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## **SPECIAL COMMENTARY**

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### **The impact of high interest rates on finance and leasing companies**

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The Sri Lankan economy has been heating-up from the beginning of 2007. The Colombo Consumer Price Index (CCPI), the official measure of inflation, stood at a high 17.3% in September, this year. Correspondingly, interest rates have risen significantly, burdening the finance and leasing sectors. LRA expects the profitability and liquidity of both finance and leasing companies to squeeze, while being beleaguered by asset quality issues over the short to medium term.

Finance and leasing companies in Sri Lanka predominantly engage in vehicle and real estate financing. However, their funding structures differ with finance companies primarily accepting deposits and leasing companies obtaining funds through bank borrowings. In contrast, commercial banks can to some extent cushion the blow of high interest rates as they enjoy a wide array of lending products of different tenures, whilst benefiting from low interest savings and interest-free current accounts, whereas, finance companies depend on fixed deposits. Even though the Central Bank has allowed finance companies to offer savings accounts, they are still disadvantaged as they either lack a wide branch-network or automated teller machine (ATM) infrastructure to effectively compete with commercial banks. This dilemma is compounded by the fact that these institutions are expected to pay a higher interest rate on their deposits as opposed to commercial banks.

Leasing companies on the other hand face a greater predicament as they are precluded from obtaining public funds and depend largely on bank funding to finance their lending portfolio. Hence, in the present interest rate environment, cost of funds has risen as bank lines are based on floating rates. Thus, funding costs of finance and leasing companies are very sensitive to interest rates; these institutions are vulnerable when interest rates are on a rising trend.

On the income side, finance and leasing companies' lending rates are fixed for 2-5 years and are not re-priced, as opposed to funding. Thus, when interest rates are trending upwards, interest expenses rise faster, squeezing margins (interest rate risk). These institutions, in an effort to overcome the margin squeeze, increase their lending rates on new facilities, even though the probability of default associated with these facilities rise in tandem. This is because the borrower has to pay a higher monthly rental and in the event of a delay, penal interest is accrued, further burdening the already financially strained borrower. The rising inflation erodes the purchasing power, adding further strain on repayment.

Thus, if finance and leasing companies are not selective in their loan sanctioning, and if they allow collections to fall into arrears, there can be serious asset quality issues; increased defaults can impair cash-flow (liquidity risk) and have a double-whammy effect on the income statement as provisioning increases. Thus, a weakening top-line and higher provisioning will deplete profitability.

Therefore, the present high interest rate scenario presents a challenging environment for financing and leasing companies. LRA expects a moderation in performance as margins thin and provisions increase. Nevertheless, the industry is expected to weather the storm as the sector is now better geared to absorb the economic shocks. Moreover, LRA will keep a close tab on the industry's performance and the risk profiles of LRA rated entities.