Leasing and Finance Companies (LFCs)

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LRA

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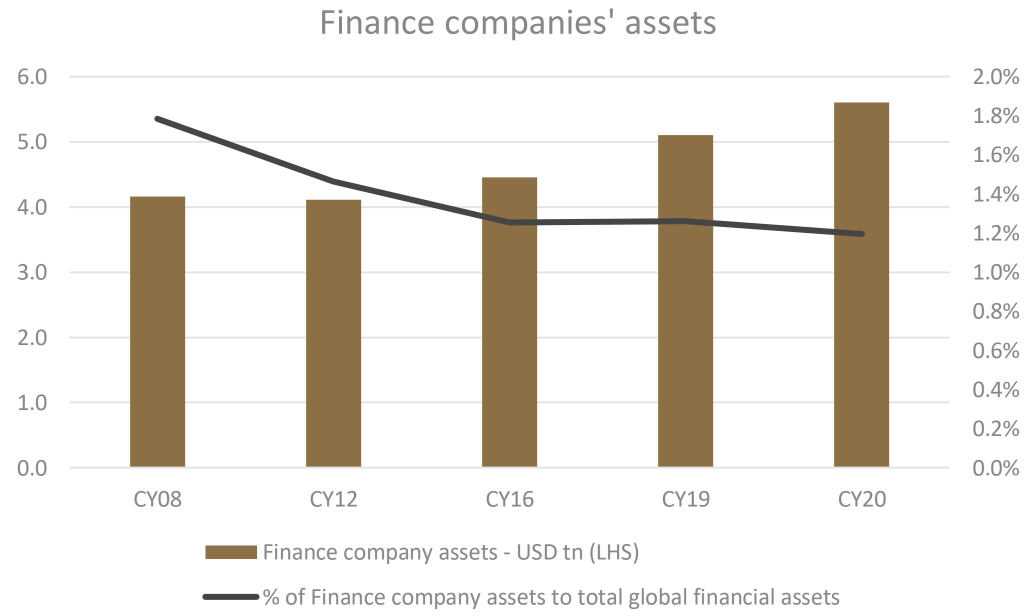
Global Industry

- The financial assets of the LFC sector amounted to USD 5.6 tn in CY20 (a growth of 9.8% from CY19), accounting for only 1.2% of the global financial system in CY20.
- In CY20, Finance company assets grew by 4.9% in advanced economies, and 4.3% in emerging economies. Germany, the US, and Japan were the largest contributors to the growth in finance company assets; asset growth in these three jurisdictions represented 71.6% of total finance company asset growth in CY20.



Snapshot of the Sri Lankan Economy

	CY18	CY19	CY20	1HCY21	CY21	Latest value
GDP growth rate (YoY)	3.3%	2.3%	-3.6%	8.0%	3.6%	1QCY22 -1.6%
Exchange rate (USD/LKR)	182.75	181.63	186.41	201.1	200.4	01-August-2022 361.0
Inflation (CCPI)	4.3%	4.3%	4.6%	5.2%	(average for the year) 5.9%	July-2022 60.8%
SDFR	8.00%	7.00%	4.50%	4.50%	5.00%	07-July-2022 14.50%
SLFR	9.00%	8.00%	5.50%	5.50%	6.00%	15.50%
USD bn	CY18	CY19	CY20	1HCY21	CY21	
Current Account balance	(2.80)	(1.80)	(1.10)	(1.0)	(3.36)	1QCY22 (1.33)
Exports	11.89	11.94	10.05	5.70	12.50	1HCY22 6.51
Imports	22.23	19.94	16.06	10.02	20.64	10.03
Trade balance	(10.34)	(8.00)	(6.01)	(4.32)	(8.14)	(3.51)
Workers' remittances	7.0	6.7	7.1	3.3	5.5	Jan-May CY22 1.34
Foreign exchange reserve	6.92	7.64	5.66	4.06	3.14	30-June-2022 1.85

Central bank of Sri Lanka

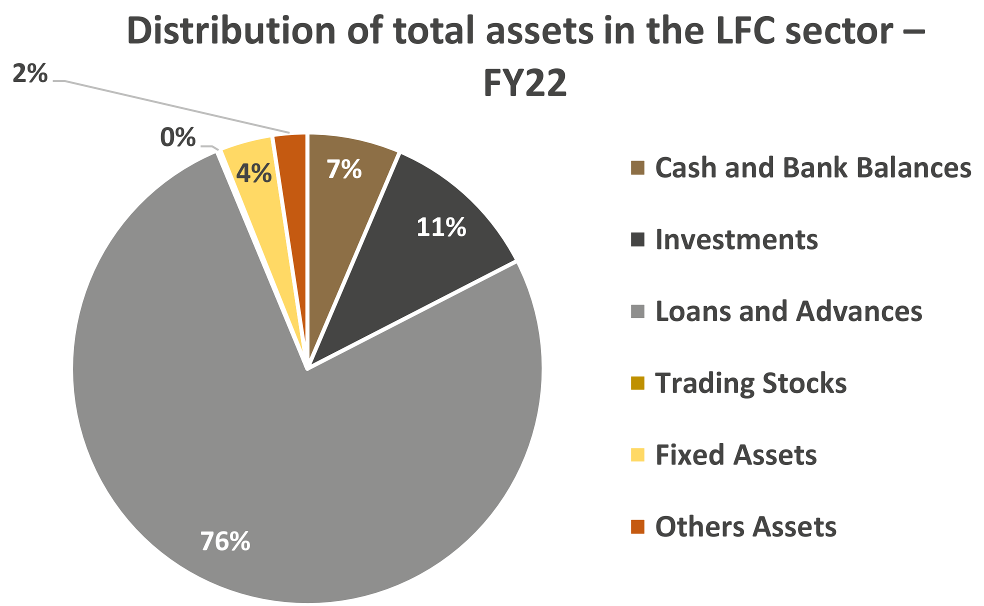
LFCs

products and services offered by LFCs

- Leasing and Hire purchase (Vehicles, equipment and machinery)
- Fixed deposits and savings
- Housing, personal and educational loans
- Gold loans
- Development finance and SME finance
- Islamic finance (Wakalah, Ijarah, Murabaha and Mudharabah
- Real estate
- Factoring

Local Industry – Leasing and Finance Companies

- Leasing and Finance companies comprise of
  - 36 Licensed Finance companies (of which 29 are listed on the CSE) and
  - 3 Specialized leasing companies
- Total capital base of the industry by end FY22 (March 2022) is LKR 266bn of which LKR 243bn (91%) is Tier I (core) capital.
- Total assets of the LFC sector is LKR 1.6tn (FY22) of which LKR 1.2tn (76%) are loans and advances.
- Total assets have been growing at a CAGR of ~10.5% from FY14 to FY22.
- Loans and advances have been growing at a CAGR of 10.9% during the same period

