8

FINANCIAL SECTOR PERFORMANCE AND SYSTEM STABILITY

8.1 Overview

During 2022, the financial system weathered headwinds from the most profound economic crisis since independence. Sovereign rating downgrade by all rating agencies, high sovereign exposure of the banking sector, economic contraction, acute foreign exchange shortage and high level of inflation along with the announcement of the standstill on external debt servicing on account of bilateral and commercial loans by the Government in April 2022 created a significant and unprecedented adverse impact on the activities of the financial sector and challenged the resilience of the financial system. Nevertheless, the stability of the banking sector was maintained during 2022 despite the looming challenges arising from continuously declining credit quality, acute pressure on liquidity, low level of profitability due to high impairments, and deteriorating capital buffers to absorb unexpected losses. Meanwhile, the sector grew in terms of assets and deposits while broadly in compliance with the prudential requirements of the Central Bank. The Licensed Finance Companies and Specialised Leasing Companies sector managed to continue its expansion during 2022 in terms of assets and deposits with adequate capital and liquidity buffers amidst challenges stemming from contraction of credit growth, declining profitability and increase in non-performing loans as indicated by Stage 3 loans. A measured adjustment in the exchange rate was allowed by the Monetary Board in early March 2022 in view of the pressure that was building up in the domestic foreign exchange market. However, the subsequent floating of the exchange rate caused a large depreciation of the exchange rate due to the dearth of liquidity in the domestic foreign exchange market and unfavourable market sentiments. Consequently, the Central Bank introduced a market guidance on the interbank foreign exchange market to ensure stability in the exchange rate. Money market liquidity, which remained at a persistently high level of deficit during the first half of 2022, declined considerably by end December 2022 mainly due to measures taken by the Central Bank. Meanwhile, money market activities recorded a lackluster performance amidst increased risk aversion among the participants. The equity market recorded a dismal performance during 2022 reflecting the high yield for fixed income securities and negative market sentiments against the backdrop of prevailing adverse macroeconomic conditions. Financial infrastructure continued to support functioning of the financial sector in this challenging economic environment. Despite all these challenges, a modest improvement was observed during early 2023 with the gradual easing of liquidity pressures in the foreign exchange and money markets, and declining yields on government securities, supported by improved market confidence with the approval of the Extended Fund Facility from the International Monetary Fund (IMF) on 20 March 2023. However, debt *restructuring may pose challenges to the financial sector. Nevertheless, the Government and Central Bank will take efforts to ensure financial system stability during the debt restructuring process.*

8.2 Performance of the Banking Sector

The stability of the banking sector was preserved during 2022 despite the looming challenges arising from continuously declining credit quality, acute pressure on liquidity, low level of profitability, and deteriorating capital levels. Nevertheless, the banking sector maintained its growth momentum while broadly maintaining compliance with the prudential requirements.

Table 8.1
Total Assets of the Financial System

Category	2021 (a)		2022 (b)	
	Rs. bn	Share (%)	Rs. bn	Share (%)
Banking Sector	**19,872.5**	**74.6**	**23,926.9**	**76.3**
Central Bank	3,046.3	11.4	4,510.3	14.4
Licensed Commercial Banks (LCBs)	14,724.3	55.3	17,225.2	54.9
Licensed Specialised Banks (LSBs)	2,101.9	7.9	2,191.4	7.0
Other Deposit Taking Financial Institutions	**1,646.2**	**6.2**	**1,830.9**	**5.8**
Licensed Finance Companies (LFCs)	1,452.0	5.4	1,610.2	5.1
Co-operative Rural Banks (c)	193.4	0.7	220.0	0.7
Thrift and Credit Co-operative Societies	0.7	0.0	0.8	0.0
Specialised Financial Institutions	**369.4**	**1.4**	**328.9**	**1.0**
Specialised Leasing Companies (SLCs)	35.7	0.1	1.0	0.0
Licensed Microfinance Companies	8.3	0.0	9.9	0.0
Primary Dealers	78.7	0.3	131.7	0.4
Stock brokers	36.5	0.1	24.8	0.1
Unit Trusts / Unit Trust Management Companies	198.5	0.7	153.5	0.5
Market Intermediaries (d)	11.8	0.0	8.0	0.0
Venture Capital Companies	N/A	N/A	N/A	N/A
Contractual Savings Institutions	**4,758.2**	**17.9**	**5,292.3**	**16.9**
Insurance Companies	881.8	3.3	947.3	3.0
Employees' Provident Fund	3,166.1	11.9	3,459.9	11.0
Employees' Trust Fund	419.1	1.6	468.8	1.5
Approved Pension and Provident Funds	207.6	0.8	330.4	1.1
Public Service Provident Fund	83.5	0.3	85.9	0.3
Total	26,646.3	100.0	31,379.0	100.0

(a) Revised
(b) Provisional
(c) Due to unavailability of data, asset base of Co-operative Rural Banks as at end 2022 was taken to be same as the asset base as at end 2022 Q3.
(d) Excluding Licensed Banks, Licensed Finance Companies & Specialized Leasing Companies, which are registered as Market Intermediaries

Source: Central Bank of Sri Lanka
Department of Co-operative Development
Department of Labour
Department of Pensions
Employees' Trust Fund Board
Insurance Regulatory Commission of Sri Lanka
SANASA Federation
Securities and Exchange Commission of Sri Lanka

Table 8.2
Distribution of Banks, Bank Branches and Other Banking Outlets

Category	End 2021 (a)	End 2022 (b)
Licensed Commercial Banks (LCBs)		
I. Total No. of LCBs	24	24
Domestic banks	13	13
Foreign banks	11	11
II.Total No. of LCB Banking Outlets	6,710	6,718
Branches (c)	2,917	2,924
Domestic Banks	2,871	2,878
Foreign Banks	46	46
Student Savings Units	3,793	3,794
III.Automated Teller Machines	5,972	6,204
Licensed Specialised Banks (LSBs)		
I. Total No. of LSBs	6	6
National Level Savings Banks	1	1
Housing Finance Institutions	2	2
Other LSBs	3	3
II. Total No. of LSB Banking Outlets	705	706
Branches (c)	705	706
National Level Savings Banks	267	268
Housing Finance Institutions	64	64
Other LSBs	374	374
III. Automated Teller Machines	466	474
Total No. of Bank Branches and Other Outlets	7,415	7,424
Total No. of Automated Teller Machines	6,438	6,678

(a) Revised
(b) Provisional
(c) All Banking Outlets excluding Student Savings Units.

Source: Central Bank of Sri Lanka

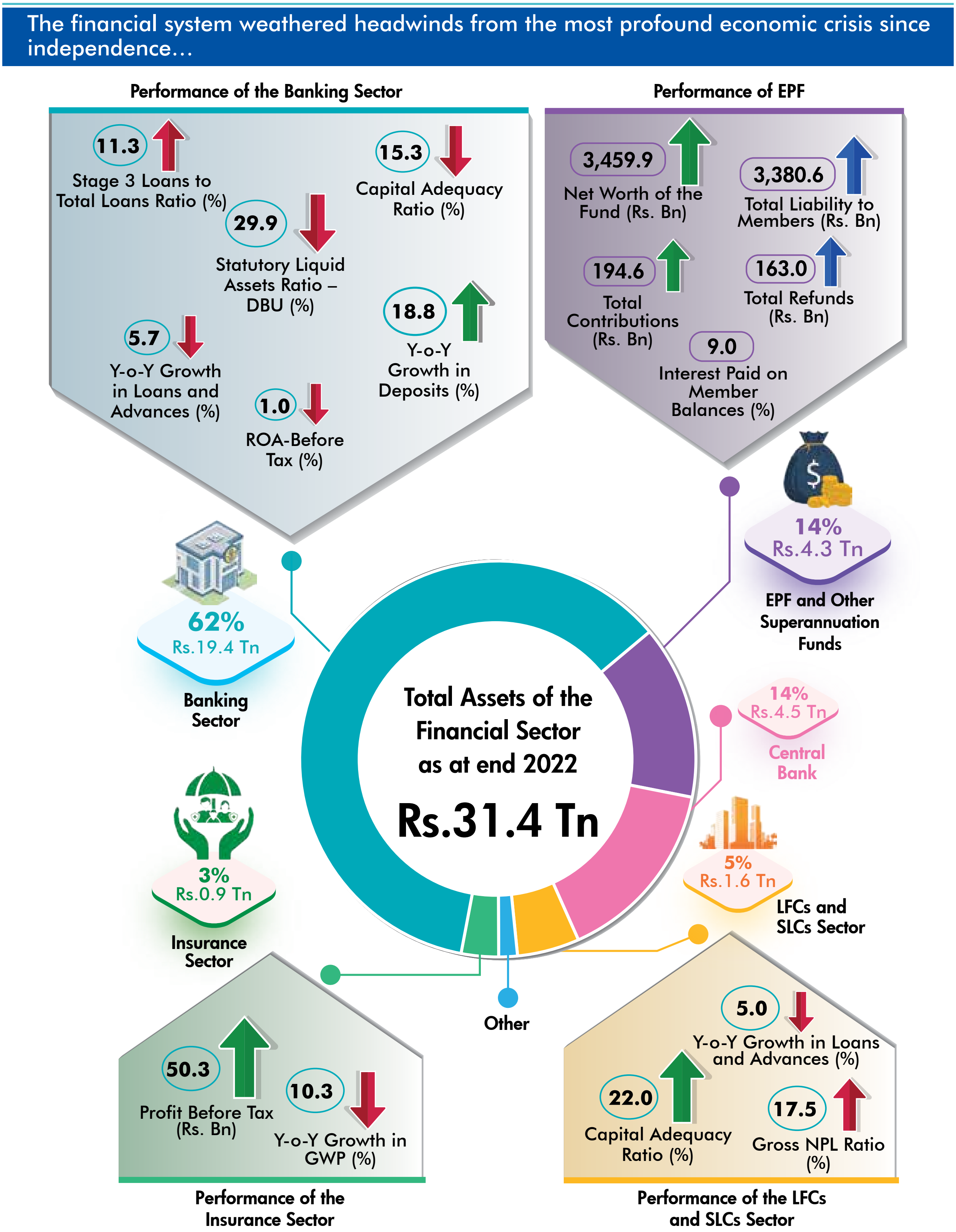
The banking sector[1] continued to dominate the financial sector, accounting for 61.9 per cent of total assets at end 2022. In line with the tight monetary policy stance of the Central Bank and challenging macroeconomic conditions, credit growth of the banking sector decelerated during 2022 compared to 2021. Deposits continued to be the dominant source of funding, while there was a notable decrease in foreign currency borrowings during 2022 as a result of sovereign rating downgrades and the announcement of standstill on external debt servicing on account of bilateral and commercial loans by the Government in April 2022.

Business Expansion

By end 2022, the banking sector comprised of 30 banks, with 24 Licensed Commercial Banks (LCBs), which included 11 branches

[1] The banking sector comprises of Licensed Commercial Banks (LCBs) and Licensed Specialised Banks (LSBs). The Central Bank is excluded.

Figure 8.1
Performance of the Financial Sector



The financial system weathered headwinds from the most profound economic crisis since independence…

Performance of the Banking Sector

- 11.3 ↑ Stage 3 Loans to Total Loans Ratio (%)
- 15.3 ↓ Capital Adequacy Ratio (%)
- 29.9 ↓ Statutory Liquid Assets Ratio – DBU (%)
- 18.8 ↑ Y-o-Y Growth in Deposits (%)
- 5.7 ↓ Y-o-Y Growth in Loans and Advances (%)
- 1.0 ↓ ROA-Before Tax (%)

Performance of EPF

- 3,459.9 ↑ Net Worth of the Fund (Rs. Bn)
- 3,380.6 ↑ Total Liability to Members (Rs. Bn)
- 194.6 ↑ Total Contributions (Rs. Bn)
- 163.0 ↑ Total Refunds (Rs. Bn)
- 9.0 Interest Paid on Member Balances (%)

Total Assets of the Financial Sector as at end 2022

Rs.31.4 Tn

- 62% Rs.19.4 Tn Banking Sector
- 14% Rs.4.3 Tn EPF and Other Superannuation Funds
- 14% Rs.4.5 Tn Central Bank
- 5% Rs.1.6 Tn LFCs and SLCs Sector
- 3% Rs.0.9 Tn Insurance Sector
- Other

Performance of the Insurance Sector

- 50.3 ↑ Profit Before Tax (Rs. Bn)
- 10.3 ↓ Y-o-Y Growth in GWP (%)

Performance of the LFCs and SLCs Sector

- 5.0 ↓ Y-o-Y Growth in Loans and Advances (%)
- 22.0 ↑ Capital Adequacy Ratio (%)
- 17.5 ↑ Gross NPL Ratio (%)

Table 8.3
Composition of Assets and Liabilities of the Banking Sector

Item	2021 (a)		2022 (b)		Change (%)	
	Rs. bn	Share (%)	Rs. bn	Share (%)	2021 (a)	2022 (b)
Assets						
Loans and Receivables	10,726.7	63.8	11,337.9	58.4	14.5	5.7
Investments	4,968.5	29.5	5,934.3	30.6	16.4	19.4
Other (c)	1,131.0	6.7	2,144.3	11.0	15.0	89.6
Liabilities						
Deposits	12,879.2	76.5	15,299.1	78.8	13.3	18.8
Borrowings	2,172.9	12.9	1,872.5	9.6	27.1	-13.8
Capital Funds	1,348.3	8.0	1,593.4	8.2	13.1	18.2
Other	425.8	2.5	651.5	3.4	20.4	53.0
Total Assets/ Liabilities	16,826.2	100.0	19,416.6	100.0	15.1	15.4

(a) Revised
(b) Provisional
(c) Includes cash and bank balances, placements, reverse repurchase agreements and fixed assets.

Source: Central Bank of Sri Lanka

of foreign banks, and 6 Licensed Specialised Banks (LSBs). The banking sector continued to support the financial intermediation of the economy by enhancing banking services and expanding the banking network. As such, 11 bank branches and 327 ATMs were established during 2022, while 3 bank branches and 87 ATMs were closed. Accordingly, the total number of banking outlets and ATMs increased to 7,424 and 6,678, respectively, by end 2022.

The banking sector continued to expand in terms of its asset base during 2022. The asset base of the sector increased by Rs. 2.6 trillion during the year and surpassed Rs. 19 trillion by end 2022, recording a growth of 15.4 per cent compared to that of 15.1 per cent at end 2021. During the months of March and April, the Sri Lanka rupee depreciated by 44.1 per cent against the US dollar, which resulted in an increase in the growth of assets denominated in foreign currency. However, the tight monetary policy stance of the Central Bank led to a deceleration in loans and receivables growth from 14.5 per cent as at end 2021 to 5.7 per cent as at end 2022. Meanwhile, the growth of investments accelerated from 16.4 per cent as at end 2021 to 19.4 per cent as at end 2022. The increase in investments during the period was mainly due to increase in financial investments at amortised cost by Rs. 1,635.2 billion and financial assets at fair value through profit or loss by Rs. 29.9 billion.

Deposits continued to be the main source of funding and represented 78.8 per cent of total liabilities, while borrowings accounted for 9.6 per cent of total liabilities at end 2022. Term deposits mainly contributed to the increase in deposits during 2022 while its share in total deposits increased from 61.0 per cent as at end 2021 to 67.9 per cent as at end 2022. Meanwhile, savings and demand deposits accounted for 24.3 per cent and 6.9 per cent, respectively, of total deposits at end 2022. Accordingly, the Current and Savings Account (CASA) ratio decreased from 38.0 per cent in 2021 to 31.2 per cent in 2022. Total borrowings of the banking sector decreased by Rs. 300.4 billion, recording a contraction of 13.8 per cent during 2022, compared to an increase of Rs. 462.8 billion, which was a growth of 27.1 per cent during 2021. This decrease was mainly attributed to foreign currency borrowings which reported a contraction of 55.2 per cent, reflecting the impact of the sovereign rating downgrades, while rupee borrowings decreased by Rs. 171.5 billion, recording a contraction of 11.5 per cent during 2022.

Due to the challenging business environment, off-balance sheet exposures decreased by Rs. 26.3 billion, reporting a contraction of

Table 8.4
Composition of Deposits of the Banking Sector

Item	2021(a)		2022(b)		Change (%)	
	Rs.bn	Share (%)	Rs.bn	Share (%)	2021 (a)	2022 (b)
Demand Deposits	888.0	6.9	1,060.0	6.9	25.9	19.4
Savings Deposits	4,011.8	31.1	3,713.0	24.3	19.7	-7.4
Time Deposits	7,860.4	61.0	10,393.0	67.9	8.6	32.2
Other Deposits	118.9	0.9	133.2	0.9	80.0	12.0
Total Deposits	12,879.2	100.0	15,299.1	100.0	13.3	18.8

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

BOX 9
The Role of Central Banks in Preventing Systemic Financial Crises and Restoring Public Confidence in the Banking Sector

1. Introduction

The banking sector of Sri Lanka plays an integral role in financial intermediation of the country and has a significant share in the financial sector, accounting for 61.9 per cent of total assets as at end 2022. Despite the recent multifaceted challenges, the Sri Lankan banking sector remained resilient as reflected by adequate capital and liquidity buffers. However, in view of the unprecedented levels of stress on the banking sector caused due to various reasons, including the Easter Attacks in 2019, COVID-19 pandemic and recent adverse macroeconomic developments, it is important to ensure that a robust crisis management framework is in place for the sector.

2. Importance of the Stability of the Banking System and Lessons Learnt from the Global Financial Crisis (GFC)

Banking sector stability is vital for efficient financial intermediation in order to promote economic growth and welfare of people. This is more important during economic shocks and stressful circumstances. However, throughout history, breach of trust in the banking system and depositor runs have caused significant negative impact on the economic activities across the globe, leading to systemic financial crises. Common causes of these systemic crises can be mainly identified as high leverage, booming credit, weakening of credit evaluation standards, lapses in governance and risk management, property and other asset bubbles, excessive exposure to the government, inadequate supervision, and often a high external current account deficit. As revealed by international examples such as the East Asian crisis (1997), GFC (2007-2008) and European crisis (2010), the financial distress resulting from a systemic crisis typically lasts for several years, largely resulting in considerable economic contractions and high fiscal costs, affecting the entire society.

Lessons Learnt from the GFC

The GFC of 2007-2008, even though comprising of similarities with past events, was rapidly transmitted across the globe in an unprecedented manner, well beyond the directly affected countries. The main reason for the high degree of contagion of GFC was the origination of the crisis in advanced economies with widespread financial networks and linkages in international financial markets. The new and extreme challenges resulting from GFC paved the way for the central banks and policy makers around the world to introduce innovative crisis management tools, while understanding the gaps and weaknesses in legal and policy frameworks.

With a view to addressing the above weaknesses, the global leaders came into a consensus that an effective **crisis management framework** with a strong financial safety-net is required in order to support the orderly management of failing financial institutions and thereby to mitigate the contagion effect on the financial system and spillover effect on the real economy. An effective crisis management framework would generally comprise the following pillars (International Monetary Fund, 2020):

(i) An institutional framework for crisis preparedness

(ii) Supervisory early intervention

(iii) Emergency liquidity assistance

(iv) Resolution of financial institutions

(i) An Institutional Framework for Crisis Preparedness

In order for a crisis management framework to be effective, a strong and independent institutional framework with effective policy coordination between the core entities of the financial safety-net is vital. The core entities of the financial safety-net can be identified as the Central Bank, financial supervisory and regulatory agencies, resolution authority, and Ministry of Finance. These entities must have clear mandates and adequate independence to be able to prepare, coordinate, and execute the crisis management tasks at any given circumstance.

(ii) Supervisory Early Intervention

Early action of the supervisor enables proactive detection of the warning signs of deterioration in the financial condition of banking institutions and thereby reduce the probability and costs of financial distress of such institutions. Supervisors need adequate resources, strong legal authority and protection, a clear mandate and operational independence with strong governance structures, in order to ensure proactive and comprehensive supervision.

(iii) Emergency Liquidity Assistance by Central Banks

Provision of emergency liquidity assistance forms an integral part of a crisis management framework as it enables central banks to mitigate the risk of temporary illiquidity of one or few financial institutions leading to insolvency of such institutions or systemic financial instability. Accordingly, framework for lending under emergency liquidity assistance should be well established by central banks as a crisis preparedness tool. Further, such liquidity provision should be subject to safeguards of protecting central bank balance sheets while reducing moral hazard.

Prior to GFC, the underlying concept of emergency liquidity assistance was that central banks should lend only to those banks possessing good collateral, with the assumption that a bank which lacks such collateral was insolvent. The key lessons learnt from GFC, which helped central banks to make significant improvements in the framework for lending under emergency liquidity assistance, can be summarised as follows (International Monetary Fund, 2020):

(a) Eligibility – All banks shall be eligible, not just the systemically important banks. In some instances, central banks should have the ability to provide these facilities to nonbank financial companies that are systemic, to preserve financial stability.

(b) Solvency – Lending shall be at the discretion of central banks to entities that are deemed by the supervisor as solvent and viable. The solvency and viability assessment should involve forward and backward-looking expert judgments. In the event where such assistance is granted to insolvent firms, an indemnity should be sought from the government.

(c) Collateral – Facilities shall always be adequately collateralised and central banks should be able to accept a wide range of unencumbered assets as collaterals. Systems should be in place to value such assets, including predetermined haircuts together with sound processes to settle, manage and realise collateral in case of counterparty default.

Key Challenges in Providing Emergency Liquidity Assistance - Stigma, i.e., the unwillingness of banks to approach central bank liquidity assistance owing to the potential erosion of public confidence, lending in foreign currency and facilitating banks which are under resolution, are the key challenges confronted by central banks.

(iv) Resolution of Financial Institutions

An effective resolution regime is of paramount importance for a strong crisis management framework, due to its criticality in addressing the problems of weak or failing banks without undermining financial system stability. Once a banking institution is identified as insolvent, likely to become insolvent or it is identified to be in serious breach of regulatory requirements, sound, decisive and rapid actions are required to maintain public confidence, while preventing any spillover effects to the larger economy. The principles embodied in international best practices of resolution aim to ensure that the authorities have powers and tools to act quickly to preserve financial system stability, while safeguarding the interests of depositors and creditors.

Even after 15 years from GFC, the global financial stability risks reflect an increasing trend particularly since the outbreak of COVID-19 pandemic, as indicated by excessive inflation, rising interest rates, and volatility in financial markets. The recent collapse of California's Silicon Valley Bank and New York's Signature Bank caused severe shock across the global financial system, while the uncertainties indicated in the European markets echoed the necessity of having an effective crisis management framework.

3. Preventing Systemic Financial Crisis and Restoring Public Confidence in the Sri Lankan Banking Sector

Sri Lanka endured a series of multifaceted challenges in the last three years since 2020, with the outbreak of COVID-19 pandemic, the biggest health and economic disaster in history. The post-pandemic disruptions together with slow recovery of the economic activities, political uncertainties, and structural issues in the economy in Sri Lanka gave rise to extraordinary macroeconomic conditions including declining external reserves, currency devaluation, fiscal sector imbalances, high inflation, scarcity of essential consumer goods, and raw materials. These exceptional circumstances caused unprecedented levels of stress on the banking sector leading to numerous challenges.

3.1. Measures Implemented by the Central Bank of Sri Lanka (CBSL) to Preserve the Financial System Stability amidst Current Challenges

There are several alternatives for the Licensed Commercial Banks (LCBs) to avail liquidity from CBSL during ordinary circumstances, as highlighted below.

