

RAM

REGISTERED FINANCE COMPANIES' SECTOR REPORT – SEPT 2009

EVOLVING AMIDST CHALLENGES



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Summary

Registered finance companies ("RFCs") represent an important component of Sri Lanka's financial landscape. Although this sector only constituted 3.7% of the entire financial system's assets as at end-December 2008, RFCs - together with their branches - are crucial to the development of small, medium-sized and even micro enterprises.

While RFCs are primarily engaged in vehicle financing, this industry supports the financial requirements of small and medium-sized enterprises ("SMEs") through other forms of asset-backed financing. In addition, there is also a segment of the industry that deals in real-estate development and housing. These loans and other assets are in turn funded through public deposits. To ensure that RFCs undertake their business activities in a prudent manner, they are regulated by the non-bank financial institutions department of the Central Bank of Sri Lanka ("the Central Bank").

Meanwhile, the much-publicised collapse of 2 finance companies in 2008 had focused the spotlight on deposit-taking financial institutions. As the public rapidly lost confidence in the financial system, many depositors had scrambled to safeguard their money amid rumours of lengthy queues at many deposit-taking institutions. As a result of sudden and substantial withdrawals, many of these entities faced liquidity pressures while the segment which was hit hardest was the RFC sector. However, well-rated and/or prudently managed RFCs had been able to withstand the pressures better than others. Moreover, the timely intervention of the Central Bank and a spate of ownership and/or stewardship changes have helped stabilise the industry.

The deposit withdrawals and the resultant liquidity crunch, combined with legal action against failed finance-company directors, have propelled the principles of risk management, corporate governance and transparency to new heights. In this regard, the Central Bank has already directed industry players to beef up their corporate governance practices. In addition, the regulator has proposed other guidelines to improve the industry's disclosure practices. RAM Ratings Lanka opines that players that embrace the trinity of risk, governance and transparency will thrive amid the evolving RFC landscape.

History

Subsequent to the economic reforms in 1977, the domestic financial industry mushroomed with numerous players entering the market. Accordingly, the number of deposit taking institutions ballooned to nearly 250 by 1985; most of these entities had however, been plagued by corruption, malpractice and mismanagement of funds. As a large number of finance companies faced bankruptcy and depositors were left in the lurch, the Central Bank intervened by tightening regulatory control through the introduction of the Finance Companies Act No. 78 of 1988 .

At present 35 RFCs are in operation in Sri Lanka, accounting for 3.7% of the financial sector's assets as at end-December 2008. These companies are mainly involved in hire-purchase ("HP") and leasing activities, primarily for the financing of vehicles. RFCs also engage in other forms of retail lending including personal loans, housing loans, pawning, micro financing and term loans. These investments are chiefly funded through public deposits and bank borrowings. RFCs principally cater to individuals as well as SMEs- a market that entails a higher degree of risk and which is usually outside the risk-tolerance levels of commercial banks. Accordingly, RFCs are compelled to pay more attractive interest rates to investors in order to entice deposits. Given the sub-prime nature of these companies' target market, RFCs' are inherently exposed to heightened risk levels.

