Financial System Stability Review 2022

Central Bank of Sri Lanka

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Abbreviations

ADs	Authorised Dealers
AML/CFT	Anti-Money Laundering/Countering Financing of Terrorism
APG	Asia Pacific Group
ASPI	All Share Price Index
AWCMR	Average Weighted Call Money Rate
AWNDR	Average Weighted New Deposit Rate
BCP	Business Continuity Plan
BFCAs	Business Foreign Currency Accounts
BIS	Bank for International Settlements
BOP	Balance of Payments
CAR	Capital Adequacy Ratio
CAS	Common ATM Switch
CASA	Current Account and Savings Accounts
CCAPS	Common Card and Payment Switch
CCPI	Colombo Consumer Price Index
CDR	Credit to Deposit Ratio
CEB	Ceylon Electricity Board
CEFTS	Common Electronic Fund Transfer Switch
CIFL	Central Investment and Finance PLC
CITS	Cheque Imaging and Truncation System
CPC	Ceylon Petroleum Corporation
CPOS	Common Point-of-Sales
CRA	Credit Regulatory Authority
CRIB	Credit Information Bureau
CSE	Colombo Stock Exchange
CSTFA	Convention on the Suppression of Terrorist Financing Act
DBUs	Domestic Banking Units
DNFBPs	Designated Non-Finance Businesses and Professions
DR	Disaster Recovery
EBIT	Earnings Before Interest and Tax
ELA	Emergency Liquidity Assistance
EMDEs	Emerging Market and Developing Economies
EMEs	Emerging Market Economies
EMPI	Exchange Market Pressure Index
EPMS	Export Proceeds Monitoring System
FAMCS	Financial Asset Management Companies
FATF	Financial Action Task Force
FC	Foreign Currency
FEA	Foreign Exchange Act
FIs	Financial Institutions
FIU	Financial Intelligence Unit
FSI	Financial Stress Index
FTRA	Financial Transactions Reporting Act
GDP	Gross Domestic Product
GWP	Gross Written Premium
ICASL	Institute of Chartered Accountants of Sri Lanka
IIAs	Inward Investment Accounts
IIS	Interest in Suspense
ILF	Intra-Day Liquidity Facility
IMF	International Monetary Fund
KYC	Know-Your-Customer
LBs	Licensed Banks
LCs	Letters of Credit
LCBs	Licensed Commercial Banks
LCPL	Lanka Clear Pvt. Ltd
LCR	Liquidity Coverage Ratio
LEAs	Law Enforcement Agencies
LFCs	Licensed Finance Companies
LPOPP	LankaPay Online Payment Platform
LSB	Licensed Specialized Bank
ISBs	International Sovereign Bonds
MDR	Merchant Discount Rate
MI	Member Institutions
MLA	Monetary Law Act

ML	Money Laundering
MSMEs	Micro, Small and Medium Enterprises
NBFIs	Non-Bank Financial Institutions
NII	Net Interest Income
NIM	Net Interest Margin
NPC	National Payment Councils
NPL	Non-performing Loans
NFCs	Non-Financial Corporates
NITF	National Insurance Trust Fund
NRA	National Risk Assessment
NSFR	Net Stable Funding Ratio
OBU	Offshore Banking Units
PAT	Profit After Tax
PBT	Profit Before Tax
PE	Price Earnings
PFCAs	Personal Foreign Currency Accounts
PIs	Participating Institutions
PMI	Purchasing Managers' Index
PMLA	Prevention of Money Laundering Act
POC	Proof of Concept
RBC	Risk Based Capital
RDs	Restricted Dealers
RIs	Reporting Institutions
ROA	Return on Assets
ROE	Return on Equity
RTGS	Real Time Gross Settlement
RWA	Risk Weighted Assets
SDAs	Special Deposit Accounts
SDFR	Standing Deposit Facility Rate
SLA	Staff Level Agreement
SLAR	Statutory Liquid Assets Ratio
SLCs	Specialised Leasing Companies
SLDBs	Sri Lanka Development Bonds
SLDILSS	Sri Lanka Deposit Insurance and Liquidity Supports Scheme
SLDILSF	Sri Lanka Deposit Insurance and Liquidity Support Fund
SLFR	Standing Lending Facility Rate
SLIPS	Sri Lanka Inter Bank Payment System
STR	Suspicious Transaction Reports
SOBEs	State-Owned Business Enterprises
SOEs	State Owned Enterprises
TF	Terrorist Financing
USD	US Dollars
WAYR	Weighted Average Yield Rates
WEO	World Economic Outlook

Governor's Foreword

The Financial System Stability Review (FSSR) of 2022 encapsulates the developments in the financial system, the risks and vulnerabilities identified thereof, and the policy measures taken by the Central Bank and other regulatory institutions in addressing such risks during the review period, which is nine months ended on 30th September 2022.The Sri Lankan economy is experiencing the most profound economic crisis since Independence, effects of which have transmitted to the financial system, challenging the stability of the financial system. Structural issues, especially in terms of fiscal imbalances, resulting in an acute foreign exchange shortage and staggering inflation, which jeopardised the activities of the real sector as well as the financial sector, surfaced in the aftermath of the COVID-19 pandemic. Both the exchange rate and domestic inflation reached record high levels, and a standstill on external debt servicing on account of bilateral and commercial loans was declared by the Government in April 2022 after being continuously downgraded by international rating agencies. The Central Bank, with its prime objective of maintaining price and economic stability, implemented policy measures to address runaway inflation. This resulted in a steep incline in market interest rates amidst debt restructuring uncertainties and elevated risk premia. Moreover, the Central Bank commenced providing market guidance to reinstate stability in the exchange rate and narrow the official and grey market exchange rate gap, amidst significant currency depreciation.

Consequent to the macroeconomic policy corrections that were warranted, the financial sector, particularly the banking sector, was affected due to a contraction in credit and a deterioration in asset quality. The Central Bank, in view of maintaining financial system stability, closely monitored the developments in the financial sector. Even though a notable adverse impact was experienced in terms of liquidity and solvency, the banking and the non-bank financial institutions sector navigated through these challenges with pragmatic behavioural responses, availing of regulatory concessions and prudential measures during the period under review.

Currently, the Government's debt restructuring negotiations are in progress to meet prerequisites for obtaining the Extended Fund Facility (EFF) of the International Monetary Fund (IMF). A series of economic reforms have been identified and initiated to steer the economy towards recovery. This will require greater independence of the Central Bank in terms of its policymaking operations, and this will be addressed in the proposed Central Banking Act. Moreover, the proposed Act will designate the Central Bank as the Macroprudential Authority of the country. Timely, coordinated and uninterrupted implementation of appropriate policies and reforms is expected to work through the economy, correcting structural imbalances, dissipating vulnerabilities while gradually strengthening economic resilience and lifting pressures from the financial system. However, it is noteworthy that the path to macroeconomic recovery, while maintaining financial system stability, is challenging. Thus, achieving the desired outcome is strictly contingent on all relevant stakeholders adhering to required policy reforms with their resolute commitment.

In this context, this FSSR 2022 will be a useful and reliable source of reference for all concerned stakeholders to better understand the contemporary macrofinancial conditions in Sri Lanka.

Dr. P Nandalal Weerasinghe

Governor

Executive Summary

The domestic economy grappling to recover from fragilities induced by COVID-19 pandemic is confronting escalated foreign currency and sovereign debt distresses amplified by pre-existing fiscal and external sector imbalances causing unprecedented challenges to the financial sector. The country experienced an acute shortage of essentials, amidst receding usable official foreign reserves and the Government was compelled to declare a standstill on external debt servicing on account of bilateral and commercial loans in April 2022 for an interim period. Inflation reached historical highs caused by imported inflation resulting from global energy and food price shocks and the sharp depreciation of the exchange rate, domestic supply side disturbances and the lagged effect of expansionary monetary policy adopted during the pandemic. Gross Domestic Product entered a contractionary trajectory. The Central Bank adopted a tight monetary policy stance with the view of pivoting inflation towards the desired disinflationary path by anchoring inflation expectations while averting a situation of persistently high inflation. Contractionary policy measures tightened the domestic financial conditions. Meanwhile, a large premium has been priced into the market yields due to risks associated with uncertainties over debt restructuring. Tax reforms have been introduced during the year targeting to achieve revenue-based fiscal consolidation and thereby facilitating the unprecedented efforts in restoring sovereign debt sustainability. A staff level agreement for an International Monetary Fund (IMF) – Extended Fund Facility (EFF) was reached in September and Sri Lanka progressed on many fronts in the macroeconomic policy adjustment programme. Sri Lanka initiated negotiations with bilateral and commercial creditors to restructure its sovereign debt to restore debt sustainability and these negotiations are currently progressing. Nevertheless, Sri Lanka is susceptible to global predicaments as the world economy confronts a sequence of woes with heightened risks to global financial stability.

Domestic financial markets were confronted with multifaceted challenges emanating from adverse macroeconomic conditions that prevailed in the country. The equity market recorded a dismal performance during the period under review reflecting the negative market sentiments on the backdrop of adverse macroeconomic conditions. The domestic government securities market continued to expand rapidly accommodating the funding requirement of the Government, amidst loss of access to international capital markets to finance the deficit. Yields on government securities reached a new high signifying the increased fiscal dependence on domestic sources, pre-existing tight market liquidity conditions and elevated sovereign risk premia on the back of concerns over debt restructuring. Exorbitant yield rates on rupee sovereign securities exacerbates the domestic debt sustainability challenges. The looming uncertainties in the macroeconomic front witnessed investor preferences being inclined more towards near-term government securities in the primary market and demonstrated a lesser appetite in the secondary market.

Money market liquidity conditions continued at deficit levels while witnessing a significant asymmetricity in the distribution of liquidity among market participants due to adherence with stringent counterparty limits. Consequently, market participants resorted to Standing Lending Facility (SLF), term reverse repo facility and Standing Deposit Facility (SDF) for managing near-term liquidity, requiring an active financial intermediation role from the Central Bank. Pre-existing fragilities in the external sector aggravated as major sources of foreign exchange inflows such as tourism and worker remittances received via formal channels dampened since the befall of the pandemic along with slow conversion of export proceeds and speculative behaviour of market participants. Loss of access to commercial foreign currency borrowings, a source of Balance of Payment deficit financing during yesteryears, was a major blow to the domestic foreign exchange market. The acute liquidity shortfall in the domestic forex market which prevailed at the onset of 2022 and the fast dwindling gross official reserves necessitated an adjustment in the administratively held exchange rate resulting in a deep depreciation. Consequently, the Central Bank introduced a market guidance on the interbank forex market to ensure stability in the exchange rate and narrow the official and grey market exchange rate gap. Meanwhile, interbank forex market activities recorded a lacklustre performance during the period under consideration.

The banking sector withstood the macroeconomic headwinds which arose during the pandemic, leveraging from accumulated capital and liquidity buffers. The sector shouldered much of the weight in providing required support and stimulus to the ailing economy exacerbated by the pandemic amidst severely constrained fiscal space. Nevertheless, the sector was battered by unfavourable developments in the economy during the pandemic coupled with sovereign rating downgrades prompting the Central Bank to grant regulatory concessions. With the debt standstill announced in April 2022, sharp depreciation in the exchange rate in March 2022 and tightening of policy rates again in April 2022, the banking sector faced unprecedented challenges in the first half of 2022. Banks navigated through these stresses, with their pragmatic behavioural responses and availing policy concessions and prudential measures. The sector commenced provisioning for Expected Credit Losses (ECL) on foreign currency denominated sovereign exposures pending the outcome of the debt restructuring. Meanwhile the sector was permitted to reclassify its holdings in government securities, facilitating the sector to rebalance risk exposures. Credit growth decelerated during the nine months ending September 2022, emulating the current macroeconomic conditions. The Sovereign-bank nexus remained worrisome to the banking sector on a backdrop of concerns over debt restructuring. The Stage 3 loan ratio surged to a double-digit level signalling an increase in default risk. Nevertheless, the sector is taking measures to provide for ECL commensurate with the rising delinquency levels. Mirroring the rise in ECL provisioning, the sector profitability declined during the period under review. However, as risks in the sector gradually crystalise; banks were trading-off between recognising expected losses and capital accumulation to compensate for unexpected and unanticipated losses. Stringent policy measures on discretionary payments and exploration of capital augmentation avenues of banks are expected to preserve and strengthen the loss absorbent capacities of banks. In addressing the challenges confronted by the sector, measures were taken by the Central Bank which include and not limited to; conducting Asset Quality Review of large banks, strengthening the Emergency Liquidity Assistance (ELA) Framework for banks as well as strengthening the crisis management and supervisory frameworks.

The Licensed Finance Companies (LFCs) and Specialised Leasing Companies (SLCs) sector showed signs of deceleration during the quarter ending September 2022 resembling the adverse macroeconomic conditions and prolonged restrictions on importation of motor vehicles. The sector experienced a deterioration in credit quality and decline in profits along with shrinking loan books. The inherent nature of lower asset quality in the sector in comparison to the banks, together with the high concentration on volatile assets raise concerns on maintaining the resilience of the sector in terms of high non-performing loans and the need for recognising higher level of impairment in the future. The Insurance sector on the contrary to the banking and LFCs sectors, reported an increase in profitability during the period ended June 2022, in terms of General Insurance as a result of revised premiums in line with the vehicle and other asset price increases. Capital and Liquid Assets of the Insurance sector were maintained above the minimum requirements stipulated.

Spill overs from the policy correction measures taken to achieve price and macroeconomic stability, resulted in an inevitable welfare loss on the households and corporates. Forthcoming tax adjustments coupled with prevailing high cost of living could further impede the disposable earning and repayment capacities of households and also impact the toplines of corporates. Domestic financial conditions tightened curtailing credit to households and corporates. Consequently, private sector borrowings from financial institutions have moderated during the period partially due to lack of demand for new credit. Meanwhile, listed non-financial corporates in the Colombo Stock Exchange recorded an improvement in aggregate profits although an uneven distribution across entities was witnessed. Nevertheless, repayment capacities of listed corporates have decreased as reflected through diminished interest coverage ratios. Further, the mean leverage ratio of listed non-financial firms has increased indicating a higher reliance on debt as opposed to internal funds to meet financial obligations. Household and corporate sector credit risks have elevated during the period consistent with the impaired repayment capacities. High dependence of State-Owned Business Enterprises (SOBEs), particularly those in the energy sector, on systemically important state commercial banks exerts pressure on the entire banking system. Reforms targeting to enhance commercial viability of these businesses in order to minimise their dependence on the financial system are required to be prioritised in the interest of the financial system and the national economy.

The financial system infrastructure, which is critical in ensuring smooth functioning of the financial system of the country functioned without any major disruption while effectively catering to the needs of the economy amidst rising macroeconomic challenges. The payment and settlement system, which is the major component of the financial system infrastructure, operated efficiently and effectively during the period.

The Central Bank is introducing reforms to major legislations with the view of strengthening the regulatory and supervisory framework of the financial system. The proposed Central Bank of Sri Lanka Act is to be enacted to strengthen the operational independence and accountability of the Central Bank. The proposed Act designates the Central Bank as the Macroprudential Authority of the country and establishes inter-coordination between the regulators of the financial system for smooth implementation of Macroprudential policies. The Central Bank continued with the drafting of a new Banking Act with the view of further strengthening and streamlining the provisions of the existing Banking Act. Moreover, the new Banking (Special Provisions) Act is in the process of being drafted for the purpose of defining the resolution authority of the Central Bank. Money laundering and financing of terrorism could pose significant and extensive adverse effects on the financial system stability. Thus, the Financial Intelligence Unit continued its functions to strengthen Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) regime of the country by strengthening the compliance, effective supervision, providing guidance and improving awareness among stakeholders.

Macroeconomic implications on the financial sector need to be carefully assessed and going forward, necessary policy actions including recapitalisation of financial institutions would be required to preserve financial system stability. However, it is pertinent to note that the path to macroeconomic recovery while maintaining financial system stability is narrow and the desired outcome is conditional on the unwavering commitment of all relevant stakeholders in adhering to essential policy reforms. Prevalent macro-financial vulnerabilities and systemic imbalances are expected to dissipate as the economy transitions onto a coordinated and credible recovery path, with holistic and effective implementation of much needed structural reforms and obtaining financing assurances from official bilateral creditors and engaging in good faith negotiations with private creditors towards the successful completion of debt restructuring, enabling the country to access the IMF EFF.

Chapter 1

Macrofinancial Conditions

1.1. Overview

Financial system resilience is challenged by multifaceted macroeconomic headwinds culminating in a considerable weakening of the macrofinancial outlook. Domestic macroeconomic vulnerabilities have led to high inflation and contraction of the economy, resulting in a deterioration of balance sheets of firms and households. On the macroeconomic front, a tight monetary policy stance was adopted to contain runaway inflation and tax adjustments were introduced to bring fiscal balances into a sustainable path. The prevailing high cost of living coupled with expected tax adjustments could further strain the balance sheets of households and firms. Mirroring the economic contraction, rise in costs and socio-political uncertainty, domestic business conditions edged down signalling the strained debt repayment capacities of firms. Meanwhile, exacerbating structural deficiencies in the labour market could impede effective financial inclusion and strain household balance sheets, raising credit risk. These developments have led to increased Non-Performing Loans and deteriorated the asset quality of financial institutions.

Furthermore, the significant depreciation of the exchange rate that occurred during the early part of the year caused a significant adjustment in banks' balance sheets in Rupee terms. Meanwhile, the Government announcement on debt standstill[1] and uncertainties related to debt restructuring also increased credit and liquidity risk for financial institutions. Amidst these developments, domestic financial markets exhibited strains, raising financial stability concerns. Furthermore, the Government's unprecedented fiscal reforms which includes debt restructuring and tax adjustments could have significant direct and indirect liquidity and solvency implications on balance sheets of financial institutions. Moreover, with the current macroeconomic vulnerabilities and declining income levels, banking sector exposures related to consumption and real estate could also pose elevated credit risk. Amidst these developments, financial intermediation in the economy has declined, which is an expected outcome of monetary tightening.

In the meantime, Sri Lanka is heavily exposed to international macrofinancial developments through its reliance on trade, tourism, and foreign borrowings particularly in the current adverse global economic outlook. The economic slowdown and cost of living crises in export market economies and tourism origins could directly affect the liquidity of the domestic foreign exchange market. However, the loss of access to international capital flows subsequent to rating downgrades, diluted the effect of some risks associated with global financial markets, as foreign investments in Rupee denominated government securities reached the near zero level.

Nevertheless, these macrofinancial vulnerabilities are expected to dissipate as the economy

1. The Government announced a standstill on external debt servicing on account of bilateral and commercial loans for an interim period in April 2022.

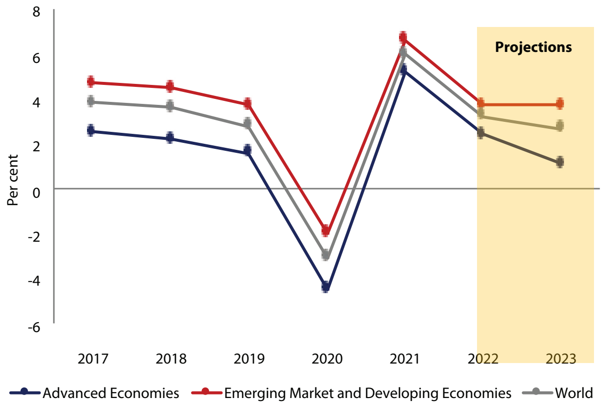
transitions onto the recovery path with the effective, timely and uninterrupted implementation of much needed economic reforms subsequent to the successful finalisation of debt restructuring negotiations. However, it is pertinent to note that the path to macroeconomic recovery while maintaining financial system stability is arduous and narrow and the desired outcome is conditional on the commitment of all relevant stakeholders in adhering to required policy reforms.

1.2. International Economic Environment and Financial Conditions

1.2.1. Global Economic Developments and Outlook

The positive global economic outlook that prevailed during the early part of 2021 eventually dampened and reversed as the global economy entered 2022. Uncertainties such as re-imposed mobility restrictions, supply side disruptions and financial market volatility gained momentum with the emergence of the Omicron variant during the latter part of 2021, threatening to set back the already fragile path to recovery. Meanwhile, subsequent to the prolonged and unprecedented accommodative monetary policy stance maintained during the pandemic period, global monetary conditions are currently being tightened. These measures are aimed at curtailing the pent-up demand pressures, addressing broad-based inflation, which have been at higher than anticipated levels and to acquire some policy space for the coming period of extreme uncertainty, particularly due to the possible continuation of geopolitical issues. As such, policymakers in many countries are compelled to make unenviable policy decisions to curtail inflation by compromising growth and employment. Furthermore, in view of the anticipated decline in output and income, i.e., the declining phase of the business cycle, many financial stability policymakers around the world have eased macroprudential policies with procyclical aspects, particularly in the form of Counter Cyclical Capital Buffers.

Chart 1.1 Global Economic Growth



Source: IMF World Economic Outlook - October 2022

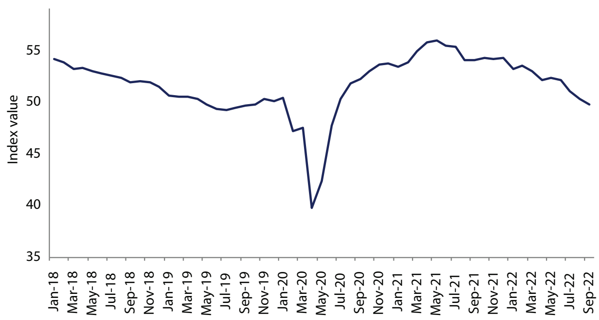
Further, the Russian invasion of Ukraine, which started in early 2022 has amplified the forces that were already disrupting the global economic recovery from the pandemic. The war and related sanctions have led to a further increase in commodity prices and intensified supply disruptions, fuelling inflation. These widespread uncertainties amidst increasing interest rates have resulted in asset price volatilities, impacting households' and corporates' balance sheets. Moreover, escalating uncertainties in the global financial environment further strengthened the safe-haven status of the US dollar, which continues to appreciate against major currencies, making foreign financing extra difficult and expensive for emerging and low-income economies, particularly when they do not have adequate reserve currency buffers.

At the turn of the third quarter of 2022, the global economy was experiencing multifaceted challenges, which further deteriorated the growth outlook. Challenges in terms of winding up of fiscal and monetary support that prevailed during the initial stages of the pandemic, inflation remaining above the levels observed during the past decades, tight financial conditions in most regions, geopolitical uncertainties, and the lingering effects of the COVID – 19 pandemic weighed heavily on the global economic outlook. As such, risks to the global economic outlook remain largely on the downside as highlighted in the World Economic Outlook (WEO) of the International Monetary Fund (IMF) in October. These downside risks include the compounding contractionary impact on output with the widespread tightening of policy interest rates to rein in inflation back to target levels, further energy and food price shocks that may cause inflation to persist for an extended period than envisaged, and US dollar appreciation and global financial tightening which could trigger widespread debt distress in both developing and emerging markets. Moreover, the worsening of China's property sector crisis could spill over to the domestic banking sector and weigh heavily on Chinese economic growth, geopolitical fragmentation amongst major trading economies, impeding trade and capital flows and the frequent occurrence of extreme and catastrophic weather events also poses challenges for the global economic outlook. Amidst the higher inclination for these downside risks to materialise which heightens the uncertainties on global growth and inflation forecasts, the IMF's October 2022 WEO update projects global growth to be 3.2 per cent in 2022, which is a sizable downgrade compared to the forecast of 4.4 per cent in the January 2022 update.

1.2.2. Global Manufacturing

Signalling the worsening of business conditions in the global manufacturing sector, the Global Manufacturing Purchasing Managers' Index (PMI) has been on a declining trend since the second quarter of 2021. The Global Manufacturing PMI stood at 49.4 in October 2022, which is its lowest level in 28 months, and slipped to contractionary territory once again since the peak of the pandemic. The new-orders-to-inventory ratio, an index of the PMI survey which signals the production trend, has

Chart 1.2 Global Purchasing Managers' Index



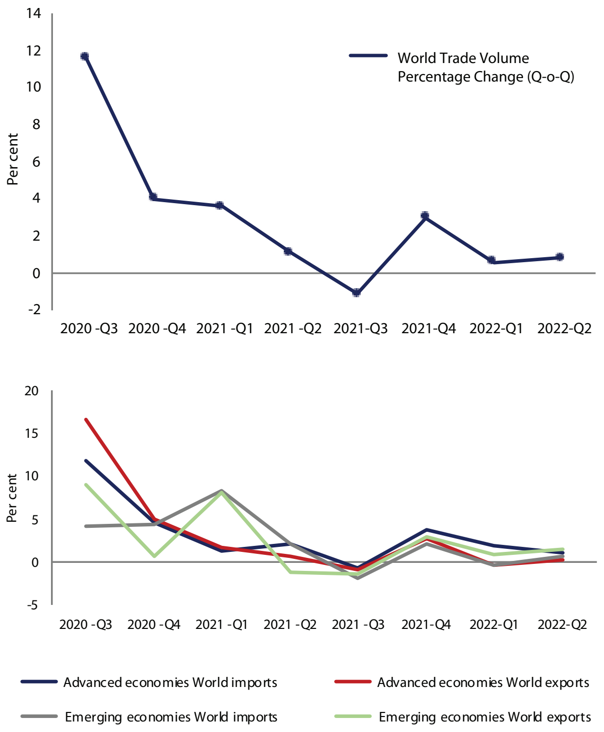
Source: S&P Global

fallen to record low levels indicating that global production may weaken further in the coming months. Nevertheless, the supply side indicated some improvements and provided slight relief for global goods producers in terms of prices as reflected by the marginal easing of the input cost and output price indices during October 2022. Global manufacturers' business confidence remains weak amid the continued deterioration of demand and price pressures, with growing risks of recession weighing down business sentiments in advanced economies. The sluggish outlook in global manufacturing could be mirrored in the Sri Lankan manufacturing sector through the resultant demand shrinkage in major export destinations due to the envisaged weak outlook.

1.2.3. Global Trade

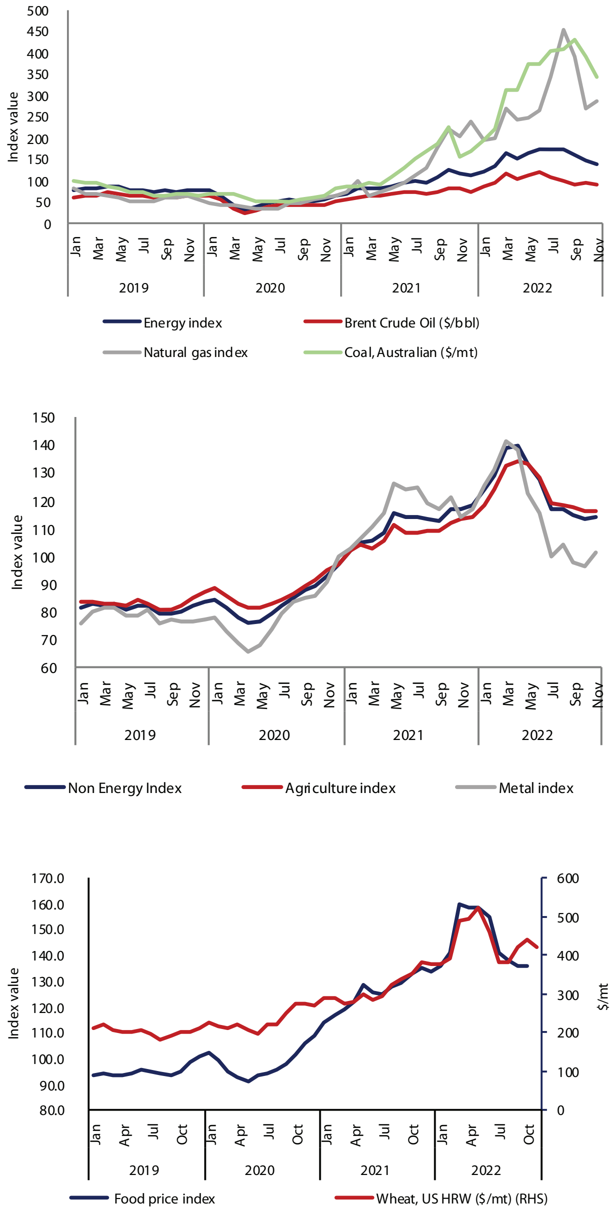
Global trade growth for 2022 and 2023 are also expected to be lower than forecasted at the turn of 2022, as import demand in major economies is expected to slow down due to numerous reasons. In Europe, the flare-up of energy prices is limiting firms' and households' budgets. In the United States, spending capacities are strained by monetary policy tightening which is raising interest-sensitive spending. The Chinese manufacturing sector continues to grapple with weak external demand coupled with the slowdown due to the zero COVID-19 policy and related production disruptions. For many countries, rising import

Chart 1.3 **World Trade Volume Percentage Change (Q-o-Q)**



Source: CPB World Trade Monitor

Chart 1.4 **Global Commodity Prices**



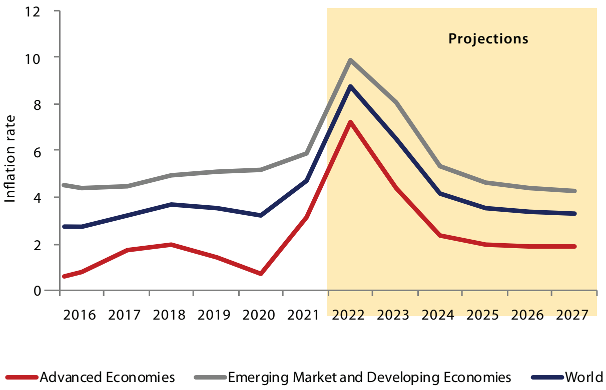
Sources: World Bank, FAO

bills in terms of fuel, food and fertiliser could require rationalising spending to avert falling into debt distress. As such, global trade growth is expected to be weaker in 2023, as per the World Trade Organisation's outlook. Hence, uncertainties surrounding a smooth flow of foreign currency earnings through exports during the period ahead could have an impact on Sri Lanka's external position. Further, if such foreign currency liquidity risks are materialised, it could adversely impact the foreign currency liquidity position of the domestic foreign exchange market.

1.2.4. Global Commodity Prices, Inflation and Monetary Policy

Although global commodity prices have started to ease from their peak levels, prices remain elevated. As global growth slows and concerns about a global recession intensify, global commodity prices have started to ease during the third quarter of 2022 from their peaks caused by the post-pandemic demand surge and the war in Ukraine. Energy prices have been extremely volatile since the outbreak of the war in Ukraine due to supply disruptions. Furthermore, energy price trends diverged widely, with Brent crude oil prices falling sharply while natural gas and coal prices continuing to increase during Q3 2022, Q-o-Q. Reflecting weaker global growth and the resultant decline in demand, non-energy prices declined in Q3 2022, Q-o-Q, with metal prices recording the largest fall. Meanwhile, agricultural commodity prices fell in Q3 2022, Q-o-Q and fears of food shortages that surfaced

Chart 1.5 **Global Inflation**

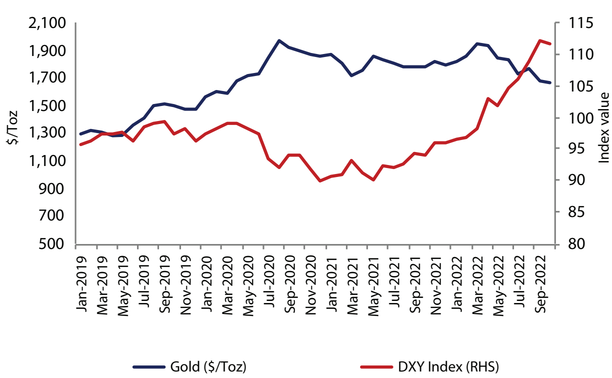


Source: IMF World Economic Outlook - October 2022

earlier in the year eased. However, food and fertiliser prices remain elevated due to the ongoing war between Russia and Ukraine, two dominant producers of wheat and fertiliser. Furthermore, with the strengthening of the US dollar, currency depreciation in many countries have resulted in higher commodity prices in domestic currency terms. As such, the exchange rate pass-through effect on inflation could be more persistent even amidst easing global commodity prices, particularly in countries which face the depreciation pressure.

Inflation has risen faster than expected since mid-2021 and remains persistent and broad-based even amidst the recent easing of commodity prices. The build-up of aggregate demand pressures

Chart 1.6 **Gold Prices and DXY Index Fluctuations**



Sources: World Bank, Bloomberg

as the lagged effect of unprecedented monetary and fiscal support during the pandemic period, disruptions in energy and commodity markets stemming from the COVID-19 pandemic and the Russian invasion of Ukraine amid heightened economic and geopolitical uncertainties have de-anchored inflation expectations. As such, global headline inflation is forecasted to increase from 4.7 per cent in 2021 to 8.8 per cent in 2022 and decline to 6.5 per cent in 2023 and 4.1 per cent in 2024 by the IMF in their October 2022 WEO. Advanced Economies have recorded highest levels of inflation after enjoying low and stable inflation for two decades.

With policymakers continuing to normalise the policy stance to curtail inflation, there are diverse effects on all economies. Higher returns and safe haven status in advanced economies will incentivise capital outflows and reversals from emerging market and developing economies. This will exert further depreciation pressure on those currencies while increasing inflation. External borrowing costs have risen amidst the capital outflow from emerging and frontier market economies with weaker macroeconomic fundamentals as global financial conditions become tighter. In advanced economies, financial conditions have tightened rapidly, while it is even tighter in some emerging markets, affecting mortgage payments and other interest-sensitive expenses, and limiting spending capacities of households and firms. However, financial conditions in China have eased to some extent due to additional support provided by policymakers to offset a rise in corporate borrowing costs stemming from strains among property developers and a deterioration in the economic outlook.

As the Federal Reserve is moving forward with the policy tightening cycle amidst the rise in the safe haven status of the US dollar due to high uncertainties tied up with many alternative investments, the US dollar index indicates a

record high level of appreciation of the US dollar. The US dollar appreciation presents a challenging situation for both advanced as well as emerging central banks. Several policymakers (including Chile, the Czech Republic, Indonesia, Japan, the Philippines and Malaysia) have resorted to or have signalled their readiness to intervene in the foreign exchange market with the objective of limiting currency volatility and the impact on inflation from higher import prices. In response to the US dollar rate movements, asset tapering expectations of the US, and interest rate-related policies taken by the advanced economies, gold prices are on a declining trend during the recent months, albeit with mild fluctuations.

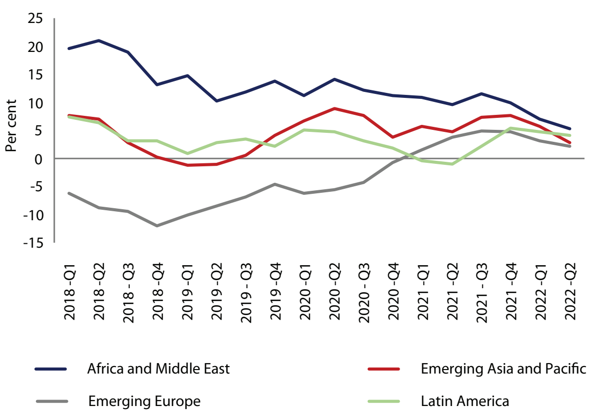
1.2.5. Global Financial Markets

The Global Liquidity Indicator compiled by the Bank for International Settlements (BIS), which tracks US dollar credit to non-bank borrowers outside the US, indicated a weakening of growth in US dollar credit to emerging markets and developing economies during the first half of 2022, compared to end 2021. The widespread strain in global liquidity conditions could further amplify with high and persistent inflation amidst rising interest rates in lending and borrowing countries. These conditions may have a significant impact on foreign currency credit not only to emerging markets and developing economies, but also to borrowers in advanced economies. Furthermore, the persistent strengthening of the US dollar, amidst rising interest rates in the US poses debt repayment challenges to dollar borrowers particularly whose reserve positions are weak.

Financial conditions, as reflected by Bloomberg Financial Conditions Indices, tightened as an intended result of monetary policy tightening and due to the uncertainties created by the Russian invasion of Ukraine. Financial conditions in the US have tightened with mild variations since the beginning of the year. However, a noteworthy tightening in financial conditions of the Euro zone was observed owing to the impact of the war in the region. Tightening financial conditions amidst high uncertainty, subdued economic performance and high inflation raises financial stability concerns in countries where balance sheets of firms and households are already constrained, and debt repayment capacities are strained.

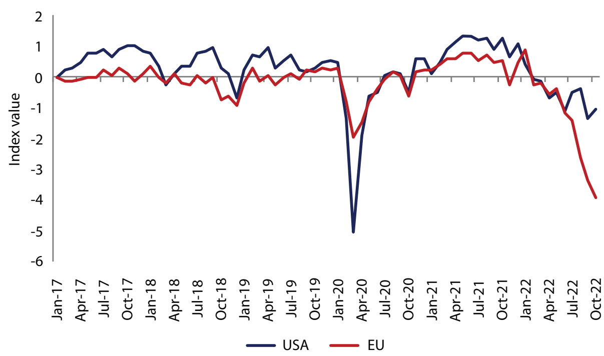
Credit market spreads on US corporate bonds, which remained low in 2021, have been increasing since the beginning of 2022 as uncertainties around global macro-financial front grow. With international credit rating agencies increasingly downgrading ratings of corporates around the world due the gloomy outlook, investor appetite on risk

Chart 1.7 Growth in Foreign Currency Credit (USD) to EMDEs



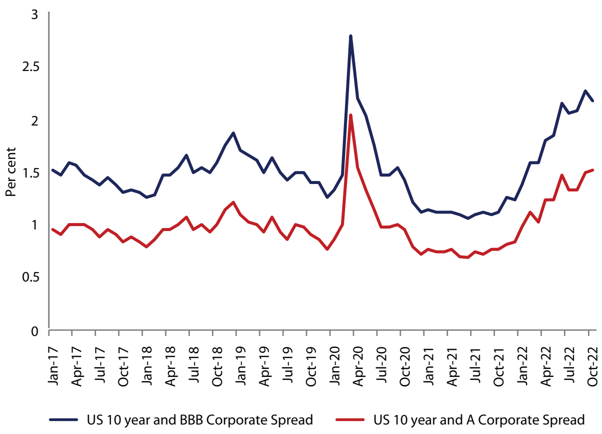
Source: Bank for International Settlements

Chart 1.8 Bloomberg Financial Conditions Index



Source: Bloomberg

Chart 1.9	US Corporate Bond Spread

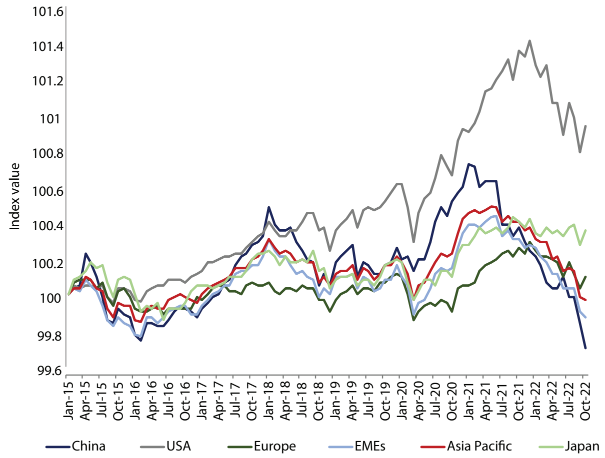


Source: Bloomberg

taking has declined and investors are increasingly more concerned about a possible default cycle. As such, firms, particularly sub-investment-grade entities, are finding it challenging to source credit. Moreover, following the increasing trend in government bond yields, the cost of new funding for corporates has risen significantly. Thus, firms in emerging market economies, which have raised balance sheet leverages subsequent to pandemic related lending concessions, face amplified re-financing risks and are particularly vulnerable in terms of debt repayments, exacerbating financial stability concerns.

Global equity market indices have fallen rapidly since central banks started policy normalisation. As economic outlook deteriorates with the expected outcome of policy normalisation and widespread uncertainty caused by geo-political tensions, investors require higher returns on their investments, to compensate the elevated risk levels. Furthermore, firms have reported that higher costs are constraining profit margins. As such, along with downward revisions of global economic growth forecasts, corporate earnings are also being revised downwards. Due to such reasons, equity risk premia have increased significantly in the recent past. As equity markets fall, the resultant capital reversals could bring in foreign currency liquidity concerns

Chart 1.10	MSCI Share Price Indices

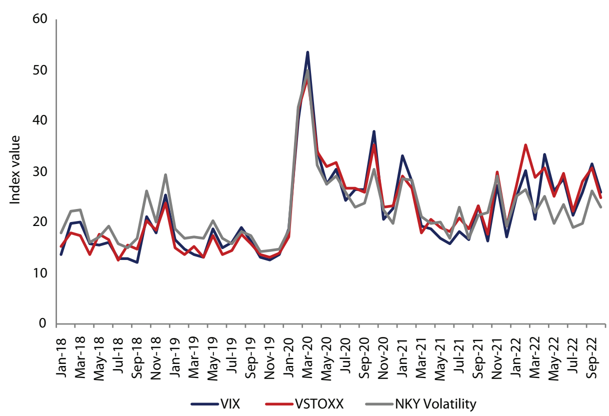


Source: Bloomberg

for, reserve limited and foreign debt burdened economies.

Stock market expected price volatility indices, indicated elevated expected volatilities, implying higher market stress throughout 2022, compared to the pre-pandemic levels. The uncertainties surrounding global economic conditions may have contributed to the elevated level of market stress. The VIX index, which indicates the expected price fluctuation of the S&P 500 index, the VSTOXX index, which indicates the implied volatility of Eurozone stocks, and the NKY Volatility index, which indicates the expected volatility of the Tokyo Stock Exchange, all moved in an almost identical path during the

Chart 1.11	Behaviour of Volatility Indices



Source: Bloomberg

recent past. The expected volatility in stock prices (or market stress), which peaked in April 2020 due to the pandemic somewhat eased during the early part of 2021, with the performance of corporates that exceeded expectations. However, market stress indices started to move on an increasing trend from the second half of 2021, as uncertainties on the path to recovery started to surface, and remains above the levels prevailed before the pandemic period, with the materialisation of anticipated risks and added uncertainties in terms of geo-political tensions.

1.3. Domestic Macrofinancial Conditions

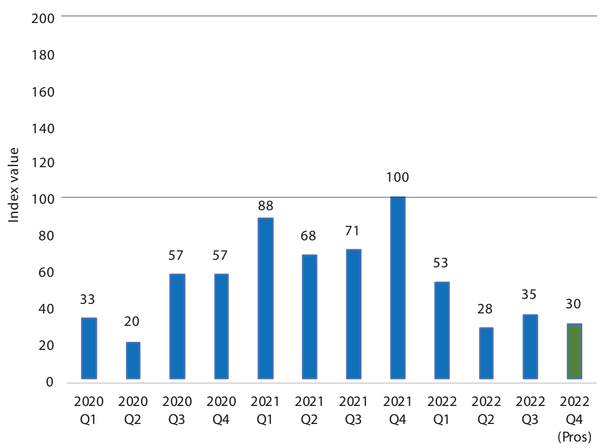
The impact of the fall in economic output during 2022 is expected to be reflected in higher Non-Performing Loans (NPLs) in the financial sector. With the GDP contraction recorded during the first half of 2022 and the envisaged contractionary path for the second half of the year, the Sri Lankan economy is expected to contract by around 8 per cent during 2022. The economic contraction observed in the first half is the result of continuous supply-side constraints, particularly in terms of energy and raw materials, social unrest and uncertainty surrounding the business environment amidst the foreign exchange shortage in the domestic foreign exchange market. Combined with these factors, the lagged effect of tight monetary and fiscal policies would be reflected through the continuation of the economic contraction to the latter part of 2022. This fall in economic output could be reflected in banks' and non-bank financial institutions' balance sheets through increased NPLs caused by declining income levels eroding debt repayment capacities of borrowers. However, with the envisaged improvements in the supply side and the timely and effective implementation of the required reforms, a modest recovery of economic activity could be expected in 2023.

Mirroring the contraction in the economy, domestic business conditions deteriorated significantly throughout 2022, compared to 2021, which signals strained debt repayment capacities of firms. Business conditions remained below the neutral threshold level as per the findings of the Business Outlook Survey conducted by the Central Bank. The deterioration of business conditions was due to supply-side constraints, and the uncertainty that prevailed in the country. According to survey findings, profitability and skilled labour availability remained below the neutral threshold, indicating deterioration of business conditions. Furthermore, demand, sales and capacity utilisation also deteriorated during the most part of 2022, as per

Chart 1.12 Quarterly GDP growth Statistics

Source: Department of Census and Statistics

Chart 1.13 Business Conditions Index



Source: Central Bank of Sri Lanka

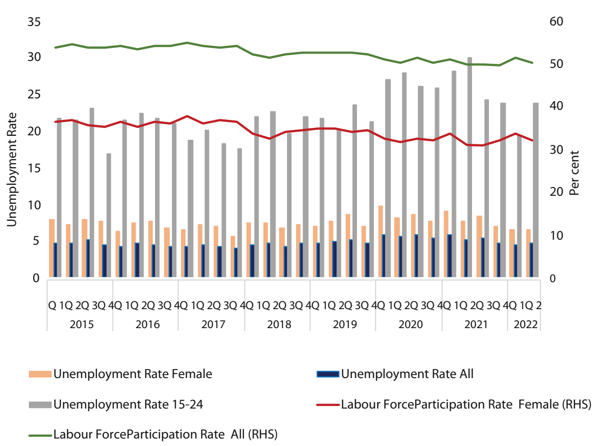
the findings of the survey. Moreover, demand, sales and capacity utilisation would further deteriorate in the period ahead as an intended result of the tight monetary policy stance. Meanwhile, the performance of listed Non-Financial Corporates (NFCs) during the nine months ending 2022 was uneven, with few key players dominating in terms of profits and earnings. Furthermore, the overall creditworthiness of listed NFCs, in terms of debt-to-equity and interest coverage ratios, deteriorated during the nine months ending 2022, Y-o-Y.

Exacerbating structural deficiencies in the labour market could have implications on financial inclusion and household balance sheets. Although the unemployment rate has been on a declining trend since the pandemic's peak, labour force participation remains around 50 per cent, indicating that the remaining 50 per cent of the working-age population is economically inactive. Furthermore, chronic structural imbalances such as high youth unemployment rate, high female unemployment rate and low female labour force participation continue to dampen the equitable distribution of income earning opportunities and directly affect access to financial markets. Moreover, such structural deficiencies also lead to fragilities in household income and could affect household debt repayment capacities, particularly amid recessionary economic conditions.

Financial intermediation declined until end September 2022, which is an envisaged outcome of monetary tightening. Financial intermediation, as measured by the Credit to Deposit Ratio (CDR), declined rapidly during the period under review. CDR, which declined during the pandemic period despite policy measures taken to enhance credit flows, further declined at a faster rate during the period under review as expected after monetary tightening. The decline in CDR during the pandemic period was due to banks raising their investments amidst the growth in deposits. However, the decrease in CDR during the most part of 2022, particularly after the unprecedented monetary policy tightening in April, was the combined effect of banks exercising cautious lending, high lending rates deterring new loans and advances, and high deposit rates attracting new deposits. The impact of the Rupee depreciation on CDR was minimal due to the composition of credit and deposits in terms of the Rupee and foreign currency. Furthermore, according to the findings of the Credit Supply Survey of the Central Bank, banks' willingness to lend and demand for loans from financial consumers declined during the period under review amidst increases in NPLs.

