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FINANCIAL SECTOR PERFORMANCE AND SYSTEM STABILITY

8.1 Overview

Amidst strong macroeconomic headwinds, the stability of the financial system was preserved during 2021. Financial intermediation by the banking sector was satisfactory, while adequate capital and liquidity buffers were maintained. In addition, the profitability of the sector improved considerably during 2021 compared to the previous year due to notable increases in both net interest income and non-interest income. However, banks faced a foreign currency liquidity shortage due to several sovereign rating downgrades and the lack of foreign inflows experienced by the country. The performance of the Licensed Finance Companies (LFCs) and Specialised Leasing Companies (SLCs) sector recorded a considerable improvement in terms of credit growth and profitability on an overall basis. In order to build strong and stable LFCs in the medium term and safeguard depositors of the sector, the implementation of the Financial Sector Consolidation Masterplan progressed during 2021. Furthermore, to ensure the flexibility in adapting to the new normal and to provide continuous support to the COVID-19 affected economy, the Central Bank relaxed some of the regulations pertaining to financial institutions under its purview during the period under review. The insurance sector also recorded an expansion in terms of assets and gross written premium while marking a marginal contraction in profits. Meanwhile, the performance of financial markets was mixed during 2021. Money market liquidity, which remained at a surplus level during the first seven months of 2021, turned to a deficit as a result of foreign debt repayments and reversal of the accommodative monetary policy stance. The domestic foreign exchange (FX) market liquidity was severely affected due to slow recovery of tourism and earnings from subdued remittances, slow conversion of export proceeds, increased import expenditure, and sovereign rating downgrades. Investor preference towards short term Treasury bills was experienced at the primary auctions of the government securities market during the latter part of 2021, and the secondary market yield curve shifted upward during the second half of 2021 with the removal of the maximum yield rate and the reversal of the accommodative monetary policy stance. With the shift of domestic investor preference to the equity market in a low interest rate environment, the Colombo Stock Exchange reported an exponential growth during 2021. Meanwhile, the country's systemically important payment and settlement system was operated smoothly by the Central Bank, with a high degree of resilience through close regulation and monitoring. Further, the Central Bank continued to introduce law reforms to major legislation with the

Table 8.1
Total Assets of the Financial System

Category	2020 (a) Rs. bn	2020 (a) Share (%)	2021 (b) Rs. bn	2021 (b) Share (%)
Banking Sector	**17,087.9**	**72.9**	**19,969.9**	**74.7**
Central Bank	2,421.6	10.3	3,046.3	11.4
Licensed Commercial Banks (LCBs)	12,828.8	54.7	14,820.5	55.4
Licensed Specialised Banks (LSBs)	1,837.5	7.8	2,103.0	7.9
Other Deposit Taking Financial Institutions	**1,536.5**	**6.6**	**1,636.7**	**6.1**
Licensed Finance Companies (LFCs)	1,367.9	5.8	1,452.0	5.4
Co-operative Rural Banks (c)	167.8	0.7	183.9	0.7
Thrift and Credit Co-operative Societies	0.8	0.0	0.8	0.0
Specialised Financial Institutions	**386.5**	**1.6**	**387.7**	**1.4**
Specialised Leasing Companies (SLCs)	33.7	0.1	35.7	0.1
Licensed Microfinance Companies	6.6	0.0	8.4	0.0
Primary Dealers	87.2	0.4	78.7	0.3
Stock brokers	19.9	0.1	36.5	0.1
Unit Trusts / Unit Trust Management Companies	204.0	0.9	198.5	0.7
Market Intermediaries (d)	18.0	0.1	11.8	0.0
Venture Capital Companies	17.1	0.1	18.2	0.1
Contractual Savings Institutions	**4,425.6**	**18.9**	**4,756.1**	**17.8**
Insurance Companies	789.7	3.4	879.8	3.3
Employees' Provident Fund	2,824.3	12.1	3,166.1	11.8
Employees' Trust Fund	376.6	1.6	419.1	1.6
Approved Pension and Provident Funds	364.9	1.6	207.6	0.8
Public Service Provident Fund	70.1	0.3	83.5	0.3
Total	**23,436.5**	**100.0**	**26,750.4**	**100.0**

(a) Revised
(b) Provisional
(c) Due to unavailabily of data, the asset base of Corporative Rural Banks as at end 2021 was taken to be same as the asset base as at end 2021 Q2.
(d) Excluding Licensed Banks, Licensed Finance Companies and Specialised Leasing Companies which are registered as Market Intermediaries.

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

view of providing a stronger legal foundation for the regulatory and supervisory framework. The Central Bank concluded the second round of discussions pertaining to a new Banking Act in 2021 and prepared amendments to the Finance Business Act No. 42 of 2011 to enhance regulatory and supervisory powers of the Central Bank.

8.2 Performance of the Banking Sector

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The banking sector expanded at a moderate pace during 2021 compared to the last year and remained resilient with adequate capital and liquidity buffers, amidst strong challenges stemming from the COVID-19 pandemic and related macroeconomic issues. Despite the continuation of debt moratoria for certain sectors and gradual lapses of the concessions introduced by the Central Bank, the banking sector was able to meet the minimum prudential requirements in terms of capital and liquidity.

The banking sector continued to dominate the financial sector accounting for 63.3 per cent of total assets as at end 2021. Despite the challenging economic environment driven by the ongoing pandemic and macroeconomy related concerns, the banking sector maintained reasonable credit growth during 2021. Deposits remained the dominant source of funding, while a notable incline in rupee borrowings was observed during 2021. However, sourcing foreign borrowings from external sources was affected by sovereign rating downgrades. During 2021, the banking sector profitability improved considerably compared to the previous year due to notable increases in net interest income and non-interest income.

Business Expansion: By end 2021, the banking sector comprised 30 banks, i.e., 24 Licensed Commercial Banks (LCBs), including 11 branches of foreign banks, and 6 Licensed Specialised Banks (LSBs). The banking sector continued with its intermediation role and expanded the banking network to facilitate financial inclusion. In 2021, with the restrictions on physically accessing banks due to the pandemic, most banks introduced technology based online products/services to customers to facilitate their banking needs.

Assets: The banking sector asset base increased by Rs. 2.3 trillion during the year and surpassed Rs. 16.9 trillion by end 2021, recording a year-on-year growth of 15.4 per cent compared to 17.1 per cent growth reported as at end 2020. Such asset growth

Figure 8.1
Performance of the Financial Sector

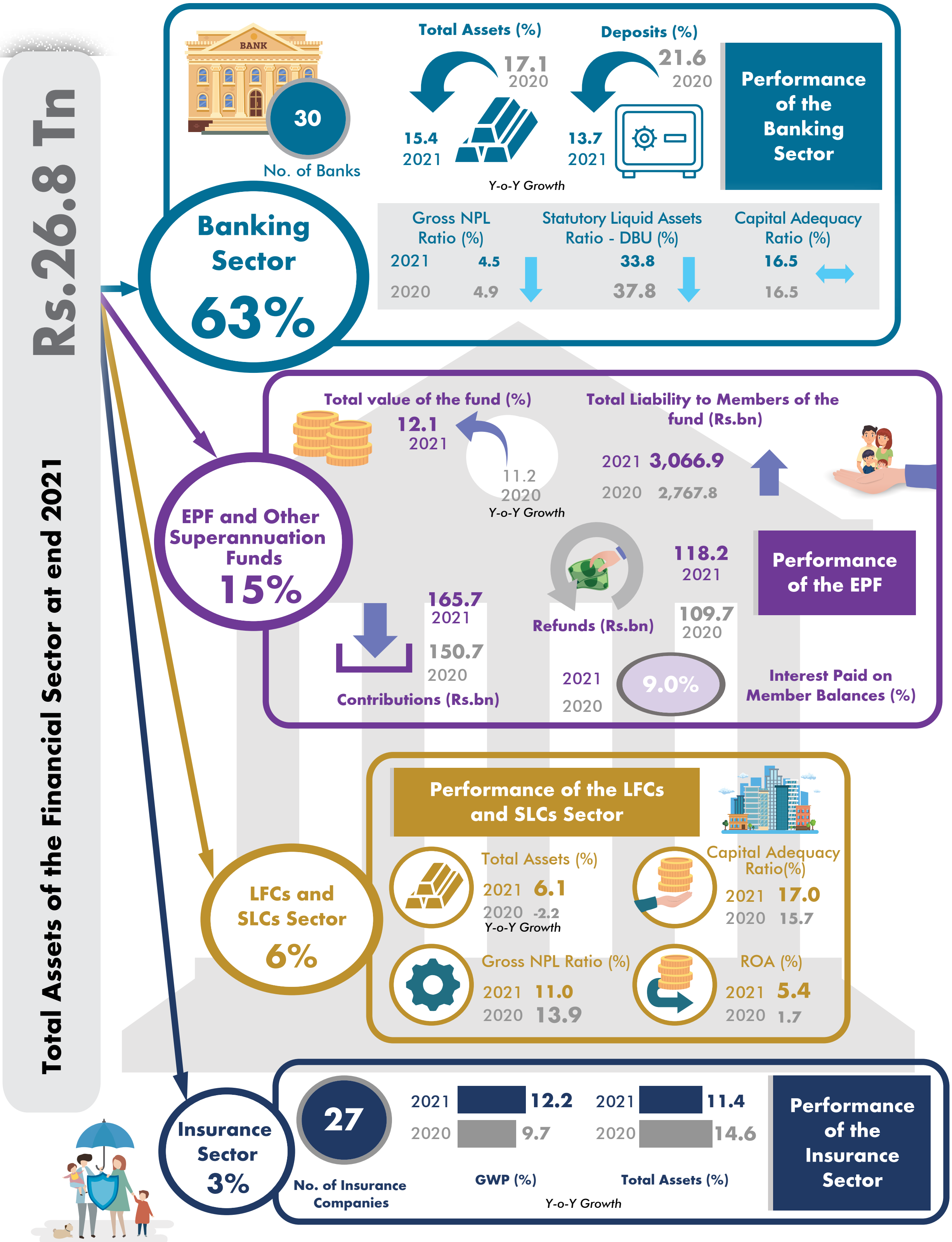

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Table 8.2
Distribution of Banks, Bank Branches and Other Banking Outlets

Category	End 2020 (a)	End 2021 (b)
Licensed Commercial Banks (LCBs)		
I. Total No. of LCBs	24	24
Domestic banks	13	13
Foreign banks	11	11
II.Total No. of LCB Banking Outlets	6,702	6,614
Branches (c)	2,915	2,919
Domestic Banks	2,869	2,874
Foreign Banks	46	45
Student Savings Units	3,787	3,695
III.Automated Teller Machines	5,744	5,891
Licensed Specialised Banks (LSBs)		
I. Total No. of LSBs	6	6
National Level Savings Banks	1	1
Housing Finance Institutions	2	2
Other LSBs	3	3
II. Total No. of LSB Banking Outlets	704	705
Branches (c)	704	705
National Level Savings Banks	266	263
Housing Finance Institutions	64	64
Other LSBs	374	378
III. Automated Teller Machines	432	451
Total No. of Bank Branches and Other Outlets	7,406	7,319
Total No. of Automated Teller Machines	6,176	6,342

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

Source: Central Bank of Sri Lanka

was mainly driven by loans and advances and investments. The growth in loans and advances increased from 11.9 per cent in 2020 to 15.3 per cent in 2021. Approximately, 92.2 per cent of the increase in the loan portfolio during 2021 was attributed to the increase in rupee loans. The increase in credit was diversified across the major sectors of the economy. In terms of products, overdrafts (40.7 per cent), pawning advances (21.5 per cent) and credit cards (12.6 per cent) reported high growth during 2021. Meanwhile, the year-on-year growth in investments decelerated from 40 per cent as at end 2020 to 16.4 per cent as at end 2021. The Held to Maturity (HTM) portfolio grew by 24.8 per cent during 2021 due to increased investments in Treasury bonds by Rs. 903.7 billion and decreased investments in Treasury bills and Sri Lanka Development Bonds (SLDBs) by Rs. 99.8 billion and Rs. 55 billion, respectively. The trading portfolio contracted by 21.2 per cent, with

Table 8.3
Composition of Assets and Liabilities of the Banking Sector

Item	2020 (a)		2021 (b)		Change (%)	
	Rs. bn	Share (%)	Rs. bn	Share (%)	2020 (a)	2021 (b)
Assets						
Loans and Advances	9,091.7	62.0	10,479.7	61.9	11.9	15.3
Investments	4,195.8	28.6	4,885.6	28.9	40.0	16.4
Other (c)	1,378.8	9.4	1,558.3	9.2	-1.8	13.0
Liabilities						
Deposits	11,140.9	76.0	12,671.3	74.9	21.6	13.7
Borrowings	1,692.2	11.5	2,181.2	12.9	0.8	28.9
Capital Funds	1,254.2	8.6	1,464.4	8.7	11.0	16.8
Other	578.9	3.9	606.6	3.6	5.0	4.8
Total Assets/ Liabilities	**14,666.3**	**100.0**	**16,923.6**	**100.0**	**17.1**	**15.4**

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

Source: Central Bank of Sri Lanka

declines in investments in Treasury bills, Treasury bonds and SLDBs by Rs. 50 billion, Rs. 47.6 billion and Rs. 63.8 billion, respectively, in nominal terms.

Liabilities: Deposits continued to be the main source of funding followed by borrowings. Term deposits accounted for 42.7 per cent of the increase in deposits during 2021 despite a decrease in its share in total deposits from 63 per cent as at end 2020 to 60.6 per cent as at end 2021. Meanwhile, savings and current deposits accounted for 29.5 per cent and 7 per cent, respectively, of total deposits as at end 2021. Accordingly, the Current and Savings Account (CASA) ratio increased from 34.5 per cent in 2020 to 36.6 per cent in 2021. Given the reduced rate of growth in total deposits during 2021, banks were compelled to increase their borrowings. Total borrowings of the banking sector increased by

Table 8.4
Composition of Deposits of the Banking Sector

Item	2020(a)		2021(b)		Change (%)	
	Rs.bn	Share (%)	Rs.bn	Share (%)	2020 (a)	2021 (b)
Demand Deposits	696.9	6.3	889.2	7.0	31.8	27.6
Savings Deposits	3,149.9	28.3	3,742.7	29.5	34.4	18.8
Time Deposits	7,022.3	63.0	7,676.3	60.6	15.3	9.3
Other Deposits	271.9	2.4	363.1	2.9	38.1	33.6
Total Deposits	**11,140.9**	**100.0**	**12,671.3**	**100.0**	**21.6**	**13.7**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

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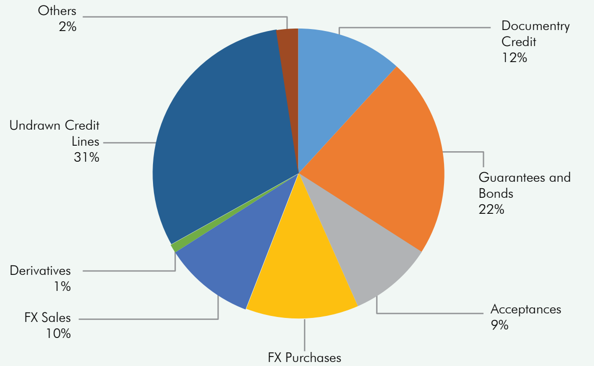
Figure 8.2
Off-Balance Sheet Exposure of the Banking Sector as at end 2021



Source: Central Bank of Sri Lanka

Rs. 489 billion (28.9 per cent) in 2021 compared to the increase of Rs. 12.8 billion (0.8 per cent) in 2020. This increase was mainly attributed to rupee borrowings which reported a growth of 86.6 per cent (Rs. 688 billion), while foreign currency borrowings decreased by 27.6 per cent (USD 1.3 billion) during 2021 reflecting the negative impact of the sovereign rating downgrades.

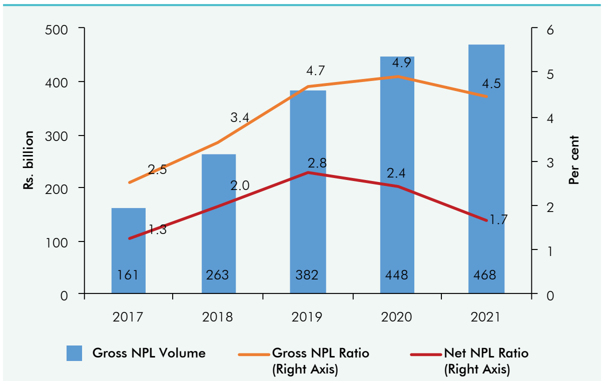
Off-balance sheet exposures: Due to the challenging business environment, off-balance sheet exposures reported a negative growth of 3.2 per cent (decrease of Rs. 160.6 billion) during 2021 compared to a growth of 16.1 per cent (Rs. 675.2 billion) recorded during 2020. Significant decreases were observed in FX exposures (Rs. 410.9 billion) and undrawn credit lines (Rs. 81.5 billion), while guarantees & bonds (Rs. 139 billion) and trade related exposures (documentary credit (Rs. 138.9 billion) and acceptances (Rs. 92 billion) reported increases during 2021.

Risks in the Banking Sector

Credit Risk

As the pandemic continued during 2021 in different scales, several extensions until 2022 were granted for the debt moratoria offered for pandemic affected individuals and businesses in certain sectors. Classification of loans and advances to non-performing categories was frozen during the period under moratoria, and normal classification rules will be applied upon cessation of the moratoria. However, banks have commenced identifying risk elevated sectors due to COVID-19 for estimating expected credit losses. Despite the freezing of classification of credit facilities under moratoria, Non-Performing Loans (NPLs) increased by Rs. 20.1 billion during 2021 compared to an increase of Rs. 66.4 billion during 2020. However, due to the comparatively higher increase in loans and advances during 2021, the gross NPL ratio decreased from 4.9 per cent as at end 2020 to 4.5 per cent by end 2021. With the downward migration of NPLs to categories requiring higher provisions, the net NPL ratio also reduced during 2021. The total loan loss provisions increased by Rs. 80.2 billion, of which specific provisions accounted for 84.7 per cent. Despite the increase in NPLs, the higher increase in provisions resulted in increases in specific and total provision coverage ratios to 64 per cent and 75.8 per cent, respectively, in 2021. As a result, the credit risk is at a manageable level as the banking sector operated with sufficient provisions and capital buffers to absorb the adverse impact arising from credit shocks.

Figure 8.3
Non-Performing Loans of the Banking Sector



Source: Central Bank of Sri Lanka

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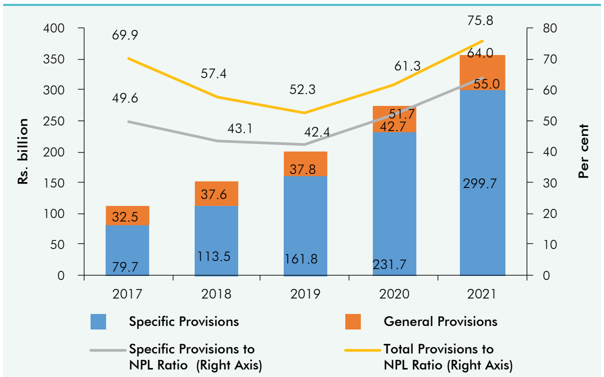
Figure 8.4
Provisioning of the Banking Sector



Source: Central Bank of Sri Lanka

Out of the total loan portfolio, 63.8 per cent of loans were mainly concentrated in 5 sectors comprising of consumption, construction & infrastructure, trade, manufacturing, and agriculture. Manufacturing, wholesale & retail trade, agriculture, construction, forestry & fishing, and tourism sectors reported NPL ratios higher than the total banking sector average of 4.5 per cent as at end 2021.

