Financial System Stability Review 2015

September 2015

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இலங்கை மத்திய வங்கி
CENTRAL BANK OF SRI LANKA

Financial System Stability Review 2015

Central Bank of Sri Lanka

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ISBN 978 - 955 - 575 - 294 - 7

Published by the Central Bank of Sri Lanka, Colombo 1.

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Governor's Message

The Sri Lankan financial system has remained resilient to internal and external shocks since the previous issue of the Financial Stability Review in June 2014, providing an environment that supported the continued expansion of economic activities. A new development has been the implementation of broad macroprudential measures to mitigate potential risks to the stability of the financial sector. Going forward, the volatility in global capital flows and lingering uncertainty on the sustainability of global recovery are likely to have an impact on the risk profile of the Sri Lankan financial system. Hence, it is important to be vigilant of global and local developments while adopting measures that support financial stability in the upcoming period, as and when necessary.

The Central Bank of Sri Lanka presents this Review with a view to providing the public with a transparent assessment of the perceived risks to Sri Lanka's financial system. I strongly believe that this Review, offering a comprehensive discussion on selected international and domestic developments as well as the financial sector developments related to Sri Lanka's financial stability, is a useful and necessary step to informing the public on the crucial aspects of Central Bank policy which have an impact on the common good.

Arjuna Mahendran
Governor
Central Bank of Sri Lanka

Acronyms

AMC	Assets Management Company
AWCMR	Average Weighted Call Money Rate
BOE	Bank of England
BOJ	Bank of Japan
BOP	Balance of Payments
CAR	Capital Adequacy Ratio
CBSL	Central Bank of Sri Lanka
CSE	Colombo Stock Exchange
ECB	European Central Bank
EMEs	Emerging Market Economies
EMDC	Emerging Market Economies and Developing Countries
Fed	United States Federal Reserve Bank
FSR	Financial Stability Report
GDP	Gross Domestic Product
HHR	Hui Heubel Ratio
IFSR	International Financial Reporting Standard
IMF	International Monetary Fund
LBs	Licensed Banks
LCB	Licensed Commercial Bank
LFCs	Licenced Finance Companies
LKR	Sri Lanka Rupee
LSB	Licensed Specialised Banks
LTV	Loan to Value
NBFIs	Non-bank Financial Institutions
NIM	Net Interest Margin
NOP	Net Open Position
NPLs	Non-performing Loans
PMWYR	Primary Market Weighted Average Yield Rate
QE	Quantitative Easing
RHS	Right Hand Side
ROA	Return on Assets
ROE	Return on Equity
SLAR	Statutory Liquid Asset Ratio
SLC	Specialised Leasing Company
SLDBs	Sri Lanka Development Bonds
SPVs	Special Purpose Vehicles
USA/US	United States of America
YOY	Year-on-Year
USD	US Dollar

Overview

International and domestic developments have increasingly been affecting Sri Lanka's financial stability. Global growth projections have been continuously revising downward and 2015 growth is projected to be lower than that in 2014, with a gradual pickup in advanced economies and a slowdown in emerging market economies and developing countries (EMDCs). Further, so far in 2015, low commodity prices have led the inflation in advanced economies to decline below the target levels. In EMDCs, however, inflation rates indicated an upward trend mainly due to depreciation of their national currencies. The aforementioned trends in growth and inflation have led to further divergence in policy responses. Accordingly, global markets have become highly unpredictable due to elevated uncertainties.

Low commodity prices in international markets are considered healthy for the financial stability as such developments will have positive impact on inflation, current account deficit and growth outlook of Sri Lanka. However, there have been several other international and domestic developments in terms of risk to the financial stability. Such international developments, primarily linked to the lingering uncertainty regarding the US Federal Reserve Bank's (Fed) decision on interest rate, include reversing capital flows, depreciation pressure on Sri Lankan rupee, increasing financial market volatility, and tighter external financing conditions. Domestic developments that increase the stability risk include increased volumes of consumption related imports and banking sector credits, pressure on market interest rates largely emanating from excessive government borrowings from domestic sources, and sharp decline in liquidity in foreign exchange, government securities and inter-bank money markets.

However, The Central Bank of Sri Lanka (CBSL) has taken broad macroprudential measures to mitigate potential risks to the financial stability from consumption related excessive lending, while maintaining its cautious monetary policy stance. It would continue to mitigate macro-financial risks by introducing further macro prudential measures.

There has been a reversal of slow rate of credit growth witnessed in the licensed banks and non-bank financial institutions sectors[1/] in 2013 and 2014. Low market interest rates with excess rupee liquidity and availability of cheap short-term funding from foreign sources in the past have helped the financial institutions to accelerate credit disbursements, with relatively high growth in lending for consumption purposes. Sector wise non-performing loans (NPL) ratios of banking and non-banking financial institutions regulated by the CBSL remained relatively low. However, possible rise in interest rates would increase the level of delinquency of loans granted by Licensed Banks (LBs) and Licensed Non-bank Financial Institutions (NBFIs). Further, there have been a few Registered Finance Companies (RFCs) with substantially high NPLs. On this background, the international and domestic developments cited above call for an intensive monitoring of financial sector developments with a view to identify potential threats to financial stability.

The liquidity position of the banking and non-bank financial institutions remain strong. LBs and NBFIs have been able to comply with prudential statutory provisions on minimum liquidity standards. However, the recent hike of negative maturity mismatch in assets and liabilities maturity profile of LBs and NBFIs have to be closely monitored on the back of sharp decline of excess liquidity in the overnight wholesale money market and also the development in the international market which would affect the ability of LBs in obtaining and rolling over of external funding. Further, any interest rate hike would increase the delinquency of the credit portfolios

1/ The Licensed Banks (LBs) sector consists of 25 Licensed Commercial Banks (LCBs) and 8 Licensed Specialized Banks (LSBs). Non-bank financial institutions (NBFIs) sector consists of 47 Registered Finance Companies (RFCs) and 9 Secialised Leasing Companies (SLCs).

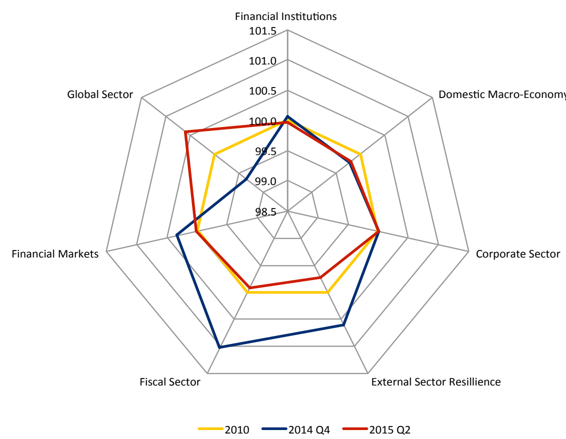
of LBs and NBFIs sectors and thereby shrinking the operating cash flows while lowering the market value of liquid assets, mostly the investments in fixed rate T-bills and T-bonds. In general, as indicated by the macro-stress test results, current levels of net interest margins and capital of LBs and NBFIs are sufficient enough to withstand against any adverse interest rate shock.

In terms of foreign exchange risk, the macro stress-test results indicate that the exchange rate shocks do not lead to pressure on the banking sector directly via their balance sheet channels as banking sector foreign exchange net open positions are strictly regulated by the CBSL and current aggregate of NOPs of all commercial banks remain less than US$ 200 million. However, indirect foreign exchange risk exposure of banks through lending in foreign currencies to their customers has to be evaluated to ensure that the banking system is adequately protected against the foreign exchange risk.

The systemically important payment and settlement systems in Sri Lanka continued to function without disruption and systemic concerns. The Retail payment and settlement systems on the other hand undergone a rapid change with innovations in electronic retail payment and settlement systems during the period since the issuance of previous FSR. As there have been new risks emerged with aforementioned developments, the regulatory and supervisory regime of CBSL was strengthened appropriately.

The Financial Stability Map (Chart 1) illustrates the systemic developments that affect financial stability in Sri Lanka during the first half of 2015 in comparison to 2010 and end of 2014. Accordingly, financial markets, fiscal sector, and external sector resilience related developments have been weaker during the first half of 2015 compared to the end of 2014 and affected negatively to the overall financial stability.

Chart 1 **Financial Stability Map[(a)]**



(a) Getting closer to the center reflects the negative contribution of the related sector to overall financial stability.

Source: Central Bank of Sri Lanka

Section 1

1. International and Domestic Developments Affecting Financial Stability

Global growth is projected at 3.5 percent in 2015, marginally lower than in 2014, with a gradual pickup in advanced economies and a slowdown in emerging and developing economies. Further, so far in 2015, low commodity prices have led the inflation in advanced economies to decline below the target levels. In EMDCs, however, inflation rates indicated an upward trend mainly due to depreciation of national currencies. The aforementioned discrepancies between growth and inflation trends of countries have led to further divergence in policy responses. Accordingly, global markets have become highly unpredictable due to elevated uncertainties.

Low commodity prices are positively affecting the inflation and current account deficit and growth outlook in EMDCs that import commodities, including oil. However, rapidly depreciating national currencies, increasing financial market volatility as a result of reversing capital flows emanating from increasingly divergent monetary policies on the back of clouded economic growth outlook in advanced economies and EMDCs and tighter external financing conditions for EMDCs are expected to increase financial stability risks.

In Sri Lanka, economic activity remained moderate in a relatively low inflation environment. However, there have been unfavorable developments in terms of financial stability since the issue of June 2014 Financial Stability Report (FSR). These developments include increasing banking sector credits for consumption purposes, excessive government borrowing from domestic sources exerting pressure on interest rates, widening trade deficit and deceleration in the growth of other inflows to the Balance of Payments

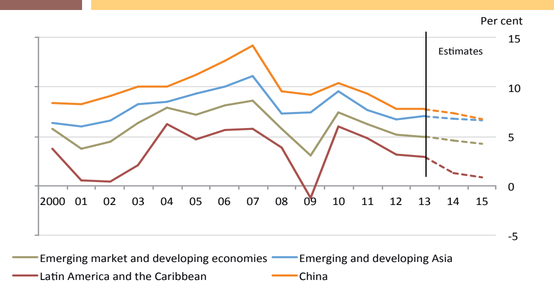
(BOP), gradual withdrawal of foreign investments in government securities, tightening external financing conditions, increased volatility on the back of weakening liquidity in foreign exchange, government securities and inter-bank money markets. The Central Bank of Sri Lanka (CBSL), however, has taken broad macroprudential measures to mitigate potential risks to the financial stability. While the CBSL maintains its cautious monetary policy stance, it would continue to mitigate macro-financial risks by introducing further measures supporting financial stability.

1.1 International Developments Affecting Financial Stability

The world output growth and growth outlook continued to remain modest and uneven. The world output grew by 3.4 per cent in 2014. It is expected to grow by 3.1 per cent and 3.6 per cent in 2015 and 2016, respectively. Amongst major world economies, the United States of America (USA) demonstrates relatively higher growth prospects compared to other advanced economies. The euro area, although in the recovery phase, growth is still subdued and the potential growth is likely to be slowed due to internal economic imbalances and high levels of indebtedness constraining consumer spending and business investment in many European countries. Contrary to the advanced economies, growth in EMDCs continued to slow down. Their growth dropped to 4.6 per cent in 2014, from 5.0 per cent in 2013, which is further expected to contract to 4.0 per cent in 2015 (Chart 1.1.1 & 1.1.2).

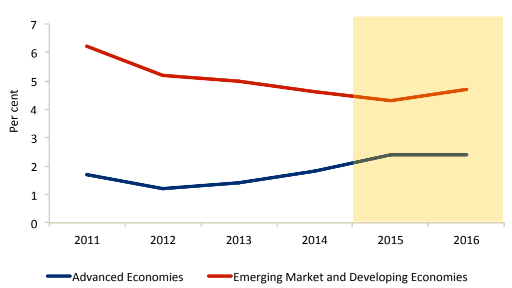
Significant divergence in inflation outlook in advanced economies and EMDCs. World commodity prices, including oil prices, have sharply declined since early 2014 owing to increased production, declining demand on the back of slowing economic activities in some EMEs, particularly in China, which is the world's largest commodity consumer (Chart 1.1.3). The decline

Chart 1.1.1 **EMEs Annual GDP Growth**



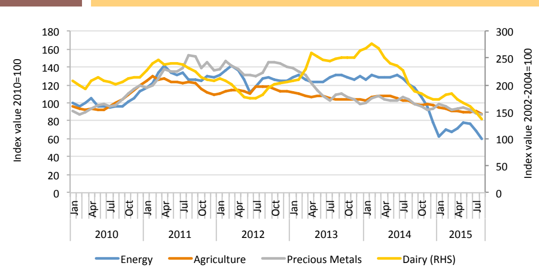
Source: IMF World Economic Outlook (April 2015)

Chart 1.1.2 **World Output (Annual Growth)**



Source: IMF World Economic Outlook (April 2015)

Chart 1.1.3 **World Commodity Prices**



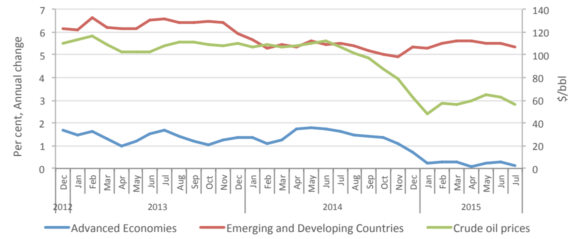
Source: World Bank

in commodity prices, principally in oil prices has reduced the inflationary pressure both in the advanced economies and the EMDCs (Chart 1.1.4). Weak demand in selected advanced countries, including euro area and Japan, resulted in keeping the inflation rates below the central banks' targets. However, the inflation rates in EMDCs demonstrate an upward trend in the recent period owing to the depreciation of their national currencies (Chart 1.1.5).

The monetary policy actions of advanced economies are expected to diverge substantially due to discrepancies in their growth and the inflation outlook. In November 2008, the Federal Reserve System of USA (Fed) embarked on Quantitative Easing (QE) with the hope of steering the world's largest economy through the depths of the financial crisis. Parallel with the Fed's QE, the European Central Bank (ECB), Bank of England (BOE), and Bank of Japan (BOJ) also commenced similar cash injection programmes in response to falling inflation and weak economic growth in their jurisdictions. As the aforementioned QE programmes, coupled with low interest rates, freed up capital in the respective economies, investors diverted a large sums of capital into EMDCs. Sri Lanka also benefitted, in the form of investment by foreigners in sovereign and corporate debt securities (Chart 1.1.6) and also investments in sovereign debt securities issued in national currencies. These inflows have helped EMDCs to increase investments and record relatively high growth rates (Chart 1.1.7).

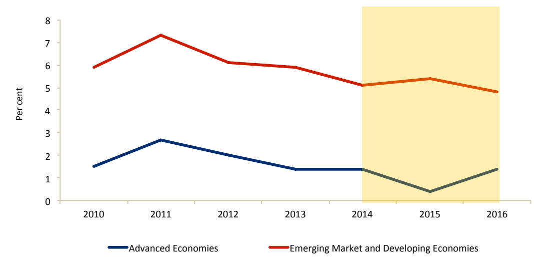
After more than five years, the ECB and BOJ, continue with their asset purchase programmes in response to falling inflation and weak economic growth. However, the QE era in the USA appears to be over and the market highly speculates of a tightening monetary policy action by the Fed in the near future on the back of forecasted economic growth and stability (Chart 1.1.8).

Chart 1.1.4 Crude Oil Prices and Inflation in Advanced Economies and EMEs & DCs



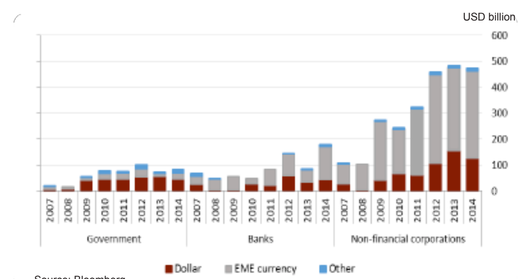
Source: Bloomberg

Chart 1.1.5 Headline Inflation – Advanced Economies and EMDCs



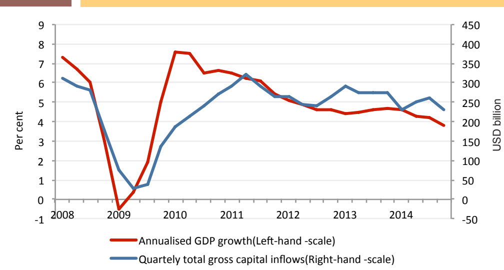
Source: World Bank and IMF

Chart 1.1.6 Annual Net Issuance of Debt by EME Borrowers



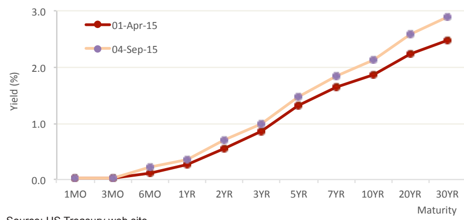
Source: Bloomberg

Chart 1.1.7 EMEs' GDP Growth and Capital Inflows



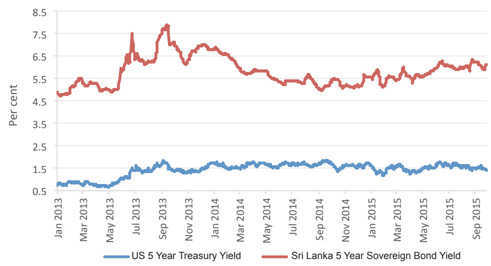
Source: IMF World Economic Outlook (April 2015)

Chart 1.1.8 **Benchmark US Treasury Yield Curve**



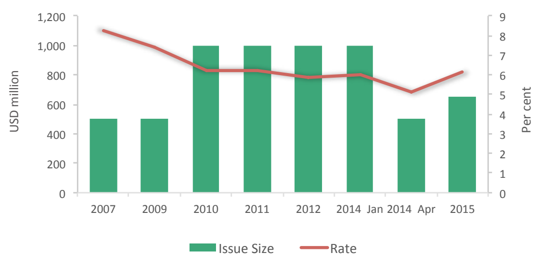
Source: US Treasury web site

Chart 1.1.9 **US Treasury Yield vs. Sri Lanka Sovereign Bond Yield**



Source: Bloomberg

Chart 1.1.10 **Sovereign Bond Issues**



Source: Bloomberg

Global economic developments offer both opportunities and challenges for Sri Lanka's Financial Stability. The decline in commodity prices, particularly oil prices, reduces the upside risks in inflation. Moreover, this decline is expected to have a positive impact on the current account and investments. The recovery of the USA and the signs of recovery in the euro area as the largest export destination for the Sri Lanka, will have substantial positive effect on the growth outlook of Sri Lanka. Improving performance of domestic corporate sector in turn would augment the credit demand, resulting improved performance of the financial sector.

