Financial Stability Review 2023

Central Bank of Sri Lanka

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The Financial Stability Review (FSR) of 2023 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 primarily covers data up to end September 2023. However, more updated selected developments are also reported in the publication. Data may include calculations made specially for this publication based on information obtained from various sources.

Adhering to the Central Bank of Sri Lanka Act, No. 16 of 2023 which was enacted in September 2023, the Financial Stability Review will be published by 31st October each year commencing from 2024.

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Abbreviations

AE	Advanced Economies
AQR	Asset Quality Review
ASPI	All Share Price Index
AWCMR	Average Weighted Call Market Rate
AWDR	Average Weighted Deposit Rate
AWLR	Average Weighted Lending Rate
AWNDR	Average Weighted New Deposit Rate
AWPR	Average Weighted Prime Lending Rate
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BSI	Banking Soundness Index
CAR	Capital Adequacy Ratio
CBSL	Central Bank of Sri Lanka
CCoB	Capital Conservation Buffer
CCPI	Colombo Consumer Price Index
CCyB	Counter Cyclical Capital Buffer
CDR	Credit to Deposit Ratio
CEB	Ceylon Electricity Board
CET-1	Common Equity Tier-1
CNY	Chinese Yuan Renminbi
CoMap	Contingent Mapping
CPC	Ceylon Petroleum Corporation
CRIB	Credit Information Bureau
CSE	Colombo Stock Exchange
DBUs	Domestic Banking Units
DDO	Domestic Debt Optimisation
DMV	Department of Motor Vehicles
D-SIBs	Domestic Systemically Important Banks
DSTI	Debt Service to Income
EBIT	Earnings before Interest and Tax
EDR	External Debt Restructuring
ELA	Emergency Loans and Advances
EMDE	Emerging Markets and Developing Economies
ESG	Environment, Social and Governance
FC	Foreign Currency
FCMC	Financial Sector Crisis Management Committee
FIs	Financial Institutions
FSAP	Financial Sector Assessment Programs
FSI	Financial Stress Index
GFC	Global Financial Crisis
GOR	Gross Official Reserves
GWP	Gross Written Premium
ICA	Interconnectedness and Contagion Analysis
ICR	Interest Coverage Ratio
IDA	International Development Association
IDR	Issuer Default Rating
IFRS	International Financial Reporting Standards
iMaPP	Integrated Macroprudential Policy Database
IMF	International Monetary Fund
IMF-EFF	International Monetary Fund Extended Fund Facility
IPCC	Inter-Governmental Panel on Climate Change
IPO	Initial Public Offerings
ISBs	International Sovereign Bonds
LCB	Licensed Commercial Banks

LCR	Liquidity Coverage Ratio
LFCs	Licensed Finance Companies
LTV	Loan to Value
MOF	Ministry of Finance
MSD	Macroprudential Surveillance Department
MSME	Micro Small and Medium Enterprises
NBFI	Non-Bank Financial Institution
NDC	Nationally Determined Contributions
NFC	Non-Financial Corporate
NII	Net Interest Income
NIM	Net Interest Margin
NPB	Net Percentage Balance
NPL	Non-Performing Loans
OCC	Official Creditor Committee
OECD	Organisation for Economic Co-operation and Development
OMO	Open Market Operations
PAT	Profit After Tax
PMI	Purchasing Managers' Index
RHS	Right Hand Side
ROA	Return on Assets
ROE	Return on Equity
RWA	Risk Weighted Assets
SLAR	Statutory Liquid Assets Ratio
SLC	Specialised Leasing Company
SLDBs	Sri Lanka Development Bonds
SLDIF	Sri Lanka Deposit Insurance Fund
SLDIS	Sri Lanka Deposit Insurance Scheme
SLF	Standing Lending Facility
SLFR	Standing Lending Facility Rate
SLFRS	Sri Lanka Financial Reporting Standards
SOEs	State Owned Enterprises
SPD	Standalone Primary Dealers
SRC	Standing Rate Corridor
SRR	Statutory Reserve Ratio
SRS	Systemic Risk Survey
TCMC	Technical Committee on Financial Sector Crisis Management
USD	United State Dollar
WEO	World Economic Outlook

Executive Summary

The financial sector, which experienced an unprecedented array of challenges in the aftermath of the economic crisis, continued to operate under challenging conditions. The overall economic contraction during the nine months ending September 2023 coupled with tax hikes aimed at supporting fiscal consolidation; and elevated price levels and interest rates resulted in strained balance sheets of economic agents. Accordingly, financial intermediation[1] witnessed a considerable decline reflecting the subdued demand and supply conditions for credit amidst a considerable deterioration in credit quality. Financial sector exposure to the Government continued to increase amidst the fall in overall credit growth, highlighting imbalances that pose challenges to the financial sector. While the approval of International Monetary Fund's Extended Fund Facility (IMF-EFF) in March 2023 brought in confidence, ensuing developments such as uncertainties about the sovereign debt restructuring process and the results of the bank diagnostics exercise raised some concerns on the sector. Reflecting the early impact of monetary policy easing, the private sector credit-to-GDP gap (The Credit Gap), which reflects the status of the credit cycle, signals that the trough of the cycle had passed, and the cycle has entered the recovery phase.

With these developments, financial markets which witnessed extreme turbulence in 2022 demonstrated signs of stabilisation. Financial market's stress as indicated by the Financial Stress Index remained broadly at low levels in the first ten months of 2023 as overall market conditions significantly eased compared to 2022. Volatility of share market indices gradually subsided though investors continued to be attracted to high yield investments in the form of Government securities. Meanwhile, banking sector stocks also depicted high sensitivity to the Government debt restructuring process reflecting their high exposure to the sovereign. Comparatively subdued domestic macroeconomic conditions together with tight global financial conditions resulted in a low level of foreign investments in the domestic equity market. The anomalous interest rate structure in terms of elevated yields in the Government securities market gradually declined, although not completely, mainly supported by the dissipation of uncertainties following the Domestic Debt Optimisation (DDO) announcement, downward adjustments in the policy rates, reduced inflation, and anchored inflation expectations. The foreign exchange market which recorded an acute shortage of liquidity resulting in a significant depreciation of the Sri Lankan Rupee during 2022 witnessed an appreciation of the domestic currency with a gradual easing of liquidity conditions. Improvement in market confidence with the approval of the IMF-EFF and increased inflows through accelerated export proceed conversions, workers' remittances and tourist earning as well as restrictions on imports, Asian Development Bank and World Bank funds in the form of budgetary support contributed to the easing of liquidity conditions in the domestic foreign exchange market. However, augmented foreign currency (FC) demand to facilitate the exchange of Sri Lanka Development Bonds under the DDO and subsequent relaxation of import restrictions contributed to the build-up of depreciation pressure on the domestic currency particularly during Q3 of 2023. Domestic money market liquidity, which recorded a persistently high deficit during 2022, improved substantially during 2023 following the measures imposed by the Central Bank to reduce banks' over-reliance on the Central Bank's Standing facilities; liquidity injections through the provisional advances to the Government; forex absorptions by the Central Bank; reduction in the Statutory Reserve Ratio; liquidity provision via term reverse repo auctions; and Liquidity Assistance Facility granted to certain licensed banks. Further, restrictions imposed on the standing facilities supported the reactivation of money market transactions.

The banking sector, which was adversely affected by the spillover effects of the recent economic crisis, continued to operate amidst challenging conditions while some signs of improvement were observed during the year ending Q3 of 2023. Credit granted by the banking sector contracted during the period albeit some

1 Financial intermediation is measured as the credit to deposit ratio of the banking sector.

recovery was observed within Q3 of 2023. Credit risk of the banking sector as indicated by the Stage 3 Loans Ratio remained elevated, reflecting deteriorated debt servicing capacities of economic agents due to shrinking balance sheets amidst adverse economic conditions. However, stabilisation of credit risk was witnessed during Q3 of 2023 as indicated by the slowdown in the increase of Stage 3 Loans. Meanwhile, credit concentration risks persisted within the banking sector with some high credit concentration on certain sectors, namely, construction and agriculture, posing higher vulnerabilities due to economic and climate related issues. In addition, the high exposure of the banking sector to the sovereign posed concerns for the sector, which necessitated the exclusion of banking sector investments in Treasury bonds from the restructuring perimeter. Increased investments in Rupee-denominated Government securities resulted in a significant increase in liquidity ratios of the banking sector while overall utilization of Standing Lending Facility by the banking sector reduced significantly. FC operations of banks also witnessed a contraction during the period under review, particularly due to the significant decline in core FC assets despite the banking sector accumulating substantial amount of FC resources in the form of balances with financial institutions abroad. Meanwhile, profitability of the sector improved with reduced new impairment charges compared to the previous year though comparatively lower impairment may have negative consequences for future profitability of the sector. Furthermore, several banks including two Domestic Systemically Important Banks (D-SIBs) reported a decline in profits during the period. Capital adequacy of the banking sector improved as a result of the decline in risk weighted assets, primarily due to the decline in exposures to corporate and retail loans and receivables, although a significant decrease in the Capital Adequacy Ratio (CAR) was observed in D-SIBs during Q3 of 2023. Going forward, banks are required to focus on strengthening their capital buffers supported by profit generation, considering the potential losses due to debt restructuring, results of the bank diagnostic exercise, and realisation of forward-looking impact assessment, which would raise recapitalisation requirements within the banking sector.

The loans and advances portfolio of the Licensed Finance Companies (LFCs) sector contracted significantly during the year ending Q3 of 2023, particularly due to the restrictions on vehicle imports which affected leasing and hire purchase activities. Amidst the decline in the core business, the LFCs sector diversified its activities particularly towards pawning/gold loan facilities which heightened the sector's risk to fluctuations in global gold prices. The asset quality of the sector also deteriorated as indicated by the increase in stage 3 loans to total loans ratio. Meanwhile, overall liquidity of the sector remained at an acceptable level while few companies faced difficulties in meeting liquidity requirements. Exposure of the LFCs sector to the sovereign also increased amidst rising investments in Government securities. Moreover, the sector recorded an increase in profit, driven by higher revenue from interest income and other operating income along with reduced new impairment charges while capital adequacy also improved, with higher growth in regulatory capital compared to subdued growth in risk weighted assets, mainly due to the contraction of loans and advances amidst higher exposure to pawning/ gold loans advances and increase in risk-free investments. Successful implementation of the Masterplan for Consolidation of Non-Bank Financial Institutions (NBFIs) introduced by the Central Bank in the latter part of 2020 helped to build the confidence of the sector. However, the continued need for consolidation exists in the LFCs sector to ensure resilience. The insurance sector witnessed an increase in Gross Written Premium (GWP) with repriced policies amidst rising price levels while insurance claims also increased during the first half of 2023. Meanwhile, general insurance lagged behind long-term insurance in terms of profitability while liquidity ratios improved for both segments. In terms of capital adequacy, these segments showed a divergent performance with the general insurance segment recording a decline in the capital adequacy ratio while the same for the long-term insurance sector improved. Going forward financial institutions, particularly banks, LFCs and insurance companies would have to closely monitor their exposure to the sovereign and implement prudent measures to minimise such risks to ensure stability of the sector. Moreover, Sri Lanka's payment and settlement system exhibited resilience despite the dynamic nature of the financial landscape and the evolving digital payment systems during 2023.

The strained balance sheets of the household and the corporate sectors in the backdrop of the severe economic crisis which resulted in an erosion of real income levels amidst elevated price levels, hindered the debt repayment capacities of households and corporates. Household and the corporate sectors, which account for a significant share of financial consumers within the economy, witnessed a deterioration in credit quality during the period under review, highlighting concerns for the financial sector. While time-bound Non-Performing Loans (NPL) ratios of both the household and institutional sectors[2] increased during the period under review, the former was at a higher level indicating higher default risk within the household sector. Moreover, within the household sector, the NPL ratio of loans obtained for Micro Small and Medium Enterprises (MSME) purposes was higher compared to that of loans obtained for household purposes. Meanwhile, in terms of credit issuing institutions, although the banking sector accounted for the larger share of credit issuances, the NBFI sector reported higher NPL ratio compared to that of the banking sector, indicating the subpar credit quality of the NBFI sector. The Non-Financial Corporate (NFC)[3] sector also witnessed a deterioration in creditworthiness during the period under review as reflected by the decline in the Interest Coverage Ratio (ICR) and solvency of the sector which affected the credit quality of financial institutions. Meanwhile, these developments coupled with relatively high interest rates during the period under consideration discouraged both borrowers and lenders from initiating new credit facilities.

Numerous policy measures implemented by the Central Bank supported in ensuring financial stability during these turbulent times. The proactive build-up of the Capital Conservation Buffer (CCoB) and the D-SIBs Buffer by the Central Bank may enable the banking sector to weather the unexpected losses arising from the economic crisis to a certain extent. The Central Bank also took measures to strengthen financial stability through the establishment of the Emergency Loans and Advances facility for licensed banks and a robust institutional framework for crisis management along with the range of policy measures initiated under the IMF-EFF programme including Asset Quality Reviews (AQRs). A roadmap was also developed for restructuring and capital enhancement for selected banks. In addition, the Banking (Special Provisions) Act, No. 17 of 2023 defined the resolution authority of the Central Bank while measures were taken to strengthen the financial and institutional capacity of the Sri Lanka Deposit Insurance Scheme (SLDIS). Moreover, the Central Bank was designated as the Macroprudential Authority of the country under the Central Bank of Sri Lanka Act, No. 16 of 2023 enacted in September 2023. Accordingly, the Central Bank was vested with powers and the tools to achieve the macroprudential objectives mentioned therein. Within this context the framework for several other macroprudential policy tools were developed by the Central Bank. These included the Counter Cyclical Capital Buffer (CCyB), Loan to Value (LTV) ratio on Housing loans and Debt Service to Income (DSTI) ratio along with reviewing of the D-SIBs framework. These tools will be implemented as and when required to address systemic imbalances and strengthen buffers in an environment of conducive underlying conditions to strengthen the resilience of the financial sector. Moreover, the establishment of the stress testing framework, which includes dynamic solvency stress testing; liquidity stress testing; and interconnectedness and contagion analysis, enables the Central Bank to identify the build-up of systemic vulnerabilities in the banking sector, thereby facilitating a timely and informed policy making process.

Financial Stability Outlook

The easing of domestic monetary policy since mid-2023, is anticipated to facilitate the recovery in financial intermediation, which was witnessed through the gradual recovery in banking sector credit during Q3 of 2023. This is expected to lead to a rebound in domestic demand and economic activity as witnessed through the modest economic growth recorded in Q3 of 2023, improving income levels and alleviating pressure on the balance sheets of households and firms. Moreover, targeted stabilisation of domestic inflation at 5 per cent

2 Analysis is based on Credit Information Bureau data for the period up to end June 2023.
3 NFCs analysis is based on data on 209 corporations up to end September 2023 listed on the Colombo Stock Exchange.

in the medium term is expected to enhance the purchasing power of economic agents and improve their debt repayment capacities. Efforts are underway to address the Sovereign-Bank Nexus[4] through policy reforms, aiming to rectify financial intermediation imbalances in the medium to long run. Recent positive developments, such as reaching an agreement in principle with the Official Creditor Committee (OCC) and the Exim Bank of China, contribute to the stability in the Government securities market. The anticipated conclusion of External Debt Restructuring (EDR) is expected to further enhance stability. Efforts are also required to improve sustainable foreign currency inflows to prevent external sector imbalances along with prudent measures towards risk mitigation by the financial sector. Moreover, banks are expected to strengthen their capital buffers, considering the potential losses which may arise from debt restructuring, results of the bank diagnostic exercise, and realisation of forward-looking impact assessment.

Although it is expected that the existing macro-financial vulnerabilities would dissipate in the period ahead, with the envisaged improvements in the macroeconomic front, continued advancement along the policy reforms agenda envisaged in the IMF-EFF agreement is essential, particularly in the fiscal front to direct the economy and the financial system into stable grounds. Any deviation from this path would bring detrimental and irreversible consequences to the financial system and the economy, though moving along this arduous and narrow path is challenging. The instigation and operationalisation of strong and appropriate frameworks that proactively address vulnerabilities and implementation of timely, well sequenced, and consistent policies is also crucial to ensure the stability of the Sri Lankan financial system.

As the economy undergoes a monetary policy easing cycle, the credit cycle is expected to enter an expansionary phase, in which macroprudential concerns could build-up. The Central Bank commits to monitoring these developments closely and implementing necessary policy actions to mitigate systemic risks and ensure financial stability through macroprudential interventions.

4 Sovereign-Bank Nexus is the interconnectedness between the sovereign and banking sector, to a degree that vulnerabilities in one sector could spillover to the other creating adverse feedback loops affecting their financial health.

MACROFINANCIAL CONDITIONS

Domestic macrofinancial developments continued to pose challenges to the financial stability

Economic contraction

- Prolonged impact of COVID-19
- Socio-political & economic uncertainties
- Elevated prices and tax
- Monetary tightening

Increased unemployment strained debt repayment capacity

Credit risk of financial institutions increased

Financial intermediation continued to decline

Market interest rates are adjusting downward

Banking sector exposure to real estate remains elevated

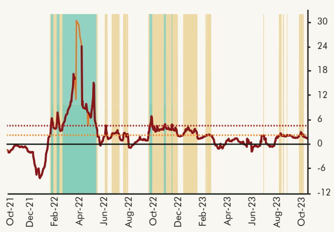
Financial Institutions' exposure to Government and SOEs have increased

Foreign investment inflows remained low

FINANCIAL MARKETS

Stress in domestic financial markets was low

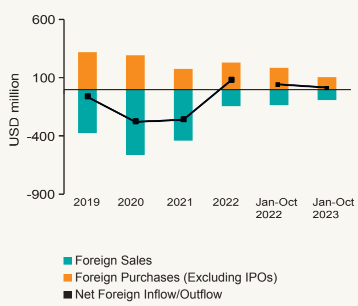
Financial Stress Index



25.4% ASPI

13.6% S&P SL20

Foreign interest in shares was low



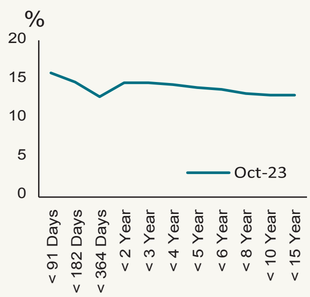
Government securities yields declined

364-day T-bill yield

31 Aug 2022: 30.5%

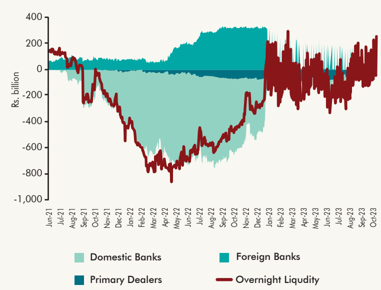
25 Oct 2023: **13.0%**

Secondary market yield curve



A net foreign inflow of $ 305.3 mn was recorded during the first 10 months of 2023 in domestic Government securities market

Money market liquidity improved



Rs **Appreciated against USD 10.9%**

Jan - Oct

Central Bank Intervention in the domestic Forex market

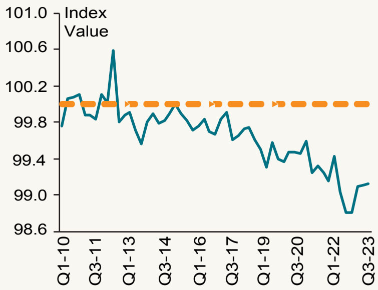
Net Absorption **$ 1,665.8 mn**

Absorption $ 2,491.5 mn

$ 825.7 mn Injection

BANKING SECTOR

Banking Soundness Index improved amidst challenging operating environment

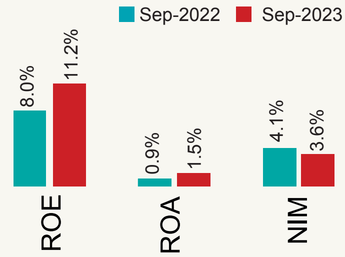


Credit contracted
6.2% y-o-y

Net Stage 3 to CET1
2023 Q3 **64.5%**
2022 Q3 60.5%

Net interest income declined
particularly in D-SIBs

PAT significantly improved
mainly due to decline in new impairment allocation by banks



Liquidity Ratios improved

43.8% SLAR

336.6% Rupee LCR

Stage 3 Loans Ratio **13.6%**

Sovereign Exposure increased » **RWA contracted** » **Capital Adequacy improved**

78.3% **Rupee Government securities/liquid assets (DBUs)**

43.4% **Sovereign exposure/total assets**

CAR
2023 Q3 **16.4%**
2022 Q3 15.3%

LICENSED FINANCE COMPANIES SECTOR

Loans and advances
- 5.6% y-o-y

Leasing reduced with import restrictions
Pawning increased with diversification

Non-performing loans have risen

DEBT

Sources of funding

Deposits increased

Borrowings declined

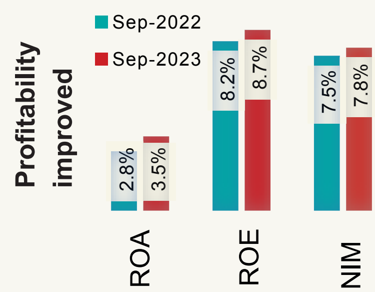
Rs
Rs

Capital increased

Funding pressure of the sector decreased

Sovereign exposure is gradually building up

CAR
2023 Q3 **22.6%**
2022 Q3 21.5%



INSURANCE SECTOR

Gross Written Premium (y-o-y)

GWP increased due to higher repricing of policies

Long-term	General	Total Industry
10.4%	7.2%	8.9%

Claims were high due to elevated health and repair costs

CAR of Insurance Industry

Long-term	General
2022 Q2 276%	2022 Q2 223%
2023 Q2 **352%**	2023 Q2 **192%**

Profitability of general insurance segment was low compared to life insurance

44.0% **Sovereign exposure/ total assets**

HOUSEHOLD AND CORPORATE SECTORS

Household Sector Credit Growth (y-o-y)

2022 Q4	2023 Q1	2023 Q2
-2.8%	-6.4%	**-6.0%**

Household sector credit declined due to:

- Diminished demand for new loans
- Stringent credit screening by FIs
- Deteriorating real income levels
- High living costs

Household Sector NPL ratio

2022 Q4	2023 Q1	2023 Q2
15.7%	16.2%	17.7%

Share of Household Sector Debt allocated to Western Province

50%

Revenue growth of NFCs slowed down

Net profit declined

Solvency declined affecting NFCs' financial strength

	Revenue Growth	Net Profit Growth	ICR	Net Profit/Debt	Debt/Equity
2022 M9	51.6%	112.1%	3.1	45.0%	0.47
2023 M9	**2.5%**	**-53.3%**	**1.8**	**18.4%**	**0.48**

1

Macrofinancial Conditions

Domestic macrofinancial developments continued to pose challenges to financial stability during the year ending Q3 of 2023. Reflecting the overall economic contraction observed during the period concerned, tax adjustments and elevated price levels due to past increases in inflation, a rise in Non-Performing Loans (NPLs) ratios was observed as households and corporates faced balance sheet strains and narrowed debt repayment capacities. Meanwhile, domestic business conditions have shown a gradual improvement yet remain below the neutral threshold while domestic inflation reached single digits since July 2023 after historically high levels prevailed in 2022. Financial intermediation continued to rapidly decline during the period under consideration, which is an anticipated outcome of unprecedented monetary tightening in the past. Subsequent to the dissipation of uncertainties surrounding the Domestic Debt Optimisation (DDO); and the decline in inflation expectations, inflation and the risk premia, anomalies observed in the interest rate structure of the economy during the recent past are correcting gradually. As such, Government securities yields declined substantially while other market interest rates also adjusted gradually. Meanwhile, banking sector exposures to real estate related activities remain elevated, with the stagnation observed in property prices and potential liquidity constraints faced by developers, posing elevated credit risks. Banks' tilted exposure to the Government created imbalances in financial intermediation and intensified the Sovereign-Bank Nexus. The credit cycle, as reflected by the Credit to GDP Gap, underwent a high oscillation phase indicating heightened financial sector stress in the recent past. However, it appears that the credit cycle passed a deep trough and entered into a recovery phase.

With the domestic monetary policy easing since mid-2023, financial intermediation is expected to recover, and domestic demand and economic activity are anticipated to rebound, thereby improving income levels, and easing the pressure on balance sheets of households and firms. Domestic inflation is expected to stabilise in its targeted level of 5 per cent in the medium term, easing the pressure on economic agents' purchasing power, while improving their debt repayment capacities. Meanwhile, the continuance of muted global economic growth outlook and geopolitical fragmentation, if worsened could create financial stability implications via strained foreign currency inflows amid high import expenditure affecting the domestic foreign exchange market liquidity conditions. The Sovereign-Bank Nexus and Banks' tilted exposure to the Government are being addressed through policy reforms, which will correct financial intermediation imbalances in the medium to long run. The country's recent success of arriving at an agreement in principle with the Official Creditor Committee (OCC) and the Exim Bank of China is a positive development and the envisaged conclusion of External Debt Restructuring (EDR) is expected to bring further stability in the Government securities market. It is expected that these positive developments will enable the financial system to flow credit to the economy gradually, thus, supporting monetary policy transmission. Further, as the economy is moving in a monetary policy easing cycle, it is expected that the credit cycle will enter an expansionary phase, in which macroprudential concerns could build up. As such, the Central Bank will monitor the developments diligently and take necessary policy actions to reduce the buildup of systemic risk to ensure financial stability through appropriate macroprudential policy interventions.

1.1 International Economic Environment and Financial Conditions

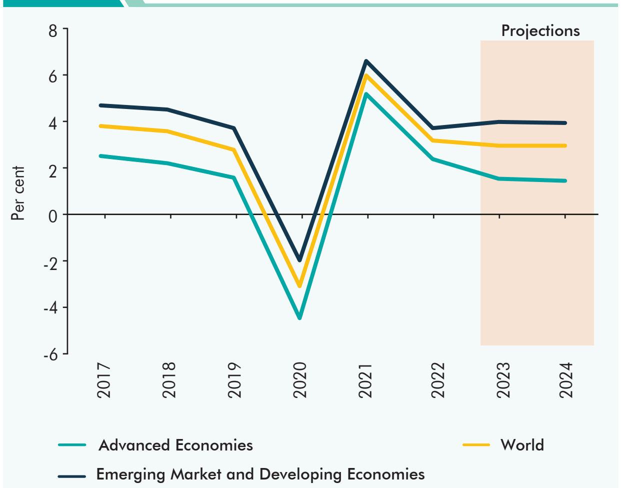
Global Macrofinancial Developments and Outlook

Uncertainties surrounding the global financial and economic outlook remain elevated amid declines in global economic activities and investments. Long-term economic effects of the pandemic, the war in Ukraine and the increasing geoeconomic fragmentation, unprecedented monetary tightening policies adopted to tame inflation, withdrawal of fiscal stimuli amid high and rising fiscal debt levels, sovereign bank nexus and extreme weather events, contribute to suppress the global economic recovery and widen growth divergences among regions. Despite these persistent challenges, declining headline inflation levels, COVID-19 no longer being recognised as a global health emergency, reorientation of global supply chains and the signs of easing global financial conditions, somewhat offset the slowdown in the global economy. Amidst these developments, global investments have fallen short of pre-pandemic trends across regions. Meanwhile, global divergences extend to the labour markets. Considering the complex interplay of factors shaping the path of recovery, while recognising challenges and divergences persisting across regions, the International Monetary Fund's (IMF) October 2023 World Economic Outlook (WEO) updated its projections of global growth to fall from 3.5 per cent in 2022 to 3 per cent in 2023 and 2.9 per cent in 2024. However, the ongoing war in the Gaza region could create regional and global repercussions if it escalates to the neighbouring regions and leads to oil and gas price surges, elevated production, and transport costs and ultimately an upward pressure on global inflation.

Global Manufacturing and Trade

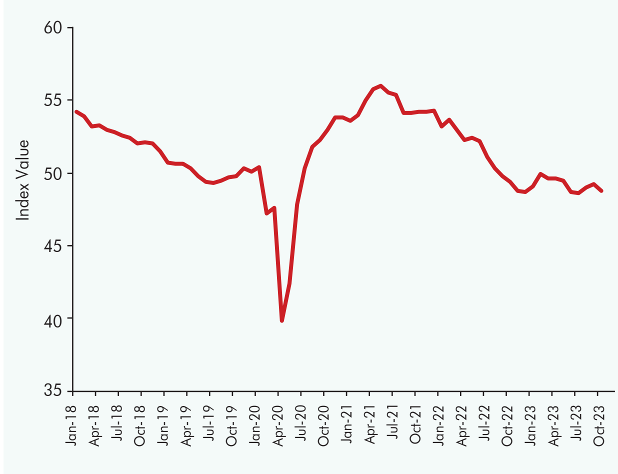
The contraction in global manufacturing and global trade growth thus far in 2023 is anticipated to persist. The Global Manufacturing PMI continued its declining trend until October 2023, reflecting the longest sequence of deterioration after nearly two decades. The decline is primarily observed in intermediate and investment goods industries, contrasting with a rise in consumer goods production. With the weakened demand, new orders decreased for the sixteenth straight month in October 2023, impacting international trade flows, with new export business falling for the twentieth consecutive month. Due to the weakened demand and the muted outlook, manufacturers reduced staffing, purchasing, and inventory holdings towards October 2023, which indicates the continuation of the decline in manufacturing for some time. Meanwhile, global trade growth also slowed, which is attributed to tighter monetary policies; slowing output across the world; property market strains in China preventing a stable recovery; and persistent inflation, particularly in the US and the EU, hindering spending capacities and

Figure 1.1 Global Economic Growth



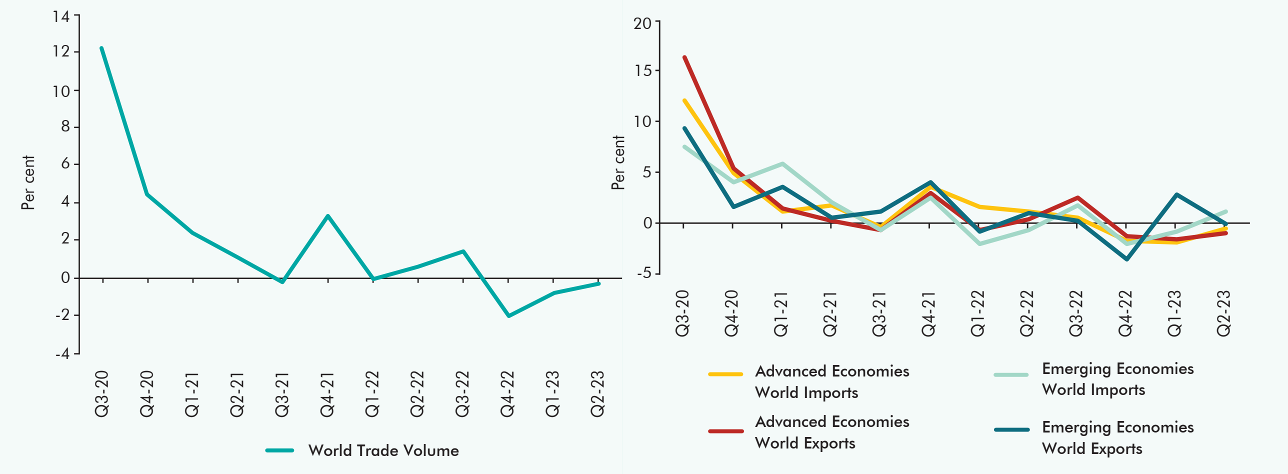
Source: IMF World Economic Outlook October 2023

Figure 1.2 Global Purchasing Managers' Index



Source: S&P Global

Figure 1.3 World Trade Volume (Q-o-Q Change)



Source: CPB World Trade Monitor

weighing down the demand. Geopolitical tensions and long-term shifts in consumption patterns occurred during COVID-19 pandemic further contribute to uncertainties and gloomy trade outlook for 2023.

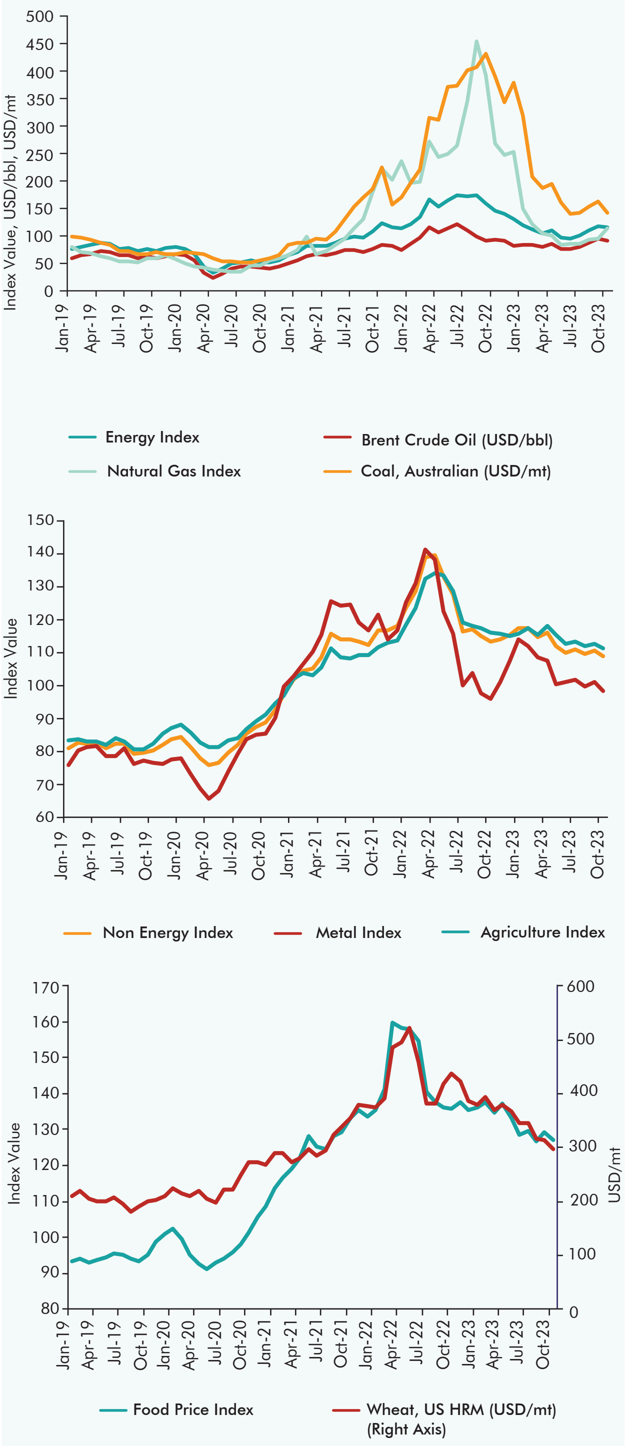
Global Commodity Prices, Inflation and Monetary Policy

Global commodity prices are on a declining trend from peaks observed in mid-2022, albeit remaining above pre-pandemic levels and with high upside risks. Commodity prices surged after the Russia-Ukraine war, but the effect was negated due to the sluggish demand pressure owing to slowdown in the global economy; favourable winter weather conditions reducing the demand for energy; and a global re-orientation of commodity trade. The World Bank's Commodity Market Outlook sees a limited impact from the conflict in the Gaza region, with commodity prices expected to fall further in 2024 and 2025, driven by weak global growth. Nevertheless, it is expected that prices will remain above pre-pandemic levels and weigh down the affordability of consumers. Geopolitical risks, especially if the Gaza conflict escalates and spreads in the region leading to substantial supply disruptions, trade restrictions and production cuts; adverse weather events that increase demand or disrupt supply and trade flows; and uncertainties related to global economic growth, particularly a stronger than expected recovery in the Chinese economy, could affect demand and supply conditions in commodity markets and cause price increases.

Global inflation decreased from its peak in 2022, driven by falling energy and food prices, albeit with a slow decline in core inflation. Owing to lower global demand, which was driven by tighter global monetary policy, prices of energy and food have fallen, causing a decline in headline inflation. As such, global inflation is forecasted to decline from 8.7 per cent in 2022 to 6.9 per cent in 2023 and decline to 5.8 per cent in 2024 by the IMF in their October 2023 WEO. However, the decline in core inflation remains sluggish, which signals that global monetary policy easing would be delayed and slow.

Persistent global inflation, which remains above pre-pandemic levels, necessitates Central Banks to maintain tight monetary policies. While core inflation remains high, particularly in advanced economies, progress of declining inflation towards the pre-pandemic levels in emerging markets appears to be better, amid divergences across regions. Furthermore, widening divergence of inflation and economic outlook may indicate the start of global monetary policy desynchronisation. In the IMF's Global Financial Stability Report of October 2023, the importance of central banks remaining vigilant against inflation; cautious emerging markets' monetary policy adjustments; implementation of robust policies in China's real estate sector; and enhancing financial sector regulation to mitigate risks have been highlighted. Despite maintaining tight monetary policy, potential risks of sharp repricing of assets including housing, weaknesses in key exposures such as real estate and geopolitical issues raise global financial stability concerns.

Figure 1.4 Global Commodity Prices

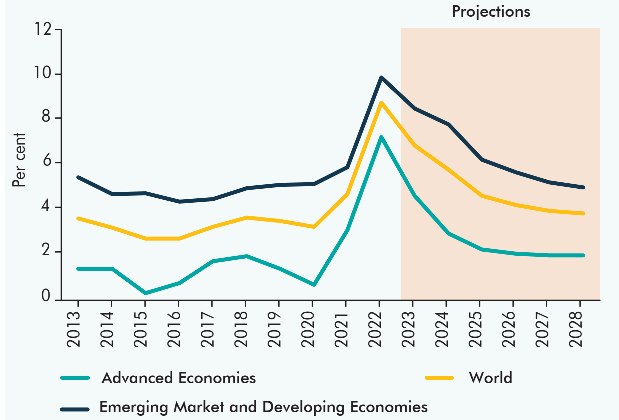


Sources: World Bank, FAO

Global Financial Markets

Tight monetary policy and financial conditions have led to a contraction of liquidity conditions across global markets. Accordingly, the Global Liquidity Indicator compiled by the Bank for International Settlements (BIS), which tracks USD

Figure 1.5 Global Inflation

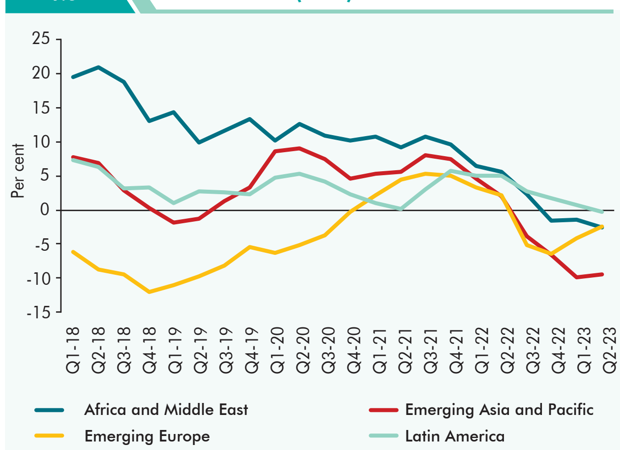


Source: IMF World Economic Outlook October 2023

credit to non-bank borrowers outside the US, indicated a contraction in USD credit to emerging markets and developing economies during the first half of 2023, compared to 2022. The unprecedentedly fast monetary tightening across the world, coupled with the gloomy economic outlook and increased sovereign exposures may have reduced the financial intermediation capacity and shifted the risk appetite of lenders and investors. As such, the IMF's October 2023 Global Financial Stability Review states that the liquidity strains in equity and foreign exchange markets have somewhat stabilised, but sovereign bond markets continue to face liquidity challenges.

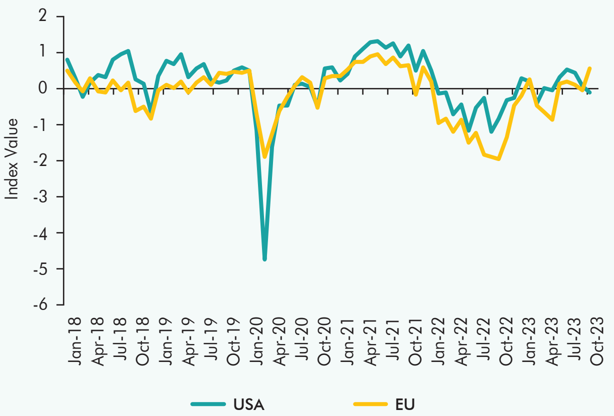
Financial conditions in advanced economies, particularly the US, mildly eased, while lending conditions tightened and demand for loans remained subdued. Financial conditions, which reflect the cost of funding, eased, driven by investors'

Figure 1.6 Growth in Foreign Currency Credit (USD) to EMDEs



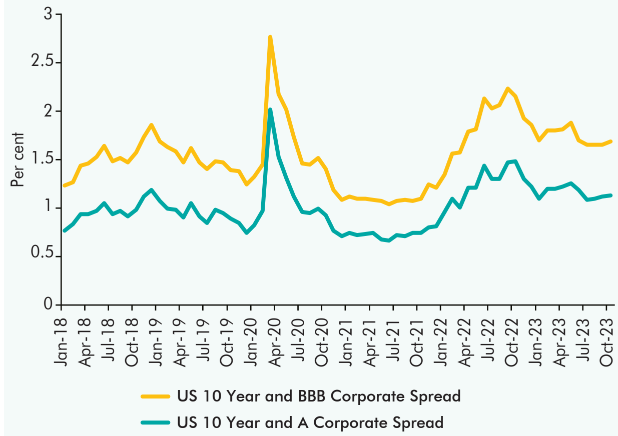
Source: Bank for International Settlements

Figure 1.7 Bloomberg Financial Conditions Index



Source: Bloomberg

Figure 1.9 US Corporate Bond Spread

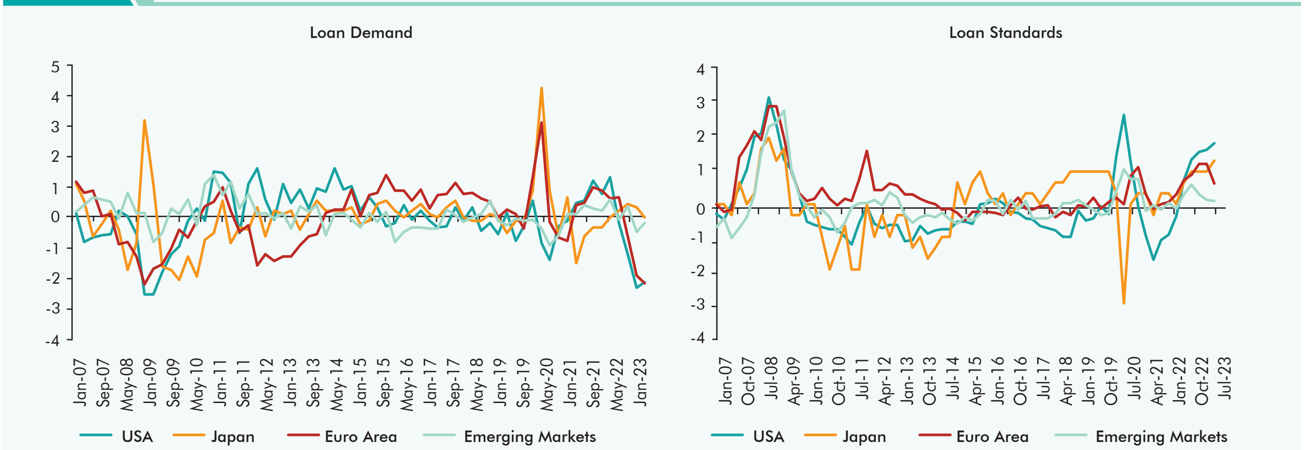


Source: Bloomberg

expectations on fast reduction in inflation, despite ongoing monetary tightening. The narrowing of equity and corporate bond market risk premia positively impacted corporate valuations in the US. Credit market spreads on US Corporate bonds declined from the latter part of 2022 reflecting the strong economic recovery of the US. Nevertheless, vulnerabilities in emerging markets remain. In China, concerns about the economic recovery and financial stability risks have negatively impacted the investor confidence. However, lending conditions have tightened with more restrictive standards and terms, especially in the euro area, the US, and some emerging markets due to concerns on borrower risk, economic outlook, and bank funding constraints. Meanwhile demand for loans remained subdued due tightened lending standards.

