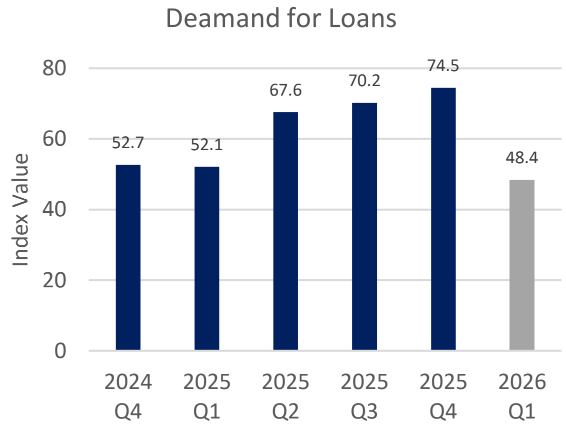
CREDIT OUTLOOK

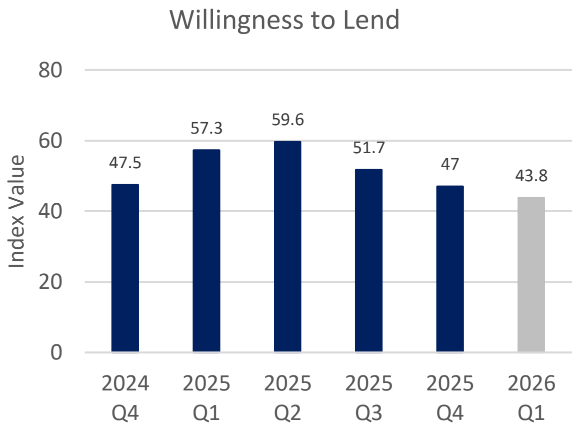
FLASH NOTE

CBSL RELEASES CREDIT SUPPLY SURVEY HIGHLIGHTING BANKING SECTOR CREDIT TRENDS IN 4Q2025 AND THE OUTLOOK FOR 1Q2026

FIRST CAPITAL OVERVIEW

- **Loan demand strengthened in 4Q2025**, with the overall demand index rising from 70.2 to 74.5, while overall willingness to lend declined from 51.7 to 47.0, which highlights **firmer appetite but more cautious supply**.
- **Retail remained the strongest operating channel** in Q4 as well: it had the highest demand, the smallest demand–willingness gap, and a sharp fall in rejected applications, indicating smoother credit access.
- **SME credit dynamics were boosted by relief programmes related to the Ditwah cyclone** which occurred in 4Q2025, though practical constraints hinder full credit flow.
- While corporate loan demand and banks' willingness to lend to corporates remained soft last quarter, **banks are signalling a shift in lending focus back towards the corporate segment this year**. In the 1Q2026 outlook, willingness to lend to corporates rises to 58.4, while willingness to lend to Retail and SMEs moderates.
- **The overall predictive outlook for 1Q2026 points to softening**, which suggests that credit growth is now driven more by sector-specific risks and operational constraints than by interest rates alone.





