FINANCIAL SYSTEM STABILITY REVIEW 2019

CENTRAL BANK OF SRI LANKA

Financial System Stability Review
2019

Central Bank of Sri Lanka
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Abbreviations

ADs	Authorised Dealers
ALMA	Active Liability Management Act
AML/CFT	Anti-Money Laundering/Countering Financing of Terrorism
ASEAN	Association of Southeast Asian Nations
AP/JG	Asia Pacific Joint Group
ASPI	All Share Price Index
AWCMR	Average Weighted Call Money Rate
AWRR	Average Weighted Repo Rate
BCP	Business Continuity Plan
BIS	Bank for International Settlements
BoE	Bank of England
BoJ	Bank of Japan
BSI	Business Sentiment Index
CAR	Capital Adequacy Ratio
CAS	Common ATM Switch
CBA	Central Bank of Sri Lanka Act
CBSL	Central Bank of Sri Lanka
CCP	Central Counter Party
CD	Credit to Deposit
CDD	Customer Due Diligence
CEFTS	Common Electronic Fund Transfer Switch
CIFL	Central Investments and Finance PLC
CPS	Common Point-of -Sales Switch
CSD	Central Securities Depository
CSE	Colombo Stock Exchange
DA	Documents against Acceptance
DBU	Domestic Banking Units
DNFBPs	Designated Non-Finance Businesses and Professions
DR	Disaster Recovery
D-SIBs	Domestic-Systemically Important Banks
D-SILFCs	Domestic-Systemically Important Licensed Finance Companies
EBIT	Earnings Before Interest and Tax
ECB	European Central Bank
EFF	Extended Fund Facility
EMBI	Emerging Market Bond Index
EMDEs	Emerging Market and Developing Economies
EMEs	Emerging Market Economies
ETP	Electronic Trading Platform
EU	European Union
FATF	Financial Action Task Force
FBA	Finance Business Act
FCTFF	Foreign Currency Term Financing Facility
FCY	Foreign Currency
FDI	Foreign Direct Investments
FIs	Financial Institutions
FIU	Financial Intelligence Unit
FMSI	Financial Market Stability Indicator
FRB	Federal Reserve Board
FSOC	Financial System Oversight Committee
FSSR	Financial System Stability Review
GDP	Gross Domestic Product
GoSL	Government of Sri Lanka
G-Sec	Government Securities
GWP	Gross Written Premium
GFSR	Global Financial Stability Report
HQLAs	High-Quality Liquid Assets
IFC	International Finance Corporation
IIS	Interest in Suspense
ILF	Intra-Day Liquidity Facility
IMF	International Monetary Fund
IPOs	Initial Public Offerings
IRCSL	Insurance Regulatory Commission of Sri Lanka
ISBs	International Sovereign Bonds
LC	Letter of Credit
LCB	Licensed Commercial Bank
LCPL	Lanka Clear Pvt. Ltd
LCR	Liquidity Coverage Ratio
LFCs	Licensed Finance Companies
LIBOR	London Inter-Bank Offered Rate
LMFC	Licensed Micro Finance Company

LNG	Liquefied Natural Gas
LSF	Liquidity Support Facility
LTV	Loan to Value
ML	Money Laundering
MTDS	Medium Term Debt Strategy
NBT	Nation Building Tax
NBFIs	Non-Bank Financial Institutions
NFIS	National Financial Inclusion Strategy
NII	Net Interest Income
NIM	Net Interest Margin
NPLs	Non-performing Loans
NSFR	Net Stable Funding Ratio
OMOs	Open Market Operations
OPEC	Organization of the Petroleum Exporting Countries
PBV	Price to Book Value
PDCs	Primary Dealer Companies
PER	Price Earnings Ratio
PIs	Participating Institutions
POC	Proof of Concept
QR	Quick Response
RED	Resolution and Enforcement Department
RTGS	Real Time Gross Settlement
ROA	Return on Assets
ROE	Return on Equity
ROs	Risk Officers
RWA	Risk Weighted Assets
RWCAR	Risk Weighted Capital Adequacy Ratio
SDFR	Standing Deposit Facility Rate
SEC	Securities Exchange Commission
SLAR	Statutory Liquid Assets Ratio
SLCs	Specialised Leasing Companies
SLDBs	Sri Lanka Development Bond
SLDILSS	Sri Lanka Deposit Insurance and Liquidity Supports Scheme
SLFR	Standing Lending Facility Rate
SLFRS	Sri Lanka Financial Reporting Standards
SLIBOR	Sri Lanka Inter-Bank Offered Rate
SMEs	Small and Medium Enterprises
SPD	Standalone Primary Dealers
SRC	Standing Rate Corridor
SRR	Statutory Reserve Ratio
TF	Terrorist Financing
TSCFL	The Standard Credit Finance Ltd
TT	Telegraphic Transfer
UNSCR	United Nations Security Council Resolutions
UK	United Kingdom
USA	United States of America
USD	US Dollar
VAT	Value Added Tax
WEO	World Economic Outlook

Governor's Foreword

The Financial System Stability Review (FSSR) is published with the view of presenting an unbiased evaluation of risks and vulnerabilities faced by the Sri Lankan financial sector and to promote public awareness on financial system stability. It is an important output of the macroprudential surveillance function of the Central Bank of Sri Lanka.

The present issue of the FSSR evaluates developments within the financial system for the year starting from October 2018 and the risks arising from them. In 2019, the macroprudential surveillance framework was considerably broadened to include the household and corporate sector. Further, the surveillance over other sectors was also improved with new data and analytical techniques.

During the above period, financial system stability was well maintained amid several challenges. Microprudential surveillance carried out by the Central Bank and other financial sector regulators have ensured that reasonable risk management systems and resources are in place in financial institutions and that the payments and settlements infrastructure functions smoothly. Enhanced capital requirements under Basel III that came into effect on 01 January 2019 improved risk absorption capacity in the banking sector. The Central Bank took stringent regulatory action regarding Licensed Finance Companies that are experiencing issues, in order to safeguard the interests of depositors and the public. Meanwhile, the macroprudential surveillance function focused on assessing vulnerabilities in the system as a whole and recommending policy actions.

In order to enhance financial intermediation, the Central Bank had to intervene with regulatory actions in addition to monetary policy easing. These efforts can complement the fiscal stimulus carried out to revive the economy, though such action must be implemented while ensuring that fiscal consolidation is carried out, to ensure fiscal and debt sustainability. Going forward, the Central Bank will continue to be cautious about risks in individual institutions as well as system-wide risks and implement proactive measures to safeguard financial system stability.

The present issue of the FSSR also provides a detailed description of policy measures relating to the financial sector taken during the period under consideration, which are expected to have long lasting impact on the financial system. The proposed Central Bank of Sri Lanka Act would establish the Central Bank's role as the macroprudential authority of the country while enhancing the framework. This proposed new Act would also establish a new Financial System Oversight Committee which would consist of members from all financial sector regulators, to take proactive macroprudential policy decisions to curtail systemic risk to the system and safeguard financial system stability.

I believe this review will serve as a reliable reference on financial sector developments and risks for all concerned stakeholders.

Dr. Indrajit Coomaraswamy
Governor
Central Bank of Sri Lanka

Executive Summary

The resilience of the financial sector was well maintained during the year from October 2018 to September 2019, though performance of the financial sector in terms of financial intermediation was muted. Low economic growth and lack of financial intermediation mutually reinforced each other; where the subdued level of economic activities compounded by political instability and low investor confidence, reduced demand for financial services from the private sector; while the lack of financial intermediation restricted growth from picking up. Meanwhile, financial markets in Sri Lanka continued to be significantly affected by developments in the international economy. Liquidity in the global financial markets improved in the latter part of 2019 following signaling of monetary policy relaxation by advanced economy central banks. However, net foreign capital outflows were recorded from the Rupee denominated government securities market and the stock market during the period under consideration, though the magnitude of the net outflows reduced compared to the previous year. Sri Lanka also successfully issued sovereign bonds twice in 2019.

Effects of low consumption, investment and production in the economy and the downturn in the private sector manifested on the financial system in numerous ways: low credit growth, high and rising Non-Performing Loans (NPL), poor stock market performance, tightening bottom lines of financial intermediaries, higher inclination of banks to boost the share of risk-free government securities in asset portfolios etc.

Though financial system stability was well maintained in the period under consideration in this publication, certain unhealthy developments occurred that increased the risk faced by the financial system. Gross NPLs as well as NPL ratios (calculated as per NPL classification methodologies Directed by the Central Bank) have been increasing since 2017. The banking sector recorded an increase in the gross NPL ratio from 3.4 per cent in December 2018 to 4.9 per cent in September 2019 while those of Licensed Finance Companies (LFCs) and Specialised Leasing Companies (SLCs) increased to 9.7 per cent as at end September 2019 compared to 7.7 per cent as at end 2018. The volume of non-performing advances from the formal financial sector to the household sector increased by 39.7 per cent in June 2019 on a year-on-year basis while the number of defaulters among corporates and households increased. The number of loss making non-financial listed companies also increased.

In this background, financial institutions tightened credit screening and vigilance, and high-risk segments of borrowers who are important stakeholders of economic growth such as small and medium enterprises, experienced greater rejection in loan applications than in previous years, as reflected in the Central Bank Credit Supply Survey. The private credit to GDP gap, which was positive since March 2018, narrowed by December 2018 and turned negative in April 2019, with the tight credit conditions spreading to all sectors of the economy. This phenomenon of low financial intermediation and low growth reinforcing each other compelled the Central Bank to adopt an accommodative monetary policy stance and intervene with interest rate ceilings and other policy measures during the period.

However, regulatory action ensured that the risk absorption capacity of financial institutions improved. On 01 January 2019, the banking sector successfully completed its Basel III capital phase-in arrangement which required incumbents to increase the minimum Capital Adequacy Ratio (CAR) on a staggered basis. Domestic Systemically Important Banks (D-SIBs) and non-D-SIBs are required to maintain a CAR of 14.0 per cent and 12.5 per cent respectively. The banking sector met other micro-prudential requirements such as the statutory liquid asset ratio, leverage ratio, liquidity coverage ratio, net open position in foreign currency exposures etc. However, deterioration of the provision coverage ratios, return on assets and return on equity ratios are a cause of concern.

The LFCs and SLCs sector was fraught with multiple issues in the period under consideration in this report, though action taken by the Central Bank prevented issues in this sector spilling over to the financial system in general. Few LFCs failed to honour deposit withdrawals. Meanwhile, several companies failed to meet the minimum capital requirement and some companies failed to meet the capital adequacy ratio. Further, dwindling credit quality and profitability as well as corporate governance issues hampered several companies leading to a decline in investor confidence in the whole sector.

The insurance sector performed moderately in 2019, recording a growth in its assets base. Payment and settlement systems too functioned smoothly facilitating transactions in the economy. However, transaction volumes via retail electronic transactions did not show a significant increase in the period under consideration, possibly reflecting subdued economic activity. There is considerable scope to improve digital transactions further, aimed particularly at improving financial inclusion in the country.

As a part of the tight credit conditions, most deposit taking institutions, particularly banks, channeled more funds into risk-free government securities, which created ample demand for treasury securities to compensate for the large-scale foreign capital outflows in 2018, as a result of the normalization of monetary policy by the Federal Reserve of the USA and elevated global uncertainties stemming from trade, technology and geopolitical tensions as well as oil prices. There has also been an outflow in 2019 though at a significantly reduced scale. Together with monetary policy easing by the Central Bank of Sri Lanka, this brought down yields at the short-end of the yield curve at the primary auctions, making the yield curve steeper as yields at the long-end were more sticky downward. However, spreads between 2-year Treasury bonds and the standing deposit facility narrowed particularly in the second and third quarters of 2019. The secondary market for government securities continued its lackluster performance, while most investors in the primary market held on to their securities. Thus, in this background, the government experienced easier borrowing conditions in the securities market, while its borrowing through bank loans also increased.

Rupee market liquidity was generally driven by policy actions taken by the Central Bank. Rupee market liquidity which was in deficit from September 2018 to mid-2019, recorded a surplus during most of the subsequent period. Such policy action which drove market liquidity constantly aimed to improve financial intermediation in the economy while maintaining stability in financial markets.

Performance of markets for corporates to raise equity and debt capital was also muted. The corporate bond market performance was poor. The majority of issuances related to banks raising capital to meet new capital adequacy requirements, while yields shifting up for primary issuances. Meanwhile, the All Share Price Index (ASPI) of the Colombo Stock Exchange (CSE) was on a declining trend during 2018 and the first ten months of 2019. Price earnings ratios and market capitalization also followed this trend. In spite of this, foreign investments in the CSE kept recording net outflows on a monthly basis in almost all months from October 2018 to September 2019 with a total net outflow of US dollar 112 million. However, the other Emerging Market and Developing Economies (EMDEs) also saw debt flows, rather than equity flows, rebounding significantly after global financial conditions softened in mid-2019. There were only three initial public offerings in the year under reference. Accordingly, the Sri Lankan stock market performed poorly during the period under concern.

Exchange rate movements were managed without excessive volatility. This facilitated efficiency in foreign exchange transactions and pricing. The exchange rate appreciated slightly during the first 11 months of 2019. Receipt of sovereign bond proceeds and IMF extended fund facility drawings, together with the reduction in the trade deficit helped to achieve this outcome.

Financial sector regulators, led by the Central Bank of Sri Lanka as the apex regulator, continuously strived to implement measures to safeguard the financial system and develop it further to support economic activities. Analytical and monitoring methods for micro and macro prudential regulations were constantly upgraded to keep abreast of the dynamism and technological advancements in the financial sector in Sri Lanka. Meanwhile, stringent regulatory actions were taken to address issues in distressed/ high-risk finance companies. Suspension of activities and cancellation of licenses had to be meted out in some cases. The Sri Lanka Deposit Insurance and Liquidity Support Scheme developed mechanisms to pay compensation to affected depositors more efficiently. The Central Bank has an internal rating system and an early warning system to identify high risk LFCs and take proactive measures.

The Central Bank also led further developments to the payment system infrastructure to improve the safety and efficiency of payment and settlement systems. Importantly, compliance with the Minimum Compliance Standard for Payment Related Mobile Applications introduced, in 2018, was monitored in the period under consideration.

Having recognized that environmental concerns are indispensable for efforts at securing financial system stability, the Central Bank and the government undertook various measures to implement the green finance initiative and incorporate action to mitigate climate change effects into the financial framework in Sri Lanka. Formulating and launching the "Roadmap for Sustainable Finance" at the Sustainable Banking Network Global Meeting, in April 2019, was an important step taken in this regard.

Outlook

In the near-term, the stability of the financial system will be supported by a number of factors. They include, the strength of the actions taken by the respective financial sector regulators, enhanced risk management systems and supporting resources in place in financial institutions, and the lower level of risk in the global financial system.

However, a number of sources of risk to the stability of the financial system can be identified, in both the global and domestic economies. In the domestic economy, due to the low growth, low profitability and the general downturn in the non-financial corporate sector, the outlook for NPLs in the financial sector is concerning. If this deteriorating asset quality persists, stability of banks and non-bank financial institutions may eventually be affected. However, measures taken to revive the private sector such as monetary policy easing, interest rate caps which have resulted in a reduction of interest rates, the recent fiscal stimulus package, and the proposed debt moratoria together with the condusive security and political environment would eventually, improve private sector performance. It is anticipated that this would result in an improvement in credit quality.

In the international macroeconomy, monetary policy loosening in advanced economies and most EMDEs have pushed yields to never-before-seen low levels (with a large amount of securities carrying negative yields), while yield curves have become flatter and spreads have tightened. This situation has prompted international investors to search for yield taking on greater risks and investing in illiquid assets. Corporate sector leverage has already increased significantly in advanced economies. Such risks in the global financial system, together with risks in other spheres of the global economy, such as outcomes of trade disputes and political developments, may cause sudden adjustments in risk premia in global financial markets.

The more conducive global financial market conditions have prompted more and more EMDEs to issue sovereign bonds in international financial markets and may allow Sri Lanka also to rollover debt at relatively favorable rates. Preserving the sovereign rating of Sri Lanka is important to access international financial markets. Continuation of the IMF Extended Fund Facility program would facilitate to preserve the sovereign rating. However, additional borrowing must be undertaken with great caution as vulnerabilities may suddenly be transferred into adverse shocks, amplifying the downward cycle and destabilizing economies with twin deficits, like Sri Lanka. At the same time, maintaining fiscal consolidation path needs to be ensured to achieve sustainability of debt which is necessary for achieving financial system stability as well.

Further, since the share of foreign currency assets, including claims on non-residents, out of total assets in the banking system is high and foreign currency based delinquency rates have also increased, it is important that foreign currency exposures of banks be managed with caution as an abrupt tightening of global financial conditions may accentuate foreign currency liquidity risks in the domestic banking system. Developments in the global economy, especially pertaining to trade, foreign direct investment, and commodity prices (including oil prices) can also pressurize the domestic financial system through the real sector. Therefore, in the context of a global economy with a new norm of low growth and muted inflation as well as long lasting structural changes to the global policy landscape, monitoring and managing developments in the global economy is vital to manage the stability of the financial system in Sri Lanka, going forward.

Fintech has advanced by leaps and bounds in the last few years and new financial concepts like blockchain has gathered more attention. Financial intermediaries in Sri Lanka too were seen to upgrade their services to the public with latest technology and the use of the internet and mobile phones to provide financial services has increased. However, novel types of cybersecurity threats were reported from around the world and the need for regulators to stay a step ahead and proactively formulate safety-nets has become paramount for financial system stability.

The Central Bank, with a view to maintain long term stability of the LFCs sector, has taken several measures, including imposing restrictions on deposits, lending and borrowing of LFCs which have not complied with regulatory requirements. Issuing a new direction on maximum ownership limits, revising the existing direction on corporate governance and an initiative to propose amendments to the Finance Business Act (FBA) on the resolution framework of LFCs are some of the actions to be taken by the Central Bank to further strengthen the LFCs and SLCs sector. These will address the issues faced by the sector in near to medium term.

The Central Bank engaged in drafting reforms to key legislations governing the financial system. The Central Bank of Sri Lanka Bill recognizes the Central Bank as the designated macroprudential authority of Sri Lanka and will broaden its mandate to enhance and ensure a stable and efficient financial system. The new Financial System Oversight Committee, which will be established and empowered under this Bill will consist of officials from the Central Bank and other supervisory authorities and will have considerable power to make recommendations to regulators and to introduce macro-prudential regulations. Enactment of the proposed Central Bank of Sri Lanka Act is important to strengthen the framework to achieve financial system stability.

The dire need at present, is enabling financial intermediation aimed at improving the productive capacity of the country on the back of a sound financial system. While it is expected that all policy measures undertaken recently with this aim will bear fruit, the current situation has brought into light the importance of complementing micro-prudential regulation with an integrated framework of monetary, macro-prudential and fiscal policies in order to achieve higher economic growth via the intermediation of a stable and efficiently functioning financial system.

Chapter 1

Macrofinancial Conditions

1.1 Overview

The developments in the international and domestic macroeconomic environment exerted pressure on financial system stability during the year from October 2018 to September 2019. Subdued economic growth caused a slowdown in the financial intermediation function as demand for loans and willingness to lend both decelerated on the back of political and policy uncertainty in the run up to the presidential election which was further aggravated by the Easter Sunday attacks. The slowdown in credit growth was somewhat eased by strong credit demand from the state sector. Credit growth declined across all major sectors of the economy except for personal loans and advances. Decelerating consumption and falling investment demand resulted in a decline in profit generation capacity of business entities causing balance sheet vulnerabilities. These developments affected the repayment capacity of the private sector resulting in a rise in non-performing loans (NPLs). The balance sheet vulnerabilities of private business entities prompted financial institutions to lend more cautiously to these entities. Due to the aforementioned pessimistic sentiment in financial markets, direct financing raised by the corporate sector also declined. The low inflation low growth scenario motivated the Central Bank to intervene in the market to bring down lending rates through policy and regulatory measures. Financial institutions and markets in Sri Lanka continued to be significantly affected by developments in the international economy. Yields dropped and liquidity improved in the global financial markets in the latter part of 2019 with monetary policy loosening by advanced economy central banks that are faced with growth moderation and low inflation expectations in their respective economies, and portfolio flows to emerging market economies picked up as a result. There were net foreign capital outflows from the rupee denominated government securities market and the Colombo Stock Exchange (CSE) during the period under consideration, while the magnitude of outflows reduced compared to the previous year. Meanwhile, Sri Lanka was also able to successfully issue sovereign bonds twice in international financial markets in 2019. While foreign capital outflows created pressure on the exchange rate to depreciate during the period under consideration, sovereign borrowings and some Central Bank interventions and other policy actions helped manage its volatility. The slippages observed in the fiscal operations resulted in an increase in the fiscal deficit and thereby the financing requirement. The impending government external debt maturities pose a systemic risk to financial system stability. Low yields and compressed spreads in global markets has prompted increased sovereign debt issues by emerging market economies. However, risk premia faced by Sri Lanka in sovereign bond issuances did not exhibit significant reduction. Further commercial borrowing to roll over debt at this juncture must be done with utmost care as sudden unfolding of vulnerabilities may occur in global financial markets. Banks also must manage their foreign currency exposures, including lending outside Sri Lanka, with great vigilance. Dissipation of the uncertainty in the policy and political landscapes with the end of the election cycle would boost growth back to potential, allowing the government to commit to the much needed fiscal consolidation path. However, continuation of structural reforms would be essential to reach the economic potential. With the expected rebound of economic growth and a return towards the fiscal consolidation path, threats to financial system stability from macroeconomic headwinds are likely to reduce.

1.2 International Economic Environment and Financial Conditions

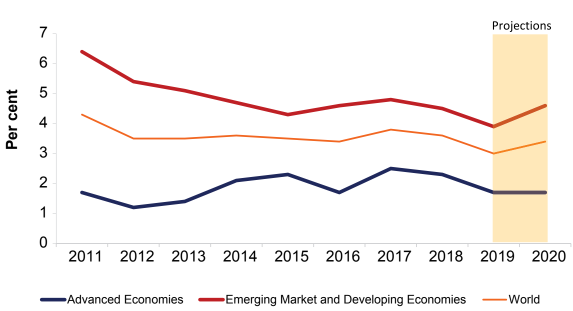
The tight conditions that marked global financial markets in late 2018 eased significantly as 2019 unfolded. Growth moderation in advanced economies and some emerging market and developing economies (EMDEs) led to monetary and macroprudential policy easing in many countries, resulting in some buoyance returning to the global financial system.

The cyclical upturn that followed the global financial crisis which was synchronized across a broad cross-section of advanced, emerging and developing economies in the last few years has begun to moderate with growth in the advanced economies returning to potential levels. The global economy started to slow down significantly since the latter part of 2018 and continued into 2019 as well. The International Monetary Fund (IMF) estimates that the global growth rate slowed from 3.6 per cent in 2018 to 3.0 per cent in 2019. This slow-down encompasses growth moderation in advanced economies and China, and weak macroeconomic outcomes of a group of key emerging market economies (EMEs) including Brazil, Mexico, India and Russia.

The slow-down in global economic activity is an outcome of a sharp reduction in global manufacturing activities as weak external demand and weak business confidence over global trade tensions led by the US-China trade war has resulted in a sharp reduction in world industrial output. Further, the slowing external demand in China, the uncertainty over the UK's withdrawal agreement from the European Union (EU), the decline in car production due to expiration of tax incentives in China, and production lines adjusting to comply with new emission standards in the Euro area (especially Germany), and slowing domestic demand in India, were among the main contributory factors to this outcome. These factors are reflected in the global purchasing managers' index which recorded a steep decline between December 2017 and July 2019 and stagnated closer to the threshold level since then, indicating that private sector sentiment is still low about the near-term business outlook.

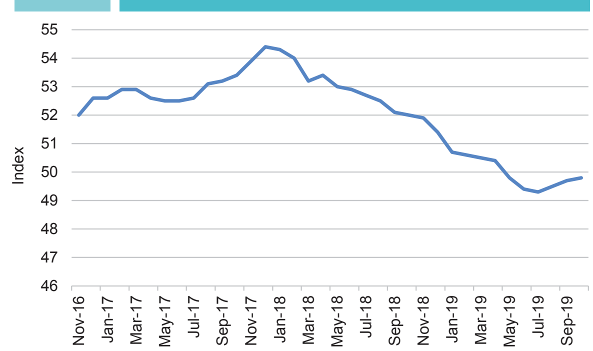
Global growth is expected to increase to 3.4 per cent in 2020 by the IMF mainly on account of a few EMEs (such as Argentina, Iran, Turkey, Venezuela) which were in distress in the recent years recovering in 2020 while growth moderates for the world's systemic economies such as the USA, Euro zone, Japan and China that also includes Sri Lanka's major export destinations. Beyond 2020, global growth for the

Chart 1.1 Global Economic Growth



Source: IMF World Economic Outlook (WEO) October 2019

Chart 1.2 Global Purchasing Managers' Index

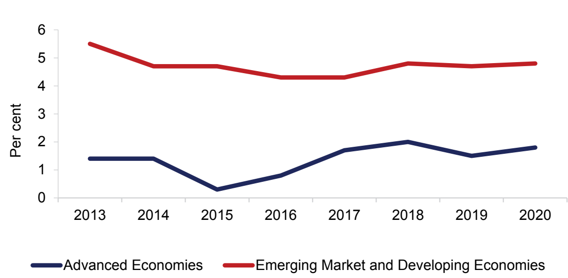


Source: Bloomberg

medium term is projected at about 3.6 per cent. Advanced economies are expected to continue into modest potential growth levels, while recovery in distressed EMDEs is predicted by the IMF in the medium term.

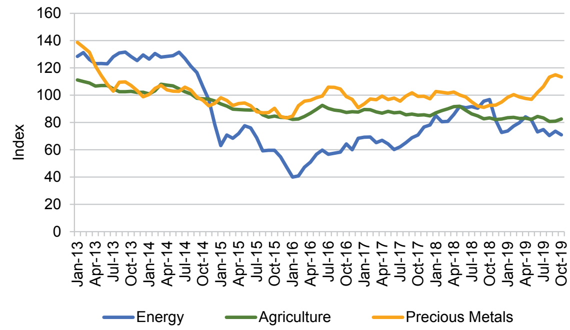
The slow-down in trade volume in 2019 as well as news on trade tensions among many countries created decisive outcomes on the global financial system through confidence and investment channels. Trade tensions were reported not only between the USA and China. Many instances of increase in tariffs, unsuccessful negotiations of trade agreements and disputes over use of technology were reported from around the world. US tariffs on European exports, trade tensions and retaliatory measures between Japan and South Korea that affected supply chains throughout Asia, India's withdrawal from the China-backed Regional Comprehensive Economic Partnership are some examples. Some countries are reported to have gained from these trade frictions as some tariff decisions led for production bases to shift to different countries and other changes to be made to supply chains. Therefore, the effects of trade tensions had differentiated impact on different countries (and their financial markets), though the culminated effect was a reduction in global trade in general in 2019. In EMDEs, impacts were evident mostly in the equity markets and exchange rates, while capital flows must also have been affected by trade outcomes. However, the IMF expects that the world trade volume will pick up in 2020, with both imports and exports by advanced as well as EMDEs recovering.

Chart 1.3 Global Inflation



Source: IMF WEO October 2019

Chart 1.4 Commodity Prices

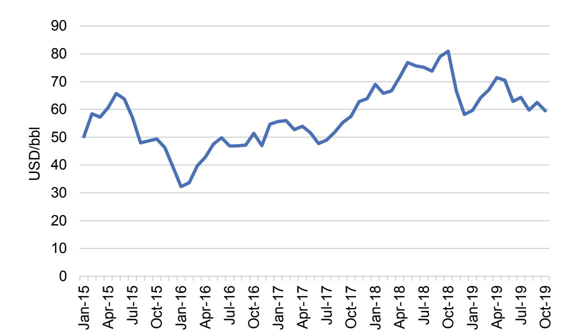


Source: The World Bank

Consumer price inflation decelerated in both advanced economies and EMEs in 2019 and is expected to rise marginally in 2020. In global commodity markets, as measured by World Bank commodity price indices, agriculture prices stagnated while prices of precious metals increased significantly in 2019.

The monthly average price of oil (Brent futures in US dollars per barrel) reached US dollars 80.93 in October 2018, which was the highest recorded since 2015, due to the supply cuts by OPEC and Russia, declining US crude stockpiles and positive momentum in financial markets. However, oil prices declined significantly after that due to record-high US oil production which served to counteract the reduction in oil production in other countries (production cuts by OPEC and Russia, strife in Venezuela and Libya and US sanctions on Iran etc). Further, the weaker economic growth prospects, especially in the EMEs, served to reduce prices of oil. The attack on refineries in Saudi Arabia on 14 September 2019 resulted in some increase in prices of oil

Chart 1.5 Brent Futures US$/bbl



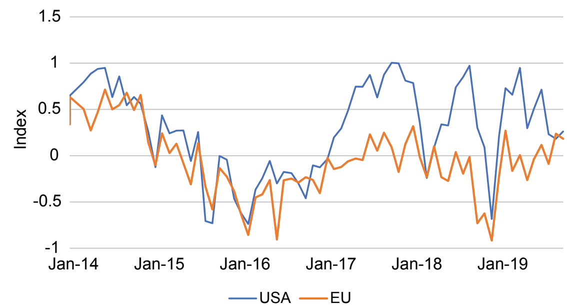
Source: Bloomberg

immediately after but prices receded quickly. OPEC and Russia agreed in July 2019 to extend their joint production cuts until March 2020 which may affect oil prices in the near future. Coal and Liquefied Natural Gas (LNG) prices also declined due to subdued industrial activity in 2019.

Central bank communications and policy actions in advanced economies, undertaken in the backdrop of the abovementioned dynamics in the global economic environment created decisive impact on global financial conditions facing small EMDEs such as Sri Lanka. Due to high growth rates and the effects of the fiscal stimulus, the Federal Reserve Board (FRB) of the USA increased interest rates in four successive steps in 2018, the last of which was in December. Other central banks also increased policy rates or kept their rates unchanged. This tight global financial condition prompted high equity sell-offs in advanced economy financial markets and considerable capital outflows from EMDEs, creating difficulties particularly for countries like Sri Lanka with twin deficits and external funding needs.

However, central banks of both advanced countries and EMDEs switched to a dovish monetary policy stance in the latter part of 2019. Faced with moderating growth projections while the effects of the fiscal stimulus began to recede and inflation numbers slid further beyond target, the Federal Reserve of the USA cut interest rates in July, September and October 2019 and ended its balance sheet reduction. The European Central Bank (ECB) too reduced its deposit rate to a record low of -0.5 per cent in September 2019 and announced bond purchases of Euro 20 billion from November 2019. Other advanced economy central banks such as Australia and New Zealand and many EMDEs, such as Brazil, Chile, India, Indonesia, Mexico, Peru, Philippines, Russia, South Africa, Thailand and Turkey, cut policy interest rates during 2019. The People's Bank of China (PBoC) too reduced its one year medium term lending facility rate that can lower funding costs of business enterprises.

Chart 1.6 Bloomberg Financial Conditions Index

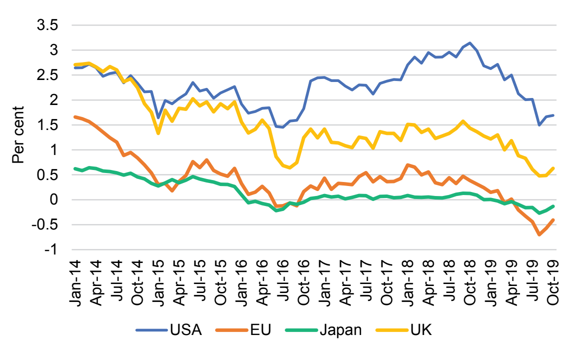


Source: Bloomberg

The relaxed monetary policy stance of the aforementioned central banks helped ease financial conditions globally. However, the sentiment in the financial markets still signify the negative developments associated with trade tensions, reduced corporate activities, the uncertainty over a "no-deal Brexit", and conflicts in geo-political hotspots. Asset prices (including equity prices) and capital flows recovered generally after the rate cuts by central banks of systemic economies, while bond yields dropped. This was reflected in the Bloomberg financial conditions indices for the USA and EU, which showed an improvement. In Asia, financial conditions have eased mainly because of reductions in external borrowing costs.

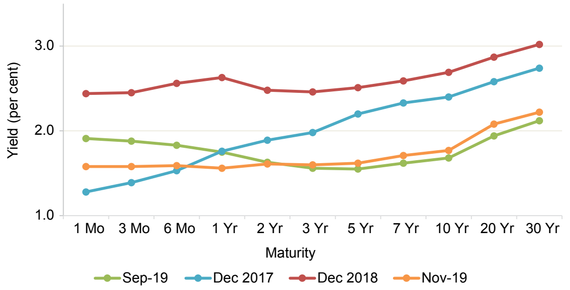
The relaxed monetary policy stance of advanced economies led to a sharp drop in their sovereign bond yields in 2019, and even stabilized into negative territory for the EU and Japan. Furthermore, yield curves have flattened substantially, and in some instances inverted, with the difference between long term and short-term yields narrowing. The IMF reports in its Global Financial Stability Report (GFSR - October 2019)

Chart 1.7 10-year Sovereign Bond Yields of Advanced Economies



Source: Bloomberg

Chart 1.8 **US Treasury Yield Curve**

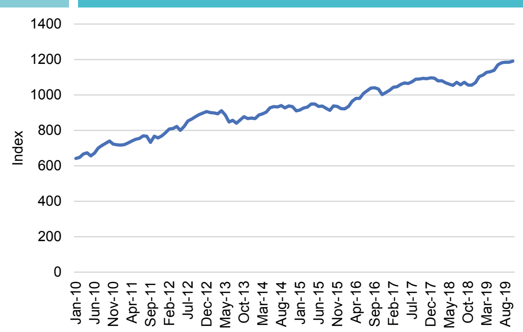


Source: Department of Treasury, USA

that the amount of bonds with negative yields has increased to about US dollars 15 trillion including more than US dollars 7 trillion in government bonds from large advanced economies, or 30 per cent of outstanding stock. The IMF estimates that about 20 per cent of sovereign bonds will have a negative yield until at least 2022.

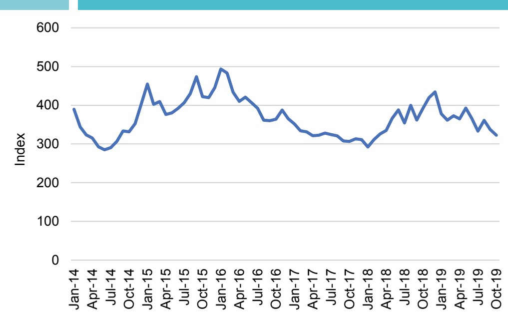
Emerging market sovereign yields declined and spreads tightened in 2019. Benchmark indices such as the Bloomberg USD sovereign bond index indicate that sovereign bond prices increased in 2019 whereas spreads of sovereign bonds issued by EMEs tightened as reflected in the EMBI Global Index.

Chart 1.9 **Bloomberg USD Emerging Sovereign Bond Index**



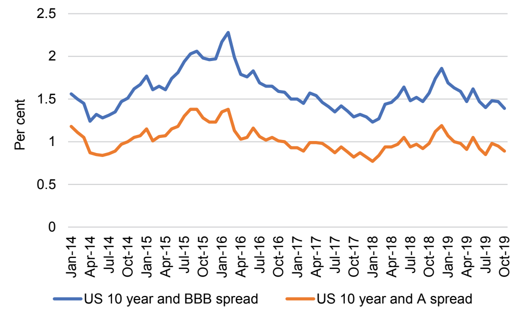
Source: Bloomberg

Chart 1.10 **JP Morgan EMBI Global Index**



Source: Bloomberg

Chart 1.11 **US Corporate Bond Spreads**

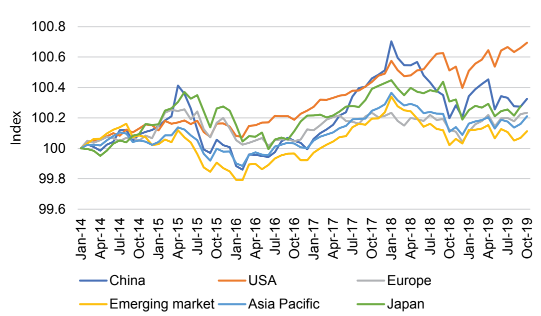


Source: Bloomberg

In credit markets such as the US corporate bond market, spreads remained generally tight in the period under consideration. A repricing of risks in corporate bond markets took place as monetary policy relaxing was signaled by advanced economy central banks. Thus, the spreads of both high yield and investment grade bonds became tighter due to investors searching for yield amid declining long-term interest rates and negative yields.

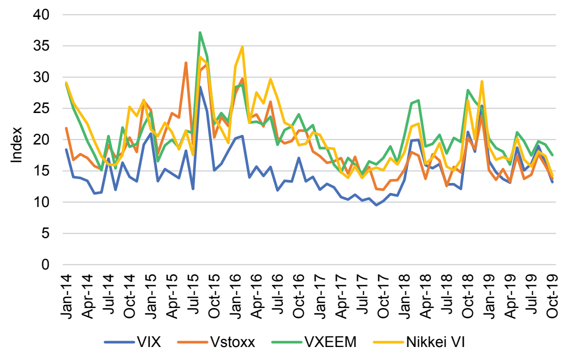
Equity market movements mirrored expectations based on global trade tensions and policy rate reductions. Advanced economy equity prices which dropped significantly with the sell offs in the latter part of 2018 recovered after policy rate cuts by major central banks. However, some industries have experienced greater growth in stock prices than others. The IT sector in the USA exhibited better stock market performance while equity prices of firms most exposed to trade tensions, such as vehicles, metals, technology, telecommunications, and transportation were sectors that were harder hit, world-over. Chinese stock markets seemed to experience larger sell-

Chart 1.12 **MSCI Share Price Indices**



Source: Bloomberg

Chart 1.13 **Behaviour of Volatility Indices**

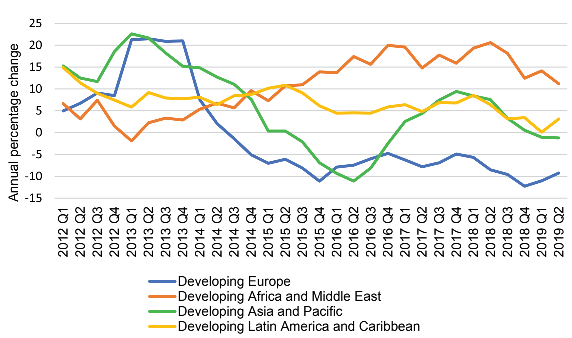


Source: Bloomberg

offs after announcement of tariffs. Though stock prices of South Korea suffered due to effects of Sino-US trade tensions in addition to trade tensions with Japan, stock prices in the ASEAN area increased notably since mid-2019 due to the effect of policy rate reductions as well as improved macroeconomic conditions in those countries. Meanwhile, movement of nominal exchange rates of these countries moved with stock price movements to some extent. US, EU and Japanese stock prices fluctuated somewhat significantly due to factors such as trade tensions, political uncertainty in Europe and other developments, though volatility was low compared to earlier months of 2018 after expectations on policy rate changes crystallized and production bases sought long term solutions for stable business activities.

