25 April 2022
Equity Research
Sri Lanka

Sovereign default impact on the banking sector

The sovereign default on foreign currency debt will negatively impact the capital adequacy of the banks in our coverage.
However we expect capital buffers to remain intact, which reduces the likelihood of the banks needing to raise additional equity to replenish regulatory capital.

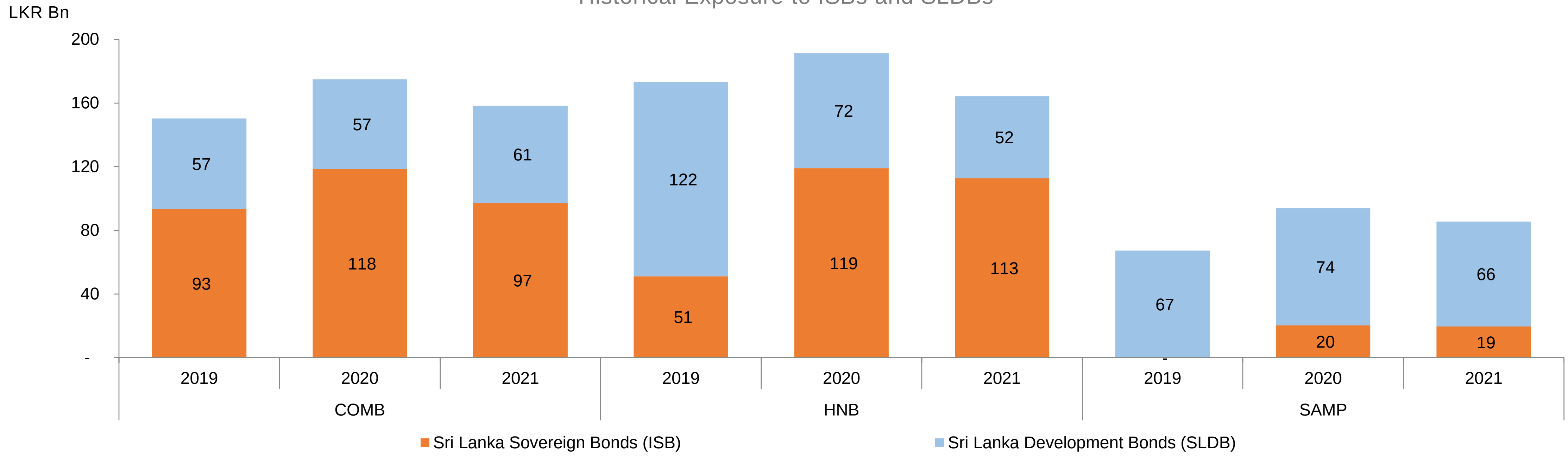
Sri Lanka | Banks

Acuity: Stock Ratings Scale

Acuity rating	Sell	Underweight	Neutral	Overweight	Buy
Equivalent ratings	Strong Sell	Underperform Moderate Sell Weak Hold Reduce	Hold	Outperform Moderate Buy Accumulate Add	Strong Buy

