Lanka Rating Agency

Rating Report

Bank of Ceylon - LKR 15Bn Basel III compliant - Tier 2 Listed Rated Unsecured Subordinated Redeemable 5 year Debentures with Non-Viability Write-Down

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Rating History

Dissemination Date	Long Term Rating	Outlook	Action	Rating Watch
29-Aug-2024	AA-	Stable	Preliminary	-

Rating Rationale and Key Rating Drivers

The rating assigned to the debentures reflects the Bank of Ceylon's ("BOC" or "the Bank") dominant position in the Banking Industry as the largest Commercial Bank in terms of Advances, Deposits and Asset base of LKR 2.2tn, LKR 3.9tn, and LKR 4.4tn respectively. The rating also factors in BOC's position as a Domestic Systemically Important Bank (DSIB) and its 100% ownership by the Government of Sri Lanka (GoSL). BOC's loan portfolio is characterized by sizable exposure to the state-owned enterprises (SOEs). The Bank's financial risk profile reflects its ability to absorb the eventual impact of SOEs' debt restructuring (if any) to an extent. BOC's exposure to GoSL International Bonds is limited and well provided for (~55%), while it maintains significant investments in the domestic Government Securities. The Bank's Gross NPL ratio (~13.5% in 3MCY24) has risen in recent years, in line with the Banking Industry trend. The Net NPL ratio of the bank stood at ~5.5% as of 3MCY24. During CY23, BOC's Net Interest Income (NII) contracted to LKR 91.2bn, while it recorded a Profit-After-Tax (PAT) of LKR 26.7bn in the same period. In 3MCY24, the Bank improved its spreads and posted a PAT of LKR 5.1bn. The Bank strategizes to limit its open position against its foreign currency exposure and further enhance its liquidity (LCR of 248.6% in 3MCY24). BOC's Capital Adequacy Ratio was recorded at 15.84% in CY23 and 15.41% in 3MCY24, slightly below its peers, but above the regulatory requirement of 14%. The rating incorporates the subordinated Tier 2 structure of debentures and a non-viability write-down feature. This feature allows for the debentures to be permanently written off upon the occurrence of a trigger event, with resultant liability being reclassified as Additional Tier 1 (ADT-1) Bonds, thereby subordinating them to the rest of the claims.

The rating is contingent upon the Bank's ability to maintain its asset quality, capitalization, and profitability in the near term. Any significant deterioration in the Bank's financial position, particularly stemming from its exposure to the SOEs and foreign currency, could negatively impact the rating, if it is not rectified in a timely manner. GoSL's 100% ownership and expected support remain the key rating factors.

Disclosure

Name of Rated Entity	Bank of Ceylon - LKR 15Bn Basel III compliant - Tier 2 Listed Rated Unsecured Subordinated Redeemable 5 year Debentures with Non-Viability Write-Down
Type of Relationship	Solicited
Purpose of the Rating	Debt Instrument Rating
Applicable Criteria	Methodology | Financial Institution Rating(Jun-22),Methodology | Debt Instrument Rating(Jun-22)
Related Research	Sector Study | Commercial Bank (Sep-23)
Rating Analysts	Nilum Liyana Arachchi | nilum@lra.com.lk | +94 114 500099

Issuer Profile

Profile Bank of Ceylon ("BOC" or "the Bank") is a Government-owned Bank domiciled in Sri Lanka, duly incorporated on August 1, 1939 under the Bank of Ceylon Ordinance No. 53 of 1938 (BOC Ordinance). It is a Licensed Commercial Bank (LCB) established under the Banking Act No. 30 of 1988 and amendments thereto. BOC was incorporated as the first state-owned Commercial Bank in Sri Lanka. The Bank's principal business activities mainly include provision of personal banking, corporate banking, development banking, offshore banking, trade financing, lease financing, primary dealing, investment banking and wealth management, treasury operations, correspondent banking and money remittances, Islamic banking, bancassurance, pawning, credit card facilities, foreign currency operations, and other financial services.

Ownership The Bank is 100% owned by the Government of Sri Lanka (GoSL). Being a state-owned Bank, it directly comes under the purview of the Ministry of Finance (MoF). Currently there are 25mn shares in issue. BOC is a Domestic Systemically Important Bank (DSIB) in Sri Lanka and therefore brings strategic importance to the GoSL. The sovereign shareholding of the Bank and its DSIB status reflects stability at the ownership level. Moreover, GoSL's support to the Bank in the form of capital infusion and guarantees on the repayment of any sum due to the Bank on any loan, overdraft, advance or other accommodation further strengthens its ownership profile. The Government has infused capital on several occasions to the Bank and is committed to make further infusions, if the need arises.

