



**GOVERNING BOARD  
CENTRAL BANK OF SRI LANKA**

**03 May 2024**

**FINANCE BUSINESS ACT DIRECTIONS**

**No.02 of 2024**

**CREDIT RISK MANAGEMENT**

- |                                            |     |                                                                                                                                                                                                                                                                                                                                                         |
|--------------------------------------------|-----|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>1. Legal provisions</b>                 | 1.1 | In terms of the powers conferred by Section 12 of the Finance Business Act, No. 42 of 2011 read with Section 133(1) of the Central Bank of Sri Lanka Act, No. 16 of 2023, the Central Bank of Sri Lanka hereby issues these directions on Credit Risk Management to every Finance Company (FC) licensed under the Finance Business Act, No. 42 of 2011. |
| <b>2. Objectives of the directions</b>     | 2.1 | Establish a credit risk management framework through formulation of a credit risk management strategy, credit risk management policy, credit risk governance structure including prudential limits, and ensuring availability of an effective system in place to identify, measure, monitor and control the credit risk.                                |
| <b>3. Applicability</b>                    | 3.1 | These directions outline the key principles for a sound credit risk management framework and the FC shall adopt the principles and practices provided in these directions.                                                                                                                                                                              |
|                                            | 3.2 | These directions shall be effective from 01.01.2025.                                                                                                                                                                                                                                                                                                    |
| <b>4. Credit risk management framework</b> | 4.1 | The credit risk management framework shall continue to be an integral component of the long-term sustainability of the FC and have a holistic approach for assessing the credit risk <sup>1</sup> .                                                                                                                                                     |
|                                            | 4.2 | The credit risk management framework of the FC shall at least contain the following elements: <ul style="list-style-type: none"><li>a) Credit risk management strategy and credit risk management policy;</li><li>b) Credit risk governance structure; and</li><li>c) Credit risk management process.</li></ul>                                         |

<sup>1</sup> Credit risk means the potential that a FCs' borrower/counterparty will fail to meet its obligations in accordance with agreed terms in the agreement.



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**4.3 Credit risk management strategy and credit risk management policy**

**a) Credit risk management strategy**

- i. The FC shall develop its credit risk management strategy in line with its business goals and credit risk tolerance level, in terms of risk appetite statement approved by the Board of Directors (BoDs) of the FC.
- ii. At a minimum, the credit risk management strategy shall outline the FC's willingness to grant credit facilities based on:
  - (a) Exposure type (for example, commercial, consumer, real estate, etc.) and limits;
  - (b) Economic sector /activities;
  - (c) Geographical location;
  - (d) Currency; and
  - (e) Maturity.
- iii. The FC shall ensure that the credit risk management strategy is long term in nature and able to take into account the cyclical aspects of the economy and the resulting changes in the composition/quality of the overall credit portfolio.

**b) Credit risk management policy**

- i. The FC shall have a comprehensive credit risk management policy developed and implemented enabling the FC to grant and manage its credit facilities and to evaluate new business opportunities.
- ii. Such policy shall be well defined, documented, duly approved by the BoDs, consistent with the best practices and regulatory requirements, and be adequate for the nature and complexity of the FC's activities and reviewed



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- annually.
- iii. At a minimum, the credit risk management policy of the FC shall include:
- (a) The role, responsibility and level of accountability of the BoDs and senior management;
  - (b) The delegation of credit authority to various levels of management and staff (including authority to approve deviations and exceptions);
  - (c) Types of credit facilities in which the FC is allowed to engage;
  - (d) The extent to which the FC is willing to accept credit risk against its portfolio, including concentration limits, with respect to borrowers/counterparties, credit extended to group of borrowers, economic sectors / activities, geographic regions and the acceptable types of collaterals;
  - (e) Procedures for granting credit facilities to group of borrowers taking into consideration an arm's length basis and free of conflicting interests;
  - (f) Details on the analysis to be conducted when introducing new credit facilities;
  - (g) A list of documentation required for each stage of the credit management process;
  - (h) Details on internal controls to mitigate credit risk; and
  - (i) Details on how credit impaired loans shall be managed and the responsible officer for managing this function.
- iv. The FC is encouraged to formulate policies and procedures for identifying connected parties in granting them credit facilities to avoid an excessive credit risk taking by introducing credit risk mitigation strategies



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including prudential limits.