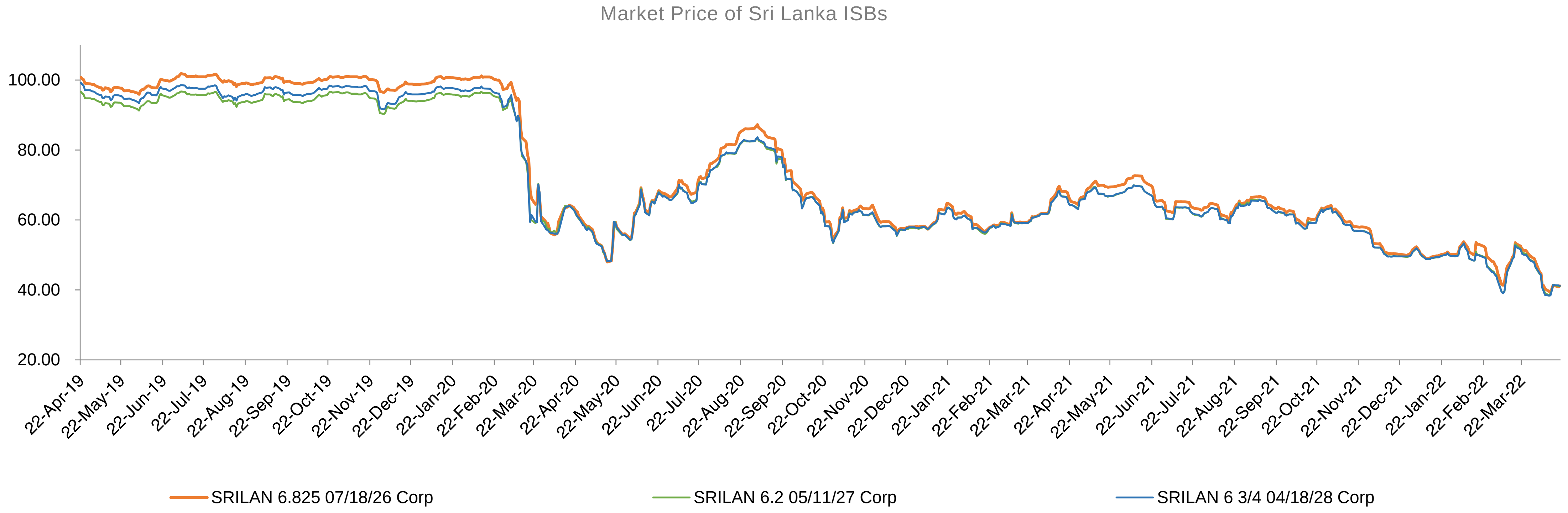
- On 12 April 2022, Sri Lanka announced that pending a negotiated debt restructuring with its creditors, the country will be suspending debt servicing on most of its foreign debt obligations, including International Sovereign Bonds (“ISB’s”), bilateral loans, foreign currency commercial loans and foreign currency loans of state entities guaranteed by the sovereign. The debt default had been anticipated by market participants with the precipitous decline in foreign reserves and USD liquidity since 2020. The debt default for the time being does not cover the foreign currency denominated Sri Lanka Development Bonds (“SLDB’s”) which are issued and settled within Sri Lanka.
- The debt restructuring is crucial to bring about debt sustainability as a prelude to an IMF Extended Fund Facility to overcome the current economic and balance of payments crisis. It is expected that both processes will proceed in parallel.
- Within the listed space, the entities directly impacted by the debt default/ restructuring are the licensed commercial banks which hold ISB’s and SLDB’s, which include COMB, HNB and SAMP within our sector coverage.

