8

FINANCIAL SECTOR PERFORMANCE AND SYSTEM STABILITY

8.1 Overview

The financial system remained resilient without causing major macroprudential concerns, though the performance of the sector, in terms of expansion, credit quality and profitability was moderated during the year. The financial sector expansion and performance slowed down during the year 2019 compared to the previous year mainly due to subdued economic activities and the uncertainty caused by the Easter Sunday attacks and the political instability which prevailed during the year. Credit quality of the deposit-taking financial institutions as reflected by the Non-Performing Loans (NPL) ratio deteriorated in 2019. However, banks and other deposit-taking financial institutions, the major segment of the financial sector, exhibited resilience amidst a challenging business environment prevailed both global and domestic contexts, by maintaining capital and liquidity well above the regulatory minimum requirements. Timely and appropriate regulatory and supervisory measures assured the overall stability of the financial system without causing any major macroprudential concerns during the year.

In line with subdued economic activities of the country, the total assets of the banking sector recorded a lower growth in 2019 compared to 2018. The lower growth in banking sector assets was an outcome of low demand for loans and advances and tightened credit screening by banks due to increasing NPLs. Lower demand for credit resulted in more funds being moved towards risk-free investments such as Treasury bills and Treasury bonds. As a result, year-on-year growth in investments increased considerably. The increase in holdings of risk-free and highly liquid government securities resulted in improvements in the Risk Weighted Capital Adequacy Ratio (RWCAR) and Statutory Liquid Assets Ratio (SLAR) of the banking sector that facilitated to enhance the resilience of the banking sector with regard to unforeseen risks. Meanwhile, asset quality, as reflected by the NPL ratio, recorded its lowest level since 2014. Total borrowings of the banking sector, both in terms of the Sri Lankan rupee and foreign currency, decreased in 2019 compared to an increase recorded in 2018. Meanwhile, the profitability of the banking sector, as reflected by the Return on Assets (ROA) ratio and Return on Equity (ROE) ratio declined significantly during the year mainly due to the deterioration in assets quality, rise in operating costs and increase in taxes.

Table 8.1
Total Assets of the Financial System

Institution	2018 (a)		2019 (b)	
	Rs. bn	Share (%)	Rs. bn	Share (%)
Banking Sector	**13,711.4**	**72.3**	**14,442.1**	**71.6**
Central Bank	1,917.4	10.1	1,919.4	9.5
Licensed Commercial Banks (LCBs)	10,372.4	54.7	10,944.0	54.3
Licensed Specialised Banks (LSBs)	1,421.6	7.5	1,578.7	7.8
Other Deposit Taking Financial Institutions	**1,603.2**	**8.5**	**1,674.2**	**8.2**
Licensed Finance Companies (LFCs)	1,454.8	7.7	1,484.7	7.4
Co-operative Rural Banks (c)	147.7	0.8	161.7	0.8
Thrift and Credit Co-operative Societies	0.7	0.0	0.8	0.0
Specialised Financial Institutions	**241.1**	**1.3**	**282.6**	**1.4**
Specialised Leasing Companies (SLCs)	48.7	0.3	43.7	0.2
Primary Dealers (d)	83.6	0.4	77.5	0.4
Stock Brokers	8.7	0.0	9.7	0.0
Unit Trusts / Unit Trust Management Companies	67.0	0.4	113.8	0.6
Market Intermediaries (e)	16.4	0.1	18.4	0.1
Venture Capital Companies	16.8	0.1	19.5	0.1
Contractual Savings Institutions	**3,414.0**	**18.0**	**3,787.5**	**18.8**
Insurance Companies	606.6	3.2	691.0	3.4
Employees' Provident Fund	2,289.4	12.1	2,540.4	12.6
Employees' Trust Fund	310.8	1.6	343.3	1.7
Approved Pension and Provident Funds (f)	149.1	0.8	149.1	0.7
Public Service Provident Fund	57.2	0.3	63.7	0.3
Total	**18,968.8**	**100.0**	**20,159.4**	**100.0**

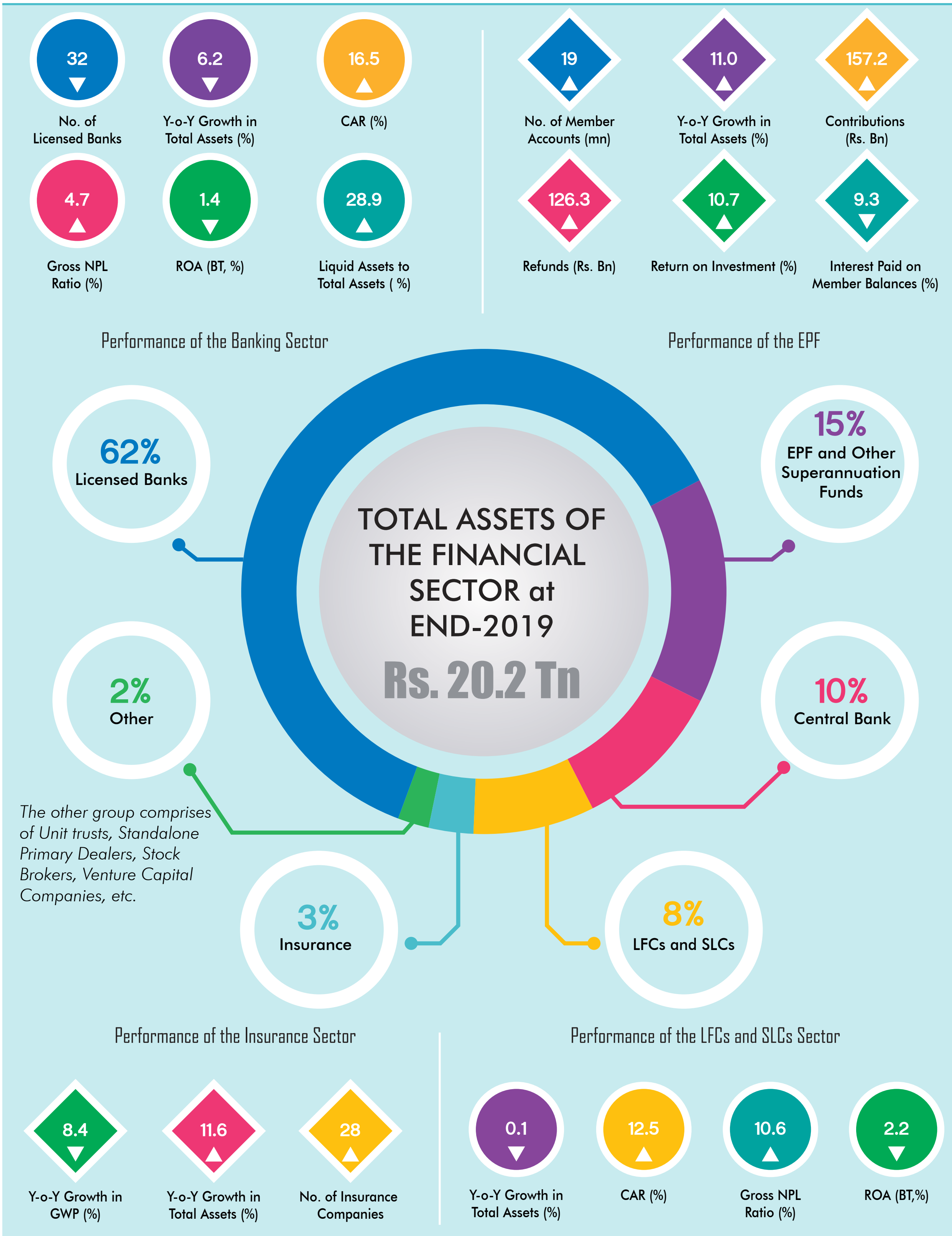
(a) Revised
(b) Provisional
(c) Due to unavailability of data, average growth for last four years was used to estimate the asset base of Co-operative Rural Banks for year 2019
(d) Excluding assets of Bank Primary Dealer units, which are included in assets of LCBs and assets of the Entrust Securities Ltd.
(e) Includes Investment Managers, Margin Providers, Underwriters and Credit Rating Agencies
(f) Due to unavailability of data the asset base of Approved Pension and Provident Funds for 2019 was taken as same as the previous year.

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

The year 2019 was challenging for the Licensed Finance Companies (LFCs) and Specialised Leasing Companies (SLCs) sector which showed only a marginal expansion in the asset base while performance of the sector deteriorated with negative credit growth, declining profitability and increase in NPLs. However, the sector as a whole, maintained capital and liquidity buffers well above the regulatory minimum levels. Meanwhile, the NPL ratio increased significantly at the end of 2019, on a year-on-year basis, showing signs of deterioration in the asset quality of the sector. This was mainly due to slowdown in the economic activities, loss of investor confidence and declined lending activities of the sector. The NPL ratio is expected to rise further with the implementation of Sri Lanka Financial Reporting Standard (SLFRS) 9. The profitability of the sector declined significantly during the year 2019 compared to 2018, mainly due to increased non-interest expenses and higher loan loss provisions against the increasing NPLs. In order to address the issues faced by a few LFCs in the sector, the Central Bank continued to take prudential measures to maintain the stability of the sector with much consideration given to reviving business operations of the companies with supervisory concerns. The insurance sector performed moderately during the year 2019, recording a growth in its assets base. Contractual savings institutions dominated by the Employees' Provident Fund (EPF) and the Employees' Trust Fund (ETF) also recorded a moderate growth providing reasonable returns, in terms of real rate of return for their members.

Domestic money market experienced a mixed performance in terms of market liquidity where a liquidity shortage prevailed until mid-April 2019 and subsequently turned into a surplus level, except for a limited period in the months of August and September, during the year 2019. Downward revision of the Statutory Reserve Ratio (SRR) and conversion of International Sovereign Bond (ISB) proceeds mainly contributed to turn the market liquidity level from a shortfall into a surplus. In the domestic foreign exchange market, the Sri Lankan rupee continued to show an appreciating trend against the US dollar throughout the year and recorded an appreciation at the end of 2019 on a year-on-year basis. The ISB issuance in June 2019, receipt of the sixth and seventh tranches of the Extended Fund Facility (EFF) from the

Figure 8.1
Performance of the Financial Sector



International Monetary Fund (IMF), and significant contraction in the trade deficit supported to uphold the value of the Sri Lankan rupee against the US dollar during the period. The Colombo Stock Exchange showed mixed developments during 2019 amidst adverse developments in domestic and global environments. The market recorded improvements in terms of All Share Price Index (ASPI), market capitalisation, Price Earnings Ratio (PER) and market capitalisation as a percentage of GDP in 2019 while S&P SL 20 index declined during the year and foreign outflow from CSE continued during 2019 albeit at a lower rate than 2018.

Recognising the actions taken by Sri Lanka to strengthen the Anti-Money Laundering (AML) and Countering the Financing of Terrorism (CFT) framework of the country, Financial Actions Task Force (FATF) delisted Sri Lanka from the Grey List in October 2019 which will have a positive impact on the financial sector and the economy of Sri Lanka. Meanwhile, 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, operations of the banking and LFCs & SLCs sectors will be challenging in terms of risk management. The increasing trend of NPL ratio and bearing additional provisions for new NPLs have already become challenging to the banking and LFCs & SLCs sectors. End of the moratoria, which were granted to the tourism and Small and Medium Enterprises (SMEs) sectors in 2019, will upwardly push the NPL ratio and provision requirements of the banking and LFCs & SLCs sectors. Further, adverse economic impacts of the COVID-19 pandemic would reflect in the financial sector, during the year 2020. Both banking and LFCs & SLCs sectors are under immense pressure to provide more relief to adversely affected economic sectors due to this pandemic as there is limited fiscal space available to provide such relief to the affected stakeholders of the economy. Therefore, maintaining the stability of the financial sector will be a challenging task in the medium term.

8.2 Performance of the Banking Sector

The banking sector continued to expand at a slower pace during the year compared to the previous year, while exhibiting resilience amidst a challenging business environment. The banking sector dominated the financial sector accounting for 62.1 per cent of total assets in the financial system at end 2019. Credit growth of the banking sector, which moderated during the first half of the year largely due to the lack of demand for credit, displayed signs of recovery towards the second half of 2019. Deposits continued to be the dominant source of financing for the sector, while a decline in borrowings was observed during the year. The banking sector profitability declined compared to the previous year due to deteriorating asset quality, rise in operating costs and increase in taxes. However, the banking system maintained capital and liquidity well above the regulatory minimum requirements, demonstrating the resilience of the sector.

Business Expansion

(a) Outreach: By end-2019, the banking sector comprised 32 banks i.e. 26 Licensed Commercial Banks (LCBs), and 6 Licensed Specialised Banks (LSBs). The 26 LCBs include 13 branches of foreign banks. Out of these, 2 branches of foreign banks had commenced closing procedures based on decisions taken by their head offices. Further, Lankaputhra Development Bank Limited was merged with Pradeshiya Sanwardana

Bank, while Sri Lanka Savings Bank Limited was acquired as a subsidiary by the National Savings Bank during the year.

The banking sector continued to support the financial intermediation of the economy by enhancing banking services and expanding the banking network, thereby promoting financial inclusion. In 2019, several banks introduced technology based products/services to facilitate financial inclusion. Further, 42 bank branches and 564 ATMs were established during 2019, while 11 bank branches and 13 ATMs were closed. Accordingly, the total number of banking outlets and ATMs had increased to 7,387 and 5,571, respectively, by end-2019.

(b) Assets: The asset base of the banking sector increased by Rs. 728.7 billion or 6.2 per cent during the year and surpassed Rs. 12.5 trillion by end-2019, whereas the growth rate recorded in 2018 was 14.6 per cent.

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

Category	End 2018 (a)	End 2019 (b)
Licensed Commercial Banks (LCBs)		
I. Total No. of LCBs	26	26
Domestic banks	13	13
Foreign banks	13	13
II.Total No. of LCB Banking Outlets	6,186	6,690
Branches (c)	2,877	2,907
Domestic Banks	2,826	2,857
Foreign Banks	51	50
Student Savings Units	3,309	3,783
III. Automated Teller Machines	4,644	5,158
Licensed Specialised Banks (LSBs)		
I. Total No. of LSBs	7	6
National Level Savings Banks	1	1
Housing Finance Institutions	2	2
Other LSBs	4	3
II. Total No. of LSB Banking Outlets	696	697
Branches (c)	696	697
National Level Savings Banks	261	262
Housing Finance Institutions	64	64
Other LSBs	371	371
III.Automated Teller Machines	376	413
Total No. of Bank Branches and Other Outlets	6,882	7,387
Total No. of Automated Teller Machines (ATMs)	5,020	5,571

(a) Revised
(b) Provisional
(c) All Banking Outlets excluding Student Savings Units.

Source: Central Bank of Sri Lanka

The challenging business environment resulting from the Easter Sunday attacks in April 2019 and political uncertainties that prevailed in the year 2019 led to a lower demand for credit resulting in a lower credit growth which contributed to the decline in assets growth. Growth in loans decreased significantly from 19.6 per cent in 2018 to 5.6 per cent during the year 2019. Of this 5.6 per cent loan growth, 77.0 per cent could be attributed to the increase in rupee loans. Increase in lending was largely diversified across major sectors of the economy. In terms of products, rescheduled loans (102.2 per cent), pawning (17.0 per cent) and credit cards (15.3 per cent) were the main products which reported a higher growth during 2019. Meanwhile, term loans, despite being the product with the highest increase in terms of value (Rs. 221.6 billion) during the year, recorded only a 5.0 per cent growth due to the high base effect. Lower demand for credit than other years resulted in more funds of banks to be directed towards investments. As a result, year-on-year growth in investments increased considerably from 4.6 per cent as at end-2018 to 12.2 per cent as at end-2019. The held-to-maturity portfolio grew by 18.1 per cent during 2019 with increases in Treasury bills, Treasury bonds and Sri Lanka Development Bonds (SLDBs) by Rs. 122.1 billion, Rs. 143.9 billion and Rs. 114.6 billion, respectively. However, investments in the trading portfolio contracted by 7.3 per cent during 2019 with investments in SLDBs decreasing by Rs. 116.0 billion, offsetting the increase in investments in Treasury bills and Treasury bonds of Rs. 52.3 billion and Rs. 22.5 billion, respectively.

(c) Liabilities: Deposits continued to be the main source of funding representing 73.2 per cent of total liabilities of the banking sector as at end 2019, while borrowings accounted for 13.4 per cent. The year-on-year increase in the deposit base in 2019 was lower than 2018. The

BOX 11
Aligning Regulations with Business Models of Licensed Banks: Proportionality

Importance of acknowledging the differences in banking business models in formulating regulatory policy

Regulators of the financial sector around the world began to shift towards increasingly complex and stringent regulatory frameworks in the aftermath of the global financial crisis that occurred in 2007/08. In light of this, the Basel III regulatory standards were introduced by the Basel Committee for Banking Supervision (BCBS) to mitigate risks of large and internationally active banks including the Globally Systemically Important Banks (G-SIBs). However, many jurisdictions opted to apply the Basel standards to a wider set of banks as the complex nature and resource intensiveness of the Basel III standards provoked the debate of optimising regulations to cater to the non-GSIBs, particularly smaller and non-complex banks (Restoy, 2019). Therefore, the concept of proportionality in banking regulations gained increasing attention at regional as well as global levels in view of introducing simpler regulations for small and non-complex financial institutions.

Introducing Proportionality

Proportionality is one of the key concepts in common law, used to convey the idea that the level of rules and laws are scaled to be in line with the expected outcome of their interventions. In simpler terms, proportionality implies that higher the risk, higher the rules and vice versa. This proposition, in the context of financial regulations, can be interpreted as scaling regulatory requirements applicable for financial institutions based on the risks posed by them on the financial system. Therefore, institutions with high importance and high systemic risk will be subject to stringent laws and regulations, while small scale and relatively simpler financial institutions will not be burdened by a high level of regulatory requirements.

Objectives of the financial sector regulators are typically associated with safeguarding financial system stability, upholding market integrity, consumer protection and promoting financial inclusion. In this regard, introducing proportionality can bring a level playing field to the market participants by implementing rules and regulations equitably without curbing market developments, healthy level of competition or limiting the diversity of market participants. This also paves the way to introduce a differentiated regulatory regime to acknowledge and facilitate financial institutions with different business models and different orientations such as development banking, payment or digital banking or rural banking that promote financial inclusion.

The application of proportionality in financial regulations is different from applying the same for financial sector supervision. The latter is widely known as risk-based supervision, which is aimed at optimising resource allocation by the regulatory authorities giving regard to the risk profiles of the financial institutions they oversee. However, proportionality in financial regulations aims at optimising the regulatory cost for financial institutions. Despite the differences in application, the end result of incorporating proportionality in both regulatory and supervisory functions complement the objective of maintaining financial system stability in a resource efficient manner (Restoy, 2018).

The rationale for aligning regulations with the business models of banks originates from the argument that the regulations should recognise the wider role of banking institutions beyond mobilising funds. Especially in developing countries, banking institutions are bestowed with the task of promoting financial inclusion, facilitating access to credit and other development related goals where other alternative channels do not have a strong presence. For instance, small banks and regional level banks predominately play the role of a development agent assisting households, small firms and rural communities. Further, in emerging markets, frugal innovations such as payment banks have the potential to promote the convenience of internet banking and cashless payments to masses. Imposing blanket regulations on the banking sector, without due consideration of respective business models of banks makes such different roles played by banks of different scales prohibitively expensive.

Moreover, excessively high regulations for small banks without a proper justification will harm the competitiveness and undermine the level playing of business. This may not be in the best interest of customers. Also, a "disproportionate" regulatory regime would force small banks to merge or consolidate to meet high regulatory requirements. Such concentrations and 'un-diversification' may not be healthy for financial system stability.

Therefore, a differentiated regulatory regime based on proportionality will be in the best interest of all participants concerned: regulators, banks and customers. Jurisdictions around the world ranging from the European Union, Hong Kong, Japan, Switzerland and the USA have incorporated elements of proportionality in setting and implementing banking regulations.

Global examples of incorporating proportionality in banking regulations

Although there are different approaches adopted by regulators worldwide to incorporate proportionality in regulations, two distinct models can be identified as the basis for implementing proportionality: (a) the categorisation approach for proportionality (CAP) and (b) the specific standard approach for proportionality (SSAP) (Carvalho, et al., 2017). In jurisdictions where CAP is implemented, regulators categorise banks according to different qualitative and quantitative characteristics to apply specific regulatory regimes for each category of banks. In jurisdictions where SSAP is implemented, regulators establish a tailored criterion for the application of specific requirements for a subset of prudential requirements such as disclosures, liquidity ratios, large exposure limits and market risks. Despite the different criteria being used to categorise banks under the two methods, the size remains a common factor.

Both approaches have their own strengths. For instance, CAP establishes consistent prudential rules for banks sharing similar characteristics in a particular jurisdiction. This allows the regulators to link regulatory frameworks with supervisory approach and resolution strategies for the same group of banks allowing a consistent application of policy frameworks for each group of banks. On the other hand, SSAP formulates a more granular tailoring of regulatory requirements to the specific characteristics of each bank by taking its business and overall risk profile into account. Therefore, SSAP permits the adoption of regulations on specific areas precisely considering its relevance for banks' business activities and risk profile. Doing so, SSAP permits reducing regulatory burdens without unduly weakening the prudential standards.

Jurisdictions such as Brazil, Japan and Switzerland are classic examples of CAP-based differentiated regulatory regimes. Brazil has divided its financial system into five categories considering the size, cross-border activities and risk profiles. Switzerland also follows a five-category classification considering total assets, assets under management, deposits insured under a deposit insurance scheme and required capital. Japan follows a two-fold classification of internationally active institutions to follow full Basel standards and non-internationally active banks to follow domestic regulations.

Jurisdictions such as the EU, where SSAP is adopted, have implemented exemptions or simplification of regulations for market risk and disclosure requirements proportionally. Similarly, the USA targets areas such as liquidity requirements, market risk and stress testing for proportionate application of regulations. Hong Kong provides exceptions in areas such as credit risk, liquidity requirements and large exposures. However, in practice, approaches followed in most other jurisdictions may use a combination of CAP and SSAP.