**4.4 Credit risk governance structure**

- a) The FC shall have a sound credit risk governance structure for successful implementation of an effective credit risk management framework.
- b) The BoDs / Board-Sub Committee shall play a crucial role in overseeing the credit risk management framework of the FC. The responsibilities of the BoDs / Board-Sub Committee shall include at a minimum:
  - i. Developing a documented credit risk management strategy;
  - ii. Approving and reviewing the credit risk management policy developed by the senior management;
  - iii. Ensuring that the senior management is fully capable of managing the credit facilities granted by the FC and such activities are done within the credit risk management strategy and policy;
  - iv. Ensuring that the credit risk management strategy and policy are effectively communicated throughout the FC, and the relevant staff in the FC is aware of the established approach to credit risk management;
  - v. Ensuring that adequate controls, including management reporting and internal audits are in place to monitor that the risks being taken are in accordance with the agreed upon internal policies;
  - vi. Monitoring of adherence to regulatory, supervisory and other legal requirements; and
  - vii. Reviewing analysis and stress tests conducted by the FC based on scenarios including the dynamics in the unsecured credit portfolio in order to identify emerging



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credit risks.

- c) Senior management / Senior management-Level Committee of the FC shall be responsible for:
- i. Adopting the credit risk strategy set out by the BoDs / Board-Sub Committee;
  - ii. Developing and implementing documented credit risk management policy and procedures;
  - iii. Establishing a communication system that disseminates the credit risk management strategy and policy to the staff engaged in the credit risk management processes;
  - iv. Complying with regulatory, supervisory and other legal requirements;
  - v. Developing and implementing adequate internal controls to mitigate credit risk; and
  - vi. Developing of appropriate Management Information System (MIS) and submitting reports to the BoDs.
- d) The FC shall cascade down the day-to-day stewardship of credit risk management to the operational level via the three (03) lines of defense mechanism.
- i. The heads of business units and branch managers shall be responsible for identifying and managing credit risk that arises from their business activities on a day-to-day basis and operate within the approved risk appetite and risk management policy.
  - ii. The division/department which handles the credit risk management and control function shall monitor effective implementation of credit risk management framework, facilitate high levels of risk awareness throughout the FC, and carry out measurement, monitoring and reporting to the senior management and BoDs.



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- iii. The FC's internal audit team shall perform an independent testing periodically and verification of the effectiveness of the credit risk management framework, including policies and procedures and compliance with these policies.

**4.5 Credit risk management process**

Effective credit risk management process shall include the identification and assessment of potential risk inherent in any credit facility. At a minimum, this process shall formalize the FC's approach to the followings:

**a) Appraisal and approval of credit facilities**

- i. The FC shall ensure that the FC receives sufficient information for assessment of the risk profile of the borrower/counterparty.
- ii. The FC shall have an internal rating system/credit risk scoring system to assess the credit worthiness of the borrower/counterparty and such system shall be consistent with the nature, size and complexity of the FC's activities.
- iii. Varied credit risk scoring system could be applied to segments of borrowers based on homogeneous characteristics (e.g.: pawning/microfinance).
- iv. The FC shall have a team of staff with sufficient knowledge, skills and experience to assess the credit risk and ensure that credit decision making process is rigorous, timely and efficient.
- v. At a minimum, in assessing a borrower, the FC shall consider:
  - (a) The purpose of the credit facility and source of repayment;
  - (b) The proposed terms of the credit facility;
  - (c) The type and value of collateral;



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- (d) Whether the borrower/counterparty could be identified within a group of borrowers; and
- (e) Borrower/counterparty's internal risk rating/credit risk scoring based on the risk profile of the borrower/counterparty.

**b) Credit administration**

The credit administration function of the FC shall support the granting and maintenance of a credit facility. The FC's credit administration function shall ensure that:

- (a) Controls over 'back office' procedures are adequate;
- (b) There shall be adequate segregation of duties;
- (c) The accuracy and timeliness of information provided to MIS; and
- (d) The efficiency and effectiveness of credit administration functions, including documentation, contractual requirements, legal contracts/agreements, collateral, etc.

**c) Measurement of credit facilities**

- i. The FC shall setup a mechanism for measuring the risks in all credit exposures, in line with Sri Lanka Accounting Standards, Sri Lanka Financial Reporting Standards and Finance Business Act Direction No. 01 of 2020 - Classification and Measurement of Credit Facilities or as amended.
- ii. At a minimum, the FC shall estimate the expected credit losses by computing the probability of default, loss given default and exposures at default for the FC's credit exposures at individual-level or portfolio-level and recognize such measurement on a timely manner in accordance with the applicable Accounting Standards.



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- iii. The credit risk measurement outputs shall also be duly considered by the FC in developing/reviewing the credit risk management strategy and credit risk management policy, particularly in the areas of approval of a credit facility, pricing, limit-setting, identification of credit impaired loans and credit loss allowances.