Global equity market indices have been on a declining trend since mid-2023 amidst uncertainties surrounding the global financial and economic outlook. The global equity market outlook for 2023 appears uncertain amidst potential challenges such as delayed Central Banks' monetary policy normalisation, geopolitical tensions, and expectations of a potential delay in global economic recovery. However, there is a positive outlook for Japan's equity market, where the equities are expected to continue to outperform other advanced economies' stocks with continued monetary policy easing, stronger corporate profits, and weak Yen, making Japanese stocks more attractive to foreign investors. Nevertheless, the overall global equity market outlook is clouded by economic and geopolitical uncertainties.

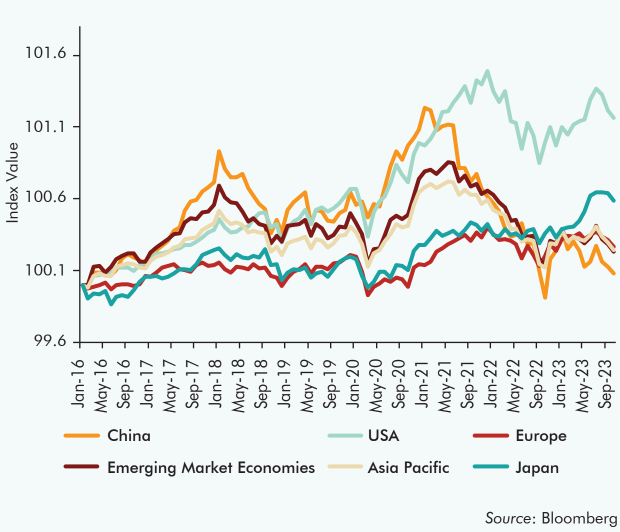
Figure 1.8 Bank Lending Standards and Reported Bank Loan Demand*(Standard Deviation)



* Note : For loan demand, positive values indicate stronger demand; negative values indicate weaker demand. For loan standards, positive values indicate tighter standards; negative values indicate looser standards.

Source : IMF Global Financial Stability Review October 2023

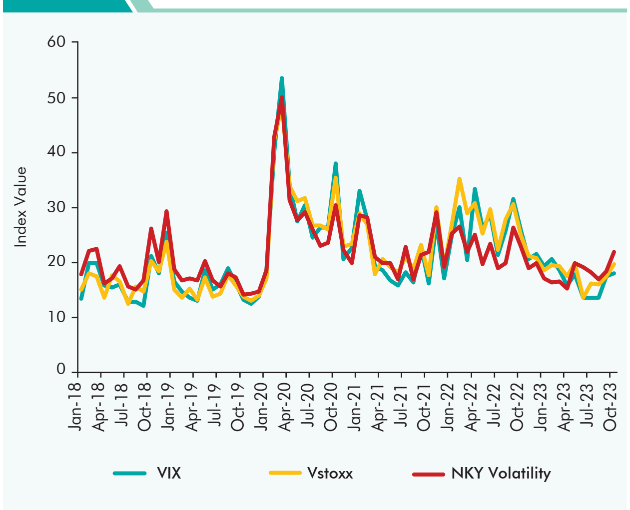
Figure 1.10 MSCI Share Price Indices



Source: Bloomberg

Stock markets' expected price volatility indices declined, indicating decreased levels of expected volatilities until mid-2023 and reversed thereafter mirroring the movements in global stock market indices. The VIX index, which measures the volatility of the S&P 500 index, the VSTOXX index which is based on the EURO STOXX 50 and the NKY Volatility index, which indicates the expected volatility of the Tokyo Stock Exchange all moved in a declining trend until mid-2023. However, the declining trend reversed in the second half of 2023. The uneven recovery of global liquidity, financial and lending conditions, continues to reflect uncertainties in global financial markets, while geopolitical tensions could also affect stock market volatilities going forth.

Figure 1.11 Behaviour of Volatility Indices



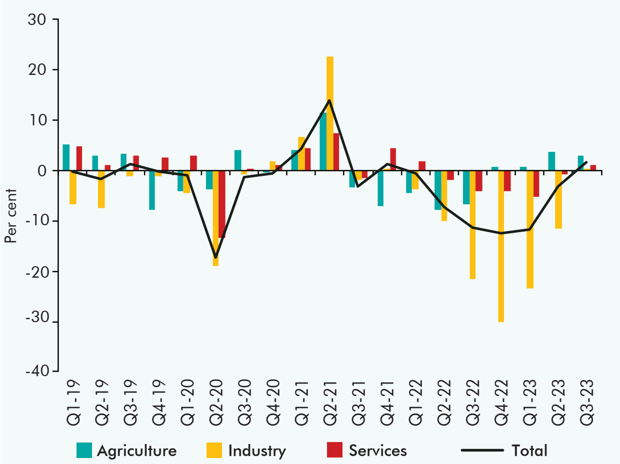
Source: Bloomberg

The continuance of muted global macrofinancial conditions could have an adverse impact on the domestic financial system. Sluggish global economic growth and trade, especially in export destinations and tourism origins, alongside relaxed domestic import restrictions and the gradual removal of foreign exchange restrictions could lead to tight liquidity conditions in the domestic foreign exchange market. Although the US economy is showing signs of recovery, the recovery of Sri Lankan apparel exports to the US, which is country's largest apparel export destination, appears to be sluggish. Further, global monetary tightening amid domestic monetary easing had already led to foreign investment reversal from the Government securities market, further exerting pressure on the domestic foreign exchange market. Although the impact of the Gaza conflict on commodity prices is low at present, if it escalates, it could destabilise migrant worker destinations and commodity markets and may have spillover effects on domestic foreign exchange market liquidity conditions via increased import expenditure, and moderation in workers' remittance inflows.

1.2 Domestic Macrofinancial Conditions

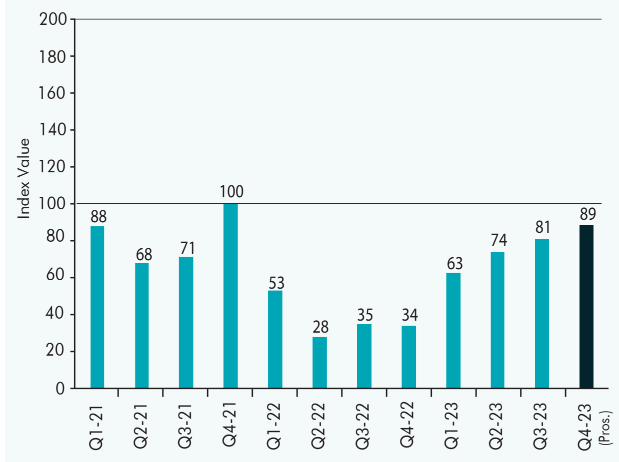
The economic contraction, high inflation and reduced income generating capacities which strained households and corporates balance sheets exerted pressure on financial institutions through aggravated credit risk. The overall economic contraction observed during the period concerned was a combined result of the prolonged impact of COVID-19 related economic slowdown; social, political, and economic uncertainties prevailed in 2022; and the aggregate demand shrinkage due to high inflation and unprecedented monetary tightening in the past and ongoing fiscal tightening. The unemployment rate increased during Q2 2023, while the wage rate indices indicate a continuous deterioration of household real income. The combined impact of the economic contraction, high inflation and tax adjustments weighed heavily on debt repayment capacities of households and firms, leading to a rise

Figure 1.12 Quarterly GDP Growth



Source: Department of Census and Statistics

Figure 1.14 Business Conditions Index



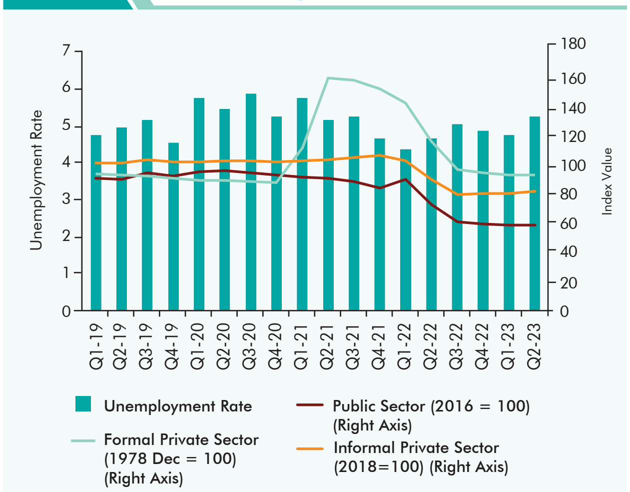
Source: Central Bank of Sri Lanka

in NPLs ratios of lending institutions and raised credit risk concerns. Furthermore, elevated price levels and interest rates hindered the borrowing capacities of economic agents. However, effects of monetary policy easing since mid-2023 are expected to flow through market interest rates and into the economy, boosting domestic demand and economic activity in the medium term. Along with expected improvements in economic activity and income, the pressure on balance sheets of households and firms is expected to gradually ease the credit risk of financial institutions.

Reflecting the domestic economic outlook, domestic business conditions are edging up, but still remain below the neutral threshold. The Business Conditions Index, compiled by the Central Bank as per the findings of the Business Outlook Survey, moved upwards in the adverse territory towards the neutral threshold. This indicates that business conditions deteriorated at a slower pace than in the previous quarters. Respondents cited the challenging macroeconomic environment as the main reason for weak business conditions. However, demand, sales and capacity utilisation improved during Q3 2023 and are expected to continue improving in Q4 2023 on a year-on-year basis.

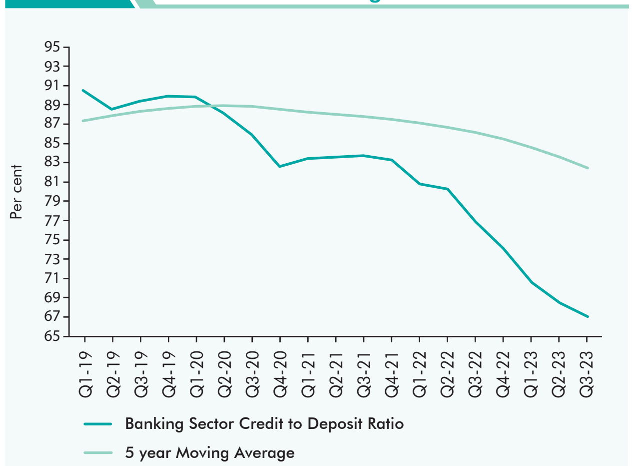
Financial intermediation, as measured by the Credit to Deposit Ratio (CDR) continued its rapid decline during the period concerned, which is an intended outcome of past unprecedented monetary policy tightening. Nevertheless, market

Figure 1.13 Unemployment Rate and Real Wage Rate Indices



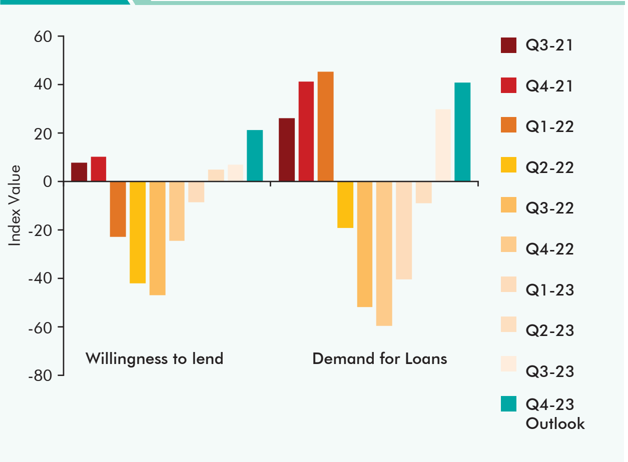
Source: Department of Census and Statistics

Figure 1.15 Credit to Deposit Ratio of the Banking Sector



Source: Central Bank of Sri Lanka

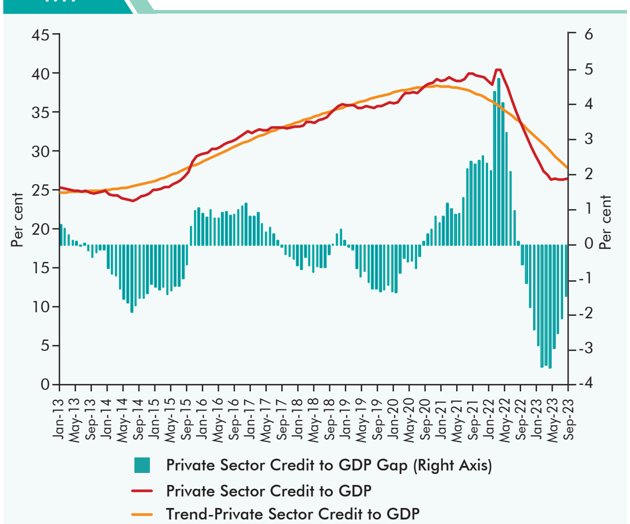
Figure 1.16 Movement of Credit Supply Survey Indices



Source: Central Bank of Sri Lanka

interest rates are adjusting downwards in response to the monetary policy easing commenced in June 2023 by the Central Bank along with falling risk premia following the finalisation of the DDO. The effects of monetary policy easing are expected to be reflected in financial intermediation, albeit with a time lag. However, the adjustment in lending interest rates is generally slower than deposit rates during a monetary policy easing cycle. In order to catalyse the monetary policy transmission, the Central Bank directed licensed banks to reduce lending interest rates in line with the easing of monetary policy and reductions in inflation expectations and risk premia. Further, as per the findings of the Credit Supply Survey for Q3 2023 of the Central Bank, banks' willingness to lend and demand for loans have increased in Q2 and Q3 of 2023 in comparison to corresponding previous quarters.

Figure 1.17 Private Sector Credit to GDP



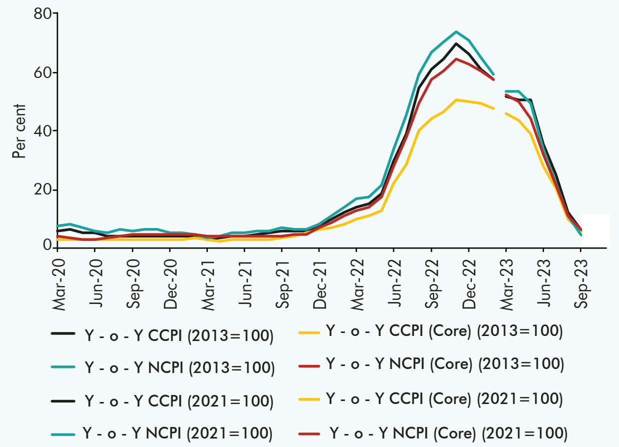
Source: Central Bank of Sri Lanka

Reflecting the early impact of monetary policy easing, the private sector credit-to-GDP gap (The Credit Gap) , which reflects the status of the credit cycle, signals that the trough of the cycle had passed, and the cycle has entered the recovery phase. The Credit Gap is an indicator used to determine the status of the credit cycle and a useful early-warning signal of the build-up of stress in the financial system. The Credit Gap exhibited a high oscillation in the current cycle, compared to past cycles, indicating the excessive buildup of risks in the system compared to recent past and the subsequent downturn. The Credit Gap, which was on a declining phase from mid-2022, appears to have bottomed out and is in the recovery phase, moving in line with the monetary policy easing commenced in June 2023.

Subsequent to historically high inflation levels during 2022, inflation reached single-digit levels owing to the lagged impact of tight monetary policy, normalisation of domestic supply side bottlenecks, appreciation of the domestic currency, the downward adjustment of global commodity prices and the base effect. The Central Bank expects inflation to stabilise at the targeted level of 5 per cent in the medium term, albeit upside risks prevail, among which some are transitory. Value Added Tax adjustments will directly affect consumer prices. Meanwhile unfavourable weather conditions may also have a negative impact on the agricultural output, which could result in transitory food price hikes. Furthermore, if upside risks on global inflation materialises, it could pass through to domestic prices. Amid these upside risks, the elevated price level due to past increases in inflation and tax adjustments continues to keep expenditures of borrowers elevated which may raise credit risk.

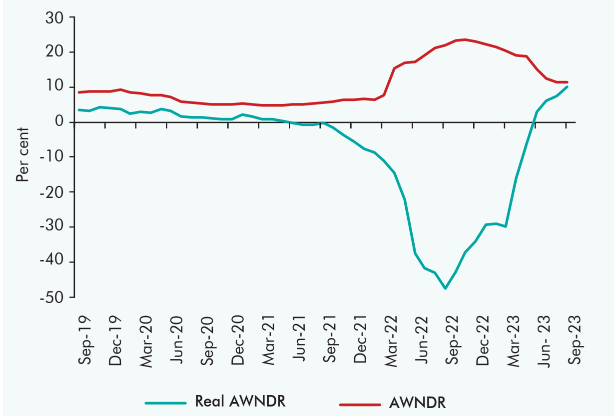
Anomalies which prevailed in market interest rates during the previous periods, are adjusting alongside the declining inflation rate and the gradual decline in government security yields with the reducing risk premia owing to the DDO. With the Central Bank reducing its policy rate from June 2023 onwards, the Average Weighted Deposit Rate (AWDR), Average Weighted Lending Rate (AWLR) and Average Weighted Prime Lending Rate (AWPR) are declining, although at different paces.

Figure 1.18 **Inflation**



Source: Department of Census and Statistics

Figure 1.20 **AWNDR and Real AWNDR**



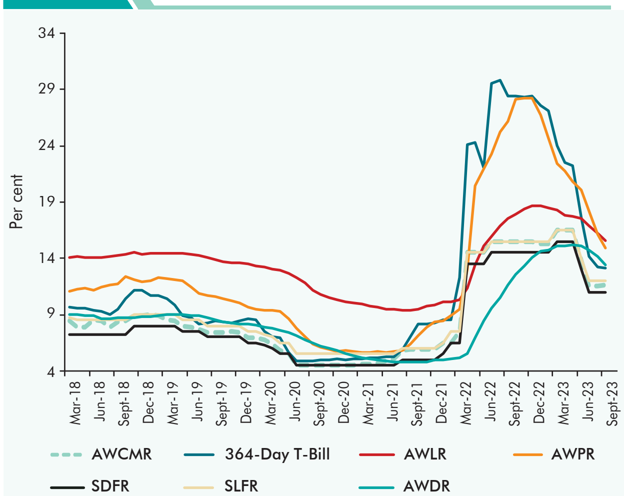
Source: Central Bank of Sri Lanka

The real Average Weighted New Deposit Rate[1] (AWNDR) which remained in the negative territory since July 2021, bottomed out in September 2022 and turned positive since June 2023. The dissipation of uncertainties surrounding the DDO perimeter, after its announcement, and the decline in inflation expectations, the yields of Government securities have been declining, albeit remaining above deposit rates. Furthermore, there is a notable gap between Government securities yields and policy rates. Moreover, the yield curve of government securities shifted downwards, albeit remaining inverted reflecting a pessimistic investor sentiment. The anomalies in the interest rate structure could hinder the ability of the financial system to flow funds through the economy and facilitate monetary policy transmission effectively. Nonetheless, market interest rate anomalies are expected to adjust gradually in the period ahead and enable the financial system to flow credit to the economy gradually, thereby supporting monetary policy transmission and the expected rebound of domestic economic activity.

Banking sector exposure to real estate related activities remained elevated during the period concerned. The combined impact of the upsurge of condominium prices owing to increased construction costs and taxes imposed on condominiums, the reduced purchasing power of buyers due to elevated prices and taxes and the inclusion of relatively low-priced units from suburban areas to the market

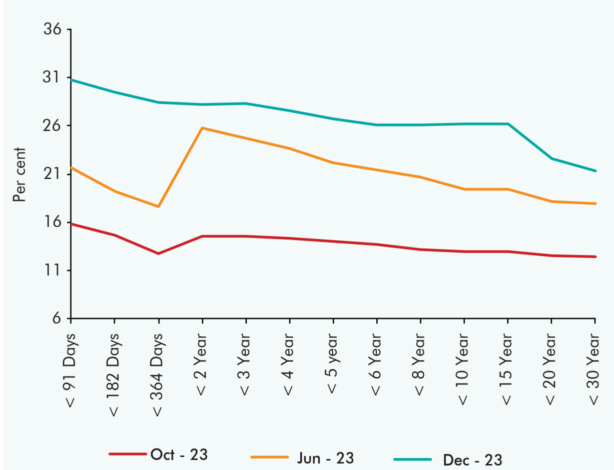
1 Real AWNDR is computed by adjusting AWNDR for inflation measured through the Colombo Consumer Price Index (CCPI).

Figure 1.19 **Market Interest Rates**



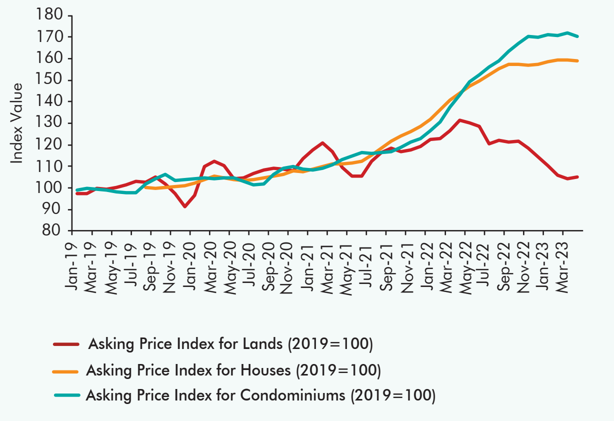
Source: Central Bank of Sri Lanka

Figure 1.21 **Secondary Market Yield Curve of Government Treasury Bills and Bonds**



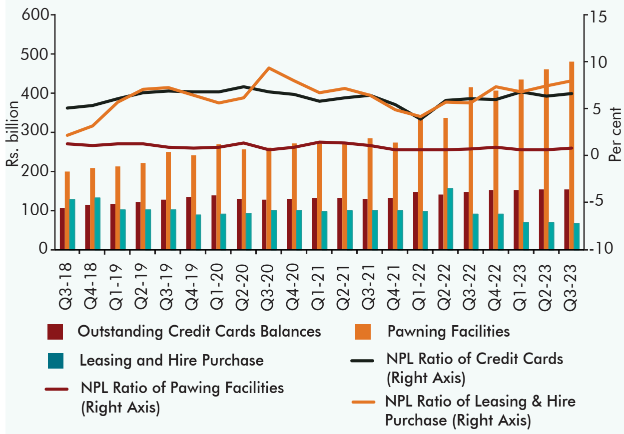
Source: Central Bank of Sri Lanka

Figure 1.22 Property Price Indices



Source: Central Bank of Sri Lanka

Figure 1.25 NPLs of Selected Loan Categories

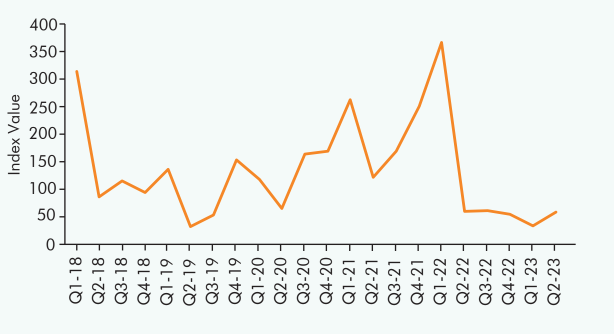


Source: Central Bank of Sri Lanka

had created an overall stagnation of prices by mid-2023, as per the Asking Price Indices for lands, houses and condominiums. Furthermore, purchases of condominiums for investment purposes and renting out have declined. However, purchases of condominium for immediate living have increased in Q2 of 2023, which could be due to the availability of affordable units for sale in the market in suburban areas. Further, as per the Condominium Market Survey conducted by the Central Bank for Q2 2023, there is an indication of stagnation in the industry owing to reduced sales volumes and rising construction costs. If this stagnation in the industry persists, developers may encounter liquidity constraints that could lead to delays in completing projects, affect buyers' confidence on the market and raise the credit risk attached to such exposures of banks. A large proportion of condominium developers' funding is through pre-sale deposits and bank loans. Moreover, increase in exposure levels of bank and non-bank to credit cards, pawning facilities and the increase in NPL ratios of credit cards, leasing and hire purchase, and pawning remains a concern in the prevalent context of strained household income and spending capacities.

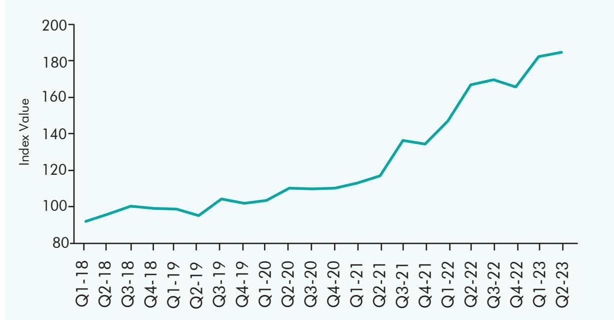
Exposure of financial institutions to the Government and Public Corporations have increased surpassing the exposure to the private sector. Exposure of financial institutions to the Government and public corporation as a share of total exposure increased to 53.0 per cent as at end August 2023, from 35.6 per cent by end 2019. High exposure of banks, particularly State Banks to the Government had created a tilt in financial intermediation towards the Sovereign and intensified the Sovereign-Bank Nexus. However, with reforms envisaged in the IMF EFF programme, such imbalances are expected to be corrected in the medium to long run. Government securities held by the banking sector was excluded

Figure 1.23 Condominium Property Volume Index



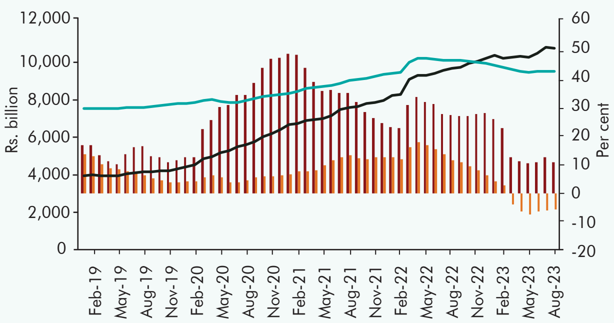
Source: Central Bank of Sri Lanka

Figure 1.24 Price Index for New Condominiums



Source: Central Bank of Sri Lanka

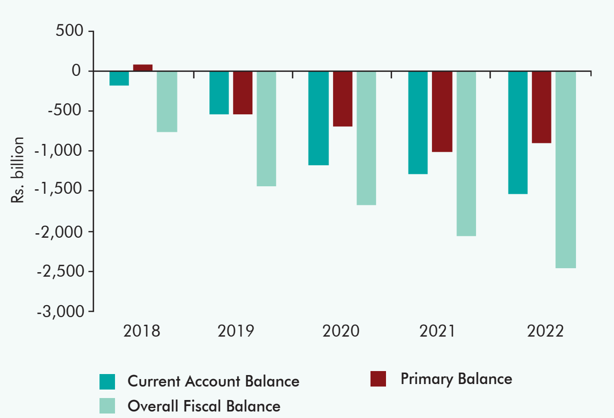
Figure 1.26 Exposure of Public and Private Sector



Source: Central Bank of Sri Lanka

from the DDO to ensure the financial stability as the exposure was significantly high. However, foreign currency denominated Sri Lanka Development Bonds (SLDBs) held by banks were exchanged to Rupee denominated Treasury Bonds under the DDO. Market sentiment towards the Sovereign had somewhat improved after the completion of DDO. Accordingly, after the completion of the DDO, Fitch Ratings upgraded Sri Lanka's Long-Term Local-Currency Issuer Default Rating (IDR) to 'CCC-'and S&P Global Ratings raised Long-Term Local Currency sovereign credit rating to 'CCC+' with a "stable" outlook. The DDO and associated reduction in the yields somewhat eased the pressure on cash flow requirements of the Government, while partially correcting the imbalances in the interest rate structure of the economy. With the envisaged conclusion of EDR, in which the country's recent success of arriving at an agreement with the Paris Club is a step forward, further adjustments in the market rates and sentiments are expected. Furthermore, the Central Bank of Sri Lanka Act, which was enacted in September 2023 restricts monetary financing, which further encourages effective Government expenditure rationalisation and revenue administration. Accordingly, the Cabinet of Ministers approved maintaining an adequate cash buffer by the Government going forward. Such developments towards Government debt sustainability would improve market sentiments and help adjust anomalies in the interest rate structure further. Such favourable fiscal developments would also prompt rating upgrades and create positive feedback loops on macroeconomic and financial stability. Fiscal consolidation together with state-owned banks and enterprise reforms envisaged under IMF EFF[2] are expected to bring down excessive exposure of the banking sector to the sovereign and thereby correct the existing tilt in financial intermediation towards the sovereign and facilitate an increase in credit flows to the private sector in the medium to long-term.

Figure 1.27 Major Fiscal Balances



Source: Ministry of Finance, Economic Stabilisation and National Policies

Foreign investment inflows were tilted towards the Government securities market during H1 2023 and reversed in H2 2023 after yields declined, amidst tight global financial conditions. Monetary authorities around the world continue to be cautious on the policy cycle in the foreseeable future amid slow decline in global inflation, which will continue to affect foreign investments. Foreign investor confidence on the domestic economic, financial and governance aspects also weigh heavily on investment inflows. Moving forward, attracting long term foreign investments to the stock market should be a policy priority as an avenue to develop the market, while facilitating stable long-term foreign inflows that contribute to relieve the pressure on currency and contribute to reserve build up, thereby supporting stability of the financial system while creating a positive feedback loop on investor confidence. Consistent policies, strong legal frameworks and advanced technological infrastructure are crucial elements of this process.

2 See Chapter 5 for details.

Risks emanating through domestic macrofinancial linkages are expected to ease gradually, but it is strictly conditional on consistent adherence to the policy reforms agenda. With the easing of the monetary policy stance, benign inflation expectations and the reduction in risk premia, the conclusion of DDO, and the expected conclusion of EDR, it is expected that market interest rates would adjust downwards gradually, correcting the anomalous structure while enabling the financial system to facilitate the flow of funds through the economy. As a result, it is expected that economic activity would recover, improving income levels and thereby relieving the pressure on household and firm balance sheets leading to an easing of credit risk of lending institutions. Banks' elevated exposure to the Sovereign and associated risks are being addressed through reforms to bring down the Sovereign-Bank Nexus, and it is expected that the tilt in financial intermediation would be corrected in the medium to long run. Nevertheless, the path to sustainable economic and financial stability of the country is narrow and arduous. Hence the continuation of the policy reforms agenda envisaged in the IMF EFF agreement and the effective implementation of such policies is crucial, particularly in the fiscal front to ensure the stability of the Sri Lankan financial system and enable the financial system to facilitate economic recovery.

Key Policy Changes and Regulatory Actions Implemented for the Financial Sector in 2023

Financial Institutions

Licensed Banks

31 January 2023	A Banking Act Determination was issued determining qualifying non-financial corporate debt securities and qualifying non-financial common equity shares as defined in the Banking Act Directions on the Liquidity Coverage Ratio under Basel III liquidity standards, to be treated as liquid assets in the computation of the Statutory Liquid Asset Ratio of the Licensed Commercial Banks (LCBs) and Licensed Specialised Banks (LSBs).
02 February 2023	Banking Act Directions were issued restricting discretionary payments of Licensed Banks (LBs) considering the prevailing macroeconomic conditions and the importance of maintaining appropriate level of liquidity and capital to ensure sustainability in LBs.
17 February 2023	An amendment to the Banking Act Directions No. 03 of 2022 on Margin Requirements Against Imports was issued, extending the applicability of the cited Directions to 64 new HS codes.
21 April 2023	A circular was issued to LBs informing that ICRA Lanka Ltd was removed as an eligible/acceptable credit rating agency for regulatory purposes pertaining to LBs, consequent to the cessation of business operations of ICRA Lanka Ltd in Sri Lanka with effect from 31.01.2023 as informed by the Securities and Exchange Commission of Sri Lanka.
25 April 2023	Amendments to the Banking Act Direction No. 01 of 2023 on restrictions on discretionary payments of LBs were issued. Accordingly, LBs were required to refrain from increasing management allowances of Chief Executive Officers (CEO), Key Management Personnel (KMP) and payments to Board of Directors, without meeting the cited requirements.
18 May 2023	Banking Act Directions were issued revoking the Banking Act Directions No. 03 of 2022 and the Banking Act Directions No. 02 of 2023, on Margin Requirements against Imports.
25 August 2023	Monetary Law Act Order was issued on the interest rates applicable on Sri Lanka Rupee (LKR) denominated lending products of LBs, imposing maximum interest rates on certain lending products and requesting LBs to reduce the interest rates of all other new and existing rupee denominated lending products by specific percentages on target dates subject to a floor rate of 13.5%. Further, LBs were requested to reduce the penal interest rate to a level not exceeding 2% per annum.

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

05 January 2023	The Monetary Board of the Central Bank, in terms of the regulations made under the Registered Stock and Securities Ordinance and the Local Treasury Bills Ordinance, extended 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 2023, in order to continue with the investigations being conducted by Central Bank.
18 January 2023	The registration of Swarnamahal Financial Services PLC as a registered finance leasing establishment was cancelled in terms of Section 9.1. (h) of the Finance Leasing Act, No.56 of 2000 (FLA).
31 January 2023	Subsequent to the amalgamation of the LOLC Development Finance PLC (LDFP) with LOLC Finance PLC (LOFP) as a part of the Masterplan for Consolidation of Non-Bank Financial Institutions (the Masterplan), the Monetary Board of the Central Bank cancelled the license issued to LDFP to carry on finance business under the Finance Business Act, No.42 of 2011 (FBA). Further, the registration of LDFP issued under the FLA was cancelled by the Director, Supervision of Non-Bank Financial Institutions (D/SNBFI).
	Guideline on declaration of dividends or repatriation of profits was issued to LFCs as a measure to strengthen resilience and capacity of LFCs to absorb economic shocks that could arise in the time of uncertainty and continue to support credit needs of customers, by maintaining sufficient capital.
02 February 2023	LFCs were informed that ICRA Lanka Ltd. was removed as an acceptable credit rating agency for specified purposes.

08 February 2023	Commercial high court of Colombo ordered the appointment of a liquidator to The Standard Credit Finance Limited, of which the license was cancelled by the Monetary Board of the Central Bank on 25 July 2018, under FBA subject to supervision of court.
03 March 2023	LFCs and SLC were requested to provide appropriate concessions to micro, small and medium enterprises and individuals affected by the macroeconomic conditions.
21 March 2023	Commercial high court of Colombo ordered the appointment of a liquidator to The Finance Company Ltd (earlier PLC), of which the license was cancelled by the Monetary Board of the Central Bank on 22 May 2020, under FBA subject to supervision of court.
25 April 2023	The Monetary Board of the Central Bank issued a notice of cancellation of license to Bimputh Finance PLC (BFP) under the section 37 (1) of FBA with effect from 25 April 2023. BFP was directed to entirety repay existing deposits and freeze granting new loan facilities.
09 June 2023	Commercial high court of Colombo ordered the appointment of a liquidator to Central Investments and Finance Ltd (earlier PLC), of which the license was cancelled by the Monetary Board of the Central Bank on 05 March 2018, under FBA subject to supervision of court.
05 July 2023	The Monetary Board of the Central Bank, in terms of the regulations made under the Registered Stock and Securities Ordinance and the Local Treasury bills Ordinance, extended 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 2023, in order to continue with the investigations being conducted by Central Bank.
31 July 2023	As a part of the Masterplan, Kanrich Finance Ltd was merged with Nation Lanka Finance PLC (NLFP) with effect from 31 July 2023 and the remaining entity was NLFP.
01 September 2023	The Monetary Board of the Central Bank has decided to cancel the license issued to BFP under the FBA to carry on finance business with effect from 01 September 2023 due to no satisfactory progress has been made by BFP to revive the critical condition faced by BFP.

Insurance

24 April 2023	A guideline was issued to set forth a framework for the essential components (elements) of the policy documents of General Insurance products offered in Sri Lanka to protect the policyholders' interests.
19 June 2023	Direction 01 of 2023 was issued to all general insurance companies considering the current practices of general insurance companies in respect of Condition of Average of motor insurance policies in the event of claims.
25 July 2023	Clarification to Direction 01 of 2023 was issued to replace the wordings of item number 1 of the Direction.
27 July 2023	Direction 02 of 2023 on Principal Officers of Insurance Companies and Insurance Brokering Companies was issued replacing Direction 05 of 2021 dated 16 December 2021 and Direction 12 of 2017 dated 04 December 2017.
01 September 2023	Amendment to Determination 13 was issued to revise the form and affidavits to be submitted by the insurers in compliance with section 33 B (1) of the Regulation of Insurance Industry Act (RII Act).
09 September 2023	Circular 01 of 2023 was issued to amend the Circular 25, revising the same to exclude the applicability of premium payment warranty clause on travel insurance, marine insurance, title insurance and for bonds issued by insurance companies on the basis that credit will not be granted for premium payment of the short-term general insurance policies.
27 September 2023	Determinations 07, 08 and 09 of 25 September 2023 were issued to replace the repealed Determinations 07 of 30 October 2002, 08 of 08 February 2008 and 09 of 13 August 2018.

Financial Markets

Government Securities Market

13 February 2023	The offering of Sri Lanka Development Bonds (SLDBs) under the Direct Issuance Arrangement was suspended.
16 March 2023	"Registered Stock and Securities (Disclosure of Information) Regulations, No.1 of 2023" was issued on 16.03.2023.

04 April 2023	The arrangement of executing the Phase II of a Treasury bill auction for a period of one hour immediately post a Treasury bill auction or close of business of the auction day, whichever falls later, in instances where Monetary Policy announcement of Central Bank is due during the normal Phase II window of a Treasury bill auction, was implemented w.e.f. the Treasury bill auction held on 04 April 2023.
12 May 2023	A resolution to increase the limit on issuance of Treasury bills from Rs. 5,000 billion to Rs. 6,000 billion in terms of the Local Treasury Bill Ordinance No. 08 of 1923 was approved by Parliament.
19 June 2023	The new web-based Treasury bill issuance system was introduced w.e.f. 21 June 2023 with the publishing of the relevant Directions on 19 June 2023.
04 July 2023	The Ministry of Finance, Economic Stabilization and National Policies announced a policy on Sri Lanka's Domestic Debt Optimisation (DDO), which is to be carried out, consistent with the Extended Fund Facility, to contribute to meeting the Debt Sustainability targets agreed upon with the International Monetary Fund. This DDO constitutes of, • Conversion/exchange of eligible Treasury bonds that have been issued under the Registered Stock and Securities Ordinance (RSSO), No. 7 of 1937 (as amended) into new Treasury bonds to be issued under the RSSO to certain eligible holders of Treasury bonds as announced under Invitation to Exchange Treasury Bonds (Memorandum for Treasury Bonds), • Conversion of Treasury bills that have been issued under the Local Treasury Bills Ordinance, No. 8 of 1923 (as amended) and are held by the Central Bank into Treasury bonds issued under the RSSO, • Conversion of the provisional advances made by the Central Bank to the Government of Sri Lanka into Treasury Bonds to be issued under the RSSO, • Exchange of outstanding SLDBs issued under the Foreign Loans Act, No. 29 of 1957 to Treasury Bonds denominated in USD or LKR issued under the RSSO and restructuring of local law foreign currency denominated bank loans of the Government as announced under invitation to Exchange SLDBs (Exchange Memorandum for SLDBs).
19 July 2023	The Expiration Date, Announcement Date and Settlement Date of the 'Invitation to Exchange Treasury Bonds' set out in the Treasury Bond Exchange Memorandum were extended to 11 August 2023, on or about 16 August 2023 and 17 August 2023, respectively.
	The Settlement Date of the Invitation to Exchange SLDBs set out in the SLDB Exchange Memorandum was extended to 15 August 2023.
11 August 2023	The Expiration Date, Announcement Date and Settlement Date of the 'Invitation to Exchange Treasury Bonds' set out in the Treasury Bond Exchange Memorandum were further extended to 28 August 2023, on or about 29 August 2023 and 31 August 2023, respectively.
15 August 2023	As per the Exchange Memorandum for SLDBs issued under the DDO programme, the settlement for these SLDBs was carried out successfully. Those eligible SLDB holders who opted for LKR-denominated bonds were allocated their respective LKR bonds. Furthermore, the accrued and arrears interest has been disbursed in LKR currency to the same investors.
21 August 2023	The Appropriation (Amendment) Bill to amend the maximum borrowing limit of the Government from Rs. 4,979 billion as set out in Section 2(1)(b) of the Appropriation Act, No. 43 of 2022, to Rs. 13,979 billion, was approved by the Parliament.
25 August 2023	The Expiration Date, Announcement Date and Settlement Date of the 'Invitation to Exchange Treasury Bonds' set out in the Treasury Bond Exchange Memorandum were further extended to 11 September 2023, on or about 12 September 2023 and 14 September 2023, respectively, and two Treasury bonds that matured on 01 September 2023 were excluded from the list of eligible bonds.
31 August 2023	Decision was taken to settle the individual investors of SLDBs in the original currency with interest accrued up to 31.08.2023. Accordingly, as the investors surrendered their SLDBs certificates, settlements were effected.
14 September 2023	As per the Exchange Memorandum for Treasury Bonds issued under the DDO programme, the settlement of Treasury bonds exchange was carried out successfully. Accepted offers were converted to new Treasury bonds which have longer maturities. Furthermore, accrued interest was paid to investors for their accepted Treasury bond amounts.

20 September 2023	Directions relevant to the new web-based system for Direct Issuance Window for Treasury bonds which was introduced with effect from 25 September 2023 was published.
21 September 2023	Outstanding credit (the "provisional advances") from the Central Bank to the Government and outstanding Treasury bills of the Government purchased by the Central Bank in the primary market were converted into ten (10) step-down fixed coupon new Treasury bonds denominated in LKR and to twelve (12) existing Treasury bills and settled on 21 September 2023 in terms of the section 129 (2) of the Central Bank of Sri Lanka Act, No. 16 of 2023 and the Appropriation (Amendment) Act, No. 12 of 2023.
03 November 2023	The Foreign Currency Banking Unit (FCBU) loan exchange under the DDO programme was successfully executed for People's Bank in terms of the Memorandum of Understanding (MOU) for restructuring of the FCBU loan balance of People's Bank signed on 18 August 2023. The loan amount was allocated to five existing Treasury bonds which were issued under DDO.

Capital Market

January 2023	Regulations were issued by the Ministry of Finance on the revised transaction fees pertaining to Repurchase Agreement (REPO) transactions on Corporate Debt securities.
April 2023	Approval in principle was obtained to introduce infrastructure related new products to the market.
	Rules to enable Green Bonds were finalized by the Colombo Stock Exchange (CSE) and the Securities and Exchange Commission (SEC)
May 2023	Rules to enable Sukuk products were finalized by the CSE and the SEC and the same were conditionally approved.
June 2023	Approval in principle was obtained to introduce high yield corporate bonds.
	Rules to enable regulated short selling and securities borrowing and lending were conditionally approved.
August 2023	Approval was obtained to introduce XBRL reporting to the listed companies of the CSE.
September 2023	Approval was obtained to reduce the transaction fees applicable for corporate debt transaction to 1 bps of the transaction value as proposed by the CSE.
October 2023	Regulatory framework to enable Blue bonds was finalized by the CSE and the approval was obtained for the same.
November 2023	Terms of Reference to introduce Sharia Supervisory Committee has been finalized and will be submitted for the approval.

Financial Infrastructure

Payments and Settlements

01 February 2023	CBSL granted approval for LankaPay (Pvt) Ltd (LPPL) to join with regional and country payment networks authorised and regulated by the respective country/authority. Accordingly, LPPL connected with UnionPay International Co., Ltd and NPCI International Payments Ltd facilitating the acceptance of payments made by Chinese and Indian nationals from their payment wallets through LANKAQR.
08 May 2023	In order to facilitate accepting LANKAQR payments from tourists, a maximum Merchant Discount Rate (MDR) of 1.8% of the transaction amount for LANKAQR transactions initiated through foreign payment apps.
20 July 2023	The multi-tiered Liability Manager Limit structure for Common ATM Switch (CAS) and Common Electronic Fund Transfer Switch (CEFTS) to support the growth of volume and value of transactions conducted through CAS and CEFTS, was revised by the CBSL.
31 August 2023	A trilingual web form was developed to collect information from the public on unsafe, unsound or unfair practices relating to payment practices or services.