Historical Exposure to ISBs and SLDBs



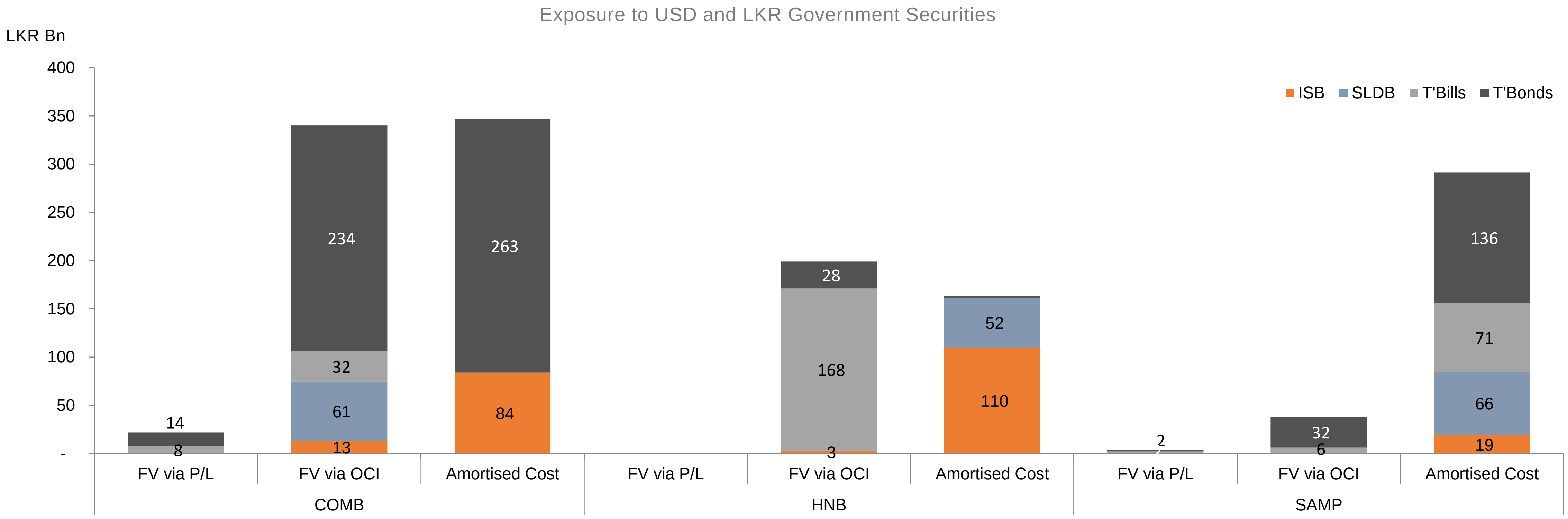
Source : Annual reports, ASB Research

- With the sovereign rating downgrade in 2020, the Sri Lanka ISB's have been trading at steep discounts to face value with the expectation of a default and debt restructuring.
- The current trading price of around US cents 40 to the USD on the five year maturities is consistent as per our estimates with an expectation of a haircut on the principal of c. 20%, c. 50% haircut on the coupon, a term extension of c. 15 years and an exit yield c. 8.5%. The prices of the bonds can be expected to change based on the progress on the debt restructuring, more clarity on the likely terms of the negotiated settlement and market interest rates/ premium on frontier market debt.



Source : Bloomberg

- As at 31 December 2021, the bank holdings of ISB's and SLDB's are primarily through their amortised cost basis portfolios. Enhanced provisions for ISB's and SLDB's are primarily expected to be through adjustments for other comprehensive income as the bulk of the provision would be from the change to the present value of the bonds arising from any changes to the coupon and/ or term extension. However, one-off adjustments through the P&L cannot be ruled out.



Source : Annual reports, ASB Research

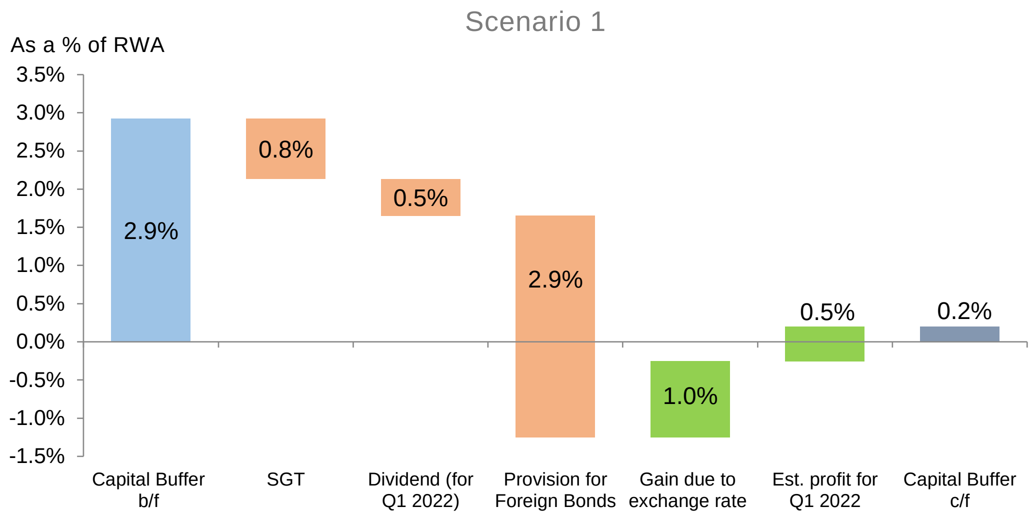
FV via P/L : Fair Value Basis through Profit & Loss Statement.
FV via OCI : Fair Value Basis through Other Comprehensive Income.
Amortised Cost : Amortised Cost Basis.