Applicability of proportionality in banking regulations in Sri Lanka

Sri Lanka is in the process of evaluating the possibility of incorporating proportionality in banking regulations using the elements of both CAP and SSAP. The Central Bank recently introduced a framework to deal with the Domestic Systemically Important Banks (D-SIBs) in line with the international timeline. Such banks were required to meet higher capital adequacy requirements, supervisory expectations in terms of tightened risk management functions, risk governance and internal controls. Also, with this methodical identification of the D-SIBs, licensed banks are segmented into two broad categories, namely, D-SIBs and non D-SIBs. Intense supervision and comprehensive regulations are applied for D-SIBs, while modified approaches are to be introduced for non D-SIBs based on proportionality.

Going forward, the regulatory process in Sri Lanka will be largely shaped by the elements of proportionality. In view of this, the upcoming Banking Act will include provisions allowing the Central Bank of Sri Lanka to implement a differentiated regulatory framework. The areas of focus for differentiated or proportionate regulations will be in terms of capital and liquidity requirements, large exposures, market risk, capital planning and supervisory review, disclosure requirements and implementing recovery and resolution planning. Complementing the shift in the regulatory process towards proportionality, licensed banks will also be strengthened and scrutinised through risk-based supervision.

Challenges and the way forward

The main challenge in implementing proportionality in the Sri Lankan context will be to strike a balance between bringing down the regulatory burden for banks, while keeping the prudential regulatory oversight intact. Therefore, reduced or relaxed regulatory requirements can only be accommodated in the areas where such simplified regulations are sufficient to ensure liquidity, solvency and long-term sustainability of the banks under consideration. In this regard, the possibility of off-setting regulatory relief with improved capital buffers (and vice versa) remains to be explored. Further, licensed banks will also have a moral obligation towards utilising the cost savings or unencumbered capital realised through relaxed regulation for the benefit of a wider range of stakeholders of the economy. As the regulator, the Central Bank will be vigilant to prevent any room for abusing the proportionality regime or it being used as a deterrent for market-led, efficiency driven consolidation of small banks and for local banks to grow and explore cross-border opportunities in the region.

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2. Restoy, F., (2018) *Proportionality in banking regulation*. London, Bank for International Settlements.
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Table 8.3
Composition of Assets and Liabilities of the Banking Sector

Item	2018 (a)		2019 (b)		Change (%)	
	Rs. bn	Share (%)	Rs. bn	Share (%)	2018 (a)	2019 (b)
Assets						
Loans and Advances	7,693.4	65.2	8,122.4	64.9	19.6	5.6
Investments	2,671.6	22.7	2,996.7	23.9	4.6	12.2
Other (c)	1,429.0	12.1	1,403.6	11.2	9.3	-1.8
Liabilities						
Deposits	8,492.4	72.0	9,162.3	73.2	14.8	7.9
Borrowings	1,763.4	15.0	1,679.4	13.4	9.7	-4.8
Capital Funds	1,030.4	8.7	1,129.9	9.0	18.9	9.7
Other	507.8	4.3	551.1	4.4	21.0	8.5
Total Assets/ Liabilities	11,794.0	100.0	12,522.7	100.0	14.6	6.2

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

Source: Central Bank of Sri Lanka

Table 8.4
Composition of Deposits of the Banking Sector

Item	2018(a)		2019(b)		Change (%)	
	Rs.bn	Share (%)	Rs.bn	Share (%)	2018 (a)	2019 (b)
Demand Deposits	544.0	6.4	528.8	5.8	9.7	-2.8
Savings Deposits	2,170.8	25.6	2,344.1	25.6	6.8	8.0
Time Deposits	5,564.9	65.5	6,092.5	66.5	18.3	9.5
Other Deposits	212.7	2.5	196.9	2.1	27.9	-7.5
Total Deposits	**8,492.4**	**100.0**	**9,162.3**	**100.0**	**14.8**	**7.9**

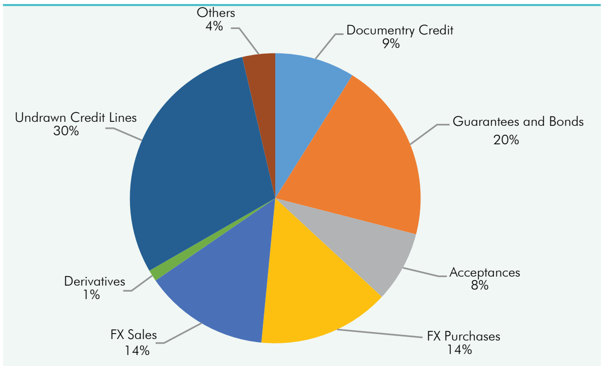
(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

deposit base increased by Rs. 669.8 billion in 2019 reaching Rs. 9.2 trillion as at end-2019 compared with the increase of Rs. 1.1 trillion in 2018. The growth rate in deposits declined to 7.9 per cent as at end-2019 from 14.8 per cent as at end-2018. Term deposits continued to be the most attractive deposit product accounting for 78.8 per cent of the increase in deposits during the year, and increased its share in total deposits from 65.5 per cent as at end-2018, to 66.5 per cent as at end-2019. Meanwhile, savings and current account deposits accounted for 25.6 per cent and 5.8 per cent, respectively, of total deposits at end-2019. Accordingly, the Current and Savings Account (CASA) ratio decreased from 32.0 per cent to 31.4 per cent over the corresponding period. Total borrowings of the banking sector decreased by Rs. 84.0 billion (contraction of 4.8 per cent) in 2019 compared to the increase of Rs. 156.3 billion (9.7 per cent) in 2018. This decrease was mainly due to the decrease in Sri Lanka rupee borrowings which reported a negative growth of 6.3 per cent (Rs. 47.0 billion) in 2019 and accounted for 56.0 per cent of the total decrease in borrowings. Meanwhile, foreign currency borrowings decreased by 3.0 per cent (US dollars 169.3 million) during 2019.

(d) Off-balance sheet exposures: A decrease in off-balance sheet exposures was reported in 2019 compared to 2018, reflecting the slowdown in business activities that took place during the year. The negative growth in off-balance sheet exposures in 2019 was 5.3 per cent (Rs. 233.5 billion), compared to the growth of 14.7 per cent (Rs. 569.4 billion) in 2018. Undrawn credit lines accounted for the largest share of off-balance sheet exposures with a share of 29.7 per cent as at end-2019. Foreign currency exposures accounted for 28.5 per cent of the total off-balance sheet exposures and were mainly attributed to unsettled foreign currency purchases (14.6 per cent) and foreign currency sales (13.9 per cent). Guarantees & bonds (Rs. 20.0 billion), undrawn credit lines (Rs. 16.2 billion) and documentary credit (Rs. 12.3 billion) reported an increase, while foreign currency exposures reported a significant decrease of 16.8 per cent (Rs. 242.0 billion).

Figure 8.2
Off-Balance Sheet Exposures of the Banking Sector (as at end 2019)



Source: Central Bank of Sri Lanka

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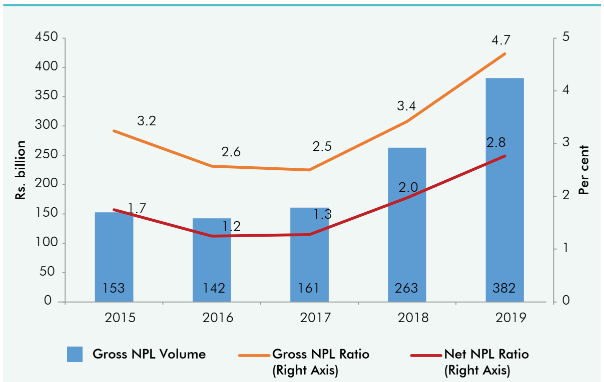
Risks in the Banking Sector

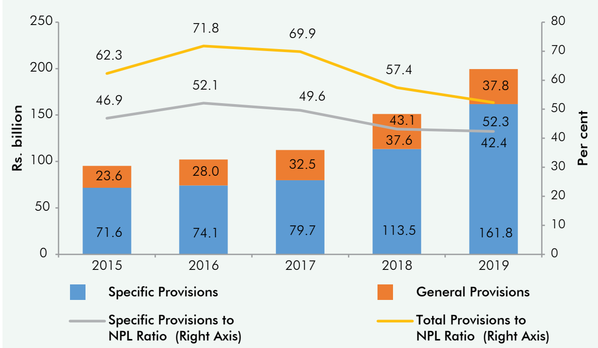
(a) Credit Risk: Quality of credit of the banking sector deteriorated further during 2019 with NPLs ratio increasing from 3.4 per cent at the end of 2018 to 4.7 per cent at the end of 2019 mainly due to the adverse business conditions which prevailed during the year. Accordingly, total NPLs of the sector increased by Rs. 118.5 billion in 2019 compared to the increase of Rs. 102.5 billion in 2018. Total loan loss provisions increased by Rs. 48.5 billion during 2019, of which specific provisions accounted for 99.6 per cent. However, higher increase in NPLs resulted in a decline in specific and total provisions coverage ratios from 43.1 per cent and 57.4 per cent, respectively, as at end-2018 to 42.4 per cent and 52.3 per cent, respectively, as at end-2019. Although individual banks had diversified their businesses among various sectors in the economy, 75.7 per cent of banking sector credit was mainly concentrated in 6 economic sectors, namely, consumption (18.4 per cent), construction (15.6 per cent), wholesale & retail trade (14.2 per cent), manufacturing (10.6 per cent), infrastructure development (8.8 per cent) and agriculture, forestry & fishing (8.1 per cent). Agriculture, forestry & fishing (8.1 per cent), manufacturing (7.3 per cent), tourism (6.4 per cent), wholesale & retail trade (6.3 per cent) and construction (5.8 per cent) sectors reported NPLs higher than the total banking sector average at

Figure 8.3
Non-Performing Loans of the Banking Sector



Source: Central Bank of Sri Lanka

Figure 8.4
Provisioning for NPLs of the Banking Sector



Source: Central Bank of Sri Lanka

end-2019. Despite the increase in NPL ratios during 2019, it was still at a manageable level as the banking sector operated with sufficient provisions and capital buffers to absorb adverse impacts of rising NPLs.

(b) Market Risk:

The exposure of the banking sector to market risk was minimal due to the limited exposure to the equity market and lower net exposures to interest rate and exchange rate movements.

Interest Rates: The interest rate sensitivity ratio (interest bearing assets as a share of interest bearing liabilities with maturities less than 12 months) marginally decreased to 76.5 per cent by the end of 2019 from 77.5 per cent as at end-2018. Capital gains on Treasury bonds reported during 2019 were Rs. 3.4 billion and were higher than the Rs. 1.9 billion reported during 2018. This was due to more funds being directed to government securities during 2019 compared to 2018, the lack of demand for loans, and the downward movement of interest rates.

Equity Prices: Equity risk of the banking sector was minimal due to low exposure to equity markets. Exposure of banks' trading portfolio to the equity market was Rs. 15.8 billion in 2019, which was only 0.1 per cent of total assets and 2.7 per cent of investments held for trading.

Table 8.5
Sectorwise Composition of Loans and Advances of the Banking Industry (at end 2019)

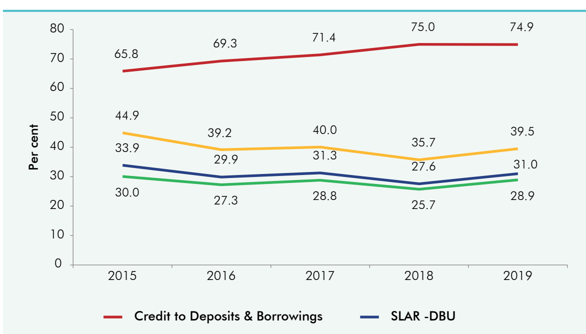
Sectors	Amount Rs. bn (a)	Share of Total Loans %	NPA Ratio %
Consumption	1,492.8	18.4	3.6
Construction	1,267.2	15.6	5.8
Wholesale & retail trade	1,154.8	14.2	6.3
Manufacturing	863.9	10.6	7.3
Infrastructure development	712.8	8.8	2.5
Agriculture, forestry & fishing	655.2	8.1	8.1
Financial services	427.5	5.3	1.0
Lending to overseas entites	334.8	4.1	1.6
Tourism	304.6	3.7	6.4
Health care, social services & support services	295.2	3.6	2.3
Lending to ministry of finance	205.7	2.5	-
Transportation & storage	199.9	2.5	3.4
Information technology and communication services	69.6	0.9	3.9
Professional, scientific & technical activities	66.2	0.8	2.2
Education	62.0	0.8	1.9
Arts, entertainment & recreation	10.3	0.1	6.8
Total Loans	**8,122.4**	**100.0**	**4.7**

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

Exchange Rates: The net foreign currency exposure of the banking sector recorded an increase between end-2018 and end-2019, due to a higher decrease in foreign currency liabilities that offset the decrease in foreign currency assets. Foreign currency assets comprise on-balance sheet and off-balance sheet foreign currency assets, while foreign currency liabilities also comprise on and off balance sheet liabilities. During 2019, on-balance sheet foreign currency assets increased mainly due to the increase in placements with banks and investments. This increase was offset by the decrease in off-balance sheet foreign currency assets such as forward purchases and other derivative products, resulting in the decline in total foreign currency assets. Meanwhile, a marginal increase in on-balance sheet foreign currency liabilities resulting from increased customer deposits, and a decline in foreign currency borrowings due to settlements was observed during 2019. However, off-balance sheet foreign currency liabilities declined due to a decrease in forward sales. This off-set the increase in on-balance sheet foreign currency liabilities and resulted in the decline in total foreign currency liabilities. The net foreign currency exposure as a percentage of banking sector on-balance sheet foreign currency assets stood at 1.1 per cent as at end-2019, which had marginally increased from the 0.8 per cent recorded at end-2018. The banking sector reported a long foreign currency position of Rs. 16.4 billion as at end-2019 in comparison to the long position of Rs. 11.7 billion as at end-2018. The net foreign currency revaluation gain was Rs. 14.2 billion during 2019, compared to Rs. 31.8 billion reported during 2018, due to the relatively lower exchange rate movements in 2019 compared to 2018.

(c) Liquidity Risk: With more funds being directed to liquid assets such as risk-free government securities during 2019, the banking sector operated with a much higher level of liquidity. The Domestic Banking Units (DBUs) of LCBs and LSBs are required to maintain a minimum SLAR of 20.0 per cent in Sri Lanka rupees while Offshore Banking Units (OBUs) are required to maintain a minimum SLAR of 20.0 per cent in US dollars. SLAR is calculated as the ratio between approved liquid assets and the total of

Figure 8.5
Liquidity Ratios of the Banking Sector

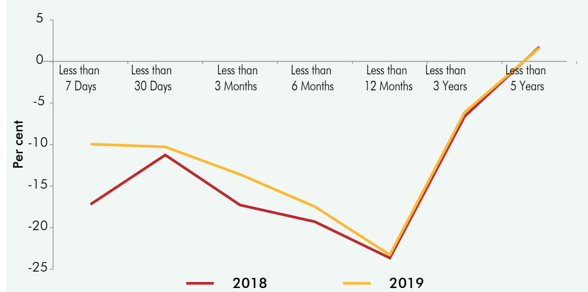


Source: Central Bank of Sri Lanka

deposits and borrowings for LCBs and the ratio between approved liquid assets and deposits for LSBs. The SLAR of DBU increased from 27.6 per cent as at end-2018 to 31.0 per cent as at end-2019, while the SLAR of OBUs increased from 45.4 per cent to 47.1 per cent during the corresponding period. Further, lower expansion of credit during 2019 resulted in a decrease in the credit to deposits and borrowings ratio by 10 basis points, while the liquid assets to total assets and liquid assets to deposits ratios increased by 318 basis points and 377 basis points, respectively.

The Rupee and All Currency Liquidity Coverage Ratios of the banking industry stood at 212.8 per cent and 178.2 per cent, respectively, by end-2019, well above the regulatory minimum of 100 per cent. Banks are required to maintain a Liquidity Coverage Ratio (LCR), which 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. In addition, the Net Stable Funding Ratio (NSFR) introduced in 2019, which requires banks to maintain sufficient stable funding sources, stood at 130.1 per cent at end-2019 well above the regulatory requirement of 100 per cent. Total liquid assets increased by Rs. 585.3 billion during 2019 compared to

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



Source: Central Bank of Sri Lanka

Rs. 73.3 billion during 2018. Total liquid assets amounted to Rs. 3,621.2 billion as at end-2019, of which investments in government securities represented 73.0 per cent. Meanwhile, the cumulative maturity gap as a percentage of cumulative liabilities of the banking sector for maturity buckets up to the "less than 12 months" bucket, narrowed as at end-2019 compared to end-2018, indicating better management of assets and liabilities in the short term. Banking sector exposure to liquidity risk was minimal due to maintenance of adequate liquidity buffers.

Resources

(a) Profitability: The net interest margin of the banking sector remained at the same level of 3.6 per cent by end-2018 and 2019, despite the interest income of the banking sector growing at a lower rate (9.3 per cent) compared to growth in interest expenses (9.8 per cent) during 2019.

Table 8.6
Composition of Liquid Assets of the Banking Sector

Item	2018 (a)		2019 (b)		Change (Rs.bn)	
	Rs.bn	Share (%)	Rs.bn	Share (%)	2018 (a)	2019 (b)
Treasury bills	685.0	22.6	871.2	24.1	-59.7	186.2
Treasury bonds	941.3	31.0	1,203.4	33.2	-19.0	262.1
Sri Lanka Development Bonds	543.0	17.9	569.7	15.7	18.2	26.7
Cash	184.0	6.1	196.9	5.4	18.5	13.0
Money at Call	120.7	4.0	168.8	4.7	10.1	48.0
Balance with Banks Abroad	386.0	12.7	427.5	11.8	58.6	41.4
Other	175.9	5.8	183.8	5.1	46.6	7.9
Total Liquid Assets	**3,035.9**	**100.0**	**3,621.2**	**100.0**	**73.3**	**585.3**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

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Net interest income increased by Rs. 33.5 billion during 2019 compared to the previous year, while non-interest income decreased by Rs. 15.4 billion. Non-interest expenses increased by Rs. 10.5 billion, largely due to the increase in staff cost by Rs. 5.1 billion, while loan loss provisions increased by Rs. 19.6 billion during 2019, compared to 2018. However, losses on trading and investment securities for the year 2019 decreased by Rs. 8.2 billion compared to the previous year. As a result, the profit before corporate tax was Rs. 173.0 billion in 2019 which was Rs. 21.7 billion lower than the previous year.

Table 8.7
Profit of the Banking Sector

Item	2018 (a) Amount (Rs.bn)	2018 (a) As a % of Avg. Assets	2019 (b) Amount (Rs.bn)	2019 (b) As a % of Avg. Assets
Net Interest Income	397.6	3.6	431.1	3.6
Interest Income	1,108.7	10.1	1,212.0	10.1
Interest Expenses	711.1	6.5	780.8	6.5
Non-Interest Income	147.7	1.3	132.3	1.1
Foreign Exchange Income	48.6	0.4	26.7	0.2
Non-Interest Expenses	254.2	2.3	264.7	2.2
Staff Cost	121.4	1.1	126.5	1.1
Loan Loss Provisions	41.3	0.4	60.9	0.5
Profit Before Tax (after VAT)	194.7	1.8	173.0	1.4
Profit After Tax	125.9	1.1	111.7	0.9

(a) Revised
(b) Provisional

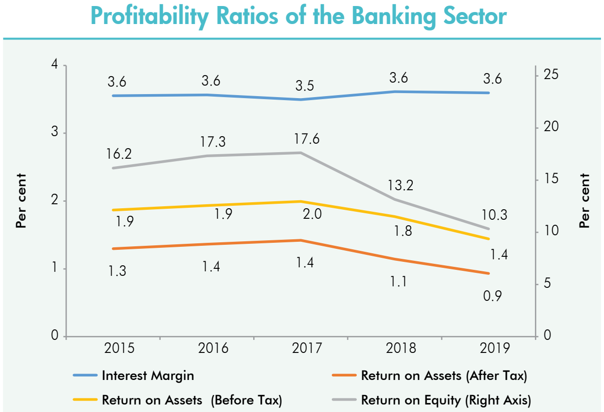
Source: Central Bank of Sri Lanka

Profit after tax of the banking industry was Rs. 111.7 billion during 2019 and contracted by 11.2 per cent compared to the previous year. Lower profits were reflected in the worsening of profitability ratios. ROA – before tax declined from 1.8 per cent in 2018 to 1.4 per cent in 2019, while ROE – after tax declined from 13.2 per cent to 10.3 per cent over the same period. Increase in operating costs resulted in the deterioration in the efficiency ratio from 50.0 per cent in 2018 to 52.6 per cent in 2019.

(b) Capital: The banking sector was in compliance with the capital requirements during 2019. Risk weighted assets of the banking sector grew only by 3.8 per cent during 2019 compared to the growth of 20.4 per cent during 2018 largely due to the lower credit growth during the year. As a result, the total risk adjusted capital ratio of the banking sector improved from 16.2 per cent as at end-2018 to 16.5 per cent as at end-2019 despite a marginal reduction in Tier 1 capital ratio from 13.1 per cent to 13.0 per cent over the same period.

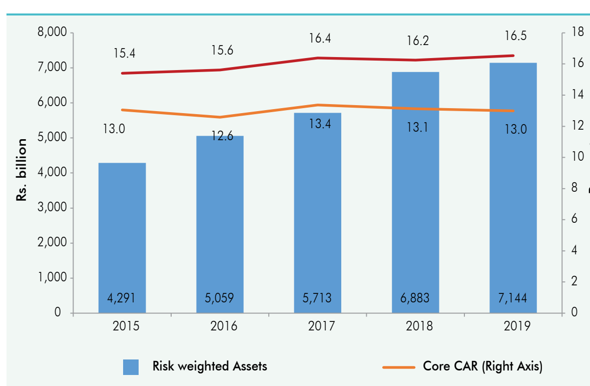
Banks were encouraged to raise high quality capital in 2019 due to the enhanced minimum capital requirements which banks need to comply with by end-2020, first day impact from implementation of SLFRS 9 which is considered for capital on a staggered basis over a period of 4 years and the Basel III capital requirements.

