Financial Stability Review 2024

Central Bank of Sri Lanka

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2024

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In terms of Section 70(1) of the Central Bank of Sri Lanka Act, No. 16 of 2023, the Central Bank is required to prepare and publish the Financial Stability Review (FSR) on or before the thirty-first day in the month of October of each year. Fulfilling this obligation, FSR of 2024 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 June 2024. 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.

For inquiries, comments and feedback please contact:
Macroprudential Surveillance Department
Central Bank of Sri Lanka
30, Janadhipathi Mawatha
Colombo 01
Email: msd@cbsl.lk

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Abbreviations

ADB	Asian Development Bank
ADs	Authorized Dealers
AFI	Alliance for Financial Inclusion
AML/CFT	Anti-Money Laundering and Countering the Financing of Terrorism
APG	Asia Pacific Group on Money Laundering
AQRs	Asset Quality Reviews
ASPI	All Share Price Index
AWCMR	Average Weighted Call Money Rate
AWDR	Average Weighted Deposit Rate
AWLR	Average Weighted Lending Rate
AWNDR	Average Weighted New Deposit Rate
AWNLR	Average Weighted New Lending Rate
AWPR	Average Weighted Prime Lending Rate
BIS	Bank for International Settlements
BNCA Act	Bilateral Netting and Collateral Arrangement Act
BRUs	Business Revival Units
BSI	Banking Soundness Index
BSPA	Banking (Special Provisions) Act
CAR	Capital Adequacy Ratio
CAS	Common ATM Switch
CCoB	Capital Conservation Buffer
CCPI	Colombo Consumer Price Index
CDD	Customer Due Diligence
CDR	Credit to Deposit Ratio
CEFTS	Common Electronic Fund Transfer Switch
CEOs	Chief Executive Officers
CET-1	Common Equity Tier-1
CGT	Common Ground Taxonomy
COR	Combined Operating Ratio
CPC	Ceylon Petroleum Corporation
CPMI	Committee on Payments and Market Infrastructures
CRIB	Credit Information Bureau
CSE	Colombo Stock Exchange
CSP	Customer Security Program
DBU	Domestic Banking Unit
DDO	Domestic Debt Optimisation
DSIBs	Domestic Systemically Important Banks
EBIT	Earnings Before Interest and Tax
EBITDA	Earnings Before Interest, Taxes, Depreciation, and Amortisation
EDR	External Debt Restructuring
EMDEs	Emerging Markets and Developing Economies
EMEs	Emerging Market Economies
ESG	Environmental, Social and Governance
EU	European Union
FAO	Food and Agriculture Organisation
FATF	Financial Actions Task Force
FBA	Finance Business Act
FCP	Financial Consumer Protection
FCs	Finance Companies
FCY	Foreign Currency
FDIs	Foreign Direct Investments
FEA	Foreign Exchange Act
FIs	Financial Institutions
FIU	Financial Intelligence Unit
FMI	Financial Market Infrastructure
FSI	Financial Stress Index
FSOC	Financial System Oversight Committee
FSPs	Financial Service Providers
FSRB	FATF-Styled Regional Bodies
FTRA	Financial Transactions Reporting Act
GCF	Green Climate Fund
GDP	Gross Domestic Product
GOR	Gross Official Reserves
GRI	Global Reporting Initiative
GWP	Gross Written Premium
HQLA	High Quality Liquid Assets
IASB	International Accounting Standards Board

ICR	Interest Coverage Ratio
IFC-WB	International Finance Corporation of the World Bank
IMF	International Monetary Fund
IMF-EFF	International Monetary Fund Extended Fund Facility
INFF	Integrated National Financing Framework
IOSCO	International Organization of Securities Commissions
ISBs	International Sovereign Bonds
KMP	Key Management Personnel
LBs	Licensed Banks
LCB	Licensed Commercial Bank
LCR	Liquidity Coverage Ratio
LFCs	Licensed Finance Companies
LKR	Sri Lankan Rupee
LMFCs	Licensed Microfinance Companies
LSBs	Licensed Specialised Banks
LTV	Loan to Value
MCS	Market Conduct Supervision
MDBs	Multilateral Development Banks
ME	Mutual Evaluation
ML	Money Laundering
MoF	Ministry of Finance
MSCI	Morgan Stanley Capital International
MSMEs	Micro, Small, and Medium Enterprises
MVTS	Money Value Transfer Services
NBFIs	Non-Bank Financial Institutions
NCGIL	National Credit Guarantee Institution Limited
NDCs	Nationally Determined Contributions
NFCs	Non-Financial Corporates
NII	Net Interest Income
NIM	Net Interest Margin
NOP	Net Open Position
NPA	Non-Performing Asset
NPL	Non-Performing Loan
NSFR	Net Stable Funding Ratio
OBU	Off-shore Banking Unit
OPEC +	Organisation of the Petroleum Exporting Countries plus selected non-member countries, including Russia
OSBB	Off-shore Banking Business
PAT	Profit After Tax
PBV	Price to Book Value
PDCs	Primary Dealer Companies
PER	Price Earnings Ratio
PMI	Purchasing Managers' Index
PSSA	Payment and Settlement Systems Act
RHS	Right Hand Side
RIs	Risk Indicators
ROA	Return on Assets
ROE	Return on Equity
RoRWA	Return on Risk Weighted Assets
RPS	Retail Payment System
RTGS	Real Time Gross Settlement
RWA	Risk-Weighted Assets
SDFR	Standing Deposit Facility Rate
SLAR	Statutory Liquid Asset Ratio
SLCs	Specialised Leasing Companies
SLDBs	Sri Lanka Development Bonds
SLFR	Standing Lending Facility Rate
SLFRS	Sri Lanka Financial Reporting Standard
SMEs	Small and Medium Enterprises
SOBEs	State Owned Business Enterprises
SOEs	State Owned Enterprises
SRC	Standing Rate Corridor
SRCC	Strikes, Riots and Civil Commotion
SRR	Statutory Reserve Requirement
SRS	Systemic Risk Survey
TBML	Trade Based Money Laundering
TF	Terrorist Financing
TR	Thematic Review
UK	United kingdom
US	United States
USD	United State Dollars
VAT	Value Added Tax
WEO	World Economic Outlook

Executive Summary

Financial system stability was maintained during the first half of 2024 amidst spillovers from the challenging macrofinancial conditions experienced during the recent past. The overall stabilisation and gradual improvement of domestic macrofinancial conditions eased the pressure on balance sheets of households and institutions to some extent and thereby lessened the risks faced by the financial sector. The downward trend in financial intermediation subsided and showed signs of stabilisation as credit growth[1] entered the positive territory, albeit lagging behind the pace of deposit growth. Decline in market interest rates with the accommodative monetary policy stance along with falling inflation and lower risk premia, which resulted in a partial correction of interest rate anomalies, supported the gradual uptick in credit. Moreover, the tilt in financial sector exposure towards the public sector also showed signs of correction, indicating an improvement in the allocation of financial resources towards the private sector. Amidst these developments, the credit cycle progressed within the expansionary phase with the gradual widening of the credit gap. While these developments are encouraging in terms of stabilisation of the financial sector, lingering macrofinancial challenges continued to pose concerns. Diminished real income amidst elevated price levels and rigidities in the labour market continued to dampen both the demand for credit and the improvement in credit quality. Moreover, the downward rigidity in market interest rates coupled with declining yet elevated yields of Government securities also hampered the progress of financial intermediation.

Along with the improvement in macrofinancial conditions, financial markets operated with improved stability during the period under review. Accordingly, financial market stress remained broadly at lower levels particularly from end 2023 with some volatility during the early part of Q2 of 2024. The stock market depicted a mixed performance in terms of key indicators. Although All Share Price Index reported a year-to-date increase during the first eight months of 2024, a declining trend was witnessed from mid-2024 amidst possible uncertainties with the election cycle. Meanwhile, volatility of price indices remained elevated compared to end 2023 while foreign inflows remained subdued, highlighting the challenges within the equity market to attract sustainable foreign investments. Easing monetary policy stance, low inflation expectations, decline in risk perceptions with positive macroeconomic developments and fiscal consolidation measures contributed towards the reduction in yields in Government securities albeit remaining at elevated levels compared to market interest rates. However, yields of Government securities started to increase in August 2024. Overall, short term yields declined at a higher rate compared to long term yields and resulted in the yield curve transitioning back to relative normalcy from the inverted curve observed for the most part of 2023. The secondary market for Government securities operated with low liquidity while foreign investor demand reduced with falling yields. Meanwhile, the rupee appreciated against the USD during the first eight months of 2024 within the domestic foreign exchange market supported by enhanced inflows, particularly in the form of higher workers' remittances, tourist earnings and export conversions. However, the rate of appreciation of the rupee moderated after the first four months of 2024 amidst the increased demand for foreign exchange. This trend may exacerbate if adverse shifts in demand and supply conditions transpire. Liquidity conditions within the domestic money market improved particularly during Q2 of 2024 along with the reduction in the significant asymmetry observed between domestic and foreign banks. Moreover, Average Weighted Call Money Rate (AWCMR) remained closer to the lower bound of the standing rate corridor, indicating improved liquidity conditions within the domestic money market, thereby facilitating a more conducive environment in terms of rupee liquidity for the financial sector.

1 Unless otherwise specified, all growth rates/comparisons are on a year-on-year basis.

Resilience of financial institutions gradually improved during the first half of 2024 amidst easing macroeconomic conditions as reflected by key financial soundness indicators of the Banking sector, such as credit quality, liquidity and capital adequacy. However, the Non-Performing Loans (NPL) ratio remained elevated highlighting continued challenges while the provision coverage ratio improved. Amid declining market interest rates and the gradual uptick in domestic demand, credit growth of the Banking sector witnessed a resurgence particularly in terms of the private sector while the dependence of State Owned Enterprises declined mainly due to the Central Government absorbing certain credit facilities of a major State Owned Enterprise. However, overall sovereign exposure of the sector continued to increase with investments in Government securities induced by elevated yields compared to other market interest rates. This in turn supported the buildup of high-quality liquid assets in the Banking sector, which contributed towards the improvement in rupee liquidity. In addition, a considerable amount of funds maintained by the sector with financial institutions abroad indicated prudent foreign currency liquidity management by banks. Profitability of the Banking sector also improved, significantly supported by the increase in net interest income. This increase in net interest income was facilitated by the notable decline in interest expenses, as a result of the decline in deposit rates outpacing that of lending rates, emphasising the inherent downward rigidity in lending rates within the sector. Enhanced level of profitability along with the significant divergence of Banking sector funds towards Government securities and raising of Tier-2 capital through debenture issuances helped in improving the capital levels of the sector. In addition, in terms of interconnectedness of the Banking sector, although interbank exposures remained low when compared to the total assets of the sector, an increase was witnessed as of Q1 of 2024 while contagion risk of the interbank network was assessed to be cautiously moderate.

The performance of both the Finance Companies (FCs) sector and the Insurance sector depicted an overall trend consistent with that of the Banking sector, highlighting the impact of improved macrofinancial conditions within the financial sector as a whole. Accordingly, the FCs sector also reported an improved performance despite the saturation in vehicle leasing activities. Assets of the sector improved, both in terms of quantity and quality, while liquid assets of the sector also recorded a growth with increased investments in Government securities. Meanwhile, similar to the Banking sector, reduced interest costs supported profit expansion while the capital adequacy levels of the sector also improved. Likewise, developments within the Insurance sector depicted an improvement during the period, as reflected through the increase in Gross Written Premium. Further, a notable asset growth was observed due to the significant growth in assets of the long term insurance subsector with continued increase in investments in Government securities. Profitability also improved amidst robust levels of capital adequacy within the insurance industry. Accordingly, the recovery, stabilisation and gradual growth of the banking, finance companies, and insurance sectors, were particularly influenced by the developments in the interest rate structure and continued investments in Government securities.

Household and Institutional sectors, which constitute key financial services consumers, recorded an expansion in credit during the first half of 2024. This reflects the uptick in the demand for financial services from these sectors within the backdrop of improving macroeconomic conditions in the economy. However, the debt stock of both sectors remained below the levels observed during the first half of 2022, reflecting the potential for further expansion of credit[2]. While the decline in interest rates and low inflation environment would have provided impetus towards the expansion in credit, lower level of real income and tax adjustments would have tapered this growth momentum. Meanwhile, although credit quality of the Household sector improved slightly, as reflected through the NPL ratio[3], it remained at elevated levels, particularly within the Non-Bank Financial Institutions (NBFI) sector, which holds a higher proportion of NPLs compared to the Banking sector. However, the NPL ratio of the Institutional sector continued to deteriorate, signalling ongoing challenges in managing the credit quality

2 Please note that the debt stock would include the impact of fluctuations in exchange rate.

3 The sectoral NPL ratios discussed in terms of the Household and Institutional sectors classify loans with 90 days in arrears as NPLs based on information obtained from the Credit Information Bureau (CRIB). Thus, NPLs referred within the sectoral assessment are not directly comparable with NPLs referred in the context of financial institutions.

of financial institutions despite the gradual improvement in macrofinancial conditions. Moreover, the listed Non-Financial Corporate (NFC)[4] sector also recorded an enhanced financial performance with increased revenue and profitability. Finance cost of the NFC sector also benefited significantly from the reduction in the market interest rates, which in turn spurred the profitability of the sector. Moreover, increased profitability led to a notable improvement in overall creditworthiness of the sector as well, which may indicate a possible easing of the credit risk emanating from listed NFCs. While the performance of the NFC sector, benefitting from the economic recovery, supported the resilience of the financial institutions during the period under review, maintaining this performance going forward, in an environment of further normalisation of macrofinancial conditions, would be crucial to ensure continued stability of the financial sector at large.

Upon closely evaluating the developments within the financial sector and the economy as a whole, the Central Bank took measures to implement appropriate policies aimed at ensuring the stability and resilience of the financial system. Accordingly, macroprudential policies were reinforced within the financial system. In order to address the credit concentration risk of Licensed Banks (LBs), large exposure caps, including that on public corporations, were tightened with full implementation spanning across six years until 2030 to ensure minimal disruptions to financial intermediation. Moreover, exposure caps of FCs were also tightened during the period under review. Additional buffers in the form of the Capital Conservation Buffer and the capital surcharge on Domestic Systemically Important Banks, which played a crucial role in sustaining the resilience of the banking sector during domestic debt restructuring and periods of economic turbulence, were maintained by the Central Bank along with the caps on Loan to Value ratio on motor vehicles. Guidelines that reinforced business revival units of LBs to support fundamentally viable businesses facing challenges were also issued by the Central Bank in order to support the economic recovery process. Furthermore, the Central Bank continued to strive towards achieving Banking sector structural benchmarks of the International Monetary Fund Extended Fund Facility (IMF-EFF) programme, which included the enactment of the Banking (Amendment) Act No. 24 of 2024. Moreover, a roadmap for nine large banks to address capital and forex shortfalls were developed along with the continued review of recapitalisation plans of private banks. In tandem to the macroprudential and microprudential policies, the Central Bank took various other measures in terms of payment and settlements, financial literacy, financial consumer protection, financial inclusion, resolution of financial institutions, corporate governance and AML/CFT[5] initiatives to enhance stability of the financial system. Going forward, the Central Bank will diligently monitor systemic risks and promptly implement appropriate macroprudential and microprudential policy measures to address any emerging risks to ensure continued financial stability.

Financial Stability Outlook

Going forward, the financial system is expected to perform better with envisaged improvements in asset quality and buildup of capital buffers while prudently managing risks, as the economy further stabilises and advances amidst continuing challenges. Although the unprecedented gravity of the crisis created deep macrofinancial imbalances within the economy, these imbalances are gradually correcting with prudent policy measures and reforms along with behavioural responses thereby supporting financial system stability. Hence, while the progress of the financial sector thus far while managing the spillovers from the economic crisis has been commendable, the sector needs to continuously strive towards assuring financial stability in the medium to long term.

Envisaged improvement in economic output would invariably create the demand for financial services, amidst relatively stable price levels, supporting improvements in financial intermediation. However, as credit expansion shifts towards the private sector, financial institutions would have to consider managing of potential pressures on credit quality and capital adequacy, in the backdrop of elevated NPL ratios and caps on large exposures.

4 Financial information derived from the Colombo Stock Exchange (CSE) served as a timely and relevant indicator for assessing the financial performance and risks associated with the NFC sector.

5 Anti-Money Laundering and Countering the Financing of Terrorism

Moreover, while attracting funds amidst low deposit rates could be challenging, continued downward pressure on lending rates could narrow the net interest income of financial institutions thereby affecting profitability. In addition, the high level of sovereign exposure of financial institutions particularly in the form of Government securities, which led to significant returns in the recent past, may also gradually subside. Further readjustment of imbalances in the external sector and the fiscal sector particularly due to suppressed import demand and delaying of meeting selected sovereign debt obligations may also need to be cautiously handled to ensure the stability of the financial system. Nevertheless, the finalisation of external debt restructuring would pave the way for accessing further financial resources from the external sector albeit in a prudent manner. Accordingly, challenges will persist as the benefits experienced through the recovery in macrofinancial conditions supported by the favourable base effect is diminishing.

Within this backdrop, realisation of the outlook depends on an array of macrofinancial factors particularly in terms of sustaining the fiscal consolidation path, efficient management of external sector imbalances with normalisation of external demand along with low and stable price levels that would create a conducive environment for economic expansion. Furthermore, the higher propensity towards risk taking during the expansionary phase of the credit cycle is also likely to heighten the buildup of vulnerabilities, highlighting the continued need for proactive management of risks within the financial sector. Thus, the Central Bank as the macroprudential authority along with the Financial System Oversight Committee will continue to assess the buildup of any systemic risks in the financial sector and recommend macroprudential policy measures to address such risks. Moreover, all stakeholders should remain committed to implement timely and well-sequenced policy measures and reforms to ensure sustained stability of the financial system.

MACROFINANCIAL CONDITIONS

Domestic macrofinancial conditions improved, but challenges remain...

- Recovery in economy
- Low inflation
- Reducing pressure on household and corporate balance sheets
- Stabilisation of credit risk for banks

- Deteriorated real income
- Elevated price levels

Economic recovery

Market interest rates are adjusting downwards

Improved foreign exchange earnings

Tilt in financial institutions exposure to Sovereign has decreased

Economic & price stability

Financial system stability

Banking sector exposure to real estate remains elevated

Foreign investment inflows remained low

Credit cycle in expansionary phase with higher risk taking

Financial intermediation

- Recovering of credit to private sector

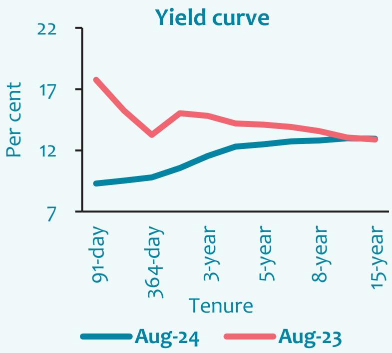
- Low credit to deposit ratio
- Cautious lending by banks

FINANCIAL MARKETS

Stock market (Jan-Aug 2024)

ASPI	S&P SL 20	Volatility	Average daily turnover	Net foreign flows
2.0%	-0.3%	low	Rs. 1,523.9 mn	-$ 17.0 mn

Government securities market (Jan-Aug 2024)



Yields are under pressure due to high domestic borrowings

Fiscal consolidation will help ease pressure on the yields

Foreign selling $ 251.4 mn

Foreign holding 0.25%

Secondary market remained illiquid

Domestic foreign exchange market (Jan-Aug 2024)

Appreciation vis-à-vis the USD 7.9%

Domestic money market (Jan-Aug 2024)

Market operated with surplus liquidity

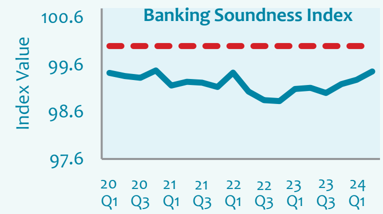
Call and repo markets were active

AWCMR was close to the SDFR

BANKING SECTOR

Developments during the year ending 2024 Q2

Banking Soundness Index improved at end Q2 of 2024

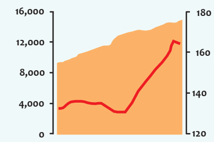


Credit expansion : 4.8 % y-o-y
Gross NPL ratio : 12.8 %
Provision coverage ratio : 51.1 %

Sovereign exposure to total assets: 45.7%

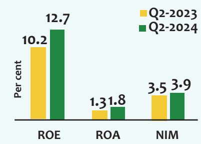
Rupee LCR : 339.9%
All currency LCR : 293.5%

Net stable funding ratio improved to 163.6%



Profit after tax : Rs. 111.8 bn
Net interest income : Rs. 395.1 bn

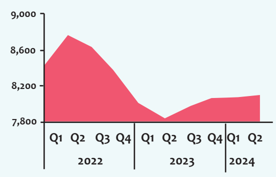
ROE, ROA and NIM improved



Capital adequacy ratio : 18.0 %
Regulatory capital : 11.4 % y-o-y

Increased issuance of Tier 2 capital

Risk weighted assets for the credit risk 3.2% y-o-y



FINANCE COMPANIES SECTOR

Loans and advances grew by 11.4% y-o-y

Asset quality indicators considerably improved

Gross non-performing loans ratio

20.5% Q2 2023 — NPL — 13.6% Q2 2024

Liquidity position reported Rs. 155.2 bn surplus at end Q2 of 2024

CAR
23.4% Q2 2023 ››› 23.8% Q2 2024

Deposits
12.6% Q2 2024 y-o-y growth

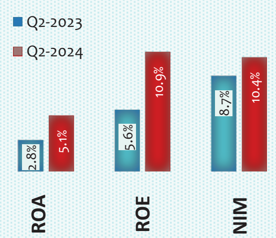
Total investments grew by 22.6% to Rs. 401.7 bn

Borrowings
4.7% Q2 2024 y-o-y growth

DEBT

Profit after tax improved by 120.8% y-o-y

Key profitability indicators improved



INSURANCE SECTOR

Sovereign exposure to total investments: 61.5%

Assets ↑ 10.5%
Long-term ↑ 16.5% y-o-y General ↓ 4.5% y-o-y

Capital adequacy ratio exceeded the minimum requirement
Long -term: 276% General: 312%

Gross written premium ↑ 11.1%
Long-term ↑ 17.4% y-o-y General ↑ 4.2% y-o-y

Insurance Sector Performance as at end H1 of 2024

Insurance penetration marginally improved to **1.1%**

	General	Long-term
ROA	9.7	3.8
ROE	21.5	18.8
Loss ratio	59.3	49.0
Retention ratio	79.7	95.6
Management expense ratio	45.3	38.8
Combined operating ratio	104.6	87.8
Premium stability ratio	6.5	17.4
Investment yield ratio	14.7	13.8

HOUSEHOLD AND CORPORATE SECTORS

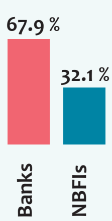
Household sector

Household sector credit expanded during the first half of 2024

The increased demand for credit with:
- Improvement in macroeconomic conditions
- Reduction in interest rates
- Resurgence in consumer confidence

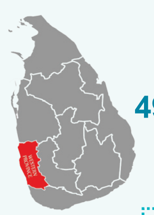
2023 Q2: - 6.0 % → 2024 Q2: 2.5 %

Composition of household sector credit



Banking sector accounted for about 2/3 of the household sector credit.

Half of the household debt was allocated to Western Province



49.9%

Slight improvement in the creditworthiness »» Non - performing loan ratio declined with the gradual economic recovery

2023 Q2 17.7% → 2024 Q2 17.1%

Corporate sector

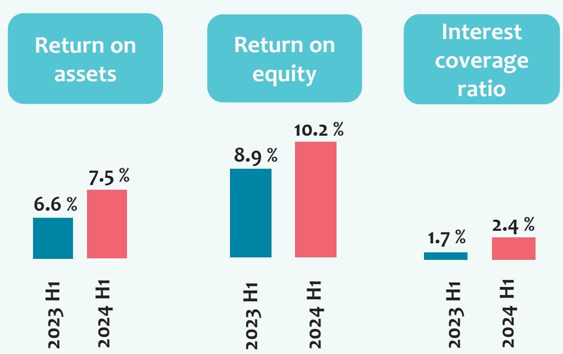
Listed non-financial corporate sector reported a revenue growth
2023 H1 9.6 % »» 2024 H1 6.8 %

A net profit growth was reported during 2024 H1
2023 H1 -54.2 % »» 2024 H1 26.1 %

Increase in profitability was mainly driven by reduction in finance costs

Positive impact of low interest rates

Profitability indicators of the listed NFC sector recorded improvements



Macrofinancial Conditions

1

Domestic macrofinancial conditions improved during the period under review. As the economy recovers from a prolonged contraction, it is expected that balance sheet pressures on households and firms would alleviate, and credit risk faced by financial institutions would soften. The credit cycle entered an expansionary phase as lending to the private sector improved gradually. As inflation and inflation expectations declined, risk premia reduced, and the eased monetary policy stance continued, market interest rates began to adjust downwards, partially correcting imbalances in the interest rate structure observed in the past. The tilt in the Financial sector's exposure to Government and public corporations is beginning to show signs of correction, opening more space for private sector credit, thereby expanding the production capacity of the private sector and contributing to the broader economic recovery. The successful completion of the Domestic Debt Optimisation (DDO) in 2023 and External Debt Restructuring (EDR) in 2024 are expected to reduce uncertainties further and bolster investor confidence.

Nevertheless, macrofinancial challenges remain as the country moves forward on the recovery path. The lasting impact of past developments such as elevated prices, diminished real income levels, tax adjustments, and rigidities in the labour market is delaying the softening of credit risk. As the credit cycle moves upwards in the expansionary phase, vulnerabilities could emerge due to the inherent nature of risk-taking behaviour and exuberance during such expansionary phases. However, due to the downward rigidity of lending rates, recovery of the Banking sector's financial intermediation remains sluggish, hindering the effective transmission of monetary policy. Although yields declined, the risk premium on Government securities remains elevated. As such, the continued progress of fiscal consolidation is essential to ensure sustainable stability, particularly with the financing requirement that arises after the finalisation of the EDR. Challenges in the external sector could surface with the expansion of economic activity in the monetary easing cycle, removal of import restrictions, and the finalisation of the EDR, resulting in tight liquidity conditions in the domestic foreign exchange market. Meanwhile, spillovers from adverse global macrofinancial developments could challenge domestic macroeconomic and financial stability. As such, to address such complex challenges and to sustain the progress made thus far, and to move towards greater macrofinancial stability, require a combination of prudent and coherent mix of policies executed in a timely manner, while continuing the reforms agenda and avoiding swings in policies.

1.1 International Economic Environment and Financial Conditions

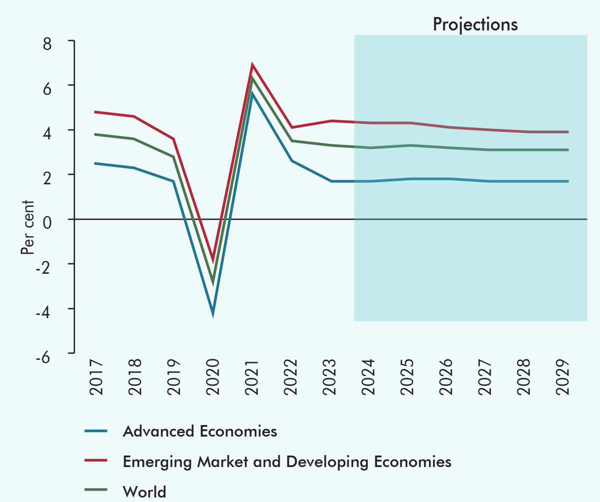
Global Macrofinancial Developments and Outlook

Global economic growth showed signs of stability, with narrowed regional divergences, albeit disinflation losing momentum and increasing policy uncertainty. Predictions of global economic growth are cautiously optimistic. During the first half of 2024, the global economy gained ground with the moderation of inflation and buoyant corporate valuations that led to eased financial conditions in advanced economies despite the painfully slow pace of monetary policy easing and picking up global trade. However, elevated debt burden, slow inflation adjustments, higher interest rates and geopolitical uncertainties remain, posing challenges. According to the World Economic Outlook (WEO) July 2024 update of the International Monetary Fund (IMF), the global economy is expected to grow at 3.2 per cent in 2024 and 3.3 per cent in 2025, compared to the 3.3 per cent growth recorded in 2023. Such projections are supported by the rebound of activities in emerging market economies such as India and China, particularly in private consumption, and the modest pickup in the Euro area driven by stronger momentum in services. However, downside risks to the outlook prevail due to the moderation of disinflation and widespread election spendings that could compel central banks to remain in the hawkish monetary policy approach for longer. Further, persistently high interest rates could lead to external, fiscal and financial sector vulnerabilities, impeding growth. Escalations in geopolitical tensions and economic policy swings would also cause negative growth spillovers worldwide.

Global Manufacturing and Trade

Global manufacturing, which entered a transitory expansion in the first half of 2024, is expected to slow down in the second half of 2024, while global trade is expected to moderate. During the first half of 2024, the Global Manufacturing Purchasing Managers' Index (PMI) remained in the expansionary territory. However, PMI slipped to contractionary territory at the turn of the second half of 2024 while signalling a bleak outlook due to weak demand and shipping constraints. Along with the short-lived uptick in manufacturing, global trade firmed up at the beginning of the year. However, trade growth is expected to moderate as manufacturing remains subdued. The likelihood of escalating trade impediments is higher due to potential policy swings and geopolitical tensions.

Figure 1.1 Global Economic Growth

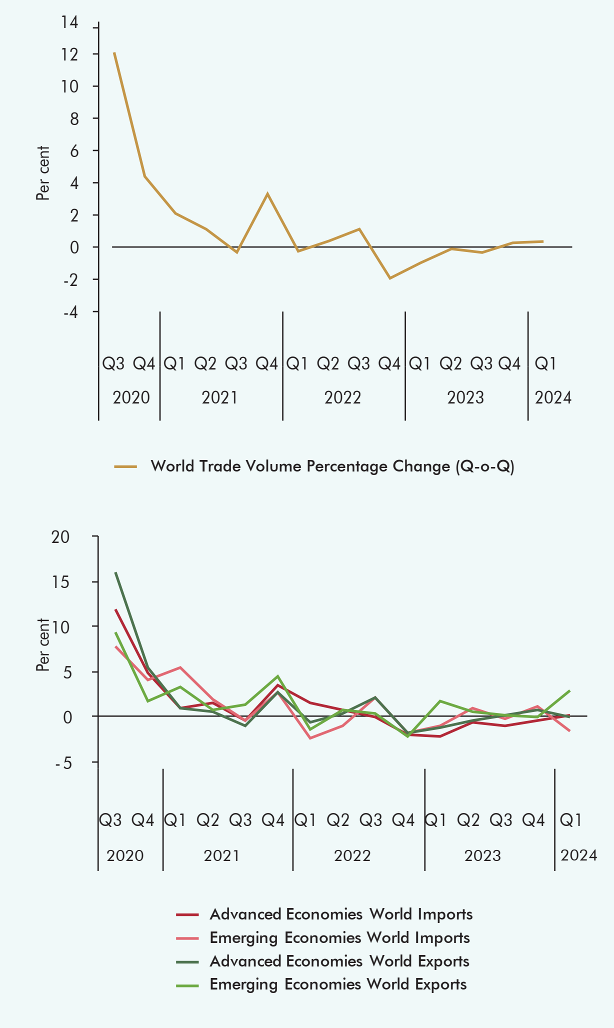


Source: IMF WEO-April 2024 and July 2024

Figure 1.2 Global Manufacturing PMI

Source: S&P Global

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



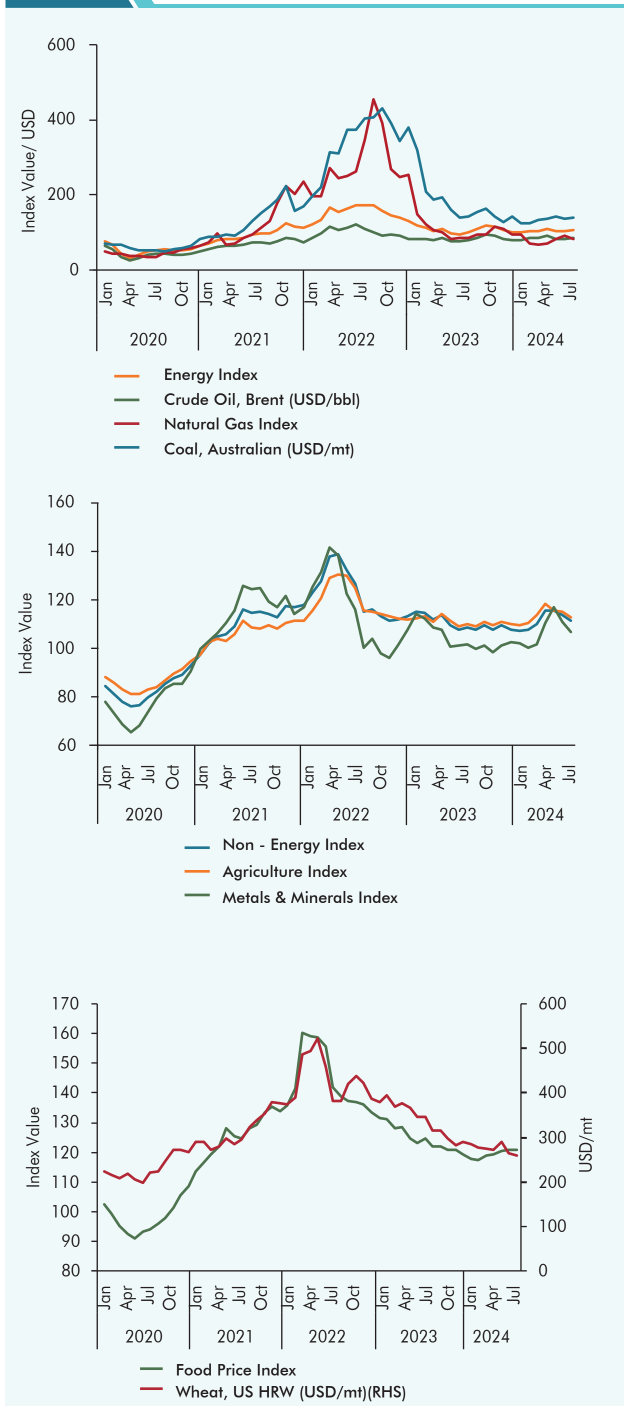
Source: CPB World Trade Monitor

Global Commodity Prices, Inflation, and Monetary Policy

Global commodity prices declined thus far in 2024, albeit remaining above pre-pandemic levels. The World Bank's Commodity Market Outlook April 2024 projects commodity prices to decline marginally in 2024 and 2025, yet remain above pre-pandemic levels. Although the commodity price outlook remains stable, risks remain tilted towards the upside, with possible energy price increases stemming from the continuance of conflict in the Middle East. In the July 2024 WEO, the IMF foresees an upward revision in commodity prices, including a rise in non-fuel prices. Further, energy commodity prices are expected to increase due to elevated oil prices maintained by the Organisation of the Petroleum Exporting Countries plus selected non-member countries, including Russia (OPEC+) and reduced but persistent pressure from geopolitical conflicts.

While the USD index is declining, the gold price index is on an uptrend, boosting the appeal of gold as a safe-haven asset. Reflecting the slowdown in economic activities in the US, the USD weakened in the latter part of the period under review, whilst

Figure 1.4 Global Commodity Prices



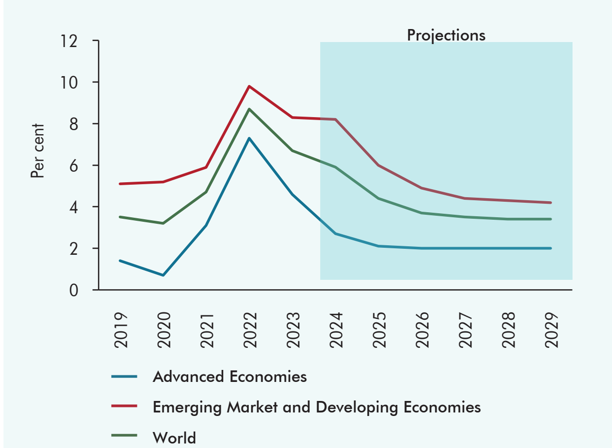
Sources: World Bank, FAO

the price of gold increased. However, the anticipated policy normalisation in the US would further elongate this trend, shifting investor preference further towards gold. On the other hand, if US inflation does not reduce as anticipated, tight monetary conditions in the US would prolong and lead to capital outflows and reversals from emerging markets and developing economies, further exerting pressure on those currencies to depreciate. Under such conditions, the appeal for gold would depend on the combined impact of several factors including bond yields and returns on equity.

Global inflation continues to decline but is losing its disinflationary momentum as upside risks are looming in the medium term. In advanced economies, the disinflationary momentum is losing ground owing to persistently higher inflation in prices for services and commodities. Inflation in emerging markets and developing economies largely reached pre-pandemic levels but is expected to continue to decrease at a slower pace due to the rebound of activity in such economies. Nevertheless, upside risks to inflation in the medium term remain owing to the lack of progress on service disinflation and price pressures emanating from trade impediments, wage pressures that do not accompany productivity gains, and geopolitical tensions.

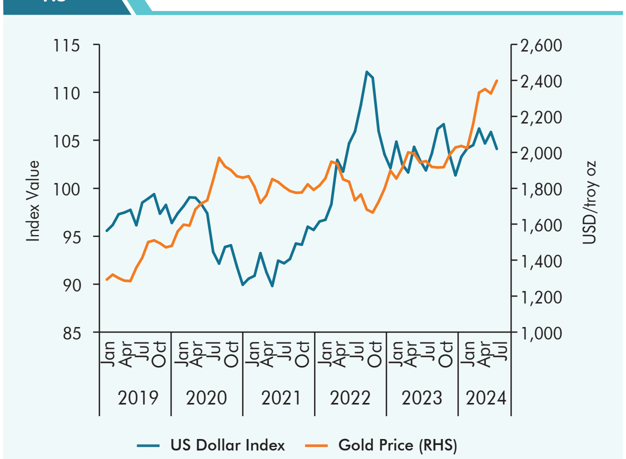
Globally, monetary policy normalisation will be much slower, with short term interest rates anticipated to remain higher for longer. With upside risks on inflation and disinflation losing momentum in the medium term, a steady but cautious economic outlook and persistent geopolitical tensions heavily influence central banks' strategies, and the expected normalisation of policies would be impeded if concerns do not wane off. Meanwhile, monetary policies across the globe appears to be desynchronised. Advanced economies signal cautious policy implementation as their macroeconomic fundamentals and priorities diverge. The US is indicating further rate hikes to balance high inflation over economic growth, whilst there is anticipation for a gradual rate cut in the second half of 2024 if the economy shows signs of slowing down or if inflation sufficiently stabilises. However, the UK and the EU started easing their monetary policy slowly and cautiously due to weaker economic growth prospects. Alongside external risks due to such developments in advanced economies,

Figure 1.6 Global Inflation



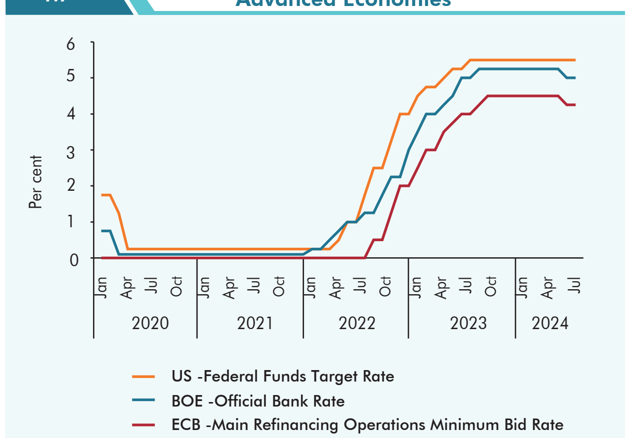
Source: IMF WEO - April 2024 and July 2024

Figure 1.5 US Dollar Index Vs. Gold Price Index



Sources: Bloomberg, World Bank

Figure 1.7 Policy Rates in Central Banks of Advanced Economies



Sources: Bank of England, The Federal Reserve and European Central Bank emerging markets and developing economies are cautious in their monetary policy stance. Further challenges to monetary policy effectiveness may be amplified with upcoming elections globally, owing to swings in economic policies and risks of large-scale fiscal spending.

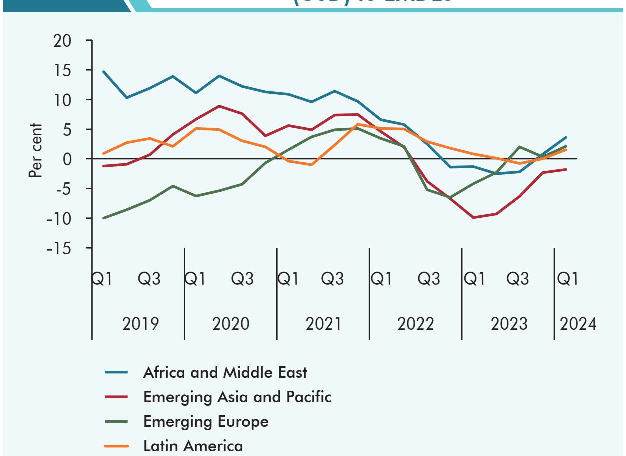
Global Financial Markets

Despite tight monetary policies, global liquidity conditions eased, possibly due to a spillover effect of softened Government yield rates and buoyant corporate performance in advanced economies. According to the Global Liquidity Indicator compiled by the Bank for International Settlements (BIS), which tracks credit to non-bank borrowers outside the respective currency areas, the USD and Euro-denominated credit inched up in Q1 of 2024, while credit in terms of yen remained subdued. However, the y-o-y growth of USD credit to the Emerging Markets and Developing Economies (EMDEs) turned positive for the first time since mid-2022. The significant growth in USD credit to Africa and the Middle East mainly contributed to this positive development. Although USD credit to the emerging Asia-Pacific slightly dropped, the increase in credit to China is significant. The indicators, despite some fluctuations, show that the overall availability of credit remained robust, although emerging markets might face tighter conditions due to potential changes in financial cycles and global monetary policy adjustments.

Globally, Government debt markets are expected to be volatile in the period ahead. Governments of advanced economies are expected to borrow heavily in the coming period as their fiscal deficits widen. Such an increase in supply could exert an upward pressure on yields amidst disinflation losing momentum and slow normalisation of monetary policy. Furthermore, according to the recent Global Financial Stability Report of the IMF, there is a shift in the buyer base of Government bonds from bank to non-bank lenders. Non-bank lenders, particularly hedge funds and households are more price sensitive while being accustomed to debt sustainability. This shift in the investor base could lead to more volatile conditions in the Government debt market while raising risk premia. Spillovers of such developments in advanced economies could affect the rest of the world, turning Government debt markets conditions more volatile and challenging amid already fragile fiscal positions.

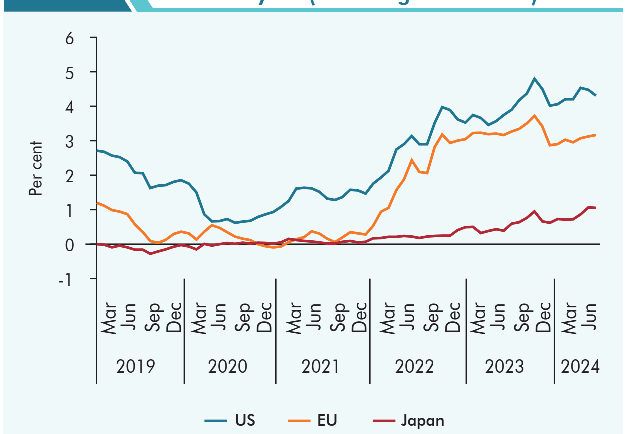
Global financial conditions eased due to buoyant corporate expectations, though tight bank lending standards prevailed. In advanced economies, investor expectations for a recovery in economic activities and low inflation despite slowing disinflation resulted in rallies in stock and corporate bond markets, easing financial conditions. Nevertheless, due to tightened lending standards and higher yields in advanced economies, emerging market economies face currency depreciation pressures, net capital

Figure 1.8 Growth in Foreign Currency Credit (USD) to EMDEs



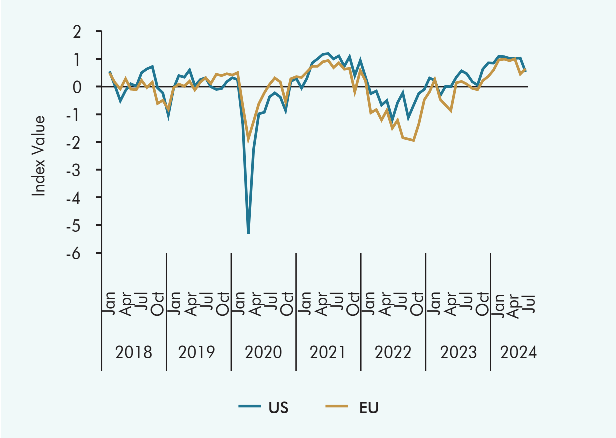
Source: Bank for International Settlements

Figure 1.9 Long Term Government Bond Yields: 10-year (Including Benchmark)



Source: Federal Reserve Bank of St.Louis - Economic Data

Figure 1.10 Bloomberg Financial Conditions Index



Source: Bloomberg

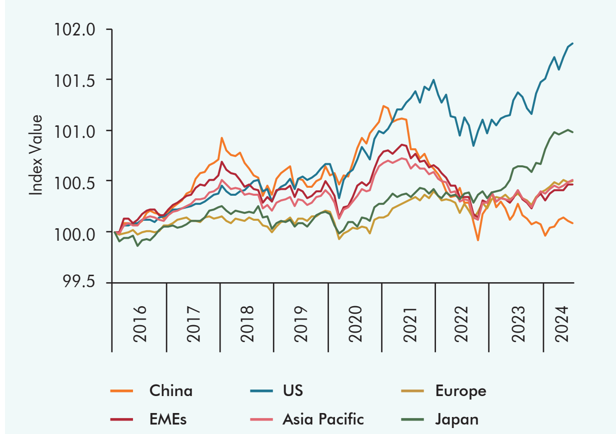
outflows and pressures on fiscal discipline. However, if inflation persists, the resulting continuation of slow monetary policy easing and subsequent impact on the economic outlook, among other uncertainties, will reverse the prevalent buoyance on corporate valuations.

Global equity markets largely exhibited positive performance while navigating a complex interplay of macrofinancial and geopolitical developments. Inflation trends, economic prospects, central bank policies, and domestic and international developments such as elections and geopolitical tensions influenced investors' behaviours. As per Morgan Stanley Capital International (MSCI) indices, equity markets in general recorded gains of varying magnitudes. Nevertheless, the Chinese equity market underperformed due to ongoing property

Figure 1.11 US Corporate Bond Spread

Source: Bloomberg

Figure 1.12 MSCI Share Price Indices



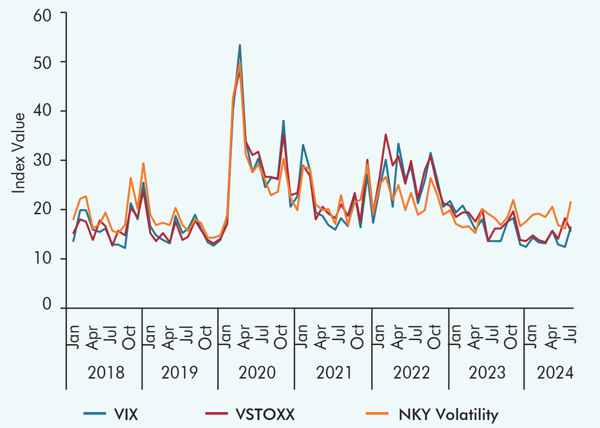
Source: Bloomberg

market imbalances and the slowdown in economic growth. The anticipated soft landing of economic performance, continued disinflation, and the resultant accommodative monetary policy would support equity market performance. However, the geopolitical and trade tensions, particularly between major players in the market like the US and China, swings in macroeconomic policies after political regime changes in major economies and their spillovers to other regions would pose risks to the global equity market performance.

Mirroring the rally in the stock market and its price indices, stock markets' expected price volatility indices edged up in July 2024. The VIX index, which measures the expected 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 on a gradually increasing trend during the period under review. Central bank policies, geopolitical events, policy uncertainties or swings arising from political developments and unexpected economic shocks would influence the volatility of equity markets.

Developments in geopolitical conditions, cyber security, and climate risk create challenging global macrofinancial conditions. Potential policy swings due to upcoming elections in many countries and persistent geopolitical tensions raise global macrofinancial concerns as such developments have

Figure 1.13 Behaviour of Volatility Indices



Source: Bloomberg

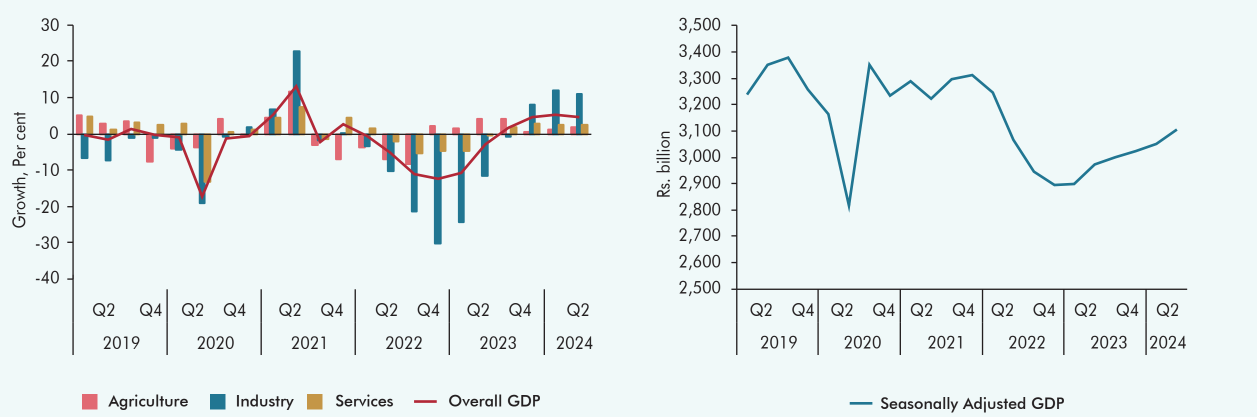
negative implications on the global economy and financial system. Changes in trade orientation policies and geopolitical tensions could cause supply-chain disruptions, escalate trade impediments and elevate energy commodity prices, compelling policymakers to balance multiple priorities in more challenging conditions. Further, cyber security concerns with potential destabilising implications on the financial systems are becoming increasingly common. Such developments could disrupt critical financial and non-financial services and undermine public trust in the financial system. Meanwhile, global financial systems are becoming increasingly exposed to climate risk via both physical and transition risk. However, globally coordinated efforts are needed to address such concerns effectively due to the complex nature of such issues.