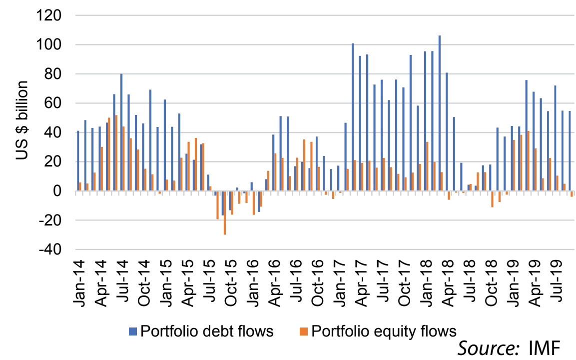
Global liquidity improved in 2019 with foreign currency credit flows to non-bank borrowers improving globally, according to the Global Liquidity Indicators compiled by the Bank for International Settlements (BIS). US dollar credit

Chart 1.14 **Growth in Foreign Currency Credit to EMDEs**



Source: BIS

Chart 1.15 **Portfolio Flows to EMDEs**

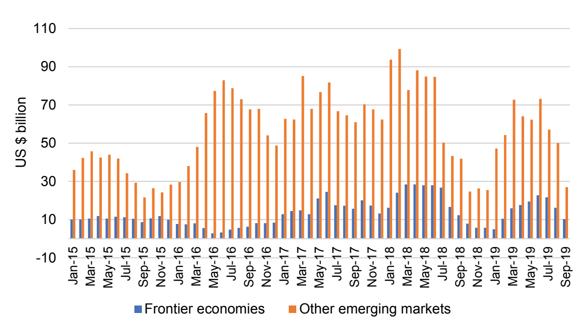


Source: IMF

to non-bank borrowers outside the USA grew by 4 per cent year on year at end-June 2019. Foreign currency credit denominated in Euros and Japanese yen expanded at a faster pace than that in US dollars, growing at annual rates of 9 per cent and 8 per cent, respectively. The annual growth rate of US dollar credit to residents of developing Asia and the Pacific were -1.1 per cent and -1.2 per cent in first quarter and second quarter of 2019 mainly owing to reduction in credit to China. However, India and South East Asian countries received considerable inflows of both bank loans and debt securities.

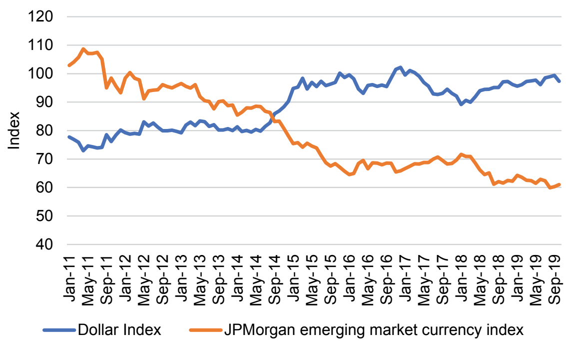
The easing in financial conditions in advanced economies and the improvement in risk appetite supported a rebound in portfolio flows to emerging markets. In particular, debt flows have rebounded. As a result of increase in such capital flows, sovereign bond issuance by EMDEs have picked up. The IMF estimates that in the last 5 years, outstanding hard-currency debt of frontier markets tripled to reach more than US dollars 200 billion as of mid-2019. However,

Chart 1.16 **Sovereign Bond Issuance by EMEs**



Source: IMF

Chart 1.17 US Dollar Index and Emerging Market Currency Index



Source: Bloomberg

investors differentiated across economies based on the rate of return and economic and political fundamentals.

Along with all above developments in the global real sector and trade and portfolio flows, notable movements in currencies were observed. The US dollar appreciated in 2019 in real effective terms along with the Swiss franc and the Japanese yen. Meanwhile, the British pound, Euro and the Renminbi depreciated. The appreciation of the dollar index and the depreciation of the emerging market currency index was almost symmetric earlier on during the period under consideration, though the emerging market currency index showed a tendency to appreciate after monetary policy relaxation in the advanced economies.

The current easy financial conditions could fuel vulnerabilities in the global financial system, putting EMDEs with high foreign currency borrowing at risk in the event of a sudden unraveling of vulnerabilities. There is already evidence that very low interest rates in the advanced economies have prompted investors to search for yield and take on riskier and more illiquid assets. This can lead to an accumulation of exposures that may amplify shocks during market stress or during the next downturn. A number of events could trigger a sharp tightening in financial conditions at the current juncture, including an intensification of trade tensions, a faster than expected slowdown in global growth, a sudden market reassessment of the outlook for monetary policy where there is a gap between market expectations and central bank communications, intensification of geo-political conflicts in global hotspots, etc. Further, a "no-deal Brexit" and the discontinuation of the London Inter Bank Offered Rate (LIBOR) are two factors that may create some impact on global financial system stability.

The UK is set to leave the European Union on 31 January 2020. Financial markets are uncertain whether the exit by the UK without a withdrawal agreement may create adverse repercussions on financial system stability in the region, spilling over to the rest of the world, by reducing the ease of accessing UK investment banks for clients in the EU region and for UK investment banks to service existing cross-border contracts. Meanwhile, the uncertainty over the ability of financial sector regulators and/or markets to develop a credible alternative to the LIBOR which is to be discontinued in December 2021 has also cast some shadow on global financial system stability. Despite all the issues of the LIBOR that had been revealed, a considerable number of financial contracts still use the LIBOR as a reference rate.

Capital flows to EMEs that have been spurred by low interest rates in advanced economies have prompted additional borrowing by EMDEs. As a result, external debt as a percentage of exports has increased for all EMDEs in general. In the event of a sharp tightening in global financial markets, increased borrowing can raise rollover and debt sustainability risks for countries with twin deficits that have borrowed heavily in foreign currency.

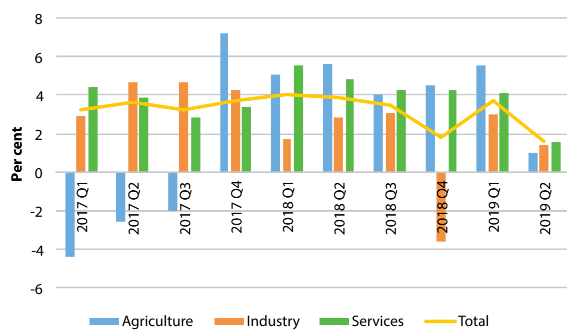
In this global context, management and lowering of exposure to the global financial market through foreign currency and local currency sovereign debt is critical to maintain the stability of Sri Lanka's financial system. When global interest rates increase and foreign capital flows out, the resulting currency depreciation and possible increase in interest rates together will exert pressure on foreign currency debt servicing ability in the future. Meanwhile, Sri Lankan banks need to actively monitor and manage their foreign currency liquidity risks as they expand their foreign currency denominated asset portfolios. Since Sri Lanka's banks have increasingly lent in foreign currencies to both residents and non-residents while borrowing from foreign sources, banks should be wary of an abrupt tightening of global financial conditions which can accentuate foreign currency liquidity risks in the domestic banking system. Meanwhile, Sri Lanka's ability to attract foreign capital to the stock market, local currency bond markets and foreign direct investment, taking advantage of the easy global financial conditions and heightened capital mobility, would depend on and how attractive Sri Lanka's macroeconomic fundamentals and doing business conditions are, relative to competitor economies.

1.3 Domestic Developments

Several macroeconomic developments exerted pressure on financial system stability during the year from October 2018 to September 2019.

Economic growth was subdued as uncertainty regarding the political and policy landscape, which commenced with the constitutional crisis in the fourth quarter of 2018, continued into 2019 in the run up to presidential elections. The economic growth moderated to 2.6 per cent during the first six months of 2019 compared to the growth of 3.9 per cent recorded in the first six months of 2018. First quarter growth which was 3.7 per cent year-on-year decelerated to 1.6 per cent year-on-year by the end of the second quarter of 2019, mainly due to the impact of the Easter Sunday attacks, weighing on the economic growth of the first half.

Chart 1.19 Quarterly Sectoral GDP Growth (Year-on-Year)

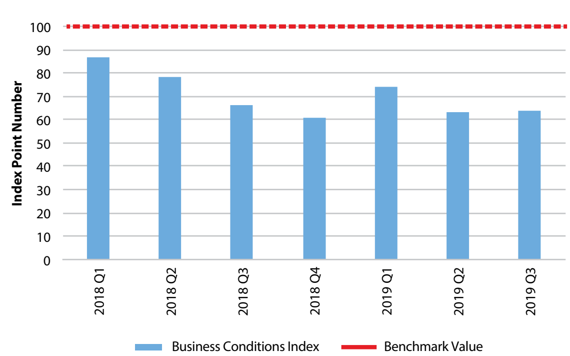


Source: Department of Census and Statistics

The deceleration in growth during the second quarter was observed mainly in tourism related industries, as they were negatively affected by the Easter Sunday attacks, and agriculture, forestry and fishing activities. The Business Conditions Index demonstrated that growing uncertainty dampened growth opportunities for businesses as the balance of opinion remained below the 100 benchmark within negative territory during the third quarter of 2019. Growth in final consumption expenditure remained subdued during the second quarter at 0.6 per cent year -on-year while gross capital formation contracted by 8.9 per cent year-on-year reflecting the low uptake of investment opportunities and relatively low consumption demand to pull growth.

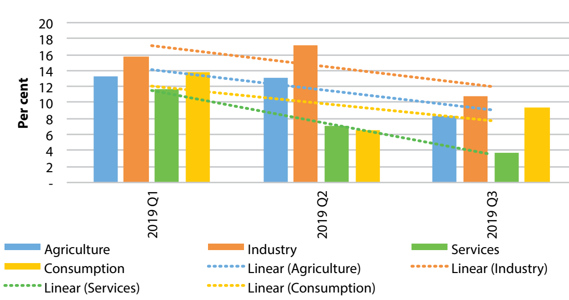
Subdued economic growth resulted in a lower credit growth across all major sectors of the economy except personal loans and advances with the credit extended towards the services sector (inclusive of tourism, transportation and

Chart 1.18 Business Conditions



Source: Central Bank of Sri Lanka

Chart 1.20 Trends in Sector-wise Year-on-Year Credit Growth of the Banking Sector



Source: Central Bank of Sri Lanka

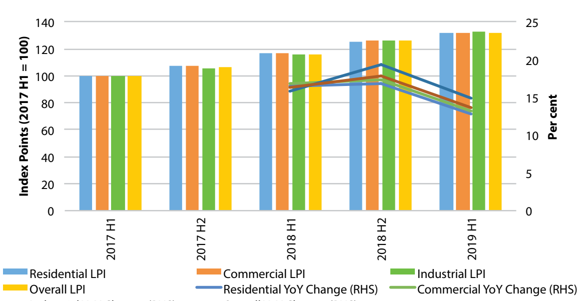
storage, wholesale/retail trade and information technology related services) showing the greatest amount of deterioration.

The construction activities, which is the second largest sector to which the banking system is exposed, contributed 7.4 per cent to Gross Domestic Product (GDP). The construction activities gathered some momentum during the first six months of 2019 recording 4.7 per cent growth compared to the contraction of 0.8 per cent recorded in the first six months of 2018. Banking sector total loan exposure to the construction sector remained at 15.4 per cent as at September 2019. Meanwhile, the construction sector exposure of the Licensed Finance Companies (LFCs) grew to 4.1 per cent as at September 2019 compared to the 3.8 per cent recorded during September 2018. However, the NPLs of the construction sector towards both the bank and LFCs increased to 6.0 per cent and 12.5 per cent, respectively, compared to the 3.8 per cent and 11.6 per cent recorded as at end September 2018.

The subdued economic conditions resulted in a moderate increase in land prices as reflected in the Colombo Land Price Index which grew by 13.6 per cent year-on-year during the first half of 2019 compared to the 16.3 per cent growth recorded during the first half of 2018. The lower growth rate stemmed from moderate performance in all three sub-indices.

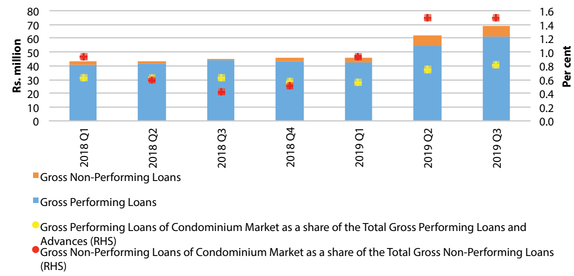
Real estate including development of condominiums accounted for only 0.7 per cent of total loans and 4.8 per cent of the construction

Chart 1.21 **Land Price Index for the Colombo District**



Source: Central Bank of Sri Lanka

Chart 1.22 **Exposure of the Banking Sector to the Condominium Market**



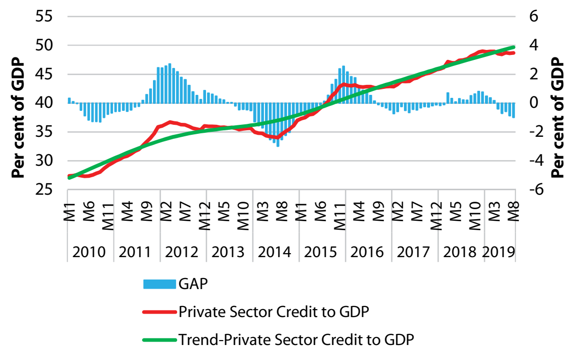
Source: Central Bank of Sri Lanka

sector loans of the banking sector as at end September 2019. Further, loans granted for the purchase of condominiums accounted for only 0.1 per cent and 0.7 per cent of total loans and construction loans of the banking sector respectively. While the rising NPLs of the condominium market is a cause of concern, the financial system is expected to remain resilient against negative spillovers from the condominium developer category due to the low exposure of the financial system to this sector. It is expected that the imposition of a Capital Gains Tax in April 2018, which was a fiscal led macroprudential measure, would arrest some of the speculative demand in the condominium sector, if any. The recent reduction in income tax rates for the construction industry and the reduction of VAT and removal of NBT are expected to provide a boost to the construction sector. However, the Central Bank remains vigilant regarding real estate sector developments to manage the banking sector exposure to the sector.

The stagnation of economic activity was associated with a decline in the financial intermediation function of the banking system. The private sector credit to GDP ratio fell below the long-term trend reflecting the loss of business confidence due to lower economic performance, policy uncertainty in the run up to the presidential election and negative sentiment caused by the Easter Sunday attacks which weighed on the credit growth of the economy.

Credit to the private sector moderated during the first nine months of 2019, mainly due to high market lending rates, subdued economic activity,

Chart 1.23 Private Sector Credit to GDP

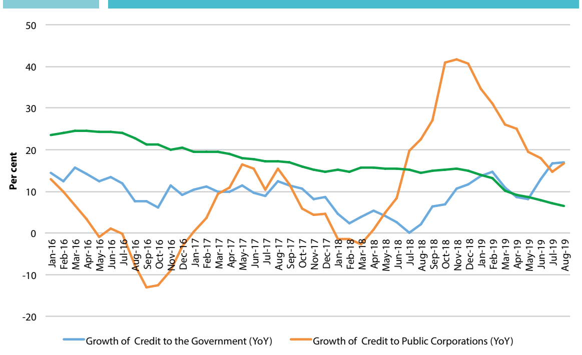


Source: Central Bank of Sri Lanka

and fiscal and regulatory actions taken by the Government of Sri Lanka (GoSL) and the Central Bank to contain macroeconomic imbalances observed in 2018. Accordingly, growth in credit to the private sector decelerated to 6.1 per cent by end September 2019 compared to the year-on-year growth of 15.9 per cent recorded at end 2018. Meanwhile credit to the public sector expanded during the period under review albeit at a slower pace compared to the corresponding period of 2018, easing the overall deceleration in credit growth. Financial institutions were more cautious in lending and the demand for credit deteriorated with the prevailing high market lending rates and subdued business opportunities in a sluggish economy. As per the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector, credit decelerated in all sectors except Personal Loans and Advances during the first half of 2019.

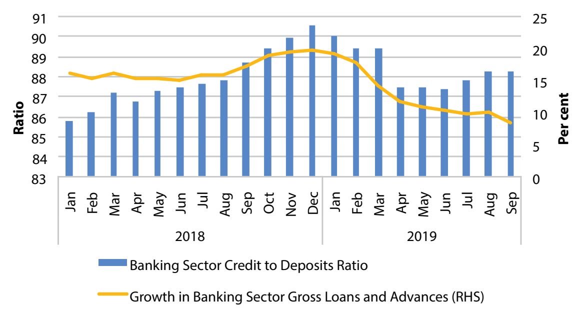
Loans and advances of the banking sector grew by 2.1 per cent during the first nine months of 2019 compared to the 13 per cent recorded in

Chart 1.24 Credit Growth Rates by Category



Source: Central Bank of Sri Lanka

Chart 1.25 Credit to Deposit Ratios and Credit Growth of the Banking Sector



Source: Central Bank of Sri Lanka

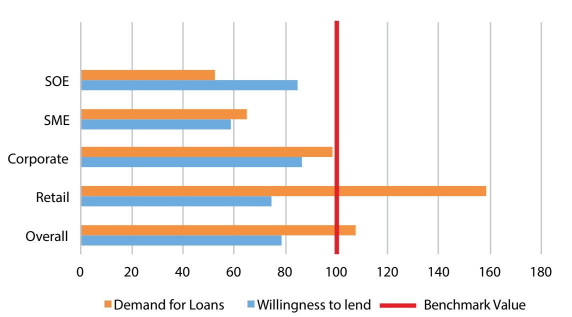
the first three quarters of 2018. The impact of the credit slowdown seen within the financial system majorly affected the LFC and Specialized Leasing Companies (SLCs) sector as their loans and advances contracted. Growth of net loans and advances of the LFC and SLC sector contracted recording a negative growth of 2.2 per cent during the first nine months of 2019 compared to the growth of 6.9 per cent recorded in the corresponding period of the previous year. The credit to total deposits ratio, which indicates the stable sourcing of lending activities of banks, declined to 88.2 in the banking sector while it declined to 156.9 in the LFC and SLCs as at end September 2019 compared to the 88.7 and 164.5 recorded as at September 2018 respectively. Banks shifted much of their excess funds towards investing in Treasury Bills and Treasury Bonds during the period under consideration as they adopted increasingly cautious lending practices and the demand for credit declined due to low business opportunities given the dampened economic climate.

The impact of the slowdown in growth and the dampening demand for consumption and investment was felt by the corporate sector during the first half of 2019. The corporate sector risk assessment which is conducted using a sample of non-financial corporates listed in the stock exchange revealed weak performance of listed corporates during the second quarter of 2019. The dampening business and demand conditions hampered growth in the non-financial corporate sector as revenue contracted by 1.7 per cent during the second quarter of 2019. Following this trend, corporate net profits also contracted by 12 per cent. Accordingly, the solvency ratio of the non-financial corporate sector deteriorated during the second quarter.

The Survey on Credit Supply for the third quarter of 2019 also reflected these developments as willingness to lend declined markedly on all lending categories in the economy. Balance sheet vulnerabilities of the corporate sector prompted the financial system to engage in more cautious lending to corporates in a rising NPL backdrop. Small and Medium Enterprises (SMEs) were hard hit and suffered from lower access to credit. Further, the findings revealed that the number of rejected loan applications toward the SME and retail sectors have also increased notably during the third quarter. NPLs increased notably in the SME and retail categories during the second quarter, while a higher increase in NPLs from the corporate sector was seen during the third quarter.

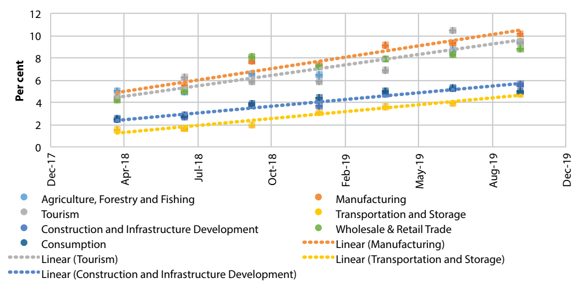
The low credit growth, consumption and investment together with further stagnating economic activity resulted in higher NPLs of the financial system. The stagnation in economic activity resulted in a lowering of household income levels and higher NPLs were observed in loans taken for consumption purposes by households as well. The asset quality of the financial system declined as the NPLs of both sectors grew. The banking sector recorded an increase in gross NPL ratio from 3.4 per cent in December 2018 to 4.9 per cent in September 2019. The gross NPL ratio of the LFC and SLCs increased to 9.7 per cent as at end September 2019 compared to the 7.7 per cent recorded as at end 2018.

Chart 1.26 Demand for Loans and Willingness to Lend



Source: Central Bank of Sri Lanka

Chart 1.27 Sector-wise Non Performing Loans of the Banking Sector and Linear Trend



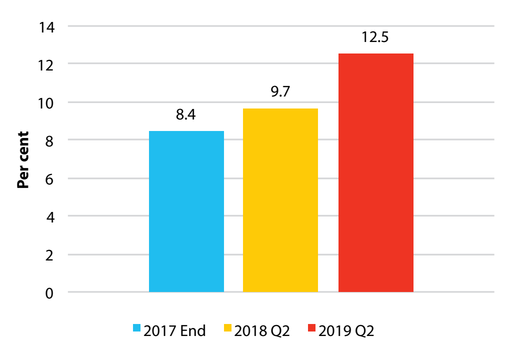
Source: Central Bank of Sri Lanka

Of the total formal financial sector lending[1], 56.2 per cent has been lent towards the non-household sector (corporate and government) as at end June 2019 whilst 43.8 percent of lending has been directed towards households. It is concerning to note that while the total debt directed towards households sector and non-household sectors grew year-on-year by 7.7 per cent and 14.6 per cent respectively, non-performing advances pertinent to the household sector recorded a 39.7 per cent year-on-year increase in June 2019.

However, the financial system is expected to remain resilient despite deterioration of asset quality as the higher capital requirements and proactively stringent loan loss provisioning that were met by the financial sector has resulted in a build-up of adequate cushions within the system.

Direct financing for business activities also reduced during 2019. A total of Rs. 7.1 billion was

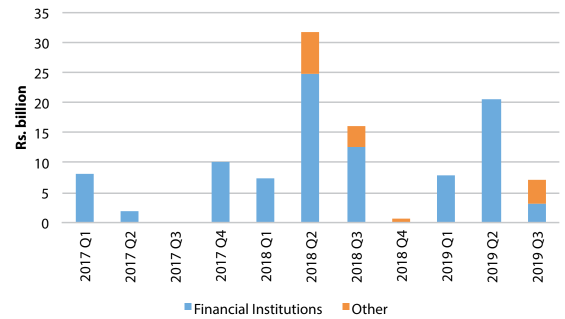
Chart 1.28 NPL Ratio of the Household Sector (with IIS)



Source: Central Bank of Sri Lanka

1 Formal financial sector lending includes lending by licensed banks, licensed finance companies and specialized leasing companies

Chart 1.29 **Amounts Raised via Debenture Issues at the CSE**



Source: Colombo Stock Exchange

raised via debenture issues at the CSE during the third quarter of 2019 which is a contraction of 55.7 per cent compared to the Rs. 16 billion raised during the third quarter of 2018[2].

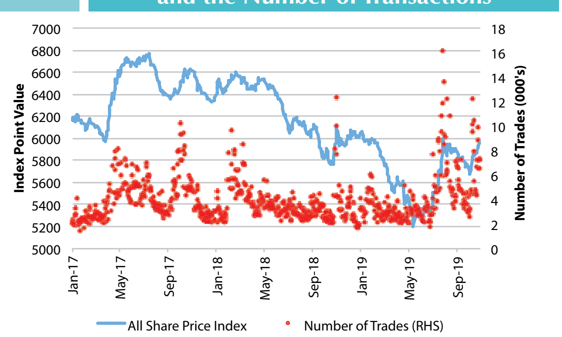
The subdued economic activity and the lack of investor confidence created by policy and political uncertainty resulted in dismal stock market performance as the All Share Price Index (ASPI) of the CSE recorded declines. The Easter Sunday attacks further aggravated prevailing negative sentiment resulting in a fall of ASPI to the lowest level in more than 3 years in mid-May 2019. However, there was an uptick in the ASPI since July 2019 as domestic investors purchased stocks in a dull market situation with expectations of higher stock prices in the coming months.

The Central Bank maintained a neutral monetary policy stance since April 2018 and reduced the Statutory Reserve Ratio (SRR) by a total of 2.50 percentage points in November 2018 and March 2019 to address a large and persistent liquidity deficit in the domestic money market observed since mid-September 2018. The lower than expected economic growth and rising NPLs of the bank, LFC and SLC sectors pointed toward the need for policy stimulus to improve business conditions. With the view of reducing cost of funds of financial institutions to lower the interest rates on deposit and lending products the Central Bank imposed caps on deposit interest rates with effect from 26 April 2019. Muted inflation and inflation outlook, decelerating private sector credit growth, high nominal and real interest rates and global monetary policy easing combined with the lack of fiscal policy space prompted the Central Bank to respond to the need for stimulus further by adopting an increasingly accommodative monetary policy stance through reducing the policy interest rates by a total of 100 basis points in May and August 2019.

However, the market lending rates remained downward rigid despite introduction of the deposit rate cap, reduction in policy rates, moral suasion and the continuous market guidance regarding the loosened policy stance. In this backdrop real interest rates remained at high levels exerting further contractionary pressures on growth which was a cause for concern in the prevailing low growth low inflation environment. Therefore, the Central Bank took action to introduce a lending rate cap on all rupee denominated loans and advances in September 2019 while the deposit rate cap on licensed banks was removed. It is anticipated that the interest rate structure resulting from these policy measures would provide strong tailwinds for growth once political uncertainties are resolved with the end of the election cycle. The lending rate restrictions are to be reviewed in March 2020.

Sri Lanka's external sector reflected strong performance during the first nine months of 2019. The cumulative trade deficit over the period January to September 2019 declined to US dollars 5,613 million compared to the deficit of US dollars 7,953 million recorded during the corresponding period of 2018. The reduction in imports observed during the first three quarters was achieved

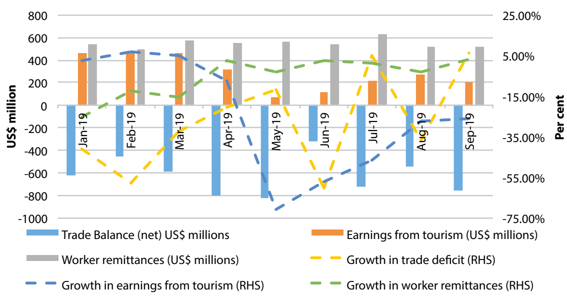
Chart 1.30 **Movements of the All Share Price Index and the Number of Transactions**



Source: Colombo Stock Exchange

2 Issuance of debentures at the primary market was high in 2018 compared to 2017 mainly due to issuance of debentures by banks to meet regulatory capital requirements.

Chart 1.31 **Trade Balance, Worker Remittances and Earnings from Tourism**



Source: Central Bank of Sri Lanka

through proactive measures taken by the Central Bank and the GoSL to reduce imports during 2018 including margin deposit requirements for letters of credit opened for import of personal motor vehicles and non-essential consumer goods imports, temporary suspension to opening of LCs for vehicles imported under concessionary vehicle permits, imposition of customs duty on gold imports and upward adjustment of duties for motor vehicle imports.

The Current Account recorded a marginal deficit in the first half of 2019 due to the reduction of earnings from tourism following the Easter Sunday Attacks and the moderation of workers' remittances. The financial account recorded a large inflow through successful issuance of International Sovereign Bonds (ISBs) amounting to US dollars 4.4 billion, while the government repaid two previously issued ISBs amount to US dollars 1.5 billion during the first half of 2019. Further, following the successful completion of the sixth review, Sri Lanka received the seventh tranche of the International Monetary Fund's Extended Fund Facility (IMF-EFF) in November 2019 strengthening market confidence.

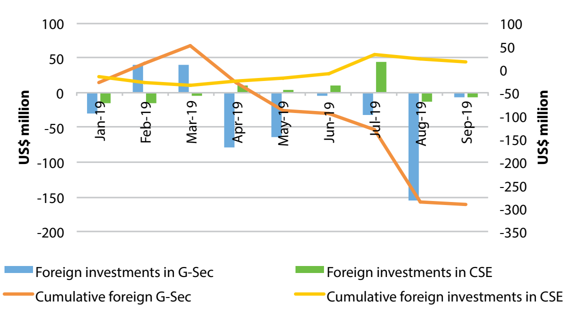
However, other flows to the financial account remained subdued owing to lower than expected foreign direct investments and foreign investments in the CSE. As of end September 2019 the Government Securities market recorded a cumulative net outflow of US dollars 291 million from foreign investors while the CSE recorded cumulative a net inflow of US dollars 15 million.

Gross official reserves grew to US dollars 7.6 billion which was equivalent to 4.6 months of imports by end September 2019. The total foreign assets which consists of both the gross official reserves and the foreign assets of the banking sector grew to US dollars 10.4 billion as at end September 2019 covering 6.2 months of imports.

There were several positive developments in the external front during the period including the improvement in the quality of reserves and the increase in the short term liability coverage. In addition, reserves were accumulated through non-debt creating sources as well.

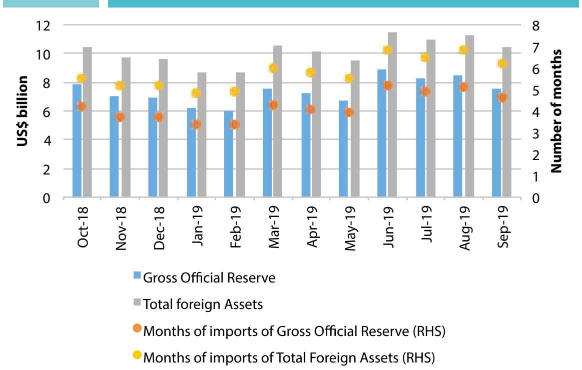
The market based exchange rate policies followed by the Central Bank, buildup of confidence with the ISB issuances and the benign market conditions created by a expansionary monetary policy stance of advanced economies reduced the pressure on the rupee. However, the gains experienced by the currency during the first four months of 2019 reversed marginally following

Chart 1.32 **Foreign Investments in CSE and Government Securities Market**



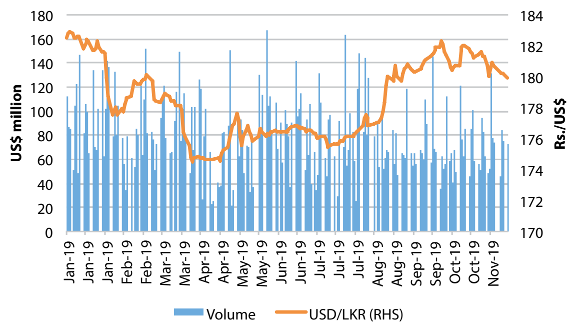
Source: Central Bank of Sri Lanka

Chart 1.33 **Reserve Adequacy**



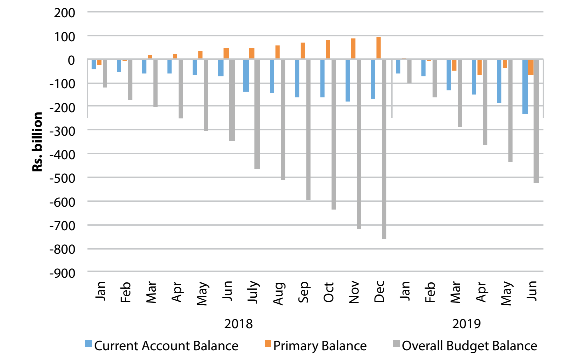
Source: Central Bank of Sri Lanka

Chart 1.34 Exchange Rate Movements and Trading Volumes



Source: Central Bank of Sri Lanka

Chart 1.35 Major Fiscal Balances



Source: Ministry of Finance

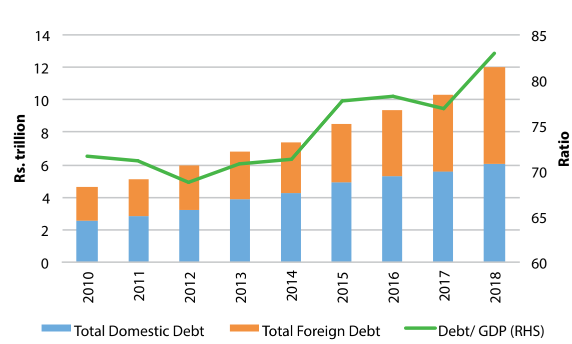
the Easter Sunday attacks and roll back of certain measures to curtail imports such as withdrawal of the suspension placed on opening of letters of credit for vehicles imported under the concessionary permit scheme. Despite the moderate pressure seen during the third quarter, the Central Bank was a net buyer in the domestic foreign exchange market and purchased US dollars 302.8 million from the domestic foreign exchange market on a net basis during the first ten months of 2019. With these developments the rupee appreciated marginally by 1.2 per cent by the first week of November 2019.

The fiscal sector of the economy underperformed during the first seven months of 2019 as both revenue and expenditure deviated from targeted levels. The primary balance, which records the current budgetary operations, recorded a deficit of 0.8 per cent of estimated GDP during the first seven months of 2019 compared to the surplus of 0.3 per cent of GDP in the first seven months of 2018. The current account balance, which reflects the difference between current expenditure and revenue, deviated from target and recorded a deficit of 2 per cent of estimated GDP during the first seven months of 2019 compared to the deficit of 1 per cent of GDP recorded during the same period of 2018. Accordingly, the budget deficit for the first seven months of 2019 amounted to 4.4 per cent of estimated GDP compared to the budget deficit of 3.2 per cent of GDP during the corresponding period 2018. The central government debt stock, which stood at Rs. 11,977.5 billion at end 2018 expanded by Rs. 668.4 billion to Rs. 12,645.9 billion as at end July 2019. The central government debt-to-GDP ratio amounted to 82.9 per cent as at end 2018 which is considerably higher than that of similarly rated peers.

Funding fiscal deficits lead to the buildup of both foreign and domestic debt which increases the vulnerability of the economy and the financial system.

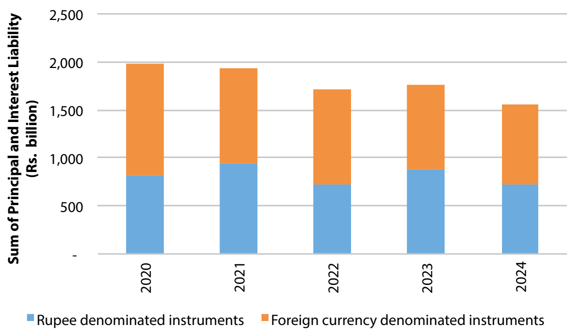
The budget deficit was financed largely through domestic sources during the first seven months of 2019. Net domestic financing during this period amounted to Rs. 571.4 billion compared to Rupees 187.6 billion recorded in the same period in 2018. Prevalence of high market liquidity, streamlined primary auctions system, accommodative monetary policy stance, muted inflation expectations and the marked preference of financial institutions to invest in government bills and bonds following loosened monetary policy and sluggish demand for credit prompted a lowering of yield rates despite higher deficit

Chart 1.36 Total Outstanding Domestic and Foreign Debt



Source: Central Bank of Sri Lanka

Chart 1.37 **Estimated Total Domestic and Foreign Debt Servicing Liabilities on the Debt Stock as at end September 2019**



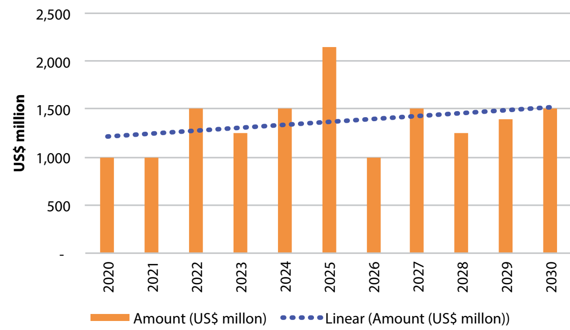
Source: Central Bank of Sri Lanka

financing from domestic sources. Accordingly, during the year up to end September 2019 primary market yields on 91-day, 182-day and 364-day Treasury Bills decreased by 239, 224 and 279 basis points.

Net foreign financing declined during the first seven months of 2019 to Rs. 112.7 billion compared to the Rs. 274.1 billion recorded during the same period of 2018. Net foreign financing comprised of net borrowings of Rs. 219.7 billion of ISBs and Rs. 0.2 billion of foreign investments in Treasury bills, and net repayments of Rs. 83.5 billion of Foreign Currency Term Financing Facility (FCTFF), Rs. 5.4 billion of foreign project loans and Rs. 18.3 billion of foreign investments in Treasury bonds.

