8

FINANCIAL SECTOR PERFORMANCE AND SYSTEM STABILITY

8.1 Overview

Financial sector showed improved performance as the supportive prudential measures continued to preserve stability of the financial system in 2017. The improved performance of the financial sector was broad-based and mainly contributed by the banks, other deposit taking financial institutions and contractual savings institutions.

The banking sector continued to expand with improved business operations and risk management practices with the implementation of timely and appropriate regulatory measures during the year. Asset growth of the banking sector, remained high though it gradually moderated during the second half of the year responding to the tight monetary policy stance and the resultant high market interest rates. Further, the quality of the banking sector assets improved as reflected in the decline in Non-Performing Loans (NPL) ratios. Capital adequacy ratios and liquidity ratios of the sector remained at healthy levels. The sector resilience was improved by the notable decline in borrowing during the period as deposits sourced the funds for banking sector expansion. Banking sector profitability also improved as reflected in both the Return on Assets (ROA) and the Return on Equity (ROE) ratios, indicating the build-up of resources to mitigate potential risks in the system. Overall, the banking sector continued to support economic growth and development through enhanced banking services and outreach, along with branch network expansion, thereby, improving financial inclusion in the country.

The Licensed Finance Companies (LFCs) and Specialised Leasing Companies (SLCs) sector performance moderated during the year with low credit growth, declining profitability and increase in non-performing loans. The slowdown in the sector was mainly due to fiscal and macroprudential policy measures taken to curtail importation of motor vehicles, moderate economic growth and natural calamities such as floods and drought conditions that prevailed in 2017. Nevertheless, the key performance indicators of the sector, including capital, liquidity and profitability, continued to be positive. The Central Bank initiated key prudential measures with much consideration on reviving the companies with weak financial positions. Necessary actions have been taken to cease or limit finance business operations of weak finance *companies to safeguard depositors and the long term stability of the financial sector. Healthy growth was recorded by the contractual savings institutions, dominated by the Employees' Provident Fund (EPF) and the Employees' Trust Fund (ETF), providing reasonable returns for their members. Other sub sectors of the financial sector, which include the insurance sector, the primary dealers in government securities and the unit trust sector, recorded positive business performance during the period, without major stability concerns.*

Financial markets remained volatile during 2017, in line with the changing local and global economic environment. Excess rupee liquidity in the money market, which declined gradually during the first half of the year, increased to a high level during the second half of the year. The undue pressure on short-term interest rates emanating from volatile liquidity conditions was addressed through active open market operations (OMO) by the Central Bank. The Sri Lankan rupee continued to depreciate gradually against the US dollar during the year, in an environment of allowing greater flexibility in exchange. Unwinding of the foreign investments in government securities market, with the expectations of an interest rate hike by the Federal Reserve Bank exerted pressure on the Sri Lankan rupee to depreciate in early 2017. However, this trend was reversed during the second half of the year with increased foreign investments in government securities, capital market and the receipt of tranche of the Extended Fund Facility (EFF) by the International Monetary Fund (IMF) to Sri Lanka. Payments and settlements systems operated efficiently and smoothly while focusing on improving the convenience and safety of payments in order to facilitate the economic activities of the country effectively. The Central Bank, being the regulator of the national payment system, broadened the regulatory and supervisory activities during the year with the objective of ensuring the stability and soundness of the financial system to mitigate the risks associated with payment and settlement systems.

Table 8.1
Total Assets of the Financial System

	2016 (a)		2017 (b)	
	Rs. bn	Share (%)	Rs. bn	Share (%)
Banking Sector	**10,575.8**	**69.5**	**11,897.4**	**69.8**
Central Bank	1,529.2	10.1	1,604.8	9.4
Licensed Commercial Banks (LCBs)	7,843.3	51.5	8,926.4	52.3
Licensed Specialised Banks (LSBs)	1,203.2	7.9	1,366.2	8.0
Other Deposit Taking Financial Institutions	**1,246.7**	**8.2**	**1,370.4**	**8.0**
Licensed Finance Companies (LFCs)	1,112.1	7.3	1,227.5	7.2
Co-operative Rural Banks	122.2	0.8	132.7	0.8
Thrift and Credit Co-operative Societies	12.4	0.1	10.2	0.1
Specialised Financial Institutions	**335.4**	**2.2**	**388.9**	**2.3**
Specialised Leasing Companies (SLCs)	99.8	0.7	127.5	0.7
Primary Dealers (c)	77.1	0.5	77.3	0.5
Stock Brokers	10.1	0.1	9.1	0.1
Unit Trusts / Unit Trust Management Companies	106.7	0.7	131.7	0.8
Market Intermediaries (d)	30.8	0.2	28.7	0.2
Venture Capital Companies	11.0	0.1	14.6	0.1
Contractual Savings Institutions	**3,058.1**	**20.1**	**3,395.8**	**19.9**
Insurance Companies	521.4	3.4	559.2	3.3
Employees' Provident Fund	1,841.5	12.1	2,066.3	12.1
Employees' Trust Fund	248.9	1.6	279.0	1.6
Approved Pension and Provident Funds	398.6	2.6	437.3	2.6
Public Service Provident Fund	47.7	0.3	53.9	0.3
Total	**15,216.0**	**100.0**	**17,052.5**	**100.0**

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

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

The regulatory framework governing the financial system was further strengthened during the year introducing prudential measures with a view to enhancing the safety and resilience of the financial sector in Sri Lanka. Prudential measures were mainly focused on enhancing transparency, capital requirements, access to finance, liquidity and risk management frameworks. In addition, *the Central Bank established the Resolution and Enforcement Department to expedite resolution of weak financial institutions, without having to affect the stability of the financial system.*

8.2 Performance of the Banking Sector

The banking sector continued to dominate the financial sector, accounting for 60.3 per cent of the total assets of the financial sector and its performance remained robust during 2017. The implementation of timely and appropriate regulatory actions and adoption of enhanced risk management measures helped the sector to maintain risks (credit, market, liquidity, operational and others) at manageable levels. Further, as a result of such prudential measures, undue concentration of loans was addressed, while operational performance and the resilience of the sector were further improved. Asset growth, which picked up during the first half of the year, gradually moderated during the second half of the year, following the adoption of targeted policy actions. Improvements in asset quality were seen in the decline in NPL ratios. Banking sector profits in 2017 improved compared to the previous year as reflected in the improvement in both the Return on Assets (ROA) and the Return on Equity (ROE) ratios. Overall, the banking sector operated with sufficient capital and liquidity buffers throughout the year.

Business Growth

(a) Outreach: The banking sector consisted of 25 Licensed Commercial Banks (LCBs), including 12 branches of foreign banks, and 7 Licensed Specialised Banks (LSBs) by end 2017. The banking sector continued to support economic growth and development by the enhanced banking services and the expansion of the banking network, thereby, promoting financial inclusion in the country. In 2017, several banks introduced technology based products/services to facilitate financial inclusion. Further, 43 new banking outlets (excluding student savings units) and 684 new Automated Teller Machines (ATMs) were established raising the number of banking outlets to 6,227 and ATMs to 4,416, at the end of 2017.

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

Category	End 2016 (a)	End 2017 (b)
Licensed Commercial Banks (LCBs)		
I. Total No. of LCBs	25	25
Domestic banks	13	13
Foreign banks	12	12
II.Total No. of LCB Banking Outlets	5,397	5,508
Branches (c)	2,841	2,869
Domestic Banks	2,788	2,816
Foreign Banks	53	53
Student Savings Units	2,556	2,639
Automated Teller Machines	3,531	4,083
Licensed Specialised Banks (LSBs)		
I. Total No. of LSBs	7	7
National Level Regional Development Banks	1	1
National Level Savings Banks	1	1
Housing Finance Institutions	2	2
Other LSBs	3	3
II. Total No. of LSB Banking Outlets	710	719
Branches (c)	683	691
National Level Regional Development Banks	265	265
National Level Savings Banks	255	259
Housing Finance Institutions	63	64
Other LSBs	100	103
Student Savings Units	27	28
Automated Teller Machines	320	333
Total No. of Bank Branches and Other Outlets	6,107	6,227
Total No. of Automated Teller Machines	3,851	4,416

(a) Revised
(b) Provisional
(c) All banking outlets except Student Savings Units

Source: Central Bank of Sri Lanka

(b) Assets: The banking sector asset base surpassed Rs. 10 trillion by end 2017, with year-on-year growth reaching 13.8 per cent by end 2017 from 12.0 per cent by end 2016. Growth in assets, which slowed down in 2016, picked up during the first half of 2017 but moderated during the last quarter of 2017. The growth in assets was mainly due to the increase in loans and advances, which accounted for 62.5 per cent of the total assets by end 2017. The impact of the tightening of

Table 8.3
Composition of Assets and Liabilities of the Banking Sector

Item	2016 (a)		2017 (b)		Change (%)	
	Rs. bn	Share (%)	Rs. bn	Share (%)	2016 (a)	2017 (b)
Assets						
Loans and Advances	5,540.8	61.2	6,430.9	62.5	17.5	16.1
Investments	2,270.5	25.1	2,554.4	24.8	-3.3	12.5
Other (c)	1,235.3	13.7	1,307.3	12.7	21.8	5.8
Liabilities						
Deposits	6,295.6	69.6	7,399.0	71.9	16.5	17.5
Borrowings	1,696.4	18.8	1,607.1	15.6	-3.5	-5.3
Capital Funds	707.3	7.8	867.0	8.4	11.1	22.6
Other	347.3	3.8	419.6	4.1	24.4	20.8
Total Assets/ Liabilities	**9,046.6**	**100.0**	**10,292.6**	**100.0**	**12.0**	**13.8**

(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	Amount (Rs. bn)		Composition (%)	
	2016 (a)	2017 (b)	2016 (a)	2017 (b)
Demand Deposits	479.2	496.0	7.6	6.7
Savings Deposits	1,858.1	2,032.3	29.5	27.5
Time Deposits	3,812.5	4,704.3	60.6	63.6
Other Deposits	145.8	166.4	2.3	2.2
Total Deposits	**6,295.6**	**7,399.0**	**100.0**	**100.0**

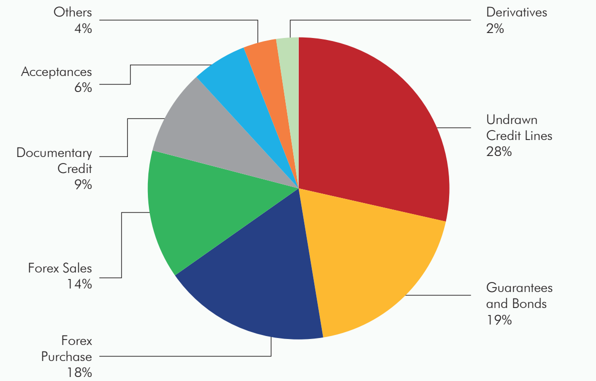
(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

monetary policy in March 2017 was reflected in the moderation of credit growth during the latter part of the year. Banking sector credit reported a steady growth during the first half of the year, reaching 20.1 per cent as at end June 2017, from 17.5 per cent as at end 2016, moderated to 16.1 per cent by end 2017. Loans and advances were extended to all major sectors of the economy during 2017. The increase in lending was reflected primarily in the lending to manufacturing (21.9 per cent), trading (19.8 per cent), construction (19.5 per cent) and consumption and other (15.8 per cent) sectors. In terms of products, term loans and overdrafts grew by 16.5 per cent and 21.2 per cent, respectively, and mainly contributed to the increase in total credit, accounting for 58.4 per cent and 17.3 per cent, respectively. Credit by way of pawning advances grew by 15.2 per cent in 2017, from a deceleration of 2.4 per cent in 2016. Leasing, which reported the highest growth rate of 52.9 per cent at end 2015, declined to 3.3 per cent at end 2016 due to the introduction of the Loan-to-Value (LTV) ratio in January 2016, grew by 5.8 per cent, in 2017. Growth in investments by 12.5 per cent in 2017, compared to a deceleration of 3.3 per cent in 2016, also contributed to the growth in total assets during the year. Investments in Treasury bills Held-to-maturity (HTM) and in the trading books increased by Rs. 91 billion and Rs. 122 billion, respectively. Meanwhile, investments in Treasury bonds in the HTM portfolio increased by Rs. 16 billion, despite a decline in Treasury bonds in the trading portfolio of Rs. 9 billion during 2017. Investments in Sri Lanka Development Bonds (SLDBs) increased by Rs. 67 billion during the year under review. Cash and due from banks increased marginally by Rs. 35 billion (3.5 per cent) during the year.

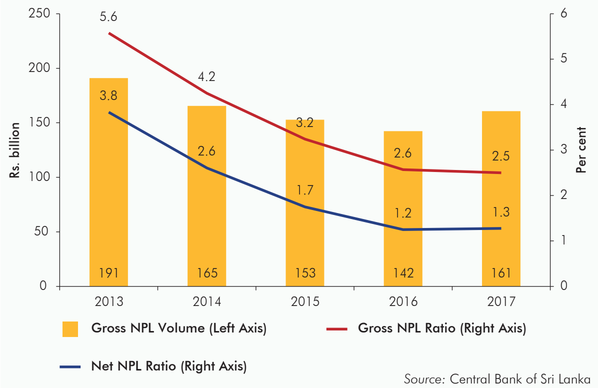
(c) Liabilities: The liability base of the banking sector, which mainly comprised deposits and borrowings, accounted for 71.9 per cent and 15.6 per cent, respectively, of the total banking sector funds at end 2017. Customer deposits, which recorded improved growth during the first half of the year, from 16.5 per cent at end 2016 to 20.6 per cent at end June 2017, grew at 17.5 per cent at end 2017, on year-on-year basis. During 2017, the share of term deposits increased to 63.6 per cent, while the share of savings deposits declined to 27.5 per cent of total deposits at end of 2017 from 60.6 per cent and 29.5 per cent, respectively, of the total deposits at the end of 2016. However, the year-on-year growth of term deposits marginally declined to 23.4 per cent as at end 2017, from 23.8 per cent as at the end 2016, while the growth in savings deposits increased to 9.4 per cent as at end 2017 from 7.4 per cent as at end 2016. Due to a rise in interest rates, the Current Account

Chart 8.1
Off-balance Sheet Exposures of the Banking Sector (as at end 2017)



Source: Central Bank of Sri Lanka

Chart 8.2
NPLs of the Banking Sector



Source: Central Bank of Sri Lanka

and Savings Account (CASA) ratio decreased to 33.2 per cent by end 2017, from 37.1 per cent at end 2016. Total rupee borrowings decreased by Rs. 66 billion (9.9 per cent), while borrowings denominated in foreign currency decreased by US dollars 290.7 million (4.2 per cent), resulting in an overall contraction of total borrowings to Rs. 1,607 billion (5.3 per cent) at end 2017

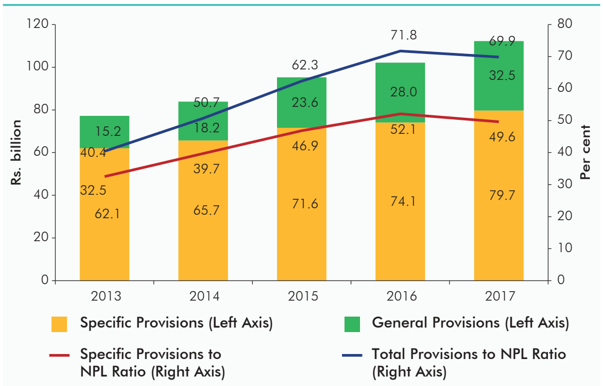
(d) Off-balance sheet exposure: Resulting from the lower foreign exchange forward transactions, the year-on-year growth of the off-balance sheet exposures of the banking sector declined by 5.6 per cent to Rs. 3,874 billion as at end 2017, from 9.1 per cent as at end 2016. Undrawn credit lines accounted for the largest share of off-balance sheet exposure as at end 2017 with a contribution of 28.5 per cent. Exposure of foreign exchange (FX) purchases (17.9 per cent) and sales (13.8 per cent) together accounted for 31.7 per cent, while guarantees and bonds, documentary credit, acceptances and derivatives comprised the remaining share of off-balance sheet exposures. Except for foreign currency exposures and derivatives, which declined by Rs. 32 billion (2.6 per cent) and Rs. 87 billion (48.6 per cent), respectively, all other off- balance sheet exposures reported increases during 2017.

Risks in the Banking Sector

(a) Credit Risk: During the year, the credit quality of the banking sector improved marginally, as reflected by the decline in the gross NPL ratio to 2.5 per cent as at end 2017, from 2.6 per cent as at end 2016, despite an increase in NPLs of Rs. 18.3 billion during 2017. Total provisions for loan losses increased by Rs. 10 billion during 2017, of which 55.3 per cent was due to an increase in specific provisions. Due to the increase in NPLs in volume terms, specific and total provision coverage ratios declined to 49.6 per cent and 69.9 per cent, respectively, as at end 2017, from 52.1 per cent and 71.8 per cent, respectively, as at end 2016.

The banking sector credit portfolio was distributed among diverse economic sectors in the economy. Five major sectors namely, consumption

Chart 8.3
Provisioning for NPLs of the Banking Sector



Source: Central Bank of Sri Lanka

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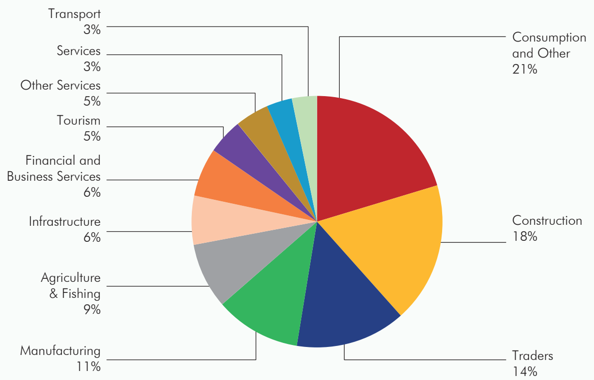
Chart 8.4
Credit Exposure of the Banking Sector (as at end 2017)



Source: Central Bank of Sri Lanka

and other (20.7 per cent), construction (18.4 per cent), trading (14.5 per cent), manufacturing (11.2 per cent), and agriculture and fishing sectors (8.6 per cent), accounted for more than 70 per cent of the total credit portfolio, at end 2017.

(b) Market Risk:

Interest Rates: The banking sector reported a net capital gain of Rs. 4.8 billion on investment in Treasury bonds, due to the decline of Treasury bond yield rates during the second half of the year. The cumulative interest rate sensitive gap of the banking sector, i.e. the gap between the rate sensitive assets and the rate sensitive liabilities, as a percentage of the rate sensitive assets up to 12 months' time bucket, widened to a negative 34.1 per cent as at end 2017, compared to a negative 30.7 per cent as at end 2016, largely due to a higher increase in deposits with maturities less than one year.

Prices of Equity: The banking sector continued to operate with minimal exposure to equity risk as the total investments in listed shares was Rs. 26 billion, which was only 1.0 per cent of the total investments and 0.2 per cent of the total assets of the banking sector as at end 2017.