Risk spillovers from the international economic environment and financial conditions to the domestic financial system are mixed. Slow but steady economic growth outlook in export destinations and tourism origins could support foreign exchange inflows and improve liquidity conditions in the domestic foreign exchange market. However, the slow decline in global inflation, the moderation in consumption in certain export destinations, the continuation of geopolitical conflicts and extensions in oil production cuts could lead to tight liquidity conditions to a certain extent in the domestic foreign exchange market, while affecting balance sheets of households and firms. Further, the implications of diverging and cautious global monetary policy developments and other global and domestic uncertainties shape foreign investors' sentiments, which could be challenging in securing long term investment inflows. Meanwhile, with the global and domestic election cycle, uncertainties in macroeconomic and trade policies that could have domestic macroeconomic and financial stability implications could emerge. Furthermore, climate-related and cyber security risks have become increasingly common and gained the attention of policymakers as a prominent challenge to financial stability.

1.2 Domestic Macrofinancial Conditions

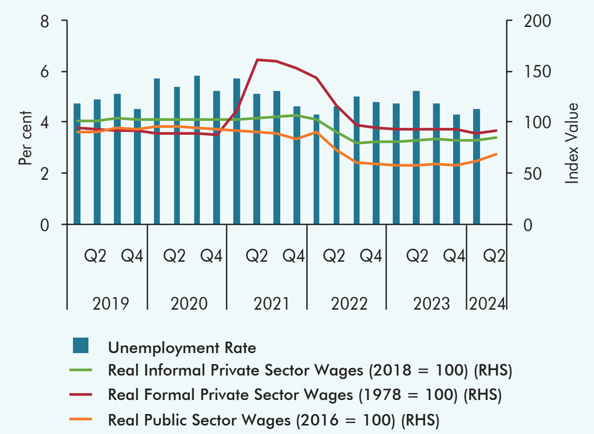
Improvements in the real sector are expected to gradually soften the balance sheet strains of households and firms and relieve the credit risk of financial institutions. The economy is recovering

Figure 1.14 Quarterly Real GDP



Sources: Department of Census and Statistics, Central Bank of Sri Lanka – Staff Calculations

Figure 1.15 Unemployment Rate and Wage Rate Indices

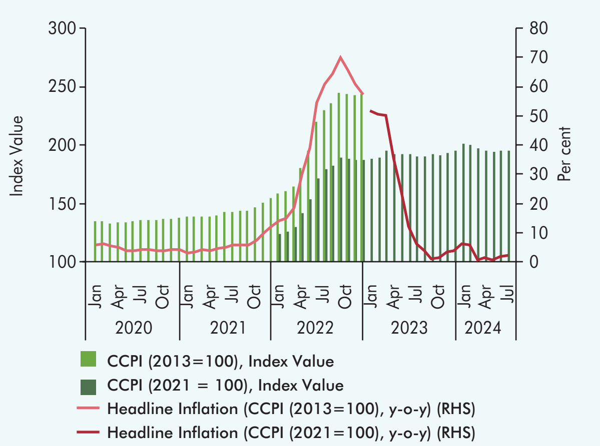


Source: Department of Census and Statistics

from the prolonged contraction observed during recent years. As the economy moves forward in the monetary policy easing cycle amidst the envisaged path of inflation, economic activity is expected to grow. However, it is noteworthy that the level of real Gross Domestic Product (GDP), although rising, remains below pre-pandemic levels, reflecting the long lasting setback of real income. Meanwhile, the labour force participation rate remains below 50 per cent indicating the majority of the working-age population is economically inactive. Such fragilities can hinder the potential economic recovery. Further, the real wage rate indices mostly indicate below pre-pandemic income levels. Although inflation has declined below the target, price levels remain at elevated levels due to past inflation. Despite the gradual economic recovery and low inflation levels, the deterioration of real income levels, as indicated by real wage rate indices, tax adjustments and elevated price levels, continues to stress balance sheets, and weigh down the debt repayment capacities of households and firms, resulting in a downward rigidity of Non-Performing Loan (NPL) ratios and credit risk. Nevertheless, with the expectation that the economy will eventually reach its potential and greater macroeconomic stability to be achieved, the credit risk of financial institutions is anticipated to dissipate gradually.

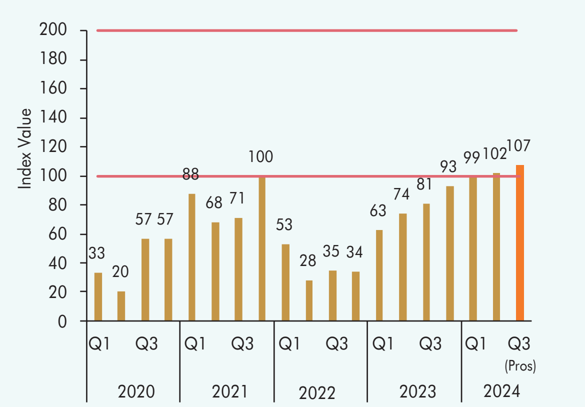
Reflecting the positive domestic economic outlook, domestic business conditions recovered and improved during the period under review. The Business Conditions Index, compiled by the Central Bank, which remained below the neutral threshold of 100 in the recent years, transitioned to the positive territory according to the Business Outlook Survey conducted for Q2 of 2024, indicating that business conditions have improved. Survey participants cited improved macroeconomic conditions as the main reason for this positive development. Furthermore, demand, sales, capacity utilisation, and investments are expected to improve in the period ahead in industry and services sectors. Meanwhile, survey respondents indicated that their demand for bank credit increased, but credit accessibility continued to be tight due to higher-than-expected market lending rates and increased standards attached to bank lending facilities.

Figure 1.16 CCPI and Headline Inflation



*Source:*Department of Census and Statistics

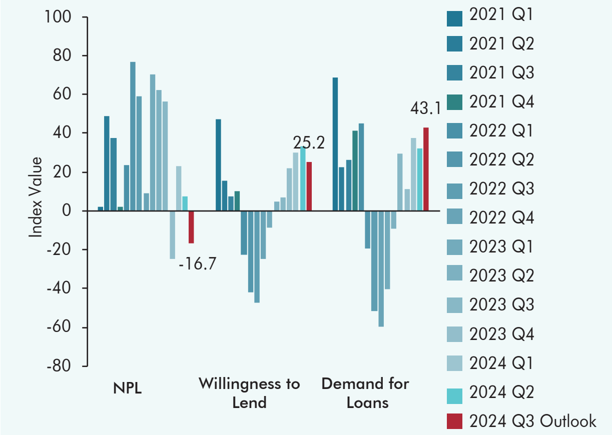
Figure 1.17 Business Conditions Index



*Source:*Central Bank of Sri Lanka

Despite the monetary policy easing, financial intermediation, as measured by the Credit to Deposit Ratio (CDR) of the Banking sector, continued to decline, although at a slower pace during the period under review, indicating that the recovery of credit is slow thus far in the current monetary policy easing cycle. The lower CDR levels imply that the Banking sector is still lending cautiously while channelling funds increasingly towards investments. The deposit growth continued its upward trend while the credit growth, although subdued, gradually began to recover in early 2024. Further, as per the findings of the Credit Supply Survey conducted by the Central Bank, both banks' willingness to lend and demand for loans have continuously improved since the start of the monetary easing cycle and are expected to improve further in Q3 of 2024. As per the survey results, the improved liquidity positions, positive expectations regarding general economic activities, and macroeconomic stability have contributed to the improvement in the willingness to lend. Meanwhile, according to the survey, the continued reduction in interest rates and improved economic conditions of the country led to an increase in demand. However, such positive sentiments revealed in the survey results are yet to be mirrored in the actual data as credit to the private sector is yet to gather momentum.

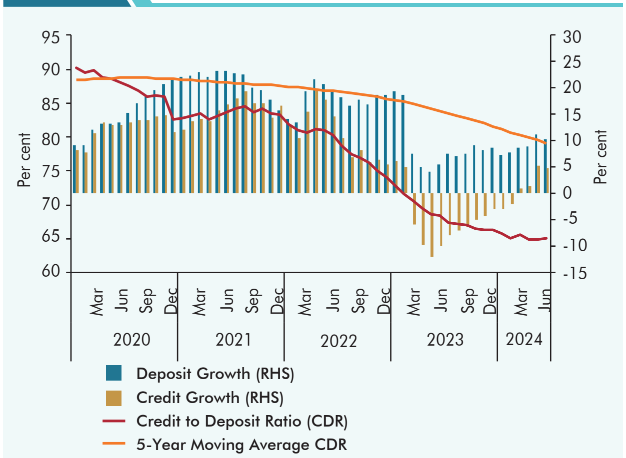
Figure 1.19 Movement of Credit Supply Survey Indices



Source: Central Bank of Sri Lanka

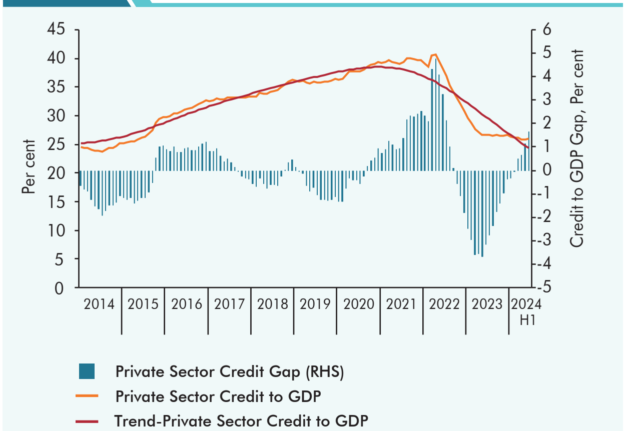
The private sector credit-to-GDP gap (The Credit Gap), which reflects the status of the credit cycle, signals that the cycle has entered the expansionary phase. The Credit Gap is an indicator used to determine the status of the credit cycle and a useful early warning signal of the buildup of stress in the financial system. In line with the monetary policy easing that commenced in mid-2023, the Credit Gap, which moved in the recovery phase during the latter half of 2023, entered positive territory in 2024, indicating that the credit cycle had entered the expansionary phase. As the economy and the credit supply expand with the relaxed monetary policy stance, the credit cycle is expected to move upwards in the expansionary phase. Credit cycles with shorter oscillations and longer frequencies are preferred as such cycles reflect cautious lending and less exuberance by market players. In contrast, having high oscillations and shorter frequencies indicate an excessive buildup of risks in the system.

Figure 1.18 Credit to Deposit Ratio of the Banking Sector



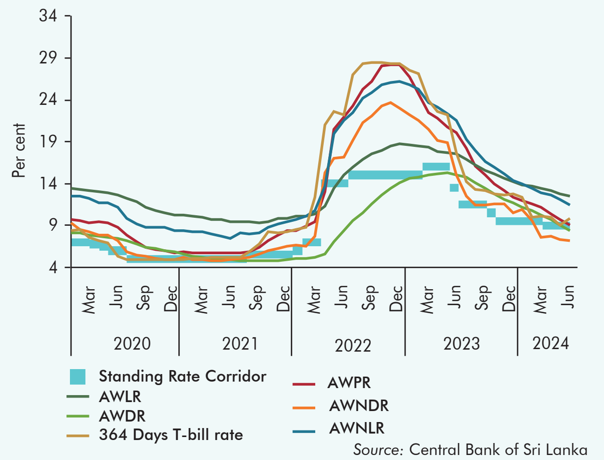
Source: Central Bank of Sri Lanka

Figure 1.20 Private Sector Credit Cycle



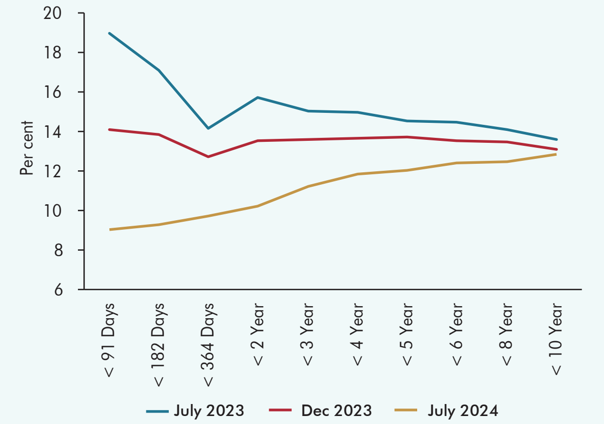
Source: Central Bank of Sri Lanka

Figure 1.21 Market Interest Rates



Source: Central Bank of Sri Lanka

Figure 1.23 Secondary Market Yield Curve of Government Securities



Source: Central Bank of Sri Lanka

Anomalies that prevailed in the market interest rate structure during the past corrected to a greater extent, but further adjustments are needed to facilitate an efficient transmission of monetary policy. Overall, market interest rates are adjusting downwards in line with the easing monetary policy cycle, which commenced in mid-2023. The decline in inflation, inflation expectations and risk premia on Government securities further supported this adjustment. Deposit rates also declined significantly, indicating the transmission of the impact of monetary policy easing into deposit rates. Although a decline in market lending rates is observed, space for further reduction remains. Particularly, since 2023, the gap between new lending and deposit rates remains higher than the 10-year historical average. On the other hand, despite the interest rates being on a declining trend, the real deposit rate, indicated by the

Figure 1.22 AWNDR and Real AWNDR

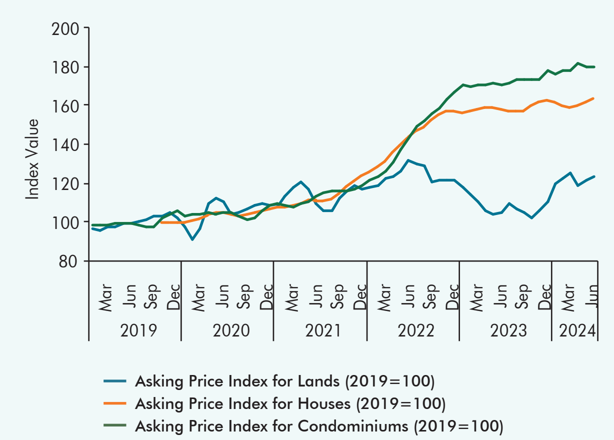
Source: Central Bank of Sri Lanka

real Average Weighted New Deposit Rate (AWNDR)[1] remains positive due to low inflation. Along with other market interest rates, Government securities yield declined substantially compared to 2023, reducing the notable gap between the yield and policy rates. Further, the Government securities yield curve has shifted from an inverted to a normal shape, reflecting an alignment of investor sentiments with the economic recovery. However, Government security yields remain above comparable deposit rates, reflecting the continuation of the high-risk premium attached to Government securities. Furthermore, the term premium of Government securities is high as investors attach higher than average risk premia on longer tenures. Nevertheless, as the economy moves forward in the envisaged policy reform agenda and uncertainties dissipate, imbalances in the market interest rate structure are expected to correct, facilitating a smooth flow of funds to the economy through the financial system; lowering financing costs to households and businesses, supporting economic recovery and greater financial stability.

The continuous increase in house and condominium prices, which is incongruent with other conditions observed in the real estate market, raises concerns over irrational pricing of properties as banking sector exposure to real estate activities remain elevated. The asking price indices published by the Central Bank indicate that

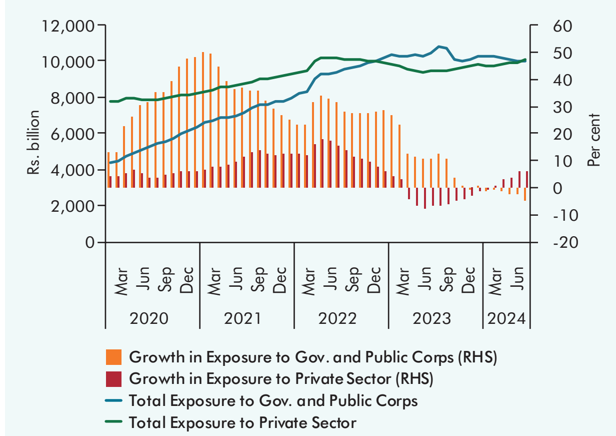
1 Real AWNDR is computed by adjusting AWNDR for inflation measured through the Colombo Consumer Price Index (CCPI).

Figure 1.24 Movements of Property Price Indices



Source: Central Bank of Sri Lanka

Figure 1.26 Exposure to Public and Private Sector

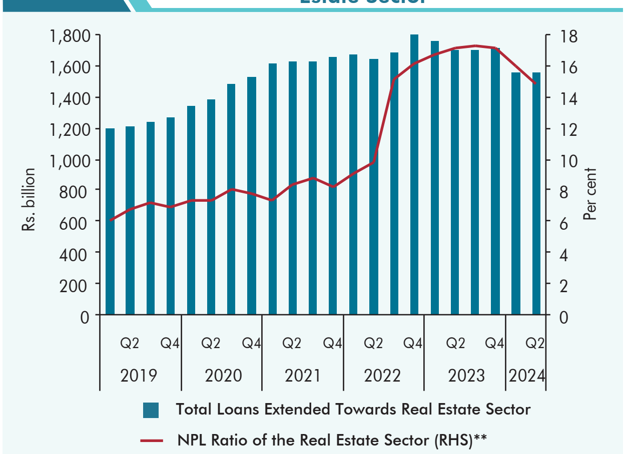


Source: Central Bank of Sri Lanka

the prices of houses and condominiums move on an increasing trend, which is incongruent to movements of bank lending rates and construction costs. Such price movements raise concerns about irrational market pricing. Meanwhile, the Banking sector's exposure to real estate related activities continues to remain elevated, also posing significant risks to the sector. Loans extended towards the real estate sector continue to remain at a substantial level of 14.1 per cent of total loans and advances, along with a high NPLs ratio of 14.9 per cent.

The tilt in exposure towards the Government and public corporations, which prevailed since the latter part of 2022, is showing signs of correction, though substantial progress needs to be achieved to expand space for the private sector to access finance. Financial institutions' exposure to the Government and public corporations surpassed the exposure to the private sector in October 2022, and such tilt continued until June 2024. Thus, after 20 months, the tilt in financial intermediation towards the Sovereign reduced and recorded 49.8 per cent by end June 2024. These advances are a result of the pickup of credit to the private sector and ongoing fiscal consolidation efforts. The continued downward adjustment in the tilt in exposure to the Government while increasing lending to the private sector is required to expand space for the private sector to access finance, allowing the private sector to increase its production capacity and contribute to economic recovery.

Figure 1.25 Loans Extended Towards Real Estate Sector*

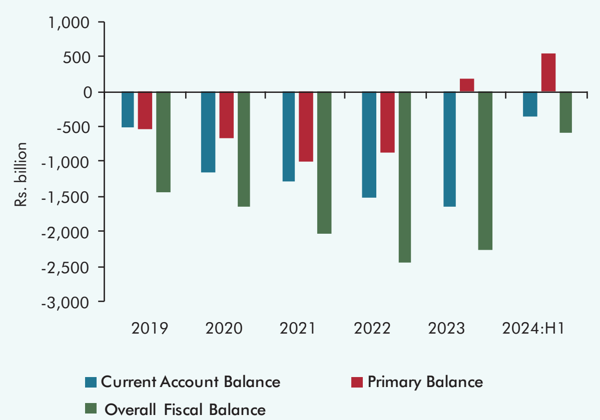


*This includes loans extended for purchase of land, construction and development of all types of residential buildings or remodeling and renovating existing residential structures; construction, development or renovation of all types of non-residential buildings or remodeling and renovating of such structures; real estate activities, including development of condominium projects, with own or leased property; and other construction activities.
**Stage III loans ratio w.e.f. 2022

Source: Central Bank of Sri Lanka

Despite significant challenges, Sri Lanka's Fiscal sector performed well thus far in 2024, while continued progress is required to manage future financing requirements. The implemented fiscal consolidation measures led to improvements in all key fiscal balances. Robust revenue based consolidation measures are key contributors to this progress. The successful completion of the DDO in 2023 and the finalisation of the EDR in 2024 would further dissipate uncertainties and restore investor confidence. As the Sovereign Bank Nexus was significant, the country was compelled to exclude the Banking sector from the DDO operation. However, going forward, maintaining the Sovereign Bank Nexus at a prudent

Figure 1.27 Major Fiscal Balances



Source: Ministry of Finance, Economic Stabilisation and National Policies

level is important. Further, continued progress of fiscal consolidation is also essential to sustain stability, particularly with the financing requirement that arises after the finalisation of the EDR.

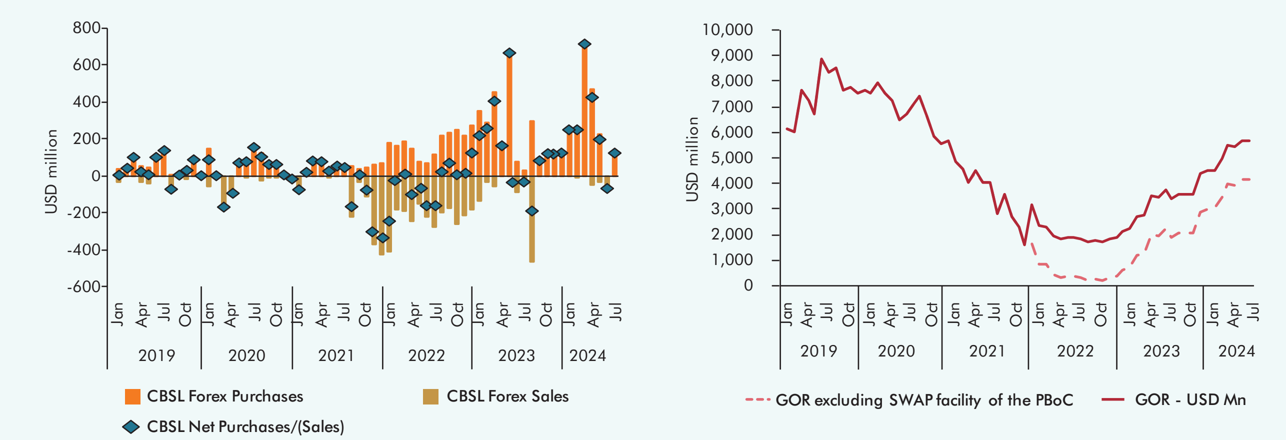
A positive momentum has been observed in the external sector thus far, but challenges could surface with the expansion of economic activity. The rupee continued its appreciating trend since the latter part of 2023 thus far in 2024, although some depreciation towards May and June 2024 was observed. Liquidity conditions in the domestic foreign exchange market softened, with significant improvements in supply from service export proceeds and workers' remittances, albeit in an environment where the demand pressures from vehicle imports and external debt servicing were partially suppressed. Meanwhile, the Central Bank was a net purchaser during the first seven months of 2024, continuing its momentum since 2023, thereby building Gross Official Reserves (GOR). Along with these developments, going forward, liquidity conditions in the domestic foreign exchange market will depend on several factors that dictate demand and supply. This includes the relaxed monetary policy stance, possible relaxation of vehicle import restrictions, the finalisation of the EDR, geopolitical tensions, swings in economic policies of trading partners after elections, foreign investor sentiments and envisaged inflows from exports, tourism and workers' remittances. If demand pressures surpass supply conditions in the domestic foreign exchange market, it may exert pressure on the exchange rate. As such, significant and sustainable foreign exchange inflows are needed to accommodate increased foreign exchange outflows with the expected release of demand suppression.

Driven by both domestic and international macrofinancial conditions, foreign investments[2] remained subdued during the first half of the year. The monetary authorities worldwide continue to be cautious about easing monetary policy owing to a slower decline in inflation and an array of uncertainties associated with geopolitical tensions and other global macrofinancial conditions. Meanwhile, as a combined effect of global uncertainties and the decline in yields and other domestic uncertainties, foreign investor appetite towards Sri Lanka remains subdued. As a result, a cumulative net outflow of foreign investment in the Government securities market and marginal net inflows to the equity market[3] and foreign direct investments were recorded during the period under review. Therefore, sustainable long term foreign investments are essential to stabilise liquidity conditions in the domestic foreign exchange market, given the anticipated increase in demand in the period ahead after the finalisation of the EDR, the anticipated increase in consumer demand for imports in the monetary policy easing cycle and the relaxation of restrictions on vehicle imports.

As the economy shows signs of recovery, the risks associated with the domestic macrofinancial conditions, although persistent, are progressively diminishing. Macrofinancial stability is gradually being restored with low inflation, improved business conditions, strengthened rupee and successful fiscal consolidation measures. However, the impact of past adverse developments such as elevated price levels, diminished real income levels, and rigidities in the labour markets remain as challenges to the macroeconomic as well as financial stability. The downward adjustment in market interest rates and the partial correction of the imbalances in the interest rate structure enabled the financial

2 Foreign investments in the Government securities market, stock market, and other Foreign Direct Investments (FDIs).
3 Include both primary and secondary markets.

Figure 1.28 **Central Bank Intervention in the Domestic Foreign Exchange Market and Gross Official Reserves**



Source: Central Bank of Sri Lanka

system to facilitate the flow of funds through the economy and facilitated the recovery of credit to the private sector. The tilt in exposure towards the Sovereign, although continues, is gradually reducing. Nevertheless, banks are lending cautiously, and the downward rigidity of lending rates delays the effective mobilisation of credit in the economy, impeding the recovery of financial intermediation. Further, the Banking sector's exposures to real estate activities and pawning facilities raise concerns and necessitate continued vigilance amidst strained balance sheets of households and businesses. Meanwhile, foreign investor sentiment towards Sri Lankan money and capital markets appears to be cautious, leading to subdued investment inflows and raising concerns over liquidity conditions in the domestic foreign exchange market going forward, given the envisaged outflows.

Fiscal consolidation is progressing and continued long term effort is needed to achieve sustainable stability. However, the ongoing election cycle may develop uncertainties on policy consistency, raising macroeconomic and financial stability concerns. In conclusion, macrofinancial conditions have improved to a greater extent during the period under review compared to the recent past. However, risks and uncertainties continue to challenge the stability of the financial system due to exogenous factors and structural imbalances in domestic macrofinancial conditions. Addressing such challenges requires a combination of prudent, timely, and coherent mix of policies while continuing the reform agenda and avoiding swings in policies to sustain the progress made thus far and to move towards greater macrofinancial stability.

Key Policy Changes and Regulatory Actions Implemented for the Financial Sector[1]

Financial Institutions

Licensed Banks

25 August 2023	A Monetary Law Act Order on "Maximum Interest Rates on Rupee Denominated Lending Products" was issued on the interest rates applicable on Sri Lanka Rupee (LKR) denominated lending products of Licensed Banks (LBs), imposing maximum interest rates on certain lending products and requesting LBs to reduce the interest rates of all other new and existing LKR denominated lending products by specific percentages on target dates subject to a floor rate of 13.5 per cent. Further, LBs were requested to reduce the penal interest rate to a level not exceeding 2 per cent per annum.
15 November 2023	The Banking (Special Provisions) Act (BSPA) No. 17 of 2023 was certified by the Parliament on 14 September 2023 and by order published in the Gazette No. 2358/46, its provisions came into operation effective from 15 November 2023.
	The BSPA Directions No. 01 of 2023 was issued on Administration and Management of the Sri Lanka Deposit Insurance Scheme to Member Institutions of the Sri Lanka Deposit Insurance Scheme.
23 November 2023	A Banking Act Determination on annual license fee was issued to LBs informing the new license fee structure applicable for the years 2024 and 2025.
27 November 2023	Determinations made under BSPA were issued to the general public under the Gazette Notification No. 2360/02.
08 December 2023	Amendments to the Banking Act Directions No. 16 of 2021 on "Regulatory Framework on Technology Risk Management and Resilience" for LBs were issued amending certain requirements pertaining to recognition of third-party service providers, identification of critical information systems, frequency of user access privilege reviews, criteria to determine ownership and management of information system infrastructure, etc. Further, considering the extraordinary circumstances prevailed, the general deadline and certain specific timelines were extended.
29 February 2024	Amendments to the Circular No. 08 of 2019 on "List of Qualified Auditors to Audit the Accounts of Licensed Commercial Banks and Licensed Specialised Banks" were issued by replacing PricewaterhouseCoopers and SJMS Associates as Deloitte Partners and Deloitte Associates, respectively, with the changes of names of aforesaid audit firms.
25 March 2024	Banking Act Directions were issued on "Large Exposures of Licensed Banks" to be implemented effective from 01 January 2026, with a view of mitigating the potential credit concentration risks, in order to ensure safety and soundness and to preserve public confidence in the banking sector.
28 March 2024	Circular was issued on "Guidelines for the Establishment of Business Revival Units in Licensed Banks" with a view of facilitating the sustainable economic revival of businesses affected by the extraordinary macroeconomic circumstances, and to ensure the proper handling of the increased impaired assets of LBs, while strengthening and reformulating already established 'Post COVID-19 Revival Units' of LBs as business revival units.
15 April 2024	Monetary Law Act Order No. 01 of 2023 dated 25 August 2023 on "Maximum Interest Rates on Rupee Denominated Lending Products" was rescinded, considering the notable easing of monetary policy and monetary conditions that have provided space for LBs to reduce the lending rates further.

1 Includes major financial sector policy measures implemented since 01 July 2023 until 31 July 2024.

13 June 2024	A Banking Act Determination was issued on "Statutory Liquidity Ratios of Licensed Banks" determining that every LB shall maintain Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) as the statutory liquidity ratios of banks, and discontinuing the maintenance of Statutory Liquid Assets Ratio (SLAR), in terms of the Section 21(1) and 76(H) of the Banking Act No. 30 of 1988, as amended by the Banking (Amendment) Act No. 24 of 2024.
14 June 2024	With the implementation of the Banking (Amendment) Act No. 24 of 2024, a Banking Act Order was issued to eliminate the demarcation of the Domestic Banking Unit (DBU) and Off-shore Banking Unit (OBU) and to identify off-shore banking business as a permissible activity that a Licensed Commercial Bank (LCB) may conduct. With the issuance of this Order, the previous Banking Act (Off-shore Banking Business Scheme) Orders and such other instruments that were applicable to OBUs of LCBs were revoked with effect from the appointed date of 15 June 2024 of the Banking (Amendment) Act.
	Banking Act Directions were issued on "Off-shore Banking Business of LCBs" with a view of facilitating the conduct of off-shore banking business, with the implementation of the Banking (Amendment) Act No. 24 of 2024. These Directions also specify the authorized businesses, eligible customers for the purpose of carrying on off-shore banking business, permitted transactions, and granting of accommodation under off-shore Banking Business.
	Banking (Off-shore Banking Business) Order was issued designating foreign currencies for the purpose of carrying on off-shore banking business by LCBs with effect from 15 June 2024.
15 June 2024	The Banking (Amendment) Bill which was drafted to strengthen the legal and regulatory framework for LBs was approved by the Parliament on 02 April 2024 and the Banking (Amendment) Act No. 24 of 2024 came into operation on the appointed date of 15 June 2024.
28 June 2024	Amendments to the Banking Act Directions No. 08 of 2019 on "Assessment of Fitness and Propriety of Directors of Licensed Banks in Sri Lanka" were issued revising the Affidavit formats given in Schedule I thereto, in order to strengthen the criteria of assessment of fitness and propriety of persons proposed to be appointed, elected or nominated as directors of LBs in line with the amendments made by the Banking (Amendment) Act No. 24 of 2024.
	Amendments to the Banking Act Determination No. 01 of 2019 on "Assessment of Fitness and Propriety of Chief Executive Officer and Officers Performing Executive Functions in Licensed Banks" were issued revising the Affidavit formats given in Schedule I thereto, strengthening criteria of the assessment of fitness and propriety of persons proposed to be appointed as Chief Executive Officer or Officers Performing Executive Functions of LBs in line with the amendments made by the Banking (Amendment) Act No. 24 of 2024.
19 July 2024	Amendments to the Banking Act Directions No. 01 of 2016 on "Capital Requirements under Basel III for Licensed Commercial Banks and Licensed Specialised Banks" were issued assigning a risk weight of 20 per cent for the portion of exposures guaranteed by National Credit Guarantee Institution Limited (NCGIL) and including NCGIL in the indicative list of Financial Institutions for the purpose of the cited Directions.

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

05 July 2023	Then 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 Ltd (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 the 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 is NLFP.
01 September 2023	Then Monetary Board of the Central Bank decided to cancel the licence issued to Bimputh Finance PLC (BFP) under the Finance Business Act (FBA) No. 42 of 2011 to carry on finance business with effect from 01 September 2023 due to the unsatisfactory progress made by BFP to improve its critical condition.
15 December 2023	The Commercial High Court of Colombo ordered to appoint a liquidator to ETI Finance Ltd under FBA subject to the supervision of court.
05 January 2024	The Governing 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 January 2024, in order to continue with the investigations being conducted by the Central Bank.
13 February 2024	A direction was issued on periodic reporting requirements with the objective of obtaining timely, accurate, consistent and complete information of FCs to ascertain the manner in which the business and corporate affairs of FCs are being conducted or for any other specified purpose.
03 May 2024	A direction was issued on credit risk management with the objective of establishing a credit risk management framework and ensuring the availability of an effective system in place to identify, measure, monitor and control the credit risk.
31 May 2024	The Governing Board of the Central Bank granted approval for a final deferment of one year for the effective implementation of Section 4.3.1.(i) of the Finance Business Act (Classification and Measurement of Credit Facilities) Direction No. 01 of 2020, subject to fulfilling certain specified conditions.
05 July 2024	The Governing 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 2024, in order to continue with the investigations being conducted by the Central Bank.

Insurance[2]

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	An Amendment to the Determination 13 was issued to revise the form and affidavits to be submitted by the insurers in compliance with section 33B (1) of the Regulation of Insurance Industry Act (RII Act) No. 43 of 2000.

2 These are policy measures taken by the Insurance Regulatory Commission of Sri Lanka.

09 September 2023	Circular 01 of 2023 was issued to amend 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 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.
08 January 2024	Circular 01 of 2024 on "Eligibility Criteria for Valuers" was issued repealing Circulars 30 and 35, combining the requirements of the same.
09 January 2024	Circular 02 of 2024 was issued repealing Circular 41, in respect of non-compliance of reporting requirements and non-compliance of the provisions of RII Act.
01 February 2024	Direction 01 of 2024 was issued to limit the minimum period of endowment policies.
08 February 2024	Direction 02 of 2024 was issued to all insurers and brokers directing them to revoke the agency contracts of individuals whose results of the G.C.E. Ordinary Level examination are not verified and confirmed to Sri Lanka Insurance Institute (SLII) as per paragraph 4 of Insurance Regulatory Commission of Sri Lanka (IRCSL) letter dated 07 April 2016.
08 May 2024	Direction 04 of 2024 was issued to the insurers outlining the terms and conditions that must be adhered prior to declaration and distributing of dividends (including interim dividends) to shareholders.
14 May 2024	Direction 03 of 2024 was issued to replace the existing guidelines for advertisements issued by insurers, insurance brokers and insurance agents for effective supervision.
20 May 2024	Circular 04 of 2024 was issued to general insurance companies prohibiting the promotion/advertisement of third-party motor insurance. However, this prohibition does not apply if a third-party motor insurance advertisement or promotion is carried out together with the advertisement/promotion of a comprehensive motor insurance cover and where emphasis is given to comprehensive motor insurance cover.

Financial Markets

Government Securities Market

04 July 2023	The Ministry of Finance, Economic Stabilization and National Policies (MOF) announced its policy on Sri Lanka's Domestic Debt Optimisation (DDO), consistent with the Extended Fund Facility, to contribute to meeting the Debt Sustainability targets agreed upon with the International Monetary Fund. This DDO comprises, ● conversion/exchange of eligible Treasury bonds that had been issued under the Registered Stock and Securities Ordinance (RSSO) No. 07 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 had been issued under the Local Treasury Bills Ordinance No. 08 of 1923 (as amended) and 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 was carried out on 15 August 2023. Those eligible SLDB holders who opted for LKR-denominated bonds were allocated their respective LKR bonds amounting to Rs. 252.2 billion. Furthermore, the accrued and arrears interest was 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.
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. Accepted offers were converted to new Treasury bonds amounting to Rs. 3,204.5 billion which had longer maturities. Furthermore, an accrued interest of Rs. 110.9 billion 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 were published.
21 September 2023	Outstanding credit (the "provisional advances") of Rs. 344.7 billion from the Central Bank to the Government and outstanding Treasury bills amounting to Rs. 2,368.4 billion 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 amounts to Rs. 2,492.3 billion and twelve (12) existing Treasury bills amount to Rs. 220.8 billion 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 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 of Rs. 27.7 billion was allocated to five existing Treasury bonds that were issued under the DDO.
11 March 2024	The amount offered at Phase II of Treasury bill auctions has been reduced to the aggregate auction shortfall at Phase I and 10 per cent of the aggregate amount offered or Rs. 5.0 billion, whichever is higher, in terms of the amended Directions issued on 07 March 2024 which were in force effective from 11 March 2024.
	The amount offered at Direct Issuance Window (DIW) of Treasury bond auctions has been reduced to 10 per cent of the amount offered from International Securities Identification Numbers (ISINs) which are fully accepted at Phase I in terms of the amended Directions issued on 07 March 2024 which was in force effective from 11 March 2024.
01 April 2024	Dispatching of printed periodic statements of Government securities investments was discontinued and replaced by converting fully into the e-statement facility where recording of valid email addresses is mandatory for all securities account holders in the Lanka Secure system, effective from 01 April 2024.

Capital Market[3]

August 2023	Approval was obtained to introduce extensible Business Reporting Language (XBRL) reporting to the listed companies of Colombo Stock Exchange (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 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 have been finalised.
	Regulated Short Selling (RSS) through Securities Borrowing and Lending (SBL) was launched by CSE.
December 2023	Recognized Shariah Scholars who certify the Shariah compliance of Sukuk products as “Supplementary Service Providers” under the Securities and Exchange Commission Act No. 19 of 2021.
January 2024	Rules relating to Shariah Compliant Debt Securities were finalised and guidelines for Shariah Scholars were published.
	Approval was obtained for the Regulatory Framework to facilitate the issuance and listing of Infrastructure bonds on CSE.
March 2024	Approval was obtained for the establishment of a Derivatives Exchange and a sub-committee was formed to drive the initiative.
April 2024	Approval was obtained for the selected Shariah scholars to be registered as “Supplementary Service Providers”.

Financial Infrastructure

Payments and Settlements

20 July 2023	The multi-tiered Liability Manager Limit structure for Common ATM Switch (CAS) and Common Electronic Fund Transfer Switch (CEFTS) were revised to support the growth of volume and value of transactions conducted through CAS and CEFTS.
31 August 2023	A trilingual web form to collect information from the public was developed on unsafe, unsound, or unfair practices relating to payment practices or services.
29 December 2023	To further improve the adoption of digital transaction channels, the Central Bank mandated LBs to join initiatives such as the LankaPay Online Payment Platform (LPOPP), the Direct Debit facility, the Shared Know-Your-Customer (KYC) facility, and the Government Digital Payment Platform (GDPP). Other priority areas identified by the Central Bank such as enabling real-time notifications for credit and debit transactions of a customer, promoting digital transactions in remote areas, immediately updating credit card settlements made through digital channels, and making the reference field mandatory for digital transactions were informed to LBs. Further, LBs that are functioning as Licensed Financial Acquirers were informed to instruct their merchants not to pass Merchant Discount Rate (MDR) to customers.
	Promoting foreign remittances together with digital transactions via e-money wallets, the enhanced and basic e-money wallet limits were raised from Rs. 50,000.00 and Rs. 10,000.00 to Rs. 150,000.00 and Rs. 20,000.00, respectively, with effect from 01 January 2024.

3 These are policy measures implemented by the Securities and Exchange Commission.

17 January 2024	The Central Bank mandated JustPay enabled mobile payment applications to request a One-Time-Password (OTP) from the financial institution of the account linked to the application for transactions equal to or exceeding Rs. 10,000.00 starting from 01 April 2024. JustPay facilitates users to link their current or savings accounts from any financial institution and make payments by pulling funds from linked accounts through the mobile application.
01 February 2024	Approval was granted for LankaPay (Pvt) Ltd (LPPL) to join with the Nepal Clearing House Ltd for the acceptance of LANKAQR transactions made by Nepali tourists through NEPALPAY QR mobile applications.
20 April 2024	Money or Value Transfer Service (MVTS) Providers Regulations No. 01 of 2024 was issued by the MOF, under the provisions of the Payment and Settlement Systems Act No. 28 of 2005. Accordingly, effective from 03 June 2024, these regulations require all MVTS providers to be registered and be monitored, offering unregistered or unlicensed MVTS providers the opportunity to formalize their operations and engage in the money transfer business through formal channels.

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

07 August 2023	Approval of the Cabinet of Ministers was received for the adoption of the National Policy on AML/CFT of Sri Lanka.
22 August 2023	Circular No. 03 of 2023 was issued as a reminder on adherence to previously issued guidelines and reporting formats on mandatory reporting under the Financial Transactions Reporting Act (FTRA) 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.
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.
13 October 2023	Red Flag Indicators No. 01 of 2023 on "Identification of Suspicious Transactions relating to Bribery and/or Corruption" was issued to LBs and FCs.
20 October 2023	Red Flag Indicators No. 02 of 2023 on "Red Flags on possible Drug Trafficking related Financial Transaction” was issued to LBs and FCs.
03 November 2023	Red Flag Indicators No. 03 of 2023 on "Identification of Suspicious Transactions relating to Insurance Sector” was issued to Insurance Companies (ICs), LBs and FCs.
18 December 2023	Approval of the Cabinet of Ministers was received for the Terms of Reference of the AML/CFT National Coordinating Committee, and the establishment of the AML/CFT Task Force.
	Red Flag Indicators No. 04 of 2023 on "Identification of Suspicious Transactions relating to Securities Sector" was issued.
19 December 2023	Red Flag Indicators No. 05 of 2023 on "Red Flag Indicators for the Money Value Transfer Service (MVTS) Providers" was issued.
06 February 2024	Red Flag Indicators No. 01 of 2024 on "Identification of Suspicious Transactions relating to Trade Based Money Laundering (TBML)" was issued to all LBs and FCs.
07 March 2024	An administrative penalty amounting to Rs. 1,000,000.00 was imposed on DFCC Bank owing to the bank's failure to adhere to the FTRA and Financial Institutions (Customer Due Diligence) Rules (CDD Rules) No. 01 of 2016.

28 March 2024	An administrative penalty amounting to Rs. 2,000,000.00 was imposed on Sampath Bank PLC owing to the bank's failure to adhere to the FTRA and CDD Rules No. 01 of 2016.
01 April 2024	Circular No. 01 of 2024 was issued on compliance with the reporting requirements under the FTRA to all LBs, FCs, Stockbrokers, ICs and MVTS providers.

Foreign Exchange Management

04 December 2023	Directions No. 02 of 2023 were issued on Business Foreign Currency Accounts (BFCAs), amending Annex I of the Directions No. 05 of 2021 dated 18 March 2021, including enterprises permitted to sell goods to domestic market in terms of the Finance Act - Commercial Hub Regulations No. 01 of 2019.
	Directions No. 03 of 2023 were issued on Accommodations to BFCA Holders amending the Directions No. 09 of 2021 dated 18 March 2021, permitting the payments to the enterprises engaged in business activities in Sri Lanka which are permitted to sell goods/products to the domestic market in terms of the Finance Act - Commercial Hub Regulations No. 01 of 2019, as amended and transfers to the BFCAs or the accounts maintained in the Off-shore Banking Units of freight forwarders, shipping/airline agents in respect of freight payments.
20 December 2023	Order under Section 22 of the Foreign Exchange Act (FEA) No. 12 of 2017, published in the Extraordinary Gazette Notifications No. 2363/26 dated 20 December 2023, was issued by rescinding the orders published in Extraordinary Gazette Notifications No. 2338/40 dated 28 June 2023 progressively easing some of the suspensions/ limitations relating to outward capital and current transactions imposed by the Orders issued earlier for six months commencing from the date of the Order.
01 January 2024	Directions No. 01 of 2024 were issued amending the Directions No. 01 of 2023 dated 27 February 2023 on Special Foreign Currency Accounts - Investee (Directions) to facilitate current transactions, by extending the validity of the same until 30 June 2024.
15 February 2024	Regulations No. 02 of 2021 published in the Gazette Extraordinary Notifications No. 2213/35 dated 03 February 2021, as amended, were further amended by the regulations published in the Gazette Extraordinary Notifications No. 2371/33 dated 15 February 2024, permitting the residents outside Sri Lanka to acquire, hold, divert or pledge as collateral any securities listed in the CSE under "Securities Borrowing and Lending" transactions in terms of the rules promulgated by a clearing house licensed under the Securities and Exchange Commission of Sri Lanka Act No. 19 of 2021. Directions No. 02 of 2024 dated 20 March 2024 were issued to Authorized Dealers (ADs) facilitating the above transaction.
16 February 2024	Regulations No. 02 of 2021 published in the Gazette Extraordinary Notifications No. 2213/35 dated 03 February 2021, as amended, were further amended by the regulations published in the Gazette Extraordinary Notifications No. 2371/48 dated 16 February 2024 removing the exchange restrictions on repayments of loans obtained from residents outside Sri Lanka. Directions No. 03 of 2024 dated 20 March 2024 were issued to ADs in this regard.
	Regulations No. 02 of 2021 published in the Gazette Extraordinary Notifications No. 2213/35 dated 03 February 2021, as amended, were further amended by the regulations published in Gazette Extraordinary Notifications No. 2371/49 dated 16 February 2024 permitting to make payments to the residents outside Sri Lanka in relations to their income or maturity proceeds of the listed debt securities or listed shares by way of conversion of Sri Lanka Rupees where the investee has no sufficient foreign exchange balances/ cash flows. Directions No. 04 of 2024 dated 20 March 2024 were issued to ADs facilitating the above transactions.
	Regulations No. 06 of 2021 published in the Gazette Extraordinary Notifications No. 2234/20 dated 30 June 2021, as amended, was repealed by the regulations published in the Gazette Extraordinary Notifications No. 2371/50 dated 16 February 2024, allowing the repayment of the loans obtained from overseas for the purpose of investing in International Sovereign Bonds and Sri Lanka Development Bonds by way of conversion of Sri Lanka Rupees.

20 March 2024	Directions No. 02 of 2024 were issued to ADs on Inward Investments Accounts (IIAs) facilitating the transactions permitted under the regulations published in the Extraordinary Gazette Notifications No. 2371/33 dated 15 February 2024.
	Directions No. 03 of 2024 were issued to ADs on the accommodations to BFCA holders amending the Directions No. 09 of 2021 in line with the regulations published in the Extraordinary Gazette Notifications No. 2371/48 dated 16 February 2024.
	Directions No. 04 of 2024 were issued to ADs on Special Foreign Currency Accounts amending Directions No. 26 of 2021 dated 30 July 2021, facilitating the transactions permitted under the regulations published in the Extraordinary Gazette Notifications No. 2371/49 dated 16 February 2024.
18 June 2024	Order under Section 22 of the FEA, published in the Extraordinary Gazette Notifications No. 2389/08 dated 18 June 2024, was issued relaxing several restrictions/limitations imposed under the Order, published in the Extraordinary Gazette Notifications No. 2363/26 dated 20 December 2023.
01 July 2024	The "Repatriation of Export Proceeds into Sri Lanka Rules No. 01 of 2024" were issued under the provisions of Central Bank Act No. 16 of 2023, published in the Gazette (Extraordinary) No. 2391/02, extending the mandatory conversion requirement for residual of export proceeds to the tenth (10th) day of the month following the expiration of three calendar months (including the month of receipt) from the date of receipt as against the period of seventh (07th) day of the following month, which had been stipulated in the previous rules. Upon parliamentary approval, these rules came into effect on 04 September 2024.

Financial Markets

2

Stress in the domestic financial markets indicated by the Financial Stress Index[1] (FSI) remained low since late 2023 despite some increases starting from mid-April 2024. Improved performance of the stock market, decreased Government securities yields and positive developments in the domestic foreign exchange market amidst improved gross official reserves mainly contributed to the sharp decline in stress level during Q1 of 2024. However, a turnaround in decline was observed from mid-April 2024, as the decline in m-o-m stock returns and increased volatilities in banking stocks exerted an upward pressure on the FSI.

Performance of the stock market varied in terms of price gain, volatility, and foreign participation in the secondary market. Share price indices showed an upward trend until mid-2024 before starting to decline due to uncertainties related to the election cycle. Meanwhile, the volatility of price indices increased marginally, compared to end 2023. Banking sector exposure in terms of the margin trading facilities provided for the investors remained low hence any spillover effects of the risks emanating from the equity market activities may only have a minimal impact on banks. Moreover, foreign participation in the secondary market somewhat increased but resulted in net outflows.

In the Government securities market, yields remained elevated compared to other market interest rates despite a downward shift in the yield curve during the period under review. Short term yields dropped substantially, but long term yields remained sticky, leading to a higher term premium. The Government's reliance on domestic market borrowing may increase due to limited external financing options. The secondary market for Government securities also remained constrained by low liquidity, discouraging foreign investments as yields declined.

Meanwhile, the domestic foreign exchange market liquidity conditions improved due to increased worker remittances, tourism earnings, and conversion of export proceeds and the Sri Lankan rupee strengthened against the USD during the first eight months of 2024. Foreign debt standstill[1] and restrictions on vehicle imports may also have contributed to improve the forex market liquidity, thereby easing the pressure on the currency.

