



Report and Recommendation of the President to the Board of Directors

Project Number: 40935
March 2007

Proposed Secured Loans Republic of the Maldives and Democratic Socialist Republic of Sri Lanka: South Asian SME Leasing Facility

In accordance with ADB's public communications policy (PCP, 2005), this abbreviated version of the RRP excludes confidential information and ADB's assessment of project or transaction risk as well as other information referred to in paragraph 126 of the PCP.

Asian Development Bank

CURRENCY EQUIVALENTS

(as of February 26 2006)

Currency Unit	–	Sri Lanka rupee/s (SLRe/SLRs)
SLRe1.00	=	\$0.00919
\$1.00	=	SLRs108.72
Currency Unit	–	rufiyaa (Rf)
Rf1.00	=	\$0.0781
\$1.00	=	Rf12.80

ABBREVIATIONS

ADB	–	Asian Development Bank
CBC	–	Commercial Bank of Ceylon
CSP	–	country strategy and program
DEG	–	Deutsche Investitions-und Entwicklungsgesellschaft mbH
DMC	–	developing member country
FMO	–	Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V. (The Netherlands Development Finance Company)
FY	–	fiscal year
HNB	–	Hatton National Bank
IFC	–	International Finance Corporation
IRR	–	internal rate of return
LOFAC	–	Lanka ORIX Factors Limited
LOFIN	–	Lanka ORIX Finance Company Limited
LOLC	–	Lanka ORIX Leasing Company Limited
MFLC	–	Maldives Finance Leasing Company Pvt. Limited
MMA	–	Maldives Monetary Authority
NDBSL	–	National Development Bank of Sri Lanka
NPL	–	nonperforming loan
OFID	–	OPEC Fund for International Development
OPEC	–	Organization of the Petroleum Exporting Countries
OPIC	–	Overseas Private Investment Corporation
PFI	–	participating finance institution
PSOD	–	Private Sector Operations Department
SME	–	small or medium enterprise
VAT	–	value-added tax

NOTES

(i) The fiscal year (FY) of Maldives Finance Leasing Company Pvt. Limited ends on 31 December. The fiscal year of Lanka ORIX Leasing Company Limited ends on 31 March. FY before a calendar year denotes the year in which the fiscal year ends.

(ii) In this report, "\$" refers to US dollars.

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I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on proposed secured loans (i) of up to \$10 million to Lanka ORIX Leasing Company Limited (LOLC), and (iii) of up to \$4.5 million to Maldives Finance Leasing Company Pvt. Ltd. (MFLC).

2. The main reason for grouping both transactions into one project is for operational efficiency. Given the geographical proximity of the two countries and the similarities of the underlying business of each company (i.e., leasing to small and medium enterprises [SMEs]), it was felt that it would be more cost and resource efficient to process the two components in one RRP. Each project will, however, be recorded separately in the Private Sector Operations Department's systems and balance sheet and will be monitored on an individual basis.

II. BACKGROUND AND RATIONALE

A. Problems Affecting the Small and Medium Enterprises Sector in Sri Lanka and the Maldives

1. Sri Lanka

3. SMEs play a significant role in the economy of Sri Lanka and are key drivers of employment, economic growth, and development. However, more than 80% of the SMEs in Sri Lanka have difficulty accessing financial services and securing financing. That is mainly due to (i) a strong risk aversion among the banks in the country with respect to SME lending; and (ii) the absence of a diversified financial sector capable of serving SMEs, which is due in part to weaknesses in the judicial system as it applies to registering and enforcing security interests.¹

4. The results of a recent survey carried out by ADB and the World Bank² indicate that the cost of finance impedes urban and rural firms alike, with almost a third of urban firms and rural businesses citing it as a major constraint. Small, urban manufacturing firms pay significantly higher average interest rates (18%) than do large ones (12%). They also pay higher rates than do rural enterprises (14.5%), which benefit from subsidies from some state financial institutions and microfinance institutions. (These subsidies, however, threaten the viability of these institutions.) With support from international funding agencies, commercial banks have started to enter the market for SME finance, although their lending remains concentrated in Colombo. Because of these distortions, interest rates in rural areas vary widely. Moreover, the Government of Sri Lanka's high and persistent budget deficits add to the cost of finance, as the Government crowds out the private sector to meet its borrowing requirements.