Figure 8.7
Profitability Ratios of the Banking Sector



Source: Central Bank of Sri Lanka

Figure 8.8
Capital Adequacy of the Banking Sector



Source: Central Bank of Sri Lanka

During 2019, banks had raised Tier I capital through issuance of new shares (Rs. 24.0 billion), retention of profits (Rs. 53.3 billion) and buildup of reserves (Rs. 29.9 billion). The regulatory capital of the banking sector reported a growth of 13.8 per cent during the year, of which Tier 1 capital contributed to 71.1 per cent. The total regulatory capital base of the banking industry amounted to Rs. 1,181.1 billion as at end-2019, of which Tier I capital represented 78.6 per cent. Tier II capital increased by Rs. 41.3 billion during 2019, mainly due to the increase in provisions (Rs. 24.0 billion) and subordinated debt capital (Rs. 18.5 billion) of banks.

The Central Bank introduced a new framework for dealing with Domestic Systemically Important Banks (D-SIBs) effective from 20 December 2019, which is in line with international standards. Accordingly, four D-SIBs which account for around 55 per cent of the total banking sector assets have been identified under the new framework. These D-SIBs are required to maintain varying higher loss absorbency requirements ranging from 1.0 per cent to 1.5 per cent. Going forward, licensed banks designated as D-SIBs will be subject to intense supervision, higher supervisory expectations on risk management, governance and internal controls.

Table 8.8
Composition of Regulatory Capital of the Banking Sector

Item	Amount (Rs. bn)		Composition (%)	
	2018 (a)	2019 (b)	2018 (a)	2019 (b)
Tier I: Capital	**826.3**	**927.9**	**100.0**	**100.0**
Share Capital	299.8	323.7	36.3	34.9
Statutory Reserve Funds	49.7	57.1	6.0	6.2
Retained Profits	310.8	364.1	37.6	39.2
General and Other Reserves	203.3	225.8	24.6	24.3
Others	7.1	6.9	0.9	0.7
Regulatory Adjustments	-44.4	-49.7	-5.4	-5.3
Tier II: Capital	**211.9**	**253.2**	**100.0**	**100.0**
Revaluation Reserves	27.8	26.1	13.1	10.3
Subordinated Term Debt	155.3	173.8	73.3	68.6
General Provisions and Other	33.9	57.9	16.0	22.9
Regulatory Adjustments	-5.1	-4.6	-2.4	-1.8
Total Regulatory Capital Base	**1,038.2**	**1181.1**		

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Supervisory and Regulatory Developments

During 2019, the Central Bank continued to introduce prudential policy measures and regulations with a view of enhancing the safety and soundness of the banking sector and facilitating business expansion of banks. Further, the Central Bank completed the implementation of key regulatory elements of the Basel III framework by 01 January 2019 and facilitated consistent adoption of the Sri Lanka Accounting Standard - SLFRS 9 - Financial Instruments for the banking sector in Sri Lanka.

Considering the need to employ expatriate officers with appropriate management skills and technical expertise, guidelines were issued to licensed banks on the employment of expatriates in licensed banks. These guidelines provide a definition on the term 'expatriate officer' and provide eligibility criteria for appointment of expatriate officers for banks incorporated in Sri Lanka and banks incorporated outside Sri Lanka.

A new set of formats for financial statements that is in line with SLFRS 9 was specified. A Circular on the Publication of Annual and Quarterly Financial Statements and Other Disclosures by Licensed Banks was issued specifying a new set of formats to publish financial statements in line with the new Sri Lanka Accounting Standard - SLFRS 9 - Financial Instruments, replacing the existing formats.

In order to prevent the undermining of the interest rate policies of the Central Bank, licensed banks were required to refrain from conducting lottery schemes/raffle draws and gift schemes that could result in a disadvantageous situation for the customers, where features of a financial product/service are distorted. This measure was taken since offering non-interest based incentive schemes for mobilising interest bearing savings and time deposits create undue competition among licensed banks, which undermines the interest rate policies implemented by the Central Bank. However, banks may conduct seasonal/promotional gift schemes provided that all customers of the relevant product, service, or category of the product/service, receive the offered gift, applicable market interest rates are offered based on the nature of the product, cost of the gift is not charged to customers, and no additional terms and conditions are imposed on customers with respect to the gifts offered.

In view of the gradual improvements in the trade balance, certain regulations issued in 2018 imposing restrictions on imports, were withdrawn in 2019. Accordingly, a Circular was issued to licensed banks informing of the removal of restrictions on opening of Letters of Credit (LCs) for the importation of motor vehicles under permits on concessionary terms. Similarly, Banking Act Directions issued to National Savings Bank on measures to curtail imports of motor vehicles were withdrawn. Further, the previous Circular "Margin Requirements against Imports on Documents against Acceptance (DA) Terms" dated 11 October 2018, which was initially issued to impose restrictions on imports under DA terms was also withdrawn with effect from 13 March 2019.

Considering the high real interest rates on deposits and lending products prevailing in the economy and the need to strengthen and expedite monetary policy transmission through the financial system, two key regulations were issued to licensed banks by the Central Bank to reduce market interest rates. Initially, a Monetary Law Act (MLA) Order No. 01 of 2019 was issued on maximum interest rates to be paid in respect of rupee deposits, enabling licensed banks to reduce their cost of funds and thereby reduce the interest rates on lending to enhance credit flows to the real economy. Subsequently, with a view to enhancing the efficiency of the transmission of recent policy decisions to rupee denominated market lending rates, Monetary Law Act Order No. 02 of 2019 was issued requiring licensed banks to reduce rupee lending rates by at least 200 bps by 15 October 2019, in comparison to the interest rates applicable as at 30 April 2019, subject to certain exclusions and a floor rate of 12.5 per cent p.a. Further, all LCBs were instructed to reduce its Average Weighted Prime Lending Rate (AWPR) by 250 bps by 27 December 2019 compared to its AWPR as published by the Central Bank as at 26 April 2019, subject to a maximum interest rate of 9.5 per cent p.a. In addition, maximum interest rate ceilings of 28 per cent p.a. and 24 per cent p.a. were imposed on credit card advances and pre-arranged temporary overdrafts, respectively, commencing 01 November 2019. The penal interest rate was capped at 4.00 per cent p.a., with effect from 15 October 2019. With the issuance of the above Order, MLA Order No. 01 of 2019 on maximum interest rates on rupee denominated deposits was withdrawn.

With a view to enhancing credit flows to SMEs, the Central Bank issued Directions to licensed banks on identifying SMEs for the purpose of capital and liquidity standards under the Basel III regulatory framework. Accordingly, the identification criteria of SMEs under Basel requirements were amended and banks are to adopt an internal mechanism approved by the Board of Directors to verify the annual turnover of SMEs. Further, a supplement to Circular No. 4 of 2018 on the adoption of Sri Lanka Accounting Standard-SLFRS 9: Financial Instruments in licensed banks was issued to licensed banks to further support enhancing credit flows to SMEs.

In view of the adverse impact on the tourism industry due to the Easter Sunday attacks, a Circular was issued to licensed banks requesting to grant concessions to individuals and entities in the tourism industry who wish

to avail such concessions. Accordingly, licensed banks were allowed to grant a moratorium, on a case-by-case basis, to individuals and entities who are registered with the Sri Lanka Tourism Development Authority (SLTDA) or any other authority/ agency under SLTDA to provide services relating to tourism. Licensed banks were instructed to convert the capital and interest falling due during the moratorium period into a term loan with a concessionary interest rate, which shall be recovered from July 2020 onwards.

Banking Act Directions were issued to licensed banks amending the maximum Loan to Value (LTV) ratios applicable for credit facilities granted for purchase or utilisation of electric, hybrid and other unregistered vehicles and registered vehicles which have been used in Sri Lanka for more/less than one year after the first registration. In addition, banks were required to consider the proforma invoice value, instead of the market value of the motor vehicle when determining the value considered for the LTV ratio with respect to credit facilities granted for the importation of motor vehicles under permits on concessionary terms. Further, these Directions were amended subsequently to increase the LTV ratio applicable for unregistered non-electric motor cars purchased under the 'Mini Taxi' concessionary loan scheme of the 'Enterprise Sri Lanka' programme to 80 per cent.

A regulatory framework was introduced to ensure that market conduct and treasury operations of licensed banks are carried out prudently and in line with international best practices. Accordingly, Banking Act Directions in this regard were issued to licensed banks, and the regulatory framework includes, inter alia, market conduct and ethical practices, confidentiality requirements, procedure for recording deal conversations, risk management principles, professionalism and knowledge level, and sanctions on non-compliance with the Directions.

In terms of the provisions of Sections 38A and 76H of the Banking Act No. 30 of 1988 (as amended) the Central Bank reviewed the list of qualified auditors to conduct audits of licensed banks and selected a new list of qualified auditors to audit accounts of licensed banks, from the financial year commencing 01 January 2021. The existing assessment criteria for the selection of qualified auditors were strengthened in line with the changes in the banking sector landscape, changes in accounting and auditing professions, introduction of the Basel III framework and Sri Lanka Accounting Standard - SLFRS 9 - Financial Instruments and the ability and competencies of the audit firms to undertake forensic audits and information technology audits of licensed banks.

Amendments were introduced to the existing regulatory framework on valuation of immovable properties of licensed banks. Accordingly, Banking Act Directions were issued amending the eligibility criteria for valuers under the regulatory framework on valuation of immovable properties of licensed banks.

During 2019, fit and proper assessment criteria for the appointment of Directors, Chief Executive Officers and Key Management Personnel of licensed banks were further strengthened. Accordingly, Banking Act Directions were issued on the assessment of fitness and propriety of Directors of licensed banks, including the information to be submitted by the persons proposed to be appointed, elected or nominated as Directors of licensed banks and for the annual reassessment of such Directors for the purpose of obtaining approval from the Director of Bank Supervision Department of the Central Bank. Previous circulars issued in this regard were revoked. Further, a Banking Act Determination was issued designating certain positions as officers performing executive functions in licensed banks and requiring such officers and Chief Executive Officers of licensed banks to furnish information in a format prescribed by the Central Bank to assess/re-assess their fitness and propriety prior to appointment/periodically for the purpose of obtaining the approval of the Director of Bank Supervision Department of the Central Bank. Previous Determinations and Circulars issued in this regard were revoked. Moreover, Banking Act Directions on Corporate Governance for licensed banks were amended introducing a cooling off period of 6 months for the appointment of a Director or a Chief Executive Officer of a licensed bank operating in Sri Lanka as a Director or a Chief Executive Officer of another licensed bank.

With a view to broad-basing assessment criteria applicable to "Domestic Systemically Important Banks" in line with international standards and best practices, the Central Bank introduced a new framework to assess D-SIBs based on multiple factors such as size, interconnectedness, substitutability and complexity. Licensed banks determined as D-SIBs are required to maintain additional Higher Loss Absorbency (HLA) requirements as a capital surcharge. In this regard, Banking Act Directions were issued determining four licensed banks as D-SIBs and specifying their respective HLA requirements. Further, Banking Act Directions on Capital Requirements under Basel III were amended incorporating additional HLA requirements in the form of Common Equity Tier 1 for D-SIBs.

Crisis preparedness and resilience of banks to face adverse scenarios will be further strengthened through the implementation of recovery plans for licensed banks. Licensed banks will be required to implement recovery plans in order to minimise the adverse impact on troubled banks and spill-over effects to the financial sector. A Consultation Paper was issued to banks in this regard for their observations, and the Banking Act Directions providing guidelines for preparations of recovery plans by banks will be issued in due course.

The Central Bank further improved the "Bank Sustainability Rating Indicator (BSRI)", the supervisory rating model which was developed to facilitate the risk based supervision framework of licensed banks. All parameters were reviewed and a comprehensive supervisory guidance framework was developed to uphold the consistent application of the BSRI framework across all banks. Implementation of the BSRI would enable early intervention and prompt corrective action through the identification of potential risks arising from emerging developments and strategic changes of licensed banks.

The Central Bank engaged in strengthening the regulatory and supervisory framework of licensed banks by initiating the drafting of a new Banking Act, in line with the changing dynamics of the banking sector, international standards and regional best practices. Key areas to be incorporated into the proposed new Banking Act include an overall mandate for supervision and regulation, a differentiated regulatory framework to facilitate proportionality, strengthening corporate governance, consolidated supervision, resolution, imposing monetary penalties/fines, ring-fencing of banks to mitigate contagion risk, strengthening provisions for mergers, acquisitions and consolidation, subsidiarisation of large foreign banks and a financial holding company structure for banks. A consultation paper comprising the key concepts proposed to be covered in the new Banking Act was issued to licensed banks and other stakeholders for their comments and observations. The Central Bank expects to complete enacting the new Banking Act by early 2021.

8.3 Performance of Non-Bank Financial Institutions

Licensed Finance Companies and Specialised Leasing Companies Sector

The LFCs and SLCs sector performance deteriorated during the year, with negative credit growth, declining profitability and increase in NPLs. The slowdown in the sector was mainly due to subdued economic activities, prevailed political uncertainty, lack of investor confidence and security concerns created by the Easter Sunday attacks. Total assets of the sector stood at Rs. 1,432.7 billion by end-December 2019, representing 7.6 per cent of Sri Lanka's financial system. The sector as a whole remained stable, with capital maintained at healthy levels along with adequate liquidity buffers well above the regulatory minimum levels. Deposits dominated the funding mix, as increased assets were mainly funded through deposits, while borrowings of the sector largely declined compared to the previous year. The Central Bank continued to take prudential measures to maintain the stability of the sector with much consideration on reviving LFCs with supervisory concerns.

Business Expansion

(a) Outreach: At end-2019, the sector comprised 42 LFCs and 4 SLCs. LFCs and SLCs contributed to the economy by providing enhanced services to the customers and expanding its branch network, thereby promoting financial inclusion in the country. There were 1,432 branches and 599 other outlets[1] of the LFCs and SLCs sector, out of which 952 branches (66.0 per cent) were located outside the Western Province. In 2019, several LFCs introduced technology based products/ services to facilitate financial inclusion.

1 Other outlets mean service centers, pawning centers, collection centers which do not mobilise public deposits.

(b) Assets: Total asset base of the sector stood at Rs. 1,432.7 billion, which expanded marginally by 0.1 per cent (Rs. 1.3 billion) during the year, compared to 5.6 per cent growth reported in 2018. The asset base of the sector mainly consisted of loans and advances which accounted for 77.0 per cent of the total assets. Finance leases accounted for the major part, representing 52.9 per cent of the gross loans and advances, followed by other secured loans, representing 37.0 per cent.

Lending Activities of the sector showed signs of slowing down during 2019. This has been in response to macroprudential policy measures to curtail importation of motor vehicles and lending towards vehicles such as the directions of LTV ratios for credit facilities granted in respect of motor vehicles, prevailed higher market interest rates on lending, sluggish economic and commercial activities due to loss of business confidence which resulted from political instability in the run up to the presidential election and negative sentiments caused by the Easter Sunday attacks. Credit provided by the LFCs and SLCs sector declined by 3.0 per cent (Rs. 34.3 billion) to Rs.1,102.7 billion, compared to the growth of 7.6 per cent in the corresponding period of 2018. Loans and advances portfolio of product categories such as finance leases (Rs. 3.9 billion), secured loans and advances (Rs. 20.8 billion) and hire purchases

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

Province	End 2018	End 2019 (a)	Movement during the year
Central	158	160	2
Eastern	110	117	7
North Central	98	99	1
North Western	148	156	8
Northern	84	89	5
Sabaragamuwa	110	113	3
Southern	151	151	0
Uva	68	67	-1
Western	446	480	34
Total	1,373	1,432	59

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

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

Item	2018		2019 (a)		Change (%)	
	Rs. bn	Share (%)	Rs. bn	Share (%)	2018	2019 (a)
Assets						
Loans and Advances (net)	1,137.0	79.4	1,102.7	77.0	7.6	-3.0
Investments	109.7	7.7	132.2	9.2	-7.1	20.5
Other	184.6	12.9	197.8	13.8	2.7	7.1
Liabilities						
Total Deposits	716.8	50.1	756.7	52.8	4.4	5.6
Total Borrowings	463.8	32.4	405.6	28.3	17.1	-12.6
Capital Elements	183.7	12.8	203.2	14.2	8.2	10.6
Other	67.0	4.7	67.2	4.7	-34.7	0.3
Total Assets/Liabilities	**1,431.3**	**100.0**	**1,432.7**	**100.0**	**5.6**	**0.1**

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

(Rs. 4.3 billion) contracted, while pawning advances increased by Rs. 15.5 billion and loans against deposits increased by Rs. 0.6 billion.

The investment portfolio of LFCs and SLCs sector comprises investments in equities, capital market debt instruments, government securities and investment properties. The investment portfolio recorded a sharp increase of 20.5 per cent (Rs. 22.5 billion) in 2019, compared to a negative growth of 7.1 per cent in 2018. This is mainly due to increased investment in government securities maturing in less than 12 months (Rs. 9.0 billion), investment in shares, units and debt securities held for trading (Rs. 8.0 billion) and investment properties (Rs. 7.1 billion). Other assets were mainly maintained in the form of cash, balances with banks and financial institutions, trading stocks, and fixed assets, which increased by 7.1 per cent (Rs. 13.2 billion) in 2019, largely due to increased placements in banks and financial institutions.

(c) Liabilities: Customer deposits still dominated the major portion of liabilities, and increased assets were mainly funded through deposits, which accounted for 52.8 per cent of the total liabilities of the sector. The deposit growth accelerated to 5.6 per cent (Rs. 39.9 billion), while borrowings declined by 12.6 per cent (Rs. 58.2 billion) in 2019.

Table 8.11
Composition of Deposits of the LFCs Sector

Item	Amount (Rs. bn)		Composition (%)	
	2018	2019 (a)	2018	2019 (a)
Time Deposits	681.3	722.2	95.1	95.5
Savings Deposits	34.6	33.5	4.8	4.4
Certificate of Deposits	0.9	0.9	0.1	0.1
Total Deposits	**716.8**	**756.7**	**100.0**	**100.0**

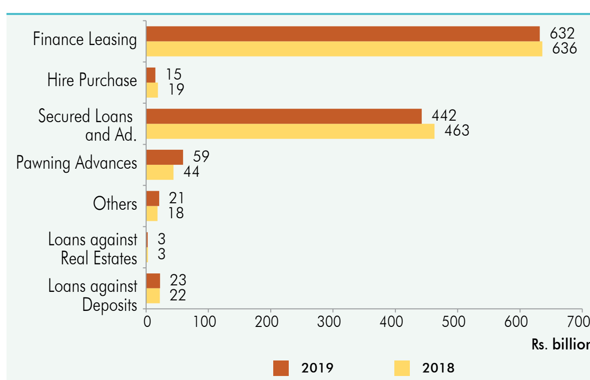
(a) Provisional — *Source:* Central Bank of Sri Lanka

Capital position improved due to the enhancement of regulatory capital requirements. The equity capital of the sector increased by 10.6 per cent (Rs. 19.5 billion), which stood at Rs. 203.2 billion by end-2019, mainly on account of the increase in capital due to the steps taken by LFCs to enhance the minimum core capital to meet Rs. 2.0 billion requirements by 1 January 2020. The sector's core capital and total RWCARs stood at 11.1 per cent and 12.5 per cent, respectively, by end-December 2019, compared to the reported levels of 9.8 per cent and 11.1 per cent in the corresponding period of 2018.

Risks in the LFCs and SLCs Sector

(a) Credit Risk: The gross non-performing advances (NPA) ratio increased to 10.6 per cent at end-December 2019, from 7.7 per cent reported at end-December 2018, reflecting deterioration in the asset quality of the sector. This is mainly due to the slowing down in economic

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



Source: Central Bank of Sri Lanka

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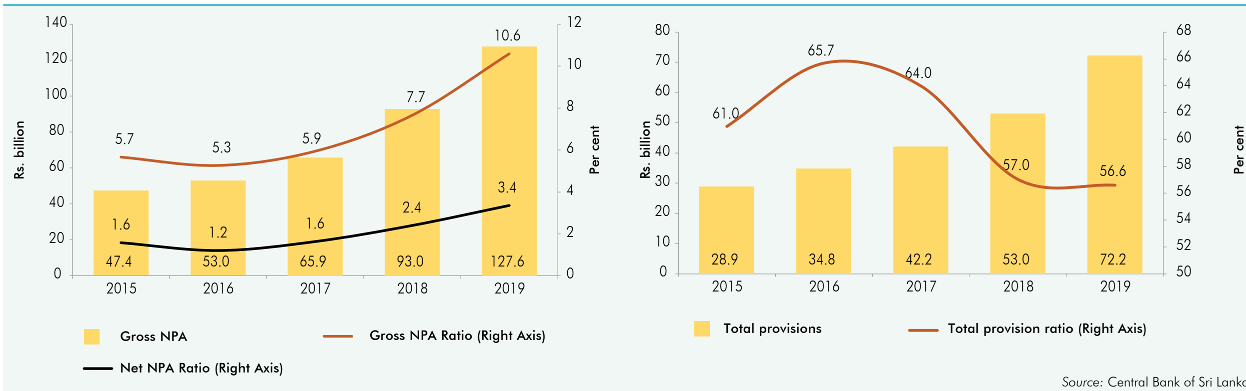
Figure 8.10
Non Performing Loans and Provision Coverage of the LFCs and SLCs Sector



Source: Central Bank of Sri Lanka

activities due to the Easter Sunday attacks, declined lending activities of the sector and spillover effects of the Debt Relief Program. The provision coverage ratio slightly deteriorated to 56.6 per cent by end-December 2019, compared to 57.0 per cent reported at end-December 2018. With the implementation of SLFRS 9, NPA will rise further which would highlight the significant credit risk of the sector.

(b) Market Risk: The sector continued to experience minimum equity risk. However, in essence, the sector is considered to be largely exposed to interest rate risk.

Interest Rate Risk: In response to the maximum interest rates on deposits and debt instruments imposed on LFCs, cost of funds declined and lending rates also reduced to some extent with the new loans and advances granted. Accordingly, interest rate risk of the sector decelerated with the prevailing negative mismatch in the maturity profile of the interest-bearing assets and liabilities.

