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Weekly Credit Brief
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Sri Lanka's sovereign debt crisis pummels the credit health of its domestic banking sector

by NUS-CRI Market Monitoring Team

- **The NUS-CRI Agg 1-year PD of Sri Lankan banks shows sharp deterioration as a worsening sovereign debt crisis threatens to pressure the banks' profitability and weaken asset quality**
- **The NUS-CRI Agg Forward 1-year PD demonstrates that possible extension of credit lines from the IMF and other countries may help Sri Lanka avoid default and alleviate the stress on banks' credit profile**

The sovereign debt crisis in Sri Lanka continues to intensify as protests over soaring inflation and lack of access to essential commodities rock the country. With dwindling forex reserves and fast approaching debt maturities, a sovereign default may be imminent, unless the country can secure funding over the near term to alleviate its repayment burden. Against this backdrop, the spotlight falls on Sri Lankan banks to understand the impact of the worsening sovereign crisis on their credit profile. The NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) of Sri Lankan banks in Figure 1a showcases a sharp deterioration in credit health in Q1 2022, concurrent with the steep decline in sovereign credit profile (See Figure 1a). Operationally, the banking sector is set to face a potential weakening in profitability and asset quality as the fallout of the sovereign debt crisis threatens to dampen credit growth and impact corporate borrowers' financials. Looking forward, the NUS-CRI Agg Forward 1-year PD (Forward PD[1]) (See Figure 1b) highlights that the impact of the sovereign crisis on Sri Lankan banks has peaked, possibly suggesting that should Sri Lankan banks be able to survive the worsened macroeconomic environment in the short-term, their credit risk outlook is set to improve on the back of rising provisions and historically robust earnings.

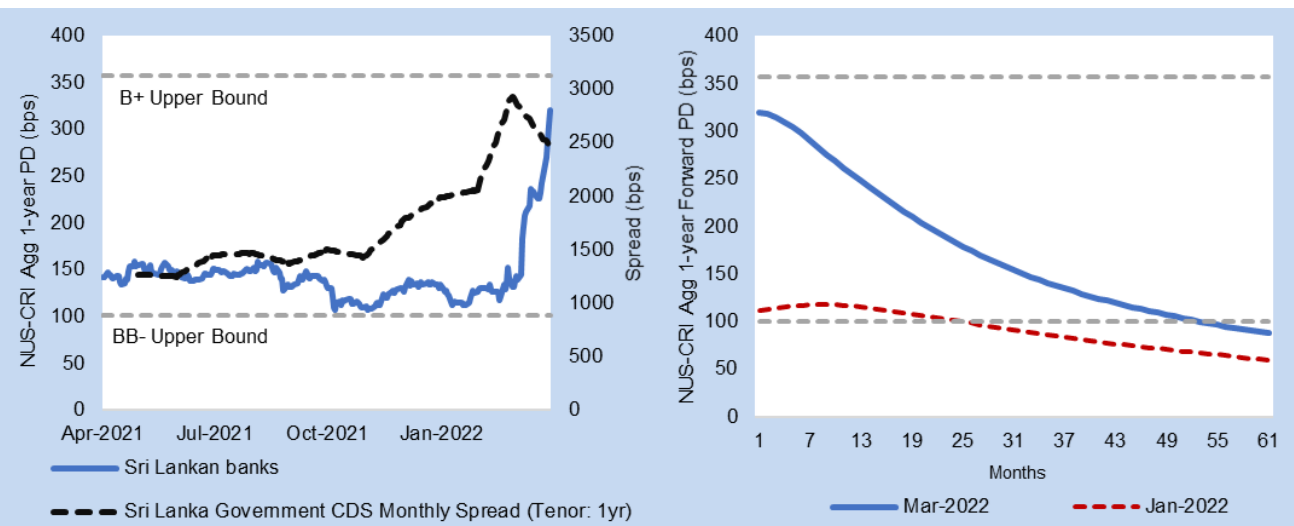

Figure 1a (LHS): NUS-CRI Agg 1-year PD for Sri Lankan banks (LHS) and Sri Lankan USD-denominated government CDS 1-year tenor (RHS) from Apr-2021 to Mar-2022 with reference to PDiR2.0[2] bounds. Figure 1b (RHS): NUS-CRI Forward PD for Sri Lankan banks as of Jan-2022 and Mar-2022. *Source: NUS-CRI, Bloomberg*

The central bank has attempted to mitigate and control the impact of the crisis through a plethora of different channels. With retail inflation at 17.5% YoY in Feb-2022, well above the 4%-6% central bank target, monetary policies were drastically tightened to slow inflation, resultantly increasing interest rates. In addition, the central

[1] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months – this is conditional on the firm's survival in the next 6 months.