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

03 March 2023	Circular No. 01 of 2023 was issued on “Calling for Due Vigilance on Compliance Lapses” to all LBs and LFCs.
07 June 2023	Circular No. 02 of 2023 was issued on “Institutional Compliance of Real Estate Sector under the Financial Transactions Reporting Act, No. 06 of 2006” to Board of Directors/Chief Executive Officers of Real Estate Institutions.
13 June 2023	Guideline No. 01 of 2023 was issued on “Reporting Domestic Electronic Fund Transfer (EFT) Threshold Transactions to the goAML System of the Financial Intelligence Unit (FIU)”.
07 August 2023	The Cabinet approved the National Policy on Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) of Sri Lanka.
22 August 2023	Circular No. 03 of 2023 was issued on "Reminder on Adherence to Previously Issued Guidelines and Reporting Formats on Mandatory Reporting under the Financial Transactions Reporting Act, No. 06 of 2006" to Financial Institutions.
01 September 2023	Guideline No. 02 of 2023 was issued on "AML/CFT Compliance for the Attorneys-at- Law and Notaries, No. 02 of 2023".
14 September 2023	The sanitized report of the 2021/22 National Risk Assessment (NRA),which highlights the most significant ML/TF threats, vulnerabilities, and risks faced by Sri Lanka, and the National AML/CFT Policy were published on the FIU official website.

Foreign Exchange Management and International Operations

26 January 2023	Revocation of operating instructions issued on “Inward Investments Swaps – (IIS) Scheme”.
	Issuance of instructions to banks on participation at the USD/LKR buy-sell and sell-buy, foreign exchange swaps auctions of the Central Bank.
24 February 2023	Reduction of weekly mandatory foreign exchange sales to the Central Bank by LBs on account of converted inward workers’ remittances, converted service sector related exports proceeds/receipts and the residual value of mandatorily converted export proceeds of goods from 25% to 15%, effective from 27 February 2023, in order to encourage market driven foreign exchange activities in the domestic foreign exchange market.
27 February 2023	Direction No. 01 of 2023 was issued permitting Authorised Dealers (ADs) to open and maintain Special Foreign Currency Accounts (SFCA) – Investee (valid until 31 December 2023), out of proceeds received, being an investment into the share capital of the company from a non-resident investor, provided investee has future requirements to meet payments for current transactions and repayments of foreign currency loans/accommodations obtained under the provisions of Foreign Exchange Act, No. 12 of 2017 (FEA).
03 March 2023	Revocation of the operating instructions issued by the Central Bank to LBs on “Managing Intraday Volatility of the Exchange Rate” on 12 May 2022, with effect from 07 March 2023.
	Revocation of the operating instructions issued by the Central Bank to LBs on “Incentive Scheme on Inward Worker Remittances” and “Repatriation of Export Proceeds into Sri Lanka”, on 27 January 2021 and 18 February 2021, respectively, as amended subsequently, with effect from 07 March 2023.
28 June 2023	An Order under Section 22 of the FEA, published in the Extraordinary Gazette Notifications No. 2338/40 dated 28 June 2023, was issued relaxing certain limitations on outward remittances for capital transactions and removing the restrictions on current transfers of emigrants while continuing the other suspensions/ limitations which were imposed under the previous Orders published in Extraordinary Gazette Notification No 2286/27 dated 30 June 2022 and 2311/38 dated 22 December 2022, for six months commencing from the date of the Order.

2

Financial Markets

Sri Lankan financial markets were exposed to extreme turbulence in 2022 and demonstrated early signs of stabilisation during the first ten months of 2023. Financial market stress as indicated by the Financial Stress Index remained broadly at low levels in the first ten months of 2023 as overall market conditions significantly eased compared to 2022. However, an upward trend could be observed from mid-August 2023 onwards owing to interest rate volatilities in money and Government securities markets. Decline in stock returns in October 2023 also exerted an upward pressure on the index.

With the decline in financial market stress, the volatility of the share market gradually declined supported by positive signals from securing of the International Monetary Fund Extended Fund Facility (IMF-EFF) in March 2023. Due to uncertainties surrounding the Domestic Debt Optimisation (DDO) perimeter, a negative signalling on banking sector stocks was observed which reversed after the announcement of exclusion of instruments held by the banking sector from DDO. However, foreign investor participation in the share market continued to be low, indicating lack of confidence in macrofinancial developments of the country.

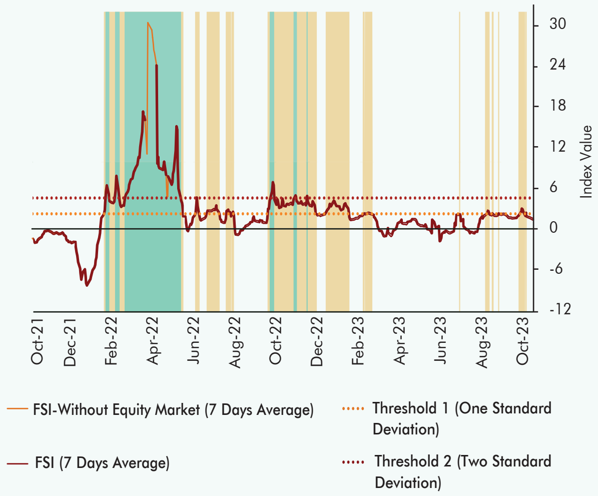
Meanwhile, the Government securities market indicated the continuation of its anomalous structure in terms of elevated yields, which however showed a gradual decline mainly supported by the dissipation of uncertainties after the announcement of the DDO, downward adjustments in the policy rates, and reduced inflation and inflation expectations. Primary market issuances of Treasury bills were tilted towards short tenured instruments posing upward pressure on Treasury bill yields. Even though the secondary market yield curve shifted downwards and flattened compared to its end 2022 pattern, it remained inverted which exhibited uncertainty in the market. A net foreign investment inflow was recorded in the Government securities market within the first 10 months of 2023 despite some sizeable outflows during July to October 2023.

Liquidity conditions in the domestic foreign exchange market improved while the Rupee appreciated against the USD in the first ten months of 2023, backed by receipt of the first tranche of the IMF-EFF in March 2023, increased conversion of export proceeds, workers' remittances, tourist arrivals and import restrictions which were in effect. Outright transaction volumes in the domestic inter-bank forex market increased, while forward transactions were tilted towards less than one month settlement period during the first ten months of 2023.

During 2023, liquidity shortage in the money market reduced notably. However, the liquidity condition was extremely volatile mainly owing to risk management practices of the foreign banks. Call and repo markets turned more active compared to 2022, following the restriction imposed by the Central Bank on accessing Standing Facilities by banks and the Central Bank injected liquidity into the market via Open Market Operations (OMO) Auctions (reverse repo) to address liquidity shortages in the money market. Average Weighted Call Money Rate (AWCMR) which moved along the upper bound of the Standing Rate Corridor (SRC) started descending towards the lower bound in the second half of 2023 as a result of improved liquidity conditions in the market broadly in line with monetary policy easing.

With the implementation of the IMF-EFF programme, the volatility observed in the financial markets during 2022 dissipated to a greater extent and the markets became relatively more active. However, it is pertinent to emphasise that continuation of economic, financial, and fiscal reforms; enabling to ensure macroeconomic stability are expected to contribute to sustain the progressive developments in the financial markets observed during 2023.

Figure 2.1 Financial Stress Index*(FSI)



* Due to equity market closures during several days in April and May 2022 a separate FSI was computed excluding Equity Market data (yellow line)

Sources: Central Bank of Sri Lanka
Colombo Stock Exchange
Bloomberg

2.1 Stock Market

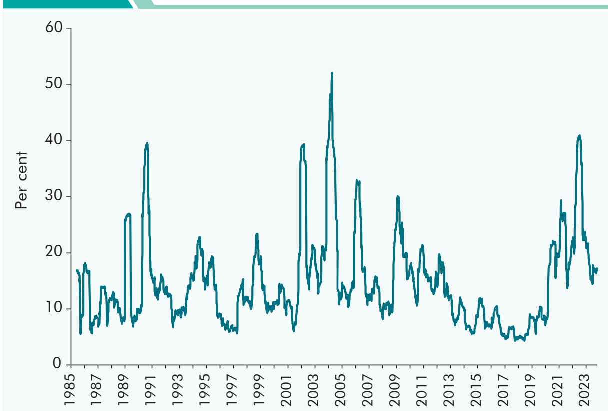
The share market volatility gradually declined in 2023. During 2023, market sentiments underwent significant shifts with the Government securing the assistance of the IMF. However, economic contraction continued to dampen the performance of listed companies leading to a slow upward movement of share prices. Furthermore, high yields diverted investors towards the Government securities market and elevated lending rates drove up investors' cost of funding weighing down the upward movement of price indices. During the 10-month period ending in October 2023, All Share Price Index (ASPI) and S&P SL20 Index grew by 25.4 per cent and 13.6 per cent. Sub-indices, representing different economic activities of listed companies, demonstrated varying levels of volatility. Banks and energy sectors were the most volatile whilst household & personal products, utilities, insurance, and health care equipment & services sectors were the most stable.

Banking stocks were sensitive to developments of Government debt restructuring. Domestic banking sector investments in Government securities increased significantly as yield on such investments rose. Banking stock prices responded negatively with the announcement of debt standstill and remained low, as uncertainties on domestic debt restructuring surfaced. By end-June 2023, the Government announced its DDO perimeter, which excluded Rupee denominated Government securities held by the banks. Responding positively to this development, investors rallied to bank stocks in mid-2023. However, with the developments related to second tranche of the IMF-EFF disbursement, bank stock prices started to become volatile.

Investors continued to be attracted to presumably risk-free instruments than equity with on-going economic uncertainty. The positive market momentum following the DDO announcement led to higher return expectations in the share market from June to September 2023. However, dismal profits of listed companies recorded in the second quarter[1] of 2023 considerably reduced equity return expectations

1 Share market earnings ratios are usually updated with a time lag based on the returns reported by listed companies. As such, the performance during Q2 of 2023 are reflected in the equity risk premium data for October.

Figure 2.2 Historical Volatility of ASPI*



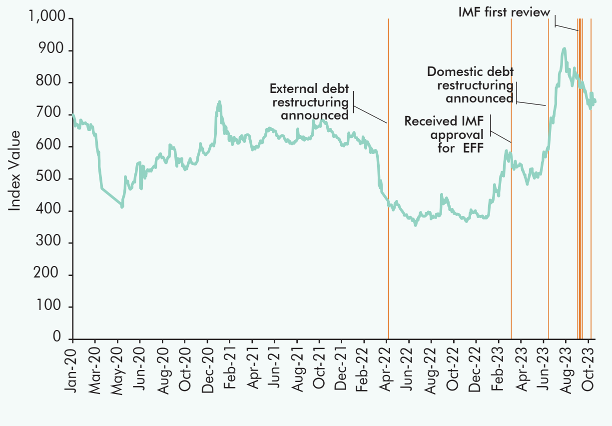
* Historical price volatility was computed as rolling 100-day annualised standard deviation of the ASPI.

Sources: Central Bank of Sri Lanka
Colombo Stock Exchange

Figure 2.3 Share Price Indices

Source: Colombo Stock Exchange

Figure 2.4 Movement of Banking Sector Index



Sources: Central Bank of Sri Lanka
Colombo Stock Exchange

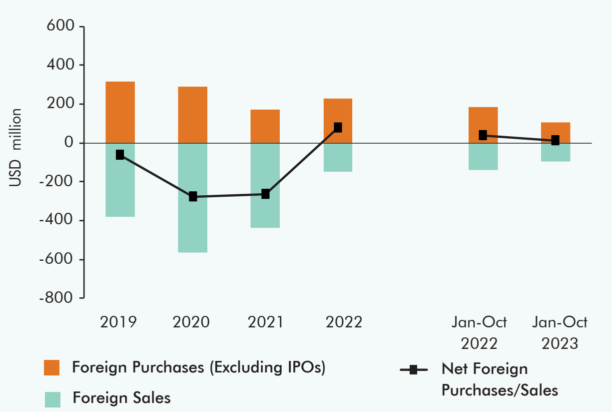
Figure 2.6 Average Daily Turnover and Average Trades

Sources: Central Bank of Sri Lanka
Colombo Stock Exchange

in October. Concerns about the overall economy and higher returns on Government securities weakened the stock market further.

Foreign interest in the share market was low as domestic macroeconomic conditions were not conducive whilst global financial conditions remained tight. High yields which prevailed in the Government securities market dampened the performance of the stock market. If sticky global inflation and domestic fiscal requirements persist in the foreseeable future, it would continue to affect foreign investments in the domestic stock market. Moving forward, attracting long-term foreign investments to the stock market should be a policy priority as an avenue to develop the market and to address the dire need for long-term foreign investments. Stable long-term foreign inflows ease the pressure in the domestic foreign exchange market, relieve the pressure on the currency, and contribute to reserve build up, thereby contributing to the stability of the financial system while creating a positive feedback loop on investor confidence. Consistent policies, strong legal frameworks and advanced technical infrastructure are crucial elements for attracting foreign investments to the stock market.

Figure 2.5 Foreign Participation in the Stock Market*



* Daily foreign purchases and sales in the share market were valued in USD terms based on daily indicative USD/LKR exchange rate.

Sources: Central Bank of Sri Lanka
Colombo Stock Exchange

The share market was illiquid with a relatively low turnover level. Average trade values were low with reduced trading volumes of stock. The number of companies listed on the Colombo Stock Exchange (CSE) is low compared to other markets in the region. This impacted the market liquidity as trading volumes were limited due to fewer listed companies. Initial Public Offerings (IPOs) were minimal in 2022 and 2023 amidst economic uncertainty. An increase in listings cannot be anticipated soon, as companies face challenges arising from the economic downturn.

Going forward, continuous market development is required to keep abreast of the developments in global financial markets. CSE and its regulator, the Securities and Exchange Commission of Sri Lanka initiated measures for the development of the equity and corporate bond markets during the past year. Enabling listing and trading of green bonds and perpetual bonds, implementation of regulated short selling, and stock borrowing and lending were among key measures taken. Plans have been underway to introduce a central counterparty clearing house to improve market liquidity by reducing credit risk of market participants. However, such an establishment is systemically significant and therefore, careful, and adequate risk management should be in place to ensure financial stability.

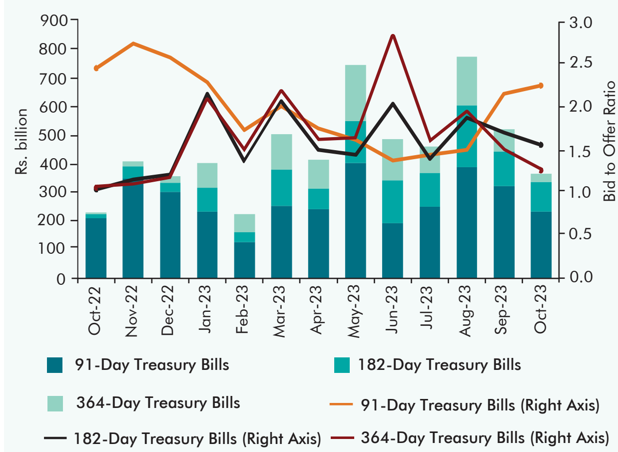
2.2 Government Securities Market

Government securities market conditions improved comparably during the period under review, albeit several anomalies continue. The IMF-EFF programme, which was approved in March 2023, the announcement of the DDO perimeter and its subsequent implementation[2] in the second half of 2023, reduction in inflation and inflation expectations, monetary policy easing, and the upgrade of local currency sovereign credit ratings partially alleviated the strains in the Government securities market supporting positive investor sentiments thereby driving down the yields. Accordingly, Government securities yields gradually declined concurrent to the downward adjustments in policy rates, and the dissipation of DDO related uncertainties. However, the behaviour of yields along with other market interest rates continue the anomalous structure impeding the efficient flow of funds through the economy and effectiveness of monetary policy transmission.

Despite the significant downward momentum, Treasury bill yields, especially 91–day yields at primary market auctions remained at an elevated level as at end October 2023 indicating that the anomalies in the interest rate structure are continuing. During the year until the end of October 2023, yields of 91–day Treasury bills, 182–day Treasury bills and 364–day Treasury bills have decreased by 1,654, 1,727 and 1,625 basis points, respectively. Yields of 364–day Treasury bills declined from historically high peaks in August 2022 (30.5 per cent) to levels close to policy rates by September 2023. However, the market response to October 2023 monetary policy easing was subdued. Meanwhile, the Average Weighted Prime Lending Rate (AWPR) remained 224 basis points lower than 91–day Treasury bill yields as at end October 2023, resembling return expected by the investors for the prevalent risks associated with the securities. However, continued high yields on Government securities could result in a downward rigidity in lending rates.

Primary market issuances of Treasury bills were tilted towards short-term tenures during the period under review. More than 40 per cent of the total issuance of Treasury bills constituted of 91–day Treasury bills in the primary market auctions during the ten months ending in October 2023. Even with large, offered amounts, investor demand remained robust in favour of 91–day Treasury bills during the first ten months ending in October 2023, while the expected return on 91–day Treasury bills remained higher than the 364–day Treasury bills. This required the primary auction size to expand as more regular issuances were needed to bridge the cashflow requirements, leading to an upward pressure on the yields. Further,

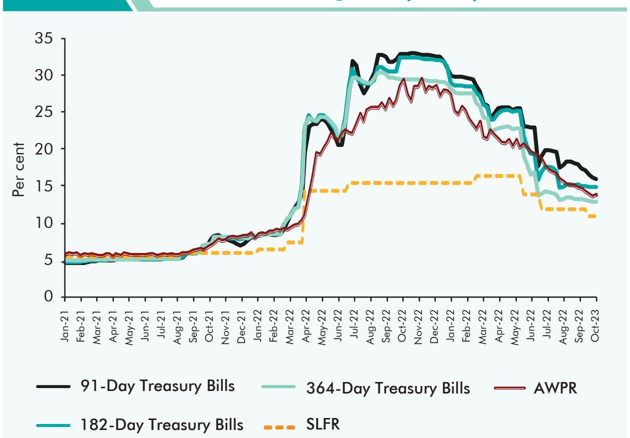
Figure 2.8 Allocated Amount and Bid to Offer Ratio at the Primary Market Treasury Bill Auction



Source: Central Bank of Sri Lanka

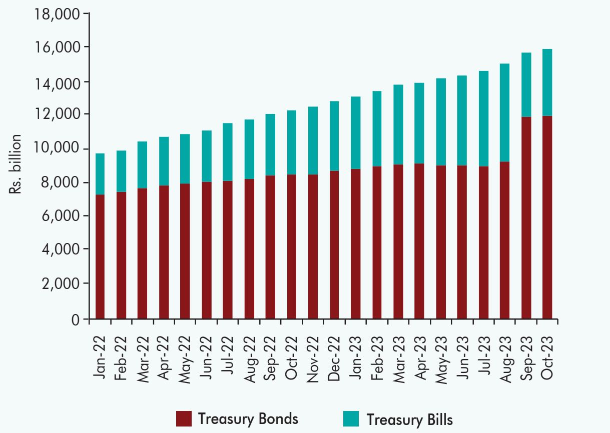
2 USD denominated Sri Lanka Development Bonds (SLDBs) were converted into five Rupee denominated Treasury bonds amounting to Rs 252.2 billion and Treasury bonds worth Rs 3.2 trillion held by superannuation funds were converted into 12 new step down fixed coupon Treasury bonds, while, outstanding provisional advances to the Government by the Central Bank and outstanding Treasury bills subscribed by the Central Bank at the primary market auctions were converted into 10 step down fixed coupon Treasury bonds and 12 existing Treasury bills.

Figure 2.7 Primary Market Weighted Average Yields of Treasury Bills, Standing Lending Facility Rate (SLFR) and Average Weighted Prime Lending Rate (AWPR)



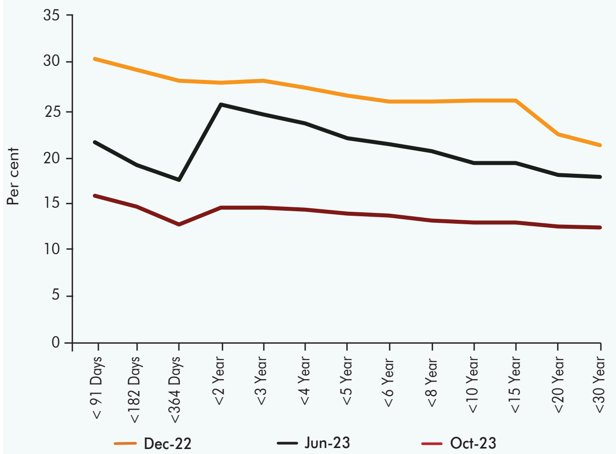
Source: Central Bank of Sri Lanka

Figure 2.9 Outstanding Treasury Bills and Treasury Bonds



Source: Central Bank of Sri Lanka

Figure 2.11 Secondary Market Yield Curve



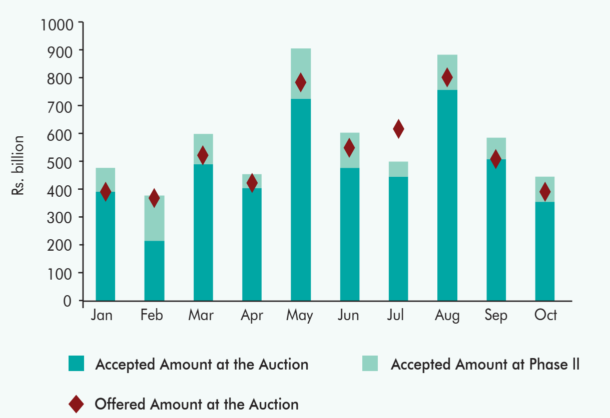
Source: Central Bank of Sri Lanka

an increase in the volume of outstanding Treasury bonds and a decline in outstanding Treasury bills were observed during September and October 2023, due to DDO actions.

By the end of October 2023, the secondary market yield curve had flattened for longer maturities but remained inverted for shorter maturities indicating the persistence of market uncertainties. Secondary market yields declined as the elimination of certain uncertainties reduced the risk premium associated with Government securities. Accordingly, during the first ten months of 2023 secondary market yields of 91–day, 364–day, 2-year, 3–year and 5–year Government securities reduced by staggering 1,490, 1,559, 1,359, 1,373 and 1,280 basis points, respectively. With this downward shift, the yield curve flattened for longer maturities as the difference between 2–year and 10–year bond yields reduced from 634 basis points at end June 2023 to 158 basis points as at end October 2023, supporting the expected positive developments in the market. However, in the less than 1-year maturity region the yield curve remained inverted reflecting negative market sentiments and anomalies in the interest rate structure. The downward trend of the yields followed a volatile path as the prominent yield decrease was observed subsequent to or concurrent to DDO and policy rate adjustments. Timely completion of External Debt Restructuring (EDR) and addressing fiscal revenue shortfalls could address the risk of high yields going forward.

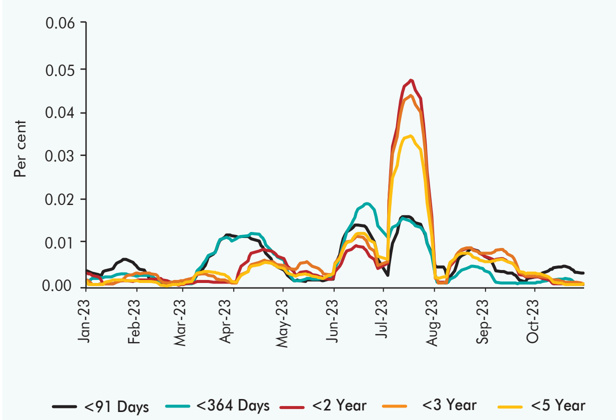
Despite signs of improvement, the secondary market for Rupee Government securities remained illiquid. Secondary market activities exhibited only a marginal improvement from mid-2023 compared to the year 2022. However, the

Figure 2.10 Offered and Accepted Amount at Primary Market Treasury Bill Auctions in 2023



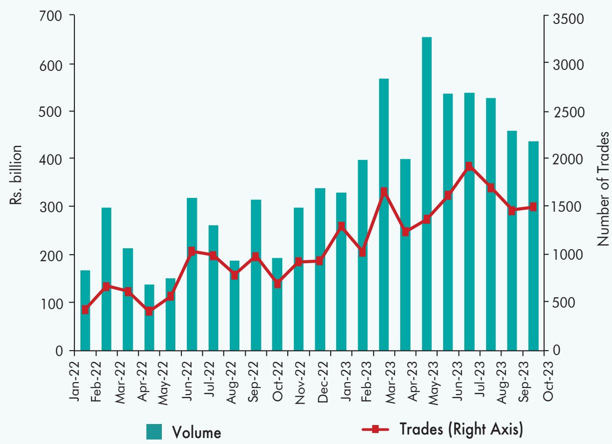
Source: Central Bank of Sri Lanka

Figure 2.12 Secondary Market Yield Volatility



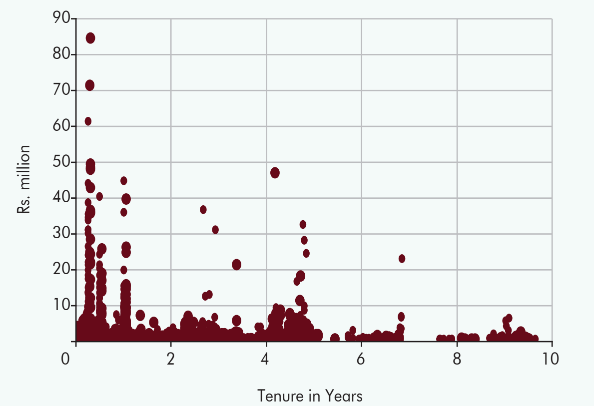
Source: Central Bank of Sri Lanka

Figure 2.13 Secondary Market Activity



Source: Central Bank of Sri Lanka

Figure 2.15 Distribution of Secondary Market Trade Volumes in 2023



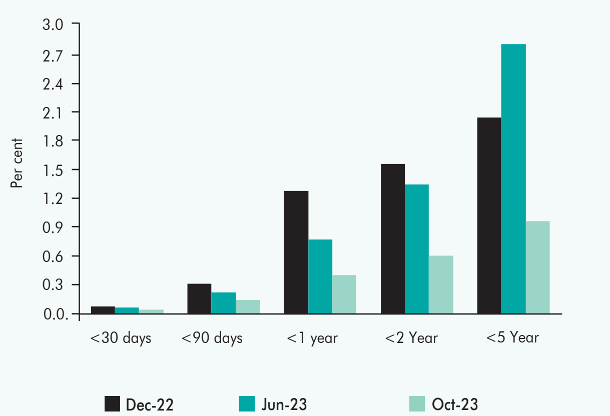
Source: Central Bank of Sri Lanka

average daily trade volume in October 2023 was Rs. 20.8 billion, whereas the turnover ratio[3] for the month of October 2023 was only 2.8, which had not improved compared to the turnover ratio of 2.7 recorded in December 2022. However, the buying and selling price spread of Treasury bonds decreased across the maturities by end October 2023 compared to end December 2022, signalling improved liquidity in the market to a certain extent. During the first ten months of 2023, the buying and selling price spread of Treasury bonds maturing in 5-years and 2-years reduced by 1.1 and 1 per cent respectively, compared to the decrease of 0.1 per cent recorded in Treasury bonds maturing in 90-days. However, the large trade volume predominantly concentrated in shorter tenured securities while low trading activities were witnessed in the longer tenured securities. These illiquid characteristics of the securities may affect the investor preference to hold long tenure instruments.

Although a net foreign inflow was recorded, the preference of foreign investors was tilted towards shorter maturities during the first ten months of 2023. Nevertheless, foreign outflows outweighed foreign inflows in the Rupee Government securities market, during July to October 2023. Due to the substantial number of foreign inflows recorded during February to June 2023, an overall net inflow of USD million 305.3 was recorded during the first ten months of 2023 compared to the net inflow of USD million 50.6 recorded during 2022. Against the backdrop of debt restructuring concerns and amidst attractive yields and the appreciation of the Rupee, foreign investors predominantly preferred shorter tenured securities,

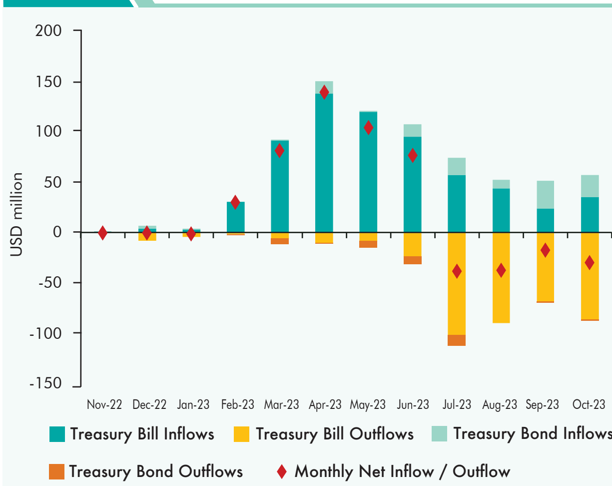
3 Turnover ratio is calculated by dividing the secondary market turnover amount during the month by the outstanding securities at the end of the month.

Figure 2.14 Buying and Selling Price Spread of Treasury Bonds



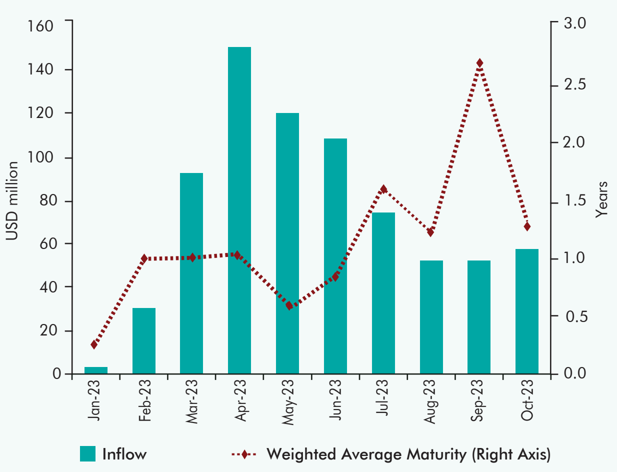
Source: Central Bank of Sri Lanka

Figure 2.16 Foreign Inflows and Outflows to Government Securities Market



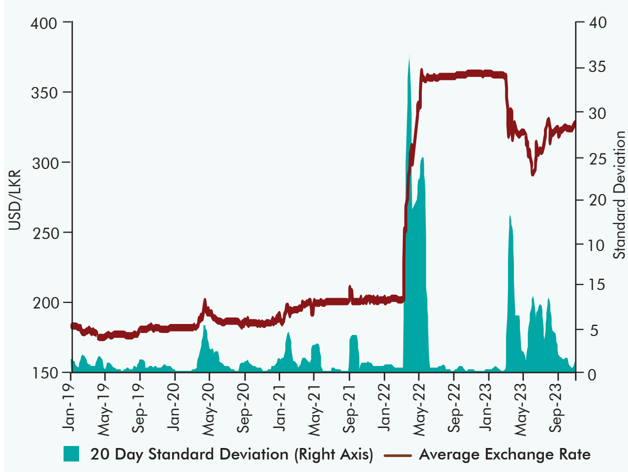
Source : Central Bank of Sri Lanka

Figure 2.17 Foreign Inflows and Weighted Average Maturities



Source: Central Bank of Sri Lanka

Figure 2.18 Exchange Rate Volatility



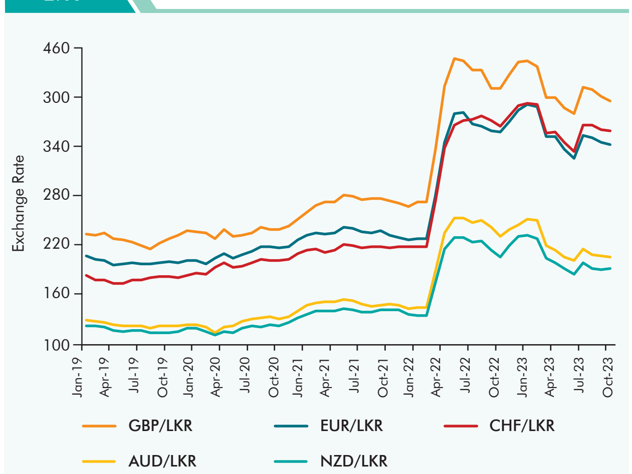
Source: Central Bank of Sri Lanka

especially Treasury bills. Subsequently, with the decline in yields, investors withdrew, consequently exerting pressure on the domestic foreign exchange market, exhibiting features akin to hot money investments. Yet, the inflows have not been entirely drained while the outflows increased gradually, and the weighted average maturities of inflows have also seen an increasing trend in recent months. Nevertheless, foreign holdings of Government securities out of total outstanding securities remained 0.9 per cent as at end October 2023.

2.3 Domestic Foreign Exchange Market

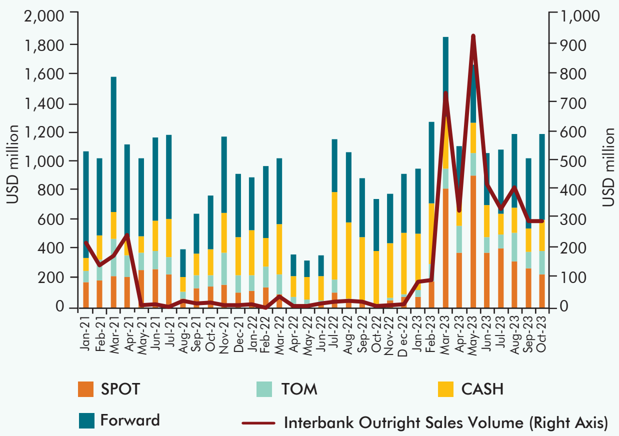
The domestic foreign exchange market activities improved while an appreciation of 10.9 per cent was observed in the Rupee against the USD during the first ten months of 2023 in comparison to the sharp depreciation of 44.8 per cent recorded in the previous year. In anticipation of the approval for the first tranche of the IMF-EFF in March 2023, Rupee appreciation pressures surfaced due to increased inflows through conversion of export proceeds, worker remittances, foreign investments in Government securities and the stock market, and positive momentum in tourist arrivals. Meanwhile restrictions prevailed in the first half of 2023 on imports also contributed to reduce the pressure on the exchange rate. Further, in May 2023, the receipt of funds from the Asian Development Bank (ADB) and the World Bank for budgetary support helped ease the pressure on rupee to depreciate. Thereafter during mid-2023, significant Rupee depreciation pressures surfaced, primarily due to the augmented forex demand in relation to the SLDBs exchange with Treasury bonds under the DDO. Furthermore, the relaxation of majority of the restrictions on imports, higher demand for forex for energy-related imports, and some reversals of foreign investments also contributed to the build-up of pressure on the exchange rate. Second half of 2023 has so far seen elevated demand for forex, despite the gradual improvement in liquidity observed during the first half of the year thereby increasing the pressure on the Rupee to depreciate. Thus far in 2023, the Rupee has appreciated against major trading currencies including the Euro, Pound Sterling, Japanese Yen, Indian Rupee, and Australian Dollar partly owing to depreciation of such currencies against the USD, as a result of the policy rate hikes by the US Federal

Figure 2.19 Movement of the Rupee against Selected Currencies



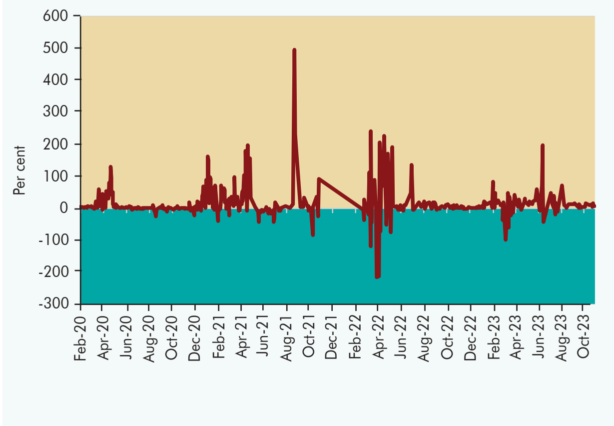
Source: Central Bank of Sri Lanka

Figure 2.20 Interbank Forex Transactions



Source: Central Bank of Sri Lanka

Figure 2.22 USD/LKR-One Week Forward Premium



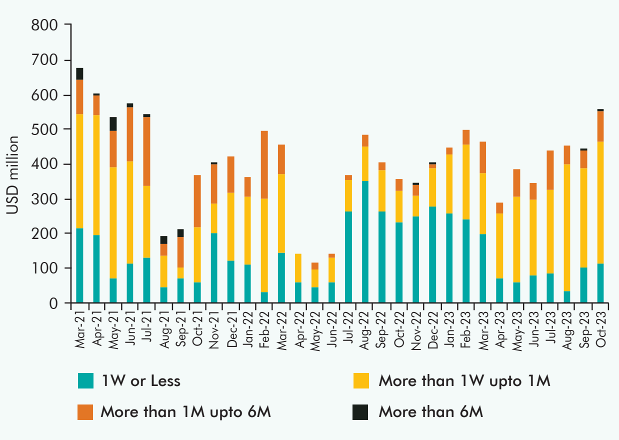
Source: Central Bank of Sri Lanka

Reserve. Going forward, the relaxation of import restrictions, possible adverse impacts in major banks' balance sheets due to the EDR and any spillover effects of the war in the Middle East may affect the liquidity conditions in the domestic forex market.

Outright transaction volumes in the domestic inter-bank forex market increased, while forward transactions were tilted towards less than one month during the first ten months of 2023. The total trading volume for ten months ending October 2023 increased by 58.9 per cent and amounted to USD 12,484 million compared to USD 7,858.7 million recorded in the corresponding period of 2022. After allowing the exchange rate to be determined by the market, both the spot market and the forward transaction market turned active from the beginning of 2023 and total volumes of spot and tom transactions rose significantly during the period. Similar to the spot market, the forward market also gained momentum during the period under review. The majority of forward transactions entered into were for more than one week up to one-month periods. However, the forward market, which spread over 3 to 6-month period was relatively low, reflecting expected market uncertainties over longer horizons.

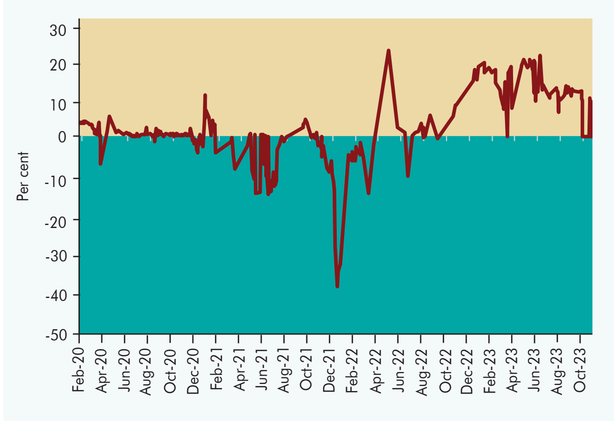
Indicating positive liquidity conditions prevailed in the domestic foreign exchange market during the year up to October 2023 compared to the corresponding period of 2022, forward premia broadly remained in the positive region. Significant positive premia were observed until August 2023 in 3-month forward transactions which however demonstrated a declining trend towards October 2023. On average, 14 per cent forward premia for one week and 10.6 per cent forward premia for 3-month

Figure 2.21 Forward Transactions



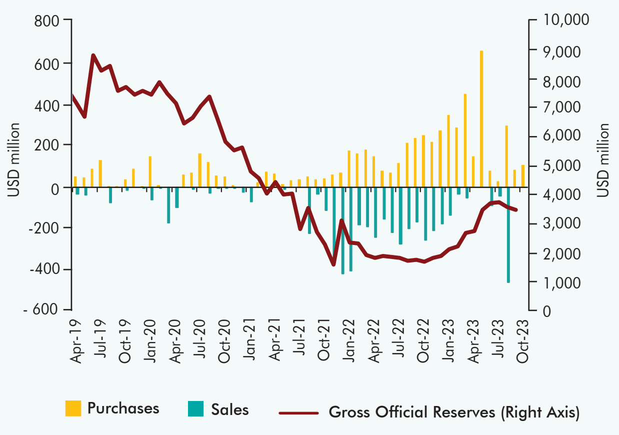
Source: Central Bank of Sri Lanka

Figure 2.23 USD/LKR-Three Months Forward Premium



Source: Central Bank of Sri Lanka

Figure 2.24 Central Bank Intervention in the Domestic Foreign Exchange Market and Gross Official Reserves



Source: Central Bank of Sri Lanka

forwards were observed during the first ten months of the year in comparison to 16.3 per cent and negative 1.8 per cent recorded for the same period in 2022, respectively, thus indicating a correction in risk premia towards longer tenures and a reduction in risk premia on shorter tenured contracts.

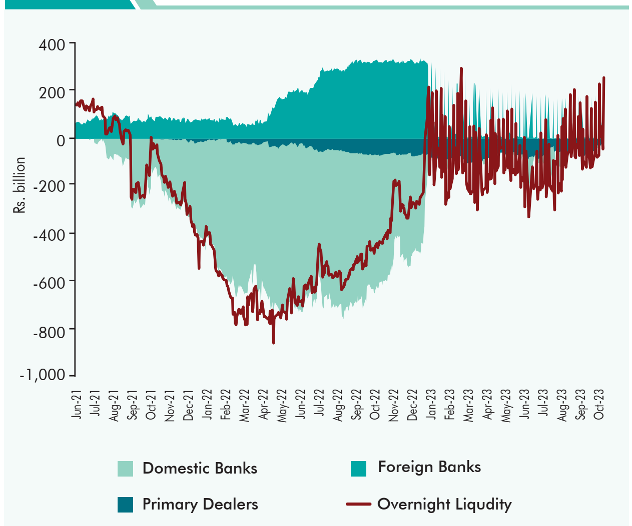
The Central Bank continued to intervene in the forex market providing liquidity where necessary and absorbing forex from the market to build Gross Official Reserves (GOR). During the first half of 2023, escalated conversion of export proceeds and increased foreign inflows to Government securities and stock markets with the renewed investor confidence after the approval of the IMF-EFF in March 2023, helped easing domestic forex market liquidity conditions. Nevertheless, market liquidity conditions tightened with the augmented forex demand required to facilitate the SLDB exchange under the DDO, the demand from the energy sector and some foreign investment reversals from the Government securities and stock markets. During the ten months ended in October, the Central Bank absorbed USD 2,491.5 million while supplying USD 825.7 million on gross basis, recording a net absorption of USD 1,665.8 million[4] added to GOR. During September and October 2023, domestic foreign exchange market operated without any injections from the Central Bank. GOR reached USD 3.5 billion, albeit it includes the People's Bank of China swap of CNY 10 billion (equivalent to USD 1.5 billion, approximately) at end September 2023.

2.4 Domestic Money Market

Money market liquidity turned extremely volatile during the first ten months of 2023 and the persistently high liquidity deficit that prevailed throughout 2022 declined substantially. The decline in liquidity deficit was observed following the restrictions imposed by the Central Bank to reduce banks' over-reliance on the Central Bank's Standing Facilities and thereby activate interbank transactions; liquidity injections through the provisional advances to the Government; forex absorptions by the Central Bank; reduction in the Statutory Reserve Ratio; liquidity provision via overnight and term reverse repo auctions; and Liquidity Assistance Facility granted to certain Licensed Commercial Banks (LCBs). Market liquidity demonstrated a very high volatility due to the behaviour of foreign banks, which maintained surplus liquidity in weekly cycles after the Central Bank introduced restrictions on accessing Standing facilities in mid-January 2023.