Exchange Rates: The foreign currency risk of the banking sector increased during the year mainly due to an increase in investments in securities denominated in foreign currency. The Domestic Banking Units (DBUs) of the banking sector reported a long foreign currency exposure of Rs. 21 billion as at end 2017, compared to Rs. 16 billion as at end 2016. The foreign currency exposure of the DBUs of the banking sector as a percentage of the banks' regulatory capital and on balance sheet assets stood at 2.3 per cent and 0.2 per cent, respectively, at end 2017. The banking sector reported a net foreign currency revaluation gain of Rs. 8.6 billion during 2017.

(c) Liquidity Risk: The banking sector operated with a high level of liquidity during 2017. The Statutory Liquid Assets Ratio (SLAR) of DBUs, which was maintained well above the regulatory minimum of 20.0 per cent, increased to 31.3 per cent as at end 2017, from 29.9 per cent in 2016. Meanwhile SLAR of Off-shore Banking Units (OBUs) was 34.6 per cent. Infusion of capital into a few banks and the deceleration of credit growth mainly contributed to the increase in liquidity in the banking sector. Further, the credit to deposits and borrowings ratio increased by 208 basis points during the year. Liquid assets to total assets and liquid assets to total deposits increased by 130 basis points and 56 basis points during 2017.

Total liquid assets of the sector increased by Rs. 474 billion (19.2 per cent) to Rs. 2,939 billion by end 2017. Government securities accounted

Table 8.5
Composition of Statutory Liquid Assets of the Banking Sector

Item	2016 (a)		2017 (b)		Change (Rs. bn)	
	Rs. bn	Share (%)	Rs. bn	Share (%)	2016 (a)	2017 (b)
Treasury Bills	506.6	20.5	742.4	25.3	-176.5	235.9
Treasury Bonds	843.0	34.2	960.3	32.7	162.6	117.3
Sri Lanka Development Bonds	451.7	18.3	515.6	17.5	-11.4	63.8
Cash	122.0	4.9	165.5	5.6	5.9	43.5
Money at Call	114.8	4.7	109.8	3.7	-27.0	-5.0
Balance with Banks Abroad	322.2	13.1	307.7	10.5	93.1	-14.5
Other	105.6	4.3	138.1	4.7	-7.7	32.5
Total Liquid Assets	**2,465.9**	**100.0**	**2,939.4**	**100.0**	**39.0**	**473.6**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

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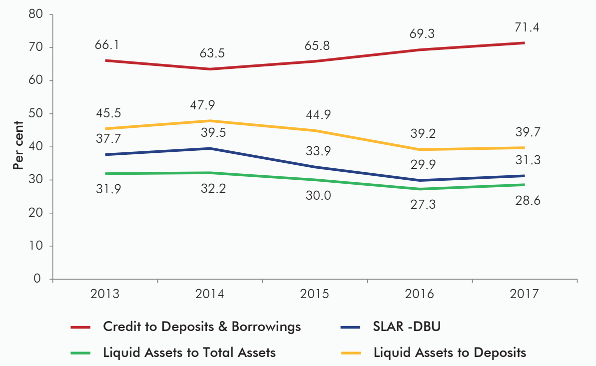
Chart 8.5
Liquidity Ratios of the Banking Sector



Source: Central Bank of Sri Lanka

for 88.1 per cent of the increase in liquid assets during 2017 and accounted for 75.5 per cent of the total liquid assets as at end 2017.

The cumulative maturity gap as a percentage of cumulative liabilities of the banking sector widened for the maturity time period (bucket) less than 30 days by end 2017, compared to end 2016. Variations in other maturity buckets were marginal.

The Liquidity Coverage Ratio (LCR) of the banking industry was maintained well above the regulatory limit of 80 per cent as at end 2017 (Banks are required to maintain 90 per cent with effect from 01 January 2018 and 100 per cent with effect from 01 January 2019). LCR for All Currency Liquidity Requirement increased to 155.6 per cent as at end 2017 from 152.6 per cent as at end 2016, while LCR for Rupee Liquidity Requirement declined to 187.1 per cent from 200.8 per cent.

Resources

(a) Profitability: Higher growth in interest expenses (39.1 per cent) compared to the growth in interest income (28.3 per cent) resulted in a marginal decline in the net interest margin to 3.5 per cent during 2017, from 3.6 per cent during 2016. Non-interest income, however, increased by Rs. 19 billion during 2017, compared to 2016, despite a decline in foreign exchange income by Rs. 2 billion. Non-interest expenses increased

Table 8.6
Profit of the Banking Sector

Item	2016 (a)		2017 (b)	
	Amount (Rs. bn)	As a % of Avg. Assets	Amount (Rs. bn)	As a % of Avg. Assets
Net Interest Income	304.3	3.6	341.6	3.5
Interest Income	757.5	8.9	971.9	9.9
Interest Expenses	453.2	5.3	630.2	6.5
Non-Interest Income	102.9	1.2	122.3	1.3
Foreign Exchange Income	25.9	0.3	23.5	0.2
Non-Interest Expenses	197.2	2.3	204.8	2.1
Staff Cost	98.4	1.2	103.1	1.1
Loan Loss Provisions	10.5	0.1	19.8	0.2
Profit before Tax (after VAT)	165.0	1.9	194.8	2.0
Profit after Tax	116.5	1.4	138.9	1.4

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

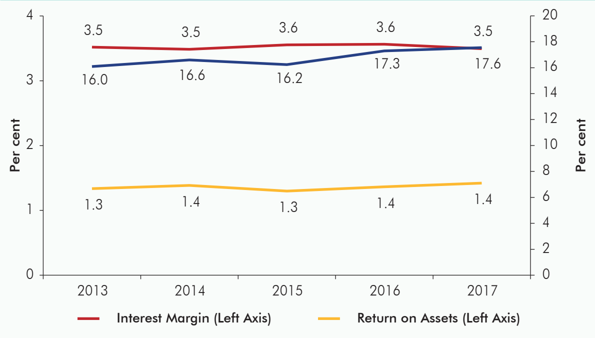
by Rs. 7 billion compared to last year, with staff costs contributing 62.6 per cent to the increase. Loan loss provisions rose by Rs. 9 billion to Rs. 19.8 billion in 2017 compared to last year's Rs. 10.5 billion mainly due to classifying of non-performing loans to loss category.

Profit after tax of the banking sector grew by 19.2 per cent, from Rs. 116.5 billion in 2016 to Rs. 139 billion in 2017. The increase in profitability was reflected in the increase in the ROE ratio by 28 basis points to 17.6 per cent and ROA - before tax ratio by 6 basis points to 1.4 per cent. The cost to income ratio has deteriorated to 76.3 per cent in 2017, from 75.6 per cent in 2016, largely due to the

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

Source: Central Bank of Sri Lanka

Chart 8.7
Profitability Indicators of the Banking Sector

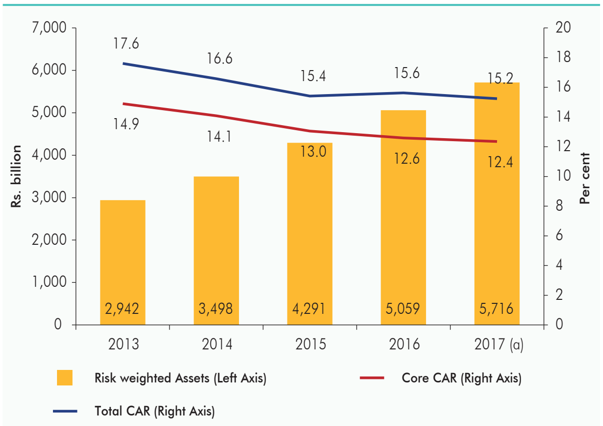


Source: Central Bank of Sri Lanka

increase in premises and establishment expenses, while the efficiency ratio improved by 358 basis points to 45.7 per cent during 2017.

(b) Capital: The Basel III capital standards were introduced to the banking sector from 01 July 2017 and the banking sector has maintained capital ratios at a comfortable level under Basel III in order to absorb any adverse shocks. The Core Capital Adequacy Ratio (CAR) and total CAR as at end December 2017, subsequent to the inclusion of estimated audited profits for 2017, stood at 12.4 per cent and 15.2 per cent, respectively. The infusion of capital to meet the increased minimum capital requirements largely contributed to the increase in Tier I capital and the share of Tier 1 capital to total capital increased to 81.1 per cent as at end 2017,

Chart 8.8
Capital Adequacy of the Banking Sector



(a) Under Basel III conditions
Source: Central Bank of Sri Lanka

Table 8.7
Composition of Regulatory Capital of the Banking Sector

Item	Amount (Rs. bn)		Composition (%)	
	2016 (a)	2017 (b)	2016 (a)	2017 (b)
Tier I Capital	633.7	706.2	100.0	100.0
Share Capital	185.5	246.0	29.3	34.8
Statutory Reserve Funds	40.8	41.7	6.4	5.9
Retained Profits	249.2	270.0	39.3	38.2
General and Other Reserves	188.8	176.9	29.8	25.1
Other	-4.9	8.6	-0.8	1.2
Regulatory Adjustments	-25.7	-37.0	-4.0	-5.2
Tier II Capital	153.4	165.0	100.0	100.0
Revaluation Reserves	13.9	15.2	9.1	9.2
Subordinated Term Debt	133.3	126.6	86.9	77.0
General Provisions and Other	23.9	27.8	15.6	16.9
Regulatory Adjustments	-17.7	-5.3	-11.5	-3.2
Total Regulatory Capital Base	787.1	870.5		

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

from 80.5 per cent as at end 2016. Tier II capital of the banking sector largely comprised subordinated term debt, which accounted for 77.0 per cent of the Tier II capital as at end 2017. The banking sector capital levels are expected to improve further with improved retained earnings and infusion of fresh capital to meet the increased capital requirements under Basel III and the enhanced minimum capital requirements by end 2020.

Risk weighted assets of the banking sector increased by 13.0 per cent during 2017, compared to 17.9 per cent growth during 2016, mainly due to the moderation in credit growth. The share of credit risk weighted assets in total risk weighted assets increased to 88.7 per cent by end 2017, from 86.6 per cent by end 2016.

Supervisory and Regulatory Developments

During 2017, the Central Bank continued to initiate prudential policy measures and regulations with a view to enhancing the safety and resilience of the banking sector. In order to strengthen the resilience of the banking sector and support the implementation of the Basel

BOX 09

Adoption of SLFRS 9: Financial Instruments by Banks in Sri Lanka

1. Background

1.1 Introduction of Sri Lanka Financial Reporting Standard 9 in Sri Lanka

During the period of the global financial crisis, there was a perception that accounting rules under International Accounting Standard 39: Financial Instruments Recognition and Measurement have contributed to worsen the economic crisis, through the use of fair value as a basis for accounting of financial instruments, which resulted in delayed recognition of loan losses. In the aftermath to the crisis, various expert groups reviewed this issue and it was highlighted that forward looking provisioning requirements are needed. Further, the need for a more logical approach towards classification and measurement of financial instruments was also highlighted, which ultimately led the standard setters to move towards International Financial Reporting Standard 9: Financial Instruments (IFRS 9), in order to ensure more proactive recognition of losses and better risk management.

Sri Lanka Financial Reporting Standard 9: Financial Instruments (SLFRS 9), issued by the Institute of Chartered Accountants of Sri Lanka (ICASL), is effective for the annual financial reporting periods beginning on or after 01 January 2018 and is mandatory for adoption by all entities. However, ICASL has granted the option to prepare the interim quarterly financial statements under the previous Sri Lanka Accounting Standard (LKAS) 39: Financial Instruments Recognition and Measurement, for the first three quarters of the first financial year under SLFRS 9.

The new standard establishes principles for reporting of financial instruments including requirements for classification, measurement, impairment, derecognition and general hedge accounting. This is the corresponding Accounting Standard for IFRS 9, which was issued by the International Accounting Standards Board in July 2014, to be effective from 01 January 2018.

1.2 Major Changes Brought About by SLFRS 9

In line with global developments, SLFRS 9 introduced a forward-looking loan loss provisioning mechanism, replacing the previous incurred loss model under LKAS 39. This forward-looking provisioning mechanism requires entities to identify significant drivers of their business model and possible futuristic macroeconomic scenarios in order to accurately capture the expected credit loss going forward. Further, SLFRS 9 introduced a new basis for financial asset classification and a model for hedge accounting that aligns the accounting process with the risk management activities.

2. Classification of Financial Instruments under SLFRS 9

2.1 Classification of Financial Assets

Previously under LKAS 39, financial assets were classified into four categories, namely, Held-to-maturity (HTM), Loans and Receivables, Fair Value through Profit or Loss (FVTPL), and available for sale. These are replaced in SLFRS 9 with two main categories, reflecting the measurement of Financial Instruments, namely amortized cost and fair value. The measure of fair value will have two sub categories, Fair Value through Other Comprehensive Income and FVTPL.

Financial asset classification under SLFRS 9 for debt securities is driven by the business model for managing financial assets and assets' contractual cash flow characteristics, and disallows the ability of the entities to classify and measure financial instruments at their discretion. Under SLFRS 9, investments in equity instruments are to be measured at fair value and under LKAS 39 there was no such restriction for classification and measurement of equity instruments.

2.2 Classification of Financial Liabilities

The classification and measurement of financial liabilities under SLFRS 9 is the same as in LKAS 39, except in circumstances where an entity has chosen to measure a financial liability at FVTPL. In such cases, changes in fair value related to changes in own credit risk are adjusted separately to Other Comprehensive Income.

3. Credit Loss Provisioning / Impairment under SLFRS 9

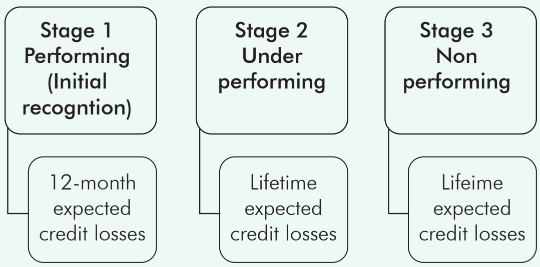
3.1 Provisioning under LKAS 39 and SLFRS 9

The accounting model for recognising credit losses under LKAS 39, commonly referred to as "incurred loss model", requires recording of credit losses that have been incurred as of reporting date, rather than of probable future losses. In contrast, SLFRS 9 requires banks to provide for loan losses based on the expected credit loss approach, in order to facilitate timely recognition of credit losses. The new standard requires banks to calculate 12-months expected credit losses and life time expected losses for performing and under-performing/ non-performing assets, respectively.

3.2 Three Stage Provisioning Model under SLFRS 9

SLFRS 9 outlines a 'Three-Stage' model for provisioning based on changes in credit quality (Figure 01). At the initial recognition, performing credit facilities are categorised into stage 1 and entities need to provide for expected credit losses for the next 12-months. Credit facilities are categorised as under-performing (stage 2) or non-performing (stage 3) when the credit risk is assumed to be increased significantly since the initial recognition and hence, lifetime expected losses must be recognised.

Figure 1:
Stages of Recognising Credit Loss under SLFRS 9



Further, banks need to account for the interest revenue depending on the performing status. If the asset is performing or under-performing, interest revenue should be calculated based on the full value of the asset and if the asset is non-performing, interest revenue must be calculated based on the value after deducting the expected credit loss from the asset.

3.3 Use of Models, Parameters and Judgements

With the adoption of SLFRS 9, role of risk models and transparency of the such models are expected to be more significant. In order to measure the expected credit loss accurately, banks' experience in assessing significant increase in credit risk, supported by reliable and justifiable forward-looking information is essential.

With the increased dependency on models, banks need to have in place validation processes to ensure that the credit risk assessment and measurement models are able to generate accurate, consistent and unbiased estimates on an on-going basis.

4. Global Regulatory Practices

4.1 Adoption of IFRS 9 in other Countries

Many countries across the globe have used various approaches on the adoption of IFRS 9, under the guidance of relevant accounting regulatory bodies. However, due to the significant impact of IFRS 9 on the financial sector, arising from the increase in loan loss provisions through the use of expected credit loss approach, the Central Banks and other prudential regulatory authorities of some countries have already issued guidance to banks to ensure smooth and consistent application of the Standard across the financial sector.

Regulatory treatment of provisions under the Standardised Approach[1] and Internal Rating Based approaches[2] for credit risk differs under Basel II/III and most countries who have already issued guidance on IFRS 9 are countries that have moved to advance approaches for credit risk. Countries using the Standardised Approach, like Sri Lanka, will find it challenging as there will be heavy dependence on complex credit provisioning models under IFRS 9.

4.2 Treatment of Accounting Provisions for Regulatory Capital Calculations

When moving towards a forward-looking loan loss provisioning mechanism, banks will need to recognise the impact of expected credit loss on the existing portfolios of loans and financial instruments to retained earnings, on the first day of adopting SLFRS 9 and this is commonly referred to as the "first day impact".

The Bank for International Settlements (BIS) has issued a paper on "Regulatory treatment of accounting provisions – interim approach and transitional arrangement" on March 2017, to provide a transitional arrangement to stagger the impact on capital up to a certain period of time to address the significant negative impact arising from the introduction of expected credit loss accounting. The staggering of the first day impact will enable banks to rebuild their capital and reduce the stress on capital.

5. Impact on the Banking Sector in Sri Lanka

5.1 Impact on Banks Capital Positions

Based on the available information, the increase in existing loan loss provisions as first day adjustment is expected on average to be around 20% to 40% for the Sri Lankan banking sector and will vary depending on the respective banks business models and practices.

In addition to the first day impact, the adoption of SLFRS 9 is also expected to have a considerable impact on capital positions and the growth ability of banks, with recognition of stage 1 losses immediately in the income statement, as and when new facilities are granted. Further, with the phase-in arrangement of higher capital requirements under Basel III, Enhanced Minimum Capital Requirements and proposed Leverage Ratio, certain banks may face a challenging position to ensure sustained growth, while maintaining appropriate levels of capital.

1. An approach used by Basel Standards to measure credit risk based on pre-defined risk weights.
2. An approach used by Basel Standards to measure credit risk based on internal rating scales given to credit facilities by banks.

5.2 Credit Risk Modelling

Currently, the standardised approach is used to measure the credit risk in Sri Lankan banks under Basel III. However, all banks will need to move towards model-based approaches to calculate the expected credit loss under SLFRS 9. Modelling of expected credit risk under SLFRS 9 requires banks to extract vast amount of additional information that have not been used before and, accordingly, banks are expected to invest in upgrading their management information systems.

5.3 Point of Deterioration of Credit Quality

SLFRS 9, introduces a rebuttable presumption that significant increase in credit risk will occur when the borrower has not settled dues within 30 days and hence it requires assets to be classified as underperforming while recognising life time expected loss for such credit facilities. Under LKAS 39, one criterion used by the banking sector to consider facilities for impairment was the threshold of 90 days, in line with the prevailing regulatory classification of credit facilities. However, the 30-day rebuttable presumption can only be rebutted if banks can prove that credit risk has not increased significantly even though contractual payments have not been paid by the borrowers for more than 30 days. The industry experts, observe that rebutting the above presumption will be challenging in the Sri Lankan context.