In addition, according to the Sri Lanka Financial Reporting Standards 9 (SLFRS 9) after the implementation of the expected loss model, the ratio of stage 3 loans to total loans in the banking sector indicated 7.64 per cent and the ratio of stage 3 loans (net of stage 3 impairment) to total loans (net of stage 3 impairment) indicated 4.26 per cent as at end 2021.

Market Risk

Interest Rate: The interest rate sensitivity ratio (interest bearing assets as a share of interest-bearing liabilities with maturities of less than 12 months) increased to 79.6 per cent as at end 2021 from 74.9 per cent as at end 2020, indicating a reduction in the exposure to interest rate risk by end 2021 compared to end 2020. Capital gains on Treasury bonds during 2021 stood at Rs. 4.1 billion and was lower than Rs. 12.2 billion recorded during 2020. This was mainly due to the low interest rates that prevailed in 2020 that led to higher gains while the upward adjustment of interest rates was observed during the latter half of 2021 with the tightening of the monetary policy.

Equity Prices: The equity risk of the banking sector was minimal throughout 2021. The exposure of banks' trading portfolio to the equity market was Rs. 12.5 billion, which was only 0.1 per cent and 2.1 per cent of the total assets and investments held for trading, respectively, as at end 2021.

Exchange Rates: The net foreign currency exposure of the banking sector increased to a long position of US dollars 133.2 million as at end 2021 compared to a short position of US dollars 30 million as at end 2020, with a higher decrease in foreign currency liabilities compared to the decrease in foreign currency assets. The net foreign currency exposure as a

Table 8.5
Sectorwise Composition of Loans and Advances of the Banking Industry (as at end 2021)

Sectors	Amount Rs. bn (a)	Share of Total Loans %	NPL Ratio %
Consumption	1,785.1	17.0	3.1
Construction	1,608.4	15.3	6.2
Wholesale & retail trade	1,373.2	13.1	6.5
Manufacturing	992.9	9.5	8.1
Infrastructure development	930.7	8.9	1.8
Lending to Ministry of Finance	857.5	8.2	-
Agriculture, forestry & fishing	813.5	7.8	6.3
Financial services	460.7	4.4	1.6
Lending to overseas entities	419.2	4.0	3.2
Health care, social services & support services	391.9	3.7	2.7
Tourism	358.2	3.4	5.6
Transportation & storage	206.0	2.0	6.1
Professional, scientific & technical activities	142.9	1.4	3.0
Information technology and communication services	73.2	0.7	5.9
Education	54.6	0.5	2.9
Arts, entertainment & recreation	11.8	0.1	4.5
Total Loans	**10,479.7**	**100.0**	**4.5**

(a) Provisional
Source: Central Bank of Sri Lanka

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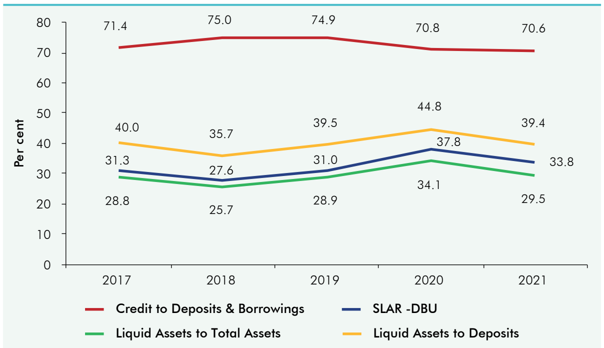
Figure 8.5
Liquidity Ratios of the Banking Sector



Source: Central Bank of Sri Lanka

percentage of banks' on-balance sheet foreign currency assets stood at 1.3 per cent as at end 2021, increasing from 0.3 per cent at end 2020. During 2021, on-balance sheet foreign currency assets increased mainly due to the increase in loans, placements with banks and investments, and the increase was lower than the decrease in off-balance sheet assets resulting from decreases in forward purchases and other derivative products. Meanwhile the increase in on-balance sheet foreign currency liabilities was attributed to the increase in customer deposits and the decrease in off-balance sheet liabilities was mainly from forward sales. The banking sector reported a net foreign currency revaluation gain of Rs. 28.7 billion during 2021 compared to Rs. 16.5 billion during 2020.

Figure 8.6
Cumulative Maturity Gap as a percentage of Cumulative Liabilities

Source: Central Bank of Sri Lanka

Liquidity Risk: On an overall basis, the banking sector was in compliance with the minimum Statutory Liquid Assets Ratio (SLAR) of 20 per cent. The Domestic Banking Units (DBUs) of LCBs and LSBs are required to maintain a minimum SLAR of 20 per cent. SLAR of DBUs declined from 37.8 per cent as at end 2020 to 33.8 per cent as at end 2021, while the SLAR of Off-shore Banking Units (OBUs) decreased from 43.2 per cent to 34 per cent during the corresponding period. Despite the higher increase in credit during 2021, the credit to deposits and borrowings ratio decreased marginally while the liquid assets to total assets and liquid assets to deposits ratios decreased.

The rupee and all currency Liquidity Coverage Ratios (LCRs), which is the stock of unencumbered high-quality liquid assets that can be converted easily and immediately into cash in the secondary market to meet liquidity needs for a period of 30 days under a liquidity stress scenario of the banking industry stood at 217.8 per cent and 171.8 per cent, respectively, by end 2021, well above the regulatory minimum of 100 per cent. In addition, the Net Stable Funding Ratio (NSFR), i.e., the amount of available stable funding relative to the amount of required stable funding, stood at 135.1 per cent by end 2021, well above the regulatory requirement of 100 per cent. Total liquid assets amounted to Rs. 5 trillion as at end 2021, of which investments in government securities represented 75.2 per cent. The cumulative maturity gap as a percentage of cumulative liabilities of the banking sector for maturity buckets less than 30 days and beyond 12 months widened as at end 2021 compared to end 2020, indicating better management of assets and liabilities in the short term, considering the declining trend in interest rates where more liabilities get repriced at lower

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Table 8.6
Composition of Liquid Assets of the Banking Sector

Item	2020 (a)		2021 (b)		Change (Rs.bn)	
	Rs.bn	Share (%)	Rs.bn	Share (%)	2020 (a)	2021 (b)
Treasury bills	1,149.9	23.0	1,040.6	20.8	278.7	-109.3
Treasury bonds	1,685.3	33.7	2,142.3	42.9	481.8	457.1
Sri Lanka Development Bonds	655.8	13.1	577.0	11.5	86.1	-78.8
Cash	203.1	4.1	231.8	4.6	6.2	28.7
Money at Call	337.7	6.8	177.2	3.5	168.9	-160.5
Balance with Banks Abroad	469.9	9.4	538.9	10.8	42.4	69.0
Other	493.6	9.9	290.3	5.8	309.8	-203.3
Total Liquid Assets	**4,995.1**	**100.0**	**4,998.0**	**100.0**	**1,373.9**	**2.9**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

interest rates compared to assets. Despite the banks being able to meet the minimum liquidity requirements, excessive widening of the maturity gap may lead to an increase in liquidity risk.

Performance of the Banking Sector

Profitability: Interest income of the banking sector increased by 3.2 per cent compared to a decrease of interest expenses by 11.5 per cent during 2021, resulting in an increase in net interest income by 28.5 per cent. As a result, the net interest margin increased from 3.1 per cent as at end 2020 to 3.4 per cent as at end 2021. Net interest income increased by Rs. 121.8 billion during 2021 compared to the previous year, while non-interest income increased by Rs. 24.6 billion, mainly due to higher foreign currency revaluation gains during 2021. Non-interest expenses increased by Rs. 47.4 billion, largely due to the increase in staff cost by Rs. 20.5 billion, while loan loss provisions increased by Rs. 7.7 billion during 2021 compared to 2020. As a result, profit before corporate tax was Rs. 258.7 billion in 2021 as per the regulatory reporting, which was Rs. 69 billion more than the previous year.

Table 8.7
Profit of the Banking Sector

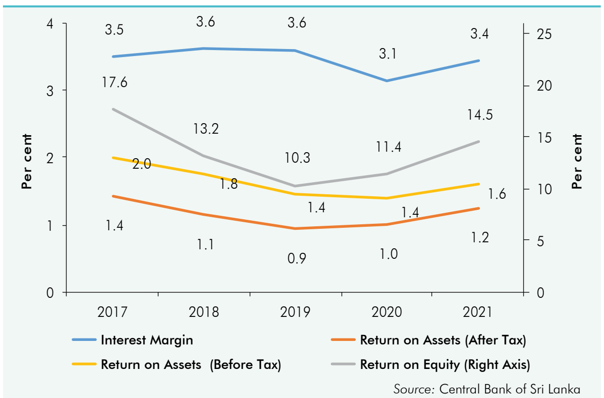
Item	2020 (a)		2021 (b)	
	Amount (Rs.bn)	As a % of Avg. Assets	Amount (Rs.bn)	As a % of Avg. Assets
Net Interest Income	427.1	3.1	548.9	3.4
Interest Income	1,161.1	8.5	1,198.3	7.5
Interest Expenses	734.0	5.4	649.3	4.1
Non-Interest Income	141.9	1.0	166.6	1.0
Foreign Exchange Income	31.5	0.2	46.4	0.3
Non-Interest Expenses	252.4	1.9	299.8	1.9
Staff Cost	128.0	0.9	148.4	0.9
Loan Loss Provisions	83.5	0.6	91.3	0.6
Profit Before Tax (after VAT)	189.7	1.4	258.7	1.6
Profit After Tax	135.8	1.0	198.4	1.2

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

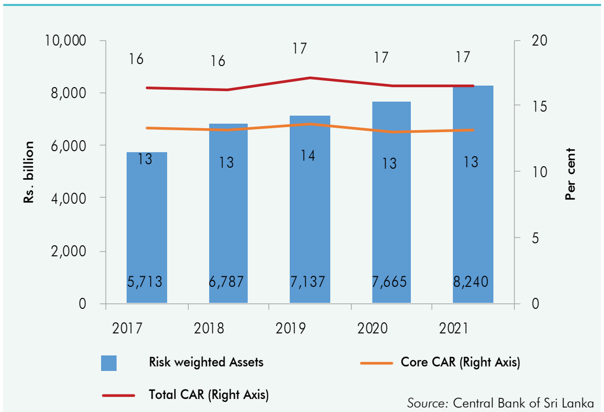
Profit after tax of the banking industry was Rs. 198.4 billion by end 2021 which recorded an increase of 46 per cent compared to the previous year. The increase in profits was reflected in Return on Assets (ROA) – before tax, which improved from 1.4 per cent as at end 2020 to 1.6 per cent as at end 2021, while Return on Equity (ROE) – after tax improved from 11.4 per cent in 2020 to 14.5 per cent in 2021. Further,

Figure 8.7
Profitability Ratios of the Banking Sector



Source: Central Bank of Sri Lanka

Figure 8.8
Capital Adequacy of the Banking Sector



the efficiency ratio improved from 51.8 per cent in 2020 to 48.1 per cent in 2021 as a result of the decrease in operating costs.

Capital: The banking sector was in compliance with the capital requirements during 2021. None of the banks drew down the capital conservation buffer during the period concerned.

Considering the challenges in raising fresh capital, the deadline to meet the enhanced minimum capital requirement for banks was extended till December 2022. Banks were encouraged to raise high quality capital after recognising the first day impact from implementation of SLFRS 9. As a result, banks raised Tier I capital through retention of profits (Rs. 70 billion) and issuance of new shares (Rs. 16.8 billion) during 2021. The regulatory capital of the banking sector reported a growth of 4.3 per cent during the year, of which Tier 1 capital contributed to 75.7 per cent of the increase.

Table 8.8
Composition of Regulatory Capital of the Banking Sector

Item	Amount (Rs. bn)		Composition (%)	
	2020 (a)	2021 (b)	2020 (a)	2021 (b)
Tier I: Capital	1,041.4	1,083.8	100.0	100.0
Share Capital	335.3	352.1	32.2	32.5
Statutory Reserve Funds	65.9	66.7	6.3	6.2
Retained Profits	410.6	480.5	39.4	44.3
General and Other Reserves	257.9	250.5	24.8	23.1
Others	32.9	21.6	3.2	2.0
Regulatory Adjustments	-61.1	-87.5	-5.9	-8.0
Tier II: Capital	266.2	279.8	100.0	100.0
Revaluation Reserves	27.2	35.3	10.2	12.6
Subordinated Term Debt	166.5	160.2	62.6	57.2
General Provisions and Other	73.7	84.7	27.7	30.3
Regulatory Adjustments	-1.3	-0.4	-0.5	-0.1
Total Regulatory Capital Base	1,307.6	1,363.6		

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Supervisory and Regulatory Developments during 2021

During 2021, the Central Bank continued to introduce prudential policy measures and regulations to strengthen the financial and operational resilience of licensed banks to ensure the safety and soundness of the banking sector. In the meantime, the Central Bank cautiously relaxed some of the regulations to facilitate the banking sector to adjust to the new normal and to continue providing concessions to economic sectors affected by the COVID-19 outbreak.

The Central Bank introduced a priority sector lending target on credit granted by licensed banks to individuals and businesses in the Micro, Small and Medium Enterprises (MSME) sector, with a view to promoting economic sectors with high growth potential in terms of domestic economic growth and exports earnings leading to a broad based revival of the economy. Accordingly, licensed banks were required to increase their credit to individuals and businesses in the MSME sector by not less than 20 per cent per annum on year-on-year basis, over the outstanding stock of lending to MSMEs at the end of the previous year. Further, licensed banks were also required to suspend recovery actions against paddy millers in the Small and Medium Enterprises (SME) sector for a period of six months, starting from 1 January 2021, considering the Government's initiatives to support SME paddy millers affected by the COVID-19 pandemic, for the upcoming harvesting season.

The Central Bank continued its efforts to support businesses and individuals affected by the COVID-19 pandemic, while ensuring the safety and soundness of the financial system, despite the impact of the prolonged debt moratoria. Policy measures adopted include providing concessions for lease facilities obtained by the affected businesses and individuals engaged in passenger transportation services for six months commencing from April 2021, extending the debt moratoria granted to COVID-19 affected businesses and individuals in the tourism sector for another six months commencing from April 2021, and extending the relief measures and concessions provided to businesses and individuals who were adversely affected by the third wave of COVID-19 outbreak. These concessions were subsequently extended in September 2021 until end 2021, and in the case of the tourism sector, up to end June 2022, considering the subsequent upsurge of the pandemic. As at end 2021 approximately 6 per cent of the loans of the banking sector were under moratoria. However, the potential impact of these loans will be net of the underlying security values and impairment already made on these loans.

As an alternative to moratoria, banks were requested to consider providing the borrowers with an option to restructure their existing facilities over a longer tenure at the prevailing low interest rates in the market, considering the future cash flows and subject to the submission of a viable revival plan. Further, the suspension of all types of recovery actions such as 'parate' execution and forced repossession of leased assets against affected borrowers was extended until end March 2022 and until end June 2022 for the tourism industry.

Table 8.9
Status of Moratorium Granted to COVID-19 Affected Performing Borrowers since March 2020 by Licensed Banks as at 31 December2021

Phase of Moratoria	Licensed Banks	
	No. of Approved Requests	Total Capital Outstanding (Rs. Bn)
Phase 1	1,266,620	2,185.0
Phase 2	127,289	939.0
Phase 3	176,188	917.0
Phase 4	145,687	642.4
Total	1,715,784	n.a.*

* The same borrowers may have obtained moratoria under several schemes

Source : Licensed Banks
Central Bank of Sri Lanka

The restrictions imposed on discretionary payments of licensed banks were temporarily relaxed in January 2021 and reimposed in July 2021. Accordingly, licensed banks were permitted to pay cash dividends and repatriate profits only after the completion of the audit of the financial statements for the year 2020, while refraining from engaging in share buy-backs and increasing non-essential expenditure and exercising extreme due diligence and prudence when incurring capital expenditure until end June 2021. The restrictions were reviewed and reimposed in July 2021, in light of the possible adverse impact on liquidity and other key performance indicators of licensed banks due to the subsequent upsurge of the COVID-19 pandemic.

During 2021, the Central Bank continued to take proactive regulatory measures to curtail the possible/potential outflow of foreign exchange from licensed banks to avoid excess volatility in the foreign exchange market, to ease the pressure on the exchange rate, and minimise the impact on banks' risk management. These measures included temporary restrictions on entering forward contracts of foreign exchange by licensed banks, margin requirements against imports and the temporary suspension of the purchase of Sri Lanka International Sovereign Bonds (ISBs) by LCBs and National Savings Bank (NSB). Further, the Central Bank introduced amendments to the Banking Act Directions on foreign currency borrowings by licensed banks to stimulate capital formation in the real economy and to support the foreign currency needs of the country.

The credit risk management and governance framework in relation to financial instruments of licensed banks were strengthened and aligned with the classification, recognition and measurement criteria for credit facilities and other financial assets under the Sri Lanka Accounting Standard 'SLFRS 9: Financial Instruments' to establish consistent and prudent practices in the banking industry. It is expected that the implementation of these new Directions will facilitate a more accurate assessment of the current as well as potential future risks of credit facilities and other financial assets of licensed banks.

Improving the operational resilience of the licensed banks was one of the key focus areas of the Central Bank during 2021. Accordingly, in June 2021, licensed banks were informed to maintain recovery plans to deal with shocks to capital, liquidity and all other aspects that may arise from institution-specific stresses, market-wide stresses, or a combination of both.

A regulatory framework for technology risk management and resilience of licensed banks was introduced to prompt banks to upgrade and strengthen their information systems and technology platforms in line with international standards and best practices. This framework sets minimum regulatory requirements on technology risk management and resilience for licensed banks in general as well as based on the sensitivity of data, the criticality of information systems, and the type of information system infrastructure used. These requirements are also aimed at improving the governance framework for technology risk management.

Maximum interest rates on foreign currency deposits of LCBs and NSB were imposed considering the prevailing interest rates of foreign currency denominated deposits, and maximum interest rates on mortgage-backed housing loans were also imposed considering the current and expected macroeconomic developments.

Several other policy measures were also introduced in 2021 as per regulatory requirements. These include amending capital requirements under Basel III for licensed banks on the risk weights applicable for foreign claims on the central Government, determination of Thai Baht as a designated foreign currency, recognition of Lanka Rating Agency Ltd. as an acceptable credit rating agency, provision of banking services during the lockdown periods, and introduction of a new structure for the annual license fee of licensed banks for the year 2022. The list of all policy changes and measures introduced during 2021 is available in the Major Economic Policy Measures 2021 section of this report.

The Central Bank upgraded its Statutory Examinations of banks to a more robust risk based examination mechanism and a comprehensive supervisory guidance framework based on the internal rating model named Bank Sustainability Rating Indicator (BSRI). Accordingly, internal ratings were assigned to all 30 licensed banks and statutory examinations of all banks were conducted in line with the BSRI framework and BSRI is being improved to facilitate risk based supervision. Ways and means to improve internal ratings assigned to banks will be focused during future statutory examinations by allocating more resources to examine high risk areas and weak/inefficient operations of banks. Further, Consolidated Risk Based Supervision of selected banking groups was conducted, extending the scope of statutory examinations of the Central Bank to the risks stemming from group entities.