[2] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

bank also devalued the Sri Lankan Rupee to stimulate remittances and foreign investments which would help boost reserves and improve its foreign exchange positions. Prior to the current debt crisis, the tourism industry and remittances from overseas, two of the country's major sources of foreign currency, had also been negatively impacted due to the pandemic. The policy measures are also expected to put the country in a better position to negotiate a debt restructure or better loan terms with the IMF. However, the steps taken by the central bank need to be supported by effective measures from the government as well. Before the pandemic, the Sri Lankan government had been ballooning their budget deficit due to politically-motivated tax cuts, which resulted in diminished revenues for the government. As the pandemic struck, increased government spending further exacerbated budget deficits, financed by money printing by the Sri Lankan central bank. Going forward, the government may need to roll back a significant part of those measures in order to boost reserves and improve the sovereign's debt service position.

However, the withdrawal of relief measures may potentially have an adverse effect on the asset quality of Sri Lankan banks as these may further strain borrowers' finances, especially in the context of the sovereign debt crisis which creates a challenging operating and financing environment. Adding further strain to the banking system's asset quality is the banks' holdings of government securities, especially those denominated in foreign currencies. The exposure to these investments also threatens to weaken the banks' capital ratios. One such example is the USD 1.4bn worth Sri Lanka Development Bond (SLDB[3]) which matures in 2022, Sri Lankan banks hold 89% of the outstanding issue. Credit extension to the government, on the whole, has also been increasing (See Figure 2a), with commercial banks having close to 75% of the total exposure. With the deteriorating sovereign condition, the ability of the government to service its bonds and loans comes into question, potentially leading to losses for the domestic banking industry.

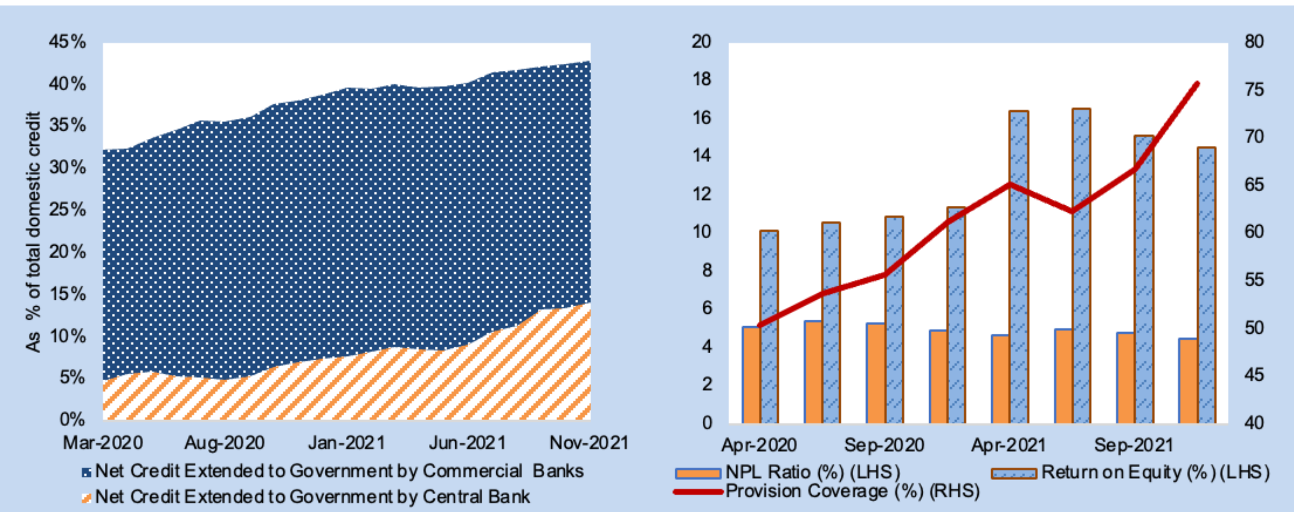

Figure 2a (LHS): Net credit extended to the government by commercial banks and net credit extended to the government by the central bank (as a percentage of total domestic credit) from Mar-2020 to Nov-2021. Figure 2b (RHS): NPL ratio, return on equity, and provision coverage ratio for Sri Lankan banks from Apr-2020 to Dec-2021. *Source: Central Bank of Sri Lanka*