Inflationary pressures increased to historical levels during 2022, raising expenditure of households and firms while straining their debt

Chart 1.14 **Unemployment and Labour Force Participation Rates**

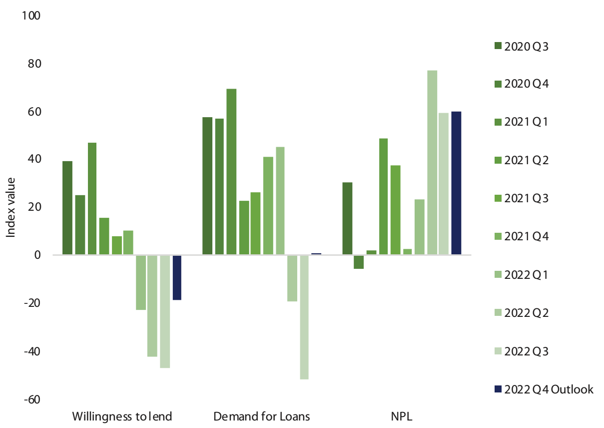


Source: Department of Census and Statistics

Chart 1.15 **Credit to Deposit Ratio of the Banking Sector**

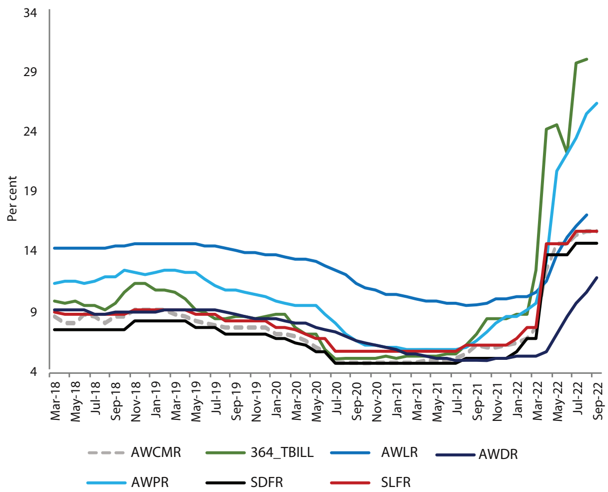
Source: Central Bank of Sri Lanka

Chart 1.16 **Movement of Credit Supply Survey Indices**



Source: Central Bank of Sri Lanka

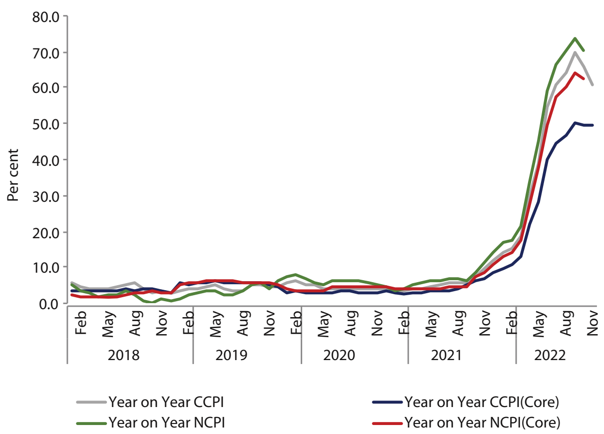
Chart 1.18 **Market Interest Rates**



Source: Central Bank of Sri Lanka

repayment capacities. Inflation, which remained in single digits during a prolonged period since 2009, started to increase at a rapid pace during the latter part of 2021 and reached record-high levels in September 2022. Global and domestic supply-side disruptions, the relaxation of administered price controls to allow prices of certain goods to be primarily market-determined, the sharp depreciation of the Rupee against the US dollar, de-anchored inflation expectations and the intensification of aggregate demand pressures as the lagged impact of monetary policy accommodation mainly contributed to recent inflation surge. Although a disinflationary path is envisaged for the period ahead, the elevated level of the general price level, combined with dampened income due to the impending economic contraction, would exert pressure on the balance sheets of households and firms, limiting their debt repayment capacities. However, the effect of tight monetary and fiscal conditions is expected to flow through the economy, weighing aggregate demand down, anchoring inflation expectations, and gradually taming inflation to the desired levels in the medium to long run.

Chart 1.17 **Inflation**

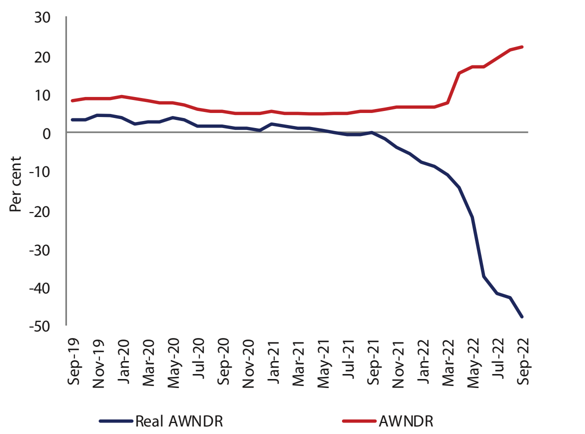


Source: Department of Census and Statistics

Several imbalances in market interest rates prevailed during the period under review, due to high inflation rates and high government security yields caused by elevated risk premia amidst debt restructuring uncertainties. Firstly, the real Average Weighted New Deposit Rate[2] (AWNDR) turned negative in June 2021 and continues to decline rapidly into the negative territory. Secondly, yield rates of government securities are much higher than the prevailing policy rates and deposit rates, as investors demanded higher premia as inflation expectations gained momentum during the most part of 2022 and the traditional status of government securities being risk-free assets became fragile due to concerns related to

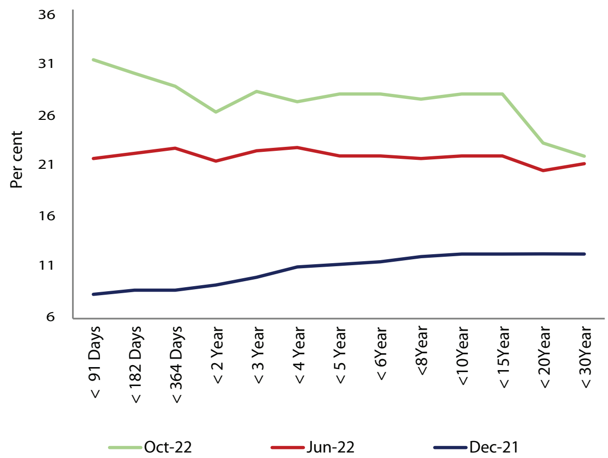
2. Real AWNDR is computed by adjusting AWNDR for inflation measured through the Colombo Consumer Price Index (CCPI).

Chart 1.19 AWNDR and Real AWNDR



Source: Central Bank of Sri Lanka

Chart 1.20 Secondary Market Yield Curve of Government T-bills and T-bonds

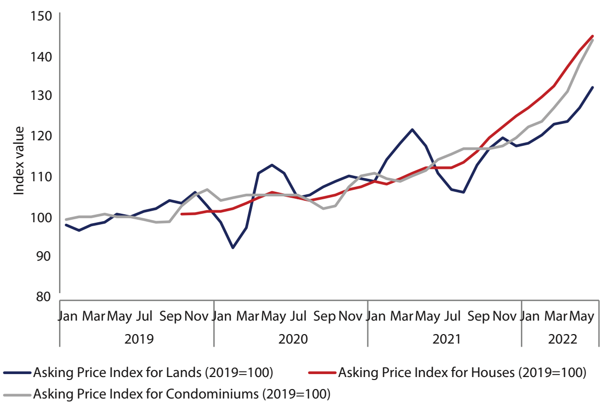


Source: Central Bank of Sri Lanka

debt restructuring. Thirdly, the yield curve of government securities shows an irregular pattern, depicting a shape closer to a flattening/ inversion, which is usually regarded as a signal of an impending recession, which undermines economic confidence. Meanwhile, in the current stressed liquidity conditions and high interest rate environment, deposit taking financial institutions offer even higher interest rates to attract deposits, particularly for longer term tenures. This is an unhealthy development as it locks their cost of funding for a longer time raising stability concerns for such institutions and affecting future monetary policy transmission when it starts to accommodate. Nevertheless, these imbalances are eventually expected to correct in the medium to long term, with the realisation of the envisaged disinflationary path, conclusion of the debt restructuring process, stabilisation of macroeconomic fundamentals of the country and eventual relaxation of monetary policy followed by a rational adjustment of market interest rates.

As the financial sector navigates challenging conditions due to macroeconomic imbalances, several banking sector exposure concerns are amplified. Banking sector exposure to real estate related activities continued to increase on Y-o-Y basis as at end June 2022. With the uncertainties surrounding financial investments and the negative real returns associated with such investments, prices in the property market for Condominiums, Lands, and Houses increased by more than 20 per cent, on Y-o-Y basis during the first half of 2022. However, sales of new condominiums fell sharply during Q2 2022, and condominium developers predict a further decline in sales during the coming period ahead, citing affordability constraints and buyers delaying purchasing decisions until economic uncertainties dissipate as reasons. In this uncertain environment, developers could face heightened level of liquidity stress, with the

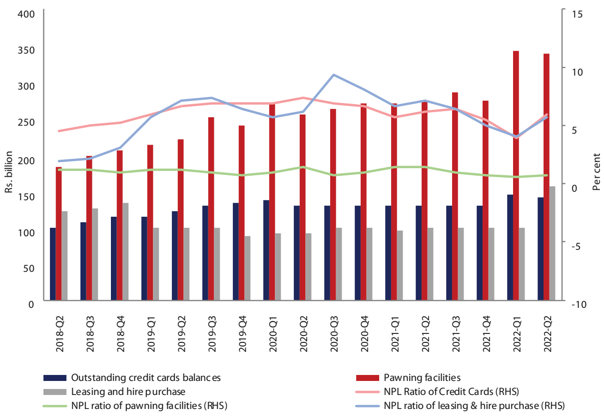
Chart 1.21 Movements in Property Price Indices



Source: Central Bank of Sri Lanka

Chart 1.22

NPLs of Selected Loan Categories



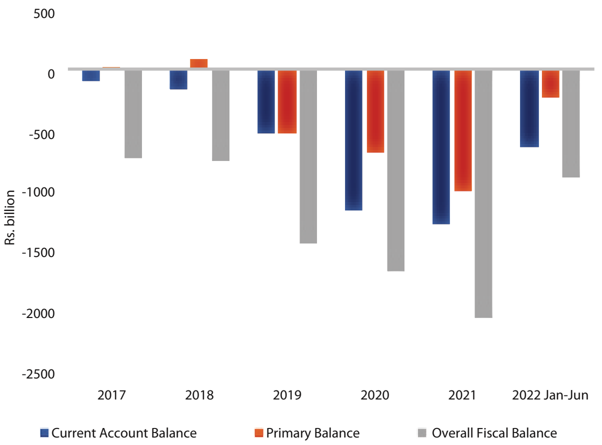
Source: Central Bank of Sri Lanka

fall in new condominium sales and rising cost of borrowing from the banking sector, as pre-deposit sales and bank loans compose the larger portion of funding for condominium developers. This could create a negative feedback loop of financial sector vulnerabilities. When developers face liquidity stresses, it raises their probabilities of default and prevent them from finishing ongoing developments. As buyers become concerned with the delay in handing over their units, they could request moratoria on mortgages and exacerbate NPL risks for banks. Meanwhile, bank and non-bank exposure levels in terms of leasing and hire purchase, pawning and credit card facilities also remain a concern in the current uncertain period amidst rising household expenditure and declining income levels.

As macroeconomic vulnerabilities intensified, poor liquidity conditions transpired to most domestic financial markets. The Treasury bonds market experienced sparse liquidity conditions tied up with fiscal and macroeconomic developments, as primary market yields skyrocketed to historical levels, and the secondary market remained illiquid. Furthermore, with the amplification of fiscal imbalances, concerns over debt restructuring and inflation expectations gaining momentum, investors demanded higher premia on Treasury bills as well. Meanwhile, counterparty risk perception of foreign banks on domestic banks in the overnight call money market intensified and market activities declined, affecting the smooth flow of funds through the financial system, requiring banks to use standing deposit and lending facilities of the Central Bank. Furthermore, the exacerbation of the domestic foreign exchange market liquidity shortage caused depreciation pressures and necessitated allowing more flexibility in the determination of the exchange rate in early March 2022, which led to a significant depreciation of the exchange rate that resulted in a substantial adjustment in banks' balance sheets in Rupee terms. Despite curtailed import expenditure, the debt standstill and modest inflows, excessive and speculative volatilities exacerbated the pressure on the intraday exchange rate. As such, the Central Bank commenced providing market guidance on the interbank weighted average spot exchange rate, which reinstated the stability in the exchange rate and narrowed the official and grey market exchange rate gap, albeit the liquidity shortage in the market remains.

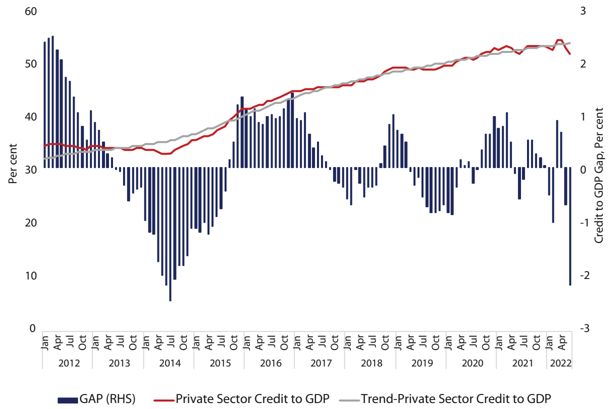
The Government's unprecedented fiscal reforms, which started with the announcement of the debt standstill in April 2022, would have significant direct and indirect implications on the financial system. Subsequent to the debt standstill announcement in April 2022, and the escalation of the Balance of Payments (BOP) crisis to an unprecedented level, the foreign currency liquidity shortage faced by banks amplified as they were unable to rollover their foreign currency liabilities. Further, tax adjustments introduced as a part of revenue enhancement measures would strain balance sheets of economic agents particularly in the household sector, which would diminish debt repayment capacities and lead to higher NPLs in the financial sector. Moreover, State Owned Business Enterprises (SOBEs) with weak financial positions also expose banks to elevated credit and liquidity risk while uncertainties surrounding the

Chart 1.23 Major Fiscal Balances



Source: Ministry of Finance, Economic Stabilisation and National Policies

Chart 1.24 Private Sector Credit to GDP



Source: Central Bank of Sri Lanka

government debt restructuring process is raising financial stability concerns.

Amidst the developments in the macroeconomy, the private sector Credit-to-GDP gap signals a declining phase of the credit cycle. Credit to GDP gap, which is an indicator used to determine the credit cycle and considered to be a useful early-warning signal for heightened stress in the financial system, remained in the negative territory since the beginning of 2022 apart from the months of March and April. The sharp depreciation of the Sri Lanka rupee since March 2022 was the key reason for the augmentation of credit to private sector in rupee terms during March and April 2022. Thus, as the gap indicates that the economy is moving along a recessionary phase of the financial cycle with tighter financial conditions and pessimistic investor sentiments where vulnerabilities in the economy could materialise and cause a significant stress in the financial system.

Nevertheless, with the effective, timely and uninterrupted implementation of much needed economic reforms subsequent to the successful finalisation of debt restructuring negotiations, it is expected that the economy would transition onto the recovery path and these macrofinancial vulnerabilities would dissipate in the medium to long run. However, the path to macroeconomic recovery while maintaining financial system stability is arduous and narrow and it is pertinent to note that the desired outcome is conditional on the commitment of all relevant stakeholders in adhering to required policy reforms.

Special Note 1

Key Policy Changes and Regulatory Actions Implemented for the Financial Sector in 2022

Financial Institutions

Licensed Banks

11 March 2022	An amendment to the Monetary Law Act (MLA) Order No. 02 of 2021 was issued informing the revised maximum interest rates on credit card advances, pre-arranged temporary overdrafts, and pawning advances considering the monetary policy tightening measures and the expected macroeconomic developments.
	An amendment to the MLA Order No. 03 of 2021 was issued removing the maximum interest rates imposed on foreign currency deposits of Licensed Commercial Banks (LCBs) and National Savings Bank (NSB), considering the recent Monetary Policy tightening measures, expected macroeconomic developments, and the prevailing interest rates on foreign currency deposits of licensed banks.
22 March 2022	Banking Act Directions were issued revoking the Banking Act Directions No. 07 of 2021, on forward Sales and Purchases of Foreign Exchange by LCBs, considering the macroeconomic developments in the country.
24 March 2022	A Circular was issued on Guidelines on the establishment of post COVID-19 revival units in licensed banks, in order to identify and assist underperforming and non-performing borrowers affected by the pandemic for the purpose of reviving viable businesses with the potential of contributing to the national economic growth, thus facilitating unwinding of moratorium in a sustainable manner.
21 April 2022	An MLA Order was issued, revoking the maximum interest rates imposed on credit card advances, pre-arranged temporary overdrafts, and pawning advances. Further, licensed banks were permitted to adjust the interest rates of deposits upwards adequately, considering the tight monetary policy measures adopted by the CBSL.
06 May 2022	Banking Act Directions were issued restricting discretionary payments, and non-essential/non-urgent expenditures of licensed banks, while requiring licensed banks to exercise extreme prudence when incurring capital expenditure, until 31 December 2022, considering the possible adverse impact on liquidity and other key performance indicators of licensed banks due to the prevailing macroeconomic conditions and the importance of maintaining appropriate levels of liquidity and capital buffers.
19 May 2022	With the objective of curtailing imports of non-essential and non-urgent goods to preserve the stability of the exchange rate and liquidity in the domestic foreign exchange market, a 100% non-interest bearing cash margin deposit requirement was introduced for imports under specified Harmonised System (HS) Codes, through Banking Act Directions to LCBs and NSB for importation under Documents against Acceptance (DA) and Documents against Payment (DP) terms and through an MLA Order to LCBs for importation under Letters of Credit (LCs).

23 May 2022	Banking Act Directions were issued to licensed banks on certain regulatory requirements considering the prevailing extraordinary macroeconomic conditions. Accordingly, licensed banks were permitted to draw down the capital conservation buffer, stagger the overnight mark-to-market losses on government securities arising from the changes in policy rates (08 April 2022) denominated in LKR that are measured at fair value up to the second quarter of 2024 for the purpose of Capital Adequacy Ratio computation, while regulatory minimum requirements for liquidity coverage and net stable funding ratios reduced from 100 per cent to 90 per cent up to 30 September 2022. Revised treatment on the Other Comprehensive Income (OCI) for computation of capital adequacy ratio was introduced in line with the International Standards. Further, the deadline to meet the minimum capital requirements was extended up to 31 December 2023 and licensed banks were encouraged to move to The Standardised Approach (TSA) or the Alternative Standardised Approach (ASA) to compute risk weighted assets for Operational Risk, until 31 December 2023, subject to conditions.
08 June 2022	An MLA Order was issued revoking the MLA Order No. 03 of 2021, on maximum interest rates on foreign currency deposits of LCBs and NSB except Order 07 of the same, in view of the recent monetary policy tightening measures.
22 June 2022	Banking Act Directions on sustainable finance activities of licensed banks were issued to provide a governance and risk management framework for sustainable finance activities of licensed banks in line with the Sustainable Finance Road Map of the CBSL to promote financing for sustainable economic activities in Sri Lanka.
04 July 2022	Addendum to the Banking Act Direction No. 08 of 2011 on Customer Charter of licensed banks was issued expanding the requirements to improve accessibility to banking services for customers with special needs, with a view to further strengthening financial consumer protection measures for such customers.
07 July 2022	A Circular was issued requesting licensed banks to provide appropriate concessions, for a period of six months, to borrowers whose income or businesses have been adversely affected due to the current macroeconomic conditions and(or) the COVID-19 pandemic while preventing any undue stress on the banking sector stability. These concessions are provided on a case-by-case basis based on the future repayment capacity of the individuals and viability of businesses/ projects.
26 August 2022	Banking Act (Off-shore Banking Business Scheme) Order was issued recognising the Indian Rupee (INR) as a designated foreign currency for foreign currency transactions of the off-shore banking units of LCBs.
29 August 2022	Banking Act Directions were issued mandating the recording of Unique Identification Numbers (UINs) of the depositors of licensed banks. Accordingly, licensed banks were required to record UINs for all new depositors w.e.f. 01 October 2022 and to complete recording UINs of the existing customers in their systems by 31 December 2023.

Licensed Finance Companies (LFCs), Specialised Leasing Companies (SLCs), Licensed Microfinance Companies (LMFCs) and Primary Dealer Companies (PDCs)

05 January 2022	The Monetary Board of the CBSL, in terms of the Regulations made under the Registered Stock and Securities Ordinance and the Local Treasury Bills Ordinance, has decided to extend the suspension of Perpetual Treasuries Limited (PTL) from carrying on the business and activities of a Primary Dealer for a further period of six months with effect from 05 January 2022, in order to continue with the investigations being conducted by the CBSL.
28 January 2022	A Direction was issued on Technology Risk Management and Resilience with the objective of setting the minimum regulatory requirements on technology risk management and resilience for LFCs.
08 February 2022	LFCs were requested to grant an incentive for Sri Lankans working abroad by reimbursing the transaction cost incurred on account of inward workers' remittances.
10 March 2022	LFCs were informed on granting transitional period until 01 July 2022 for the effective implementation of sections 10 and 12 of the Finance Business Act (FBA) Direction No. 05 of 2021 on Corporate Governance.
18 March 2022	A Direction was issued on Mobile Phone based E-money Services in order to provide a solution for easy access to finance by enabling convenient banking and to improve efficiency of the operations of LFCs.
21 March 2022	Subsequent to the amalgamation of Sinhaputhra Finance PLC (SFP) with Commercial Leasing and Finance PLC as a part of the Masterplan for Consolidation of Non-Bank Financial Institutions (NBFIs), the Monetary Board of the CBSL has cancelled the license issued to SFP to carry on finance business under the FBA, No. 42 of 2011. Further, registration of SFP issued under the Finance Leasing Act, No. 56 of 2000 (FLA), was cancelled by the Director, Supervision of Non-Bank Financial Institutions (D/SNBFI).
31 March 2022	Subsequent to the amalgamation of the Commercial Leasing and Finance PLC (CLFP) with LOLC Finance PLC as a part of the Masterplan for Consolidation of NBFIs, the Monetary Board of the CBSL has cancelled the license issued to CLFP to carry on finance business under the FBA. Further, registration of CLFP issued under the FLA, was cancelled by D/SNBFI.
	Prevailing maximum interest rates on deposits and debt instruments have been revised due to the increase in policy rates.
	LFCs and SLCs were informed on deferment of the implementation of section 4.3.1.(i) of the FBA Direction No. 01 of 2020 and FLA Direction No. 01 of 2020 on Classification and Measurement of Credit Facilities by a period of two years due to the present economic conditions.

18 April 2022	Prevailing maximum interest rates on deposits and debt instruments were revised allowing LFCs to decide the maximum interest rates on deposits and debt instruments, and SLCs to decide the maximum interest rates on debt instruments based on the moving average of Weighted Average Yield Rate of the last four treasury bill auctions.
12 May 2022	Subsequent to the amalgamation of the Prime Finance PLC (PFP) with HNB Finance PLC as a part of the Master plan for Consolidation of NBFIs, the Monetary Board of the CBSL has cancelled the license issued to PFP to carry on finance business under the FBA. Further, registration of PFP issued under the FLA was cancelled by the D/SNBFI.
08 June 2022	LFCs, SLCs, and LMFCs were informed on removing the maximum interest rate on microfinance loans considering the significant increase in the market interest rates.
05 July 2022	The Monetary Board of the CBSL, in terms of the Regulations made under the Registered Stock and Securities Ordinance and the Local Treasury Bills Ordinance, has decided to extend the suspension of PTL from carrying on the business and activities of a Primary Dealer for a further period of six months with effect from 05 July 2022, in order to continue with the investigations being conducted by the CBSL.
20 July 2022	A Circular was issued to LFCs and SLCs requesting them to provide concessions to borrowers whose income or businesses have been adversely affected due to the current macroeconomic conditions.
29 August 2022	Assetline Finance Ltd. (formerly known as Assetline Leasing Co. Ltd., a SLC registered under FLA) was issued with a finance business licence in terms of Section 5(7) of FBA, as a part of the Masterplan for Consolidation of NBFIs.
02 September 2022	A Direction was issued mandating the recording of Unique Identification Numbers (UINs) of the depositors of LFCs. Accordingly, all LFCs were required to record UINs for all new depositors w.e.f. 01 October 2022 and to complete recording UINs of the existing customers in their systems by 31 December 2023.
30 September 2022	LFCs were informed that the appointment of an external audit firm to an LFC shall be made after a cooling off period of 2 years, if such audit firm had been previously engaged in the internal audit function of that LFC, with a view of ensuring the best governance practices, independency, and transparency, with reference to Section 10 of the Corporate Governance Direction No.05 of 2021.
12 October 2022	LFCs were informed that the transitional provisions prevailing until 01 July 2024 will be effective for Sections 10 and 12.1(a), in addition to the transitional provision stated under Section 19 of the Corporate Governance Direction No.05 of 2021. The letter dated 10 March 2022 on this subject was replaced by the letter issued on 12 October 2022.

Insurance

26 January 2022	Amendments were issued to Determinations 14 and 15 to all insurance companies on "The regulatory reporting formats of the Annual Return and Actuarial Abstract were amended for the purpose of facilitating the submission via Email".
	Direction 01 of 2022 was issued to the industry in respect of restriction of providing codes and restriction on changing codes.
	Circular 01 of 2022 was issued on Prohibition of providing different quotations (reduction of premium) to same policyholder for the same insurance cover.
03 February 2022	Direction 02 of 2022 was issued on a Corporate Governance Framework for Insurers.
25 February 2022	Direction 02 of 2022 (Revised) was issued informing the revision of Direction 02 of 2022 on Corporate Governance Framework for Insurers.
01 July 2022	Guidelines were issued on advertisements to all insurers, brokering companies, and agents, and required them to comply with the same with effect from 01 July 2022.
24 August 2022	Direction 03 of 2022 was issued to the industry with regard to the cooling-off period, guaranteed and non-guaranteed benefits and applicable schedules of long term insurance policy.
06 October 2022	Amendments to Determination 12 was issued to revise the templates of the quarterly regulatory reporting templates of insurance companies.
	Clarification to Circular 01 of 2021 was issued to clarify that the Actuarial Certificate referred to in this Circular shall be issued by the Actuary appointed in terms of Section 46 of the Act.
10 November 2022	Clarification to Circular 40 was issued to clarify that if the stand-alone health covers are renewed at the end of the term of five years or more, the subsequent period of cover shall be for a period of five years or more, and that the premium agreed shall not be increased or the benefits shall not be decreased during the said period.

Financial Markets

Government Securities Market

01 February 2022	An incentive scheme was introduced for Arrangers including Designated Agents (DAs) who bring investments for Sri Lanka Development Bonds (SLDBs) via the Direct Window. The incentive is equivalent to the US dollar investment amount in SLDBs brought in, multiplied by 50 basis points (0.5 per cent), converted to Sri Lankan rupees (LKR) as per the indicative exchange rate applicable on the settlement date of the transaction. Incentives will be disbursed through DAs to the designated LKR account.
12 April 2022	The Ministry of Finance announced an interim policy on the servicing of Sri Lanka's external public debt, which will be the policy of the Government to suspend normal debt servicing of all Affected Debts as indicated in the policy statement for an interim period, pending an orderly and consensual restructuring of the obligations in a manner consistent with an economic adjustment programme supported by the International Monetary Fund (IMF).

29 April 2022	SLDBs have been excluded from the "Affected Debts" under the interim policy on servicing Sri Lanka's external public debt as announced on 12 April 2022. However, an alternative mechanism for settlement of SLDBs was introduced based on constraints on availability of liquid foreign currency resources. • Settlement in LKR, subject to monetary policy considerations (LKR settlement date may depend on the fund availability of the General Treasury). At the introduction, extremely small values of SLDB maturities and interest payments were settled in foreign currency and discontinued subsequently. • Extension of the maturity period of respective SLDB investments (including the interest payment) up to a minimum of six months from due payment date with original terms and conditions, i.e., interest rates applicable to each individual bid of original issuance. • Facilitation of Government securities (Treasury bills or Treasury bonds) auctioned at the immediate preceding primary market issuance at the weighted average yield rate or in the case of different maturities other than the maturities offered at the immediate preceding primary auction, at interpolated or extrapolated weighted average yield rates for remaining maturity. This arrangement proposed for settlement of SLDBs via government securities is now facilitated only in Treasury bonds.
07 June 2022	A resolution to increase the limit on Treasury bills to Rs. 4,000 billion from the previous limit of Rs. 3,000 billion was approved by the Parliament (No. 36 Order Paper of Parliament).
22 June 2022	A Phase II for Treasury bill auctions was introduced for further subscription until 3.30 pm on the day prior to the settlement date of the respective Treasury bill auction. Maximum amount offered for Phase II would be the auction shortfall plus 25 per cent from the aggregate amount offered at the auction. The issuance is made at the Weighted Average Yield Rates determined for respective maturities at the auction. In the event of oversubscription, allocation will be made based on aggregate successful participation by auction participants at the auction.

Capital Market

February 2022	Approval was granted for the measures to further streamline the dividend payment process.
April 2022	Approval was granted for the final policy framework for regulated short selling through securities borrowing and lending.
	Approval was granted for the proposed revisions to the transaction cost applicable for repurchase of corporate debt.

June 2022	Approval in principle was granted for the introduction of blue bonds in CSE.
	A Memorandum of Understanding was signed between the Securities and Exchange Commission, the Chartered Financial Analyst Institute, and the Colombo Stock Exchange for promoting awareness on Environmental, Social and Governance (ESG).
	Approval was granted for the introduction of a central counterparty settlement mechanism.
	Completed the third phase of the digitisation of the Sri Lankan Capital Market.
September 2022	Approval was granted for the proposed regulatory framework for issuing sukuk products.

Financial Infrastructure

Payments and Settlements

25 January 2022	After fulfilling the eligibility requirements, participant status of the LankaSettle System was granted to NSB. NSB is the first Licensed Specialised Bank (LSB) to obtain the participant status of the LankaSettle System.
08 February 2022	The CBSL launched the National Remittance Mobile Application, 'Lanka Remit' in February 2022, which provides Sri Lankans working abroad to send money to Sri Lanka and to pay utility bills using Electronic Fund Transfer Cards. Further, the 'Lanka Remit' app has the remittance tracking facility, and the user can access global money transfer operators linked with the local LCBs.
28 February 2022	The General Directions on Sri Lanka Interbank Payment System (SLIPS), Common ATM Switch (CAS), Common Electronic Fund Transfer Switch (CEFTS), and Common Point-of-Sales (POS) Switch were revised and issued under the Payment and Settlement Systems Act No. 28 of 2005 to include LSBs to obtain Primary Membership of SLIPS, CAS, CEFTS, and Common POS Switch, after becoming a participant in the RTGS System.
28 March 2022	People's Bank commenced a pilot project on issuing a debit card under the National Card Scheme where the debit card can also function as a transit card with the support of its Stored Value function.
20 June 2022	Revised the multi-tiered Liability Manager Limit structure for CAS and CEFTS in order to include NSB that has obtained the participant status of the LankaSettle System and the Primary Membership of CAS and CEFTS in January 2022.

Anti-Money Laundering (AML) and Countering the Financing of Terrorism (CFT)

10 January 2022	Circular No. 01 of 2022 was issued to amend the Circular No. 02 of 2021 on Guidelines for Financial Institutions on Closed-Circuit Television (CCTV) operations for AML/CFT purposes.
22 March 2022	Circular No. 02 of 2022 was issued on further information requested on Suspicious Transaction Reports.
25 August 2022	Circular No. 03 of 2022 was issued on provision of efficient banking services to Sri Lanka expatriates.

Foreign Exchange Management and International Operations

19 January 2022	Operating instructions were issued to all licensed banks on reimbursement of the transaction cost of workers' remittances with an objective of encouraging more workers' remittances to the country through formal fund transferring channels.
21 January 2022	'Acceptance of foreign exchange within Sri Lanka by Hotel Service Providers Rules, No. 01 of 2022' as published in the Extraordinary Gazette Notification No. 2263/41 was issued under the MLA, mandating hotel service providers registered with and licensed by the Sri Lanka Tourism Development Authority to accept payments in respect of services rendered to persons resident outside Sri Lanka only in foreign exchange.
31 January 2022	Extension of the effective periods of "Additional Incentive Scheme on Inward Workers' Remittances" and "Incentives for General Public for Depositing, Converting, and Investing of Foreign Currency Held in Hand" schemes, until further notice, in order to improve foreign exchange inflows to the country through formal channels and to promote foreign currency notes of the country to be channelled through the formal banking system.
24 February 2022	Directions No. 01 of 2022 were issued to Authorised Dealers (ADs) permitting the debit of funds from Personal Foreign Currency Accounts (PFCAs) of Sri Lankans employed abroad (other than an emigrant) to Business Foreign Currency Accounts (BFCAs) of the local educational institutions, to facilitate payment for the purpose of tuition fees in respect of immediate family members who have been enrolled as students of such educational institutions.
	Directions No. 02 of 2022 were issued to ADs permitting ADs to credit funds to BFCAs from PFCAs of Sri Lankans employed abroad (other than an emigrant) of the local educational institutions, to facilitate payment for the purpose of tuition fees in respect of immediate family members who have been enrolled as students of such educational institutions.
09 March 2022	Termination of the additional incentives offered by the CBSL of Rs. 8.00 per US dollar on the conversion of workers' remittances and Rs. 10.00 per US dollar on the conversion of foreign currency notes held in hand, as per the Operating Instructions issued by the CBSL on "Additional Incentive Scheme on Inward Workers' Remittances" and "Incentives for General Public for Depositing, Converting, and Investing of Foreign Currency Held in Hand" schemes with effect from 09 March 2022.

11 March 2022	Repatriation of Export Proceeds into Sri Lanka Rules No. 1 of 2022 was issued under the MLA as published in the Gazette (Extraordinary) Notifications No. 2270/66 imposing inter alia following mandatory conditions on the exporters: • To receive the export proceeds in Sri Lanka, in respect of all goods exported and/ or services provided outside Sri Lanka, within one hundred and eighty (180) days from the date of shipment or provisioning of services • To submit all related documentary evidence on each and every receipt of export proceeds, to the licensed bank, that receives such proceeds, in Sri Lanka; and • To convert residual of the export proceeds received in Sri Lanka, into Sri Lanka Rupees upon utilising such proceeds only in respect of the authorized payments, including local supplier payments specified thereto, on or before the seventh (7th) day of the following month.
	Directions No. 03 of 2022 were issued to ADs determining 'Thai Baht' as a designated foreign currency for the purpose of the Foreign Exchange Act No. 12 of 2017 (FEA).
22 March 2022	Temporary increase of the percentage of weekly mandatory foreign exchange sales to the CBSL by licensed banks on account of converted inward workers' remittances and mandatorily converted export proceeds from 25 per cent to 50 per cent, from the week commencing from 21 March 2022, until the week ending on 29 July 2022, in order to further improve foreign exchange inflows to the CBSL to facilitate essential imports of the country.
28 March 2022	Regulations under the FEA, as published in the Gazette (Extraordinary) Notifications No. 2273/06, were issued to extend the initial period of 24 months given to open and maintain Special Deposit Accounts (SDAs) in the Domestic Banking Units (DBUs) and to transfer from Inward Investment Accounts (IIAs) or accounts maintained in the Offshore Banking Unit (OBU) of the account holder by a further 12 months. Accordingly, eligible persons may open SDAs until 08 April 2023 by inward remittances received to Sri Lanka or by transferring funds from IIAs or accounts maintained in the OBU of the account holder.
7 April 2022	Directions No. 04 of 2022 were issued extending the period by twelve months against the initial period of twenty- four months granted for ADs to open and maintain SDAs at the DBUs and to transfer from IIAs or accounts maintained in the OBU by the account holder, out of the proceeds received as inward remittances in favour of the account holder.

11 April 2022	Reduction of the temporarily increased percentage of weekly mandatory foreign exchange sales to the CBSL by licensed banks on account of converted inward workers' remittances and mandatorily converted export proceeds from 50 per cent to 25 per cent, effective from 11 April 2022 until further notice, considering the prevailing domestic foreign exchange market condition and foreign exchange commitments of banks.
12 May 2022	Introduction of a middle rate of the USD/LKR exchange rate applicable for interbank foreign exchange market transactions, together with the permitted USD/LKR variation margin, to be announced on a daily basis to facilitate orderly behaviour of foreign exchange market and to manage undue intraday volatility in the exchange rate.
03 June 2022	Further broadening the eligibility to open and maintain accounts for the purpose of engaging in foreign exchange transactions, a Regulation under the FEA was issued, as published in the Gazette (Extraordinary) Notifications No. 2282/60, including following persons resident in Sri Lanka who earn foreign exchange from an authorised person who is permitted to engage in business in and from the area of authority of the Colombo Port City in accordance with the provisions of the Colombo Port City Economic Commission Act, No. 11 of 2021 (CPCECA). • An employee of an authorised person, • Any person who is engaged in business with an authorised person for the purpose of provisioning of goods or services.
	Foreign Exchange (Investment in Colombo Port City) Regulations No. 01 of 2022, published in the Gazette (Extraordinary) Notifications No. 2282/59, were issued granting permission for any person resident outside Sri Lanka or any company incorporated in Sri Lanka which is fully owned by persons resident outside Sri Lanka or a joint venture registered/incorporated in Sri Lanka (i.e., investor), to make investments in the Colombo Port City out of inward remittances received from overseas being the funds to finance the investments in the Colombo Port City, subject to the permission granted under the provisions of CPCECA.
08 June 2022	Removal of the ceiling of US dollar interest rate which was applicable to USD/LKR swap transactions by allowing market forces to determine the swap prices with an expectation to enhance the funding status of the domestic foreign exchange market and to improve the financial discipline of banks.

15 June 2022	Directions No. 05 of 2022 were issued to Restricted Dealers on buying, selling and exchanging foreign currencies in addition to the General Conditions specified in Direction No.11 of 2020, including the following additional conditions. • Suspension of offering higher exchange rates by money changers to customers, than the exchange rates offered to them by ADs with whom they maintain accounts to deposit foreign currencies, • Mandating money changers to take necessary measures to assure continuous and uninterrupted operations of the Closed- Circuit Television (CCTV) System, to maintain CCTV recordings for a minimum period of 30 days and to provide the same upon the request of the Department of Foreign Exchange (DFE).
16 June 2022	'Acceptance of foreign exchange within Sri Lanka by Hotel Service Providers Rules, No. 01 of 2022', as published in the Gazette (Extraordinary) Notifications No. 2263/41 issued under the MLA, mandating hotel service providers to accept payments in respect of services rendered to persons resident outside Sri Lanka only in foreign exchange was repealed by the Rule published in the Gazette (Extraordinary) Notifications No. 2284/40.
	An amendment to the Order under Section 8 of the FEA, as published in the Gazette (Extraordinary) Notifications No. 2284/34, was issued to implement the following: • Reducing the amount of foreign currency retained in possession by a person in, or resident in, Sri Lanka from US Dollar 15,000 to US Dollar 10,000 or its equivalent in other foreign currencies; and • Granting an amnesty period of 14 working days effective from the date of the Order for persons in, or resident in, Sri Lanka who hold foreign currency notes in possession to deposit into a PFCA or into a BFCA, or to sell to an AD as appropriate.
28 June 2022	Directions No. 06 of 2022 were issued permitting ADs to open and maintain Colombo Port City Investment Account - Investor (CPCIA- Investor) for the eligible persons, in order to facilitate investments in the Colombo Port City, subject to the conditions stipulated therein.
	Directions No. 07 of 2022 were issued, permitting ADs to open and maintain Colombo Port City Investment Account - Investee (CPCIA- Investee) for the authorised persons under the provisions of CPCECA.

30 June 2022	An Order under Section 22 of the FEA, published in the Extraordinary Gazette Notifications No. 2286/27 dated 30 June 2022, was issued to suspend/limit outward remittances with respect to selected capital transactions for six months commencing from the date of the Order.
	Directions No. 08 of 2022 were issued to permit the credit of earnings/ payments in foreign exchange received by an account holder from a foreign currency account of an authorized person who is permitted to engage in business in and from the area of authority of the Colombo Port City in accordance with the provisions of the CPCECA to the PFCAs opened and maintained in terms of Directions No. 04 of 2021.
	Directions No. 09 of 2022 were issued to permit the credit of earnings/ payments in foreign exchange received by an account holder from a foreign currency account of an authorized person who is permitted to engage in business in and from the area of authority of the Colombo Port City in accordance with the provisions of the CPCECA to the BFCAs opened and maintained in terms of Directions No. 05 of 2021.
05 July 2022	On the lapse of the Order under Section 8 of the FEA as published in the Gazette (Extraordinary) Notifications No. 2284/34, a New Order under Section 8 of the FEA was published in the Gazette (Extraordinary) Notifications No. 2287/16, extending the amnesty period by 14 working days, for persons in or resident in Sri Lanka who hold foreign currency notes in possession to deposit such foreign currency notes into a PFCA, or a BFCA, or to sell to an AD as appropriate.
12 August 2022	'Repatriation of Export Proceeds into Sri Lanka Rules' No. 2 of 2022 were issued under the MLA, as published in the Gazette (Extraordinary) Notifications No. 2292/50, excluding the exporters of services from the conversion requirements stipulated in the Repatriation of Export Proceeds Rules No. 01 of 2022.
15 August 2022	On the lapse of the Order under Section 8 of the FEA, as published in the Gazette (Extraordinary) Notifications No. 2284/34, a New Order under Section 8 of the FEA was published in the Gazette (Extraordinary) Notifications No. 2293/07, extending the amnesty period by one month, for persons in, or resident in, Sri Lanka who hold foreign currency notes in possession, to deposit such foreign currency notes into a PFCA or a BFCA, or to sell to an AD as appropriate.
25 August 2022	Instructed banks to sell 25 per cent of the service export receipts/proceeds converted into Sri Lanka rupees to the CBSL, with effect from 12 August 2022, to effect the mandatory foreign exchange sale requirement to the CBSL on converted service export proceeds, following the Gazette Extraordinary No. 2292/50 dated 12 August 2022.
26 August 2022	Directions No. 10 of 2022 were issued to ADs determining 'Indian Rupees (INR)' as a designated foreign currency for the purpose of the FEA.
31 August 2022	Circular No. 02/2022 was issued by the Ministry of Labour and Foreign Employment on granting permits/licenses for the importation of fully electric vehicles by Sri Lankans employed abroad who remit foreign exchange to Sri Lanka through the banking system of the country.

08 September 2022	Regulations under the FEA were issued, as published in the Gazette (Extraordinary) Notification No. 2296/12, granting permission to roll-over SDAs already opened for a maximum period of thirty-six months from the initial date of placing such deposits.
09 September 2022	Circular No. 02/2022 issued by the Ministry of Labour and Foreign Employment on granting permits/licenses to import fully electric vehicles for Sri Lankans employed abroad was amended, revising certain eligibility conditions as follows. • Removing the maximum limit of Cost, Insurance and Freight (CIF) value of the vehicle to be imported, • Allowing the migrant workers to transfer the vehicle to a third party prior to the expiration of two (02) year time period by paying a transfer tax of equivalent to 10% of the CIF value of the vehicle.
16 September 2022	Circular No. 02/2022 issued by the Ministry of Labour and Foreign Employment on granting permits/licenses to import fully electric vehicles for Sri Lankans employed abroad was amended, by granting permission to an agent/authorized distributor of the manufacturer who is registered in Sri Lanka to import 3 brand new fully electric vehicles in 3 different models.
08 November 2022	Directions No. 11 of 2022 were issued permitting ADs to open and maintain Golden Paradise Foreign Currency Accounts (GPFCAs) in the names of foreign nationals who wish to stay in Sri Lanka on 10 years' resident visas under the 'Golden Paradise Visa Programme' implemented by the Department of Immigration and Emigration.

Chapter 2

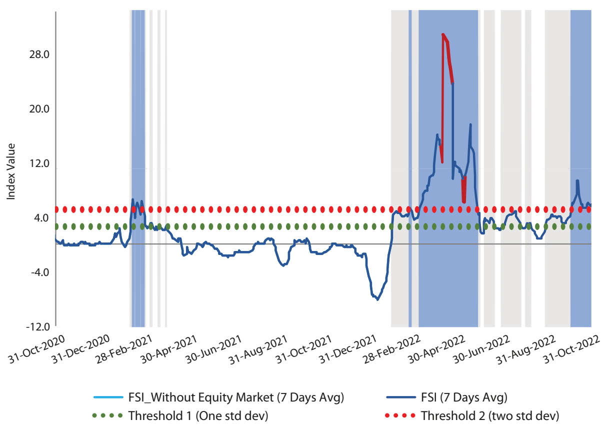
Financial Markets

2.1 Overview

Financial markets underwent numerous challenges emanating from adverse macroeconomic conditions that prevailed in the country. The financial markets' stress level as denoted by the Financial Stress Index (FSI) generally remained high during the ten months ending October 2022. FSI reached its peak in mid-April reflecting uncertainties that prevailed in the financial markets amidst the tightened monetary policy stance, adverse macroeconomic conditions, the announcement of debt standstill in April 2022, supply side disturbances, dampened market confidence, and socio-political unrest.

The equity market recorded dismal performance during the ten months ending October 2022 compared to the corresponding period of the previous year, reflecting the negative market sentiments against the backdrop of adverse macroeconomic conditions. The market capitalisation and price indices recorded a significant year-to-date decline while domestic turnover moderated from the previously recorded elevated levels. On a positive note, foreign inflows to the equity market improved during the period concerned.

Chart 2.1 **Financial Stress Index (FSI) [1]**



Sources: Central Bank of Sri Lanka
Colombo Stock Exchange

1. FSI was estimated excluding the equity market data, from 11 April 2022 to 22 April 2022 and from 10 May 2022 to 11 May 2022 since the CSE was closed during these periods. The estimated values are shown with a blue line in Figure 2.1.

Meanwhile, the government securities market continued to expand rapidly during the ten months ending October 2022 along with the need for accommodating substantive funding requirements of the Government and loss of access to international capital markets. Historically high yields were observed in the government securities market due to a multitude of factors such as the unprecedented policy interest rate hike in early April 2022, the announcement of debt standstill which gave rise to debt restructuring concerns, and the heavy funding requirements of the Government. Further, greater investor preference for shorter tenured securities was observed during the ten months ending October 2022 reflecting uncertainty over the longer term. This exerts pressure on the government securities market, particularly in the short term and may pose some rollover risk to the issuer.

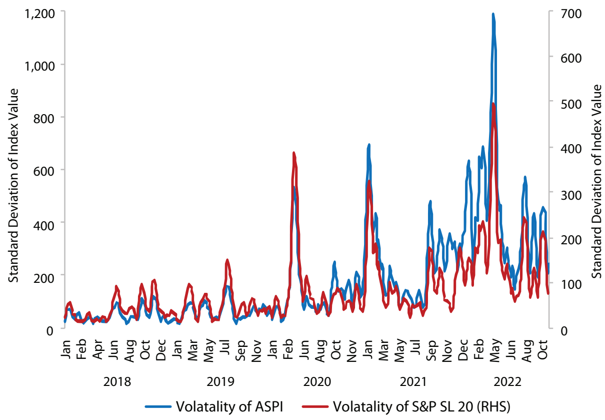
Both the domestic money market and the domestic foreign exchange market experienced strained liquidity conditions. Money market liquidity remained at a persistent deficit level and a *significant asymmetricity in liquidity distribution among market participants was observed. With the stringent counterparty limits of the market participants subsequent to the announcement of the debt standstill by the Government, transactions in the overnight call money market remained subdued, reflecting the increased concerns over counterparty risks. As a result, Participating Institutes (PIs) relied heavily on the facilities provided by the Central Bank. The domestic foreign exchange market remained less active during the ten months ending October 2022 amidst severely strained foreign exchange liquidity. Even though significant intraday volatilities in the USD/LKR exchange rate were observed after allowing more flexibility in the determination of the exchange rate in March 2022, with the start of providing daily guidance to all Licensed Commercial Banks on the spot exchange rate with an allowable two-sided variation margin since mid-May, fluctuations and the intraday volatility in the exchange rate started to stabilise gradually. However, the USD/LKR exchange rate recorded an overall depreciation of 44.8 per cent during the ten months ending October 2022.*

Owing to the progress made thus far in relation to the Staff Level Agreement (SLA) of the International Monetary Fund-Extended Fund Facility (IMF-EFF) programme and debt restructuring negotiations to achieve debt sustainability, the gradual recovery of foreign inflow sources such as tourism, and comparably improved socio-economic and political stability due to some swift policy actions have reduced the strain in the financial markets to a greater extent in the latter part of the period under consideration.

