Lanka Rating Agency

# Rating Report

## State Mortgage & Investment Bank

**Report Contents**



**Rating History**

| Dissemination Date | Long Term Rating | Short Term Rating | Outlook | Action | Rating Watch |
|---|---|---|---|---|---|
| 20-Nov-2023 | BBB | - | Stable | Initial | - |

**Rating Rationale and Key Rating Drivers**

The rating of the State Mortgage and Investment Bank (SMIB or The Bank) reflects 100% ownership of the Government of Sri Lanka. Over the years, the bank's Net Interest Margin (NIM) has been well above the sector margins, however, it has gradually decreased to 0.51% while the sector NIM was recorded at 2.3% in 6MCY23. Due to a significant increase in interest expenses and lagged repricing of the advances portfolio, profitability indicators declined and resulted in a loss in 6MCY23. The bank's Non-Performing Loans (NPL) remained on the higher levels over the past with 21.17% in 6MCY23. The overall high NPLs are due to the sizeable composition of EPF loans which is indicated through the NPL ratio excluding EPF reporting at 12.62% in 6MCY23. Nevertheless, the rating takes comfort in the ability to recover the default amount against the borrower's EPF balance. Despite the decline in profitability, the bank recorded healthy capital adequacy ratios (CAR) where it reported Tier 1 and Total capital adequacy ratios at 18.36% and 20.41% respectively in CY22 compared to the regulatory requirement of 8.5% and 12.5%. However, the bank's minimum core capital is below the LKR 7.5Bn regulatory requirement which the bank is expected to comply with or get an extension of three years as soon as possible.

The rating is dependent on asset quality, profitability indicators, and the capitalization of the bank. The bank's continuous ability to meet regulatory requirements will remain key. Any further weakening of profitability levels and delay in meeting regulatory capital requirements will have a negative effect on the rating.

**Disclosure**

| | |
|---|---|
| **Name of Rated Entity** | State Mortgage & Investment 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 (Dec-22) |
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## Profile

**Structure** State Mortgage and Investment Bank (SMIB or The Bank) is a government-owned bank established under State Mortgage and Investment Bank Law No. 13 of 1975. The Bank was recognized as a Licensed Specialized Bank (LSB) and the license was issued by the Central Bank of Sri Lanka on 27th April 1998 in terms of the Banking Act No. 30 of 1988.

**Background** SMIB was inaugurated as the Ceylon State Mortgage Bank (CSMB) in 1931 by Ordinance No. 16 of 1931. SMIB formed by amalgamating the Ceylon State Mortgage Bank and the Agricultural and Industrial Credit Corporation established in 1943. The bank commenced its operation on 1st January 1979.

**Operations** The Bank's Principal operations consist of promoting housing, agricultural and industrial development finance and mobilization of deposits. SMIB operates 25 branches as of CY22, with a staff strength of 387.

## Ownership

**Ownership Structure** 100% of shares owned by government of Sri Lanka and all directors are appointed by the relevant line of Ministry as stipulated in the State Mortgage and Investment Bank Law No. 13 of 1975.

**Stability** SMIB as one of the state-owned specialized banks is of strategic importance to the Government of Sri Lanka (GOSL). The bank's ownership has remained stable, with the government maintaining its 100% ownership since 1979.

**Business Acumen** Since the Bank comes directly under the purview of the Ministry of Finance, Economy, and Policy Development, SMIB stands to gain industry-specific knowledge from the government.

**Financial Strength** There was no capital infusion by the Government of Sri Lanka to date even though there was a proposal to inject equity by CY22 in order to meet the capital shortfall of 1.7Bn.

## Governance

**Board Structure** SMIB's Board of Directors is appointed by the Ministry of Finance, Economy and Policy Development as stipulated in the State Mortgage and Investment Bank Law No. 13 of 1975. The Bank has a board of five Non-Executive directors and all the members are Independent directors.

**Members' Profile** The Chairman of the Bank Mr. J.M. Soosaithasan is a fellow member of the Chartered Institute of Management Accountants and has over 25 years of experience in apparel manufacturing, the leisure sector in Sri Lanka and overseas. The other members of the board hold decades of experience and qualifications in fields such as legal, finance, and banking.

**Board Effectiveness** The board has formed four board sub committees, namely, Board Integrated Risk Management Committee (BIRMC), Board Audit Committee (BAC), Board Nomination Committee (BNC), Board Human Resources and Remunerations Committee (BHRRC).

**Financial Transparency** The external auditors of the company, the National Audit Office, issued an unqualified audit opinion pertaining to annual financial statements for CY22.