Liquidity in the overnight money market remained positive after the first quarter of 2024 despite a persistent asymmetric distribution among market participants. Restrictions on overnight deposits imposed by the Central Bank in 2023 boosted interbank lending. Therefore, such restrictions were lifted by April 2024. Call and repo markets became more active, with significant increases in transaction volumes compared to 2023. The Average Weighted Call Money Rate (AWCMR) moved closer to the lower bound of the Standing Rate Corridor (SRC) and remained less volatile.

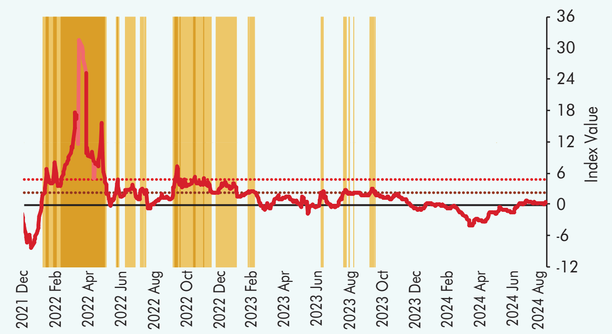
Overall, financial markets operated with resilience during the period under review as macrofinancial conditions and market perceptions improved compared to the previous years. As the economy moves forward in a monetary easing cycle, further improvements are expected in financial markets. However, at the same time, vulnerabilities could emerge with the expansion in economic activity. Although long term imbalances in the fiscal and external sectors

1 This index captures the combined stress emanating from equity, domestic foreign exchange, government securities and domestic money markets.

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

are being gradually corrected, substantial progress is still needed to maintain the stability of financial markets. As experienced during the crisis period, imbalances in one market can propagate into others with amplified impact, while creating self-fulfilling vicious cycles. Dynamics of international financial markets will also spillover to domestic markets through international investors' behaviour. Therefore, to ensure smooth functioning of financial markets, it is vital to boost market confidence by maintaining macroeconomic stability.

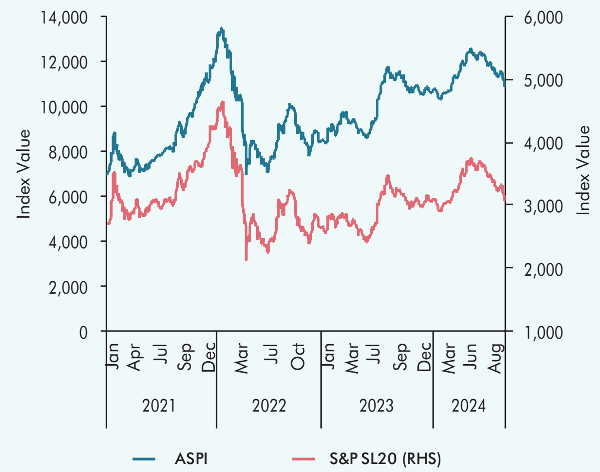
Figure 2.1 Financial Stress Index*



*Due to equity market closure during several days in April and May 2022, a separate FSI was computed excluding equity market data.

Sources: Central Bank of Sri Lanka
Colombo Stock Exchange
Bloomberg

Figure 2.2 Share Price Indices



Source: Colombo Stock Exchange

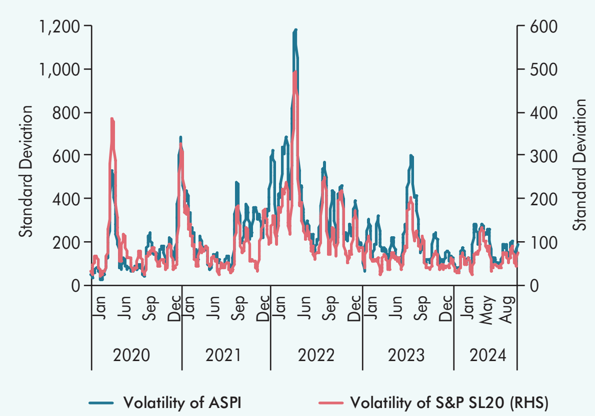
2.1 Stock Market

Stock market price indices moved on an upward trend until May 2024 and started to decline thereafter amidst uncertainties associated with the elections cycle. Market adjustments to the positive economic outlook anticipated since Q4 of 2023 were slow in the beginning of 2024. However, share price indices started to gain momentum since February 2024 and peaked in May 2024. Afterwards, bearish sentiments could be witnessed from June 2024, possibly owing to uncertainties associated with the election cycle. Nevertheless, during the 8-month period that ended in August 2024, All Share Price Index (ASPI) improved by 2.0 per cent while S&P SL20 Index deteriorated by 0.3 per cent.

Compared to the level that prevailed at end 2023, market volatility slightly increased by the end of August 2024 in an environment of political uncertainties. Stock market volatility,[3] as measured by the standard deviation of the daily share price index, remained elevated in July 2023, but declined towards end 2023 due to early signs of stabilisation of the economy. The first half of 2024, however, indicated an incline in volatility owing to increase in perceived risk as uncertainties emerged due to the delayed finalisation of External Debt Restructuring (EDR) and upcoming elections. The positive outlook on the macroeconomic front and improved performance of listed corporates reversed the negative impact of such uncertainties to a certain extent. The volatility declined since May 2024, but remained above the levels prevailed at the end of 2023.

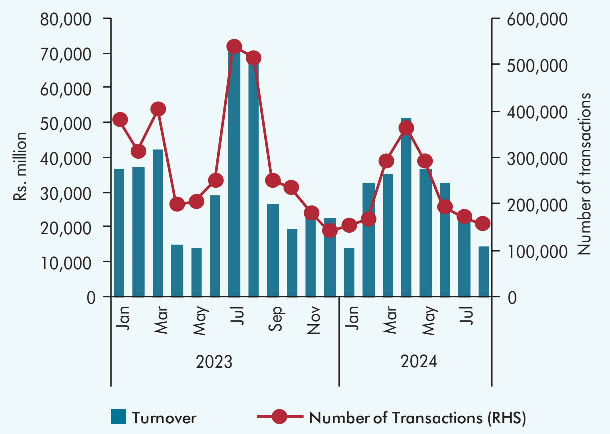
3 Stock market volatility is measured by the standard deviation of ASPI and S&P SL 20 for preceding 20 days of active operation at CSE.

Figure 2.3 Volatility of Share Price Indices



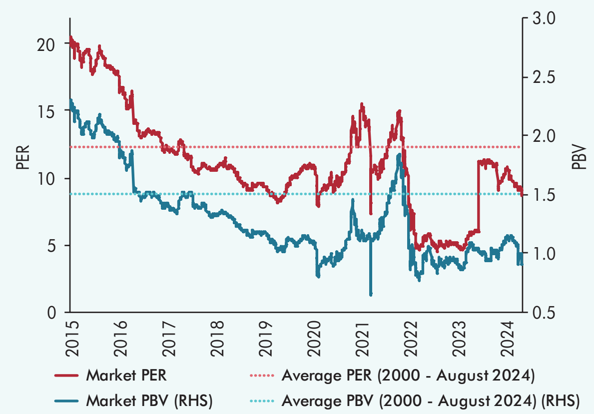
Sources: Central Bank of Sri Lanka
Colombo Stock Exchange

Figure 2.4 Stock Market Turnover and Trade Volume



Source: Colombo Stock Exchange

Figure 2.5 PBV and PER



Sources: Colombo Stock Exchange
Central Bank of Sri Lanka

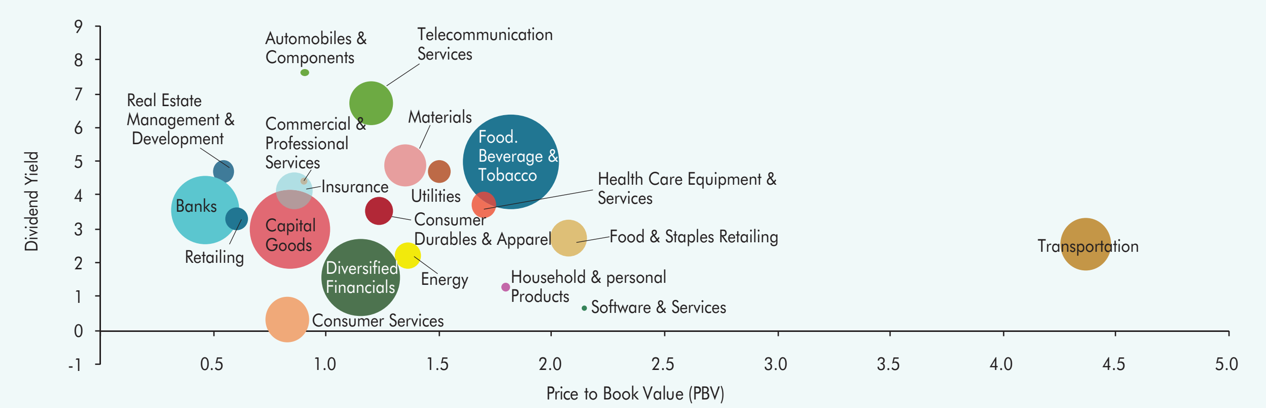
Monthly stock market turnover increased until April 2024 and entered a declining phase thereafter. After the very high levels recorded in Q3 of 2023 due to increased banking sector share trades post Domestic Debt Optimisation (DDO), monthly turnover dried down in Q4 of 2023 and remained subdued until January 2024. Thereafter, it showed an upward momentum from February to end April 2024. Average daily turnover recorded up to end August 2024 was Rs. 1,523.9 million whilst an average daily turnover of Rs. 1,696.2 million was recorded during 2023.

The Price Earnings Ratio[4] (PER) and the Price to Book Value (PBV) Ratio which were high between the months of May and June 2024, started to decline thereafter and remained below the long term average PER and PBV indicating an undervalued equity market. The market recorded a PER of 8.7 by end August 2024 which was below the long term average PER of 12.3 for the periods from 2000 to August 2024 and was below the PER of 11.1 recorded at end December 2023. Similarly, PBV was 0.9 by end August 2024 and was below the long term average of 1.5. This indicates possible undervaluation of stock prices, reflecting the earning potential of the share market.

Based on data on the secondary market activities during the past five years, PBV of banks remained below 1, positioning as undervalued stocks on the Colombo Stock Exchange. In terms of the dividend yield and PBV, automobile & components, real estate management & development and commercial

4 In Figure 2.5, the increase in the PER for the periods starting from 09 October 2023 was due to updated financial information released by the listed companies as at quarter ended 30 June 2023 which impacted the denominator (earnings).

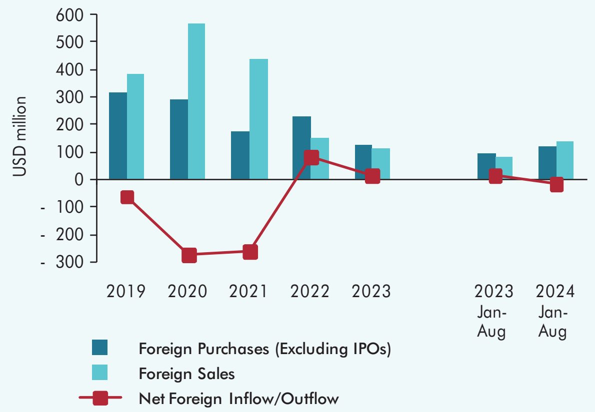
Figure 2.6 Sector Wise Positioning



* Market capitalisation of the respective sector as at end August 2024 is indicated by the size of the circle.

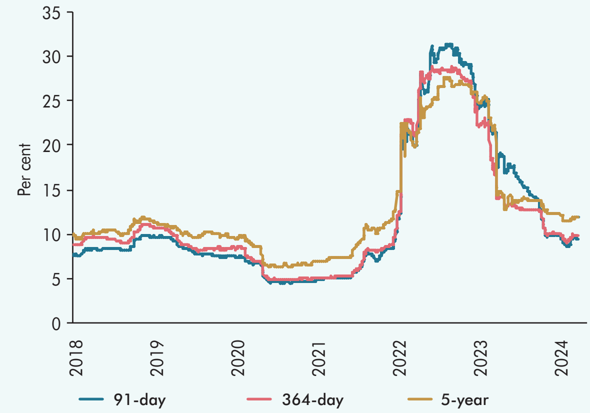
Sources: Central Bank of Sri Lanka
Colombo Stock Exchange

Figure 2.7 Foreign Participation in the Stock Market



Sources : Central Bank of Sri Lanka
Colombo Stock Exchange

Figure 2.8 Secondary Market Yields



Source: Central Bank of Sri Lanka

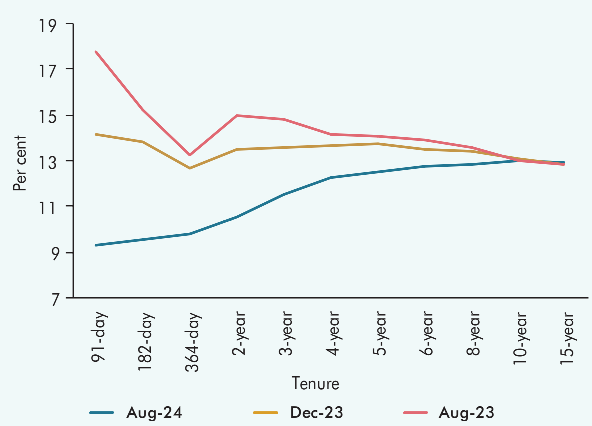
& professional services sectors were positioned as undervalued stocks with the highest dividend yields. Bank shares also had a five-year average dividend yield of 3.6 at end August 2024. However, banks need to be cautious about the impact of high dividend distribution on the capital base.

Foreign participation in the stock market improved during the first eight months of 2024 compared to the corresponding period of 2023, yet net foreign inflow to the secondary market was negative. Foreign purchases of USD 119.4 million were recorded in the period under review, compared to foreign purchases of USD 94.4 million recorded for the same period of 2023. However, on a net basis, foreigners were sellers in the secondary market. On the contrary, net foreign buying was recorded over the past two years. Eight months ending in August 2024 recorded a net foreign outflow of USD 17.0 million compared to the net foreign inflow of USD 14.7 million recorded during the same period in 2023. Along with the anticipated continuation of macroeconomic stability, securing inflows which are long term in nature to the stock market will help stabilise the domestic foreign exchange market.

2.2 Government Securities Market

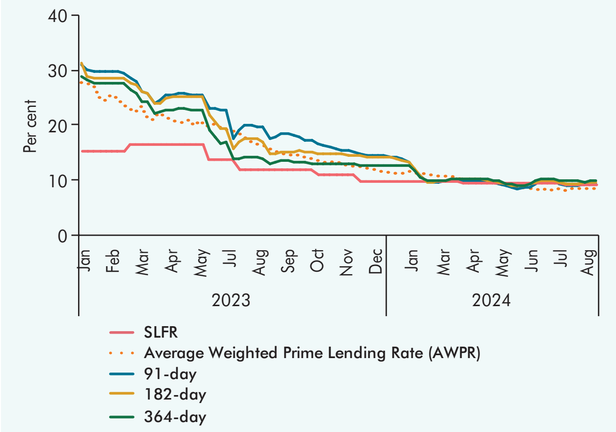
Yields on Government securities, which declined in 2023, continued to drop in early 2024 as well, particularly during January and February 2024, and moderated afterwards. However, these yields increased in August 2024. The accommodative monetary policy stance, low inflation expectations, reduction in perceived risk due to positive macroeconomic developments, improvements in the fiscal front, particularly with respect to tax collection and improved liquidity of banks contributed to ease the pressure on yields during the period under review. Short term yields, which were far higher than long term yields during the most of 2023, fell substantially. Accordingly, the term premium of interest rates for Government securities, which was negative during the most of 2023, turned positive. However, stickiness observed in long term yields led to widened spread between long and short term yields, reflecting higher term premia associated with Government securities. Although a significant downward shift in the yield curve of Government securities was observed during

Figure 2.9 Yield Curve



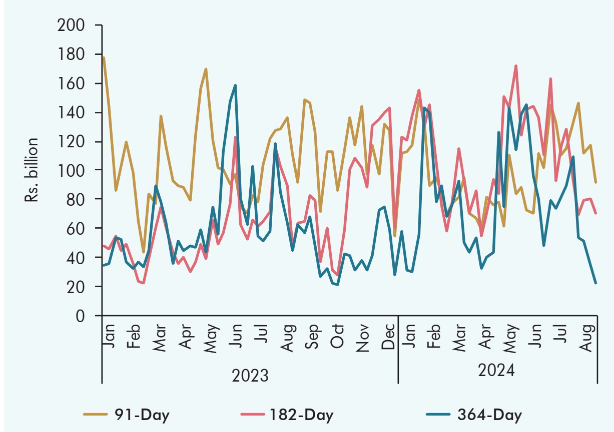
Source: Central Bank of Sri Lanka

Figure 2.10 Interest Rates



Source: Central Bank of Sri Lanka

Figure 2.12 Subscription Levels at Treasury Bill Auctions

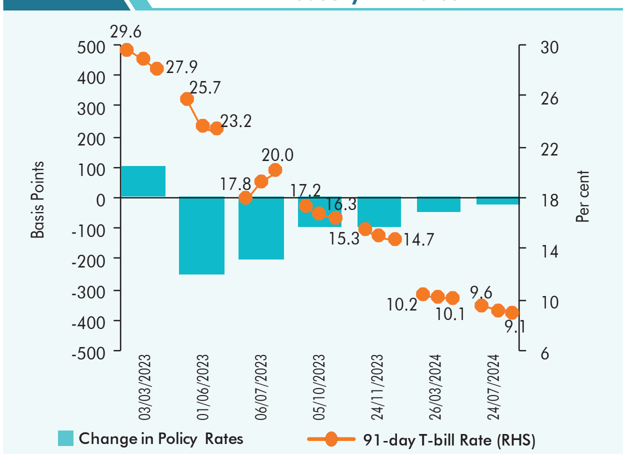


Source: Central Bank of Sri Lanka

the period under review, yields remained above comparable deposit rates offered by banks, indicating the continuation of the high-risk premia attached to Government securities. However, going forward, it is anticipated that continuation of the fiscal consolidation which may lead to less borrowings will help to ease the pressure on yields.

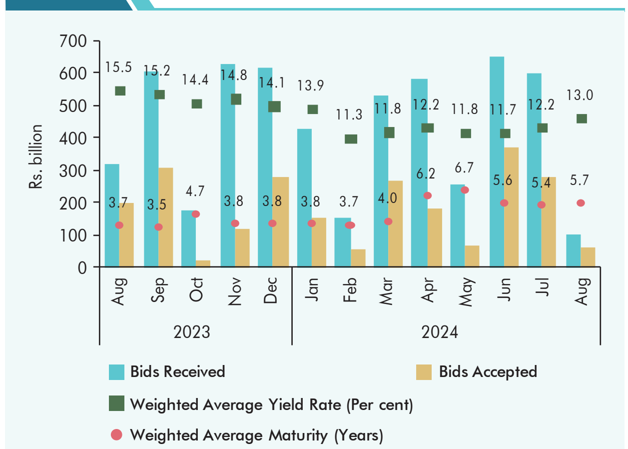
The high borrowing requirement of the Government amid increasing private credit growth could increase volatilities in yields due to demand and supply imbalances. During first eight months of 2024, the 91-day Treasury bill rate fell substantially by 502 basis points in the primary market. Furthermore, in February 2024, 91-day Treasury bill yields fell below the Standing Lending Facility Rate (SLFR) for the first time after 29 months as the market started to respond more effectively to monetary policy easing. Hence, the arbitrage possibilities available to primary dealers and banks dissipated. Nonetheless, increased issuances at certain auctions caused marginal upward shifts in yields. Though the conclusion of the EDR would help bring down the risk premium, the commencement of repayment of debt pertaining to the EDR could elevate the funding requirement of the Government and would exert pressure on yields. Further, with improved intermediation, preference of banks may shift from investments in Government securities towards lending to the private sector. Therefore, the Government maintaining an adequate cash buffer is a requisite to withstand upward pressure on yields, and to curb volatilities in yields.

Figure 2.11 Policy Rate Adjustments and 91-day Treasury Bill Rates



Source: Central Bank of Sri Lanka

Figure 2.13 Treasury Bond Auctions



Source: Central Bank of Sri Lanka

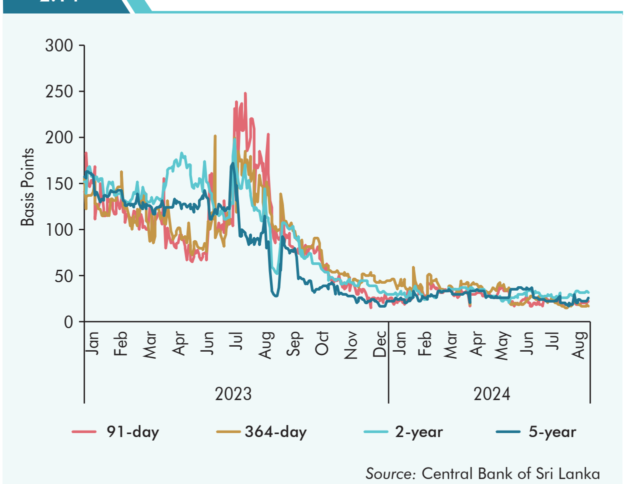
Investor preference for 364-day and 182-day maturities gained some momentum at the majority of primary Treasury bill auctions held during the period under review. However, subdued investor demand for 364-day Treasury bills were observed at the auctions held during August 2024. From the issuer's perspective, with the expectation to reduce interest cost going forward, the Government continued to issue high volumes at Treasury bill auctions. Nevertheless, the demand for Government securities remained robust even amidst declining yields, mainly due to increased rupee liquidity of financial institutions. In the Treasury bond auctions, overall allocation levels remained high despite a few auctions being under allocated.

An illiquid secondary market for Government securities would not be conducive to attracting much needed foreign investments. The secondary market average daily trade volume increased to Rs. 28 billion during the first eight months of 2024 from Rs. 25.4 billion recorded during the corresponding period of 2023. The turnover ratio[5] of the market which continued to hover around 40 per cent during the first seven months of 2024, declined sharply to 23.3 per cent by August 2024. Transactions in the secondary market remained moderate yet concentrated on short term securities during the year until end-July 2024. However, transactions in the secondary market were very low during August 2024. These constrained liquidity conditions will impede the downward adjustment in yields and discourage foreign investments as the investors demand returns to compensate the liquidity risk as well. Foreigners who invest in developing economies due to comparatively high yields would not find domestic securities attractive as held-to-maturity investments during monetary easing. Instead, such investors would prefer buy-and-sell strategies. However, an illiquid market does not support such strategies.

Foreign investors' demand for rupee Government securities reduced as the yields declined. Higher returns attracted significant foreign inflows to the Government securities market during H1 of 2023. This trend began to reverse by H2 of 2023 as the Central Bank initiated the current easing cycle. Accordingly,

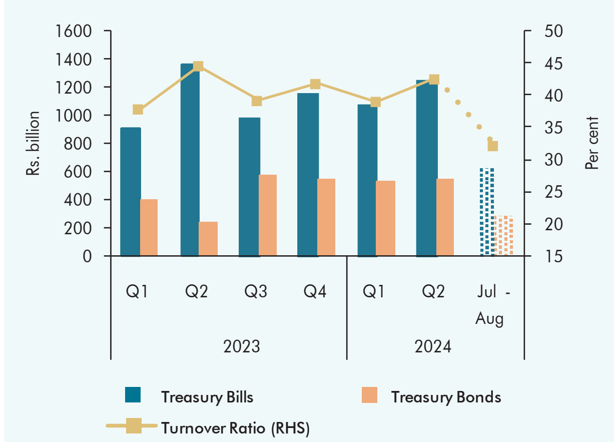
5 Turnover ratio is calculated by dividing the annualised secondary market turnover for the month by the outstanding securities at the end of the period.

Figure 2.14 Secondary Market Yield Spreads



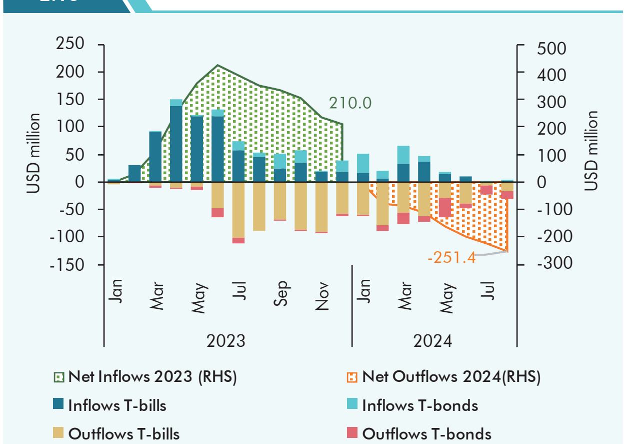
Source: Central Bank of Sri Lanka

Figure 2.15 Secondary Market Trades



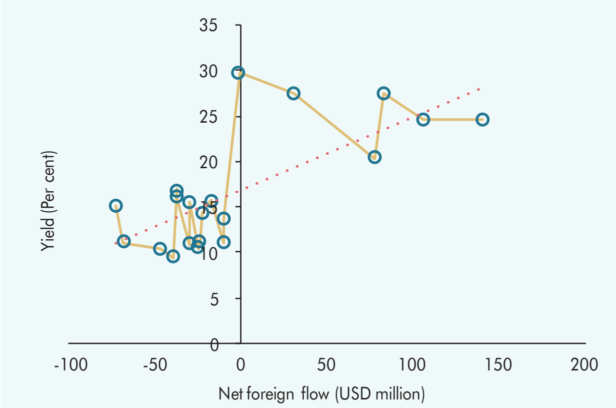
Source: Central Bank of Sri Lanka

Figure 2.16 Foreign Inflows and Outflows



Source: Central Bank of Sri Lanka

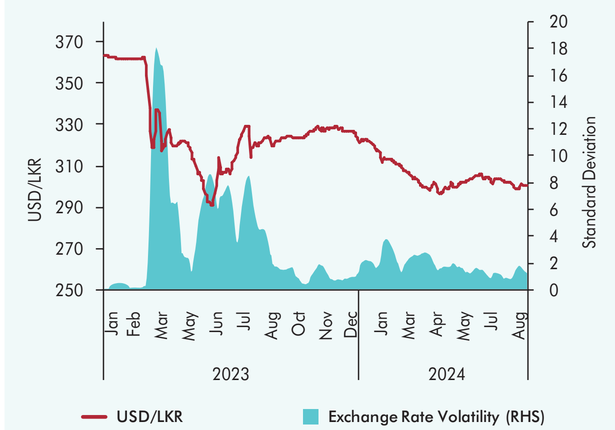
Figure 2.17 **Yields vs Foreign Flows**



* Monthly inflows against monthly average yield from January 2023 to August 2024.

Source: Central Bank of Sri Lanka

Figure 2.18 **Movement of USD/LKR**



Source: Central Bank of Sri Lanka

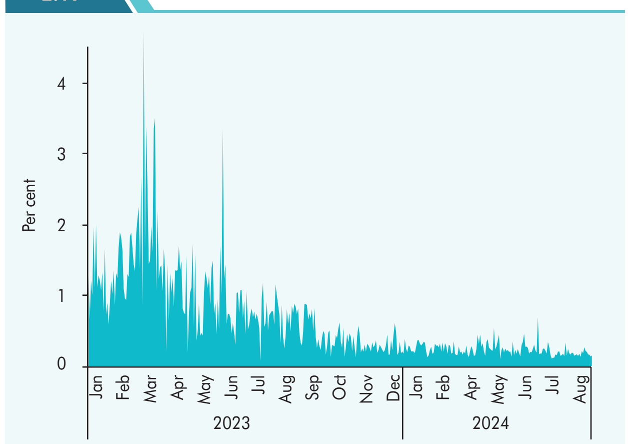
net foreign outflows continued into the first eight months of 2024 as well, leading to a cumulative net outflow of USD 251.4 million compared to a net inflow of USD 210.0 million recorded during 2023. Foreign holdings remained as low as 0.25 per cent of total outstanding securities as at end August 2024.

2.3 Domestic Foreign Exchange Market

The rupee strengthened against the USD during the first eight months of 2024 due to improved inflows and controlled outflows. Increased worker remittances, earnings from tourism and conversion of export proceeds helped to ease the pressure on the rupee value against the USD during the year thus far. However, it is important to note that this rupee appreciation occurred during the external debt standstill and restrictions on vehicle imports and may not sustain in the medium term. The sharp appreciation of the rupee witnessed in the first four months of the year decelerated with increased imports due to recovering economic activity and continuous net outflow of foreign investments in Government securities. However, the pressure on the rupee decreased with the receipt of IMF funding in June 2024. Since then, the USD/LKR exchange rate movement has shown less volatility. Overall, year-to-date appreciation of the rupee against the USD was 7.9 per cent at end August 2024. Going forward, there are several concerns that could affect demand and supply conditions in the domestic foreign exchange market. The anticipated gradual pick up of import demand due to economic recovery amidst the relaxed monetary policy stance and the relaxation of restrictions on vehicle imports will exert pressure on the rupee unless this outflow requirement is compensated by increased inflows, especially by long term oriented foreign direct investments. Furthermore, if the geo-political tensions, particularly in the Middle East, escalate, it would affect inflow of worker remittances, expenditure on fuel and trade.

Narrow bid-ask spreads reflected liquid domestic foreign exchange market conditions although there were instances with pressure to widen the spread. The spread between USD selling and buying

Figure 2.19 **Bid-Ask Spread - USD/LKR**



Sources: Central Bank of Sri Lanka
Bloomberg

Figure 2.20 T-bill Spread and USD/LKR Rate

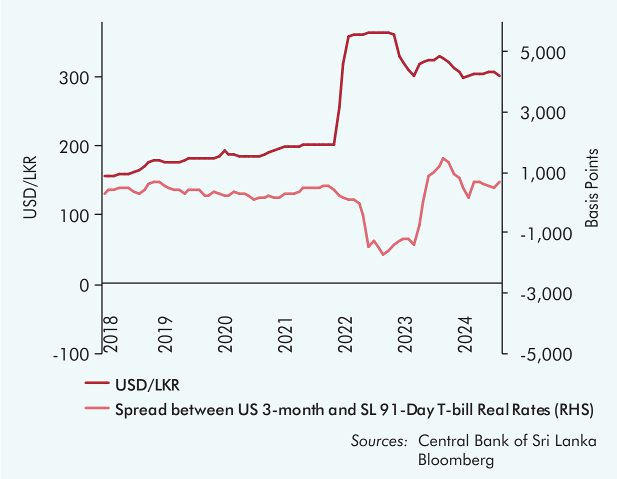
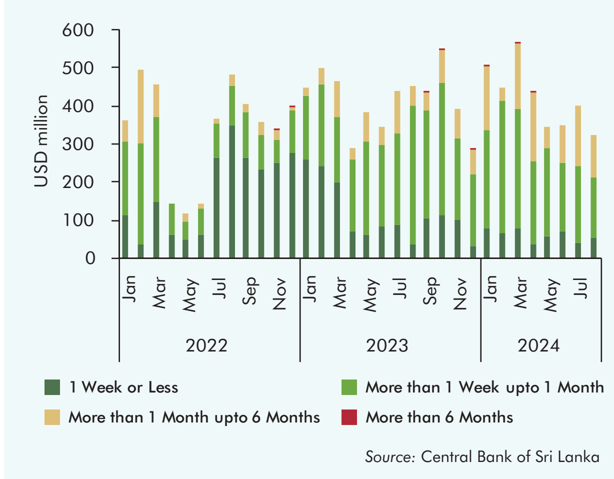


Figure 2.22 Forward Transactions



rates[6] declined along with the decreased volatility in exchange rate during the first eight months of 2024. At times, the reduced demand for imports made the market operate with surplus foreign exchange. Therefore, the Central Bank continued to intervene in the market and managed such situations to minimise significant fluctuations in the exchange rate. However, at these times, the Central Bank absorbed the forex liquidity and released more rupee liquidity into the market. Such absorptions supported the increase in foreign reserve. The year so far recorded low foreign investments in money and capital markets as the spreads between US and domestic real interest rates reduced mainly due to domestic monetary easing.

6 Spread indicates the ratio of difference between ask and bid rates to the ask rate quoted on each day.

Compared to the corresponding period of 2023, the total value of interbank forex transactions in the first eight months of 2024 remained nearly unchanged. During early 2024, as the rupee was on an appreciating path, exporters entered into forward agreements to hedge against further decrease of earnings whilst increasingly converting export proceeds. However, by April 2024, the pickup in imports due to the festival demand, indicated the possibility of rupee depreciation leading to less forward transactions. The interbank transaction volumes were relatively low until July 2024. The total transaction volume in July 2024 increased notably by 36.0 per cent compared to June 2024, mainly due to the increase in spot transactions. However, the transaction volume did not change much in August 2024 when compared to July 2024. In the forward

Figure 2.21 Interbank Forex Transactions

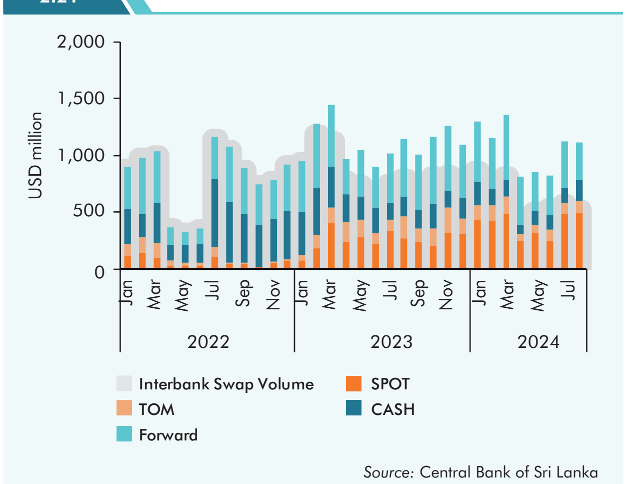
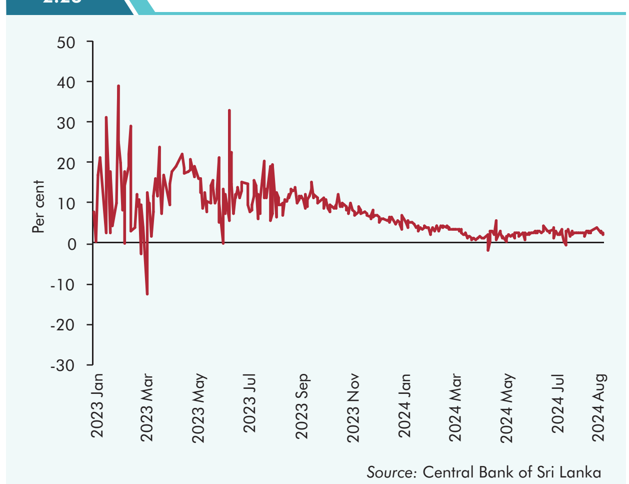


Figure 2.23 1 Month Forward Premium



market, the majority of transactions entered into were for more than one week up to a one-month period. The total volume of forward transactions recorded a decrease of 4.7 per cent in the first eight months of 2024 compared to the corresponding period of 2023. The more active one-month forward premium broadly remained positive but with a declining trend during the period considered.

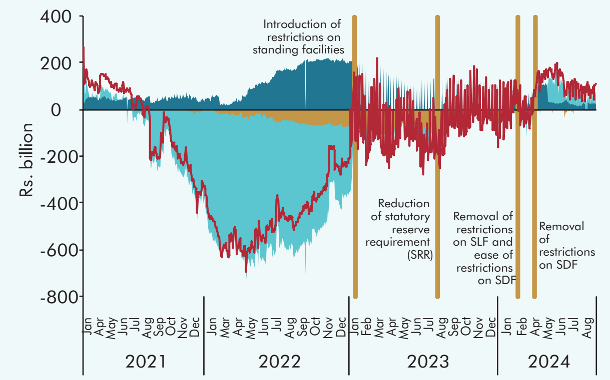
2.4 Domestic Money Market

Liquidity in the money market remained positive but volatile in recent months. Although overall market liquidity oscillated between positive and negative territories until the end of Q1 of 2024, it remained constantly positive during the period from April to July 2024 and recorded a surplus of Rs. 111.0 billion by the end of August 2024. The improvement in market liquidity, especially amongst domestic banks, was mainly supported by net foreign exchange purchases and term reverse repo auctions by the Central Bank. Nevertheless, along with maturities of Treasury bills and coupon payments of Treasury bonds held by the Central Bank, liquidity levels declined in July 2024. This decline exerted some temporary upward pressure on short-term market interest rates.

The significant asymmetry of liquidity distribution among market participants in previous years reduced in 2024. Restrictions imposed from early 2023 till April 2024 on SDF with the Central Bank gradually reduced the liquidity disparity amongst market participants. Although asymmetry of liquidity between domestic and foreign banks reduced to a certain extent, it continues. Moreover, standalone primary dealers continued to frequently operate with a deficit liquidity position.

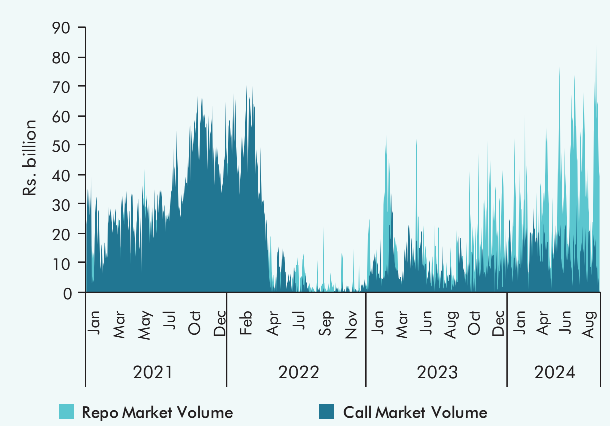
Call and repo markets were relatively more active during the first eight months of 2024 compared to the corresponding period of 2023. The call money market recorded a total transaction volume of Rs. 2,220.4 billion during January to August 2024 compared to Rs. 1,383.0 billion recorded in the corresponding period of 2023. Limited participation by the foreign banks in the call money market in previous years was somewhat addressed by measures taken by the Central Bank to limit access to the SDF. The interbank repo market operated with a higher turnover of Rs. 5,251.4 billion during the first eight months of 2024 compared to Rs. 1,842.0 billion recorded in the same period of 2023. During the first eight months of 2024, average volumes of call and repo markets were Rs. 13.8 billion and Rs. 32.6 billion, respectively, compared to the averages of Rs. 8.7 billion and Rs. 11.7 billion recorded in the corresponding period of 2023.

Figure 2.24 Money Market Liquidity Distribution



Source: Central Bank of Sri Lanka

Figure 2.25 Call and Repo Market Transaction Volumes



Source: Central Bank of Sri Lanka

Special Note 1

Systemic Risk Survey

The Systemic Risk Survey (SRS) has been conducted semi-annually by the Central Bank since 2017 to assess the risks to the stability of the Sri Lankan financial system based on the perceptions of executives responsible for risk management in financial sector institutions.[1] This special note summarises the key findings[2] of the latest survey conducted for the second half of 2024.

Confidence on the Financial System Stability

Respondents' overall confidence[3] on the stability of the financial system as indicated by the net percentage balance improved compared to the previous survey, as more responses shifted from less confident to more confident territories during the year. As a result, a substantial proportion of respondents expressed 'fairly confident' or better outlook reflecting their improved confidence towards financial system stability. This improvement was observed in both short term and medium term outlooks. Although the net percentage balance increased, it remained in the negative territory.

Perceived Probability of a Negative High Impact Event

Respondents were asked to indicate their perceived probability of a negative high impact event in the financial system in the short to medium term. The perceived probability of the materialisation of a negative high impact event continued to decline as reflected by the net percentage balance,[4] which reached the lowest level since 2021. The successful completion of domestic debt restructuring and improved macrofinancial conditions in the country may have supported the improvement in market sentiments over the declined probability of high impact event affecting the stability of the financial system.

1 The participants in the survey represent a diverse range of financial institutions including licensed banks, licensed finance companies, a specialised leasing company, 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 necessarily convey the views of the Central Bank.

3 The overall level of confidence is measured by the net percentage balance. It 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.

4 In this context, the net percentage balance is calculated by weighing 1 for 'very high', 0.5 for 'high', 0 for 'medium', -0.5 for 'low' and -1 for 'very low' likelihood.

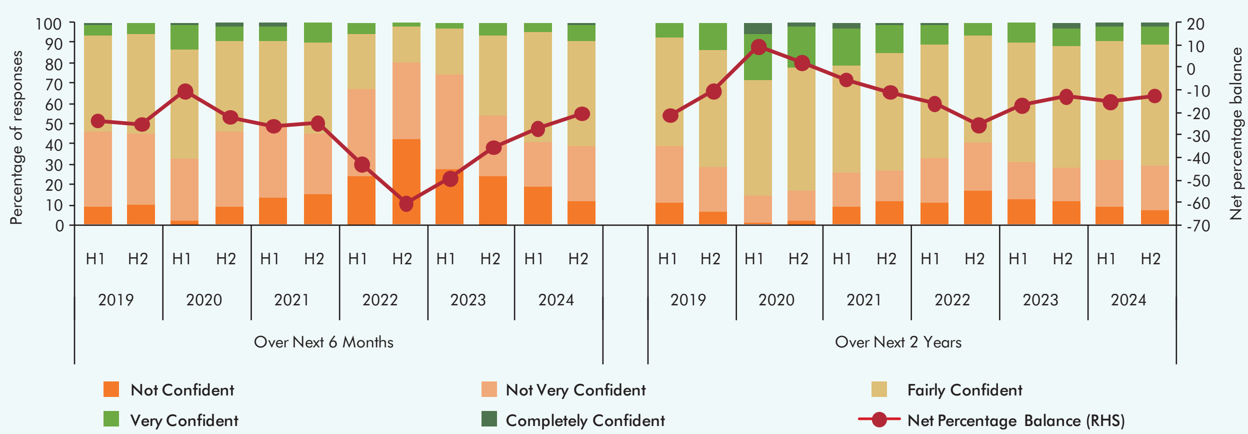
Sources of Risks to the Financial System

Domestic macroeconomic risks continued to be the most prominent perceived risk category, which was emanating from its sub-risks, macroeconomic and fiscal policy uncertainty, and loss of investors' confidence in the economy. General risk and financial market risk categories also ranked high. Further, risks related to financial institutions are also highlighted due to credit risk including asset quality deterioration, concentration, counterparty, and collateral risk.

Macroeconomic and fiscal policy uncertainty was consistently highlighted as a significant sub-risk in both surveys conducted in 2024. Additionally, survey participants expressed concerns over the potential impact of uncertainties on financial system stability in the election cycle. Furthermore, participants pointed out domestic economic growth outlook, exchange rate fluctuations and interest rate risk as other major sub-risks which have a high likelihood of a negative impact on financial system stability. Opinions of respondents regarding the risks that are the most challenging for them to manage underlined the possible negative effects of uncertainties due to the election cycle, macroeconomic and fiscal policy uncertainty, interest rate risk, loss of investors' confidence in the economy and inflation.

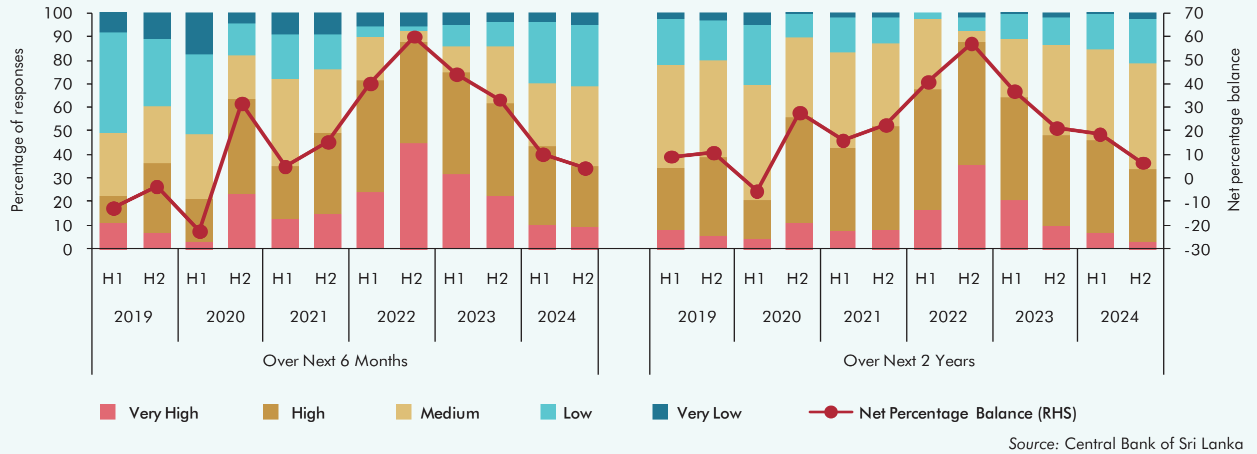
During both H1 and H2 of 2024 surveys, survey participants indicated a positive sentiment across all aspects on the ability of the financial system to withstand high impact events. Notably, the confidence levels on 'financial system capital sufficiency and adequacy for large losses', 'vigilance of financial institutions/markets in monitoring high impact events' and 'contingency planning by financial institutions'

Figure 1 Confidence on the Stability of the Financial System



Source: Central Bank of Sri Lanka

Figure 2 Perceived Probability of Materialising a High Impact Event in Financial System



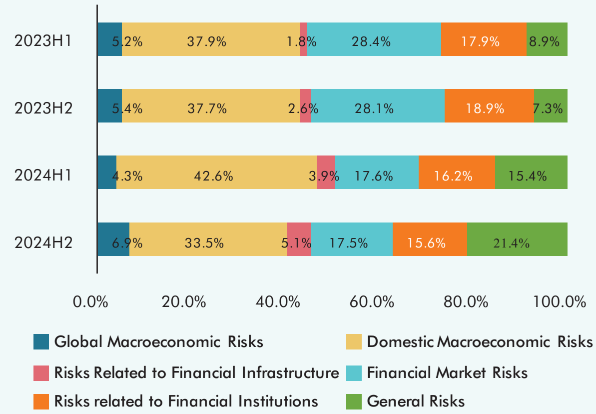
Source: Central Bank of Sri Lanka

improved in 2024. This positive shift in sentiments reflects the effectiveness of measures implemented by stakeholders to ensure the stability of the financial system.

Conclusion

Recent findings of the SRS signal that respondents' confidence in the stability of the financial system has improved. Meanwhile, perceived probability of negative high impact events reduced in 2024, continuing the declining momentum gained in 2023. Furthermore, respondents cited improved sentiments on the ability of financial system to withstand high impact events. While confidence improved, domestic macroeconomic risks, risks related to financial institutions, and general risks continued to be lingering key concerns, possibly shaping risk management strategies of respondents.

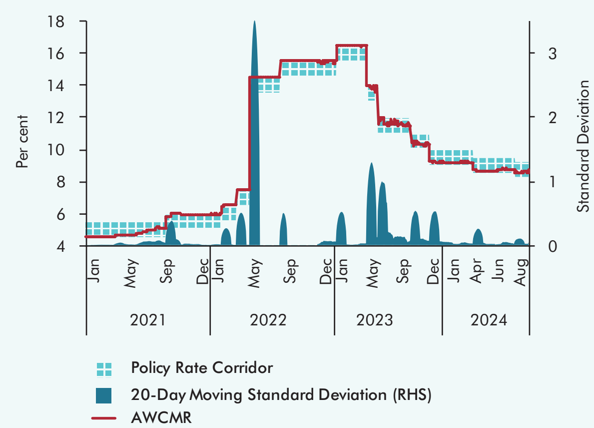
Figure 3 Dynamics of Major Risk Categories



Source: Central Bank of Sri Lanka

Reflecting the improved liquidity conditions in the market, the AWCMR remained closer to the lower bound of the SRC with low volatility. The Central Bank reduced policy interest rates by 725 basis points since the beginning of June 2023 until August 2024 and the Standing Deposit Facility Rate (SDFR) and SLFR were 8.25 per cent and 9.25 per cent, respectively, at end August 2024. Due to improved liquidity distribution in the domestic money market, the AWCMR moved around 8.55 per cent on average in August 2024. This was a shift towards the lower bound of the SRC compared to what was recorded a year ago. In addition, the AWCMR remained less volatile during the year thus far.

Figure 2.26 AWCMR and Policy Rates



Source: Central Bank of Sri Lanka

Financial Institutions

3

Financial institutions that navigated through unprecedented challenges during the height of the economic crisis demonstrated an improvement in resilience during the year amidst easing macroeconomic conditions. Prudent policy actions/interventions and sequencing of economic and financial reforms expedited the recovery in the performance of financial institutions. These developments collectively contributed to a resurgence in private sector lending, decreased reliance of state owned enterprises on the banking sector, an improvement in the quality of the credit portfolio, a reduction in default probabilities, and relatively improved capital levels, particularly following domestic debt optimisation efforts.

This recovery path was reflected in the gradual improvement of the Banking Soundness Index during the year until Q2 of 2024, from its lowest levels recorded in the second half of 2022. Credit expansion resumed during the first half of 2024, largely fuelled by domestic lending. The gradual improvement in resilience of the Banking sector was evident in the reduction of Non-Performing Loans (NPLs) as indicated by stage 03 loans and the improved provision coverage on expected credit losses, albeit the NPL Ratio remaining at an elevated level. Despite these developments, the sovereign exposure of the banking sector remained high, mainly due to increased exposure to government securities. Rupee liquidity in the Banking sector improved significantly, as reflected by the Rupee Liquidity Coverage Ratio, which was mainly driven by increased investments in government securities. The Foreign Currency (FCY) liquidity position of banks also recorded a notable improvement, supported by the accumulation of usable FCY assets. The sector's market risk was effectively mitigated by a favourable asset-liability structure, positioning banks to benefit from declining interest rate conditions. However, careful management of interest bearing assets and liabilities factoring in developments in market interest rates would be required to sustain profitability. Banking sector profitability surged in the first half of 2024, driven by reduced interest expenses, leading to a significant increase in Profit After Tax. Capital adequacy also improved, with the issuance of Tier-2 capital instruments and internal capital generation from retained earnings, invariably contributing to enhancing the resilience of the banking sector. However, maintaining adequate capital levels remained challenging for a few banks, especially in light of the potential impacts that may arise at the finalisation of debt restructuring.