2.2 Equity Market

The equity market was in a declining trend in terms of price indices amidst higher volatilities during the ten months ending October 2022. Ongoing economic contraction, high inflation, accelerated moves to raise policy rates domestically and abroad, slowdown in net profit growth in corporate sector coupled with an anticipated further decline in corporates' bottom line due to tax adjustments, and adverse global economic conditions arising from cross border effects from Russia's invasion of Ukraine contributed to the volatility of the equity market.

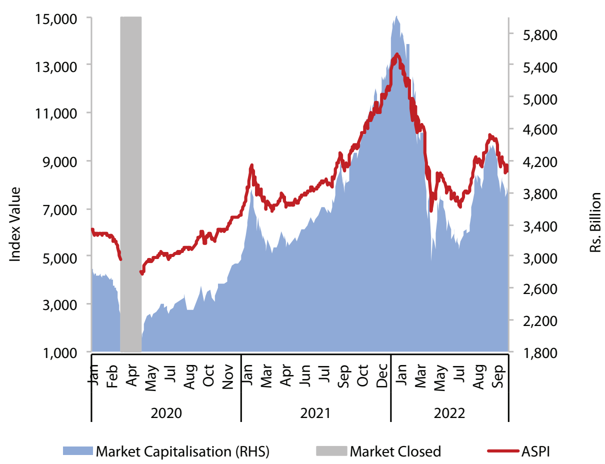
Chart 2.2 Volatility of Price Indices



Source: Colombo Stock Exchange

The All Share Price Index (ASPI) and Standard & Poor's (S&P) Sri Lanka 20 index recorded negative year-to-date growth of 29.6 per cent and 38.8 per cent, respectively, during the ten months ending October 2022. ASPI surpassed the 13,000 points level on 05 January 2022 and recorded

Chart 2.3 Movements of ASPI and Market Capitalization

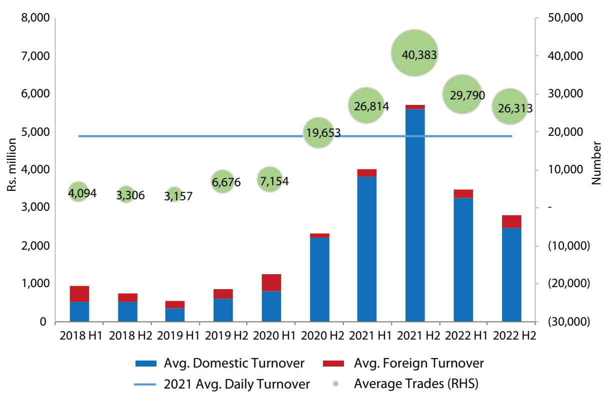


Source: Colombo Stock Exchange

the historically highest value of 13,462.4 on 19 January 2022. The equity market witnessed a steep fall since early February 2022 as investors started withdrawing their funds amid increased concerns over forex liquidity which resulted in an energy crisis and political instability. However, this declining trend moderated since May 2022, and showed signs of improvement since July 2022. Nevertheless, at end October 2022, the price indices were significantly below the levels observed at end 2021. A similar trend was observed in market capitalisation. Market capitalisation contracted by 31.1 per cent to Rs. 3,779.4 billion at end October 2022 compared to Rs. 5,489.2 billion at end 2021.

The expansion in daily turnover, which was driven by domestic investors in 2021, slowed down during the ten months ending October 2022. The upsurge in daily market activities observed since mid-May 2020, started to plunge since February 2022 as negative sentiments spread among investors amidst economic and political instability. The average daily turnover decreased to Rs. 3,193.6 million during the ten months ending October 2022 from Rs. 4,419.7 million during the ten months ending October 2021, recording a negative growth of 27.7 per cent. A similar trend was observed in terms of the average number of trades.

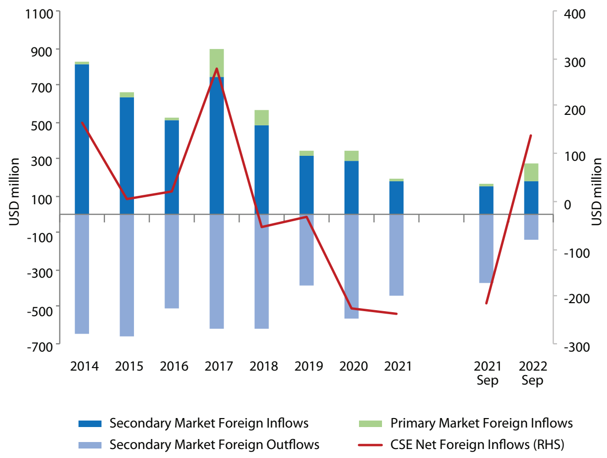
Chart 2.4 **Average Daily Turnover and Average Trades**



Note: Average turnover and average trade values for 2022 H2 are calculated using data up to 31 October 2022

Source: Colombo Stock Exchange

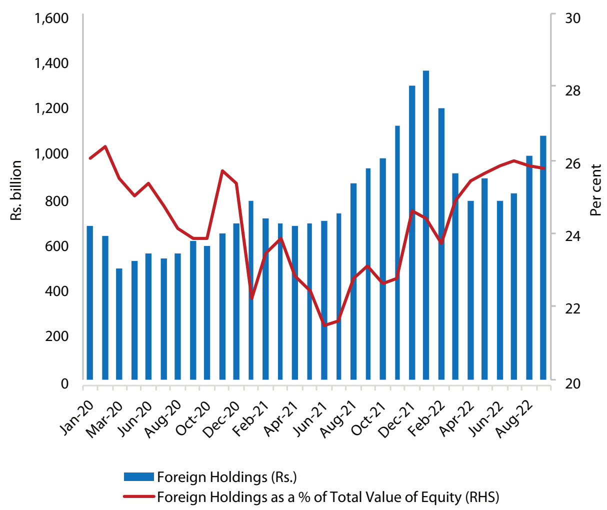
Chart 2.5 **Net Foreign Flows to CSE (Annual)**



Source: Colombo Stock Exchange

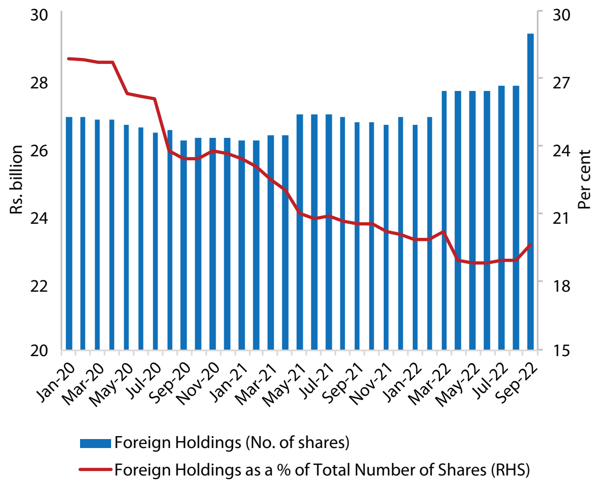
In terms of foreign flows, an improvement was observed. Amidst the strained macroeconomic conditions, a noticeable improvement in terms of net foreign inflows was observed in the equity market during the nine months ending September 2022. Accordingly, the net foreign inflow was at US dollars 138 million during the year until end September 2022 compared to a net outflow of US dollars 215 million recorded during the corresponding period of 2021. Even though some improvements were witnessed, it was mainly owing to increased foreign party interest in a few major companies rather than the market as a whole.

Chart 2.6 **Foreign Holdings of Equity (By Value)**



Source: Central Depository Systems

Chart 2.7 **Foreign Holdings of Equity (By Volume)**



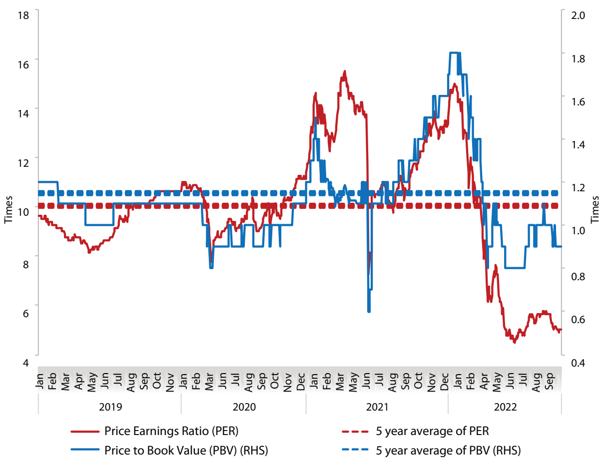
Source: Central Depository Systems

Foreign holdings in the Rupee terms of equity improved during the period under consideration mainly due to the depreciation of the Rupee. Foreign holdings in Rupee terms increased by 15.5 per cent to Rs. 1,061.2 billion at end September 2022 from Rs. 918.7 billion recorded at end September 2021. Nevertheless, foreign holdings in US dollars decreased by 36.3 per cent to US dollars 2.9 billion at end September 2022 from US dollars 4.6 billion recorded at end September 2021. The total value of shares held by foreign investors as a percentage of total equity marginally increased to 25.8 per cent at end September 2022 compared to 23.1 per cent at end September 2021. Meanwhile, the total number of shares held by foreign investors recorded an increase of 9.6 per cent at end September 2022 compared to the corresponding period of 2021 while the total number of shares held by foreign investors as a percentage of total equity marginally decreased to 19.6 per cent at end September 2022 compared to 20.6 per cent at end September 2021.

Indicators which represent the valuation of the stock market declined substantially during the ten months ending October 2022. The market Price Earnings Ratio (PER) hovered between the ranges of 4.5 to 15.0 times during the ten months ending October 2022 compared to the range of 7.3 to 15.5 times during the corresponding period of 2021. The market PER declined to 4.5 times during the third quarter of 2022, which is the lowest recorded for the past five years.

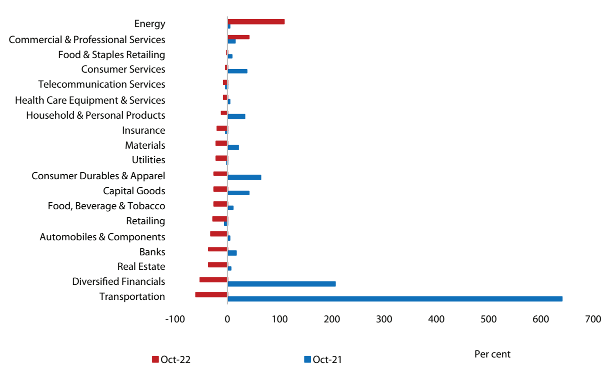
Similar to the overall market, the majority of sectors demonstrated a dismal performance. When considering the sector-wise disaggregation of the price indices, all sectors except two (Energy (108.1 per cent) and Commercial & Professional Services (41.5 per cent)), have recorded a negative year to date growth in price indices at end October 2022 reversing the trend of a positive year to date growth observed at end October 2021. The Transportation sector recorded the highest negative year to date growth of 59.9 per cent at end October 2022, followed by the Diversified Financial (-52.4 per cent) and Real Estate sector (-36.7 per cent).

Chart 2.8 **Market PE Ratio between 2019 - October 2022**



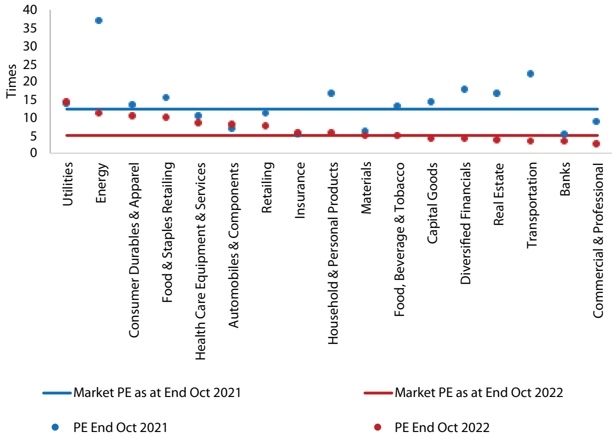
Source: Colombo Stock Exchange

Chart 2.9 **Year to Date Growth of Sector Wise Price Indices**



Source: Colombo Stock Exchange

Chart 2.10 PE Ratio of Sectors

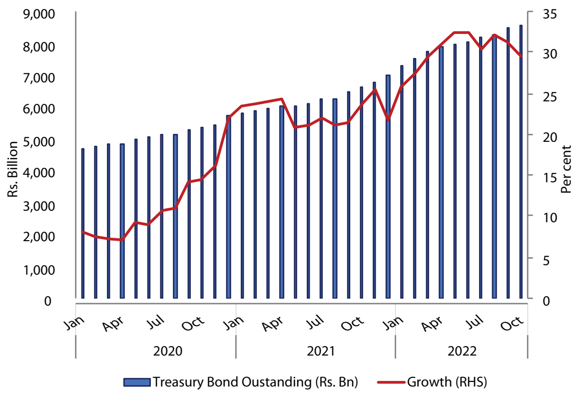


Source: Colombo Stock Exchange

2.3 Treasury Bond Market

The Treasury bond market continued to remain as the largest segment of the capital market catering to the increased financing needs of the Government. The stock of Treasury bonds as a percentage of GDP[2] increased to 40.7 per cent as at end June 2022 compared to 35.8 per cent as at end June 2021. Loss of access to international capital markets due to rating downgrades and announced debt standstill amidst falling fiscal revenue forced the Government to rely heavily on domestic debt instruments which resulted in continuous and rapid expansion of the Treasury bond market. The outstanding stock of Treasury bonds increased by a staggering amount of Rs 1,573 billion during the ten months ending October 2022 and reached Rs 8,541 billion at end October 2022, compared to an increase of Rs 878.7 billion in the corresponding period of the previous year.

Chart 2.11 Outstanding Treasury Bonds



Source: Central Bank of Sri Lanka

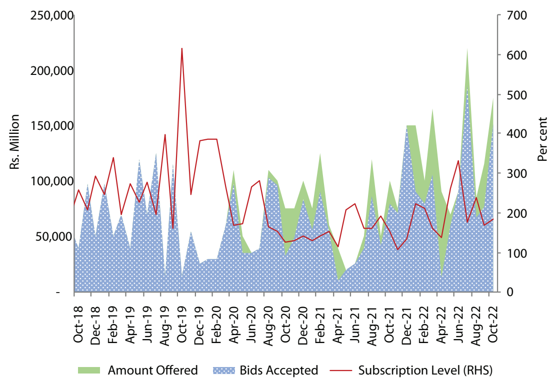
Table 2.1 Minimum and Maximum Weighted Average Yield Rates (WAYR) of Treasury bonds in Primary market

Treasury Bonds Maturity	WAYR	
	2021	2022*
2 - year	6.19 - 9.36	-
3 - year	6.25 - 9.16	14.41 - 32.63
4 - year	6.34 - 9.94	11.05 - 28.45
10 - year	8.86 - 11.91	12.01 - 30.09

** During the ten months ending October 2022*
Source: Central Bank of Sri Lanka

Primary market yields of Treasury bonds have skyrocketed to historically high levels. A multitude of factors such as the unprecedented policy interest rate hike in early April 2022, the announcement of debt standstill in April 2022, the precarious financial position of the Government amidst heavy funding requirements, debt restructuring concerns and heightened uncertainty in market conditions have contributed to increased yields. However, even with the towering yield rates, market appetite has remained low as evidenced by lower subscription

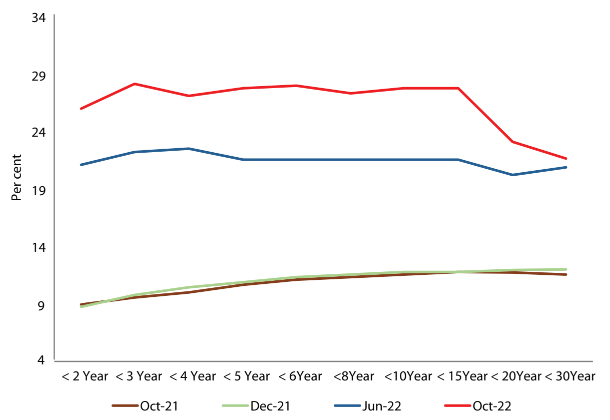
Chart 2.12 Subscription and Allocation Levels at Primary Market



Source: Central Bank of Sri Lanka

2. Nominal GDP as an aggregate of current quarter and previous three quarters.

Chart 2.13 **Secondary Market Yields**

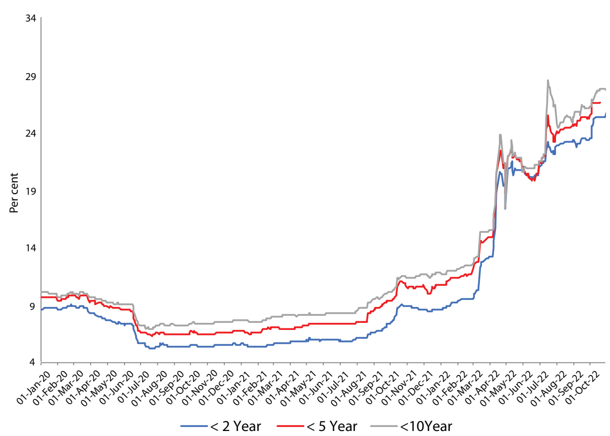


Source: Central Bank of Sri Lanka

levels in primary market auctions due to increased uncertainty over the long term. Nevertheless, offered amounts have increased due to financing requirements of the Government.

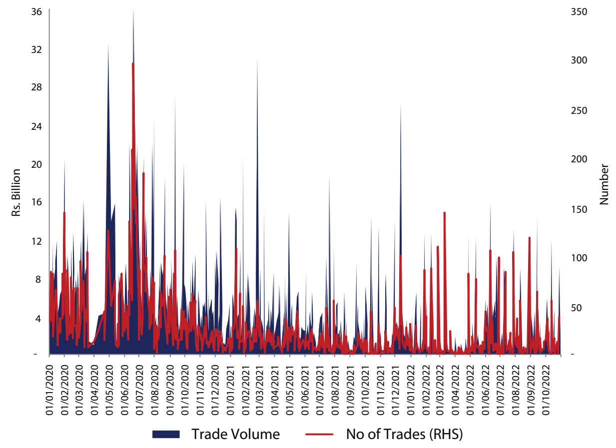
Abnormal distribution of secondary market yield rates of Treasury bonds factors looming uncertainty in the market. In conjunction with the developments in the primary market, secondary market yield rates also reached very high levels where the 2-year, 3-year, 5-year and 10-year yield rates increased by 1,714, 1,840, 1,692 and 1,597 basis points, respectively, during the ten months ending October 2022, compared to the respective increase of 323, 342, 383 and 373 basis points recorded during the corresponding period of the previous year.

Chart 2.14 **Secondary Market Bond Yields**



Source: Central Bank of Sri Lanka

Chart 2.15 **Secondary Treasury Bond Market Transactions**



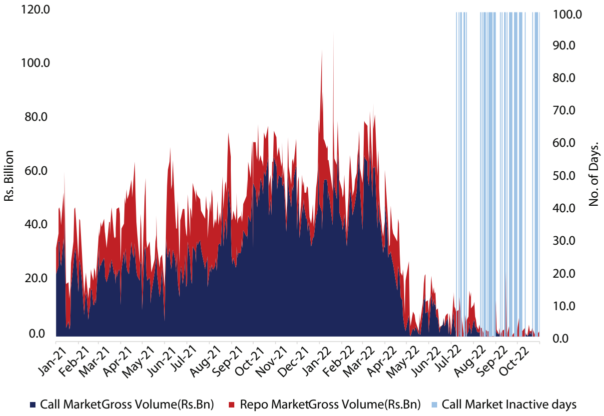
Source: Central Bank of Sri Lanka

Treasury bonds continue to remain illiquid in the secondary market reflecting the liquidity shortage in the market. Investors have no appetite to trade in the secondary market due to mark-to-market losses they may incur in an increased interest rate environment. This may have also contributed to the illiquid secondary market. Despite the prevailing high yields and large outstanding stock of Treasury bonds, investor demand remains subdued. In the secondary market of Treasury bonds the average number of trades per day and average turnover amount per day further decreased to 13.3 and Rs 2.1 billion respectively during the ten months ending October 2022 compared to 14 and Rs 3.5 billion reported during the corresponding period of 2021. The illiquid nature of Treasury bonds causes risks to the market participants and affects their asset and liability management.

2.4 Domestic Money Market

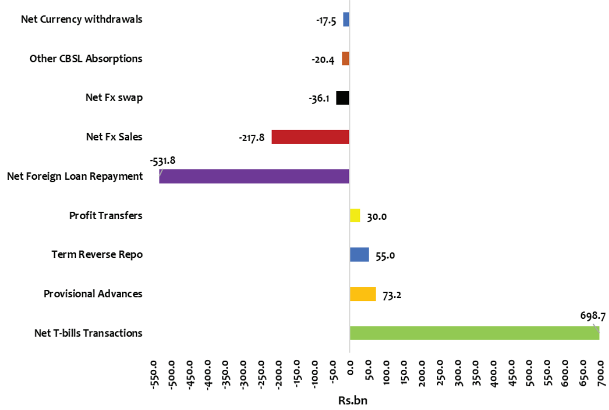
Amidst the liquidity deficit in the domestic money market and stringent counterparty limits adopted by the market participants subsequent to the announcement of the debt standstill by the Government, transactions in the overnight call money market remained substantially low, especially since mid-April 2022. As a result, PIs mainly relied on the facilities provided by the Central Bank to borrow funds, while PIs with excess

Chart 2.16 **Call and Repo Market Transaction Volumes**



Source: Central Bank of Sri Lanka

Chart 2.18 **Factors Contributed to Liquidity (End 2021 to 01.11.2022)**

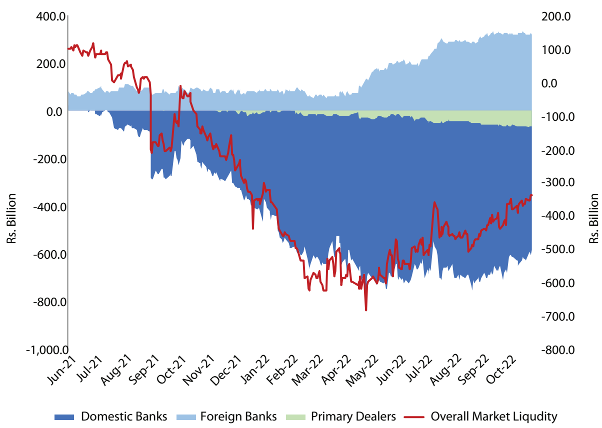


Source: Central Bank of Sri Lanka

liquidity relied on the Standing Deposit Facility (SDF) to park their excess funds with the Central Bank. Subdued call and repo market activities reflected the increased concerns over counterparty risks. During the ten months ending October 2022, average volumes of call and repo markets declined to around Rs. 18.8 billion and Rs. 7.7 billion, respectively compared to Rs. 29.4 billion and 15.8 billion. Further, the call money market and repo market transaction volume remained dismal since mid-April and averages amounted only to Rs. 3.5 billion and Rs. 4.6 billion, respectively.

The money market suffered from both deficit liquidity and asymmetric distribution of liquidity. Liquidity in the domestic money market, which was

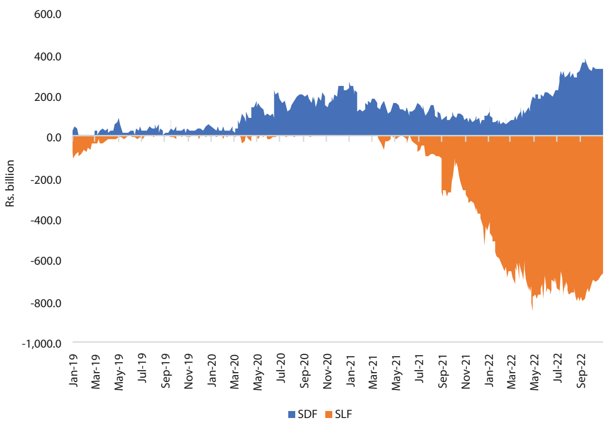
Chart 2.17 **Money Market Liquidity Distribution**



Source: Central Bank of Sri Lanka

in deficit levels since mid-August 2021, remained in persistent deficit in 2022 and stood at Rs. 344.1 billion at end October 2022. The overall liquidity deficit in the domestic money market is mainly driven by the large liquidity deficit in two state owned Licensed Commercial Banks, while foreign banks maintain a notable surplus. Market Liquidity shortage peaked at Rs. 688.3 billion towards end April 2022 and showed gradual improvements since then. Subscribing to Treasury bills at the primary auctions and special allocations, as well as granting provisional advances and transferring profits to the Government by the Central Bank mainly contributed to liquidity improvements in the domestic money market. However, the impact of such injections was negated due to a host of factors, including scheduled foreign loan repayments, currency withdrawals as well as maturities of foreign currency swap transactions and Treasury bills held by the Central Bank. Further, it was noted that the banking sector recorded an increase in currency deposits due to the prevailing high interest rates, thereby improving liquidity in the banking sector to a certain extent. In addition, the Central Bank was compelled to infuse liquidity through term reverse repo auctions during 2022 with a view to reducing significant liquidity stress among certain banks and the asymmetric nature of liquidity distribution in the banking system.

Chart 2.19 Utilization of SLF and SDF



Source: Central Bank of Sri Lanka

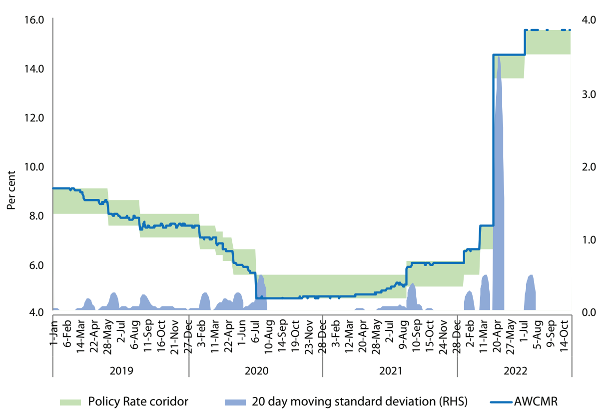
While some of the domestic banks faced persistent deficit liquidity conditions, foreign banks continued to maintain notable surpluses. This asymmetry in money market led to substantially higher utilisation of the facilities provided by the Central Bank. Despite liquidity surpluses, foreign banks resorted to parking their excess liquidity at the SDF instead of lending in the call market due to more stringent counterparty and exposure limits on domestic banks with the Treasury's announcement of a pre-emptive default of its foreign debt and subsequent sovereign downgrades. Current uncertainty, lack of market confidence and the vulnerability of several banks also adversely affected call and repo market activities. Moreover, participation of certain banks in the repo market was limited due to inadequate collateral availability. Consequently, domestic banks continue to depend on liquidity facilities of the Central Bank, including the Standing Lending Facility (SLF), Intra Day Liquidity Facility (ILF) and term reverse repo facilities to fulfill liquidity requirements. In line with the continued tight monetary policy stance, the Average Weighted Call Money Rate (AWCMR) remained at 15.5 per cent at end October 2022 compared to 5.93 per cent at end October 2021.

2.5 Treasury Bill Market

Historically high yields are observed in the Treasury bill market. Yield rates of Treasury bills, which are traditionally considered as a safe and risk-free investment rose sharply from late 2021 and surged above the policy interest rates reflecting the high-risk premium expected by market participants and increased financing needs of the government. Investor sentiment towards Treasury bills turned negative with the announced debt standstill, socio-political turmoil, and adverse economic conditions.

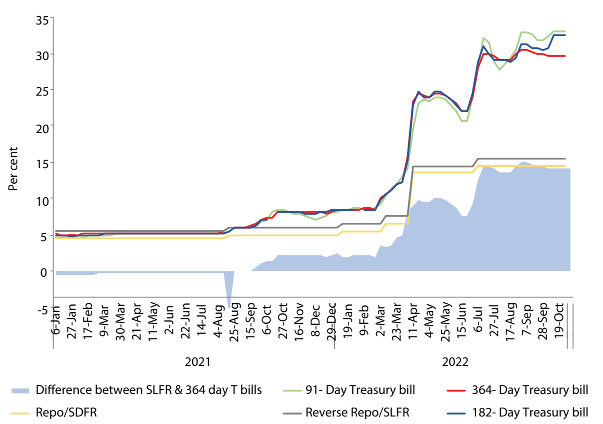
Sharp rises of yields in multiple short periods of time instead of a gradual increase revealed the market's vulnerability towards economic, social, and political concerns. In the primary market auctions the 91 - day, 182 - day, and 364-day Treasury bill rates rose by significant number of 2,489, 2,420 and 2,136 basis points respectively during the ten

Chart 2.20 AWCMR & Its Volatility



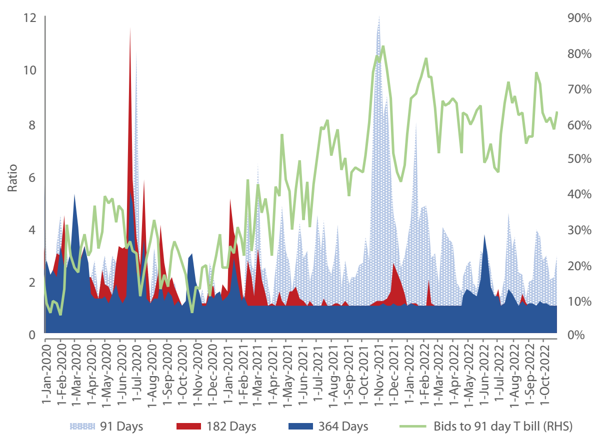
Source: Central Bank of Sri Lanka

Chart 2.21 Treasury Bill Rates & Policy Rates



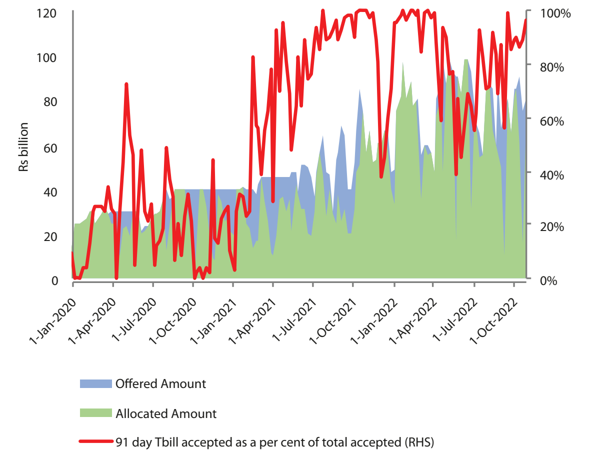
Source: Central Bank of Sri Lanka

Chart 2.22 Bid to Offer Ratios of Treasury Bills



Source: Central Bank of Sri Lanka

Chart 2.23 Offered and Allocated Amounts at Primary Market Auctions



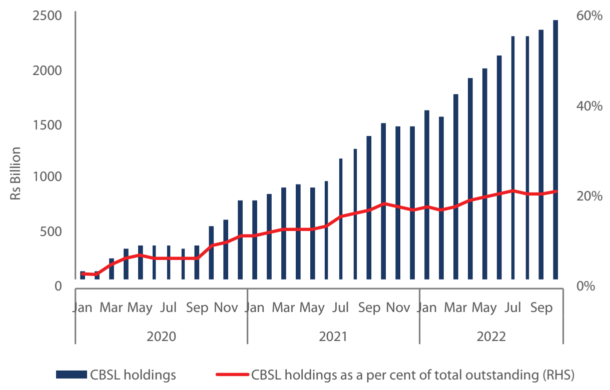
Source: Central Bank of Sri Lanka

months ending October 2022, compared to an increase of 374, 336 and 313 basis points during the corresponding period of 2021. Despite, the Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR) remaining at 14.5 per cent and 15.5 per cent respectively, the yield rates of 91 - day, 182 - day, and 364-day Treasury bills reached historically high levels of 33.1, 32.5 and 29.6 per cent respectively, at end October 2022. However, the y-o-y inflation remains well above the rate of return on Government securities hampering the already lowered investor incentive to hold Treasury bills. Nevertheless, improved overall economic conditions and corrective measures in the fiscal front amidst improved socio-political stability could bring the yields to acceptable levels.

Investor preference stayed heavily skewed towards 91 - day Treasury bills in the primary market auctions. Investors remained reluctant to bid for longer tenure securities amidst uncertainties over debt restructuring. Even with the slight increase of allocations due to the acceptance of phase II bids for Treasury bills at primary market auctions from late June 2022, bids to offer ratio of 91- day Treasury bills remained well above the ratios for 182 - day and 364 - day Treasury bills. Meanwhile out of the total bids, bids on 91-day Treasury bills accounted for 62.2 per cent as an average during the ten months ending October 2022, compared to an average of 42.5 per cent in the corresponding period of the previous year. Skewed demand towards 91 - day Treasury bills resulted in a very high allocation of 91 - day Treasury bills in weekly auctions compared to 182 – day and 364 – day Treasury bills. Accordingly, during the ten months ending October 2022, the allocation of 91 - day Treasury bills constituted of 83 per cent of the total allocated Treasury bills. The lack of demand for higher tenure Treasury bills and increased allocation of 91-day Treasury bills escalated the rollover risk. In the period under review, the Treasury bill market continued to expand with much higher offered amounts compared to the corresponding period in the previous year in the primary market auctions to meet the substantial funding requirements of the Government. In a few instances, the primary market auctions were not fully allocated since the investors gambled for higher yield.

The Central Bank's holdings of Government securities increased by Rs. 1,003.8 billion during the ten months ending October 2022, compared to an increase of Rs. 741.7 billion during the corresponding period of the previous year. However, the Central Bank has gradually reduced its subscription at primary market auctions of Treasury bills and the y-o-y growth of the Central Bank's holdings of government securities was 65 per cent as at end October 2022 compared to a

Chart 2.24 **Central Bank's Holdings of Government Securities**



Source: Central Bank of Sri Lanka

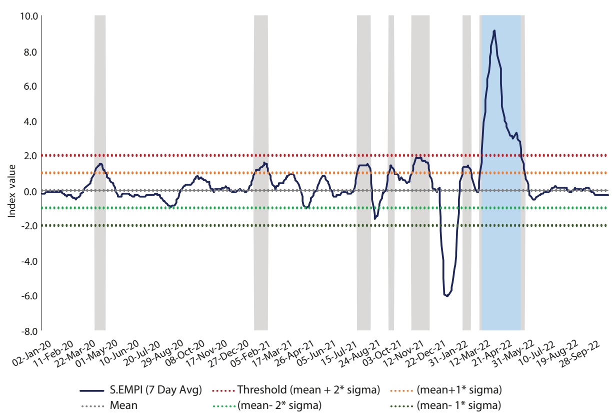
year-on-year growth of 200 per cent recorded as at end October 2021.

2.6 Domestic Foreign Exchange Market

Sri Lankan domestic foreign exchange market remained fragile during the ten months ending October 2022 amidst severely strained foreign exchange liquidity. Accordingly, the Exchange Market Pressure Index (EMPI)[3] showed increased stress levels from February 2022 to May 2022. With the help of the Central Bank intervention in the domestic foreign exchange market and the use of moral suasion, the external value of the Sri Lanka Rupee was maintained broadly at stable levels during the latter part of 2021 and early 2022. However, a significant shortage of liquidity in the domestic foreign exchange market along with the low level of Gross Official Reserves continued to exert pressures on the exchange rate, which necessitated more flexibility in its determination in early March 2022. After the relaxation, the exchange rate underwent a large depreciation and reflected significant intra-day volatilities. Thus, to reduce this significant volatility driven by excessive speculation and to curtail the impact on inflation, the Central Bank introduced a new exchange rate arrangement on 13 May 2022 by providing daily guidance to all Licensed Commercial Banks on the degree of volatility in the spot exchange rate with an allowable two-sided variation margin, based on the weighted average spot exchange rate determined in the interbank market on the preceding day. Accordingly, only a marginal depreciation in the Sri Lankan Rupee against the US dollar was witnessed since 13 May 2022. Overall, the USD/LKR exchange rate recorded a depreciation of 44.8 per cent during the ten months ending October 2022 compared to a 7.7 depreciation recorded during the ten months ending October 2021. In line with the USD/LKR movement, the Sri Lankan Rupee depreciated against other major currencies such as the Australian dollar, the pound sterling, euro, the Swiss franc, and the Japanese yen during the ten months ending October 2022.

The interbank forex market faced severe foreign currency shortages and the activities of the market remained dismal during the ten months ending October 2022, mainly from April 2022 to June 2022. The total trading volume, during the ten months ending October 2022 declined by 21.9

Chart 2.25 **Exchange Market Pressure Index**



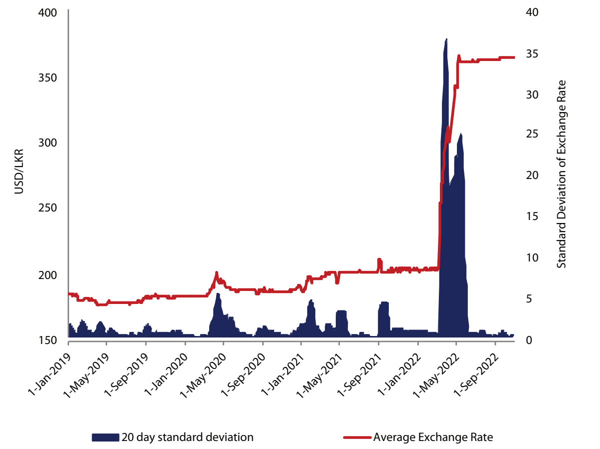
Source: Central Bank of Sri Lanka

3. This captures the depreciation of the LKR with respect of US dollar and the reduction in foreign exchange reserves. This iscalculated using the formula:

$$EMPI_{i,t} = \frac{(\Delta e_{i,t} - \mu_{\Delta e})}{\sigma_{i,\Delta e}} - \frac{(\Delta RES_{i,t} - \mu_{i,\Delta RES})}{\sigma_{i,\Delta RES}}$$

Where Δe and ΔRES denote month-on-month percentage changes in the foreign exchange rate of local currency per US dollar and foreign exchange reserves, while σ and μ are standard deviation and the mean, respectively.

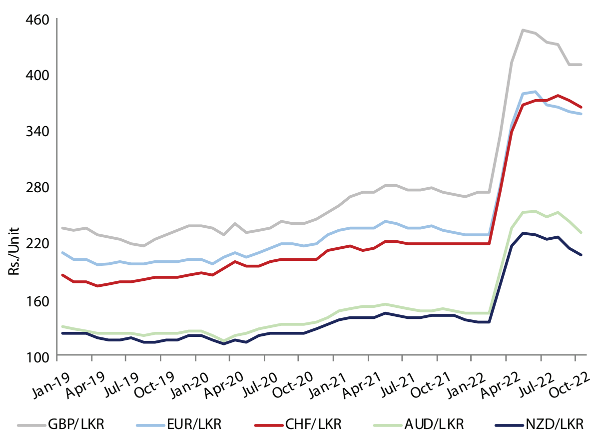
Chart 2.26 **Exchange Rate and its Volatility**



Source: Central Bank of Sri Lanka

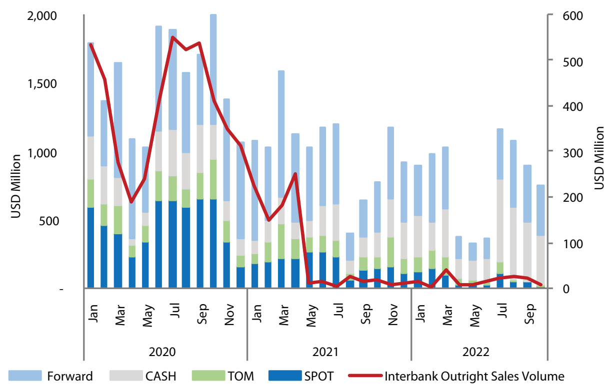
per cent and amounted to USD 7,858.7 million compared to USD 10,056.1 million recorded in the corresponding period of 2021. In addition to the severe US dollar shortage in the interbank market, the stringent counter party limits imposed by foreign banks on domestic banks, deteriorated access to the international capital markets due to downgrades of sovereign credit ratings. The strategy of accumulation of foreign currency by certain banks to meets their future obligations amidst restricted foreign exchange dues to the banks through International Sovereign Bonds (ISBs) and Sri Lanka Development Bonds (SLDBs), also contributed to this severe reduction in the interbank transaction volume. Similar to the overall forex market, the forward market was also less

Chart 2.27 **Exchange Rate Movement against Selected Currencies**



Source: Central Bank of Sri Lanka

Chart 2.28 **Interbank Transaction Volumes**

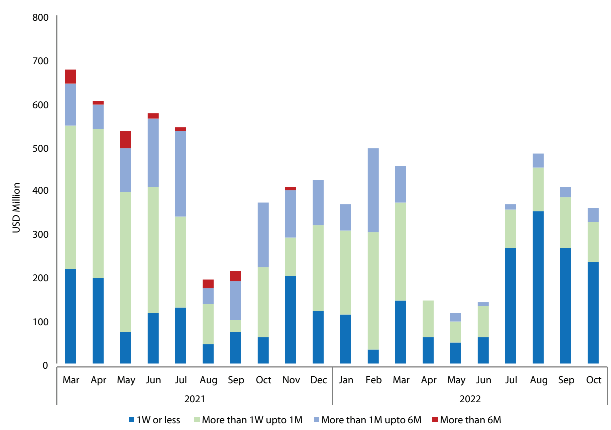


Source: Central Bank of Sri Lanka

active during the period concerned. Further, most forward transactions occurred for shorter tenure (1 week or less) while the forward market for transactions which spread over a 6-month period was inactive since November 2021, reflecting the expected uncertainties over longer horizons.

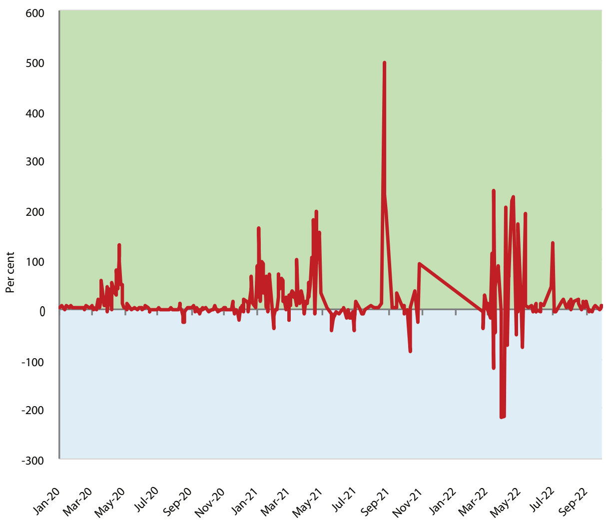
Meanwhile, indicating the prevailing stress on forex liquidity in the domestic foreign exchange market and the higher demand for foreign exchange liquidity, forward premia broadly remained negative during the latter part of 2021 and early 2022. Further, significant deep discounts were observed during December 2021 and January 2022, especially in 3-month forward

Chart 2.29 **Transaction Volumes - Forward Market**



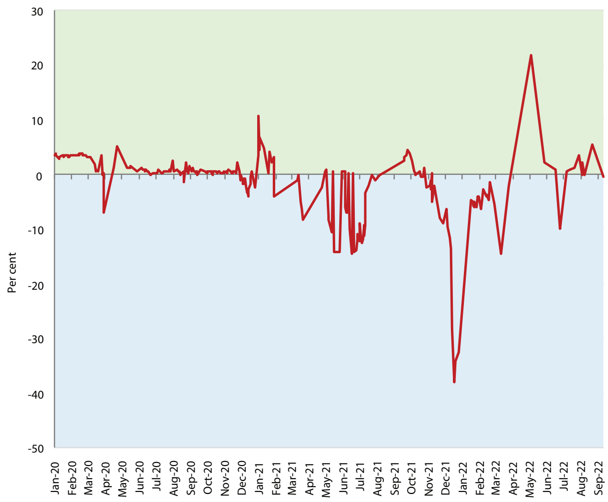
Source: Central Bank of Sri Lanka

Chart 2.30 One Week Forward Premium



Source: Central Bank of Sri Lanka

Chart 2.31 Three Months Forward Premium



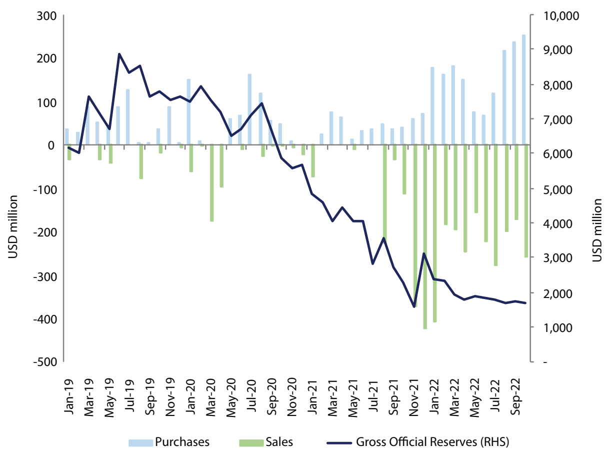
Source: Central Bank of Sri Lanka

premia. However, the forward premium turned positive again except for a few instances since May 2022 mainly due to policy rate adjustments and moderately improved forex market transaction levels. USD/LKR swap points[4] in the domestic foreign exchange market broadly also showed a similar behaviour.

The gross official reserves declined to US dollar 1.7 billion including the Asian Clearing Union (ACU) balance and the People's Bank of China swap of CNY 10 billion (approximately equivalent to US dollars 1.5 billion) at end October 2022 recording a 45.8 per cent depletion as the Central Bank continued to provide forex liquidity to finance essential imports while a majority of Government debt repayments were also settled through reserves. The limited gross official reserve position of the Central Bank further exerted stress on forex liquidity and functionality of the domestic forex market. In this context, several measures were taken to strengthen foreign reserves such as mandating licensed banks to sell a certain percentage of converted workers' remittances and mandatorily converted export proceeds into Sri Lankan Rupees. Nevertheless, the acute shortage of liquidity conditions in the domestic foreign exchange market necessitated the Central Bank to supply US dollars to finance essential imports such as fuel, gas, and coal throughout the period, to ensure the continuation of essential economic activities of the country. Accordingly, during the ten months ending in 2022, the Central Bank absorbed USD 1,638 million and supplied US dollar 1,798.8 million, resulting in a net sale of USD 160.9 million.

4. The difference between the forward rate and the spot rate for a particular currency pair when expressed in price interest point (pips) is typically known as the swap points.

Chart 2.32 The Central Bank Intervention in the Domestic Foreign Exchange Market and Gross Official Reserves



Source: Central Bank of Sri Lanka

Implementation of several measures[5] by the Ministry of Finance to curtail shadow foreign exchange market activities helped manage the limited foreign currency inflow effectively by directing such flows to finance essential imports. These measures included the cessation and limitation of the importation of non-essential goods via open accounts payment terms and prioritisation of essential imports of the country while discouraging non-essential imports to a greater extent. While the Central Bank started announcing exchange rate guidance to licensed banks, based on the previous day's weighted average spot exchange rate with a variation margin to reduce large intraday variances in May 2022, managing the exchange rate without having sufficient reserves or healthy foreign inflow would be challenging in the medium to long term. Going forward, when the economy gradually regains its momentum and an adequate level of reserves are built, it is vital to gradually allow the exchange rate to accurately reflect the market conditions and any pressure in the external sector, thereby allowing the exchange rate to function as a shock absorber. In addition, the implementation of a more flexible exchange rate regime performing current account transactions without any restrictions may possibly be required once the IMF programme is implemented.