Impending government external debt maturities pose a systemic risk to financial system stability. Financing the repayments of upcoming external debt maturities will require continuous issuances of debt securities in the international capital market or need to be partly financed by non-debt creating inflows over the period 2020 to 2025. If such financing is achieved through ISB issuances, it would expose the economy to sovereign risk in addition to exchange rate risk. Bunching up of ISB maturities have raised concerns regarding risks to debt refinancing, rollover and sustainability. Continuous refinancing of external debt amid developments in the international markets and exposure to rating agencies poses risks to the fiscal and external sectors while pressurizing

Chart 1.38 **ISB Maturity Profile as at end September 2019**



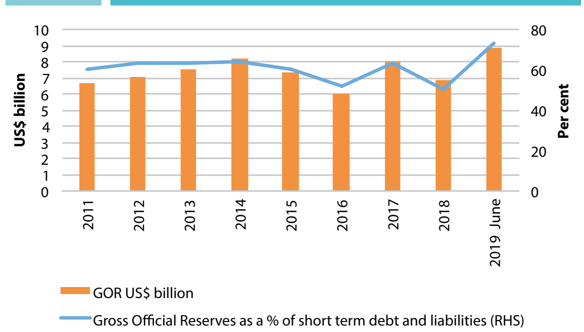
Source: Central Bank of Sri Lanka

the exchange rate. Recently observed fiscal slippages, if not addressed with the end of the election cycle, would increase the sovereign risk and become a further threat to financial system stability.

The GoSL has maintained its unblemished record of servicing public debt obligations during the period under review. While oncoming maturities raise concerns regarding the ability of foreign reserves to meet the short term debt obligations it must be noted that gross reserves as a percentage of external short term debt liabilities (which is an indicator of the sovereign repayment capacity) has risen to 73 per cent as at end June 2019.

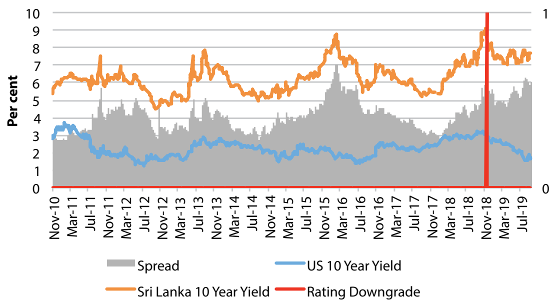
However, debt overhang results in a higher risk premium when raising funds in the international market for both the government and private sectors. Further, rising external debt exposes the financial markets to external sentiment and volatility of capital flows.

Chart 1.39 **Gross Reserves as a Percentage of Short Term Debt Liabilities**



Source: Central Bank of Sri Lanka

Chart 1.40 Assumed Risk Premiums on 10 Year International Sovereign Bonds[3]



Sources: Central Bank of Sri Lanka
Bloomberg

A rising risk premium indicates a greater exposure to sovereign risk and vulnerability to systemic imbalances. The sovereign risk was further amplified by the downgrade of Sri Lanka's sovereign rating by both Fitch Ratings and Standard and Poor's (S&P Global Ratings) from 'B+' (Stable) to 'B' (Stable) as a result of the constitutional crisis faced in end 2018 despite an array of measures taken to minimize the potential impact on the economy including the Active Liability Management initiative and creation of a buffer fund for repayment of ISB maturities.

The Parliament approved the Active Liability Management Act No 8 of 2018 (ALMA), in March 2018 and passed the resolution to raise Rupees 310 billion by way of loans in or outside of Sri Lanka. Furthermore, a resolution was passed by the Parliament in July 2019 to raise up to Rupees 480 billion for liability management purposes under the ALMA. This will enable the government to proactively address part of the refinancing requirements ahead of time (thus reducing rollover peaks) and extend the maturity duration and/or smoothen repayments structure of ISBs and other debt maturities.

The Central Bank is actively engaged in liability management to minimize the realization of foreseen risks. In general, liability management will help the government to diversify the investor base, provide opportunities to streamline the cost of borrowing based on market conditions, extend the duration of the liability portfolio, reduce refinancing risk in the near term and create a favorable price tension for any new issuances. The Central Bank has also initiated raising funds and building required buffers in the domestic market by executing its first liability management based Treasury bond issuance amounting to Rs. 15 billion in October 2019. Another round of liability management based Treasury bond offerings is proposed in December 2019 to facilitate meeting future debt related liabilities and to smoothen the debt structure. Further, in the external market, opportunities to raise funds from alternative bond markets including the "Samurai" bond market is initiated with the aim of diversifying the international capital market issuance base and building up the required buffers. The Medium Term Debt Management Strategy of the Central Bank for the period 2019-2023 was published during 2019.

The financial system evolved during 2019 facing these macroeconomic headwinds. Continuation of the IMF-EFF rebuilt investor confidence regarding the continued passage of fiscal reforms and the passing of the ALMA of 2018 allowed for active debt management, would support the resilience of the economy. Going forward, the proposed Central Bank of Sri Lanka Act is expected to ensure monetary policy independence from fiscal developments, thereby supporting the Central Bank to anchor inflation expectations and commit towards flexible inflation targeting framework. Further, it is expected that the new Act will designate the Central Bank as the macroprudential authority of the country. This would permit the development of a comprehensive financial system surveillance framework and expedite financial system stability through harmonized macroprudential measures, monetary and fiscal policies. Economic growth is likely to rebound on the back of these developments, reducing the pressure on financial

3. Sri Lanka's assumed country risk premium based on the difference between ten year US Treasury yields and the ten year Sri Lankan ISB yields.

system vulnerabilities. However, risks stemming from the fiscal sector remain material for financial system stability. Recent fiscal stimulus targeting the private sector is expected to stimulate growth in the short term. However, slowdown in fiscal and structural reform efforts would result in widening of risk premia exposing the financial system to considerable risks if prudent measures are not implemented to ensure continued commitment to the fiscal consolidation path.

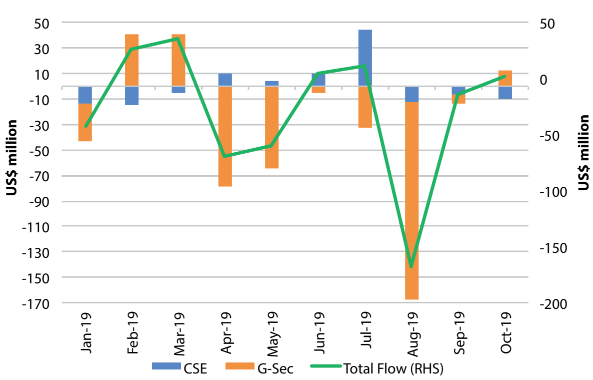
Chapter 2

Financial Markets

2.1 Overview

Financial markets of Sri Lanka were resilient amidst numerous challenges such as subdued economic activities, subpar performance of corporate sector, political uncertainty, deteriorated investor confidence which was intensified with security concerns caused by the Easter Sunday attacks, and the significant depreciation of the rupee against major currencies during the second half of 2018. Most of these adverse conditions which were triggered during the first half of 2018 exacerbated in the latter part of 2018 and continued into 2019. Despite favorable global liquidity conditions, subsequent to easing of tight financial conditions in early 2019 the Sri Lankan financial market was unable to re-attract foreign investments due to adverse country specific developments. As a result, the equity and government securities markets recorded a total net outflow of US dollars 274 million during the first ten months of 2019. However, net outflows were relatively low compared to total outflows of US dollars 639 million recorded during the first ten months of 2018.

Chart 2.1 Net Foreign Flows in Equity and Government Securities Market



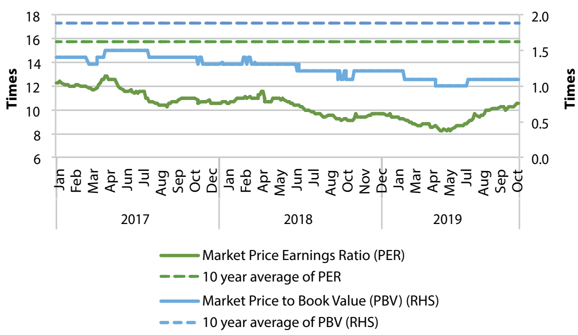
Sources: Central Bank of Sri Lanka
Colombo Stock Exchange

Sluggish performance was observed in the CSE as reflected by the decrease in both ASPI and S&P Sri Lanka 20 indices by 1.0 per cent and 4.9 per cent respectively during the first ten months of 2019. Further, key indicators such as market capitalization and average daily turnover also declined during the period under review. On a positive note, the total Treasury bond market expanded with a strong investment appetite from domestic investors. Further, the yield curve shifted downwards enabling investors to record a mark to market gain. Nevertheless, foreign investors withdrew their investments from the Government securities markets which resulted in a net outflow of US dollar 280 million during the first ten months of 2019. Despite the downward shifting Treasury bond yield curve, the corporate bond yield curve shifted upwards at the primary issuance market mainly due to the high expectation of risk premium by investors. With regard to the forex market, depreciation pressure observed during the second half of 2018 eased during 2019 and rupee appreciated by 1.2 per cent by the first week of November 2019 from end 2018. Liquidity in the domestic money market was volatile and recorded a deficit position in general during the period under review.

2.2 Equity Market

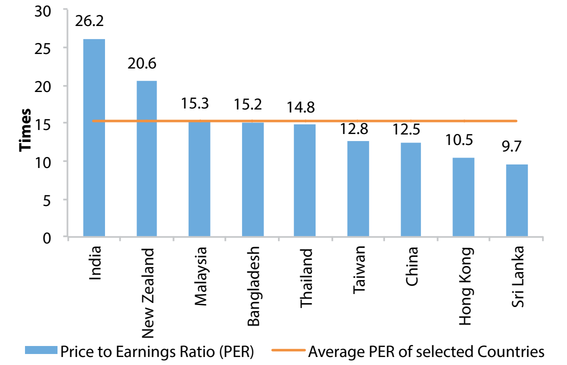
Market activities of CSE were subdued during the first ten months of the year. Key market indicators such as price indices, market capitalization and Price Earnings Ratio (PER) deteriorated on the ground of adverse developments in both domestic and global environments during the period. Though portfolio flows to some emerging market economies which were not affected by

Chart 2.2 **Market Price Earnings Ratio and Market Price to Book Value**



Source: Colombo Stock Exchange

Chart 2.3 **Market Price Earnings Ratio of Regional Countries as at end 2018**



Source: World Federation of Exchanges

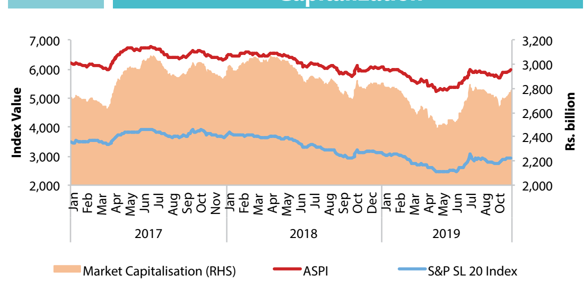
the trade tensions picked up, the Sri Lankan equity market was not benefited by improved global financial conditions. Subdued domestic economic activities, loss of investor confidence coupled with security concerns created by Easter Sunday attacks and the political instability which prevailed within the country resulted in sluggish market activities of the CSE. In addition, the downgrading of the sovereign rating at the end of 2018 affected foreign investor confidence and participation in the market. Outflow of foreign investments from the CSE which commenced in 2018 with the normalization of policy rates in the US increased as developments in the domestic front weighed on confidence. Further, security concerns caused by the Easter Sunday attacks which affected investor confidence resulted in a net outflow from secondary market of equity in CSE.

However, subsequent to the presidential election held in November 2019 the market activities of CSE improved as domestic investors have purchased shares, reflecting a positive expectation towards increasing share prices.

With the negative developments experienced during the last quarter of 2018 and during the first quarter of 2019 along with the Easter Sunday attack, the market PER declined and reached 8.1 times during the second quarter of 2019, which is the lowest recorded for the past ten years. However, the market activity gradually picked up by end July 2019 which was led by increased interest of investors in buying stocks at the low prices which prevailed at that time. However, this momentum did not continue in the following months. Even though, PER increased to 10.6 times at end October 2019 compared to the 9.7 times which prevailed at the end 2018, it remained considerably below the ten-year average of 15.7 times. In addition, as at end 2018 the PER of Sri Lanka remained one of the lowest in the region. The Price to book value (PBV), which indicates a firm's stock price level relative to its liquidation value, remained at 1.1 times at end October 2019 falling below the ten-year average of 1.9 times.

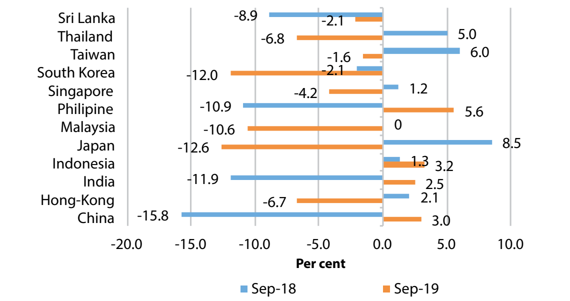
Reflecting the immediate adverse shock of the Easter Sunday attacks, both the ASPI and S&P SL20 index declined significantly by 3.6 per cent and 4.4 per cent respectively. The overall price index (ASPI) and S&P SL 20 fluctuated throughout the first ten months of 2019 in line with these movements. The ASPI and S&P SL 20 decreased by 5.0 per cent to 6,052.4 and 14.6 per cent to 3,135.2 respectively by end 2018 compared to end 2017. The ASPI and S&P SL 20 indices further decreased by 1.0 per cent and 4.9 per cent, respectively, during the first ten months of 2019.

Chart 2.4 **Movements of Price Indices and Market Capitalization**



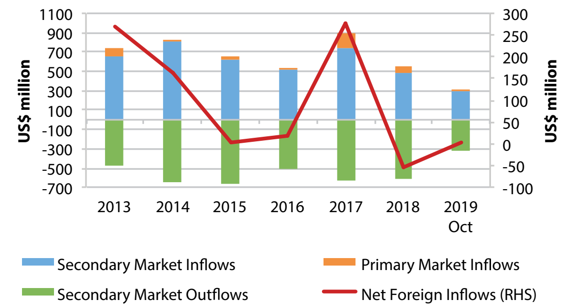
Source: Colombo Stock Exchange

Chart 2.5 Growth of Overall Share Price Indices of Regional Countries as at end Sep 2019



Source: Colombo Stock Exchange

Chart 2.7 Net Foreign Flows to CSE (Annual)



Sources: Central Bank of Sri Lanka
Colombo Stock Exchange

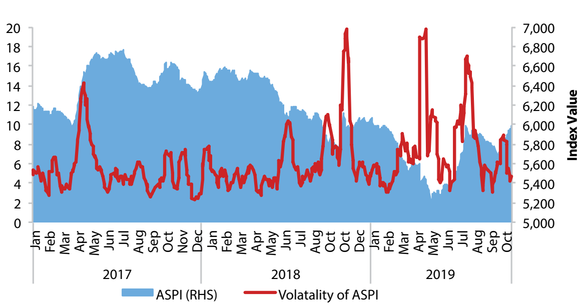
However, subdued performance in equity markets was common among the countries in the region which also experienced year-on-year decrease of overall price indices in 2018. Meanwhile, countries in the region showed mixed performance during the first nine months of 2019. Some of the countries in the region benefited by improved global liquidity conditions and attracted investments to the equity market. Trade tariff issues, fear of low economic growth and country specific conditions resulted in sluggish growth in overall price indices of regional countries. However, only Sri Lanka and South Korea recorded negative growth during the last two consecutive years.

The volatility of the overall index which remained at a high level during the early part of 2018, surged to its peak in October and November 2018 with the deterioration in investor confidence created by political uncertainty. Even though the activity level of CSE remained low during the first two months of 2019, the volatility of index remained at a moderate level. An elevated volatility was observed in the aftermath of the Easter Sunday attacks in April 2019. The price index showed rapid upward ascent of volatility responding to the positive developments in the market since July 2019 as domestic investors started to buy stocks in a dull market situation.

The foreign participation in primary market transactions remained low throughout the year. A total foreign inflow of US dollars 29.7 million was recorded during the first ten months of 2019 compared to US dollars 77.2 million recorded during the corresponding period of the previous year. In the secondary market, the net foreign outflow was US dollars 24.4 million during the first ten month of 2019 compared to the cumulative foreign outflow of US dollars 76.4 million recorded during the considered period of 2018. Accordingly, the contribution of foreign investors to total market turnover during the first ten months of 2019 decreased to 39.1 per cent when compared to 46.3 per cent recorded at end 2018.

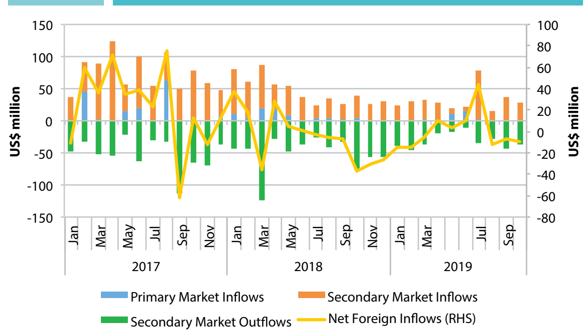
Market capitalization decreased to Rs. 2,781.7 billion at end October 2019 compared to Rs. 2,839.4 billion at end 2018. Meanwhile,

Chart 2.6 ASPI and its Volatility



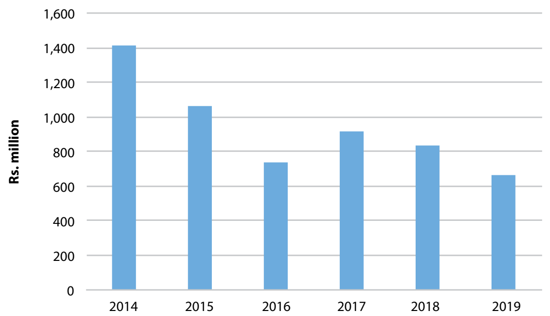
Source: Colombo Stock Exchange

Chart 2.8 Net Foreign Flows to CSE (Monthly)



Source: Colombo Stock Exchange

Chart 2.9 Average Daily Turnover

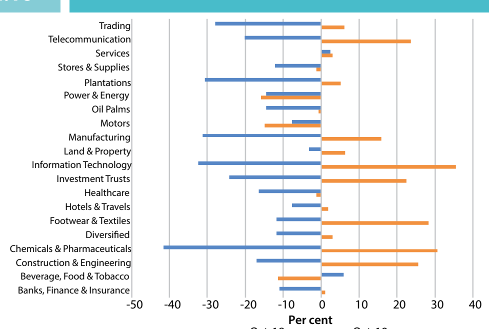


Source: Colombo Stock Exchange

average daily turnover for the period decreased to Rs. 667.6 million as at end October 2019 compared to Rs. 833.6 million in the previous year. During the first ten months of 2019, three Initial Public Offerings (IPOs) in the CSE raised Rs. 3.7 billion compared to two IPOs which raised Rs. 2 billion during the corresponding period of 2018. Further, during this period Rs. 30.6 billion was raised through 14 rights issues compared to Rs. 42.2 billion raised through 16 right issues during the corresponding period of 2018.

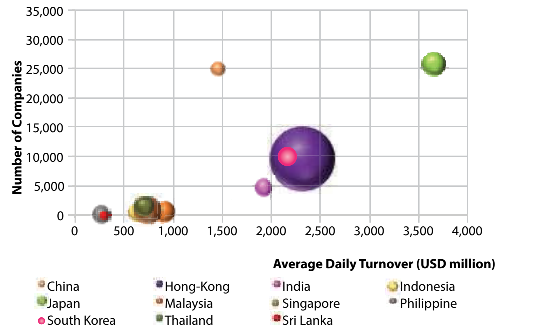
Out of the twenty sub sectors, Banks, finance and insurance; Beverage, food and tobacco; Diversified holdings, Hotels and travels and Telecommunications dominated the market and accounted for 82.5 per cent of total market capitalization. As a majority of the sectors recorded a negative year-on-year growth in October 2018, most of the sectors improved on a year-on-year basis in October 2019 due to the low base. However, Healthcare, Motors, Oil palms, Power & energy and Stores & supplies sectors recorded negative year-on-year growth for the past two consecutive years.

Chart 2.10 Growth of Sector Wise Price Indices



Source: Colombo Stock Exchange

Chart 2.11 Comparison of Global Stock Markets According to Size as at end 2018



Sources: World Federation of Exchanges
World Bank

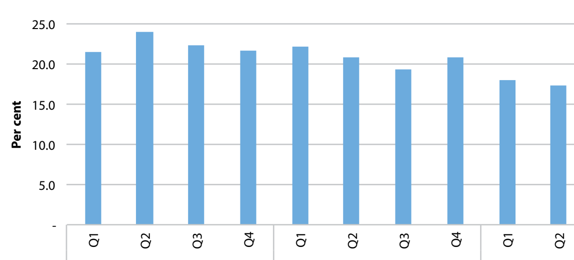
Note: The size of the sphere is proportional to market capitalization as a percentage of GDP

The size of the CSE remains small in terms of market capitalization, average daily turnover and the number of listed companies, compared with the other counties in the region. Lack of diversified investment opportunities remained as an inherent bottleneck which negatively affects the long term performance of the CSE.

Market capitalization as a percentage of GDP registered a declining trend from 2017 and this trend continued till the end of the period under review. Declining of share prices, lower number of new listings, lack of investor confidence and pulling out of investments by foreign investors were some of the reasons for declining market capitalization as a percentage of GDP.

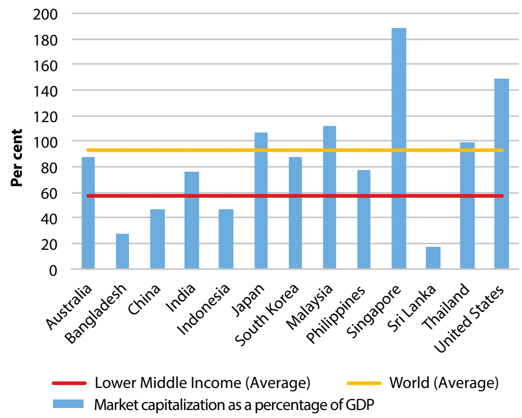
As at end 2018, the market capitalization as a percentage of GDP pertaining to the CSE remained par below the regional countries. This indicates that dynamism in the CSE need to be encouraged with sound and consistent policy measures for the corporate sector to mobilize capital.

Chart 2.12 Market Capitalization as a Percentage of GDP



Sources: Department of Census and Statistics
Colombo Stock Exchange

Chart 2.13 Market Capitalization as a Percentage of GDP (Global Comparison) as at end 2018



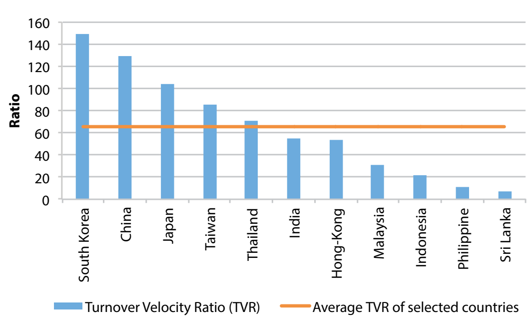
Source: World Bank

The turnover velocity ratio, which is used to measure market liquidity and efficiency, has remained significantly low compared to other stock exchanges in the region. Low turnover velocity implies higher cost of trading and low participation in the market.

2.3 Treasury Bond Market

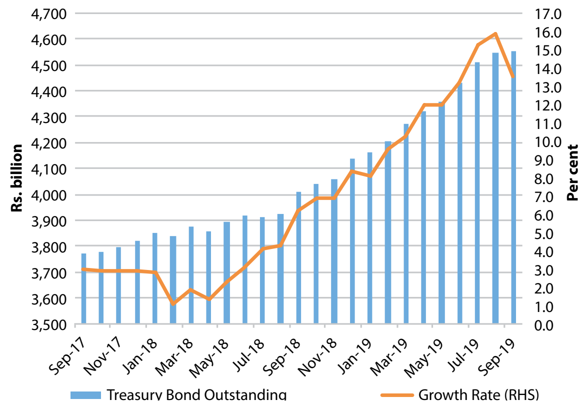
The Treasury bond market, the largest segment of the financial market of the country, recorded a significant expansion during 2019 with excess demand witnessed in the primary Treasury bond market. Rollover of maturing Treasury bonds, financing a part of the fiscal deficit by issuing new Treasury bonds, increased domestic investors' appetite on investing in risk free investments like Treasury bills and Treasury bonds and improvements to issuance mechanism of Treasury bonds contributed for the rapid expansion of the market. However, the secondary market for Treasury bond was illiquid

Chart 2.14 Market Turnover Velocity Ratio (Global comparison) as at end 2018



Source: World Federation of Exchangers

Chart 2.15 Outstanding Treasury Bonds[(a)]



Source: Central Bank of Sri Lanka

(a) Excludes foreign holdings

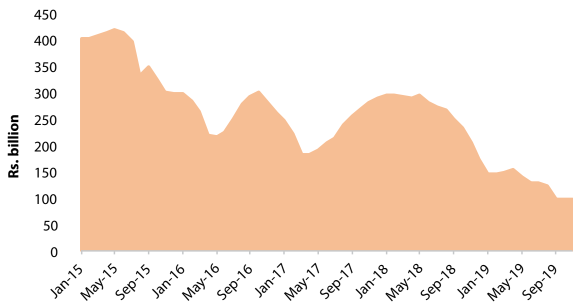
during the period under review mainly due to lack of market infrastructure such as a real time price discovery mechanism and a guaranteed settlement method to facilitate more vibrant trading activities. Nevertheless, Liquidity of the secondary market for Treasury bonds and the transparency of the price discovery mechanism is expected to strengthen with the proposed Central Counterparty (CCP) Clearing House and a state of art Electronic Trading Platform (ETP).

Total size of the Treasury bond market was 28.7 per cent of GDP at end 2018. Overall, Treasury bond market recorded a year-on-year growth of 13.5 per cent from Rs. 4,007 billion by end September 2018 to Rs. 4,550 billion (face value basis) by end September 2019 compared to 6.2 per cent growth observed during the corresponding period of the previous year[1].

Appetite of foreign investors to invest or hold Treasury bonds deteriorated during the period under review. Though net inflow of US dollars 82 million for government securities was observed during February and March of 2019, foreign investors withdrew their funds invested in Sri Lankan government papers since second half of 2018 and this trend continued during the first nine months of 2019. The changes in global market conditions and deteriorated investor confidence resulted in foreign investors selling a significant amount of Treasury bonds at the secondary Treasury bond market. As a result, the foreign

1 These Treasury bond balances excludes foreign holdings

Chart 2.16 Foreign Holdings of Treasury Bonds

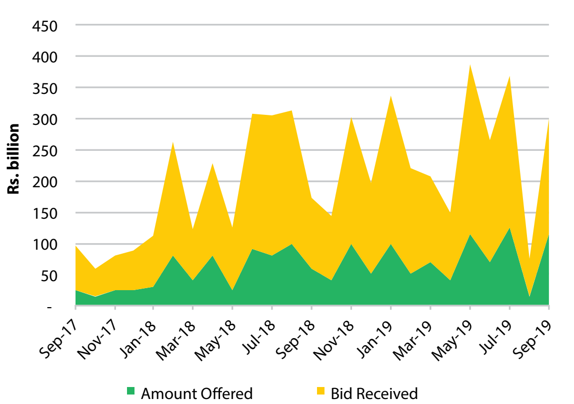


Source: Central Bank of Sri Lanka

holding of Treasury bonds declined from Rs 232 billion at end October 2018 to Rs. 98 billion at end October 2019. The country experienced a net outflow from the government securities market amounting to US dollars 990 million and US dollars 280 million during 2018 and the first ten months of 2019 respectively.

Nevertheless, excess demand from domestic investors, particularly by the banking sector, was observed in the primary market for Treasury bonds during the period under review. The banking sector experienced lower demand for loans and advances due to challenging business conditions and the political instability which prevailed in the country. As a result, banks diverted excess funds to investment in risk free government papers which amplified excess demand for Treasury bonds in the primary market. This expanded the overall Treasury bond market despite the unexpected selling pressure which arose from foreign investors pulling investments from the secondary Treasury bond market.

Chart 2.17 Demand for Treasury Bonds at Primary Market

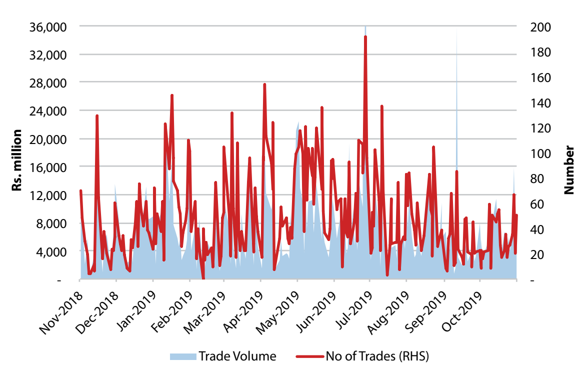


Source: Central Bank of Sri Lanka

The Secondary market for Treasury bond recorded moderate trade activities as it was in previous years. However, a high volatility in number of transactions was observed for the period under review. Less availability of adequate market infrastructure in the government securities market such as lack of mechanisms to extract information on real time prices of government securities, non-availability of centralized clearing and settlement arrangements and less availability of liquid Treasury bond series in the secondary market remain as constraints for the development of the secondary market for Treasury bonds. Daily turnover ratio in the secondary market for Treasury bonds was less than 0.5 per cent during the period from November 2018 to end October 2019. However, average number of daily transactions and average volume of daily transactions stood at approximately 50 and Rs. 7.5 billion respectively for the same period mentioned above. It is envisaged that the introduction of a state of the art ETP, CCP and Central Securities Depository (CSD) would facilitate to enhance the liquidity in the secondary market of government securities.

The five-year yield of the secondary market for Treasury bonds which exhibits the long-term movement of interest rates continued to decline from the last quarter of 2018 till end September 2019. As the Treasury bond yield declined, the investors recorded sizable capital gains in their books during 2019. However, high volatility has been observed in the yield of secondary market for

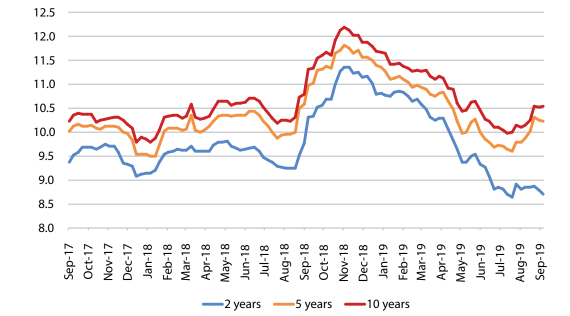
Chart 2.18 Secondary Market Transactions for Treasury Bonds



Source: Central Bank of Sri Lanka

Note: Prepared based on the government securities secondary market trade summary

Chart 2.19 Secondary Market Yield for Treasury Bonds

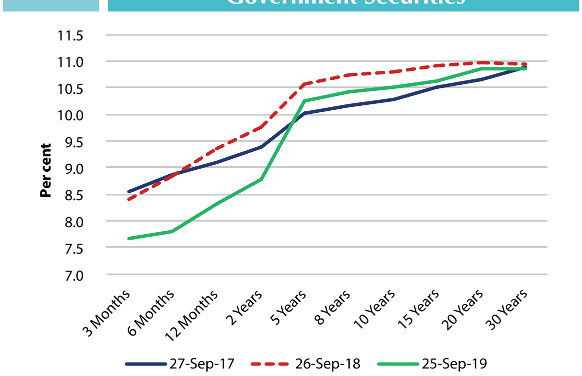


Source: Central Bank of Sri Lanka

Treasury bonds with the term premium widening between the two-year Treasury bond yield and the ten-year Treasury bond yield during the second and third quarter of 2019. This reveals that there is lower appetite among investors for longer-term maturities. Further, this indicates that investors' sentiments are biased towards higher interest rates in the long run, and that their expectations over low interest rates are temporary.

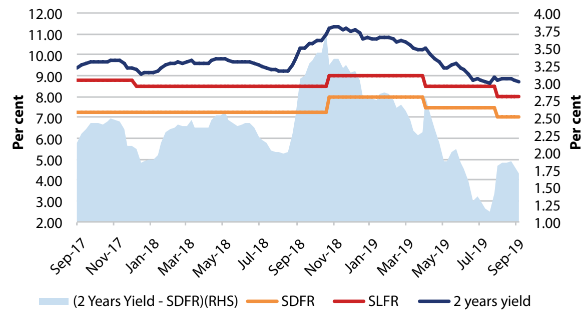
The yield curve for secondary market of Treasury bond recorded a downward shift at the end of September 2019 compared to the corresponding period of 2018. Downward shift of the market yield curve was significant for the shorter end Treasury bonds and the corresponding yield curve shift for longer end Treasury bonds such as Treasury bonds with maturity of five or more years was not significant. A relatively high investor appetite prevailed for shorter end Treasury bonds in the secondary market due to relatively shorter cycle of interest rates which resulted in a visible downward shift in the market yield curve at the shorter end compared to the longer end.

Chart 2.20 Secondary Market Yield Curve for Government Securities



Source: Central Bank of Sri Lanka

Chart 2.21 Policy Rates and Treasury Bond Yield



Source: Central Bank of Sri Lanka

Domestic market liquidity influenced the secondary Treasury bond market yield rates. Spreads between the policy rates (standing deposit facility rate and standing lending facility rate) and two-year Treasury bond yield rates fluctuated during the period under review. The spread between standing deposit facility and two-year Treasury bond yield rates narrowed down during the period of 2017 and first half of 2018 while it widened from the third quarter of 2018 till the first quarter of 2019. The narrowing of spreads was observed repeatedly during the second and third quarter of 2019 as well.

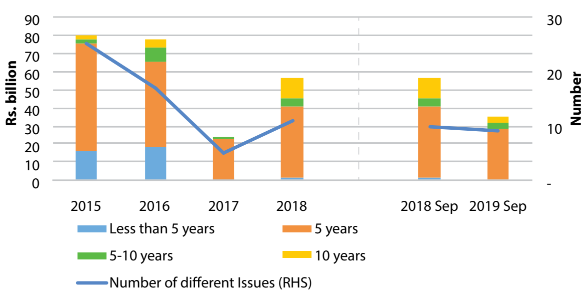
2.4 Corporate Bond Market

The corporate bond market remained as a small fraction of the financial market in Sri Lanka with low number of daily transactions observed in the secondary market.

New issuances in the corporate bond market declined marginally during the first nine months of 2019 compared to the corresponding period of 2018. During the period under consideration, 17 listings of corporate debentures by 9 institutions were recorded at the primary market, compared to 20 listings by 10 institutions during the corresponding period of the previous year. Accordingly, the total funds mobilised through debentures declined to Rs. 35.6 billion during the first nine months of 2019 compared to Rs. 55.3 billion recorded in the corresponding period of the previous year. This may be on account of the corporate sector's low appetite towards business expansion.

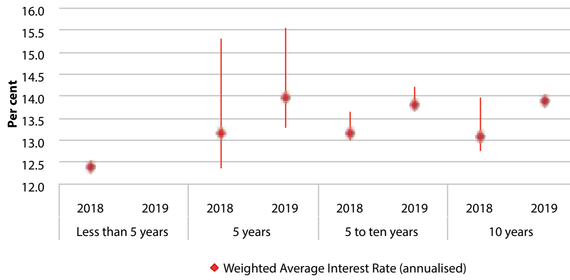
Issuance of corporate bonds at the primary market was high in 2018 compared to 2017 and it was

Chart 2.22 **Listed Debentures based on Maturity**



Source: Colombo Stock Exchange

Chart 2.24 **Annualised Interest Rates of Fixed Interest Debentures by Maturity** (a)



Source: Colombo Stock Exchange

(a) First nine months of the year

mainly due to issuance of debentures by banks to meet regulatory capital requirements. When considering the maturity period of debenture issuance, the debentures with maturity period of five years dominated the market.

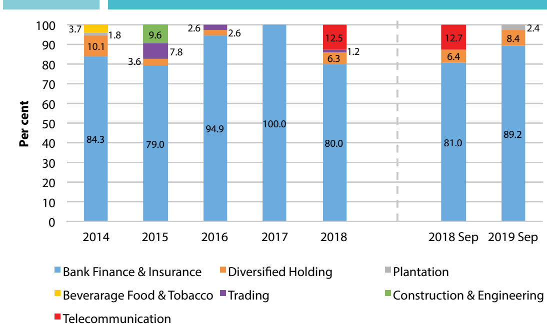
The financial sector which accounts for around 80 per cent of the total value of debentures issued is the major player in the debenture market. The debenture issuances from other sectors remained low. However, a considerable percentage of debentures are issued by the diversified holding sector in most years, which is only second to the debenture issues made by the financial sector.

Out of seventeen debentures issued, only one debenture was issued with a floating rate and the balance was issued with a fixed rate during the period under review. The investors showed preference towards fixed interest rate debentures as the interest rate cycle is comparatively short. As a result, most of the corporate debentures are issued with fixed interest rate. The annualised fixed interest rates pertaining to debentures issued during the first nine months of 2019 were in the range of 13.3 - 15.6 per cent, compared to the annualised interest rates of 12.40 - 15.30 per cent observed during the first nine months of 2018.

The secondary market for corporate debt remained less active though some improvements were seen in recent years. Turnover of the secondary debt market declined significantly in 2016 compared to 2015. However, since 2016, a gradual increase in annual turnover was observed until 2018. The secondary market turnover for the first nine months of 2019, increased to Rs. 4.3 billion compared to Rs. 3.1 billion recorded in the corresponding period of 2018. However, the number of trades slightly declined to 189 during the first nine months of 2019 from 201 recorded in the first nine months of 2018. The foreign contribution reduced to 0.2 per cent compared to 5.7 per cent recorded in the corresponding period of the previous year. The value of outstanding debentures as at end September 2019 stood at Rs. 293.6 billion compared to Rs.288.6 billion stood at end 2018.