(a) Standing Lending Facility – Collateralised overnight lending to LCBs

(b) Intraday Liquidity Facility – Collateralised intraday lending to LCBs

(c) Term Repo Facility – Providing liquidity to LCBs via Open Market Operations Auctions

However, these alternatives may not ensure adequate liquidity for the banking sector during exceptional circumstances that emanate from extreme adverse economic and market developments.

3.2. Crisis Management Tools Adopted by CBSL

Amidst the recent extraordinary macroeconomic developments that continued in Sri Lanka since the outbreak of the pandemic, several measures were initiated by CBSL to strengthen the crisis preparedness of the banking sector, by improving liquidity in the sector to adequate levels with the objective of preserving financial system stability, while safeguarding public confidence on the financial system. This article explains mainly the preemptive measures implemented by CBSL, inter-alia, the framework on Emergency Loans and Advances (ELA) to the banking sector, strengthening the bank resolution framework, establishment of the crisis management committee and enhanced supervisory approaches.

3.2.1. Lender of Last Resort: Framework on ELA

As per the existing Monetary Law Act (MLA) No. 58 of 1949, under its core objective of financial system stability, CBSL is entrusted with the ultimate responsibility of ensuring public confidence on the financial system. In this context, acting as the Lender of Last Resort (LOLR) is one of the key roles to be undertaken by CBSL to minimise any adverse implications that may arise in the financial system by promoting the safety and soundness of financial institutions.

As the LOLR for the Sri Lankan banking sector, CBSL is empowered and responsible for exercising applicable provisions/measures available under MLA to pre-empt any adverse developments that might cause any systemic financial panic. Accordingly, CBSL established the framework on ELA in 2020, under Section 86 of MLA to prevent any threat to monetary and banking stability. Strengthening the liquidity position of banking institutions to ensure continued supply of credit to the economy and to meet urgent liquidity requirements during exceptional circumstances, thereby maintaining public confidence on the financial system was the main outcome expected from the ELA framework.

In 2022, the ELA framework of CBSL was further enhanced by incorporating a broader range of collaterals with valuation methodology, criteria on liquidity and solvency assessment, supervisory actions and an improved coordination mechanism among the departments of CBSL that are involved in executing the framework.

3.2.2. Salient Features of the ELA Framework

(a) **Eligible Financial Institutions:** All LCBs and Licensed Specialized Banks (LSBs) (hereinafter, referred to as "licensed banks") which are in a temporary liquidity distress, where the bank has exhausted all available liquidity options.

(b) **Provision of ELA is at the discretion of CBSL,** hence will not be considered as a right of licensed banks.

(c) **Currency:** ELA will be provided only in Sri Lankan Rupee at all times and will not be provided in foreign currency, in order to mitigate any potential exchange rate risks, currency mismatches and recoverability risks.

(d) **Interest rate:** The interest rate will be determined by the Monetary Board taking into consideration the prevailing market interest rates and the monetary policy stance.

(e) **Acceptable collaterals for providing of ELA:** A range of acceptable collateral that encompasses Sri Lanka Government Securities, lands and buildings, and loan receivables secured by selected collateral.

(f) **Assessment of the ELA request:** ELA will be provided only to a licensed bank that is considered to be solvent, with a view to preventing any adverse impact on the CBSL balance sheet. ELA facility may be granted to a bank which is assessed to be insolvent or likely to become insolvent in future, under exceptional circumstances to mitigate any systemic risks on a case-by-case basis, while an explicit guarantee to be provided by the Government of Sri Lanka to CBSL in the case of absence of adequate collateral with ELA requesting banks.

(g) **Supervisory Actions on ELA receiving banks:** ELA receiving banks will be subject to intensified supervision of CBSL, while several supervisory restrictions will be imposed on such banks with respect to expansion of the lending portfolio and making discretionary payments.

3.2.3. Strengthening the Bank Resolution Framework

CBSL identified strengthening the resolution framework of licensed banks as an urgent priority under the crisis management framework considering the challenging outlook for the banking sector and the need to strengthen financial sector safety-net measures. Accordingly, measures were taken to draft a Banking (Special Provisions) Act as a supplement to the Banking Act, No. 30 of 1988, by including provisions relating to resolution, deposit insurance, and winding up of licensed banks.

CBSL considered the Key Attributes of Effective Resolution Regimes for Financial Institutions issued by Financial Stability Board (FSB) and the Core Principles for Effective Deposit Insurance Systems issued by the International Association of Deposit Insurers (IADI) when drafting the Banking (Special Provisions) Act. It is expected to enact the proposed Banking (Special Provisions) Act during 2023.

3.2.4. Establishing a Crisis Management Committee

The present unprecedented levels of financial and economic distresses in Sri Lanka have given rise to the urgent need of strengthening the policy coordination between competent authorities on financial sector crisis management. The lack of an institutional framework for crisis management has prompted to set up a Financial Sector Crisis Management Committee (FCMC) for policy coordination between CBSL and Ministry of Finance to focus on crisis preparedness, to reduce the risk of coordination failures, and to minimise the impact of the financial crisis. The proposed FCMC will be assisted by a Technical Committee on Financial Sector Crisis Management (TCMC) and will function in both crisis and non-crisis times. FCMC will be chaired by the Governor and will comprise a Monetary Board member, Secretary to the Treasury, Deputy Secretary of Ministry of Finance and officials of CBSL.

3.2.5. Enhanced Supervision Approaches Adopted by CBSL

Due to the impact of recent macroeconomic developments of the banking sector, the Bank Supervision Department (BSD) of CBSL improved the frequency of reporting to the Monetary Board regarding liquidity and capital positions of the banking sector, while intensifying the supervision of licensed banks.These intensified supervisory measures include close monitoring of financial indicators, undertaking thematic reviews on identified banking functions and frequent adhoc meetings with Chief Executive Officers (CEOs) and Key Management Personnel (KMP) of licensed banks on liquidity and capital positions. Further, continuous meetings have been held by the Monetary Board with the Boards of Directors, CEOs, and KMP of licensed banks to better understand individual bank's positions and crisis preparedness.

3.2.6. Communication Strategy:

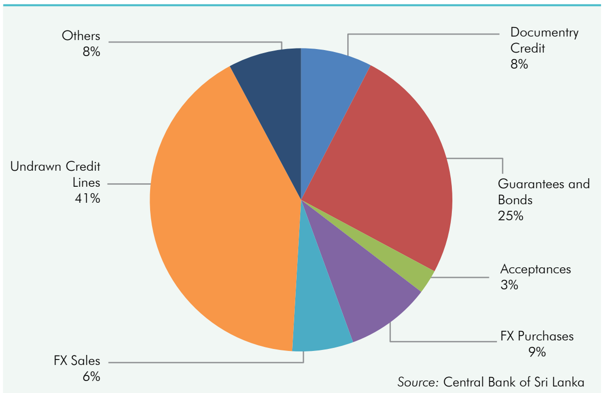
The existing communication strategy is currently being expanded to cover broad aspects of crisis preparedness targeting to ensure public confidence in the banking sector.

Way Forward: CBSL intends to further strengthen crisis preparedness measures while operationalising the proposed Banking (Special Provisions) Act and ensuring the readiness for providing of ELA to licensed banks with a view to preserving public confidence and stability in the financial system.

Reference

1. International Monetary Fund. (2020). Managing Systemic Banking Crises - New Lessons and Lessons Relearned. Departmental Paper No. 2020/003. International Monetary Fund, Washington D.C.

Figure 8.2
Off-Balance Sheet Exposure of the Banking Sector as at end 2022



Source: Central Bank of Sri Lanka

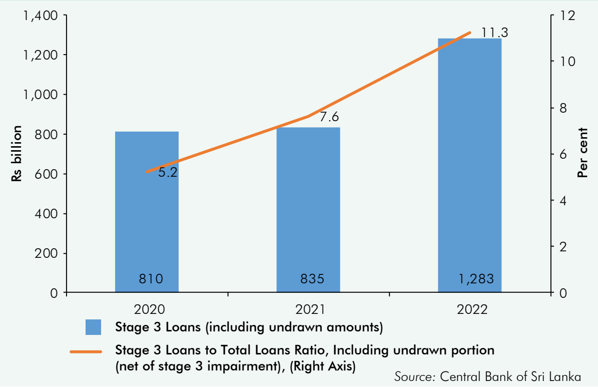
0.6 per cent during 2022, compared to a decrease of Rs. 131.5 billion which was a contraction of 2.7 per cent during 2021. Significant decreases of Rs. 318.3 billion, Rs. 204.2 billion, Rs. 172.4 billion, and Rs. 171.7 billion were observed in acceptances, documentary credit, FX sales, and FX purchases, respectively. Meanwhile, undrawn credit lines and guarantees and bonds reported increases of Rs. 470.9 billion and Rs. 122.6 billion, respectively, during 2022.

Risks in the Banking Sector

Credit Risk

During 2022, debt moratoria and concessions on loan repayments were extended to affected individuals and businesses in certain sectors due to persistent unfavorable business conditions. Accordingly, classification of loans and receivables to non-performing categories was frozen during the period under moratoria/concessions and normal classification rules were applied upon cessation of the moratoria/concessions. Nevertheless, banks continued to identify sectors with elevated risks for the purpose of estimating expected credit losses. Despite the freezing of classification of credit facilities under moratoria, Non-Performing Loans (NPLs) as indicated by Stage 3 loans (including undrawn amounts) increased by Rs. 447.3 billion during 2022, recording a growth of 53.6 per cent and reached Rs. 1.3 trillion as at end 2022, compared to an increase of Rs. 20.1 billion during 2021.

Figure 8.3
Stage 3 Loans of the Banking Sector

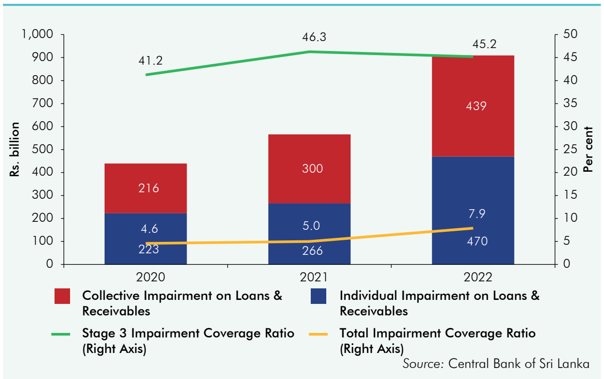


Source: Central Bank of Sri Lanka

NPL Ratio as indicated by Stage 3 Loans to Total Loans (including undrawn amounts) Ratio increased from 7.6 per cent as at end 2021 to 11.3 per cent by end 2022, induced by higher growth in Stage 3 loans and lower growth in credit. Meanwhile, total impairment recorded a growth of 60.6 per cent during the year and reached Rs. 909 billion as at end 2022.

Out of the total loan portfolio of the banking sector, 68.2 per cent of loans were concentrated into 5 sectors, namely, consumption, construction, wholesale and

Figure 8.4
Impairment on Loans & Receivables of the Banking Sector



Source: Central Bank of Sri Lanka

Table 8.5
Sectorwise Composition of Loans and Receivables of the Banking Industry

Sectors	Amount Rs. bn (a)	Share of Total Loans %	Stage 3 Loans to Total Loans %
Consumption	1,864.4	16.4	4.7
Construction	1,795.5	15.8	16.1
Wholesale & Retail Trade	1,716.3	15.1	12.8
Manufacturing	1,243.9	11.0	14.7
Infrastructure Development	1,115.3	9.8	4.8
Agriculture, Forestry & Fishing	920.3	8.1	11.8
Lending to Overseas Entities	593.4	5.2	6.1
Tourism	525.7	4.6	23.4
Financial Services	458.9	4.0	5.5
Health Care, Social Services & Support Services	400.2	3.5	7.4
Transportation & Storage	302.7	2.7	26.1
Professional, Scientific & Technical Activities	133.2	1.2	7.0
Lending to Ministry of Finance	109.2	1.0	-
Information Technology and Communication Services	81.0	0.7	10.9
Education	65.1	0.6	12.5
Arts, Entertainment & Recreation	12.8	0.1	12.7
Total Loans	**11,337.9**	**100.0**	**11.1**

(a) Provisional

Source: Central Bank of Sri Lanka

retail trade, manufacturing, and infrastructure development. Transportation and storage, tourism, construction, manufacturing, wholesale and retail trade, arts, entertainment and recreation, and education sectors reported Stage 3 Loans to Total Loans Ratios (excluding undrawn amounts) higher than the total banking sector average of 11.1 per cent as at end 2022. Since high Stage 3 Loans to Total Loans Ratios were reported in certain sectors to which the banking sector has high exposures, banks are expected to adopt more stringent credit risk mitigation mechanisms internally for exposures related to these sectors.

Market Risk

The Interest Rate Sensitivity Ratio[2] decreased to 76.3 per cent as at end 2022 from 79.6 per cent as at end 2021, thereby increasing the exposure to interest rate risk by end 2022 compared to end 2021. Net gain from financial instruments at fair value through profit and loss during 2022 stood at Rs. 11.5 billion and was higher than Rs. 2.4 billion recorded during 2021. This was due to more funds being directed to government securities during 2022 compared to 2021 as a result of higher yields on government securities that prevailed during the year.

Equity risk of the banking sector was minimal throughout 2022. The equities listed under fair value through profit or loss and fair value through other comprehensive income portfolio stood at Rs. 7.4 billion and Rs. 2.2 billion, respectively, as at end 2022. The low share of equity investments in the total investment portfolio ensures that the market risk of the banking sector due to equity price fluctuations was minimal.

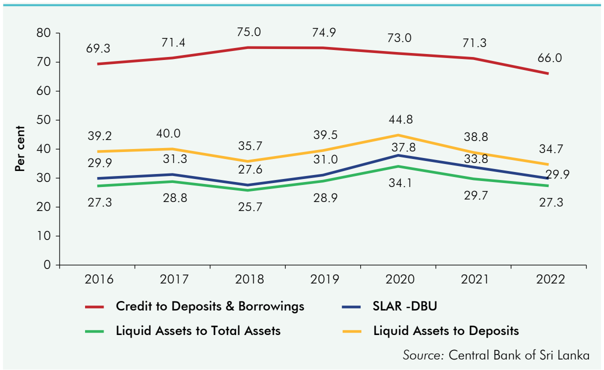
Net foreign currency exposure of the banking sector increased to a long position of US dollars 659.4 million at end 2022 compared to a long position of US dollars 133.2 million at end 2021. Higher decrease in on-balance sheet foreign currency liabilities compared to the decrease in on-balance sheet foreign currency assets during 2022 contributed to the increased long position of the net foreign currency exposure. On-balance sheet foreign currency assets decreased mainly due to decline in loans and placements with banks during the year. Accordingly, net foreign currency exposure as a percentage of banks' on-balance sheet foreign currency assets stood at 4.7 per cent at end 2022. The banking sector reported a net foreign currency revaluation gain of Rs. 28.1 billion during 2022 compared to a gain of Rs. 26.3 billion during 2021.

Liquidity Risk

The banking sector experienced an acute pressure on liquidity during 2022. Although the banking sector maintained Statutory Liquid Assets Ratio (SLAR) of Domestic Banking Units (DBU)

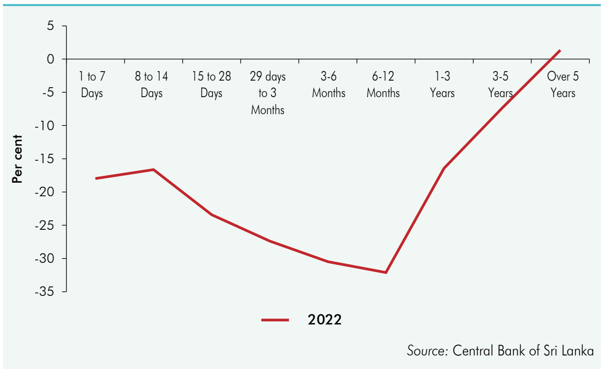
[2] It is calculated as interest bearing assets as a share of interest bearing liabilities with maturities of less than 12 months.

Figure 8.5
Liquidity Ratios of the Banking Sector



Source: Central Bank of Sri Lanka

Figure 8.6
Cumulative Maturity Gap as a percentage of Cumulative Outflows



Source: Central Bank of Sri Lanka

above the minimum requirement of 20 per cent, it declined from 33.8 per cent as at end 2021 to 29.9 per cent as at end 2022. During the year, certain domestic banks heavily depended on the standing facilities provided by the Central Bank for their day-to-day liquidity management. The Credit to Deposits and Borrowings Ratio slightly decreased due to lower growth in credit during 2022, while the Liquid Assets to Total Assets and Liquid Assets to Deposits ratios also recorded a decline.

The Rupee and All Currency Liquidity Coverage Ratios (LCRs) of the banking sector stood at 237.5 per cent and 191.2 per cent, respectively, by end 2022, well above the regulatory minimum requirement of 90 per cent. LCR is the stock of unencumbered high-quality liquid assets that can be converted easily and immediately into cash in the secondary market to meet a bank's liquidity needs for a period of 30 days under a liquidity stress scenario. In addition, the Net Stable Funding Ratio (NSFR) introduced in 2019, which requires banks to maintain sufficient stable funding sources, stood at 140.8 per cent at end 2022 well above the regulatory requirement of 90 per cent. Total liquid assets amounted to Rs. 5.3 trillion as at end 2022, of which investments in government securities represented 62.9 per cent. A new mechanism to monitor the maturity gap was introduced in the beginning of 2022. Accordingly, the cumulative maturity gap as a percentage of cumulative outflows of the banking sector for maturity buckets less than 12 months periods displayed higher values, indicating that long term assets are funded by short term funding products. Despite banks being able to meet the minimum liquidity requirements, excessive widening of the maturity gap may lead to an increase in liquidity risk.

Table 8.6
Composition of Liquid Assets of the Banking Sector

Item	2021 (a)		2022 (b)		Change (Rs.bn)	
	Rs.bn	Share (%)	Rs.bn	Share (%)	2021 (a)	2022 (b)
Treasury bills	1,040.6	20.8	982.6	18.5	-109.3	-58.0
Treasury bonds	2,142.3	42.9	1,887.8	35.6	457.1	-254.5
Sri Lanka Development Bonds	577.0	11.5	466.2	8.8	-78.8	-110.9
Cash	231.8	4.6	273.3	5.2	28.7	41.6
Money at Call	177.2	3.5	385.5	7.3	-160.5	208.4
Balance with Banks Abroad	538.9	10.8	1,144.4	21.6	69.0	605.5
Other	290.3	5.8	161.6	3.0	-203.3	-128.7
Total Liquid Assets	**4,998.0**	**100.0**	**5,301.4**	**100.0**	**2.9**	**303.4**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

8

Profitability and Capital Adequacy

Profitability depleted during the year mainly due to increase in impairment. Interest income of the banking sector increased by 74.7 per cent compared to an increase in interest expenses by 106.2 per cent during 2022, resulting in an increase in net interest income by 37.8 per cent. As a result, the net interest margin increased from 3.5 per cent as at end 2021 to 4.0 per cent as at end 2022. Net interest income increased by Rs. 207.7 billion during 2022, while non-interest income increased by Rs. 124.1 billion, mainly due to higher fees and commission income during 2022. Non-interest expenses increased by Rs. 59.1 billion, largely due to the increase in staff cost by Rs. 26.8 billion, while impairment for loans and other losses increased by Rs. 298.5 billion during 2022. As a result, profit before corporate tax was Rs. 192.2 billion in 2022 as per the regulatory reporting, which was Rs. 35.3 billion lower than the profit level recorded in the previous year.

Profit after tax of the banking industry was Rs. 150.2 billion during 2022 which recorded a decrease of 12.7 per cent compared to the previous year. Possible losses from interest rate movement on fixed income portfolios of banks were partially negated through the accounting flexibility offered in terms of one-off reclassification of investments from Fair Value through Other Comprehensive Income portfolio to Amortised Cost portfolio. The decrease in profits was reflected in Return on Assets (ROA) before tax, which depleted from 1.4 per cent as at end 2021 to 1.0 per cent as at end 2022, while Return on Equity (ROE) after tax depleted from 13.4 per cent in 2021 to 10.2 per cent in 2022. Further, the Efficiency Ratio decreased from 38.0 per cent in 2021 to 31.5 per cent in 2022 due to the increases in net interest income and non-interest income.

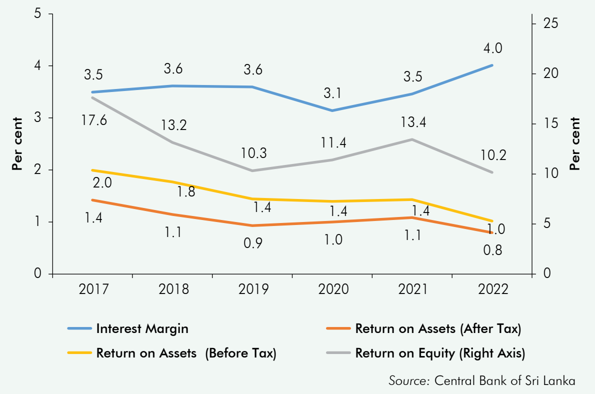
Table 8.7
Profit of the Banking Sector

Item	2021 (a)		2022 (b)	
	Amount (Rs.bn)	As a % of Avg. Assets	Amount (Rs.bn)	As a % of Avg. Assets
Net Interest Income	549.9	3.5	757.6	4.0
Interest Income	1,193.8	7.5	2,085.2	11.0
Interest Expenses	643.9	4.1	1,327.6	7.0
Non-Interest Income	152.9	1.0	277.0	1.5
Net Fee & Commission Income	88.6	0.6	127.5	0.7
Non-Interest Expenses	266.8	1.7	325.9	1.7
Staff Cost	147.0	0.9	173.8	0.9
Impairment for Loans & Other Losses	157.6	1.0	456.1	2.4
Profit Before Tax (after VAT)	227.5	1.4	192.2	1.0
Profit After Tax	172.1	1.1	150.2	0.8

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

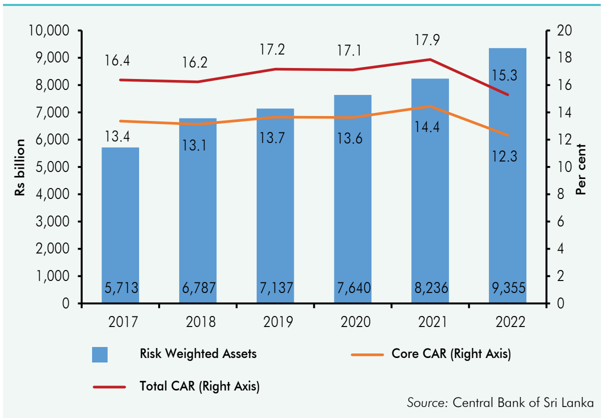
Figure 8.7
Profitability Ratios of the Banking Sector



Source: Central Bank of Sri Lanka

The Banking sector was largely in compliance with the capital requirements during 2022. However, considering the challenges in raising fresh capital in the prevailing macroeconomic

Figure 8.8
Capital Ratios of the Banking Sector



Source: Central Bank of Sri Lanka

Table 8.8
Composition of Regulatory Capital of the Banking Sector

Item	Amount (Rs. bn)		Composition (%)	
	2021 (a)	2022 (b)	2021 (a)	2022 (b)
Tier I: Capital	**1,083.8**	**1,152.0**	**100.0**	**100.0**
Share Capital	352.1	366.7	32.5	31.8
Statutory Reserve Funds	66.7	74.3	6.2	6.4
Retained Profits	480.5	544.5	44.3	47.3
General and Other Reserves	250.5	295.2	23.1	25.6
Others	21.6	67.2	2.0	5.8
Regulatory Adjustments	-87.5	-195.9	-8.1	-16.9
Tier II: Capital	**279.8**	**278.0**	**100.0**	**100.0**
Revaluation Reserves	35.3	35.4	12.6	12.7
Subordinated Term Debt	160.2	135.4	57.2	48.7
General Provisions and Other	84.7	107.3	30.3	38.6
Regulatory Adjustments	-0.4	-0.2	-0.1	-0.1
Total Regulatory Capital Base	**1,363.6**	**1,429.9**		

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

conditions, the deadline to meet the enhanced minimum capital requirement of Rs. 20.0 billion for domestically incorporated LCBs and Rs. 7.5 billion for LSBs was extended till December 2023. Banks were encouraged to raise high quality capital to absorb the potential losses from the risks arising from challenging business conditions. As a result, banks increased Tier I capital through the retention of profits (Rs. 64.0 billion), increase in reserves (Rs. 44.7 billion), and issuance of new shares (Rs. 14.6 billion) during 2022. The regulatory capital of the banking sector reported a growth of 4.9 per cent during the year, which was mainly supported by the increase in Tier I capital.

