

ICRA Lanka assigns [SL]AA(hyb) for the proposed Basel III Compliant Additional Tier I Capital Bond Programme of People's Bank

March 22, 2021

Instrument*	Rated Amount (LKR Mn)	Rating Action
Issuer rating	N/A	[SL]AAA (Stable); Assigned
Basel III Compliant Additional Tier I Capital Bond Programme	6,000	[SL]AA (hyb) (Stable); Assigned

Rating action

ICRA Lanka Limited has assigned the issuer rating of [SL]AAA (pronounced as S L triple A) with Stable outlook for People's Bank (PB or the Bank).

ICRA Lanka has also assigned the rating of [SL]AA(hyb) (pronounced as S L double A hybrid) with Stable outlook for the proposed LKR 5,000 Mn (with option to increase up to LKR 6,000 Mn) Basel III Compliant, Unlisted, Rated, Unsecured, Subordinated, Perpetual, Additional Tier I (AT1) Capital Bond Programme of People's Bank. The letters 'hyb' in parenthesis suffixed to a rating symbol stand for 'hybrid', indicating that the rated instrument is a hybrid subordinated instrument with equity-like loss-absorption features, which may translate into higher levels of rating transition and loss severity vis-à-vis conventional debt instruments.

Rationale

The rated Basel III compliant Tier I bond programme (Additional Tier I or AT-I bonds) has the following loss-absorption features that make them riskier:

- Coupon payments are non-cumulative and discretionary, and the Bank has the full discretion at all times to cancel coupon payments. Cancellation of discretionary payments shall not be an event of default.
- Coupon can be paid out of current year profits. However, if the current year's profit is not sufficient, or, if the payment of coupon is likely to result in a loss, the coupon payment can be done through reserves and surpluses created through appropriation of profits¹. However, the coupon payment is subject to the Bank meeting the minimum regulatory requirements for CET I, Tier I and total capital ratios (including capital conservation buffer, CCB) at all times as prescribed by the Central Bank of Sri Lanka under the Basel III regulations.

These Tier I bonds are expected to absorb losses through the write-down mechanism at the objective pre-specified trigger point. The trigger point event is the earlier of;

¹ As per CBSL, any dividend or coupon to be paid under the capital instrument is only paid to the extent that the Bank has retained profits for distributions

- A decision that a write-down, without which the Bank would become non-viable, is necessary, as determined by the Monetary Board; and
- The decision to make a public sector injection of capital, or equivalent support, without which the Bank would have become non-viable, as determined by the Monetary Board.

Given the above distinguishing features of the Tier I bonds, ICRA Lanka has assigned a two notch lower rating to these bonds compared to its Issuer rating. The distributable reserves², that can be used for servicing the coupon in case of inadequate profits or a loss during the year, stood at a comfortable 7.93% of the risk-weighted assets (RWAs) as in Dec-20 as compared to 8.19% as in Dec-19.

The ratings factor in the government ownership, which provides a strong likelihood of sovereign support and PB's position as the second-largest licensed commercial bank (LCB) in the country with an asset base of LKR 2.2 Tn as in December 2020. PB is one of the four systemically important LCB's in the country, with an extensive network of about 740 branches, island wide. The ratings also factor in the healthy deposit franchise of the Bank, with industry-leading CASA indicators and its relatively conservative investment profile with modest exposure to Sri Lankan dollar bonds. The ratings also take comfort from healthy asset quality indicators of the Bank with gross NPAs below the industry average and that of similar peers. However, the ratings take cognizance of the moderate capitalization profile of the Bank and moderate profitability indicators, due to lending margin compression. ICRA Lanka notes that the proposed additional Tier 1 debt program is expected to improve the capitalization profile in the short to medium term.

People Bank's ability to maintain a healthy capitalization profile, with adequate buffers over the regulatory requirements and its ability to improve overall profitability will be crucial, going forward.

Outlook: Stable

The outlook may be revised to "Negative" in case of further deterioration of capital buffers or profitability indicators.

Key rating drivers

Credit strengths

GoSL owned, systematically important bank, with the largest retail franchise in the country: People's Bank is the second-largest LCB in the country, with a total asset base of LKR 2.2 Tn as in Dec-20. Also, PB is one of the four systematically important banks, along with Bank of Ceylon (BOC), rated [SL]AAA (Negative) by ICRA Lanka, Hatton National Bank PLC, and Commercial Bank of Ceylon PLC. The ratings also consider PB's position as the leading retail bank in the country with an extensive network of about 740 branches spread across the island. The Bank's systemic importance also stems from its status as a key lender to the GoSL, with about 50% of the total portfolio as in Dec-20 representing exposures to the GoSL and State-owned Enterprises (SOEs). PB's gross advances in CY2020 grew by 24% YoY (4% YoY in CY2019) which was higher than the 13% YoY growth reported in Dec-20 by the LCB industry; the growth was mainly driven by lending to the GoSL and SOEs.

Healthy deposit franchise with industry leading CASA indicators: PB's main funding source is its public deposits which contribute close to 88% of the total borrowings as in Dec-20. The Bank represents the second

² Distributable reserves include all the distributable items created from retained profits; the Bank's distributable items include retained earnings and general reserves of the Bank

largest deposit base in the country, at about LKR 1.8Tn as in Dec-20; the deposit base remains largely retail, aided by the Bank's well-established branch network and the digital banking infrastructure. Foreign currency-denominated deposits accounted for about 10% of the total deposit base as in Dec-20. The ratings also take comfort from the industry leading CASA indicators of the Bank, with CASA ratio at about 41% as in Dec-20 (38% in Dec-19), compared to the LCB sector average of about 37% as in Dec-20 (33% in Dec-19).