Call and repo market activities gained momentum during 2023, which remained subdued during the second half of 2022. During the ten months ending in October 2023, average volumes of call and repo markets remained around Rs. 8.6 billion and Rs. 12.2 billion, respectively, compared to Rs. 18.8 billion and 7.6 billion during the same period of 2022. Despite the reactivation of the money market in 2023, it was observed that the call money market transaction volume remained dismal mainly due to risk management practices of foreign banks and

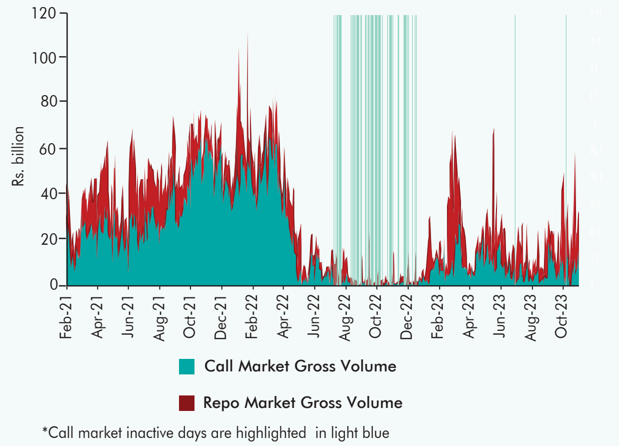
Figure 2.25 Money Market Liquidity Distribution



Source: Central Bank of Sri Lanka

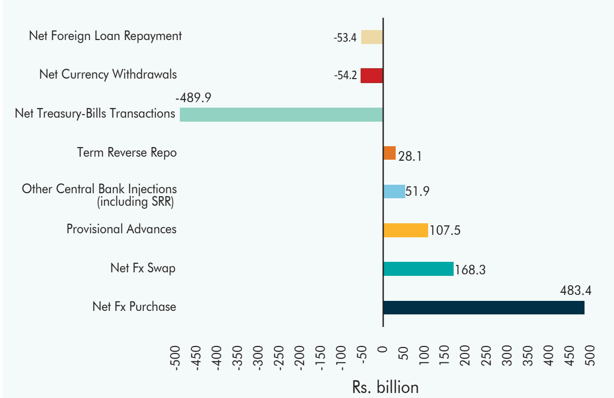
4 Transaction date basis

Figure 2.26 Call and Repo Market* Transaction Volumes



Source: Central Bank of Sri Lanka

Figure 2.28 Net Impact of Factors Contributed to Change in Liquidity (End 2022 to End October 2023)



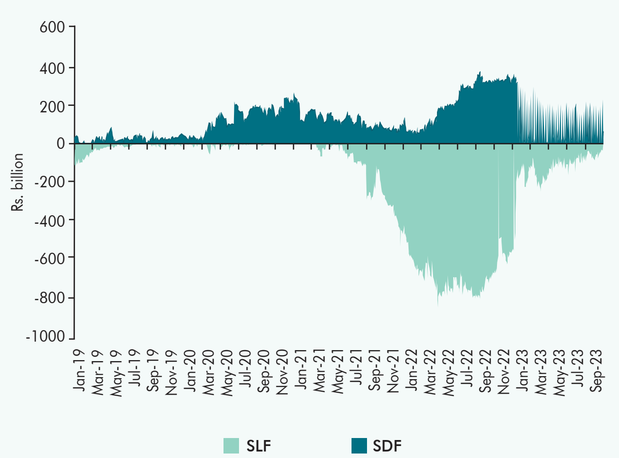
Source: Central Bank of Sri Lanka

partly due to continuous liquidity injections through OMO auctions (reverse repo) by the Central Bank to address the liquidity shortage in the money market.

A persistent asymmetry of liquidity distribution was observed in the market. The Central Bank conducted reverse repo auctions to provide liquidity to LCBs continuously. Further, the heavy reliance on the Standing Lending Facility (SLF) by the Standalone Primary Dealers (SPDs) subdued towards the second half of 2023 up to November. The overall utilisation of SLF by Participatory Institutions reduced from Rs. 561.6 billion as at end 2022 to Rs. 28.3 billion by the end of October 2023. Reactivation of the repo market has provided some opportunity to obtain funds from the market resulting in reduced exposure to the Standing Facilities.

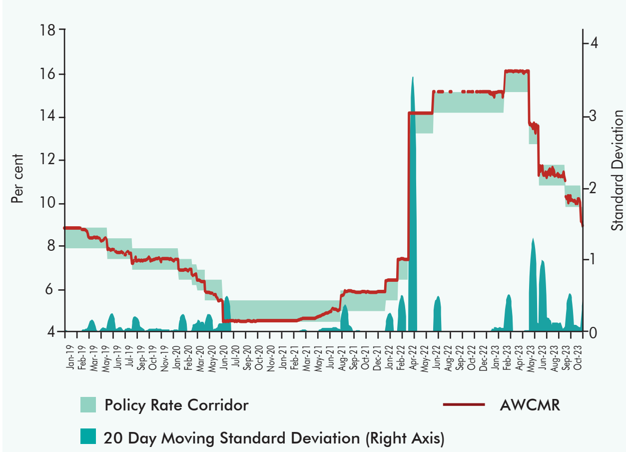
The AWCMR that moved along the upper bound of the SRC during the first half of 2023 due to tight liquidity conditions in the market, moved downwards in the SRC during the second half of the year up to October, as a result of improved liquidity conditions. Net foreign exchange purchases by the Central bank mainly contributed to money market liquidity, while the net Treasury bill transactions affected most negatively to the money market liquidity. In line with the continued expansionary monetary policy stance, the Central Bank reduced its policy interest rates by a cumulative of 550 basis points so far on five occasions during 2023, thereby decreasing Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) to 9 per cent and 10 per cent, respectively.

Figure 2.27 Utilisation of SLF and SDF



Source: Central Bank of Sri Lanka

Figure 2.29 AWCMR & Its Volatility



Source: Central Bank of Sri Lanka

Special Note 1

Systemic Risk Survey 2023

The Systemic Risk Survey (SRS) is conducted biannually to capture market participants' forward-looking assessments of risks to the stability of the Sri Lankan financial system, along with their level of confidence on the financial system. The survey gathers responses from executives responsible for risk management in financial institutions[1]. This special note presents the findings[2] of the two surveys conducted by the Macroprudential Surveillance Department (MSD) during the year 2023.

Confidence on the Financial System

Negativity in the overall level of confidence[3] which exacerbated by end 2022, reduced during the year 2023. The number of respondents expressing confidence in the financial system increased during the survey rounds conducted in 2023. Consequently, the overall confidence, though remaining in the negative territory, moved upwards towards the positive territory, due to respondents recognising economic stability through controlled inflation (Figure 1).

Sources of Risks to the Financial System

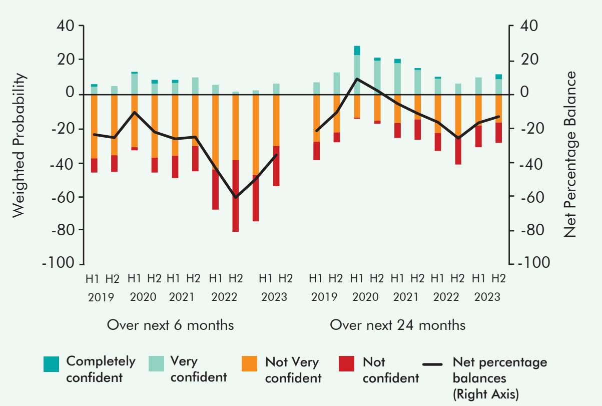
Respondents were asked to rank potential risks based on the perceived severity of their impact on the stability of the financial system. 'Domestic Macroeconomic Risks' and 'Financial Market Risks' continued to be the primary sources of concern, as observed in the survey rounds of the previous year. Moreover, concerns over the risk category

1 The participants in the survey encompass a diverse range of entities including licensed banks, Licensed Finance Companies (LFCs), a Specialised Leasing Company (SLC), insurance companies, unit-trust managing companies, stock-brokering companies, licensed microfinance companies and rating agencies.

2 Findings discussed in this note are derived from survey responses and do not convey the views of Central Bank of Sri Lanka concerning risks to the Sri Lankan financial system.

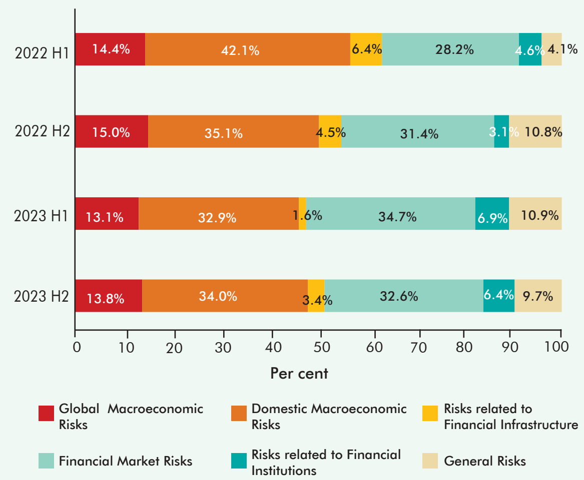
3 The overall level of confidence is measured by the Net Percentage Balance (NPB). NPB is calculated by weighing 1 for 'Completely confident', 0.5 for 'Very confident', 0 for 'Fairly confident', -0.5 for 'Not very confident' and -1 for 'Not confident' responses.

Figure 1 Overall Confidence on the Financial System Stability



Source: Central Bank of Sri Lanka

Figure 2 Dynamics of Major Risk Categories



Source: Central Bank of Sri Lanka

'Domestic Macroeconomic Risks' increased during the latter part of 2023 compared to H1 primarily due to the increase observed in concerns over GDP contraction and Inflation. Concerns regarding 'Risks related to Financial Infrastructure' were mainly driven by payment and settlement system risks and changes in the legal and regulatory framework. Conversely, concerns on 'Financial Market Risks' slightly weakened during H2 of 2023 when compared to the previous survey (Figure 2).

Mostly Cited 'Sub-risks'[4]

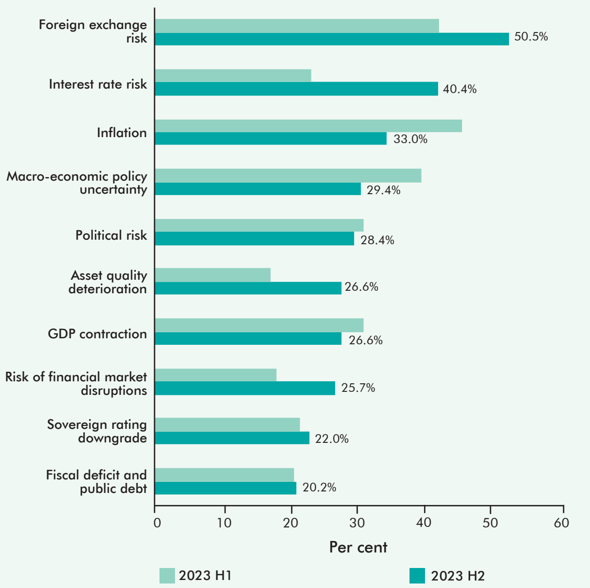
Foreign exchange risk, which is a 'sub-risk' that is included in the survey questionnaire under the risk category 'Financial Market Risks' was the most frequently emphasised sub-risk by respondents. Interest rate risk emerged as the second most frequently cited risk for the latter half of 2023. Respondents' concerns on these two sub-risks heightened for the latter part of 2023, as reflected by higher response rates of the sub-risks in the H2 of 2023 survey compared to the H1 of 2023 survey. However, the response rates for the three remaining mostly cited sub-risks, namely inflation, macroeconomic policy uncertainty, and political risk reduced in the H2 of 2023 survey, when compared with the responses of H1 of 2023 survey (Figure 3).

Most Challenging Risks to Manage as a Firm

Opinions from respondents regarding the risks that pose the greatest challenges for firms (banks, LFCs/ SLC and insurance sector firms) were collected from

4 A grid of 62 sub-risk categories which are classified into six major risk categories namely global macroeconomic risks, domestic macroeconomic risks, risks related to financial infrastructure, financial market risks, risks related to financial institutions and general risks were provided to the respondents.

Figure 3 **Most Cited Risks**



Source: Central Bank of Sri Lanka

the survey. Interest rate risk was identified as one of the most challenging risks to manage by all three respondent groups. The banking sector respondents ranked asset quality deterioration, while LFC/SLC sector respondents highlighted inflation and interest rate risk, as the most challenging risks to manage as firms. Moreover, foreign exchange risk was noted as one of the top five challenges by both the banking and LFC/SLC sector respondents (Table 1).

Conclusion

SRS for 2023 results signal that risk perceptions of market participants gradually improved in 2023 compared to 2022 though remaining in the negative territory. While confidence improved, lingering concerns about domestic macroeconomic and financial market risks, as well as specific sub-risks, require vigilant monitoring and risk management strategies to ensure the continued stability of the financial sector in Sri Lanka. These findings provide a valuable snapshot of the prevailing sentiments within the financial sector, offering a basis for further analysis and informed decision-making in safeguarding the stability of the financial system.

Table 1 **Most Challenging Risks to Manage as a Firm***

Banks	LFC/SLC	Insurance
1. Asset quality deterioration	1. Inflation	1. Interest rate risk
2. Sovereign rating downgrade/ Sovereign risk	2. Interest rate risk	2. Inflation
2. Market liquidity risk	3. Foreign exchange risk	3. GDP contraction
4. Foreign exchange risk	3. Asset quality deterioration	3. Macro-economic policy uncertainty/policy implementation/ policy formation
4. Interest rate risk	3. Global economic outlook	5. Risk of financial institution failure/distress
		5. Global economic outlook

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

Source: Central Bank of Sri Lanka

3

Financial Institutions

Financial institutions, which were adversely affected by the spillover effects of the recent economic crisis, continued to operate amidst challenging conditions while some signs of improvements were witnessed during the year ending Q3 of 2023. This was reflected in the gradual improvement of the Banking Soundness Index (BSI) during the year until Q3 of 2023 from its lowest levels recorded in the second half of 2022. However, loans and receivables (credit) of the banking sector contracted during the year ending Q3 of 2023, amidst the tight monetary policy stance adopted until end Q2 of 2023, albeit a gradual increase in credit was witnessed in Q3 of 2023 with easing of policy rates by the Central Bank. Meanwhile, concentration risk of the banking sector remained high at end Q3 of 2023, as credit was concentrated to six main sectors, which included a few sectors that displayed comparatively high risk of default. Overall default risk of the sector as reflected through Stage 3 Loans Ratio remained at an elevated level at end Q3 of 2023 compared to the corresponding period of the previous year. However, stabilisation of credit risk was witnessed during Q3 of 2023 as indicated by the slowdown in the growth of stage 3 loans. The sovereign-bank nexus continued to be a concern as banks were highly exposed to the sovereign through investments in Government securities and credit to State Owned Enterprises (SOEs). As a result of increased investments in Rupee denominated Government securities, liquid asset ratios of the banking sector significantly increased. Although, banks experienced market liquidity stresses as reflected by the frequent use of Standing Lending Facility (SLF), it significantly reduced by Q3 of 2023. Spillover effects of the standstill on repayment of certain categories of external debt, which was announced by the Government in April 2022, were felt by banks on their Foreign Currency (FC) liquidity. Banks were faced with FC liquidity pressures from freezing of cashflows of International Sovereign Bonds (ISBs), repayment of Sri Lanka Development Bonds (SLDBs) in Rupees, and the low rollover risk appetite of counterparties amidst uncertainty surrounding restructuring of sovereign debt. Consequently, core FC operations of banks further contracted during the year, though banks accumulated a sizable amount of placements with financial institutions (FIs) abroad and maintained a positive net foreign asset position. Despite reduced Net Interest Income (NII) of several large banks, profits of the sector significantly improved as banks allocated less impairment during the year ending Q3 of 2023, compared to the corresponding period of the previous year. Capital adequacy of the sector recorded an improvement at end Q3 of 2023 compared to Q3 of 2022, as risk weighted assets declined during the period, mainly due to the credit contraction, increased investments in Government securities, and the appreciation of the Sri Lankan Rupee. Although Rupee denominated Government securities held by the banking sector were excluded from the domestic debt optimisation perimeter with the objective of ensuring financial stability, banks are required to focus on strengthening their capital buffers considering the recapitalisation needs that would arise due to the external debt restructuring, restructuring of FC exposures of SOEs, bank diagnostic exercise, and forward-looking impact assessments.

The Licensed Finance Companies (LFCs) sector experienced a significant contraction in its loans and advances portfolio in the year ending Q3 of 2023, primarily due to challenges in its core business of leasing and hire purchase. The restrictions on vehicle imports and adverse macroeconomic conditions compelled the sector to diversify its loan portfolio, particularly towards pawning advances or gold-backed loans. However, this diversification poses risks, especially given the volatility of gold prices in the global market. The asset quality of the sector deteriorated, indicated by an increase in Stage 3 Loans to Total Loans. The liquidity position of the sector remained above the regulatory requirement, mainly due to increased investments in Government securities. However, some companies faced challenges in meeting the minimum liquidity requirement. The sector increased its exposure to sovereign risk by investing more in Government securities. Despite the challenges, stable funding sources reduced the sector's funding *risk. Profit after tax increased, driven by higher revenue and reduced impairment charges. The Capital Adequacy Ratio (CAR) of the sector improved with higher regulatory capital growth compared to risk weighted assets. However, there is a need for continued consolidation in the sector to ensure resilience. Overall, the sector faced challenges, and its ability to evolve its business model will be crucial for navigating the economic turbulence.*

During the first half of 2023, the insurance sector recorded a rise in Gross Written Premium (GWP) with repriced policies amidst rising price levels. Long-term insurance outpaced general insurance in asset growth, while claims were also high due to elevated motor repair cost. General insurance lagged behind long-term insurance in terms of profitability while liquidity ratios improved for both segments. General insurance's CAR declined while that of long-term insurance strengthened. Amid these dynamics, the sector faces market risks with a significant share of investments in Government and corporate securities, necessitating attention to maintain capital adequacy for resilience against adverse economic shocks, if arises.

The International Monetary Fund's Extended Fund Facility (IMF-EFF) arrangement was approved in March 2023 with prior actions, quantitative performance targets and structural benchmarks on governance, macroeconomic stability, financial stability, and debt sustainability, laying a sequence of policy measures and structural reforms to ensure the resilience of the financial system[1], including minimising sovereign-bank nexus. Ensuring financial sector stability would depend on a multitude of interlinked factors, including the successful implementation of the IMF-EFF programme, which would address key imbalances within the domestic economy and the financial system, and pave the way towards sustainable economic recovery that would enable a resilient financial sector.

3.1 Banking Sector

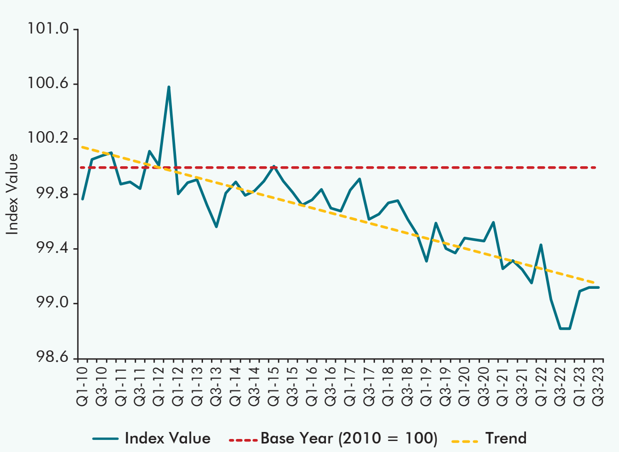
Banking Soundness Index[2]

Overall soundness of the banking sector as indicated by the BSI improved at end Q3 of 2023 compared to the corresponding period of the previous year. However, the index remained below 100 during the recent past, reflecting the challenging operating environment of the banking sector. Liquidity, market risk, capital adequacy, and profitability sub-indices improved at end Q3 of 2023 compared to Q3 of 2022, while asset quality and efficiency sub-indices deteriorated during the same period. Increasing Stage 3 Loans Ratios contributed to the deterioration of the asset quality sub-index, while rising operating expenses contributed to the deterioration of the efficiency sub-index.

1 Chapter 5 of the report presents details on policy measures adopted to ensure the financial stability.

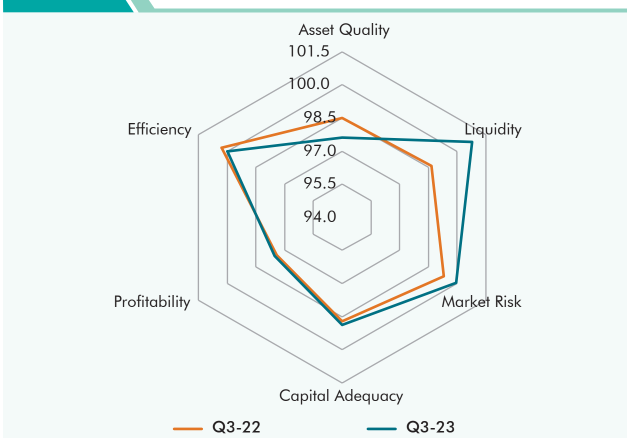
2 The BSI is a composite indicator which reflects the overall stability of the banking sector based on developments in assets quality, liquidity, capital adequacy, resilience to market risk, profitability, and efficiency. The index is weighted based on the market share of each bank. BSI is to be interpreted by factoring that the index has been prepared based on SLFRS-9 data from Q1 of 2021 onwards.

Figure 3.1 Banking Soundness Index



Source: Central Bank of Sri Lanka

Figure 3.2 Banking Soundness Map*



* Deviation from the centre indicates a positive impact to the banking system stability.

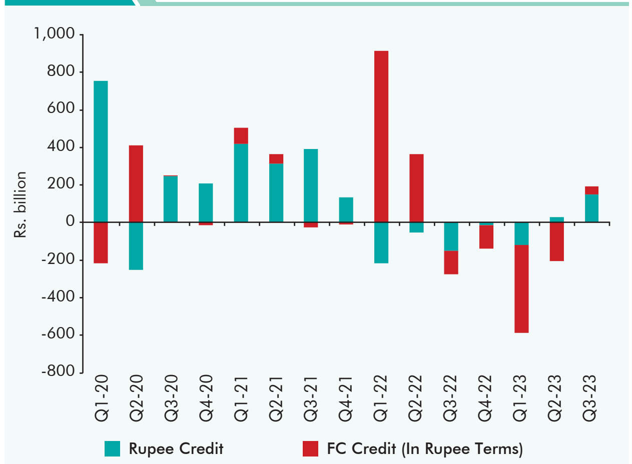
Source: Central Bank of Sri Lanka

Credit Risk

Loans and receivables of the banking sector recorded a contraction on a year-on-year (y-o-y) basis at end Q3 of 2023. However, credit expanded during Q3 of 2023. Credit of the sector contracted by 6.2 per cent on a y-o-y basis to Rs. 10.8 trillion at end Q3 of 2023, compared to a credit growth of 8.2 per cent y-o-y at end of the corresponding period of the previous year. However, during Q3 of 2023, credit expanded by 1.8 per cent on a quarter-on-quarter (q-o-q) basis, which is Rs. 194.5 billion, indicating the effect of the relaxation of policy rates since June 2023. This credit expansion was mainly supported by the increase in Rupee denominated credit, which increased by Rs. 151.4 billion (77.9 per cent of the increase in total credit). Although FC denominated credit in Rupee terms increased by Rs. 43 billion as a result of the exchange rate fluctuation, it contracted in USD terms by USD 224 million during the quarter.

Although Domestic Systemically Important Banks (D-SIBs) recorded a credit contraction on a y-o-y basis at end Q3 of 2023, credit of D-SIBs expanded during Q3 of 2023. D-SIBs recorded a credit contraction of 4.8 per cent y-o-y at end Q3 of 2023, compared to a credit growth of 5.7 per cent y-o-y at end of the corresponding period of the previous year. However, credit of D-SIBs expanded by 3.5 per cent q-o-q at end Q3 of 2023, which is Rs. 217.6 billion. In contrast, the credit of other domestic banks and foreign banks remained contracted during the quarter. Hence, the banking sector credit expansion in Q3 of 2023 was solely driven by D-SIBs.

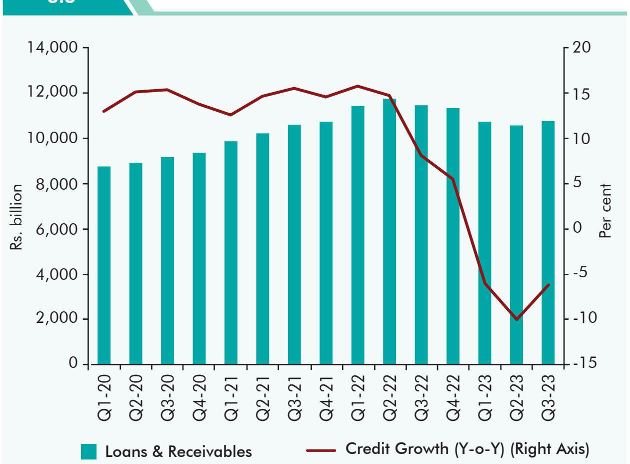
Figure 3.4 Change in Credit based on Currency (Quarterly)



Source: Central Bank of Sri Lanka

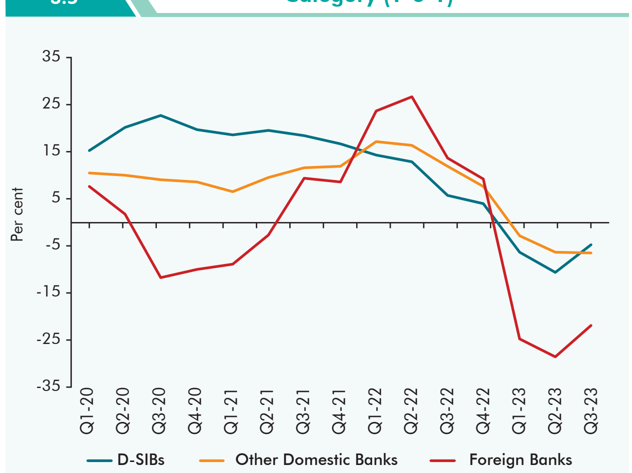
The concentration risk of the banking sector remained high as credit was concentrated to six main sectors, and some of these sectors reported relatively high Stage 3 Loans Ratios, indicating higher risk of default. Credit of the sector was mainly concentrated on Consumption, Construction, Trade, Manufacturing, Infrastructure, and Agriculture sectors. Credit concentration on these sectors slightly increased to 77.8 per cent at end Q3 of 2023, compared to 76.2 per cent at end Q3 of 2022. Out of these six sectors, Manufacturing, Trade, Construction, and Agriculture sectors reported Stage

Figure 3.3 Loans and Receivables



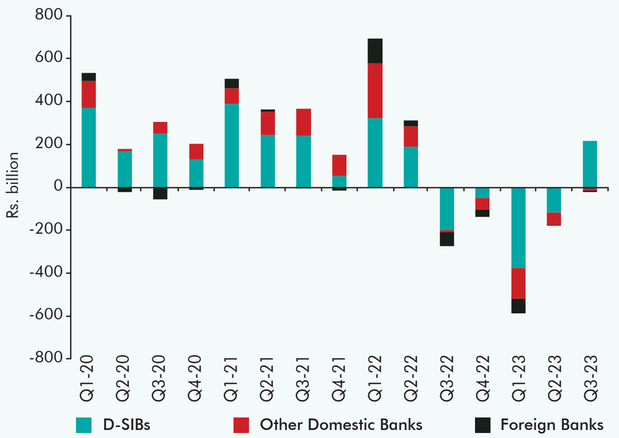
Source: Central Bank of Sri Lanka

Figure 3.5 Credit Growth based on Bank Category (Y-o-Y)



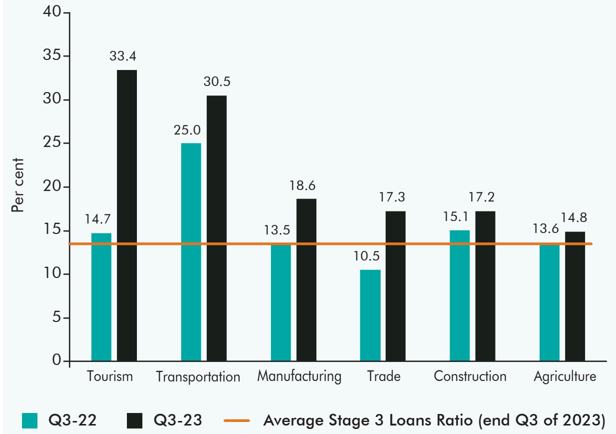
Source: Central Bank of Sri Lanka

Figure 3.6 Change in Credit based on Bank Category (Quarterly)



Source: Central Bank of Sri Lanka

Figure 3.8 Sectors with High Stage 3 Loans Ratios



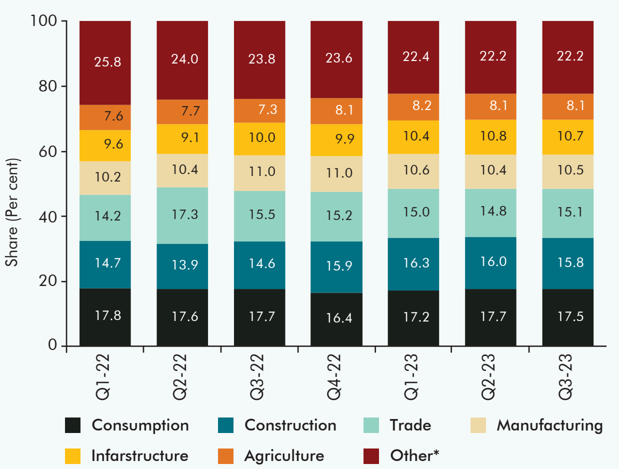
Source: Central Bank of Sri Lanka

3 Loans Ratios above the banking sector average. Furthermore, climate-related developments may pose a risk to the banking sector due to the sector's considerable exposure to Agriculture sector (8.1 per cent of total credit) and the Stage 3 Loans Ratio of Agriculture sector was high at 14.8 per cent at end Q3 of 2023.

The credit of the Consumption sector contracted on a y-o-y basis, while Stage 3 Loans Ratio of the sector increased during the first three quarters of 2023. The Consumption sector, which has the highest credit concentration of the banking sector, recorded a credit contraction of 7.2 per cent y-o-y at end Q3 of 2023, however, a credit expansion of Rs. 10.4 billion was observed during Q3 of 2023. Pawning became the main consumption category during the year ending Q3 of 2023, expanding by 15.5 per cent y-o-y and representing 25.6 per cent of the consumption loans, while personal loans contracted significantly by 17.3 per cent y-o-y, representing only 23.8 per cent of the consumption loans at end Q3 of 2023. Stage 3 Loans Ratio of consumption loans gradually increased to 6 per cent at end Q3 of 2023 but remained well-below the banking sector average.

The Construction sector, which represented 15.8 per cent of the total credit portfolio of the banking sector, reported a relatively high Stage 3 Loans Ratio, indicating potential credit risk in the sector induced by adverse economic conditions. Credit growth of the Construction sector decelerated during the first three quarters of 2023 and reported a growth of 0.8 per cent y-o-y at end Q3 of 2023. The

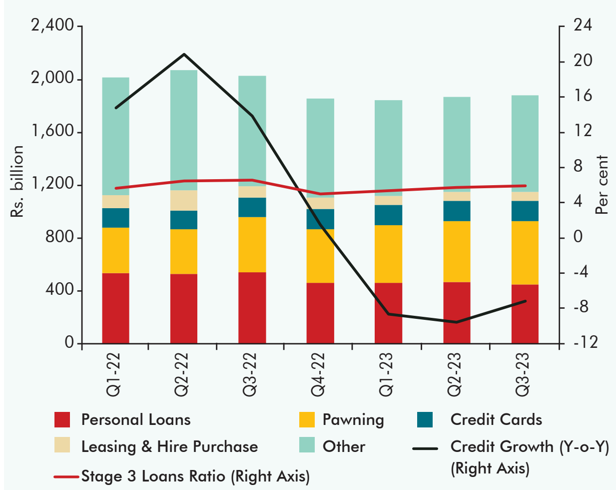
Figure 3.7 Sector wise Composition of Loans and Receivables



* Includes all other sectors except for the six main sectors.

Source: Central Bank of Sri Lanka

Figure 3.9 Credit to Consumption Activities

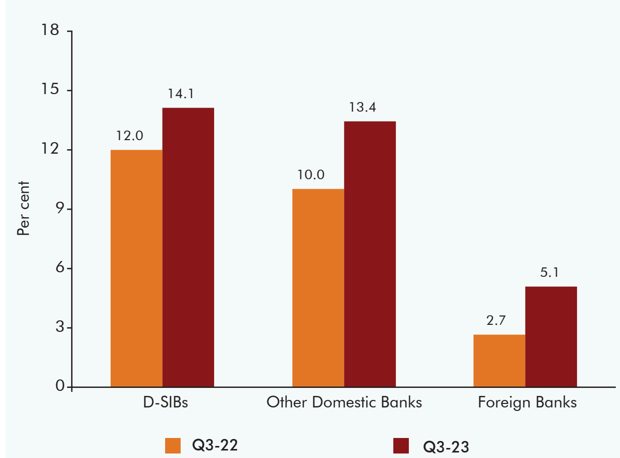


Source: Central Bank of Sri Lanka

Figure 3.10
Credit to Construction Sector

Source: Central Bank of Sri Lanka

Figure 3.12
Stage 3 Loans Ratio based on Bank Category



Source: Central Bank of Sri Lanka

contraction in credit to non-residential construction activities mainly contributed to this deceleration in credit growth of the sector. High material prices, high interest rates, and import restrictions on some construction-related material affected the sector during the year. Default risk of the sector, as indicated by the increase in Stage 3 Loans Ratio, increased from 15.1 per cent at end Q3 of 2022 to 17.2 per cent at end Q3 of 2023. Although the outlook for the sector during Q4 of 2023 is positive as per the Construction Purchasing Managers' Index (PMI)[3], this may be contingent upon recovery of both private sector and public sector spending.

Overall default risk of the banking sector remained high, while some stabilisation of the risk was witnessed during Q3 of 2023. Default risk of the sector as indicated by the Stage 3 Loans Ratio (including undrawn amounts) increased to 13.6 per cent at end Q3 of 2023, compared to 10.8 per cent at end Q3 of 2022. Decelerating, but high growth in stage 3 loans as well as the decelerating growth in total loans and receivables contributed to the increase in Stage 3 Loans Ratio during the year ending Q3 of 2023. All the bank categories, i.e. D-SIBs, other domestic banks, and foreign banks, reported increases in their respective Stage 3 Loans Ratios during the year ending Q3 of 2023, although it was comparatively low for foreign banks when compared to domestic banks. D-SIBs reported the highest Stage 3 Loans Ratio of 14.1 per cent at end Q3 of 2023, which was above the sector average, indicating higher exposure to default risk. Moreover, although the Stage 3 Loans Ratio of other domestic banks is low compared to D-SIBs, the increase in the Ratio was higher for other domestic banks, indicating higher build-up of credit risk during the period under consideration.

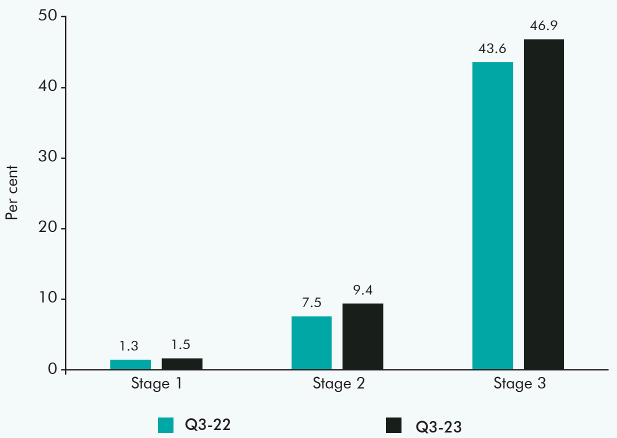
Stage 3 impairment (including undrawn amounts) of the banking sector increased at a slower pace than the stage 3 loans and receivables (including undrawn amounts) during the year ending Q3 of 2023. During the year ending Q3 of 2023, stage 3 loans (including undrawn amounts) increased by Rs. 217.3 billion, however, stage 3 impairment increased by only Rs. 142.5 billion. Although the Stage 3 Impairment Coverage Ratio (including undrawn amounts) slightly improved from 43.6 per cent at end Q3 of 2022 to 46.9 per cent at end Q3 of 2023, it could be further improved considering the relatively high

3 Construction PMI is published by the Central Bank of Sri Lanka monthly.

Figure 3.11
Stage 3 Loans Ratio

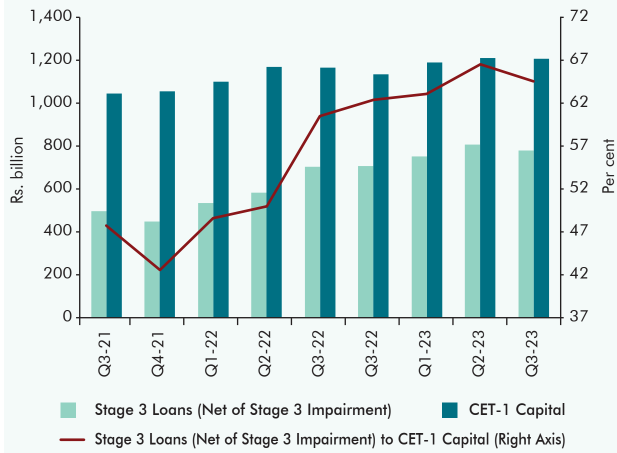
Source: Central Bank of Sri Lanka

Figure 3.13 Impairment Coverage Ratios



Source: Central Bank of Sri Lanka

Figure 3.15 Net Stage 3 Loans to CET-1Capital



Source: Central Bank of Sri Lanka

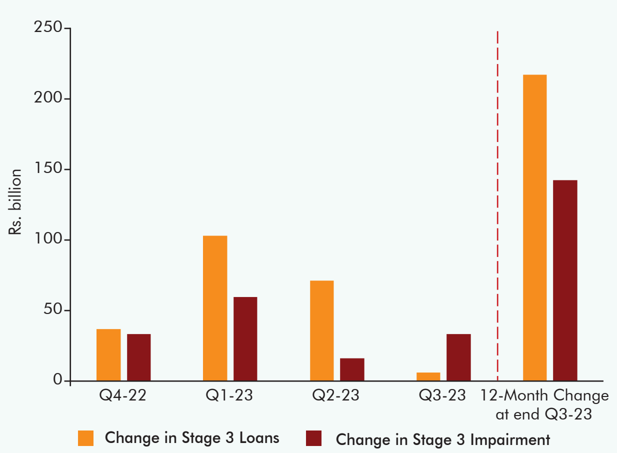
credit risk of the sector. Even though comparatively lower impairment may increase profits during the current period, it could have negative consequences for the future profitability of the sector. Furthermore, according to the results of the diagnostic exercise/ Asset Quality Review (AQR) conducted on selected banks, it is prudent to increase the impairment coverage of the respective banks.

Lower impairment made during the year ending Q3 of 2023 compared to the previous year was further reflected by the increase in the Net Stage 3 Loans (Net of Stage 3 Impairment) to Common Equity Tier-1 (CET-1) Capital Ratio. Net Stage 3 Loans to CET-1 Capital Ratio increased from 60.5 per cent at end Q3 of 2022 to 64.5 per cent at end Q3 of 2023. However, the Ratio declined slightly at end Q3 of 2023 compared to the previous quarter, reflecting a higher impairment allocation compared to the increase in stage 3 loans during Q3 of 2023.

Stage 3 Loans Ratio of large borrowers[4] of D-SIBs were higher than that of other domestic banks and foreign banks. The average Stage 3 Loans Ratio of large borrowers of D-SIBs was comparatively high at 11.9 per cent, denoting a higher credit risk to D-SIBs. Furthermore, it was observed that 67.4 per cent of the total credit of foreign banks was granted to their large borrowers, on average, indicating a higher concentration risk of foreign banks. Nevertheless, the average Stage 3 Loans Ratio of these large borrowers of foreign banks remained low at 7 per cent.

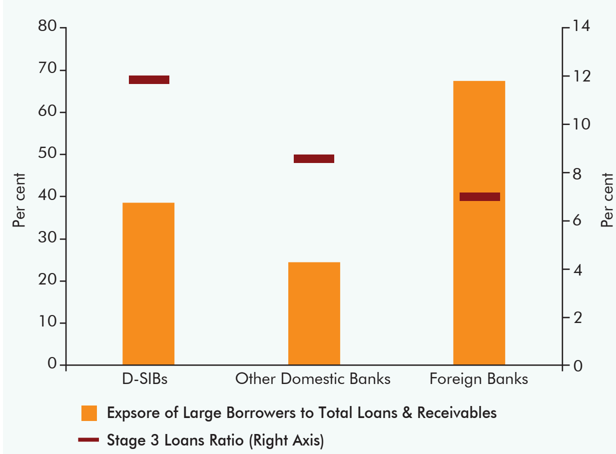
4 This analysis was carried out using the data of the largest fifty borrowers of each licensed bank as at end Q3 of 2023, including the Central Government and SOEs.

Figure 3.14 Change in Stage 3 Loans and Stage 3 Impairment



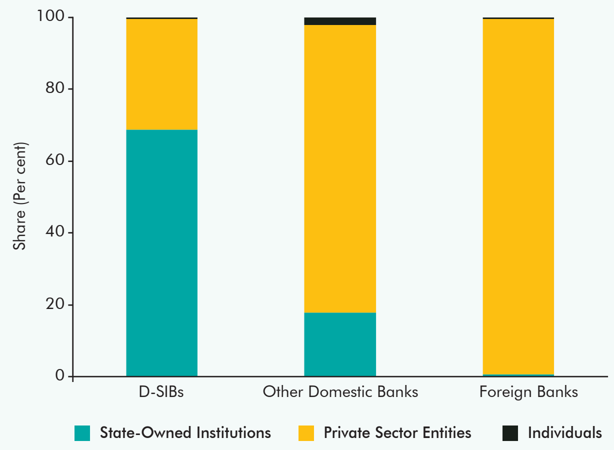
Source: Central Bank of Sri Lanka

Figure 3.16 Exposure to Large Borrowers



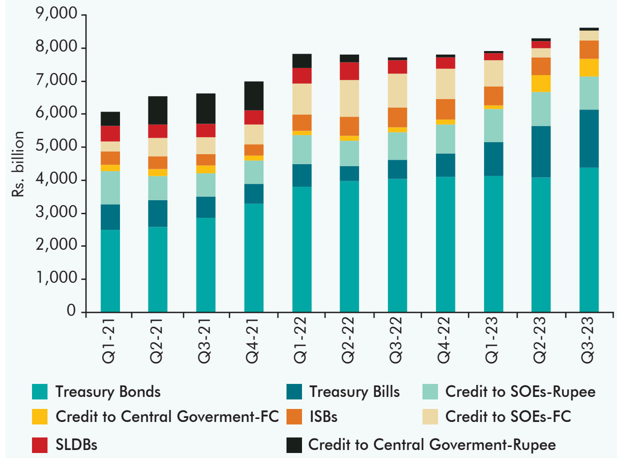
Source: Central Bank of Sri Lanka

Figure 3.17 Credit Concentration of Large Borrowers by Bank Category



Source: Central Bank of Sri Lanka

Figure 3.19 Banking Sector Exposure to the Central Government and SOEs

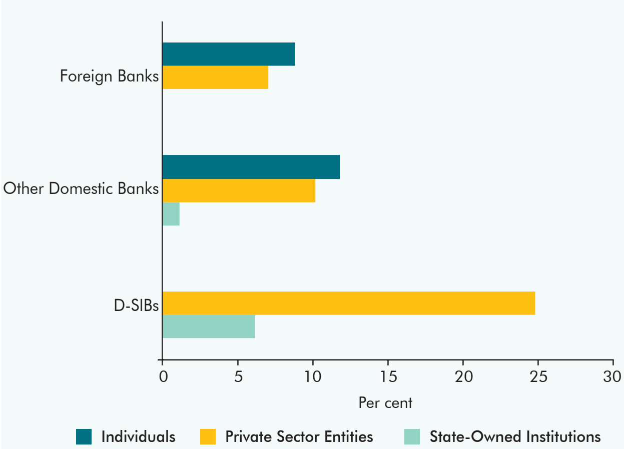


Source: Central Bank of Sri Lanka

Credit extended by some D-SIBs to several large private sector borrowers possess high Stage 3 Loans Ratios. Private sector entities represented 30.7 per cent of the credit granted by D-SIBs to their largest borrowers, on average. Out of which 24.8 per cent of large private sector borrowers of D-SIBs were classified as stage 3 loans, indicating a relatively high credit risk emanating from the private sector. D-SIBs mostly catered to state-owned institutions, which represented 68.8 per cent of the credit granted by D-SIBs to their largest borrowers on average, mainly due to the exposure of the two state-owned LCBs. However, the average Stage 3 Loans Ratio of the large state-owned borrowers was comparatively low.

