Budget 2014: Impact on the Banking and Financial Sector

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Implications on the Banking and Financial Sector

- 2% NBT on the banking and the financial institutions
- Consolidation of finance companies (subsidiary company owned) by acquisition within the group
- Import duty reduction and removing the surcharge on Gold
- Interest rates implications of the Budget

Taxes on the Financial Services (FS)

- BTT and NSL were applicable to FS before GST
- When GST was implemented in 1998 BTT and NSL were maintained because the FS was not liable for GST
- When VAT was introduced in 2002 (Act No.14) both BTT and NSL were abolished and FS were free from taxes
- Under the “Additive Principle” VAT was extended to the FS in January 2003 with a rate of 10% (Amd. No. 7)
- VAT was estimated on profit before taxes and employment expenses due to difficulties in computing Value Addition on FS (Israel was the only country that imposed VAT on FS)

Taxes and the Financial Services

- Jan 2004 VAT on FS was increased to 15% (Amd. No. 13)
- Jan 2005 VAT on FS was increased to 20% (Amd No.6) which continued till end 2010
- Jan 2011 VAT on FS was reduced to 12% (but 8% on a special investment incentive account in the Central Bank) (Amd. No. 9)

Implications

- VAT on FS not estimated on value added basis (difficult) but on profit before tax and employment expenses
- FS were thus burdened with tax payments that were not deductible or qualifying for input credits
- They had no option but to pass part of the burden to the borrower/consumer as higher interest rates

PTC Submission

- VAT of 20% on FS too high
- Capital gains, dividends, etc., on which other people pay taxes should be exempted in FS VAT computation
- High VAT has eroded capital formation within the FS which is impeding growth
- On this basis, the PTC suggested the abolition of the VAT on FS and replacing with a FSTT

Implications of NBT

- Jan 2014 (under 2014 Budget) while the 12% VAT remains, the 8% for CBSL Special Investment Account is going to be withdrawn and replaced with 2% NBT
- If NBT is going to be on profits, the NBT Act has to be amended; if NBT is going to be on turnover the banks will find it difficult to absorb it and will pass on to the borrower/consumer in terms of higher lending rates (as in the case of 20% VAT)
- If NBT is on the same ‘VAT base’, then the earlier mentioned issues will remain unresolved and there again passing part of the burden to the borrower may prevail

Consolidating Finance Companies (FCs)

- Out of the 47 FCs 30 FCs are subsidiaries of banks or holding companies
- 20 FCs have an asset base over Rs. 20 bn
- 20% of FCs control 90% of business
- 80% of FCs control 10% of business
- Given how sentiments work in this sector, if a small company crashes it will have a knock-on effect on the entire system in terms on panic/withdrawal

Consolidation Process

- Mergers may be costly with possible retrenchment/exit of labour as well as capital
- To support M & A the Budget proposes the cost of M&A can be claimed as a qualifying payment for deduction over a 3 year period
- CBSL also stated that it will be voluntary and not compulsory and a clear announcement will be issues in early January 2014

Implications

- Reduce the vulnerability of weak FCs to shocks
- Reduce risks to depositors and improve confidence in the system
- Increase transparency
- CBSL will be able to give better individual supervision to existing lot which will be far less than 47
- Good for overall stability of the financial system in the country

Implications of the Gold Price decline

- Surge in gold pawning (gold based loans) in 2012; commercial bank exposure grew at 20% ($2.6 bn) in 2012; CBSL says it amounted to 14.4% of the 2012 total loans
- Gold imports continued increasing at 47.1% during the first half of 2013
- 10% duty and later 100% surcharge was imposed to discourage importation (some imports were smuggled to India)
- After June 2013 gold prices started declining and banks and financial institutions that had significant pawning became vulnerable to this

Already hitting the NPL

- Many customers who had pawned their jewellery were not keen to redeem them as they could purchase gold at a lower price and convert into jewellery
- "Moral hazard" problem aggravated the situation – regulations do not require banks to submit credit history of pawning borrowers to the CRIB – default does not harm the credit history
- All these aggravated the NPL ratios in those bank and financial institutions (BFIs) that had an exposure to pawning

Budget: Implications

- Import duty on gold reduced from 10% to 7.5% and subsequently the 100% surcharge was abolished
- The argument is that this was done to assist the jewellery industry, where gems and jewellery sector is a large exporter in the industrial sector
- But while it may assist one sector, it will not assist the BFIs exposed to gold/pawning as they will get a further hit by the reduction of the gold prices
- This will be reflected in the NPLs in those BFIs that have excessive exposure to gold based loans

Interest rates

- After the February 2012, stabilization measures (flexible exchange rate, higher interest rates, etc.) the interest rates were relaxed several times (Dec 2012, May 2013, ..etc.)
- Before reasonable stability in the external account manifested this relaxation was done perhaps to boost growth and achieve the per capita target
- Budget 2013 it was stated that there would not be external commercial borrowing, thus it appeared that room for interest rate relaxation was difficult
- But external commercial borrowing via state banks and other commercial banks in 2013 gave some space for interest rate relaxation

Budgetary Financing Implications

- 2014 Budget plans to engage in more external commercial borrowing to finance 45.6% of the budget deficit
- Compared to 2011 (43%), 2012 (37%), and 2013 (29%) this dependence on external borrowing is on the high side
- 2013 Budget estimated 17% reliance of foreign financing of the deficit but eventually has manifested around 29% (tentative). This can happen in 2014 also
- Thus excessive foreign borrowing will create space for bringing down interest rates although economic fundamentals does not permit this

- Thank you