FINANCIAL SYSTEM STABILITY REVIEW 2018

Central Bank of Sri Lanka

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Governor's Message

The Sri Lankan financial system remained resilient amidst challenging domestic and global developments. Subdued economic growth, dampened business confidence in the backdrop of political uncertainty as well as the increased level of government debt brought many challenges to the Sri Lankan Financial system. Global developments coupled with the widening trade deficit exerted pressure on Sri Lanka's external sector. Capital outflows resulting from increasing global yields and tightening of liquidity conditions in advanced economies adversely affected the growth prospects of emerging and developing market economies including Sri Lanka. Sri Lanka experienced significant foreign investment outflows from the government securities market and the Colombo Stock Exchange which exerted continuous pressure on the rupee.

A number of proactive measures were taken by the Central Bank and the government to effectively withstand such external and internal shocks to the financial system. The imposition of a loan-to-value ratios on motor vehicle leasing, a 200 per cent margin requirement on letters of credit for vehicle imports and letters of credit margins on importation of selected luxury items as well as the maintenance of a market based exchange rate policy are among the major policy measures taken by the Central Bank to mitigate the envisaged risks. The Central Bank will continue to be cautious on emanating risks and vulnerabilities to safeguard the financial system stability and macroeconomic stability of the economy.

This Financial System Stability Review is published with the view of presenting an unbiased evaluation of risks and vulnerabilities faced by the Sri Lankan financial sector. Hence, I believe this review will serve as a reliable reference for all stakeholders.

Dr. Indrajit Coomaraswamy

Governor

Central bank of Sri Lanka

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Acronyms and Abbreviations

ACU	Asian Clearing Union
ALMA	Active Liability Management Act
AML/CFT	Anti Money Laundering/ Countering the Financing of Terrorism
APG	Asia/Pacific Group of Money Laundering
ATM	Average Time to Maturity
AWCMR	Average Weighted Call Money Rate
BOP	Balance of Payment
CAR	Capital Adequacy Ratio
CCPI	Colombo Consumer Price Index
CSE	Colombo Stock Exchange
D-SIBs	Domestic-Systemically Important Banks
ECB	European Central Bank
EFF	Extended Fund Facility
FATF	Financial Action Task Force
FinTech	Financial Technology
GDP	Gross Domestic Product
GSP+	Generalised Scheme of Preferences Plus
GWP	Gross Written Premium
HHR	Hui Heuble Ratio
HLQAs	High-Quality Liquid Assets
IMF	International Monetary Fund
IRCSL	Insurance Regulatory Commission of Sri Lanka
ISBs	International Sovereign Bonds
LBs	Licensed Banks
LC	Letter of Credit
LCR	Liquidity Coverage Ratio
LFCs	Licensed Finance Companies
LFPR	Labour Force Participation Rate
LTV	Loan to Value
MAP	Macroprudential Policy
MIP	Microprudential Policy
NAV	Net Asset Value
NCPI	National Consumer Price Index
NFA	Net Foreign Assets
NIM	Net Interest Margin
NOP	Net Open Position
NPLs	Non-performing Loans
NSFR	Net Stable Funding Ratio
PDs	Primary dealers in Government Securities
QR	Quick Response
RAMIS	Revenue Administration Management Information System
ROA	Return on Assets
ROE	Return on Equity
SDFR	Standing Deposit Facility Rate
SIFIs	Systematically Important Financial Institutions
SLAR	Statutory Liquid Assets Ratio
SLCs	Specialised Leasing Companies
SLDBs	Sri Lanka Development Bonds
SLFR	Standing Lending Facility Rate
SLFRS	Sri Lanka Financial Reporting Standard
SRS	Systemic Risk Survey
UTs	Unit Trusts

Overview

Stability of Sri Lanka's financial system was preserved amidst challenging domestic and global market conditions. Capital outflows resulting from normalizing of yields and, tightening of liquidity conditions in advanced economies combined with expansionary US fiscal policy, exerted pressure on the stability of the domestic financial system of Sri Lanka, as in other emerging markets. Sri Lanka's external sector is subjected to incremental stability risk, as the external sector is highly vulnerable to developments in international markets, especially to international yield rates and capital outflows. This was evident from foreign investment outflows from government securities market and the Colombo Stock Exchange (CSE) that continued from mid-2018.

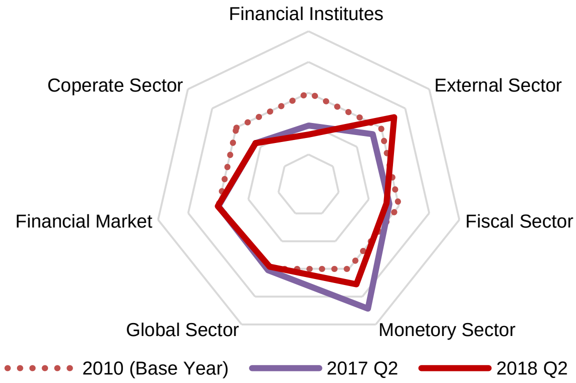
Emerging risks in the domestic economy also challenged financial system stability as political uncertainty and dampened business confidence weighed on growth. Reflecting subdued economic growth, asset quality of the financial sector deteriorated. Deterioration of the external balance with import expenditure outpacing export income, less than expected foreign exchange inflows to the current account, increased capital outflows, and inadequate foreign investments pressurised the external sector of the economy. Depreciation of the Sri Lankan rupee at a significant rate and the depletion of reserves caused several stability concerns. Though the increased phase of depreciation could have pass through effects on inflation, improved supply conditions of the domestic economy helped consumer price inflation to be subdued. Managing the exposure of government debt obligations amidst slippages in the envisaged fiscal consolidation path also challenged financial system stability.

Credit growth moderated from end 2017 in response to tightening of monetary policy implemented from end 2015 until April 2018. Despite the deceleration in overall credit growth, consumption related lending grew at relatively high rates. The loan to value (LTV) ratios imposed by the Central Bank of Sri Lanka with the view of curtailing excessive credit growth and importation of motor vehicles for private use was diluted by the decrease in import tax on small hybrid/petrol cars by the government in October 2017. The exposure of the banking sector to construction and real estate activities have also been high and is being vigilantly monitored in light of increasing real-estate prices.

The payments and settlement systems of the country operated smoothly without any major disruptions to facilitate the smooth functioning of the financial system while adopting new technological advancements as well. With the emergence of fintech and blockchain technologies, the business models of financial institutions may change significantly over time while opening up new business opportunities and challenges for regulators. These developments may pose challenges to the payments and settlement systems and lead to significant technology risk on the financial system stability.

The Financial Stability Map (Chart 1) illustrates the developments that affect the stability of overall financial system of Sri Lanka during the first half of 2018 in comparison to the first half of 2017. According to this Map, financial Institutions, the fiscal sector, and

Chart 1
Financial Stability Map[1]



Source: The Central Bank of Sri Lanka

[1] Getting closure to the center reflects the negative side contribution of the related sector to overall financial stability.

cooperate sector resilience related developments have been weaker during the first half of 2018 compared to corresponding period of 2017.

Number of proactive measures were taken by the Central Bank and the government to address the emerging risks in order to safeguard the financial system stability and macroeconomic stability of the economy. Imposition of LTV ratios on motor vehicle leasing, Letter of Credit (LC) margins on importation of selected luxury items and maintenance of market based exchange rate policy are among the policy measures taken by the Central Bank to mitigate the envisaged risks. The Central Bank also took measures to improve liquidity levels in the foreign exchange and domestic money market by decreasing the limits on Net Open Positions (NOP) of banks and reducing the Statutory Reserve Requirement (SRR). As a proactive measure to manage exchange rate risk, the Government raised funds through International Sovereign Bond (ISB) issuances and syndicated loans resulting in an improvement of the reserve coverage. In the fiscal front, diversification of funding sources of the government, imposition of a 15% tax on gold imports, introduction of an automatic fuel price formula, increasing taxes on vehicle imports and suspending concessional permits for vehicle importation are some of the major policy measures taken by the government. Further, the Central Bank will continue to review the required macroprudential measures to stabilise the vulnerable sectors in the economy which can exert risk on financial system stability.

Stability Outlook

The above elaborated risks, which are still at moderate level, could increase significantly in the future in the event of continuation of policy uncertainty, unfavourable deviations from the envisaged fiscal consolidation programme, and a faster-than-expected tightening in monetary normalization in US. Further depreciation of Sri Lankan rupee and intervention by the Central Bank to curb excessive volatility of the exchange rate could lead to further depletion of gross official reserves of the country. Delays in the receipt of the next tranche of Extended Fund Facility program with the International Monetary Fund (IMF), the large foreign debt service payments that have bunched up for 2019 (including sovereign debt service payments), further outflows from government securities and the CSE and expected deceleration in tourist earnings would also pose pressure on the exchange rate. Growth performance of the country could also be dampened further with a deterioration in investor sentiment, lower than expected FDIs resulting from adverse developments in the international financial and trade environment as well as domestic political uncertainty and the recent measures undertaken to curb excessive import demand. Continuation of the slowdown in economic activity may further weaken the demand for credit and reduce quality of assets of the financial sector. This could hinder internal capital generation capability of banks that is required for the transition towards higher capital standards of Basel III. Therefore, regulators need to be cautious of a further increase in non-performing loans (NPLs) and ensure that proper risk management mechanisms are in place to mitigate all relevant risks emanating from increasing NPLs. Sri Lanka's government debt obligation is exceptionally higher than its rating peers and Sri Lanka is burdened with regular debt maturities, including international commercial debt, for the period from 2018 to 2023. Debt to Gross Domestic Product (GDP) ratio surpassed 75 per cent during recent years. In terms of risk emanating from government borrowings, issuance of new debt to repay existing debt will not be sustainable in the long run and will further burden public finance in the future unless accumulation of debt is arrested through a strictly committed fiscal consolidation process. It is anticipated that the space and flexibility provided under the Active Liability Management Act would ease the rollover risk of public debt. However, external space in terms of public finance is also limited given the gradual normalisation of interest rates in the United States and elevated outflows from emerging market economies. As Sri Lanka graduated to lower middle income country status, access to concessional financing is limited. Therefore, Sri Lanka is exposed to market risks and sovereign ratings by international rating agencies as the country increasingly relies upon external commercial financing. Therefore, revenue based fiscal consolidation is the key to overcome this unprecedented public debt burden and Sri Lanka cannot afford any slippages in the implementation of fiscal consolidation processes. In the backdrop of current political uncertainty, a firm commitment by the government is essential to achieve the envisaged fiscal targets for 2018 country could also be dampened further with the deterioration in investor sentiment, lower than expected FDIs in view of international financial and trade environment as well as domestic political uncertainty and the recent measures undertaken to curb excessive import demand. The continuation of slowdown in economic activity would further weaken the demand for credit and decrease in quality of assets of the financial sector. This could hinder the ability on internal capital generation of banks given the transition for higher capital standards under Basel III. Therefore, regulators need to be cautious of a further increase in non-performing loans and ensure that proper risk management mechanisms are in place to mitigate all relevant risks emanating from increasing NPLs. Sri Lanka's government debt obligation is exceptionally higher than its rating peers and the country is burdened with regular debt maturities, including that of international commercial debt, for the period from 2018 to 2023. Debt to GDP ratio surpassed 75 per cent during recent years. 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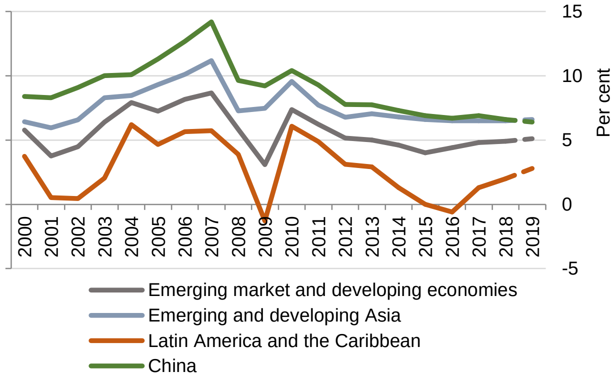
Therefore, revenue based fiscal consolidation is the key to overcome this unprecedented public debt burden and country cannot afford the slippage in effective implementation of fiscal consolidation process. In the backdrop of current political uncertainty, firm commitments by the government is needed to achieve the envisaged fiscal targets for 2018 and beyond.

1. International and Domestic Developments Affecting Financial Stability

1.1. International Developments

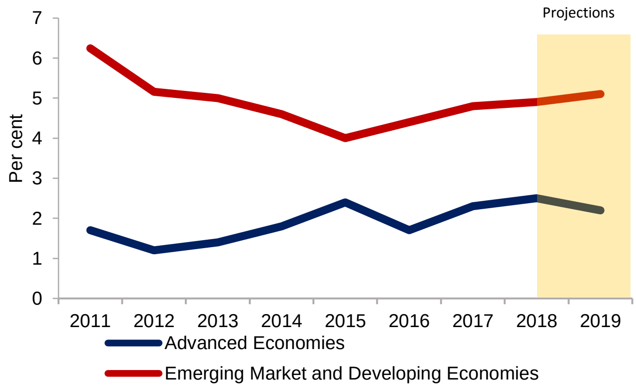
Global growth is projected to reach 3.7 per cent in 2018 and 2019 in the World Economic Outlook of the IMF. However, growth prospects for the medium term remain uncertain since global growth has become less synchronized across countries. The rate of economic expansion appears to have peaked in some major economies, particularly in the estate], while other large economies such as the Euro area, Japan and the United Kingdom have slowed down in 2018. Exogenous shocks emanating from, but not limited to, capital outflows resulting from normalization of monetary policy in the United States, changes in investor sentiment and trade tensions between major economies exerted pressure on growth prospects of emerging market economies. Equity indices have declined modestly among emerging markets reflecting above-mentioned imbalances while increasing downside risk to growth outlook (Chart 1.1.1 and 1.1.2).

Chart 1.1.1
Emerging Market Annual GDP Growth (Per cent)



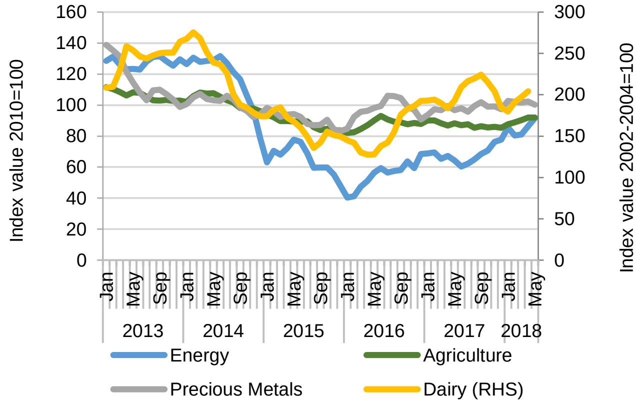
Source: IMF World Economic Outlook (October 2018)

Chart 1.1.2
World Output (Annual Percentages)



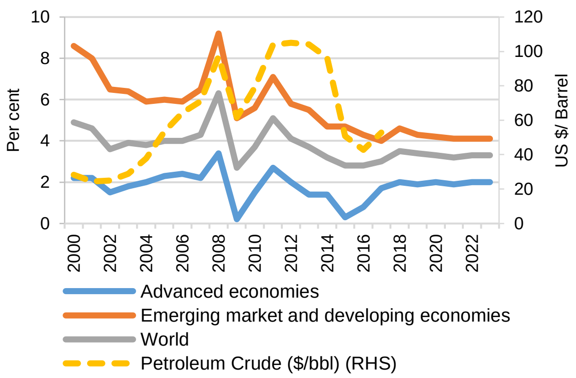
Source: IMF World Economic Outlook (October 2018)

Chart 1.1.3
World Commodity Prices



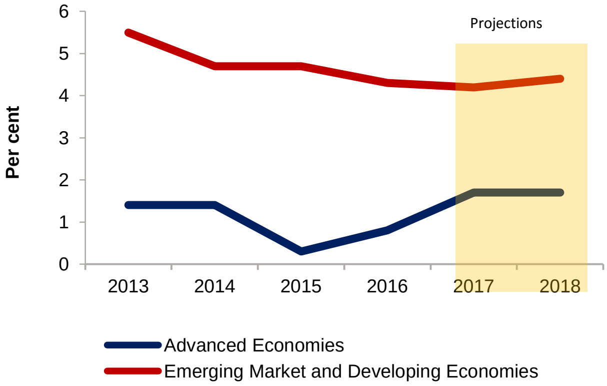
Source: World Bank

Chart 1.1.4
Crude Oil Prices and Inflation in Advanced Economies and Emerging Market and Developing Economies



Source: IMF

Chart 1.1.5
Headline Inflation – Advanced Economies and Emerging Market and Developing Economies



Source: IMF

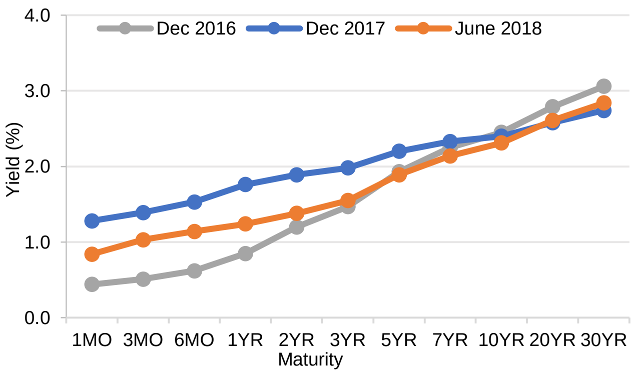
Risks to the global economy are growing. Recently announced tariff increases by the United States and retaliatory protectionist measures by its trading partners have posed risk to global trade. Accommodative financial market conditions that prevailed in advanced economies are changing with the rising trade tensions, geopolitical concerns and mounting political and policy uncertainty. Tighter financial conditions in the global economy is likely to cause greater volatility in the exchange rates of emerging markets, portfolio adjustments and further withdrawals of capital from emerging markets.

Global oil prices increased substantially in mid-2018 due to shortfalls in supply and geopolitical uncertainties in oil producing countries. The upsurge in fuel prices raised headline inflation in some advanced and emerging market economies. However decline in oil prices in the global market since mid-October eased the pressure on inflation to a certain extent. Further, core inflation in many emerging market economies has been fueled by depreciation of their currencies. Core inflation in the Euro area marginally increased while it remains stable in the

United States (Chart 1.1.3, 1.1.4 and 1.1.5).

Financial conditions in advanced economies remain generally accommodative. The US Federal Reserve continued with policy normalization in the context of favorable inflation and employment conditions. The Federal Reserve raised the benchmark Federal Fund rate by 25 basis points in June and September 2018. Further, it signaled the possibility of additional rate hikes in 2018 and three hikes in 2019. The European Central Bank (ECB) declared that it would narrow down the monthly asset purchases with its anticipation to end the quantitative easing program. ECB also indicated that it will keep policy rates unchanged for a longer period than anticipated by the markets. Central Banks in key emerging market economies, including India, Indonesia and Mexico have raised policy rates in order to curb the pressure on inflation and the exchange rates (Chart 1.1.6).

Chart 1.1.6
Benchmark US Treasury Yield Curve



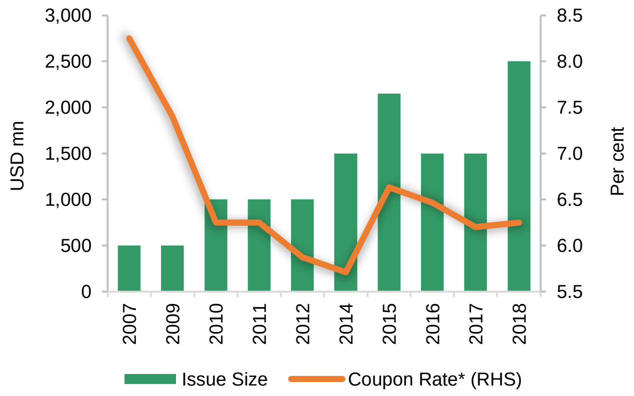
Source: US Treasury website

As of September 2018, the US dollar had strengthened significantly while other major currencies such as Euro, Japanese Yen, and Sterling Pound weakened. Further, some emerging market currencies sharply depreciated. Most severe cases observed were the Argentine Peso and the Turkish Lira which came under pressure due to both domestic and global developments. The Brazilian Real and the South African Rand were also among the currencies which experienced large depreciations in the recent past. Central Banks of several countries such as Indonesia, India, Mexico and the Philippines increased their policy rates to curb increased inflation and to protect their currencies in some cases. Capital outflows from emerging market economies and looming concerns about financial and macroeconomic imbalances emanating from exogenous shocks were among the major reasons for large currency depreciation in many emerging market economies.

Global economic developments bring many challenges for Sri Lanka and the stability of the Sri Lankan financial system due to its high exposure to international markets. Capital outflow, higher financing costs and significant depreciation of the rupee are some of the major stability concerns. The increase in commodity prices, particularly due to increase in global oil prices, and upward revision to energy prices and associated second-round effects posed upside risks on inflation. However, the recent decline in oil prices in the global market may ease the pressure on inflation amidst depreciation of the exchange rate. Tightening of global financial conditions in line with monetary policy normalization in advanced economies could further accelerate capital outflows particularly from emerging market economies, including Sri Lanka. This has been the recent experience in relation to foreign investments in government securities and in CSE.