Healthy asset quality indicators, better than the systemic levels and that of similar peers: Historically People's Bank has witnessed GNPA levels lower than that of the LCB sector and the Bank has the lowest GNPA ratios among similar peers. The Gross NPA ratio of the Bank as on Dec-20 was 3.25% (Dec-19- 3.31%) against the systemic average of 4.74% (Dec-19- 4.61%). The Gross NPA ratio which increased to 3.57% as on June-20 as a result of the COVID-19 outbreak and its aftermath, have marginally come down in Sep-20 to 3.38% and further to 3.25% as on Dec-20. Higher exposure to sovereign-backed lending, and exposure to relatively safer retail asset classes such as housing and gold has largely contributed to better asset quality indicators of the Bank. The ratings also take comfort from the adequate provision coverage of the Bank, at about 64% in Dec-20, vis-à-vis 60% in Dec-19 and 72% in Dec-18; Banks' provision coverage has remained higher than the LCB sector average, which stood at about 60% over the last 3 years.

Conservative investment profile with minimum exposure to GoSL International Sovereign Bonds (ISBs): As in Dec-20, about 96% of the Bank's total investments (about 99% in Dec-19) were deployed in securities backed by the GoSL. And the total investments represent about 20% of the total asset base of the Bank in CY2019 and CY2020. ICRA Lanka notes that, Sri Lankan LCBs have a sizable exposure to international bonds issued by the GoSL. However, given the larger size of the Bank, PB has the lowest exposure of about 0.8% of total assets, among Sri Lankan LCBs.

Credit challenges

Moderate capitalization levels, proposed hybrid debt program is expected to provide some comfort over the short to medium term: As in Dec-20, common equity Tier I ratio and Tier 1 capital adequacy ratio of the Bank stood at 9.53% (10.68% in CY2019 and 11.02% in CY2018), compared to the regulatory minimum of 7.0% for CET1 and 8.5% for Tier I, respectively. ICRA Lanka also notes that the increase in the Bank's net pension fund liability by LKR 15 Bn between Dec-18 to Dec-20, due to the sharp interest rate movement has largely contributed to the weakening of the Bank's capital position as in Dec-20. Despite the GoSL having demonstrated a track-record of providing capital support for the Bank (LKR 5 Bn capital infusion in CY2017), ICRA Lanka expects the Bank to manage its short-term capital requirements through internal generation and issue of hybrid debt instruments. The proposed LKR 6 Bn hybrid debt program, which is recognized as Additional Tier 1 Capital, will provide capital support in the short term.

Moderation in profitability largely due to core margin compression: ICRA Lanka notes that People's Bank's core lending margins have moderated in CY2020, largely due to the recognition of the first-day impact of the COVID-19 debt moratorium and the sharp decline in systemic interest rates. PB's NIM (Net Interest Income/ ATA) was 2.97% in CY2020, vis-à-vis 3.39% in CY2019 and 3.46% in CY2018. Muted growth in retail lending (growth in CY2020 was largely from SOEs) has also contributed to the margin compression during the year. PB's increase in credit costs (loan provisioning/ATA) in CY2020 was somewhat moderate, with 0.56% being reported, vis-à-vis 0.47% in CY2019 and 0.16% in CY2018, as the Bank has been able to better manage its asset quality, compared to its peers. Impact of lending margin compression was somewhat offset by operating cost savings, and for the 12M ended Dec-20, the Bank reported a stand-alone PAT of LKR 14.2Bn, compared to the PAT of LKR 12.9Bn during the previous fiscal.

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 Bank:

People's Bank is the second-largest licensed commercial bank in Sri Lanka, owned by the government of Sri Lanka (GoSL). The Bank with assets of over LKR 2.2 trillion accounts for approximately 15% of the total banking sector assets as of Dec-20. The Bank was incorporated in 1961. Currently, PB operates with over 740 branches, spread across the island.

During the CY2020, PB reported profit after tax (PAT) of LKR 14.2 Bn on a total asset base of LKR 2,230 Bn as compared to a PAT of LKR 12.9 Bn on a total asset base of LKR 1,873 Bn in the previous financial year.

Key financial indicators (audited)

LKR Mn	CY2018	CY2019	CY2020
Net Interest Income	55,406	61,207	60,934
Profit after Tax	17,095	12,926	14,175
Net worth	91,210	94,964	101,984
Loans and Advances	1,265,667	1,310,150	1,635,579
Total Assets	1,734,703	1,873,406	2,230,119
Return on Equity	20.27%	13.89%	14.39%
Return on Assets (based on PAT)	1.07%	0.72%	0.69%
Gross NPA	2.49%	3.31%	3.25%
Net NPA	1.36%	1.85%	1.74%
Tier 1 Capital Adequacy Ratio (BASEL III)	11.02%	10.68%	9.53%

Rating history for last three years:

Instrument	Current Rating (CY2021)		Chronology of Rating History for the past 3 years		
	Amount Rated (LKR Mn)	Date & Rating in CY2021	Date & Rating in CY2020	Date & Rating in CY2019	Date & Rating in CY2019
Issuer rating	N/A	[SL]AAA (Stable) Mar-21	N/A	N/A	N/A
Basel III Compliant Additional Tier I Capital Bond Programme	6,000	[SL]AA (hyb) (Stable)	N/A	N/A	N/A



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