Lanka Rating Agency

Rating Report

Regional Development Bank

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Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
17-Jan-2024	BBB+	-	Stable	Initial	-

Rating Rationale and Key Rating Drivers

The rating reflects sovereign ownership of the bank, its well-established network and adequate performance over the years. The rating is constrained by relatively high non-performing loans, stretched capital (Tier 1 capital) and the Bank's exposure to economically vulnerable segments based on its mandate. Regional Development Bank ("RDB" or "the Bank") is a state-owned Licensed Specialized Bank (LSB) in Sri Lanka, operating with the mandate of economic development by granting financial assistance to Microfinance Institutions and Small & Medium Enterprises. The Bank provides loans to Industry, Commercial, Agriculture and Individual segments. As at End-Sep'23, the Bank's Non-Performing loans (NPLs) increased to ~13.42% (CY22: ~9.66%), surpassing the Industry average of ~10.1%, reflecting higher credit risk. A sizable portion of the Bank's GLP is represented by securitized loans, i.e., pawning (~22% in 9MCY23), which has low infection ratio. The Bank's earnings profile is represented by adequate net interest spreads. However, impairment charges and implementation of increased VAT on Financial services exerted pressure on the net profitability of the Bank. RDB follows a cautious approach towards repricing its assets especially amid changing interest rate environment, given its specified mandate. Alternatively, the Bank strategizes on investing in Government Securities to augment the asset yields and maintain the target spread. RDB's funding mix, on the other hand, is dominated by short-term fixed & saving deposits, largely granular in nature with a depositor base of over ~6.8mln. With the average cost of funds between 10%-12%, the Bank intends to sustain its core spread between 4% - 5%. RDB's Tier-1 capital adequacy ratio (CAR) remains stretched and stands at 8.72% in 9MCY23. During CY22, Tier-1 capital dropped below the 8.5% minimum regulatory requirement to 8.29%. Meanwhile, total CAR remained well above the regulatory benchmark of 12.5% (16.1% in 9MCY23). In terms of liquidity, the Bank remains compliant with the CBSL's statutory liquidity requirements, however liquid assets as a percentage of the Bank's funding base (deposits + borrowings) remained relatively low at ~29% in 9MCY23 (27% in CY22). The Bank's overall performance remained satisfactory during 9MCY23 as it posted a PAT of LKR~518mln during 9MCY23 (LKR~241mln in 9MCY22).

The rating is dependent on improving asset quality and profitability indicators of the Bank. Similarly, sustaining and strengthening capital profile of the Bank is important. Any adverse impact on capital and related regulatory ratios resulting in regulatory breach would have negative rating repercussions. Moreover, the Bank’s progress on meeting its earning targets, asset quality and having strong governance framework is critical.

Disclosure

Name of Rated Entity	Regional Development Bank
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Financial Institution Rating(Jun-22)
Related Research	Sector Study | Commercial Bank (Sep-23)
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Profile

Structure The Regional Development Bank ("RDB" or "the Bank") was established under the Pradeshiya Sanwardana Bank Act No. 41 of 2008 as a fully state-owned national level bank. The registered office of the Bank is located at No 933, Kandy Road, Wedamulla, Kelaniya.

Background In 1985, seventeen banks were founded at the district level categorized as Regional Rural Development Banks. In 1997, these banks were merged into six provincial level Banks. This collective transformation in 2010 resulted in the establishment of a national-level development bank known as the Pradeshiya Sanwardana Bank (Regional Development Bank or RDB).

Operations The main focus of the Bank revolves around fostering the comprehensive economic development of Sri Lanka. The primary mechanism for this support is through the provision of financial assistance to Microfinance Institutions and Small & Medium Enterprises.

Ownership

Ownership Structure RDB is 100% state-owned (directly and indirectly) with the Ministry of Finance having a stake of 94% and the three public sector banks (Bank of Ceylon, People's Bank & National Savings Bank) holding 2% each.

Stability The bank's ownership has remained stable, with government maintaining its 94% ownership along with the other three major banks.

Business Acumen The Government of Sri Lanka provides RDB with industry specific working knowledge and strategic thinking capabilities as the major shareholder. As per the RDB's Bank Act, Deputy Secretary to the Treasury ("DST") and the General Manager (GM) are required to be a member of the Board of Directors, which implies industry-specific working knowledge to be in place.

Financial Strength The Government Treasury of Sri Lanka has taken strategic financial actions in the past to support the Bank, where needed. This indicates that the Government follows a proactive approach to address the financial challenges of the Bank, where needed.

Governance

Board Structure The Bank has a board of nine (9) Non-Executive directors, out of which five (5) members are Independent directors. The Secretary to the Treasury nominates the Chairman and the other directors. The appointment is done through the Ministry of Finance, while four (4) Directors are nominated as ex-officio by the shareholders representing the General Treasury, Bank of Ceylon, People's Bank and National Savings Bank.

