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FINANCIAL SECTOR PERFORMANCE AND SYSTEM STABILITY

8.1 Overview

The financial sector continued to expand during the year whilst exhibiting resilience amidst challenging market conditions both globally and domestically. Along with the expansion, the stability of the financial system was maintained without causing any major macroprudential concerns in an environment of supportive regulatory measures for stability. The growth of the financial sector was buoyed by the expansion in banking, other deposit taking financial institutions and contractual savings institutions.

The banking sector maintained its capital and liquidity levels well above the statutory minimum requirement while assets of the sector recorded a lower growth in 2016 compared to 2015. The increase in banking assets was mainly driven by the expansion in loans and advances in line with the growth in deposits. Borrowings of the banking sector declined during the year with a drop in foreign currency borrowings enabling banks to manage foreign currency exposures within the prudential limits. The increase in interest income of the banking sector mainly contributed to the higher profitability of the banking sector as reflected in Return on Assets (ROA) and Return on Equity (ROE). Meanwhile, asset quality measured by the Non-Performing Loan (NPL) ratio recorded its lowest level for the last two decades.

The licensed finance companies (LFCs) and specialised leasing companies (SLCs) sector showed an expansion in the asset base. The growth in assets during the year was funded by domestic borrowings and deposits. Although credit growth decelerated in the first quarter of 2016 as a result of macroprudential measures with respect to the lending on motor vehicles, the improvement in other lending activities in the second half of the year caused a rebound in the expansion of credit. Despite weak financial position of few LFCs, liquidity, capital and NPL levels of the sector remained healthy while profitability as reflected in the ROA and ROE increased during the year. Insurance sector, even though, marked a growth in terms of both assets and total profits during the year, remained considerably underpenetrated compared to peer countries and is yet to grasp its full potential. Contractual savings institutions including the Employees' Provident Fund (EPF) and the Employees' Trust Fund (ETF) also recorded healthy growth providing reasonable returns for their members.

Domestic financial markets continued to be volatile during the year in response to changing local and global economic environment. Excess rupee liquidity in the domestic money market declined gradually into deficit levels during the year and rebounded to a surplus by end December 2016. The Sri Lankan rupee continued to depreciate against the US dollar during 2016 reflecting high demand in the domestic foreign exchange market, exacerbated capital outflows and import related demand. The domestic equity market was sluggish during the year in an environment of upward revisions in interest rates in both domestic and US markets, and the depreciation of exchange rates. The national payment and settlement systems facilitated smooth, reliable and safe mechanism for efficient settlement of transactions without any major systemic risk at both retail and large value payment systems. The values and volume of the transactions handled by national payment and settlement systems increased during the year in line with the expansion in financial sector of the country.

Strengthening of the supervisory and regulatory framework governing the financial sector continued during the year to ensure that potential risks to financial system stability are addressed in a timely manner. Several prudential measures taken by the Central Bank targeting banking and LFC and SLC sector stability mainly focused on cyber security, enhancing transparency and capital requirements under the Basel III framework. In addition, the Microfinance Act, No. 6 of 2016 was enacted with the objective of regulating microfinance institutions and the Central Bank issued prudential directions with respect to licensed microfinance companies (LMFCs) and guidelines to the Registrar of Voluntary Social Services Organisations for the regulation and supervision of microfinance non-governmental organisations during the year.With regard to the insurance sector, the Insurance Board of Sri Lanka (IBSL) issued directions with respect to the ownership of insurance companies, share capital, complaints handling by insurers and brokers, and cooling-off period to examine the terms and conditions of the policy documents during the year 2016.

Table 8.1
Total Assets of the Financial System

	2015 (a)		2016 (b)	
	Rs. bn	Share (%)	Rs. bn	Share (%)
Banking Sector	**9,503.7**	**68.8**	**10,575.8**	**68.7**
Central Bank	1,426.2	10.3	1,529.2	9.9
Licensed Commercial Banks (LCBs)	6,974.3	50.5	7,843.3	51.0
Licensed Specialised Banks (LSBs)	1,103.2	8.0	1,203.2	7.8
Other Deposit Taking Financial Institutions	**1,044.2**	**7.6**	**1,246.7**	**8.1**
Licensed Finance Companies (LFCs)	915.3	6.6	1,112.1	7.2
Co-operative Rural Banks	117.6	0.9	122.2	0.8
Thrift and Credit Co-operative Societies	11.3	0.1	12.4	0.1
Specialised Financial Institutions	**557.8**	**4.0**	**522.8**	**3.4**
Specialised Leasing Companies (SLCs)	80.8	0.6	99.8	0.6
Primary Dealers	282.6	2.0	264.5	1.7
Stock Brokers	9.8	0.1	10.1	0.1
Unit Trusts / Unit Trust Management Companies	134.0	1.0	106.7	0.7
Market Intermediaries (c)	42.2	0.3	30.8	0.2
Venture Capital Companies	8.3	0.1	11.0	0.1
Contractual Savings Institutions	**2,711.1**	**19.6**	**3,040.3**	**19.8**
Insurance Companies	453.6	3.3	503.1	3.3
Employees' Provident Fund	1,664.9	12.0	1,841.5	12.0
Employees' Trust Fund	223.5	1.6	249.4	1.6
Approved Pension and Provident Funds	323.0	2.3	398.6	2.6
Public Service Provident Fund	46.1	0.3	47.7	0.3
Total	**13,816.7**	**100.0**	**15,385.7**	**100.0**

(a) Revised
(b) Provisional
(c) 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 Board of Sri Lanka
SANASA Federation
Securities and Exchange Commission of Sri Lanka
Unit Trust Association of Sri Lanka
Venture Capital Companies

8.2 Performance of the Banking Sector

The asset base of the banking sector expanded by Rs. 969 billion during the year surpassing Rs. 9 trillion by end December 2016 albeit at a slower growth of 12.0 per cent (y-o-y) in 2016 compared

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to 15.9 per cent reported in 2015. The increase in assets was mainly attributed to the increase in loans and advances of Rs. 825 billion, which was primarily funded by a growth in deposits of 16.5 per cent during the year. Borrowings of the banking sector declined to Rs. 1.7 trillion with a negative growth of 3.5 per cent in 2016 compared to the growth of 21.4 per cent in 2015. This was mainly due to decrease in foreign currency borrowings by US dollars 319 million recording a decline of 4.4 per cent compared to the previous year. Profit recorded an increase mainly arising from higher net interest income. Profitability of the banking sector as reflected in ROA and ROE increased during the period. The banking sector continued to manage its risks prudently during the year and maintained a comfortable level of liquidity and capital. The asset quality improved during the year recording the lowest NPL ratio in the past two decades. Meanwhile, interest rate risk and re-pricing risks increased due to upward movements in interest rates. The banking sector expanded its operations throughout the year through the establishment of new banking outlets and installation of new Automated Teller Machines (ATMs).

Table 8.2
Distribution of Banks and Bank Branches

Category	End 2015 (a)	End 2016 (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	5,795	5,854
Branches (c)	2,925	2,984
Domestic Banks	2,705	2,763
Foreign Banks	220	221
Student Savings Units	2,870	2,870
Automated Teller Machines	3,188	3,523
Licensed Specialised Banks (LSBs)		
I. Total No. of LSBs	7	7
National Level Regional Development Bank	1	1
National Level Savings Banks	1	1
Housing Finance Institutions	2	2
Private Savings and Development Banks	3	3
II. Total No. of LSB Banking Outlets	799	805
Branches (c)	624	630
National Level Regional Development Bank	255	255
National Level Savings Banks	223	228
Housing Finance Institutions	57	57
Private Savings and Development Banks	89	90
Student Savings Units	175	175
Automated Teller Machines	289	320
Total No. of Bank Branches and Other Outlets	6,594	6,659

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

Source: Central Bank of Sri Lanka

Business Growth

(a) Outreach: By the end of 2016, the banking sector consisted of 25 licensed commercial banks (LCBs) and 7 licensed specialised banks (LSBs). There were 12 branches of foreign banks within the total number of LCBs. The banking sector continued to contribute to economic activity and development throughout the year by enhancing banking services and expanding its network and accessibility throughout the country. Accordingly, 70 new banking outlets (excluding student savings units) were opened and 366 new ATMs were installed during the year. By end 2016, there were 6,659 banking outlets and 3,843 ATMs installed for the purpose of providing efficient banking operations. During the year, approvals were granted for 1 LCB to open a branch in Maldives and for another LCB to open a branch in Bangladesh and to commence a banking subsidiary for microfinance in Myanmar.

(b) Assets: The asset portfolio of the banking sector further expanded during the year, reaching Rs. 9 trillion by end 2016. The asset portfolio mainly consisted of loans and advances, which accounted for 61.2 per cent of the banking assets. Accordingly, the loan portfolio was the major contributor to the 17.5 per cent increase of the total asset portfolio (Rs. 825 billion) during 2016 compared to 21.1 per cent (Rs. 821 billion) in the previous year. Loans and advances were extended to all major sectors of the economy. About 91.8 per cent of the increase in the loan portfolio of the banking sector was attributed to the increase in rupee loans. While the pawning portfolio contracted during the year, the leasing portfolio expanded only marginally by Rs. 7.8 billion (3.3 per cent) in 2016, compared to Rs. 81.1 billion (52.9 per cent) in 2015. This could be attributed to the implementation of the loan to value

Table 8.3
Composition of Assets and Liabilities of the Banking Sector

Item	2015 (a) Rs. bn	2015 (a) Share (%)	2016 (b) Rs. bn	2016 (b) Share (%)	Change (%) 2015 (a)	Change (%) 2016 (b)
Assets						
Loans and Advances	4,715.3	58.4	5,540.8	61.2	21.1	17.5
Investments	2,347.6	29.1	2,270.5	25.1	21.8	-3.3
Other (c)	1,014.6	12.6	1,235.3	13.7	-11.8	21.8
Liabilities						
Deposits	5,403.1	66.9	6,295.6	69.6	15.3	16.5
Borrowings	1,758.4	21.8	1,696.4	18.8	21.4	-3.5
Capital Funds	636.7	7.9	707.3	7.8	12.0	11.1
Other	279.2	3.5	347.3	3.8	3.9	24.4
Total Assets/ Liabilities	**8,077.5**	**100.0**	**9,046.6**	**100.0**	**15.9**	**12.0**

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

Source: Central Bank of Sri Lanka

ratio in respect of loans and advances granted by licensed banks for the purpose of purchase or utilisation of motor vehicles. Meanwhile, the investments portfolio contracted to 25.1 per cent of the asset portfolio as it reported a negative growth of 3.3 per cent during 2016 compared to the significant growth of 21.8 per cent during the preceding year.

(**c**) **Liabilities:** The customer deposits continued to be the major source of liabilities which accounted for 69.6 per cent of the total liabilities of the banking sector. The deposit base of the banking sector increased during the year mainly due to the increase in term deposits denominated in Sri Lankan rupees. Time deposits reported an increase of 23.8 per cent in 2016 compared to an increase of 13.9 per cent in the previous year. As a consequence, the share of time deposits as a percentage of total deposits increased to 60.6 per cent in 2016 from 57.0 per cent in 2015. Meanwhile, there was an increase in savings and current account deposits during the year growing at a slower rate of 7.4 per cent and 7.3 per cent, respectively, in 2016 compared to a growth of 18.3 per cent and 17.2 per cent, respectively, in 2015. The increase in term deposits was partly

Table 8.4
Composition of Deposits of the Banking Sector

Item	Amount (Rs. bn) 2015 (a)	Amount (Rs. bn) 2016 (b)	Composition (%) 2015 (a)	Composition (%) 2016 (b)
Demand Deposits	446.4	479.2	8.3	7.6
Savings Deposits	1,729.6	1,858.1	32.0	29.5
Time Deposits	3,079.5	3,812.4	57.0	60.6
Other Deposits	147.6	145.8	2.7	2.3
Total Deposits	**5,403.1**	**6,295.6**	**100.0**	**100.0**

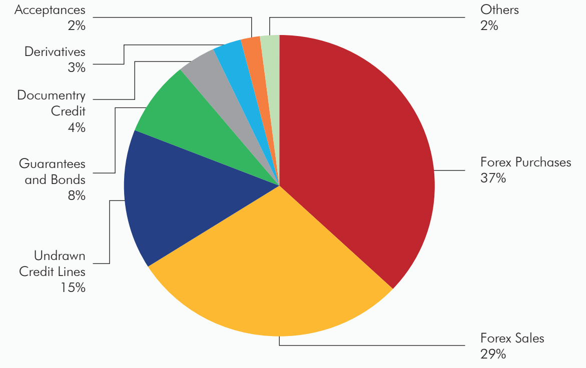
(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

attributed to the upward movement in interest rates during the year. The current accounts and savings accounts (CASA) ratio decreased marginally to 37.1 per cent by end 2016 from 40.3 per cent in 2015 indicating a decline in low cost funding. Total borrowings of the banking sector displayed a negative growth of 3.5 per cent due to foreign borrowings declining by Rs. 47.8 billion and rupee borrowings declining by Rs. 14.2 billion. Nevertheless, foreign currency borrowings accounted for major share of total borrowings representing 60.7 per cent.

(d) Off-Balance Sheet Exposure: Off-balance sheet exposure more than doubled during the year increasing by Rs. 3,794 billion to Rs. 7,158 billion due to increase in undrawn credit, forward purchases and forward sales. Off-balance sheet exposure was mainly concentrated in the sectors of foreign exchange purchases (37.2 per cent)

Chart 8.1
Off-Balance Sheet Exposures of the Banking Sector (as at end 2016)



Source: Central Bank of Sri Lanka

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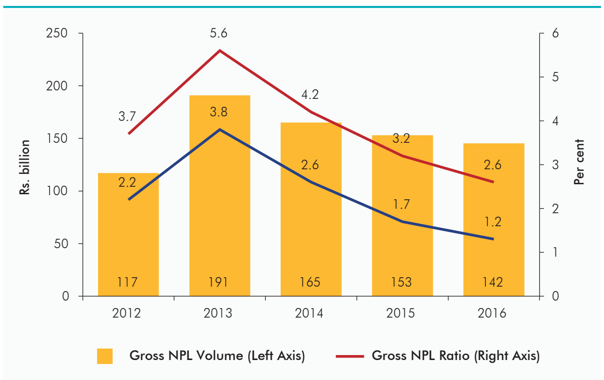
and sales (29.1 per cent), undrawn credit lines (15.0 per cent), which together accounted for 81.3 per cent of the off-balance sheet exposures. Guarantees and bonds, documentary credit, derivatives, acceptances and other non-funded activities contributed to the remaining share of off-balance sheet exposures.

Risks in the Banking Sector

(a) Credit Risk: Risk weighted assets for credit risk increased during the year with increased lending and the expansion of loan portfolios. Credit quality improved substantially during the year due to aggressive credit recovery policies adopted by banks. The NPL ratio declined further to 2.6 per cent in 2016 from 3.2 per cent in 2015 due to a decline in NPLs by an absolute amount of Rs. 10.6 billion. Total provisions increased by Rs. 6.9 billion mainly with an increase in specific provisions made for NPLs reporting a specific provision coverage ratio of 52.1 per cent.

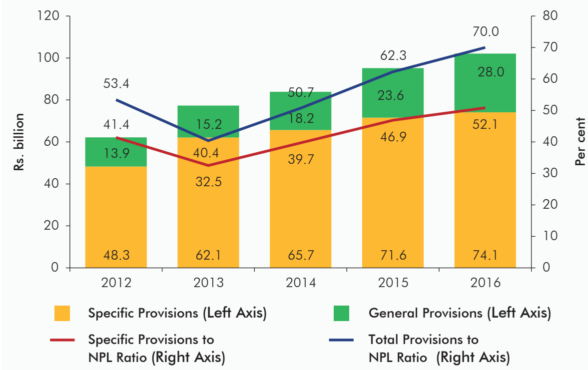
The credit portfolio was diversified across certain sectors such as construction (17.8 per cent), traders (14.0 per cent), manufacturing (10.7 per cent), and agriculture and fishing (9.0 per cent), which accounted for more than 50 per cent of the credit portfolio.

Chart 8.2
NPLs of the Banking Sector



Source: Central Bank of Sri Lanka

Chart 8.3
Provisioning for NPLs of the Banking Sector

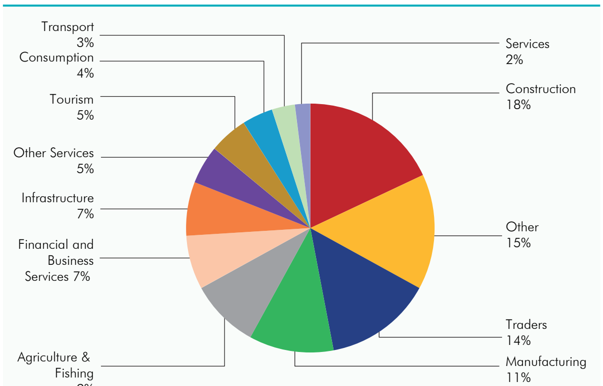


Source: Central Bank of Sri Lanka

(b) Market Risk: Risk weighted assets for market risk increased during 2016 to Rs. 144 billion from Rs. 125 billion as at end 2015 due to increase in foreign currency risk resulting in an increase in the capital charge.

Interest Rates: Market interest rates increased during the year causing an increase in the re-pricing risk. A net capital gain of Rs. 3.2 billion from the sale of Treasury bonds was reported during the year despite the volatility in interest rates. The cumulative interest rate sensitive gap of the banking sector, which is the gap between interest rate sensitive assets and interest rate sensitive liabilities as a percentage of interest rate sensitive assets up to 12 months' time bucket widened to negative 33.7 per cent as at end 2016 compared to negative 17.3 per cent as at end 2015.

Chart 8.4
Credit Exposure of the Banking Sector (as at end 2016)



Source: Central Bank of Sri Lanka

Prices of Equity: Equity risk of the banking sector remained at low levels during the year as the exposure to the equity market in the form of investments in listed shares was minimal at Rs. 22.1 billion. This was only 1.4 per cent and 0.4 per cent, respectively, of total investments and total assets of the banking sector.

