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FINANCIAL SECTOR PERFORMANCE AND SYSTEM STABILITY

8.1 Overview

The financial sector continued to expand moderately during the year without causing any major macroprudential concerns, amidst challenging market conditions both globally and domestically. However, credit quality of the banking sector and the Licensed Finance Companies (LFCs) and Specialised Leasing Companies (SLCs) sector deteriorated considerably during 2018 with increased non-performing loans and advances compared to 2017. The challenging global and domestic market conditions, unfavourable weather conditions in 2017 and slowdown of economic activities in 2018 contributed significantly to the deterioration of quality of credit. Further, overall performance of LFCs and SLCs sector slowed down significantly during 2018 due to low credit growth, declining profitability and increasing nonperforming loans. Unfavourable developments in global and domestic markets are also reflected in moderate growth recorded by other sub sectors such as insurance and primary dealers and decline in equity market activities.

The banking sector showed a moderate expansion during the year while maintaining capital and liquidity levels above the regulatory minimum requirements. The growth of the asset base of the banking sector was moderate during the first half of the year but accelerated in the second half due to high growth in credit. The expansion in credit growth was broad-based with diversified lending across major sectors of the economy. The profitability of the banking sector, as reflected by Return on Assets (ROA) ratio and Return on Equity (ROE) ratio declined during the year mainly due to the deterioration in assets quality, rise in operating costs and increase in taxes. The Central Bank continued to strengthen the soundness of the banking sector by implementing prudential policy measures and regulations including enforcement of Basel III requirements and adoption of Sri Lanka Accounting Standards 9 (SLFRS 9) during the year.

LFCs and SLCs sector recorded a moderate expansion, with a slowdown in credit growth and profitability and a decline in asset quality. The slowdown in credit growth was mainly attributed to the fiscal and macroprudential policy measures taken by authorities to curtail import of motor vehicles with certain exceptions. Quality of assets of the LFCs and SLCs sector deteriorated as reflected in the increase in Non-Performing Loans (NPL)

Table 8.1
Total Assets of the Financial System

Institution	2017 (a) Rs. bn	2017 (a) Share (%)	2018 (b) Rs. bn	2018 (b) Share (%)
Banking Sector	**11,897.4**	**69.7**	**13,708.3**	**72.5**
Central Bank	1,604.8	9.4	1,914.3	10.1
Licensed Commercial Banks (LCBs)	8,926.4	52.3	10,372.4	54.9
Licensed Specialised Banks (LSBs)	1,366.2	8.0	1,421.6	7.5
Other Deposit Taking Financial Institutions	**1,370.4**	**8.1**	**1,542.7**	**8.1**
Licensed Finance Companies (LFCs)	1,227.5	7.2	1,383.7	7.3
Co-operative Rural Banks	132.7	0.8	147.7	0.7
Thrift and Credit Co-operative Societies	10.2	0.1	11.3	0.1
Specialised Financial Institutions	**388.9**	**2.3**	**240.0**	**1.4**
Specialised Leasing Companies (SLCs)	127.5	0.7	47.6	0.3
Primary Dealers (c)	77.3	0.5	83.6	0.4
Stock Brokers	9.1	0.1	8.7	0.1
Unit Trusts / Unit Trust Management Companies	131.7	0.7	67.0	0.4
Market Intermediaries (d)	28.7	0.2	16.4	0.1
Venture Capital Companies	14.6	0.1	16.8	0.1
Contractual Savings Institutions	**3,402.9**	**19.9**	**3,414.3**	**18.0**
Insurance Companies	564.9	3.3	606.6	3.2
Employees' Provident Fund	2,066.3	12.1	2,289.4	12.1
Employees' Trust Fund	279.0	1.6	312.1	1.7
Approved Pension and Provident Funds	437.3	2.6	149.1	0.7
Public Service Provident Fund	55.4	0.3	57.2	0.3
Total	**17,059.7**	**100.0**	**18,905.3**	**100.0**

(a) Revised
(b) Provisional
(c) Excluding assets of Bank Primary Dealer units, which are included in assets of LCBs
(d) Include Investment Managers, Margin Providers, Underwriters and Credit Rating Agencies

Source: Central Bank of Sri Lanka
Department of Co-operative Development
Department of Labour
Department of Pensions
Employees' Trust Fund Board
Insurance Regulatory Commission of Sri Lanka
SANASA Federation
Securities and Exchange Commission of Sri Lanka
Unit Trust Association of Sri Lanka
Venture Capital Companies

ratios mainly due to the unfavourable weather conditions experienced in 2017. Profitability of the sector during the period also slowed down with increased funding cost and loan loss provisions. With a view of safeguarding the financial system stability, the Central Bank continued to take appropriate prudential measures where necessary to strengthen the supervisory and regulatory framework of LFCs and SLCs and also to address the issues relating to several weak finance companies. The contractual savings institutions sector dominated by the Employees' Provident Fund (EPF) and Employees' Trust Fund (ETF), other than the Approved Pension and Provident Funds recorded a moderate expansion during the year. The Insurance Sector and Primary Dealers in government securities expanded moderately during the year without causing major stability concerns. Nevertheless, a notable contraction of the Unit Trust sector was observed during the year.

Domestic money market experienced a persistent liquidity shortage during the second half of the year mainly due to foreign exchange related transactions carried out by the Central Bank and the imposition of margin requirement on Letters of Credit on motor vehicle imports. Despite, the reduction of the Statutory Reserve Ratio (SRR) by 1.50 percentage points to 6.00 per cent, from 7.50 per cent, with effect from 16 November 2018, with a view to easing the liquidity shortfall, the domestic money market continued to experience a significantly low level of liquidity at end 2018. In response, the Central Bank further reduced the SRR by 1.00 percentage points with effect from 01 March 2019. Meanwhile, the Sri Lankan rupee depreciated significantly against the US dollar during the year in the face of four consecutive interest rate hikes by the Federal Reserve Bank of the USA and the high demand for foreign exchange from importers and reversal of some portfolio investments. The pressure on Sri Lankan rupee was further aggravated by the negative sentiment created through political instability that ensued during the last quarter of the year, followed by the International Monetary Fund (IMF) withholding the sixth tranche of the Extended Fund Facility (EFF), which was expected to be disbursed during the year. The Central Bank intervened in the forex market to curb the excessive volatility by supplying US dollars 1,120 million on net basis during the year. The Colombo Stock Exchange (CSE) recorded yet another year of poor performance during the period due to adverse developments in local and global economic environment. The *negative developments in the CSE were evident by the significant decline in share prices, market turnover, market capitalization and Price to Earning (PE) ratios throughout the year. The operations of the payments and settlement systems of the country were well maintained during the year without major concerns over safety of the payment and settlement infrastructure, and catered to the payment needs of the economy without any major disruptions.*

Going forward, operating conditions of the banking industry in the medium term will be challenging due to the transition to higher capital standards under Basel III, adoption of the Sri Lanka Financial Reporting Standard (SLFRS) 9. However, in the long run, implementation of Basel III and SLFRS 9 will improve the resilience and stability of the banking sector. Also, capital levels of the LFC and SLC sector are expected to be strengthened as a result of enhanced capital requirements. Continuous strengthening of risk management framework pertaining to financial institutions are vital for improving resilience of the financial sector.

8.2 Performance of the Banking Sector

The banking sector expanded during the year, whilst exhibiting resilience by maintaining capital and liquidity well above the regulatory minimum though both global and local conditions were challenging. The banking sector continued to dominate the financial sector, accounting for about 62.4 per cent (excluding the Central Bank) of the total assets of the financial sector at end 2018. The growth of assets of the banking sector, which moderated during the first half of the year, picked up during the second half and was driven mainly by growth in credit. Deposits continued to be the dominant source of funding of the banking sector, while the declining trend in borrowings, as a source of funds, reversed during the year. The profitability of the banking sector declined compared to the previous year, as a result of deterioration in asset quality, rise in operating costs and increase in taxes.

Table 8.2
Distribution of Banks, Bank Branches and Other Banking Outlets

Category	End 2017 (a)	End 2018 (b)
Licensed Commercial Banks (LCBs)		
I. Total No. of LCBs	**25**	**26**
Domestic banks	13	13
Foreign banks	12	13
II.Total No. of LCB Banking Outlets	**5,494**	**6,185**
Branches	2,855	2,876
Domestic Banks	2,803	2,825
Foreign Banks	52	51
Student Savings Units	**2,639**	**3,309**
III. Automated Teller Machines	**4,086**	**4,655**
Licensed Specialised Banks (LSBs)		
I. Total No. of LSBs	**7**	**7**
National Level Savings Banks	1	1
Housing Finance Institutions	2	2
Other LSBs	4	4
II. Total No. of LSB Banking Outlets	**719**	**696**
Branches	691	696
National Level Savings Banks	259	261
Housing Finance Institutions	64	64
Other LSBs	368	371
Student Savings Units	**28**	**-**
III.Automated Teller Machines	**333**	**376**
Total No. of Bank Branches and Other Outlets	**6,213**	**6,881**
Total No. of Automated Teller Machines (ATMs)	**4,419**	**5,031**

(a) Revised
(b) Provisional

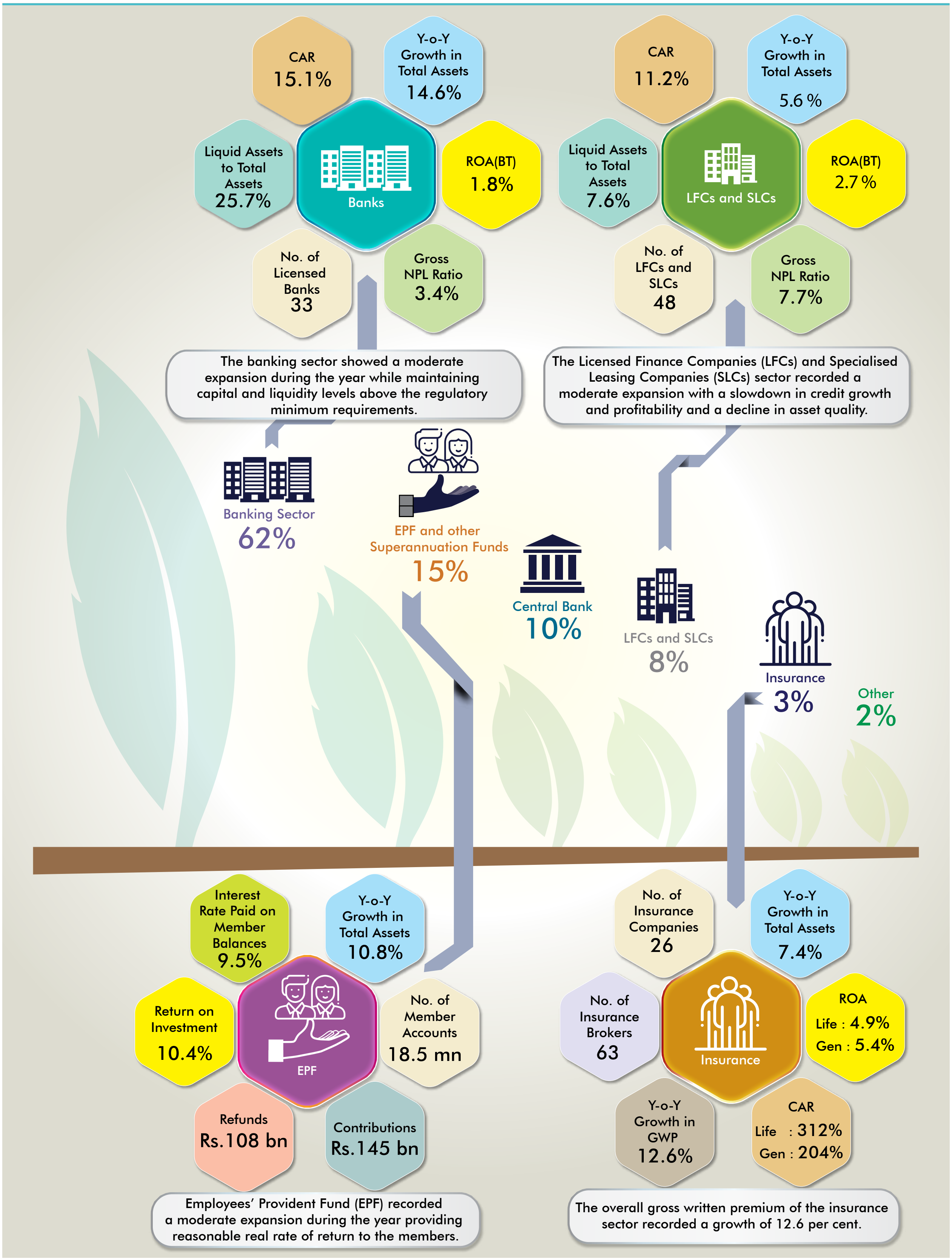
Source: Central Bank of Sri Lanka

Business Expansion

(a) Outreach: At end 2018, the banking sector comprised 33 banks, of which 26 were Licensed Commercial Banks (LCBs) and 7 were Licensed Specialised Banks (LSBs). Of the 26 LCBs, 13 were foreign bank branches. The banking sector continued to support economic growth and development by enhancing banking services and expanding the banking network, thereby promoting financial inclusion in the country. In 2018, several banks introduced technology based products/services to facilitate financial inclusion. Further, 34 new

Figure 8.1

Financial Sector Asset Composition and Selected Indicators



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bank branches and 801 new Automated Teller Machines (ATMs) were established, raising the number of banking outlets to 6,881 and ATMs to 5,031 at end 2018.

(b) Assets: The asset base of the banking sector expanded by Rs. 1.5 trillion during the year surpassing Rs. 11 trillion at end 2018. The asset base grew by 14.6 per cent in 2018 compared to the 13.8 per cent growth reported in 2017. During the second half of 2018 the Sri Lankan rupee depreciated by 16.4 per cent against the US dollar, which resulted in an increase in the growth of assets and liabilities denominated in foreign currency. The loans and advances increased by Rs.1.3 trillion during the second half of 2018. The increase in loans accounted for 84.1 per cent of the assets growth during 2018, with the growth in loans increasing from 16.1 per cent in 2017 to 19.6 per cent in 2018. About 72 per cent of the increase in the loan portfolio of the banking sector was attributed to the increase in rupee loans. The increase in lending was largely diversified across the major sectors of the economy. In terms of products, credit cards (24.3 per cent), overdrafts (23.7 per cent) and term loans (19.9 per cent) were the main products which reported high growth rates during 2018. However, the share of credit cards out of total loans was minimal at 1.2 per cent. Meanwhile, year-on-year growth in investments declined considerably from 12.5 per cent at end 2017 to 4.6 per cent at end 2018. The investments in the trading portfolio contracted by 4 per cent during 2018 with the investments in Treasury bills and Sri Lanka Development Bonds (SLDBs) decreasing by Rs. 47.9 billion and Rs. 2.3 billion, respectively, while investment in Treasury bonds increased by Rs. 18.9 billion. However, the Held-to-Maturity (HTM) portfolio grew by 7.5 per cent during 2018 with increases in Treasury bills, Treasury bonds and SLDBs by Rs. 89.4 billion, Rs. 35.2 billion and Rs. 26.3 billion, respectively.

Table 8.3
Composition of Assets and Liabilities of the Banking Sector

Item	2017 (a)		2018 (b)		Change (%)	
	Rs. bn	Share (%)	Rs. bn	Share (%)	2017 (a)	2018 (b)
Assets						
Loans and Advances	6,430.9	62.5	7,693.4	65.2	16.1	19.6
Investments	2,554.4	24.8	2,671.6	22.7	12.5	4.6
Other (c)	1,307.1	12.7	1,429.0	12.1	5.8	9.3
Liabilities						
Deposits	7,399.0	71.9	8,492.4	72.0	17.5	14.8
Borrowings	1,607.1	15.6	1,763.4	15.0	-5.3	9.7
Capital Funds	866.7	8.4	1,030.4	8.7	22.5	18.9
Other	419.6	4.1	507.8	4.3	20.8	21.0
Total Assets/ Liabilities	10,292.4	100.0	11,794.0	100.0	13.8	14.6

(a) Revised
(b) Provisional
(c) Includes cash and bank balances, placements, reverse repurchase agreements and fixed assets.

Source: Central Bank of Sri Lanka

(c) Liabilities: Deposits continued to be the main source of funding representing 72 per cent of total liabilities of the banking sector at end 2018, while borrowings accounted for 15 per cent. The deposit base of the banking sector increased by Rs. 1.1 trillion during the year reaching Rs. 8.5 trillion at end 2018. Year-on-year growth in deposits declined to 14.8 per cent at end 2018 from 17.5 per cent at end 2017. Growth in time deposits accounted for 78.7 per cent of the increase in total deposits during the year, while savings and demand deposits accounted for 12.7 per cent and 4.4 per cent, respectively, at end 2018. As a result, the share of time deposits in total deposits had increased to 65.5 per cent at end 2018 compared to 63.6 per cent at end 2017, while causing for Current

Table 8.4
Composition of Deposits of the Banking Sector

Item	2017(a)		2018(b)		Change (%)	
	Rs.bn	Share (%)	Rs.bn	Share (%)	2017 (a)	2018 (b)
Demand Deposits	496.0	6.7	544.0	6.4	3.5	9.7
Savings Deposits	2,032.3	27.5	2,170.8	25.6	9.4	6.8
Time Deposits	4,704.3	63.6	5,564.9	65.5	23.4	18.3
Other Deposits	166.3	2.2	212.7	2.5	14.1	27.9
Total Deposits	7,399.0	100.0	8,492.4	100.0	17.5	14.8

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

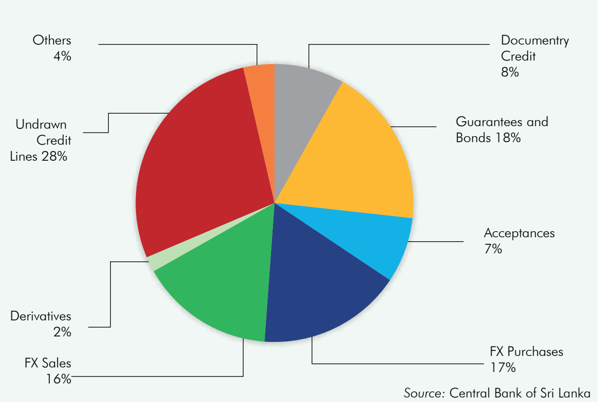
and Savings Account to total deposits (CASA) ratio to decrease from 34.2 per cent to 32 per cent over the corresponding period. Total borrowings of the banking sector increased significantly by Rs.156.3 billion (9.7 per cent) in 2018 compared to the decline of Rs. 89.3 billion (negative growth of 5.3 per cent) in 2017. This increase was mainly due to increased rupee borrowings which grew by 23.7 per cent (Rs. 142.3 billion) in 2018. The increase in rupee borrowing accounted for 91 per cent of the total increase in banking sector borrowings. Meanwhile, foreign currency borrowings in terms of Sri Lankan rupees grew marginally by 1.4 per cent (Rs. 14 billion) mainly due to the depreciation of the Sri Lankan rupee during the year.

(d) Off-balance sheet exposure: Off-balance sheet exposures grew significantly by 14.7 per cent (Rs. 569.4 billion) during 2018 compared to the growth of 5.3 per cent (Rs. 194.6 billion) during 2017. Undrawn credit lines accounted for the largest share of off-balance sheet exposures with a share of 27.8 per cent at end 2018. Foreign exchange (FX) exposures accounted for 32.5 per cent of the total off-balance sheet exposure and was caused mainly by unsettled FX purchases (16.8 per cent) and FX sales (15.7 per cent). During 2018, foreign currency exposures (39.2 per cent), undrawn credit lines (22.1 per cent), acceptances (19.3 per cent) and guarantees and bonds (16.3 per cent) contributed to the increase in total off-balance sheet exposures, while derivatives were the only off-balance sheet item to report a marginal decrease of 2.3 per cent (Rs. 13.1 billion).

Risks in the Banking Sector

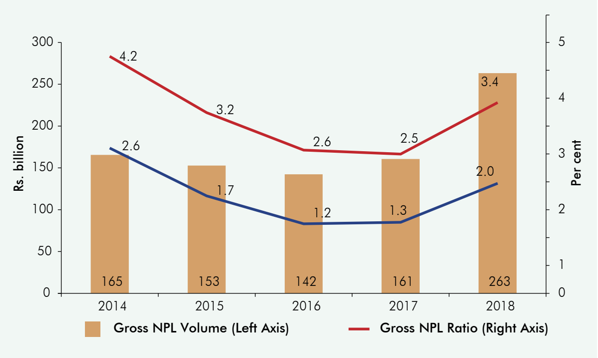
(a) Credit Risk: Risk weighted assets considered for credit risk in the capital adequacy computation increased during the year due to the expansion of loan portfolios. Quality of credit of the banking sector deteriorated considerably during 2018 with non-performing loans (NPLs) increasing by Rs. 102.5 billion compared to the increase of Rs. 18.3 billion during 2017. The challenging global and domestic market conditions that prevailed in 2018 may have contributed to the deterioration of quality of credit. Consequently, the gross NPL ratio increased from a historically low figure of 2.5 per cent at end 2017 to 3.4 per cent at end 2018. Total loan loss provisions increased by Rs. 38.9 billion during 2018, out of which specific provisions accounted for 86.8 per cent of the increase. However, the higher increase in NPLs had resulted in a decline in specific and total provision coverage ratios from 49.6 per cent and 69.9 per cent at end 2017 to 43.1 per cent and 57.4 per cent at end 2018, respectively. Despite the increase in the NPL ratio during 2018, it is still at a manageable level compared to the levels

Figure 8.2
Off-balance Sheet Exposures of the Banking Sector (at end 2018)



Source: Central Bank of Sri Lanka

Figure 8.3
Non Performing Loans of the Banking Sector



Source: Central Bank of Sri Lanka

Table 8.5
Sectorwise Composition of Loans and Advances of the Banking Industry (at end 2018)

Sectors	Amount Rs. bn (a)	Share of Total Loans %	NPA Ratio %
Consumption	1,392.7	18.1	3.0
Construction	1,214.3	15.8	3.8
Wholesale & Retail Trade	1,154.8	15.0	4.7
Manufacturing	810.5	10.5	5.2
Infrastructure Development	627.7	8.2	1.5
Agriculture, Forestry & Fishing	625.6	8.1	5.3
Financial Services	423.9	5.5	0.6
Health Care,Social Services & Support Services	338.0	4.4	0.8
Tourism	302.0	3.9	4.7
Lending to Overseas Entities	280.3	3.6	2.0
Transportation & Storage	197.4	2.6	2.1
Lending to Ministry of Finance	138.4	1.9	-
Information Technology and Communication Services	64.1	0.8	4.6
Education	58.0	0.8	1.5
Professional, Scientific & Technical Activities	56.5	0.7	2.3
Arts, Entertainment & Recreation	9.0	0.1	11.2
Total Loans	7,693.4	100.0	3.4

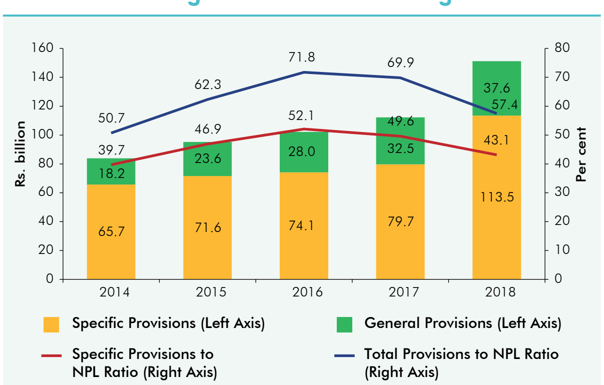
(a) Provisional

Source: Central Bank of Sri Lanka

observed during 2013 that exceeded 5 per cent. Further, the banking sector operated with healthy levels of provisions and capital buffers to absorb any adverse impact.