Tightening of the US monetary policy has already affected the secondary market yields of ISBs issued by Sri Lanka. Continuation of such outflows could exert pressure on the Sri Lankan rupee to depreciate further against the US dollar and other major currencies. In this backdrop, sourcing new financing from the international market would be more costly to the government and the corporate sector (Chart 1.1.7). Trade frictions between the US and China will not pose an imminent direct threat to Sri Lanka's trade performance as most of the products which are subject to higher tariffs are not major export or import items of Sri Lanka. However, the possible slowdown in global trade due

Chart 1.1.7
Sovereign Bond Issues



Source: Central Bank of Sri Lanka
*Weighted average coupon rate of all issues during the year

to the disruption to global value chains may have an adverse impact on Sri Lanka's external trade. While the Central Bank of Sri Lanka maintains its cautious monetary policy stance, it would continue to mitigate macro-financial risks by introducing further macroprudential policy measures to support financial and macroeconomic stability. Diversification of funding sources, maintenance of a market based exchange rate policy, imposition of LTVs for leases on motor vehicles and introduction of 100 to 200 per cent LC margins on importation of vehicles and selected non-essential consumer products are among the recent policy measures implemented. The Central Bank also took measures to improve liquidity levels in the foreign exchange and domestic money market by decreasing the limits on NOP of banks and reducing the Statutory Reserve Requirement (SRR).

In addition to the above, introduction of automatic fuel pricing formula, increasing taxes on import of vehicles less than 1000cc, suspending concessional permits for vehicle importation and imposition of a 15% custom duty on gold imports are some of the major fiscal led macroprudential policy measures implemented by the government. As a proactive measure to manage exchange rate risk, the government raised funds through ISB issuances and syndicated loans resulting in an improvement of the reserve coverage.

1.2. Domestic Developments

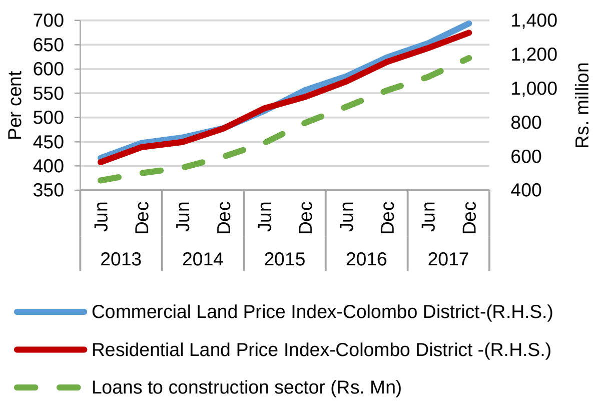
1.2.1 Economic Growth

The Sri Lankan economy grew by 3.6 per cent in real terms during the first half of 2018 compared to the 3.2 per cent growth in the first half of 2017 and the annual growth of 3.3 per cent in 2017. The agriculture sector that was affected by adverse weather conditions in 2017 recorded a recovery in 2018 with an expansion of 4.9 per cent during the first half of 2018.

Conducive weather conditions that prevailed during the third and the fourth quarter of the year could create a favorable impact on agriculture and related industries. Industrial activities recorded a modest growth of 1.6 per cent in the first half of2018 particularly with the contraction in construction activities and slowdown in mining and quarrying activities. Manufacturing activities, which is the largest subsector within the industry sector, also recorded a moderate growth of 3.1 per cent. The expansion of 4.8 per cent in services related activities was largely driven by the growth in financial services and wholesale and retail trade activities.

Although the construction sector showed subdued performance during the first half of 2018, it contributed significantly to the economic growth in recent past. A significant growth was observed in the real estate sector including the condominium residential property market. Meanwhile, banking sector exposure to the real estate sector has also gradually increased. Since the real estate sector could be an originator of a substantial volume of risky claims held by financial institutions, identifying risks and vulnerabilities emanating from the real estate sector and its implications on financial stability at an early stage and developing measures for systemic risk mitigation to strengthen financial system is extremely important. Therefore, the Central Bank is vigilant about the real estate sector, continuous increase in land prices in Colombo and the rapidly growing condominium sector, in order to assess the plausible buildup of systemic risk (Chart 1.2.1).

Chart 1.2.1
Land Price Index and Banking Sector Loans to Construction Sector



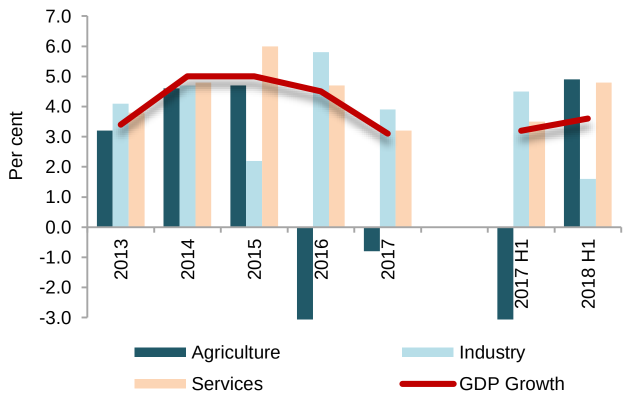
Source: Central Bank of Sri Lanka

With the high volume & value of residential property transactions

taking place in the country, the need for enforcing suitable prudential regulations, including the use of escrow accounts, has been identified to protect the interest of property buyers, to maintain the long term stability of the real estate sector in line with international best practices. Further, escrow accounts enable regulators to closely monitor the inflow of funds to the real estate sector which could be a source of systemic risk leading to the build-up of imbalances in the system. The Condominium Management Authority is in the process of evaluating the possible use of escrow accounts for condominium purchases and therefore implementing such conditions by the regulator is envisage.

On the expenditure side, the expansion in the economy was supported by the increase in both consumption and investment expenditure during the first half of 2018. However, the negative growth in net external demand continued to dampen economic growth (Chart 1.2.2). Lower growth in income levels coupled with any possible rise in cost of living could impact adversely on the quality of credit and debt servicing

Chart 1.2.2
Real GDP (2010 = 100) Growth and Sectorial Performances (Per cent)



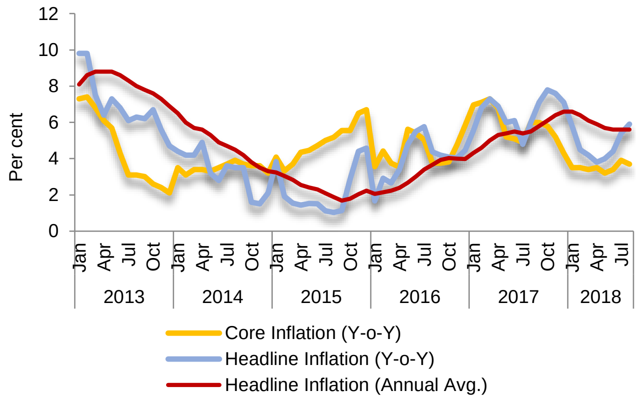
Source: Department of Census and Statistics ability of households as well as the corporate sector.

1.2.2 Inflation

Inflation broadly remained at mid-single digit levels in first half of 2018 mainly due to the decline in prices of both food and non-food items as well as the favourble base effect (Chart 1.2.3 and 1.2.4). Favorable supply side conditions eased the pressure on inflation amidst rate depreciation. Meanwhile, demand inflation based on both Colombo Consumer Price Index (CCPI) and the National Consumer Price Index (NCPI) remained subdued during the first half of 2018 with the proactive monetary policy measures undertaken by the Central Bank together with anchored inflation expectations.

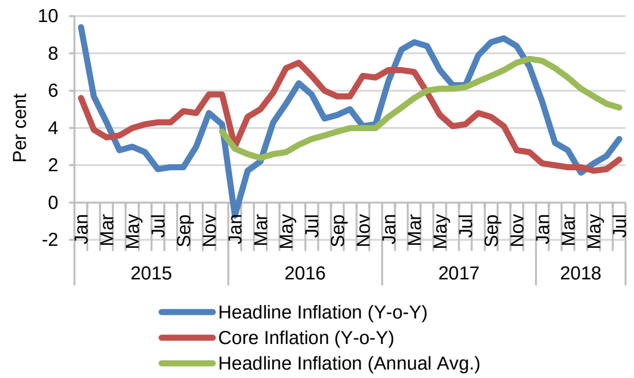
Further, continuation of fiscal consolidation efforts are expected to complement the Central Bank's endeavor to keep core inflation at low single digit level during the period ahead.

Chart 1.2.3
Headline Inflation and Core Inflation (CCPI)



Source: Department of Census and Statistics

Chart 1.2.4
Headline Inflation and Core Inflation (NCPI)

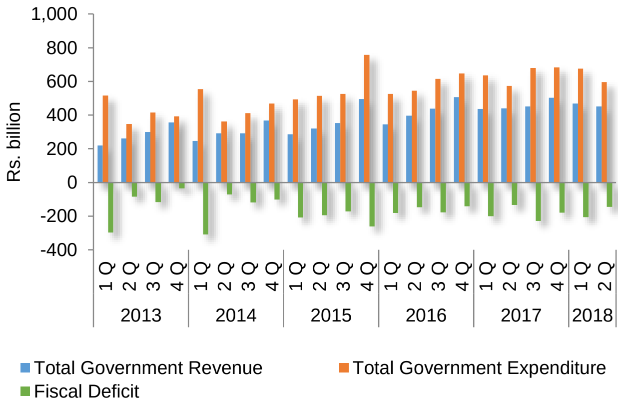


Source: Department of Census and Statistics

1.2.3 Fiscal Sector Developments and Debt Management

Performance of the fiscal sector showed improvements in spite of the slippages observed. Despite the fiscal consolidation efforts, the government revenue to GDP ratio declined to 6.4 per cent during the first half of 2018 from 6.7 per cent in the corresponding period of 2017 mainly due to the decline in tax revenue from import duties. However, total revenue in nominal terms increased by 5.1 per cent to Rs. 920.8 billion during the first half of 2018 from Rs. 876.3 billion recorded in the corresponding period of the previous year. The current account deficit increased to 0.5 per cent of the estimated GDP during the first half of 2018 from 0.3 per cent recorded in the same period of 2017 due to both the increase in total government expenditure and decrease in revenue (Chart 1.2.5). However, the overall budget deficit declined to 2.4 per cent of the estimated GDP during the first half of 2018 from 2.6 per cent in the corresponding period of 2017.

Chart 1.2.5
Government Revenue, Expenditure and Fiscal Deficit

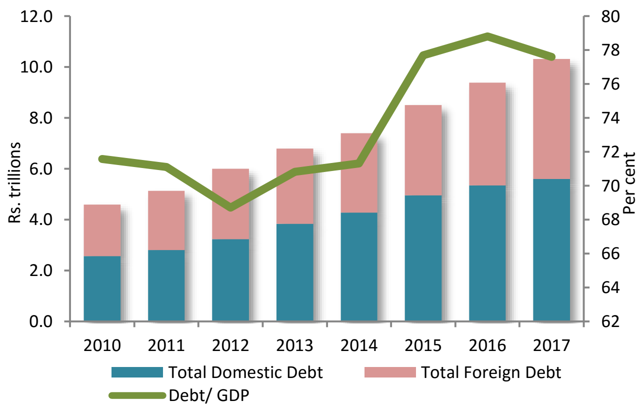


Source: Central Bank of Sri Lanka

The government took several measures to progress in its fiscal consolidation path. The Inland Revenue Act, No. 24 of 2017 and the Revenue Administration Management Information System (RAMIS) were introduced in order to simplify, standardize and rationalize tax standards. In addition, several measures were taken to improve public debt management. However, achieving fiscal targets as stipulated in the Budget 2018 would be challenging due to delays in implementing several new levies, lower revenue collection from import duties, increased expenditure on interest payments and natural disaster related relief spending.

The deficit in the budget recorded in the first half of 2018 was financed through domestic and foreign sources (Chart 1.2.6). Considering the comparatively higher interest rates and the liquidity shortage prevailed in the domestic money market, the strategies adopted for debt issuance in the first half of 2018 included issuance of ISBs amounting to US dollar 2,500 million, issuance of Sri Lanka Development Bonds (SLDBs) amounting to US dollar 712.2 million and issuance of Treasury bonds mainly of medium-term maturities. This was also intended to offset the possibility of crowding out the domestic investible funds by the government. The issuance of relatively high volume of medium-term Treasury Bonds in the first half of the year has suppressed the Average Time to Maturity (ATM) of the domestic debt portfolio.

Chart 1.2.6
Total Domestic and Foreign Debt



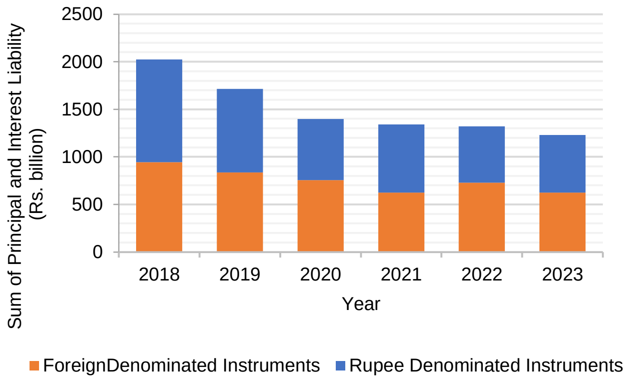
Source: Central Bank of Sri Lanka

Forthcoming government external debt maturing remain one of the

significant systemic risks to financial system stability. The government will have to undertake continuous issuance of debt securities, in order to meet the maturing external debt service obligations due from 2018 to 2023. Continuous issuance of new debt to repay existing debt may not be sustainable given the developments in the international markets and is likely to further burden public finance in the future. Therefore, the next five years is crucial in terms of debt sustainability due to the maturing of a significant amount of external commercial debt, amidst unfavorable developments in global financial markets, exposure to rating agencies and challenges faced by the government in adhering to fiscal consolidation. (Chart 1.2.7 and 1.2.8).

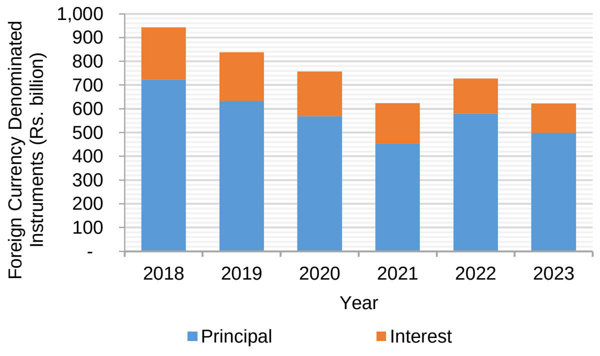
The Active Liability Management Act, (ALMA) No. 8 of 2018 enacted in March 2018 envisages to manage public debt and improve the underlying risk profile of the public debt stock. Act provides space for the government to raise funds within the domestic resource availability or directly through offshore markets. However, the external space for liability management is limited given gradual normalization of interest rates in the US

Chart 1.2.7
Estimated Total Domestic and Foreign Debt Liabilities



Source: Central Bank of Sri Lanka

Chart 1.2.8
Foreign Currency Denominated Debt Liabilities



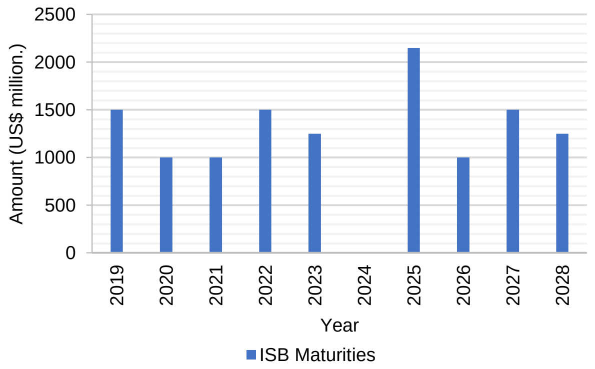
Source: Central Bank of Sri Lanka

and elevated outflows from emerging market economies. In this context, slippages in achieving revenue-based fiscal consolidation targets would adversely affect debt management and increase the debt burden of the country.

ISBs are given priority for liability managemnt considerations. Among the options available for reducing the roll-over risks of ISBs, priority is given to switching/exchanging maturing ISBs to longer maturity bonds. This would create the space to plan new issuance cycles to benefit from international capital market conditions in the medium-term. Further, diversifying capital market access outside Eurobond issuances, syndicated financing arragements and divestitures of non-strategic public assets are also a few options available to meet the external debt service obligations (Chart 1.2.9).

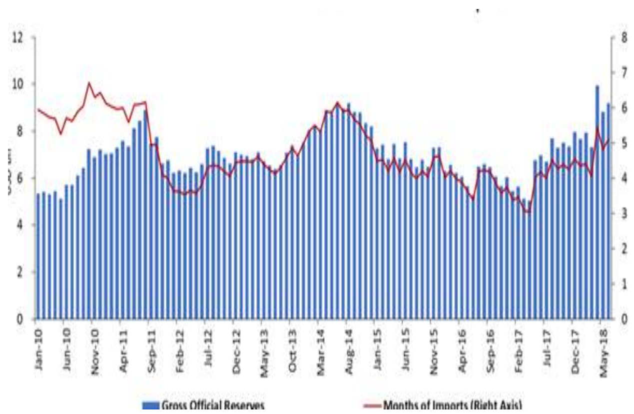
In addition, the annual Treasury bond maturities during 2019-2023 will smoothen substantialy compared to 2018, thereby providing more space to finance the fiscal deficit. The Treasury bond maturities which peaked at over Rs. 606 billion in 2018 will decline to around Rs. 456 billion in 2019 and further to around Rs. 299 billion in 2020. Therefore, the government can use this

Chart 1.2.9
ISB Maturities



Source: Central Bank of Sri Lanka

Chart 1.2.10
Evolution of gross Reserves



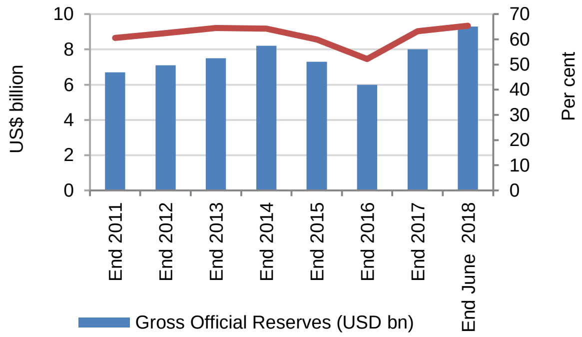
Source: Central Bank of Sri Lanka

space to raise the required funds domestically for financing the maturing ISBs to counter the roll-over risks subject to the availability of net foreign assets (Chart 1.2.10). Although reserve coverage and reserves as a percentage of short-term external libilities improved by end June 2018 inline with the IMF-EFF and maintance of a flexible exchange rate policy, it could be a challenge to raise required funds domestically under the current market conditions (Chart 1.2.11).

1.2.4 Government Securities Secondary Market

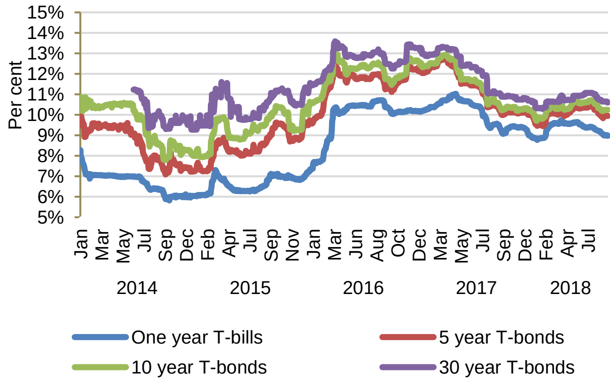
The secondary market yield curve of government securities witnessed a parallel shift downwards by the end of the first half of 2018, compared to the corresponding period in 2017 (Chart 1.2.12). The improved market conditions together with inflows from ISBs, and funds received from divesting the Hambantota port, combined with enhanced transparency and predictability in the issuance process of government securities continued positively towards easing the pressure on interest rates in the domestic market. Weekly issuance volumes of Treasury bills at the primary auctions

Chart 1.2.11
Gross Reserves as a % of Short Term Debt Liabilities



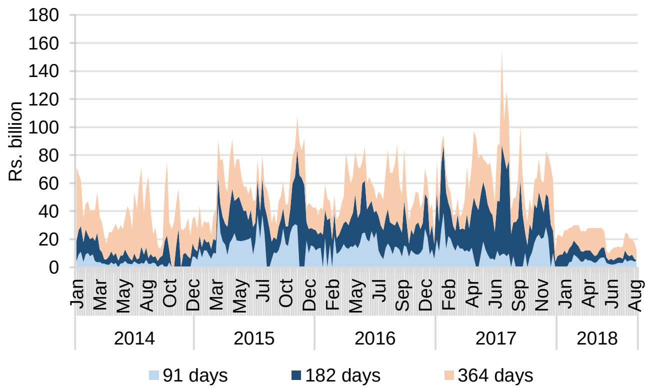
Source: Central Bank of Sri Lanka
Debt and Liabilities

Chart 1.2.12
Secondary Market Yield Rates of T-bills and T-bonds



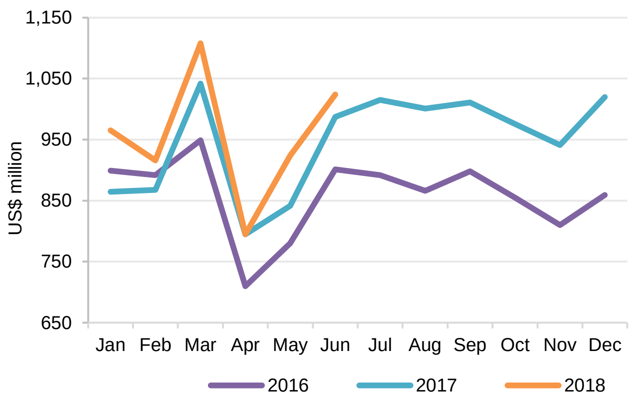
Source: Central Bank of Sri Lanka

Chart 1.2.13
Demand for T-bills at Primary Auctions



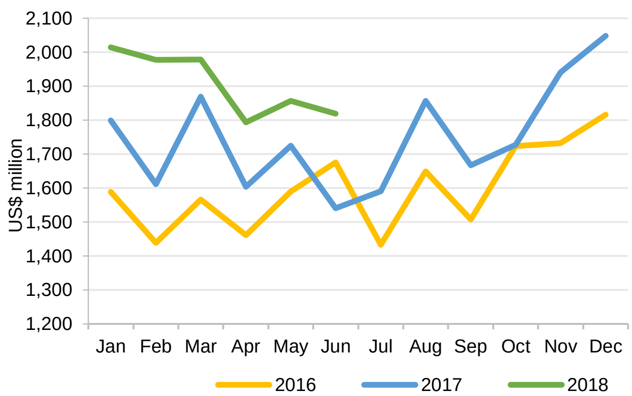
Source: Central Bank of Sri Lanka

Chart 1.2.14
Export Performance



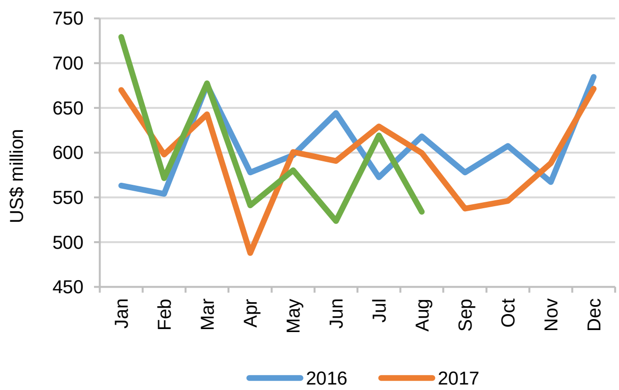
Source: Central Bank of Sri Lanka

Chart 1.2.15
Import Performance



Source: Central Bank of Sri Lanka

Chart 1.2.16
Worker's Remittances



Source: Central Bank of Sri Lanka

were brought down to a manageable level in the first half of 2018 compared to 2017 (Chart 1.2.13).