BOX 9

COVID-19 Concessions and Moratoria: Challenges and Way Forward

The biggest economic challenge faced by humankind in the past century

COVID-19 is arguably the biggest health and economic challenge faced by humankind in this century. In 2020, over 90 per cent of the countries worldwide recorded contractions in their economic activities. The interconnectedness and interdependence of the global economy made the impact of the pandemic unprecedented, surpassing the effects of the two world wars, the great depression, and the global financial crisis (The World Bank, 2022).

How did Central banks react to COVID-19?

Central banks and monetary authorities worldwide introduced both conventional and unconventional policy responses to address the multifaceted challenges of the pandemic. These measures include monetary policy relaxations, asset repurchasing/quantitative easing programmes, and regulatory forbearances, as well as government-led fiscal measures such as tax reductions/deferments, direct cash payments, insolvency support and payment freezes/moratoria (International Monetary Fund, 2022).

In the wake of the pandemic, the Central Bank of Sri Lanka (CBSL) also introduced a series of extraordinary policy measures to provide liquidity to the economy and regulatory forbearances to provide operational flexibility to licensed banks and non-banking financial institutions (NBFIs), (hereinafter referred to as financial institutions, FIs) to assist their customers.

Accordingly, CBSL requested FIs to provide a six-month moratorium on capital and interest payments on loans obtained by borrowers affected by the pandemic and to waive off any accrued and unpaid penal interest charged on such loans. Considering the subsequent waves of the pandemic, this was extended for more than 18 months for customers who were severely affected.

Additionally, CBSL also introduced a Rs. 50 billion refinancing and credit guarantee scheme to provide low-cost funding for Small and Medium Enterprise (SME) customers, reduced interest rates on targeted lending products, provided liquidity facility to the construction sector and other government suppliers, suspended recovery actions against non-performing loans, and reduced fees and charges on several banking services to provide relief to retail customers.

New Challenges and Opportunities created by the Pandemic

COVID-19 affected businesses disproportionately. Some businesses and economic sectors came to a complete standstill while some found new opportunities and avenues to grow their businesses amidst the pandemic.

As the pandemic unfolds, many businesses worldwide adopted remote working and flexible working arrangements, which have now become a norm due to its' versatility and cost savings. Similarly, many businesses have already replaced expensive business travels and meetings with online conferences and virtual meetings. These shifts in preferences have forced businesses to rewire their infrastructure to be predominantly hybrid (Sadun, Simcoe, & Conti, 2021; Nugent, 2021). Further, the increased consumer preferences towards digital services and online shopping have pushed many businesses in the service sector such as supermarkets, retail, fashion, and entertainment to bring their businesses mobile-first. This phenomenon was also apparent in the local context such as increasing demand for online retail shopping, video consultations for doctors, online learning and tuition service providers and reduced demand for cinemas, large wedding receptions, concerts, exhibitions, and events. While these changes affected some businesses and their value chains adversely, many firms have embraced the change to spur innovation turning the changes into opportunities.

Similarly, FIs as well as the financial sector witnessed their fair share of pains and gains during the pandemic. Liquidity and credit risks were the most significant challenges faced by FIs worldwide during the pandemic. Closure of businesses, loss of jobs and income due to the pandemic and induced economic disruptions made it increasingly difficult for borrowers to honour their debt repayment obligations. Even for those who were repaying promptly, the probability of default in the future increased significantly, due to the increasing uncertainty in the global economy. This significantly impacted the asset quality of FIs. Liquidity positions of FIs also tightened as borrowers delayed their repayments and depositors withdrew their monies more often. This impaired FIs' ability to lend, curtailing credit flows to revive economic activities.

Raising new funds and rolling over the existing funding lines was another challenge faced by FIs as lenders, depositors, and investors of FIs were reluctant to commit more funds due to the increased uncertainty. This increased the cost of funding and refinancing risk of FIs.

The pandemic also increased other risks such as operational risk, health & safety risk, and business continuity risk. The increased reliance on digital delivery channels elevated the cybersecurity risk and technology risk, compelling FIs to commit more resources to mitigate these emerging risks and threats. Ultimately, the foregoing translated into increased strategic risk. FIs were required to reassess their risks, rearrange their priorities, and refocus their business directions as strategies planned before the pandemic became no longer valid in the "new normal".

However, certain business segments such as online banking, cashless payments and digital wallets witnessed exponential growth during the pandemic. FIs benefited from the reduced interest rates generally observed globally and in the local context, and from the exchange rate movements, due to mark-to-market gains on foreign currency assets. CBSL monitored these developments and introduced timely regulatory measures, where necessary, to prudently manage the increased risks in the financial sector.

Balancing Basics: Concessions and Stability

CBSL, as the apex financial authority in the country, took timely measures to provide concessions and revive the affected economic sectors while avoiding excessive risk buildup which can impact the core objectives of CBSL: to maintain economic and price stability and the financial system stability.

CBSL introduced the debt moratorium as a short-term remedy for borrowers who faced cashflow difficulties amidst the pandemic and to prevent loans of such borrowers from getting into non-performing category and its ensuing consequences. However, as the tenure of the moratoria and the value of loans grew bigger, FIs had to find alternative funding to pay their depositors and to meet other operating costs during the moratorium period. Considering the above, CBSL permitted FIs to charge a nominal interest on the moratoria, sufficient to cover the costs of funds. Subsequently, CBSL initiated preparatory works to introduce a mechanism to provide a least-cost solution to both borrowers and FIs, having considered the difficulties faced by borrowers due to charging additional interest.

Despite sparking much debate among the public, this additional interest allowed FIs to permit their borrowers to defer loan repayments for more than 18 months, without creating undue stress on depositors' funds and maintaining the stability of the individual FIs and the financial system.

Unwinding Moratoria: The Importance of Timing

As economic activities are returning to normalcy and countries opening their borders for trade, Central banks worldwide gradually phased out the extraordinary policy measures placed in response to COVID-19. However, experts warn that a premature upliftment of support measures that maintained liquidity and solvency of the economy may cause widespread credit constraints, debt foreclosures, insolvencies, and increased unemployment. This can be detrimental to post-pandemic economic revival and the self-reinforcing nature of these effects can have both short and long term consequences due to the feedback effect (Financial Stability Board, 2021).

On the other hand, maintaining support measures for too long can result in increased indebtedness, excessive risk-taking by firms and households, increased credit risk and creating moral hazard. The cost of running concessions for too long can be prohibitively expensive for countries with tight fiscal positions. Further, it can also slow down the necessary economic adjustments such as culling weak and unviable business/business models to reallocate economic resources to more efficient sectors, and technological transformation (Financial Stability Board, 2021).

What's beyond moratoria?

Unwinding moratoria and other relief measures can be challenging for both borrowers and FIs. As discussed above, the pandemic made permanent changes in several industries making some business models no longer profitable as they used to be (Jacobides & Reeves, 2020).

From a business continuity point of view, the pandemic was an acid test for firms that lack capital, contingency planning and agile decision making. For some firms, the main factor that kept such businesses afloat during the pandemic was the concessionary measures. Therefore, any efforts to revive businesses by FIs should focus on firms that are financially viable but suffering from liquidity and solvency problems caused directly by the pandemic. Also, such interventions should be transparent and should not distort the market competition (OECD, 2021).

Considering the above, CBSL issued guidelines to licensed banks to establish post-pandemic economic revival units in licensed banks to revive viable businesses. Accordingly, licensed banks will formulate revival plans and identify under-performing and non-performing borrowers with viable businesses who require rehabilitation assistance, including those who require liquidity support to unwind moratoria.

A mix of financial and non-financial assistance will be available to such borrowers to restructure/reschedule their existing credit facilities and will also grant additional credit facilities and/or any other appropriate support measures on a need basis to revive their businesses.

However, these will not be available to borrowers that have been identified as willful defaulters, defaulters who have diverted the borrowed funds for other purposes and those with unviable businesses or business projects and those who have defaulted due to mismanagement and/or fraud in their businesses.

The Way Forward: A Sustainable, Inclusive Economic Recovery

The end goal of all the above interventions is to minimise disruptions to the economy and restore normalcy in the livelihood of the people. In this regard, all stakeholders of the economy should collectively reflect on the lessons learnt from the pandemic and make conscious efforts to secure a sustainable and inclusive post-pandemic economic recovery.

Going forward, both FIs and firms should rethink their business models, explore new business opportunities created by the pandemic and redesign their processes and procedures to improve efficiency and competitiveness. Investing in technology and upgrading IT infrastructure while prudently managing increased risks will be another priority going forward. In doing so, they may also have to be mindful of their debt levels and seek to consolidate, restructure, or reschedule their debt to match their new cashflows and repayment capacities or find alternative avenues for low-cost funding or internal capital formation to maintain solvency and support such growth.

In this regard CBSL has initiated several policy measures to promote internal capital formation, recovery planning, technology risk management, provide long-term low-cost funding and orderly disposal of non-performing assets of FIs.

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8.3. Performance of Non-Bank Financial Institutions

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

Performance of the LFCs and SLCs sector improved considerably during 2021, especially in terms of credit growth and profitability. Total assets of the sector amounted to Rs. 1,487.7 billion as of end 2021, representing 5.6 per cent of the assets of Sri Lanka's financial system. Despite certain institutions encountering difficulties to meet the regulatory requirements at an individual level, the sector remained stable with capital and liquidity maintained at healthy levels above the minimum regulatory requirements. The Central Bank continued to monitor the key prudential indicators placing consideration on reviving the LFCs/SLCs with weak financial positions. The implementation of the Financial Sector Consolidation Masterplan (Masterplan) is underway to build strong and stable LFCs in the medium term, with the objective of safeguarding depositors of the non-bank financial institutions sector. Further, a number of measures were introduced to provide LFCs and SLCs with flexibility to support the businesses and individuals affected by the outbreak of the COVID-19 pandemic.

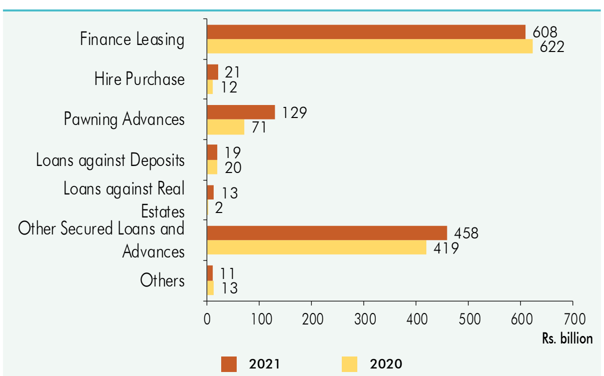
Table 8.10
Distribution of Branches of LFCs and SLCs Sector by Province

Province	End 2020 (a)	End 2021 (b)	Movement during the year
Central	166	184	18
Eastern	119	142	23
North Central	107	111	4
North Western	165	180	15
Northern	96	119	23
Sabaragamuwa	116	122	6
Southern	162	178	16
Uva	70	82	12
Western	516	589	73
Total	**1,517**	**1,707**	**190**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Figure 8.9
Total Loans and Advances (Gross) by Productwise for 2020 and 2021



Source: Central Bank of Sri Lanka

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Business Expansion

Outreach: By end 2021, the sector comprised 39 LFCs[1] and 3 SLCs. There were 1,707 branches and 309 other outlets, of which 1,359 branches and outlets (67.4 per cent) were located outside the Western Province.

Assets: The asset base of the sector increased by 6.1 per cent (by Rs. 86 billion) to Rs. 1,487.7 billion in 2021, compared to the 2.2 per cent contraction observed in 2020. The sector expansion was mainly driven by the growth in the loans and advances portfolio. Loans and advances accounted for 76.8 per cent of the total assets of the sector. The loans and advances portfolio of the sector was highly concentrated on finance leases which accounted for 48.3 per cent of total loans and advances as at end 2021. The growth of the leasing portfolio declined mainly due to the restrictions imposed by the Government on the importation of motor vehicles as a measure to restrict FX outflows. However, the loans and advances portfolio of the sector recorded a growth during the year due to the increase in other secured loans and advances and pawing advances. Accordingly, the loans and advances provided by the LFCs and SLCs sector increased by 9.9 per cent (Rs. 102.7 billion) to Rs. 1,142.5 billion in 2021 compared to the contraction of 5.7 per cent in 2020.

[1] Including two companies whose business operations were suspended on 13 July 2020 by the Monetary Board.

Table 8.11
Composition of Assets and Liabilities of the LFCs and SLCs Sector

Item	2020 (a)		2021 (b)		Change (%)	
	Rs. bn	Share (%)	Rs. bn	Share (%)	2020 (a)	2021 (b)
Assets						
Loans and Advances (net)	1,039.8	74.2	1,142.5	76.8	-5.7	9.9
Investments	158.9	11.3	167.4	11.3	20.2	5.4
Other	203.0	14.5	177.9	12.0	2.6	-12.4
Liabilities						
Total Deposits	748.6	53.4	783.3	52.7	-1.1	4.6
Total Borrowings	328.0	23.4	325.9	21.9	-19.1	-0.6
Capital Elements	248.1	17.7	304.0	20.4	22.1	22.6
Others	77.0	5.5	74.5	5.0	14.6	-3.3
Total Assets/Liabilities	**1,401.7**	**100.0**	**1,487.7**	**100.0**	**-2.2**	**6.1**

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

Table 8.12
Composition of Deposits of the LFCs Sector

Item	Amount (Rs. bn)		Composition (%)	
	2020 (a)	2021 (b)	2020 (a)	2021 (b)
Time Deposits	710.5	744.3	94.9	95.0
Savings Deposits	37.3	38.4	5.0	4.9
Certificate of Deposits	0.8	0.6	0.1	0.1
Total Deposits	**748.6**	**783.3**	**100.0**	**100.0**

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

The investment portfolio of the LFCs and SLCs sector comprises investments in equities, corporate debt instruments, government securities and investment properties. The investment portfolio recorded only a marginal growth of 5.4 per cent reaching Rs. 167.4 billion in 2021 compared to the significant growth of 20.2 per cent in 2020, mainly due to the increased investments in government securities maturing in less than 12 months. Other assets that mainly include cash and cash balances with banks and financial institutions declined by 12.4 per cent in 2021.

Liabilities: Customer deposits continued to dominate the liabilities of the LFCs and SLCs sector accounting for a share of 52.7 per cent. The deposits increased by 4.6 per cent (Rs. 34.7 billion) to Rs. 783.3 billion, while borrowings declined by 0.6 per cent (Rs. 2.1 billion) to Rs. 325.9 billion during the year.

Profitability: The net interest income of the sector significantly increased by 18.2 per cent (Rs. 20.2 billion) in 2021 reaching Rs. 131.4 billion. This was due to the significant decline

Table 8.13
Composition of Income and Expenses of the LFCs and SLCs Sector

Item	2020 (a)		2021 (b)	
	Amount (Rs. bn)	As a % of Avg. Assets	Amount (Rs. bn)	As a % of Avg. Assets
Interest Income	228.5	15.0	217.0	14.2
Interest Expenses	117.4	7.7	85.6	5.6
Net Interest Income	**111.2**	**7.3**	**131.4**	**8.6**
Non-Interest Income	32.0	2.1	49.5	3.2
Non-Interest Expenses	78.4	5.2	87.1	5.7
Loan Loss Provisions (Net)	38.2	2.5	11.1	0.7
Profit Before Tax	**26.6**	**1.7**	**82.7**	**5.4**
Profit After Tax	**13.7**	**0.9**	**55.6**	**3.6**

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

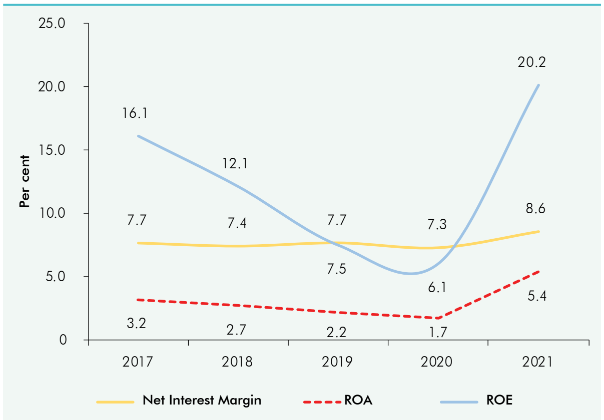
in interest expenses by 27.1 per cent (Rs. 31.8 billion) despite the decline in interest income by 5 per cent (Rs. 11.5 billion). The net interest margin of the sector (net interest income as a percentage of average assets) increased to 8.6 per cent in 2021 from the 7.3 per cent in 2020, due to a greater increase in the net interest income compared to the marginal increase in (gross) average assets.

The non-interest income increased by 54.5 per cent (Rs. 17.5 billion) and non-interest expenses increased by 11.1 per cent (Rs. 8.7 billion) during 2021 which significantly contributed to the profitability of the sector. Non-interest expenses increased mainly due to the increases in salaries, wages, and other benefits to the staff (Rs. 4.7 billion), administrative expenses (Rs. 2.8 billion), and other expenses (Rs. 3 billion). The loan loss provisions made against NPLs declined by Rs. 27.1 billion, largely due to increased collection during the period. The sector's profit after tax significantly grew by 307.1 per cent from Rs. 13.7 billion in 2020 to Rs. 55.6 billion in 2021, mainly due to the substantial increase in non-interest income by Rs. 17.5 billion including gains from trading or investment securities by Rs. 1.2 billion, service charges by Rs. 1.8 billion and default charges by Rs. 6.8 billion. The increase in profitability was reflected in the sharp increase in the Return on Equity (ROE) to 20.2 per cent and Return on Assets (ROA) before tax to 5.4 per cent in 2021, relative to 6.1 per cent and 1.7 per cent recorded respectively, in 2020. High ROA and ROE figures would be beneficial for the sector's capital generation enabling the attraction of new investors to the sector. The cost to income ratio also improved to 69 per cent in 2021, from 89.7 per cent in 2020, largely due to the reduction in total expenses and increased income during the period, while the efficiency ratio improved to 51.3 per cent during 2021.

Capital: The sector continued to remain resilient with capital maintained above the minimum regulatory requirement during the year. The capital base improved to Rs. 251.6 billion by end 2021 compared to Rs. 218.9 billion recorded by end 2020, with the infusion of new capital by several LFCs to meet regulatory requirements of Rs. 2 billion by 01 January 2021 and Rs. 2.5 billion by 01 January 2022. The sector's core capital and total capital ratios increased to 15.5 per cent and 17 per cent, respectively, by end 2021 from the reported levels of 14.5 per cent and 15.7 per cent at end 2020.

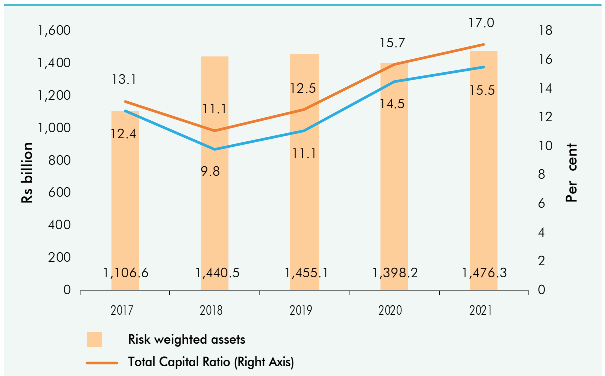
In 2021, the Masterplan was introduced to build a strong and stable 25 Non-Bank Financial Institutions complying with prudential requirements with diversified business models.