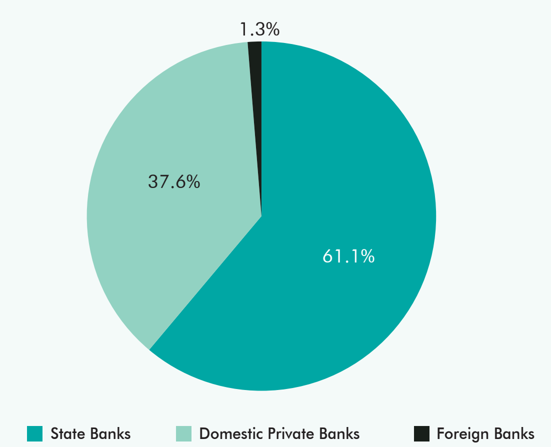
The banking sector's exposure to the Central Government and SOEs (sovereign exposure) continued to increase during the year ending Q3 of 2023, particularly through investments in Rupee denominated Government securities. Sovereign exposure of the banking sector increased by Rs. 895 billion from end Q3 of 2022 to end Q3 of 2023 and reached Rs. 8,612.3 billion. Accordingly, sovereign exposure amounted to 43.4 per cent of the banking sector's total assets. During this period, investments in Treasury bills and Treasury bonds increased by Rs. 1,500.9 billion, and FC credit to the Central Government increased by Rs. 371.2 billion, mainly due to the Central Government absorbing FC denominated credit facilities of the Ceylon Petroleum Corporation (CPC). This development contributed to the decline in FC credit to SOEs during the period. Furthermore, the sector completed the restructuring of SLDBs under the Domestic Debt Optimisation (DDO) programme during the period. When Q3 of

Figure 3.18 Stage 3 Loans Ratio of Large Borrowers based on Borrower Category



Source: Central Bank of Sri Lanka

Figure 3.20 Sovereign Exposure by Bank Category at end Q3 of 2023



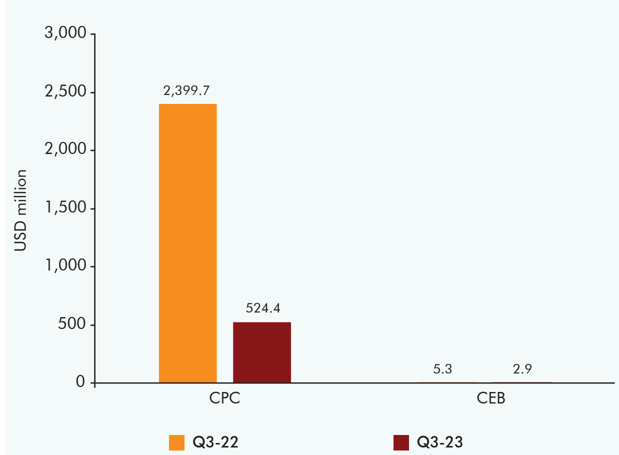
Source: Central Bank of Sri Lanka

2023 is concerned, sovereign exposure increased by Rs. 323.1 billion, mostly due to investments in Treasury bills and Treasury bonds.

State banks were highly exposed to the sovereign as at end Q3 of 2023. State banks represented 61.1 per cent of the total sovereign exposure, mainly due to exposure of the two state-owned LCBs. Domestic private banks also possessed a notable portion of the total sovereign exposure, while the exposure of foreign banks to the sovereign was low and mainly generated through investment in Rupee denominated Government securities.

The banking sector's exposure to major SOEs declined amidst efforts to restructure these entities. The sector's total exposure to CPC reduced by 55.1 per cent during the period, mainly due to the transfer of outstanding guaranteed FC debt of CPC to the Government, in line with the actions agreed under the IMF-EFF arrangement to restructure the balance sheets of selected SOEs. CPC was solely supported by the two state-owned LCBs that had granted FC facilities amounting to USD 2.4 billion as at end Q3 of 2022, which was subsequently reduced to USD 524.4 million as at end Q3 of 2023, due to the aforementioned debt transfer arrangement. However, one state-owned LCB is yet to reflect this arrangement in its financials as at end Q3 of 2023, due to ongoing negotiations regarding the terms of the arrangement. Moreover, it was observed that the two state-owned LCBs have not extended further credit to the Ceylon

Figure 3.22 Banking Sector Exposure to CPC and CEB - Foreign Currency



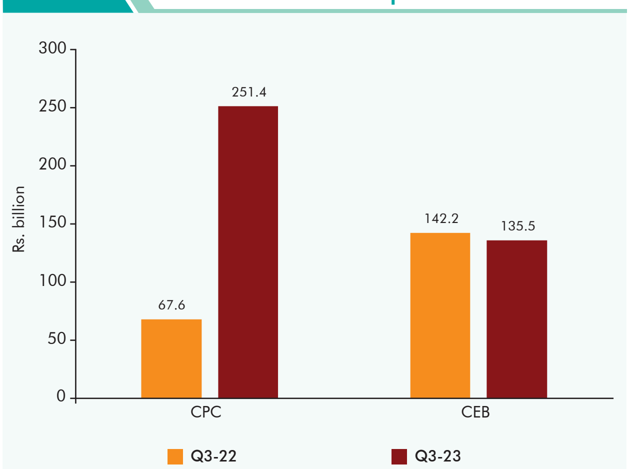
Source: Central Bank of Sri Lanka

Electricity Board (CEB) during recent months, and the banking sector's exposure to CEB reduced by 5.3 per cent during the year ending Q3 of 2023, with the improved cashflow of CEB. Restructuring of SOEs and running them as commercially viable entities is essential for the stability of the SOEs as well as the financial sector.

Liquidity Risk

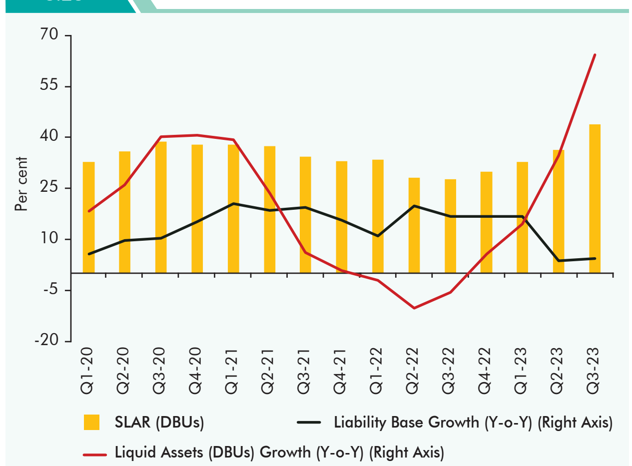
Liquidity ratios of the banking sector significantly improved during the period under review, as indicated by the Statutory Liquid Assets Ratio (SLAR) and Rupee Liquidity Coverage Ratio (LCR), while overall utilisation of SLF by the banking sector reduced significantly. Domestic Banking Units (DBUs) of the banking sector recorded

Figure 3.21 Banking Sector Exposure to CPC and CEB - Rupee



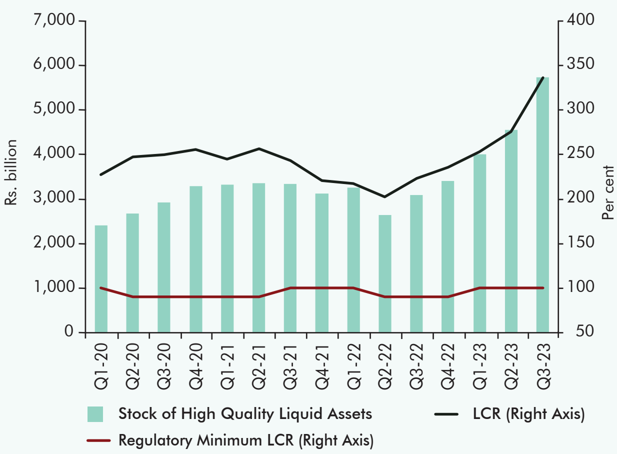
Source: Central Bank of Sri Lanka

Figure 3.23 SLAR of DBUs



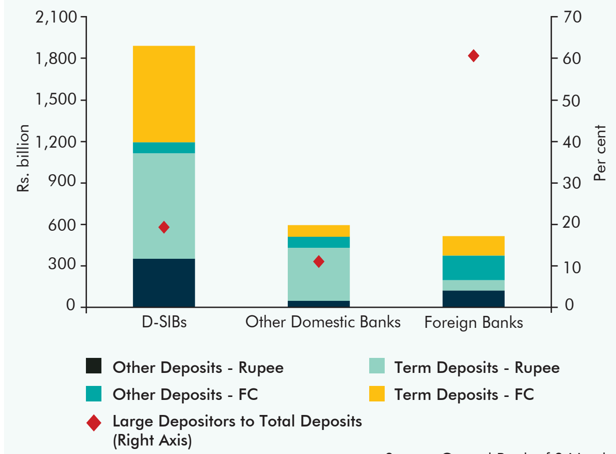
Source: Central Bank of Sri Lanka

Figure 3.24 Rupee LCR



Source: Central Bank of Sri Lanka

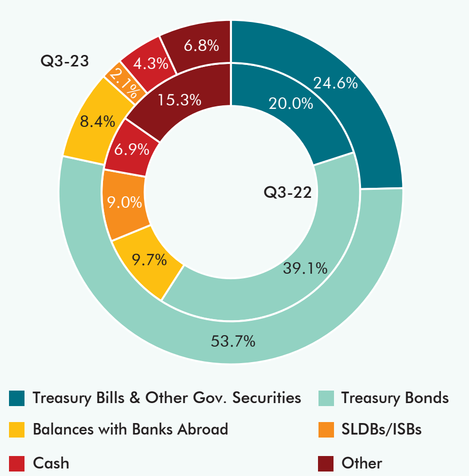
Figure 3.26 Large Depositors by Bank Category



Source: Central Bank of Sri Lanka

a SLAR of 43.8 per cent and Rupee LCR of 336.6 per cent at end Q3 of 2023, mainly due to the increased growth in liquid assets in the form of investments in Government securities. However, it was observed that the inter-bank market recorded liquidity deficits, with few banks frequently accessing the Central Bank's SLF in 2023 to fulfil their liquidity needs. Thus, to provide a permanent solution to the liquidity deficit in the market, the Central Bank reduced the Statutory Reserve Ratio (SRR) to 2 per cent in August 2023. In addition, the Monetary Board of the Central Bank has approved the Emergency Loans and Advances (ELA) framework in November 2022 to provide emergency liquidity facilities to licensed banks, if a need arises. However, none of the banks requested liquidity under the ELA facility during the period under review.

Figure 3.25 Liquid Assets (DBUs) Composition



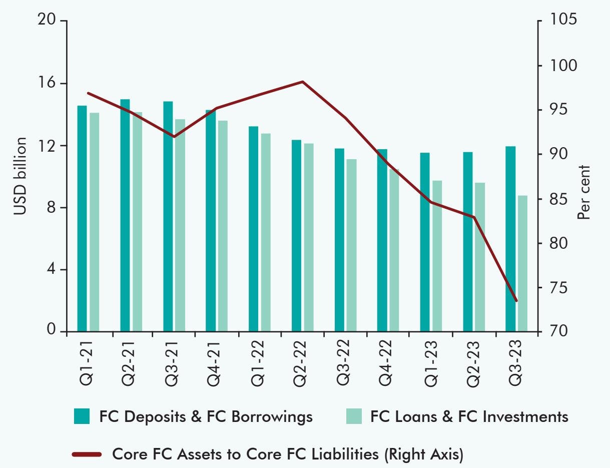
Source: Central Bank of Sri Lanka

Increased liquid assets in the form of investments in Government securities exaggerated the liquid asset ratios of the banking sector. Banks have increasingly been investing in Government securities, prompted by attractive interest rates and low demand for loans, which contributed to the growth of liquid assets by 64.3 per cent y-o-y at end Q3 of 2023. Further, the increased intrinsic value of Treasury bonds reflecting reduced interest rates also contributed to the increased market value of Treasury bonds considered for liquid assets. Accordingly, out of Rs. 6.9 trillion of total liquid assets of the banking sector as at end Q3 of 2023, Rs. 3.7 trillion (representing 53.7 per cent) were in the form of Treasury bonds while Treasury bills constituted Rs. 1.7 trillion (representing 24.6 per cent), highlighting the significant share of Government securities within the liquid assets of DBUs consequent to the considerable expansion compared to the corresponding period of the previous year. Hence, this carries a risk of overexposure to the sovereign.

Domestic banks diversified funding sources compared to foreign banks. On average, large depositors[5] of foreign banks represented 60.6 per cent of their total deposits at end Q3 of 2023. In contrast, large depositors of D-SIBs and other domestic banks accounted for a much lower share of their deposit base. However, large depositors of the two state-owned LCBs amounted to Rs. 1.5 trillion.

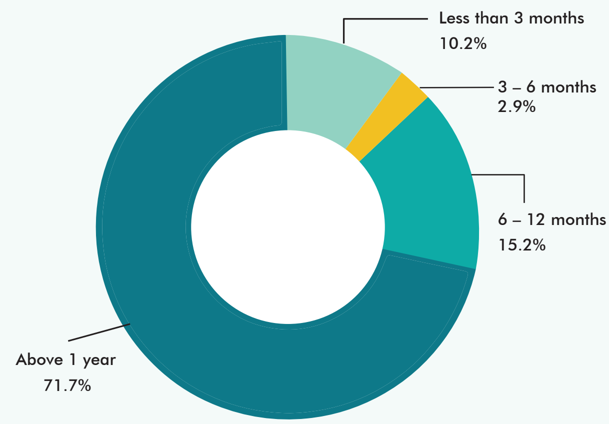
5 This analysis was carried out using the data of the largest fifty depositors of each licensed bank as at end Q3 of 2023.

Figure 3.27 Core FC Assets and Liabilities



Source: Central Bank of Sri Lanka

Figure 3.28 Maturity Profile of FC Borrowings at end Q3 of 2023

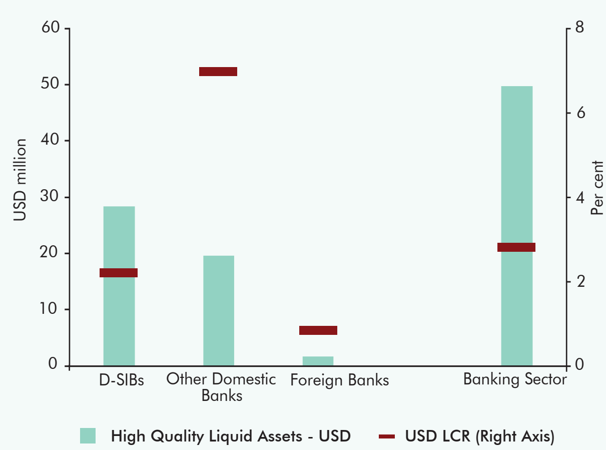


Source: Central Bank of Sri Lanka

FC liquidity showed a slight improvement with increased placements with banks abroad, however, overall FC core operations of the banking sector continued to shrink. In April 2022, the Government announced a standstill on certain categories of its external debt repayments and spillover effects were felt by banks. Amidst uncertainties surrounding sovereign debt, banks faced FC liquidity pressures due to the low rollover risk appetite of counterparties. Furthermore, banks faced FC liquidity constraints with the freezing of cashflows of ISBs in bank portfolios and repayment of SLDBs in Rupees and Rupee denominated securities. Consequently, core FC assets of the banking sector (FC loans and investments) contracted by 21.1 per cent y-o-y at end Q3 of 2023, despite the banking sector accumulating USD 4.3 billion in balances with financial institutions abroad. Contraction of core FC assets indicates reduced lending and investment activity in foreign currency, which could impact on the profitability of the banking sector. On the other hand, core FC liabilities (FC deposits and borrowings) recorded a growth of 1 per cent, mainly due to increased FC deposits, particularly of foreign banks, while FC borrowings recorded a significant contraction of 36.7 per cent y-o-y at end Q3 of 2023. The reduction in FC borrowings was influenced by the downgrading of sovereign ratings to default category and delay in finalisation of the external debt restructuring process. These developments affected the banking sector's capacity to grant FC loans, undertake new investments, secure new debt and/or renew existing debt arrangements. It was also observed that the banks maintained an overall positive net foreign asset position in FC, to manage regular operations and possibly to meet any upcoming obligations. Nevertheless, despite the provisions made by the banks on forex investments, the ongoing discussions with creditors on the treatment of ISBs under external debt restructuring may affect the forex liquidity of certain banks which hold sizeable ISBs. Further, the restructuring of FC debt of SOEs will impact the FC liquidity, mainly in the two state-owned LCBs.

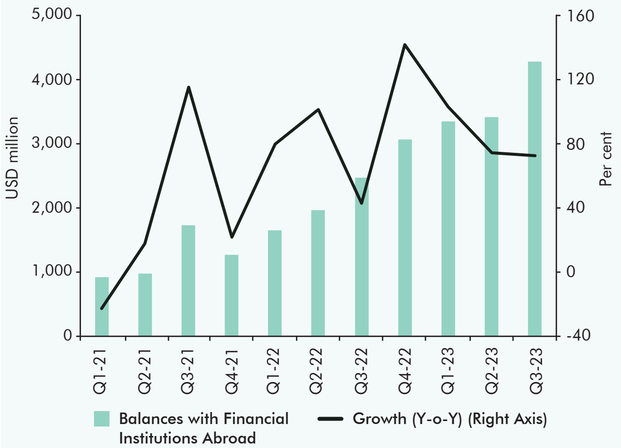
FC borrowings that are to mature in the near term significantly reduced compared to the previous year, as most of the banks may have settled their short-term borrowings at their maturity due to

Figure 3.29 USD LCR at end Q3 of 2023



Source: Central Bank of Sri Lanka

Figure 3.30 Balances with Financial Institutions Abroad



Source: Central Bank of Sri Lanka

difficulties in rolling over of FC debt. Out of the total FC borrowings of the banking sector, approximately 10.2 per cent were scheduled to mature in less than 3 months as of end Q3 of 2023. Meanwhile, a substantial portion of 71.7 per cent are to mature after a period of 1 year from end Q3 of 2023.

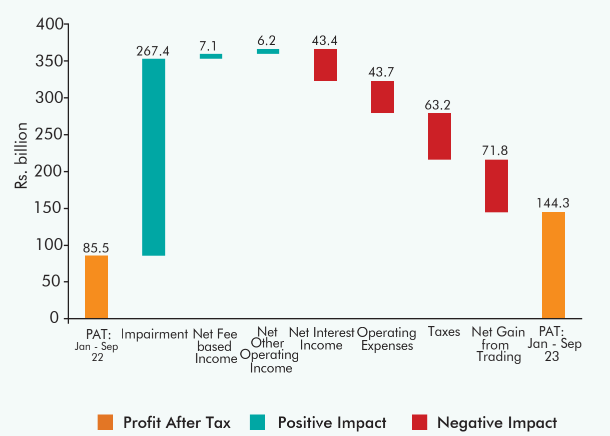
Many LCBs recorded an extremely low level of USD LCR at end Q3 of 2023, while the sector average stood at 2.8 per cent calculated as per Basel guidelines. All categories of banks recorded USD LCR figures below 10 per cent by end Q3 of 2023. Nonetheless, it was observed that LCBs held FC worth of USD 4.3 billion in FC placements with financial institutions abroad at end Q3 of 2023, and these placements were not factored into the computation of USD LCR, as per the existing direction under Basel III liquidity standards guidelines. However, if the placements with foreign financial institutions by LCBs are included, the USD LCR will exceed 200 per cent. This indicates that banks perceived and implemented strategic measures to effectively manage potential shocks to their FC liabilities.

Profitability

Profit After Tax (PAT) of the banking sector significantly increased during the nine months ending September 2023 compared to the corresponding period of the previous year, however, several banks, including two D-SIBs, reported declined profits during the period. The PAT of the banking sector increased by 68.7 per cent to Rs. 144.3 billion during the nine months ending September 2023 compared to the PAT of Rs. 85.5 billion in the corresponding period of the previous year. The main reason for this increased profit is the decline in new impairment allocation by banks, which decreased by 70.6 per cent compared to the respective period of 2022, mainly due to the fact that banks charged high impairment in 2022 considering the extraordinary market conditions. Moreover, ten banks representing a market share of 47.4 per cent, including two D-SIBs, reported a decline in their PAT for the nine months ending September 2023, compared to the corresponding period of the previous year.

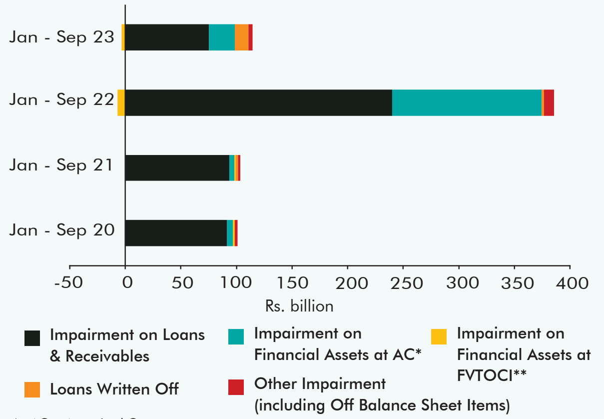
Banks curtailed charging of new impairment for loans and receivables and other financial assets significantly during the nine months ending September 2023 compared to the same period of the previous year. During 2022, the credit quality of the banking sector loans started to deteriorate due to the impact of the COVID-19 pandemic and subsequent economic crisis. The Government's decision to enter a debt standstill on external debt servicing on account of bilateral and commercial loans created uncertainty on banks retrieving their investments in FC denominated Government securities such as ISBs and SLDBs. As a result, banks had to charge impairment on their loan portfolio and investments in ISBs and SLDBs at an unprecedented level during 2022. However, due to the declining credit growth, which continued in the first half of 2023 and banks' stagnant investment in ISBs and restructuring of SLDBs under the DDO,

Figure 3.31 Impact of Income and Expenses on PAT



Source: Central Bank of Sri Lanka

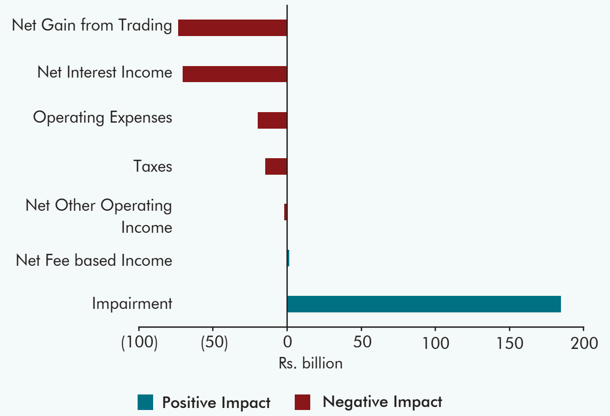
Figure 3.32 Impairment Charged on Assets



* AC - Amortised Cost
** FVTOCI - Fair Value Through Other Comprehensive Income

Source: Central Bank of Sri Lanka

Figure 3.34 Impact of Income and Expenses on PAT of D-SIBs



Source: Central Bank of Sri Lanka

banks reduced charging new impairment for loans and receivables and other financial assets during the period under consideration, compared to the corresponding period of the previous year. However, as the Stage 3 Loans Ratio of the sector continues to remain high (13.6 per cent as at end September 2023), banks are required to be prudent and charge new impairment in line with the increased portion of stage 3 loans.

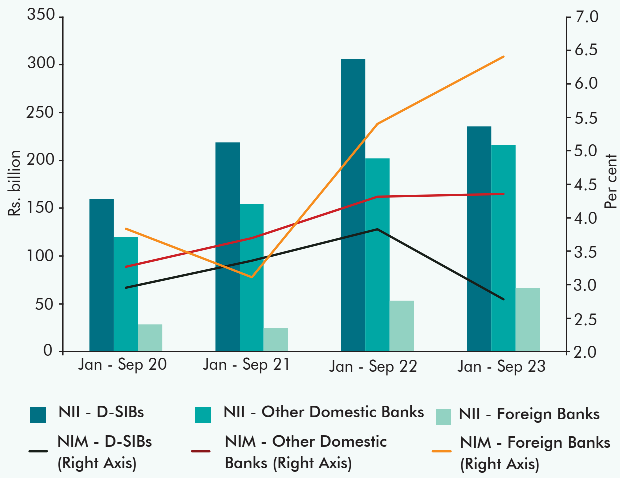
Lower growth in PAT of D-SIBs may reduce their capacity for internal capital generation. The increase in PAT of the banking sector during the nine months ending September 2023 compared to the nine months ending September 2022 was mainly contributed by foreign banks, which recorded a PAT increase of 527.9 per cent over the aforementioned period, primarily due to the reversal of impairment made during 2022. Other domestic banks recorded a notable PAT increase of 90.6 per cent, while the PAT of D-SIBs only grew by 10.6 per cent. The PAT of all three bank groups increased mainly due to the decline in new impairment charges during the nine months ending September 2023 compared to the corresponding period of the previous year. However, net losses from trading, declined net interest income, increased operating expenses, and taxes weighed down on the PAT of D-SIBs. Lower profit growth may lead to limited internal capital generation of these banks; hence, banks are required to ensure a sustainable level of profit growth by effectively managing the interest rate risk, exchange rate risk, and operating expenses.

Figure 3.33 PAT by Bank Group

Source: Central Bank of Sri Lanka

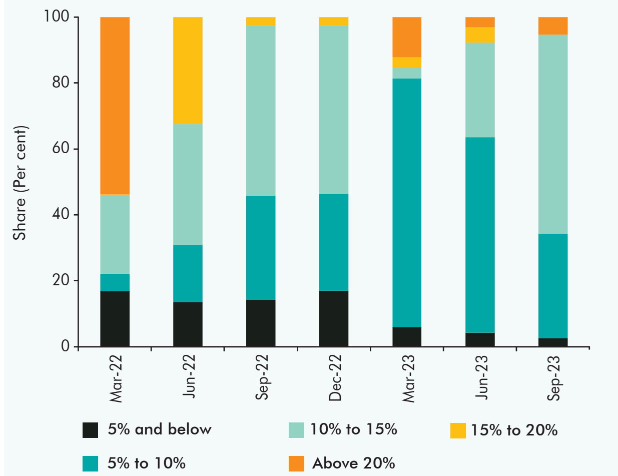
D-SIBs recorded a decline in NII while other domestic banks and foreign banks reported increases in NII, during the nine months ending September 2023 compared to the corresponding period of the previous year, reflecting the low adaptability of D-SIBs amidst volatile economic conditions. NII of D-SIBs declined by 23 per cent, while NII of other domestic banks and foreign banks improved by 6.8 per cent and 24.5 per cent, respectively, during the nine months ending September 2023 compared to the nine months ending September 2022. As a result of the decline in NII of D-SIBs, overall NII of the sector decreased by 7.7 per cent y-o-y in the period under consideration. While loan rates remained high during the period, deposit rates also remained high throughout the first

Figure 3.35 NII and NIM by Bank Category



Source: Central Bank of Sri Lanka

Figure 3.37 Distribution of Banks based on ROE (Share in Assets)

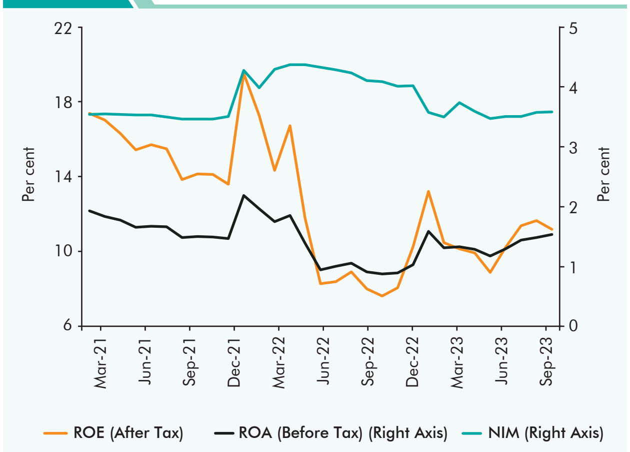


Source: Central Bank of Sri Lanka

half of the year driven by high yields on Government securities and the Rupee liquidity concerns of banks. Accordingly, interest expense on deposits of D-SIBs grew by 103.8 per cent, while interest income on loans and receivables grew by only 27 per cent on a y-o-y basis. As a result, D-SIBs found it difficult to earn an adequate spread on loans.

Although the Return on Equity after tax (ROE) and Return on Assets before tax (ROA) of the sector improved in line with the increased profits, Net Interest Margin (NIM) deteriorated due to the decline in NII. ROE of the banking sector considerably improved to 11.2 per cent in September 2023, compared to 8 per cent reported by September 2022. Banks representing a market share of 60.4 per cent reported a reasonable ROE between 10 to 15 per cent by September 2023. Nevertheless, banks representing a market share of 34.3 per cent, which included a D-SIB, reported ROE below 10 per cent, which was well below the sector average. Therefore, banks should take measures to improve their ROE, particularly in an environment where market rates are declining. ROA of the banking sector followed a similar trend to ROE, increasing to 1.5 per cent by September 2023 from 0.9 per cent by the corresponding period of the previous year. However, following the decline in NII during the period, NIM of the sector deteriorated to 3.6 per cent by September 2023, compared to 4.1 per cent by the corresponding period of 2022.

Figure 3.36 Profitability Ratios (Annualised)

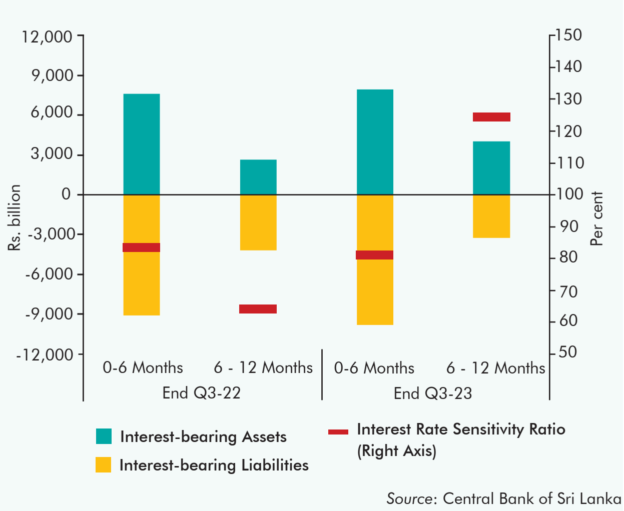


Source: Central Bank of Sri Lanka

Market Risk

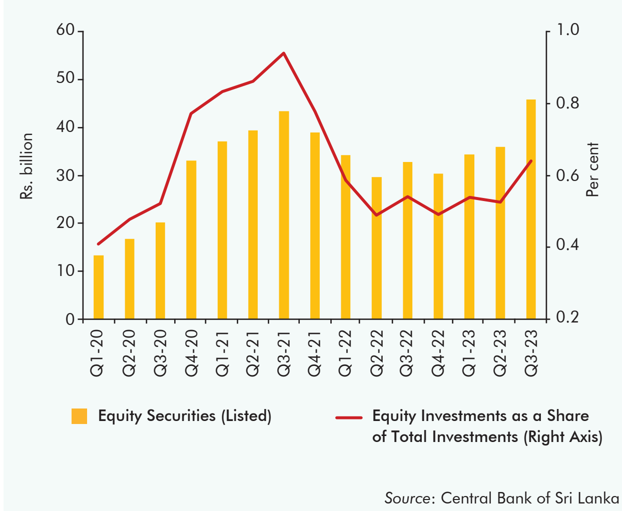
Interest rate risk of the banking sector declined at end Q3 of 2023 compared to end Q3 of 2022, due to the change in the structure of interest-bearing assets and liabilities during the year. It was observed that interest-bearing liabilities up to 6 months as a share of total interest-bearing liabilities increased to 75.1 per cent at end Q3 of 2023, compared to 68.6 per cent at the end of the corresponding period of the previous year. Simultaneously, interest-bearing assets between 6 to 12 months as a share of total interest-bearing assets increased to 33.7 per cent at end Q3 of 2023, compared to 26 per cent at end Q3 of 2022. This indicates that most of the interest-bearing liabilities may be repriced in the near term, while increased amount of interest-bearing assets may be repriced in a comparatively longer term. In the current easing monetary policy cycle, this development is

Figure 3.38 Interest-bearing Assets and Liabilities



Source: Central Bank of Sri Lanka

Figure 3.40 Equity Investments

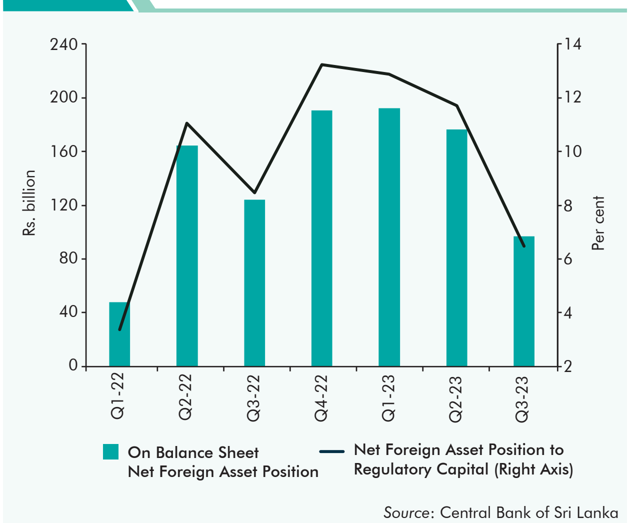


Source: Central Bank of Sri Lanka

beneficial for banks, as most of their interest-bearing liabilities may be repriced at lower market rates in the near term, while a notable portion of interest-bearing assets may continue to bear elevated market rates for a comparatively longer period. This is further reflected by the increase of the Interest Rate Sensitivity Ratio for 6 to 12 months, to 124.6 per cent at end Q3 of 2023 from 64.2 per cent at end Q3 of 2022.

Net Foreign Asset Position to Regulatory Capital Ratio of the banking sector significantly declined at end Q3 of 2023 in comparison to the corresponding period of the previous year. Moreover, the decline in net foreign asset position was even more pronounced at end Q3 of 2023 when compared with the previous quarters of 2023, indicating a lower exposure of unhedged forex position to the banking sector regulatory capital. However, the banking sector continued to maintain a positive net foreign asset position, holding more FC assets compared to FC liabilities. Accordingly, by end Q3 of 2023, the banking sector recorded a Net Foreign Asset Position to Regulatory Capital Ratio of 6.5 per cent compared to 8.5 per cent recorded in the previous year. However, few individual domestic LCBs possessed negative net foreign asset positions at end Q3 of 2023.

Figure 3.39 Net Foreign Asset Position to Regulatory Capital



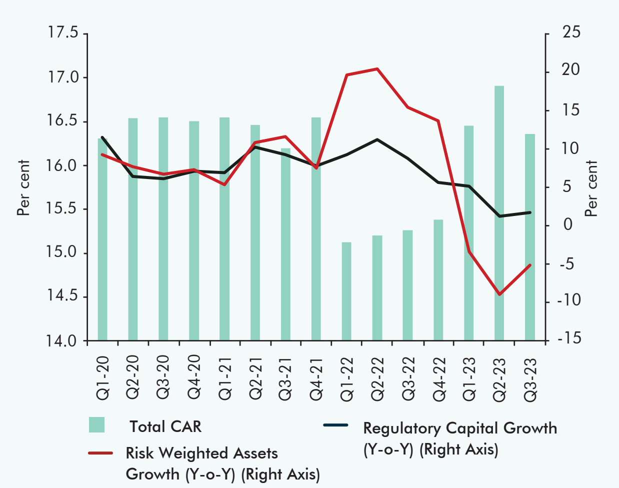
Source: Central Bank of Sri Lanka

Equity risk of the banking sector remained low. As at end Q3 of 2023, equity investment of banks represented only 0.6 per cent of the total gross investments of the banking sector. Therefore, risk emanating from fluctuations in equity prices was significantly low.

Capital Adequacy

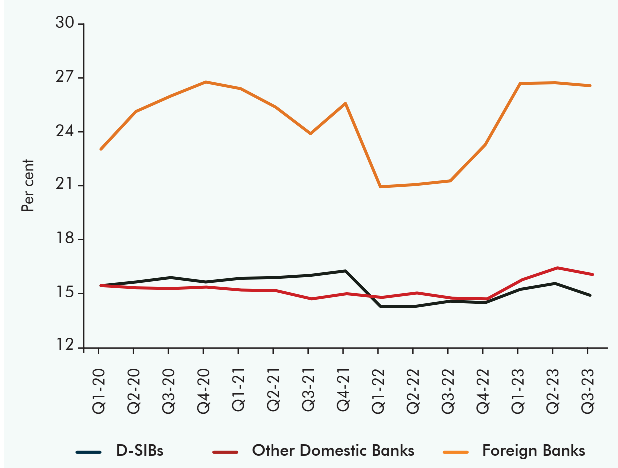
CAR of the banking sector improved considerably at end Q3 of 2023 compared to the corresponding period of the previous year, mainly due to contraction of Risk Weighted Assets (RWA) of the sector. The banking sector recorded a CAR of 16.4 per cent at end Q3 of 2023, compared to 15.3 per cent at end Q3 of 2022, mainly due to contraction of RWA by 5.1 per cent y-o-y. Meanwhile, regulatory capital of the sector increased marginally by 1.8 per cent y-o-y, also contributing to the increase of CAR at end Q3 of 2023. However, the sector recorded a decline in CAR during Q3 of 2023 as RWA increased, reflecting the credit expansion during the quarter.

Figure 3.41 Capital Adequacy Ratio



Source: Central Bank of Sri Lanka

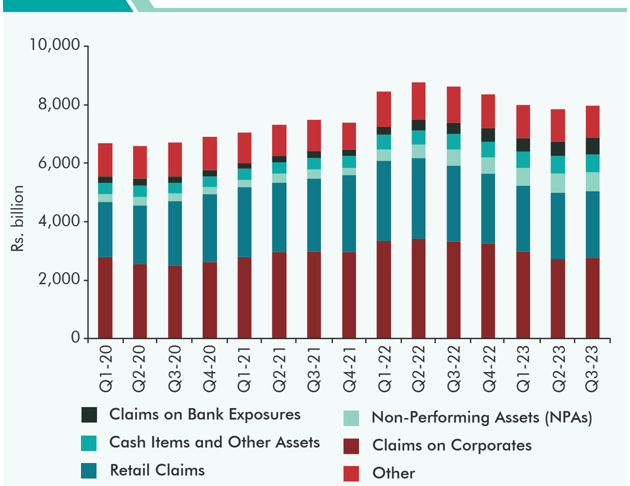
Figure 3.43 CAR by Bank Category



Source: Central Bank of Sri Lanka

The contraction of RWA of the banking sector at end Q3 of 2023 was primarily attributable to a decline in exposures to corporate and retail loans and receivables. Out of the total RWA of Rs. 9.1 trillion at end Q3 of 2023, a substantial portion of Rs. 8 trillion (87.3 per cent of total RWA) was attributed to the credit risk. RWA of corporate claims included in credit risk significantly declined to Rs. 2.8 trillion at end Q3 of 2023, compared to Rs. 3.3 trillion at end Q3 of 2022, reflecting high interest rates that prevailed during the first two quarters of the year, which curtailed the demand for loans and receivables, contributing to the decline of overall RWA. Nevertheless, RWA of the sector increased during Q3 of 2023, reflecting the credit expansion during the quarter.

Figure 3.42 Risk Weighted Assets for Credit Risk

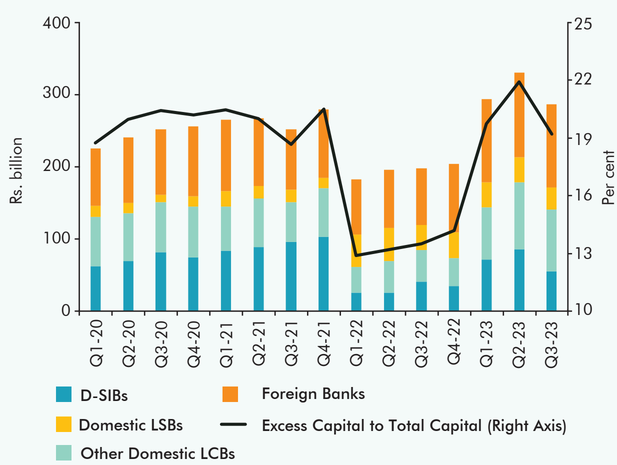


Source: Central Bank of Sri Lanka

A Significant decline in CAR was observed in D-SIBs at end Q3 of 2023 compared to Q2 of 2023, mainly due to the increase in RWA during the quarter induced by the expansion in credit of D-SIBs. CAR of D-SIBs declined to 14.9 per cent at end Q3 of 2023 from 15.6 per cent at end of the previous quarter, although CARs of all bank categories, i.e. D-SIBs, other domestic banks, and foreign banks, remained above the minimum capital requirement. The Central Bank permitted banks to drawdown their Capital Conservation Buffers (CCoB) up to 2.5 per cent, subject to the conditions stipulated in the Banking Act Direction No. 01 of 2016 on Capital Requirements under Basel III, and banks were requested to submit capital augmentation plans to rebuild the CCoB within 3 years. Accordingly, a few banks utilised the option of drawing down CCoB, however, all banks restored CCoB by end Q3 of 2023. The Central Bank also permitted banks to stagger the overnight mark-to-market losses on Rupee denominated Government securities held at fair value, arising from changes in policy interest rates, for the purpose of computing the CAR.

Excess Capital available in the banking sector increased as a result of the decline in RWA. The banking sector recorded an excess capital of Rs. 286.8 billion at end Q3 of 2023, which was an increase of Rs. 88.5 billion compared to the excess capital recorded at end of the corresponding period of the previous year. However, excess capital of the sector reduced by Rs. 43.5 billion during the quarter, reflecting the increase of RWA in the same period.

Figure 3.44 Excess Capital



Source: Central Bank of Sri Lanka

Foreign banks made the highest contribution to the excess capital of the sector, which was 40.2 per cent of the total excess capital of the sector. Accordingly, the ratio of Excess Capital to Total Capital of the sector significantly increased to 19.2 per cent at end Q3 of 2023 compared to 13.5 per cent at end Q3 of 2022.

The banking sector may need to absorb expected losses resulting from restructuring of ISBs and FC exposures of SOEs, and recapitalisation requirement arising from bank diagnostic exercise and forward-looking impact assessment. Hence, banks are being directed to submit recapitalisation plans to address capital shortfalls, if any. State-owned banks are also largely expected to be recapitalised with public funds. Accordingly, under Budget 2024, an allocation of Rs. 450 billion has been made to support the capital augmentation process of the banking sector. In addition, it was also proposed to allocate 20 per cent of the two state-owned LCBs to strategic investors or the public.

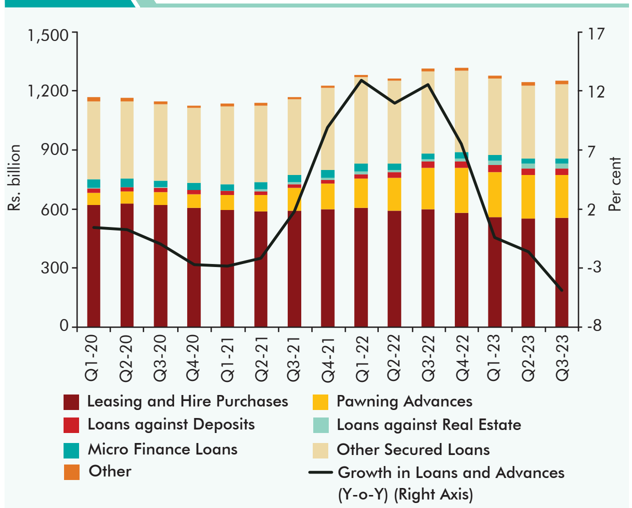
3.2 Licensed Finance Companies (LFCs) Sector

Credit Risk

Loans and advances portfolio of the LFCs sector significantly contracted during the year ending at end Q3 of 2023. As at end Q3 of 2023, total loans and advances of the sector contracted by 5.6 per cent y-o-y and stood at Rs. 1.1 trillion compared to the 14.5 per cent y-o-y growth recorded during the corresponding period in 2022. Restrictions on vehicle imports and adverse macroeconomic conditions continued to affect the core business of the sector, i.e., leasing and hire purchase, which as a share of total loans and advances has been on a declining trend reaching 44.5 per cent as at end Q3 of 2023 compared to 45.6 per cent at end Q3 of 2022 against the backdrop of increasing pawning advances of the sector. This contraction was further exacerbated by the slowdown in domestic economic activity and the sector was compelled to deviate from its core business to a more diversified loan portfolio due to restrictions on vehicle imports.