6. Way Forward

6.1 Approach of the Central Bank

The Central Bank of Sri Lanka (CBSL) has already reviewed the preparedness of banks and impact to the banking sector on adopting SLFRS 9 and intends to issue broad guidelines on the adoption of SLFRS 9 by licensed banks, to ensure the consistent application of SLFRS 9 and to streamline the implementation process. Further, CBSL will facilitate a dialogue between relevant stakeholders on SLFRS 9 and build an effective channel of communication between banks and CASL to ensure consistent application across the sector.

CBSL will consider a similar approach as provided by BIS, to stagger the impact on Capital Adequacy for a few years, in order to enable banks to absorb the increase of loan loss provisions due to the adoption of SLFRS 9. CBSL also intends to assess the status of banks on the adoption of SLFRS 9 and will facilitate all efforts to build capacity within the sector.

6.2 Supervisory Expectations

Due to the limited expertise available in banks, most banks have obtained the services of consultants to guide the SLFRS 9 implementation process. Therefore, banks are expected to ensure capacity building within the organisations, by providing suitable training to staff and acquiring the required skills.

Further, banks are required to build new models to determine loan loss provisions and due to the complexity in the models, the implementation process will require a significant amount of time and preparedness and hence effective coordination and communication within internal functions in banks will become more important. Specially, internal audit and risk management departments of banks along with the senior management must ensure consistent bank-wide application of SLFRS 9, including validating models and ensure the proper documentation of the adoption process is in place. Banks are also expected to make a new range of qualitative disclosures on financial assets, use of judgements and expected loss provisioning process in the financial statements, to facilitate proper market conduct.

Boards of Directors of banks, particularly the Board Audit Committee, are expected to oversee the SLFRS 9 implementation process on a regular basis, while streamlining capital planning, stress testing and internal capital adequacy assessment process (ICAAP) in line with the adoptation of SLFRS 9, to ensure compliance with regulatory requirements and address other challenges banks may face. Going forward, CBSL expects consistent application across the banking sector on models to be used, model inputs, use of assumptions and disclosures relating to SLFRS 9.

6.3 Future Benefits

Amidst the challenges, timely adoption of SLFRS 9 in banks will lead to improved management information systems, strong credit-management practices, enhanced disclosures and the need to closely monitor the behaviour of each credit facility from the point of origination. Therefore, SLFRS 9 is expected to result in enhanced credit quality, advanced performance monitoring systems of credit facilities, increased shock absorption capacity and improved prudence and risk management across the banking sector.

Sources: The related documents published by the International Accounting Standards Board, Institute of Chartered Accountants of Sri Lanka, Basel Committee on Banking Supervision and information received from licensed banks in Sri Lanka.

III framework, licensed banks were informed to enhance minimum capital requirements by 31 December 2020. Accordingly, existing locally incorporated licensed commercial banks are required to maintain Rs. 20 billion of minimum capital, while banks incorporated outside Sri Lanka with assets up to Rs. 100 billion are required to maintain Rs. 5 billion and banks with assets over Rs. 100 billion are required to maintain Rs. 10 billion, respectively. Licensed specialised banks will need to maintain Rs. 7.5 billion. Banks are also required to formulate capital plans to meet the enhanced requirements, where necessary. Licensed banks that fail to comply with these requirements will not be permitted to pay dividends, repatriate profits or adopt any other measure that will further deteriorate the capital of the bank until such compliance is affected.

Further, any new locally incorporated licensed commercial bank and licensed specialised bank are required to bring in Rs. 20 billion and Rs. 7.5 billion, respectively, as the capital at point of entry. Banks incorporated outside Sri Lanka are required to bring in capital of Rs. 10 billion.

A consultation paper on the Implementation of Leverage Ratio under the Basel III framework was issued to banks and commencing 31 March 2017, banks were required to report Leverage Ratio for monitoring purposes within 30 days from the end of each quarter. Leverage ratio will restrict the build-up of excessive leverage in the banking sector that can adversely affect the broader financial system and the economy, and Directions on Basel III Leverage Ratio will be issued in the second half of 2018. Net Stable Funding Ratio (NSFR) under Basel III requires banks to maintain a stable funding profile in relation to their composition of assets and off-balance sheet activities. Accordingly, a consultation paper on NSFR under Basel III was issued to licensed banks, requesting their comments and Directions on NSFR will also be issued for implementation in the second half of 2018.

Banking Act Directions on financial derivatives were issued to licensed banks with a view to strengthening risk management of derivative transactions. Accordingly, banks are required to have in place Board approved policies and procedures on derivative transactions and risk management framework to identify, quantify and evaluate the exposures, manage risk and monitor derivative transactions.

With a view to further strengthening risk management aspects of foreign currency borrowings by banks, a new policy was implemented, effective from 01 January 2018. The new policy was introduced with the objective of addressing the high dependence on foreign currency borrowings and resulting foreign exchange risks in licensed banks and minimising the pressure on foreign reserves of the country and exchange rate, resulting from large borrowings in foreign currency.

As a macroprudential measure to curtail the excessive credit in the banking sector for purchase of motor vehicles, licensed banks were instructed to follow LTV ratios, when granting credit facilities including finance leases, hire purchase facilities and all other facilities for purchase or utilisation of motor vehicles by end-users. However, credit facilities granted to any company engaged in tourism and/or transportation for the purpose of vehicle fleets to be utilised for their core business operations are exempted from these restrictions, provided that such vehicles are not transferred to another party.

BOX 10
The Future of Banking driven by Technology

History of Technology in Banking

The banking sector has embraced the use of technology throughout its transformation from a brick-and-mortar style banking to digital banking. In the past, such as in 600 BC, the first official coin was minted and thereon the journey passed many milestones; the first cheque was written in 1659, the credit card was originated in 1920s, the first debit card was issued in 1978 and in 1984 the first on-line shopping transaction was executed.

Era of Digitalisation

As technology entwined into customer needs, it opened opportunities that never existed in conventional banking, leading to banks transforming to the digitalised era. As mobile wallets, e-wallets, pre-paid cards, contactless cards, wrist band payments and other digitalised alternatives are gaining attraction, fewer people tend to visit the bank in person. With continual improvements in technology and consumers' increasing reliance on it, changes to delivery of banking products are likely to happen more efficiently and effectively.

Future driven by Technology

Fintechs and telecommunication companies (telcos) in the recent past have led innovation while radically altering the financial ecosystem. They offer personalised solutions for tech-savvy customers, catering to the changing dynamics of customers and demand for digital financial services. Fintechs and telcos have the potential to lessen barriers to enter into financial services, elevate the reliance on information driven financial services and drive the emergence of new business models. The fast pace of change in fintechs and telcos has made the business models of banks more challenging and competitive. Banks need to thrive in the digital economy to compete with new entrants, by being cost effective and serving based on customer demographics. However, banks need to be able to navigate through a strong regulatory framework in line with the risks involved, to fully embrace opportunities presented by the digital era.

Emerging Technologies

During the recent past the banking sector has been attracted towards the following emerging technologies:

(a) Open banking

In open banking, third party applications will be permitted to access consented customer data through Application Programming Interfaces (APIs). This provides greater convenience and choice in banking by allowing access to different banks through a single electronic platform.

(b) Cloud computing

Cloud computing is a shift in how computer processing resources are generated, consumed and shared. Service providers offer data centers so that banks do not require the maintenance of their own data centers as they have access to on-demand processing and storage facilities. Cloud computing provides cost efficiency, operational flexibility and increased security. However, privacy of data, uninterrupted accessibility, and implications over national security remain to be addressed in the adoption process.

(c) Electronic onboarding (e-onboarding) and authentication

The face-to-face interaction when establishing the business relationship has been a salient feature of banking. However, as banks leverage on technology and customers are unwilling to visit a bank at least once, e-onboarding of customers is becoming a necessity. The benefits are obvious; however the challenge would be effective adherence to Anti-Money Laundering (AML), Countering the Financing of Terrorism (CFT) and Customer Due Diligence (CDD) requirements.

(d) Cryptocurrency

Cryptocurrency is a digital asset designed to work as a medium of exchange that uses cryptography, and operates independent of a central bank. Regulators are cautious on cryptocurrency due to their associated risks such as monetary implications, speculative pressure, security breaches, lack of regulations, money laundering/financing of terrorism risks and tax evasion. Certain regulators have taken a restrictive approach due to these risks.

(e) Distributed Ledger Technology (DLT) and blockchain

DLT is an asset database that can be shared across a network where participants can have their own identical copy of the ledger. Blockchain is a variation of DLT where data is organised in blocks. Certain countries are exploring its usage in compiling credit information, sharing KYC, detecting money laundering and other forms of illicit finance. DLT developments, including blockchain, trigger concerns over data privacy and lack of industry standards.

(f) Artificial Intelligence (AI) and big data analytics

Artificial intelligence has enabled the computer programs to interact and learn to undertake tasks previously done by humans and has enabled faster and accurate decision making. Main benefits are enhanced customer personalisation, productivity gains, fraud mitigation, and better product/service recommendations. This has been complimented by the developments in big data analytics, allowing the analysis of unstructured data like pictures, voice records, and social media behaviours.

Emerging Risks in the Banking Sector due to High Reliance on Technology:

(a) Risks in money laundering, Know Your Customer (KYC) and financing of terrorism

Replacement of traditional banking by disruptive innovations impair the ability of banks in effective surveillance. Fintech and e-banking developments force banks to adopt e-customer onboarding, eliminating face-to-face interaction, imposing a heightened level of money laundering/KYC/ financing of terrorism threat.

(b) Technology risk management and cyber security

The unstoppable trend towards digitalisation in the banking sector increases the technology and cyber risk exposure. Recent high profile global cyber-attacks have shown its increasing sophistication and frequency, threatening the stability and soundness of the financial system.

(c) Privacy and data protection

Customers' right to privacy and data protection has become a growing concern with challenges posed by the new transformed operating environment of banks. Data leakages across the world has proven that sensitive customer information can end up in wrong hands, unless protected.

(d) Demise of humane and intuitive decision making

The dominance of big data analytics and machine learning algorithms in the decision-making process of banks detaches the industry further from society, posing the risk of sole dependence on inputs fed on systems.

Challenges

Making changes to legal and regulatory frameworks, challenging role of central banks and banks are the main challenges that are faced in technology driven banking, as discussed below.

(a) Making changes to legal and regulatory frameworks

Rapid technological advances cause existing legal and regulatory frameworks to become outdated. The long process to be followed in introducing new laws and regulations further complicates the situation. In the local context, Computer Crime Act and Electronic Transactions Act are key legislations governing the matters related to information systems and e-transactions. Further, specific regulations imposed by the Central Bank cover areas on information security, availability of systems, and customer protection. However, areas like data protection, cryptocurrency, and cloud computing remain to be adequately addressed through legislations and regulations.

(b) Challenging role of central banks

The society's prevalent adoption of new technologies like cryptocurrency and DLT pose challenges to both price stability and financial system stability objectives of central banks. It is also probable that a large unregulated alternative financial system come into existence, unless technological advances are not carefully brought under the purview of regulations.

(c) Challenging role of banks

Banks are faced with constantly evolving challenges that require comprehension and appropriate reactions while going forward in the digital era. They require cautious defensive mechanisms to address new loopholes/ evolving cyberattacks/possible AML/CFT and other regulatory non-compliances, parallel to achieving their business objectives. The Board of Directors and top management of banks need to understand the risks associated with technology in the decision making process.

Way Forward

Cautious adoption of technology

Banks relying on innovative technologies need to ensure that effective risk management processes and controls are in place to address new sources of risks effectively. Further, as banks are increasingly relying on third party service providers for technology based financial services, the adequacy of controls over those services should remain of the same standard as if the bank itself has conducted the service.

Need expertise on technology and far sighted Boards for leadership

The importance of information technology goes beyond the management of infrastructure and maintaining applications for the business. Prudent and far sighted Boards, equipped with relevant digital literacy, are essential in assuring the strategic alignment of IT function and prudent management of technology and cyber risk for future banking.

Adaptive regulatory approach and use of technology in regulation (RegTech)

A supportive and conscious regulatory regime is essential for society to derive maximum benefit from disruptive innovations and to adequately protect against emerging risks. Clearly spelled out regulations for the use of technology will help maintain financial system stability and subdue the risk of emergence of a large unregulated alternative financial system.

Strengthening technology risk resilience

In this regard, CBSL has developed a roadmap to improve technology risk resilience in the banking sector, which includes technology risk assessments, external confirmations in compliance with Baseline Security Standards, security reviews on information and communication technology infrastructure, awareness sessions for Boards and top management, training/certification programs for technology risk management staff, regulations on a minimum number of IT staff with designated qualifications, and having professionals qualified in information security in the internal audit.

Further, CBSL is in the process of exploring the possibility of mandating banks with higher inherent technology risk to establish dedicated information security operations centers (ISOC) or subscribe to a third party shared ISOC. In addition, CBSL is in the process of establishing policy frameworks for streamlining the digitalisation of banking operations, defining minimum regulatory expectations on cloud computing and use of fintech solutions. CBSL has also established two committees with industry participation to study and provide recommendations on the use of blockchain technology and adoption of suitable fintech innovations in Sri Lanka. These initiatives will provide a legislative and regulatory basis for a level playing field between fintechs and incumbent banks.

A circular was issued to licensed banks permitting the banks to charge interest rates and penal interest as per their policies with a view to reducing non-performing loans, rising market interest rates and the requirement to discourage unproductive short-term personal loans, which have increased during the recent past. Such rates are required to be published along with the basis of calculation and changes prior to effecting such revision. This will enable all licensed banks to charge a competitive interest rate on credit products. However, the banks were advised to charge penal interest, if any, only for the amount in arrears during the overdue period. Banks were also requested to ensure that applicable interest rates on credit products are published in a legible manner when promoting credit products in any media at all times and to publish penal interest rates, if any, with basis of computation at least in the bank's website for the information of the public and to update regularly to reflect the current rates. Banks were requested to inform borrowers on applicable interest rates prior to the completion of credit documentation and any subsequent changes to interest rates prior to effecting any such revision to existing credit.

With the intention of preventing smuggling of gold out of the country through bulk purchases of pawned gold articles at auctions conducted by banks, a determination was issued instructing licensed banks to report monthly details of the purchases of gold articles of Rs. 500,000 or above at auctions. Further, any suspicious transactions, which indicate a collusion between two or more parties in order to buy large quantities of gold at auctions should also be reported.

Licensed banks were informed to grant concessions on a case-by-case basis to the borrowers affected by the floods, adverse weather conditions and connected circumstances in terms of the national policy adopted to facilitate the rehabilitation of businesses and normal operations of borrowers in the national interest and report details to the Director of Bank Supervision by 30 June 2017.

In order to support the Government's initiative for enhancing access to finance, as proposed in the Budget 2017, licensed banks were informed to take appropriate measures to increase distribution of credit to certain identified sectors. Accordingly, credit granted as a percentage of total loans, may not be less than

10 per cent each for small and medium enterprises, exports and tourism activities and for agriculture and 5 per cent each for youth and women.

Licensed banks were further informed to enhance several banking services, such as maintaining at least 15 per cent of deposits mobilised by each branch within the same area for credit granted by bank branches, expediting the process of granting credit with a value of less than Rs. 5 million in less than one month, and at least opening one branch in each district on all 7 days of the week, excluding the religious holidays. Further, commencing 01 July 2017, all licensed banks were required to report details of credit granted as required above, for each quarter, in order to monitor the banks' compliance with the national policy.

8.3 Performance of Non-Banking Financial Institutions

Licensed Finance Companies and Specialised Leasing Companies (LFCs and SLCs) Sector

The LFC and SLC sector performance moderated during the year with low credit growth, declining profitability and increase in non-performing loans. The sector expanded in 2017, with an asset growth of 11.8 per cent, representing 7.9 per cent of Sri Lanka's financial system. The sector remained strong, with capital maintained at healthy levels along with adequate liquidity buffers well above the regulatory minimum levels. The sector exhibits a shift in funding mix, as increased assets were mainly funded through deposits while borrowings of the sector declined compared to the high growth recorded during the previous year. The Central Bank continued to take prudential measures to maintain the stability of the sector with much consideration on reviving the companies with weak financial positions.

Business Growth

(a) Outreach: By the end of 2017, the sector comprised of 45 LFCs and 6 SLCs. During the year, two amalgamations were completed between Chilaw Finance PLC merging with Richard Peiris Finance Ltd. and Isuru Leasing Co. Ltd. merging with Central Finance PLC. LFCs and SLCs contributed to economic activities and development throughout the year by enhancing services provided to customers and expanding its branch network. By end 2017, there were 1,362 branches and 781 other outlets of the LFCs and SLCs sector. Out of total branches, 920 branches (67 per cent) were concentrated outside of the Western Province.

(b) Assets: The total asset base of the sector grew moderately by Rs. 143 billion during the year reaching Rs. 1,355 billion by end 2017, at a growth

Table 8.8
Distribution of Branches of the LFCs and SLCs Sector by Province

Province	End 2016	End 2017 (a)
Western	424	442
Southern	144	148
Sabaragamuwa	105	111
North Western	136	147
Central	147	152
Uva	66	68
North Central	94	100
Eastern	107	110
Northern	81	84
Total	**1,304**	**1,362**

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

Table 8.9
Composition of Assets and Liabilities of the LFCs and SLCs Sector

Item	2016 (a)		2017 (b)		Change (%)	
	Rs. bn	Share (%)	Rs. bn	Share (%)	2016 (a)	2017 (b)
Assets						
Loans and Advances (net)	962.7	79.4	1,057.1	78.0	21.0	9.8
Investments	111.7	9.2	118.1	8.7	12.1	5.7
Other	137.5	11.3	179.8	13.3	36.6	30.8
Liabilities						
Total Deposits	530.7	43.8	686.7	50.7	10.4	29.4
Total Borrowings	438.7	36.2	396.0	29.2	39.6	-9.7
Capital Elements	146.1	12.1	169.7	12.5	18.7	16.1
Other	96.4	8.0	102.6	7.6	23.5	6.4
Total Assets/Liabilities	**1,211.9**	**100.0**	**1,355.0**	**100.0**	**21.7**	**11.8**

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

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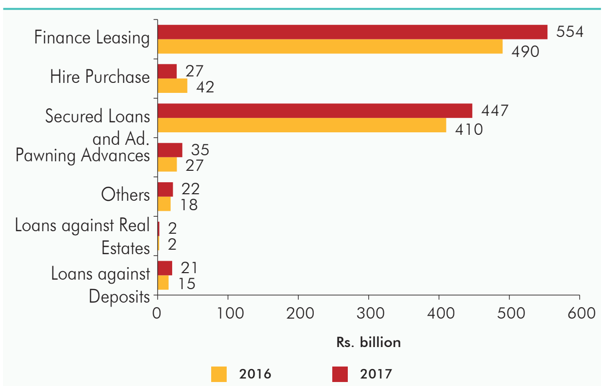
rate of 11.8 per cent, compared to the 21.7 per cent growth reported in 2016. The assets base of the sector mainly consisted of loans and advances and accounted for 78 per cent of the total assets which contributed to 66 per cent of the assets growth. Finance leases accounted for 50 per cent of the loans and advances followed by other secured loans which accounted for 40 per cent.