Figure 8.10
Profitability Indicators of the LFCs and SLCs sector



Source: Central Bank of Sri Lanka

Figure 8.11
Risk Weighted Assets and CAR of the LFCs and SLCs Sector



Source: Central Bank of Sri Lanka

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6 preliminary approvals have already been granted to 12 LFCs/SLCs for acquisitions and amalgamations under the Masterplan. In addition to the introduction of the Masterplan, several regulatory actions were also initiated by the Central Bank with a view to avoiding further deterioration of the financial positions, maintaining the stability of such institutions, and safeguarding the interests of depositors.

Risks in the LFCs and SLCs Sector

Credit Risk: Total gross NPLs reduced by 13.9 per cent (Rs. 22. billion) by end December 2021 on a year-on-year basis, compared to an increase of 26.2 per cent (Rs. 33.4 billion) recorded at end December 2020. Although the gross NPL ratio declined to 11 per cent by end 2021 from 13.9 per cent reported as at end 2020, still the NPL ratio of the sector remains high. The net NPL ratio reduced to 2.7 per cent by end 2021 from 4.2 per cent reported by end 2020, due to higher provision coverage for NPLs. The provision coverage ratio increased to 66.8 per cent in December 2021, compared to 58.9 per cent reported in December 2020. Though the underlying credit risk of the sector still remains manageable, the impact of the freezing of classification of loans under the moratoria needs to be factored in when assessing the credit risk of the sector. Similarly, following the COVID-19 pandemic, there was an increasing trend in pawning advances and gold loans in 2021 (by Rs. 58 billion). Hence, any potential price drop in the gold market would adversely affect the performance of the sector and its NPLs.

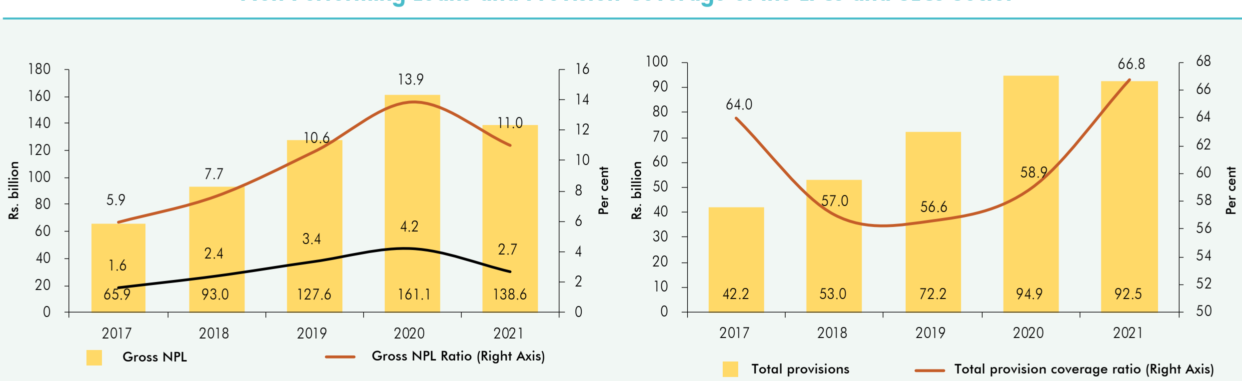
Market Risk: The sector continued to experience a low market risk which comprises interest rate risk and equity risk.

Interest Rate Risk: With the recent persistent upward revisions of Treasury bill interest rates, reference rates for deposits were revised upward from 01 November 2021. Accordingly, interest rate risk may increase due the negative mismatch in the maturity profile of the interest-bearing assets and liabilities.

Equity Risk: Equity risk of the sector remained low during the period under review as the exposure to equity market in the form of investments in listed shares declined to 0.8 per cent in 2021 from 1 per cent of total assets in 2020.

Liquidity Risk: The sector maintained liquidity well above the minimum required level during 2021. The overall regulatory liquid assets available in the sector was Rs. 155.9 billion by end December 2021, against the stipulated minimum requirement of Rs. 89.9 billion. However, the liquidity surplus by end 2021 declined by 25.9 per cent (Rs. 23

Figure 8.12
Non Performing Loans and Provision Coverage of the LFCs and SLCs Sector



Source: Central Bank of Sri Lanka

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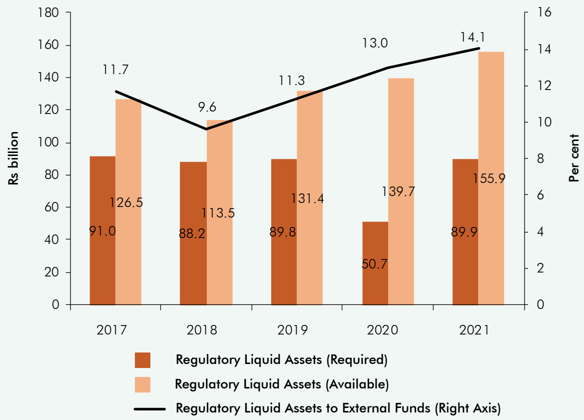
Figure 8.13
Regulatory Liquidity Indicators of the LFCs and SLCs Sector



Source: Central Bank of Sri Lanka

billion) compared to the liquidity surplus of Rs. 89 billion recorded in December 2020, mainly due to the increase in minimum liquidity requirements consequent to the discontinuation of regulatory relaxations imposed on liquid asset requirements in response to the COVID-19 pandemic. The liquidity ratio (liquid assets against deposits and borrowing) increased to 14.1 per cent by end December 2021, compared to 13 per cent recorded by end 2020.

Primary Dealer Companies in Government Securities

As at end 2021, there were 6 LCBs and 7 Primary Dealer Companies (PDCs) appointed as Primary Dealers (PDs) in the government securities market. Pan Asia Banking Corporation PLC (PABC) and Perpetual Treasuries Limited (PTL) were suspended from carrying on business and activities of a PD on 15 August 2017 and 06 July 2017, respectively. The participation in primary auctions was prohibited for Entrust Securities PLC (ESP) w.e.f. 24 July 2017. Accordingly, only 5 LCBs and 5 PDCs were active in the government securities market as PDs as at end of 2021.

Assets and Liabilities: Total assets of PDCs decreased by 9.8 per cent to Rs. 78.7 billion in 2021. The total investment portfolio of government securities, consisting of trading, available for sale and HTM portfolios amounted to Rs. 70.5 billion as at end 2021, which recorded a decline of 12 per cent during the year. The trading portfolio decreased to Rs. 54.9 billion by end 2021 from Rs. 62.6 billion recorded as at end 2020, while the HTM portfolio declined to Rs. 12 billion as at end 2021 from Rs. 14.7 billion as at end 2020. The available for sale portfolio increased to Rs. 3.6 billion by end of 2021 compared to Rs. 2.8 billion as at end 2020.

Profitability: PDCs reported a loss after tax of Rs. 0.4 billion during 2021 compared to the profit after tax of Rs. 4.9 billion reported during 2020, indicating a significant decline in profitability consequent to the increase in yield rates. The significant drop in capital gains along with the considerable increase in mark-to-market losses recorded by PDCs in 2021 compared to 2020, largely contributed to the after-tax loss reported in 2021. Furthermore, ROA and ROE of PDCs contracted to negative 0.7 per cent and negative 3.2 per cent, respectively, by end of 2021 from 7.6 per cent and 30.5 per cent, respectively, as recorded in 2020.

Capital: Equity of PDCs contracted by 6.7 per cent mainly due to losses incurred during the year. The Risk Weighted Capital Adequacy Ratio (RWCAR) of the PDCs was well above the minimum required amount of 10 per cent and increased to 42.8 per cent as at end 2021 from 27 per cent reported as at end 2020.

Risks in the PDCs Sector

Market Risk: The proportion of the trading portfolio in the total investment portfolio of PDCs decreased marginally and was recorded at 77.9 per cent as at end 2021 compared to 78.2 per cent as at end 2020, reflecting a marginal decrease in the relative market risk exposure of the industry.

Liquidity Risk: The overall liquidity risk exposure of PDCs increased due to the increase in overnight negative mismatch in the maturity profile of assets and liabilities of PDCs by end 2021. The overnight negative mismatch increased to Rs. 20.3 billion as at end 2021 from Rs. 13 billion (79.5 per cent) as at end 2020. This is an increase in overnight liabilities by 82.8 per cent as at end 2021. In view of holding a large volume of government securities, which is free of credit risk, by PDCs and the ability to use such government securities as collateral for obtaining funds to bridge any unforeseen liquidity gaps, the liquidity risk profile of PDCs remained low throughout the year except ESP which was facing liquidity issues. Most of the PDCs had standby contingency funding arrangements to bridge any liquidity gaps.

Market Conduct

Primary Market Activities: The participation in primary auctions in respect of Treasury bills and Treasury bonds by PDCs showed a mixed performance during 2021. Of the total bids accepted at 52 Treasury bills auctions conducted in 2021, the effective participation of LCBs appointed as PDCs, PDCs and Employees' Provident Fund (EPF) accounted to 43.1 per cent, 56.3 per cent and 0.6 per cent, respectively. At 22 Treasury bond auctions conducted during 2021, effective participation of LCBs appointed as PDCs, PDCs and EPF accounted to 36 per cent, 27.5 per cent and 36.5 per cent, respectively.

Secondary Market Activities of PDCs: Secondary market transactions in government securities (in terms of value) by PDCs decreased by 33.1 per cent to Rs. 5,068.3 billion in 2021, out of which repo transactions accounted to 63.5 per cent. During 2021, outright purchases decreased by 56 per cent and outright sales by PDCs increased by 11.4 per cent, compared to 2020.

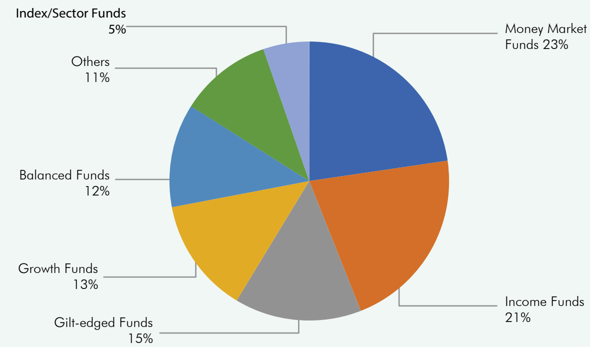
Licensed Microfinance Companies

The Licensed Microfinance Companies (LMFC) sector consisted of 4 companies and reported a 27.2 per cent growth of its assets base reaching Rs. 8.4 billion as at end 2021. Microfinance loans and advances accounted for the largest share of total assets with 74.6 per cent. Microfinance Loans and Advances amounted to Rs. 6.3 billion as at end 2021 in comparison to the Rs. 5.3 billion as at end 2020, reporting a growth of 14.8 per cent. NPLs of LMFCs stood at 16.8 per cent as at end 2021. The total deposit base of the sector grew by 11 per cent in 2021 from Rs. 488 million in 2020 to Rs. 544 million in 2021. Despite the increase in total liabilities of the sector by 29 per cent from Rs. 4.4 billion in 2020 to Rs. 5.5 billion in 2021, the debt-to-equity ratio increased to 2.0 per cent by end 2021 with the increase of equity from 1.9 per cent recorded at end 2020. In order to utilise the available liquid assets to meet operational costs during the COVID-19 pandemic, the Monetary Board continued its decision to withdraw the requirement for LMFCs to maintain liquid assets as per the Microfinance Act No. 6 of 2016. The core capital level of the sector remained at Rs. 2.7 billion and all LMFCs were in compliance with the minimum prudential regulations on core capital.

Unit Trusts

The number of Unit Trusts (UTs) remained unchanged at 75 at end 2021 similar to end 2020, while the number of UT management companies decreased to 16 at end 2021, from 18 reported at end 2020. The UTs funds were mainly dominated by money market funds and followed by Income Funds with the representation of 23 per cent and 21 per cent of the UT industry, respectively. In addition, Gilt Edged Funds, Growth Funds and Balanced Funds accounted for 15 per cent, 13 per cent and 12 per cent of the UT industry, respectively.

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



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

Source: Unit Trust Association of Sri Lanka

Business Growth: A contraction was observed in the total asset base of the UT sector during year 2021. The total assets of the sector decreased by 3 per cent to Rs. 195 billion at end 2021. It is observed that the number of units issued also decreased to 7,835 million at end 2021 from 8,014 million reported at end 2020. However, the total number of unit holders increased to 59,426 at end 2021 from 52,402 reported at end 2020.

Investments: The share of investments on government securities by UTs as a percentage of net assets decreased to 12.1 per cent at end 2021 from 12.6 per cent reported at end 2020. However, investment in equities as a percentage of net assets increased to 9.1 per cent at end 2021 compared to 7 per cent at end 2020.

Table 8.14
Performance of UT Sector

Item	2020 (a)	2021 (b)
No. of Unit Trusts	75	75
Total No. of Unit Holders	52,402	59,426
No. of Units in Issue (mn)	8,014	7,835
Total Assets (Rs. bn)	201.0	195.0
Net Asset Value-NAV (Rs. bn)	201.5	191.3
Investments in Equities (Rs. bn)	14.1	17.6
Share of Total Net Assets (%)	7.0	9.1
Investments in Government Securities (Rs. bn)	25.3	23.4
Share of Total Assets (%)	12.6	12.1

(a) Revised
(b) Provisional

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

Insurance Sector

By end 2021, there were 27 insurance companies operating in the country comprising 13 long term insurance companies, 12 general insurance companies and 2 companies involved in both long term and general insurance business.

The insurance sector reported a modest growth in its asset base in 2021. The total assets of the insurance sector grew by 11.4 per cent by end 2021 on a year-on-year basis and reached Rs. 879.8 billion. The asset base of the long term insurance subsector grew by 12.3 per cent to Rs. 633 billion by end 2021 compared to a growth of 16.1 per cent recorded at end 2020, whereas the asset base of the general insurance subsector increased by 9.2 per cent and reached Rs. 246.8 billion at end 2021. The share of the asset base of the long term insurance subsector over the total insurance sector asset base remained high at 71.9 per cent by end 2021 which was a marginal increase from 71.4 per cent recorded by end 2020. Corresponding to this increase, the share of general insurance subsector assets over total assets declined to 28.1 per cent by end 2021 from 28.6 per cent recorded at end 2020.

Gross written premium of the insurance sector grew by 12.2 per cent to Rs. 233.8 billion at end 2021 from Rs. 208.2 billion at end 2020. Gross written premium of the long term insurance subsector and general insurance subsector increased by 21.1 per cent and 3.6 per cent respectively, during the period under consideration. Accordingly, the long term insurance subsector became the main contributor to the gross written premium of the sector which recorded a share of 53.3 per cent at end 2021. The general insurance subsector mainly focused

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on motor insurance and represented 55.9 per cent share of general insurance at end 2021. The gross written premium of the motor insurance subsector decreased marginally by 0.3 per cent at end 2021.

Profitability of the insurance sector decreased during 2021, reporting a decrease of 4.9 per cent in profits before tax. Profits before tax of the long term insurance subsector reported an increase of 16.1 per cent and the general insurance subsector profits before tax reported a decrease of 20.7 per cent during 2021 due to increased claims in 2021. Meanwhile, the underwriting profits of the sector also decreased by 22.1 per cent at end 2021.

Claims from the insurance sector increased by 17.8 per cent and recorded Rs. 94.7 billion at end 2021. Claims of both long term and general insurance subsectors increased by 22.3 per cent and 13.8 per cent, respectively, at end 2021.

ROA and ROE of the long term insurance subsector increased, while ROA and ROE of the general insurance subsector declined during the year under review compared to 2020. ROA of the long term insurance subsector increased to 3.4 per cent, while the ROA of the general insurance subsector decreased to 7.8 per cent by end 2021. The ROE of the long term insurance subsector increased to 15.7 per cent by end 2021 from 14.5 per cent recorded at end 2020, whereas the ROE of the general insurance subsector declined to 15.5 per cent by end 2021 from 22.7 per cent recorded at end 2020.

Capital to total assets of the long term insurance subsector declined to 20.9 per cent by end 2021 from 22.1 per cent by end 2020, whereas the capital to total assets of the general insurance subsector increased to 50.4 per cent by end 2021 from 48.3 per cent reported at end 2020.

Table 8.15
Performance of the Insurance Sector*

Rs. billion

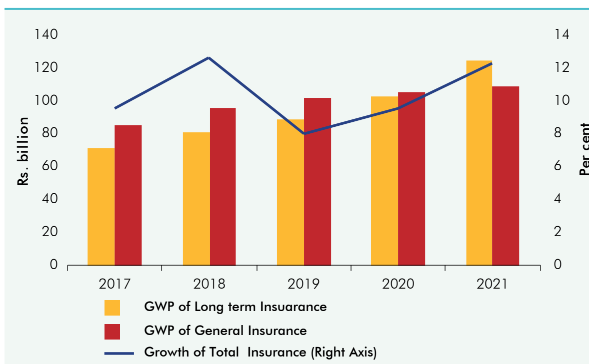
Item	2020 (a)	2021 (b)
Total Assets	789.7	879.8
Government Securities	309.3	337.1
Equities	44.8	53.8
Cash & Deposits	117.3	132.5
Gross Premium	208.2	233.8
Total Income	264.3	298.6
Premium Income	208.2	233.8
Investment Income	56.1	64.9
Profit Before Tax	40.4	38.4
Capital Adequacy Ratio (%) - Long-term Insurance	352.0	384.0
- General Insurance	272.0	224.0
Retention Ratio (%) - Long-term Insurance	95.4	96.0
- General Insurance	82.4	76.2
Claims Ratio (%) - Long-term Insurance	38.6	38.7
- General Insurance	49.2	55.8
Combined Operating Ratio (%) - Long-term Insurance	82.7	81.2
- General Insurance	88.6	94.9
Return on Assets (ROA) (%) - Long term Insurance	3.3	3.4
- General Insurance	10.7	7.8
Return on Equity (ROE) (%) - Long term Insurance	14.5	15.7
- General Insurance	22.7	15.5
Underwriting Ratio (%) - General Insurance	32.6	25.3

(a) Revised
(b) Provisional
* Information excluding the National Insuarance Trust Fund

Source: Insurance Regulatory Commission of Sri Lanka

The investments made by the insurance sector continued to be highly concentrated on government securities. The share of long term insurance subsector assets on government securities decreased to 46.1 per cent at end 2021 compared to 46.8 per cent at end 2020 while the share of general insurance subsector assets on government securities increased to 45.7 per cent at end 2021 compared to 40.7 per cent at end 2020. However, the share of investments on equity of the long term insurance subsector and general

Figure 8.15
Gross Written Premium of the Insurance Sector



Source: Insurance Regulatory Commission of Sri Lanka

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insurance subsector increased to 7.2 per cent and 8 per cent, respectively, at end 2021 from 6.3 per cent and 7.6 per cent at end 2020.