Even though 75.7 per cent of credit was concentrated on six economic sectors, the exposure of individual banks to various sectors of the economy, was rather diverse. The credit portfolio consisted of loans for consumption (18.1 per cent), construction (15.8 per cent), wholesale and retail trade (15 per cent), manufacturing (10.5 per cent), infrastructure developments (8.2 per cent) and agriculture, forestry and fishing (8.1 per cent) sectors.

Figure 8.4
Provisioning for NPLs of the Banking Sector



Source: Central Bank of Sri Lanka

(b) Market Risk:

Interest Rates: The interest rate sensitivity ratio (interest bearing assets as a share of interest bearing liabilities with maturities of less than 12 months) had marginally increased to 77.5 per cent at end 2018 from 76.5 per cent at end 2017. Capital gains on Treasury bonds during 2018 stood at Rs. 1.9 billion and was lower than Rs. 4.8 billion reported during 2017. This was due to the increase in market interest rates during 2018.

Equity prices: Equity risk of the banking sector was minimal due to low exposure to equity markets. Exposure to the equity market of banks' trading portfolio was Rs. 16.8 billion and was only 0.1 per cent and 2.7 per cent, respectively, of total assets and investments held for trading of the banking sector at end 2018.

Exchange Rates: The net foreign currency exposure of the banking sector had decreased at end 2018 compared to end 2017, with the higher increase in liabilities denominated in foreign currency, compared to the increase in assets denominated in foreign currency. During 2018, on-balance sheet assets denominated in foreign currency increased mainly due to the increase in placements with banks and investments, while off-balance sheet foreign currency liabilities increased mainly due to forward sales and other off-balance sheet liabilities. The net foreign currency exposure as a percentage of banks' on-balance sheet foreign currency assets stood at 0.8 per cent at end 2018. The banking sector reported a long foreign currency position of Rs. 11.7 billion at end 2018 in comparison to a long position of Rs. 19.9 billion at end 2017. The banking sector reported a net foreign currency revaluation gain of Rs. 31.8 billion during 2018 compared to Rs. 8.6

Table 8.6
Composition of Liquid Assets of the Banking Sector

Item	2017 (a)		2018 (b)		Change (Rs.bn)	
	Rs.bn	Share (%)	Rs.bn	Share (%)	2017	2018 (b)
Treasury bills	744.7	25.1	685.0	22.6	238.1	-59.7
Treasury bonds	960.4	32.4	941.3	31.0	117.3	-19.0
Sri Lanka Development Bonds	524.7	17.7	543.0	17.8	73.0	18.2
Cash	165.5	5.6	184.0	6.1	43.5	18.5
Money at Call	110.6	3.7	120.7	4.0	-4.1	10.1
Balance with Banks Abroad	327.4	11.1	386.0	12.7	5.2	58.6
Other	129.3	4.4	175.9	5.8	23.7	46.6
Total Liquid Assets	**2,962.6**	**100.0**	**3,035.9**	**100.0**	**496.8**	**73.3**

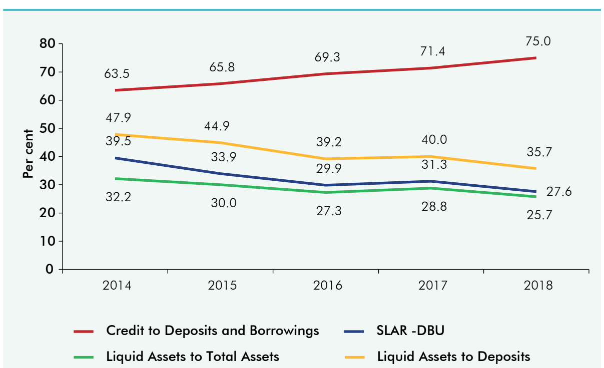
(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

billion during 2017 resulting from the depreciation of Sri Lankan rupee against the US dollar by 16.4 per cent during 2018 compared to the depreciation of 2 per cent during 2017.

(c) Liquidity Risk: Despite the growth in credit during 2018, the banking sector operated with an adequate level of liquidity. The Domestic Banking Units (DBU) of LCBs and LSBs are required to maintain a minimum Statutory Liquid Asset Ratio (SLAR) of 20 per cent. SLAR is calculated as the ratio of approved liquid assets over total deposits and borrowings for LCBs and the ratio of approved liquid assets over total deposits in the case of LSBs. The SLAR of domestic banking units decreased from 31.3 per cent at end 2017 to 27.6 per cent at end 2018 but remained well above the regulatory minimum of 20 per cent, while the SLAR of off-shore banking units increased from 35.5 per cent at end 2017 to 45.4 per cent at end 2018. Further, the expansion of credit during 2018 had resulted in an increase in the credit to deposits and borrowings ratio by 361 basis points, while liquid assets to total assets and liquid assets to deposits ratios had declined by 304 basis points and 429 basis points, respectively.

Figure 8.5
Liquidity Ratios of the Banking Sector



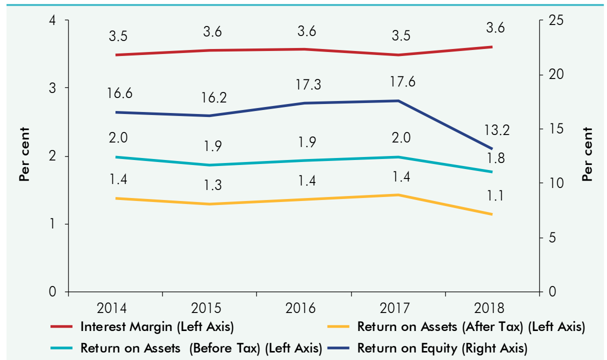
Source: Central Bank of Sri Lanka

The Rupee and All Currency Liquidity Coverage Ratios of the banking industry stood at 176.5 per cent and 152.1 per cent, respectively, at end 2018, well above the regulatory minimum of 90 per cent. The Liquidity Coverage Ratio (LCR), which banks are required to maintain, is the stock of unencumbered high-quality liquid assets that can be converted easily and immediately into cash in the secondary market to meet a bank's liquidity needs for a period of 30 days under a liquidity stress scenario. Total liquid assets increased only by Rs. 73.3 billion during 2018 compared to Rs. 496.8 billion during 2017, due to the higher growth in credit during 2018 compared to 2017. Total liquid assets amounted to Rs. 3,035.9 billion at end 2018, of which investments in government securities represented 71.5 per cent. In addition to the LCR, the Net Stable Funding Ratio (NSFR) which is expected to be implemented in 2019, under which banks need to maintain sufficient stable funding sources, the liquidity risk profile of banks will be further strengthened.

Figure 8.6
Cumulative Maturity Gap as a percentage of Cumulative Liabilities of the Banking Sector

Source: Central Bank of Sri Lanka

Figure 8.7
Profitability Indicators of the Banking Sector



Source: Central Bank of Sri Lanka

The cumulative maturity gap as a percentage of cumulative liabilities of the banking sector for maturity buckets over 30 days and upto less than 3 years narrowed marginally at end 2018 compared to end 2017 indicating better management of assets and liabilities in the medium term. Banking sector exposure to liquidity risk is considered minimal due to maintenance of adequate liquidity buffers.

Resources

(a) Profitability: Interest income of the banking sector grew at a higher rate (14 per cent) compared to interest expenses (12.8 per cent) during 2018, resulting in the net interest margin of the banking sector increasing from 3.5 per cent in 2017 to 3.6 per cent in 2018. Net interest income increased by Rs. 55.7 billion during 2018 compared to the previous year, while non-interest income increased by Rs. 25.7 billion largely owing to revaluation of foreign currency. However, the increase in non-interest expenses by Rs. 49.6 billion, largely owing to the increase in staff cost by Rs. 18.3 billion together with the increase in loan loss provisions by Rs. 21.1 billion, had resulted in lower profit before corporate tax of Rs. 194.7 billion in 2018 compared to the previous year.

Table 8.7
Profit of the Banking Sector

Item	2017 (a) Amount (Rs.bn)	2017 (a) As a % of Avg. Assets	2018 (b) Amount (Rs.bn)	2018 (b) As a % of Avg. Assets
Net Interest Income	341.9	3.5	397.6	3.6
Interest Income	972.5	10.0	1,108.7	10.1
Interest Expenses	630.6	6.5	711.1	6.5
Non-Interest Income	122.0	1.2	147.7	1.3
Foreign Exchange Income	23.4	0.2	48.5	0.4
Non-Interest Expenses	204.7	2.1	254.2	2.3
Staff Cost	103.0	1.1	121.4	1.1
Loan Loss Provisions	20.2	0.2	41.3	0.4
Profit Before Tax (after VAT)	194.4	2.0	194.7	1.8
Profit After Tax	138.5	1.4	125.9	1.1

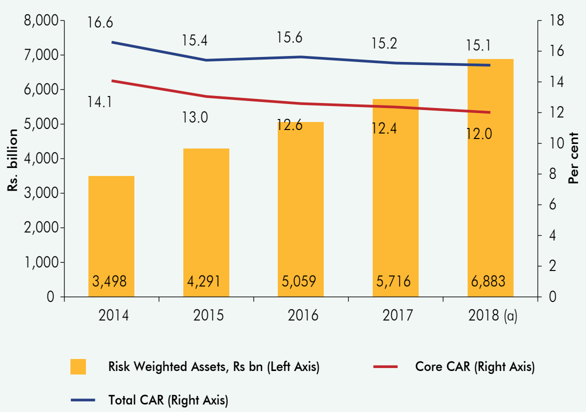
(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Profit after taxes of the banking industry was Rs. 125.9 billion during 2018 and had contracted by 9.1 per cent compared to the previous year due to increase in provisioning, staff cost and higher taxation of the banking industry. The ROA declined from 2 per cent in 2017 to 1.8 per cent in 2018, while the ROE declined from 17.6 per cent to 13.2 per cent over the same period. The efficiency ratio deteriorated from 45.7 per cent in 2017 to 50 per cent in 2018, due to the increase in operating costs.

(b) Capital: All banks were in compliance with the Basel III capital requirements. Risk weighted assets of the whole banking sector grew by 20.4 per cent during 2018 largely due to the increased credit growth during the year. As a result, the core capital ratio and the total capital ratio of the banking sector had marginally declined from 12.4 per cent and 15.2 per cent,

Figure 8.8
Capital Adequacy of the Banking Sector



(a) Under Basel III conditions (Provisional)

Source: Central Bank of Sri Lanka

respectively, at end 2017 to 12 per cent and 15.1 per cent, respectively, at end 2018. Enhanced minimum capital requirements which banks need to comply with by end 2020, the first day impact from implementation of SLFRS 9 which is considered for capital on a staggered basis over a period of 4 years and the Basel III capital requirements had encouraged banks to raise high quality capital. The regulatory capital of the banking sector reported a growth of 19.3 per cent during the year, of which Tier I capital contributed to 71.6 per cent. The regulatory capital base of the banking industry amounted to Rs. 1,038.2 billion at end 2018, of which Tier I capital represented 79.6 per cent.

Table 8.8
Composition of Regulatory Capital of the Banking Sector

Item	Amount (Rs. bn)		Composition (%)	
	2017 (a)	2018 (b)	2017 (a)	2018 (b)
Tier I: Capital	**706.2**	**826.3**	**100.0**	**100.0**
Share Capital	246.0	299.8	34.8	36.3
Statutory Reserve Funds	41.7	49.7	5.9	6.0
Retained Profits	270.0	310.8	38.2	37.6
General and Other Reserves	176.9	203.3	25.1	24.6
Others	8.6	7.1	1.2	0.9
Regulatory Adjustments	-37.0	-44.4	-5.2	-5.4
Tier II: Capital	**164.3**	**211.9**	**100.0**	**100.0**
Revaluation Reserves	15.2	27.8	9.2	13.1
Subordinated Term Debt	126.6	155.3	77.0	73.3
General Provisions and Other	27.8	33.9	16.9	16.0
Regulatory Adjustments	-5.3	-5.1	-3.1	-2.4
Total Regulatory Capital Base	**870.6**	**1,038.2**		

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Supervisory and Regulatory Developments

The Central Bank introduced a number of prudential policy measures and regulations to further strengthen the safety and soundness of the banking sector during 2018. Licensed banks were informed to refrain from the issuance of Usance Letters of Credit for importation of motor vehicles commencing from 01 January 2018, as proposed under the National Budget for 2018, and decided by the Parliament.

Banking Act Directions were issued to all licensed banks informing Loan to Value (LTV) ratios commencing from 01 January 2018, when granting credit facilities (which includes finance leases, hire purchase facilities and all other facilities) for purchase or utilisation of electric, hybrid and other registered and unregistered vehicles. However, LTV ratios were not applicable for credit facilities granted for any company engaged in tourism and/or transportation for purchase of vehicle fleets to be utilised for their core business operations, provided that such vehicles are not transferred to any person or entity within one year from the date of the first registration, and for credit facilities granted for procurement of vehicles for government agencies under the finance leasing method specified by the Ministry of Finance and Mass Media. Further, LTV ratios were not applicable for credit facilities granted for purchase of motorcycles by field officers in the public service and teachers serving in difficult areas under the proposed concessionary leasing facility provided by the government. Licensed banks were requested to maintain internal limits and adopt adequate risk management procedures for granting credit facilities to such exempted categories. A Direction was issued to licensed banks on measures to curtail import of motor vehicles. Accordingly, LTV ratio for credit facilities granted for the purpose of purchasing

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BOX 10

Stability and Sustainability of Banks by Strengthening the Regulatory Framework

1. Background

The banking sector in Sri Lanka constitutes 33 banks and maintains assets totaling Rs. 11.8 trillion as at end 2018. The financial system is dominated by the banking sector accounting for nearly 60 per cent of the total assets of the financial system. At present, the banking sector is mainly funded by deposits accounting for more than 70 per cent of the total assets, whilst shareholders contribute to approximately 8.7 per cent of total assets. Presently, four banks of Sri Lanka are ranked among the top 1000 banks in the world, according to the Banker Magazine, UK.

Considering the important role played by the banking sector in the financial system and the economy of the country, the Central Bank of Sri Lanka (CBSL) continues to introduce prudential policy measures and regulations based on internationally adopted regulations and best practices, to further strengthen the stability and sustainability of the banking sector, as any stress in the banking sector can adversely impact the economy.

2. Enhance the Stability of the Banking System

2.1 Completion of Basel III Framework

In the aftermath of the global financial crisis, the Basel Committee on Banking Supervision (BCBS) further strengthened the capital and liquidity requirements under the Basel III framework in order to address a number of shortcomings in the pre-crisis regulatory framework and to provide a foundation for a resilient banking system that will help avoid the build-up of systemic vulnerabilities.

2.1.1 Enhancing Capital Standards

Basel introduced two main capital standards viz., risk-based Capital Adequacy Ratio (CAR)[1] and non-risk based Leverage Ratio[2].

The Basel III capital standards endeavor to improve the quality and quantity of capital of banks by placing a greater focus on going-concern loss-absorbing capital in the form of Common Equity Tier 1 (CET1) capital when computing minimum CAR. Introducing capital buffers such as capital conservation buffer (CCB), countercyclical capital buffer and capital buffer for Domestic Systemically Important Banks (D-SIBs), in addition to the higher minimum CAR ensures that banks are sufficiently resilient to withstand losses in times of stress.

One of the underlying causes of the global financial crisis was the build-up of excessive on and off-balance sheet leverage in the banking system. The Leverage Ratio under Basel III is a simple, transparent, non-risk based supplementary measure to the risk-based capital requirement. The Leverage Ratio will restrict banks to use excessive debt for financing its assets where higher leverage ratio reflects banks' ability to withstand against adverse shocks to its balance sheet.

2.1.2 Liquidity Standards

The deficiencies in liquidity risk management of banks revealed during the global financial crisis led BCBS to reinforce global principles and standards for the measurement and management of liquidity risks in banks. The Basel III liquidity framework is centred on two standards; namely the Liquidity Coverage Ratio (LCR)[3] and the Net Stable Funding Ratio (NSFR)[4] which were developed to serve two separate but complimentary objectives.

The objective of LCR is to promote the short-term resilience of a bank's liquidity risk profile by ensuring that a bank has an adequate stock of unencumbered high quality liquid assets (HQLA) that can be readily converted to cash within the next 30 days, whereas NSFR promotes resilience over long-term time horizons by creating more incentives for banks to fund their activities with more stable sources on an ongoing basis. NSFR is intended to complement LCR by creating incentives for structural changes to bank funding profiles over a longer time horizon, thereby promoting a structurally sound banking system. Therefore, NSFR aims to reduce undue reliance on wholesale short-term funding and to encourage better liquidity risk management of banks.

2.1.3 Implementation of Basel III in Sri Lanka

CBSL has issued Banking Act Directions covering the above mentioned capital and liquidity standards under the Basel III framework to licensed banks in Sri Lanka and closely monitors their compliance in this regard.

1 CAR=Total Regulatory Capital as a % of Total Risk Weighted Assets

2 Leverage Ratio=Capital Measure as a % of Exposure Measure

3 LCR=Stock of HQLAs as a % of Total net cash outflows over the next 30 calendar days

4 NSFR=Available amount of stable funding as a % of Required amount of stable funding

Table B 10.1
Implementation of Basel III Framework in Sri Lanka

Capital Standards with effect from 01.01.2019	Applicable Ratio	
Total Capital Adequacy Ratio		
• for banks with Assets less than Rs. 500 bn	12.50%	
• for banks with Assets more than Rs. 500 bn (D-SIBs)	14.00%	
Leverage Ratio	3.00%	
Liquidity Standards with effect from 01.01.2019		
LCR	100%	
NSFR	01.01.2019	01.07.2019
	90%	100%

Alignment to international regulatory standards such as the Basel III framework will be beneficial to banks not only in terms of improving capital adequacy, leverage and liquidity as stated above, but may also help banks in obtaining better credit ratings, which will be advantageous in sourcing funds from international markets and in maintaining correspondent banking relationships.

2.2 Strengthening Corporate Governance Framework

The Organisation for Economic Co-operation and Development (OECD) defines corporate governance as a set of relationships between a company's management, its Board, its shareholders and other stakeholders, which provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance. It helps define the way authority and responsibility are allocated and how corporate decisions are made.

The objective of a corporate governance framework in banks is to help achieve robust and transparent risk management and effective decision-making, while ensuring responsibility and accountability of the Board of Directors and management and, in doing so, promote public confidence and uphold the safety and soundness of the banking system.

CBSL has issued Directions on corporate governance that comprehensively cover responsibilities of the Board of Directors of a bank, the Board's composition, criteria to assess the fitness and propriety of Directors, management functions delegated by the Board, the role and responsibilities of the Chairman and the Chief Executive Officer (CEO) of a bank, duties and functions of the Board appointed committees and related party transactions and disclosures. CBSL strictly monitors the adherence of banks with these Directions in an effort to strengthen the corporate governance culture of banks. In addition, the existing framework on the assessment of fitness and propriety under corporate governance for banks will be further strengthened with robust assessment criteria and measures such as cooling-off periods.

To strengthen corporate governance and to avoid ownership concentration, dominance in the banks' Boards, conflict of interest and risks in relation to related party transactions, share ownership in banks need to be broad-based. Therefore, the existing requirements on share ownership will be reviewed and a policy encouraging shareholders of international repute and diverse skills in the banking sector to hold shares in banks will be promoted.

2.3 Aligning to International Accounting Standards

With the implementation of Sri Lanka Accounting Standard – SLFRS 9: Financial Instruments, financial reporting of financial assets and liabilities of all entities for annual periods beginning or after 01 January 2018, is in line with the new Accounting Standard. Accordingly, licensed banks are required to provide for loan losses under the expected credit loss approach instead of the previous incurred loan loss approach. CBSL promotes consistent and prudent application of SLFRS 9 in the banking sector and has issued guidelines to licensed banks on the adoption of SLFRS 9. The adoption of SLFRS 9 will have a significant impact on banks and in order to avoid stress on capital and in line with the guidance given by BCBS, licensed banks were permitted to stagger audited first day impact on CAR under Basel III throughout a transitional period of four years.

2.4 Regulations on Market Conduct and Treasury Operations

There have been numerous instances in the banking industry across the globe where unethical and weak practices with respect to market conduct and treasury operations of banks have resulted in negative financial impact to customers and damages to the integrity of the market. This has resulted in banks facing enhanced regulation, substantial penalties and remediation costs as well as causing significant loss of trust amongst depositors and the public. Therefore, CBSL is continuously monitoring market conduct and treasury operations of banks and is in the process of reviewing the regulatory framework in this regard.

2.5 Technology Risks, Cloud Computing and Cyber Security

Digital transformation in the banking industry through developments in financial technology such as cloud computing, distributed ledger technology, artificial intelligence etc., have paved the way for creating new products and services, increasing access to customers, strengthening bank controls and lowering costs. However, new technologies generate new risks, and recent high-profile cyber-attacks on financial institutions have also focused attention on the need to strengthen cyber security as banks are very vulnerable to cyber-attacks. Therefore, CBSL, as the regulator, is committed to achieving a balance between regulation, innovation and digital transformation, whilst taking measures to minimize technological risks.

Accordingly, CBSL issued a Road Map to licensed banks to improve technological risk resilience with a timeline for implementation from 2018 to 2020. Banking Act Directions in this regard, covering areas such as; information security governance, information security training and awareness for Board of Directors and staff of banks, implementation of an industry standard user access and identity management system, data classification based on information security sensitivity and data encryption, establishment of Security Operation Centers (SOC) for banks (i.e., particularly for D-SIBs), information security testing, system availability, staff competency requirements, compliance with international standards and requirements on different types of information system infrastructure ownership, management and location, will also be issued in due course to complement the Road Map.