**d) Monitoring of credit facilities**

- i. The FC shall have a system that enables it to monitor and assess the credit risk involved in exposures to an individual borrower/counterparty, and at product, sector and collateral levels. Further the unsecured credit portfolio shall be subjected to more frequent reviews by BoDs/Board-Sub Committee as required at section 4.4 b) vii above.
- ii. The FC shall deploy a proper MIS which assists the FC to comprehensively monitor its credit portfolio and any associated credit risk. The information generated from the MIS shall be used to take decisions by the BoDs and senior management and facilitate the on-going assessment of credit risk.
- iii. The FC shall perform stress testing for identifying possible events or future changes in economic conditions that could have unfavorable effects on the FC's credit exposures and assessing the FC's ability to withstand such changes.
- iv. An effective credit monitoring process shall ensure the followings:
- (a) Update the financial condition of the borrower/counterparty at regular intervals;
  - (b) Assess, where applicable, collateral coverage relative





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- to the borrower's/counterparty's current condition;
- (c) Identify contractual payments in arrears and classify as credit impaired loans on a timely manner;
  - (d) Reflect the updated financial condition of the borrower/counterparty in the FC's internal risk rating or credit risk scoring; and
  - (e) Monitor the credit quality, maintain regular contact with the borrower/counterparty, and conduct follow-up actions.
- v. The management of credit impaired loans shall be undertaken by the FC in a structured and targeted manner, with a focus on improving recovery outcomes and providing with feedback to further strengthen the FC's credit risk management strategy and credit risk management policy.
- vi. Write-off shall be undertaken by the FC in a timely manner and reflect realistic repayment and recovery expectations. At a minimum, the FC shall set out the circumstances, conditions and approving authority under which a credit facility can be written-off based on the write-off policy approved by the BoDs and maintain adequate information on written-off credit facilities.
- 5. Granting accommodation**
- 5.1 No FC shall grant any accommodation:
- a) To its holding company or ultimate parent company or any other party that exerts substantial interest over the FC.
  - b) On the security of its own shares or on the security of the shares of any of its subsidiary companies or its holding company or ultimate parent company;
  - c) To purchase its own shares; or



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- d) On the guarantee or indemnity of a director of the FC, a relative of a director of the FC or any employee of the FC. However, this will not be applicable to staff loans granted to the employees of such FC given under an approved common scheme.
- e) In accordance with any scheme, for the purchase of or subscription of shares in the FC, by or for the benefit of employees of the company, from the effective date of this direction.
- 5.2 The FC may grant accommodations to a director and /or a relative of a director of such FC, where collateral satisfying the following requirements are available, subject to 5.3 below:
- a) Bank guarantee, where the accommodation granted shall not exceed hundred per cent (100%) of the guarantee;
  - b) Sri Lanka Government or Central Bank of Sri Lanka Securities free from any lien or charge, where the accommodation granted would not exceed ninety per cent (90%) of the face value or the market value, whichever is lower of such securities; or
  - c) Deposits in the FC held free from any lien except for the accommodation under consideration, where the accommodation granted would not exceed ninety per cent (90%) of such deposits.
- 5.3 However, a director subject to 5.1(a) above and/or a relative of such director, shall not be granted an accommodation, despite having fulfilled the requirements at 5.2 above.
- 5.4 The FC may grant accommodations to its subsidiary companies or associate companies subject to the limits specified in the direction 6 below.



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**6. Prudential limits**

6.1 The maximum amount of accommodation that may be granted by the FC shall not exceed the following percentage of core capital of such FC subject to the directions 7 and 9 below.

**a) Individual borrower limit**

The maximum amount of a single accommodation or the aggregate of accommodations granted by the FC and outstanding amount of accommodations at any point of time from an individual borrower, shall not exceed fifteen per cent (15%) of the core capital of such FC as shown in the capital adequacy return in the immediate preceding quarter.

**b) Group borrowers limit**

The maximum amount of a single accommodation or the aggregate of accommodations granted by the FC and outstanding amount of accommodations at any given point of time from any group of borrowers of such FC shall not exceed twenty per cent (20%) of the core capital of such FC as shown in the capital adequacy return in the immediate preceding quarter.

**c) Aggregate limit**

Single accommodations granted to and outstanding in respect of categories of borrowers referred to in a) and b) above, each of which exceeds ten per cent (10%) of core capital of such FC as shown in the capital adequacy return in the immediate preceding quarter when all such amount of accommodations are aggregated, shall not exceed fifty per cent (50%) of the total outstanding amount of accommodations of such FC as of the immediate preceding quarter.