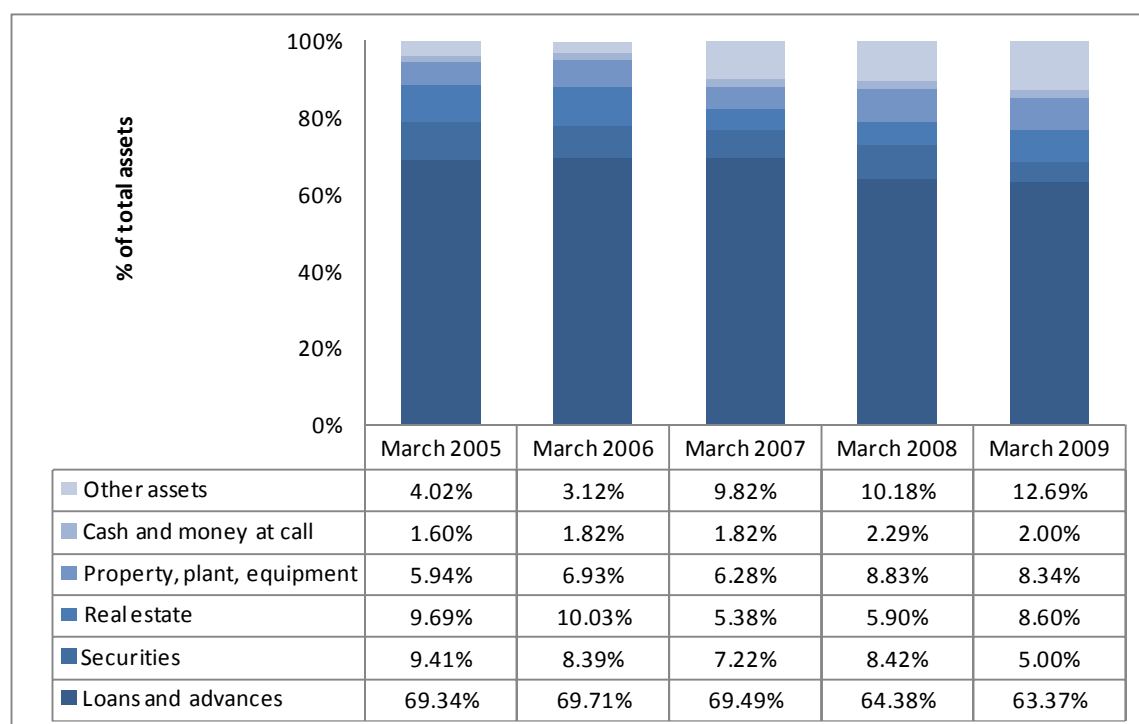
Therefore, when 2 unregulated finance companies crashed in the latter part of 2008, RFCs were the worst affected as public confidence waned. Such companies had encountered sudden deposit withdrawals, which had eroded their liquidity positions. These pressures had been further intensified by the inherent timing mismatch between short-tenured deposit liabilities and longer-term assets in which RFCs typically invest their depositors' funds. A flight to quality had ensued, with the public withdrawing funds held with RFCs and re-investing in relatively safer commercial banks. Almost a year down the line, the liquidity crisis has now passed, braced by the Central Bank's timely intervention to safeguard other failing financial institutions.

Importance of Asset Quality

RFCs' business models typically involve obtaining public deposits and investing these funds in various avenues in a bid to generate returns. When analysing the stability of RFCs, it is crucial to gain an understanding of the quality of the investments where depositors' funds have been placed.

As mentioned earlier, Sri Lankan RFCs mainly engage in the provision of leasing and HP facilities for vehicle financing. These main segments, along with other loan assets, accounted for some 63% of the RFC industry's assets as at end-March 2009; investments in land and properties accounted for another 9% while investments in government securities and equities took up about 5% (refer to Chart 1).

Chart 1: RFC industry's asset mix



Loan Portfolio

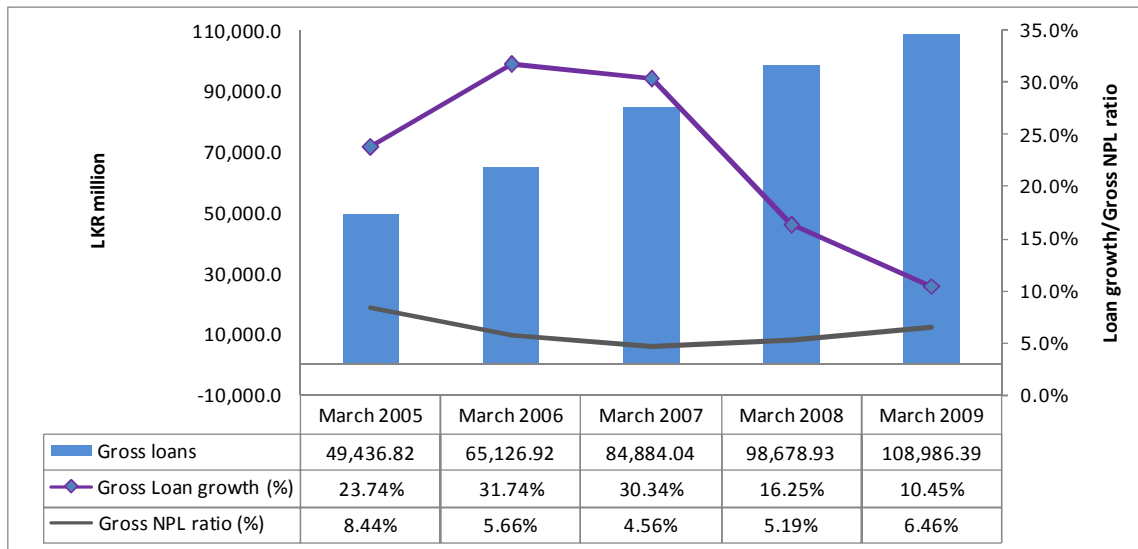
Overall, asset quality in the RFC industry has been deteriorating over the past 2 years, having been affected by the economic downturn. Going forward, loan growth is expected to decelerate while asset quality is likely to be tied to macroeconomic fundamentals and overall business sentiments. Although asset quality varies significantly among the different industry players, RAM Ratings Lanka also notes that many RFCs have improved their credit-origination standards and monitoring procedures, aside from strengthening their recovery efforts in a bid to maintain asset quality.