While the banking sector's loan portfolio is dominated by credits to the industrial and the services sector, net credit to the government has been picking up, surging to 62.7% YoY in 2020 to aid in the finance of government expenditures due to the pandemic. This continued until 2021, ultimately comprising 42.2% of outstanding loans as of Sep-2021. Normally, these loans are considered to have minimal risk, but the uncertainties in Sri Lanka's current economic and financial situation translate to a significant increase in the credit risk of their loan portfolio. Moreover, as the Sri Lankan government struggles to service its foreign debt to avoid sovereign default, domestic banks could be left to settle for what is residually available for the repayment of their material government exposures. On the other hand, the reported gross non-performing loans (NPL) ratio of 4.5% as of Dec-2021, excludes the portion of loans that are covered by debt moratorium, particularly those from the tourism sector that was heavily hit by the pandemic. The moratorium would have supposedly expired by Sep-2021 but the central bank further extended the relief until Jun-2022 to ease the economic stress. Since the stimulus package and economic relief provided by the government delayed the recognition of bad loans, its full impact on the banking sector's asset quality is yet to be determined. In an effort to reduce the impact of potentially rising NPLs, the Sri Lankan banking industry has increased its provisions (See Figure 2b) in anticipation of a withdrawal of relief support by the government due to the sustained stress of the debt crisis, boding well for the domestic industry's capital position in the future.

[3] SDLB is a USD-denominated bond issued by the Sri Lankan government.

Aside from credit extension to the government, loan growth has been generally anemic notwithstanding the central bank's policies to control lending rates to incentivise borrowing even at the expense of banks' profitability. Yet, even with the imposition of interest rate ceilings, return on equity has been sustained at a relatively high level (See Figure 2b) indicating that the banks' ability to generate revenue is unhampered. Nevertheless, this balancing act is expected to subject banks' capital to severe pressure necessitating interventions. As such, in Dec-2021, the banking sector maintained a capital adequacy ratio (CAR) and common equity tier 1 (CET 1) capital ratio of 16.5% and 12.8% respectively. While the ratios are above the minimum requirement under the Basel III capital standards[4], heightened sovereign risk, which may translate to higher market and credit risk capital charges on government securities holdings, coupled with deteriorating quality of their loan portfolio, could potentially deplete Sri Lankan banks' capital position.

The increasing credit exposure of Sri Lankan banks to the government, both in terms of government securities holdings and loans, makes the banking sector highly vulnerable to sovereign risk. As such, Sri Lanka's current unfavorable economic and financial condition that restricts its access to external financing, as well as the devaluation of the currency, could further seep into the banking sector and magnify the still unrealized impact of the distressed tourism sector on liquidity and capital adequacy. A silver lining for the sovereign, and vis-a-vis the banking industry, could be potential credit lines from other nations and supranational financial organizations such as the IMF. For example, India, and the IMF, have already provided credit lines and financial support for key commodities to Sri Lanka. Further aid from them to Sri Lanka may allow the country to meet its short-term debt obligations. In such a scenario, the banking industry may benefit from an improved perception of asset quality and funding availability. However, in the more adverse scenario that Sri Lanka defaults, especially given the latest reshuffle in the country's cabinet, the domestic banking sector may continue to face woes in its profitability and asset quality.

[4] Licensed banks in Sri Lanka adopted Basel III capital standards commencing Jul-2017.

Credit News

Corporate debt issuance surges in March despite Q1 slump

Apr 1. Bond markets have witnessed a high level of volatility in Q1 2022 driven by the hawkish stance taken by the US Fed and the ECB and the Russia - Ukraine war. When taken together with lower funding requirements, the result has been a decline in debt issuance across all categories. However, the month of March showed a diverging trend with an increase in issuance activity. Europe and US markets experienced an increase in issuance activity with USD 130bn of sales in the US and with Europe's investment-grade market activity at the highest since Sep 2020. The increase in activity comes as there was stability in credit markets and as risk premia declined to levels seen before the initiation of the Russia-Ukraine crisis. (Reuters)