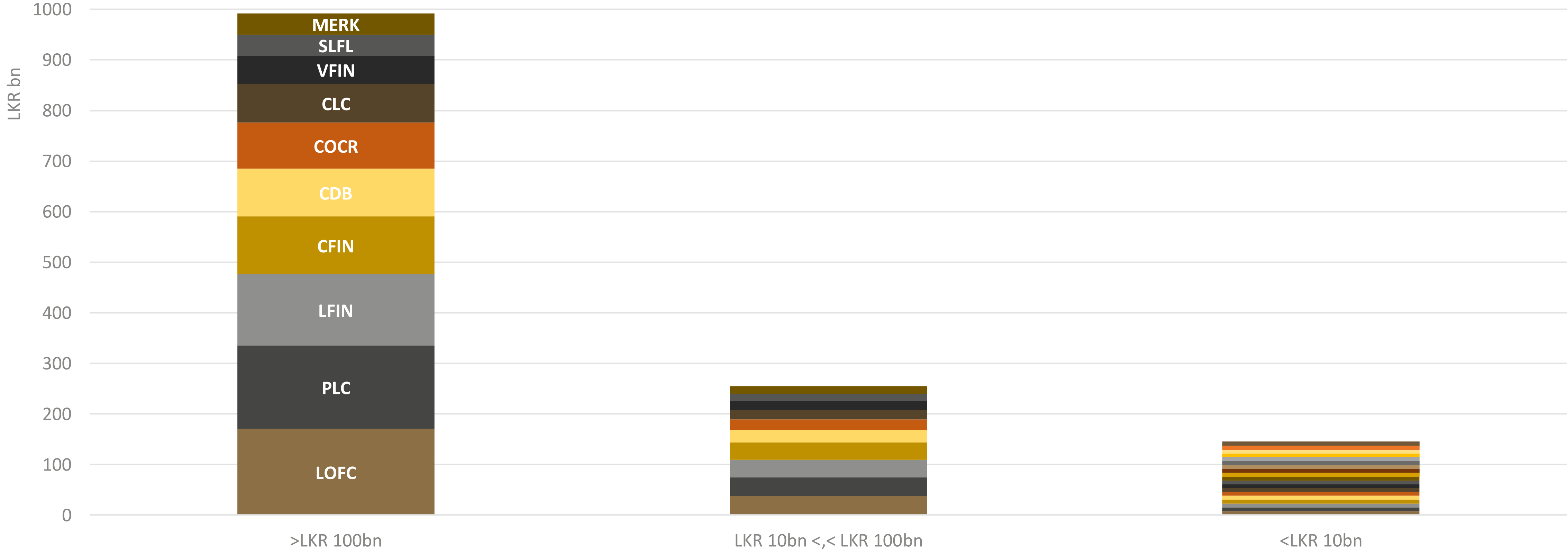


Total Capital	CAGR (FY14-22)
LKR 266bn	**15.6%**

Total assets	CAGR (FY14-22)
LKR 1.6tn	**10.5%**

Local Industry - assets

- The industry is skewed towards the large companies with the 10 largest entities accounting for over 71% (almost LKR 1tn) of the total assets.

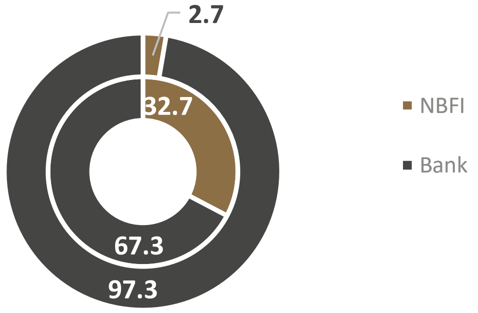


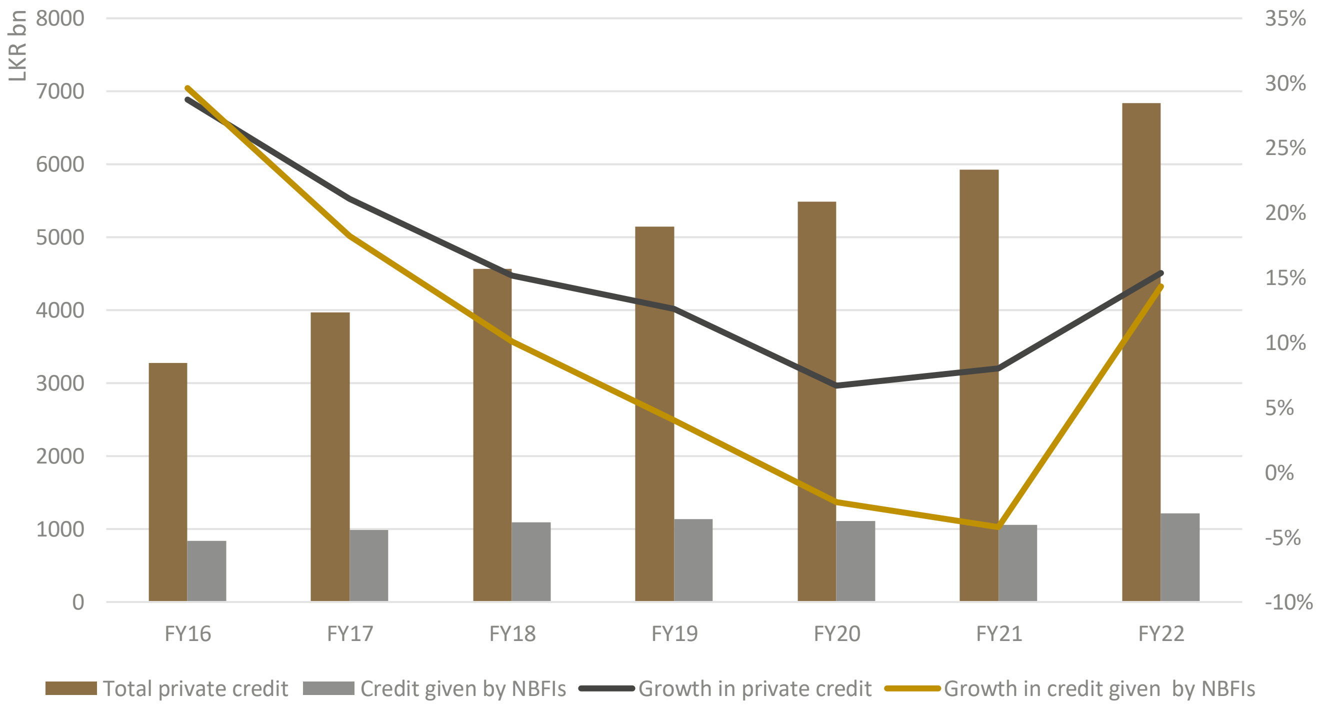
Source – Company annual reports

Local Industry - credit

- Total private sector credit in end FY22 was LKR 6.8 tn of which only LKR 1,.2 tn (17.75%) was held by LFCs.
- Growth in LFC credit had been negative for two years consecutively, but bounced back in FY22 to record a y-o-y growth of 14%.
- The growth in LFC credit over the years has not matched the growth in private sector credit and the share of private sector credit held by the LFC sector has been decreasing gradually, with larger portions leaking out to the banking sector.
- LFC share of private credit has reduced to 17.75% in FY22 from 25% in FY15.
- Of credit given to households, 33% is held by LFCs while LFCs hold only 3% of credit given to institutions (which includes the corporate sector, government and public corporations).