2.6 Macroprudential Measures

Macroprudential policy measures and tools are primarily used to deal with systemic risks in the financial system as a whole considering inter-linkages between the financial sector and the real sector as opposed to just focusing on individual financial institutions. The following macroprudential regulatory measures introduced by CBSL are currently in place for the banking sector.

- Loan-to-value ratios (LTV)[1] have been introduced to curtail credit granted, with respect to purchase/ utilization of motor vehicles.
- Banking Act Directions issued on foreign currency borrowings of licensed banks provide a framework for short-term and long-term limits on foreign currency borrowings of banks. The limits on foreign currency borrowings are based on a score calculated considering the bank's external long-term credit rating and CAR, and is computed as a percentage of total assets.
- Macroprudential regulatory measures on capital and liquidity implemented under Basel III framework are as follows:
    - o Capital buffer for D-SIBs to counter systemic risk.
    - o Imposition of capital conservation buffer (CCB), which is required to be built during good times and to be drawn down in a stressed situation.
    - o Minimum non-risk based Leverage Ratio as a macroprudential tool to restrict funding sources.
    - o Imposition of LCR and NSFR as counter-cyclical liquidity measures.

1 LTV sets the maximum percentage of a loan that can be granted with respect to the market value of an asset.

2.7 Facilitating Alternative Channels to Deliver Banking Services

Considering the high costs of maintaining brick and mortar structures to facilitate banking services, technological innovations and shift in consumer preferences, banks have moved towards alternate delivery channels, in order to expand the reach of banking services beyond traditional delivery channels while enhancing convenience to customers. This has led to a paradigm shift in the banking sector with banks expressing interest to venture into agent banking business through partnerships with entities such as fintechs, telecommunication companies and other retailers.

CBSL has issued Directions on a regulatory framework to oversee agent banking business in order to ensure the safety and soundness of the financial system whilst protecting customers. The Directions set out the permitted agent banking business and the requirements to be met by licensed banks in terms of risk management, selection of agents including sub-agents, consumer protection, complaint measures and relief mechanisms.

2.8 Memorandum of Understanding (MoUs) and other Inter Regulatory Initiatives

Core Principles for Effective Banking Supervision issued by the Bank for International Settlements (BIS) strengthen supervisory and regulatory frameworks of banks' risk management and set the minimum standards for prudential regulation and supervision of banks. Accordingly, Basel Core Principle 3 on 'cooperation and collaboration' and Core Principle 13 on 'home-host relationships', highlight the need to have in place a framework for co-operation and collaboration with relevant domestic authorities and foreign supervisors, whilst reflecting the need to protect confidentiality of information.

Therefore, considering the internationalization of the Sri Lankan banking sector and its cross-border presence, CBSL has initiated action to enter into MoUs with other supervisory authorities in the Asian region to exchange information as well as supervisory cooperation. At present, CBSL has entered into MoUs with the State Bank of Pakistan, the Reserve Bank of India and the Bangladesh Bank on cross-border supervisory cooperation and information sharing among regulators. Further, CBSL has also entered into MoUs for exchange of information with domestic regulators viz., Securities and Exchange Commission of Sri Lanka (SEC) and the Insurance Regulatory Commission of Sri Lanka (IRCSL).

2.9 Way Forward

2.9.1 New Banking Act

The banking sector is fast evolving and is becoming increasingly complex. Considering that the banking sector dominates the financial sector, and that certain banks are systemically important, strengthening the regulatory framework pertaining to licensed banks is important to maintain a dynamic and resilient banking sector that supports sustainable economic growth. Therefore, CBSL has initiated drafting a new Banking Act with a view to further strengthening the supervision and regulation of licensed banks. The key areas to be factored in to the proposed new Act include an overall mandate for supervision and regulation, strengthening corporate governance, digital banking, consolidated supervision, resolution, imposing monetary penalties/ fines, ring-fencing to mitigate contagion risk, strengthening provisions for mergers, acquisitions and consolidation, subsidiarisation of large foreign banks and differentiated regulatory framework for banks.

2.9.2 Determining D-SIBs

The Financial Stability Board (FSB) states that Systemically Important Financial Institutions (SIFIs) are institutions whose disorderly failure, due to their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity. In October 2012, BCBS finalised its framework for dealing with D-SIBs and this framework involves a set of principles on the assessment methodology and the higher loss absorbency (HLA) requirement for banks identified as D-SIBs.

At present, in Sri Lanka, D-SIBs are identified as banks with assets of Rs. 500 bn or above and apply a capital surcharge of 1.5 per cent commencing January 2019 on computation of CAR. Considering the importance and impact of D-SIBs to the banking sector and the economy, CBSL intends to formulate a comprehensive framework for determination of D-SIBs, in accordance with the principle-based framework issued by BCBS.

2.9.3 Subsisdiarisation of Large Foreign Banks

At present, certain foreign banks operate in a large scale in the local market similar to mid-sized domestic banks. Therefore, in the medium-term, large foreign banks currently operating as branches would be required to convert to wholly owned subsidiaries of the respective foreign bank, if such banks are deemed as systemically important. The proposed framework of CBSL will require such banks to create separate legal entities, requiring these banks to have their own capital base, local Board of Directors and to clearly demarcate assets and liabilities of the domestic bank from that of its parent bank. Further, amendments will also be brought into the new Banking Act to facilitate the subsidiarisation of large foreign banks.

2.9.4 Consolidated Supervision

The global financial crisis highlighted the significant role that financial groups, including financial conglomerates play in the stability of global and local economies. Therefore, there is a need to supervise banking groups on an individual as well as on a consolidated basis, considering the need to protect banks from contagion risk, and to ensure the stability and the soundness of the banking sector and the financial system. Thus, the supervisor should have powers to carry out consolidated supervision of licensed banks, including powers to examine holding companies, subsidiaries and other affiliates of licensed banks and have full access to banking groups. In order to facilitate this process, CBSL intends bringing in provisions that will enable consolidated supervision of banking groups in to the new Banking Act, as well as formulating a regulatory framework on consolidated supervision. Further, in order to strengthen inter-regulatory cooperation and collaboration in this regard, CBSL, SEC and IRCSL entered into a tri-partite MoU on risk-based consolidated supervision where CBSL will be the lead regulator.

Further, initiatives have also been taken to strengthen other regulatory areas in the banking sector including recovery planning, cyber security and digitization for banks and sustainable finance.

3. Conclusion

As the apex institution in the financial sector, CBSL has the authority to administrate and regulate the financial system. Therefore, the Central Bank of Sri Lanka is committed towards promoting a dynamic and resilient banking sector through the timely introduction of prudential policy measures, in line with regulatory and market developments and international best practices and effective implementation of same. This would help to preserve the stability of the banking system, whilst protecting depositors' interests and enhancing public confidence.

or utilisation of hybrid motor vehicles was reduced to 50 per cent for unregistered and registered vehicles which have been used in Sri Lanka for less than one year after the first registration, with a view to curtailing imports of motor vehicles and the adverse impact on the exchange rate. Further, with effect from 01 October 2018 and until further notice, licensed banks were instructed to refrain from opening letters of credit for importation of motor vehicles under the scheme for issuance of motor vehicle permits on concessionary terms issued by the Government of Sri Lanka.

Banking Act Orders under the off-shore banking business scheme were issued to all licensed banks permitting to credit/debit an account maintained by a non-resident in any designated foreign currency in an off-shore banking unit with transactions that are allowed under the provisions of the Foreign Exchange Act, No. 12 of 2017. Licensed banks were permitted to undertake foreign currency borrowings and engage in foreign currency borrowings with a resident subject to terms and conditions in Banking Act Directions No. 11 of 2018 on Foreign Currency Borrowings by licensed banks.

Banking Act Directions on "Appointment of Agents" were issued to all licensed banks informing the regulatory framework on appointment of agents of licensed banks. This Direction focuses on approval and selection process of agents and sub agents and their permitted activities, risk management, oversight and, customer protection etc including responsibilities of banks, in order to ensure effective agent oversight, risk management and customer protection. Subsequently, an amendment to the Directions was issued permitting licensed banks to provide inward remittance services to persons other than existing customers.

The Central Bank is in the process of reviewing the existing list of Qualified Auditors to conduct audits of licensed banks under the Banking Act. Accordingly, Expressions of Interest were called from the Audit Firms for the evaluation and selection to conduct audits for the financial year commencing from 01 January 2020. The assessment will be based on various factors which include qualification of partners, staff strength, experience and expertise and technical competencies to audit banks.

Banking Act Directions on financial derivatives were issued to licensed banks with a view to strengthening risk management of licensed banks. Accordingly, licensed banks are required to have in place Board approved policies and procedures on derivative transactions and risk management framework to identify, quantify and evaluate the exposures, manage risk and monitor performance related to derivative transactions. The new Directions revoked the Banking Act Directions No. 06 of 2017 dated 29 November 2017 on financial derivative transactions for licensed banks.

Margin requirement against imports on documents against acceptance (DA) terms was issued to licensed commercial banks. Accordingly, licensed commercial banks were informed to request importers to place a 100 per cent cash margin on the invoiced value of imports of non-essential consumer goods under DA terms. The cash margin requirement was placed on the total value of the invoice, regardless that the same invoice includes items which are not subject to the margin requirement. Further, licensed commercial banks were instructed to endorse the invoice to the effect that the margin deposit has been obtained and the margin deposit should be released on the production of documentary evidence or payments through the banking channels in Sri Lanka and customs documents of clearance of imports. Licensed commercial banks were also informed not to grant loan facilities to enable importers to place the margin deposits in respect of these imports. Banking Act Directions were issued to National Savings Bank (NSB) with regard to facilitation of import of motor vehicles and non-essential consumer goods. NSB was informed to refrain from facilitating importation of motor vehicles other than certain items specified and non-essential consumer goods (specified) by opening letters of credit or using other modes of payment until further notice.

A Banking Act Determination was issued informing banks the annual licence fees of the licensed banks for the calendar years 2019 and 2020. The licence fees are based on the total assets of licensed banks, at end of the previous year.

A consultation paper was issued to licensed banks on "Technology Risk Resilience". The Directions to be issued will set minimum regulatory expectations on technology risk resilience for licensed banks on certain areas such as information security governance, training and certification, user access management, data encryption, establishment of Security Operation Centres, staff competency requirement etc. The proposed Directions will complement existing Central Bank Directions on information technology and information security.

Banking Act Directions on Net Stable Funding Ratio (NSFR) under Basel III Liquidity Standards were issued to licensed banks. This direction was issued with the objective of ensuring a stable funding profile in relation to the composition of assets and off-balance sheet activities of licensed banks. Accordingly, commencing from 01 January 2019 every licensed bank shall at all times maintain an NSFR of 90 per cent which is to be increased to 100 per cent from 01 July 2019. Further, amendments to Banking Act Directions No. 01 of 2015 on Liquidity Coverage Ratio under Basel III Liquidity Standards was issued to licensed banks in order to align the Directions in accordance with the risk weight assigned to foreign claims of government and to streamline the classification of the customer base.

Banking Act Directions on foreign currency borrowings were issued to licensed banks introducing a new policy framework for borrowings in foreign currency by licensed banks. In terms of the new policy framework, short-term and long-term limits on foreign currency borrowings will be based on a certain percentage of assets depending on a score based on the bank's external credit rating and the capital adequacy ratio. The new Directions revoked the Banking Act Directions No. 07 of 2017 on Foreign Currency Borrowings by licensed banks and Circular No. BD/FX/196 dated 13 January 1997 issued by the Chief Accountant of the Central Bank.

A consultation paper on "Market Conduct and Treasury Operations" was issued to licensed banks with a view to further strengthen the market conduct and practices of treasury operations of licensed banks, and to ensure that the treasury operations of licensed banks are carried out prudently and in line with international best practices. The proposed regulatory framework covers inter alia market conduct and ethical practices, confidentiality requirements, procedure for recording deal conversations, risk management principles, professionalism, expertise and sanctions on non-compliance with the Directions.

Banking Act Directions on "Leverage Ratio under Basel III" were issued to licensed banks with the aim of introducing a framework with a simple, transparent and a non-risk based Leverage Ratio to act as a credible supplementary measure to the risk based capital requirement. This is in order to restrict the build-up of leverage in the banking sector, and to avoid any destabilising deleveraging processes which can damage the broader financial system and the economy. Accordingly, commencing from 01 January 2019 the minimum leverage ratio of 3 per cent will be applicable to all licensed banks. Further, due to the NSB Act mandating that 60 per cent of deposits in savings and deposit accounts of the bank be invested in government securities, a Circular was issued to NSB granting permission to exclude investment in government securities that represent 60 per cent of deposits in savings and deposit accounts of the bank, from the computation of leverage ratio exposure measure for NSB.

A consultation paper on "Amendments to the Banking Act Directions on Corporate Governance" was issued to licensed banks. The expected amendments purport to strengthen the assessment of fitness and propriety of Directors, CEOs and key management personnel of licensed banks. Accordingly, more information on qualifications and suitability of nominated/ appointed persons for the above positions is to be obtained to facilitate the most suitable persons to be appointed for the Board of Directors and management positions of licensed banks. Further, imposition of a cooling-off period will be considered to avoid conflict of interest and to enhance the accountability of these positions.

The Central Bank issued Guidelines to licensed banks on Adoption of SLFRS 9: Financial Instruments, to establish consistent and prudent practices on the adoption of the same by licensed banks. These guidelines were prepared based on the 'Guidance on Credit Risk and Accounting for Expected Credit Losses' issued by the Basel Committee on Banking Supervision in December 2015, the best practices and guidelines issued by monetary authorities/financial sector regulators on implementation of International Financial Reporting Standards 9: Financial Instruments, and taking into consideration the comments from the Institute of Chartered Accountants of Sri Lanka, Panel of Auditors and licensed banks in this regard. Accordingly, licensed banks are required to adhere to these Guidelines (in addition to the existing applicable regulations) as a minimum; on classification and measurement of financial assets and financial liabilities, management of credit risk, impairment of financial assets, valuation of collateral, role of the internal audit, regulatory and reporting requirements when preparing, presenting and publishing financial statements.

A new supervisory rating model (Bank Sustainability Rating Indicator-BSRI) was developed by the Central Bank with a view to facilitating the risk based supervision framework of licensed banks and to enable early intervention and prompt corrective actions for licensed banks. Accordingly, risk based examinations based on the BSRI was commenced with effect from 01 January 2019. Going forward, the Central Bank will continue to review and strengthen banking sector regulations in line with international standards and best practices in order to ensure the stability and sustainability of the financial sector while increasing the resilience of the financial system to global and domestic shocks while protecting the interest of depositors.

8.3 Performance of Non-Bank Financial Institutions

Licensed Finance Companies and Specialised Leasing Companies Sector

The performance of the Licensed Finance Companies (LFCs) and Specialised Leasing Companies (SLCs) sector moderated during the year in terms of credit growth, profitability and non-performing loans. Fiscal and macroprudential policy measures taken to curtail importation and credit granted for, purchasing motor vehicles negatively affected the demand for core lending products in the sector. Further, it is observed that the LFCs and SLCs are gradually moving away from vehicle financing to other secured lending activities. However, the sector expanded in 2018, with an asset growth of 5.6 per cent and represented 7.6 per cent of Sri Lanka's financial sector assets by end 2018. The sector as a whole maintained capital at a healthy level along with adequate liquidity buffers above the regulatory minimum levels. The sector also exhibited a shift in the funding mix, as increased assets were mainly funded through borrowings while deposits increased slightly compared to high growth recorded during the previous year. The Central Bank continued to take prudential measures to maintain stability of the sector with much consideration on reviving several companies with weak financial positions.

Business Growth

(a) Outreach: The sector comprised of 43 LFCs and 5 SLCs at end 2018. LFCs and SLCs contributed to the economy by providing enhanced services to the customers and expanding its branch network. At end 2018, there were 1,373 branches and 658 other outlets of the LFCs and SLCs sector, out of which 927 branches (68 per cent) were concentrated outside the Western Province.

Table 8.9
Distribution of Branches of LFCs and SLCs Sector by Province

Province	End 2017	End 2018 (a)
Central	152	158
Eastern	110	110
North Central	100	98
North Western	147	148
Northern	84	84
Sabaragamuwa	111	110
Southern	148	151
Uva	68	68
Western	442	446
Total	1,362	1,373

(a) Provisional Source: Central Bank of Sri Lanka

(b) Assets: The expansion of total assets slowed down, recording a growth rate of 5.6 per cent (Rs. 76.3 billion) during the year reaching Rs.1,431.3 billion compared to the 11.8 per cent growth reported in 2017. The asset base of the sector mainly consists of loans and advances which accounted for 79.4 per cent of the sector assets. Finance leases accounted for the highest share of loans and advances, representing 52.8 per cent followed by other secured loans (38 per cent).

Lending activities of the sector showed signs of slowing down in response to fiscal and macroprudential policy measures taken to curtail importation of motor vehicles and lending towards vehicles and the slow down in economic activities among other reasons. Credit provided by the LFCs and SLCs sector grew by 7.6 per cent (Rs. 79.9 billion) to Rs.1,137 billion compared to the growth of 9.8 per cent in the corresponding period of 2017. The expansion in finance leases contributed to 84.5 per cent of the credit growth while 16.1 per cent was through secured loans and advances. The hire purchase portfolio contracted during the year by Rs. 8 billion (29.7 per cent). However, the growth of finance lease portfolio for the year 2018 was 14.7 per cent compared to growth of 13 per cent recorded in year 2017.

Table 8.10
Composition of Assets and Liabilities of the LFCs and SLCs Sector

Item	2017		2018 (a)		Change (%)	
	Rs. bn	Share (%)	Rs. bn	Share (%)	2017	2018 (a)
Assets						
Loans and Advances (net)	1,057.1	78.0	1,137.0	79.4	9.8	7.6
Investments	118.1	8.7	109.7	7.7	5.7	-7.1
Other	179.8	13.3	184.6	12.9	30.8	2.7
Liabilities						
Total Deposits	686.7	50.7	716.8	50.1	29.4	4.4
Total Borrowings	396.0	29.2	463.8	32.4	-9.7	17.1
Capital Elements	169.7	12.5	183.7	12.8	16.1	8.2
Other	102.6	7.6	67.0	4.7	6.4	-34.7
Total Assets/Liabilities	1,355.0	100.0	1,431.3	100.0	11.8	5.6

(a) Provisional Source: Central Bank of Sri Lanka

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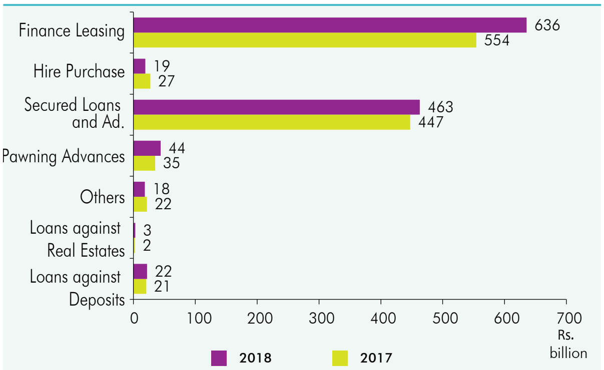
Figure 8.9
Total Loans and Advances (Gross) by Productwise for LFCs and SLCs Sector



Source: Central Bank of Sri Lanka

The investment portfolio of the LFCs and SLCs sector, comprises of investment in equities, capital market debt instruments, government securities and Investment properties. Investment portfolio recorded a negative growth of 7.1 per cent to Rs 109.7 billion in 2018 compared to a growth of 5.7 per cent to Rs. 118.1 billion in 2017 mainly due to the decline in market value of investments in subsidiaries, associates and unit trusts. Other assets, mainly maintained in the form of cash, balances with banks and financial institutions, trading stocks, and fixed assets showed an increase of 2.7 per cent in 2018 largely due to increased placements in banks and financial institutions.

(c) Liabilities: Customer deposits still dominate the major portion of liabilities which accounted for 50.1 per cent of the total liabilities of the sector. Borrowings recorded a growth of 17.1 per cent (Rs. 67.8 billion) in 2018, a shift from the negative growth recorded in the year 2017. Deposit growth slowed down to 4.4 per cent, compared with the growth of 29.4 per cent recorded in the corresponding period of 2017. The sector showed a reliance on bank borrowings over deposits due to flexibility and negative public perception towards LFCs which reduced the funds mobilized through deposits.

Table 8.11
Composition of Deposits of the LFCs Sector

Item	Amount (Rs. bn)		Composition (%)	
	2017	2018 (a)	2017	2018 (a)
Time Deposits	655.7	681.3	95.4	95.1
Savings Deposits	30.0	34.6	4.4	4.8
Certificate of Deposits	1.0	0.9	0.2	0.1
Total Deposits	686.7	716.8	100.0	100.0

(a) Provisional

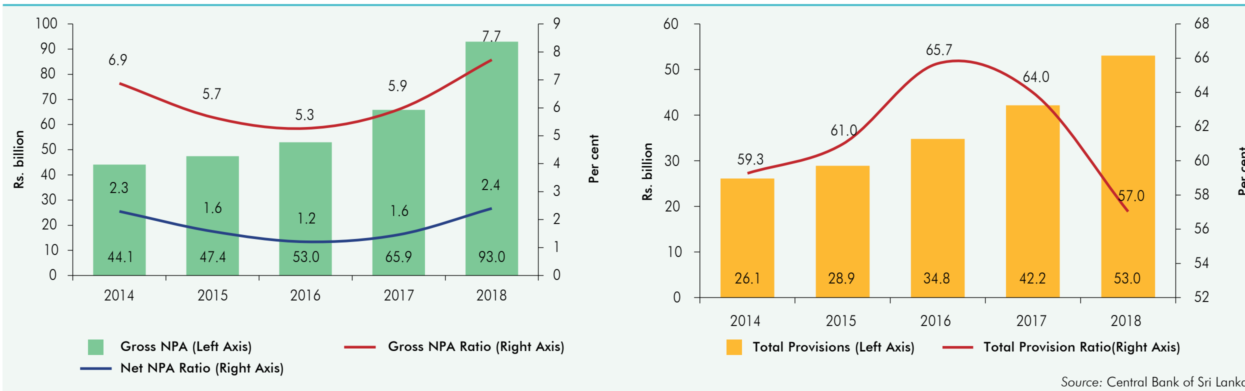
Source: Central Bank of Sri Lanka

The growth in deposits were mainly attributed to the declining trend in deposit interest rates. The capital elements of the sector increased by 8.2 per cent to Rs.183.7 billion at end 2018, mainly on account of the increase in capital due to steps taken by LFCs to enhance the minimum core capital to meet the Rs. 1.5 billion requirement by 01 January 2019 and due to accumulation of profits for the financial year 2017/18.