Banking Sector Supervisory and Regulatory Developments during 2022

During 2022, the Central Bank made several prudential policy interventions, including the issuance of regulations and strengthening of the supervisory approach to maintain the resilience of the banking sector amidst the prevailing turbulent macroeconomic circumstances. In the meantime, the Central Bank also cautiously relaxed some of the regulations to allow the banking sector to maintain liquidity and facilitate effective financial intermediation amidst the multifaceted challenges.

Accordingly, after careful consideration of the extraordinary circumstances caused by the current macroeconomic conditions, the Central Bank introduced certain regulatory requirements. These include permitting to draw down on the Capital Conservation Buffer, reducing the regulatory minimum requirements for the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR), permitting licensed banks to stagger the mark-to-market losses on government securities over two years, encouraging licensed banks to move to more sophisticated approaches to compute risk weighted assets for the operational risk under capital adequacy requirements, extending the deadlines to meet the minimum capital requirements, and the submission of Internal Capital Adequacy Assessment Process document. Further, guidelines were issued to licensed banks requiring them to maintain liquid assets of an amount not less than 20 per cent of total adjusted liabilities on a consolidated basis for the overall bank until further notice. Licensed banks were also permitted to maintain LCR and NSFR at a level not less than 90 per cent up to end December 2022, with enhanced supervision and frequent reporting.

Further, restrictions on discretionary payments of licensed banks were reintroduced, considering the possible adverse impact on liquidity and other key performance indicators of licensed banks due to prevailing macroeconomic conditions and the importance of maintaining appropriate levels of liquidity and

capital buffers. Accordingly, licensed banks were required to defer the payment of cash dividends and repatriation of profits not already declared until the financial statements/interim financial statements for the year 2022 were finalised and audited by its External Auditor. Furthermore, licensed banks were requested to refrain from engaging in share buybacks, increasing management allowances and payments to Board of Directors, incurring non-essential and/or non-urgent expenditure while exercising extreme due diligence and prudence when incurring capital expenditure until the end of 2022.

Several Orders under the Monetary Law Act, No.58 of 1949 (MLA) were issued during the first half of 2022 including amendments to the limits on interest rates of lending and deposit products of licensed banks, inclusive of foreign currency deposits, considering the monetary policy measures and exchange rate movements. Subsequently, such limits were revoked in light of the market developments and the tight monetary policy stance adopted by the Central Bank. Similarly, restrictions imposed on forward sales and purchases of foreign currencies were also revoked, while reintroducing margin requirements against imports to curtail imports of non-essential and non-urgent goods, to preserve the stability of the exchange rate and foreign currency liquidity in the banking system.

Moreover, a Direction in relation to sustainable finance was issued to banks in 2022. Considering the national importance of promoting sustainable financing initiatives and the need for providing governance and risk management framework for licensed banks in respect of sustainable finance activities, Banking Act Directions on Sustainable Finance Activities of Licensed Banks were issued in line with the Road Map for Sustainable Finance in Sri Lanka.

The Central Bank requested licensed banks to provide broader concessions to borrowers affected by the COVID-19 pandemic and subsequent extraordinary macroeconomic circumstances to unwind the moratoria granted for general and tourism activities. Licensed banks were requested to provide appropriate concessions, for a period of six months until end December 2022, to borrowers whose income or businesses have been adversely affected due to the current macroeconomic conditions and/or the COVID-19 pandemic on a case-by-case basis based on the future repayment capacity of individuals and viability of businesses/ projects while preventing any undue stress on the banking sector stability. Further, a Circular was issued providing guidelines to establish post COVID-19 revival units to identify and assist under performing and non-performing borrowers of licensed banks who were affected by COVID-19 and were facing financial difficulties due to reduction of income or sales and reduction or impairment of business operations or the closure of business etc.

Several key regulatory measures were introduced during 2022 in addition to the aforementioned measures. Those include amending the Customer Charter of licensed banks, introducing specific measures to improve accessibility to banking services for customers with special needs, determination of Indian Rupee as a designated foreign currency, informing banks the annual licence fees for the calendar year 2023, and mandating the recording of Unique Identification Numbers of the depositors of licensed banks.

BOX 10
Establishment of a Macroprudential Authority in Sri Lanka

Background

The new Central Bank Act, which is expected to be enacted, recognises securing financial system stability as an objective of the Central Bank while designating it as the Macroprudential Authority of Sri Lanka. As such, the new Act expands the Central Bank's mandate and scope in its current role in maintaining financial system stability. Accordingly, this article intends to educate stakeholders on concepts of macroprudential policies and systemic risk, interactions between macroprudential polices and other Central Bank policies, macroprudential tools and targeted aspects, the Central Bank's role as the macroprudential authority of Sri Lanka and the way forward.

Macroprudential Policies and Systemic Risk

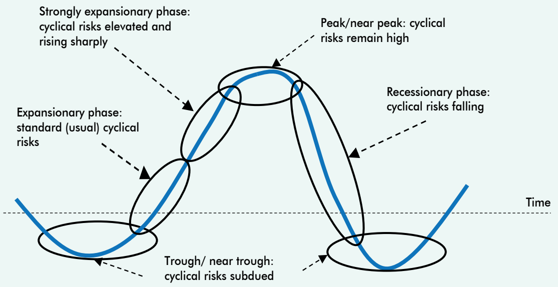
The importance of a macroprudential approach to central banking surfaced from lessons learnt from the Global Financial Crisis (GFC) of 2007-2009. GFC showed that a crisis can emerge even in a stable economic environment and merely microprudential policies would not be adequate to prevent such a crisis as regulatory policies were focused on individual institutions with no policies available to deal with systemic risks. Systemic risk is defined as the risk of disruptions to the provision of financial services that is caused by an impairment of all or parts of the financial system and can cause serious negative consequences for the real economy (International Monetary Fund, Financial Stability Board, and Bank for International Settlements, 2009). Hence, GFC raised the need for a strong macroprudential policy framework to constrain the buildup of risks in the financial system. Central Banks in the post GFC era recognised the significance of linkages between the macroeconomy and the financial system vis-a-vis macrofinancial linkages. Thus, it became apparent that it is vital to identify macrofinancial linkages and interdependence of institutions while systemic risks need to be contained by dedicated financial sector policies.

Thus, 'macroprudential' refers to an approach to financial regulation that fills the gap between conventional macroeconomic policy and traditional microprudential regulation of individual financial institutions (Elliott, 2011). Accordingly, macroprudential policy fills the gap by safeguarding financial system stability by limiting 'systemic risk' and strengthening the resilience of the financial system.

Systemic risk often arises gradually and unobserved, and such risks in the financial system may not show obvious signs of an adverse situation or a series of adverse developments. Hence, the real time uncertainty and evolving nature of systemic risk over the cycle requires constant assessment of developments and evaluation of the adequacy of macroprudential policy responses. In this sense, macroprudential policy represents a proactive approach to prudential regulation through a set of instruments and measures that respond flexibly when warranted in a time varying fashion over the financial cycle. The macroprudential stance that aggregates the overall macroprudential policy mix tends to tighten in the expansionary phase of the financial cycle[1] as cyclical risks tend to accumulate and loosen in the recessionary phase of the cycle (see Figure B 10.1).

Macroprudential policy aims to contain systemic risk through two components, i.e., cross sectional and cyclical. The cross sectional component focuses on mitigating or developing resistance for risk of failure that arises from externalities on individual systemically important financial institutions and the systemic risk that arises from the interconnectedness of a financial institution within the financial system. Meanwhile, the

Figure B 10.1
Evolution of cyclical risks over the financial cycle


Strongly expansionary phase: cyclical risks elevated and rising sharply
Peak/near peak: cyclical risks remain high
Recessionary phase: cyclical risks falling
Expansionary phase: standard (usual) cyclical risks
Time
Trough/ near trough: cyclical risks subdued

Source: Czech National Bank (2022)

[1] Similar to the economic cycle, the financial cycle has an expansionary phase, a recessionary phase and turning points – a peak and a trough. The financial cycle may at times follow an atypical course with some of these phases either not occurring at all or lasting an unusually short or long time.

cyclical component attempts to mitigate or develop resilience for systemic risk in the time dimension (Adrian, 2017). Such cyclical threats include asset price bubbles that are associated with rapidly growing leverage and credit conditions (Elliott, Feldberg, & Lehnert, 2013).

Interactions with Other Policies

The tendency to mobilise all available policy tools (including prudential policies) to stabilise the real economy in response to large shocks has been observed since GFC in 2009. Moreover, this was more apparent during the COVID-19 pandemic where prudential policies played an important macro-stabilisation role along with more traditional fiscal and monetary policy measures and a vital role in Central Banks' policy mix (Warjiyo and Juhro, 2022). While macroprudential policy may have to be implemented with other policies, there is a high level of interaction with monetary policy and microprudential policy. Accordingly, monetary and financial system stability objectives and tools can conflict with or complement each other. For instance, monetary policy may under certain circumstances contribute to the buildup of imbalances and influence risk taking behaviour of agents. For example, prolonged accommodative monetary policy periods may lead to asset price bubbles and excessive credit growth episodes. Hence, there might be a need for countercyclical macroprudential policy tools to combat financial stability risks. On the other hand, a stable financial system enables smooth transmission of monetary policy and better allocation of resources in the economy. This close relationship predetermines the need to monitor, analyse, and assess the impact of monetary and macroprudential policies and measures on the attainment of such policy objectives and, if necessary, to coordinate between the said policies. Moreover, the activities of macroprudential policy and microprudential oversight also complement each other as they use the same information base, and a substantial amount of the information obtained during microprudential supervision is considered in macroprudential policymaking. Such complementarities and conflicts must be carefully considered, and synergistic effects must be used when applicable (Warjiyo and Juhro, 2022). Further, the need for close coordination is necessary as these objectives are hard to be separated and strict separation would be counterproductive.

Operationalising the Macroprudential Framework - Policy Tools and Targeted Aspects

Policymakers use a variety of macroprudential tools to minimise the frequency and severity of a systemic risk. Macroprudential tools thus used can be categorised into broad based tools, sectoral (e.g. household/corporate) tools, liquidity tools, and structural tools.

Broad based tools affect all credit exposures of the banking system and can include *Countercyclical Capital Buffers* (CCyBs), leverage ratios, and dynamic loan loss provisioning requirements (DPRs) (International Monetray Fund, 2014). Sectoral tools can address vulnerabilities arising from excessive credit to specific sectors such as the household and corporate sectors, and include imposing/increasing sectoral capital requirements (risk weights), limits on credit growth, *Loan to Value* (LTV) ratios, and *Debt Service to Income* (DSTI) ratios. Liquidity tools (for example, *liquidity buffer requirements* that ensure banks hold enough liquid assets to cover outflows during a stressed period for a few weeks, *stable funding requirements* that ensure banks hold stable liabilities to fund their illiquid assets such as loans and *liquidity charges* that impose a levy on non-core funding) contain systemic liquidity risks.

The structural dimension of systemic risk arises from interconnectedness and the risk of contagion from the failure of individual systemic institutions. Structural macroprudential policy tools target two objectives: (1) increasing the resilience of too important to fail institutions; and (2) reducing excessive exposures within the financial system. Identifying and strengthening the resilience of systemically important financial institutions has emerged as the key strategy in addressing the problem of institutions that are "too important to fail," and capital surcharges on such institutions are increasingly used across countries. Further, discouraging exposures to these institutions or make such exposures more secure are used as strategies to limit the excessive exposures to these financial institutions.

The Central Bank as the Macroprudential Authority in Sri Lanka

Although the Central Bank is engaged in macroprudential analysis, developing tools for such analyses, and introducing policy measures for regulated financial institutions, the new Central Bank Act once enacted will designate the Central Bank as the Macroprudential Authority of the country which will expand its mandate and scope in terms of the current role in maintaining financial system stability. Thus, with the enactment of the new Act, the Central Bank will be entrusted with the responsibilities to work towards its macroprudential objectives in order to maintain the resilience of the financial system even under turbulent economic and financial conditions by periodically updating the overall approach to the use of macroprudential tools. This will include maintenance of healthy credit and leverage conditions among financial institutions without any unsustainable fluctuations as well as preserving the health of such institutions by containing any risks stemming from interconnectedness and failure of systemically important entities. The Central Bank will be vested with powers to monitor the financial system as a whole, assess risks, introduce macroprudential instruments, and make recommendations to other regulators of the financial sector authorities.

Way Forward

The Central Bank has already embarked on strengthening its macroprudential framework with the technical assistance from global experts in this area, while strengthening the frameworks on risk assessment, and calibration of instruments. Dynamic bank solvency stress testing, liquidity stress testing, interconnectedness analysis frameworks, and strengthened data collection frameworks related to such risk analyses have been already established and several fruitful rounds have been completed. The Central Bank is currently developing a series of macroprudential tools targeted at financial sector participants regulated and supervised by the Central Bank or their exposures. In executing the powers vested on the implementation of macroprudential policies and in line with international best practices, the Central Bank will develop and propose prudential standards to be applied by financial sector authorities in respect of financial sector participants regulated by such authorities. In doing so, data gaps are being identified and the Central Bank is working on addressing them. The Central Bank will endeavor to strengthen the institutional framework that supports its macroprudential mandate once the new Act is enacted to establish a well coordinated mechanism for macroprudential policymaking. In this regard, the Central Bank will strengthen the involvement of the Financial System Oversight Committee (FSOC) in financial stability matters, which will coordinate with the relevant financial sector authorities representing the financial system in implementing proposals/recommendations made by the Central Bank. The Financial System Stability Review currently being published by the Central Bank will be enriched and will cater to the statutory requirement of publishing a review report on the stability of the financial system on an annual basis. This report will include the Central Bank's assessment of financial system stability, risks and vulnerabilities identified thereof, an overview of the measures taken by the Central Bank, and other financial sector authorities in the given period to address the risks identified and an overview of the recommendations made by FSOC with the current level of progress in implementation.

With the establishment of the Macroprudential Authority it is expected that the objective of securing financial system stability will be ensured in line with international best practices which would help strengthen financial system stability.

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8.3. Performance of Non-Bank Financial Institutions

Licensed Finance Companies and Specialised Leasing Companies Sector

The Licensed Finance Companies (LFCs) and Specialised Leasing Companies (SLCs) sector managed to continue its expansion during 2022 amidst the economic contraction experienced by the country. Despite challenges faced from shrinking credit growth, declining profitability and increase in non-performing loans as indicated by Stage 3 loans, the LFCs and SLCs sector grew in terms of assets and deposits with adequate capital and liquidity buffers during 2022. The Masterplan for consolidation of Non-Bank Financial Institutions (the Masterplan) is implemented with the objective of establishing strong and stable LFCs in the medium term and thereby safeguarding the interest of depositors of the sector and preserving the financial system stability.

Business Expansion

Total assets of the sector amounted to Rs. 1,611.2 billion by end 2022, representing 5.2 per cent of the total assets of Sri Lanka's financial system. By end 2022, the sector comprised of 36 LFCs[3] and 1 SLC and there were 1,834 branches, of which 1,204 branches (65.6 per cent) were located outside the Western Province. Further, 127 new branches were established by the sector during 2022.

The asset base of the sector expanded by Rs. 123 billion recording a growth of 8.3 per cent and stood at Rs. 1,611.2 billion by end 2022, compared to the 6.1 per cent growth recorded in 2021. The asset expansion was mainly driven by the growth of loans and advances portfolio followed by increase in investments and liquid assets. Loans and advances accounted for 74.4 per cent of the total assets of the sector. Finance leases dominated the loans and advances portfolio of the sector and accounted for 41.6 per cent of total loans and advances by end 2022 compared to that of 48.3 per cent by end 2021. The share of leasing

Table 8.9
Distribution of Branches of LFCs and SLCs by Province

Province	End 2021	End 2022 (a)	Movement during the year
Central	184	193	9
Eastern	142	154	12
North Central	111	120	9
North Western	180	187	7
Northern	119	139	20
Sabaragamuwa	122	127	5
Southern	178	193	15
Uva	82	91	9
Western	589	630	41
Total	**1,707**	**1,834**	**127**

(a) Provisional *Source:* Central Bank of Sri Lanka

Table 8.10
Composition of Assets and Liabilities of the LFCs and SLCs Sector

Item	2021		2022 (a)		Change (%)	
	Rs. bn	Share (%)	Rs. bn	Share (%)	2021	2022 (a)
Assets						
Loans and Advances (net)	1,142.4	76.8	1,199.2	74.4	9.9	5.0
Investments	167.4	11.3	199.6	12.4	5.4	19.3
Others	177.9	12.0	212.4	13.2	-12.4	19.4
Liabilities						
Total Deposits	783.3	52.7	864.5	53.7	4.6	10.4
Total Borrowings	325.9	21.9	322.6	20.0	-0.6	-1.0
Capital Elements	304.0	20.4	364.1	22.6	22.6	19.8
Others	74.5	5.0	60.1	3.7	-3.3	-19.4
Total Assets/Liabilities	**1,487.7**	**100.0**	**1,611.2**	**100.0**	**6.1**	**8.3**

(a) Provisional *Source:* Central Bank of Sri Lanka

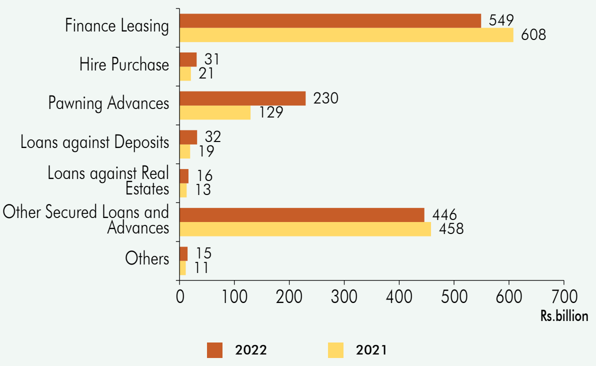
Table 8.11
Status of Moratoria granted to COVID-19 affected borrowers since March 2020

Phase of moratoria	No. of approved requests	Total capital outstanding at the time of granting the moratorium (Rs. bn)	Total capital outstanding as at 31.12.2022 (Rs. bn)
Phase 1 (Mar 2020- Sep 2020)	814,336	312.61	44.58
Phase 2 (Oct 2020- Mar 2021)	99,912	59.93	11.82
Phase 3 (Apr 2021- Sep 2021)	492,734	168.14	68.41
Phase 4 (Oct 2021- Mar 2022)	54,387	37.63	17.16
Phase 5 (Jul 2022- Jan 2023)	42,283	20.19	32.62
Total	**1,503,652**	**n.a ***	**174.58**

* Same borrower may have obtained moratoria under several Schemes. *Source:* Central Bank of Sri Lanka

[3] Excluding ETI Finance Limited.

Figure 8.9
Total Loans and Advances (Gross) by Productwise for 2021 and 2022



Source: Central Bank of Sri Lanka

portfolio in total loans and advances decreased as a result of contraction of the leasing portfolio mainly due to the continuation of restrictions imposed by the Government on the importation of motor vehicles as a measure to restrict foreign currency outflows. However, the loans and advances portfolio of the sector recorded a growth of 5.0 per cent and stood at Rs. 1,199.2 billion at end 2022 compared to the growth of 9.9 per cent at end 2021. The growth of loans and advances portfolio was mainly supported by a surge in the pawning/ gold loans which grew by 77.5 per cent at end 2022.

During 2022, debt moratoria and concessions on loan repayments were extended to assist affected borrowers of the LFCs and SLCs sector due to the prevailing extraordinary macroeconomic circumstances. By end 2022, approximately 13.2 per cent of the loans and advances portfolio of the LFCs and SLCs sector were under moratoria.

Table 8.12
Composition of Deposits of the LFCs Sector

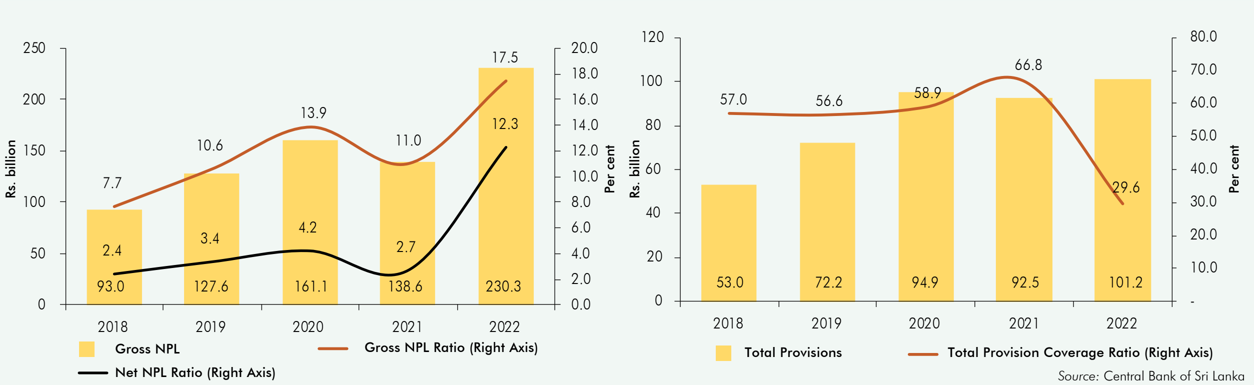
Item	Amount (Rs. bn)		Composition (%)	
	2021	2022 (a)	2021	2022 (a)
Time Deposits	744.3	830.2	95.0	96.0
Savings Deposits	38.4	34.3	4.9	4.0
Certificate of Deposits	0.6	0.0	0.1	0.0
Total Deposits	**783.3**	**864.5**	**100.0**	**100.0**

(a) Provisional *Source:* Central Bank of Sri Lanka

The investment portfolio of the LFCs and SLCs sector comprises investments in equities, corporate debt instruments, government securities and investment properties. The investment portfolio recorded a significant growth of 19.3 per cent reaching Rs. 199.6 billion in 2022 compared to the marginal growth of 5.4 per cent in 2021, mainly due to the increased investments in government securities maturing in less than 12 months consequent to increased interest rates in short term maturities. Other assets that mainly include cash and balances with banks and financial institutions also recorded a significant growth of 19.4 per cent in 2022 compared to the 12.4 per cent contraction in 2021 particularly due to increased placements with LCBs.