Foreign Currency Risk: The foreign currency risk of the banking sector increased during the year due to increase in foreign currency deposits, despite a decline in foreign currency borrowings. The banking sector reported Rs. 16.4 billion more foreign currency denominated assets than foreign currency denominated liabilities (long foreign currency exposure). This long foreign currency exposure as a percentage of the banks' regulatory capital and on balance sheet assets stood at 2.1 per cent and 0.2 per cent, respectively, by end 2016. The banking sector reported a net gain of Rs. 12.3 billion at the end of 2016 resulting from the depreciation of the rupee against the US dollar.

(c) Liquidity Risk: There was excess liquidity in the banking sector during 2016 despite high demand for lending. The statutory liquid assets ratios (SLARs) of the domestic banking units (DBUs) and offshore banking units (OBUs) were maintained well above the minimum statutory level at 30.0 per cent and 35.3 per cent, respectively. However, SLAR of DBUs decreased by 400 basis points during the year as a result of increased lending. Accordingly, the loans to deposits ratio increased to 88.0 per cent in 2016 from 87.3 per cent in 2015.

Table 8.5
Composition of Statutory Liquid Assets of the Banking Sector

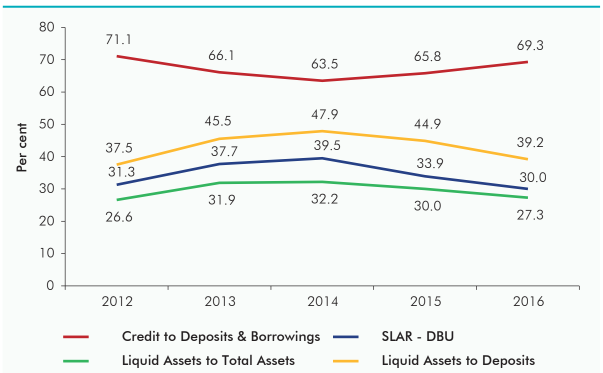
Item	2015 (a)		2016 (b)		Change (Rs. bn)	
	Rs. bn	Share (%)	Rs. bn	Share (%)	2015 (a)	2016 (b)
Treasury Bills	683.1	28.1	506.6	20.5	105.5	-176.5
Treasury Bonds	680.5	28.0	843.0	34.2	-111.6	162.6
Sri Lanka Development Bonds	463.1	19.1	451.7	18.3	72.8	-11.4
Cash	116.1	4.8	122.0	4.9	18.8	5.9
Money at Call	141.8	5.8	114.8	4.7	35.4	-27.0
Balance with Banks	229.0	9.4	322.2	13.1	41.4	93.2
Other	113.3	4.7	105.6	4.3	22.7	-7.7
Total Liquid Assets	**2,426.9**	**100.0**	**2,465.9**	**100.0**	**185.0**	**39.0**

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

Liquid assets to total assets and liquid assets to total deposits decreased by 280 basis points and 575 basis points, respectively, during the year. Total liquid assets stood at Rs. 2,466 billion and Treasury bills, Treasury bonds, Sri Lanka Development Bonds and balances with banks contributed to 86.1 per cent of total liquid assets.

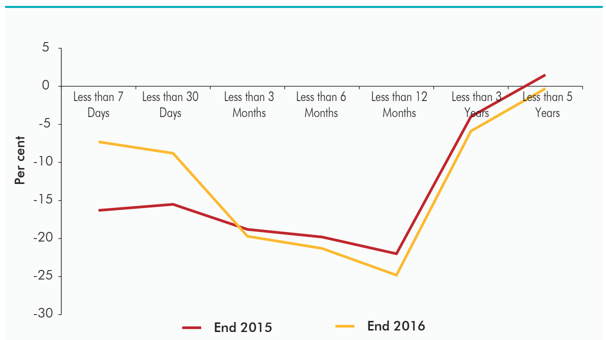
The cumulative maturity gap as a percentage of cumulative liabilities of the banking sector narrowed for the maturity time periods (buckets) less than 3 months and widened for maturity time periods greater than 3 months and less than 12 months.

Chart 8.5
Liquidity Ratios of the Banking Sector



Source: Central Bank of Sri Lanka

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



Source: Central Bank of Sri Lanka

The liquidity coverage ratio (LCR) for rupee liquidity requirements and all currency liquidity requirements of the banking sector were 199.2 per cent and 152.8 per cent, respectively, remaining well above the stipulated minimum requirement of 70.0 per cent as at end December 2016.

Profitability and Capital Resources

(a) Profitability: The net interest income of the banking sector increased at a slower rate than in 2015 recording a growth of 14.4 per cent, mainly due to the increase in interest expenses by 39.4 per cent. However, the net interest income as a percentage of average assets increased marginally during 2016. Non-interest income increased by about 6 per cent during the year despite a negative growth in foreign exchange income.

Non-interest expenses also increased significantly by 10.6 per cent due to increase in staff costs. While profit after tax of the banking sector stood at Rs. 116 billion with an increase of 19.5 per cent, ROE increased by 110 basis points during the year, reporting a ratio of 17.3 per cent. However, ROA increased only marginally to 1.4 per cent in 2016 from 1.3 per cent in the previous year. The interest margin remained unchanged at 3.6 per cent. Cost to income ratio has deteriorated to 75.6 per cent in 2016 from 73.1 per cent in 2015. Meanwhile, the efficiency ratio, as measured by relative share of non-interest expenses to total income, improved by 164 basis points due to a decrease in the ratio of staff costs to operating expenses.

Table 8.6
Profit of the Banking Sector

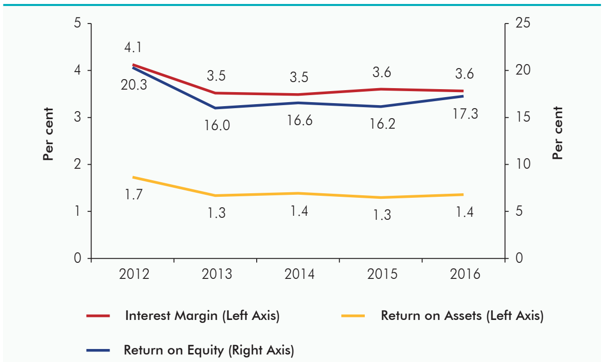
Item	2015 (a)		2016 (b)	
	Amount (Rs. bn)	As a % of Avg. Assets	Amount (Rs. bn)	As a % of Avg. Assets
Net Interest Income	**265.8**	**3.6**	**304.1**	**3.6**
Interest Income	590.9	7.9	757.4	8.9
Interest Expenses	325.1	4.3	453.2	5.3
Non-Interest Income	**97.5**	**1.3**	**102.9**	**1.2**
Foreign Exchange Income	27.5	0.4	26.0	0.3
Non-Interest Expenses	178.4	2.4	197.3	2.3
Staff Cost	89.3	1.2	98.3	1.2
Loan Loss Provisions	18.7	0.3	11.1	0.1
Profit before Tax (after VAT)	**139.9**	**1.9**	**164.3**	**1.9**
Profit after Tax	**97.0**	**1.3**	**116.0**	**1.4**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

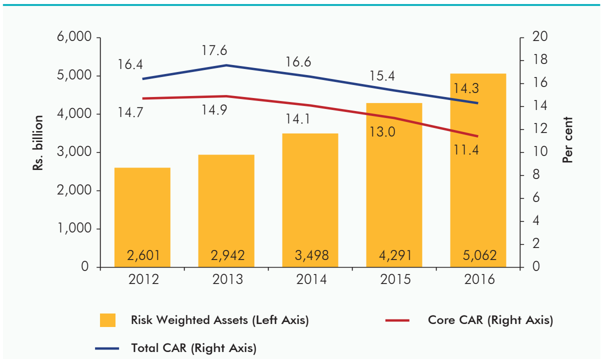
(b) Capital: The banking sector maintained its capital at a comfortable level during the year enhancing the capacity to absorb any adverse shocks. Capital adequacy ratios of the banking sector demonstrated a declining trend, but continued to be at a level higher than the minimum regulatory requirements. Subsequent to the inclusion of estimated profits for 2016, the core capital adequacy ratio (CAR) and total CAR as at end December 2016,

Chart 8.7
Profitability Indicators of the Banking Sector



Source: Central Bank of Sri Lanka

Chart 8.8
Capital Adequacy of the Banking Sector



Source: Central Bank of Sri Lanka

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BOX 10
Strengthening Capital Regulations to enhance the Resilience of Banks

1 Introduction

The global financial crisis, which emerged during the period of 2008-2012, compelled the regulators to introduce new regulations while strengthening the existing regulations for enhancing the safety and soundness of the financial institutions. The excessive risk taken through on-balance sheet and off-balance sheet exposures by banks with securitisations of sub-prime mortgages led to heavy losses, thereby eroding banks' capital. Many reputed financial institutions around the globe with large amounts of assets, which were considered by the market as Too-Big-To-Fail, were severely affected. Accordingly, certain large institutions were rescued by implementing various measures, including taking over or merging with other financial institutions, nationalisation and bailing-out by the respective governments, while some financial institutions were declared insolvent or liquidated. With these consequences, regulators around the globe emphasised the need to enhance quality and quantity of capital of banks. Accordingly, regulators have focused on increasing minimum capital requirements, which were required to be met with capital components with a higher loss absorbing capacity such as common shares, share premium and retained earnings.

2 Regulatory Developments with respect to Capital - The Basel Capital Accord

2.1 The Basel Committee on Banking Supervision (BCBS), headquartered at the Bank for International Settlements (BIS) in Basel has implemented a series of international standards for bank regulations on capital adequacy commonly known as Basel Accord. The Basel Committee issued its first Accord in 1988 (Basel I) requiring banks to maintain a minimum ratio of capital to risk weighted assets - capital adequacy ratio (CAR) of 8 per cent. It was strengthened by introducing Basel II in 2004 which comprised three pillars, viz. minimum capital requirements, supervisory review process and market discipline.

2.2 In response to the global financial crisis, the three pillars introduced under Basel II were strengthened by adding several new components and in December 2010, the Basel Committee issued advanced global standards (Basel III) for strengthening the capital adequacy framework. These standards were focused on increasing high quality capital, eliminating inconsistencies in the definition of capital across the jurisdictions and enhancing disclosure requirements to assess and compare the quality of capital. The Basel III requirements were implemented on a staggered basis commencing 1 January 2013.

3 Salient Features of Basel III

3.1 Definition of Capital

The Basel regulations have specified the elements of capital which includes,

(i) Tier I capital - Going concern capital

- Common equity Tier I capital
- Additional Tier I

(ii) Tier II capital - Gone concern capital

The Committee has indicated a set of criteria to be met before inclusion in the relevant category. Further, the above capital components need to be maintained at all times as follows.

- Common equity Tier I must be at least 4.5 per cent of risk weighted assets
- Tier I capital must be at least 6 per cent of risk weighted assets
- Total capital i.e. Tier I and Tier II, must be at least 8 per cent of risk weighted assets

3.2 Introducing the Bail-in Provisions

The Committee has introduced bail-in provisions where creditors of a bank will get involved in rescuing the bank before the involvement of external parties. In this regard, subordinated debentures included in additional Tier I and Tier II can be converted to equity at a point of non-viability as determined by the regulator. These financial instruments will qualify for regulatory capital purposes only if the bank has issued it with the feature of convertibility. Thus, before a bail-out by a relevant authority, banks are allowed to convert the contingent convertible capital instruments to absorb losses when the capital of the issuing bank falls below a certain level.

3.3 Introducing the Capital Conservation Buffer (CCB)

The Basel III Framework has introduced CCB to ensure that banks build up capital buffers during good periods, which can be drawn down during stress periods. Holding additional capital buffers compels banks to retain greater proportion of earnings without generously distributing it to shareholders and place depositors' interest above shareholders' interests. CCB of 2.5 per cent comprising common equity Tier I will be fully effective by 01 January 2019.

3.4 Identifying Global Systemically Important Banks (G-SIBs)

Failures of globally active large banks during the financial crisis and its impact to the real economy led the Committee to strengthen the resilience

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of such banks in addition to the capital adequacy measures, which are commonly applicable to all banks. Accordingly, G-SIBs are identified based on selected indicators of systemic importance viz. the size of the banks, their interconnectedness, lack of readily available substitutes or financial institution infrastructure for the services they provide, their global activity and complexity. In order to reduce the probability of failure of G-SIBS, such banks are required to increase their loss absorbing capacity by maintaining an additional capital buffer (ranging from 1 per cent - 3.5 per cent of Risk Weighted Assets) comprising Common Equity Tier I Capital.

3.5 Introducing the Countercyclical Buffer

The framework has introduced countercyclical capital buffer to protect banks from risks arising from the excess credit growth in the economy, which can lead to a system wide risk in the banking sector. If such a systemic risk is observed by a national authority, it is empowered to decide the size of the countercyclical buffer that varies from 0 per cent to 2.5 per cent of the Risk Weighted Assets.

3.6 Introducing the Leverage Ratio

During the period of global financial crisis, the financial regulators identified that one of the reasons for the crisis was building excessive on and off balance sheet leverage by banks while maintaining healthy capital ratios. Therefore, the Basel Committee has introduced a simple, transparent and non-risk based leverage ratio as a supplementary measure to the risk based capital requirement. The Committee has set a minimum Tier I leverage ratio of 3 per cent, measured as capital to total exposure, comprising both on-balance sheet and off-balance sheet exposures.

3.7 Reforms to the Counterparty Credit Risk Framework

The Basel III has introduced measures to strengthen the capital requirement for counterparty credit risk exposures and risk management, focusing on the risk arising from derivatives, repo and securities financing activities. Accordingly, banks will be subject to a capital charge for potential marked-to-market losses, caused by the deterioration of worthiness credit of the counterparty.

4 Implementation of Basel III for Licensed Banks in Sri Lanka

Basel regulations on Capital Framework were adopted by banks in Sri Lanka since 2008 with the introduction of capital adequacy ratio. Progressing towards Basel III, the Central Bank issued Banking Act Directions No.01 of 2016 on Capital Requirement under Basel III for licensed commercial banks and licensed specialised banks.

In terms of the Banking Act Directions on Basel III, July 2017, licensed banks are required to maintain minimum capital requirements and buffers with respect to its risk weighted assets.

In line with the capital requirements for domestic systemically important banks (D-SIBs) by the Basel Committee, Central Bank imposed a capital surcharge buffer of 1.5 per cent for D-SIBs which are identified as banks with assets over Rs. 500 billion or more. At present, there are 6 such banks in the country accounting for 71 per cent of the total banking assets. The minimum capital requirement for D-SIBs are given in Table B 10.1

Table B 10.1
Capital Requirement for D-SIBs

Component of Capital	Banks with Assets with Rs. 500 bn or more		
	01.07.2017	01.01.2018	01.01.2019
Common Equity Tier I	6.25%	7.375%	8.5%
Total Tier I	7.75%	8.875%	10.00%
Total Capital Ratio	11.75%	12.875%	14.00%

Note: Including Capital Conservation Buffer and Capital Surcharge on D-SIBs

The other banks will have to maintain capital as follows.

Table B 10.2
Capital Requirement for Banks with Assets less than Rs. 500 bn

Component of Capital	Banks with Assets less than Rs. 500bn		
	01.07.2017	01.01.2018	01.01.2019
Common Equity Tier 1	5.75%	6.375%	7.00%
Total Tier I	7.25%	7.875%	8.50%
Total Capital Ratio	11.25%	11.875%	12.5%

Note: Including Capital Conservation Buffer

As a measure to secure compliance with the minimum capital requirements, banks which fail to comply with the requirements, will not be permitted to pay dividends or repatriate profits or adopt any other measure that will further deteriorate the regulatory capital position of such bank. Further, commencing 01 July 2017, banks are required to disclose key information in relation to regulatory capital, liquidity and risk management with the published financial statements with comparative information on both individual and consolidated basis.

5 Way Forward

5.1 Enhanced Minimum Capital Requirement

The Central Bank intends to increase the minimum capital requirement for existing and new banks to be established in Sri Lanka from the existing minimum capital requirement of Rs. 10 billion. for licensed commercial banks and Rs. 5 billion for licensed specialised banks and branches of foreign banks. in order to enhance the resilience of the domestic banking sector.

5.2 Meeting Enhanced Capital Requirements on a Staggered Basis

Commencing 1 July 2017, banks need to comply with minimum capital ratios. However adhering to Basel III minimum capital requirement will be challenging for banks that currently have CAR marginally above the regulatory minimum. Hence, banks with lower CAR may need to infuse share capital or will need to build capital internally by limiting dividends and other discretionary payments. CBSL is closely monitoring the readiness of the banks to comply with these requirements.

Although raising capital will increase the cost of funds, banks' will benefit through high credit rating, leading to a reuction of the risk premium charged when raising funds for banking operations.

5.3 Leverage Ratio

The Consultation Paper on Leverage Ratio was issued to licensed banks in early 2017 and commencing 31 March 2017, banks are requested to report the Leverage Ratio for monitoring purposes. The Directions on Leverage Ratio will be issued by the Central Bank consequent to BCBS issuing the final guidelines.

Sources:

Basel III: A Global Regulatory Framework for more resilient banks and banking systems issued by Basel Committee, Banking Act Directions No 01. of 2016 on Capital Requirement under Basel III for licensed commercial banks and licensed specialised banks issued by the Central Bank of Sri Lanka, www.bis.org

stood at 11.4 per cent and 14.3 per cent, respectively. The regulatory capital was composed of Tier I and Tier II capital of which Tier I capital contributed to nearly 80 per cent of the total regulatory capital. Tier I capital constituted primarily of share capital, retained profits, and general and other reserves. Almost 85.8 per cent of Tier II capital comprised subordinated term debt, while the revaluation reserve represented 9.6 per cent. The banking sector actively engaged in the issuance of debentures during the year and retained a portion of earnings of banks as internally generated capital to maintain capital at a sustainable level as per the regulatory requirements.