The overall credit expansion indicated clear signs of slowing down the sector growth during the year 2017. The slowdown of credit growth witnessed during the year, compared to 2016 can be attributed to fiscal and macroprudential policy measures taken to curtail the importation of motor vehicles and lending towards vehicles, the moderate economic growth witnessed in the economy during the year and high interest rates that prevailed in the market. Credit growth of the sector decelerated to 9.8 per cent (Rs. 94 billion) amounting to Rs. 1,057.1 billion, compared to 21.0 per cent experienced during 2016. Around 62 per cent of this growth was through finance leases, while 36 per cent was through secured loans and advances. The hire purchase portfolio contracted during the year by Rs. 15 billion (35.6 per cent). However, the growth of finance lease portfolio for the year 2017 was 13 per cent, compared to the growth of 17 per cent recorded in the year 2016.

Chart 8.9
Product wise Loans and Advances (Gross) of the LFCs and SLCs Sector



Source: Central Bank of Sri Lanka

The growth of investment portfolio, which comprises investment in equities, capital market debt instruments, government securities and investment properties, slowed down during the year 2017, with a growth rate of 5.7 per cent, compared to the growth of 12.1 per cent in 2016. The investments in government securities and investment in equities declined during the year and there was a notable increase in investment in unit trusts during the year. Other assets mainly comprised cash, balances with banks and financial institutions, trading stocks, and fixed assets, which showed an increase of 30.8 per cent in 2017, largely due to increased placements in banks and financial institutions.

(c) Liabilities: Customer deposits became the major portion of liabilities in 2017 and accounted for 50.7 per cent of the total liabilities of the sector. Sector borrowings and capital accounted for 29.2 per cent and 12.5 per cent, respectively.

The sector exhibited a shift in the funding mix as the expansion was largely funded through the customer deposit mobilisation. The deposits grew by 29.4 per cent to Rs. 686.7 billion in 2017, compared to the growth of 10.4 per cent in 2016. Time deposits grew by 29.2 per cent compared to the growth of 11.1 per cent in the year 2016 and savings deposits grew by 35.3 per cent compared to the negative growth of 1.7 per cent recorded in the previous year. Nevertheless, time deposits accounted for a major share of total deposits, representing 95.5 per cent. The sector borrowings indicated a negative growth of 9.7 per cent to

Table 8.10
Composition of Deposits of the LFCs Sector

Item	Amount (Rs. bn)		Composition (%)	
	2016	2017 (a)	2016	2017 (a)
Time Deposits	507.7	655.7	95.7	95.5
Savings Deposits	22.2	30.0	4.2	4.4
Certificate of Deposits	0.9	1.0	0.2	0.2
Total Deposits	**530.7**	**686.7**	**100.0**	**100.0**

(a) Provisional Source: Central Bank of Sri Lanka

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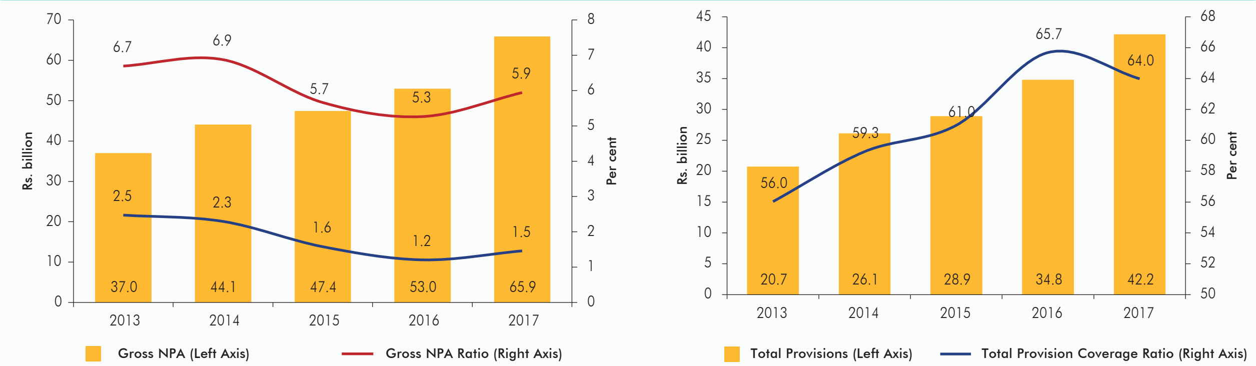
Chart 8.10
Non-performing Loans and Provision Coverage of the LFCs and SLCs Sector



Source: Central Bank of Sri Lanka

Rs. 396.0 billion in 2017, compared with the high growth of borrowings of 39.6 per cent experienced during 2016. The increasing reliance on deposits were mainly attributed to the declining trend of deposit interest rates.

The capital elements of the sector increased by 16.1 per cent to Rs. 169.7 billion as at end 2017, mainly on account of steps taken by companies to enhance the minimum core capital to meet the Rs. 1 billion requirement by 01 January 2018 as well as through the internally generated profits for the financial year 2016/17.

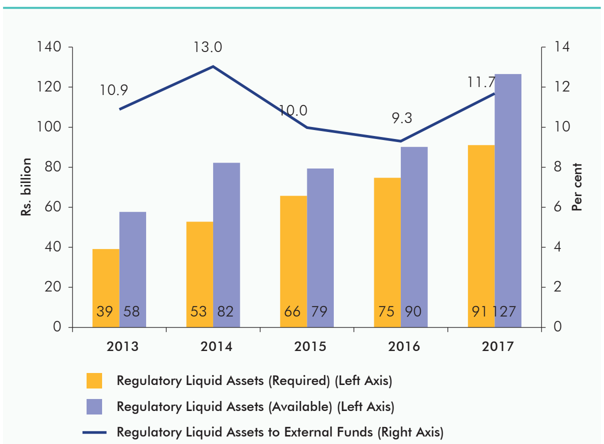
Risks in the LFCs and SLCs sector

(a) Credit Risk: Gross non-performing loans (NPLs) portfolio increased to Rs. 65.9 billion by Rs. 12.9 billion in 2017 (24 per cent) mainly due to the floods that occurred during the first half of 2017, nationwide drought and slowing down of the economy. The gross NPL ratio increased to 5.9 per cent in 2017 from 5.3 per cent reported in 2016 due to the increase in gross NPLs and decline in the growth of the loan portfolio. The total loan loss provisions increased by Rs. 7.4 billion to Rs. 42.2 billion due to the increase in the specific provisions made for NPLs. The provision coverage ratio declined to 64.0 per cent in 2017, compared to 65.7 per cent in 2016. As a result, net NPL ratio increased to 1.5 per cent in 2017 from the reported ratio of 1.2 per cent in 2016, showing signs of deterioration in the asset quality of the sector. However, with appropriate risk mitigation techniques, credit risk of the sector remained at manageable levels.

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

Interest Rate Risk: Along with the gradual decrease in interest rates towards the second half of the year, interest rate risk of the sector

Chart 8.11
Regulatory Liquid Assets of the LFCs and SLCs Sector



Source: Central Bank of Sri Lanka

decreased. The prevailing negative mismatch in the maturity profile of the interest bearing assets and liabilities of the sector enabled to maintain a positive net interest margin.

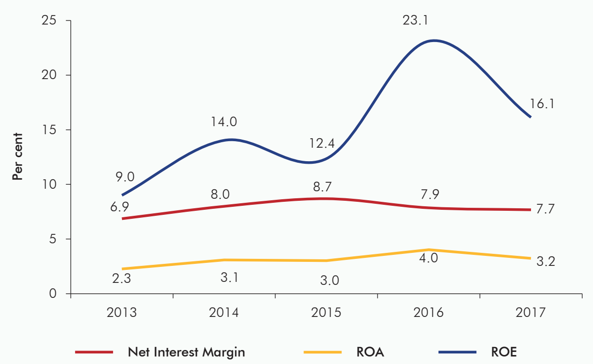
Prices of Equity: Equity risk of the sector remained low during the year as the exposure to equity market in the form of investment in listed shares was minimal at Rs. 14.2 billion, which was only 1.0 per cent of the total assets of the sector.

(c) Liquidity Risk: The overall statutory liquid assets available in the sector during 2017 showed a surplus of Rs. 35.5 billion as against the stipulated minimum requirement of Rs. 91.1 billion. The surplus liquid assets increased during 2017 compared to Rs. 15.4 billion in 2016 due to the contraction of lending activities of the sector. As a result, the liquid assets to total assets ratio increased to 8.9 per cent from 7.1 per cent in 2016. The liquid asset to deposits ratio was well above the statutory minimum requirement of 10.0 per cent of time deposits and borrowings, and 15 .0 per cent of savings deposits as at end 2017.

Profitability and Capital Resources

(a) Profitability: The net interest income of the sector increased at a slower rate than in 2016, recording a growth of 11.5 per cent to Rs. 102.7 billion. This was mainly due to the increase in interest expenses by 33.1 per cent, compared to the growth of interest income only by 22.6 per cent. As a result, net interest margin of the sector (net interest income as a percentage of average assets) declined marginally to 7.7 per cent in 2017 from 7.9 per cent in 2016. Non-interest income increased by 20.3 per cent mainly due to the increase in default charges and other service charges, while non-interest expenses also increased by 21.9 per cent, affecting adversely towards sector profitability, mainly due to the increase in staff costs. The loan loss provisions made against NPLs, which was Rs. 13.5 billion, increased by Rs. 6 billion during 2017, when compared to the provision of

Chart 8.12
Profitability Indicators of the LFCs and SLCs Sector



Source: Central Bank of Sri Lanka

Table 8.11
Composition of Income and Expenses of the LFCs and SLCs Sector

Item	2016 (a)		2017 (b)	
	Amount (Rs. bn)	As a % of Avg. Assets	Amount (Rs. bn)	As a % of Avg. Assets
Net Interest Income	92.1	7.9	102.7	7.7
Interest Income	188.9	16.1	231.5	17.3
Interest Expenses	96.8	8.3	128.9	9.6
Non-Interest Income	28.3	2.4	34.0	2.5
Non-Interest Expenses	65.6	5.6	80.0	6.0
Loan Loss Provision (Net)	7.6	0.6	13.5	1.0
Profit before Tax	47.2	4.0	43.2	3.2
Profit after Tax	31.5	2.7	25.8	1.9

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Table 8.12
Composition of Regulatory Capital of the LFCs and SLCs Sector

Item	Amount (Rs. bn)		Composition (%)	
	2016 (a)	2017 (b)	2016 (a)	2017 (b)
Tier I: Core Capital	113.0	139.3	100.0	100.0
Issued and Paid-up Ordinary Shares/ Common Stock (Cash)	63.4	65.9	56.2	47.3
Non-cumulative, Non-redeemable Preference Shares	0.1	0.1	0.1	0.1
Share Premium	0.6	0.5	0.5	0.4
Statutory Reserve Fund	15.6	19.1	13.8	13.7
General and Other Free Reserves	24.0	28.0	21.2	20.1
Other	9.3	25.7	8.2	18.5
Tier II: Supplementary Capital	14.1	17.1	100.0	100.0
Eligible Revaluation Reserves	2.3	2.3	16.0	13.4
General Provisions	0.4	0.5	2.5	2.9
Eligible Approved Unsecured Subordinated Term Debt	11.7	14.6	82.8	85.1
Other	-0.2	-0.2	-1.4	-1.4
Regulatory Adjustments	-10.9	-11.1		
Total Regulatory Capital Base	116.2	145.3		

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

8

BOX 11

Introduction of the Financial Customer Protection Framework for Licensed Finance Companies and Specialised Leasing Companies

1. Introduction

Customer confidence and trust are the main pillars in the financial services market that promote financial stability, growth, efficiency and innovation over the long term. In this regard, it is important to root out unfair, deceptive, or abusive acts of financial service providers by enforcing the laws, enhancing customer knowledge through increasing financial literacy, improving disclosure requirements, promoting responsible conduct of both the customers and the service providers, and providing an opportunity to access effective complaint handling mechanisms.

2. Present Status of Financial Customer Protection in Sri Lanka

In Sri Lanka, the Consumer Affairs Authority was established under the Consumer Affairs Authority Act, No. 9 of 2003. It is empowered to take the necessary actions to safeguard the interests of the customers of goods and services, whereas limited protection is available for customers of financial services. The Financial Ombudsman office was established in 2003, specifically to protect the rights and interests of financial customers. The Sri Lanka Banks' Association established a credit counselling centre named, "Upadeshana" in January 2009, to provide counselling services for financially distressed persons. Apart from the above, there is no formal authority to protect the rights and interests of the financial customers in Sri Lanka.

The Central Bank of Sri Lanka has issued a Direction on a customer charter for licensed banks, in December 2011, in view of safeguarding the rights and interests of bank customers. It is designed to build up a healthy relationship between customers and licensed banks and thereby, ensure customer confidence and stability in the banking sector. Further, a Direction on a customer charter was issued in November 2013, to govern the relationship between primary dealers and its customers, with the view of meeting the expectations of the investors in government securities.

3. Licensed Finance Companies(LFCs) and Specialised Leasing Companies(SLCs) sector

The LFCs and SLCs sector has expanded throughout the country, with a branch network of approximately 1,360 branches, serving nearly 3 million loan customers and 4 million depositors. Even though the sector is facilitating financial inclusion in the country, over the past few years there have been several malpractices reported regarding the conduct of businesses, which are detrimental to the rights of customers and stability of the financial system. These include, unethical recovery practices, multiple lending, and charging exorbitant interest rates and other charges leading to over indebtedness of the customer. Considering the above, the Central Bank of Sri Lanka decided to put in place a Financial Customer Protection Framework, with the objective of addressing the issues relating to the conduct of the business operations of the LFC and SLC sector.

4. New Financial Customer Protection Framework

The Financial Customer Protection Framework, which will come into effect from April 2018, includes a set of guidelines and instructions that need to be adhered to by the financial institutions to mitigate the potential harm to the customer, i.e. those who use any financial products/ services. This framework was developed based on the high-level principles on financial consumer protection endorsed by G-20 Finance Ministers and Central Banks, and developed together with the Organization for Economic Co-operation and Development, Financial Stability Board and other international organizations.

5. Salient Features of the Framework

5.1. Role and Responsibility of the Board of Directors

The Boards of Directors of LFCs and SLCs are responsible for ensuring that customers are well informed and their rights are protected. This needs to be considered as an integral part of corporate governance, culture and strategic decision-making of financial institutions. The Boards of Directors are mandated to monitor the compliance of all employees and appointed agents with the minimum standards on customer protection set out in the Direction.

5.2. Minimum Standards on Financial Customer Protection

i. Disclosure and Transparency

The principle of disclosure and transparency is important as it is clearly in customers' best interest that they are given complete, clear and non-misleading information about financial products and services. Information disclosure, which includes the standardized and prescribed information that should be made available to the customers, supports the decision-making process of the customers and allows them to make an informed assessment of the financial products/services on offer. An appropriate level of standardization provided in the Direction supports the customer by improving the opportunity to compare different products and services.

The Direction allows customers to receive key information that makes them aware of the fundamental benefits, risks and terms of the product in the language preferred by them, i.e. Sinhala/Tamil/English. The disclosure and transparency requirements are applicable at all stages of the relationship with the customer as explained below.

- **Advertisement Stage:** All financial promotional material should be accurate, understandable and not misleading. The advertisements published in any form are required to cover the key information about the product/service and not be obscure and be in line with the advertisement regulations issued by the Central Bank of Sri Lanka from time to time.
- **Pre-contractual Stage:** Every company should have a standardized document in the form of a "key facts document" made available to all prospective customers, which contains basic information regarding loan and deposit products, such as description of the products/services, financial and other benefits, fees and charges, commissions, interest rates, procedures to be followed, major terms and conditions, complaint handling procedures, restrictions on accounts and transactions, etc.
- **Contractual Stage:** It is the right of the customer to obtain the opportunity to fully understand the terms & conditions on products/services. The provision of advice ought to be as objective as possible and based on the customer's profile, considering the complexity of the product, the risks associated with it as well as the customer's financial objectives, knowledge, capabilities and experience.
- **Upon Request:** Customers are entitled to receive product statements upon request, which includes detailed transactional information, interest rate charged, fees charged for reporting period and the outstanding balance.
- **General Disclosures:** All companies are required to display the finance business/finance leasing license issued by the Central Bank of Sri Lanka, latest audited financial statements, credit rating, contact details of the Financial Ombudsman, business hours and holidays, in all business places.

ii. Customer Education and Awareness

Promoting customer education and awareness is of utmost importance in a sector which serves customers with low financial literacy levels. LFCs and SLCs are required to maintain appropriate mechanisms to help existing and future customers to improve their knowledge, skills and confidence, to appropriately understand the opportunities and risks of financial products/services. Customers need to be educated with specific warnings related to over indebtedness, consequences of multiple borrowing, late repayments, etc.

iii. Responsible Business Conduct

The principle of responsible business conduct is important to ensure that financial service providers and appointed agents act fairly, honestly, professionally, with due skill, care and diligence when dealing with customers. Depending on the nature of the transaction and based on the information primarily provided by customers, financial service providers should assess the related financial capabilities and needs of their customers before agreeing to provide them with a product, advice or service. Particular attention needs to be paid to the ability of the customer to financially bear the risks associated with the product/service. All financial service providers are required to conduct a customer repayment capacity analysis to properly assess credit worthiness, to prevent the over indebtedness of the customer.

Staff (especially those who interact directly with customers) need to be properly trained and qualified. In this regard, it is important to have continuous programs on capacity building and awareness on products/services in order to develop the soft skills of the staff. The remuneration structure for staff of both financial service providers and appointed agents should be designed to encourage responsible business conduct, fair treatment of customers and avoidance of unreasonable risk taking. Employees and appointed agents should avoid harassing customers, using abusive debt collection practices, disclosing customer information to others and giving false or misleading information about products/services and unduly influencing customers or the general public to buy or get involved in the products/services. Financial service providers are required to have rigorous and regular monitoring of the conduct of the employees and appointed agents.

iv. Complaint Handling and Redress

Effective complaint handling and redress mechanisms provided by financial service providers, regulators and other independent entities is central to financial customer protection. All customers should have access to adequate complaint handling and redress mechanisms that are accessible, affordable, independent, fair, accountable, timely and efficient. Such mechanisms should not impose unreasonable costs, delays or burdens on customers. In the first instance, customers are encouraged to seek recourse through the internal complaint handling mechanism and independent redress process, such as referring to the financial ombudsman or regulatory authority available, to address complaints that are not efficiently resolved by the financial service provider.

v. Equitable and Fair Treatment

Financial service providers and appointed agents are expected to adopt equitable and fair treatment of customers as an integral part of their business culture. Treating all the financial customers equitably, honestly and fairly at all stages of their relationship with the financial service providers, irrespective of their cast, religion, language, gender, etc. is a requisite of the Direction. The customers such as elderly, differently abled or customers with low financial literacy have the right to receive special attention to facilitate them to have fair access to financial services.

vi. Protection of Customer Data and Privacy

All LFCs and SLCs are required to take necessary steps to protect customer data and privacy, in line with the applicable legal provisions. It is the responsibility of the financial service providers to inform customers regarding the sharing of personal data related to them with the Credit Information Bureau and the exact purpose and conditions of the collection, processing and distribution of data held about them and the related confidentiality rules adopted.

