FitchRatings

12 Mar 2020 | Comment

Fitch Ratings: New Rules to Accelerate NPL Recognition by Sri Lankan FLCs

Fitch Ratings-Colombo-12 March 2020: Tighter regulation in Sri Lanka on classification and measurement of credit facilities for finance and leasing companies (FLCs) will accelerate recognition of bad loans in 2020-2022, which is likely to exert pressure on FLCs' capitalisation due to the knock-on effects on their profitability, Fitch Ratings says. Nonetheless, the more stringent norm will strengthen reporting standards and transparency, contributing to the sector's stability in the longer term.

Under the new rules, FLCs will be required to recognise credit facilities repayable on a monthly basis that are more than 120 days past due as regulatory non-performing loans (NPLs) with effect from 1 April 2021 and credit facilities repayable on a monthly basis that are over 90 days past due as NPLs from 1 April 2022. This is more stringent than the existing standard, which recognises credit facilities overdue by more than 180 days as NPLs.

The changes could increase FLCs' regulatory NPL ratios during the transition period as the weak operating environment would make any improvement in loan recovery challenging. The FLC sector's regulatory NPL ratio (past due over 180 days) reached to 10.6% at end-December 2019, which is substantially higher than the banking sector's regulatory NPL ratio (over 90 days past due) of 4.7%. Further, we estimate that the 90 days past due NPLs of Fitch-rated FLCs are 1.5x-3.0x higher than their 180 days past due NPLs, reflecting these companies' higher exposure to more vulnerable market segments.

The classification of the quality of loans and advances of FLCs under SLFRS 09 has also been adjusted to match that of banks, where a significant increase in credit risk (Stage II loans and advances) and impaired loans (Stage III loans and advances) will be recognised when they are 30 and 90 days past due, respectively, by the financial year ending 31 March 2023. In the interim period, FLC should classify loans that are 60 days past due as Stage II loans and those that are 120 days past due as Stage III loans by 31 March 2022. At present, FLCs have been given flexibility by the Central Bank of Sri Lanka to classify loans and advances under SLFRS 09 in different time buckets based on their business models, reflecting FLCs' less stringent credit standards than that of banks.

Early recognition of bad loans under SLFRS 09 is likely to exacerbate profitability pressure on FLCs, elevating the risk that weaker companies will breach minimum regulatory capital thresholds. On average, the credit costs have wiped out 30% of the Fitch-rated FLCs' pre-impairment profits at end-September 2019. The impact is more significant for the five smaller FLCs rated by Fitch, where credit costs accounted for over 75% of pre-impairment profits, considerably restricting their ability to absorb any additional shocks to earnings.

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