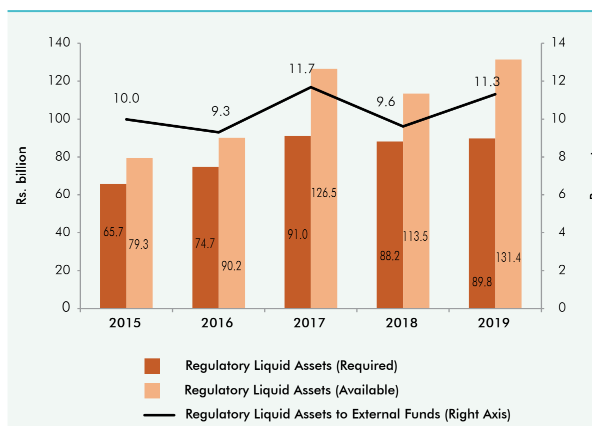
Equity Risk: Equity risk of the sector remained low during the year as exposure to the equity market in the form of investment in listed shares held for trading was minimal at Rs. 14.0 billion, which was only 1.0 per cent of the total assets of the sector.

(c) Liquidity Risk: The sector maintained adequate liquidity buffers well above the regulatory minimum levels. The overall regulatory liquid assets available in the sector at end-December 2019 indicated a surplus of Rs. 41.6 billion as against the stipulated minimum requirement of Rs. 89.8 billion. The liquidity ratio (liquid assets on deposits and borrowing) increased to 11.3 per cent at end-December 2019, compared to 9.6 per cent recorded at end-December 2018.

Profitability and Capital Resources

(a) Profitability: Net interest income of the sector during the year was Rs. 117.4 billion, which increased by 7.9 per cent (Rs. 8.6 billion). This was due to the combined effects of increased

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

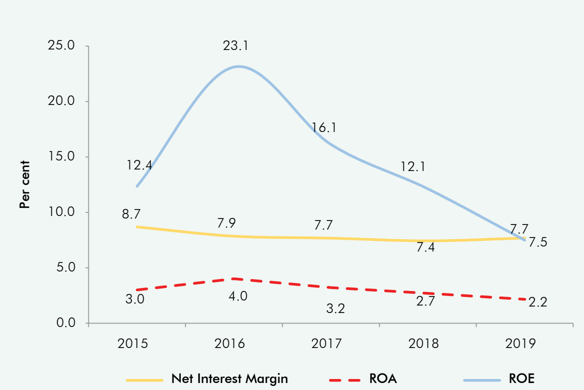
Item	2018		2019 (a)	
	Amount (Rs. bn)	As a % of Avg. Assets	Amount (Rs. bn)	As a % of Avg. Assets
Interest Income	241.5	16.5	259.8	17.0
Interest Expenses	132.6	9.1	142.4	9.3
Net Interest Income	**108.8**	**7.4**	**117.4**	**7.7**
Non-Interest Income	38.1	2.6	39.4	2.6
Non-Interest Expenses	81.2	5.5	93.8	6.1
Loan Loss Provisions (Net)	25.9	1.8	30.2	2.0
Profit Before Tax	**39.7**	**2.7**	**32.8**	**2.2**
Profit After Tax	**21.4**	**1.5**	**14.5**	**1.0**

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

interest income by 7.6 per cent (Rs. 18.3 billion) and increased interest expenses by 7.4 per cent (Rs. 9.8 billion). Net interest margin of the sector (net interest income as a percentage of average assets) increased to 7.7 per cent in 2019 from 7.4 per cent in 2018, due to the combined effects of increased net interest income (7.9 per cent) and increased (gross) average assets (4.3 per cent).

Non-interest income increased by 3.4 per cent (Rs. 1.3 billion) mainly due to increase in default charges and other service charges, while non-interest expenses increased by 15.5 per cent (Rs. 12.6 billion) affecting sector profitability in an adverse manner. Non-interest expenses increased mainly due to increased administrative expenses (Rs. 4.1 billion), loss on valuation/ disposal of repossessed items (Rs. 2.7 billion), staff costs (Rs. 2.5 billion) and other expenses (Rs. 1.3 billion). The loan loss

Figure 8.12
Profitability Indicators of the LFCs and SLCs Sector



Source: Central Bank of Sri Lanka

Table 8.13
Composition of Regulatory Capital of LFC and SLC Sector

Item	Amount (Rs. bn)		Composition (%)	
	2018 (a)	2019 (b)	2018 (a)	2019 (b)
Tier I: Core Capital	**155.4**	**173.2**	**100.0**	**100.0**
Stated Capital	71.8	82.4	46.2	47.6
Non-Cumulative, Non-redeemable Preference Shares	0.1	0.1	0.1	0.1
Statutory Reserve Fund	22.3	26.8	14.4	15.5
General and Other Free Reserves	30.6	31.7	19.7	18.3
Others	30.6	32.2	19.7	18.6
Tier II: Supplementary Capital	**22.5**	**25.5**	**100.0**	**100.0**
Eligible Revaluation Reserves	2.3	3.2	10.3	12.6
General Provisions	5.8	6.6	26.0	25.9
Instruments qualified as Tier 2 Capital	14.4	15.7	64.2	61.7
Others	-0.1	-0.0	-0.5	-0.2
Regulatory Adjustments	**-17.9**	**-16.4**		
Total Regulatory Capital Base	**160.0**	**182.2**		

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

provisions made against NPAs during the year was Rs. 30.2 billion, which increased by 16.2 per cent (Rs. 4.2 billion), when compared to the provision made in 2018.

The sector posted a profit after tax of Rs. 14.5 billion, a decline of 31.9 per cent compared to the profit recorded in year 2018, mainly due to increased non-interest expenses and higher loan loss provisions. ROA also decreased by 56 basis points during the year, reporting a ratio of 2.2 per cent, and ROE decreased by 463 basis points, reporting a ratio of 7.5 per cent which shows signs of stress in the sector profitability.

(b) Capital: The sector remained resilient with capital maintained at healthy levels during the year. The total regulatory capital levels improved by Rs. 22.3 billion in 2019, compared to the figures reported in 2018, mainly due to the enhancement of minimum capital requirement by the Central Bank to Rs. 2.0 billion by 01 January 2020 and Rs. 2.5 billion by 01 January 2021. The regulatory capital comprises Tier I and Tier II capital, of which Tier I capital contributed to 95.1 per cent of the total regulatory capital. Tier I capital mainly comprises issued share capital, statutory reserve fund and published retained profits.

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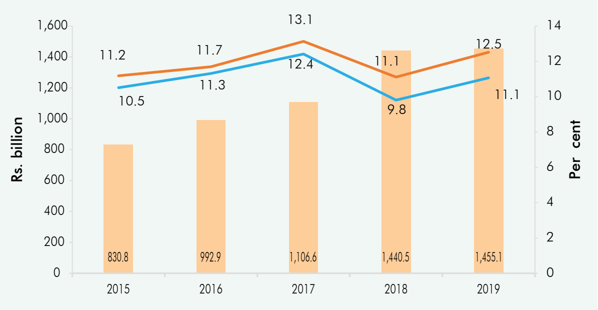
Figure 8.13
Risk Weighted Assets and CAR of the LFCs and SLCs Sector



Source: Central Bank of Sri Lanka

The sector's core capital and total RWCAR stood at 11.1 per cent and 12.5 per cent, respectively, in 2019 which increased by 1.3 per cent and 1.4 per cent from the reported ratios in 2018. LFCs and SLCs with assets less than Rs. 100.0 billion are required to maintain Tier I capital adequacy ratio of 6.5 per cent and Total capital ratio of 10.5 per cent, whereas LFCs and SLCs with assets of Rs. 100.0 billion and above are required to maintain Tier I capital adequacy ratio of 7.0 per cent and Total capital ratio of 11.0 per cent, with effect from 1 July 2019.

There were a few LFCs that were non-compliant with the minimum core capital requirement and/or with the minimum capital adequacy ratios. Several regulatory actions were initiated to avoid further deterioration of the financial position, maintain the stability of such institutions and safeguard the interest of depositors.

Supervisory and Regulatory Developments

Throughout 2019, the Central Bank introduced several policy measures and prudential regulations to further strengthen the supervisory and regulatory framework of LFCs and SLCs for enhancing the stability and soundness of the sector to preserve customer confidence. A Direction was issued to introduce maximum interest rates on deposits and debt instruments of the LFCs and SLCs, considering the high real interest rates on deposits and high rates on lending products observed in the economy and the need to strengthen and expedite monetary policy transmission through the financial system, while enhancing credit flows to the real economy. This Direction was revised subsequently in consideration of requests made by the LFCs to remain competitive in the market and also to reduce the impact on profits of LFCs.

The existing LTV Direction issued to LFCs was revised to incorporate the 2019 Budget proposals by allowing higher LTV ratios for light trucks. The earlier 70 per cent LTV ratio in respect to light trucks was revised to an increased ratio of 90 per cent.

The existing Direction on Valuation of Immovable Properties issued to LFCs and SLCs was revised. The eligibility criteria for valuers was updated and the frequency of valuation for different categories of assets classes was amended. Accordingly, valuation of residential property which is occupied by the borrower for residential purposes obtained as collateral against loans and advances that are non-performing, shall be carried out in a less than five years frequency, and in respect to all other credit facilities, the valuation shall be carried out in a less than four years frequency. Valuation of immovable property obtained as collateral against loans and advances which are performing, shall be made at the time of initial granting and at a time of any subsequent enhancement of credit facilities. Revaluation of land, and land & building which are purchased or acquired for the purpose of conducting business of LFCs which are measured and disclosed in accordance with LKAS

16: Property, Plant and Equipment, and those purchased or acquired as LFCs' investments which are measured and disclosed in accordance with LKAS 40: Investment Property, shall be made in line with the internal policies or depending on any significant volatile changes in fair value.

A Circular was issued to LFCs and SLCs in view of mitigating the adverse impact on the tourism sector due to the Easter Sunday attacks. This enabled these institutions to grant a moratorium to individuals and entities who have registered with the Sri Lanka Tourism Development Authority or any other authority/agency to provide services to the tourism sector. Several explanatory notes were issued following the circular with more clarifications, specific instructions and reporting requirements on LFCs and SLCs.

Under the Extraordinary Gazette No.2125/58, regulations were issued on the priority of claims in a winding up of an LFC. Accordingly, the liquidator shall pay out of the assets of the LFC the expenses, fees and claims according to its tenor to the extent and in the order of priority set-out in the Schedule to the said regulation. After paying the preferential claims in accordance with the regulations, only thereafter shall the liquidator apply the assets of the company in satisfaction of all other claims in accordance with provisions of the Companies Act No. 7 of 2007.

A consultation paper was issued on introducing ownership limits to LFCs, with the objective of diversifying the ownership of shares in LFCs. Over the past few years there has been an increase in the prominence of the LFCs sector in terms of its market penetration and its contribution towards financial inclusion of the country. However, due to various reasons there have been instances where several LFCs have either failed or become almost bankrupt during the last few decades. Introducing ownership limits on LFCs is viewed as an important part of the process of strengthening good corporate governance practices in this sector. Based on the observations received from the stakeholders on the first consultation paper, a second consultation paper was issued for observations during the latter part of the year.

A consultation paper was issued on credit risk management for LFCs. The existing directions on credit risk management are outdated and create a distortion in the treatment of NPLs in the LFCs and SLCs sector. Thus, credit risk directions need to be changed regularly to keep pace with international and local developments in the financial industry, emerging international best practices emanating in the Basel Committee on Bank Supervision, accounting standards and to be compliant with other standard setting bodies. Meanwhile, in order to maintain the confidence of the public in the financial system, the Central Bank continued with litigation relating to unauthorised finance companies, prohibited schemes and other issues in the financial sector, with the assistance of the Attorney General's Department and other law enforcement agencies under the provisions of the Finance Business Act, No. 42 of 2011 and the Banking Act, No. 30 of 1988.

Primary Dealers in Government Securities

Currently, there are 7 Licensed Commercial Banks and 8 companies are in operation as Primary Dealers. Out of those, Perpetual Treasuries Limited (PTL) and Pan Asia Banking Corporation PLC (PABC), were suspended from carrying on business and activities of a Primary Dealer (PTL w.e.f. 6 July 2017 and PABC w.e.f. 15 August 2017). Participation in government securities Primary Auctions was prohibited for

Table 8.14
Performance of Primary Dealer Companies

Rs. billion

Item	2018	2019 (a)	Annual Growth Rate (%)	
			2018	2019 (a)
Total Assets	83.6	77.5	8.1	-7.2
Total Investment Portfolio	76.7	69.3	22.6	-9.6
Trading Securities	62.8	57.5	23.3	-8.5
Held-to-maturity	8.7	8.6	0.7	-1.7
Available for Sale	5.2	3.3	74.2	-36.4
Reverse Repo	4.3	6.0	-67.6	39.4
Equity and Liabilities	83.6	77.5	8.1	-7.2
Total Capital	11.5	15.2	-50.1	31.5
Repo	68.7	60.3	30.7	-12.2
Profit before Tax	-0.0	4.8	-100.4	34,968
Profit after Tax	0.2	3.8	-92.2	1,622.1
Return on Assets (%)	-0.0	6.0	-4.2	6.0
Return on Equity (%)	2.0	28.5	-10.9	26.5
Risk Weighted Capital Adequacy Ratio (%)	21.3	27.6	-34.6	6.3
Leverage Times	6.0	4.0	161.9	-33.2
Dealings	7,965.5	8,674.5	-4.4	8.9
Primary Market Dealings	436.3	566.1	3.0	29.8
Secondary Market Dealings	7,529.2	8,108.4	-5.8	7.7
Outright Purchases	456.9	629.6	2.9	37.8
Outright Sales	826.0	1,016.0	2.4	23.0
Repo, Reverse Repo	6,246.3	6,462.7	-7.3	3.5

(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 excludes data of Perpetual Treasuries Ltd

Source: Central Bank of Sri Lanka

Entrust Securities PLC (ESP) w.e.f. 24 July 2017. Therefore, currently 6 Licensed Commercial Banks (LCBs) and 6 Primary Dealer Companies (PDs) are active in the PD industry in the government securities market.

Assets and Liabilities

Assets and Liabilities: The total assets of PDs decreased by 7.2 per cent to Rs. 77.5 billion in 2019. The total investment portfolio of government securities, consisting of trading, available for sale and held to maturity amounted to Rs. 69.3 billion at end-2019, recording a decrease of 9.6 per cent during the year. This change was due to decreases in the trading portfolio, held to maturity portfolio and the available for sale portfolio of government securities. The trading portfolio decreased to Rs. 57.5 billion by end-2019, from Rs. 62.8 billion recorded at end-2018; the held to maturity portfolio decreased to Rs. 8.6 billion in end-2019 from Rs. 8.7 billion in end-2018, and the available for sale portfolio, decreased to Rs. 3.3 billion during 2019 compared to Rs. 5.2 billion as at end-2018.

Profitability: The PDs reported profit after tax of Rs. 3.8 billion during 2019 against that of Rs. 0.2 billion during 2018 indicating a significant market improvement. The significant increase in the capital gain and large revaluation gain recorded in 2019 against the revaluation losses from the government securities in 2018 largely contributed to the increase in profits. Consequently, ROA and ROE for PDs increased to 6.0 per cent and 28.5 per cent, respectively, by end-2019 from negative 0.02 per cent and 2.0 per cent recorded in 2018, respectively.

Capital: Equity of PDs considerably increased by 31.5 per cent largely due to the accumulation of profits during the year. The RWCAR of the PDs was above the minimum RWCAR of 10 per cent while the ratio increased to 27.6 per cent at end-2019 from 21.3 per cent as at end-2018.

Exposure to Risks

Market Risk: The proportion of trading portfolio to total investment portfolio of PDs did not change notably and recorded 82.9 per cent at end-2019 compared to 81.9 per cent at end-2018, reflecting a marginal increase in the market risk exposure of the industry.

Liquidity Risk: The overall liquidity risk exposure of standalone PDs decreased due to the decrease in over-night negative mismatch in the maturity profile of assets and liabilities of the industry by end-2019. The overnight negative mismatch decreased to Rs. 11.1 billion or 72.1 per cent of the overnight liabilities at end-2019, from Rs. 36.3 billion or 91.9 per cent at end-2018. In view of holding a large volume of risk free government securities by

BOX 12
Standardising the Market Practices for Repurchase and Reverse Repurchase Transactions in Government Securities

Background

Government securities are debt instruments issued by a government to borrow money to fund its expenditure. In the Sri Lankan context, the most common rupee denominated government securities are Treasury Bills and Treasury Bonds. Treasury Bills are issued for a maximum tenor of one year while Treasury Bonds are issued for tenors of over one year and typically up to 30 years. The Central Bank of Sri Lanka (CBSL), as the statutory manager of government debt, is tasked with the issuance and management of Treasury Bills and Treasury Bonds on behalf of the government, in terms of the Local Treasury Bills Ordinance No. 8 of 1923 (LTBO) and the Registered Stock and Securities Ordinance No. 7 of 1937 (RSSO), respectively.

Treasury Bills and Treasury Bonds were issued in paper form, i.e., as printed certificates, until 2004. In 2004, by way of necessary amendments to the legislation, the outstanding Treasury Bills and Treasury Bonds were converted into scripless form and the issuance of new Treasury Bills and Treasury Bonds in scripless form was initiated. A digital depository, namely the Central Depository System (CDS), is maintained by the CBSL to record the ownership of these scripless Treasury Bills and Treasury Bonds.

Efficient functioning of the government securities market is an essential prerequisite in ensuring that funds are sourced for the government at optimal cost. Development of the government securities market by improving and standardising market practices on repurchase and reverse repurchase transactions on Treasury Bills and Treasury Bonds is a critical aspect to this end.

Repurchase and Reverse Repurchase Transactions in Treasury Bills and Treasury Bonds

A repurchase transaction is a transaction where a person who owns a Treasury Bill or a Treasury Bond sells it to another person at a particular price with the agreement to buy back on an agreed future date, at an agreed price. In effect, the person who owns the security is borrowing funds using that security as collateral. The difference between the selling price of the security and the buyback price of the security is the interest cost for borrowing funds. A reverse repurchase transaction, on the other hand, is a lending transaction collateralised by a Treasury Bill or a Treasury Bond, i.e., the inverse of a repurchase transaction.

RSSO and LTBO Direction No. 01 of 2019 on Repurchase and Reverse Repurchase Transactions of Dealer Direct Participants in Scripless Treasury Bonds and Scripless Treasury Bills

The CBSL, on 20.12.2019, in terms of the powers conferred by the RSSO and the LTBO, issued Directions to Dealer Direct Participants (DDPs),[1] prescribing the manner in which repurchase and reverse repurchase transactions on scripless Treasury Bills and scripless Treasury Bonds shall be carried out by such DDPs. These Directions were intended to standardise the basic parameters of repurchase and reverse repurchase transactions while leaving space for effective market-making, enabling parties to enter into repurchase and reverse repurchase transactions in a transparent manner. Directions were also intended to address the shortfalls in the regulatory framework identified during the failure of one of the Primary Dealers and the supervision of other DDPs. These Directions came into operation on 01.01.2020 subject to certain transitional provisions aimed at providing market participants with adequate time to make necessary adjustments to their existing practices.

Salient Features of the New Directions

1. Uniformity in valuing securities

The new Directions recommend that the Treasury Bills and Treasury Bonds used for repurchase and reverse repurchase transactions be priced at market value based on the dirty price, i.e. the price inclusive of accrued interest, corresponding to the average of the bid and offer quotes for the relevant Bill or Bond published daily by the CBSL. However, in recognition of other valuation methods available to DDPs to derive accurate valuations, DDPs have also been allowed the option of using an alternative valuation method subject to certain conditions.

2. Introduction of minimum haircut requirements

A haircut is the discount applied on the market value of Treasury Bills and Treasury Bonds when such Treasury Bills and Treasury Bonds are used for repurchase and reverse repurchase transactions. A haircut is a universally accepted concept that is developed to mitigate the risk posed to the lender due to adverse movements in the price of underlying securities. In the past, haircut percentages for securities used for repurchase and reverse repurchase

1 DDPs are persons appointed as DDPs in terms of the RSSO and LTBO, and at present include all Licensed Commercial Banks and Primary Dealers Companies.

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transactions varied greatly among DDPs. However, in order to introduce a degree of standardisation to the repo market, the new Directions imposed the following minimum haircut requirements, at the time of entering into repurchase and reverse repurchase transactions, which are based on the remaining term to maturity of the Treasury Bill or the Treasury Bond, excluding transactions between two Direct Participants (DPs)[2].

Table B 12.1
Minimum haircut requirements

Remaining Term to Maturity of the Eligible Security	Minimum Haircut (%)
up to 1 year	4.0
more than 1 year and up to 3 years	6.0
more than 3 years and up to 5 years	8.0
more than 5 years and up to 8 years	10.0
more than 8 years	12.0

3. Streamlining the sale, substitution and replenishment of securities used for repurchase and reverse repurchase transactions

While the existing regulatory framework contained provisions to safeguard the interest of both lenders and borrowers in repurchase and reverse repurchase transactions, the new Directions introduced several further measures including the prohibition of outright selling of securities received by a DDP as collateral for reverse repurchase transaction and requiring DDPs to simultaneously substitute securities used for repurchase transactions if such securities are to be used by the DDPs. Further, the new Directions require DDPs to allocate or obtain additional securities, depending on the type of transaction, if the market value of securities used for a repurchase or reverse repurchase transaction falls below the maturity value of the transaction at any time prior to its maturity.

2 DPs are persons appointed as DPs in terms of the RSSO and LTBO, and at present include the CBSL, all Licensed Commercial Banks, Primary Dealers Companies, Employees' Provident Fund (EPF) and the Central Depositary System of the Colombo Stock Exchange.

4. Improving accountability and risk management practices of DDPs

The new Directions, while mandating certain key requirements with respect to repurchase and reverse repurchase transactions, recognise the importance of robust internal structures in DDPs to ensure the safety and soundness of the repurchase and reverse repurchase market. Accordingly, the responsibilities of the Board of Directors of DDPs, roles of the internal and external auditors, risk management and compliance functions of DDPs are drawn.