Superannuation Funds

The total assets of the superannuation funds were reported at Rs. 3,876.3 billion by end 2021 contributing to 14.5 per cent of the financial sector assets. The sector is dominated by the EPF, which accounts for 81.7 per cent of the total assets of the superannuation sector. In addition to the EPF, there are two other publicly managed funds, namely, the Employees' Trust Fund (ETF) and the state sector Public Service Provident Fund (PSPF).

Employees' Provident Fund

As per the Employees' Provident Fund Act No. 15 of 1958 (EPF Act), the Monetary Board of the Central Bank is entrusted with the custodianship of the Employees' Provident Fund (EPF/Fund), 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 duties and functions as per the provisions of the EPF Act.

The total value of the Fund increased by Rs. 341.8 billion to Rs. 3,166.1 billion as at end 2021 from Rs. 2,824.3 billion reported by end 2020, recording a 12.1 per cent growth. This growth was an outcome of a combined effect of the net contributions of the members (amount of contributions received less refunds paid) and the income generated through investments of the Fund. Total liability to the members stood at Rs. 3,066.9 billion as at end 2021 recording a 10.8 per cent increase from Rs. 2,767.8 billion as at end 2020. The total contribution for the year 2021 increased by 9.9 per cent to Rs. 165.7 billion, while the total amount of refunds to the members and their legal heirs was Rs. 118.2 billion in 2021, which was an increase of 7.7 per cent over 2020. Accordingly, the net contribution to the Fund was Rs. 47.5 billion compared to Rs. 41.0 billion recorded in the previous year. The annual profit of the Fund increased by 22.1 per cent to Rs. 299.1 billion in 2021 from Rs. 244.9 billion recorded in the previous year. This was mainly due to the increase in the net gain on financial instruments at fair value through profit or loss (listed equities) by Rs. 36.8 billion.

The total investment portfolio (book value) of the Fund grew by 12.2 per cent to Rs. 3,173.3 billion as at end of 2021 from Rs. 2,829.5 billion as at end of 2020. The investment policy of the Fund is focused on providing long term positive real returns to the members, while ensuring the safety of the Fund and the availability of adequate level of liquidity to meet refund payments and other expenses of the Fund. Accordingly, as at end of 2021, the investment portfolio consisted of 93.2 per cent in government securities, 3.8 per cent in equity, 0.8 per cent in corporate debentures, 1.8 per cent in fixed deposits, and the remaining 0.4 per cent in Reverse Repurchase agreements.

Investment Income: The total investment income of the Fund was Rs. 342.2 billion in 2021 and recorded an increase of 19.9 per cent compared to previous year. Interest income continued to be the major source of income to the Fund which grew by 5.9 per cent to Rs. 293.7 billion in 2021 from Rs. 277.4 billion in 2020. Dividend income increased by 124.0 per cent to Rs. 6.7 billion in 2021 compared to Rs. 3.0 billion in 2020. Net Gain/Loss on financial instruments at fair value through profit or loss recorded a net gain of Rs. 41.8 billion in 2021 compared to net gain of Rs. 5.0 billion in 2020.

Table 8.16
Five year Performance Summary of the EPF

Item	2017	2018	2019	2020(a)	2021(b)
Total Value of the Fund (Rs. bn)	2,066.3	2,289.4	2,540.4	2,824.3	3,166.1
Total Liability to the Members (Rs. bn)	2,020.8	2,254.2	2,497.6	2,767.8	3,066.9
Total Contribution (Rs. bn)	133.3	145.0	157.2	150.7	165.7
Total Refunds (Rs. bn)	117.5	108.0	126.3	109.7	118.2
Net Contribution (Rs. bn)	15.8	37.0	30.9	41.0	47.5
Interest rate (%)	10.50	9.50	9.25	9.00	9.00
Total Number of Member Accounts (mn)	18.1	18.7	19.4	19.8	19.8
Active Number of Member Accounts (mn)	2.8	2.9	2.9	2.6	2.3

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Overall Return of the Fund: The Fund earned a total gross income of Rs. 342.4 billion in 2021, recording an increase of 19.9 per cent compared to the previous year. After adjusting for operating expenditure and tax expenditure, the net profit for the year 2021 was Rs. 299.1 billion which is an increase of 22.1 per cent compared to that of 2020. Accordingly, the Return on Average Investment of the EPF in 2021 was 11.40 per cent. Further, the Fund was able to maintain operating expenses to gross income ratio at 0.48 per cent in 2021. However, the tax expenditure of the Fund increased by Rs. 2.6 billion compared to 2020 following the increase of profit in 2021. Nevertheless, the adoption of SLFRS 9, the Accounting Standard applicable for classification and measurement of Financial Instruments, where listed equity instruments are measured at fair value and also due to the favourable performance observed in the listed equity market, a net gain of Rs. 41.8 billion was recorded as an income for the year 2021. Accordingly, the EPF declared an interest rate of around 9.00 per cent on member balances in 2021.

Activities of the EPF Department were conducted while adhering to the risk management and internal control requirements in place, even while experiencing certain disruptions during the year to its regular operating mechanisms due to the COVID-19 pandemic. Accordingly, all investment activities were conducted in line with the requirements specified in the Monetary Board approved Investment Policy Statement, Strategic Asset Allocation and Investment Guidelines, while ensuring the safety and optimal return to the Fund. The investment climate prevailed in the country during the year was quite challenging due to significant changes in the market interest rates, fluctuations in the equity market and other economic conditions. Accordingly, robust investment decisions were taken while addressing any risks of the changing economic environment. Further, actions were taken to revisit and revise the prevailing investment guidelines in order to facilitate investment decisions considering the market conditions, international standards and best practices with the collaboration of Risk Management Department of the Central Bank.

Employees' Trust Fund

The ETF, which contributed to 10.8 per cent of the asset base of the superannuation sector, recorded an improvement in its asset base, total contributions, and investments while the number of member accounts registered a decline. Out of 14.7 million member accounts of the ETF, only 2.1 million accounts were active as at end 2021. The number of employers contributing to the fund declined to 44,501 at end 2021 from 75,756 at end 2020. The total member balance of the ETF increased by 8.3 per cent year-on-year to reach Rs. 406.3 billion at end 2021. The total contributions received to the ETF increased by 11 per cent year-on-year and reached Rs. 29.7 billion, while total benefits paid to members increased by 6.6 per cent year-on-year and reached Rs. 20.2 billion at end 2021.

Meanwhile, the total assets of the ETF increased by 11.3 per cent year-on-year and reached Rs. 419.1 billion at end 2021.

Table 8.17
Performance of the ETF

Item	2020 (a)	2021 (b)
Total Assets (Rs. bn)	376.6	419.1
Total Member Balance (Rs. bn)	375.2	406.3
Number of Member Accounts (mn)	15.9	14.7
Number of Active Member Accounts (mn)	2.5	2.1
Number of Employers Contributing	75,756	44,501
Total Contributions (Rs. bn)	26.8	29.7
Total Refunds (Rs. bn)	18.6	19.8
Total Investments Portfolio (Rs. bn)	371.3	410.1
o/w : Government Securities (%)	80.0	86.0
Gross Income (Rs. bn)	34.7	35.5
Profit Available for Distribution (Rs. bn)	31.5	32.7
Return on Investments (%)	9.1	8.6
Interest Rate Paid on Member Balances (%)	8.0	7.3

(a) Revised
(b) Provisional

Source : Employee's Trust Fund Board

Investments made by the ETF increased to Rs. 410.1 billion at end 2021, which is an increase of 10.5 per cent compared to end 2020. Out of these investments, 86 per cent was invested in government securities at end 2021, compared to 80 per cent at end of the previous year. The share of investments in fixed deposits considerably decreased to 6.9 per cent at end 2021 compared to 14.3 per cent at end 2020. The ETF managed to pay a return of 7.3 per cent on its member balances for 2021, a decline from the 8 per cent of return paid during the previous year.

Other Superannuation Funds

The PSPF, which accounted for 2.2 per cent of the superannuation sector, increased in terms of assets, investments, and net contribution during 2021. The fund grew by 19.1 per cent and reached Rs. 83.5 billion in terms of assets at end 2021. The number of active members of the fund was 241,384 at end 2021 when compared to 235,884 active members at end 2020. Meanwhile, the investments of the fund also grew by 16.4 per cent reaching Rs. 81 billion at end 2021. The PSPF has invested 57.4 per cent of its total investments in government securities while other investments accounted for 42.6 per cent of the total investments as at end 2021. The net contribution was Rs. 835 million during 2021 compared to the net contribution of Rs. 507 million reported during the previous year. The rate of return on member balances was 8 per cent in 2021 compared to 9.75 per cent in 2020.

Approved Pension and Provident Funds (APPFs) accounted for 5.4 per cent of the superannuation sector by end 2021. The number of members covered by APPFs was estimated to be 76,692 and total assets of the funds were estimated to be Rs. 207.6 billion at end 2021.

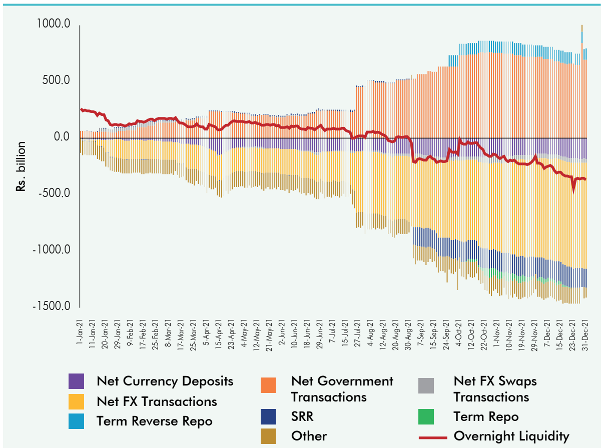
8.4 Performance of Financial Markets

Domestic Money Market

Market Liquidity

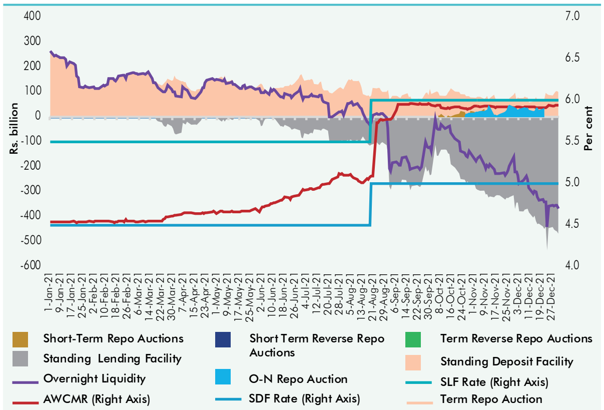
Liquidity in the domestic money market, which persistently remained at a surplus level during 2020 and the first half of 2021, declined considerably from mid-July 2021 and turned negative from end August 2021. The substantial surplus liquidity during the first half of 2021 was mainly due to purchases of Treasury bills at the primary market and foreign exchange related

Figure 8.16
Factors that Affected Daily changes in Money Market Liquidity



Source: Central Bank of Sri Lanka

Figure 8.17
Open Market Opearation Auctions, Standing Facility, Standing Rate Corridor and Average Weighted Call Money Market Rate (01 Jan 2021-End Dec 2021)



Source: Central Bank of Sri Lanka

transactions by the Central Bank. However, surplus liquidity in the domestic money market declined thereafter, mainly due to foreign loan repayments by the Government, currency withdrawals by LCBs, maturities of Treasury bills held by the Central Bank, and maturing of foreign currency buy-sell swap transactions of the Central Bank with LCBs. With the reversal of the accommodative monetary policy stance in mid-August 2021 and the increase of the Statutory Reserve Ratio (SRR) by 2.00 percentage points to 4.00 per cent with effect from the reserve maintenance period commencing 01 September 2021, liquidity of the domestic money market declined significantly. Accordingly, market liquidity, which remained at a surplus of Rs. 206.8 billion by end 2020, recorded a deficit of Rs. 119.6 billion by end September 2021. As guided by the monetary policy stance, a deficit was maintained in the overnight money market liquidity through open market operations by conducting repo auctions since late August 2021. Moreover, the Central Bank conducted auctions of outright sales of Treasury bills in November and December 2021, in order to mop up excess liquidity on a permanent basis, resulting mainly from primary purchases of Treasury bills by the Central Bank and special allocations of Treasury bills to the Central Bank, thereby curbing any downward pressure on the Average Weighted Call Money Rate (AWCMR). Meanwhile, the Central Bank conducted term reverse repo auctions, on two occasions, to ease liquidity pressures experienced by certain banks, towards the second half of 2021. However, by end 2021, domestic money market liquidity recorded a deficit of Rs. 366.2 billion.

Money Market Interest Rates

AWCMR, which is the operating target of the monetary policy framework, moved gradually towards the upper bound of the Standing Rate Corridor (SRC) with the tightening of money market liquidity conditions since 2021, alongside the upward adjustment of policy interest rates in August 2021. Since mid-July 2021, AWCMR remained above the middle of the SRC in line with the declining money market liquidity. Accordingly, other short term money market rates also showed an upward adjustment from July 2021 onwards. Increased borrowings by certain banks, liquidity concentration among a

Table 8.18
Summary of Money Market Transactions and OMOs

Transactions	Volume (Rs.bn)		Weighted Average Interest Rate (Min-Max) at end Year (%)	
	2020	2021	2020	2021
Market				
Call Money (Overnight)	3,234	7,935	4.52 - 7.50	4.53-5.97
Repo (Overnight)	3,151	3,533	4.53 - 7.53	4.55-6.00
Open Market Operations				
Overnight Basis				
Repo	320	1,183	6.73 - 7.51	5.71-5.99
Reverse Repo	175	-	5.88 - 7.54	-
Liquidity Support Facility	18	-	6.23 - 7.12	-
Short Term Basis				
Repo	31	423	7.01 - 7.16	5.96-5.99
Reverse Repo	66	-	4.53 - 6.85	-
Liquidity Support Facility	48	-	6.30 - 6.93	-
Long Term Basis			-	
Repo	3	60	7.10 - 7.15	6.04-6.05
Reverse Repo	299	204	4.53 - 7.53	6.13-7.20
Liquidity Support Facility	86	-	4.88 - 7.16	-
Outright Basis				
Purchase of T-bills	-	-	-	-
Purchase of T-bonds	22	-	8.42-9.68	-
Sale of T-bills	-	14	-	7.00-7.23
Sale of T-bonds	-	-	-	-
Standing Facility (at Policy Interest Rates)				
Standing Deposit Facility	32,809	29,450	4.50	5.00
Standing Lending Facility	715	30,095	5.50	6.00

Source: Central Bank of Sri Lanka

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few foreign banks as well as the exposure limits applicable for money market transactions among market participants contributed to the increase in domestic money market interest rates. Further, with the upward adjustment in policy interest rates by 50 basis points on 19 August 2021, AWCMR increased further and remained at 5.94 per cent at end September 2021. However, by end 2021, AWCMR broadly stabilised closer to the upper bound of the SRC. The Average Weighted Repo Rate (AWRR) also moved in line with AWCMR during this period. As at end 2021, AWCMR and AWRR stood at 5.95 per cent and 5.98 per cent, respectively.

Domestic Foreign Exchange Market

During 2021, the Sri Lanka rupee depreciated against the US dollar by 7 per cent from Rs. 186.41 as at end 2020 to Rs. 200.43 as at end 2021. The exchange rate, which levelled off around Rs. 186 at the beginning of the year, came under pressure during the first quarter of the year with the elevated demand in the foreign exchange market mainly due to high import volumes and continuous external debt service payment requirements despite the limited supply caused by the effects of the COVID-19 pandemic such as the delay in the revival of tourism industry, comparatively low remittances and restricted access to international capital markets amidst consecutive sovereign rating downgrades. The persistent liquidity shortage in the domestic forex market was further aggravated by lower exporter conversions and divergence of workers' remittances into informal channels with the emergence of shadow foreign exchange markets. Since the end of April 2021, banks mutually agreed to execute FX transactions within the USD/LKR exchange rate band of Rs. 200 - Rs. 203, in order to curb the depreciation pressure and market speculation on the exchange rate to a certain extent. The depreciation pressure was largely abated by the significant supply of foreign exchange liquidity, through substantial outright interventions along with a series of bilateral sell-buy foreign exchange swap transactions, to facilitate essential import bills by the Central Bank. Since early September 2021, following the Central Bank's instructions to all banks to execute FX transactions within the USD/LKR exchange rate between Rs. 200 - Rs. 203, the average spot exchange rate in the domestic interbank FX market hovered within the specified range. Meanwhile, a number of incentive schemes were introduced in line with the policy directions taken by the Government and the Central Bank to foster foreign exchange conversions while attracting more foreign exchange inflows to the country. In line with the overall depreciation of Sri Lankan rupee against the US dollar, the average US dollar buying and selling exchange rates of commercial banks for telegraphic transfers as of end 2021 were at Rs. 198.50 and Rs. 203.00, whilst comparative figures in end 2020 were at Rs. 184.12 and Rs. 189.18, respectively. Meanwhile, during the year 2021, the Sri Lankan rupee depreciated against the sterling pound, the Indian rupee and the Australian dollar.

The Central Bank was a net seller in the domestic forex market in 2021. Despite the modest purchases of foreign exchange from banks, mainly under the requirement imposed on banks to sell a certain percentage of foreign exchange to the Central Bank of converted workers' remittances and to mandatorily convert export proceeds to build up the gross official reserve position, the Central Bank significantly supplied foreign exchange to the market to facilitate essential imports. This supply of foreign exchange by the Central Bank helped address the foreign exchange liquidity shortage in the domestic foreign exchange market to a limited extent. Accordingly, the Central Bank absorbed US dollars 506 million and supplied US dollars 1,253 million, resulting in a net sale of US dollars 747 million in 2021.

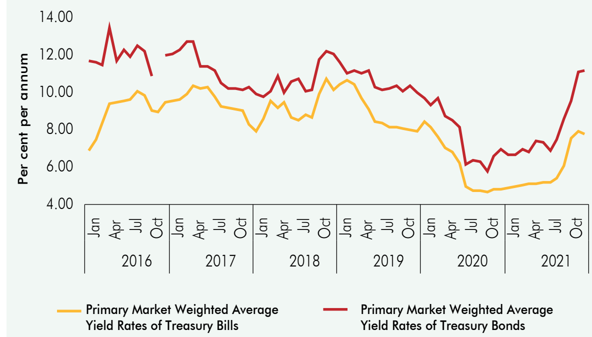
Moreover, with the objective of attracting more FX inflows to the country and thereby to improve the liquidity in the domestic FX market, the Government together with the Central Bank, offered several incentives for workers' remittances channelled through the formal banking sector. The public were also incentivised with a number of temporary measures, including an additional Rs. 10 per US dollar, when converting their foreign currency notes into Sri Lanka rupees.

In 2021, the total volume of inter-bank foreign exchange transactions amounted to US dollars 12.2 billion, compared to US dollars 18.4 billion in 2020. Accordingly, trading volumes in the domestic foreign exchange inter-bank market declined by 33.9 per cent compared to that of 2020. In line with this development, the average daily volumes in the inter-bank foreign exchange market declined to US dollars 50 million in 2021 from US dollars 77 million in 2020.

Government Securities Market

The yield curve of government securities increased and settled at higher levels towards the latter part of 2021. The yield rates of government securities adjusted upward in response to the monetary policy actions in August 2021 with a 50 basis point increase in the policy rates and a 200 basis point increase in the SRR. Another round of upward adjustments in yield rates was observed with the removal of the announcement of maximum acceptance yield rates in September 2021, coupled with negative sovereign rating actions and increased government borrowings amid allocations of unsubscribed Treasury bills to the Central Bank.