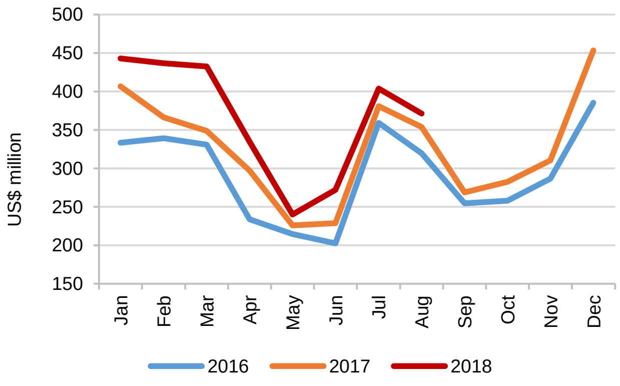
1.2.5 External Sector

Sri Lanka's external sector was under pressure during the second and third quarters of the year. Higher than expected growth in import expenditure which outpaced the increase in export earnings resulted in considerable widening of the trade deficit. The significant increase in import expenditure was driven by intermediate goods imports, particularly fuel, motor vehicles and gold imports. However, favourable developments such as restoration of the European Union's Generalised Scheme of Preferences Plus (GSP+) facility, increase in export commodity prices in the international market and increase in tourist earnings were observed during the period concerned. Meanwhile, worker remittances for the first quarter of 2018 increased at a lower rate of 3.5 per cent (Chart 1.2.14, 1.2.15, 1.2.16 and 1.2.17).

The widening trade deficit necessitated the supply of more US dollars to meet import expenditure. Hence the demand for US dollars rose exerting pressure on the exchange rate to depreciate while frontloading of payments by importers exuberated the situation. Meanwhile delay in repatriation of export proceeds by exporters to benefit from further depreciation of the rupee also aggravated the pressure on the exchange rate. In the external front, the broad-based strengthening of the US dollar in the global market and investment outflows from the government securities market also added pressure on the exchange rate.

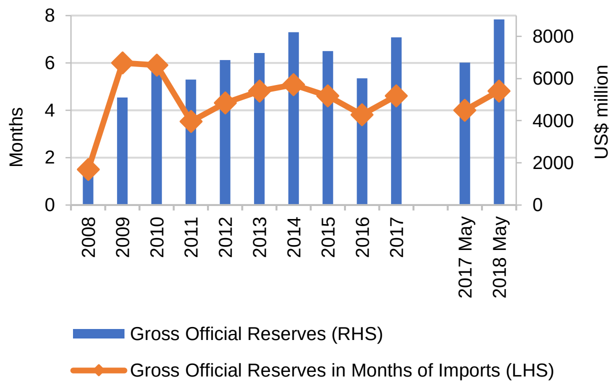
Reflecting higher inflows to the financial account, gross official reserves increased to the historically highest level of US dollars 9.9 billion as at end April 2018. Proceeds from ISBs, divestiture of Hambantota Port and receipt of the fifth tranche of the IMF-EFF programme helped the buildup of gross official reserves to US dollars 9.9 billion by end April 2018 (Chart 1.2.18 and 1.2.19). Supplying of foreign exchange to domestic forex market by the Central Bank to avoid undue fluctuation of the exchange rate, outflows on account of debt service payments and payments to the Asian Clearing Union (ACU) resulted in gross official reserves to declining to US dollars 7.2 billion by end September 2018.

Chart 1.2.17
Worker's Remittances



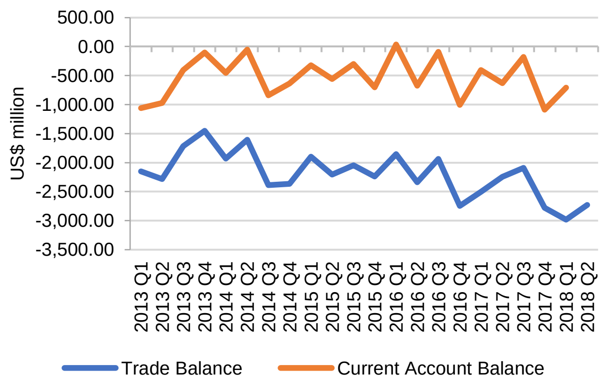
Source: Central Bank of Sri Lanka

Chart 1.2.18
Official Reserves of Sri Lanka



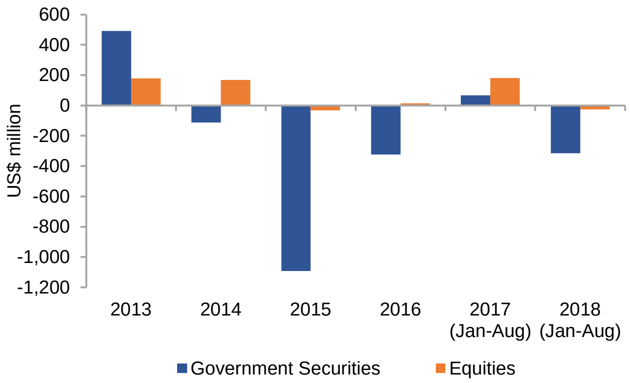
Source: Central Bank of Sri Lanka

Chart 1.2.19
Trade Balance and Current Account Balance



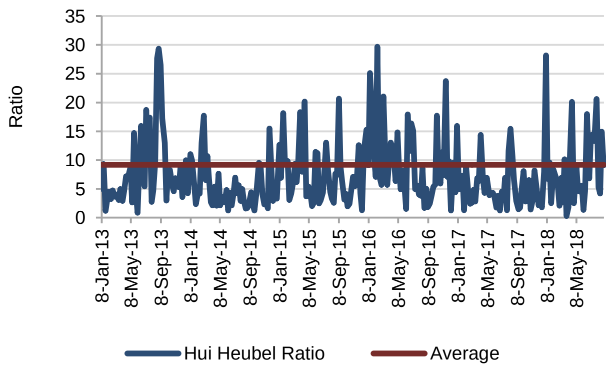
Source: Central Bank of Sri Lanka

Chart 1.2.20
Net Foreign Investments in Government Securities (T-bills and T-bonds) and Equities



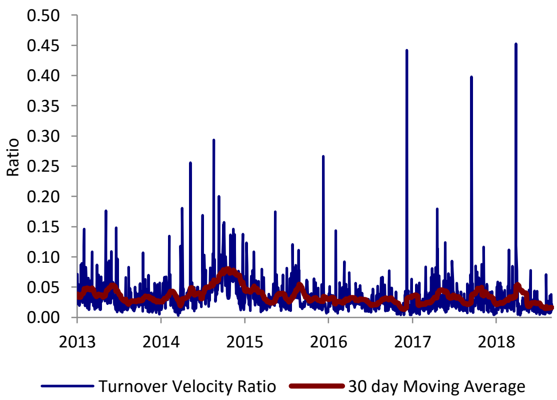
Sources: Colombo Stock Exchange
The Central Bank of Sri Lanka

Chart 1.2.21
Hui-Heubel Liquidity Ratio for CSE



Source: Colombo Stock Exchange

Chart 1.2.22
CSE Turnover Velocity Ratio



Source: Colombo Stock Exchange

1.2.6 Net Portfolio Flow

Net portfolio flows to Sri Lanka remained negative since end of March 2018. The Colombo stock market was volatile due to unstable foreign participation and increased investor uncertainty over tax policy directions, global developments, pressure on the exchange rate and lack of diversified investment opportunities. Net portfolio investment by non-residents in the equity and debt securities declined substantially in 2018 (Chart 1.2.20). Tightening of global financial conditions in line with monetary policy normalization of the United States have accelerated capital outflows from Sri Lanka. The Hui-Heubel Ratio (HHR) remained above the long- term average during most of the period in 2018 indicating low resilience of CSE due to unstable foreign participation (Chart 1.2.21, 1.2.22 and 1.2.23).

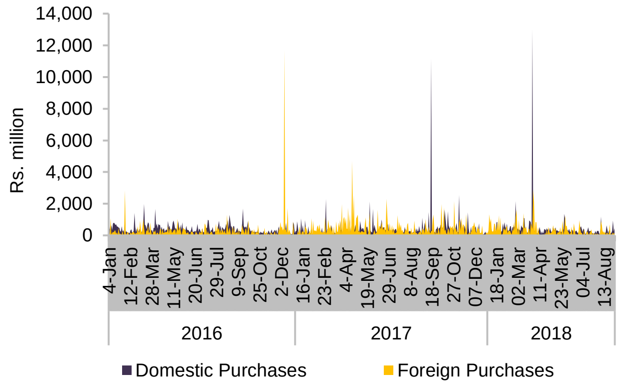
1.2.7 Domestic Foreign Exchange Market

In the first nine months of 2018, Sri Lankan rupee depreciated against US dollar by 9.7 per cent from Rs. 152.85 as at end December 2017 to

Rs. 169.24 as at end September 2018. The exchange rate, which remained relatively stable during the first four months of 2018, underwent a significant pressure since then. Although the Central Bank was able to absorb foreign exchange from the domestic foreign exchange market during the first four months amidst the influx of foreign exchange inflows, a turnaround was experienced since May 2018 onwards along with normalization of the monetary policy in United States and resultant unwinding of foreign investments in the government securities markets. Meanwhile speculative behaviour of the market participants and unwarranted growth in import expenditure also added pressure on the exchange rate.

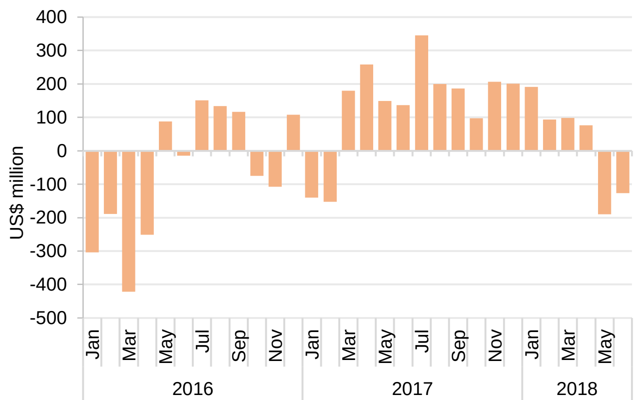
Continued outflows amidst widening trade deficit and debt service payments exerted a significant pressure on the rupee. This necessitated the Central Bank to intervene in the domestic foreign exchange market in few occasions to curb the excess volatility (Chart 1.2.24). Nevertheless, the Sri Lankan rupee depreciated substantially against the US dollar. Any further increase in the pace of depreciation of the Sri Lankan rupee may increase imported

Chart 1.2.23
CSE Daily Turnover



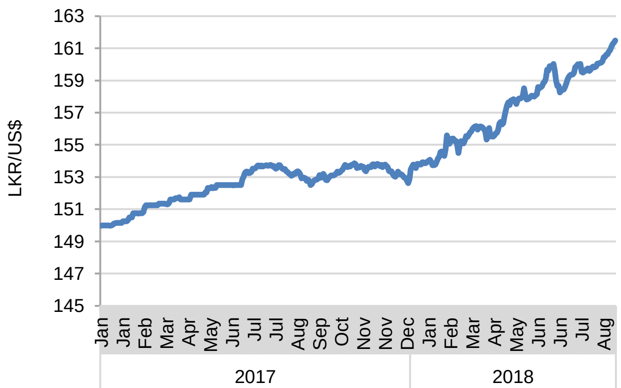
Source: Colombo Stock Exchange

Chart 1.2.24
Net Purchases of US$ by the Central Bank



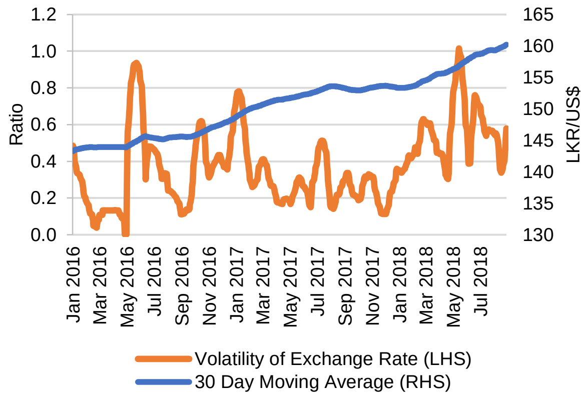
Source: Central Bank of Sri Lanka

Chart 1.2.25
Movement of US$/LKR Exchange Rate



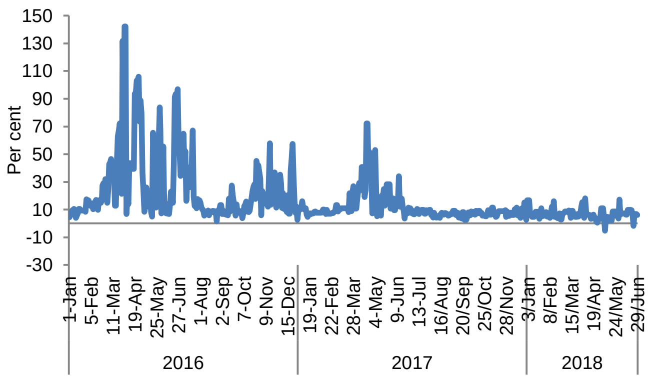
Source: Central Bank of Sri Lanka

Chart 1.2.26
US$/LKR Exchange Rate Volatility



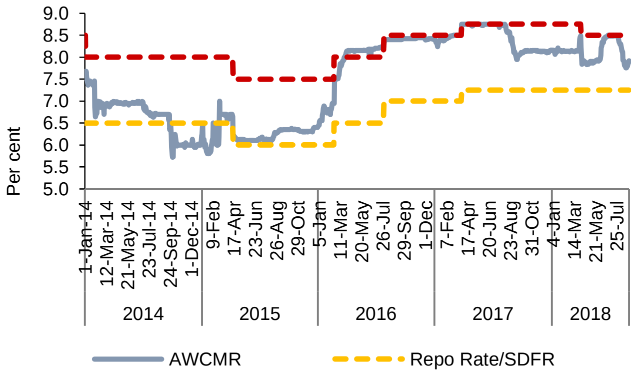
Source: Central Bank of Sri Lanka

Chart 1.2.27
One Week Forward Premium (% per annum) Yield Curve



Source: Central Bank of Sri Lanka

Chart 1.2.28
Central Bank Policy Rate Corridor and AWCMR



Source: Central Bank of Sri Lanka

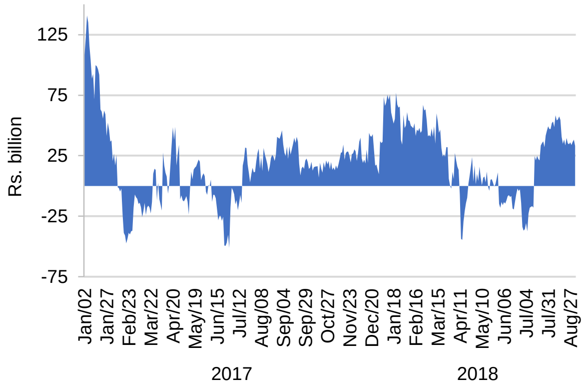
inflation and exert pressure on rupee liability of foreign debt service and settlements. (Chart 1.2.25, 1.2.26 and 1.2.27).

1.2.8 Monetary Policy and Open Market Operations

In an environment of adverse inflation expectations and excessive monetary and credit expansion, the Central Bank continued a tight monetary policy stance in the second half of 2017. However, considering favorable developments in inflation and inflation outlook as well as the subpar performance in real economic growth, the Central Bank signaled the end to the tightening of monetary policy stance in April 2018. Accordingly, the Central Bank reduced the Standing Lending Facility Rate (SLFR) by 25 basis points to 8.50 per cent, while keeping the Standing Deposit Facility Rate (SDFR) unchanged at 7.25 per cent, thereby narrowing the width of the policy interest rate corridor to 125 basis points from 150 basis points (Chart 1.2.28). Short term interest rates responded to monetary policy easing exercised in April 2018 along with improved market liquidity conditions. Consequently, the

Average Weighted Call Money Rate (AWCMR), which hovered around the upper bound of the policy rate corridor until mid-July 2017 in response to the tight monetary policy stance of the Central Bank and the deficit liquidity position, declined gradually thereafter responding to improved liquidity conditions and monetary policy easing in April 2018 (Chart 1.2.29). Consequently, AWCMR remained months of 2018. However, AWCMR increased since early June 2018 and mostly around middle levels of the policy rate corridor during the first five hovered around the upper bound of the policy rate corridor, with deficit liquidity conditions in the domestic markets.

Chart 1.2.29
Inter-bank Money Market Liquidity Curve



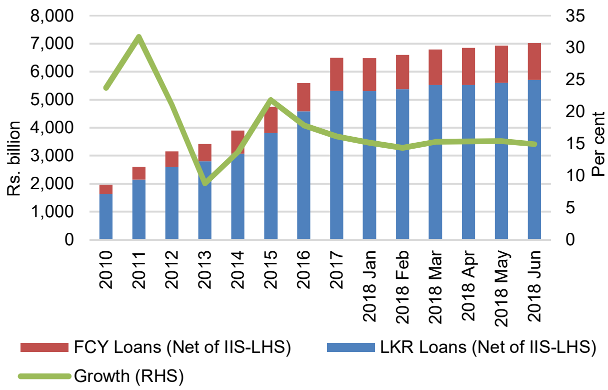
Source: Central Bank of Sri Lanka

2. Financial Sector Developments and Stability

Banking sector recorded a moderate growth in loans and advances, which was resulted from the tightening of Monetary Policy implemented from end 2015 onwards, adverse weather conditions prevailed in 2017, slowdown in economic growth and prudential policy actions taken by the Central Bank to curtail the build-up of systemic imbalances. A marginal decline in profits in the Banking Sector was observed during the period under consideration while NPLs also increased. The capital generation ability of the banking sector would be hindered if this trend continues. Operating conditions of the banking industry in the medium term will be challenging due to the transition to higher capital standards under Basel III, adoption of the Sri Lanka Financial Reporting Standard (SLFRS) 9 and decline in the quality of assets. However, in the long run, implementation of Basel III and SLFRS 9 will improve the resilience and stability of the banking sector.

A slowdown in the performance of the LFCs & SLCs sector was observed with subdued economic

Chart 2.1.1
Loans and Advances of LBs and YOY Growth



Source: Central Bank of Sri Lanka

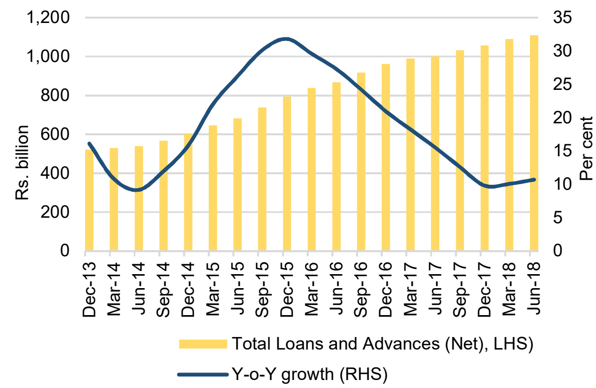
growth, natural calamities and macroprudential measures imposed on leasing advances for vehicles. LFC & SLC sector's overall capital and liquidity levels were at a satisfactory level, whereas the asset quality and profits declined. Necessary prudential actions are being carried out by the Central Bank to revive certain weak finance companies. Other financial institutions such as insurance companies, unit trusts (UTs) and stock brokers continued expanding their business operations without major stability concerns.