Normalisation of the US monetary policy would affect the yields of international sovereign bonds issued by Sri Lanka (Chart 1.1.9 & 1.1.10), which would eventually affect the future borrowing cost and volumes of the government of Sri Lanka and Sri Lankan corporate entities, including banks, in the international markets.

1.2 Domestic Developments Affecting Financial Stability

Economic growth is projected to accelerate in 2015. The Sri Lankan economy is expected to grow at 5.7 per cent in 2015 compared to 4.5 per cent in 2014. The agriculture sector, which contributed nearly 7.5 per cent to the Gross Domestic Product (GDP), demonstrated positive developments in the first half of 2015, reversing the weaker performances witnessed in 2014. The industry sector, representing 26.5 per cent of total GDP also improved in the first half of 2015, largely driven by manufacturing of basic metals, fabric metals products and machinery and equipment. However, the growth in construction declined mainly due to slow down in implementation of large government infrastructure projects. The services sector that contributed the highest share of 61.2 per cent to the GDP, improved substantially during the first half of 2015 with the expansion of all sub-sectors manly driven by wholesale and retail trade, transportation and storage, accommodation and food service activities, financial and insurance activities and real estate activities (Chart 1.2.1 & 1.2.2).

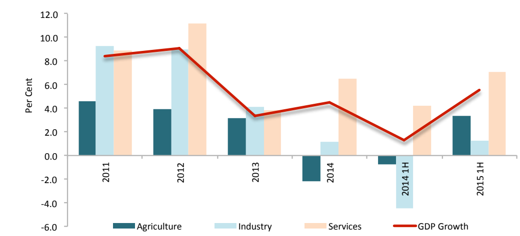
Low and stable inflation. The annual average headline inflation dropped to 1.0 per cent in August 2015 from 1.3 per cent in July 2015 (Chart 1.2.3). However, the core inflation slightly increased to 3.9 per cent in August 2015, from 3.5 per cent recorded in the previous month on year-on-year basis, while annual average core inflation remained unchanged. The special commodity levy on imports of certain consumer items and considerable volatility in the exchange rate market increase the upside risks to inflation, although, this is likely to partly offset by continued low oil prices. Going forward, the inflation outlook and inflation expectations remain favourable for the remainder of the year, supported by improved domestic supply conditions and subdued global commodity prices.

Low unemployment. Despite slight increase in the unemployment rate to 4.7 per cent during the first quarter 2015 compared to 4.4 per cent at end December 2014, the unemployment rate continued to remain at relatively low levels (Chart 1.2.4). However, compared to the first quarter of 2014, the female unemployment rate has increased in 2015 from 6.1 per cent to 7.9 per cent as against the slight decline in male unemployment rate from 3.0 per cent to 2.9 per cent.

Net portfolio flows to Sri Lanka remain weak. Uncertainties over the normalization of the Fed's monetary policy led to fluctuations in domestic financial markets – government securities, equity, foreign exchange and corporate debt markets.

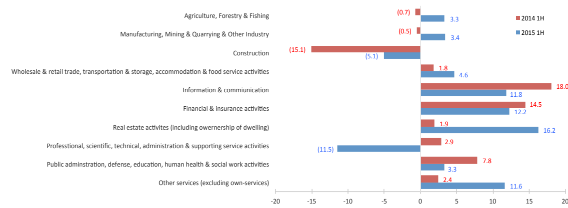
Net portfolio investment by non-residents in the equity and debt securities has declined substantially in 2015 (Chart 1.2.5). As a result,

Chart 1.2.1 Real GDP (2010 = 100) Growth and Sectorial Performance



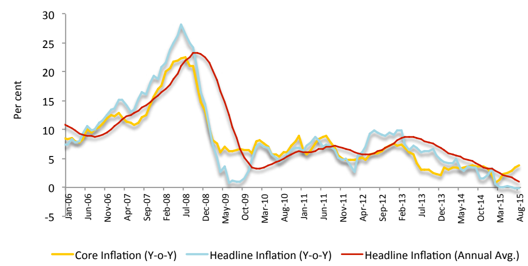
Source: Department of Census and Statistics

Chart 1.2.2 Point to Point Growth of Value Added by Economic Activities (2010 = 100)



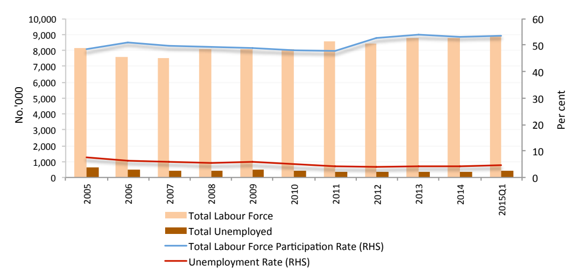
Source: Department of Census and Statistics

Chart 1.2.3 Headline Inflation and Core Inflation



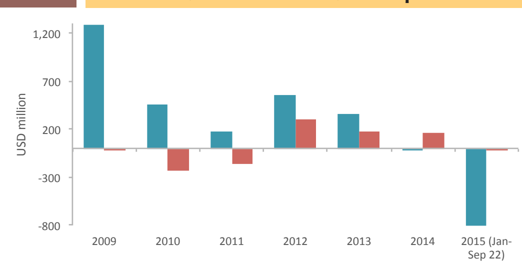
Source: Department of Census and Statistics

Chart 1.2.4 Unemployment and Labour Force Participation Rate



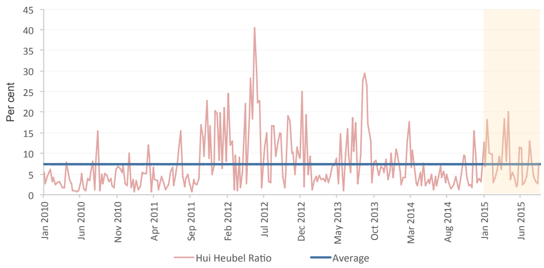
Source: Department of Census and Statistics

Chart 1.2.5 Net Foreign Investments in Government Securities (T-bills & T-bonds) and Equities



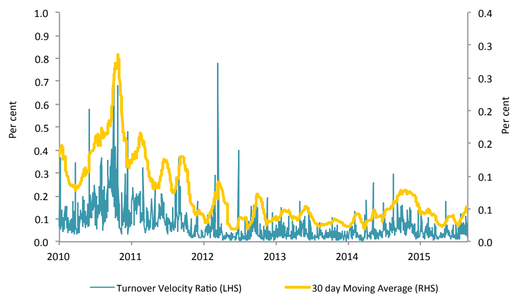
Sources: Central Bank of Sri Lanka
Colombo Stock Exchange (CSE)

Chart 1.2.6 **Hui Heubel Liquidity Ratio for CSE**



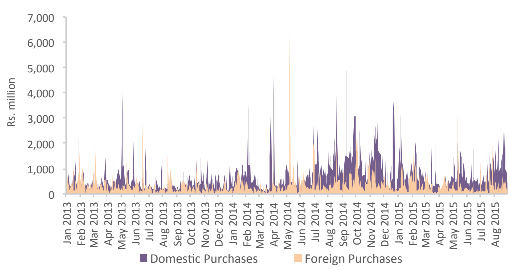
Sources: Calculations of the Central Bank of Sri Lanka and CSE

Chart 1.2.7 **CSE Turnover Velocity Ratio**



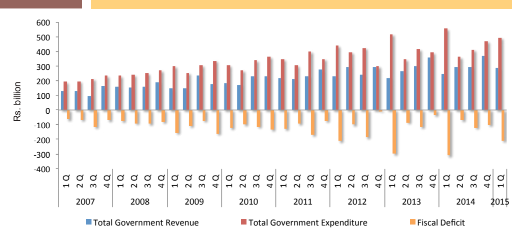
Source: Central Bank of Sri Lanka

Chart 1.2.8 **CSE Daily Turnover**



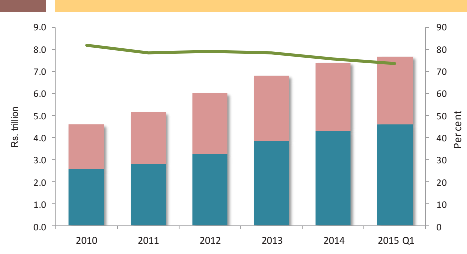
Sources: Central Bank of Sri Lanka and CSE

Chart 1.2.9 **Government Revenue, Expenditure and Fiscal Deficit**



Source: Central Bank of Sri Lanka

Chart 1.2.10 **Total Domestic and Foreign Debt**



Source: Central Bank of Sri Lanka

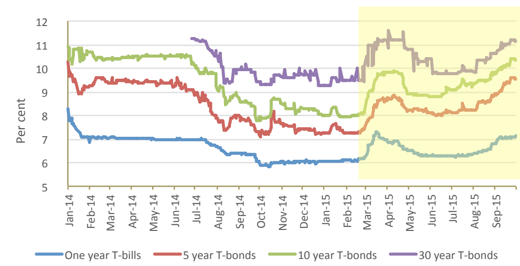
the resilience of the equity market became low as reflected by higher Hui Heuble Ratio (HHR), which is a measure of resilience and depth in the equity market and relates the volume of trades to its impact on prices. Most of the period during the first eight months of 2015, HHR for the Colombo Stock Exchange (CSE) remained above its long- term average, indicating the low volume of trades relative to the price changes or less resilience of the market (Chart 1.2.6). CSE market liquidity also declined as reflected by low liquidity ratios (Chart 1.2.7). Trading volumes, both by the foreign investors and domestic investors, have declined substantially during the first eight months of 2015, but there was a gradual pick-up towards September 2015 (Chart 1.2.8).

Government fiscal operations will have bearings on financial markets and financial stability. There has been pressure building on domestic financial markets as a result of increasing government cash flow requirements from domestic sources. The recurrent expenditure of the government also increased during the first half of 2015 due to higher salaries and pensions for public sector employees and other transfers and subsidies. The recurrent expenditure is expected to remain high in the remainder of the year as well as in following years. The government revenue, on the other hand, as a percentage of GDP declined during the first half 2015, which is likely to prevail during the rest of the year signaling an increase in overall budget deficit (Chart 1.2.9). In view of the increased budget deficit and decline in borrowing from foreign sources, the government reluctantly compelled to depend on domestic sources for financing the cash flow needs. The debt to GDP ratio slightly increased in 2015 (Chart 1.2.10).

During the first half of 2015, new issuances of Treasury bills (T-bills) and Treasury bonds (T-bonds) increased and hence, primary market weighted average yield rates (PMWYR) increased (Chart 1.2.11). The yield rates were further stressed by continued withdrawal of foreigners from T-bills and T-bonds. Sharp decline in domestic market liquidity (Chart 1.2.12) and increased lending activities of banks (Chart 1.2.13) also contributed to this development. The bidding patterns at the T-bills primary auctions demonstrate an increasing skewedness of investor preference towards the shorter end of the yield curve which reflects the investor reluctance to increase their portfolio duration and also strong market expectation of increasing yield rates on government securities (Chart 1.2.14). Accordingly, increased pressure on domestic interest rates emanating from the increased borrowing need of the government, increased volatility and upward movement in T-bills and T-bond yields in spite of low inflation expectation and the withdrawals of investments in T-bills and T-bonds held by foreigners are key areas of concerns for financial stability.

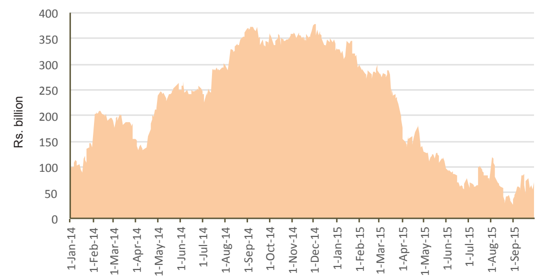
Allowing greater flexibility to the market in determining exchange rate. Sri Lanka has a combined exposure to foreign currency borrowing and foreign investor holdings of rupee debt. The increasing speculation of rising interest rates in USA has affected to spark sizable capital outflow from Sri Lanka while restricting new inflows (Chart 1.2.5). In addition, widened trade deficit, slow growth in workers' remittances and increased repayment of foreign loans of the government from domestic borrowing drained domestic foreign exchange market liquidity substantially thereby adding pressure on the exchange rate. The CBSL attempted to ease the pressure on the rupee by bridging the supply gap through regular interventions until 4th September 2015. (Chart 1.2.15). However, with effect from 4th September 2015, the CBSL decided to allow greater flexibility to the market in determining the exchange rate. As a result, there has been a rapid depreciation of the rupee during the month of September 2015.

Chart 1.2.11 Secondary Market Yield Rates of T-bills and T-bonds



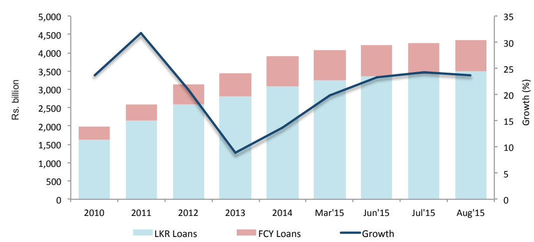
Source: Central Bank of Sri Lanka

Chart 1.2.12 Inter-bank Call Money Market Rupee Market Daily Liquidity



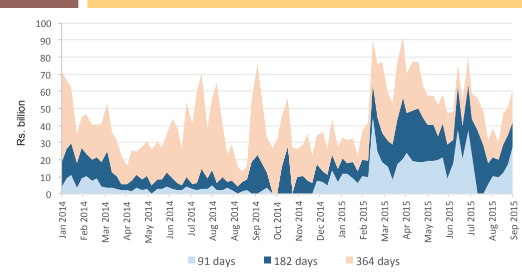
Source: Central Bank of Sri Lanka

Chart 1.2.13 Banking Sector Loan Growth



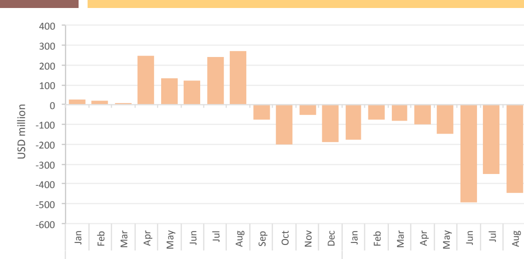
Source: Central Bank of Sri Lanka

Chart 1.2.14 Demand for T-bills at Primary Auctions



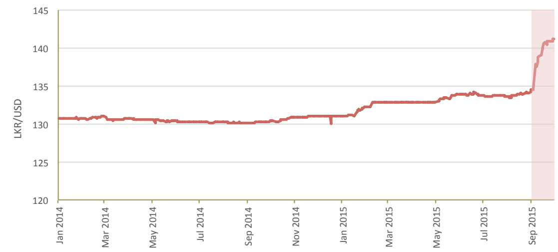
Source: The Central Bank of Sri Lanka

Chart 1.2.15 Net Purchases of USD by the CBSL



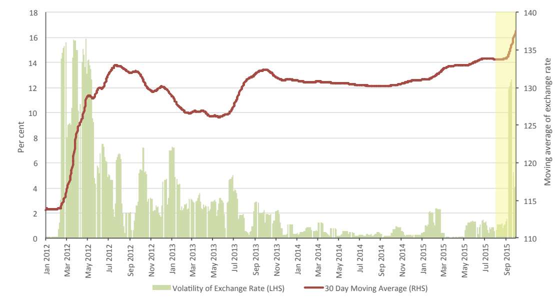
Source: Central Bank of Sri Lanka

Chart 1.2.16 **Movement of USD/LKR Exchange Rate**



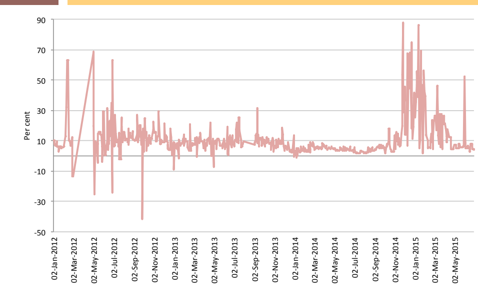
Source: Central Bank of Sri Lanka

Chart 1.2.17 **USD/LKR Exchange Rate Volatility**



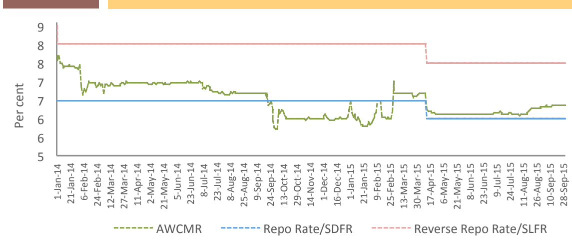
Source: Calculations of the Central Bank of Sri Lanka

Chart 1.2.18 **One Week Forward Premium (% per annum) Yield Curve**



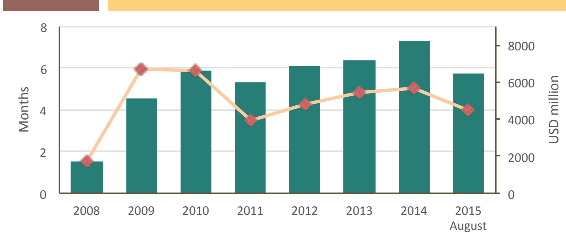
Sources: Central Bank of Sri Lanka and CSE

Chart 1.2.19 **CBSL Policy Rate Corridor and AWCMR**



Source: Central Bank of Sri Lanka

Chart 1.2.20 **Official Reserves of Sri Lanka**



Source: Central Bank of Sri Lanka

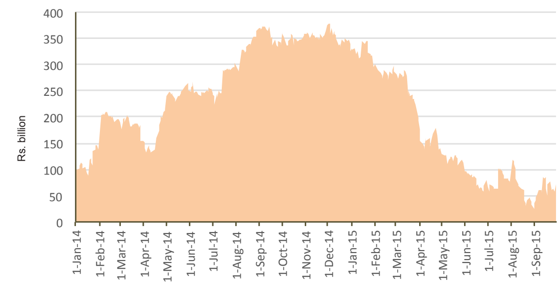
During the first seven months of 2015, the rupee depreciated by about 7.0 per cent (Chart 1.2.16) while increasing the exchange rate volatility (Chart 1.2.17) and also the forward premium (Chart 1.2.18).