Table 8.7
Composition of Regulatory Capital of the Banking Sector

Item	Amount (Rs. bn)		Composition (%)	
	2015 (a)	2016 (b)	2015 (a)	2016 (b)
Tier I Capital	**560.0**	**578.6**	**100.0**	**100.0**
Share Capital	165.7	185.4	29.6	32.0
Statutory Reserve Funds	34.3	34.2	6.1	5.9
Retained Profits	216.7	199.8	38.7	34.5
General and Other Reserves	166.9	167.2	29.8	28.9
Other	0.6	16.8	0.1	2.9
Regulatory Adjustments	-24.2	-24.8	-4.3	-4.3
Tier II Capital	**101.3**	**145.0**	**100.0**	**100.0**
Revaluation Reserves	13.9	13.9	13.7	9.6
Subordinated Term Debt	83.1	124.4	82.0	85.8
General Provisions and Other	20.1	24.0	19.9	16.5
Regulatory Adjustments	-15.8	-17.3	-15.5	-11.9
Total Regulatory Capital Base	**661.3**	**723.6**		

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Supervisory and Regulatory Developments

The Central Bank initiated several measures to strengthen the supervisory and regulatory framework for licensed banks with the view to further promoting safety and soundness of the banking sector thereby enhancing public confidence in the sector. Considering the increasing risk in cyber security, on 25 January 2016, a Circular was issued to licensed banks requiring them to report cyber security events within 1 working day of the detection of any event and within 15 days from the end of each quarter

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with immediate effect. With a view to expanding disclosures to customers by banks, on 1 February 2016, a Circular was issued to licensed banks to display fees charged from customers for fund transfers through the Lankasettle System, Sri Lanka Inter Bank Payment System (SLIPS) and Common Electronic Fund Transfer Switch (CEFTS) in all branches and publish same in banks' website in the given format commencing from 10 February 2016. The aforementioned fees will be determined by the Central Bank and communicated to all banks.

Meanwhile, in order to promote the secondary market for government securities by enhancing transparency and price discovery, a Circular dated 1 September 2016 on secondary market trading of government securities and reporting by licensed banks was issued to licensed banks requiring banks to use the Bloomberg trading platform available to Sri Lanka to conduct all outright trades with other banks and primary dealers and to report yield rates and volumes of all outright trades carried out over-the-counter in excess of Rs. 50 million, within 30 minutes of each such trade commencing 15 September 2016. The Central Bank further strengthened capital regulations of banks by issuing Banking Act Direction No. 01 of 2016 dated 29 December 2016, on Capital Requirements under Basel III for licensed banks requiring banks to maintain the minimum capital ratios and buffers in respect of total risk weighted assets commencing from 1 July 2017. Accordingly, commencing from 1 July 2017, large banks maintaining assets over Rs. 500 billion will be required to maintain a Tier I capital ratio of 10.0 per cent and total ratio of 14.0 per cent while other banks will be required to maintain a Tier I capital ratio of 8.5 per cent and total ratio of 12.5 per cent by 1 January 2019. In order to ensure the compliance with minimum capital requirements, banks which fail to comply with the requirements, will not be permitted to pay dividends or repatriate profits or adopt any other measure that will further deteriorate the regulatory capital position of such bank until the bank complies with the Direction. In addition, commencing from 1 July 2017, all licensed banks are required to disclose key information on regulatory capital, liquidity and risk management with the published financial statements with comparative information on both solo and consolidated basis.

8.3 Performance of Non-Banking Financial Institutions

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

The LFCs/SLCs sector recorded a strong performance in terms of asset growth and branch network expansion during 2016 amidst a challenging business environment, while placing emphasis on gradually moving out from its core business of vehicle financing to other loan products. The growth in the sector was mainly funded through domestic borrowings. While maintaining the growth, risk remained under control, as reflected in healthy level of NPLs and comfortable liquidity and capital levels. However, as risks emanating from few LFCs with weak financial positions could cause macroprudential concerns on financial system stability of the country, the Central Bank continued to adopt prudential measures with a specific focus on reviving the aforementioned weak companies to maintain stability of the sector.

Business Growth

(a) Outreach: By end 2016, this sector comprised of 46 LFCs, 7 SLCs and 1,313 branches, out of which 886 branches were located outside the Western Province. During the year, a new finance leasing licence for Sarvodaya Development Finance Ltd. was granted and the finance leasing licence of People's Bank was cancelled on their request while 101 new branches were added to the branch network.

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

Province	End 2015	End 2016 (a)
Western	394	427
Southern	134	144
Sabaragamuwa	92	105
North Western	129	140
Central	139	147
Uva	61	66
North Central	89	95
Eastern	98	108
Northern	80	81
Total	**1,216**	**1,313**

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

(b) Assets: During 2016, the LFCs/SLCs sector was able to expand their asset base exceeding the one trillion rupee mark while maintaining marginally lower growth than in previous year. The total asset base of the sector grew by 21.7 per cent (Rs. 215.8 billion) in 2016 to Rs. 1,211.9 billion compared to a growth of 22.3 per cent (Rs. 181.6 billion) in 2015. The 77.3 per cent growth of assets was mainly led by lending activities. The increased assets were funded mainly through borrowings by 57.6 per cent and the balance by deposits, equity capital and other liabilities which represented 23.3, 10.6 and 8.4 per cent, respectively.

Credit growth of the LFCs/SLCs sector moderated during the first quarter of 2016 as a result of macroprudential measures implemented with respect to the lending on motor vehicles mainly in the form of a loan to value ratio (LTV).

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

Item	2015 (a)		2016 (b)		Change (%)	
	Rs. bn	Share (%)	Rs. bn	Share (%)	2015 (a)	2016 (b)
Assets						
Loans and Advances (net)	795.8	79.9	962.7	79.4	31.8	21.0
Investments	99.6	10.0	111.7	9.2	-9.2	12.1
Other	100.7	10.1	137.5	11.3	-0.4	36.6
Liabilities						
Total Deposits	480.6	48.3	531.0	43.8	16.1	10.5
Total Borrowings	314.3	31.6	438.7	36.2	44.6	39.6
Capital Elements	123.1	12.4	146.1	12.1	5.4	18.7
Total Funds	**918.0**	**92.2**	**1,115.7**	**92.1**	**22.7**	**21.5**
Other	78.1	7.8	96.2	7.9	17.9	23.2
Total Assets/Liabilities (net)	**996.1**	**100.0**	**1,211.9**	**100.0**	**22.3**	**21.7**

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

However, with the increased exposure to other lending products, the credit growth accelerated during the second half of 2016 resulting in an overall expansion of credit of 21.0 per cent (Rs. 166.8 billion) to Rs. 962.7 billion as at end 2016, compared to a high growth rate of 31.8 per cent (Rs. 192.1 billion) during 2015. Around 73.1 per cent of this credit growth was mainly through other loan products such as term loans, revolving loans, microfinance, factoring and draft loans, while 23.7 per cent was through finance leases and hire purchases.

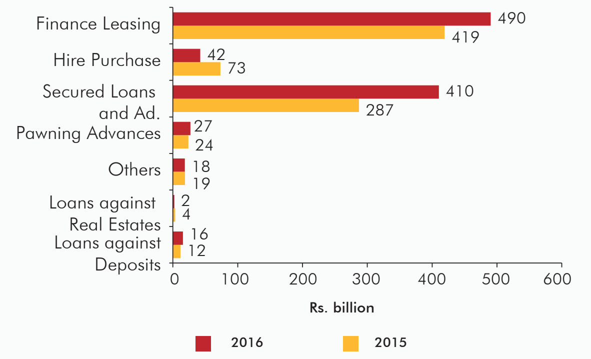
The investment portfolio comprises of investments in equities, corporate debt instruments, government securities and investment properties and recorded a growth of 12.1 per cent in 2016 compared to a negative growth of 9.2 per cent in 2015. This was mainly on account of increased investments in short-term government securities. Other assets comprised of cash, balances with banks and financial institutions, trading stocks and fixed assets, showed an increase of 36.6 per cent in 2016 largely due to increased placements in banks and financial institutions.

(c) Liabilities: The sector's reliance on retail deposits has gradually shifted towards bank borrowings over the past two years considering the flexibility and cost factor. This has changed the overall funding structure of the sector by increasing the share of borrowings to 36.2 per cent in 2016 from 31.6 per cent in 2015, while the share of deposits decreased to 43.8 per cent in 2016 from 48.3 per cent in 2015. During 2016, the borrowings increased by 39.6 per cent or Rs. 124.4 billion to Rs. 438.7 in absolute terms compared to a growth of 44.6 per cent recorded in 2015. The borrowings are predominantly from the banking and finance sector (58.5 per cent) followed by debenture issues (16.5 per cent), foreign borrowings (4.9 per cent) and overdraft facilities (4.5 per cent).

The deposits recorded a moderate growth of 10.5 per cent or Rs. 50.3 billion to Rs. 531.0 billion in 2016, compared to a 16.1 per cent growth in 2015. The deposit mobilisation was mainly through time deposits accounting for 95.6 per cent of the total deposits, whilst the residual was mainly from savings deposits.

The capital elements of the sector increased by 18.7 per cent to Rs. 146.1 billion as at end 2016, mainly on account of internally generated profits.

Chart 8.9
Product wise Loans & Advances of the LFCs/SLCs Sector



Source: Central Bank of Sri Lanka

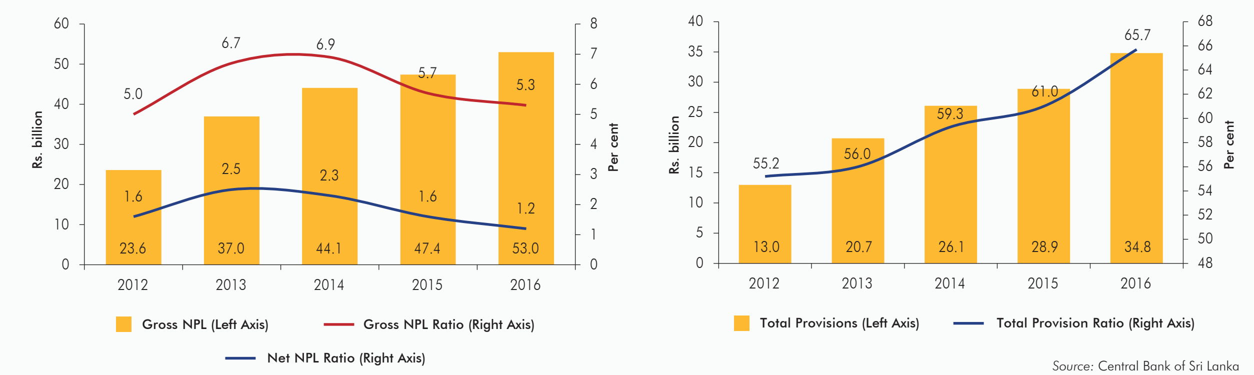
Risks in the LFCs/SLCs sector

(a) Credit Risk: Amidst the growth in the sector, the quality of loans portfolio was maintained due to aggressive credit recovery policies adopted by LFCs and SLCs. The NPL ratio showed a decline from 5.7 per cent in 2015 to 5.3 per cent in 2016. The increase of Rs. 5.6 billion in NPLs in 2016 was not significant compared to higher growth of the loan portfolio. The total loan loss provisions increased by Rs. 5.9 billion to Rs. 34.8 billion mainly due to an increase in the specific provisions made for NPLs with a delinquency period of more than 12 to 24 months. As a result, the net NPL ratio decreased to 1.2 per cent as at end of 2016 compared to 1.6 per cent in 2015 and the provision coverage increased to 65.7 per cent in 2016 compared to 61.0 per cent enabling a minimisation of potential default risk of the sector.

(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 transactions. Market interest rates increased during the year, resulting higher "re-pricing risk", which reduced the sector margin due to prevailing negative assets and liabilities mismatch. However, the increased interest rate risk was minimised due to the improvement of the negative assets and liabilities mismatch up to 12 months' time bucket.

(c) Liquidity Risk: The excess liquidity in the LFCs/SLCs sector witnessed in the previous year continued to remain high during the year under review amidst increased lending activities of the sector. The overall statutory liquid assets available in the LFCs/SLCs sector were at a surplus of Rs.

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



Source: Central Bank of Sri Lanka

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15.4 billion by end 2016 compared to the stipulated minimum requirement of Rs. 74.7 billion. About 74.9 per cent liquid assets of the sector were in the form of government securities. The liquid assets to total assets ratio decreased marginally to 7.1 per cent from 7.6 per cent in 2015. Further, the liquid asset to deposits ratio was well above the statutory minimum of 10.0 per cent of time deposits and unsecured borrowings and 15.0 per cent of savings deposits.

Profitability and Capital Resources

(a) Profitability: Greater business expansion of the LFCs/SLCs sector in to new areas of lending during the year enabled the sector to post increased level of profits. Accordingly, the sector posted a profit after tax of Rs. 31.5 billion compared to that of Rs. 15.2 billion in 2015 reporting a more than two fold increase. Increased business volumes, improved other income and improved operational efficiency were the main contributory factors for increased profits. The net interest income of the sector increased at a slower rate of 12.0 per cent to Rs. 92.1 billion compared to 32.0 per cent increase in the previous year, mainly due to increased funding cost, while this affected the net interest margin of the sector negatively as it declined to 7.9 per cent from 8.7 per cent in 2015. The non-interest income recorded an increase in comparison to 2015 mainly on account of default and service charges, while

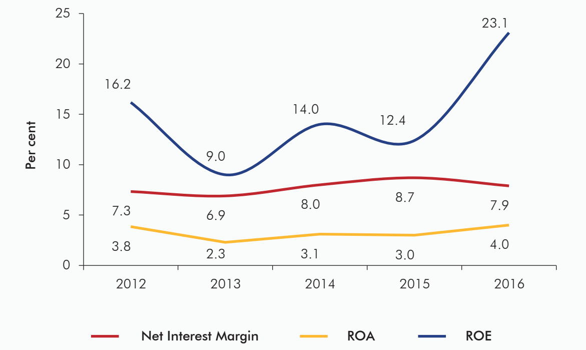
Table 8.10
Composition of Income and Expenses of the LFCs/SLCs Sector

Item	2015 (a) Amount (Rs. bn)	2015 (a) %*	2016 (b) Amount (Rs. bn)	2016 (b) %*
Net Interest Income	**82.2**	**8.7**	**92.1**	**7.9**
Interest Income	150.4	15.9	188.9	16.1
Interest Expenses	68.2	7.2	96.8	8.3
Non-Interest Income	**22.8**	**2.4**	**28.3**	**2.4**
Non-Interest Expenses	67.0	7.1	65.6	5.6
Loan Loss Provisions (Net)	9.5	1.0	7.6	0.6
Profit before Tax	**28.5**	**3.0**	**47.2**	**4.0**
Profit after Tax	**15.2**	**1.6**	**31.5**	**2.7**

(a) Revised
(b) Provisional
* as a percentage of average assets

Source: Central Bank of Sri Lanka

Chart 8.11
Profitability Indicators of the LFCs/SLCs Sector



Source: Central Bank of Sri Lanka

the non-interest expenses decreased marginally leading to an improved efficiency ratio. The loan loss provisions made against NPLs was lower by Rs. 1.9 billion during 2016 when compared to Rs. 9.5 billion reported for 2015. The profitability indicators of the sector, ROA and ROE, increased to 4.0 per cent and 23.1 per cent, respectively, in 2016 compared to 3.0 per cent and 12.4 per cent, respectively, in 2015.

(b) Capital: The total regulatory capital of the sector improved by 25.1 per cent to Rs. 116.2 billion mainly due to retained profits. The regulatory capital was composed of Tier I and Tier II capital of which, the Tier I capital contributed to 97.2 per cent of the total regulatory capital. The core capital and total risk weighted capital ratios of the sector increased to 11.4 and 11.7 per cent, respectively, as at end 2016 from 10.5 and 11.2 per cent, respectively, as at end of 2015. However, there were few companies operating below the minimum required capital levels due to weak financial position, requiring the Central Bank to adopt certain measures to rectify such issues.

Action on Distressed Licensed Finance Companies

The existing distressed finance companies in the sector with negative capital and inadequate liquidity position still continued in the process of revival at various stages. During

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Table 8.11
Composition of Regulatory Capital of the LFCs/SLCs Sector

Item	Amount (Rs. bn)		Composition (%)	
	2015 (a)	2016 (b)	2015 (a)	2016 (b)
Tier I: Core Capital	88.0	113.0	100.0	100.0
Issued and Paid-up Ordinary Shares/ Common Stock (Cash)	62.4	63.4	70.9	56.1
Non-cumulative, Non-redeemable Preference Shares	0.1	0.1	0.1	0.1
Share Premium	0.2	0.6	0.2	0.5
Statutory Reserve Fund	12.3	15.6	14.0	13.8
General and Other Free Reserves	22.5	24.0	25.6	21.2
Other	-9.4	9.4	-10.7	8.3
Tier II: Supplementary Capital	14.7	14.1	100.0	100.0
Eligible Revaluation Reserves	2.1	2.3	14.4	16.0
General Provisions	0.1	0.4	0.8	2.5
Eligible Approved Unsecured Subordinated Term Debt	12.5	11.7	85.0	82.8
Other	0.0	-0.2	-0.3	-1.4
Regulatory Adjustments	-9.8	-10.9		
Total Regulatory Capital Base	92.9	116.2		

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

the year, the Central Bank attached highest priority to resolve these companies under the statutory powers it encompasses. A resolution plan for 3 financially distressed companies was principally approved by the Monetary Board subject to legal and other clearances required for proper implementation. As announced in the Government Budget 2016, action has been taken to set up a Financial Asset Management Agency and draft Bill has been approved by the Cabinet of Ministers. The Boards of three companies were reconstituted with the view to restructuring and stabilising the company. In addition, regular meetings were held with stakeholders of these companies while efforts were made to find prospective investors to infuse capital for the purpose of restructuring.

