ICRA LANKA

Special Release

The Central Bank's COVID Response | Finding balance between financial sector stability and credit growth

July 2020

Key Takeaways

- Steady credit flow to the real economy is imperative for the post-COVID-19 recovery. In order to facilitate this, the Central Bank needs to ensure financial institutes have both the capacity and the willingness to lend.

- Financial institutions were on a weaker footing even before the COVID crisis due to the Basel III capitalization requirements, the deterioration in asset quality, and dwindling profitability due to macro factors. Therefore, the risk appetite of the financial institutes at the moment is low.

- The reduction in policy interest rates beyond a certain point may not generate appreciable expansion in credit in the economy as the financial institutes' risk appetite would not improve in a state of crisis.

- The credit guarantee scheme is a step in the right direction to improve the risk appetite but its success depends on whether the banks can recover the value of the guarantee in a timely manner in case of defaults.

- The net outcome of the CBSL actions have far more intricate dynamics and risk implications for the system therefore, looking forward, it is important to strike a balance between financial stability and credit growth.

Introduction

The financial sector in Sri Lanka is under heavy pressure as the country was brought to a standstill due to the COVID-19 pandemic. As the country limps back, the economy is expected to contract (ICRA Lanka forecasts the 2020 Q2 growth to record a 4.5% recession).

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

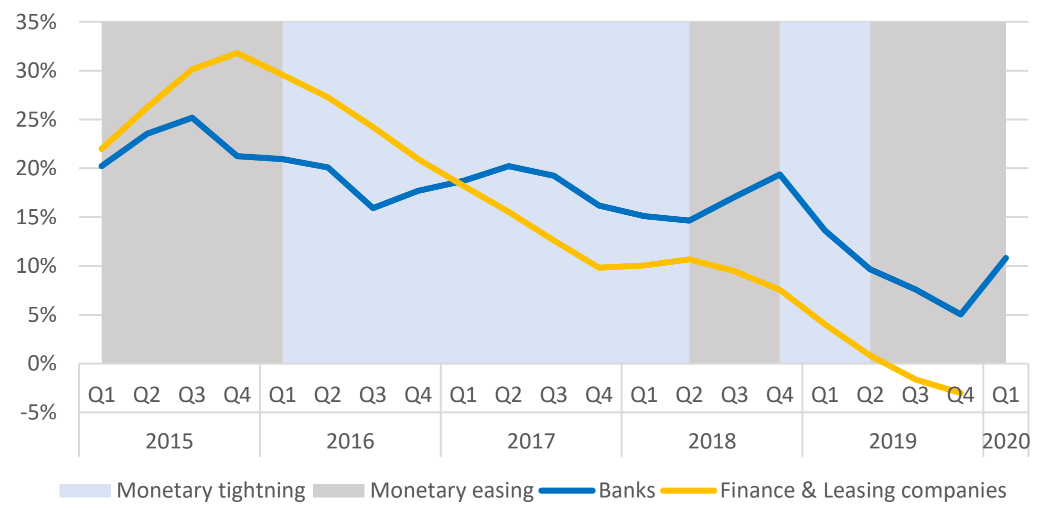
With a view of facilitating speedier economic recovery, the Central Bank of Sri Lanka (CBSL) has taken a number of steps to increase credit flow to the economy by enhancing the liquidity in the banking and the financial sector. While noting the timely actions and the need to act swiftly given the severity of the challenges faced by the economy, ICRA Lanka believes maintaining the soundness of the financial system is of paramount importance to long term economic stability and wishes to highlight number of observations from credit standpoint with regard to the CBSL's COVID response.

What was the state of the financial institutions before the COVID crisis?

Financial sector performance for last four years can be described as subpar. The sector went through series of crises just before confronting with the COVID-19 pandemic. Financial institutions[1](FIs) were required to raise capital under the Basel III capitalization requirements before the crisis. This together with the deterioration in asset quality and dwindling profitability in the last three years had already posed major challenges for the sector, especially for finance and leasing companies.