5. Rural enterprises avail themselves of external finance but have extremely limited access to formal finance. They obtain most of their financing for new investments from internal sources (43%) and family and friends (35%). Public financial institutions, despite their widespread presence in rural areas, account for a far smaller share of rural investment finance. Private commercial banks provide a minimal share (2%), and mostly to larger enterprises. For firms with inadequate external finance, the consequence is limited opportunities for growth. Collateral in the form of land is especially important for rural enterprises. For many rural entrepreneurs, however, high levels of public landownership, unclear ownership records, and widespread

¹ ADB. 2005. *Sri Lanka Financial Sector Assessment*. Manila.

² ADB and World Bank. 2004. *Investment Climate Assessment*. Washington D.C.

restrictions on the use and transfer of land make it difficult to use land as collateral, thus limiting access to external finance.

2. The Maldives

6. A recent survey carried out by the World Bank³ showed that most of the 2,500 registered SMEs in the Maldives are quite small, with an average turnover of less than \$80,000 per annum. Their activities were generally limited to a very few economic sectors: tourism, fisheries, manufacturing, transport, and related services. Most of them are located in the capital, Male, which accounts for 27% of the total population.

7. Among the major obstacles mentioned, more than 65% of all respondents identified a lack of access to finance as the most important and most severe constraint affecting enterprise performance. The financial sector is shallow and the banks in the Maldives have been following a very conservative approach that has a high exposure to the tourism sector. The commercial banks are still focused on collateral rather than on cash-based lending, and there are no venture capital companies in the country to support emerging entrepreneurs in the various SME sectors. Moreover, there is no credit information system or bureau that would facilitate lending, and especially to new borrowers.

B. The Financial Sector in Sri Lanka and the Maldives

8. As of the end 2005,⁴ the Sri Lankan financial sector had 22 licensed commercial banks (11 domestic private banks and 11 foreign), 2 state banks, 26 registered finance companies, and 14 licensed specialized banks (2 development finance institutions, 1 national savings bank, 3 housing finance institutions, 2 private savings and development banks, and 6 regional development banks).

9. The two state-owned banks still play an important role in the domestic banking sector and hold almost 42% of total banking assets. Their market share has dropped significantly in the last 5 years, however, while the share of the private banks in total assets grew from 34.5% in 1998 to 43.0% as of the end of 2005.⁵ The state banks have nationwide branch networks, but remain highly inefficient and undercapitalized. The state-owned banks' ratios for nonperforming loans declined from 18% in 2003 to 8% in June 2006, thereby reaching levels similar to those of domestic private banks. Capital adequacy ratios have also improved (to 8% of total assets), and steps have been taken to further enhance the regulatory and supervisory framework, including plans to adopt the Basel II capital accord by 2008.

10. The major private commercial banks have widened their networks to cover almost the entire country. The four leading private commercial banks—Hatton National Bank (HNB), Commercial Bank of Ceylon (CBC), Seylon Bank, and Sampath Bank—have over 200 branches among them nationwide. They continue to dominate the private banking sector, accounting for 85% of its assets, 90% of the deposits, and 85% of the loans granted. CBC and Sampath Bank are seeking greater prudential safety and security through diversification, as their loan portfolios were traditionally concentrated in financing large enterprises. HNB has been an innovator in SME lending in Sri Lanka and one of the earliest financial institutions to recognize that lending to SMEs can be profitable and provide a cushion to the bank in times of economic decline.

³ World Bank. 2006. *The Maldives: Sustaining Growth and Improving the Investment Climate*. Washington, DC.

