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BOX 02

Recent Banking Sector Reforms to Strengthen Resilience

1. Background

Banks are the essence of the financial system and they play a vital role as the key financial intermediaries in driving economic growth and development of the country. The banking sector in Sri Lanka comprises 30 Licensed Banks (LBs) with an asset base of over Rs. 22 trillion as at end 2024. In response to the challenges posed by recent adverse macroeconomic conditions, the Central Bank of Sri Lanka implemented a series of financial sector reforms in addition to the measures to stabilise the macroeconomy. These strategies to enhance resilience in the banking sector were aimed at preventing a potential crisis, and mitigating contagion risks and spillover effects on the broader economy. Accordingly, despite the challenges evolving from adverse macroeconomic conditions, the Sri Lankan banking sector remained resilient.

2. Measures implemented by the Central Bank from 2022 to date

Crisis Preparedness Measures

As a key crisis preparedness measure, the existing framework on providing emergency loans and advances to banks with temporary liquidity distress was strengthened in order to prevent any adverse implications on financial system stability. Further, the Central Bank identified strengthening the resolution framework of LBs while strengthening the financial sector safety-net measures as an urgent priority under the crisis management framework. Accordingly, the Central Bank enacted the Banking (Special Provisions) Act No.17 of 2023, focusing mainly on resolution measures for banks and safeguarding the interest of depositors and other stakeholders. Further, in order to strengthen the financial sector safety net measures, necessary actions were initiated to establish the Financial Stability Fund and to improve the institutional arrangements and financial capacity of the Sri Lanka Deposit Insurance Scheme. Additionally, with a view to strengthening the policy coordination between the Central Bank and Ministry of Finance to focus on crisis preparedness and to minimise the impact of a financial crisis, the Financial Sector Crisis Management Committee was established under the Banking (Special Provisions) Act.

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Enactment of the Banking (Amendment Act)

Following the gradual recovery of the economy, the Central Bank implemented several policy measures including the issuance of regulations and strengthening of the supervisory approach through intensified supervision to maintain the resilience of the banking sector. A pivotal initiative undertaken in 2024 to strengthen the banking sector was the enactment of the Banking (Amendment) Act No. 24 of 2024, which became effective from 15 June 2024, marking a significant milestone in strengthening the legal framework applicable to LBs. This Banking (Amendment) Act strengthened the provisions on several key areas, inter alia licensing requirements, criteria for shareholder suitability including information on ultimate beneficial ownership, corporate governance requirements, bank ownership, acquisitions, mergers and consolidation, proportionality, large exposures, related party transactions, offshore banking business, subsidiarization of foreign banks, requirements on accounts and audit.

Strengthening Regulatory Framework

The Central Bank issued several new regulations/guidelines to LBs to facilitate the implementation of the Banking (Amendment) Act. Accordingly, Revised Directions on large exposures of LBs were issued with a view to mitigating the credit concentration risk posed by the large corporate borrowers as well as State Owned Enterprises (SOEs) in the banking sector. The revised Directions include stringent prudential limits and strengthened criteria on determining interconnectedness between borrowers in line with international best practices. In this backdrop, large corporates and SOEs will be required to diversify their sources of funds and to restructure the balance sheets.

Furthermore, a Banking Act Determination was issued determining Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) as the statutory liquidity ratios for LBs, while discontinuing the maintenance of Statutory Liquid Assets Ratio (SLAR). In addition, several other regulations were also introduced to facilitate the implementation of the Banking (Amendment) Act, including the Banking Act Directions on Offshore Banking Business (OSBB) for licensed commercial banks, and Banking (Off-Shore Banking Business) Order designating foreign currencies for OSBB. Furthermore, Banking Act Directions and Determinations were issued on assessment of fitness and propriety of Directors, Chief Executive Officers (CEOs) and officers performing executive functions of LBs. Moreover, Regulations were issued specifying related parties of LBs, approved securities and limits in respect of accommodation granted to such related parties.