Customer deposits continued to dominate the liabilities of the LFCs sector accounting for a share of 53.7 per cent of total liabilities.

Figure 8.10
Non Performing Loans and Provision Coverage of the LFCs and SLCs Sector



Source: Central Bank of Sri Lanka

Deposits increased by Rs. 81.1 billion recording a year-on-year growth of 10.4 per cent to Rs. 864.4 billion, while borrowings declined by 1.0 per cent to Rs. 322.6 billion during 2022.

Risks in the LFCs and SLCs Sector

Credit Risk

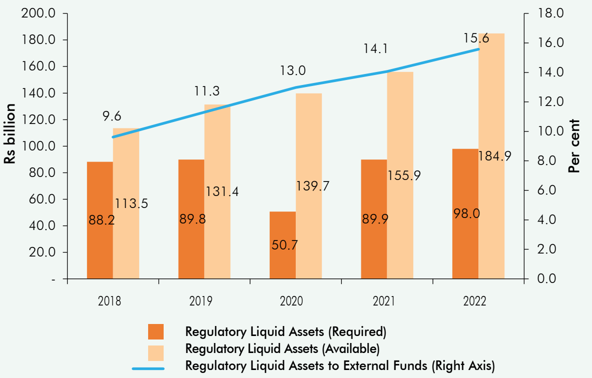
The total gross NPLs/Stage 3 loans increased by 66.1 per cent as at end 2022 on a year-on-year basis, compared to the decrease of 13.9 per cent recorded as at end 2021. The time based classification of NPLs was replaced with SLFRS 9 based Stage 3 Loans on 01 April 2022, where LFCs were required to adopt 120 days past the due date for classification of Stage 3 loans instead of the earlier classification of 180 days. As a result of changing the loan classification methodology into a SLFRS based approach, lapsed debt moratoria, and the impact of adverse macroeconomic conditions, the sector's Gross Stage 3 Loans Ratio substantially increased to 17.5 per cent as at end 2022 from 11.0 per cent reported as at end 2021.

The net impaired Stage 3 Loans Ratio increased to 12.3 per cent as at end 2022 from 2.7 per cent reported as at end 2021. The impairment coverage ratio[4] for Stage 3 loans was reported at 29.6 per cent as at end 2022. The recent market developments, including interest rate movements, economic contraction, the impact of the moratoria schemes granted, and the introduction of higher taxes, will adversely affect the asset quality of the sector and its NPLs in the future.

Interest Rate Risk

Tight monetary policy and concerns over domestic debt restructuring uncertainties resulted in a sharp increase in the Treasury bill yields. This led to a substantial increase in maximum interest rates offered by LFCs on deposits and debt instruments and an upward revision in lending rates. The interest rate sensitivity ratio (interest bearing assets as a share of interest bearing liabilities with maturities of less than 12 months) increased to 96.8 per cent as at end 2022 from 85.6 per cent as at end 2021, indicating a reduction in the exposure to interest rate risk resulted from increased interest rates in 2022 compared to 2021.

Figure 8.11
Regulatory Liquidity Indicators of the LFCs and SLCs Sector



Source: Central Bank of Sri Lanka

Market Risk

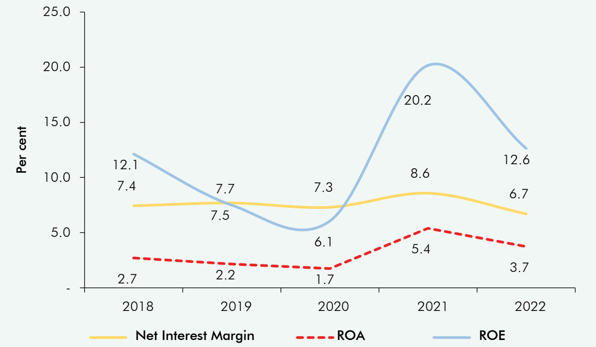
The equity risk in the sector was minimal throughout the year 2022. The exposure of the trading portfolio to the equity market declined to 0.3 per cent of total assets in 2022 from 0.8 per cent in 2021.

Liquidity Risk

On an aggregate basis, the sector maintained liquidity well above the minimum required level during 2022. The overall regulatory liquid assets available in the sector was Rs. 184.9 billion as at end 2022, against the stipulated minimum requirement of Rs. 98.0 billion recording a liquidity surplus of Rs. 86.9 billion as at end 2022, compared to Rs. 66.0 billion recorded as at end 2021. However,

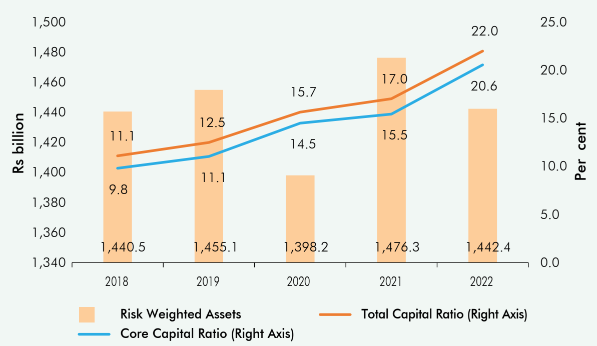
[4] Commencing from April 2022, the provision coverage ratio was replaced with impairment coverage ratio calculated as Stage 3 impairment divided by Stage 3 loans.

Figure 8.12
Profitability Indicators of the LFCs and SLCs sector



Source: Central Bank of Sri Lanka

Figure 8.13
Risk Weighted Assets and CAR



Source: Central Bank of Sri Lanka

the sector may face increased liquidity risk in the future due to early withdrawals, loan defaults, and non-availability of funding lines due to adverse economic conditions.

Profitability and Capital Adequacy

Profitability of the sector declined in 2022 compared to the previous year. The sector's Profit After Tax (PAT) reduced by 21.0 per cent from Rs. 55.6 billion in 2021 to Rs. 43.9 billion in 2022, mainly due to substantial increase in interest expenses. The decrease in profitability was reflected in the significant decrease in the Return on Equity (ROE) to 12.6 per cent and Return on Assets (ROA) before tax to 3.7 per cent in 2022, compared to 20.2 per cent and 5.4 per cent recorded, respectively, in 2021. The cost to income ratio increased to 87.3 per cent in 2022, from 72.6 per cent in 2021, while the efficiency ratio increased to 68.9 per cent during 2022.

Table 8.13
Composition of Income and Expenses of the LFCs and SLCs Sector

Item	2021		2022 (a)	
	Amount (Rs. bn)	As a % of Avg. Assets	Amount (Rs. bn)	As a % of Avg. Assets
Interest Income	217.0	14.2	271.7	15.8
Interest Expenses	85.6	5.6	156.5	9.1
Net Interest Income	**131.4**	**8.6**	**115.2**	**6.7**
Non-Interest Income	49.5	3.2	43.5	2.5
Non-Interest Expenses	87.1	5.7	87.7	5.1
Loan Loss Provisions (Net)	11.1	0.7	6.6	0.4
Profit Before Tax	**82.7**	**5.4**	**64.4**	**3.7**
Profit After Tax	**55.6**	**3.6**	**43.9**	**2.6**

(a) Provisional

Source: Central Bank of Sri Lanka

The net interest income of the sector decreased to Rs. 115.2 billion by 12.3 per cent in 2022 compared with the growth of 18.2 per cent recorded in 2021. This was due to the significant increase in interest expenses by Rs. 70.9 billion, recording a growth of 82.8 per cent, despite the increase in interest income by Rs. 54.7 billion with a growth of 25.2 per cent due to the substantial increase in interest rate consequent to the prevailing macroeconomic environment. As a result, the net interest margin of the sector decreased to 6.7 per cent in 2022 from the 8.6 per cent in 2021 contributing to the decline in the profitability of the sector.

The non-interest income significantly decreased by 12.1 per cent while non-interest expenses increased marginally by 0.7 per cent during 2022. The loan loss provisions made against NPLs declined by Rs. 4.5 billion largely due to loan loss provision reversals during first few months of 2022.

The sector showed resilience with capital maintained well above the minimum regulatory requirement on an aggregate level during the year. The capital base improved to Rs. 317.5 billion as at end 2022 compared to Rs. 251.6 billion recorded as at end 2021, due to retained profits by several large LFCs during the previous financial year, suspension of the licence of an LFC with a large negative net worth and enhancement of capital as a result of the completion of several consolidation transactions, even though 6 LFCs[5] were non-compliant with the minimum core capital requirement and/or capital adequacy requirements. The sector's core capital and total capital ratios increased significantly to 20.6 per cent and 22.0 per cent, respectively, as at end 2022 from the reported levels of 15.5 per cent and 17.0 per cent as at end 2021.

Progress of Implementation of the Masterplan

In 2020, the Masterplan was introduced to address the weaknesses and risk exposures in the LFCs and SLCs sector. Under Phase I of the Masterplan, 5 transactions were fully completed during 2022 and 3 proposed amalgamations which were approved by the Monetary Board in 2022 are currently in progress. Further, the companies that were unable to find a partner to merge with were directed to exit from the market upon cancellation of the licence, and two such transactions are currently in progress.

Primary Dealer Companies in Government Securities

As at end 2022, there were 6 LCBs, and 7 Primary Dealer Companies (PDCs) registered as Primary Dealers (PDs) in the government securities market. Nevertheless, Pan Asia Banking Corporation PLC and Perpetual Treasuries Limited were suspended from carrying on the business and activities of a PD on 15 August 2017 and 06 July 2017, respectively. Participation in primary auctions was prohibited for Entrust Securities PLC w.e.f. 24 July 2017. Accordingly, only 5 LCBs and 5 PDCs were active in the government securities market as PDs as at end 2022.

Assets

Total assets of PDCs increased by 67.4 per cent to Rs. 131.7 billion in 2022. The total investment portfolio of government securities, consisting of trading, Available For Sale (AFS) and Held To Maturity (HTM) portfolios amounted to Rs. 126.1 billion as at end 2022, which recorded a year-on-year increase of 79 per cent. Both trading and HTM portfolios increased to Rs. 100.7 billion and 23.8 billion, respectively, as at end 2022 from Rs. 54.9 billion and Rs. 12 billion, respectively, recorded as at end 2021, while the AFS portfolio declined to Rs. 1.7 billion as at end 2022 from Rs. 3.6 billion prevailed as at end 2021.

Profitability

PDCs reported a Profit After Tax (PAT) of Rs. 1.7 billion during 2022 compared to the loss of Rs. 0.4 billion reported during 2021, indicating a significant increase in profitability. The significant increase in interest income from investments in government securities and increased revaluation gains recorded by PDCs in 2022 compared to 2021, largely contributed to the profits reported in 2022. Furthermore, ROA and ROE of PDCs as at end 2022 increased to 3 per cent and 11.4 per cent, respectively, from negative 0.7 per cent and negative 2.5 per cent, respectively, recorded as at end 2021.

Capital

Equity of PDCs increased by 68.3 per cent mainly due to profit earned during the year. The Risk Weighted Capital Adequacy Ratio (RWCAR) of the PDCs was well above the minimum required amount of 10 per cent despite a significant reduction in the RWCAR to 23.2 per cent as at end 2022 from 42.8 per cent reported as at end 2021.

[5] Regulatory restrictions such as deposit caps, lending caps, freeze acceptance of new deposits and granting new loans were imposed on LFCs which were non-compliant with the minimum core capital requirement and/or capital adequacy requirements. Further, several LFCs are in the process of completing transactions under the Masterplan.

Risks in the PDCs Sector

Market Risk

The proportion of the trading portfolio in the total investment portfolio of PDCs increased marginally. The trading portfolio of PDCs was at 79.8 per cent of the total investment portfolio as at end 2022 compared to 77.8 per cent as at end 2021, reflecting a marginal increase in the relative market risk exposure of the industry.

Liquidity Risk

The overall liquidity risk exposure of PDCs increased due to the increase in overnight negative mismatch in the maturity profile of assets and liabilities of PDCs as at end 2022. The overnight negative mismatch in liquidity significantly increased to Rs. 78.1 billion as at end 2022 from Rs. 20.3 billion as at end 2021 and recorded a growth of 270 per cent. This was mainly due to the significant increase in overnight liabilities by 219.9 per cent at end 2022. Except for one PDC, which was facing liquidity issues, the liquidity risk profile of other PDCs remained low throughout the year, in view of holding a large volume of government securities and the ability to use such government securities as collateral for obtaining funds to bridge any unforeseen liquidity gaps. Most PDCs had standby contingency funding arrangements to bridge any liquidity gaps. However, uncertainties related to possible debt restructuring may increase credit risk and liquidity risk and may have an adverse impact on the capital levels of PDCs.

Market Conduct

Primary Market Activities of PDCs

The participation in primary auctions of Treasury bills and Treasury bonds by PDCs showed a mixed performance during 2022. Out of the total bids accepted at 52 Treasury bill auctions conducted in 2022, the effective participation of PDCs accounted for 49.5 per cent, and at 24 Treasury bond auctions conducted during 2022, the effective participation of PDCs accounted for only 22.4 per cent.

Secondary Market Activities of PDCs

The value of Secondary market transactions in government securities by PDCs significantly increased by 204.3 per cent to Rs. 15,423.4 billion in 2022, out of which repo transactions accounted for 76.4 per cent. During 2022, outright purchases increased by 94 per cent, and outright sales increased by 80.7 per cent compared to 2021.

Licensed Microfinance Companies

The Licensed Microfinance Companies (LMFCs) sector consisted of 4 companies and reported 18.7 per cent growth of its assets base, reaching Rs. 9.9 billion as at end 2022. Micro-loans accounted for the largest share of total assets of the LMFCs sector, with 74.1 per cent of representation. Micro-loans amounted to Rs. 7.4 billion as at end 2022 compared to Rs. 6.9 billion as at end 2021 and reported a growth of 8.4 per cent. NPLs of LMFCs stood at 8.7 per cent as at end 2022. The total deposit base of the sector grew by 19 per cent in 2022 from Rs. 544 million in 2021 to Rs. 648 million in 2022. With the increase in total liabilities of the sector by 29 per cent from Rs. 5.5 billion in 2021 to Rs. 7.2 billion in 2022, the debt-to-equity ratio increased to 4.3 per cent as at end 2022. The core capital level of the sector was reported at Rs. 2.5 billion and all LMFCs were in compliance with the minimum prudential regulations on core capital.

Unit Trusts

The number of Unit Trusts (UTs) in operation increased to 80 as at end 2022 from 75 reported as at end 2021. The number of UT management

Table 8.14
Performance of UT Sector

Item	2021 (a)	2022 (b)
No. of Unit Trusts	75	80
Total No. of Unit Holders	59,426	67,912
No. of Units in Issue (mn)	7,835	6,283
Total Assets (Rs. bn)	195	150
Net Asset Value-NAV (Rs. bn)	191	143
Investments in Equities (Rs. bn)	17.6	11.8
Share of Total Net Assets (%)	9.1	7.9
Investments in Government Securities (Rs. bn)	23.4	84.9
Share of Total Net Assets (%)	12.1	56.7

(a) Revised
(b) Provisional

Source : Unit Trust Association of Sri Lanka
Securities and Exchange Commission of Sri Lanka

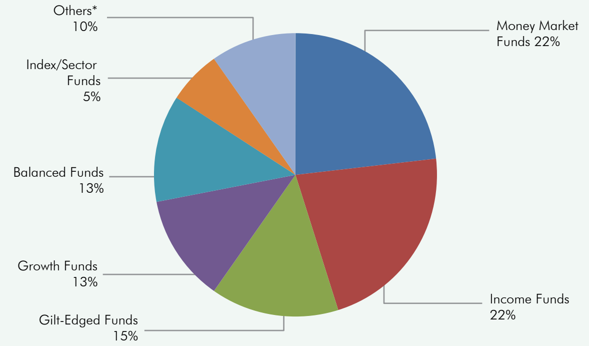
companies remained unchanged at 16 as at end 2022 compared to end 2021. The UTs funds were equally dominated by Money Market Funds and Income Funds accounting for 22.5 per cent each of the UT industry. In addition, Gilt Edged Funds, Growth Funds and Balanced Funds accounted for 15.0 per cent, 12.5 per cent and 12.5 per cent of the UT industry, respectively.

A contraction was observed in the total asset base of the UT sector as at end 2022. The total assets of the sector significantly decreased by 23.1 per cent to Rs. 150 billion as at end 2022 from Rs. 195 billion as at end 2021. It is observed that the number of units issued also decreased to 6,283 million as at end 2022 from 7,835 million reported as at end 2021. However, the total number of unit holders increased to 67,912 as at end 2022 from 59,426 reported as at end 2021.

The share of investments in government securities by UTs as a percentage of total net assets significantly increased to 56.7 per cent as at end 2022 from 12.1 per cent reported as at end 2021. Meanwhile, investment in equity as a percentage of net assets decreased to 7.9 per cent as at end 2022 compared to 9.1 per cent as at end 2021.

Insurance Sector

Figure 8.14
Categorisation of the UT Sector in terms of the Number of Funds



*Other: Shariah Funds 3, Dollar Funds 3, IPO Fund 1 and Growth and Fixed Income Fund 1

Source: Securities and Exchange Commission of Sri Lanka

Despite the challenges emanating from adverse macroeconomic conditions, the insurance sector reported modest growth in terms of asset base and Gross Written Premium (GWP) as at end 2022. The sector comprised 27 companies in operation as at end 2022, of which 14 operated as exclusive long term insurance companies and 11 as exclusive general insurance companies, while 2 as long term and general insurance businesses. Insurance penetration in Sri Lanka, calculated based on total premium as a percentage of GDP, declined to 1 per cent for the year 2022 from 1.4 per cent for the year

Table 8.15
Performance of the Insurance Sector*

Rs. billion

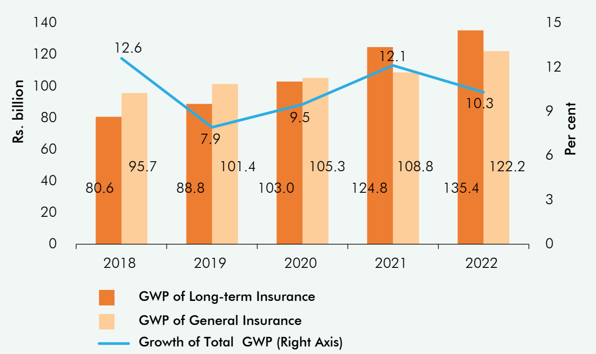
Item		2021 (a)	2022 (b)
Total Assets		881.8	947.3
Government Securities		338.6	413.3
Equities		55.7	47.2
Cash & Deposits		132.1	112.5
Gross Premium		233.5	257.6
Total Income		299.0	336.1
Premium Income		233.5	257.6
Investment Income		65.5	78.6
Profit Before Tax		42.2	50.3
Capital Adequacy Ratio (%)	- Long-term Insurance	384.0	303.0
	- General Insurance	307.0	210.0
Retention Ratio (%)	- Long-term Insurance	96.0	95.1
	- General Insurance	76.4	75.3
Claims Ratio (%)	- Long-term Insurance	38.5	47.1
	- General Insurance	55.6	64.0
Combined Operating Ratio (%)	- Long-term Insurance	81.1	89.5
	- General Insurance	95.3	105.3
Return on Assets (ROA) (%)	- Long term Insurance	3.9	3.6
	- General Insurance	8.0	10.1
Return on Equity (ROE) (%)	- Long term Insurance	17.7	17.1
	- General Insurance	16.3	20.8
Underwriting Ratio (%)	- General Insurance	24.8	16.9

(a) Revised
(b) Provisional

Source: Insurance Regulatory Commission of Sri Lanka

* Information excluding the National Insurance Trust Fund

Figure 8.15
Gross Written Premium of the Insurance Sector



Source: Insurance Regulatory Commission of Sri Lanka

2021, mainly due to high growth in GDP at market prices driven by high inflation, and decelerating growth in GWP on year-on-year basis. Insurance penetration in Sri Lanka remained considerably low compared to peer countries. During 2022, insurance penetration of long term and general insurance sub sectors were 0.6 per cent and 0.5 per cent, respectively.

Business Expansion

The total assets of the insurance sector grew by 7.4 per cent as at end 2022 and reached Rs. 947.3 billion. The asset base of the long term insurance sub sector grew by 5.7 per cent to Rs. 668.7 billion as at end 2022 compared to a growth of 12.2 per cent recorded at end 2021. Meanwhile, the asset base of the general insurance sub sector increased by 11.8 per cent and reached Rs. 278.6 billion as at end 2022. The share of the asset base of the long term insurance sub sector remained high at 70.6 per cent of the total assets of the insurance sector as at end 2022 with a marginal decrease from 71.7 per cent recorded as at end 2021. Corresponding to this decrease, the relative share of the general insurance sub sector increased to 29.4 per cent of the total assets of the insurance sector as at end 2022 from 28.3 per cent recorded at end 2021.

Gross written premium of the insurance sector grew by 10.3 per cent to Rs. 257.6 billion at end 2022 from Rs. 233.5 billion at end 2021. Gross written premium of the long term insurance sub sector and general insurance sub sector increased by 8.5 per cent and 12.4 per cent, respectively, during the period under review. However, the long term insurance sub sector remained the main contributor to the gross written premium of the sector which recorded a share of 52.6 per cent at end 2022. The gross written premium of the motor insurance, the main business area of the general insurance sub sector represented 53.5 per cent share of general insurance and grew by 9.5 per cent at end 2022.

The investment portfolio of the sector grew by 5.6 per cent year-on-year to Rs. 776.6 billion at end 2022. The sector investments continued to be highly concentrated on government securities and the share of both long term and general insurance sub sectors' investments on government securities increased to 53.8 per cent and 51.3 per cent, respectively, as at end 2022 compared to 46.1 per cent and 45.9 per cent as at end 2021 with the relatively higher interest rates that prevailed during 2022. Meanwhile, the share of investments on equity of the long term and general insurance sub sectors decreased to 6.2 per cent and 5.8 per cent, respectively, as at end 2022 from 7.5 per cent and 7.8 per cent as at end 2021.

Profitability and Capital Adequacy

Profitability of the insurance sector increased during 2022 and reported a growth of 19.4 per cent in profits before tax. Profits before tax of the general insurance sub sector reported a significant growth of 41.2 per cent during the period under consideration with 15.4 per cent increase recorded in total income as at end 2022. However, the long term insurance sub sector reported a marginal growth of 1.3 per cent in profits before tax mainly due to 31.5 per cent increase recorded in claims at end 2022.

ROA and ROE of the long term insurance sub sector declined, while ROA and ROE of the general insurance sub sector increased at end 2022 compared to 2021. ROA and ROE of the long term insurance sub sector decreased to 3.6 per cent and 17.1 per cent, respectively, as at end 2022 from 3.9 per cent and 17.7 per cent recorded as at end 2021. Meanwhile, ROA and ROE of the general insurance sub sectors increased to 10.1 per cent and 20.8 per cent, respectively, as at end 2022 from 8.0 per cent and 16.3 per cent recorded at end 2021.

Capital to total assets of both the long term insurance sub sector and the general insurance sub sector declined to 20.8 per cent and 47.5 per cent as at end 2022 from 21.3 per cent and 49.7 per cent, respectively, as at end 2021. Meanwhile, the Capital Adequacy Ratio (CAR) of the long term insurance sub sector and general insurance sub sector declined to 303 per cent and 210 per cent, respectively as at end 2022 from 384 per cent and 307 per cent, respectively as at end 2021.