Financial institutes, especially finance and leasing companies, were required to raise capital under the Basel III capitalization requirements before the crisis. This together with the deterioration in asset quality and dwindling profitability in the last three years has already posed major challenges for the sector

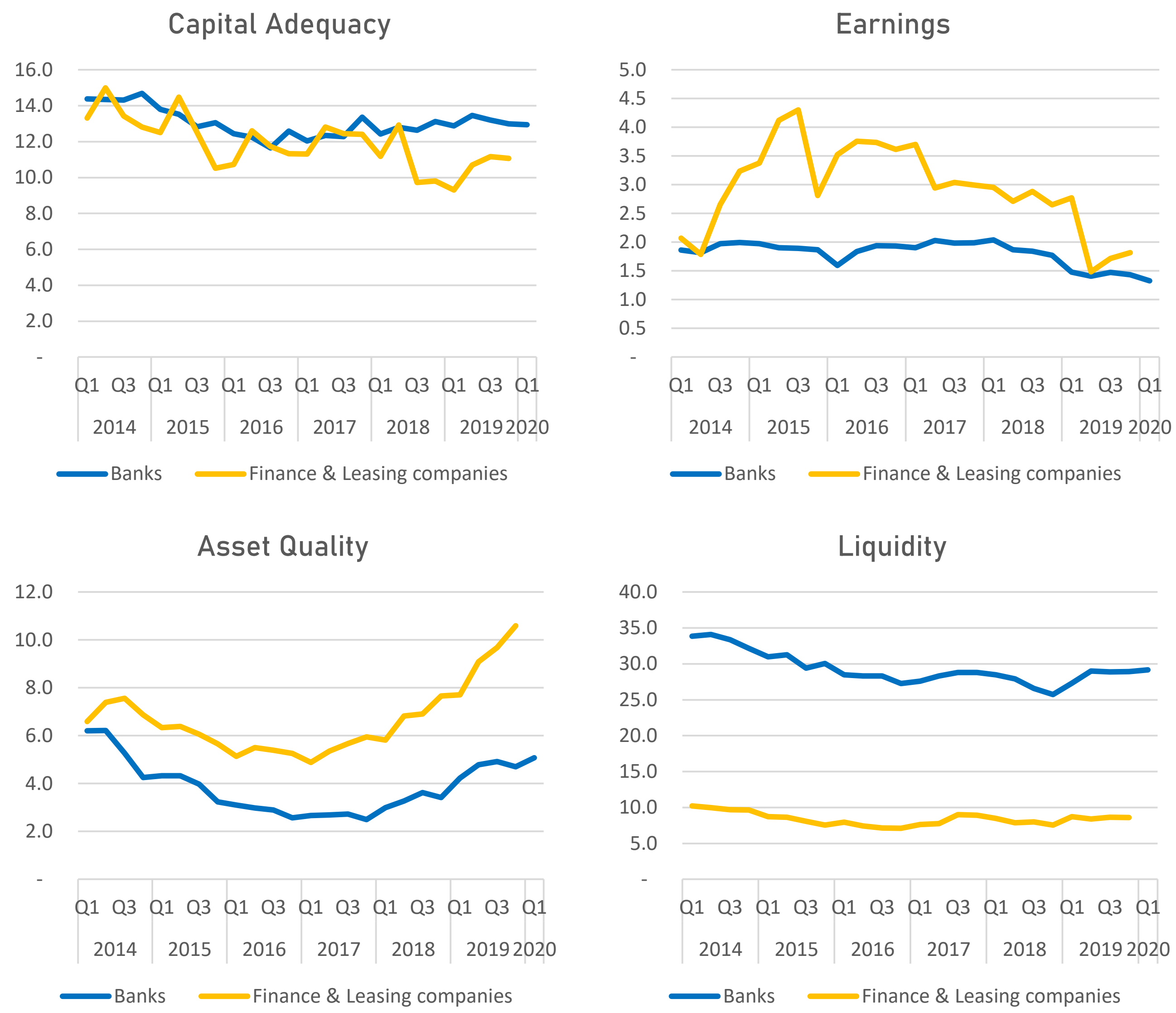
Figure 1: Credit growth vs. the CBSL policy stance 2015-Q1 2020



Notes: Quarter on quarter growth in net loans and advances *Source: CBSL*

[1]Throughout this text, banks and finance and leasing companies are collectively referred to as the financial institutes.