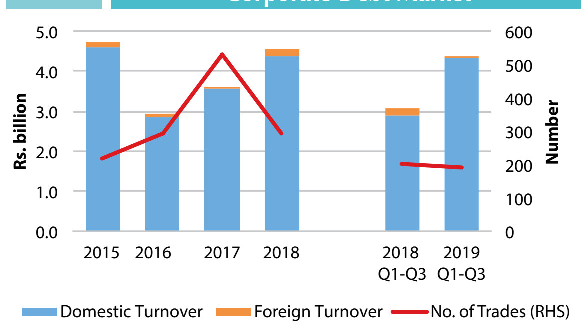
The development of the corporate debt market is necessary in order to meet the medium to long-

Chart 2.23 **Listed Debenture Issues by Sector**



Source: Colombo Stock Exchange

Chart 2.25 **Secondary Market Transactions of the Corporate Debt Market**



Source: Colombo Stock Exchange

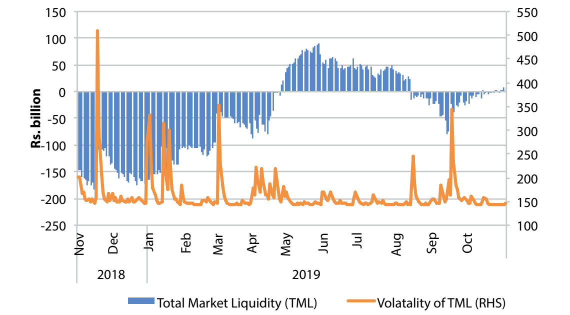
term financing needs of the corporate sector, as well as public sector institutions. Furthermore, the development of a domestic capital market will strengthen the financial system by providing opportunities to diversify the risk and funding sources.

2.5 Domestic Money Market

Liquidity in the domestic money market was volatile and recorded a mixed liquidity position during the period under review. Despite the mixed liquidity position, the money market experienced a deficit liquidity position in general during most of the period under review. The deficit liquidity position which was triggered at the latter part of the third quarter of 2018, continued till the beginning of the second quarter of 2019. Subsequently, a liquidity surplus was observed which remained till end August 2019 mainly due to the impact of SRR reduction, conversion of sovereign bond proceeds and currency deposits after the New Year as well as the open market operations of the Central Bank to inject liquidity. With the maturing of swaps transactions and Treasury bills held by the Central Bank, liquidity in the domestic money market turned into deficit levels again by end August 2019. Nevertheless, market entered into a liquidity surplus condition from the latter part of the third quarter of 2019 mainly due to conversion of ISB proceeds and open market operations, resulting in a liquidity surplus of Rs. 20.9 billion by end October 2019.

Money market interest rates as reflected by the Average Weighted Call Money Rate (AWCMR) and Average Weighted Repo Rate (AWRR) significantly declined during the first ten months of 2019 in response to the monetary policy relaxing measures. AWCMR was at around 9.0 per cent close to the upper bound of the Standing Rate Corridor (SRC) during the latter part of 2018 and early 2019. Subsequent to the reduction of SRR by 150 bps and 100 bps in November 2018 and March 2019 respectively along with reduction in each policy rates by 50 basis points in May 2019, AWCMR and AWRR declined during the second quarter of 2019. Further, AWCMR and AWRR

Chart 2.26 Money Market Liquidity and its Volatility



Source: Central Bank of Sri Lanka

indicated a significant downward adjustment with the reduction of SDFR and SLFR by 50 basis points in August 2019.

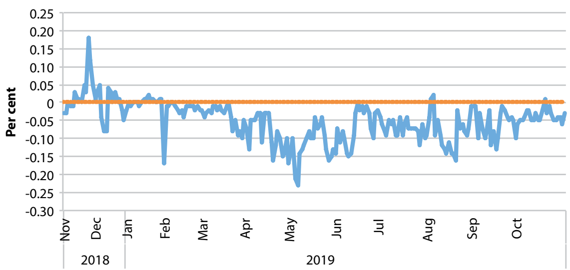
The asymmetric liquidity distribution among Licensed Commercial Banks (LCBs) and the limited participation of the foreign owned LCBs in the call money market led to an upward pressure in the interbank call money market rate, despite the liquidity surplus in the domestic money market. With the reduction of policy rates by further 50 basis points in August 2019, the call money market rate recorded a significant downward adjustment. Overall, AWCMR sharply declined by 151 bps from 8.96 per cent at end February 2019 to 7.45 per cent at the end October 2019. Pass-through of declining interest rate in the money market was reflected in the downward shift of the Treasury bill yield curve.

In 2019, Central Bank took several measures to smoothen money market activities. Considering the need for providing liquidity assistance for Primary Dealer Companies (PDCs) a Liquidity Support Facility (LSF) was introduced by the

Chart 2.27 Policy and Money Market Rates

Source: Central Bank of Sri Lanka

Chart 2.28 Spread between AWCMR and AWRR



Source: Central Bank of Sri Lanka

Central Bank in September 2019 to fulfill their overnight liquidity requirements and to ensure smooth functioning of the domestic money market.

Accordingly, a sum of Rs. 16.8 billion liquidity was injected to the PDCs on overnight basis during September and October 2019. In line with the current monetary policy stance and the open market operations of the Central Bank the gap between AWCMR and AWRR narrowed down. Asymmetric liquidity distribution among money market participating institutions was observed, even though some banks were operating with a significant amount of excess liquidity. This phenomenon is caused as, some banks are reluctant to lend to other banks possibly due to exposure limits restrictions from internal risk management frameworks. This situation compelled other market participating institutions to face a considerable risk on fulfilling overnight funding needs. As a result, Central Bank provided liquidity in excess to the overnight requirement to mitigate such risk.

Considering the need for providing permanent liquidity to the market and lower demand for Treasury bills at outright auctions, the Central Bank introduced auctions for outright purchases of Treasury bonds to inject liquidity to the domestic money market on a permanent basis. Accordingly, the Central Bank injected liquidity of Rs. 43.2 billion on permanent basis by end October 2019 to the domestic money market by way of conducting outright purchase of Treasury bond auctions.

2.6 Treasury Bill Market

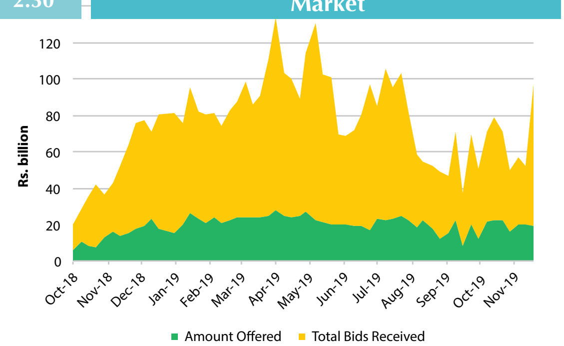
Treasury bill market is a popular segment in the financial market as it facilitates short-term risk free investments and is comparably more active and liquid. Strong demand was witnessed from the domestic investors in the primary market for Treasury bill following monetary policy measures targeting downward movement of the interest rate during the first nine months of 2019.

The yield rates of secondary market for Treasury bills decreased from the beginning of 2019, in line with the primary market developments. Accordingly, the yield rates of the secondary market for Treasury bills reduced across all three maturities; i.e. 91 days, 182 days and 364 days at end October 2019, compared to the corresponding period in 2018. The reduction in yield rates across all maturities was substantial as the yield rates for 91 day, 182 day and 364 day Treasury bills declined by 182 bps, 208 bps and 207 bps respectively during the period under consideration.

Chart 2.29 Overnight Liquidity Distribution of Money Market Participants

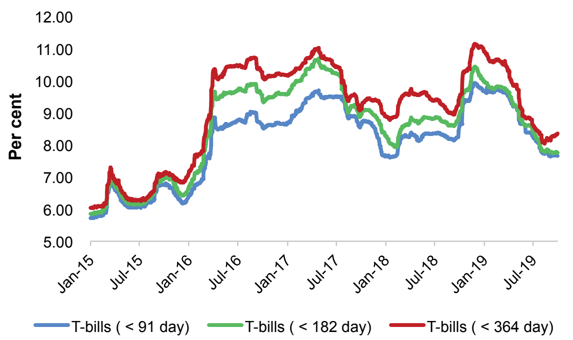
Source: Central Bank of Sri Lanka

Chart 2.30 Demand for Treasury Bills at Primary Market



Source: Central Bank of Sri Lanka

Chart 2.31 Secondary Market Average Quotes on Treasury Bills



Source: Central Bank of Sri Lanka

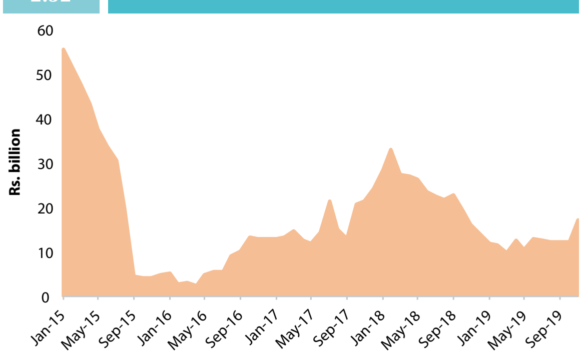
Foreign investments in Treasury bills gradually declined for the period from 2015 to end October 2019. Foreign investments in Treasury bills continued to show a declining trend in the first 10 months of 2019 mainly due to country specific developments.

2.7 Domestic Foreign Exchange Market

The domestic foreign exchange market showed an appreciation trend with the commencement of the year 2019 reversing the depreciation trend observed during the second half of 2018. Accordingly, in the first ten months of 2019, the Sri Lankan Rupee marginally appreciated against US dollar by 0.63 per cent from Rs. 182.75 as at end December 2018 to Rs. 181.60 as at end October 2019.

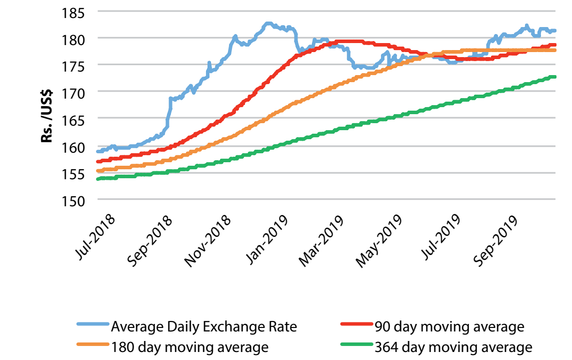
Technical analysis of the exchange rate movements within the domestic foreign exchange market clearly depicts the pressures faced by the Sri Lankan Rupee due to both domestic and external forces.

Chart 2.32 Foreign Holdings of Treasury Bills



Source: Central Bank of Sri Lanka

Chart 2.33 USD: LKR Exchange Rate Movements



Source: Central Bank of Sri Lanka

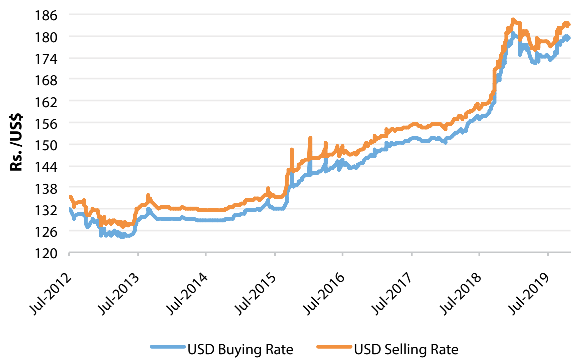
The moving average bands depict the depreciation pressures which were faced by the exchange rate during the second half of 2018 due to the policy rate hikes in the USA and the resulting capital outflows, expansion of the trade deficit and adverse developments in the political environment. Accordingly, the 90 day and 180 day moving average rates remained well above the 364 day moving average and the gap between the moving averages increased over time.

The depreciation trend continued until the beginning of 2019 when the pressure on the currency eased with the positive impact of the policy measures taken by the Central Bank and the government in late 2018 to mitigate the sharp depreciation pressure exerted on the exchange rate in 2018. This was further supported by the easing of external pressure and the increase in conversion of export proceeds in 2019. Accordingly, the 90 day moving average showed a downward trend since the beginning of 2019, reflecting the appreciation trend.

Despite an increase in the pressure on the currency following the Easter Sunday attacks and the decline in inflows on account of tourism observed in the aftermath of the attacks, the receipts of the delayed sixth tranche of the Extended Fund Facility (EFF) from the IMF in May 2019, and the ISB issuance in June 2019 supported to uphold the value of Sri Lanka Rupee against US dollar.

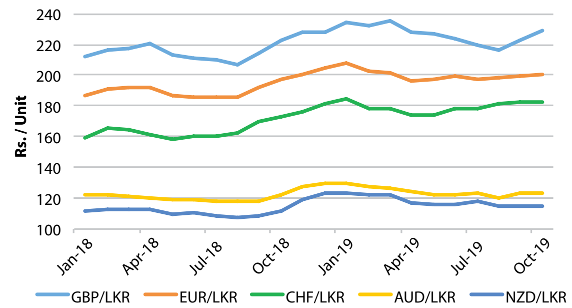
Depreciation pressures recommenced in August mainly due to the repatriation of foreign

Chart 2.34 Buying and Selling Rates of Commercial Banks



Source: Central Bank of Sri Lanka

Chart 2.35 Exchange Rate Movements



Source: Central Bank of Sri Lanka

investments from the government securities market, which continued till September 2019. This was further aggravated by the gradual increase in import demand for vehicles following the easing of policy measures that were imposed in 2018 and the high demand for oil bills during the third quarter of 2019.

The average spread between the commercial banks' Telegraphic Transfer (TT) buying and selling rates increased to Rs. 3.80 during 2019 compared to the Rs. 3.60 which prevailed during the second half of 2018.

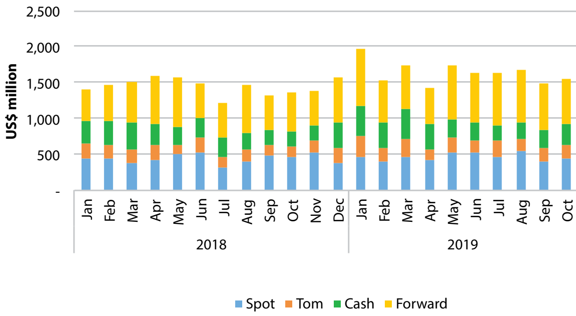
Meanwhile, during the first ten months of 2019, the interest rate cut by the Reserve Bank of India and Reserve Bank of Australia led the Sri Lankan rupee to appreciate against the Indian rupee and Australian dollar. Further, political uncertainties in the Euro Zone caused Sri Lankan rupee to appreciate against Euro during the reference period. Increase in the safe haven demand for Japanese yen caused the Sri Lankan rupee to depreciate against Japanese yen. Positive sentiments through the new expectations on Brexit with the up coming UK general elections to be held in December 2019, caused Sri Lankan rupee to depreciate against the Sterling pound during the period up to end October 2019 as well.

It is expected that pressure on the exchange rate from global developments would be limited as the Federal Reserve Board (FRB) is likely to hold the interest rates during next year (with foreseen risks to the downside) as it is anticipated that the Fed's main objective during the year would be to prevent the US economy from going in to a recession. Further, this rate cutting scenario is supported by the friction created by the US - China trade war which has spillover effects to the world economy. The FRB policy is expected to have an impact on the domestic foreign exchange market through financial markets by affecting currency exchange rates, interest rates and international flows of investment money. ECB, BOE and BOJ are also expected to stimulate their economies during the coming year to avoid the slowdown in respective economies.

With the scenario of various kinds of easing being used in advanced economies, emerging economies have experienced an inflow of foreign funds. This in turn may be beneficial depending on the ability of Sri Lanka to preserve market confidence and maintain macroeconomic stability and a stable policy framework to attract foreign investors. However, such inflows need to be treated and earmarked cautiously as this kind of a scenario could sometimes create excessive volatility and abrupt outflows at the least expected moments.

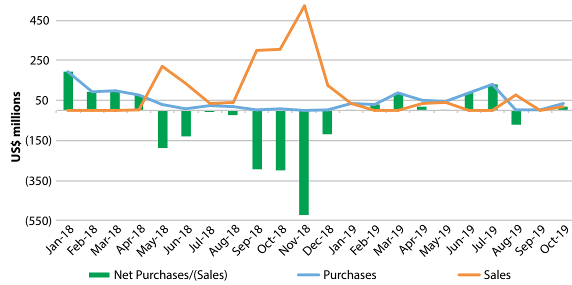
Trading volumes in the domestic foreign exchange market during the period up to end October 2019 recorded a significant increase of 13.6 per cent to US dollars 16.4 billion from US dollars 14.4 billion in the corresponding period of 2018 by reflecting the inter-bank market activities and increased foreign exchange liquidity. During the period under review the spot and forward transaction volumes have increased to US dollars 4.7 billion and US dollars 6.7 billion respectively,

Chart 2.36 Volumes of Cash, Spot, Tom and Forward Transactions



Source: Central Bank of Sri Lanka

Chart 2.38 Interventions in the Domestic Foreign Exchange Market



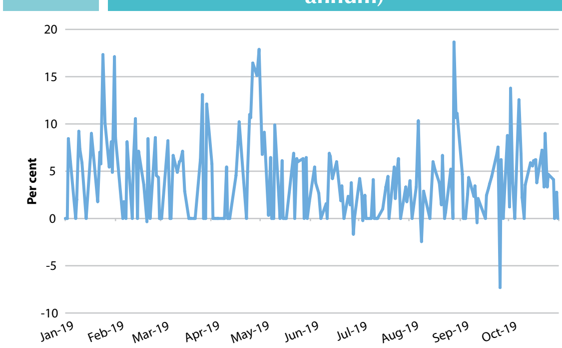
Source: Central Bank of Sri Lanka

from US dollars 4.4 billion and US dollars 5.5 billion in the corresponding period of 2018. The daily average volumes in the inter-bank foreign exchange market also increased substantially by 11.9 per cent to US dollars 80.4 million during the reference period, from US dollars 71.8 million in the corresponding period of 2018.

Although 26 authorized foreign exchange dealers operate in the foreign exchange market, the largest six players in the foreign exchange market contributed to around 60 per cent of the transaction volume during the period under review.

The Central Bank was a net buyer in the domestic foreign exchange market during the first ten months of 2019. Continuous purchases of US dollars from the market despite moderate sales during periods of excessive volatility in the exchange rate, enabled the Central Bank to build up the foreign reserves of the country. Accordingly, during the period up to end October, the Central Bank absorbed US dollars 504.7 million and supplied US dollars 201.9 million resulting in a net purchase of US dollars 302.8 million. With the strategic objective of adopting a flexible inflation targeting framework by the Central Bank, it is expected to manage the exchange rate by allowing greater flexibility in determining the rate. Further, improving price discovery and enhancing transparency in the domestic foreign exchange market would also contribute to manage the excessive volatility of the exchange rate. Intervention, if any, would be to avert the excessive volatility not supported by fundamentals. To support the process of price discovery, the Central Bank wishes to publish an intraday benchmark rate to the domestic foreign exchange market. It is expected that this would prevent any disorderly movements in the exchange rate.

Chart 2.37 Weekly Forward Premium (per cent per annum)



Source: Central Bank of Sri Lanka

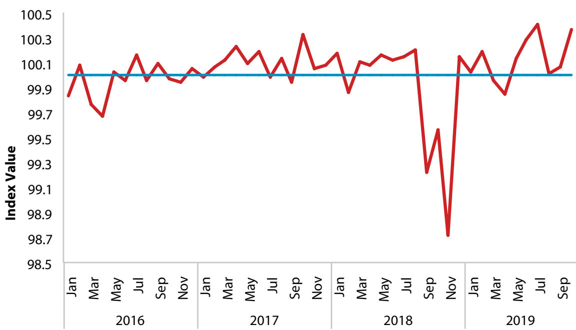
Note: An outlier has been removed to improve visibility.

2.8 Financial Market Stability Index

In general, the Financial Market Stability Index (FMSI)[2] was volatile during the period under review due to negative market developments. In November 2018, the FMSI recorded its lowest value of 98.9 since 2012. This was mainly due to the volatility in the market liquidity and high volatility in the domestic foreign exchange market following the political uncertainty. However, since January 2019, the market stability was restored due to improvements seen in the money market and domestic foreign exchange market, after the ending of political uncertainty. Volatility in the market liquidity started to show positive signs

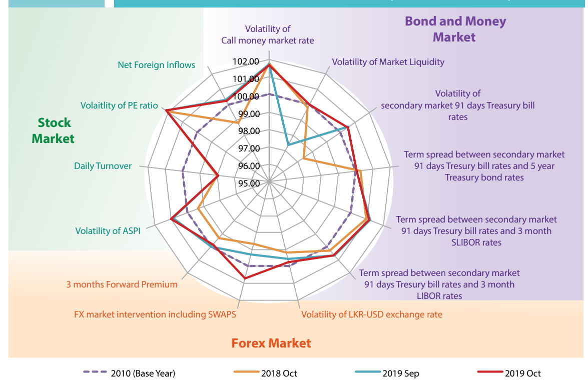
2 FMSI is the composite indicator depicting financial stability sensitive developments. It is compiled by tracking 13 partial indicators, covering the foreign exchange market, money market, bond market and equity market. The base year of FMSI is the year 2010.

Chart 2.39 **Financial Market Stability Index (2010 =100)**



Source: Central Bank of Sri Lanka
Colombo Stock Exchange

Chart 2.40 **Financial Market Stability Map -Comparison of Partial Variables (2010 =100)**



Source: Central Bank of Sri Lanka
Colombo Stock Exchange

Note: Deviation from the center indicates a positive impact to the financial system stability.

since February 2019 responding to monetary policy measures and open market operations conducted by the Central Bank.

Although the index value dropped in April with negative developments in the market,an increase in the indicator was recorded during May and June reflecting an improvement in overall market stability. The market stability deterioration in April 2019 was partly due to increased volatility in ASPI, depicting the immediate effects of Easter Sunday attack. Volatility in the market liquidity also increased in April 2019 mainly due to seasonal currency withdrawal and foreign exchange related transactions. In July 2019, the FMSI peaked largely due to improvements seen in the equity market. However, this positive development in equity market was slightly reversed in August and September 2019. In October 2019, overall financial market stability improved mainly due to reduced volatility of market liquidity and forex market intervention including swaps.

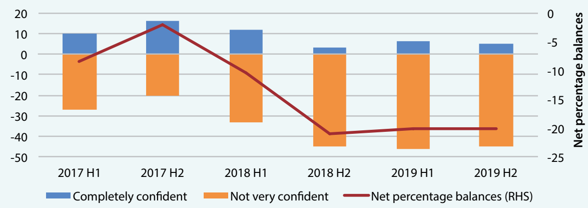
BOX - 01 Systemic Risk Survey - 2019

Introduction

Assessing systemic risks and predicting systemic events have risen to the top of the agenda for the central banks aftermath of the Global Financial Crisis. Therefore, Central Banks are constantly challenged to develop new techniques and upgrade their toolkits in order to diagnose buildup of risks. Systemic Risk Surveys emerged as a new macroprudential tool to feed back the independent risk assessment of market participants and experts into a risk assessment matrix, and thus in the design of stress scenarios. Central Bank of Sri Lanka compiled both qualitative and quantitative tools which emerged to identify the systemic risks and carries out a series of systemic risk assessments on an ongoing basis in conducting macroprudential surveillance of the financial system.

The Central Bank introduced the Systemic Risk Survey in the first half of 2017, to its macroprudential surveillance toolkit while providing a platform to showcase the opinion of leading experts and market participants in financial sector of the country. This bi-annual survey tracks general perceptions regarding key sources of risks to financial system stability emanating from within the country or externally. Materialization of these risks could potentially disrupt the financial intermediation process including the orderly functioning of the financial institutes, financial markets and payments system while also affecting the public confidence on the financial system stability. The survey results provide early warning signals to foresee systemic risks to the financial system and facilitate to take appropriate policy measures. Further, SRS helps to validate the internal assessments of the Macroprudential Surveillance team on emanating vulnerabilities of the financial system. The SRS is conducted among Risk Officers (RO) of Financial Institutions such as licensed banks, licensed finance companies, specialized leasing companies, insurance companies, unit trusts managing companies, stock brokering companies and rating agencies. This box article highlights trends in perceptions of market participants regarding financial system stability with a special focus on 2019.

Chart B 1.1 Confidence on the Stability of the Financial System (over next 6 months)



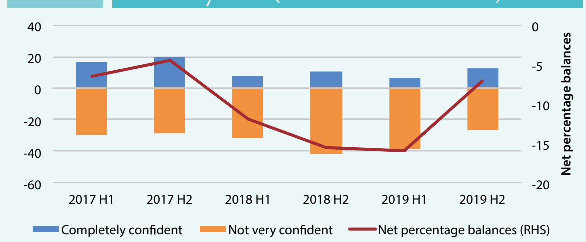
Source: Central Bank of Sri Lanka

Note: The net percentage balance is calculated by weighing, 1 for 'completely confident' responses, 0 for ''fairly confident', -1 for 'not very confident'.

Confidence on the Financial System

The findings of the SRS for the first half of 2019 (2019 H1) revealed a slight improvement in the short-term confidence level compared to second half of 2018. However, the confidence on the financial system was bleak for the medium term. SRS results for the second half of 2019 (2019 H2) indicated that the confidence on the financial system over the short-term horizon remained at the same level though medium term outlook improved. However, as per market participant's perceptions their confidence on the financial system has deteriorated since second half of 2017 though some improvement is expected over the next 24 months.

Chart B 1.2 Confidence on the Stability of the Financial System (over next 24 months)



Source: Central Bank of Sri Lanka

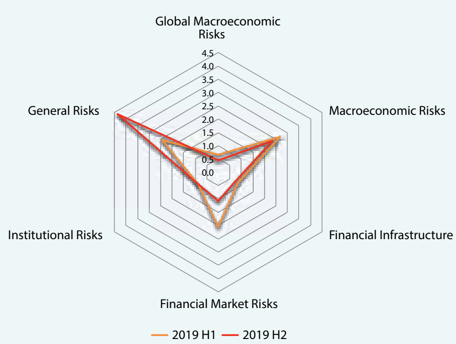
Note: The net percentage balance is calculated by weighing, 1 for 'completely confident' responses, 0 for ''fairly confident', -1 for 'not very confident'.

Sources of Risk to the Financial System

General risks[1] which comprises of perceived political risk, terrorism etc. which remained as one of the main risks during the first half of the survey, increased substantially in 2019 H2 reflecting the impact of the Easter Sunday attack and the continuation of political instability. Of the ten most frequently cited sub risk categories, political risk continued to be the top most cited risk in both surveys conducted during 2019. In the aftermath of the Easter Sunday attack, terrorism emerged as the second most cited risk in 2019 H2. Loss of investors' confidence on the economy has also risen to become a top most cited risk in the second half of 2019. Overall, political risk, macro-economic policy uncertainty, policy implementation, policy formation and low GDP growth have remained within the top five perceived risks in all surveys since the first half of 2018.

However, risk perceptions related to financial markets declined due to appropriate monetary policy stimulus and resulting improved market liquidity conditions. This was further supported by the stability observed in the domestic foreign exchange market.

Chart B 1.3 **Dynamics of major risk categories**



Source: Central Bank of Sri Lanka
Colombo Stock Exchange

Note: The above graph depicts the weighted index for each major risk category. First, a weighted index for each sub risk was calculated using the number of respondents and the ranking given for each sub risk category by each respondent. The weighted index attributed to each sub group were then aggregated to compute the weighted index for major risks categories. Deviation from the center indicates a proportional increase in respondents citing respective categories of risk.

Table B 1.1 **Top most cited sub risks**

Risks[1]	Top Ten Ranks 2017 H1	2017 H2	2018 H1	2018 H2	2019 H1	2019 H2
Political risk	7	8	1	1	1	1
Terrorism	-	-	-	-	-	2
Macro-economic policy uncertainty/policy implementation/ policy formation	10	5	2	2	2	3
Loss of investors' confidence on the economy	-	-	-	-	-	4
GDP Growth	-	-	3	3	3	5
Asset quality deterioration	4	10	-	-	9	6
Cyber-attacks and Phishing etc.	8	2	3	7	7	7
Foreign Exchange Risk	3	7	6	6	4	8
Inflation	-	-	-	10	-	9
Interest rate risk	2	4	8	5	4	9
Public governance, transparency and corruption	-	-	8	10	-	9
Liquidity risk	1	-	5	9	4	-
Trade account deficit	-	-	-	-	7	-
Public debt (domestic/ external borrowings)	-	-	6	8	9	-
Sovereign rating downgrade	-	-	-	4	-	-
Access to funding/ liquidity risk	-	1	-	-	-	-
Global Economic Outlook	-	3	-	-	-	-
Payment and settlement system risk	5	6	-	-	-	-
Operational risk	6	8	-	-	-	-
Deficiency in capital	9	-	-	-	-	-

Source: Central Bank of Sri Lanka

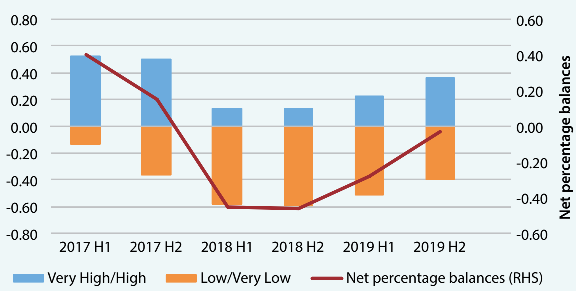
Note: The SRS consists of sixty-nine sub risk categories. belonging to six major categories, namely: Global Macroeconomics Risk, Domestic Macroeconomic Risks, Risk pertaining to Financial Infrastructure, Risks related Financial Markets, Institutional Risks and General Risks. Some sub risk categories have been recategorized in 2019

Perceived Probability of a High Impact Event

The perceived probability of a high-impact event in the financial system elevated significantly in 2019 reflecting concerns over political instability and the Easter Sunday Attack. The perceived probability of high impact event which declined since second half of 2017 started to increase significantly from second half of 2018.

1 The SRS consists of sixty-nine 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.

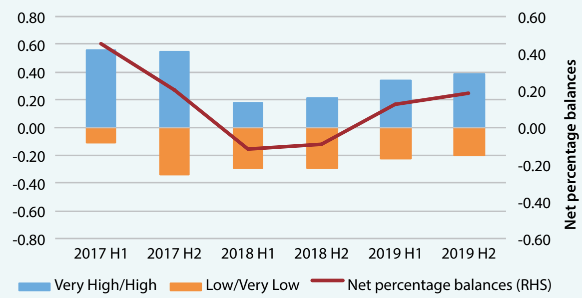
Chart B 1.4 **Perceived probabilities of materializing a high impact event (over 6 months)**



Source: Central Bank of Sri Lanka

Note: The net percentage balance is calculated by weighing 1 for 'very high/ high' responses, 0 for 'Medium' responses, and -1 for 'low/very low' responses.

Chart B 1.5 **Perceived probabilities of materializing a high impact event (over 12 months)**



Source: Central Bank of Sri Lanka

Note: The net percentage balance is calculated by weighing 1 for 'very high/ high' responses, 0 for 'Medium' responses, and -1 for 'low/very low' responses.

Chapter 3

Financial Institutions

3.1 Overview

Financial institutions of the country remained resilient amidst challenging market conditions during first nine months of 2019. Banking sector performance moderated resulting from subdued economic activities, the political uncertainty which prevailed and deterioration of investor confidence caused by Easter Sunday attacks in April 2019. Consequently, banking sector credit growth decelerated and non-performing advances increased. The asset base continued to grow at a slower pace compared to preceding years. The profitability of the banking sector deteriorated resulting from increased loan loss provision charges, higher operating expenses and taxes. However, the banking sector maintained capital and liquidity well above the regulatory minimum requirements. Going forward, implementation of Basel III framework is expected to enhance the resilience of the banking sector. Prudential policy measures were taken by the regulator with the aim of restoring the unhealthy developments in the sector. The eased monetary policy stance enhanced liquidity levels and improved the yield of asset portfolios of banks. The imposition of ceilings on deposit rates which was subsequently rescinded, enabled banks to reduce their cost of funds. Maximum interest rates imposed on lending products is expected to stimulate the credit demand and reverse the moderating trend in credit growth in the near future.

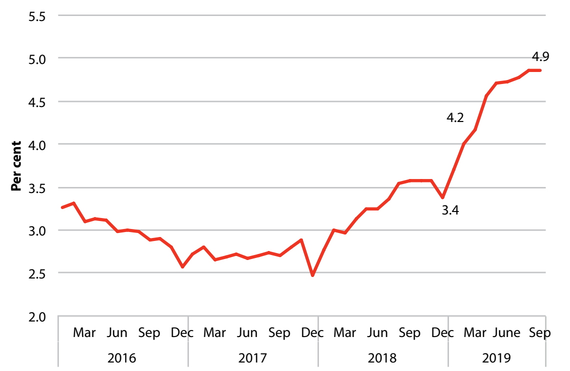
Licensed Finance Companies (LFCs), Specialized Leasing Companies (SLCs) and Insurance Companies were considered as key participants of the financial sector from among the non-bank financial institutions. The LFCs and SLCs sector was affected by similar adverse conditions faced by licensed banks but to a greater extent than licensed banks. Thereby, this sector's growth in asset base decelerated, subsequent to the negative credit growth. When considering the risks faced by the sector, credit risk aggravated with higher non-performing loans and advances, reputation risk is becoming severe with few LFCs failing to honor depositors, risk of governance was also observed as a common concern, while market risk and liquidity risk were at a bearable level. Nevertheless, LFCs and SLCs have made adequate provisions to withstand credit risk, while maintaining capital and liquidity levels above the regulatory minimum requirements at a consolidated level. At present, the Central Bank has identified a few LFCs as in distress situation or with weak financial performance to which various timely resolution actions were taken or are being taken. It is expected that improvement of economic activities, investor confidence and political stability of the country and ongoing regulatory actions will have a positive impact on the outlook of the LFCs and SLCs sector in the medium term. With regard to the Insurance sector, a moderate performance was observed with a growth in its asset base. Further, it was noted that capital and liquidity levels of the insurance sector was at a satisfactory level.

3.2 Banking Sector

Credit Risk

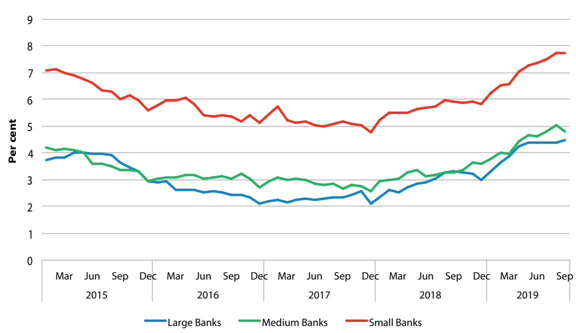
Delinquency levels of loans and advances have been rising since December 2017 and registered a Non-Performing Loan (NPL) ratio of 4.9 per cent in September 2019; the highest since October 2014. The rising NPL was observed across the

Chart 3.1 **NPL Ratio of the Banking Sector**



Source: Central Bank of Sri Lanka

Chart 3.2 **NPL Ratio of Bank Groups[1]**

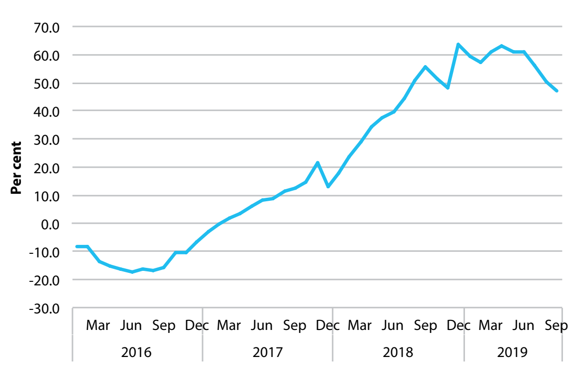


Source: Central Bank of Sri Lanka

banking sector while small sized[1] banks reported the highest NPL ratio as at end September 2019.

During the first nine months of 2019 NPLs increased by 47 per cent as opposed to a credit growth of 1.8 per cent.

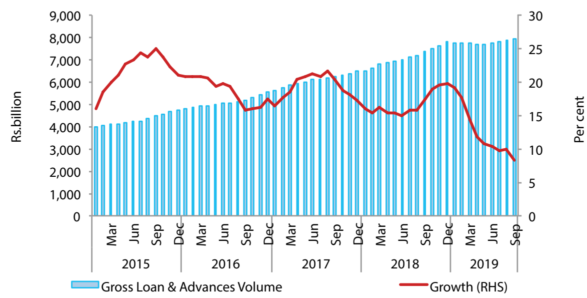
Chart 3.3 **Banking Sector NPL Growth Rates, Y-o-Y**



Source: Central Bank of Sri Lanka

1. For this publication banks have been categorized based on the asset size as at December 31, 2018. Banks with asset base of more than Rs. 500 billion have been classified as large banks, banks with asset base of between Rs. 200 billion and Rs. 500 billion have been classified as medium sized and the rest as small sized banks.

Chart 3.4 **Banking Sector Loans & Advances**



Source: Central Bank of Sri Lanka

NPLs continued to grow at 47 per cent on y-o-y basis in September 2019 while credit growth moderated to 8.1 per cent.

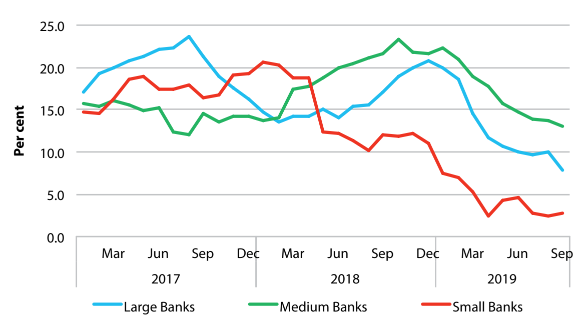
The moderation in credit is observed with all bank groups since December 2018 and it is more pronounced with small sized banks.

Credit portfolio of small sized banks contracted by 0.2 per cent during first nine months of 2019 while the portfolio of large sized banks marginally increased by 1.0 per cent. However, loan book of medium sized banks increased by 8.1 per cent during the nine months of 2019.

Despite the rising NPLs, banks could generally evergreen their assets on the back of credit expansion. However, moderating credit further deteriorated the asset quality of the banking sector limiting the space for ever-greening their loan portfolios. Consequently, NPL ratio stepped up since December 2018.