6.2 The aggregate of unsecured accommodations granted to and outstanding at any point of time from all borrowers shall not exceed twenty per cent (20%) of core capital of such FC as shown



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- in the capital adequacy return in the immediately preceding quarter.
- 7. Exclusion of accommodations from prudential limits**
- 7.1 When computing the maximum amount of accommodations under direction 6 above;
- a) Where credit facilities are granted to borrower/s against the collaterals indicated below, the value of such collateral may be deducted from the relevant credit facilities.
- i. Deposits in a licensed bank and licensed finance company, free from any lien or charge;
- ii. Sri Lanka Government or Central Bank of Sri Lanka Securities, free from any lien or charge; and
- iii. Bank guarantees.
- b) Investments in Sri Lanka Government or Central Bank of Sri Lanka Securities may be deducted from accommodations.
- 8. Transitional provision**
- 8.1 In the instances where accommodations granted to any category of customers referred in direction 6 above exceed due to the amendments in the prudential limit, the accommodation shall be reduced within one year from the effective date of this direction.
- 9. Definitions**
- 9.1 The following definitions shall be applicable for the purposes of these directions.
- a) “Accommodations” shall mean loans; facilities under hire purchase or lease agreements; provision of funds through debt instruments such as bonds, debentures, asset backed securities, commercial papers/promissory notes; all off-balance sheet accommodations such as any commitment to grant any loan or advances or such other facility including commitment to accept a contingent liability, or such other financial facility as may be determined by the Director.
- b) “Amount of accommodations” shall mean the total of on-balance sheet accommodations and off-balance sheet



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accommodations.

- i. “Amount of on-balance sheet accommodations” shall mean the total of the accommodation limits prevailing at any given time or the total outstanding amount of all accommodations, whichever is higher.
  - ii. “Amount of off-balance sheet accommodations” shall mean the credit equivalent amount of total accommodation limits prevailing at any given time or the outstanding amount of accommodations, whichever is higher excluding the undrawn amount of credit facilities recognized under on-balance sheet accommodation.
- c) “Associate company” shall have the same meaning as in Section 74 of the Finance Business Act, No.42 of 2011.
- d) “Connected parties” shall mean two or more natural or legal persons deemed to be a group of connected counterparties if at least one of the following criteria is satisfied.
- i. Control relationship: One of the counterparties, directly or indirectly, has control over the other(s). The control can be ascertained as follows:
    - (a) Control of voting rights;
    - (b) Significant influence on senior management.
  - ii. Economic interdependence: If one of the counterparties were to experience financial problems, in particular funding or repayment difficulties, the other(s), as a result, would also be likely to encounter funding or repayment difficulties.
- e) “Core Capital” shall have the same meaning as in Section 74 of the Finance Business Act, No.42 of 2011.
- f) “Credit equivalent amount of off-balance sheet



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- accommodations” shall mean the credit equivalent amount computed using the credit conversion factors applicable to off-balance sheet accommodations in the computation of the Capital Adequacy Ratio.
- g) “Director” shall mean the Director of the Department of Supervision of Non-Bank Financial Institutions of the Central Bank of Sri Lanka, unless otherwise specified of being a director of an FC.
- h) “Group of borrowers” shall mean the aggregate to:
- i. An individual, his relative, a company or a firm in which he or his relative has a substantial interest;
  - ii. A company and one or more of the following:
    - (a) Its holding company or ultimate parent company;
    - (b) Its subsidiary company;
    - (c) Its joint venture;
    - (d) Its associate company;
    - (e) A subsidiary or associate of its holding company;
    - (f) A company in which such company or its subsidiary company, or its holding company or its joint ventures or its associate company, or a subsidiary company or associate company of its holding company has a substantial interest.
- i) “Holding company” shall have the same meaning as in Section 74 of the Finance Business Act, No.42 of 2011.
- j) “Individual borrower” shall mean a single company, public corporation, firm, association of persons or a natural person.
- k) “Loan” shall have the same meaning as in Section 74 of the Finance Business Act, No.42 of 2011
- l) “Relative” shall have the same meaning as in Section 74 of the Finance Business Act, No.42 of 2011.



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**10. Revocation of  
directions**

- m) "Subsidiary company" shall have the same meaning as in Section 74 of the Finance Business Act, No.42 of 2011.
- n) "Substantial interest" shall have the same meaning as in Section 74 of the Finance Business Act, No.42 of 2011.
- 10.1 The following Directions will be revoked from the effective date of this Direction.
- a) Finance Companies (Register of Written off Loans) Direction No. 10 of 1991
- b) Finance Companies (Single Borrower Limit) Direction No. 4 of 2006
- c) Finance Companies (Lending) Direction No. 1 of 2007
- d) Finance Companies (Business Transactions with Directors and their Relatives) Direction No. 2 of 2007 and
- e) Finance Companies (Writing off of Accommodations) Direction No. 2 of 2013.

**Dr. P Nandalal Weerasinghe**  
*Chairperson of the Governing Board and  
Governor of the Central Bank of Sri Lanka*