2.1. Credit Risk

The effect of tight monetary policy which continued until March 2018 from end 2015 was reflected in the financial sector as credit growth moderated since late 2017 and continued into the first half of 2018. Moreover, disruptive weather conditions prevailed in the second half of 2016 and 2017, moderation in economic growth and prudential policy measures taken by the government and the Central Bank to curtail build-up of systemic imbalances have helped slowing the credit growth. Year-on-year credit growth of the Licensed Banking (LBs) sector decelerated to 14.7 per cent in June 2018 from 20.1 per cent in June 2017. Meanwhile year-on-year credit growth of LFC & SLC sector decelerated to 10.7 per cent in June 2018 compared to 15.5 per cent in June 2017. The slowdown in credit growth of the LFC & SLC sector was mainly attributed to the introduction of the LTV ratio which contained the excessive growth of finance lease business.

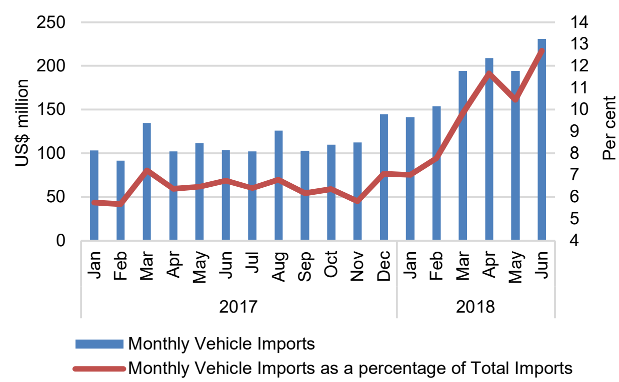
With a view of curtailing excessive credit-driven-importation of motor vehicles, which weigh substantially on the Balance of Payments (BoP), the Central Bank imposed a LTV ratio on motor vehicles in September 2015. The requirement of LTV ratio, a macroprudential tool to correct the build-up of systemic risks, had contained the rapid acceleration of leasing advances in banking and LFC & SLC sector since late 2015. Growth in the leasing portfolio of the banking sector and LFC & SLC sector which once reached 63.0 per cent and 52.1 per cent, respectively, in September 2015, moderated to 5.8 per cent and 13.0 per cent, respectively, by end 2017. The monthly vehicle import bill which averaged at US dollar 177 million in 2015 declined to US dollar 112 million during 2016 and 2017. The drop in motor vehicle imports was more pronounced when analyzed for motor car and three-wheeler imports which

Chart 2.1.2
Loans and Advances of LFCs and SLCs Sector



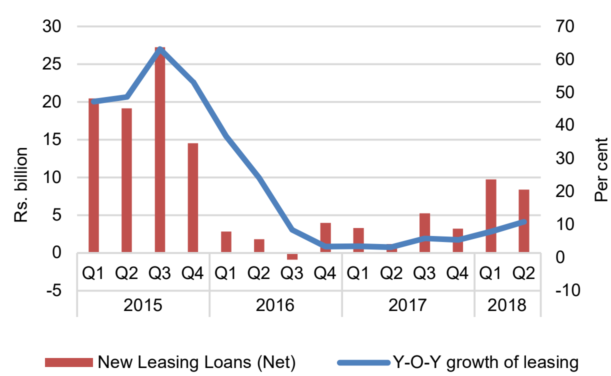
Source: Central Bank of Sri Lanka

Chart 2.1.3
Monthly Total Vehicle Imports and its Relative Share of Total Import Bill



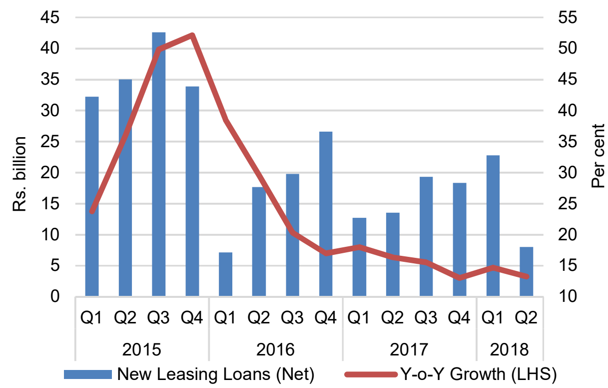
Source: Central Bank of Sri Lanka, Sri Lanka Customs

Chart 2.1.4
Change in Leasing Facilities on Net Basis of LB Sector



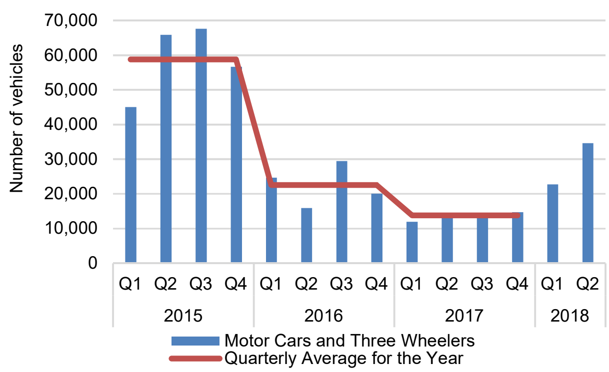
Source: Central Bank of Sri Lanka

Chart 2.1.5
Change in Leasing Facilities on Net Basis of LFCs & SLCs Sector



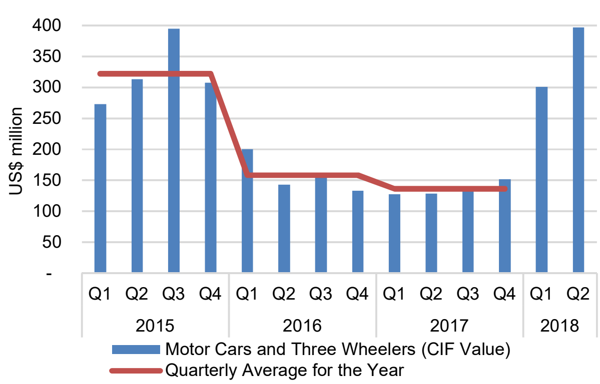
Source: Central Bank Sri Lanka

Chart 2.1.6
Motor Car and Three-wheeler Imports: Volume



Source: Sri Lanka Customs

Chart 2.1.7
Motor Car and Three-wheeler Imports: CIF Value



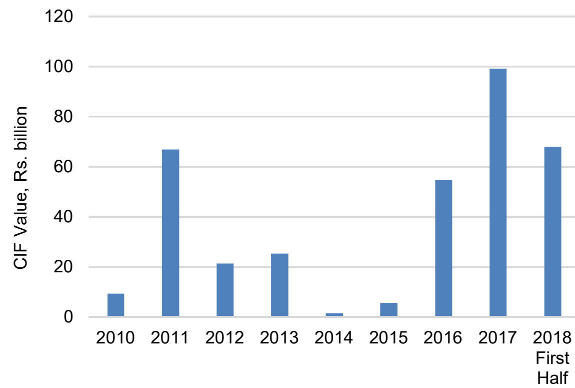
Source: Sri Lanka Customs

were categorically targeted through LTV measures.

Nevertheless, vehicle importation accelerated in numbers and values following the budget 2018 with the ad-valorem rate of excise duty on motor vehicles being replaced with the engine capacity pegged excise duty. Consequently, prices of several small hybrid/petrol cars decreased considerably compared to the previous duty regime while the duty of a few other petrol cars became relatively less expensive. This price distortion has prompted speculative purchase of small vehicles in the market which amplified vehicle importation during the first half of 2018, resulting in an increase in monthly average vehicle imports to US dollar 231 million. In this backdrop, the government increased the excise duty on vehicles with engine capacity less than 1000 cc, effective from August 01, 2018 with the view of dampening the excess demand on small vehicles. However, such selective measures could lead to a surge in importation of other vehicles whose duty remained unchanged, as speculators would perceive them relatively inexpensive. This may exert further pressure on the BoP and exchange rate.

Having observed the rapid escalation in gold imports from 2016 until Q1 of 2018, the government imposed a customs duty of 15 per cent on gold imports in April 2018. The high volume of gold importation had been a concern in terms of impact on BoP and possible smuggling to neighbouring countries which was an attempt to syphon away foreign currency.

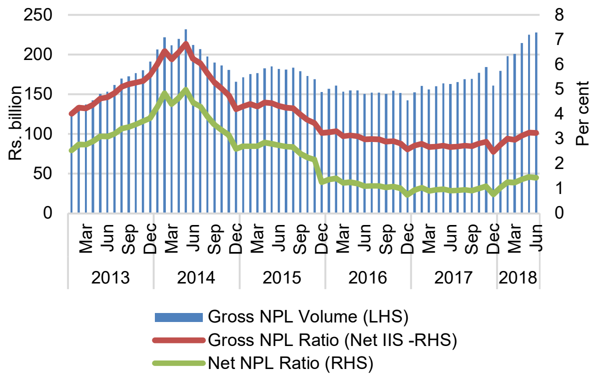
Chart 2.1.8
Gold Imports



Source: Sri Lanka Customs

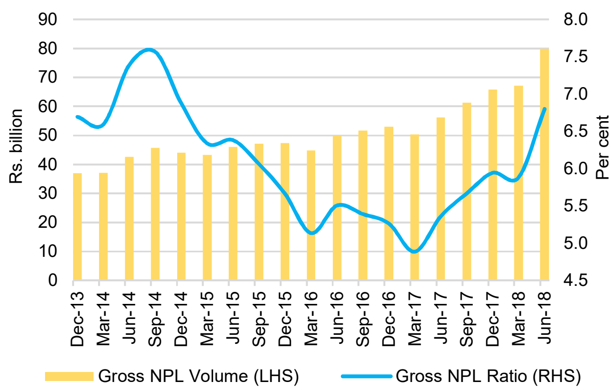
The imposition of customs duty on gold resulted in a price differential between domestic and international prices. This would induce borrowers to top-up their existing pawned advances at prevailing LTV ratios and attract new borrowers since financial institutes consider duty inclusive gold prices for lending. These lending institutes may face undue risk in the event of a revocation of import duty on gold or a material reduction in international gold prices as value of gold kept as collateral may fall below the outstanding credit advanced. Pawning advances of the LBs sector has been increasing since September 2016 and it accounts for approximately 3.9 per cent of the total loan book as at end June 2018.

Chart 2.1.9
Banking Sector NPLs



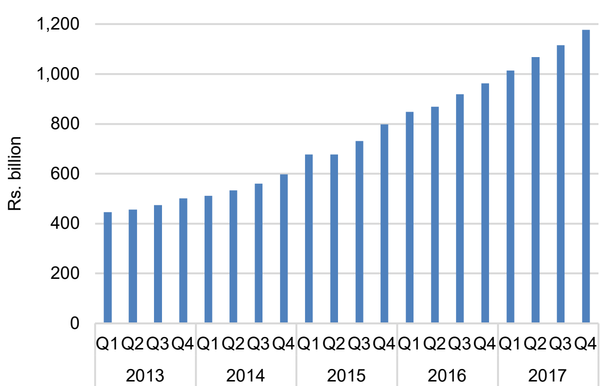
Source: Central Bank of Sri Lanka

Chart 2.1.10
LFCs and SLCs Sector NPLs



Source: Central Bank of Sri Lanka

Chart 2.1.11
Construction Sector Loans by LBs



Source: Central Bank of Sri Lanka

Gold prices in the international market has declined notably since mid-April 2018 and it may decline further with the strengthening of the US dollar and expectation of further policy rate hikes in the United States. A significant drop in gold prices in domestic market could wipe out the collateral values of pawning advances, requiring banks to make higher provisioning in the event of a delinquency. This may adversely affect the bottom lines of banks and hinder their internal capital generation.

The construction sector has been a key driver of GDP during recent quarters and the LBs sector has an exposure of 14 per cent to the same. Despite the moderate level of risk exposure at present, it is advisable to be vigilant on the developments of the construction sector in light of increasing real-estate prices. The construction sector in Sri Lanka is regarded as a growing industry with prospects. Therefore, an enhanced regulatory framework is required at this juncture to improve transparency and governance, to enhance investor confidence and to sustain the growth.

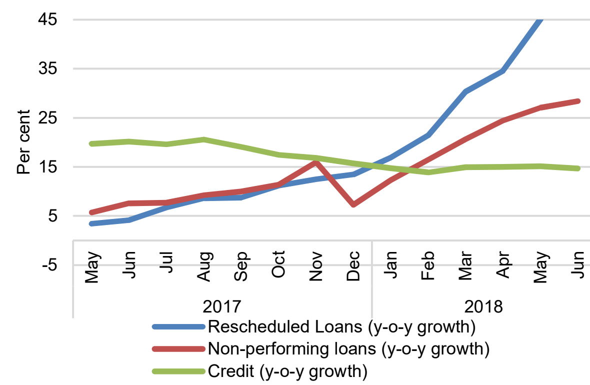
Delinquency of loans and advances of LBs sector and LFC & SLC sector

were on the rise since end 2017. During the first half of 2018 NPLs of LBs sector increased by 41.7 per cent while NPL ratio increased to 3.3 per cent. Total NPLs of the LFC & SLC sector increased by 42.4 per cent (Rs. 23.7 billion) from Rs. 56.2 billion in June 2017 to Rs. 79.9 billion in June 2018. The main reason associated with the increase in NPL is natural calamities that occurred in 2017. As loans and advances of the LFCs & SLCs sector increased marginally and the NPL volume increased, the NPL ratio of the sector also increased to 6.8 per cent in June 2018 compared to 5.4 per cent in June 2017.

Rescheduled loans of LBs sector reported a year-on-year growth of 45 per cent in June 2018. The rapid increase in rescheduled loans is an early indicator of asset quality deterioration. The loan rescheduling may inflate the profits with unrealised earnings. Such higher earnings may induce profit distribution while hindering internal capital generation.

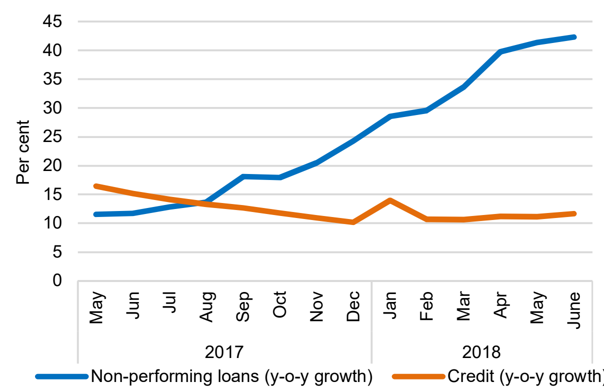
Further, most of the rescheduled loans are prone to be classified as NPLs requiring more write-offs and provisions lately. The increasing delinquency in the loan book of LBs sector is also visible as more new loans were added to the special mentioned category.

Chart 2.1.12
LBs Sector: Trend in Credit Growth, NPL Growth and Rescheduled Loans



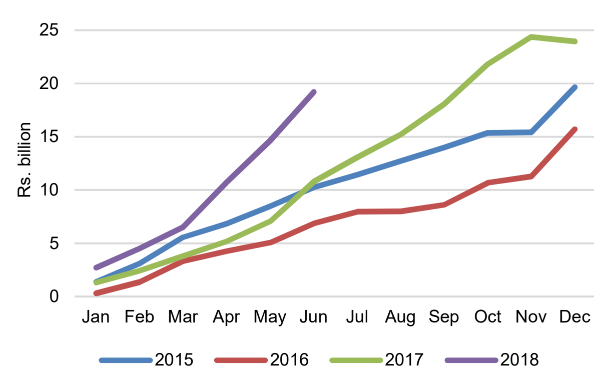
Source: Central Bank of Sri Lanka

Chart 2.1.13
LFCs and SLCs Sector: Trend in Credit Growth and NPL Growth



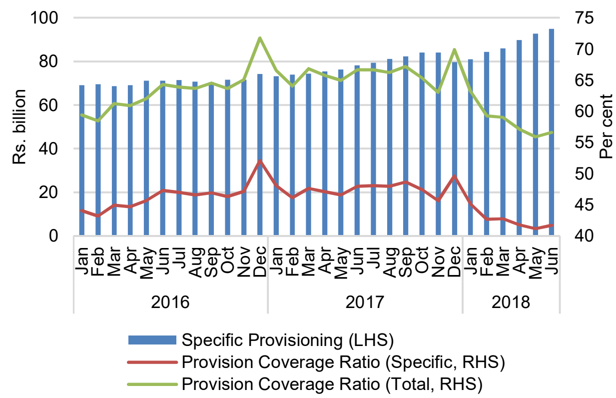
Source: Central Bank of Sri Lanka

Chart 2.1.14
LBs sector- Specific Provision Charge on Income Statement



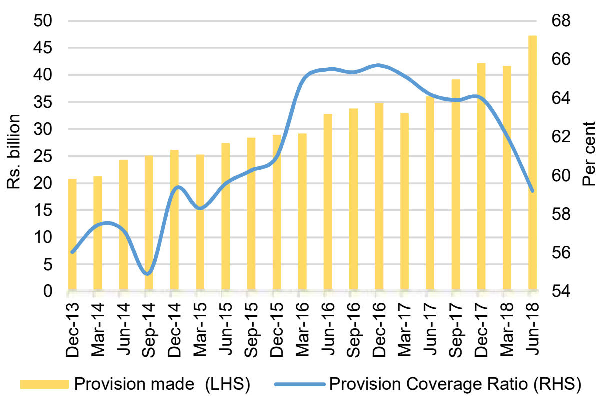
Source: Central Bank of Sri Lanka

Chart 2.1.15
LBs sector- Provision Coverage



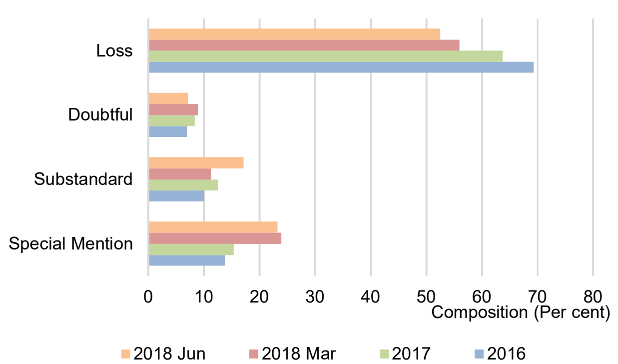
Source: Central Bank of Sri Lanka

Chart 2.1.16
LFCs and SLCs Sector- Total Provision Coverage



Source: Central Bank of Sri Lanka

Chart 2.1.17
LBs Sector NPLs



Source: Central Bank of Sri Lanka

Amidst the rising trend in delinquency of LBs sector and LFC & SLC sector, provision coverage ratios have eroded notably during the first half of 2018. Total provision to NPL ratio and specific provision to NPL ratio have slipped from 69.9 per cent and 49.6 per cent, respectively, as at end 2017 to 56.6 per cent and 41.7 per cent, respectively, in June 2018. The provision coverage ratio of the LFC & SLC sector declined to 59.2 per cent in June 2018 compared to 64.4 per cent in June 2017 in line with the increase of NPLs.

The specific provision charge on profit and loss account of the banking sector reported a substantial surge during the first half of 2018 recording an increase of 78.1 per cent compared to the corresponding period of 2017. Considering the rising trajectory of the delinquency levels and downward migration of NPLs classified under the special mention and substandard categories, loan loss provision charge on the income statement are expected to reach record high levels by end 2018 and subsequent years if interest rates continue to increase while economic growth remains low. This may have an adverse impact on the bottom lines of several banks and hinder their ability to generate internal capital given the transition to higher capital standards under Basel III. Semi-annual income statements of the LBs sector in 2018, which experienced a marginal decline in profit after tax for the first time in recent history signifies the challenge for internal capital generation.

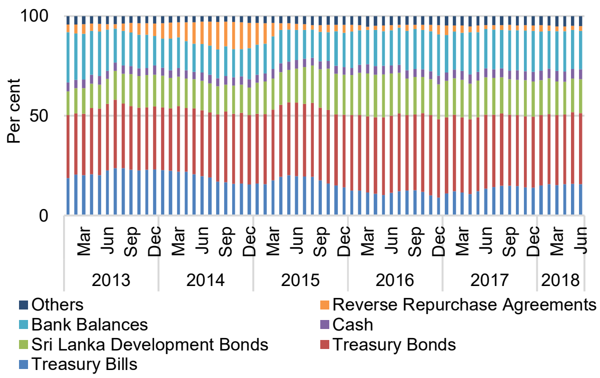
Stress test results on the credit risk of LBs sector suggest that some banks are vulnerable to an increase in NPL ratio given the lower level of capital. Further, they are required to comply with higher capital standards under Basel III phase-in arrangement. As per the requirement, Domestic - Systemically Important Banks (D-SIBs), and Non-D-SIBs are required to maintain Capital Adequacy Ratio (CAR) of 14.0 per cent and 12.5 per cent, respectively, effective from 01.01.2019. In light of this, regulators need to be vigilant on of capital augmentation plans and internal capital adequacy assessment process of banks.