5. Please refer the section on foreign exchange market in Box Article 1: Key Policy Changes and Regulatory Actions Implemented for the Financial Sector in 2021 for further details on key policy measures taken.

Special Note 2

Systemic Risk Survey - 2022

The Systemic Risk Survey (SRS) is a forward-looking survey designed to quantify and track perceptions of financial sector participants[1] on financial system stability which may signal any build-up of systemic vulnerabilities. It inquires financial sector participants about their confidence in the financial system and perceived risks to the stability of the Sri Lankan financial system. The Macroprudential Surveillance Department of the Central Bank has conducted SRS on a biannual basis since 2017. This special note mainly focusses on the results of the eleventh and the twelfth rounds of SRS conducted for 2022. The surveys were carried out one month prior to the start of the period under review such that it serves as a leading indicator for proactive decision making.

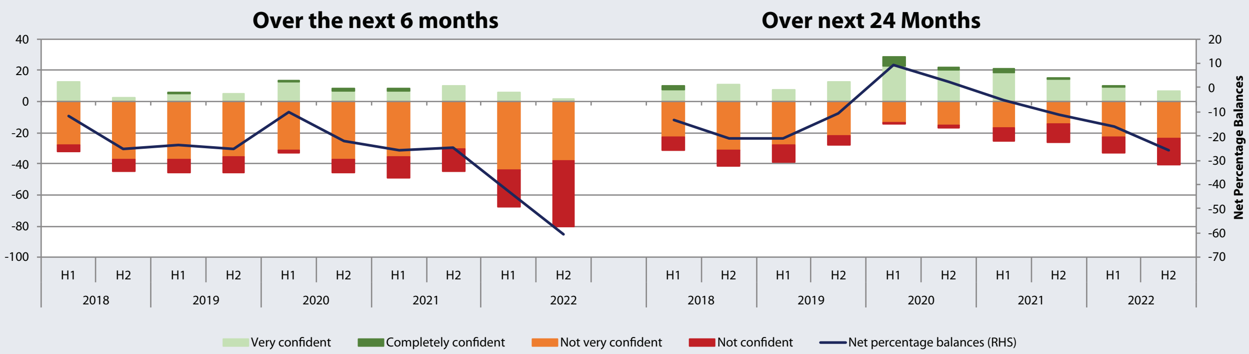
Confidence in the Financial System

Reflecting prevailing gloomy market sentiments over both short and medium term, confidence in the financial system continued to decline significantly in 2022. The confidence over short term declined to a record low level during 2022 H2 which was already at a significantly high negative level, since the 2020 H2 survey in the outset of COVID-19 pandemic. Further, confidence in the financial system over the next 24 months has steadily declined since 2020 H2 reversing the positive sentiment observed in 2020 and remained at a negative territory since 2021 H2. It is noteworthy that none of the respondents have expressed complete confidence over both short and medium term in 2022 H2 (Refer Chart 1).

Sources of Risks to the Financial System

Respondents were asked to choose five risks they believe would have the greatest impact on the financial system if they were to materialise, from a grid which list sub risks[2]. Respondents have raised higher concerns over Financial Market Risks and Domestic Macroeconomic Risk in 2022 compared to the previous two years. The concern over sub risks such as foreign exchange risk, interest rate risk and market liquidity risk have contributed to heightened concerns over the "Financial Market Risk" category. Among the subcategories of Domestic Macroeconomic risk, increased concerns were raised on risks such as (1) Inflation, (2) Risk arising from sovereign rating downgrade, and (3) Fiscal deficit and public debt. It is noteworthy that the concerns over General risks increased during

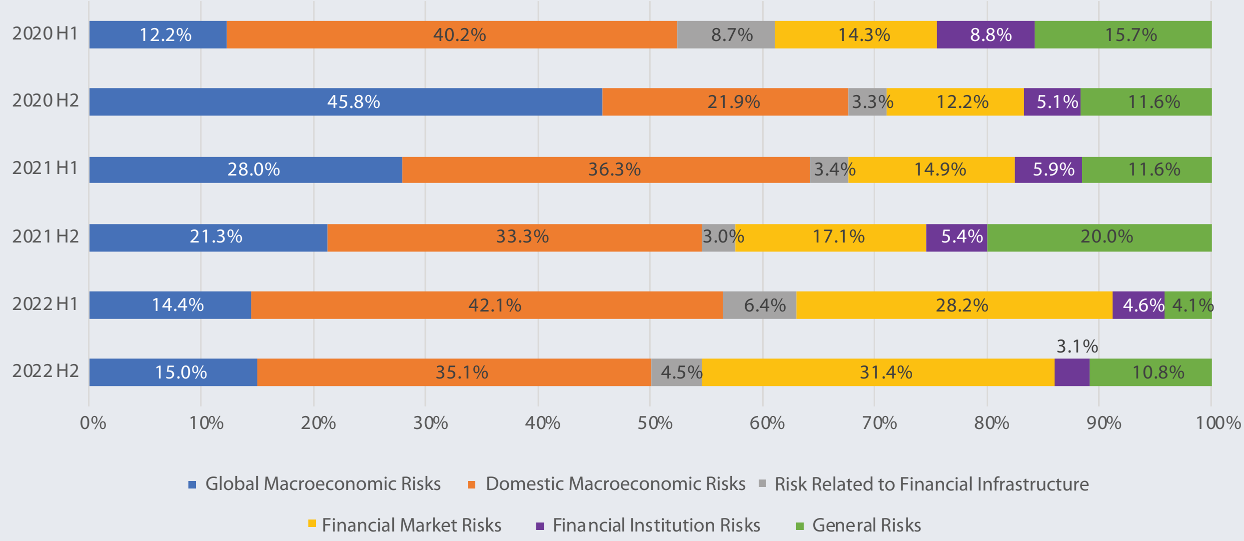
Chart 1: Confidence on the Stability of the Financial System



1. Chief Risk Officers or the head of the Risk Function of financial institutions such as licensed banks, Licensed Finance Companies (LFCs), Specialised Leasing Companies (SLCs), insurance companies, unit trusts managing companies, stock brokering companies and rating agencies are considered as respondents of the survey.

2. A grid of 62 sub risk categories which are classified into 5 major risk categories were provided to the respondents.

Chart 2: Dynamics of Major Risk Categories[3]



the 2022 H2 survey mainly owing to the noticeable increase in concerns over political risk (Refer Chart 2).

Foreign exchange risk which is sub risk category within the Financial Market Risks Category was the most frequently highlighted sub risk by the respondents out of the 62 sub risk categories considered where 64.8 per cent of respondents have marked the foreign exchange risk during the 2022 H2. Inflation emerged as the second most cited risk during the 2022 H2 where 57.4 per cent of total respondents mentioned it among the topmost risks. Both political risk and Interest rate risk was highlighted by 34 per cent of the respondents while market liquidity risk and risk arising from sovereign rating downgrade was highlighted by 31 per cent and 27 percent of the respondents respectively. The macroeconomic policy uncertainty is the sixth most emphasised risk by the respondents (24 per cent). Moreover, 19 per cent of the respondents have cited the Loss of investors' confidence in the economy, fiscal deficit and public debt and trade account deficit as most likely to materialise (Refer Chart 3).

Further, respondents' opinion on the risks that are most challenging to manage as a firm were also collected. During the 2021 H2 survey, respondents of all three sector groups have marked interest rate risk as one of the topmost risks to manage as a firm. The banking sector has marked the risks arising from sovereign rating downgrade as the most challenging risk to manage as a firm while the Licenced Finance Companies (LFCs) and Specialised Leasing Companies (SLCs) sector has marked Interest rate risk as the most challenging. Insurance sector respondents have marked Inflation as the topmost challenging risk to manage which was also highlighted by the LFC and SLC sector respondents as the second most challenging risk (Refer Table 1).

Respondents were asked for their opinions on the probability of a high impact event materialising in the financial system in the short (6-months ahead) and medium (12-months ahead) term. In 2022, the perceptions on the probability of a high impact event materialising over the short term and the medium term continued to increase to significantly higher levels.

3. Constructed using the weighted topmost responses given for each sub risk category.

Chart 3: Most Cited Risk during 2022 H2 Survey

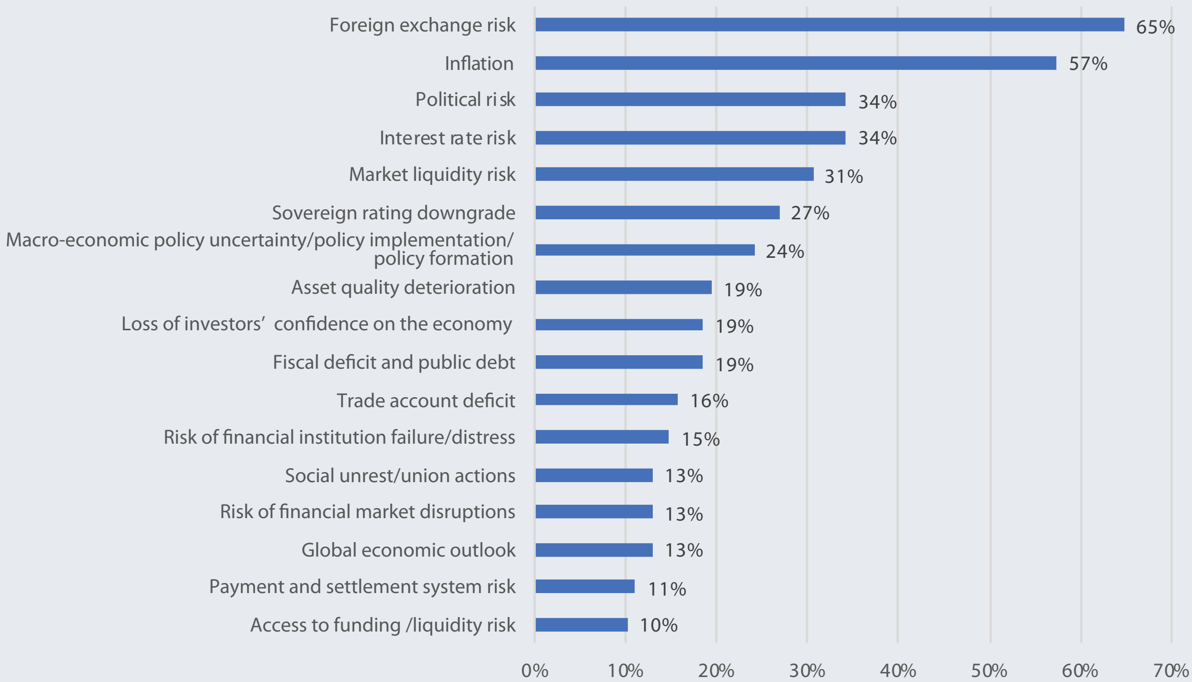


Table 1: Most Challenging Risks to Manage as a Firm[4]

Banks	LFCs and SLCs	Insurance
1. Sovereign Rating Downgrade 1. Foreign Exchange Risk 3. Access to funding /liquidity risk 3. Political Risk 5. Interest rate risk	1. Interest rate risk 2. Inflation 3. Access to funding /liquidity risk 4. Default risk/Asset quality deterioration 5. Macro-economic policy uncertainty/ policy implementation/ policy formation	1. Inflation 2. Foreign exchange risk 3. Political Risk 4. Interest rate risk 5. Market liquidity risk

Conclusion

With the challenging economic conditions experienced amidst the debt standstill and strained macroeconomic conditions, confidence levels of financial sector participants in the financial system have further deteriorated in the short to medium term. The challenging economic environment has led respondents to place greater emphasis on domestic macroeconomic risks such as Inflation, while foreign exchange risk, interest rate risk, and market liquidity risk were given prominence out of the Financial Market Risk category. The perceived probabilities of a high-impact event materialising remain at a relatively higher level.

4. Sub risks which were given similar importance by the respondents are shown with the same ranking.

Chapter 3

Financial Institutions

3.1 Overview

Financial Institutions (FIs) underwent significant pressure due to challenging macroeconomic conditions coupled with an acute foreign exchange crisis that culminated during the period covered in this review. However, the banking sector as the nerve center of the financial system remained resilient so far, amidst the vulnerabilities that emanated in terms of solvency, liquidity, and profitability. The effects of the economic contraction were witnessed by a drastic decline in banking sector credit during the latest two quarters under review amidst the effect of depreciation of the Rupee on Foreign Currency (FC) loans and receivables. Banks were exposed to high concentration risk as their lending mainly concentrated into six sectors of the economy, including the construction sector, which were severely impacted by the economic downturn. The overall Gross Stage 3 Loans Ratio of the sector surged to a double digit level during the period, indicating deterioration of the credit quality of the banking sector and future need for impairment that will threaten the solvency of the sector unless addressed in advance. High sovereign-bank nexus remains a concern against a backdrop of a potential sovereign debt restructuring as well as the high dependence of poorly performing State Owned Enterprises (SOEs) on the banking sector. To safeguard the stability of the banking sector, maintenance of a tolerable level of sovereign exposure, strict adherence to the stipulated single borrower limits on SOEs, and ensuring that arm's length transactions on a commercial basis are carried out with such counterparts remain crucial, and need to be addressed through a strong fiscal consolidation process coupled with restructuring of SOEs. Due to the liquidity stresses, both in terms of the Rupee and FC, Domestic Banking Units faced deterioration in the Statutory Liquid Asset Ratio compared to the previous year. Subsequent to the announcement of debt standstill in April 2022, all three major rating agencies further downgraded sovereign ratings of Sri Lanka and the banking sector became more vulnerable in terms of FC operations as the sector faced difficulties to roll-over its FC borrowings. Driven by increased impairment charges and high interest expenses, banking sector profitability declined considerably during the nine months ending September 2022. The sector's capital adequacy also declined as a result of lower profitability and higher risk weighted assets.

The Licensed Finance Companies (LFCs) and Specialised Leasing Companies (SLCs) sector, similar to the banking sector, experienced the effects of the contractionary monetary policy measures taken. However, it remained resilient at the end of the period under review despite deterioration observed during the period to contain high inflation that resulted in declining credit, deteriorated credit quality, and lower profitability. With the import restrictions in effect, the LFCs and SLCs sector diversified its credit portfolio to other product categories away from leasing and hire purchase which resulted in high concentration on pawning/gold loan products which increased the credit risk of the sector as the world bullion prices demonstrated volatility during the period amid deteriorated income levels of borrowers. The inherent nature of lower asset quality in the sector in comparison *to the banks, together with the high concentration on volatile assets raised concerns on the resilience of the sector in terms of high non-performing loans and the need for recognising higher level of impairment in the future.*

The Insurance sector, in comparison to the banking and LFCs and SLCs sectors, reported an increase in profitability in terms of general insurance during the six months ending June 2022 as a result of revised premiums in line with vehicle and other asset price increases. Capital and liquid assets of the Insurance sector were maintained above the minimum requirements stipulated, while the liquid assets of the sector recorded an increase owing to the high investments maintained in Government securities which are expected to generate higher yields for the sector in future.

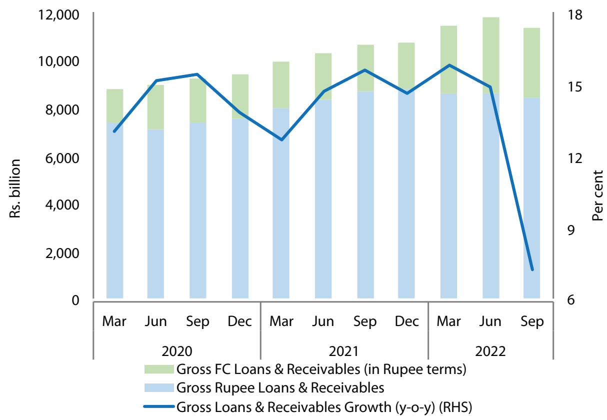
In addressing the challenges faced by FIs in terms of lower asset quality, Rupee liquidity, and solvency, measures were taken by the Central Bank which include and not limited to; conducting Asset Quality Review for selected banks, strengthening the Emergency Liquidity Assistance (ELA) Framework for the banks as well as the crisis management and supervision frameworks for the regulated FIs. Although individual banks implemented risk mitigation processes to address the uncertainties, weathering any unprecedented but necessary policy actions may be constrained unless FIs are adequately capitalised hence the outlook remains challenging.

3.2. Banking Sector

3.2.1. Credit Risk

Amidst intensified macroeconomic uncertainties and tightened monetary policy measures since April 2022, credit growth of the banking sector significantly decelerated during the nine months ending September 2022. Gross loans and receivables recorded a significant decline in its growth to 7.2 per cent y-o-y and reached Rs.

Chart 3.1 Gross Loans and Receivables



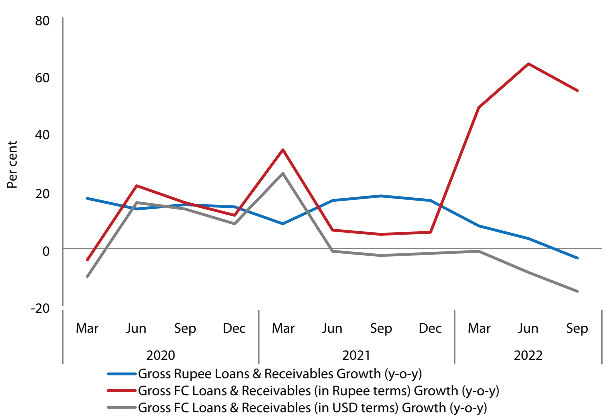
Source: Central Bank of Sri Lanka

11.4 trillion at end September 2022, compared to a growth of 15.5 per cent y-o-y at end September 2021. Low appetite of banks to grant new loans and advances to risky businesses coupled with ongoing unprecedented adverse business conditions resulted in a contraction of loans and receivables during the third quarter by 3.3 per cent over the previous quarter. Accordingly, contraction in credit during the quarter ending September 2022 amounted to Rs. 389.9 billion, in comparison to a credit growth of Rs. 322.5 billion recorded in the preceding quarter.

However, overall credit growth[1] of the banking sector was negative during the nine months ending September 2022, when the effect from Rupee depreciation is eliminated. Growth in loans and receivables during the first nine months of 2022 was mainly driven by the growth in gross FC loans and receivables, which was overstated by a significant depreciation of the exchange rate between early March 2022 and mid May 2022. Gross FC loans and receivables in Rupee terms recorded a considerable growth of 54.4 per cent y-o-y and reached Rs. 3.0 trillion at end September 2022, compared to a subdued growth of 5.0 per cent y-o-y at end September 2021. Nevertheless,

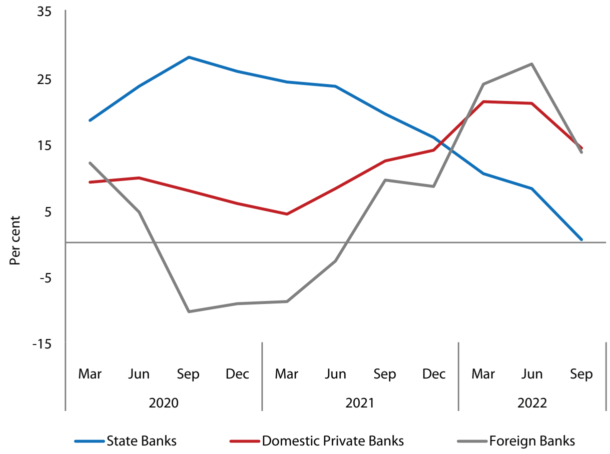
1. Credit of the banking sector represents all the loans and advances granted by banks including loans to other banks, the private sector, the Government, and SOEs.

Chart 3.2 **Currency wise Growth in Gross Loans & Receivables**



Source: Central Bank of Sri Lanka

Chart 3.3 **Growth in Gross Loans & Receivables by Bank Category**

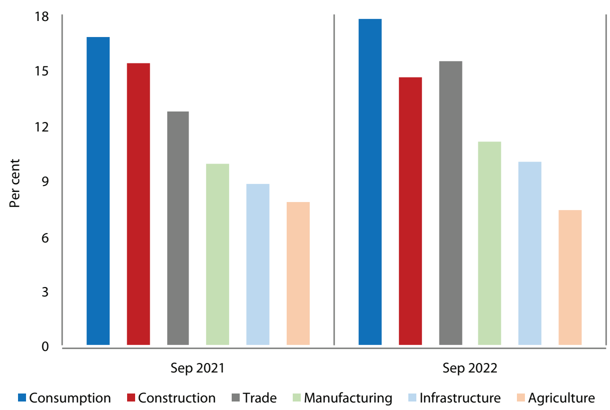


Source: Central Bank of Sri Lanka

FC loans and receivables in USD terms, which shows the real growth in FC loans and receivables, significantly contracted by 14.9 per cent y-o-y and stood at USD 8.2 billion at end September 2022, compared to a contraction of 2.6 per cent y-o-y at end September 2021. Meanwhile, Rupee loans and receivables of the banking sector contracted by 3.3 per cent y-o-y and stood at Rs. 8.4 trillion at end September 2022, compared to a growth of 18.2 per cent y-o-y recorded at the end of the corresponding period of the previous year. The contraction in Rupee loans and receivables during the quarter ending September 2022 amounted to Rs. 164.1 billion, in comparison to a contraction of Rs. 43.1 billion recorded during the previous quarter, as a reflection of the rising market interest rates and dampened business conditions. When the growth of overall loans and receivable is accounted for by eliminating the effect of the rupee depreciation, and a contraction of 5.3 per cent y-o-y was observed in total gross loans and receivables of the banking sector at end September 2022.

Deceleration in credit growth of state owned banks mainly contributed to the overall decline in credit growth of the banking sector at end September 2022. As at end September 2022, gross loans and receivables of the banking sector represented by state owned banks, domestic private banks, and foreign banks amounted to 47.1 per cent, 48.2 per cent, and 4.7 per cent, respectively. Credit growth of state owned banks significantly declined to 0.4 per cent y-o-y at the end September 2022, compared to a growth of 19.2 per cent y-o-y at end of the corresponding period of the previous year. However, credit of domestic private banks and foreign banks grew by 14.1 per cent and 13.0 per cent y-o-y, respectively, at end September 2022, compared to 12.4 per cent and 9.4 per cent y-o-y, respectively, at end September 2021. Furthermore, during the quarter ending September 2022, State-owned banks recorded the highest contraction in credit of Rs. 221.1 billion, while domestic

Chart 3.4 **Sector Concentration**

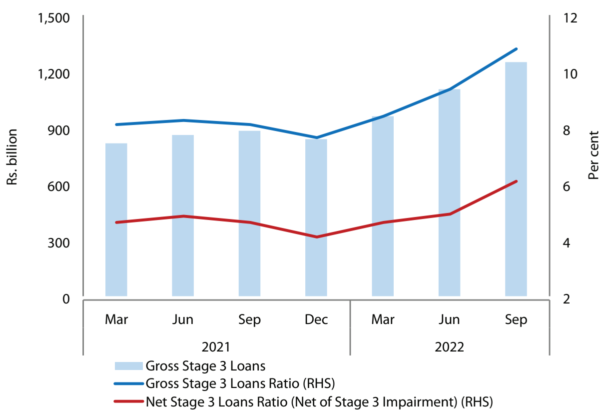


Source: Central Bank of Sri Lanka

private banks and foreign banks reported credit contractions of Rs. 101.3 billion and Rs. 67.4 billion, respectively. Considerable decline in credit provided to the Government and SOEs by state owned banks also contributed to this contraction in credit disbursed by state owned banks.

High concentration of loans and receivables to certain sectors of the economy remained a concern in credit risk management of the banking sector. Out of the total loans and receivables of the banking sector, 76.2 per cent was concentrated in 6 sectors, namely, Consumption, Construction, Trade, Manufacturing, Infrastructure, and Agriculture, at end September 2022. Credit concentration in the same set of sectors at end September 2021 was 71.2 per cent. Out of these 6 sectors, Trade, Infrastructure, Manufacturing, and Consumption recorded an increase in concentration during the year ending September 2022. The concentration of lending to a few sectors or segment of customers could expose the banking sector to an undue credit risk in the events of adverse sector specific macroeconomic developments and climate change. Since high Stage 3 Loans Ratios were reported in Manufacturing, Trade, and Construction sectors, to which the banking sector has high exposures, banks are expected to have stringent credit risk mitigation mechanisms for exposure related to these sectors.

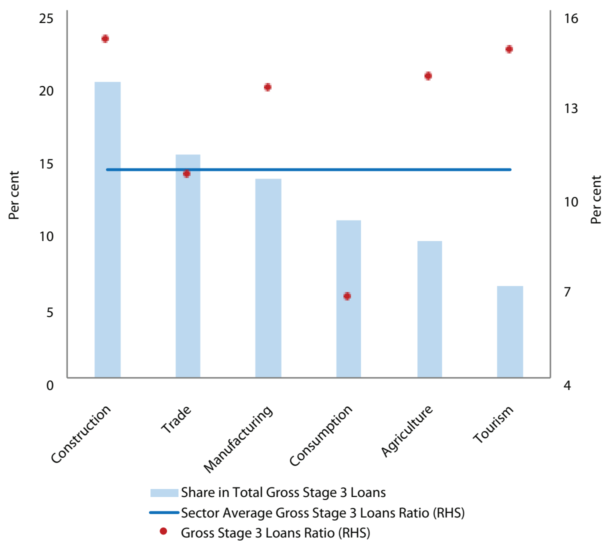
Chart 3.5 **Stage 3 Loans Ratios (including undrawn amounts)**



Source: Central Bank of Sri Lanka

The banking sector exhibited a deterioration in credit quality during the nine months ending September 2022. This was driven by the exponential growth in gross stage 3 loans and the decelerating growth in gross loans and receivables. The Gross Stage 3 Loans to Gross Total Loans Ratio (Gross Stage 3 Loans Ratio) of the sector increased to 10.8 per cent at end September 2022, compared to 8.1 per cent at the end of the corresponding period of 2021. Growth in gross stage 3 loans surged to 41.7 per cent y-o-y at end September 2022. This high growth in stage 3 loans could be attributed to the cessation of debt moratoria[2] for most sectors on December 31, 2021, and for tourism and passenger transportation sectors on June 30, 2022, coupled with the adverse macroeconomic conditions. Following a similar pattern to the Gross Stage 3 Loans Ratio, the Net Stage 3 Loans to Gross Total Loans Ratio (Net Stage 3 Loans Ratio) increased to 6.1 per cent at end September 2022 from 4.6 per cent at end September 2021.

Chart 3.6 **Sector wise Stage 3 Loans Ratios at end September 2022**



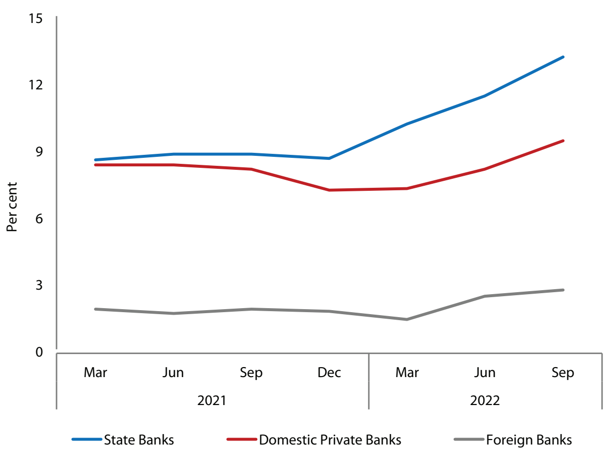
Source: Central Bank of Sri Lanka

2 COVID-19 related debt moratoria concessions granted by the banking sector for all other sectors except tourism and passenger transportation sectors were ceased on December 31, 2021, while concessions for tourism and passenger transportation were ceased on June 30, 2022. A separate set of concessions offered on a case-by-case basis for borrowers affected by the prevailing adverse macro-financial conditions was introduced on July 07, 2022.

When considering the sector wise Stage 3 Loans Ratio, certain highly concentrated sectors reported higher Stage 3 Loans Ratios compared to the overall average of the banking sector. As at end September 2022, six sectors namely, Construction, Trade, Manufacturing, Consumption, Agriculture, and Tourism accounted for 75.1 per cent of gross stage 3 loans of the banking sector. Gross stage 3 loans of the construction sector accounted for the highest share of the overall gross stage 3 loans at 20.2 per cent, while it recorded the highest Gross Stage 3 Loans Ratio of 15.0 per cent. Except the consumption and trade sectors, the other four sectors reported Gross Stage 3 Loans Ratios above the banking sector average of 10.8 per cent at end September 2022, and these four sectors accounted for 37.7 per cent of the gross loans and receivables of the banking sector. Hence, considering the prolonged adverse macroeconomic conditions, banks need to implement necessary risk mitigation measures such as fixing an internal ceiling for the exposure to vulnerable sectors and/or recognition of prudence-based impairment for the exposure to the highly vulnerable sectors.

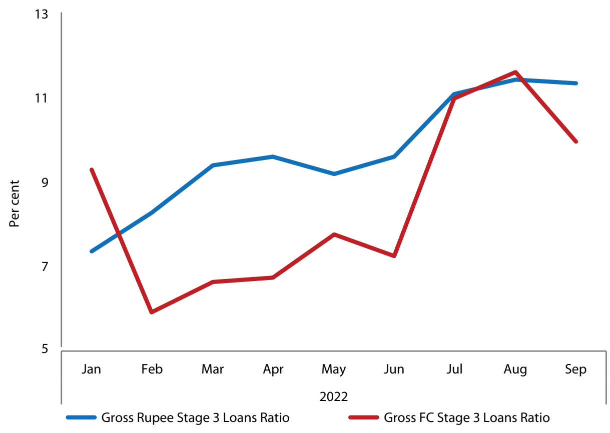
Deterioration of credit quality in the State-owned banks was significant compared to other banks. The Gross Stage 3 Loans Ratio of state owned banks increased to 13.2 per cent at end September 2022

Chart 3.7 **Stage 3 Loans Ratio (including undrawn amounts) by Bank Category**



Source: Central Bank of Sri Lanka

Chart 3.8 **Currency wise Stage 3 Loans Ratio**



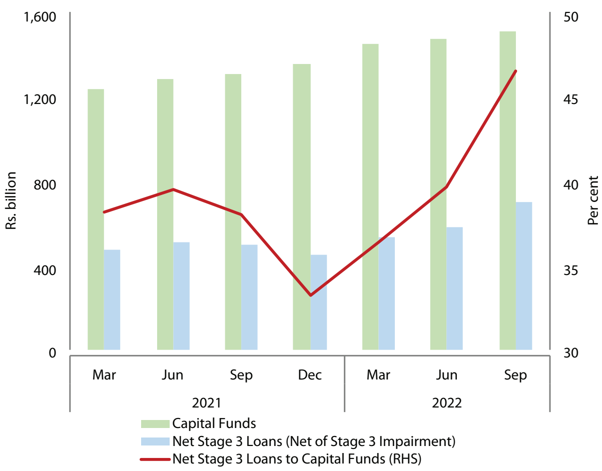
Source: Central Bank of Sri Lanka

from 8.8 per cent at end September 2021, reflecting the higher growth in gross stage 3 loans and higher deceleration in credit growth compared to other bank categories. State owned banks recorded a growth of 51.3 per cent y-o-y in stage 3 loans at end September 2022. Further, domestic private banks and foreign banks also contributed to the overall deterioration in credit quality of the sector, recording increases in Gross Stage 3 Loans Ratio from 8.1 per cent and 1.8 per cent, respectively, at end September 2021 to 9.4 per cent and 2.7 per cent, respectively, at end September 2022.

Asset quality of Rupee loans and receivables was low compared to FC loans and receivables at end September 2022. The Gross Stage 3 Loans Ratios of the Rupee exposure and FC exposure were 11.3 per cent and 9.9 per cent, respectively, at end September 2022.

Net Stage 3 Loans (net of stage 3 impairment) to the Capital Funds Ratio increased during the first nine months of 2022 due to higher growth in stage 3 loans. The Net Stage 3 Loans to Capital Funds Ratio increased to 46.5 per cent at end September 2022, compared to 38 per cent at end of the corresponding period of 2021. Net stage 3 loans growing by a higher rate of 41.3 per cent y-o-y against the growth in capital funds by 15.6 per cent y-o-y at end September 2022, resulted in a considerable

Chart 3.9 **Net Stage 3 Loans (Net of Stage 3 Impairment) to Capital Funds**

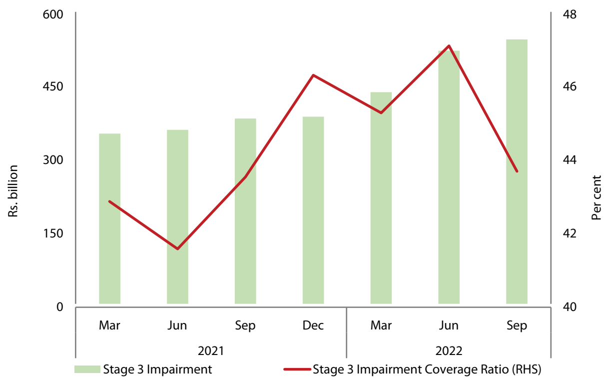


Source: Central Bank of Sri Lanka

increase in the ratio from September 2021 to the period under consideration. A higher Stage 3 Loans to Capital Funds Ratio exposed the banking sector to higher risks as banks do not possess adequate capital to compensate for additional losses arising from stage 3 loans in the event of a write-off. However, it would be challenging for banks to maintain the Stage 3 Loans to Capital Funds Ratio at a lower level in an environment of declining profits, decelerating growth in capital, and rapid increase in stage 3 loans.

The Stage 3 Impairment Coverage Ratio recorded a marginal improvement at end September 2022 when compared with the corresponding period of the previous year. The Stage 3 Impairment Coverage Ratio, measured as Stage 3 Impairment to Gross Stage 3 Loans, marginally increased to 43.6 per cent at end September 2022, compared to 43.5 per cent at end September 2021. Stage 3 impairment recorded a marginally higher growth of 42.2 per cent y-o-y against gross stage 3 loan growth of 41.7 per cent y-o-y at end September 2022, leading to the marginal improvement of the ratio. Higher impairment coverage provides a cushion to the banking sector to absorb risks arising from the non-performing credit facilities. Hence,

Chart 3.10 **Stage 3 Impairment Coverage Ratio (including undrawn amounts)**



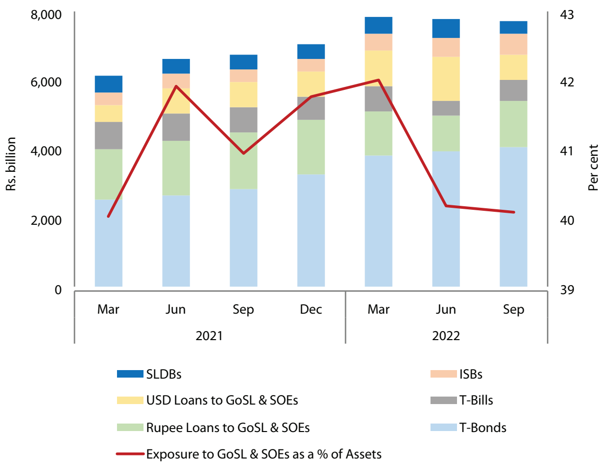
Source: Central Bank of Sri Lanka

banks need to ensure that an adequate impairment is recognised pertaining to the rising stage 3 loans.

Sovereign bank nexus[3] continued to remain high at end September 2022, though it slightly contracted during the third quarter of 2022 over the previous quarter. Banking sector exposure to the Central Government and SOEs amounted to Rs. 7.7 trillion and represented 40.1 per cent and 512.2 per cent of total assets and capital funds of the banking sector, respectively, at end September 2022. Although it is a considerable increase from the exposure of Rs. 6.7 trillion recorded at end September 2021, a slight contraction was observed from the exposure of Rs. 7.8 trillion recorded at end June 2022. The exposure at end September 2022 included investments in government securities which amounted to Rs. 5.7 trillion and represented 73.1 per cent of the banking sector exposure to the Central Government and SOEs, and loans and receivables which amounted to Rs. 2.1 trillion and recorded 26.9 per cent of the sector exposure to the Central Government and SOEs. The two state owned Licensed Commercial Banks (LCBs) accounted for 55.5 per cent of the total exposure to the Central

3. Exposure of the banking sector to the Central Government and SOEs includes investments made by licensed banks in Sri Lanka Development Bonds (SLDBs), International Sovereign Bonds (ISBs), Treasury Bonds (T/bonds), Treasury Bills (T/bills), and loans and advances granted by licensed banks to the Central Government and SOEs in both FC and Rupees.

Chart 3.11 Banking Sector Exposure to the Central Government and SOEs



Source: Central Bank of Sri Lanka

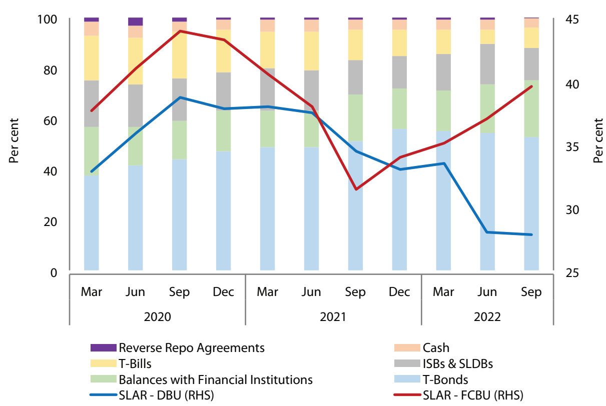
Government and SOEs. Nevertheless, the sector commenced provisioning for expected credit losses on FC denominated sovereign exposures pending the outcome of the debt restructuring. Uncertainties in debt restructuring pose risks to the banking sector due to high sovereign-bank nexus. To safeguard the stability of the banking sector it is paramount that the exposure to the Central Government and SOEs is minimised to a tolerable level in the medium term with the expected fiscal consolidation and restructuring of SOEs.

3.2.2. Liquidity Risk

The banking sector experienced liquidity stresses in terms of both Rupee liquidity as well as FC liquidity during the nine months ending September 2022. Although the Statutory Liquid Assets Ratio (SLAR) of the banking sector was above the statutory minimum required level at end September 2022, SLAR of Domestic Banking Units (DBUs) declined to 27.8 per cent at end September 2022 from 34.4 per cent at end September 2021. Nevertheless, SLAR of Offshore Banking Units (OBUs) improved to 39.6 per cent at end September 2022 from 31.4 per cent at end of the corresponding period of the previous year. The Interbank Money Market liquidity recorded a persistent deficit since end August 2021 and transactions in the Overnight Call Money Market remained substantially low, especially since mid-April 2022 as banks with excess liquidity refrained from trading with deficit units in the call money market. As a result, banks with deficit liquidity, especially LCBs with state ownership, relied heavily on the Intra-day Liquidity Facility, Standing Lending Facility, and Term Repo to fulfil their funding needs. Furthermore, certain banks were continuously dependent on these facilities for their day-to-day liquidity requirements. Heavy reliance of these banks on short term liquidity facilities of the Central Bank for long periods remains a concern. However, an overall decline in the deficit of market liquidity was observed since the latter part of April 2022, as the liquidity surplus of foreign banks increased. Further, the banking sector has been facing stress conditions on the FC liquidity since beginning of 2021, mainly due to the inability to rollover the existing facilities, delays in meeting forex obligations to the banks by the Central Government and SOEs, and the settlement of FC denominated Government securities in the local currency at their maturities or their rollover. Nevertheless, the banking sector comparably improved the management of its FC inflows and outflows during the third quarter of 2022 amidst an overall FC shortage in the domestic forex market.

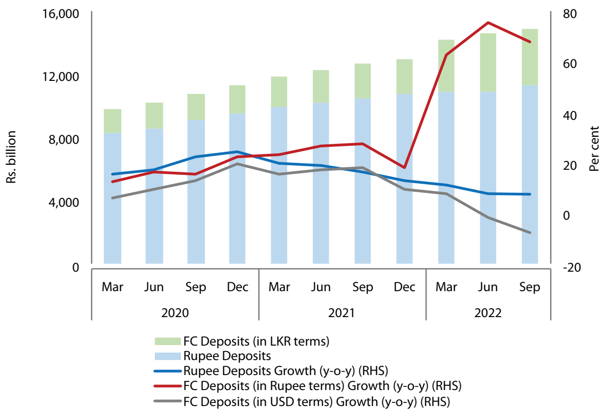
Growth in Rupee deposits recorded a deceleration while FC deposits in USD terms contracted, adding pressure to FC liquidity of banks. Rupee deposits continued to be the major source of funding for the

Chart 3.12 Relative Share of Liquid Assets



Source: Central Bank of Sri Lanka

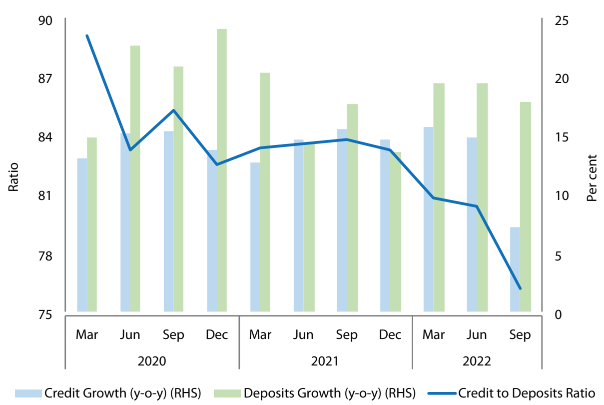
Chart 3.13 **Growth in Deposits**



Source: Central Bank of Sri Lanka

banking sector and amounted to Rs. 11.3 trillion as at end September 2022, 58.3 per cent of the total assets. Rupee deposit growth decelerated since end March 2021 and recorded a growth of 7.5 per cent y-o-y at end September 2022, compared to a growth of 15.9 per cent y-o-y recorded at end September 2021. This deceleration of growth in Rupee deposits of the banking sector, despite the Central Bank increasing its policy rates by 800 basis points since April 2022 and banks offering high interest rates, may be a result of increased spending induced by high inflation and the public moving to alternative investments due to prevailing higher yield rates on Rupee denominated government securities as well as higher rates offered on Rupee deposits by the Licensed Finance Companies (LFCs). FC deposits in

Chart 3.14 **Credit to Deposits Ratio**



Source: Central Bank of Sri Lanka

Rupee terms surged since March 2022 and recorded a growth of 67.4 per cent y-o-y at end September 2022 reaching Rs. 3.7 trillion, mainly due to the high depreciation of the exchange rate. Nevertheless, FC deposits in USD terms recorded a contraction of 7.7 per cent y-o-y and stood at USD 10.1 billion at end September 2022. Moreover, the Credit to Deposit Ratio declined to 76.2 per cent at end September 2022 from 83.7 per cent at end September 2021, indicating a sharp decline in credit growth relative to the decline in deposits growth.

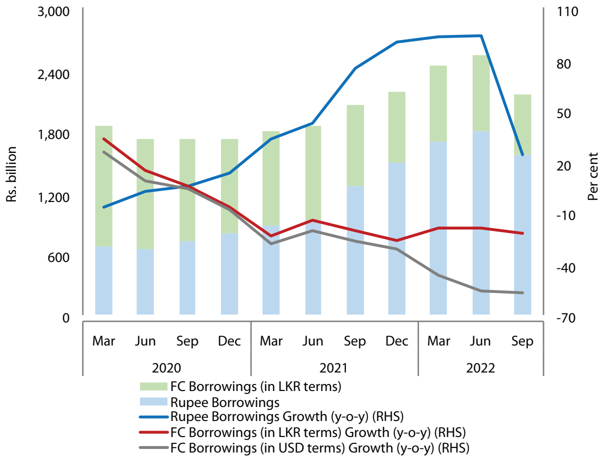
FC borrowings continued to contract during the nine months ending September 2022 while Rupee borrowings recorded a contraction during the quarter ending September 2022. Growth in Rupee borrowings of the sector surged to 93.4 per cent y-o-y at end June 2022, declined thereafter to a growth of 23.2 per cent y-o-y at end September 2022 and stood at Rs. 1.6 trillion. FC borrowings growth decelerated since April 2020 reflecting the impact of the downgrade of sovereign ratings and adverse macroeconomic conditions. As at end September 2022, FC borrowings in Rupee terms contracted by 22.0 per cent y-o-y and decreased to Rs. 609.2 billion, while FC borrowings in USD terms contracted by 57.0 per cent y-o-y and fell to USD 1.7 billion. As a result of the decelerating growth in Rupee deposits and Rupee borrowings, and contraction in FC borrowings, growth in total funding[4] of the banking sector declined to 16.1 per cent y-o-y at end September 2022 compared to 17.5 per cent at end September 2021.

Since June 2021, Rupee borrowings have exceeded FC borrowings (in Rupee terms) of the sector and represented 71.8 per cent of total borrowings as at end September 2022. This reveals the difficulties that banks have faced in rolling over the existing FC borrowings and sourcing new FC borrowings due to the sovereign rating downgrades and the announcement of the debt standstill. External

4. Total funding of the banking sector includes deposits, borrowings, and capital funds.

Chart 3.15

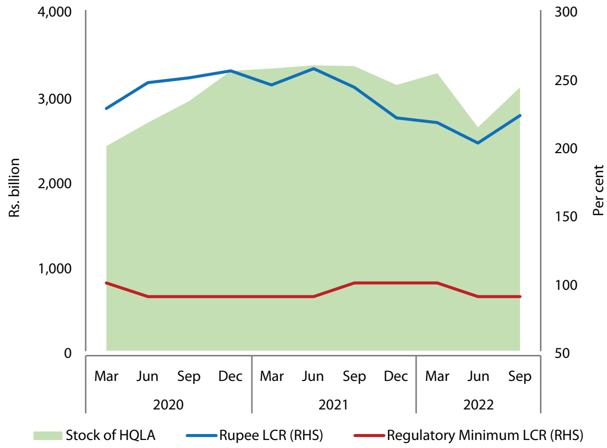
Growth in Borrowings



Source: Central Bank of Sri Lanka

Chart 3.17

Liquidity Coverage Ratio - Rupee



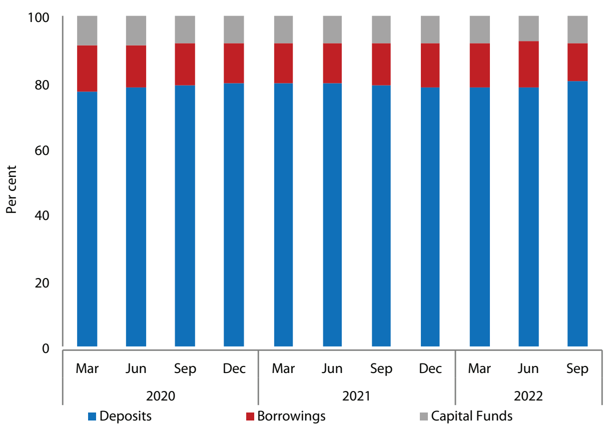
Source: Central Bank of Sri Lanka

borrowings have been the largest source of FC borrowings of the sector and represented 97.3 per cent of the total FC borrowings at end September 2022. The share of total borrowings in total funding decreased to 11.6 per cent at end September 2022 compared to 12.7 per cent at the end of the corresponding period of the previous year. Furthermore, FC borrowings represented 3.4 per cent of the total on-balance sheet liabilities of the banking sector at end September 2022, which declined from 5.2 per cent at end September 2021.