Supervisory and Regulatory Developments

Throughout 2016, the Central Bank closely monitored the developments in the LFCs/ SLCs sector especially the gradual movement of business concentration towards other loan products as a result of policy measures taken to curtail vehicle importation since 2015. Further, in view of strengthening the regulatory framework of LFCs/SLCs, a detailed review was conducted on the existing regulatory framework. This was conducted to keep the pace with international and local developments in the financial industry, emerging international best practices guided by the Basel Committee on Banking Supervision and other standard setting bodies. Accordingly, the Central Bank is in the process of introducing new regulations along with the consultation with stakeholders of the sector.

In addition, LFCs and SLCs were given guidance to focus more on their branch expansion strategies in view of balancing the financial inclusion objective and internal strengths through business efficiency. Hence, a new framework on branch openings, closure and relocation was introduced by streamlining the existing policies and practices. Further, a policy was implemented to encourage LFCs/SLCs to open only branches instead of other outlets in view of streamlining the branch expansion process. The methodology used in setting the maximum upper limit of interest rates on deposits and debt instruments was revised to neutralise the impact of sudden changes in the interest rates.

Microfinance Institutions Sector

A regulatory framework for microfinance companies was introduced by the Central Bank during the year in terms of the powers vested under the Microfinance Act, No. 6 of 2016 (Microfinance Act), which came into effect on 15th July 2016. The regulatory framework is intended for licensing, regulation and supervision of microfinance companies and Microfinance Non-Governmental Organisations (MNGOs). Accordingly, the Central Bank issued rules focusing on licencing criteria and licence fee, while prudential directions covering minimum core capital,

BOX 11
Regulatory Framework under the Microfinance Act, No. 6 of 2016

Overview

Financial inclusion, simply defined as the proportion of individuals and firms that use (not just have access to) financial services, is an essential element of financial sector development in any part of the world. Without access to formal financial services, the unserved and underserved segments of society will be excluded from economic growth and its benefits and would be lured by the informal financial sector. The low income customers and microenterprises are generally neglected by formal financial institutions due to their low income and inability to provide collateral and thereby, lack of access to basic financial services. Nevertheless, microfinance functions as a tool of financial inclusion by providing various financial services including; loans, savings, insurance, remittances and other services, such as training and consultation, targeting these low income customers and microenterprises. By providing access to financial services, microfinance is expected to expand and improve income generation activities and capacity of low income persons and microenterprises and thereby ensure benefits for the society as a whole, through effective allocation of economic resources.

In Sri Lanka, unregulated microfinance activities have led to various issues including illegal deposit mobilisation, exploitation of customers through excessive interest rates and unethical recovery methods. Furthermore, poor corporate governance, and weak systems and controls in these institutions could result in weak credit disbursement standards, low repayment rates, high transaction costs and recurring losses, leading the institutions to distress. The exploitation of customers by unregulated institutions would adversely affect the recipients of microfinance and keep the low income segments within the 'cycle of poverty'. At the same time, such practices would affect the consumer confidence in the financial sector, including the formal regulated sector. Low confidence in the financial sector would adversely affect financial system stability. Therefore, there was a necessity to regulate and supervise entities engaged in microfinance business in Sri Lanka.

Streamlining the operations of microfinance institutions, through regulation and supervision, is essential for transmitting the real benefits accruing from operations of Micro Finance Institution (MFI) to the society, effectively. A regulatory mechanism for microfinance is expected to ensure the financial soundness of microfinance institutions, making their operations efficient, viable and sustainable. With the implementation of a sound regulatory framework, effectiveness and efficiency in the delivery of financial services to low income persons, and microenterprises, would improve and thereby, increase financial inclusion. Being regulated under a regulatory and supervisory authority would facilitate microfinance institutions to access wider sources of funding (including becoming partners with the State, the Central Bank, donors and other credit institutions). Further, a regulatory mechanism would lead to the promotion of consumer protection standards and the safety of deposits, which would finally lead to a safe, efficient and stable financial system.

The Microfinance Act, No.6 of 2016

The Microfinance Act, No. 6 of 2016 (the Act) came into effect on 15 July 2016, with the Central Bank of Sri Lanka entrusted with the responsibility of licensing, regulation and supervision of microfinance companies in Sri Lanka. The Act further provides for the registration of Non-Governmental Organisations[1] that accept limited savings deposits by the Registrar of Voluntary Social Service Organisations, as Microfinance Non-Governmental Organisations (Microfinance NGOs). The Act also provides for the establishment of principles, standards and guidelines for the regulation and supervision of Microfinance NGOs by the Monetary Board of the Central Bank of Sri Lanka (Monetary Board).

Salient Features of the Act:

(i) Definition of Microfinance Business

The Act defines Microfinance Business as, accepting deposits, and providing financial accommodation in any form and/or providing other financial services, mainly to low income persons and microenterprises.

(ii) Persons Authorised to Carry on Microfinance Business

The Act provides that no person other than a Licensed Microfinance Company (LMFC), a Microfinance NGO or an exempted institution[2] under Section 2 of the Act, shall carry on microfinance business. Such persons shall be liable on conviction, after a summary trial before a Magistrate, to a fine not exceeding one million rupees and/or to imprisonment for a term not exceeding one year.

However, any person carrying on microfinance business on the day preceding the date on which the Act came into operation i.e., 14.07.2016, may continue to carry on such business for a period of 18 months from such date and apply for a licence or registration under the Act, within that period.

1. Non-governmental organizations registered under the Voluntary Social Service Organizations (Registration and Supervision) Act, No. 31 of 1980.
2. Institutions exempted from the application of the Microfinance Act are licensed commercial banks and licensed specialized banks within the meaning of the Banking Act, No. 30 of 1988, licensed finance companies within the meaning of the Finance Business Act, No. 42 of 2011, co-operative societies registered under the Co-operative Societies Law, No. 5 of 1972 and a co-operative society registered under a Statute of a Provincial Council, divineguma community based banks and divineguma community based banking societies established under the Divineguma Act, No. 1 of 2013, and entities formed in terms of the Agrarian Development Act, No. 40 of 2000

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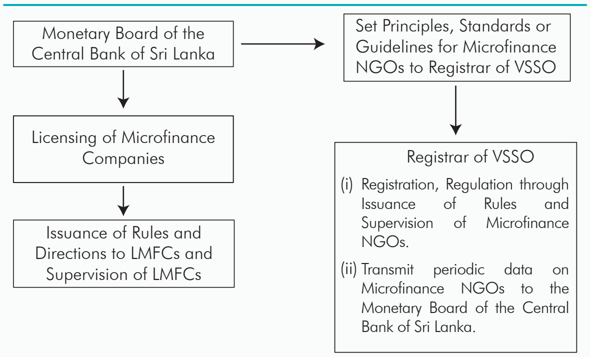
(iii) Regulatory and Supervisory Structure

The Act provides for the licensing of microfinance companies, and the regulation and supervision of LMFCs through the Monetary Board of the Central Bank of Sri Lanka (Monetary Board). The Microfinance NGOs are registered, regulated and supervised by the Registrar of Voluntary Social Service Organizations (Registrar of VSSO). However, the Monetary Board is required to set principles, standards or issue guidelines for their supervision, to which the Registrar of VSSO shall give effect through Rules issued to Microfinance NGOs. The structure established for the regulation and supervision of microfinance institutions is described in the diagram, below.

Chart B 11.1

Regulatory and Supervisory Structure of Microfinance Institutions



Source: Central Bank of Sri Lanka

(iv) Licensing Requirements

As a Licensed Microfinance Company

As per the Act, the basic requirement for a licence as a licensed microfinance company is being registered under the Companies Act, No. 7 of 2007, not being a company limited by guarantee, a private company, an offshore company or an overseas company.

As a Microfinance NGO

A non-governmental organisation registered under the Voluntary Social Service Organizations (Registration and Supervision) Act, No. 31 of 1980 is eligible to apply for a certificate of registration as a Microfinance NGO.

(v) Awareness through the Act

No person other than a LMFC, Microfinance NGO or an institution exempted under Section 2 of the Act shall use in its name, the word 'microfinance' or any of its derivatives, transliteration or its equivalent in any other language, without the prior written approval of the Monetary Board.[3] Every LMFC shall exhibit its licence at its principal place of business and a copy of such licence at every branch[4] and every Microfinance NGO shall exhibit its certificate of registration at its principal place of business and a copy of such certificate at each branch.[5]

(vi) Issue of Rules, Directions, Principles, Standards and Guidelines

For Licensed Microfinance Companies

The Monetary Board has issued 2 Rules and 8 Directions. The Microfinance Act Rules, No. 1 of 2016, on Licensing Criteria, in addition to the licensing requirements set out in the Act, provides that an applicant company shall have an initial core capital of Rs. 100 million or such higher amount as may be determined from time to time by the Monetary Board,[6] and shall be able to provide audited financial statements and a report on its microfinance related activities for the last 3 years (New microfinance institutions should engage in microfinance related activities for at least 3 years before applying for a licence). As per Microfinance Act Directions No. 03 of 2016 on Deposits, the maximum aggregate amount a LMFC may hold from a single depositor, individually or jointly, is Rs. 300,000. The maximum lending limits have also been stipulated in the Microfinance Act Directions No. 07 of 2016, on Regulatory Framework for Accommodation, based on the capital level of LMFCs and the customer type.

For Registered Microfinance NGOs

The Monetary Board has set Principles, Standards and Guidelines to be issued to the Registrar of VSSO, under Section 28(1) of the Act. Accordingly, the minimum net worth requirement for a NGO depends on its outreach. A net worth of Rs. 2 million for the District level[7] Microfinance NGO and Rs. 5 million for the National level[8] Microfinance NGO has been stipulated. In addition, an applicant NGO shall have a track record of microfinance related activities for a minimum period as stipulated by the Registrar of VSSO. Under the Act, Microfinance NGOs are only permitted to accept "limited savings deposits".[9]

3. Section 34 of the Act
4. Section 7of the Act
5. Section 21 of the Act
6. As per Microfinance Act Directions No.1 of 2016 on Minimum Core Capital
   i. For companies applying for licence on or before 15.01.2018, every licensed microfinance company shall maintain a core capital of Rupees one hundred million (Rs. 100,000,000/-) and maintain a core capital at a level not less than Rupees One Hundred and Fifty million (Rs. 150,000,000) from 15.01.2019
   ii. For companies applying for the licence after 15.01.2018, every licensed microfinance company shall maintain a core capital at a level not less than Rupees One hundred and Fifty million (Rs. 150,000,000).
7. Microfinance NGOs operating within only one district are considered as operating at the District level
8. Microfinance NGOs operating within more than one district are considered as operating at the National level
9. Limited Savings Deposits are interpreted in the Principles, Standards and Guidelines, stated above, as savings deposits obtained as a security deposit/cash collateral from borrowers against loans granted by registered microfinance NGOs.

statutory reserve, deposits, minimum liquid asset ratio, assessment of shareholders, assessment of fitness and propriety of directors and chief executive officers, and the reporting requirements with respect to licensed microfinance companies. The Central Bank also set principles, standards and guidelines to be issued to the Registrar of Voluntary Social Service Organisations (Registrar of VSSO) for the regulation of MNGOs. Licensing of new microfinance companies and registration of new MNGOs are expected to be commenced during the year 2017.

Primary Dealers in Government Securities

The Primary Dealer (PD) sector recorded gradual moderation of its activities during the year. Total assets and total investment portfolio of 7 LCB primary dealers and 8 standalone PDs recorded a decline, whereas the total capital and profitability of the sector recorded a growth. Significant impairment of the assets of a particular PD, rapidly increasing interest rates, and the withdrawal of primary dealership by another company with effect from 01.04.2016 are the main reasons for the decline in total assets and total investment portfolio of the sector. Due to liquidity issues faced by Entrust Securities PLC during 2015, the management of the company vested with the National Savings Bank in January 2016 through a direction issued by the Monetary Board of the Central Bank.

Assets and Liabilities

The total assets of PD sector decreased by 6.4 per cent to Rs. 264.5 billion in 2016 compared to Rs. 282.6 billion in 2015. Total investment portfolio of government securities accounted for 84.8 per cent of the total assets of the industry. The total investment portfolio of government securities, consisting of trading, available for sale and held to maturity amounted to Rs. 224.2 billion at end 2016, recording a decrease of 4.2 per cent over 2015. This change was due to decreases in the trading portfolio and the available for sale portfolio of government securities. The trading portfolio decreased to Rs. 98.1 billion by end 2016 from Rs. 132.8 billion at end 2015 and available for sale portfolio decreased by 63.9 per cent to Rs. 19.3 billion during 2016 compared to Rs. 53.4 billion at end 2015. Held to maturity portfolio increased significantly by 123.7 per cent to Rs. 106.8 billion by end 2016 from Rs. 47.8 billion reported at end 2015.

Risks in PD Sector

(a) Market Risk: Market risk exposure declined in 2016. The proportion of trading portfolio to total investment portfolio decreased from 56.8 per cent at end 2015 to 43.8 per cent at end 2016, reducing the possible high market risk exposure of the sector.

Table 8.12
Performance of Primary Dealers

Rs. billion

Item	2015 (a)	2016 (a)	Annual Growth Rate (%) 2015 (a)	Annual Growth Rate (%) 2016 (a)
Total Assets	**282.6**	**264.5**	**44.7**	**-6.4**
Total Investment Portfolio	234.0	224.2	54.1	-4.2
Trading Securities	132.8	98.1	11.6	-26.1
Held to Maturity	47.8	106.8	59.4	123.7
Available for Sale	53.4	19.3	1,776.3	-63.9
Reverse Repo	44.1	24.4	8.3	-44.7
Equity and Liabilities	**282.6**	**264.5**	**44.7**	**-6.4**
Total Capital	32.9	34.6	15.8	5.3
Repo	179.3	137.0	44.8	-23.6
Head Office Payables (b)	50.6	85.3	43.8	68.7
Profit before Tax	**8.8**	**15.1**	**2.0**	**70.4**
Profit after Tax	8.4	14.6	7.8	72.6
Return on Assets (ROA) (%)	3.7	5.5	-0.7	1.8
Return on Equity (ROE) (%) (c)	42.7	72.6	3.3	29.9
Risk Weighted Capital Adequacy Ratio (%) (c)	**25.5**	**21.7**	**3.7**	**-3.8**
Leverage Times (c)	4.8	6.6	-2.5	1.8
Dealings	17,308.9	22,529.5	23.2	30.2
Primary Market Dealings	1,895.3	1,508.2	-4.4	-20.4
Secondary Market Dealings	15,413.6	21,021.3	27.8	36.4
Outright Purchases	1,410.5	1,184.9	-16.7	-16.0
Outright Sales	2,189.9	1,688.0	2.0	-22.9
Repo	11,813.2	18,148.4	43.7	53.6

(a) Provisional
(b) Bank PDUs Only
(c) Standalone PDs only
Note: Financial information of Entrust Securities PLC are included in data up to June 2016 only.

Source: Central Bank of Sri Lanka

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(b) Liquidity Risk: Liquidity risk exposure also decreased in 2016. The overall liquidity risk exposure of PD sector decreased due to the decline in over-night negative mismatch in the maturity profile of assets and liabilities of the sector by end 2016. The overnight negative mismatch decreased significantly to Rs. 2,671.8 million or 15.7 per cent of the total overnight liabilities at end 2016 from Rs. 7,101.5 million or 37.2 per cent at end 2015. In view of holding a large volume of risk free government securities by PDs and also the ability to use such government securities as collateral for obtaining funds to bridge any unforeseen liquidity gaps, the liquidity risk profile of PDs remained low throughout the year except for a particular PD who was facing liquidity issues since the fourth quarter of 2015. Most of the PDs operated with stand-by contingency funding arrangements to bridge any liquidity gaps.

Profitability and Capital

The PDs reported a 72.6 per cent growth in profit after tax amounting to Rs. 14.6 billion during 2016 against that of Rs. 8.4 billion during 2015. This significant growth in PDs profit is mainly due to an exorbitant profit recorded by one PD. The capital gains generated from the sale of government securities largely contributed to the increase of profits. Consequently, ROA for the sector as a whole and ROE for standalone PDs increased to 5.5 per cent and 72.6 per cent, respectively, by end 2016 from 3.7 per cent and 42.7 per cent in 2015.

Equity of the PDs increased by 5.3 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 December 2016, all standalone PDs, except Entrust Securities PLC, maintained their core capital above the minimum requirement of Rs. 1,000 million. Although the Risk Weighted Capital Adequacy Ratio (RWCAR) of the standalone PDs was above the minimum requirement of 10.0 per cent, the ratio decreased to 21.7 per cent as at the end 2016 from 25.5 per cent as at the end 2015.

Market Participation

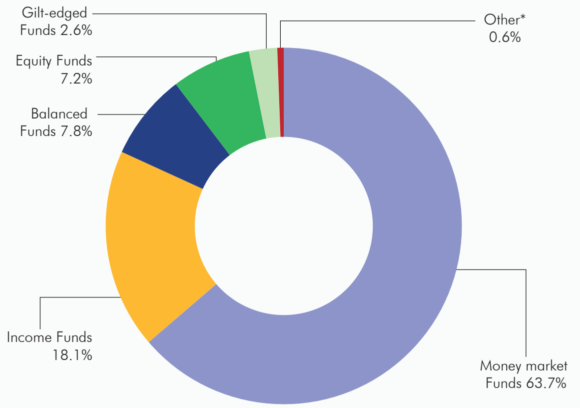
Primary Market Activities: The participation in primary market auctions in respect of Treasury bills and Treasury bonds by PDs has shown mixed performance. Out of the total bids accepted from the total Treasury bill auctions (52) conducted in 2016, the participation of Bank PDs, Standalone PDs and EPF accounted for 66.9 per cent, 28.2 per cent and 4.9 per cent, respectively. However, participation of Treasury bond auctions in 2016 was dominated by standalone PDs with a 50.7 per cent share of the total bids accepted through 23 auctions conducted in 2016.

Secondary Market Activities: Secondary market transactions in government securities increased significantly by 36.4 per cent to Rs. 21,021.3 billion during 2016 compared to 2015, of which, repo transactions accounted for 86.3 per cent of the total volume of secondary market transactions in 2016. During 2016, outright purchases and outright sales declined by 16.0 per cent and 22.9 per cent, respectively, compared to the values in 2015.