2.2. Liquidity Risk

LBs are required to maintain a Ratio (SLAR) against their total on balance sheet liabilities, other than liabilities to shareholders and the Central Bank. LFCs & SLCs are obliged to maintain a minimum level of liquid assets against customer deposits and borrowings. Classes of liquid assets for this purpose have been clearly defined in the applicable statues. Both LBs and LFCs & SLCs have been maintaining liquid assets much higher than the minimum amount of liquid assets required for meeting statutory liquidity ratios (Chart 2.2.1 and 2.2.2).

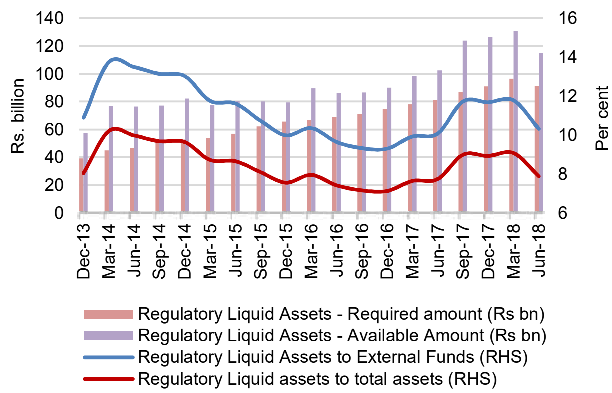
LBs are also required to maintain a minimum Liquidity Coverage Ratio (LCR) for their rupee currency operations and all currency operations respectively, in terms of Basel III liquidity standards. Accordingly, LBs are required to maintain an adequate stock of unencumbered High-Quality Liquid Assets (HQLAs) that can be converted easily and immediately into cash in the secondary market to meet their liquidity needs for a period of 30 calendar days under a liquidity stress scenario.

Chart 2.2.1
LBs Relative Share of Statutory Liquid Assets



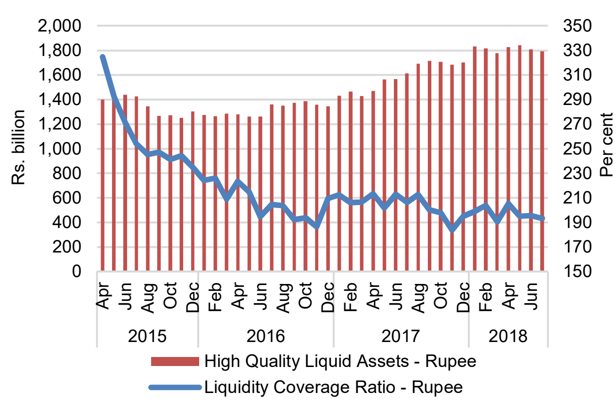
Source: Central Bank of Sri Lanka

Chart 2.2.2
LFCs and SLCs Sector - Total Liquid Assets and Liquidity Ratio



Source: Central Bank of Sri Lanka

Chart 2.2.3
LBs – Liquidity Coverage Ratio – LKR



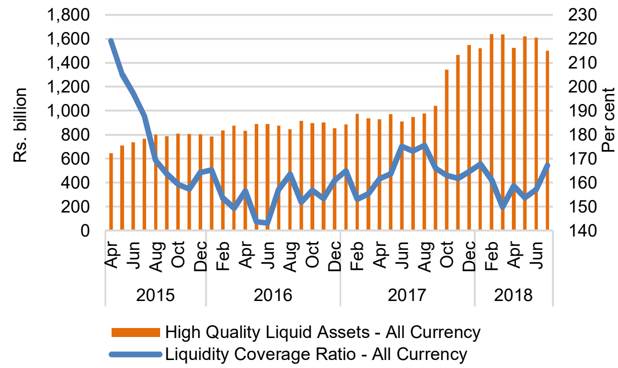
Source: Central Bank of Sri Lanka

Despite moderation in growth rate, rupee deposits remained to be the major source of funding for LBs. The deceleration in rupee deposits since September 2017 is in tandem with the moderation in assets growth of the LB Sector (Chart 2.2.5).

Nevertheless, the relative share of rupee deposits increased in June 2018 as foreign borrowings decreased during the month of June 2018. Meanwhile, the share of rupee time deposits improved during recent months marking an improvement in stable funding sources.

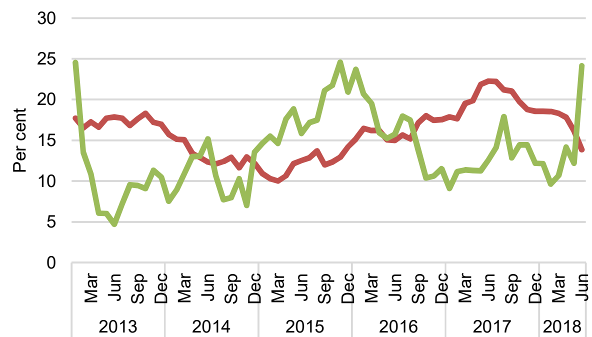
The relative share of non-deposit funding of LBs declined with the contraction in foreign currency borrowings. Nevertheless, the share of foreign currency borrowings outweigh rupee borrowings largely due to depreciation of domestic currency. Borrowings from foreign sources i.e. external borrowings was the largest financier of foreign currency borrowings of banking sector as of the reporting date. This external funding has originated from borrowings from banks and financial institutes abroad and debt instruments issued in the international capital markets. Despite the gradual moderation, higher foreign borrowings

Chart 2.2.4
LBs – Liquidity Coverage Ratio – All Currency



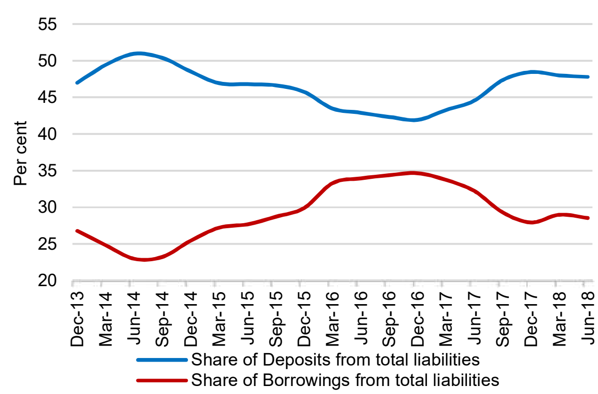
Source: Central Bank of Sri Lanka

Chart 2.2.5
LBs Growth in Deposits



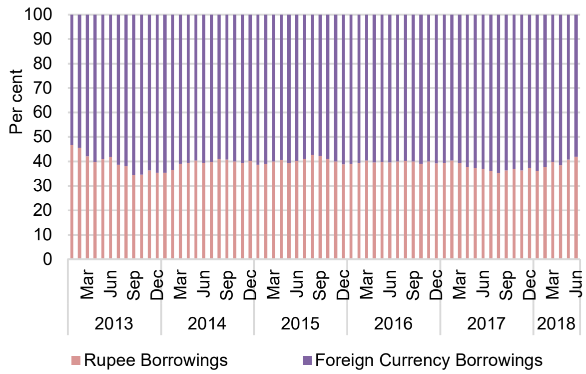
Source: Central Bank of Sri Lanka

Chart 2.2.6
LFCs and SLCs Sector - Relative Share of Deposits and Borrowing in Total Liability



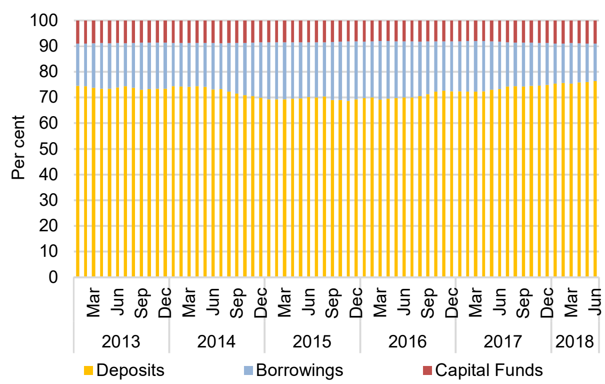
Source: Central Bank of Sri Lanka

Chart 2.2.7
LBs – Relative Share of Rupee Borrowings and Foreign Currency Borrowings



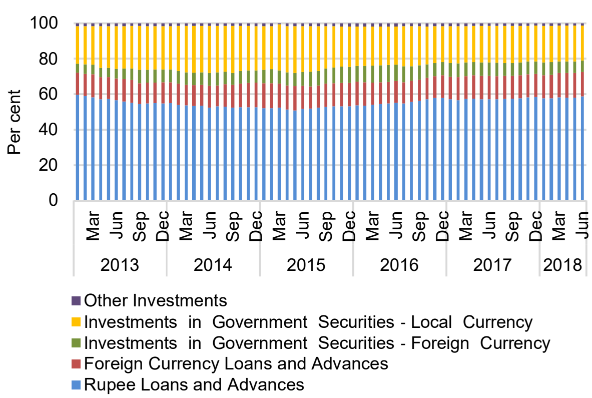
Source: Central Bank of Sri Lanka

Chart 2.2.8
LBs – Relative Share of Deposits, Borrowings and Capital Funds



Source: Central Bank of Sri Lanka

Chart 2.2.9
LBs Sector - Investments and Lending



Source: Central Bank of Sri Lanka

may affect the resilience of the LBs sector due to its less stable nature of funding and heightened overreliance on external funding. Moreover, higher foreign currency borrowings may erode profits in terms of the reporting/presentation currency on the back of depreciating local currency making it less favorable. Besides, interest rate normalisation in advanced economies may heighten refinancing risk of foreign borrowings. In view of the foregoing, banks are expected to have adequate standby funding arrangements to cover short-term external liability. The main source of funds of the LFC sector is also deposits. Nevertheless, an increase in the funds raised through borrowings was witnessed during the past years in this sector.

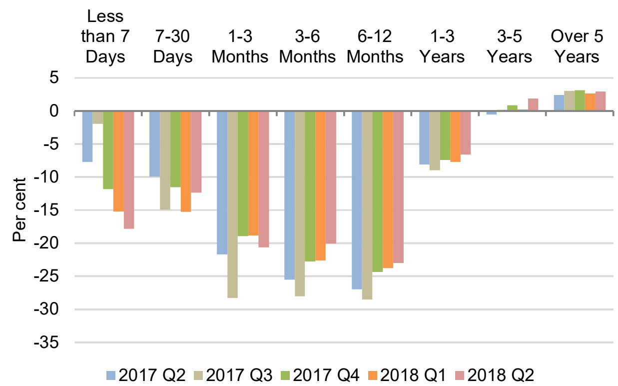
Repo borrowings and subordinated debentures eligible for capital adequacy purposes were the top two non-deposit domestic funding sources of LBs sector. Capital augmentation plans to comply with Basel III minimum capital standards by end 2018 and the market liquidity condition cum-cheap funding through repo borrowings prompted LBs to source funds via aforesaid non-deposit domestic instruments.

Investment in fixed income government securities encompassing Treasury securities and SLDBs represents 68 per cent of total liquid assets of the banking sector. Further, investment in Treasury securities, which have been regarded as HQLAs, represents 51 per cent of total liquid assets of LBs sector.

Share of loans and advances in total earning assets increased to 73.0 per cent in June 2018 from 66 per cent reported in end 2015 and continued to be the principal earning assets of the LBs sector. Investment in Treasury securities and SLDBs were the second largest earning asset representing approximately 26.0 per cent of total earning assets of the sector. Treasury securities classified under trading account signifies 20.0 per cent of investments in government securities which are susceptible to a change in market interest rates.

Maturity profile of assets and liabilities of LBs sector and LFC & SLC sector indicated varying results for different maturity buckets. With regard to LBs, the negative gap for less than 7-day bucket and 1-3 month bucket increased, whereas negative maturity gaps of all other maturity buckets until next 3 years improved in

Chart 2.2.10
LBs Sector – Maturity Gaps in the Assets and Liability



Source: Central Bank of Sri Lanka

June 2018 compared to previous quarter.

Liquidity risk of LFC & SLC sector is contingent on the current short-term contractual maturity mismatches and rising interest rates whereas the latter curtails internal cash generation from earning assets and obstructs external credit lines from LBs due to plausible deterioration in asset quality in the financial system to have a satisfactory amount of stable funding relative to the amount of required stable funding.

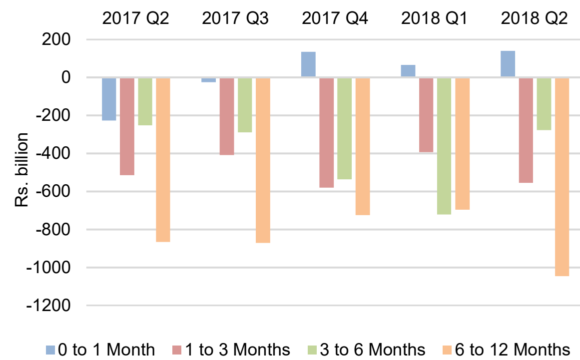
2.3. Interest Rate Risk and Foreign Exchange Risk

In view of the developments in the international markets and normalization of monetary policy in advanced economies, escalating trade tensions and strengthening of the US dollar had induced several emerging market economies to tighten their domestic monetary policies and allow depreciation of their currencies. Sri Lankan rupee depreciated during first 9 months of 2018 in line with other regional currencies. These developments are expected to reflect on the performance of LBs sector and LFC & SLC sector as the former is exposed to foreign currency risk and interest rate risk while the latter is largely exposed to interest risk.

The maturity profile of interest sensitive assets and liabilities of the LBs sector indicated a widening of negative maturity gaps for several maturity buckets, up to 12 months except for the maturity bucket less than 1 month. This suggests that the LBs sector has continued funding its long-term assets through short term liabilities. Further, Net Interest Margins (NIM) of LBs were on the rise during recent past reflecting their ability to pass incremental cost of funding to borrowers. Hence, it is unlikely that a possible upward interest rate shock may adversely affect NIMs. Therefore, maturity profile of interest sensitive assets and liabilities may not cause a material impact in the short run given the higher capital level of LBs. However, stress test results revealed that the rupee interest rate shock of 400 basis points is likely to erode the LBs sector CAR by 115 basis points. This shock could be significant for some banks given the requirement for enhancing the CAR by January 1, 2019 under Basel III framework.

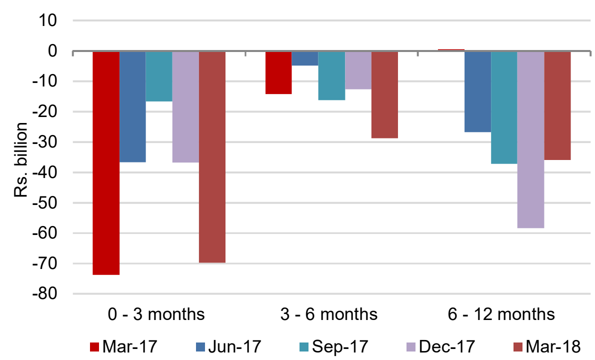
LFC & SLC sector has maintained a steady NIM during the past few years. The NIM was on a declining

Chart 2.3.1
LBs Sector – Maturity Gaps in Interest Sensitive Assets and Liabilities



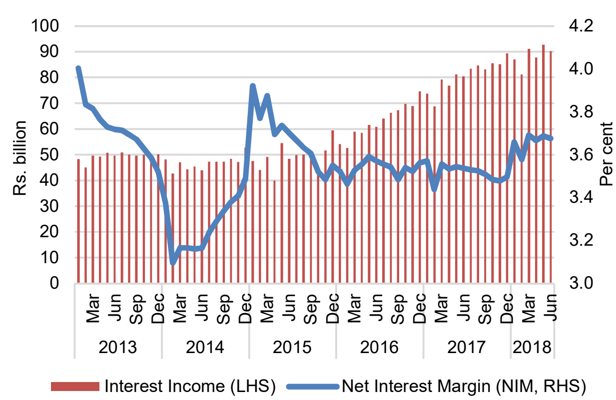
Source: Central Bank of Sri Lanka

Chart 2.3.2
LFCs Sector – Maturity Gaps in Interest Sensitive Assets and Liabilities



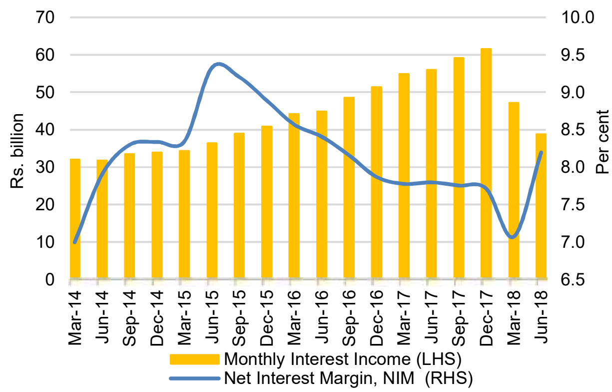
Source: Central Bank of Sri Lanka

Chart 2.3.3
LBs Sector - NIM



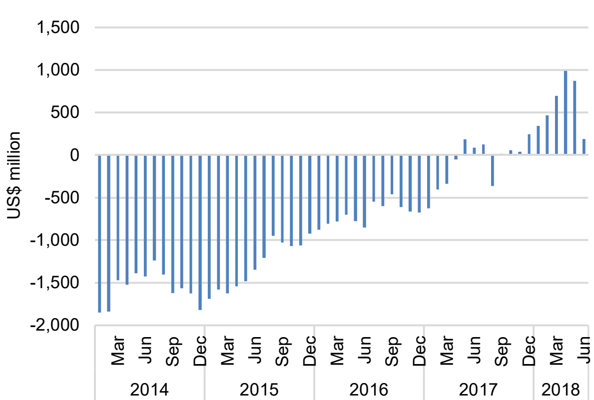
Source: Central Bank of Sri Lanka

Chart 2.3.4
LFCs and SLCs Sector - NIM



Source: Central Bank of Sri Lanka

Chart 2.3.5
LBs Sector – Net Foreign Assets



Source: Central Bank of Sri Lanka

trend till March 2018 and has improved to 8.2 per cent in June 2018.

As 26 per cent of earning assets of LBs sector is invested in fixed rate government securities, the sector is susceptible to interest rate risk. An increase in interest rates would adversely affect the market value of such investments held in the trading portfolio.

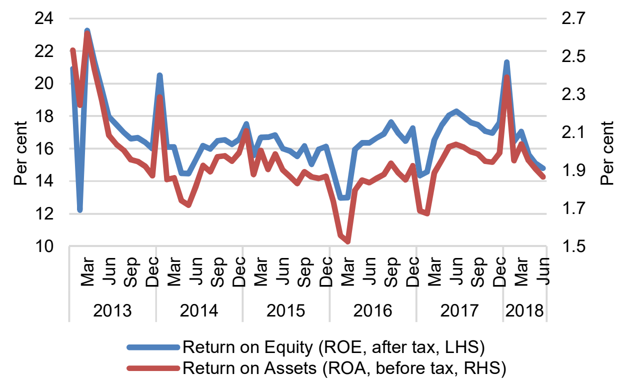
Given the net open position, LBs sector's sensitivity to foreign exchange rate risk is limited. Nevertheless, banks are exposed to foreign exchange risk via translation of assets and liabilities denominated in foreign currencies. Net Foreign Assets (NFAs) position of the banking sector grew steadily since December 2017 from US dollar 244.9 million to US dollar 988.3 million in April 2018. However, since then, NFA position contracted dramatically to US dollar 187.3 million in June 2018. LBs sector reported a significant increase in foreign currency gains i.e. a y-o-y growth of 32.0 per cent, during first half of 2018 compared to the corresponding period in 2017. This is largely attributed to the depreciation of Sri Lankan rupee in line with other regional currencies and substantial holding of NFA by LBs during first few months of 2018.

2.4. Capital Adequacy, Profitability and Resilience to Shocks

Despite steady growth in annual net profit until 2017, the LBs sector experienced a notable moderation in profit during first half of 2018 largely due to substantial increase in loan loss provisions resulting from the deterioration of asset quality and the rise in corporate/value added taxes. Return on Assets (ROA) and Return on Equity (ROE) of the sector declined to 1.9 per cent and 14.8 per cent, respectively, in June 2018 from 2.0 per cent and 18.3 per cent, respectively, in June 2017. Further, the efficiency ratio deteriorated during the period from 45.6 per cent in June 2017 to 48.6 per cent in June 2018 signifying an increase in operating costs and loan loss provisions during the first half of 2018. Nevertheless, NIMs were poised well above 3.6 per cent portraying LBs' resilience to adapt to interest rate volatility and provisioning on NPLs.