At end Q2 of 2024, the Finance Companies (FCs) sector achieved significant asset growth, primarily driven by credit and investments. Credit of the sector gained momentum during the first half of 2024 in line with improved macroeconomic conditions. The sector's investment portfolio improved, especially in unit trusts, repos, and government securities, highlighting a notable shift in its investment portfolio. Asset quality of the sector improved as reflected by the NPL Ratio, with a decline in NPLs and the increase in gross loans and advances. Liquidity in the FCs sector remained healthy, with liquid assets exceeding regulatory requirements, leading to a liquidity surplus. Meanwhile, profitability as indicated by key financial metrics, such as Return on Assets, Return on Equity, and Net Interest Margin, improved significantly. The sector’s Capital Adequacy Ratio improved, though a few companies continued to face challenges in meeting capital requirements. Nevertheless, the Central Bank continued to encourage consolidation of companies to make the sector more resilient.

Insurance penetration in the country continued to remain at a lower level during the first half of 2024. Asset growth of the overall Insurance sector decelerated at end Q2 of 2024, while the sector showed significant exposure to the sovereign. Profitability of insurance subsectors recorded a mixed performance, as ROA and ROE of the long term subsector declined while that of the general insurance subsector improved in the first half of 2024. The sector's capital adequacy remained well above the minimum regulatory requirement.

Across the Banking, FCs, and Insurance sectors, the period under review was a year of recovery, growth, and resilience. While challenges remained, particularly in managing risks and maintaining stability, the sectors demonstrated an improved performance, setting a foundation for continued progress.

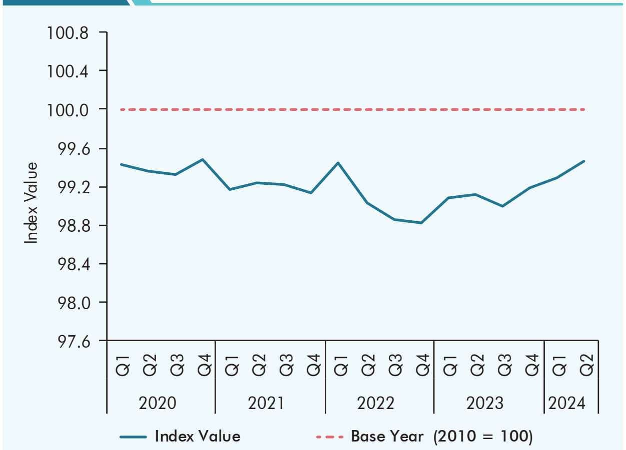
3.1 Banking Sector

Banking Soundness Index (BSI)[1]

The overall soundness of the banking sector as indicated by the BSI improved at end Q2 of 2024 compared to the corresponding period of the previous year. However, the index remained below 100, reflecting the relatively challenging operating environment of the Banking sector at end Q2 of 2024. Liquidity, Profitability, Capital Adequacy, Asset Quality, and Resilience to Market Risk sub-indices improved at end Q2 of 2024 compared to end Q2 of 2023, while the Efficiency sub-index deteriorated during the same period, mainly due to increased operating expenses.

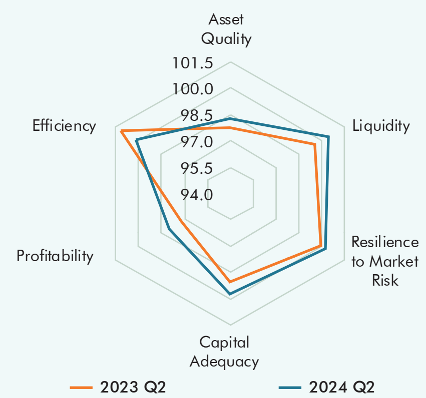
1 Banking Soundness Index (BSI) is a composite indicator which reflects the overall stability of the banking sector based on developments in Assets Quality, Liquidity, Capital Adequacy, Resilience to Market Risk, Profitability, and Efficiency. The index is weighted based on the market share of each Bank. 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 sector stability.

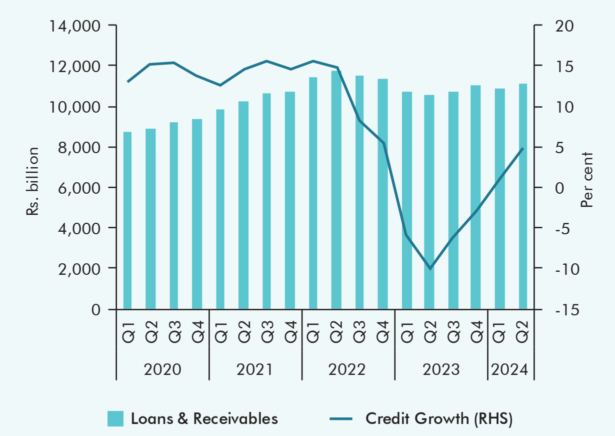
Source: Central Bank of Sri Lanka

Credit Risk[2]

The contractionary trend observed in loans and receivables of the Banking sector during 2023 began to reverse with the monetary easing cycle that commenced in mid-2023, leading to an expansion in credit during the first half (H1) of 2024. With significant monetary tightening amidst adverse macroeconomic developments, credit growth of the Banking sector declined and experienced a contraction during 2023. Subsequent to the easing of inflation expectations and improvements in other macroeconomic variables, the Central Bank commenced monetary easing in June 2023 by reducing policy rates for the first time since July 2020. Accordingly, the rate of contraction in credit declined since Q3 of 2023 and recorded a growth

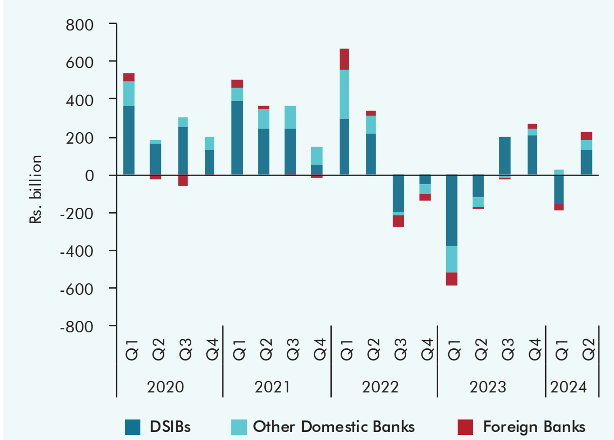
2 Throughout this section, the NPL Ratio refers to the Stage 3 Loans Ratio, which is calculated as Stage 3 loans and receivables divided by total loans and receivables (including undrawn amounts).

Figure 3.3 Loans & Receivables



Source: Central Bank of Sri Lanka

Figure 3.5 Quarterly Change in Credit based on Bank Category



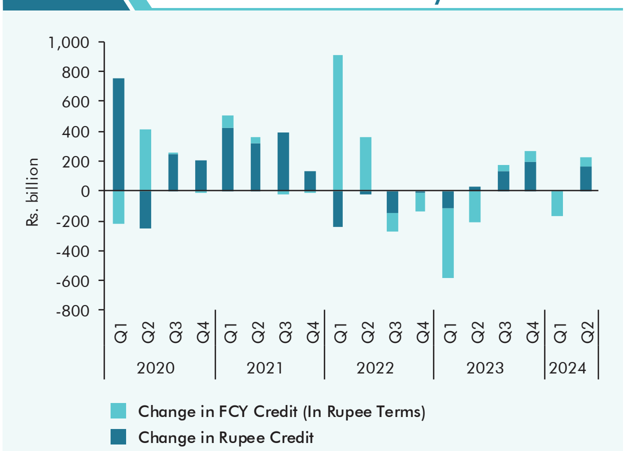
Source: Central Bank of Sri Lanka

during H1 of 2024. As at the end of Q2 of 2024, credit of the sector grew by 4.8 per cent, an expansion of Rs. 508.8 billion and reached Rs. 11.1 trillion, compared to a contraction of 10.1 per cent at end Q2 of 2023. Improvement in economic activities, stabilisation in NPLs, and increased demand for loans and receivables amidst comparably low interest rates mainly contributed for the credit expansion of the Banking sector.

Credit expansion during the year ending Q2 of 2024 was mainly supported by Rupee denominated credit. Rupee denominated credit of the Banking sector increased by Rs. 494.2 billion, accounting for 97.1 per cent of the credit expansion during the period. Meanwhile, FCY denominated credit grew by USD 123.5 million (Rs. 14.6 billion) during the year ending Q2 of 2024 mainly due to lending to overseas entities. Further, Domestic Systemically Important Banks (DSIBs) recorded the highest credit expansion, representing 76.7 per cent of the total credit expansion during the period under consideration. Credit of other domestic banks and foreign banks also increased, mainly driven by the increasing demand for loans amidst declining market interest rates. Going forward, with the improvement of liquidity positions of banks, expected growth in economic activities, easing of import restrictions, and improved business conditions followed by higher working capital requirements, credit growth of the banking sector is expected to accelerate.

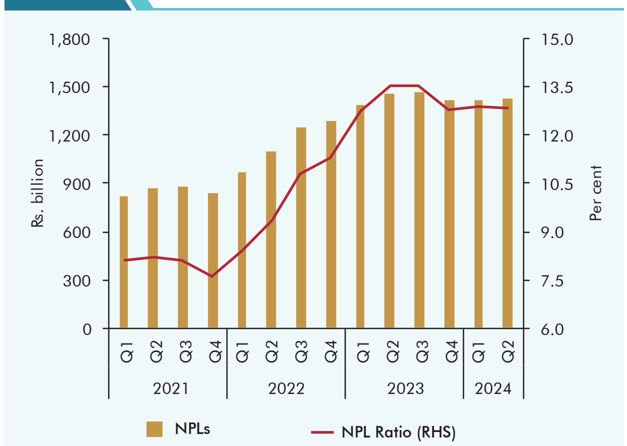
Overall default risk of the Banking sector declined at end Q2 of 2024 compared to the corresponding period of the previous year, as reflected by the contraction in NPLs. Although the NPL Ratio of

Figure 3.4 Quarterly Change in Credit based on Currency



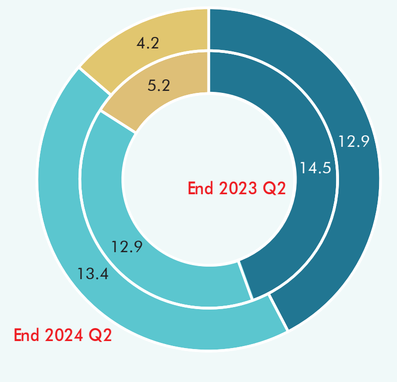
Source: Central Bank of Sri Lanka

Figure 3.6 NPL Ratio



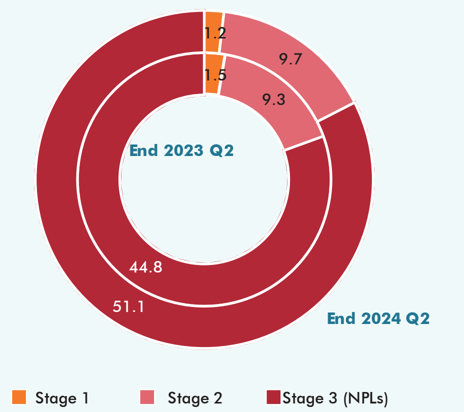
Source: Central Bank of Sri Lanka

Figure 3.7 NPL Ratio based on Bank Category (%)



Source: Central Bank of Sri Lanka

Figure 3.8 Provision Coverage Ratios (%)



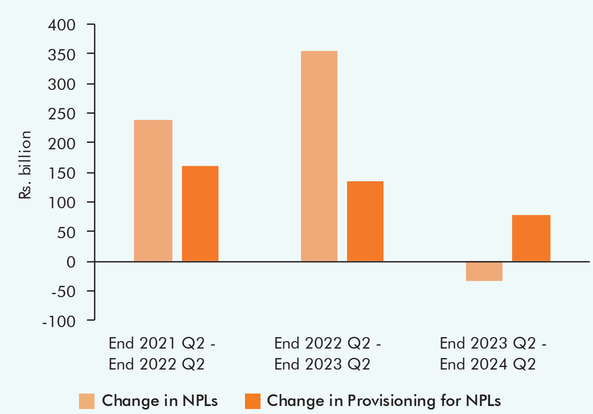
Source: Central Bank of Sri Lanka

the sector, as indicated by the Stage 3 Loans Ratio, marginally decreased to 12.8 per cent at end Q2 of 2024 compared to 13.5 per cent at end Q2 of 2023, it remained at an elevated level. A 2.2 per cent contraction in NPLs along with the expansion in credit contributed to the decline in the NPL Ratio of the Banking sector over the period. DSIBs and foreign banks reported declines in their respective NPL Ratios, while the NPL Ratio of other domestic banks increased to 13.4 per cent at end Q2 of 2024 compared to 12.9 per cent at end of the corresponding period of the previous year. This contrasted with the situation which prevailed at end Q2 of 2023 where DSIBs reported the highest default risk. Moreover, during H1 of 2024, as per the guidelines of the Central Bank, licensed banks reinforced their business revival units to support fundamentally viable businesses facing actual or potential financial difficulties to assist these borrowers in overcoming challenges, which will contribute to improve the asset quality.

The Provision Coverage Ratio for NPLs recorded a notable improvement at end Q2 of 2024 compared to end Q2 of 2023. The Provision Coverage Ratio, as measured by the Stage 3 Impairment Coverage, considerably improved to 51.1 per cent at end Q2 of 2024 compared to 44.8 per cent at the end of the corresponding period of the previous year. Despite the contraction in NPLs, the improvement in the Banking sector provisioning for NPLs indicates that banks have taken prudent measures to manage credit risk. This may provide more cushion for banks to absorb unexpected losses, particularly in an environment where Parate Executions have been suspended until 15 December 2024. As a best practice, banks may continuously be vigilant on potential losses arising from the suspension of Parate Executions as it could create a moral hazard among borrowers, which may lead to further defaults in coming periods.

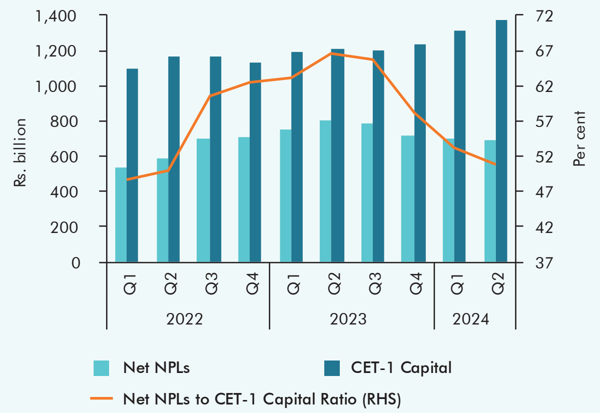
Increased provisioning amidst improved capital during the year ending Q2 of 2024 was also reflected by the decreasing Net NPLs to Common Equity Tier-1 (CET-1) Capital Ratio, which measures the capacity of high quality capital to absorb potential losses from defaults that have not been covered by provisioning. Net NPLs to CET-1 Capital Ratio significantly declined to 50.8 per cent at end Q2 of 2024 compared to 66.5 per cent at end Q2 of 2023. The contraction of Net NPLs by

Figure 3.9 Change in NPLs and Provisioning for NPLs



Source: Central Bank of Sri Lanka

Figure 3.10 Net NPLs to CET-1 Capital



Source: Central Bank of Sri Lanka

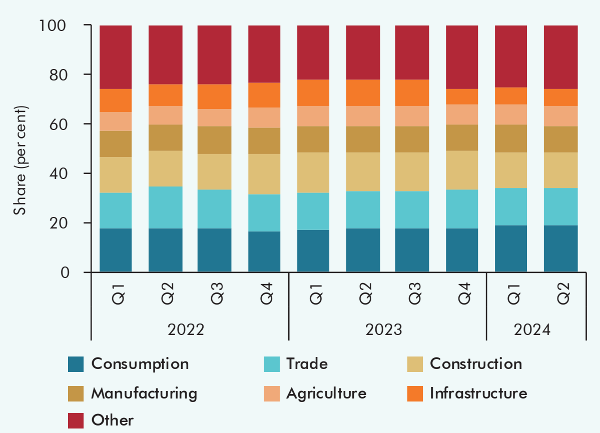
Figure 3.12 Sector wise Contribution to the Change in Credit during the Year ending Q2 of 2024

Source: Central Bank of Sri Lanka

13.7 per cent amidst the growth of CET-1 capital by 13.1 per cent at the end of the period contributed to the decline of the ratio, signifying the increased high quality capital to compensate potential losses arising from net NPLs.

Credit concentration of the Banking sector declined at end Q2 of 2024 compared to the corresponding period of the previous year, mainly due to the transferring of debt of a State Owned Enterprise (SOE) to the central Government as a part of the restructuring process of balance sheets of certain SOEs. Credit of the sector was mainly concentrated to the Consumption, Construction, Trade, Manufacturing, Agriculture, and Infrastructure sectors. Credit concentration to these sectors decreased to 74.1 per cent at end Q2 of 2024, compared to 77.8 per cent at end Q2

Figure 3.11 Sector wise Composition of Loans & Receivables

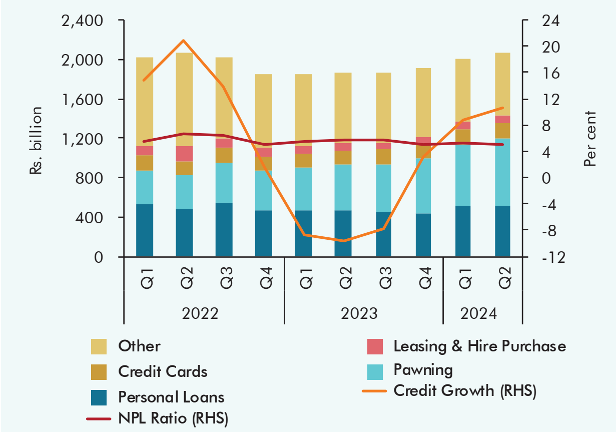


Source: Central Bank of Sri Lanka

of 2023. The main reason for this decline in credit concentration to the six main sectors was a credit transfer from the Infrastructure sector to the Ministry of Finance (MoF) which took place during Q4 of 2023, in respect of a state owned Licensed Commercial Bank (LCB) transferring the outstanding guaranteed debt of a major SOE to the central Government. Further, the appreciation of LKR against USD where FCY denominated loans are translated to LKR at a lower value also contributed to the decline in credit concentration. Accordingly, credit to the Infrastructure sector declined by Rs. 396.2 billion, while credit to MoF surged by Rs. 409.9 billion during the year ending Q2 of 2024. In addition, increase in credit of Consumption, Trade, Manufacturing, Overseas entities, and Agriculture sectors also contributed to the increase in overall credit of the Banking sector during the period concerned.

Consumption loans recovered from its contractionary trend since end Q4 of 2023, while the NPL Ratio moderated along with the expansion of credit. Consumption loans, which has the highest credit concentration of the banking sector, recorded a considerable credit growth of 10.7 per cent at end Q2 of 2024 compared to a credit contraction of 9.6 per cent at end Q2 of 2023. This credit expansion in the Consumption loans were mainly driven by the increase in Pawning activities which grew significantly by 48.3 per cent at end Q2 of 2024. This significant expansion in Pawning may be attributed to the imposition of a maximum lending

Figure 3.13 Credit to Consumption Activities



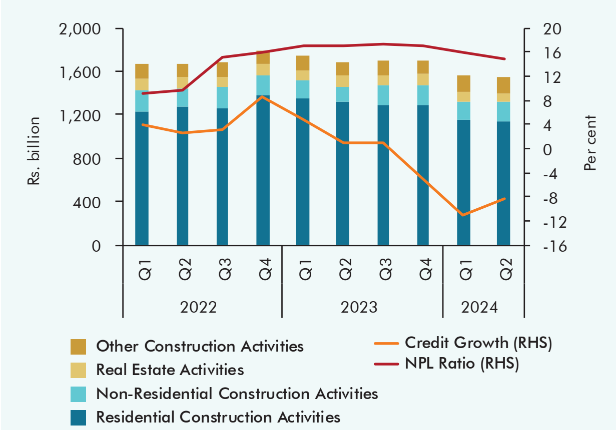
Source: Central Bank of Sri Lanka

rate for pawning facilities granted by banks. Overall NPLs of Consumption loans recorded a contraction of 2.8 per cent at end Q2 of 2024, and NPL Ratio declined to 5.0 per cent at end Q2 of 2024 from 5.7 per cent at the end of the corresponding period of the previous year, indicating a moderation of default risk of Consumption loans.

The Banking sector was highly exposed to the Construction industry while the industry recorded an elevated NPL Ratio. Credit to the Construction sector, which represented 14.1 per cent of the total credit portfolio of the Banking sector, recorded a credit contraction of 8.2 per cent at end Q2 of 2024 compared to a credit growth of 1.0 per cent at end Q2 of 2023. The Construction sector was highly concentrated on residential construction activities which contracted by Rs. 183.3 billion during the year ending Q2 of 2024. Nevertheless, a certain improvement in residential construction activities is expected in the upcoming periods along with declining cost of funds, downward adjustments in prices of construction materials, and revival of economic activities. Meanwhile, NPLs of the Construction sector contracted by 20.0 per cent during the year ending Q2 of 2024. Accordingly, the NPL Ratio of the sector considerably declined to 14.9 per cent at end Q2 of 2024 compared to 17.1 per cent at end Q2 of 2023. However, the NPL Ratio of the sector remained relatively high compared to several other economic sectors.

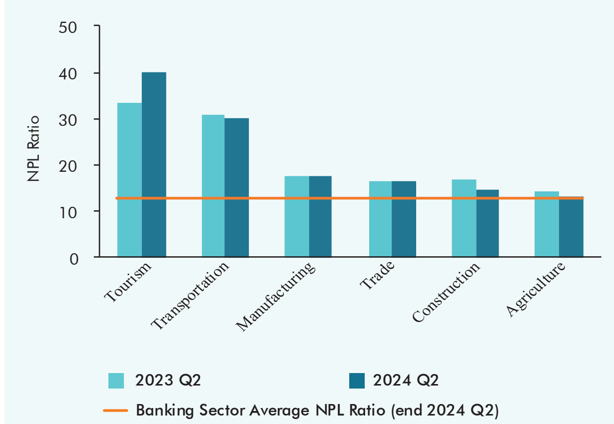
Despite the decline in the overall NPL Ratio, credit to certain economic sectors reported high NPL Ratios at end of the period under consideration. The Tourism sector has reported a significantly high NPL Ratio of 40 per cent, despite the improved performance of the sector in recent periods. Nevertheless, the Tourism sector represented only 3.8 per cent of the total credit of the Banking sector, indicating a lesser impact of default risk to the overall Banking sector. Furthermore, the Manufacturing, Trade, and Construction sectors, which each represented more than 10 per cent of credit of the Banking sector, also displayed high NPL Ratios, manifesting that the default risk has spanned through multiple important economic sectors of the country. Furthermore, climate related developments may pose a risk to the Banking sector due to the

Figure 3.14 Credit to Construction Sector



Source: Central Bank of Sri Lanka

Figure 3.15 Economic Sectors with High NPL Ratios

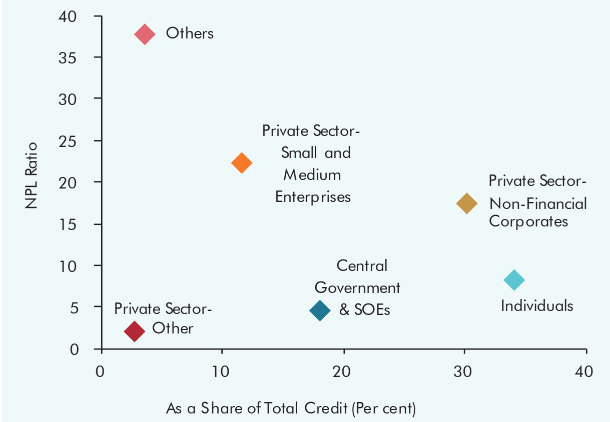


Source: Central Bank of Sri Lanka

sector's notable exposure to the Agriculture sector (8.4 per cent of total credit) with a relatively high NPL Ratio of 13.3 per cent at end Q2 of 2024. Nevertheless, downward trends in NPL Ratios were observed in many sectors during recent periods, manifesting a moderation of the default risk of the Banking sector.

Credit to private sector institutions, which includes Non-Financial Corporates (NFCs) and Small and Medium Enterprises (SMEs), represented the largest portion of the Banking sector credit, followed by credit to individuals. Private sector institutions accounted for 45.2 per cent of the total credit of the banking sector at end Q2 of 2024, and within the private sector, NFCs represented the largest share, which amounted to 30.9 per cent of the total Banking sector credit. Default risk of private sector institutions, as indicated by the NPL Ratio, was 17.5 per cent, which was higher than the average NPL Ratio of the banking sector of 12.8 per cent. Accordingly, sub-components of private sector institutions, i.e., NFCs and SMEs also reported high NPL ratios of 16.9 per cent and 21.9 per cent, respectively. Meanwhile, credit granted to individuals was significant, representing 34.1 per cent of the banking sector credit, however, default risk of the segment was considerably low at 7.6 per cent. Furthermore, government related entities also accounted for a material share of total credit of the sector.

Figure 3.17 Default Risk by Segment

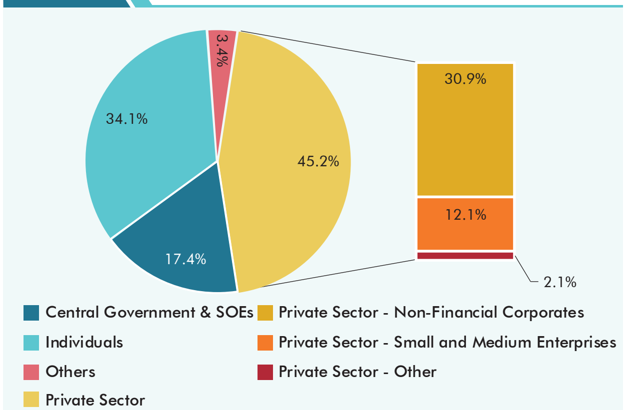


Source: Central Bank of Sri Lanka

Credit granted to Micro, Small, and Medium Enterprises (MSMEs[3]) was mainly concentrated into 5 economic sectors. Credit obtained by MSMEs in the Trade, Manufacturing, Construction and Infrastructure, Agriculture, and Tourism sectors represented 84.5 per cent of the credit granted to MSMEs by the Banking sector at end Q2 of 2024. Most of these sectors recorded extremely high NPL Ratios, reflecting the prevailing high default risk among MSME customers. Out of the 5 main sectors, the Tourism sector reported the highest NPL Ratio of 35.9 per cent. Hence, banks are expected to be vigilant on the credit risk arising from MSMEs.

3 MSMEs are classified as follows: annual turnover less than or equal Rs. 15 million - Micro, annual turnover greater than Rs. 15 million or less than or equal Rs. 250 million - Small, annual turnover greater than Rs. 250 million or less than or equal Rs. 1 billion - Medium.

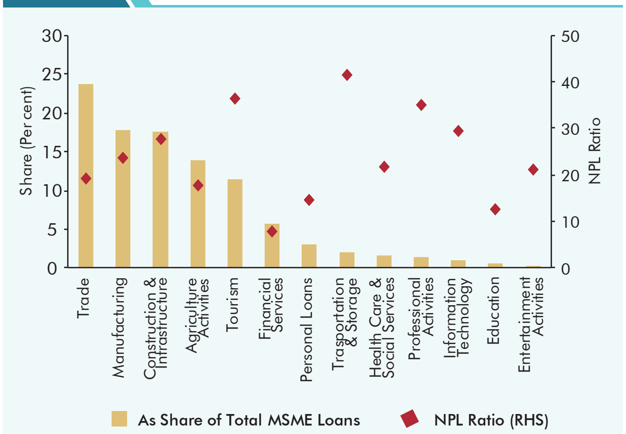
Figure 3.16 Credit Composition as at end Q2 of 2024*



* Central Government & SOEs represent loans to the Government, ministries, departments, SOEs, and any other Government-related entity.

Source: Central Bank of Sri Lanka

Figure 3.18 Composition and Default Risk of Credit to MSMEs



Source: Central Bank of Sri Lanka

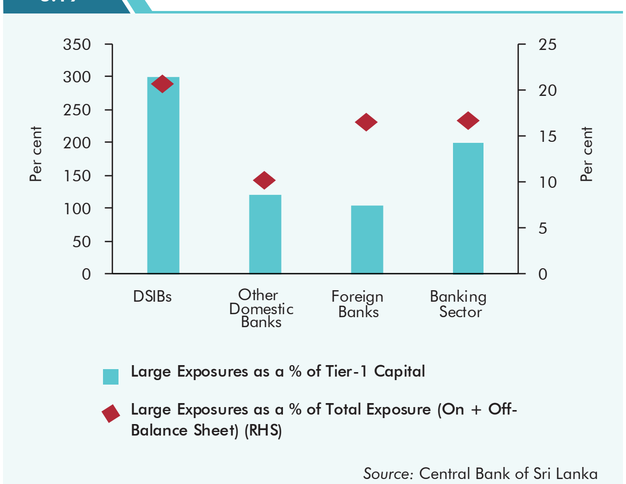
Large exposures[4] of the Banking sector represented approximately twice the sector's Tier-1 capital as at end Q2 of 2024. The cumulative value of large exposures of the Banking sector represented 198.9 per cent of the Tier-1 capital of the Banking sector at end Q2 of 2024. However, large exposures accounted for only 16.7 per cent of the total exposures of the sector, which included both on-balance sheet loans and receivable and off-balance sheet exposures. DSIBs represented 69.1 per cent of the large exposures of the banking sector, representing close to thrice of the Tier-1 capital of DSIBs, mainly due to the large exposures of the two state owned LCBs. Large exposures of the state owned LCBs mainly consisted of exposure to the central Government and SOEs, exposing these banks to sovereign risk. Large exposures of other domestic banks and foreign banks remained relatively low compared to DSIBs and mainly consisted for lending to private sector corporates. Furthermore, it was observed that several private sector groups of companies have large exposures to multiple banks, hence, a failure of such large groups might affect the credit quality of the sector. Considering the concentration risk arise from the large exposures, the Central Bank issued a more stringent direction on large exposures of licensed banks. However, as the economy is in the recovery mode to support the intermediation, implementation of the direction was made effective from 01 January 2026.

4 Large exposures shall mean those exposures of a licensed bank to an individual borrower or a group of connected borrowers, which is equal to or in excess of 10 per cent of the Tier-1 capital.

The Banking sector's exposure to the central Government and SOEs (sovereign exposure[5]) increased during the year ending Q2 of 2024, particularly through investments in Rupee denominated government securities. Sovereign exposure of the banking sector increased by Rs. 1.2 trillion from end Q2 of 2023 to end Q2 of 2024 and reached Rs. 9.5 trillion. Accordingly, sovereign exposure amounted to 45.7 per cent of the Banking sector's total assets. During this period, investments in Treasury Bills and Treasury Bonds increased by Rs. 1.4 trillion and accounted for 74.1 per cent of the total sovereign exposure. Meanwhile, credit to the central Government surged and credit to SOEs declined, mainly due to the absorption of certain credit facilities of the Ceylon Petroleum Corporation (CPC) by the central Government, in line with the restructuring of balance sheets of selected SOEs. Furthermore, the sector completed the divestment in Sri Lanka Development Bonds (SLDBs) under the Domestic Debt Optimisation (DDO) programme during the period, which reduced the Banking sector's exposure to the sovereign by Rs. 225.1 billion.

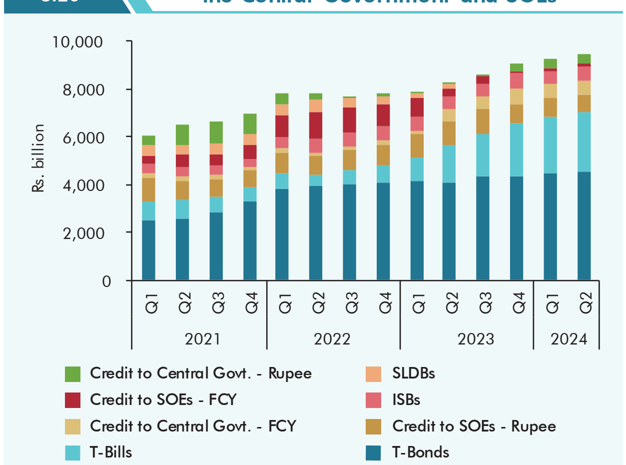
5 Sovereign exposure of the banking sector includes the investments made by licensed banks in Sri Lanka Development Bonds (SLDBs), International Sovereign Bonds (ISBs), Treasury Bonds (T-bonds), Treasury Bills (T-bills), and loans & advances granted by licensed banks to the central Government and SOEs in both foreign currency and rupees.

Figure 3.19 Large Exposures



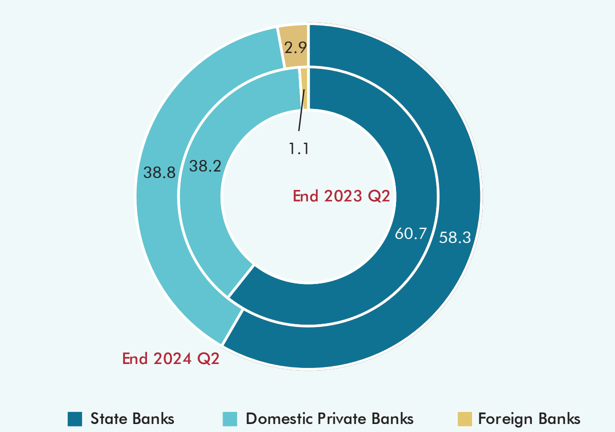
Source: Central Bank of Sri Lanka

Figure 3.20 Banking Sector Exposure to the Central Government and SOEs



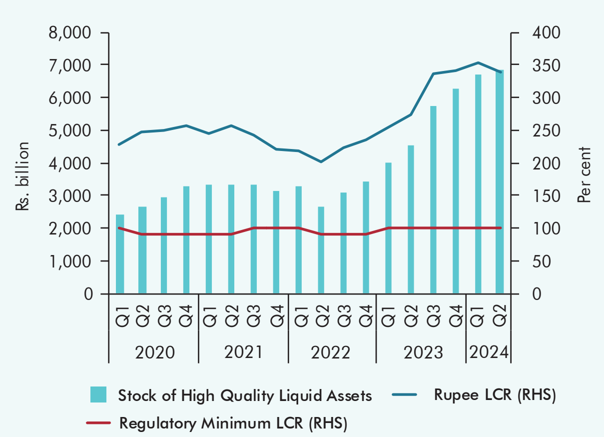
Source: Central Bank of Sri Lanka

Figure 3.21 Sovereign Exposure by Bank Category (%)



Source: Central Bank of Sri Lanka

Figure 3.22 Rupee LCR



Source: Central Bank of Sri Lanka

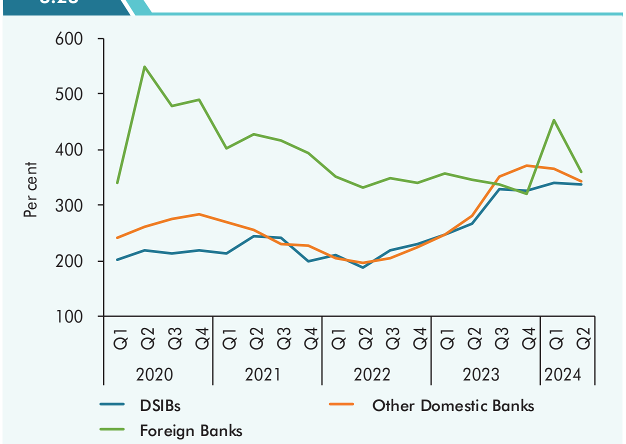
Although state banks remained highly exposed to the sovereign, their share of sovereign exposure slightly declined at end Q2 of 2024 compared to end Q2 of 2023. State banks represented 58.3 per cent of the total sovereign exposure at end Q2 of 2024, a decline from 60.7 per cent at end of the corresponding period of the previous year. This was mainly due to the increase in sovereign exposures of domestic private banks and foreign banks through investments in Rupee denominated government securities. The sovereign exposure of foreign banks grew notably by 196.9 per cent at end Q2 of 2024 compared to end Q2 of 2023, although foreign banks accounted for only 2.9 per cent of the sovereign exposure of the Banking sector.

Liquidity Risk

Rupee liquidity condition of the Banking sector, as measured by the Rupee Liquidity Coverage Ratios (LCR), significantly improved at end Q2 of 2024 compared to end Q2 of 2023 mainly due to increased investments in government securities. Rupee LCR of the Banking sector improved to 339.9 per cent at end Q2 of 2024 compared to 274.7 per cent at end Q2 of 2023 and stood well above the minimum regulatory requirement of 100 per cent, indicating that banks possess adequate High Quality Liquid Assets (HQLA) to meet any possible net cash outflow requirements. Rupee HQLA of the sector expanded by Rs. 2.3 trillion from end Q2 of 2023 to end Q2 of 2024, contributing to the improvement of the Rupee LCR. Rupee HQLA of DSIBs considerably increased during the period under consideration and accounted for 62.9 per cent of the total expansion of Rupee HQLA of the sector. Consequently, although Rupee LCR of domestic banks significantly improved during the year ending Q2 of 2024, it remained slightly below the Rupee LCR of foreign banks at the end of the period.

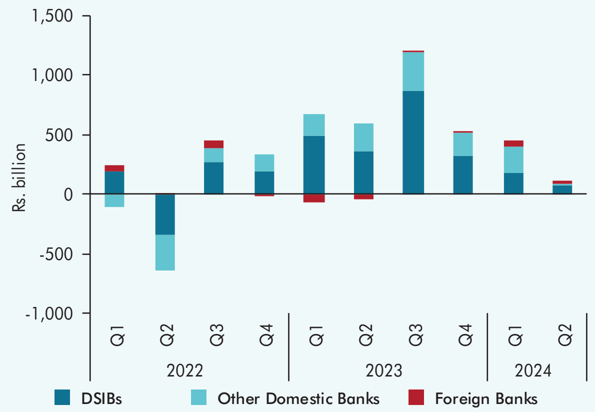
All-Currency LCR and Net Stable Funding Ratio (NSFR), which are indicators of overall liquidity of the Banking sector, improved at end Q2 of 2024 compared to the corresponding period of the previous year. All-Currency LCR of the Banking sector improved to 293.5 per cent at end Q2 of 2024 compared to 224.6 per cent at end Q2 of 2023, while NSFR improved to 163.6 per cent at end Q2 of 2024 compared to 149.2 per cent at the end of the corresponding period of the previous year, indicating

Figure 3.23 Rupee LCR based on Bank Category



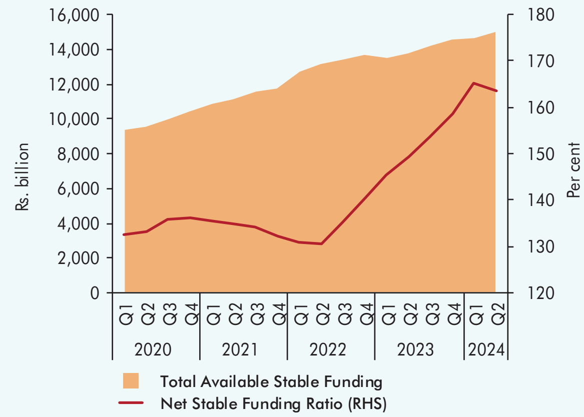
Source: Central Bank of Sri Lanka

Figure 3.24 Quarterly Change of Rupee HQLA by Bank Category



Source: Central Bank of Sri Lanka

Figure 3.26 NSFR



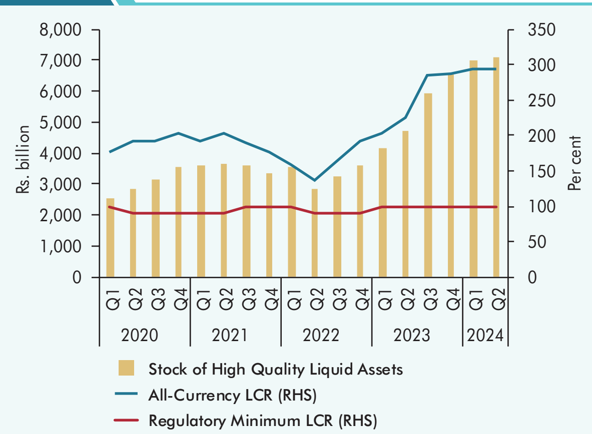
Source: Central Bank of Sri Lanka

that banks possess adequate stable funding to cover their long term assets and are better positioned to withstand funding shocks.

The increase in total HQLA[6] predominantly in the form of government securities highlights the dependence of banks on the marketability of such securities for liquidity. As at end Q2 of 2024, 90.7 per cent of total HQLA of the Banking sector comprised of level 1 qualifying marketable securities with a 0 per cent risk weight issued/ guaranteed by sovereigns, which were mostly Treasury bills and Treasury bonds. Banks continued to invest in government securities as it provided a steady source of income for banks despite the decline in yields during the period under review, in an environment of limited demand for credit. Accordingly, government securities recorded a growth of 65.0 per cent during the period under consideration, contributing to the expansion of HQLA. This poses a concentration risk in the liquid asset portfolio of the sector. Furthermore, it was observed that foreign banks which significantly reduced their investments in government securities during 2022 and 2023 in order to limit their exposure to the sovereign, have invested a considerable amount of their excess cash in government securities in the first half of 2024, despite the Central Bank revoking restrictions on accessing the Standing Facilities for licensed banks. This signifies an improvement in risk perception of foreign banks on government securities in post DDO and improving fiscal conditions.

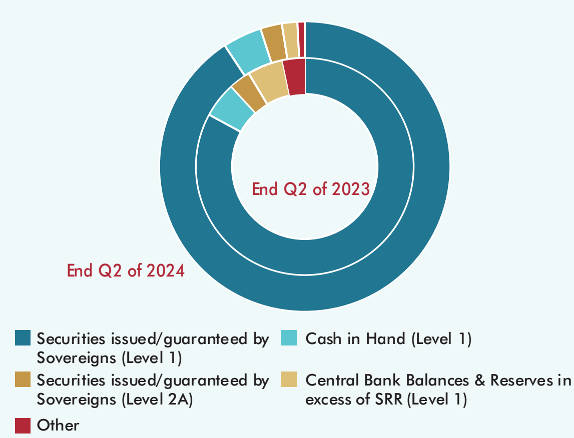
6 Total HQLA denominated in all currencies.

Figure 3.25 All-Currency LCR



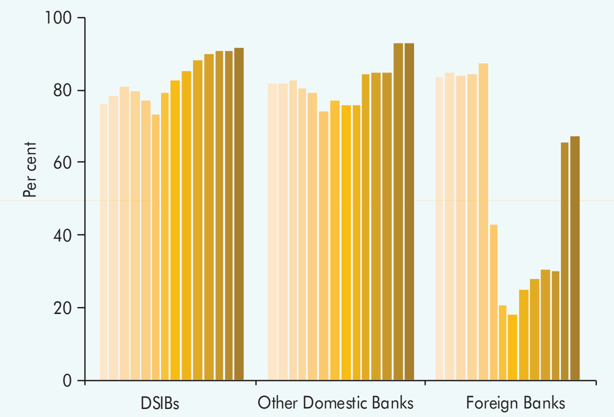
Source: Central Bank of Sri Lanka

Figure 3.27 Composition of HQLA (All Currency)



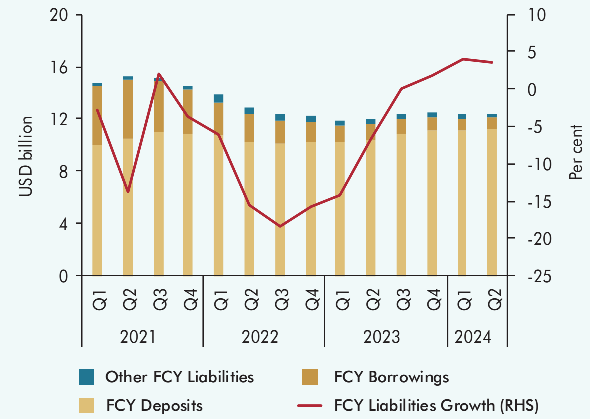
Source: Central Bank of Sri Lanka

Figure 3.28 Level 1 Securities issued/guaranteed by Sovereigns as a share of Total HQLA (End 2021 Q1 to End 2024 Q2)



Source: Central Bank of Sri Lanka

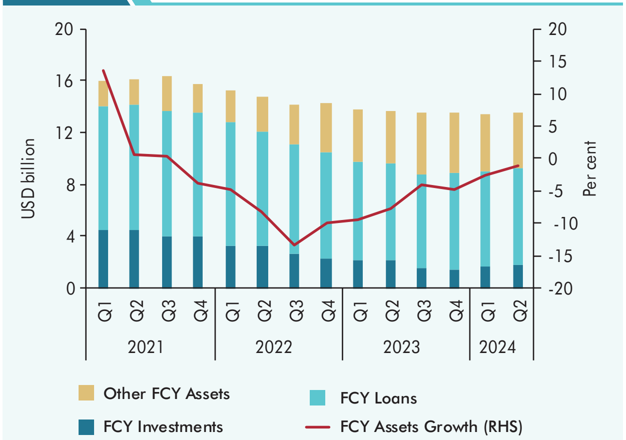
Figure 3.30 FCY Liability Composition



Source: Central Bank of Sri Lanka

Net FCY Assets of the Banking sector continued to contract at end Q2 of 2024 as FCY assets remained contracted while FCY liabilities continued to grow. Total FCY assets of the Banking sector contracted by 1.2 per cent and stood at USD 13.5 billion at end Q2 of 2024, compared to a 7.9 per cent contraction at end Q2 of 2023. This contraction in FCY assets was mainly due to the decline in FCY investments which recorded a contraction of 20.7 per cent at end Q2 of 2024. FCY investments declined primarily as a result of the settlement of SLDBs under the DDO programme. However, FCY loans and receivables grew by 1.7 per cent at the end of the period under consideration, indicating the improving demand for credit amidst revival of economic activity. Furthermore, other FCY assets, which accounted for 31.3 per cent of the total FCY assets, recorded a growth of 4.0 per cent, driven by the increased placements of banks in financial institutions abroad. On the other hand, total FCY liabilities of the Banking sector grew by 3.6 per cent, reaching USD 12.4 billion at the end of Q2 of 2024, compared to a contraction of 6.7 per cent at end of the corresponding period of the previous year. This growth in FCY liabilities was mainly due to FCY deposits, which have been growing continuously since Q2 of 2023. However, FCY borrowings recorded a contraction of 28.8 per cent, reflecting a reduced propensity or necessity for banks to secure new FCY debt and/or renew existing debt arrangements. Overall, the rate of contraction in FCY operations is slowing down and further improvement in FCY operations is expected in coming periods, along with the positive macroeconomic developments.

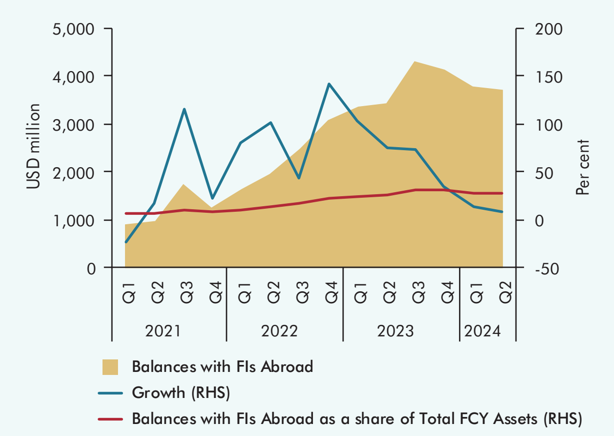
Figure 3.29 FCY Asset Composition



Source: Central Bank of Sri Lanka

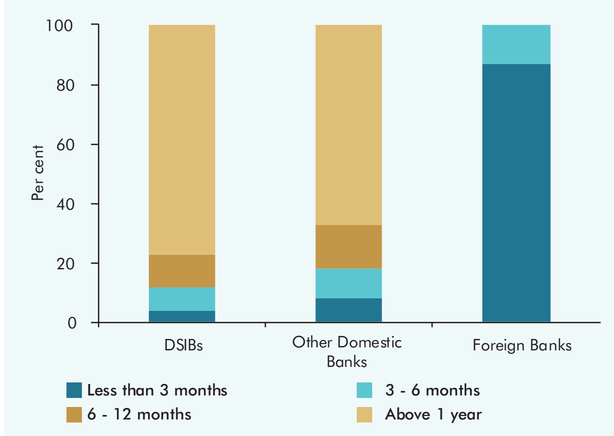
The Banking sector maintained a considerable amount of FCY funds with financial institutions abroad for the prudential liquidity risk management. The Banking sector significantly improved their balances with financial institutions abroad since 2021 to meet their liquidity needs in FCY, in an environment where a FCY liquidity deficit was prevailing in the domestic forex market. This enabled banks to maintain their ability to meet FCY obligations and facilitate the importation of necessities. As at end Q2 of 2024, the Banking sector maintained a balance of USD 3.7 billion with financial institutions abroad with a growth of 8.7 per cent. However, higher accumulation of funds

Figure 3.31
FCY Balances with Financial Institutions (FIs) Abroad



Source: Central Bank of Sri Lanka

Figure 3.33
Maturity of FCY Borrowings by Bank Category



Source: Central Bank of Sri Lanka

abroad may reduce the profitability of the Banking sector due to tying up of funds that might otherwise be used for more profitable investments. Nevertheless, it was observed that such balances declined over the past 3 quarters, mainly due to the decline in balances of domestic banks which are not DSIBs and foreign banks. DSIBs maintained the highest amount of balances with financial institutions abroad of USD 1.6 billion while foreign banks also possessed a significant amount of balances amounting to USD 1.5 billion, at end Q2 of 2024.