In the 5 years up to end-March 2008, the RFC industry's loan books had expanded by a robust compound annual growth rate of 25.1%, buoyed by strong growth in the trade, services and transportation sectors of the economy. On the other hand, loan growth slowed down to only 10.5% in the 12 months ended 31 March 2009, in line with heightened interest rates and the non-conducive economic environment. In recent years, loan-book expansion has been mainly driven by HP due to its relative cost advantage over finance leases.

One of the key indicators of the health of a financial institution's loan portfolio is its gross non-performing-loan ("NPL") ratio. The NPL ratio of an RFC measures the proportion of loans that have been in arrears for a period of 6 months or more. We note that the industry's gross NPL ratio has been deteriorating in the past two

years, rising from 4.56% as at end-March 2007 to 6.46% as at end-March 2009 (refer to Chart 2). The quality of loans has weakened as many borrowers have been unable to service their debts as a result of elevated interest rates and inflationary pressures. In line with the poorer asset quality, most RFCs have taken steps to curtail lending and have adopted a relatively conservative approach when expanding their loan books. However, it is vital to note the significant level of variance among the different RFCs with regard to risk management and hence, asset quality. Certain players have successfully maintained consistently healthy, better-than-industry asset quality due to their commendable credit-origination standards and unmitigated focus on monitoring.

Chart 2: Trends in RFC industry's loan growth, gross NPLs and ratios



RFCs are required by the Central Bank to maintain loan-loss provisions as a measure of cushioning the impact of NPLs against capital. Accordingly, each institution is required to keep aside funds each year, corresponding to a certain percentage of its NPLs. The adequacy of provisioning is measured by the level of the entity's gross NPL coverage, which assesses the ability of its loan-loss provisions to fully cover the losses arising from its NPLs. In line with increasing NPLs, the industry's gross NPL coverage ratio has been declining in the last 4 years, falling to 55.31% as at end-March 2009 (end-March 2006: 70.21%). The deterioration in coverage levels was also exacerbated by the adoption of Direction 3 pertaining to the provision of bad and doubtful debts, which permitted the netting off of collateral values when calculating provisions.

On a more positive note, it is evident that most RFCs have strengthened their recovery procedures with regard to repossessing vehicles for which payments are in arrears. Accordingly, we note that there has been a build-up of seized assets in the industry. Given the slump in demand for vehicles, however, many RFCs face

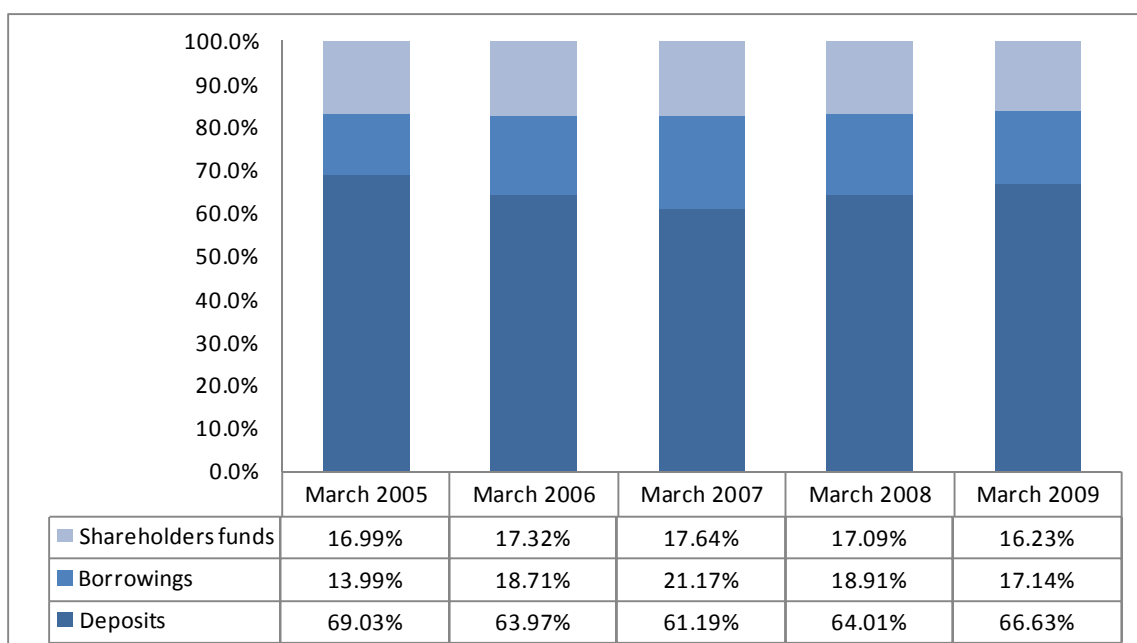
difficulties when trying to dispose of these repossessed items. This is viewed with concern as several players have been forced to sell off such vehicles at a loss.