Source: CBSL

Key Highlights

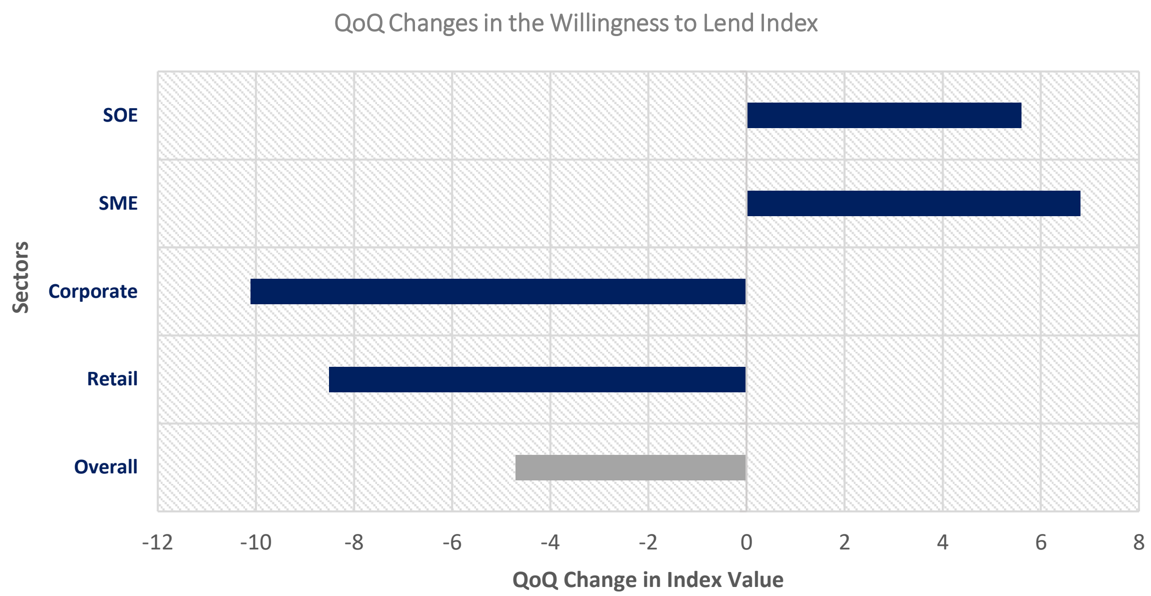
1. Loan Demand & Supply Divergence in Q4

❖ **Loan Demand Strengthens as Banks Reduce Willingness to Lend**: Loan demand increased further in 4Q2025, with the overall diffusion index rising to 74.5 from 70.2 in Q3. The increase was led by SMEs (81.5 vs 69.2), while retail (93.8 vs 94.1) and corporate (88.0 vs 92.4) demand remained expansionary; SOE demand remained in contraction (–53.7 vs –81.4). In contrast, banks' overall willingness to lend eased to 47.0 from 51.7, which indicates softening appetite to extend credit relative to Q3.

2. Ditwah Credit Schemes Seem to be Driving SME Credit Dynamics

- **SME Demand Strengthened in 4Q2025**: SME credit demand remained a major driver of overall loan demand in 4Q2025, supported by stronger business activity, improved market sentiment, and low-cost funding schemes targeting the SME sector. While SME demand increased, banks' willingness to lend to the SME segment also rose from 3Q2025 (from 50.7 to 57.5). In contrast, willingness to lend declined across the retail and corporate sectors, while SOE sentiment turned less negative but stayed below zero.

- **Rising Bank Confidence Supported by Government Schemes**: This suggests that banks have become more confident in lending SMEs, likely due to government risk-sharing support.