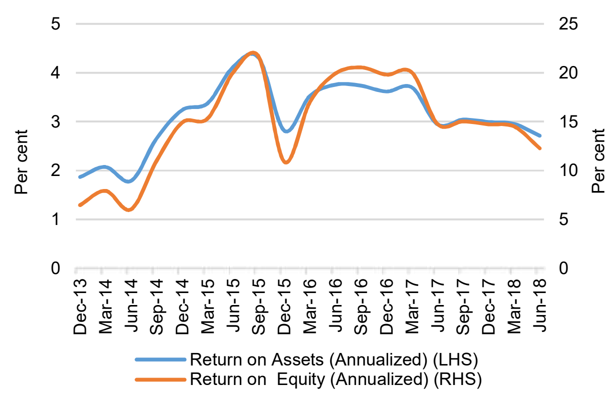
The annual net profit of LFC & SLC sector remained high during the recent past. The ROA and ROE of this sector recorded 2.7 per cent and 12.3 per cent, respectively, for the year ended June 2018. The improving operating efficiency and increasing NIM

Chart 2.4.1
LBs Sector – ROA and ROE



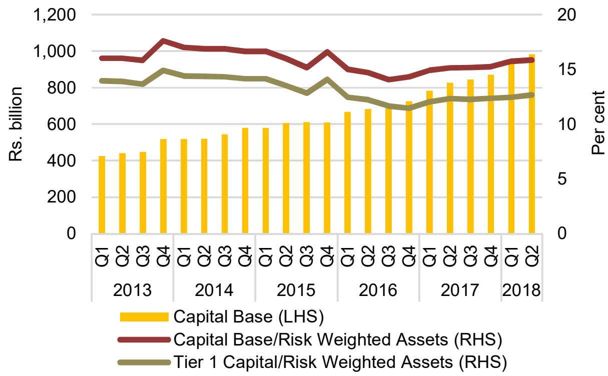
Source: Central Bank of Sri Lanka

Chart 2.4.2
LFCs and SLCs Sector – ROA and ROE



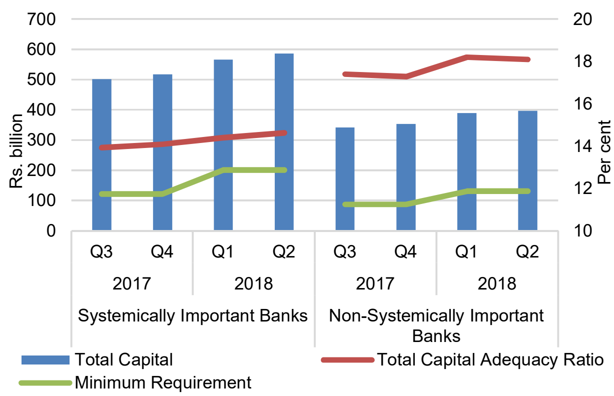
Source: Central Bank of Sri Lanka

Chart 2.4.3
LBs Sector - CAR



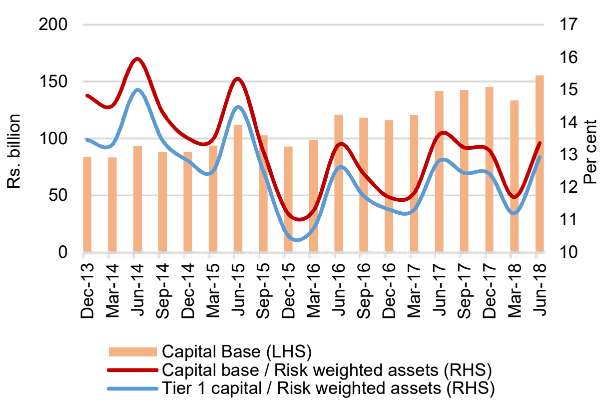
Source: Central Bank of Sri Lanka

Chart 2.4.4
LBs Sector – CAR for D-SIBs and Non D-SIBs



Source: Central Bank of Sri Lanka

Chart 2.4.5
LFCs and SLCs Sector – CAR



Source: Central Bank of Sri Lanka

may contribute in maintaining the profits of the sector.

LB sector remained sound as it maintained CAR well above the regulatory minimum. Moreover, commencing from July 2017, LBs sector migrated to Basel III capital standards requiring incumbents to increase CAR on a staggered basis. The CAR and Tier 1 capital ratio encompassing conservation buffer of the LB sector stood at 15.8 and 12.7 per cent, respectively, as at June 2018. Further, aggregate CAR of D-SIBs and non D-SIBs remained above the minimum requirement so far during the transitional period of Basel III adoption. Nevertheless, there was one LB representing 1.6 per cent of total LBs sector assets failed to comply with the CAR requirement at end June 2018. However, it is envisaged that the proposed consolidation framework would address the issue.

Capital position of the LFC & SLC sector remained well above the regulatory minimum levels. CAR of the sector has slightly declined to 13.4 per cent as at June 2018 compared to 13.6 per sent as at end June 2017. Nevertheless, 7 LFCs were not compliant with CAR while few LFCs and SLCs were operating with Core

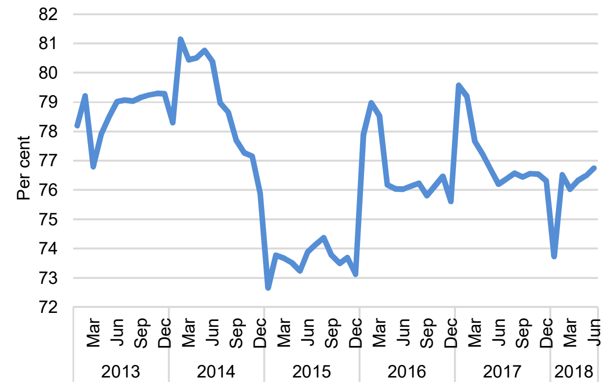
Capital below the prescribed minimum. The LFCs which didn't comply with CAR represented 5.7 per cent of assets of LFC and SLC sector.

Banking Sector Soundness index indicates the systemic reflection of the developments in the LB sector risk indicators. The risk indicators illustrate a significant deterioration in asset quality and profitability in the second quarter of 2018 (Q2 2018) compared to the corresponding period in 2017 resembling the rising delinquency levels and its effect on profits through loan loss provisioning.

Despite the healthy levels of liquidity, its sub index subdued reflecting a marginal drop in liquidity ratios in Q2 2018 compared to levels reported a year ago. Sub index on resilience to market risk also marginally declined y-o-y basis. The capital adequacy sub index remained unchanged in Q2 2018 compared to Q1 2018.

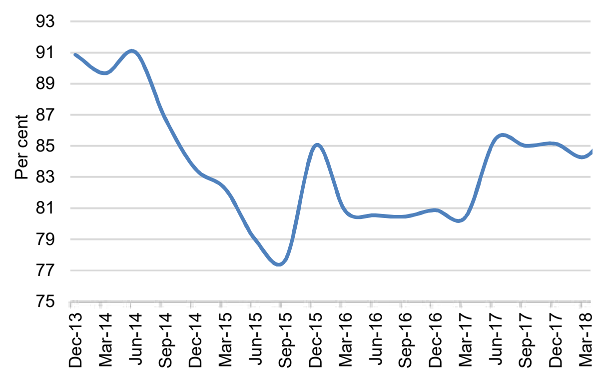
When the LFC sector Soundness Index is considered, it is observed that asset quality, liquidity, resilience to market risk, capital adequacy and profitability sub-indices have remained more or less

Chart 2.4.6
LBs Sector – Cost to Income Ratio



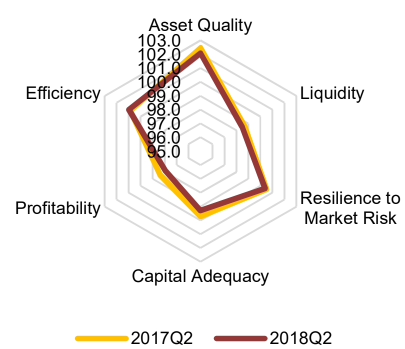
Source: Central Bank of Sri Lanka

Chart 2.4.7
LFCs and SLCs Sector – Cost to Income Ratio



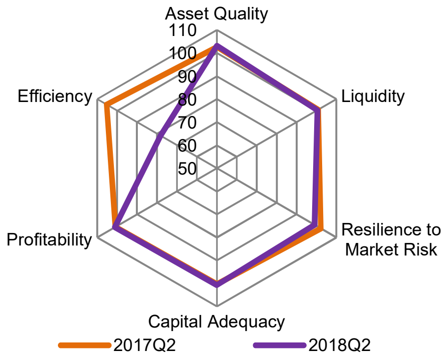
Source: Central Bank of Sri Lanka

Chart 2.4.8
Banking Soundness Index (2010 = 100)



Source: Central Bank of Sri Lanka

Chart 2.4.9
LFCs Soundness Index (2010 = 100)



Source: Central Bank of Sri Lanka

similar in the second quarter of 2018 compared to the second quarter of 2017. Nevertheless, a decline in the efficiency sub index is observed indicating that efficiency of the sector has improved during the period under consideration.

Capital adequacy of LBs are expected to strengthen further to cover unexpected loss with ongoing Basel III phase-in arrangements and the direction on enhancing minimum capital requirement by the regulator. However, there are a few financial institutions including LFCs & SLCs which are short of meeting the CAR and minimum capital requirement as at Q2 2018. These financial institutions account for 1.5 per cent of total financial sector assets. The results of the stress testing indicate that the impact on the capital levels of banks was within accepted level for baseline scenario.

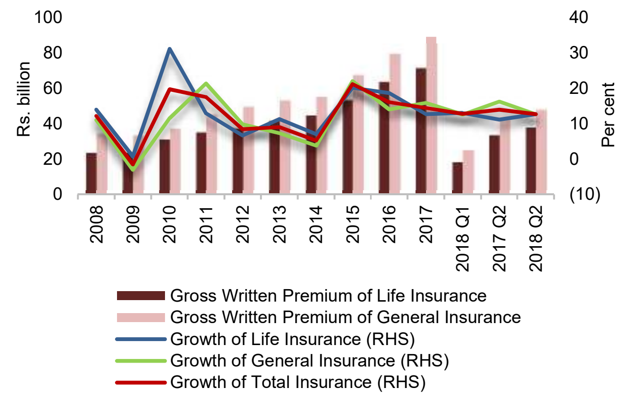
2.5. Insurance Sector

Insurance sector continued to grow during 2017 and the first half of 2018, without facing major stability concerns. The Gross Written Premium (GWP) of the sector increased moderately in the first half of 2018. Nevertheless, the growth rate of the GWP has been in a declining trend from 2015. The long-term insurance sector growth of GWP has increased during the period under consideration compared to the corresponding period in 2017. However, a decrease in the growth of GWP is observed on the general insurance sector.

Profits of the insurance sector has increased during the first half of 2018. The increase in total profits before tax was driven by the long-term insurance sector owing to disposal of a subsidiary and one off surplus transfer done by 2 insurance companies. This surplus was resulted from the change in valuation method of life policy holder liabilities, to comply with regulations of the Insurance Regulatory Commission of Sri Lanka (IRCSL).

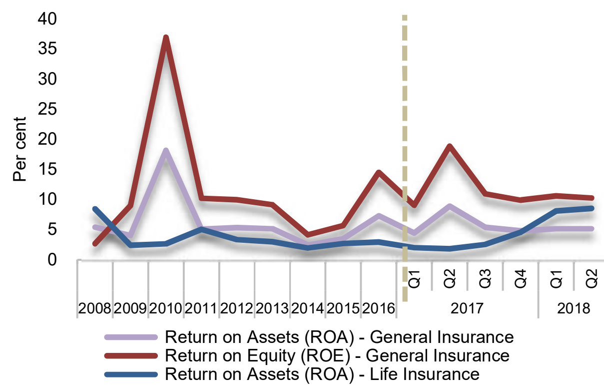
ROA and ROE of the long-term insurance sector increased to 8.5 per cent and 47.2 per cent from 1.8 per cent and 12.8 per cent respectively during the

Chart 2.5.1
Gross Written Premium of the Insurance Sector



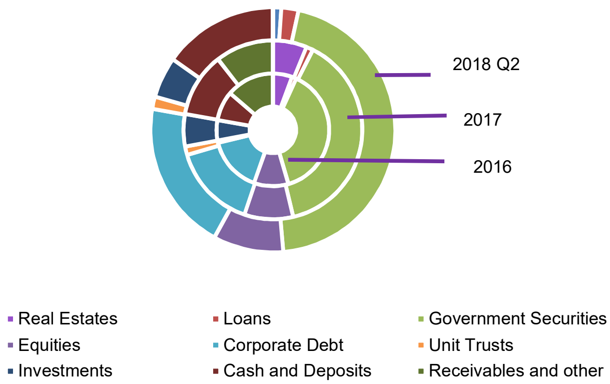
Source: Insurance Regulatory Commission of Sri Lanka

Chart 2.5.2
Profitability of the Insurance Sector



Source: Insurance Regulatory Commission of Sri Lanka

Chart 2.5.3
Equity Exposure of the Insurance Sector



Source: Insurance Regulatory Commission of Sri Lanka

corresponding period of year 2017. The increase in the ROA and ROE ratios of the long-term insurance sector resulted through the unusual profit reported during the period under consideration. Nevertheless, ROA and ROE of the general insurance sector declined to 5.1 per cent and 10.4 per cent from 8.9 per cent and 18.3 per cent respectively during the corresponding period of year 2018.

Insurance sector maintained a satisfactory level of capital to withstand possible shocks to the sector. However, one composite (already suspended) and general insurance business of a composite insurer (representing 1 per cent of the sector) did not comply with the capital adequacy requirement imposed by regulations. Non-compliances to regulatory requirements are addressed then and there by taking appropriate corrective actions and continuous monitoring. Certain regulations on operational matters such as employing personnel for insurance companies, treatment of one off surpluses and management of insurance funds were issued by the IRCSL. Further, a framework on corporate governance to all insurers in order to adopt best practices to govern insurance companies is expected to be issued in the near future.

2.6. Primary Dealers in Government Securities

Primary dealers in government securities (PDs) indicated a decline in sector performance as reflected throgh a number of key indicators. Total assets of the industry declined by 14.5 per cent to Rs. 348.1 billion as at June 2018 from Rs. 407.2 billion as at June 2017. This is largely due to the suspension of two PDs from securities primary auctions.

The total capital funds of the stand-alone PDs stood at a satisfactory level. However, the risk weighted CAR of the sector has declined to 23.7 per cent as at June 2018 from 58.5 per cent as at end June 2017. The major source of funding for PDs, which is borrowing from repo agreements, has declined considerably by 64.0 per cent to Rs. 63.1 billion as at June 2018 from Rs. 172.9 billion as at June 2017.

Profitability of the PDs Industry slightly declined. The PD industry recorded a profit before tax of Rs. 6.3 billion during the six-month period ended June 2018 compared to a profit of Rs. 6.6 billion for the corresponding period of 2017. The ROA and ROE of the PDs have also declined to 2.3 per cent and 13.1 per cent, respectively, during the six-month period ended June 2018, compared to 3.6 per cent and 14.0 per cent, respectively, in the corresponding period of 2017.

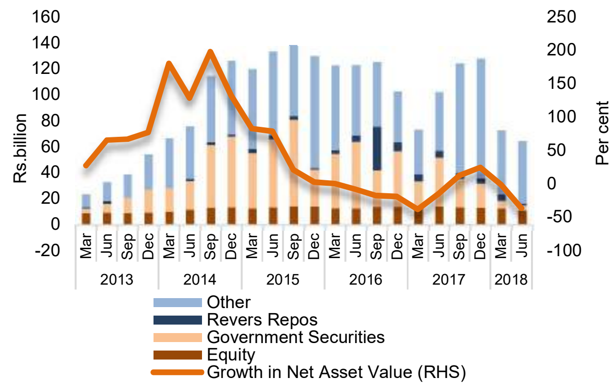
The trading portfolio of PDs continued to decline, thereby reducing the possible high market risk exposure of the industry. The proportion of trading portfolio to total investment portfolio decreased marginally, from 48.4 per cent at end June 2017 to 40.9 per cent during the period under consideration. Trading portfolio decreased from Rs. 182.5 billion to Rs. 137.1 billion.

The increase of the overnight mismatch in the market portfolio of assets and liabilities enhanced the liquidity risk of the PD sector. The overnight negative maturity mismatch increased significantly to Rs. 19.0 billion or 82.7 per cent of the overnight liabilities at end June 2018, from overnight negative maturity mismatch of Rs. 6.0 billion or 36.1 per cent reported at end June 2017.

2.7. Unit Trusts

UT sector's growth was decreased during the period under consideration. The growth in the Net Asset Value (NAV) decreased during the period under consideration compared to the corresponding period in 2017. The downward movement in the share market may have adversely affected the performance of the UTs. Further, the amendment in government tax policy on government securities may have discouraged investors obtaining services of UTs. This has led to the close down of funds of some UT companies.

Chart 2.7.1
Growth in NAV and Investment portfolio of the Unit Trust Sector



Source: Unit Trust Association of Sri Lanka

2.8. Financial Intelligence

In October 2017, the Financial Action Task Force (FATF), the global policy setter had listed Sri Lanka as a jurisdiction with strategic AML/CFT deficiencies in the FATF's Compliance Document which is more commonly identified as "the Grey List". This assessment is not about actual incidence of money laundering or terrorism financing and rather about absence or weakness of controls that make the country vulnerable to such risks. In light of this, Sri Lanka made a high-level commitment to work with the FATF and the Asia/Pacific Group on Money

Laundering (APG) to strengthen the effectiveness of its anti- money laundering and counter-financing of terrorism regime and to address any technical deficiencies. Sri Lanka has made commendable progress in implementing the recommendation of FATF which includes strengthening international cooperation through the enacting required legal provisions, improving risk-based supervision and enhancing outreach to financial and non-financial business, strengthening Management Information Systems of competent authority to obtain beneficial ownership information in relation to legal person in timely manner and establish a targeted financial sanctions regime to implement relevant United Nations Security Councils Resolutions.

2.9. Payments and Settlements

The payments and settlement systems of the country operated smoothly without any major disruptions to facilitate the smooth functioning of the financial system while adopting new technological advancements as well. With the emergence of fintech and blockchain technologies, the business models of financial institutions may change significantly over time while opening up new business opportunities and challenges for regulators. These developments may pose challenges to the payments and settlement systems and lead to significant technology risk on the financial system stability.

3. Special Notes

3.1. Systemic Risk Survey

Since the Global Financial Crisis, the importance of assessing systemic risks has drawn significant attention. Central Banks all over the world are constantly challenged to develop new techniques and upgrade their toolkits in order to diagnose systemic risks. As a result, a variety of methodologies, both qualitative and quantitative have emerged to identify and measure systemic risks. The Systemic Risk Survey (SRS) is one such qualitative tool that has emerged to assess build-up of risks.

Central Bank of Sri Lanka carries out a series of systemic risk assessment measures on an ongoing basis in order to conduct macro-prudential surveillance of the financial system. The Bank of England, Reserve Bank of India, Central Bank of Brazil (Banco Central do Brasil) and a few other global institutes have already introduced the SRS to their toolkit considering concerns that arose after the global financial crisis. Along with the global trends, Central Bank of Sri Lanka started the SRS in the first half of 2017, and conducted it on biannual basis since then.

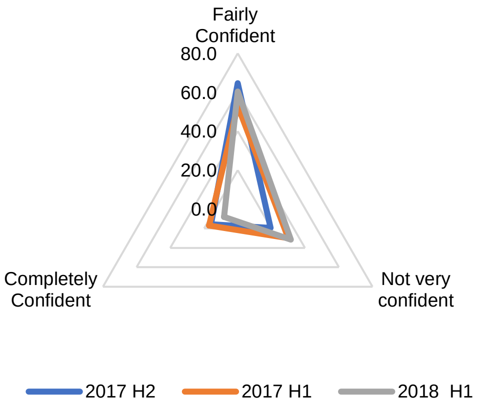
The main goal of SRS is to seek perceptions of market participants on sources of risk to the system and their confidence on the system. The survey captures the views of a wide range of market participants. Responses are collected from risk managers of key financial institutes which entailed Licensed Banks, Specialized Leasing Companies, Licensed Finance Companies, Insurance Companies, Unit Trusts Management Companies, Stock Brokering Companies and Rating Agencies. The survey is arranged in the form of a structured questionnaire with specific but simple questions. The questionnaire is disseminated both by post and e-mail.Once the responses are received, the analysis is carried out comparing with previous survey responses. A series of stability indices are constructed to assess movements in various risk dimensions which have an impact on the entire financial system. The findings of the survey have become an integral part of internal discussions on financial sector policy making process.

The SRS asks market participants about the key sources of risks to financial system stability emanating within the country or externally. The respondents are given a grid consisting of 69 sub risk categories belonging to six major categories, namely: Global Macroeconomics Risk, Domestic Macroeconomic Risks, Risk pertaining to Financial Infrastructure, Risks related Financial Markets, Institutional Risks and General Risks. Then respondents are asked to rank risks with the greatest impact on the smooth functioning of financial system of Sri Lanka if they were to materialize. In addition, the questionnaire allows the participants to provide more details on the rationale behind their responses. Ten most frequently cited sub risk categories are analysed to identify the top most risks emerging to the market. The table 3.1.1 depicts the top ten risk frequently ranked by the respondents in the second half of 2017 and the first half of 2018. Six of the ten frequently cited risks in 2018 H1 have been repeated in the frequently cited list in two previous surveys viz. Political risk, Policy uncertainty/ implementation/ formation, Cyber-attacks and phishing, Foreign

Table 3.1.1
Top Ranked Risk

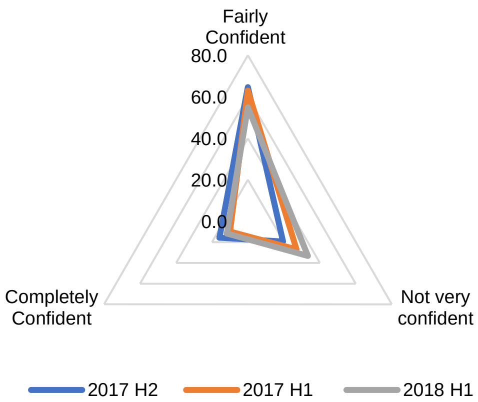
Top Ten Risks	2017 H2	2018 H1
Access to funding	1	
Cyber-attacks and Phishing etc.	2	4
Global economic outlook	3	
Interest rate risk	4	10
Policy uncertainty/implementation/formation	5	2
Payment and settlement system risk	6	
Foreign Exchange Risk	7	7
Political risk	8	1
Asset quality deterioration	9	
Monetary policy measures	10	8
GDP Growth		3
Liquidity risk		5
Public debt (domestic/external borrowings)		6
Public governance, transparency and corruption		9

Chart 3.1.1
Confidence over 6 months



Source: Central Bank of Sri Lanka

Chart 3.1.2
Confidence over 24 months



Source: Central Bank of Sri Lanka

exchange risk, monitory policy measures and Interest rate risk. However, GDP growth, Liquidity risk, Public debt (domestic/external borrowings) and Public governance, transparency and corruption has been newly emerged as top risks in the first half of 2018.