Governance The BOC Ordinance lays out the manner in which the Board of BOC is structured. The MoF appoints the Board of Directors (BoD) as per the provisions of the BOC Ordinance. The management and administration of the affairs of the Bank are overseen by the BoD. The Board members are appointed by the Minister, and one of the directors is representative of the MoF. The Bank has a board of six Non-Executive Directors of which five are independent. Mr. Kavan Ratnayaka is currently the Chairman of the BoD. He possesses over three decades of experience in the Banking, IT, Telecommunication and Tourism industries. The remaining members of the BoD hold decades of experience in fields such as Banking, Finance, Asset Management, IT, Law and Tourism. The BoD has formed five board sub-committees, namely, (i) Audit Committee (AC), (ii) Integrated Risk Management Committee (IRMC), (iii) Human Resources and Remuneration Committee (HRRC), (iv) Nomination and Corporate Governance Committee (NCGC), and (v) Information and Communication Technology Committee (ICTC). Mr. Naresh Abeyesekera heads the AC with his decades of experience in the financial sector. The External Auditor of the Bank, The National Audit Office, issued an unqualified audit opinion pertaining to the Annual Financial Statements of CY23 for the Bank.

Management The Chief Executive Officer (CEO)/General Manager (GM), Mr. W P Russel Fonseka, heads the management team of the Bank. All departments report to the CEO/GM through their respective Deputy General Managers (DGM). The CEO/GM joined the Bank in January 1990 and in his tenure of over 34 years, he gained a wealth of experience serving in various capacities within the Bank in local and international settings. The Bank has in place 29 Executive Committees. The day-to-day management of the Bank is delegated to the corporate management team through these committees, each established with clearly defined mandates and responsibilities. The Bank has separate and integrated systems for ATMs, credit cards, treasury management, trade finance, internet & mobile banking and other services. The BoD bears the overall responsibility of formulating a robust risk management policy and overseeing the Bank's risk management and internal control frameworks. It also decides the risk appetite levels, formulate the risk policy and check the effectiveness of the risk management processes.

Business Risk The Banking Industry comprises 30 Banks, out of which, 24 are Licensed Commercial Banks (LCBs) and 6 are Licensed Specialized Banks (LSBs). Out of the 24 LCBs, there are eleven (11) Foreign Banks, eleven (11) Private Banks and two (2) Public Banks including the BOC. As at End-Dec'23, the sector recorded an asset base of LKR 20.4tn, reflecting a growth of ~5%, compared to End-Dec'22. Similarly, the Investments and Deposit base of the sector also increased by ~23.1% and ~7.4% YoY respectively during CY23. However, the sector's net advances reduced slightly by ~3.3% compared to CY22. The sector's Net Interest Income (NII) was recorded at LKR 714.6bn during CY23, a decline of ~4.9% YoY basis. This came on the backdrop of combined effect of rising interest rates during 1HCY23 and the lagged repricing adjustments on the sector's Advances portfolio. Despite the decline, the sector's Profit-After-Tax (PAT) increased by ~25.2% during CY23 to LKR 192.6bn, compared to LKR 153.8bn in CY22. BOC continues to maintain its position as the largest LCB in Sri Lanka with an asset base of LKR~4.4tn, representing ~21.6% of the sector's total assets as at End-Dec'23. In addition, the Bank holds the highest share in terms of the sector's Advances and Deposit base accounting for ~22.3% of the sector's total Advances and ~23.6% of the sector's total Deposit base. BOC's investment portfolio also represents ~24.3% of the sector's market share. On the other hand, the Bank contributed ~12.8% to the sector's Net Interest Income (NII) and ~13.9% to the Sector's Profit-After-Tax (PAT) for the same period. During CY23, the Bank's performance remained in line with the sector. In absolute terms, the Bank's NII was recorded at LKR 91.2bn during CY23 (a reduction of ~27.8% from CY22) and LKR 25.9bn during 3MCY24. Consequently, the Bank's PAT declined by ~17%, from LKR 31.9bn in CY22 to LKR 26.7bn in CY23. In contrast, the Bank's PAT for the 3MCY24 rose significantly by ~53.3%, clocking at LKR 5.1bn compared to LKR~3.3bn in 3MCY23 driven by higher NII and net fee and commission income compared to the same period last year. Overall, the Bank's mix of core and non-core income remains healthy, while exposure to foreign exchange risk persists which bears an impact on the Bank's non-core income/expenses. Going forward, the Bank intends to pursue its strong emphasis on digitalization and digital products in order to foster its significance in the economy, expand its footprints and keep up on a stable growth trajectory.