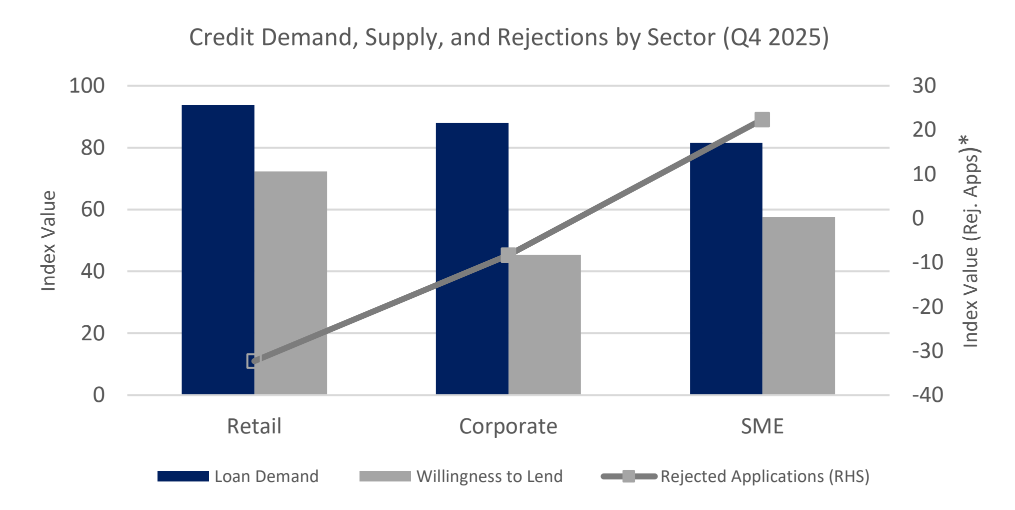


Source: CBSL/ FCR Calculations

3. Households Remain the Sweet Spot of Credit Activity

- **Retail Borrowers Drive the Strongest Credit Momentum**: Households (retail borrowers) continued to be the strongest source of credit momentum in 4Q2025. Retail loan demand remained the highest among all categories, reaching 93.8, while willingness to lend stayed comparatively strong at 72.3. The gap between demand and willingness was therefore the smallest in the retail segment, indicating better alignment between borrower needs and bank appetite. At the same time, rejected loan applications in retail declined sharply (from 9.6 to –32.3), showing a smoother and more efficient credit channel for households, while its contribution to sustained longterm credit growth may be limited.

- **External Factors Boosted Retail Demand and Approvals**: External market dynamics, such as the surge in vehicle imports in 2025 and the continued growth in pawning (gold-backed lending), likely contributed to the strength of retail credit activity by supporting both credit demand and the ease of loan approvals.



Source: CBSL/FCR Calculations

*Negative values mean banks rejected fewer loan applications compared to the previous quarter.

4. Corporates Still Remain Soft but Portfolio Rebalancing May Be in the Cards

- **Corporate Borrowing Appetite Continues to Weaken**: Corporate loan demand index value declined from 92.4 to 88.0, with further moderation expected to 74.9 in 1Q2026, indicating a softening in borrowing appetite within the sector.

- **Bank Willingness Softens but Outlook Improves**: Banks' willingness to lend to corporates also eased from 55.5 to 45.4 in Q4 2025. However, the outlook for 1Q2026 improves to 58.4, suggesting that banks may intend to tilt their loan portfolios toward the corporate segment as retail loan demand begins to moderate.

- **Portfolio Rebalancing Likely as Retail Surge Fades**: This potential rebound could reflect a gradual rebalancing of banks' loan portfolios, particularly as pent-up vehicle loan demand begins to taper off, which creates a space for renewed appetite for corporate credit expansion. In addition, with more moderate growth expectations, tilting loan portfolios toward corporates becomes a less risky option for banks.

Source: CBSL/FCR Calculations

5. Challenges Restrict Credit Transmission

- **SME-Related Frictions Continue to Hinder Credit Flow**: Despite the supportive policy environment, credit flow remains constrained by few factors at the moment, specifically related to the SME sector, which could include elevated credit-risk assessments, collateral requirements and documentation issues. These frictions are underscored by the fact that the highest level of rejections occurred in the SME sector in 4Q2025.

6. Q1 2026 Outlook Indicates a Softening Trend

- **Loan Demand and Lending Appetite Expected to Ease Across Sectors**: The projected outlook for 1Q2026 indicates that both loan demand and banks' willingness to lend are expected to soften across most sectors. This suggests that the improvement observed during 2025 may lose momentum in early 2026, which reflects a gradual stabilization in credit appetite.

Implications

- **Credit Growth Expected to Stay Positive but Moderated**: Credit growth is expected to remain positive but moderate in the near term. The survey expectations are in line with the First Capital strategy report, which forecasts that slow economic conditions may trickle down to slower credit growth. In addition, while lending continued to expand in 4Q2025, several non-interest-rate constraints are likely to weigh on the outlook for early 2026. Among these, banks are signalling a more cautious risk appetite, tightening underwriting standards, and adopting selective sectoral exposure, which is expected to slow new credit growth while simultaneously shifting lending away from pent-up retail borrowers toward the corporate sector. Additionally, operational frictions and the scale of government risk-sharing support will play a key role in shaping lending activity. As a result, the credit outlook points to steady but constrained expansion, with structural and institutional factors driving conditions.

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