Banking Sector Report – Dec 2020

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Private banks face a challenging year with profits contracting for the 3rd consecutive year

Taken as an aggregate, the private banks covered in this report saw net profits decline by 10% in 2020, higher than the contraction recorded in the previous two years. The 2 primary contributors to the decline were low interest income and high impairment costs in the face of the pandemic. Profit in 4Q20 also saw the same trend, contracting by 23% YoY, following contractions of 18% and 6% in 3Q20 and 2Q20 respectively.

Below, we take a look at the main trends impacting banking sector profits and performance during the year and the final quarter of 2020, and how these might pan out in 2021.

1. Low interest rates and Covid relief schemes weigh down on interest income

According to the CBSL data, Net Interest Margin at commercial banks dropped from 3.6% in 2019 to 3.1% the largest drop seen since 2013 when NIMs dropped from 4.3% to 3.7%. In addition, the modification (or day 1) losses on account of moratoriums and other relief measures resulted in a further reduction in interest income. For eg: SAMP which saw net profit drop by R. 3.1 Bn YoY in 2020 would have seen no change in profits this year if there was no modification loss charged (Rs. 3.1 Bn) on account of debt moratoriums.

In the latter half of the year the drop in interest income continued, but the drop in interest expenses accelerated compared to earlier in the year, stabilizing NIMs at 3.1% in 2H20. Our expectation is for the interest rates (based on the t bill and bond rates) to see an increase of at least 200-300 bps from current levels by the end of the year. As such, we expect NIMs to improve by year end, resulting in low double digit growth in NII at private banks (vs -6% in 2020). Non-interest income is likely to see a growth with export trade volumes increasing, higher credit card spending and LKR depreciation expected during the year.

2. Limited growth in NPLs but impairments jump

Overall gross NPLs at commercial banks ended only marginally higher at 4.7% relative to the 4.6% recorded as at end 2019. Most of the larger private banks, except HNB, however recorded NPL ratios higher than this average. On a more positive note, the share of loans under moratorium at most banks which was reported to be around 30%-40% during the first phase of moratoriums (ending in September 2020) reduced by December 2020 while NPLs (commercial bank sector) also reduced from 5.1% to 4.7% during 4Q20.

In terms of impairment charges, there was only a small change in the share of stage 3 loans (loan category against which the highest impairment provisioning is done). Stage 2 loans also either decreased or increased slightly at all larger banks, except at HNB and SAMP. Despite this, most banks saw significant increases in impairment costs (most by more than 50%) compared to 2019. This was as a result of additional provisioning or management overlays made on account of potential losses that models may not be currently capturing and provisions made against foreign currency government securities. The exception to this trend among the larger banks was SAMP which saw a reduction in impairment costs of 6% as a result of the base effect of higher impairments against stage 3 loans in 2019, as per management.

We expect NPLs to reach 6-7.5% this year once moratoriums expire, but impairment charges are not expected to see significant increases from 2020 given that they're already at an elevated level.

3. Low private sector credit growth led to higher investments in government securities

CBSL's policy measures led to excess liquidity reaching very high levels in 2020. However, despite high market liquidity and all-time low interest rates, private sector credit growth failed to gain momentum with demand remaining low and due to selective lending practices. Lower discretionary spending led to deposit seen considerable growth and CASA ratios improving, resulting in the loan to deposit ratios of most banks seeing a steady decline from 2Q20.

Looking at the sector-wise concentration of loans at private banks, consumption loans increased at several banks as a number of refinance/relief schemes were deployed during the year while trade related loans declined amidst import controls and a plunge in exports.

Low credit to the private sector also resulted in net credit to the government growing by 63% during the year. Investments in foreign currency government securities (International Sovereign Bonds - ISBs and Sri Lanka Development Bonds - SLDBs) by private banks increased from Rs. 460 Bn as at end 2019 to Rs. 570 Bn by the end of 2020. While almost all private banks saw their exposure increase in absolute terms, some of them, including the banks with the highest exposure (COMB, HNB) saw the ratio of foreign currency government securities as a % of total assets reducing during the year. These positions are however likely to be changed now, with the rally in Sri Lanka sovereign bonds in March 2021 (particularly in the 2021 maturity) following the news of agreement to the China swap being signed.

We expect YoY loan growth at private banks to pick up to 10-12% in 2021 (2020: 5%) on the back of high liquidity and low rates during part of the year and consumer demand expected to return on positive developments around vaccine deployment.

4. Capital levels at comfortable levels in 2020

Capital buffers at banks remain at comfortable levels alongside measures taken by the CBSL to loosen minimum capital restrictions in 2020. There was some level of capital raising in early 2020 but unfavorable market conditions particularly in the 4th quarter saw DFCC's debenture issue being undersubscribed while SEYB's announced issue was postponed. Nevertheless, ROE of the sector declined with profits coming down during the year. It should also be noted that the capital charge for foreign claims on the government was reduced in 2021 to 10% of risk weighted assets from the 20% it originally was, which might not fully reflect balance sheet risks during this year. Several banks have announced plans to raise capital via rights and debenture issues early this year.

Overall, we expect aggregate profits at private banks to increase in 2021 from a low base, propped up by expanding margins, higher loan growth and reduced taxes (based on the currently proposed lower corporate taxes) coming into effect.

Key Performance Indicators

	COMB		HNB		SAMP		NDB		NTB		DFCC		SEYB		PABC		UBC		BOC	
	FY20	4Q20	FY20	4Q20	FY20	4Q20	FY20	4Q20	FY20	4Q20	FY20	4Q20	FY20	4Q20	FY20	4Q20	FY20	4Q20	FY20	4Q20
ROE (%)	11.3	11.3	8.8	8.8	7.6	7.6	13.1	13.1	11.8	11.8	4.9	4.9	6.4	6.4	14.3	14.3	3.2	3.4	11.9	8.1
ROA (%)	1.0	1.0	0.9	0.9	0.8	0.8	1.0	1.0	1.1	1.1	0.5	0.5	0.6	0.6	1.2	1.2	0.5	0.5	0.7	0.7
Net Interest Margin (%)	3.7	3.8	4.0	3.7	3.6	3.1	3.3	3.1	4.4	3.6	3.7	2.3	4.0	3.6	10.4	4.7	3.6	3.0	3.0	3.4
Op Cost/ Avg. Assets (%)	1.6	1.5	1.8	1.7	1.9	1.9	1.6	1.6	3.0	3.2	1.7	1.7	2.4	2.4	2.6	2.1	3.1	3.0	1.2	1.2
Cost / Net Income (%)	33.9	31.2	39.3	36.9	43.5	47.1	37.0	38.1	47.0	48.6	49.0	53.9	50.3	53.3	45.3	37.4	70.2	74.2	35.4	32.1
Imp. Charges/ Avg. Assets (%)	1.4	1.1	1.3	1.1	1.1	0.2	1.2	1.5	1.2	1.4	0.8	0.6	1.3	1.1	1.0	0.2	0.6	0.6	1.2	1.5
Gross NPL Ratio (%)	5.1	5.1	4.3	4.3	6.3	6.3	5.4	5.4	7.2	7.2	5.6	5.6	6.4	6.4	6.7	6.7	6.1	6.1	4.8	4.8
Total CAR (%)	16.8	16.8	18.0	18.0	16.4	16.4	14.3	14.3	18.0	18.0	15.8	15.8	14.3	14.3	15.7	15.7	17.0	17.0	14.2	14.2
Equity / Assets	9.1	9.1	10.4	10.4	9.7	9.7	7.1	7.1	10.0	10.0	10.6	10.6	8.8	8.8	8.7	8.7	14.7	14.7	5.3	5.3

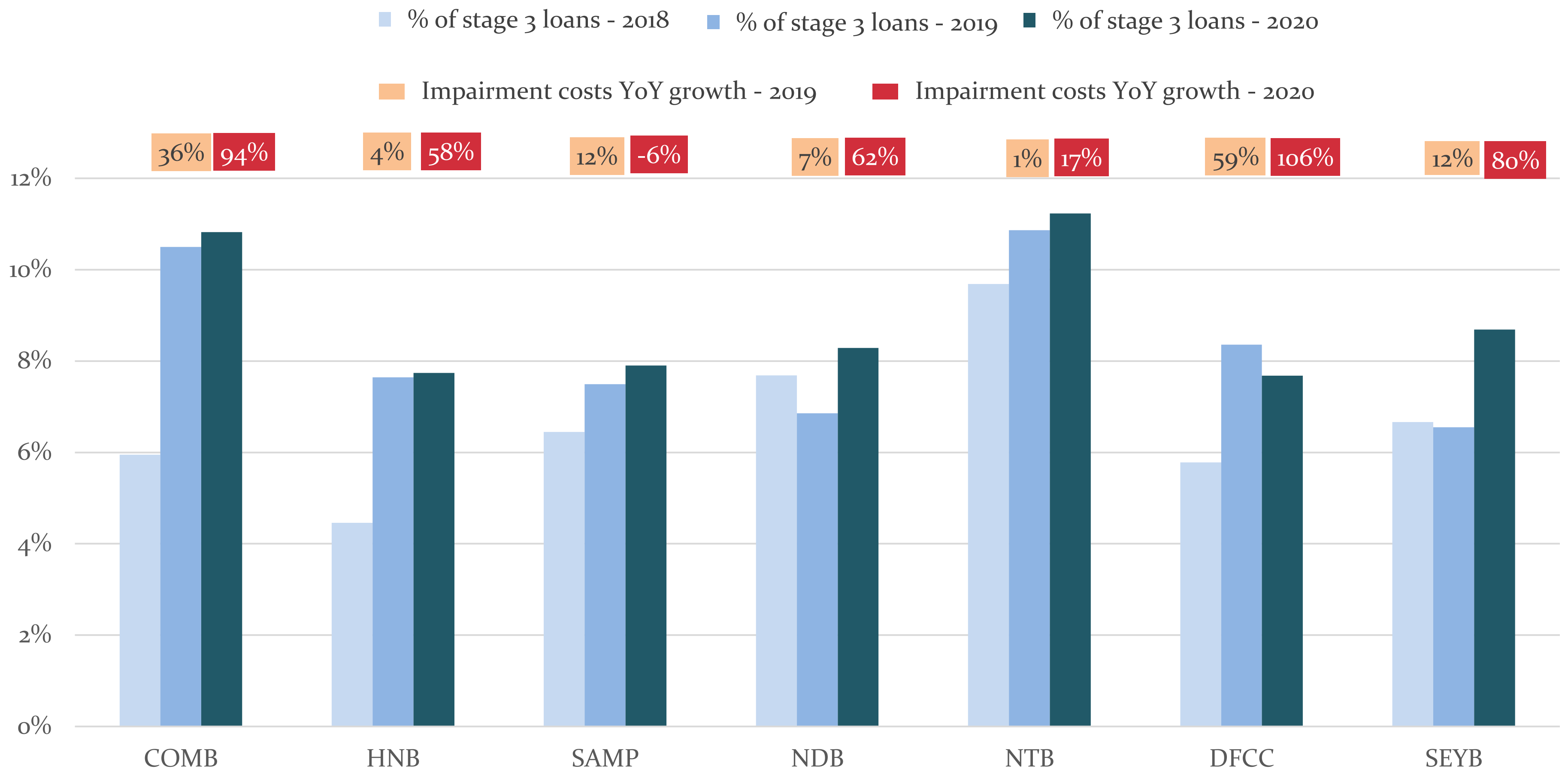
Back to Performance Summary

Top 5 charts

Back to Executive Summary

Despite only a small change in the share of stage 3 loans seen, most banks saw significant increases in impairment costs (most by more than 50%) compared to 2019.