Figure 8.18
Primary Market Weighted Average Yield Rates of Treasury Bills and Treasury Bonds (per cent per annum)



Source: Central Bank of Sri Lanka

At the primary auctions of Treasury bills, the market preference was towards 91-day maturity, particularly towards the latter part of the year. On the contrary, the longer tenure Treasury bonds were preferred by investors in general at the primary auctions. The short term 91-day Treasury bill yield rates remained broadly stable towards the end of 2021 at 8.16 per cent while benchmark 182-day and 364-day remained at 8.33 per cent and 8.24 per cent, respectively. However, 91-day, 182-day and 364-day Treasury bill yield rates increased by 314, 334 and 324 basis points respectively as at end 2021 from end 2020. The yield rates of Treasury bonds also increased noticeably during

Table 8.19
Yield Rates of Government Securities

Per cent per annum

Item	Primary Market		Secondary Market	
	2020	2021	2020	2021
Treasury bills				
91-Days	4.51 - 7.55	4.69 - 8.43	4.50 - 7.54	4.63 - 8.00
182-Days	3.87 - 8.15	4.75 - 8.33	4.61 - 8.12	4.71 - 8.07
364-Days	4.13 - 8.61	4.98 - 8.26	4.80 - 8.57	4.94 - 8.33
Treasury bonds				
2 Years	5.47 - 5.86	6.19 - 9.36	5.16 - 8.94	5.25 - 8.96
3 Years	5.72 - 9.33	6.25 - 9.94	5.59 - 9.38	5.68 - 9.81
4 Years	6.32 - 9.39	6.34 - 8.55	6.02 - 9.59	6.21 - 10.40
5 Years	6.50 - 9.81	6.72 - 11.14	6.30 - 9.81	6.43 - 11.03
6 Years	6.57 - 8.59	7.44 - 10.90	6.37 - 9.89	6.61 - 11.26
8 Years	6.97 - 9.99	7.16 - 11.63	6.63 - 9.99	6.98 - 11.55
10 Years	9.99	8.86 - 11.91	6.84 - 10.05	7.44 - 11.80
15 Years	7.84	8.44 - 12.06	7.13 - 10.18	7.76 - 11.85
20 Years	-	-	7.15 - 10.25	7.89 - 11.83
30 Years	-	-	7.61 - 10.52	8.04 - 11.81

Source: Central Bank of Sri Lanka

Table 8.20
Primary Market Weighted Average Yield Rates of Treasury Bills

Per cent per annum

Year	Maturity			Annualised Overall Average
	91-days	182-days	364-days	
2017	9.01	9.80	10.07	9.77
2018	8.40	8.58	9.68	9.36
2019	8.15	8.44	9.40	9.06
2020	5.93	5.72	6.37	6.09
2021	6.35	6.13	5.33	6.24

Note: 10% Witholding tax on interest on Government Securities was removed effective from 01st April, 2018

Source: Central Bank of Sri Lanka

2021. In aggregate, Treasury bonds amounting to Rs. 1,762 billion with a Weighted Average Yield Rate (WAYR) of 8.70 per cent were issued in 2021 compared to Rs. 1,332.1 billion with a WAYR of 7.39 per cent in 2020. Moreover, Treasury bills amounting to Rs 3,821.4 billion were issued in 2021 with an overall WAYR of 6.09 per cent compared to Rs. 2,590.5 billion issued with an overall WAYR of 5.82 per cent in 2020.[2]

Access to international capital markets remained restrictive compounded by multiple negative sovereign ratings, prohibitive secondary market yield levels for Sri Lanka's ISBs, and continued uncertainties emanating from the COVID-19 pandemic. The ISB which matured in July 2021 was settled without resorting to new ISB issuance in line with the intention of gradually reducing of external liabilities, especially high cost commercial borrowings. In the domestic foreign currency financing front, SLDBs amounting to US dollars 1,041.3 million were raised in 2021, which is marginally lower than the SLDBs matured during the year.

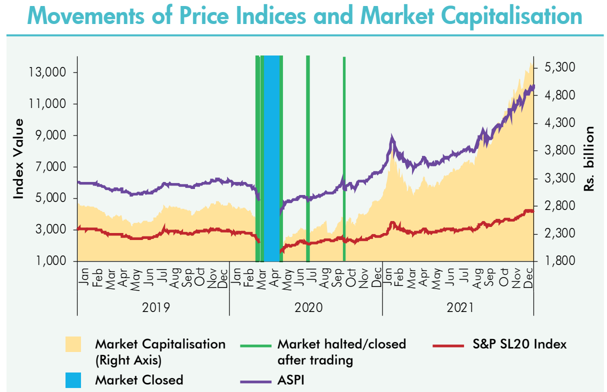
The total net outflow of foreign investments in Treasury bonds and Treasury bills amounted to US dollars 27.3 million during the year compared to the outflow of US dollars 552.7 million in 2020. In rupee terms, foreign holdings in government securities were recorded at Rs. 1.8 billion at end 2021 compared to Rs. 6.7 billion at end 2020, opening up substantive space for new investments.

Equity Market

The Colombo stock market recorded an exponential growth during the year 2021, driven by local investors. The All Share Price Index (ASPI) and Standard & Poor's Sri Lanka 20 (S&P SL 20) index recorded growth of 80.5 per cent and 60.5 per cent, respectively, during the year 2021. The market capitalisation stood at Rs. 5,489.2 billion as at end 2021 recording a growth of 85.4 per cent. Further, market capitalisation as a percentage of GDP reached a 10-year high of 36.7 per cent at end 2021 compared to 19.7 per cent at end 2020.

Domestic investors' presence in the equity market was prominent with their preference shifting towards equity investments due to the prevailed low interest rate regime in 2021. Quantities of securities held by local individual investors increased to Rs. 30.5 billion as at end 2021 recording a year-on-year growth of 53.3 per cent. Meanwhile, quantities of securities held by local institutional investors recorded a

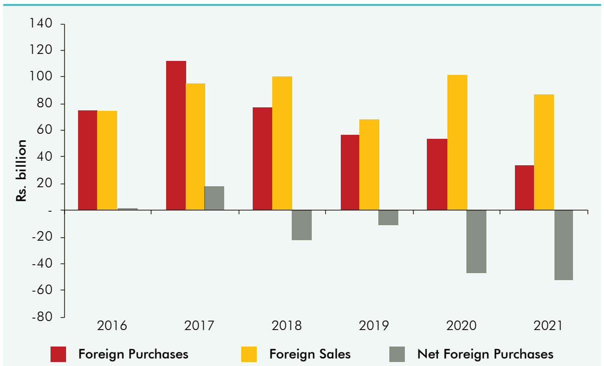
Figure 8.19
Movements of Price Indices and Market Capitalisation



Source: Colombo Stock Exchange

2 The overall WAYR includes the total average borrowing cost, including the cost of administratively instructed issuances.

Figure 8.20
Foreign Participation at the CSE



Source: Colombo Stock Exchange

17.8 per cent year-on-year growth. However, the quantities of securities held by individuals and institutional foreign investors recorded a marginal a year-on-year growth of 0.3 per cent and 2.6 per cent, respectively.

With active domestic investor participation and some timely initiatives carried out by both the Colombo Stock Exchange (CSE) and Securities and Exchange Commission (SEC) such as digitisation, the daily turnover and capital raising improved during 2021. During 2021, there were 13 new equity Initial Public Offerings (IPOs) which raised Rs. 12.7 billion. The Price to Earnings Ratio (PER) and Price to Book Value (PBV) stood at 13.6 and 1.7, respectively, at end 2021 compared to PER of 11.2 and PBV of 1.1 remained by end 2020. The secondary market recorded an extraordinary average daily turnover of Rs. 4,888.2 million during the year 2021 compared to an average daily turnover of Rs. 1,899 million recorded during the year 2020.

Foreign participation at the market remained negligible during the period under review. Only 2.9 per cent of total turnover in 2021 originated through foreign purchases compared to the 13.4 per cent contribution recorded in 2020, while foreign outflows from the market continued. The market recorded Rs. 52.6 billion foreign outflows during the year 2021 compared to an outflow of Rs. 51.1 billion recorded during the previous year. Accordingly, the foreign holding as a percentage of the total value of equity reduced to 24.6 per cent as at end 2021, compared to 25.4 per cent recorded at end 2020.

Corporate Debt Securities Market

The Commercial Paper (CP) market was relatively active in 2021 compared to 2020. During 2021, Rs. 5.8 billion was raised through the CPs issued with the support of licensed banks compared to Rs. 4.5 billion raised through issues in 2020. Interest rates of CPs varied between the range of 6.00 to 12.00 per cent during the year 2021 compared to the range of 6.50 to 15.50 per cent reported in the previous year.

Level of activity in the corporate debenture market improved significantly during 2021 compared to 2020. During 2021, there were 27 IPOs of corporate debentures issued by 14 companies in the CSE which raised Rs. 84.4 billion compared to Rs. 21.9 billion raised in 2020. Debentures with both fixed and floating interest rates were issued during 2021 while the fixed interest rates were in the range of 8.00 to 12.00 per cent compared to the range of 9.00 to 13.25 in the previous year.

8.5 Development Finance and Access to Finance

The Central Bank through various credit schemes contributed to overcome the challenges faced by MSMEs including self-employed individuals of all economic sectors during the COVID-19 pandemic. The Central Bank continued to coordinate, facilitate, and implement various refinance, interest subsidy and credit guarantee schemes, while providing a range of credit supplementary services during 2021. Total loans released during 2021 was Rs. 27,268 million among 80,899 beneficiaries through Participating Financial Institutions (PFIs) under 14 refinance loan schemes and 6 interest subsidy and credit guarantee schemes of which 58 per cent accounted for refinance schemes and 42 per cent accounted for interest subsidy and credit guarantee schemes.

Extraordinary measures were taken by the Central Bank to cope with the COVID-19 Pandemic. The Central Bank continued to implement several extraordinary policy measures throughout the year providing concessions to businesses and individuals affected by the pandemic. Accordingly, moratoria were offered for the concessionary credit schemes implemented by the Central Bank viz extending the repayment period up to 36 months from 24 months and grace period until 30 September 2021 and subsequently extended until 31 December 2021. Further, the tourism sector was facilitated with extraordinary measures by extending the grace period for loans until 30 June 2022. The Central Bank continued to support MSMEs by providing moratoria and implemented several credit schemes. With the intention of establishing market driven value chain financing in the country, the Central Bank implemented a Domestic Agriculture Development programme (DAD-PP) as a pilot project to identify gaps and opportunities to develop a comprehensive value chain programme for the agriculture sector in Sri Lanka. Further, Operating Instructions were issued to introduce and implement a credit guarantee and interest subsidy scheme for MSME rice mill owners and intensification of shrimp farms in Sri Lanka. A credit guarantee and interest subsidy scheme to enhance the dairy farming and developing MSMEs were initiated in 2021.

Developing and implementing a National Financial Inclusion Strategy (NFIS) for Sri Lanka was identified during the recent past as a key focus area of the country in order to achieve the Sustainable Development Goals. The Central Bank successfully launched the NFIS of Sri Lanka in March 2021 and several actions were taken to operationalise the implementation of the NFIS to identify and promote financial inclusion across the country. In recognition of the need for improving financial education as a priority action across all policy pillars of the NFIS, an island wide financial literacy survey was successfully completed in 2021, and the modules and educational materials are being developed by the Ministry of Education in collaboration with the Central Bank and other relevant stakeholders to incorporate financial education into the school curriculum as a compulsory subject starting from Grade 6 to 11.

Financial literacy is one of the main pillars identified under the NFIS and a main role has to be played by the Regional Development Department (RDD) of the Central Bank in order to enhance financial literacy of the country's people. With the objective of enhancing financial literacy throughout the country, RDD initiated several programmes during the year with the support of 6 Regional Offices of the Central Bank. Accordingly, 08 Training of Trainers (TOT) discussions, 17 Radio and TV programmes, 07 knowledge sharing programmes and more than 330 financial literacy, entrepreneurship and skill development programmes were conducted in 2021. Amidst the constraints associated with widespread uncertainties of the COVID-19 pandemic, several programmes were carried out as online programmes utilising the newly developed online oriented training and awareness materials.

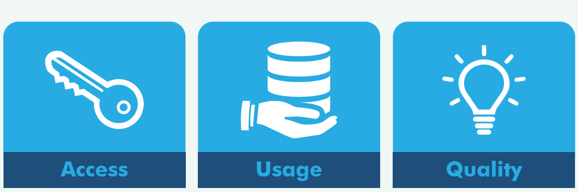
BOX 10
National Financial Inclusion Strategy of Sri Lanka: "Better Quality Inclusion for Better Lives"

Introduction

Financial inclusion can be broadly defined as the state, where individuals and businesses have access to useful and affordable financial products and services that meet their needs – transactions, payments, savings, credit and insurance – delivered in a responsible and sustainable way.[1] Financial inclusion is also identified as inclusive finance, since it strives to remove barriers for individuals and businesses to participate in the formal financial sector and to use financial services to improve their sources of income and standards of living.

The concept of financial inclusion has become a central part of global policy agenda since early 2000. Many countries use financial inclusion as an effort to promote a level playing field for individuals and businesses to work towards elevating themselves out of poverty and contribute to sustainable economic growth. Increasing access to financial services and products for those who are excluded from the financial sector enables them to plan and better manage their finances, while opening up opportunities for better standards of living. Access to finance for Micro, Small and Medium Enterprises (MSMEs) encourages them to invest in new and more productive business activities, contributing to economic growth while generating employment opportunities. Although, financial inclusion alone cannot elevate people out of poverty, it helps to promote building better lives. Further, the importance of financial inclusion is now widely recognized in building a strong foundation of a country's financial stability, which in turn will facilitate inclusive economic development. In this regard, upgrading financial inclusion concepts and efforts to the policy platforms requires assessment and quantification of level of financial inclusion and careful scrutinisation of the actual requirements of the economy and the individuals.

In this backdrop, assessment of the level of financial inclusion in Sri Lanka has been carried out by the Sri Lankan policy makers with the intention to set targets at national level and to monitor the progress of the financial inclusion initiatives under three dimensions:



1 World Bank

"Access" dimension reflects the depth of outreach of financial services, i.e. penetration of bank branches, ATMs or Point of Sale (POS) devices, or demand-side barriers faced by customers to access financial institutions, such as cost or information. "Usage" dimension reflects how customers use financial services, such as the frequency and duration of the financial product/service over time. "Quality" of the products and the service delivery describe the availability of choices to meet the needs of the customer, as well as aspects of financial consumer protection and the degree of the awareness and understanding of financial products and services.[2]

Where does Sri Lanka Stand on Financial Inclusion?

Sri Lanka's long-standing efforts to increase financial inclusion date back to the early 20th century. As a result of these efforts, Sri Lanka has made significant advancements in financial inclusion. According to the National Financial Inclusion Survey conducted by CBSL, supported by International Finance Corporation (IFC), World Bank Group, in 2018, account ownership in Sri Lanka stands at 88 per cent, which is higher than the South Asia average.[3] Noticeably, it has been reported of having no gender disparity or any significant difference in account ownership among less advantaged segments of the population, including rural residents, or low-income people. Sri Lanka also enjoys high level of bank branch penetration, with bank branch density of 16.4 branches per 100,000 adults as of December 2021.[4] However, in contrast to the high literacy level (92.9%[5]) among the Sri Lankans, the low level of financial literacy (35%[6]) has been recognized among certain pockets as an impediment to the universal achievements.

More broadly, despite high levels of access, usage of accounts and uptake of other financial products and services such as mobile money, insurance, retirement schemes and bond and equity instruments are modest. More importantly, access to appropriate credit products from formal providers remains a significant barrier for both individuals and MSMEs.[7] Although, urban and industry MSMEs get better access to formal financial sources, small scale village based MSMEs are often denied of access to financial facilities in Sri Lanka. As a result, vulnerable groups have been forced to resort

2 World Bank, 2015

3 Global Findex, 2017: 73.65 per cent of adults in Sri Lanka have accounts at a financial institution and the regional average in South Asia is 70 per cent (36 per cent excluding India).

4 CBSL

5 Economics and Social Statistics Report, 2021, CBSL

6 The Standard and Poor's Global Financial Literacy Survey, 2014-2015

7 National Financial Inclusion Strategy of Sri Lanka

to the informal sector, thereby exposing them to higher risks, difficulties due to financial malpractices and make them more vulnerable to poverty. The potential for further growth in usage of digital payments and other Digital Financial Services has been highlighted by the National Financial Inclusion Survey 2018. However, the nation has failed in reaping maximum possible benefits to a sustainable extent, due to lack of financial skills and capability to make use of available financial products and services. Lack of an effective regulatory authority and legal protection for affected groups have been the major factors that have contributed to the financial exclusion practices observed in Sri Lanka.

In this context, the formulation of the National Financial Inclusion Strategy (NFIS) of Sri Lanka is considered as a timely initiative, bringing together all key stakeholders for the first time to carry out a long-term, comprehensive and coordinated strategy for achieving financial inclusion in Sri Lanka. The development of the NFIS has been led by the CBSL with the collaboration of all stakeholders, including government institutions, formal financial service providers and other relevant professional bodies. The NFIS was approved by the Cabinet of Ministers in March 2020 and launched in March 2021 by the CBSL and currently in operation in collaboration with more than 20 implementing entities.

NFIS Policy Framework and Implementation

The aim of the NFIS is to provide a long-term, comprehensive, standardised and well-coordinated approach for all stakeholders to move towards improving the financial inclusiveness of the country.

The vision of the NFIS of Sri Lanka provides the strategic direction for the priorities of the Strategy, that reflects the aspirational, long-term goal that stakeholders of the NFIS seek to collaboratively achieve.

"Better quality inclusion for better lives"

All individuals and enterprises in Sri Lanka have well-informed, fair and equitable access to a range of high-quality, appropriate, secure and affordable financial products and services that they can use to contribute to economic growth and improve their standard of living.

The vision incorporates important concepts beyond simple "access" to financial services, where prevalence of enabling environment for well-informed consumers to select and use financial products and services appropriately. The NFIS focuses on ensuring expanded access to high-quality financial products that are appropriately designed, affordable and delivered through formal financial sector.

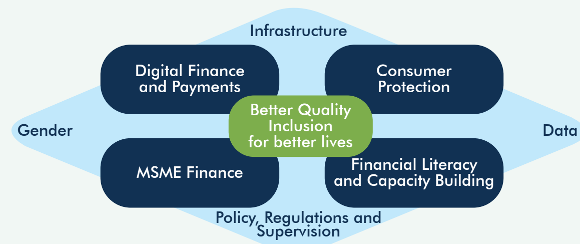
Sri Lanka's country definition of financial inclusion is aligned with the vision of the NFIS, which recognised financial inclusion is not as a stand-alone goal, yet lead to positive economic and social impact to the community.

Financial inclusion *is a state where all individuals and enterprises in Sri Lanka can access high-quality, appropriate, secure, and affordable financial services based on their needs and an informed choice and use these services efficiently and effectively to support their economic activities and improve the quality of their lives.*

The NFIS clearly defines a set of specific policy objectives that are centered around four key policy pillars.

I. Digital Finance and Payments,
II. Micro, Small and Medium Enterprises (MSME) Finance,
III. Consumer Protection and
IV. Financial Literacy and Capacity Building.

