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இலங்கை மத்திய வங்கி
CENTRAL BANK OF SRI LANKA

Issued By	Macroprudential Surveillance Department
Date	2023.12.29

The Central Bank of Sri Lanka Releases the Financial Stability Review for the Year 2023

The Financial Stability Review (FSR) of 2023 encapsulates the developments in the financial system, the risks and vulnerabilities identified thereof, and the policy measures taken by the Central Bank and other regulatory institutions in addressing such risks during the review period, which primarily covers data up to end September 2023. The electronic version of the publication can be accessed through the Central Bank website.
(https://www.cbsl.gov.lk/sites/default/files/cbslweb_images/publications/fssr/fssr_2023e.pdf)

A summary of the FSR 2023 and the financial stability outlook is given below:

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

With these developments, financial markets which witnessed extreme turbulence in 2022 demonstrated signs of stabilisation. Financial market's stress as indicated by the Financial Stress Index remained broadly at low levels in the first ten months of 2023 as overall market conditions significantly eased

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

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

The banking sector, which was adversely affected by the spillover effects of the recent economic crisis, continued to operate amidst challenging conditions while some signs of improvement were observed during the year ending Q3 of 2023. Credit granted by the banking sector contracted during the period albeit some recovery was observed within Q3 of 2023. Credit risk of the banking sector as indicated by the Stage 3 Loans Ratio remained elevated, reflecting deteriorated debt servicing capacities of economic agents due to shrinking balance sheets amidst adverse economic conditions. However, stabilisation of credit risk was witnessed during Q3 of 2023 as indicated by the slowdown in the increase of Stage 3 Loans. Meanwhile, credit concentration risks persisted within the banking sector with some high credit concentration on certain sectors, namely, construction and agriculture, posing

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

The loans and advances portfolio of the Licensed Finance Companies (LFCs) sector contracted significantly during the year ending Q3 of 2023, particularly due to the restrictions on vehicle imports which affected leasing and hire purchase activities. Amidst the decline in the core business, the LFCs sector diversified its activities particularly towards pawning/gold loan facilities which heightened the sector's risk to fluctuations in global gold prices. The asset quality of the sector also deteriorated as indicated by the increase in stage 3 loans to total loans ratio. Meanwhile, overall liquidity of the sector remained at an acceptable level while few companies faced difficulties in meeting liquidity requirements. Exposure of the LFCs sector to the sovereign also increased amidst rising investments in Government securities. Moreover, the sector recorded an increase in profit, driven by higher revenue from interest income and other operating income along with reduced new impairment charges while capital adequacy also improved, with higher growth in regulatory capital compared to subdued growth in risk weighted assets, mainly due to the contraction of loans and advances amidst higher exposure to pawning/gold loans advances and increase in risk-free investments. Successful implementation of the Masterplan for Consolidation of Non-Bank Financial Institutions (NBFIs) introduced by the Central Bank in the latter part of 2020 helped to build the confidence of the sector. However, the continued need for consolidation exists in the LFCs sector to ensure resilience. The insurance sector witnessed an

increase in Gross Written Premium (GWP) with repriced policies amidst rising price levels while insurance claims also increased during the first half of 2023. Meanwhile, general insurance lagged behind long-term insurance in terms of profitability while liquidity ratios improved for both segments. In terms of capital adequacy, these segments showed a divergent performance with the general insurance segment recording a decline in the capital adequacy ratio while the same for the long-term insurance sector improved. Going forward financial institutions, particularly banks, LFCs and insurance companies would have to closely monitor their exposure to the sovereign and implement prudent measures to minimise such risks to ensure stability of the sector. Moreover, Sri Lanka's payment and settlement system exhibited resilience despite the dynamic nature of the financial landscape and the evolving digital payment systems during 2023.

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

Numerous policy measures implemented by the Central Bank supported in ensuring financial stability during these turbulent times. The proactive build-up of the Capital Conservation Buffer (CCoB) and the D-SIBs Buffer by the Central Bank may enable the banking sector to weather the unexpected losses arising from the economic crisis to a certain extent. The Central Bank also took measures to strengthen

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

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

Financial Stability Outlook

The easing of domestic monetary policy since mid-2023, is anticipated to facilitate the recovery in financial intermediation, which was witnessed through the gradual recovery in banking sector credit during Q3 of 2023. This is expected to lead to a rebound in domestic demand and economic activity as witnessed through the modest economic growth recorded in Q3 of 2023, improving income levels and alleviating pressure on the balance sheets of households and firms. Moreover, targeted stabilisation of domestic inflation at 5 per cent in the medium term is expected to enhance the purchasing power of economic agents and improve their debt repayment capacities. Efforts are underway to address the Sovereign-Bank Nexus[4] through policy reforms, aiming to rectify financial intermediation imbalances in the medium to long run. Recent positive developments, such as reaching an agreement in principle with the Official Creditor Committee (OCC) and the Exim Bank of China, contribute to the stability in the Government securities market. The anticipated conclusion of External Debt Restructuring (EDR)

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

is expected to further enhance stability. Efforts are also required to improve sustainable foreign currency inflows to prevent external sector imbalances along with prudent measures towards risk mitigation by the financial sector. Moreover, banks are expected to strengthen their capital buffers, considering the potential losses which may arise from debt restructuring, results of the bank diagnostic exercise, and realisation of forward-looking impact assessment.

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

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