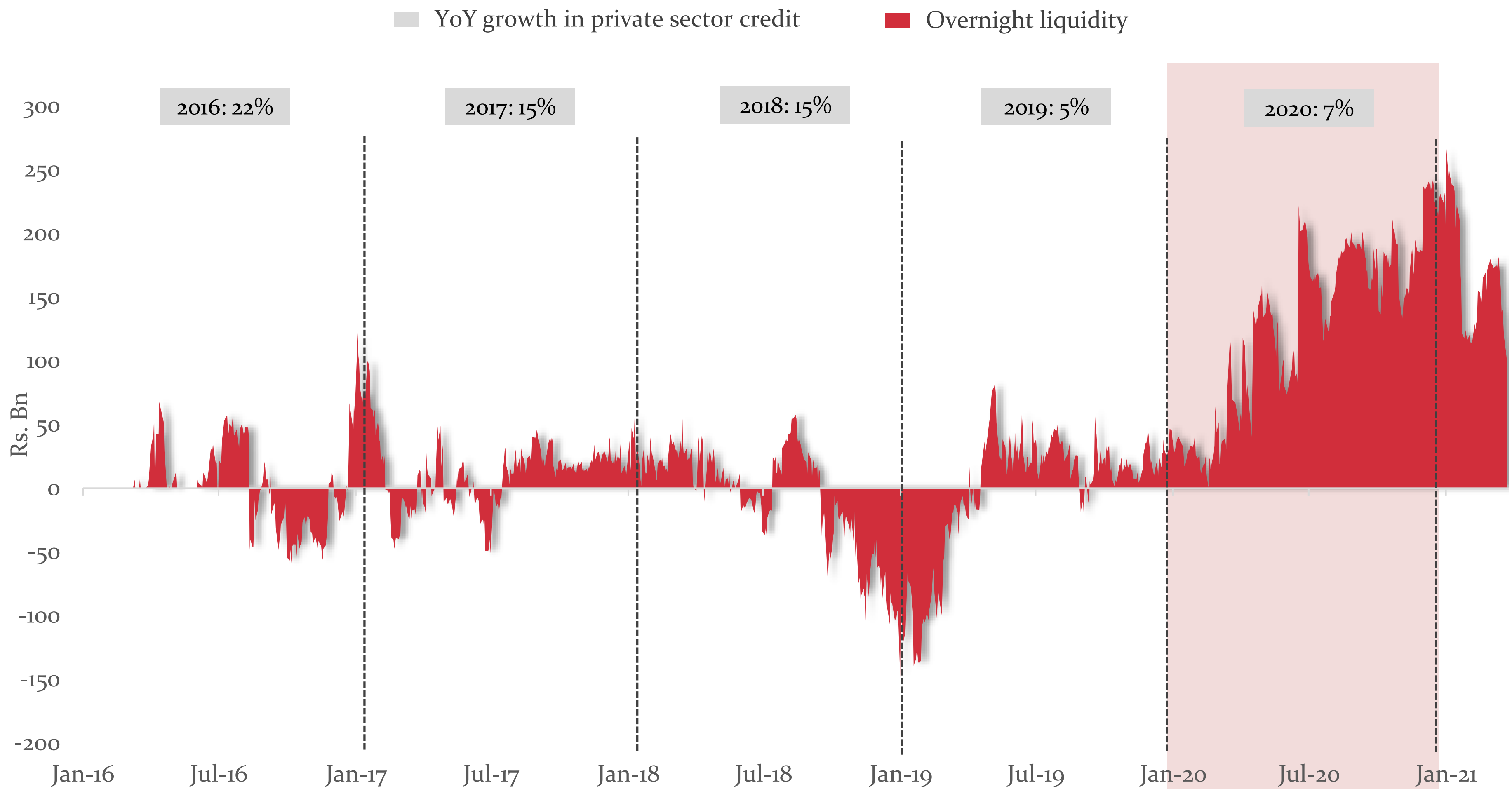
% of stage 3 loans in total loan book vs impairment costs