⁴ Central Bank of Sri Lanka. 2005. *Annual Report 2005*. Colombo.

⁵ IMF. 2006. *Financial Sector Quarterly Update*. Washington, DC.

11. Commercial interests and competition for deposit and loan customers have led a number of the commercial banks to lend more aggressively to SMEs. Banks such as Sampath, HNB, and CBC play leading roles in this regard. Although encouraging, these resource mobilization activities will first and foremost fund activities bearing relatively lower risks for the banks, such as housing and car loans, and only then be available for SME lending. Their volumes are limited, given the relatively high short-term interest rates. Additionally, there remains the problem of high unit transaction costs in processing relatively small SME loans.

12. The financial sector in the Maldives is very narrow and is dominated by the banking sector. Nonbank financial institutions in the country consist of only a few companies. The dominant player in the banking sector is the state-owned Bank of the Maldives, the country's only indigenous bank, with 17 branches located in the capital and some of the distant atolls servicing the island communities. The other banks in the country are branches of the State Bank of India, Bank of Ceylon, Habib Bank, and HSBC, all of which have single locations in the capital Male. Competition among banks is intense given the rate of growth in the economy.⁶ Lending tends to be short to medium term and fixed-rate funding is scarce.

13. All financial institutions are under the supervision of the Maldives Monetary Authority (MMA) which promulgated and issued the Regulations for Finance Leasing Companies and Finance Leasing Transactions in 2001.

C. The Leasing Sector in Asia

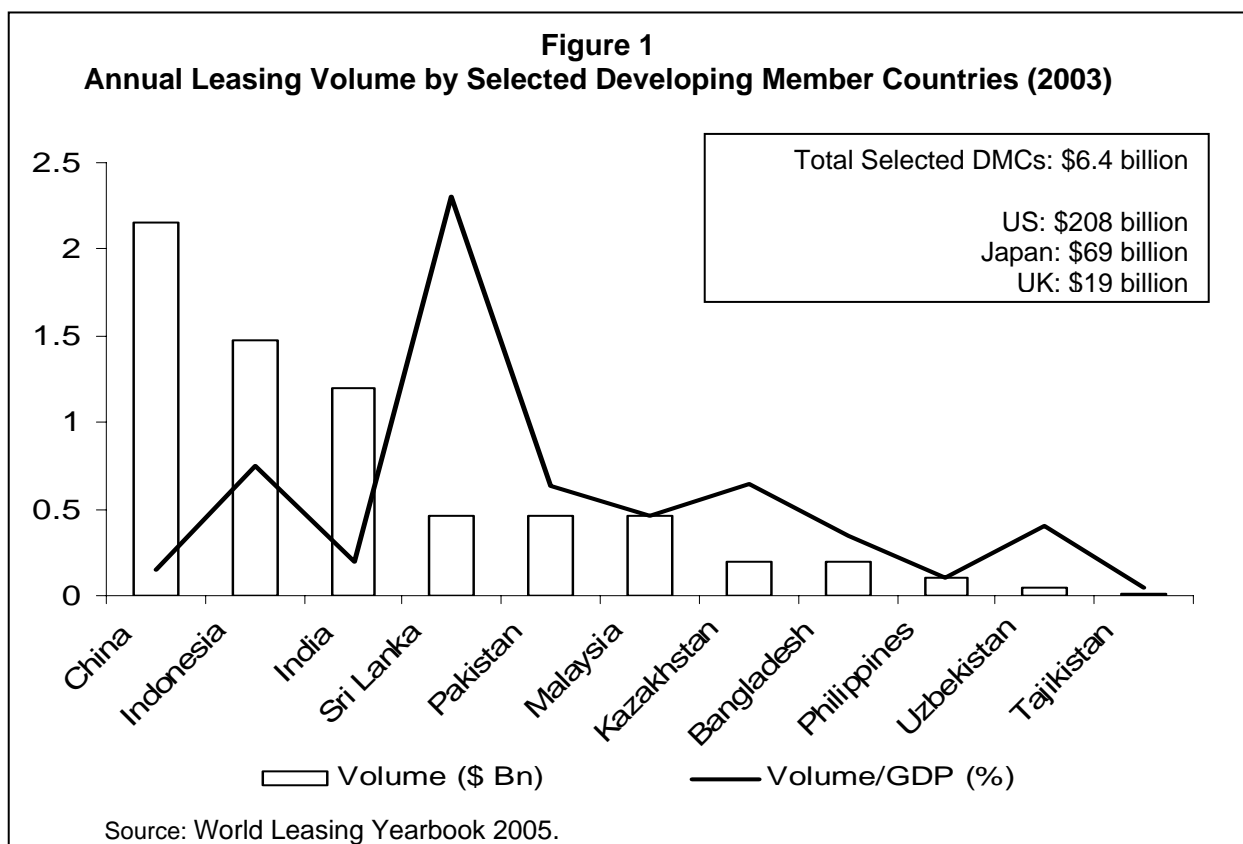
14. In most developing countries, capital markets are relatively undeveloped and banks are often unable or unwilling to undertake term lending. Banks prefer to lend to larger, established businesses with well-developed balance sheets and credit histories. Operations in microenterprises and small businesses are oriented to cash flow but rarely have organized historical financial records or the assets needed for collateral to obtain conventional bank financing.⁷ In developing countries generally, therefore, but particularly in Asia, SMEs often have unmet needs for lease financing.