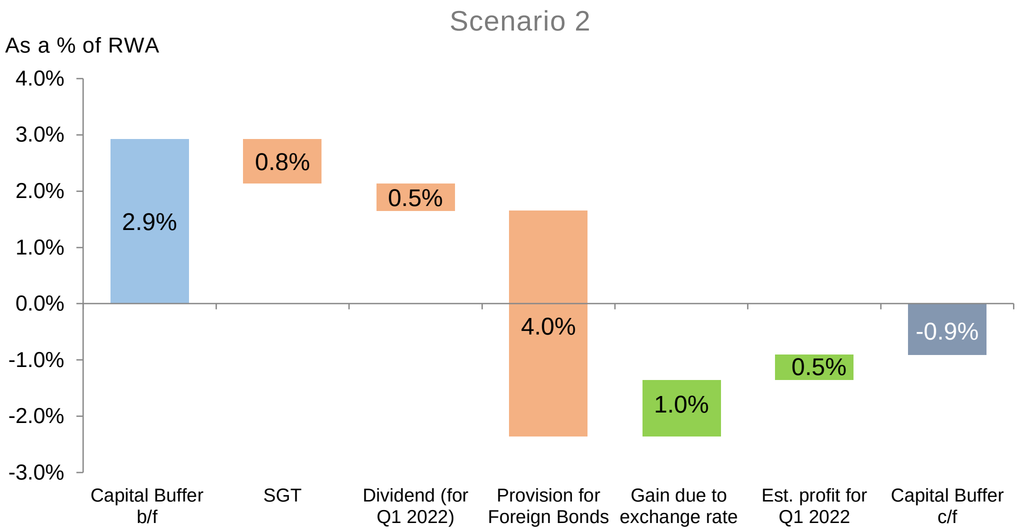
- We have estimated the impact to the buffer capital of the banks (the capital in excess of their regulatory capital requirements) from provisioning for the ISB's and SLDB's under several scenarios as highlighted below, based on their respective capital buffers as at end 2021 adjusted for super gains tax, dividends and 1Q 2022 expected net profits.
- Scenario 1, we have assumed provisions will be made only for the **ISB's** which will be written down to market value. The SLDB's are currently not part of the debt default. Since the SLDB's are settled in Sri Lanka, it is probable that the Government would continue to service the debt on the basis that the bonds would be rolled over on maturity in order to avoid undue stress on the financial system.
- Scenario 2 we have assumed that **ISB's** which will be written down to market value and there would be a 20% provision on the carried value for the **SLDB's** based on a corresponding haircut to the principal value of the bonds.
- Scenario 3 is a worst case scenario where we have assumed that debt restructuring will extend to LKR government bonds in the event that debt sustainability cannot be achieved through restructuring of the foreign debt alone. However, the IMF and creditors would consider a restructuring of the LKR debt as a last resort given the enormous stress on the financial system which could do more harm than good. We therefore believe this scenario is unlikely. We also believe that Sri Lanka's current economic crisis is largely due to a shortfall of tax revenues and that primarily revenue based fiscal consolidation along with restructuring of the foreign debt would suffice to generate primary balance surpluses to bring about debt sustainability. Scenario 3 therefore serves as an extreme stress scenario.