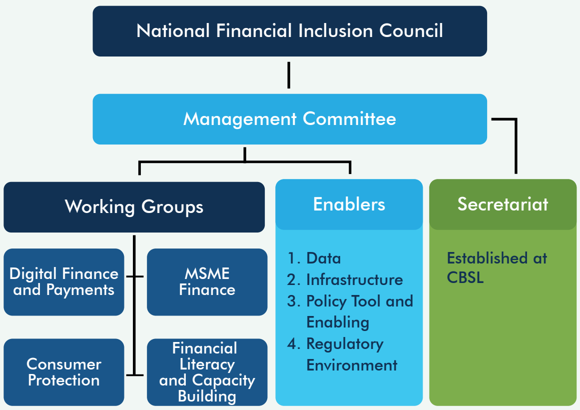
A set of core enablers has also been identified to support achieving progress in these focus areas, namely; Data, Infrastructure and Policy Tools and Enabling Regulatory Environment.



The Framework of the NFIS

By assessing the current state of financial inclusion and identifying obstacles and opportunities relevant to each pillar, necessary policy initiatives have been identified and the Action Plan of the NFIS has been formulated accordingly to achieve higher level of financial inclusion. The Action plan comprises a set of sequenced and time-bound actions with clear indication of institutional level responsibilities.

In operationalising the NFIS of Sri Lanka, a governance structure comprising 04 levels of entities has been established. The National Council at the top level is to provide overall policy guidance relevant to implementation of the NFIS with the Management Committee entrusted to oversee the day-to-day implementation of the NFIS and to provide regular updates to the National Council. Meanwhile, Working Groups under each policy pillar are to serve as consultation forums with the NFIS Secretariat established at the CBSL to ensure coordination and monitoring across different implementing entities to secure achieving NFIS targets within the intended time frame.



NFIS Governance Structure

The National Results Framework of NFIS under the Monitoring and Evaluation (M&E) system explicitly articulates the expected outcomes throughout the process with the key objectives of financial inclusion translated into measurable indicators. Encompassing all policy areas, the need of improving financial education has been highlighted as a priority action in the overall process. Prioritising the actions introduced under the policy areas of financial literacy and capacity building, respective stakeholders are actively collaborated in implementing the actions. As a timely and an effective policy tool to ensure financial inclusion among future generations, the Ministry of Education has undertaken several measures along with relevant stakeholders in order to incorporate the financial education into school curriculum as a compulsory element from grade 6 to 11.

In order to standardise the adult's financial education programmes, education modules on financial literacy and digital literacy were developed and Training of Trainers (TOT) programs are being rolled out. Further, an island wide financial literacy survey was conducted in 2021 to assess the level of financial literacy of the country. The data collected through the survey will be used to assess the level of financial literacy among Sri Lankans. The survey has been designed according to standard financial literacy score system recognized internationally under three key elements of financial knowledge, financial behavior and financial attitudes. Considering the importance of moving towards a single direction, a coordination mechanism is being developed to improve synergies across all the stakeholder entities conducting financial literacy programmes and MSME support programmes. Going beyond, the proposed Financial Literacy and Capacity Building Road Map will set out the strategic direction and principles for development and implementation of financial education and MSME support programmes.

How NFIS will support achieving the financial inclusion goals in Sri Lanka ?

The strategy is not limited to improving the overall national financial inclusion level, but also is aimed at reducing disparities in levels of financial inclusion combined with social and demographic attributes such as income, geographical location, age, gender etc., by the conclusion of the NFIS.

It is expected to increase access to financial products and services that help unserved and underserved segments to improve their financial resilience. Further, with the increased access to finance, MSMEs will grow and become more productive towards generating income and creating more formal employment opportunities.

In parallel, with well-designed, coordinated and comprehensive financial literacy initiatives will broader the right financial knowledge, skills and behavior of financial consumers and will ensure the ability of future Sri Lankans to meet their basic financial needs. More financially capable and empowered consumers will eventually promote good market conduct and improve financial services, resulting in a virtuous cycle for financial inclusion. Through the NFIS, consumer protection will also be reinforced by having appropriate regulatory environment to strengthen the market conduct of all types of financial service providers. The best practices to be established for well-being of customers, while increasing trust of consumers facilitating the broader objective of financial system stability.

The significant improvements in the digital finance ecosystem on the other hand, will be a boon for financial inclusion, as they facilitate significant cost efficiencies and viable delivery of financial services to the low-income individuals and small enterprises of the society complemented by a more conducive regulatory environment and necessary digital infrastructure, enabling market players to deliver more innovative financial services.

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8.6 Financial Infrastructure

Payment and Settlement Systems

Amidst several waves of the COVID-19 pandemic during 2021, the Central Bank continued to facilitate economic activities by ensuring uninterrupted payment and settlement services in the country. The Central Bank continued to regulate and supervise the payment and settlement systems in the country to facilitate an efficient and secure national payment infrastructure.

The LankaSettle System, which consists of the Real Time Gross Settlement (RTGS) System, and the LankaSecure System operated smoothly to accommodate the increasing transaction volumes during the period under review. The value of RTGS transactions recorded a significant increase of 96.3 percent during 2021. In value terms, the share of RTGS transactions in total non-cash payments accounted for 94 per cent during the period under review. The Central Bank continued to provide the interest free Intra-day Liquidity Facility (ILF) against the collateral of government securities to the Participating Institutions (PI) of the RTGS System to avoid any disruptions that could arise due to any liquidity issues of PIs. During 2021, the Central Bank released a daily average value of Rs. 208.5 billion per business day to PIs who requested the ILF.

The aggregate of Scripless Securities held in LankaSecure as at end 2021 was Rs. 9,238.6 billion (Face Value) which comprised of Treasury bills and Treasury bonds worth Rs. 2,270.7 billion and Rs. 6,967.9 billion, respectively. LankaSecure facilitated transactions[3] amounting to Rs. 262.8 trillion during 2021.

3 The LankaSecure system settles all government securities related transactions including transactions of primary issuances, secondary market trades (outright, repurchase transactions, pledge transactions), Open Market Operations, and Intra-Day Liquidity Facility.

During 2021, the Cheque Clearing System of the country operated by LankaClear (Pvt.) Ltd (LCPL) cleared a total volume of 33 million cheques amounting to Rs. 8,311.5 billion. Even though the volume of cheques cleared by LCPL demonstrates a marginal decrease of 1.8 per cent, the value of the cheques recorded a 11 per cent growth compared to the previous year.

The Sri Lanka Interbank Payment System (SLIPS), which is operated by LCPL, mainly facilitates low value retail bulk payments, and recorded a growth in terms of both the volume and value of payments by 13.7 per cent and 26.8 per cent to 41.9 million and Rs. 2,862.2 billion, respectively, during 2021.

Common ATM Switch (CAS), the first phase of Common Card and Payment Switch (CCAPS), enables cash withdrawals and balance inquiries from any Automated Teller Machine (ATM) connected to the CAS network. The transaction volume of CAS increased by 18.8 per cent to 58.2 million, while the value of CAS transactions increased by 32.4 per cent to Rs. 671 billion, respectively, during the period under review. As at end 2021, 29 financial institutions were integrated to the CAS network. Shared ATM Switch, which was launched in 2015 to provide services to financial institutions, which do not have the capacity to operate their own card management system, had two members and continued its operations smoothly during the review period.

Common Electronic Fund Transfer Switch (CEFTS), which was launched in 2015, facilitates retail fund transfers among member institutions on a real time basis. The volume of CEFTS transactions demonstrated a significant growth of 97.8 per cent from 27.6 million to 54.7 million, while the CEFTS transaction value increased by 104 per cent to Rs. 4,926.6 billion from Rs. 2,415.3 billion during 2021. This was mainly due to the promotional

Table 8.21
Transactions Through Payment Systems

Payment system	2020(a)		2021(b)	
	Volume ('000)	Value (Rs. bn)	Volume ('000)	Value (Rs. bn)
Large Value Payment Systems				
RTGS System	397	150,051	450	294,602
Retail Value Payment Systems				
Main Cheque Clearing System	33,631	7,491	33,021	8,311
Sri Lanka Interbank Payment System (SLIPS)	36,830	2,257	41,868	2,862
Credit Cards	44,692	222	50,689	283
Debit Cards	75,094	210	108,040	316
Internet Banking	57,861	4,442	135,387	6,470
Phone Banking	26,701	485	27,897	538
Postal Instruments	646	5	596	5
Total	275,852	165,163	397,948	313,387
US Dollar Cheque Clearing System	32	48	28	51

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

campaigns conducted continuously by the Central Bank and financial institutions to promote digital payment methods and consumers switching to digital payment methods since the Government reimposed travel restrictions due to the COVID-19 pandemic.

EPF, Import and Export Control Department, Sri Lanka Standard Institution and the Department of Inland Revenue also joined the LankaPay Online Payment Platform (LPOPP), which was launched in order to facilitate online payments to government institutions via CEFTS during the period under review. The LPOPP transaction volume significantly increased by 433.9 per cent, from 96,258 transactions to 513,961 transactions, while the LPOPP transaction value grew from Rs. 75.3 billion to Rs. 198.2 billion by 163.1 per cent during the period under review. The increase in the volume and value of LPOPP transactions was largely due to the increase in transactions related to the Sri Lanka Customs and the Department of Inland Revenue joining LPOPP during the review period.

During 2021, a substantial growth was observed in LANKAQR based transactions with total volume and value which increased by 625.4 per cent to 1,154,984 and 361.3 per cent to Rs. 2,487 million, respectively, with 126,670 joining as new LANKAQR merchants. With the aim of popularising LANKAQR payments among small and medium merchants as well as consumers, the "LANKAQR Nationwide Rollout Campaign" was launched in October 2021. Further, the maximum Merchant Discount Rate of 0.5 per cent for LANKAQR initiated transactions was extended until further notice to encourage merchants to accept LANKAQR as a payment mode.

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 to function as issuers of debit cards as per the Regulations. Due to the resurgence of the COVID-19 pandemic and the Government imposing travel restrictions, virtual onsite supervision was carried out with respect to a service provider of mobile payment systems while off-site supervision was strengthened to continue to monitor compliance with the regulations imposed on service providers of payment cards and mobile payment systems to ensure smooth functioning of licensed service providers.

The Central Bank successfully concluded the deployment and testing of the Proof of Concept (POC) for the Blockchain Technology based shared Know Your Customer (KYC) facility. This indicated the potential of Blockchain Technology to enable innovations in the financial sector in Sri Lanka.

The National Payments Council (NPC), the industry consultative and monitoring committee on payment and settlement systems continued to monitor the Payment System Road Map for

BOX 11
The FinTech Invasion: Way forward for Banking Supervisors

Introduction

Banking has had a close relationship with technology for decades, from computerised banking systems to automated teller machines (ATM) to internet banking systems. Adoption of technology has enabled banks to continuously increase efficiencies, lower intermediation cost, and increase profitability. The intensive use of technology by banks to increase profitability has attracted the attention of the technology investors and has created new business avenues, giving rise to the modern day's FinTech industry.

FinTech or Financial technology as it is more formally known, has grown rapidly during the last decade and is now posing challenges to both traditional banking business models as well as traditional banking supervisory methodologies.

In addition to increased efficiencies, products and services enabled by FinTech also offer opportunities for unbanked and underbanked population, who may have limited or no access to banks, to receive traditional financial services through non-traditional channels. This is mainly due to the use of smart mobile phones as a primary channel to deliver FinTech based banking services and relatively high mobile phone penetration even among the underprivileged segments of population. Accordingly, it is evident that FinTech provides opportunities for more competition, increased efficiency, and reduced intermediation cost in banking business. However, complacency on the part of traditional banks will see them rapidly losing business to emerging FinTech driven companies as a result of flight to efficiency by banking customers.

The rapid emergence of FinTech has given rise to potential new risks relating to technology, data governance, and market conduct. This poses the need for a supervisory approach that supports fintech adoption by the banking industry. Such an approach needs to address relevant risks to protect consumers while fostering innovation and competition.

Fintech innovations that will impact traditional banking

Even though there are many FinTech innovations, some will significantly impact the traditional banking channel. Virtual banking, open banking, peer-to-peer lending, and digital currencies are four such FinTech innovations that have the potential to materially change the way traditional banking is conducted. These are explained in detail below:

Virtual banking

A bank that offers its services entirely through electronic channels without requiring physical interaction with customers is considered a virtual bank. This will provide significant cost savings due to reduced need for physical locations and staff. Both existing and newer banks are pursuing virtual banking due to the cost attractiveness. Customers of a virtual bank will be able to perform all banking activities from account opening to making deposits to borrowing funds via mobile application or through internet banking instead of visiting a bank branch. Virtual banking will also be one of the most convenient ways for traditional banks to successfully counter challenges emerging from FinTech driven banks and services offered by other FinTech businesses, due to the decision making and processing functions being similar for banking products offered through both traditional and virtual banking.

Open banking

Open banking allows consented third parties to access customer data in a bank using application programming interfaces (API). This enables third-party FinTech providers to present variety of solutions to consumers such as mobile applications that allow accessing banking data from different financial institutions and easily perform transactions using multiple banks. A bank that has enabled open banking will become significantly different from a traditional institution. Open banking puts customers in control of their data, which gives consumers the opportunity to take advantage of customized and precision designed financial services that their original bank could not offer initially. Accordingly, both individual customers and businesses will be able to manage their finances more efficiently with open banking. Even more importantly, open banking facilitate innovation in the FinTech industry, allowing new technologies to emerge and reengineer how financial services are offered by banks.

Peer-to-peer lending platforms

Peer-to-peer lending is probably the most direct challenge posed to the traditional banking model by emerging FinTech businesses. Peer-to-peer lending platforms intend to directly connect lenders and borrowers, thereby drastically reducing the cost of financial intermediation. The peer-to-peer lending platforms initially emerged as an alternative funding source for unbanked and underbanked customers who do not have access to bank lending. However, due to its cost efficiency peer-to-peer lending is now attracting usual customers of traditional banks as well. Even a medium scale migration of banking customers to peer-to-peer lending platforms will become a financial stability concern for banking supervisors, given that there are no prudential measures such as capital adequacy or liquidity requirements as well as safety net measures like deposit insurance for peer-to-peer lending activities.

Digital currencies

The emergence of digital currencies is probably the biggest FinTech driven challenge faced by traditional monetary and banking systems. Two types of digital currencies, cryptocurrencies and central bank digital currencies (CBDCs), are likely to become significant as banking and financial transactions conducted by general public becomes more digital. Cryptocurrency is a digital asset that is secured by cryptography and operates using blockchain technology, which is a distributed ledger that utilizes a large decentralized network of computers. Cryptocurrencies are not issued by any central authority such as a Central Bank. This also make cryptocurrencies less affected by government interventions and thereby possibly impacting the effectiveness of central bank monetary policy. On the other hand, CBDCs that will be issued by a country’s monetary authority will act as a digital token of the country's official currency. As CBDCs are issued by a country’s monetary authority they are fully backed by the issuing government and will be under the full policy control of the issuing monetary authority.

What should be the regulatory and supervisory approach towards FinTech

The need to adopt an open yet cautious regulatory approach when facilitating banks’ adoption of FinTech

The rapid rise of FinTech raises questions to banking supervisors, such as the need to expand the supervisory limits to include new risks; whether existing regulations are adequate for newer types of digital financial services; and how to identify, monitor and mitigate the risks faced by banks due to FinTech innovations and exposures to FinTech businesses.

Further, FinTech driven products and services are heavily reliant on range of information systems and data connected to the internet. Therefore, technology, cybersecurity and data protection related risks associated with FinTech needs to be well understood and prudently managed.

However, it should be noted that excessive regulation and supervision may deter innovation and could place banks at a competitive disadvantage while also discouraging consumers. Therefore, banking supervisors need to carefully assess risks and benefits and avoid hindering required innovation.

There are two extremes in the supervisory approaches that could be taken by banking supervisors when it comes to the supervision of FinTech products and services. The first is the “laissez faire” approach, where innovation is permitted without any supervisory intervention up to the point where serious risks to the banking system emerge. The other extreme approach is to limit innovation only to products and services desired by the supervisors by enforcing regulations that limit innovation.

The need for supervisors to move on with Supervisory Technology (SupTech)

It is the responsibility of the banking supervisors to keep the banking system stable while utilizing the benefits of FinTech for the betterment of both the consumers and the banks. The current supervisory policies, techniques, and resources, that are designed to address risks posed by traditional banking channels, could be inadequate to address the risks introduced by FinTech. Further, the amount of resources of a banking supervisor is limited. Therefore, the adoption of supervisory practices that enable effective supervision, with the use of limited resources and a focus on risk and stability of financial institutions has become imperative.

These factors have required bank supervisors developing and implementing new technology based supervisory approaches, broadly referred to as Supervisory Technology or SupTech. The adoption of SupTech by banking supervisors will have a deep impact on how banks are supervised.

Essential SupTech capabilities for banking supervisors

Sophisticated supervisory information systems, advanced data analytic capabilities, and use of artificial intelligence to extract knowledge from relevant unstructured data sources are some of the key SupTech capabilities required for any modern banking supervisor. These are detailed below:

Supervisory information systems

A supervisory information system is an information system that facilitate collection, validation, and analytics of information reported by banks and other financial institutions. The features of such includes functionality for banks to submit data or for the supervisor to retrieve data; a data warehouse with facilities to store, manage, and secure documents and data; smaller databases or datamarts to enable data querying and analysis by different teams within the banking supervisor; and data analytics and business intelligence tools that enable generation of supervisory insights.

Advanced data analytics capabilities to generate accurate and timely early warning signals

Banking supervisors will benefit immensely by implementing advanced data analytics capabilities together with a supervisory information system. This will include capabilities for querying, analysis, and visualization of data. An analytics platform will facilitate end-to-end computation of both standardized and ad hoc data analysis requirements of bank supervisors.

A comprehensive data analytics platform will enable generation of early warnings for different risk categories, banks, and clusters of banks through predictive analytic models using structured data submitted by banks, data insights from credit bureau and other external data repositories, and macroeconomic forecasts. Such a platform will also enable the banking supervisors to conduct periodic forward looking stress tests based on macroeconomic forecasts and institutional trends.

Use of artificial intelligence (AI) to generate supervisory insights from public and non-public unstructured data

Fully developed data analytics capabilities should enable banking supervisors to conduct analysis and interpretation of both structured and unstructured data using conventional statistical tools as well as emerging artificial intelligence-based technologies. Accordingly, use of artificial intelligence based technologies by banking supervisors to generate supervisory insights from public and non-public unstructured data will focus on extracting knowledge from various unstructured (text based) data sources to augment structured data based analytics and computations already conducted on the data analytics platform including bank ratings and early warning computations.

Initiatives already taken by CBSL

CBSL has taken multiple steps to facilitate FinTech as well as to address the key risks. Some of these initiatives are detailed below:

Regulatory framework on technology risk management and resilience

The CBSL in 2021 introduced regulatory framework on technology risk management and resilience as a set of minimum regulatory requirements for licensed banks. The key characteristics of the framework are the introduction of enhanced information security, system availability, and resilience requirements for critical information systems, enhanced information security requirements for sensitive data, and higher risk management measures for domestic systemically important banks.