15. The leasing industry in Asia makes an important contribution to the economic development of the region by providing a financing tool to both large enterprises and SMEs. In doing so, it increases the level of private investment in capital equipment. The essential proposition underlying the concept of leasing is that a business enterprise earns its profits from the use of assets rather than through ownership of those assets. In developing countries with unclear property rights, poorly functioning asset registries, and weak laws for securing transactions, leasing can provide an attractive alternative to both lessees without collateral and lessors wanting to improve the possibility of repossession, if necessary.

⁶ The Maldives economy has been growing at an annual average of 7.5% for the past decade. Although growth suffered in 2005 and was actually negative due to the adverse affects of the tsunami, it is expected to bounce back and for GDP to grow at a double-digit rate. GDP in 2005 was \$669.5 million, or approximately \$1,860 per capita. Tourism is the main industry, contributing over 33% of GDP. Fisheries, marine transportation, and trade follow close behind. Interest rates have been virtually constant in the range of 7.75%–13.00% since 2003. Previously, they had been as high as 12%–15%. The country has a managed exchange rate regime with the local currency, the rufiyaa, currently pegged to the US dollar at a rate of Rf12.75 = \$1. The rufiyaa is freely exchangeable.

⁷ World Bank. Leasing to Support Small Businesses and Micro Enterprises. *Policy Research Working Paper*. Washington, DC (WPS 1857).

16. ADB, by supporting policy reforms and contributing private sector investment, has played a critical role in launching the leasing industries in a number of Asian countries, including Bangladesh, India, Indonesia, Pakistan, and the Philippines. However, the leasing industries in most of ADB's developing member countries (DMCs) remain underdeveloped. A recent study commissioned by ADB⁸ on the leasing industry in 13 DMCs indicates that the total annual leasing volume in these countries is less than \$7 billion in a global leasing industry of over \$500 billion. Leasing has an average penetration of 0.4% of GDP⁹ in those countries while that figure exceeds 1% in developed countries.