Although the Liquidity Coverage Ratio (LCR) for Rupee operations and LCR for all currency operations remained above the minimum regulatory required level, the banking sector faced stress conditions in terms of Rupee and FC liquidity. Rupee LCR decreased to 223.2 per cent in September 2022 from 243.6 per cent in corresponding period of 2021. However, it was an improvement when compared to the Rupee LCR of 202.5 per cent which prevailed in June 2022. All currency LCR also declined to 163.0 per cent in September 2022 from 189.5 per cent in September 2021, mainly due to reduced USD liquidity in the banking sector. Similar to Rupee LCR, it was an increase compared to all currency LCR of 137.0 per cent in June 2022. Although the sector as a whole maintained the LCR above the minimum

Chart 3.16

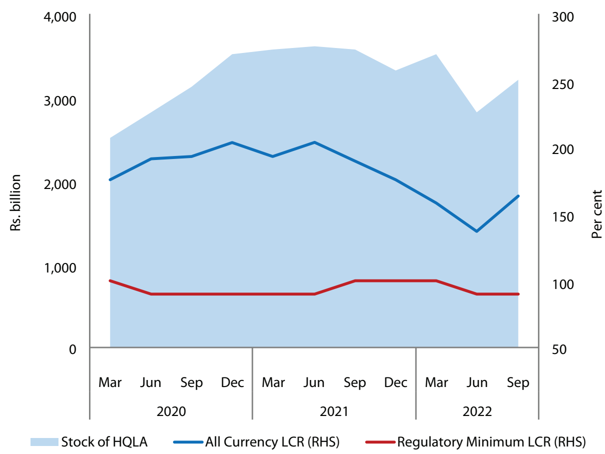
Relative Share of Deposits, Borrowings, and Capital Funds



Source: Central Bank of Sri Lanka

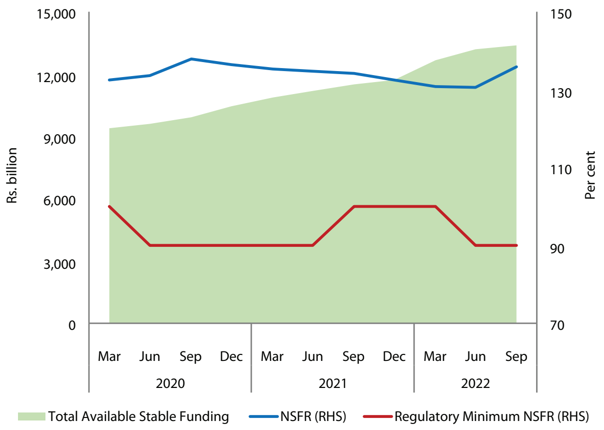
Chart 3.18

Liquidity Coverage Ratio - All Currency



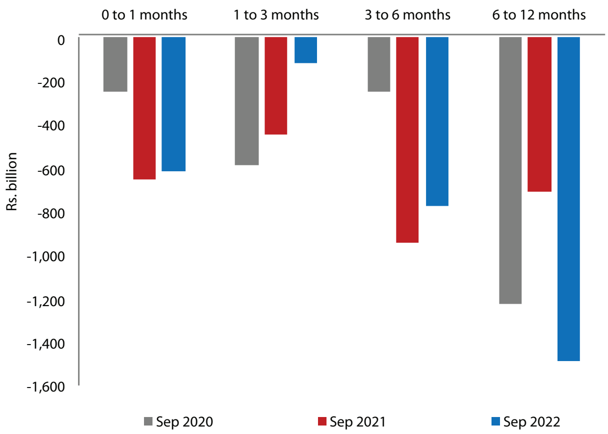
Source: Central Bank of Sri Lanka

Chart 3.19 Net Stable Funding Ratio



Source: Central Bank of Sri Lanka

Chart 3.20 Net Interest Sensitive Assets



Source: Central Bank of Sri Lanka

liquidity requirement, banks are obliged to be more attentive in managing the liquidity, given the prevailing adverse macroeconomic conditions.

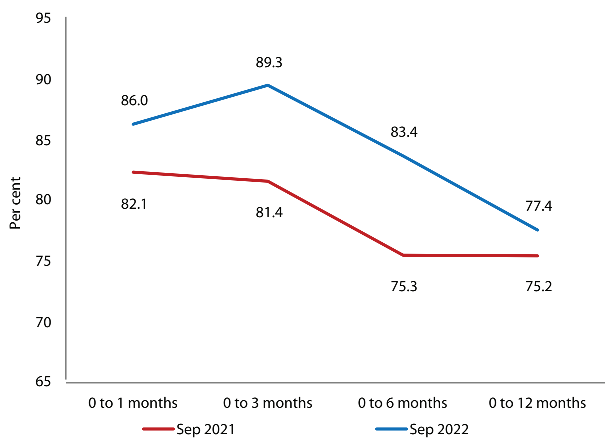
The Net Stable Funding Ratio (NSFR) also remained above the minimum regulatory required level. NSFR, which measures the available amount of stable funding over a time horizon of one year relative to the amount of required stable funding, marginally increased to 135.8 per cent in September 2022, compared to 134.3 per cent in September 2021.

3.2.3. Market Risk

The banking sector operates with an assets and liabilities structure that is highly sensitive to changes in interest rates. The cumulative negative gap between interest rate sensitive assets and liabilities of the banking sector up to 6 months contracted to Rs. 1.5 trillion at end September 2022 compared to Rs. 2.0 trillion at end September 2021. The highest reduction in the negative gap was reported for 1 – 3 months by Rs. 328.2 billion, as a result of increase in loans and receivables and contraction in borrowings at end September 2022 compared to end September 2021. However, the negative gap between interest rate sensitive assets and liabilities widened for 6 – 12 months by Rs. 780.5 billion, due to high increase in deposits and contraction in credit at end September 2022 compared to the end of the corresponding period of 2021. Further, Interest Rate Sensitivity Ratios of the banking sector also indicated that interest bearing liabilities exceeded the interest bearing assets of the sector in all maturity buckets on a cumulative basis. Accordingly, market interest rate behaviour may pose a relatively higher risk for the banking sector, particularly in relation to the 6 to 12 months bucket.

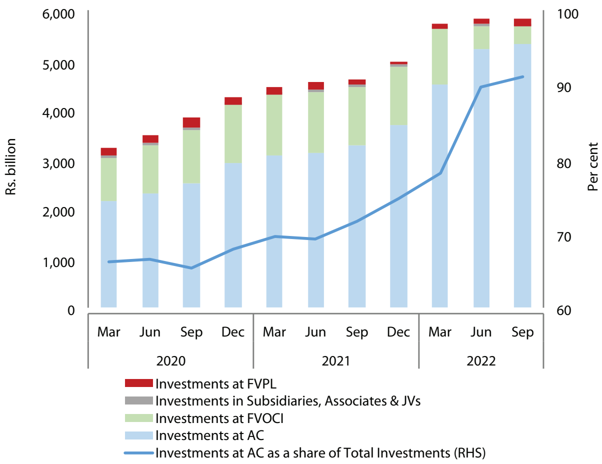
Furthermore, investments of the banking sector may not reflect the market conditions due to the changes in accounting classifications. Investments

Chart 3.21 Interest Rate Sensitivity Ratio (Cumulative)



Source: Central Bank of Sri Lanka

Chart 3.22 **Investments**[5]



Source: Central Bank of Sri Lanka

of the banking sector increased by 26.8 per cent y-o-y and reached Rs. 5.8 trillion at end September 2022, compared to a growth of 18.9 per cent y-o-y at end September 2021, mainly due to the Rupee depreciation. At end September 2022, banks increased the allocation of financial investments under amortised costs to 91.0 per cent of total investments, compared to 71.5 per cent at end of the corresponding period of the previous year. This was mainly a result of the reclassification of investments from Fair Value through Other Comprehensive Income portfolio to Amortised Cost portfolio as allowed by the Statement of Alternative Treatments issued by Institute of Chartered Accountants of Sri Lanka (ICASL). This contributed to partially negating the possible losses from interest rate movements, thus overstating the investments portfolio.

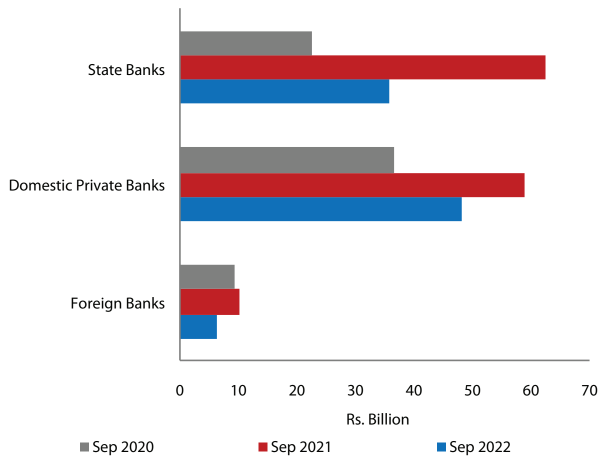
The net open position of the banking sector strengthened to mitigate the increased forex risk as a result of the intensified Rupee depreciation. The net long position of FC exposure of the banking sector increased to a long position of USD 422.3 million as at end September 2022 compared to a long position of USD 132.2 million as at end December 2021 due to higher increase in FC assets compared to the increase in FC liabilities. A net gain of Rs. 19.0 billion on FC revaluation was recorded during the nine months ending in September 2022 compared to a net gain of Rs. 26.1 billion during the corresponding period of 2021.

3.2.4. Profitability

A significant decline in profits of the banking sector was observed during the period concerned. The banking sector reported a Profit After Tax (PAT) of Rs. 90.2 billion during the nine months ending September 2022, which is a reduction of Rs. 41.5 billion and recorded a contraction of 31.5 per cent compared to the PAT reported during the nine months ending September 2021. During the period under consideration, aggregate profits of state owned banks, domestic private banks, and foreign banks declined compared to the corresponding period of the previous year.

The contraction in profits of the banking sector was mainly driven by the significant increase in new impairment charges during the period. Impairment charges increased by Rs. 272.5 billion during the nine months ending September 2022 compared to the corresponding period of the previous year. However, increased income on fees and commissions and foreign exchange gains

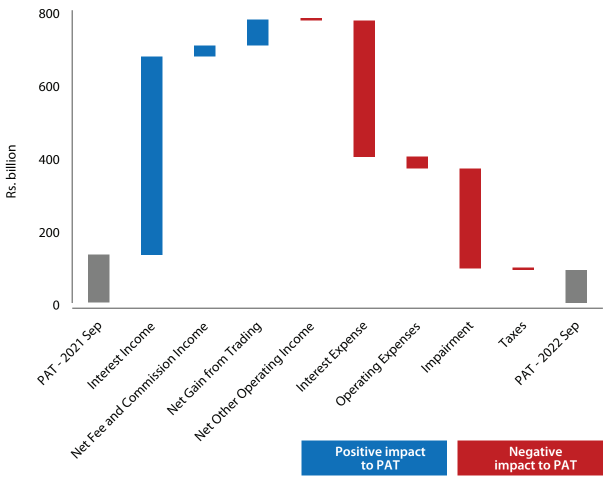
Chart 3.23 **PAT of Banks**



Source: Central Bank of Sri Lanka

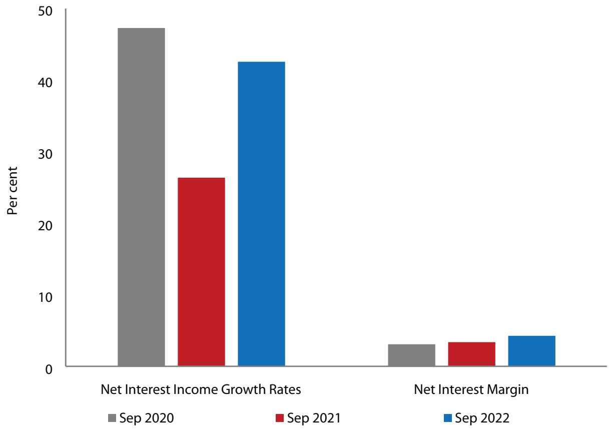
5. FVPL = Fair Value through Profit or Loss, FVOCI = Fair Value through Other Comprehensive Income, AC = Amortised Cost, JVs = Joint Ventures

Chart 3.24 **Impact of Change in Income and Expenses on Profits**



Source: Central Bank of Sri Lanka

Chart 3.26 **Net Interest Income Growth and Net Interest Margin**



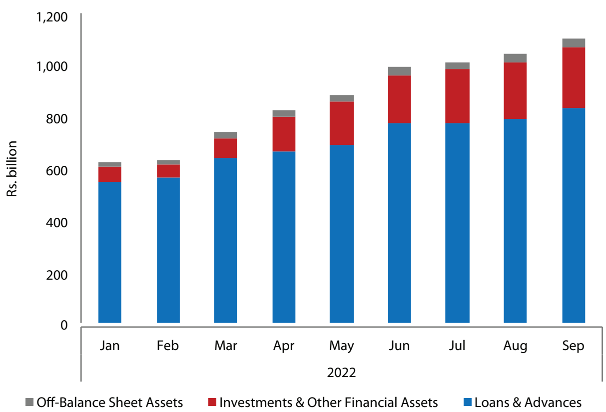
Source: Central Bank of Sri Lanka

on trading activities positively contributed to the profits of the banking sector during the nine months ending September 2022.

Impairment charges increased with the migration from time based provisioning to Sri Lanka Financial Reporting Standards (SLFRS) 9 stage wise classification of loans and receivables and investments. Stage-wise total impairment (including undrawn amounts) on loans and receivables, investments, off-balance sheet liabilities, and other financial assets of the banking sector gradually increased during the period of nine months ending September 2022 under the SLFRS 9 reporting requirement and led to the reduction in profitability with the increased impairment charges during the period under consideration.

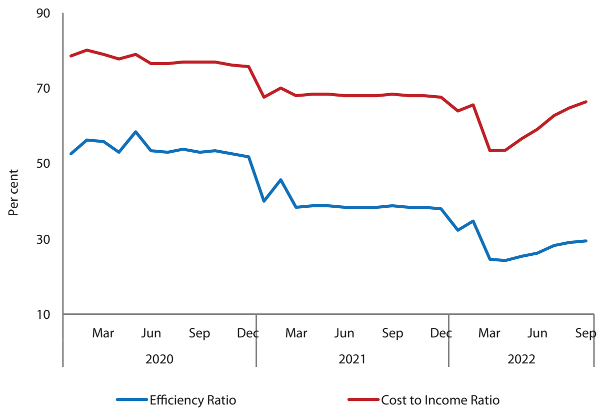
Net Interest Income (NII) and Net Interest Margin (NIM) of the sector increased, reflecting the rigidity in the deposit rates than the lending rates. The NII accelerated and recorded a growth of 42.7 per cent y-o-y during the nine months ending September 2022 compared to a growth of 26.4 per cent y-o-y recorded during the corresponding period of 2021. Since the interest rate pass through is quicker for loans and receivables than for deposits, interest income increased by Rs. 542 billion, while interest expense increased only by Rs. 372.1 billion for the nine months ending September 2022 compared

Chart 3.25 **Total Impairment**



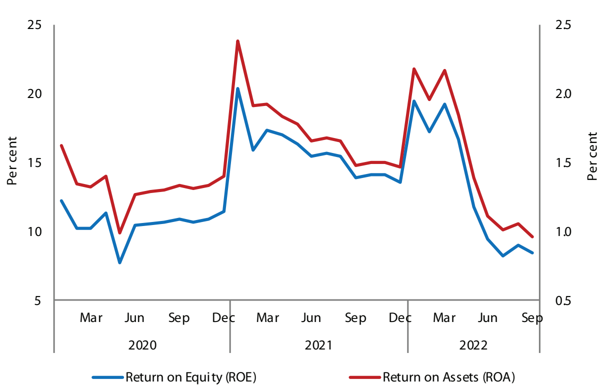
Source: Central Bank of Sri Lanka

Chart 3.27 **Cost to Income and Efficiency Ratios**



Source: Central Bank of Sri Lanka

Chart 3.28 ROA and ROE



Source: Central Bank of Sri Lanka

to the corresponding period of 2021. Accordingly, the NIM of the sector increased to 4.2 per cent of the average assets for the nine months ending September 2022 compared to 3.5 per cent for the corresponding period of 2021.

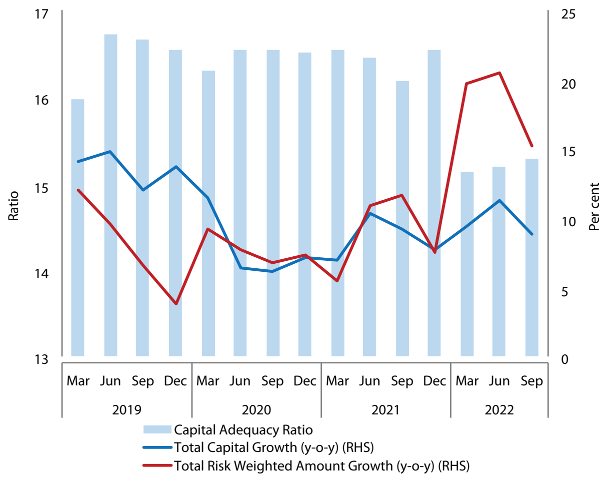
Reductions in the Cost to Income and Efficiency Ratios were observed during the period under consideration. The Cost to Income Ratio as well as Efficiency Ratio decreased to 66.3 per cent and 29.6 per cent, respectively, at end September 2022 compared to 68.3 per cent and 38.8 per cent, respectively, in the corresponding period of the previous year. However, both ratios increased during the second and third quarters of 2022 over the previous quarter, reflecting the challenges faced by the banking sector to maintain its costs in an efficient manner.

Return on Assets (ROA) and Return on Equity (ROE) of the sector decreased considerably during the period under consideration. ROA and ROE decreased from 1.5 per cent and 13.8 per cent in September 2021, respectively, to 1.0 per cent and 8.5 per cent, respectively, in September 2022, reflecting the depletion of profits of the banking sector.

3.2.5. Capital Adequacy and Leverage

The banking sector managed to absorb unexpected shocks amidst turbulent macroeconomic

Chart 3.29 Capital Adequacy Ratio

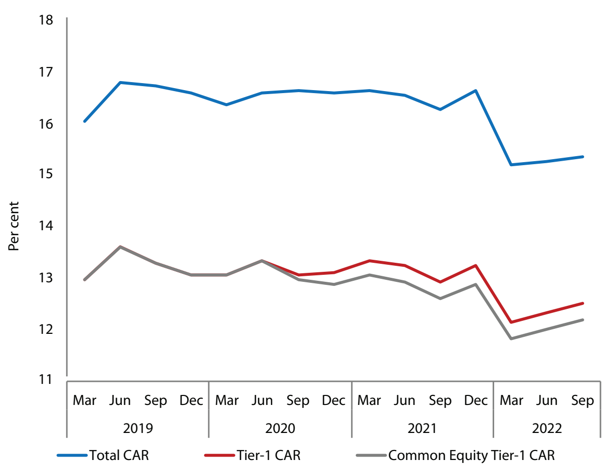


Source: Central Bank of Sri Lanka

conditions. The Total Capital Adequacy Ratio (CAR) and Tier-1 CAR of the banking sector declined to 15.3 per cent and 12.4 per cent, respectively, at end September 2022, compared to 16.2 per cent and 12.9 per cent, respectively, at end September 2021. However, the aggregate CAR of the state and domestic private banks as well as foreign banks remained above the stipulated minimum regulatory requirement. Nevertheless, y-o-y growths of both capital and Risk Weighted Asset (RWA) have decelerated since June 2022 owing to the effects of the economic contraction.

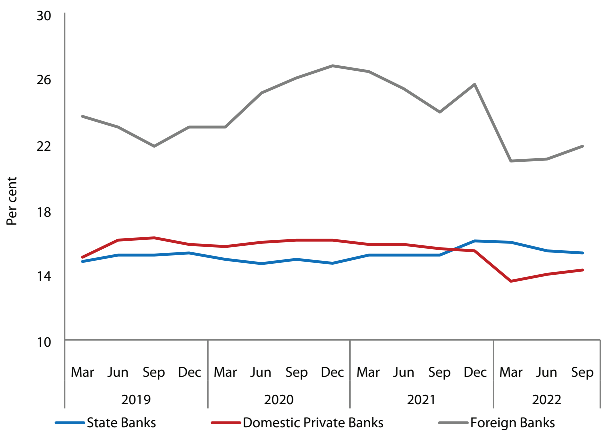
Foreign banks maintained higher levels of regulatory capital in comparison to domestic

Chart 3.30 Regulatory Capital Ratios



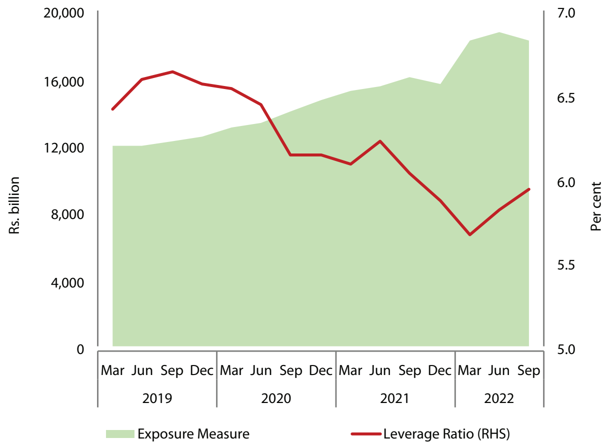
Source: Central Bank of Sri Lanka

Chart 3.31 CAR by Bank Category



Source: Central Bank of Sri Lanka

Chart 3.33 Leverage Ratio

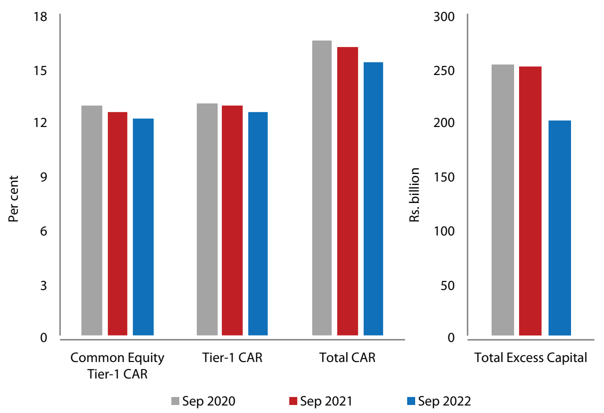


Source: Central Bank of Sri Lanka

banks. State owned banks recorded a CAR of 15.3 per cent while domestic private banks recorded 14.2 per cent at end September 2022. Foreign banks, which accounted for 9.1 per cent of the RWA of the sector recorded a CAR of 21.8 per cent for the same period. Although all banks complied with the regulatory minimum capital ratio of 10 per cent, few banks struggled to maintain the capital conservation buffer during the nine months ending September 2022.

CAR of the banking sector has gradually decreased over the past 3 consecutive years as recorded at end September of each year. Tier-1 CAR has decreased from 13.0 per cent recorded in September 2020 to 12.4 per cent in September 2022, while Total CAR has declined from 16.6 per cent to 15.3 per cent for the same period, respectively. Total Excess Capital preserved by the sector eroded by Rs. 51.8 billion over the past 3 years ending September 2022.

Chart 3.32 Banking Sector Capitalisation



Source: Central Bank of Sri Lanka

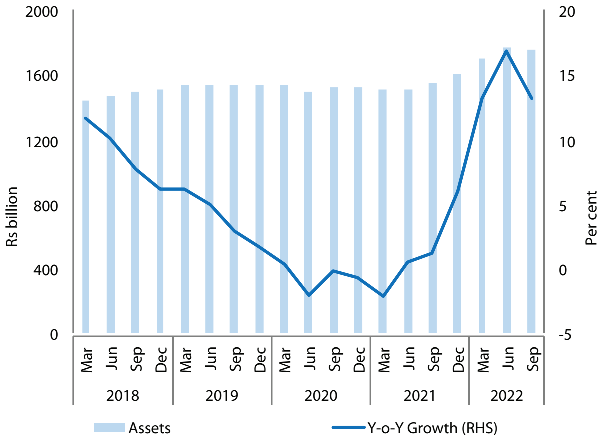
The banking sector was moderately leveraged during the period under review. The Leverage Ratio of the sector was 5.9 per cent at end September 2022 which showed an increasing trend since March 2022. This is well above the minimum regulatory requirement of 3.0 per cent. However, the higher ratio was attained mainly due to a decrease in asset exposure irrespective of the lower Tier-1 capital recorded for the period.

3.3. Licensed Finance Companies and Specialised Leasing Companies Sector[6]

The asset base of the LFCs and SLCs sector which continued to expand since the first quarter of 2021 maintained its momentum during the third quarter of 2022 amidst challenging macroeconomic conditions. The total asset base of the sector increased by Rs. 201.6 billion, recording a significant growth of 13.1 per cent y-o-y at end

6. For this analysis, financial statements of all registered Licensed Finance Companies (LFCs) were considered, including LFCs that reported despite their licenses being suspended.

Chart 3.34
Assets of the LFCs and SLCs Sector



Source: Central Bank of Sri Lanka

September 2022 despite the economic contraction experienced by the country, compared to the 1.2 per cent y-o-y growth recorded at end September 2021. However, the asset base of the sector declined by Rs. 13.4 billion, recording a growth of 13.1 per cent at end September 2022 compared to a growth of 16.8 per cent at end June 2022, discontinuing the upward trend observed since March 2021.

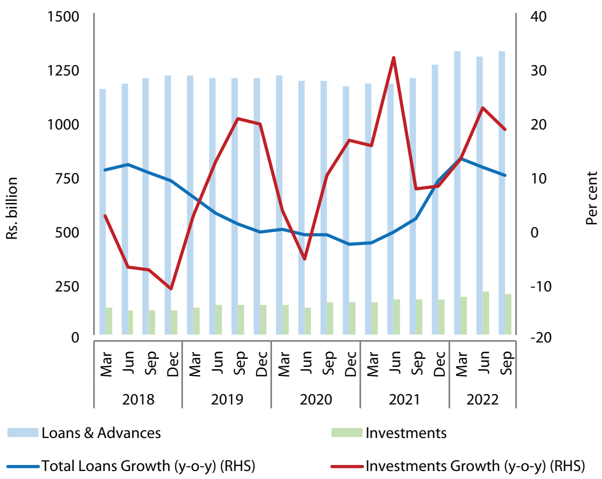
Loans and Advances and Investments mainly contributed towards sector expansion. The sector expansion was largely represented by an increase in Loans and Advances which accounted for 75.5 per cent of the total assets. The total loan portfolio grew by Rs. 117.3 billion with a 9.8 per cent y-o-y growth at end September 2022 compared to 1.6 per cent recorded at end September 2021. Investments accounted for 11.1 per cent of asset base, which amounted to Rs. 193.5 billion, and significantly grew by 18.1 per cent at end September 2022 compared to 7.4 per cent at end September 2021. The increase in Investments was mainly due to the increase of investments in government securities which represented 56.6 per cent of the total investments and 37.4 per cent of Capital Funds of the sector at end September 2022.

3.3.1. Credit Risk

LFCs and SLCs sector credit was mainly concentrated in three product categories. During the period under review, 93.1 per cent of the loan and advances portfolio of the sector was concentrated in leasing and hire purchase (45.6 per cent), secured loans (31.6 per cent), and pawning/gold loan advances (15.9 per cent). The high concentration on these products could pose a concentration risk to the sector.

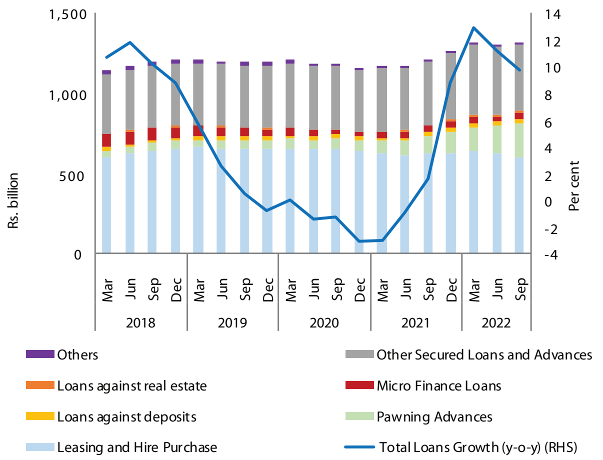
The concentration on leasing and hire purchase products as a share of total loans and advances declined during the period under review. The concentration on leasing and hire purchase products, which were the core loan products of the

Chart 3.35
Loans and Investments of the LFCs and SLCs Sector



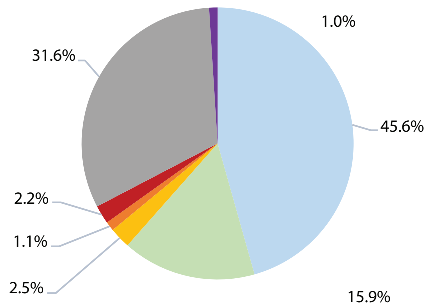
Source: Central Bank of Sri Lanka

Chart 3.36
Loans and Advances of the LFCs and SLCs Sector



Source: Central Bank of Sri Lanka

Chart 3.37 **Product-wise Loans and Advances by end September 2022**



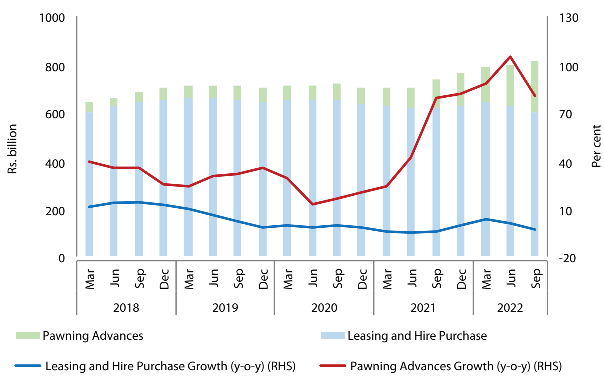
Source: Central Bank of Sri Lanka

LFCs and SLCs sector, was adversely affected mainly due to prolonged restrictions on vehicle imports as a measure to limit forex outflows and the low purchasing power of households. Accordingly, the concentration on leasing and hire purchases decreased to 45.6 per cent at end September 2022, compared to 51.6 per cent at end September 2021.

A surge in the pawning/gold loans exposure of the LFCs and SLCs sector was observed. Since the sector diverts its funds to the pawning/gold loan portfolio as an alternative to the low demand for leasing and hire purchase and the people's propensity to borrow heavily through pawning as the higher inflation affected the disposable income of households, the pawning/gold loans exposure of the LFCs and SLCs sector accelerated with 80.0 per cent y-o-y growth at end September 2022. As a result, the concentration on pawning/gold loans advances of the sector surged to 15.9 per cent at end September 2022 from 9.7 per cent during the corresponding period of the previous year. This could pose additional risk to the sector as gold prices were highly volatile in the world market during the recent past.

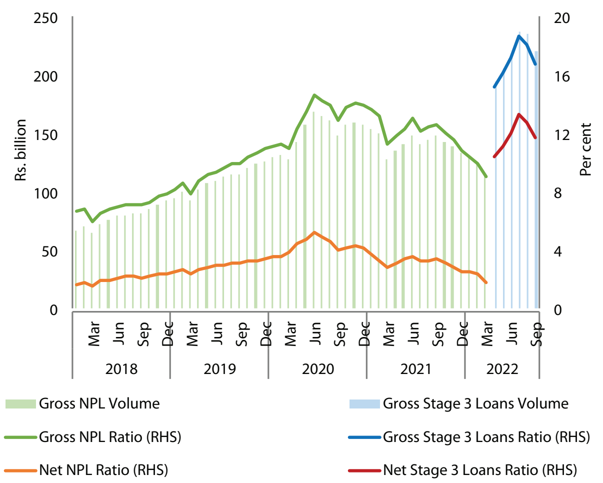
The LFCs and SLCs sector is inherently exposed to higher credit risk compared to the banking sector as the nature of its business model is to deal with high risk customers. Asset quality of the sector deteriorated as indicated by stage 3 loans. The time based classification of non-performing loans was replaced with SLFRS 9 based stage 3 loans as the LFCs and SLCs sector migrated to SLFRS 9 based reporting since April 01, 2022. As a result of shifting the loan classification methodology into a SLFRS based approach and the impact from adverse macroeconomic conditions, the Gross and Net Stage 3 Loans Ratios stood at 16.8 per cent and 11.7 per cent, respectively, at end September 2022. Meanwhile the Gross and Net Non-Performing Loans (NPL) Ratios stood at 12.7 per cent and 3.3 per cent, respectively, at end September 2021. The possible downgrading of loans and advances

Chart 3.38 **Pawning Advances and Leasing and Hire Purchase of LFCs and SLCs Sector**



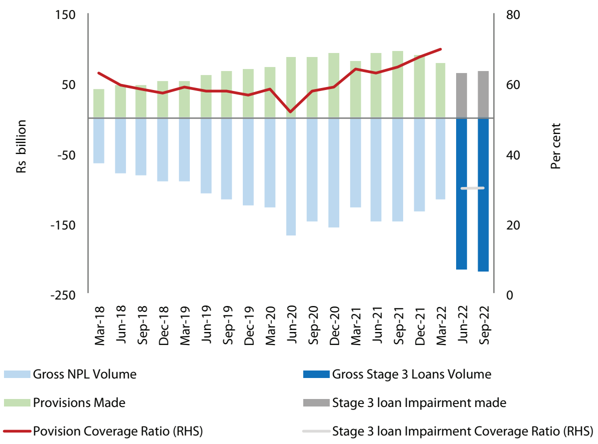
Source: Central Bank of Sri Lanka

Chart 3.39 **NPLs/Stage 3 Loans of the LFCs Sector**



Source: Central Bank of Sri Lanka

Chart 3.40 Provision/ Impairment Coverage Ratio of the LFCs Sector



Source: Central Bank of Sri Lanka

after the expiration of the debt moratoria granted in consideration of the COVID-19 pandemic could further deteriorate the asset quality of the LFCs sector. Further, going forward, economic contraction could aggravate the credit risk of the sector and further accelerate deterioration of asset quality. As such, at the given macroeconomic conditions, the credit risk of the sector could reach a challenging level and eventually threaten the stability of the sector.

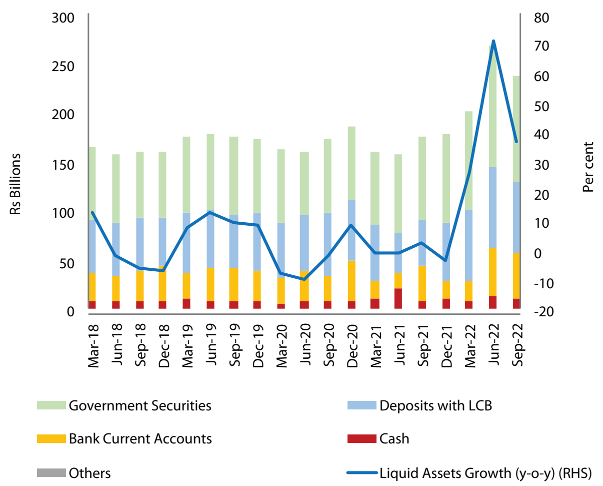
Resilience of the LFCs sector could be affected as some LFCs have reported exorbitantly high stage 3 loans which is above 20 per cent. Seventeen LFCs representing 21.6 per cent of the total asset base of the sector, which recorded a higher Stage 3 Loans Ratio during the period under consideration, could face severe credit risk and that could threaten the stability of the sector. The LFCs sector managed to mitigate the negative effects of high credit risk to a certain extent by way of recognising impairment for stage 3 loans and advances, with the coverage ratio of 30.0 per cent at end September 2022. Meanwhile, the provision coverage ratio stood at 64.4 per cent at end September 2021.

3.3.2. Liquidity Risk

The sector, on an aggregate basis, maintained liquidity well above the minimum requirement as a result of increased mobilization of deposits triggered by high interest rates. The overall available liquid assets of the sector at end September 2022 showed a surplus of Rs. 62.7 billion as against the stipulated minimum requirement of Rs. 98.0 billion. However, the liquidity surplus at end September 2022 declined by 11.2 per cent, amounting to Rs. 7.9 billion, compared to the liquidity surplus at end September 2021, mainly due to increased minimum liquidity requirements by 14.8 per cent with the increased external funds of the sector. Although the available liquid assets of the sector as a whole were higher than the regulatory minimum requirement, a few LFCs reported a decline in liquidity for the period under consideration.

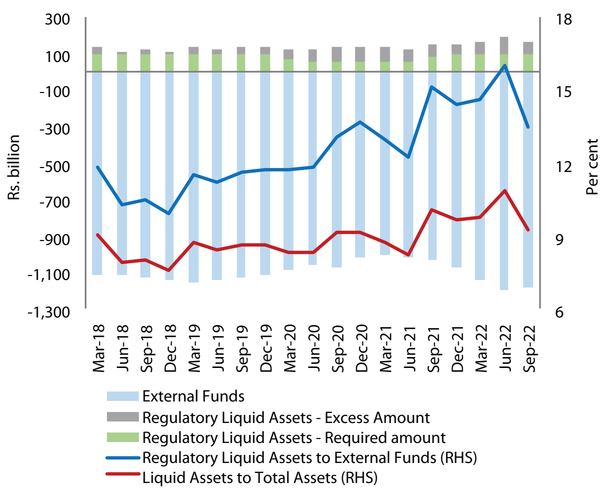
The LFCs and SLCs sector accumulated its excess funds in the form of liquid assets as a risk mitigation measure to face the adverse liquidity concerns of the financial sector. Liquid assets of the sector grew by 36.3 per cent to Rs. 237.4 billion at the end September 2022 compared to Rs. 174.1 billion recorded at the end of the corresponding period of 2021. Liquid Assets comprised mainly of 46.1 per cent of government securities and 30.5 per cent of deposits with LCBs. However, the high growth in liquid assets was mainly driven by 55.0 per cent growth of deposits with LCBs reflecting the prevailing higher interest rate scenario.

Chart 3.41 Composition of Liquid Assets of the LFCs and SLCs Sector



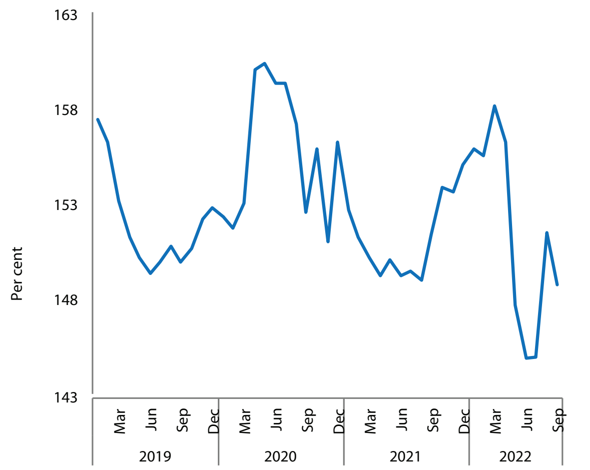
Source: Central Bank of Sri Lanka

Chart 3.42 **Liquid Assets to External Funds and Total Assets**



Source: Central Bank of Sri Lanka

Chart 3.44 **Credit to Deposits and Debentures Ratio of LFCs & SLCs Sector**

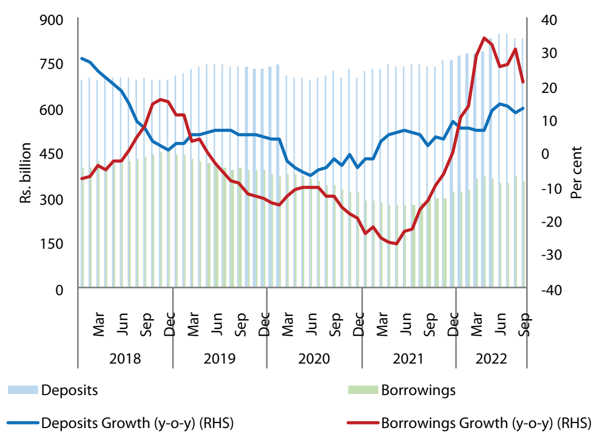


Source: Central Bank of Sri Lanka

Liquid assets related to external funds and total assets declined. The Regulatory Liquid Assets to External Funds Ratio declined to 13.5 per cent at end September 2022 against 15.1 per cent reported in the corresponding period of the previous year due to increased deposits and borrowings of the sector. Meanwhile, the Liquid Assets to Total Assets Ratio also decreased to 9.2 per cent at end September 2022 compared to 10.1 per cent reported in the corresponding period of the previous year mainly due to considerable growth recorded in the total assets of the sector.

The increasing trend in the deposit base of the sector continued. The deposits as the main funding source of the LFCs sector, representing 47.8 per cent of the total liabilities, recorded a higher growth of 13.1 per cent y-o-y at end September 2022 compared to 1.7 per cent at end September 2021. Overshooting of Treasury Bill yields during the 2nd and 3rd quarters of 2022 provided greater flexibility to the LFCs sector for offering competitively higher interest rates for the deposits. However, with the current challenging macroeconomic conditions, the increasing trend in the deposit base of the sector could not be sustained in the future.

Chart 3.43 **Deposits and Borrowings of the LFCs & SLCs Sector**



Source: Central Bank of Sri Lanka

The growth of borrowings of the LFCs and SLCs sector decelerated since May 2022 reflecting the higher borrowing cost. In addition, higher mobilisation of deposits also contributed to reduce the need for additional borrowings. Borrowings of the sector, which represented 20.5 per cent of the total liabilities, grew by 20.8 per cent y-o-y at end September 2022 compared to a growth of 32.2 per cent at end May 2022 and a contraction of 14.3 per cent at end September 2021. The prevailing higher interest rates could further negatively impact the sector borrowings and may result in further deceleration of borrowings affecting the funding sources.

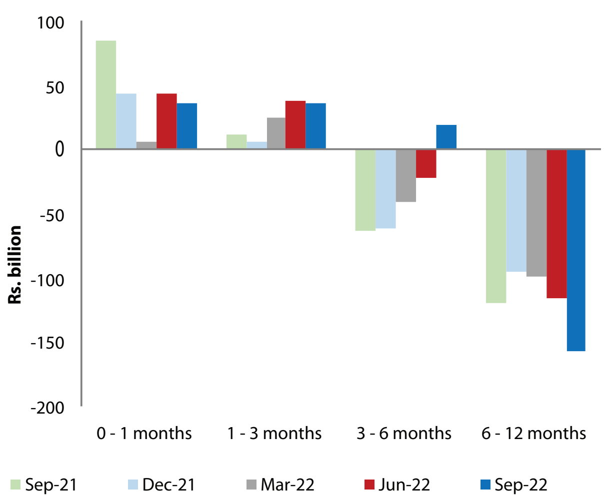
The Credit to Deposit and Debenture Ratio of the Sector declined, reflecting the higher growth in deposits. Comparably higher deposit growth than the credit growth and comparably lower borrowings through the issuance of debentures resulted in a fall in the Credit to Deposit and Debenture Ratio to 148.8 per cent at end September 2022 from 151.4 per cent reported at end September 2021. This indicates that LFCs are moving towards relying on stable funding sources to grant loans and advances, which is a favorable development in terms of liquidity management. Foreign Currency Borrowings of the LFCs sector reported USD 100.9 million, which is Rs. 36.6 billion, at end September 2022, and accounted for 10.3 per cent and 12.5 per cent of the total borrowings and capital funds of the sector, respectively.

3.3.3. Market Risk

The LFCs and SLCs sector was exposed to a lower level of equity risk. The sector continued to experience minimum exposure to equity risk as total exposure to equity market was minimal, which amounted to Rs. 21.4 billion at end September 2022 compared to Rs. 20.2 billion at end September 2021 and represented only 1.2 per cent of the total assets of the sector.

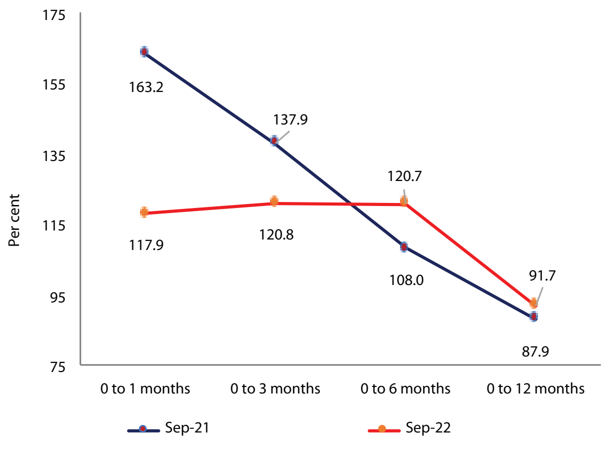
The sector's interest rate risk was maintained at a tolerable level. At end September 2022, positive mismatches in interest sensitive assets and

Chart 3.45 Net Interest Sensitive Assets of LFCs Sector



Source: Central Bank of Sri Lanka

Chart 3.46 Interest Rate Sensitivity Ratio



Source: Central Bank of Sri Lanka

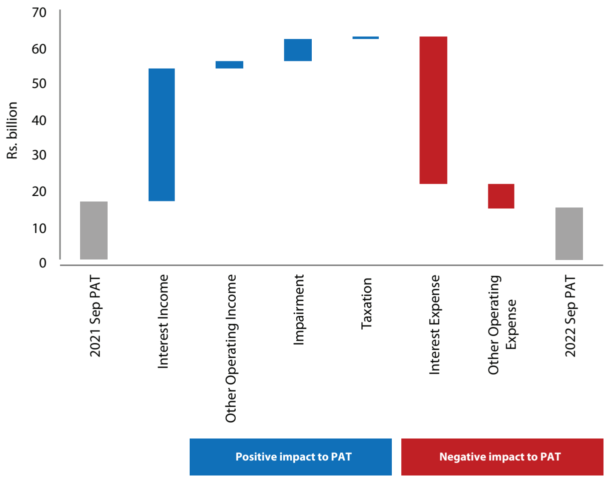
liabilities were observed up to 6 months maturity buckets of the LFCs sector indicating that the sector's interest rate risk was at a favorable level for periods less than 6 months in a tightening monetary policy cycle. However, the sector recorded a higher negative mismatch in the 6-12 months maturity bucket at end September 2022 compared to previous quarters. It could expose the sector to a higher interest rate risk as a significant portion of the interest sensitive assets and liabilities is in this bucket. Further, the Interest Rate Sensitivity Ratio also indicated that the sector was in a favorable position in relation to managing interest rate risk up to 6 months and could be exposed to risk in a 6-12 months period where its interest bearing liabilities would exceed its interest bearing assets.

3.3.4. Profitability

Profitability of the LFCs and SLCs sector decreased during the period under consideration. PAT of the sector amounted to Rs. 14.6 billion during the six months[7] ending September 2022 recording a negative y-o-y growth of 10.1 per cent compared to the significant y-o-y growth rate recorded during the six months ending September 2021. Profits of

7. Financial year of LFCs and SLCs falls between April 01 and March 31. Therefore, the period referred to as six months in the analysis implies the first six months of the financial year from 01.04.2022 to 31.03.2023.

Chart 3.47 **Impact of Change in Income and Expenses on Profit**

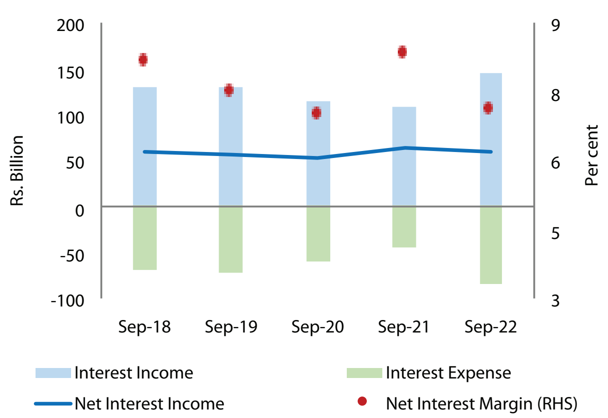


Source: Central Bank of Sri Lanka

the sector declined mainly due to the decline in NII as a result of a significant increase in interest expenses by 94.0 per cent y-o-y at end September 2022 with the prevailing higher interest rate scenario. Accordingly, NIM of the sector significantly decreased to 7.1 per cent at end September 2022 from 8.4 per cent recorded at end September 2021. Further, other operating expenses increased by 16.2 per cent y-o-y, also contributing to lower profits during the period under consideration.

