



## RATING ACTION COMMENTARY

# Fitch Assigns Merchant Bank of Sri Lanka & Finance First-Time Rating of 'BBB+(lka)'; Outlook Stable

Thu 22 Feb, 2024 - 1:29 AM ET

Fitch Ratings - Mumbai - 22 Feb 2024: Fitch Ratings has assigned Merchant Bank of Sri Lanka & Finance PLC (MBSL) a first-time National Long-Term Rating of 'BBB+(lka)'. The Outlook is Stable.

MBSL is 84.5% owned by Bank of Ceylon (BOC, A(lka)/Stable) and other BOC group entities. BOC is the largest banking group in the country.

## KEY RATING DRIVERS

**Shareholder Support Drives Ratings:** MBSL's rating is driven by our view that the parent, BOC, would provide extraordinary support to MBSL, if required. BOC's ability to support MBSL is reflected in its credit profile, which is underpinned by its standalone strength. We believe that any required support for MBSL would be manageable relative to BOC's financial capacity.

Our support assessment also takes into consideration BOC's majority shareholding in MBSL, increasing product offerings by MBSL that are complementary to those provided by BOC, the parent's oversight of MBSL's policies and strategy through board representation, and the usage of the BOC brand by MBSL in its business operations, which raises reputational risk for BOC should MBSL default.

**Limited Importance to Parent:** MBSL is rated two notches below BOC due to its limited importance to the group. MBSL mainly serves high-yielding, under-banked segments that have limited overlap with BOC's core customer base, but this is partly offset by BOC's focus on increasing merchant banking via MBSL to strengthen group fee-based revenue. MBSL made up 0.8% of BOC's consolidated assets at end-September 2023, and makes negligible

contribution to group profitability. MBSL also has considerable management independence and there is limited operational integration between the entities.

**Weak Standalone Profile:** We assess MBSL's standalone credit profile as being weaker than its support-driven rating because of its small franchise with 1.8% market share of sector loans, evolving business model, and weak financial profile, which is reflected in its poor asset-quality metrics, weak profitability and high leverage. MBSL focuses on vehicle leasing, and gold- and property-backed loans. It has a high risk profile stemming from its significant exposure to borrower segments that are highly susceptible to economic and interest rate cycles.

**Stabilising Economic Outlook:** We expect the operating environment for Sri Lankan finance and leasing companies (FLCs) to continue to stabilise following the inflation and interest-rate shocks over the past two years. Easing inflation and interest-rate pressures should provide steadier conditions for FLC sector performance. Some headwinds linger, as higher taxes will continue to weigh on household finances in 2024. Investor confidence will also take time to recover. Nonetheless, we expect economic activity in Sri Lanka to improve in the financial year ending March 2025 as GDP growth recovers.

**Asset Quality Pressure:** The company's loans that are more than three months past due were high at 25.3% of total loans at end-September 2023 (end-2022: 24.3%) due to its high risk profile. Nonetheless, MBSL's focus on bad debt recovery has resulted in a decline in the non-performing loan ratio from a much higher level in previous years. We expect a pick-up in borrowers' business activity and declining interest rates to aid loan collections in the medium term.

**Weaker Profitability:** MBSL's pre-tax profit/average asset ratio was low at 0.9% in 9M23 and -0.9% in 2022, primarily due to the sharp reduction in its net interest margin and increase in operating costs on lower business volumes. We expect MBSL's profitability to improve in the near to medium term, though it will likely remain weaker than that of peers, as its lending operations pick up, borrowing costs decline, and bad debt recovery improves.

**History of Capital Shortfalls:** MBSL's capital adequacy ratio (CAR) rose to 16.9% (equity Tier 1 ratio at 13.4%) by end-September 2023 from 12.3% (11.7%) at end-2022, and against the regulatory minimum CAR of 12.5%. MBSL suffered significant capital shortfalls in 2020, with CAR at end-2020 of 5.6% below the minimum required 10.5% due to losses. BOC injected equity into MBSL in 2021 to improve its capitalisation. The breaches resulted in the regulator limiting MBSL's deposit and lending balances, which affected its business franchise. The caps were removed after its capital ratios increased.

The recent improvement in CAR was due to significant reduction in total gross loans, an increase in gold loans, which carry lower risk weights, in the lending mix, and an increase in Tier 2 capital. We expect capitalisation pressure to ease in the medium term due to improved profitability prospects.

## **RATING SENSITIVITIES**

### **Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade**

MBSL's rating is sensitive to changes in BOC's credit profile, as reflected in BOC's National Long-Term Rating, as well as Fitch's opinion around BOC's ability and propensity to extend timely extraordinary support. Developments that could lead to a downgrade include:

- meaningful reduction in the parent's ownership, control or influence that could weaken its propensity to support the subsidiary
- notable decline in MBSL's capital buffers, indicating reduced timeliness in financial support to back growth or meet regulatory norms
- insufficient or delayed liquidity support from the parent relative to MBSL's needs, which hinders MBSL's ability to meet its obligations in a timely manner
- sustained weak performance of MBSL that we believe will weaken the parent's propensity to support the subsidiary
- a material increase in size relative to the parent that makes extraordinary support more onerous for the parent.

### **Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade**

An upgrade is less likely in the near term. However, a significantly greater strategic role for MBSL within the BOC group, along with closer integration with BOC across broader functional areas and greater sharing of the BOC brand name besides the operational usage of brand, could be positive for the rating in the long term.