Financial Risk The Bank's credit risk stems from its Advances exposure to the state-owned Enterprises (SOEs). As of End-Dec'23, out of the total asset base of LKR 4.4tn, sizable amount of assets were linked to the GoSL, either directly or indirectly. This exposure included investment in government securities and advances provided to SOEs. G-Sec securities largely represent domestic holdings with LKR 1.27tn invested in T-Bonds and LKR 374.5bn pertaining to T-Bills (End-Dec'23). International sovereign bonds accounted for LKR 87.3bn (End-Dec'23) which have been duly provided for (~55.2% provisioning). In terms of the Advances of the Bank, the top 20 advances reflected sizable amount of the Bank's loan book (End-Dec'23). The Bank remains exposed to any extensive debt restructuring of its SOE portfolio. Nonetheless, the standalone financial profile of the Bank can withstand the likely impact to an extent. Furthermore, GoSL has allocated LKR 450bn in the latest budget to support the State-Owned Banks, if needed. The Bank's Gross NPL ratio (~13.5% in 3MCY24) has risen in the recent years, in line with the Banking industry, resulting in a considerable provisioning expense. The Net NPL ratio of the bank stood at ~5.5% as of 3MCY24. The trend has now stabilized as the economy improves and interest rates have come down. Meanwhile, liquidity position has also improved in the recent years (~248.6%) with improved economic conditions. In terms of the funding base, the Bank's Deposit base accounted for ~94.4% of its funding in 3MCY24, a slight decrease from ~95.5% in CY23. Time deposits constitute the largest share of the Deposit base, at ~62.7%, while Saving deposits represent ~31% as at End-Dec'23. As at End-Mar'24, the top 20 depositors accounted for sizable portion of the Deposit base. The Bank's exposure to foreign currency risk remains high as significant portion of its Advances and its Deposit base pertained to foreign currency (End-Dec'23). However, the Bank strategizes on limiting its open position. The Capital Adequacy Ratio (CAR) of the Bank was recorded at ~15.84% as at End-Dec'23 (~15.38% as at End-Dec'22). The required rate of the CBSL is 14%. The Bank's Tier 1 Capital stood at ~12.76% as at CY23 compared to ~12.41% as at CY22. The required rate of the CBSL is 10%. The CAR and Tier 1 capital were recorded at 15.41% and 12.41% respectively in 3MCY24.

Instrument Rating Considerations

About The Instrument BOC is expected to issue a Basel III-compliant, Tier 2, listed, rated, unsecured, subordinated, redeemable 5-year debentures with non-viability write-down features, aiming to raise up to LKR 15bn. The initial issue is 5bn and Bank retains the option to issue an additional LKR 10bn in the event of oversubscription. The issue comprises two types of debentures: Type A offers a fixed annual interest rate, while Type B provides a floating rate with payments to be made annually. The primary objectives of this issuance are to enhance Tier 2 capital, manage and minimize the gap exposure in the Bank's asset/liability portfolios and strengthen the Bank's liquidity position.

Relative Seniority/Subordination Of Instrument The claims of the debenture holders shall, in the event of the winding up of the Bank rank after all the claims of depositors and holders of senior debt and claims of secured and other unsecured creditors of the Bank and any preferential claims under any Statutes governing the Bank but shall rank in priority to and over the claims and rights of the Shareholder of the Bank.

Credit Enhancement Repayment of the principal sum and interest on these debentures not being secured by any specific asset of Bank of Ceylon.