Source: Annual Reports

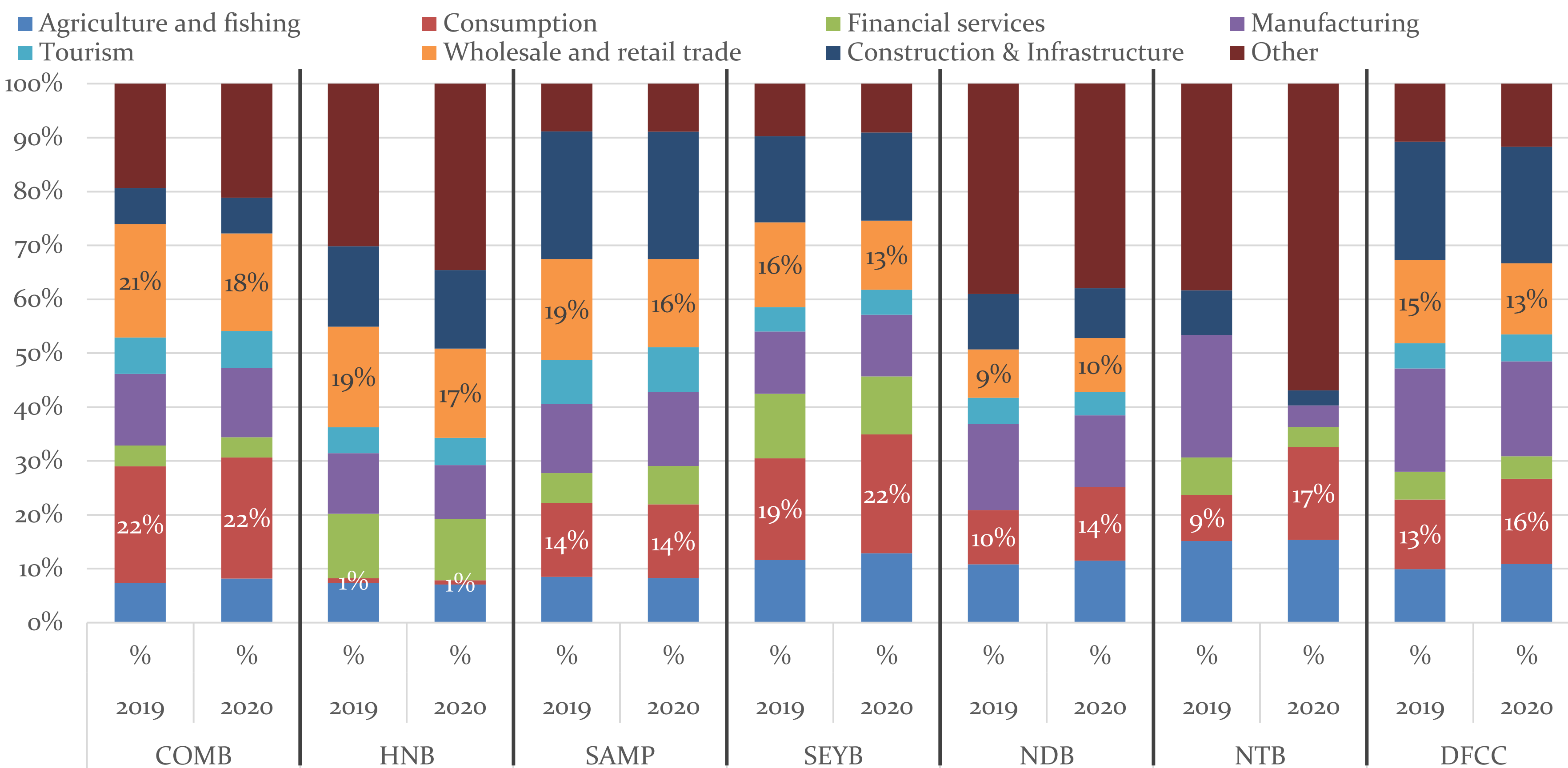
Back to Executive Summary

Private sector credit remained low despite very high excess liquidity levels



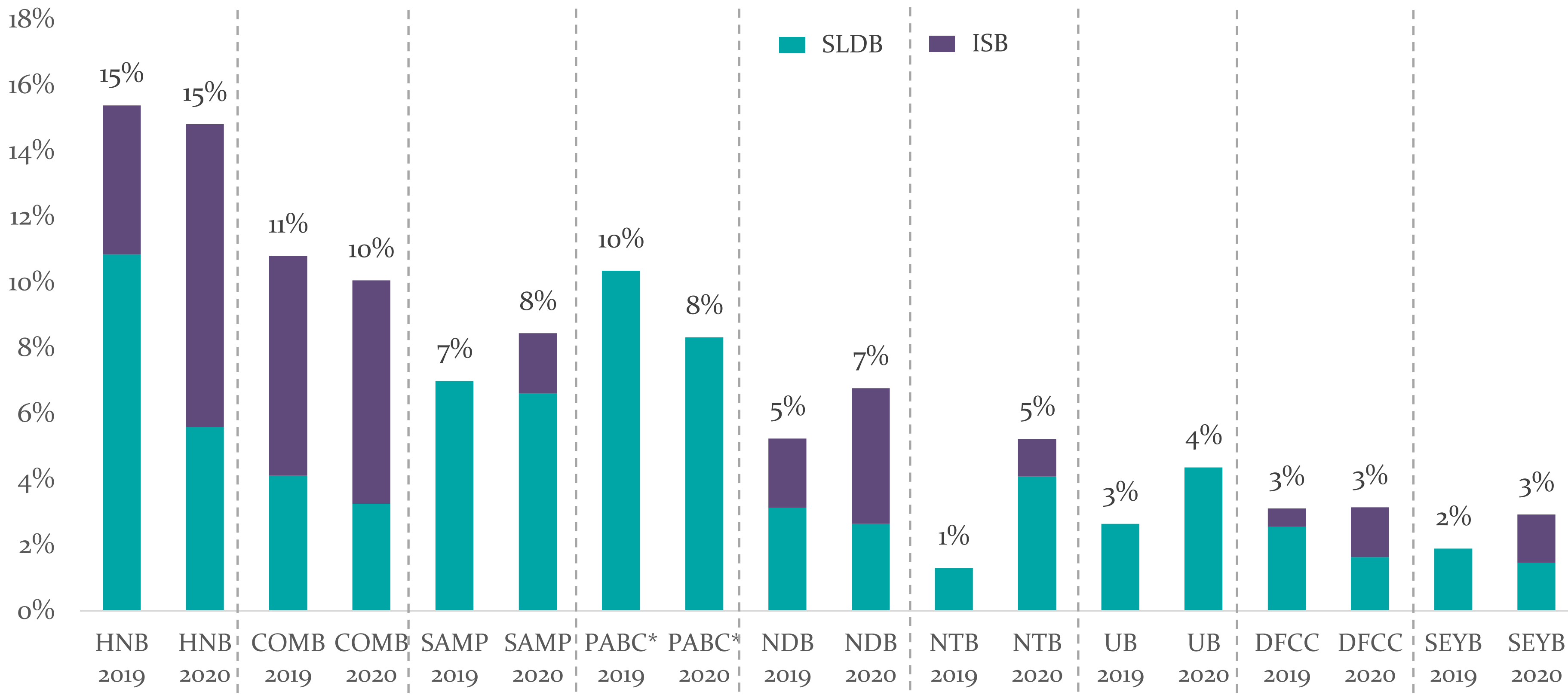
Trade related loans declined at most banks while consumption loans increased at several banks as several refinance schemes were deployed

Sector-wise composition of loans



Most banks saw their exposure to foreign currency government securities increase in absolute terms, some of them saw the ratio of foreign currency government securities as a % of total assets reducing during the year

Gov FCY security holding as a % of assets



*Breakdown of SLDB and ISBs not provided

Source: Annual Reports

Back to Executive Summary

Share of loans under moratorium at most banks which was around 30%-40% during the first phase of moratoriums (ending in September 2020) reduced by December 2020 while NPLs also reduced during 4Q20

Bank	% of loan book under moratorium as at 31st Dec 2020	Saubhagya loan disbursements in 2020 (Rs.Bn)
COMB	16%	27
HNB	14%*	24
SAMP	30%	9**
NDB	22%	18
SEYB	9%	10

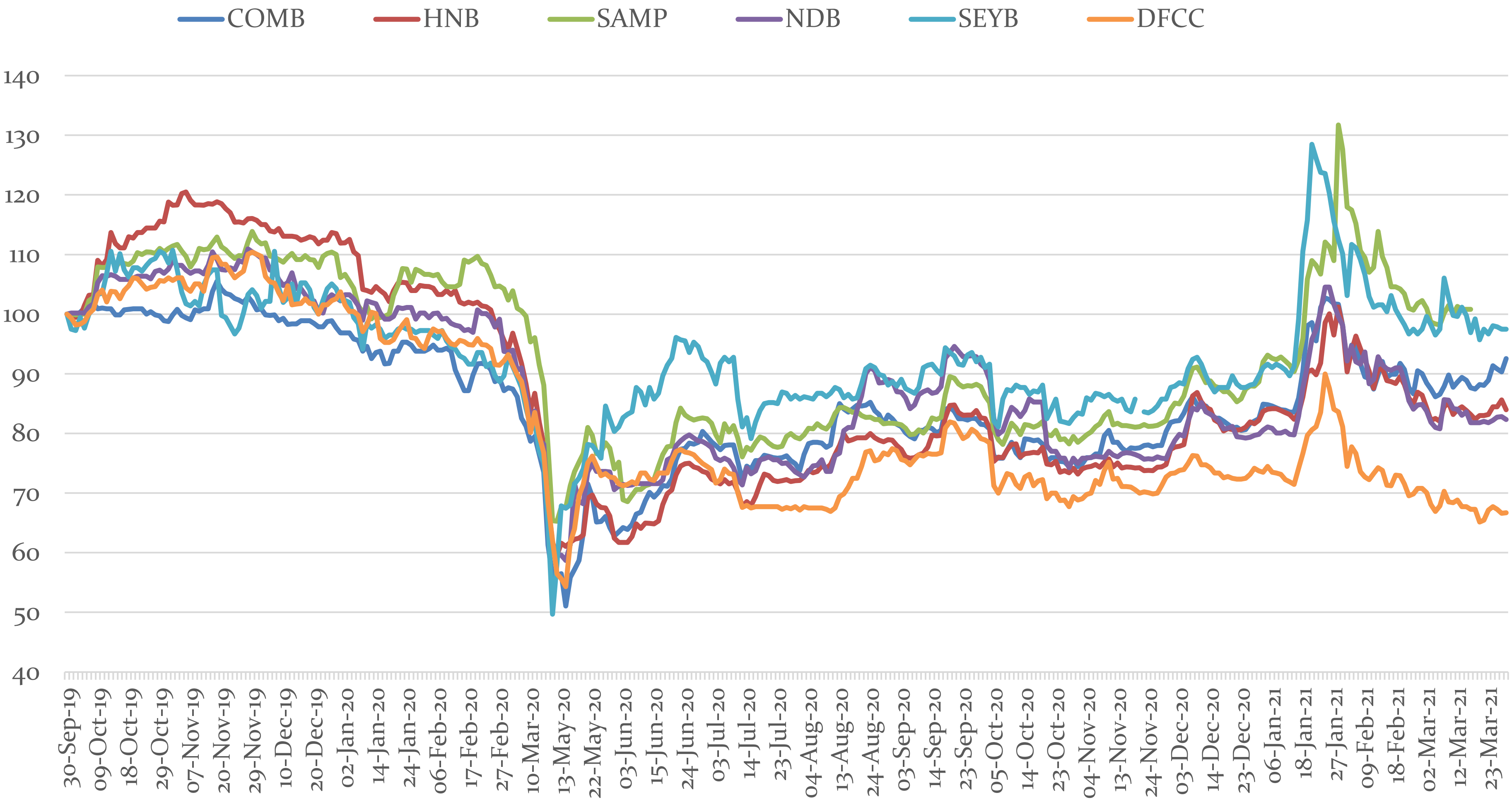
*Estimation based on data given in annual report
**As at October 2020