6. Conclusion

Due to the increased complexity of financial products/services, rapid technological changes and financial market development and innovation, often low income and less experienced customers face challenges in the market place. Failure to proactively identify and mitigate customer risks associated with the marketing and sale of financial products/services creates unnecessary risks to a financial institutions' reputation and can result in loss of customers' trust and confidence. With the implementation of the Financial Customer Protection Framework, it is expected that customer rights and interests will be safeguarded and customer confidence strengthened, to ensure the stability and soundness of the sector.

Rs. 7.6 billion made in 2016, which also affected the profitability in 2017. Accordingly, the sector posted a profit after tax of Rs. 25.8 billion, an 18.0 per cent decline compared to the profit of Rs. 31.5 billion recorded in the year 2016, mainly due to increased funding cost and higher loan loss provisions. ROA decreased by 80 basis points during the year, reporting a ratio of 3.2 per cent and ROE declined nearly by 700 basis points, reporting a ratio of 16.1 per cent, which showed sign of stress towards the profitability of the sector.

(b) Capital: The sector maintained its overall capital level well above the minimum requirement during the year, enhancing the resilience to any perceived adverse shocks. The total regulatory capital improved by 25.1 per cent to Rs. 145.3 billion, mainly due to efforts taken by the companies to enhance the minimum capital requirement up to Rs. 1 billion by 01 January 2018 as required, coupled with increase in retained profits.

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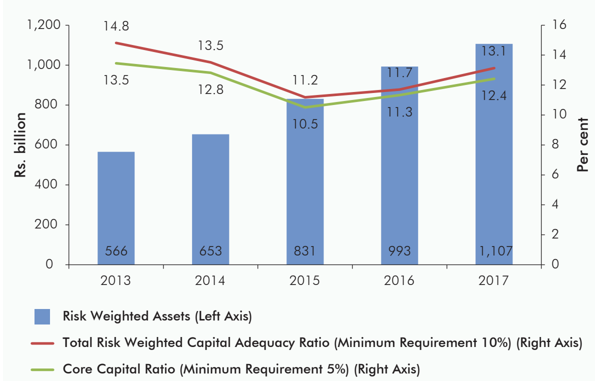
The capital adequacy ratios of the sector demonstrated an increasing trend, in which core capital and total capital ratios increased to 12.4 per cent and 13.1 per cent, respectively, compared to 11.3 per cent and 11.7 per cent recorded in year 2016, which was well above the minimum threshold level. The regulatory capital comprised of Tier I and Tier II capital, of which Tier I capital contributed to 95.9 per cent of the total regulatory capital. Tier I capital mainly comprised issued share capital, statutory reserve fund and published retained profits. 82.8 per cent of the Tier II capital comprised subordinated term debt, while revaluation reserves represented 16.0 per cent. However, there were few companies which maintained the capital below the minimum required levels, due to weak financial positions and necessary resolution actions are currently being undertaken.

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



Source: Central Bank of Sri Lanka

Supervisory and Regulatory Developments

During the year 2017, the Central Bank initiated several prudential policy measures to strengthen the supervisory and regulatory framework of LFCs and SLCs with the aim of enhancing the stability and soundness of the sector and increasing the customer confidence in the sector.

A new prudential direction was issued to revise the LTV ratio for credit facilities in line with the national budget proposal for year 2017. Further, the minimum core capital requirement for LFCs was increased to be completed on a staggered basis, in view of strengthening the capital position of the sector and increasing the capacity to absorb unexpected internal and external shocks. Accordingly, the minimum core capital was increased from Rs. 400 million to Rs. 1.0 billion by 01 January 2018, Rs. 1.5 billion by 01 January 2019, Rs. 2.0 billion by 01 January 2020 and Rs. 2.5 billion by 01 January 2021.

Numerous regulatory actions were taken regarding weak LFCs and SLCs during the year. A cap on deposits and borrowings was imposed on all LFCs and SLCs, which did not comply with the minimum core capital requirement. Penalties were imposed on non-compliances identified through supervision of LFCs and SLCs. Further, a lending cap was imposed on one LFC due to repeated non-compliance of supervisory concerns. Initiatives are being taken to resolve distressed finance companies, largely through mergers and recapitalization through strategic investors. In order to streamline such regulatory actions, a resolution framework for the financial system is to be introduced with the concurrence of the newly established Resolution and Enforcement Department.

A circular was issued in May 2017, where LFCs and SLCs were allowed to grant concessions to borrowers who have been affected by floods, adverse weather conditions and connected circumstances in terms of the national policy adopted to facilitate the rehabilitation of businesses and normal operations of such borrowers in the national interest.

Primary Dealers in Government Securities

The Primary Dealer (PD) sector recorded gradual moderation of its activities during the year. Total assets, total investment portfolio and total capital of 7 LCBs, primary dealers and 8 Standalone PDs[1] recorded a considerable growth, whereas the profitability of the industry recorded a marginal decline.

Assets and Liabilities

The total assets of the PD sector increased by 29.7 per cent to Rs. 337.2 billion in 2017, compared to Rs. 260.0 billion in 2016. Total investment portfolio of government securities accounted for 93.2 per cent of the total assets of the industry. This investments portfolio, consisting of trading, available for sale and HTM, amounted to Rs. 314.2 billion at end 2017, recording an increase of 41.0 per cent over 2016. This change was due to the significant increase in the trading portfolio and the available for sale portfolio of government securities. The trading portfolio increased to Rs. 127.6 billion by end 2017, from Rs. 96.6 billion at end 2016 and available for sale portfolio, increased to Rs. 78.7 billion by end 2017, compared to Rs. 19.3 billion at end 2016. HTM portfolio increased marginally to Rs. 107.8 billion at end 2017, from Rs. 106.8 billion reported at end 2016.

1 Two PDs, Perpetual Treasuries Limited (PTL) and Pan Asia Banking Corporation PLC – Primary Dealer Unit (PABC), were suspended from carrying on business and activities of a primary dealer for a period of six months (PTL w.e.f. 06th July 2017 and PABC w.e.f. 15th August 2017 initially and the suspension of PTL was extended further six months period from 05 January 2018). Entrust Securities PLC does not participate in government securities primary auctions w.e.f. 24 July 2017.

Table 8.13
Performance of Primary Dealers

Rs. billion

Item	2016	2017 (a)	Annual Growth Rate (%) 2016	Annual Growth Rate (%) 2017 (a)
Total Assets	**260.0**	**337.2**	**-2.3**	**29.7**
Total Investment Portfolio	222.7	314.2	-3.9	41.0
Trading Securities	96.6	127.6	-26.0	32.1
Held-to-maturity	106.8	107.8	123.7	1.0
Available for Sale	19.3	78.7	-63.9	308.2
Reverse Repo	21.5	17.5	-27.9	-18.8
Equity and Liabilities	**260.0**	**337.2**	**-2.3**	**29.7**
Total Capital	45.4	53.3	43.3	17.5
Repo	124.0	59.1	-24.4	-52.3
Group/Head Office Payables (b)	85.3	200.6	68.7	135.2
Profit before Tax	**15.2**	**15.1**	**70.8**	**-0.1**
Profit after Tax	14.7	13.4	73.0	-8.9
Return on Assets (ROA) (%)	5.8	5.1	1.7	-0.7
Return on Equity (ROE) (%) (c)	52.1	12.9	3.7	-39.2
Risk Weighted Capital Adequacy Ratio (%) (c)	**61.5**	**55.9**	**33.5**	**-5.6**
Leverage Times (c)	2.6	2.3	-1.4	-0.3
Dealings	22,073.7	17,085.8	35.6	-22.6
Primary Market Dealings	1,508.2	1,660.0	-20.4	10.1
Secondary Market Dealings	20,565.5	15,425.8	42.9	-25.0
Outright Purchases	1,184.8	824.2	-12.9	-30.4
Outright Sales	1,687.5	1,178.5	-21.0	-30.2
Repo, Reverse Repo	17,693.2	13,423.1	62.4	-24.1

(a) Provisional
(b) Bank PD Units only
(c) Standalone PDs Only

Source: Central Bank of Sri Lanka

Note: Excludes financials of Entrust Securities PLC

Risks in PD Sector

(a) Market Risk: The proportion of trading portfolio to total investment portfolio decreased from 43.4 per cent at end 2016 to 40.6 per cent at end 2017, reducing the possible high market risk exposure of the industry.

(b) Liquidity Risk: The overall liquidity risk exposure of the PD industry decreased due to the reduction in overnight negative mismatch in the maturity profile of assets and liabilities of the industry at end 2017. The overnight negative mismatch decreased significantly to Rs. 1,077.4 million or 9.5 per cent of the overnight liabilities at end 2017, from Rs. 2,671.8 million or 15.7 per cent reported at end 2016. In view of holding a large volume of risk free government securities by PDs and 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 since the fourth quarter of 2015. Most of the PDs had stand-by contingency funding arrangements to bridge any liquidity gaps.

Profitability and Capital

The PDs industry reported a profit after tax of Rs. 13.4 billion during 2017 against that of Rs. 14.7 billion during 2016. Despite the substantial increase in net interest income, from Rs. 8.8 billion during 2016 to Rs. 14.1 billion during 2017, the significant reduction in capital gains was reported from Rs. 8.4 billion in 2016 to Rs. 2.1 billion in 2017, largely contributing to the decrease of profits of the PD industry. Nevertheless, the exorbitant capital gains in 2016 was as a result of the sale of government securities by one PD. Consequently, ROA for the sector and ROE for standalone PDs decreased to 5.1 per cent and 12.9 per cent, respectively, by end 2017, from 5.8 per cent and 52.1 per cent in 2016.

Equity of the PDs increased by 17.5 per cent largely due to the enhancement of the minimum core capital requirement, from Rs. 350 million to Rs. 1,000 million. As at end 2017, all standalone PDs, except Entrust Securities PLC, maintained their core capital above the minimum requirement of Rs. 1,000 million. The Risk Weighted Capital Adequacy Ratio (RWCAR) of the standalone PDs was above the minimum RWCAR of 10 per cent and the ratio decreased to 55.9 per cent at end 2017 from 61.5 per cent reported at end 2016, subsequent to the increase of minimum core capital.

Market Participation

Primary Market Activities: The participation in primary market auctions in respect of Treasury bills and Treasury bonds by PDs has shown mixed performance. Out of the total bids accepted from the total Treasury bills auctions (52) conducted in 2017, the participation of Bank PDs, Standalone PDs and Employees' Provident Fund (EPF) accounted to 66.6 per cent, 26.7 per cent and 6.7 per cent, respectively. However, participation in Treasury bond auctions in 2017 was dominated by Standalone PDs, with 37.6 per cent share from the total bonds accepted through 16 auctions conducted in 2017, while the participation of Bank PDs and EPF accounted for 30.5 per cent and 31.9 per cent, respectively.

Secondary Market Activities: Secondary market transactions in government securities decreased significantly by 22.6 per cent to Rs. 17,085.8 billion during 2017, compared to Rs. 22,073.7 billion reported in 2016, of which, Repo transactions accounted for 87.0 per cent of the total volume of secondary market transactions in 2017. During 2017, outright purchases and outright sales declined by 30.4 per cent and 30.2 per cent, respectively, compared to the values in 2016.

Unit Trusts

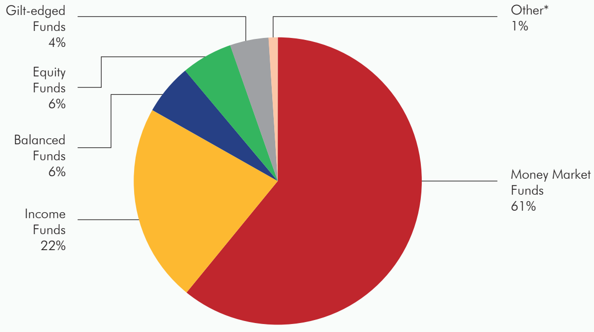
Unit trusts (UTs) decreased its number by three with the closure of four UTs and the launch of one UT during the year 2017. The new entrants this year is comparatively lower than the 4 new entrants in year 2016. The number of UT management companies remained at 14 and the

Table 8.14
Performance of the UT Sector

Details	2016	2017
No. of Unit Trusts	78	79
Total No. of Unit Holders	41,154	41,037
No. of Units in Issue (mn)	7,141	7,638
Total Assets (Rs. bn)	104.0	128.8
Net Asset Value - NAV (Rs. bn)	103.1	127.6
Investments in Equities (Rs. bn)	13.9	13.0
Share of Total Net Assets (%)	13.5	10.2
Investments in Government Securities (Rs. bn)	49.6	22.5
Share of Total Assets (%)	48.1	17.7

Source: Unit Trust Association of Sri Lanka

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



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

Source: Unit Trust Association of Sri Lanka

UTs decreased to 74 by end 2017, from 77 funds by end 2016. From the total 74 funds, 71 operated as open-ended funds, 2 operated as closed-ended funds and 1 operated as a dollar bond fund. The open-ended funds included 18 money market funds, 13 gilt-edged funds, 14 income funds, 8 equity growth funds, 8 balanced funds, 5 shariah funds, 4 index funds and 1 initial public offer (IPO) fund.

Business Growth

Total assets of the UT sector grew by 23.8 per cent (Rs. 24.8 billion) to Rs. 128.8 billion as at end 2017, compared to Rs. 103.1 billion as at end 2016. The number of units issued also increased to 7,638 at end 2017 compared to 7,141 at end 2016. However, the total number of unit holders decreased to 41,037 at end 2017 from 41,154 at end 2016. The net asset value per unit has considerably increased to Rs. 16.71 as at end 2017, as against Rs. 14.44 as at end 2016.

Investment

The share of investment in government securities and equities in total assets decreased considerably in 2017. The investment in government securities declined substantially to Rs. 22,543.3 million, by 54.5 per cent, from

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Table 8.15
Performance of the Insurance Sector

Rs. billion

Item	2016 (a)	2017 (b)
Total Assets	521.4	559.2
Government Securities	202.3	218.0
Equities	51.4	49.2
Cash & Deposits	44.2	65.2
Total Income	184.4	201.6
Premium Income	143.0	160.4
Investment Income	41.5	41.1
Profit Before Tax	25.6	24.7
Capital Adequacy Ratio (%) (c) - Long-term Insurance	307.0	336.0
- General Insurance	180.6	175.7
Retention Ratio (%) - Long-term Insurance	96.1	95.9
- General Insurance	81.4	77.9
Claims Ratio (%) - Long-term Insurance	37.4	29.8
- General Insurance	64.8	64.3
Combined Operating Ratio (%) - Long-term Insurance	84.9	80.0
- General Insurance	100.2	102.7
Return on Assets (ROA) (%) - Long-term Insurance	3.2	4.5
- General Insurance	9.4	4.7
Return on Equity (ROE) (%) - Long-term Insurance	19.7	28.6
- General Insurance	18.1	9.9
Underwriting Ratio (%) - General Insurance	21.6	17.4

(a) Revised
(b) Provisional
(c) Introduced in 2016, in lieu of solvency margin ratio

Source: Insurance Regulatory Commission of Sri Lanka

Rs. 49,632.4 million as at end 2016. The investment on equities indicated a decline of 6.5 per cent to Rs. 13,011.6 million as at end 2017, from Rs. 13,923.4 million as at end 2016.

Insurance Sector

The insurance sector recorded a growth in terms of its asset base, while earnings declined during 2017. As at end 2017, 27 insurance companies were operating with the licences obtained from the Insurance Regulatory Commission of Sri Lanka (IRCSL), out of which, 13 companies operated as exclusive general insurance companies, 12 companies operated as exclusive life insurance companies and 2 companies were involved in both long-term and general insurance business. It was noted that 9 insurance companies were listed with the Colombo Stock Exchange. Further, there were 61 insurance brokering companies engaged exclusively in general insurance or engaged in both general and long-term insurance.

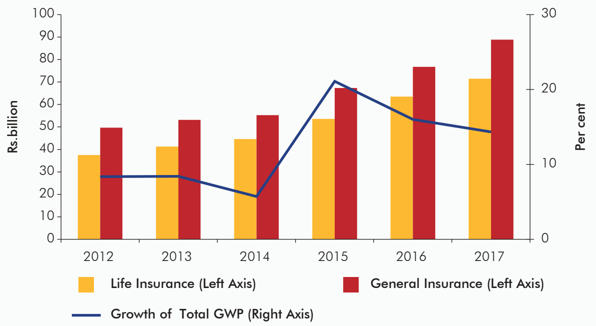
Insurance penetration in Sri Lanka which is calculated on total premium as a percentage of GDP (at current market prices), remained at 1.2 per cent in 2017. This amount is considerably lower than the peer countries, urging the requirement of popularizing insurance in Sri Lanka. Insurance penetration for long-term insurance was 0.5 per cent, whereas general insurance penetration was 0.7 in 2017. Nevertheless, insurance density has increased marginally to Rs. 7,482 per person in 2017, from Rs. 6,743 per person in 2016.

Business Growth

The total assets of the insurance sector grew during 2017, mainly due to the growth in the long-term insurance sector assets even though the general insurance sector assets declined. Asset growth of the insurance sector during 2017 was 7.2 per cent, resulting in a total asset base of Rs. 559.2 billion as at end 2017, when compared to Rs. 521.4 billion as at end 2016. This expansion was as a result of the growth in the long-term insurance sector. This sub sector grew by 14.0 per cent during the year to reach Rs. 394.2 billion, from Rs. 345.7 billion as at end 2016. A notable increase in the share of long-term insurance as against the total asset base was observed as the share increased to 70.5 per cent in 2017 as against the share of 66.3 per cent in 2016. However, the overall general insurance sub sector reported a decline in its asset base, to 165.1 billion in 2017, compared to Rs. 175.7 billion as at end 2016. Accordingly, the share of this sector as a percentage of total insurance sector assets declined to 29.6 per cent in 2017, from 33.7 per cent in 2016.