Members' Profile The Chairman of the Bank, Mr. W.A.D.S.Gunasinghe, has served in a number of Ministries in various posts. He was appointed to the Board of Directors on the 30th of October 2023.

Board Effectiveness The board has formed six board sub-committees, namely Integrated Risk Management Committee, Audit Committee, Human Resource & Remuneration Committee, Nomination Committee, Credit Committee and IT Committee.

Financial Transparency The External Auditors of the Company, The National Audit Office, issued an unqualified audit opinion pertaining to the Annual Financial Statements for CY22.

Management

Organizational Structure All departments of the Bank report to the Chief Executive Officer ("CEO")/General Manager ("GM"), through their respective Deputy General Managers ("DGM").

Management Team The management team is headed by the CEO/GM, Mr. P.S.Edirisuriya was appointed as acting CEO/GM. He joined RDB in January 2017. Mr Edirisuriya possesses over 31 years of experience in different fields.

Effectiveness The Bank has formed three management committees, namely, Assets and Liabilities Committee, Operational Risk Management Sub Committee and IT Steering Committee.

MIS The Bank uses Intellect CBS Banking System as the core operating system. It also has separate systems for HR, Debt collection, internal and Card Centre reported issues and other services. Currently, the Bank has only counters and ATMs for the customers to do their day-to-day transactions.

Risk Management Framework The Bank has a risk management framework based on the three lines of defence model. The Board of Directors of the Bank own the final responsibility in the overall risk management of the Bank.

Business Risk

Industry Dynamics The Banking Sector comprises of 30 banks, out of which 24 are Licensed Commercial Banks (LCBs) and 6 are Licensed Specialized Banks (LSBs). As at Sep'23, the Banking Sector recorded an asset base of LKR~19.8trn, out of which ~12% pertained to the LSBs. The asset base of LSBs increased by ~5% during 9MCY23. The Banking Sector recorded Loans and Advances of LKR~9.8trn as at Sep'23, a decline of ~6% from CY22. LSBs account for ~9% of the Banking Sector's Loans and Advances.

Relative Position RDB is considered a medium-sized LSB having 272 branches and a share of ~12% in the total deposits of LSBs and ~23% in the Loans and Advances of LSBs (Sep'23). RDB is considered the 2nd largest LSB following National Savings Bank (NSB).

Revenues The Bank earned a Net Interest Income ("NII") of LKR~15.6bn during CY22, which is a ~15% increase from the previous year. During 9MCY23, the Bank earned LKR~12.01bn, an ~8% increase from 9MCY22. The interest expense increased by a sizable amount during CY22 to LKR~19bn which (~99% increase from CY21), while the interest income increased by ~50% to LKR~36bn during CY22. During 9MCY23, the Bank surpassed its revenue targets and Markup Income was recorded at LKR~35bln.

Performance The Bank recorded an operating profit of LKR~1,998mn in CY22, a 4% rise from the previous year (CY21: LKR~1,926mn). However, due to the Tax implications mainly on VAT and SSCL, PBIT dropped by ~54% from LKR~775mn in CY21 to LKR~359mn in CY22. Owed to a large deferred tax reversal, the Bank earned PAT of LKR~1,349Mn in CY22 which was LKR~306Mn in CY21. In 9MCY23, PBT of LKR~681mn and PAT of LKR~517mn was recorded while during 9MCY22, it was LKR~884mn and LKR~241mn respectively.

Sustainability The Bank plans to implement stringent recovery mechanism from 2HCY23 onwards, in order to contain the rising NPLs in its Loans and Advances. The Bank also intends to rationalize its investment avenues in order to meet its spreads and earnings targets for CY24. SME financing shall be given special consideration while increasing digital footprint is another strategy on the cards to reach a higher customer base.

Financial Risk

Credit Risk The Bank's Gross NPLs increased from ~9.66% in CY22 to ~13.42% in 9MCY23, higher than the Industry average of ~10.1%. It was as a result of the Stage-III loans increasing by ~37% in 9MCY23, while the Loan Portfolio decreased by ~0.1% during the same period. The Net NPLs increased from ~6.53% in CY22 to ~8.93% in 9MCY23.

Market Risk The Bank's investment portfolio mainly consists of Investment in government securities which represented 60% of the total investment in 9MCY23. The share has increased significantly during 9MCY23 by ~352% from CY22. Investment in Fixed deposits reduced by ~52% during 9MCY23 from CY22.

Liquidity And Funding The Bank is more dependent on deposits for its funding as it constituted ~82% (LKR~221bn) of the funding base as at 9MCY23 (CY22: ~82% (LKR~210bn). The borrowings represent ~18% (LKR~49bn) of the funding as at 9MCY23 (CY22: ~18% (LKR~47bn). In regards to liquidity, the bank monitors and maintains the liquidity movements through regular cash flow forecasts, Statutory Liquid Asset Ratio ("SLAR") and Liquidity Coverage Ratio ("LCR") assuring that they are above the central bank stipulated levels. The bank's liquid assets mainly consist of cash, balances with banks and government securities.