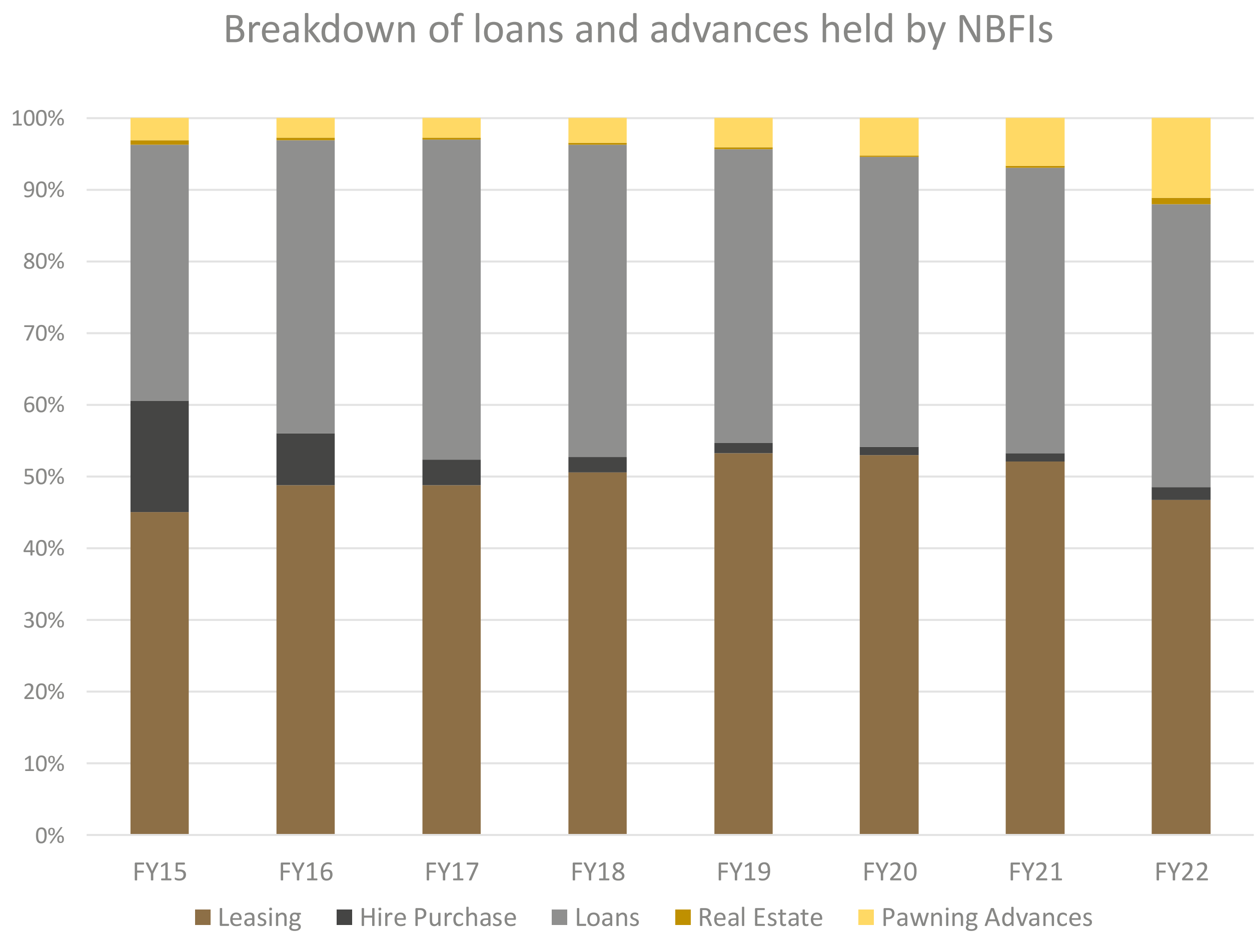
Distribution of credit from bank and non-bank sectors to households (inner doughnut) and institutions (outer doughnut) – CY20





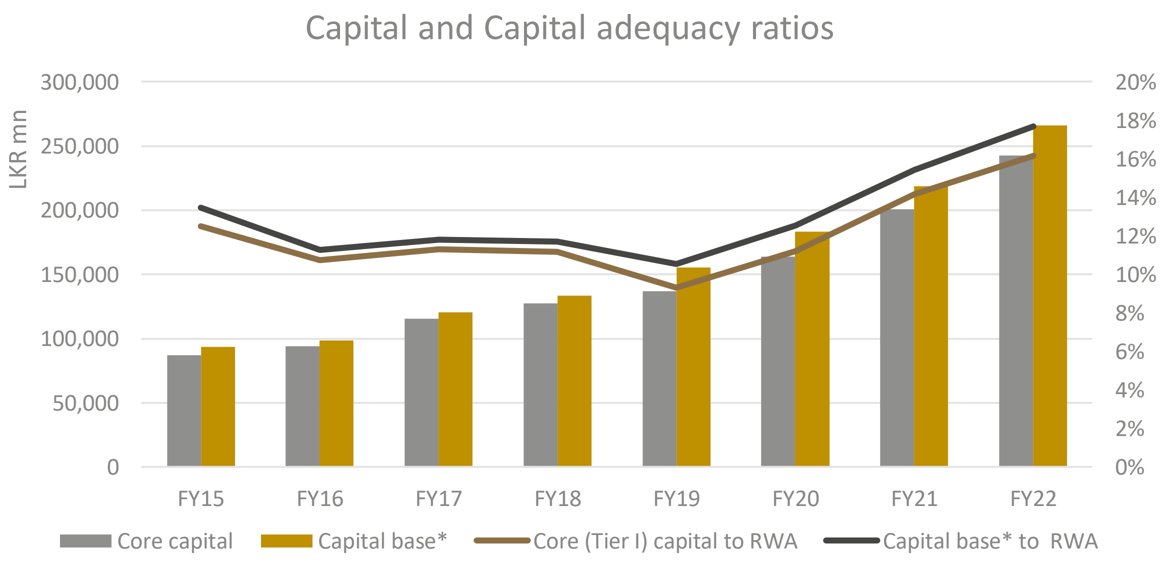
Local Industry - credit

- Leasing dominates the loans and advances held by LFCs amounting to 50.8%, and has grown at a CAGR of 10.4% from FY15 to FY22.
- The loans segment too has grown considerably at a CAGR of 11.4% amounting to 42.8% in FY22
- Hire purchases used to be quite popular (almost 21% of the total assets in FY14), but has reduced to just 1% after the removal of the tax advantage it had over leasing.
- Pawning too has increased, especially in the last three years, with the percentage of credit given for pawning doubling from 4% in FY18 to 12% in FY22.
- Loans against real estate are a very small percentage (1% in FY22) in the LFC sector of loans and advances, and are primarily taken from banks.