D. The Leasing Industry in Sri Lanka and the Maldives

1. Sri Lanka

17. It can be noted from the figure above that Sri Lanka has a leasing penetration of approximately 2.4% of GDP, which is significantly larger than that of any of the other DMCs under observation. It is even greater than the average leasing penetration in the US or Japan. The main reason for the higher use of leasing as a financing tool in Sri Lanka as compared with other DMCs in the region lies in the fact that the leasing sector in that country developed much earlier. The major growth in leasing occurred following the formation of the first two specialized leasing companies, namely, Lanka ORIX Leasing Company Limited and Mercantile Lloyds Leasing, in the early 1980s. These companies focused their leasing activities primarily on providing leasing facilities to SMEs—a segment that traditionally was neglected by the banking

⁸ ADB. 2005. *PSOD Leasing Industry Report*. Manila.

⁹ Median of Bangladesh (0.33%), People's Republic of China (0.16%), India (0.21%), Indonesia (0.69%), Kazakhstan (0.38%), Malaysia (0.36%), Pakistan (0.53%), Philippines (0.13%), Sri Lanka (2.27%), Uzbekistan (0.38%).

industry in many DMCs. Furthermore, leasing's strong market share in Sri Lanka can be explained by the weakness of traditional financing for the SME sector. That, in turn, is due to the weakness of certain legal provisions for registering and enforcing security interests (e.g., inefficiencies in the registries for land and movable properties).¹⁰

18. Sixty-eight companies were registered with the Central Bank of Sri Lanka as providing leasing as of the end of 2005. However, only 20 of these were registered exclusively to provide leasing. Leasing is also offered by commercial banks, specialized banks, and finance companies.

19. Leases in Sri Lanka are predominantly financial leases because the Leasing Act in existence applies to financial leases and not operating leases.¹¹ Passenger cars and commercial vehicles are the main categories absorbing the bulk of financial leases although trade and transportation also enjoy continued growth among the various leasing subsectors. For further information on the leasing sector in Sri Lanka, see Appendix 1.

20. In LOLC's case, for example, 41% of its borrowers are in the trading business, followed by 15% in the service sector, and 14% in the industrial sector.

2. The Maldives

21. From a base of zero in May 2002, the Maldives leasing industry had grown to a \$15 million portfolio of financial leases by mid-2006. That represented approximately 1.5% of GDP. Small leases are normally under \$50,000 while a medium-sized lease would be under \$200,000.¹² The majority of the leases executed are for acquiring productive assets. A small proportion of the transactions are of the sale-and-lease-back type. Consumer financing in the form of leasing occurs informally in the economy, and in particular for motorcycles.

22. The general regulatory climate is very conducive to the industry. The MMA actively supports leasing as a tool to broaden the base of the economy and to empower the SME sector for participating in the country's economic growth. The leasing regulations in place are very comprehensive without being too restrictive. They have not yet been well tested, however, in such areas as recovery, repossession, and legal proceedings.

23. Lessors require a specific license from the MMA to commence leasing operations in the Maldives, and they are subject to the MMA's regulatory supervision and the provisions of the existing leasing regulations.

III. PROJECT BENEFITS AND IMPACTS

A. Justification for ADB's Participation

1. Primary Objective

a. Strengthen Leasing Industry

24. The proposed ADB assistance is expected to strengthen the leasing industry further and expand the funding resources and financial services available to the SME sector in the two

¹⁰ ADB. 2005. *Sri Lanka Financial Sector Assessment*. Manila.

¹¹ *Daily News*. 2005. Leasing Industry Poised for Growth.

¹² Maldives Monetary Authority. Available: <http://www.mma.gov.mv>.

countries. The activity of leasing companies in Sri Lanka and the Maldives is constrained by the need to borrow at short maturity to fund a business that lends at a longer maturity. The underdeveloped nature of corporate debt markets in both countries has made nonbank leasing firms heavily dependent on commercial banks for their funding through short-term borrowings and commercial paper. This has resulted in maturity mismatches in assets and liabilities and higher costs of funds for these institutions.

b. Promote SME growth

25. The proposed loans from ADB to the two companies will provide them access to long-term funds and thereby enable them to promote alternative financing instruments to SME entrepreneurs, promote their operations and profitability, and enhance their competitiveness.