Growth in Gross Written Premium (GWP) of the insurance sector was driven by both general and long-term insurance sectors. The GWP of the overall insurance sector accelerated

Chart 8.15
Gross Written Premium of the Insurance Sector



Source: Insurance Regulatory Commission of Sri Lanka

by 12.2 per cent in 2017. Despite losing its share to the long-term insurance sub sector in terms of total asset base, the general insurance sub-sector continued to be the main contributor towards total GWP of the insurance sector with a share of 55.4 per cent. The growth in the GWP of the general insurance sector was 11.9 per cent, amounting to Rs. 88.9 billion at end 2017. Motor insurance, which indicated an increase of 9.1 per cent during 2017, is the main contributor for the GWP of the general insurance sector. The motor insurance sector contributed to 60.5 per cent of the GWP of general insurance sector. The long-term insurance sector's GWP has also grown similarly, with a growth rate of 12.6 per cent during the year, amounting to Rs. 71.5 billion.

Earnings

Despite the improvement of earnings of the long-term insurance sector, the overall earnings of the insurance sector declined as a result of the sharp decrease of the general insurance sector earnings. Total profits earned by the insurance sector reduced by 3.6 per cent in 2017, compared to a 67.5 per cent growth in 2016. This drastic change was mainly due to the decline in the performance of the general insurance sector. However, it was observed that the long-term insurance sector has improved considerably as a result of a surplus transfer of a particular company. The underwriting profits of the sector declined by 15.9 per cent to 11.4 billion in 2017, from Rs. 13.5 billion in 2016.

Total claims of the insurance sector marginally declined to Rs. 62.6 billion in the year 2017, from Rs. 63.6 billion in the year 2016, which is a decrease of 1.7 per cent. The claims of the general insurance sector marginally increased by 2.7 per cent to Rs. 42.1 billion, from Rs. 41.0 billion in 2016. In the meantime, claims of the long-term insurance sector declined by 9.6 per cent to Rs. 20.4 billion in 2017, from Rs. 22.6 billion in 2016.

The total investment income indicated a marginal decrease of 1 per cent to Rs. 41.1 billion in 2017 from Rs. 41.5 billion in 2016. As the GWP increased and the investment income declined marginally, the total income of the insurance industry increased to Rs. 201.5 billion in 2017, from Rs. 184.5 billion in 2016, which is an increase of 9.2 per cent.

ROE of the general insurance sector decreased to 9.9 per cent in 2017, from 18.1 per cent in 2016, whereas the ROE in the long-term insurance sector has increased to 28.6 per cent in 2017, from 19.7 per cent in 2016. In terms of the ROA, the general insurance sector decreased to 4.7 per cent in 2017, from 9.4 per cent in 2016, whereas the long-term insurance increased to 4.5 per cent in 2017 from 3.2 per cent in 2016.

Capital and Investment

All insurance companies, except for two insurance companies, complied with the statutory capital adequacy requirements imposed by the IRCSL during the year. Further, registration of one company was suspended and another company stopped accepting new insurance business in 2017. Capital to total assets ratio of the general insurance sector slightly declined to

48.5 per cent in 2017 from 49.1 per cent in 2016, whereas the capital to total assets ratio of the long-term insurance sector increased to 16.6 per cent in 2017, from 14.8 per cent in 2016.

The investments of general insurance and long-term insurance sector remained mainly concentrated on government securities. The long-term insurance sector assets in government securities was 46.5 per cent in 2017, which is a slight decrease from 46.9 per cent in 2016. Similarly, the general insurance sector assets on government securities also decreased slightly to 21.0 per cent in 2017, from 22.8 per cent in 2016. When considering the share of investment in equity, the share of long-term insurance decreased to 8.2 per cent in 2017, from 9.8 per cent in 2016, whereas the general insurance sector recorded an increase of 10.2 per cent in 2017, from 10.0 per cent in 2016. The investment in corporate debt securities was 7.6 per cent of the general insurance sector in 2017, compared to 6.6 per cent in 2016. Long-term insurance sector assets on corporate debt securities was 18.5 per cent in 2017, compared to 20.6 per cent in 2016.

Supervisory and Regulatory Developments

The IRCSL issued several guidelines and amendments to the existing regulatory structure, in view of promoting professionalism and enhancing the reputation of the industry, while safeguarding the interest of the policyholders. A Direction on ancillary services provided by insurance brokers was issued, which required insurance brokers to seek approval of the IRCSL to provide ancillary services other than insurance brokering. A direction prohibiting all insurance brokers from marketing and/or canvasing for sale, on behalf of any other insurance broker/sub agent or foreign health insurance product was also issued. Further, all insurers are required to employ at least one person with Associate of Chartered Insurance Institute, or equivalent qualification, to be designated as a specified officer, as per the roles and responsibility defined by the IRCSL.

Superannuation Funds

The superannuation funds sector represented three publicly managed funds, namely, the Employees' Provident Fund (EPF), Employees' Trust Fund (ETF) and Public Service Provident Fund (PSPF) and 149 privately managed Approved Pension and Provident Funds (APPFs). The sector is estimated to account for 16.6 per cent of total financial sector asset base as at end 2017. The assets of the sector increased to Rs. 2,836.5 billion as at end 2017 from Rs. 2,537.2 billion as at end 2016. The EPF accounted for 72.8 per cent of assets in the superannuation fund sector.

Employees' Provident Fund

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

Membership, Member Balances and Refunds: The total value of the Fund increased by Rs. 224.8 billion to Rs. 2,066.3 billion as at end 2017, from Rs. 1,841.5 billion recorded at end 2016, showing a 12.2 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 the effective and prudent investments of the Fund. Total liability to the members, including member interest, stood at Rs. 2,020.8 billion as at end 2017, recording an 11.6 per cent increase from Rs. 1,810.6 billion as at end 2016. The total contribution for the year 2017 increased by 12.8 per cent to Rs. 133.4 billion, while the total amount of refunds made to the members and their legal heirs in 2017 was Rs. 117.5 billion, which was an increase of 8.4 per cent over 2016. Accordingly, the net contribution was Rs. 15.9 billion, compared to Rs. 9.9 billion recorded in the previous year. The net income of the Fund increased by 15.3 per cent to Rs. 202.9 billion in 2017, from Rs. 175.9 billion in the previous year.

Investment Portfolio: The total investment portfolio (book value) of the Fund grew by 12.4 per cent to Rs. 1,992.4 billion in 2017, from Rs. 1,772.2 billion in 2016. 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 an adequate level of liquidity to meet refund payments and other expenses of the Fund. Accordingly, the investment portfolio consisted of 91.3 per cent in government securities, 4.2 per cent in equity, 2.1 per cent in corporate debentures and trust certificates and the remaining 2.4 per cent in fixed deposits as at end 2017.

Investment Income: The total investment income of the Fund amounted to Rs. 222.6 billion in 2017, recording an increase of 15.4 per cent compared to previous year. Interest income continued to be the major source of income to the Fund, accounting for 84.6 per cent of the investment income and grew by 13.8 per cent to Rs. 188.3 billion in 2017 from Rs. 165.5 billion in 2016. Amortisation gains on HTM financial instruments also increased by 11.0 per cent to

Table 8.16
Performance of the EPF and the ETF

Item	EPF		ETF	
	2016 (a)	2017 (b)	2016 (a)	2017 (b)
Total Assets (Rs. bn)	1,841.5	2,066.3	248.9	279.0
Total Member Balance (Rs. bn)	1,810.6	2,020.8	245.6	274.2
Number of Member Accounts (mn)	17.3	17.3	12.5	12.6
Number of Active Member Accounts (mn)	2.6	2.6	2.5	2.6
Number of Contributing Employers	73,479	75,756	77,842	81,515
Total Contributions (Rs. bn)	118.3	133.4	20.3	22.8
Total Refunds (Rs. bn)	108.4	117.5	13.9	17.2
Total Investments Portfolio (Rs. bn)	1,772.2	1,992.4	234.7	262.5
o/w : Government Securities (%)	93.1	91.3	85.2	78.2
Gross Income (Rs. bn)	193.1	223.2	24.6	29.0
Profit Available for Distribution (Rs. bn)	176.1	203.1	17.0	20.3
Return on Investments (%)	11.4	11.8	9.1	11.0
Interest Rate Paid on Member Balances (%)	10.5	10.5	9.0	9.0

(a) Revised
(b) Provisional

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

Rs. 31.3 billion in 2017, from Rs. 28.2 billion in 2016. However, dividend income decreased by 30.2 per cent to Rs. 3.0 billion in 2017, compared to Rs. 4.3 billion in 2016. Net gain on financial instruments at fair value through profit or loss increased by 287.5 per cent to Rs. 1.5 billion in 2017, from the loss of Rs. 0.8 billion in 2016. The Impairment of equity investment decreased by 71.2 per cent to Rs. 1.5 billion in 2017.

Overall Return of the Fund: The Fund earned a total gross income of Rs. 223.2 billion in 2017, recording an increase of 15.6 per cent compared to the previous year. The EPF was able to declare an interest rate of 10.5 per cent on member balances in 2017 for the fourth consecutive year, while maintaining operating expenses to gross income ratio at around 0.77 per cent in 2016 and 0.60 per cent in 2017.

Employees' Trust Fund

The Employees' Trust Fund, that contributed to 9.8 per cent of the asset base of the superannuation sector, recorded a growth in terms of the number of members and total assets, whilst net contributions decelerated. The ETF has around 12.6 million accounts, of which about 2.6 million are active accounts. Number of employers contributing to the fund were

81,515. The total outstanding member balances in the ETF rose by 11.6 per cent to stand at Rs. 274.2 billion at the end of 2017. Total contributions increased by 12.0 per cent to Rs. 22.8 billion, while total benefits paid out increased by 24.3 per cent to Rs. 17.2 billion, resulting in a significant decrease of 14.3 per cent in the net inflow of funds during the year. At end 2017, total assets of the fund amounted to Rs. 279.0 billion, recording a growth of 12.1 per cent. The total investments of the ETF rose by 11.8 per cent to Rs. 262.5 billion at the end of 2017. The investment profile of the ETF is similar to that of the EPF with the majority of its investments in government securities. However, there was a significant drop in investments in government securities to 78.2 per cent at end 2017 from the 91.2 per cent recorded at the end of 2016. The fund has made arrangements to reinvest inflows from divested government securities in term deposits. Investments in equity and corporate fixed income securities accounted for 2.7 per cent and 1.4 per cent, respectively, of total investments during the year and the fund managed to secure a rate of return of 9.6 per cent on its investments.

Other Superannuation Funds

The Public Service Provident Fund (PSPF), which is 15.4 per cent of the Sri Lankan superannuation sector, contracted in terms of number of members and net contributions, while asset grew during the year. The fund, which has been established with a view to provide benefits to certain non-pensionable government sector employees, recorded a slight decline in total number of members. However, all 239,184 members of the fund were active at end 2017. A positive net contribution of Rs. 843.8 million was recorded during 2017, compared to Rs. 909.3 million recorded in 2016. The total asset base of the fund grew by 16.2 per cent and stood at Rs. 55.4 billion. Further, the investment of the PSPF improved to 52.9 billion in 2017, compared to 46.2 billion recorded at end 2016. The investments were highly concentrated in government securities and accounted for 94.5 per cent of total investments. The rate of return on member balances was 13.0 per cent for the year 2017.

APPFs, accounting for 1.9 per cent of the superannuation sector, expanded in terms of the number of members, total assets and investments. However, the number of approved provident funds declined to 149 by the end of 2017, from the 152 that remained by the end of 2016. These private provident funds covered a membership of 169,301 persons. The total assets of the APPFs is estimated to be Rs. 437.3 billion as at end 2017. This is a 9.7 per cent growth from the asset base of Rs. 398.6 billion that remained during 2017. Investment portfolios of such funds amounted to Rs. 267.1 billion as at 2017, recording a 9.5 per cent growth.

8.4 Performance of Financial Markets

Money Market

The Average Weighted Call Money Rate (AWCMR) was allowed to move closer to the upper bound of the Standing Rate Corridor (SRC), formed by the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR), till early August. It was brought downwards thereafter, and was maintained at levels around the middle of the SRC from around mid-September till the end of the year. The AWCMR, which was at 8.42 per cent by end December 2016, was allowed to increase towards the upper bound of the SRC with the decline in excess money market liquidity, which reached deficit levels by around mid-February 2017 Continuing to tighten

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Table 8.17
Money Market Transactions

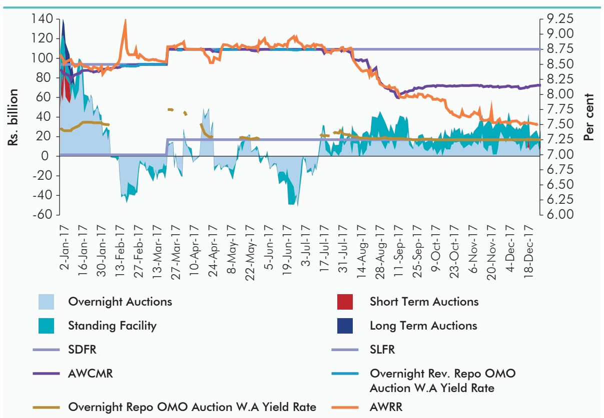
Market	Volume (Rs. bn)		Weighted Average Interest Rate (Min-Max) - %	
	2016	2017	2016	2017
Call Money	3,493.4	3,900.4	6.43-8.44	7.95 - 8.75
Inter-Bank Repo	6,572.5	4,205.6	6.29-9.15	7.50 - 9.14
Central Bank Repo	251.9	3,327.7	6.29-7.50	7.25 - 7.75
Central Bank Reverse Repo	3,937.7	1,049.6	6.59-8.50	8.47 - 8.75
Standing Deposit Facility	5,572.7	3,954.9	-	-
Standing Lending Facility	3,208.3	2,129.5	-	-

Source: Central Bank of Sri Lanka

its monetary policy stance, the Central Bank raised its policy interest rates by 25 basis points each in March 2017, as a result of which the SDFR and the SLFR increased to 7.25 per cent and 8.75 per cent, respectively. Consequently, the AWCMR increased further and was maintained at rates close to the upper bound of the SRC until early August 2017. While the money market continued to have surplus levels of liquidity since around mid-July 2017, the weighted average yield rate at the daily overnight repo auctions conducted by the Central Bank was brought down gradually to settle at the floor of the SRC in the latter part of the year, and it was 7.25 per cent by end December 2017. Following this trend, the AWCMR also declined to around 8.00 per cent by mid-September 2017 and increased marginally thereafter to stabilise around 8.15 per cent, and remained at that level by end December 2017. Following the movements of call money rates, the Average Weighted Repo Rate, which had moved close to the upper bound of the SRC till early August, declined thereafter, and by end December 2017 it was at 8.52 per cent, having recorded a sharper drop than the AWCMR.

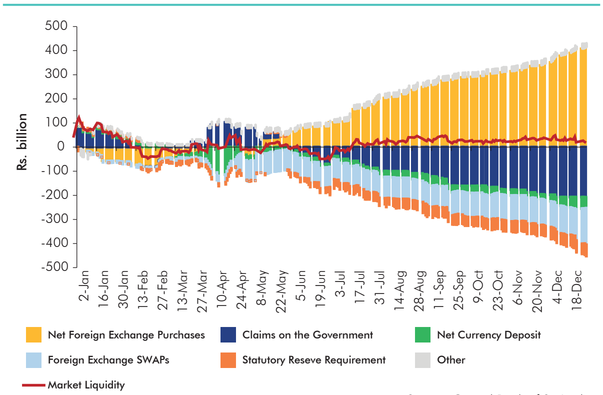
Excess rupee liquidity in the domestic money market increased sharply at the beginning of 2017. Whilst declining to deficit levels by early February, market liquidity fluctuated thereafter, between deficit and surplus levels, up to mid-July. Since mid-July, the domestic money market continued to have excess rupee liquidity. The sharp increase in money market liquidity from a surplus of Rs. 39.2 billion at end 2016 to over Rs. 100 billion at the beginning of the year 2017 was mainly due to an increase in the Central Bank's claims on the Government, following the Central Bank's purchases of Treasury bills in the primary market as well as provisional advances made to the government. However, thereafter, money market liquidity declined and the market experienced a deficit in market liquidity from time to time from around mid-February until mid-July, primarily as a result of the Central Bank allowing its Treasury bills holdings to mature as well as outright sales

Chart 8.16
Standing Rate Corridor, OMO Auctions Yield Rate, AWCMR, AWRR and Absorption of Market Liquidity



Source: Central Bank of Sri Lanka

Chart 8.17
Changes in the Central Bank's Balance Sheet driving Money Market Liquidity in 2017



Source: Central Bank of Sri Lanka

of Treasury bills by the Central Bank. Seasonal withdrawals of currency also drained rupee liquidity during the month of April. This situation however reversed in the second half of the year as a result of net purchases of foreign exchange by the Central Bank in the domestic foreign exchange market. While the money market continued to have excess liquidity from around mid-July, the excess liquidity in the money market amounted to Rs. 18.3 billion by end 2017.

Treasury bill holdings of the Central Bank declined substantially during the year as a result of maturities and outright sales of Treasury bills. Central Bank holdings of Treasury bills amounted to Rs. 9.9 billion by end 2017, compared to the holdings of Treasury bills amounting to Rs. 331.4 billion at the beginning of 2017. Since, the reduction in the Central Bank's holdings of Treasury bills was not sufficient to drain market liquidity, the use of alternative instruments to absorb the excess liquidity in the market was necessitated. Accordingly, the Bond Borrowing Programme, where the Central Bank borrows Treasury bonds from an institutional investor to provide collateral for transactions under repo auctions, was revived in November 2017.

A few issues were encountered in the process of implementation of monetary policy during the year 2017. The anomaly created in the call and repo rates due to the notional tax credit applicable to transactions involving government securities continued to affect the interest rate structure in the money market in 2017. However, with the implementation of the new Inland Revenue Act, the notional tax credit payable on interest income in relation to secondary market transactions involving government securities will no longer be applicable from April 2018, thus resolving this issue.

With a view to encouraging price discovery in the money market and promoting informed decision making by market participants as well as to improve market signalling of OMO, measures were taken to make more information on OMO available to the market, commencing from August 2017. The Central Bank commenced publishing cut-off rates of the OMO auctions to signal the desired path for short-term interest rates. Moreover, the overnight liquidity estimate was also made available to the market, in the morning, on a daily basis.

Domestic Foreign Exchange Market

Market liquidity: The Central Bank allowed greater flexibility in the exchange rate during the year 2017. Accordingly, the Sri Lankan rupee depreciated against the US dollar by 2.00 per cent, from Rs. 149.80 at end December 2016 to Rs. 152.85 at end December 2017. Unwinding of the foreign investments in government securities market with the expectations of an interest rate hike by the Federal Reserve Bank of New York, USA in March 2017 exerted pressure on the Sri Lankan rupee to depreciate in early 2017. The pressure was further surged due to debt service payments and increased import demand during the first quarter of 2017. With the conversions of exports proceeds by exporters and the positive sentiments created through the receipt of the third and fourth tranches of the EFF from the IMF, the pressure on the exchange rate eased gradually towards the end of 2017. In-line with the overall depreciation of the Sri Lankan rupee against the US dollar, the average US dollar buying and selling exchange rates of commercial banks for telegraphic transfers as of end 2017 were recorded at Rs. 151.31 and Rs. 155.15, respectively, whilst comparative figures as of end 2016 were Rs. 147.84 and Rs. 151.66, respectively.