5. Introduction of penalties

While the existing framework provided for several regulatory actions that could be taken against DDPs who fail to comply with the requirements with respect to repurchase and reverse repurchase transactions, the new Directions impose financial penalties to further curb such non-compliances.

Expected Benefits to the Government Securities Market and its Participants

Tradability of government securities, in terms of both outright and repo trading, is a key factor affecting the cost of funds for the government, as investors prefer to invest in liquid securities. These new Directions on repurchase and reverse repurchase transactions in Treasury Bills and Treasury Bonds will further strengthen the market practices relating to such transactions and thereby improve the tradability of government securities.

Further, protection of DDPs and their customers who engage in repurchase and reverse repurchase transactions will be further strengthened as the measures introduced by these Directions are effectively coupled with safeguards already put in place by the CBSL, such as the Short Message Service (SMS) and e-mail notification system for CDS accountholders, whereby security movements with respect to repurchase and reverse repurchase transactions are notified to customers.

The above benefits will lead to the development of the government securities market as a whole and enhance investor confidence.

PDs 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 PDs remained low throughout the year except for one PD that was facing liquidity issues. Most of the PDs had stand-by contingency funding arrangements to bridge liquidity gaps.

Market Participation

Primary Market Activities: The participation in primary market auctions in respect of Treasury bills and Treasury bonds by PDs showed a mixed performance. Of the total bids accepted from the total Treasury bills auctions (52) conducted in 2019, the participation of LCBs, PDs and EPF account for 70.9 per cent, 28.3 per cent and 0.8 per cent respectively. However, participation of Treasury bond auctions in 2019 was dominated by the EPF with a 41.1 per cent share from the total bonds accepted through 12 auctions conducted in 2019.

Secondary Market Activities: Secondary market transactions in government securities increased by 7.7 per cent to Rs. 8,108.4 billion, out of which repo transactions accounted for 79.7 per cent of the total volume of secondary market transactions in 2019. During 2019, outright purchases and outright sales increased by 37.8 per cent and 23.0 per cent respectively, compared to 2018.

Supervisory and Regulatory Developments

Several regulatory and supervisory measures were taken on primary dealers during 2019. In order to standardise the market practice on repurchase transactions of government securities, a Direction dated 20 December 2019 was issued to Dealer Direct Participants relating to repurchase and reverse repurchase transactions on Scripless Treasury Bonds and Scripless Treasury Bills.

Licensed Microfinance Companies

Three microfinance companies were granted licences under the Microfinance Act, No. 6 of 2016 by the Monetary Board of the Central Bank; namely, Berendina Micro Investments Company Limited, Lak Jaya Micro Finance Limited and Dumbara Micro Credit Limited. The Licensed Microfinance Companies (LMFC) sector reported assets worth Rs. 5.8 billion as at the end of 2019, out of which the microfinance loans and advances to customers accounted for Rs. 4.7 billion, representing 81.7 per cent of the total assets. The Core Capital level of the sector was Rs. 1.9 billion at end-2019 and all LMFCs were compliant with the minimum

Table 8.15
Performance of Licensed Microfinance Companies

Rs. billion

Item	2019
Total Assets	**5.8**
Loans and advances	4.7
Investments	0.1
Others	1.0
Total Liabilities	**3.7**
Total Borrowings	2.5
Others	1.3
Equity	**2.1**
Stated Capital	1.1
Reserves	0.1
Core Capital	1.9
Interest Income	1.6
Interest Expenses	0.3
Net Interest Income	1.3
Profit/ (Loss) before Tax	0.2
Profit/ (Loss) after Tax	**0.1**

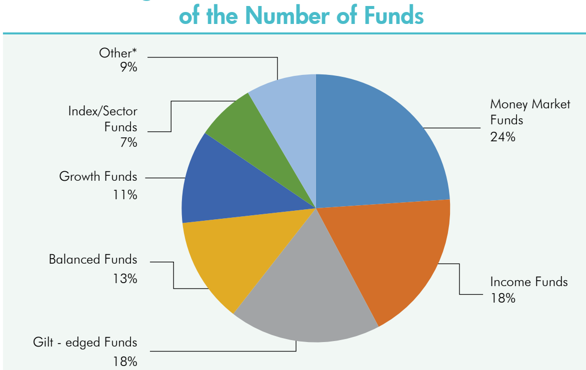
Source: Central Bank of Sri Lanka

prudential regulations on Core Capital and Liquidity requirements. Despite a significant increase in the operating expenses, the LMFC sector reported an overall profit of Rs.0.1 billion after taxation as at end-2019.

Unit Trusts

The number of Unit Trusts (UTs) declined to 71 by end-2019, from 75 reported at end-December 2018, whereas the number of UT management companies remained at 14 in 2019. The 71 UTs comprise 17 Money Market Funds, 13 Gilt Edged Funds, 13 Income Funds, 9 Balanced Funds, 8 Growth Funds, 5 Index Funds, 4 Shariah Funds, 1 (Initial Public Offering) IPO Fund and 1 Dollar Bond Fund.

Figure 8.14
Categorisation of the UT Sector in terms of the Number of Funds



*Other: Shariah funds 4, IPO fund 1 and Dollar fund 1

Source: Securities and Exchange Commission

Table 8.16
Performance of the UT Sector

Details	2018(a)	2019(b)
No. of Unit Trusts	75	71
Total No. of Unit Holders	42,093	46,481
No. of Units in Issue (mn)	3,368	4,769
Total Assets (Rs. bn)	64.3	104.9
Net Asset Value - NAV (Rs. bn)	64.2	104.8
Investments in Equities (Rs. bn)	9.5	9.8
Share of Total Net Assets (%)	14.7	9.4
Investments in Government Securities (Rs. bn)	2.5	4.0
Share of Total Assets (%)	3.8	3.8

(a) Revised
(b) Provisional

Source: Securities and Exchange Commission of Sri Lanka
Unit Trust Association of Sri Lanka

Business Growth

An expansion was observed in the total asset base of the UTs sector during the year 2019. The total assets of the sector increased by 63.2 per cent to Rs. 104.9 billion by end-2019. The number of units issued also increased to 4,769 million by end-2019 from 3,368 million reported at end-2018. As a result, the total number of unit holders increased to 46,481 by end-2019 from 42,093 reported at end-2018.

Investment

The share of the UT sectors' investment in government securities as a percentage of total assets remained at 3.8 per cent at end-2019. However, investment in equities as a percentage of total assets declined to 9.4 per cent at end-2019 compared to 14.7 per cent at end-2018.

Insurance Sector

The insurance sector reported a decline in net operational performances in spite of its increased asset base in 2019. There were 28 insurance companies in business by end-2019, out of which 13 were long-term insurance companies, 12 were general insurance companies and 3 companies were involved in both long-term and general insurance business. The Insurance Regulatory Commission of Sri Lanka (IRCSL) issued one new licence to a general insurance company in 2019. There were 9 insurance companies registered in the CSE in 2019. In addition, there were 66 Insurance Brokering Companies in 2019, which either engaged exclusively in general insurance business or both general and long-term insurance business.

Business Growth

Total assets of the insurance sector grew by 11.6 per cent during 2019 and reached Rs. 691.4 billion by end-2019. The long-term insurance subsector enhanced its asset base by 13.4 per cent from Rs. 429.7 billion at end-2018 to Rs. 487.2 billion at end-2019. Meanwhile, the general insurance subsector increased its asset base by only 7.4 per cent to reach Rs. 204.2 billion by end-2019. It was observed that the share of the asset base of the long-term insurance subsector over the total insurance sector asset base remained high at 70.5 per cent at end-2019, which is a slight increase from 69.3 per cent at end-2018. Corresponding to this increase, the share of general insurance subsector assets over total assets declined slightly to 29.5 per cent at end-2019 from 30.7 per cent at end-2018.

Gross written premium of the insurance sector grew by 8.4 per cent and reached Rs. 196.8 billion at end-2019 from Rs. 181.5 billion at end-2018. The long-term insurance subsector's gross written premium increased by 10.6 per cent, whereas the gross written premium of the general insurance subsector increased by 6.7 per cent during the year. However, the general insurance subsector remained the main contributor to the gross written premium of the sector which recorded a share of 54.9 per cent at end 2019. The gross written premium of the motor insurance, which is the main area of business in the general insurance subsector, grew slightly by 4.0 per cent at end-2019. The highest growth of gross written premium in the general insurance subsector was recorded from the health insurance area, which is a growth of 16.9 per cent, followed by the fire insurance area which recorded a growth of 15.5 per cent during 2019. Marine insurance which is the lowest contributor for the gross written premium grew by 1.3 per cent during the year 2019.

Earnings

Profitability of the insurance sector dropped during 2019, reporting a decrease of 21.7 per cent in profits. The decline in profitability was observed in both long-term insurance and general insurance subsectors. Profits of the long-term insurance subsector reported a decline of 25.9 per cent and the general insurance subsector reported a decline of 12.9 per cent during the year. Meanwhile, the underwriting profits of the sector also declined by 11.1 per cent during 2019.

The insurance sector reported an increase in its claims by 10.3 per cent to reach Rs. 97.8 billion by end-2019. The general insurance subsector claims increased by 12.6 per cent, while claims of the long-term insurance subsector increased by 7.1 per cent in 2019.

Table 8.17
Performance of the Insurance Sector

Rs. billion

Item	2018 (a)	2019 (b)
Total Assets	619.8	691.4
Government Securities	229.6	242.4
Equities	42.4	41.4
Cash & Deposits	93.5	108.2
Total Income	228.7	252.2
Premium Income	181.5	196. 8
Investment Income	47.2	55.2
Profit Before Tax	35.4	27.8
Capital Adequacy Ratio (%) - Long-term Insurance	312.1	298.0
- General Insurance	178.3	231.2
Retention Ratio (%) - Long-term Insurance	95.8	95.8
- General Insurance	81.6	83.0
Claims Ratio (%) - Long-term Insurance	47.1	45.6
- General Insurance	65.1	67.4
Combined Operating Ratio (%) - Long-term Insurance	100.6	96.0
- General Insurance	101.3	105.3
Return on Assets (ROA) (%) - Long term Insurance	5.9	3.9
- General Insurance	6.0	6.1
Return on Equity (ROE) (%) - Long term Insurance	25.8	16.0
- General Insurance	13.1	12.3
Underwriting Ratio (%) - General Insurance	18.0	14.7

(a) Revised
(b) Provisional

Source: Insurance Regulatory Commission of Sri Lanka

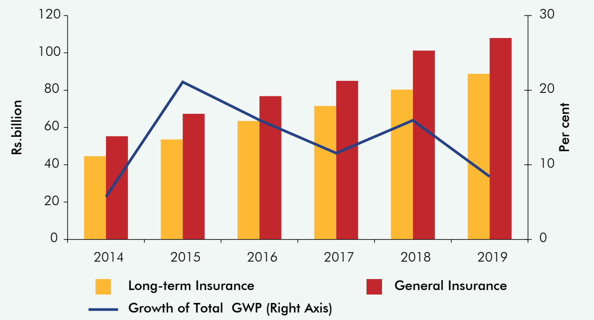
The total investment income of the insurance sector indicated a growth of 16.8 per cent during 2019. However, all profitability ratios of the insurance sector reported a decline during the year except for the ROA of the general insurance subsector which slightly increased to 6.1 per cent in 2019 from 6.0 per cent in 2018. The underwriting ratio declined to 14.7 per cent during 2019 from 18.1 per cent reported during 2018. The ROA of the long-term insurance subsector declined to 3.9 per cent in 2019 from 5.9 per cent in 2018. The ROE for the general insurance subsector slightly declined to 12.3 per cent from 13.1 per cent recorded in 2018, whereas, the ROE for the long-term insurance subsector significantly declined to 16.9 per cent in 2019 from 25.8 per cent recorded in 2018.

Capital and Investment

Capital to total assets of the long-term insurance subsector remained at 23.0 per cent during 2019, whereas the capital to total assets of the general insurance subsector slightly declined to 46.0 per cent at end-2019 from 49.0 per cent at end-2018. All insurance companies complied with the capital adequacy requirements imposed by the IRCSL.

The investments made by the insurance sector continued to be highly concentrated in government securities. However, long-term insurance subsector assets on government securities as a share of its total assets slightly declined to 38.7 per cent at end-2019 compared to 41.1 per cent at end-2018. In line with this slight decrease, the share of the general insurance subsector's assets invested on government securities also declined slightly to 26.4 per cent at end-2019 compared to 28.0 per cent reported at end-2018. The share of

Figure 8.15
Gross Written Premium of the Insurance Sector



Source: Insurance Regulatory Commission of Sri Lanka

investment on equity of the long-term insurance subsector decreased to 6.2 per cent at end-2019 compared to 6.9 per cent at end-2018. Meanwhile, the general insurance subsector's investment on equity declined to 5.6 per cent at end-2019 from 6.7 per cent at end-2018.

Supervisory and Regulatory Developments

The regulatory and supervisory function of the insurance sector was further strengthened in the year 2019 by the IRCSL issuing directions and circulars. A circular was issued to long-term insurance companies to address the matter of issuing stand-alone health insurance policies and the Direction "Supply of Policy Documents to Life Assured/Beneficiary" was amended as certain life assureds/beneficiaries had not been given a copy of the policy document in the instances where the life assured was not a policyholder. Further, a direction was issued by the IRCSL to insurance brokers on compliance with the minimum net capital requirement.

Superannuation Funds

The total assets of the superannuation funds were reported to be Rs. 3,096.5 billion at end-2019 reporting 15.4 per cent of the financial sector assets. The sector was dominated by the EPF, which accounted for 82.0 per cent of its assets in 2019. In addition to the EPF, there were two other publicly managed funds, namely, the ETF and the state sector Public Service Provident Fund (PSPF).

Employees' Provident Fund

As per the Employees' Provident Fund 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.

(a) Membership, Member Balances and Refunds: The total value of the Fund increased by Rs. 251.1 billion to Rs. 2,540.4 billion at end-2019 from Rs. 2,289.4 billion recorded by end-2018 recording an 11.0 per cent growth. This increase was due to the combined effect of the 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. 2,497.6 billion at end-2019 recording a 10.8 per cent increase from Rs. 2,254.2 billion at end-2018. The total contribution for the year 2019 increased by 8.4 percent to Rs. 157.2 billion while the total amount of refunds made to the members and their legal heirs in 2019 was Rs. 126.3 billion, which was an increase of 17.0 per cent over 2018. Accordingly, the net contribution was Rs. 30.9 billion compared to Rs. 37.0 billion recorded in the previous year. The annual profit of the Fund increased by 16.9 per cent to Rs. 222.8 billion in 2019 from Rs. 190.6 billion from the previous year. This was mainly due to the increase in the interest income of Rs. 25.2 billion compared to 2018 and the reduction of marked to market losses from listed equity investments from Rs. 10.9 billion in 2018 to Rs. 1.9 billion in 2019.

(b) Investment of Funds and Return: The total investment portfolio (book value) of the Fund grew by 10.9 per cent to Rs. 2,548.7 billion as at the end of 2019 from Rs. 2,298.8 billion at the end of 2018. 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 the adequate level of liquidity to meet refund payments and other expenses of the Fund. Accordingly, at the end of 2019, the investment portfolio consisted of 93.8 per cent in government securities, 3.0 per cent in equity, 1.7 per cent in corporate debentures and trust certificates, 0.9 per cent in fixed deposits and the remaining 0.6 per cent in Reverse Repurchase agreement.

The total investment income of the Fund was Rs. 259.0 billion in 2019, and recorded an increase of 16.5 per cent compared to the previous year. Interest income including amortisation gains continued to be the major source of income to the Fund which grew by 11.0 per cent to Rs. 254.7 billion in 2019 from Rs. 229.4 billion in 2018. Dividend income also increased by 60.7 per cent to Rs. 6.2 billion in 2019 compared to Rs. 3.9 billion in 2018. Net loss on Financial Instruments (FIs) at Fair Value Through Profit or Loss (FVTPL) recorded a loss of Rs. 1.9 billion in 2019 compared to net loss of Rs. 10.9 billion in 2018.

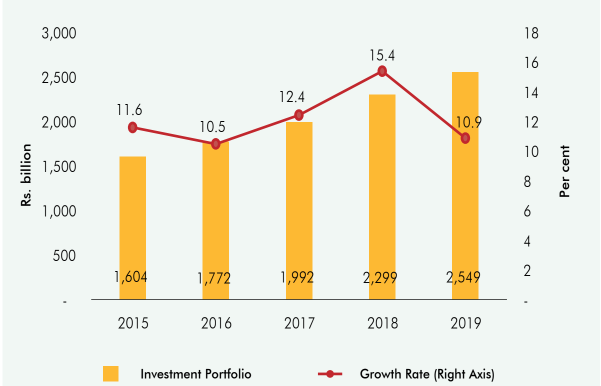
The Fund earned a total gross income of Rs. 259.3 billion in 2019, recording an increase of 16.4 per cent compared to the previous year. After adjusting for operating expenditure and tax expenditure, the net profit for the year 2019 was Rs. 228.8 billion which is an increase of 16.9 per cent compared to that of 2018. The EPF was able to earn a 10.7 per cent Return on Average Investment in 2019 while maintaining operating expenses to a gross income ratio of 0.6 per cent in 2019. 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. 4.2 billion in the tax expenditure when compared with the previous year. Furthermore, the Withholding Tax (WHT) of 10.0 per cent paid on Treasury bond interest income which had been recognised as part of gross income under the previous tax regulations has been abolished with effect from 01 April 2018. Also, the adoption of SLFRS 09, the Accounting Standard applicable for classification and measurement of Financial Instruments, where listed equity instruments are measured at a fair value and under the prevailed market conditions, a marked to market loss of Rs. 1.9 billion was charged against the profit for the year 2019. Accordingly, the EPF has taken measures to declare an interest rate of 9.25 per cent on member balances in 2019 after transferring Rs. 7.7 billion to the Profit Equalisation Reserve.

Table 8.18
Five year Performance Summary of EPF

Item	2015	2016	2017	2018	2019(a)
Total Value of the Fund (Rs. bn.)	1,664.9	1,841.5	2,066.3	2,289.4	2,540.4
Total Liability to the Members (Rs. bn.)	1,625.5	1,810.6	2,020.8	2,254.2	2,497.6
Total Contribution (Rs. bn.)	102.5	118.3	133.3	145.0	157.2
Total Refunds (Rs. bn.)	77.8	108.4	117.5	108.0	126.3
Net Contribution (Rs. bn.)	24.7	9.9	15.8	37.0	30.9
Net Profit (Rs. bn.)	156.9	175.9	202.9	190.6	228.8

(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

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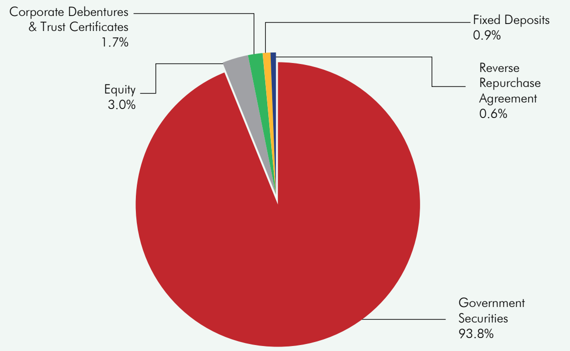
Figure 8.17
Composition of Investment Portfolio of EPF
(as at end 2019)



Source: Central Bank of Sri Lanka

(c) Risk Management: The existing risk management framework of the investment activities was further strengthened in 2019 with a view of enhancing the accountability and transparency of such activities. Accordingly, the Investment Policy Statement was revised and updated to be in line with updated market requirements, to improve the existing work procedures and to provide greater independence over the investment decision making process while maintaining an adequate level of internal controls. Further, the revised Investment Guideline is to be introduced, shortly. In addition, a comprehensive risk assessment was carried out by a team of World Bank risk experts to identify and cater to the prominent financial and non-financial risk aspects of the EPF Department with the guidance of the Risk Management Department of the Central Bank of Sri Lanka. The regular process of reporting the departmental risks to the Monetary Board through the Board Risk Oversight Committee of the Central Bank was continued throughout the year.

Table 8.19
Five Year Summary of Key Financial Performance of EPF

Rs. million

Item	2015	2016	2017	2018	2019(a)
Interest and Amortization gains	**169,645.9**	**193,656.3**	**219,635.3**	**229,446.0**	**254,681.0**
Dividend Income	3,512.4	4,262.6	2,993.6	3,887.6	6,247.5
Realized Capital Gains / (Loss)	1,724.3	1,064.0	-	7.2	0.1
Net gain / (loss) from FI at FVTPL	-394.0	-842.1	1,476.9	-10,901.3	-1,890.0
Impairment of Financial Assets	-2,956.6	-5,231.6	-1,502.1	0.6	0.3
Investment Income	**171,532.0**	**192,909.1**	**222,603.7**	**222,440.1**	**259,038.9**
Other Income	323.3	162.3	588.8	403.0	283.8
Total Gross Income	**171,855.3**	**193,071.4**	**223,192.5**	**222,843.1**	**259,322.7**
Operating Expenditure	-1,190.6	-1,487.2	-1,348.7	-1,505.3	-1,581.8
Income Tax	-13,727.4	-15,657.2	-18,897.1	-30,720.4	-34,964.6
Profit for the Year	**156,937.3**	**175,927.0**	**202,946.8**	**190,617.4**	**222,776.4**
Retained Profit b/f	311.3	215.6	189.3	2,471.0	159.5
Capital Gain on Disposal of Unlisted Equity	-	-	-	-	90.0
Profit available for distribution	**157,248.6**	**176,142.5**	**203,136.1**	**193,088.4**	**223,025.8**
Return on Average Investment (%)	11.3	11.4	11.8	10.4	10.7
Interest rate (%)	10.50	10.50	10.50	9.50	9.25

(a) Provisional
Source: Central Bank of Sri Lanka

Employees' Trust Fund

The Employees' Trust Fund that contributed 11.1 per cent of the asset base of the superannuation sector recorded an improvement in its asset base, number of members and the total contributions. Out of 15.3 million member accounts of the ETF, only 2.6 million accounts were active in 2019. The number of employers contributing to the fund slightly declined to 82,375 at end-December 2019 from 82,416 at end-December 2018. Total member balance of the ETF increased by 10.5 per cent to reach Rs. 338.6 billion at end-December 2019 compared to Rs. 306.5 billion at end-December 2018. The total contribution of the ETF increased by 8.7 per cent and reached Rs. 27.5 billion, while total refunds increased by 8.3 per cent and reached Rs. 19.8 billion which resulted in an increase of 9.7 per cent net inflow of funds during the year 2019.