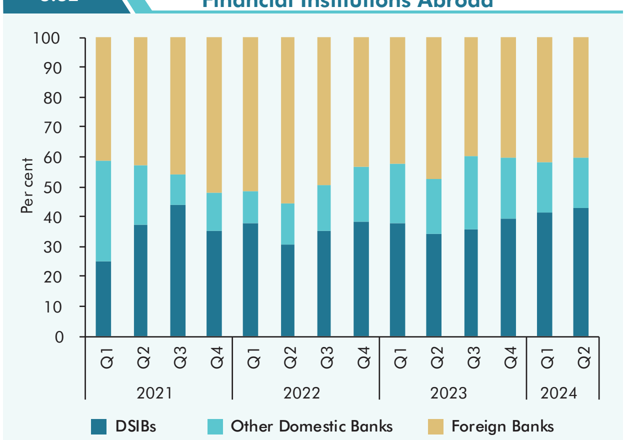
FCY borrowings of the Banking sector further declined as many banks have settled their obligations during the period. FCY borrowings of the Banking sector stood at USD 836 million at end Q2 of 2024. Out of the total FCY borrowings of domestic banks, 72.3 per cent were expected to be maturing in more than 1 year from end Q2 of 2024, which signifies less stress on the short term FCY liquidity of these banks. Furthermore, due to the maintenance of a positive net FCY asset position at the end of the period under consideration, the Banking sector is expected to service their outstanding obligations without difficulty.

Unsecured wholesale funding[7] of the Banking sector recorded a higher growth than retail funding[8] during past periods, indicating a relatively higher funding risk to some banks. Retail funding

7 Include i) operational deposits generated by clearing, custody and cash management activities, ii) cooperative banks in an institutional network (qualifying deposits with the centralised institution), iii) non-financial corporates, sovereigns, central banks, MDBs and Public Sector Enterprises, iv) other legal entity customers.

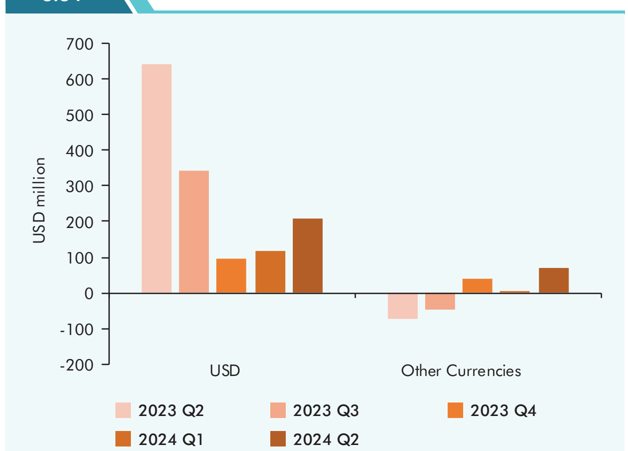
8 Include i) demand, savings, and term deposits (less than 30 days maturity), ii) term deposits with residual maturity greater than 30 days.

Figure 3.32
Composition of FCY Balances with Financial Institutions Abroad



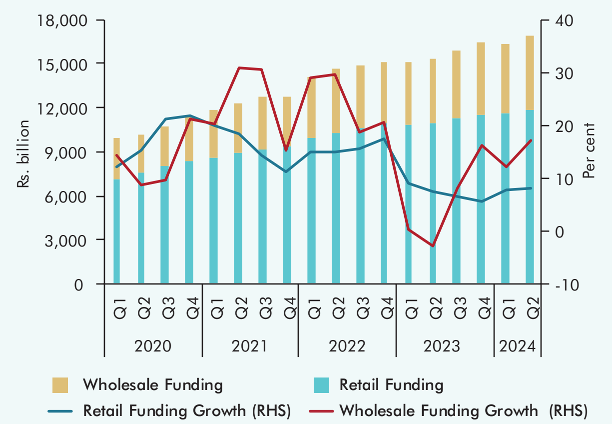
Source: Central Bank of Sri Lanka

Figure 3.34
Net FCY Asset Position (On-Balance Sheet)



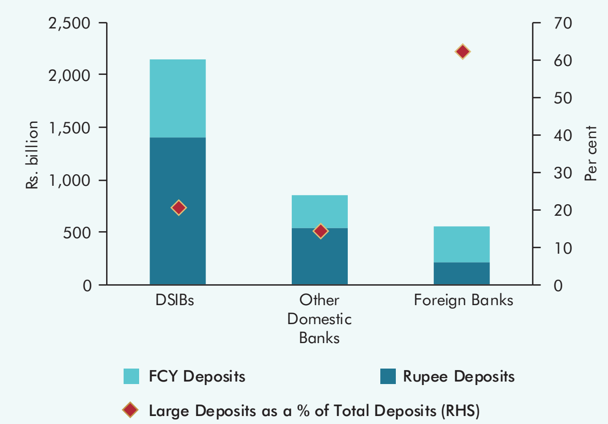
Source: Central Bank of Sri Lanka

Figure 3.35 Retail and Wholesale Funds



Source: Central Bank of Sri Lanka

Figure 3.37 Large Depositors by Bank Category



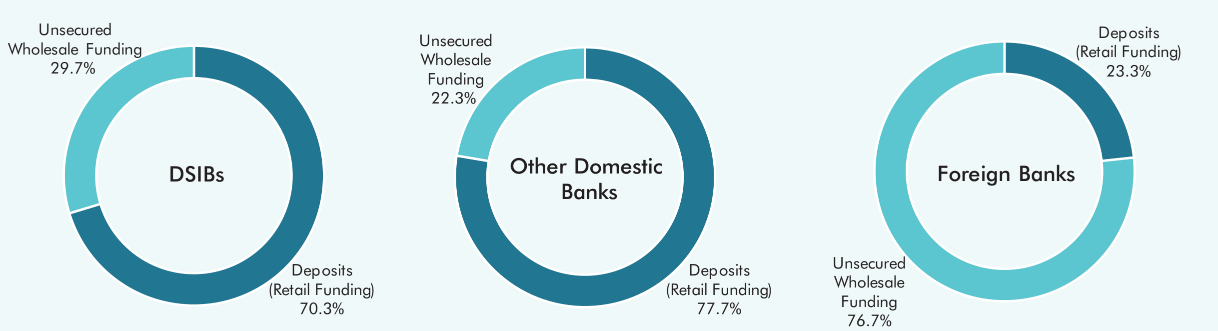
Source: Central Bank of Sri Lanka

of the Banking sector amounted to Rs. 11.9 trillion, while unsecured wholesale funding amounted to Rs. 5.0 trillion at end Q2 of 2024. When the past 4-year period is considered, retail funding of the Banking sector grew by 57.7 per cent, while wholesale funding grew at a higher rate by 92.9 per cent. Hence, a tendency towards wholesale funding was observed in the sector. Also, in an environment of an easing monetary policy cycle, low interest rates offered to retail funds could further slowdown the growth of retail funds. Moreover, it was observed that foreign banks were mainly dependent on wholesale funding to fund their operations in line with their business models, while DSIBs also possessed a notable amount of wholesale funds. Wholesale funding often involves larger transactions/deposits with a smaller number of counterparties; mostly institutional investors such as NFCs, public sector enterprises, sovereigns, etc. If banks become increasingly dependent on wholesale sources, and such sources withdraw or become unavailable, banks could face liquidity shortages. Furthermore, wholesale funds are more sensitive to market fluctuations such as interest rates, liquidity constraints, risk perceptions, etc., making such funds less stable than retail funds. Hence, banks with a considerable amount of wholesale funds may be required to maintain adequate HQLA to compensate possible outflows of such funds.

The diversified funding base of domestic banks in comparison to foreign banks was further evidenced by the analysis of large depositors. On average, large depositors[9] of foreign banks represented 62.4 per cent of their total deposits

9 This analysis was carried out using the data of the largest 50 depositors of each licensed bank as at end Q2 of 2024.

Figure 3.36 Retail and Wholesale Funds by Bank Category

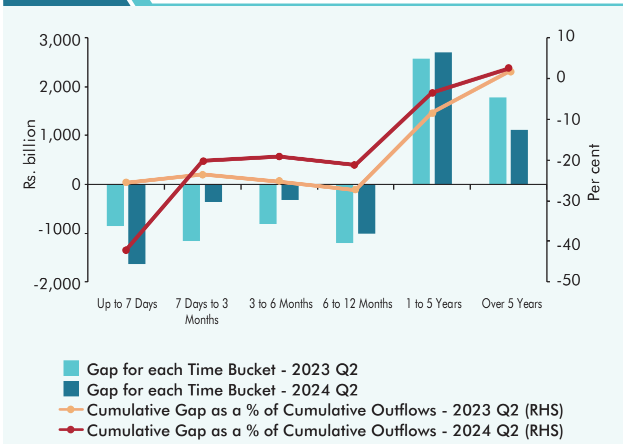


Source: Central Bank of Sri Lanka

at end Q2 of 2024. In contrast, large depositors of DSIBs and other domestic banks accounted for only 20.7 per cent and 14.7 per cent, respectively, of their total deposits, denoting that domestic banks possess a large retail customer base compared to foreign banks.

The cumulative maturity gap of the Banking sector has generally narrowed across most time horizons at end Q2 of 2024 compared to end Q2 of 2023, reflecting an improvement in liquidity risk management. Maturity gap analysis reveals that while banks are maintaining positive gaps, holding more assets than liabilities in long term horizons (over 12 months), they are also maintaining negative maturity gaps in short-term horizons. This negative gap in the short term could place pressure on banks to meet their immediate obligations, potentially increasing liquidity risk. However, a notable decrease in the maturity gap for the 3 to 6 months and 6 to 12 months baskets is observed at end Q2 of 2024 compared to the same period in the previous year, which indicates a significant reduction in short term funding pressures. This improvement suggests that banks are becoming more efficient in managing their short term liquidity needs. To sustain and further enhance their liquidity positions, banks could continue to implement and possibly strengthen prudential measures in managing their short term liquidity, ensuring they are well-prepared to meet both expected and unexpected funding requirements.

Figure 3.38 Maturity Gap by Time Period



Source: Central Bank of Sri Lanka

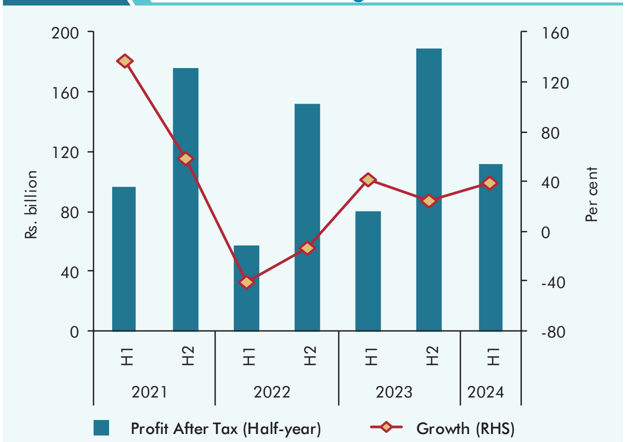
Profitability

Net profit of the Banking sector significantly increased during the first half (H1) of 2024 compared to the H1 of 2023 mainly due to the substantial reduction in interest expense. The Banking sector reported a Profit After Tax (PAT) of Rs. 111.8 billion during the H1 of 2024 compared to Rs. 80.5 billion during H1 of 2023, recording a growth of 38.8 per cent in the period under review.

Despite the overall improvement in PAT of the Banking sector during the H1 of 2024, PAT of foreign banks declined. Accordingly, although overall PAT of the Banking sector increased by 38.8 per cent, growth of foreign banks declined by 17.5 per cent during H1 of 2024, mainly due to decline in Net Interest Income (NII). Comparative downward rigidity in the cost of funding may be attributed to the declining NII of the foreign banks since they highly depend on wholesale funding. Hence, the profit growth in the Banking sector was mainly supported by DSIBs and other domestic banks, which recorded growth rates of 65.5 per cent and 62.9 per cent, respectively, during the H1 of 2024.

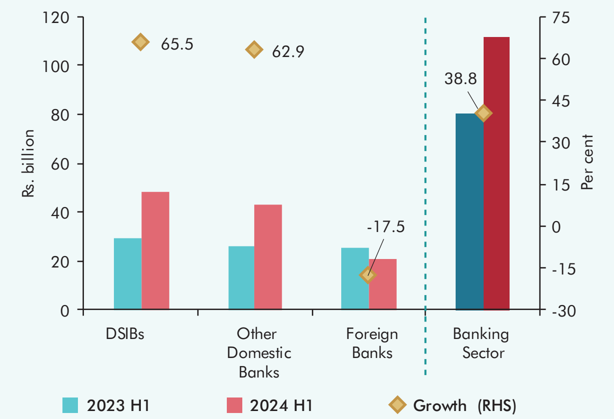
Increased NII mainly contributed to the increased profitability of the Banking sector during H1 of 2024. NII of the Banking sector increased to Rs. 395.1 billion in H1 of 2024 from Rs. 336.4 billion in H1 of 2023. Moreover, as the growth was supported by a notable decline in interest expenses, stemming from the reduction in deposit rates outpacing that of lending rates, highlighting the inherent downward

Figure 3.39 Half-Year (Cumulative) PAT of the Banking Sector



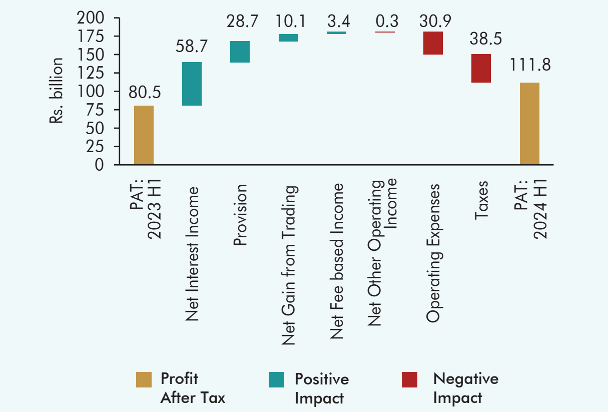
Source: Central Bank of Sri Lanka

Figure 3.40 Bank Category wise PAT



Source: Central Bank of Sri Lanka

Figure 3.42 Impact of Income and Expenses on PAT during H1 of 2024



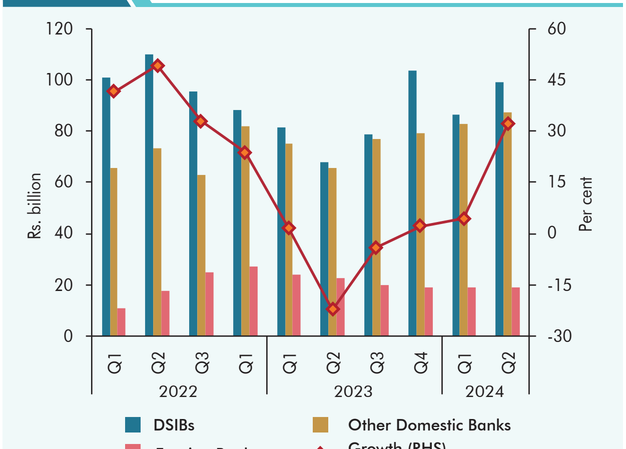
Source: Central Bank of Sri Lanka

rigidity in lending rates within the banking sector. Despite decreases in policy rates, lending rates have not decreased proportionately in line with the broader monetary policy shifts. Further, during H1 of 2024, the sector reported new provisions of Rs. 47.9 billion, compared to Rs. 76.6 billion in H1 of 2023. In addition, increased net gains from trading (by Rs. 10.1 billion) also contributed to the amplified profits compared to H1 of 2023. However, the increase in taxes and operating expenses along with decline in other operating income, adversely impacted on the profitability of the Banking sector during H1 of 2024 compared to H1 of 2023.

Although new provisions were relatively lower during H1 of 2024 when compared to H1 of 2023, there was a gradual improvement in total provision of the Banking sector since Q1 of 2022. The sector recorded an accumulated provision, which includes total provision on loans & receivables, investments, and off-balance sheet exposures, of Rs. 1,316.3 billion at end Q2 of 2024 covering 6.3 per cent of total exposure while provision for NPLs covered 49.8 per cent of total NPLs exposure of the Banking sector.

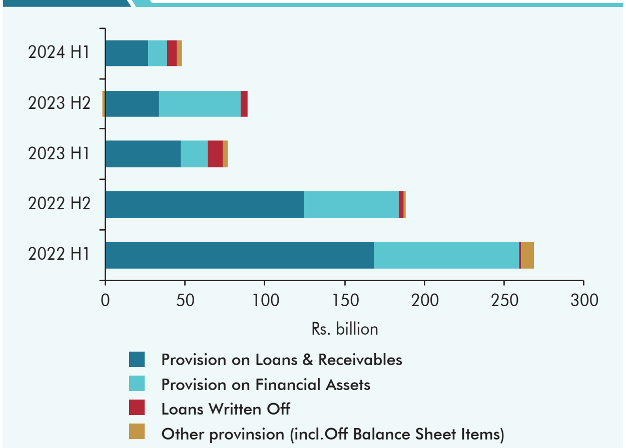
Return on Equity (ROE) and Return on Assets (ROA) of the Banking sector improved considerably during H1 of 2024. ROE of the Banking sector improved to 12.7 per cent during H1 of 2024, compared to 10.2 per cent reported during H1 of 2023. Meanwhile, ROA of the Banking sector followed a similar trend to ROE and increased to 1.8 per cent during H1 of 2024 from 1.3 per cent during H1 of 2023. However, ROE of foreign banks notably decreased to 11.2 per cent during the H1 of

Figure 3.41 NII by Bank Category



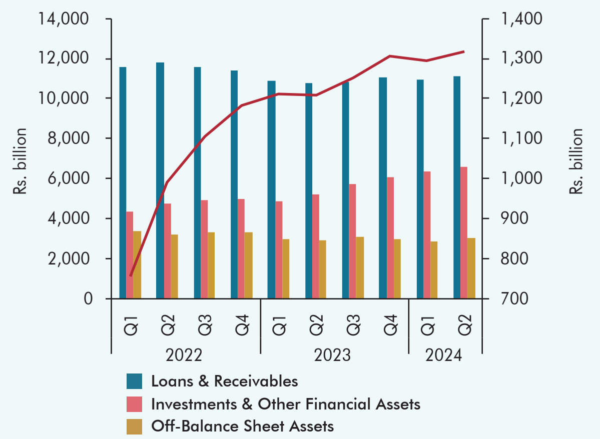
Source: Central Bank of Sri Lanka

Figure 3.43 New Provisions Charged on Assets



Source: Central Bank of Sri Lanka

Figure 3.44 Exposure and Total Provisions



Source: Central Bank of Sri Lanka

Figure 3.46 ROE by Bank Category

Source: Central Bank of Sri Lanka

2024 compared to 16.9 per cent in the H1 of 2023 reflecting the decline in PAT during the H1 of 2024. Net Interest Margin (NIM) of the Banking sector increased to 3.9 per cent during H1 of 2024 from 3.5 per cent at the end of H1 of 2023, depicting the fact that the sector has earned more from its interest earning assets compared to its expenses on interest bearing liabilities.

Since the Banking sector gradually diverted its funds into investments in risk free Treasury securities, the Return on Risk Weighted Assets (RoRWA)[10] showed a clear improving trend from 2022, indicating better returns on risk-weighted assets (RWA) over time. The RoRWA considerably increased to 3.9 per cent in H1 of 2024 compared to 2.7 per cent in 2023 in H1 of 2023. Further, RWA Density[11] has been on a declining trend indicating a reduction in the proportion of RWA relative to total assets, due to the shift towards lower risk assets such as Treasury bills and Treasury bonds in the Banking sector. However, this may reverse with the expected credit expansion in improved macroeconomic conditions.

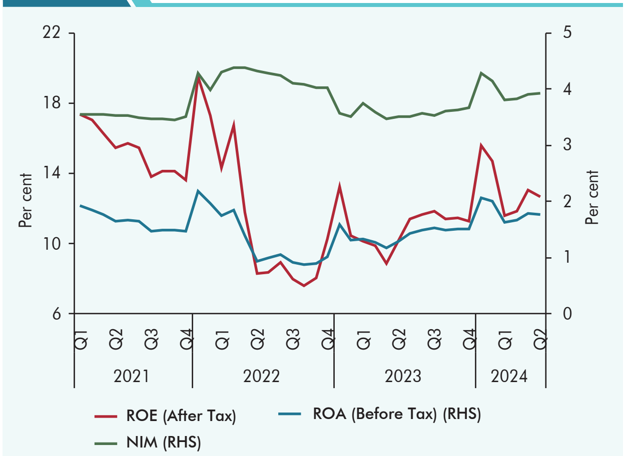
Market Risk

The interest sensitive assets and liabilities composition of the sector indicates a positive outlook for potential net interest income in the current monetary easing cycle. With a larger portion of interest rate sensitive liabilities are to be matured

10 RoRWA is a ratio where the numerator represents the returns or profits generated by the bank, and the denominator is the risk-adjusted measure of the bank's total assets. This metric reveals the cost efficiency per unit of risk a bank is generating.

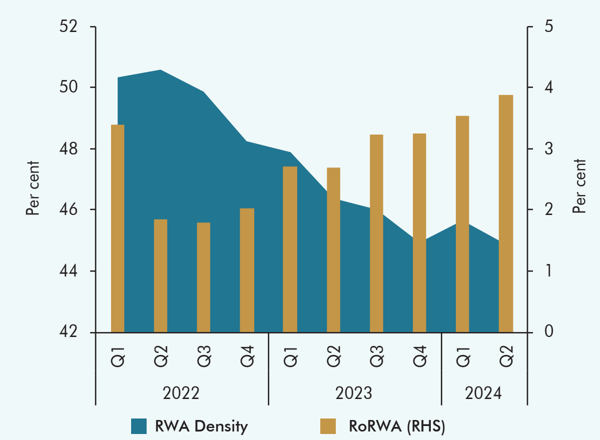
11 RWA Density is the percentage of risk weighted assets relative to total assets.

Figure 3.45 Profitability Ratios



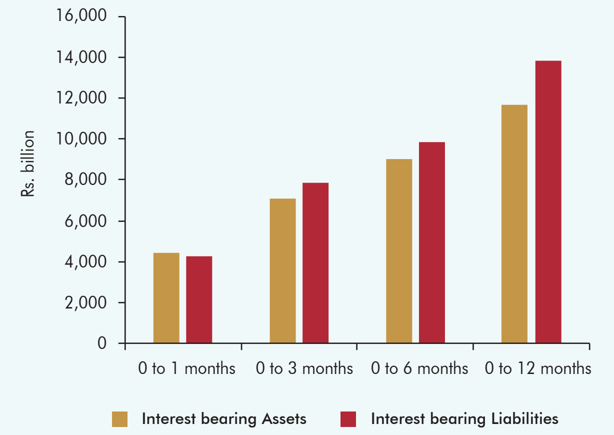
Source: Central Bank of Sri Lanka

Figure 3.47 Return on RWA and RWA Density



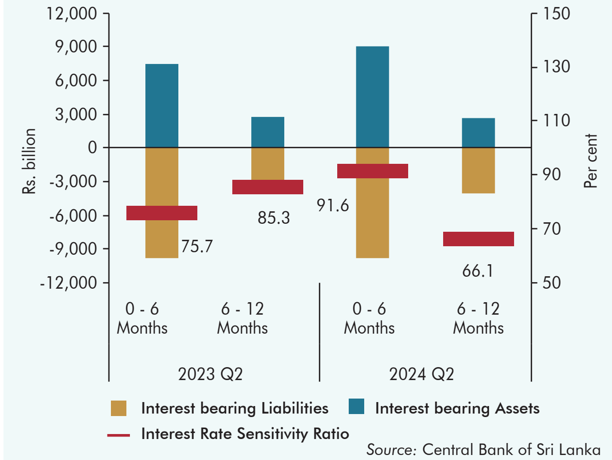
Source: Central Bank of Sri Lanka

Figure 3.48 Interest bearing Assets and Liabilities as at end June 2024



Source: Central Bank of Sri Lanka

Figure 3.49 Interest Rate Sensitivity Ratio



Source: Central Bank of Sri Lanka

over the next 12 months starting from July 2024 than interest rate sensitive assets, banks are likely to benefit in prevailing low-interest rate regime. As interest rates decline, these maturing liabilities can be refinanced at lower costs, reducing interest expenses. Meanwhile, the less sensitive and longer-maturing assets may continue to yield income at higher rates, thereby enhancing the sector's profitability. However, if the economy moved into a higher interest rate path in the future, it may pose a risk to the Banking sector with the current assets and liabilities composition.

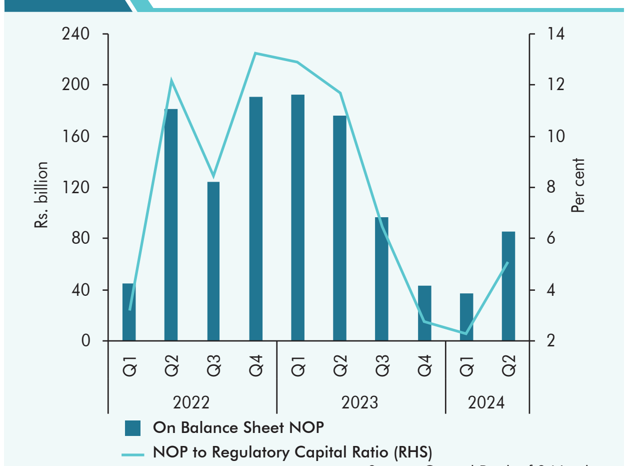
The Banking sector encountered challenges during the year due to shifts in the structure of interest bearing assets and liabilities compared to a year ago. The Interest Rate Sensitivity Ratio[12] for up to 6 months horizon, increased to 91.6 per cent at end Q2 of 2024 from 75.7 per cent at end Q2 of 2023, whereas the Interest Rate Sensitivity Ratio in 6-12 months horizon declined to 66.1 per cent at end Q2 of 2024 compared to 85.3 per cent in Q2 of 2023. This is also observed from the higher share of interest bearing assets up to 6 months as the share of total interest bearing assets stood at 77.3 per cent at end Q2 of 2024 compared to 73.1 per cent at end Q2 of 2023. Simultaneously, interest bearing liabilities up to 6 months as a share of total interest bearing liabilities decreased to 71.0 per cent at end Q2 of 2024, compared to 75.4 per cent at end Q2 of 2023. Maintaining a higher sensitivity ratio in the very short time horizon may be challenging for banks in repricing during the period of declining interest rates. Therefore, banks must remain vigilant in managing interest sensitive asset-liability mismatches, as this will be critical for maintaining profitability amid changing market conditions.

On Balance Sheet Net Open Position (NOP)[13] to Regulatory Capital Ratio of the banking sector significantly declined at end Q2 of 2024 in comparison to Q2 of 2023. By the end Q2 of 2024, the Banking sector recorded a NOP to Regulatory Capital ratio of 5.1 per cent compared to 11.7 per cent recorded at end Q2 of 2023, due to substantial reduction in the NOP of banks and

12 The Interest Rate Sensitivity Ratio is calculated as the proportion of Interest bearing Assets to Interest bearing Liabilities during the specified period.

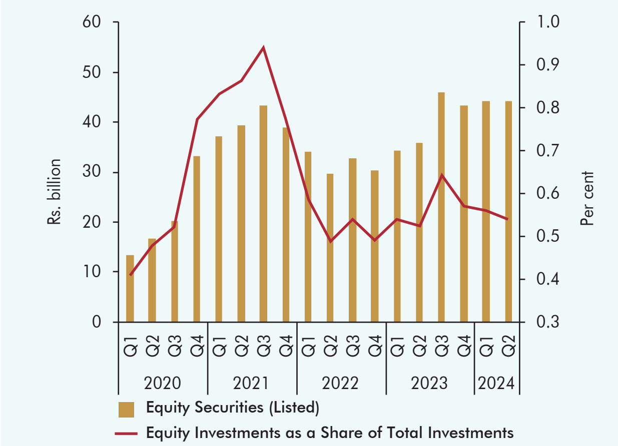
13 The Net Open Position (NOP) refers to the difference between the sector's FCY assets and its FCY liabilities (on-balance sheet position).

Figure 3.50 NOP to Regulatory Capital



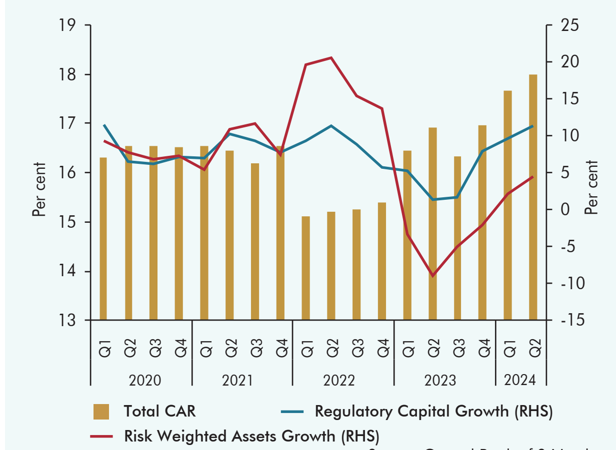
Source: Central Bank of Sri Lanka

Figure 3.51 Equity Investments



Source: Central Bank of Sri Lanka

Figure 3.52 Capital Adequacy Ratio



Source: Central Bank of Sri Lanka

increased regulatory capital. Accordingly, NOP reduced to Rs. 85.3 billion at end Q2 of 2024 compared to Rs. 176.1 billion at end Q2 of 2023, whereas the Regulatory Capital increased to Rs. 1,684.4 billion at end Q2 of 2024 from Rs. 1,506.3 billion at end Q2 of 2023.

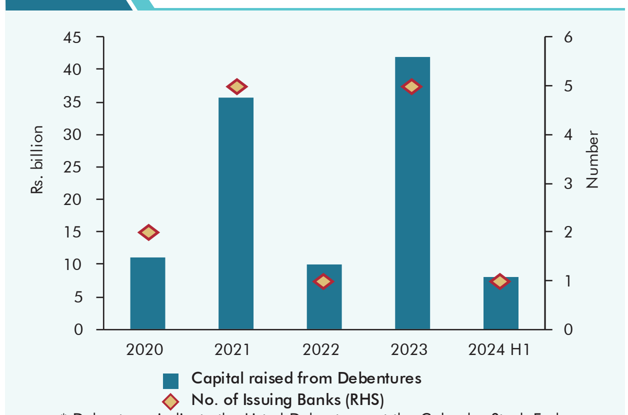
Equity risk of the Banking sector remained minimum at end Q2 of 2024. The equities reported under the fair value through profit or loss and fair value through other comprehensive income portfolio stood at Rs. 8.0 billion and Rs. 36.2 billion, respectively, as at end Q2 of 2024. Further, a consistent growth in both net and gross investments indicates a healthy expansion of the investment portfolio. As at end Q2 of 2024, equity investments of banks represented only 0.5 per cent of the total gross investments of the Banking sector. Therefore, the risk emanating from fluctuations in equity prices is significantly low.

Capital Adequacy

The Banking Sector Capital Adequacy Ratio (CAR) improved at end Q2 of 2024 compared to Q2 of 2023. The growth in CAR is mainly driven by strong profitability, new issuance of Tier-2 debenture capital and significantly diverted funds into risk free government papers. The banking sector recorded CAR of 18.0 per cent at end Q2 of 2024 compared to 16.9 per cent at end Q2 of 2023, as a result of the increase in regulatory capital. The total regulatory capital of the Banking sector grew considerably by 11.4 per cent mainly due to an increase in Common Equity Tier-1 Capital induced by retained profits and Tier-2 debenture capital. In addition, the shift towards investments with risk free government securities also contributed to the improved CAR of the Banking sector. Further, the exclusion of the Banking sector from domestic debt restructuring supported to sustain the capital levels of the sector. However, in line with increase in loans and receivables, the growth in RWA was observed during the Q2 of 2024 compared to the contraction observed throughout the previous year indicated an increased level of risk exposure of the Banking sector.

Whereas the increase in CAR of DSIBs and other domestic banks were gradual, the CAR of foreign banks showed a steeper growth throughout the year ended Q2 of 2024. CAR of foreign banks increased to 32.5 per cent at end Q2 of 2024 compared to 26.7 per cent at end Q2 of 2023. This

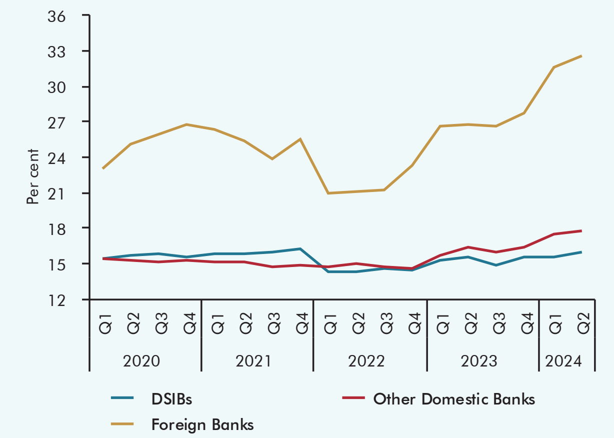
Figure 3.53 Capital raised from Listed Debentures*



* Debentures indicate the Listed Debentures at the Colombo Stock Exchange. Issued date of the debenture is considered to calculate capital raised for the year.

Source: Colombo Stock Exchange

Figure 3.54 **CAR by Bank Category**



Source: Central Bank of Sri Lanka

Figure 3.56 **RWA for Credit Risk**

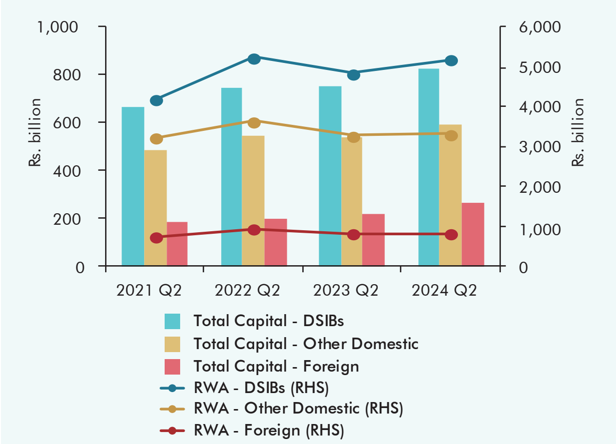
Source: Central Bank of Sri Lanka

was mainly due to a significant increase of regulatory capital by 21.5 per cent and a marginal contraction of RWA by 0.2 per cent compared to Q2 of 2023. For DSIBs, total regulatory capital and RWA increased by 9.2 per cent and 7.3 per cent, respectively, during Q2 of 2024. Further, the total regulatory capital of other domestic banks also increased by 10.5 per cent while RWA increased by 1.5 per cent, contributing to the higher CAR of 17.9 per cent at end Q2 of 2024. Hence, the increase witnessed in RWA growth during Q2 of 2024 was mainly prompted by DSIBs, rather than other domestic banks and foreign banks.

RWA for the credit risk category, which represents 87.2 per cent of total RWA, increased by 3.2 per cent during Q2 of 2024 mainly due to substantial increase in credit to corporates. Credit to corporates constitute 36.5 per cent of the Total Risk Weighted Amount for Credit Risk and increased to Rs. 2,961.2 billion at end Q2 of 2024 compared to Rs. 2,716.4 billion at end Q2 of 2023. Increase in Non-Performing Assets (NPAs) and Claims on Bank Exposures further contributed to the increase in RWA at end Q2 of 2024. However, Retail Claims and Claims on Central Government and Central Bank of Sri Lanka substantially reduced at end Q2 of 2024 compared to Q2 of 2023.

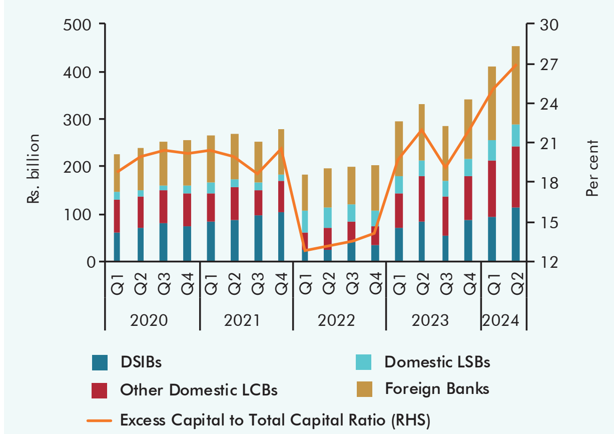
Although the sector as a whole possesses a considerable amount of excess regulatory capital, excess capital available in DSIBs was comparably lower than the other banks at end Q2 of 2024. The sector recorded an excess capital of Rs. 454.5 billion at end Q2 of 2024, which was an increase of Rs. 124.2 billion compared to the excess capital recorded at end Q2 of 2023. Foreign banks

Figure 3.55 **Total Capital and RWA by Bank Category**



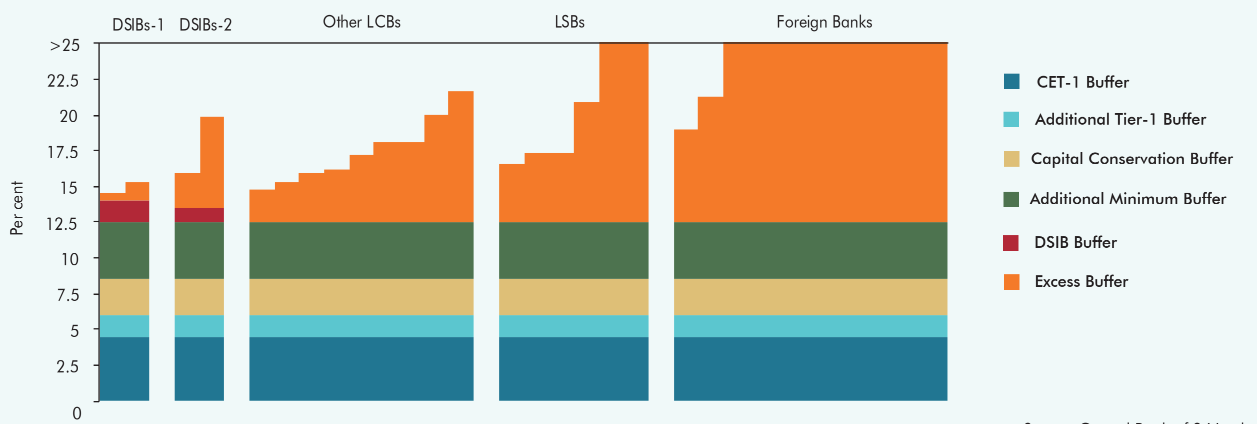
Source: Central Bank of Sri Lanka

Figure 3.57 **Capital in Excess of the Minimum Regulatory Requirement**



Source: Central Bank of Sri Lanka

Figure 3.58 Bank wise Capital Buffers

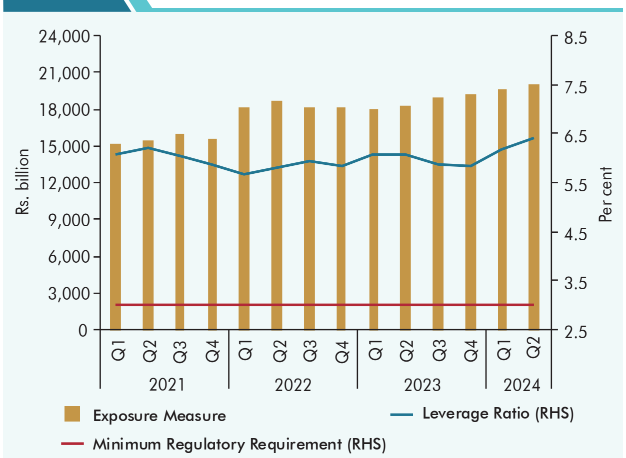


Source: Central Bank of Sri Lanka

made the highest contribution to the excess capital of the sector, which was 36.2 per cent of the total excess capital of the sector. The excess capital of foreign banks reached Rs. 164.7 billion at end Q2 of 2024 compared to Rs. 117.2 billion recorded at end Q2 of 2023, thus reaching the highest level of excess capital ever recorded for foreign banks. Accordingly, the Ratio of Excess Capital to Total Capital of the sector increased to 27.0 per cent at end Q2 of 2024 compared to 21.9 per cent at end Q2 of 2023.

Foreign banks maintained substantial capital buffers to absorb losses by considerably exceeding the minimum capital adequacy requirement. Meanwhile, other banks also collectively reported excess capital buffers albeit lower than that of the level recorded by foreign banks. However, as of the end of Q2 of 2024, a few LCBs and Licensed Specialised Banks (LSBs) are yet to sufficiently build up their capital to meet the minimum requirements set for their respective categories under the Banking Act Direction No. 05 of 2017, though extended time was granted to such banks to meet the requirements.

Figure 3.59 Leverage Ratio



Source: Central Bank of Sri Lanka

The Leverage Ratio of the sector improved to 6.4 per cent at end Q2 of 2024 compared to 6.2 per cent at end Q2 of 2023, which is well above the minimum regulatory requirement of 3 per cent. A growth of 8.0 per cent was witnessed in the exposure measure along with a 12.4 per cent increase in Tier-1 capital at end Q2 of 2024 compared to a contraction of 2.6 per cent in the exposure measure and a 3.4 per cent growth in Tier-1 capital at end Q2 of 2023.

Interconnectedness and Contagion Analysis[14,15]

Interconnectedness is defined as financial linkages between financial institutions or correlations across the market prices of financial institutions[16]. As such, financial system is interlinked through various direct (e.g., lending, placements) and indirect exposures (e.g., exposure to common

14 Please refer Special Note 3, “Establishing a Framework for Interconnectedness and Contagion Analysis” (page-68) in the Financial Stability Review 2023, for details on methodology and implementation. https://www.cbsl.gov.lk/sites/default/files/cbslweb_images/publications/fssr/fssr_2023e.pdf

15 The banking sector interconnectedness through direct exposures as at end Q1 of 2024 was assessed using contagion mapping.

16 Forbes, K. J. 2012. “The “Big C”: Identifying Contagion." NBER Working Paper 18465, National Bureau of Economic R search, Cambridge, MA.

assets)[17]. Stress cascading through these links could snowball, severely threatening the overall financial system stability. Contagion is defined as a significant increase in cross-market linkages after a shock or more generally, linkages after a shock to one or more financial institutions[18]. Therefore, contagion mapping helps find, evaluate, and mitigate systemic risk arising from interconnectedness of the financial system. Triggering a distress event, i.e., 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 domestic interbank network remained dominated by DSIBs as it accounted for 69 per cent of the total interbank exposures, despite the aggregate interbank exposures accounting for less than 4 per cent of banking sector assets as at end March 2024. In terms of gross exposures, average interbank exposures were around Rs 2.4 billion with a few exposures exceeding Rs. 10 billion. Despite subdued overall credit growth of 0.9 per cent, interbank exposures showed an growth of 6.8 per cent as at end March 2024.

The contagion risk of the interbank network was assessed to be cautiously moderate. An idiosyncratic trigger event of an entity, which is an assumed distress condition, could affect any other exposed bank through credit and funding channels, thereby adversely affecting capital and liquidity[19]. Accordingly, 3 banks were identified as potential sources of contagion with contagion level[20] ranged between 1 to 2 banks. The capital loss inflicted, excluding the trigger bank, ranged between 5.5 to 8.5[21] per cent out of the total capital of the banking system. The contagion cascades primarily transmitted through solvency channel.

Few domestic banks, including certain DSIBs, showed heightened contagion potential compared to other banks, while vulnerabilities of banks with limited excess capital elevated. Contagion events were driven by asymmetric interlinks in the interbank network with a few banks having larger exposures. Meanwhile, on the flipside, vulnerabilities of certain banks with limited excess capital (over and above minimum regulatory levels) and large exposures were elevated. As such, the vulnerability levels as measured by number of times a bank gets distressed in responses to hypothetical failure of other banks across the simulations ranged between 1 to 2. However, as observed during Q2 of 2024, certain banks' endeavours in sourcing capital both internally and externally might lower the vulnerabilities in the system, thereby containing the propagation.

17 Bricco, M.J. and Xu, M.T., 2019. Interconnectedness and contagion analysis: A practical framework. International Monetary Fund.

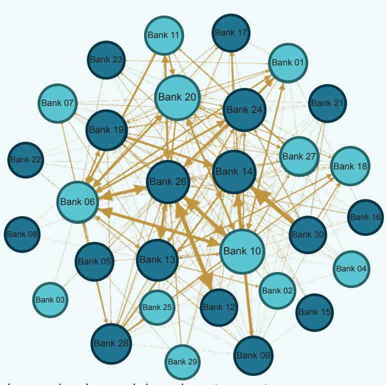
18 Forbes, K. J., and R. Rigobon. 2002. "No Contagion, Only Interdependence: Measuring Stock Market Comovements." Journal of Finance 57 (October): 2223–2261.

19 If a bank's capital and/or liquidity levels fall below regulatory requirements, it is considered as a distressed bank. However, it was assumed that banks may drawdown CCoB if required.

20 Contagion level is number of induced distress banks if one institute fails hypothetically.

21 Capital losses resulting without a single distress event have been excluded.

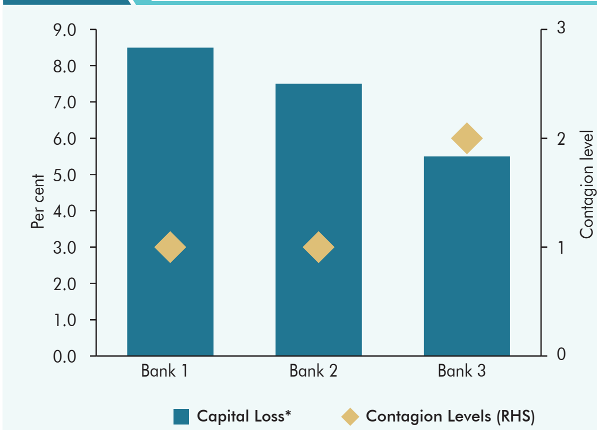
Figure 3.60 Interbank Network - Gross Exposures* - Q1 of 2024



*The nodes are banks, and the edges (arrows) represent gross exposure from one bank to another.
Edge thickness is proportional to the exposure amount.

Source: Central Bank of Sri Lanka

Figure 3.61 System wide Capital Losses - Q1 of 2024



* Excluding the trigger bank's capital

Source: Central Bank of Sri Lanka

Special Note 2

Risk Heat Map for the Banking Sector

The Risk Heat Map is a graphical representation of risk assessment results of the Banking sector. It provides multi-dimensional assessment of the risk indicators. In the heat map, risk values of the overall Banking sector are represented as traffic lights along with the market share. Moreover, the key emerging risks that need to be managed are indicated by the heat map. Accordingly, the Central Bank has established heatmap based on the methodology adopted by the European Banking Authority. Key risks are grouped under four categories of Capital Adequacy, Asset Quality, Profitability and Funding & Liquidity. Further, the Risk Indicators (RIs) under the four categories are classified into three performance buckets, with green representing the best performance, yellow indicating an intermediate performance and red denoting the worst performance.

As per the Bucket classification, banks are assigned to one of the three buckets (green, yellow, red) based on the performance of the respective RI. Market share of banks representing each bucket is given in the coloured cells. The classification of thresholds for each bucket is determined based on the historical distribution of RIs or regulatory requirements, if available. Traffic light system in the heat map emphasises the trend of the worst performing bucket compared to the historical pattern of the same bucket, using the same colour codes as the bucket classification. For instance, Tier-1 Capital Ratio's traffic light indicates the current period's performance in yellow, which implies that the current period's worst bucket has an intermediate stature compared to the historical pattern from Q1 of 2021.

By end Q2 of 2024, profitability, capital adequacy, funding & liquidity indicators were moderate whereas the asset quality indicators deteriorated compared to the historical trend. One profitability indicator (ROA) was better than its historical average, whereas ROE and NIM remained modest. Asset quality indicators measured by NPL ratio and Net NPLs to Regulatory capital were unfavourable, except for Provision coverage, indicating a rise in NPLs compared to the historical performance. Capital Adequacy as indicated by capital and leverage ratios, Funding & Liquidity as measured by LCR and NSFR remained modest by end Q2 of 2024 compared to historical trend.

