicators:** PAT for CY2019 has come down sharply to about LKR 500 Mn from LKR 1,074 Mn in CY2018; the Bank reported a marginal PAT of LKR 44 Mn for the 3M ended March 2020. The sharp decline in profitability is largely attributable to higher credit cost during the period, where provisioning cost was 1.3% in CY2019 and 1.4% in Q1CY2020, vis-à-vis 0.8% in CY2018, due to the deterioration of overall asset quality during the period. In addition, NIM moderation due to lower credit growth has also contributed to the overall contraction in profitability. NIM for CY2019 was 6.6%, and 5.6% in 3M ended March 2020, compared to 6.7% in CY2018. Cost to income ratio of RDB showed a marginal improvement in Q1 CY2020, to about 69%, compared to about 73% in CY2019 and CY2018.

**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 CY2019, RDB reported a profit after tax (PAT) of LKR 500 Mn (LKR 1,074 Mn in CY2018) on a total asset base of LKR 200 Bn (LKR 177 Bn as of Dec-18). For the three months ended March 2020, the Bank reported a PAT of LKR 44 Mn (un-audited) on a total asset base of LKR 202 Bn.

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