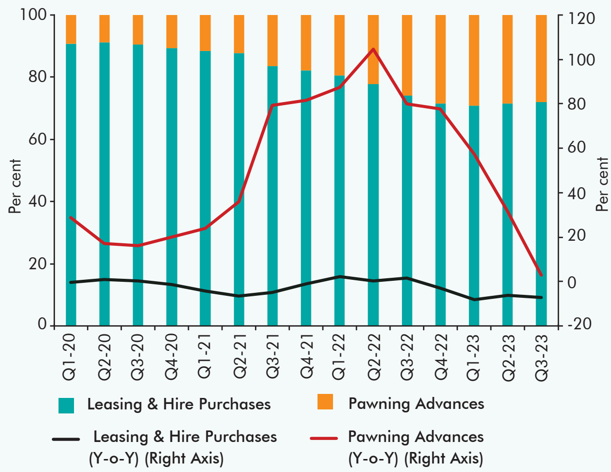
The sector encountered numerous challenges during the period concerned, primarily stemming from a reduced demand for their core business. Historically, LFCs have been involved in providing funding for vehicle purchases and their business model has evolved around leasing and hire purchases. However, continuous restrictions on vehicle imports as a measure to limit foreign exchange outflow has significantly contracted the leasing and hire purchase portfolio of LFCs. This contraction has been further exacerbated by a slowdown in domestic economic activity. Hence, the sector diversified its business towards pawning advances/gold-backed loans. The pawning portfolio of the sector increased sharply in 2021 and 2022, nevertheless, in 2023, there was a noticeable deceleration in the growth of pawning

Figure 3.45 Loans and Advances



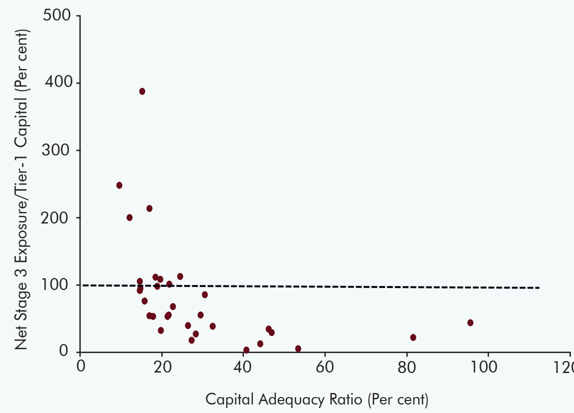
Source: Central Bank of Sri Lanka

Figure 3.46 Pawning vs. Leasing Portfolio



Source: Central Bank of Sri Lanka

Figure 3.48 Capital vs. Stage 3 Exposure of LFCs*



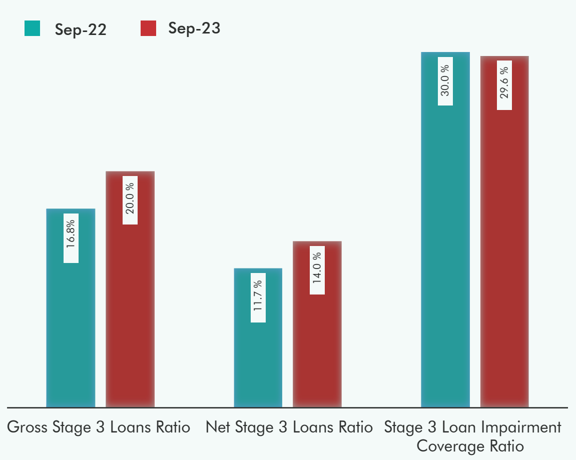
* One company with negative capital was not included in the sample for better presentation.

Source: Central Bank of Sri Lanka

advances which reflect the base effect. Borrowers resorted to pawning mainly for consumption as elevated inflation and eroded disposable income of households made them borrow through pawning. LFCs facilitated this need as their lending was backed by gold, which is viewed as a safe haven asset amidst economic turbulences. Nevertheless, heightened exposure to pawning advances may pose a risk due to the inherent volatility of gold prices in the global market. While moving towards diversification presents opportunities for growth, it is concurrently emerging as a risk to the sector.

Asset quality of the sector, indicated by Stage 3 Loans to Total Loans, deteriorated during the year ending Q3 of 2023. Gross and Net Stage 3 Loans

Figure 3.47 Asset Quality Indicators



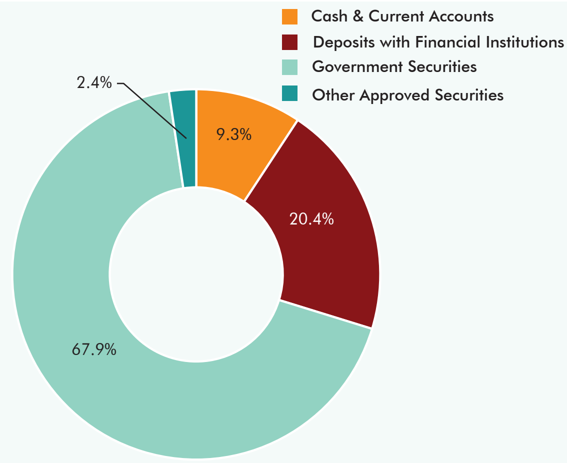
Source: Central Bank of Sri Lanka

Ratios escalated to 20 per cent and 14 per cent, respectively, by end Q3 of 2023, a notable increase from 16.8 per cent and 11.7 per cent, respectively, reported by end Q3 of 2022, showing deterioration in the asset quality thereby increasing the vulnerability of the sector to credit risk. Deterioration in asset quality to some extent can be attributed to amendments in regulatory requirements for LFCs to adopt 90 past due days for classification of non-performing/stage 3 loans with effect from 01 April 2023. Meanwhile, Stage 3 Impairment Coverage Ratio declined to 29.6 per cent by end Q3 of 2023, compared with 30.0 per cent reported by end Q3 of 2022. Given the elevated exposure of many individual LFCs to stage 3 loans in terms of their capital, it would be prudent for LFCs sector to accumulate higher impairment coverage to withstand any unexpected credit shock.

Liquidity Risk

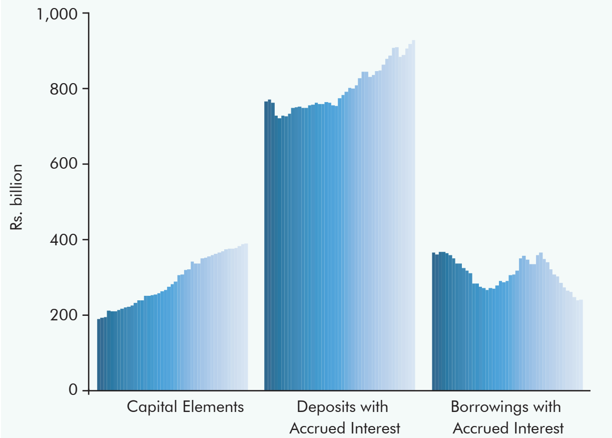
Liquidity position of the sector remained above the minimum regulatory requirement, reporting a surplus of Rs. 150 billion mainly due to increased investments in Government securities. Total regulatory liquid assets available in the sector was Rs. 251.9 billion as at end Q3 of 2023, against the stipulated minimum requirement of Rs. 101.9 billion. Out of total liquid assets of the sector, investments in Government securities represented a higher contribution and accounted to 67.9 per cent of LFCs'

Figure 3.49 Composition of Liquid Assets at end Q3 of 2023



Source: Central Bank of Sri Lanka

Figure 3.51 Major Sources of Funding (2020 to 2023 September)

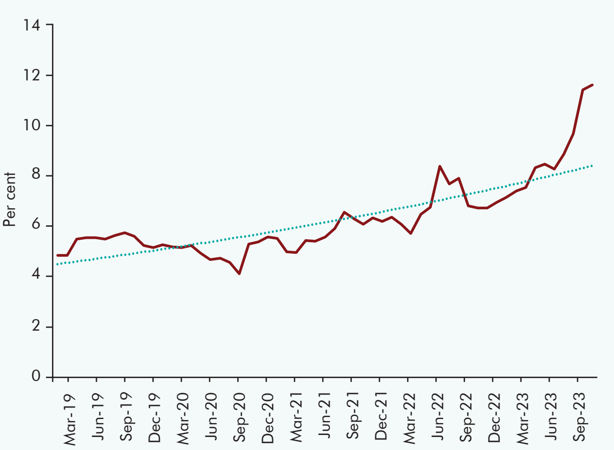


Source: Central Bank of Sri Lanka

liquid assets. Although the industry recorded a surplus there were instances where one or two companies could not meet the minimum liquidity requirement.

LFCs' exposure to the sovereign increased during the period concerned. Investments in Government securities as a share of total assets of the sector increased considerably to 11.6 per cent at end Q3 of 2023 compared to 6.7 per cent at end Q3 of 2022 reflecting the attractive yields for Government securities. In the meantime, a significant shift in the investment composition of the sector has been observed in the recent past. The sector's interest in long-dated Government securities has been a major contributor to this phenomenon. Although LFCs are not exposed to sovereign risk as much as

Figure 3.50 Investments in Government Securities as a Share of Total Assets



Source: Central Bank of Sri Lanka

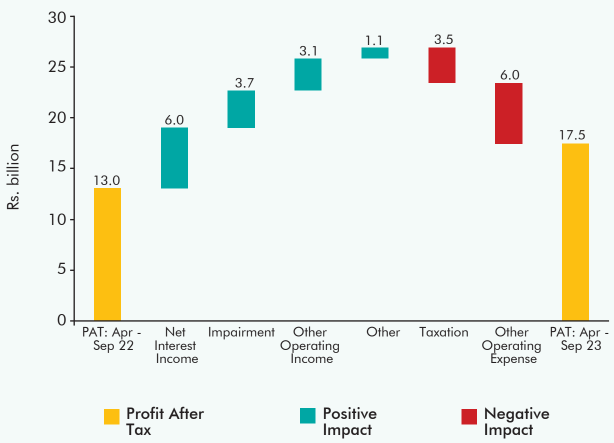
banks, the escalating trend in relative investments in Government securities exhibits the sector tilting towards sovereign.

Increasing stable funding sources eased the pressure on the sector's funding risk. On an overall basis, capital and deposits were on an increasing trend, while borrowings were on a declining trend during the period under review. Successful implementation of the Masterplan for Consolidation, which helped to build up confidence of the sector caused an increase in capital, an improvement in deposit growth, and a decline in borrowings in the sector. Accordingly, the Borrowings to Total Liabilities, which was above 28.9 per cent at end Q3 of 2022, declined to 19.4 per cent at end Q3 of 2023. However, declining interest rates with monetary policy easing may cause a reversal in deposit growth and declining borrowings in the sector.

Profitability

PAT of LFCs increased during the six months ending September 2023 in the financial year 2023/24 compared to the corresponding period of the previous year. The PAT of the LFCs sector increased by 33.9 per cent to Rs. 17.5 billion during the six months ending September 2023 compared to the PAT of Rs. 13.0 billion in the corresponding period of the previous year. Increased revenue including interest income and reduced impairment charges for loan losses positively contributed to the increase

Figure 3.52
Impact of Income and Expenses on PAT



Source: Central Bank of Sri Lanka

of profitability of the sector. However, reducing new impairment charges when stage 3 loans are rising may not be sustainable.

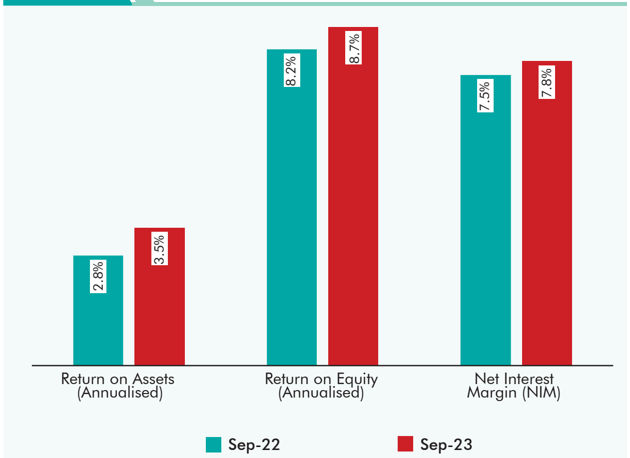
In line with other profitability measures, profitability indicators improved at end Q3 of 2023. The profitability of the sector as indicated by NIM, ROA and ROE increased to 7.8 per cent, 3.5 per cent and 8.7 per cent, respectively, at end Q3 of 2023 compared to 7.5 per cent, 2.8 per cent and 8.2 per cent, respectively, recorded at end Q3 of 2022. Nevertheless, economic challenges have not abated, and the sector will have to continue evolving its business model in mitigating risks and ensuring the sector's resilience during economic turbulence.

Capital Adequacy

CAR of the LFCs sector improved at end Q3 of 2023 compared to Q3 of 2022. Higher growth of regulatory capital against subdued growth of risk weighted assets contributed to this positive development. Contraction of loans and advances amidst higher exposure to pawning advances and increase in risk-free investments mainly contributed to subdued growth of risk weighted assets. Tier-1 eligible capital continued to dominate the total capital of the LFCs sector accounting for 94.5 per cent of total capital. Irrespective of strengthening capital position of the sector, few companies need to comply with minimum capital requirements. Therefore, continuation of the consolidation of LFCs is required to maintain resilience of the sector.

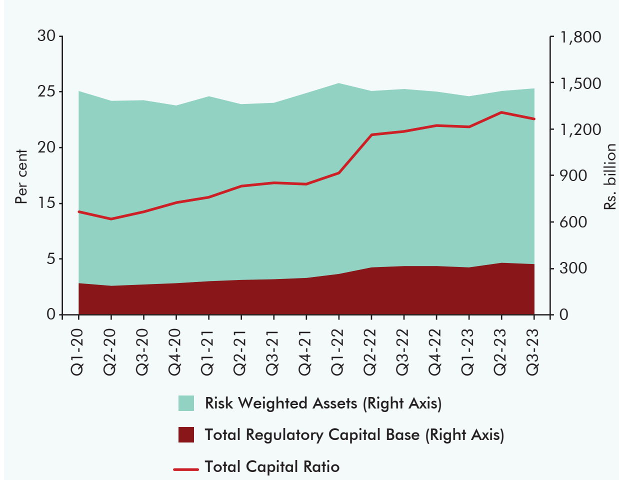
The Masterplan for Consolidation of Non-Bank Financial Institutions (the Masterplan) was introduced in the latter part of 2020 with a view to creating a strong and stable Non-Bank Financial Institutions Sector. So far under the Masterplan, 5 amalgamations have been completed while another is expected to be completed shortly. In addition, 2 Specialised Leasing Companies were upgraded to LFCs, through their active participation in the Masterplan. Cancellation of 2 LFCs was facilitated through providing funding for the settlement of deposits of those institutions. Further, several LFCs enhanced their capital levels to be compliant with the requirements imposed under the Masterplan for LFCs to continue as standalone companies.

Figure 3.53
Profitability Indicators



Source: Central Bank of Sri Lanka

Figure 3.54
Capital Adequacy



Source: Central Bank of Sri Lanka

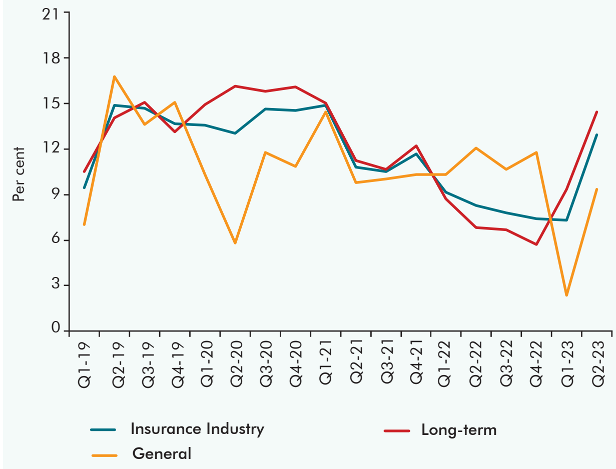
3.3 Insurance Sector

The insurance sector recorded increased GWP during the first half of 2023. GWP in the long-term and general insurance sectors grew by 10.4 per cent and 7.2 per cent during the first half of 2023, y-o-y, mainly due to repricing of policies amidst rising price levels. Insurance penetration in the country, measured by annualised GWP as a percentage of gross domestic product[6] was only 1.2 per cent by end Q2 of 2023.

Asset growth of long-term insurance was ahead of general insurance by end Q2 of 2023. Y-o-y asset growth of general insurance was 9.3 per cent whilst the y-o-y asset growth of long-term insurance was 14.4 per cent at end Q2 of 2023. Compared to long-term insurance, the general insurance sector had less investments in Government securities and corporate debt in total asset composition. The domestic debt optimisation announcement in June 2023 was limited to Treasury bond holdings of pension funds and SLDBs. The insurance sector, which was under pressure due to heavy investments in Government securities, benefitted from the exclusion from DDO. However, interest rate risk of the industry is high as the sector invested in interest bearing assets and insurers need to consider portfolio duration with careful and thorough analysis to minimise market losses.

6 Gross domestic product for 2022 was used in the computation.

Figure 3.56 Asset Growth (Y-o-Y)

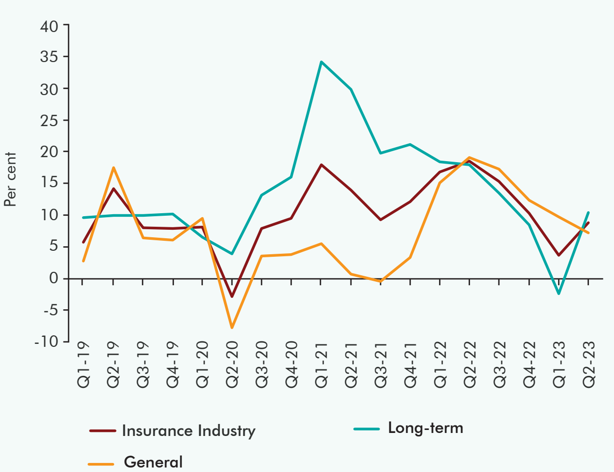


Source: Insurance Regulatory Commission of Sri Lanka

Claims of the insurance industry were high due to elevated prices. Prices of repair costs in motor insurance increased tremendously in the recent past leading to higher claims. Total claims made by the long-term insurance sub sector, which includes maturity and death benefits, increased by 47.2 per cent during the six months ended Q2 of 2023 compared to the corresponding period of the previous year, whereas the claims made by the motor (3.5 per cent), fire (68 per cent), marine (10.4 per cent) and other (38.5 per cent) insurance sub-sectors recorded increased claims.

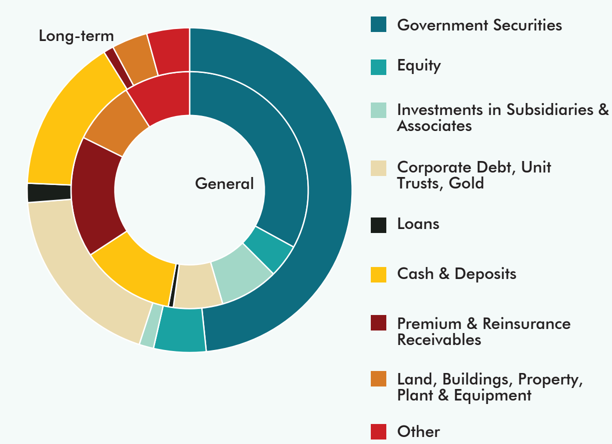
Profitability of the general insurance segment was low compared to life insurance as long-term insurance benefited from higher investment

Figure 3.55 Gross Written Premium Growth (Y-o-Y)



Source: Insurance Regulatory Commission of Sri Lanka

Figure 3.57 Composition of Total Assets of Insurance Segments



Source: Insurance Regulatory Commission of Sri Lanka

earnings due to higher investments in Government securities. The Combined Operating Ratio, which is the total of Loss Ratio[7] and Management Expense Ratio[8], for general insurance surpassed 100 per cent in the beginning of 2022. At end Q2 of 2023, the Combined Operating Ratio for general insurance was 111.7 per cent. The ratio was 96.8 per cent for long-term insurance segment. Similarly, ROA and ROE of general insurance deteriorated during the period under review whilst the same indicators for long-term insurance improved.

The Liquidity Ratio of both segments improved during the period under review. The Liquidity Ratio of the general insurance sub sector improved to 0.88 at end Q2 of 2023 compared to 0.85 at end Q2 of 2022. In the long-term segment, the Liquidity Ratio improved to 0.81 at end Q2 of 2023 compared to 0.76 at end Q2 of 2022.

7 Loss Ratio (Claims Ratio) = Claims as a percentage of premium income
8 Management Expense Ratio = Operating expenses as a percentage of its premium income

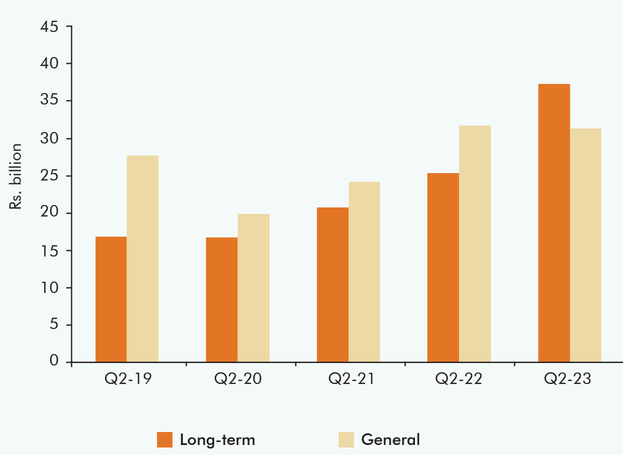
Table 3.1 Other Profitability Indicators

		Q2-20	Q2-21	Q2-22	Q2-23
Long-term	Return on assets	3.2	3.0	3.2	4.3
	Return on equity	14.6	13.9	15.4	20.6
General	Return on assets	7.7	9.4	9.7	6.5
	Return on equity	16.2	19.3	19.9	13.6

Source: Insurance Regulatory Commission of Sri Lanka

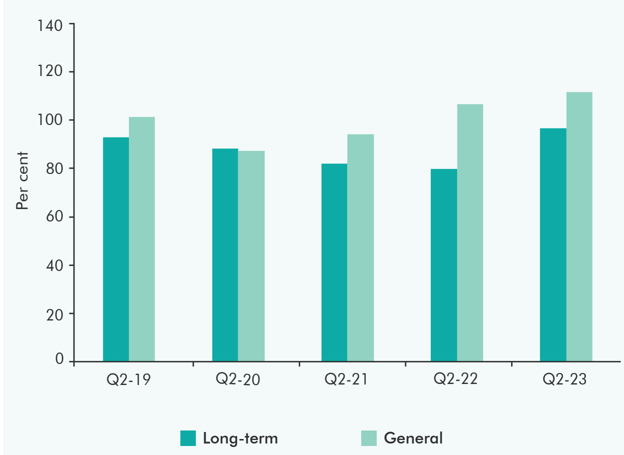
During the period under review, the capital position of general insurance weakened while the capital position of long-term insurance improved. CAR of general insurance declined to 192 per cent by Q2 of 2022 from 223 per cent a year ago. In long-term insurance, CAR improved to 352 per cent from 276 per cent, a year ago. The insurance sector is vulnerable to market risk due to high share of investments in Government and corporate securities. In addition, risk of natural calamities occurring and ageing population will also increase the probability of higher claims. Therefore, capital adequacy of the sector is important to strengthen the resilience of the sector to adverse economic shocks, if they arise.

Figure 3.58 Claims Paid based on Insurance Segment



Source: Insurance Regulatory Commission of Sri Lanka

Figure 3.59 Combined Operating Ratio based on Insurance Segment



Source: Insurance Regulatory Commission of Sri Lanka

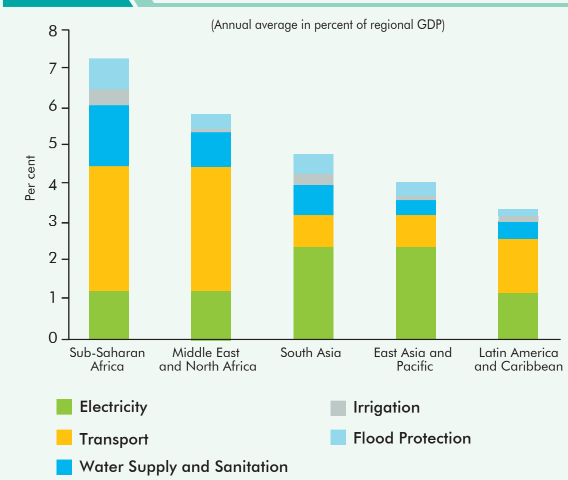
Special Note 2

Mitigating the Impact of Climate Risk on Financial System Stability

Climate change has emerged as a source of risk for the financial system with the potential spillover effects due to the rise of surface temperature which will jeopardise economic activity leading to volatility both in terms of price and financial system stability. Climate risk could be identified in two dimensions, physical risk, and transition risk. Physical risk depends on the physical hazard itself due to damage to property, agricultural crops, loss of revenue, etc. Based on simulation results, it is expected that the net effect on global real GDP as estimated by OECD in 2015, will be between negative 1.0- 3.3 per cent by 2060 due to climate vulnerabilities. Transition risk would arise due to the efforts made in moving towards a low carbon economy by reducing CO_2 emissions which will require investments in decarbonisation and reengineering business models. Paris Agreement demanded for holding the increase in the global average temperature increase to 1.5 ºC above pre-industrial levels (IPCC 2018), which was transformed via nationally determined contributions (NDCs) for the countries which ratified the agreement, leaving behind a major transition task towards carbon neutrality. It is expected that by 2030, an additional investment of about 5.0 per cent of annual average GDP will be required for South Asian countries to meet Paris Agreement requirements.

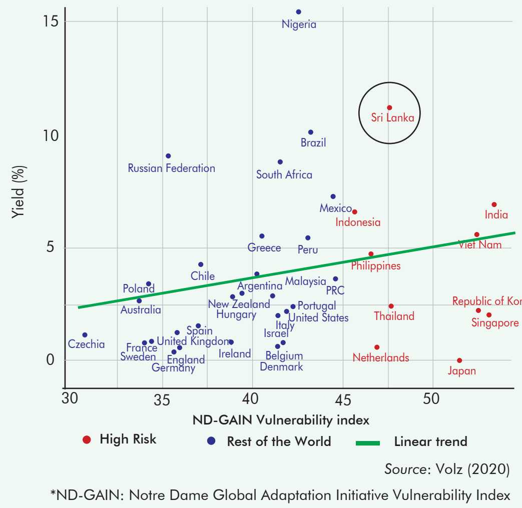
Both physical and transition risks of climate change are linked to price stability and financial system stability of an economy where the physical damages will result in low production leading to increase in price levels while financial institutions will be exposed to increasing non-performing assets due to unsustainable business activities being financed. It would be a twofold process to increase the resilience of the financial sector which will lead to a series of adaptation strategies while gearing financial institutions to meet the financing needs emanating from the sustainable activities as part of the mitigation strategies.

Figure 1 Capital Investment Required for Transitioning to Green Economy



Source: World Bank-Rozenberg and Fay 2019

Figure 2 Climate Vulnerability and Sovereign Bond Yields



Source: Volz (2020)

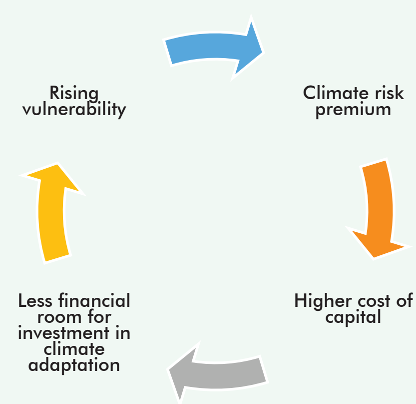
*ND-GAIN: Notre Dame Global Adaptation Initiative Vulnerability Index

Sri Lanka's Climate Vulnerability

As identified by Volz (2020), Sri Lanka is among the highly vulnerable countries in terms of resilience to climate risk specifically on sovereign bond yields as per the Climate Vulnerability Index developed by Kling et al (2020).

In addition to the inherent risk the country faces as a small island economy, the current economic crisis has further amplified the vulnerability of the nation to climate risk. Hence, the deterioration in the resilience of the country to face these challenges may in turn worsen the economic situation. Unless timely actions on addressing the impacts of climate risk are taken, limited availability of low-cost funding for the expansion of the economy may lead the economy towards a vicious cycle in terms of recovery. Thus, development of the financial sector needs to include sustainable financing initiatives that support the country's adaptation and mitigation strategies in combating climate risk.

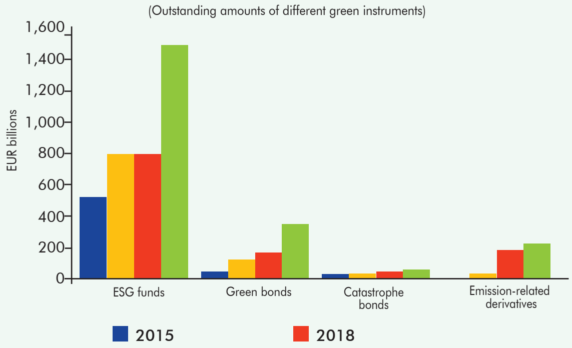
Figure 3 Vicious Cycle of Climate Risk and Cost of Capital



Source: Volz (2018)

Figure 4 Climate Financing Instruments Issued Worldwide

(Outstanding amounts of different green instruments)



Sources: Artemis
Bloomberg
EMIR
EPFR
Lipper
EMIR data
ECB calculations

Building Resilience of the Financial System

In addressing the financing needs for climate adaptation and mitigation, numerous measures are expected of the financial system. One such prerequisite is streamlining financial sector activities, which is facilitated through a taxonomy for recognising the green activities with uniformity across the sector. Based on the taxonomy, it is the responsibility of the financial institutions to introduce innovative financial products that are resilient to climate risk and will complement sustainable development. A range of products from green loans, green bonds, sustainability linked products and nature swaps are being introduced globally in addressing climate related risks.

Financial sector disclosures, both mandatory and voluntary, are equally important for the financial institutions to assess the risk exposures which will be a useful input for Environment, Social and Governance (ESG) risk management. A Direction and guidelines[1] have already been issued to the regulated financial institutions on sustainable financing activities and banks have reported sector wise sustainable lending which accounts to 1 per cent of the total lending portfolios of banks by mid-2023. Reporting by the banks in Sri Lanka is being streamlined with the taxonomy which was introduced in 2022. Adaptation of International Financial Reporting Standards (IFRS) S1 and S2 on sustainability related financial information and climate related risks is expected to further strengthen disclosures on climate risk and sustainable financing.

In terms of building resilience of the financial sector, countries have adopted ESG Risk management frameworks, and Scenario Planning to assess the level of resilience for a potential climate event taking place in the economy.

1 Banking Direction:
https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/laws/cdg/Banking_Act_Directions_No_5_of_2022.pdf

2 LFC Guidelines:
https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/laws/cdg/snbfi letter_to_ceos_of_lfc_20221129_e.pdf

Climate Stress Testing is carried out by many jurisdictions to calibrate multiple stress conditions into Macrofinancial stress testing models to reflect both physical and transition risks. IMF Financial Sector Assessment Programmes (FSAP) also incorporate Climate risk in their risk analysis which can be adopted by countries for their Macrofinancial analyses as well as banking sector solvency stress testing. However, at present these models and scenarios are challenged with lack of data and reliable estimates for climate scenario analysis. There are numerous uncertainties in mapping the impact of climate change to financial stability, from understanding how weather patterns will change in a warming climate, to the adaptation measures taken by governments and others and the effects this will have on economies and financial markets, to the impact on individual financial institutions and financial system stability.

With the current conditions prevailing in the country, fiscal support on incentivising the financial sector for adopting sustainable financing initiatives is rather limited, given the debt restructuring priorities and expenditure rationalisation expected of the State. Hence, it is expected that the private sector will take the initiative to explore the possibility of climate financing options, including that of external sources in a prudent manner. However, the Central Bank as the regulator, going forward, may consider granting regulatory forbearances/ incentives for the financial institutions who are committed to greening their portfolios and support the transitioning of the country into a green economy.

Building capacities domestically while learning from the global communities is crucial to drive sustainable finance institutions in the economy. International co-operation and leadership by supra-national agencies are vital in building these linkages by way of knowledge platforms, alliances and working groups, etc. The Central Bank is working on building capacities of the financial sector by conducting an array of training programmes, workshops, and virtual seminars for both internal and external participants of the financial sector.

Ultimately, it should be emphasised that tackling climate risk by the financial sector will no longer be an optional strategy as the country is considered a hot spot for climate vulnerabilities. Hence, going forward, implementation of prudential measures for both climate mitigation and adaptation will ensure minimum hinderance to economic and financial system stability.

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4

Household and Corporate Sectors

As household and corporate sectors constitute a significant share of financial services consumers in the economy, their developments have a significant impact on overall soundness of the financial system. Accordingly, the early detection of vulnerabilities within these sectors and prompt implementation of mitigation measures to effectively curtail risks are crucial to ensure financial stability. Within this context, the quarterly aggregate credit data of the Credit Information Bureau (CRIB) was employed to draw insights about the credit dynamics of Household and Institutional sectors while the financial information sourced from the Colombo Stock Exchange (CSE) served as a timely proxy for the assessment of the Non-Financial Corporate (NFC) sector.

Thus, analysis of CRIB data up to the end of June 2023 revealed rising time-bound Non-Performing Loans (NPLs) ratios for both Household and Institutional sectors with the Household sector recording a higher NPL ratio compared to the Institutional sector. Moreover, within the Household sector, loans obtained for Micro Small and Medium Enterprises (MSME) purposes indicated a higher NPL ratio signalling elevated default risks within the MSME sector. Further disaggregation of NPLs in terms of financial institutions revealed that although NPLs in both bank and Non-Bank Financial Institution (NBFI) sectors increased the latter recorded a higher NPL ratio, highlighting subpar credit quality within the NBFI sector, which would pose further challenges for such institutions. Meanwhile, both Household and Institutional sector credit experienced a notable y-o-y decline in debt levels by end June 2023 amidst challenging economic conditions. Elevated price levels, which constrained income levels, diminished the debt repayment capacities of economic agents, and limited their ability to obtain new credit facilities. Moreover, deteriorating credit quality drove financial institutions to engage in cautious lending. Hence, these developments raise some stability concerns for the financial sector which may gradually dissipate upon the recovery of the economic growth trajectory.

The assessment of NFCs unveiled a decline in the Interest Coverage Ratio (ICR), indicating reduced margin of safety for timely debt repayment by these entities. Moreover, solvency, which is measured by net profit as a share of debt obligations, declined during the period as well, raising concerns about the long-term financial strength of NFCs. These developments in creditworthiness were underpinned by the deterioration of revenue and profitability of NFCs. Revenue growth of NFCs recorded a significant slowdown during the period reflecting the notable decline in demand amidst adverse economic conditions. Furthermore, the fact that over 90 per cent of the increase in revenue emanated from two major players also highlights the uneven performance of the sector. Meanwhile, the net profit of the NFC sector also contracted significantly due to a substantial increase in cost of sales, decline in finance income and increase in finance costs resulting in the deterioration of key profitability indicators during the period. These findings underscore the challenges faced by NFCs and the risks emanating from such challenges to the financial sector.

Elevated price levels and interest rates within the economy during the period under review not only hampered the debt repayment capacity of economic agents but also impacted on their future borrowing potential as well. In addition, the limited spending capacity resulted in the contraction in overall domestic demand which also impacted the income generating capacities of both households and corporates. However, going forward, with the envisaged economic recovery amidst the current stabilisation in price levels and declining interest rates, along with implementation of prudent credit management strategies, and addressing sector-specific challenges, an improvement in credit quality in the financial sector can be expected, which would support the resilience of financial institutions and consequently, stability of the financial system as a whole.

4.1 Risk Assessment on the Household[1] and Institutional[2] Sectors

This section assesses the financial vulnerabilities exhibited by borrowers within the Household and Institutional sectors, based on aggregate credit data[3] obtained from the CRIB on a quarterly basis up to end June 2023.

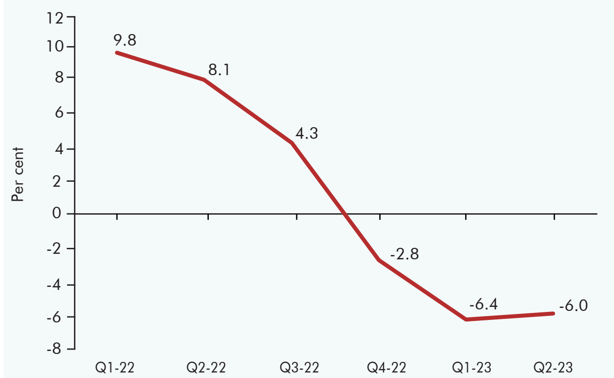
Risk Assessment on Household Sector Credit

Reflecting adverse repercussions of the economic crisis, Household sector credit experienced a substantial y-o-y decline during the period under review. The level of credit in the Household sector which represents 42.3 per cent of the total formal financial sector lending[4], reported a significant decline of 6 per cent as of end June 2023, compared to 8.1 per cent growth recorded at end June 2022 reflecting diminished demand for new loans from this sector due to elevated interest rates for loans and advances, deteriorating real income levels and high living costs. Moreover, this highlights the reluctance of formal financial sector lenders to provide new credit facilities within the current economic climate. Furthermore, the banking sector played a substantial role in meeting the borrowing needs of the Household sector, representing 70.7 per cent of the total, while the NBFI[5] sector accounted for the remaining portion of loans obtained by households.

The NPL[6] ratio of the Household sector was steadily increasing, amidst constrained debt repayment capacities of household borrowers. By end of June 2023, the NPL ratio for the Household sector increased to 17.7 per cent, a considerable increase from the 14.1 per cent recorded during the corresponding period of the previous year. The share of non-arrears loans[7] within the total Household sector also gradually decreased since the beginning of 2022 while the share of arrears loans was on the rise in tandem, indicating a continuous deterioration in the credit quality of the Household sector which may persistent in the future if adverse economic conditions are to continue.

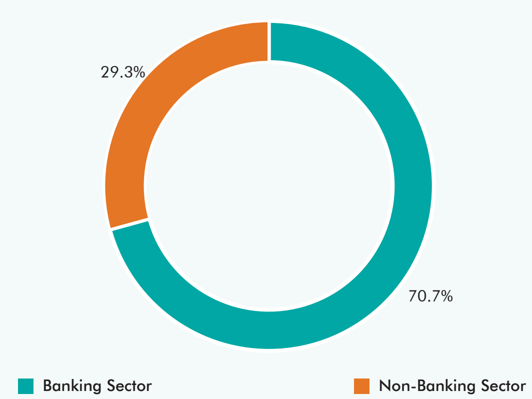
While the banking sector was the main source of credit for the Household sector, the NBFI sector accounted for the higher share of NPLs. Although, both the banking and NBFI sectors experienced a rise in their NPL ratios as at end June 2023, the NBFI sector accounted for 58.3 per cent of total non-performing advances of the Household sector, indicating higher potential for default risk.

Figure 4.1 Growth in Household Sector Credit Level (Y-o-Y)



Source: Credit Information Bureau of Sri Lanka

Figure 4.2 Composition of Household Sector Credit as at end June 2023



Source : Credit Information Bureau of Sri Lanka

1 The Household sector debt presented in this analysis comprises loans and advances obtained by individuals who are identified by their National Identity Card or passport number. Moreover, the Household sector debt includes facilities obtained by households for the purpose of business activities in terms of MSMEs.

2 The Institutional sector debt includes facilities granted to institutions which are registered as business entities and accommodations to State Owned Business Enterprises and the Government.

3 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.

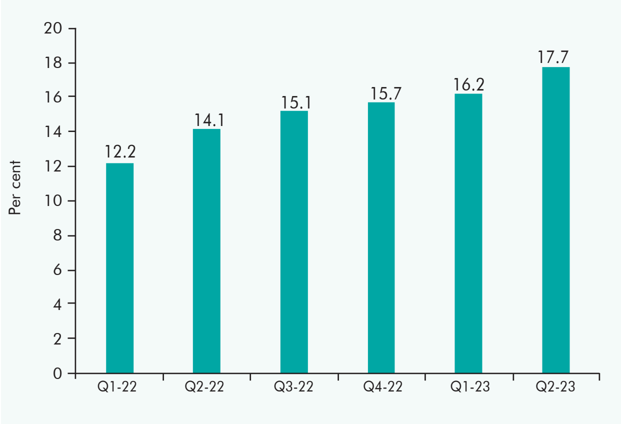
4 Formal financial sector lending includes lending by licensed banks, licensed finance companies and a specialised leasing company.

5 NBFIs encompasses licensed finance companies and a specialised leasing company.

6 This 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 9 (SLFRS 9) guideline on classification of stage 3 loans.

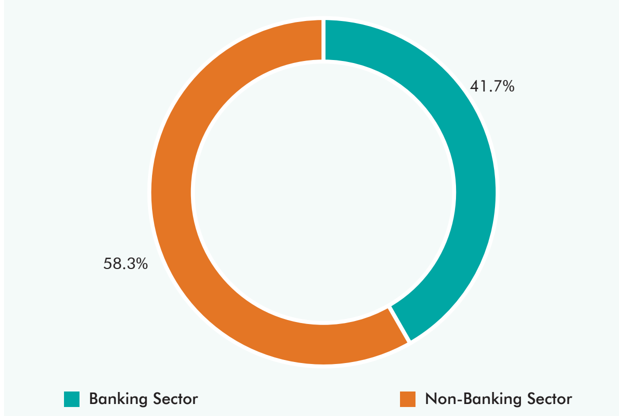
7 Facilities with zero days in arrears.

Figure 4.3 NPL Ratios of the Household Sector



Source: Credit Information Bureau of Sri Lanka

Figure 4.5 Composition of Household Sector NPLs as at end June 2023



Source: Credit Information Bureau of Sri Lanka

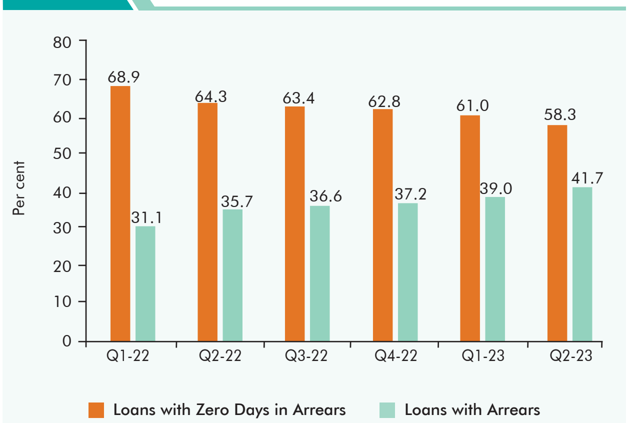
The Western province accounted for a majority of the debt allocated to the Household sector. Approximately 50 per cent of the total debt was granted to households in the Western province which accounts for 28 per cent of the population. However, the highest NPL ratio among provinces in the Household sector was recorded in the Central province, with the Western province accounting for the second highest NPL ratio. As of end of June 2023, the NPL ratios for these provinces were 19.7 per cent and 18.9 per cent, respectively.

