

SRI LANKA – Country Report

Current Market - Overview

Leasing which commenced in the early 80's with two specialised leasing companies has grown significantly over the years. At present there are 74 institutions, engaged in leasing. Among them are 21 specialised leasing companies, 34 finance companies, 11 commercial banks, and specialised banks. The severe competition among lessors has resulted in the erosion of margins and accommodation of risk at the expense of quality. This strategy is now causing concerns among the industry participants due to increased incidence of arrears and non performing leases and also reduced operating profits

Growth of the Industry

In 2007/08 the value of leases booked was around Rs. 70.9 Billion (US\$ 650,000,000). As a percentage of GDP it was around 2.3%. The average of growth in the value of leases written over the past five years up to 2007/08 approximately 30%. The year 2008/09 recorded only Rs.58.1 billion with a negative growth of 18% over the previous year due to on-going financial crisis.

The industry remains mainly centered around, commercial and passenger vehicles. Around 95% of the leases are for vehicles. Leasing companies have not been aggressive in promoting equipment leases mainly due to the lack of an established secondary market, and the difficulties in the recovery of leased assets (in the event of default) combined with delays in court procedure.

In recent times leasing companies have been actively promoting leases in rural areas which were untapped hereto. This is one of the main reasons for the growth in volumes in the latter part of 2009.

Industry perspective at a glance	30.09.2009	30.09.2008
• Share of finance lease portfolio – Specialised Leasing Cos.	26%	31%
- Registered Finance Co.	30%	24%
- Banks	44%	45%
• Specialised Leasing Companies (SLC's) (Nos.)	21	21
Asset wise market share of four big players (Over Rs. 5 Billion)	75%	76%
• Profitability /Quality of Portfolio		
-Net interest income increased due to low cost of borrowings	Rs.5.6 billion	Rs.5.0 billion
- Non performing ratio	7.5%	4.6%
- Non Performing portfolio	Rs.80.0 billion	Rs.95.0 billion

Constraints and Opportunities

Even though the industry grew up to 2007/08, there has been a drastic decline in the value of leases written in 2008/09 due to the shift to hire purchase. Over 50% of the leases are for used vehicles on which the lessor does not get an input credit for VAT at the time of purchasing the asset. However the entire lease rental is liable for VAT (15% prior to 1st January 2009 and 12% thereafter). Hire purchase and loan installments are not liable for VAT. Hence a hire purchase/loan installment is significantly lower than a lease rental. Due to this disparity there is a significant shift of lease business to hire purchase. It is expected that lease volumes would come down by around 50% due to this. Also due to the revised customs duty structure on imported vehicles, especially those running on diesel, new vehicle sales remained depressed.

A similar issue is faced in the leasing of agricultural machinery. In recognising the importance of the agriculture sector to the economy and the livelihoods the government has exempted the import and supply of agricultural equipment from VAT. However the lease rental payable on a lease for agricultural machinery is liable for VAT. This results in increasing the cost of leasing compared to a hire purchase/loan facility. Even though numerous representations have been made in this regard the anomaly has not been addressed as yet.

Capital allowances for plant and machinery is claimable over a period of eight years. (12.5% per annum). low rate of capital allowances on plant and machinery is a deterrent to investment and also financing of plant and machinery through leasing. Lease rentals falling due in an year of assessment is considered income in the hands of the lessor. Such rentals include capital and interest. The lessor is allowed to claim capital allowances as an expense. As most equipment leases are for tenors of four to five years (lessors do not enter into longer term leases due to credit risks, risk of obsolescence interest rate risk, lack of matching long term funds etc.) the capital recovery considered to be income is higher than the capital allowances claimable as an expense (spread over an eight year term). Due to this the lessor has to pay higher taxes initially on income, which he never received.

Sri Lanka went through a relatively low interest rate regime from 2002 – 2006. During the past three years the interest rates have kept increasing. Most leasing companies were exposed to interest rate risk due to long term debt instruments. The drastic increase in borrowing rates has caused a serious problem to the industry up to June 2009. However, the dominant players managed to attract funds on variable rates of interest mainly on the strength of their investor confidence and their financial stability.

The effects of the global recession had its effects on the Sri Lankan economy. The export industries were experiencing a reduction in orders. Foreign remittance from the Middle East which is the main source of foreign exchange for the country has also declined. Due to the slowing down in economic activity the banks have restricted lending to leasing companies. Hereto most leasing companies (specially specialised leasing companies) were heavily reliant on bank funding. At the direction given by the Central bank of Sri Lanka the interest regime (deposit and lending rates) was relaxed from June 2009. The cost of borrowing is gradually being reduced to promote the private sector credit economy.

Many leasing companies see an opportunity to move into leasing of plant and equipment and also agricultural machinery. The industry is trying to convince the regulators and other policy makers to address the concerns it has with regard to fiscal policy and the legal process.

Financial system and stability policies for 2010 and beyond

The main thrust of the policies will be to cater to the increasing demand for diversified financial services. The economy is expected to grow more than 5% in 2010 due to the end of the civil conflict and the gradual recovery of global economy. Annual inflation is projected to be around 5-6%. The new programme of re-building the Northern and Eastern provinces has touched farmers, families, fishermen/families and entrepreneurs alike. New laws will be introduced to regulate and supervise micro-finance institutions. Implementation of Credit Guarantee Scheme for SMEs by Central Bank and mandatory Deposit Insurance arrangements are in the agenda.

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Sri Lanka

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