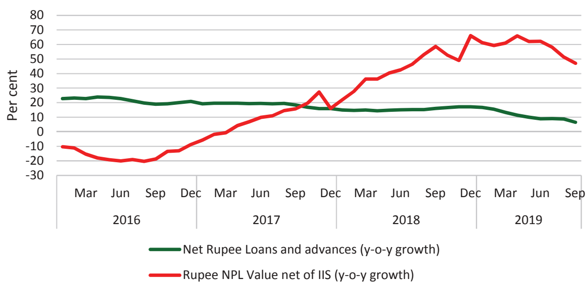
Rupee NPLs and Foreign Currency (FCY) NPLs grew at 47.1 per cent and 35.8 per cent respectively in September 2019, on y-o-y basis.

Chart 3.5 **Loan Growth by Bank Groups, Y-o-Y**



Source: Central Bank of Sri Lanka

Chart 3.6 **Banking Sector Rupee Loans & NPL Growth**



Source: Central Bank of Sri Lanka

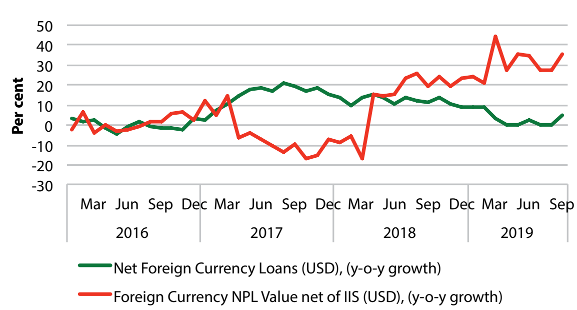
In contrary, rupee loans and foreign currency loans (in USD terms) grew at 6.9 per cent and 5.3 per cent, respectively on y-o-y basis reflecting the slowdown in credit growth during first nine months of 2019.

NPL ratios of rupee advances and FCY advances increased from 3.8 per cent and 1.9 per cent, respectively in December 2018 to 5.5 per cent and 2.5 per cent, respectively in September 2019. The credit quality of bank sector may further deteriorate if the rising delinquency levels and moderating credit growth persist as the leeway for evergreening is curtailed.

The Monetary Law Act Order No. 2 of 2019 imposed ceilings on lending products. It is expected that this measure would stimulate the credit demand and reverse the moderating trend in credit growth, with the improved business confidence.

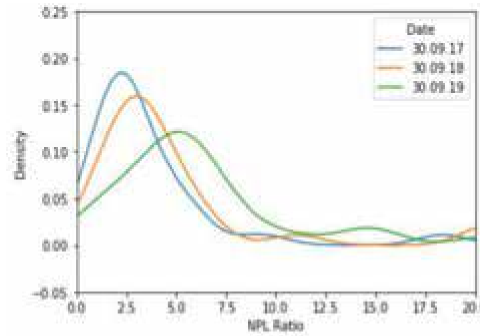
Probability density function of NPL ratios depicts the changes in assets quality, distribution of NPLs and its severity across the time horizons. The

Chart 3.7 **Banking Sector FCY Loans & NPL Growth**



Source: Central Bank of Sri Lanka

Chart 3.8 **Probability Densities of Non-Performing Advances**



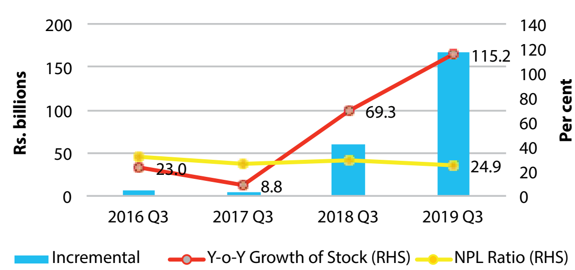
Source: Central Bank of Sri Lanka

Note: The probability distribution was derived using non-parametric Kernel Density Estimate.

probability density functions of NPLs have been constructed for reporting periods as at September 2017, September 2018 and September 2019. The downward shift in probability density functions at the lower percentiles revealed that a significant number of banks shifted from lower levels of NPL ratios to higher levels of NPL ratios during the past few months. A flatter-tailed distribution could be expected in the short-run if the rising delinquency levels continues. Therefore, banks shall be vigilant on plausible tail risks stemming from credit quality deterioration in the sector.

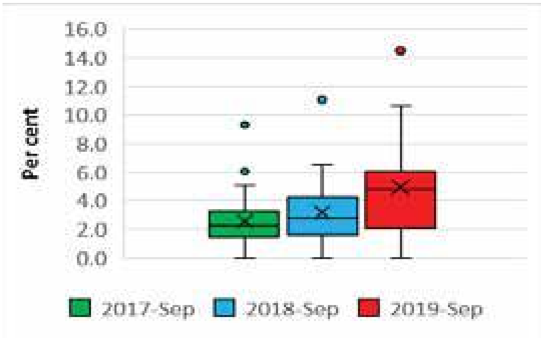
Rescheduled loan growth has been 115.2 per cent, y-o-y with an NPL ratio of 24.9 per cent in September 2019, signifying the depth of the credit quality deterioration. The share of rescheduled loans in total loans increased from 2.4 per cent in December 2018 to 4.5 per cent in September 2019. Given the higher rate of NPLs in rescheduled loans, the potential NPL ratio of the banking sector will be higher if the

Chart 3.9 **Rescheduled Loans**



Source: Central Bank of Sri Lanka

Chart 3.10 **Shift in Inter-Quartile Distribution of NPL Ratios**



Source: Central Bank of Sri Lanka

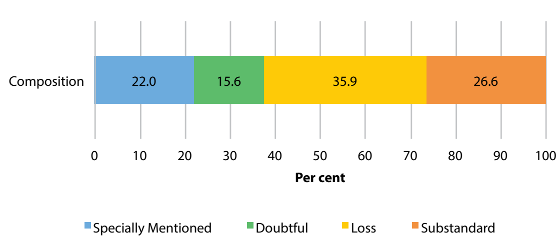
Note: A few extreme values were excluded in the Inter-quartile ranges to avoid the disproportionate influence of the outliers.

performing rescheduled loans are classified as non-performing.

The inter-quartile[2] distribution of NPL ratios of individual banks has widened since September 2017 due to increase in number of observations in upper quartile reflecting the deterioration in credit quality of the banking sector. Consequently, median value of NPL ratio increased from 2.2 per cent to 4.8 per cent.

The banking sector was requested to grant a debt moratorium to individuals and entities in the tourism industry following the Easter attacks in April 2019. The current NPL ratio and corresponding provision charge are likely to have been understated given the higher probability of default of facilities that availed the concession. A large share of NPLs are in special mentioned and substandard categories which require either no provisioning or lower provisioning. Specific provision coverage ratio and total

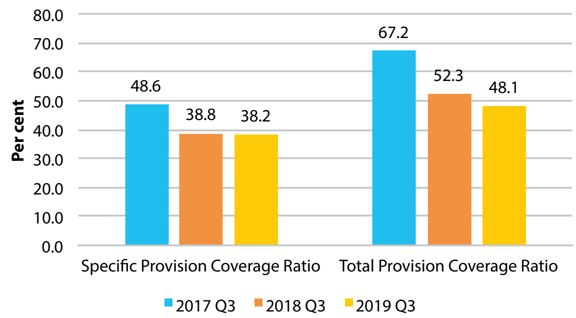
Chart 3.11 **Composition of NPLs as at September 2019**



Source: Central Bank of Sri Lanka

2. A measurement of variability being equal to difference between upper and lower quartile values in a data set.

Chart 3.12 **Provision Coverage**



Source: Central Bank of Sri Lanka

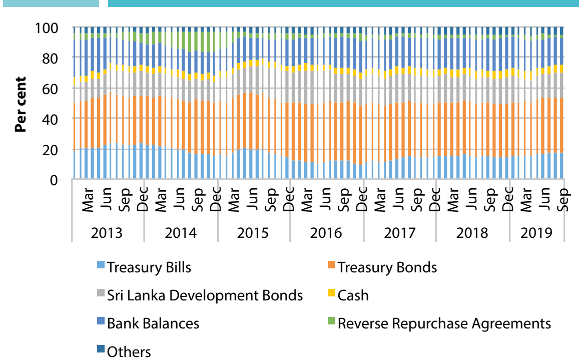
provision coverage ratio have decreased by 10.4 percentage points and 19.1 percentage points, respectively, during the third quarter of 2017 to third quarter of 2019. However, the lower increase in provisions was due to the new NPLs being classified under categories which require lower provisions and availability of underlying collaterals.

Stress test results on credit risk revealed that certain banks are vulnerable to rising NPLs given the low level of capital. Nevertheless, the banking sector is resilient to the credit shocks given availability of underlying collaterals and augmented capital levels resulting from the duly completed Basel III capital phase-in arrangement.

Liquidity Risk

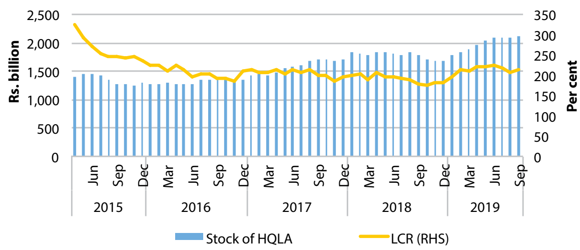
The banking sector continued with a healthy level of liquidity during first nine months of 2019 and exhibited a higher resilience against liquidity risk. Statutory Liquid Asset Ratio (SLAR) of the Domestic Banking Units (DBU) of banking sector

Chart 3.13 **Relative Share of Statutory Liquid Assets**



Source: Central Bank of Sri Lanka

Chart 3.14 **Liquidity Coverage Ratio - LKR**



Source: Central Bank of Sri Lanka

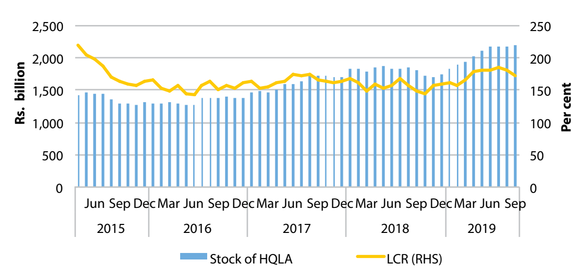
which measures the adequacy of liquid assets against deposits and borrowings, remained well above the regulatory minimum.

Liquidity Coverage Ratios (LCR), which measure the availability of High Quality Liquid Assets (HQLA) in a 30-calendar day stress scenario improved significantly by end September 2019. LCR ratio for rupee currency operations and all currency operations increased from 179.7 and 148.0 respectively in September 2018 to 215.5 and 173.1 respectively in September 2019.

Moderation in credit growth and increased investments in Government Securities positively contributed to further improve liquidity levels/ coverages of the banking sector. Credit to deposit ratio declined to 88.2 per cent in September 2019 from 90.6 per cent in December 2018 indicating the easing of credit growth relative to deposits growth.

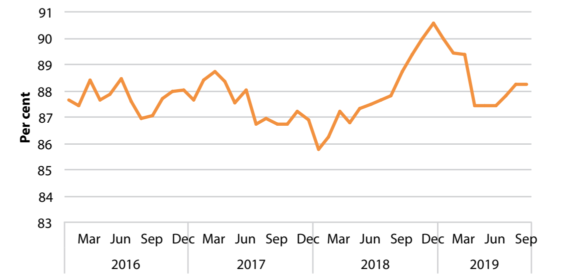
Rupee deposits continued to be the major source of funding for the banking sector despite moderation in growth rates. Nevertheless, the deceleration in growth of rupee deposits is in tandem with the moderation in assets and credit growth of the banking sector.

Chart 3.15 **Liquidity Coverage Ratio – All Currency**



Source: Central Bank of Sri Lanka

Chart 3.16 **Credit to Deposit Ratio**



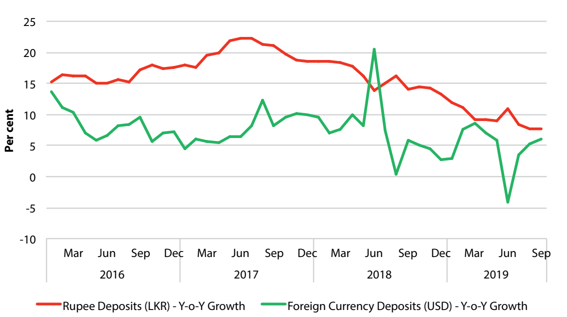
Source: Central Bank of Sri Lanka

Investment in Government securities encompassing Treasury Bills, Treasury bonds and Sri Lanka Development Bonds (SLDBs) represented majority of total liquid assets.

Subordinated debentures eligible for capital adequacy purposes and repo borrowings continued to be major non-deposit domestic funding sources of the banking sector. Basel III capital phase-in arrangement which concluded in January 2019 and the envisaged minimum capital augmentation requirement prompted banks to source funds via subordinated debentures. With deceleration in credit growth and reduction of Statutory Reserve Requirement (SRR) in April 2019, reliance on repo borrowings declined in September 2019. Consequently, share of borrowings in total funding decreased to 14.7 per cent in September 2019 from 16.0 per cent in September 2018.

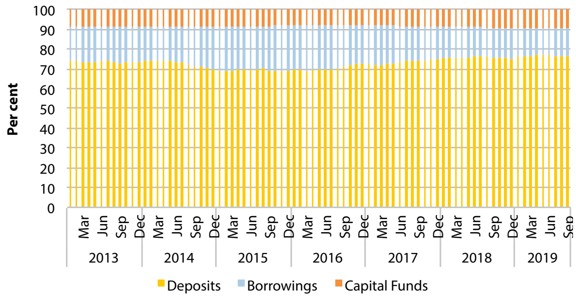
Foreign currency borrowings of the banking sector exceeded rupee borrowings and represented 57.8 per cent of total borrowings as at September 2019. External borrowings have been the largest source of foreign currency borrowings of the

Chart 3.17 **Growth in Deposits**



Source: Central Bank of Sri Lanka

Chart 3.18 Relative share of Deposits, Borrowings and Capital Funds



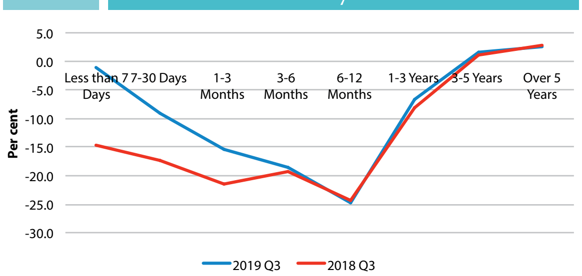
Source: Central Bank of Sri Lanka

banking sector. Foreign currency borrowings represented 7.7 per cent of total assets of the banking sector. Higher reliance on foreign currency borrowings may adversely affect the profitability of the sector if the rupee depreciates. Besides, external funding is less stable in nature and refinancing could be challenging in an environment of heightened sovereign risk.

The maturity profile of assets and liabilities of the banking sector improved in September 2019 compared to September 2018. Cumulative maturity gap as a percentage of cumulative liabilities of the banking sector for maturity buckets up to six months narrowed in September 2019 compared to September 2018 indicating an improvement in maturity profile of assets and liabilities.

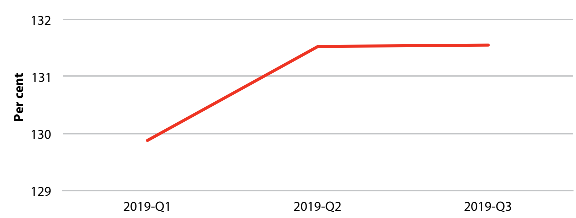
Net Stable Funding Ratio (NSFR) which measures the available amount of stable funding over a time horizon of one-year relative to the amount of required stable funding, remained well above the minimum requirement as at end September 2019.

Chart 3.19 Maturity Gap in the Assets and Liabilities Maturity Profile



Source: Central Bank of Sri Lanka

Chart 3.20 Net Stable Funding Ratio

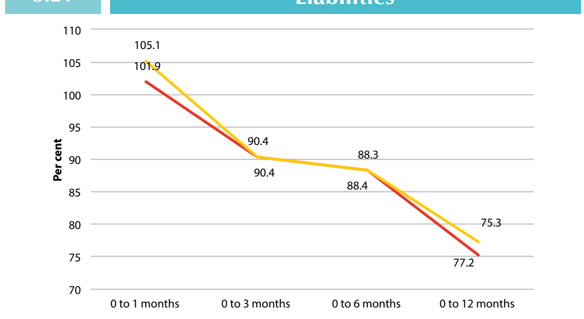


Source: Central Bank of Sri Lanka

Interest Rate Risk and Foreign Exchange Risk

The maturity profile of interest sensitive assets and liabilities indicated a relatively optimal maturity gap up to one month in September 2019 and a relatively consistent interest sensitive asset to liability ratio up to 3 months and up to 6 months compared to the position in September 2018. However, the negative maturity gap for interest sensitive assets and liabilities up to 12 months increased in September 2019. This suggests that the banking sector has continued funding its long-term assets through short-term liabilities. Despite the ceilings imposed on deposit rates and lending rates, the banking sector managed to maintain its Net Interest Margin (NIM) reflecting the ability to pass the interest rate adjustments to borrowers. Hence, it is unlikely that a possible interest rate shock may adversely affect NIM. Therefore, maturity profiles of interest sensitive assets and liabilities may not cause a material impact. Stress test results on interest rate risk indicated that a few banks were susceptible for an increasing interest rate environment and the sector is resilient in an environment of decreasing

Chart 3.21 Interest Sensitive Assets to Interest Sensitive Liabilities



Source: Central Bank of Sri Lanka

interest rate. Foreign currency denominated financial products constituted 20.3 per cent of the banking sector assets and 22.3 per cent of the banking sector liabilities as at September 2019.

Net foreign currency exposure of the sector was 0.5 per cent of regulatory capital and 0.2 per cent of foreign currency assets as at end September 2019. However, the net exposure of the banking sector is curtailed by the limits on net open position of individual banks.

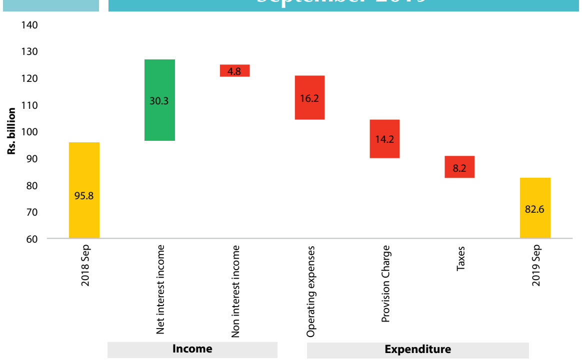
Operational Risk

The banking sector is moving towards offering highly advanced technology and banking solutions where systems and processes play a vital role. This makes the banking sector vulnerable for cybersecurity risk such as ransomware, cross-site scripting, phishing and SQL injection attacks. In this backdrop, banks are compelled to operate with advanced internal controls and operational risk management practices in order to mitigate any adverse impact of possible operational risk events. In addition to ensuring compliance with prudential requirements such as corporate & Information Technology governance, internal controls and capital buffers on operational risk, the Central Bank examines internal policies and guidelines for sound operational risk management within the scope of its statutory examinations of banks.

Volatility of Profits and Profitability

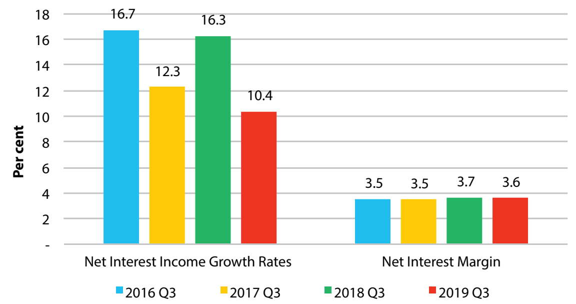
Banking sector profits have declined since 2017 due to increase in loan loss provisions resulting

Chart 3.22 Decomposition of Change in Profits in September 2019



Source: Central Bank of Sri Lanka

Chart 3.23 Net Interest Income and Net Interest Margin



Source: Central Bank of Sri Lanka

Note: Growth rates of NII have been computed comparing the performance of banking sector for first nine months of respective years

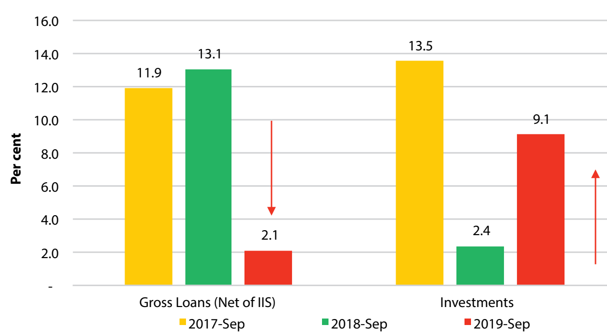
from the deterioration in credit quality and increased corporate & value added taxes.

Net profits for the nine months period ending September 2019 declined to Rs. 82.6 billion from Rs. 95.8 bn compared to the corresponding period in 2018. The increase in Net Interest Income (NII) was inadequate to compensate the decrease in non-interest income and increase in expenses which encompasses non-interest expenses, taxes and provisions.

Despite the increase in NII, its growth rates have moderated during first nine months of 2019 compared to previous years. The slow growth in NII could be attributed to the moderation in credit and consequent reallocation of resources to low yielding fixed income securities.

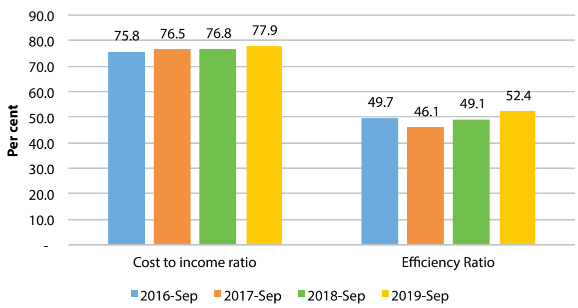
However, the NIM of the sector remained unchanged at 3.6 per cent of the average assets. Decline in non-interest income during the nine months period ending September 2019 relative

Chart 3.24 Nine Months Growth Rates of Loans and Investments



Source: Central Bank of Sri Lanka

Chart 3.25 **Cost and Efficiency Ratios**



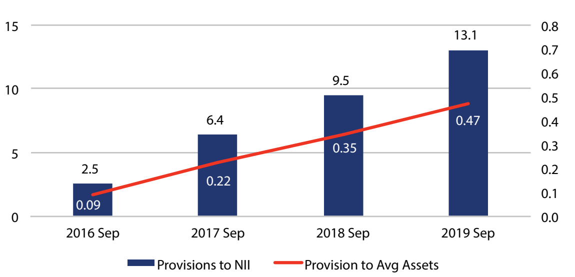
Source: Central Bank of Sri Lanka

to the corresponding period in 2018 was largely due to decrease in foreign currency revaluation gains. The banking sector reported an abnormal foreign currency revaluation gain during the first nine months of 2018 resulting from the broad-based strengthening of US dollar following the policy rate hikes in the United States.

Cost to income ratio and efficiency ratios deteriorated in September 2019 reflecting the increase in operating expenses by 8.9 per cent and contraction in non-interest income by 4.7 per cent.

Intermediation results from core banking operations i.e. NII have been eroded due to weakening quality of assets that triggered a higher loan loss provisions. Provision charge to average asset ratio has increased from 0.09 in September 2016 to 0.47 in September 2019. Further, provisions have cost approximately 13.1 per cent of NII of the banking sector as at September

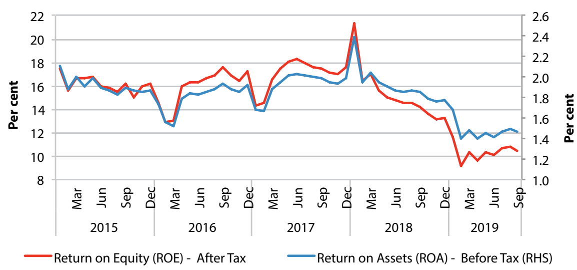
Chart 3.26 **Loan Loss Provision Charge**



Source: Central Bank of Sri Lanka

Note: Left axis is in per cents that represents Loan Loss Provision charge to Net Interest Income. Right axis represents the Loan Loss Provision as a fraction of Average Assets.

Chart 3.27 **Return on Assets and Return on Equity**



Source: Central Bank of Sri Lanka

2019. The incremental specific provision charge for the nine months ending September 2019 has increased by 59.8 per cent compared to the same period of 2018 and approximately 2.7 times the level reported in September 2017.

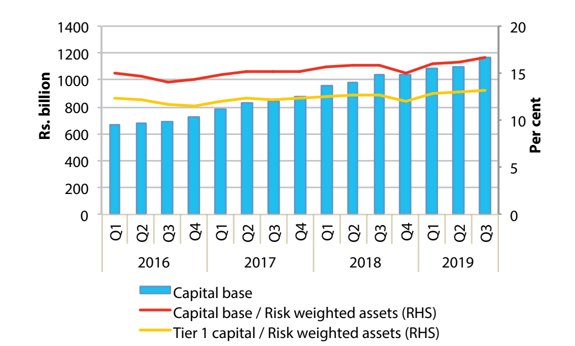
Return on Assets (ROA) and Return on Equity (ROE) of the sector declined from 1.8 per cent and 14.1 per cent, respectively in September 2018 to 1.5 per cent and 10.5 per cent, respectively in September 2019.

Subdued performances observed with non-financial corporate sector and household sector (further details in Chapter 4) are yet to reflect on the performance and financial conditions of banks, which, if materialized, could become a concern to the overall stability.

Capital Adequacy and Leverage

Despite the challenging macro environment, the banking sector remained resilient supported

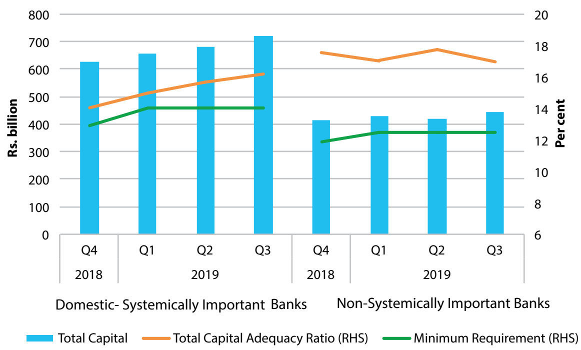
Chart 3.28 **Capital Adequacy Ratio**



Source: Central Bank of Sri Lanka

Note: Basel III Capital Phase-in arrangement commenced effective from July 1, 2017.

Chart 3.29 CAR of D-SIBs and Non-D-SIBs



Source: Central Bank of Sri Lanka

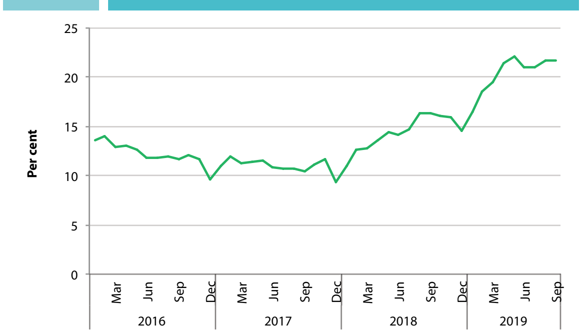
by healthy Capital Adequacy Ratios (CAR) which were well above the regulatory minimum requirement. The banking sector successfully completed its Basel III capital phase-in arrangement on January 1, 2019 which required incumbents to increase the minimum CAR on a staggered basis. Accordingly, Domestic Systemically Important Banks (D-SIBs) and non-D-SIBs are required to maintain a minimum CAR of 14.0 per cent and 12.5 per cent, respectively.

The CAR and Tier I capital ratio encompassing the capital conservation buffer of the banking sector stood at 16.7 per cent and 13.2 per cent, respectively. Aggregate CAR of D-SIBs and non-D-SIBs remained well above the stipulated regulatory minimum.

Despite the rapid increase in NPLs, net NPLs to Capital Fund ratio remained improved demonstrating the resilience of the banking sector.

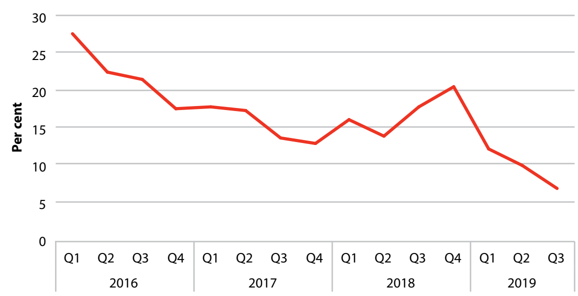
Growth in Risk Weighted Assets (RWA) moderated during 2019 resembling the slowdown

Chart 3.30 Net NPLs to Capital Funds



Source: Central Bank of Sri Lanka

Chart 3.31 Growth in RWA, Y-o-Y



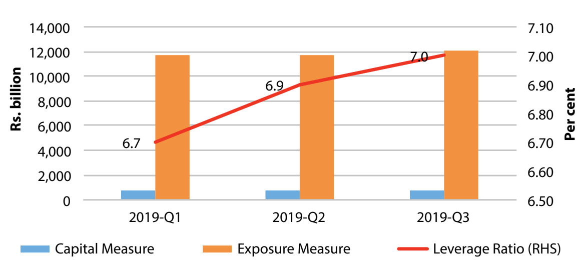
Source: Central Bank of Sri Lanka

in credit growth. This moderation in credit growth and increased investments in risk free treasury securities have positively contributed to improve the banking sector CAR. Leverage ratio, a non-risk based capital measurement that assesses adequacy of Tier 1 capital to on-balance sheet and off-balance sheet exposures, reached 7.0 per cent as of September 2019, which is well above the regulatory minimum. The leverage ratio was mandated for banks operating in Sri Lanka effective from January 1, 2019.

3.3 Licensed Finance Companies and Specialised Leasing Companies Sector

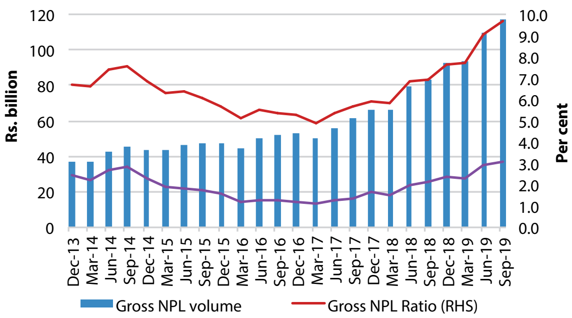
The LFC and SLC sector remained resilient during the year amidst subdued economic activity, political uncertainty, lack of investor confidence and security concerns created by the Easter Sunday attacks. Credit quality as reflected by Non-Performing Loans (NPL) ratio and profitability of the sector deteriorated by end September 2019 compared to the corresponding period of 2018. Nevertheless, resources to

Chart 3.32 Leverage Ratio of Banks



Source: Central Bank of Sri Lanka

Chart 3.33 NPLs of the LFCs and SLCs Sector



Source: Central Bank of Sri Lanka

mitigate such risks such as capital and liquidity of the sector were maintained above the regulatory requirements at a consolidated level. Further, with the view of maintaining the long-term financial system stability, stringent regulatory actions were taken by the Central Bank to decisively address issues in distressed/ high-risk finance companies of the industry. The corporate governance of the LFCs and SLCs sector, needs to be improved in line with acceptable best practices to minimise the business continuity risk of the sector.

Risk Profile of the LFCs and SLCs Sector

Credit Risk

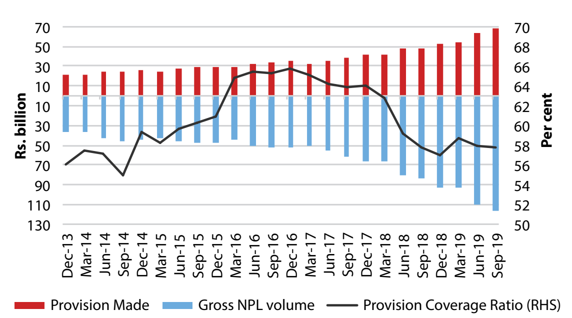
The LFCs and SLCs sector is inherently exposed to higher credit risk than the banking sector as the nature of its business model is to deal with high risk customers. Customers who may not be able to obtain loans from banks are the main customers of LFCs and SLCs. The asset quality of the sector deteriorated during the period under review as the sector was exposed to a high credit risk reporting NPL ratios at an increasing trend. The gross NPL ratio of the sector reached to 9.7 per cent at end September 2019 as against 6.9 per cent at end September 2018. The sharp increase of NPL ratio may be attributable to both increasing NPLs and declining total loans and advances of the sector due to slowdown in economic activities. Total loans and advances of the sector decreased by 1.6 per cent during the period under consideration. However, net NPL ratio of the sector was at a manageable rate of 3.1 per cent at the end of September 2019 mainly due to high provisioning for loan losses as reflected by the provision coverage ratio calculated based on regulatory requirements of the sector.

However, a significant number of LFCs have reported NPL ratios higher than the industry average level of 9.7 per cent and some LFCs have reported more than 20 per cent of NPL ratio leading such LFCs to face severe credit risk which may affect the performance of the sector.

Currently, the sector classifies loans and advances into NPL if such loans and advances are in arrears for six months. The international best practice and requirement of Licensed Banks is to classify loans and advances if it is in arrears for three months or more. Once similar requirement of Licensed Banks is adopted the NPL ratio of the sector would be much higher than the current level of 9.7 per cent. If the sector reclassifies their loan portfolio in line with classification adopted by the licensed banks, it will have to make necessary provisions in order to manage credit risk.

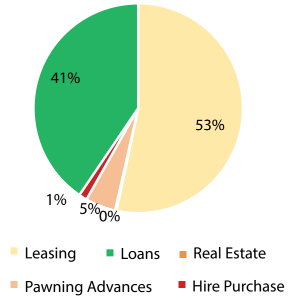
However, the sector managed to mitigate the credit risk to a certain extent, through making adequate provisions as reflected in the provision coverage ratio which was 57.7 per cent at end September 2019 compared to 57.8 per cent reported at end September 2018. Despite a slight decline in the provision coverage ratio, the provisions made by the sector for potential loan losses increased in absolute term from Rs. 47.9 billion at end September 2018 to 67.6 billion in September 2019.

Chart 3.34 Provision Coverage Ratio of the LFCs and SLCs Sector



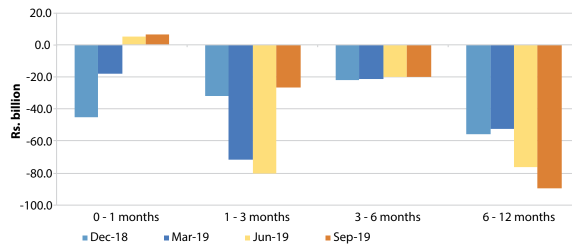
Source: Central Bank of Sri Lanka

Chart 3.35 **Product-wise Loans and Advances of the LFCs and SLCs Sector**



Source: Central Bank of Sri Lanka

Chart 3.36 **Interest Sensitive Net Assets of the LFCs Sector**



Source: Central Bank of Sri Lanka

Note: It indicates the net of interest sensitive assets of the sector.

To identify the concentration risk of the sector, the composition of loans and advances was considered. It was observed that loans of the sector were highly concentrated on leasing and hire purchase product which accounted for 58.8 per cent of total loans and advances at the end of September 2019. However, growth of leasing and hire purchase product declined from 13.8 per cent at end September 2018 to 1.5 per cent at the correspondence period in 2019 mainly due to prevailing Loan to Value (LTV) ratio, upward revision of taxes for motor vehicles and increase of vehicle cost due to the depreciation of the rupee. A potential risk of increasing NPL ratio of lease and hire purchase products pertaining to the sector is expected mainly due to the declining growth in lease and hire purchase loans and subdued vehicle market activities. The performance of the sector will be affected adversely due to high concentration in leasing and hire purchase sector. Hence, relaxation of existing LTV ratio is not prudent at the prevailing market conditions.

Market Risk

The market risk of the LFCs and SLCs sector was low compared to other financial risks such as credit and liquidity risks as its trading book's size was not significant for the period under review. The sector continued to experience a minimum exposure to equity risk as total exposure to equity market was minimal at Rs. 21.5 billion at end September 2019, which was only 1.5 per cent of the total assets of the sector.

During the first nine months of 2019, negative mismatches in interest sensitive assets and liabilities were observed for all maturity buckets of the LFCs sector except for the less than 1-month maturity bucket, exposing the sector to a high interest rate risk.

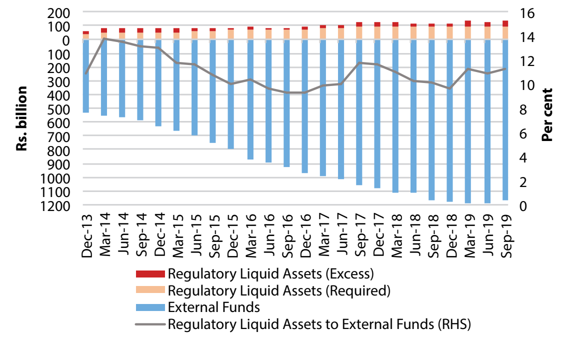
As lending interest rates of the banking sector is capped with the imposition of the Monetary Law Act Order, No. 2 of 2019 on "Enhancing Efficiency of the Transmission of Recent Policy Decisions to Rupee Denominated Market Lending Rates", the lending rates charged by LFCs sector may also reduce in accordance with market forces. This will have a negative impact on interest rate risk of the sector.

Further, stress test results on the credit risk and interest rate risk of LFCs sector revealed that, as a whole this sector will be less resilient to shocks originating from such risks through certain individual companies which recorded a lower level of capital.