Figure 2: Financial sector key indicators 2014 – Q1 2020



Notes: Capital adequacy indicators; for banks- Tier 1 Capital Ratio, for finance/leasing companies – Core Capital to Risk Weighted Assets, Earnings indicators; for banks- Return on Assets – before tax, for finance/leasing companies – Return on Assets (Annualized), Asset quality indicators; for banks- Non-performing Loans to Total Loans and Advances, for finance/leasing companies – Gross Non Performing Advances to Total Advances, Liquidity indicators; for banks- Liquid Assets to Total Assets, for Finance/leasing - Regulatory Liquid Assets to Total Assets, The data for finance/leasing companies for Q1 2020 is not available

Source: CBSL

Following the budget proposals to provide relief to vehicle imports together with accommodative monetary policy, the credit growth peaked in 2015. Finance and leasing companies reported record growth in loans and advances during this time. As the pressure on the exchange rate mounted due to hefty vehicle imports bill, the CBSL imposed caps on the maximum loan-to-value (LTV) ratios which subsequently led to deceleration of credit over the years. From 2016 to Q1 2018, the CBSL maintained a tighter monetary stance. The money market liquidity frequently ran into shortages as a result of forex market intervention by the CBSL putting pressure on

FIs from funding standpoint. To ease the pressure, the CBSL cut the Statutory Reserve Ratio (SRR) in two steps to release liquidity to the banking sector. This helped the banks to recover credit growth to some degree but as more tightening was followed for the next two quarters, the credit growth lost the momentum.

In addition, flood and drought conditions that prevailed from the latter part of 2016 and during 2017 further dented the growth of the sector. The constitutional crisis in 2018, and Easter Attacks in 2019 had profound impacts on the loan growth. The impact on the finance and leasing sector was severe as it generally caters to vulnerable income groups. Unsound state interventions in the microfinance segment during 2018 also contributed to the challenging outlook for the said sector. The net loans and advances of the leasing and finance sector recorded a negative growth following Q2 2019. Subsequently, the CBSL cut policy rates to support the recovery. The loan growth of the banking sector bounced back in Q1 2020 just before the COVID-19 breakout in the country.

Unsound state interventions in the microfinance segment during 2018 also contributed to the challenging outlook for the said sector.

Asset quality indicators which were recording significant improvements since 2014 gradually started to deteriorate from 2017 onwards. The growth in net loans and advances outpaced the growth in risk weighted assets indicating banks had become more risk averse overtime. A key factor that contributed to this deterioration was the drought and flood situation that prevailed in 2017 which directly affected the agriculture and SME sector loan recoveries. The government also followed some austerity measures during 2016-18 period. As a result, the interest subsidy on the deposits of the senior citizens, which is long overdue from the state to the banks, was getting accumulated. The constructions sector, which the banks had the highest credit exposure to, often suffered liquidity shortages as a result of the delays in receivables from the state sector. Consequently, the banks saw the construction related non-performing loans (NPLs) rising. In addition, tourism sector was impacted due to the constitutional crisis and the Easter Attacks and contributed to rise in NPLs in the last 3 years.

Sri Lanka started transitioning to Basel III from Q2 2015 and the FIs were required to raise capital. Capital adequacy levels declined as the asset quality started to wane. Improvement in NPLs helped enhance the profitability of FIs in early years, but from 2017 onwards the profitability was on the decline due to deterioration in asset quality compounded by the rising interest rates. Implementation of SLFRS 9 in 2018 also had a bearing on the risk appetite of FIs, given the need to provide higher provisions for credit losses amidst deteriorating asset quality. Increase in taxes and operational costs also had major impacts on the profitability of the banking sector. Consequently, the risk appetite started to diminish and resulted in more funds being moved towards low risk investments such as government securities.

Low risk appetite resulted in more funds being moved towards risk-free investments such as government securities.

Moreover, the country's persistent lackluster economic performance and challenging global conditions did not provide a conducive environment for higher credit growth.

Read ICRA Lanka's report on the post-confinement outlook of NBFI sector

What has the CBSL done in response to COVID-19 crisis?