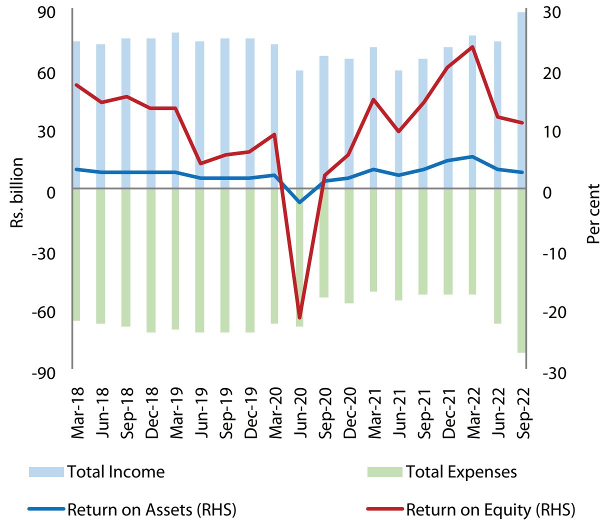
ROA and ROE of the sector declined. Acceleration of sector's asset base and the capital along with

Chart 3.48 **Net Interest Income & Net Interest Margin**



Source: Central Bank of Sri Lanka

Chart 3.49 **Profitability of the LFCs and SLCs Sector**

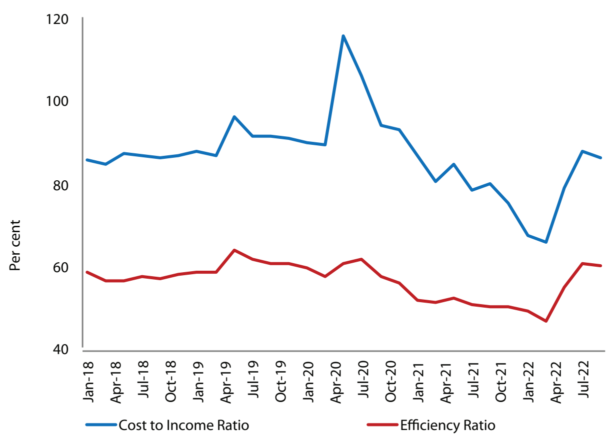


Source: Central Bank of Sri Lanka

the reduction in profits led the ROA and ROE of the sector to decrease and reported at 2.8 per cent and 10.7 per cent, respectively, at end September 2022 compared to 3.4 per cent and 14.2 per cent, respectively, recorded at end September 2021. As such, considering the prevailing high interest rate scenario, low profitability could negatively affect the accumulation of new capital to the sector since the low ROE may not be able to attract new investors to the sector in the future.

The efficiency and cost to income ratios of the LFCs and SLCs sector increased. The efficiency and

Chart 3.50 **Cost to Income and Efficiency Ratios of the LFCs and SLCs Sector**



Source: Central Bank of Sri Lanka

cost to income ratios of the sector surged to 59.6 per cent and 85.7 per cent, respectively, at end September 2022 from 50.1 per cent and 79.8 per cent, respectively, in the corresponding period of 2021 indicating that costs raised at a higher rate than the income.

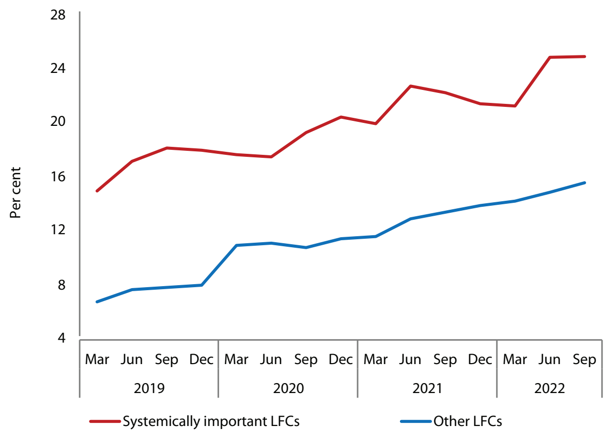
3.3.5. Capital Adequacy

Capital of the LFCs and SLCs sector on an aggregate basis improved during the period under review. This is mainly due to infusion of new capital by LFCs to meet the regulatory requirement of enhancing the core capital to Rs. 2.5 billion by January 01, 2022 as a part of the Master Plan for Consolidation of Non-bank Financial Institutions. Accordingly, the total regulatory capital of the sector improved by Rs. 44.2 billion to Rs. 293.2 billion by end September 2022 compared to Rs. 249.0 billion recorded in the corresponding period of 2021. However, there were a few LFCs which did not comply with the minimum core capital requirement.

The Core CAR and Total CAR of the sector increased to 18.5 per cent and 20.0 per cent, respectively, by end September 2022 from the reported level of 16.0 per cent and 17.6 per cent at end September 2021. Moderate growth of RWA and higher growth of capital led to higher CAR of the sector during the period under consideration. Hence, the prevailing higher CAR will provide an additional cushion to the sector to withstand unexpected solvency risk to some extent. However, significant contraction in the economy, which could lead to higher stage 3 loans, which might adversely affect CAR through additional impairment in the future.

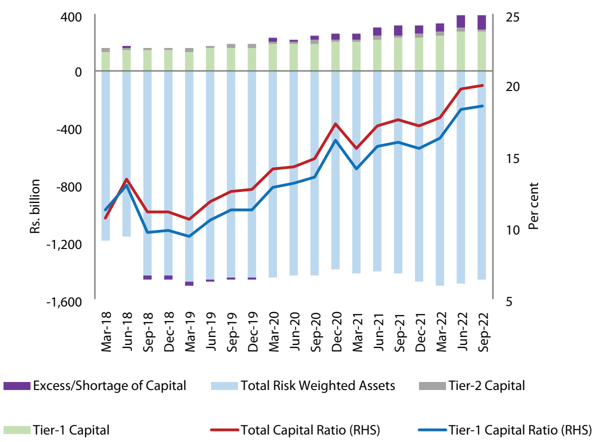
Systemically important LFCs recorded a significantly higher CAR compared to the statutory minimum requirement which will strengthen the sector resilience. The average CAR of the four systemically important LFCs was 24.7 per cent, well above the minimum requirement of 14.0 per cent while the average CAR of the other LFCs was

Chart 3.52
CAR by LFC Category



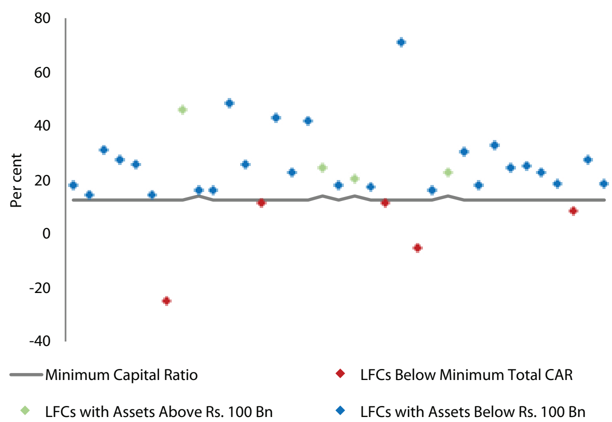
Source: Central Bank of Sri Lanka

Chart 3.51
Capital Adequacy of the LFCs and SLCs Sector



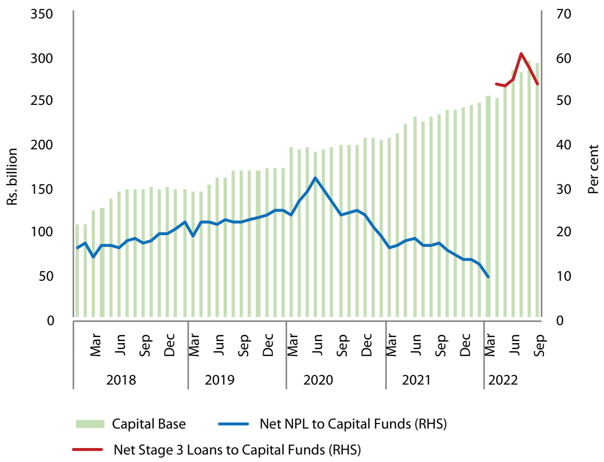
Source: Central Bank of Sri Lanka

Chart 3.53
Total Capital Ratio of individual LFCs as at end September 2022



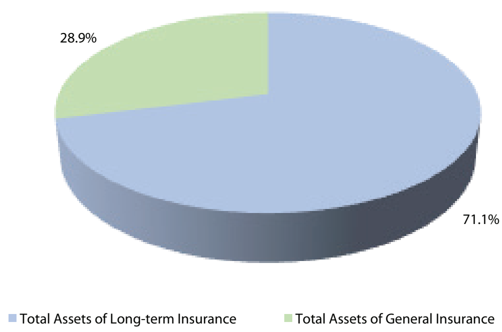
Source: Central Bank of Sri Lanka

Chart 3.54 **Net NPLs/Stage 3 Loans to Capital Funds**



Source: Central Bank of Sri Lanka

Chart 3.55 **Total Assets at end June 2022**



Source: Insurance Regulatory Commission of Sri Lanka

15.3 per cent, above the minimum requirement of 12.5 per cent. At end September 2022, five LFCs recorded total CARs well above the minimum required level. Many other LFCs recorded CARs at the required level. However, out of thirty-five LFCs, five LFCs representing 7.5 per cent of the total assets recorded CAR below the minimum requirement. Further, the Net Stage 3 Loans to Capital Fund Ratio of LFCs sector was at 53.3 per cent at end September 2022 compared to the net NPLs to Capital Fund Ratio of 16.8 per cent of LFCs sector at end September 2021. However, the Net Stage 3 Loans to Capital Fund Ratio has decelerated since July 2022.

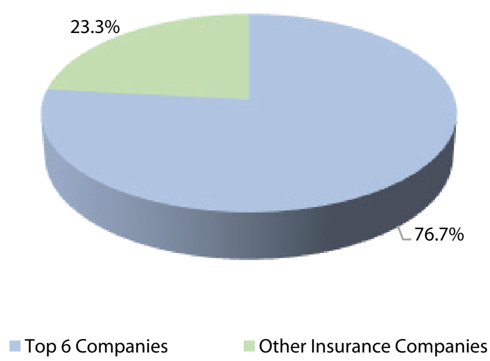
3.4. Insurance Sector

The Insurance sector is dominated by six companies in terms of total assets of the sector. Out of twenty-seven[8] insurance companies in the sector, six companies contributed to 76.7 per cent of the total assets of the sector at end June 2022. In addition, 71.1 per cent of the market share based on total assets was dominated by the long term insurance sub sector at end June 2022. High concentration in terms of institution poses additional risks as any vulnerability in a large company could significantly affect the sector.

The insurance sector, which faced headwinds and heightened uncertainties in its business expansion, grew at a slower rate in terms of total assets during the first half of 2022. The total asset base of the sector increased by Rs. 65.8 billion, recorded an expansion of 7.9 per cent y-o-y at end June 2022 compared to the asset growth of 10.8 per cent reported during the corresponding period of 2021. Adverse business conditions and decline in disposable income level of households negatively affected the expansion of the insurance sector during the period under consideration.

The insurance sector expansion was mainly represented by a surge in investments in

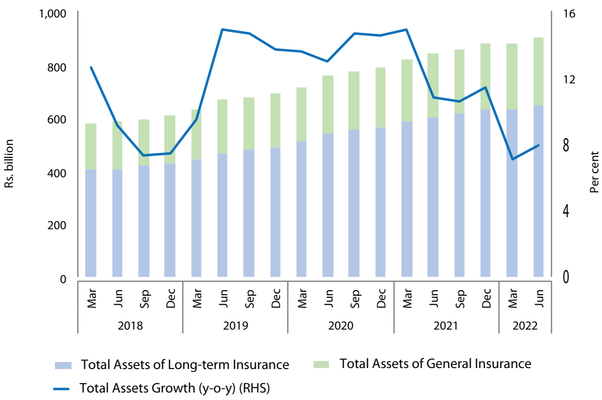
Chart 3.56 **Share of Total Assets at end June 2022**



Source: Insurance Regulatory Commission of Sri Lanka

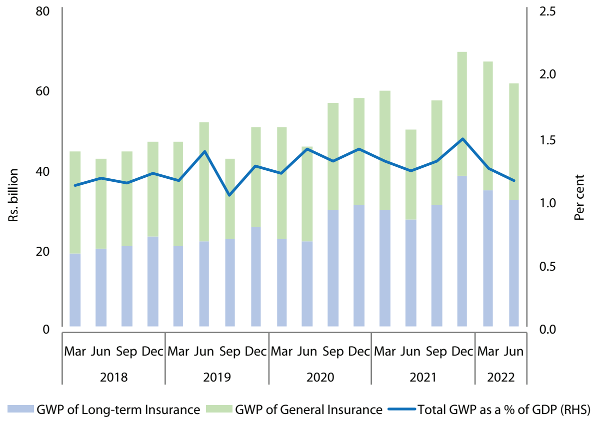
8. Particulars related to National Insurance Trust Fund (NITF) are excluded from this analysis.

Chart 3.57 Total Assets



Source: Insurance Regulatory Commission of Sri Lanka

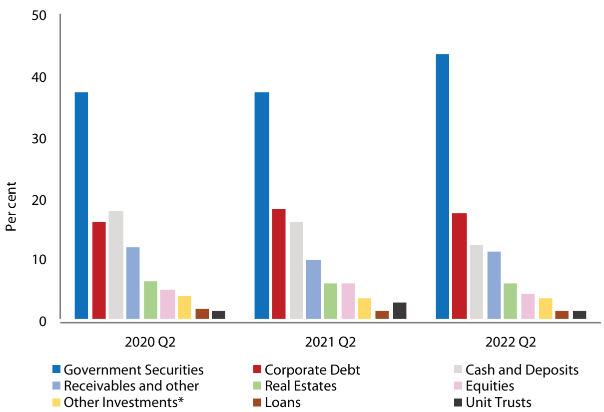
Chart 3.59 Gross Written Premium as a Percentage of GDP[10]



Source: Insurance Regulatory Commission of Sri Lanka
Department of Census and Statistics

government securities. The y-o-y growth in investments on government securities accounted for 26.5 per cent at end June 2022 due to higher yields prevailed for Treasury bills and Treasury bonds compared to a growth of 10.4 per cent at end June 2021. Investments in government securities and investments in corporate bonds accounted for 43.5 per cent and 17.5 per cent of the total assets, respectively, at end June 2022. Nevertheless, investments in equities declined and recorded a negative y-o-y growth of 23.1 per cent since the sector moved its investment funds to fixed income securities considering the prevailing high yields on government securities.

Chart 3.58 Distribution of Total Assets[9] of Insurance Companies



Source: Insurance Regulatory Commission of Sri Lanka

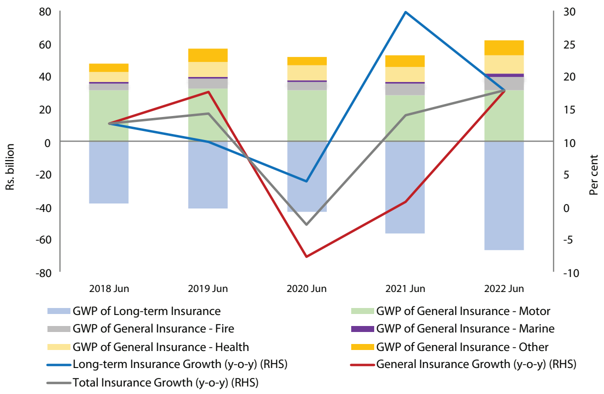
9. Other Investments include investments in subsidiaries, investments in associates and investments in gold.

The penetration of the Insurance sector, as measured by Gross Written Premium (GWP) to Gross Domestic Product (GDP) at current price decreased marginally during 2022. GWP as a percentage of GDP decreased to 1.1 per cent at end June 2022 compared to 1.2 per cent which was recorded at end June 2021, reflecting the increased GDP growth at current price than increased GWP during the period under consideration.

Growth of GWP of the Insurance sector accelerated during the period under consideration. The Insurance sector as a whole recorded a growth of 17.8 per cent in GWP during the first half of 2022, which is an increase compared to the growth of 13.9 per cent reported during the corresponding period of 2021. GWP of both long term and general insurance sub sectors increased by 17.9 per cent and 17.7 per cent y-o-y, respectively, during the first half of 2022 compared to the growth of 29.8 per cent and 0.7 per cent, respectively, during the first half of 2021. When considering sub sectors of the general insurance, health insurance being the second largest sub sector of the general insurance, recorded the highest growth in GWP of 23.7 per cent during the first half of 2022. However, it was observed that the growth of GWP of the motor insurance sub sector, the largest sub

10. Based on the GDP at current price.

Chart 3.60 **Gross Written Premium (GWP)**

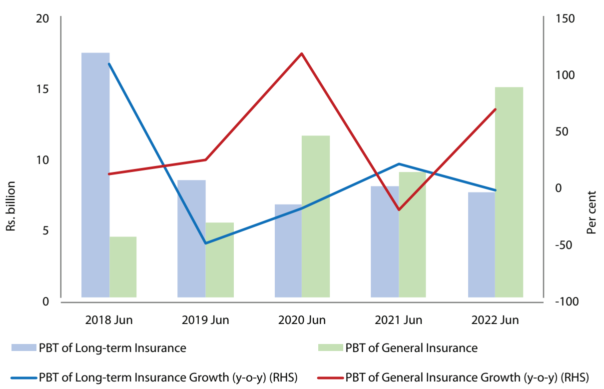


Source: Insurance Regulatory Commission of Sri Lanka

sector, reported a growth of 10.0 per cent during the period under consideration mainly due to the surge in vehicle prices in the secondary market and increased usage of vehicles in the post lockdown periods.

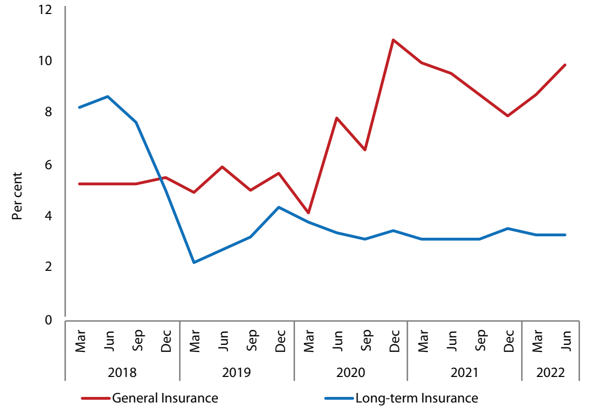
The profits of the sector increased during the first half of 2022 compared to the corresponding period of the last year. The Profit Before Tax (PBT) of the sector grew by 33.3 per cent during the first half of 2022 compared to the negative growth of 7.2 per cent during the corresponding period of 2021. This was mainly due to accelerated growth of PBT of the general insurance sub sector which contributed to 66.8 per cent of the Insurance sector profits. PBT of the general insurance sub sector increased to its highest level in 5 years and recorded 66.9 per cent y-o-y growth at the end June 2022. Meanwhile,

Chart 3.61 **Profit Before Tax (PBT)**



Source: Insurance Regulatory Commission of Sri Lanka

Chart 3.62 **Return on Assets (ROA)**

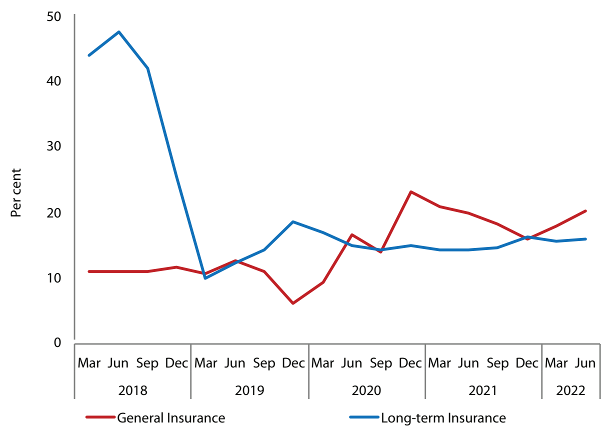


Source: Insurance Regulatory Commission of Sri Lanka

PBT of the long term insurance sub sector declined by 5.1 per cent during this period. Further, it was observed that around 80.0 per cent of market players in the Insurance sector reported profits during the period under consideration while the rest of the companies made losses.

Profitability of the Insurance sector increased as indicated by ROA and ROE for the period under review. ROA and ROE of the general insurance sub sector increased to 9.7 per cent and 19.9 per cent, respectively, at end June 2022 from 9.4 per cent and 19.3 per cent recorded at end June 2021. Meanwhile, ROA and ROE of the long term insurance sub sector also increased to 3.2 per cent and 15.4 per cent, respectively, at end June 2022 from 3.0 per cent and 13.9 per cent recorded at end June 2021.

Chart 3.63 **Return on Equity (ROE)**

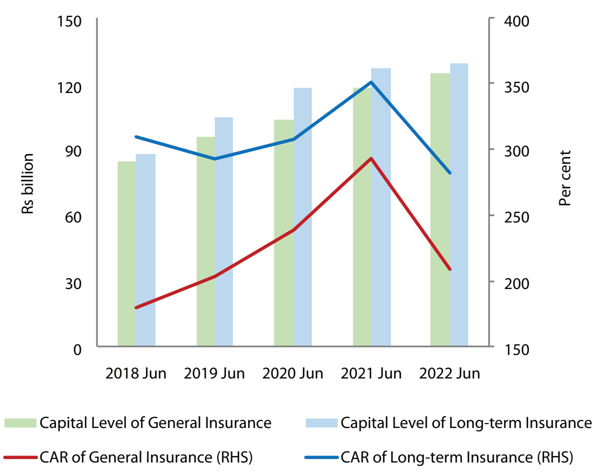


Source: Insurance Regulatory Commission of Sri Lanka

Claims made by the Insurance sector increased, while a decrease in investment income was observed during the first half of 2022. Total claims made by the long term insurance sub sector, which includes maturity and death benefits, increased by 22.1 per cent, whereas the claims made by the general insurance sub sector recorded a y-o-y growth of 30.4 per cent. Meanwhile, the investment income of the sector decreased by 8.6 per cent for the first half of 2022 compared to the growth of 10.7 per cent during the corresponding period of 2021 mainly due to the decelerated investment income recorded by the long term insurance sub sector. However, investment income is expected to increase in the coming period as investments in high yield government securities have increased.

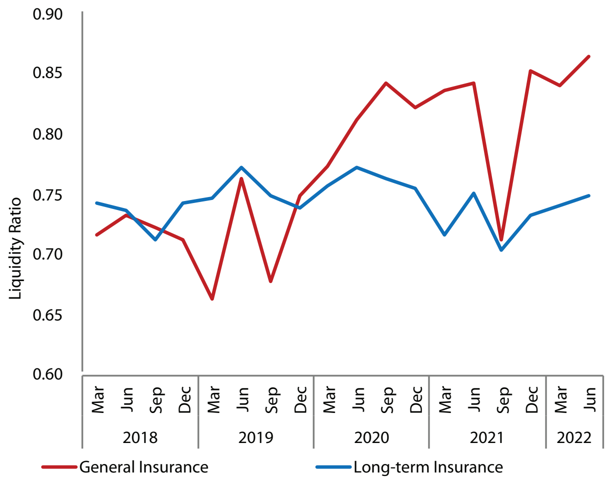
CAR of both the long term insurance sub sector and the general insurance sub sector declined during the period under consideration, though the sector maintained CAR above the minimum requirement of 120 per cent[11]. CAR of long term insurance sub sector and general insurance sub sector considerably declined to 282.0 per cent and 209.0 per cent, respectively, at end June 2022 compared to 351.0 per cent and 293.0 per cent, respectively, recorded at end the of the corresponding period of 2021. The Insurance sector may face various risks such as market risk, liquidity risk, and operational risk, and risks emanating from adverse shocks such as natural calamities and economic downturns. Therefore, adequate levels of capital and liquidity are important to withstand possible shocks to the sector. Although the prevailing higher CAR may act as an additional cushion to the sector to withstand the risks to some extent, a significant contraction in the economy could further deteriorate the capital of the sector.

Chart 3.64 **Capital Adequacy**



Source: Insurance Regulatory Commission of Sri Lanka

Chart 3.65 **Liquidity**



Source: Insurance Regulatory Commission of Sri Lanka

Liquidity ratios of the Insurance sector increased marginally during the period under review. The availability of liquidity is vital for the business continuity of insurance service providers. It was observed that the liquidity ratios of the general insurance sub sector increased marginally to 0.86 per cent at end June 2022 compared to 0.84 per cent at end June 2021 while the liquidity ratios of the long term insurance sub sector remained at 0.75 per cent at end June 2022 on par with the ratio recorded at end June 2022 compared to end June 2021.

11. CAR of the insurance sector is calculated based on the Risk Based Capital (RBC) Framework implemented in Sri Lanka with effect from January 01, 2016. The RBC methodology measures the amount of available capital relative to the risks inherent in liabilities and the adequacy of capital to absorb unforeseen losses.

Special Note 3

Strengthening the Framework for Bank Solvency Stress Testing

The Central Bank introduced a significantly upgraded, dynamic stress testing framework for banks. The new bank solvency stress tests provide a macroprudential perspective by assessing resilience of the financial system as a whole under a hypothetical scenario. The macroprudential perspective emphasises in particular a systemic viewpoint that ultimately links key sources of risk, transmission mechanisms and vulnerabilities in the banking system to the real economy. The framework thus differs from supervisory stress tests that focus predominantly on resilience of individual institutions. The bank solvency stress tests represent an established part of central banks' macroprudential policy frameworks around the world.

Existing Static Stress Testing Framework

The static bank solvency stress testing was the point of departure for the transition to an upgraded stress testing framework. The Macroprudential Surveillance Department of the Central Bank has conducted periodic top-down solvency stress tests of banks using the static stress testing framework since 2009. This framework was developed with the Technical Assistance (TA) of International Monetary Fund (IMF) in 2015. The static stress testing framework considered credit risk, interest rate risk, and direct foreign exchange risk. It employed a collection of single equation models and there was no formalised methodology to calibrate the severity of the Adverse scenarios. The size of adverse shocks to exogenous variables was decided with expert judgements based on baseline projections discussed at the pre-monetary policy meetings. The framework relied on the time-based approaches for classification of loans and advances, provisioning, and income recognition.

Transition to an Upgraded Dynamic Stress Testing Framework

The upgraded dynamic stress testing framework represents major changes from the original benchmark on several elements. The key elements of the upgradation entail the use of Sri Lanka Financial Reporting Standards (SLFRS) 9 reporting for stress testing purposes, transition to dynamic stress testing, integration of Expected Credit Loss (ECL) provisioning, and enhanced risk coverage (Figure 1). Further, the new solvency stress testing framework expands the time horizon to 3 years at quarterly frequency. The following sections discuss each key element in more detail.

Figure 1: Key elements of the upgraded Stress Testing Framework

The upgraded stress testing framework fully integrates SLFRS 9 reporting for stress testing purposes. The early decision to integrate SLFRS 9 anticipated the pending regulatory alignments as per the Banking Act Directions No 13 and 14 of 2021 on Classification, Recognition and Measurement of Financial Assets in Licensed Banks. The changes linked to the adoption of SLFRS 9 in a broader sense provide an opportunity for the macroprudential authorities to enhance a forward-looking element in risk surveillance and understand better how banks factor in future risks in their provisions. The ECL model of impairments under SLFRS 9 replaced the incurred loss model under Sri Lanka Accounting Standards (SLAS 39). The shift to ECL was one of the major changes under the new accounting regime, together with the measurement and classification of assets and liabilities and hedge accounting. The integration of SLFRS 9 was a pre-condition for a shift to the ECL provisioning model.

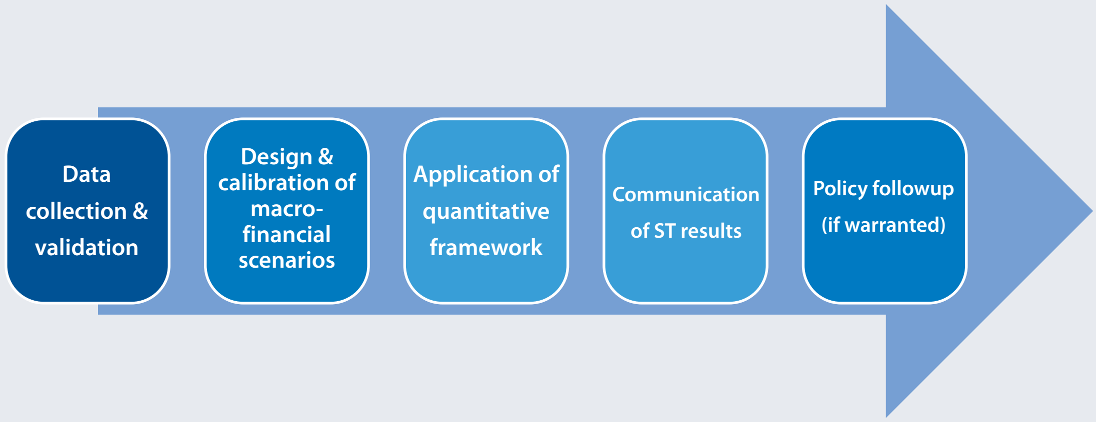
Dynamic stress testing implies the need for consistent macroeconomic scenario generation. Given that macroeconomic scenarios determine the intensity of the shocks, transmission channels and their distribution over time; their economic consistency is a prerequisite for overall credibility of the exercise. Dynamic stress testing thus implies a need for careful modelling of risks transmission in order to follow a richer dynamic and interaction of risk factors and transmission channels over multiple stress testing periods.

The stress testing upgradation entails deepening of the stress testing framework enabling more refined assessment of risks over time and enhancing risk coverage that broadened the scope of the framework. The stress testing framework integrates the risks embedded within the original stress testing framework in addition to credit risk, interest rate risk, and direct foreign exchange risk. The stress testing framework further introduces repricing owing to interest rate and counterparty risks which allow, among other things, for the assessment of sovereign risk in banks' portfolios. The additional features also allow for the treatment of funding risks for individual institutions as a part of the upgraded stress testing framework. Deepening of the framework includes increased data granularity to enhance the analysis of sectoral risks encompassing the real-estate sector. The framework deepening will be supported by enhancements and further considerations on simplifying assumptions on the indirect effect of a shock on foreign currency denominated loans and advances.

Implementation

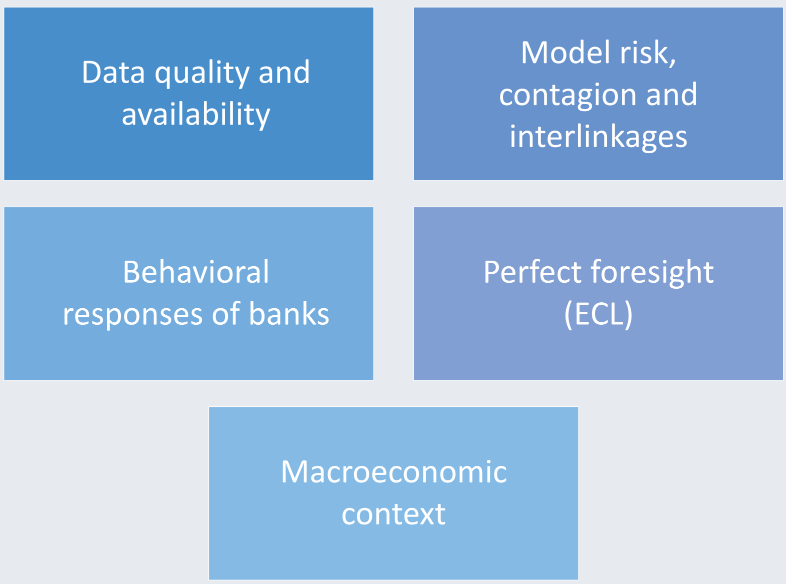
The bank solvency stress testing framework entails the entire process rather than a mere numerical calculation. Similarly, to the Forecasting and Policy Analysis System (FPAS) for monetary policy purposes, the bank solvency stress testing framework entails several elements above and beyond the quantitative toolkit (Figure 2). A dedicated modelling team with clearly defined responsibilities overlook the entire operational process entailed in the upgraded stress testing exercise. The framework encompasses data collection and maintenance of a broader data infrastructure, generation of stress testing scenario with a set of applied tools and execution of the quantitative toolkit which embodies the risk modules with transmission mechanisms accommodating envisaged shocks to the banks' balance sheets and resilience. A reporting process, schedule of meetings with the management and stakeholders and potential follow-up policy reaction completes the stress testing framework.

Figure 2: Bank solvency stress testing framework – The process



Solvency stress testing provides a coherent framework which is nonetheless a simplified representation of the real world. The conditioning factors and assumptions facilitate the tractability and flexibility of the stress testing framework. At the same time, the same factors may have material implications for the system behavior and outcomes of stress testing assessment. The conditioning factors and assumptions include limitations on data quality and availability, assumed transmission channels such as bank interlinkages and bank behavior and foresight capacities (Figure 3). The interpretation of results is closely linked to the broader macroeconomic context. The assessment of banking system resilience is best achieved through the combined perspectives of solvency stress testing and complementary tools to achieve policy objectives.

Figure 3: Conditioning factors in bank solvency stress testing



Way Forward

The upgradation of solvency stress testing is the first step towards broadening the spectrum of macroprudential surveillance and strengthening the governance mechanisms and methodologies for the macroprudential policy framework. The results and the inferences of the bank solvency stress testing framework are expected to complement policy making at the Central Bank in accomplishing its dual objective of achieving price and economic stability and financial system stability.

Chapter 4

Household and Corporate Sectors

4.1 Overview

Households, Private Non-Financial Corporates (NFCs), and State-Owned Business Enterprises (SOBEs) constitute a considerable portion of the banking and Licensed Finance Companies and Specialised Leasing Companies (LFC and SLC) sector borrowers, and thus have a significant exposure to the sector. Accordingly, fragilities that arise within these sectors may have spillover effects on the banking and LFC and SLC sectors through the credit channel by causing vulnerabilities and systemic risks.

Household sector debt showed signs of moderation along with the aversion of financial institutions to lend and lack of demand for new loans from the households amidst rising interest rates and high inflation which affected real income levels. Institutional sector debt, which comprises NFCs, the Government and SOBEs, continued to grow at a significant rate.

The Non-Performing Loan (NPL) ratios (with Interest in Suspense-(IIS)) of both Household and Institutional sectors recorded an increase as at end June 2022 after a continuous decline observed until end March 2022, gradually reflecting the impact of lifting moratoria. NPLs are expected to further increase in the coming quarter as the full impact of lifting moratoria is yet to materialise. In addition, proposed revisions to income tax and corporate tax are expected to impact income levels negatively and limit the ability of households and corporates to service their debt, having a spillover effect on the financial system through the increase in NPL levels.

Despite the challenging and volatile operating environment, the NFCs sector, as reflected through the listed entities in the Colombo Stock Exchange (CSE), recorded an improvement in terms of profit on an overall basis. Even though, a majority of the companies were profitable during the nine months ending September 2022, the contribution was uneven and driven by a few key players. Meanwhile, most creditworthiness indicators of the sector have weakened, along with increased leverage, finance cost and corporate tax. Hence, although revenue and profits remained high during the period under review, higher input, and labour costs along with the challenging macroeconomic and policy environment are expected to negatively impact future profitability of the sector. Thus, their debt repayment capacities may also weaken along with the financial performance amid increases in finance cost and higher debt levels, which may affect the credit quality of the banking sector going forward.

High dependence, particularly of SOBEs in the energy sector, on systemically important state owned commercial banks exert pressure on the banking system. This poses solvency and liquidity risks to the entire banking sector which necessitates strict implementation of single borrower limits. Measures taken to implement cost reflective pricing to improve the commercial viability of such SOBEs are encouraging and may improve their financial performance going forward. Thus, it is of utmost importance to restructure these underperforming SOBEs to improve their business viability in order to mitigate risks to financial system stability.

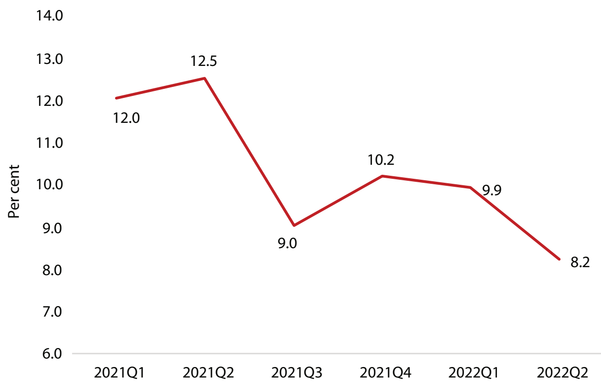
4.2 Risk Assessment on Household and Institutional Sectors Credit

Financial soundness of the Household and Institutional sectors has an impact on overall financial stability. Accordingly, this section analyses the indebtedness of these sectors to assess the financial vulnerabilities emanating from such borrowers and identify possible buildup of systemic risks. The analysis is based on aggregate credit data obtained from the Credit Information Bureau (CRIB) as at end June 2022[1].

4.2.1 Risk Assessment on Household Sector Credit

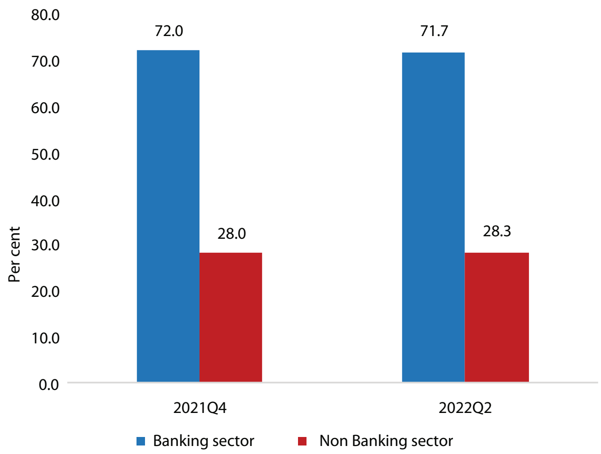
The Household sector credit level, which accounted for 41.3 per cent of the total formal financial sector lending, grew at a slower rate of 8.2 per cent as at end June 2022 compared to the growth of 12.5 per cent recorded as at end June 2021. This reflects both the aversion of financial institutions to lend and lack of demand for new loans from the household sector amidst rising interest rates and cost of living. Household sector

Chart 4.1 Y-o-y Growth in Household Sector Debt Level



Source: Credit Information Bureau (CRIB)

Chart 4.2 Sources of Household Sector Credit



Source: Credit Information Bureau (CRIB)

loans predominantly relied on loans granted by the banking sector which amounted to 71.7 per cent of household sector credit as it continued to dominate the financial sector.

With the cessation of debt moratoria[2] granted for COVID-19 affected households, the NPL ratio of

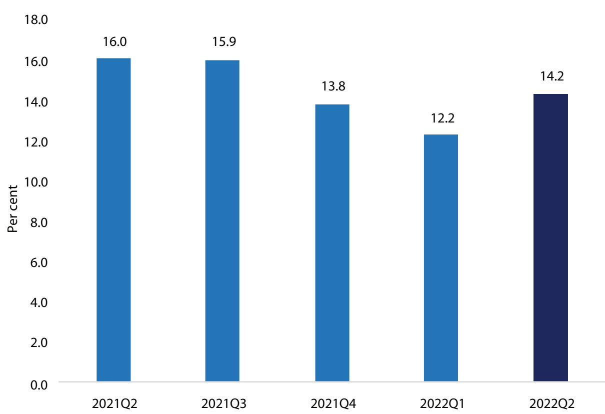
1. The Household sector debt presented in this analysis comprises loans and advances obtained by individuals who are identified by their NIC or passport number. Moreover, the Household sector debt includes facilities obtained by households for the purpose of business activities in terms of Micro, Small and Medium Enterprises (MSMEs). The Institutional sector debt includes facilities granted to institutions which are registered as business entities and accommodations to SOBEs and the Government. Further, a disaggregation in the Institutional sector debt, i.e., private corporates, SOBEs and the Government is not possible using the CRIB database. Further, this section focusses on formal sector lending by regulated financial institutions to the Household and Institutional sectors. Thus, it does not capture Household sector borrowings obtained from other formal, semi-formal, and informal sources. The analysis presented here cannot be directly compared with FINNET (Financial Information Network) returns which is used by Banks and Non-Bank Financial Institutions (NBFIs) to report financial data requested under regulations of the Banking Act, No. 30 of 1988 to the Central Bank as CRIB data does not include pawning advances, while it includes receivable interest of leasing portfolios and several off-balance sheet items such as bank guarantees and Letters of Credit. Moreover, the analysis classifies loans with 90 days in arrears as NPLs. Thus, NPLs cannot be directly comparable with NPLs reported in Chapter 3 of this Report which are based on the Sri Lanka Financial Reporting Standards (SLFRS) 9 guideline on classification of stage 3 loans.

2. Regulated financial institutions provided relief measures in terms of the debt moratoria on capital and interest to eligible borrowers from March 2020. Concessions provided by licensed banks ceased on December 31, 2021. Nevertheless, the extension of the debt moratoria for the tourism sector was further extended up to June 30, 2022. Moreover, the moratoria for performing credit facilities in the NBFIs sector was extended until March 31, 2022. However, as announced by the Central Bank on July 20, 2022, further concessions may be provided by respective financial institutions to affected borrowers amidst the prevailing extraordinary macroeconomic circumstances on a case-by-case basis depending on the future repayment capacity of such individuals.

the household sector (with IIS) increased by the end June 2022 compared to end 2021. The NPL ratio of the household sector increased to 14.2 per cent by end June 2022 from 13.8 per cent reported by end 2021. However, further concessions may be provided to affected borrowers on a case-by-case basis by the respective financial institutions depending on their future repayment capacity. Thus, NPL ratios may not signify the accurate repayment conditions in the economy, as they are masked by debt concessions offered as economic relief measures. Further, it is noteworthy to highlight that NPLs recorded in June 2022 are still at a lower level as compared to June 2021. With the gradual phasing out of debt moratoria offered as COVID-19 economic relief measures from March 2022, the share of non-arrears[3] loans declined by end June 2022 to 64.1 per cent from 67.8 per cent by end 2021. Consequently, the share of arrears loans increased in tandem during the period under consideration.

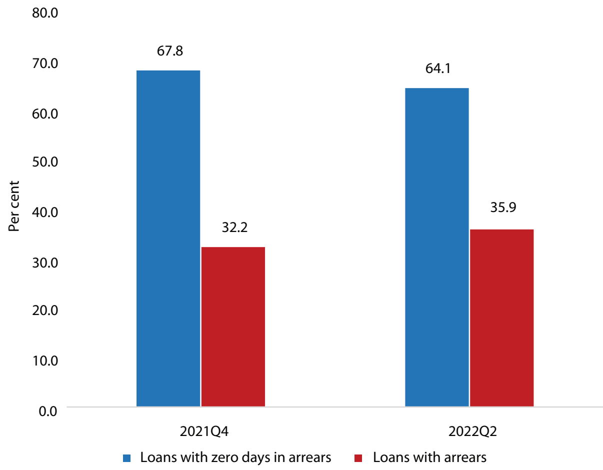
Household sector NPLs are primarily concentrated in the Non-Bank Financial Institutions (NBFI)[4] sector. The NBFI sector accounts for a share of 60.5 per cent of total non-performing advances in the household sector as at the end June 2022 and recorded a NPL ratio of 30.5 per cent[5]. Out of the total loans of the formal financial sector classified as non-performing by end June 2022, majority of the loans were more than 540 days in arrears. Further, 39.1 per cent of the loans were in the two buckets of 90-180 days in arrears and 180-

Chart 4.3 **NPL Ratios of the Household Sector**



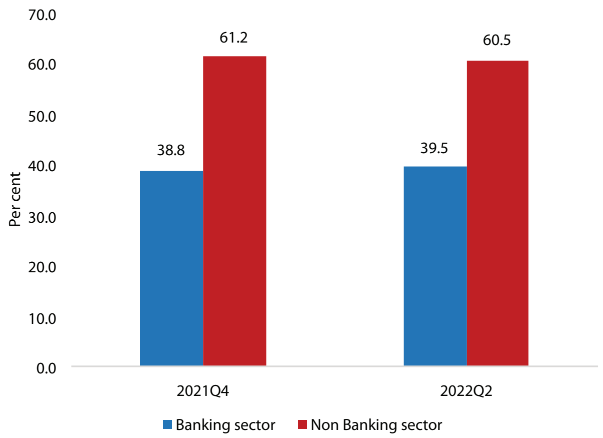
Source: Credit Information Bureau (CRIB)

Chart 4.4 **Structural Changes in Credit Quality of Household Debt**



Source: Credit Information Bureau (CRIB)

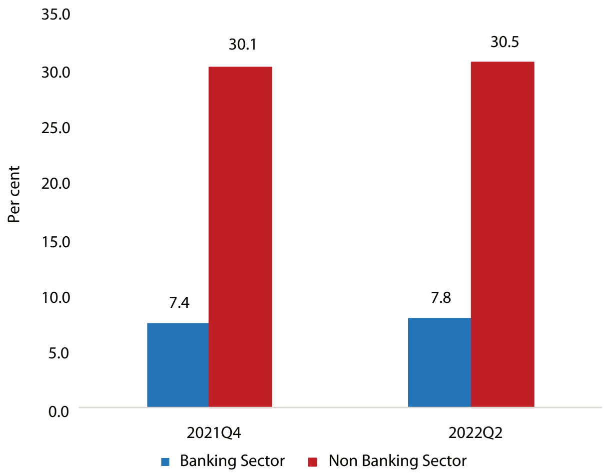
Chart 4.5 **Composition of Household Sector NPLs by Type of Financial Institution**



Source: Credit Information Bureau (CRIB)

3. Facilities with zero days in arrears
4. NBFIs include LFCs and SLCs.
5. The analysis classifies loans with 90 days in arrears as NPLs for both the banking and NBFIs sector for compatibility. Thus, NBFIs sector NPLs cannot be directly comparable with NPLs reported in FINNET which are based on 180 days in arrears (for institutions ending the financial year on December 31, 2022) and 120 days in arrears (for institutions ending the financial year on March 31, 2022).

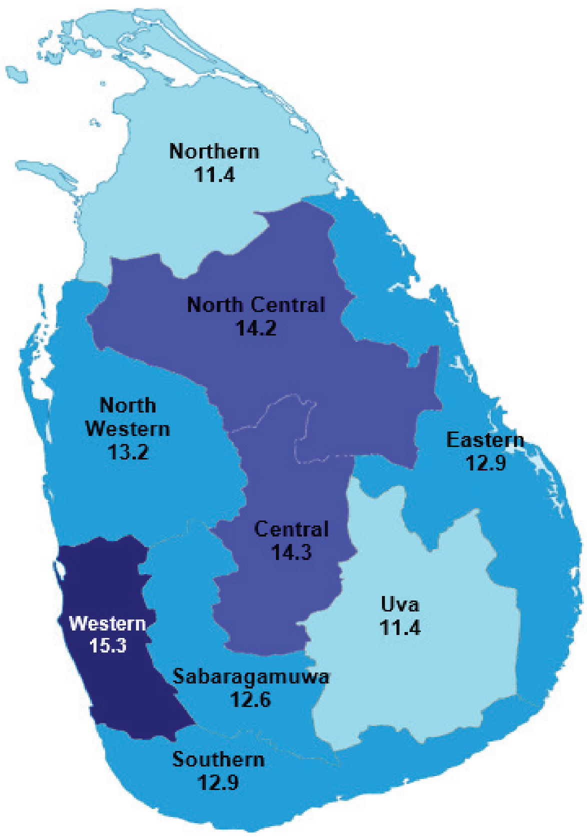
Chart 4.6 NPL Ratios of Household Sector by Type of Lending Institution



Source: Credit Information Bureau (CRIB)

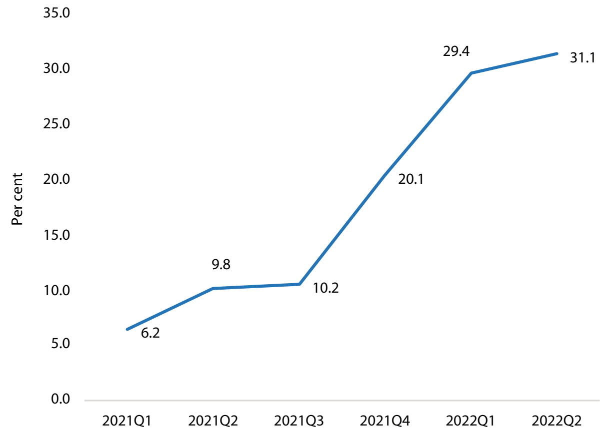
360 days in arrears. A further downgrade of the loans in these buckets in the future may cause stress to the financial system with provisioning requirements by financial institutions increasing significantly.