Kenyan banks poised for fastest credit growth in six years

Apr 1. Because of the central bank's intervention in loan pricing, with proposal discussions extending up to 2 years, banks had been dissuaded to grow their lending operations. In the meantime, they placed excess liquidity in government securities. Nevertheless, the tide is turning, as banks expect approval of most of their proposals just in time for the elections. The approved risk-based pricing schemes would motivate banks to grow their loan portfolios as they have more flexibility to manage their margins, in contrast to when lending rates were capped. (Bloomberg)

China's mega banks face new obstacles after comeback year

Mar 31. After a pandemic-induced lull, major Chinese banks' profits surged in 2021 to their highest since 2013 in response to the relaxation of lending policies to stimulate economic growth. However, the rally was short-lived as heightened credit risk from the real estate sector, a resurgence of COVID-19 infections, spillover effects of the Russian invasion push credit demand back down and are expected to dampen earnings in 2022. Its initial effects have been felt as borrowings plunged in the first quarter of the year despite the central bank's efforts to encourage earnings. Nevertheless, measures implemented to support the economy are also intended to renew confidence in the banking sector and provide new opportunities for growth. (Bloomberg)

Jet leasing firms start to tally up cost of Russian invasion

Mar 29. Russia transferred nearly 800 jets to its registry, triggering a wave of insurance claims from leasing companies. For example, Avolon, the second-largest aircraft lessor in the world, recovered four aircraft from Russia, but still left 10 stranded in the country. With all contracts canceled, Avolon's balance sheet exposure is estimated at less than USD 200mn on the back of deposits and letters of credit withdrawal from Russian customers and insurance claims made to cover potential losses. Meanwhile, AerCap, the world's largest jet leasing company, had 142 planes in Russia and has submitted a USD 3.5bn claim on its all-risks policy. The asset value of claims related to the Russia-Ukraine war could be USD 10bn in total, and insurers' liability would be limited to about 10% to 15% of the total asset value. (Bloomberg)

Banks demand more protection on new risk amid volatility

Mar 29. Recent market turbulence has caused banks to be more cautious in their dealings such that they require risks to be accounted for either in terms of higher pricing, expanded protection, or fuller fees. This is particularly true for the leveraged loan market. Banks are also reducing the proportion of underwriting they are taking amid the perceived riskiness both in the market and the anticipated effects of inflation and consequent monetary tightening. Because of the averseness of banks, private credit is stepping up to fill in the gaps seeking returns of a minimum of 500 bps, which makes them an attractive alternative in addition to bank financing. (Bloomberg)

Russian corporate bonds rebound as investors embrace risks (WSJ)

Latin American debt emerges as a haven 6,000 miles away from war (Bloomberg)

India firms' credit health recovers at fastest pace in a decade (Bloomberg)

Regulatory Updates

BoJ to boost bond buying even as yen suffers worst month since 2016

Mar 31. Even though Japan's currency is under heavy pressure, the Bank of Japan still insists on boosting its government bonds purchases over the coming three months at a faster pace than it had previously. This action is in line with Japan's yield curve control policy (YCC), under which the debt yields are kept in a fixed range, keeping Japan's interest rates low, but causing a widening gap with global borrowing costs. As a result, the yen tumbled 5.5% in March. Although the government has faith that a cheaper yen was good for the economy, soaring costs of imported energy and commodities pose challenges to small- and medium-sized businesses. Limiting the bond yield via YCC and the currency via intervention simultaneously is impossible. Policymakers face the dilemma of keeping policy loose and avoiding deep currency depreciation. The market expects that the currency was approaching the government's so-called line in the sand, which may force the government to intervene with support when necessary. (FT)

Faster Southeast Asian inflation puts rate hike outlook in focus

Mar 30. Rapidly increasing inflation in Southeast Asia is expected to push central banks to raise rates earlier than expected. Even prior to the Russia-Ukraine war, driven by supply chain congestion, prices had started inching upwards. The Russian invasion of Ukraine resulted in a sharp rise in commodity prices and is expected to continue to push up prices of essential commodities. The Monetary Authority of Singapore is expected to raise rates in April on the back of a possible increase in inflation due to a tight labor market. Although Malaysian and Indonesian banks are not expected to raise rates till late 2022, the rapid rise in inflation may prompt them to revise their timeline of rate hikes. (Nikkei Asia)

Fed's Mary Daly says case for half-point rate rise in May has grown (FT)

US yield curve re-inverts following strong jobs report (FT)

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