Risks in the LFCs and SLCs Sector

(a) Credit Risk: The gross non-performing advances (NPAs) ratio increased to 7.7 per cent in 2018 compared to 5.9 per cent reported in 2017. This is the highest NPA ratio recorded since February 2015. The main reasons attributable to this increase are unfavourable weather conditions during 2017 and slowing down in economic activities in 2018. Further, the provision coverage ratio declined to 57 per cent in 2018 compared to 64 per cent reported in 2017. As a result, net NPA ratio also increased to 2.4 per cent in 2018 from the reported ratio of 1.6 per cent in 2017 showing signs of deterioration in the asset quality of the sector. It is expected that NPA will rise further if extreme weather conditions prevail and due to spillover effect of the Debt Relief program that was introduced by the Ministry of Finance and Mass Media in August 2018. Further, implementation of SLFRS 9 is also expected to be a challenge for credit risk of the sector.

Figure 8.10
Non Performing Loans and Provision Coverage of the LFCs and SLCs Sector



Source: Central Bank of Sri Lanka

(b) Market Risk: The LFCs and SLCs sector continued to experience a minimal market risk due to the lower exposure to trading portfolio and foreign currency transactions.

Interest Rate Risk: Along with the gradual increase in the interest rates during the year, interest rate risk of the sector slightly increased. Despite the prevailing negative mismatch in the maturity profile of the interest-bearing assets and liabilities, the sector was able to maintain a positive net interest margin.

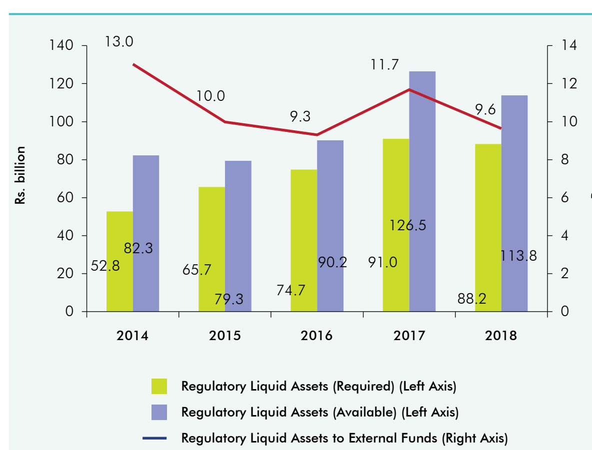
Prices of Equity: Equity risk of the sector remained low during the year as the exposure to equity market in the form of investment in listed shares was minimal at Rs. 14.3 billion, which was only 1 per cent of the total assets of the sector.

(c) Liquidity Risk: The overall statutory liquid assets available in the sector during 2018 indicated a surplus of Rs. 25.6 billion as against the stipulated minimum requirement of Rs.88.2 billion. However, the surplus liquid assets declined during 2018 compared to the surplus liquid assets level of Rs. 35.5 billion in 2017. Further, the liquid assets to total assets ratio reduced to 7.6 per cent from 8.9 per cent in 2017. The liquid asset to deposits ratio also was well above the statutory minimum requirement of 10 per cent of time deposits and borrowings, and 15 per cent of savings deposits at end December 2018.

Profitability and Capital Resources

(a) Profitability: The net interest income of the sector increased at a slower rate than in 2017, recording a growth of 6 per cent to Rs. 108.8 billion. This was mainly due to increase in interest income by 4.3 per cent and the growth of interest expenses by 2.9 per cent. As a result, the net interest margin (net interest income as a percentage of average assets) of the sector declined marginally to 7.4 per cent in 2018 from 7.7 per cent in 2017. However, non-interest income increased by 11.9 per cent mainly due to increase in default charges and other service charges while non-interest expenses also increased by 1.5 per cent adversely affecting the sector

Figure 8.11
Regulatory Liquid Assets of the LFCs and SLCs Sector



Source: Central Bank of Sri Lanka

Table 8.12
Composition of Income and Expenses of the LFCs and SLCs Sector

Item	2017		2018 (a)	
	Amount (Rs. bn)	As a % of Avg. Assets	Amount (Rs. bn)	As a % of Avg. Assets
Interest Income	231.5	17.3	241.5	16.5
Interest Expenses	128.9	9.6	132.6	9.1
Net Interest Income	**102.7**	**7.7**	**108.8**	**7.4**
Non-Interest Income	34.0	2.5	38.1	2.6
Non-Interest Expenses	80.0	6.0	81.2	5.5
Loan Loss Provisions (Net)	13.5	1.0	25.9	1.8
Profit Before Tax	43.2	3.2	39.7	2.7
Profit After Tax	25.8	1.9	21.4	1.5

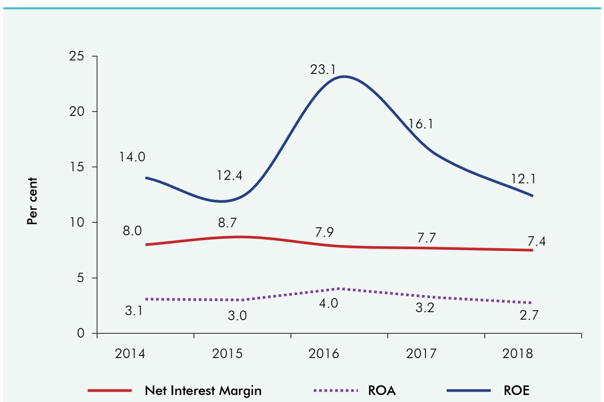
(a) Provisional   *Source:* Central Bank of Sri Lanka

profitability mainly due to increase in staff costs. The loan loss provisions made against NPLs increased by Rs.12.4 billion during 2018 when compared to the provision of Rs. 13.5 billion made in 2017. The sector posted a profit after tax of Rs. 21.4 billion which declined by 17.2 per cent compared to the profit recorded in year 2017 mainly due to increased funding cost and higher loan loss provisions. ROA also decreased by 51 basis points during the year, reporting a ratio of 2.7 per cent and ROE declined nearly by 400 basis points, reporting a ratio of 12.1 per cent which shows sign of stress towards profitability of the sector.

(b) Capital: The sector maintained its overall capital level well above the minimum requirement during the year enhancing the resilience to any perceived adverse shocks. The total regulatory capital levels improved by Rs. 15.5 billion in 2018 compared to the figures reported in 2017, mainly due to the enhancement of the minimum capital requirement by the Central Bank to Rs. 1 billion from 01 January 2018. This minimum requirement is further increased to Rs.1.5 billion by 01 January 2019.

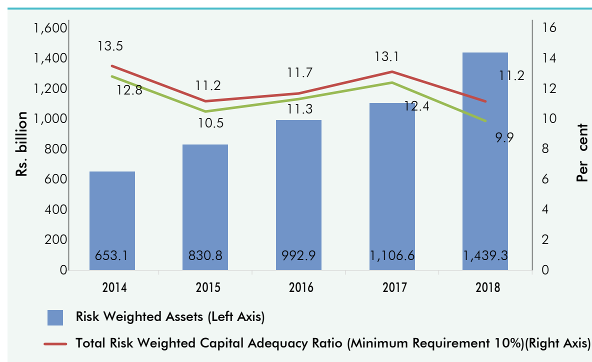
However, the sector core capital and total risk weighted capital adequacy ratios decreased to 9.9 per cent and 11.2 per cent in 2018 from the reported levels of 12.4 per cent and 13.1 per cent in 2017 as the companies had to report risk weighted assets with a more risk sensitive focus covering credit risk and operational risk under new capital adequacy framework. LFCs and SLCs are required to maintain minimum Tier I capital adequacy ratio of 6 per cent and total capital ratio of 10 per cent with effect from 01 July 2018 under the new capital adequacy framework. The regulatory capital comprises of Tier I and Tier II capital of which Tier I capital contributed to 97 per cent of the total regulatory capital. Tier I capital mainly comprises of issued share capital, statutory reserve fund and published retained profits. Subordinated term debt is 63.9 per cent of Tier II capital while revaluation reserves represents 10.3 per cent. However, there

Figure 8.12
Profitability Indicators of the LFCs and SLCs Sector



Source: Central Bank of Sri Lanka

Figure 8.13
Risk Weighted Assets and CAR of the LFCs and SLCs Sector



* With effect from 2018 July, the minimum requirement of Core Capital Ratio was increased to 6% from 5%

Source: Central Bank of Sri Lanka

Table 8.13
Composition of Regulatory Capital of the LFCs and SLCs Sector

Item	Amount (Rs. bn)		Composition (%)	
	2017 (a)	2018 (b)	2017 (a)	2018 (b)
Tier I: Core Capital	**139.3**	**156.0**	**100.0**	**100.0**
Stated Capital	66.4	71.8	47.6	46.0
Non-cumulative, Non-redeemable Preference Shares	0.1	0.1	0.1	0.1
Statutory Reserve Fund	19.1	22.3	13.7	14.3
General and Other Free Reserves	28.0	31.0	20.1	19.9
Other	25.7	30.7	18.5	19.7
Tier II: Supplementary Capital	**17.1**	**22.6**	**100.0**	**100.0**
Eligible Revaluation Reserves	2.3	2.3	13.4	10.3
General Provisions	0.5	5.7	2.9	25.4
Instruments qualified as Tier II Capital	14.6	14.4	85.1	63.9
Others	-0.2	0.0	-1.4	0.0
Regulatory Adjustments	**-11.1**	**-17.6**		
Total Regulatory Capital Base	**145.3**	**160.8**		

Source: Central Bank of Sri Lanka

(a) Revised
(b) Provisional
Note : Composition of Regulatory capital for 2017 is based on the Finance Companies (Risk Weighted Capital Adequacy Ratio) Direction No. 02 of 2006 and Finance Leasing (Capital Adequacy Ratio) Direction No 01. of 2011. Regulatory capital for 2018 is based on the Finance Business Act Direction No. 3 of 2018: (Capital Adequacy Requirements) and Finance Leasing Act Direction No. 3 of 2018:(Capital Adequacy Requirements)

were a few companies below the minimum required levels of Rs. 1.5 billion by 01 January 2019 due to weak financial positions and regulatory actions were taken against those companies.

Supervisory and Regulatory Developments

Throughout 2018, the Central Bank initiated several policy measures to strengthen the supervisory and regulatory framework of LFCs and SLCs with the aim of enhancing stability and soundness of the sector and increasing the customer protection and confidence. The "Financial Customer Protection Framework" was issued in the form of a Direction which emphasizes minimum standards for customer protection in the areas of disclosure and transparency, financial education and awareness, responsible business conduct, complaint handling and redress, equitable and fair treatment and protection of customer data and privacy. A Direction was issued to regularise the valuation procedure of the LFCs and SLCs regarding immovable properties. Further, a new Capital Adequacy Framework for LFCs and SLCs was implemented with a view to fostering a strong emphasis on risk management and to encourage ongoing improvements in LFCs and SLCs' risk assessment capabilities. A new Direction on "Outsourcing of Business Operations" was introduced to standardise the outsourcing arrangements by introducing a risk management guideline to manage the risk arising from outsourcing and to impose restrictions on outsourcing core business functions/operations and activities. A new Direction on "Maximum Rate of Interest on Microfinance Loans" was introduced for LFCs and SLCs with the objective of protecting customers from being charged with exorbitant interest rates for microfinance loans. LTV Ratio on vehicle imports was further revised to curtail imports requiring LFCs and SLCs to adopt the new ratio with effect from 01 October 2018. A circular was issued in March 2018, where LFCs were required to obtain a credit rating from a credit rating agency acceptable to the Central Bank and required to publish such rating with effect from 01 October 2018.

Primary Dealers in Government Securities

At the end of 2018, there were 7 Licensed Commercial Banks and 8 companies registered as Primary Dealers. Out of those, Perpetual Treasuries Limited (PTL) and Pan Asia Banking Corporation PLC (PABC), have been suspended from carrying out business and activities of a Primary Dealer (PTL w.e.f. 06 July 2017 and PABC w.e.f. 15 August 2017) by the Central Bank. Participation in government securities primary auctions was prohibited for Entrust Securities PLC (ESP) w.e.f. 24 July 2017 and resolution action has also been initiated on ESP. Therefore, currently 6 Licensed

Table 8.14
Performance of Primary Dealer Companies

Rs. billion

Item	2017	2018 (a)	Annual Growth Rate (%) 2017	Annual Growth Rate (%) 2018 (a)
Total Assets	**77.3**	**83.6**	**0.3**	**8.1**
Total Investment Portfolio	62.6	76.7	33.4	22.6
Trading Securities	50.9	62.8	34.0	23.3
Held-to-maturity	8.6	8.7	45.8	0.7
Available for Sale	3.0	5.2	0.6	74.2
Reverse Repo	13.4	4.3	-31.9	-67.6
Equity and Liabilities	**77.3**	**83.6**	**0.3**	**8.1**
Total Capital	23.1	11.5	10.2	-50.1
Repo	52.5	68.7	-3.8	30.7
Profit before Tax	**3.2**	**-0.1**	**-62.7**	**-100.4**
Profit after Tax	2.8	0.2	-66.7	-92.2
Return on Assets (%)	4.2	0.02	4.2	-4.2
Return on Equity (%)	12.9	2.0	-39.2	-10.9
Risk Weighted Capital Adequacy Ratio (%)	**55.9**	**21.3**	**-5.6**	**-34.6**
Leverage Times	2.3	6.0	-12.7	161.9
Dealings	8,897.1	7,965.5	-20.9	-10.5
Primary Market Dealings	485.6	436.3	13.1	-10.2
Secondary Market Dealings	8,411.5	7,529.2	-22.3	-10.5
Outright Purchases	443.9	456.9	-38.4	2.9
Outright Sales	806.6	826.0	-30.2	2.4
Repo, Reverse Repo	7,160.9	6,246.3	-19.9	-12.8

(a) Provisional
Note: 1. Excludes performance of primary dealer units of licensed commercial banks as these are included in the banking sector performance
2. Excludes financials of Entrust Securities PLC
3. Financials of 2018 excludes data of Perpetual Treasuries Ltd

Source: Central Bank of Sri Lanka

Commercial Banks (LCBs) and 6 Primary Dealer (PD) Companies are active in the PD industry in the government securities market.

Assets and Liabilities

The total assets of PD companies increased to Rs 83.6 billion in 2018 resulting growth in assets increasing from 0.3 per cent in 2017 to 8.1 per cent in 2018. The total investment portfolio of government securities, consisting of trading, available for sale and held to maturity amounted to Rs. 76.7 billion at end 2018, recording an increase of 22.6 per cent over 2017. This change was due to increases in the trading portfolio and the available for sale portfolio of government securities. The trading portfolio increased to Rs. 62.8 billion at end 2018, from Rs. 50.9 billion recorded at end 2017 and available for sale portfolio, increased to Rs. 5.2 billion compared to Rs. 3 billion at end 2017. Held to maturity portfolio increased marginally by 0.7 per cent to Rs. 8.7 billion at the end 2018 from Rs. 8.6 billion at the end of 2017.

Profitability: The PD companies reported profit after tax of Rs. 0.2 billion during 2018 against that of Rs. 2.8 billion during 2017. The significant revaluation losses from government securities has largely contributed to the decline in profits. Consequently, the ROA and ROE ratios for PD companies decreased to 0.02 per cent and 2.0 per cent, respectively, at the end 2018 from 4.2 per cent and 12.9 per cent recorded in 2017.

Capital: Equity of PD companies considerably declined by 50.1 per cent largely due to the suspension of a PD company and concentration on repo borrowings to fund the total assets growth. The Risk Weighted Capital Adequacy Ratio (RWCAR) of the PD companies was above the minimum RWCAR of 10 per cent even though the ratio decreased to 21.3 per cent at the end of 2018 from 55.9 per cent at the end 2017.

Exposure to Risks

Market Risk: The ratio of trading portfolio to the total investment portfolio of PD companies has not changed notably and recorded at 81.9 per cent at end 2018 compared to 81.4 per cent at end 2017. This reflects a marginal increase in the market risk exposure of the industry.

Liquidity Risk: The overall liquidity risk exposure of PD companies increased due to the increase in over-night negative mismatch in the maturity profile of assets and liabilities of the industry at end 2018. The overnight negative mismatch increased significantly to Rs. 41.3 billion or 92.8 per cent of the overnight liabilities at end

2018, from Rs. 1.1 billion or 9.5 per cent at end 2017. In view of holding a large volume of risk free government securities by PD companies and also the ability to use such government securities as collateral for obtaining funds to bridge any unforeseen liquidity gaps, the liquidity risk profile of PD companies remained low throughout the year except for one PD who was facing liquidity issues. Most of the PD companies had stand-by contingency funding arrangements to bridge any liquidity gaps.

Market Participation

Primary Market Activities: The participation in Treasury bills and Treasury bonds by PDs has showed a mixed performance. Of the total bids accepted from the total Treasury bills auctions (51) conducted in 2018, the participation of Bank PDs, PD companies and Employees' Provident Fund (EPF) is accounted to 70.5 per cent, 25.6 per cent and 3.8 per cent, respectively. However, participation in Treasury bond auctions in 2018 is dominated by the EPF with 46.3 per cent share from the total bonds accepted through 11 auctions conducted in 2018.

Secondary Market Activities: Secondary market transactions in government securities decreased significantly by 10.5 per cent to Rs.7,529.2 billion during 2018 compared to 2017, of which Repo transactions accounted for 82.9 per cent of the total volume of secondary market transactions in 2018. During 2018, outright purchases and outright sales increased by 2.9 per cent and 2.4 per cent respectively, compared to the values in 2017.

8

Unit Trusts

Number of Unit Trusts (UT) in operation at end 2018 were 75 which had declined by 4 during the year. The number of UT management companies remained at 14 in year 2018. From the total 75 UT funds, 16 operated as Income Funds, 15 Money Market Funds, 14 Gilt Edged Funds, 11 operated as balanced funds, 8 Growth Funds, 4 Index Funds, 4 Shariah Funds, 2 Initial Public Offering Funds and 1 dollar Bond Fund.

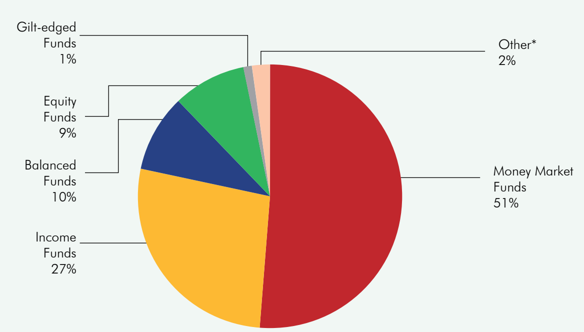
Business Growth

Contraction in UT sector assets was noted during year 2018, decreasing the asset base by 101 per cent to Rs. 64.2 billion at end December 2018. Simultaneously, the number of units issued also declined to 3,368 in 2018 compared to 7,683 issued in 2017. However, the total number of unit holders increased marginally to 42,093 in 2018 from 41,037 in 2017. The Net Asset Value also declined considerably to Rs. 64.2 billion at end 2018, when compared to Rs. 128.8 billion at end 2017.

Investment

A notable decrease in investment in government securities as a percentage of net assets was observed in 2018. The share of investment in government securities declined to 3.8 per cent at end 2018 compared to 17.7 per cent at end 2017. Investment in government securities decreased substantially by 88.9 per cent in 2018

Figure 8.14
Categorisation of the UT Sector in terms of the Net Asset Value



*Other: Shariah funds 0.7%, Index funds 0.1%, IPO funds and Dollar fund

Source: Unit Trust Association of Sri Lanka

Table 8.15
Performance of the UT Sector

Details	2017(a)	2018(b)
No. of Unit Trusts	79	75
Total No. of Unit Holders	41,037	42,093
No. of Units in Issue (mn)	7,638	3,368
Total Assets (Rs. bn)	128.8	64.2
Net Asset Value - NAV (Rs. bn)	127.6	64.2
Investments in Equities (Rs. bn)	13.0	9.5
Share of Total Net Assets (%)	10.2	14.7
Investments in Government Securities (Rs. bn)	22.5	2.5
Share of Total Assets (%)	17.7	3.8

(a) Revised
(b) Provisional

Source: Unit Trust Association of Sri Lanka

to Rs. 2.5 billion compared to Rs. 22.5 billion at end 2017. The investment in equities also declined significantly by 27 per cent at end 2018.

Insurance Sector

The insurance sector reported a moderate growth during year 2018 in terms of assets. A total of 26 insurance companies were in operation at end 2018, out of which 12 companies operated as exclusive general insurance companies, 12 companies operated as exclusive long-term insurance companies and 2 companies were involved in both long-term and general insurance business. The number of insurance companies listed in the Colombo Stock Exchange (CSE) remained at 9 in 2018. In addition, there are 63 Insurance Brokering Companies in 2018, where 2 new companies joined the industry in 2018. These brokering companies are either engaged exclusively on general insurance business or in both general and long-term insurance business.

Business Growth

Insurance sector assets showed a moderate expansion of 7.4 per cent at end 2018 with an increase in the asset base from Rs. 564.9 billion at end 2017 to Rs. 606.6 billion. The long-term insurance subsector recorded a growth of 9.4 per cent and reached an asset base of Rs. 429.4 billion at end 2018, whereas the general insurance subsector has recorded a growth of 2.7 per cent and reached an asset base of Rs. 177.1 billion at end 2018. The share of the long-term insurance subsector, in terms of the total assets of the insurance sector remained high at 70.8 per cent at end 2018 compared to 69.5 per cent at end 2017. Accordingly, the general insurance subsector has further reduced its share in total assets of the insurance sector to 29.2 per cent at end 2018 as against 30.5 per cent at end 2017.