Meanwhile, the total assets of the ETF increased by 10.5 per cent and reached Rs. 343.3 billion at end December 2019. The ETF's investment improved to Rs. 324.9 billion, which is an increase of 11.6 per cent compared to the year 2018. Out of these investments 76.9 per cent was invested in government securities in 2019, a marginal increase from the 75.2 per cent recorded in 2018. The share of investments in fixed deposits has slightly decreased to 17.2 per cent in 2019 compared to 18.3 per cent in 2018. Further, the share of

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Table 8.20
Performance of the EPF and the ETF

Item	EPF		ETF	
	2018 (a)	2019 (b)	2018 (a)	2019 (b)
Total Assets (Rs. bn)	2,289.4	2,540.4	310.8	343.3
Total Member Balance (Rs. bn)	2,254.2	2,497.6	306.5	338.6
Number of Member Accounts (mn)	18.6	19.0	14.6	15.3
Number of Active Member Accounts (mn)	2.8	2.5	2.6	2.6
Number of Employers Contributing	78,651	74,956	82,416	82,375
Total Contributions (Rs. bn)	145.0	157.2	25.3	27.5
Total Refunds (Rs. bn)	106.8	126.3	18.3	19.8
Total Investments Portfolio (Rs. bn)	2,298.8	2,548.7	291.1	324.9
o/w : Government Securities (%)	92.2	93.8	75.2	76.9
Gross Income (Rs. bn)	222.8	259.3	28.8	32.1
Profit Available for Distribution (Rs. bn)	193.1	223.0	23.3	24.6
Return on Investments (%)	10.4	10.7	9.7	9.7
Interest Rate Paid on Member Balances (%)	9.5	9.25	9.0	8.0

(a) Revised
(b) Provisional

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

investment in equity also declined to 3.3 per cent in 2019 compared to the share of 3.7 per cent reported in 2018. The fund managed to secure a rate of return of 8.0 per cent on its member balances for the year.

Other Superannuation Funds

The Public Service Provident Fund, which accounted for 2.1 per cent of the superannuation sector, continued to decrease in terms of the number of members and net contributions, while reporting a growth in terms of its assets. The number of active members of the fund was 222,739 at end-December 2019 when compared to 227,816 at end-December 2018. The total assets of the PSPF grew by 11.4 per cent and reached Rs. 63,674.8 million at end-December 2019. Meanwhile, the investments of the fund also grew by 12.6 per cent reaching Rs. 62,315.4 million in December 2019. The net contribution was positive: Rs. 491.3 million during the year 2019 when compared to the net contribution of Rs. 381.2 million reported in the year 2018. PSPF invested 35.5 per cent in government securities as a percentage of its total investments in 2019. The rate of return on member balances was 12.6 per cent for the year 2019.

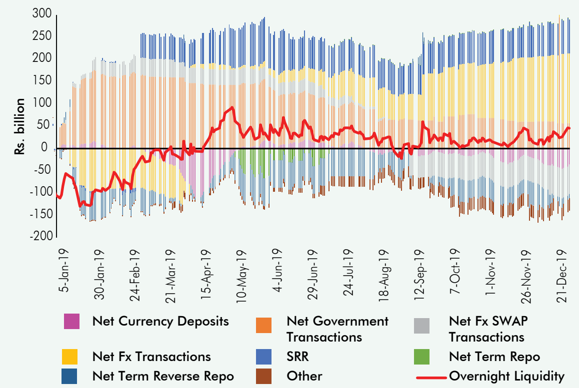
8.4 Performance of Financial Markets

Domestic Money Market

Market Liquidity

Liquidity in the domestic money market, which was in deficit levels until mid-April 2019, turned into a surplus level except for a brief period in August and September 2019. The downward revision of the SRR by 100 basis points to 5.00 per cent with effect from 01 March 2019 was instrumental in easing the pressure on liquidity conditions in the domestic money market. Nevertheless, the liquidity deficit continued to persist until mid-April 2019 largely due to currency withdrawals during the festive season and foreign loan repayments of the government. Subsequently, market liquidity deficit turned into a surplus level from mid-April 2019 as a result of the conversion of ISB proceeds supported by the foreign currency purchases by the Central Bank as well as currency deposits after the festive season. Although the money market reported surplus liquidity on an aggregate basis, liquidity was mainly concentrated among certain LCBs, particularly foreign banks. Considering such an asymmetric distribution of liquidity in the domestic

Figure 8.18
Daily Changes in the Money Market Liquidity and Contributory Factors in 2019



Source: Central Bank of Sri Lanka

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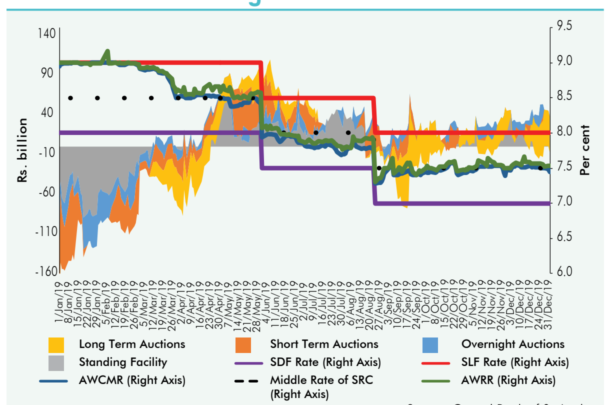
money market and resulting pressure on short term interest rates, the Central Bank conducted reverse repurchase auctions with a view to induce a downward adjustment in the Average Weighted Call Money Rate (AWCMR) in spite of the surplus liquidity position in the domestic money market. With the maturing of foreign currency swap transactions and Treasury bills held by the Central Bank, liquidity in the domestic money market turned into a deficit by end-August 2019. Considering the anticipated movements in liquidity conditions in the domestic money market during the ensuing period and considering lower demand for Treasury bills at the outright auctions due to unavailability of required securities with the market participants, by expanding the eligible instruments for OMOs, the Central Bank introduced outright purchase of Treasury bonds since mid-September 2019 to inject liquidity into the domestic money market on a permanent basis. By end-December 2019, the Central Bank had injected around Rs. 47.7 billion to the domestic money market by way of purchasing Treasury bonds at the outright auctions. Meanwhile, in view of providing liquidity assistance for Standalone Primary Dealers (SPDs), a Liquidity Support Facility (LSF) was introduced in September 2019 to ensure smooth functioning of the domestic money market. LSF also facilitated the effective signalling of OMOs and the maneuverability of the AWCMR to the desired levels. Under LSF, the Central Bank provided about Rs. 22.6 billion by end-December 2019 to support overnight funding needs of SPDs. The Central Bank continued to ensure the availability of adequate liquidity in the domestic money market with the objective of steering the AWCMR around the middle rate of the Standing Rate Corridor (SRC). In addition to newly introduced measures, the Central Bank actively engaged in OMOs on a daily and term basis to infuse liquidity and absorb liquidity depending on market developments. Accordingly, market liquidity stood at a surplus of around Rs. 37.8 billion by end-December 2019.

Money Market Interest Rate

The AWCMR which remained closer to the upper bound of the SRC during the first three months of 2019, responded swiftly to monetary policy relaxing measures, while active OMOs helped in steering the AWCMR around the middle of the SRC. During the latter part of 2018 and early 2019, the AWCMR was maintained closer to the upper bound of the SRC in view of external sector concerns. With the improvements of the external sector environment, the AWCMR was allowed to move towards the middle of the SRC supported by the availability of adequate liquidity in the domestic money market. Following the policy rate reductions by a total of 100 basis points during the months of May and August 2019, the AWCMR declined even below the middle point of the SRC. Accordingly, appropriate OMOs were conducted to steer the AWCMR towards the desired level. The Average Weighted Repo Rate (AWRR) also followed a similar trend to the AWCMR. By end-December 2019, the AWCMR and the AWRR stood at 7.45 per cent and 7.53 per cent, respectively.

Figure 8.19
Open Market Operations and Movements in Overnight Interest Rates



Source: Central Bank of Sri Lanka

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Table 8.21
Overall Summary of Money Market Transactions and OMOs

Transactions	Volume (Rs. bn)		Weighted Average Interest Rate (Min-Max) - %	
	2018	2019	2018	2019
Market				
Call Money (Overnight)	4,196	4,775	7.76 - 9.00	7.28 - 9.00
Repo (Overnight)	2,761	3,456	7.48 - 9.00	7.30 - 9.17
Open Market Operations				
Overnight Basis				
Repo	1,530	661	7.25 - 8.33	7.31 - 8.56
Reverse Repo	3,386	2,043	7.85 - 8.98	7.31 - 9.00
Liquidity Support Facility (Reverse Repo)	-	23	-	7.46 - 7.60
Short Term Basis				
Repo	215	327	7.27 - 8.28	7.55 - 8.61
Reverse Repo	969	566	7.85 - 9.00	7.39 - 9.00
Long Term Basis				
Repo	97	103	7.38 - 8.33	7.85 - 8.67
Reverse Repo	318	397	7.97 - 8.74	7.30 - 8.86
Outright Basis				
Purchase of T-bills	40	42	8.25 -10.10	7.75 - 10.50
Purchase of T-bonds	-	48	-	8.47 - 9.25
Sale of T-bills	64	-	7.40 - 8.34	-
Sale of T-bonds	-	-	-	-
Standing Facility (at Policy Rates)				
Standing Deposit Facility	4,503	7,489	-	-
Standing Lending Facility	3,058	4,794	-	-

Source: Central Bank of Sri Lanka

Other Developments

The Central Bank expanded its monetary policy instruments under OMO in 2019. Introduction of the LSF and outright auctions of Treasury bonds in conjunction with the existing OMOs which operated largely through repurchase and reverse repurchase auctions added more stimulus to the liquidity management mechanism of the Central Bank. The LSF helped to improve the signalling effect of OMOs and the outright auctions of Treasury bonds facilitated resolving the structural liquidity concerns which prevailed in the domestic money market.

Although monetary policy implementation encountered certain issues in 2019, the Central Bank was able to effectively manage market liquidity and ensure stability in short-term money market rates. Asymmetric distribution of liquidity amongst market participants and the counterparty limits applicable for LCBs led some participants to continuously borrow from the Central Bank and induce some pressure on the repo market. However, depending on market developments, the Central Bank conducted OMOs appropriately to ease any possible pressure on interest rates. These measures yielded reduction of the volatility of short-term money market interest rates. Furthermore, with the introduction of the LSF, the gap between AWCMR and AWRR was reduced positively.

Domestic Foreign Exchange Market

During the year the Sri Lankan rupee appreciated marginally against the US dollar by 0.61 per cent from Rs. 182.75 as at end-December 2018 to Rs. 181.63 as at end-December 2019. With the positive impact of the policy measures taken by the Central Bank and the government in late 2018 to mitigate the sharp depreciation pressure exerted on the exchange rate in 2018, the Sri Lankan rupee continued to show an appreciating trend throughout 2019. This was further supported by the easing of external pressure and the increase in conversion of export proceeds in 2019. Despite the slight increase in the pressure on the exchange rate following the Easter Sunday attacks and the decline in inflows on account of tourism observed in the aftermath of the attacks, the receipts of the

Figure 8.20
Movement of Rupee per US dollar in 2019

Source: Central Bank of Sri Lanka

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delayed sixth tranche of the EFF from the IMF in May 2019, and the ISB issuance in June 2019 supported to uphold the value of the Sri Lankan rupee against US dollar. Accordingly, the Sri Lankan Rupee appreciated at a higher pace during the first half of 2019.

Although this overall appreciating trend slowed down during the month of August mainly due to the repatriation of foreign investments from the government securities market, following the presidential election in November 2019, the exchange rate appreciated again at a moderate pace. However, during the month of December, with the repatriation of foreign investments from the government securities market, the exchange rate depreciated. Accordingly, during the year 2019 the Sri Lankan rupee appreciated by 0.61 per cent against the US dollar. Further, in line with the overall appreciation of Sri Lankan rupee against the US dollar, the average US dollar buying and selling exchange rate of LCBs for telegraphic transfers as of end-2019 were at Rs. 179.66 and Rs. 183.33, whilst comparative figures for end-2018 were Rs. 180.72 and Rs. 184.70, respectively.

Meanwhile, during the year the Sri Lankan rupee appreciated against the Indian rupee, Australian dollar and Euro, whereas it depreciated against Japanese yen and Sterling pound. Interest rate cuts by the Reserve Bank of India and Reserve Bank of Australia led the Sri Lankan rupee to appreciate against the Indian rupee and Australian dollar. Further, political uncertainties in the Euro Zone resulted in the Sri Lankan rupee appreciating against the Euro during the year. Increase in safe haven demand for the Japanese yen due to geo-political uncertainty and potential expectation of Brexit after the new Prime Minister's appointment in Great Britain led to the depreciation of the Sri Lankan rupee against the Japanese yen and Sterling pound during the year 2019.

The Central Bank was a net buyer in the domestic foreign exchange market during the year 2019. Continuous purchases of US dollars from the market despite moderate sales during periods of excessive volatility in the exchange rate, enabled the Central Bank to build up the foreign reserves of the country. Accordingly, during 2019 the Central Bank absorbed US dollars 593.9 million and supplied US dollars 206.9 million resulting in a net purchase of US dollars 387.0 million.

During the year 2019, trading volumes in the domestic foreign exchange inter-bank market increased by 11.3 per cent compared to that of 2018. The total volume of inter-bank foreign exchange transactions amounted to US dollars 19.4 billion during this period compared to US dollars 17.4 billion in the corresponding period of 2018. In line with this, the daily average volumes in the inter-bank foreign exchange market increased to US dollars 80 million in 2019, from US dollars 73 million in 2018. Further, even though the total volume of forward transactions for the year 2019 increased to US dollars 7.7 billion compared to US dollar 6.6 billion during the period in 2018, the spot transaction volumes remained unchanged at 60 per cent of the total annual volume in 2019 as well, reflecting the developed nature of the domestic foreign exchange market.

Government Securities Market

The Treasury bill yield rates adjusted downwards towards the end of the first quarter of 2019 from the higher levels that prevailed at end-2018. The strategic issuance arrangements with predictable issuance calendar, improvement of money market liquidity due to reduction of the SRR applicable on LCBs, by 100 basis points to 5.00 per cent in March 2019 and the positive

Table 8.22
Yield Rates of Government Securities

Per cent per annum

Item	Primary Market		Secondary Market	
	2018	2019	2018	2019
Treasury bills				
91-Days	7.75 - 10.07	7.45 - 9.55	7.61 - 9.93	7.40 - 9.79
182-Days	7.95 - 10.03	7.58 - 9.95	7.93 - 10.44	7.55 - 9.96
364-Days	8.80 - 11.25	8.11 - 10.99	8.78 - 11.15	8.04 - 10.91
Treasury bonds				
2-Years	-	9.79 - 10.85	9.05 - 11.36	8.46 - 11.16
3-Years	9.55 - 11.88	9.65 - 10.72	9.32 - 11.61	8.86 - 11.42
4-Years	-	-	9.37 - 11.82	9.37 - 11.53
5-Years	9.44 - 11.69	9.83 - 11.58	9.45 -11.87	9.56 - 11.58
6-Years	-	-	9.53 - 11.97	9.79 - 11.64
10-Years	10.20 - 12.23	10.23 - 11.73	9.72 - 12.25	9.94 - 11.87
15-Years	10.05 - 10.88	10.59	9.97 - 12.37	10.11 - 12.01
30-Years	-	-	10.29 - 12.39	10.36 - 12.15

Source: Central Bank of Sri Lanka

market sentiments that emanated from the issuance of ISB to the value of US dollars 2.4 billion in March 2019 were the main contributory factors for the downward adjustment of yield rates in the short-term government securities market during the first quarter of 2019. The excess funds of the banking sector due to low demand for loans and advances, and the move towards risk-free investments such as Treasury bills also contributed towards the downward adjustment of the yield curve. Continuation of the accommodative monetary policy stance of the Central Bank where Standing Deposit and Lending Facility Rates were also adjusted downwards in May and August 2019, issuance of benchmark maturities in line with market preference and resource availability coupled with the second successful accessing of international capital markets for 2019 by the government in June 2019 for US dollars 2.0 billion, further eased the pressure in the domestic market and as a result a gradual decline in short-term interest rates of government securities

Table 8.23
Primary Market Treasury Bond Issuances

Year	Amount Issued (Rs. bn)		
	Auction	Placements	Total
2016	654	9	664
2017	536	13	549
2018	763	-	763
2019	798	-	798

Source: Central Bank of Sri Lanka

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was observed during the second and third quarter of 2019. The downward adjustment continued in the fourth quarter as well, albeit at a slower pace until the rates started to move upwards post the credit rating downgrade by the rating agencies towards end-2019 and early 2020. Withdrawal of foreign investments from emerging market economies including Sri Lanka mainly due to continuing growth and positive economic outlook in the United States resulted in reduced foreign holdings of Treasury bills and Treasury bonds by end-2019 compared to end-2018.

The debt management strategies adopted during the year focused mainly on maintaining a stable outlook in the government securities market. Accordingly, the benchmark 364-day Treasury bill yield rate which was above 10.00 per cent levels since October 2018 declined to below 10.00 per cent levels in early January 2019 and recorded a decline of 275 basis points by end-2019 compared to end-2018. Further, the yield rates for 91-day, 182-day and 364-day maturity Treasury bills stood at 7.51 per cent, 8.02 per cent and 8.45 per cent, respectively, as at end-December 2019. Moreover, the downward adjustment in short-term interest rates was also reflected in medium term Treasury bond yield rates during the second half of 2019.

Total net outflow of foreign investments in Treasury bonds and Treasury bills amounted to US dollars 333.7 million which consisted of net inflow of US dollars 54.5 million in Treasury bills and net outflow of US dollars 388.2 million in Treasury bonds during the year 2019. The outstanding foreign holdings of Treasury bonds and Treasury bills as at end-2019 amounted to Rs. 103.9 billion compared to Rs. 158.6 billion as at end-2018, recording a noteworthy decrease of 34.5 per cent on a year-on-year basis.

In order to convert a part of the government floating rate securities to fixed rate securities and lengthen the maturity profile, the Central Bank only raised US dollars 345.2 million against the

Table 8.24
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
2019	8.15	8.44	9.40	9.07

Source: Central Bank of Sri Lanka

maturing amount of US dollars 621.8 million of Sri Lanka Development Bonds (SLDBs) during 2019 and funds raised through the ISBs were utilised to pay back the remaining maturities of SLDBs which eased the pressure on government financing requirement and stabilised the interest rates in the domestic market. During 2019, the Average Time to Maturity (ATM) of the outstanding central government domestic currency debt decreased to 5.78 years by end-2019 compared to 5.91 years at end-2018 primarily due to higher levels of yield structure which prevailed in the early part of 2019 and higher volumes of fund requirement. The ATM of the outstanding Treasury bond portfolio decreased to 6.82 years at end-2019 compared to 6.88 years at end-2018. The marginal downward adjustment of the ATM is mainly attributed to issuance of short to medium term maturities of Treasury bonds during 2019.

Corporate Debt Securities Market

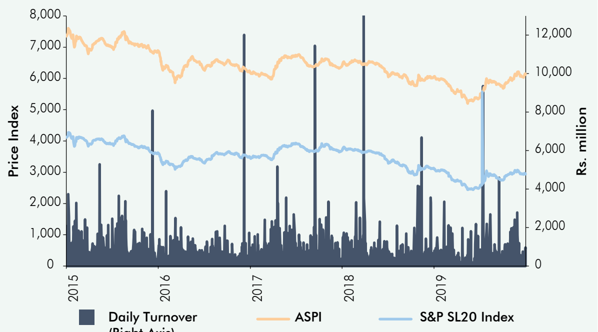
The Commercial Paper (CP) market was relatively active in 2019 compared to 2018. During 2019, Rs. 4.2 billion was raised through fifteen CP issuances with the support of licensed banks compared to Rs. 1.9 billion raised through six issues in 2018. Interest rates of CPs varied in the range from 13.00 to 16.25 per cent during the year compared to a range of 13.10 to 15.00 per cent reported in the previous year. Out of the total amount raised through CPs during the year 2019, 79.7 per cent was raised through CPs with maturities less than three months while the remaining 20.3 per cent was raised through CPs with maturity of twelve months. The total outstanding value of CPs amounted to Rs. 2.1 billion at end-2019 compared to Rs. 1.1 billion at end-2018.

Level of activity in the corporate bond (debenture) market improved during 2019 compared to 2018. During 2019, there were thirty corporate debenture IPOs by 15 companies in the Colombo Stock Exchange (CSE) which raised Rs. 57.9 billion compared to Rs. 55.9 billion raised in 2018. Out of the fifteen companies which listed their corporate debentures in the CSE, ten institutions were banks and other financial institutions. Debentures with both fixed and floating interest rates were issued during 2019 while the fixed interest rates were in the range from 12.30 to 15.50 per cent compared to the range of 12.00 – 14.75 in the previous year. The two-highest listed corporate debt issuances recorded in 2019 were by DFCC Bank and Hatton National Bank which raised Rs. 10.0 billion each.

Equity Market

The CSE recorded mixed performance during 2019 amidst adverse developments in the domestic and global environment. The ASPI grew by 1.3 per cent in 2019 against the 5.0 per cent decline reported in 2018 while S&P SL20 index declined by 6.3 per cent in 2019 compared to the 14.6 per cent decline reported in 2018. ASPI declined by 3.6 per cent immediately after the Easters Sunday attacks and reached 5,200 in May 2019, its lowest value reported since 2012 and picked up gradually. The CSE indicators picked during the month of November 2019 mainly due to the positive sentiments that prevailed among investors towards the presidential election.