Loans disbursed for MSME purposes[8] showed a higher NPL ratio compared to that of loans granted for Household purposes. The higher default risk of MSME purpose debt suggests that households have had a higher tendency towards evading repayment on MSME purpose loans. Accordingly, although loans extended for Household[8] purposes have consistently outnumbered those granted for MSME purposes, particularly when the 'Others[9]' category is excluded, the NPL ratio remained low reflecting better credit quality. However, the persistent upward trend observed in NPLs for both MSME and Household purposes can be attributed to the adverse effect of declining disposable income.

8 The loans obtained by the Household sector for consumption and housing purposes were classified as debt obtained for "Household purposes". Rest of the loans excluding the "Others" category were classified as an approximation for debt obtained for "MSME purposes".

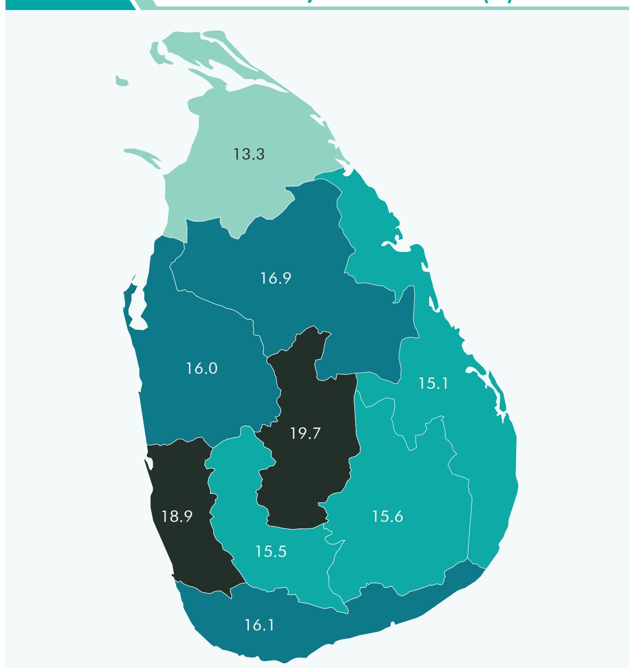
9 The classification is provided by CRIB and further disaggregation is not available.

Figure 4.4 Credit Quality of the Household Sector



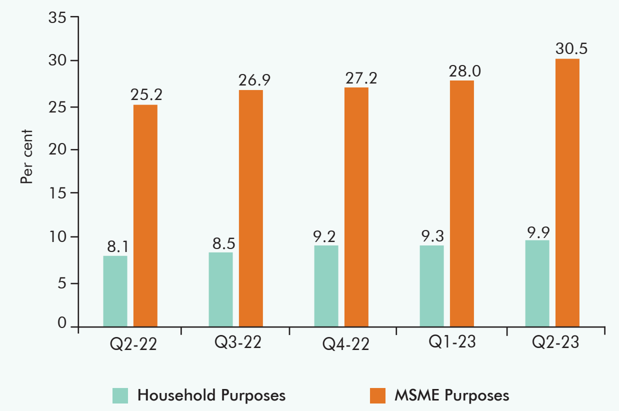
Source : Credit Information Bureau of Sri Lanka

Figure 4.6 Distribution of Household Sector NPL Ratios by end June 2023 (%)



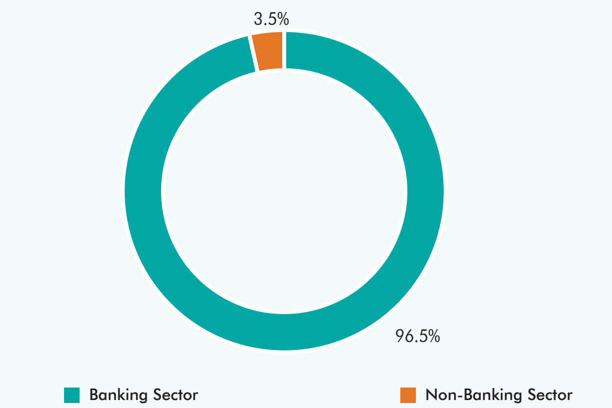
Source: Credit Information Bureau of Sri Lanka

Figure 4.7 NPL Ratios: Household vs. MSME Purposes



Source: CBSL approximation based on CRIB data

Figure 4.9 Composition of Institutional Sector Credit as at end June 2023



Source: Credit Information Bureau of Sri Lanka

Risk Assessment on Institutional[10] Sector Credit

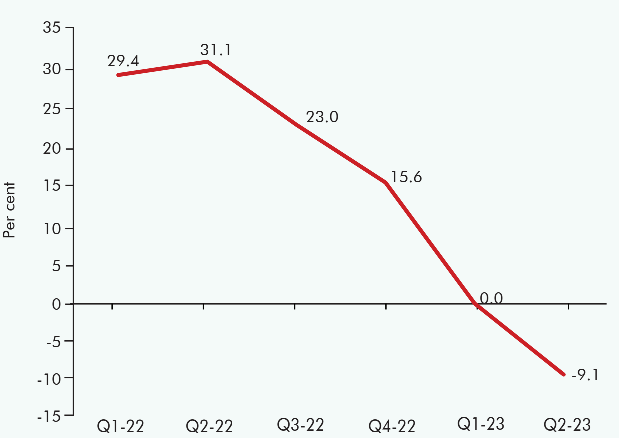
Institutional sector credit experienced a notable y-o-y decline in debt levels by June 2023 amidst challenging business conditions against the backdrop of the economic crisis. The level of credit in the Institutional sector, which accounts for 57.7 per cent of the total formal financial sector lending, recorded a more pronounced y-o-y decline of 9.1 per cent in debt levels by end June 2023 when compared to the Household sector. This decline stands in significant contrast to the substantial growth of 31.1 per cent recorded in the corresponding period of the previous year.

Reduced willingness to extend credit by financial institutions to the Institutional sector amidst worsening credit quality, stringent credit screening by financial institutions and decline of credit granted to public corporations may have led to the decline in Institutional sector credit. Elevated interest rates for loans and advances could also have an impact on borrowing costs, subsequently influencing credit demand. Additionally, Institutional sector loans were predominantly provided by the banking sector accounting for a share of 96.5 per cent of the total Institutional sector credit.

In line with the trend observed in the Household sector, the NPL ratio in the Institutional sector increased during the period under review. There was a notable increase in NPL ratios compared to the same period in the previous year, surging from 8.9 per cent to 13.3 per cent. Meanwhile, the share of non-arrears loans in the Institutional sector decreased compared to the corresponding period of the previous year from 75.1 per cent to 71.5 per cent while the

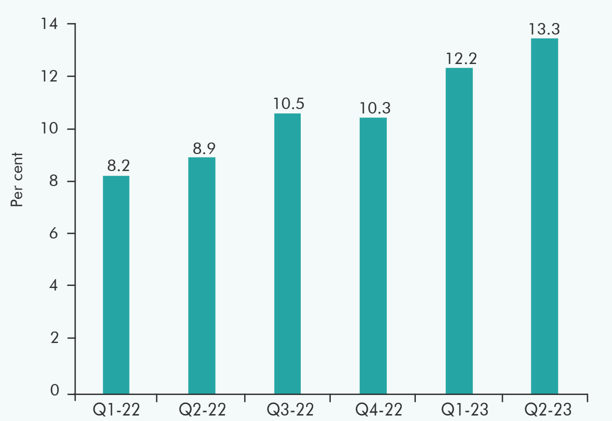
10 The Institutional sector encompasses the corporate sector, government, and public corporations.

Figure 4.8 Growth in Institutional Sector Credit Level (Y-o-Y)



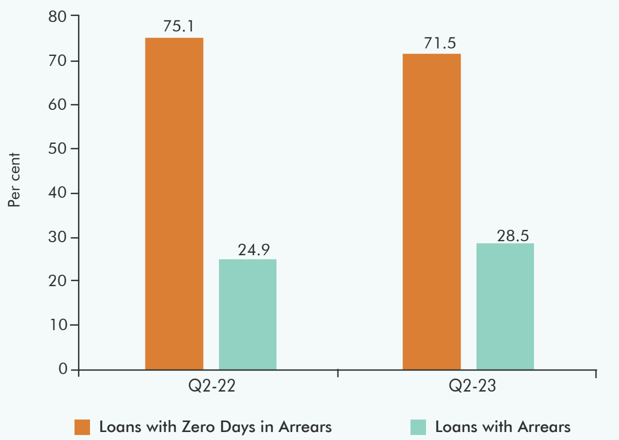
Source: Credit Information Bureau of Sri Lanka

Figure 4.10 NPL Ratios of the Institutional Sector



Source: Credit Information Bureau of Sri Lanka

Figure 4.11 Credit Quality of the Institutional Sector

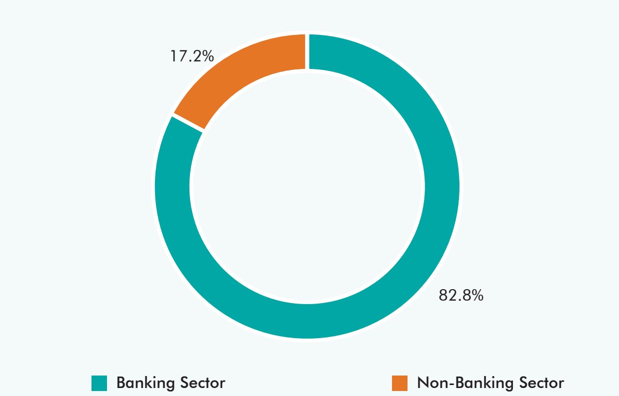


Source: Credit Information Bureau of Sri Lanka

share of loans in arrears was increasing. These developments indicate the credit risk emanating from the Institutional sector to the financial institutions.

Among the total NPLs recorded within the Institutional sector, a significant majority originated from the banking sector. The banking sector held 82.8 per cent of Institutional sector NPLs, while the non-banking sector stood at 17.2 per cent of NPLs as at end June 2023. It is important to note that despite the significant presence of NPLs in the banking sector, their NPL ratio remains considerably lower when compared to that of the non-banking sector. Going forward, reducing the risks emanating from the Institutional sector towards financial stability would depend on the pace of economic recovery amidst prudent credit management by financial institutions.

Figure 4.12 Composition of Institutional Sector NPLs as at end June 2023



Source: Credit Information Bureau of Sri Lanka

4.2 Risk Assessment on Listed Non-Financial Corporates

This section assesses the risks and vulnerabilities emanating from NFCs to the financial sector, based on data of 209 corporations listed on the CSE as at end September 2023, serving as a proxy for the NFC sector.

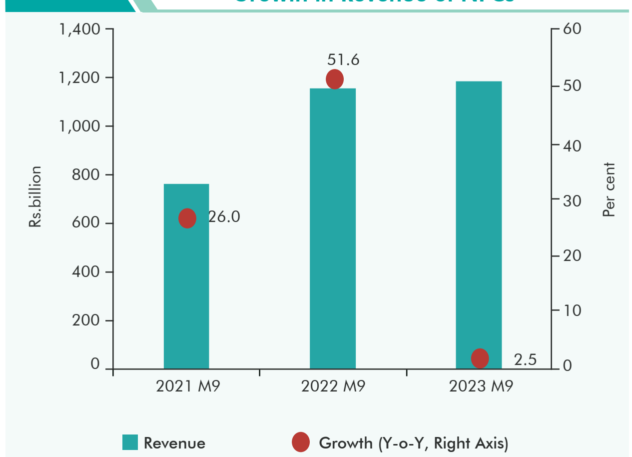
Financial Performance of Listed NFCs

The revenue growth for NFCs recorded a significant slowdown, reaching 2.5 per cent y-o-y during the nine months ending September 2023, in contrast to the y-o-y revenue growth of 51.6 per cent witnessed during the corresponding period of the previous year. Moreover, the share of NFCs that reported an increase in corporate revenue, compared to the previous year, declined noticeably during the nine months ending September 2023, reflecting an accelerated slowdown in demand. However, more than 90 per cent of the revenue increase arose from only two key performers, highlighting the uneven performance within the NFC sector. If these two companies are excluded, the revenue growth would be limited to 0.1 per cent, which reflects the impact of economic contraction on the NFCs.

In terms of sector-wise[11] performance, the Hotels sector recorded the highest revenue growth. This revenue growth can be attributed to

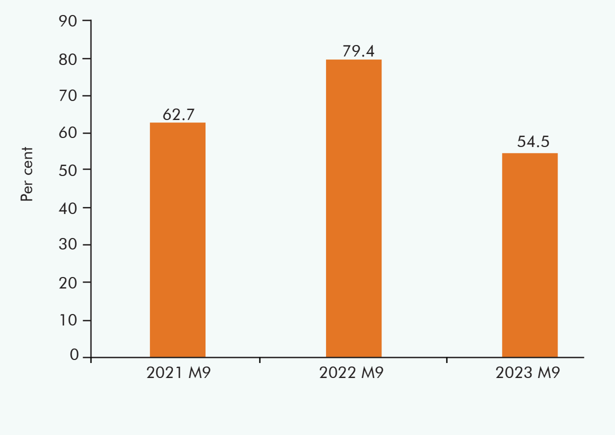
11 Company figures were used for the analysis instead of consolidated figures in the diversified holdings sector as the analysis focuses on the standalone performance of the parent company and to avoid duplication as subsidiaries and associates of the group that are publicly listed are included in other sectors of the dataset.

Figure 4.13 Revenue and Y-o-Y Growth in Revenue of NFCs



Source: Colombo Stock Exchange

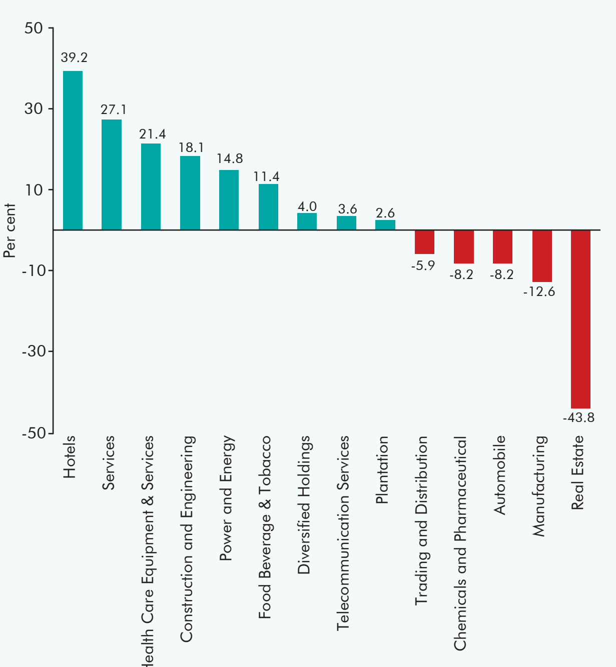
Figure 4.14 Share of NFCs that Reported an Increase in Revenue



Source: Colombo Stock Exchange

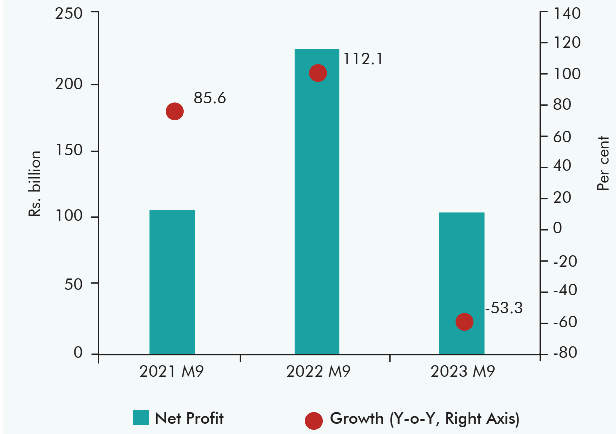
the tourist arrivals, which exceeded one million during the nine months ending September 2023 compared to the low base during the corresponding period of the previous year. Alongside the Hotels sector, Services and Healthcare Equipment and Services sectors recorded y-o-y revenue growth exceeding 20 per cent. However, significant declines in revenue were evident in several sectors, including Real Estate, Manufacturing, Automobile, Chemicals and Pharmaceuticals and Trading and Distribution. The performance of the Real Estate sector was hindered by deteriorating business conditions and

Figure 4.15 Sector-wise Revenue Growth for the nine months ending September 2023



Source: Colombo Stock Exchange

Figure 4.16 Net Profit and Y-o-Y Growth in Net Profit of NFCs

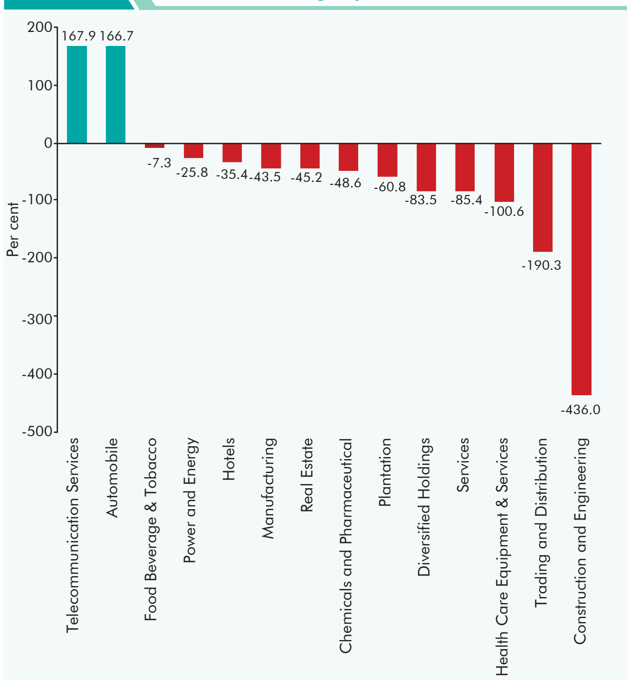


Source: Colombo Stock Exchange

the increased cost of raw materials in the country. The scarcity of imported raw materials, a slowdown in most advanced economies, and reduced capital investments due to the high cost of borrowing led to the Manufacturing sector to forgo revenue growth. The sustained slump in revenue in the Automobile sector was primarily driven by the import ban imposed on vehicles since March 2020.

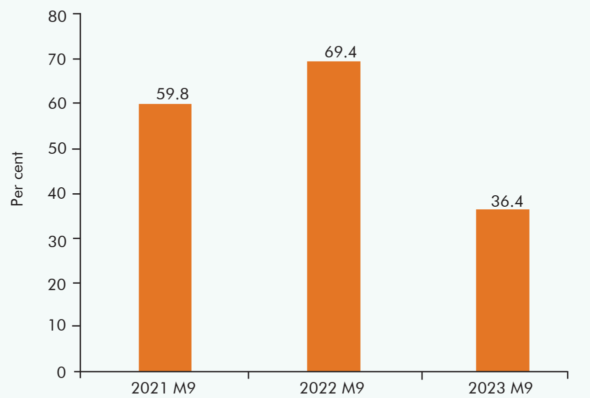
The NFC sector witnessed an overall net profit contraction of 53.3 per cent, y-o-y, during the nine months ending September 2023. This was

Figure 4.17 Sector-wise Net Profit Growth for the nine months ending September 2023



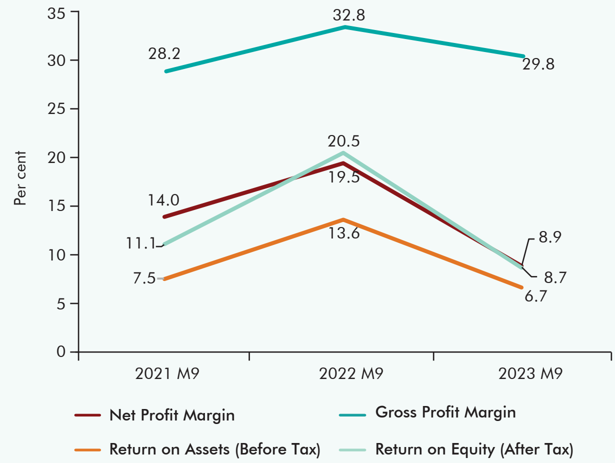
Source: Colombo Stock Exchange

Figure 4.18 Share of NFCs that Reported an Increase in Net Profit



Source: Colombo Stock Exchange

Figure 4.20 Profitability Indicators

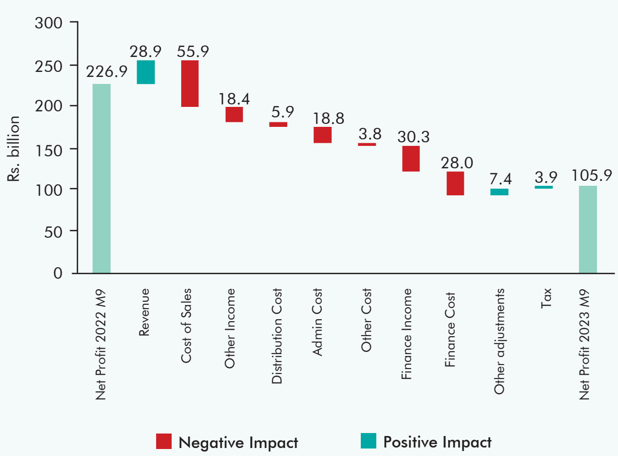


Source: Colombo Stock Exchange

primarily attributed to a significant y-o-y decline in finance income of 37.7 per cent and a notable y-o-y increase in finance costs of 29.4 per cent. However, the relaxed monetary policy stance is expected to reduce the finance cost and would positively affect the net profit during the period ahead. Moreover, the share of NFCs that reported an increase in corporate net profit, compared to the previous year, almost halved from 69.4 per cent to 36.4 per cent during the nine months ending September 2023.

Cost of sales, finance income and finance cost had a significant negative impact on the net profit of NFCs in the sample. The adverse impact on the net profit of these NFCs is mainly attributed to the significant rise in the cost of sales. Furthermore, the

Figure 4.19 Components of Net Profit



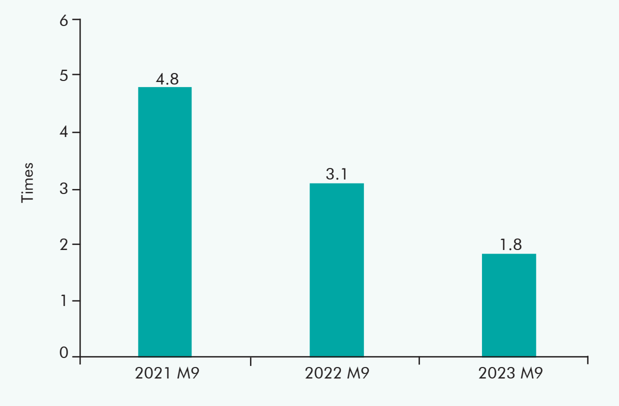
Source: Colombo Stock Exchange

decline in finance income mainly driven by reduced exchange gains and increase in finance cost amidst prevailing elevated interest rates also had a negative impact on corporate profits.

Although many sectors recorded an increase in revenue growth, all sectors other than Telecommunication Services and Automobile sectors observed a notable decline in net profit during the nine months ending September 2023. Heightened cost components, including increased costs of sales, distribution, and administration expenses contributed to the decline in net profits. Furthermore, a significant decrease in income components, particularly in other income and finance income, further exacerbated the decline in net profit. The Telecommunication Services sector demonstrated notable y-o-y growth, with a significant increase of 167.9 per cent in net profit amid low growth in revenue mainly due to increased foreign exchange gains. Even with a decrease in revenue, the Automobile sector managed to secure the second-highest growth in net profit, primarily owing to the decrease in finance costs.

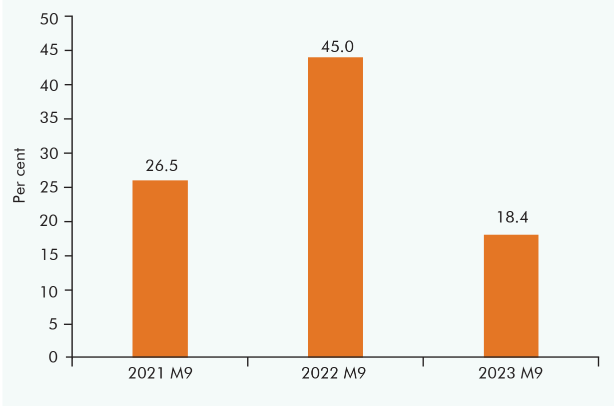
Key profitability indicators namely gross profit margin, net profit margin, Return on Assets (ROA), and Return on Equity (ROE) deteriorated during the nine months ending September 2023. ROA and ROE declined to 6.7 per cent and 8.7 per cent, respectively, during the period under review, compared to 13.6 per cent and 20.5 per cent, respectively, recorded in the first nine months of 2022. The widening gap between the gross profit margin

Figure 4.21 Interest Coverage Ratio



Source: Colombo Stock Exchange

Figure 4.23 Net Profit as a Share of Debt Obligations



Source: Colombo Stock Exchange

and net profit margin is a result of increasing indirect expenses comprising distribution, administration, and finance costs, alongside a simultaneous decline in indirect income sources, namely other operating income, and finance income.

Corporate Sector Creditworthiness

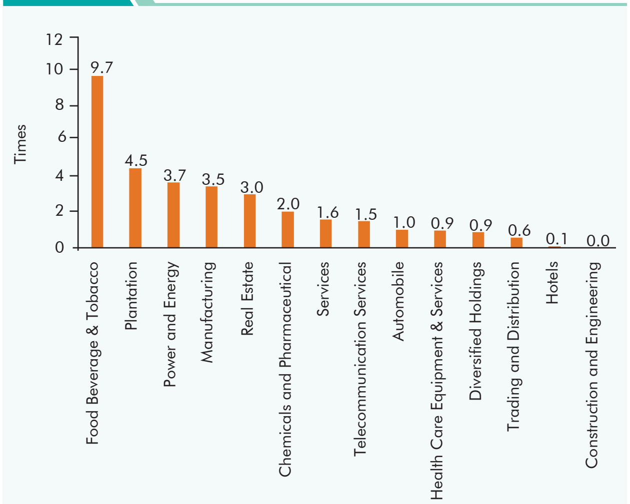
The Interest Coverage Ratio (ICR)[12], which measures the corporation's margin of safety for the timely repayment of interest on its outstanding debt, has deteriorated. The ICR of NFCs declined to 1.8 times as of the end September 2023 from 3.1 times recorded during the corresponding period in the previous year. The ICR declined mainly due to the y-o-y increase in finance costs by 29.4 per cent and the y-o-y reduction in Earnings before Interest and Tax (EBIT) by 22.6 per cent. Amongst the sub-sectors, the Food, Beverage, and Tobacco sector recorded the highest ICR during the period under review, signalling a significant margin of safety that protects the sector against fluctuations in earnings. On the contrary, Hotels and Construction and Engineering sectors recorded ICRs close to zero indicating the higher credit risk of the two industries.

Solvency[13], which is also measured by net profit as a share of debt obligations reflecting the ability of NFCs to fulfil their debt obligations in the long-term, declined during the nine months ending September 2023 due to reduced corporate net profits. This ratio declined to 18.4 per cent in the

12 ICR is calculated by dividing EBIT by Finance Cost.

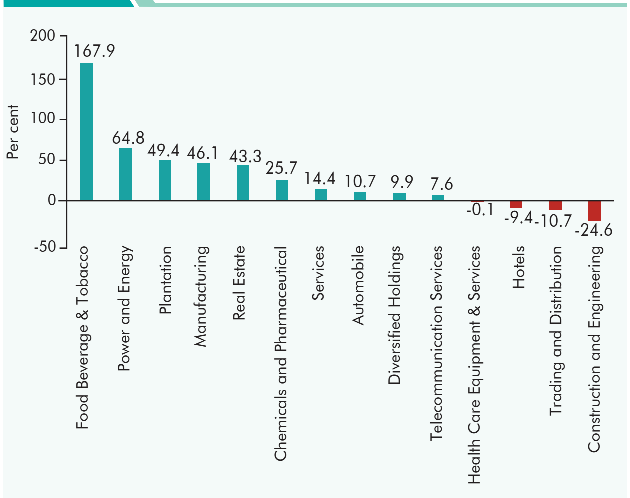
13 For the purpose of the study, the solvency is calculated by dividing the net profit by average debt.

Figure 4.22 Sector-wise Interest Coverage Ratio



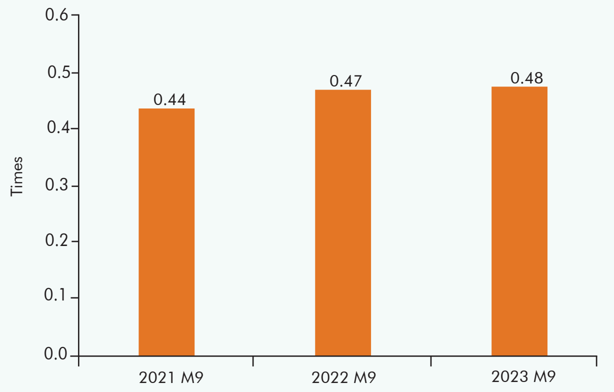
Source: Colombo Stock Exchange

Figure 4.24 Sector-wise Net Profit as a Share of Debt Obligations



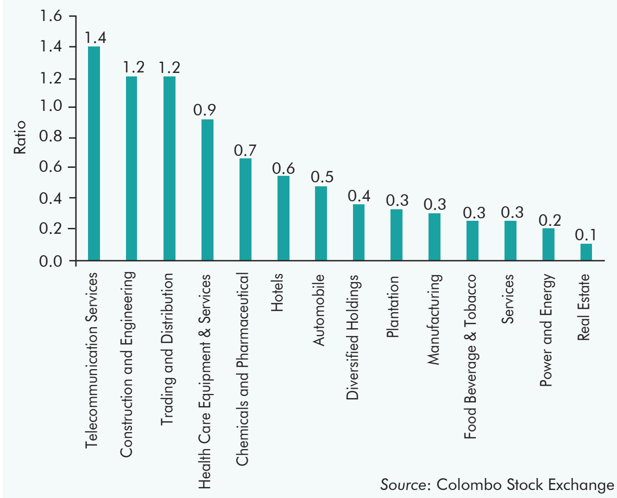
Source: Colombo Stock Exchange

Figure 4.25 Debt-to-Equity



Source: Colombo Stock Exchange

Figure 4.26 Sector-wise Debt-to-Equity



Source: Colombo Stock Exchange

period under review from 45 per cent recorded a year ago, raising concerns about the financial strength of NFCs in the long-term. Construction and Engineering, Trading and Distribution, Hotels and Healthcare Equipment and Services sectors, which recorded losses during the nine months ending September 2023 showed signs of deteriorating solvency.

The debt-to-equity ratio[14], offering insights into the financial leverage of the sector, hovered around 0.5 times during the nine months ending September 2023. Telecommunications Services, Construction and Engineering, and Trading and Distribution sectors reported debt-to-equity ratios surpassing one due to the nature of the business requiring heavy capital investments, which are funded by borrowings. Therefore, these sectors are highly sensitive to interest rate change, especially rate hikes, and managing such risks need to be prioritised by the sectors and financial institutions need to take prudential measures to mitigate credit risk emanating from such high leverage.

14 The debt-to equity ratio is calculated by dividing the total debt of corporates by the total equity.

5

Macroprudential and Other Policies for Financial Stability

Macroprudential policy aims at preserving the overall stability of the financial system by mitigating systemic risk and maintaining the resilience of the financial system even under adverse economic and financial conditions. After the Global Financial Crisis (GFC), it was evident that traditional regulation which focuses on the stability of individual financial institutions would not be sufficient to safeguard the financial system as a whole during a financial crisis of systemic nature. Moreover, the GFC emphasised the importance of macroprudential policy in mitigating systemic risk emanating from the spillover effects of developments in the real economy. However, macroprudential policy does not intend to replace traditional microprudential policy in safeguarding the financial system but rather to complement it.

In September 2023, the Central Bank was designated as the Macroprudential Authority in Sri Lanka by the Central Bank of Sri Lanka Act, No. 16 of 2023 (CBSL Act) and it is entrusted with the necessary legal mandate to conduct the macroprudential policy in Sri Lanka. The Act has equipped the Central Bank with powers and a set of tools which could be utilised to achieve its macroprudential objectives of maintaining the resilience of the financial system, in a manner that supports the provision of financial services even under adverse economic and financial conditions, containing risks from unsustainable increases in credit and leverage, contain risks from interconnectedness within the financial system and controlling the risk of failure of individual systemically important institutions.

The Central Bank has already made use of several Macroprudential tools in ensuring financial stability at present. With the implementation of the BASEL III framework, the Capital Conservation Buffer (CCoB) which is a broad based macroprudential tool, has been implemented in Sri Lanka. Further, the Central Bank has imposed capital surcharges on Domestic Systemically Important Banks (D-SIBs) to mitigate risks arising from such banks. Moreover, cap on Loan to Value (LTV) ratio, which is a borrower based macroprudential tool, has been successfully implemented and is currently in force for credit facilities obtained for purchase of motor vehicles. Furthermore, several other macroprudential policy tools such as leverage ratio, net stable funding ratio, forward looking loan loss provisions, concentration limits, margin deposit requirements and restrictions on unsecured loans are being used by the Central Bank with the objective of securing financial stability.

Several other macroprudential policy tools have been developed by the Central Bank in accordance with international best practices to further strengthen its macroprudential framework. The Central Bank has developed frameworks for macroprudential tools such as the Counter Cyclical Capital Buffer (CCyB), LTV ratio on housing loans and Debt Service to Income (DSTI) ratio. The Central Bank actively monitors and analyses risks in the financial system on an ongoing basis and, where necessary, responds to changes in systemic risk and resilience. With the expected economic recovery, the Central Bank shall apply appropriate macroprudential tools mentioned above or initiate changes to the existing tools to strengthen the stability of the financial system as macro-financial conditions may warrant.

In addition to macroprudential instruments, the Central Bank introduced several other measures during 2022 and 2023 to enhance crisis preparedness and to avoid the economic crises leading to a financial crisis in the country. The Emergency Loans and Advances (ELA) framework for licensed banks which was established in 2020 was further *enhanced in November 2022 by incorporating a broad range of collateral with valuation methodology, criteria on liquidity and solvency assessment, supervisory actions, and an improved coordination mechanism among the departments of the Central Bank that are involved in executing the framework. The Financial Sector Crisis Management Committee (FCMC) and Technical Committee on Financial Sector Crisis Management (TCMC) were also formed to identify and address any potential systemic crisis in the financial sector and thereby its effects on the real economy. Furthermore, a range of policy measures were initiated as per the prior conditions and structural benchmarks of the International Monetary Fund Extended Fund Facility (IMF-EFF) agreement.*

5.1 Capital Conservation Buffer (CCoB)

CCoB was introduced as a part of the BASEL III framework to enhance the resilience of banks and to promote financial stability. CCoB is a broad based macroprudential tool which mandates banks to maintain an additional layer of Common Equity Tier I (CET-1) capital, on top of the regulatory minimum capital requirement. The buffer is intended to act as a cushion that provides banks with capacity to absorb losses and continue to lend and operate even during economic downturns. According to BASEL III regulatory requirements, CCoB is required to be at a level of 2.5 per cent of total Risk Weighted Assets (RWA) of the bank and when the CCoB of a bank falls below the threshold of 2.5 per cent, automatic restrictions for capital distribution (for example, dividends, share buybacks and discretionary bonus payments) will be imposed.

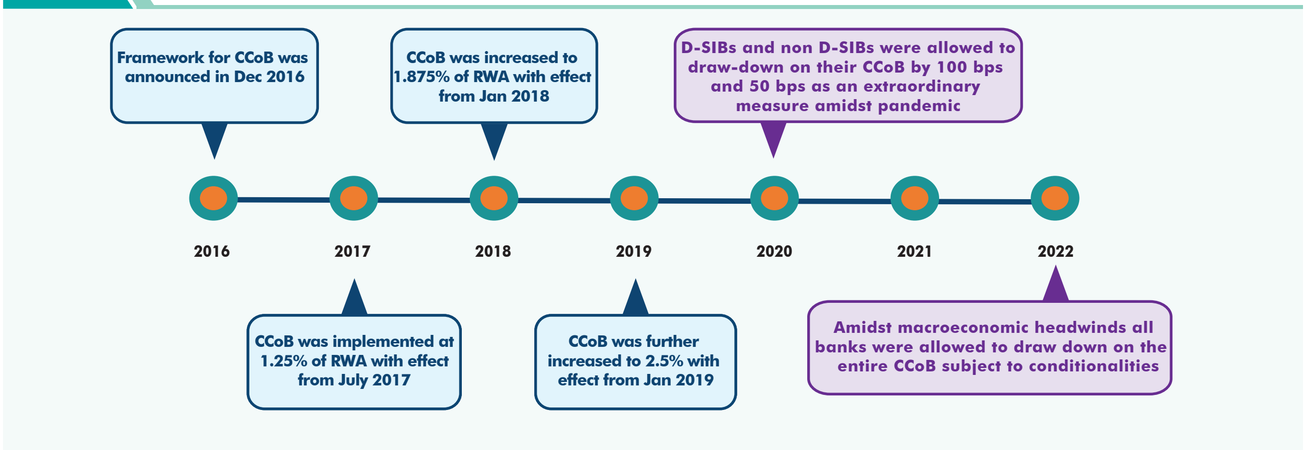
In Sri Lanka, CCoB was first announced in December 2016 and implemented in three stages over a period of three years. Banks had to build the CCoB to 1.25 per cent of RWA with effect from 1 July 2017, then increase it to 1.875 per cent with effect from 1 January 2018, and then to 2.5 per cent with effect from 1 January 2019 to fully comply with the BASEL III standards[1].

Considering the impact of the COVID-19 pandemic and adverse macroeconomic conditions, the Central Bank allowed banks to draw down on their CCoB. Extraordinary measures were introduced amidst the pandemic, allowing D-SIBs and non-D-SIBs to draw down on their CCoB by 100 bps and 50 bps, respectively, out of the total of 250 bps, subject to conditionalities, with effect from March 27, 2020. Further, amidst the adverse macroeconomic headwinds in the aftermath of external debt standstill announcement by the Government, the Central Bank took further measures to allow banks to draw down on the entire CCoB subject to conditionalities[2]. Accordingly, few banks utilised the option of drawing down on CCoB, however, all banks have restored CCoB by end Q3 of 2023.

1 Banking Act Direction No 01 of 2016: https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/laws/cdg/Banking_Act_Directions_No_01_2016_capital_requirements_basel_III_e_0.pdf

2 Banking Act Direction No 04 of 2022: https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/laws/cdg/Banking_Act_Directions_No_4_of_2022.pdf

Figure 5.1 Evolution of the CCoB



Source: Central Bank of Sri Lanka

5.2 Capital Surcharges for Systemically Important Financial Institutions

The D-SIB capital surcharge (D-SIB buffer)[3] aims to enhance the resilience of the banking sector to adverse shocks by improving the capital of systemically important banks. As such, the D-SIB buffer would enhance the ability of systemically important banks to absorb losses enabling the financial system to be more resilient towards handling shocks that are specific to individual institutions which have the potential to create widespread systemic fragilities. This heightened resilience can, in the long run, positively impact financial intermediation by decreasing the likelihood and severity of systemic banking crises and minimising the impact on economic output.

The Basel Committee on Banking Supervision (BCBS) published a framework for dealing with domestic systemically important banks in October 2012. The BCBS framework specifies principles related to the assessment of D-SIBs and these principles have been incorporated into national legal and regulatory frameworks, albeit with variations, reflecting each country's unique financial sector characteristics[4]. Notably, the identification and management of D-SIBs differ across countries, as the BCBS framework does not prescribe specific indicators for the identification criteria. Instead, it grants national authorities the discretion to select indicators tailored to their respective jurisdictions. In Sri Lanka, the Central Bank introduced a D-SIB buffer with effect from 1 July 2017 based on the asset base of banks[5]. This was reviewed in 2019 and a broader D-SIB framework was introduced based on the principles stipulated in the BCBS framework[6]. Currently, there are four banks, which have been classified as systemically important and are subject to the D-SIB capital buffers with two banks required to maintain a D-SIB buffer of 1.5 per cent of RWA while the remaining two banks are subject to a buffer of 1 per cent of RWA[7].

The Central Bank recently reviewed the existing D-SIB framework. The new framework for designation of D-SIBs and calibration of the size of the D-SIB buffer is expected to be announced in the near future. Further, the Central Bank expects to develop a similar framework for LFCs in line with international standards.

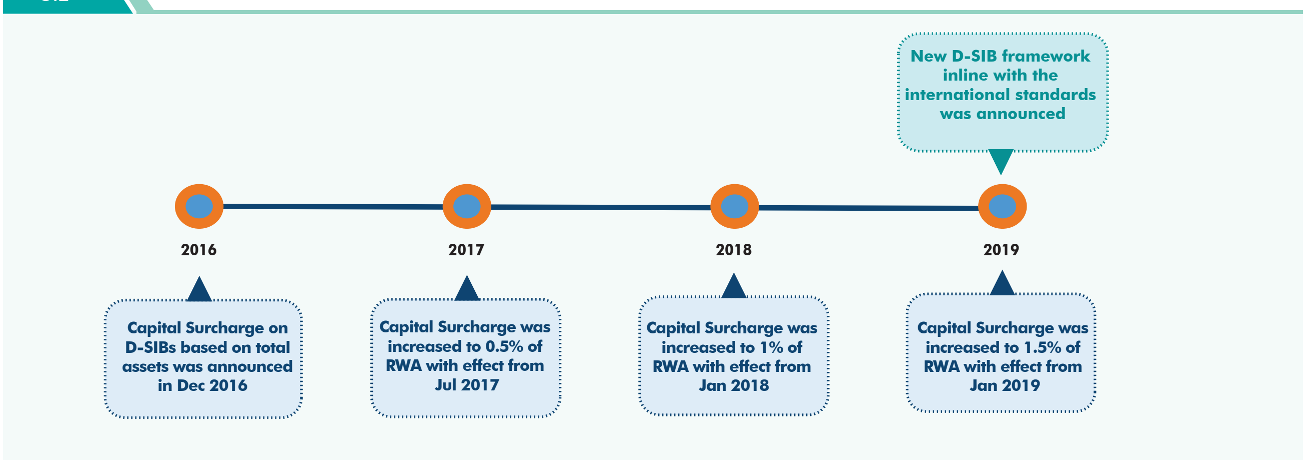
5.3 Caps on Loan to Value Ratio (LTV) and Debt Service to Income Ratio (DSTI)

Caps on LTV is a borrower based macroprudential tool which could be used to reduce excessive credit growth and thereby support the resilience of the financial system. Applying a cap on LTV, which is the ratio between the amount borrowed and

3 Also termed as Higher Loss Absorbency capacity on D-SIBs
4 BCBS, A., 2012. A framework for dealing with domestic systemically important banks.