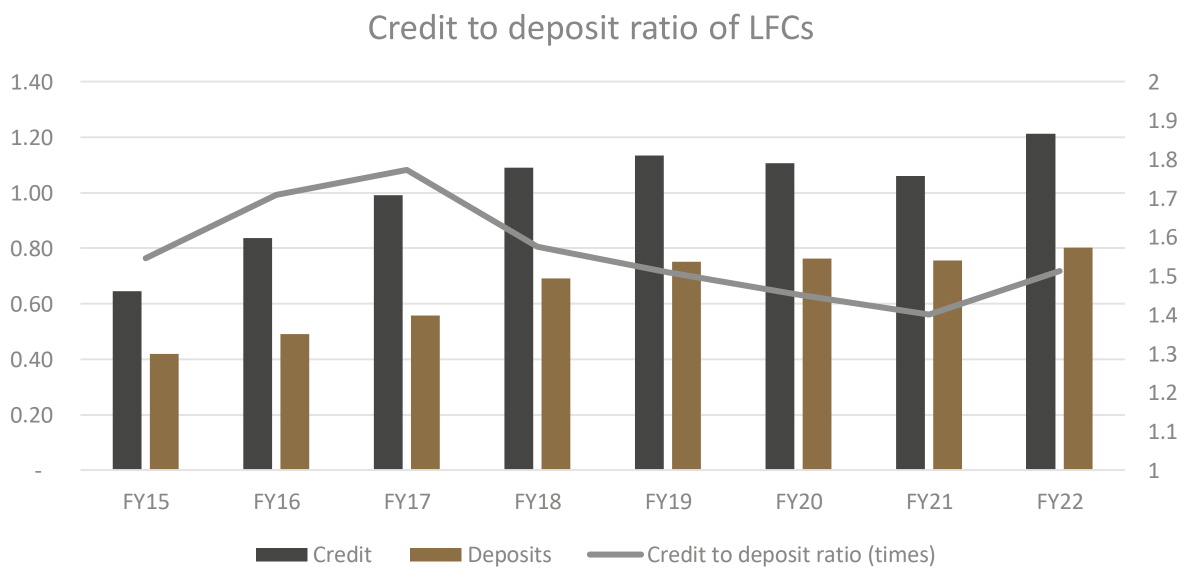


Local Industry – capital

- Capital adequacy ratios are monitored and regulated by the CBSL. Depending on the size of the financial institution, it should have between 7% and 8% of Core capital to risk weighted assets (RWA) and between 11% and 12% of the total capital base to RWA.
- The core and total regulated capital has been increasing during the period studied (from FY15 to FY22). During the period FY15 to FY18 total capital grew by a CAGR of 12% while total credit given grew by 18%. This mismatch resulted in the capital adequacy ratios declining, which prompted the CBSL to increase the minimum capital adequacy ratios in 2020.

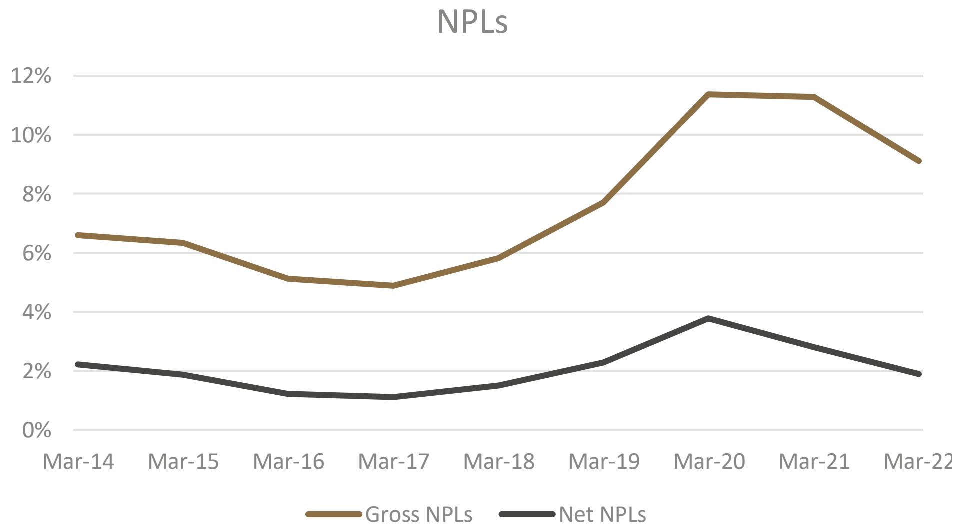


*Total regulated capital

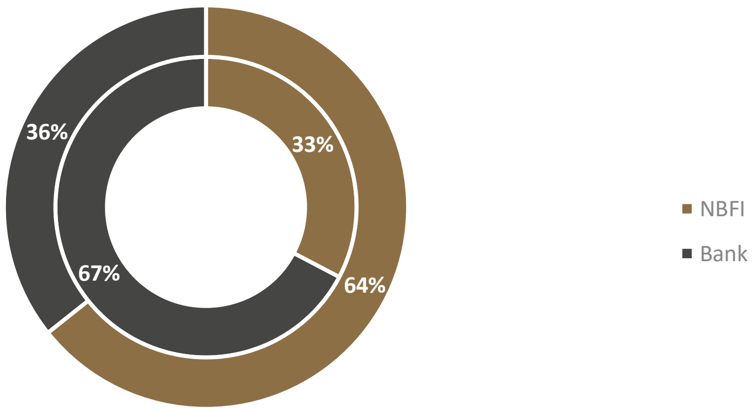


Local Industry – asset quality

- Asset quality has been depleting over time with NPLs growing steadily since FY18. Gross NPL increased to a staggering 14.1% in June 2020.
- However a reduction was observed in the NPL ratio in the past two years with the gross NPL reducing to 9.1% in FY22 and the net NPL reducing to 1.9%
- NPLs are higher in the LFC sector compared to the banking sector. As an example, the total credit given to the household sector by LFCs is 32.7%, however the percentage of the LFC sector in household sector NPLs is 64.3%.
- Since April 2020, under instruction from CBSL, bank and non-bank financial institutions have been providing concessions and moratoria to credit holders due to the financial distress caused by the Covid-19 pandemic.
- While moratoria due to Covid-19 have ceased since June 2022, the banks have been instructed to provide concessions and flexibility for businesses affected by the current economic crisis.

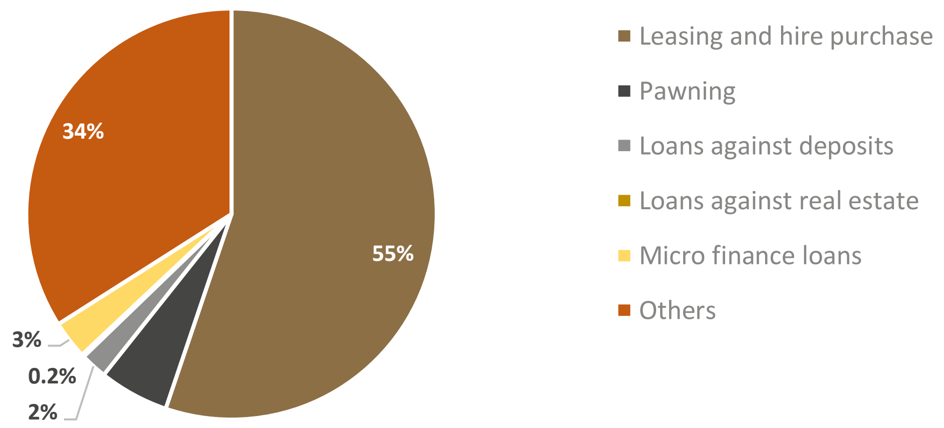


Total credit to the household sector (inner doughnut) and NPLs of the household sector (outer doughnut)