Table 8.16
Performance of the Insurance Sector

Rs. billion

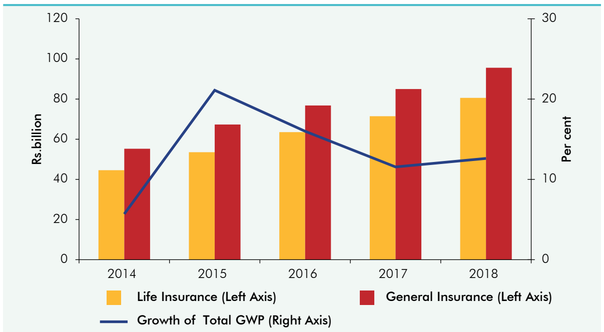
Item		2017 (a)	2018 (b)
Total Assets		564.9	606.6
Government Securities		218.6	217.6
Equities		49.2	42.6
Cash & Deposits		64.8	94.3
Total Income		201.9	221.2
Premium Income		160.4	176.2
Investment Income		41.5	45.0
Profit Before Tax		47.8	29.5
Capital Adequacy Ratio (%)	- Long term Insurance	302.0	312.0
	- General Insurance	177.0	204.0
Retention Ratio (%)	- Long term Insurance	96.0	95.8
	- General Insurance	77.8	77.9
Claims Ratio (%)	- Long term Insurance	24.3	46.2
	- General Insurance	64.3	63.7
Combined Operating Ratio (%)	- Long term Insurance	85.2	101.0
	- General Insurance	100.7	102.9
Return on Assets (ROA) (%)	- Long term Insurance	10.6	4.9
	- General Insurance	5.4	5.4
Return on Equity (ROE) (%)	- Long term Insurance	44.4	25.0
	- General Insurance	10.5	11.2
Underwriting Ratio (%)	- General Insurance	19.3	18.1

(a) Revised
(b) Provisional

Source: Insurance Regulatory Commission of Sri Lanka

The overall gross written premium of the sector recorded a growth of 12.6 per cent at end 2018. The growth of gross written premium of the long-term insurance subsector was 12.7 per cent whereas the gross written premium of the general insurance subsector was 12.5 per cent at end 2018. Nevertheless, the general insurance subsector has been the main contributor for the insurance sector gross written premium with a share of 54.3 per cent. The gross written premium of the motor insurance category which is the most significant category

Figure 8.15
Gross Written Premium of the Insurance Sector



Source: Insurance Regulatory Commission of Sri Lanka

in the general insurance subsector grew by 12.9 per cent during the period under consideration. The fire insurance category has grown by 3.7 per cent and the marine insurance category has grown by 8.3 per cent. However, a drop in the gross written premium is observed in the health insurance category which is a decline by 11.6 per cent.

Earnings

The total profits of the insurance sector recorded a considerable decline of 38.4 per cent during 2018. This was mainly attributable to the drop in profits by three long-term insurance companies. In addition, the profit recorded in 2017 was extraordinary as it was resulted from some long-term insurance companies making one off surplus transfers which emerged as a result of changing the valuation method of policy holder liabilities, to comply with regulations of the IRCSL. Accordingly, the drop in the long-term insurance subsector was 48.5 per cent in 2018. Meanwhile an increase in the profits of the general insurance subsector was observed at 8.3 per cent during 2018. The underwriting profits of the insurance sector increased to Rs. 13.1 billion in 2018 from Rs. 12.7 billion recorded in 2017.

Total claims of the insurance sector increased to Rs. 81.6 billion from Rs. 68.1 billion recording a growth of 19.9 per cent during year 2018. The long-term insurance subsector claims have significantly increased by 37.5 per cent, whereas the claims of the general insurance subsector has moderately increased by 9.1 per cent during 2018.

The total investment income of the insurance sector has also indicated a growth of 8.4 per cent during year 2018. The ROA of the long-term insurance subsector decreased substantially to 4.9 per cent in line with the drop in profits recorded during this period. This trend is also reflected in ROE reporting a decrease of 25 per cent during 2018 compared to 44.4 per cent during 2017. Meanwhile, the ROA of the general insurance subsector remained more or less similar at 5.4 per cent during 2018, whereas, ROE slightly increased to 11.2 per cent in 2018 from 10.5 per cent in 2017.

Capital and Investment

Capital to total assets of the long-term insurance subsector declined to 22 per cent from 23 per cent at end 2017, whereas the capital to total assets ratio of the general insurance subsector slightly improved to 48 per cent at end 2018 from 47 per cent at end 2017. The drop in profits may have been accountable to the decline in capital of the long-term insurance subsector. Further, one insurance company failed to comply with the Risk Based Capital Adequacy requirement imposed by the IRCSL in 2018.

The investments made by the insurance sector continued to be highly concentrated on government securities. Nevertheless, the long-term insurance subsector assets on government securities decreased to 29 per cent at end 2018 compared with 32.5 per cent at end 2017. However, the general insurance subsector assets on government securities increased slightly to 7 per cent at end 2018 from 6.2 per cent reported at end 2017. When considering the share on investment on equity, the long-term insurance subsector share decreased to 4.9 per cent at end 2018 compared to 6.5 per cent at end 2017. The investment on equity of the general insurance subsector decreased to 2.1 per cent at end 2018 compared to 3.2 per cent at end 2017.

Supervisory and Regulatory Developments

Several regulatory and supervisory developments were initiated by the IRCSL in 2018. A Direction on corporate governance was issued to ensure greater transparency in insurance business. Further, directions on operational matters such as management of insurance funds and treatment of one-off surplus have been issued to long-term insurance companies. Furthermore, some regulations have been amended in line with the new developments of the insurance sector. With regard to supervisory actions, a procedure for taking enforcement actions on non-compliance with provisions of reporting requirements has been enforced by the IRCSL.

Superannuation Funds

The assets of the superannuation funds stood at Rs. 2,807.7 billion at end 2018 and were estimated to account for 14.8 per cent of the financial sector assets. The sector is dominated by the Employees' Provident Fund (EPF), which accounts for about 81.5 per cent of the assets of the superannuation sector. In addition to EPF, there are two other publicly managed funds, namely, the Employees' Trust Fund (ETF) and the Public Service Provident Fund (PSPF). Further, there were 123 privately managed Approved Pension and Provident Funds (APPFs) operative in Sri Lanka at end 2018.

Employees' Provident Fund

As per the Employees' Provident Fund (EPF) Act. No. 15 of 1958, the Monetary Board of the Central Bank of Sri Lanka is entrusted with the custodianship of the Fund while the Commissioner of Labour is entrusted with the general administration of the Fund. The EPF Department of the Cental Bank facilitates the Monetary Board (MB) to perform its powers, duties and functions as per the provisions of the EPF Act.

(a) Membership, Member Balances and Refunds: The total value of the Fund increased by Rs. 223.1 billion to Rs. 2,289.4 billion at end 2018 from Rs. 2,066.3 billion recorded at end 2017 registering a 10.8 per cent growth. This increase was due to the combined effect of net contributions of the members (contributions less refund payments) and the income generated through investments of the Fund. Total liability to the members stood at Rs. 2,254.2 billion at end 2018 recording an 11.6 per cent increase from Rs. 2,020.8 billion at end 2017. The total contribution for the year 2018 increased by 8.8 per cent to Rs. 145.0 billion while the total amount of refunds made to the members and their legal heirs in 2018 was Rs.108.0 billion, which was a decrease of 8.0 per cent over 2017. Accordingly, the net contribution was Rs. 37.0 billion compared to Rs. 15.8 billion recorded in the previous year.

Table 8.17
Five Year Performance Summary of EPF

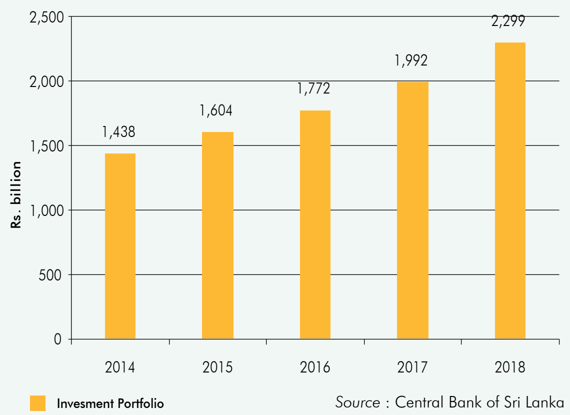
Rs. billion

Item	2014	2015	2016	2017	2018(a)
Total Value of the Fund (Rs. Bn.)	1,486.9	1,664.9	1,841.5	2,066.3	2,289.4
Total Liability to the Members (Rs. Bn.)	1,445.5	1,625.5	1,810.6	2,020.8	2,254.2
Total Contributions (Rs. Bn.)	90.0	102.5	118.3	133.3	145.0
Total Refunds (Rs. Bn.)	65.1	77.8	108.4	117.5	108.0
Net Contribution (Rs. Bn.)	24.9	24.7	9.9	15.8	37.0
Interest Rate (%)	10.50	10.50	10.50	10.50	9.50

(a) Provisional

Source: Central Bank of Sri Lanka

Figure 8.16
Growth of the Investment Portfolio of EPF
(in book value)

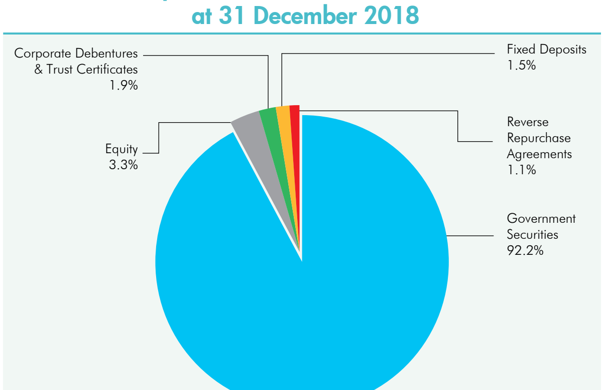


Source : Central Bank of Sri Lanka

The annual profit of the Fund decreased by 6.1 per cent to Rs.190.6 billion in 2018 from Rs.202.9 billion from the previous year. This was mainly due to the increase in the income tax expense of the fund as per the Inland Revenue Act No. 24 of 2017 and the marked to market losses from listed equity investments with the adoption of new Accounting Standard on Financial Instruments in 2018.

(b) Investment of Funds and Return: The total investment portfolio (book value) of the Fund grew by 15.4 per cent to Rs. 2,298.8 billion at end 2018 from Rs. 1,992.4 billion at end 2017. The investment policy of the Fund focused on providing a long-term positive real rate of return to the members while ensuring the safety of the Fund and availability of adequate level of liquidity to meet refund payments and other expenses of the Fund. Accordingly, at end of 2018, the investment portfolio consisted of 92.2 per cent in government securities, 3.3 per cent in equity, 1.9 per cent in corporate debentures and trust certificates, 1.5 in fixed deposits and the remaining 1.1 per cent in Reverse Repurchase agreements.

Figure 8.17
Composition of Investment Portfolio
at 31 December 2018



Source : Central Bank of Sri Lanka

Table 8.18
Five Year Summary of Income Data of EPF

Rs. million

Item	2014	2015	2016	2017	2018(a)
Interest and Amortization gains	153,395.3	169,645.9	193,656.3	219,635.3	229,446.0
Dividend Income	3,321.4	3,512.4	4,262.6	2,993.6	3,887.6
Realized Capital Gains / (Loss)	6,359.4	1,724.3	1,064.0	-	7.2
Net gain / (loss) from FI at FVTPL	89.4	-394.0	-842.1	1,476.9	-10,901.3
Impairment of Financial Assets	-	-2,956.6	-5,231.6	-1,502.1	0.6
Investment Income	**163,165.4**	**171,532.0**	**192,909.1**	**222,603.7**	**222,440.1**
Other Income	708.1	323.3	162.3	588.8	403.0
Total Gross Income	**163,873.5**	**171,855.3**	**193,071.4**	**223,192.5**	**222,843.1**
Operating Expenditure	-1,042.9	-1,190.6	-1,487.2	-1,348.7	-1,505.3
Income Tax	-12,168.7	-13,727.4	-15,657.2	-18,897.1	-30,720.4
Profit for the Year	**150,661.9**	**156,937.3**	**175,927.0**	**202,946.8**	**190,617.4**
Retained Profit b/f	140.7	311.3	215.6	189.3	2,471.0
Profit available for distribution	150,802.6	157,248.6	176,142.5	203,136.1	193,088.4

(a) Provisional
Source: Central Bank of Sri Lanka

The total investment income of the Fund was Rs. 222.4 billion in 2018, and recorded a decrease of 0.1 per cent compared to previous year. Interest income including amortization gains continued to be the major source of income to the Fund which grew by 4.5 per cent to Rs. 229.4 billion in 2018 from Rs. 219.6 billion in 2017. Dividend income also increased by 29.9 per cent to Rs. 3.9 billion in 2018 compared to Rs. 3.0 billion in 2017. Net loss on financial instruments at fair value through profit or loss recorded a loss of Rs. 10.9 billion in 2018 compared to net gain of Rs. 1.5 billion in 2017.

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The Fund earned a total gross income of Rs. 222.8 billion in 2018, recording a decrease of 0.2 per cent compared with the previous year. EPF was able to earn 10.4 per cent return on investment in 2018 while maintaining operating expenses to gross income ratio at 0.7 per cent in 2018. With the introduction of the new Inland Revenue Act, No. 24 of 2017, which was effective from 01 April 2018, the income tax rate applicable for the Fund increased from 10 per cent to 14 per cent, which resulted in an increase of Rs. 12 billion in the tax expenditure when compared with the previous year. Furthermore, the Withholding Tax (WHT) of 10 per cent paid on Treasury bond interest income which had been recognized as a part of gross income under the previous tax regulations has been abolished with effect from 01 April 2018. Also, the adoption of SLFRS 9, the Accounting Standard applicable for classification and measurement of Financial Instruments, where listed equity instruments were measured at fair value and under the prevailed market conditions, a marked to market loss of Rs. 10.9 billion was charged against the profit for the year 2018. Due to these reasons, the profit available for distribution decreased by Rs. 10 billion or by 4.9 per cent compared to 2017. However, EPF has taken measures to declare an interest rate of 9.5 per cent on member balances in 2018 partly utilising the funds in the Profit Equalization Reserve.

(c) Risk Management: In 2018, a number of measures have been taken for improving the overall risk management framework of the EPF, with a view of enhancing the accountability and transparency of the investment activities. As a result, new Investment Policy Statement and Investment Guidelines have been developed incorporating these requirements. While the EPF is in the overall risk management framework of the Central Bank several initiatives were taken to strengthen the governance structure of the EPF risk management. This includes the establishment of EPF Investment Oversight Committee (EIOC) to oversee the investment activities of the EPF by providing strategic and policy guidance for the management of the Fund and the EIOC delegates its duties and powers with respect to the day-to-day decision-making function of the EPF fund management activities to a departmental level committee called EPF Investment Committee (EIC). Further, Risk Management Department of the Central Bank, as the second line of defence carries out the risk oversight activities of the EPF and reports to the Monetary Board through the Board Risk Oversight Committee of the Central Bank on a regular basis. Therefore, risk mitigation activities which address both financial and non-financial risks of the Fund and the actions pertaining to strengthen the internal controls relating to operational activities have been continued throughout the year.

Employees' Trust Fund

The Employees' Trust Fund which accounts for 11.1 per cent of the asset base of the superannuation sector reported a healthy growth in 2018 in terms of assets. The ETF has around 14.6 million accounts, of which only 2.6 million were active, at end 2018. The number of employers contributing to the fund increased to 82,416 , at end 2018 compared to 81,515 recorded at end 2017. The total outstanding member balances in the ETF rose by 2.5 per cent and stood at Rs. 281.1 billion at end 2018. Meanwhile, total contributions decreased by 2.2 per cent to Rs. 22.3 billion, while total benefits paid out increased by 8.9 per cent to Rs. 18.8 billion, resulting in a significant decrease of 36.9 per cent in the net inflow of funds during the year. However, total assets of the fund amounted to Rs. 312.1 billion, recording a growth of 11.9 per cent at end 2018 compared to the growth of 12.1 per cent at end 2017. The total investments of the ETF rose

Table 8.19
Performance of the EPF and the ETF

Item	EPF		ETF	
	2017 (a)	2018 (b)	2017 (a)	2018 (b)
Total Assets (Rs. bn)	2,066.3	2,289.4	279.0	312.1
Total Member Balance (Rs. bn)	2,020.8	2,254.2	274.2	281.1
Number of Member Accounts (mn)	18.0	18.5	12.6	14.6
Number of Active Member Accounts (mn)	2.8	2.6	2.5	2.6
Number of Employers Contributing	76,782	78,977	81,515	82,416
Total Contributions (Rs. bn)	133.4	145.0	22.8	22.3
Total Refunds (Rs. bn)	117.5	108.0	17.2	18.8
Total Investments Portfolio (Rs. bn)	1,992.4	2,298.8	262.5	291.7
o/w : Government Securities (%)	91.3	92.2	78.2	75.1
Gross Income (Rs. bn)	223.2	222.8	29.0	29.1
Profit Available for Distribution (Rs. bn)	203.1	193.1	17.2	n.a.
Return on Investments (%)	11.8	10.4	11.0	8.4
Interest Rate Paid on Member Balances (%)	10.5	9.5	9.0	9.0

(a) Revised
(b) Provisional
n.a. - not available

Sources: Central Bank of Sri Lanka
Employees' Trust Fund Board

by 11.1 per cent to Rs. 291.7 billion at end 2018. The share of investments in government securities reduced to 75.1 per cent at end 2018 from the 78.2 per cent recorded at end 2017. The ETF has made arrangements to reinvest inflows from divested government securities in term deposits. Investments in equity and corporate fixed income securities accounted for 4.0 per cent and 1.0 per cent, respectively, of total investments during the year, and the fund managed to secure a rate of return of 8.4 per cent on its investments.

Other Superannuation Funds

The Public Service Provident Fund (PSPF), which represents 2 per cent of the superannuation sector, contracted in terms of the number of members and net contributions, while its assets grew during the year. The active members of the fund declined to 227,816 at end 2018 compared to 228,214 recorded at end 2017. Total assets grew by 3.1 per cent and stood at Rs. 57.2 billion while investments of the PSPF grew by 4.5 per cent to 55.3 billion in 2018. The positive net contribution was declined to Rs. 381.2 million in 2018, compared to Rs. 843.8 million in 2017. The investments in government securities accounted for 48.8 per cent of total investments. The rate of return on member balances was 13 per cent for 2018.

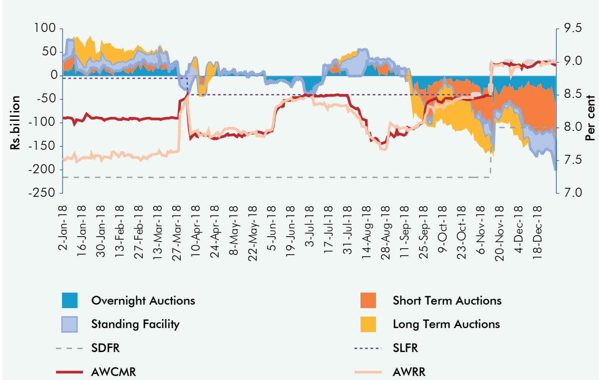
APPFs accounts for 5.3 per cent of the superannuation sector and recorded a contraction in 2018. The number of approved provident funds declined to 123 at end 2018 with the winding up of 26 funds due to cessation of workers, bankruptcy of companies and transferring funds to the Central Bank. Accordingly, the number of members covered by private provident funds reduced to 134,456 at end 2018 from 169,257 recorded in 2017. Further, total assets of the APPFs is estimated to be Rs. 149.1 billion at end 2018. This is a 65.9 per cent reduction of the asset base of Rs. 437.3 billion recorded at end 2017. Investment portfolios of such funds amounted to Rs. 114.8 billion at 2018, which recorded a 57 per cent negative growth.

8.4 Performance of Financial Markets

Money Market

The Average Weighted Call Money Rate (AWCMR), which serves as the operating target of the enhanced monetary policy framework, responded swiftly to policy rate changes in 2018. Policy interest rates of the Central Bank were revised in two instances in 2018 impacting the movements in AWCMR. The AWCMR, which was at 8.15 per cent at end December 2017,

Figure 8.18
Behaviour of Money Market in 2018



Source: Central Bank of Sri Lanka

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continued to remain closer to that level with the surplus liquidity in the domestic money market until end March 2018. Some transitory increase in the AWCMR was observed towards end March 2018 due to the misinterpretation of the effect of the withholding tax adjustment by commercial banks. In response to the reduction of the Standing Lending Facility Rate (SLFR) by 25 basis points at the beginning of April, the AWCMR declined below 8 per cent. The wide gap prevailed between AWCMR and Average Weighted Repo Rate (AWRR) narrowed and both rates moved closely with the removal of the notional tax on government security transactions from April 2018. Although AWCMR remained within the policy rate corridor since April, it increased towards the upper bound of the corridor by mid-2018 and remained around the same levels during the remainder of the year except for a short period during July-September 2018. With the increase in Standing Deposit Facility Rate (SDFR) by 75 basis points to 8.00 per cent and the SLFR by 50 basis points to 9.00 per cent in November 2018, both the AWCMR and the AWRR continued to hover around the upper bound of the corridor. Accordingly, AWCMR and the AWRR remained at 8.95 per cent and 9.00 per cent, respectively, at end December 2018. As a result of policy rate changes in 2018, the width of the policy rate corridor narrowed to 100 basis points from 150 basis points. The AWCMR, which remained closer to the upper bound of the policy rate corridor until end February 2019, indicated a downward adjustment following the policy actions by the Central Bank to reduce SRR with effect from 01 March 2019 with a view to inject market liquidity as well as the monetary operations of the Central Bank to provide liquidity to the domestic money market.

Table 8.20
Money Market Transactions

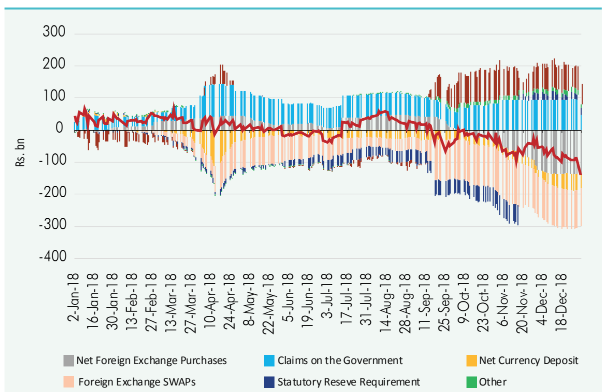
Market	Volume (Rs. bn)		Weighted Average Interest Rate (Min-Max) - %	
	2017	2018	2017	2018
Call Money	3,900.4	4,196.2	7.95 - 8.75	7.76-9.00
Inter-Bank Repo	4,205.6	2,761.2	7.50 - 9.14	7.48-9.00
Central Bank Repo	3,327.7	1,530.3	7.25 - 7.75	7.25-8.33
Central Bank Reverse Repo	1,049.6	3,385.7	8.47 - 8.75	7.85-8.98
Standing Deposit Facility	3,954.9	4,502.9	-	-
Standing Lending Facility	2,129.5	3,057.5	-	-

Source: Central Bank of Sri Lanka

Market Liquidity

Rupee liquidity in the domestic money market, which displayed both positive and negative levels until mid-September 2018, turned to a persistently negative condition during the latter part of 2018. Liquidity position turned into a persistently high deficit mainly due to foreign exchange related transactions carried out by the Central Bank. However, variation of liquidity level witnessed during the year was mainly led by government transactions with the Central Bank. Purchase of government securities by the Central Bank increased liquidity, while maturing of such securities led to a decline in liquidity levels. Similarly, forward transactions initiated by the Treasury with the Central Bank raised market liquidity, while reversal of these forward transactions reduced market liquidity. Margin

Figure 8.19
Daily Changes in the Money Market Liquidity in 2018



Source: Colombo Stock Exchange

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requirements were imposed in September 2018 for Letters of Credit opened with commercial banks for importation of motor vehicles and non - essential consumer goods with the view of reducing import demand to curtail the pressure on the exchange rate to depreciate. Imposition of 100 per cent reserve requirement on such margins considerably increased the required reserves to be maintained by LCBs with the Central Bank leading to a decline in liquidity in the domestic money market at the same proportion. The SRR applicable to rupee deposit liabilities of commercial banks was reduced by 1.50 percentage points to 6.00 per cent from 7.50 per cent with effect from 16 November 2018. As a result of the SRR reduction, about Rs. 90 billion was injected into the market aiding to reduce the pressure on money market liquidity. Liquidity management operations were carried out by the Central Bank aimed at keeping the AWCMR within the policy rate corridor consistent with the monetary policy stance, while avoiding large fluctuations in AWCMR and maintaining adequate liquidity in the market to facilitate smooth functioning of the payments and settlements system. Accordingly, the Central Bank actively engaged in Open Market Operations (OMOs) by conducting overnight, short term and long-term reverse repurchase auctions to inject liquidity on a temporary basis and also outright Treasury-bill purchases to inject liquidity to the market on a permanent basis. As the liquidity deficit continued to remain high, the Central Bank reduced SRR by further 1.00 percentage points to 5.00 per cent in February 2019 to be effected from 01 March 2019 to reduce the liquidity deficit in the domestic money market.