Source: Annual Reports

Performance Summary

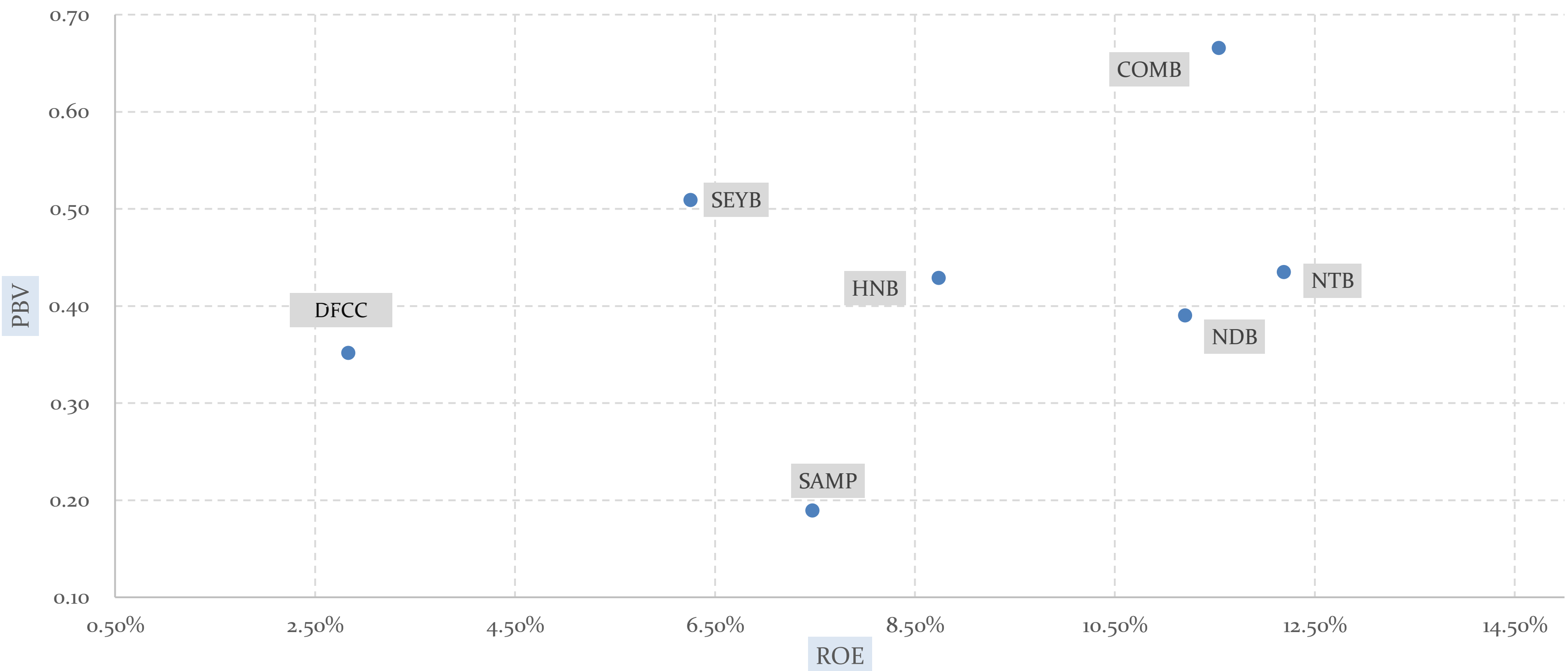
Stock price movements

18-month indexed* stock price movements of selected banks



*closing stock price as at 30.09.2019 indexed to 100

PBV vs. ROE – as at 4Q20*



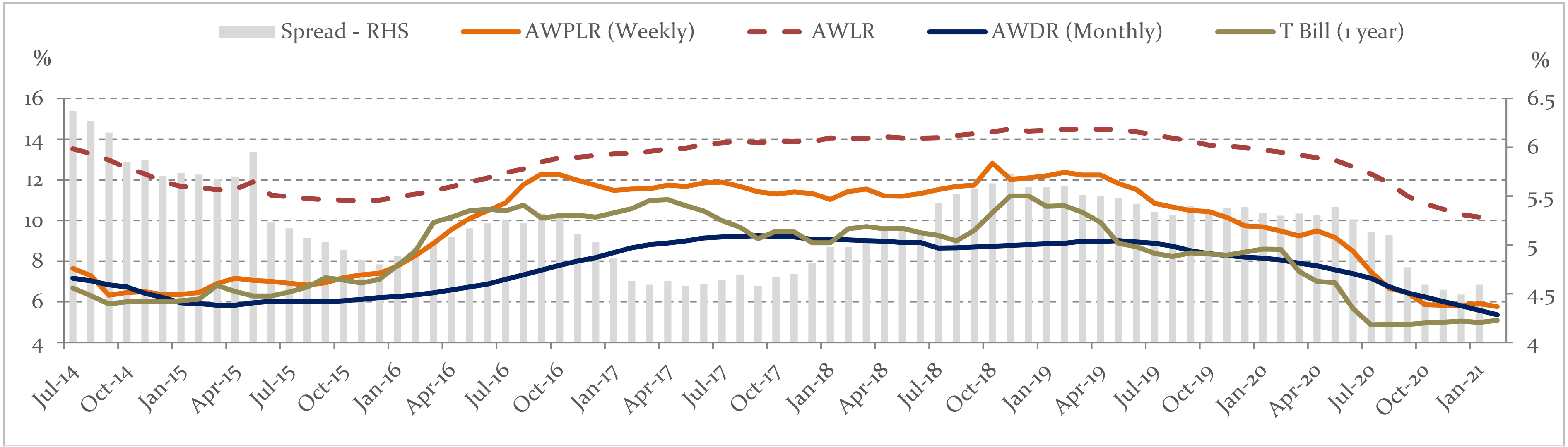
*Price : Based on closing price of each stock on 29th March 2021
Book value per share : Based on Group book value per share as at 31st December 2020 and has not been adjusted for subsequent rights issues

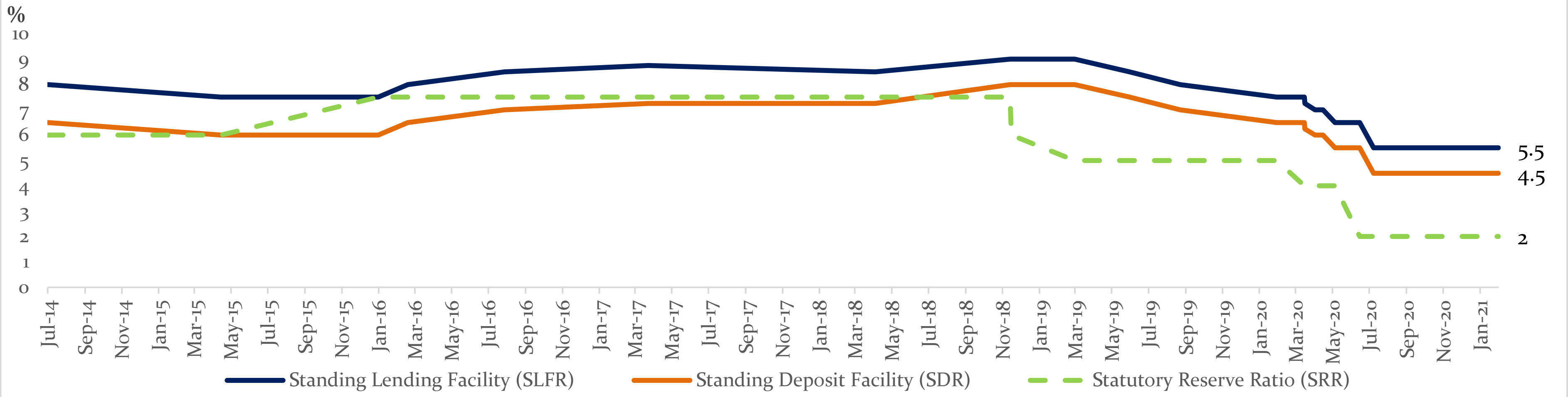
ROE : Calculated based on Group financial data available as at 31st December 2020

$$\frac{\text{Annual PAT attributable to shareholders of parent company}}{\text{Average shareholders' equity (excluding non-controlling interest)}}$$

Lending

Lending Rates & Policy Rates

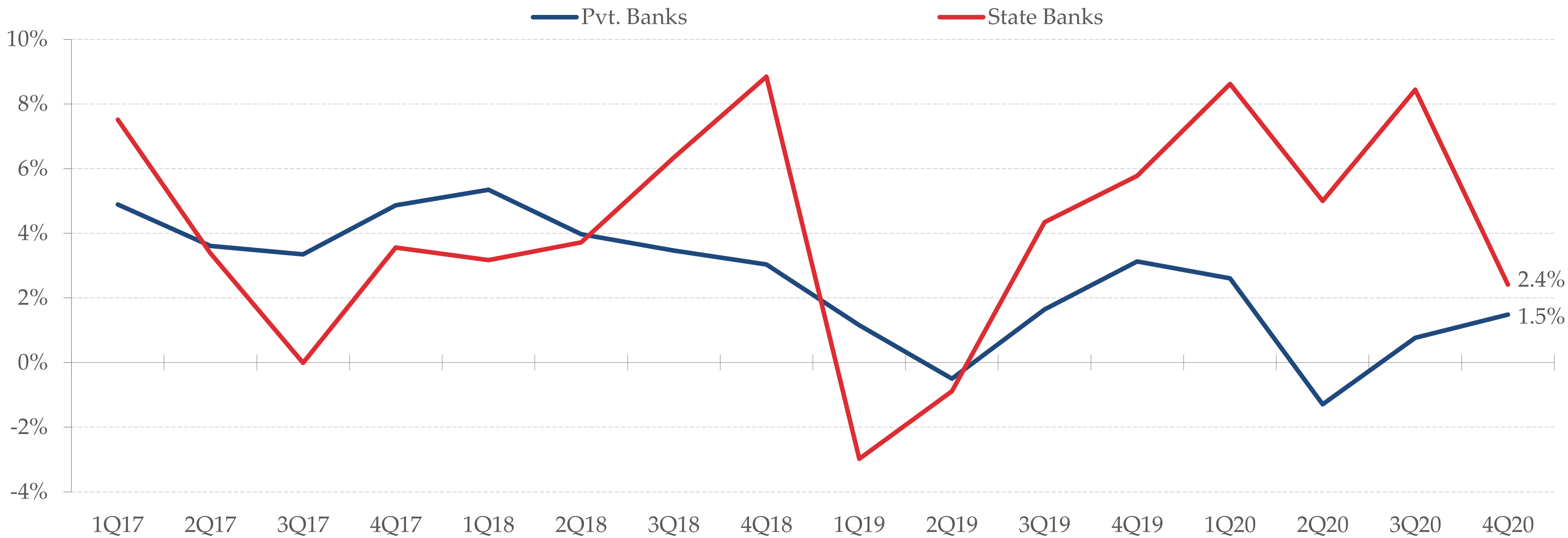




Source: CBSL

Private bank loan growth sluggish in 2020 with demand for credit remaining low

Net Loan Growth QoQ



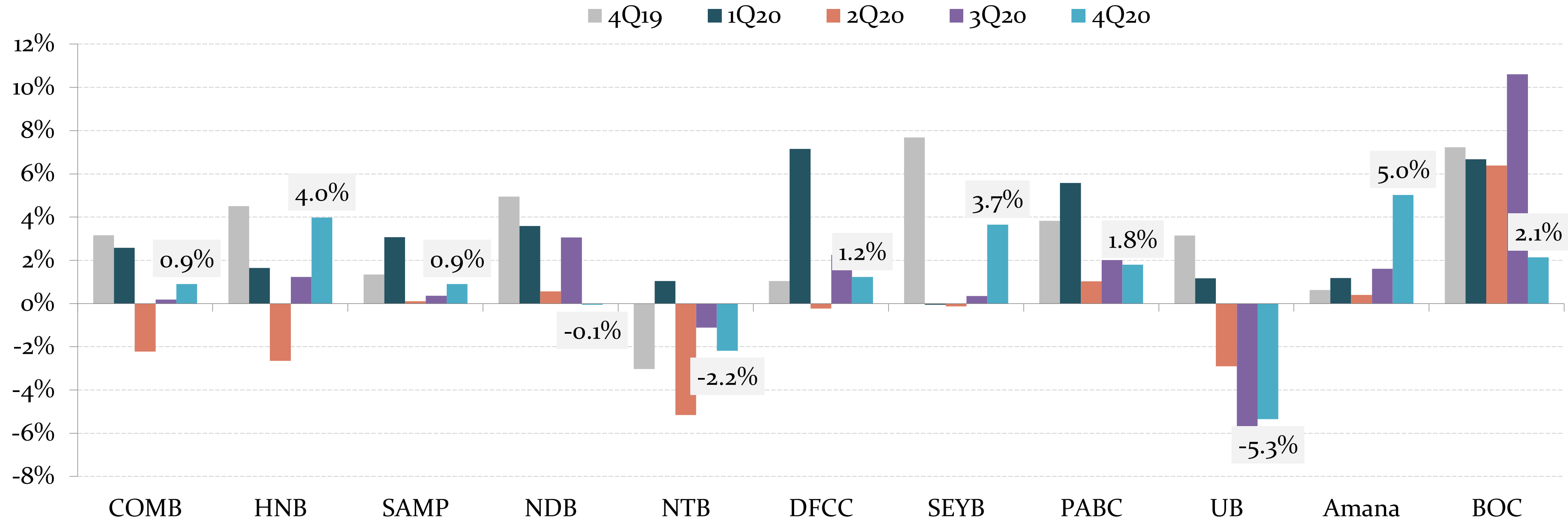
Net loan growth at private banks picked up to 1.5%, recording the highest quarterly growth since the pandemic. Growth for the year fell to 4% from 6% in FY19. This was the lowest net loan growth recorded for over a decade. In contrast, loan growth at state banks increased to 27% for the year (FY19: 6%).