26. The project is in line with ADB's country strategies for Sri Lanka and the Maldives. It will promote private sector participation in SME development. The demonstration effects related to long-term funding will be positive.

27. The project is also complementary to ADB's public sector approach as exemplified by ADB's recent financial markets loan.¹³ This program is intended to facilitate participation of the private sector, including SMEs, in the Sri Lankan economy by supporting government reforms to eliminate impediments to and develop opportunities for their involvement.

c. Improve Broader Capital Markets Development

28. Leasing companies can also boost capital markets development. Once they have established operating histories, they can tap and foster equity markets. Their demand for term debt broadens the term lending options for banks, finance houses, pension funds, and insurance companies. They can also issue bonds or other marketable instruments. Finally, leasing companies can securitize their lease receivables, taking some assets off balance sheet to achieve a higher leverage and better returns while adding another tradable instrument to local capital markets. ADB is currently in discussions with LOLC regarding a possible securitization of part of its lease portfolio whereby ADB would provide a guarantee to credit enhance the issue and/or purchase the mezzanine tranche of such a structured transaction. This would represent the first true securitization deal in the capital markets of Sri Lanka. This would also represent a strong example of cooperation between the public sector and private sector departments within ADB, where ADB's public sector window would provide a loan to focus on introducing publicly traded securitized bonds in the capital market¹⁴ and the Private Sector Operations Department would test the regulatory framework by structuring the first such transaction.

2. Development Impact

29. From a development perspective, a well-functioning leasing industry is an important financing tool for SMEs. Such enterprises are particularly constrained by the lack of assets that can be used as collateral for bank loans. When credit is available from informal sources, it tends to be short-term and too costly for investment financing. Advantages of leasing over alternative forms of finance for SMEs include a lower down payment, credit availability, simpler documentation and security arrangements, faster credit approval, and tax incentives. In fact,

¹³ ADB. 2004. *Financial Markets Program for Private Sector Development*. Manila (R265-04).

¹⁴ A securitization bill will be introduced to Parliament whereby special purpose vehicles may be established as separate legal entities to pool real or intangible assets against which public securities may be issued. This securitization bill is one of the components of ADB's Financial Markets Program.

leasing and supplier credit¹⁵ are often the only sources of credit available to SMEs. In promoting the small enterprise in developing countries, leasing plays a role in reducing poverty by generating income and employment.

30. It is expected that about 200 SMEs will be assisted through lease financing. That would result in additional capital formation, value added, employment, foreign exchange earnings and savings, as well as promotion of new entrepreneurs. This is fully in line with the focus of the governments of Sri Lanka and the Maldives, which have given priority to the development of enterprises by new entrepreneurs and of the SME sector in general.

31. Moreover, a robust leasing industry has the potential to contribute to the development of capital markets by introducing SMEs to formal financial markets and providing demand from leasing companies for capital markets funding.

3. Measures for Development Impact

32. ADB will measure the expected development impact of the proposed loans. These performance measures follow the Multilateral Development Banks—Evaluation Cooperation Group’s Standards for Evaluation of Private Sector Investment Operations. Development impact is measured in three distinct categories: (i) business performance of the project itself, (ii) economic sustainability, and (iii) private sector development. Examples of development impact measures are (i) business performance (overall profitability and commercial viability of the financial institution): return on equity, net interest margin, growth in assets; (ii) economic sustainability (allocation of resources and provision of financial services to viable private enterprises): increase of lending to small business enterprises, disbursements to rural areas, credit quality in lending; (iii) private sector development (contribution to the growth of viable financial sector and financial markets development): operational improvement (e.g., credit appraisal methods), evidence of spillover effects (e.g., competitors adopting best practices of bank), contribution to financial strength of sector (e.g., better match of assets and liabilities). Please refer to Appendix 2 for the full development impact framework.