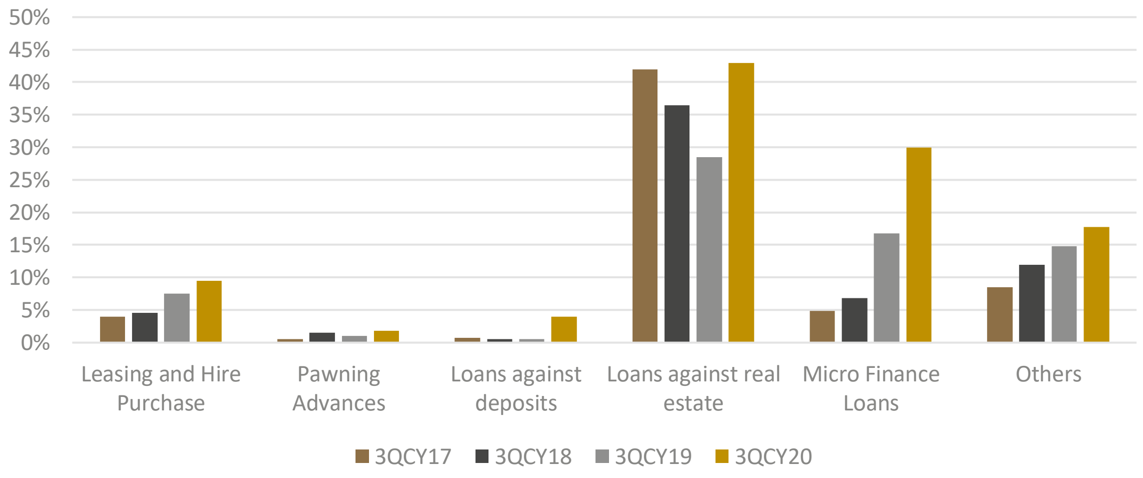


- The largest sector (product) to which the LFC sector has lent is for leasing and hire purchase. However the largest sectors that have defaulted are loans against real estate and micro finance loans.
- The year to Sep-2020 saw a rise in NPLs of all products. The rise in micro-finance loan defaults was the highest, which increased by 76% from 17% to 30%. This was because low income people and their small businesses were the most affected by the Covid-19 pandemic and related lockdowns and travel restrictions and the reduction in tourist arrivals.

Product wise loans and advances

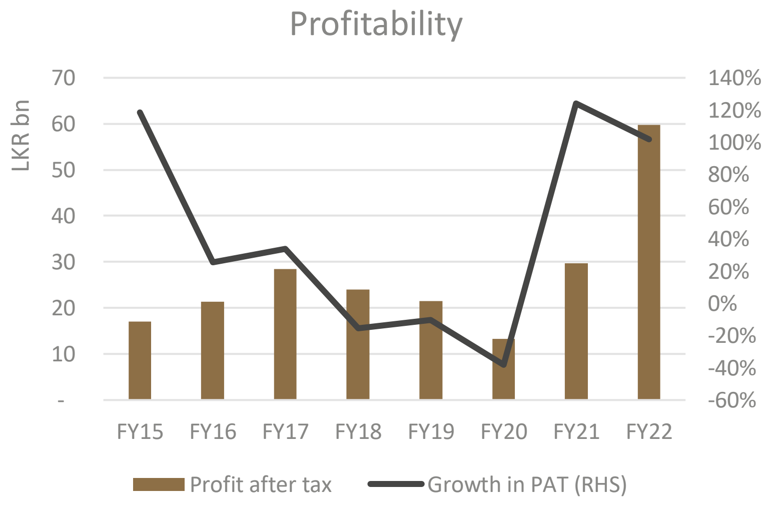


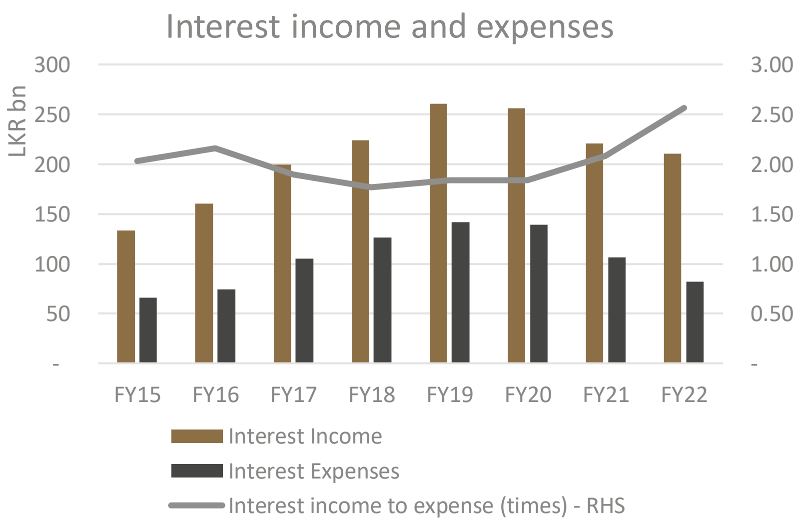
Product wise NPLs

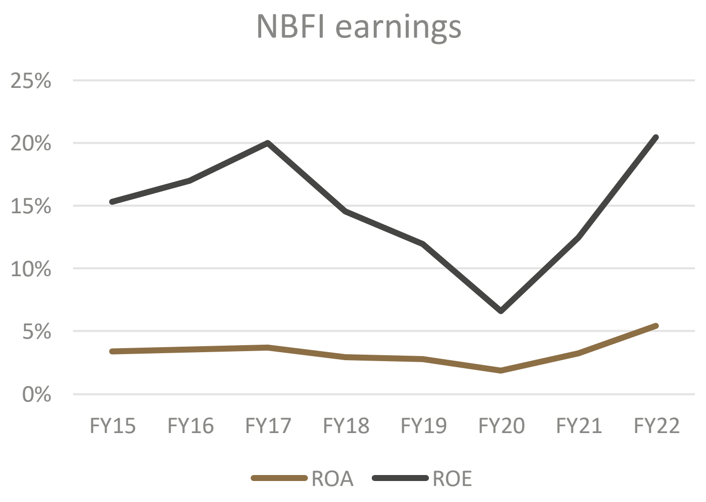


Local Industry – profitability

- Profitability of the LFC sector had been declining over the 4 years to FY20, but it grew by a staggering 124% in FY21 and another 102% in FY22. ROA and ROE too increased in FY21 and further in FY22.
- Both interest income and expenses dropped for the 3rd consecutive year. Interest expenses dropped by LKR 24bn and income dropped by LKR 11bn in FY22. Net interest income grew by LKR 13bn (~12%) during FY22.
- However, the large increase in profit was due to the reduction in loan loss provisions compared to FY21 which declined by LKR 20bn (77%). This was due to the significant provisions which were made in the previous years and the Covid-19 related relief measures that were in place during that time.