In 2020, private credit demand failed to respond to falling rates with a majority of the lending going to the government, as net credit to the government grew by 63% relative to the 6.5% growth in credit to the private sector.

Source: Frontier Research, CSE

Net loan growth improves at most banks in 4Q20

Net Loan Growth QoQ – by bank



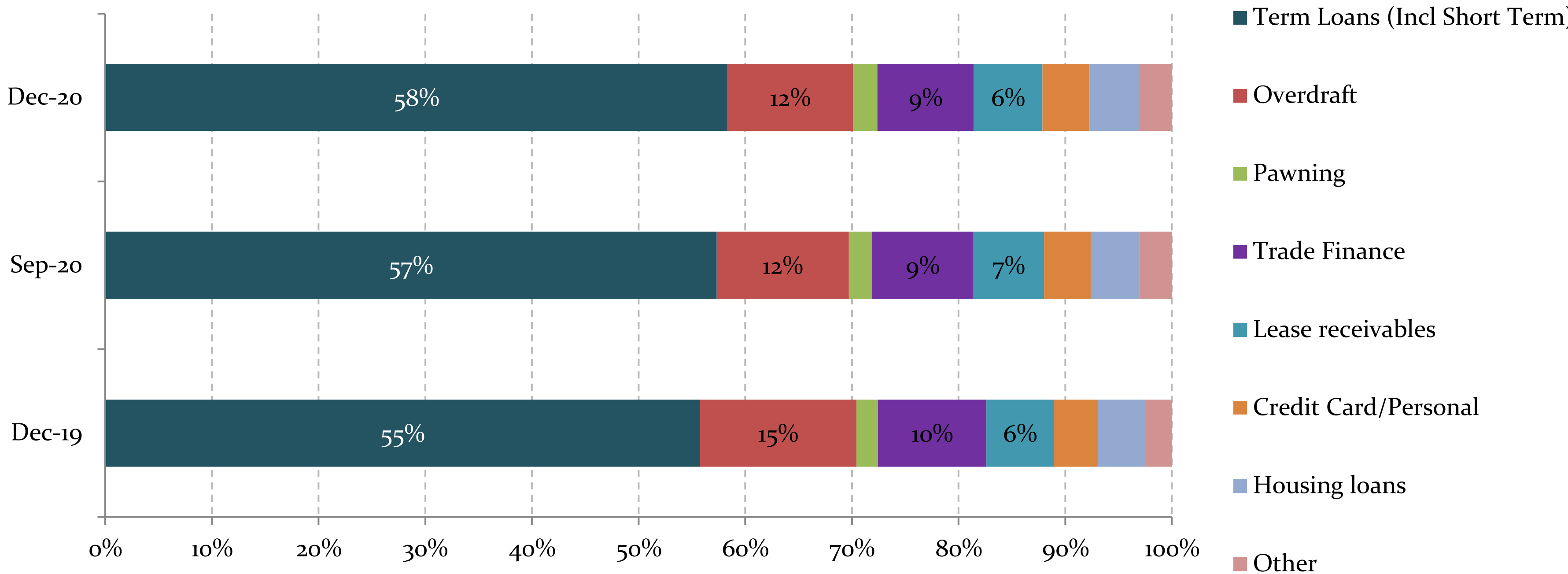
Among the larger banks, **HNB** and **SEYB** saw a relative recovery in loan growth but **Amana** recorded the highest growth on a quarterly basis across all banks in the report. **UB** and **NTB** recorded contractions for the 3rd consecutive quarter as most key loan categories contracted at both banks.

BOC's loan book surpassed Rs. 2 Tn in 2020 with positive loan growth stemming through both government and private lending, alongside various loan schemes implemented to boost lending.

Source: Frontier Research, CSE

The share of overdrafts saw a steady decline throughout the year

Lending Composition –Private Banks (based on Gross loan values)



Trade finance loans contracted by 2.9% with restrictions on imports in place throughout the year while exports also contracted. The overdraft portfolio contracted for the last 3 quarters of the year, contracting by 3.8% in 4Q20 (-7.5% in 3Q20). From a YoY perspective, overdrafts contracted by 16.2% as CASA balances increased during the year alongside the pandemic.

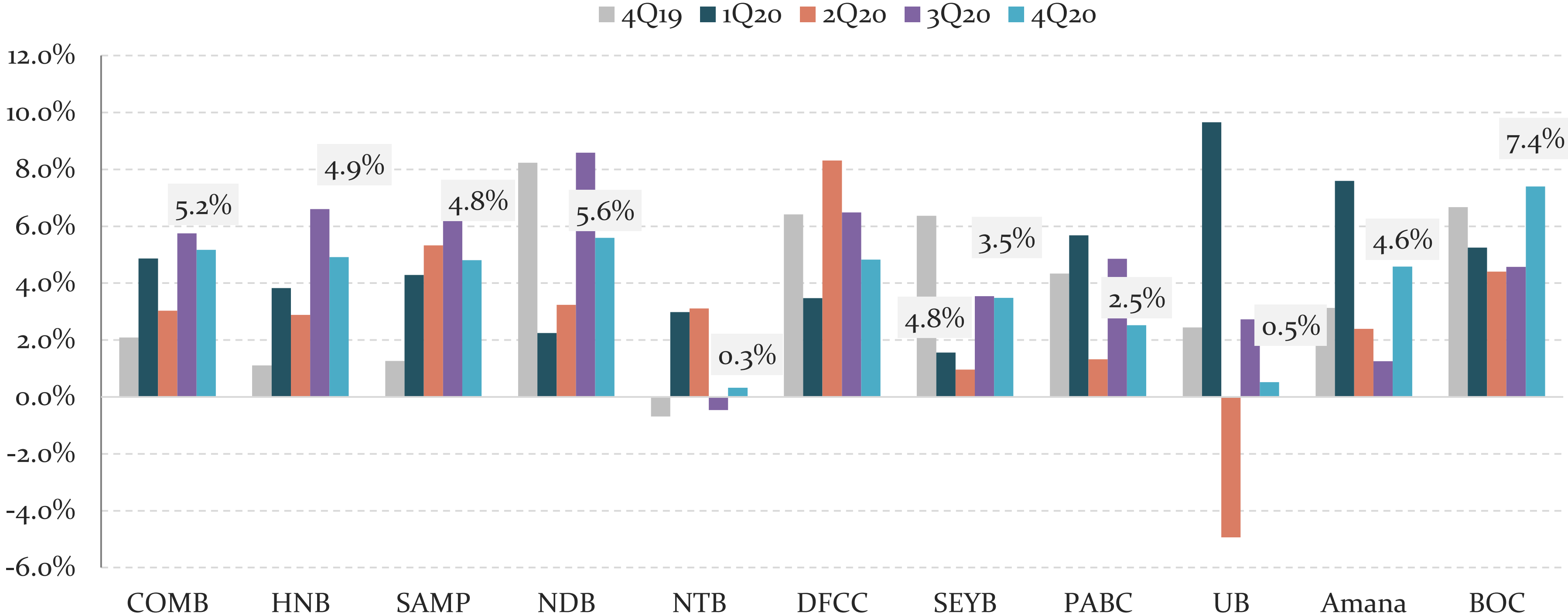
*Other includes Staff and Other loans, excludes investment in Govt and Corporate Debt Securities

Source: Frontier Research, CSE

Funding

Deposit growth remained strong despite low rates

Deposit Growth - QoQ



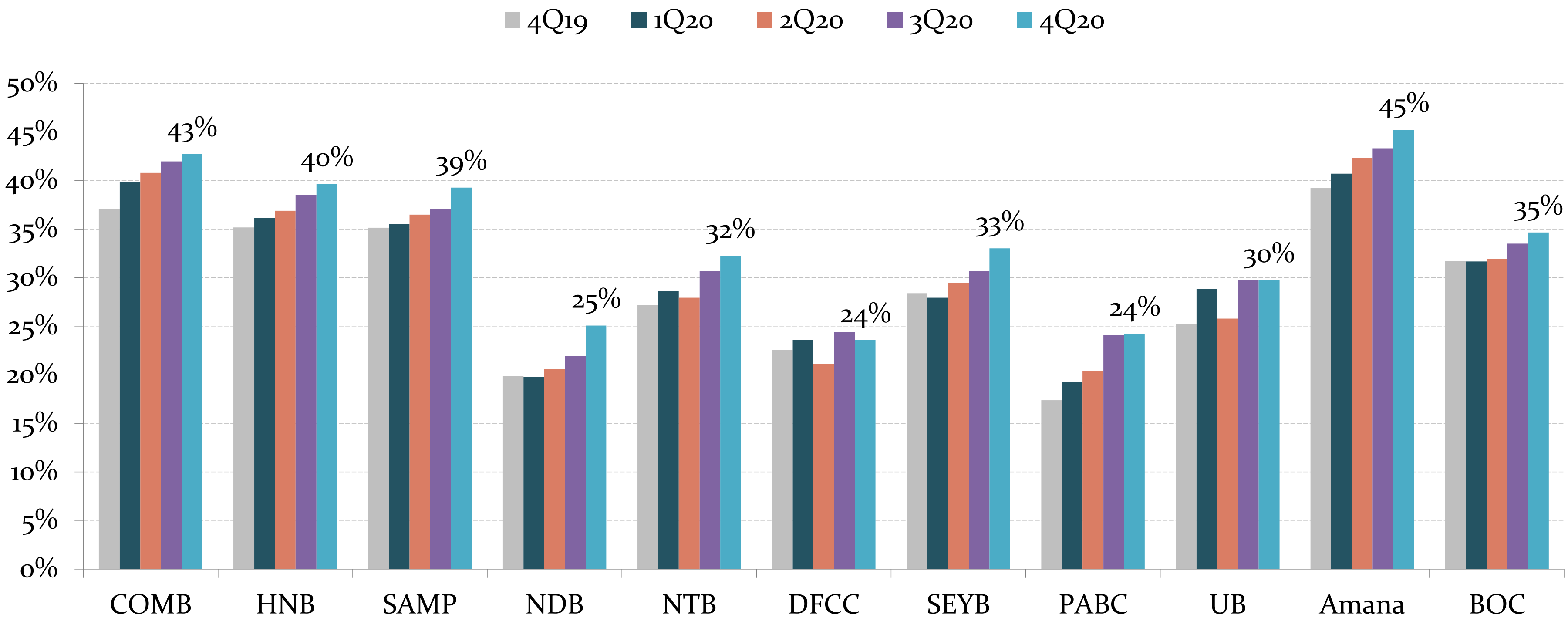
Despite deposits becoming less attractive in the current low rate environment, deposit growth at private banks remained relatively high in 4Q20. Aggregate private bank deposit growth in 2020 was 19% against 6% recorded in 2019.