The CBSL continued its cautious monetary policy stance while containing excess market liquidity. The CBSL introduced a measured rate cut in April 2015 and since then, the record low policy rate corridor was maintained (Chart 1.2.19). This cautious stance of the monetary policy needed to be maintained taking into account the declining inflation, the level of investments needed to address the concerns of economic growth, and the external vulnerabilities emanating from aforementioned international developments. Further, the CBSL introduced additional measures to address elevated exchange rate volatility. Meanwhile, the gross official reserves which stood at US$ 7.5 billion at the end of June 2015, has decreased to US$ 6.4 billion by end August 2015 (Chart 1.2.20). On the other hand, the excess liquidity in the domestic inter-bank rupee market, which was increased to a record level after the issuance of the 2014 Financial Stability Report, has declined significantly since the beginning of 2015 (Chart 1.2.21). As a result of the rapid decline in rupee liquidity, the Average Weighted Call Money Rate (AWCMR), which represents the shortest end of the yield curve, exhibited some volatility and started to move up from the lower bound of the policy rate corridor (Chart 1.2.19).

Trade deficit widened and foreign inflows decelerated in 2015. On a cumulative basis, earnings from exports declined marginally by 0.9 per cent during the first seven months of 2015 compared to 16.1 per cent growth during the corresponding period in 2014 (Chart 1.2.22 & 1.2.24). Expenditure on imports during the first seven months of 2015 increased by 1.9 per cent, as against the increase of 2.9 per cent in the same period in 2014 (Chart 1.2.23 & 1.2.24). Consequently, the trade deficit widened by 6.0 per cent during the first seven months of 2015 compared to the decline of 11.7 per cent during the corresponding period of 2014 (Chart 1.2.25). The cumulative earnings from tourism increased by 16.8 per cent during the first seven months of 2015 in comparison to the cumulative increase of 33.8 per cent during the same period in 2014. On a cumulative basis, workers' remittances during the first seven months of the year grew moderately by 1.6 per cent compared to 11.2 per cent growth during the corresponding period of 2014.

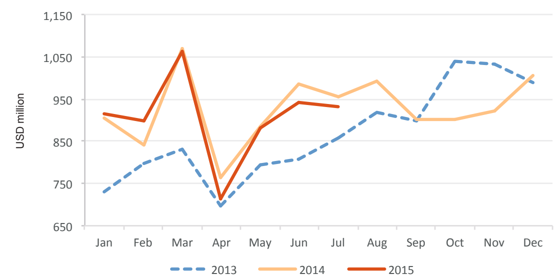
However, with the decision of the CBSL to allow greater flexibility in the determination of the exchange rate, and also with the enforcement of loan-to-value ratio, Sri Lankan exports are expected to be more competitive while curtailing non-essential imports. Such developments are expected to have a favourable impact on the trade balance. Along with regular inflows of worker remittances and earnings from tourism and other inflows to the services account, the current account deficit is expected to narrow improving the external sector resilience.

Chart 1.2.21 Interbank Call Money Market Rupee Liquidity



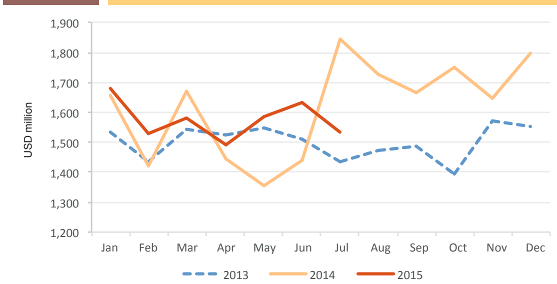
Source: Central Bank of Sri Lanka

Chart 1.2.22 Export Performance



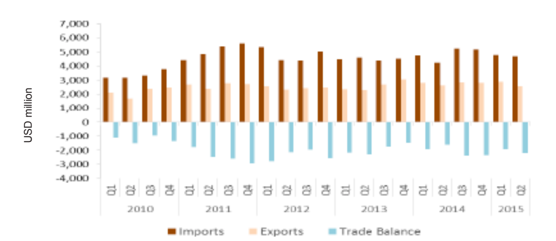
Source: Central Bank of Sri Lanka

Chart 1.2.23 Import Performance



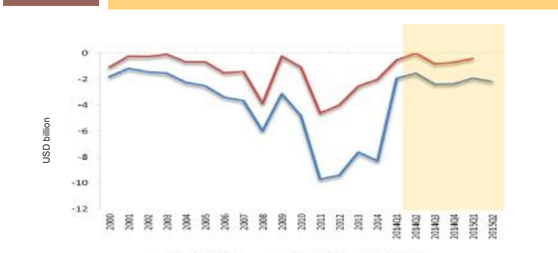
Source: Central Bank of Sri Lanka

Chart 1.2.24 External Trade Performance



Source: Central Bank of Sri Lanka

Chart 1.2.25 Trade Balance and Current Account Balance



Source: Central Bank of Sri Lanka

Section 2

2. Financial Sector Developments and Stability

There has been a reversal of slow rate of credit growth witnessed in the banking and non-bank financial sectors in 2013 and 2014. Low market interest rates with excess rupee liquidity and availability of cheap short-term funding from foreign sources helped the financial sector to increase credit disbursements in 2015, thereby accelerating credit growth. Meanwhile, as there had been a rapid growth of credit exposures of banks and financial institutions to motor vehicles in the recent past, the CBSL has enforced appropriate macro-prudential measures to preempt this trend being developed into a system-wide risk to the financial sector. Even though, the sector wise non-performing loans (NPL) ratios of banking and non-banking financial institutions regulated by the CBSL are low, the existence of a few LFCs with substantially high NPL ratios and also negative implications of possible rise in interest rates have been concerns of financial stability. Further, the relative share of borrowing as a source of funding of the rapid growth in assets of the financial sector has been increasing in the recent past. These developments and the international and domestic developments explained in Section 1 of this Report calls for a close monitoring of financial sector credit, liquidity and interest rate risks with a view to identify potential threat to the financial stability.

The liquidity position of LBs and NBFIs sectors remain strong. All licensed banks have been able to meet the statutory liquid assets ratio (SLAR) of 20 per cent and the sector average SLAR was about 36 per cent in the month of July 2015.

However, the recent hike of negative maturity mismatch in assets and liabilities maturity profile of licensed banks has to be closely monitored on the back of sharp decline of excess liquidity in the overnight wholesale money market and also the development in the international market which would affect the continued ability of banks in obtaining and rolling over external debt. Further, possible implications of any interest rate hike and the impact of such development on operating cash flows from the largest earning assets of both the sectors and the market value of liquid assets, mostly the investments in fixed rate T-bills and T-bonds, have to be closely monitered.

The macro-stress test results indicated that the current net interest margins and capital adequacy ratios of LBs are sufficient enough to cover the likely losses that may originate from possible interest rate rise. However, the existence of a few LBs and NBFIs without sufficient space in their capital buffers is a risk to the financial stability

In terms of foreign exchange risk, as banking sector foreign exchange net open positions are regulated by the CBSL, the macro stress-test results indicate that the exchange rate shocks do not lead to pressure on the banking sector directly via their balance sheet channels. However, indirect foreign exchange risk exposure of banks through lending in foreign currencies to their customers has to be evaluated to ensure that the banking system is adequately protected against the foreign exchange risk.

The systemically important payment and settlement systems in Sri Lanka continued to function without disruption and systemic concerns. The Retail payment and settlement systems on the other hand undergone a rapid change with innovations in electronic retail payment and settlement systems during the period since the issuance of previous FSR. As there have been new risks emerged with aforementioned developments, the regulatory and supervisory regime of CBSL was strengthened appropriately.

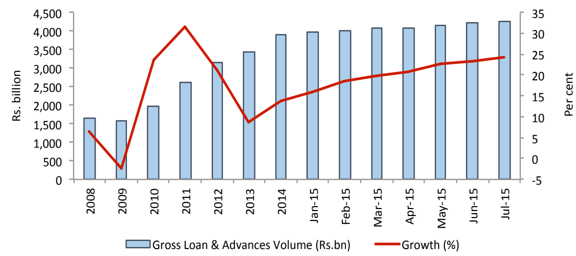
2.1 Credit Risk

Low interest rates in the market and the excess liquidity in the domestic wholesale market along with cheap short-term foreign financing have helped the LBs and NBFIs sectors to record rapid growth in their loans and advances portfolios (Chart 2.1.1 & 2.1.2). Year-on-year credit growth of LBs sector has accelerated to 24.4 per cent at the end of June 2015 from 13.7 per cent in December 2014 whereas year-on-year growth of credits of NBFIs accelerated to 25.3 per cent in June 2015 compared to 16.0 per cent in December 2014. This was largely contributed by finance leases, which grew by 24 per cent in June 2015 against a growth of 11.0 per cent in June 2014.

With the imposition of Loan-to-Value (LTV) ratio in respect of loans and advances granted by LBs and NBFIs for the purpose of purchase or utilisation of motor vehicles, the high concentration on consumption related general purpose personal loans such as credit card, pawning advances, and leasing and hire purchase, categorised under "Other Customers" category is expected to be addressed (Charts 2.1.3 & 2.1.4).

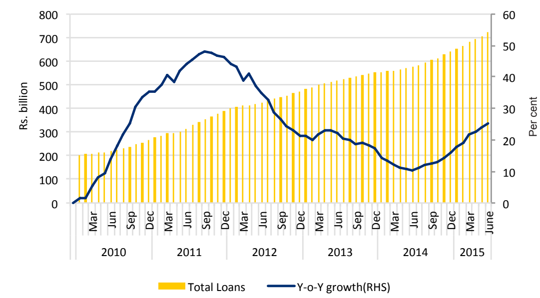
The CBSL, having observed the surge of motor vehicle financing by LBs and NBFIs sectors in the recent past, imposed a maximum LTV ratio of 70 per cent in respect of loans and advances granted for the purpose of purchase or utilisation of motor vehicles by LBs and NBFIs, with effect from December 01, 2015. Vehicle imports related foreign currency outflows increased sharply starting from the second half of 2014. The monthly average vehicle import bill of about US$ 87 million, or about 6 per cent of the total monthly imports, during the first half of 2014 was surged to a monthly average of US$ 180 million (or 10.4 per cent of total imports) during the second half of 2014 and further to US$ 183 million (or 11.7 per cent of total imports) during the first five months of 2015 (Chart 2.1.5). Accordingly,

Chart 2.1.1 Loans & Advances of LBs and YOY Growth



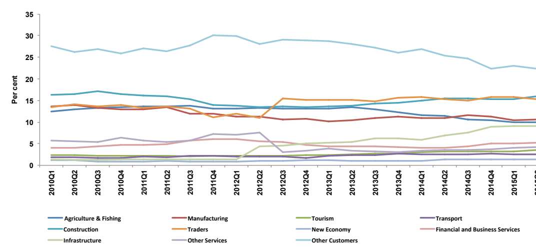
Source: Central Bank of Sri Lanka

Chart 2.1.2 Loans & Advances of NBFIs Sector



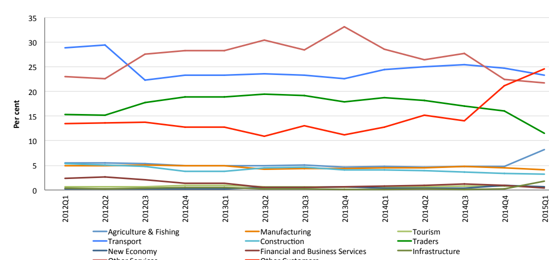
Source: Central Bank of Sri Lanka

Chart 2.1.3 LBs - Sector Wise Distribution of Loans & Advances



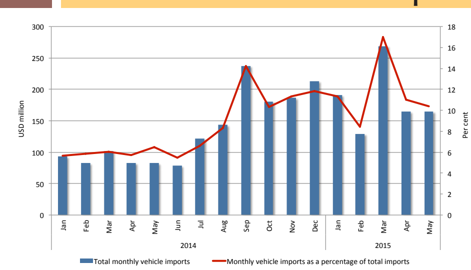
Source: Central Bank of Sri Lanka

Chart 2.1.4 NBFIs - Sector Wise Distribution of Loans & Advances



Source: The Central Bank of Sri Lanka

Chart 2.1.5 Monthly Total Vehicle Imports and their Relative Share of Total Import Bill



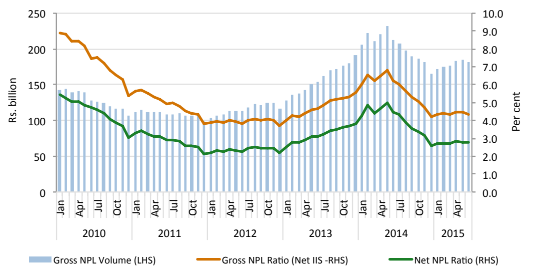
Source: Central Bank of Sri Lanka

total credit facilities in the form of leasing and hire purchase extended by LBs and NBFIs also increased by about 20.8 per cent from 01.01.2014 to 31.03.2015. It was observed that total leasing and hire purchase portfolio of LBs increased by 28.3 per cent well above the overall credit growth rate of 19.8 per cent. However, with the imposition of the aforementioned LTV ratio, the high concentration of lending to consumption related motor vehicle financing is expected to disperse thereby mitigating the potential financial stability risk.

Marginal increase in the delinquency of loans and advances of LBs and NBFIs. Both the LBs and the NBFIs sectors have experienced a marginal increase in the volume of NPLs during the first half of 2015 in spite of the positive impact of full recovery and removal of non-performing pawning advances from books through auctioning of pledged gold articles. The stock of NPLs of LBs sector rose by 10.0 per cent to 182 billion during the first six months of 2015 from Rs. 165.5 billion at the end of 2014 (Chart 2.1.6). Total NPLs of NBFIs sector increased by 4.4 per cent or Rs 3.4 billion from Rs. 44.4 billion at the end of 2014 to Rs. 46.0 billion at the end of June 2015 (Chart 2.1.7). NPL ratio of LBs sector increased marginally but NBFIs sector NPL ratio declined despite the increase in the volume of NPLs as a result of increase in gross loans and advances. The increasing delinquency in the loan book of the LBs sector is visible as there have been new loans added to the "special mentioned" category (Chart 2.1.8).

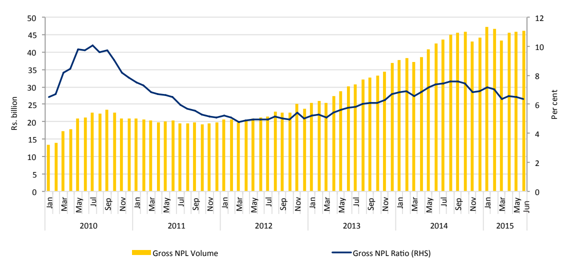
In LBs sector, other than the gross NPL ratio in loans extended to "Other Customers" sector, which has the high shares in terms of total loans, gross NPL ratios in respect of other sectors display a modest outlook in general (Chart 2.1.9). "Other Customers" sector gross NPL ratio has come down sharply from its high of 9.2 per cent in the first quarter of 2014 to 4.4 per cent in the first quarter of 2015 mainly due to the recovery and removal of

Chart 2.1.6 **Banking Sector NPLs**



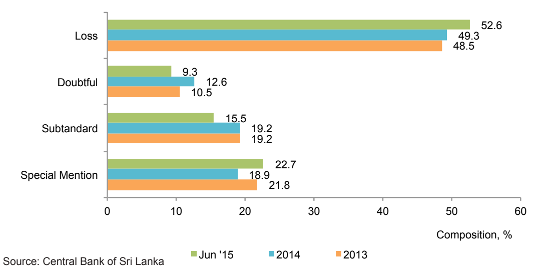
Source: Central Bank of Sri Lanka

Chart 2.1.7 **NBFIs Sector NPLs**



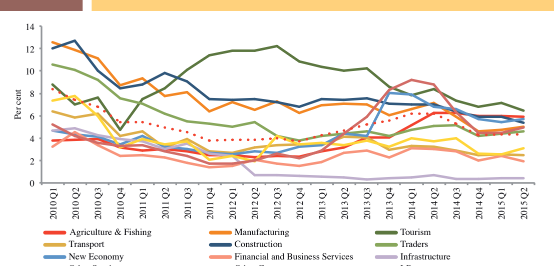
Source: Central Bank of Sri Lanka

Chart 2.1.8 **LBs Sector NPLs – Categorisation**



Source: Central Bank of Sri Lanka

Chart 2.1.9 **Sector Wise NPLs of LBs**



Source: The Central Bank of Sri Lanka

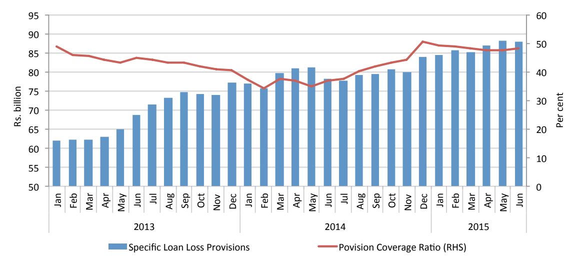
non-performing pawning advances by auctioning the gold articles pledged against such advances. Hence, the improvement in the NPL ratio of the LBs sector should not be considered as a positive development if the delinquency of the loans portfolio of banks continue to incerase. In that background, the recent increasing trend in the NPL ratio of the "Other Customers" sector is required to be closely monitored in view of domestic and international developments explained in the Section 1 of this Report with a view to pre-empt this trend which may develop into a system-wide risk to the financial sector.