## Management

**Organizational Structure** The management of the Bank is overseen by the Board of Directors through CEO and Board Committees. All departments of the Bank report to the Chief Executive Officer (CEO)/ General Manager (GM), through its respective Deputy General Managers (DGM).

**Management Team** The management team is headed by the CEO/General Manager, Mr. I.T. Asuramanna. He was appointed in July 2022 and has over 23 years of experience in finance management and in various sectors. The CEO is supported by a large team of DGMs and Assistant General Managers (AGM).

**Effectiveness** The Bank has formed six management committees, namely, Executive Credit Committee (ECC), Asset Liability Management Committee (ALCO), Marketing Committee (MC), Product Development Committee (PDC), Recovery Committee (RC), Executive Integrated Risk Management Committee (EIRMC).

**MIS** SMIB currently uses an in-house developed core banking system using AS400. The entire business operation is handled and managed through this AS 400 system.

**Risk Management Framework** The Bank has a risk management framework based on the three lines of defense model. The BIRMC advises the Board of Directors on risk-related matters.

## Business Risk

**Industry Dynamics** The banking sector comprises 30 banks, out of which 24 are commercial banks and 6 are specialized banks. As of 6MCY23, the sector recorded an improvement in assets, investments, and deposits compared to the same quarter of the previous year. However, sector loans and advances and profitability deteriorated compared to previous year.

**Relative Position** SMIB being a small sized bank with only 25 branches, it holds 4% and 2% of the licensed specialized banking sector advances and deposits respectively as at 6MCY23.

**Revenues** The bank's interest expenses increased by a sizable amount by 171% to 4.65bn in 6MCY23 and interest income increased by 64% to 4.93bn in 6MCY23 compared to the same quarter of the previous year. However, the net interest income dropped by 77% to 296Mn in 6MCY23. Due to the significant increase in interest expenses and not repricing their advances portfolio its profitability reduced and ended up in a loss of 701Mn in 6MCY22. The bank's core spread is -7.2% in 6MCY23. Over the years, Net Interest Margin ("NIM") of SMIB has gradually decreased and stood at 0.51% in 6MCY23, while the sector NIM recorded at 2.3% in the same period. However, the bank's NIM was well above the sector margins over the periods from CY20 to CY22 and only during CY23 it went below the sector margin.

**Performance** The profitability of the bank dropped by 29% to LKR 252mn in CY21. However, the performance dropped further by 20% to LKR 201mn in CY22. It was a result of the high interest expenses due to the high interest rate environment. Its cost of funds increased significantly in 6MCY23 to 18.5% (6MCY22: 7.4%), as a result of the interest expense increasing rapidly compared to CY22. The ROA and ROE have declined in comparison to the previous financial years, as a result of the lower profits and losses in comparison to the previous financial years.

**Sustainability** The bank is in the process of implementing a state-of-the-art core banking and infrastructure upgrade which the bank plans to launch in mid of next year (2024). Along with the core banking solution and infrastructure upgrade, real-time fund transfers and ATM network connectivity will be available for SMIB customers as the initial step of moving to digital products.

## Financial Risk

**Credit Risk** The gross stage 3 loans/total advances are recorded at 21.17% as of 6MCY23 compared to 19.33% in CY22. EPF loans contribute significantly to the overall high NPLs which is around 60% of stage 3 loans, as most borrowers expect the bank to recover loan liabilities out of EPF balances. As a result, the Gross NPL excluding EPF stood at 12.62% in 6MCY23.

**Market Risk** The bank increased its investments in debt and other instruments during 6MCY23 to 9.8Bn and the increase was due to high investments in government securities. The Government securities have remained at over 95% of its investments since CY20.

**Liquidity And Funding** The bank is more dependent on its deposits as it constitute almost 99% of the funding as of 6MCY23. The bank has maintained the Statutory Liquid Asset Ratio (SLAR) of 34.62% in CY22 whereas the Central Bank stipulated requirement is 20%.

**Capitalization** The bank's common equity Tier 1 capital ratio stands at 18.36% and the Total capital ratio was 20.41% in CY22 while Central Bank capital adequacy requirements for Licensed Specialized banks are 8.5% and 12.5% respectively. However, the minimum regulatory capital requirement as per CBSL is 7.5bn, whereas, SMIB has a capital shortfall of 1.7bn. The Bank is expecting an extension of three years to meet this capital requirement.