Capitalization As per the CBSL capital adequacy requirements for Licensed Specialized Banks it is required to maintain, at all time, minimum Tier-1 capital of 8.5% and Total capital ratio of 12.5%. The RDB's Tier 1 capital ratio stood at 8.29% in CY22 (CY21: 9.26%) while total capital ratio clocked at 15.22% in CY22 (CY21: 13.16%). Even though Tier-1 capital ratio did not comply with the minimum requirement in CY22, it rebounded to 8.72% during 9MCY23.

LRA

Financials (Summary) in LKR mln

Lanka Rating Agency

Regional Development Bank Public Limted	Sep-23	Dec-22	Dec-21	Dec-20
	9M	12M	12M	12M
A BALANCE SHEET				
1 Stage I | Advances - net	133,819	146,906	127,122	114,512
2 Stage II | Advances - net	42,966	37,045	30,012	21,977
3 Stage III | Advances (NPLs)	28,887	20,656	25,466	27,078
4 Stage III | Impairment Provision	(9,662)	(6,599)	(7,370)	(6,873)
5 Investments	51,895	11,487	4,814	3,771
6 Debt Instruments	655	624	624	1,026
7 Other Earning Assets	34,272	59,104	56,017	50,604
8 Non-Earning Assets	15,713	16,171	9,205	9,014
Total Assets	298,544	285,395	245,890	221,109
6 Deposits	221,181	210,301	187,752	172,883
7 Borrowings	49,060	47,471	31,501	23,797
8 Other Liabilities (Non-Interest Bearing)	11,260	11,397	11,243	9,316
Total Liabilities	281,501	269,169	230,496	205,995
Equity	17,043	16,226	15,393	15,114
B INCOME STATEMENT				
1 Mark Up Earned	35,052	35,273	23,545	23,182
2 Mark Up Expensed	(23,038)	(19,640)	(9,893)	(12,294)
3 Non Mark Up Income	979	929	947	1,172
Total Income	12,993	16,563	14,599	12,060
4 Non-Mark Up Expenses	(8,972)	(11,712)	(9,416)	(7,988)
5 Provisions/Write offs/Reversals	(1,876)	(2,852)	(3,257)	(2,011)
Pre-Tax Profit	2,146	1,998	1,927	2,060
6 Taxes on Financial Services	(1,464)	(1,639)	(1,151)	(1,047)
Profit Before Income Taxes	682	359	776	1,013
7 Income Taxes	(165)	990	(469)	(609)
Profit After Tax	517	1,350	306	404
C RATIO ANALYSIS				
1 Revenues				
Advances' Yield	15.8%	13.0%	11.8%	13.1%
Net Interest Margin	1.4%	3.2%	6.2%	5.1%
Minimum Lending Rate Margin	-5.4%	-4.0%	-1.0%	-1.3%
2 Performance				
Cost of Funds [Mark Up Expensed / Average (Deposits + Borrowings)]	11.6%	8.2%	4.8%	6.6%
ROE	4.1%	8.5%	2.0%	2.7%
3 Capital Adequacy				
Capital Adequacy Ratio	16.1%	15.2%	14.3%	14.9%
Net Stable Funding Ratio [Available Stable Funding / Required Stable Funding]	101.0%	101.0%	127.0%	143.0%
4 Funding & Liquidity				
Liquid Assets / (Deposits + Borrowings Net of Repo)	29.2%	26.1%	25.4%	25.3%
Demand & Saving Deposit Coverage Ratio	1.0	1.7	1.2	1.2
Top 20 Deposits / Deposits	8.0%	7.4%	9.1%	11.2%
5 Credit Risk				
Impaired Loan Ratio | [Stage III | Advances (NPLs) / Gross Advances]	13.5%	9.7%	13.5%	16.3%
Provision Coverage Ratio | [Impairment Provision / Stage III | Advances (NPLs)]	33.4%	31.9%	28.9%	25.4%

Credit Rating

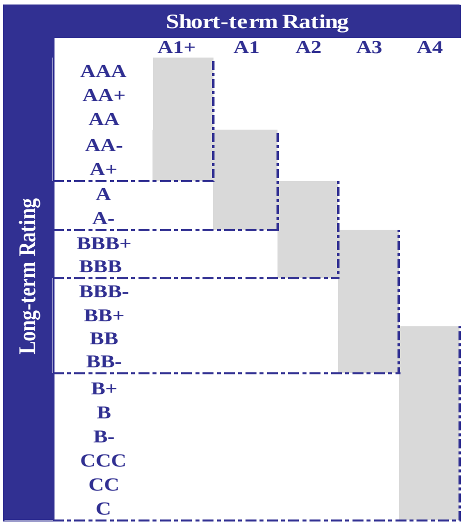
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

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

(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