The specific loan loss provision coverage of the LBs sector fell marginally to 48.3 per cent by end June 2015 from 50.7 per cent at the end of 2014 mainly due to the lower level of specific provision required on increased special mentioned category loans (Chart 2.1.10). However, in consideration of underlying collateral values, banks' profitability and level of capitalization, the current level of provision coverage in the LBs sector does not trigger a systemic concern.

Stress test results on credit risk of LBs sector suggest that banks remain resilient to an increase in NPL ratio. 180 bps negative shocks to the LBs sector NPL ratio will have up to 160 bps negative effect on the Capital Adequacy Ratio (CAR) of LBs sector. LBs sector CAR stood at 15.3 per cent at the end of June 2015 against the statutory minimum requirement of 10.0 per cent.

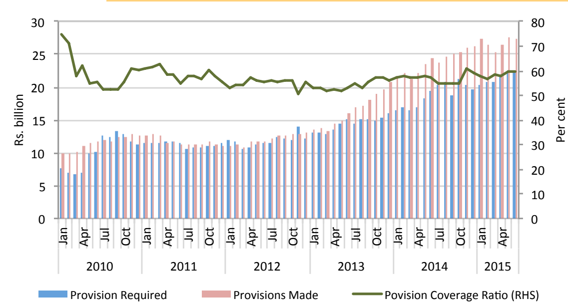
In the recent past, NBFIs sector has been maintaining more than required level of specific loan loss provision to mitigate its underlying credit risk (Chart 2.1.11). However, the existence of a few RFCs with high NPLs has been a risk to the financial stability.

Chart 2.1.10 **LBs Sector – Specific Loan Loss Provision Coverage**



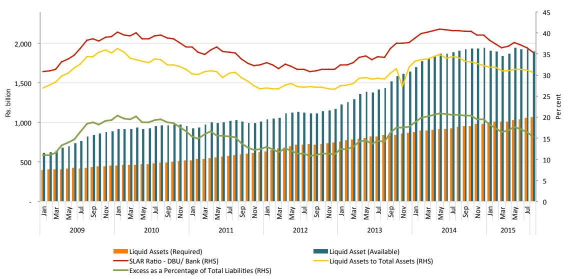
Source: Central Bank of Sri Lanka

Chart 2.1.11 **NBFIs – Specific Loan Loss Provision and Provision Coverage**



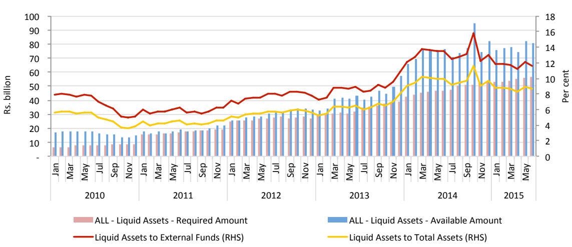
Source: Central Bank of Sri Lanka

Chart 2.2.1 **LBs – SLAR and Total Liquid Assets**



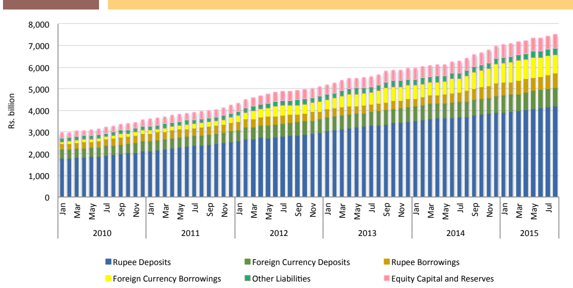
Source: Central Bank of Sri Lanka

Chart 2.2.2 **NBFIs - Total Liquid Assets and Liquidity Ratio**



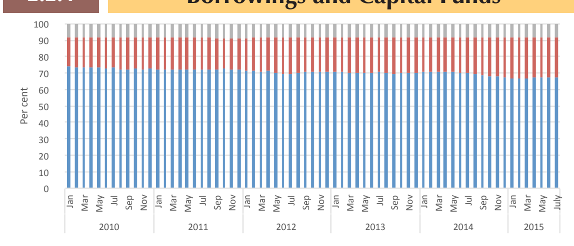
Source: Central Bank of Sri Lanka

Chart 2.2.3 **LBs Sector - Composition of Funding**



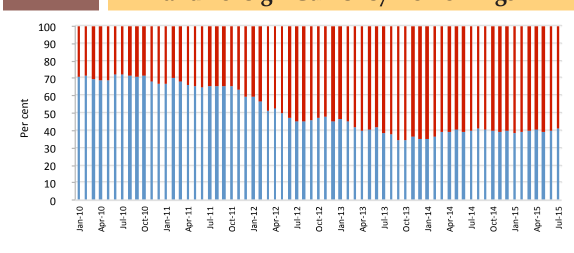
Source: Central Bank of Sri Lanka

Chart 2.2.4 **LBs – Relative Share of Deposits, Borrowings and Capital Funds**



Source: Central Bank of Sri Lanka

Chart 2.2.5 **LBs – Relative Share of Rupee Borrowings and Foreign Currency Borrowings**



Source: Central Bank of Sri Lanka

2.2 Liquidity Risk

LBs are obliged to maintain a minimum Statutory Liquid Asset Ratio (SLAR) against their total on balance sheet liabilities, other than liabilities to shareholders and the CBSL. NBFIs are obliged to maintain minimum level of liquid assets against customer deposits and borrowings. Classes of liquid assets for this purpose have been clearly defined in the applicable statutes. Both LBs and NBFIs have been maintaining liquid assets much higher than the minimum amount of liquid assets required for meeting legal liquidity coverage ratios (Chart 2.2.1 & 2.2.2).

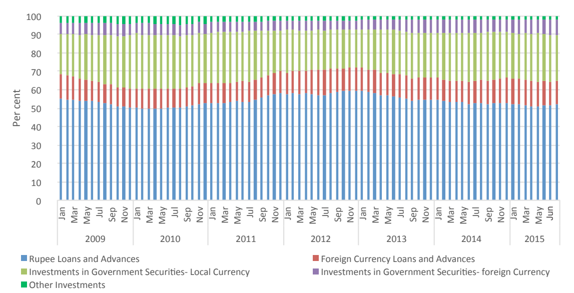
Rupee deposits continue to be the primary source of funding of the LBs sector (Chart 2.2.3). However, the relative share of rupee deposits has come down marginally over the period as part of such deposit liability has been switched to repo borrowings (Chart 2.2.4). The declining importance of deposits as a stable funding source increases the liquidity risk outlook in the Sri Lankan banking sector.

Non-deposit funding of LBs continued to increase, while the relative share of external funding in the composition of total non-deposit funding of the LBs sector increased since 2011. The rupee equivalent of external funding, that constitutes the majority of non-deposit funding continues to increase (Charts 2.2.4 & 2.2.5). An important portion of the rise in non-deposit external funding has originated from funding obtained from banks and financial institutions abroad and debt instruments issued in the international capital markets. The favourable external borrowing conditions on the back of low interest rate regime in advanced economies helped domestic banks to enjoy increasing funding facilities from foreign sources. Even though, borrowings from banks and financial institutions abroad introduced financing flexibility, it increases the sensitivity of LBs to liquidity shocks due to its unstable nature. Moreover, on the back of international developments detailed in the Section 1 of this Report, and further reversal of capital flows from EMDCs due to anticipated interest rate hike by the Fed, continued reliance on such funding sources increases risk of financial stability. In order to manage the foreign exchange liquidity risk, it is crucial for banks to have adequate standby funding arrangements to cover short-term external liabilities.

Securities sold under repurchase (repo) agreements represent the bulk of domestic non-deposit funding. Continued domestic interbank liquidity conditions helped banks to obtain cheap financing under repo agreements which are not subject to statutory reserve requirement, unlike deposits.

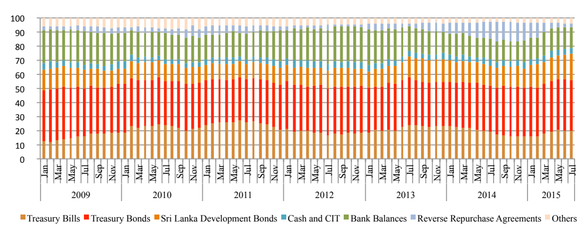
Loans and advances continue to be the principal earning asset of the banking sector which generate a steady flow of cashflow. However, there has been a gradual decline in the relative share of loans and advances of the banking sector since beginning of 2013. The relative share of loans and advances in the total earning assets has come down to about 65 per cent at the end of June 2015 from about 72 per cent at the end of 2012 (Chart 2.2.6). Investments in government securities, and floating rate US$ denominated Sri Lanka Development Bonds (SLDB), have been the second largest earning assets of the sector. About 26 per cent of earning assets of the sector represented investments in T-bills and T-bonds, which forms the principal portion of liquid assets of the sector. An increase in market interest rates will have combined effect on the the liquidity risk outlook as a result of reduced cash flows of earning assets due to increased delinquency of loan portfolio on one hand and realized marked-to-market losses on fixed rate government securities holdings in case of the necessity for liquidating such investments in governmet securites for bridging any unforseen cashflow needs, on the other. Total investments in fixed rate government securities, which have been claimed as liquid assets under the SLAR, represents about 58 per cent of total statutory liquid assets of LBs sector (Chart 2.2.7).

Chart 2.2.6 **LBs Sector - Investments and Lending**



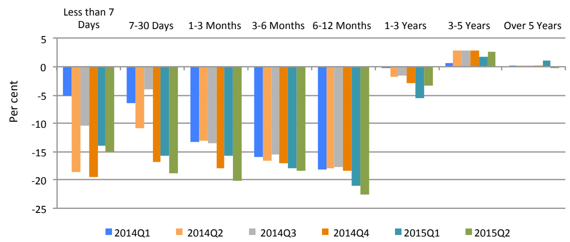
Source: Central Bank of Sri Lanka

Chart 2.2.7 **LBs Sector – Relative Share of Statutory Liquid Assets**



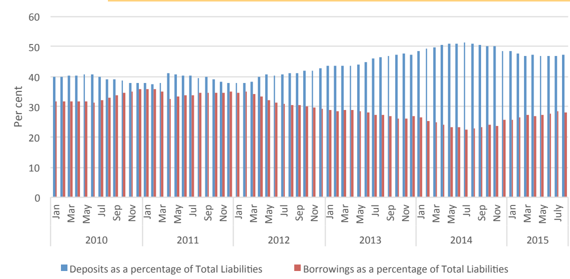
Source: Central Bank of Sri Lanka

Chart 2.2.8 LBs Sector – Maturity Gaps in the Asset and Liability Maturity Profile



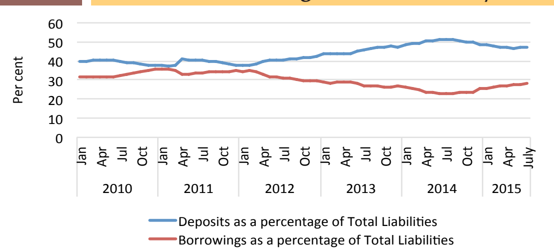
Source: Central Bank of Sri Lanka

Chart 2.2.9 NBFIs - Relative Share of Deposits and Borrowings



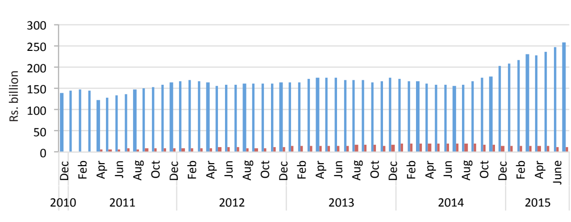
Source: Central Bank of Sri Lanka

Chart 2.2.10 NBFIs Sector - Relative Share of Deposits and Borrowings in Total Liability



Source: Central Bank of Sri Lanka

Chart 2.2.11 NBFIs - Rupee and Foreign Currency Borrowings



Source: Central Bank of Sri Lanka

Maturity profile of assets and liabilities of the LBs sector indicates an increasing negative gap up to "6–12 months" time bucket (Chart 2.2.8). This indicates the increased usage of short-term funding with maturity less than 12 months by LBs sector for financing longer term assets. Thus, the share of short-term liabilities due for maturity in one year increased and the upward effect of this change in the maturity profile of assets and liabilities of banking sector funding structure may increase the sector's sensitivity to liquidity shocks as a result of the developments discussed in the Section 1 of this Report.

Rupee deposits continue to be the primary source of funding of the NBFIs sector as well (Chart 2.2.9). However, the relative share of rupee borrowings has increased in the recent past. Borrowings from domestic banks and financial institutions represent the majority of borrowings of the sector and its foreign currency borrowings remained negligible (Chart 2.2.11). The declining importance of deposits as a stable funding source increases the liquidity risk outlook in the NBFIs sector.

2.3 Interest Rate Risk and Foreign Exchange Risk

In consideration of the international and domestic developments affecting the financial stability and lingering uncertainty, a close monitoring of the implications of possible rise in interest rate is warranted. The economic and financial developments discussed in the Section 1 of this Report and related expectations would principally affect the funding costs, both domestic and foreign, of LBs and NBFIs sectors while incurring re-valuation losses on the valuation of fixed rate investment portfolios.

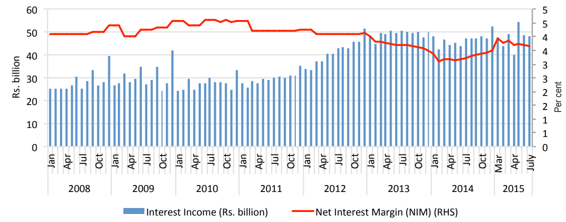
LBs and NBFIs have been maintaining steady net interest margins (NIM) over the years (Chart 2.3.1 & 2.3.2). LBs and NBFIs have effectively been able to pass any incremental cost in their cost of funding to their customers. Hence, possible rise in the cost of funding as a result of expected developments discussed in the Section 1 of this Report are not likely to have major impact on NIM of LBs and NBFIs.

The maturity mismatch between assets and liabilities of the LBs and NBFIs sectors have widened in the recent past (Chart 2.3.3 & 2.3.4). The increasing negative maturity gap has been the result of the funding of long-term assets through short term funding sources on the back of the availability of rupee liquidity. However, as both sectors have been able to manage their cost of funds and lending rates and the change in the cost of funds have been passed on to customers, their NIMs have not been affected. Hence, rising gaps in assets and liabilities maturity profiles of LBs and NBFIs would not cause material impact in terms of interest rate risks in the short to medium term, unless there is a severe shock.

However, rising interest rates would affect credit growth of LBs and NBFIs and finally the GDP growth. Historically, there has been a strong negative correlation between the interest rates and credit growth of LBs sector (Chart 2.3.5). One of the negative consequences of possible rise in interest rates would be the slowing of credit growth and potential rise in NPLs which would eventually lower the efficieny of earning assets while requiring for additional provision for loan losses affecting the overall profitability of both sectors which would be a financial stability concern.