Monetary policy implementation process encountered few issues. The spread between the SLFR and primary market Treasury bills yields of 91 days, 182 days and 364 days continued to increase and stood at 101 basis points, 87 basis points and 170 basis points, respectively, at end 2018. A higher spread could lead to arbitrage gains for market participants by exploiting the OMO and standing facilities. Despite high AWCMR, LCBs were compelled to borrow funds without collaterals from the call money market at higher rates than that of OMO auctions in order to comply with the requirement of maintaining the Minimum Liquidity Asset Ratio. The high liquidity deficit in the market was triggered by the continued borrowing, particularly by domestic bank, while considerable liquidity was concentrated on foreign banks. Asymmetric distribution of liquidity among market participants also led some participant's to continuously borrow from the Central Bank. As the excessive reliance on OMO facilities by non-bank primary dealers affected the efficiency of the signaling effect of OMOs, from 25 September 2018 the participation of non-bank Primary Dealers at OMO auctions was restricted. However, standing facility and ILF facility continued to be available without any restrictions to all Participating Institutions.

Access to real time accurate information on money market transactions is critical to facilitate the price discovery of the money market. The Central Integrated Market Monitor (CIMM) was introduced to LCBs, PDs and Money Brokers with effect from 1 March 2018 to report information on call money, foreign exchange and government security markets. CIMM also requires LCBs and PDs to report highly accurate liquidity estimates before 08:30 hours on each working day to prepare the daily liquidity estimate of the banking system.

Domestic Foreign Exchange Market

Sri Lankan rupee depreciated significantly against the US dollar during the year. Four consecutive interest rate hikes by the Federal

Reserve Bank, USA which resulted in severe capital flight, together with high importer demand for US dollars caused a substantial depreciation of the Sri Lankan rupee against the US dollar. The pressure was aggravated due to the prolonged political instability ensued during the last 3 months of the year. Further, significant foreign debt service payments befell during the year as well as, the negative sentiment created through the delayed 6th tranche of EFF from the IMF contributed to the extreme pressure on the exchange rate. Accordingly, the Sri Lankan rupee depreciated against the US dollar by a notable 16.36 per cent, from Rs. 152.85 reported at end 2017 to Rs. 182.75 at end 2018, while the respective depreciation recorded in 2017 was only 2 percent. In line with the overall depreciation of the Sri Lankan rupee against the US dollar, the average US dollar buying and selling exchange rates of Licensed Commercial Banks for telegraphic transfers at end 2018 were recorded at Rs. 180.72 and Rs. 184.70, whilst comparative figures at end 2017 were Rs. 151.31 and Rs. 155.15, respectively.

During the year, the Sri Lankan rupee depreciated against other major currencies in line with the depreciation against US dollar. Although uncertainties that emerged from the 'Brexit' caused the Sterling Pound to depreciate against the US dollar, the pressure on the Sri Lankan rupee against US dollar surpassed the depreciation of GBP against US dollar. Consequently, the Sri Lankan rupee depreciated by 11.35 per cent against the Sterling Pound during 2018. Similarly, the Sri Lankan rupee depreciated by 12.68 per cent against the Euro as the general depreciation of the Euro against the US dollar resulting from the strengthened dollar was not sufficient to overcome the adverse impact on exchange rate between Sri Lankan rupee and Euro. Owing to the trade war between USA and China, excessive demand created over Japanese Yen as a safe-heaven asset within an environment of geopolitical uncertainty and the general depreciation of Sri Lankan rupee against the US dollar, led for the Sri Lankan rupee to depreciate against the Japanese Yen by 18.06 per cent and Indian rupee by 8.72 per cent during the year.

The Central Bank was a net seller in the domestic foreign exchange market in 2018. The Central Bank absorbed US dollars 557 million during the first three months of the year from the market. However, in order to combat the continued pressure on the exchange rate and to curb the excessive volatility whille facilitating capital outflows, the Central Bank supplied US dollars 1,676 million to the market. Accordingly, the Central Bank supplied US dollars 1,120 million to the domestic foreign exchange market on a net basis during the year.

During 2018, trading volumes in the domestic foreign exchange market recorded a significant increase of 12.7 per cent compared to the previous year. Transaction volumes of foreign exchange in the domestic inter-bank market increased to US dollars 17,402 million in 2018 from US dollars 16,451 million in 2017. In line with this, the daily average volumes in the inter-bank foreign exchange market also increased to US dollars 73 million in 2018 in comparison to US dollars 68 million recorded in 2017.

Government Securities Market

Reflecting the high debt service payments and tight government cash flow requirements during the first quarter of the year, the downward adjustment in Treasury bill yield rates observed since the second half of 2017 was reversed starting from early part of 2018. However, the reduction of the Standing Lending Facility Rate (SLFR) by 25 bps to 8.50 per cent effective from 4 April 2018 contributed to moderate

Table 8.21
Primary Market Treasury Bond Issuances

Year	Amount Issued (Rs. bn)		
	Auction	Placements	Total
2016	654	9	664
2017	536	13	549
2018	763	-	763

Source: Central Bank of Sri Lanka

the upward pressure on Treasury bill yield rates which remained broadly stable thereafter until end September 2018. However, uncertainty in the financial markets that emanated mainly from the developments in political and external spheres, drove the Treasury bill yield rates up at end October 2018 and the yield rates stabilised thereafter albeit at relatively higher levels at end 2018. The debt management strategies adopted during the year in the form of maintaining a stable and low interest rate environment, especially during the first three quarters of the year, was supported by the positive market momentum created by the expectation on accessing the international capital market, smoothening the Treasury bills reissuance process, adherence to the pre-announced auction calendar for Treasury bills and Treasury bonds and the continuous dialogue with market participants on future arrangements and macroeconomic developments. Further, Sri Lanka successfully accessed the international capital markets by issuing International Sovereign Bonds in April 2018 for US dollars 2,500 million. However, withdrawal of foreign investments from emerging market economies, including Sri Lanka, mainly due to normalisation of interest rates in the USA and the challenging domestic as well as global economic conditions that prevailed towards the latter part of the year not only contributed to an upward pressure on the yield structure of government securities but also resulted in reduced foreign holdings of Treasury bills and Treasury bonds at end 2018 compared to end 2017. Accordingly, the benchmark yield rate of 364-day Treasury bills recorded an increase of 230 bps at end 2018 compared to end 2017. Further, the yield rates for 91-day, 182-day and 364-day maturity Treasury bills stood at 10.01 per cent, 9.99 per cent and 11.20 per cent, respectively, at end 2018. Moreover, the upward adjustment in short-term interest rates was also reflected in medium term Treasury bond yield rates during the latter part of 2018.

Total net outflow of foreign investments in Treasury bonds and Treasury bills amounted to US dollars 990.7 million which consisted of net outflow of US dollars 96.4 million in Treasury bills and US dollars 893.6 million in Treasury bonds during the year 2018. The outstanding foreign holdings of Treasury bonds and Treasury bills at end 2018 amounted to Rs. 158.6 billion compared to Rs. 322.6 billion at end 2017, recording a noteworthy decrease of 50.8 per cent.

Table 8.22
Primary Market Weighted Average Yield Rates of Treasury Bills

Per cent per annum

Year	Maturity			Annualised Overall Average
	91-days	182-days	364-days	
2014	6.58	6.57	6.73	6.68
2015	6.32	6.50	6.60	6.46
2016	8.26	9.23	10.20	9.38
2017	9.01	9.80	10.07	9.77
2018	8.40	8.58	9.68	9.36

Source: Central Bank of Sri Lanka

Table 8.23
Yield Rates of Government Securities

Per cent per annum

Item	Primary Market		Secondary Market	
	2017	2018	2017	2018
Treasury bills				
91-Days	7.69 – 9.73	7.75 - 10.07	7.65 - 9.70	7.61 - 9.93
182-Days	8.30 – 10.79	7.95 - 10.03	8.30 - 10.68	7.93 - 10.44
364-Days	8.90 – 11.11	8.80 - 11.25	8.89 – 11.03	8.78 - 11.15
Treasury bonds				
2-Years	9.83 – 12.30	-	9.33 – 11.98	9.05 - 11.36
3-Years	-	9.55 - 11.88	9.59 – 12.44	9.32 - 11.61
4-Years	11.13 – 11.94	-	9.81 – 12.69	9.37 - 11.82
5-Years	10.09 – 12.89	9.44 - 11.69	9.96 – 12.73	9.45 -11.87
6-Years	11.21 – 11.49	-	10.01 – 12.84	9.53 - 11.97
10-Years	9.90 - 12.21	10.20 - 12.23	10.14 – 12.94	9.72 - 12.25
15-Years	-	10.05 - 10.88	10.32 – 13.07	9.97 - 12.37
30-Years	-	-	10.62 – 13.33	10.29 - 12.39

Source: Central Bank of Sri Lanka

The Central Bank raised US dollars 1,492.1 million by issuing Sri Lanka Development Bonds (SLDBs) during 2018 against the maturing amount of US dollars 2,304.2 million, in order to gain advantage of the market conditions. This eased the pressure on domestic rupee market financing and enabled to maintain orderly domestic interest rates during first three quarters of 2018.

During 2018, the Average Time to Maturity (ATM) of the overall domestic public debt portfolio increased and recorded 5.91 years at end 2018 compared to 5.78 years at end 2017. The ATM of outstanding Treasury bond portfolio at end 2018 increased to 6.88 years from 6.72 years at end 2017. The upward adjustment in ATM is attributed to issuance of longer term maturities of Treasury bonds under the conducive market environment prevailed mainly in the first half of 2018.

Corporate Debt Securities Market

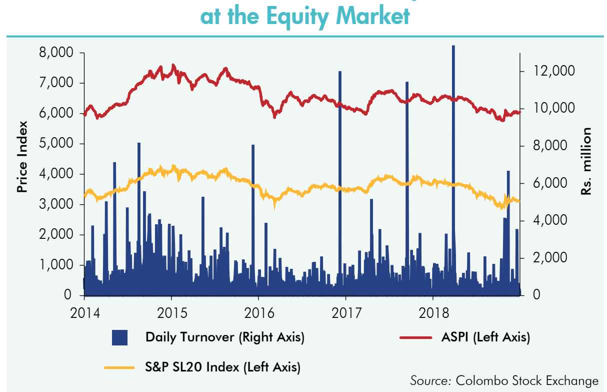
The level of activity in the commercial paper (CPs) market continued to remain low. There was a total of 6 issues with the support of banks amounting to Rs. 1.9 billion in 2018 compared to 15 issues worth Rs. 6.5 billion in 2017. Interest rates of the CPs fluctuated between the relatively lower range of 13.10 to 15.00 per cent in 2018 compared to the range of 13.75 to 16.50 per cent recorded in the previous year. All CPs issued in 2018 had a maturity of 3 months or less. The total outstanding value of CPs amounted to Rs. 1.2 billion at end 2018 compared with Rs. 1.7 billion at end 2017.

The corporate bond market was relatively active in 2018 compared to the previous year. During 2018, There were eleven issues of debentures which raised Rs. 55.9 billion compared to five issues totaling Rs. 20.0 billion in 2017. With the new Basel III requirement, majority of banks raised capital through Basel III compliant debentures which boosted activities of the cooperate debt market in 2018. Out of the eleven institutions listed during the period, eight institutions were banks or other financial institutions. The highest listed corporate debt issuance recorded in 2018 amounting to Rs. 10.0 billion was issued by Commercial Bank of Ceylon PLC and the second largest issuance of Rs. 7.5 billion was by Sampath Bank PLC. Among the debenture issuance, there were one floating rate debenture and one zero coupon debenture during the period. The fixed interest rates applicable to bonds issued in 2018 were in the range of 12.00 – 14.75 per cent, compared to the range of 11.95 – 15.00 per cent in 2017.

Equity Market

The Colombo Stock Exchange recorded a declining trend in 2018 reversing the growth achieved in 2017. The All Share Price Index (ASPI) and the S&P Sri Lanka 20 Index of the Colombo Stock Exchange declined in 2018 responding to the adverse developments in the domestic and global environment. The ASPI decreased by 5.0 per cent to 6,052.4 at end 2018, which is comparatively worse than the 2.3 per cent increase recorded in the previous year. The ASPI reached 5,761.1 in October 2018, its lowest during the year recording a decrease of 9.6 per cent. The ASPI

Figure 8.20
ASPI, S&P SL20 Index and Daily Turnover at the Equity Market



Source: Colombo Stock Exchange

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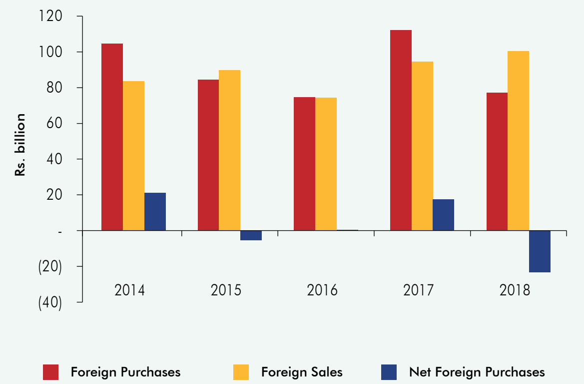
showed relatively lower decrement than the overall equity market indices of most Asian countries such as China, Japan, South Korea, Hong-Kong, Philippines, Malaysia and Thailand mainly due to the size and limited exposure to the global market. However, India's equity market indices recorded a lesser decline than Sri Lanka's ASPI. Meanwhile, S&P SL20 index decreased by 14.6 per cent during 2018 compared to the increase of 5.0 per cent recorded in 2017.

The market recorded a negative development in terms of turnover, capitalisation and Price to Earning (PE) ratio. The average daily turnover was declined to Rs. 833.6 million during 2018, when compared to Rs. 915.3 million in 2017. The market capitalization and the number of companies listed remained low. In 2018, the turnover velocity (the ratio of total turnover to average market capitalisation) decreased to 6.9 per cent from 7.5 per cent in 2017. Lower turnover velocity implies high cost of trading, low investor participation levels and lower liquidity. Meanwhile, market capitalisation declined to Rs. 2,839.5 billion at end 2018 from Rs. 2,899.3 billion recorded at end 2017. Market capitalisation at end 2018 was equivalent to 21.4 per cent of GDP which was lower than the

Figure 8.21
Foreign Participation at the Equity Market



Source: Colombo Stock Exchange

Table 8.24
Selected Indicators of Equity Market

Item	2017	2018
All Share Price Index (1985=100) (a)	6,369.3	6,052.4
Year-on-Year Change (%)	2.3	-5.0
S&P SL 20 Index (17.12.2004 = 1000) (a)	3,671.7	3,135.2
Year-on-Year Change (%)	5.0	-14.6
Market Capitalisation (Rs. bn) (a)	2,899.3	2,839.5
As a Percentage of GDP (%)	24.5	21.4
Market Price Earnings Ratio (a)	10.6	9.7
Turnover to Market Capitalisation (%)	7.6	7.0
Average Daily Turnover (Rs. mn)	915.3	833.6
Value of Shares Traded (Rs. bn)	220.6	200.1
Number of Shares Traded (mn)	8,468.3	6,000.7
Number of Companies Listed	296.0	297.0
Introductions (b)	1.0	1.0
Number of Initial Public Offers/ Offers for Sale (b)	2.0	2.0
Number of Rights Issues	15.0	16.0
Amount Raised Through Rights Issues and Initial Public Offers (Rs. bn)	51.6	44.2

(a) End of the year
(b) There are 3 methods to obtain a listing: i.e. an introduction where no public issue is required, an offer for sale where existing shares are issued to the public and an offer for subscription where new shares are issued to the public.

Source: Colombo Stock Exchange

24.5 per cent recorded in 2017. The market PE was relatively lower at 9.7 at end 2018 compared to 10.6 at end December 2017. During the year, the ratio reached its highest value of 11.5 in April 2018 and the lowest of 9.0 in October 2018.

Continued foreign outflows from the CSE was witnessed during 2018. In the secondary market, the market recorded a net foreign outflow of Rs. 23.1 billion at end 2018 compared to the net foreign inflow of Rs.17.7 billion at end 2017. Net foreign outflows prevailed in the market during the recent past were mainly driven by the increased pressure on the exchange rate, political uncertainty and the shift in investor sentiments due to global developments. In addition, lack of diversified investment opportunities has also negatively affected foreign investments in the CSE. Foreign investors contribution to total market turnover declined marginally to 44.3 per cent in 2018 compared to 46.9 per cent recorded during 2017.

The primary market remained less active. There were two Initial Public Offering (IPO) in 2018 which raised Rs. 2.0 billion while one IPO raised 1.0 billion in 2017. Further, Rs. 42.2 billon was raised through 16 rights issues in 2018 while Rs. 50.6 billion was raised through 15 right issues in 2017.

Price indices of most sub sectors showed a weaker performance in 2018 compared to the previous year. Construction and Engineering (-40.9 per cent), Manufacturing (-27.7 per cent), Information Technology (-25.9 per cent), Plantations (-24.5 per cent), Telecommunication (-20.9 per cent) and Trading (-20.2 per cent) sectors recorded a substantial decline. Among the 20 sub sectors, only two sectors recorded a growth during the year, namely: Stores & Supplies and Beverage and Food & Tobacco which increased by 3.1 per cent and 5.3 per cent respectively during the year.

During 2018, several regulatory measures were introduced to improve the smooth functioning of the equity market. The Securities and Exchange Commission (SEC) established a cross divisional committee to review the comments received from the stakeholders to the Securities Exchange Bill published in the Gazette in November 2017. In addition, SEC had conducted discussions with the delegates from the World Bank on some of the issues highlighted. Further, the SEC enforced rules on minimum public holding requirement and procedures on listed public companies violating listing requirements of CSE, to facilitate the conduct of stock market activity in a healthier manner. A Small and Medium Enterprise (SME) board was launched facilitating SMEs to raise capital via CSE.

8.5 Development Finance and Access to Finance

The development finance policy strategies of the Central Bank focused mainly on enhancing inclusive and balanced economic growth through effective credit delivery and financial inclusion in the country. To achieve the aforesaid objective, the Central Bank continued to coordinate, facilitate and implement various refinance, interest subsidy and credit guarantee schemes, while providing a range of credit supplementary services to the individuals and the Micro, Small and Medium Scale Enterprises (MSMEs) scattered across the country.

In 2018, the Central Bank implemented various credit schemes, with the funding from the Central Bank, the government, international donor agencies and Participating Financial Institutions (PFIs). Accordingly, the Central Bank implemented 11 refinance, interest subsidy and credit guarantee schemes through the Regional Development Department (RDD) and provided concessionary credit facilities amounting to Rs. 16,435.4 million through PFIs to 105,874 beneficiaries island-wide. Meanwhile, the Poverty Alleviation Microfinance Project II – Revolving Fund (PAMP II - RF) was successfully completed in July 2018 as scheduled.

In 2018, the government together with the International Fund for Agricultural Development (IFAD) established the Smallholder Agribusiness Partnership Programme (SAPP) under the Public-Private-Producer Partnerships (4Ps) model to develop value chain partnerships and to improve outcomes for all engaged parties. The RDD implements the Credit Component of the SAPP loan schemes whereas the Project Management Unit (PMU) of SAPP implements the programme under the Presidential Secretariat which acts as the Lead Programme Agency of the SAPP. The SAAP will be funded by both IFAD and the government. Accordingly, in March 2018, an Administrative Agreement was signed between the government and IFAD for the implementation of the SAPP and in April 2018, operating instructions were issued to PFIs to introduce six new loan schemes under the SAPP. The loan proceeds for credit provided by the IFAD is utilised for financing Public-Private-Producer Partnerships (4Ps) Capital, 4P Seasonal and Youth Loan Schemes. The government is providing counterpart financing for SAPP to implement Revolving Fund Loan Schemes (RF Loan Schemes) of SAPP, namely, RF Capital, RF Seasonal and RF Income Generation Scheme. In this regard, the government established a Consolidated Revolving Fund (CRF) under the SAPP, utilizing the recoveries of the previous IFAD funded financial lines of credits, namely, Dry Zone Livelihood Support and Partnership Programme – Revolving Fund (DZLiSPP-RF), Smallholder Plantation and Entrepreneurship Development Programme (SPEnDP) and National Agribusiness Development Project (NADeP). The CRF is utilised for all the previous and present IFAD funded project beneficiaries to meet their financing requirements under RF Loan Schemes. Further, responding to the needs of the farmers who engage in seasonal agricultural activities, maximum repayment period and the grace period were increased to 30 months and 18 months respectively from 12 months and 6 months respectively, in December 2018 in relation to Seasonal Loans of SAPP. In October 2018, a Memorandum of Understanding (MOU) was signed with the PMU of the SAPP to develop an automation system to automate the operations of the loan schemes implemented by RDD under the SAPP loan schemes.

During 2018, the government contributed to further improve the development finance and access to finance in the country through the "Enterprise Sri Lanka" (ESL) Programme. The Ministry of Finance and Mass Media (MoF&MM) introduced 15 loan schemes under the programme. The ESL programme was introduced with the objective of making all Sri Lankans as stakeholders in a production economy to achieve the government's medium-term development targets of increasing the per capita income up to US dollars 5,000, creation of one million new employment opportunities, doubling of exports and sustaining economic growth over 5 per cent by 2020. Through this programme, the government has expected to improve the agriculture, industry and services sectors in the country by providing concessionary financial and non-financial assistance to youth, women and the MSMEs identified as the driving force of the economic development.