Chart 4.7 Distribution of Household Sector NPL Ratios by End June 2022



Source: Credit Information Bureau (CRIB)

Chart 4.8 Y-o-y Growth in Institutional Sector Debt Level



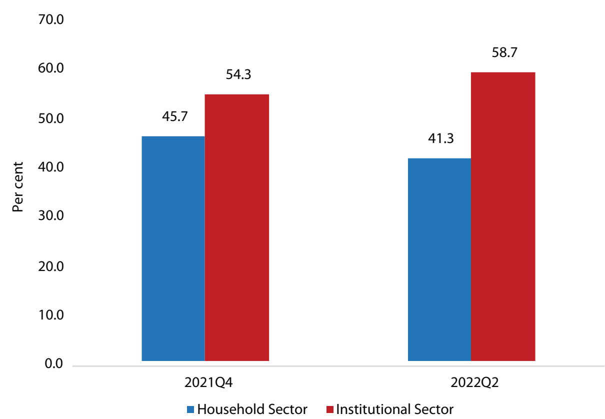
Source: : Credit Information Bureau (CRIB)

Approximately half of the household sector debt was disbursed in the Western province. In terms of geographical distribution, the Western Province accounted for 48.7 per cent of loans and advances granted to the Household sector and recorded the highest province-wise NPL of 15.3 per cent.

4.2.2 Risk Assessment on Institutional Sector Credit

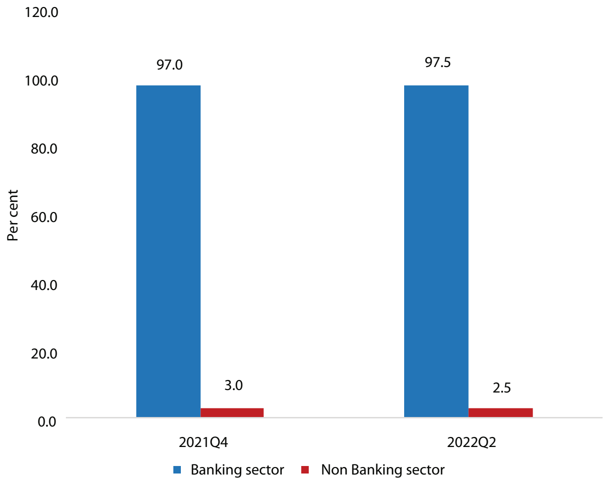
A significant y-o-y growth of 31.1 per cent was observed in Institutional sector debt as at end June 2022. This could be partly due to the re-valuation of foreign currency debt after the

Chart 4.9 Composition of Financial Sector Lending



Source: Credit Information Bureau (CRIB)

Chart 4.10 **Sources of Institutional Sector Credit**

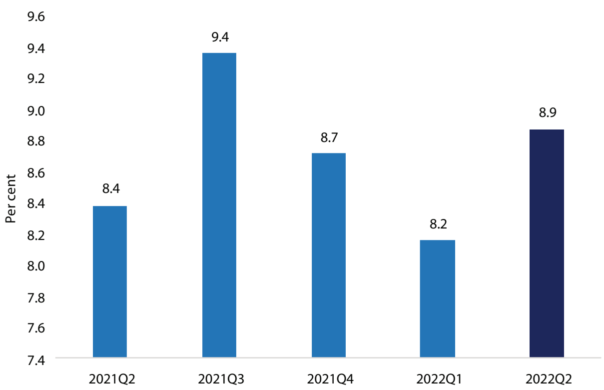


Source: Credit Information Bureau (CRIB)

sharp depreciation of the rupee. Moreover, the Institutional sector accounted for 58.7 per cent of the total formal financial sector lending as at end June 2022. Institutional sector loans were predominantly provided by the banking sector accounting for a share of 97.5 per cent of the total institutional sector credit.

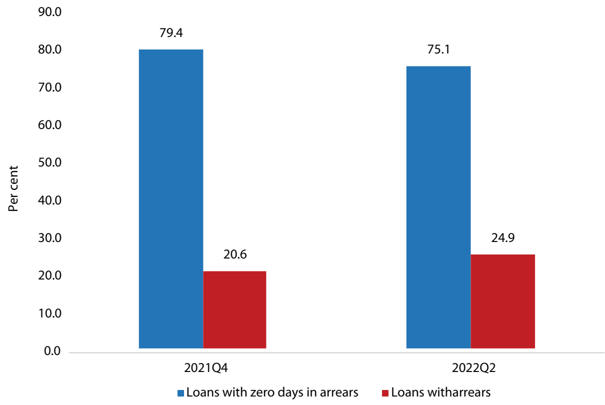
The NPL ratios of the Institutional sector increased as at end June 2022 after a decline until end March 2022. The increase in NPL ratios as at end June 2022 may be due to the lifting of moratoria concessions from March 2022. Consequently, loans with no arrears declined marginally as at end June 2022 as

Chart 4.11 **NPL Ratios of the Institutional Sector**



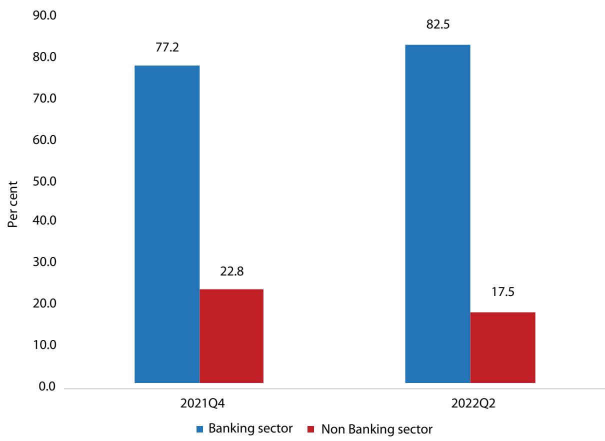
Source: : Credit Information Bureau (CRIB)

Chart 4.12 **Structural Changes in Institutional Sector Debt**



Source: : Credit Information Bureau (CRIB)

Chart 4.13 **Composition of Institutional Sector NPLs by Type of Financial Institution**



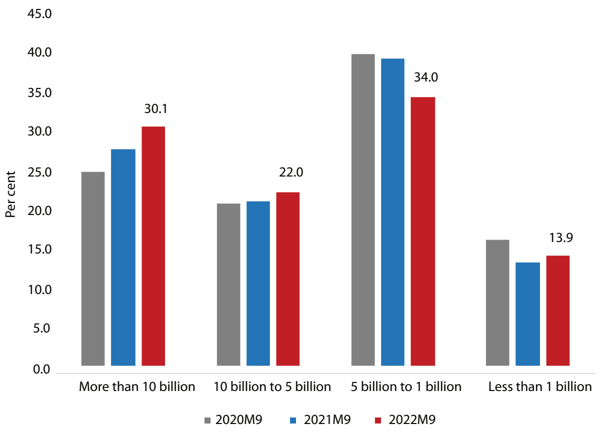
Source: Credit Information Bureau (CRIB)

compared to end 2021, while loans in arrears increased. Meanwhile, the Banking sector held the largest share of Institutional sector NPLs, which stood at 82.5 per cent as at end June 2022. Further, most institutional sector loans classified as NPL were in arrears for more than 540 days.

4.3 Risk Assessment on Listed Non-Financial Corporates

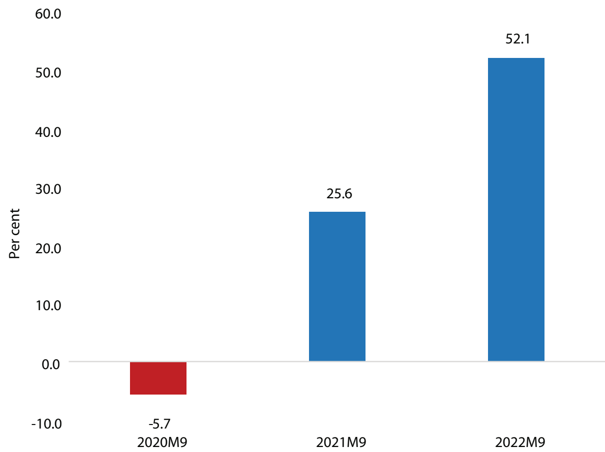
Analysis on the performance of NFCs provides inputs to the Macroprudential surveillance framework as their creditworthiness has an

Chart 4.14 Assets Distribution of Listed NFCs as at end September 2022



Source: Colombo Stock Exchange (CSE)

Chart 4.16 NFCs Revenue Growth as at end September 2022



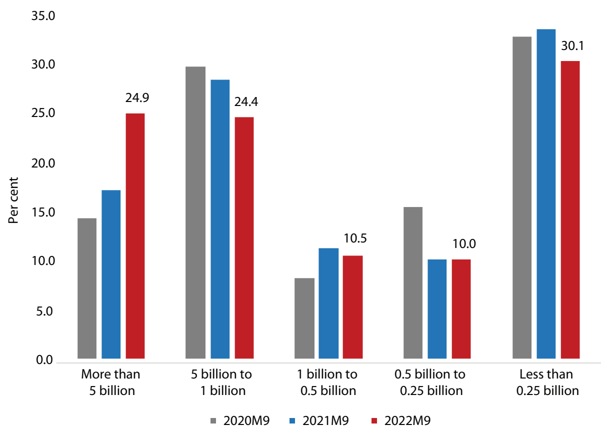
Source: Colombo Stock Exchange (CSE)

impact on financial system stability. Cohesive behavior of corporates or conduct of a single systemically important corporate could influence the macroeconomy and financial system stability. Thus, vulnerabilities of the corporate sector are analysed to assess risks emanating from NFCs to the financial system, using information on 209 NFCs listed in the CSE which serves as a proxy for the non-financial corporate sector.

4.3.1 Assets and Revenue Structure of Listed NFCs

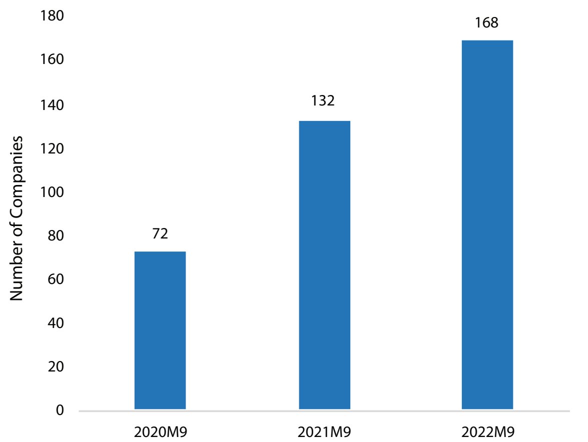
The asset base and the revenue base of NFCs increased during the nine months ending September 2022 compared to the corresponding period of the previous year, indicating an expansion of the sector. The number of NFCs that had assets worth more than Rs. 5 billion improved in the nine months ending September 2022 over the comparative period of the previous year. Moreover, 86.1 per cent of listed NFCs held assets worth more than Rs. 1 billion during the nine months ending September 2022. In terms of revenue, NFCs that earned more than Rs. 5 billion also increased during the nine months ending September 2022 over the comparative period of the previous year.

Chart 4.15 Revenue Distribution of Listed NFCs as at end September 2022



Source: Colombo Stock Exchange (CSE)

Chart 4.17 Number of NFCs that reported an Increase in Revenue



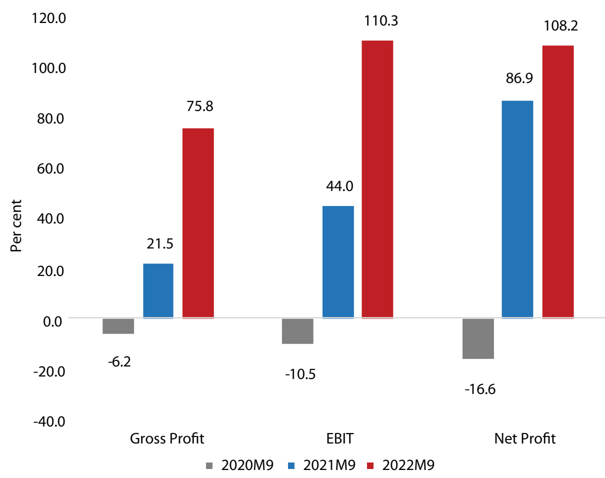
Source: Colombo Stock Exchange (CSE)

4.3.2 Financial Performance of Listed NFCs

Amidst challenging economic conditions, NFCs recorded a strong financial performance in terms of revenue and profit during the nine months ending September 2022 compared to the corresponding period of the previous year. NFCs recorded an increase in revenue growth amounting to 52.1 per cent amidst rising inflation during the period under consideration with most NFCs contributing to such increase. Accordingly, 80.4 per cent of NFCs recorded an increase in revenue during the nine months ending September 2022, which amounts to 168 NFCs out of 209 NFCs considered for the analysis. However, the top ten performers contributed to around 60.1 per cent of this revenue growth, highlighting the uneven performance of the sector. Without these key players, the revenue growth would have fallen to 28.9 per cent. Thus, the majority of NFCs recorded a modest revenue growth.

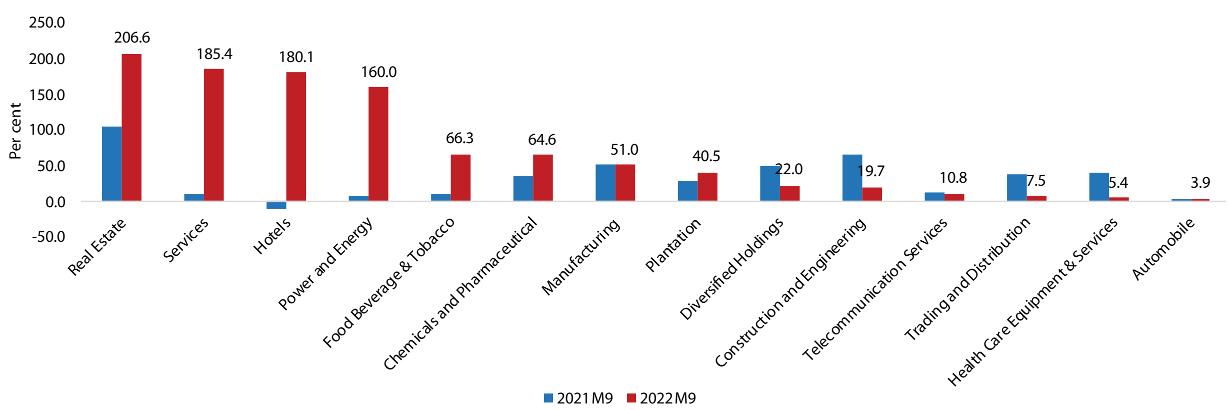
In terms of sector-wise performance, several sectors reported a significantly high revenue growth. The Real estate sector, which accounts for 1.8 per cent of the revenue share, recorded the highest y-o-y revenue growth with increasing real estate prices and the increase in cost of construction material amidst inflation. The Services, Hotels, and Power and Energy sectors also recorded significant expansions over the lower bases in the previous year. Meanwhile, the Automobile sector recorded the lowest sectoral revenue growth of 3.9 per cent during the period under consideration.

Chart 4.19 Growth in NFCs Profit as at end September 2022



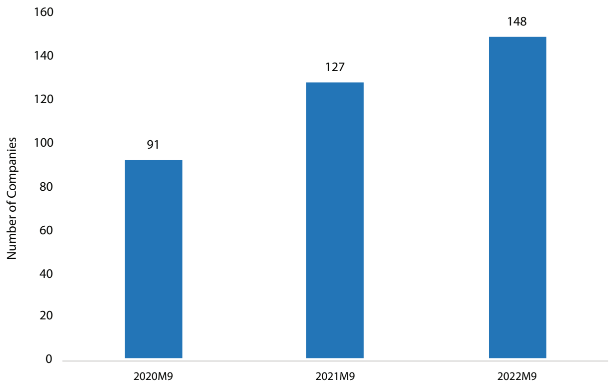
Source: Colombo Stock Exchange (CSE)

Chart 4.18 Sector-wise Revenue Growth



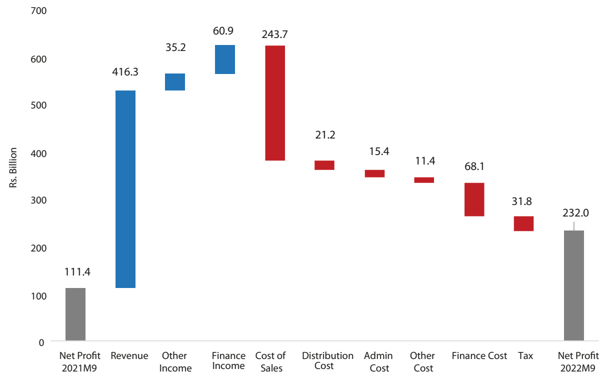
Source: Colombo Stock Exchange (CSE)

Chart 4.20 **Number of NFCs that reported an Increase in Net Profit**



Source: Colombo Stock Exchange (CSE)

Chart 4.22 **Contributions to Change in Profits from 2021M9 to 2022M9**

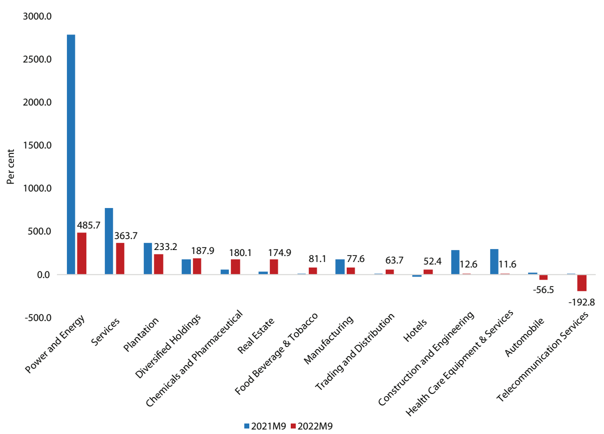


Source: Colombo Stock Exchange (CSE)

Although profitability of NFCs improved during the nine months ending September 2022 compared to the corresponding period of the previous year amidst challenging economic conditions, this improvement was not broad based. The net profit of listed NFCs increased by 108.2 per cent during the nine months ending September 2022 compared to the 86.9 per cent growth recorded in the corresponding period of 2021, with 70.8 per cent of the companies recording an increase in net profit. However, more than 80 per cent of the contribution to this growth originated from ten companies. Hence, net profit growth would fall to 25.0 per cent during the nine months ending September 2022 as compared to 88.7 per cent recorded in the previous year, if these key players were excluded. Moreover, Earnings before Interest and Tax (EBIT) also recorded a significant improvement, with an expansion of 110.3 per cent during the period under review against the 44.0 per cent growth recorded in the corresponding period of 2021.

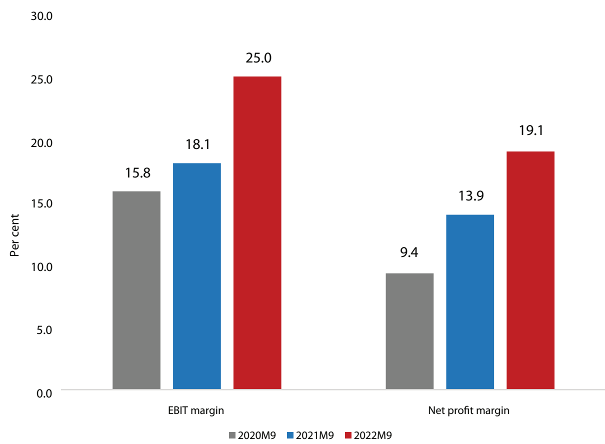
The Telecommunications services and Automobile sectors recorded further deterioration in net profit during the nine months ending September 2022. The net losses in the telecommunications sector were due to a substantial forex loss on outstanding

Chart 4.21 **Sector-wise Net Profit Growth**



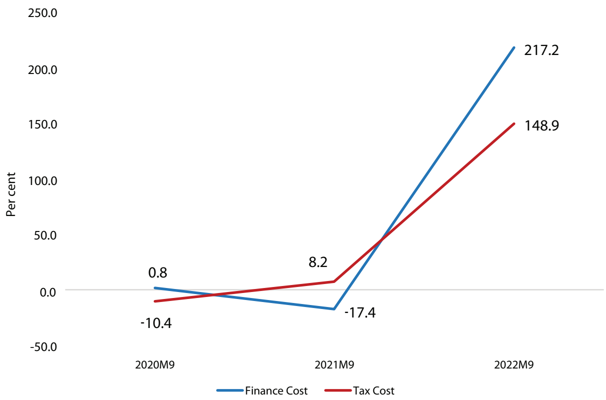
Source: Colombo Stock Exchange (CSE)

Chart 4.23 **EBIT Margin Vs. Net Profit Margin**



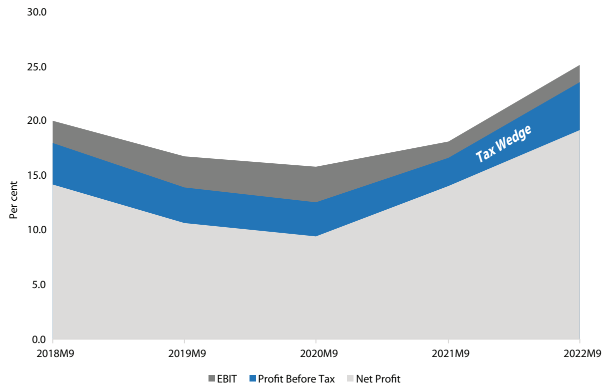
Source: Colombo Stock Exchange (CSE)

Chart 4.24 Growth in Finance Cost and Corporate Tax



Source: Colombo Stock Exchange (CSE)

Chart 4.26 Profit Margins



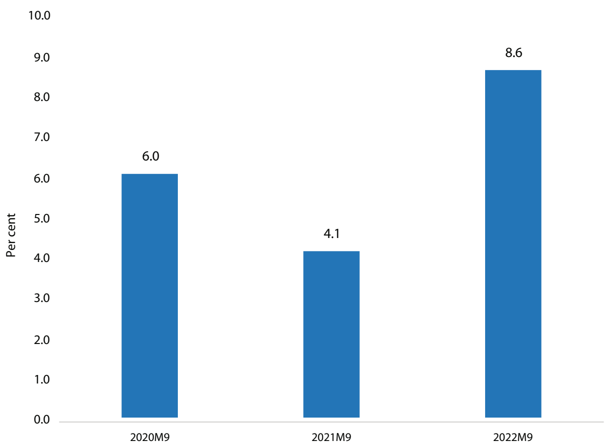
Source: Colombo Stock Exchange (CSE)

USD-denominated debt obligations and foreign vendor liabilities of one major company. In addition, the prevailing import ban on vehicles since 2020 with the deteriorating foreign exchange reserves of the country, difficulty in opening Letters of Credit (LCs) for spare parts and lubricants, increased freight costs, rupee depreciation, and rapidly rising costs restrained the growth of the Sri Lankan automobile retail industry. Meanwhile, the Power and Energy sector continued its high profitability momentum, recording a 485.7 per cent growth in net profits during the nine months ending September 2022.

NFCs were able to maintain profitability amidst considerable challenges particularly in terms of rising costs. The high level of net profit growth even amidst increases in cost of sales, finance cost and tax rates applicable to NFCs during the period under review, can indicate that firms tend to pass a significant amount of cost burden towards the consumers in order to maintain profit margins. However, this may not be feasible going forward with the continuous erosion in purchasing power of consumers.

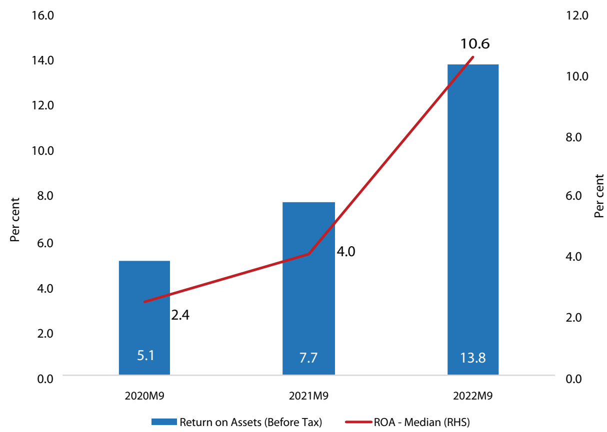
NFCs recorded a continuous improvement in profit margins, which are expressed as relative share of sales, led by increased profits. Profit margins of the sector improved during the period under review reflecting an improvement in NFCs' ability to generate profits from their operations. Accordingly, EBIT margin and net profit margin improved to 25.0

Chart 4.25 Finance Cost as a Percentage of Total Cost



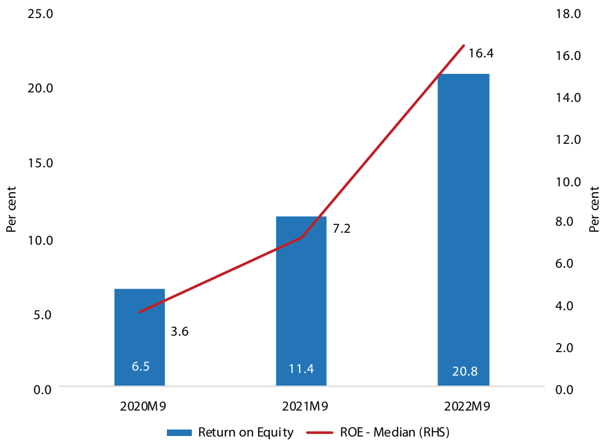
Source: Colombo Stock Exchange (CSE)

Chart 4.27 Annaualised Return on Assets



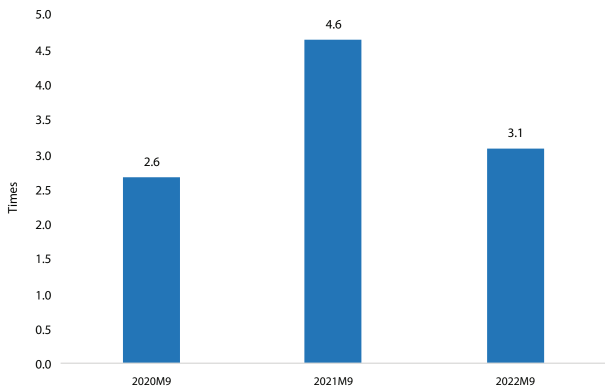
Source: Colombo Stock Exchange (CSE)

Chart 4.28 **Annaualised Return on Equity**



Source: Colombo Stock Exchange (CSE)

Chart 4.30 **Interest Coverage Ratio**

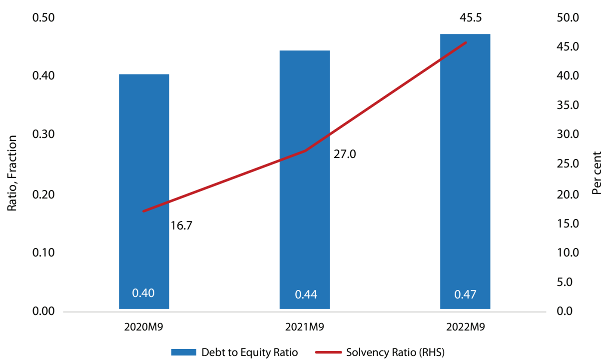


Source: Colombo Stock Exchange (CSE)

per cent and 19.1 per cent, respectively, during the first nine months of 2022, compared to 18.1 per cent and 13.9 per cent, respectively, during the corresponding period of 2021.

A significant increase in finance cost and corporate tax was observed during the nine months ending September 2022. The overall finance cost, which accounts for 8.6 per cent of the total cost, increased by 217.2 per cent during the nine months ending September 2022, compared to a decline of 17.4 per cent reported in the corresponding period of the previous year. The significant increase in finance cost can be attributed to increase in interest rates on debt in line with the tightening of monetary policy stance along with increase in debt level. Meanwhile, the corporate tax cost also increased by 148.9 per cent during the nine months ending September 2022, compared to an increase of 8.2 per cent during the corresponding period of 2021. Applying the surcharge tax[6], which was enacted in April 2022, was one of the reasons for this substantial increase in taxes along with increase in profits. However, NFCs have managed to maintain the growth momentum of their profit margins with the tax wedge being almost constant over time.

Chart 4.29 **Debt to Equity Vs. Solvency**



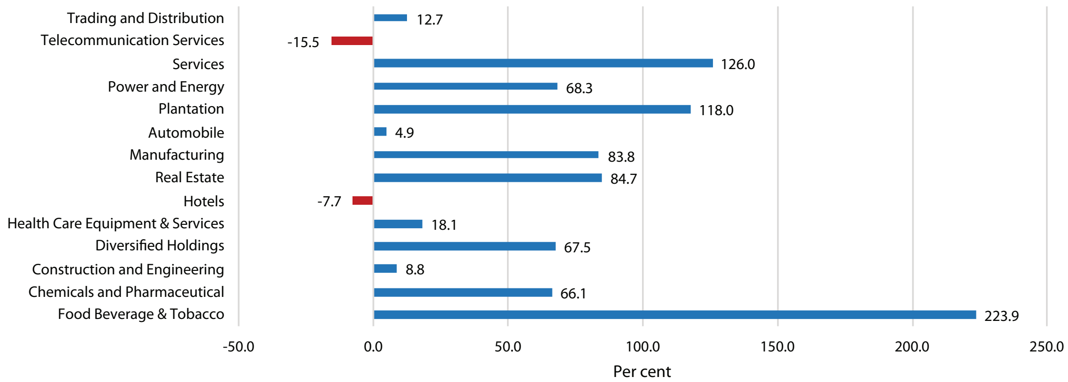
Source: Colombo Stock Exchange (CSE)

NFCs recorded an increase in return on investment. Return on Assets (ROA) and Return on Equity (ROE) improved to 13.8 per cent and 20.8 per cent, respectively, during the nine months ending September 2022, compared to 7.7 per cent and 11.4 per cent, respectively in the corresponding period of 2021. Moreover, median ROA and ROE also demonstrated a similar trend.

6. This was calculated in accordance with the provisions of the Inland Revenue Act, No. 24 of 2017, for institutions that exceed a taxable income of Rs. 2,000 million, for the year of assessment 2020/2021.

Chart 4.31

Solvency



Source: Colombo Stock Exchange (CSE)

Financial health of NFCs in terms of the solvency ratio, which determines whether the company can meet its financial obligations in the long term, improved. The solvency ratio[7], which measures corporate profits relative to debt holding as at end September 2022, improved to 45.5 per cent from 27.0 per cent as at end September 2021 due to a higher increase in corporate profits compared to the increase in corporate debt. However, if net profit decreases in the future, that may impact the solvency of NFCs.

Nevertheless, the interest coverage ratio of the sector declined indicating the vulnerability of debt servicing capacity of the NFC sector. The interest coverage ratio decreased from 4.6 times as at end September 2021 to 3.1 times as at end September 2022. The decrease in the interest coverage ratio was due to the increase in interest cost in line with the rise in market interest rates. At the same time, the leverage of the sector also increased during the period under review. The corporate debt level in terms of the corporate debt to equity ratio[8] increased from 0.44 as at end September 2021 to 0.47 as at end September 2022, indicating that NFCs are relying more on debt for financing purposes, which could in turn increase the financing risk.

Hotels, Telecommunications[9], Automobile, and Construction and Engineering have relatively low solvency ratios compared to the other categories indicating that their long term financial stability is comparatively low. The substantial forex loss on outstanding USD denominated debt obligations and foreign vendor liabilities of the telecommunications services sector, slower than expected recovery in the tourism sector, the prevailing import ban on vehicles since 2020, difficulty in opening Letters of Credit (LCs) for spare parts and lubricants with 100 per cent margin requirement, increased freight costs, rupee depreciation, and rapidly rising costs in Sri Lankan automobile retail industry adversely impacted the solvency of these NFCs.

4.4 Risk Assessment on Major State-Owned Business Enterprises

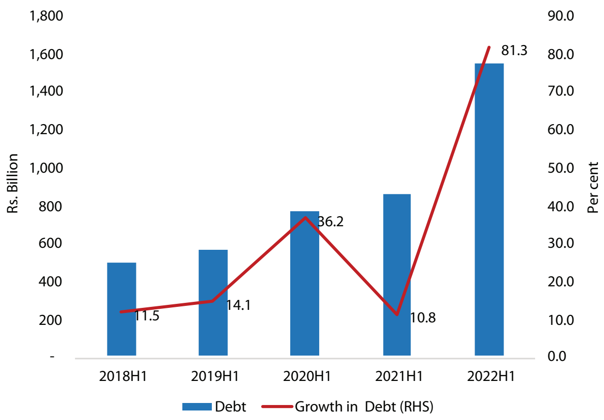
SOBEs pose a significant risk to financial system stability through excessive borrowings amidst a lack of profitability. The banking sector is highly exposed to SOBEs due to the considerable amount of loans and advances granted to these institutions.

7. For the purpose of this study, the solvency ratio was computed considering net profit as the numerator and average debt as the denominator.

8. The debt to equity ratio is computed by taking total debt of corporates as the numerator and total equity as the denominator. The ratio measures corporate debt relative to the corporate equity as at a given balance sheet date.

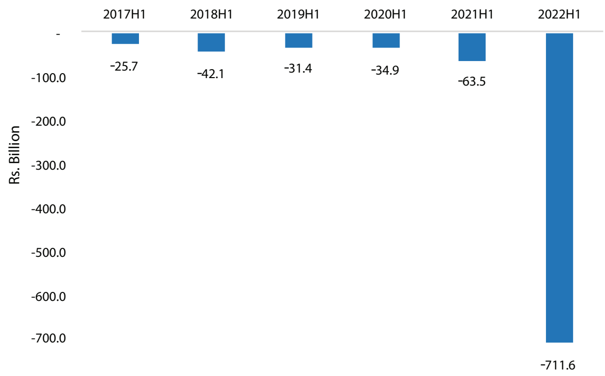
9. It is noted that the Telecommunications sector constitutes of considerable foreign holdings.

Chart 4.32 **Debt Level and Growth**



Sources: Ceylon Electricity Board (CEB),
Ceylon Petroleum Corporation (CPC)

Chart 4.34 **Energy Sector SOBEs Profits/(Losses)**

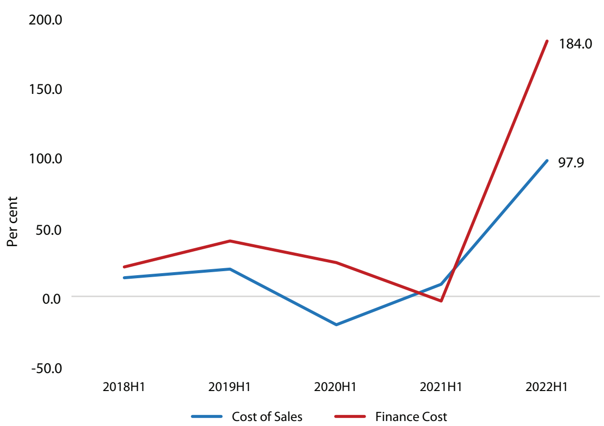


Sources: Ceylon Electricity Board (CEB),
Ceylon Petroleum Corporation (CPC)

Thus, financial system stability is at risk as the banking system is affected by the poor financial performance of SOBEs through their significant exposures especially to systemically important state-owned Licensed Commercial Banks (LCBs). As deteriorated balance sheets of these SOBEs pose severe solvency and liquidity risks to the stability of the entire banking sector, monitoring of their balance sheets is essential to assess buildup of such systemic risk.

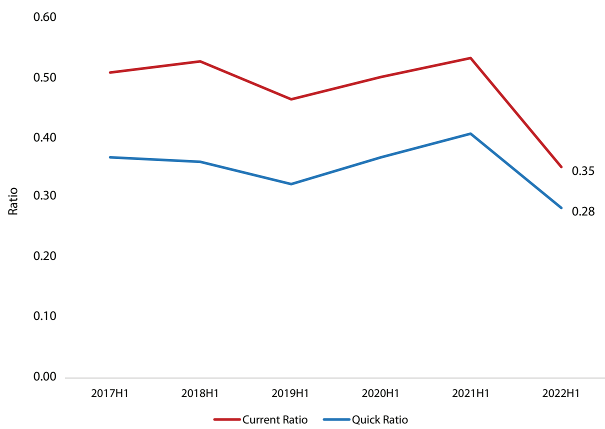
The analysis focuses on SOBEs pertaining to the Energy sector considering their high level of exposure within the banking sector. There are around 52 SOBEs carrying out operations in Sri Lanka though most of them are not commercially viable and are under financial distress. Out of the total exposure to SOBEs by the banking sector, 57.2 per cent of loans and advances amounting to Rs. 1,067.9 billion were granted to Energy sector SOBEs by state-owned LCBs. Thus, this section presents a risk assessment on energy sector SOBEs. The current analysis is limited to two major SOBEs in the energy sector namely, Ceylon Petroleum Corporation (CPC) and Ceylon Electricity Board (CEB) which are among major loss making SOBEs and heavily rely on the banking sector to finance their operations.

Chart 4.33 **Growth in Finance Cost and Cost of Sales**



Sources: Ceylon Electricity Board (CEB),
Ceylon Petroleum Corporation (CPC)

Chart 4.35 **Liquidity Ratios: Current Ratio and Quick Ratio**



Sources: Ceylon Electricity Board (CEB),
Ceylon Petroleum Corporation (CPC)

Total borrowings of the two Energy sector SOBEs, which includes borrowings from both the banking sector and capital markets grew by 81.3 per cent and amounted to Rs. 1,540.7 billion as at end June 2022 compared to June 2021. The significant growth in debt recorded in the first half of 2022 was partly due to the re-valuation of foreign currency debt after the sharp depreciation of the rupee. The debt level of the sector has been continuously rising indicating higher dependence on external funds for its operations. This reflects the deterioration in their debt servicing capacity, posing additional risk towards the banking sector.

Energy sector SOBEs witnessed a considerable increase in cost of sales and finance cost, which challenged the profitability of the sector. Finance cost, which mainly includes interest payments for borrowings, grew significantly by 184.0 per cent y-o-y during the first half of 2022 due to a significant increase in interest bearing borrowings by the Energy sector SOBEs. This is expected to further continue with the increase in market interest rates. Cost of sales is also expected to worsen in the future as these SOBEs do not have sufficient buffers to withstand any adverse shocks.

Energy sector SOBEs have been making losses consistently over the years. The sector recorded a loss during the first half of 2022 which amounted to Rs. 711.6 billion on top of the Rs. 63.5 billion losses reported in the corresponding period of the previous year. Thus, this will have a negative impact on their net worth going forward and increase the indebtedness of the sector, which would further affect the credit quality of the banking sector. Total equity of the Energy sector SOBEs remained at a considerably low level due to accumulation of losses as well, and if equity continues to deteriorate it will impact the solvency of the sector.

Inadequate liquidity levels also strained the financial performance of these SOBEs. Current and Quick ratios[10] of the Energy sector SOBEs were at low levels of 0.35 times and 0.28 times, respectively, as at end June 2022, indicating that the short term assets or the comparatively liquid assets are insufficient to meet these institutions short term obligations. This will affect the liquidity of the banking sector, through the significant exposure towards this sector.

Having recognised that the performance of Energy sector SOBEs poses a considerable risk to financial system stability and strained public finances, cost reflective price adjustments were introduced to improve the financial viability of these two SOBEs. Going forward, ensuring commercial viability of CPC and CEB will be vital in safeguarding the stability of the banking system.

10. Current ratio is the ratio between current assets and current liabilities whereas the quick ratio is the ratio between current assets (excluding inventories) and current liabilities.

Chapter 5

Financial System Infrastructure

5.1 Overview

The financial system infrastructure, which is critical in ensuring smooth functioning of the financial system of the country, functioned without any major disruption while effectively catering to the needs of the economy amidst rising macroeconomic challenges. The Central Bank continued to ensure effective and efficient operations of the payment and settlement system, which is the major component of the financial system infrastructure, ensuring a high level of resilience with a view of maintaining financial system stability. Both large value and retail value payment systems reported a healthy growth in value and volume of transactions during the nine months ending September 2022 compared to corresponding period of the previous year, with the public moving towards using electronic payment systems and instruments. Popularity and increased usage of web based financial systems are positive developments in moving towards an efficient digital economy. Thus, the Central Bank continued its efforts towards the advancement of the payment and settlement system of the country.

With the objective of strengthening and enhancing the regulatory and supervisory regime in the financial sector of the country by addressing the emerging risks to maintain financial system stability, the Central Bank took several measures to introduce reforms to major pieces of legislation. In this regard, the proposed Central Bank of Sri Lanka Act is to be enacted to strengthen the operational independence and accountability of the Central Bank. The proposed Act designates the Central Bank as the Macroprudential Authority of the country and facilitates building inter-coordination between the regulators of the financial system for smooth implementation of Macroprudential policies to ensure financial system stability. Further, the Central Bank continued the drafting of a new Banking Act with the view of further strengthening and streamlining the provisions of the existing Banking Act. Moreover, the new Banking (Special Provisions) Act is in the process of being drafted for the purpose of defining the resolution authority of the Central Bank. In addition, a Financial Asset Management Act is being drafted by the Central Bank within the conceptual framework for the purpose of establishing a regulatory framework for financial asset management companies in Sri Lanka and steps have also been taken to finalise the Micro Finance and Credit Regulatory Act which focuses on a regulatory framework for licensed micro finance institutions and introduces new regulatory framework for the money lending business of the country. Further, initiatives were taken to introduce new laws under the capital market development project while amendments are being introduced to several existing pieces of legislation as well.

Money laundering and financing of terrorism could pose significant and extensive adverse effects on the financial system stability as well as the entire economy of the country. Thus, the Central Bank continued its functions to strengthen the Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) regime of the country by strengthening compliance, effective supervision, guidance, and improvement of awareness among stakeholders. Moreover, the Central Bank continued to strengthen the financial consumer protection *framework of entities regulated by the Bank to promote and safeguard the rights and interests of financial consumers.*

Going forward, alongside the smooth functioning of the financial system infrastructure, it is expected that the implementation of the resolution powers and designating the Central Bank as the Macroprudential Authority of the country by the proposed Central Bank of Sri Lanka Act would help further strengthen the financial system stability.

5.2 Payment and Settlement Systems

Payment and settlement systems of the country operated smoothly and efficiently with electronic payment systems and instruments recording a growth in terms of both volumes and values of transactions. With the increase in usage of electronic payment systems, the Central Bank took measures to further promote electronic payments while minimising any potential risks related to payment and settlement systems. Moreover, measures were also taken to ensure compliance of electronic payment systems with international standards and best practices while educating the public on new electronic payment instruments and secure usage of electronic payment instruments to protect consumers from financial frauds and scams.

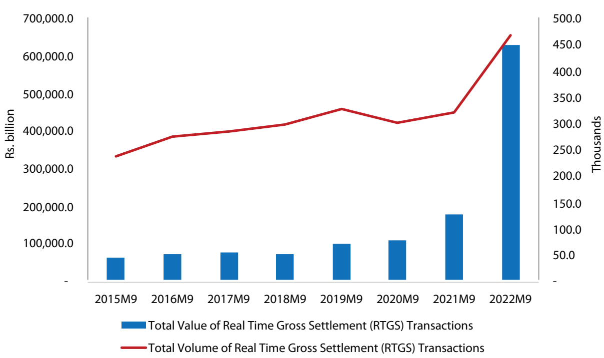
The Central Bank continued to ensure the smooth operations of the LankaSettle System with high levels of availability and resilience as any disruptions to the LankaSettle System would cause a significant interruption and risk to the entire payment system of the country. The LankaSettle System comprises of the Real Time Gross Settlement (RTGS) System and the LankaSecure System. Further, the National Savings Bank (NSB) became the first Licensed Specialised Bank (LSB) to obtain participant status of the LankaSettle System, enabling it to actively transact in the financial market.

Increased use of Intra-Day Liquidity Facility (ILF) was witnessed during the period under review. The Central Bank provides interest free ILF to ensure that LankaSettle transactions are settled smoothly during the business day. Accordingly, participating institutions (PIs) utilised an average daily ILF amount of Rs. 684.1 billion per business day during the nine months ending September 2022 which was an increase of 316.8 per cent compared to the same period of the previous year, indicating shortage of liquidity in the market, mainly due to the impact from foreign loan repayments, maturity of foreign currency swap transactions, and currency withdrawal from the Central Bank.

The RTGS System recorded a growth in terms of both volume and value of transactions. The increase in the volume of Standing Deposit Facility/ Standing Lending Facility transactions mainly contributed to such increase. RTGS System also settles the interbank multilateral net clearing balances generated by LankaClear (Pvt) Ltd (LCPL) in respect of the Cheque Imaging and Truncation System (CITS), Sri Lanka Interbank Payment System (SLIPS), Common ATM Switch (CAS), Common Electronic Fund Transfer Switch (CEFTS), and the Common Point-of-Sales (CPOS) Switch.

Electronic retail payments also showed a growth with the increased use of such payment systems

Chart 5.1 Transactions of Large Value Payment Systems



Source: Central Bank of Sri Lanka

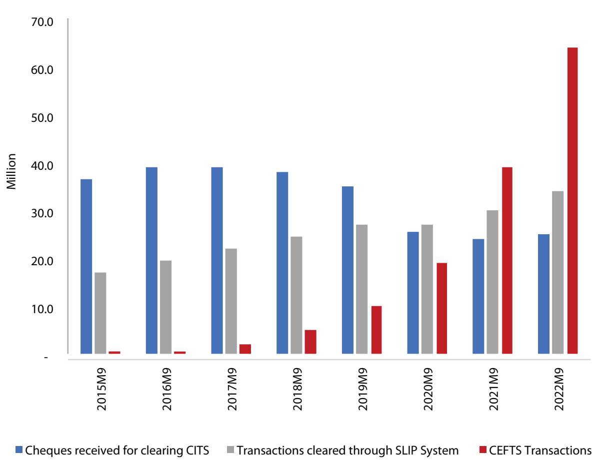
and instruments by the public. The volume and value of cheques cleared by CITS increased during the nine months ending September 2022 compared to the corresponding period of the previous year, recovering from the declining trend observed in 2021, which was mainly due to businesses being unable to issue cheques as a result of travel restrictions imposed by the government owing to the COVID-19 pandemic.

The SLIPS, which facilitates retail payments for low-value bulk fund transfers, slowed down in terms of volume and value of transactions during the nine months ending September 2022, compared to the transaction growth during 2017-2021. The popularity of SLIPS for bulk fund transfers among the public is reducing amidst the availability of other electronic real-time payment mechanisms.