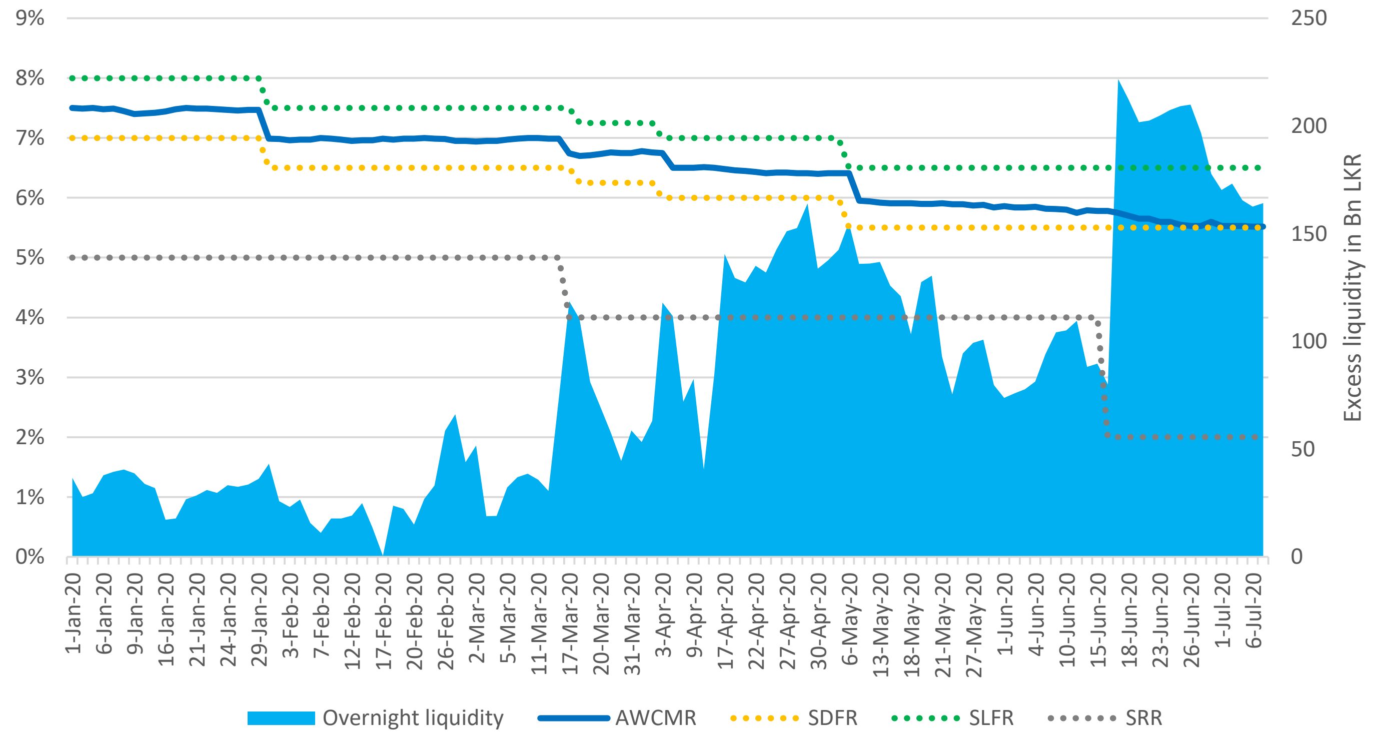
The business confidence and economic activity levels are currently at dismal levels as seen from the Business Outlook Survey conducted by the CBSL and the daily electricity generation data. In a weaker economy, credit growth slows as FIs cut lending to the real economy in expectation of tighter liquidity and augmented default risks leading to prolonged economic recovery. In such a situation, the Central Bank may respond by ensuring the FIs have sufficient capacity to lend and by enhancing the risk appetite of FIs.

Broadly speaking, the key objectives behind the CBSL's COVID-19 response so far are; to provide relief to the affected individuals and businesses, to ensure the FIs have adequate liquidity to stay afloat through the crisis, and to encourage FIs to extend credit to the real economy during the crisis. To achieve the aforementioned objectives, the CBSL has implemented several initiatives; reduced its policy rates historical lows, released part of capital and liquidity buffers built up overtime as a result of the adoption of Basel III, relaxed administrative and supervisory compliance requirements for FIs, and implemented a debt moratorium and credit schemes to support COVID affected businesses and individuals.