Total loans granted under the ESL programme increased significantly in 2018, the first full year of operations compared to nine months of the previous year. The total number of loans registered under the ESL programme in 2018 increased to 34,476 and the value of loans granted amounted to Rs. 65,364 million compared to 6,460 of registered loans and Rs. 16,381 million worth of loans granted during the previous year. Out of the total loans provided in 2018, a majority of 51.4 per cent (42 per cent of the total no. of loans) has been disbursed in 6 districts (i.e. Gampaha, Colombo, Kurunegala, Kalutara, Hambantota and Galle) whilst the balance 48.6 per cent (58 per cent of the total no. of loans) was granted in 19 districts which indicates the need for more focus on lending to the lagging districts under the programme. In 2018, it was further observed that, out of the total value of the loans, 30.4 per cent has been disbursed to manufacturing industries, 26 per cent to the agriculture sector and 20.2 per cent to the tourism industry. Further, it was proposed to introduce a Credit Guarantee Scheme (CGS) in 2018, to provide government guarantees through the Central Bank to the PFIs for the loans granted under "Ran Aswenna", "Govi Navoda", "Jaya Isura", "Diri Saviya" and "Green Loan" loan schemes of the ESL programme.

The CGS is considered as a risk sharing tool for loans granted under the above schemes which operate with a view to developing the MSMEs in Sri Lanka. Accordingly, an agreement to this effect was signed between the MoF&MM and the Central Bank in January 2019.

During 2018, the Ministry of Industry & Commerce and Resettlement of Protracted Displaced Person and Cooperative Development continued the "Small and Micro Industry Leader and Entrepreneur Promotion Project Phase III – Revolving Fund (SMILE III - RF)" to provide concessionary funding for the micro or small-scale manufacturing or industrial enterprises. These low interest rate loans were granted to establish new enterprises or to enhance productivity or the level of operations, improve the quality of products offered, improvement of organisational capacity and product development by existing enterprises. Loans were granted under two main loan schemes, namely the "General Loan Scheme" and the "Technical Transfer Assistance Loan Scheme". In addition to the above organisations that implemented refinance and interest subsidy loan schemes and other related support services, several other governmental and non-governmental institutions too carried out operations with a view to enhance development finance and access to finance throughout the country. The efforts of those institutions lead to improvements in access to finance and financial inclusiveness in the country.

The Central Bank continued its drive towards the establishment of a National Financial Inclusion Strategy (NFIS) on the foundation laid down in the previous year. Accordingly, an agreement of Cooperation was signed with International Finance Corporation (IFC), a member of World Bank Group in January 2018 to acquire technical assistance to develop NFIS for Sri Lanka. Four potential policy pillars have been identified and four working groups/committees were formed on the areas of Digital Finance and Payments, MSME Finance, Consumer Protection and Financial Literacy & Capacity Building. Meanwhile, the RDD with the assistance of IFC initiated actions to conduct a Financial Inclusion Survey to understand the overview and general landscape for financial inclusion levels across the country, under the NFIS project. The financial inclusion survey was conducted island wide covering 480 Grama Niladari Divisions in all districts through a dedicated survey firm selected for this purpose. NFIS would serve to deepen and accelerate national efforts to reach higher levels of financial inclusion in the future.

The Central Bank continued to conduct awareness programmes and workshops to promote financial literacy, financial inclusiveness and entrepreneurship development among the different stakeholder groups and rural communities. During the year, the Central Bank conducted 154 programmes on financial literacy, entrepreneurship development and skills development with special focus on those who have no access to the formal financial sector. These programmes were attended by school leavers, government officials, farmers and new and existing entrepreneurs.

8.6 Financial Infrastructure

Payment and Settlement Systems

The Central Bank continued to ensure safe and efficient payment and settlement infrastructure in the country in order to cater to the payment needs of the individuals and institutions and to effectively facilitate the economic activities of the country. As the regulator of the national payment system, the Central Bank further broadened the regulatory and supervisory activities with the objective of ensuring

Table 8.25
Transactions through Payment Systems

Payment System	2017 (a) Volume ('000)	2017 (a) Value (Rs. bn)	2018 (b) Volume ('000)	2018 (b) Value (Rs. bn)
Large Value Payment Systems				
RTGS System	377	92,303	405	100,473
Retail Value Payment Systems				
Main Cheque Clearing System	51,963	10,482	50,352	10,528
Sri Lanka Inter-bank Payment System (SLIPS)	30,018	1,725	32,943	1,972
Credit Cards	36,964	199	43,600	242
Debit Cards	46,964	135	56,595	159
Internet Banking	23,066	2,101	26,979	2,933
Phone Banking	3,809	32	8,176	143
Postal Instruments	1,308	7	1,022	6
Total	194,469	106,983	220,072	116,457
US Dollar Cheque Clearing System	56	74	51	36

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

the stability and soundness of the financial system by effectively mitigating the risks associated with payment and settlement systems.

The LankaSettle System comprises of the Real Time Gross Settlement (RTGS) System, which is the only large-value electronic payment system in the country, and the LankaSecure System, which is the scripless government securities settlement system. During the year under review, RTGS System settled 405,200 transactions registering an increase of 7.39 per cent, while the aggregate value of RTGS transactions amounted to Rs. 100,473.1 billion recording an increase of 8.85 per cent when compared with the previous year. In value terms, the share of RTGS transactions in total non-cash payments accounted for 86.3 per cent in 2018. The Central Bank continued to provide the Intra-day Liquidity Facility (ILF) to the participating institutions of the RTGS System to minimise the liquidity risk of the system. The daily average value of the ILF utilised by the RTGS participants during the year amounted to Rs. 55 billion. At end 2018, the total value of scripless securities held in the LankaSecure amounted to Rs. 5,103 billion (Face Value) consisting of Treasury bills of Rs.758.8 billion and Treasury bonds of Rs 4,344.2 billion.

The Cheque Clearing System of the country operated by LankaClear (Pvt.) Ltd. (LCPL) functioned smoothly during the year under review. Aggregate volume of cheques cleared through the Cheque Clearing System accounted for 20.5 per cent of the total volume of non-cash payments of the country during 2018. When compared with 2017, the total volume of cheques cleared through the Cheque Clearing System recorded a negative growth of 3.10 per cent while the aggregate value of cheques cleared grew marginally by 0.44 per cent in 2018.

During 2018, the Sri Lanka Inter-bank Payment System (SLIPS) which mainly facilitates retail bulk payments such as salaries continued to operate smoothly. The operations of SLIPS recorded a growing trend with both the volume and value of payments processed through the system increasing over the previous year. The volume and value of the payments effected through SLIPS grew by 9.75 per cent to 33 million and by 14.33 per cent to Rs. 1,972 billion respectively.

The Common Card and Payment Switch (CCAPS) which functions under the brand name "LankaPay" recorded a noteworthy progress in 2018 with the increased transaction volumes in the three sub-switches launched so far, namely the Common ATM Switch (CAS), Common Electronic Fund Transfer Switch (CEFTS) and Shared ATM Switch (SAS). CAS, which connects ATMs of member financial institutions, enables customers of such financial institutions to perform cash withdrawals and balance inquiries from any ATM connected to the CAS network. In 2018, the transaction volume and value of CAS increased by 22.9 per cent to 40.5 million and 30.5 per cent to Rs. 344.6 billion respectively, in comparison to the previous year. At the end of the review period, the total number of financial institutions connected to

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BOX 11
Evolution of the National Payment System of Sri Lanka

Modernisation of the national payment system

Sri Lanka has been a forerunner in introducing electronic payment systems to its economy and remains comparable with many developed Asian and Western economies. The national payment system[1] has been designed with the flexibility to evolve and facilitate the dynamic payment needs of the economy. With the aim of gradually transitioning into a digitalised economy, the Central Bank of Sri Lanka (CBSL) began modernising the national payment system in 2002.

As an initial step of the modernisation programme, legislative changes were introduced recognising the importance of payment and settlement systems for a modern economy. Accordingly, the Monetary Law Act, No. 58 of 1949 (as amended) (MLA) was amended in 2002 establishing the intrinsic relationship between the monetary, financial and payment systems to achieve economic and price stability, and financial system stability. The CBSL was thereby made the authority responsible for the administration, regulation and supervision of payment systems in Sri Lanka and was given broad powers to fulfill this responsibility. Dedicated legislation was introduced by way of the Payment and Settlement Systems Act, No. 28 of 2005 (PSSA). The PSSA provided the framework for the regulation, supervision and monitoring of payment, clearing and settlement systems, money services, and to facilitate electronic presentment of cheques. Further, it enabled the development of new payment methods and technologies, and advancing cooperation among all participants in the evolution of payment systems. The PSSA provided the CBSL with powers to ensure that payment services operating in Sri Lanka were safe and sound. The legislative changes also enabled the CBSL to divest its payment and clearing activities to LankaClear (Pvt) Limited (LCPL), which is jointly owned by the CBSL and licensed commercial banks.

1 A "payment system" consists of a set of instruments, banking procedures and, typically, interbank funds transfer systems that ensure the circulation of money (Committee on Payment and Settlement Systems, 2003). Payment systems include i) payment instruments; ii) payment infrastructure (clearing and settlement mechanisms); iii) other ancillary services (market players and institutional structure); iv) oversight and supervisory arrangements; and v) the legal and regulatory framework (Jayamaha, 2014 p. 5).
The national payment system comprises both centralised systems that interlink stakeholders, such as the CBSL, licensed banks, non-bank financial institutions, card networks and mobile operators, as well as proprietary systems that are independently operated by stakeholders.

Major electronic payment, clearing and settlement systems in Sri Lanka

Settlement infrastructure

The Real Time Gross Settlement (RTGS) System, which is owned and operated by the CBSL, was introduced in 2003, for real-time settlement of large value fund transfers through the banking system on gross basis. Prior to the RTGS System, all interbank payments were settled on deferred-net settlement basis. Under the RTGS process, participants must maintain sufficient funds in their accounts with the CBSL to enable real-time settlement. As a measure of mitigating liquidity risk of the RTGS System, the CBSL provides the Intraday Liquidity Facility (ILF) to participants who experience liquidity issues during the day. The RTGS System is designated as a Systemically Important Payment System (SIPS). The growth of the economy has increased the demand for real-time settlement of large value fund transfers, making the RTGS System a vital payment infrastructure in Sri Lanka.

Major interbank payment and clearing systems

Sri Lanka's journey in electronic interbank systems began with the introduction of the Sri Lanka Interbank Payment System (SLIPS) in 1994, as an offline electronic fund transfer system. SLIPS automated periodic and bulk payments, such as salaries and utility bill payments, replacing the manual process of issuing cheques for payments. There are two main types of SLIPS payments – credit transfers and direct debit. SLIPS was upgraded to an online system in 2010, resulting in the settlement period being shortened to T+0 (same day but not real-time). SLIPS remained the only electronic interbank payment system in Sri Lanka, until the launch of the RTGS System in 2003.

The Cheque Imaging and Truncation System (CITS) was launched in 2006 and has also been designated as a SIPS. Sri Lanka is a relatively early adopter of a cheque imaging and truncation system, in comparison to leading economies.[2] This system reduced cheque realisation time from 5-7 days to next-day (T+1) realisation as cheques were cleared by LCPL using cheque images that were electronically transferred by banks.

2 Examples of economies that implemented cheque imaging and truncation systems: New Zealand – 1995; USA – 2004; India – 2008; UK- 2017 (Sources: respective Central Bank websites).

National Payment Switch

The launch of the Common Card and Payment Switch (CCAPS), in 2013, marked a key milestone in the evolution of Sri Lanka's electronic retail payment infrastructure. CCAPS is a multi-switch facility that comprises five sub switches, i.e., Common ATM Switch (CAS), Common Electronic Fund Transfer Switch (CEFTS), Shared ATM Switch (SAS), Common POS Switch (CPS) and Common Mobile Switch (CMobS). CCAPS has been designated as the "National Payment Switch" and is operated by LCPL under the brand name of 'LankaPay'. CCAPS is being launched in phases, of which three phases have already been completed.

CAS, which is the first phase of CCAPS, started live operations in July 2013. It integrated the country's ATM infrastructure enabling ATM cardholders to use any ATM machine in the LankaPay network. SAS allows banks and non-bank financial institutions (NBFIs) that are unable to invest in their own ATM switches or card management systems to link to the CAS switch at a low cost via LankaPay. SAS extends ATM facilities to customers of such financial institutions.

The introduction of CEFTS, in 2015, has revolutionised the retail payment system of Sri Lanka. CEFTS created immense opportunities for payment innovations as it facilitates interbank real-time fund transfers using Internet and mobile banking, ATM and over-the-counter channels. Its versatility has made CEFTS the basis for several payment infrastructure innovations in Sri Lanka.

The LankaPay Online Payment Platform (LPOPP), which was introduced in 2017, enabled online real-time payments to government institutions using CEFTS. LPOPP was introduced to streamline government revenue collection. Accordingly, Sri Lanka Customs was the first institution to utilise LPOPP for payments. Subsequently, approval was granted by the CBSL to integrate four more government institutions to LPOPP. As at 31 December 2018, eight licensed commercial banks have connected to LPOPP.

JustPay, which was launched in 2017, is a key infrastructure innovation that supports mobile based FinTech innovations, such as mobile applications, to securely link to banking networks. It facilitates low value payments directly from customer accounts using the CEFTS direct debit facility.

The regulatory framework required to implement the fourth phase of CCAPS, CPS, is in place to facilitate the switching and clearing of transactions under the National Card Scheme (NCS). CMobS will enable interoperability between e-money wallets and support wallet-to-wallet transfer.

Payment cards and e-money

Sri Lanka has several other retail payment methods, such as payment cards and e-money. These are proprietary systems that are regulated through the PSSA and other laws related to the banking industry to ensure their safety and soundness in order to achieve financial system stability. There are two mobile network operators that are licensed to provide e-money services in Sri Lanka.

LCPL, under the guidance and supervision of the CBSL, has entered into a strategic partnership with the international payment card network JCB (Japan Credit Bureau) to establish the NCS. The NCS will enable banks and financial institutions to issue LankaPay-JCB co-branded debit cards that will be processed locally through LankaPay's CAS and CPS networks, and internationally through the JCB network. The main objective of the NCS project is to reduce the cost of card transactions to all stakeholders, i.e., cardholders, merchants, issuers and acquirers, by domestically routing card payments.

QR Code based payments

Responding to the need for ubiquitous digital payment methods and real-time settlement of retail payments, the CBSL introduced the LANKAQR code standard in 2018. This standard is based on the "EMV QR Code Specification for Payment Systems", which facilitates the interoperability of different payment mechanisms and eliminates the need to have multiple QR codes. By adopting the LANKAQR code, financial institutions will be able to provide customers and merchants access to low-cost digital payments and to increase customer convenience.

Way forward

The CBSL has been promoting digital payment systems to meet the needs of a less-cash society and continuously works with the industry to create an environment that advances the use of new technologies. Accordingly, inter-industry collaborations to implement FinTech solutions such as the National Transit Card and Open Application Programming Interface (Open API) platforms are among new priorities undertaken. Further, the CBSL has begun working closely with relevant stakeholders to explore the feasibility of adopting Blockchain Technology in areas such as Know-Your-Customer (KYC) processes and trade finance to improve the safety and efficiency of financial services. In order to adopt virtual banking and e-KYC processes, CBSL is evaluating the possibility of integrating with the national e-NIC (Electronic National Identity Card) initiative of the Department for Registration of Persons. This will enable the introduction of many FinTech innovations that require digital means of identity verification as well as increase access to finance by reducing onboarding costs. While adopting new technologies, the CBSL is also highly aware of the risks of data sharing. Therefore, the CBSL has strengthened its regulatory framework to ensure the safety of customer funds and information. Further, the CBSL is collaborating with relevant national agencies to develop a strong legislative framework on Data Protection for Sri Lanka. With these proactive measures, it is expected that the national payment system of Sri Lanka will continue to cater to the evolving payment needs of a digitalised economy.

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the CAS network was recorded as 28. SAS, which was launched in 2015 to provide card management and ATM transaction routing services to financial institutions which do not have the capacity to operate their own card management system, had two members and continued its operations smoothly during the review period.

CEFTS, the second phase of CCAPS, was launched in 2015 to facilitate real time retail fund transfers among member institutions. In comparison to the previous year, the CEFTS transaction volume increased remarkably by 128.7 per cent to 7.2 million while the CEFTS transaction value grew by 141.2 per cent to Rs. 660.3 billion in 2018, recording a noteworthy progress in CEFTS transactions. Meanwhile, as per the approval granted by the Central Bank to facilitate online payments to governmental institutions, LCPL launched the LankaPay Online Payment Platform (LPOPP) initially to facilitate online real time payments to Sri Lanka Customs. At end of 2018, eight licensed commercial banks have joined LPOPP to provide real time payment facilities and during 2018 15,431 transactions with an aggregate value of Rs. 12 billion were processed through LPOPP. In 2018, the Central Bank granted approval to LCPL to connect with three other governmental institutions to provide online real time payment facilities.

In October 2018, the number of clearing cycles per business day for CAS and CEFTS were increased from two to four in order to enable faster clearing and settlement of CAS and CEFTS transactions. In addition, the Central Bank imposed the minimum liability limits in CAS and CEFTS for primary participants in order to ensure smooth operations of these systems.

With a view to reduce costs incurred by cardholders and merchants on domestic payment card transactions, the Central Bank granted approval for LCPL to implement a National Card Scheme (NCS). NCS was launched in 2018 with one licensed commercial bank starting to issue ATM cards under NCS. In order to facilitate routing of transactions carried out using a payment card issued under NCS, the Central Bank monitored the progress of licensed financial acquirers joining the Common Point-of-Sales Switch.

The Central Bank continued its regulatory and supervisory activities with regard to payment cards and mobile payment systems in terms of the provisions of the Payment Cards and Mobile Payment Systems Regulations No. 1 of 2013. Accordingly, two financial institutions which were licensed to function as issuers of debit cards were granted approval to function as issuers of credit cards while another financial institution was granted a licence to function as a financial acquirer of payment cards, in terms of the Regulations.

The Central Bank, continued its supervisory function and further strengthened the regulatory framework in order to minimise the risks in the national payment and settlement system. In 2018, the Central Bank continued supervisory activities to minimise the risks associated with payment cards and mobile payment systems. Accordingly, on-site and off-site supervision was carried out to ensure compliance with the regulations by Service Providers of Payment Cards and Mobile Payment Systems.

In addition, taking the payment system developments into consideration, the Central Bank broadened its regulatory framework in 2018 by issuing regulations on acquiring payment card based electronic commerce transactions through service providers and on payment related mobile applications. Considering the risk in the involvement of third party payment platform providers in e-commerce transactions, the Direction on Acquiring Payment Card based Electronic Commerce Transactions through Service Providers was issued on 18 January 2018 to stipulate conditions on acquiring payment card based transactions through payment platform providers. The Central Bank issued the Guidelines on Minimum Compliance Standard for Payment Related Mobile Applications in January 2018 to set minimum compliance standards for Mobile Applications used by Financial Institutions.

Having considered the global trend in adopting new technologies for the development of payment and settlement systems, the National Payments Council, the consultative committee on payment and settlement systems, appointed two committees to study developments in the financial technology (FinTech) sector and Blockchain technology. As per the recommendations made by the Fintech Committee, PSD issued the Payment and Settlement Systems Circular No. 06 of 2018 to establish the National Quick Response (QR) Code Standard for Local Payments. In addition, as per another recommendation made by the FinTech Committee, initiated actions to establish a FinTech Regulatory Sandbox to provide an environment that supports and promotes the financial technology innovations in the country while maintaining appropriate regulatory standards. The working committee appointed as per the recommendation of the Committee on Blockchain Technology to further study the adoption of blockchain technology in the financial sector is evaluating the feasibility of a shared KYC blockchain solution to be used in the banking sector.

The Central Bank plans to establish a state-of-the-art financial market infrastructure and the enabling legal and regulatory framework in Sri Lanka, based on international standards and best practices to address the inherent limitations of the existing trading and settlement systems for domestic financial market transactions. An Electronic Trading Platform (ETP), a Central Counterparty clearing and settlement system (CCP) and a Central Securities Depository (CSD) system to facilitate electronic trading and straight-through processing (STP) of transactions in the domestic financial market, with emphasis to government securities and foreign exchange transactions are proposed to be established under this system. In line with this proposal, new IT infrastructure on ETP and CCP are to be introduced to facilitate transparent and efficient primary and secondary market operations in government securities transactions, which is vital for the development of government securities market and modernization of the public debt management.

Anti-Money Laundering and Countering the Financing of Terrorism

Money laundering and Terrorist financing can influence the stability of the financial system. The Financial Intelligence Unit of Sri Lanka (FIU), established under the statutory provisions of the Financial Transactions Reporting Act, No. 6 of 2006 (FTRA) continued to strengthen the Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) regime of the country to preserve the stability of the financial system. During 2018, the FIU performed the role of receiving financial information relating to Money Laundering/Terrorist Financing (ML/TF) including Suspicious Transactions Reports (STRs), analyzing and disseminating analytic results to the law enforcement agencies, regulators and other relevant entities where necessary. Further during the year, the FIU with the coordination of other stakeholders actively engaged in working towards successful completion of the time bound action plan provided to Sri Lanka to address the strategic deficiencies identified in the AML/CFT activities by Financial Action Task Force (FATF). FATF is the global standard setter in AML/CFT activities.

During the year FIU received 1,022 STRs from reporting institutions, law enforcement agencies and general public and after analysis and assessment a total of 317 STRs was referred to the law enforcement and regulatory authorities for further investigations. Reporting institutions also continued to report Cash Transactions (CTRs) and Electronic Fund Transfers (EFTs -Inward and outwards) exceeding the threshold of Rs. 1.0 million or its equivalent in foreign currencies as per Section 6 of the FTRA. During the period, reporting institutions have reported 5.6 million CTRs and 6.3 mn EFTs respectively.

Compliance Monitoring and Legislative Developments

Compliance with the AML/CFT framework of the country is essential for the prevention of money laundering, terrorist financing and connected financial crimes which could threaten the stability of domestic as well as global economic and financial systems. During the year, 19 risk based onsite examinations were conducted to assess financial institutions' compliance with the FTRA and rules and regulations issued thereunder. Furthermore, during the year the FIU issued guidelines on Suspicious Transactions Reporting, Money Laundering and Terrorist Financing Risk Management and Identification of Beneficial Ownership for financial institutors to strengthen the AML/CTF supervision process and institutional compliance.