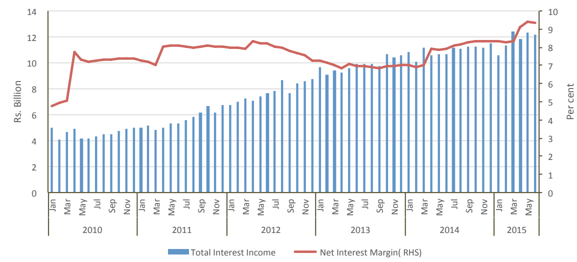
LBs and NBFIs sectors' investments in fixed rate securities are sensitive to interest rate shocks. The share of fixed securities, mainly the investments in T-bills and T-bonds, in total assets of the LBs and NBFIs has been in an upward trend in recent years (Chart 2.3.6). An adverse interest rate shock emanating from the international and domestic developments discussed in the Section 1 of this Report, would affect the consolidated balance sheet of the financial sector via revaluation losses

Chart 2.3.1 LBs Sector – NIM



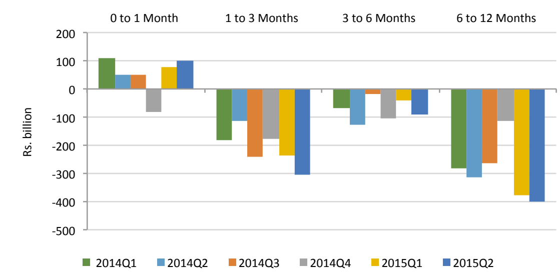
Source: Central Bank of Sri Lanka

Chart 2.3.2 NBFIs Sector – NIM



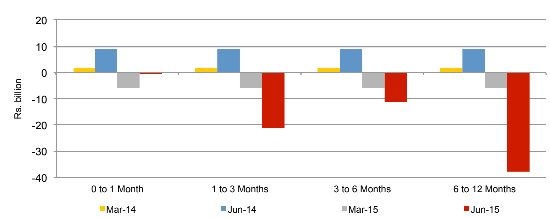
Source: Central Bank of Sri Lanka

Chart 2.3.3 LBs Sector - Gaps in Interest Sensitive Assets and Liabilities Maturity Profile



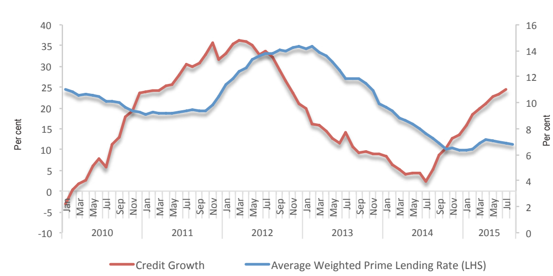
Source: Central Bank of Sri Lanka

Chart 2.3.4 NBFIs Sector - Maturity Gaps in Assets and Liabilities Maturity Profile of LFCs



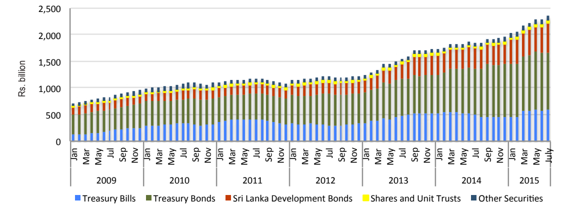
Source: Central Bank of Sri Lanka

Chart 2.3.5 AWPLR and the LBs' Sector Credit Growth



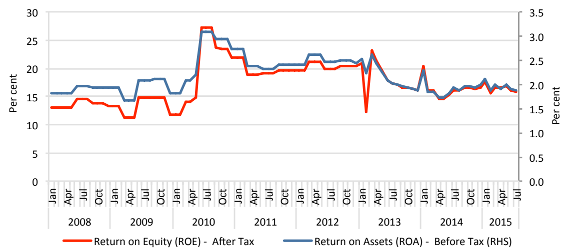
Source: Central Bank of Sri Lanka

Chart 2.3.6 **LBs Sector – Composition of Investments**



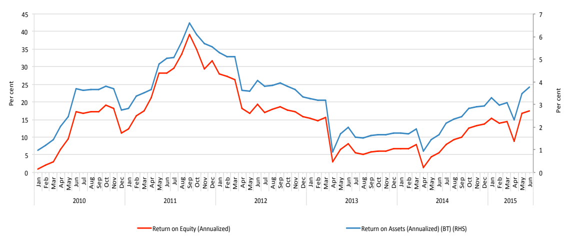
Source: Central Bank of Sri Lanka

Chart 2.4.1 **LBs Sector – ROA and ROE**



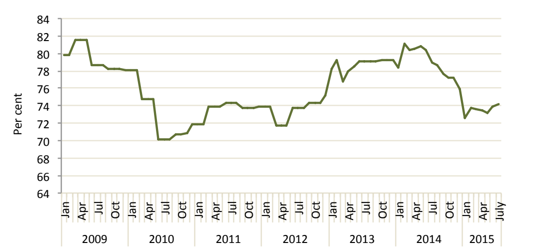
Source: Central Bank of Sri Lanka

Chart 2.4.2 **NBFIs Sector – ROA and ROE**



Source: Central Bank of Sri Lanka

Chart 2.4.3 **LBs Sector – Cost to Income Ratio**



Source: Central Bank of Sri Lanka

charged against earnings. In consideration of substantial negative gaps reported by LBs in their interest rate sensitive assets and liabilities maturity profile (Chart 2.3.3), the sensitivity to securities portfolio-based interest rate shocks of the sector is not a matter of concerns in terms of financial stability due to over capitalisation of the sector. As per the stress test results, rupee interest rate shock of up to 660 bps will have up to 180 bps of a negative impact on the LBs sector CAR.

LBs sector's sensitivity to exchange rate shocks is limited as a result of limited aggregate net open position of less than US$ 200 million granted by CBSL at the end of June 2015. However, indirect foreign exchange risk exposure of banks through lending in foreign currencies to their customers has to be evaluated to ensure that the banking system is adequately protected against the foreign exchange risk.

2.4 Capital Adequacy, Profitability and Resilience to Shocks

The annual net profits (after tax) of the LBs and NBFIs sectors remained high in the recent past. The ROA of LBs sector remained around 2 per cent while ROE has been well above 15 per cent. The ROA and ROE of NBFIs sector have been well over 3 per cent and 15 per cent, respectively (Chart 2.4.1 & 2.4.2). Stable and rising NIM driven by a combination of factors, including overall business expansion, increased lending and investment activities on the back of cheap funding and improved operating efficiency (Charts 2.4.3 & 2.4.4) stemming principally from lower level of loan loss provisions owing to lower NPLs have helped both the LBs and NBFIs sectors to record increased profitability in the recent past.

LBs and NBFIs sectors have been well capitalized. Capital position of LBs sector continued to be well above the minimum regulatory requirement, reflecting its loss-absorbing capacity in times of distress. The CAR of LBs sector stood at 16.6 per cent in December 2014 and 15.8 per cent in June 2015 (Chart 2.4.5). Moreover, the sector is currently in compliance with the new capital requirements under Basel III. By end June 2015, the banking sector operated with a common equity ratio of 13.4 per cent and a total capital ratio of 15.8 per cent, well above the proposed Basel III requirements of 4.5 per cent and 10.0 per cent, respectively.

NBFIs sector CAR has increased to 15.1 per cent in June 2015 from 13.4 per cent in March 2015 and in 14.5 per cent in March 2014 owing to increased profitability (Chart 2.4.6).

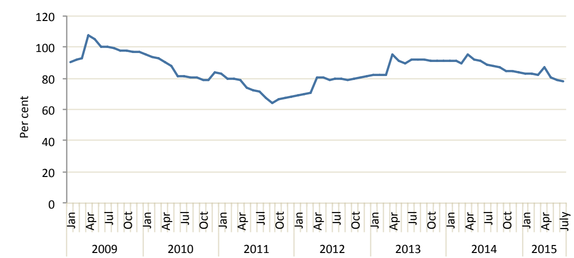
The Banking Sector Soundness Index (Chart 2.4.7) illustrates the systemic reflection of the developments in LBs sector risk indicators since the issuance of FSSR in June 2014. Accordingly, the developments in the LBs sector risk indicators shows that efficiency, liquidity and management soundness have deteriorated whereas the sector's resilience to market risk has been improved marginally. There has not been any significant change in the profitability and capital adequacy indicators.

2.5 Insurance Sector

Insurance sector continued to maintain its growth momentum in 2014 and first half of 2015 without having major stability concerns. The Gross Written Premium (GWP) of the insurance sector which showed moderate growth since mid-2011, turned upward from the fourth quarter of 2014 (Chart 2.5.1). Relatively high growth in premium of general insurance sector, particularly motor insurance owing to the higher number of new vehicles registration, has largely contributed toward the higher growth of overall GWP, despite the intense price competition.

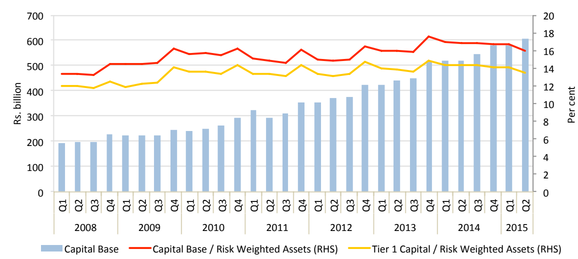
Profitability of the sector has been affected by the low interest rates prevailed in the market.

Chart 2.4.4 NBFIs Sector – Cost to Income Ratio



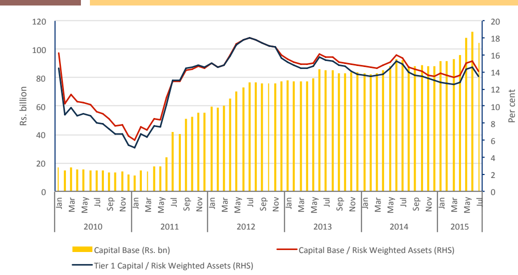
Source: Central Bank of Sri Lanka

Chart 2.4.5 LBs Sector - CAR



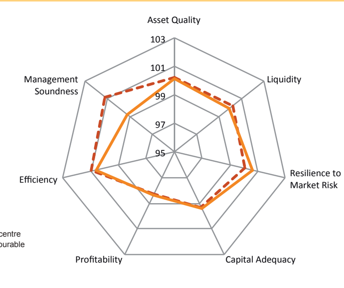
Source: Central Bank of Sri Lanka

Chart 2.4.6 NBFIs Sector - CAR



Source: Central Bank of Sri Lanka

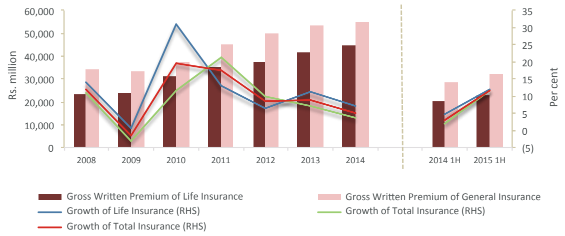
Chart 2.4.7 Banking Soundness Index (2010 = 100)



Note: Moving away from the centre denotes increasing favourable scenario

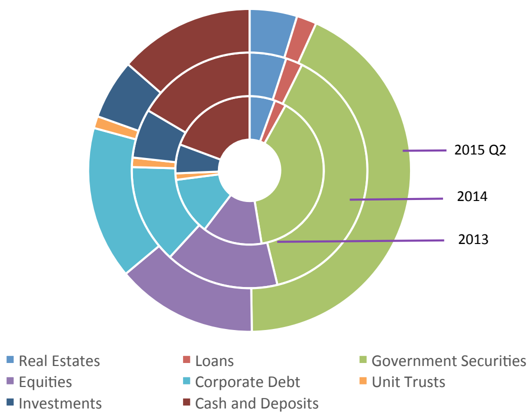
Source: Central Bank of Sri Lanka

Chart 2.5.1 **Gross Written Premium (GWP) of the Insurance Sector**



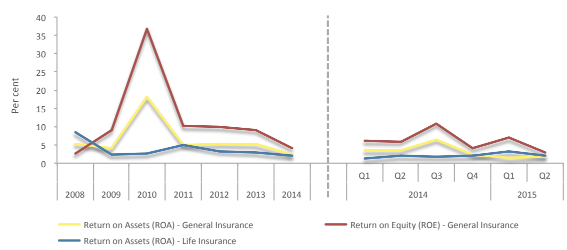
Source: Insurance Board of Sri Lanka

Chart 2.5.2 **Equity Exposure of the Insurance Sector**



Source: Insurance Board of Sri Lanka

Chart 2.5.3 **Profitability of the Insurance Sector**



Source: Insurance Board of Sri Lanka

Total investment income of the insurance sector decreased significantly in the first half of 2015 when compared to the corresponding period of 2014. The decrease in total investment income as a result of low interest rates encouraged insurance companies to search for higher return investments, including equity (Chart 2.5.2).

The ROA and ROE ratios of general insurance sector declined to 1.79 per cent and 2.91 per cent, respectively in the first half of 2015 from 3.54 per cent and 5.96 per cent in the same period of 2014. With respect to the long-term insurance (life insurance), ROA and ROE ratios declined to 1.99 per cent and 4.88 per cent, respectively in the first half of 2015 from 2.90 per cent and 7.75 per cent in the corresponding period of the previous year. In addition, declined underwriting results in the general insurance sector, mainly due to high intense price competition prevailed in the motor sector also affected the overall profitability in the insurance sector.

Insurance sector maintained higher solvency position to meet unforeseen liabilities arising from market shocks. The industry overall solvency margin ratios for both life and general insurance were remained well above the minimum level of 1 time at the end June 2015. Individually, all insurance companies except one long-term insurer met the statutory solvency margin requirement as at end June 2015.

Outlook of the insurance sector is stable with on-going regulatory changes. The segregation of long-term insurance and general insurance from 2015 is expected to promote greater transparency and policyholder protection. The proposed risk based capital (RBC) model for the insurance sector is expected to create better risk management in the sector. Moreover, increased minimum capital requirement of the sector is expected to enhance the risk absorption capacity with efficient capital allocation within the industry.

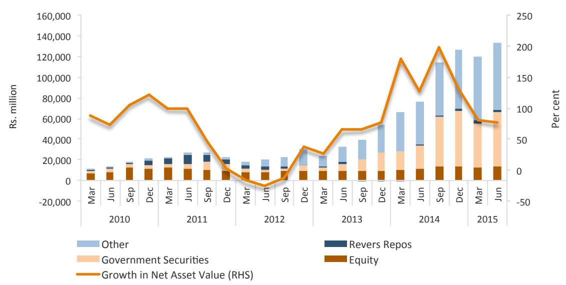
2.6 Primary Dealers in Government Securities

Primary dealers in Government Securities industry (PDs) continued to grow, within prudential framework prescribed by CBSL. Total assets and the total portfolio of government securities held by PDs recorded a healthy growth of about 19 per cent (YoY) at the end of June 2015. The borrowings under repo agreements, which has been the major source funding of PDs, relative to total assets, however, recorded a decline of around 12 per cent (YoY) at the end of June 2015. All stand-alone primary dealers maintained their total capital funds position over and above the minimum requirement of Rs. 300 million as at end June 2015. The Risk Weighted Capital Adequacy Ratio (RWCAR) of the industry continued to remain higher than the minimum prescribed level of 8 per cent, although the ratio decreased to 19.7 per cent by end June 2015 from 21.8 per cent at the end of 2014, owing to the increase in risk weighted assets.

Profitability of PDs Industry was maintained. The PD industry recorded a profit of Rs. 3.3 billion during the six-month period ended June 2015 compared to a profit of Rs. 3.7 billion for the corresponding period of 2014. The profitability measured in terms of the Return on Assets (ROA) and Return on Equity (ROE) of all stand-alone primary dealers stood at 3.0 per cent and 34.8 per cent, respectively, during the first six months of 2015 compared to 4.3 per cent and 44 per cent, respectively, in the year of 2014.

Overall risk profile of the industry improved. The trading portfolio as a proportion to total portfolio decreased from 71.3 per cent at end June 2014 to 53.6 per cent at end June 2015 and thus the exposure of the industry to the market risk has also decreased. In view of the large proportion of risk free government securities holdings of PDs and also due to the ability of PDs to use such government securities as collateral for obtaining funds to

Chart 2.7.1 Growth in NAV and Investment Portfolio of Unit trust Sector



Source: Central Bank of Sri Lanka

bridge unforeseen liquidity gaps, the liquidity risk profile of PDs remained low. Further, most PDs had stand-by contingency funding arrangements to bridge liquidity gaps, if emerged.

2.7 Unit Trusts

Unit Trust sector (UTs) growth has been decelerated. The Net asset value of the UTs showed moderate growth as at end June 2015 compared to the corresponding period of 2014. The reduction in interest rates and the downward movement in the share market affected the performances of UTs in a negative manner.

2.8 Superannuation Funds

The risk profile of the two main superannuation funds – Employees' Provident Fund (EPF) and Employees' Trust Fund (ETF) remained relatively neutral and the residual risks have been managed effectively. The credit risk relating to EPF and ETF was negligible as the two funds have most of their investments in fixed rate government securities. However, the market risk exposure of the two funds have been increasing as a result of increasing interest rate have had negative impact on the carrying book values of fixed rate government securities portfolios held. Both funds have maintained adequate liquidity and also their monthly member contributions exceeded the monthly refunds to members. However, the decision to allow the eligible members to withdraw of 30 per cent of outstanding balances is likely to alter the liquidity and investment patterns of EPF in the future.

2.9 Payments and Settlement Systems

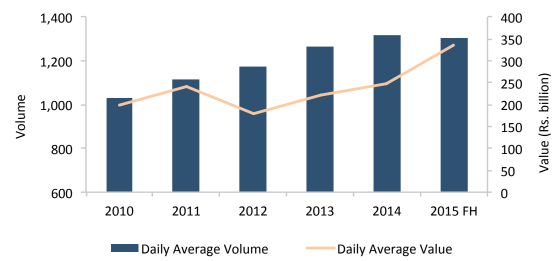
The LankaSettle System operated by CBSL and the Cheque Clearing System operated by LankaClear Private Limited (LCPL) – the systemically important payment and settlement systems

in Sri Lanka – continued to function without systemic concerns. LankaSettle System – the Real Time Gross Settlement (RTGS) System and the LankaSecure System – continued to provide a safe and reliable mechanism for efficient settlement of transactions in the country. The upward trend in value and volume of transactions settled through RTGS System maintained its upward trend since 2012. During the first half of 2015, RTGS System settled 151,517 transactions amounting to an aggregate value of Rs. 38,800 billion, an increase of 43 per cent, in spite of the decrease in aggregate transaction volume by 1.1 per cent in comparison to the first half of 2014 (Chart 2.9.1). The RTGS System accounted for about 80 per cent of non-cash payments and continued to be the main large value fund transfer system in the country. In order to resolve liquidity issues of participating institutions, CBSL, as the operator of the system, continued to provide the interest free Intra-day Liquidity Facility (ILF) and the daily average value of ILF utilized by participating institutions in 2014 was Rs. 21.3 billion and in the first half of 2015 was Rs. 22.0 billion.