The Financial Sector Consolidation Master Plan (FSCMP)

- The Central Bank of Sri Lanka (CBSL) introduced a master plan to revive and re-consolidate weak and stressed financial institutions. This entailed reaching specific capital and asset targets set by the CBSL.
- The CBSL hopes to reduce the total number of LFCs to 25, with all of them listed on the CSE by mid 2026.
- Targets given to LFCs were as follows:
  - Increase the core capital to LKR 2.5bn by 31/12/2021.
  - Increase capital adequacy as follows:

	Tier 1 to RWA	Total capital to RWA		Tier 1 to RWA	Total capital to RWA
For LFCs with assets more than LKR 100bn			For LFCs with assets less than LKR 100bn		
by 01/07/2022	10.00	14.00	by 01/07/2022	8.50	12.50

  - Increase asset base to LKR 20bn by mid-2023.
- The following companies have been placed under regulatory restrictions for failing to comply with regulatory capital requirements:
  - Bimputh Finance PLC
  - Kanrich Finance Ltd - in the process of executing a consolidation transaction under the FSCMP
  - Nation Lanka Finance PLC
  - Softlogic Finance PLC – required to submit a viable capital restoration plan to comply with CAR

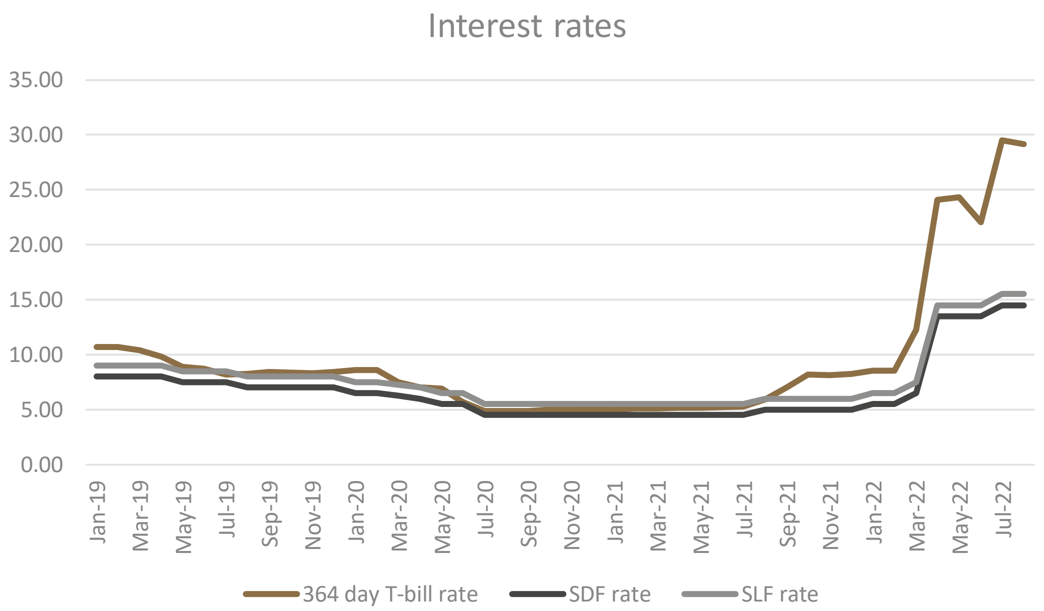
The Financial Sector Consolidation Master Plan (FSCMP)

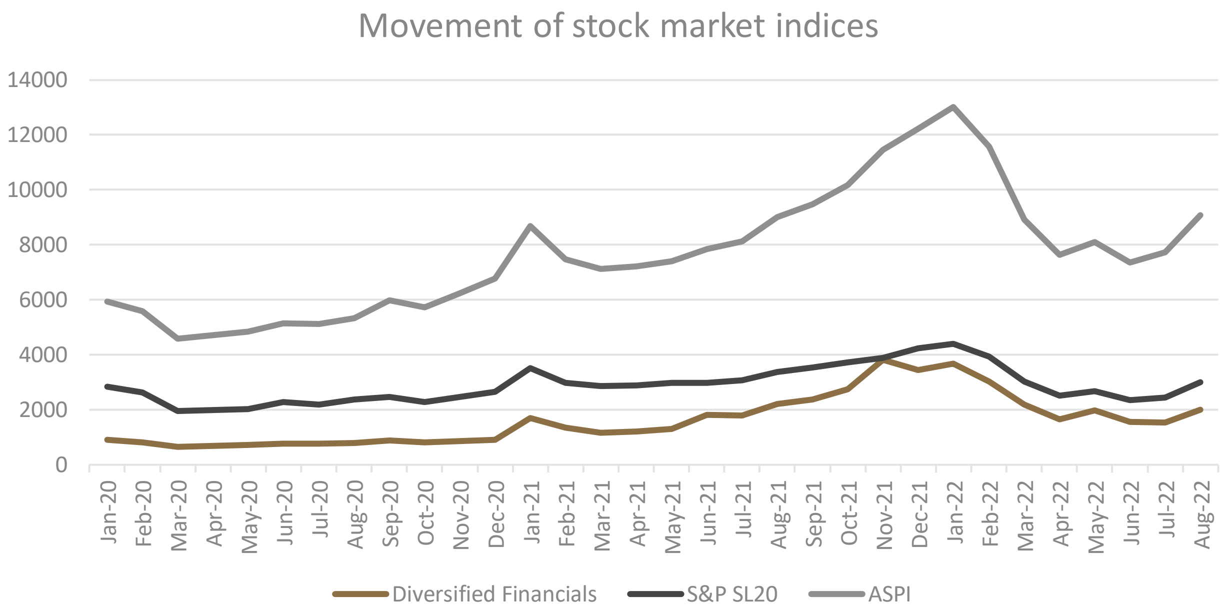
- The following companies have undergone consolidation as per the FSCMP:
  - Arpico Finance Co PLC has been amalgamated with Associated Motor Finance Co PLC with effect from 01.04.2021
  - Prime Finance PLC has been amalgamated with HNB Finance PLC with effect from 12.05.2022
  - Sinhaputra Finance PLC has been amalgamated with Commercial Leasing and Finance PLC on 21.03.2022 and subsequently Commercial Leasing & Finance PLC has been amalgamated with LOLC Finance PLC on 31.03.2022
  - LB Finance PLC acquired 64.63% of ordinary voting shares of Multi Finance PLC by investing Rs.400 Mn