Superannuation Funds

The total assets of Superannuation funds were reported at Rs. 4,345.0 billion as at end 2022 contributing to 13.8 per cent of the financial sector assets. However, the sector is dominated by the Employees' Provident Fund (EPF), which accounts for 79.6 per cent of the total assets of the Superannuation sector. There were two publicly managed funds, namely, the Employees' Trust Fund (ETF) and the state sector Public Service Provident Fund (PSPF) in operation which accounted 10.8 per cent and 2.0 per cent of the total assets of the Superannuation sector respectively as at end 2022. In addition, there were 117 Approved Pension and Provident Funds (APPFs) managed by the private sector as at end 2022.

Employees' Provident Fund

The EPF continued to dominate the Superannuation sector, accounting for 79.6 per cent of total assets of the sector at end 2022. The total value of the EPF increased by Rs. 293.7 billion to Rs. 3,459.9 billion as at end 2022 from Rs. 3,166.1 billion recorded as at end 2021, recording a 9.3 per cent growth. This growth was contributed by combined effect of the net contributions of the members (net amount of contributions received and refunds paid) and the income generated through investments of the Fund. Total liability to the members stood at Rs. 3,380.6 billion as at end 2022 recording a 10.2 per cent increase from Rs. 3,066.9 billion as at end 2021. The total contribution for the year 2022 increased by 17.4 per cent to Rs. 194.6 billion, while the total amount of refunds made to the members and their legal heirs was Rs. 163.0 billion in 2022, which was an increase of 37.9 per cent over 2021. Accordingly, the net contribution to the Fund was Rs. 31.6 billion in 2022 compared to Rs. 47.5 billion recorded in the previous year. The annual profit of the Fund decreased by 11.7 per cent to Rs. 264.1 billion in 2022 from Rs. 299.1 billion recorded in the previous year. This was mainly due to the unrealised mark-to-market

Table 8.16
Five year Performance Summary of the EPF

Item	2018	2019	2020	2021	2022(a)
Net Worth of the Fund (Rs. bn)	2,289.4	2,540.4	2,824.3	3,166.1	3,459.9
Total Liability to the Members (Rs. bn)	2,254.2	2,497.6	2,767.8	3,066.9	3,380.6
Total Contributions (Rs. bn)	145.0	157.2	150.7	165.7	194.6
Total Refunds (Rs. bn)	108.0	126.3	109.7	118.2	163.0
Net Contribution (Rs. bn)	37.0	30.9	41.0	47.5	31.6
Interest Rate on Member Balance (%)	9.50	9.25	9.00	9.00	9.00
Total Number of Member Accounts (mn.)	18.7	19.4	19.8	20.3	20.4
Active Number of Member Accounts (mn.)	2.9	2.9	2.6	2.5	2.4

(a) Provisional

Source: Central Bank of Sri Lanka

loss of Rs. 40.9 billion on listed equities during 2022 compared to the unrealised mark-to-market gain of Rs. 41.8 billion recorded in previous year.

The total investment portfolio (book value) of the Fund grew by 9.2 per cent to Rs. 3,466.5 billion as at end 2022 from Rs. 3,173.3 billion as at end 2021. The investment policy of the Fund is focused on generating an optimal risk adjusted return to its members, while ensuring the safety of the Fund and the availability of adequate level of liquidity to meet refund payments and other expenses of the Fund. Accordingly, as at end 2022, the investment portfolio consisted of 96.9 per cent in government securities, 2.3 per cent in equity, 0.7 per cent in corporate debentures, and the remaining 0.1 per cent in Reverse Repurchase agreements.

The total investment income of the Fund was Rs. 315.9 billion in 2022 and recorded a decrease of 7.7 per cent compared to Rs. 342.2 billion recorded in the previous year. Interest income, continued to be the major source of income of the Fund which grew by 18.9 per cent to Rs. 349.3 billion in 2022 from Rs. 293.7 billion in 2021. Dividend income increased by 12.6 per cent to Rs. 7.5 billion in 2022 compared to Rs. 6.7 billion in 2021. As stated earlier, Listed Equity Portfolio recorded an unrealized mark-to-market loss of Rs. 40.9 billion in 2022 compared to unrealised mark-to-market gain of Rs. 41.8 billion in 2021.

The Fund earned a total gross income of Rs. 316.2 billion in 2022, recording a decrease of 7.6 per cent compared to Rs. 342.4 billion in the previous year. After adjusting for operating expenditure and tax expenditure, the net profit for the year 2022 was Rs. 264.1 billion which is a decrease of 11.7 per cent compared to Rs. 299.1 billion in 2021. Accordingly, the Return on Average Investment of EPF in 2022 was 9.96 per cent. Despite substantial increase recorded in prices of goods and services, the Fund was able to maintain the operating expenses to gross income ratio at 0.67 per cent in 2022. However, the tax expenditure of the Fund increased by Rs. 7.3 billion compared to 2021 following the increase of interest income and dividend income in 2022. Nevertheless, the adoption of SLFRS 9, the Accounting Standard applicable for classification and measurement of Financial Instruments, where listed equity instruments were measured at fair value and also under the unfavorable conditions in the market, a net loss of Rs. 40.9 billion was charged from the investment income for the year 2022. Further, considering the low interest rates that prevailed in the market until April 2022, only the funds invested after May 2022, yielding a high interest rate as the investable funds accumulated during the previous periods were invested at low interest rates.

Further, the size of the Fund compared to the size of the Sri Lankan capital and financial market, provided limited investment opportunities, making EPF to commit its investments mostly towards Government securities. Such high dependence on sovereign has created some risk to the EPF in an environment of possible domestic debt optimisation. The investment decision making process of the Fund was challenging during the year due to adverse economic and financial conditions prevailed. Considering the above challenges, the EPF Department reshaped its investment strategies to make robust investment decisions to achieve an optimal risk adjusted return in compliance with the Monetary Board approved risk management framework (Investment Policy Statement, Strategic Asset Allocation and Investment Guidelines) and internal control system in place.

Employees' Trust Fund

The ETF, which contributed to 10.8 per cent of the asset base of the superannuation sector, recorded a growth in terms of asset base, total contributions, and investments during 2022. Out of 16.8 million member accounts of ETF, only 2.4 million accounts were active as at end 2022. The number of employers contributing to the fund increased to 68,488 as at end 2022 from 44,501 as at end 2021. The total member balance of ETF increased by 4.1 per cent and reached Rs. 422.9 billion as at end 2022. The total contributions received to ETF increased by 17.4 per cent year-on-year and reached Rs. 34.8 billion, while total benefits paid to members increased by 26.4 per cent year-on-year and reached Rs. 25.0 billion as at end 2022.

Meanwhile, the total assets of ETF increased by 11.9 per cent to Rs. 468.8 billion as at end 2022. Investments made by ETF improved to Rs. 442.5 billion as at end 2022, which is an increase of 7.8 per cent compared to end 2021. Out of these investments, 94 per cent was invested in government securities as at end 2022, compared to 86.7 per cent reported as at end of the previous year. The share of investments in fixed deposits considerably decreased to 0.1 per cent as at end 2022 compared to 6.9 per cent reported as at end 2021. ETF managed to pay a return of 8.80 per cent on its member balances for 2022, which is an increase from the 7.30 per cent of return paid during the previous year.

Table 8.17
Performance of the ETF

Item	2021 (a)	2022 (b)
Total Assets (Rs. bn)	419.1	468.8
Total Member Balance (Rs. bn)	406.3	422.9
Number of Member Accounts (mn)	14.7	16.8
Number of Active Member Accounts (mn)	2.1	2.4
Number of Employers Contributing	44,501	68,488
Total Contributions (Rs. bn)	29.7	34.8
Total Refunds (Rs. bn)	19.8	25.0
Total Investments Portfolio (Rs. bn)	410.6	442.5
o/w : Government Securities (%)	86.7	94.0
o/w : Fixed Deposits (%)	6.9	0.1
Gross Income (Rs. bn)	35.5	47.5
Profit Available for Distribution (Rs. bn)	28.6	38.5
Return on Investments (%)	8.6	9.2
Interest Rate Paid on Member Balances (%)	7.3	8.8

(a) Revised
(b) Provisional

Source : Employee's Trust Fund Board

Other Superannuation Funds

PSPF, which accounted for 2.0 per cent of the superannuation sector, increased in terms of assets, and investments while its net contribution decreased during 2022. The Fund grew by 2.9 per cent and reached Rs. 85.9 billion in terms of assets as at end 2022. The number of active members of the Fund was 267,367 at end 2022 when compared to 241,384 active members as at end 2021. Meanwhile, the investments of the Fund also grew by 5.4 per cent reaching Rs. 85.4 billion as at end 2022. The PSPF invested 42.7 per cent of its total investments in government securities while other investments accounted for 57.3 per cent of the total investments as at end 2022. The net contribution was Rs. 262 million during 2022 compared to the net contribution of Rs. 835 million reported during the previous year. The rate of return on member balances remained unchanged at 8.00 per cent in 2022.

APPFs accounted for 7.6 per cent of the Superannuation sector as at end 2022. The number of members covered by APPFs was estimated to be 122,800 and the total assets of the funds was estimated to be Rs. 330.4 billion as at end 2022.

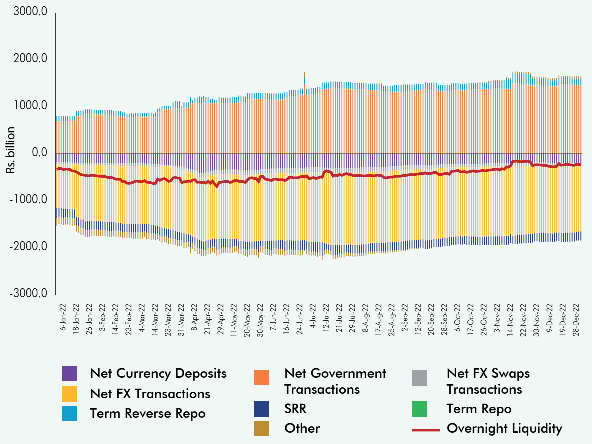
8.4 Performance of Financial Markets

Domestic Money Market

Money Market Liquidity

Liquidity shortage in the domestic money market declined considerably compared to end December 2021 and recorded Rs. 231 billion as at end December 2022, although it remained at a persistently high deficit level during the first half of 2022. Liquidity deficit, which was at Rs. 366 billion as at end December 2021, increased substantially during the first four months of the year 2022, and recorded a peak level of Rs. 688 billion as at end April 2022. Although subscribing to Treasury bills by the Central Bank in primary auctions as well as granting provisional advances and transferring profits to the Government by the Central Bank injected liquidity to the market, the substantially high deficit in the liquidity during 2022 mainly arose from currency withdrawals from licensed banks, scheduled foreign loan repayments as well as the maturities of foreign currency swap transactions and foreign exchange sales for financing the importation of essential goods. However, a gradual decline in the liquidity deficit was observed from May 2022 onwards with the increase in deposits in the banking sector due to high market interest rates and the Central Bank's subscription to Treasury bills through special issuances to support urgent cash flow needs of the government. In addition, the Central Bank occasionally infused liquidity through term reverse repo auctions during 2022 with a view to reducing the significant liquidity shortage experienced by certain LCBs. As a result, the liquidity deficit declined as at end December 2022. Meanwhile, from mid-June 2022 the Central Bank conducted outright sales of Treasury bills, as needed, to partially negate the impact of liquidity injections due to primary purchases of Treasury bills by the Central Bank. Market liquidity indicated an asymmetric distribution in 2022, where certain domestic banks, particularly state banks, recorded significant liquidity deficits mainly due to increased borrowings by the Government from the banking sector, while foreign banks recorded a notable liquidity surplus.

Figure 8.16
Factors that affected Daily Changes in Money Market Liquidity



Source: Central Bank of Sri Lanka

Money Market Interest Rates

The Average Weighted Call Money Rate (AWCMR) moved towards the upper bound of the Standing Rate Corridor (SRC) and remained stagnant at SRC. In line with the continued tight monetary policy stance, the Central Bank increased its policy interest rates by a cumulative of 950 basis points in four occasions during 2022, thereby increasing the Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR) to 14.50 per cent and 15.50 per cent, respectively, by end 2022. In response to the tight monetary conditions, AWCMR continued to remain at the upper bound of SRC, thereby

BOX 11
Central Bank Intervention in Addressing Systemic Liquidity Issues during Stress Periods to Ensure Monetary and Financial Stability

Introduction

The Global Financial Crisis (GFC) that emerged mid 2007 caused revived concerns about the need for ensuring financial system stability and a renewed focus on the fundamental role of central banks in managing and preventing systemic crises. In response to the turmoil caused by GFC, central banks around the world used both new and existing tools to supply liquidity to financial institutions and markets extensively. During 2022, the Sri Lankan economy experienced the most severe economic crisis since its independence from the British in 1948. The crisis had an impact on the financial system of the country, increasing the risks and vulnerabilities of the financial system. The domestic money market encountered multidimensional challenges that arose from adverse macroeconomic conditions in the country. Money market liquidity conditions continued to be at deficit levels, while witnessing a significant asymmetry in the distribution of liquidity among market participants due to adherence to stringent counterparty limits. Consequently, market participants excessively resorted to central bank facilities to manage liquidity, requiring an active financial intermediary role from the Central Bank. As such, the Central Bank took remedial measures to exercise its role in providing liquidity through appropriate tools to ensure monetary and financial stability. This article aims to enhance the awareness and understanding of the Central Bank's policy interventions in addressing the systemic liquidity issues during stress periods to ensure monetary and financial stability in Sri Lanka.

Role of the Central Bank in Liquidity Management

The word 'liquidity' has several broader definitions based on the context within which it is used. Generally, three notions of liquidity are relevant to liquidity management. The first is 'market liquidity', which is the ability to trade financial assets on a short notice and without significant losses with a limited impact on market prices. Hence, market liquidity is related to the depth and resilience of the market. The second is 'funding liquidity', which refers to how easily financial institutions raise funds by asset sales or borrowings to make settlement obligations in a timely manner at a market acceptable cost. The third is 'central bank liquidity', which refers to the sum of the reserve balances held with a central bank on a particular day for the purpose of central bank liquidity management. This represents 'aggregate liquidity', i.e., the amount of reserves that the central bank supplies to the banking system for the purpose of monetary operation (Cecchetti and Disyatat 2009).

Liquidity management of the central bank is described as the framework, a set of instruments and tools that are being employed in steering the amount of commercial bank reserves to control short term interest rates. The prime objective of central bank liquidity management is to regulate the level of aggregate reserves in the banking system to assist the realisation of the policy objectives through steering short term interest rates and the continued functioning of the payments system. Hence, central bank liquidity remains an important variable in facilitating the process of monetary policy implementation, as market interest rates and credit creation are closely related to liquidity. However, in a broader perspective, active liquidity management is more or less related to all core functions within the mandate of the central bank in achieving both price and financial system stability. While it plays an important role in the implementation of monetary policy, the smooth functioning of the payments system and safeguarding of financial system stability also remains vital. Accordingly, monetary policy tools of a central bank used in liquidity management aim to curtail the swings in liquidity and price of money (interest rates), which has an impact on the both objectives of the central bank.

Central banks and monetary authorities worldwide have introduced conventional and unconventional policies on liquidity management in response to challenges encountered, in view of safeguarding the financial system. Especially in crisis times, central bank liquidity provision can be positively associated with funding and market liquidity. In its capacity as the final liquidity provider, the central bank supplies liquidity to the banking system in different ways. Amongst them, lending through Open Market Operations (OMOs) is the principal liquidity management tool to manage reserves in the banking system, thereby steering the short term interest rates in normal economic conditions. To provide liquidity on a temporary basis, the central bank engages in transactions with financial institutions whereby the central bank buys government securities, agreeing to resell them back to financial institutions later. Also, to offer liquidity on a permanent basis, the central bank buys securities in the secondary market on an outright basis. As OMOs are conducted through competitive bidding auctions, these auctions are not directed at a specific financial institution. Also, these operations are conducted at the central bank's preference to regulate the aggregate reserve level to ensure the smooth functioning of the payments and settlements system and achieve the target for interbank call market rates in line with the monetary policy stance of the central bank.

Further, central banks also conduct liquidity providing transactions targeted at specific institutions instead of the market as a whole. The standing facility is a typical example of this type of transaction that can take place as and when required by a financial institution based on the availability of the funding liquidity. For example, the Standing Lending Facility (SLF) of the Central Bank of Sri Lanka provides liquidity directly to a particular financial institution to fulfill residual funding needs when conditions in the interbank money market are tightened, or a particular financial institution faces short term funding pressures. Similarly, if a financial institution possesses excess funds at the day end, such excess can be parked at the Central Bank using the Standing Deposit Facility (SDF) and earn an interest income. These tools are considered as the conventional tools that the Central Bank uses in liquidity management. Aside from the use of conventional tools and liquidity facilities, financial crises and market uncertainty induce central banks to expand their toolkits for conducting liquidity operations and supplying central bank liquidity to financial institutions and financial markets.

Liquidity Shortage in the Banking System in Sri Lanka

From September 2021, the banking system gradually experienced a systemic liquidity shortage partly due to foreign loan repayments, uncertainty driven currency withdrawals, and the shortfall developed resulting from the intervention of the Central Bank in the forex market. The Central Bank was compelled to implement unprecedented policy measures during 2022, aimed at restoring macroeconomic balance. To reverse the deteriorating economic outlook, the Central Bank revised policy rates by 700 basis points and introduced subsequent adjustments. However, market liquidity conditions continued to be at deficit levels and started witnessing a systemic liquidity shortage caused by asymmetric liquidity distribution among market participants. As the systemic shortage is an aggregate shortage of liquidity situation, as opposed to institution specific shortages, most banking institutions find it challenging to fulfill the Central Bank liquidity requirement (reserve requirement) simultaneously. Such a market-wide stress situation, together with low activity in the interbank money market, could lead to potential financial and macroeconomic stability implications. As banks play an important role in financing the economy and being a key intermediary in the payments and settlements system of the economy, the failure of one bank to fulfill funding liquidity may potentially cause blockages in the entire payments and settlements system and lead to otherwise preventable failures of financial institutions through possible bank runs. Due to the interconnectivity amongst banks and other financial institutions, there can be contagion and spillover effects that could ultimately have widespread implications on financial system stability and public confidence as well as significant implications on the real economy. Hence, considering prolonged systemic liquidity shortages, which posed a threat to financial instability and the Central Bank's role in preventing and managing a systemic crisis, the Central Bank used a wide range of conventional and unconventional liquidity management tools to ensure both monetary and financial stability.

Usage of Conventional Tools during the Period of Liquidity Stress

The liquidity deficit in the domestic money market, which remained significantly high during the first half of 2022, declined in the latter part of 2022. With a view to reducing significant liquidity stress among banking institutions, the Central Bank expanded liquidity operations and infused liquidity through term reverse repo auctions and allowed financial institutions to access the standing facilities without any limit as a backstop option in managing liquidity needs on a regular basis. The higher volume of market interventions by the Central Bank is not a new practice, as during the COVID 19 pandemic, the Central Bank intervened in the financial markets at an extraordinary size, pace and scope, aiming at injecting sufficient liquidity into the market and lowering borrowing costs, thus supporting financial markets and their recovery.

Accordingly, the Central Bank conducted OMOs extensively and introduced concessional loan schemes by way of accepting a wide array of collaterals (under the Saubagya COVID-19 Renaissance Facility) to provide funding to meet the working capital requirements of businesses affected by the pandemic. However, from the later part of 2022, in spite of the improvements in money market liquidity conditions, market interest rates continued to remain high, partly due to subdued activity in the interbank money markets. At the same time, it has been observed that several Licensed Commercial Banks (LCBs) have continued to depend excessively on the overnight standing facilities under OMOs of the Central Bank, without considering market based funding options to address their funding liquidity needs. Such LCBs have not indicated any signs of taking remedial actions to reduce the over dependency on overnight facilities offered by the Central Bank, which are available to be used as fallback options after utilising all other funding options. Such behaviour of LCBs affects the efforts of the Central Bank to reactivate the money markets, primarily the interbank call money market and the repo market, while posing a threat to the smooth channelling of funds in the economy with a possibility of clogging the payment and settlement systems.

Accordingly, as a part of unprecedented policy measures taken since April 2022 aiming at restoring overall macroeconomic balance, including preserving the stability of the monetary and financial sector and addressing the risks, the Central Bank imposed restrictions on the availability of standing facilities to LCBs under the OMOs. Hence, with effect from 16 January 2023, SDF, the overnight deposit facility that allows LCBs to park excess liquidity and earn interest, was limited to a maximum of five (05) times per calendar month. At the same time, the SLF, which is the collateralised facility provided for LCBs to fulfill any further shortage of the liquidity requirements from the Central Bank at the end of the day, was also be limited to 90 per cent of the Statutory Reserve Requirement (SRR) of each LCB at any given day. As a result of this restriction, daily borrowings of LCBs through SLF declined significantly as LCBs were compelled to take remedial measures to address persistent liquidity issues, while making attempts to raise funds from money markets. Moreover, with restricted SDF to park excess liquidity, the interbank money market started functioning, and reallocations of liquidity from banks with an excess to banks with a deficit were observed. In order to minimise the market disturbance that could arise from such restriction, the Central Bank conducted term reverse repo auctions to provide liquidity to banking institution until initiating the bank internal correction in near term. Further, these measures were instrumental in inducing a moderation in the market interest rate structure (of both retail interest rates and government security yields) along with improving market liquidity conditions and reduction of perceived risk premium which helped to restore the stability of the Sri Lankan economy, while preserving the stability of the financial system.

Unconventional Tools Used under the Liquidity Management Framework

Additionally, to manage possible future financial shocks and their consequences, numerous measures have been taken under the Central Bank liquidity management provision to safeguard the financial system, while attempting to limit the social cost. The Central Bank used both conventional and unconventional policies on an unprecedented scale to mitigate system-wide liquidity risks. As a part of crisis preparedness and to address systemic liquidity stress, the Central Bank designed non-traditional novel liquidity provision tools to supply liquidity to financial institutions and financial markets, under the provision of the Central Bank governing law and certain such facilities are summarised below:

1. Introducing the Liquidity Assistance Facility of the Central Bank

This facility is enabled under existing legal provisions, i.e., Sections 82 and 83 (1) (c) of the Monetary Law Act (MLA), No. 58 of 1949, where banking institutions are entitled to obtain credit as a liquidity assistance facility for any fixed period not exceeding 180 days upon promissory notes secured by the pledging of government securities at the cost of the Average Weighted New Deposit Rate (AWNDR) with a margin. The amount of credit granted under this facility is determined by the Central Bank after an assessment of the liquidity requirement of the loan requested bank. With this facility, banks have the opportunity to obtain liquidity for a longer tenure than in the OMOs at a relatively competitive price. The facility avail to address the system-wide liquidity stress and to minimise the effect on banking institutions. Hence, this facility is an effective way of dealing with the stigma[1] associated with the emergency liquidity assistance facility.