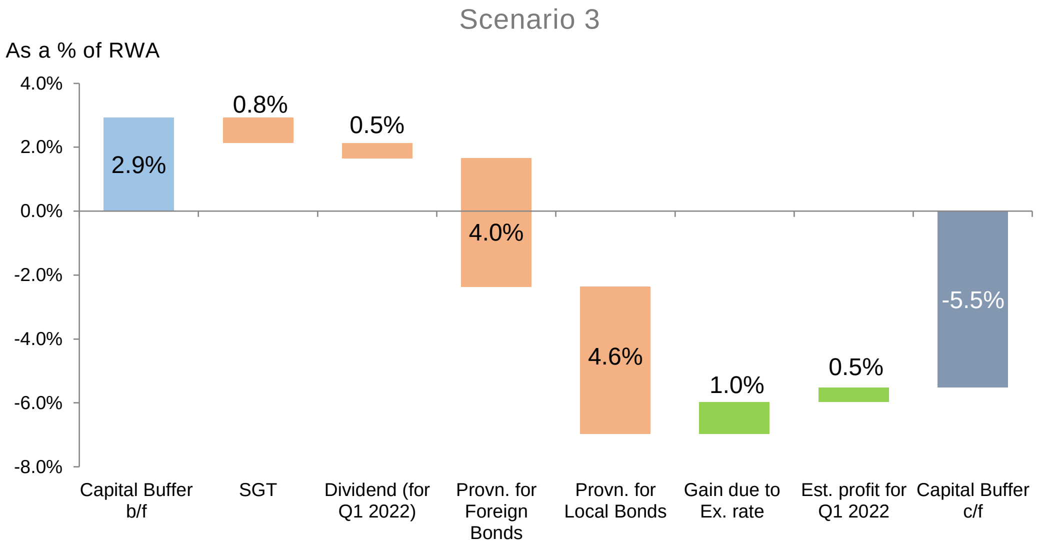
Assumption	Scenario 1	Scenario 2	Scenario 3
Provision for ISB's	Marked down to market value	Marked down to market value	20% haircut on carried value
Provision for SLDB's	None	20% haircut on carried value	20% haircut on carried value
Provision for LKR Treasury Bonds	None	None	10% haircut on carried value

COMB impact on capital buffer

- Based on our estimates, the capital buffer of COMB would remain positive under Scenario 1. COMB may require to raise additional regulatory capital in the event that the debt default extends to SLDB's and/ or LKR bonds, given its higher exposure to LKR treasuries and lower buffer relative to the other banks in our coverage.