### **Date of Relevant Committee**

19 February 2024

### **REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING**

The principal sources of information used in the analysis are described in the Applicable Criteria.

## PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

The rating is linked to rating on the parent, BOC.

### RATING ACTIONS

ENTITY / DEBT ↕	RATING ↕
Merchant Bank of Sri Lanka & Finance PLC	Natl LT    BBB+(lka) Rating Outlook Stable
	New Rating

[VIEW ADDITIONAL RATING DETAILS](#)

## FITCH RATINGS ANALYSTS

### Siddharth Goel

Director

Primary Rating Analyst

+91 22 4000 1760

siddharth.goel@fitchratings.com

India Ratings and Research Private Limited

Wockhardt Tower, West Wing, Level 4 Bandra Kurla Complex, Bandra East Mumbai

400051

### Waruni Perera

Associate Director

Secondary Rating Analyst

+94 11 7066 613

waruni.perera@fitchratings.com

### Jonathan Lee

Managing Director

Committee Chairperson

+886 2 8175 7601

jonathan.lee@fitchratings.com

## **MEDIA CONTACTS**

### **Vivian Kam**

Hong Kong

+852 2263 9612

vivian.kam@thefitchgroup.com

### **Kyoshi Quyn**

Colombo

+94 11 7066 606

kyoshi.quyn@fitchratings.com

This report was prepared by Fitch in English only. The company may prepare or arrange for translated versions of this report. In the event of any inconsistency between the English version and any translated version, the former shall always prevail. Fitch is not responsible for any translated version of this report.

Additional information is available on [www.fitchratings.com](http://www.fitchratings.com)

## **PARTICIPATION STATUS**

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer's available public disclosure.

## **APPLICABLE CRITERIA**

[National Scale Rating Criteria \(pub. 22 Dec 2020\)](#)

[Non-Bank Financial Institutions Rating Criteria \(pub. 18 Jan 2024\) \(including rating assumption sensitivity\)](#)

## **ADDITIONAL DISCLOSURES**

[Solicitation Status](#)

[Endorsement Policy](#)

[Potential Conflicts Resulting from Revenue Concentrations](#)

## **ENDORSEMENT STATUS**

## DISCLAIMER & DISCLOSURES

All Fitch Ratings (Fitch) credit ratings are subject to certain limitations and disclaimers.

Please read these limitations and disclaimers by following this link:

<https://www.fitchratings.com/understandingcreditratings>. In addition, the following <https://www.fitchratings.com/rating-definitions-document> details Fitch's rating definitions for each rating scale and rating categories, including definitions relating to default. ESMA and the FCA are required to publish historical default rates in a central repository in accordance with Articles 11(2) of Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 and The Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019 respectively.

Published ratings, criteria, and methodologies are available from this site at all times. Fitch's code of conduct, confidentiality, conflicts of interest, affiliate firewall, compliance, and other relevant policies and procedures are also available from the Code of Conduct section of this site. Directors and shareholders' relevant interests are available at

<https://www.fitchratings.com/site/regulatory>. Fitch may have provided another permissible or ancillary service to the rated entity or its related third parties. Details of permissible or ancillary service(s) for which the lead analyst is based in an ESMA- or FCA-registered Fitch Ratings company (or branch of such a company) can be found on the entity summary page for this issuer on the Fitch Ratings website.

In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety

of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed. Fitch Ratings makes routine, commonly-accepted adjustments to reported financial data in accordance with the relevant criteria and/or industry standards to provide financial metric consistency for entities in the same sector or asset class.

The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Fitch also provides information on best-case rating upgrade scenarios and worst-case rating downgrade scenarios (defined as the 99th percentile of rating transitions, measured in each direction) for international credit ratings, based on historical performance. A simple average across asset classes presents best-case upgrades of 4 notches and worst-case downgrades of 8 notches at the 99th percentile. Sector-specific best- and worst-case scenario credit ratings are listed in more detail at <https://www.fitchratings.com/site/re/10238496>

The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents

in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001. Fitch Ratings, Inc. is registered with the U.S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (the "NRSRO"). While certain of the NRSRO's credit rating subsidiaries are listed on Item 3 of Form NRSRO and as such are authorized to issue credit ratings on behalf of the NRSRO (see <https://www.fitchratings.com/site/regulatory>), other credit rating subsidiaries are not listed on Form NRSRO (the "non-NRSROs") and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.

dv01, a Fitch Solutions company, and an affiliate of Fitch Ratings, may from time to time serve as loan data agent on certain structured finance transactions rated by Fitch Ratings.

Copyright © 2024 by Fitch Ratings, Inc., Fitch Ratings Ltd. and its subsidiaries. 33 Whitehall Street, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved.

[READ LESS](#)



## **SOLICITATION STATUS**

The ratings above were solicited and assigned or maintained by Fitch at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

## **ENDORSEMENT POLICY**

Fitch's international credit ratings produced outside the EU or the UK, as the case may be, are endorsed for use by regulated entities within the EU or the UK, respectively, for regulatory purposes, pursuant to the terms of the EU CRA Regulation or the UK Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, as the case may be. Fitch's approach to endorsement in the EU and the UK can be found on Fitch's [Regulatory Affairs](#) page on Fitch's website. The endorsement status of international credit ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.