NDB posted the highest quarterly deposit growth across all private banks in this report, driven by efforts to expand the deposit base in retail and SME segments as per the bank.

Source: Frontier Research, CSE, Investor calls

Clear growth in low cost fund base in 2020

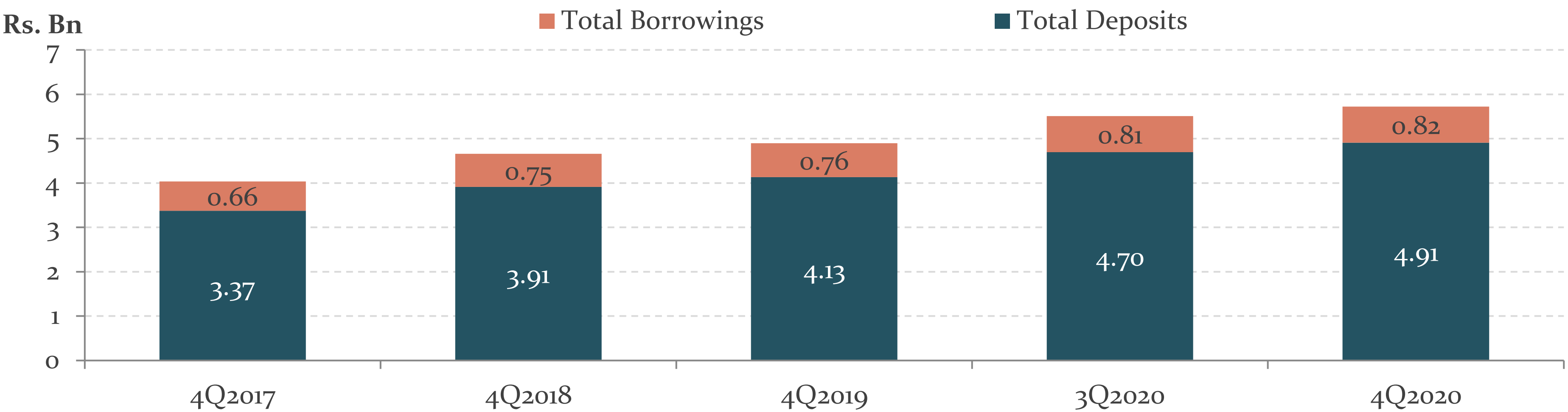
CASA Ratio



With less avenues for discretionary spending available to customers and deposits being moved from finance companies to 'safer' institutions such as banks, most banks saw their CASA base see a continual increase through the year. **DFCC** saw a relatively slow growth in the CASA ratio compared to other banks with a contraction in the savings deposits in 2Q20.

Funding shift at private banks

Funding Composition – Private banks



The share of deposits in the funding composition increased during the year alongside strong growth in the CASA base. Announcements of foreign funding lines made available to Sri Lankan banks since our last report in Dec 2020 are listed below.

Date of Announcement	Bank	Amount (US$ Mn)	Lender
Jan 2021	NTB	25	IFC
Feb 2021	NSB	35	Indian Bank and Indian Overseas Bank
Feb 2021	BOC	90	AIIB
Feb 2021	PB	90	AIIB

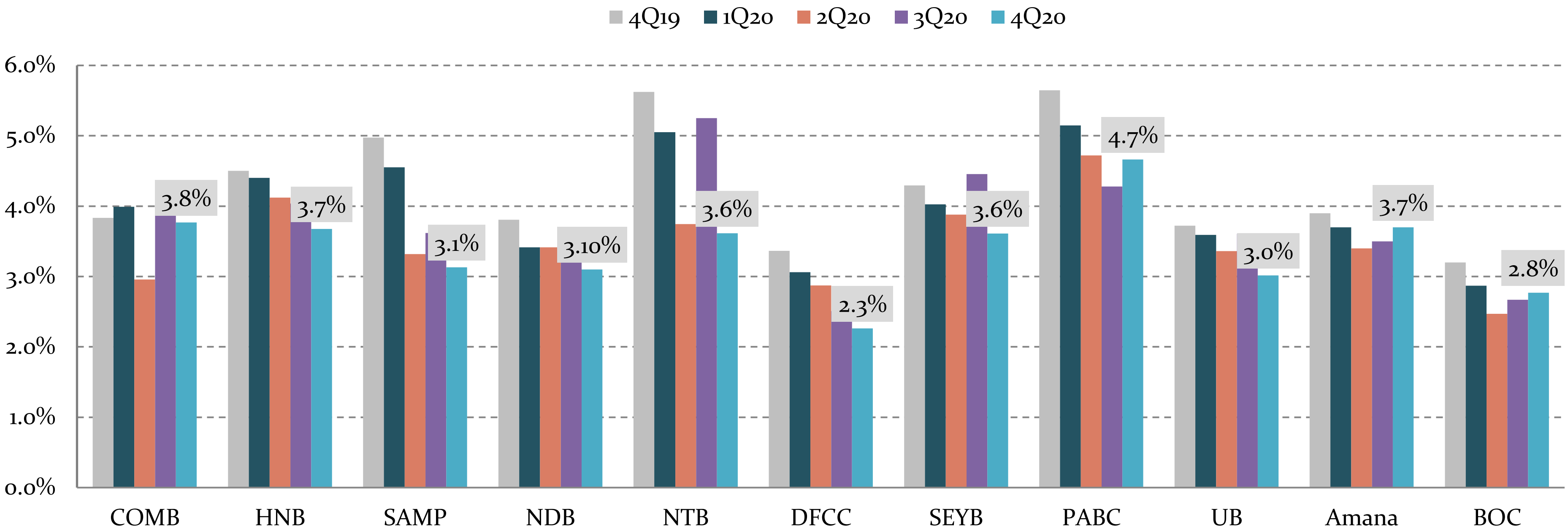
See page 32 for a list of capital raising activities announced by banks

Source: Frontier Research, CSE

Topline
&
Profitability

NIMs came down across most banks over the year

Net Interest Margins



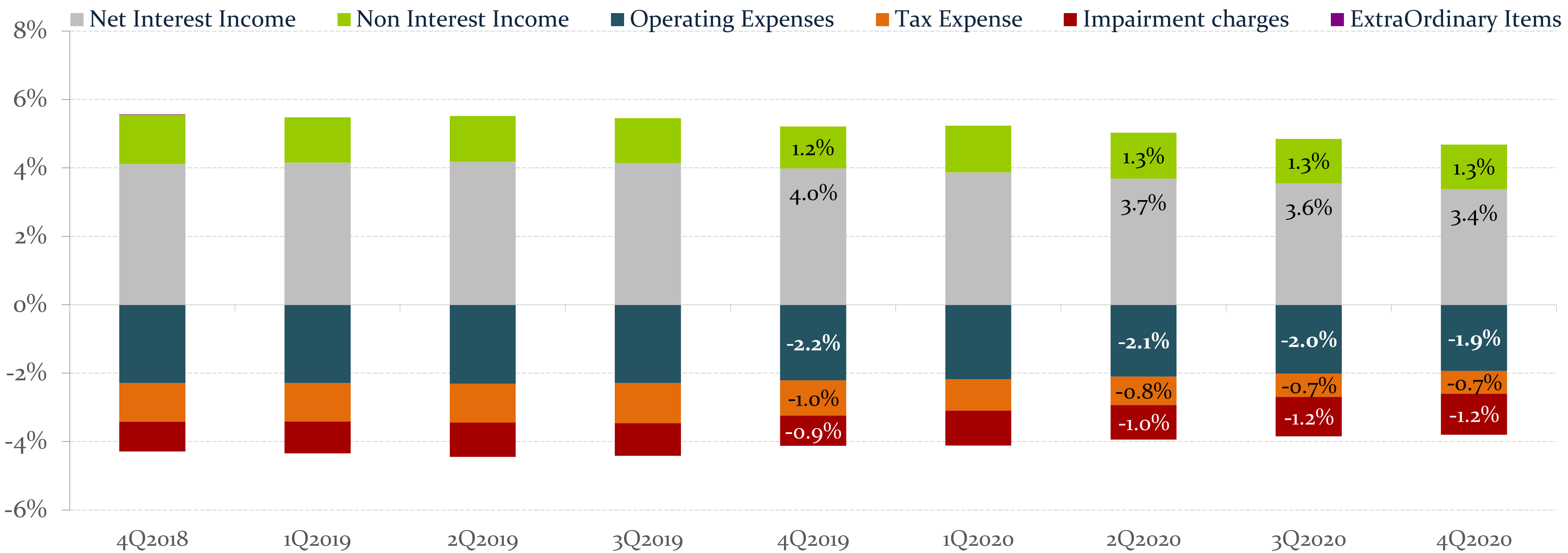
NIMs continued on a steady decline into 4Q20 at most banks amidst the low interest rate environment, with NIM's for private banks in the report dropping from 4.3% as at end 2019 to 3.5% by end 2020. **SAMP** and **NTB** saw the steepest drops in NIMs for the year among private banks.

BOC recorded an improvement in NIM due to the fall in the average cost of funds offsetting the fall in the average yield of interest earning assets during the quarter.