With the issuance of Designated Non-Finance Business (Customer Due Diligence) Rules, No. 1 of 2018 in January 2018 the FIU expanded its assessment of institutional compliance to the designated non-financial businesses and professions (DNFBPs). Accordingly, the FIU conducted 27 progress review visits to the DNFBPs which were recognised as high risk sectors for money laundering, to examine the effective implementation of the AML/CFT measures. During the year the FIU took measures to strengthen the institutional compliance of DNFBPs by issuing sector specific Guidelines on AML/CFT Compliance Obligations.

During the 2018 the FIU entered into two Memoranda of Understanding (MOUs) with the Insurance Regulatory Commission of Sri Lanka and the Securities and Exchange Commission of Sri Lanka which are regulatory and supervisory body of the Insurance Sector and Securities Sector respectively to establish

BOX 12

Anti-Money Laundering and Countering the Financing of Terrorism Obligations for Designated Non-Finance Businesses and Professions in Sri Lanka

Overview

Although globalisation, powered by advancement in technology, has accelerated economic growth and development of countries, it has introduced new dangers to the global economy. Money Laundering (ML) and Terrorist Financing (TF) have been identified as two such major dangers. If there is a healthy global financial system within which there are no loopholes to inject proceeds derived from illegal activities or to channel funds for terrorist activities, the benefits of globalisation can be assured and reaped at an optimal level. Money launderers and terrorist financiers exploit the weak and ineffective controls in some countries and enter and eventually damage the global financial system. Therefore, strong anti-money laundering and countering the financing of terrorism (AML/CFT) regimes at country level are required to protect the international financial system. With the understanding of this requirement, the Financial Action Task Force[1] has set global standards in preventing ML/TF. At the beginning, these standards were more focused on finance businesses such as banks, financial institutions, lending institutions and money and currency changing services as they are usually more attractive for ML/TF. However, the scope was gradually expanded to designated non-finance businesses and professions (DNFBPs)[2] with the recognition of their high potentiality of being used by money launderers and terrorist financiers. Records have shown that DNFBPs constitute an increasing ML/TF threat in the Sri Lankan context too.[3] Therefore, these global standards were introduced for Sri Lankan non-finance businesses and professions under the legal enactment of Financial Transactions Reporting Act, No. 6 of 2006 (FTRA).

Money Laundering and Terrorist Financing through DNFBPs

Money launderers and terrorist financiers always search for channels through which they can transfer criminal proceeds and terrorist funds to conceal their illicit origins. DNFBP sector has become attractive for money launderers and terrorist financiers mainly due to non-availability of proper controls, policies or procedures to mitigate such risks. In particularly, a majority of DNFBPs are unaware of AML/CFT requirements or do not willingly contribute to implement them. Also, it is very difficult to assess the ways and means being used for ML/TF since they are evolving with the advancement in technology, such as transferring funds using wire transfers and online payment facilities.

Conversion of illegal money into legal money can be done through DNFBPs in many ways. For example, real estate transactions can be misused for ML/TF purposes in various ways such as investing illegally earned money (e.g. drug proceeds) for buying properties and reselling them to further conceal the illegal origin of the money or to make complex the audit trails, purchasing properties for expansion of illegal or terrorist activities, making initial deposits for properties using illicit money and then requesting for a refund to a given bank account to enter the illicit funds to the formal financial system, etc. Further, money launderers and terrorist financiers prefer to invest in commodities such as gold, gems and jewellery due to possibility of investing a large amount of money in small items which can be carried easily between countries as personal belongings. Also, they may use gambling websites and virtual gaming sites to convert their ill-gotten money to legal money. Further, professionals like accountants, lawyers, notaries and company service providers can be used for money laundering and terrorist financing with or without their knowledge. Professional service providers are referred to as "Gate Keepers" in the money laundering context, as these professionals' goodwill is used by money launderers to hide themselves in the money laundering process.

Regulatory Framework and AML/CFT Legal Obligations for DNFBPs in Sri Lanka

Sri Lanka's AML/CFT framework consists of three pieces of legislation including FTRA and two other legal enactments namely Convention on the Suppression of Terrorist Financing Act, No. 25 of 2005 (CSTF) and Prevention of Money Laundering Act, No. 05 of 2006 (PMLA). The Financial Intelligence Unit of Sri Lanka (FIU-SL) is vested with the regulatory powers under the provisions of the FTRA to implement the AML/CFT legal requirements and such requirements are coordinated through the AML/CFT National Coordinating Committee (NCC), which is chaired by the Governor of the Central Bank.

In terms of the FTRA, person/s (natural/legal person including a body of persons) engaging in or carrying out any Finance Business and Designated Non-Finance Business are required to comply with the provisions of the Act. Among others, casinos, real estate agents, dealers in precious metals and precious stones, lawyers,

1 FATF is the inter-governmental body which was setup as the global policy setter against ML & TF in 1989. The global standards issued by the FATF are commonly called as 'Recommendations' for combatting of ML/TF and Proliferation of Weapons of Mass Destruction (PWMD) (www.fatf-gafi.org). At present, there are 40 such Recommendations against ML, TF and PWMD that every country should comply with.

2 DNFBPs include casinos, gambling houses or conducting of a lottery, real estate agents, dealers in precious metals and dealers in precious and semi-precious stones, lawyers, notaries, accountants and trusts or company service providers among others.

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notaries, accountants and trusts and company service providers, as defined in Section 33 of the FTRA are being given priority in applying AML/CFT obligations. Considering the FATF recommendations, the FIU-SL has issued rules and guidelines[4] for these DNFBPs under the FTRA. Accordingly, the following are the key AML/CFT obligations that should be complied by the DNFBPs in Sri Lanka.

Customer Due Diligence (CDD) and Record Keeping

As per FATF Recommendations, Customer Due Diligence measures should be applied as a preventive measure against ML/TF risks. This should be done at the time of establishing a business relationship, carrying out occasional transactions, any suspicion on ML/TF or any doubt on previously obtained identification data of a customer or a beneficial owner.[5]

Section 2 of the FTRA stipulates the requirement of identifying the customer. As per the CDD rule referred to above, minimum information such as full name, permanent address, occupation, official personal identification number, source of funds and purpose of transaction should be obtained and person's identity should be verified using a legally valid identification document such as National Identity Card, Passport or driving license. The customer should be then categorised according to the ML/TF risk levels. Further, DNFBPs are required to follow enhanced customer due diligence measures for both customers categorised as "high risk" and for business relationships or transactions where higher risks are involved (Eg. when a customer is a Politically Exposed Person (PEP), or having non-face-to-face business relationships with the customer). Also, CDD is required as specified by law when a customer is a legal person or a legal arrangement.

Apart from the above, it is required to maintain all necessary records on transactions for at least five years as per the FATF Recommendations. However, as required by Section 4 of the FTRA, the specified records should be retained for at least 6 years in a manner which allows data to be retrieved easily and quickly whenever required or requested by the FIU.

Suspicious Transactions Reporting

According to FATF Recommendations, if a DNFBP suspects or has reasonable grounds to suspect that funds are the proceeds of a criminal activity or are related to terrorist financing, it should be required by law, to report its suspicion to the FIU of the country.

4 Designated Non-Finance Business (Customer Due Diligence) Rules, No. 01 of 2018, Guidelines on Anti-Money laundering/Countering the Financing of Terrorism Compliance Obligations for Casinos & Gambling Houses, No.02 of 2018 and Guidelines on Anti-Money laundering/Countering the Financing of Terrorism Compliance Obligations for Dealers in Real Estate, Precious Metals, Precious & Semi-Precious Stones, No. 03 of 2018.

5 Beneficial owner means the ultimate natural person who benefits from the underlying transactions.

Accordingly, Section 7 of the FTRA requires to report suspicious transactions (STRs) immediately to the FIU-SL after forming a suspicion or receiving information related to ML/TF activities, but no later than two working days therefrom. An STR can be submitted by email or telephone and should be followed up in writing within twenty-four hours. Accordingly, the FIU has prescribed the "Suspicious Transactions (Format) Regulations of 2017, where the "Schedule V" of the regulation is for the DNFBPs to report STRs to the FIU. Further, the FIU has provided the DNFBPs with ML/TF suspicion indicators, which are called "Red flags".

Regulation and Supervision of DNFBPs

In line with FATF Recommendations, there should be a comprehensive regulatory and supervisory regime that ensures the effective implementation of the necessary AML/CFT measures in DNFBPs and they should be subject to effective systems for monitoring and ensuring compliance with AML/CFT requirements in a country.

Accordingly, the FIU-Sri Lanka works as the AML/CFT monitoring body for the DNFBPs of Sri Lanka and applies risk-based approach in monitoring relevant DNFBPs. DNFBPs are required to appoint a Compliance Officer (CO) to implement a risk-based compliance programme at institutional level. The required awareness, training and technical assistance are provided by the FIU. An offsite examination for each DNFBP is conducted against the collected information through the CO and followed by an onsite examination based on the risk categorisation of the offsite examination. Corrective action for non-compliance is initiated by the FIU as per the FTRA.

Other Relevant AML/CFT Measures for DNFBPs

In addition to the above, the DNFBPs are required to apply other AML/CFT measures, such as assessing the institution's ML/TF risk periodically, documenting and implementing AML/CFT policies and procedures, screening customers against the designated persons and entities by the United Nations Security Council Resolutions (UNSCRs), conducting AML/CFT training for all the relevant employees, screening employees before hiring and conducting an independent audit on institutional AML/CFT framework.

In introducing these measures for the DNFBP sector, the FIU-SL closely works with relevant regulators, licensing bodies, associations and other key institutions such as National Gem and Jewellery Authority, Sri Lanka Gem and Jewellers Association, Condominium Management Authority, Condominium Developers Association, Urban Development Authority, National Housing Development Authority, Ceylon Chamber of Commerce, Institute of Chartered Accountants of Sri lanka and Bar Association of Sri Lanka.

Cost of Non-Compliance with International Standards of AML/CFT

Money laundering and terrorist financing pose threats to the stability of the global financial system with their extended impact on economies. Some unfavourable consequences of ML/TF are inequalities in resource allocation, persuading young generation to make easy-money, jeopardising world peace, corrupting legal systems, irrational increases in property prices and damaging the reputation of the country by building up stigma as a high-risk country for financial frauds, etc. Hence, the economic and social cost of such crimes and the possibility of laundering the proceeds of crimes are tremendously high. Therefore, every country should adopt AML/CFT measures in order to ensure that there is deterrence at the country level to prevent integration of illegal or criminal proceeds with legitimate cash flows of the global financial system. AML/CFT compliance may enhance the reputation of a country among the international community while any failure will ultimately result in economic and political sanctions by the international community and international policymakers. Costs of addressing such deficiencies are also significant as procedures for rectifying them may be cumbersome. Sri Lanka is currently working with a high commitment in implementing international standards of AML/CFT. Therefore, the support of all stakeholders and the general public is required to uplift Sri Lanka's image as a country with zero tolerance towards ML/TF.

References

Bureau of International Narcotics and Law Enforcement Affairs (2004), Money Laundering and Terrorist Financing: A Global Threat, International Narcotics Control Strategy Report.

FATF (2012-2018), International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation, FATF, Paris, France.

a framework for sharing information on supervisory findings based on comprehensive risk-based supervision focused on AML/CFT in both sectors. Further, with a view to enhancing the FIU's analysis function, an MOU were signed with the Department of Motor Traffic.

Listing by Financial Action Task Force and Progress made towards Improving Sri Lanka's AML/CFT Compliance

AML/CFT compliance is regularly monitored by FATF through its regional bodies such as Asia Pacific Group on Money Laundering (APG), and mutual evaluations are conducted for the same. The 2nd Mutual Evaluation (ME) on Sri Lanka was conducted during 2014/15 by APG with the intention of assessing Sri Lanka's AML/CFT compliance on the international AML/CFT standards. The Mutual Evaluation Report (MER) adopted in July 2015 recommended a series of actions to be implemented by Sri Lanka under the APG's "expedite enhanced follow up" process. In October 2016, the FATF informed that Sri Lanka will be subject to a review of the International Cooperation Review Group (ICRG) of the FATF to assess the progress of AML/CFT effectiveness. After several discussions and progress reports, the FATF informed that Sri Lanka has not made sufficient progress in four areas, namely International Cooperation, Supervision, Legal Persons and Arrangements and Targeted Financial Sanctions on Proliferations (North Korea & Iran). As a result, the FATF at its Plenary held at Buenos Aires, Argentina in October 2017, listed Sri Lanka as a jurisdiction with strategic AML/CFT deficiencies in the FATF's Compliance Document which is more commonly identified as the "Grey List". Upon listing, a time bound action plan to address the strategic deficiencies identified was provided to Sri Lanka. Since the listing in November 2017, Sri Lankan authorities have taken effective and tangible steps to implement the FATF Action Plan including passing Trust Ordinance (Amendment) Act No. 6 of 2018, Mutual Assistance in Criminal Matters (Amendment) Act No. 24 of 2018, Issue of regulation/directives/guidelines on implementing United National Security Council Resolutions on North Korea and Iran, extending the AML/CFT coverage to DNFBPs by issuing Customer Due Diligence Rule, conducting risk based AML/CFT supervision of the financial and DNFBPs sector, taking enforcement actions on non-compliances observed and conducting island wide outreach for financial institutions and DNFBPs on AML/CFT obligations, identification of beneficial ownership information , implementation of targeted financial sanctions etc.

The FATF assessed Sri Lanka's progress in implementing the Action Plan through Asia Pacific Joint Group (AP/JG). Four progress reports were submitted and face-to-face discussions were held with the AP/JG on the progress made by Sri Lanka during January, May and September 2018 and January 2019 respectively. The AP/JG acknowledged that Sri Lanka has made significant progress and has largely addressed the action plan given by the FATF. Accordingly, it is expected that Sri Lanka will be able to exit the "Grey List" by mid-2019.

Legal Reforms related to the Financial Sector

With a view to strengthen and enhance the regulatory and supervisory powers vested on the Central Bank, several legal reforms including amendments to the existing laws and new enactments have been carried out during the year 2018. As such, amendments on the Monetary Law Act, No. 58 of 1949, Banking Act, No. 30 of 1988, Finance Business Act, No. 42 of 2011, Registered Stock and Securities Ordinance, No. 7 of 1937, and the Payment and Settlement Systems Act, No. 28 of 2005 have been initiated in 2018. Further, amendments have been proposed for the Debt Recovery (Special Provisions) Act, No. 2 of 1990 to enable all the specialised banks licensed under the Banking Act to benefit from the expeditious procedures for recovering debt, and thereby enhancing the efficiency of the recovery of loans. Furthermore, the Active Liability Management Act, No. 8 of 2018 to facilitate the legal framework for active management of the public debt was enacted during this year. Commencement of drafting of the "Sharing of Information among Financial Sector Regulators Bill" in collaboration with the Legal Draftsman's Department to facilitate joint efforts of financial sector regulators to peruse respective statutory objectives for a stable and robust financial system in the country, has been an important milestone that took place during this year.

Resolution and Enforcement Action on Weak Financial Institutions

The Monetary Board granted approval to cancel the licences issued to two distressed member institutions namely Central Investments and Finance PLC (CIFL) and the Standard Credit Finance Ltd (TSCFL) with effect from 05 March 2018 and 25 July 2018 respectively. Accordingly, compensation payments to the depositors of CIFL commenced from 27 August 2018 in accordance with the Sri Lanka Deposit Insurance Scheme Regulation and the total compensation payments made at 31 December 2018 amounted to Rs. 597.6 million.

The Sri Lanka Deposit Insurance and Liquidity Supports Scheme (SLDILSS) which is maintained as a resolution procedure for financial institutions licensed under the Central Bank, comprised of 75 member institutions with a total fund of approximately Rs. 53 billion (unaudited) at end 2018. Licensed banks which maintained a capital adequacy ratio of 14 per cent or above at the end of the immediately preceding financial year were required to pay a premium of 0.10 per cent per annum on the total amount of all eligible deposits and all other banks were charged a premium of 0.125 per cent per annum. The premium applicable for licensed finance companies was 0.15 per cent per annum. Premia and penalties from member institutions during the year amounted to Rs. 8.8 billion. With effect from 01 January 2018, the deposit insurance coverage per depositor per institution is Rs. 600,000.

In order to streamline the resolution and enforcement actions in accordance with the prevailing laws and regulations, a comprehensive Resolution Framework for the financial institutions licensed by the Central Bank would be developed.

Credit Information

The Credit Information Bureau continued to experience a considerable growth in demand for credit reports during the year 2018 with an increase of 9.2 per cent compared to previous year. During 2018 the CRIB issued a total of 9.9 million credit reports to the industry of which 96 per cent were consumer credit reports. Demand for reports on commercial loan facilities has also seen a 12 per cent increase compared to 2017.

Demand for self-inquiry credit reports (iReports) continued to increase further in 2018. The number of customers who requested their own credit reports from the bureau increased compared to the last year. The number of disputes raised against the information contained in iReports decreased on a year-on-year basis. The bureau initiated several measures to improve data submission standards and enhance the quality of data. The bureau database now receives monthly updates of more than 11 million credit facilities.

The Credit Information Management System (CRIMS), the ICT infrastructure and the bureau application system maintained by the CRIB was able to meet the growing demand for credit information services. However, the CRIB is in the process of revamping this infrastructure to reposition its business model to meet emerging market needs and future demand for credit information services with an enhanced capacity and agility. CRIB will be able to add more value to the data it collects in line with its new development road map, whilst delivering service and operational efficiency to all stakeholders. CRIB is currently devising a 5-year development road map along with the proposed system upgrade to cater to the present development needs of the bureau.

During 2018, security rights registration, an electronic register maintained by the Bureau continued its operations, recording a total of 13,713 transactions reported by member institutions, who are currently active in the system. Since its implementation, growth of the registry operations had been below expectations, due to legal constraints in the STR Act. However, the CRIB has actively engaged in the ongoing effort to strengthen the Secured Transactions legal framework with other stakeholders. During the year CRIB also spearheaded the task force on 'Getting Credit' formed by the Cabinet of Ministers, for the World Bank Doing Business Survey Project.

Table 8.26
Key Prudential Measures Recently taken by the Central Bank on Banks, LFCs and SLCs

Date	Prudential Measures
01 January 2015	Deposit insurance coverage per depositor per institution under the Sri Lanka Deposit Insurance and Liquidity Support Scheme (SLDILSS) was increased to Rs. 300,000 from Rs. 200,000.
31 March 2015	Directions were issued to licensed banks to implement the Liquidity Coverage Ratio under Basel III Liquidity Standards from 01 April 2015.
14 September 2015	Directions were issued to licensed banks, LFCs and SLCs to maintain a maximum LTV ratio of 70 per cent on loans and advances granted for the purpose of purchase or utilisation of motor vehicles with effect from 15 September 2015.
29 October 2015	Directions were issued to licensed banks, LFCs and SLCs informing that the applicability of the maximum LTV ratio of 70 per cent shall come into force with effect from 01 December 2015.
30 October 2015	A minimum cash margin requirement of 100 per cent on LCs opened with LCBs for the importation of motor vehicles was imposed until 01 December 2015.
18 January 2016	Directions were issued to strengthen and streamline the existing policies and practices in respect of the opening of new branches and automated teller machines, closure and relocation of branches and other outlets of LFCs and SLCs.
28 October 2016	The Direction on maximum interest rates on deposits and debt instruments that could be offered by LFCs was revised.
29 December 2016	Direction was issued requiring licensed banks to maintain the minimum capital ratios and buffers in respect of total risk weighted assets as per Basel III guidelines, commencing from 01 July 2017.
13 January 2017	Directions were issued to licensed banks informing the LTV for credit facilities granted by the licensed banks for the purpose of purchase or utilisation of vehicles commencing 16 January 2017.
13 January 2017	The Directions issued to LFCs and SLCs on LTV for credit facilities in respect of motor vehicles were revised in line with the Budget proposal for 2017.
23 February 2017	The Direction to increase the minimum core capital for LFCs up to Rs. 2.5 billion by the beginning of 2021 on a staggered basis was issued.
22 March 2017	A determination was issued to licensed banks amending the pawning conditions issued on 07 September 1998
26 October 2017	A Direction on enhancing the Minimum Capital Requirement of licensed banks was issued.
29 November 2017	Banking Act Directions on financial derivatives were issued to licensed banks to be effective from 01 January 2018
12 December 2017	Banking Act Directions were issued to licensed banks to inform a new policy on foreign currency borrowings to be effective from 01 January 2018.
05 January 2018	Deposit insurance coverage per depositor per institution under the Sri Lanka Deposit Insurance and Liquidity Support Scheme (SLDILSS) was increased to Rs. 600,000 from Rs. 300,000.
16 January 2018	A Direction on a customer protection framework was issued to LFCs and SLCs.
8 February 2018	Directions were issued to all licensed banks, LFCs and SLCs informing LTV ratio, ranging from 70 per cent to 90 per cent, applicable for credit facilities in respect of electric, hybrid and other unregistered vehicles and registered vehicles, which have been used in Sri Lanka for less than one year after the first registration, commencing 01 January 2018.
13 March 2018	Guidelines were issued to LFCs requiring to obtain a credit rating by 01 October 2018.
06 June 2018	A Direction was issued to impose a new capital adequacy framework which requires LFCs and SLCs to maintain capital adequacy ratio on a more risk sensitive focus covering credit and operational risks under the basic approach of the Basel accord.
21 August 2018	Directions on financial derivatives were issued to licensed banks to further strengthen the risk management of derivative transactions.
28 September 2018	Directions were issued to licensed banks to reduce the LTV ratio for unregistered or registered hybrid vehicles which have been used in Sri Lanka for less than one year, to 50 per cent.
01 October 2018	The LTV ratio for LFCs and SLCs was amended to reduce to 50 per cent for unregistered or registered hybrid vehicles which have been used in Sri Lanka for less than one year.
11 October 2018	A circular was issued to LCBs to impose a cash margin of 100% on Letter of Credits opened for importation of non-essential consumer goods with a view to curtail imports and adverse impact on the exchange rate.
21 November 2018	Directions on Net Stable Funding Ratio under Basel III liquidity standards were issued to licensed banks.
30 November 2018	Directions were issued to licensed banks on a new policy on foreign currency borrowings.
03 December 2018	A Direction on maximum rate of interest on microfinance loans was issued for LFCs and SLCs to protect customers from exorbitantly high interest rates.
28 December 2018	Directions on Leverage Ratio under Basel III were issued to licensed banks requiring the minimum leverage ratio of 3% commencing from 01 January 2019.
31 December 2018	A circular on guidelines on the adoption of Sri Lanka Accounting Standard – SLFRS 9: Financial Instruments was issued to licensed banks.