Unit Trusts

Number of unit trusts (UTs) increased by 3 with the launch of 4 new trusts and the closure of one during the year. However, new entrants in 2016 were lower than the launch of 11 new trusts in 2015. Total number of UTs managed by 14 unit trust management companies increased to 77 funds by end 2016 from 74 funds by end of 2015. Out of these funds, 74 operated as open-ended funds, 2 operated as closed-ended funds and 1 as a

Chart 8.12
Categorisation of the UT Sector in terms of the Net Asset Value



*Other : Shariah Funds 0.4%, Index Funds 0.2%, IPO Funds and Dollar Bond Fund

Source: Unit Trust Association of Sri Lanka

dollar bond fund. The open–ended funds included 18 money market funds, 15 gilt-edged funds, 14 income funds, 8 equity growth funds, 8 balanced funds, 5 shariah funds, 4 index funds and 2 initial public offer (IPO) funds.

Business growth

The total assets of the UTs sector decreased by Rs. 27.2 billion to Rs. 103.1 billion at end 2016, compared to Rs. 130.3 billion at end 2015. The number of units issued decreased to 7,150 at end 2016 from 8,766 at end 2015, while the total number of unit holders increased to 41,249 at end 2016 from 38,008 reported at end 2015. The net asset value per unit also marginally declined to Rs. 14.42 by end 2016, compared to Rs. 14.76 by end 2015.

Table 8.13
Performance of UT Sector

Details	2015	2016
No. of Unit Trusts	74	77
Total No. of Unit Holders	38,008	41,249
No. of Units in Issue (mn)	8,766	7,150
Total Assets (Rs. mn)	130,301.9	103,079.3
Net Asset Value - NAV (Rs. mn)	129,398.5	103,109.7
Investments in Equities (Rs. mn)	14,407.1	13,923.4
Share of Total Net Assets (%)	11.1	13.5
Investments in Government Securities (Rs. mn)	29,404.7	49,632.4
Share of Total Assets (%)	22.6	48.1

Source: Unit Trust Association of Sri Lanka

Investment

The share of investment in both government securities and equities by UTs increased significantly in 2016. The investment in government securities increased to Rs. 49,632 million by 68.8 per cent from Rs. 29,405 million at the end of 2015. Further, the share of equities in the investment portfolios of UTs increased to 13.5 per cent by end of 2016 compared to 11.1 per cent at end 2015.

Insurance Sector

The insurance sector recorded improved performance in terms of asset growth and earnings during the year. As at end 2016, there were 29 insurance companies operating in Sri Lanka registered with the IBSL. While 14 companies operated as exclusive general insurance companies and 12 companies operated as exclusive long-term insurance business companies, the remaining 3 companies engaged in both long-term insurance and general insurance business. There were 59 companies engaged in insurance brokering business mainly focusing

Table 8.14
Performance of the Insurance Sector

Rs. billion

Item	2015 (a)	2016 (b)
Total Assets	453.6	503.1
Government Securities	167.5	190.7
Equities	53.4	49.0
Cash & Deposits	58.9	46.1
Total Income	152.1	181.0
Premium Income	120.9	140.3
Investment Income	31.2	40.7
Profit Before Tax	12.9	21.6
Capital Adequacy Ratio (%) (c) - Life Insurance	NA	317.0
- General Insurance	NA	192.0
Retention Ratio (%) - Life Insurance	96.3	96.6
- General Insurance	80.0	80.1
Claims Ratio (%) - Life Insurance	40.7	37.5
- General Insurance	65.7	65.9
Combined Operating Ratio (%) - Life Insurance	86.5	84.2
- General Insurance	105.9	105.2
Return on Assets (ROA) (%) - Life Insurance	2.7	2.9
- General Insurance	3.5	7.3
Return on Equity (ROE) (%) - Life Insurance	32.4	25.0
- General Insurance	5.7	14.5
Underwriting Ratio (%) - General Insurance	16.4	17.8

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

Source: Insurance Board of Sri Lanka

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on general insurance sector. Eight insurance companies were listed on Colombo Stock Exchange (CSE) as at end 2016, while 5 companies operated with foreign affiliations. Insurance penetration in Sri Lanka, calculated based on total premium as a percentage of GDP, slightly increased to 1.2 per cent in 2016 from 1.1 per cent in 2015 mainly due to increase in total premium, but remained considerably low compared to peer countries. In 2016, insurance penetration of long-term insurance and general insurance were at 0.5 per cent and 0.6 per cent, respectively. However, insurance density has marginally increased to Rs. 6,617 per person in 2016 from Rs. 5,768 per person in 2015.

Business Growth

Total assets of the insurance sector expanded by 10.9 per cent to Rs. 503.1 billion in 2016 from 453.6 billion in 2015. Both long-term insurance and general insurance business category contributed to this expansion. Total assets of long-term insurance business sub-sector increased to Rs. 334.4 billion at end 2016, accounting for 66.5 per cent of the total assets of the insurance sector compared to 67.3 per cent at the end of 2015. Accordingly, the relative share of the general insurance business sub sector slightly increased up to 33.5 per cent of the total assets of the insurance sector, which amounted to Rs. 168.8 billion at the end of 2016.

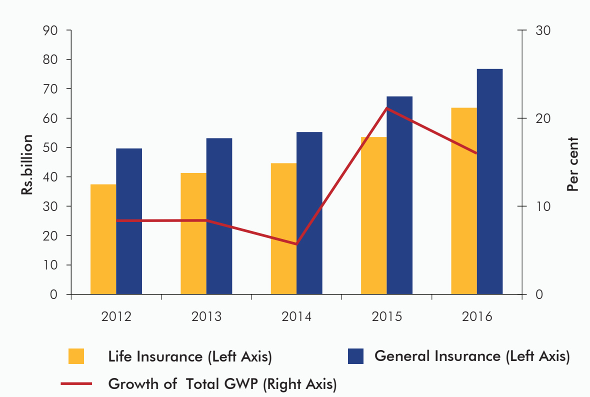
The growth of Gross Written Premium (GWP) of the insurance industry decelerated to 16.0 per cent in 2016 compared to the growth of 21.1 per cent recorded in 2015. The general insurance sub sector accounted for 54.7 per cent of GWP of the industry. This sub sector registered a growth of 14.0 per cent compared to 21.9 per cent in 2015. Motor insurance activities continued to maintain its growth momentum during the period under consideration. The GWP for motor insurance, increased by 15.1 per cent in 2016, which contributed for 77.7 per cent of the total GWP of the general insurance sub sector. GWP for long-term insurance amounted Rs. 63.5 billion, which grew by 18.6 per cent compared to 20.1 per cent in the previous period. The deceleration in growth of the GWP is partly due to significantly high premium income recorded during the previous year.

Earnings

Total profits earned by the insurance sector marked a 67.5 per cent growth in 2016. This impressive growth was mainly attributable to the performance in general insurance sector. The higher growth rate recorded during years was supported by higher market interest rate prevailed in 2016. The underwriting profits increased to Rs. 10.1 billion in 2016 compared to Rs. 8.1 billion in 2015 and recorded a 24.9 per cent growth during the year. Profit of long-term insurance business grew at 24.8 per cent, while profits in the general insurance sector grew by 125.9 per cent.

Claims of general insurance sector, increased by 15.9 per cent to Rs. 37.7 billion, while the claims for long term insurance increased by 9.0 per cent to Rs. 22.7 billion in 2016. Total claims in the overall sector amounted to

Chart 8.13
Gross Written Premium of the Insurance Sector



Source: Insurance Board of Sri Lanka

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Rs. 60.3 billion and recorded a 13.2 per cent growth compared to 7.5 per cent in 2015. Total investment income of insurance companies increased by 30.4 per cent to Rs. 40.7 billion in 2016 as against the decline of 9.0 per cent in 2015, mainly due to higher interest rates in the market compared to the previous year. The increase in investment income and GWP contributed to improving total income of the sector in 2016 which amounted to Rs. 181.0 billion compared to previous year's figure of Rs. 152.1 billion. The ROE of the general insurance sector increased to 14.5 per cent in 2016 from 5.7 per cent in 2015, while ROA for general insurance increased to 7.3 per cent from 3.5 per cent. ROA of long-term insurance slightly improved to 2.9 per cent in 2016 compared to 2.7 per cent in 2015. In addition, for the long term insurance sector, the ROE ratio decreased to 25.0 per cent form 32.4 per cent in 2015.

Capital and Investment

All general and long-term insurance companies except one general insurance company achieved the statutory solvency margin requirements as at end 2016. However, the ratio of capital to total assets decreased to 52.0 per cent at end of 2016 from 55.0 per cent at end of 2015 in the general insurance sector, while the ratio declined to 12.0 per cent from 15.0 per cent in long-term sub sector. When the breakup of investments portfolio of insurance sector is considered, 48.0 per cent of long-term insurance assets and 17.9 per cent of general insurance assets were invested in government securities as at end 2016. The relative share of equity in the total investment of long-term insurance declined to 7.9 per cent in 2016 from 10.8 per cent in 2015. Meanwhile, the share of equity in total investment of general insurance sector, improved to 23.6 per cent from 22.3 per cent recorded in the previous year. Investments in corporate debt securities accounted for 11.2 per cent of the total investments of general insurance at end 2016, compared to a share of 8.8 per cent in 2015. Meanwhile, investments in corporate debt securities by the long-term insurance sector increased to 23.0 per cent at end 2016 from 18.5 per cent in 2015.

Supervisory and Regulatory Developments

In 2016, the IBSL adopted several regulatory measures and issued guidelines with the aim of promoting professionalism and enhancing the reputation of the industry, while safeguarding the interests of the policyholders. Accordingly, IBSL issued a Direction to all insurers and insurance brokers to obtain the written approval from IBSL on changes in ownership or control over 50 per cent of issued shares or financial instruments with voting rights when converted would amount to 50 per cent or more of issued share capital. Further, long-term insurance companies were directed to grant policyholders a cooling-off period (free-look period) of 21 days to examine the terms and conditions of the policy documents. This will provide the policyholder an opportunity to terminate the policy during this period and the insurer is liable to refund the initial deposits or premium paid by the prospective policyholder. IBSL also issued a Circular requiring all insurance companies to inform IBSL about new insurance products along with the launch date of such products. Accordingly, all general insurance companies are required to submit relevant documents prior to the launch whilst long-term insurance companies need to submit actuarial certificate, policy document and proposal form at least 45 days prior to the launch. In addition, IBSL issued several guidelines with the view of enhancing the quality and image of the industry. Accordingly, a set of Guidelines on Complaints Handling by insurers and brokers was issued in October 2016 with the objective of ensuring that processes are in place for timely and fair handling of complaints by insurers and brokers. Further, IBSL amended the Guidelines on Linked Long-Term Insurance Business.

Superannuation Funds

In 2016, total assets of the superannuation funds sector recorded a growth of 12.4 per cent to Rs. 2,537.2 billion compared to Rs. 2,257.5 billion in 2015. This sector comprised of the Employees' Provident Fund (EPF), the Employees' Trust Fund and the Public Service Provident Fund managed by government institutions and 152 privately managed Approved Pension and Provident Funds. Assets of this sector contributed for 16.5 per cent of the total financial sector assets by end 2016 in comparison to 16.3 per cent reported in 2015.

Employees' Provident Fund

As per the Employees' Provident Fund Act. No. 15 of 1958 (EPF Act), the Monetary Board of the Central Bank of Sri Lanka is entrusted with the custodianship of EPF, while the Commissioner of Labour is entrusted with the general administration of the Fund. The EPF Department of the Central Bank 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: Total value of the Fund increased by 10.6 per cent or Rs. 176.6 billion to Rs. 1,841.5 billion at end 2016 compared to Rs. 1,664.9 billion recorded by end 2015. 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 investment of the Fund. Total liability to the members including member interest stood at Rs. 1,810.6 billion as at end 2016 recording an 11.4 per cent increase from Rs. 1,625.5 billion as at end 2015. The total contribution for the year 2016 increased by 15.4 per cent to Rs. 118.3 billion. The total amount of refunds made to the members and their legal heirs in 2016 was Rs. 108.4 billion, which was an increase of 39.3 per cent over 2015 mainly due to increased payments made under the 30 per cent withdrawal facility for members. Accordingly, the net contribution was only Rs. 9.9 billion compared to Rs. 24.7 billion recorded in the previous year. The net income of the Fund increased by 12.1 per cent to Rs. 175.9 billion in 2016 compared to Rs. 156.9 billion recorded in the previous year.

Investment Portfolio: The total investment portfolio (book value) of the Fund grew by 10.5 per cent to Rs. 1,772.2 billion in 2016 from Rs. 1,604.2 billion in 2015. 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 sufficient level of liquidity to meet refund payments and other expenses of the Fund. Accordingly, as at end 2016 the investment portfolio consisted of 93.1 per cent investments in government securities, 4.6 per cent in equity and 2.1 per cent in corporate debentures. The remaining 0.2 per cent was invested in highly liquid assets such as reverse repos backed by government securities to maintain day to day liquidity requirements and overnight repos or standing deposit facilities with the Domestic Operations Department of the Central Bank.

Investment Income: The total investment income of the Fund amounted to Rs. 192.9 billion in 2016, recording an increase of 12.5 per cent compared to the previous year. Interest income continued to be the major source of income of the Fund accounting for 85.8 per cent of the income and grew by 15.7 per cent to Rs. 165.5 billion in 2016 from Rs. 143.1 billion in 2015. Due to adverse market conditions, capital gains from government securities decreased to Rs. 0.6 billion in 2016 from Rs. 1.2 billion in 2015, whereas

Table 8.15
Performance of EPF and ETF

Item	EPF		ETF	
	2015 (a)	2016 (b)	2015 (a)	2016 (b)
Total Assets (Rs. bn)	1,664.9	1,841.5	223.5	249.4
Total Member Balance (Rs. bn)	1,625.5	1,810.6	200.5	225.3
Number of Member Accounts (mn)	16.9	17.1	12.4	12.5
Number of Active Member Accounts (mn)	2.6	2.4	2.4	2.5
Number of Contributing Employers	72,578	73,973	76,674	77,842
Total Contributions (Rs. bn)	102.5	118.3	18.1	20.3
Total Refunds (Rs. bn)	77.8	108.4	11.5	13.5
Total Investments Portfolio (Rs. bn)	1,604.2	1,772.2	210.7	235.7
o/w : Government Securities (%)	92.7	93.1	91.1	84.8
Gross Income (Rs. bn)	171.9	193.1	19.9	22.1
Profit Available for Distribution (Rs. bn)	157.2	176.1	19.1	20.2
Return on Investments (%)	11.3	11.4	9.3	9.1
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

capital gains from equity investments decreased to Rs. 0.5 billion from Rs. 0.6 billion. However, dividend income increased by 21.4 per cent to Rs. 4.3 billion in 2016.

Overall Return of the Fund: The Fund earned a total gross income of Rs. 193.1 billion in 2016, recording an increase of 12.3 per cent compared to the previous year. EPF was able to pay an interest rate of 10.5 per cent on member balances, while maintaining operating expenses to income ratio around 0.69 per cent in 2015 and 0.77 per cent in 2016.

Employees' Trust Fund

Employees Trust Fund (ETF) is the second largest superannuation fund which accounts for 9.8 per cent of the total assets of the superannuation funds sector. ETF is the employer contributory retirement scheme administrated by the Employees' Trust Fund Board of the Ministry of National Policies and Economic Affairs. During the year, the Fund continued to expand at a somewhat similar growth to that recorded in 2015 with respect to assets, income and investment. ETF held about 12.5 million accounts with 2.5 million accounts remaining active. The total outstanding member balances of ETF increased by 12.4 per cent to Rs. 225.3 billion by end 2016 from Rs. 200.5 billion at end 2015. During the year, total contributions of the Fund increased to Rs. 20.3 billion from Rs. 18.1 billion in the previous year enabling a net positive contribution to the Fund, after paying Rs. 13.5 billion as member benefits in 2016. Total investment portfolio of ETF rose by 11.9 per cent to Rs. 235.7 billion at end 2016 and government securities account for 84.8 per cent of these investment. Investments in equity and corporate fixed income securities accounted for 5.2 per cent and 0.9 per cent, respectively, of the total investments. The effective rate of return on member balances of ETF showed a marginal decline to 9.1 per cent in 2016 in comparison to 9.3 per cent in 2015.

Other Superannuation Funds

Other superannuation funds consist of Public Service Provident Fund (PSPF) and Approved Pension and Provident Funds (APPFs). The active member accounts of the PSPF decreased to 232,135 accounts at end 2016 from 232,793 in 2015. Total contributions to the PSPF, decreased by 40.8 per cent to Rs. 1,463.3 million in 2016 from Rs. 2,469.9 million in 2015 due to the absorption of employees who worked in government institutions on contract basis to their permanent carder. Total refunds made by the Fund to its members in 2016 decreased by 24.5 per cent to Rs. 554.0 million. Accordingly, the net contributions to the Fund also decreased by 47.6 per cent to Rs. 909.3 million in 2016 compared to Rs. 1,735.8 million in 2015. However, total assets of PSPF increased by 3.4 per cent to Rs. 47.7 billion at end 2016 from Rs. 46.1 billion at end 2015. Government securities accounted for 99.8 per cent of total investments of the Fund at end 2016. Apart from PSPF, there were 152 privately managed Approved Provident and Pension Funds monitored by the Department of Labouras at end 2016. The total membership of these privately managed funds was 160,130 persons at the end of 2016. Total assets and total investments of these funds amounted to Rs. 398.6 billion and Rs. 244.0 billion, respectively, as at end 2016.