Figure 8.21
ASPI, S&P SL20 Index & Daily Turnover at the CSE



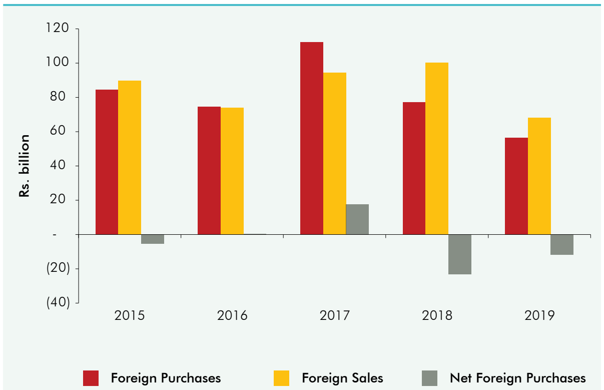
Source: Colombo Stock Exchange

Market recorded improvements in terms of market capitalisation and Price to Earnings Ratio (PER) in 2019. Market capitalisation increased marginally by 0.4 per cent from Rs. 2,839.5 billion in 2018 to Rs. 2,851.3 billion at end-2019. As a percentage of GDP, total market capitalisation reached 21.5 per cent at end-2019, a marginal increase from 21.4 per cent reported in 2018, which remained low compared to peers in the Asian region. However, the average daily turnover declined to Rs. 711.2 million during 2019 compared to Rs. 833.6 million in 2018. The turnover velocity (the ratio of total turnover to average market capitalisation) further deteriorated to 6.4 per cent in 2019 from 6.9 per cent in 2018. Market PER increased to 10.8 times at end-2019 from 9.7 times reported at end-December 2018. The ratio reported its lowest value which was 8.1 per cent in May 2019 and highest value of 11.0 per cent in December 2019.

Foreign outflows from CSE continued during 2019, though some improvements were observed in terms of net foreign outflows when compared to 2018. In the secondary market, CSE reported a net foreign outflow of Rs. 11.7 billion during the year 2019 compared to Rs. 23.2 billion in the year 2018. The outflows from the secondary market reported during 2019 are mainly due to security concerns caused by Easter Sunday attacks and prevailed political instability which affected investor confidence. Meanwhile, the foreign investor contribution to total market turnover significantly declined to 36.4 per cent in 2019 from 44.3 per cent in 2018.

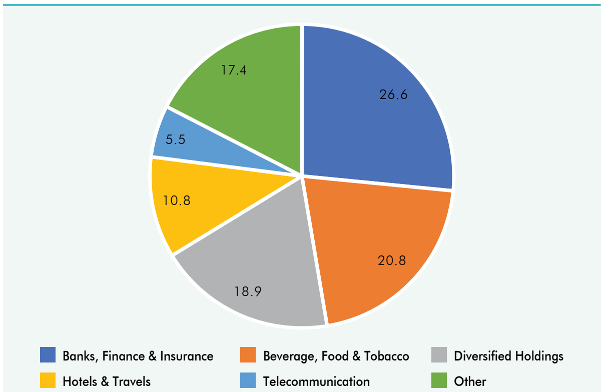
The primary market continued to remain less active in 2019. There were no Initial Public Offerings in 2019 compared to Rs. 2.0 billion raised through two IPOs during 2018. Meanwhile, Rs. 31.0 billion was raised through 18 right issues in 2019 compared to Rs. 42.2 billion raised through 16 issues in 2018.

Figure 8.22
Foreign Participation at the CSE



Source: Colombo Stock Exchange

Figure 8.23
Market Capitalisation at the CSE (as at December 2019)



Source: Colombo Stock Exchange

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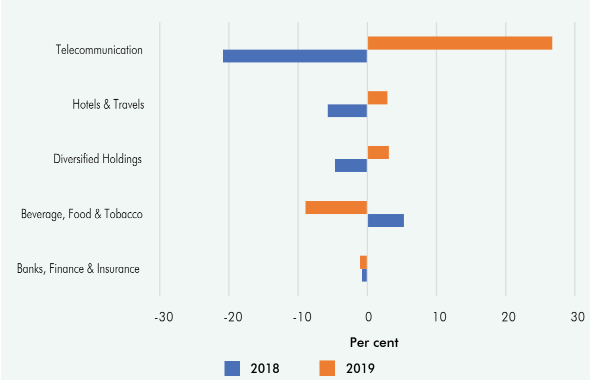
Figure 8.24
Year on Year Growth in Indices of Major Subsectors at CSE



Source: Colombo Stock Exchange

Most of the price indices of subsectors of the equity market reported an improvement in 2019 compared to the previous year. The bank, finance & insurance, beverage, food & tobacco, diversified holdings, hotels & travels and telecommunication sectors were the five major subsectors which altogether contributed to 82.6 per cent of the total market capitalisation by December 2019. The banks, finance & insurance sector index declined in both 2019 and 2018 year-on-year by 1.0 per cent and 0.8 per cent, respectively. Index of the beverage, food & tobacco sector which accounts for 20.8 per cent of the total market capitalisation, declined by 8.9 per cent year-on-year in 2019 compared to the 5.3 per cent growth that was registered in the previous year. Indices of the subsectors diversified holdings, hotels & travels, and telecommunication improved in 2019 when compared to the previous year. Even though the hotels & travels sector index significantly declined in April 2019 as a result of the adverse shock created by Easter Sunday attacks, the index picked up in the second half of 2019.

Impact of the recent downturn in major stock markets was reflected in the performance of the CSE. Price indices of the CSE declined notably in early March 2020 in line with the downturn in the Asian stock market triggered by the COVID-19 outbreak. A net market foreign outflow of US dollars 12.4 million was recorded from CSE from 01 February 2020 to 20 March 2020.

Several regulatory measures were taken by the Securities and Exchange Commission to ensure the smooth functioning of the equity market. SEC introduced a revised qualification framework to ensure a minimum level of competency for investment advisors in the stock broking industry. Further, the business and operational specification of the Delivery vs. Payment and enhanced margining model were finalised, and the CSE is instructed to commence the implementation process. The duality of Chief Executive Officer and Chairperson of listed companies was imposed by amending the Corporate Governance Framework. Furthermore, SEC formulated the BASEL III approval framework for state-owned banks' listing of contingent convertibles.

Table 8.25
Selected Indicators of Equity Market

Item	2018	2019
All Share Price Index (1985=100) (a)	6,052.4	6,129.2
Year-on-Year Change (%)	-5.0	1.3
S&P SL 20 Index (2004 = 1000) (a)	3,135.2	2,937.0
Year-on-Year Change (%)	-14.6	-6.3
Market Capitalisation (Rs. bn) (a)	2,839.5	2,851.3
As a Percentage of GDP (%)	21.4	21.5
Market Price Earnings Ratio (a)	9.7	10.8
Turnover to Market Capitalisation (%)	7.0	6.0
Average Daily Turnover (Rs. mn)	833.6	711.2
Value of Shares Traded (Rs. bn)	200.1	171.4
Number of Shares Traded (mn)	6,000.7	9,855.0
Number of Companies Listed	297	289
Introductions (b)	1	2
Number of Initial Public Offers/ Offers for Sale (b)	2	0
Number of Rights Issues	16	18
Amount Raised Through Rights Issues and Initial Public Offers (Rs. bn)	44.2	31.0

(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

8.5 Development Finance and Access to Finance

The Central Bank continued to engage in development finance and regional development activities by implementing various credit schemes and other programs, in fulfilling the agency function on behalf of the Government of Sri Lanka (GOSL) in 2019. Individuals and the Micro, Small and Medium Scale Enterprises (MSMEs) of the country have benefitted from these programmes through numerous refinance, interest subsidy and credit guarantee schemes, and credit supplementary services offered during the year by the Central Bank.

With the objective of enhancing income generating activities of the people in the rural areas of the country to achieve balanced economic growth, the Central Bank implemented 11 refinance, interest subsidy and credit guarantee schemes through the Regional Development Department (RDD). These schemes provided concessionary credit facilities amounting to Rs. 15,320 million through Participating Financial Institutions (PFIs) to 104,238 beneficiaries island wide. Out of this total disbursed amount, 68 per cent was for the interest subsidy schemes while the remaining balance of 32 per cent went to refinance for different loan schemes implemented by the Central Bank during the year 2019. When considering the total number of loans granted to beneficiaries, 83 per cent accounted for interest subsidy schemes and the balance part of 17 per cent accounted for refinance loan schemes. The funding sources of these schemes were mainly the Central Bank, the GOSL and international donor agencies such as International Fund for Agriculture Development (IFAD) and own funds of PFIs.

The GOSL continued the "Enterprise Sri Lanka" (ESL) Programme in 2019 to improve the development finance and access to finance in the country by providing concessionary financial and non-financial assistance to youth, women and the micro, small and medium scale entrepreneurs operating in the agriculture, industry and services sectors in the country. The total number of loans granted under the ESL programme increased significantly to 44,841 in 2019 from 34,476 loans in 2018, and the value of loans granted increased to Rs. 84,882 million in 2019 from Rs. 65,364 million in 2018. Out of the total value of loans provided in 2019, 70.0 per cent (54.0 per cent of the total number of loans) was disbursed in 8 districts (i.e., Gampaha, Colombo, Kalutara, Galle, Matara, Hambantota, Kandy and Kurunegala) whilst the balance 30.0 per cent (46.0 per cent of the total no. of loans) was granted in 17 districts, which indicates the need of lending to the lagging districts under the programme. The GOSL paid approximately Rs. 2,525 million as the interest subsidy payments for the above loans in 2019. Further, the Ministry of Finance continued the ADB funded Rooftop Solar Power Generation Line of Credit (RSPGLoC) and Small and Medium-sized Enterprises Line of Credit Project (SMELoC) during the year. Accordingly, in 2019, RSPGLoC loan scheme granted 1,162 loans amounting to Rs. 1,967 million to households and entrepreneurs while SMELoC loan scheme granted 971 loans amounting to Rs. 7,323 million to SME entrepreneurs.

An important new interest subsidiary scheme namely 'Smallholder Tea and Rubber Revitalisation (STaRR)' was implemented in 2019 to provide concessionary loans to the smallholder farmers involved in tea replanting and rubber new planting activities in the country. The STaRR Project is jointly funded by the GOSL and the IFAD with the collaboration of the Ministry of Plantation Industries and Export Agriculture (MPI&EA). This "STaRR Interest Subsidy Scheme", introduced under the "Inclusive Rural

Finance Component" of the STaRR Project, has a project duration of 2 years from 2019 to 2021. The Central Bank was identified as the agency for implementing the scheme. As a supplementary task for refinancing activities continued by the PFIs, interest subsidy payment to such PFIs will be released through the Central Bank starting from 2020 until 2024. The granting of the concessionary loans under this scheme is expected to be started in 2020.

Further, Smallholder Agribusiness Partnerships Programme (SAPP) which commenced its lending activities in the fourth quarter of 2018, continued to perform well during 2019. The SAPP programme is jointly funded by the IFAD and the GOSL. Considering the feedback at the initial phase of the scheme, the credit component of the SAPP was restructured to enhance the operational efficiency and develop better delivery channels for the beneficiaries in the country. Further, Operating Instructions for 5 new loan schemes were issued during the year 2019 to enhance different types of income generating activities of the community in the country. The loan scheme of SAPP includes two parts. One part is related to the Public-Private-Producer-Partnership (4P) model i.e. 4P Agribusiness and RF Agribusiness loan scheme 4P. The other part is related to individual models on value chain financing Youth Loan Schemes and RF Youth & RF Income Generation Loan Schemes.

Initiatives were taken to improve the financial inclusion in the country. The National Financial Inclusion Strategy (NFIS), developed by the Central Bank, with the technical and financial assistance obtained from the International Finance Corporation (IFC) of the World Bank Group, is a strategic policy initiative to identify and promote a more effective and efficient process to improve financial inclusion of the country. A Financial Inclusion Survey was conducted island-wide successfully in 2018 under the NFIS project and was further scrutinised to identify the existing strengths and weaknesses of the general landscape for improving financial inclusion level of the country.

In the latter part of 2019, groundwork for the establishment of a new Credit Guarantee Scheme (CG Scheme) to accelerate already affected businesses which need to fulfill the working capital requirements especially for defaulted SMEs was initiated by the Central Bank. The proposed CG Scheme is expected to act as a risk sharing tool to develop the SME sector by increasing access to finance by absorbing part of the credit risk of the PFIs and encouraging their lending to the SMEs. The Central Bank also conducted various programmes on entrepreneurship development and skill development, specially covering the young and women entrepreneurs in the country.

8.6 Financial Infrastructure

Payment and Settlement Systems

The Central Bank continued to maintain an effective payment and settlement infrastructure in the country in order to cater to the payment needs of the individuals and institutions and to successfully facilitate the economic activities of the country through a well-functioning national payment and settlement system. Accordingly, the Central Bank, as the regulator of the national payment system, efficiently conducted its regulatory and supervisory activities to ensure the smooth functioning of the financial system by effectively mitigating the risks associated with the national payment and settlement system.

LankaSettle System comprises of the Real Time Gross Settlement (RTGS) System and the LankaSecure System which is the scripless government securities settlement system. During the year under review, the country's only large-value electronic payment system, which is the RTGS System, functioned effectively and efficiently. In 2019, RTGS System settled 428,161 transactions, registering an increase of 5.6 per cent when compared with the previous year. In value terms, the share of RTGS transactions in total non-cash payments accounted for 87.5 per cent in 2019. The Central Bank continued to provide the interest free Intra-day Liquidity Facility (ILF) against the collateral of government securities to the participating institutions to minimise the liquidity risk of the RTGS System. Accordingly, during the year, participants of the RTGS System utilised an average value of Rs. 63 billion per business day. At end-2019, total value of scripless securities held in LankaSecure amounted to Rs. 5,584.2 billion (Face Value) consisting of Treasury bills of Rs. 897.7 billion and Treasury bonds of Rs. 4,686.5 billion.

During the year under review, LankaClear (Pvt.) Ltd (LCPL), which operates the Cheque Clearing System of the country, functioned smoothly. LCPL cleared a total volume of 46.8 million cheques amounting to Rs. 9,863 billion which accounted for 7.4 per cent of the total value of non-cash payments of the country. When compared with 2018, the total volume of cheques cleared through the Cheque Clearing System recorded a negative growth of 7.1 per cent and the total value declined by 6.3 per cent in 2019.

The Sri Lanka Interbank Payment System (SLIPS) which mainly facilitates low-value retail bulk payments such as salaries and pensions continued to operate efficiently during 2019. The operations of SLIPS recorded a growth in terms of both volume and value of payments by 11.1 per cent to 36.6 million and 6.7 per cent to Rs. 2,104 billion, respectively.

In 2019, the Common Card and Payment Switch (CCAPS) which operates under the brand name 'LankaPay' recorded a significant progress and launched the Common Point of Sale Switch (CPS). Further, the other three switches launched so far, namely the Common ATM Switch (CAS), Common Electronic Fund Transfer Switch (CEFTS) and Shared ATM Switch (SAS) increased its transaction volumes over the previous year. 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 2019, the transaction volume and value of CAS increased by 17.2 per cent to 47.4 million and 23.4 per cent to Rs. 425.2 billion respectively, in comparison to the previous year. As at the end of 2019, 30 financial institutions were integrated to the CAS network. 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 period under review.

CEFTS, which provides a common infrastructure for switching and clearing facilities to real time retail fund transfers, among member institutions, carried out through multiple payment channels such as ATM, Internet Banking, Mobile Banking, Kiosks and over the counter. In comparison to the previous year, a significant progress in CEFTS transactions were observed during 2019. The CEFTS transaction volume increased by 104.6 per cent to 14.8 million, while the CEFTS transaction value grew by 109.4 per cent to Rs. 1,382.8 billion in 2019. In order to facilitate online payments to governmental institutions, LankaPay Online Payment Platform (LPOPP) was launched in 2017. LPOPP currently facilitates online real time payments to Sri Lanka Customs. As at the end of 2019, 13 LCBs and one LSB have joined LPOPP. During the year under review, 37,238 transactions

Table 8.26
Transactions through Payment Systems

Payment System	2018 (a) Volume ('000)	2018 (a) Value (Rs. bn)	2019 (b) Volume ('000)	2019 (b) Value (Rs. bn)
Large Value Payment Systems				
RTGS System	405	100,473	428	117,151
Retail Value Payment Systems				
Main Cheque Clearing System	50,352	10,528	46,802	9,863
Sri Lanka Inter-bank Payment System (SLIPS)	32,943	1,972	36,612	2,104
Credit Cards	43,600	242	50,969	277
Debit Cards	56,595	159	71,096	195
Internet Banking	26,930	2,939	36,483	3,875
Phone Banking	8,176	143	17,630	339
Postal Instruments	1,022	6	906	6
Total	220,023	116,462	260,926	133,810
US Dollar Cheque Clearing System	51	36	50	49

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

with an aggregate value of Rs. 34.3 billion were processed through LPOPP. In addition, for CAS and CEFTS, there are four clearing cycles per business day in order to enable faster clearing and settlement of CAS and CEFTS transactions. The Central Bank has imposed the Minimum Liability Manager Limits in CAS and CEFTS for primary participants in order to ensure smooth operation of these switches.

The National Card Scheme (NCS), operated by LCPL in partnership with Japan Credit Bureau International of Japan was launched with a view to promote card payments and thereby enable financial inclusion by reducing costs incurred by cardholders and merchants on domestic payment card transactions. During 2019, several financial institutions started issuing payment cards under NCS. In addition, 4 licensed financial acquirers joined the CPS, which provides switching and clearing facilities for payment cards issued under NCS carried out at point of sale terminals.

The Central Bank continued its regulatory and supervisory activities with regard to payment cards and mobile payment systems in terms of the Payment Cards and Mobile Payment Systems Regulations No. 1 of 2013 (The Regulation). Accordingly, three financial institutions were licensed to function as issuers of debit cards while another financial institution was granted a licence to function as a financial acquirer of payment cards, in terms of the Regulation. Further, on-site and off-site supervisions were carried out to ensure compliance with the Regulation by Service Providers of Payment Cards and Mobile Payment Systems.

The Central Bank, as the regulator of payment and settlement systems of the country, continued its supervisory function and further strengthened the regulatory framework in order to minimise the risks associated with the national payment and settlement system. Considering the risks involved in using electronic payment modes, the Central Bank issued a Circular to all financial institutions facilitating electronic payment instruments, regarding providing real time notifications by the financial institutions to customers who use electronic payment modes. Accordingly, financial institutions were informed to use an appropriate communication method to notify customers when providing payment services through electronic payment instruments/mechanisms. Further, during the year 2019, the Central Bank monitored the compliance of financial institutions to the Guideline on the minimum compliance standard for payment related mobile applications, which was issued to set minimum security standards to minimise the risks of using mobile applications to perform financial transactions.

The National Payments Council (NPC), the industry consultative and monitoring committee on payment and settlement systems, appointed several committees on FinTech developments to focus on new innovations such as Digital Payment Platform, Open Application Programming Interface (API) and Virtual Banking, and to popularise the mass use of digital payments by raising awareness among the general public. Focusing on the transition towards a "less cash society", the NPC finalised the

Road Map for 2020-2022, covering areas of facilitating innovative payment products, promoting e-payments, enhancing standardisation and interoperability among payment mechanisms, strengthening payment system security and implementing measures to increase public awareness on payment systems.

The National QR Code Specification branded as "LankaQR" was issued to promote customer convenience and safety through no transaction cost, instant payment notification etc., while encouraging more merchants to join as acquirers due to zero maintenance cost, low set up and transaction cost while "LankaQR" also ensures interoperability of different payment mechanisms and instruments. Several financial institutions launched "LankaQR" based payment products during the year under review.

The Central Bank established the "FinTech Regulatory Sandbox", which provides innovators a safe space to test their products and services without infringing the regulatory requirements. The FinTech Regulatory Sandbox is expected to create robust and sustainable innovations that can provide more efficient financial intermediation, greater financial inclusion, and create a less-cash society through digitalisation.

Considering the new technological developments in the payment industry, the Central Bank appointed a Working Committee on Blockchain Technology to assess the possibility of applying Blockchain Technology in the financial industry in Sri Lanka. As per the recommendations of the Committee, the Central Bank initiated to develop a Proof-of-Concept for the Blockchain Technology based Shared Know-Your-Customer (KYC) facility, which could facilitate to streamline KYC processes in financial institutions. It is expected that this would increase efficiencies in the financial sector and thereby enhance financial inclusion in Sri Lanka.

The Central Bank announced the year 2020 as the "Year of Digital Transactions". This initiative was made with the objective of improving awareness on digital transactions among the public including merchants and employees of financial institutions by using newspaper advertisements, interviews, press conferences and radio broadcasting. Further, a Committee was appointed to carry out campaign for the "Year of Digital Transactions" throughout the country.

Further, the Central Bank increased the maximum hold value of a wallet account maintained in mobile phone based e-money systems from Rs. 25,000.00 to Rs. 50,000.00 in wallet accounts that have fulfilled all KYC requirements while limiting e-money accounts to one per individual irrespective of the mobile network used by the e-money account holder to connect to the mobile phone based e-money system, by issuing a Circular on Number of e-Money Accounts, Individual Stored Value Limits, Day Limits and Transaction Limits Applicable for Customer e-Money Accounts.

Anti-Money Laundering and Countering the Financing of Terrorism

The Financial Intelligence Unit of Sri Lanka (FIU), in line with the international standards to strengthen Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) regime of the country, carried out its functions vigorously in 2019 to preserve the overall integrity and stability of the financial system. The FIU in its principle role as the national focal point to counter Money Laundering / Terrorism Financing (ML/TF) risks, receives financial information relating to suspicious transactions, on any transaction or attempted transaction, which may be related to the commission of unlawful activity submitted by Reporting Institutions (RIs) in terms of Section 7 of the Financial Transactions Reporting Act, No. 6 of 2006 (FTRA). Suspicious Transaction Reports (STRs) are analysed and the results are disseminated to the Law Enforcement Agencies (LEAs), regulators and other relevant entities where necessary. The total number of STRs received significantly increased to 2,806 during 2019 compared to 1,020 STRs received during 2018. A total of 1,478 STRs were referred by the FIU to the LEAs and regulatory authorities after operational and strategic analyses, for further investigations during 2019 compared to 338 STRs referred during 2018. This significant increase in STRs both received by FIU and referred by FIU to LEAs can be largely attributed to the Easter Sunday attacks. Awareness building and outreach conducted by the FIU for its RIs during the year may have also contributed to the significant increase. As mandated, the RIs continue to report Cash Transactions (CTRs) and Electronic Fund Transfers (EFTs-inward and outwards) subject to the specified reporting threshold of Rupees one million or its equivalent in foreign currencies as per the Section 6 of the FTRA. RIs have reported 4.9 million (provisional) CTRs and 6.6 million (provisional) EFTs during the year 2019.