	Risk Indicator (RI)	Threshold	Traffic light: Current (2024 Q2) vs previous quarters for the worst bucket	2021 Q1	2021 Q2	2021 Q3	2021 Q4	2022 Q1	2022 Q2	2022 Q3	2022 Q4	2023 Q1	2023 Q2	2023 Q3	2023 Q4	2024 Q1	2024 Q2
Capital Adequacy	Tier-1 Capital Ratio	>12.5%	🟡	50.4%	21.2%	17.5%	48.1%	15.6%	18.2%	19.4%	20.1%	43.5%	49.8%	28.6%	38.9%	42.7%	38.9%
		(10%-12.5%)		49.6%	78.8%	82.5%	51.9%	83.0%	80.3%	79.1%	78.4%	54.9%	50.2%	71.4%	61.1%	57.3%	61.1%
		<8.5%		0.0%	0.0%	0.0%	0.0%	1.4%	1.4%	1.5%	1.5%	1.5%	0.0%	0.0%	0.0%	0.0%	0.0%
	Total Capital Ratio	>14%	🟡	91.1%	94.0%	78.4%	82.6%	74.4%	71.5%	80.6%	71.7%	89.3%	100.0%	93.1%	96.9%	100.0%	100.0%
		(12.5%-14%)		8.9%	5.1%	21.6%	17.4%	10.9%	28.5%	19.4%	25.5%	10.7%	0.0%	6.9%	3.1%	0.0%	0.0%
		<12.5%		0.0%	0.9%	0.0%	0.0%	14.8%	0.0%	0.0%	2.9%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
	Leverage Ratio	>5%	🟡	60.0%	59.8%	58.7%	57.9%	44.1%	56.9%	57.1%	58.1%	59.1%	60.0%	60.8%	56.4%	61.9%	61.6%
		(3%-5%)		40.0%	40.2%	41.3%	42.1%	55.9%	43.1%	42.9%	41.9%	40.9%	40.0%	39.2%	43.6%	38.1%	38.4%
		<3%		0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Asset Quality	Gross NPL Ratio	<8%	🔴	53.3%	53.0%	55.7%	66.5%	67.0%	46.8%	31.6%	17.5%	14.3%	15.4%	14.8%	15.8%	16.7%	15.3%
		(8%-12%)		44.0%	44.3%	41.6%	31.2%	9.1%	50.6%	21.2%	62.2%	29.7%	18.7%	17.6%	26.1%	23.9%	25.0%
		>12%		2.7%	2.6%	2.7%	2.3%	23.9%	2.5%	47.2%	20.3%	55.9%	65.9%	67.6%	58.1%	59.4%	59.6%
	Provision Coverage for NPLs	>46%	🟢	54.9%	53.6%	56.7%	60.8%	45.7%	51.0%	47.0%	49.8%	49.4%	49.8%	52.2%	60.7%	75.9%	75.4%
		(43%-46%)		4.4%	4.0%	11.1%	19.0%	12.3%	14.3%	6.1%	0.0%	1.1%	1.2%	8.4%	0.0%	15.3%	19.8%
		<43%		40.7%	42.4%	32.2%	20.1%	42.0%	34.7%	46.8%	50.2%	49.6%	49.0%	39.3%	39.3%	8.8%	4.8%
	Net NPLs to Regulatory Capital	<35%	🔴	38.6%	40.7%	40.6%	55.4%	51.3%	49.9%	40.4%	28.9%	19.6%	19.7%	20.2%	29.3%	32.3%	44.7%
		(35%-49%)		22.9%	17.5%	19.8%	4.2%	24.0%	5.2%	8.6%	45.1%	29.1%	29.8%	32.9%	23.7%	20.9%	7.9%
		>49%		38.5%	41.8%	39.6%	40.4%	24.6%	44.9%	51.0%	26.0%	51.3%	50.5%	47.0%	47.0%	46.8%	47.4%
Profitability	ROE	>14.7%	🟡	66.0%	68.0%	50.8%	51.3%	54.4%	32.6%	2.6%	3.0%	15.4%	17.5%	5.9%	17.6%	40.9%	46.0%
		(9.5%-14.7%)		26.0%	17.5%	32.6%	33.4%	23.5%	36.5%	51.6%	69.8%	18.6%	26.5%	60.2%	59.5%	4.2%	27.8%
		<9.5%		8.0%	14.5%	16.7%	15.3%	22.1%	30.9%	45.8%	27.3%	66.0%	56.1%	33.9%	22.9%	54.9%	26.2%
	ROA	>1.8%	🟢	63.3%	18.9%	14.6%	16.2%	39.3%	3.4%	3.9%	9.3%	20.9%	18.2%	41.6%	29.1%	37.7%	44.7%
		(1.2%-1.8%)		29.6%	72.3%	59.0%	72.3%	17.2%	23.1%	15.6%	28.1%	8.0%	27.6%	5.6%	17.3%	18.2%	13.9%
		<1.2%		7.2%	8.7%	26.4%	11.5%	43.6%	73.6%	80.5%	62.7%	71.2%	54.2%	52.8%	53.6%	44.1%	41.4%
	NIM	>4%	🟡	18.2%	4.5%	5.1%	8.3%	58.0%	62.7%	35.4%	35.8%	35.4%	37.4%	41.5%	41.3%	54.2%	53.3%
		(3.3%-4%)		73.1%	87.3%	86.5%	83.5%	41.6%	36.1%	35.1%	17.8%	5.3%	4.1%	0.4%	13.0%	9.0%	8.9%
		<3.3%		8.7%	8.2%	8.4%	8.2%	0.4%	1.2%	29.5%	46.4%	59.3%	58.5%	58.2%	45.7%	36.8%	37.8%
Funding & Liquidity	LCR	>125%	🟡	98.1%	99.0%	99.4%	99.7%	98.5%	98.7%	99.7%	100.0%	99.7%	99.7%	100.0%	100.0%	100.0%	99.7%
		(100%-125%)		1.9%	1.0%	0.6%	0.3%	1.5%	1.3%	0.3%	0.0%	0.0%	0.3%	0.0%	0.0%	0.0%	0.3%
		<100%		0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.3%	0.0%	0.0%	0.0%	0.0%	0.0%
	NSFR	>125%	🟡	56.5%	57.8%	58.0%	41.6%	63.4%	41.6%	62.5%	78.6%	93.8%	95.5%	96.9%	100.0%	99.0%	97.7%
		(100%-125%)		43.5%	42.2%	42.0%	58.4%	36.6%	58.4%	37.5%	21.4%	6.2%	4.5%	3.1%	0.0%	1.0%	2.3%
		<100%		0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

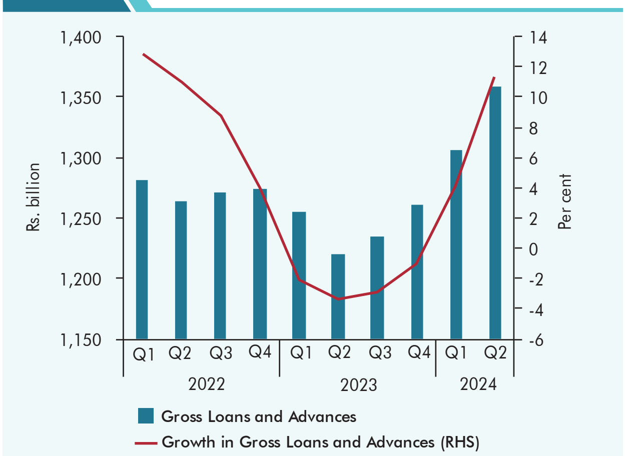
3.2 Finance Companies Sector

The FCs sector expanded significantly in terms of assets at end Q2 of 2024 amidst easing macroeconomic conditions and steady demand for credit. Total assets of the sector grew by 13.2 per cent at end Q2 of 2024 compared to a marginal growth of 0.1 per cent at end Q2 of 2023. This recent growth was supported by the expansion of loans & advances and investments which accounted for 69.9 per cent and 22.2 per cent of the total assets respectively at end Q2 of 2024.

Loans and advances of the FCs sector gained momentum during the first half of 2024, following a significant contraction in 2023 reflecting improved macroeconomic conditions and demand for credit. Recovering business activities amidst reduced market interest rates contributed to an increase in the demand for credit despite challenges in the sector's key business segments, such as vehicle leasing and hire purchase. Accordingly, total gross loans and advances of the sector increased by 11.4 per cent, reaching Rs. 1,359.3 billion at end Q2 of 2024.

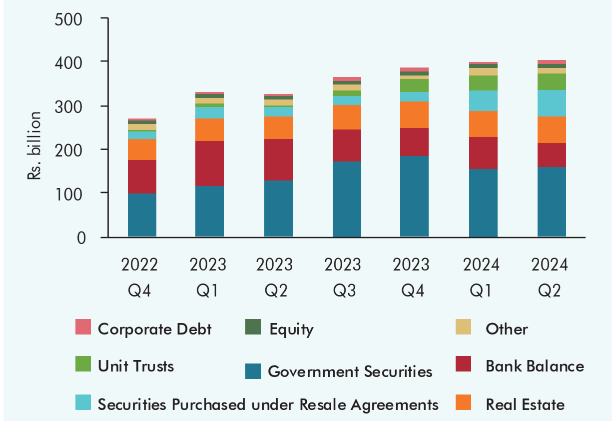
Total investments of the FCs sector have shown a significant growth during the period under review. Total investments of the sector grew by 22.6 per cent, to Rs. 401.7 billion at the end of Q2 of 2024 compared to Rs. 327.7 billion reported at the end of Q2 of 2023. At end Q2 of 2024, investments

Figure 3.62 Gross Loans and Advances



Source: Central Bank of Sri Lanka

Figure 3.63 Investment Composition



Source: Central Bank of Sri Lanka

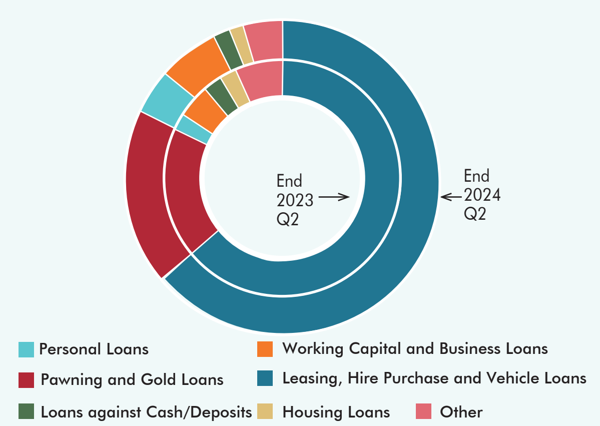
in Government securities accounted for 39.8 per cent of sector's total investments. Meanwhile, the sector displayed an increase in the preference towards investments in unit trusts and the repo market during the period under review. Investments in unit trusts and repos as a percentage of total investments increased from 1.6 per cent and 5.9 per cent at end Q2 of 2023 to 9.3 per cent and 15.0 per cent respectively, at end Q2 of 2024, highlighting a notable shift in its investment portfolio.

Credit Risk

The credit portfolio of the FCs sector was highly concentrated into vehicle and gold backed products. At end Q2 of 2024, leasing, hire purchase and vehicle loans accounted for 64.0 per cent of the FCs sector loans and advances whilst pawning and gold loans accounted for 18.3 per cent. During the period under review, growth in leasing, hire purchase and vehicle loans was 10.9 per cent whilst the growth in pawning and gold loans was 13.5 per cent. Despite ongoing restrictions on vehicle imports, increased prices in the used vehicle market facilitated the growth in the leasing, hire purchase and vehicle loans segments.

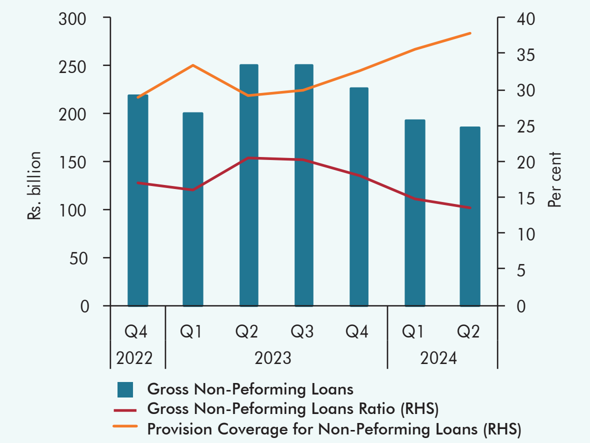
Asset quality of the sector considerably improved, driven by a decline in NPLs reducing the perceived credit risk of the sector during the period under review. Gross and net NPLs decreased by 25.8 per cent, and 34.7 per cent, respectively, at end Q2 of 2024 compared to end Q2 of 2023.

Figure 3.64 Composition of Loans and Advances



Source: Central Bank of Sri Lanka

Figure 3.66 Asset Quality Indicators



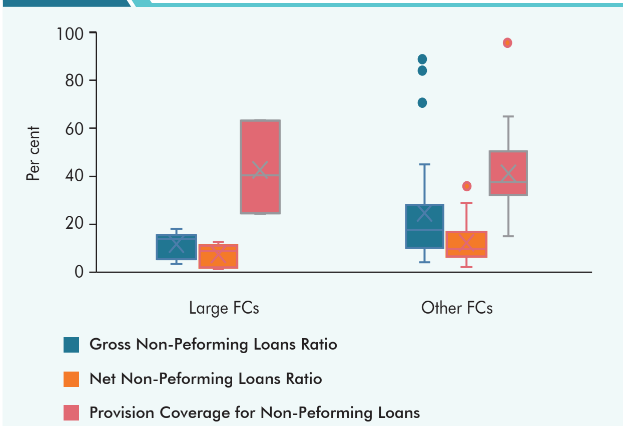
Source: Central Bank of Sri Lanka

Accordingly, gross and net NPL ratios improved to 13.6 per cent and 8.5 per cent, respectively, at the end of Q2 of 2024 compared to 20.5 per cent and 14.5 per cent, respectively, at the end of Q2 of the previous year. The growing loans & advances and improving macroeconomic conditions contributed to improvements in NPL ratios of the sector. Further, a higher credit quality was observed in large FCs compared to smaller FCs. FCs with assets less than Rs. 100 billion recorded a slightly higher net NPL ratio of 9.8 per cent compared to the average net NPL ratio of 7.6 per cent pertaining to six large FCs [22].

Provision coverage ratio for NPLs significantly improved during the period under review mainly due to declined NPLs. Accordingly, provision coverage ratio for NPLs increased to 37.8 per cent at end Q2 of 2024 compared to 29.3 per cent at end Q2 of 2023. However, the sector recorded an overall reduction in provisions. Provisioning for NPLs decreased by 4.1 per cent, whilst provisioning for total loans and advances declined by 2.7 per cent, at end Q2 of 2024. Although there was an improvement in the provision coverage for NPLs, the FCs sector provision coverage was lower than the Banking sector. Considering the differences in creditworthiness of borrowers in the two sectors, it would be prudent for FCs to maintain higher provision coverage ratios.

22 Large FCs are six FCs that had assets over Rs. 100 billion as at end Q2 of 2024.

Figure 3.65 Distribution of Asset Quality Indicators as at end Q2 of 2024



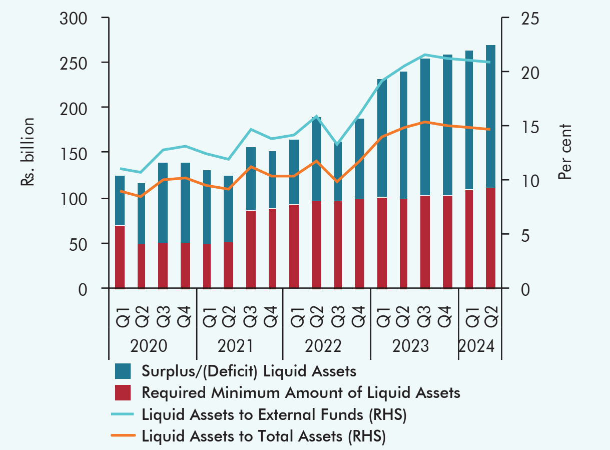
Source: Central Bank of Sri Lanka

Liquidity Risk

Liquid assets of the FCs sector as a whole continued to remain above the minimum regulatory requirement. Total liquid assets of the sector grew by 12.7 per cent, to Rs. 265.6 billion at end Q2 of 2024, significantly above the minimum regulatory requirement of Rs. 110.4 billion. This resulted in a surplus of Rs. 155.2 billion in liquid assets. Further, the ratio of liquid assets to deposits and borrowings, which had remained stable between 20.0 per cent and 21.0 per cent during the period under review, stood at 20.9 per cent at end Q2 of 2024. Similarly, the ratio of liquid assets to total assets hovered around 14.7 per cent during the same period.

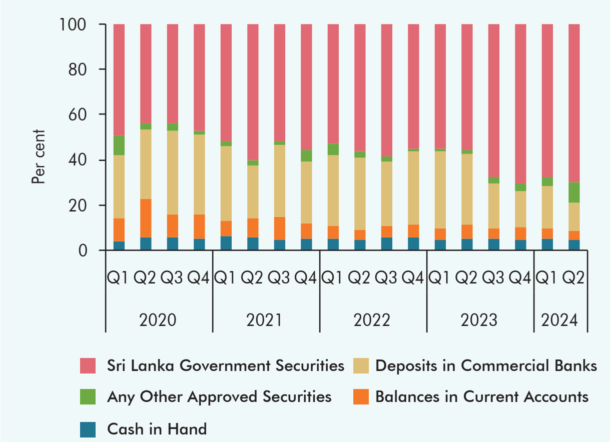
There were individual FCs that maintained significant surplus positions in terms of liquidity compared to the industry's average surplus. Investments in short term Government securities by

Figure 3.67 Regulatory Liquid Assets to External Funds and Total Assets



Source: Central Bank of Sri Lanka

Figure 3.69 Composition of Liquid Assets

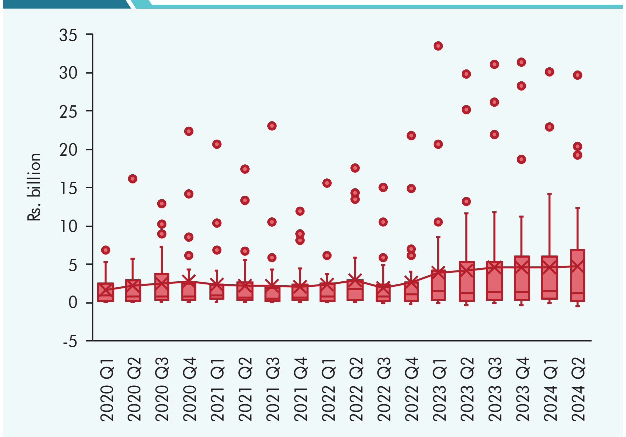


Source: Central Bank of Sri Lanka

the FCs sector increased over time due to high yields on Government securities in the recent past and inherent risk-free nature of Government securities. This led to a more significant increase in liquid assets of the sector compared to short term liabilities, driving the growth in surplus liquid assets. Since 2020, certain FCs maintained surplus levels far higher than the industry average indicating differences in asset and liability management within the industry.

Investments in short term Government securities continued to dominate liquid assets of the FCs sector. Investments in short term Government securities increased by 41.1 per cent, to Rs. 185.4 billion by end Q2 of 2024. Major changes witnessed in the composition of liquid assets of FCs by end Q2 of 2024 included the reduction in the share of deposits

Figure 3.68 Distribution of Surplus Liquid Assets



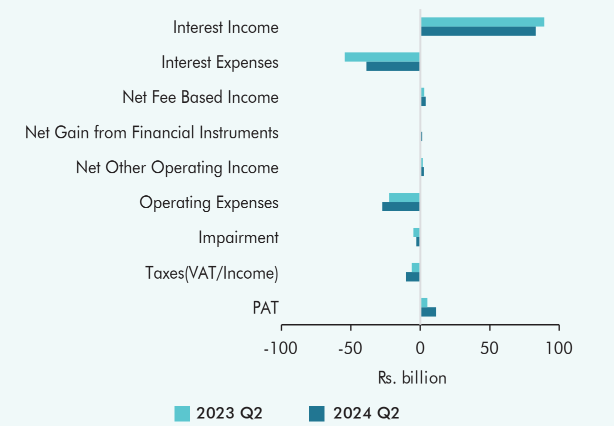
Source: Central Bank of Sri Lanka

in commercial banks and the increase in the share of other approved securities. Share of deposits in commercial banks out of total liquid assets decreased to 12.8 per cent by end Q2 of 2024 from 31.5 per cent at end Q2 of 2023. To the contrary, share of other approved securities out of total liquid assets increased to 9.1 per cent by end Q2 of 2024 from 1.5 per cent at end Q2 of 2023. Other approved securities segment largely comprised securities transferred to FCs under repurchase agreements. Given the sharp downward adjustment in deposit rates, the sector increasingly lent in the repo market to earn relatively higher returns.

Profitability

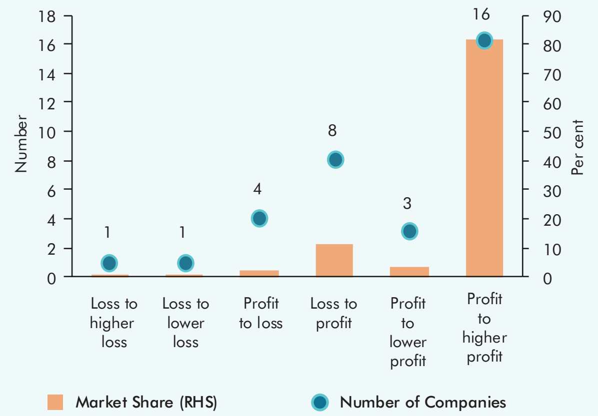
Profit After Tax of the FCs sector during the first 3 months of the financial year 2024/25 (Q2 of 2024) was significantly higher than the corresponding period of the previous financial year mainly due to reduced interest expenses. The y-o-y increase in PAT of the FCs sector was 120.8 per cent as the sector recorded a PAT of Rs. 11.3 billion during the first 3 months of the financial year 2024/25 compared to Rs. 5.1 billion reported in the corresponding period of the financial year 2023/24 (Q2 of 2023). Reduction in interest expenses in Q2 of 2024, amounting to Rs. 15.6 billion, compared to Q2 of 2023, was the main cause for increased profitability. Although interest income decreased by Rs. 6.0 billion during the same period, the substantial reduction in interest expenses led to a net increase

Figure 3.70 Impact of Income and Expenses on PAT



Source: Central Bank of Sri Lanka

Figure 3.71 Change in Profit Level from Q2 of 2023 to Q2 of 2024



Source: Central Bank of Sri Lanka

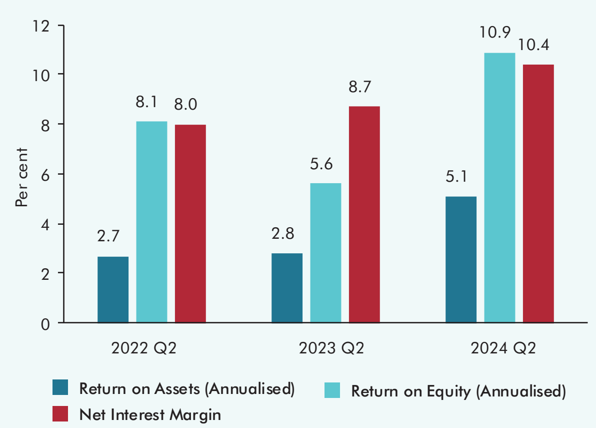
of Rs. 9.6 billion in total NII. This improvement in NII significantly contributed to the sector's overall financial performance.

Reducing market interest rates during monetary easing led to high NII and is a situational phenomenon which would eventually moderate. Most of the deposits and borrowings of the sector were maturing in less than 12 months (short term) by end Q2 of 2023. Therefore, when the Central Bank started to reduce policy rates in the beginning of June 2023, maturing deposits and borrowings were renewed at a reduced interest expense. During the period from the beginning of June 2023 to end-June 2024, the Central Bank reduced policy rates by 700 basis points. Negating this benefit, most of this sector's loans and advances were also short-term and caused a reduction in interest income as new disbursements had to carry a lower interest rate. As at end Q2 of 2023, short term deposits and borrowings amounted to Rs. 831.7 billion whilst short term performing loans and advances were Rs. 558.4 billion, thereby leading to a higher reduction in expenses when compared to income over the year. Similarly, at end Q2 of 2024 short term deposits and borrowings amounted to Rs. 916.7 billion whilst short term performing loans and advances were Rs. 644.2 billion. Considering the low likelihood of another significant reduction in policy rates in the medium term, transitory high net interest margins benefiting the sector's profitability would eventually come down with interest rate adjustments.

The six largest companies in the sector accounted for 82.0 per cent of sector profits at end Q2 of 2024. Total PAT recorded by these companies amounted to Rs. 9.3 billion in Q2 of 2024. In Q2 of 2024, 24 FCs that reported improvements in profits compared to Q2 of 2023, collectively represented 93.5 per cent of sector's total assets at the end of Q2 of 2024. However, 4 FCs, which recorded marginal profits in Q2 of 2023 recorded losses in the Q2 of 2024. Altogether, 6 companies reported losses amounting to Rs. 685.1 million during Q2 of 2024.

Key profitability indicators of the FCs sector improved in Q2 of 2024 compared to Q2 of 2023. ROA and ROE increased to 5.1 per cent and 10.9 per cent, respectively, at end Q2 of 2024 compared to 2.8 per cent and 5.6 per cent,

Figure 3.72 Profitability Indicators



Source: Central Bank of Sri Lanka

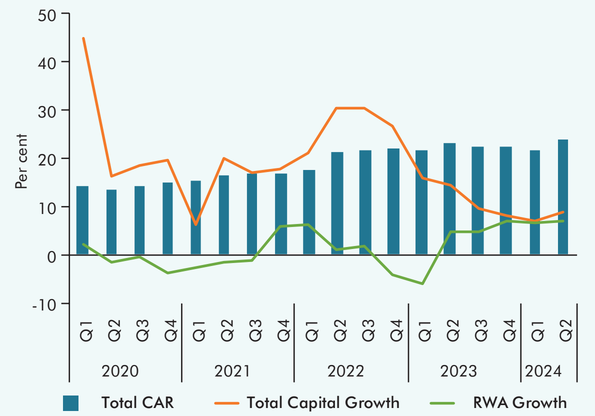
respectively, recorded at end Q2 of 2023. NIM of the FCs sector increased to 10.4 per cent at the end Q2 of 2024 compared to 8.7 per cent reported at the end of the corresponding period of the previous year.

Capital Adequacy

Capital adequacy ratios of the FCs sector improved by end Q2 of 2024 compared to the level recorded a year ago mainly due to increased capital. Compared to end Q2 of 2023, growth in total capital surpassed the growth in RWA at end Q2 of 2024. As a result, the total CAR of the sector improved to 23.8 per cent at end Q2 of 2024 from 23.4 per cent recorded a year ago. Although a few FCs did not meet the minimum capital requirements, such FCs accounted for only 2.0 per cent of sector assets at end Q2 of 2024. Nevertheless, the Central Bank continued to encourage consolidation of companies to make the sector more resilient.

Total CAR of large FCs grew whilst the total CAR of smaller FCs declined during the period under review. At end Q2 of 2024, total CAR of large FCs was 26.3 per cent whilst it was 19.6 per cent for other companies of the sector. However, the total CAR of the other FCs deteriorated during the period under review mainly due to stagnation in total capital. Total CAR of large FCs increased by 156 basis points whilst total CAR of smaller FCs decreased by 136 basis points during the year under review.

Figure 3.73
Capital Adequacy Ratio



Source: Central Bank of Sri Lanka

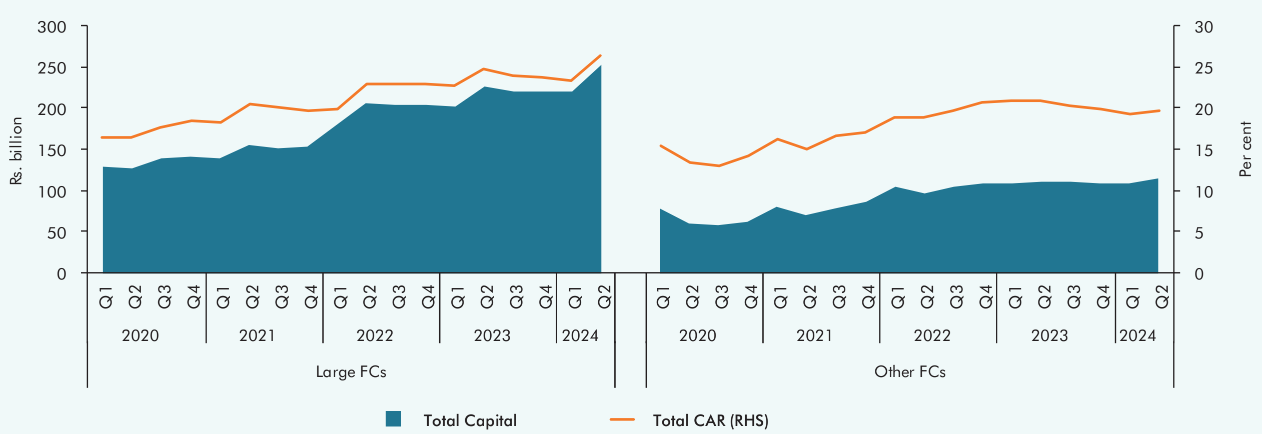
3.3 Insurance Sector

Insurance penetration in the country continued to remain at a lower level during the first half (H1) of 2024. Insurance penetration as measured by annualised Gross Written Premium (GWP)[23] as a percentage of gross domestic product[24] marginally improved to 1.1 per cent at end Q2 of 2024 compared to 1.0 per cent at end Q2 of 2023. The sector comprises 29 companies at end Q2 of 2024, of which 15 operated as exclusive long term insurance companies and 13 as exclusive general insurance companies, while one company had both long term and general insurance businesses.

23 Gross written premiums are the total revenue from a contract expected to be received by an insurer before deductions for reinsurance or ceding commissions.

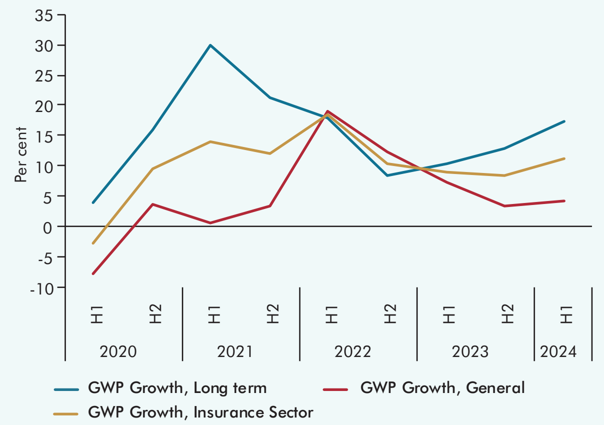
24 Gross domestic product for 2023 was used in the computation.

Figure 3.74
Distribution of Capital



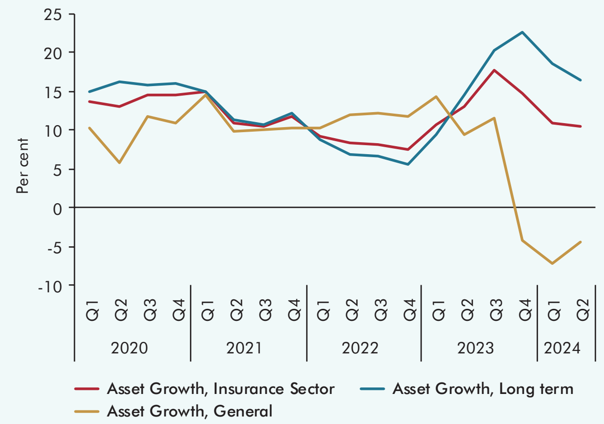
Source: Central Bank of Sri Lanka

Figure 3.75 Gross Written Premium



Source: Insurance Regulatory Commission of Sri Lanka

Figure 3.77 Asset Growth



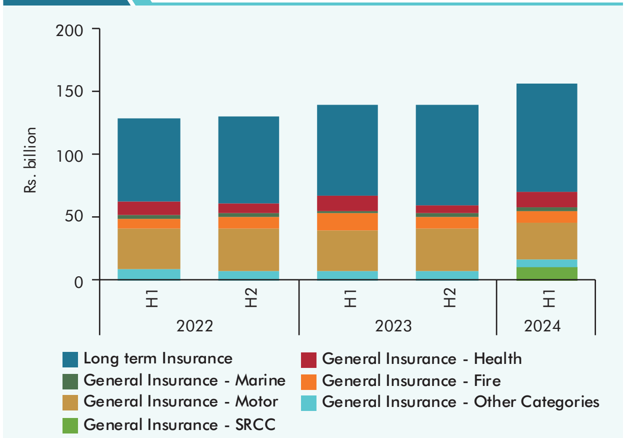
Source: Insurance Regulatory Commission of Sri Lanka

The insurance sector demonstrated a notable growth of 11.1 per cent in GWP during first half of 2024 compared to the corresponding period of 2023. GWP of the long term insurance subsector grew significantly by 17.4 per cent during H1 of 2024 compared to 10.4 per cent recorded in H1 of 2023, while the GWP growth of the general insurance subsector declined to 4.2 per cent during H1 of 2024 compared to 7.2 per cent recorded during H1 of 2023. The decline in growth of GWP was observed across all categories within the general insurance subsector, except for health insurance. However, a growth of GWP of the general insurance subsector could be expected with continued revival of economic activities.

Assets growth of the overall insurance sector decelerated to 10.5 per cent at end Q2 of 2024 compared to a growth of 12.9 per cent at end Q2 of 2023. Moreover, assets of general insurance subsector contracted by 4.5 per cent, whilst the assets of the long term insurance subsector recorded a significant growth of 16.5 per cent at end Q2 of 2024.

Both subsectors of insurance industry showed significant exposure to sovereign at end Q2 of 2024. Government securities continued to dominate the investment portfolio of both the subsectors, constituting 61.5 per cent and 61.2 per cent by long term insurance subsector and general insurance

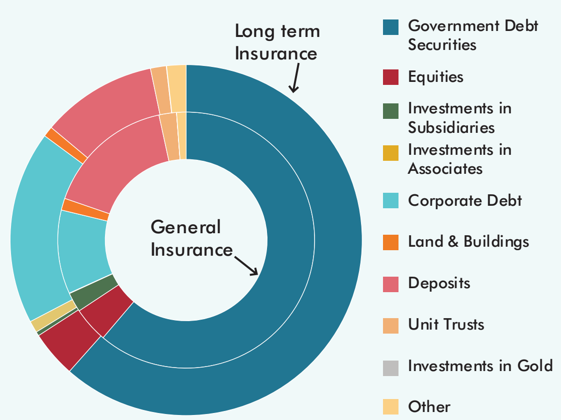
Figure 3.76 Subsector wise GWP*



* From Q2 of 2024, SRCC (Strikes, Riots and Civil Commotion) under General Insurance Subsector has beem presented separately according to the Cabinet Approval Memorondum Number MF/PE/007/CM/2024/098

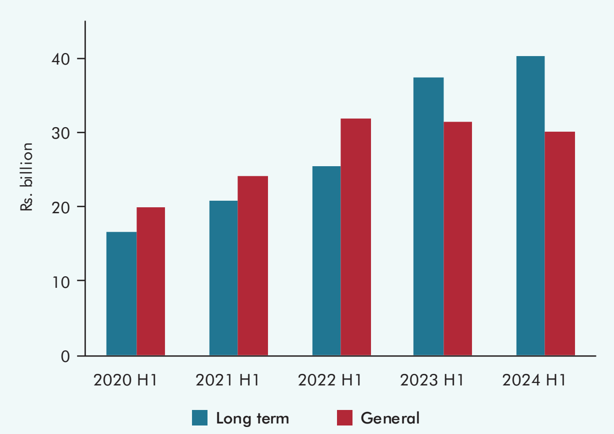
Source: Insurance Regulatory Commission of Sri Lanka

Figure 3.78 Composition of Total Investments of Insurance Subsectors



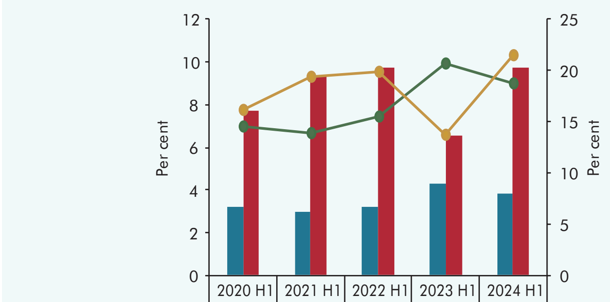
Source: Insurance Regulatory Commission of Sri Lanka

Figure 3.79 Claims Paid based on Insurance Subsector



Source: Insurance Regulatory Commission of Sri Lanka

Figure 3.81 ROA and ROE



	2020 H1	2021 H1	2022 H1	2023 H1	2024 H1
Long term ROA	3.2	3.0	3.2	4.3	3.8
General ROA	7.7	9.4	9.7	6.5	9.7
Long term ROE (RHS)	14.6	13.9	15.4	20.6	18.8
General ROE (RHS)	16.2	19.3	19.9	13.6	21.5

Source: Insurance Regulatory Commission of Sri Lanka

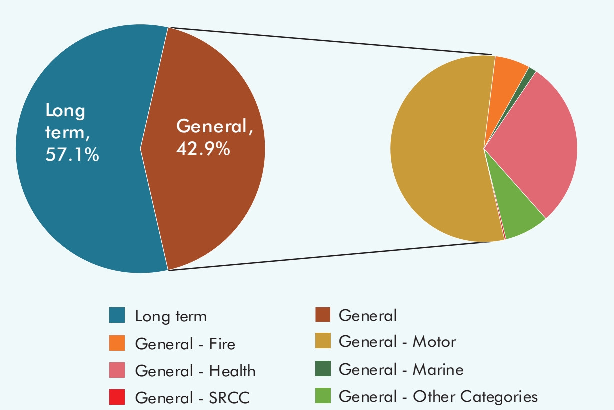
subsector respectively at end Q2 of 2024, complying with the minimum requirement stipulated in the Regulation of Insurance Industry Act, No. 43 of 2000. Further both subsectors had a sizeable portion of investments in the corporate debts and deposits with financial institutions.

Claims of insurance subsectors showed a mixed performance during H1 of 2024. The claims of long term insurance subsector increased by 7.8 per cent, while general insurance subsector recorded a decline of 3.8 per cent in H1 of 2024 compared to H1 of 2023. Within general insurance, there were notable decreases in motor claims by 12.0 per cent and health claims by 4.4 per cent, while claims of other categories increased by 85.2 per cent.

Profitability of the insurance subsectors recorded mixed performance during H1 of 2024 compared to H1 of 2023. Both the ROA and ROE of the long term insurance subsector decreased from 4.3 per cent and 20.6 per cent respectively in H1 of 2023 to 3.8 per cent and 18.8 per cent respectively in H1 of 2024. However, the ROA of general insurance subsector increased from 6.5 per cent in H1 of 2023 to 9.7 per cent in H1 of 2024 along with the improvement in ROE from 13.6 per cent in H1 of 2023 to 21.5 per cent in H1 of 2024 indicating improved profitability within the subsector.

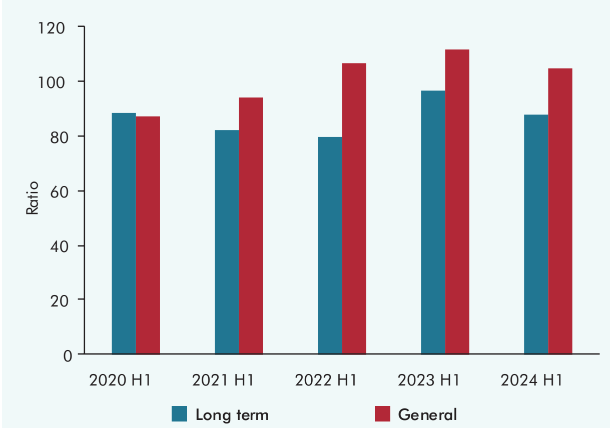
Since the beginning of 2022, the Combined Operating Ratio (COR), has consistently exceeded 100 per cent for general insurance subsector, whereas the long term insurance subsector recorded a COR of less than 100 per cent.

Figure 3.80 Claims Paid in H1 of 2024



Source: Insurance Regulatory Commission of Sri Lanka

Figure 3.82 Combined Operating Ratio based on Insurance Subsector



Source: Insurance Regulatory Commission of Sri Lanka

Figure 3.83 Long term Insurance Profitability - Loss vs. Retention Ratios of H1*

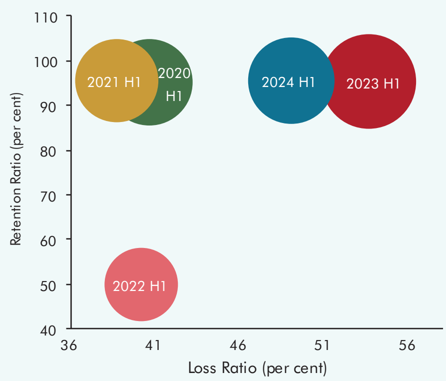
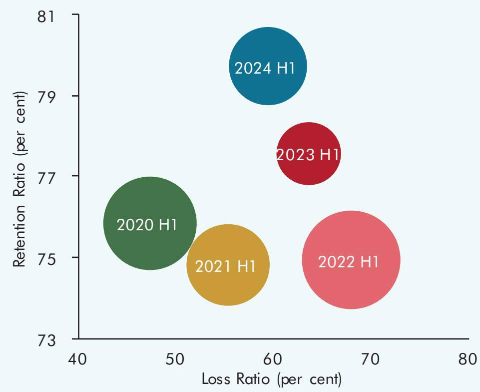


Figure 3.84 General Insurance Profitability - Loss vs. Retention Ratios of H1*



* The above charts intend to show the positional indication of the 3 variables i.e., Retention ratio, Loss ratio and Profitability ratio from H1 of 2020 to H1 of 2024. Size of the bubbles represent the profitability for each period.

Source: Insurance Regulatory Commission of Sri Lanka

The COR, which comprises the Loss Ratio[25] and Management Expense Ratio[26], stood at 104.6 per cent for the general insurance subsector, whereas the COR was lower at 87.8 per cent for the long term insurance subsector in H1 of 2024. This indicates that the profitability of the general insurance subsector was mainly driven by other income, particularly from investment income, rather than by GWP.

Both the long term insurance and the general insurance subsectors displayed notable improvements in claims management, as measured by the Loss Ratio. The Loss Ratio of long term insurance subsector improved significantly to 49.0 per cent at end H1 of 2024, down from 53.6 per cent at end H1 of 2023, while Loss Ratio of general insurance subsector also improved to 59.3 per cent at end H1 of 2024 from 63.5 per cent at end H1 of 2023, reflecting better claims management.

Retention Ratio[27] for both subsectors recorded an improvement in H1 of 2024 compared to H1 of 2023. The Retention Ratio of long term insurance subsector slightly improved to 95.6 per cent at end H1 of 2024 compared to 95.2 percent at end H1 of 2023, while the Retention Ratio of the general insurance subsector increased to 79.7 per cent at end H1 of 2024 from 77.6 per cent at end H1 of 2023, reflecting effective policy retention strategies adopted by both subsectors.

The liquidity level of the Insurance sector continued to remain at a healthy level mainly due to increased investments in the Government securities. Accordingly, the Liquidity Ratio[28] of the general insurance subsector improved to 0.91 at end Q2 of 2024 compared to 0.88 at end Q2 of 2023. Meanwhile, the Liquidity Ratio of the long term insurance subsector slightly decreased to 0.84 at

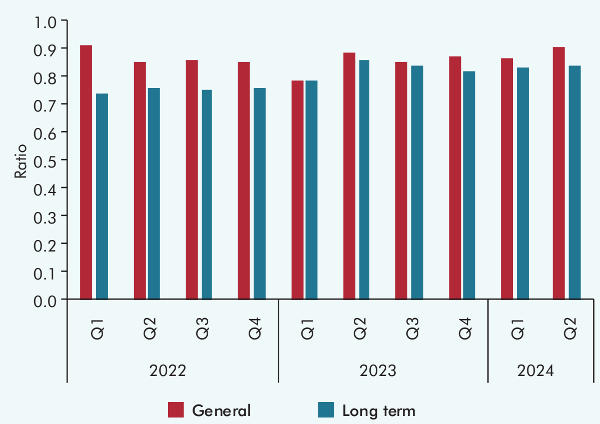
25 The loss ratio is the proportionate relationship of incurred losses to earned premiums expressed as a percentage. (International Risk Management Institute, Inc.). The loss ratio is calculated as the proportion of claims to net earned premium.

26 Management Expense ratio refers to the proportion of costs such as Underwriting, operating and administration costs, financing costs, other insurance related costs and profit attributable to unit holders to net premiums earned.

27 Retention ratio is calculated as Net earned premium as a proportion of Gross earned premium.

28 Liquidity ratio is calculated as the proportion of Liquid assets (Government debt securities, Deposits and Cash & Cash Equivalents) to Total Liabilities.

Figure 3.85 Liquidity Ratio

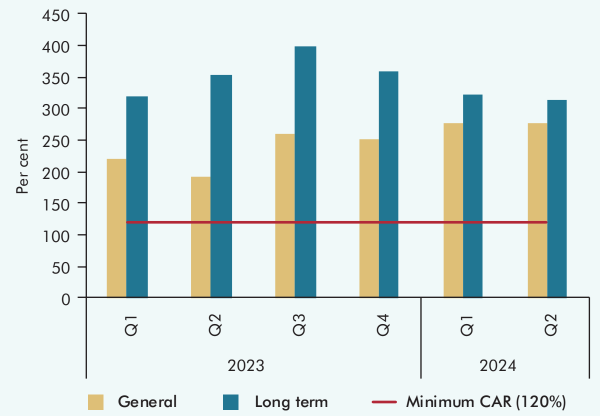


Source: Insurance Regulatory Commission of Sri Lanka

Figure 3.86 Premium Stability Ratio

Source: Insurance Regulatory Commission of Sri Lanka

Figure 3.87 Capital Adequacy Ratio



Source: Insurance Regulatory Commission of Sri Lanka

end Q2 of 2024 compared to 0.86 at end Q2 of 2023. Further, the Premium Stability Ratio[29] of the general insurance subsector significantly increased to 6.5 per cent in H1 of 2024 from negative 0.5 per cent in H1 of 2023, while the long term insurance subsector also recorded a considerable improvement with a ratio of 17.4 per cent in H1 of 2024 from 10.4 per cent in H1 of 2023, highlighting the consistency in measures adopted by both the sub sectors in maintaining their premium levels.

The capital level of both insurance subsectors exceeded the minimum CAR requirement of 120.0 per cent. The CAR of the general insurance subsector increased considerably from 192.0 per cent at end Q2 of 2023 to 276.0 per cent at end Q2 of 2024. However, the CAR of the long term insurance subsector contracted, from 352.0 per cent at end Q2 of 2023 to 312.0 per cent at end Q2 of 2024.

29 The Premium Stability Ratio is used to measure the consistency and stability of an insurance company's premium income over a period of time. The Premium Stability Ratio is calculated by comparing the premium income of 2024 H1 with premium income of 2023 H1.

Household and Corporate Sectors[1]

4

Both the Household and Institutional sectors[2], which are key consumers of financial services in the economy, showed an expansion in credit amidst the improvement in macroeconomic conditions, particularly reduction in market interest rates and resurgence in consumer confidence during the first half of 2024. Household sector credit, which contracted for five consecutive quarters since Q4 of 2022, entered a territory of positive growth during H1 of 2024 signalling gradual improvements in credit demand and supply conditions. However, the household credit stock[3] remained below the levels observed at Q2 of 2022 indicating further potential for credit growth to reach pre-crisis levels. Although credit to the Institutional sector improved, it remained at lower levels compared to the recent past, reflecting the limited flow of credit to the sector. This comparatively modest credit growth may reflect the combined effect of low real incomes and upward tax adjustments. Meanwhile, Non-Performing Loans (NPL)[4] of the Household sector credit, slightly reduced yet remained at elevated levels, particularly in the Non-Bank Financial Institutions (NBFI) sector, which holds a significantly higher proportion of NPLs compared to the Banking sector. Furthermore, the NPL ratio for institutional credit increased, signalling ongoing challenges in maintaining credit quality of financial institutions. Going forward, with the economy gathering the momentum, credit growth of both the Household and Institutional sectors is expected to further improve.

During the first half of 2024, the Non-Financial Corporate (NFC)[5] sector recorded an improvement in the overall performance compared to the corresponding period of the previous year. Although the revenue of the sector reported modest growth during the period, the profitability of the sector reported a significant improvement. Reduction in the market interest rates in line with the accommodative monetary policy stance significantly reduced financial burden on the income statements of the listed NFCs, contributing towards the profitability of the sector. The sector's enhanced profitability also led to a notable improvement in its overall creditworthiness. However, it is essential to sustain the enhanced profitability and the creditworthiness of the NFC sector in the long term, as a decline in the sector's creditworthiness could negatively impact the asset quality of the banking sector and, in turn, affect overall financial stability.

1 Data presented in this chapter is based on information obtained from the Credit Information Bureau (CRIB) and the Colombo Stock Exchange (CSE). Thus, the data reported in this chapter is not directly comparable with Chapter 3, which is based on FinNET data.
2 Quarterly aggregate credit data from the CRIB was utilised to provide comprehensive insights into the credit dynamics and behaviours of both the Household and Institutional sectors.
3 Please note that the debt stock would include the impact of fluctuations in exchange rate.
4 Loans with 90 days in arrears are classified as NPLs.
5 Financial information derived from the CSE served as a timely and relevant indicator for assessing the financial performance and risks associated with the NFC sector.

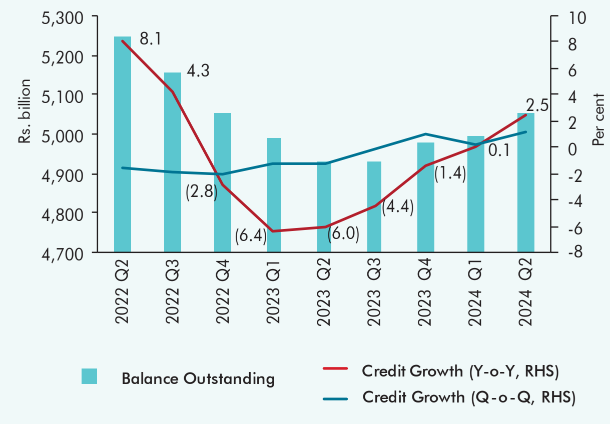
4.1 Risk Assessment on the Household[6] and Institutional[7] Sectors

This section assesses the financial vulnerabilities of borrowers in both the Household and Institutional sectors based on aggregated credit data[8] obtained from the Credit Information Bureau (CRIB) on a quarterly basis until end June 2024.

Risk Assessment on Household Sector Credit

Household sector credit expanded during the first half of 2024. The growth[9] of the Household sector credit, which remained negative during 2023, turned positive in the first half of 2024 with increased demand for credit from the sector reflecting the gradual recovery in economic activities. Household sector credit, which represents 41.3 per cent of the total formal financial sector lending[10], recorded a modest growth of 2.5 per cent by end Q2 of 2024, compared to the 6.0 per cent decline recorded in the corresponding period of the previous year. Further, the Banking sector alone disbursed Rs. 736.4 billion new credit facilities to households during the first half of 2024, a substantial increase from Rs. 412.1 billion credit issued in the corresponding period of the previous year. Similarly, NBFIs[11] also recorded a notable uptick in credit issuance over this period. Heightened consumer confidence with improved economic conditions led households to feel more secure in their financial management, and consequently, to increase their appetite for borrowings. Further, comparatively low interest rates and increased willingness to lend made borrowings more attractive, encouraging households to borrow for both consumption and investment purposes. Furthermore, the Banking sector played a significant role in meeting the borrowing needs of the Household sector, representing 67.9 per cent of the total credit issued to households, while NBFI sector accounted for the remaining portion of the loans obtained by households. Moreover, an increase in the share of credit granted to the Household sector by NBFIs was observed by end Q2 of 2024 compared to Q2 of 2023.