Liquidity Risk

Overall liquidity position of the LFCs and SLCs sector improved from January 2019 in line with the improved domestic market liquidity conditions which experienced a shortage at the later part of 2018. The overall regulatory liquid assets available in the sector at end September 2019 showed a surplus of Rs. 40.7 billion as against the stipulated minimum requirement of Rs. 91.3 billion. The surplus increased by 42.7 percent (Rs.12.2 billion) compared with the regulatory

Chart 3.37 Liquidity of the LFCs and SLCs Sector



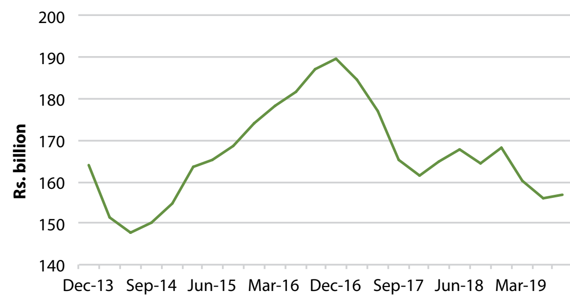
Source: Central Bank of Sri Lanka

surplus available in September 2018. Regulatory liquid assets to external funds ratio improved to 11.3 per cent against 10.1 per cent reported in the corresponding period of the previous year due to increased regulatory liquid assets of the sector. Prevailed excess liquidity at the institutional level and the market level exposed the sector to a minimum funding risk.

When considering the funding mix of LFCs, it was observed that LFCs were mainly funded through deposits which contributed to 49.9 per cent of total assets as at September 2019 which has improved from 48.8 per cent recorded as at September 2018. Meanwhile, borrowings of the sector represented 26.7 per cent of the total liabilities at end September 2019 and showed a negative growth of 8.5 percent compared to the growth of 10.4 per cent recorded in the corresponding period of 2018. The credit to deposits ratio of the sector as at end September 2019 was recorded at 156.9 per cent.

The deposits growth declined to 5.4 per cent at end September 2019 from 10.9 per cent reported in the corresponding period of 2018. The interest rate ceiling applicable to LFCs was amended in April 2019 through the issuance of Direction No. 01 of 2019 on Maximum Interest Rates on Deposits and Debt Instruments. Accordingly, the maximum rate a LFC could grant for a depositor reduced considerably. In response, deposits of LFCs have declined from Rs. 765 billion reported in May 2019 to Rs. 763 billion as at end September 2019. Consequently, in October 2019 this Direction was amended to allow LFCs

Chart 3.38 Credit to Deposit Ratio of the LFCs Sector



Source: Central Bank of Sri Lanka

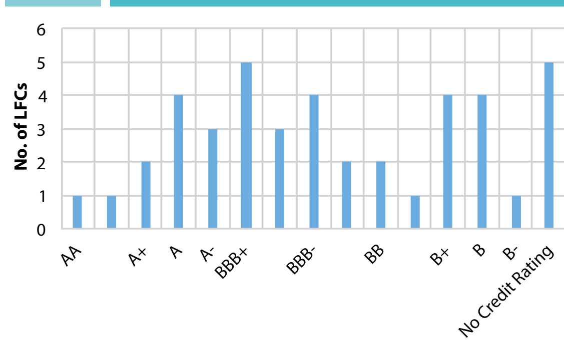
to grant a comparatively higher deposit interest rates.

Reputation Risk

The issues relating to the existing distressed/ high-risk finance companies in the sector with negative capital/insufficient capital buffer to absorb shocks, customer complaints and public reactions on regulatory actions against such LFCs, affected the reputation of the LFCs and SLCs sector as a whole. Going forward this could impact deposit mobilisation and profitability of the sector.

The credit ratings of financial institutions are an indicator which influence the assessment of the risk faced by institutions of the particular sector. In 2018, the Central Bank required all LFCs to obtain a credit rating and make their respective ratings available to customers, by issuing Circular No. 1 of 2018 on “Credit Ratings”. However, out of 42 LFCs in the sector, only 37 LFCs obtained credit ratings. Out of the LFCs which obtained rating, 14 LFCs were rated below the investment

Chart 3.39 Credit Rating of the LFCs Sector



Source: Fitch Ratings and ICRA Ratings grade of BBB- whereas, 24 LFCs were rated as investment grade or above. As such, a considerable number of LFCs may face difficulty in raising funds at a competitive rate to carry out their business operations.

Risk of Governance

It has been observed that, one of the reasons for failure of LFCs is improper governance issues where the ownership and decision making is concentrated with the main shareholder or few shareholders linked to the main shareholder. Thus, strengthening the Corporate Governance by the introduction of ownership limitations is another timely regulatory measure which is proposed to be introduced. However, concessions will be given for investors who invested in distressed LFCs with the intention of restructuring such companies.

Revising the existing Direction on Corporate Governance with a view to further strengthen good corporate governance practices in LFCs is also to be carried out in the near future. Strong corporate governance processes and practices facilitate the conduct of the finance business in a responsible and accountable manner to promote safety and soundness of individual LFCs, thereby leading to stability of the sector.

Thus, it is apparent that institutions of the LFCs and SLCs sector are exposed to a number of risks; default risk, concentration risk, liquidity risk, interest rate risk, reputation risk and risk of improper governance. Hence, stringent regulations and necessary amendments to the existing legal framework such as amending the Finance Business Act and strengthening the resolution and enforcement framework are required to safeguard the stability of the sector in the long run.

Adequacy of Resources to Mitigate Risks Faced by the Sector

The key prudential indicators that show the resilience of the sector, including capital and liquidity, continued to be positive and remained well above the minimum regulatory requirements, except for a few distressed/ high-risk LFCs. The Central Bank continued to monitor those key prudential measures with a consideration on reviving the companies with weak financial positions. Accordingly, necessary actions have been taken to cease or limit finance business operations of high-risk LFCs to safeguard the interest of depositors and other creditors to ensure the long-term stability of the financial sector.

Capital

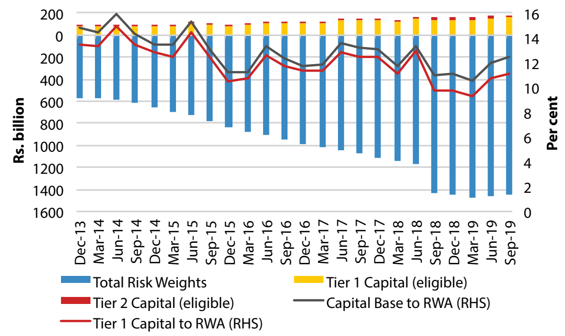
The capital position of the LFCs and SLCs sector improved due to the enhancement of regulatory capital requirements during the period under review. The total regulatory capital levels improved by Rs. 21.9 billion to Rs. 180.2 billion by end September 2019 compared to Rs. 158.3 billion recorded in the corresponding period of 2018.

The sector core capital ratio and total risk weighted capital adequacy ratio increased to 11.2 per cent and 12.5 per cent, respectively, by end September 2019 from the reported level of 9.7 per cent and 11.0 per cent at end September 2018. Growth of the risk weighted assets of the sector was largely stagnated during the period under review. The stagnated growth of risk weighted assets along with strong capital availability has resulted in the sector reporting capital adequacy ratios at a satisfactory level.

Even though risk weighted capital adequacy position of the sector is satisfactory at the consolidated level, several LFCs are in violation of the minimum capital requirement of Rs. 1.5 billion imposed by the Finance Business Act, Direction No. 2 of 2017 on "Minimum Core Capital". As a result, the Central Bank has taken measures such as deposit caps, lending caps, restricting business expansion on LFCs which have violated the Direction.

An additional capital requirement was imposed on systemically important LFCs as a systemic

Chart 3.40 **Capital Adequacy of the LFCs and SLCs Sector**

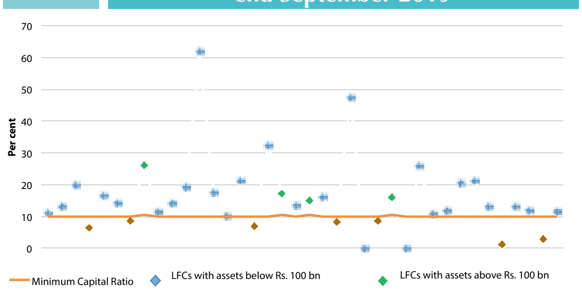


Source: Central Bank of Sri Lanka

risk mitigating measure. Accordingly, as per the Finance Business Act, Directions No. 3 of 2018 on "Capital Adequacy Requirements", LFCs which have recorded total assets equal or over Rs. 100 billion are considered as Domestic Systemically Important LFCs (D-SILFC) and are required to have an additional capital requirement which is expected to be increased up to 1.50 per cent of the total risk weighted assets on a staggered basis, compared to LFCs with a total asset base below Rs. 100 billion. As such, D-SILFCs were required to have a capital surcharge of 0.5 per cent with effect from 1 July 2019.

At end September 2019, there were four LFCs which were identified as D-SILFCs which have recorded total capital adequacy ratios well above the required level. When considering other LFCs, most LFCs have recorded capital adequacy ratios at the required level and several LFCs have recorded capital adequacy ratio below the required level. Out of these non-compliant LFCs, few LFCs which have a weak financial position have recorded negative capital adequacy ratios. The Central Bank has taken numerous regulatory measures to address the non-compliance to the Capital Adequacy Directions.

Chart 3.41 **Total Capital Ratio of Individual LFCs* as at end September 2019**



Source: Central Bank of Sri Lanka

*The LFCs which have recorded negative Total Capital Ratios were omitted in the graph to improve visibility

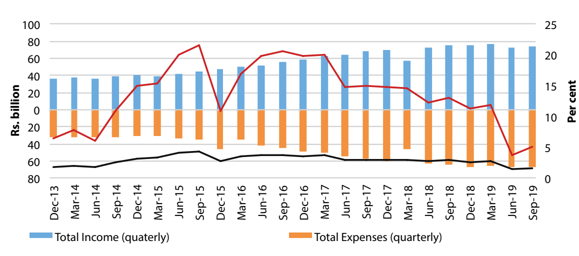
Profitability

Profitability of the LFCs and SLCs sector has declined during the period under review. The profits of the sector during the first six months of the financial year declined to Rs. 4.8 billion from Rs. 11.3 billion recorded during the corresponding period of 2018. It is observed that the drop in profits is mainly due to the drop in NIM and increased operating expenses. The drop in NIM is attributable to the increase in interest expenses by 3.8 per cent while the interest income increased marginally by 0.1 per cent during the period under review. Operating expenses has also increased by 2.7 per cent during this period. Further, the provisions made by the sector has increased considerably by 31.3 per cent corresponding to the increased NPLs. Subsequently, the ROA and ROE ratios of the sector were reported at 1.7 per cent and 5.0 per cent respectively during the period under review which declined from 2.9 per cent and 13.1 per cent respectively compared September 2018.

Challenges and Threats Faced by the Sector

The sector outlook in the short and medium term will be challenging due to subdued economic growth, enhancement of minimum capital requirements, the higher loan loss provisioning in line with SLFRS 9 and lack of best practices in corporate governance of the sector. These factors have caused rising NPLs, declining

Chart 3.42 **Profitability of the LFCs and SLCs Sector**



Source: Central Bank of Sri Lanka

profitability, increased risk profiles and muted growth prospects for the sector. Central Bank will intervene proactively against the non-compliant distressed and high risk LFCs, which will include imposing regulatory actions such as restriction on businesses, suspension and cancellation of licences.

Improvement of economic activities, investor confidence, political stability of the country and ongoing regulatory actions will have a positive impact on the outlook of the LFCs and SLCs sector in the medium term.

Inadequacy of capital: Despite the directions issued in the interest of the safety and soundness of the sector to increase the core capital of LFCs and to maintain minimum capital adequacy ratios at an unimpaired level, several LFCs were non-complaint with the regulatory minimum requirements. Inadequacy of capital is considered as a serious regulatory concern as it weakens the resilience of LFCs.

With the enhanced minimum capital levels and the implementation of new capital adequacy requirements, capital levels are expected to increase during the next few years. The enhanced capital requirements of the sector will improve the shock absorbing capacity during periods of stress and would also encourage voluntary consolidation among LFCs.

Increasing provisioning requirements: In order to provide the required cushion to absorb losses due to increasing NPLs, implementation of Sri Lanka Financial Reporting Standards (SLFRS) 9 and the proposed direction on classification and measurement of credit facilities, provisioning requirements of LFCs will further increase. Such increase in provisions will lower the profits of the sector which in turn may affect the capital position of LFCs and SLCs.

Non-rectification of supervisory concerns: The threat to the sector remains high with non-compliance of few LFCs with regulatory actions and/or inability to take corrective actions on the supervisory concerns raised by the Central Bank. Non-compliance with the prudential or operational requirements will adversely affect the performance of such LFCs and SLCs threatening the interest of its depositors.

Increasing risk appetite of LFCs: It is observed that the sector is expanding in to riskier non-core lending segments such as real estate development and microfinance, indicating the high-risk appetite of the sector. This may be due to LFCs seeking to remain in business and secure their market share amidst tight competition from a large number of LFCs and licensed banks penetrating aggressively into the lending market. The ability of LFCs to withstand such risky ventures is questionable with the prevailing macroeconomic environment.

Resolution Actions against Distressed and High Risk LFCs

Central Bank has an internal rating system and an early warning system to identify high risk LFCs, to take proactive measures. Accordingly, Central Bank has taken a myriad of regulatory actions against distressed and high risk LFCs in order to safeguard the interest of depositors of such LFCs. Central Bank has imposed restrictions on deposits, lending and borrowings on LFCs which have not complied to with regulatory requirements. With regard to distressed LFCs, the Central Bank appointed management panels to manage the business affairs and facilitated repaying of deposits. Further, regulatory actions against the wrongdoers to recover the loss caused to such LFCs by their actions, including impounding passports and seizing personal bank accounts and properties were also initiated during the period under review.

Establishment of a proper resolution framework will also be carried out in the medium time horizon. Initiatives are currently being taken to resolve the distressed LFCs, as per the provisions of the Finance Business Act (FBA). The process of settling the depositors of LFCs whose licences were cancelled are being carried out through the Sri Lanka Deposit Insurance and Liquidity Support

Scheme at present. To facilitate expeditious resolution action in respect of distressed/high risk LFCs, amendments are proposed to the FBA on the resolution framework for LFCs.

In order to improve public awareness on weak LFCs the Central Bank required such LFCs to disclose regulatory actions taken against them, in all publications including advertisements soliciting deposits and debt from public. Further, Central Bank disclosed the names of LFCs, which are subject to regulatory restrictions, in the Central Bank official website and in the Central Bank Annual Report 2018.

Proposed Amendments to the Finance Business Act

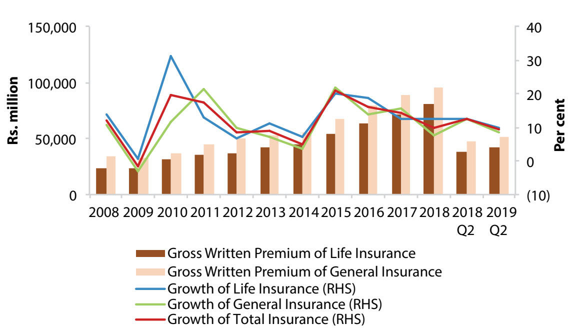
The stability of the sector is expected to be reinforced further in the medium term with changes to the existing regulatory framework. Amendments are proposed to the FBA, which are to be finalized during the second half of 2020. In line with such developments, the regulatory framework of LFCs and SLCs will be revisited to strengthen the supervision and regulation of LFCs and SLCs to minimize forbearances similar to licensed banks.

3.4 Insurance Sector

The insurance sector performed moderately during the year 2019, recording a growth in its assets base. The asset base grew by 12.4 per cent at end June 2019 as against 9.1 per cent growth reported during the corresponding period of the previous year. The Gross Written Premium (GWP) grew by 9.2 per cent as at end June 2019 which is a deceleration from 12.6 per cent reported as at end June 2018. The GWP growth of the long-term insurance sector was slightly higher than the growth of GWP of the general insurance sector. When considering the sub-sectors of general insurance sector, health insurance recorded the highest growth of GWP followed by fire insurance, marine insurance and motor insurance. Compared to the corresponding period of year 2018, fire insurance, health insurance and marine insurance have recorded higher growth rates in GWP, whereas, motor insurance has decelerated.

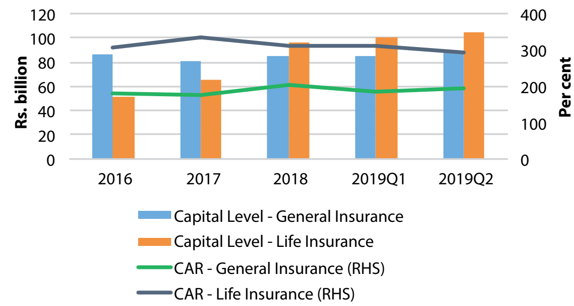
Profits of the sector declined significantly by 42.4 per cent on a year-on-year basis at end June 2019. Decline of the long-term insurance sector profits by 51.6 in the period under consideration, largely contributed for the drop in profits of the sector. Even though, the decline is significant in nature, it is attributable to the base effect on reporting an exorbitant profit by two long-term insurance companies in June 2018. Nevertheless, the Return on Assets (ROA) and Return on

Chart 3.43 Gross Written Premium of the Insurance Sector



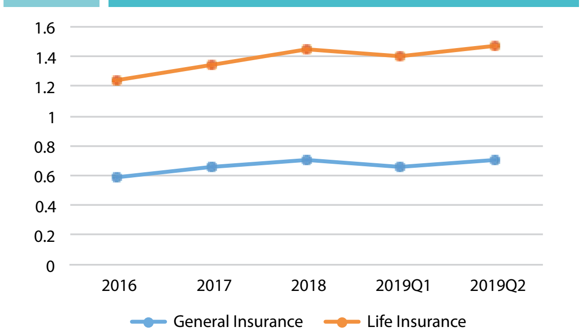
Source: Insurance Regulatory Commission of Sri Lanka

Chart 3.44 Capital Adequacy of the Insurance Sector



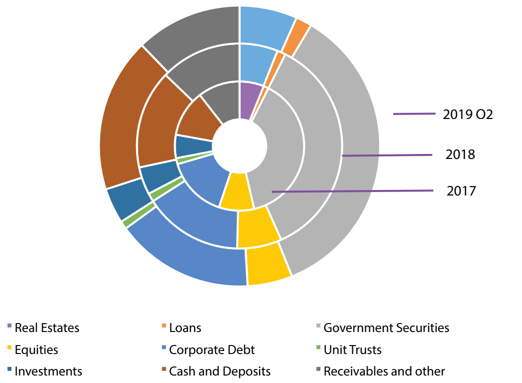
Source: Insurance Regulatory Commission of Sri Lanka

Chart 3.45 Liquidity Ratios of the Insurance Sector



Source: Insurance Regulatory Commission of Sri Lanka

Chart 3.46 Distribution of Total Assets of Insurance Companies



Source: Insurance Regulatory Commission of Sri Lanka

Equity (ROE) of the long-term insurance sector increased marginally during the period under consideration. Meanwhile, the ROA and ROE of the general insurance sector declined slightly.

The insurance sector may face various risks such as, market risk, liquidity risk, and operational risk and face adverse shocks like natural calamities and economic downturns. Therefore, insurance sector should have adequate levels of capital and liquidity levels to withstand possible shocks to the sector. The capital levels of both long-term insurance sector and general insurance sector has been in an increasing trend and the total capital adequacy ratio has been well above the minimum requirement of 120 per cent. However, one insurance company has reported a non-compliance with capital adequacy requirements. Such non-compliances are vigilantly addressed by the Insurance Regulatory Commission of Sri Lanka with a view of maintaining financial system stability.

Availability of liquidity is also vital for the business continuity of an insurance service provider. It is observed that the liquidity ratios of both general and long-term insurance sub-sectors are at an increasing trend. Further, the asset base of the insurance sector was mainly comprised of investments in government securities followed by cash and deposits. Therefore, a major component of the asset base is liquid assets which mitigates the liquidity risk faced by the sector.

Chapter 4

Household Sector and Corporate Sector

4.1 Overview

Private sector leverage, which is measured by the private credit to nominal GDP, moderated during first eight months of 2019. The private credit to GDP gap which was positive from March 2018, began narrowing since December 2018 and turned negative in April 2019.

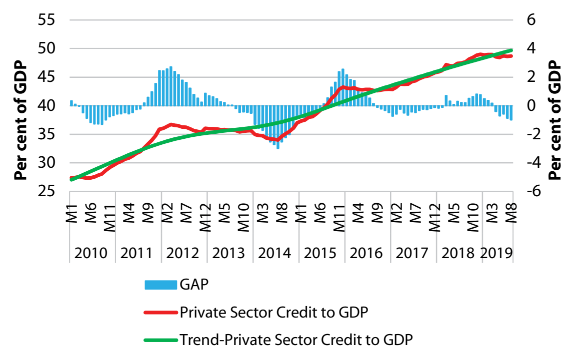
Lower than expected economic activities, political uncertainty and recent challenges to national security weighed on the credit moderation in the economy. The Survey on Credit Supply conducted by the Central Bank shed light on the receding demand for credit in the economy, rising finance costs, rising delinquency levels, tightened credit screening accompanied by decreased willingness to lend by lending institutions.

Credit to government and public corporations to GDP, an indicator of state sector leverage, has continued to rise resulting in a positive credit gap in August 2019. Increased credit demand from the state sector has eased the contractionary pressure on domestic credit growth to a certain extent during the first eight months of 2019. However, the long-term trend of credit to state sector appears to be flattening.

The moderation in private sector credit is evident in household and non-household sectors (i.e. both corporate and government sectors together). Delinquency levels of household and non-household sectors have been rising. Consequently, non-performing loan ratios (with interest in suspense – IIS) have increased for these sectors.

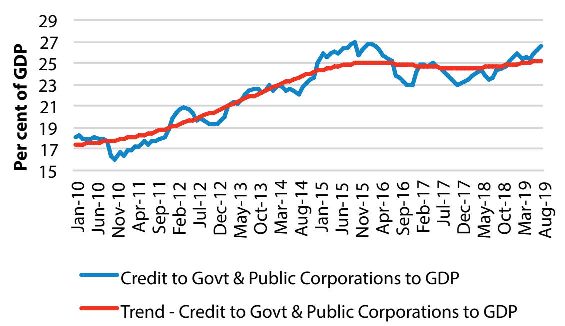
The non-financial corporate sector reported subdued performance during recent quarters as reflected through decline in sales, eroding profit margins and decreasing profits. Early signs of vulnerabilities could be observed in non-financial corporate sector particularly with impaired debt servicing capabilities, decreased solvency levels and increased gearing ratios. The subdued developments of the non-financial corporate sector could adversely reflect on the financial statements of financial institutes with a time lag.

Chart 4.1 Private Credit to GDP



Source: Central Bank of Sri Lanka

Chart 4.2 Credit to Government & Public Corporations to GDP



Source: Central Bank of Sri Lanka

4.2 Household Sector Credit and Vulnerabilities

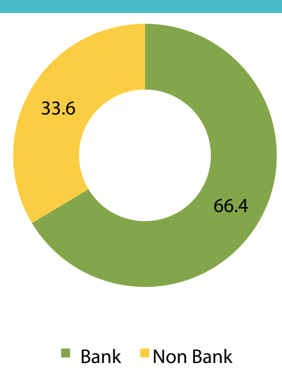
Household sector credit, which accounts for 43.8 per cent of total formal financial sector lending[1], has been growing at a slower pace during first half of 2019. The semi-annual credit growth of household sector moderated to 2.1 per cent in June 2019 from 6.2 per cent in June 2018. The banking sector was the main source of household borrowings with a contribution of approximately two third of total credit to household sector from formal financial sector.

Credit quality of household sector deteriorated, signalling a plausible build-up of imbalances in the sector. Nevertheless, the prevalent credit risk is at manageable levels with prudential measures being taken by regulated financial institutions.

The share of non-arrears loans[2] in total household sector has been decreasing since December 2017 while the share of arrears loans was rising, depicting a structural change in household sector credit quality.

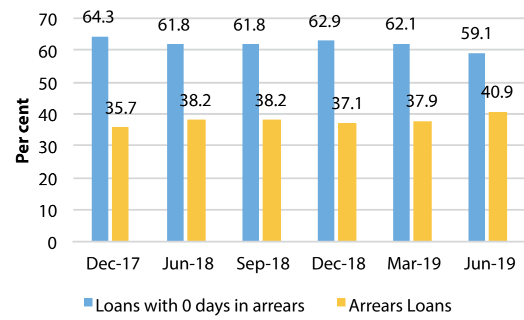
Despite the banking sector being the main source of household sector debt, the non-performing loans (NPLs) were largely stemming from non-bank financial institutions (NBFI)[3] sector. The NBFI sector accounts for 64.5 per cent of total non-performing advances of household sector as at end June 2019.

Chart 4.3 Sources of Household Sector Credit



Source: Central Bank of Sri Lanka

Chart 4.4 Structural Change in Credit Quality of Household Debt

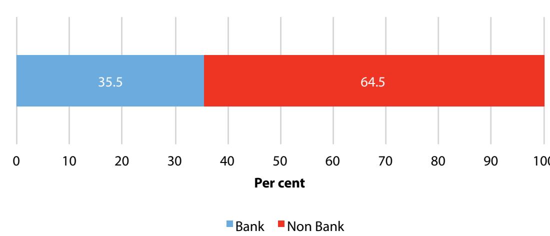


Source: Central Bank of Sri Lanka

The NPL ratio of the household sector (with interest IIS) has been rising since December 2017 signifying a worsening of asset quality. Non-performing advances reported a growth rate of 39.7 per cent, y-o-y, while the total household debt increased at a rate of 7.7 per cent, y-o-y.

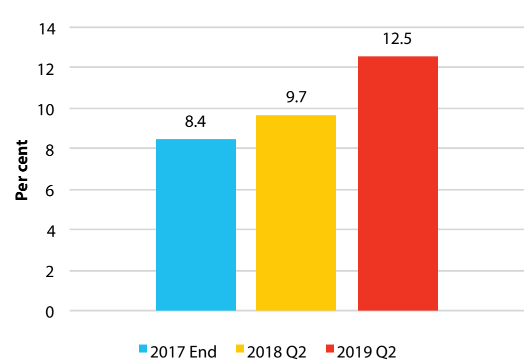
The arrears loans grew at 12.4 per cent during first half of 2019 while non-arrears loans contracted by 3.9 per cent during the same period. It is evident that there exists a downward migration from non-arrears loans to arrears loans, considering the dismal increase of 2.1 per cent in total household debt during the first half of

Chart 4.5 Composition of NPL of Household Sector as at June 2019



Source: Central Bank of Sri Lanka

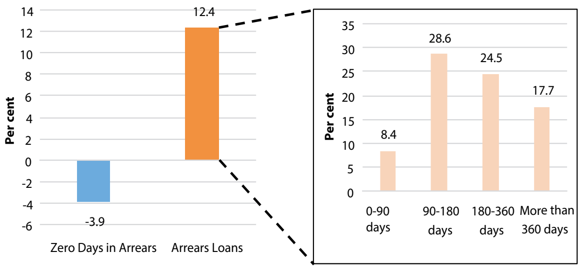
Chart 4.6 NPL Ratio (with IIS)



Source: Central Bank of Sri Lanka

1 Formal Financial sector lending includes lending by licensed banks, licensed finance companies and specialised leasing companies.
2 Facilities with zero days in arrears
3 Non-Bank Financial Institutions encompass Licensed Finance Companies and Specialised Leasing Companies

Chart 4.7 Growth Rates for the First Six Months of 2019



Source: Central Bank of Sri Lanka

2019. Of the arrears loans, facilities in arrears for 90-180 days (Special mentioned) and 180- 360 day (Substandard) buckets grew at substantially higher rates.

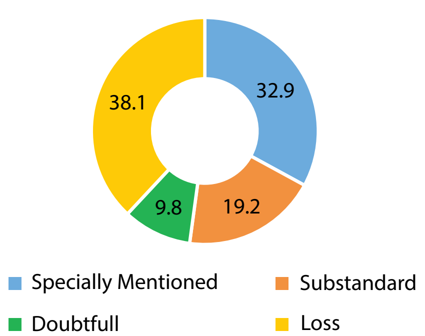
Special mentioned and substandard categories represented 32.9 per cent and 19.2 per cent of total non-performing loans in household debt, respectively. This indicates a threat to the financial system if the arrears loans are further downgraded requiring substantial provisioning.

Number of household defaulters has been steadily on the rise since the second quarter of 2017 irrespective of the value of the debt in default.

The majority of defaulters (91.8 per cent) had a borrowing of less than Rs. 1 million and accounted for 33.7 per cent of total household debt in default.

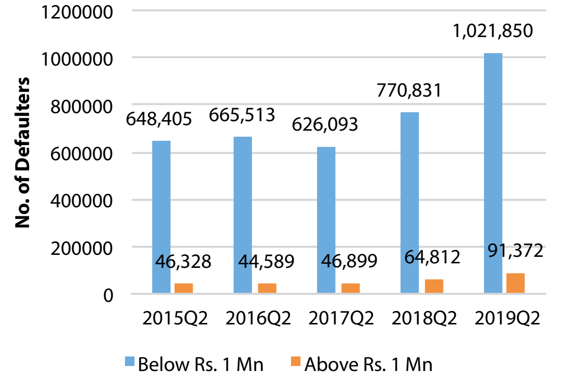
The heatmap on the distribution of household sector consumption credit indicated that approximately 50 per cent of total consumption loans has been directed to Colombo district. The Colombo district reported the highest NPL ratio (with IIS) in consumption loans as at end June 2019.

Chart 4.8 Composition of NPLs as at June 2019



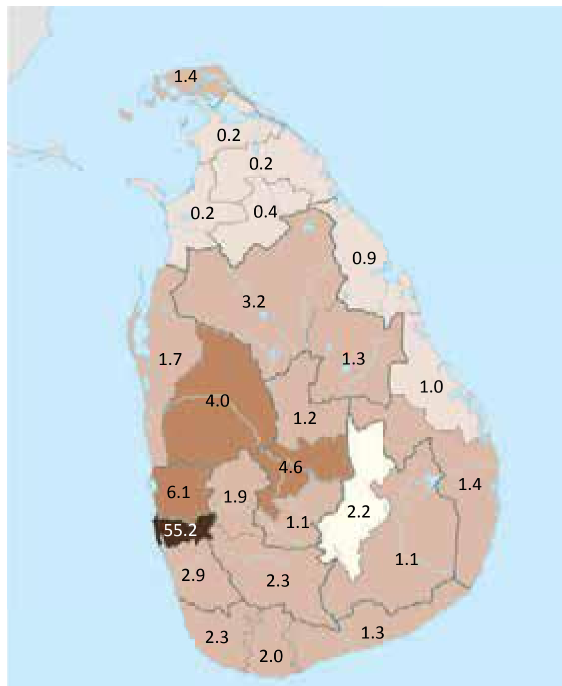
Source: Central Bank of Sri Lanka

Chart 4.9 Number of Defaulters in Household Sector



Source: Central Bank of Sri Lanka

Chart 4.10 Distribution of Household Consumption Credit

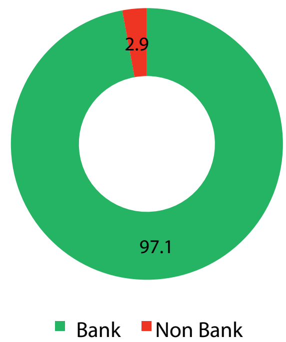


4.3 Credit to Non-Household Sector

Non– household sector[4] accounted for 56.2 per cent of total formal financial sector lending as at end June 2019. During the first half of 2019, credit to non-household sector contracted by 1.5 per cent indicating a net repayment of debt in the sector. Despite the contraction in the first half, credit to non-household sector grew by 14.6 per cent on y-o-y basis in June 2019 resulting from the significant credit growth reported in Q4 of 2018. Non-household sector debt requirements

4 Non-household sector encompasses, corporate sector, government and public corporations

Chart 4.11 **Sources of Non-Household Sector Debt**



Source: Central Bank of Sri Lanka

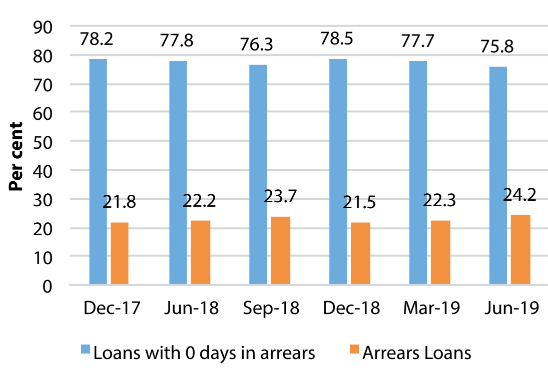
were predominantly served by the banking sector with a share of 97.1 per cent of total non-household debt.

The share of non-arrears loans in total non-household sector has been decreasing since December 2018 while the share of arrears loans was rising, depicting a structural change in non-household sector credit quality.

Asset quality of non-household sector measured through NPL ratio (with IIS) has been deteriorating since December 2017. Total non-performing advances increased by 52.4 per cent, y-o-y. Banking sector accounted for a share of 78 per cent in total non-performing loans of non-household debt as at end June 2019.

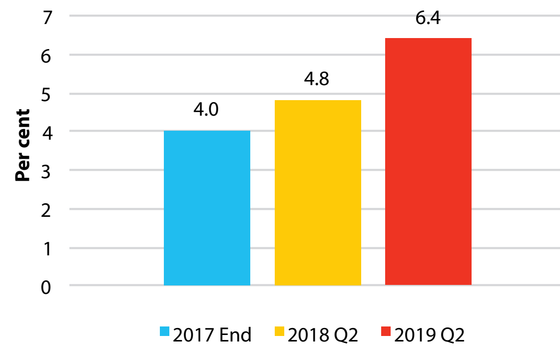
Total non-household debt contracted by 1.5 per cent during first half of 2019. Non-arrears loans depicted a similar trend as it contracted by 4.9 percent during the same period. In contrast, arrears loans grew by 10.8 per cent during first half of 2019 signifying a downward migration

Chart 4.12 **Structural Change in Credit Quality**



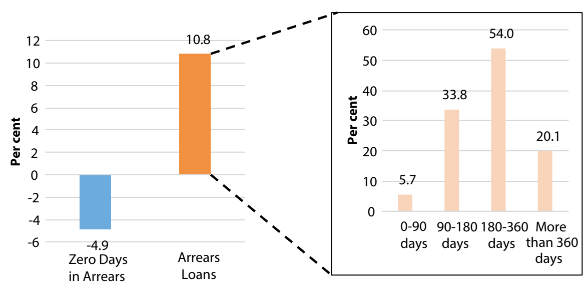
Source: Central Bank of Sri Lanka

Chart 4.13 **NPL Ratios (with IIS)**



Source: Central Bank of Sri Lanka

Chart 4.14 **Growth Rates for the First Six Months of 2019**



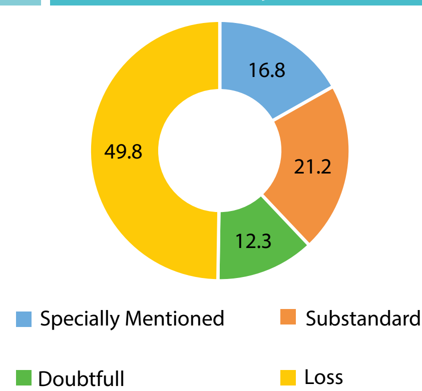
Source: Central Bank of Sri Lanka

from non-arrears loans to arrears. Of the arrears loans, facilities in arrears for 90 -180 days (Special mentioned) and 180-360 day (Substandard) buckets grew at substantially higher rates.

Special mentioned and substandard categories represented 16.8 per cent and 21.2 per cent of total non-performing loans in non-household sector debt.

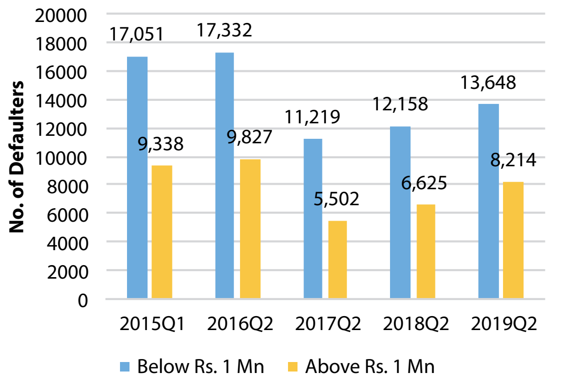
Number of non-household defaulters increased by 3,079 from 18,783 in the second quarter of 2018 to 21,862 in the second quarter of 2019.

Chart 4.15 **Composition of Non-Household NPLs as at June 2019**



Source: Central Bank of Sri Lanka

Chart 4.16 Number of Defaulters in Non-Household Sector



Source: Central Bank of Sri Lanka

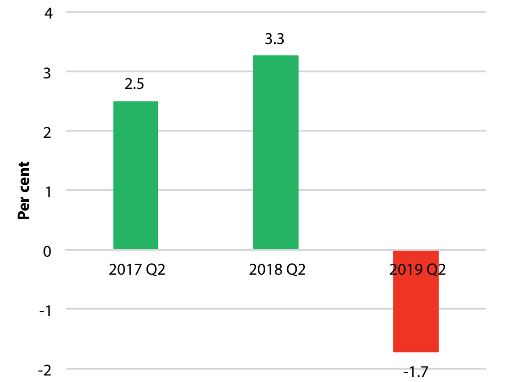
Non-household defaulters who had more than Rs. 1 million in default represented 37.6 per cent of total defaulters and held 93.4 per cent of total non-household debt in default.

The deterioration in asset quality may adversely affect the banking and NBFI sectors as it hinders the internal capital generation. If the depleting asset quality persists, it could erode the existing capital levels of some financial institutions. Consequently, meeting minimum capital requirements for banks and NBFIs would be more challenging.

4.4 Non-Financial Corporate Sector Risk[5] Assessment

Corporates as economic actors influence the macroeconomy and the financial system through their cohesive behaviour. Meanwhile, they are exposed to changes in the macroeconomy and the financial system. Analysis of the corporate sector enables policy makers to foresee plausible systemic vulnerabilities and thereby acts as an early warning indicator.