CBSL requirements for LFCs

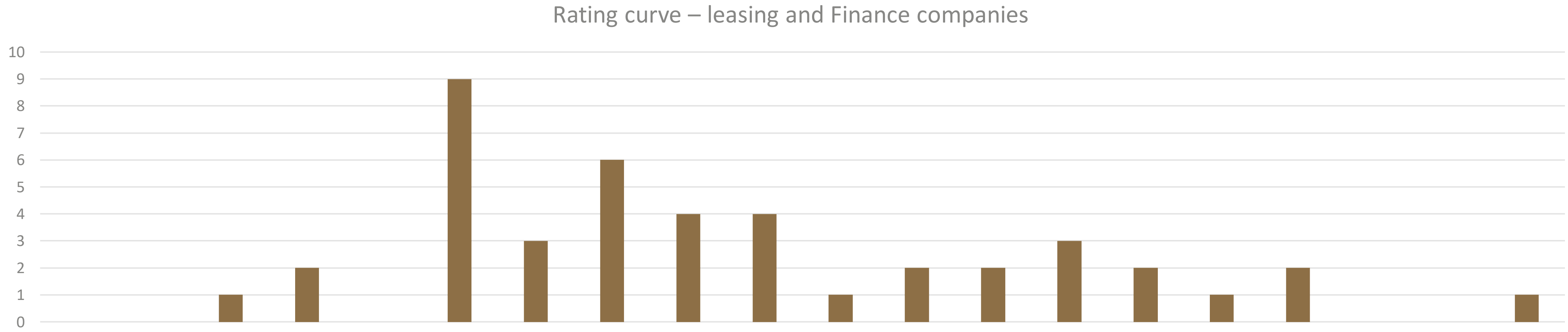
	Requirement	
Core capital	LKR 2.0bn by 31/12/2020	LKR 2.5bn by 31/12/2021
Capital adequacy for LFCs with total assets more than 100bn		
Tier 1 to RWA	8.00 by 01/07/2021	10.00 by 01/07/2022
Total capital to RWA	12.00 by 01/07/2021	14.00 by 01/07/2022
Capital adequacy for LFCs with total assets less than 100bn		
Tier 1 to RWA	7.00 by 01/07/2021	8.50 by 01/07/2022
Total capital to RWA	11.00 by 01/07/2021	12.50 by 01/07/2022
Total asset base	LKR 20bn by mid 2023	
Liquid assets	10% of time deposits + 15% of savings deposits + 5% of unsecured borrowings The above should include government treasury bills, government securities and CBSL securities equivalent to 7.5% of the average of its month end total deposit liabilities and borrowings of the 12 months of the proceeding financial year.	
Single borrower limit	Individual – LKR 412mn	Group – LKR 549mn

LFC interest rates and movement in stock market indices





Rating curve



	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-	CCC/C+	CC/C	C/C-	D
Fitch			1	2		5		1	1							1				
ICRA						4	3	5	3	4		2	2	3	2		2			1
LRA											1									

PESTEL Analysis

POLITICAL

- Import restrictions on personal vehicles and the subsequent price hike resulted in a significant decline in vehicle leases.
- Reduction of policy rates and the SRR which injected ample liquidity into the market, lowered the cost

ECONOMICAL

- Covid-19 induced mobility restrictions, and financial distress caused economic activity to be subdued and demand for credit to be less.
- Inflation is high and disposable income has been eroded.
- Asset quality too has been reducing despite the debt moratoria provided.
- Low forex availability and the depreciating LKR has put pressure on importers.
- Increased prices of commodities, specially fuel has depleted the terms of trade and increased import spending despite import restrictions, worsening the forex crisis.

SOCIAL

- The pandemic influenced, health, job-security and living standards, lay-offs and pay cuts lowered disposable income.
- Income disparity increased further.
- SMEs, LFCs primary customers were the worst affected by

PESTEL Analysis

POLITICAL

- Import restrictions on personal vehicles and the subsequent price hike resulted in a significant decline in vehicle leases.
- Reduction of policy rates and the SRR which injected ample liquidity into the market, lowered the cost of funding, enabled higher credit flows to the economy and smooth functioning of the finance system under the challenging circumstances caused by the pandemic.
- Tax concessions, debt moratoria and fiscal policy geared towards helping an ailing economy.

ECONOMICAL

- Covid-19 induced mobility restrictions, and financial distress caused economic activity to be subdued and demand for credit to be less.
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SOCIAL

- The pandemic influenced, health, job-security and living standards, lay-offs and pay cuts lowered disposable income.
- Income disparity increased further.
- SMEs, LFCs primary customers were the worst affected by the pandemic related financial stress.
- Changes in customer requirements and demand for greater convenience.
- Increased customer financial literacy and failures of few LFCs increased demand for transparency and accountability.

PESTEL Analysis

TECHNOLOGICAL

- Increased demand for online services during the Covid-19 pandemic, a change which is here to stay.
- Increased risk of cyber security threats with technological sophistication and increased usage of online platforms.
- Improvements in the digital front to obtain competitive advantage (e.g.- smart financing).

ENVIRONMENTAL

- Increased environmental consciousness in communities.
- Which has opened avenues for more sustainable, environmental friendly products, services and businesses (e.g. hybrid vehicle financing and renewable energy financing)

LEGAL

- Introduction of the Financial Sector Consolidation Master Plan (FSCMP) by the Central bank to create strong and stable LFC's to steer future economic growth and to safeguard the interest of depositors, thereby enhancing the overall credibility of the sector as a whole.
- Which has increased the minimum capital requirement, capital adequacy ratios and asset base to be achieved by given dates.
- Relief schemes and debt moratoria introduced by the CBSL for Covid-19 affected customers.