Figure 4.1 Household Sector Credit

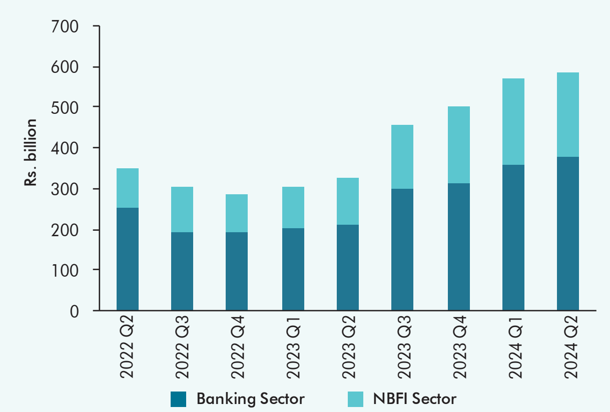


Source: Credit Information Bureau of Sri Lanka

The Household sector credit to GDP[12] ratio reported a gradual decline since the end of 2021. This decline is a combination of low credit growth in the Household sector along with high increase

12 Household Sector credit to GDP ratio was calculated using annualised nominal GDP values.

Figure 4.2 Household Sector New Credit



Source: Credit Information Bureau of Sri Lanka

6 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 purpose of business activities in terms of Micro, Small and Medium Enterprises (MSMEs).

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

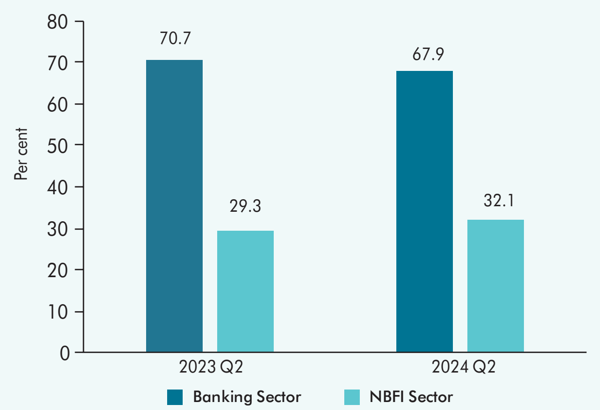
8 CRIB data does not include pawning advances, while it includes receivable interest of leasing portfolios and several off-balance sheet items such as bank guarantees and letters of credit.

9 Unless otherwise specified, all growth rates in this chapter are presented on a year-over-year basis.

10 Formal financial sector lending includes lending by Licensed Banks, Finance Companies (FCs), and Specialised Leasing Companies (SLCs).

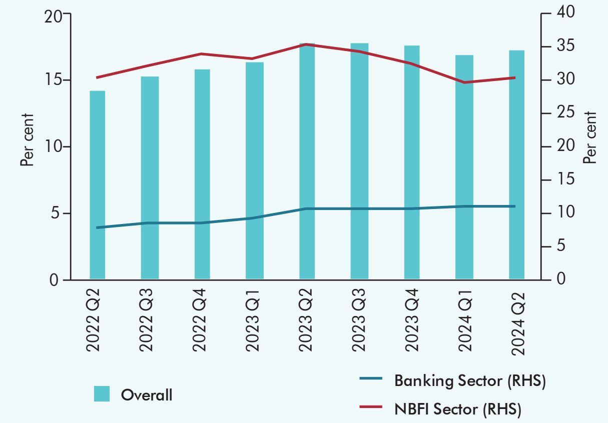
11 NBFIs include FCs and SLCs.

Figure 4.3 Composition of Household Sector Credit



Source: Credit Information Bureau of Sri Lanka

Figure 4.5 NPL Ratios of the Household Sector



Source: Credit Information Bureau of Sri Lanka

in nominal GDP during the period, reflecting the underlying developments in the economy particularly in terms of overall price levels.

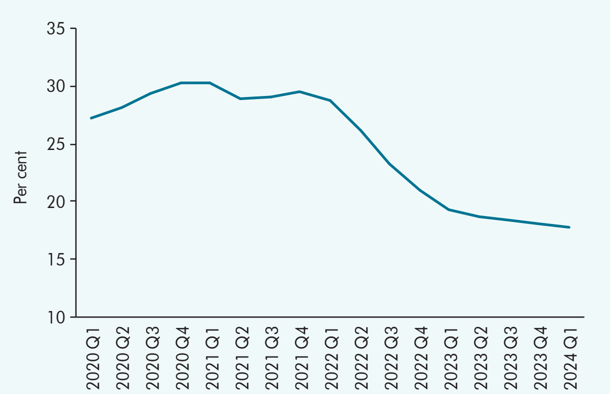
The NPL[13] ratio of the Household sector recorded a marginal decline by end Q2 of 2024 compared to the corresponding period of the previous year, indicating a slight improvement in the creditworthiness of the sector amidst improved economic conditions. The NPL ratio of the sector declined marginally to 17.1 per cent in Q2 of 2024 from 17.7 per cent in Q2 of 2023 with the gradual economic recovery. However, the NPL ratio reported a marginal increase in Q2 of 2024 compared to Q1 of 2024. NPL levels of the Household sector are expected to further reduce in the upcoming quarters, and credit growth to be supported by low interest rates and with the continuation of the stable macroeconomic conditions. Moreover, the NPL ratios in the NBFI sector were consistently higher compared to those in the Banking sector. Additionally, the proportion of loans in non-arrears[14] status within the Household sector has been increasing since Q2 of 2023, while the share of loans in arrears status has declined, signalling an improvement in the credit quality of the sector.

While the Banking sector was the main source of credit for the Household sector, the NBFI sector accounted for a higher share of NPLs, indicating a higher potential default risk for the NBFI sector.

13 The analysis classifies loans with 90 days in arrears as NPLs. Thus, NPLs cannot be directly comparable with NPLs reported in Chapter 3 of this report which are based on the SLFRS 9 guideline on classification on stage 3 loans.

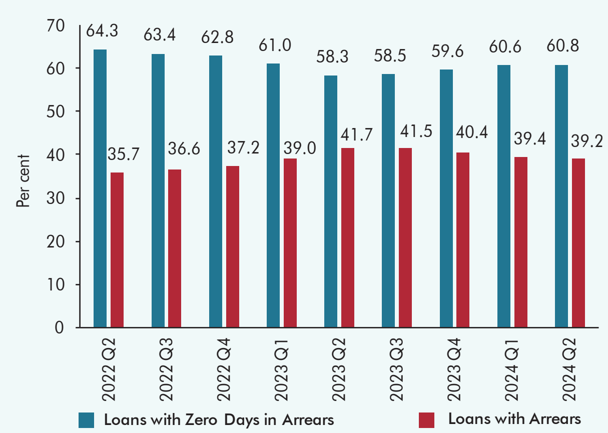
14 Facilities with zero days in arrears.

Figure 4.4 Household Sector Credit to GDP



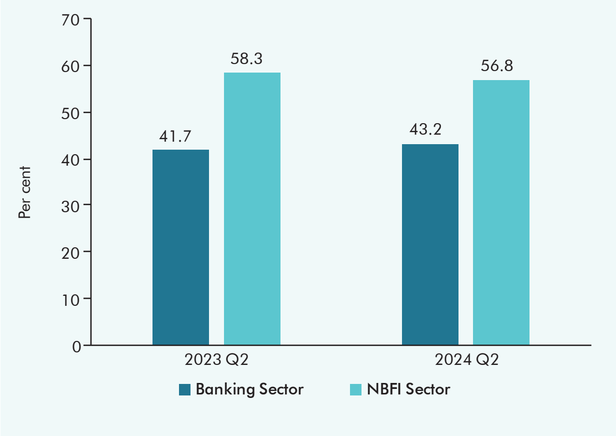
Sources: Credit Information Bureau of Sri Lanka
Department of Census and Statistics

Figure 4.6 Credit Quality of the Household Sector



Source: Credit Information Bureau of Sri Lanka

Figure 4.7 Composition of Household Sector NPLs

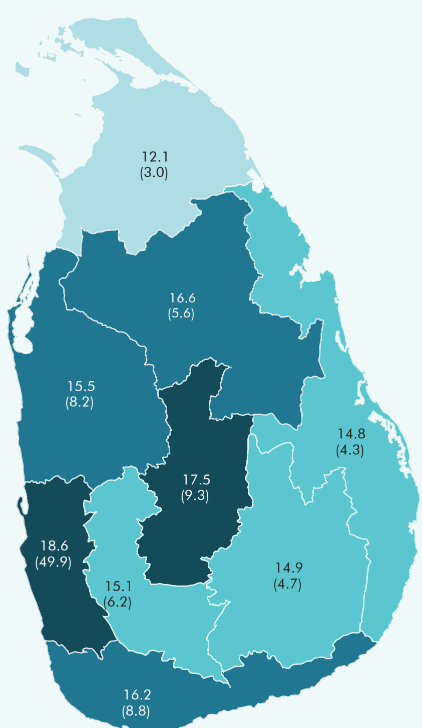


Source: Credit Information Bureau of Sri Lanka

The NBFI sector accounted for 56.8 per cent of total NPLs of the Household sector while the Banking sector accounted for 43.2 per cent of the NPLs of the sector.

The Western Province remained as the province with the highest share of credit allocation to the Household sector. Further, the Western Province recorded the highest NPL ratio of 18.6 per cent among all the provinces. It was followed by the Central Province and the North Central Province with NPL ratios of 17.5 per cent and 16.6 per cent, respectively, as of the end of June 2024.

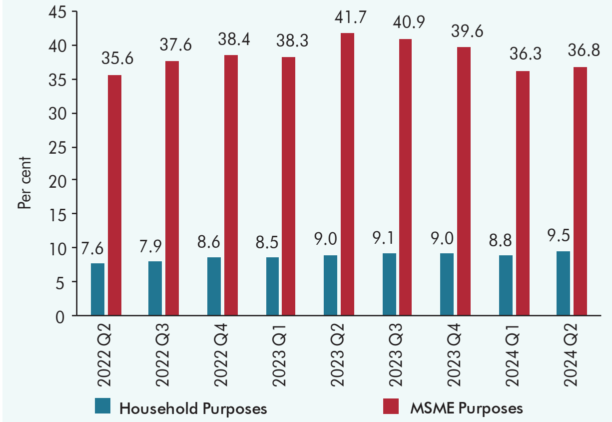
Figure 4.8 Distribution[15] of Household Sector NPL Ratios and Loans by end June 2024 (%)



Source: Credit Information Bureau of Sri Lanka

15 The first figure represents the NPL ratio of the specific province, while the figure in parentheses indicates the share of loans obtained by each province.

Figure 4.9 NPL Ratios: Household vs. MSME Purposes

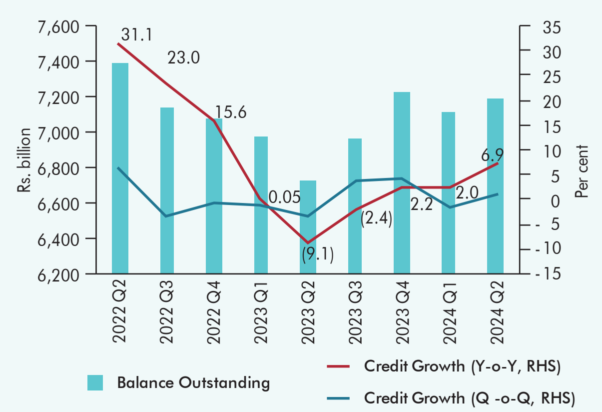


Source: CBSL approximation based on CRIB data

The NPL ratio for loans disbursed to MSMEs was notably higher than that of loans disbursed for household purposes[16]. This elevated default risk in MSME loans implies a greater propensity for households to evade repayment obligations on MSME-targeted loans. However, in Q2 of 2024, the NPL ratio for household loans increased, whereas the NPL ratio for MSME loans declined compared to the same period in 2023.

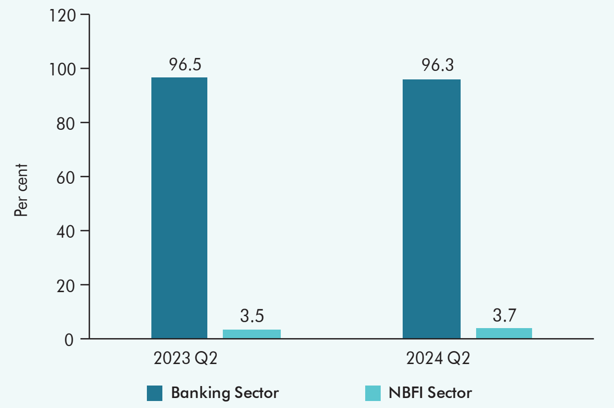
16 The loans obtained by the Household sector for consumption, personal housing and staff housing were classified as debt obtained for 'Household purposes.' The rest of the loans excluding 'Others' category was classified as an approximation for debt obtained for MSME purposes.

Figure 4.10 Institutional Sector Credit



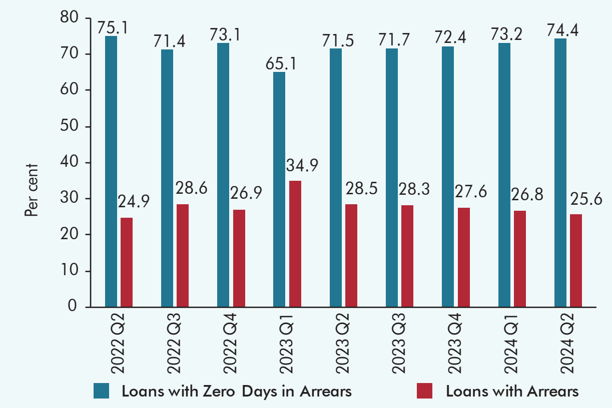
Source: Credit Information Bureau of Sri Lanka

Figure 4.11 Composition of Institutional Sector Credit



Source: Credit Information Bureau of Sri Lanka

Figure 4.13 Credit Quality of the Institutional Sector



Source: Credit Information Bureau of Sri Lanka

Risk Assessment on Institutional[17] Sector Credit

Institutional sector credit experienced a considerable growth of 6.9 per cent by end Q2 of 2024 compared to the decline of 9.1 per cent reported in the corresponding period of the previous year. This was mainly driven by the improved economic conditions and enhanced business confidence in 2024 along with the reduction in market interest rates. Moreover, Institutional sector loans were predominantly provided by the banking sector accounting for a share of 96.3 per cent of the total Institutional sector credit.

In contrast to the trend observed in the Household sector, the NPL ratio for Institutional sector credit increased by end June 2024. The NPL ratio of the Institutional sector was 14.1 per cent by end June 2024 compared to 13.3 per cent reported in the corresponding period of the previous year. However, the proportion of loans in the Institutional sector that are not in arrears has consistently risen since the beginning of 2023, while the share of loans in arrears gradually decreased over the same period.

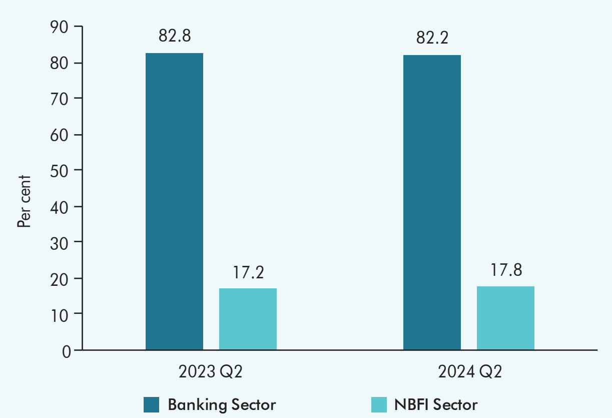
Among the total NPLs recorded within the Institutional sector, a significant majority originated from the Banking sector. As of end June 2024, the Banking sector accounted for 82.2 per cent of Institutional sector NPLs, while the Non-banking sector represented 17.8 per cent. Notably, despite the substantial presence of NPL volumes in the Banking sector, its NPL ratio remained considerably lower compared to that of the Non-banking sector.

17 The Institutional sector encompasses the private corporates sector, central government, and public corporations.

Figure 4.12 NPL Ratio of the Institutional Sector

Source: Credit Information Bureau of Sri Lanka

Figure 4.14 Composition of Institutional Sector NPLs



Source: Credit Information Bureau of Sri Lanka

4.2 Risk Assessment on the Listed Non-Financial Corporates

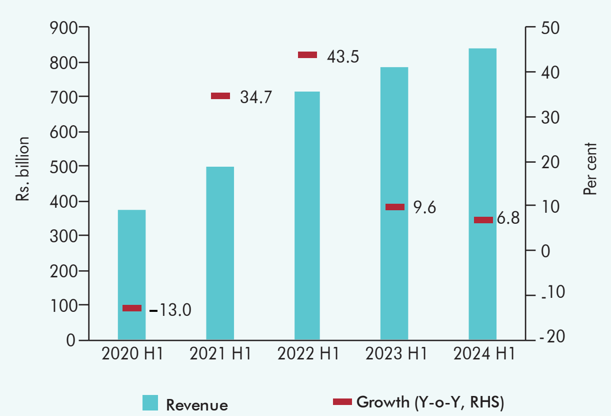
This section evaluates the risks and vulnerabilities that NFCs pose to the Financial sector, by assessing the financial performance of 210 corporates listed on the Colombo Stock Exchange (CSE) as of the end June 2024. These listed corporates serve as a proxy for the NFC sector, providing insights into the potential challenges and systemic risks that may arise within the broader financial system.

Financial Performance of Listed NFCs as of End H1 of 2024

While the economy is recovering from a prolonged contraction, the listed NFC sector reported a modest revenue growth[18] during the first half of 2024. The sector reported a revenue growth of 6.8 per cent amidst the significant slowdown in inflation, which is a slight deceleration from the 9.6 per cent growth reported during the corresponding period of the previous year. However, the share of listed NFCs which reported an increase in revenue compared to the previous year increased to 60 per cent in H1 of 2024 from 57.1 per cent reported in H1 of 2023 reflecting a more broad-based increase in revenues, signalling an improved business environment and relatively higher demand driven by improved macroeconomic conditions in the country.

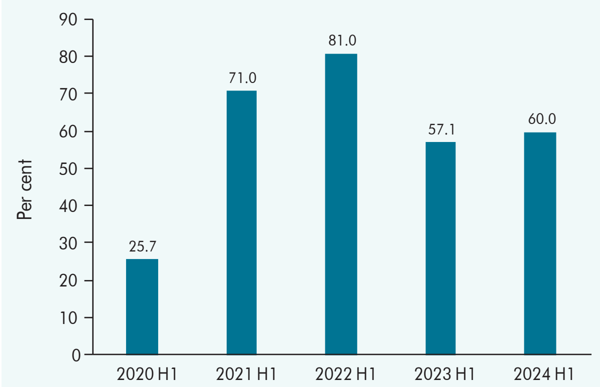
18 Unless otherwise specified, all growth rates in this chapter are presented on a year-over-year basis.

Figure 4.15 Revenue and Growth in Revenue of NFCs



Source: Colombo Stock Exchange

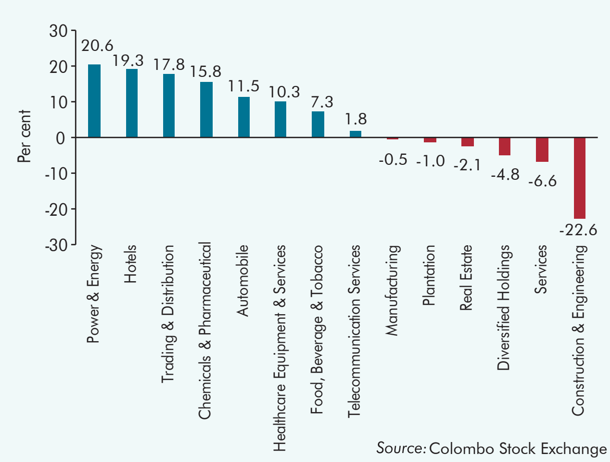
Figure 4.16 Share of NFCs that reported an Increase in Revenue



Source: Colombo Stock Exchange

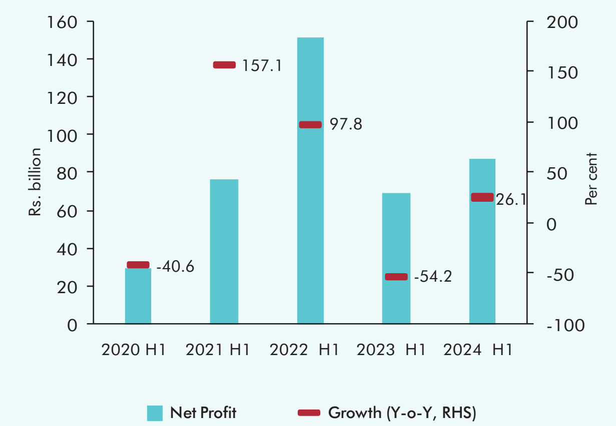
The Power and Energy, and Hotels sectors reported the highest revenue growths during H1 of 2024. The Power and Energy sector led revenue growth in H1 of 2024 with an increase of 20.6 per cent amidst improved demand for power and energy. The Hotels sector reported the second highest revenue growth during the H1 of 2024, primarily fuelled by a resurgence in tourist arrivals. However, certain sectors faced declines in revenue compared to the corresponding period in the previous year, including Construction and Engineering sector reporting the largest decline of 22.6 per cent. Nevertheless, given the limited number of listed companies within this sector, the data may not fully represent the entire construction industry. The Services and Diversified Holding sector also reported a decline in revenue by 6.6 per cent and 4.8 per cent in H1 of 2024 compared to corresponding period of the previous year.

Figure 4.17 Sector-wise Revenue Growth for H1 of 2024



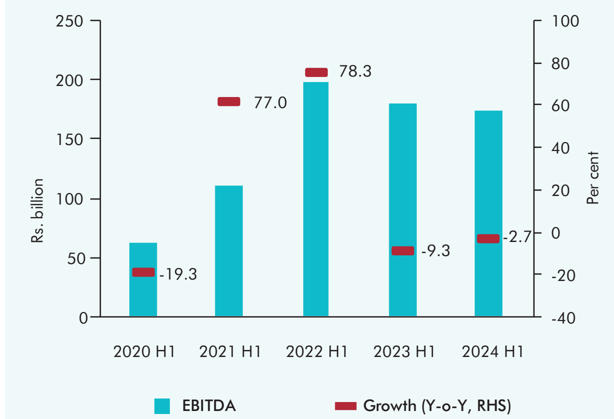
Source: Colombo Stock Exchange

Figure 4.18 Net Profit and Growth in Net Profit of NFCs



Source: Colombo Stock Exchange

Figure 4.20 EBITDA and Growth in EBITDA of NFCs

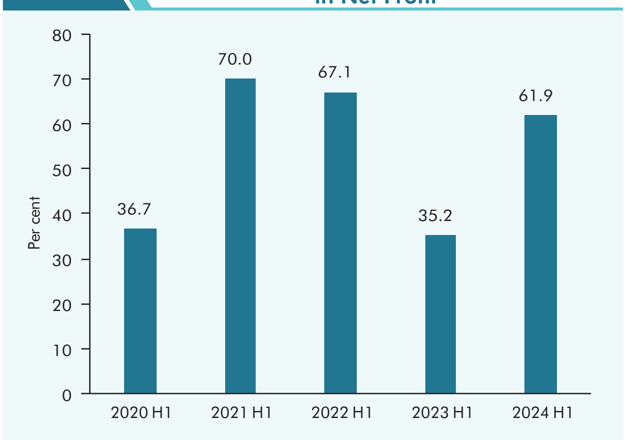


Source: Colombo Stock Exchange

The listed NFC sector reported a significant net profit growth of 26.1 per cent during H1 of 2024 compared to the corresponding period in 2023. This notable increase in profitability was largely driven by a y-o-y reduction in finance costs, which eased the financial burden of NFCs. Furthermore, the proportion of NFCs reporting improved corporate profits also increased considerably from 35.2 per cent in the H1 of 2023 to 61.9 per cent in the H1 of 2024. This significant increase not only highlights the sector's improved financial health but also signals a broader economic recovery, indicating that more listed NFCs in the sample are successfully navigating post-crisis challenges and enhancing their profitability. However, during the first half of 2024, the NFC sector experienced a 2.7 per cent contraction in Earnings Before Interest, Taxes, Depreciation, and Amortisation (EBITDA). This decline reflects a gradual weakening in operating performance that has been continuing since the first half of 2022, emphasising the need for NFCs to enhance their operational efficiencies.

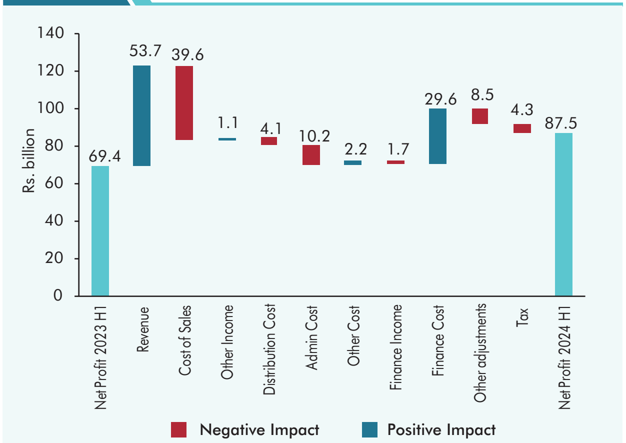
Reduction in finance costs positively impacted on the net profit of listed NFCs. The substantial decline in finance costs by 31.5 per cent can be attributed to several factors, including comparatively low interest rates and improved debt management strategies. Further, during H1 of 2024, other operating costs fell by 13.5 per cent compared to the corresponding period in 2023. The reduction in other operating costs further supported profitability by decreasing overall expenditure. Collectively, these developments strengthened the sector's overall profitability, indicating a more stable and positive outlook.

Figure 4.19 Share of NFCs that Reported an Increase in Net Profit



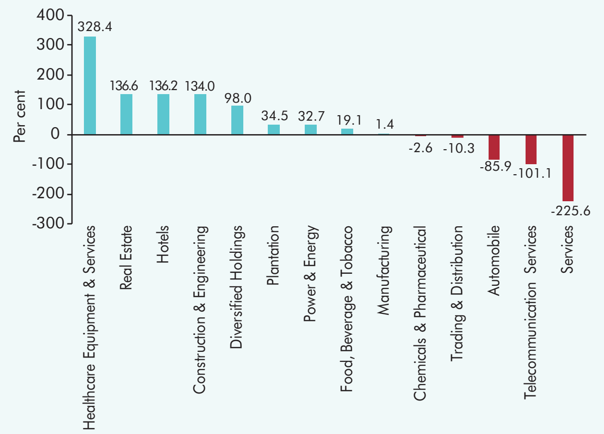
Source: Colombo Stock Exchange

Figure 4.21 Components of Net Profit



Source: Colombo Stock Exchange

Figure 4.22 Sector-wise Net Profit Growth for H1 of 2024



Source: Colombo Stock Exchange

In terms of sectoral performance, most sectors within listed NFCs reported improvements in net profit. Notably, the Healthcare Equipment and Services sector achieved significantly high net profit growth, largely due to the base effect, compared to the loss reported during H1 of 2023. Similarly, the Hotels sector, which reported losses in consecutive years, also managed to report a net profit in H1 of 2024, mainly benefiting from the improvement in tourist arrivals, which greatly enhanced its financial performance. Meanwhile, the Real Estate sector recorded the second-highest growth in net profit. This could be attributed to favorable economic conditions which supported the real estate market[19]. However, the Services, Telecommunication Services, Automobile, Trading and Distribution, and Chemicals and Pharmaceuticals sectors reported a fall in net profit during the period under review.

Key profitability indicators of the listed NFC sector also recorded improvements in H1 of 2024, with gains in Return on Assets (ROA) and Return on Equity (ROE) despite a minor decline in gross profit margin. Both ROA and ROE showed improvements, with ROA increasing to 7.5 per cent and ROE rising to 10.2 per cent during H1 of 2024, compared to 6.6 per cent and 8.9 per cent, respectively, in H1 of 2023. These gains highlight a positive momentum in the sector's financial performance. The improvement in profitability indicators was likely driven by the positive impact of low interest rates, which resulted in lower financing costs, a key contributor to net profit growth despite the marginal decline in gross profit margin.

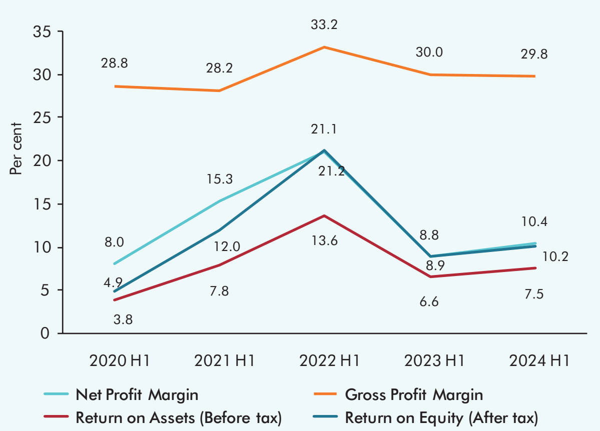
Corporate Sector Creditworthiness

The Interest Coverage Ratio (ICR)[20], which assesses a corporate's ability to meet its interest obligations on outstanding debt, improved in H1 of 2024. The ICR increased to 2.4 during the period under review, which amounted to 1.7 in H1 of 2023. An ICR above one signifies that the sector's operating income adequately covers its interest payments, highlighting the NFC sector's improved capacity to meet its debt obligations. The stronger ICR suggests that NFCs are better positioned to manage their debt, potentially freeing up resources for further investment and growth.

19 Several listed companies in this sector have reported considerable amount of non-operational revenue during the period. Therefore, the sector managed to record a profit growth amidst the decline in revenue.

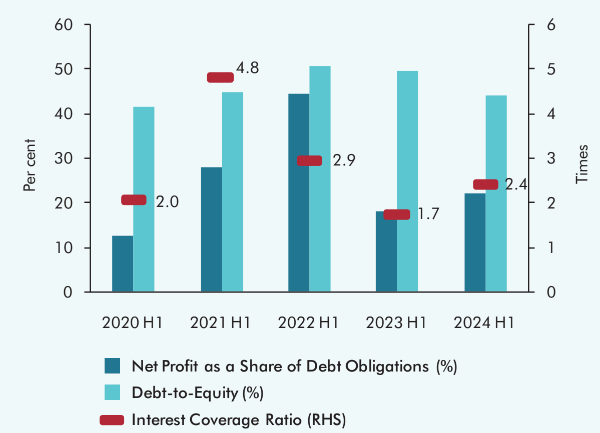
20 Interest coverage ratio (ICR) = Earnings before interest and tax (EBIT) / Finance expense

Figure 4.23 Profitability Indicators



Source: Colombo Stock Exchange

Figure 4.24 Key Financial Performance Indicators



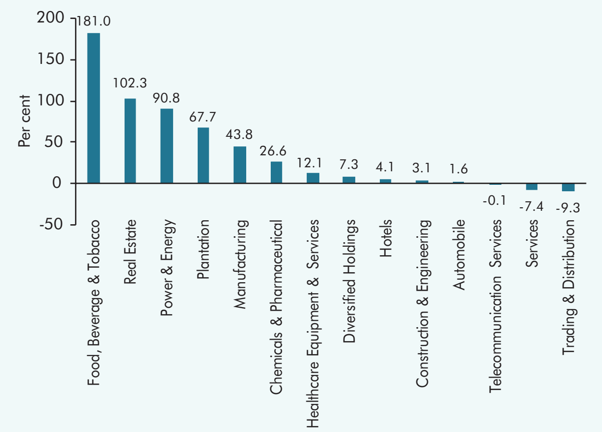
Source: Colombo Stock Exchange

The Food, Beverage and Tobacco, and Real Estate sectors reported the highest ICRs, indicating strong financial position with the capacity to meet interest obligations. Conversely, sectors such as Construction and Engineering, Services, Automobile, Diversified Holdings, and Trading and Distribution reported ICRs below one. This lower ICR signifies a decline in the creditworthiness of these sectors, reflecting potential difficulties in covering interest payments with operating income.

In H1 of 2024, the net profit as a share of debt obligations improved, driven by robust profit growth, although some sectors still faced challenges. The ratio increased to 21.9 per cent from 17.8 per cent in H1 of 2023, primarily due to the 26.1 per cent growth in net profit, which outpaced the rise in average debt levels. While most sectors demonstrated improved net profit as a share of debt obligations, reflecting better financial positions, sectors such as Trading and Distribution, Services, and Telecommunication Services reported net losses. This divergence highlights the varying financial dynamics across sectors.

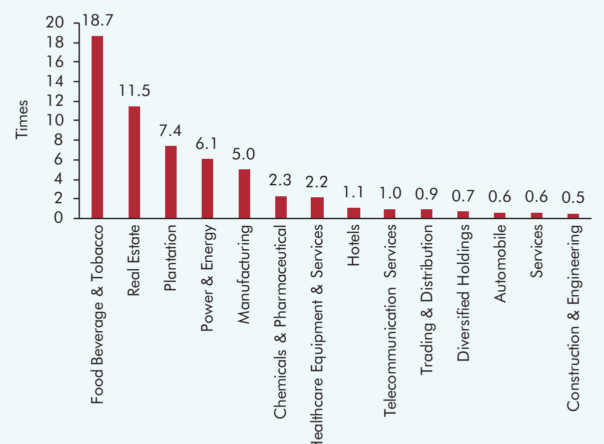
Leverage of the listed NFC sector as indicated by the debt-to-equity ratio continued its downward trend, signalling enhanced financial stability within the Corporate sector and a growing equity base. Despite this overall improvement, industries such as Telecommunication Services, Construction and Engineering, and Trading and Distribution still exhibited high debt-to-equity ratios, exceeding one. This indicates a greater reliance on debt within these sectors compared to other sectors with lower ratios. Such high leverage renders these sectors particularly vulnerable to interest rate fluctuations, which could substantially affect their financial performance.

Figure 4.26 Sector-wise Net Profit as a Share of Debt Obligations



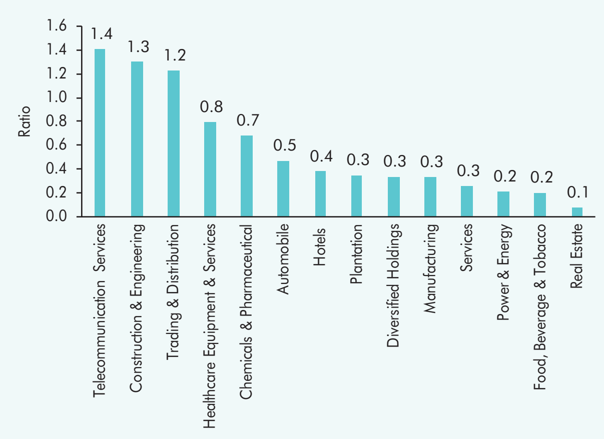
Source: Colombo Stock Exchange

Figure 4.25 Sector-wise Interest Coverage Ratio



Source: Colombo Stock Exchange

Figure 4.27 Sector-wise Debt-to-Equity



Source: Colombo Stock Exchange

Policies for Financial Stability

5

The Central Bank took an array of policy measures aimed at ensuring the stability and resilience of the financial system, so that it continues to support the economy as it recovers from the crisis. During the period under review, the Central Bank reinforced its macroprudential policies to enhance the stability of the financial system, ensuring its resilience. Exposure caps on large exposures of Licensed Banks (LBs), including those to public corporations, were introduced to mitigate concentration risks in the Banking sector. Considering the need to support economic recovery amidst current macro-financial conditions, these exposure caps will be phased in over a six-year period, with the full implementation scheduled for 2030, to ensure minimal disruption to financial intermediation. In addition, exposure limits for Finance Companies (FCs) were tightened and a comprehensive Credit Risk Framework was introduced during the period under consideration. Moreover, the Central Bank maintained the capital surcharge on Domestic Systemically Important Banks (DSIBs), Capital Conservation Buffer (CCoB), and the Loan to Value (LTV) ratio on motor vehicles at current levels. Further, the Financial System Oversight Committee (FSOC) was established to enhance the stability of the financial system which aims to bring financial institutions not directly supervised or regulated by the Central Bank under one umbrella, ensuring a coordinated approach to policy recommendations, aimed at financial system stability.

The Central Bank remained committed to meeting structural benchmarks for the Banking sector of the International Monetary Fund Extended Fund Facility (IMF-EFF) programme, including the introduction of the Banking (Amendment) Act No. 24 of 2024. The timely achievement of these benchmarks contributed to the stability and revival of the country's economic conditions. The Central Bank developed a roadmap for nine large banks to address capital and forex shortfalls after a comprehensive assessment of Asset Quality Reviews (AQRs), forward-looking assessments based on macro-financial scenarios, and the impact of domestic and external debt restructuring. Accordingly, private banks' recapitalisation plans were reviewed, and the Central Bank continued the post-implementation reviews on bank recapitalisation plans. Meanwhile, the recapitalisation strategy for the two state owned commercial banks is anticipated to be successfully completed by the end of the year 2024.

In addition to these macroprudential and microprudential policies, the Central Bank implemented several other measures with the aim of ensuring financial system stability. Accordingly, the Central Bank introduced measures to strengthen payment and settlement infrastructure, including upgrading the Real Time Gross Settlement (RTGS) system, setting regulatory standards for technology risk management, and gaining authority to oversee Money/ Value Transfer Service Providers outside the formal financial system. Further, the Financial Literacy Roadmap for Sri Lanka which offers evidence based guidance to all stakeholders engaged in financial literacy initiatives, was launched in May 2024. Moreover, the Central Bank also focused on strengthening financial consumer protections and enhancing financial inclusion across the country during the period under review. Accordingly, Market Conduct Supervision (MCS), which is one of the key pillars of financial consumer protection was initiated in May 2024. The resolution framework for the resolution of financial institutions which falls under the purview of the Central Bank was *further strengthened by drafting a Resolution Policy which provides a clear framework for resolving failing financial institutions during the period under review. During the review period, the Central Bank enhanced the Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) regime by issuing red flag indicators for suspicious transactions in the securities sector, money value transfer services, and trade based money laundering, while also imposing administrative penalties on two banks for non-compliance with financial regulations. While enforcing policies to uphold securing financial system stability, the Central Bank implemented Financial sector policies that also support a steady economic recovery. Business Revival Units (BRUs) were established in LBs to assist viable businesses impacted by the economic crisis.*

A wide range of policy measures are in place and more policies are underway covering multiple aspects of the financial system. Such measures are expected to enhance the resilience and ensure the stability of the financial system, so that it is able to support the economy even under adverse conditions as witnessed during the crisis period. As the economy recovers and the credit cycle moves in the expansionary phase, vulnerabilities may arise due to increased risk taking and heightened exuberance. As such, the Central Bank will diligently monitor systemic risks and promptly implement appropriate macroprudential and microprudential policy measures to address any emerging risks to ensure continued financial stability.

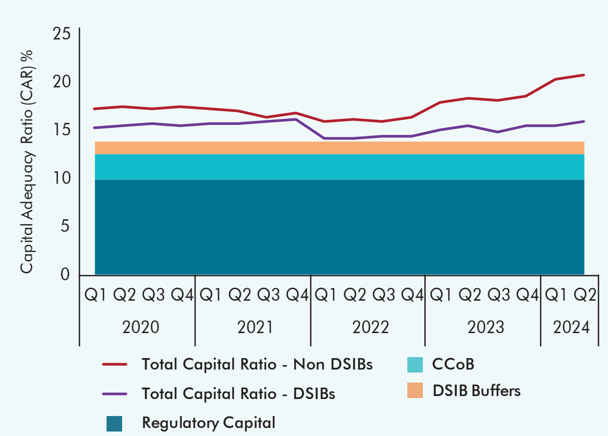
5.1. Enhanced Macroprudential Policies for Stability

The Central Bank strengthened its macroprudential policies during the period under review to enhance resilience and to ensure the stability of the financial system, enabling it to support the economic recovery. The CCoB remained unchanged at 2.5 per cent of Risk Weighted Assets (RWA), while the capital surcharges for DSIB buffer were maintained at 1.0 to 1.5 per cent of RWA throughout the period under review. These buffers played a crucial role in sustaining the resilience of the Banking sector during domestic debt restructuring and periods of economic turbulence. To ensure that the classification of DSIBs reflects the current dynamics of the banking system, the existing framework for the designation of DSIBs and the calibration of the DSIB buffer is under review. The cap on the LTV ratio on motor vehicles was also maintained at existing levels during the period under review amidst Government restrictions on the vehicle imports continued thus far during 2024.

The imposition of limits on lending by LBs was necessitated by growing exposures to public corporations, which have significantly heightened the Sovereign-Bank Nexus amid challenging economic conditions. Previously, LBs had a maximum limit on accommodations[1] set at 30 percent of their capital base for individual exposures and 33 percent on an aggregate basis for groups of connected borrowers. These limits were imposed in the face of challenging economic conditions, characterised by constrained Government finances and the LBs extended significant financial support by way of accommodations to key public corporations such as the Ceylon Petroleum Corporation and the Ceylon Electricity Board. This assistance was crucial in ensuring the uninterrupted provision of essential

1 Banking Act Direction No. 07 and No. 08 on Maximum Amount of Accommodation were the predecessor to the Direction on Large Exposures.

Figure 5.1 Capital Buffers of the Banking Sector



Source: Central Bank of Sri Lanka

Table 5.1 **Caps on LTV Ratio on Credit Facilities for Purchase of Motor Vehicles**

Vehicle Category		LTV Ratio	
		Electric Vehicles	Other
Motor Vehicles used in Sri Lanka for less than one year since the initial registration	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%	
Motor Vehicles used in Sri Lanka for more than one year since the initial registration		70% for LBs, 80% for FCs and SLCs	

Source: Central Bank of Sri Lanka

services during such conditions. However, as a result, Banking sector exposures to public corporations significantly increased over time, eventually reaching a level that contributed to high Sovereign-Bank Nexus. Following the economic crisis in 2022, various reform measures under the IMF-EFF programme, including the restructuring and divestment of certain public corporations, have been undertaken to address the Sovereign-Bank Nexus.

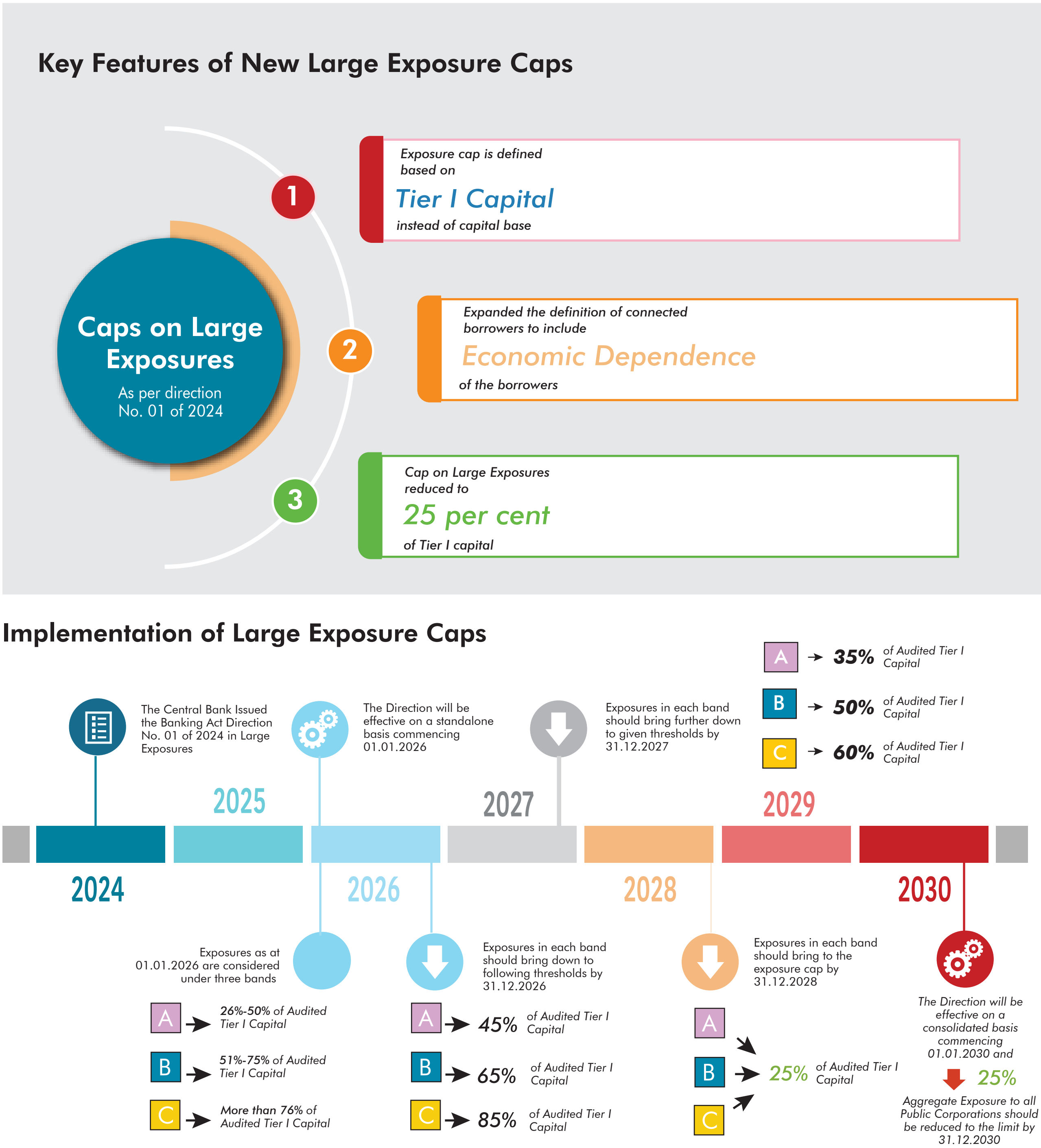
Caps on large exposures[2] of LBs were tightened with a view to mitigating the potential credit concentration risks to ensure safety and soundness of the Banking sector. Moreover, as the economy recovered and stabilised, the Central Bank introduced stringent limits on large exposures, including those to public corporations, to mitigate concentration risks in the Banking sector. This move aims to reduce the risk associated with significant exposures and enhance the resilience of the banking system. Therefore, a direction was issued in March 2024 reducing the cap on large exposures for LBs to 25 per cent of the bank's Tier 1 capital with effect from 01 January 2026, applicable to borrowers such as individual companies, public corporations, firms, associations of persons, and individuals on individual basis as well as on aggregate basis to a group of connected borrowers by the Direction No. 01 of 2024[3]. This direction will be in effect from 01 January 2026 on a standalone basis and from 01 January 2030 on a consolidated basis. Considering the current macro-financial conditions and ongoing need to support economic recovery, these exposure caps will be introduced gradually over a six year period, culminating in the full implementation by 2030. This phased approach is designed to ensure a stable and orderly transition that supports undisturbed financial intermediation to thereby facilitate the economic revival.

The updated regulations have tightened controls on large exposures by redefining connected borrowers and introducing phased compliance requirements to mitigate systemic risks within the Banking sector. The Direction has also expanded the definition of connected borrowers to include the economic dependence of the borrowers to be broadly in line with the “Supervisory framework for measuring and controlling large exposures” published by Basel Committee on Banking Supervision. Two borrowers are economically dependent if 50 per cent or more of one borrower's income/turnover per annum is derived from transactions with another borrower or 50 per cent or more of one borrower's production input per annum is obtained from another borrower or one borrower has fully guaranteed the exposure of another borrower. Economic dependence shall be assessed in all instances where the total exposure to a borrower exceeds 10 per cent of Tier 1 capital. This measure would enhance the resilience of the Banking sector by reducing the systemic risk that could arise due to the economic dependence between borrowers. LBs with higher large exposures above the cap of 25 per cent are required to bring down the respective exposures below the cap by end 2028 on a staggered basis. Similarly, in the case of large exposures to public corporations, banks are required to comply

2 Large exposures shall mean those exposures of a licensed bank to an individual borrower or a group of connected borrowers, which is equal to or in excess of 10 per cent of the Tier 1 capital.

3 Banking Act Directions No. 01 of 2024: https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/laws/cdg/Banking_Act_Directions_No_1_of_2024_e1.pdf

Figure 5.2 Caps on Large Exposures: Key Features and Implementation



with the cap on large exposure by end 2030 also on a staggered basis. Further, the aggregate limit on large exposures is required at 55 per cent of the total exposures of the bank.

The caps on exposures of FCs were tightened during the period under consideration. The individual borrower and group borrower limits which were at 15 per cent and 20 per cent of capital funds, respectively were tightened to 15 per cent and 20 per cent of core capital by the Direction No. 02 of 2024 on Credit risk management[4]. This directive takes effect on January 1, 2025, and affected FCs must comply with the new prudential limits within one year of this effective date.

4 Finance Business Act Direction No. 02 of 2024: https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/laws/cdg/snbfi_finance_business_act_directions_no_2_of_2024_e.pdf

The Central Bank strengthened the macroprudential framework and its governance structure. The FSOC was established as a statutory committee by the Central Bank of Sri Lanka Act, No. 16 of 2023 to contribute to secure the stability of the financial system in line with the macroprudential policy. The committee is mainly responsible for examining the macroprudential policy to mitigate identified building-up of systemic risks affecting the financial system, coordinate the implementation of macroprudential policy, issue recommendations to relevant public authorities and financial sector authorities on corrective action in response to the risk identified, and monitor compliance with its recommendations. As macrofinancial conditions gradually softened and the resilience of the financial system improved compared to the recent past, the FSOC did not observe any systemic risks that needed escalation to policy interventions during the period under review. Additionally, as per Section 63(2) of the Central Bank of Sri Lanka Act, the Central Bank has published the Macroprudential Policy Framework. This publication is articulated to inform relevant stakeholders about the macroprudential policymaking process and the critical role of macroprudential policy in maintaining the stability of the financial system. The document outlines the objectives and purposes of macroprudential policies, surveillance of systemic risks and associated indicators, application of macroprudential tools, interplay with other Central Bank policies, institutional framework, and communication of systemic risk developments and macroprudential stance of the Central Bank.