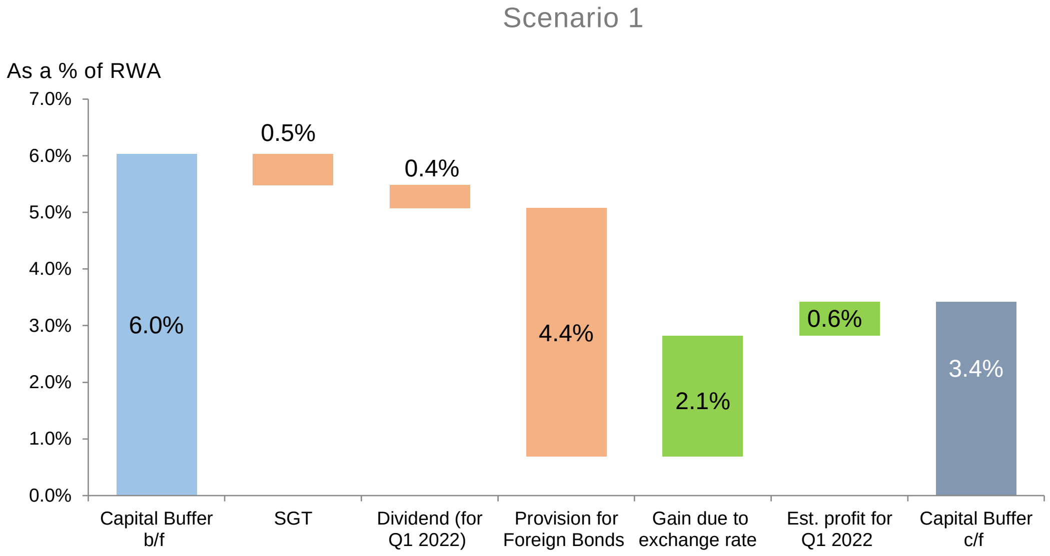


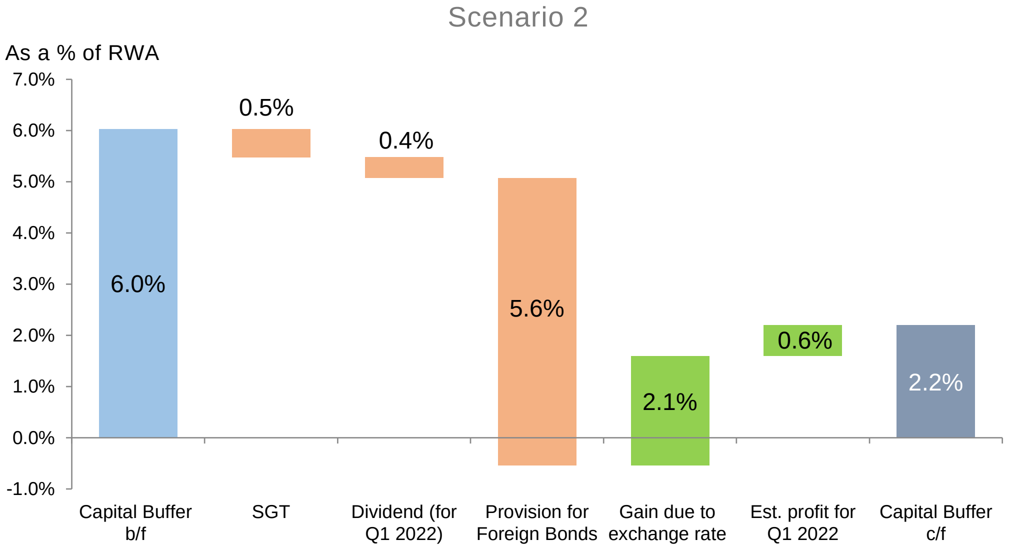


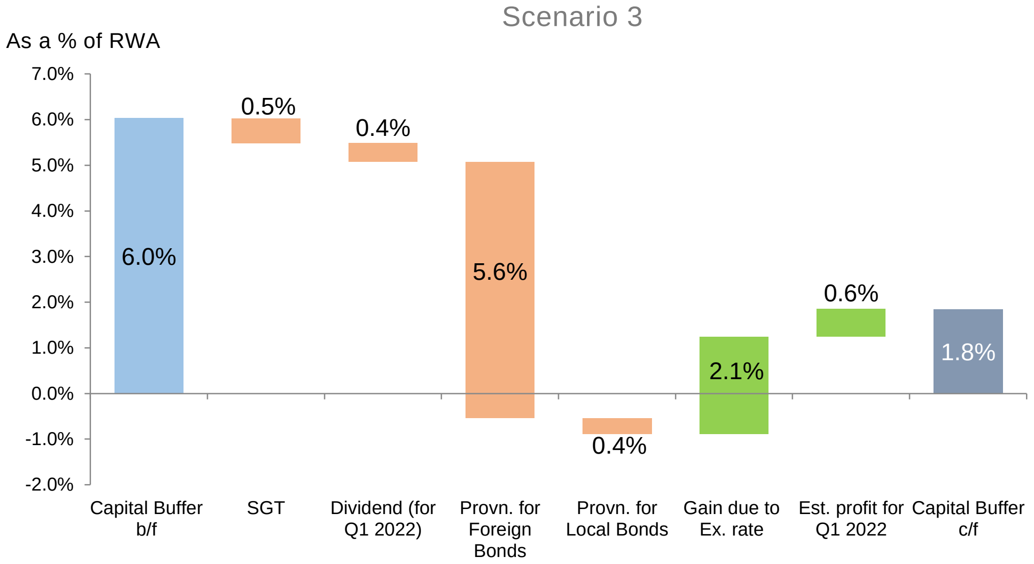
Source : Annual reports, ASB Research

HNB impact on capital buffer

- Based on our estimates, the capital buffer of HNB would remain positive under all three scenarios given HNB's high existing buffer and lower exposure to LKR bonds.