[1] This refers to a financial institution's hesitance to use the central bank facility, expecting that it may send a negative signal about their financial health

2. Strengthening the Emergency Liquidity Assistance (ELA) Facility and its Operational Framework

As a part of the policy toolkit to prepare for the possible systemic risk of the banking sector, the Central Bank strengthened the ELA framework. As per Section 86 of the MLA, in periods of emergency or of imminent financial panic, which directly threaten monetary and banking stability, the Central Bank is allowed to grant extraordinary loans or advances to banking institutions. Accordingly, ELA is an extraordinary loan or advance that the Central Bank uses to provide liquidity to address idiosyncratic (institutional specific) shocks that affect one or a few individual banking institutions. The principal objective of ELA is to avoid the risk that temporary illiquidity leads to insolvency and to mitigate the contagion and spillover effects. When a banking institution faces difficulties in fulfilling funding liquidity, it may lead to a failure of banking institutions. Hence, apart from conducting liquidity management provisions to steer short term interest rates under monetary policy, the Central Bank facilitates ELA to banking institutions as an exceptional means of providing central bank liquidity for banking institutions facing temporary liquidity issues. Accordingly, under the above legal provisions, any banking institution that is considered to be solvent but is facing a temporary illiquid position, is entitled to the ELA facility against a wide array of collaterals at the discretion of the Central Bank to strengthen its liquidity position. This facility is available at a fixed interest rate, generally referred to as the Bank Rate, which is determined using AWNDR, with a margin, at present. Accordingly, this facility is granted to a banking institution using a unique ability to create liquidity in the form of central bank reserves and as a core responsibility of central banks being a Lender of Last Resort (LOLR). Further, banking institutions shall ensure adherence to strict conditions in terms of banking operations, which leads to reduced moral hazards and protects the central bank from losses that could compromise its independence or interfere with its ability to undertake monetary policy.[2]

By providing the above liquidity facilities, the Central Bank indicates its willingness and ability to act decisively in the event of a financial distress and to eliminate possible vulnerabilities that threaten the solvency of the financial system in advance. It restores system-wide confidence among the financial market participants and avoids the fire sales of assets and preserves functionality of the financial system as a whole.

Conclusion

Central bank liquidity management activities are related to all essential functions within the central bank mandate. It creates an important pillar for the transmission of monetary policy, the smooth functioning of the payments and settlements system and for protecting financial system stability. Without any doubt, in ensuring financial system stability, the central bank liquidity provision played a vital role in responding to the liquidity crisis faced by the country during its worst economic crisis since independence. In managing unprecedented challenges to the banking and financial system, the Central Bank is compelled to utilise innovative tools to prevent potential liquidity stress depending on domestic money market conditions. In this context, conventional and standard liquidity management tools ensure steering short term interest rates at a level in line with the monetary policy stance, to achieve the objective of price stability. Further, the Central Bank uses unconventional liquidity management tools effectively and in a timely manner to stabilise financial markets alleviating possible significant systemic risks, even in extremely tight liquidity conditions without a significant impact on the strength of the balance sheet of the Central Bank.

[2] In this context, potential moral hazard arises if the banking institution is tempted to ignore the effective use of allocated funds in their daily liquidity management operations.

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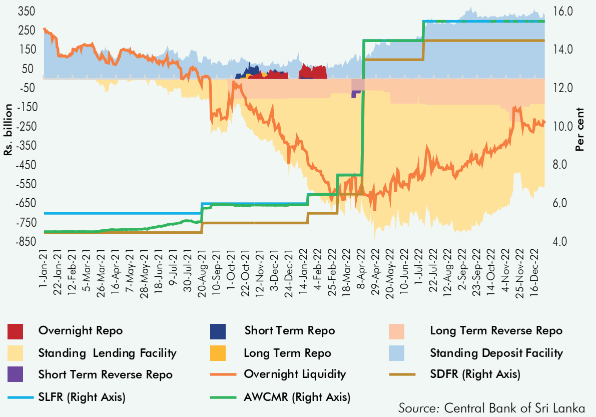
Figure 8.17
Open Market Operations Auctions,Standing Facility, Standing Rate Corridor and Average Weighted Call Money Market Rate



Source: Central Bank of Sri Lanka

recording 15.50 per cent as at end December 2022. As the policy interest rates were raised by a further 100 basis points in the first quarter of 2023, AWCMR also adjusted upwards by a similar magnitude. Although AWCMR hovered at the upper bound of SRC, the call money market remained less active since mid-April 2022. With the stringent counterparty limits imposed by market participants amidst increased uncertainty in the markets, particularly on account of the speculation on fiscal sector developments, transactions in the overnight call money market were substantially low compared to the first few months of the year. The Average Weighted Repo Rate (AWRR) also moved broadly in line with the movements of AWCMR and remained at 15.50 per cent as at end December 2022. Meanwhile, Participating Institutions (PIs) continued to rely on the facilities provided by the Central Bank to borrow funds through the Standing Lending Facility (SLF) or deposit excess funds at the Standing Deposit Facility (SDF). PIs with high liquidity shortage continued to depend excessively on the overnight facility of the Central Bank ignoring market-based funding options to address their structural liquidity needs. Such behaviour, particularly of LCBs affected active money market transactions and the effectiveness of monetary policy measures taken by the Central Bank. Hence, with effect from 16 January 2023, SDF, the overnight deposit facility that allows LCBs to park excess liquidity and earn interest, was limited to a maximum of 5 times per calendar month. At the same time, SLF, the facility provided for LCBs to fulfill any further shortage of the liquidity requirements from the Central Bank at the end of the day on overnight basis, was also limited to 90 per cent of the Statutory Reserve Requirement (SRR) of each LCB at any given day. With the imposition of restrictions and measures adopted by LCBs to rectify liquidity issues, an activation of the money market was observed along with the improvements in the liquidity levels in the banking sector.

Table 8.18
Summary of Money Market Transactions and Open Market Operations

Transactions	Volume (Rs.bn)		Weighted Average Interest Rate (Min-Max) (%)	
	2021	2022	2021	2022
Market				
Call Money (Overnight)	7,935	3,746	4.53 - 5.97	5.94 - 15.50
Repo (Overnight)	3,533	1,568	4.55 - 6.00	5.95 - 15.50
Open Market Operations				
Overnight Basis				
Repo	1,183	1,533	5.71 - 5.99	5.96 - 6.49
Reverse Repo	-	-	-	-
Liquidity Support Facility (a)	-	-	-	-
Short Term Basis				
Repo	423	22	5.96 - 5.99	5.95 - 6.49
Reverse Repo	-	235	-	7.50
Liquidity Support Facility (a)	-	-	-	-
Long Term Basis				
Repo	60	-	6.04 - 6.05	-
Reverse Repo	204	955	6.13 - 7.20	7.73 - 33.07
Liquidity Support Facility (a)	-	-	-	-
Outright Basis				
Purchase of T-bills	-	-	-	-
Purchase of T-bonds	-	-	-	-
Sale of T-bills	14	24	7.00-7.23	20.75 - 26.97
Sale of T-bonds	-	-	-	-
Standing Facility (at Policy Interest Rates)				
Standing Deposit Facility	29,450	54,528	5.00 (b)	14.50 (b)
Standing Lending Facility	30,095	163,058	6.00 (b)	15.50 (b)

(a) Liquidity Support Facility is a reverse repo auction available for Standalone Primary Dealers under Open Market Operations.
(b) End year rates

Source: Central Bank of Sri Lanka

Domestic Foreign Exchange Market

In 2022, the Sri Lanka rupee depreciated significantly against the US dollar by 44.8 per cent from Rs. 200.43 as at end 2021 to Rs. 363.11 as at end 2022. The exchange rate, which fluctuated between Rs. 200.00 to Rs. 203.00 at the beginning of the year, started to depreciate rapidly after allowing more flexibility on the exchange rate on 07 March 2022. However, the persistent Foreign Exchange (FX) liquidity shortage that prevailed in the domestic FX market since the COVID-19 pandemic, plunged to an unprecedented level in early 2022 with demand for FX amidst challenges in raising foreign funds following continuous sovereign rating downgrades by global rating agencies and lack of FX inflows which resulted in a sharp depletion of usable foreign reserves of the Central Bank. However, the depreciation pressure was largely abated by the announcement of a daily exchange rate guidance to licensed banks with a variation margin as compelled by the FX conditions that prevailed at that time, effective from 13 May 2022. As a result, the exchange rate started to stabilise gradually at around Rs. 363.00 level during the second half of 2022.

The Central Bank was a net seller in the domestic FX market in 2022, similar to 2021. Despite the sharp depletion of foreign reserves, the severe liquidity shortage in the domestic FX market compelled the Central Bank to finance the importation of essential imports. Accordingly, the Central Bank supplied US dollars 2,712 million to the market in 2022. The Central Bank managed the provision of FX mainly with the purchase of US dollars 2,133 million based on the mandatory FX sales requirement imposed on LCBs and National Savings Bank.

However, the liquidity condition in the domestic FX market improved during the latter part of 2022. In addition to the measures taken by the Central Bank, this improvement was led by several initiatives, such as the restrictions imposed on certain imports by the Government, prudent FX liquidity management by banks and reduced demand for FX from State-Owned Business Enterprises (SOBEs) due to rationalising of fuel demand, price adjustment for energy related products and cooking gas, and high cost due to the impact of the depreciation of the exchange rate and domestic market interest rates. Further, a gradual surge in export proceeds conversions was observed in the last few months of 2022 due to the positive sentiments of exchange rate stability in light of the progressive discussions with the IMF. Further, workers' remittances appeared to be increasingly shifting to official channels from curb markets due to initiatives introduced by the Central Bank. In addition, earnings from tourism improved. Accordingly, the supply of FX liquidity through outright interventions to facilitate essential imports by the Central Bank was almost wound up by the end of the year as respective authorities were encouraged to source their FX requirements from the market. Thus, with these developments, incentive schemes offered for workers' remittances and the general public related to FX inflows were terminated in 2022.

The average US dollar buying and selling exchange rates of commercial banks for telegraphic transfers as at end 2022 were Rs. 360.41 and Rs. 371.61, whilst comparative figures as at end 2021 were Rs. 198.50 and Rs. 203.00, respectively. Meanwhile, during 2022, the Sri Lanka rupee depreciated against all major currencies including the sterling pound, the Indian rupee, and the Australian dollar.

During 2022, trading volumes in the domestic foreign exchange inter-bank market decreased by 21.3 per cent compared to that of 2021. In 2022, the total volume of inter-bank foreign exchange transactions amounted to US dollars 9.6 billion, compared to US dollars 12.2 billion in 2021. In line with this development, the average daily volumes in the inter-bank foreign exchange market declined to US dollars 40 million in 2022, from US dollars 50 million in 2021. Further, the total volume of forward transactions during 2022 decreased to US dollars 4.1 billion compared to US dollars 6.3 billion during 2021 and the spot transaction volumes decreased to US dollars 0.8 billion in 2022 compared to US dollars 2.2 billion in 2021.

Government Securities Market

Yield rates of government securities reached historically high levels during mid November 2022 owing to the announcement of the debt standstill by the Government, unprecedented policy rate adjustments, and significantly high deficit financing requirement of the Government, which exerted upward pressure on returns on rupee securities. Weakened investor confidence mainly due to deteriorated socio economic conditions and widespread public unrest coupled with the 700 basis point increase in policy rates on 08 April 2022 caused a sharp upward adjustment in yields of government securities in late April 2022 following a prolonged period of broadly stable and low interest rates, mainly driven by the administrative arrangement of announcing a maximum yield rate of acceptance. Meanwhile, the announcement of the debt standstill on 12 April 2022 and the subsequent build-up of market speculations on the Government's ability to service domestic debt in the foreseeable future coupled with the socio political crisis which continued in the following months, posed a significant challenge to meet the Government's substantive funding requirement. The upward pressure created through the uncertainty made the yields of government securities reach historically high levels with investors factoring in increased risk premia in their investment decisions.

Table 8.19
Yield Rates of Government Securities

Per cent per annum

Item	Primary Market		Secondary Market	
	2021	2022	2021	2022
Treasury bills				
91-Days	4.69 - 8.43	8.26 – 33.14	4.63 - 8.00	7.84 – 31.37
182-Days	4.75 - 8.33	8.30 – 32.53	4.71 - 8.07	8.12 – 30.17
364-Days	4.98 - 8.26	8.39 – 30.50	4.94 - 8.33	8.28 – 28.78
Treasury bonds				
2 Years	6.19 - 9.36	14.41 – 33.01	5.25 - 8.96	8.59 – 28.29
3 Years	6.25 - 9.94	20.30 – 32.63	5.68 - 9.81	9.61 – 28.55
4 Years	6.34 - 8.55	-	6.21 - 10.40	10.33 – 28.33
5 Years	6.72 - 11.14	11.92 – 31.78	6.43 - 11.03	10.65 – 27.60
6 Years	7.44 - 10.90	11.70 – 21.86	6.61 - 11.26	11.04 – 28.02
8 Years	7.16 - 11.63	26.51 – 30.85	6.98 - 11.55	11.38 – 27.83
10 Years	8.86 - 11.91	12.01 – 30.86	7.44 - 11.80	11.64 – 28.51
15 Years	8.44 - 12.06	-	7.76 - 11.85	11.77 – 27.80
20 Years	-	-	7.89 - 11.83	11.72 – 25.34
30 Years	-	-	8.04 - 11.81	11.78 – 22.96

Source: Central Bank of Sri Lanka

The market preference was skewed towards 91-day maturity at the primary auctions of Treasury bills compared to relatively longer 182-day and 364-day maturity Treasury bills. As at end 2022, the yield rates of 91-day, 182-day and 364-day Treasury bills were recorded at 32.64 per cent, 32.20 per cent and 29.27 per cent, compared to 8.16 per cent, 8.33 per cent and 8.24 per cent recorded as at end 2021, respectively. Unlike Treasury bills, market preference was tilted towards relatively longer maturities for Treasury bonds. Given the elevated

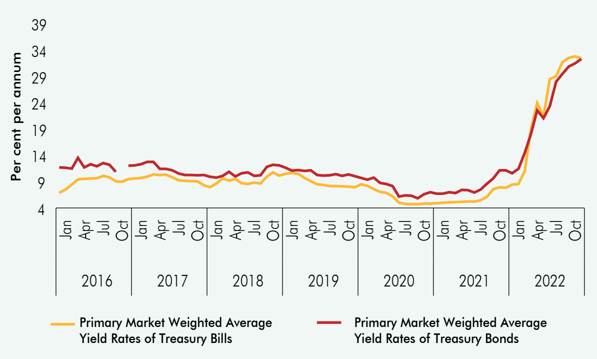
Table 8.20
Primary Market Weighted Average Yield Rates of Treasury Bills

Per cent per annum

Year	Maturity			Annualised Overall Average
	91-days	182-days	364-days	
2018	8.40	8.58	9.68	9.36
2019	8.15	8.44	9.40	9.06
2020	5.93	5.72	6.37	6.09
2021	6.35	6.13	5.33	6.24
2022	23.23	26.85	25.65	23.73

Source: Central Bank of Sri Lanka

Figure 8.18
Primary Market Weighted Average Yield Rates of Treasury Bills and Treasury Bonds (per cent per annum)



Source: Central Bank of Sri Lanka

interest rate structure, Treasury bonds with less than 5-year maturity were considered favourable at primary issuances towards the latter part of the year by the issuer. Treasury bond yield rates hovered above 30 per cent levels as at end 2022 compared to the less than 12 per cent levels that prevailed a year ago, reflecting the significant upward adjustment in the yield rates of government securities during the year. The secondary market yield rates of government securities also broadly followed the yield rate movement observed in the primary market.

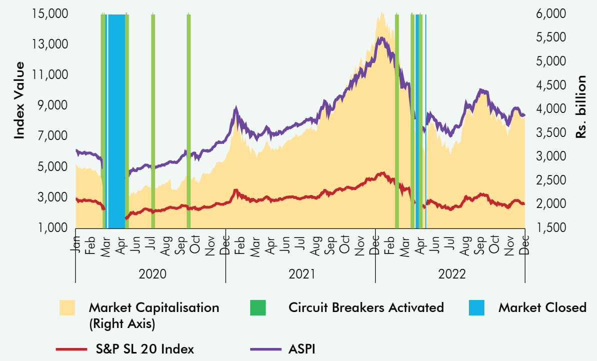
During 2022, Treasury bonds amounting to Rs. 2,373.0 billion were issued at the Weighted Average Yield Rate (WAYR) of 21.29 per cent compared to Rs. 1,762.0 billion Treasury bonds issued at the WAYR of 8.70 per cent in 2021. Moreover, Treasury bills amounting to Rs. 9,942.8 billion were issued in 2022 in gross terms with an overall WAYR of 25.21 per cent compared to Rs. 3,821.4 billion issued with an overall WAYR of 6.09 per cent in 2021[6].

Government funding was confined mainly to domestic sources. However, depicting a positive development, the total net inflow of foreign investments in Treasury bonds and Treasury bills amounted to US dollars 50.6 million during 2022 compared to the net outflow of US dollars 27.3 million in 2021.

Equity Market

The Equity Market recorded a bleak performance in terms of price indices, market capitalisation and daily turnover during 2022 amidst adverse macroeconomic developments. Further, a significant volatility in price indices was observed, and index-based circuit breakers were activated on several occasions. Ongoing economic contraction, high inflation, accelerated moves to raise policy rates domestically and abroad, an anticipated decline in corporate profits due to high tax adjustments, geopolitical tensions, and adverse global economic conditions contributed to the volatility of the equity market. Even though the All Share Price Index (ASPI) recorded the historically highest value of 13,462.4 on 19 January 2022, the indices witnessed a declining trend since early February 2022, reversing its expansionary trend observed during 2021. Accordingly, ASPI and Standard & Poor's Sri Lanka 20 (S&P SL 20) index contracted by 30.6 per cent and 37.7 per cent, respectively, during 2022 while market capitalisation deteriorated by 29.9 per cent and stood at Rs. 3,847.2 billion as at end 2022. Further, market capitalisation as a

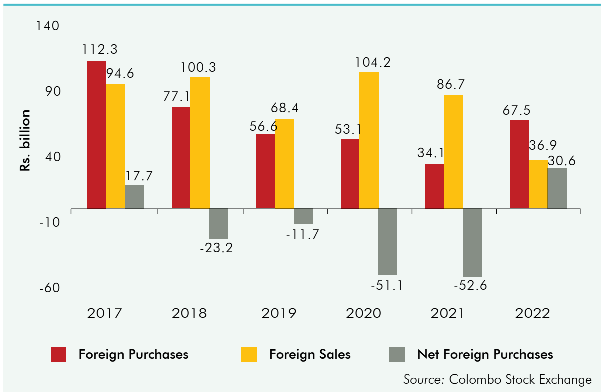
Figure 8.19
Movements of Price Indices and Market Capitalisation



Source: Colombo Stock Exchange

[6] The overall WAYR includes the total average borrowing cost including the cost of administratively instructed issuances.

Figure 8.20
Foreign Participation at the CSE



Source: Colombo Stock Exchange

percentage of GDP declined to 15.9 per cent as at end 2022 compared to 31.2 per cent as at end 2021. Meanwhile, the Colombo Stock Exchange (CSE) recorded an average daily turnover of Rs. 2,972.3 million in 2022, which was a considerable decline compared to Rs.4,888.2 million recorded in 2021.

However, a noticeable improvement in terms of net foreign inflows was observed during 2022 compared to the previous year owing to foreign investment attracted by a few major companies. Accordingly, the market recorded net foreign inflows of Rs. 30.6 billion (approximately US dollars 74.3 million) during 2022 compared to an outflow of Rs. 52.6 billion (approximately US dollars 264.4 million) recorded in 2021. In addition, the quantities of securities held by individuals and institutional foreign investors recorded a year-on-year growth of 4.7 per cent and 5.5 per cent, respectively as at end 2022 compared to the year-on-year growth of 0.3 per cent and 2.6 per cent, recorded as at end 2021. However, quantities of securities held by local individual and institutional investors recorded a year-on-year growth of 7.2 per cent and 15.1 per cent, respectively, as at end 2022, recording a significant decline from the year-on-year growth of 53.3 per cent and 17.8 per cent as at end 2021 with the investor preference shifting towards fixed income investments with relatively higher interest rates during 2022.

The market valuation indicators recorded a significant setback during 2022. The Price to Earnings Ratio (PER) and Price to Book Value (PBV) significantly decreased to 4.9 and 0.9 times, respectively, as at end 2022 compared to PER of 13.6 times and PBV of 1.7 times remained as at end 2021. Meanwhile, there were 4 new equity Initial Public Offerings (IPOs) that raised Rs. 4.8 billion in 2022, which is a considerable decline compared to Rs. 12.7 billion raised with 13 IPOs in 2021.

Corporate Debt Securities Market

The Commercial Paper (CP) market was relatively inactive in 2022 compared to 2021. During 2022, only Rs. 2.0 billion was raised through CPs issued with the support of licensed banks compared to Rs. 5.8 billion raised through issues in 2021. The interest rates of CPs varied between 11.00 and 36.00 per cent during 2022 compared to the range of 6.00 to 12.00 per cent reported in the previous year.

Activities of the corporate debenture market recorded a significant setback during 2022 compared to 2021 due to the high interest rates and adverse economic conditions. During 2022, there were only 10 IPOs of corporate debentures issued by 4 companies in the CSE, which raised Rs. 12.7 billion compared to Rs. 84.4 billion raised in 2021 through 27 IPOs by 14 companies. Debentures with both fixed and floating interest rates were issued during 2022, while the fixed interest rates ranged from 15.42 to 28.00 per cent compared to the range of 8.00 to 12.00 per cent in the previous year.

8.5 Development Finance and Access to Finance

During 2022, the Central Bank continued to coordinate, facilitate, and implement various refinance, interest subsidy, and credit guarantee

schemes, with the intention of granting affordable financial facilities for Micro, Small and Medium Enterprises (MSMEs) and individuals, while providing a range of credit supplementary services. Accordingly, the total amount of loans disbursed during 2022 was Rs. 17,244.4 million among 63,202 beneficiaries through Participating Financial Institutions (PFIs) under 17 refinance loan schemes which accounted for 57.6 per cent and 5 interest subsidy and credit guarantee schemes which accounted for 42.4 per cent.

The Central Bank continued to implement proactive measures to align loan schemes operated by the Central Bank during 2022. Considering adverse economic conditions and the significant increase in market interest rates, the interest rate of the Saubagya (Prosperity) loan scheme was revised upwards from 6.00 per cent to 9.00 per cent during the year. Further, PFIs were instructed to ensure granting 80 per cent of new loans to sectors such as agriculture, livestock, fisheries and related activities considering a possible food shortage. In addition, debt moratoria were granted under the loan schemes operated by the Central Bank to support businesses that were severely affected by the current economic situation. Further, operating instructions of the New Comprehensive Rural Credit Scheme (NCRCS) were amended to revise the applicable interest rates and scale of finance considering the prevailing economic conditions in the country and the government policy to encourage agriculture activities to ensure food security, reducing the foreign exchange outflow on food imports, making people more inclined towards agricultural products and uplifting the socio-economic conditions of small scale farmers.

Moreover, the Central Bank continued to monitor the implementation of the National Financial Inclusion Strategy (NFIS) aligning with its action plan to ensure achieving the set targets. Out of the 82 broad actions of the NFIS Action Plan, approximately 24 per cent was completed while other actions are in progress with the collaboration of key implementing entities. The first ever island wide financial literacy survey was successfully completed with the assistance of the International Finance Corporation (IFC) to understand the current state of financial literacy across the population. The key survey findings were made available for public access through the Central Bank website. A consultative mission was conducted to obtain technical assistance from the World Bank in developing a Roadmap for financial literacy and capacity building. Further, actions were initiated to conduct a survey to identify the potentials and barriers in the SME (Small and Medium Enterprises) sector with the aim of promoting SMEs to tap the export market.

