ICRA LANKA

Sector Outlook | NBFIs

Post-COVID Impact Analysis

5 June 2020

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NBFI Outlook in the post-confinement period

Sri Lanka's economic activities had slowed down during Q1 CY2020 and the economy is expected to contract by 4.5% in Q2 as per ICRA Lanka's assessment, amidst the outbreak of the COVID-19 virus.

Read ICRA Lanka's report on the economic impact of COVID-19.

ICRA Lanka expects the outlook for Sri Lanka Non-banking Financial Institutes (NBFIs) to be more challenging than for Licensed Commercial Banks (LCBs) in the period following the confinement mainly due to 3 key reasons.

Reason 1: The asset quality of the sector will continue to deteriorate

Traditionally, the finance companies in Sri Lanka cater to the informal and relatively vulnerable segments of the economy such as self-employed individuals, micro businesses, SMEs. The income levels of these segments are volatile and the COVID-19 disruption has amplified the volatility.

As the data indicates, asset quality indicators of the Licensed Finance Companies (LFCs), like that of the banking sector, did not recover following the Easter attack events of April 2019. LFC sector NPA ratio was close to 10.8% as in December 2019 compared to 9.2% in June 2019, the quarter ended immediately after Easter events. ICRA Lanka expects significant deterioration in asset quality triggered by defaults and deferred payments in Q2 this year.

The asset quality of the NBFI sector has not recovered following the Easter attacks incident.

ICRA Lanka takes cognizance of the CBSL debt moratorium that will prevent a larger portion of these facilities being classified as non-performing. Regardless of the NPA classification, the fundamental asset quality of the segment will significantly deteriorate, as a result of the crisis. Also, the recovery of the same is likely to take longer, as witnessed after the April 2019 Easter events.

Reason 2: Funding and liquidity are the most significant vulnerabilities for the finance companies

Funding profiles of Sri Lanka's finance companies have been largely characterized by limited diversity, with fixed deposits dominating the funding profile. As of December 2019, about 65-70% of the total funding (debt) was contributed by customer deposits, while the balance was mainly from bank borrowings. Further, ICRA Lanka notes that funding diversity of smaller finance companies is even less, with deposit concentration going up to about 90% of the total debt. Higher deposit dependence coupled with limited access to funding lines could create liquidity stress for finance companies,

The LFCs' funding profiles are dominated by deposits, which leave them wide open for "flight-to-safety" behavior of depositors.

especially for the smaller ones, as deposits will tend to move to safer asset classes during crisis periods.

Further, the debt moratorium offered by the CBSL covers some of the key asset classes of finance companies - commercial vehicle leasing, SME loans, loans for the self-employed and gold loans/ pawning. Collections on other facilities that are not covered by the moratorium are also likely to be much slower during the immediate to short term. The sharp overall reduction in loan recoveries is expected to significantly affect the liquidity profile of finance companies.

On the other hand, subdued loan growth of the sector (NBFI sector loan growth over the 12 months ended December 2019 was -2.7%), which is likely to extend over the short term to medium, will provide some comfort from a liquidity point of view, for the finance companies. Also, the recent reduction of the statutory liquidity limit for LFCs is expected to provide further liquidity support.

Reason 3: Core capital requirement imposed by the CBSL is expected to put additional pressure on the finance companies in the medium term.

As of March 2020, a large number of small-medium sized finance companies (about 13) were operating below the minimum core capital requirement stipulated by the CBSL and all these entities were undergoing capital enhancement initiatives to meet the same. The pandemic crisis and the country-wide lockdown is likely to affect the timelines of the capital raising exercises.

About 13 LFCs were already operating below the minimum core capital requirement as of March 2020.

In light of the current situation, the CBSL has extended the timelines to comply with the minimum capital requirement and this will provide some breathing space for the LFCs. However, given the challenging macro environment, meeting the minimum capital requirement will remain a major hurdle.

About ICRA

ICRA Lanka Limited is a credit rating agency licensed by the Securities and Exchange Commission of Sri Lanka (SEC). ICRA Lanka is a fully owned subsidiary of ICRA Limited of India. The company was incorporated in December 2010 and was granted license by the SEC in May 2011.

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