B. Environment and Social Safeguards

33. **Environment.** This financing is classified as category FI. All borrowers will be required to adopt appropriate environmental management systems in accordance with ADB guidelines.

34. **Social Safeguards.** This financing is classified as category C. No involuntary resettlement or any impact on indigenous peoples is expected as a result of this financing. All sub-borrowers are extremely small and serve individuals and SMEs. Their clients are in the private sector and do not have the power to trigger involuntary resettlement. ADB’s policies for involuntary resettlement and indigenous peoples will be explained to the participating firms.

C. Anticorruption Policy; Combating Money Laundering and the Financing of Terrorism

35. The two companies have been advised of ADB’s policy on *Anticorruption* (1998, as amended to date) and policy relating to the Combating of Money Laundering and the Financing of Terrorism. Consistent with its commitment to good governance, accountability, and transparency, ADB will require LOLC and MFLC to institute, maintain, and comply with internal

¹⁵ Supplier credit is basically a period of delay allowed by a firm’s supplier to pay its invoices. Frequently, the terms are 2% discount on invoices if paid in 10 days or net if paid in 30 days.

procedures and controls following international best practice standards for preventing corruption or money laundering activities or the financing of terrorism, and covenant with ADB to refrain from engaging in such activities. The documentation between ADB and each company will further allow ADB to investigate any violation or potential violation of these undertakings.

IV. ASSURANCES

36. A framework agreement confirming ADB's status, privileges, and immunities with respect to its equity investments, lending operations, and guarantee operations in the private sector is in effect between the governments of Sri Lanka and the Maldives and ADB. ADB will obtain confirmation by the governments of Sri Lanka and the Maldives, respectively, that they have no objection to the financing by ADB prior to any funding being made available.

37. ADB will enter into suitable loan and security documentation and other required legal documents, following approval of the proposed financing by the Board. These agreements will be on terms and conditions satisfactory to ADB.

V. RECOMMENDATION

38. I am satisfied that the proposed loans would comply with the Articles of Agreement of the Asian Development Bank (ADB) and, acting in the absence of the President, under the provisions of Article 35.1 of the Articles of Agreement of ADB, I recommend that the Board approve the two loans of (i) up to \$10 million to Lanka ORIX Leasing Company Limited, and (ii) up to \$4.5 million to Maldives Finance Leasing Company Pvt. Ltd., from ADB's ordinary capital resources, on such terms and conditions as are substantially in accordance with those set forth in this report, or as may be subsequently reported to the Board.

Liqun Jin
Vice President

5 March 2007

THE LEASING SECTOR IN SRI LANKA

A. Background

1. From the late 1970s, finance companies in Sri Lanka offered some leasing within their range of financial products, but the major growth in finance leasing occurred following the formation of two International Finance Corporation-sponsored specialized leasing companies. These were Lanka Orient Leasing Company (LOLC), in 1980, and Mercantile loyds bank only one Leasing, in 1983. At the end of 1985, these two leasing companies accounted for 77% of lease transactions.¹ The companies were provided tax holidays for 5 years from their formations. Generous capital allowance. Vehicles 4 years, 3 years for equipment. Vehicles for year 6 years

2. Until 2001, leasing companies were largely unregulated and mainly specialist by nature. In 2001, a new leasing act was introduced permitting new leasing companies to be established as long as they met a minimum capital requirement of SLRs75 million (\$0.75 million). This prompted a number of leasing companies to enter the industry.