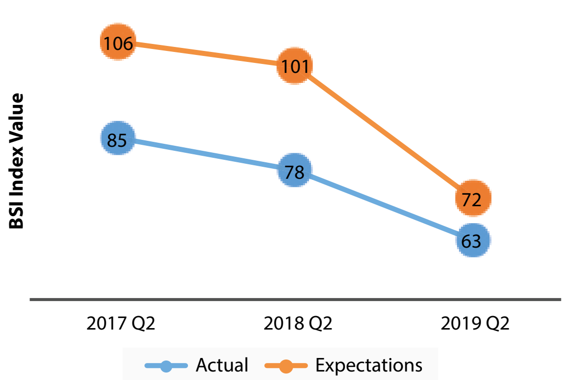
Chart 4.18 Growth of Corporate Revenue



Source: Central Bank of Sri Lanka

Non-financial corporates reported weak financial performances in the second quarter of 2019, on y-o-y basis, as reflected through negative sales growth and profits. The decline in corporate performance could be attributed to moderation in economic growth, Easter Sunday attacks, policy and political uncertainty, change in tax/ duty structure, rising overheads and increase in effective finance cost. The dismal performance of corporate sector was also revealed in the Business Outlook Survey[6] in the second quarter of 2019 with worsened Business Sentiment Index (BSI).

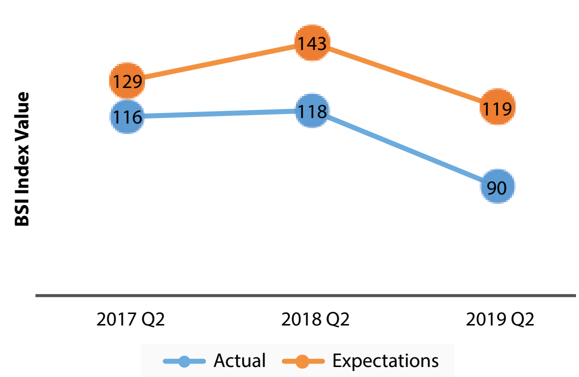
Chart 4.17 Business Sentiment Index



Source: Central Bank of Sri Lanka

Note: BSI below 100 shows a contraction in business sentiment.

Chart 4.19 Business Sentiment Index – Sales Sub-Index

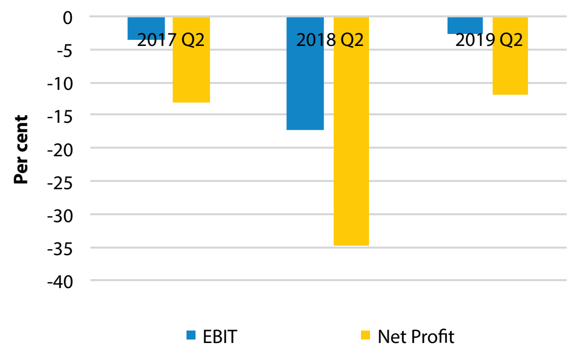


Source: Central Bank of Sri Lanka

5 Corporate sector risk assessment was conducted using non-financial corporates listed in Colombo Stock Exchange.

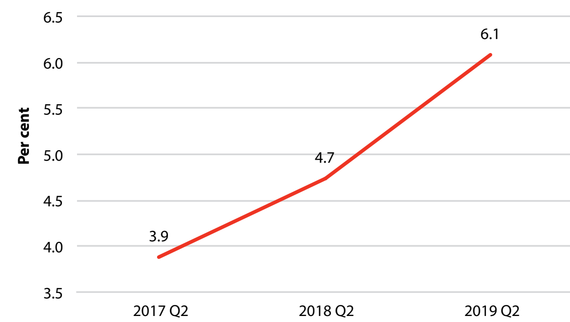
6 Business Outlook Survey captures short-term market developments using a sample of large-scale enterprises.

Chart 4.20 **Growth of Corporate Profit**



Source: Central Bank of Sri Lanka

Chart 4.22 **Effective Finance Cost as a Share of Sales**

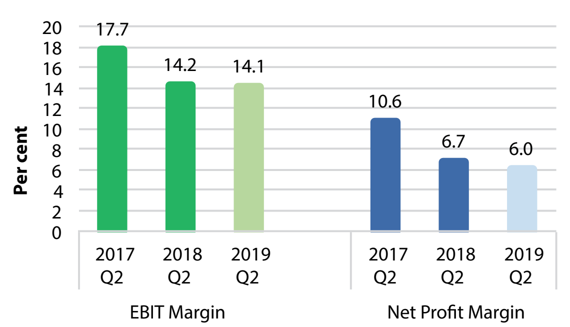


Source: Central Bank of Sri Lanka

Corporate revenue which reported a modest growth of 2.5 per cent and 3.3 per cent in the second quarter of 2017 and the second quarter of 2018, turned negative in the second quarter of 2019, reporting a negative growth of 1.7 per cent. Hotel and travel sector, motor sector, construction and engineering sector, plantation sector, power and energy sectors and trading sector largely contributed to this contraction in corporate sales. Negative revenue growth in the second quarter of 2019 is witnessed in the sales sub-index of BSI.

The decreasing trend in profits of listed non-financial corporates continued in the second quarter of 2019 due to negative revenue growth, squeezed profit margins and increased overheads. However, the negative growth of profits have improved in the second quarter of 2019. The contraction in corporate profits were more visible with hotels and travel sector, power and energy sector, construction and engineering sector, telecommunication sector and trading sectors. Number of loss-making corporates increased to 102 in the second quarter of 2019 from 89 in the second quarter of 2018.

Chart 4.21 **Profit Margins**



Source: Central Bank of Sri Lanka

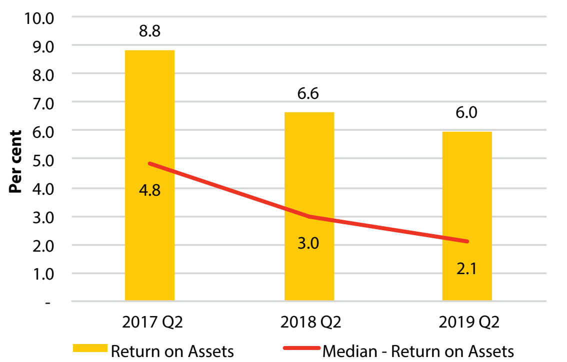
Net profit margin and Earnings Before Interest and Taxes (EBIT) margin which are expressed as a relative share of sales, narrowed to 6.0 per cent and 14.1 per cent, respectively in second quarter of 2019 compared to 6.7 per cent and 14.2 per cent, respectively in the second quarter of 2018.

Increased overhead expenses, deteriorated efficiency levels, rising finance cost largely resulted in shrinking the margins of corporates. The weakened efficiency levels were observed with receded assets turnover ratios of non-financial corporates which slipped from 0.450 times in second quarter of 2018 to 0.426 times in the second quarter of 2019. The finance expenditure for the second quarter of 2019 increased by 26.3 per cent on y-o-y basis.

Annualised Return on Assets (ROA) and Return on Equity (ROE) declined to 6.0 per cent and 4.3 per cent, respectively in the second quarter of 2019 compared to 6.6 per cent and 5.0 per cent, respectively, in the second quarters of 2018. Meanwhile, median ROA and median ROE demonstrated a similar trajectory indicating that the diminishing profitability in corporate sector is broad-based.

Corporate balance sheets reflect the internal and general environmental challenges confronted by the non-financial corporate sector and their responses. Early signs of balance-sheet vulnerabilities could be observed in the

Chart 4.23 Return on Assets of Corporates

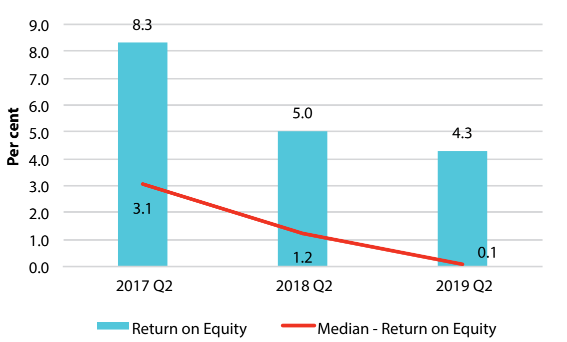


Source: Central Bank of Sri Lanka

sector particularly with impaired debt servicing capabilities.

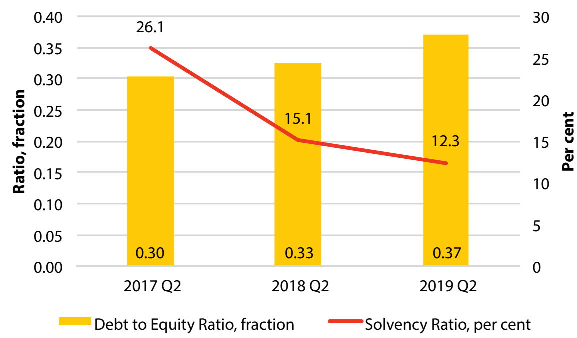
Solvency ratio, which measures the corporate profits relative to its debt holding, deteriorated in the second quarter of 2019 to 12.3 per cent from 15.1 per cent in the second quarter of 2018 due to significant decrease in corporate profits and increase in debt levels. Consequently, corporates' ability to service debt has lessened and the probability of defaulting debt has heightened. Interest coverage ratio decreased from 3.0 times in second quarter of 2018 to 2.3 times in the second quarter of 2019, reflecting a trajectory of rising finance cost and diminishing operating profits of corporates. Number of companies with interest coverage ratio less than 1 increased to 87 in the second quarter of 2019 from 72 in the second quarter of 2018. Corporate debt to equity ratio, which reflects the funding structure of companies, has increased from 0.33 in the second quarter of 2018 to 0.37 in the second quarter of 2019.

Chart 4.24 Return on Equity of Corporates



Source: Central Bank of Sri Lanka

Chart 4.25 Debt to Equity and Solvency Ratios of Corporates

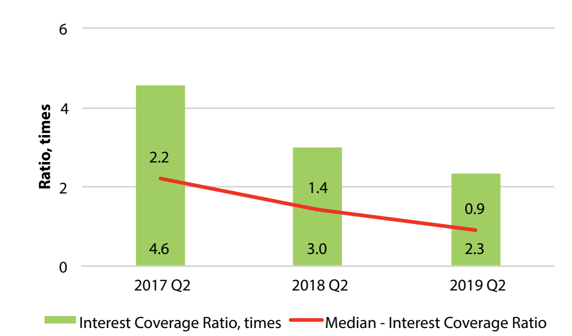


Source: Central Bank of Sri Lanka

Decrease in profits which hinder internal capital generation, weakened cash generation from operations and consequent reliance on debt capital for operations and business expansions largely underpinned the increase in corporate debt levels. Number of listed companies reporting more than 40 per cent y-o-y increase in debt levels, was 55 in the second quarter of 2019 compared to 46 in the second quarter of 2018.

Continuation of the low growth scenario and lack of market confidence created through political instability could exert pressure on the performance of the corporate sector during the remaining two quarters of the year. Further, plausible negative impacts emanating from Easter Sunday attacks could further deteriorate corporate sector performance in second half of 2019 particularly in tourism related industries. The subdued performance of non-financial corporate sector could adversely reflect on the financial statements of financial institutes with a time lag. However, with the restoration of political stability,

Chart 4.26 Interest Coverage Ratio



Source: Central Bank of Sri Lanka

easing of security concerns and declining interest rates, the economic growth may bounce back to its potential which would eventually improve the non-financial corporate sector performance in the medium term. The recent fiscal stimulus package offered will also have a positive impact on the non-financial corporate sector as it would stimulate the consumption demand of households and the reduction in direct taxes would improve profitability of non-financial corporates.

Chapter 5

Financial System Infrastructure

5.1 Overview

The Central Bank has been the driving force in the development of financial sector infrastructure of the country to facilitate smooth flow of transactions while avoiding risk of deficiencies in financial flows. Financial infrastructure comprises of the national payment and settlement systems as well as the legal and institutional framework. The national payment system continued to facilitate all retail and high-value transactions effectively and was able to address the myriad payment requirements of Sri Lanka. The regulatory and supervisory activities of the Central Bank, in the area of the payment system was mainly focused on emerging developments in payment and settlement systems and risks associated with such developments with particular attention to issues relating to maintaining liquidity, adopting innovative technology and business continuity.

With a view of maintaining financial system stability in the long run, the Central Bank is in the process of introducing reforms to strengthen the legal and institutional framework of the financial sector. In 2019 the Central Bank drafted the new Central Bank of Sri Lanka Act which recognizes the Central Bank as the designated macroprudential authority of Sri Lanka and broadened its mandate to enhance and ensure a stable and efficient financial system. Formulation of a new Banking Act is also in progress to address the legal and regulatory issues confronting the developments in the banking system. Further, new policies are being formulated in areas such as regulation and supervision of banks and finance companies, resolution of financial institutions, transactions in financial markets, foreign exchange transactions, Anti-Money Laundering and Countering the Financing of Terrorism, deposit insurance and liquidity support scheme to ensure the efficiency and the stability of the financial system.

The surveillance of foreign exchange operations and mechanisms to address data gaps were also strengthened to foresee the build-up of risk and violation of regulations. As an outcome of collective efforts made by the Financial Intelligence Unit (FIU) of Sri Lanka and other stakeholders, in October 2019, the country was excluded from the "the Grey List" compiled by the Financial Action Task Force (FATF)[1] which listed Sri Lanka as a jurisdiction with strategic Anti-Money Laundering/Countering Financing of Terrorism (AML/CFT) deficiencies in November 2017. It is expected that these development in financial infrastructure will have positive impact on economic growth and stability of the financial system.

5.2 Payments and Settlements

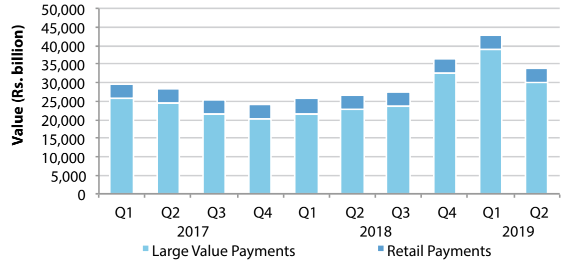
The large value payment system and the retail payment systems operated smoothly during the period while catering to the diverse payment needs of the country, demonstrating relatively low settlement risk and adequate liquidity to settle transactions amidst a steady increase in the volume.

Large Value Payment System

Considering the criticality of an efficient payment system to ensure financial system stability, the

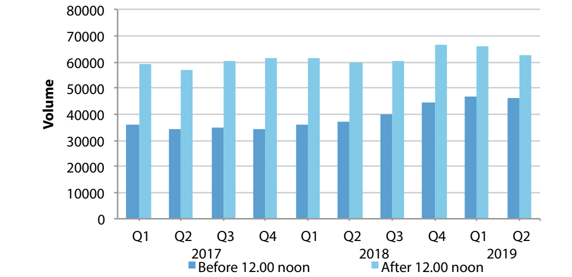
1 FATF is an independent inter-governmental body that develops and promotes policies to protect the global financial system against money laundering, terrorist financing and the financing of proliferation of weapons of mass destruction.

Chart 5.1 Large Value Payments and Retail Payments



Source: Central Bank of Sri Lanka

Chart 5.3 Time Distribution of RTGS Transactions (in Value Terms)

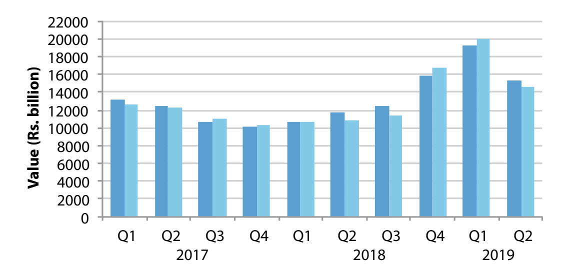


Source: Central Bank of Sri Lanka

Central Bank operated the LankaSettle System and other related systems with a high level of resilience and maintained a high level of system availability, well above the accepted norms. The LankaSettle System is a systemically important payment system in Sri Lanka which comprises of two well-integrated systems; namely RTGS and LankaSecure System. The RTGS system, the only large-value electronic payment system in the country, facilitates real-time settlement of high value and time critical interbank payments, in addition to providing settlement facilities for non-cash retail payment systems operated by LankaClear Pvt. Ltd (LCPL). The LankaSecure system consists of the Central Depository for Government Securities and the Scripless Securities Settlement System which electronically records transactions and ownership in Government securities and is a customer-based title registry for Government securities.

During the period of January to October 2019, a total of 362,220 RTGS transactions were performed with an average of 1,776 transactions per day. The total value transacted through the system during this period was Rs. 101.8 trillion. In order to ensure that the operations of the RTGS system is not adversely affected by liquidity issues of the Participating Institutions (PIs), the Central Bank as the operator of the system, continued to provide the interest free Intra-Day Liquidity Facility (ILF) during the first half of the year. PIs utilized an average ILF value of Rs. 64.7 billion in a business day.

Chart 5.2 Time Distribution of RTGS Transactions (in Volume Terms)



Source: Central Bank of Sri Lanka

The Central Bank engaged in regulatory and supervisory activities, focusing on new developments in the national payment system and risks associated with such developments. The Central Bank has formulated a Business Continuity Plan (BCP) which covers the LankaSettle System and other related systems of the Central Bank. The BCP is tested twice per annum to ascertain the readiness of above systems and the operational staff to resume business promptly following an interruption to operations at the primary location of the Central Bank.

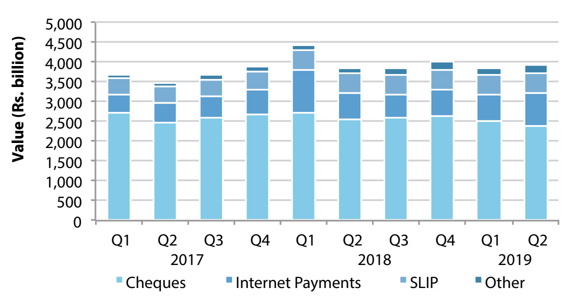
Having considered the consequences of systemic risk which could be caused by disruption to operations of the LankaSettle System, Central Bank advised PIs to have proper BCP and Disaster Recovery (DR) sites in order to achieve a consistent level of resilience in LankaSettle System. During the period under review, the Central Bank continued to conduct on-site and off-site surveillance to monitor the adherence of PIs of the LankaSettle System to the BCP Guidelines issued by the Central Bank and based on the observations and BCP drill reports, the Central Bank made recommendations to improve their BCP and DR arrangements.

Retail Payment Systems

Accelerating the migration to e-payments is one of the key priorities of the Central Bank. Therefore, the Central Bank has taken a series of measures to foster greater adoption of e-payments. Strengthening the transaction security and promoting the adoption of cost-effective e-payment services against cheques and cash payments are the main focus of these measures. In exercising the powers entrusted by legislation, the Central Bank continued the regulatory and supervisory functions in order to minimize risks associated with retail payment systems operating in the country. The Central Bank monitored the progress of implementing the sub switches of common card and payment switch namely Common ATM Switch (CAS), Common Electronic Fund Transfer Switch (CEFTS) and Common Point-of-Sales Switch (CPS). Further, the National Quick Response (QR) Code specification branded as "LankaQR" was issued to promote customer convenience, safety and ensure interoperability of different payment mechanisms and instruments. Several financial institutions launched "LankaQR" based payment products during 2019.

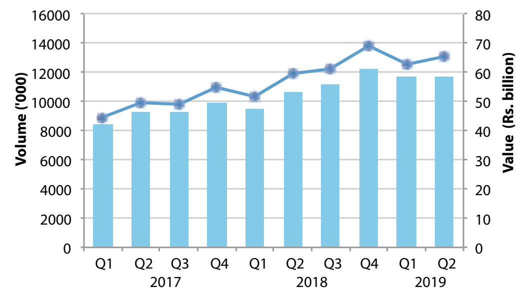
During the period under review, the Central Bank continued supervision of the operations of licensed service providers of payment cards and mobile payment systems, to ensure the operations of these systems are in accordance with the regulatory framework. The Central Bank made several recommendations based on supervision findings to mitigate risks and to maintain smooth operations of these system.

Chart 5.4 Retail Payments



Source: Central Bank of Sri Lanka

Chart 5.5 Credit Card Transactions

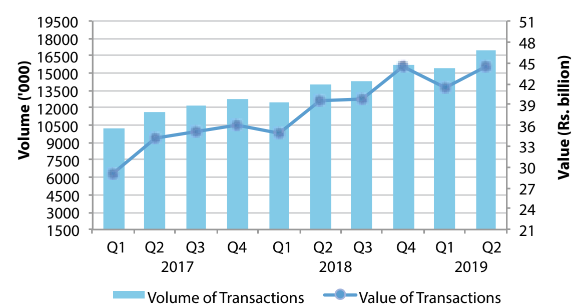


Source: Central Bank of Sri Lanka

Considering the recent trend of using mobile applications for financial transactions, the Central Bank issued the Guideline on Minimum Compliance Standard for Payment Related Mobile Applications in January 2018 to set minimum security standards to minimize the risks of using mobile applications to perform financial transactions with a view to protect customer privacy and security of transactions. During the year 2019, the Central Bank monitored the compliance of financial institutions to this Guideline.

Even though, electronic payment modes provide convenience and efficiency, risks of fraudulent transactions being carried out using electronic payment modes are higher than the traditional paper-based payment modes. Therefore, in order to make electronic transactions more secure, instructions were issued to financial institutions regarding providing real time notifications to customers who use electronic payment modes. Accordingly, customers who use the real-time notification facility will be able to report fraudulent transactions from their accounts immediately,

Chart 5.6 Debit Card Transactions (Carried out at POS terminals)



Source: Central Bank of Sri Lanka

enabling financial institutions to stop fund movements from the affected accounts.

With the rapid growth in FinTech innovations in the country, the Central Bank initiated actions to establish a Regulatory Sand Box, which would provide a safe space in a controlled environment for innovators to test their products and services without infringing on regulatory requirements, in order to provide an environment for FinTech innovators to reach the market thus providing greater financial feasibility for new initiatives. The Central Bank is also focused on adopting Blockchain Technology for a shared KYC (Know Your Customer) solution to facilitate efficient customer onboarding, improve data quality and provide low cost and security of data. The Central Bank will initially develop a shared KYC Proof of Concept (POC) to better understand the potential of Blockchain Technology to improve KYC processes in Sri Lanka as well as understand the challenges and risks that could pose to the financial system.

As a part of its on-going endeavor in upgrading domestic financial system infrastructure, including the government securities trading, settlement and Central Securities Registry related IT infrastructure, and the enabling legal and regulatory framework, The Central Bank has initiated the process for establishment of a state-of-the-art Electronic Trading Platform (ETP), a Central Counterparty (CCP) clearing and settlement system and a Central Securities Depository (CSD) system to facilitate electronic trading and straight-through processing of transactions in the domestic financial market. Proposed financial market infrastructure development is aimed at multifaceted objectives which include deepening and widening of the activities of the domestic financial market to facilitate efficient price discovery and enhanced efficiency through properly managed settlement and counterparty risks and greater investor protection to ensure continued financial system stability.

5.3 Strengthening Legal Framework to Maintain Stability

The Central Bank drafted the new Central Bank of Sri Lanka Act (CBA) in 2019 to strengthen the independence of the Central Bank, with enhanced accountability and to facilitate the adoption of flexible inflation targeting as the monetary policy framework to ensure sustained price stability in Sri Lanka, to strengthen financial sector oversight and to improve governance of the Central Bank. The drafted legislation will facilitate institutional arrangements for setting inflation targets and to introduce improvements to monetary operations. In addition to the introduction of flexible inflation targeting, the amendments also seek to address the recommendations made by Presidential Council to strengthen governance of the Central Bank.

Under the draft CBA, securing financial system stability is recognized as a core objective of the Central Bank. The Act also recognizes Central Bank as the designated macroprudential authority of Sri Lanka and it is empowered, inter alia, to monitor, identify or assess the build-up of risks and vulnerabilities in the financial system; designate systematically important financial sector participants; adopt and apply enhanced macroprudential oversight to such participants; adopt and apply macroprudential instruments as enumerated in the Act to financial institutions; monitor domestic and international financial regulatory developments and advise on legislative or regulatory measures that will enhance financial stability.

The CBA establishes the Financial System Oversight Committee (FSOC) which shall consist of the Governor of the Central Bank (Chairperson), the Deputy Governor in charge of macroprudential policy; the Deputy Governor in charge of regulation and supervision, a Deputy Secretary to the Treasury nominated by the Secretary to the Treasury, Chief Executive Officer of the Insurance Regulatory Commission of Sri Lanka, Chief Executive Officer of the Securities and Exchange Commission of Sri Lanka and another person who may be appointed by the Governing Board of the Central Bank. The FSOC shall function with the mandate to strengthen the macroprudential policy framework of Sri Lanka, to secure the stability of the financial system through inter-regulatory coordination. FSOC will have the power to make recommendations to other regulators, to which such regulators shall "comply or explain" i.e. other regulators should either follow such recommendations or give reasons to reject such recommendations. Additionally, provisions are laid down in the draft CBA for the establishment of Coordination Council consisting of the Minister of Finance (Chairperson), the Governor of the Central Bank, the Secretary to the Treasury and Secretary to the ministry of the Minister assigned with the subject of Economic Policy with a view to ensure coordination of fiscal, monetary and financial stability policies of the Central Bank.

According to the draft CBA, it is mandatory to publish Financial Stability Review[2] by the Central Bank on or before the thirty-first day of October each year, which includes, assessment of financial system stability, the risks and vulnerabilities of the financial system, an overview of measures taken to identify and manage such risks, vulnerabilities or disturbances, an overview of recommendations by FSOC and progress made in implementing such recommendations.

Amongst other regulatory developments, a new Banking Act is currently under formulation to address the legal and regulatory issues confronting the financial system and to contain the lacunas identified against the regulatory and market developments. New policies are being formulated in areas such as resolution mechanisms for financial institutions, regulation of transactions and market participants in the Government Securities market, and deposit insurance and liquidity support scheme to ensure the efficiency and the stability of the financial system. Further, arrangements and discussions are in progress to amend the Finance Business Act, No. 42 of 2011, Registered Stock and Securities Ordinance, No. 7 of 1937, Local Treasury Bills Ordinance No.8 of 1923, Payment and Settlement Systems Act, No. 28 of 2005, the Foreign Exchange Act, No 12 of 2017 and the Debt Recovery (Special Provisions) Act, No. 2 of 1990 with a view to strengthen and enhance the regulatory and supervisory framework of the country.

5.4 Resolution & Enforcement and Deposit Insurance Scheme

Spread of a system-wide contagion in a systemic crisis can be contained through an efficient resolution and enforcement framework, including existence of credible financial safety nets. Such a framework helps maintain credibility and confidence in the system. Therefore, Central Bank has established the Resolution and Enforcement Department (RED) in 2018 for the purpose of resolving distressed financial institutions, conducting special investigations relating to alleged violations of laws including prohibited schemes and unauthorized deposit taking entities. RED is in the process of formulating the resolution and enforcement framework within the existing legal framework to achieve its objectives. An Enforcement Committee as well as Operational Procedures on conducting investigations and law enforcement was established. Several investigations were conducted on unauthorized finance businesses and prohibited schemes under the relevant provisions of the Finance Business Act and the Banking Act. Awareness programs had also been conducted island wide with a view to improve financial literacy and to educate on the ill-effects of unauthorized finance businesses and prohibited schemes.

With the objective of compensating the small depositors, the Sri Lanka Deposit Insurance Scheme was established in 2010 by Sri Lanka Deposit Insurance Scheme Regulation No.01 of 2010, in the interest of the overall financial system stability of the country. It was renamed in 2013 as Sri Lanka Deposit Insurance and Liquidity

2 The Central Bank continued to publish Financial Stability Review since 2007. However, CBA proposes to include Financial Stability Review as a mandatory publication.

Supports Scheme (SLDILSS). The objective of the scheme is to protect small depositors from failure of financial institutions, thereby promoting the stability of financial institutions by maintaining confidence among small depositors. All Licensed Banks and Licensed Finance Companies are members of SLDILSS. Currently, SLDILSS comprises 73 member institutions and the balance of the Sri Lanka Deposit Insurance and Liquidity Support Fund at the end of September 2019 was approximately Rs.61.2 billion (unaudited). Sri Lanka Deposit Insurance and Liquidity Support Fund has been invested in Government Securities and one Liquidity Support loan of which outstanding balances as at end September 2019 is approximately Rs.58.6 billion (book value unaudited) and Rs.1.91 billion (book value unaudited), respectively.

Licensed banks which maintained a capital adequacy ratio of 14 per cent or above at the end of the immediately preceding financial year are required to pay a premium of 0.10 per cent per annum on the total amount of all eligible deposits and all other banks are charged a premium of 0.125 per cent per annum. The premium applicable for LFCs is 0.15 per cent per annum. Premia collected from member institutions during the nine months period ending September 2019 was amounted to Rs. 6.89 billion. The maximum coverage of SLDILSS, per depositor per institution is Rs. 600,000.

The Monetary Board cancelled the license of the two distressed member institutions namely Central Investments and Finance PLC (CIFL) and The Standard Credit Finance Ltd (TSCFL) during 2018. SLDILSS was able to pay compensation to 2,765 depositors of CIFL and 2,100 depositors of TSCFL amounting to Rs. 1,177.34 million and Rs. 869.68 million respectively. Further, license of one member institution, namely TKS Finance Limited was cancelled by the Monetary Board with effect from 19 September 2019 and compensation payments for the insured depositors of TKS Finance Limited would be made as per the Sri Lanka Deposit Insurance Scheme Regulations, (as amended).

5.5 Anti-Money Laundering and Countering the Financing of Terrorism

Sri Lanka had been listed as a jurisdiction with strategic Anti-Money Laundering/ Countering the Financing of Terrorism (AML/CFT) deficiencies in November 2017 by FATF in their Compliance Document which is more commonly referred to as "the Grey List". Since being listed in the FATF's Compliance Document, the Financial Intelligence Unit (FIU) of Sri Lanka and stakeholders have taken a number of effective measures towards successful completion of the time-bound action plan provided to Sri Lanka by FATF to address the strategic deficiencies identified in AML/CFT activities. These measures include passing the Trusts (Amendment) Act, No. 6 of 2018, Mutual Assistance in Criminal Matters (Amendment) Act, No. 24 of 2018, issuance of regulations/ directives/guidelines on implementing United Nations Security Council Resolutions (UNSCR) on North Korea and Iran, extending the AML/ CFT coverage to Designated Non-Finance Businesses and Professions (DNFBPs) by issuing Customer Due Diligence (CDD) Rules, conducting risk-based AML/CFT supervision of the Financial Institutions (FIs) and DNFBPs sector, taking enforcement actions on non-compliances observed and conducting island wide awareness for FIs and the DNFBPs on AML/CFT obligations, identification of beneficial ownership information and implementation of targeted financial sanctions.

The FATF assessed Sri Lanka's progress in implementing the Action Plan through the Asia Pacific Joint Group (AP/JG). In February 2019, the FATF made the initial determination that Sri Lanka has completed its action plan substantially. Subsequently, an on-site visit was conducted by the AP/JG to verify implementation of the FATF Action Plan and AP/JG representatives had face-to-face meetings with all relevant stakeholders, including the private sector and the highest political authorities to ascertain Sri Lanka's political and institutional commitment towards implementation of AML/CFT. The recommendations made by the review team on Sri Lanka's progress were discussed at the FATF Plenary held in October 2019 and all members have endorsed the decision to delist Sri Lanka from "the Grey List". It is expected that the delisting by the FATF will have positive economic and financial impact on Sri Lanka since stability of the financial system depends heavily on perceived reputation of its integrity. Potential adverse economic and financial consequences of Money Laundering (ML) and Terrorist Financing (TF) include, reduction of government tax revenue due to misreporting income, undermining the legitimate transactions, inexplicable changes in money demand, weakening the soundness of FIs, increased reputational risk followed by reduced access to global markets, discouraging foreign investments and increased volatility of exchange rates due to unanticipated cross-border asset transfers. Due to the globally interconnected economies, ML and TF pose a significant risk to the system integrity. Therefore, strong AML/CFT regime is a precondition for stability of the entire financial system.

5.6 Surveillance on Foreign Exchange Transactions

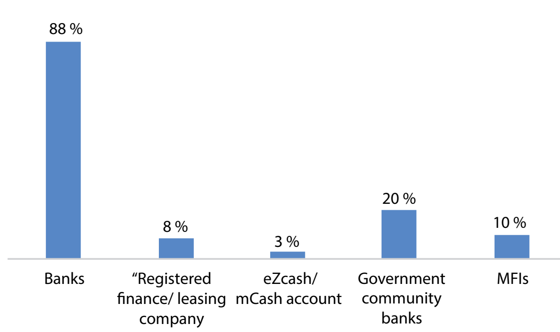
Foreign Exchange Act, No. 12 of 2017 introduced a new foreign exchange regime to facilitate greater flexibility and convenient cross border transactions which enable the acquisition of assets and liabilities through variety of investment channels. Accordingly, the limits for such cross-border transactions were expanded with simplified procedures. The expected high volume of cross border transactions as a result of such liberalization warranted introduction of more stringent monitoring infrastructure in the foreign exchange market. Accordingly, the Central Bank has taken initiatives to implement a comprehensive cross border transactions and foreign currency transactions monitoring system in order to collect data from Authorized Dealers (ADs) as a mechanism to capture all data on foreign exchange sales and purchases and inflows and outflows to the domestic foreign exchange market. This mechanism is intended to fill data gaps affecting policy formulation and enable Central Bank to engage in continuous surveillance of the foreign exchange operations.

5.7 Financial Inclusion

It is commonly accepted that financial inclusion is an important enabler to achieve inclusive growth although from a financial stability perspective, growing financial inclusion poses certain concerns. Financial inclusion of the country continued to improve with the strong penetration of financial sector services access points. Given its broader mandate to promote inclusive growth and financial inclusion, the Central Bank took number of initiatives to increase financial inclusion in the country. The Central Bank encouraged and facilitated the expansion of branch network and service points of the Licensed Banks and Non-Bank Financial Institutions (NBFIs), the key players in financial inclusion landscape. The banking sector penetration (Number of bank branches per 100,000 people) recorded over 16.5 at end 2018. According to the National Financial Inclusion Survey conducted by the Central Bank, account ownership of the country reached 89 per cent by end 2018. However, the key gaps in financial inclusion still remain, exacerbated by low levels of financial literacy across the regions and different segments of the society as well as limited usage of digital finance.

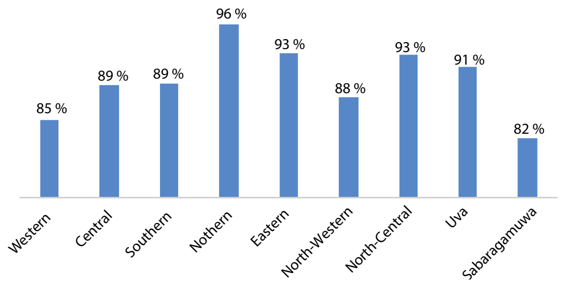
Digital finance has also emerged as a key factor nurturing the financial inclusion of the country while supporting to enhance the efficiency of

Chart 5.7 Bank Account Ownership



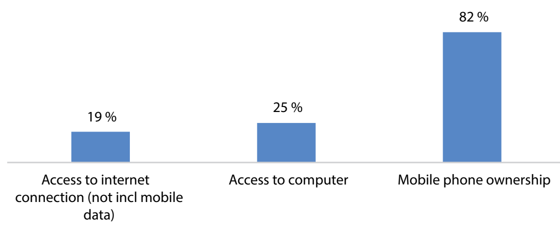
Sources: National Financial Inclusion Survey - 2018, Central Bank of Sri Lanka

Chart 5.8 Bank Account Ownership Across Provinces



Sources: National Financial Inclusion Survey - 2018, Central Bank of Sri Lanka

Chart 5.9 Access to Technology



Sources: National Financial Inclusion Survey - 2018, Central Bank of Sri Lanka

the payment system. The Central Bank actively engaged in efforts to stimulate non-cash transactions in order to expand financial access as well as to improve the efficiency of the financial system during the period. However, the demand for digital payments have been contained by the fees associated with the digital transactions and strong preference to use cash mainly due to low financial literacy and limited access to technology.

Even though, mobile phone penetration among adults is over 81 per cent, only 3 per cent of adults owned a mobile money account in the country (National Financial Inclusion Survey 2018). This low level may be due to the low smart phone penetration among adults which is only 31 per cent. The usage of mobile phone or internet for financial transactions is also limited in the country. Therefore, addressing the lack of awareness and financial literacy in the area of digital finance and payment is a prerequisite of improving financial inclusion through digital finance. The low level of smart phone penetration among adults is expected to be improved in line with the increase of household income and competitive prices of smart phone handsets in the medium term.

Central Bank is also in a process of developing a National Financial Inclusion Strategy (NFIS) with the assistance of International Finance Corporation (IFC) and other government institutions to facilitate more accessible, effective, efficient, and affordable financial services to every individual and enterprise of the country, in a manner that is responsive to their needs. NFIS is designed to address the constraints in advancing financial inclusion in Sri Lanka in four focus areas namely; Digital finance and payments, micro, small and medium enterprises finance, consumer protection and financial literacy and capacity building.

BOX - 02 Central Banks and Climate Change

Introduction

Climate change, also known as global warming, refers to an increase in prevailing global temperatures due to excessive greenhouse gas emissions. Climate change can result in catastrophic and irreversible outcomes such as rising sea levels and extreme weather events. The impacts of climate change are pervasive and potentially systemic as it can transform the functioning of the entire economy (Villeroy de Galhau, 2019).

Dealing with climate change requires collective leadership and globally coordinated action as it suffers from a classic problem in environmental economics; the tragedy of the commons[1] (Carney, 2015). Therefore, it features prominently in the broader range of issues addressed by central banks under the theme of sustainable finance.

Confronting climate change, however, requires central banks to look beyond the time periods it considers for conventional policy formulation. Economic forecasting for monetary policy is done over a 2-3 year period while the time horizon generally considered for matters of financial stability is about a decade i.e. the credit cycle period (Carney, 2015). The effects of climate change will be felt beyond these traditional horizons. As famously stated by Mark Carney, the Governor of the Bank of England, climate change is the 'tragedy of the horizon'.