The analysis carried out by comparing the changes of market perception, compared to the previous surveys, will yield the market perception of emerging risk to the system. In addition, participants are requested to rank the risks that are most challenging to manage to their firm which will be analysed according to each sector. These analysis provide policy makers a clear picture of issues faced by the market and thereby help to prioritize risks to be dealt first.

A separate set of questions included the respondents' degree of confidence in the stability of the domestic system in different time periods and also how it has changed due to the events unfolding over the short and medium-term periods. The chart 3.1.1 and chart 3.1.2 summarizes the responses for the first three surveys conducted. The participants confidence in the system in the short term (6 month ahead) fluctuated over the three survey periods.(Chart 3.1.1) Respondents were less likely to judge themselves completely confident (12%) in the first half of 2018 compared to 16% recorded in the second half of 2017. However, the respondents were more likely to judge themselves completely confident compared to previous survey in the first half of 2017.The confidence of the respondents over the next 24 months (over medium term) reduced in the first half of 2018 compared to the first two surveys in terms of proportion of respondents marking themselves as completely confident. The proportion of respondents marking themselves as not very confident of the financial system also marginally increased. (Chart 3.1.2) The analysis carried out will give an understanding of the changes in market confidence. It is important for policy makers and regulators to gauge an idea on market confidence as financial system stability greatly depend on market confidence. Furthermore, the respondents are asked to rank the likelihood of a high impact event materializing in Sri Lankan financial system in periods ahead and how these perceived probabilities changed over short and medium term.

Central Bank intends to expand the questionnaire, by adding extra questions on several new areas. As a result, a series of questions on the ability of financial system to react to high impact events and opinion on the level of optimism on the current phase of financial and business cycles will be added. These additional questions will expand the horizon of analysis and will give further insights on market perception.

Systemic risks are complex and measuring them with precision is a challenging endeavour. Market perceptions itself provides reasonable insights on the financial system's health. Therefore, SRS is believed to aid and complement department's own analysis of risks to the Sri Lankan financial system.

3.2. Household Sector Creditworthiness Survey – 2018

The household sector is an important element in any economy with regard to monetary and financial stability as the spending and savings habit of the household

sector will certainly have an impact on determining the market prices of an economy. Therefore, the household sector could be a propagator of shocks to the economy, as wealth is redistributed across households with differing propensities to consume. It could also be an originator of a substantial volume of risky claims on financial institutions. Hence, to identify risks and vulnerabilities emanating from the household sector which may have implications on the financial stability at an early stage and to propose measures for systemic risk mitigation to strengthen stability, information on households' leverage is essential. In the Sri Lankan context, it is observed that there is a rapid growth in total banking sector loans and advances especially with regard to consumption based loans and advances. Therefore, in a macroprudential perspective, it is important to assess the household sector leverage and indebtedness through monitoring the flow of income, expenditure, credit and investments.

Information related to household indebtedness and investments is not captured through official Household surveys of Sri Lanka. Therefore, Central Bank decided to conduct the "Household Sector Creditworthiness Survey 2018". Accordingly, the primary objective of this survey is to establish a comprehensive data system on the household sector information that would enable assessment of debt servicing capacity of the households and its implications on financial stability. In addition, the collected information could be used to evaluate the magnitude and depth of the household sector dependence on formal and informal sources for their borrowings.

The survey will be carried out in a few districts covering different geographical areas of the country. The population frame for the survey is the housing units in all Grama Niladhari divisions in selected districts. A systemic sampling method is used to determine the samples totaling to a sample size of approximately 2000 households. Data collection is to be conducted through visiting each household in the sample. The collected data will be analysed to conclude the household creditworthiness of Sri

Lanka in order to derive macroprudential policies to ensure systemic stability.

3.3. Strengthening the Monetary Law Act to Incorporate a Macroprudential Policy Framework

The Monetary Law Act (MLA) is to be amended to support the adoption of an inflation targeting framework by 2020 and to streamline the objective of financial system stability of the country. At present the MLA stipulates that the Central Bank is responsible for financial system stability. However, it implies that Central Bank is only accountable for the institutions under its supervision with regard to stability. The macroprudential policy framework is expected to set a clear institutional structure for analysing systemic risk in a financial sector as a whole and formulate and implement macroprudential measures to address these risks. Such a framework would allocate roles and responsibilities to all the regulators in the financial system, modalities for information exchange and cooperation, methods of accountability, and rules and guidelines for policy formulation process. Under the proposed amendments, the Central Bank will have the power to make recommendations to other regulators through the Financial System Oversight Committee (FSOC), a proposed inter-regulatory body, to which such regulators shall “comply or explain”. i.e. other regulators should either follow such recommendations or give reasons to rejecting such recommendations.

Appendix Table 1

Financial Soundness Indicators - All Banks

	2010	2011	2012	2013	2014	2015	2016	2017 (a)	2018 Jun (a)
1. Capital Adequacy									
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	16.2	16.0	16.4	17.6	16.6	16.6	15.6	15.2	15.8
1.2 Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	14.3	14.4	14.7	14.9	14.1	14.1	12.6	12.4	12.7
1.3 Net Non-Performing Loans to Total Capital Funds	14.4	11.5	12.5	26.3	17.6	12.8	9.6	9.3	14.2
1.4 Debt to Capital Funds	172.0	171.4	184.7	207.4	254.7	276.2	239.8	185.4	164.1
1.5 Capital to Assets Ratio	8.3	8.7	8.6	8.2	8.2	7.9	7.8	8.4	8.6
2. Asset Quality									
2.1 Gross Non-Performing Loans (NPL) to Total Gross Loans (w/o Interest in Suspense)	5.4	3.8	3.7	5.6	4.2	3.2	2.6	2.5	3.3
2.2 Gross Non-Performing Loans (NPL) to Total Gross Loans (with Interest in Suspense)	7.3	6.2	5.7	7.7	6.2	4.9	4.1	3.9	4.7
2.3 Net Non-Performing Loans to Total Gross Loans	3.0	2.1	2.2	3.8	2.6	1.2	0.7	1.2	1.9
2.4 Provision Made against Gross Loans	3.2	2.2	2.0	2.3	2.2	2.0	1.8	1.7	1.8
2.5 Provision Coverage Ratio (Total)	58.1	57.1	53.4	40.4	50.7	62.3	71.8	69.9	56.6
2.6 Provision Coverage Ratio (Specific)	45.3	45.0	41.4	32.5	39.7	46.9	52.1	49.6	41.7
2.7 Sector-wise NPL to Total Sector Loans									
Agriculture and Fishing	3.2	2.5	2.4	4.1	6.0	4.5	3.5	4.0	
Manufacturing	8.7	6.4	6.3	6.0	4.6	4.3	3.9	2.8	
Tourism	4.7	11.4	10.9	8.6	6.8	5.3	3.1	4.6	
Transport	4.2	2.8	3.4	3.0	2.5	1.8	1.5	1.7	
Construction	8.4	7.5	6.8	7.1	5.9	4.2	3.0	2.7	
Traders	7.5	5.3	3.8	4.2	4.2	3.8	3.4	3.7	
New Economy	3.4	2.7	3.3	8.0	5.7	3.7	3.0	2.4	
Financial and Business Services	2.4	1.4	1.6	2.3	2.0	1.3	1.0	0.9	
Infrastructure	3.9	2.6	0.6	0.5	0.4	0.3	0.6	0.4	
Other Services	3.2	2.1	3.4	3.3	2.6	2.7	1.4	1.5	
Other Customer	3.3	1.7	2.2	8.3	4.5	3.0	2.3	1.8	
2.8 Sectoral Distribution of Loans to Total Gross Loans									
Agriculture and Fishing	13.4	13.1	13.1	12.2	10.4	9.1	8.9	8.5	
Manufacturing	13.0	12.0	10.8	11.3	11.3	10.7	10.9	11.1	
Tourism	2.1	2.2	2.4	2.6	3.2	3.8	4.6	4.6	
Transport	1.7	2.2	1.8	2.6	2.6	2.9	2.8	3.3	
Construction	16.5	13.9	13.4	14.5	15.3	16.9	17.6	18.3	
Traders	14.0	11.2	15.2	15.6	15.7	14.8	14.2	14.4	
New Economy	0.9	0.9	1.2	1.0	1.4	1.5	1.6	1.5	
Financial and Business Services	4.6	6.1	4.8	4.2	5.0	6.2	7.2	6.3	
Infrastructure	1.3	1.3	5.1	6.3	8.9	8.7	7.1	6.3	
Other Services	6.4	7.2	3.3	3.1	3.7	4.6	4.6	4.5	
Other Customer	26.0	30.0	28.9	26.7	22.3	21.0	20.5	21.1	
2.9 Provision Made against Total Assets	1.8	1.3	1.2	1.3	1.2	1.2	1.1	1.1	1.2
2.10 Total Loans (Gross) to Total Assets	55.6	61.2	61.8	57.7	55.9	58.4	61.2	63.1	64.8
2.11 Investments to Total Assets	30.4	24.9	23.9	28.5	27.6	29.1	25.1	24.8	24.1
2.12 Total Income to Total Assets	11.2	9.8	11.3	11.4	9.5	8.5	9.5	10.6	11.0
2.13 Net Interest Income to Total Assets	4.2	3.9	3.9	3.3	3.2	3.3	3.4	3.3	3.5
2.14 Operating Income to Total Assets	6.1	5.3	5.4	4.7	4.6	4.5	4.5	4.5	4.7
3. Earnings & Profitability									
3.1 Return on Equity (ROE) – After Tax	22.2	19.7	20.3	16.0	16.6	16.1	17.3	17.6	14.8
3.2 Return on Assets (ROA) – Before Tax	2.7	2.4	2.4	1.9	2.0	1.9	1.9	2.0	1.9
3.3 Return on Assets (ROA) – After Tax	1.8	1.7	1.7	1.3	1.4	1.3	1.4	1.4	1.2
3.4 Interest Income to Total Income	83.1	85.5	86.3	87.3	85.1	85.8	88.0	88.8	89.0
3.5 Net Interest Income to Total Income	37.7	39.4	34.3	29.0	33.5	38.6	35.4	31.2	31.9
3.6 Non-Interest Income to Total Income	16.9	14.5	13.7	12.7	14.9	14.2	12.0	11.2	11.0
3.7 Non-Interest Expenses (Operating Expenses) to Total Income	26.6	27.9	23.2	21.0	24.3	25.9	22.9	18.7	19.7
3.8 Staff Expenses to Non-Interest Expenses	45.2	43.7	45.8	44.9	43.5	45.6	44.9	46.4	45.2
3.9 Personnel Expenses to Total Income	12.0	12.2	10.6	9.4	10.6	11.8	10.3	8.7	8.9
3.10 Provisions to Total Income	0.6	1.2	2.5	3.9	3.4	3.7	2.3	2.6	3.6
3.11 Total Cost to Total Income	71.9	73.9	75.2	79.3	75.9	73.1	75.6	76.3	76.7
3.12 Efficiency Ratio	45.2	52.3	49.4	53.4	51.4	50.9	49.3	45.7	48.6
3.13 Interest Margin	4.6	4.2	4.1	3.5	3.5	3.5	3.6	3.5	3.7
4. Liquidity									
4.1 Liquid Assets to Total Assets	31.4	26.8	26.6	31.9	32.2	30.0	27.3	28.6	27.9
4.2 Statutory Liquid Assets Ratio – DBU	36.6	32.4	31.4	37.7	39.5	39.5	30.0	31.3	30.2
5. Assets / Funding Structure									
5.1 Deposits	72.8	72.3	71.1	70.2	67.2	66.9	69.6	71.9	73.2
5.2 Borrowings	14.3	14.9	15.8	17.1	20.8	21.8	18.8	15.6	14.1
5.3 Capital to External Funds	9.5	10.0	9.8	9.4	9.3	8.9	8.8	9.6	9.9
5.4 Credit to Deposits	76.4	84.7	86.9	82.2	83.1	87.3	88.0	87.8	88.5
5.5 Credit to Deposits & Borrowings	63.9	70.1	71.1	66.1	63.5	65.8	69.3	72.1	74.2
5.6 Credit to Deposits & Borrowings & Capital	58.3	63.8	64.7	60.4	58.1	60.5	63.7	65.8	67.5

(a) Provisional

Source: Central Bank of Sri Lanka

Appendix Table 2

Financial Soundness Indicators - LCBs

	2010	2011	2012	2013	2014	2015	2016	2017 (a)	2018 Jun (a)
1. Capital Adequacy									
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	15.2	15.5	15.8	17.5	17.0	15.3	15.6	15.2	15.8
1.2 Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	13.0	13.4	12.2	14.3	14.0	12.7	12.5	12.3	12.7
1.3 Net Non-Performing Loans to Total Capital Funds	14.6	9.9	10.9	24.4	13.1	9.7	7.6	7.5	12.4
1.4 Debt to Capital Funds	190.5	185.5	198.3	197.1	241.7	264.6	223.7	169.2	147.7
1.5 Capital to Assets Ratio	7.9	8.5	8.4	8.3	8.3	8.2	8.2	8.9	9.1
2. Asset Quality									
2.1 Gross Non-Performing Loans (NPL) to Total Gross Loans (w/o Interest in Suspense)	5.1	3.5	3.4	5.2	3.6	2.9	2.4	2.3	3.1
2.2 Gross Non-Performing Loans (NPL) to Total Gross Loans (with Interest in Suspense)	7.0	6.0	5.5	7.3	5.6	4.7	3.9	3.8	4.6
2.3 Net Non-Performing Loans to Total Gross Loans	2.7	1.7	1.9	3.4	1.9	0.8	0.5	1.0	1.7
2.4 Provision Made against Gross Loans	3.2	2.2	2.0	2.3	2.2	2.1	1.9	1.8	1.9
2.5 Provision Coverage Ratio (Total)	61.8	62.6	58.4	44.4	61.5	72.6	80.3	77.8	61.4
2.6 Provision Coverage Ratio (Specific)	48.4	50.7	45.5	35.6	48.1	54.8	58.5	55.4	45.3
2.7 Sector-wise NPL to Total Sector Loans									
Agriculture and Fishing	2.7	2.3	2.0	2.8	3.7	3.2	2.9	3.7	
Manufacturing	8.7	6.4	6.3	5.6	4.2	4.0	3.7	2.6	
Tourism	4.4	11.7	11.3	8.3	6.9	5.3	3.1	4.6	
Transport	3.7	2.6	3.0	2.6	2.2	1.7	1.5	1.6	
Construction	7.1	6.0	5.2	5.4	4.2	2.9	2.0	1.6	
Traders	7.5	5.3	3.7	4.1	4.1	3.8	3.3	3.6	
New Economy	3.5	2.8	3.2	7.7	5.7	3.7	3.0	2.4	
Financial and Business Services	2.4	1.6	1.6	1.9	1.5	1.1	0.8	0.7	
Infrastructure	4.8	3.5	0.6	0.4	0.4	0.4	0.7	0.5	
Other Services	3.0	1.9	3.1	3.2	2.7	3.1	1.4	1.7	
Other Customer	3.3	1.7	2.3	8.7	3.9	2.9	2.4	1.8	
2.8 Sectoral Distribution of Loans to Total Gross Loans									
Agriculture and Fishing	13.9	13.3	13.1	12.2	10.5	9.2	9.1	8.6	
Manufacturing	13.6	12.6	11.2	11.8	11.9	11.5	11.5	11.9	
Tourism	2.3	2.3	2.5	2.9	3.5	4.2	5.1	5.1	
Transport	1.7	2.2	1.8	2.9	2.8	3.0	3.0	3.5	
Construction	14.1	11.8	11.5	12.4	13.1	14.7	16.0	17.0	
Traders	15.2	12.0	16.3	16.9	17.3	16.3	15.7	15.9	
New Economy	1.0	1.0	1.2	1.2	1.5	1.7	1.8	1.6	
Financial and Business Services	4.5	5.4	4.6	4.0	5.0	6.1	7.2	6.2	
Infrastructure	1.1	1.1	5.3	6.5	7.9	8.0	6.3	5.5	
Other Services	6.9	7.8	3.2	3.1	3.7	4.4	4.6	4.3	
Other Customer	25.8	30.7	29.5	26.2	22.9	20.9	19.7	20.3	
2.9 Provision Made against Total Assets	1.9	1.4	1.3	1.4	1.3	1.3	1.2	1.2	1.3
2.10 Total Loans (Gross) to Total Assets	59.3	65.1	65.0	61.3	58.7	61.1	63.8	65.5	67.5
2.11 Investments to Total Assets	25.7	20.0	20.0	24.4	23.7	26.0	22.1	22.3	21.5
2.12 Total Income to Total Assets	10.8	9.7	11.3	11.5	9.3	8.3	9.4	10.5	10.9
2.13 Net Interest Income to Total Assets	4.3	3.9	4.0	3.6	3.2	3.2	2.4	3.4	3.5
2.14 Operating Income to Total Assets	6.0	5.4	5.6	5.1	4.7	4.6	3.3	4.6	4.9
3. Earnings & Profitability									
3.1 Return on Equity (ROE) – After Tax	0.0	0.0	0.0	0.0	16.8	15.7	17.2	17.5	15.2
3.2 Return on Assets (ROA) – Before Tax	2.5	2.4	2.5	2.0	2.0	1.9	2.0	2.1	2.0
3.3 Return on Assets (ROA) – After Tax	0.0	0.0	0.0	0.0	1.4	1.3	1.4	1.5	1.3
3.4 Interest Income to Total Income	83.8	84.5	85.4	86.6	84.3	84.1	86.7	87.9	87.8
3.5 Net Interest Income to Total Income	40.0	40.4	35.5	30.9	34.8	39.1	35.9	32.0	32.5
3.6 Non-Interest Income to Total Income	16.2	15.5	14.6	13.4	15.7	15.9	13.3	12.1	12.2
3.7 Non-Interest Expenses (Operating Expenses) to Total Income	29.6	29.9	24.1	21.9	25.6	27.2	23.7	19.2	19.9
3.8 Staff Expenses to Non-Interest Expenses	44.6	42.8	44.9	43.8	42.9	44.6	44.1	45.4	43.7
3.9 Personnel Expenses to Total Income	13.2	12.8	10.8	9.6	11.0	12.1	10.5	8.7	8.7
3.10 Provisions to Total Income	0.4	1.3	2.8	4.3	3.8	4.3	12.9	2.9	3.9
3.11 Total Cost to Total Income	73.4	74.0	74.0	77.6	75.0	72.2	74.6	75.2	75.2
3.12 Efficiency Ratio	50.8	53.9	49.3	52.6	51.6	51.1	49.0	45.2	47.4
3.13 Interest Margin	4.7	4.3	4.3	3.7	3.6	3.5	3.6	3.5	3.7
4. Liquidity									
4.1 Liquid Assets to Total Assets	27.0	22.9	23.5	28.0	28.9	27.4	24.9	26.4	25.7
4.2 Statutory Liquid Assets Ratio – DBU	29.4	26.2	26.2	30.8	33.2	28.7	25.5	27.2	26.2
5. Assets / Funding Structure									
5.1 Deposits	72.4	71.5	70.3	70.7	67.6	66.5	69.5	72.0	73.5
5.2 Borrowings	15.1	15.8	16.7	16.4	20.2	21.8	18.4	15.0	13.4
5.3 Capital to External Funds	9.1	9.8	9.7	9.6	9.5	9.3	9.4	10.2	10.4
5.4 Credit to Deposits	81.9	91.1	92.5	86.7	86.9	91.8	91.9	91.0	91.8
5.5 Credit to Deposits & Borrowings	67.8	74.6	74.7	70.3	66.9	69.2	72.6	75.3	77.7
5.6 Credit to Deposits & Borrowings & Capital	62.1	67.9	68.1	64.2	61.1	63.3	66.4	68.3	70.3