The key objectives behind the CBSL COVID-19 response are to provide relief to the affected individuals and businesses, to ensure the FIs have adequate liquidity to stay afloat through the crisis, and to encourage FIs to extend credit to the real economy during the crisis.

Would these steps lead to the expected growth in credit?

Figure 3: Policy rates vs. overnight liquidity (Daily data)



Notes: AWCMR- Average Weighted Call Money Rate, SDFR- Standing Deposit Facility Rate, SLFR- Standing Lending Facility Rate, Data from 23rd to 26th March was censored as markets were mostly inactive

Source: CBSL

As a result of the rate cuts and release of buffers, the money market liquidity shot up driving the short-term interest rates down (see Figure 3). The idea behind this is to make cheaper wholesale funding available for FIs, so that the interest margins are enticing enough to cover the risk. However, as the crisis deepens, the risk premium will overshadow the interest rate cuts and ultimately, it would come to a stage where the rate cuts would not have any effect on the lending as FIs' implicit risk premium is far greater than what the borrowers are willing to pay for. As pointed out earlier, Sri Lankan financial sector was already on a weaker footing before the crisis, hence FIs, especially the banks would be cautious when lending. Therefore, the reduction in interest rates beyond this point may not generate appreciable expansion in credit in the economy, as the FIs' risk appetite would not improve in a state of crisis.

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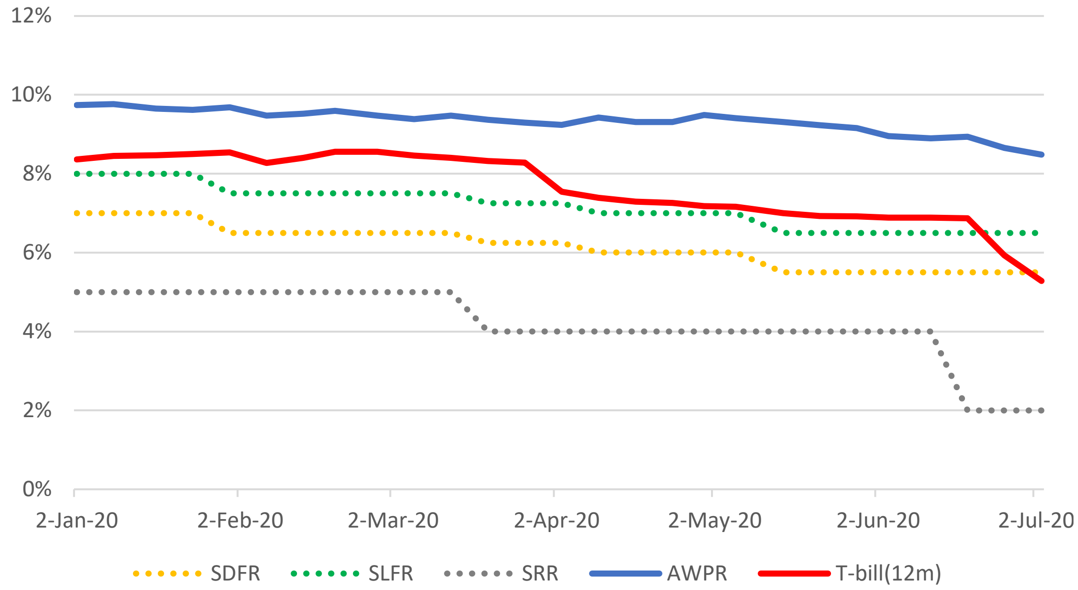
Figure 4: Policy rates vs. long term rates (weekly averages)



Notes: AWPR- Average Weighted Prime Lending Rate, SDFR- Standing Deposit Facility Rate, SLFR- Standing Lending Facility Rate, T-bill yields are for the secondary market

Source: CBSL

The slowdown in credit is mirrored by the widening spread between the AWPR and 1-year T-bill (see Figure 4). For the month of April 2020 only LKR 13 Bn credit was disbursed to the private sector as opposed to LKR 120 Bn disbursements in March 2020. This indicates, the FIs are likely to channel the funds towards government securities and the private credit will not grow fast enough to warrant a V-shape recovery.