The LankaSecure System consists of Scripless Securities Settlement System (SSSS) and the Central Depository System (CDS) in government securities, which operates with RTGS System to settle government securities transactions on delivery versus payment (DVP) basis.

Retail Payment and Settlement Systems – Retail payment and settlement systems have undergone a rapid change with innovations in electronic retail payment and settlement systems in the recent past. Accordingly, new electronic payment methods such as payment cards, mobile and internet banking have become popular method of settling retail financial transactions due to their efficiency and convenience. As these retail payment methods are associated with new risks and security issues, the regulatory and supervisory regime of CBSL has been strengthened appropriately during the period under review.

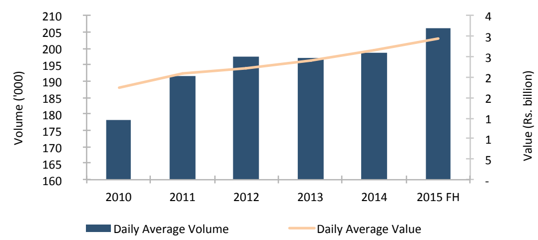
Chart 2.9.1 **RTGS Transactions (Volume & Value)**



Source: Central Bank of Sri Lanka

Cheque Imaging and Truncation (CIT) System – The CIT System which was introduced to shorten the time taken for a cheque to be cleared to a one business day, continued to maintain its momentum by clearing a total volume of about 24 million cheques, a 1.3 per cent increase, amounting to Rs. 3,983 billion, a 9.1 per cent increase, during the first half of 2015, when compared with the first half of previous year (Chart 2.9.2).

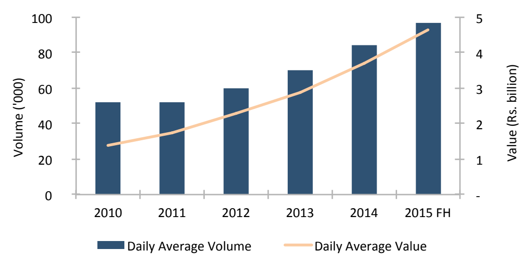
Chart 2.9.2 **Cheque Image and Transaction Clearing**



Source: Central Bank of Sri Lanka

Sri Lanka Interbank Payment System (SLIPS), the inter-bank retail payment system operated by LCPL for low-value fund transfers continued its steady growth in its volume and value of transactions. During the first half of 2015, the aggregate volume of SLIPS transactions grew by 13.6 per cent to 11.2 million whilst the aggregate value of total transactions grew by 31.6 per cent to Rs. 537 billion, in comparison to the first half of previous year (Chart 2.9.3).

Chart 2.9.3 **SLIPS Transaction Volumes (First half of 2015)**



Source: Central Bank of Sri Lanka

Business Continuity Plans – In consideration of the systemic risk associated with possible disruption to operations of Participating Institutions (PIs) of LankaSettle System, Business Continuity Plans (BCPs) of PIs have been further streamlined in compliance with the BCP guidelines issued by CBSL. Accordingly, PIs of LankaSettle System are made responsible for institutionalizing proper BCPs and also maintaining disaster recovery sites to ensure continuity of business operations in an unforeseen event of failure of internal systems or external events including natural disasters. The BCP arrangements of PIs continued to be under strict surveillance of CBSL.

Payment and Settlement System Oversight – CBSL continued to promote electronic retail payment systems in Sri Lanka while strengthening the prudential regulatory and supervisory regime to minimize risks associated with such electronic retail payment systems. CBSL licensed nine new operators in the payment card industry since January 2014 and also allowed existing licensed operators to expand their value added services and coverage.

The Common ATM Switch (CAS), of LCPL which is the first phase of Common Card and Payment Switch (CCAPS), already connects over 2,500 ATMs of eleven participating members island wide. The Common Electronic Funds Transfer Switch (CEFTS), which is the second phase of CCAPS, is expected to commence its operations during the second half of 2015 and would serve as a common infrastructure for multiple payment channels such as automated teller machines, mobile banking, internet banking and inter-operability among multiple payment channels. The prudential and obligatory requirements to LCPL and members of CEFTS have been sufficiently covered under extant regulatory regime applicable to electronic retail payment systems.

Section 3

Special Notes

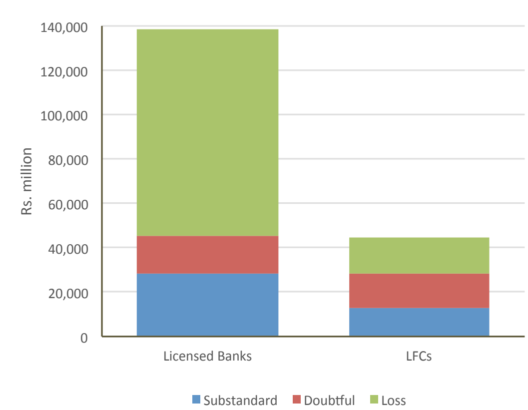
3.1 Management of Impaired Assets of the Financial Sector for Continued Stability

An asset is to be impaired or non-performing, if its value in market is less than the stated value in books. In the case of a bank loan, it is said to be impaired when, based on current information and events, it is probable that the lending institution will not be able to collect all amounts due according to the contractual terms of the loan agreement. As far as the regulated financial institutions, banks and other non-bank financial institutions are concerned, impaired assets management is part and parcel of normal business of such financial institutions. However, if (i) the size of the accumulated stock of such impaired assets of the financial system reaches systemic proportion, or, (ii) one or a few financial institutions become insolvent and non-viable so that a large number of depositors and creditors in the financial system is affected, it would create a massive social upheaval which in turn could develop to a systemic threat to the stability. Therefore, ensuring formal arrangements for resolving financial sector distress and the overhang of impaired assets has become one of the principal prerequisites for the continued stability of the financial system.

The Issue of Impaired (Non-performing) Assets

The asset quality is an important indicator in deciding insolvency of individual financial institutions as well as the financial system of a country as a whole. A careful analysis of failed financial institutions as well as regional financial crisis in the recent past indicate the gradual buildup of NPLs prior to such failures of individual institutions or country specific financial crises. Further, such international

Chart 3.1 Sri Lankan Financial System – NPLs to LBS and NBFIs



Source: Central Bank of Sri Lanka

experiences also highlight the implications of poor asset quality on the effectiveness and efficiency of relevant financial systems. Thus, building up of the impaired assets in the financial system to a systemic proportion affects the economic development of the country owing to locking up of scare resources in unproductive sectors, thus hindering the economic growth while impairing the economic efficiency. In the financial stability view point, each financial institution with relatively high impaired assets or non-performing loans is considered to be a threat. The delay in resolving the issue of impaired assets of systemically important financial institution/s or several financial institutions that would signifies a systemic proportion would eventually lead to systemic concerns requiring costly bailout by governments. At the same time this could adversely affect the investor confidence and smooth operations of economic activities.

There is no global standard definition for impaired or non-performing assets at the practical level. Variations exist in terms of the impaired assets classification systems, the scope, and contents. Such a problem potentially leads to disorder and uncertainty in addressing the impaired assets issues. However, over the years, the measurements of impaired assets have gradually broadened the scope and scales of the risk-management method. More countries, regulators, and banks are moving towards adopting better and more consensus practices. Regulators have prescribed the adoption of valuation methods prescribed under the International Financial Reporting Standards (IFRS) in addition to time based classification of non-performing assets and a dual system of reporting accordingly.

In addition to the standardised system, efforts have been made to improve the identification of impaired assets, including loans. For example, more countries are shortening the period when unpaid loans become past due, intending to put loans on lenders' timetable sooner and require them to address these loans before losses start to escalate. The IFRS 39, for example, focuses on recognition and measurement of financial instruments and, most importantly, defines and establishes the measurement and evaluation of impaired financial assets. In addition, many global economists, rating agencies, and multilateral agencies evaluate the effects of impaired assets on country's GDP growth by discounting the potential growth to reflect the time and cost of resolving large impaired assets, including non-performing loans issues.

International Experience in Resolving the Overhang of Impaired Assets

As per international experience, there have been two commonly used approaches to resolving financial sector distress and the overhang of impaired assets: There were 112 episodes of systemic banking crises occurred in 93 countries since late 1970s due to accumulated impaired assets as highlighted in many studies. Most of these crises required a major and expensive overhaul of their financial systems. Financial institutions restructuring often has to be accompanied by debt restructuring as most of the impaired assets of such troubled institutions are usually loans to non-financial institutions which are no longer be able to serve their obligations. Countries have adopted either flow or stock approaches in resolving financial sector distress and the overhang of bad debt. Whether a country should adopt a flow or stock solutions depends, among other things, on the degree of distress in the system and the extent of the official safety net.

(a) **Flow approach:** Flow approach allows financial institutions to strengthen their capital base over time through recapitalization of earnings or injection of new capital on a flow basis and do not explicitly address the stock of impaired assets in the system. However, cross country evidence suggests that flow approaches are only successful when financial distress is limited, i.e.

non-systemic, and the official safety net is either limited or the supervisory authority is willing to intervene in those financial institutions whose capital base is further deteriorating.

(b) Stock approach: Stock approach in resolving distressed financial institutions has been adopted by countries which had national crisis in the financial sector due to domestic or international contagion. It involves introduction of major legal enactments within a short period of time, considerable amount of government bailout or budgetary financial support, tax concessions or incentives, creation of asset management companies or special purpose vehicles (SPVs), liquidation of unviable financial institutions, disposal and management of impaired assets of such unviable institutions and the restructuring distressed yet viable financial institutions.

Sri Lankan Financial System and Impaired Assets

Even though it is not at an alarming situation at present, the Sri Lankan financial system does have a considerable amount of impaired assets in its overall balance sheets (Chart 3.1). Further, currently, there are several insolvent and non-viable registered finance companies (RFCs), mainly due to inherent structural problems in their balance sheets burdened with relatively high share of impaired assets and funding mismatches, which demands the need for formal mechanism to address the issue on the back of customer deposits mobilized by such institutions. The persistence delay in resolving the issue of non-viable RFCs due to various legal and regulatory impediments, as in the past, would make the issue out of control in the end as a result of continued mobilization of deposits for the survival of such institutions.

An Asset Management Company (AMC) to deal with Impaired Assets in the Sri Lankan Financial System

The handling of impaired assets require other specific skills and legal authority than are normally available in a financial institution. In order to deal with the impaired assets of the system, specific expertise and legal powers are required. In addition, dealing in impaired assets of troubled financial institutions would interface with the daily running of other financial institutions as well. Accordingly, an AMC which permits a consolidation of required skills, resources and specific legal powers would help addressing the issue in hand for the benefit of financial stability and efficient financial intermediation. Among the benefits of such centralized approach; (i) securitization of assets as the central entity will have a large pool of assets while central ownership of collaterals provide potentially more leverage over debtors and more efficient management, (ii) impaired assets could be removed clearly, quickly and completely from the financial system allowing financial institutions to focus on their core activities, (iii) the centralized approach would help breaking the links between such insolvent financial institutions and their borrowers and better be able to collect on connected lending, and (iv) the central unit could be given special legal powers required as it would allow orderly restructuring of the financial sector, application of uniform workout practices, and easier government monitoring and supervision of such workout practices.

What Needs to be Considered in Framing an AMC

Ownership: In view of the substantial amount of impaired assets has to be transferred over a short period of time, it would be difficult to find a private investor in an AMC without government guarantees or concessions covering the future value of the impaired assets. Hence, it would require the government to own the AMC itself. The AMC, however, should not be setup as a unit within the Central Bank of Sri Lanka, since anticipated activities would require taking on large amount of impaired assets which would be counterproductive for its statutory stability objectives.

Legal powers: In view of the existing gaps in the law that hinder the expeditious recovery process with clearly defined ownership as well as the legal obligations between debtors and creditors and does not provide for the orderly resolution of disputed claims, the legal basis of the AMC should provide special legal powers that are necessary for the acquisition, management, financing and disposition of assets and liabilities, the appointment of special administrators with powers to administer and manage persons whose assets or liabilities have been acquired by the AMC and for matters connected thereto, including the following, in addition to the legal authority given under the Banking Act, No. 30 of 1988 and the Finance Business Act, No. 42 of 2011:

- Special vesting powers that insulate AMC and subsequent purchasers from undisclosed claims made after AMC acquires the impaired assets from the distressed/selling financial institution,
- AMC is able to appoint special administrators without having to go to courts, and
- AMC can rapidly foreclose on collateral.

Governance: The AMC should be both independent and transparent with regard to its operations. In view of its role, it is important that it be insulated from political interference in the disposition and restructuring of assets. However, appropriate check and balance is brought so that AMC does not take inappropriate actions as a result of pressure, but at the same time is responsive to the public. The AMC could be governed by a board of directors of which majority should be outside independent directors. The board should be able to establish all policies and procedures, including policies for staff compensation, asset disposition strategies, credit and restructuring, budgets, and financial reporting.

Incentives: The success of an AMC is determined by how fast it accomplishes the responsibilities entrusted on it, and exit. Hence, in order to make the AMC a success so that it would liquidate the assets under its management through restructuring and disposition and ceases to exist, it is important that the overall setup is designed in such a way so that it would not become a "warehouse" of impaired assets.

Operational issues: The AMC has to have a commercial orientation of its operations. Commercial orientation, in turn, depends critically on policies regarding selection of assets to be purchased or transferred, pricing of such assets, funding, and strategies for asset recovery. Therefore, the following guidelines may serve as the baseline for consideration:

– Selection of assets: In selecting assets to be acquired, the AMC could consider the impaired or non-performing assets/loans of non-viable financial institutions, distressed financial institutions and such assets of all other licensed financial institutions but those with NPL ratio in excess of the industry average and required to reduce their NPL ratios. Also, it may be prudent to apply a minimum threshold to the loans that the AMC will purchase.

– Pricing: The transfer of assets to the AMC, regardless of the method of transfer, could be executed at fair market value to ensure that the AMC does not serve as a mean by which the government bails out licensed financial institutions by buying their impaired assets. A realistic valuation/pricing of collaterals/assets based on fair market pricing, sound accounting norms, strong loan classification and provisioning standards, and/or discounted present values is critical for the success of the AMC. Rigorous recognition of loan losses is the first and most critical element of an effective strategy for dealing with impaired/bad assets, as it creates the right incentives for licensed financial institutions to restructure their loans and foreclose on collaterals.

– **Funding:** The AMC could be funded from the issuance of government bond with maturity parallel to the anticipated life of the AMC. Accordingly, the government could consider issuing long-term bonds for the difference between the fair value of impaired assets and the underlying claims of the depositors and creditors, with the provision that, whenever the AMC realizes losses, such losses be directly absorbed by the budget.

– **Asset management and disposition:** Such asset management and disposition strategies should primarily have commercial aim with a view to maximizing the recovery value of assets in consideration of market conditions and the funding costs of the AMC.

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3.2 Regulation of Microfinance Institutions for Financial Stability

There has been growing acceptance of the fact that improving access of low-income households and small businesses to basic financial needs that has been denied or distanced by the formal financial sector of a country promotes economic growth and reduce poverty. At the same time, there has been a surge in financial services by microfinance institutions (MFIs), led by non-governmental organizations (NGOs) as well as informal unregulated financial service providers in the economy targeting those who have not been able to access the formal financial services, including regulated entities. This has been true in case of Sri Lanka as well.

A MFI is an organisation that offers financial services to low income communities. Microfinance business is not limited to lending, but also includes other financial services such as maintaining savings deposits, providing insurance, fund transfer facilities etc. Saving facilities offered by MFIs are a particularly important aspect in terms of financial stability when considering the prudential regulation of MFIs, because the prospective microfinance target group, in any developing country, is usually many times larger in deposit business than lending.

Establishment of a clear and transparent regulatory framework has become necessary in recent times as MFIs traditional funding sources are appear to be not keeping pace with their lending business. This may force MFIs to have more and more access to external finance to complement their own resources and also from donors, in order to meet the increasing demand of the borrowers. In Sri Lanka, private sector deposits are becoming the most popular alternative source of funding, simply because such MFIs are not matured enough to issue securities in the formal capital market or obtain loans from other financial institutions. Even though mobilization of private savings, mainly from a large number of small sized savers, raises the issue as to whether these MFIs are in compliance with extant statutory and regulatory framework. On the other hand, access to capital market by these institutions is constrained to the level of their compliance with extant regulatory framework on securities.

The relevance, in terms of financial stability of MFIs, can be broadly divided into two namely, the impact on the Financial System/Macro economy and the impact on the clients. Individual MFIs in the country are not big enough to impact the financial system/macro economy as individually each one of them represents only a very small percentage of the total financial market. However, the total number of depositors of each of these MFIs is supposedly large, as well as vulnerable. Another key parameter for assessing systemic importance is the concern for the safety of public deposits as these MFIs are not covered under the public safety nest. This primacy of regulatory concern is well accepted globally. In the case of MFIs, most of the savings are in the nature of compulsory savings linked to lending and not voluntary savings collected from the general public. Typically, the loan in the client's hand is more than her savings in the MFI's hand. Yet another parameter is protection of borrowers of MFIs from high rates and unfair practices. Traditionally it is perceived that these two issues are controlled through state level legislations and the laws relating to financial crimes. Serving this market will require access to funding far beyond what donors and governments can provide. Thus, many MFIs want to expand their outreach by raising funds from commercial sources, including borrowings from licensed banks as banks also eying the high lending rates in this sector through lending to MFIs. Hence, failure of MFIs would create spillover effects to entire financial system by creating systemic risk.