8.4 Performance of Financial Markets

Money Market

Excess rupee liquidity in the domestic money market, which remained high in the latter part of December 2015, declined gradually and turned to a deficit towards the end of the first quarter of 2016. Excess liquidity remained high in the early part of 2016, mainly due to Central Bank purchasing Treasury bills in the primary market and providing provisional advances to the government. Excess liquidity was absorbed during this period on a temporary basis by way of short-term and long-term repo auctions as well as on a permanent basis by way of outright sales of Treasury bills. In addition, the Central Bank increased the Statutory Reserve Ratio (SRR) applicable to all rupee deposit liabilities of commercial banks by 1.50 percentage points to 7.50 per cent with effect from 16 January 2016, which resulted in a permanent absorption of liquidity amounting to Rs. 52 billion from the domestic money market. Further, foreign exchange related transactions of the Central Bank, including foreign loan repayments on behalf of the government, also contributed to the gradual decline in excess liquidity in the domestic money market. The average excess liquidity in the domestic money market which stood at Rs. 71.1 billion in January, declined to around Rs. 8.6 billion in March 2016. Thereafter, except for a few days in November and the latter part of December 2016, market liquidity, in general, continued to remain in deficit levels, reflecting the combined impact of the maturing of Treasury bills held by the Central Bank as well as foreign currency related transactions of the Central Bank. The deficit in liquidity in the domestic money market, on a daily basis, during the period from April to November 2016 averaged to Rs. 23.4 billion. From mid-December 2016, market liquidity was in surplus, mainly due to occasional purchases of Treasury bills and foreign exchange related transactions of the Central Bank and foreign loan disbursements and by end December 2016, excess market liquidity amounted to Rs. 39.2 billion.

Table 8.16
Money Market Transactions

Market	Volume (Rs. bn)		Weighted Average Interest Rate (Min-Max) - %	
	2015	2016	2015	2016
Call Money	2,828.0	3,493.0	5.80-7.00	6.43-8.44
Inter-Bank Repo	1,962.0	6,572.0	5.00-6.91	6.29-9.15
Central Bank Repo	750.0	252.0	5.86-6.42	6.29-7.50
Central Bank Reverse Repo	44.0	3,938.0	6.15-6.30	6.59-8.50
Standing Deposit Facility	17,990.0	5,573.0	-	-
Standing Lending Facility	23.0	3,208.0	-	-

Source: Central Bank of Sri Lanka

The average weighted call money rate (AWCMR) displayed an increasing trend during the first quarter of 2016 due to the increase in policy interest rates of the Central Bank, by 50 basis points in February 2016 as well as the gradual decline in market liquidity. The AWCMR increased to 7.51 per cent by 24 February 2016 from 6.40 per cent at end 2015 and thereafter, it increased rapidly towards the upper bound of the standing rate corridor, breaching the upper bound of the standing rate corridor by end March as a result of the distortion created by the tax applicable to interest income from secondary market transactions in government securities. It was hovering around 8.20 per cent immediately prior to the Central Bank increasing the policy rates, i.e. standing deposit facility rate (SDFR) and standing lending facility rate (SLFR) to 7.00 per cent and 8.50 per cent, respectively, to be effective from 28 July 2016. Compared to the significantly large adjustment in the AWCMR following the policy rate revision in February 2016, the adjustment in the AWCMR consequent to the policy rate revision in

July 2016 was much lower. While remaining within the standing rate corridor from end July 2016, the AWCMR was at 8.42 per cent at end 2016.

A few banks resorted to borrowing persistently in the call market during the year. In terms of the volume distribution of call transactions, around 66 per cent of the total borrowing was accounted for by three banks which borrowed most, whilst around 52 per cent of the total lending was done by three banks which lent the most. In terms of the frequency of resorting to the call market (total number of trading days in the call money market by all banks), four banks which resorted to borrowing in the call market the most number of days were active on 47 per cent of the total number of days of such borrowing. Further, three banks which lent on the most number of days in the call market were active on 30 per cent of the total number of days on which banks had lent. Some primary dealers (PDs) borrowed continuously from the Central Bank at the reverse repo auctions at rates at or close to the SLFR whereas the average weighted repo rate (AWRR) in the repo market remained lower than the SLFR. This was mainly due to the counterparty lending limits imposed by the lenders in view of the risk associated with such secondary market transactions. Meanwhile, some LCBs and PDs continued to run short positions for a relatively long period, possibly due to their investments, or granting of credit without a corresponding increase in deposits in the case of banks.

Domestic Foreign Exchange Market

Amidst high demand in the domestic foreign exchange market, Sri Lankan rupee continued to depreciate against the US dollar during 2016. Sri Lankan rupee depreciated by 3.83 per cent against US dollar from Rs. 144.06 as at end December 2015 to Rs. 149.80 as at end December 2016. Depreciation of USD/LKR exchange rate in 2016 was relatively low compared to the depreciation of 9.03 per cent recorded during 2015. The capital outflows including the repatriation of foreign investments held in government securities parallel to the expectations of an interest rate hike by the Federal Reserve as well as the higher demand for foreign exchange emanated from import bills exerted pressure on the exchange rate to depreciate during the year. In line with the overall depreciation of the Sri Lankan rupee against the US dollar, the average US dollar buying and selling rates of commercial banks for telegraphic transfers as of end 2016 were recorded at Rs. 147.84 and Rs. 151.66, whilst comparative figures as of end 2015 were Rs. 141.94 and Rs. 146.18, respectively. During the year, Sri Lankan rupee depreciated against other major currencies such as, euro, Japanese yen and Indian rupee by 0.32 per cent, 7.05 per cent and 1.72 per cent, respectively. On the contrary, Sri Lankan rupee appreciated against Pound sterling by 16.04 per cent during 2016, attributed mainly to the depreciation of Pound sterling against major currencies consequent to the decision by British electorate to leave the European Union in June 2016.

During 2016, trading volumes in the domestic foreign exchange market increased by 8.66 per cent compared to the previous year. Transaction volumes of foreign exchange in the domestic inter-bank market increased to US dollars 14,769.50 million in 2016 from US dollars 13,592.48 million in 2015. Accordingly, the daily average volume in the inter-bank foreign exchange market recorded a similar increase, amounting to US dollars 61.03 million in 2016 in comparison to US dollars 56.64 million in 2015.

In order to curb the excess volatility in the exchange rate, Central Bank intervened by selling foreign exchange in the domestic market in 2016. During the year, Central Bank purchased US dollars 1,132.22 million, while injected US dollars 1,900.38 million. Accordingly, the Central Bank supplied US dollars 768.16 million on net basis to the domestic foreign exchange market in 2016.

Government Securities Market

The Treasury bill yield rates which showed an increasing trend in January 2016 continued in February 2016 responding to the increase in policy rates by 50 basis points in February 2016. However, the increasing trend moderated by end April 2016 and remained broadly stable thereafter till end July 2016. In July 2016, the Central Bank further tightened its monetary policy stance by increasing the policy rates by 50 basis points. Accordingly, Treasury bill rates showed an upward adjustment and remained at elevated levels till end August 2016. However, from September 2016, Treasury bill yield rates decreased marginally and remained broadly stable thereafter till end 2016. The debt management strategy adopted to lowering cost of borrowing was supported by borrowings from international capital markets. Accordingly, International Sovereign Bonds were issued in July 2016 amounting to US dollars 1,500 million and this helped to ease the pressure on interest rates in the domestic market. Despite these efforts, foreign holdings of Treasury bills and Treasury bonds declined during the latter part of 2016, mainly due to increase in US policy rates, which resulted in capital outflows from emerging markets. Adjustments in the sovereign ratings during the year also resulted in a less appealing investment landscape. As a result of foreign outflows and due to the increased SRR by the Central Bank, the benchmark yield rate on 364 day Treasury bills recorded an increase of 287 basis points by end 2016 from that of end 2015. Treasury bill rates for 91 day, 182 day and 364 day maturities as at end December 2016 stood at 8.72 per cent, 9.63 per cent and 10.17 per cent, respectively. The upward movement in short-term interest rates have pushed, Treasury bond yields to an upward trajectory towards end 2016.

Table 8.17
Primary Market Treasury Bond Issuances

Year	Amount Issued (Rs. bn)		
	Auction	Placements	Total
2014	28	833	861
2015	712	158	870
2016	654	9	663

Source: Central Bank of Sri Lanka

Table 8.18
Primary Market Weighted Average Yield Rates of Treasury Bills

Per cent per annum

Year	Maturity			Overall Average
	91-days	182-days	364-days	
2012	10.72	12.29	12.14	11.81
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

Source: Central Bank of Sri Lanka

The foreign investor preference for Treasury bills and bonds has declined somewhat considerably during 2016. Treasury bill and bond holdings by foreign investors amounted to Rs. 260.03 billion as at end December 2016. With the announcement of Budget 2016, the government revised the exposure on government securities for non-residents from 12.5 per cent to 10.0 per cent of the total outstanding stock of Treasury bills and bonds, with the objective of mitigating the undue strain on reserves with the sudden withdrawal of funds by non-residents.

With the policy decision to bring down the domestic foreign currency denominated debt in the medium-term plan, only US dollars 1,365.88 million worth of Sri Lanka Development Bonds (SLDBs) were raised

Table 8.19
Yield Rates of Government Securities

Per cent per annum

Item	Primary Market		Secondary Market	
	2015	2016	2015	2016
Treasury Bills				
91-Days	5.74 - 7.10	6.45 - 9.04	5.72 - 7.00	6.43 - 9.04
182-Days	5.86 - 7.31	6.83 - 9.94	5.85 - 7.12	6.72 - 9.91
364-Days	6.00 - 7.37	7.30 - 10.75	6.03 - 7.30	7.18 - 10.72
Treasury Bonds				
2-Years	6.70 - 8.14	10.00 - 11.83	5.95 - 7.75	7.52 - 11.63
3-Years	7.18 - 8.70	11.51 - 11.75	6.93 - 9.02	8.76 - 11.97
4-Years	8.15 - 9.50	10.61 - 12.78	7.13 - 9.42	9.31 - 12.38
5-Years	8.11 - 9.79	11.42 - 13.00	7.24 - 9.63	9.49 - 12.56
6-Years	8.87 - 9.90	11.98 - 12.03	7.45 - 9.85	9.69 - 12.67
10-Years	7.88 - 10.94	11.05 - 13.93	7.93 - 10.43	10.01 - 13.07
15-Years	9.67 - 10.96	11.46 - 14.23	7.65 - 10.71	10.35 - 13.24
30-Years	11.73	-	9.27 - 11.60	11.05 - 13.58

Source: Central Bank of Sri Lanka

against the maturing amount of US dollars 2,186.19 million during 2016. Funds raised through International Sovereign Bonds (ISBs) and syndicated loans were utilised to payback the maturing SLDBs. Further, the proceeds of these foreign loans eased the quantity of rupee denominated securities required to finance the government borrowing programme enabling to stabilise the interest rates in the domestic market.

During 2016, the average time to maturity of the overall domestic public debt portfolio decreased to 5.98 years compared to 6.28 years recorded at the end of the previous year. The average time to maturity of outstanding Treasury bond portfolio at end December 2016 decreased to 7.07 years from 7.35 years at end December 2015.

Corporate Debt Securities Market

The market for commercial papers (CPs) was less active in 2016 compared to 2015. Total value of CPs issued in 2016, decreased to Rs. 7.0 billion from Rs. 7.9 billion in 2015. The interest rates applied to CPs varied in a range of 8.7 per cent - 14.8 per cent in 2016 in comparison to a range of 7.0 per cent - 12.0 per cent in 2015. CPs with a maturity up to 3 months accounted for 42.9 per cent of total new issuances, while the share of CPs with a maturity between greater than 3 months and 6 months was 30.0 per cent. The remainder was the CPs with a maturity greater than 6 months but less than 12 months. Total outstanding value of CPs amounted to Rs. 2.2 billion by end of 2016 compared to Rs. 4.5 billion in 2015.

The market for debentures recorded a slight decline in 2016. CSE recorded 17 debenture issuances by 14 companies during 2016 and raised about Rs. 78.0 billion compared to Rs. 83.4 billion through 25 debenture issuances in 2015. The highest listed corporate debt issuance in 2016 amounting to Rs. 8.0 billion was recorded by People's Leasing & Finance PLC. In addition, Hatton National Bank PLC, Commercial Bank of Ceylon PLC and DFCC Bank PLC issued debentures worth Rs. 7.0 billion each.

Colombo Stock Market

Colombo Stock Exchange (CSE) recorded a dismal performance in 2016 for the second consecutive year. All Share Price Index (ASPI) declined by 9.7 per cent to 6,228.3 points and S&P SL20 Index declined by 3.6 per cent to 3,496.4 points at end 2016 compared to 6,894.5 and 3,625.7, respectively, at end 2015. The upward trend in interest rates in both domestic and international markets and the depreciation of the Sri Lankan rupee were amongst the factors that affected negatively to the performance of CSE. As a result, price indices pertaining to main sub sectors, namely banks, finance and insurance, diversified holdings, hotels and travels and telecommunication declined substantially by 7.7 per cent, 16.4 per cent, 7.4 per cent and 12.5 per cent, respectively, during the year.

Market capitalisation of the CSE declined in 2016. The market capitalisation as a percentage of GDP declined to 23.2 per cent at end 2016 from 26.8 per cent in 2015. In terms of market capitalisation, banks, finance and insurance (23.8 per cent), beverage, food and tobacco (19.4 per cent) and diversified holdings (18.7 per cent) were the first three largest sectors of CSE while the ten largest companies listed on CSE accounted for 41.7 per cent of total market capitalisation compared to 40.8 per cent in 2015.

The daily average turnover of the CSE declined by 30.4 per cent to Rs. 737.2 million in 2016 from Rs. 1,059.6 million in 2015, reflecting a sluggish performance during the year. Foreign investors accounted for 42.2 per cent of the total turnover.

Table 8.20
Selected Indicators of CSE

Item	2015	2016
All Share Price Index (1985=100) (a)	6,894.5	6,228.3
Year-on-Year Change (%)	-5.5	-9.7
S&P SL20 Index (2004=1000) (a)	3,625.7	3,496.4
Year-on-Year Change (%)	-11.3	-3.6
Market Capitalisation (Rs. bn) (a)	2,938.0	2,745.4
As a Percentage of GDP (%)	26.8	23.2
Market Price Earnings Ratio (a)	18.0	12.4
Turnover to Market Capitalisation (%)	8.4	6.2
Average Daily Turnover (Rs. mn)	1,059.6	737.2
Value of Shares Traded (Rs. bn)	253.3	176.9
Number of Shares Traded (mn)	9,414.7	7,195.8
Number of Companies Listed	294	295
Introductions (b)	2	1
Number of Initial Public Offers/ Offers for Sale (b)	27	20
Number of Rights Issues	15	6
Amount Raised Through Rights Issues and Initial Public Offers (Rs. bn)	100.0	82.4

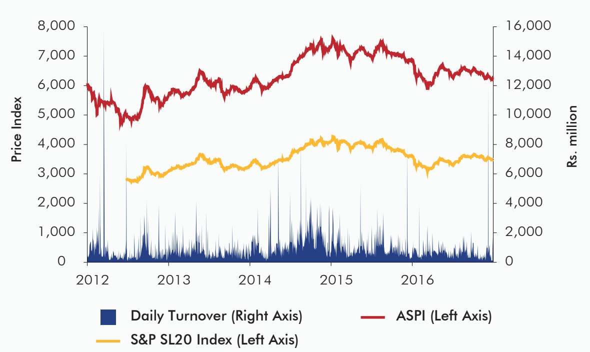
(a) End of the year
(b) There are 3 methods to obtain a listing: i.e. an introduction where no public issue is required, an offer for sale where already existing shares are issued to the public and an offer for subscription where new shares are issued to the public.

Source: Colombo Stock Exchange

Meanwhile, cumulative foreign purchases amounted to Rs. 74.6 billion, while cumulative foreign sales were Rs. 74.2 billion, resulteding in a marginal net inflow to the market in 2016.

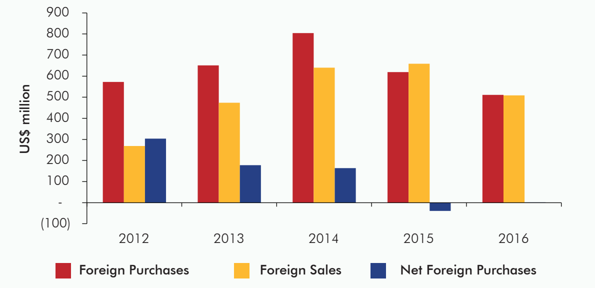
The primary market remained active during the year. In 2016, Rs. 82.4 billion was raised through 20 Initial Public Offerings (IPOs), both equity and debt, 6 right issues and 1 new introduction.

Chart 8.14
ASPI, S&P SL20 Index & Daily Turnover at the CSE



Source: Colombo Stock Exchange

Chart 8.15
Foreign Participation at the CSE



Source: Colombo Stock Exchange

During 2016, the Securities and Exchange Commission of Sri Lanka (SEC) and CSE have taken a number of regulatory measures to develop the equity market. Revising Minimum Public Float requirements with a view to providing more options for listed companies to comply with the rules pertaining to Minimum Public Float, and implementation of Risk Based Capital Adequacy requirement to the licensed stock brokers, are amongst the key measures implemented during the year.

8.5 Development Finance and Access to Finance

The Central Bank continued to execute many concessionary development lending programmes through Participating Financial Institutions (PFIs). These programmes were expected to enhance access to finance and financial inclusion and to achieve inclusive and equitable regional development in the country. Under these schemes, refinance facilities, credit guarantees and/or interest subsidies and credit supplementary services were provided targeting the development of the Agriculture, Livestock and Micro, Small and Medium Scale Enterprise (MSME) sectors. From a policy perspective, a number of new policy measures were taken to ensure effective functioning of the credit delivery mechanism in 2016. Loans totalling Rs. 20,809.1 million were disbursed among 136,503 beneficiaries through 13 credit schemes by the Central Bank during the year. Of the total lending, 46.4 per cent was directed towards the Agriculture and Livestock Sector, while MSME and Microfinance sectors received 40.6 per cent and 13.0 per cent of total disbursements, respectively.