The slowdown in credit is mirrored by the widening spread between the AWPR and 1-year T-bill. This means the funds have moved to government securities instead of the private sector.

In a crisis, the market shows clear bifurcation where there are borrowers with good credit standing and borrowers with the opposite. FIs start competing for good credit in the market. Once the scope to lend to good borrowers is depleted, the growth in the FI asset portfolio slows down.

The reduction in interest rates has several implications on the balance sheets of the FIs. With the real interest on savings eroding, we expect the deposit base of the banks and LFCs to shrink in the medium to long term resulting in an increase in funding cost.

In addition, in a recession the asset prices are expected to plummet therefore the banks may ask for higher haircuts on underlying collaterals or increase loan loss provisions. In this situation the borrowers may be compelled to sell off assets as opposed to borrowing making the asset prices decline further leading to a collapse of the mortgage loan market.

Another explanation for slow expansion in credit is that, in an environment where there are expectations for interest rate to decline, credit worthy borrowers may delay borrowing. They could delay borrowing as the economy is weak and the investment opportunities are scarce.

On 28th June 2020 the CBSL announced a credit guarantee and interest subsidy scheme for businesses affected by the COVID-19. This step will likely to increase the risk appetite of the FIs as it acts as a backstop to credit risk for loans extended to individuals and businesses during the crisis. However, the success of this scheme depends on whether the banks will be in a position to enforce the guarantees and recover outstanding amounts in case of defaults.

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What does all this mean in terms of risk to the system?

Heavy handed credit expansion inevitably leads to buildup of excessive credit risks and inefficient allocation of funds. It could help ‘bad borrowers’ (i.e. individuals or companies which have had poor financial standing even before the crisis) to prolong their survival. Low interest rates may also attract individuals who do not have a genuine requirement (reckless investors/speculators) to borrow. Given the recent relaxation of macro-prudential requirements, these trends could increase the credit risk for the system.

Risk based capital adequacy frameworks and higher minimum capital levels were introduced recently to ensure proper risk priced lending by banks and leasing/finance companies to ensure systemic stability. With the CBSL lowering the capital requirement these efforts are now being nullified. With relatively smaller capital base, now the FIs can operate with higher leverage. This could increase the vulnerability of the financial system if the credit expands rapidly.

With relatively smaller capital base the FIs can now operate with higher leverage. This could increase the vulnerability of the financial system if the credit expands rapidly.

With real interest rates falling to lower single digit levels, the quest for yield will be on. This could drive individuals and companies to take riskier investment positions. The repercussions of such an event can be devastating on the faltering economy as seen from the past events.

In addition, the CBSL has relaxed various supervisory requirements, collateral eligibility, asset eligibility to provide banks with greater flexibility in supporting lending. However, these steps increase the vulnerability of the system and delay recognition of issues.

Currently, the excess liquidity level is significantly greater than the pre-crisis levels. If high surplus liquidity level persists for a long time, it would end up permanently in the SDF and the CBSL would have to print money to pay interest on the SDF deposits in the process fueling more liquidity. Buildup of excess liquidity puts pressure on the rupee to depreciate as well. This will be a major obstacle to attract foreign investment to debt and equity markets to build much needed forex reserves for the country.

Conclusion

Steady credit flow to the real economy is imperative for the post-COVID-19 recovery. In order to facilitate this, a Central Bank needs to ensure FIs have both the capacity and the willingness to lend. The CBSL has taken numerous steps in response to COVID crisis. The net outcome of the CBSL actions have far more intricate dynamics and risk implications for the system. Therefore, it is critical to be cautious about striking the right balance between credit growth and system stability. Moreover, ICRA Lanka believes, in the current context, non-monetary measures should also play a pivotal role in spurring economic growth which will in return lead to a healthier credit expansion.

Abbreviations

AWPR	Average Weighted Prime Rate
CBSL	Central Bank of Sri Lanka
NPL	Non-performing Loan
SDF	Standing Deposit Facility
SLF	Standing Lending Facility
SLFRS	Sri Lanka Financial Reporting Standards
SME	Small and Medium Enterprises
SRR	Statutory Reserve Ratio

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About ICRA

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