*Net Interest Margins are calculated relative to average interest earning assets

No major change in the ROA composition observed during the quarter

ROA Composition – Pvt. Banks

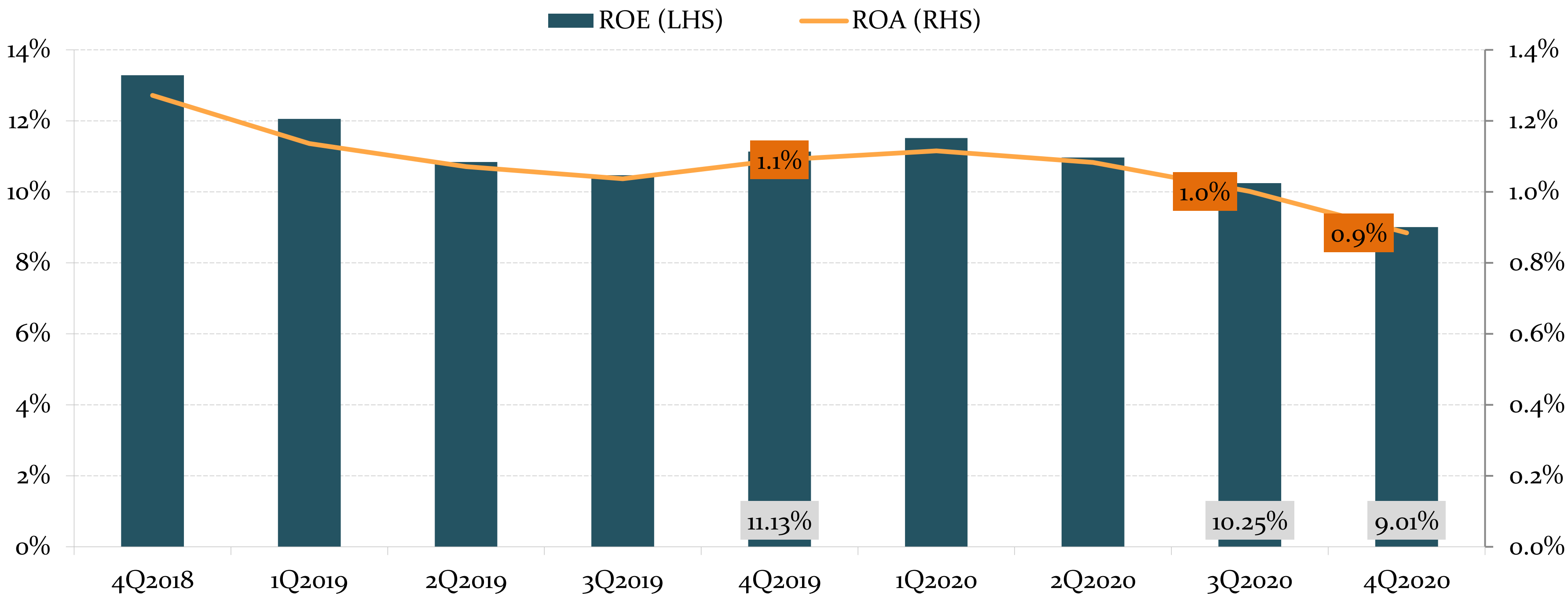


Aggregate ROA at private banks came down gradually since 1Q20 as the reduction in costs was not sufficient to set off the drop in income. In addition to the impact of low interest rates, modification losses charged during the year on account of debt moratoriums given brought down interest income. Overall, NII dropped by 6% in FY20. While operating costs and tax expenses fell compared to FY19, impairment costs saw an increase of 50% compared to FY19 but saw a QoQ drop in 4Q20.

Source: Frontier Research, CSE

ROE & ROA continued on a downward trend in 4Q20

ROE vs ROA – Pvt. Banks

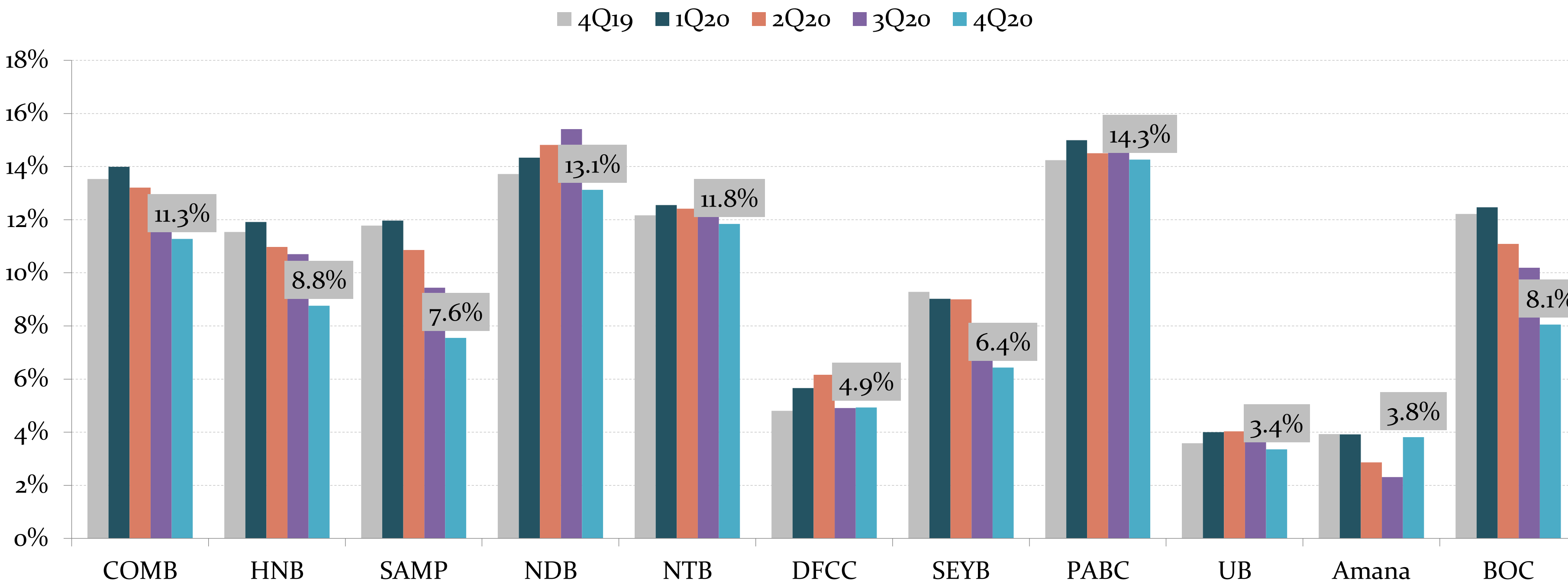


Trailing 12M ROE and ROA declined during the year as profits alongside balance sheet growth. Although PAT recorded a 36% growth QoQ in 4Q20, profits fell by 10% on an annual basis in FY2020 at private banks taken as an aggregate. This was the 3rd consecutive year profits fell, as the sector has been facing multiple headwinds since 2018.

Source: Frontier Research, CSE

ROE came down for most banks over the year

Returns on Equity



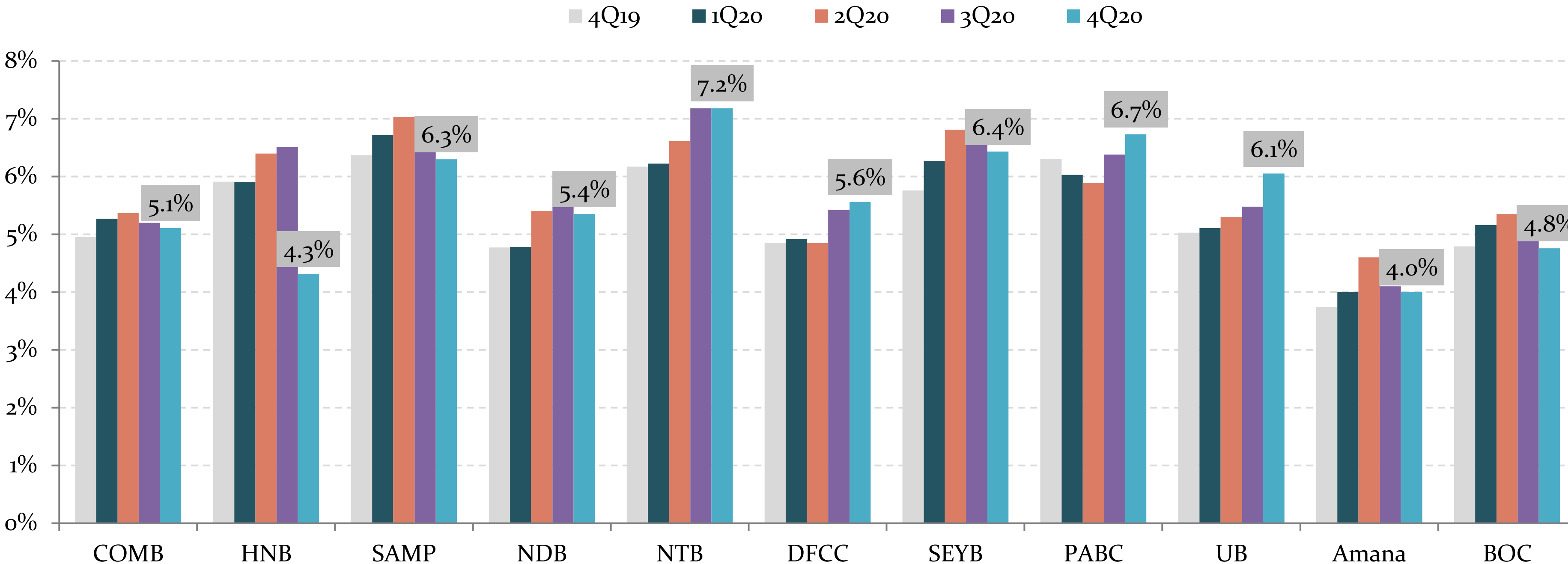
All banks covered in the report with the exception of **Amana** recorded a fall in ROE in 4Q20. **PABC** recorded the highest ROE followed by NDB **DFCC** was the only bank to record an increase in ROE compared to FY19, with a PAT growth of 15% recorded in FY2020. **BOC** recorded a decline in ROE to 8.1% from 10.2% in 3Q20.