With the objective of enhancing financial literacy, the Central Bank initiated several programmes during the year with the support of its six Regional Offices. Accordingly, Training of Trainers (TOT) discussions, Radio and TV programmes, a knowledge sharing programme, and a large number of financial literacy, entrepreneurship, capacity building and skill development programmes were conducted in 2022.

8.6 Financial Infrastructure

Payment and Settlement Systems

Payment and settlement systems of the country operated smoothly and efficiently during 2022 with increased adoption of digital transactions by both the general public and payment service providers. During the first half of 2022, where there was social unrest due to power cuts and shortages of major commodities, the Central Bank implemented measures such as activating its Business Continuity Plan (BCP)

Table 8.21
Performance of the Payment Systems and Instruments - Volume of Transactions

Payment System/ Instrument	2018 ('000)	2021 ('000)	2022 (a) ('000)	Growth % 2018-22	Growth % 2021-22
Large Value Payment System					
Real Time Gross Settlement (RTGS) System	405.2	449.8	638.7	57.6	42.0
Retail Value Payment Systems / Instruments					
Cheque Imaging and Truncation System (CITS)	50,352.2	33,021.2	33,049.6	-34.4	0.1
Sri Lanka Interbank Payment System (SLIPS) (online fund transfers)	32,943.3	41,867.7	45,536.4	38.2	8.8
Common ATM Switch (CAS)	40,464.4	58,210.5	84,141.2	107.9	44.5
Common Electronic Fund Transfer Switch (CEFTS) (online real-time fund transfers)	7,233.6	54,675.5	91,782.0	1,168.8	67.9
Of which;					
LankaPay Online Payment Platform (LPOPP)	15.4	514.0	891.7	5,690.3	73.5
Mobile phone based low value payments (JustPay)	45.6	9,014.7	14,512.4	31,725.4	61.0
LANKAQR*	-	848.9 (b)	599.5	-	-29.4
Credit Cards transactions carried out online and at POS terminals	43,599.8	50,689.1	59,843.5	37.3	18.1
Debit Card transactions carried out at POS terminals	56,595.1	108,039.7	146,478.9	158.8	35.6

*LANKAQR was implemented in 2018 and data is available from the year 2020.

Source: Central Bank of Sri Lanka

(a) Provisional
(b) Revised

including Work From Home (WFH) arrangements for its employees, in order to ensure continuous, efficient and secure operations of the national payment and settlement infrastructure, to facilitate economic activities and to serve the general public.

The systemically important large value payment and settlement system, the LankaSettle, comprising of the Real Time Gross Settlement (RTGS) System and the LankaSecure System, operated with high availability and resilience despite disruptions such as power cuts in 2022. The volume of RTGS transactions increased by 42 per cent during the period under consideration, while the value of the total transactions settled via the RTGS System increased by 181 per cent, from Rs. 295 trillion in 2021 to Rs. 827 trillion in 2022, owing mainly to the increase in the volume of SDF and SLF transactions that took place during 2022. Moreover, PIs utilised an average daily Intra-Day Liquidity Facility (ILF)[7] amounting to Rs. 658.5 billion during 2022 compared to Rs. 208.5 billion in 2021, indicating a shortage of liquidity in domestic financial markets. Further, in 2022, the National Savings Bank became the first LSB to obtain the participant status of LankaSettle, enabling it to actively transact in the financial market.

The LankaSecure system continued to support all government securities related transactions during 2022. The aggregate of Scripless Securities held in LankaSecure as at end 2022 was Rs.12,848.5 billion (Face Value) comprising Treasury bills and Treasury bonds valued at Rs. 4,126.4 billion and Rs. 8,722.1 billion, respectively. The Scripless Securities Settlement System of LankaSecure facilitated transactions amounting to Rs. 1,028.6 trillion during 2022[8] in comparison to Rs. 262.8 trillion in 2021.

The retail digital payments in the country recorded strong growth with the public increasingly adopting digital payment methods. Common Electronic Fund Transfer Switch (CEFTS) which enables real time retail fund transfers through multiple payment channels, significantly contributed to the popularity of digital payments in Sri Lanka. During 2022, CEFTS transaction volume grew by 67.9 per cent to 91.8 million from 54.7 million, while the value of CEFTS transactions grew by 80.3 per cent to Rs. 8,881.3 billion from Rs. 4,926.6 billion.

CEFTS forms the technological foundation for several innovations within the payment infrastructure, such as the LankaPay Online

[7] The Central Bank provides interest free ILF to ensure that LankaSettle transactions are settled smoothly during the business day.

[8] LankaSecure system settles all government securities related transactions including transactions of primary issuances, secondary market trades (outright, repurchase transactions, pledge transactions), Open Market Operations, Intra-Day Liquidity Facility, etc.

Table 8.22
Performance of the Payment Systems and Instruments - Value of Transactions

Payment System/ Instrument	2018 (Rs.bn)	2021 (Rs.bn)	2022 (a) (Rs.bn)	Growth %	Growth %
				2018-22	2021-22
Large Value Payment System					
Real Time Gross Settlement (RTGS) System	100,473.1	294,602.0	827,105.1	723.2	180.8
Retail Value Payment Systems / Instruments					
Cheque Imaging and Truncation System (CITS)	10,528.4	8,311.5	9,813.8	-6.8	18.1
Sri Lanka Interbank Payment System (SLIPS) (online fund transfers)	1,972.2	2,862.2	3,368.4	70.8	17.7
Common ATM Switch (CAS)	344.6	671.0	1,012.9	193.9	51.0
Common Electronic Fund Transfer Switch (CEFTS) (online real-time fund transfers)	660.3	4,926.6	8,881.3	1,245.0	80.3
Of which;					
LankaPay Online Payment Platform (LPOPP)	12.5	198.2	498.3	3,886.4	151.4
Mobile phone based low value payments (JustPay)	0.1	34.6	67.8	67,700.0	96.0
LANKAQR*	-	1.9	2.0	-	5.3
Credit Cards transactions carried out online and at POS terminals	241.8	282.6	401.5	66.0	42.1
Debit Card transactions carried out at POS terminals	158.7	315.9	528.9	233.3	67.4

*LANKAQR was implemented in 2018 and data is available from the year 2020.
(a) Provisional

Source: Central Bank of Sri Lanka

Payment Platform (LPOPP), LANKAQR, JustPay, and numerous Mobile Payment Applications. During 2022, LPOPP, which enables the public to make payments to government institutions, such as Inland Revenue Department, Sri Lanka Customs directly from their CASA, recorded a significant increase in terms of the volume and value of transactions by 73.5 per cent and 151.4 per cent respectively, showing an increasing trend in Government institutions shifting towards digital payments. Even though a significant increase in LANKAQR transactions was observed during the previous year, a slight decline in transaction volume was observed during the first three quarters of 2022 indicating a need to increase awareness of both customers and merchants on QR payments. Further, LankaPay (Pvt) Ltd launched a mobile remittance application, 'LankaRemit' in 2022, in collaboration with the Central Bank, which enables migrant workers to remit money to Sri Lanka and pay utility bills through payment cards issued overseas.

The Sri Lanka Interbank Payment System (SLIPS), which facilitates small value bulk fund transfers such as payments of pensions and salaries, as well as other retail value payments that are scheduled or settled on the same day basis, continued to record a moderate growth in terms of the value and volume of transactions. Accordingly, SLIPS facilitated transactions amounting to Rs. 3,368.4 billion during 2022, which is a growth of 17.7 per cent compared to 2021.

During 2022, the volume of credit and debit card transactions increased by 18.1 per cent and 35.6 per cent to 59.9 million and 146.5 million, respectively, and the value of credit and debit card transactions grew by 42.1 per cent and 67.4 per cent to Rs. 401.5 billion and Rs. 528.9 billion, respectively. The increase is mainly due to the increase in transactions in e-commerce, mobile payments, and internet banking.

The Cheque Imaging and Truncation System (CITS) is the interbank cheque clearing system of Sri Lanka, which clears the interbank cheque payments settled on the next business day basis using cheque images, recorded a declining trend, in terms of both volume and value of cheques cleared in the recent years. However, the value of the cheques recorded an 18.1 per cent growth during 2022 compared to 2021 mainly due to businesses being unable to successfully operate with travel restrictions imposed by the Government in view of the COVID-19 pandemic, and the subsequent lifting of travel restrictions in 2022.

In 2022, the Common ATM Switch (CAS), which enables cash withdrawals and balance inquiries from any ATM connected to the

LankaPay CAS network, showed an increase in the CAS transaction volume by 44.5 per cent to 84.1 million, and value by 51.0 per cent to Rs. 1,012.9 billion. As at end 2022, 30 financial institutions were integrated with the CAS network. Meanwhile, the Shared ATM Switch, which was launched in 2015 to provide services to financial institutions, which do not have the capacity to operate their own card management system, had 3 members and continued its operations smoothly during 2022.

The Central Bank continued its regulatory and supervisory activities related to payment and settlement systems, in terms of the Payment and Settlement Systems Act, No. 28 of 2005 and related regulations. Accordingly, on-site supervision and off-site surveillance were carried out to ensure the smooth functioning of the services of Payment Cards and Mobile Payment Systems. Further, the Central Bank continued to monitor the compliance of the Mobile Payment Application Providers, to minimise any risks associated with mobile payment applications in conducting financial transactions. In addition, the Central Bank continued to monitor the BCP and Disaster Recovery (DR) arrangements of LankaSettle participants by reviewing their BCP reports and visiting their DR sites in order to ensure continuation of payment services with proper contingency planning.

The National Payments Council (NPC)[9] played a vital role in several initiatives during the period by promoting secure digital transactions by upgrading payment cards to EMV[10] standards, enabling customers to receive real time notifications and increasing customer awareness on new digital payment methods and payment related scams. Additionally, the NPC monitored the Payment System Roadmap 2022-2024 to develop the payment system infrastructure in the country and several NPC appointed committees conducted studies related to payment and settlement systems such as new payment technologies, secured digital transactions and increasing customer awareness on digital payment methods. This included conducting a survey relating to levels of public awareness on financial scams using digital methods. The findings resulted in the Central Bank and financial institutions continuing broad awareness campaigns to safeguard customers.

Anti-Money Laundering and Countering the Financing of Terrorism

During 2022, the Finance Intelligence Unit (FIU) continued to perform its core functions in line with the international standards on Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) amidst the economic crisis that prevailed in the country. During the year, FIU received 1,481 Suspicious Transaction Reports (STRs) from Reporting Institutions (RIs), and the general public. After analyses, 419 STRs were referred to relevant Law Enforcement Agencies (LEAs), and Regulatory Authorities (RAs) for further investigation or regulatory actions. Meanwhile, 605 STRs were kept under surveillance, and 134 STRs were subjected to further study. The remaining STRs were categorised as no further action is required. Further, in terms of Section 6 of the Financial Transactions Reporting Act No. 6 of 2006 (FTRA), FIU received 7.6 million (provisional) Cash Transactions and 10.8 million (provisional) Electronic Fund Transfers (EFTs-inward and outward) of those exceeding the reporting threshold of Rs. 1.0 million or its equivalent in any foreign currency from the RIs, during the year 2022.

[9] Comprising representatives from licensed banks and finance companies, LankaPay (Pvt) Ltd, Securities and Exchange Commission of Sri Lanka, Colombo Stock Exchange, Sri Lanka Banks' Association, Sri Lanka Forex Association, Primary Dealer Association, Lanka Financial Services Bureau Ltd, Credit Information Bureau of Sri Lanka, Ministry of Finance and the Operators of mobile phone based e-money systems.

[10] EMV is a global technology standard for chip-based debit and credit card transactions to increase security and interoperability of card transactions. EMV stands for Europay, Mastercard and Visa, the 3 companies that initially created the standard.

In order to ensure institutional compliance with the AML/CFT requirements set out in the FTRA, Customer Due Diligence (CDD) Rules on Financial Institutions (FIs) and Designated Non-Finance Businesses and Professions (DNFBPs), and Regulations issued under the FTRA, FIU continued to conduct risk based AML/CFT supervision on FIs and DNFBPs during the year 2022. Accordingly, 03 risk based on site examinations, 22 joint risk-based onsite examinations and 22 offsite/onsite spot examinations were conducted to assess AML/ CFT compliance of RIs. Furthermore, five thematic reviews were also conducted on FIs and DNFBPs. Based on the examinations conducted in 2022, financial penalties amounting to Rs. 11.75 million were imposed on 6 licensed banks on violations of the FTRA and CDD Rules. Also, 8 show cause letters and 9 warning letters were issued during the year to FIs on non-compliances with the provisions of the FTRA and the CDD Rules and Regulations issued thereunder. The AML/CFT supervision of DNFBPs was further strengthened by implementing measures that continued to enhance AML/CFT compliance.

During the year 2022, FIU took various actions to bring legislative amendments to the legal framework on AML/CFT to improve the effectiveness of the AML/CFT regime of the country in compliance with international AML/ CFT standards. Furthermore, FIU continued the conduct of National Risk Assessment (NRA) on Money Laundering/ Terrorist Financing (ML/TF) with technical assistance from the World Bank, in compliance with Recommendation 1 of the Financial Action Task Force Recommendations. The outcome of the NRA is expected to be published in the first half of 2023. In addition, FIU initiated various steps to enhance the awareness among all stakeholders involved. In order to strengthen the AML/ CFT supervision process and institutional compliance, FIU issued several circulars and conducted awareness programmes during the year 2022.

Legal Reforms Related to the Financial Sector

During 2022, the Central Bank with the assistance of various stakeholders including the Ministry of Finance, Attorney General's Department, Legal Draftsman's Department, IMF, and World Bank, was engaged in the drafting of the Central Bank of Sri Lanka Bill (CBSL Bill), which was gazetted on 01 November 2019 as a prior action of the IMF programme. The CBSL Bill captures new areas in central banking in association with such relevant stakeholders. The CBSL Bill also includes provisions for the autonomy of the Central Bank with enhanced governance standards, advanced Board structure to secure the objects thereof, enhanced regulatory and supervisory powers. Once enacted, the CBSL Bill will replace the MLA.

In addition, the Central Bank was engaged in drafting several laws which are expected to contribute to enhancing the stability of the financial system during 2022. The new laws include Trading, Clearing and Netting Act, the Banking (Special Provisions) Act, and the Microfinance and Credit Regulatory Authority Act which would enhance the regulatory, supervisory, and resolution framework of the Central Bank. In addition, the Central Bank is in the process of introducing amendments to the Finance Business Act, No. 42 of 2011, Finance Leasing Act, No. 56 of 2000, Foreign Exchange Act, No. 12 of 2017 and Payment and Settlement Systems Act, No. 28 of 2005, with a view to enhancing the regulatory and supervisory authority of the Central Bank in order to address various challenges arising from market developments in the country.

Financial Consumer Protection

The Central Bank continued to strengthen the financial consumer protection in the context of the entities regulated by the Central Bank during 2022. During the year, the Central Bank

BOX 12
Financial Consumer Protection Framework: A Way Forward

Introduction

The level of financial literacy among the population and strength of consumer protection frameworks in place are two integral components that determine financial inclusion, which remains a key ingredient in the sustainable development of a country. Continuous technological advances, increasing complexity of financial services, and growing competition among market participants have compelled financial regulators to place greater emphasis on consumer awareness and sufficiency of the consumer protection framework. As evident, the Global Financial Crisis that preceded us exposed, among other things, the shortcomings in this important area. This exhibited the need for a more robust consumer protection framework, which could contribute to maintaining public confidence, a necessary ingredient for ensuring financial system stability during a crisis. On the contrary, it is widely accepted that a sound financial consumer protection framework effectively facilitates anticipation, identification, and resolution of issues related to consumer protection in a timely manner, minimising any impact on financial system stability.

In this context, being the apex institution in the financial market in the country, the Central Bank of Sri Lanka (CBSL) undertook several initiatives and coordinated efforts through the entities it regulates to increase the level of financial inclusion and financial consumer protection in the country. Consequently, having recognised the limitations of the current consumer protection framework and developments taking place in the rest of the world, CBSL launched an initiative to strengthen the financial consumer protection framework with the engagement of all stakeholders.

Current Financial Consumer Protection Framework of CBSL

The financial sector in Sri Lanka is diverse, with a range of financial service providers subject to different regulatory regimes under different laws and regulations. As the CBSL regulated entities accounts for about 70 per cent of financial sector assets in Sri Lanka, the regulatory measures that will be taken by CBSL in this area are expected to create a significant and lasting impact on the wellbeing of both the financial consumers and overall financial system of the country. Over the years, regulatory departments of CBSL have initiated several actions to strengthen the financial consumer protection framework applicable to entities under their purview. For example, for the first time the Banking Act Directions No. 08 of 2011 on the Customer Charter of Licensed Banks set out a code of conduct that all licensed banks must follow, aimed at fostering a healthy relationship between financial consumers and licensed banks. The Directions list regulatory expectations regarding the introduction and promotion of banking products and services to financial consumers, the implementation of a complaint handling mechanism at the banks level, raising awareness and promoting understanding of the terms and conditions of banking products and services, providing protection from agents of banks and special attention and care for the financial consumers with special needs. Further, the Finance Business Act Directions No. 01 of 2018 and Finance Leasing Act Directions No. 01 of 2018 outline the financial consumer protection framework for Licensed Finance Companies and Specialised Leasing Companies that ensure the protection of the rights and interests of their financial consumers. The directions specify the minimum standards on financial consumer protection in the areas of disclosure and transparency, consumer education and awareness, responsible business conduct, complaint handling and redress, equitable and fair treatment, and consumer data and privacy protection. These guidelines cover transactions related to savings, lending, and other consumer related activities as well. Similarly, Primary Dealers in government securities are also required to adhere to a customer charter issued in 2013 under the Local Treasury Bills Ordinance, No. 08 of 1923 and the Registered Stock and Securities Ordinance, No. 07 of 1937. All these initiatives set a fairly solid base for the financial institutions to ensure that consumers are able to make informed decisions and have access to transparent and fair financial services.

Nevertheless, the fragmented approach of existing frameworks of CBSL has created incompatibilities and complexities, hindering the achievement of the overall objective of consumer protection. Thus, CBSL took a policy decision to introduce an integrated and comprehensive financial consumer framework aimed at strengthening the financial consumer protection framework that applies to the entities under its regulation. As a first step in this direction, and in accordance with the decision made by the Monetary Board of CBSL, the Financial Consumer Relations Department (FCRD) was established as a separate department within the CBSL in August 2020. At present, FCRD is working on issuing and implementing a new comprehensive financial consumer protection framework for entities regulated by CBSL as the medium term target, while serving as the single point of contact for receiving and disseminating all external complaints and grievances directed to CBSL by financial consumers of institutions regulated by CBSL.

New Regulations on Financial Consumer Protection

CBSL with the technical support of IFC and World Bank developed draft Regulations, which are to be issued mid-2023 in terms of Section 10 of the Monetary Law Act, No. 58 of 1949. The draft Regulations were made available for public and industry for observations/ consultations in order to make the drafting process transparent and facilitate stakeholder engagement. The proposed regulations have been prepared to cover all entities currently regulated by CBSL, namely Licensed Commercial Banks, Licensed Specialised Banks, Licensed Finance Companies, Specialised Leasing Companies, Money Brokers, and Participants of Payment and Settlement Systems, encompassing the existing consumer protection principles, rules, as well as current practices and possible near-term developments in the consumer protection areas. Due consideration was given to the following directions/areas under these draft regulations:

a. Banking Act Directions No. 08 of 2011 on the Customer Charter of licensed banks.

b. Finance Business Act Directions No. 01 of 2018 and Finance Leasing Act Directions No. 01 of 2018 on the financial customer protection framework for Licensed Finance Companies and Specialised Leasing Companies.

c. Best practices and regulations on consumer protection of other jurisdictions.

d. Current issues of financial consumers and gaps/ trends identified by CBSL in relation to consumer protection activities in Sri Lanka.

Accordingly, the draft regulations include the following key areas required for an effective consumer protection framework for entities regulated by CBSL, with the necessary empowerment for CBSL to implement these regulations and closely supervise these entities:

a. Powers, Supervisory Actions of CBSL and Governance by Financial Service Providers

b. Disclosure, Transparency, and Accessibility Procedures

c. Responsible Business Conduct, Complaints Handling, and Redress Mechanism

d. Competitive Environment and Protection of Consumer's Assets and Information

e. Fair and Equitable Treatment for Consumers, Financial Education, and Awareness

These regulations will specially empower CBSL to examine the books, records, accounts, documents, information, and other supervisory activities of CBSL-regulated entities, allowing for effective monitoring of consumer protection and market conduct. Further, these proposed regulations will provide the basis for the market conduct supervision of CBSL-regulated entities as well as enforcement of regulatory actions, enabling the Monetary Board of CBSL to take regulatory actions for market misconduct that affects the financial consumers, the market, or the financial system. Furthermore, these regulations will streamline the two tiered complaint handling procedure of both financial institutions and CBSL and empower CBSL to make binding determinations to financial institutions as one of the out-of-court settlements for valid complaints made by financial consumers. Overall, these regulations will strengthen the current financial consumer protection frameworks of CBSL, particularly Banking Act Directions No. 08 of 2011, Finance Business Act Directions No. 01 of 2018, and Finance Leasing Act Directions No. 01 of 2018, in line with international standards and establish the foundation for market conduct supervision by CBSL facilitating the development of a trusted and stable financial system in Sri Lanka, instilling confidence of financial consumers.

Challenges and Way Forward

Implementing an integrated financial consumer protection framework that caters to a diverse set of financial service providers is a daunting task to the financial institutions as well as to the CBSL given the vast differences in terms of size, scope, product and services, and consumer segments. In this regard, most of the large financial entities have already improved their business operations and practices to a great extent to meet the standards expected by the new regulations. However, there could be a number of entities that require significant changes to their existing policies, procedures, operations, resources, infrastructure and systems in order to comply with the requirements of the new regulations. It is expected that such entities would adhere to the regulations within the transitory period offered for the implementation timelines.

received 5,149 complaints and grievances with the majority being related to requests for concessions on the financing facilities obtained from such entities, charging of high interest rates, matters relating to moratoria, non-provision of information/ documents requested and charging of high fees and commissions. The Central Bank was able to conclude around 75 per cent of valid complaints and grievances of financial consumers received during the year under review.

A comprehensive set of new regulations was developed by the Central Bank, enabling the introduction of an integrated financial consumer protection framework for entities regulated by the Central Bank. These regulations are expected to define specific regulatory powers for supervisors to facilitate market conduct supervision while providing clarity to both service providers and recipients on the areas to be considered in delivering or obtaining financial services. Draft Regulations were made available to the industry and public for stakeholder consultation, and the final regulations are expected to be effective in mid-2023. In addition, the Central Bank, with the assistance of the IFC is in the process of developing a media campaign on financial consumer awareness, which is to be launched in early 2023.

Deposit Insurance, Resolution Actions and Investigation over Prohibited Schemes

The Central Bank continued to manage the Sri Lanka Deposit Insurance and Liquidity Support Scheme (SLDILSS) to ensure the maintenance of financial system stability. The payment of compensation to the insured depositors of finance companies of whose licenses were cancelled/suspended, namely Central Investments and Finance PLC, The Standard Credit Finance Ltd., TKS Finance Ltd., The Finance Company PLC Swarnamahal Financial Services PLC, and ETI Finance Ltd. continued during the year. Accordingly, SLDILSS paid Rs. 30,499.24 million to 72,641 depositors upto 2022. The quantum of compensation paid was 86.57 per cent of the total insured value of Rs. 35,229.22 million.