LRA

Financials (Summary) in LKR mln

Lanka Rating Agency	LKR mln	LKR mln	LKR mln	LKR mln
Bank of Ceylon	**Mar-24**	**Dec-23**	**Dec-22**	**Dec-21**
Licensed Commercial Bank	**3M**	**12M**	**12M**	**12M**
A BALANCE SHEET				
1 Stage I | Advances - net	1,642,713	1,776,333	1,947,217	2,146,079
2 Stage II | Advances - net	308,102	309,345	247,801	139,892
3 Stage III | Advances (NPLs)	314,942	311,863	324,630	251,158
4 Stage III | Impairment Provision	(187,773)	(188,480)	(194,054)	(123,366)
5 Investments	1,781,537	1,770,573	1,636,870	1,118,197
6 Debt Instruments	2,177	2,132	3,428	4,132
7 Other Earning Assets	153,446	151,595	88,650	41,860
8 Non-Earning Assets	266,394	278,386	281,918	225,333
Total Assets	4,281,538	4,411,748	4,336,460	3,803,284
6 Deposits	3,718,130	3,882,232	3,334,774	2,866,894
7 Borrowings	220,661	182,568	648,388	691,522
8 Other Liabilities (Non-Interest Bearing)	88,661	95,234	99,113	44,108
Total Liabilities	4,027,452	4,160,034	4,082,276	3,602,524
Equity	254,086	251,715	254,184	200,760
B INCOME STATEMENT				
1 Mark Up Earned	108,589	524,798	456,267	260,513
2 Mark Up Expensed	(82,704)	(433,610)	(329,921)	(149,261)
3 Non Mark Up Income	4,527	9,169	50,396	26,379
Total Income	30,413	100,356	176,742	137,631
4 Non-Mark Up Expenses	(14,618)	(52,257)	(47,296)	(41,681)
5 Provisions/Write offs/Reversals	(3,250)	4,906	(87,156)	(43,734)
Pre-Tax Profit	12,545	53,006	42,290	52,217
6 Taxes	(7,471)	(26,312)	(10,318)	(14,627)
Profit After Tax	5,074	26,694	31,972	37,590
C RATIO ANALYSIS				
1 Performance				
ROE	8.0%	10.6%	14.1%	21.0%
2 Capital Adequacy				
Capital Adequacy Ratio	15.4%	15.8%	15.4%	17.8%
Net Stable Funding Ratio [Available Stable Funding / Required Stable Funding]	157.0%	145.0%	139.0%	125.0%
3 Credit Risk				
Impaired Loan Ratio | [Stage III | Advances (NPLs) - net / Gross Advances]	5.5%	5.1%	5.3%	5.1%
Provision Coverage Ratio | [Impairment Provision / Stage III | Advances (NPLs)]	59.6%	60.4%	59.8%	49.1%

Credit Rating

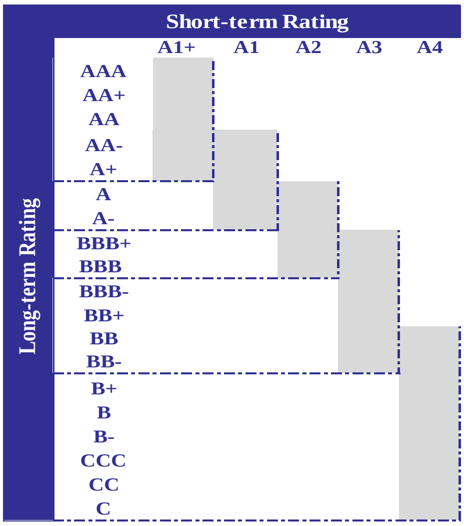
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long-term Rating

Scale	Definition
AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
AA+ AA AA-	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ BBB BBB-	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ BB BB-	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ B B-	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC CC C	**Very high credit risk.** Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

Short-term Rating

Scale	Definition
A1+	The highest capacity for timely repayment.
A1	A strong capacity for timely repayment.
A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.
A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial conditions.
A4	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions. Liquidity may not be sufficient.



**The correlation shown is indicative and, in certain cases, may not hold.*

Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

Rating Watch Alerts to the possibility of a rating change subsequent to, or, in anticipation of some material identifiable event with indeterminable rating implications. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating watch may accompany rating outlook of the respective opinion.

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) the debt instrument is redeemed, c) the rating remains suspended for six months, d) the entity/issuer defaults., or/and e) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

Surveillance. Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.

Note. This scale is applicable to the following methodology(s):

a) Broker Entity Rating
b) Corporate Rating
c) Debt Instrument Rating
d) Financial Institution Rating
e) Holding Company Rating
f) Independent Power Producer Rating
g) Microfinance Institution Rating
h) Non-Banking Finance Companies Rating

Regulatory and Supplementary Disclosure

Nature of Instrument	Size of Issue (LKR)	Tenor	Security	Quantum of Security	Nature of Assets	Trustee	Book Value of Assets as at FY24 (LKR)
Basel III Compliant, Tier 2, Listed, Rated, Unsecured, Subordinated, Redeemable 5 year debentures with Non-viability Write down Feature	15Bn	5 years	Unsecured	N/A	N/A	Hatton National Bank	N/A

Name of Issuer	Bank of Ceylon
Issue Date	August 2024
Maturity	August 2029
Coupon Basis	Annually
Repayment	on maturity
Option	Redeemable

* Note - The issue date is contingent upon receiving approvals from the relevant regulatory bodies. The proportion of Type A and Type B debentures will be determined, and the interest rate will be finalized upon the opening of the issue. The repayment schedule will be disclosed upon the issuance of the debentures.