5 Banking Act Direction No 01 of 2016: https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/laws/cdg/Banking_Act_Directions_No_01_2016_capital_requirements_basel_III_e_0.pdf
6 Banking Act Direction No 10 of 2019: https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/laws/cdg/Banking_Act_Directions_No_10_of_2019.pdf
7 Banking Act Direction No 12 of 2019: https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/laws/cdg/Banking_Act_Directions_No_12_of_2019.pdf

Figure 5.2 Evolution of the D-SIB Buffer in Sri Lanka



Source: Central Bank of Sri Lanka

Special Note 3

Establishing a Framework for Interconnectedness and Contagion Analysis

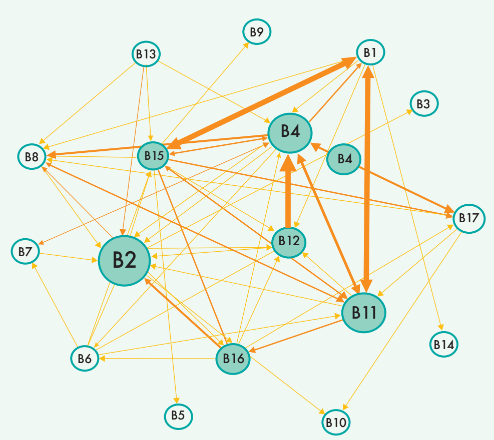
Introduction

Interconnectedness within the financial system refers to the financial linkages or correlations observed in the market prices of financial institutions under various global conditions (Bricco and Xu, 2019). Contagion is characterised by a noteworthy rise in cross-market linkages following a shock affecting a single country (or a group of countries) or, more broadly, linkages that intensify after a shock impacting one or more financial institutions (Bricco and Xu, 2019). High level of interconnectedness of the financial system has been identified as one of the main sources of systemic risk that contributed to the Global Financial Crisis (GFC). As a result, regulators began integrating network analytical tools and models depicting financial system interconnections into their routine analytical and policy framework. (Fukker and Kok, 2021)

Network and Contagion Analysis by the Central Bank

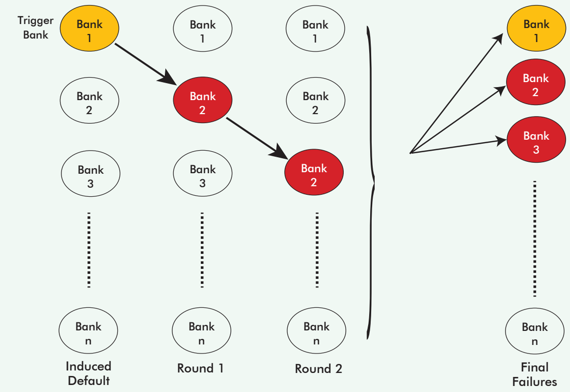
The Central Bank developed a new framework for Interconnectedness and Contagion Analysis (ICA) in 2022 which is based on a complementary Contingent Mapping (CoMap) model (Covi, Gorpe and Kok, 2021). The new ICA framework extends the scope beyond the banking sector and assesses the contagion risks emanating from the State-Owned Enterprises (SOEs) and Non-Bank Financial Institutions (NBFIs) while factoring both solvency (credit shock and funding shocks) and liquidity channels in the model. Credit shock factors the impact of a bank defaulting on its liabilities to other banks while funding shock represents withdrawal of short-term funding from other banks forcing

Figure 1 A Hypothetical Interbank Network*



*The nodes are banks, and the edges (arrows) represent gross lending from one bank to another. The node size is proportional to bank's size and edge thickness is proportional to the exposure amount.

Figure 2 Distress Cascades in the Banking Sector – Illustrative Example



Source: : Covi, Gorpe and Kok, 2021

them to deleverage by selling assets at a discount (fire sales) (Covi, Gorpe and Kok, 2021). ICA methodology was further extended to capture contagion risk emanating from Non-Financial Corporates (NFCs) who are classified as top fifty borrowers of banks. ICA analyses how a hypothetical triggering distress event (e.g., a hypothetical bank distress), cascades within the banking network as it transmits through solvency and liquidity channels. Bank-specific default thresholds and liquidity thresholds have been defined to ascertain the level of contagion and level of vulnerability.

The development of the ICA framework is another step forward taken by the Central Bank in broadening the spectrum of macroprudential surveillance methodologies in the macroprudential policy framework of the Central Bank. ICA is one of the three frameworks used by the Central Bank to assess the impact of hypothetical stress/distress scenarios. The other two frameworks used by the Central Bank are dynamic bank solvency stress testing (see Special Note 3 in the Financial System Stability Review – 2022) and liquidity stress testing (see Special Note 4).

References

1. Bricco, M.J. and Xu, M.T., 2019. Interconnectedness and contagion analysis: A practical framework. International Monetary Fund.
2. Fukker, G. and Kok, C., 2021. On the optimal control of interbank contagion in the euro area banking system.
3. Covi, G., Gorpe, M.Z. and Kok, C., 2021. CoMap: mapping contagion in the euro area banking sector. Journal of Financial Stability, 53, p.100814.
4. Forbes, K., 2012. The" Big C": identifying contagion.
5. Forbes, K.J. and Rigobon, R., 2002. No contagion, only interdependence: measuring stock market comovements. The journal of Finance, 57(5), pp.2223-2261.

the value of the underlying securities, would reduce the funding available to borrowers and screen out the marginal borrowers from such markets. Usually, caps on LTVs are applied on secured loans such as housing loans, vehicle leasing/loans or pawning facilities.

An LTV ratio was first imposed in Sri Lanka on credit facilities for purchase of motor vehicles granted by licensed banks, LFCs and Specialised Leasing Companies (SLCs) with effective from 15 September 2015 with the view of curtailing excessive credit growth and importation of motor vehicles which weigh substantially on Trade deficit in the Balance of Payment[8]. Initially, the LTV limit was set at 70 per cent for both licensed banks, LFCs and SLCs. Then the LTV framework on credit facilities for motor vehicles was revised in 2017 and LTV limits were applied based on the vehicle classes provided by the Department of Motor Vehicles (DMV)[9]. Subsequently, different LTV ratios were introduced for licensed banks and for LFCs and SLCs in 2018 based on the energy source used and period of initial registration[10]. Currently, LTV for credit facilities granted by licensed banks, LFCs and SLCs for the purchase of motor vehicles which have been used in Sri Lanka for less than one year since the initial registration vary in the range of 25 per cent to 90 per cent. Meanwhile, LTV on facilities granted for vehicles which has been used in Sri Lanka for more than one year after the initial registration is 70 per cent in the case of facilities issued by licensed banks and the same is 80 per cent in the case of facilities issued by LFCs and SLCs.

8 Banking Act Direction No 02 of 2015: https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/laws/cdg/Banking_Act_Direction_2_2015_e_0.pdf
Finance Business Act Direction No 01 of 2015:
https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/laws/cdg/SNBFI_FC_Direction_1_2015_Loan%20to%20Value%20Ratio%20for%20Loans%20and%20Advances%20in%20respect%20of%20Motor%20Vehicles_0.pdf
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https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/laws/cdg/SNBFI_FL_Direction_1_2015_Loan%20to%20Value%20Ratio%20for%20Loans%20and%20Advances%20in%20respect%20of%20Motor%20Vehicles_0.pdf

9 Banking Act Direction No 02 of 2017: https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/laws/cdg/BankingActDirectionNo2of2017_0.pdf
Finance Business Act Direction No 04 of 2017: https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/laws/cdg/Finance_Business_Act_Directions_No_4_of_2017_e.pdf
Finance Leasing Act No 03 of 2017: https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/laws/cdg/Finance_Leasing_Act_Directions_No_3_of_2017_e.pdf

10 Banking Act Direction No 01 of 2018: https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/laws/cdg/Banking_Act_Direction_No_1_of_2018.pdf
Finance Business Act Direction No 02 of 2018:
https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/laws/cdg/Finance_Business_Act_Directions_No_2_of_2018_e.pdf
Finance Leasing Act No 02 of 2018:
https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/laws/cdg/Finance_Leasing_Act_Directions_No_2_of_2018_e.pdf

Table 5.1 LTV on Credit Facilities for Purchase of Motor Vehicles which have been Used in Sri Lanka for Less Than One Year since the Initial Registration

Vehicle Category	LTV Ratio	
	Electric Vehicles	Other
Commercial Vehicles	90%	90%
Motor Cars, SUVs, and Vans	90%	50%
Locally assembled Motor Cars, SUVs, and Vans	90%	70%
Three wheelers	90%	25%
Light Trucks	90%	90%
Any other vehicle	90%	70%
Hybrid Motor Cars, Vans, and SUVs	50%	

The Central Bank is well equipped with frameworks to expand the caps on LTV beyond the credit facilities granted for the purchase of motor vehicles. In 2023, the Central Bank developed a framework to introduce a cap on LTV for credit facilities granted for housing purposes to strengthen its suite of macroprudential tools which can be implemented when the need arises to address systemic imbalances in the economy.

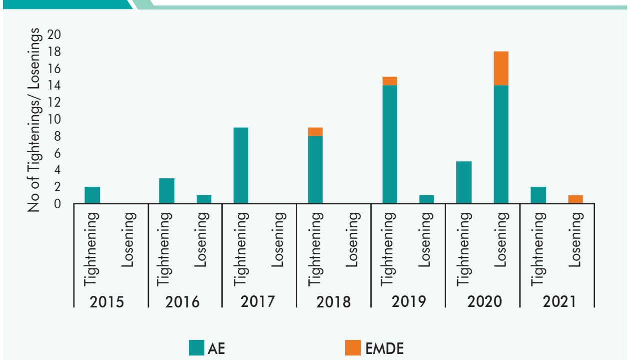
The Debt-Service-to-Income (DSTI) ratio is a measure of the amount of debt service payments relative to total disposable income of an individual in the household sector. The imposition of caps on DSTI serves as a borrower-based macroprudential tool used to mitigate unwarranted credit expansion within the household sector. The purpose of DSTI is to limit banks' potential credit losses and to mitigate risks associated with over indebtedness of households. The Central Bank has developed the frameworks for this purpose. However, the Central Bank has not implemented DSTI measures for any borrowers within the financial sector at present. The Central Bank will continuously monitor the developments in the household sector and impose such measures as and when necessary to enhance the resilience of the financial system.

5.4 Counter Cyclical Capital Buffer (CCyB)

The CCyB is a broad based macroprudential tool which aims to enhance the resilience of the banking sector to adverse shocks and may also reduce the procyclicality of bank lending in a proactive manner. The CCyB is intended to accumulate capital buffers during periods with favourable economic conditions where the imbalances in the financial system start to grow and risks accumulate due to high exuberance. The buildup of capital through CCyB is designed to enhance the resilience of banks, enabling them to better withstand potential losses during periods of financial downturn when risks built up during the exuberance period start to materialise. The CCyB, which is classified as a CET1 buffer requirement applicable to exposures within the geographical boundaries of a country, is generally established within the range of 0 per cent to 2.5 per cent. Macroprudential authorities usually specify a neutral CCyB which ranges between 1-1.5 per cent. During the boom phase of a credit cycle, when there is a buildup of system-wide risks associated with excessive credit expansion or other cyclical systemic risks, authorities will require banks to slowly build the CCyB beyond the neutral rate, which generally ranges between 1.5 and 2.5 per cent. Conversely, during a downturn, authorities release CCyB so that banks have adequate space to carry out financial intermediation.

A relaxation of the CCyB was witnessed across many countries during the COVID-19 pandemic as a measure to support financial sector resilience. The Integrated Macroprudential Policy Database (iMaPP) of the IMF reveals that there are at least 85 countries, out of which 34 countries are Advanced Economies (AE) while the rest are Emerging Markets and Developing Economies (EMDE), where regulatory provisions are available for the implementation of CCyB. It was observed that the 18 countries with a positive CCyB relaxed

Figure 5.3 Tightening/Loosening of the CCyB by AEs and EMDEs



Source : iMaPP

their buffer in 2020, which was the highest value reported since 2015, to maintain the resilience of the financial system amidst the COVID-19 pandemic. This underscores the significance of maintaining the CCyB for a country.

The Central Bank has developed the framework and the country specific analysis methodology that supports the decision-making process of the implementation of the CCyB. The Central Bank expects to introduce the CCyB in Sri Lanka with the revival of the economy in the upcoming years when conditions turn appropriate.

5.5 Other Policies for Mitigating Systemic Risk

Sri Lanka's financial sector is undergoing significant reforms through the IMF-EFF program and arrangements with other multilateral agencies such as the World Bank and Asian Development Bank. As such, a range of measures aimed at improving and restructuring various aspects of the country's financial system were initiated. Accordingly, in line with World Bank Development Policy Operation requirements, the Central Bank enhanced the ELA framework for licensed banks and established a robust institutional framework for crisis management as a pre-emptive measure to safeguard the financial system. During 2023, as a structural benchmark under the IMF-EFF programme, independent Asset Quality Reviews (AQRs) for nine domestic banks which account for more than 90 per cent of the domestically owned bank assets, were completed covering loans and advances both in foreign currency and domestic currency and foreign currency denominated financial instruments. Further, the Central Bank developed a roadmap for restructuring and capital enhancement of the five large banks through careful assessment of the results of AQRs, forward-looking stress testing based on macrofinancial scenarios, and the impact of domestic and external debt (including FX debt granted by state banks to State Owned Enterprises (SOEs) such as Ceylon Petroleum Corporation) restructuring followed by a recapitalisation strategy to meet the potential capital shortfalls. A similar process is being followed for the four smaller domestically owned banks which were subjected to the AQR.

Special Note 4

Establishing a Framework for Liquidity Stress Testing

Stringent liquidity risk management is important for preserving the stability of the financial system. Assessing the resilience of the financial system against liquidity shocks is crucial for identifying vulnerabilities in the system and formulating proactive policy measures to mitigate liquidity risks to enhance its resilience. The Central Bank developed a liquidity stress testing framework for the banking sector, which represents around 62 per cent of the financial system of Sri Lanka.

Methodology and Implementation

Liquidity stress testing is a cashflow model which asseses the ability of banks to counterbalance the maturity mismatches in a hypothetical stressed scenario. A template which identifies cash inflow-outflow mismatches and counterbalancing capacities of financial assets and financial liabilities denominated in LKR and USD and their respective maturities was developed by the Central Bank to collect required data. The data collected were fed into the quantitative toolkit after calibrating the run-off rates[1], roll-off[2] rates and haircuts[3] to generate a stressed scenario. The liquidity stress testing exercise is conducted on a semi-annual basis and the results are submitted to the governing board along with appropriate policy recommendations.

Way Forward

The implementation of the liquidity stress testing to other deposit taking financial institutions is another step towards broadening the spectrum of macroprudential surveillance. The results and conclusions derived from the bank liquidity stress testing framework enhance availability of information used for the Central Bank's policymaking, particularly towards its financial stability objective. The scope of the stress testing exercise will be widened gradually to include Licensed Finance Companies.

1 Run-off rate is the rate at which categories of liabilities and off-balance sheet commitments are expected to be drawn down.
2 Roll-off rate indicates the fraction of maturing assets that is converted into cash inflow by the bank and not being rolled over.
3 Haircut refers to a percentage reduction applied to the market value of an asset when calculating its liquidity value.

Figure 1 Bank Liquidity Stress Testing Framework – The Process

The ELA framework which was established in 2020 was further enhanced in November 2022. This included the expansion of its scope to encompass a wider array of collateral, refining valuation methodologies, incorporating criteria for liquidity and solvency assessment, outlining supervisory actions, and enhancing coordination among various departments of the Central Bank responsible for implementing the framework. ELA is a liquidity assistance facility which will be provided only in Sri Lankan Rupees to licensed banks which are in temporary liquidity distress, where the bank has exhausted all available liquidity options. This facility is accessible exclusively by banks which are assessed to be solvent. However, should a bank seeking ELA be appraised as insolvent or expected to face insolvency in the imminent future, the ELA framework incorporates provisions for extending the facility to such banks under exceptional circumstances to mitigate systemic risk. In such instances, the Government is obligated to provide an explicit guarantee to the Central Bank[11].

The Financial Sector Crisis Management Committee (FCMC) and Technical Committee on Financial Sector Crisis Management (TCMC) which includes officials both from the Central Bank and the Ministry of Finance, were established to strengthen the crisis preparedness framework of the sector. The objective of these committees is to identify and address potential systemic crises in the financial sector and its effects on the real economy,

11 Annual Report (2022). Central Bank of Sri Lanka, Box 9: The Role of Central Banks in Preventing Systemic Financial Crises and Restoring Public Confidence in the Banking Sector

to minimise possible damage to the financial sector and to mobilise support through interagency coordination and communication towards ensuring financial stability. The two committees will operate in two phases. During the first phase committees will focus on the crisis and closely monitor the liquidity risk and capital levels of the banking and LFCs sectors while during the second phase a permanent framework will be established for crisis preparedness, crisis management and to minimise the impact of a financial crisis.

Extensive reliance on systemically important state-owned Licensed Commercial Banks by the Government and SOEs for funding has posed significant challenges to the stability of the financial system. The Central Bank is in the process of formulating Directions that stipulate prudential limits for the large exposures that banks can have vis-à-vis single borrowers and to a group of connected borrowers, including SOEs. Further, a framework will be developed in consultation with the IMF to strengthen the governance of state banks, requiring their boards to have a majority of independent members, and nominations for board and senior management to be made by the banks' nomination committees following open search procedures with clear requirements for independence and professional experience.

The Central Bank took measures to strengthen the legal framework governing the financial sector of Sri Lanka. The Banking (Special Provisions) Act, No. 17 of 2023 is one important piece of legislation that was introduced for the purpose of defining the Resolution Authority of the Central Bank and resolution powers thereof. The Act introduced financial safety net mechanisms, new resolution measures to be implemented in consultation with the Government and included provisions for establishment of a separate department within the Central Bank to exercise its Resolution Authority. Further, the 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 LFCs, as and when appropriate, is also enabled under the Banking (Special Provisions) Act. Further, the Central Bank continued with drafting amendments to the 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 international standards. The Central Bank is also in the process of amending the Finance Business Act, No.42 of 2011 and Finance Leasing Act, No.56 of 2000. In addition, the Central Bank was involved in drafting new legislation such as the Financial Assets Management Act and Micro Finance and Credit Regulatory Act.

The Central Bank took several measures to enhance the resilience of the LFCs sector. A minimum core capital requirement was introduced for LFCs in 2017 with a view to encouraging consolidation to enhance the safety and soundness of the sector. Further, a capital surcharge framework was introduced on LFCs with assets bases more than Rs.100 billion with effect from July 2019. Moreover, the Central Bank implemented a Masterplan in 2020 for the consolidation of Non-Bank Financial Institutions which aimed at creating robust and resilient LFCs over the medium term. This initiative is driven by the goal of safeguarding the interests of depositors within the sector and ensuring the overall stability of the financial system. Furthermore, a Guideline on declaration of dividends or repatriation of profits was issued in 2023 to LFCs as a measure to strengthen resilience and capacity of LFCs to absorb economic shocks that could arise in the time of uncertainty and continue to support credit needs of customers, by maintaining sufficient capital.

Measures were taken to strengthen the financial and institutional capacity of Sri Lanka Deposit Insurance Scheme (SLDIS) to enhance the public confidence towards the financial system. The inadequacy of reserves in the Sri Lanka Deposit Insurance Fund (SLDIF) was identified as one of the main challenges of the financial sector safety net mechanisms of Sri Lanka. Therefore, the financial and institutional capacity of SLDIS will be strengthened through the engagement of concessionary investment project financing mechanism offered by the World Bank through the International Development Association (IDA). Further, initiatives were taken to establish back stop funding arrangements for SLDIS with the Ministry of Finance.

The financial sector in Sri Lanka was navigating through challenging conditions during the recent years due to fragilities that stemmed from adverse macrofinancial developments. These conditions warranted the Central Bank to take a range of policy

Special Note 5

Strengthening Sri Lanka's AML/CFT Framework: FIU Measures and Legislative Amendments

Introduction

Failure to comply with Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) rules and regulations or having a weak AML/CFT framework can pose systemic implications particularly through reputational and operational risks. A weak AML/CFT framework allows criminals to exploit the financial system for money laundering and terrorist financing activities. This could lead to the infiltration of illicit funds into the economy, potential funding of criminal enterprises and terrorist organisations. Further, a weak AML/CFT framework can increase operational risks for financial institutions and could undermine the stability of financial institutions and markets. Inadequate due diligence procedures and controls may expose institutions to legal, financial, and reputational risks, affecting their overall stability and sustainability. Most importantly, inadequate efforts to combat money laundering and terrorist financing can erode public trust in financial institutions affecting confidence on the financial sector.

Failure to comply with international AML/CFT standards can result in reputational damage for a country due to the identification as a country with strategic deficiencies in its AML/CFT framework (Grey List or Black List). This may deter foreign investment, damage relationships with correspondent banks and harm the country's overall economy. Non-compliance with AML/CFT regulations may lead to legal and regulatory consequences. This could lead to sanctions or restrictions imposed by international regulatory bodies, impacting the financial sector and broader economy.

Review Process of the AML/CFT Framework al

Through the periodic peer review process, countries are assessed by the international regulator to evaluate the level of compliance with Financial Action Task Force (FATF) Recommendations and the effectiveness of measures taken to combat money laundering and terrorist financing. The Financial Intelligence Unit (FIU) plays a key role in ensuring that stakeholders are taking all measures to strengthen their AML/CFT framework and the country is compliant with the FATF Recommendations. Further, financial institutions as regulated entities are obliged to comply with the AML/CFT rules and regulations. Accordingly, financial institutions are required to comply with the Customer Due Diligence Rules, submit Suspicious Transaction Reports to the FIU, appoint a Compliance Officer to monitor and oversee that proper safeguards are implemented to protect the Institution, etc.

Sri Lanka's 3rd Mutual Evaluation on AML/CFT framework, coordinated by the Asia Pacific Group on Money Laundering (APG), is scheduled to commence from March 2025. Sri Lanka is required to ensure that the country is technically compliant with the 40 Recommendations of the FATF and the AML/CFT framework is effective under the FATF 11 Immediate Outcomes. Together with the relevant stakeholders, the FIU is taking all possible measures to ensure compliance at the upcoming assessment.

Measures to Strengthen the AML/CFT Framework

In order to strengthen the AML/CFT framework in the country, the FIU conducted the Money Laundering and Terrorism Financing National Risk Assessment (NRA) during 2021/22 and the sanitised NRA report was published in September 2023. The National Policy on AML/CFT for 2023 - 2028 was developed based on the threats, vulnerabilities and risks identified in the NRA and the same was approved by the Cabinet of Ministers on 07.08.2023. The FIU has also drafted Action Plans to be implemented by relevant stakeholders to improve the effectiveness and technical compliance level of AML/CFT framework and the approval of the Cabinet of Ministers was received for the same on 07.08.2023. The FIU is following up on the Action Plans provided to the stakeholders to address the remaining gaps.

The FIU is also in the process of introducing amendments to three main legislative enactments that support the AML/CFT framework of Sri Lanka. The approval of the Cabinet of Ministers has been received to introduce amendments to the Convention on the Suppression of Terrorist Financing Act, No. 25 of 2005, the Prevention of Money Laundering Act, No. 05 of 2006 and the Financial Transactions Reporting Act, No. 06 of 2006. Passing amendments to these three legislation is important for Sri Lanka to address the gaps identified at the Mutual Evaluation carried out by the APG in 2014/2015 and to further strengthen several areas of concern in the implementation of such legislation.

The cooperation of all stakeholders in ensuring compliance with the AML/CFT framework is important to manage the reputational and operational risks which may affect the financial system and the economy as a whole.

actions to maintain and strengthen the resilience of the banking sector. Furthermore, a range of structural reforms were introduced through the IMF-EFF programme. The financial system was carefully steered through a turbulent period by the Central Bank with careful policy interventions while strengthening the crisis preparedness and management frameworks, underlining the commitment to ensuring the stability and integrity of the financial system. The Central Bank broadened its suites of macroprudential tools and will be implemented when necessitated to address systemic imbalances, if any. However, the path ahead continues to be narrow and arduous, and it is imperative that all stakeholders adhere to the policy reforms agenda with unwavering commitment to achieve the desired resilience and stability.

Appendix 1

Financial Soundness Indicators - Banking Sector

		2018	2019	2020	2021	2022* (a)	2023 Sep* (b)
1. Capital Adequacy							
1.1	Capital Adequacy Ratio (c)	16.2	17.2	17.1	16.5	16.1	16.4
1.2	Tier-1 Capital Ratio (d)	13.1	13.7	13.6	13.2	13.1	13.5
1.3	Net Non-performing Loans (e) to Equity Capital & Reserves	14.5	19.5	17.2	11.5		
1.4	Net Stage 3 Loans to Equity Capital & Reserves					44.0	45.3
1.5	Debt to Equity Capital & Reserves	171.1	148.6	134.9	148.9	117.1	79.3
1.6	Equity Capital & Reserves to Total Assets	8.7	9.0	8.6	8.7	8.2	8.7
2. Asset Quality							
2.1	Non-performing Loans (f) to Total Loans and Advances	3.4	4.7	4.9	4.5		
2.2	Stage 3 Loans (g) to Total Loans and Advances (g)					11.3	13.6
2.3	Net Non-performing Loans (e) to Total Loans and Advances	2.0	2.8	2.4	1.7		
2.4	Stage 3 Loans (h) to Total Loans and Advances (h)					11.6	13.4
2.5	Total Provisions (i) to Total Loans & Advances	2.0	2.5	3.0	3.4		
2.6	Total Provision Coverage Ratio (j)	57.4	52.3	61.3	75.8		
2.7	Total Impairment Coverage Ratio (k)					7.9	8.9
2.8	Specific Provision Coverage Ratio (l)	43.1	42.4	51.7	64.0		
2.9	Stage 3 Impairment Coverage Ratio (m)					45.2	46.9
2.10	Total Provisions (i) to Total Assets	1.3	1.6	1.9	2.1		
2.11	Total Impairment (n) to Total Assets					4.7	4.8
2.12	Total Loans & Advances to Total Assets	65.2	64.9	62.0	61.9	58.3	54.3
2.13	Investments to Total Assets	22.9	24.2	28.8	29.1	30.5	34.9
2.14	Total Income to Total Assets	10.7	10.7	8.9	8.1	12.2	10.8
2.15	Net Interest Income to Total Assets	3.4	3.4	2.9	3.2	3.9	2.6
2.16	Operating Income (o) to Total Assets	4.6	4.5	3.9	4.2	5.3	3.4
3. Earnings & Profitability							
3.1	Return on Equity (ROE) – After Tax (p)	13.2	10.3	11.4	14.5	10.4	11.2
3.2	Return on Assets (ROA) – Before Tax (q)	1.8	1.4	1.4	1.6	0.9	1.5
3.3	Return on Assets (ROA) – After Tax (r)	1.1	0.9	1.0	1.2	0.8	1.0
3.4	Interest Income to Total Income	88.2	90.2	89.1	87.8	88.1	92.8
3.5	Net Interest Income to Total Income	31.6	32.0	32.8	40.2	31.8	24.3
3.6	Non-Interest Income to Total Income	11.8	9.8	10.9	12.2	11.9	7.2
3.7	Non-Interest Expenses (Operating Expenses) to Total Income	20.2	19.7	19.4	22.0	13.7	12.7
3.8	Staff Expenses to Non-Interest Expenses	44.1	44.6	46.4	45.2	53.5	51.3
3.9	Staff Expenses to Total Income	8.9	8.8	9.0	9.9	7.3	6.5
3.10	Provision Charge to Total Income	3.3	4.6	6.4	6.7		
3.11	Impairment Charge to Total Income					19.9	5.2
3.12	Total Cost to Total Income (s)	76.8	77.8	75.7	69.5	70.0	81.2
3.13	Efficiency (Operating Cost) Ratio (t)	50.0	52.7	51.8	48.1	31.4	40.4
3.14	Net Interest Margin (u)	3.6	3.6	3.1	3.4	4.0	3.6
4. Liquidity							
4.1	Liquid Assets to Total Assets (v)	25.7	28.9	34.1	29.7	27.4	38.9
4.2	Liquid Assets Ratio - Domestic Banking Unit Operations (DBUs) (w)	27.6	31.0	37.8	33.8	29.9	43.8
5. Assets / Funding Structure							
5.1	Deposits to Total Assets	72.0	73.2	76.0	76.4	78.8	81.0
5.2	Borrowings to Total Assets	15.0	13.4	11.5	13.1	9.6	6.9
5.3	Capital to External Funds (x)	10.0	10.4	9.8	9.9	9.3	9.9
5.4	Credit to Deposits	90.6	88.7	81.6	82.7	73.9	67.0
5.5	Credit to Deposits & Borrowings	75.0	74.9	70.8	70.6	65.9	61.8
5.6	Credit to Deposits & Borrowings & Capital	68.2	67.8	64.5	64.2	60.3	56.2

* Based on SLFRS 9 data.

Source: Central Bank of Sri Lanka

(a) Revised
(b) Provisional
(c) The ratio of regulatory capital to risk-weighted assets
(d) The ratio of core capital to risk-weighted assets
(e) Non performing loans net of interest in suspense and specific provisions
(f) Net of interest in suspense
(g) Including undrawn portion
(h) Excluding undrawn portion
(i) Specific loan loss provisions and general loan loss provisions
(j) The ratio of specific provisions and general provisions to non-performing loans net of interest in suspense
(k) The ratio of total impairment to total loans and receivables
(l) The ratio of specific provisions to non-performing loans net of interest in suspense
(m) The ratio of stage 3 impairment to stage 3 loans
(n) Individual impairment and collective impairment
(o) Operating income (gross income) includes net interest income and non-interest income
(p) Profit after tax (annualised) as a percentage of average equity
(q) Profit before tax (annualised) as a percentage of average assets
(r) Profit after tax (annualised) as a percentage of average assets
(s) The ratio of interest expenses and non-interest expenses to interest income and non-interest income
(t) The ratio of operating expenses to gross income
(u) The ratio of net interest income (annualised) to average assets
(v) The ratio of liquid assets as defined in the Banking Act to total assets
(w) The ratio of liquid assets as defined in the Banking Act to total liabilities subject to minimum liquid assets requirement in Domestic Banking Unit
(x) Deposits and borrowings (debt)

Appendix 2

Financial Soundness Indicators - Licensed Commercial Banks

		2018	2019	2020	2021	2022* (a)	2023 Sep* (b)
1. Capital Adequacy							
1.1	Capital Adequacy Ratio (c)	16.2	17.2	17.1	16.7	16.0	16.3
1.2	Tier-1 Capital Ratio (d)	13.0	13.7	13.6	13.2	13.0	13.5
1.3	Net Non-performing Loans (e) to Equity Capital & Reserves	13.2	18.3	15.5	9.9		
1.4	Net Stage 3 Loans to Equity Capital & Reserves					43.5	44.7
1.5	Debt to Equity Capital & Reserves	167.0	147.5	137.9	154.6	118.0	74.0
1.6	Equity Capital & Reserves to Total Assets	9.1	9.5	9.0	9.0	8.6	9.1
2. Asset Quality							
2.1	Non-performing Loans (f) to Total Loans and Advances	3.3	4.6	4.7	4.3		
2.2	Stage 3 Loans (g) to Total Loans and Advances (g)					11.5	13.9
2.3	Net Non-performing Loans (e) to Total Loans and Advances	1.8	2.6	2.2	1.4		
2.4	Stage 3 Loans (h) to Total Loans and Advances (h)					11.9	13.7
2.5	Total Provisions (i) to Total Loans & Advances	2.0	2.5	3.1	3.4		
2.6	Total Provision Coverage Ratio (j)	61.1	54.0	64.7	80.4		
2.7	Total Impairment Coverage Ratio (k)					8.2	9.2
2.8	Specific Provision Coverage Ratio (l)	45.9	43.8	54.6	67.9		
2.9	Stage 3 Impairment Coverage Ratio (m)					46.2	48.0
2.10	Total Provisions (i) to Total Assets	1.3	1.7	2.0	2.2		
2.11	Total Impairment (n) to Total Assets					5.1	5.2
2.12	Total Loans & Advances to Total Assets	67.3	67.3	64.6	64.5	59.9	55.8
2.13	Investments to Total Assets	20.8	21.9	26.4	26.6	28.5	32.9
2.14	Total Income to Total Assets	10.5	10.6	8.7	7.9	12.2	10.8
2.15	Net Interest Income to Total Assets	3.4	3.5	2.9	3.1	4.0	2.7
2.16	Operating Income (o) to Total Assets	4.8	4.6	3.9	4.2	5.6	3.6
3. Earnings & Profitability							
3.1	Return on Equity (ROE) – After Tax (p)	13.7	10.6	10.9	13.8	11.0	11.6
3.2	Return on Assets (ROA) – Before Tax (q)	1.9	1.5	1.4	1.6	1.0	1.7
3.3	Return on Assets (ROA) – After Tax (r)	1.2	1.0	1.0	1.2	0.9	1.1
3.4	Interest Income to Total Income	87.0	89.1	87.9	86.3	86.9	92.2
3.5	Net Interest Income to Total Income	32.3	32.5	33.0	39.7	32.7	25.4
3.6	Non-Interest Income to Total Income	13.0	10.9	12.1	13.7	13.1	7.8
3.7	Non-Interest Expenses (Operating Expenses) to Total Income	20.4	20.0	19.7	22.2	13.4	12.6
3.8	Staff Expenses to Non-Interest Expenses	42.7	43.1	45.2	43.6	51.4	49.0
3.9	Staff Expenses to Total Income	8.7	8.6	8.9	9.7	6.9	6.2
3.10	Provision Charge to Total Income	3.5	4.8	7.1	7.3		
3.11	Impairment Charge to Total Income					21.8	5.5
3.12	Total Cost to Total Income (s)	75.1	76.6	74.7	68.8	67.5	79.4
3.13	Efficiency (Operating Cost) Ratio (t)	48.5	51.8	51.7	48.2	29.2	38.0
3.14	Net Interest Margin (u)	3.7	3.6	3.1	3.3	4.1	3.8
4. Liquidity							
4.1	Liquid Assets to Total Assets (v)	24.5	27.1	31.8	27.7	26.8	38.6
4.2	Liquid Assets Ratio - Domestic Banking Unit Operations (DBU) (w)	25.0	27.8	34.4	30.9	28.8	43.0
5. Assets / Funding Structure							
5.1	Deposits to Total Assets	71.4	72.0	74.7	75.1	77.9	80.7
5.2	Borrowings to Total Assets	15.1	14.0	12.4	14.1	10.1	6.7
5.3	Capital to External Funds (x)	10.5	11.1	10.3	10.3	9.7	10.4
5.4	Credit to Deposits	94.2	93.4	86.5	87.6	76.9	69.2
5.5	Credit to Deposits & Borrowings	77.7	78.1	74.2	73.7	68.1	63.9
5.6	Borrowings & Credit to Deposits & Borrowings & Capital	70.4	70.4	67.3	66.9	62.0	57.9

* Based on SLFRS 9 data

Source: Central Bank of Sri Lanka

(a) Revised
(b) Provisional
(c) The ratio of regulatory capital to risk-weighted assets
(d) The ratio of core capital to risk-weighted assets
(e) Non performing loans net of interest in suspense and specific provisions
(f) Net of interest in suspense
(g) Including undrawn portion
(h) Excluding undrawn portion
(i) Specific loan loss provisions and general loan loss provisions
(j) The ratio of specific provisions and general provisions to non-performing loans net of interest in suspense
(k) The ratio of total impairment to total loans and receivables
(l) The ratio of specific provisions to non-performing loans net of interest in suspense
(m) The ratio of stage 3 impairment to stage 3 loans
(n) Individual impairment and collective impairment
(o) Operating income (gross income) includes net interest income and non-interest income
(p) Profit after tax (annualised) as a percentage of average equity
(q) Profit before tax (annualised) as a percentage of average assets
(r) Profit after tax (annualised) as a percentage of average assets
(s) The ratio of interest expenses and non-interest expenses to interest income and non-interest income
(t) The ratio of operating expenses to gross income
(u) The ratio of net interest income (annualised) to average assets
(v) The ratio of liquid assets as defined in the Banking Act to total assets
(w) The ratio of liquid assets as defined in the Banking Act to total liabilities subject to minimum liquid assets requirement in Domestic Banking Unit
(x) Deposits and borrowings (debt)

Appendix 3

Financial Soundness Indicators - Licensed Specialised Banks

		2018	2019	2020	2021	2022* (a)	2023 Sep* (b)
1. Capital Adequacy							
1.1	Capital Adequacy Ratio (c)	17.1	16.2	16.8	14.6	18.5	17.6
1.2	Tier-1 Capital Ratio (d)	15.0	12.9	13.7	12.0	14.8	14.3
1.3	Net Non-performing Loans (e) to Equity Capital & Reserves	28.7	33.0	36.8	27.6		
1.4	Net Stage 3 Loans to Equity Capital & Reserves					50.3	52.9
1.5	Debt to Equity Capital & Reserves	214.7	162.6	101.6	93.6	106.4	143.3
1.6	Equity Capital & Reserves to Total Assets	6.3	5.6	5.6	6.4	5.6	5.8
2. Asset Quality							
2.1	Non-performing Loans (f) to Total Loans and Advances	4.8	5.5	6.9	6.5		
2.2	Stage 3 Loans (g) to Total Loans and Advances (g)					9.0	10.6
2.3	Net Non-performing Loans (e) to Total Loans and Advances	3.6	3.9	4.9	4.1		
2.4	Stage 3 Loans (h) to Total Loans and Advances (h)					8.4	10.1
2.5	Total Provisions (i) to Total Loans & Advances	1.6	2.1	2.5	2.8		
2.6	Total Provision Coverage Ratio (j)	32.9	38.6	36.7	43.8		
2.7	Total Impairment Coverage Ratio (k)					4.3	5.3
2.8	Specific Provision Coverage Ratio (l)	24.3	31.3	30.9	37.5		
2.9	Stage 3 Impairment Coverage Ratio (m)					31.4	32.2
2.10	Total Provisions (i) to Total Assets	0.8	1.0	1.1	1.2		
2.11	Total Impairment (n) to Total Assets					1.9	2.2
2.12	Total Loans & Advances to Total Assets	50.1	48.1	43.6	44.0	45.4	42.6
2.13	Investments to Total Assets	38.2	40.0	46.0	46.5	46.8	50.2
2.14	Total Income to Total Assets	11.8	11.3	9.9	9.0	11.5	11.0
2.15	Net Interest Income to Total Assets	3.2	3.3	3.1	3.9	2.8	1.7
2.16	Operating Income (o) to Total Assets	3.6	3.6	3.5	4.1	2.9	2.0
3. Earnings & Profitability							
3.1	Return on Equity (ROE) – After Tax (p)	7.7	6.8	16.7	21.5	3.4	7.2
3.2	Return on Assets (ROA) – Before Tax (q)	0.8	0.8	1.3	1.7	0.3	0.2
3.3	Return on Assets (ROA) – After Tax (r)	0.5	0.4	0.9	1.3	0.2	0.4
3.4	Interest Income to Total Income	96.1	97.1	96.3	97.4	98.6	97.4
3.5	Net Interest Income to Total Income	27.1	29.0	31.7	43.7	24.1	15.8
3.6	Non-Interest Income to Total Income	3.9	2.9	3.7	2.6	1.4	2.6
3.7	Non-Interest Expenses (Operating Expenses) to Total Income	18.9	17.5	17.3	20.5	16.7	13.3
3.8	Staff Expenses to Non-Interest Expenses	54.2	55.4	55.0	55.7	67.2	67.5
3.9	Staff Expenses to Total Income	10.2	9.7	9.5	11.4	11.2	9.0
3.10	Provision Charge to Total Income	1.6	2.9	2.2	3.0		
3.11	Impairment Charge to Total Income					3.4	2.4
3.12	Total Cost to Total Income (s)	87.8	85.6	81.9	74.3	91.2	94.9
3.13	Efficiency (Operating Cost) Ratio (t)	63.8	60.1	52.0	47.3	65.4	72.2
3.14	Net Interest Margin (u)	3.2	3.4	3.4	4.1	2.8	2.4
4. Liquidity							
4.1	Liquid Assets to Total Assets (v)	35.1	41.5	49.6	43.6	31.6	41.2
4.2	Liquid Assets Ratio - Domestic Banking Unit Operations (DBU) (w)	47.7	53.1	60.4	52.8	38.2	49.4
5. Assets / Funding Structure							
5.1	Deposits to Total Assets	76.3	80.9	84.6	85.7	85.9	83.3
5.2	Borrowings to Total Assets	13.5	9.0	5.7	6.1	6.0	8.3
5.3	Capital to External Funds (x)	7.0	6.2	6.3	7.2	6.1	6.3
5.4	Credit to Deposits	65.7	59.5	51.6	52.5	52.9	51.2
5.5	Credit to Deposits & Borrowings	55.8	53.5	48.3	49.0	49.5	46.5
5.6	Credit to Deposits & Borrowings & Capital	52.1	50.4	45.5	45.7	46.6	43.8

* Based on SLFRS 9 data.

Source: Central Bank of Sri Lanka

(a) Revised
(b) Provisional
(c) The ratio of regulatory capital to risk-weighted assets
(d) The ratio of core capital to risk-weighted assets
(e) Non performing loans net of interest in suspense and specific provisions
(f) Net of interest in suspense
(g) Including undrawn portion
(h) Excluding undrawn portion
(i) Specific loan loss provisions and general loan loss provisions
(j) The ratio of specific provisions and general provisions to non-performing loans net of interest in suspense
(k) The ratio of total impairment to total loans and receivables
(l) The ratio of specific provisions to non-performing loans net of interest in suspense
(m) The ratio of stage 3 impairment to stage 3 loans
(n) Individual impairment and collective impairment
(o) Operating income (gross income) includes net interest income and non-interest income
(p) Profit after tax (annualised) as a percentage of average equity
(q) Profit before tax (annualised) as a percentage of average assets
(r) Profit after tax (annualised) as a percentage of average assets
(s) The ratio of interest expenses and non-interest expenses to interest income and non-interest income
(t) The ratio of operating expenses to gross income
(u) The ratio of net interest income (annualised) to average assets
(v) The ratio of liquid assets as defined in the Banking Act to total assets
(w) The ratio of liquid assets as defined in the Banking Act to total liabilities subject to minimum liquid assets requirement in Domestic Banking Unit
(x) Deposits and borrowings (debt)

Appendix 4

Financial Soundness Indicators - Licensed Finance Companies

	2019	2020	2021	2022	2022* (a)	2023 Sep* (b)
1. Capital Adequacy						
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	10.1	12.0	14.8	17.3	21.9	22.6
1.2 Tier 1 Capital/Risk Weighted Assets (Tier 1 RWCAR)	8.8	10.6	13.6	15.8	20.5	21.3
1.3 Regulatory Capital to Total Assets	10.1	12.2	15.0	16.3	18.9	20.2
1.4 Borrowings to Equity (times)	2.4	1.9	1.1	1.1	0.8	0.6
1.5 Investment Properties to Regulatory Capital	14.5	15.5	16.6	16.9	16.9	15.5
1.6 Stage 3 Loans Net of Impairments to Regulatory Capital (c)	18.8	26.6	15.6	9.2	44.1	53.2
2. Asset Quality						
2.1 Gross Stage 3 Loans to Total Advances (d)	7.8	11.6	11.3	9.0	16.0	20.0
2.2 Impairment made against Total Advances (e)	4.6	6.4	7.2	6.3	7.6	7.9
2.3 Impairment Coverage Ratio (f)	58.8	54.5	64.0	69.6	33.3	29.6
3. Earnings & Profitability						
3.1 Return on Assets (Annualised)	2.6	1.7	3.1	5.3	3.0	3.3
3.2 Return on Equity (Annualised) (g)	12.0	6.2	12.8	20.8	8.9	8.7
3.3 Operating Profit Before Provision to Total Assets	4.4	4.2	5.3	5.6	4.0	2.1
3.4 Interest Income to Interest Expenses	181.5	180.9	204.2	252.1	159.8	160.2
3.5 Net Interest Income to Profit After Tax	568.2	955.6	381.3	213.5	365.0	387.7
3.6 Operating Cost to Net Interest Income	78.2	79.9	70.6	63.6	83.8	82.6
3.7 Net Interest Income to Average Assets (g)	7.8	7.4	7.4	8.0	6.7	7.3
3.8 Net Interest Income to Interest Income	44.9	44.7	51.0	60.3	37.4	37.6
3.9 Non-Interest Expenses to Total Cost	38.9	39.3	42.4	49.2	33.4	33.2
3.10 Efficiency Ratio	70.0	77.7	62.4	49.1	65.1	64.7
3.11 Cost to Income Ratio	86.9	91.1	81.7	67.0	85.4	85.1
4. Liquidity						
4.1 Liquid Assets to Total Assets	8.8	8.3	8.9	9.8	13.0	14.4
4.2 Liquid Assets to Deposits and Borrowings	11.2	11.0	12.6	14.1	19.1	21.5
4.3 Net Loans to Total Borrowings	264.8	291.2	375.5	337.4	404.9	469.5
5. Assets / Funding Structure						
5.1 Borrowings to Total Assets	29.3	26.4	20.2	22.6	17.5	14.7
5.2 Investments to Total Assets	9.1	9.5	11.4	11.3	13.8	17.3

Source: Central Bank of Sri Lanka

(a) Revised
(b) Provisional
(c) Before April 2023 Net Non-performing Loans to Regulatory Capital was used
(d) Before April 2023 Gross Non Performing Advances to Total Advances was considered
(e) Before April 2023 Provisions to Total Advances was considered
(f) Before April 2023 Provision Coverage Ratio was considered
(g) Gross assets after adding back provisions for loan and investment losses were used

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