The Central Bank took initiatives to strengthen the legal framework of the existing deposit insurance mechanism of the country by introducing suitable provisions in the proposed Banking (Special Provisions) Act. This draft law also includes provisions aimed at strengthening the legal framework for resolution for licensed banks as well as Non-Bank Financial Institutions licensed, regulated and supervised by Central Bank. Considering that the draft law addresses many facets hitherto unknown to Sri Lanka's legal infrastructure, the expertise and technical inputs provided by the IMF and World Bank became very useful in the drafting process. The draft law which received the approval of the Cabinet of Ministers in mid-November 2022 is expected to be enacted by the Parliament in early 2023.

Accordingly, the Central Bank conducted several investigations on certain schemes that are alleged to be contraventions of the provisions of the Banking Act, No.30 of 1988. Further actions were taken to follow up on the requests made to the Attorney General's Department for prosecution of offenders already revealed in the investigations concluded thus far. With a view to improving financial literacy of different segments of the general public and in particular to educate them on the negative effects of joining prohibited schemes, the Central Bank conducted awareness programmes covering all possible channels, during the year.

Regulation and Supervision of Foreign Exchange

During 2022, the Central Bank took numerous steps to promote and regulate foreign exchange as the agent of the Government in implementing

Table 8.23
Export Proceeds Repatriation into Sri Lanka and Sri Lanka Rupee (LKR) Conversions during the year 2022

USD million

	Q1	Q2	Q3	Q4	Total
Total amount of exports proceeds repatriated (a)	4,286.15	4,370.37	4,575.14	4,524.20	17,755.85
Total amount of export proceeds converted into LKR (a)	1,164.77	954.27	1,030.93	1,070.20	4,220.18

(a) Provisional

Source: Central Bank of Sri Lanka

the provisions of the Foreign Exchange Act, No. 12 of 2017 (FEA). Accordingly, Regulations and Directions were issued granting permission to companies incorporated under the Companies Act No. 07 of 2007 to obtain short term loans from their overseas parent companies or companies within the same group of companies incorporated outside Sri Lanka, to facilitate payments for the import of raw materials. Further, an amnesty period of two months was granted to persons who held foreign currency notes to either deposit the same in foreign currency accounts or to sell such currency to an Authorised Dealer (AD), while reducing the maximum limit applicable for the possession of foreign currency by residents to US dollars 10,000 from US dollars 15,000. Accordingly, the total amount of foreign currency sold/deposited during the amnesty period was US dollars 35.4 million. Moreover, the Central Bank issued Directions under the FEA to facilitate transactions under the "Golden Paradise Visa program" implemented by the Department of Immigration and Emigration supporting inward remittances from persons residing outside Sri Lanka under this scheme. Furthermore, the validity period for opening Special Deposit Accounts (SDAs) was extended and existing SDAs were allowed to be rolled over. In addition, an Order which was initially issued under the provisions of the FEA, by the Minister of Finance to suspend and limit outward remittances for certain capital transactions, was further extended during the year.

The Central Bank took various measures to promote investments and bilateral trade to improve liquidity in the domestic foreign exchange market. In order to facilitate investments and transactions in the Colombo Port City Special Economic Zone (Colombo Port City), Regulations and Directions were issued granting permission to open foreign currency accounts for investors, investees and employees of the companies in the Colombo Port City. Further, the Indian rupee was determined as a designated foreign currency under the FEA. In addition, special permissions were granted to open 29 Special Foreign Currency Accounts, mainly to facilitate the uninterrupted supply of essential imports amid the tight foreign currency liquidity situation. Moreover, new Rules were issued under the MLA, mandating the repatriation of export proceeds into Sri Lanka within 180 days and conversion of such proceeds by the exporters of goods. Accordingly, with continuous monitoring, an increasing trend in the repatriation of export proceeds was observed during the year, while the

Table 8.24
Summary of Transactions on Foreign Currency Accounts

USD million

Category of Account	Inward Remittances		Outward Remittances		Closing Balance as of 31 December	
	2021	2022 (a)	2021	2022 (a)	2021	2022 (a)
Personal Foreign Currency Accounts	663.2	601.8	234.1	270.7	2,715.4	2,804.8
Business Foreign Currency Accounts	7,647.9	8,209.4	3,756.9	5,269.7	3,071.7	2,795.0
Inward Investment Accounts	854.7	862.2	1,221.9	843.2	1,969.2	1,714.1
Special Deposit Accounts (SDAs)	207.1(b)	111.7(b)	83.0	61.4	585.2	751.6
Outward Investment Accounts	11.2	31.3	6.9	7.4	n.a.	n.a.

(a) Provisional
(b) Excluding funds transferred from Inward Investment Accounts, Offshore Banking Unit Accounts and Foreign Currency Deposits.

Source: Central Bank of Sri Lanka

Table 8.25
Remittances on Capital Transaction Rupee Accounts (CTRAs) and Foreign Exchange Sales and Purchases against/into Sri Lanka Rupees

	2021	2022
Migrant Fund Transfers		
No. of CTRAs registered with the Central Bank for remitting migration allowances	787	215
Outward remittances through CTRAs (in USD mn)	4.5	0.9
Foreign Exchange Sales and Purchases (in USD mn)		
Foreign Exchange Sales (Form 1)	11,974.43	11,158.81(a)
Foreign Exchange Purchases (Form 2)	12,039.72	12,141.28(a)

(a) Provisional

Source: Central Bank of Sri Lanka

conversion into Sri Lanka rupees also improved towards the end of the year. Additionally, the Central Bank took initiatives to implement an automated Export Proceeds Monitoring System (EPMS) to extensively monitor foreign exchange transactions in collaboration with Sri Lanka Customs and ADs. Meanwhile, outward remittances under the migration allowance and the number of Capital Transaction Rupee Accounts (CTRAs) opened during the year reduced, while ADs recorded net foreign exchange purchases during the year, supporting liquidity conditions in the domestic foreign exchange market.

The performance of Restricted Dealers (RDs) was also closely monitored by the Central Bank during the year and Directions were issued to RDs that are solely engaged in money changing business (i.e. Money Changers), prohibiting the offering of higher exchange rates with a view to reducing any undue pressure on the exchange rate. Accordingly, US dollars 159.8 million was deposited into the banking system and US dollars 10.5 million was sold by RDs during the year, which is a considerable improvement in performance compared to the previous year amidst the gradual stabilisation of economic conditions to some extent and increase in tourist arrivals by the latter part of the year.

Credit Information

The Credit Information Bureau (CRIB) of Sri Lanka achieved a major milestone during 2022 with the implementation of the state-of-the-art Credit Information Management System (CIMS) with many value additions. As such, the pilot run of the new system which commenced in May 2022 with the participation of 9 member lending institutions was successfully completed in July 2022 with positive feedback from the members involved. Thereafter, the parallel run of the new system and the legacy system was commenced in August 2022 enabling access to the new system to all users in member lending institutions to familiarise themselves with the new system. The CIMS was fully launched in December 2022. The new system brings greater efficiency and international practices to the processes of CRIB and expands the product portfolio while revolutionising the risk management and credit evaluation techniques of lending institutions to better manage lending portfolios. In addition, this system will also improve the Bureau's capacity to collect non-traditional data.

Meanwhile, CRIB continued its statutory role as the national credit registry by providing 6.1 million credit reports to member lending institutions during the year 2022. However, a 27 per cent decrease in credit reports issued was recorded during 2022, compared to 2021. The member lending institutions obtained 5.6 million consumer credit reports and 0.4 million corporate credit reports in 2022. Moreover, CRIB issued 729,635 credit reports to the lending institutions through the "Bulk Request" mode during 2022. Meanwhile, the demand for the self-inquiry credit reports (iReports) recorded a 13.7 per cent decrease in 2022, compared to 2021.

BOX 13
Strengthening the Financial Safety Net in Sri Lanka

1. Introduction

Financial safety nets are a set of institutions, laws, and procedures that seek to promote an efficient and stable banking system during normal economic conditions and to manage the eventuality of a financial crisis. The framework of financial safety nets encompasses prudential regulation, supervision, resolution, lender of last resort, deposit insurance, and the role of Ministry of Finance (MOF) or the Treasury functioning with the broad objectives of promoting economic growth and financial stability of a country. Financial safety nets are important for an economy as a means of supporting crisis prevention mechanisms, financing during a crisis, and promoting sound macroeconomic policies by providing incentives.

The financial system plays a crucial role in the functioning of any economy. Financial institutions, while providing financial intermediation, tend to take on higher risk exposures through their diverse and complex deposit liability profiles. Therefore, financial safety net measures are of utmost importance for an economy to protect less sophisticated depositors. Depending on a country's supervisory structure, multiple organisations play important roles within the country's financial safety net. However, in some countries, central banks have exclusive responsibility for bank regulation, supervision, and resolution, and provides explicit or implicit deposit insurance protection as well.

In Sri Lanka, the financial system has undergone notable growth and development in recent years and the increasing complexity of the financial system has made it more vulnerable to financial shocks and crises, while underlining the need for robust financial safety net to strengthen the resilience of the financial system and safeguard the interests of depositors and other stakeholders in the financial system. In order to ensure the strength and efficiency of the country's financial system, the Central Bank of Sri Lanka (CBSL) and MOF collaborate closely as the primary stakeholders in the financial safety net.

2. Role of the Central Bank and Ministry of Finance

The CBSL plays a critical role in the financial safety net mechanism through functions, such as the lender of last resort, the supervisory authority of banks and Non-Bank Financial Institutions (NBFIs), resolution authority, and deposit insurer of the depositors of Licensed Banks (LBs) and Licensed Finance Companies (LFCs). On the other hand, MOF is a key participant in the financial safety net, responsible for setting financial sector policies during normal economic conditions and playing a pivotal role in crisis management during financial emergencies.

3. Lender of Last Resort

During times of financial turmoil, banks may encounter challenges in obtaining necessary funding for their daily operations and may turn to their lender of last resort, the CBSL. This can occur when banks become hesitant to lend to each other and depositors begin to withdraw their funds from their bank accounts. In such situations, the CBSL serves as the lender of last resort because its prime responsibility is promoting the smooth functioning of financial markets and maintaining a stable financial system.

The CBSL generally executes its lender of last resort function during emergencies that induce financial panic and threaten monetary and banking stability. In such circumstances, the CBSL has the discretion to provide extraordinary loans or advances to banks, secured with any collateral defined as acceptable in the Emergency Loans and Advances (ELA) Framework and may also renew such loans or advances as needed.

Currently, banks are not required to meet any specific requirements to access ELA. However, the CBSL has the discretion over deciding on the applicable interest rates, tenor, renewals, collateral, and other related matters. Nonetheless, if a LB is deemed insolvent, or likely to be insolvent, or has no reasonable prospect of becoming solvent in future, such bank would be ineligible for ELA, except in an exceptional circumstance.

ELA provided by central banks is typically viewed as a measure to address pure liquidity problems in banks that essentially are solvent. However, such situation is rare in practice. In most cases where banks face liquidity problems, there is some uncertainty about the solvency of the institutions involved. The assessment of the solvency of an institution usually takes time and is covered by the prudential regulation and supervisory actions.

4. Prudential Regulation and Supervisory Frameworks

Prudential regulation establishes standards and policies that financial institutions are expected to adhere to. Under the supervisory framework, it monitors the implementation of these standards and policies to ensure the safety and soundness of the financial sector and to achieve the financial system stability objective.

The regulatory and supervisory framework for banks and NBFIs of Sri Lanka is primarily specified in the Monetary Law Act (MLA), No.58 of 1949, the Banking Act, No. 30 of 1988, and the Finance Business Act (FBA), No. 42 of 2011. The CBSL is empowered to license banks and finance companies, issue prudential directions, determinations, orders, and guidelines to licensed entities, conduct supervision and examination and enforce regulatory actions, and resolve weak LBs and LFCs. The CBSL adheres to internationally recognised supervisory standards established by the Basel Committee for Banking Supervision. In order to prepare for potential crises, supervisors require banks and NBFIs to develop and implement contingency plans that include measures to address failures of banks and NBFIs.

5. Deposit Insurance System (DIS)

The role of a deposit insurer is to stabilise the financial system by ensuring public confidence in it, especially in the event of bank failures. The deposit insurer assures depositors that they will have immediate access to their insured funds, even if their bank/NBFI fails, thereby reducing depositors' the possibility of a "run" on the bank/NBFI and the risk of contagion and foster financial system stability, which in turn would have positive spillover on the wider economy.

DISs are generally governed by institutions called Deposit Insurance Agencies (DIAs), which may have different mandates that range from narrow systems ('pay-box') to those with broader powers and responsibilities, such as risk or loss minimisation with a variety of combinations in between. Some DIAs may have a limited 'pay box' mandate, which focuses on the reimbursement of the insured depositors in the event of a financial institution failure. Other DIAs may have an enhanced 'pay box plus' mandate, which includes responsibilities and powers related to providing financial assistance for resolution activities of financial institutions such as separating assets, opening a bridge bank, providing open bank assistance, and bailing in, among others. DIAs could also employ a direct mandate, which aims to minimise loss or risk. Loss minimisers operate with the goal of minimising the costs of resolving failed banks, while risk minimisers aim to minimise risk for the financial system as a whole.

6. Sri Lanka Deposit Insurance and Liquidity Support Scheme

The DIA of Sri Lanka is called the Sri Lanka Deposit Insurance and Liquidity Support Scheme (SLDILSS) and falls under the purview of the CBSL. With a view to upholding public trust in the financial system, SLDILSS was established in 2010 as a mandatory Deposit Insurance System invoking the provisions of the MLA, Banking Act, and the then prevailing FBA. SLDILSS is currently governed by the Sri Lanka Deposit Insurance and Liquidity Support Scheme Regulations No.02 of 2021.

SLDILSS has outlined a mechanism to protect small depositors in the event of a failure of a LB or LFC. SLDILSS maintains an Ex-Ante fund called the Sri Lanka Deposit Insurance and Liquidity Support Fund (SLDILSF), and the primary regular source of funding for SLDILSS is the premium paid by Member Institutions (MIs). All LBs and LFCs in Sri Lanka are MIs of SLDILSS and are required to pay insurance premium to the SLDILSS quarterly based on their capital adequacy ratio and monthly at a flat rate, respectively. At present, SLDILSS operates with a 'pay box' mandate and functions as a crisis prevention and management tool as well.

7. Strengthening the Financial Safety Net

Proper functioning of the Financial Safety Net is crucial for fostering economic growth, and it is imperative to explore the ways and means of strengthening it. Past financial crises have emphasised the significance of having ample safety net mechanisms at the global, regional, and national levels. It underlines the necessity of a well functioning financial safety net to bolster market confidence during periods of financial strains. Enhanced regional cooperation to uphold financial stability and resilience is recognised as vital safeguarding in exigent times. Lack of funding could cause severe challenges and additional costs. Therefore, the resolution authority might resort to resolution techniques that offer required liquidity. In addition, inadequate funding could lead to delays in resolution process. When a resolution authority has to defer resolving an institution, the quality of assets is likely to deteriorate further, and the moral hazard problem becomes more pronounced.

It is essential to streamline and strengthen the legal framework governing the financial safety net in order to improve its effectiveness. Currently, the legal framework governing the bank resolution is dispersed, resulting in a complex, confusing, and often opaque framework. Further, the court driven procedures for banks followed in Sri Lanka are slow paced, which can delay resolution process if the shareholders of a bank challenge the authority of the regulator to resolve the bank. The bureaucratic process involved in bank mergers further complicates the resolution of banks and creates uncertainty, which can potentially destabilise the financial system. This would require addressing the flaws in the current framework and adopting a more efficient and streamlined process for bank resolution and mergers.

Strengthening DIS is vital for improving financial system stability. For over a decade, SLDILSS played a crucial ‘pay box’ role. However, in its efforts to make timely payments to depositors, SLDILSS faces challenges due to inadequate information sharing arrangements regarding depositors, as well as the failure to maintain depositor information under a unique identification number at LBs and LFCs. Addressing these challenges and implementing robust information sharing and identification systems for depositors can go a long way in enhancing the effectiveness of SLDILSS, and ultimately, strengthening the financial system's stability.

Globally, deposit insurance systems, equipped with broad mandates, are assuming a significant role in the resolution of troubled banks. This arrangement provides the insurer with a greater ability to address costs compared to pure ‘pay box’ systems. Thus, SLDILSS should adopt the “least cost” approach for resolving a failed institution. This approach entails closer cooperation and coordination among safety net participants, the Government, regulatory bodies, the CBSL, and the Deposit Insurer. Experience shows that deposit insurers with sufficiently broad mandates, adequate powers, operational independence, and assured sources of contingency funding are more effective in building and maintaining public confidence and dealing with financial crises. In an extraordinary situation of systemic failure of banks, it is imperative that the deposit insurer has unlimited and quick access to backstop funding so that financial stability is not jeopardised. Overall, the success of the deposit insurance system depends on its ability to provide reliable and effective protection to depositors.

In strengthening the financial safety net, the regulatory and supervisory requirements for banks and NBFIs should be harmonised. In finalising and adopting the new Banking Act, this factor should be taken into consideration.

The existence of the safety net leads to moral hazards by encouraging risky behaviour among financial risk takers who believe they will reap the benefits from their risky investments while being protected from losses. Moral hazards can be raised by applying at a uniform rate to all categories of LFCs. SLDILSS should opt to charge a risk based premium while implementing a mechanism to manage the tradeoff between moral hazard and placing an additional burden of a higher premium on banks that are already weak. However, the imposition of market based risk premiums could negatively impact the share prices of already weak banks due to the higher premium burden. Accordingly, appropriate controls are required to ensure a balance between financial stability and market discipline, such as the introduction of risk based premiums, exclusion of certain deposit categories from the coverage, intensive supervision and regulation, and timely intervention and resolution of distressed institutions. Allowing insolvent financial institutions to fail and imposing costs on those that come close to failing can be the most effective way for the marketplace to discipline financial risk takers and limit moral hazard within the design of the safety net. A reasonable balance between moral hazard and a stable financial system would permit a very limited exception for failures that pose a systemic risk, while allowing the market to discipline improvident behavior. Thus, insolvent banks should in general be allowed to fail and shareholders should lose their equity if a bank is assisted to stay open. This proper balance between a stable financial system and moral hazard assures that, as a rule, the safety net will be a net through which insolvent institutions can fall and not a floor that prevents insolvent institutions from falling far enough to fail.

8. Steps taken to strengthen the Financial Safety Net and way forward

Currently, substantial measures are being taken by the CBSL to strengthen the financial safety net of Sri Lanka. It would be important to broaden CBSL's regulatory powers and upgrade the resolution framework by setting up a special resolution regime for financial institutions, expanding resolution tools, improving deposit insurance, and enhancing emergency liquidity assistance. The finalisation and adoption of the new Banking (Special Provisions) Act would help in achieving these goals. Although larger and more sophisticated financial institutions should be subject to stricter regulatory and supervisory requirements, it is essential to maintain a level playing field for banks and LFCs that conduct essentially the same banking operations.

While the Central Bank Bill that has been submitted to the Parliament acknowledges the CBSL as the responsible authority for the resolution of financial institutions, the proposed Banking (Special Provisions) Act provides further details on the recovery and resolution planning process, triggers for resolution, and more importantly, the resolution powers that can be exercised by both CBSL and MOF. As a safety net measure, the resolution of a financial institution will ensure,

i. the stability of the financial system, including the payment, clearing, and settlement systems;

ii. continuity of critical functions of LBs;

iii. protection of public funds by minimising public financial support;

iv. protection for depositors of such banks; and

v. avoiding unnecessary destruction of the value of assets and seek to minimise losses to creditors and overall costs of resolution.

The maximum compensation amount payable per depositor per institution from SLDILSS has been increased from Rs.200,000 at the establishment of SLDILSS to Rs.1,100,000 by now. Accordingly, SLDILSS has been paying compensation to the insured depositors of six license cancelled/suspended finance companies, i.e., Central Investments and Finance PLC (CIFL), The Standard Credit Finance Ltd. (TSCFL), TKS Finance Ltd. (TKSFL), The Finance Company PLC (TFC), and ETI Finance Ltd. (ETIFL) and Swarnamahal Financial Services PLC (SFSP).

With the implementation of the proposed Banking (Special Provisions) Act, the legally instituted DIS would be available with an expanded mandate beyond the existing 'pay box' mandate. Further, the operational capability and payout readiness of DIS are being ensured through the implementation of the Depositor Wise Data Collection System, which is currently in the testing phase. The implementation of risk based premium system by DIS would ensure that financial institutions avoid excessive risk taking and reflect fairness in the payment of premiums. Further, the funding adequacy of DIS would be ensured through alternative funding sources, such as from international financial institutions, while funding contingencies would be addressed by entering into backup funding arrangements with the Government.

Additionally, a draft new ELA framework will be implemented in due course by the CBSL, which will consider avoiding any moral hazard from any of the financial safety net measures and ultimately avoiding negative impact on the CBSL balance sheet.

In order to ensure the stability of the financial system, and simultaneously reduce the cost of resolving bank failures, the CBSL must ensure that the proposed regulations and laws take adequate measures to prevent insolvent banks from keeping opened and to close failing banks early enough before their capital is depleted. This can be achieved by reducing CBSL discretion in discount-window lending, by permitting lending only to problem banks that are likely to survive liquidity problems and resolving financial institutions promptly.

Implementation of the Roadmap for Sustainable Finance in Sri Lanka

The Central Bank launched the Sri Lanka Green Finance Taxonomy in May 2022 in collaboration with relevant stakeholders. The taxonomy provides a detailed classification of economic activities that can be considered as environmentally sustainable with the intention of providing guidance to financial institutions in mobilising funds for green/climate finance products and services. The taxonomy was developed as a part of implementing the Roadmap for Sustainable Finance in Sri Lanka which was launched in 2019 based on the International Platform on Sustainable Finance's (IPSF) Common Ground Taxonomy which harmonises both European and Chinese taxonomies. The IFC extended financial and technical assistance in developing the taxonomy and a wide array of stakeholders including and not limited to the Securities and Exchange Commission (SEC), the Insurance Regulatory Commission of Sri Lanka (IRCSL), the Ministry of Environment, and the Ministry of Agriculture, participated in this exercise.

During the year 2022, the Central Bank engaged in numerous other measures aimed at implementing the Roadmap for Sustainable Finance in Sri Lanka. The Central Bank issued a Direction for LCBs and a Guideline for LFCs in 2022, for facilitating sustainable finance activities in line with the Sri Lanka Green Finance Taxonomy considering the need for providing the financial sector with a governance and risk management framework for any such activities. Further, the Central Bank engaged in the process of developing a Green Bond Framework for the issuance of sovereign green bonds initiated by the Ministry of Finance. United Nations Economic and Social Commission for Asia and Pacific (UNESCAP) provides technical assistance in the development of the Green Bond Framework which is also a regulatory action identified in the Roadmap for Sustainable Finance in Sri Lanka for the advancement of the capital markets. Moreover, the Central Bank continues to work closely with international agencies, including the United Nations Development Programme (UNDP), IFC, UNESCAP and other relevant stakeholder groups both locally and globally in promoting sustainable financing initiatives in the country.