Regulatory and Supplementary Disclosure

(Rules applicable to Credit Rating Agencies, No. 19 of 2021 - issued on 15th March 2022)

Rating Team Statements
(1) Credit Rating Agency means a body corporate engaged in the business of assessing and evaluating the credit- worthiness of any issuer or a specific issue of securities. https://www.sec.gov.lk/credit-rating-agency/

Conflict of Interest
(2) i. LRA will disclose to the Commission all other business activities it is engaged in at the time of applying for its licence and inform the Commission in writing prior to engaging in any other business activity after obtaining a licence from the Commission. (Section 34 – Rules applicable to Credit Rating Agencies)
(2) ii.LRA will not engage in any other business which in the view of the Commission creates a conflict of interest unless prior written approval of the Commission is obtained. (Section 35 – Rules applicable to Credit Rating Agencies)
(2) iii.In the conduct of any such other business activity, the LRA will ensure that proper processes are in place to have a clear demarcation of the different functions pertaining to such businesses. (Section 36 – Rules applicable to Credit Rating Agencies)

Restrictions
(3) (i) LRA will not be outsource any part of its work, which has a direct bearing on the function of rating. (Section 24 – Rules applicable to Credit Rating Agencies)
(3) (ii) LRA will enter into a written agreement with the party to whom any work is outsourced. Such agreement contains an undertaking from the party to whom any work is outsourced that they shall comply with the laws, rules, and directives that the LRA is bound to follow. (Section 25 – Rules applicable to Credit Rating Agencies)

(4) The LRA will not appoint any individual as a member of the rating committee who:
(a) has a business development function of the Credit Rating Agency; or
(b) who initiates or participates in discussions regarding fees or payments with any Client of the LRA. (Section 28 – Rules applicable to Credit Rating Agencies)

Conduct of Business
(5) Prior to the commencement of a rating or during such process the LRA will not promise, assure or guarantee to a Client that a particular rating will be assigned. (Section 39 – Rules applicable to Credit Rating Agencies)

(6) LRA performs a rigorous and formal periodic review of all its methodologies. Such methodologies will be made available to the Commission for perusal, upon request. (Section 41 – Rules applicable to Credit Rating Agencies)

Independence & Conflict of interest
(7) LRA receives compensation from the entity being rated or any third party for the rating services it offers. The receipt of this compensation has no influence on LRA´s opinions or other analytical processes. In all instances, LRA is committed to preserving the objectivity, integrity, and independence of its ratings.

(8) LRA will not engage in any other business which in the view of the Commission creates a conflict of interest unless prior written approval of the Commission is obtained. (Section 35 – Rules applicable to Credit Rating Agencies)

(9) LRA will structure its rating teams and processes to promote continuity, consistency and avoid bias in the rating process. (Section 47 – Rules applicable to Credit Rating Agencies)

Monitoring and review
(10) For purposes of transparency the LRA will publish sufficient information about an entity/security rated, frequency of default and whether a rating grade assigned has changed over time. The definitions and computation methods for the default rates stated in the default studies shall also be disclosed. (Section 44 – Rules applicable to Credit Rating Agencies)

LRA maintain the following records pertaining to Clients:
(a) all internal records to support its credit rating opinions;
(b) all particulars relating to Clients at its office which shall include the name and registered address and contact numbers of such Client, names and addresses of their directors as at the date of rating, its issued share capital and the nature of business; and
(c) a written record of all complaints received from Clients and action taken thereon by the LRA. (Section 48 – Rules applicable to Credit Rating Agencies)

(11) LRA maintains confidentiality of all non-public information entrusted to it by Clients at all times including such Client's identity and transactions carried out for such Client unless and to the extent such disclosure is required by law, or unless authorised by the Client to disclose such information. (Section 50 – Rules applicable to Credit Rating Agencies)

(12) LRA does not destroy, conceal or alter any records, property or books relating to the business of the Credit Rating Agency which are in its possession or under its control with the intention of defeating, preventing, delaying or obstructing the carrying out of any examination (Section 53 – Rules applicable to Credit Rating Agencies)

Probability of Default
(13) LRA's Rating Scale reflects the expectation of credit risk. The highest rating has the lowest relative likelihood of default (i.e., probability).

Proprietary Information