Behaviour of the external value of the Sri Lankan rupee against major currencies, with reference to exchange rates and their volatility: During the year, the Sri Lankan rupee depreciated against other major currencies. The likelihood of the European Central Bank reducing its asset purchases and the interest rate hike by the Bank of England, exerted pressure on the Sri Lankan rupee to depreciate against the euro by 13.49 per cent and pound sterling by 10.46 per cent during the reference period. Owing to geopolitical uncertainty and the general depreciation of the Sri Lankan rupee against the US dollar, the Sri Lankan rupee was led to depreciate against the Japanese yen by 5.08 per cent and the Indian rupee by 7.54 per cent during the year 2017.

During 2017 trading volumes in the domestic foreign exchange market recorded a significant increase of 11.4 per cent, compared to the previous year. Transaction volumes of foreign exchange in the domestic inter-bank market increased to US dollars 16,451.1 million in 2017, from US dollars 14,769.5 million in 2016. In line with this, the daily average volumes in the inter-bank foreign exchange market also increased to US dollars 68 million in 2017, in comparison to US dollars 61 million recorded in 2016.

The Central Bank continued to absorb foreign exchange from the domestic inter-bank foreign exchange market, thereby building up the quantum of non-borrowed foreign exchange reserves, while meeting the end December net international reserve target under the IMF-EFF program. During the year 2017, the Central Bank absorbed US dollars 2,214.1 million from the market and supplied US dollars 549.8 million to the market, resulting in a net purchase of US dollars 1,664.4 million, thereby contributing to increase the non-borrowed foreign exchange reserves of the Central Bank.

Government Securities Market

The upward adjustment in yield rates for government securities continued until April 2017 in line with the increase in policy rates by 25 basis points in March 2017. However, the increasing trend moderated towards latter part of the first half of 2017. The Treasury bill yield rates adjusted downwards, in general, since May 2017. The debt management strategies adopted during the year in the form of maintaining a stable and low interest rate environment especially during the second half of the year was supported by positive market momentum, created by the expectation on accessing the international capital market, successful buffer building exercises and improved predictability and discipline in the new Treasury bond auction system introduced during 2017. The new system replaced the fully auction based issuance system for Treasury bonds with the main purpose of improving the efficiency of the process of funding the Government at least possible cost while maintaining transparency. The International Sovereign Bonds were issued in May 2017 amounting to US dollars 1,500 million and buffer funds were built through Treasury bond auctions commencing from the second half of 2017. These strategies helped ease the pressure on interest rates in the domestic market. In addition, positive adjustments in the sovereign ratings outlook during the year and conducive investment landscape contributed positively to increase foreign inflows during the year, resulting in higher foreign holdings of Treasury bills and Treasury bonds at the end of 2017, compared to end 2016. As a result, the

Table 8.18
Primary Market Treasury Bond Issuances

Year	Amount Issued (Rs. bn)		
	Auction	Placements	Total
2015	712	158	870
2016	654	9	663
2017	536	13	549

Source: Central Bank of Sri Lanka

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Table 8.19
Primary Market Weighted Average Yield Rates of Treasury Bills

Per cent per annum

Year	Maturity			Overall Average
	91-days	182-days	364-days	
2013	7.54	7.85	8.29	8.20
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

Source: Central Bank of Sri Lanka

benchmark yield rate of 364 day Treasury bills recorded a decrease of 127 basis points by end 2017, compared to end 2016. The Treasury bill rates for 91 day, 182 day and 364 day maturities as at end December 2017 stood at 7.69 per cent, 8.30 per cent and 8.90 per cent, respectively. The decline in short-term interest rates was reflected by the decrease in Treasury bond yield rates during the latter part of 2017.

Total net inflow of foreign investments in Treasury bonds and Treasury bills amounted to US dollars 440.6 million, which consisted of a net inflow of US dollars 80.5 million in Treasury bills and US dollars 360.1 million in Treasury bonds during the year 2017. The outstanding foreign holdings of Treasury bonds and Treasury bills as at end 2017 amounted to Rs. 322.6 billion, compared to Rs. 260.0 billion as at end 2016, recording a substantial increase of 24.1 per cent on a year-on-year basis.

Table 8.20
Yield Rates of Government Securities

Per cent per annum

Item	Primary Market		Secondary Market	
	2016	2017	2016	2017
Treasury Bills				
91-Days	6.45 - 9.04	7.69 – 9.73	6.43 - 9.04	7.65 - 9.70
182-Days	6.83 - 9.94	8.30 – 10.79	6.72 - 9.91	8.30 - 10.68
364-Days	7.30 - 10.75	8.90 – 11.11	7.18 -10.72	8.89 – 11.03
Treasury Bonds				
2-Years	10.00 - 11.83	9.83 – 12.30	7.52 - 11.63	9.33 – 11.98
3-Years	11.51 - 11.75	-	8.76 - 11.97	9.59 – 12.44
4-Years	10.61 - 12.78	11.13 – 11.94	9.31 - 12.38	9.81 – 12.69
5-Years	11.42 - 13.00	10.09 – 12.89	9.49 - 12.56	9.96 – 12.73
6-Years	11.98 - 12.03	11.21 – 11.49	9.69 - 12.67	10.01 – 12.84
10-Years	11.05 - 13.93	9.90 - 12.21	10.01 - 13.07	10.14 – 12.94
15-Years	11.46 - 14.23	-	10.35 - 13.24	10.32 – 13.07
30-Years	-	-	11.05 – 13.58	10.62 – 13.33

Source: Central Bank of Sri Lanka

The Public Debt Department raised US dollars 2,231.4 million by issuing Sri Lanka Development Bonds (SLDBs) during 2017 against the maturing amount of US dollars 1,878.0 million, in order to gain advantage of the market conditions. This eased the pressure on domestic rupee market financing and enabled to maintain orderly domestic interest rates.

During 2017, the Average Time to Maturity (ATM) of the overall domestic public debt portfolio reduced and recorded 5.78 years by end 2017, compared to 5.98 years at end 2016. The ATM of outstanding Treasury bond portfolio at end 2017 decreased to 6.72 years, from 7.07 years at end 2016. The downward adjustment in ATM is partly attributed to comparatively higher interest rates and substantially higher volume of financing that prevailed in the early part of 2017.

Corporate Debt Securities Market

Activity level of the market for Commercial Papers (CPs) was relatively low in 2017 when compared to the previous year. During 2017, Rs. 6.5 billion worth CPs were issued with the support of licensed banks, a slight decline compared to Rs. 7.0 billion in 2016. Interest rates pertaining to CPs varied between 13.75 per cent and 16.50 per cent during the year, whilst interest rates varied between a range of 8.70 per cent and 14.80 per cent in 2016. The CPs issued during the year were with shorter maturities. CPs with maturities up to 3 months accounted for 95.9 per cent of total issues during the year, whilst the remaining 4.1 per cent consisted of CPs with a 6-month maturity. The total outstanding value of CPs was low at Rs. 1.7 billion at end 2017, compared to Rs. 2.2 billion at end 2016.

Activities in the corporate bond market was limited, reflecting a low issuer and investor base. As per the Colombo Stock Exchange

(CSE), there were 5 initial public offerings (IPO) and one introduction of corporate debentures by 6 institutions during the year 2017, compared to 17 IPO issues by 14 institutions in 2016. Accordingly, the total value of the corporate bonds during 2017 were Rs. 22.8 billion, marking a significant decline of 70.8 per cent from Rs. 78.0 billion recorded in the previous year. Debentures issued in 2017 carried both fixed and floating rates. The fixed interest rates applicable to these bonds were in the range of 11.95 – 15.00 per cent in 2017, compared to the range of 9.60 – 13.75 per cent in 2016. The highest listed corporate debt issuance recorded in 2017 amounting to Rs. 8.0 billion was issued by Bank of Ceylon and the second largest issuance of 7.0 billion was by Sampath Bank PLC.

Colombo Stock Market

The All Share Price Index (ASPI) and the S&P Sri Lanka 20 Index of the CSE improved in 2017. The ASPI rose by 2.3 per cent at the end of 2017, which is comparatively healthier than the 9.7 per cent decline recorded in the previous year. Meanwhile, the S&P SL20 index increased by 5.0 per cent at the end of 2017, compared to the decline of 3.6 per cent recorded in the corresponding period of 2016. However, the growth of price indices of the CSE was low when compared with other countries in the Asian region. The volatility of the ASPI, as measured by the standard deviation, was relatively low, while the volatility of the S&P SL20 index was slightly higher than the corresponding values of the previous year.

Price indices of most sub sectors showed better performance in 2017 compared to the previous year. Among the main sub sectors, banking, finance and insurance; beverage, food & tobacco; diversified holdings sectors increased

Table 8.21
Selected Indicators of Equity Market

Item	2016	2017
All Share Price Index (1985=100) (a)	6,228.3	6,369.3
Year-on-Year Change (%)	-9.7	2.3
S&P SL20 Index (2004=1000) (a)	3,496.4	3,671.7
Year-on-Year Change (%)	-3.6	5.0
Market Capitalisation (Rs. bn) (a)	2,745.4	2,899.3
As a Percentage of GDP (%)	23.2	24.5
Market Price Earnings Ratio (a)	12.4	10.6
Turnover to Market Capitalisation (%)	6.2	7.6
Average Daily Turnover (Rs. mn)	737.2	915.3
Value of Shares Traded (Rs. bn)	176.9	220.6
Number of Shares Traded (mn)	7,195.8	8,468.3
Number of Companies Listed	295	296
Introductions (b)	1	1
Number of Initial Public Offers/ Offers for Sale (b)	3	2
Number of Rights Issues	6	15
Amount Raised Through Rights Issues and Initial Public Offers (Rs. bn)	4.4	51.6

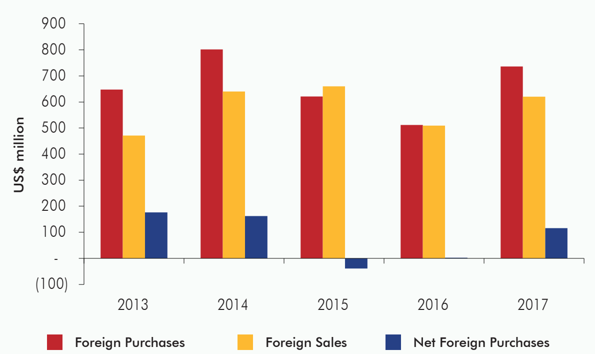
(a) End of the year
(b) There are 3 methods to obtain a listing: i.e. an introduction where no public issue is required, an offer for sale where existing shares are issued to the public and an offer for subscription where new shares are issued to the public.

Source: Colombo Stock Exchange

Chart 8.18
ASPI, S&P SL20 Index & Daily Turnover at the Equity Market

Source: Colombo Stock Exchange

Chart 8.19
Foreign Participation in Equity Market



Source: Colombo Stock Exchange

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by 5.1 per cent, 8.8 per cent and 8.0 per cent, respectively, while hotels & travel and manufacturing sectors declined by 6.8 per cent and 9.1 per cent, respectively. The plantations sector showed a significant increase of 51.7 per cent amongst small sectors. Moreover, the five largest and ten largest companies accounted for 27.4 per cent and 42.1 per cent, respectively, of market capitalisation.

CSE remained small in terms of scale, compared with its peers in the Asian region, having only 296 listed companies and market capitalisation of US dollars 18,959.5 billion at end 2017. Market capitalisation, however, increased by 5.6 per cent (Rs. 154 billion) in 2017, compared to the decline of 6.6 per cent (or Rs. 193 billion) exhibited in 2016. The market price earnings (PE) ratio showed relatively lower value of 10.6 by end December 2017, compared to 12.4 recorded at end December 2016. During the year, the ratio reached its highest value of 12.9 in April 2017 and declined to its lowest of 10.4 in August 2017. There was only one IPO of shares in CSE in 2017, which raised Rs. 14.1 billion, while one offer for sale was recorded during the year. Further, Rs. 51.5 billon was raised through 19 rights issues.

In the secondary market, the foreign investments at CSE, on a net basis, improved significantly to Rs. 17.7 billion in 2017, from Rs. 383.5 million in 2016. This was partly due to the availability of fundamentally strong stocks at low prices. Foreign companies dominated the foreign participation, accounting for 97.7 per cent of the total foreign purchases, while foreign individuals accounted only for 2.3 per cent. Foreign investor contribution to total market turnover improved marginally to 46.9 per cent in 2017, compared to 42.0 per cent during 2016.

During 2017, a number of regulatory measures were taken and proposed by the Securities and Exchange Commission (SEC) to develop market infrastructure to increase market confidence. The SEC introduced a Minimum Capital Adequacy Requirement for stock brokers in March 2017 which intends to expand to other players. Among the major proposed measures for market infrastructure, SEC intends to introduce a Delivery versus Payment (DvP) system and Central Counterparty (CCP) clearing. In addition, CSE is in the process of finalising Multicurrency Board, which facilitates any company listed in another country to come for a secondary listing in CSE. Furthermore, introducing short selling, demutualisation of CSE and enhancing the regulatory framework in line with international standards are several expected developments.

8.5 Development Finance and Access to Finance

Development finance and access to finance have been identified as predominant factors required for achieving balanced and inclusive economic growth and combatting poverty in an effective manner. In the context of Sri Lanka, several governmental and non-governmental institutions including the Central Bank implement various lending programmes to promote development finance and access to finance islandwide. These programmes focused not only on providing concessionary finance but also on providing credit supplementary facilities to the less privileged sectors of the society.

During 2017, the Central Bank implemented 15 refinance and interest subsidy schemes through the Regional Development Department and provided concessionary credit facilities amounting to Rs. 19,251.0 million to 126,742 beneficiaries islandwide. These schemes were funded by the Central Bank, Government of Sri Lanka (GOSL), donor agencies and Participating Financial Institutions (PFIs).

Shouldering the national responsibility of supporting disaster affected economic activities to resume operations, the Central Bank implemented two refinance loan schemes namely, “Athwela” loan scheme and the "Post-disaster Economic Activity Recovery" Loan (PEARL) Scheme, which is under the National Agri-business Development Project. These schemes were funded by the GOSL and the International Fund for Agricultural Development (IFAD), respectively. A new loan scheme in the name of “Swashakthi – Towards One Million Jobs” loan scheme, was introduced in 2017 with the collaboration of the Ministry of National Policies and Economic Affairs (MNPEA), identifying the importance of the presence of a Government-led support mechanism to address financial, technical, marketing and entrepreneurship needs of new and existing entrepreneurs of the country. The loan scheme mainly serves youth and young graduates, women and differently abled people. The ultimate objective of the “Swashakthi” loan scheme is to contribute to the Government's broader policy objective of generating one million jobs over the next five-year period.

In 2017, the Central Bank acted as a main stakeholder of the Agriculture Sector Modernisation Project (AMP) of Sri Lanka which was funded by the International Development Association (IDA). The AMP is being implemented by the Ministry of Primary Industries and the Ministry of Agriculture. The two implementing agencies operate AMP with the objective of supporting enhanced agriculture productivity, increasing efficiency, improving market access, and enhancing value addition by all stakeholders in the agricultural production process. The Central Project Coordination Committee established under the MNPEA is expected to provide overall policy oversight, guidance and project monitoring for the AMP. Under the AMP, the Central Bank has established the Partial Credit Guarantee (PCG) scheme in 2017. This scheme is expected to operate as an innovative risk sharing tool that will address the current and changing needs of financial intermediaries, while supporting the development objective of the AMP. The PCG scheme will also address the issue of collateral requirements of the PFIs in the process of funding farmers.

Continuing its battle against financial exclusion in the country, the Central Bank carried out 150 financial literacy, entrepreneurship development and skills development programmes during 2017 with special focus on those who have no access to the formal financial sector due to various reasons. These programmes were designed to create awareness among the general public, mainly on the drawbacks of financial exclusion and the benefits of linking with the formal financial sector. These programmes also acted as knowledge sharing forums on good banking and financial habits, financial discipline and new financial instruments and services available in the formal sector. During the year, the Central Bank was able to utilise print and electronic media effectively, in creating awareness among the general public.

Showing the continued efforts of the GOSL in development finance and in increasing access to finance, the Ministry of Finance and Mass Media (MOFMM) initiated the following 08 concessionary interest subsidy schemes in March 2017, with the intention of generating 50,000 new job opportunities in the country.

1. “Ran Aswenna” loan scheme
2. “Govi Navoda” loan scheme
3. “Diri Saviya” loan scheme
4. “Jaya Isura” loan scheme
5. “Rivi Bala Savi” loan scheme
6. “Soduru Piyasa” loan scheme
7. “Riya Shakthi” loan scheme
8. “Madya Aruna” loan scheme

These interest subsidy schemes were implemented in line with the "Enterprise Sri Lanka" programme of the GOSL, which intends to make all Sri Lankans stakeholders in a production economy, achieving the medium-term objectives of the GOSL; achieving a per capita income up to US dollars 5,000, creating one million new employment opportunities, doubling exports and sustaining economic growth at over 5 per cent by the year 2020.

The main objective of the "Ran Aswenna" scheme is to enhance productivity in the agriculture sector through facilitating commercialised agriculture. The "Govi Navoda" loan scheme intends to financially empower the small-scale farmers, enabling them to increase harvest and minimise the production cost. On the other hand, the "Diri Saviya" scheme provides concessionary credit facilities to self-employed individuals to obtain deep freezers, with the intention of uplifting the distribution of qualitative poultry products.

The "Riya Shakthi" scheme has been introduced by the MOFMM to provide safer school transport service to school children by establishing a more effective school transport service in the country. Meanwhile, "Jaya Isura" scheme was implemented to provide loans to the small and medium scale enterprises in various other sectors including agriculture, fisheries, livestock, floriculture, horticulture, light engineering, printing, tourism, handicrafts, garments, information technology and production industry sectors.

In addition, the "Rivi Bala Savi" scheme introduced by the MOFMM will enable the house owners to generate electricity for their own usage at a lower cost, while enabling them to supply their excess production to the national electricity grid. While the "Rivi Bala Savi" scheme will benefit the house owners, the newly introduced "Soduru Piyasa" scheme will enable individuals who have already embarked on building their houses but need financial assistance, to complete their houses. In contrast, the "Madya Aruna" loan scheme is designed to facilitate registered journalists and media personnel for the modification of their media equipment to carry out their duties without any hindrance.

The Ministry of Industry and Commerce also continued to serve new and existing entrepreneurs in the country through the Small and Micro Industry Leader and Entrepreneur Promotion Project Phase III– Revolving Fund (SMILE III - RF), which consists of two main loan schemes, namely "General Loan Scheme" and the "Technical Transfer Assistance Loan Scheme." These schemes provide concessionary funding for the micro or small-scale manufacturing or industrial enterprises.