Source: Frontier Research, CSE, Company websites

Asset Quality
&
Capital Adequacy

Mixed changes in NPL's observed in 4Q20

Gross NPL Ratios

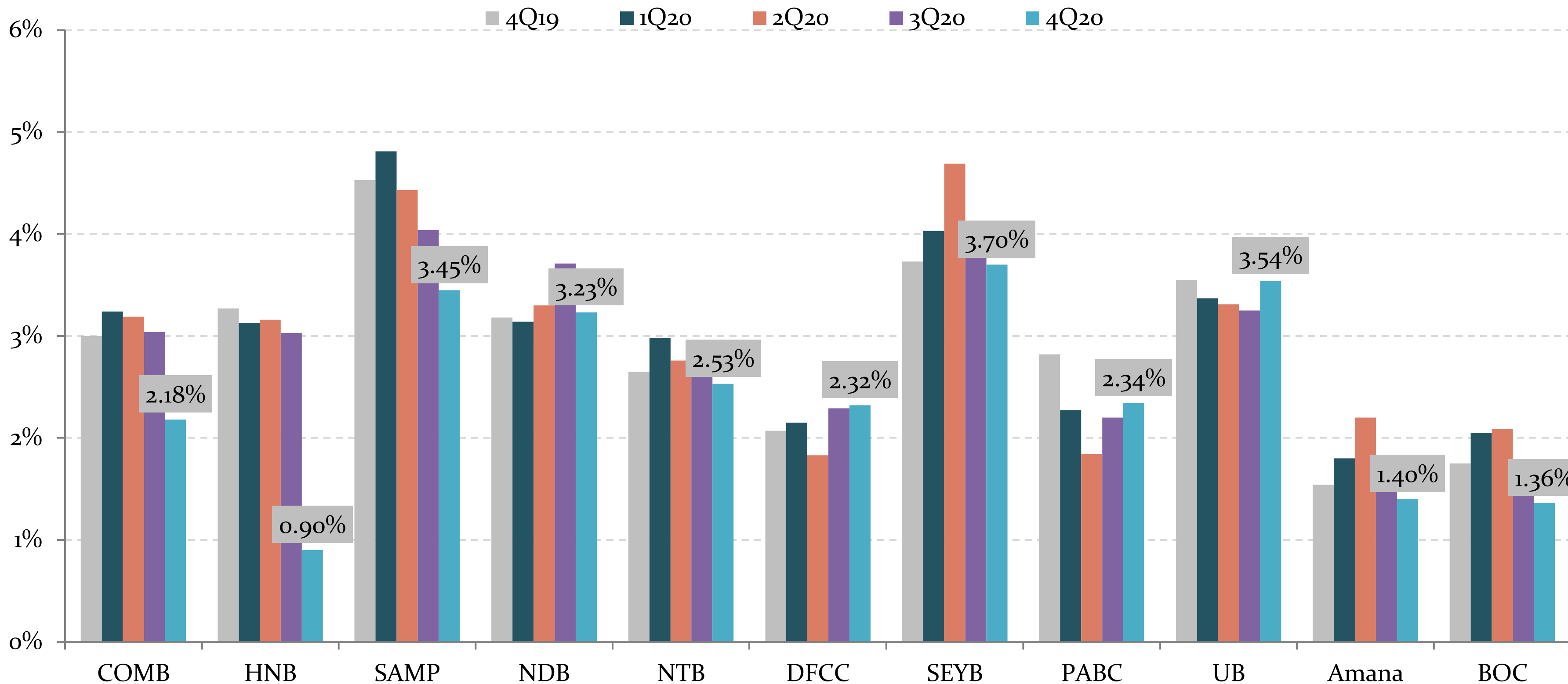


The trend in NPLs was mixed, with 6 out of the 10 private banks recording a fall in Gross NPL's in comparison to the previous quarter. **UB** recorded the highest increase in NPLs while only **SAMP** and **HNB** recorded NPLs lower than the end 2019 ratios.

BOC managed to keep the Gross NPL ratio down to the same level as at December 2019 (4.8%) despite NPL's rising over the first half of the year.

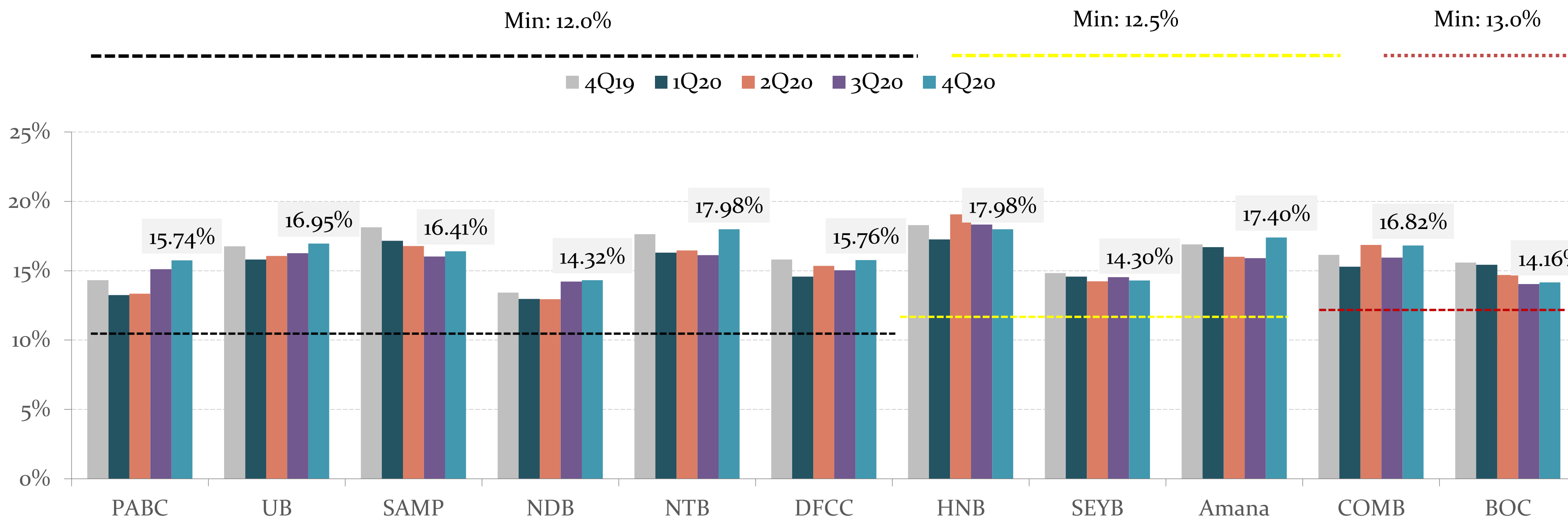
Most banks saw net NPLs reducing in 4Q20 with significant reduction in NPLs at HNB following the regularization of a loan due from an SOE

Net NPL Ratios



Source: Frontier Research, CSE, CBSL

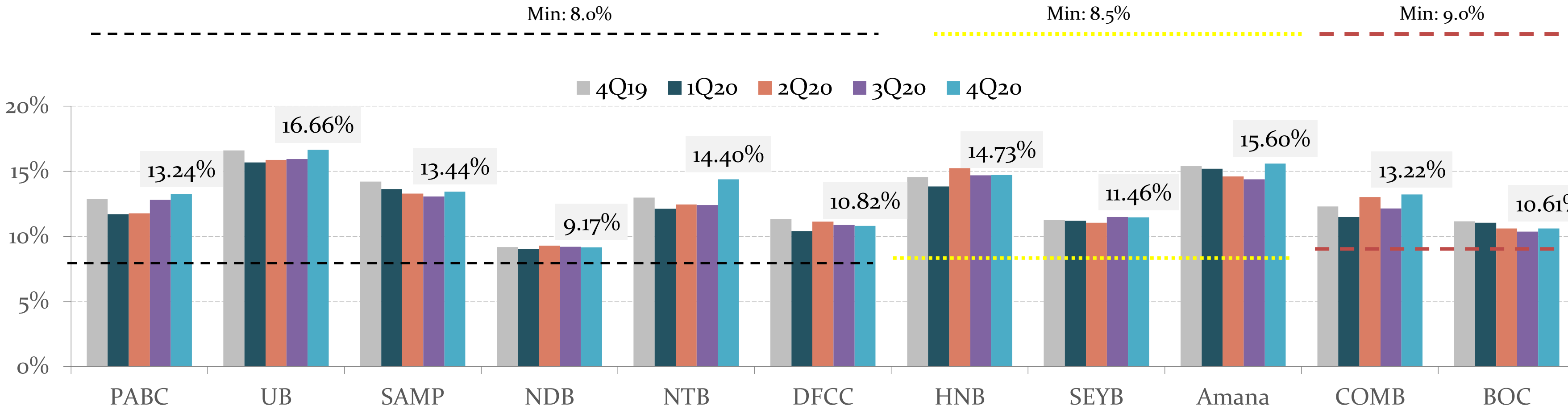
Total Capital



Changes in capital adequacy ratios across banks for 4Q20 continued to be mixed.-The largest drop in Capital Adequacy Ratios (CAR) for 4Q20 was by **HNB.** **HNB** and **NTB** recorded the highest capital adequacy ratios with the lowest capital adequacy ratio being recorded by **BOC**. All banks continued to maintain capital above both Tier 1 and Total capital regulations. **NDB, DFCC** and **BOC** carried out debenture issues during the year.

Back to Funding Composition

Tier 1 Capital



Announcements of capital raising activities since our last report in December 2020

Bank	Funding type	Date of Announcement	Amount to be raised (Rs. Bn)
NDB (CSE)	Rights issue	March 2021	Up to 8.0
NDB (CSE)	Private placement by Norfund	March 2021	3.1
SAMP (CSE)	Debenture	February 2021	Up to 6.0
HNB (CSE)	Debenture	March 2021 (Originally announced in Nov 2020)	Up to 7.0
SEYB (CSE)	Debenture	March 2021	Up to 6.0 (Amount revised down from Rs. 10 Bn proposed in August 2020)

Source: Frontier Research, CSE, Media

Index

COMB: Commercial Bank Of Ceylon PLC

HNB: Hatton National Bank PLC

SAMP: Sampath Bank PLC

SEYB: Seylan Bank PLC

NDB: National Development Bank PLC

NTB: Nations Trust Bank PLC

DFCC: DFCC Bank PLC

PABC: Pan Asia Banking Corporation PLC

UB: Union Bank Of Colombo PLC

AMANA: Amana Bank PLC

BOC: Bank Of Ceylon

"Private Banks" comprise of all listed local commercial banks

"State banks" include BOC

Unless stated otherwise, financials for all banks have been taken on a solo (Bank) basis

Numbers are based on quarterly financial publications of the banks

Glossary

Net Interest Margin (annualized): Net interest income/ Average Interest Earning Assets

Trailing ROA: 12 Month PAT/ Average Assets

Trailing ROE: 12 Month PAT/Average shareholder funds *(is not a weighted average that reflects movements in shareholding within the period in consideration)*

Impairment/ Average Assets: Total quarterly impairment including loan and other impairment/ Average assets

Loan impairment/ Average Loans: Quarterly loan impairment only/ Average gross loans

Cost to net income: Quarterly Non-interest expense (excluding impairment charges and taxes)/ Total net income

Financial Investments(FI) include Financial assets at amortised cost, Financial assets recognised through profit or loss and Financial assets - fair value through other comprehensive income

Credit growth is accounted as Net Loans and Advances Growth

Loans and Advances exclude "Financial Investment in Loans and Receivables"

This report is a quarterly publication.

For further details or clarifications please contact:
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