B. Portfolio Concentration

3. The Sri Lankan leasing sector has played an important role in developing the transport sector, especially in rural areas. Passenger and commercial vehicles are the main category of assets financed by leasing, with a 70% share of the total portfolio in 2004 (down from 77% in 2003). Over 75% of leasing companies in Sri Lanka still concentrate on vehicle leasing and only a few have diversified into such other products as the financing of warehouses, hospitals, educational institutions, and office equipment. Over 50% of leases were utilized to purchase secondhand vehicles²

4. The Central Bank of Sri Lanka is calling for the leasing industry to diversify into other areas and to target SME financing.³ The leasing of non-vehicle equipment has been hampered by the absence of a clear legal process with regard to the repossession of equipment and the short commercial life of so much modern equipment (unlike vehicles, which have a ready secondhand value). In a recent interview,⁴ the CEO of People's Leasing Company, the second largest leasing company in Sri Lanka, Mr. Kumarage, pointed out that it is typical, with the exception of a small number of developed markets, for vehicles to dominate the leasing industry. He points out that factories often have less need for leasing in Sri Lanka as they receive favorable credit lines from development finance institutions. However, he also highlighted machinery required for the tea industry as a potential avenue for development.

C. Entry of Banks

5. Most of the recent entrants into the Sri Lankan leasing industry are subsidiaries of banks rather than specialist leasing companies. There is some resentment among specialist leasing companies toward these banking entrants, who are regarded as "fair-weather" lenders.

¹ ADB. 1987. *Technical Assistance to the Democratic Socialist Republic of Sri Lanka for the Preparation of Second Water Supply Sector*. Manila (TA 1584-SRI).

² Leasing Industry in the Asian Development Bank's Developing Member Countries, Michael Fox, Manila, 2005

³ Leasing Industry in the Asian Development Bank's Developing Member Countries, Michael Fox, Manila, 2005.

⁴ Leasing Industry in the Asian Development Bank's Developing Member Countries, Michael Fox, Manila, 2005.

Moreover, as independent specialist leasing companies depend upon banks for funding, there is a concern that loan requests may be rejected for competitive reasons. People's Leasing Company, a subsidiary of People's Bank, is now the largest leasing business by volume. In its 7 years of operation the company has raised SLRs2.4 billion (\$24 million) through securitization.

D. Legal Recourse and Repossession Laws

6. In Sri Lanka, litigation to recover bad debts is a protracted and costly process. An arbitration procedure designed to improve this process is not proving as successful as had been hoped, with procedures often proving even more unwieldy and expensive.⁵ Leasing companies are excluded from Sri Lanka's Debt Recovery Act, which enables other financial institutions to repossess and sell collateral without court intervention. Weaknesses in the guarantee and repossession laws hamper growth of the leasing sector, especially outside the better understood urban automotive sector.

E. Regulation and Tax Considerations

7. Under the 2001 leasing act, all leasing companies were required to be regulated by the Central Bank of Sri Lanka⁶.

8. In recent years there have been a number of significant changes in the fiscal treatment of leasing. In 2002, a value-added tax (VAT) regime was introduced and the leasing sector was subjected to input and output rates. The input and output taxes have been aligned at 15%. It has been argued that these changes have had the effect of making leases less competitive.⁷

9. The state is now contemplating a number of changes in legislation that might hamper the industry. First, the state is considering to reduce depreciation allowances from 25% to 12.5%. Second, the Government is proposing to charge leasing companies the higher of 1% of turnover or SLRs50 million (\$0.5 million). LOLC argues that "increases in the VAT rate on leasing, special VAT rates on leasing companies, economic service charges and changes to depreciation rates on vehicles and machinery are likely to make leasing an unattractive financing option to our core customer base of small and medium-sized business enterprises. Furthermore, these fiscal disincentives could effectively undermine the collective efforts of the leasing companies to serve the small and medium entrepreneurs who are expected to make a substantial contribution to the national economy."

10. The Sri Lankan leasing industry would benefit from improvements in the process of asset recovery, greater self-regulation, and the removal of VAT charges on leasing.

⁵ Leasing Industry in the Asian Development Bank's Developing Member Countries, Michael Fox, Manila, 2005.

⁶ ADB (2005), *Financial Assessment Report for Sri Lanka*. Manila.

⁷ Ms R.L. Nanayakkara. 2004. Statement of Lanka ORIX Leasing Company Ltd. *Annual Report (2004)*. Colombo.