A continuous growth was observed in the usage of interoperable payment systems linking banks and other financial institutions to a common payment switch, which is the Common Card and Payment Switch (CCAPS) operating under the brand name of LankaPay. The CAS, the first phase of CCAPS transactions (which facilitates domestic ATM transactions originating from any ATM in the CAS member network comprising 30 participating financial institutions) continued to record an increase in volume and value of transactions, reflecting customer preference in using CAS member ATMs due to convenience. Common CEFTS transactions, which enables real time retail fund transfers through multiple payment channels such as ATMs, Internet Banking, Mobile Banking, Kiosks, and over-the-counter transactions of 48 primary and secondary participating members, showed a significant growth during the period under review. This was mainly due to reduced fee of CEFTS from Rs. 50 to Rs. 30 in 2021, increased limits on JustPay transactions[1] from Rs. 25,000 to Rs. 50,000 in 2021, increased LankaPay Online Payment Platform (LPOPP) transactions, continuous promotional campaigns carried out by financial institutions on real time payments, and the public preferring to conduct online real time transactions due to convenience.

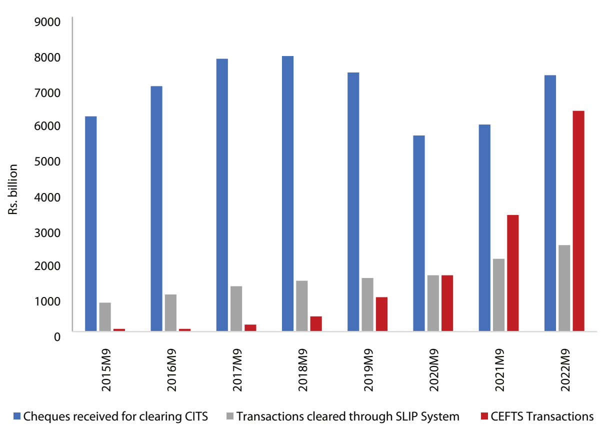
LPOPP, which enables the public to pay government institutions directly from their Current Account and Savings Accounts (CASA), reported a growth in terms of transaction volume and value during the nine months ending September 2022 compared to the corresponding period in the previous year. This was largely due to the increased transactions relating to the Sri Lanka Customs and Department of Inland Revenue.

Chart 5.2 **Volume of Transactions through Retail Value Payment Systems**



Source: Central Bank of Sri Lanka

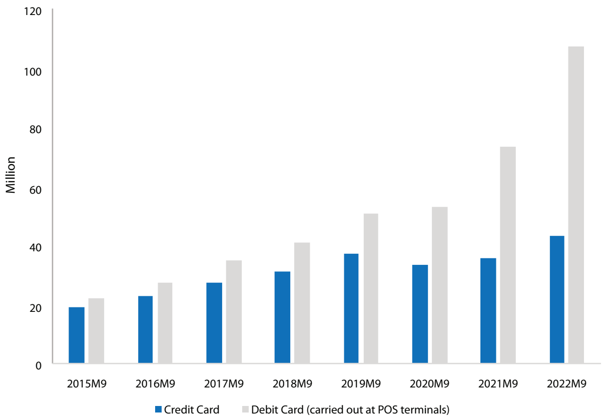
Chart 5.3 **Value of Transactions through Retail Value Payment Systems**



Source: Central Bank of Sri Lanka

1. JustPay transactions are real-time low-value payments conducted through a mobile phone using a customer's CASA

Chart 5.4 Volume of Debit and Credit Card Transactions

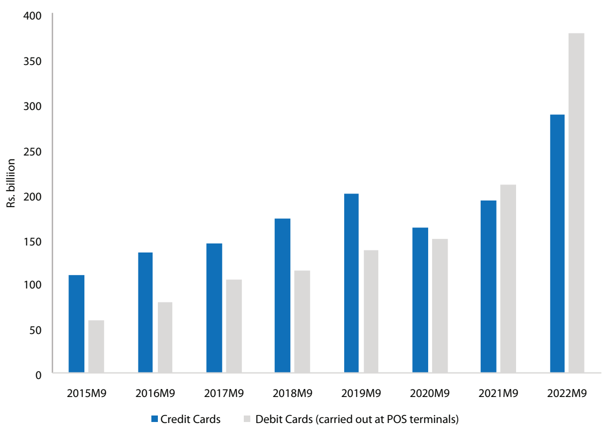


Source: Central Bank of Sri Lanka

The volume and value of credit and debit card transactions demonstrated a healthy growth during the nine months ending September 2022 compared to the corresponding period of the previous year. This is a significant recovery led by the lifting of travel restrictions by the end of 2021 and increase in e-commerce transactions.

A notable decline in both volume and value was observed in LANKAQR based transactions during the period under consideration indicating a need to increase awareness of both customers and merchants in making QR payments. However, registered LANKAQR merchants as of 30 September 2022 increased by 22.9 per cent, i.e., from 273,160 to 335,639 when compared with the same period in the previous year. Meanwhile, the Merchant Discount Rate (MDR) of LANKAQR transactions continued to be at 0.5 per cent, which is significantly lower than the MDR of payment cards.

Chart 5.5 Value of Debit and Credit Card Transactions



Source: Central Bank of Sri Lanka

During the period under review, the Central Bank took several measures to ensure the smooth functioning of the payment and settlement system of the country and thereby minimise the risks that may affect the financial system. The Central Bank continued to monitor the compliance of Mobile Payment Application Providers with the Guidelines issued on the minimum compliance standard for payment related mobile applications, to minimise the risks of using such applications in conducting financial transactions. This covers various aspects related to the mobile application eco-system including security, compliance and governance. In addition, the Central Bank continued to educate the public on the usage, security, and new developments regarding digital payment instruments/mechanisms.

The Central Bank also continued its regulatory and supervisory activities related to payment cards and mobile payment systems. Accordingly, on-site and off-site supervision were carried out to ensure the smooth functioning of the services of Payment Cards and Mobile Payment Systems, by monitoring compliance with the regulations imposed on Service Providers of Payment Cards and of Mobile Payment Systems. In addition, as a part of continuous off-site surveillance of the participating institutions, the Central Bank continued to monitor the Business Continuity Plans (BCP) and Disaster Recovery (DR) arrangements of the LankaSettle PIs during the period under review to ensure continuation of payment services with proper contingency planning.

With the aim of promoting inward foreign remittances, LCPL launched a mobile remittance application, 'LankaRemit' in February 2022, in

collaboration with the Central Bank. This enables migrant workers to remit money to Sri Lanka and to pay utility bills using payment cards. Further, the Central Bank along with LCPL and the Sri Lanka Bureau of Foreign Employment conducted an awareness programme in August 2022 to popularise the LankaRemit mobile application among migrant workers, and it was extended globally with the support of the Ministry of Foreign Affairs and Sri Lankan foreign missions.

The Proof of Concept (POC) on Blockchain based Shared Know-Your-Customer (KYC) solution for financial institutions was successfully completed. The Central Bank and other industry experts are currently determining the way forward in adopting a Blockchain based KYC to streamline the KYC processes in financial institutions and to offer a better experience and convenience for customers, while lowering operational costs and reducing the operational risk of the financial institutions in terms of KYC procedures.

The National Payments Council (NPC), the industry consultative and monitoring committee on payment and settlement systems, continued its efforts towards the advancement of the payment and settlement system in the country. The NPC played a catalytic role in several initiatives through NPC working committees such as Monitoring Committee for the implementation of the National Roadmap for Digitalization of Payment Services, Working Group for Creating Customer Awareness Programmes on Payment Related Scams, and Working Group to Coordinate LANKAQR. The above committees took several measures to increase customer awareness on new digital payment methods and payment related scams.

The usage of Virtual Currency (VC) has been growing rapidly in the country during the past few years and the Central Bank took numerous measures to increase public awareness on potential risks associated with such currencies. Considering recent developments in VC transactions, the Central Bank published several press releases warning the public of possible exposure to significant financial, operational, legal and security related risks as well as customer protection concerns posed to users by investing in VCs. Further, in numerous occasions, the Central Bank emphasised the high risk in the volatility of the value of VCs due to its speculation aspect and the inability of any regulatory or specific legal recourse in the event of a dispute. In addition, the public was also warned not to fall prey to various types of scams offered as VC schemes through the Internet as well as other forms of media.

5.3 Strengthening the Legal Framework to Maintain Stability

The Proposed Central Bank of Sri Lanka Act is to be enacted to strengthen the operational independence and accountability of the Central Bank. In the proposed Act, the primary objective of the Central Bank shall be to achieve and maintain domestic price stability. Further, the Central Bank is also vested with another objective of securing financial system stability. Additionally, provisions on the supervisory and regulatory authority of the Central Bank have been enhanced, *inter alia* empowering the Central Bank to impose administrative sanctions within the parameters provided for in the proposed Act. Similarly, it is to be noted that in the proposed Act, the Central Bank is designated as the Macroprudential Authority of the country.

The new Banking Act is one of the critical pieces of legislation expected to be introduced by the Central Bank. The Central Bank continued with drafting of the new Banking Act with the view of further strengthening and streamlining the provisions of the existing Banking Act, No. 30 of 1988, and to ensure that the provisions thereof are in line with the international standards. Through the proposed Act, supervisory and regulatory powers of the Central Bank in relation to the banking industry will be further enhanced and a corporate governance framework will also be introduced.

The new Banking (Special Provisions) Act is also in the process of being drafted. This could be considered as one of the important pieces of legislation that has been initiated for the purpose of defining the resolution authority of the Central Bank and its resolution powers thereof. The proposed Act introduces financial safety net mechanisms that need to be exercised by the Central Bank in relation to licensed banks, new resolution measures to be implemented by the Central Bank in consultation with the Government and provides for the establishment of a separate department within the Central Bank to exercise Resolution Authority thereof. Further, the said proposed Act grants statutory recognition to the Deposit Insurance Scheme, while setting up a procedure for orderly winding up of licensed banks. Extension of the resolution measures which are applicable for licensed banks to licensed finance companies, as and when appropriate, is also enabled under the proposed Banking (Special Provisions) Act.

The proposed Financial Asset Management Act is being drafted by the Central Bank within the conceptual framework for the purpose of establishing a regulatory framework for financial asset management companies in Sri Lanka. The framework was initiated with a view to offload impaired or underperforming assets of financial institutions designated therein, as reflected in their balance sheets, to financial asset management companies (FAMCs) subject to the legal framework recognised in the proposed Act. In addition, the proposed Act introduces an expeditious recovery process over impaired or underperforming assets and facilitates designated financial institutions to strengthen their balance sheet solvency and thereby, inoculate the said assets in any exigencies arising as a result of vulnerable economic conditions.

The Central Bank took steps to finalise a new piece of legislation titled the 'Micro Finance and Credit Regulatory Act'. This will ameliorate the regulatory framework relating to licensed micro finance institutions and introduce a new regulatory framework for the money lending business of the country. The draft law aims at repealing the existing Microfinance Act, No. 06 of 2016 and to establishing a Credit Regulatory Authority (CRA). Further, the new Act proposes a regulatory and supervisory framework for money lending and micro finance businesses while enhancing the legal framework for consumer protection and governance principles.

Initiatives were taken to introduce new laws under the capital market development project. Accordingly, multiple initiatives were taken by the Central Bank under the said project which aspires to introduce new laws on trading, clearing and netting of government securities and foreign exchange transactions. Accordingly, a new law titled 'Trading Clearing and Netting Act (TCN Act)' is in the process of being drafted and the proposed Act provides for the establishment of a central counterparty clearing and electronic trading platform, which entails significant changes to be made to the existing legal framework applicable to capital markets. The objective of introducing a new TCN Act for Sri Lanka is to provide an enhanced regulatory framework for trading, clearing, netting, settlement, and custody related to transactions of government securities and foreign exchange. The proposed 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, a multi-currency Real Time Gross Settlement System, etc.

The Central Bank took steps to update some of the existing laws to be compatible with recent developments. Accordingly, amendments are being introduced to the Foreign Exchange Act, Finance Business Act, Finance Leasing Act, and Payment and Settlement Systems Act to keep the same abreast with changes in the financial sector and financial innovations.

5.4 Resolution & Enforcement and Deposit Insurance & Liquidity Supports Scheme

Sri Lanka Deposit Insurance and Liquidity Supports Scheme (SLDILSS) continued its operations during the period under review. SLDILSS was established with the objective of protecting small depositors in the event of failure of financial institutions and providing liquidity support for the Member Institutions (MIs). It comprises 67 MIs including all License Banks (LBs) and Licensed Finance Companies (LFCs). The maximum coverage of SLDILSS is currently Rs.1,100,000.00 on a per-depositor per-institution basis. The Central Bank continued compensation payments for six failed finance companies under SLDILSS. These include Central Investment and Finance PLC (CIFL), The Standard Credit Finance Ltd (TSCFL), TKS Finance Company PLC (TKSFL), The Finance Company PLC (TFC), ETI Finance Limited (ETI), and Swarnamahal Financial Services PLC (SFSP). However, compensation payments to the depositors of SFSP were suspended as the company is being considered under the Masterplan for Consolidation. Further, the process of accepting new claims in relation to compensation payments from the depositors of CIFL and TSCFL was discontinued due to expiration of maximum period of 4 years as specified in the SLDILSS Regulations. Accordingly, Rs. 30,290 million has been paid as compensation to 72,259 depositors of failed financial institutions as at end September 2022.

The Central Bank introduced several measures to further strengthen the resolution framework of the country. The Sri Lanka Deposit Insurance and Liquidity Support Fund (SLDILSF) as at end 2021 was Rs. 67.88 billion after making provisions for compensation payment liabilities of all six failed LFCs. The total compensation payable liability of the scheme on eligible deposit liabilities of all MIs as at end 2021 approximated to Rs.5,413 billion, of which Rs.5,224 billion was for LBs and Rs.188 billion for LFCs. Thus, measures are being taken to bring necessary legal provisions in the draft Banking (Special Provisions) Act to broaden the mandate of SLDILSS with necessary resolution financing powers in the context of the current economic and financial conditions of the country. Further, directions were issued on mandating the recording of Unique Identification Number of depositors of all LBs and LFCs to facilitate compiling of information by the SLDILSS and strengthen the soundness and integrity of the information management process for key policy decisions of the financial sector. The Central Bank conducted several investigations on prohibited schemes under the relevant provisions of the Banking Act upon complaints received from the public or other entities and several awareness programmes were also conducted continuously to educate the public on the risks of engaging in prohibited schemes.

5.5 Anti-Money Laundering and Countering the Financing of Terrorism

The Financial Intelligence Unit (FIU) continued its functions to strengthen the AML/CFT regime of the country, in line with international standards. Having identified emerging risks, the FIU continued to perform its functions to strengthen the AML/CFT regime of the country, in line with international standards while recognising and adjusting to the ‘new normalcy’ under post pandemic circumstances. The FIU performed its key tasks of receiving, analysing and disseminating information on suspicious financial transactions related to Money Laundering (ML)/ Terrorist Financing (TF) or any other unlawful activity, in terms of the Financial Transactions Reporting Act, No. 6 of 2006 (FTRA). Upon analysis of information received through Suspicious Transaction Reports (STRs) from Reporting Institutions (RIs), Law Enforcement Agencies (LEAs), Regulatory Authorities (RAs), and the general public, together with other relevant information obtained from numerous sources, the

FIU disseminated the analytical results to relevant competent authorities for further investigation or actions, where necessary. Further, as stipulated in the FTRA, the FIU continues to receive Cash Transactions Reports and reports on Electronic Fund Transfers (inward and outward) exceeding the reporting threshold of Rs. 1.0 million or its equivalent in any foreign currency from RIs.

The FIU continued to ensure RIs' compliance with the AML/CFT requirements by effective supervision and enforcement actions. During the twelve month period ending September 2022, on-site supervision, off-site monitoring and thematic reviews were conducted on Financial Institutions (FIs) as well as Designated Non-Finance Businesses and Professions (DNFBPs) to ensure their compliance with the AML/CFT laws, rules and regulations of the country and to protect the financial system from possible money laundering and financing of terrorism. Accordingly, 37 risk-based on-site, off-site and spot examinations as well as 4 thematic reviews, were carried out during the period, covering LBs and LFCs. Also, 17 risk-based on-site, off-site and spot examinations and a thematic review were conducted on registered DNFBPs. Moreover, based on the findings of the examinations conducted in 2021 and 2022, 2 warning letters and 6 show cause letters were issued to FIs. During the period under review, the FIU imposed penalties totaling Rs. 8.5 million on 5 FIs for non-compliance with the provisions of the FTRA and Customer Due Diligence Rules.

The FIU continued to provide guidance to RIs and conducted programmes to enhance stakeholders' awareness on AML/CFT measures and obligations. With a view to strengthening institutional compliance with the country's AML/CFT framework and thereby minimising the risks arising from money laundering and financing terrorism towards stability of the financial system, the FIU issued several circulars. Accordingly, the FIU issued 4 circulars during the twelve month period ending September 2022 in relation to deposits made under the Finance Act, No. 18 of 2021, CCTV operations for AML/CFT purposes, STR reporting, and provision of efficient banking services to Sri Lankan expatriates. The FIU also carried out awareness programmes to enhance the understanding of stakeholders on the importance of measures and obligations in relation to AML/CFT. Further, the FIU initiated the introduction of a new transaction reporting system, 'goAML' for RIs, which is currently at the finalisation stage of the implementation process.

The FIU continued to strengthen compliance with AML/CFT related laws, rules, and regulations. Ensuring compliance with the Recommendation 1 of the Financial Action Task Force (FATF), recommendations that require the country to identify and assess its ML/TF risk and to keep the risk assessment up-to-date in 2021, the FIU initiated updating the ML/TF National Risk Assessment (NRA) of Sri Lanka, with the participation of 66 public and private stakeholder agencies. Based on the results of the NRA, the National AML/CFT Policy of Sri Lanka will be revisited. Further, the FIU is in the process of introducing amendments to the Convention on the Suppression of Terrorist Financing Act, No. 25 of 2005 (CSTFA), the Prevention of Money Laundering Act, No. 5 of 2006 (PMLA), and the FTRA, the three main legislative enactments that support the AML/CFT framework of Sri Lanka. Draft amendments to the CSTFA and PMLA are at stakeholders' consultation level, and amendments to the FTRA are being reviewed by the FIU. Passing amendments to these three legislations is important for Sri Lanka to address the gaps identified at the Mutual Evaluation carried out by the Asia Pacific Group (APG) on ML in 2014/2015 and to further strengthen possible areas of concern with the implementation of these amendments to the legislations.

5.6 Surveillance on Foreign Exchange Transactions

The Central Bank took a number of measures to address developments in the foreign exchange market during the period under review. Several policy measures were introduced under the

Foreign Exchange Act, No. 12 of 2017 with the aim of facilitating the economic activities of the country while addressing the issues/concerns of various stakeholders and to further facilitate foreign exchange transactions amidst the liquidity constraints in the domestic foreign exchange market.

Rules on Repatriation of Export Proceeds into Sri Lanka under provisions of the Monetary Law Act, No. 58 of 1949 (MLA) in February 2021 were reissued. These rules were reissued in October 2021 and March 2022 to strengthen measures requiring exporters to repatriate export proceeds to Sri Lanka and to convert such proceeds after making the authorised payments, in line with several other measures introduced by the Central Bank to ease the pressure on the exchange rate and to support foreign currency liquidity in the domestic foreign exchange market. The percentage of conversion of export proceeds of service exporters was higher than the conversions of goods exporters as the authorised payments in relation to service exports were comparatively low. However, by the Rules issued in August 2022, the requirement of converting export proceeds of service exporters was withdrawn considering possible discouragement of service exporters to repatriate their export proceeds into the country. Further, probable risk with exporters of goods to circumvent the residual conversion requirement to a certain extent is expected to be limited with the amendments to the Rules restricting the exports proceeds to be used for the current transactions not related to their exports.

In view of mitigating any unfavourable effects on the exchange rate stability with possible abrupt capital outflows, the order issued under Section 22 of the FEA which suspended outward remittances in respect of certain capital transactions which will lapse by 29 December 2022 was further extended during the period under review. However, given these restrictions under the subject Order, the informal sector is likely to grow as people may tend to shift into informal remittance methods such as Hawala and Undial.

Inward remittances to Special Deposit Accounts (SDAs) introduced during early 2020 was extended for a period of 12 months up to 07 April 2023 considering the potential of SDAs to attract foreign exchange inflows to the country. This has supported the management of the foreign exchange reserves of the country to a certain extent. However, a gradual drain in the capital flow is expected upon maturity of such SDAs exerting a possible pressure on the exchange rate as approximately USD 434 million deposits are to mature during the period from October 2022 to September 2023. Thus, to encourage retention of these funds within the country, it was allowed to roll over SDAs provided that the accumulated period of the said SDAs does not exceed a maximum of 36 months from the initial date of placing such deposits.

Several Directions were issued to ensure the compliance of Restricted Dealers (RDs) and Authorised Dealers (ADs). Considering non-compliances of the RDs (i.e., Money Changers) in respect of offering higher buying rates for foreign currencies, Directions were issued to RDs prohibiting the offering of higher exchange rates to customers, other than the exchange rates offered to them by ADs with whom they maintain accounts to deposit foreign currencies and mandating RDs to take necessary measures to assure continuous and uninterrupted operations of the CCTV System. The issuance of these Directions streamlined the operations of RDs while supporting *inter-alia* to lessen the gap in the exchange rates between the formal and parallel market which deliberately drives depreciation of the local currency.

The Central Bank developed and implemented an online Export Proceeds Monitoring System (EPMS) from June 2022 which will be in operation from early 2023. The main objective of this initiative is to ensure all details of exports of goods from the country are captured into a database facilitating the stringent monitoring of the repatriation of export proceeds as per the Rules on Repatriation of Export Proceeds into Sri Lanka.

5.7 Financial Consumer Protection

The Central Bank continued to strengthen the financial consumer protection framework of the entities regulated by the Bank, which promotes the rights and interests of financial consumers and fairness and transparency of financial products and services offered to financial consumers. Accordingly, the Central Bank received 5,735 complaints and grievances regarding the entities regulated by the Central Bank for the twelve month period ending September 2022. Out of the total complaints and grievances, about 55 per cent were related to LCBs and LSBs, while about 19 per cent were associated with LFCs and SLCs. Further, about 16 per cent of complaints and grievances received by the Central Bank were related to entities not regulated by the Central Bank, failed finance companies or general financial issues. The Central Bank was able to conclude 74 per cent of valid complaints and grievances of financial consumers received during the period under review.

The Central Bank commenced the process of issuing new regulations/guidelines to facilitate a comprehensive financial consumer protection framework for entities regulated by the Central Bank. In this regard, the first draft of the Regulations is currently under review and is expected to be made available for stakeholder consultations by the end of 2022. Further, with the issuance of these Regulations the Central Bank is expected to commence Market Conduct Supervision by the end of 2023.

Appendix 1- Financial Soundness Indicators - All Banks

	2017	2018	2019	2020	2021	2022 Sep
1. Capital Adequacy						
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	16.4	16.2	17.2	17.1	16.5	15.3
1.2 Tier-1 Capital to Risk Weighted Assets (Tier-1 RWCAR)	13.4	13.1	13.7	13.6	13.2	12.5
1.3 Net Non-Performing Loans to Equity Capital & Reserves	9.3	14.5	19.5	17.2	11.5	-
1.4 Net Stage 3 Loans(a) to Equity Capital & Reserves	-	-	-	-	-	46.3
1.5 Debt to Equity Capital & Reserves	185.4	171.1	148.6	134.9	148.9	143.0
1.6 Capital Funds to Total Assets	8.4	8.7	9.0	8.6	8.7	7.8
2. Asset Quality						
2.1 Non-Performing Loans (NPL) to Total Loans & Advances (w/o Interest in Suspense)	2.5	3.4	4.7	4.9	4.5	-
2.2 Stage 3 Loans(b) to Total Loans and Advances(c)	-	-	-	-	-	10.9
2.3 Net Non-Performing Loans to Total Loans & Advances	1.3	2.0	2.8	2.4	1.7	
2.4 Net Stage 3 Loans(a) to Total Loans and Advances(c)	-	-	-	-	-	10.8
2.5 Provisions to Total Loans & Advances	1.7	2.0	2.5	3.0	3.4	-
2.6 Provision Coverage Ratio (Total)	69.9	57.4	52.3	61.3	75.8	-
2.7 Total Impairment Coverage Ratio(d)	-	-	-	-	-	7.3
2.8 Provision Coverage Ratio (Specific)	49.6	43.1	42.4	51.7	64.0	-
2.9 Stage 3 Impairment Coverage Ratio(e)	-	-	-	-	-	43.6
2.10 Provisions to Total Assets	1.1	1.3	1.6	1.9	2.1	-
2.11 Impairment to Total Assets	-	-	-	-	-	4.4
2.12 Total Loans & Advances to Total Assets	62.5	65.2	64.9	62.0	61.9	58.9
2.13 Investments (including investment in Associates and Subsidiaries) to Total Assets	25.0	22.9	24.2	28.8	29.1	30.1
2.14 Total Income to Total Assets	10.6	10.7	10.7	8.9	8.1	8.5
2.15 Net Interest Income to Total Assets	3.3	3.4	3.4	2.9	3.2	2.9
2.16 Operating Income to Total Assets	4.5	4.6	4.5	3.9	4.2	4.1
3. Earnings and Profitability						
3.1 Return on Equity (ROE) – After Tax	17.6	13.2	10.3	11.4	14.5	8.5
3.2 Return on Assets (ROA) – Before Tax	2.0	1.8	1.4	1.4	1.6	1.0
3.3 Return on Assets (ROA) – After Tax	1.4	1.1	0.9	1.0	1.2	0.7
3.4 Interest Income to Total Income	88.8	88.2	90.2	89.1	87.8	86.9
3.5 Net Interest Income to Total Income	31.2	31.6	32.1	32.8	40.2	34.7
3.6 Non-Interest Income to Total Income	11.2	11.8	9.8	10.9	12.2	13.1
3.7 Non-Interest Expenses (Operating Expenses) to Total Income	18.7	20.2	19.7	19.4	22.0	14.2
3.8 Staff Expenses to Non-Interest Expenses	46.4	44.1	44.6	46.4	45.2	53.6
3.9 Personnel Expenses to Total Income	8.7	8.9	8.8	9.0	9.9	7.6
3.10 Provision Charge to Total Income	2.6	4.0	5.3	7.6	8.7	-
3.11 Impairment Charge to Total Income	-	-	-	-	-	52.2
3.12 Total Cost to Total Income	76.3	76.8	77.8	75.7	69.5	66.3
3.13 Efficiency Ratio	45.7	50.0	52.6	51.8	48.1	29.6
3.14 Interest Margin	3.5	3.6	3.6	3.1	3.4	4.2
4. Liquidity						
4.1 Liquid Assets to Total Assets	28.8	25.7	28.9	34.1	29.7	25.3
4.2 Liquid Assets Ratio - Domestic Banking Unit Operations (DBU)	31.3	27.6	31.0	37.8	33.8	27.8
5. Assets / Funding Structure						
5.1 Deposits to Total Assets	71.9	72.0	73.2	76.0	74.9	77.3
5.2 Borrowings to Total Assets	15.6	15.0	13.4	11.5	12.9	11.2
5.3 Capital to External Funds	9.6	10.0	10.4	9.8	9.9	8.8
5.4 Credit to Deposits	86.9	90.6	88.7	81.6	82.7	76.2
5.5 Credit to Deposits & Borrowings	71.4	75.0	74.9	70.8	70.6	66.5
5.6 Credit to Deposits & Borrowings & Capital	65.1	68.2	67.8	64.5	64.2	61.1

(a) Net of stage 3 impairment (including undrawn portion)
(b) Excluding undrawn portion
(c) Total loans and receivables (including stage 3 loans and excluding undrawn portion)
(d) The ratio of Total Impairment to Total Loans and Receivables (including undrawn portion)
(e) The ratio of Stage 3 Impairment to Stage 3 Loans

Appendix 2- Financial Soundness Indicators-Licensed Commercial Banks

	2017	2018	2019	2020	2021	2022 Sep
1. Capital Adequacy						
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	16.4	16.2	17.2	17.1	16.7	15.2
1.2 Tier-1 Capital to Risk Weighted Assets (Tier-1 RWCAR)	13.4	13.0	13.7	13.6	13.2	12.3
1.3 Net Non-Performing Loans to Equity Capital & Reserves	7.5	13.2	18.3	15.5	9.9	-
1.4 Net Stage 3 Loans(a) to Equity Capital & Reserves	-	-	-	-	-	45.8
1.5 Debt to Equity Capital & Reserves	169.2	167.0	147.5	137.9	154.6	146.1
1.6 Capital Funds to Total Assets	8.9	9.1	9.5	9.0	9.0	8.1
2. Asset Quality						
2.1 Non-Performing Loans (NPL) to Total Loans & Advances (w/o Interest in Suspense)	2.3	3.3	4.6	4.7	4.3	-
2.2 Stage 3 Loans(b) to Total Loans and Advances(c)	-	-	-	-	-	11.2
2.3 Net Non-Performing Loans to Total Loans & Advances	1.0	1.8	2.6	2.2	1.4	
2.4 Net Stage 3 Loans(a) to Total Loans and Advances(c)	-	-	-	-	-	11.0
2.5 Provisions to Total Loans & Advances	1.8	2.0	2.5	3.1	3.4	-
2.6 Provision Coverage Ratio (Total)	77.8	61.1	54.0	64.7	80.4	-
2.7 Total Impairment Coverage Ratio(d)	-	-	-	-	-	7.5
2.8 Provision Coverage Ratio (Specific)	55.4	45.9	43.8	54.6	67.9	-
2.9 Stage 3 Impairment Coverage Ratio(e)	-	-	-	-	-	44.6
2.10 Provisions to Total Assets	1.2	1.3	1.7	2.0	2.2	-
2.11 Impairment to Total Assets	-	-	-	-	-	4.7
2.12 Total Loans & Advances to Total Assets	64.9	67.3	67.3	64.6	64.5	60.6
2.13 Investments (including investment in Associates and Subsidiaries) to Total Assets	22.5	20.8	21.9	26.4	26.6	28.0
2.14 Total Income to Total Assets	10.5	10.5	10.7	8.7	7.9	8.5
2.15 Net Interest Income to Total Assets	3.4	3.4	3.5	2.9	3.1	3.0
2.16 Operating Income to Total Assets	4.6	4.8	4.6	3.9	4.2	4.3
3. Earnings and Profitability						
3.1 Return on Equity (ROE) – After Tax	17.5	13.7	10.7	11.0	13.8	8.9
3.2 Return on Assets (ROA) – Before Tax	2.1	1.9	1.5	1.4	1.6	1.0
3.3 Return on Assets (ROA) – After Tax	1.5	1.2	1.0	1.0	1.2	0.7
3.4 Interest Income to Total Income	87.9	87.0	89.1	87.9	86.3	85.5
3.5 Net Interest Income to Total Income	32.0	32.3	32.5	33.0	39.7	35.4
3.6 Non-Interest Income to Total Income	12.1	13.0	10.9	12.1	13.7	14.5
3.7 Non-Interest Expenses (Operating Expenses) to Total Income	19.2	20.4	20.0	19.7	22.2	13.7
3.8 Staff Expenses to Non-Interest Expenses	45.4	42.7	43.1	45.2	43.6	51.3
3.9 Personnel Expenses to Total Income	8.7	8.7	8.6	8.9	9.7	7.0
3.10 Provision Charge to Total Income	2.9	4.4	5.6	8.4	9.6	-
3.11 Impairment Charge to Total Income	-	-	-	-	-	55.5
3.12 Total Cost to Total Income	75.2	75.1	76.6	74.7	68.8	63.9
3.13 Efficiency Ratio	45.2	48.5	51.7	51.7	48.2	27.5
3.14 Interest Margin	3.6	3.7	3.6	3.1	3.3	4.3
4. Liquidity						
4.1 Liquid Assets to Total Assets	26.7	24.5	27.1	31.8	27.7	24.3
4.2 Liquid Assets Ratio - Domestic Banking Unit Operations (DBU)	27.2	25.0	27.8	34.4	30.9	26.2
5. Assets / Funding Structure						
5.1 Deposits to Total Assets	72.0	71.4	72.0	74.7	73.6	76.2
5.2 Borrowings to Total Assets	15.0	15.1	14.0	12.4	13.9	11.9
5.3 Capital to External Funds	10.2	10.5	11.1	10.3	10.3	9.2
5.4 Credit to Deposits	90.1	94.2	93.4	86.5	87.6	79.5
5.5 Credit to Deposits & Borrowings	74.6	77.7	78.1	74.2	73.7	68.8
5.6 Credit to Deposits & Borrowings & Capital	67.7	70.4	70.4	67.3	66.9	63.0

(a) Net of stage 3 impairment (including undrawn portion)

(b) Excluding undrawn portion

(c) Total loans and receivables (including stage 3 loans and excluding undrawn portion)

(d) The ratio of Total Impairment to Total Loans and Receivables (including undrawn portion)

(e) The ratio of Stage 3 Impairment to Stage 3 Loans

Appendix 3- Financial Soundness Indicators-Licensed Specialized Banks

	2017	2018	2019	2020	2021	2022 Sep
1. Capital Adequacy						
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	16.3	17.1	16.2	16.8	14.6	17.5
1.2 Tier-1 Capital to Risk Weighted Assets (Tier-1 RWCAR)	13.4	15.0	12.9	13.7	12.0	14.4
1.3 Net Non-Performing Loans to Equity Capital & Reserves	29.3	28.7	33.0	36.8	27.6	-
1.4 Net Stage 3 Loans(a) to Equity Capital & Reserves	-	-	-	-	-	51.3
1.5 Debt to Equity Capital & Reserves	360.1	214.7	162.6	101.6	93.6	106.3
1.6 Capital Funds to Total Assets	5.4	6.3	5.6	5.6	6.4	5.6
2. Asset Quality						
2.1 Non-Performing Loans (NPL) to Total Loans & Advances (w/o Interest in Suspense)	4.3	4.8	5.5	6.9	6.5	-
2.2 Stage 3 Loans(b) to Total Loans and Advances(c)	-	-	-	-	-	8.7
2.3 Net Non-Performing Loans to Total Loans & Advances	3.4	3.6	3.9	4.9	4.1	
2.4 Net Stage 3 Loans(a) to Total Loans and Advances(c)	-	-	-	-	-	9.3
2.5 Provisions to Total Loans & Advances	1.3	1.6	2.1	2.5	2.8	0.0
2.6 Provision Coverage Ratio (Total)	31.1	32.9	38.6	36.7	43.8	-
2.7 Total Impairment Coverage Ratio(d)	-	-	-	-	-	4.4
2.8 Provision Coverage Ratio (Specific)	21.4	24.3	31.3	30.9	37.5	-
2.9 Stage 3 Impairment Coverage Ratio(e)	-	-	-	-	-	30.9
2.10 Provisions to Total Assets	0.6	0.8	1.0	1.1	1.2	-
2.11 Impairment to Total Assets	-	-	-	-	-	1.9
2.12 Total Loans & Advances to Total Assets	46.8	50.1	48.1	43.6	44.0	45.6
2.13 Investments (including investment in Associates and Subsidiaries) to Total Assets	41.6	38.2	40.0	46.0	46.5	46.7
2.14 Total Income to Total Assets	11.4	11.8	11.3	9.9	9.0	7.9
2.15 Net Interest Income to Total Assets	3.0	3.2	3.3	3.1	3.9	2.3
2.16 Operating Income to Total Assets	3.7	3.6	3.6	3.5	4.1	2.4
3. Earnings and Profitability						
3.1 Return on Equity (ROE) – After Tax	19.2	7.7	6.8	16.6	21.5	4.0
3.2 Return on Assets (ROA) – Before Tax	1.5	0.8	0.8	1.3	1.7	0.4
3.3 Return on Assets (ROA) – After Tax	1.0	0.5	0.4	0.9	1.3	0.2
3.4 Interest Income to Total Income	94.2	96.1	97.1	96.3	97.4	98.4
3.5 Net Interest Income to Total Income	26.5	27.1	29.0	31.7	43.7	29.2
3.6 Non-Interest Income to Total Income	5.8	3.9	2.9	3.7	2.6	1.6
3.7 Non-Interest Expenses (Operating Expenses) to Total Income	15.6	18.9	17.5	17.3	20.5	17.9
3.8 Staff Expenses to Non-Interest Expenses	54.3	54.2	55.4	55.0	55.7	68.8
3.9 Personnel Expenses to Total Income	8.5	10.2	9.7	9.5	11.4	12.3
3.10 Provision Charge to Total Income	0.9	1.6	2.9	2.2	2.9	-
3.11 Impairment Charge to Total Income	-	-	-	-	-	23.5
3.12 Total Cost to Total Income	83.3	87.8	85.6	81.9	74.3	87.1
3.13 Efficiency Ratio	49.3	63.8	60.1	52.1	47.3	58.0
3.14 Interest Margin	3.2	3.4	3.5	3.1	4.2	3.1
4. Liquidity						
4.1 Liquid Assets to Total Assets	42.6	35.1	41.5	49.6	43.6	32.7
4.2 Liquid Assets Ratio - Domestic Banking Unit Operations (DBU)	61.6	47.7	53.1	60.4	52.8	39.5
5. Assets / Funding Structure						
5.1 Deposits to Total Assets	71.3	76.3	80.9	84.6	83.8	86.2
5.2 Borrowings to Total Assets	19.4	13.5	9.0	5.7	6.0	5.9
5.3 Capital to External Funds	5.9	7.0	6.2	6.3	7.2	6.0
5.4 Credit to Deposits	65.6	65.7	59.5	51.6	52.5	52.8
5.5 Credit to Deposits & Borrowings	51.6	55.8	53.5	48.3	49.0	49.4
5.6 Credit to Deposits & Borrowings & Capital	48.7	52.1	50.4	45.5	45.7	46.6

(a) Net of stage 3 impairment (including undrawn portion)
(b) Excluding undrawn portion
(c) Total loans and receivables (including stage 3 loans and excluding undrawn portion)
(d) The ratio of Total Impairment to Total Loans and Receivables (including undrawn portion)
(e) The ratio of Stage 3 Impairment to Stage 3 Loans

Appendix 4 : Financial Soundness Indicators - LFCs and SLCs Sector *

	2017 Mar	2018 Mar	2019 Mar	2020 Mar	2021 Mar	2022 Mar (b)	2022 Sep (a)
1. Capital Adequacy							
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	11.9	12.1	10.6	14.2	15.5	17.8	20.0
1.2 Tier 1 Capital/Risk Weighted Assets (Tier 1 RWCAR)	11.5	11.5	9.4	12.8	14.3	16.2	18.5
1.3 Capital Funds to Total Assets	11.9	11.6	12.3	13.7	17.9	19.7	19.2
1.4 Borrowings to Equity (times)	2.8	2.5	2.3	1.8	1.0	1.1	1.1
2. Asset Quality							
2.1 Gross Stage 3 Loans to Total Advances (c)	4.9	5.9	7.7	10.8	11.3	9.1	16.8
2.2 Provision made against Total Advances	3.2	3.6	4.6	6.3	7.2	6.3	7.2
2.3 Impairment Coverage Ratio (d)	64.8	62.8	58.9	58.0	63.9	69.7	30.0
3. Earnings and Profitability							
3.1 Return on Assets (Annualized)	3.7	3.0	2.7	2.0	3.3	5.3	2.8
3.2 Return on Equity (Annualized)	24.4	17.2	13.5	8.9	14.6	23.5	10.7
3.3 Operating Profit Before Provision to Total Assets	4.1	4.1	4.2	4.3	4.9	5.2	1.9
3.4 Interest Income to Interest Expenses	189.9	177.1	184.3	187.8	210.9	258.4	170.6
3.5 Net Interest Income to Profit After Tax	333.0	405.8	552.9	731.8	359.7	210.2	410.9
3.6 Operating Cost to Net Interest Income	76.3	76.4	76.9	75.5	68.4	61.9	81.0
3.7 Net Interest Income to Average Assets	7.8	7.1	7.9	7.7	7.4	7.8	7.1
3.8 Net Interest Income to Interest Income	47.4	43.5	45.7	46.7	52.6	61.3	41.4
3.9 Non-Interest Expenses to Total Cost	39.0	34.0	35.5	34.5	37.9	48.1	34.0
3.10 Efficiency Ratio	57.8	56.0	58.1	57.4	50.7	46.4	59.6
3.11 Cost to Income Ratio	80.4	84.3	86.2	89.2	80.2	65.5	85.7
4. Liquidity							
4.1 Liquid Assets to Total Assets	7.6	9.1	8.7	8.3	8.7	9.8	9.2
4.2 Liquid Assets to Deposits and Borrowings	9.9	11.8	11.5	11.4	12.9	14.6	13.5
4.3 Net Loans to Total Borrowings	227.4	260.9	262.8	294.3	379.0	336.7	337.2
5. Assets/Funding Structure							
5.1 Borrowings to Total Assets	33.7	29.0	28.2	24.5	18.7	21.2	20.4
5.2 Investment to Total Assets	9.9	9.0	8.7	8.9	10.5	10.5	11.1

* For this analysis, financial statements of all registered Licensed Finance Companies (LFCs) have been considered, including the LFCs that have reported despite their license being suspended

(a) Provisional

(b) Revised

(c) Before September 2022 Gross Non Performing Advances to Total Advances was considered

(d) Before September 2022 Provision Coverage Ratio was considered

Appendix 5 : Financial Soundness Indicators - Licensed Finance Companies Sector*

	2017 Mar	2018 Mar	2019 Mar	2020 Mar	2021 Mar	2022 Mar (b)	2022 Sep (a)
1. Capital Adequacy							
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	10.4	11.0	10.1	13.7	14.9	17.4	19.8
1.2 Tier 1 Capital/Risk Weighted Assets (Tier 1 RWCAR)	10.1	10.4	8.8	12.4	13.7	15.9	18.3
1.3 Capital Funds to Total Assets	10.8	11.0	11.7	13.0	17.3	19.3	19.1
1.4 Borrowings to Equity (times)	2.8	2.5	2.3	1.8	1.0	1.1	1.1
1.5 Investment Properties to Capital Funds	8.2	11.5	11.9	13.5	13.3	13.3	15.0
1.6 Stage 3 Loans Net of Impairments to Capital (c)	8.7	10.9	15.4	23.0	12.6	7.3	46.5
2. Asset Quality							
2.1 Gross Stage 3 Loans to Total Advances (d)	5.2	5.9	7.9	11.0	11.3	9.0	16.8
2.2 Provision made against Total Advances	3.4	3.7	4.6	6.4	7.2	6.3	7.2
2.3 Impairment Coverage Ratio (e)	64.8	62.8	58.9	58.0	63.9	69.7	30.0
3. Earnings and Profitability							
3.1 Return on Assets (Annualized)	3.4	2.9	2.6	1.9	3.2	5.2	2.9
3.2 Return on Equity (Annualized)	25.3	19.0	13.6	8.7	15.2	24.1	11.2
3.3 Operating Profit Before Provision to Total Assets	3.8	3.9	4.1	4.1	4.8	5.0	1.9
3.4 Interest Income to Interest Expenses	184.3	173.5	181.9	184.7	206.7	254.1	170.4
3.5 Net Interest Income to Profit After Tax	339.4	419.6	567.7	771.4	353.3	209.1	409.0
3.6 Operating Cost to Net Interest Income	79.2	78.8	78.4	77.2	69.7	62.8	81.1
3.7 Net Interest Income to Average Assets	7.3	7.2	7.7	7.4	7.2	7.7	7.2
3.8 Net Interest Income to Interest Income	45.8	42.4	45.0	45.9	51.6	60.6	41.3
3.9 Non-Interest Expenses to Total Cost	38.4	33.7	35.3	34.3	37.7	47.8	34.0
3.10 Efficiency Ratio	58.8	57.1	58.8	58.3	51.2	46.9	59.7
3.11 Cost to Income Ratio	81.4	85.3	86.9	89.9	80.4	66.1	85.7
4. Liquidity							
4.1 Liquid Assets to Total Assets	7.4	8.5	8.8	8.3	8.8	9.8	9.2
4.2 Liquid Assets to Deposits and Borrowings	9.5	11.0	11.5	11.4	12.9	14.4	13.5
4.3 Net Loans to Total Borrowings	247.2	269.5	271.5	302.2	389.9	347.7	338.2
5. Assets/Funding Structure							
5.1 Borrowings to Total Assets	30.8	28.0	27.2	23.8	18.1	20.5	20.4
5.2 Investment to Total Assets	10.3	9.3	8.9	9.1	10.8	10.7	11.1

* For this analysis, financial statements of all registered Licensed Finance Companies (LFCs) have been considered, including the LFCs that have reported despite their license being suspended.

(a) Provisional

(b) Revised

(c) Before September 2022 Non Performing Loans Net of Provisions to Capital was considered

(d) Before September 2022 Gross Non Performing Advances to Total Advances was considered

(e) Before September 2022 Provision Coverage Ratio was considered

Appendix 6 : Financial Soundness Indicators
Specialised Leasing Companies Sector

	2017 Mar	2018 Mar	2019 Mar	2020 Mar	2021 Mar	2022 Mar (b)	2022 Sep (a)
1. Capital Adequacy							
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	33.4	45.0	23.5	27.7	34.4	28.6	81.9
1.2 Tier 1 Capital/Risk Weighted Assets (Tier 1 RWCAR)	31.2	44.7	22.9	27.0	33.6	27.8	83.0
1.3 Capital Funds to Total Assets	23.9	29.1	29.8	36.5	43.6	36.7	57.0
1.4 Borrowings to Equity (times)	2.8	2.1	2.0	1.4	1.0	1.3	0.4
2. Asset Quality							
2.1 Gross Stage 3 Loans to Total Advances (c)	1.5	2.6	4.4	5.4	11.0	13.7	34.6
2.2 Provision made against Total Advances	1.2	1.4	2.5	3.5	7.7	8.5	21.3
2.3 Impairment Coverage Ratio (d)	78.3	55.9	55.9	68.3	70.9	62.9	63.5
3. Earnings and Profitability							
3.1 Return on Assets (Annualized)	6.7	3.6	6.9	7.1	5.8	10.2	0.1
3.2 Return on Equity (Annualized)	18.0	9.0	11.9	11.3	7.0	14.2	0.0
3.3 Operating Profit Before Provision to Total Assets	6.8	10.0	8.4	11.1	10.4	10.1	2.2
3.4 Interest Income to Interest Expenses	258.5	334.7	272.9	318.8	472.9	527.0	418.4
3.5 Net Interest Income to Profit After Tax	296.7	277.1	380.4	399.0	532.4	236.9	16843.5
3.6 Operating Cost to Net Interest Income	57.3	43.3	50.4	46.9	46.5	40.8	54.7
3.7 Net Interest Income to Average Assets	13.9	6.5	14.1	16.2	16.7	14.4	1.5
3.8 Net Interest Income to Interest Income	61.3	70.1	63.4	68.6	78.9	81.0	76.1
3.9 Non-Interest Expenses to Total Cost	45.7	46.5	42.1	41.6	46.8	57.1	39.2
3.10 Efficiency Ratio	52.8	40.4	49.1	49.8	55.3	35.4	92.5
3.11 Cost to Income Ratio	71.0	59.3	69.6	70.5	72.6	49.0	96.9
4. Liquidity							
4.1 Liquid Assets to Total Assets	10.5	8.1	7.8	6.7	5.5	11.5	9.3
4.2 Liquid Assets to Deposits and Borrowings	15.8	13.4	12.9	12.7	12.8	23.3	35.0
4.3 Net Loans to Total Borrowings	123.7	139.4	140.1	161.2	191.2	155.5	146.3
5. Assets/Funding Structure							
5.1 Borrowings to Total Assets	67.4	61.4	62.3	55.2	46.6	54.4	30.6
5.2 Investment to Total Assets	5.5	1.0	1.0	0.8	0.8	0.5	2.3

(a) Provisional
(b) Revised
(c) Before September 2022 Gross Non Performing Advances to Total Advances was considered
(d) Before September 2022 Provision Coverage Ratio was considered