The FIU strengthened its multifaceted strategy to enhance compliance of RIs by regularly improving the legal, supervisory and operational framework in line with the international best practices on AML/CFT. Further, the FIU strengthened ties with other sector specific regulators through consolidated and cooperative efforts. During 2019, 32 risk-based on-site examinations were conducted to assess financial institutions' (i.e. LCBs, LSBs, LFCs, Insurance Companies and Stock Brokers) compliance with the provision of the FTRA, Customer Due Diligence (CDD) Rules and other regulations issued. During the year, the FIU carried out 4 follow-up examinations, issued 32 warning letters and 6 Show-Cause Letters to FIs. The FIU imposed proportionate and dissuasive sanctions amounting to Rs. 5 million against FIs that failed to comply with the requirements stipulated in the FTRA and CDD rules during the period under consideration.

The FIU took measures to enhance the compliance level of the designated non-finance businesses and professions (DNFBPs), which were recognised as a high risk sector for ML/TF in the 2014 National Risk Assessment. During 2019, 36 risk-based supervisions were conducted to assess the level of compliance of several DNFBP sectors: Casinos, Gem & Jewellery and Real Estate sectors. The FIU issued letters to 22 institutions of the DNFBPs sector informing the deficiencies identified and provided a time bound action plan to rectify the identified deficiencies during the year. With the aim of increasing outreach, the FIU published several advertisements through print media on AML/CFT compliance obligations for DNFBPs throughout the year.

With a view of strengthening the AML/CFT supervision process and institutional compliance, the FIU issued several rules and guidelines during the year 2019 on suspicious transactions reporting, conducting ongoing CDD based on a risk-based approach, enhanced due diligence, identification of beneficial ownership and identification of Politically Exposed Persons. In 2019, the FIU conducted 55 awareness programmes for FIs, DNFBPs, government authorities and other stakeholders on AML/CFT obligations, identification of beneficial ownership information and implementation of targeted financial sanctions. The outreach exercises conducted by the FIU had around 3,688 participants during 2019. In addition, the FIU hosted a team of officials from Financial Intelligence Unit of Maldives for a study visit during

2-5 December 2019 for sharing experience on AML/CFT risk based supervision, analysis of STR and Sri Lankan experience on Mutual Evaluation. The FIU successfully conducted the BIMSTEC SG-CFT Workshop on "Experience in Countering Terrorism and Terrorist Financing through Case Studies" at Colombo during 27-29 November 2019 with the participation of 40 delegates from BIMSTEC member countries. The workshop provided an opportunity to share Sri Lanka's experience in Countering Terrorism and Terrorist Financing with other members of the BIMSTEC.

The FIU, in view of fostering strong relationships and enhanced cooperation with foreign agencies for information sharing and cooperation, entered into two Memoranda of Understanding (MoUs) with the Financial Intelligence Unit of Maldives and Financial Analysis and Supervision Unit of Papua New Guinea during 2019, increasing the total number of MoUs with foreign counterparties to 39. Further, with a view to exchange information, three MoUs were signed with domestic agencies i.e. the National Gem and Jewellery Authority, the Condominium Management Authority and INTERPOL National Central Bureau for Sri Lanka during the year, thus increasing the total number of MoUs signed with domestic agencies up to 11.

Since being listed in the FATF[2] Compliance Document (which identifies countries with strategic AML/CFT deficiencies) "The Grey List" in November 2017, the FIU and other stakeholders took a number of effective measures towards the successful completion of the time-bound action plan provided to Sri Lanka by the FATF to address several strategic deficiencies identified in AML/CFT activities. These measures included passing the Trusts (Amendment) Act, No. 6 of 2018, the Mutual Assistance in Criminal Matters (Amendment) Act, No. 24 of 2018, issuing regulations/directives/guidelines on implementing United Nation's Security Council Resolutions on North Korea and Iran, extending the AML/CFT coverage to DNFBPs by issuing CDD Rules, conducting risk-based AML/CFT supervision of the FIs and DNFBPs sector, taking enforcement actions on non-compliances observed and increasing awareness on AML/CFT.

The FATF assessed Sri Lanka's progress in terms of implementing the Action Plan through the Asia Pacific Joint Group (AP/JG). In February 2019, FATF made the initial determination that Sri Lanka had completed its action plan substantially. Subsequently, an on-site assessment was conducted by the AP/JG to verify implementation of the FATF Action Plan, during 16-17 September 2019. The AP/JG representatives had face-to-face meetings with all relevant stakeholders, including the private sector and the Minister of Finance to ascertain Sri Lanka's political and institutional commitment towards the implementation of the AML/CFT framework in a suitable manner. The recommendations made by the review team on Sri Lanka's progress were discussed at the FATF Plenary held in October 2019 and all members endorsed the decision to delist Sri Lanka from the Grey List. Accordingly, on 18 October 2019 the FATF announced that Sri Lanka is no longer subject to the FATF monitoring process. The delisting by the FATF is expected to have a positive economic and financial impact on Sri Lanka.

Legal Reforms related to the Financial Sector

During the year 2019, the Central Bank carried out many rigorous law reforms to the legislations applicable thereto with the objective of strengthening and enhancing the regulatory and supervisory powers vested therein. Accordingly, the Central Bank formulated the new

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

BOX 13
Requirement for Regulating the Informal Moneylending Business in Sri Lanka

Introduction

Moneylending can be described as lending of money at an interest, with or without a security, by a moneylender to a borrower. In Sri Lanka, moneylending is mainly carried out by the Licensed Banks and other financial institutions such as the Licensed Finance Companies, Licensed Microfinance Companies, Microfinance Non-Governmental Organizations, Co-operative Rural Banks and Thrift and Credit Co-operative Societies, and Samurdhi Community-Based Banks. However, there are informal moneylenders as well, who operate throughout the country in the forms of individuals, sole proprietors, partnerships or companies.

Although the moneylending activities of licensed banks and other financial institutions are regulated, [1]the informal moneylenders are not regulated or supervised by any regulatory authority in Sri Lanka. The existing legal framework is mainly focused on financial institutions, which are engaged in financial intermediation and important from the view point of financial system stability. Further, the Money Lending Ordinance, No. 2 of 1918 (the Money Lending Ordinance), which provides protection for customers of moneylenders coming under its purview, does not mandate a specific regulator nor a licensing/registration requirement for moneylenders. Thus, a customer, who intends to seek redress under the Money Lending Ordinance, needs to initiate legal procedure, which could involve considerable amount of financial and other resources.

In this background, the Central Bank of Sri Lanka (CBSL) identifies the need to establish a prudential regulatory framework in the informal moneylending business in the country. Such need was amply justified by the amount of evidence collected through the field visits by the CBSL, and complaints received in relation to various malpractices and customer harassment incidents by moneylenders.

Importance of Regulating the Informal Moneylending Business

a) Regulation of informal moneylenders is important from the view point of customer protection. As informal moneylenders are not subject to any customer protection regulations, customers of such moneylenders are often subjected to unfair terms and conditions, as well as harassment. Thus, the customers of informal moneylenders may lose trust and confidence, and eventually end up with no access to financial services .

b) At present, the informal moneylending businesses do not report information on their borrowers to the Credit Information Bureau of Sri Lanka (CRIB). Therefore, formal moneylending institutions tend to lack comprehensive information on their customers when assessing creditworthiness. Further, non existence of CRIB reporting by informal moneylenders encourages some borrowers, particularly with a default history, to access the unregulated moneylenders for their financial requirements. The absence of a proper assessment of creditworthiness by unregulated moneylenders results in granting multiple-loans to the same customer, leading to over-indebtedness,[2] which could lead to various socio-economic costs such as disruption of education of children, increase in malnutrition, loss of livelihood etc.

c) Existence of a larger number of informal moneylenders in the country could sometimes lead to severe competition in the formal money lending businesses as well, resulting in unethical practices and harassment of customers.

d) Collecting information on the microfinance industry of Sri Lanka is a challenge when informal moneylenders are not required to report information to any formal authority.

e) Existence of a large number of unregulated money lending businesses could create issues in designing and implementing credit policies, particularly for small and medium scale enterprises.

Regional Experience on Regulating the Moneylending Business

Several countries in the region regulate the moneylending business, as indicated below.

(a) In Malaysia, moneylenders are required to obtain a licence under the Moneylenders Act 1951 (as amended). The Moneylenders Act provides for regulation of moneylending business, including protection of customers of moneylending businesses.

1 The Licensed Banks and Licensed Finance Companies and Licensed Microfinance Companies are regulated by the Central Bank of Sri Lanka; the Non-Governmental Organizations engaged in microfinance business are regulated by the Registrar of Voluntary Social Services Organizations; Co-operative Rural Banks and Thrift and Credit Co-operative Societies are regulated by the Department of Co-Operative Development; and the Samurdhi Community Based Banks are regulated by the Department of Samurdhi Development.

2 Over-indebtedness has been defined by the Consultative Group to Assist the Poor (CGAP), as the inability to repay all debts fully and on time.https://www.cgap.org/blog/over-indebtedness-roles-and-responsibilities-all-actors

(b) In Bangladesh, microcredit institutions are required to obtain a license under the Microcredit Regulatory Authority Act, No.32 of 2006, to conduct micro credit programs, and are regulated by the Microcredit Regulatory Authority of Bangladesh.

(c) The Central Bank of Philippines regulates the business of extending credit by creditors in the customer protection perspective under the Truth in Lending Act, (Republic Act No. 3765).

(d) The Reserve Bank of India regulates systemically important, non-deposit taking, non-bank finance companies, under the Reserve Bank of India Act of 1934.

The Proposed Microfinance Credit Regulatory Authority Act (proposed Act)

With a view to addressing some of the issues highlighted above, the CBSL proposed the enactment of the proposed Act. The proposed Act which was approved by the Monetary Board of the CBSL enables the establishment of the Microfinance and Credit Regulatory Authority (the Authority), which is a statutory body to be set up within the Ministry of Finance (MOF). This Authority, which consists of ex-officio representatives from the MOF, the CBSL, and nominees of the Governor of CBSL and the Minister of Finance, is mandated to regulate the microfinance institutions and unregulated moneylenders.

The proposed Act further provides protection for customers of microfinance and moneylending business while necessitating the reporting requirement to the CRIB by the regulated institutions. The proposed Act would repeal and replace the Microfinance Act, No.6 of 2016 (Microfinance Act).

Concluding Remarks

The issues associated with the informal moneylenders such as the over-indebtedness of customers, lack of reporting of credit information to authorities, and lack of protection for customers etc., could lead to significant socio-economic costs, unless appropriate measures are initiated on a priority basis. In that context, the proposed Act is expected to address such issues identified in the informal and unregulated moneylending business in the country. The proposed Act could also assist in addressing some of the shortcomings identified in the existing Microfinance Act, where there could be a possibility of a regulatory arbitrage due to the existence of different regulators for Licensed Microfinance Companies and Microfinance Non-Governmental Organizations, and also more emphasis given to regulation of deposit taking microfinance institutions over micro-credit institutions, which could result in lack of protection for small time borrow.

Central Bank of Sri Lanka Bill which intends to repeal its Act of incorporation, the Monetary Law Act, No. 58 of 1949. With the assistance of various stakeholders such as the Ministry of Finance, the Attorney General's Department and the Legal Draftsman's Department, the draft Bill was published in the Gazette in November 2019. In addition, amendments to the Foreign Exchange Act, No. 12 of 2017, Registered Stocks and Securities Ordinance, No. 07 of 1937, the Debt Recovery (Special Provisions) Act, No. 2 of 1990 and the Electronic Transactions Act, No. 19 of 2006 were introduced. The Central Bank also assisted relevant stakeholders, in various capacities, in the process of drafting legislation such as the International Financial Centre Bill, Data Protection Bill, Cyber Security Bill, etc. to establish a comprehensive legal framework for the financial sector in Sri Lanka.

Resolution and Enforcement Action on Weak Financial Institutions

Resolution and enforcement functions were continued while managing Sri Lanka Deposit Insurance and Liquidity Support Scheme (SLDILSS). Payment of compensation for the depositors of failed LFCs, namely Central Investments and Finance PLC (CIFL) and The Standard Credit Finance Limited (TSCFL) was continued under the SLDILSS. Compensation to 3,024 depositors of CIFL and 2,309 depositors of TSCFL which amounted to Rs. 1,271.4 million and Rs. 947.3 million, respectively were paid during 2019. All the arrangements were made to commence compensation payments for the depositors of TKS Finance Ltd. from January

2020. The Central Bank is in the process of formulating a resolution framework for licensed banks and LFCs with the assistance of the expert advisors from the US Treasury, and arrangements were made for the inclusion of provisions on resolution procedures and deposit insurance in drafting the new Banking Act.

Enforcement actions were continued with the cooperation of the Attorney General's Department and law enforcement authorities such as the Sri Lanka Police and Financial Crimes Investigation Division. Upon receiving complaints from the general public, a few investigations were conducted on unauthorised finance businesses and prohibited schemes under the relevant provisions of the Finance Business Act and the Banking Act respectively. Awareness programmes were also conducted island-wide by the Central Bank with a view to improve financial literacy and to educate on the ill-effects of unauthorised finance businesses and prohibited schemes.

Regulation and Supervision of Foreign Exchange

The Central Bank continued to monitor foreign exchange transactions of the country. The activities of the Restricted Dealers (RDs) who have been authorised to engage in money changing business were continuously monitored with a view of developing the domestic foreign exchange market further. During the year, RDs deposited US dollars 268.6 million to the banking system, recording

Table 8.27
Summary of Transactions on Foreign Currency Accounts

USD million

Category of Account	Inward Remittances	Outward Remittances	Closing Balance as of 31.12.2019
Personal Foreign Currency Accounts	841.6	279.1	2,528.7
Business Foreign Currency Accounts	7,660.9	3,174.1	1,335.0
Inward Investment Accounts	2,033.9	2,070.8	1,748.7
Outward Investment Accounts	8.0	54.0	n.a

n.a Not avaliable

Source: Central Bank of Sri Lanka

Table 8.28
Remittances on Capital Transaction Rupee Accounts (CTRAs) and Foreign Exchange Sales and Purchases against/into Sri Lanka Rupees-2019

Migration Fund Transfers	
No. of CTRAs registered with Department of Foreign Exchange for remitting migration allowance	1,353
Outward remittances through CTRAs (USD mn)	40.7
Foreign Exchange Sales and Purchases	
Foreign Exchange Sales (Form 1) (USD mn)	13,359.4
Foreign Exchange Purchases (Form 2) (USD mn)	14,706.8

Source: Central Bank of Sri Lanka

a decrease of 46.1 per cent compared to 2018. Meanwhile, RDs have sold US dollars 21.6 million in 2019, an increase of 47.1 per cent compared to 2018. As a result, in 2019, gross purchases of foreign currencies by RDs (sum of deposits of RDs to the banking system and their sales of foreign currency) decreased by 43.4 per cent to US dollars 290.2 million compared to the previous year.

The Central Bank initiated several measures to facilitate foreign exchange transactions of the country. During 2019, a number of amendments were finalised to the existing Regulations, Orders and Directions issued under the provisions of the Foreign Exchange Act, No. 12 of 2017 (FEA). In addition, amendments to the FEA also proposed to address issues and concerns in respect of certain provisions of the FEA with regard to implementing the Act, including empowerment to combat unauthorised foreign exchange transactions. Meanwhile, the Central Bank facilitated the issuance of three Regulations by the Minister of Finance under the provisions of the FEA. Accordingly, these Gazette Notifications were issued permitting the GOSL to issue ISBs in 2019 and to make related payments to non-resident investors, allowing GOSL and State-Owned Enterprises of the GOSL to borrow from outside Sri Lanka with the approval of the line Ministry without such loan proceeds being routed through lenders' Inward Investment Accounts, and extending the time period required for exporters of goods to repatriate export proceeds to Sri Lanka from 120 to 180 days from the date of such exportation since 17 October 2019. Further, to align with other measures adopted by the Central Bank a directive was issued in early 2019 to Authorised Dealers (ADs), removing the restrictions imposed in the latter part of 2018, with regard to the conversion of Sri Lanka rupees in to foreign exchange for making payments for import of certain non-essential consumer goods under the advance payment terms. The Central Bank has taken initiatives to implement a comprehensive cross border and foreign currency transactions monitoring system in order to collect data from ADs as a mechanism to capture and monitor foreign exchange transactions in terms of the Regulations and Directions issued under FEA, while supporting macroeconomic decision-making on important policy areas by obtaining and analysing data relevant to the foreign exchange transactions.

Credit Information

During 2019 the Credit Information Bureau (CRIB) issued 10.1 million credit reports to the industry recording a 2.0 per cent slight increase compared to the previous year. The lending institutions obtained 9.3 million consumer credit reports and 0.8 million corporate credit reports in 2019.

Demand for the self-inquiry credit reports (iReports) continued to increase further in 2019 recording a 7.2 per cent increase compared to the year 2018. During 2019, 16,006 customers visited the Bureau to obtain their iReports and 2,053 customers applied their iReports through the banks. A total of 448 new individuals were registered for the iReport online service during the year and 1,375 users accessed their iReports online in 2019. The CRIB currently receives monthly updates of more than 12 million credit facilities to be processed through its automated Credit Information Management System (CRIMS).

In 2019, the CRIB initiated the implementation of a new Credit Bureau System. This strategic initiative encompasses the implementation of state-of-the-art credit bureau solutions including a new credit scoring system, a first of its kind in the country, to bring changes to the overall Credit Risk Management framework with the aim of developing an agile financial infrastructure in Sri Lanka. The CRIB expects to go-live with the new system by late 2020.

As an interim solution until the new Credit Bureau System comes online, the CRIB launched its latest product, the "CRIB's Credit Score", Sri Lanka's first credit scoring system which is branded as "CRIB Score" to the industry in December 2019. The introduction of credit score is expected to improve the country's position on the World Bank's "Ease of Doing Business Ranking" under the 'Ease of Getting Credit' performance indicator. This ranking is an important international benchmark sought by various international investors when assessing any country's investment environment and its economic competitiveness. The "CRIB Score" is a number ranging from 250 to 900, which provides lending institutions with a consistent indication of underlying the credit risk levels, for objective assessment of credit worthiness and probability of default of a particular borrower. The CRIB Scores of all individuals were made available to the lending institutions, initially. The CRIB is also planning to release "CRIB Score – Corporate" to the member lending institutions, during 2020. Subsequently, the public would also be able to obtain their own credit scores, through the CRIB or through the financial institution they wish to obtain their service from.

Table 8.29
Key Prudential Measures Recently taken by the Central Bank on Banks, LFCs and SLCs

Date	Prudential Measures
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 from 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.
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 from 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.
18 January 2019	A Circular was issued to licensed banks on Publication of Annual and Quarterly Financial Statements and Other Disclosures by licensed banks.
06 March 2019	A Direction was issued on 'Deposits', restricting Licensed Microfinance Companies (LMFCs) in accepting deposits other than collateral deposits.
07 March 2019	A Circular was issued to withdraw the minimum margin requirements imposed for the importation of motor vehicles and non-essential consumer goods.
13 March 2019	A Circular was issued to licensed banks preventing them from conducting lottery schemes/raffle draws & gift schemes and imposing conditions on promotional gift schemes.
18 April 2019	A Circular was issued to licensed banks informing the removal of restrictions on opening of Letters of Credit for the importation of motor vehicles under the permits on concessionary terms.
26 April 2019	A Monetary Law Act Order was issued to licensed banks imposing maximum interest rates that can be offered or paid by licensed banks on Sri Lanka Rupee deposits.
26 April 2019	A Direction was issued to introduce a maximum interest rate on microfinance loans granted by LMFCs.
29 April 2019	A Direction was issued to introduce maximum interest rates on deposits and debt instruments of LFCs and SLCs.
08 May 2019	A Circular was issued to licensed banks enabling them to grant a moratorium to individuals and entities, who have registered with the Sri Lanka Tourism Development Authority (SLTDA) or any other authority to provide services relating to the tourism sector.
21 May 2019	A Circular was issued to LFCs and SLCs enabling them to grant a moratorium to individuals and entities who have registered with the SLTDA or any other authority/agency to provide services relating to the tourism sector.
31 May 2019	Banking Act Directions were issued to licensed banks to increase the LTV ratio for light trucks to 90 per cent from 70 per cent.
31 May 2019	Regulations were issued on priority of claims in a winding up of a LFC.
04 June 2019	The LTV Direction issued to LFCs was revised to incorporate the 2019 Budget proposals by allowing higher LTV ratios for light trucks.
29 August 2019	Banking Act Directions were issued to licensed banks on market conduct and treasury operations of licensed banks.
06 September 2019	A Circular was issued to introduce a Liquidity Support Facility by way of reverse repurchase transactions for Standalone Primary Dealers.
24 September 2019	Monetary Law Act Order No. 01 of 2019 on maximum interest rates on Sri Lanka Rupee Deposits of licensed banks was rescinded.
24 September 2019	A Monetary Law Act Order was issued to licensed banks on enhancing efficiency of the transmission of recent monetary policy decisions to rupee denominated market lending rates.
18 October 2019	The Direction on maximum interest rates on deposits and debt instruments of LFCs and SLCs was revised.
18 November 2019	A Circular was issued announcing a new list of qualified auditors to audit the accounts of licensed banks from financial years commencing 01 January 2021.
19 December 2019	Existing regulations on assessment of fitness and propriety of Directors, Chief Executive Officers and officers performing executive functions were amended.
19 December 2019	The Direction on Valuation of Immovable Properties issued to LFCs and SLCs was revised with changes in eligibility criteria for valuers and frequency of valuation.
20 December 2019	Banking Act Directions were issued introducing a new framework for dealing with Domestic Systemically Important Banks.