Risk Analysis

Risk Analysis

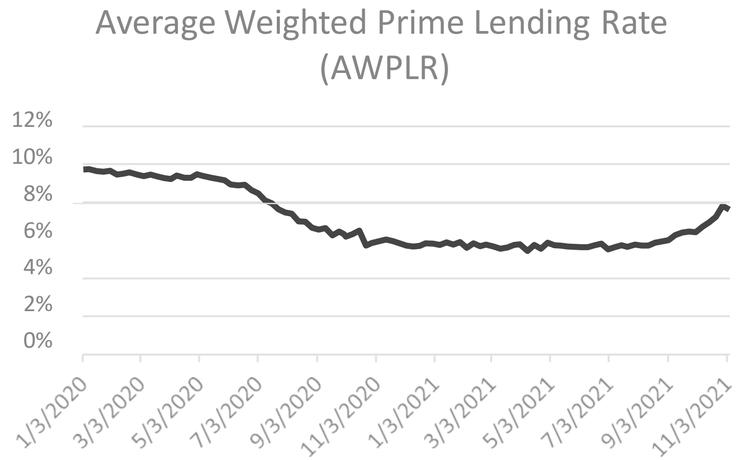
Credit risk

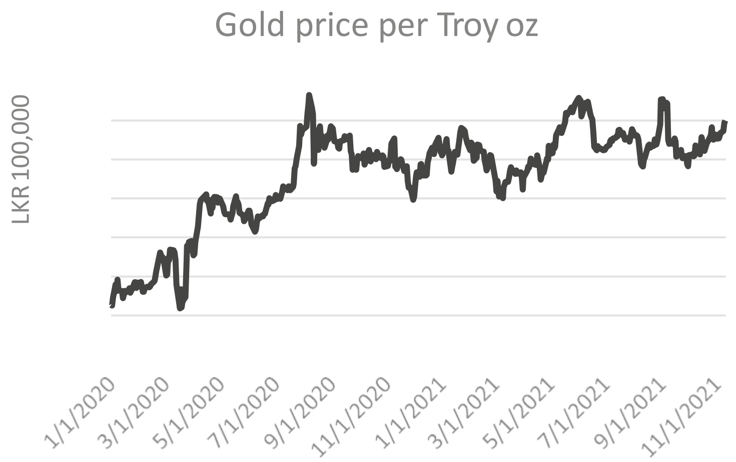
- Losses arising from the failure of obligators to meet their financial or contractual obligations as and when they fall due.
- The Company's credit risk arises mainly from different types of accommodation granted and could be identified as the most significant risk faced by the Company.
- Credit risk is addressed by granting credit according to approved policies and procedures. The credit approval process will define the lending authority, client selection and due diligence in line with the company's risk appetite.
- Customer creditworthiness is analyzed through rigorous customer evaluation initially and thereafter reviewing repayments.
- The NPL ratio is the salient measure in managing credit risk, and this is monitored regularly at branch, regional and company levels. Portfolio delinquency and loan impairments as well as portfolio quality are constantly monitored and exposures are reduced for the products with continuously high NPLs.
- 3-months overdue ratio and provisions coverage ratio are two other ratios that are used to evaluate credit risk.
- Product concentration too affects credit risk and therefore companies aim to maintain a satisfactory diversity among product range, industry sector and asset category. Concentration is monitored by the single/group borrower limit and the HHI index.
- Technology and business intelligence is used to improve automated processes focusing on delinquency management and recoveries through enhanced systems, processes and analytics.
- The Covid-19 pandemic posed difficulties in managing the credit risk. Customers' inability to meet debt obligations due to restrictions in economic activity increased NPLs/impairment charges. This was managed to a certain extent by moratoria provided by the CBSL, however NPLs could increase once these moratoria are discontinued.

Risk Analysis

Market risk

- Risk arising from fluctuations in market variables such as interest rates, exchange rates, equity prices, commodity prices such as gold.
- Since the industry involves granting of accommodation, accepting deposits and obtaining funding facilities, the movements in interest rates constitute the most important market risk.
- Excessive movement in market interest rates could bring volatility to the companies' net interest income and net interest margin.
- Interest rate risks are managed principally through minimizing interest rate sensitive assets and liability gaps.
- Company ALCOs closely monitor the interest rate movements and issue directions to lending and borrowing units on interest rate strategies.
- Interest rate stress tests, Interest rate sensitivity ratio and repricing gap ratio are some tools used to monitor market risk.
- In order to minimize the financial distress caused by the Covid-19 pandemic, the CBSL adopted an accommodative monitory policy stance reducing SDF and SLF rates by a total of 250 basis points during the CY20. It has since been raised by 5 basis points to 5.00 and 6.00 respectively.





Source - Central bank of Sri Lanka

Risk Analysis

Liquidity risk

- Risk arising from failure to maintain or generate sufficient cash resources to meet day-to-day obligation.
- Management of mismatches in the timing of cashflows, effective management of liquidity is considered of utmost importance in order to ensure smooth functionality of the companies' operations. Proper liquidity management provides critical defense against other risks such as financial, reputation and compliance.
- Monitoring liquidity risk indicators helps asses the efficacy of the comfort provided by liquid assets. Key ratios to focus on :
  - liquid asset ratios
  - maturity mismatch ratio
  - funding mix
  - exposure to bulk deposits
- Liquidity stress testing, based on different worst case scenarios and liquidity contingency plans are helpful in managing liquidity risks.
- The CBSL reduced the Statutory reserve ratio (SRR) by 300 basis points in CY20, in order to inject ample liquidity into the market enabling smooth flow of the financial system. Current SRR is 4.00%.
- The overall regulatory liquid assets available in the sector indicated a surplus of LKR 89.0 bn as against the stipulated minimum requirement of LKR 50.7 bn in December 2020.

Source - Central bank of Sri Lanka, Company annual reports

Future Outlook

- According to the World Economic Outlook published by the IMF in July 2022, the global economy is expected to grow at 3.2% this year (a slower growth than the 6.1% recorded in CY21). Negative spillovers from the war in Ukraine and a worse-than-anticipated slowdown in China, reflecting COVID- 19 outbreaks and lockdowns have been cited as the major influencing factors for this estimation.
- Sri Lanka is going through a severe economic crisis. Inflation is rising rapidly and the critically low level of foreign reserves has hampered the import of essential goods and raw materials. The economy is thus expected to contract significantly in CY22. LRA expects the GDP growth rate to decline to about 2% this year.
- The outlook of the economy looks quite bleak at this stage, and a lot would depend on how soon negotiations with the IMF will be finalized, and how effective the measures taken by the CBSL and the government to revive the economy will be.
- Supply issues are expected to amplify in the near future with a global food crisis being eminent. The war in Ukraine has affected the supply of many food items, and high inflation the world over has increased the prices of many essentials.
- Tourism which resumed post Covid-19 early this year declined in April due to the unfavourable economic and political environment.

Source - https://www.imf.org/en/Publications/WEO/Issues/2022/07/26/world-economic-outlook-update-july-2022
https://www.imf.org/en/News/Articles/2022/06/30/pr22242-imf-staff-concludes-visit-to-sri-anka#:~:text=%E2%80%9CSri%20Lanka%20is%20going%20through,the%20import%20of%20essential%20goods.

LFCs

- Small businesses which were affected badly by Covid-19-related lockdowns are the largest hit this time around too. Many restaurants have had to close down due to the unavailability of cooking gas, and many other small businesses have been affected by power interruptions and the unavailability of fuel to run generators. Taxi drivers and food delivery partners have also had their revenues reduced drastically.
- This is expected to increase the short-term NPLs of both the banking sector and leasing and finance companies. Credit to the private sector too would be tightened further.
- The CBSL has provided concessions for individuals and businesses affected by the pandemic. The CBSL also continued to review and monitor the key prudential indicators and introduced several regulatory and supervisory frameworks to strengthen the business functionality of certain weak LFCs in order to support and revive them.
- The authorities have been taking various measures since April to minimize the damage, however, it will be a long time before things return to normalcy.

Future Outlook

- The role of financial institutions in a recovering economy encompasses assisting customers in adversely affected sectors to stay afloat while also supporting growth in thriving sectors of the economy.
- However, financial difficulties caused by the pandemic, and drop in repayment capacity of corporates and individuals may lead to defaults which will result in financial institutions showing reluctance to lend. Such decline in credit will in turn lead to an economic downturn creating a feed-back loop between the economy and the financial sector.
- Leasing of vehicles which constitutes a major part of credit given by LFCs has been affected by the import restrictions of private vehicles. This has caused a surge in demand for second-hand vehicles in the market inflating prices by up to 50% sometimes depending on the type of the vehicle.
- The higher prices have supported loan recoveries from repossession, but the unaffordability has lowered the demand for leases. Once the ban on vehicle imports are lifted, the depreciating rupee would have a material effect on the price of vehicles imported, which too could reduce demand for leases.
- The CBSL's LFC consolidation plan too could alter the dynamics of the sector, with amalgamations and ceasing of operations due to take place.
- The pandemic has changed certain aspects of the trade and some of these changes are here to stay. Customers of LFCs are now demanding the convenience of conducting their financial services from the comfort of their homes, and hence many companies are looking to upgrade their technological capabilities.
- The use of technology results in operational efficiencies and enhanced customer experiences which will drive profitability and as a result the financial services industry will gradually gain its attractiveness to investors.