The Agriculture and Livestock Sector continued to dominate in receiving a greater proportion of concessionary credit facilities provided by the Central Bank. These loans were channeled through a host of loan schemes, i.e. the New Comprehensive Rural Credit Scheme (NCRCS), Commercial Scale Dairy Development Loan Scheme (CSDDLS) and Tea Development Programme Revolving Fund (TDP-RF). Under these schemes, total loans amounting to Rs. 9,660.5 million were disbursed among 89,730 farmers in the relevant sectors. Of the total disbursements, 82.9 per cent were delivered through the NCRCS, which is the principal scheme that provides both interest subsidy and credit guarantee for loans granted by PFIs to meet working capital requirements of the small scale farmers for 33 short-term crop varieties. This scheme alone contributed to 63.8 per cent of loans granted to the Agriculture Sector.

The disbursements of loans under NCRCS increased significantly in 2016 mainly due to the favorable weather condition prevailed in Maha Season in major cultivation areas. Compared to 2015, loans granted through NCRCS in 2016 increased by 12.2 per cent. Following the usual pattern, the Anuradhapura District received the highest (17 per cent) amount of loans disbursed under the Scheme among all districts, followed by Pollonnaruwa (13 per cent), and Ampara (10 per cent) districts. Paddy being the major crop, received the highest share (63 per cent) of total loans disbursed under NCRCS. In order to facilitate the national policy for the development of sugar industry that targeted achieving 50 per cent self-sufficiency in 2020, the Central Bank in 2016 included “Sugar Cane” also as an eligible crop under the NCRCS enabling provision of concessionary credit to the suger cane growers.

Loans disbursements under CSDDLS increased significantly by 32.8 per cent in 2016 compared to the previous year. Under this scheme, loans amounting to Rs. 1,633.5 million were granted by PFIs among 2,667 dairy farmers and among dairy entrepreneurs for the dairy related activities covering farm development, processing, transportation, storing and marketing. Since the gestation period of the most of dairy related activities are relatively longer than 6 months, the Central Bank on the basis of the requests made by dairy farmers and the PFIs on behalf of their customers, increased the maximum grace period of the CSDDLS from 06 months to 12 months depending on the requirements of the respective projects. This measure allows sufficient time period for the dairy investors to generate positive cash flow to meet their payment obligations under the Loan Scheme. In addition, the maximum repayment period for the loans granted under the CSDDLS, was also increased from 5 years to 6 years, inclusive of a maximum grace period of 01 year with effect from 06 February 2017. In the performance perspective, total amount of loans granted under NCRCS and CSDDLS increased by 15.3 per cent in 2016.

With the intention of addressing emerging and changing needs of intermediary financial service providers, the Central Bank initiated actions to introduce the Partial Credit Guarantee Scheme (PCG) under the proposed Agriculture Sector Modernisation Project (AMP) funded by the World Bank. The PCG was introduced as an innovative risk sharing tool under the AMP, which operates with the objectives of supporting agriculture productivity and efficiency,

BOX 12
Promoting Sustainable Finance for Sustainable Development

Economic activities exert externalities on the natural environment. Increased attention to negative environmental effects has created a widespread discussion on achieving sustainable economic development, which broadly refers to development that meets the needs of the present without compromising the ability of future generations to meet their own needs. Accordingly, sustainable development indicates the need to preserve the ability of natural systems to provide natural resources and ecosystem services for future economic activity, in the process of economic development.

Financial institutions, particularly banks, play a significant role in promoting growth and development through supporting the activities of economic agents, which also have implications on the environment. Nevertheless, for a considerable period, financial institutions did not focus on issues related to the environment, which are affected by economic activities funded by the financial institutions. This situation has changed over time as financial institutions have shown an increased interest in incorporating environmental concerns and issues into their business decisions and thereby have increased their participation in promoting sustainable development. In particular, there is growing awareness in the financial sector that the natural environment brings risks as well as opportunities for financial institutions, and hence green or sustainable financing policies have been developed in the recent decades (Jeucken, 2001).

With the implementation of the United Nations' Sustainable Development Goals (SDGs)[1] and the Paris Agreement on Climate Change, governments and businesses around the world are taking important initiatives to develop sustainable financial systems to facilitate sustainable development. The G20 also highlighted sustainable finance as a global priority and formed the Green Finance Study Group with the aim of enhancing mobilisation of sustainable finance through financial markets.

Sustainable Finance and Its Significance

As defined in the G20 Green Finance Synthesis Report of Green Finance Study Group, sustainable finance can be described as the financing of investments that provide benefits in the broader context of environmentally sustainable development. These environmental benefits include, reductions in air, water and land pollution, reductions in greenhouse gas emissions, improved energy efficiency as well as mitigation of, and adaptation to climate change and their co-benefits. As such, sustainable finance refers to financial services and products integrating environmental, social and governance criteria into business or investment decisions to obtain lasting benefits for the society. In a broader context, sustainable finance reflects a blend of two factors: (i) Risk management: screening and managing environmental and social risks as a part of financial institutions' decision making process to avoid or mitigate financial losses, reputational risk or harm to the environment and people, and (ii) Loan origination: supporting lending to businesses that are environmentally friendly and socially responsible in line with the global commitment to increase funding for climate change solutions.

It is observed that by effectively managing environmental and social risks and identifying opportunities alongside these risks, financial institutions, especially banks, can create long-term value for their businesses by adopting sustainable finance practices. In order to realise the commercial dimension of sustainable development, financial institutions, especially banks, will need to introduce new financial services and products, which can be more valuable and less risky for the bank and yield socially responsible investment in economic activity. Hence, banks can initiate and develop sustainable finance by introducing a wide range of financial products, asset classes and instruments, including green loans, green bonds and green investment funds for project financing.

International Experiences in Sustainable Finance

Banks in the United States were the first to consider environmental policies in order to comply with certain regulations that made banks directly responsible for environmental pollution and even imposed remediation costs for non-compliance (Jeucken, 2001). However, European banks were not exposed to such liabilities and they only began to develop policies in relation to environmental issues during the mid-1990s leading to the development of new products, such as environmentally friendly investment funds.

Since the launch of the United Nations Environment Programme (UNEP) Statement by Financial Institutions on the Environment and Sustainable Development, in Rio de Janeiro in 1992, there has been a clear direction towards environmentally friendly finance. According to Jeucken (2001), a survey among the signatories of the UNEP Statement concluded that many banks have setup environmental departments and are developing environmentally friendly financial products. Moreover, with the influence of multilateral development agencies such as the World Bank, there has been a shift towards environmental standards, as the financial community adopted measures such as the 'Dow Jones Sustainability Group Index (1999)' and the 'FTSE4Good Index (2001)' with a view to tracking the performance of sustainability driven corporates.

1. See Box Article No. 6 of the Central Bank of Sri Lanka Annual Report 2015 for a detailed discussion on SDGs.

Since the late 2000s, the concept of sustainable finance was increasingly adopted by many countries by launching country specific national policies or road maps to align their financial systems to facilitate sustainable development. For example, the United Kingdom created a Green Investment Bank (GIB) in 2012 aiming to mobilise investments in innovative, environmentally-friendly areas. South Korea also introduced a Framework on Low Carbon Green Growth and a five year plan to implement a green growth strategy covering green financing with the intention of promoting a carbon-trading system and infrastructure for green finance. While the Asia Pacific region remains the most active region for sustainable finance, sustainable banking initiatives became popular across multiple emerging markets. As such, a number of emerging economies have launched sustainable finance policies, guidelines, and road maps for banks to strengthen environmental and social-risk management and innovate green investment.

In emerging markets, the Sustainable Banking Network (SBN), supported by the International Finance Corporation (IFC), is providing guidance to advance sustainable finance through knowledge sharing, capacity building and providing support to develop national enabling frameworks. SBN is a community of financial sector regulatory agencies and banking associations from emerging markets committed to advancing sustainable finance in line with international best practices. It facilitates collective learning of members, and supports them in policy development and related initiatives to create drivers for sustainable finance in their home countries. The idea for SBN emerged during the first International Green Credit Forum hosted by the IFC and the China Banking Regulatory Commission, in Beijing, in May 2012, where banking regulators and associations from 10 countries requested that IFC facilitate a global knowledge network on sustainable banking. The Network was formally launched in September 2012. Among SBN members, the Bangladesh Bank introduced environmental risk management guidelines and policy guidelines for green banking, in 2011, to address policy and governance of green banking. China introduced 'Green Credit Guidelines' in 2012 for banks to consider environmental impact and energy efficiency as a part of lending decisions and to implement green banking. In 2015, China also introduced green credit key performance indicators to strengthen, monitor and evaluate green banking. Indonesia also launched a road map for sustainable finance in 2014 to contribute to the national commitment to address climate change including mitigation, adaptation, and the transition to a competitive low carbon economy. The Reserve Bank of India embarked on promoting sustainable development and non-financial reporting in 2007, followed by the India Bankers' Association launching the responsible financing principles in 2017, while the State Bank of Pakistan is also in the process of launching green banking guidelines in 2017. IFC provides strategic and technical advisory services to support the development of these country specific policies/guidelines and to harmonise them with international good practices.

8

Promoting Sustainable Finance in Sri Lanka and the Way Forward

With the implementation of the Sustainable Development Agenda, Sri Lanka has identified several development priorities including environmental sustainability and promoting green business. Towards the achievement of this goal, Sri Lanka has already launched initiatives such as the Blue-Green Development Strategy in line with the Blue-Green economy concept of the UNEP, which addresses environmental concerns, while fulfilling the relevant SDGs towards sustainable and resilient development.

For the process of achieving such priorities and development challenges, a responsible and inclusive financial system can play a vital role in Sri Lanka. In particular, since the Sri Lankan financial system is predominantly driven by banks, they need to take an initiative towards sustainable finance as a part of broader strategies for sustainable banking. Further, by providing green loans, banks can contribute to, and benefit from environmentally sound projects. As environmental risks associated with economic activities entail financial risks for the financial institutions, banks can formulate their policies or make efforts to shift the preferences of their customers towards activities that would ensure sustainability.

Though sustainable finance is being popularised across many financial and banking markets, the development of sustainable finance still faces many challenges such as, (a) Externalities: how to internalise environmental externalities appropriately and cost-effectively; (b) Maturity mismatch: due to inadequate supply of long-term funding relative to the demand for funding by long-term projects; (c) Lack of clarity in sustainable finance: identifying what constitutes sustainable finance activities and products can be an obstacle; (d) Asymmetric information: lack of disclosure of environmental information; and (e) Inadequate analytical capabilities: little understanding and lack of capacity of the financial implications of environmental risks by financial institutions (G20 Green Finance Synthesis Report). These challenges, which are valid for the Sri Lankan context can be overcome by improved knowledge sharing, capacity building, stronger and clearer policy directives, and clarity in defining of sustainable finance activities.

With the leadership of the Sri Lanka Banks' Association (Guarantee) Ltd (SLBA), a number of banks in Sri Lanka have already adopted a set of voluntary principles on sustainable banking. These principles cover the areas of environmental and social risk management, environmental and social footprint, rights of the respective stakeholders, financial inclusion, environmental and social governance, promotion of ethical finance, promotion of 'green economy' growth, capacity building, collaborative partnerships, promotion of transparency and accountability, and refraining from 'racing to the bottom'(not competing with other banks on environmental and social issues) to operationalise the sustainable finance concept in Sri Lanka. These principles are expected to enhance innovation, competitiveness and the quality of bank credit, while helping society to address sustainability challenges such as social inequity, climate change, resource scarcity and environmental damage.

The Central Bank of Sri Lanka is also making an effort to expand these initiatives with the support of stakeholders and is guiding financial institutions to effectively manage environmental and social risks in the projects that they finance and promote businesses that are greener and climate friendly. For this purpose, a roadmap is being formulated with the support of key stakeholders, which will provide guidance and support to Sri Lankan financial institutions in expanding engagement in sustainable finance, thereby contributing to the sustainable development of the Sri Lankan economy.

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improving market access and enhancing value addition. Further, the Matching Grant component of AMP that covers 50 per cent of the project cost is expected to further promote access to finance.

Lending to the MSME sector continued to gain priority in 2016. The Central Bank provided concessionary credit to the MSME sector focusing on sustainable economic growth, employment generation, poverty eradication, etc. through 5 credit schemes namely, the Saubagya Loan Scheme (SLS), Small Holder Plantation Entrepreneurship Development Programme (SPEnDP), Dry Zone Livelihood Support and Partnership Programme – Revolving Fund (DZLiSPP-RF), Self-Employment Promotion Initiative Loan Scheme – Phase II (SEPI-ph-II) and Working Capital Loan Scheme for Tea Factories (WCLSTF). These schemes together disbursed loans totaling to Rs. 8,447.2 million among 13,810 beneficiaries 2016. Of all these schemes, the SLS which is operated island-wide as the flagship loan scheme that provides loans to the MSME sector, alone disbursed Rs. 4,767.1 million or 56.4 per cent of the loans disbursed to the MSME sector. The WCLSTF, which was introduced in August 2015, disbursed Rs. 3,539.8 million of short-term working capital loans among 115 registered tea factory owners who were eligible under the Scheme. It accounted for a sizable portion of 41.9 per cent of loans granted to the SME sector in 2016. Further, SPEnDP, DZLiSPP and SEPI-ph-II disbursed a total of Rs. 140.2 million among 677 borrowers. Total disbursements made under these schemes in 2016, excluding that of WCLSTF, increased by 42.5 per cent compared to the amount disbursed in 2015.

The Central Bank has taken a number of new policy measures to strengthen the effective credit delivery to the development of the MSME sector. These measures include implementation of Phase II of the Self-Employment Promotion Initiative Loan Scheme (SEPI-ph-II), on behalf of the government. This Scheme will continue to provide refinancing for the loans granted by PFIs to initiate self-employment projects by the students who have completed vocational training courses conducted by the relevant vocational training institutes.

Targeting the MSME sector development and employment generation, the Central Bank jointly with the Ministry of National Policies and Economic Affaires introduced a new Loan Scheme named "SWASHAKTHI – towards one million jobs". This scheme is expected to provide financial support for both new entrants and existing entrepreneurs who engage in income generating activities in the Agriculture and Livestock, Industrial and Services sectors at village level.

Lending to the Microfinance sector was continued in 2016 with a view to broadening the financial outreach among the masses and promoting poverty alleviation in the country. In order to achieve this objective, the Central Bank operated five microfinance loan schemes, namely, Poverty Alleviation Micro-Finance Project II-Revolving Fund (PAMP II-RF), Poverty Alleviation Micro-Finance Project - Revolving Fund (PAMP-RF), Small Farmers and Landless Credit Project-Revolving Fund (SFLCP-RF), Microfinance Loan Scheme and "Tharuna Diriya" Loan Scheme under the National Agribusiness Development Programme (NADeP). Through these schemes, loans amounting to Rs. 2,701.4 million were disbursed among 32,963 beneficiaries during 2016. These schemes mainly targeted the micro level entrepreneurs who were engaged in income generating activities pertaining to industries, agriculture, livestock, fisheries trade and other services in the country. Overall, loans disbursed under the microfinance loan schemes implemented by the Central Bank, increased by 31.6 per cent in 2016 compared that in the previous year.

The Central Bank has taken a number of initiatives to enhance the access to finance of the microfinance sector. In January 2016, the Microfinance Component of National Agribusiness Development Programme (NADeP) was recommenced to disburse Rs. 90 million funded by the International Fund for Agricultural Development (IFAD) by targeting the micro level entrepreneurs who were engaged in income generating activities at micro level in the industries, agriculture, livestock, fisheries trade and other services. In response to the requests made by individuals to grant loans of less than Rs. 30,000, the lower band of the loan limit was reduced to Rs. 10,000 under this scheme in 2016. Thus, with this amendment now, beneficiaries are able to obtain loans ranging from Rs. 10,000 to Rs. 300,000. In addition, a new loan scheme named, "Tharuna Diriya" Youth Empowerment and Employment Project under the NADeP was introduced in 2016 to assist the rural youth to improve their livelihood by providing credit facilities and required training to establish small scale enterprises. Accordingly, the operating instructions pertaining to this loan scheme were issued to PFIs during the year. In addition, the 'Value Chain Development Capital Agriculture Loan Scheme' and 'Value Chain Development Seasonal Agriculture Loan Scheme' were also implemented under the 'Out-Grower Farmers Loan Scheme' of NADeP, targeting an increase in the production, productivity, quality and value addition of agriculture produce.

The Central Bank continued to promote financial literacy, financial inclusiveness and entrepreneurship development through a number of programmes and workshops, covering various areas of financial literacy, financial management, entrepreneurship development, Training of Trainers (TOT) and project appraisal workshops for entrepreneurs. Accordingly, the Central Bank conducted 172 awareness programmes in 2016 to educate beneficiaries and other stakeholders. In addition, the Central Bank under the PAMP II-RF Scheme also gave priority for the formation of homogeneous solidarity groups called Self Help Groups with a view to empowering grass root level entrepreneurs to cross pass poverty.

The Central Bank also conducted the first-ever island-wide field survey in Sri Lanka to collect demand side information on the financial inclusiveness. The information gathered under this survey will provide baseline information to measure the level of financial inclusion of the country paving the way to developing a National Strategy for Financial Inclusion for Sri Lanka.

8.6 Financial Infrastructure

Payment & Settlement Systems

In 2016, the Central Bank continued to regulate and supervise the national payment and settlement systems in order to ensure an efficient and secure national payment infrastructure to facilitate economic activities of the country. Accordingly, the Central Bank strengthened its oversight activities and initiated action to introduce regulatory measures to address risk associated with innovative payment means with the view of promoting new developments. In addition, during 2016, the Central Bank ensured that the large value and retail payment systems operated smoothly catering to individual and institutional payment needs.