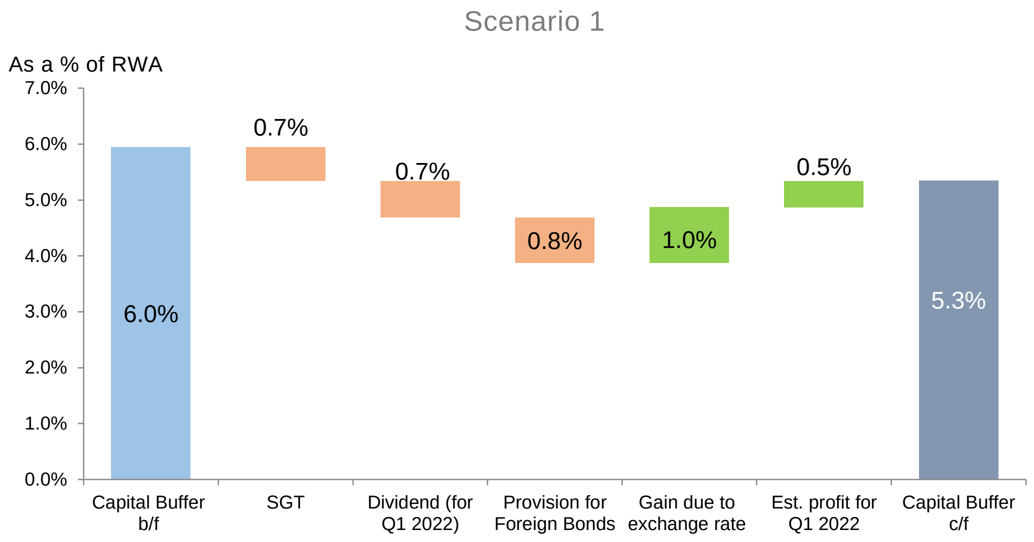


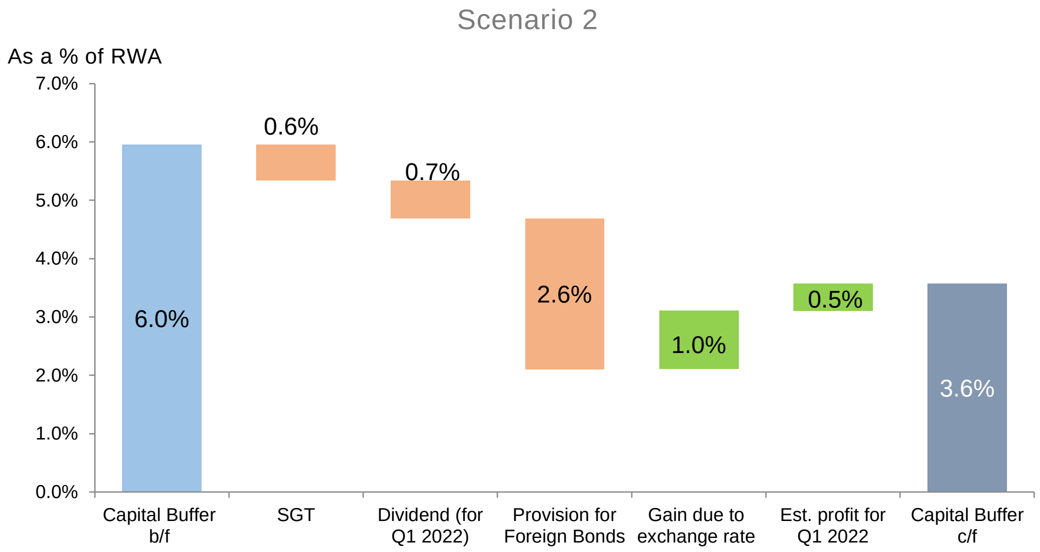


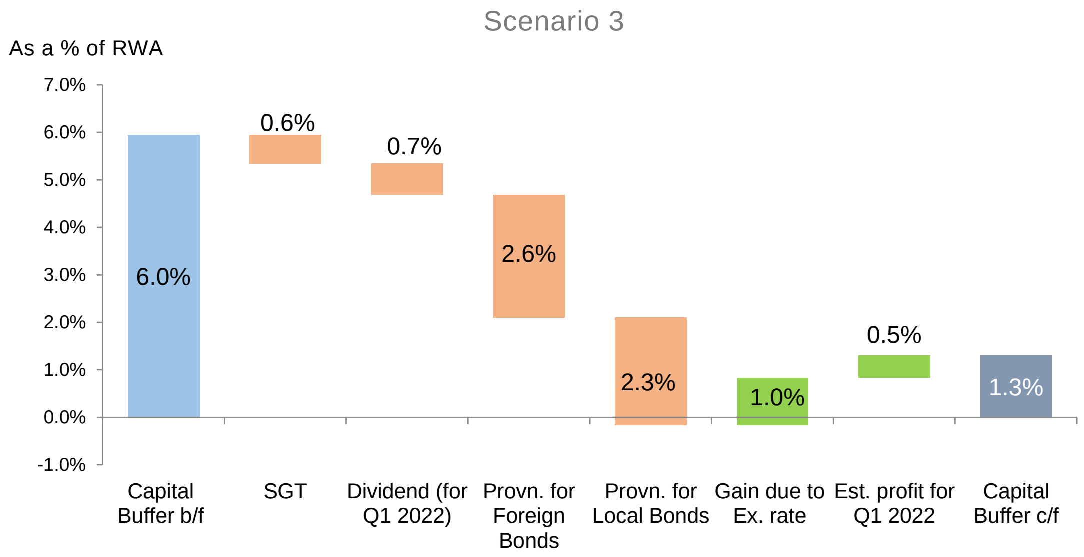
Source : Annual reports, ASB Research

SAMP impact on capital buffer

- Based on our estimates, the capital buffer of SAMP would remain positive under all three scenarios given its high existing buffer and lower exposure to ISB's.







Source : Annual reports, ASB Research

Conclusion

- We find that the majority of banking stocks within our coverage are capitalised sufficiently to absorb a reasonable level of provisioning for ISB’s and SLDB’s, which reduces the likelihood that the banks would need to raise additional regulatory capital in the short term.
- However, based on the ongoing negotiations with creditors, if higher levels of haircuts on ISB’s and SLDB’s are deemed to be necessary it would necessitate correspondingly higher levels of provisioning which could erode the capital buffers beyond our stress scenarios. Higher NPA’s arising from the deteriorating economic situation in Sri Lanka in 2022 is also a risk factor, although we believe that margin expansion in a rising interest rate environment will help to absorb incremental NPA’s to some extent.
- In the context of highly discounted valuations relative to the market, we maintain our Overweight rating on the sector and the banking stocks in our coverage. The outcome of the foreign debt restructuring and higher NPA’s in a weak economic environment are our main concerns which could negatively impact our ratings going forward.

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