In order to mitigate potential systemic concerns in the micro finance sector in Sri Lanka, it is necessary to ensure activities of MFIs are regulated within a prudential regulatory framework that ensures the safety of its depositors. Current absence of a regulatory framework appears to be creating sufficient regulatory arbitrage between the formal financial sector and MFIs sector which in turn has been the principal factor for the rapid growth of the MFIs sector. Considering the growing size of the unregulated MFIs sector over and above the systemic proportion, and also the potential of creating a systemic risk to the overall stability, an effective regulatory framework for MFIs would accrue, inter alia, the following benefits:

(a) Well-functioning MFIs sector improves the efficiency of the process of intermediation between savings and investments while facilitating change in the composition of the financial system with regard to the transactions and the clients, the new risks created, and possibly the institutions that operate in newly created or expanded markets. This would facilitate the overall balance sheet of the financial system to grow with more diversity involving a broader spectrum of economic agents as improved financial inclusion via MFIs would help banks and other financial institutions source a stable retail base of deposits. Low income savers and borrowers in the MFIs sector tend to maintain steady financial behaviour through the business cycle both in terms of deposit keeping and borrowing. Thus, during periods of systemic crises, deposits from low income clients of MFIs would serve as an anchor even as other sources of credit dry up or become difficult to roll over.

(b) Well-functioning MFIs sector would facilitate greater participation by different segments of the economy in the formal financial system. The link between formal banking system and the MFIs sector which represents a larger share of informal sector would improve the transmission of monetary policy as a significant segment of otherwise financially excluded households and small businesses would now make financial decisions in consideration of, and influenced by, the monetary policy actions of the Central Bank of Sri Lanka, yielding an important positive externality as a result of effective monetary policy transmission.

(c) Well-functioning MFIs sector would encourage people move from the cash economy to bank accounts which in turn would eventually help protecting the domestic financial system being used for illegal activities, including the proposer implementation of prescriptions of the Financial Action Task Force (FATF) as well.

(d) Well-functioning MFIs sector would contribute to enhanced financial stability through contributing to the improved health of the household sector, of small businesses and, to some extent, that of the corporate sector. The health of the household sector is improved through improved economic linkages, reducing reliance on the costly informal sector and through improved ability to make and receive payments, including government transfer payments. Further, improved economic linkages for the rural and deprived communities through MFIs would address the issue of lacking of access to or availability of a vehicle for saving while preventing the households, especially low income households, resorting to expensive short-term debt. Additionally, MFIs could help avoiding possible debt trap as a result of high interest rates leading to households sector while improving the access to finance and the quality and cost of the service that small businesses receive from banks and MFIs. These factors are key to the profitability and prosperity of these businesses and that of the economy.

A clearly articulated regulatory framework on MFIs, consists of three pillars – consumers protection, efficient functioning of markets, and preserving stability of the financial system- is being formulated by Sri Lankan authorities.

Proposed regulations on protecting consumers generally seeks to prevent abuses of client rights and includes standards of transparency, corporate governance, and other rules of market conduct while improving efficiency in the functioning of the financial market including rules to prevent and correct market imperfections. Regulation to preserve the stability of the financial system is usually limited to those entities whose failures could generate high social costs. Although some rules serve several of these purposes, the preservation of financial stability is the main purpose of prudential regulation, which is a basic standard in the Core Principles for Effective Banking

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Appendix Table 1

Financial Soundness Indicators – All Banks

	2010	2011	2012	2013	2014 (a)	2015 (a) June
1. Capital Adequacy						
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	16.2	16.0	16.3	17.6	16.6	16.0
1.2 Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	14.3	14.4	14.7	14.9	14.1	13.5
1.3 Net Non-Performing Loans to Total Capital Funds	15.2	11.5	12.5	26.3	17.6	18.9
1.4 Debt to Capital Funds	172.0	171.4	184.5	207.4	254.7	250.7
1.5 Capital to Assets Ratio	8.3	8.7	8.6	8.2	8.2	8.2
2. Asset Quality						
2.1 Gross Non-Performing Loans (NPL) to Total Gross Loans (w/o Interest in Suspense)	5.4	3.8	3.7	5.6	4.2	4.3
2.2 Gross Non-Performing Loans (NPL) to Total Gross Loans (with Interest in Suspense)	7.3	6.2	5.7	7.7	6.2	6.3
2.3 Net Non-Performing Loans to Total Gross Loans	2.3	1.7	1.8	3.8	2.6	2.7
2.4 Provision Made against Gross Loans	3.1	2.2	2.0	2.3	2.2	2.1
2.5 Provision Coverage Ratio (Total)	45.3	45.0	41.4	32.5	39.7	37.6
2.6 Provision Coverage Ratio (Specific)	58.1	57.1	53.4	40.4	50.7	48.4
2.7 Sector-wise NPL to Total Sector Loans						
Agriculture and Fishing	3.2	2.5	2.4	4.1	6.0	5.9
Manufacturing	8.7	6.4	6.3	6.0	4.6	5.0
Tourism	4.7	11.4	10.9	8.6	6.8	6.5
Transport	4.2	2.8	3.4	3.0	2.5	2.5
Construction	8.4	7.5	6.8	7.1	5.9	5.4
Traders	7.5	5.3	3.8	4.2	4.2	4.6
New Economy	3.4	2.7	3.3	8.0	5.7	5.7
Financial and Business Services	2.4	1.4	1.6	2.3	2.0	1.9
Infrastructure	3.9	2.6	0.6	0.5	0.4	0.4
Other Services	3.2	2.1	3.4	3.3	2.6	3.1
Other Customer	3.3	1.7	2.2	8.3	4.5	5.0
2.8 Sectoral Distribution of Loans to Total Gross Loans						
Agriculture and Fishing	13.4	13.1	13.1	12.2	10.4	10.0
Manufacturing	13.0	12.0	10.8	11.3	11.3	10.6
Tourism	2.1	2.2	2.4	2.6	3.2	3.5
Transport	1.7	2.2	1.8	2.6	2.6	2.6
Construction	16.5	13.9	13.4	14.5	15.3	16.0
Traders	14.0	11.2	15.2	15.6	15.7	15.2
New Economy	0.9	0.9	1.2	1.0	1.4	1.3
Financial and Business Services	4.6	6.1	4.8	4.2	5.0	5.3
Infrastructure	1.3	1.3	5.1	6.3	8.9	9.0
Other Services	6.4	7.2	3.3	3.1	3.7	4.1
Other Customer	26.0	30.0	28.9	26.7	22.3	22.3
2.9 Provision Made against Total Assets	1.8	1.3	1.2	1.3	1.2	1.2
2.10 Total Loans (Gross) to Total Assets	55.6	61.2	61.8	57.7	55.9	57.3
2.11 Investments to Total Assets	30.4	24.9	23.9	28.5	27.6	30.7
2.12 Total Income to Total Assets	11.2	9.8	11.3	11.4	9.5	9.0
2.13 Net Interest Income to Total Assets	4.2	3.9	3.9	3.3	3.2	3.5
2.14 Operating Income to Total Assets	6.1	5.3	5.4	4.7	4.6	4.7
3. Earnings & Profitability						
3.1 Return on Equity (ROE) – After Tax	22.0	19.8	20.3	16.0	16.6	16.0
3.2 Return on Assets (ROA) – Before Tax	2.7	2.4	2.4	2.0	2.0	1.9
3.3 Return on Assets (ROA) – After Tax	1.8	1.7	1.7	1.3	1.4	1.3
3.4 Interest Income to Total Income	83.1	85.5	86.3	87.3	85.1	86.7
3.5 Net Interest Income to Total Income	37.7	39.4	34.3	29.0	33.5	38.8
3.6 Non-Interest Income to Total Income	16.9	14.5	13.7	12.7	14.9	13.3
3.7 Non-Interest Expenses (Operating Expenses) to Total Income	26.6	27.9	23.2	21.0	24.3	26.0
3.8 Staff Expenses to Non-Interest Expenses	45.2	44.2	45.8	44.9	43.5	46.6
3.9 Personnel Expenses to Total Income	12.0	12.4	10.6	9.4	10.6	12.1
3.10 Provisions to Total Income	0.6	1.2	2.5	3.9	3.4	3.9
3.11 Total Cost to Total Income	72.0	74.1	75.2	79.3	75.9	73.9
3.12 Efficiency Ratio	47.2	52.7	49.4	53.4	51.4	51.9
3.13 Interest Margin	4.6	4.2	4.1	3.5	3.5	3.7
4. Liquidity						
4.1 Liquid Assets to Total Assets	31.4	26.8	26.6	31.9	32.2	31.3
4.2 Statutory Liquid Assets Ratio – DBU	36.6	32.4	31.4	37.7	39.5	37.2
5. Assets / Funding Structure						
5.1 Deposits	72.8	72.3	71.1	70.2	67.2	67.4
5.2 Borrowings	14.3	14.9	15.8	17.1	20.8	20.6
5.3 Capital to External Funds	9.5	10.0	9.9	9.4	9.3	9.3
5.4 Credit to Deposits	76.4	84.7	86.9	82.2	83.1	85.0
5.5 Credit to Deposits & Borrowings	63.9	70.1	71.1	66.1	63.5	65.1
5.6 Credit to Deposits & Borrowings & Capital	58.3	63.8	64.7	60.4	58.1	59.6

(a) Provisional

Source: Central Bank of Sri Lanka

Appendix Table 2

Financial Soundness Indicators – LCBs

	2010	2011	2012	2013	2014 (a)	2015 (a) June
1. Capital Adequacy						
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	15.2	15.5	15.8	17.5	17.0	15.8
1.2 Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	13.0	13.4	12.2	14.3	14.0	13.0
1.3 Net Non-Performing Loans to Total Capital Funds	14.6	9.9	10.9	24.4	13.1	14.7
1.4 Debt to Capital Funds	190.5	185.5	198.3	197.1	241.7	237.8
1.5 Capital to Assets Ratio	7.9	8.5	8.4	8.3	8.3	8.4
2. Asset Quality						
2.1 Gross Non-Performing Loans (NPL) to Total Gross Loans (w/o Interest in Suspense)	5.1	3.5	3.4	5.2	3.6	3.7
2.2 Gross Non-Performing Loans (NPL) to Total Gross Loans (with Interest in Suspense)	7.0	6.0	5.5	7.3	5.6	5.7
2.3 Net Non-Performing Loans to Total Gross Loans	2.7	1.7	1.9	3.4	1.9	2.1
2.4 Provision Made against Gross Loans	3.2	2.2	2.0	2.3	2.2	2.2
2.5 Provision Coverage Ratio (Total)	48.4	50.7	45.5	35.6	48.1	45.1
2.6 Provision Coverage Ratio (Specific)	61.8	62.6	58.4	44.4	61.5	57.8
2.7 Sector-wise NPL to Total Sector Loans						
Agriculture and Fishing	2.7	2.3	2.0	2.8	3.7	3.6
Manufacturing	8.7	6.4	6.3	5.6	4.2	4.6
Tourism	4.4	11.7	11.3	8.3	6.9	6.7
Transport	3.7	2.6	3.0	2.6	2.2	2.2
Construction	7.1	6.0	5.2	5.4	4.2	3.9
Traders	7.5	5.3	3.7	4.1	4.1	4.5
New Economy	3.5	2.8	3.2	7.7	5.7	5.7
Financial and Business Services	2.4	1.6	1.6	1.9	1.5	1.4
Infrastructure	4.8	3.5	0.6	0.4	0.4	0.4
Other Services	3.0	1.9	3.1	3.2	2.7	3.4
Other Customer	3.3	1.7	2.3	8.7	3.9	4.4
2.8 Sectoral Distribution of Loans to Total Gross Loans						
Agriculture and Fishing	13.9	13.3	13.1	12.2	10.5	10.2
Manufacturing	13.6	12.6	11.2	11.8	11.9	11.0
Tourism	2.3	2.3	2.5	2.9	3.5	3.7
Transport	1.7	2.2	1.8	2.9	2.8	2.8
Construction	14.1	11.8	11.5	12.4	13.1	13.9
Traders	15.2	12.0	16.3	16.9	17.3	16.8
New Economy	1.0	1.0	1.2	1.2	1.5	1.5
Financial and Business Services	4.5	5.4	4.6	4.0	5.0	5.3
Infrastructure	1.1	1.1	5.3	6.5	7.9	8.1
Other Services	6.9	7.8	3.2	3.1	3.7	3.9
Other Customer	25.8	30.7	29.5	26.2	22.9	22.8
2.9 Provision Made against Total Assets	1.9	1.4	1.3	1.4	1.3	1.3
2.10 Total Loans (Gross) to Total Assets	59.3	65.1	65.0	61.3	58.7	60.1
2.11 Investments to Total Assets	25.7	20.0	20.0	24.4	23.7	27.5
2.12 Total Income to Total Assets	10.8	9.7	11.3	11.5	9.3	8.8
2.13 Net Interest Income to Total Assets	4.3	3.9	4.0	3.6	3.2	3.5
2.14 Operating Income to Total Assets	6.0	5.4	5.6	5.1	4.7	4.8
3. Earnings & Profitability						
3.1 Return on Equity (ROE) – After Tax	20.8	20.3	21.7	17.4	16.8	15.9
3.2 Return on Assets (ROA) – Before Tax	2.5	2.4	2.5	2.0	2.0	1.9
3.3 Return on Assets (ROA) – After Tax	1.7	1.7	1.8	1.4	1.4	1.3
3.4 Interest Income to Total Income	83.8	84.5	85.4	86.6	84.3	85.2
3.5 Net Interest Income to Total Income	40.0	40.4	35.5	30.9	34.8	39.6
3.6 Non-Interest Income to Total Income	16.2	15.5	14.6	13.4	15.7	14.8
3.7 Non-Interest Expenses (Operating Expenses) to Total Income	29.6	29.9	24.1	21.9	25.6	27.4
3.8 Staff Expenses to Non-Interest Expenses	44.6	42.8	44.9	43.8	42.9	45.4
3.9 Personnel Expenses to Total Income	13.2	12.8	10.8	9.6	11.0	12.4
3.10 Provisions to Total Income	0.4	1.3	2.8	4.3	3.8	4.4
3.11 Total Cost to Total Income	73.4	74.0	74.0	77.6	75.0	73.0
3.12 Efficiency Ratio	50.8	53.9	49.3	52.6	51.6	52.3
3.13 Interest Margin	4.7	4.3	4.3	3.7	3.6	3.7
4. Liquidity						
4.1 Liquid Assets to Total Assets	27.0	22.9	23.5	28.0	28.9	28.5
4.2 Statutory Liquid Assets Ratio – DBU	29.4	26.2	26.2	30.8	33.2	31.6
4.3 Loans to Deposits Ratio	81.9	91.1	92.5	86.7	86.9	88.7
5. Assets / Funding Structure						
5.1 Deposits	72.4	71.5	70.3	70.7	67.6	67.8
5.2 Borrowings	15.1	15.8	16.7	16.4	20.2	20.0
5.3 Capital to External Funds	9.1	9.8	9.7	9.6	9.5	9.6
5.4 Credit to Deposits	81.9	91.1	92.5	86.7	86.9	88.7
5.5 Credit to Deposits & Borrowings	67.8	74.6	74.7	70.3	66.9	68.5
5.6 Credit to Deposits & Borrowings & Capital	62.1	67.9	68.1	64.2	61.1	62.5