5.2. Other Financial Sector Policies Supporting Economic Stability and Revival

Business revival units were established within LBs to facilitate the sustainable economic revival of viable businesses affected by the economic crisis. Recent adverse economic conditions have significantly impacted many businesses, particularly Small and Medium Enterprises (SMEs), hindering their ability to repay debt, leading to elevated level of impaired assets within the Banking sector. Therefore, the Central Bank issued a circular [5] to establish BRUs independent of Loan Originating Units within LBs to identify and assist performing and non-performing borrowers of LBs who are facing challenges or may face potential financial (and/or business) difficulties due to reductions of income, cash flows or sales, reduction or impairment of business operations or temporary closure of business emanating from adverse macroeconomic circumstances. BRUs will consider financial revival mechanisms as well as operational revival mechanisms. Under financial revival, BRUs will use financial restructuring tools including debt forgiveness, debt rescheduling, adjustment of interest rates, maturity extensions, and provision of new financing, including interim financing and exit financing. Further, BRUs may consider recommending fundamental changes in a business's operations or assets to restore commercial viability. This could involve developing a new business plan or strategy, improving operational efficiency and profitability, enhancing cash management systems, reviewing pricing strategies, and evaluating customer retention and/or acquisition approaches. Additionally, BRUs may conduct awareness programmes on rehabilitation initiatives and offer credit counselling and business advisory services to attract potential investors. Furthermore, the Central Bank established a framework for corporate workouts to address the financial and/or business distress faced by corporate borrowers who have obtained credit facilities from more than one licensed bank[6]. Further, considering the need to facilitate and revive SMEs following the challenges faced due to the COVID-19 pandemic as well as the recent macroeconomic developments, Banking Act Directions on Capital Requirements under Basel III for LBs were amended providing a concessional risk weight to the exposures guaranteed by the National Credit Guarantee Institution Limited (NCGIL).

5 Circular No. 02 of 2024: https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/laws/cdg/bsd_circular_no_2_of_2024_e_0.pdf

6 Annual Economic Review – Box 3: The Establishment of Business Revival Units in Licensed Banks to Support Sustainable Economic Recovery: https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/publications/aer/2023/en/11_Box_03.pdf

The Central Bank remained committed to meeting structural benchmarks agreed with multilateral agencies such as the International Monetary Fund (IMF), World Bank, Asian Development Bank (ADB), relevant to the Banking sector, thereby contributing to the stability of the financial system and revival of the economy. The continued effort and commitment towards adhering to the reforms agenda facilitated implementing policies that ensures sustainable macrofinancial stability and contributed to regain confidence of both domestic and international stakeholders.

With a view to further strengthen the legal and regulatory framework applicable for LBs and enhancing the resilience of the Banking sector of Sri Lanka, the Banking Act, No. 30 of 1988 was amended. Accordingly, the Banking (Amendment) Act, No. 24 of 2024, which was a structural benchmark under the IMF-EFF programme, came into operation on 15 June 2024. The key areas included in the Banking (Amendment) Act inter alia are, minimum licensing requirements that need to be complied with to be eligible to apply for a bank license, criteria for shareholder suitability, empowerment for subsidiarisation of foreign banks, if deemed necessary; enhanced measures on bank ownership, conduct of consolidated supervision, facilitate proportionality in bank supervision and regulation, broaden provisions on large exposures, strengthen provisions on related party transactions, strengthened governance requirements by reinforcing the assessment of the fitness and propriety of directors, Chief Executive Officers (CEOs) and Key Management Personnel (KMP) of LBs across the Banking sector, including the governance of state-owned banks, improved requirements on financial statements and audit and strengthening capital and liquidity frameworks of banks. In addition, with the implementation of Banking (Amendment) Act, an Order was issued to eliminate the demarcation of the Domestic Banking Unit (DBU) and Off-shore Banking Unit (OBU) and to identify Off-shore Banking Business (OSBB) as a permissible activity that a LCB may conduct. With this, the previous Banking (Off-shore Banking Business Scheme) Orders and other instruments that were applicable to OBUs of LCBs were revoked with effect from 15 June 2024 of the Banking (Amendment) Act. Further, a few other regulations to facilitate the implementation of the Banking (Amendment) Act such as designating foreign currencies for OSBB, Banking Act Directions and Determinations on assessment of fitness and propriety of directors, CEOs and officers performing executive functions of LBs were also issued.

The Central Bank continued post-implementation reviews on bank recapitalisation plans. In 2023, the Central Bank developed a comprehensive roadmap for the restructuring and recapitalisation of nine large banks. This process involved a meticulous assessment of AQRs, forward-looking assessments based on macro-financial scenarios, and the impact of domestic and external debt restructuring. The strategy included a recapitalisation plan to address potential capital shortfalls. Accordingly, private banks submitted their recapitalisation plans, which were reviewed by the Central Bank. Banks proactively strengthened their capital positions by taking strategic measures and making adequate provisions to cover potential losses from the upcoming foreign exchange sovereign debt restructuring. These actions significantly improved their overall resilience, over capital requirements. Moreover, banks are required to implement their capital plans and report their progress to Central Bank every six months for ongoing evaluation. The Central Bank will take necessary actions based on these assessments. Additionally, the recapitalisation plans for two state banks were evaluated by a Specific Task Force comprising Central Bank and Ministry of Finance officials. The recapitalisation strategy for these state banks is expected to be completed within the year.

5.3. Policies for a Safe and Sound Payment and Settlement Systems and Infrastructure

Measures were taken to enhance the operational resilience of the RTGS, which is a systemically important Financial Market Infrastructure (FMI) that facilitates the settlement of large-value and time-critical payments in Sri Lanka. The RTGS system was upgraded to state-of-the-art technology in March 2024, aligning with Principles for FMI developed by the Committee on Payments and Market Infrastructures (CPMI) and the International Organisation of Securities Commissions (IOSCO), and adopting the ISO 20022 messaging standard. These upgrades will reduce technology risks and align the payment systems with international standards. When considering the Retail Payments Systems (RPS) operating in the country, the Common Electronic Fund Transfer Switch (CEFTS) and the Common ATM Switch (CAS) have shown system-wide importance, as evidenced by their transaction volume and value reflecting high public reliance in these systems. During the past year, all retail payment systems operated without any major disruptions, providing consumers and businesses with confident access to electronic payment methods, despite increased transaction volumes and technological advancements.

The Central Bank implemented measures to strengthen cyber resilience, which is vital for financial system stability. These efforts protect essential infrastructure from cyber threats and ensure the continuity and security of operations. Recognising the importance of prudent management of technology risks, including cybersecurity, the Central Bank established minimum regulatory requirements through the Regulatory Framework on Technology Risk Management and Resilience for LBs. Over the past year, participants in payment and settlement systems conducted vulnerability assessments and penetration testing, resulting in no major cyber incidents during the review period. Additionally, banks worked to meet the security controls outlined in the SWIFT Customer Security Program (CSP) to further enhance cyber resilience in the financial industry.

The Central Bank was granted the authority to serve as the regulatory and supervisory body for Money Value Transfer Services (MVTS) Providers by MVTS Providers Regulations[7] No. 01 of 2024 dated 20 April 2024 issued by the Minister of Finance, Economic Stabilisation, and National Policies, in terms of provisions in the Payment and Settlement Systems Act, No. 28 of 2005. MVTSPs are a type of financial service providers who accept money in various forms such as cash, cheques or other financial instruments from one person and then transfers an equivalent amount to another. There are entities offering MVTS that operate outside the formal system of the country and they may disrupt the money transfer process as they are not subject to the regulatory framework for AML/CFT. In order to address these issues, the Minister of Finance, Economic Stabilisation, and National Policies issued the MVTS Providers Regulations, No. 01 of 2024 dated 20 April 2024, under the provisions of the Payment and Settlement Systems Act, No. 28 of 2005. Accordingly, the Central Bank was appointed as the regulatory and supervisory authority of MVTS providers.

5.4. Policies to Strengthen the Resolution Framework for LBs and FCs

Measures were taken to enhance the framework for resolution of financial institutions under the purview of the Central Bank. The Banking (Special Provisions) Act (BSPA), No. 17 of 2023, was enacted to define the Resolution Authority of the Central Bank and outline its resolution powers. As a new legislative framework, the BSPA introduces concepts and mechanisms that are unprecedented in Sri Lanka's Financial sector, creating practical implementation challenges, particularly in the absence of established precedents and operational guidelines tailored to the Sri Lankan context, and lack of funding to facilitate urgent resolution financing requirements. To address such challenges, a Resolution Policy which is in line with the Act and provides a clear framework for resolving failing financial institutions is currently in place. Further, the Central Bank is strengthening the resolution framework with technical assistance received from the ADB under the Financial Sector Stability and Reforms Programme, incorporating international best practices to enhance robustness and adaptability. Further, detailed operational procedures on resolution of LBs tailored to the Sri Lankan context are being developed to clarify the roles and responsibilities of stakeholders. The Central Bank also conducted a series of discussions

7 Money or Value Transfer Service Providers Regulations No. 01 of 2024: https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/laws/cdg/psd_reg_2024__1_e.pdf

Special Note 3

Way Forward for Sustainable Financing

Background

Since the launch of the Roadmap for Sustainable Finance in Sri Lanka in 2019, the Central Bank and other regulators of the Financial sector have initiated policy actions related to popularising sustainable finance[1]. However, momentum in the Financial sector in terms of the growth of sustainable financing is not yet satisfactory as the sustainable lending portfolio of the Banking sector is limited to 1 per cent of the total accommodations after five years of launching the Roadmap. As a country that is highly susceptible to climate risk, Sri Lanka has advanced its target of achieving carbon neutrality (net zero) to 2050, a decade earlier than previously planned, under the updated Nationally Determined Contributions (NDCs)[2]. Furthermore, as global markets increasingly demand sustainable products, the Export sector's reliance on sustainable practices is becoming crucial for the country's economic competitiveness as well. These broad national and international developments highlight the need for intensification of efforts on sustainable initiatives across all sectors of the country. In this backdrop, this special note discusses the challenges faced by the Financial sector of the country in implementing its sustainable financing agenda and proposes several strategic interventions to overcome such challenges.

1 Financial Stability Review 2023 includes a Special Note (Page 52) on Mitigating the Impact of Climate Risk on Financial System Stability. https://www.cbsl.gov.lk/sites/default/files/cbslweb_images/publications/fssr/fssr_2023e.pdf

2 The Paris Agreement requires each party of the agreement to prepare, communicate, and maintain successive NDCs that it intends to achieve, which embody efforts by each party to reduce national emissions and adapt to the impacts of climate change.

Challenges for the Financial Sector

In navigating the path toward sustainable finance, Sri Lanka's Financial sector faces several critical challenges that must be addressed to realise the goals outlined in the Roadmap for Sustainable Finance and other national policies and frameworks. These challenges are multifaceted and interconnected, impacting the sector's ability to scale up sustainable financing effectively. The following figure provides a snapshot of the key challenging areas such as the need for bankable projects and innovative financial products, attracting investments, developing financial sector infrastructure, and addressing gaps in capacity and awareness. A deeper understanding of these challenges is essential for identifying strategic interventions that can help overcome the barriers to sustainable finance in Sri Lanka.

Figure 01 Challenges for Sustainable Finance

Projects/ Products

- Lack of effective fiscal incentives
- Difficulties in implementing blended finance solutions
- Insufficient capacity in developing project proposals
- Lack of awareness and engagement in the demand side

Investments

- Lack of a robust and well-defined investment pipeline
- Macroeconomic conditions limiting foreign and local funds
- Degree of interoperability of standards, including taxonomies

Infrastructure

- Adoption of international standards in terms of reporting, accreditation, and verification
- High cost of technical expertise
- Need for holistic cordination and consistency

Capacity

- Insufficient capacity within financial institutions
- Need for upskilling regulators

Bankable Projects and Innovative Financial Products

The existing sustainable financing products/ projects are predominantly in areas promoting green energy by way of solar power and electric conversion of transportation/ mobility. Hence, one of the key challenges faced by the Financial sector is the lack of marketable financial products which will qualify under the Green Finance Taxonomy and will be viable from a business perspective. Even though the financial institutions are ready to finance sustainable projects, lack of feasible projects and technical knowledge to articulate a flawless project proposal have led to a low success rate of attracting funds for the sustainable financing projects. Furthermore, it was observed that in many countries, such as China, fiscal incentives have played a key role in scaling up sustainable finance by making it more attractive and viable. However, the limited fiscal space available to offer such incentives in Sri Lanka has become a major constraint in scaling up sustainable finance in the country. Additionally, within this limited fiscal space, implementing blended finance solutions becomes difficult, as the Government would still need to bear a significant share of the funding. Moreover, creating demand for sustainable financing and raising awareness regarding the market potential remains a challenge.

Attracting Investments

Lack of investments as a consequence of the economic condition that prevailed has been a major bottleneck in terms of expanding the Financial sector's exposure to the sustainable finance sphere. Consequently, rationalisation of fiscal expenditure has limited Government funds available for sustainable initiatives, apart from the foreign aid received for few targeted projects. Hence, developing a robust and well-defined investment pipeline for the sustainable projects is a challenge, particularly in an environment where the lingering effects of the economic crisis remain. Furthermore, different jurisdictions using different sustainable finance taxonomies may add another layer of complexity. This could create uncertainty for some investors, especially if the interoperability of these taxonomies is not ensured, making it difficult to attract cross-border investments. However, Sri Lanka's Green Finance Taxonomy was developed based on the Common Ground Taxonomy (CGT)[3], which integrates key features of the green taxonomies from both the European Union (EU) and China. This alignment may enhance the interoperability of Sri Lanka's taxonomy, potentially making it more supportive in tapping cross-border investments.

Developing Financial Sector Infrastructure

Establishing the appropriate financial infrastructure is crucial in facilitating sustainable financing activities. In this context, the need for establishing reporting standards for the Financial sector as well as for facilitating accreditation and verification for addressing 'green washing' at an affordable cost remains a challenge to be addressed. Adoption of Environmental Social and Governance (ESG) reporting frameworks such as Global Reporting Initiative (GRI) standards is demanded by the market, and the accounting standards issued by the International Accounting Standards Board (IASB) on sustainability reporting (Standards S1 and S2) will be adopted by the listed corporates from 2025 onwards. Moreover, it is crucial to maintain a common understanding among a multitude of stakeholders, especially the Financial and Non-financial sector regulators to adhere to a common set of infrastructure that will include commonly accepted definitions and processes which will be governed by a strategy at the national level as absence of such infrastructure may hinder progression of sustainable financing within the country.

Gaps in Capacity and Awareness

One of the key constraints in the supply side is lack of capacity in the sustainable finance sphere, particularly amidst the dynamic nature of the global developments in the field which requires updating of the skill set on a regular basis. Officers of financial institutions who engage in credit operations and the management personnel who develop innovative financial products should be adequately capacitated to contribute to sustainable activities. Simultaneously, regulatory institutions should also be equipped with the necessary technical knowledge to examine sustainable financing activities of financial institutions. During the recent past it has been a challenge to update the human capital in the field due to spillover effects on the human resources management of both regulatory institutions and Financial sector participants owing to the economic crisis.

Way forward

With the Sustainable Finance Roadmap 2.0, the Central Bank intends to expand the coverage by including the social aspect of sustainability into the equation and developing a target driven approach for achieving Financial sector milestones in line with the country's climate agenda. Concurrently, collaborative efforts initiated by the Ministry of Finance and the Ministry of Environment in terms of developing a national strategy for climate change, Integrated National Financing Framework (INFF) for the Energy sector, marine spatial planning, etc. are being implemented with the collaboration of the international agencies, which aim to strengthen the overall infrastructure. Additionally, national level commitment from the political leadership of the country would play a pivotal role in establishing such national level strategies and scaling up sustainable finance in the country.

As the country comes out of the crisis, the Financial sector will be able to approach the investor funds available at the global level by way of showcasing strong business cases

3 CGT is a report resulting from an in-depth comparison exercise that puts forward areas of commonality between the EU and China's taxonomies, which was developed by the International Platform on Sustainable Finance (IPSF).

and projects. At the national outset, the Ministry of Finance and the Ministry of Environment may source funding for the national climate agenda which will have components for the private sector investments that could be utilised by the financial institutions. Further, philanthropic funds may be available both domestically and internationally that could be deployed for sustainable financing if the banks and finance companies strategise sustainable deposits and investment products.

Another step towards overcoming the challenge of bankable projects is that domestic financial institutions obtaining accreditation from international funding organisations. At present, one commercial bank is being accredited for the Green Climate Fund (GCF) and a few more banks are in the process of securing an accreditation. This accreditation will enable these banks to access funds specifically for eligible sustainable projects, thereby boosting the sector's capacity to finance such initiatives. Additionally, various authorities and non-governmental agencies are supporting the demand side in crafting investor-friendly business proposals and projects that are marketable, which is expected to create momentum for the banking sector to introduce groundbreaking financial products.

The Central Bank has identified the capacity requirements in terms of popularising sustainable financing in the Financial sector and expanding market outreach. At present, with the collaboration of international stakeholders, the Central Bank is designing a series of capacity building programmes for operationalising the green finance taxonomy by engaging stakeholders from multiple sectors of the economy. Simultaneously, various other initiatives are being implemented targeted at the capital market and the Industrial sector to promote sustainable finance for Small and Medium Sized Enterprises, as well as inclusive green financing across all tiers of the economy. In addressing the future demand of the Financial sector, the Central Bank is also planning to undertake capacity development for the regulators and supervisors in order to avoid possible green washing and ensuring accountability in undertaking sustainable activities. While meeting climate targets and transitioning to a sustainable financing landscape within the set timelines will be challenging, with collaboration and active engagement from a wide array of stakeholders, Sri Lanka can still make significant strides in achieving its sustainability goals.

References

1. Bank Negara Malaysia. 2023. 'Towards a Greener Financial System'. Annual Report 2023, 102-118.
2. Central Bank of Sri Lanka. 2023. 'Mitigating the Impact of Climate Risk on Financial System Stability, Special Note 2'. Financial Stability Review 2023, 52-54.
3. Volz, U. 2017. 'On the Role of Central Banks in Enhancing Green Finance. Inquiry Working Paper No. 17/01'. Geneva: UN Environment Inquiry into the Design of a Sustainable Financial System.
4. World Bank. 2012. Inclusive Green Growth: The Pathway to Sustainable Development. @ Washington, DC. http://hdl.handle.net/10986/6058.

with selected LBs, FCs, investment banks, leading audit firms, and other stakeholders to gather insights and feedback.

Moreover, to facilitate resolution financing, the Central Bank is currently engaged in discussions with the Ministry of Finance to establish the Financial Stability Fund in accordance with the BSPA. Accordingly, the Central Bank anticipates a contribution from the Ministry of Finance as a part of the initial corpus to establish the Financial Stability Fund. Additionally, public communication strategies are being developed to build public confidence in the resolution process and the financial system, educating and reassuring the public about the steps being taken to ensure financial stability.

5.5. Policies to Enhance Financial Consumer Protection and Financial Literacy

Full implementation of the Financial Consumer Protection Regulations (FCP Regulations) No. 01 of 2023 came into effect from 09 August 2024, and the main objectives of the Regulations are to ensure that financial consumers of institutions regulated by the Central Bank (Financial Service Providers- FSPs), are treated in a fair and transparent manner as well as to ensure responsible business conduct by the FSPs. As an initial step towards implementing the Regulations, an online Thematic Review (TR) was conducted on the existing internal complaint handling mechanisms, of all LBs and Non-Bank Financial Institutions (NBFIs) to assess how these institutions manage and resolve their customer complaints, identifying areas for further improvement and ensuring that the complaint handling processes are efficient, transparent, and fair. With the authority given through the FCP Regulations, the Central Bank commenced Market Conduct Supervision (MCS) of FSPs during the second quarter of 2024. Furthermore, during the third quarter of 2024, the Central Bank commenced targeted limited scope on-site examinations focusing on selected areas such as high lending rates, high fees, charges, and commissions charged by FSPs.

The Central Bank conducted numerous awareness programmes and training sessions targeting employees of regulated FSPs as well as public sector employees through regional awareness programmes and public media channels to disseminate the knowledge. During the period under consideration, 15 such awareness programmes and training sessions were conducted by the Central Bank. Furthermore, the Central Bank actively engaged with international experts on financial consumer protection and market conduct supervision, such as the International Finance Corporation of the World Bank (IFC-WB) and Alliance for Financial Inclusion (AFI). The Central Bank aims to continuously improve its regulatory framework and supervisory practices on financial consumer protection and to stay abreast with the latest developments in financial consumer protection.

While the Central Bank's recent initiatives mark a significant step towards protecting financial consumers, its ongoing challenge lies in ensuring comprehensive and consistent implementation of these Regulations across the Financial sector. Hence, through continued oversight, financial consumer education and stringent enforcement of compliance, the Central Bank aims to foster a more transparent, fair, and resilient financial environment in the country.

The Financial Literacy Roadmap for Sri Lanka was launched in May 2024, which offers evidence based guidance to all stakeholders engaged in financial literacy initiatives, aligning them towards a common objective: improving the financial behaviour of Sri Lankans and bolstering their financial resilience. The Central Bank launched the Financial Literacy Roadmap for Sri Lanka in May 2024 marking a significant milestone of the National Financial Inclusion Strategy and will be implemented as a five-year programme from 2024. The roadmap for financial literacy consolidates all efforts under a unified policy direction to nurture a financially literate community.

5.6. Other Policies to Improve the Resilience of the Financial System and Public Confidence

The Central Bank took measures to enhance the corporate governance of the Banking sector. With a view of further strengthening the existing Banking Act Directions on Corporate Governance, the Central Bank commenced drafting amendments in order to reflect the present market developments, international best practices, and evolving requirements in relation to corporate governance. A Consultation Paper on Amendments to Directions on Corporate Governance was issued in May 2024, proposing amendments mainly on healthy composition of the Board of Directors, effective functioning of Board subcommittees, effectiveness of risk oversight and control functions, competency and professional integrity of directors, CEOs and officers performing executive functions.

The regulatory framework for FCs was further strengthened, focusing on setting standards for improving risk management practices of the sector, whilst the supervision was broad-based to further examine the measures and controls implemented by FCs to address enhanced regulatory requirements. The Finance Business Act Direction No. 02 of 2024 was issued to FCs, requiring the establishment of a comprehensive credit risk management framework that outlines key principles for effective credit risk management. The framework will encompass a credit risk management strategy and policy tailored for FCs, along with a governance structure and management process for overseeing credit risk. In addition, it is expected to reinforce the stability of the sector with changes to the existing regulatory framework, while facilitating technology driven business models and strengthened corporate governance practices.

The Central Bank continued to implement the Masterplan for the consolidation of NBFIs, introduced in 2020, with the aim of creating a stronger and more stable NBFI sector. So far under Phase I of the Masterplan, eight transactions have been completed, and the license issued to an FC to carry on finance business is to be cancelled shortly, subsequent to the completion of amalgamation with another FC. With the implementation of Phase II of the Masterplan, it is expected to further enhance the stability of the FCs sector by 2028.

The Central Bank implemented measures to strengthen the legal framework governing Sri Lanka's Financial sector. The Central Bank provided technical assistance in drafting the Financial Asset Management Act for the purpose of establishing a regulatory framework for financial asset management companies in Sri Lanka. The framework was initiated with a view of off-loading impaired or underperforming assets of financial institutions designated therein as reflected in their balance sheets to financial asset management companies subject to the legal framework recognised in the proposed Act. The proposed Act has been forwarded to the Ministry of Finance for the finalisation of the same. Further, during the year under review, the Central Bank took initiatives to introduce the Bilateral Netting and Collateral Arrangement Act (BNCA Act), with a view of ensuring the adherence to international standards with regard to the enforceability of bilateral netting agreements and collateral arrangements in Sri Lanka in accordance with their terms, notwithstanding the commencement of insolvency proceedings or bank resolution proceedings. Drafting of the new Payment and Settlement Systems Act (PSSA) is also underway with the objective of establishing a regulatory framework that facilitates advancements in payment technologies, regulates payment systems and services, and supports innovation.

During the period under review, the Central Bank took several measures to strengthen the AML/CFT regime of the country. Accordingly, red flag indicators were issued by the Financial Intelligence Unit (FIU) on identification of suspicious transactions relating to the Securities sector, indicators for the money value transfer service providers, and identification of suspicious transactions relating to Trade Based Money Laundering (TBML). In addition, FIU imposed administrative penalties on two banks for their failure to adhere to the Financial Transactions Reporting Act and Financial Institutions Customer Due Diligence Rules.

Special Note 4

The Consequences of Grey Listing: The Importance of a Successful Mutual Evaluation for the Integrity of the Financial System of Sri Lanka

Money Laundering (ML) and Terrorist Financing (TF) could pose severe threats to the integrity of an economy, its financial system and to the security of the global financial system. Therefore, it is vital for Sri Lanka to have a robust domestic mechanism in place to mitigate the risks of ML/TF. In order to combat such crimes, the Financial Actions Task Force[1] (FATF), the global policy setter on Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT), has introduced 40 recommendations to be implemented by every country.

The FATF, through its FATF-styled regional bodies (FSRBs) periodically conducts Mutual Evaluations (MEs) to assess each country's technical compliance with FATF's 40 recommendations. These evaluations also measure the effectiveness of such implementation through 11 immediate outcomes to ascertain how well the country has adopted the FATF recommendations. As a member of the Asia Pacific Group on Money Laundering (APG), the FSRB set-up for Asia and the Pacific region, Sri Lanka is subject to periodic evaluation by the APG to assess the country's compliance with the FATF recommendations. This involves an in-depth analysis of the country's AML/CFT system, undertaken as a peer review. As such, Sri Lanka has undergone two MEs in 2006 and 2014/15. Both these evaluations resulted in Sri Lanka being listed as a "jurisdiction with strategic deficiencies" in its AML/CFT framework, commonly referred to as the "Grey List", by the FATF.

The third ME on the AML/CFT framework of Sri Lanka is scheduled to commence in March 2026. This evaluation process is of significant national importance as it identifies weaknesses in the national systems and areas for improvement within the AML/CFT framework of the country. Having a weak AML/CFT framework could pose system wide implications particularly through reputational and operational risks. The upcoming ME will be a significant event in the country's economic and financial progression, given the two previous MEs, which resulted in Sri Lanka being included in the FATF "Grey List" and subsequent economic and financial repercussions.

Any adverse listing by the FATF following the upcoming ME would have negative consequences on multiple fronts. One significant impact could be on correspondent banking relationships, leading Sri Lankan banks to reassess international relationships and potentially causing disruptions in operations and efficiency in cross-border transactions. Sri Lankan financial institutions, legal entities, and individuals may face heightened scrutiny and enhanced due diligence in international dealings, complicating cross-border transactions and curtailing access to global financial services. Additionally, increased scrutiny by foreign banks and potential listings or warnings from international organisations could further complicate international transactions and raise compliance costs. Elevated borrowing costs and risk premia are inevitable for domestic borrowers, making it more difficult and expensive to access international debt markets. Further, increase in country's risk premium could potentially discourage investments to Sri Lanka. A grey listing could also harm the country's image in the international financial markets, undermining investor confidence, reducing foreign direct investments, and negatively impacting on branding efforts. The adverse listing would also negatively affect the country's sovereign and credit ratings, as well as its Ease of Doing Business rankings.

In view of foregoing, Sri Lanka is required to showcase strong performance at the upcoming ME. The Financial Intelligence Unit (FIU) plays a key role in ensuring that stakeholders are taking all possible measures to strengthen the country's AML/CFT framework and that the country is compliant with the FATF recommendations. Therefore, financial sector institutions must comply with the AML/CFT legal obligations to avoid legal and regulatory consequences. Furthermore, these institutions and sector prudential regulators should have a thorough understanding of the national ML/TF risk factors particularly those affecting their sector/institution. The sectors are encouraged to gain awareness, have systems to counter and mitigate institutional risk events, and have a proactive approach to support the efforts of the FIU and sector prudential supervisors to enhance integrity of the financial system.

1 The FATF is an intergovernmental organisation founded in 1989 on the initiative of the G-7 economies, which is now represented by the G-20 group of countries and having among its direct membership of 38 countries and 2 regional organisations, namely, the Gulf Cooperation Council and the European Commission.

Appendix 1

Financial Soundness Indicators - Banking Sector

		2019	2020	2021	2022	2023*	2024 Jun**
1. Capital Adequacy							
1.1	Capital Adequacy Ratio (a)	17.2	17.1	16.5	16.2	18.4	18.0
1.2	Tier-1 Capital Ratio (b)	13.7	13.6	13.2	13.2	15.2	15.0
1.3	Net Non-Performing Loans (c) to Equity Capital & Reserves	19.5	17.2	11.5			
1.4	Net Stage 3 Loans (Net NPLs) (d) to Equity Capital & Reserves				44.0	40.9	38.2
1.5	Debt to Equity Capital & Reserves	148.6	134.9	148.9	117.1	79.1	69.7
1.6	Equity Capital & Reserves to Total Assets	9.0	8.6	8.7	8.2	8.7	8.8
2. Asset Quality							
2.1	Non-Performing Loans (e) to Total Loans and Advances	4.7	4.9	4.5			
2.2	Stage 3 Loans (NPLs) (f) to Total Loans and Receivables (f)				11.3	12.8	12.8
2.3	Net Non-Performing Loans (c) to Total Loans and Advances	2.8	2.4	1.7			
2.4	Net Stage 3 Loans (Net NPLs) (d) to Total Loans and Receivables (f)				6.5	7.0	6.7
2.5	Total Provisions (g) to Total Loans & Advances	2.5	3.0	3.4			
2.6	Total Provision Coverage Ratio (h)	52.3	61.3	75.8			
2.7	Total Impairment (Total Provision) Coverage Ratio (i)				7.9	8.6	8.7
2.8	Specific Provision Coverage Ratio (j)	42.4	51.7	64.0			
2.9	Stage 3 Impairment (Provision for NPLs) Coverage Ratio (k)				45.2	49.0	51.1
2.10	Total Provisions (g) to Total Assets	1.6	1.9	2.1			
2.11	Total Impairment (Total Provisions) (l) to Total Assets				4.7	4.7	4.7
2.12	Total Loans & Receivables to Total Assets	64.9	62.0	61.9	58.3	54.0	53.5
2.13	Investments to Total Assets	24.2	28.8	29.1	30.5	35.8	37.9
2.14	Total Income to Total Assets	10.7	8.9	8.1	12.2	13.8	5.8
2.15	Net Interest Income to Total Assets	3.4	2.9	3.2	3.9	3.5	1.9
2.16	Operating Income (m) to Total Assets	4.5	3.9	4.2	5.3	4.5	2.4
3. Earnings & Profitability							
3.1	Return on Equity (ROE) – After Tax (n)	10.3	11.4	14.5	10.4	11.5	12.7
3.2	Return on Assets (ROA) – Before Tax (o)	1.4	1.4	1.6	0.9	1.5	1.8
3.3	Return on Assets (ROA) – After Tax (p)	0.9	1.0	1.2	0.8	1.0	1.1
3.4	Interest Income to Total Income	90.2	89.1	87.8	88.1	92.6	92.0
3.5	Net Interest Income to Total Income	32.0	32.8	40.2	31.8	25.4	32.8
3.6	Non-Interest Income to Total Income	9.8	10.9	12.2	11.9	7.4	8.0
3.7	Non-Interest Expenses (Operating Expenses) to Total Income	19.7	19.4	22.0	13.7	13.3	17.5
3.8	Staff Expenses to Non-Interest Expenses	44.6	46.4	45.2	53.5	50.8	52.9
3.9	Staff Expenses to Total Income	8.8	9.0	9.9	7.3	6.7	9.3
3.10	Provision Charge to Total Income	4.6	6.4	6.7			
3.11	Impairment Charge (Provision Charge) to Total Income				19.9	6.1	4.0
3.12	Total Cost to Total Income (q)	77.8	75.7	69.5	70.0	80.5	76.7
3.13	Efficiency (Operating Cost) Ratio (r)	52.7	51.8	48.1	31.4	40.5	42.9
3.14	Net Interest Margin (s)	3.6	3.1	3.4	4.0	3.7	3.9
4. Liquidity							
4.1	All-Currency High Quality Liquid Assets to Total Assets	18.2	24.0	22.5	18.5	32.2	34.4
4.2	Rupee Liquidity Coverage Ratio	212.8	255.9	217.8	237.8	340.9	339.9
4.3	All-Currency Liquidity Coverage Ratio	178.2	202.1	171.8	191.2	288.4	293.5
5. Assets / Funding Structure							
5.1	Deposits to Total Assets	73.2	76.0	76.4	78.8	81.5	82.1
5.2	Borrowings to Total Assets	13.4	11.5	13.1	9.6	6.9	6.1
5.3	Capital to External Funds (t)	10.4	9.8	9.9	9.3	9.8	10.0
5.4	Credit to Deposits	88.7	81.6	82.7	73.9	66.3	65.1
5.5	Credit to Deposits & Borrowings	74.9	70.8	70.6	65.9	61.1	60.6
5.6	Credit to Deposits & Borrowings & Capital	67.8	64.5	64.2	60.3	55.7	55.1

Note: Information from 2020 are based on Sri Lanka Financial Reporting Standards based reporting.

Source: Central Bank of Sri Lanka

* Revised

** Provisional

(a) The ratio of regulatory capital to risk-weighted assets
(b) The ratio of core capital to risk-weighted assets
(c) Non-performing loans net of interest in suspense and specific provisions
(d) Net of stage 3 impairment and including undrawn portion
(e) Net of interest in suspense
(f) Including undrawn portion
(g) Specific loan loss provisions and general loan loss provisions
(h) The ratio of specific provisions and general provisions to non-performing loans net of interest in suspense
(i) The ratio of total impairment to total loans and receivables
(j) The ratio of specific provisions to non-performing loans net of interest in suspense
(k) The ratio of stage 3 impairment to stage 3 loans
(l) Individual impairment and collective impairment
(m) Operating income (gross income) includes net interest income and non-interest income
(n) Profit after tax (annualised) as a percentage of average equity
(o) Profit before tax (annualised) as a percentage of average assets
(p) Profit after tax (annualised) as a percentage of average assets
(q) The ratio of interest expenses and non-interest expenses to interest income and non-interest income
(r) The ratio of operating expenses to gross income
(s) The ratio of net interest income (annualised) to average sssets
(t) Deposits and borrowings (debt)

Appendix 2

Financial Soundness Indicators - Licensed Commercial Banks

		2019	2020	2021	2022	2023*	2024 Jun**
1. Capital Adequacy							
1.1	Capital Adequacy Ratio (a)	17.2	17.1	16.7	16.0	18.3	17.8
1.2	Tier-1 Capital Ratio (b)	13.7	13.6	13.2	13.1	15.1	14.8
1.3	Net Non-Performing Loans (c) to Equity Capital & Reserves	18.3	15.5	9.9			
1.4	Net Stage 3 Loans (Net NPLs) (d) to Equity Capital & Reserves				43.5	40.2	37.3
1.5	Debt to Equity Capital & Reserves	147.5	137.9	154.6	118.0	75.0	67.6
1.6	Equity Capital & Reserves to Total Assets	9.5	9.0	9.0	8.6	9.0	9.1
2. Asset Quality							
2.1	Non-Performing Loans (e) to Total Loans and Advances	4.6	4.7	4.3			
2.2	Stage 3 Loans (NPLs) (f) to Total Loans and Receivables (f)				11.5	13.0	13.0
2.3	Net Non-Performing Loans (c) to Total Loans and Advances	2.6	2.2	1.4			
2.4	Net Stage 3 Loans (Net NPLs) (d) to Total Loans and Receivables (f)				6.5	6.9	6.6
2.5	Total Provisions (g) to Total Loans & Advances	2.5	3.1	3.4			
2.6	Total Provision Coverage Ratio (h)	54.0	64.7	80.4			
2.7	Total Impairment (Total Provision) Coverage Ratio (i)				8.2	8.9	8.9
2.8	Specific Provision Coverage Ratio (j)	43.8	54.6	67.9			
2.9	Stage 3 Impairment (Provision for NPLs) Coverage Ratio (k)				46.2	50.1	52.5
2.10	Total Provisions (g) to Total Assets	1.7	2.0	2.2			
2.11	Total Impairment (Total Provisions) (l) to Total Assets				5.1	5.0	5.0
2.12	Total Loans & Receivables to Total Assets	67.3	64.6	64.5	59.9	55.6	54.9
2.13	Investments to Total Assets	21.9	26.4	26.6	28.5	33.8	36.2
2.14	Total Income to Total Assets	10.6	8.7	7.9	12.2	13.7	5.7
2.15	Net Interest Income to Total Assets	3.5	2.9	3.1	4.0	3.6	1.9
2.16	Operating Income (m) to Total Assets	4.6	3.9	4.2	5.6	4.7	2.4
3. Earnings & Profitability							
3.1	Return on Equity (ROE) – After Tax (n)	10.6	10.9	13.8	11.0	11.8	12.6
3.2	Return on Assets (ROA) – Before Tax (o)	1.5	1.4	1.6	1.0	1.6	1.8
3.3	Return on Assets (ROA) – After Tax (p)	1.0	1.0	1.2	0.9	1.1	1.1
3.4	Interest Income to Total Income	89.1	87.9	86.3	86.9	92.1	91.2
3.5	Net Interest Income to Total Income	32.5	33.0	39.7	32.7	26.4	32.8
3.6	Non-Interest Income to Total Income	10.9	12.1	13.7	13.1	7.9	8.8
3.7	Non-Interest Expenses (Operating Expenses) to Total Income	20.0	19.7	22.2	13.4	13.2	17.4
3.8	Staff Expenses to Non-Interest Expenses	43.1	45.2	43.6	51.4	48.4	50.2
3.9	Staff Expenses to Total Income	8.6	8.9	9.7	6.9	6.4	8.7
3.10	Provision Charge to Total Income	4.8	7.1	7.3			
3.11	Impairment Charge (Provision Charge) to Total Income				21.8	6.6	4.4
3.12	Total Cost to Total Income (q)	76.6	74.7	68.8	67.5	78.8	75.7
3.13	Efficiency (Operating Cost) Ratio (r)	51.8	51.7	48.2	29.2	38.3	41.7
3.14	Net Interest Margin (s)	3.6	3.1	3.3	4.1	3.8	3.9
4. Liquidity							
4.1	All-Currency High Quality Liquid Assets to Total Assets	15.5	21.3	20.1	17.3	31.1	33.3
4.2	Rupee Liquidity Coverage Ratio	196.8	244.1	213.1	248.5	346.1	344.2
4.3	All-Currency Liquidity Coverage Ratio	159.0	184.9	159.9	190.5	285.4	290.4
5. Assets / Funding Structure							
5.1	Deposits to Total Assets	72.0	74.7	75.1	77.9	81.3	81.8
5.2	Borrowings to Total Assets	14.0	12.4	14.1	10.1	6.7	6.2
5.3	Capital to External Funds (t)	11.1	10.3	10.3	9.7	10.2	10.4
5.4	Credit to Deposits	93.4	86.5	87.6	76.9	68.4	67.1
5.5	Credit to Deposits & Borrowings	78.1	74.2	73.7	68.1	63.1	62.4
5.6	Credit to Deposits & Borrowings & Capital	70.4	67.3	66.9	62.0	57.3	56.5

Note: Information from 2020 are based on Sri Lanka Financial Reporting Standards based reporting.
Source: Central Bank of Sri Lanka

* Revised
** Provisional

(a) The ratio of regulatory capital to risk-weighted assets
(b) The ratio of core capital to risk-weighted assets
(c) Non-performing loans net of interest in suspense and specific provisions
(d) Net of stage 3 impairment and including undrawn portion
(e) Net of interest in suspense
(f) Including undrawn portion
(g) Specific loan loss provisions and general loan loss provisions
(h) The ratio of specific provisions and general provisions to non-performing loans net of interest in suspense
(i) The ratio of total impairment to total loans and receivables
(j) The ratio of specific provisions to non-performing loans net of interest in suspense
(k) The ratio of stage 3 impairment to stage 3 loans
(l) Individual impairment and collective impairment
(m) Operating income (gross income) includes net interest income and non-interest income
(n) Profit after tax (annualised) as a percentage of average equity
(o) Profit before tax (annualised) as a percentage of average assets
(p) Profit after tax (annualised) as a percentage of average assets
(q) The ratio of interest expenses and non-interest expenses to interest income and non-interest income
(r) The ratio of operating expenses to gross income
(s) The ratio of net interest income (annualised) to average sssets
(t) Deposits and borrowings (debt)

Appendix 3

Financial Soundness Indicators - Licensed Specialised Banks

		2019	2020	2021	2022	2023*	2024 Jun**
1. Capital Adequacy							
1.1	Capital Adequacy Ratio (a)	16.2	16.8	14.6	18.5	20.1	20.9
1.2	Tier-1 Capital Ratio (b)	12.9	13.7	12.0	14.8	16.8	17.6
1.3	Net Non-Performing Loans (c) to Equity Capital & Reserves	33.0	36.8	27.6			
1.4	Net Stage 3 Loans (Net NPLs) (d) to Equity Capital & Reserves				50.3	49.6	47.4
1.5	Debt to Equity Capital & Reserves	162.6	101.6	93.6	106.4	129.5	93.4
1.6	Equity Capital & Reserves to Total Assets	5.6	5.6	6.4	5.6	5.9	6.4
2. Asset Quality							
2.1	Non-Performing Loans (e) to Total Loans and Advances	5.5	6.9	6.5			
2.2	Stage 3 Loans (NPLs) (f) to Total Loans and Receivables (f)				9.0	10.6	11.2
2.3	Net Non-Performing Loans (c) to Total Loans and Advances	3.9	4.9	4.1			
2.4	Net Stage 3 Loans (Net NPLs) (d) to Total Loans and Receivables (f)				6.4	7.3	7.6
2.5	Total Provisions (g) to Total Loans & Advances	2.1	2.5	2.8			
2.6	Total Provision Coverage Ratio (h)	38.6	36.7	43.8			
2.7	Total Impairment (Total Provision) Coverage Ratio (i)				4.3	5.5	5.8
2.8	Specific Provision Coverage Ratio (j)	31.3	30.9	37.5			
2.9	Stage 3 Impairment (Provision for NPLs) Coverage Ratio (k)				31.4	34.0	34.6
2.10	Total Provisions (g) to Total Assets	1.0	1.1	1.2			
2.11	Total Impairment (Total Provisions) (l) to Total Assets				1.9	2.4	2.4
2.12	Total Loans & Receivables to Total Assets	48.1	43.6	44.0	45.4	42.0	41.9
2.13	Investments to Total Assets	40.0	46.0	46.5	46.8	51.3	51.3
2.14	Total Income to Total Assets	11.3	9.9	9.0	11.5	14.7	6.5
2.15	Net Interest Income to Total Assets	3.3	3.1	3.9	2.8	2.6	2.1
2.16	Operating Income (m) to Total Assets	3.6	3.5	4.1	2.9	3.1	2.3
3. Earnings & Profitability							
3.1	Return on Equity (ROE) – After Tax (n)	6.8	16.7	21.5	3.4	7.7	13.8
3.2	Return on Assets (ROA) – Before Tax (o)	0.8	1.3	1.7	0.3	0.4	1.4
3.3	Return on Assets (ROA) – After Tax (p)	0.4	0.9	1.3	0.2	0.4	0.8
3.4	Interest Income to Total Income	97.1	96.3	97.4	98.6	97.0	97.9
3.5	Net Interest Income to Total Income	29.0	31.7	43.7	24.1	17.8	33.0
3.6	Non-Interest Income to Total Income	2.9	3.7	2.6	1.4	3.0	2.1
3.7	Non-Interest Expenses (Operating Expenses) to Total Income	17.5	17.3	20.5	16.7	14.0	18.6
3.8	Staff Expenses to Non-Interest Expenses	55.4	55.0	55.7	67.2	67.8	71.0
3.9	Staff Expenses to Total Income	9.7	9.5	11.4	11.2	9.5	13.2
3.10	Provision Charge to Total Income	2.9	2.2	3.0			
3.11	Impairment Charge (Provision Charge) to Total Income				3.4	2.6	0.7
3.12	Total Cost to Total Income (q)	85.6	81.9	74.3	91.2	93.2	83.4
3.13	Efficiency (Operating Cost) Ratio (r)	60.1	52.0	47.3	65.4	67.2	52.8
3.14	Net Interest Margin (s)	3.4	3.4	4.1	2.8	2.6	4.3
4. Liquidity							
4.1	All-Currency High Quality Liquid Assets to Total Assets	37.5	42.8	38.9	27.9	40.4	42.8
4.2	Rupee Liquidity Coverage Ratio	272.3	300.4	235.3	197.6	313.2	316.0
4.3	All-Currency Liquidity Coverage Ratio	272.3	298.6	235.3	194.5	308.1	314.5
5. Assets / Funding Structure							
5.1	Deposits to Total Assets	80.9	84.6	85.7	85.9	83.7	84.8
5.2	Borrowings to Total Assets	9.0	5.7	6.1	6.0	7.7	6.0
5.3	Capital to External Funds (t)	6.2	6.3	7.2	6.1	6.5	7.1
5.4	Credit to Deposits	59.5	51.6	52.5	52.9	50.2	49.4
5.5	Credit to Deposits & Borrowings	53.5	48.3	49.0	49.5	46.0	46.2
5.6	Credit to Deposits & Borrowings & Capital	50.4	45.5	45.7	46.6	43.2	43.1

Note: Information from 2020 are based on Sri Lanka Financial Reporting Standards based reporting.

Source: Central Bank of Sri Lanka

* Revised
** Provisional

(a) The ratio of regulatory capital to risk-weighted assets
(b) The ratio of core capital to risk-weighted assets
(c) Non-performing loans net of interest in suspense and specific provisions
(d) Net of stage 3 impairment and including undrawn portion
(e) Net of interest in suspense
(f) Including undrawn portion
(g) Specific loan loss provisions and general loan loss provisions
(h) The ratio of specific provisions and general provisions to non-performing loans net of interest in suspense
(i) The ratio of total impairment to total loans and receivables
(j) The ratio of specific provisions to non-performing loans net of interest in suspense
(k) The ratio of stage 3 impairment to stage 3 loans
(l) Individual impairment and collective impairment
(m) Operating income (gross income) includes net interest income and non-interest income
(n) Profit after tax (annualised) as a percentage of average equity
(o) Profit before tax (annualised) as a percentage of average assets
(p) Profit after tax (annualised) as a percentage of average assets
(q) The ratio of interest expenses and non-interest expenses to interest income and non-interest income
(r) The ratio of operating expenses to gross income
(s) The ratio of net interest income (annualised) to average sssets
(t) Deposits and borrowings (debt)

Appendix 4

Financial Soundness Indicators - Finance Companies Sector

	2019 Mar	2020 Mar	2021 Mar	2022 Mar	2023 Mar (a)	2024 Mar (b)	2024 June (b)
1. Capital Adequacy							
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	10.1	12.0	14.8	17.3	22.0	21.9	23.8
1.2 Tier-1 Capital/Risk Weighted Assets (Tier-1 RWCAR)	8.8	10.6	13.6	15.8	20.7	21.0	22.9
1.3 Regulatory Capital to Total Assets	10.1	12.2	15.0	16.3	18.9	18.7	20.3
1.4 Borrowings to Equity (times)	2.4	1.9	1.1	1.1	0.7	0.6	0.6
1.5 Investment Properties to Regulatory Capital	14.5	15.5	16.6	16.9	17.3	18.0	17.0
1.6 Net Non-performing Loans to Regulatory Capital	18.8	26.6	15.6	9.2	43.2	37.4	31.4
2. Asset Quality							
2.1 Gross Non-performing Loans to Total Advances	7.8	11.6	11.3	9.0	15.9	14.7	13.6
2.2 Provision made against Total Advances	4.6	6.4	7.2	6.3	7.6	7.0	6.9
2.3 Provision Coverage Ratio	58.8	54.5	64.0	69.6	33.3	35.8	37.8
3. Earnings & Profitability							
3.1 Return on Assets (Annualised)	2.6	1.7	3.1	5.3	3.8	5.5	5.1
3.2 Return on Equity (Annualised)	12.0	6.2	12.8	20.8	9.4	12.9	10.9
3.3 Interest Income to Interest Expenses	181.5	180.9	204.2	252.1	171.2	185.3	214.5
3.4 Net Interest Income to Profit After Tax	568.2	955.6	381.3	213.5	407.3	321.4	392.3
3.5 Operating Cost to Net Interest Income	78.2	79.9	70.6	63.6	62.8	60.7	61.6
3.6 Net Interest Income to Average Assets (Annualised)	7.8	7.4	7.4	8.0	8.5	10.0	10.4
3.7 Net Interest Income to Interest Income	44.9	44.7	51.0	60.3	41.6	46.0	53.4
3.8 Non-Interest Expenses to Total Cost	38.9	39.3	42.4	49.2	29.4	33.2	39.6
3.9 Efficiency Ratio	70.0	77.7	62.4	49.1	58.6	52.4	55.9
3.10 Cost to Income Ratio	86.9	91.1	81.7	67.0	82.8	76.8	76.2
4. Liquidity							
4.1 Liquid Assets to Total Assets	8.8	8.3	8.9	9.8	14.0	14.8	14.7
4.2 Liquid Assets to Deposits and Borrowings	11.2	11.0	12.6	14.1	19.2	21.0	20.9
4.3 Net Loans to Total Borrowings	264.8	291.2	375.5	337.4	412.2	488.7	471.6
5. Assets / Funding Structure							
5.1 Borrowings to Total Assets	29.3	26.4	20.2	22.6	17.3	14.1	14.8
5.2 Investments to Total Assets	9.1	9.5	11.4	11.3	20.2	22.7	22.2

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

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