Asset Quality Review and Development of Bank Recapitalisation Strategy

The Central Bank completed the Asset Quality Review of 9 large banks and developed a Roadmap for the restructuring and recapitalization of such banks with the objective of ensuring strong and adequately capitalised LBs amidst the continuous macroeconomic challenges endured by the banking sector. Further, the Central Bank together with Ministry of Finance developed a banks' recapitalisation strategy that includes the size, timing, instruments, and terms and conditions for government recapitalisation of viable banks which are unable to close capital shortfalls from private sources. For this purpose, a budgetary allocation of Rs. 450 billion was made in 2024 Budget. However, the need to use such funds did not arise in 2024. As part of this strategy, the 9 banks submitted recapitalisation plans to the Central Bank and the assessment of such plans was completed. The progress of implementing these recapitalization plans is monitored by the Central Bank on an ongoing basis.

Strengthening Corporate Governance

Banking Act Directions were also issued to further strengthen corporate governance processes and practices of LBs, considering current market developments, international best practices, and evolving regulatory requirements. These Directions mainly focus on enhancing the composition and independence of the Board of Directors, emphasising the competency and professional integrity of Directors, CEOs, and Key Management Personnel (KMP), ensuring the effective functioning

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of Board sub-committees whilst improving risk oversight and control mechanisms including the oversight of related party transactions.

Establishment of Business Revival Units in LBs and Relief Measures

In order to facilitate revival of businesses affected by extraordinary macroeconomic circumstances and to improve assets quality of LBs, the Central Bank issued Guidelines on establishing Business Revival Units (BRUs) in March 2024. The purpose of BRUs is to identify and assist performing and non-performing borrowers of LBs who are facing financial and operational challenges or may face potential difficulties inter alia due to reduction of income, sales, cash flow disruptions, reduction or impairment of business operations or the temporary closure of business emanating from the extraordinary macroeconomic challenges. With the suspension of Parate Action coming to an end, the Central Bank continued its efforts to support economic sectors by outlining relief measures for Small and Medium Enterprises (SMEs) affected by the Easter Sunday attacks, the COVID-19 pandemic, and recent extraordinary macroeconomic conditions.

3. Policy Measures for 2025 and beyond

With a view to further strengthening the regulatory framework and to ensure safety and soundness of the banking system, several policy measures are expected to be implemented in 2025 and beyond.

The implementation of the recapitalisaton plans developed by nine large banks under the bank recapitalisation strategy would be monitored semi-annually, with ongoing oversight to ensure compliance with minimum capital requirements for all banks. Further, to ensure that the financial system comprises strong and resilient banks with adequate capital, a framework for market-driven consolidation of LBs is to be established and consolidation is expected to be facilitated on a case-by-case basis. The resilience of the financial system would also be strengthened through enhanced crisis management and resolution measures and the Central Bank would continue to coordinate and assist the functioning of the Financial Sector Crisis Management Committee on an ongoing basis.

The implementation of the Directions issued under the Banking (Amendment) Act covering areas such as large exposures, corporate governance, liquidity ratios, related party transactions, and offshore banking business will be monitored inter alia in 2025. In addition, existing Regulations will be reviewed in line with market developments and international best practices to ensure the regulatory framework is further strengthened. The effectiveness of risk-based supervision would be enhanced by improving the supervisory infrastructure and the continuous surveillance of banks would also be intensified. Additionally, the Central Bank will continue to further strengthen the conduct of risk-based Anti-Money Laundering and Countering the Financing of Terrorism examinations of banks in terms of the Financial Transactions Reporting Act.

In view of the above, the banking sector is expected to operate with sound financials, strong prudential ratios, and operational resilience to support the economic growth of the country.

2.2 Non-Bank Financial Institutions Sector

Finance Companies

The FCs sector recorded a significant expansion in 2024, whilst exhibiting resilience by maintaining capital and liquidity well above the regulatory minimum levels.

The FCs sector grew in terms of loans and advances, deposits, and borrowings. Further, the asset quality of the sector improved as reflected by the reduction in NPL denoted by Stage 3 loans. The sector comprised 32 FCs[3] accounting for 5.4% of the total financial

3 Excluding ETI Finance Limited (The Commercial High Court of Colombo ordered that the winding up of ETI Finance Limited be carried out subject to the Supervision of the Court on the 15th day of December 2023).