(a) Provisional

Source: Central Bank of Sri Lanka

Appendix Table 3

Financial Soundness Indicators – LSBs

	2010	2011	2012	2013	2014 (a)	2015 (a) June
1. Capital Adequacy						
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	24.4	20.0	20.5	18.6	18.3	17.7
1.2 Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	25.0	21.1	20.3	20.6	19.9	18.7
1.3 Net Non-Performing Loans to Total Capital Funds	17.8	19.0	20.8	37.6	45.9	45.4
1.4 Debt to Capital Funds	97.2	105.1	111.9	268.5	336.9	333.2
1.5 Capital to Assets Ratio	10.1	9.7	9.3	7.7	7.2	7.1
2. Asset Quality						
2.1 Gross Non-Performing Loans (NPL) to Total Gross Loans (w/o Interest in Suspense)	7.9	6.8	6.4	9.3	9.5	8.9
2.2 Gross Non-Performing Loans (NPL) to Total Gross Loans (with Interest in Suspense)	9.5	8.1	7.5	10.8	11.2	10.5
2.3 Net Non-Performing Loans to Total Gross Loans	5.8	5.1	5.0	7.8	8.2	7.8
2.4 Provision Made against Gross Loans	3.0	2.2	1.9	1.9	1.8	1.6
2.5 Provision Coverage Ratio (Total)	29.0	25.4	22.3	17.2	15.0	13.2
2.6 Provision Coverage Ratio (Specific)	38.2	32.7	29.7	20.6	19.0	17.6
2.7 Sector-wise NPL to Total Sector Loans						
Agriculture and Fishing	8.8	5.6	5.7	15.3	26.7	27.7
Manufacturing	9.6	6.4	6.0	10.1	9.6	10.4
Tourism	14.7	5.8	4.4	4.9	5.1	2.8
Transport	8.6	4.9	6.9	6.4	6.0	5.8
Construction	12.8	12.4	12.0	13.0	11.4	10.2
Traders	8.0	5.0	5.7	10.4	7.5	8.2
New Economy	2.2	2.0	3.7	1.4	10.4	5.3
Financial and Business Services	2.7	0.7	1.0	4.8	6.1	6.4
Infrastructure	1.1	0.1	0.3	1.2	0.3	0.3
Other Services	8.0	6.5	5.9	3.4	2.2	1.2
Other Customer	3.2	2.0	1.1	7.3	10.1	10.1
2.8 Sectoral Distribution of Loans to Total Gross Loans						
Agriculture and Fishing	9.3	11.2	13.2	12.8	9.2	8.4
Manufacturing	8.3	7.1	7.5	7.2	7.2	7.0
Tourism	0.7	1.1	1.4	1.6	1.6	1.6
Transport	1.7	2.0	2.0	2.0	1.6	1.5
Construction	37.6	32.8	31.3	34.2	32.6	32.9
Traders	3.7	3.8	5.3	3.7	3.2	3.1
New Economy	0.3	0.2	0.5	0.1	0.0	0.0
Financial and Business Services	5.6	12.2	6.7	5.7	5.1	4.9
Infrastructure	3.1	3.3	3.4	4.9	16.9	16.1
Other Services	2.2	1.8	4.3	3.1	4.4	6.1
Other Customer	27.4	24.5	24.3	24.7	18.2	18.5
2.9 Provision Made against Total Assets	1.1	0.9	0.8	0.7	0.7	0.6
2.10 Total Loans (Gross) to Total Assets	36.7	40.4	42.9	37.8	40.5	41.8
2.11 Investments to Total Assets	55.1	50.5	47.0	51.2	49.1	48.3
2.12 Total Income to Total Assets	14.8	11.4	12.0	10.9	10.4	10.1
2.13 Net Interest Income to Total Assets	4.4	4.8	6.3	2.0	2.8	3.5
2.14 Operating Income to Total Assets	4.4	4.8	6.3	2.9	3.9	4.2
3. Earnings & Profitability						
3.1 Return on Equity (ROE) – After Tax	27.1	17.4	13.6	8.6	15.1	16.6
3.2 Return on Assets (ROA) – Before Tax	3.8	2.5	1.8	1.0	1.7	1.8
3.3 Return on Assets (ROA) – After Tax	2.6	1.7	1.3	0.8	1.2	1.2
3.4 Interest Income to Total Income	80.1	90.2	91.5	91.2	89.3	93.8
3.5 Net Interest Income to Total Income	28.7	34.9	27.4	17.9	27.3	35.3
3.6 Non-Interest Income to Total Income	19.9	9.8	8.5	8.8	10.7	6.2
3.7 Non-Interest Expenses (Operating Expenses) to Total Income	14.8	18.2	18.0	15.6	17.8	19.7
3.8 Staff Expenses to Non-Interest Expenses	50.0	51.5	52.8	54.0	47.3	54.3
3.9 Personnel Expenses to Total Income	7.4	9.4	9.5	8.4	8.4	10.7
3.10 Provisions to Total Income	1.7	0.5	0.8	1.4	1.7	1.5
3.11 Total Cost to Total Income	66.2	73.6	82.2	88.9	79.9	78.2
3.12 Efficiency Ratio	31.0	41.9	49.9	60.1	49.9	49.3
3.13 Interest Margin	4.1	4.0	3.3	2.2	3.1	3.8
4. Liquidity						
4.1 Liquid Assets to Total Assets	54.0	47.7	45.1	53.2	49.9	45.5
4.2 Statutory Liquid Assets Ratio – DBU	74.3	65.4	61.4	80.3	77.7	70.5
5. Assets / Funding Structure						
5.1 Deposits	75.1	76.3	76.0	67.1	65.3	65.4
5.2 Borrowings	9.8	10.2	10.4	20.7	24.1	23.8
5.3 Capital to External Funds	11.9	11.2	10.8	8.8	8.0	8.0
5.4 Credit to Deposits	48.8	52.9	56.5	56.3	62.1	64.0
5.5 Credit to Deposits & Borrowings	43.2	46.7	49.7	43.0	45.4	46.9
5.6 Credit to Deposits & Borrowings & Capital	38.6	42.0	44.9	39.5	42.0	43.5

(a) Provisional

Source: Central Bank of Sri Lanka

Appendix Table 4

Financial Soundness Indicators – LFCs and SLCs Sector

	2010 March	2011 March	2012 March	2013 March	2014 March	2015 March	2015 June (a)
				March			
1. Capital Adequacy							
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	11.3	7.2	14.8	14.9	14.5	13.4	15.3
1.2 Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	9.8	6.4	14.8	14.4	13.6	12.5	14.6
1.3 Capital Funds to Total Assets	13.1	11.8	14.1	14.2	13.3	13.1	14.2
1.4 Debt to Capital Funds (Borrowings other than Deposits)	241.1	296.1	242.2	203.1	187.5	207.3	194.6
1.5 Investment Properties to Capital Funds	12.0	10.0	7.6	27.4	7.8	7.4	6.5
1.6 Net Non-Performing Advances to Capital	21.0	14.6	12.2	9.9	12.5	11.0	10.0
2. Asset Quality							
2.1 Gross Non-Performing Advances to Total Advances	8.2	6.8	4.8	5.1	6.6	6.3	6.4
2.2 Net Non-Performing Advances to Total Advances	4.1	2.4	2.2	1.8	2.2	1.9	1.8
2.3 Required Bad Debts Provision to Total Advances	3.2	3.9	2.6	2.6	2.9	3.1	3.1
2.4 Provision made against Total Advances	4.8	4.3	2.6	2.7	3.8	3.7	3.8
2.5 Provision Coverage Ratio (Specific Provisions to NPA)	37.7	42.0	41.0	39.9	46.7	51.6	56.5
2.6 Provision Coverage Ratio (Total Provisions to NPA)	58.2	62.4	54.5	52.1	57.4	58.3	59.6
3. Liquidity							
3.1 Liquid Assets to Total Assets	5.7	4.2	5.3	6.4	10.2	8.7	8.7
3.2 Liquid Assets to External Funds	14.1	11.2	12.1	13.0	18.8	17.4	17.2
4. Earnings							
4.1 Return on Assets (Annualized)	1.4	3.5	5.1	3.2	1.9	3.1	3.8
4.2 Return on Equity (Annualized)	3.1	17.4	26.3	15.7	7.8	14.5	17.6
4.3 Interest Income to Interest Expenses	142.9	181.8	196.8	167.1	166.3	202.9	220.1
4.4 Net Interest Income to Profit After Tax	1190.2	297.3	189.6	280.4	626.2	399.1	340.9
4.5 Operating Cost to Net Interest Income	113.6	91.0	72.0	76.5	86.6	72.8	67.7
4.6 Net Interest Income to Gross Assets	4.8	6.1	7.0	6.2	6.5	7.6	2.1
4.7 Net Interest Income to Interest Income	30.0	45.0	49.2	40.2	39.9	50.7	54.6
4.8 Non-Interest Income to Total Cost	30.7	40.9	42.0	33.0	33.7	38.9	40.8
4.9 Efficiency Ratio (Operating Cost)	67.8	57.8	51.1	57.0	63.8	55.7	53.4
4.10 Cost to Income Ratio	92.5	79.5	70.3	81.9	89.7	82.2	79.0
5. Assets / Funding Structure							
5.1 Borrowings	31.5	35.0	34.2	28.9	24.9	27.2	27.7
5.2 Investments	4.0	6.6	2.6	2.3	2.3	4.4	4.5
6. Lending							
6.1 Total Accommodation Growth	5.7	40.7	38.9	21.6	12.1	21.6	25.3

(a) Provisional

Source: Central Bank of Sri Lanka

Appendix Table 5

Financial Soundness Indicators – Licensed Finance Companies

	2010 March	2011 March	2012 March	2013 March	2014 March	2015 March	2015 June (a)
1. Capital Adequacy							
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	11.3	7.2	11.7	13.5	13.2	12.2	13.8
1.2 Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	9.8	6.4	10.8	12.7	11.9	11.2	12.9
1.3 Capital Funds to Total Assets	9.6	7.8	10.8	13.0	12.1	12.0	13.2
1.4 Capital Funds to Deposits Liabilities	15.0	12.5	20.5	26.7	22.2	23.8	26.2
1.5 Net Non-Performing Advances to Capital	35.9	33.6	14.5	11.1	13.6	12.6	11.3
2. Asset Quality							
2.1 Gross Non-Performing Advances to Total Advances	9.7	8.9	5.7	5.2	6.7	6.7	6.7
2.2 Provisions Non-Performing Advances	55.6	54.9	52.3	51.3	57.5	57.8	59.0
3. Liquidity							
3.1 Liquid Assets to Total Assets	9.0	7.0	6.3	6.3	10.2	8.8	8.7
3.2 Liquid Assets to External Funds	12.0	9.1	10.2	8.6	10.9	11.7	11.5
4. Earnings							
4.1 Return on Assets – Before Tax (Annualized)	0.1	6.9	5.5	2.9	1.7	3.0	3.7
4.2 Return on Assets – After Tax (Annualized)	-0.7	1.0	5.0	2.0	0.8	1.6	0.5
4.3 Return on Equity – After Tax (Annualized)	-7.4	12.3	12.8	15.6	6.7	14.4	19.2
4.4 Net Interest Income to Gross Assets	22.2	33.1	39.3	33.9	33.1	41.7	45.7
4.5 Net Interest Income to Total Assets	4.2	5.7	6.8	6.0	6.1	7.1	2.0
4.6 Non-Interest Expenses (Operating Expenses) to Income	30.8	35.1	31.6	27.2	30.9	32.5	32.7
4.7 Staff Expenses to Non-Interest Expenses	36.6	34.4	35.5	36.9	34.2	37.8	41.7
4.8 Total Cost to Total Income	99.7	63.7	66.5	83.3	91.4	84.1	81.0
5. Assets / Funding Structure							
5.1 Deposits	63.9	62.2	52.4	48.6	54.3	50.5	50.5
5.2 Loans and Advances	63.7	70.3	77.4	77.0	74.6	76.1	76.8
5.3 Investments	2.5	3.3	2.3	2.3	2.3	4.7	4.8
5.4 Credit to Deposits	99.7	112.9	147.7	158.6	137.4	150.6	152.0

(a) Provisional

Source: Central Bank of Sri Lanka

Appendix Table 6

Financial Soundness Indicators – Specialised Leasing Companies

	2010 March	2011 March	2012 March	2013 March	2014 March	2015 March	2015 June (a)
1. Capital Adequacy							
1.1 Capital Funds to Total Assets	19.1	18.1	23.4	24.9	25.3	27.6	26.9
1.2 Total borrowings to Capital Funds (Gearing) - Times	3.5	3.8	2.9	3.2	3.3	2.8	2.5
2. Asset Quality							
2.1 Gross Non-Performing Advances to Total Advances	6.0	3.8	2.5	3.9	5.8	2.1	2.2
2.2 Provision made against Total Accommodations	3.9	3.3	1.7	2.4	3.2	1.6	1.8
2.3 Total Accomodation to Total Assets	74.3	74.4	87.5	82.3	77.5	84.6	86.0
2.4 Total Accomodation to Total Borrowings	111.4	109.6	130.8	128.6	121.8	143.0	138.1
3. Liquidity							
3.1 Net Loans to Total Borrowings	105.8	104.7	127.9	124.6	116.8	140.3	135.3
3.2 Liquid Assets to Total Assets	10.2	4.2	2.6	6.7	10.2	7.8	8.7
3.3 Liquid Assets to Total borrowings	15.3	6.1	3.9	10.4	16.0	13.2	14.0
4. Earnings							
4.1 Return on Assets (Annualized)	3.8	5.3	6.9	5.5	5.3	7.4	9.2
4.2 Operating Profit Before Provision to Total Assets	2.8	5.7	6.1	5.7	7.3	10.5	2.7
4.3 Return on Equity (Annualized)	11.8	20.5	21.4	16.0	15.1	20.3	24.5
4.4 Interest Income to Interest Expenses	224.0	205.6	212.2	211.1	230.6	368.7	382.2
4.5 Net Interest Income to Profit Before Tax	176.6	164.6	112.5	156.4	198.3	176.6	164.6
4.6 Operating Cost to Net Interest Income	47.4	71.3	51.8	53.5	47.0	38.8	41.2
4.7 Total Cost to Total Income	55.6	66.2	64.3	68.3	63.6	50.5	51.3
5. Assets / Funding Structure							
5.1 Borrowings	66.7	67.9	66.9	64.0	63.6	59.1	62.3
5.2 Investments	6.7	11.5	3.3	1.9	2.1	0.2	0.2

(a) Provisional

Source: Central Bank of Sri Lanka

Glossary

Balance of Payments (BOP)	A statement that summarizes an economy's transactions with the rest of the world for a specified time period. Encompasses all transactions between a country's residents and its non-residents involving goods, services, income, current transfers, acquisition of financial assets and incurrence of financial liabilities. The balance of payments classifies these transactions into three accounts; namely, the current account, the capital account and the financial account. The current account shows flows of goods, services, primary income and secondary income between residents and non-residents. The capital accounts shows credit and debit entries for non-produced non-financial assets and capital transfers between residents and non-residents and represent only a small portion of BOP. The financial account shows the net acquisition and disposal of financial assets and liabilities. The sum of the balances of the current and capital accounts represents the net lending (surplus) or net borrowing (deficit) by the economy. This is conceptually equal to the net balance in the financial account.
Bond Yields	Return an investor would earn for a bond purchased. Usually, the longer the term of a bond, the higher the interest rate that's paid to the holder, compensating for the inflation risk involved in having money tied up for a long time.
Capital	Used to generate wealth through investments. Includes financial assets, factories, machinery and equipment owned by business. Besides being used in production, capital can be rented out for a monthly or annual fee to create wealth.
Corporate Bonds	Medium or long-term securities of private sector companies which obligate the issuer to pay interest and redeem the principal at maturity.
Credit Card	"Credit Card" means, a payment card which involves a line of credit granted by the issuer to the cardholder where the credit utilized can be settled in full or in part on or before a specified date. The issuer may charge interest or other charges on any amount not settled on the specified date.
Credit Risk	The risk of financial loss if a customer or counterparty fails to meet a payment obligation under a contract.
Depreciation	The monetary value of an asset decreases over time due to use, wear and tear or obsolescence.

Equity Ratio	A financial ratio indicating the relative proportion of equity used to finance a company's assets. Equity Ratio = Total Shareholder's equity / Total Assets
Euro Area	The Eurozone officially called the euro area, is an Economic and Monetary Union (EMU) of 18 European Union (EU) member states that have adopted the euro (€) as their common currency and sole legal tender.
Finance lease	A contract whereby a lessor (seller) conveys to the lessee (buyer) the right to use an asset for rent over an agreed period of time which is sufficient to amortize the capital outlay of the lessor. The lessor retains ownership of the asset but transfers substantially all the risks and rewards of ownership to the lessee.
Gross Domestic Product (GDP)	Monetary value of all the finished goods and services produced within a country's borders in a specific time period.
Government Securities	Bonds, bills, and other debt instruments sold by a government, to finance its borrowings.
Hire purchase	Hire purchase is the legal term for a contract, in which a purchaser agrees to pay for goods in parts or a percentage over a number of months.
Inflation	Increase in general price level of goods and services in an economy over a period of time.
Interest Margin	The difference between the interest income generated by banks or other financial institutions and the amount of interest paid out (for example, to depositors), relative to the amount of their (interest-earning) assets.
Liquid Assets	Term used to describe an asset that can be quickly converted to cash at a price close to fair market value.
Liquidity Ratios	Financial ratios measuring the company's ability to meet its short-term obligations. Generally, the higher the value of the ratio, the larger the margin of safety that the company possesses to cover short-term obligations.
Market Risk	Market risk can be defined as the risk of losses in on and off-balance sheet positions arising from adverse movements in market prices such as interest rates, exchange rates, equity prices and commodity prices.

Maturity	The period of time for which a financial instrument remains outstanding. Maturity refers to a finite time period at the end of which the financial instrument will cease to exist and the principal is repaid with interest.
Maturity Mismatches	The tendency of a business to mismatch its balance sheet by possessing more short-term liabilities than short-term assets and having more assets than liabilities for medium and long-term obligations.
Monetary Policy	One of the core objectives of the Central Bank of Sri Lanka is economic and price stability. The Central Bank formulates and implements its monetary policy, i.e., actions to influence the cost and availability of money, to attain this objective. The Monetary Law Act (MLA), the legislation under which the Central Bank has been established and operates, has provided a wide range of instruments for monetary management. At present, the monetary policy framework of the country places greater reliance on market based policy instruments and the use of market forces to achieve the desired objectives.
Non-Performing Loans (NPL)	A loan is classified as non-performing as specified in the Directions issued under the provisions of the Banking Act, No. 30 of 1988 and Finance Business Act No. 42 of 2011 when payments of interest and/or principal have been in arrears, i.e., for more than 3 months or more, or based on the potential risk.
Provision Coverage Ratio	Ratio of provisions made against the non-performing loans .
Repurchase Agreements (Repo) and Reverse repurchase agreement (Reverse Repo)	Arrangements which involve the sale, for cash, of securities (usually government securities) at a specified price with a commitment to repurchase the same or similar securities at a fixed price on a specified future date. The difference between the sale price and the repurchase price is the interest income. The agreement is called reverse repo when viewed from the perspective of the securities buyer. A repo is similar to a loan that is collateralized by the securities underlying the agreement. Most repos are very short-term money market instruments.
Return on Assets (ROA)	A financial ratio that shows the percentage of profit that a company earns in relation to its overall resources (total assets). ROA (after tax) = Net profit after tax / Total assets (or Average Total assets)
	The amount of net income returned as a percentage of shareholders equity. It reveals how much profit a company earned in comparison to the total amount of shareholder equity found on the balance sheet.

Return on Equity (ROE)	ROE = Net profit after tax / Shareholder's equity (or Average Shareholder's equity)
Statutory Liquid Asset Ratio (SLAR)	The ratio of liquid assets as determined under the provisions of the Banking Act, No. 30 of 1988 maintained by licensed banks as a per centum of the total liabilities or deposits as the case may be.
Trade Deficit	The difference between the monetary value of exports and imports of output in an economy over a certain period, measured in the currency of that economy. A negative balance is referred to as a trade deficit or, informally, a trade gap.