The components of the regulatory framework include requirements relating to governance framework for technology risk management, information security, information system availability and disaster recovery, staff competencies, compliance with international standards, and use of third-party infrastructure including cloud computing.

Proof-of-concept (POC) on KYC data sharing

In 2021, CBSL also completed the process of developing and testing a Blockchain technology based shared Know-Your-Customer (KYC) Proof-of-Concept (POC) solution. The purpose of developing a Blockchain Technology based POC of an industry-wide Shared KYC process was to assess the potential to improve customer experience, lower operational costs and reduce the operational risk of banks and other financial institutions. It is expected that digitalization of the KYC process, especially with user friendly and secure designs, would encourage customers to use digital financial services and increase their access to financial services.

The findings demonstrated several salient features of Blockchain Technology that enabled secure and efficient sharing of customer KYC information between banks. This was a pioneering national project initiated by the CBSL that drew the voluntary participation of the Banking Industry and the Information Technology Industry to collaboratively explore the potential of Blockchain Technology to enable innovations in many financial services.

Regulatory sandbox

In 2020, CBSL commenced operations of a FinTech Regulatory sandbox with the objective of encouraging and enabling FinTech initiatives that promote greater efficiency and increased access to financial products and services. The sandbox is intended to provide a safe space for selected innovators to test their products and services, without the risk of infringing on regulatory requirements.

Way Forward

In order to obtain the maximum economic benefits from FinTech while ensuring that it does not impact the financial system stability adversly, the financial sector regulators will need to adopt a two-fold approach. The financial regulators shall make necessary changes to the regulatory framework to ensure that the regulatory environment facilitates FinTech innovations appropriately, while risks posed by such innovations are adequately monitored and mitigated. Further, such FinTech enabling regulatory framework shall need to be continuously evolving to reflect the changes introduced by rapidly developing FinTech industry. On the other hand, the supervisory capacity of banking supervisors needs to be significantly enhanced by moving to more technology based and automated supervisory methodologies. These will include implementing modern supervisory information systems, developing advanced data analytics capabilities, and introducing artificial intelligence assisted supervisory technology (SupTech) tools. Such a supervisory environment will enable the banking supervisors to effectively supervise the banking system in a FinTech driven era.

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2020-2022 and discussed the draft Road Map for 2022-2024 to increase efficiencies in the financial sector while monitoring the risks in order to effectively facilitate economic activities of the country. The report of the NPC appointed working committee to study and suggest new remittance channels for Sri Lanka was submitted to the NPC during 2021. Further, reports of several committees on innovative payment products/platforms such as Open Banking, Virtual Currencies, Central Bank Digital Currencies, and Artificial Intelligence were submitted to the NPC during the year under review.

Anti-Money Laundering and Countering the Financing of Terrorism

The Financial Intelligence Unit (FIU) of the Central Bank performed its key role of receiving, analysing, and disseminating information on suspicious financial transactions relating to Money Laundering/Terrorist Financing (ML/TF) or any other unlawful activity. During the year 2021, FIU received 4,696 Suspicious Transaction Reports (STRs) and Information Requests from Reporting Institutions (RIs), Law Enforcement Agencies (LEAs), Regulatory Authorities (RAs) and the general public. After conducting operational and strategic analyses of the STRs received, 1,830 STRs were referred where necessary to relevant LEAs and RAs for further investigation or regulatory actions. In the period under review, 2,220 STRs were kept under surveillance and 641 STRs were kept for initial analysis and further studies, while the remaining STRs were categorised as no further action required. Further, in terms of Section 6 of the Financial Transactions Reporting Act (FTRA) No. 6 of 2006, FIU received 5.7 million (provisional) Cash Transactions Reports (CTRs) and 9.2 million (provisional) Electronic Fund Transfers (EFTs-inwards and outwards) exceeding the reporting threshold of Rs. 1 million or its equivalent in any foreign currency from RIs, during the year 2021.

FIU continued conducting risk based Anti-Money Laundering/Terrorist Financing (AML/CFT) supervision during the year in order to ensure institutional compliance with the AML/CFT legal framework of the country. Risk based examinations were conducted in Financial Institutions (FIs) as well as Designated Non-Finance Businesses and Professions (DNFBPs) in Sri Lanka. Despite certain difficulties faced in conducting the planned onsite examinations due to the pandemic situation, FIU successfully conducted 2 risk based onsite examinations, 7 joint risk based onsite examinations and 7 spot examinations. Further, 4 offsite follow-up examinations were initiated to assess AML/CFT compliance of FIs. Moreover, 5 thematic reviews were conducted on FIs, and 2 thematic reviews were conducted on DNFBPs to assess the sector wide AML/CFT compliance. Based on the examinations conducted in 2021, administrative penalties amounting to Rs. 10.5 million were imposed on 4 LCBs and 5 LFCs on violations of Customer Due Diligence (CDD) Rules in relation to the United Nations sanctions screening, customer identification and verification, Suspicious Transactions Reporting and implementation of proper risk controls and mitigation measures. In addition, 9 show cause letters and 5 warning letters were issued during the year to FIs on non-compliance with the provisions of the FTRA and CDD Rules, regulations and guidelines issued thereunder. The AML/CFT supervision of DNFBPs was further strengthened by implementing continuous measures to enhance the number of DNFBP institutions for AML/CFT compliance.

Several initiatives were taken to introduce legislative amendments to the legal framework on AML/CFT with the objective of improving

the effectiveness of the AML/CFT regime of the country during the year 2021. Furthermore, FIU initiated updating the National Risk Assessment (NRA) on ML/TF with technical assistance from the World Bank, in compliance with Recommendation 1 of the Financial Action Task Force Recommendations. The NRA working groups consist of 66 public and private stakeholder agencies with more than 123 officials.

FIU initiated various steps to enhance awareness among all stakeholders involved. In order to strengthen the AML/ CFT supervision process and institutional compliance, FIU issued several guidelines and circulars and provided resource assistance to 50 awareness/training programmes during the year.

Legal Reforms Related to the Financial Sector

The Central Bank continued introducing law reforms to major pieces of legislation administered with the view of providing a stronger legal foundation for the regulatory and supervisory framework of the Central Bank. As such, the Central Bank concluded the second round of discussions pertaining to a new Banking Act in 2021 with the expectation of further strengthening and streamlining the provisions of the Banking Act on par with international standards. In addition, to enhance regulatory and supervisory powers of the Central Bank over the non-bank financial institutions including the resolution authority of the Central Bank, necessary amendments to the Finance Business Act, No. 42 of 2011 were prepared by the Central Bank.

The Central Bank also engaged in developing new pieces of legislation, namely, the Trading, Clearing and Netting Act, Financial Assets Management Act and Microfinance and Credit Regulatory Authority Act. The objective of introducing a new Trading, Clearing and Netting Act for Sri Lanka is to provide for enhanced regulations on trading, clearing, netting, settlement, and custody related to the transactions of government securities and foreign exchange. This Act primarily focuses on introducing a comprehensive legal and technological infrastructure that may transform the markets for government securities and foreign exchange into safer, modern, competitive, and fair marketplaces supported by modern post-trade clearing, central counterparty systems, multi-currency RTGS System, etc. The Financial Assets Management Act was developed with the aim of introducing a concept based legal framework to establish financial asset management companies in Sri Lanka with a view of easing the burden of the balance sheets of regulated financial institutions caused by underperforming assets. The new Microfinance and Credit Regulatory Authority Act was drafted in order to establish a separate regulatory authority for the regulation and supervision of business of money lending and business of microfinance to ensure consumer protection.

In addition, amendments were proposed by the Central Bank to the Registered Stock and Securities Ordinance, No. 07 of 1937 and subsidiary pieces of legislation issued thereunder to strengthen the issuance procedure of Treasury bonds and to improve investor confidence in the government securities market in Sri Lanka. Moreover, amendments to the Foreign Exchange Act, No. 12 of 2017 were proposed with a view of facilitating the smooth functioning of the foreign exchange market and strengthening the regulatory powers.

The Central Bank contributed to review legislation that is relevant to the Central Bank and the financial sector drafted by several other stakeholders, such as the Colombo Port City Economic Commission Bill, Coronavirus

Disease 2019 (COVID-19) (Temporary Provisions) Bill, Finance Bill, Data Protection Bill, National Savings Bank Act, and the Bank of Ceylon Ordinance. During such reviews, the Central Bank assessed the impact of said enactments/amendments to the existing regulatory and supervisory framework of the Central Bank given the national importance embedded therein. In order to maintain the resilience of public confidence towards the financial system, the Central Bank continued litigation related to unauthorised finance companies, prohibited schemes and other issues in the financial sector, with the assistance of the Attorney General's Department and other Law Enforcement Agencies (LEAs) under the provisions of the Finance Business Act, No.42 of 2011 and the Banking Act, No. 30 of 1988.

Financial Consumer Protection

The financial consumer protection framework aims to protect the interests of financial consumers and promote fairness and transparency for consumers of financial products and services. New initiatives were taken by the Central Bank in streamlining the processing of complaints and requests, introducing suitable legal provisions to facilitate financial consumer protection framework either through new legislations or by making amendments to existing legislations and conducting examinations/ investigations on specific complaints. These measures will empower authorities to take prompt actions on financial consumer protection related issues. The Financial Consumer Relations Department (FCRD) of the Central Bank received 6,186 complaints and requests during 2021, with an average of around 500 complaints per month. Out of the complaints that require action, more than 91 per cent were attended and approximately 45.7 per cent of the total complaints were settled succeesfully. It is observed that most of the complaints were from COVID-19 affected small and medium scale businesses and individuals with respect to moratoria, rescheduling of loans, high interest rates, unacceptable/unethical practices, and early settlement of credit facilities. In 2021, the FCRD of the Central Bank introduced a simplified Complaint Submission Form (CSF), improving the efficiency of the complaint handling process.

Resolution and Enforcement Action on Weak Financial Institutions

The Central Bank continued to manage Sri Lanka Deposit Insurance and Liquidity Support Scheme (SLDILSS). In addition to the regulations issued to increase the maximum compensation payable amount from Rs. 600,000 to Rs. 1,100,000, a new regulation, viz Sri Lanka Deposit Insurance Liquidity Support Scheme Regulations No. 02 of 2021, was issued repealing and replacing previous regulations of SLDILSS to improve operations and management of SLDILSS in line with international best practices. Amidst the COVID-19 pandemic, the Central Bank ensured the smooth functioning of compensation payments to insured depositors of the license cancelled/suspended finance companies, namely, Central Investments and Finance PLC (CIFL), The Standard Credit Finance Ltd. (TSCFL), TKS Finance Ltd. (TKSFL), The Finance Company PLC (TFC), ETI Finance Ltd (ETIFL) and Swarnamahal Financial Services PLC (SFSP) during the corresponding period. The Central Bank paid compensation through SLDILSS to 70,832 depositors amounting to Rs. 29,251.46 million in relation to the above six (06) companies, as at 31 December 2021 by following an internally developed payment mechanism and under the Agency Banking Agreement with the People's Bank. The loan outstanding (capital) of one member institution, given under the liquidity support facility as at 31 December 2021 was Rs. 1.4 billion.

Table 8.22
Summary of Transactions on Foreign Currency Accounts

USD million

Category of Account	Inward Remittances		Outward Remittances		Closing Balance as of 31 December	
	2020	2021	2020	2021	2020	2021
Personal Foreign Currency Accounts	766.7	663.2	205.6	234.1	2,666.2	2,715.4
Business Foreign Currency Accounts	6,796.7	7,647.9	2,805.7	3,756.9	1,951.0	3,071.7
Inward Investment Accounts	1,382.9	854.7	1,901.1	1,221.9	1,861.1	1,969.2
Special Deposit Accounts (SDAs)	214.9[1]	207.1[1]	3.2[2]	83.0	290.0	585.2[3]
Outward Investment Accounts	138.2	11.2	8.4	6.9	n.a.	n.a.

1 Except for funds transferred from Inward Investment Accounts, Offshore Banking Unit Accounts and Foreign Currency Deposits.
2 Outward remittances were occurred from 07 October 2020 upon maturity of deposits under SDAs.
3. Including funds transferred from Inward Investment Accounts. Offshore Banking unit Accounts and Foreign Currency Deposits.

Source: Central Bank of Sri Lanka

The Central Bank conducted several investigations on prohibited schemes under the relevant provisions of the Banking Act No. 30 of 1988 upon receiving complaints from the general public. Further, several awareness programmes were conducted island wide with a view of improving the financial literacy of different segments of the general public to educate them on the ill effects of joining prohibited schemes. The Central Bank is in the process of formulating a resolution framework for licenced banks and licenced finance companies within the existing regulator framework.

Regulation and Supervision of Foreign Exchange

The Central Bank continued to regulate and supervise foreign exchange transactions during the year, amidst the challenges faced due to the pandemic. Several policy measures were introduced under the provisions of the Foreign Exchange Act No. 12 of 2017 (FEA) with a view to preserving foreign currency reserves and improving liquidity in the domestic foreign exchange market.

Table 8.23
Export Proceeds Repatriation into Sri Lanka and Sri Lanka Rupee (LKR) Conversions

USD million

	Q1*	Q2	Q3	Q4	Total
Total amount of exports proceeds repatriated during the year 2021	477.32	1,072.04	1,458.12	3,169.36	6,176.84
Total amount of export proceeds converted into LKR during the year 2021	111.08	215.02	367.49	878.19	1,571.78

* Rules under the MLA were issued w.e.f. 28.02.2021 and accordingly data were available from March 2021.

Source: Central Bank of Sri Lanka

A revised set of Regulations, Orders and Directions were issued under the FEA with effect from 22 March 2021 replacing the previously issued Regulations, Orders and Directions in order to address practical issues and concerns of Authorised Dealers (ADs) and other stakeholders, with the purpose of achieving greater efficiency in the domestic foreign exchange market. Further, considering liquidity issues in the domestic foreign exchange market, certain outward remittances in respect of capital transactions were limited by an Order issued by the Minister of Finance under Section 22 of the FEA. Opening of Special Deposit Accounts (SDAs), which was introduced in the year 2020, was extended for another one year period from 08 April 2021 considering its positive impact on the country in terms of the increase in inward remittances. Moreover, Directions were issued facilitating resident companies to receive proceeds for equity in foreign currency from non-resident investors, while also enabling them to utilise such proceeds for

Table 8.24
Remittances on Capital Transaction Rupee Accounts (CTRAs) and Foreign Exchange Sales and Purchases against/into Sri Lanka Rupees

	2020	2021
Migrant Fund Transfers		
No. of CTRAs registered with the Central Bank for remitting migration allowances	742	787
Outward remittances through CTRAs (in USD mn)	12.7	4.5
Foreign Exchange Sales and Purchases (in USD mn)		
Foreign Exchange Sales (Form 1)	11,484.3	12,019.6[1]
Foreign Exchange Purchases (Form 2)	20,246.3	12,153.5[1]

1. Provisional

Source: Central Bank of Sri Lanka

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Table 8.25
Performance of Restricted Dealers

	2020	2021	% Change
Amount deposited into the banking system (in USD Mn)	132.71	22.78	-82.8
Amount sold to persons resident in Sri Lanka (in USD Mn)	3.64	3.72	2.2

Source: Central Bank of Sri Lanka

current transactions, without converting them into Sri Lanka rupees. Further, in order to attract more inward remittances, companies incorporated in Sri Lanka were permitted to purchase ISBs issued by the Government of Sri Lanka from the secondary market, out of the externally borrowed funds.

In an effort to attract foreign currency in the hands of residents into the formal channels, an Order under Section 4 of the FEA was issued by the Minister of Finance permitting hotels registered with the Sri Lanka Tourism Development Authority to accept foreign currency from persons resident in Sri Lanka who have foreign currency in their possession. Additionally, to improve the liquidity of the domestic foreign exchange market, Rules were issued under the Monetary Law Act No. 58 of 1949 (MLA) requiring exporters to repatriate export proceeds into the country within 180 days and to convert the same into Sri Lanka rupees. These rules were amended from time to time as necessary, adjusting the percentage of export proceeds required to be converted into Sri Lanka rupees. Accordingly, the amount of export proceeds repatriated to Sri Lanka and converted into Sri Lanka Rupees as required by the Rules showed a gradual improvement throughout the year, supporting the domestic foreign exchange market to a certain extent.

Activities of Restricted Dealers (RDs) who are authorised to engage in money changing business were continuously monitored to ensure their compliance with the Rules and Regulations. The overall performance of RDs deteriorated during the year given the subdued economic activities amidst the pandemic. Additionally, data on export proceeds collected from ADs on a monthly basis were continuously monitored to ensure compliance by exporters and ADs with the Rules issued under the MLA. Actions were also taken during 2021 to implement a comprehensive cross border foreign currency transactions monitoring system to collect data from ADs in terms of the Regulations and Directions issued under the FEA, including inflows/ outflows of the domestic foreign exchange market, whilst supporting macroeconomic decision making on foreign exchange operations.

Credit Information

Despite the challenging environment posed by COVID-19 pandemic, the Credit Information Bureau (CRIB) continued its operations by providing 8.37 million credit reports to member lending institutions during 2021. However, reports issued recorded a slight decrease of 3.2 percent compared to the previous year. Demand for the self-inquiry credit reports (iReports) recorded a 0.6 per cent decline in 2021, compared to the year 2020. During the year 2021, 8,114 customers visited the Bureau to obtain their iReports and 1,438 customers applied for their iReports through banks. CRIB issued 2,988 self-inquiry credit reports online in 2021. Also, the demand for the CRIB Score (Credit Score) Reports increased by 183 per cent in year 2021.

CRIB also supported financial institutions to roll out debt moratoria. In line with the directions issued by the Monetary Board of the Central Bank, CRIB issued reporting guidelines to lenders, which ensured that credit data of borrowers who availed debt moratoria were reported in a manner which had no negative impacts to the credit reports and credit scores of those borrowers, during the period under moratoria.

In addition, CRIB accelerated its digital growth plans to equip its system and processes to operate more efficiently in the new normal. Accordingly, CRIB took measures to invest in upgrading its current system to accommodate the evolving needs of the users and stakeholders of CRIB, while enhancing its service standards and turnaround times. Development of the Host-to-Host Application Programming Interface (API), the automation of the personal iReport issuance and integration of same with Mobile Banking Applications of member institutions, were some of the important aspects, to give speed and ease of access to CRIB users.

Implementation of the Road Map for Sustainable Finance in Sri Lanka

The Central Bank joined the Sustainable Finance Network supported by the International Finance Corporation (IFC) in 2016, with a view to promoting sustainable finance practices in Sri Lanka. Subsequently, with the technical assistance of the IFC and the financial assistance of the United Nations Development Programme (UNDP), the Central Bank launched a 'Road Map for Sustainable Finance in Sri Lanka' in April 2019. This Road Map provides a broad direction to financial regulators, financial institutions, and the markets to effectively manage environmental, social and governance (ESG) risks associated with projects they finance and promotes assistance to businesses that are greener, climate-friendly, and socially inclusive.

In operationalising the actions of the Road Map, the Central Bank initiated a process of devising an applicable Green Finance Taxonomy in 2021, which is a key requirement in facilitating the financial sector towards sustainable finance. The said taxonomy will establish a classification and measurement system for green activities and provide a common consensus to financial institutions in determining green/sustainable projects. The Central Bank is working closely with the IFC, which provides technical and financial support in developing the Green Finance Taxonomy, and expects to launch it in the first half of 2022.