During the year under review, the Real Time Gross Settlement (RTGS) System and the LankaSecure System, which are the two main components of the LankaSettle System operated smoothly to accommodate increasing transaction volumes. The RTGS System, which settles interbank high value and time critical Sri Lanka rupee transactions on a real time basis, settled 365,991 payment transactions amounting to Rs. 93,378 billion in 2016. The RTGS System accounted for 88 per cent of the total value of non-cash payments and continued to be the main interbank funds transfer system in the country. In order to address liquidity issues of the participating institutions, the Central Bank as the operator of the system, continued to provide the interest free Intra-day Liquidity Facility (ILF) against the collateral of government securities. During the year, participating institutions utilised ILF of Rs. 9.2 trillion recording an average value of Rs. 38.4 billion per business day. The total value of scripless securities held by LankaSecure amounted to Rs. 4,846.0 billion (face value) consisted of Treasury bills of Rs. 792.4 billion and Treasury bonds of Rs. 4,053.6 billion as at end December 2016.

During the year under review, the Cheque Clearing System operated by LankaClear (Pvt.) Ltd (LCPL) cleared a total volume of 51.9 million cheques amounting to Rs. 9,601 billion. In terms of total transaction volume, the share of payments made through cheques in non-cash payments accounted for 30.3 per cent in 2016, reflecting the continuing popularity of cheques in effecting retail payments. As a measure of enhancing the security of cheque images during the transmission, in October 2016, LCPL upgraded the cheque image submission mode used by licensed commercial banks when submitting cheque images to LCPL for

Table 8.21
Transactions through Payment Systems

Payment System	2015 (a)		2016 (b)	
	Volume ('000)	Value (Rs. bn)	Volume ('000)	Value (Rs. bn)
Large Value Payment Systems				
RTGS System	322	84,432	366	93,378
Retail Value Payment Systems				
Main Cheque Clearing System	49,326	8,434	51,996	9,601
Sri Lanka Interbank Payment System (SLIPS)	23,279	1,169	26,647	1,458
Credit Cards	26,335	154	31,858	182
Debit Cards	30,686	83	38,083	108
Internet Banking	13,725	1,205	18,164	1,589
Phone Banking	1,993	12	3,444	16
Postal Instruments	1,262	7	1,244	7
Total	**146,928**	**95,497**	**171,802**	**106,339**
US Dollar Cheque Clearing System	**62**	**34**	**59**	**39**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

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BOX 13
The Role of the Central Bank of Sri Lanka in the Regulation of Payment Systems

Payment Systems

The Payment and Settlement Systems Act, No. 28 of 2005 of Sri Lanka defines a Payment System as "institutions and mechanisms facilitating payment in money and the transfer of monetary value by means of payment transactions, including mechanisms for clearing and settlement of obligations to make payments." The transfer of monetary value was done traditionally by cash or by payment instruments, such as cheques and letters of credit. With the development of technology, countries have moved towards to electronic payment methods which are now commonly used throughout the world. This article highlights the role played by the Central Bank of Sri Lanka in monitoring and regulating payment systems and their new developments.

Importance of Sound Payment Systems

Price stability and financial system stability are considered to be prerequisites for the achievement of economic growth. The Central Bank of Sri Lanka (CBSL) has two core objectives, maintaining economic and price stability, and financial systems' stability. Maintaining financial system stability can be described as ensuring a stable financial system where financial intermediaries can engage in transactions based on a smooth and efficient market infrastructure to promote economic growth. To maintain financial system stability, sound payment systems with minimal risk should be in place to ensure the smooth functioning of the financial sector. As all the participants of the payment system are interrelated, if one participant is exposed to risk, it may spread to other participants, causing systemic risk. Systemic risk is the risk of an entire system collapsing due to the 'domino effect' (a chain reaction) caused by the failure of one or more members of the system. In a payment system, credit or liquidity problems experienced by one member of the system could trigger a chain reaction, which will then affect other members of the same system.

Regulatory Framework

- The Central Bank vested with the sole authority under the Monetary Law Act, No. 58 of 1949 and Payment & Settlement Systems Act, No. 28 of 2005 to supervise and regulate the payment, clearing and settlement systems of the country. Under the Payment & Settlement Systems Act, the Central Bank has the power to "formulate, adopt, and monitor the implementation of a payment system policy in Sri Lanka". The Central Bank is also the authority responsible for "the preparation of a plan for the national payment system and is charged with the responsibility of providing guidance and leadership for the establishment and development of payment, clearing and settlement system for Sri Lanka". Under the same Act, the Central Bank has been given the statutory authority to supervise, regulate and monitor all service providers who provides money services in Sri Lanka

- The Payment Cards and Mobile Payment Systems Regulations No. 01 of 2013, issued under the Payment and Settlement Systems Act, has provided the Central Bank with the authority to regulate and supervise service providers of payment cards and mobile payment systems. In terms of Regulations, the Central Bank has the authority to carry out on-site and off-site supervision, and to issue directives on business relating to payment cards and mobile payment systems. Accordingly, the Central Bank has issued credit card guidelines in 2010 to ensure secure and safe operations of credit cards as payment instruments. In order to protect the customers who use mobile phone based payment services and service providers offering such services, Central Bank has issued guidelines in 2011.

- According to Business Continuity Planning (BCP) guidelines issued by the Central Bank, the participants of major payment systems of the country are required to conduct BCP drills periodically to build resilience in relation to payment systems. The Central Bank has the authority to carry out on-site and off-site supervisions to monitor the readiness of participating institutions to continue business in the event of a disruption to operations at the primary location of the institution. It also reviews BCP activities of participants to minimise the legal, financial and systemic risks arising from such disruptions.

Role of the Central Bank of Sri Lanka

For regulatory purposes, the Central Bank designs policies and implements them at national level to facilitate the overall stability of the entire financial system by promoting safety, accuracy and efficiency of the payment system, and controlling the associated threats. The Central Bank facilitates safe payment methods and requires participants to be in accordance with international standards and certifications (electronic and non-electronic) to minimise fraud, in order to ensure the safety of the entire payment system. Furthermore, the introduction of standards to the system will enable the management of existing resources, productively. The Central Bank monitors payment and settlement activities of all the participants so that vulnerabilities do not affect the system as a whole. Therefore, this will result in the participants having greater confidence in the system.

The safety and efficiency of a payment system in a country is essential since all its financial activities depend on it. Therefore, the Central Bank encourages new innovations and embraces new technologies with required security features to ensure smooth operations in the payment and settlement systems.

There are a multitude of payment services available in the market, which may or may not be interoperable with each other. An absence of interoperability could lead to an unnecessary fragmentation of the payment system and redundancy of such systems. In addition, it is essential for the regulator to continuously monitor payment systems to ensure effective utilisation, to minimise security threats to the system, and to avoid inconveniences caused to the public. To achieve these goals, the Central Bank evaluates to identify any negative impact to the payment system and to the system stability.

Another important aspect is the regulation of fees and charges in the payment system. Such regulations are to ensure that the participants of payment systems do not overcharge their customers for services provided. Therefore, the Central Bank imposes the maximum fee chargeable for a particular service in the payment system and reevaluates this fee to promote the service and to give the benefit of new innovations in the field to customers.

Way Forward

According to the Acts specified in this article, the Central Bank is entrusted with regulation, supervision and monitoring of payment, clearing, and settlement services. It is also important to note that the current Payment and Settlement Systems Act encompasses the stability and security aspects to protect both existing and future payment systems, their participants and customers. Further, the Central Bank has set a regulatory framework in place and constantly monitors the performance of the participants to foresee whether any of them are headed towards potential instability. Such participants will be steered away from possible risks such as credit, liquidity, reputation, operations, legal, and settlement, in order to maintain the stability of the entire system and thus will safeguard the general public as well. Accordingly, the Central Bank will continue to maintain the integrity of the payment system to ensure the economic growth of the country through a stable financial system.

References

Monetary Law Act, No 58 of 1949, Sri Lanka
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BCP Guidelines No: 01/2006
Payment Systems in Sri Lanka, 2004, Bank for International Settlements.

clearing. Accordingly, LCPL introduced a system for online cheque submission replacing the system of submitting cheque images in CDs via a courier service.

Sri Lanka Interbank Payment System (SLIPS), which is operated by LCPL, provides facility to execute low-value fund transfers and remains a popular mode of effecting salary payments. In year 2016, the aggregate volume of SLIPS transactions grew by 14.5 per cent to 26.6 million whilst the aggregate value grew by 24.7 per cent to Rs. 1,458 billion, in comparison to the previous year.

The Central Bank continued its regulatory and supervisory activities with regard to payment cards and mobile payment systems in terms of the provisions of the Payment Cards and Mobile Payment Systems Regulations No. 1 of 2013. Accordingly, two financial institutions were licensed during the year to function as issuers of payment cards, while one financial institution was licensed to function as an operator of a customer account based mobile payment system, increasing the total number of licensed service providers of payment cards and mobile payment systems to 35. In 2016, three licensed service providers, with the approval of the Central Bank, introduced stored value card products to expand the scope of their operations. In addition, permission was also granted to extend the single purpose stored value transport card and fare collection system introduced in the Western Province to a pilot project implemented in the Central Province. The Central Bank continued to carry out off-site and on-site supervision in order to minimise the risks associated with payment cards and mobile payment systems and monitored the progress in compliance with the regulatory requirements by licensed service providers of payment cards and mobile payment systems.

During the year 2016, the Central Bank continued to provide assistance to LCPL to implement the Common Card and Payment Switch (CCAPS), which is a network of five interoperable switches, i.e. Common ATM Switch (CAS), Common Electronic Fund Transfer Switch (CEFTS), Shared ATM Switch, Common Point of Sale (POS) Switch and Common Mobile Switch, under the brand name of 'LankaPay'. Accordingly, the Central Bank monitored the progress of financial institutions joining CAS and CEFTS and facilitated the expansion of services offered through CEFTS. CCAPS which is a landmark development in the payment and settlement infrastructure provides a nationwide common platform for switching and clearing of electronic retail payment systems in the country.

The Common ATM Switch (CAS), which is the first phase of CCAPS, commenced live operations in July 2013. During 2016, 11 financial institutions integrated with CAS increasing the membership to 23. During the year, CAS processed 31.3 million transactions amounting to Rs. 174.1 billion. As at 31 December 2016, 3,820 ATMs were integrated with CAS providing card holders with facilities to withdraw cash and inquire account balances using ATMs of CAS member banks.

The Common Electronic Funds Transfer Switch (CEFTS), which is the second phase of CCAPS, was launched on 21 August 2015. At the beginning, CEFTS provided a common infrastructure for switching and clearing of credit transfers effected through multiple payment channels such as ATM, Internet Banking, Mobile Banking, Kiosks and over-the-counter. In 2016, direct debit facility was enabled expanding the services offered by CEFTS. During 2016, 13 financial institutions integrated with CEFTS increasing the members of CEFTS to 22. In 2016, about 894,674 transactions amounting to Rs. 69.4 billion were effected through CEFTS. LCPL implemented a payment solution for cash based low value transactions under the brand name of "JustPay" using CEFTS direct debit facility. In addition, the Central Bank gave approval to LCPL to develop an online payment platform to facilitate online payments to Sri Lanka Customs through CEFTS.

The Central Bank continued to strengthen the regulatory framework in order to mitigate risks associated with adoption of new technologies by financial institutions to provide payment facilities to their customers. Further, the Central Bank commenced preparing standards for financial institutions offering payment related mobile applications to protect customer information and secure financial transactions. During 2016, the National Payment Council finalised the 'Payment System Roadmap 2016-2020' incorporating the proposals submitted by members and related parties.

Credit Information

During 2016, Credit Information Bureau (CRIB) continued its work to increase the robustness of the financial sector by promoting financial inclusion of the country through providing credit information on request to shareholder lending institutions and simultaneously to borrowers. In addition to Credit Information Management System (CRIMS), CRIB maintains a Secured Transactions Registry System, a database, to register the security interest of movables with the objective of providing Information on prior security interests of movable

BOX 14
Sri Lanka's Compliance with International AML/CFT Standards

FATF Standards on AML/CFT

The Financial Action Task Force (FATF), an inter-governmental body established in 1989 by the G7 countries, has developed a series of recommendations since 1990 that are recognised as the international standards on Anti Money Laundering and Countering the Financing of Terrorism (AML/CFT) and proliferation of weapons of mass destruction. These standards were revised in 2012, in order to ensure that they remain up to date and relevant. Every country in the world is required to follow the standards, thereby assuring that the domestic financial system is less vulnerable to criminal activities and the country is able to integrate into the global financial system without difficulty.

Importance of Complying with International AML/CFT Standards

A weak AML/CFT regime has the potential to undermine the soundness and stability of financial institutions and systems, discourage foreign investments and distort international capital flows. Conversely, a robust national AML/CFT framework benefits a country in a number of different ways;

1. Financial institutions that follow international standards are often reluctant to enter into business/market relationships with customers or institutions based in countries that are perceived to pose serious Money Laundering (ML) and Terrorist Financing (TF) risks. Financial institutions could broaden their links with counterparts abroad based on a strong and effective AML/CFT framework within the country.
2. A country or financial institutions could partner with more developed financial centres to attract foreign investments and participate in global payments systems in an effective manner.
3. Effective AML/CFT controls drive countries to establish legal, regulatory and institutional framework, facilitating financial transparency and strengthening the rule of law. Besides, a strong and robust AML/CFT regime forms a part of the broader effort to fight against crime and corruption.
4. Implementation of effective AML measures, such as the conduct of customer due diligence, identification of beneficial owners of financial transactions and reporting of suspicious transactions, can effectively control tax evasion, which is considered to be a predicate offence of ML.

Measuring the Country Compliance with International AML/CFT Standards

The FATF conducts reviews of each member on an ongoing basis to evaluate the levels of compliance with its recommendations. Currently, such reviews are mostly carried out through FATF Styled Regional Monitoring Bodies (FSRBs). At present, there are 9 FSRBs that are engaged in the assessment of member countries coming under each FSRB's purview and these peer reviews are referred to as Mutual Evaluations (MEs).

With the revision introduced to FATF recommendations in 2012, the methodology used in the MEs was also revised and the FATF adopted the revised methodology in 2013, mainly focusing on the following two areas;

1. Technical Compliance (TC) - Assess the status of the relevance of the legal and institutional framework of the country and the powers and procedures of the competent authorities to comply with the FATF 40 Recommendations.
2. Effectiveness - Assess the extent to which the legal and institutional framework is capable of producing the expected results. The effectiveness assessment is based on 11 outcomes stated in the FATF methodology.

AML/CFT Compliance of Sri Lanka

Sri Lanka is a founding member of the Asia Pacific Group on Money Laundering (APG), the FSRB for the Asia and Pacific region, which was formed in 1997. In accordance with the APG membership rules, Sri Lanka is committed to an ME by the APG to determine its level of compliance every six years.

Sri Lanka had its first ME by the APG in 2006 soon after the establishment of the FIU–Sri Lanka. A series of recommendations were made in the first Mutual Evaluation Report (MER), in order to rectify the gaps identified therein, including the requirement to amend several legislations and promulgate regulations on the implementation of the United Nations Security Council Resolutions (UNSCRs). Sri Lanka was able to fully implement the recommendations in the first MER by 2013.

The second ME on Sri Lanka was conducted in 2014/15 by a panel of evaluators representing the FIUs of Australia, Bhutan, Hong Kong, Malaysia, Singapore and the APG Secretariat. The MER was adopted at the 18th Annual Plenary and Technical Assistance Forum of the APG held in Auckland, New Zealand in July 2015. Sri Lanka was rated compliant or largely compliant for

12 recommendations out of 40 recommendations on TC and substantially and moderately effective in two immediate outcomes out of 11 immediate outcomes.

Major Actions Taken to Ensure Compliance

In response to the deficiencies highlighted in the MER, the FIU-Sri Lanka, together with other relevant stakeholders, implemented several systematic and concrete steps to improve the country's compliance with the FATF standards. These included;

- Adoption of the AML/CFT National Policy for 2015-2020 with the approval of the Cabinet of Ministers
- Development of an institution-wise action plan to be implemented through each stakeholder as approved by the Cabinet of Ministers
- Issuance of Customer Due Diligence Rule No 1 of 2016 on 27.01.2016 covering all institutions engaged in finance business as defined in the FTRA.
- Introduction of risk-based AML/CFT supervision on financial institutions in 2016.
- Issuance of a separate AML/CFT guideline for MVTS providers.
- Enhancement of the investigative and prosecutorial capabilities of the Criminal Investigations Department and Attorney General's Department on ML, respectively.
- Signing of Memoranda of Understandings (MOUs) with relevant domestic institutions and foreign counterparts by the FIU to share/receive information/intelligence to facilitate investigations.

Subsequent to the adoption of the MER in 2015, Sri Lanka was required to report the progress of implementation to the APG bi-annually, under the `Expedite Enhanced Follow-up Process' Accordingly, the 1st progress report was submitted in January 2016. The report was discussed at the APG Annual Plenary held in San Diego, United States in September 2016 by all members and the Plenary decided that Sri Lanka has made considerable progress on TC in relation to 9 recommendations initially rated as non-compliant or partially compliant. Accordingly, Sri Lanka's AML/CFT compliance level has improved as follows:

Table B 14.1
Technical Compliance After the Re-rating

Level of Compliance	At the Adoption of the MER in July 2015	Re-rating in January 2016 due to the Progress Achieved
Compliant (C)	5	5
Largely Compliant (LC)	7	16
Partially Compliant (PC)	16	13
Non-Compliant (NC)	12	6

Sri Lanka is currently under the APG `Enhanced Follow-up Process', requiring the country to report AML/CFT progress to the APG annually.

However, Sri Lanka is yet to reach a satisfactory level of TC in relation to 19 recommendations, which have been rated partially compliant or non-compliant. Moreover, all stakeholders concerned are required to implement necessary actions highlighted in the MER and the action plan approved by the Cabinet of Ministers to improve AML/CFT effectiveness of the country in order to match the FATF standards.

property to enable financial institutions to make informed business decisions. 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.

During the year 2016, CRIB issued 7,948,967 credit reports on corporate and individual borrowers, reporting a 15.4 per cent growth on issuing credit information reports compared to 6,890,270 reports issued in 2015. This indicated expanding credit related activities in the economy. CRIB had a total of 87 reporting credit institutions as its members by end 2016.