Financials (Summary) in LKR mln

Lanka Rating Agency

LKR mln

| State Mortgage and Investment Bank<br>Licensed Specialized Bank | Jun-23<br>6M | Dec-22<br>12M | Dec-21<br>12M | Dec-20<br>12M |
|---|---|---|---|---|
| **A BALANCE SHEET** | | | | |
| 1 Stage I \| Advances - net | 25,945 | 28,035 | 27,784 | 26,479 |
| 2 Stage II \| Advances - net | 3,707 | 3,284 | 2,410 | 1,999 |
| 3 Stage III \| Advances (NPLs) | 9,405 | 9,055 | 8,895 | 9,146 |
| 4 Stage III \| Impairment Provision | (1,371) | (1,106) | (987) | (766) |
| 5 Investments | 9,864 | 2,580 | 2,023 | 2,442 |
| 6 Debt Instruments | - | - | - | - |
| 7 Other Earning Assets | 8,641 | 13,002 | 11,775 | 11,812 |
| 8 Non-Earning Assets | 2,177 | 2,115 | 1,423 | 1,692 |
| Total Assets | 58,369 | 56,965 | 53,323 | 52,802 |
| 6 Deposits | 51,306 | 49,140 | 45,738 | 45,388 |
| 7 Borrowings | 54 | 301 | 302 | 415 |
| 8 Other Liabilities (Non-Interest Bearing) | 1,302 | 1,049 | 999 | 978 |
| Total Liabilities | 52,661 | 50,490 | 47,039 | 46,782 |
| Equity | 5,708 | 6,474 | 6,284 | 6,020 |
| **B INCOME STATEMENT** | | | | |
| 1 Mark Up Earned | 4,953 | 7,402 | 5,254 | 6,077 |
| 2 Mark Up Expensed | (4,657) | (5,463) | (2,951) | (3,960) |
| 3 Non Mark Up Income | 37 | 115 | 172 | 184 |
| Total Income | 333 | 2,054 | 2,474 | 2,300 |
| 4 Non-Mark Up Expenses | (781) | (1,540) | (1,490) | (1,239) |
| 5 Provisions/Write offs/Reversals | (253) | (366) | (362) | (270) |
| Pre-Tax Profit | (701) | 148 | 621 | 790 |
| 6 Taxes | - | 53 | (368) | (434) |
| Profit After Tax | (701) | 202 | 253 | 356 |
| **C RATIO ANALYSIS** | | | | |
| **1 Revenues** | | | | |
| Advances' Yield | 15.8% | 11.9% | 11.9% | 13.5% |
| Spread \| Asset Yield - Cost of Funds | 2.4% | 4.8% | 5.7% | 5.6% |
| **2 Performance** | | | | |
| Cost of Funds [Mark Up Expensed / Average (Deposits + Borrowings)] | 18.5% | 11.4% | 6.4% | 8.6% |
| ROE | -23.0% | 3.2% | 4.1% | 5.9% |
| **3 Capital Adequacy** | | | | |
| Capital Adequacy Ratio | 22.9% | 22.3% | 22.6% | 20.9% |
| Net Stable Funding Ratio [Available Stable Funding / Required Stable Funding] | 122.0% | 104.0% | 136.0% | 138.0% |
| **4 Funding & Liquidity** | | | | |
| Liquid Assets / (Deposits + Borrowings Net of Repo) | 36.2% | 31.8% | 30.2% | 31.5% |
| Demand & Saving Deposit Coverage Ratio | 0.4 | 0.3 | 0.3 | 0.3 |
| Top 20 Deposits / Deposits | 37.1% | 34.5% | 37.1% | 37.4% |
| **5 Credit Risk** | | | | |
| Impaired Loan Ratio \| [Stage III \| Advances (NPLs) / Gross Advances] | 23.7% | 22.0% | 22.5% | 24.1% |
| Provision Coverage Ratio \| [Impairment Provision / Stage III \| Advances (NPLs)] | 14.6% | 12.2% | 11.1% | 8.4% |

## Credit Rating

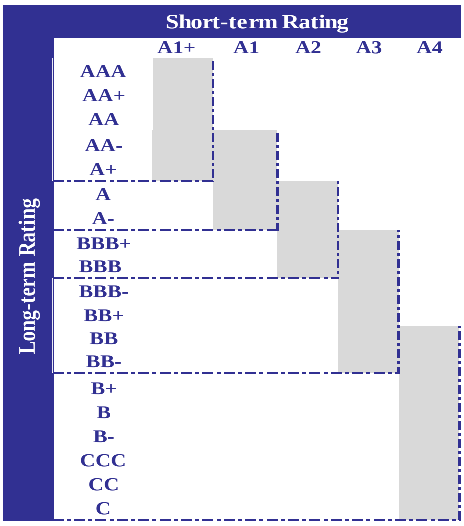
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

### 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+<br>AA<br>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+<br>A<br>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+<br>BBB<br>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+<br>BB<br>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+<br>B<br>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<br>CC<br>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**