(a) Provisional

Source: Central Bank of Sri Lanka

Appendix Table 3

Financial Soundness Indicators - LSBs

	2010	2011	2012	2013	2014	2015	2016	2017 (a)	2018 Jun (a)
1. Capital Adequacy									
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	24.4	20.0	20.5	18.6	18.3	16.6	15.3	15.2	15.8
1.2 Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	25.0	21.1	20.3	20.6	19.9	16.6	13.5	12.8	12.7
1.3 Net Non-Performing Loans to Total Capital Funds	17.8	19.0	20.8	37.6	45.9	40.7	31.1	29.3	32.6
1.4 Debt to Capital Funds	97.2	105.1	111.9	268.5	336.9	382.6	409.6	360.1	333.5
1.5 Capital to Assets Ratio	10.1	9.7	9.3	7.7	7.2	5.7	5.1	5.4	5.7
2. Asset Quality									
2.1 Gross Non-Performing Loans (NPL) to Total Gross Loans (w/o Interest in Suspense)	7.9	6.8	6.4	9.3	9.5	6.4	4.5	4.2	5.0
2.2 Gross Non-Performing Loans (NPL) to Total Gross Loans (with Interest in Suspense)	9.5	8.1	7.5	10.8	11.2	7.5	5.2	4.9	5.7
2.3 Net Non-Performing Loans to Total Gross Loans	5.8	5.1	5.0	7.8	8.2	5.3	3.2	3.3	3.9
2.4 Provision Made against Gross Loans	3.0	2.2	1.9	1.9	1.8	1.3	1.3	1.3	1.4
2.5 Provision Coverage Ratio (Total)	38.2	32.7	29.7	20.6	19.0	19.4	29.6	31.1	29.1
2.6 Provision Coverage Ratio (Specific)	29.0	25.4	22.3	17.2	15.0	13.4	20.6	21.4	20.9
2.7 Sector-wise NPL to Total Sector Loans									
Agriculture and Fishing	8.8	5.6	5.7	15.3	26.7	19.2	10.7	6.6	
Manufacturing	9.6	6.4	6.0	10.1	9.6	15.4	11.0	7.4	
Tourism	14.7	5.8	4.4	4.9	5.1	31.6	20.1	10.1	
Transport	8.6	4.9	6.9	6.4	6.0	4.4	5.3	4.5	
Construction	12.8	12.4	12.0	13.0	11.4	9.2	7.7	8.5	
Traders	8.0	5.0	5.7	10.4	7.5	19.1	22.4	20.8	
New Economy	2.2	2.0	3.7	1.4	10.4	28.4	42.8	40.9	
Financial and Business Services	2.7	0.7	1.0	4.8	6.1	3.4	2.5	2.6	
Infrastructure	1.1	0.1	0.3	1.2	0.3	0.0	0.0	0.0	
Other Services	8.0	6.5	5.9	3.4	2.2	0.6	0.5	0.4	
Other Customer	3.2	2.0	1.1	7.3	10.1	3.7	1.9	1.8	
2.8 Sectoral Distribution of Loans to Total Gross Loans									
Agriculture and Fishing	9.3	11.2	13.2	12.8	9.2	7.8	7.5	8.1	
Manufacturing	8.3	7.1	7.5	7.2	7.2	2.8	3.6	3.6	
Tourism	0.7	1.1	1.4	1.6	1.6	0.1	0.1	0.0	
Transport	1.7	2.0	2.0	2.0	1.6	1.2	1.0	1.1	
Construction	37.6	32.8	31.3	34.2	32.6	36.9	34.1	30.5	
Traders	3.7	3.8	5.3	3.7	3.2	0.6	0.5	0.4	
New Economy	0.3	0.2	0.5	0.1	0.0	0.0	0.0	0.0	
Financial and Business Services	5.6	12.2	6.7	5.7	5.1	6.9	7.5	7.1	
Infrastructure	3.1	3.3	3.4	4.9	16.9	15.7	13.3	13.6	
Other Services	2.2	1.8	4.3	3.1	4.4	6.1	6.3	6.7	
Other Customer	27.4	24.5	24.3	24.7	18.2	21.9	26.0	28.9	
2.9 Provision Made against Total Assets	1.1	0.9	0.8	0.7	0.7	0.5	0.6	0.6	0.7
2.10 Total Loans (Gross) to Total Assets	36.7	40.4	42.9	37.8	40.5	41.4	44.3	47.4	47.2
2.11 Investments to Total Assets	55.1	50.5	47.0	51.2	49.1	48.4	44.5	41.7	41.0
2.12 Total Income to Total Assets	14.8	11.4	12.0	10.9	10.4	10.0	10.4	11.4	11.6
2.13 Net Interest Income to Total Assets	4.4	4.8	6.3	2.0	2.8	3.6	3.4	3.0	3.3
2.14 Operating Income to Total Assets	4.4	4.8	6.3	2.9	3.9	4.2	3.8	3.7	3.7
3. Earnings & Profitability									
3.1 Return on Equity (ROE) – After Tax	0.0	0.0	0.0	0.0	15.1	20.3	18.3	19.2	10.9
3.2 Return on Assets (ROA) – Before Tax	3.8	2.5	1.8	1.0	1.7	1.6	1.5	1.5	1.1
3.3 Return on Assets (ROA) – After Tax	0.0	0.0	0.0	0.0	1.2	1.1	1.0	1.0	0.6
3.4 Interest Income to Total Income	80.1	90.2	91.5	91.2	89.3	94.8	95.7	94.2	96.5
3.5 Net Interest Income to Total Income	28.7	34.9	27.4	17.9	27.3	36.4	32.4	26.5	28.1
3.6 Non-Interest Income to Total Income	19.9	9.8	8.5	8.8	10.7	5.2	4.3	5.8	3.5
3.7 Non-Interest Expenses (Operating Expenses) to Total Income	14.8	18.2	18.0	15.6	17.8	19.4	18.4	15.6	18.1
3.8 Staff Expenses to Non-Interest Expenses	50.0	51.5	52.8	54.0	47.3	52.1	51.1	54.3	55.0
3.9 Personnel Expenses to Total Income	7.4	9.4	9.5	8.4	8.4	10.1	9.4	8.5	10.0
3.10 Provisions to Total Income	1.7	0.5	0.8	1.4	1.7	0.8	0.3	0.9	1.5
3.11 Total Cost to Total Income	66.2	73.6	82.2	88.9	79.9	77.8	81.7	83.3	86.5
3.12 Efficiency Ratio	31.0	41.9	49.9	60.1	49.9	50.2	51.5	49.3	59.9
3.13 Interest Margin	4.1	4.0	3.3	2.2	3.1	3.8	3.5	3.2	3.4
4. Liquidity									
4.1 Liquid Assets to Total Assets	54.0	47.7	45.1	53.2	49.9	0.0	0.0	42.6	42.1
4.2 Statutory Liquid Assets Ratio – DBU	74.3	65.4	61.4	80.3	77.7	68.5	61.4	61.6	59.9
5. Assets / Funding Structure									
5.1 Deposits	75.1	76.3	76.0	67.1	65.3	69.3	70.3	71.3	71.5
5.2 Borrowings	9.8	10.2	10.4	20.7	24.1	21.7	20.9	19.4	18.9
5.3 Capital to External Funds	11.9	11.2	10.8	8.8	8.0	6.2	5.6	5.9	6.3
5.4 Credit to Deposits	48.8	52.9	56.5	56.3	62.1	59.8	63.0	66.5	66.1
5.5 Credit to Deposits & Borrowings	43.2	46.7	49.7	43.0	45.4	45.5	48.6	52.3	52.2
5.6 Credit to Deposits & Borrowings & Capital	38.6	42.0	44.9	39.5	42.0	42.9	46.0	49.4	49.1

(a) Provisional

Source: Central Bank of Sri Lanka

Appendix Table 4

Financial Soundness Indicators - LFCs and SLCs Sector

	2010 Mar	2011 Mar	2012 Mar	2013 Mar	2014 Mar	2015 Mar	2016 Mar	2017 Mar	2018 Mar (a)	2018 Jun (a)
1. Capital Adequacy										
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	11.3	7.2	14.8	14.9	14.5	13.4	11.3	11.9	12.5	13.4
1.2 Tier 1 Capital/Risk Weighted Assets (Tier 1 RWCAR)	9.8	6.4	14.8	14.4	13.6	12.5	10.8	11.5	11.5	12.9
1.3 Capital Funds to Total Assets	13.1	11.8	14.1	14.2	13.3	13.1	11.2	8.9	10.0	11.6
1.4 Debt to Capital funds (Borrowings other than Deposits)	241.1	296.1	242.2	203.1	187.5	207.3	297.7	377.4	289.6	246.0
1.5 Investment Properties to Capital Funds	12.0	10.0	7.6	27.4	7.8	7.4	7.8	9.1	12.2	12.3
1.6 Non Performing Loans Net of Provisions to Capital	21.0	14.6	12.2	9.9	12.5	11.0	8.5	9.7	11.6	13.5
2. Asset Quality										
2.1 Gross Non Performing Advances to Total Advances	8.2	6.8	4.8	5.1	6.6	6.3	5.1	4.9	5.4	6.8
2.2 Provision made against Total Advances	4.8	4.3	2.6	2.7	3.8	3.7	3.3	3.2	3.6	4.0
2.3 Provision Coverage Ratio (Specific Provisions to NPA)	37.7	42.0	41.0	39.9	46.7	51.6	63.0	63.4	60.1	57.8
2.4 Provision Coverage Ratio (Total Provisions to NPA)	58.2	62.4	54.5	52.1	57.4	58.3	64.9	65.4	64.2	59.2
3. Earnings and Profitability										
3.1 Return on Assets (Annualized)	1.4	4.0	5.7	3.6	2.1	3.4	3.5	3.7	3.0	2.7
3.2 Return on Equity (Annualized)	3.1	17.4	26.3	15.7	7.8	14.5	17.0	20.0	14.5	12.3
3.3 Interest Income to Interest Expenses	142.9	181.8	196.8	167.1	166.3	202.9	215.9	189.9	177.1	183.9
3.4 Net Interest Income to Profit After Tax	1190.2	297.3	189.6	280.4	626.2	399.1	404.6	333.0	405.8	561.0
3.5 Operating Cost to Net Interest Income	113.6	91.0	72.0	76.5	86.6	72.8	77.8	76.3	76.4	73.6
3.6 Net Interest Income to Gross Assets	4.8	6.1	7.0	6.2	6.5	7.6	7.6	7.3	6.8	2.0
3.7 Net Interest Income to Interest Income	30.0	45.0	49.2	40.2	39.9	50.7	53.7	47.4	43.5	45.6
3.8 Non-Interest Expenses to Total Cost	30.7	40.9	42.0	33.0	33.7	38.9	44.9	39.0	34.0	34.1
3.9 Efficiency Ratio	76.9	61.1	51.5	59.6	73.1	63.2	69.6	61.4	64.4	68.4
3.10 Cost to Income Ratio	92.5	79.5	70.3	81.9	89.7	82.2	80.8	80.4	84.3	86.7
4. Liquidity										
4.1 Liquid Assets to Total Assets	5.7	4.2	5.3	6.4	10.2	8.7	8.0	7.6	9.1	7.9
4.2 Liquid Assets to Short Term Liabilities	7.9	5.8	7.3	8.8	13.7	11.8	10.4	9.9	11.8	10.3

(a) Provisional

Source: Central Bank of Sri Lanka

Appendix Table 5

Financial soundness Indicators - Licensed Financial Sector

	2010 Mar	2011 Mar	2012 Mar	2013 Mar	2014 Mar	2015 Mar	2016 Mar	2017 Mar	2018 Mar (a)	2018 Jun (a)
1. Capital Adequacy										
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	11.3	7.2	11.7	13.5	13.2	12.2	9.9	10.4	10.4	12.2
1.2 Tier 1 Capital/Risk Weighted Assets (Tier 1 RWCAR)	9.8	6.4	10.8	12.7	11.9	11.2	9.4	10.1	10.4	12.2
1.3 Capital Funds to Assets Ratio	9.6	7.8	10.8	13.0	12.1	12.0	10.0	9.7	10.3	11.9
1.4 Capital Funds to Deposits Liabilities	15.0	12.5	20.5	26.7	22.2	23.8	21.2	20.7	20.9	24.2
1.5 Non Performing Loans Net of Provisions to Capital Funds	35.9	33.6	14.5	11.1	13.6	12.6	10.1	9.7	11.6	13.6
2. Asset Quality										
2.1 Gross Non-Performing Advances to Total Advances	9.7	8.9	5.7	5.2	6.7	6.7	5.4	5.2	5.9	7.0
2.2 Provisions to Non-performing Advances	55.6	54.9	52.3	51.3	57.5	57.8	64.3	64.8	62.8	59.4
3. Earnings and Profitability										
3.1 Return on Assets - Before Tax (Annualized)	0.1	6.9	5.5	2.9	1.7	3.0	3.1	3.4	2.9	2.7
3.2 Return on Assets - After Tax (Annualized)	-0.7	1.0	5.0	2.0	0.8	1.6	1.6	2.2	1.7	1.4
3.3 Return on Equity - After Tax (Annualized)	-7.4	12.3	12.8	15.6	6.7	14.4	15.6	20.7	15.5	12.9
3.4 Net Interest Income to Gross Income	22.2	33.1	39.3	33.9	33.1	41.7	44.7	39.5	36.5	39.5
3.5 Net Interest Income to Total Assets	4.2	5.7	6.8	6.0	6.1	7.1	7.1	6.9	6.5	1.9
3.6 Non-Interest Expenses (Operating Expenses) to Income	30.8	35.1	31.6	27.2	30.9	32.5	37.0	31.3	28.8	29.5
3.7 Staff Expenses to Non-interest Expenses	36.6	34.4	35.5	36.9	34.2	37.8	34.6	40.6	40.3	40.8
3.8 Total Cost to Total Income	99.7	63.7	66.5	83.3	91.4	84.1	82.9	78.1	78.4	77.9
4. Liquidity										
4.1 Liquid Assets to Total Assets	9.0	7.0	6.3	6.3	10.2	8.8	7.7	7.4	8.5	7.9
4.2 Liquid Assets to Short Term Liabilities	14.1	39.7	21.8	13.0	18.8	17.4	16.3	15.1	15.1	15.1

(a) Provisional

Source:Central Bank of Sri Lanka

Appendix Table 6

Financial soundness Indicators - Specialised Leasing Companies Sector

	2010 Mar	2011 Mar	2012 Mar	2013 Mar	2014 Mar	2015 Mar	2016 Mar	2017 Mar	2018 Mar (a)	2018 Jun (a)
1. Capital Adequacy										
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	34.0	32.1	24.5	30.2	32.6	33.5	33.5	33.4	28.6	43.7
1.2 Tier 1 Capital/Risk Weighted Assets (Tier 1 RWCAR)	33.5	33.5	24.5	30.1	32.6	34.0	32.1	31.2	26.9	43.4
2. Asset Quality										
2.1 Gross Non-Performing Advances to Total Advances	6.0	3.8	2.5	3.9	5.8	2.1	1.7	1.3	4.5	2.7
2.2 Provision made against Total Advances	3.9	3.3	1.7	2.4	3.2	1.6	1.4	1.2	1.4	1.7
2.3 Total Advances to Total Assets	74.3	74.4	87.5	82.3	77.5	84.6	85.5	83.5	85.7	85.6
2.4 Total Advances to Total Borrowings	111.4	109.6	130.8	128.6	121.8	143.0	135.4	125.5	142.0	142.0
3. Liquidity										
3.1 Net Loans to Total Borrowings	105.8	104.7	127.9	124.6	116.8	140.3	133.2	123.7	139.4	138.9
3.2 Liquid Assets to Total Assets	10.2	4.2	2.6	6.7	10.2	7.8	11.2	10.5	26.4	8.1
3.3 Liquid Assets to Total borrowings	15.3	6.1	3.9	10.4	16.0	13.2	17.7	15.8	43.8	13.5
4. Earnings and Profitability										
4.1 Return on Assets (Annualized)	3.8	5.3	6.9	5.5	5.3	7.4	9.1	3.2	2.6	2.4
4.2 Operating Profit Before Provision to Total Assets	2.8	5.7	6.1	5.7	7.3	10.5	9.1	3.2	7.3	5.6
4.3 Return on Equity (Annualized)	11.8	20.5	21.4	16.0	15.1	20.3	24.2	18.0	9.0	7.5
4.4 Interest Income to Interest Expenses	224.0	205.6	212.2	211.1	230.6	368.7	343.4	258.5	334.7	275.8
4.5 Net Interest Income to Profit Before Tax	154.9	127.1	112.5	156.4	198.3	176.6	165.3	194.8	156.4	179.4
4.7 Operating Cost to Net Interest Income	47.4	71.3	64.3	68.3	63.6	50.5	56.2	68.1	54.7	62.9
4.8 Total Cost to Total Income	20.4	66.2	64.3	68.3	63.6	50.5	56.2	68.1	54.7	62.9

(a) Provisional

Source: Central Bank of Sri Lanka

Glossary

Balance of Payments (BOP)	A statement that summarizes an economy's transactions with the rest of the world for a specified time period. Encompasses all transactions between a country's residents and its non-residents involving goods, services, income, current transfers, acquisition of financial assets and incurrence of financial liabilities. The balance of payments classifies these transactions into three accounts; namely, the current account, the capital account and the financial account. The current account shows flows of goods, services, primary income and secondary income between residents and non-residents. The capital accounts shows credit and debit entries for non-produced non-financial assets and capital transfers between residents and non-residents and represent only a small portion of BOP. The financial account shows the net acquisition and disposal of financial assets and liabilities. The sum of the balances of the current and capital accounts represents the net lending (surplus) or net borrowing (deficit) by the economy. This is conceptually equal to the net balance in the financial account.
Bond Yields	Return an investor would earn for a bond purchased. Usually, the longer the term of a bond, the higher the interest rate that's paid to the holder, compensating for the inflation risk involved in having money tied up for a long time.
Capital	Used to generate wealth through investments. Includes financial assets, factories, machinery and equipment owned by business. Besides being used in production, capital can be rented out for a monthly or annual fee to create wealth.
Corporate Bonds	Medium or long-term securities of private sector companies which obligate the issuer to pay interest and redeem the principal at maturity.
Credit Card	"Credit Card" means, a payment card which involves a line of credit granted by the issuer to the cardholder where the credit utilized can be settled in full or in part on or before a specified date. The issuer may charge interest or other charges on any amount not settled on the specified date.
Credit Risk	The risk of financial loss if a customer or counterparty fails to meet a payment obligation under a contract.

Depreciation	The monetary value of an asset decreases over time due to use, wear and tear or obsolescence.
Equity Ratio	A financial ratio indicating the relative proportion of equity used to finance a company's assets. Equity Ratio = Total Shareholder's equity / Total Assets
Euro Area	The Eurozone officially called the euro area, is an Economic and Monetary Union (EMU) of 18 European Union (EU) member states that have adopted the euro (€) as their common currency and sole legal tender.
Finance lease	A contract whereby a lessor (seller) conveys to the lessee (buyer) the right to use an asset for rent over an agreed period of time which is sufficient to amortize the capital outlay of the lessor. The lessor retains ownership of the asset but transfers substantially all the risks and rewards of ownership to the lessee.
Gross Domestic Product (GDP)	Monetary value of all the finished goods and services produced within a country's borders in a specific time period.
Government Securities	Bonds, bills, and other debt instruments sold by a government, to finance its borrowings.
Hire purchase	Hire purchase is the legal term for a contract, in which a purchaser agrees to pay for goods in parts or a percentage over a number of months.
Inflation	Increase in general price level of goods and services in an economy over a period of time.
Interest Margin	The difference between the interest income generated by banks or other financial institutions and the amount of interest paid out (for example, to depositors), relative to the amount of their (interest-earning) assets.
Liquid Assets	Term used to describe an asset that can be quickly converted to cash at a price close to fair market value.
Liquidity Ratios	Financial ratios measuring the company's ability to meet its short-term obligations. Generally, the higher the value of the ratio, the larger the margin of safety that the company possesses to cover short-term obligations.

Market Risk	Market risk can be defined as the risk of losses in on and off-balance sheet positions arising from adverse movements in market prices such as interest rates, exchange rates, equity prices and commodity prices.
Maturity	The period of time for which a financial instrument remains outstanding. Maturity refers to a finite time period at the end of which the financial instrument will cease to exist and the principal is repaid with interest.
Maturity Mismatches	The tendency of a business to mismatch its balance sheet by possessing more short-term liabilities than short-term assets and having more assets than liabilities for medium and long-term obligations.
Monetary Policy	One of the core objectives of the Central Bank of Sri Lanka is economic and price stability. The Central Bank formulates and implements its monetary policy, i.e., actions to influence the cost and availability of money, to attain this objective. The Monetary Law Act (MLA), the legislation under which the Central Bank has been established and operates, has provided a wide range of instruments for monetary management. At present, the monetary policy framework of the country places greater reliance on market based policy instruments and the use of market forces to achieve the desired objectives.
Non-Performing Loans (NPL)	A loan is classified as non-performing as specified in the Directions issued under the provisions of the Banking Act, No. 30 of 1988 and Finance Business Act No. 42 of 2011 when payments of interest and/or principal have been in arrears, i.e., for more than 3 months or more, or based on the potential risk.
Provision Coverage Ratio	Ratio of provisions made against the non-performing loans.
Repurchase Agreements (Repo) and Reverse repurchase agreement (Reverse Repo)	Arrangements which involve the sale, for cash, of securities (usually government securities) at a specified price with a commitment to repurchase the same or similar securities at a fixed price on a specified future date. The difference between the sale price and the repurchase price is the interest income. The agreement is called reverse repo when viewed from the perspective of the securities buyer. A repo is similar to a loan that is collateralized by the securities underlying the agreement. Most repos are very short-term money market instruments.

Return on Assets (ROA)	A financial ratio that shows the percentage of profit that a company earns in relation to its overall resources (total assets). ROA (after tax) = Net profit after tax / Total assets (or Average Total assets)
Return on Equity (ROE)	The amount of net income returned as a percentage of shareholders equity. It reveals how much profit a company earned in comparison to the total amount of shareholder equity found on the balance sheet. ROE = Net profit after tax / Shareholder’s equity (or Average Shareholder’s equity)
Statutory Liquid Asset Ratio (SLAR)	The ratio of liquid assets as determined under the provisions of the Banking Act, No. 30 of 1988 maintained by licensed banks as a per centum of the total liabilities or deposits as the case may be.
Trade Deficit	The difference between the monetary value of exports and imports of output in an economy over a certain period, measured in the currency of that economy. A negative balance is referred to as a trade deficit or, informally, a trade gap.