Meanwhile, another concern is the industry's heightened exposure to real-estate assets. The RFC industry's investments in real estate spiked up LKR 5.40 billion to LKR 14.0 billion in the year ended 31 March 2009, translating into 8.6% of the sector's total assets (end-March 2008: 5.8%). Increasing exposure to real estate is deemed risky because of the current slump in the property market and the inability to dispose of assets in the short term, thereby exposing RFCs to liquidity risk. Apart from liquidity risk, real estate also brings into the balance sheet market and legal risks. However, it is worth noting that industry data is skewed by the largest RFC which has significant exposure to real-estate investments.

Funding

When analysing the financial stability of an RFC, it is vital to understand the funding structure of the company. The bulk of the industry's funding requirements stems from public deposits, which accounted for about 66% of its total funding needs as at end-March 2009. Other borrowings (primarily consisting of bank loans) and capital accounted for 17.1% and 16.2%, respectively (refer to Chart 3). We note that RFCs have been relying more on public deposits in the past few years, as banking facilities have become increasingly difficult to obtain.

Chart 3: RFC industry's sources of funding



Deposit Growth

Total deposits in the RFC industry augmented by an average of 31% in the 3 years up to 31 March 2008, supported by escalating interest rates. However, deposit growth slowed to 14.30% in the year ended 31 March 2009, reaching LKR 98.28 billion. We note that momentum had decelerated in line with dissipating public confidence last year. However, we believe that confidence has now been restored, particularly in well-established RFCs. With interest rates trending downwards, investors are once again showing signs of sensitivity to rate movements. In view of the relatively limited branch networks of most RFCs vis-a-vis commercial banks, however, we believe that RFCs will face challenges in trying to attract deposits. That said, it is noteworthy that several RFCs have been aggressively expanding their branch networks in the past few years.

Borrowings

Notably, RFCs' access to bank borrowings has been constrained of late, against the backdrop of commercial banks' conservative lending approach and limited facilities granted to the RFC sector. Therefore, the composition of borrowings to total funding declined from 18.9% as at end-March 2008 to 17.1% as at end-March 2009. However, it should also be noted that the larger and more established RFCs have better access to bank funding lines while their smaller peers encounter challenges when trying to secure such facilities.

It is therefore evident that RFCs are weighed down by their funding structures and limited access to funds. Given the inherent timing mismatch between their shorter-tenured deposits and longer-term investments, these companies may face severe liquidity crunches, particularly if there is a sudden outflow of deposits. We note that this delicate funding structure is also a symptom of RFCs' weak risk-management frameworks in general, and inefficient management of asset-liability mismatches in particular. It should also be highlighted that RFCs with more exposure to real estate assets have elevated liquidity risks.

Going forward, the funding structure of the RFC industry will remain fragile in view of the difficulties in garnering deposits and limited access to borrowings. That said, the larger and more established players are likely to maintain healthy funding levels, supported by their expanding branch networks (thus enabling the inflow of deposits) and access to alternative funding lines. RAM Ratings Lanka also notes the emergence of asset-liability management in some RFCs; although the importance of this risk-management mechanism varies, we opine that its role is set to assume more importance.