During 2017, apart from the above organisations that implemented refinance and interest subsidy loan schemes, several other governmental and non-governmental institutions too carried out operations with a view to enhance development finance and access to finance in the country. These efforts, irrespective of their scale, present a fragmented approach towards increasing access to finance in Sri Lanka. Hence, identifying the need for a national level holistic approach in this regard, the Central Bank initiated action to develop a comprehensive National Financial Inclusion Strategy (NFIS) in 2017. Accordingly, in January 2018, the Central Bank signed an Agreement of Co-operation with the International Financial Corporation (IFC), a member of the World Bank Group, to obtain technical assistance to develop the NFIS. Having an NFIS could be identified as an important step towards standardised approach for the use of all stakeholders to operate in one direction to improve the financial inclusiveness of the country. The NFIS can serve to deepen and accelerate national efforts to reach higher levels of financial inclusion in the future.

The economic impact expected by the implementation of the NFIS is diverse. In the short run, it will expand the retail payments infrastructure and foster easier access to and greater use of electronic transaction instruments, encouraging the use of a diverse set of financial services. It will also create an enabling environment for the provision of affordable financial services, while ensuring that all consumers of financial services are adequately educated, protected, informed, and fairly treated and their conflicts are resolved in a cost- effective and efficient manner. In the medium to long term, it is expected to achieve a comprehensively inclusive financial system that includes each and every adult and enterprise in the country. This inclusive financial system would allow its participants to make full use of a range of adequate, quality, and affordable financial services without any hassle or interruption.

8.6 Financial Infrastructure

Payment & Settlement Systems

The payment and settlement infrastructure continued to cater for the payment needs of individuals and institutions, while focusing on enhancing the efficiency, convenience and safety of payments, in order to effectively facilitate the economic activities of the country. The Central Bank, being guided by the vision of moving towards a less cash society, initiated policies to promote electronic payment mechanisms while ensuring security of such mechanisms. As the regulator of the national payment system, the Central Bank further broadened the regulatory and supervisory activities with the objective of ensuring the stability and soundness of the financial system by effectively mitigating the risks associated with payment and settlement systems.

Table 8.22
Transactions through Payment Systems

Payment System	2016 (a)		2017 (b)	
	Volume ('000)	Value (Rs. bn)	Volume ('000)	Value (Rs. bn)
Large Value Payment Systems				
RTGS System	366	93,378	377	92,303
Retail Value Payment Systems				
Main Cheque Clearing System	51,996	9,601	51,963	10,482
Sri Lanka Inter-bank Payment System (SLIPS)	26,647	1,458	30,018	1,725
Credit Cards	31,858	182	36,964	199
Debit Cards	38,083	108	46,964	135
Internet Banking	18,164	1,589	23,066	2,101
Phone Banking	3,444	16	3,809	32
Postal Instruments	1,244	7	1,308	7
Total	**171,802**	**106,338**	**194,494**	**106,983**
US Dollar Cheque Clearing System	**59**	**39**	**56**	**74**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

The large value payment system and the retail payment systems functioned smoothly in 2017, facilitating increasing volumes of payment transactions. The two subsystems of the LankaSettle System, namely the Real Time Gross Settlement (RTGS) System and the LankaSecure System, continued to facilitate large value and time critical fund transfers and government securities transactions respectively, by providing the electronic payment and settlement infrastructure for effecting such transactions. During the period under review, 377,312 transactions with a value of Rs. 92,303 billion were effected through the RTGS System. In comparison to the previous year, the RTGS transaction volume registered a growth of 3.1 per cent, while the aggregate value of RTGS transactions declined marginally by 1.2 per cent in 2017. The RTGS system continued to be the largest contributor for non-cash payments in terms of aggregate transaction value in 2017, and the aggregate value of RTGS transactions accounted for 86.3 per cent of the aggregate value of non-cash payments in the country. The Central Bank, as the operator of the RTGS System, continued to extend the interest free Intra-day Liquidity Facility (ILF) to participating institutions of the system, against the collateral of government securities, to support RTGS participants to meet their liquidity requirements, and by that means reduce the liquidity risk of the RTGS System. In 2017, the daily average value of ILF utilised by RTGS participants was recorded as Rs. 47.4 billion.

At end 2017, total value of scripless securities held in LankaSecure amounted to Rs. 4,912.2 billion (face value), consisting of Treasury bills of Rs. 724.7 billion and Treasury bonds of Rs. 4,187.5 billion.

The Cheque Clearing System of the country operated by LankaClear (Pvt.) Ltd. (LCPL) functioned smoothly during the year under review and the aggregate volume of cheques cleared through the Cheque Clearing System accounted for 24.3 per cent of the total volume of non-cash payments of the country during 2017. When compared with 2016, the total volume of cheques cleared through the Cheque Clearing System recorded a negative growth of 0.1 per cent while the aggregate value of cheques cleared grew by 9.2 per cent in 2017.

During the year under review, the Sri Lanka Inter-bank Payment System (SLIPS), which facilitates retail inter-bank payments, continued the growing trend in its operations with both the volume and value of payments processed through the system increasing over the previous year. The aggregate volume and value of the payments effected through SLIPS grew by 12.7 per cent to 30 million and by 18.4 per cent to Rs. 1,725 billion, respectively. In September 2017, the number of clearing cycles of SLIPS per business day was increased from two to three, in order to enable faster processing and settlement of SLIPS transactions.

The Common Card and Payment Switch (CCAPS), which functions under the brand name "LankaPay" further expanded its operations, recording a noteworthy progress in 2017, with the three sub-switches launched so far, namely the Common ATM Switch (CAS), Common Electronic Fund Transfer Switch (CEFTS) and Shared ATM Switch (SAS). The CAS provides interconnectivity among the ATMs of member financial institutions, thereby enabling customers of such financial institutions to perform cash withdrawals and balance inquiries from any ATM connected to the CAS network. In 2017, the ATM transaction volume and value of CAS increased by 44.4 per cent to 32.9 million and 52.6 per cent to Rs. 264.1 billion respectively, in comparison to the previous year. At the end of the review period, the total number of financial institutions connected to the CAS network was recorded as 27, while all licensed banks operating their own ATM switches completed the integration with CAS. The Central Bank encouraged CAS members to adopt EMV technology and decided on 01 January 2018 as the liability shift date for EMV migration in CAS. EMV, which stands for EuroPay, MasterCard and Visa, is an international standard for enhancing security of card payments by authenticating transactions using chip card technology. CAS member institutions that have not enabled EMV by the liability shift date will be more probable to assume fraud liability, as the liability will shift to the member institutions which have not adopted EMV technology. SAS, which was launched in 2015 to provide card management and ATM transaction routing services to financial institutions that do not have the capacity to operate their own card management system and ATM switch for routing ATM transactions, continued its operations smoothly during the review period.

CEFTS, the second phase of CCAPS was launched in 2015 to facilitate retail fund transfers among member institutions on a real time basis. The noteworthy progress recorded in CEFTS during the review period was reflected by the CEFTS transaction growth both in volume and value terms. In comparison to the previous year the CEFTS transaction volume increased remarkably by 253.6 per cent to 3.2 million while the CEFTS transaction value grew by 294.5 per cent to Rs. 273.7 billion in 2017. Further, the Central Bank granted approval to implement several developments in CEFTS in order to better facilitate fund transfer requirements in the country. Accordingly, LankaClear Private Ltd. (LCPL) was authorised to implement the LankaPay Online Payment Platform (LPOPP) linked to CEFTS to provide the facility to execute online real time payments to Government institutions. LPOPP was launched in July 2017 to initially facilitate real time payments to Sri Lanka Customs and the platform will be extended to other government institutions in the future. LPOPP will contribute to streamline the government revenue collection procedures as well as offer convenience benefits to individuals and institutions in making payments to Government institutions. Further, LPOPP has the capability to facilitate payments to any other institution, enabling such institutions to reap the benefits of LPOPP. As at end 2017, seven licensed commercial banks had joined LPOPP and during the few months in operation, 1,276 transactions with an aggregate value of Rs. 514 million were processed through LPOPP. Considering the average per transaction values of tariff payments made to Sri Lanka Customs, the Payment and Settlement Systems Circular No. 01 of 2015 was replaced by issuing Payment and Settlement Circular No. 08 of 2017 to increase the maximum per transaction value limit for transactions carried out through a specific transaction code assigned to LPOPP, in order to prevent disruptions to the operations of LPOPP due to the maximum transaction value limit imposed for CEFTS transactions. In addition, the Central Bank granted approval to introduce the concept for Payment Exchange Name for CEFTS transactions, where the payee’s mobile number and a nickname assigned for the account will be used for fund transfers instead of the account number. The Payment Exchange Name concept is intended to further enhance customer convenience and more importantly reduce CEFTS transaction rejections due to incorrect entry of account numbers.

With a view to reducing costs incurred by cardholders and merchants on domestic payment card transactions, the Central Bank granted approval to LCPL to implement a National Card Scheme (NCS). The NCS will be launched in partnership with an international card scheme providing worldwide acceptance for cards issued under NCS. LCPL plans to commence issuing cards under NCS in 2018. Further, as the fourth phase of CCAPS, LCPL will implement the Common Point-of-Sale Switch in line with NCS to provide clearing facilities for point-of-sale transactions executed using cards issued under NCS.

The Central Bank, as the regulator of payment and settlement systems of the country, continued to further strengthen the regulatory framework and the supervisory practices in order to minimise the risks in the national payment and settlement system. In 2017, an LCB and an LFC, which were licensed in terms of the Payment Cards and Mobile Payment Systems Regulations No. 1 of 2013 were granted approval to operate a Customer Account based Mobile

Payment System and to function as an Issuer of Credit Cards, respectively. In addition, taking the payment system developments into consideration, the Central Bank intends to revise the credit card operational guidelines and to broaden the regulatory framework by issuing regulations on acquiring payment card based electronic commerce transactions through service providers and on payment related mobile applications. On the other hand the Central Bank, in performing the role of the catalyst of payment and settlement systems, continued policy formulation measures to support the digitalisation move in the national payment and settlement system. Considering the developments in the payments landscape, the National Payments Council, the consultative committee on payment and settlement systems, appointed two committees to study developments in the financial technology (FinTech) sector and Blockchain technology.

Foreign Exchange Act, No. 12 of 2017

In line with the Government Policy, a new legislative and policy framework for foreign exchange operations was implemented by repealing the Exchange Control Act, No. 24 of 1953 and introducing the new Foreign Exchange Act, No. 12 of 2017, with effect from 20 November 2017. The Department of Foreign Exchange was established in place of the Exchange Control Department, to implement provisions of the new Act.

New regulations were implemented with a view to further liberalise capital flows and simplify the processes associated with foreign exchange transactions through relaxing regulations and restrictions. The new foreign exchange regime would be more facilitative in the conduct of foreign exchange transactions. Therefore, it is expected that these regulations would meet expectations of the stakeholders and potential investors.

Anti-Money Laundering and Countering the Financing of Terrorism

The legal framework and measures relating to mitigating Money Laundering and Terrorist Financing (ML/TF) in the country is vital for the stability of the financial system. The Financial Intelligence Unit (FIU) of Sri Lanka continued its operations during 2017 in terms of the statutory provisions of the Financial Transactions Reporting Act, No. 6 of 2006 (FTRA). The main functions carried out were collection of data relating to suspicious financial transactions to facilitate the prevention, detection, investigation and prosecution of the offences relating to ML/TF and issue rules to financial institutions and non-financial institutions to undertake due diligence measures to combat money laundering and the financing of terrorism.

Receipt, Analysis and Dissemination of Information

Reporting institutions, namely LCBs, LSBs, LFCs, Stock Brokering Firms (SBs), Insurance Companies (ICs) and Authorised Money Changing Companies (AMCCs), continued to report Cash Transactions (CTRs) and Electronic Fund Transfers (EFTs-inward and outwards) subject to the specified reporting threshold of Rs. 1.0 million or its equivalent in foreign currencies as per the Section 6 of the FTRA. During the period, reporting institutions have reported 4.5 million CTRs and 4.3 million EFTs.

In addition, Suspicious Transactions Reports (STRs) on any transaction or attempted transactions which may be related to the commission of any unlawful activity were filed with the FIU by the above Reporting Institutions in terms of Section 7 of the FTRA. The FIU received 925 STRs from reporting institutions, law enforcement agencies and general public and after analysis and assessment a total of 418 STRs were referred to the law enforcement and regulatory authorities for further investigations during the period.

Compliance Monitoring

Twenty one risk based on-site examinations were conducted during the period to monitor the financial institutions' compliance with the FTRA and rules issued thereunder.

Signing of Memoranda of Understanding (MOUs)

Five MOUs were signed with the Anti-Money Laundering Office (AMLO) of the Kingdom of Thailand, The FIU of the Kingdom of Bhutan, China AML Monitoring and Analysis, Qatar Financial Information Unit Center, and FIU of Trinidad and Tobago during the period, to share financial information in facilitating investigation and prosecution of persons suspected of being involved in ML/TF, increasing the total number of MOUs signed with foreign counterparts up to 37. Two MOUs with the Department for Registration of Persons and Sri Lanka Police were signed to facilitate the FIU analysis function, increasing the total number of MOUs signed with domestic agencies up to five.

Listing by Financial Action Task Force and Measures Initiated to Improve Compliance

The Financial Action Task Force (FATF), the global policy setter for Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT), evaluates legal, institutional framework and effective implementation of AML/CFT measures of countries regularly through regional monitoring bodies. Sri Lanka was subjected to its second Mutual Evaluation (ME) by APG during 2014/15. The 2nd Mutual Evaluation Report (MER) on Sri Lanka that was adopted in July, 2015, recommended Sri Lanka to initiate a number of actions to rectify the AML/CFT deficiencies identified during the ME. FATF at its Plenary held at Buenos Aires, Argentina in October 2017, listed Sri Lanka as a jurisdiction with strategic AML/CFT deficiencies in the FATF's Compliance Document, which is more commonly identified as the "Grey List". Upon listing, a time bound action plan to address the strategic deficiencies identified was provided to Sri Lanka and the Central Bank together with other relevant stakeholders have already taken necessary initiatives towards the successful completion of the said action plan within the given time frame for Sri Lanka to improve compliance and country rating.

Legislative Developments

The Suspicious Transactions (Format) Regulation of 2017 was issued on 21 April 2017 by way of Gazette Extraordinary 2015/56, applicable for all institutions.

Credit Information

The Credit Information Bureau (CRIB) provides credit information reports on borrowers to member institutions. During the year 2017, the CRIB issued 9,096,132 credit reports, compared with 7,948,967 reports in 2016, which is a 14.4 per cent growth. This growth is mainly attributable to the expanding credit related activities in the economy. The CRIB had a total of 85 reporting credit institutions as its members at end 2017.

Several measures are being taken to expand the services and improve the coverage of CRIB. The CRIB intends to introduce a new bureau system in the short term, which is expected to deliver a credit score to both individuals and business entities. Through this new bureau system, CRIB could also host and disseminate data of non-financial institutions, i.e. telecommunications, insurance & utilities. Features and products from this new bureau system is expected to enhance credit risk management in the lending industry, expand the credit market, enhance and improve credit to underserved segments, finally improving the country's Doing Business Index score and its financial stability. The CRIB also continued with its user awareness and educational programs among credit officers and other staff of reporting lending institutions as well as general public to provide a better understanding of the CRIB's role in credit market and to enable prudent interpretation of credit reports for risk management purposes.

Table 8.23
Key Prudential Measures Recently Taken by the Central Bank on Licensed Banks, LFCs and SLCs

Date	Prudential Measures
17 January 2014	The maximum limit on rates of interest that could be offered by LFCs on time deposits, non-transferable certificate of deposits and debt instruments was revised.
31 March 2014	Guidelines on the standardised approach on computation of risk-weighted amount for operational risk under Basel II capital adequacy framework were issued to the licensed banks.
05 June 2014	Regulatory framework on valuation of immovable property, including the eligibility criteria for valuers, was issued to licensed banks.
17 June 2014	A Credit Guarantee Scheme for Pawning Advances (CGSPA) was introduced.
26 June 2014	Directions on maximum amount of accommodation were amended. Directions were issued to licensed banks to implement the baseline security standards for information security management from 01 July 2015 onwards.
23 December 2014	Two circulars were issued to LCBs and LSBs, respectively, to maintain a minimum core capital level of Rs. 10 billion and Rs. 5 billion, respectively, commencing from 01 January 2016.
01 January 2015	Deposit insurance coverage per depositor per institution under the Sri Lanka Deposit Insurance and Liquidity Support Scheme (SLDILSS) was increased to Rs. 300,000 from Rs. 200,000.
31 March 2015	Directions were issued to licensed banks to implement the Liquidity Coverage Ratio under Basel III Liquidity Standards from 01 April 2015.
14 September 2015	Directions were issued to licensed banks, LFCs and SLCs to maintain a maximum LTV ratio of 70 per cent on loans and advances granted for the purpose of purchase or utilisation of motor vehicles with effect from 15 September 2015.
14 September 2015	Directions were issued to licensed banks, LFCs and SLCs to maintain a maximum LTV ratio of 70 per cent on loans and advances granted for the purpose of purchase or utilisation of motor vehicles with effect from 15 September 2015.
29 October 2015	Directions were issued to licensed banks, LFCs and SLCs informing that the applicability of the maximum LTV ratio of 70 per cent shall come into force with effect from 01 December 2015.
30 October 2015	A minimum cash margin requirement of 100 per cent on LCs opened with LCBs for the importation of motor vehicles was imposed until 01 December 2015.
18 January 2016	Directions were issued to strengthen and streamline the existing policies and practices in respect of the opening of new branches and automated teller machines, closure and relocation of branches and other outlets of LFCs and SLCs.
28 October 2016	The Direction on maximum interest rates on deposits and debt instruments that could be offered by LFCs was revised.
29 December 2016	Direction was issued requiring licensed banks to maintain the minimum capital ratios and buffers in respect of total risk weighted assets as per Basel III guidelines, commencing 01 July 2017.
13 January 2017	Directions were issued to licensed banks informing the LTV for credit facilities granted by the licensed banks for the purpose of purchase or utilisation of vehicles commencing 16 January 2017.
13 January 2017	The Directions issued to LFCs and SLCs on LTV for credit facilities in respect of motor vehicles were revised in line with the Budget proposal for 2017.
23 February 2017	The Direction to increase the minimum core capital for LFCs up to Rs. 2.5 billion by the beginning of 2021 on a staggered basis was issued.
22 March 2017	A determination was issued to licensed banks amending the pawning conditions issued on 07 September 1998.
26 October 2017	A Direction on further 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 informing a new policy on foreign currency borrowings to be effective from 01 January 2018.
16 January 2018	Finance Business Act, Direction No. 1 of 2018 on a customer protection framework was issued to LFCs.
8 February 2018	Directions were issued to all licensed banks, LFCs and SLCs on LTV ratio, ranging from 70 per cent to 90 per cent, applicable for credit facilities in respect of electric, hybrid and other unregistered vehicles and registered vehicles, which have been used in Sri Lanka for less than one year after the first registration, commencing 01 January 2018.
13 March 2018	Guidelines were issued to licensed finance companies requiring to obtain a credit rating by 01 October 2018.