The Central Bank views climate change through its relevance for achieving the mandated objectives of economic and price stability and financial system stability.

Climate Risk and Price Stability

Climate change increases the occurrence of adverse weather conditions and increases food price volatility. Furthermore, energy prices could also face sharp adjustments if adverse weather conditions effect its extraction and supply (Villeroy de Galhau, 2019).

Extreme weather conditions also harm infrastructure, buildings and productivity of employees resulting in resource shortages, loss of activity and growing uncertainty. These issues consequently impact production and price structures of the economy (Villeroy de Galhau, 2019).

Climate Risk and Financial System Stability

Global warming is one of many sources of structural change affecting the financial system. Carney (2015) points out three types of risks from climate change:

Physical risk – This is the risk of damage to property, land, and infrastructure due to broad climate trends and a higher frequency of catastrophic weather related events.

Such destruction can result in damages to collateral held by financial institutions against credit. Further, financial institutions with higher exposure to the agricultural sector may face higher variability in returns and rising non-performing loans which dilutes the asset quality of the financial sector. Sudden catastrophes may also cause a greater number of insurance claims, pressurizing the insurance sector. This could have a domino effect as banks may have exposure to such insurance firms.

Transition risk – These are financial risks associated with shifting toward a low-carbon economy. Such changes would tend to render assets or business models reliant on the high-carbon economy obsolete.

As economic agents shift toward low carbon emission products and sustainable energy solutions, existing infrastructure built for high

1 This paradox describes a situation in which self-interested individuals over-utilize shared resources leading to the deterioration of the common good of all users.

carbon based industries will lose value. In situations where such industries are heavily indebted, defaults may be inevitable.

Liability risk – This is the risk that parties affected by climate change seek compensation from those they hold responsible. Such claims could arise decades in the future leading to substantial losses.

In addition to the risks posed by climate change to the financial system stability, the financial sector may also inadvertently encourage carbon intensive activities.

Banks have the power to create new money when they lend. Thus by making lending decisions they have the power to influence the resource allocation within the economy. This may lead to a market failure in the form of inadequate lending to green industries if the social benefits of such investments are not considered in the lending decision. (Macquarie, 2018)

Role of the Central Bank in Tackling Climate Change

Aiming for the objective of financial system stability is futile within an unsustainable economic model. Therefore, climate change is a matter of concern for central bankers (Macquarie, 2018). Accordingly, several steps have been taken by the GoSL and the Central Bank to promote the green economy and combat climate change.

With the view to formalize the national response to the climate change catastrophe, Sri Lanka became the first country to appoint a Parliamentary Select Committee on Sustainable Development. It established the Sustainable Development Council to ensure sustainable economic growth while the enactment of the Sustainable Development Act, No 19 of 2017 provides the legal framework for attaining the Sustainable Development Goals. Further, the Sustainable Sri Lanka Vision and Strategic Path 2030 outlines the national transition required towards a balanced, inclusive and green growth path.

There have also been several industry-led initiatives to promote sustainable finance including launch of the Sri Lanka Sustainable Banking Initiative by the Sri Lanka Banks' Association and the Colombo Stock Exchange joining the UN Sustainable Stock Exchanges Initiative during 2015.

The Central Bank also took measures to merge climate awareness into its regulatory role by joining the International Finance Corporation (IFC) supported Sustainable Banking Network in 2016 which consists of central banks, banking regulators and banking associations from 38 member countries. Under this initiative the Central Bank appointed a Steering Committee to facilitate developing the Sustainable Finance Roadmap for the financial sector in Sri Lanka through an inclusive and multi-stakeholder process. The Roadmap for Sustainable Finance was launched at the Sustainable Banking Network Global Meeting of the IFC in Washington D.C, USA in April 2019. This Roadmap provides a broad direction to both regulators and financial institutions engaged in banking, leasing, insurance and capital market activities regarding the proposed action plan to achieve sustainability. Development of sustainable loan and savings products including leasing products, development of climate and disaster related insurance products and adaptation of international standards on sustainable bonds are key actions identified within this Roadmap. These actions are expected to effectively manage environmental, social and governance risks associated with projects financed by these sectors and promote assistance to businesses that are greener, climate friendly and socially inclusive.

Challenges and Way Forward

There are several further measures which can be initiated by the Central Bank to encourage a greener economic model. However, these measures require a shift to the mindset of both regulators and the industry to incorporate intricate changes to the currently prevailing systems and processes.

Changing climatic conditions are difficult to analyze, predict and model and attempts to include such shocks in macroeconomic modelling complicate the central bank's interpretation of economic conditions (Villeroy de Galhau, 2019). It will thus become imminent that models used by central banks for the purposes of inflation forecasting and monetary policy formulation allow for higher variability of prices due to climate change.

Monitoring climate related risks is a preliminary concern which requires development of forward looking scenarios and climate change stress tests. An efficient passage towards a low carbon economy requires differentiated risk assessments between green and brown assets. Ensuring consistent, comparable, reliable and clear disclosure around the carbon intensity of different assets of the financial system would allow greater transparency regarding the carbon intensity of investments. This would allow investors to assess the risks to company business models whilst also encouraging best practices in terms of reporting the climate change footprint (Carney, 2015).

Consideration of climate risks within the prudential framework would raise awareness regarding climate concerns among financial institutions and also set supervisory expectations regarding governance and risk management, all of which would positively contribute towards the envisioned green economy.

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Key Policy Changes and Regulatory Actions Implemented for the Financial Sector in 2019

Financial Institutions

Licensed Banks

04 January 2019	A Circular was issued to licensed banks informing Guidelines on the Employment of Expatriate Officers in licensed banks in Sri Lanka revoking the previous Circular issued in this regard.
18 January 2019	A Circular was issued to licensed banks on Publication of Annual and Quarterly Financial Statements and Other Disclosures by licensed banks specifying a new set of formats of financial statements to replace the existing formats in line with the new Accounting Standard.
12 March 2019	A Circular dated 11 October 2018 on Margin Requirements against Imports on Documents against Acceptance (DA) Terms, initially issued imposing restrictions on imports under DA terms was withdrawn, with effect from 13 March 2019.
13 March 2019	A Circular was issued to licensed banks preventing them from conducting lottery schemes/raffle draws and gift schemes which would distort the features of a financial product/ service. Further, conditions to conduct seasonal/ promotional gift scheme were also informed to licensed banks.
18 April 2019	A Circular was issued to licensed banks informing the removal of restrictions on opening of Letters of Credit (LCs) for the importation of motor vehicles under the permits on concessionary terms.
26 April 2019	A Monetary Law Act Order was issued to licensed banks imposing maximum interest rates that can be offered or paid by licensed banks on Sri Lanka Rupee deposits where interest rates of savings and other deposits of a tenure of less than three months or maturity is not specified shall be based on SDFR and interest rates of term deposits of three months or more shall be based on 364 days Treasury bill rates.
26 April 2019	A Circular was issued to licensed banks informing certain measures (in respect of the adoption of Sri Lanka Accounting Standards-SLFRS 9) during the interim period of 01 January 2019 to 30 June 2020 in order to enhance credit to SMEs.
26 April 2019	Banking Act Directions were issued to licensed banks informing the regulatory requirements to identify Small and Medium Enterprises (SMEs) for the purpose of capital and liquidity requirements under Basel III framework.
08 May 2019	A Circular was issued to licensed banks enabling them to grant a moratorium to individuals and entities, who have registered with the Sri Lanka Tourism Development Authority or any other authority/agency to provide services relating to tourism sector, on a case-by-case basis, till 31 March 2020, in respect of outstanding performing credit facilities as at 18 April 2019.

31 May 2019	Banking Act Directions were issued to licensed banks amending the Banking Act Direction No. 01 of 2018 on Loan to Value ratios (LTV) for credit facilities granted in respect of motor vehicles by increasing the LTV ratio for light trucks to 90 per cent from 70 per cent.
28 June 2019	Banking Act Directions were issued to licensed banks informing that an LTV ratio of 80 per cent is applicable for unregistered non-electric motor cars which are purchased under the "Mini Taxi" concessionary loan scheme of the "Enterprise Sri Lanka" programme.
18 July 2019	An Explanatory Note was issued to licensed banks in order to align the Capital Adequacy Ratio (CAR) under Basel III with SLFRS 9 to ensure the consistency of capital and risk weighted assets computation in terms of the Banking Act Directions No. 1 of 2016 on capital requirements under Basel III.
18 July 2019	An Explanatory Note was issued to licensed banks pertaining to Interpretations for Banking Act Directions No. 12 of 2018 on Leverage Ratio under Basel III for Licensed Commercial Banks and Licensed Specialised Banks.
29 August 2019	Banking Act Directions were issued to licensed banks on market conduct and treasury operations of licensed banks in Sri Lanka, including market conduct and ethical practices, confidentiality requirements, procedure for recording of deal conversations, risk management principles, professionalism and knowledge level and sanctions on non-compliance with the Directions.
24 September 2019	Monetary Law Act Order No. 01 of 2019 on maximum interest rates on Sri Lanka Rupee Deposits of licensed banks was rescinded.
24 September 2019	A Monetary Law Act Order was issued to licensed banks on enhancing efficiency of the transmission of recent policy decisions to rupee denominated market lending rates. Accordingly, all licensed banks were required to reduce interest rates of rupee denominated loans and advances by target dates. Further, interest rate caps were introduced for credit card advances, pre-arranged temporary overdrafts and penal interest for amount in excess of an approved limit or in arrears, during the overdue period.
18 November 2019	A Circular was issued announcing the new list of qualified auditors to audit the accounts of licensed banks, from financial years commencing 01 January 2021.

Licensed Finance Companies and Specialised Leasing Companies

01 March 2019	The licence issued to the Newest Capital Ltd. under the Finance Leasing Act, No. 56 of 2000 was cancelled and the company was acquired by another LFC under the consolidation programme.
06 March 2019	A Direction was issued on 'Deposits', restricting Licensed Microfinance Companies (LMFCs) in accepting deposits other than collateral deposits.
26 April 2019	A Direction was issued to introduce a maximum interest rate on microfinance loans granted by LMFCs to protect the customers from exorbitant interest rates.
29 April 2019	A Direction was issued to introduce maximum interest rates on deposits and debt instruments of the LFCs and SLCs.

15 May 2019	A consultation paper was issued on 'Introducing Ownership Limits to LFCs', with the objective of diversifying the ownership of shares in LFCs.
21 May 2019	A Circular was issued to LFCs and SLCs enabling them to grant a moratorium to individuals and entities who have registered with the Sri Lanka Tourism Development Authority or any other authority/agency to provide services relating to tourism sector.
31 May 2019	Business operations and activities of the NatWealth Securities Ltd., a primary dealer company, was suspended for a period of six months with effect from 31 May 2019.
31 May 2019	Under the Extraordinary Gazette No. 2125/58, regulations were issued on priority of claims in a winding up of a LFC.
04 June 2019	The existing Loan to Value (LTV) Direction issued to LFCs was revised to incorporate the 2019 Budget proposals by allowing higher LTV ratios for light trucks.
10 July 2019	Notice of cancellation of the licence was issued to TKS Finance Ltd. and Sinhaputhra Finance PLC.
19 September 2019	The Monetary Board decided to provide Sinhaputhra Finance PLC with an opportunity to implement the capital augmentation plan proposed by the company.
19 September 2019	The licence issued to TKS Finance Ltd. was cancelled under the Finance Business Act, No. 42 of 2011.
26 September 2019	The proposed Microfinance and Credit Regulatory Authority Act as approved by the Monetary Board to regulate and supervise moneylending and microfinance businesses was submitted to Ministry of Finance.
18 October 2019	The Direction on maximum interest rates on deposits and debt instruments of the LFCs and SLCs, issued on 29.04.2019, was revised with slightly increased rates.
23 October 2019	Notice of cancellation of the licence was issued to The Finance Co. PLC.

Insurance

24 February 2019	A Direction was issued by the Insurance Regulatory Commission of Sri Lanka (IRCSL) to long-term insurers requiring not to consider any unclaimed benefits as profits of the Life Fund.
25 February 2019	A Circular was issued by the IRCSL to long-term insurers to address the matter of issuing stand-alone health insurance policies.
26 February 2019	IRCSL amended the direction on "Supply of Policy Documents to life assured/beneficiary" as certain life assured/beneficiary has not been given a copy of the policy document in the instances, where the life assured is not a policyholder of an insurance policy.
24 July 2019	A Direction was issued by the IRCSL to insurance brokers on compliance with minimum net capital requirement.

Financial Markets

Money Market

Date	Policy measure
14 February 2019	The Money Broking Regulations No. 1 of 2019 was issued with effect from 14 Feb 2019, amending the Money Broking Regulations No. 1 of 2018 on fit and proper requirements, restriction of control over money broking businesses, internal controls, reporting requirements and examinations of books.
22 February 2019	Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of LCBs was reduced by 1.00 percentage point to 5.00 per cent from 6.00 percent with effect from the reserve maintenance period commencing 01 March 2019.
07 March 2019	A Circular was issued to withdraw the minimum cash margin requirements imposed for the importation of motor vehicles and non-essential consumer goods.
31 May 2019	The Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR) were reduced by 50 basis points to 7.50 per cent and 8.50 per cent, respectively.
23 August 2019	SDFR and SLFR were reduced by 50 basis points to 7.00 per cent and 8.00 per cent, respectively.
05 September 2019	A Circular was issued to introduce Liquidity Support Facility (LSF) by way of reverse repurchase transactions for Standalone Primary Dealers (SPDs) with effect from 06 September 2019.
05 September 2019	A Circular was issued to announce the acceptance of Treasury Bonds for outright auctions (sales/purchases) conducted by the CBSL under Open Market Operations (OMOs) with effect from 06 September 2019.
05 September 2019	A Circular was issued making SPDs eligible to participate in the outright sale/purchase auctions for Treasury bills/bonds conducted under OMOs with effect from 06 September 2019.

Government Securities Market

27 January 2019	Threshold of foreign investments in Treasury Bills and Treasury Bonds reduced from 10 per cent to 5 per cent out of the total outstanding stock of Treasury Bills and Treasury Bonds.
11 April 2019	The Medium-term Debt Management Strategy (MTDS) compiled by the Ministry of Finance and Central Bank for the period 2019-2023 was published.
09 July 2019	Resolution to raise up to Rs. 480 billion as per the Active Liability Management Act, No. 8 of 2018 was approved by Parliament.

Capital Market

01 January 2019	A revised qualification framework was introduced by the Securities and Exchange Commission (SEC) for the securities industry to ensure a minimum level of competency for investment advisors in the stock broking industry.
January 2019	Finalised the business and operational specification of the Delivery vs. Payment (DvP) and enhanced margining model and instructed the Colombo Stock Exchange (CSE) to commence the implementation process.
25 January 2019	The Corporate Governance Framework was amended by the SEC to implement duality of Chief Executive Officer and Chairman of listed companies.
21 June 2019	Formulating the BASEL III approval framework for state owned

Financial Infrastructure

Payments and Settlements

26 February 2019	Payment and Settlement Systems Circular No. 01 of 2019 was issued instructing financial institutions to provide real time notifications for transactions effected through electronic payment instruments and mechanisms.
11 March 2019	Payment and Settlement Systems Circular No. 02 of 2019 was issued for the establishment of a National Quick Response Code standard for local payments, replacing the Payment and Settlement Systems Circular No. 06 of 2018 on the same to streamline the distribution of revenue.

Anti-Money Laundering and Countering the Financing of Terrorism

13 May 2019	Extraordinary Gazette No. 2123/14 was issued to institutions engaged in long term insurance business to conduct ongoing customer due diligence based on a “Risk-Based Approach”.
23 May 2019	Under the Financial Institutions (Customer Due Diligence) Rules, No. 1 of 2016, Circular No. 1 of 2019 was issued on conducting enhance due diligence with respect of the Non-Governmental Organizations, Not-for-Profit Organizations or charities.
23 May 2019	Extraordinary Gazette No. 2124/32 was issued by the Ministry of Defence incorporating amendments to the List of Designated Persons under Regulation 4(7) of the United Nations Regulations No. 1 of 2012.
22 August 2019	Guideline No. 1 of 2019 was issued on suspicious transactions reporting for designated non-finance businesses.
02 September 2019	Guideline No. 2 of 2019 was issued on identification of beneficial ownership for designated non-finance businesses.
09 September 2019	Extraordinary Gazette No. 2140/16 was issued by the Ministry of Defence incorporating amendments to the List of Designated Persons under Regulation 4(7) of the United Nations Regulations No. 1 of 2012.
01 October 2019	Guideline No. 3 of 2019 was issued on identification of politically exposed persons for financial institutions and designated non-finance businesses.

Foreign Exchange

27 February 2019	Extraordinary Gazette No. 2112/17 was issued permitting the Government of Sri Lanka (GOSL) to issue International Sovereign Bonds in 2019 and to make any payments to non-resident investors in relation to such issuance.
28 February 2019	Extraordinary Gazette No. 2112/25 was issued permitting the GOSL and State Owned Enterprises (SOEs) of the GOSL with over 50 per cent share capital owned by the government to borrow from outside Sri Lanka in designated foreign currency, subject to the approval of the relevant line ministry and any other relevant authority, without the loan proceeds being routed through the Inward Investment Account of the lender.
26 March 2019	Directions were issued to Authorised Dealers informing the withdrawal of the restriction on releasing foreign exchange to importers of goods which involves conversion of Sri Lanka rupees for making payments for the importation of certain non-essential consumer goods under the advance payment terms.

Appendices

Appendix Table 1

Financial Soundness Indicators - All Banks

	2015	2016	2017	2018	2019 Sep (a)
1. Capital Adequacy					
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	15.4	15.6	16.4	16.2	16.7
1.2 Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	13.0	12.6	13.4	13.1	13.2
1.3 Net Non-Performing Loans to Total Capital Funds	12.8	9.6	9.3	14.5	21.6
1.4 Debt to Capital Funds	276.2	239.8	185.4	171.1	146.7
1.5 Equity Capital & Reserves to Total Assets Ratio	7.9	7.8	8.4	8.7	9.1
2. Asset Quality					
2.1 Gross Non-Performing Loans (NPL) to Total Gross Loans (w/o Interest in Suspense)	3.2	2.6	2.5	3.4	4.9
2.2 Gross Non-Performing Loans (NPL) to Total Gross Loans (with Interest in Suspense)	4.9	4.1	3.8	4.7	6.4
2.3 Net Non-Performing Loans to Total Gross Loans	1.7	1.2	1.3	1.9	3.0
2.4 Provision Made against Gross Loans	2.0	1.8	1.7	1.9	2.3
2.5 Provision Coverage Ratio (Total)	62.3	71.8	69.9	57.4	48.1
2.6 Provision Coverage Ratio (Specific)	46.9	52.1	49.6	43.1	38.2
2.7 Provision Made against Total Assets	1.2	1.1	1.1	1.3	1.5
2.8 Total Loans (Gross) to Total Assets	58.4	61.2	62.5	65.2	64.2
2.9 Investments to Total Assets	29.1	25.1	24.8	22.7	24.0
2.10 Total Income to Total Assets	8.5	9.5	10.6	10.7	8.3
2.11 Net Interest Income to Total Assets	3.3	3.4	3.3	3.4	2.6
2.12 Operating Income to Total Assets	4.5	4.5	4.5	4.6	3.5
3. Earnings & Profitability					
3.1 Return on Equity (ROE) – After Tax	16.2	17.3	17.6	13.2	10.5
3.2 Return on Assets (ROA) – Before Tax	1.9	1.9	2.0	1.8	1.5
3.3 Return on Assets (ROA) – After Tax	1.3	1.4	1.4	1.1	0.9
3.4 Interest Income to Total Income	85.8	88.0	88.9	88.2	90.2
3.5 Net Interest Income to Total Income	38.6	35.4	31.2	31.6	31.9
3.6 Non-Interest Income to Total Income	14.2	12.0	11.1	11.8	9.8
3.7 Non-Interest Expenses (Operating Expenses) to Total Income	25.9	22.9	18.7	20.2	19.7
3.8 Staff Expenses to Non-Interest Expenses	45.5	44.9	46.5	44.1	44.4
3.9 Personnel Expenses to Total Income	11.8	10.3	8.7	8.9	8.7
3.10 Provisions to Total Income	3.7	2.3	2.6	4.0	4.9
3.11 Total Cost to Total Income	73.1	75.6	76.3	76.8	77.9
3.12 Efficiency Ratio	51.0	49.2	45.7	50.0	52.4
3.13 Interest Margin	3.6	3.6	3.5	3.6	3.6
4. Liquidity					
4.1 Liquid Assets to Total Assets	30.0	27.3	28.8	25.7	28.9
4.2 Liquid Assets Ratio	33.9	29.9	31.3	27.6	30.5
5. Assets / Funding Structure					
5.1 Deposits	66.9	69.6	71.9	72.0	73.2
5.2 Borrowings	21.8	18.8	15.6	15.0	13.3
5.3 Capital to External Funds	8.9	8.8	9.6	10.0	10.5
5.4 Credit to Deposits	87.3	88.0	86.9	90.6	88.2
5.5 Credit to Deposits & Borrowings	65.8	69.3	71.4	75.0	74.7
5.6 Credit to Deposits & Borrowings & Capital	60.5	63.7	65.1	68.2	67.6

(a) Provisional

Source: Central Bank of Sri Lanka

Appendix Table 2

Financial Soundness Indicators - Licensed Commercial Banks

	2015	2016	2017	2018	2019 Sep (a)
1. Capital Adequacy					
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	15.3	15.6	16.4	16.2	16.7
1.2 Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	12.8	12.5	13.4	13.0	13.2
1.3 Net Non-Performing Loans to Total Capital Funds	9.7	7.6	7.5	13.2	20.1
1.4 Debt to Capital Funds	264.6	223.7	169.2	167.0	145.0
1.5 Capital to Assets Ratio	8.2	8.2	8.9	9.1	9.5
2. Asset Quality					
2.1 Gross Non-Performing Loans (NPL) to Total Gross Loans (w/o Interest in Suspense)	2.9	2.4	2.3	3.3	4.8
2.2 Gross Non-Performing Loans (NPL) to Total Gross Loans (with Interest in Suspense)	4.7	3.9	3.7	4.6	6.3
2.3 Net Non-Performing Loans to Total Gross Loans	1.3	1.0	1.0	1.8	2.9
2.4 Provision Made against Gross Loans	2.0	1.8	1.7	2.0	2.3
2.5 Provision Coverage Ratio (Total)	72.6	80.3	77.8	61.1	50.4
2.6 Provision Coverage Ratio (Specific)	54.8	58.5	55.4	45.9	40.0
2.7 Provision Made against Total Assets	1.3	1.2	1.2	1.3	1.6
2.8 Total Loans (Gross) to Total Assets	61.1	63.8	64.9	67.3	66.3
2.9 Investments to Total Assets	26.0	22.1	22.3	20.5	21.9
2.10 Total Income to Total Assets	8.3	9.4	10.5	10.5	8.2
2.11 Net Interest Income to Total Assets	3.2	3.4	3.4	3.4	2.7
2.12 Operating Income to Total Assets	4.6	4.6	4.6	4.8	3.5
3. Earnings & Profitability					
3.1 Return on Equity (ROE) – After Tax	15.7	17.2	17.4	13.7	10.9
3.2 Return on Assets (ROA) – Before Tax	1.9	2.0	2.1	1.9	1.6
3.3 Return on Assets (ROA) – After Tax	1.3	1.4	1.5	1.2	1.0
3.4 Interest Income to Total Income	84.1	86.7	88.0	87.0	89.1
3.5 Net Interest Income to Total Income	39.1	35.9	32.0	32.3	32.4
3.6 Non-Interest Income to Total Income	15.9	13.3	12.0	13.0	10.9
3.7 Non-Interest Expenses (Operating Expenses) to Total Income	27.2	23.7	19.2	20.4	19.9
3.8 Staff Expenses to Non-Interest Expenses	44.6	44.1	45.4	42.7	43.1
3.9 Personnel Expenses to Total Income	12.1	10.5	8.7	8.7	8.6
3.10 Provisions to Total Income	4.3	2.6	2.9	4.4	5.2
3.11 Total Cost to Total Income	72.2	74.6	75.2	75.1	76.6
3.12 Efficiency Ratio	51.1	48.9	45.2	48.5	51.2
3.13 Interest Margin	3.5	3.6	3.5	3.7	3.6
4. Liquidity					
4.1 Liquid Assets to Total Assets	27.4	24.9	26.7	24.5	27.2
4.2 Liquid Assets Ratio	28.7	25.4	27.2	25.0	27.6
5. Assets / Funding Structure					
5.1 Deposits	66.5	69.5	72.0	71.4	72.3
5.2 Borrowings	21.8	18.4	15.0	15.1	13.8
5.3 Capital to External Funds	9.3	9.4	10.2	10.5	11.1
5.4 Credit to Deposits	91.8	91.9	90.1	94.2	92.4
5.5 Credit to Deposits & Borrowings	69.2	72.6	74.6	77.7	77.5
5.6 Credit to Deposits & Borrowings & Capital	63.3	66.4	67.7	70.4	69.8

(a) Provisional

Source: Central Bank of Sri Lanka

Appendix Table 3

Financial Soundness Indicators - Licensed Specialised Banks

	2015	2016	2017	2018	2019 Sep (a)
1. Capital Adequacy					
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	16.6	15.3	16.3	17.1	15.7
1.2 Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	16.6	13.5	13.4	15.0	13.3
1.3 Net Non-Performing Loans to Total Capital Funds	40.7	31.1	29.3	28.7	39.8
1.4 Debt to Capital Funds	382.6	409.6	360.1	214.7	167.5
1.5 Capital to Assets Ratio	5.7	5.1	5.4	6.3	5.8
2. Asset Quality					
2.1 Gross Non-Performing Loans (NPL) to Total Gross Loans (w/o Interest in Suspense)	6.4	4.5	4.3	4.8	6.2
2.2 Gross Non-Performing Loans (NPL) to Total Gross Loans (with Interest in Suspense)	7.5	5.2	4.9	5.4	7.1
2.3 Net Non-Performing Loans to Total Gross Loans	5.6	3.6	3.4	3.6	4.3
2.4 Provision Made against Gross Loans	1.2	1.3	1.3	1.5	1.9
2.5 Provision Coverage Ratio (Total)	19.4	29.6	31.1	32.9	31.6
2.6 Provision Coverage Ratio (Specific)	13.4	20.6	21.4	24.3	25.2
2.7 Provision Made against Total Assets	0.5	0.6	0.6	0.8	1.0
2.8 Total Loans (Gross) to Total Assets	41.4	44.3	46.8	50.1	49.5
2.9 Investments to Total Assets	48.5	44.5	41.6	38.2	39.0
2.10 Total Income to Total Assets	10.0	10.4	11.4	11.8	8.8
2.11 Net Interest Income to Total Assets	3.6	3.4	3.0	3.2	2.5
2.12 Operating Income to Total Assets	4.2	3.8	3.7	3.6	2.8
3. Earnings & Profitability					
3.1 Return on Equity (ROE) – After Tax	20.3	18.3	19.2	7.7	5.5
3.2 Return on Assets (ROA) – Before Tax	1.6	1.5	1.5	0.8	0.7
3.3 Return on Assets (ROA) – After Tax	1.1	1.0	1.0	0.5	0.3
3.4 Interest Income to Total Income	94.8	95.7	94.2	96.1	97.3
3.5 Net Interest Income to Total Income	36.4	32.4	26.5	27.1	28.8
3.6 Non-Interest Income to Total Income	5.2	4.3	5.8	3.9	2.7
3.7 Non-Interest Expenses (Operating Expenses) to Total Income	19.4	18.4	15.6	18.9	18.2
3.8 Staff Expenses to Non-Interest Expenses	52.1	51.1	54.3	54.2	54.3
3.9 Personnel Expenses to Total Income	10.1	9.4	8.5	10.2	9.9
3.10 Provisions to Total Income	0.8	0.3	0.9	1.6	2.7
3.11 Total Cost to Total Income	77.8	81.7	83.3	87.8	86.6
3.12 Efficiency Ratio	50.2	51.5	49.3	63.8	62.9
3.13 Interest Margin	3.8	3.5	3.2	3.2	3.5
4. Liquidity					
4.1 Liquid Assets to Total Assets	46.5	42.9	42.6	35.1	40.7
4.2 Liquid Assets Ratio	68.5	61.4	61.6	47.7	52.1
5. Assets / Funding Structure					
5.1 Deposits	69.3	70.3	71.3	76.3	80.1
5.2 Borrowings	21.7	20.9	19.4	13.5	9.7
5.3 Capital to External Funds	6.2	5.6	5.9	7.0	6.5
5.4 Credit to Deposits	59.8	63.0	65.6	65.7	61.8
5.5 Credit to Deposits & Borrowings	45.5	48.6	51.6	55.8	55.1
5.6 Credit to Deposits & Borrowings & Capital	42.9	46.0	48.7	52.1	51.8

(a) Provisional

Source: Central Bank of Sri Lanka

Appendix Table 4

Financial Soundness Indicators - Licensed Finance Companies and Specialised Leasing Companies Sector

	2015 Mar	2016 Mar	2017 Mar	2018 Mar	2019 Mar	2019 Sep (a)
1. Capital Adequacy						
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	13.5	11.3	11.8	11.7	10.6	12.5
1.2 Tier 1 Capital/Risk Weighted Assets (Tier 1 RWCAR)	12.5	10.7	11.3	11.2	9.3	11.2
1.3 Capital Funds to Total Assets	13.1	11.2	11.3	11.0	11.7	13.4
1.4 Borrowings to Equity (times)	2.0	2.9	2.8	2.5	2.4	2.0
1.5 Net Non Performing Loans to Equity Capital	10.6	8.2	7.5	10.3	14.7	18.3
2. Asset Quality						
2.1 Gross Non Performing Advances to Total Advances	6.3	5.1	4.9	5.8	7.7	9.7
2.2 Provision made against Total Advances	3.7	3.3	3.2	3.6	4.6	5.6
2.3 Provision Coverage Ratio (Specific Provisions to NPA)	51.6	63.0	63.1	60.8	56.5	55.7
2.4 Provision Coverage Ratio (Total Provisions to NPA)	58.3	64.9	65.1	62.7	58.8	57.7
3. Earnings and Profitability						
3.1 Return on Assets (Annualized)	3.4	3.5	3.7	3.0	2.8	1.7
3.2 Return on Equity (Annualized)	15.3	17.0	20.0	14.5	12.0	5.0
3.3 Operating Profit Before Provision to Total Assets	4.4	3.8	4.1	4.1	4.2	2.0
3.4 Interest Income to Interest Expenses	202.9	215.9	189.9	177.1	183.9	178.8
3.5 Net Interest Income to Profit After Tax	399.1	404.6	333.0	405.8	553.6	1196.0
3.6 Operating Cost to Net Interest Income	72.8	77.8	76.3	75.9	76.7	80.0
3.7 Net Interest Income to Average Assets	8.3	8.6	7.8	7.1	8.0	7.5
3.8 Net Interest Income to Interest Income	50.7	53.7	47.4	43.5	45.6	44.1
3.9 Non-Interest Expenses to Total Cost	38.9	44.9	39.0	33.8	35.3	33.8
3.10 Efficiency Ratio	64.3	65.4	61.6	64.5	68.9	77.8
3.11 Cost to Income Ratio	82.2	80.8	80.4	84.3	86.3	91.2
4. Liquidity						
4.1 Regulatory Liquid Assets to Total Assets	8.7	8.0	7.6	8.5	8.7	8.6
4.2 Regulatory Liquid Assets to Deposits and Borrowings	11.8	10.4	9.9	11.0	11.2	11.3
4.3 Net Loans to Total Borrowings	266.2	223.1	227.2	260.9	256.5	272.3
5. Assets/Funding Structure						
5.1 Borrowings to Total Assets	27.2	33.3	33.7	29.0	28.9	26.7
5.2 Investment to Total Assets	12.2	10.9	9.9	9.0	8.7	9.1

(a) Provisional

Source: Central Bank of Sri Lanka

Appendix Table 5

Financial Soundness Indicators -Licensed Finance Companies Sector

	2015 Mar	2016 Mar	2017 Mar	2018 Mar	2019 Mar	2019 Sep (a)
1. Capital Adequacy						
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	12.3	9.9	10.3	11.0	10.1	11.9
1.2 Tier 1 Capital/Risk Weighted Assets (Tier 1 RWCAR)	11.3	9.4	10.0	10.4	8.8	10.6
1.3 Capital Funds to Total Assets	12.0	10.0	10.2	10.4	11.1	12.7
1.4 Borrowings to Equity (times)	2.0	2.9	2.9	2.5	2.4	2.1
1.5 Investment Properties to Capital Funds	8.7	9.4	8.7	12.2	12.6	12.9
1.6 Net Non Performing Loans to Equity Capital	12.1	9.6	8.8	10.9	15.4	19.4
2. Asset Quality						
2.1 Gross Non Performing Advances to Total Advances	6.7	5.4	5.2	5.9	7.8	9.9
2.2 Provision made against Total Advances	3.9	3.5	3.4	3.7	4.6	5.7
2.3 Provision Coverage Ratio (Specific Provisions to NPA)	50.9	62.4	62.8	61.0	56.9	55.9
2.4 Provision Coverage Ratio (Total Provisions to NPA)	57.8	64.3	64.8	62.8	58.8	57.7
3. Earnings and Profitability						
3.1 Return on Assets (Annualized)	3.0	3.1	3.4	2.9	2.6	1.6
3.2 Return on Equity (Annualized)	14.4	15.7	20.4	15.6	12.0	4.6
3.3 Operating Profit Before Provision to Total Assets	3.9	3.4	3.8	3.9	4.2	1.9
3.4 Interest Income to Interest Expenses	194.1	207.2	184.3	173.5	181.5	176.0
3.5 Net Interest Income to Profit After Tax	442.1	452.3	339.4	419.6	568.2	1339.5
3.6 Operating Cost to Net Interest Income	77.9	82.8	79.2	78.2	78.2	81.9
3.7 Net Interest Income to Average Assets	7.9	8.0	7.3	7.2	7.8	7.3
3.8 Net Interest Income to Interest Income	48.5	51.7	45.8	42.4	44.9	43.2
3.9 Non-Interest Expenses to Total Cost	38.7	44.6	38.4	33.5	35.1	33.6
3.10 Efficiency Ratio	67.2	68.4	62.8	66.1	70.0	79.0
3.11 Cost to Income Ratio	84.1	82.9	81.4	85.3	86.9	91.8
4. Liquidity						
4.1 Regulatory Liquid Assets to Total Assets	8.8	7.7	7.4	8.5	8.8	8.7
4.2 Regulatiory Liquid Assets to Deposits and Borrowings	11.7	9.9	9.5	11.0	11.2	11.2
4.3 Net Loans to Total Borrowings	289.1	238.1	247.0	269.5	264.8	280.6
5. Assets/Funding Structure						
5.1 Borrowings to Total Assets	24.8	30.9	30.8	28.0	27.9	25.8
5.2 Investment to Total Assets	12.9	11.5	10.3	9.3	8.9	9.3

(a) Provisional

Source: Central Bank of Sri Lanka

Appendix Table 6

Financial Soundness Indicators -Specialised Leasing Companies Sector

	2015 Mar	2016 Mar	2017 Mar	2018 Mar	2019 Mar	2019 Sep (a)
1. Capital Adequacy						
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	34.0	33.5	33.4	45.0	23.5	27.5
1.2 Tier 1 Capital/Risk Weighted Assets (Tier 1 RWCAR)	34.0	32.1	31.2	44.7	22.9	27.0
1.3 Capital Funds to Total Assets	27.5	26.0	23.9	29.1	29.8	33.6
1.4 Borrowings to Equity (times)	2.1	2.4	2.8	2.1	2.0	1.7
1.5 Net Non Performing Loans to Equity Capital	1.6	0.8	1.2	3.3	5.6	4.4
2. Asset Quality						
2.1 Gross Non Performing Advances to Total Advances	2.1	1.7	1.5	2.6	4.4	4.5
2.2 Provision made against Total Advances	1.6	1.4	1.2	1.4	2.5	2.7
2.3 Provision Coverage Ratio (Specific Provisions to NPA)	75.3	84.8	74.6	48.2	36.3	42.4
2.4 Provision Coverage Ratio (Total Provisions to NPA)	75.4	84.8	78.3	55.9	55.9	61.3
3. Earnings and Profitability						
3.1 Return on Assets (Annualized)	7.4	9.1	6.7	3.6	6.9	5.9
3.2 Return on Equity (Annualized)	20.3	24.2	18.0	9.0	11.9	10.5
3.3 Operating Profit Before Provision to Total Assets	10.5	9.1	6.8	10.0	8.4	4.9
3.4 Interest Income to Interest Expenses	368.7	343.4	258.5	334.7	272.9	291.1
3.5 Net Interest Income to Profit After Tax	243.2	240.0	296.7	277.1	380.4	439.8
3.6 Operating Cost to Net Interest Income	38.8	45.8	57.3	43.3	50.4	50.3
3.7 Net Interest Income to Average Assets	13.1	15.0	13.1	5.6	13.3	14.1
3.8 Net Interest Income to Interest Income	72.9	70.9	61.3	70.1	63.4	65.6
3.9 Non-Interest Expenses to Total Cost	41.3	48.7	45.7	46.5	42.1	40.0
3.10 Efficiency Ratio	40.7	43.1	52.8	40.4	49.1	54.7
3.11 Cost to Income Ratio	62.4	60.9	71.0	59.3	69.6	75.1
4. Liquidity						
4.1 Regulatory Liquid Assets to Total Assets	7.8	11.2	10.5	8.1	7.8	7.1
4.2 Regulatory Liquid Assets to Deposits and Borrowings	13.2	17.7	15.8	13.4	12.9	12.6
4.3 Net Loans to Total Borrowings	140.3	133.2	123.7	139.4	138.1	146.6
5. Assets/Funding Structure						
5.1 Borrowings to Total Assets	59.0	63.1	66.5	60.3	60.4	56.8
5.2 Investment to Total Assets	2.7	3.8	5.5	1.2	1.3	1.9

(a) Provisional

Source: Central Bank of Sri Lanka