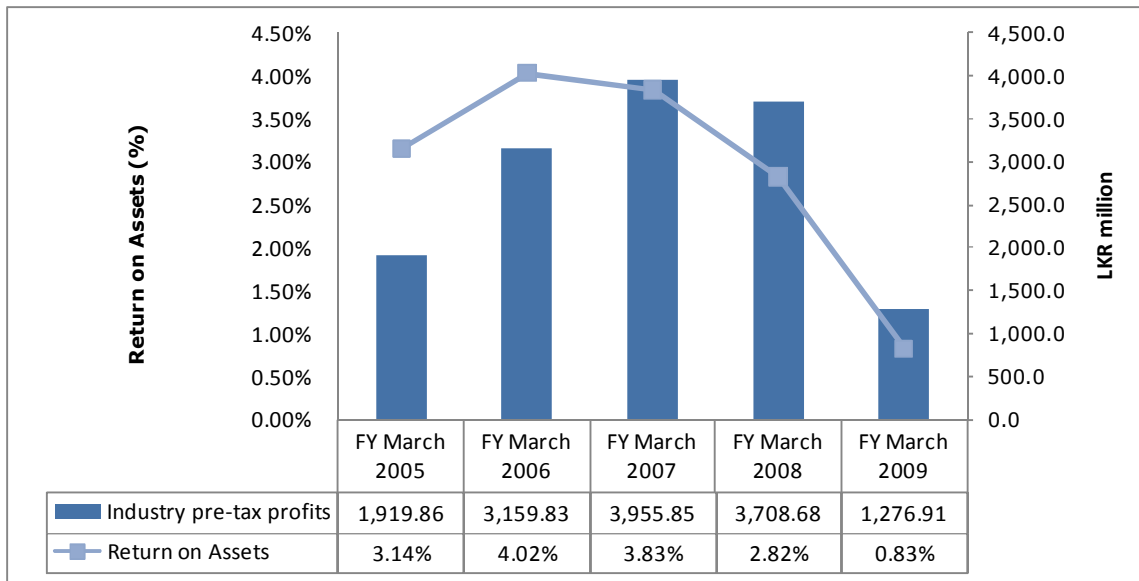
Capital

The level of capital maintained by an RFC signifies the amount of shareholders' funds in the company, and demonstrates the entity's ability to absorb potential financial losses. Hence, its capital acts as a cushion that protects depositors from possible losses. The industry's ratio on net NPLs (i.e. after provisions) to shareholders' funds - which indicates a company's capital cushion - has been gradually deteriorating over the past 4 years, rising from 8.12% as at end-March 2006 to 19.2% as at end-March 2009. On a more positive note, the RFC industry's capital adequacy remains well above the statutory requirement imposed by the Central Bank. Nevertheless, we observe that the Basel I capital-adequacy architecture - currently in operation - fails to capture the myriad risks that RFCs are exposed to. For example, for the purpose of computing risk-weighted capital adequacy, real estate is accorded a risk weight of only 10% although these investments expose companies to a range of risks, i.e. liquidity, interest rate and market.

Profitability

Meanwhile the profit performance of RFCs is assessed as a company's retained profits strengthen its capital base. The RFC industry's pre-tax profit has augmented by an average of 31% in the 4 years to 31 March 2008, supported by robust expansion of loan books. On the other hand, the sector's pre-tax profit tumbled from LKR 3.71 billion in the year ended 31 March 2008 to LKR 1.28 billion in fiscal 2009 (refer to Chart 4). The poorer performance had been due to decelerating loan growth and lofty interest rates, which had pushed up interest expenses during the year. Accordingly, the industry's return on assets fell sharply from 2.82% to 0.83% over the same span. Nonetheless, it should be noted that the industry's profitability may be skewed by a significant loss incurred by the largest RFC in the country.

Chart 4: Trends in RFC industry's profitability



Moving forward, we believe that the sector's profitability will be hampered by slower loan expansion and weakened asset quality. Even so, loan growth is anticipated to improve towards the second half of 2010, driven by recovering macroeconomic fundamentals and better business sentiments. We therefore believe that the RFC industry's profit performance will show moderate improvement in fiscal 2011. That said, significant variances in profitability are likely to be seen among different players. On a related note, the profit performance of companies with substantial exposure to real-estate investments is likely to be inflated as a result of accounting treatment, which allows the entire recognition of profits prior to the actual receipt of funds.



Corporate Governance

Public reaction to the recent domestic financial scandals has been very strong, with an outcry against opaque disclosures and weak risk management. Against this backdrop, the importance of adequate corporate governance has come to light; emphasis should be placed on the risk-management processes implemented by these organisations. Furthermore, consideration should be given to the magnitude of related-party transactions and the adequacy of internal control systems, among others. We note that the level of importance placed on risk management also varies significantly among industry players.

In the meantime, the Central Bank has taken steps to strengthen the corporate governance practices of RFCs. In this regard, Finance Companies (Corporate Governance) Direction No. 3 of 2008 has been introduced - regulating *inter alia* board composition, board committees and related-party transactions. In addition, we believe that restrictions should be imposed on single-shareholder limits and multiple ownership of RFCs by a single individual/group. In this regard, the requirement to list all RFCs by 2011 is viewed positively as it would dilute their shareholding structures and improve transparency. Looking ahead, we anticipate RFCs to place more emphasis on risk management and corporate governance, mainly in view of the loss of public confidence following the recent financial upheavals.

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