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Evolution of Global Stock Exchanges and the Sri Lankan Experience

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Introduction

A stock exchange[1] can be defined as a formal organization or the infrastructure that facilitates the trade of equity of a company. It is essentially a physical or virtual place where investors buy and sell shares that represent ownership claims of publicly traded companies. Stock exchange participants can range from small individual investors to large institutional investors such as financial institutions, pension funds, insurance funds and hedge funds. The primary objective of the stock market is to enable businesses to grow through raising adequate capital for business expansion and innovation. Stock exchanges have become one of the key drivers of the modern global economy by facilitating the efficient allocation of funds, while enabling investors to harvest the gains from a diversified group of investments of their choice.

The Origins of Stock Markets

Although, the origins of formal stock exchanges can be traced back to the 17th century, the foundations of the capital markets[2] dates back to the 12th century. It was the Europeans, particularly the Dutch, who pioneered several financial inventions, that laid the foundation for the formation of the stock market. The bourse or the exchange was conceptualized in Dutch-speaking cities like Antwerp even before the birth of formal stock exchanges. Although exchanges dealt only in promissory notes and bonds in the 1500s, the concept of profit-sharing widened in the 1600s, as companies that brought goods from the East through sea voyages wanted to share the risks involved. These sea voyages, which were extremely profitable, were at risk of pirates' attacks and poor weather conditions, that the ship-owners' wanted to share the risks. This led to the formation of East India companies that issued stocks to investors, on which the company paid dividends for the proceeds garnered from a group of voyages. In the absence of a physical exchange, the investors in shares of East India companies, faced difficulties selling them; mainly as the shares were

1 *The term Stock Market (or Equity Market) is interchangeably used in many literature and regarded to have similar meaning. However, the term stock market is generally defined as an umbrella term used to represent all stocks that trade in a particular geographical region or country.*

2 *Capital markets is broader concept and generally refers to any segment of the financial system aimed at channelling funds to those in need of capital. The capital markets usually include Share (Equity) Markets, Corporate Bond Markets and Government Securities Markets.*

issued in the form of paper and the investors had to track down a broker to carry out a trade which was usually carried out in various coffee shops in Europe. Eventually, addressing these issues in the 1700s, formal exchanges were established, facilitating secondary markets for securities issued by companies and laying the base for the modern stock exchanges. In 1973, the first exchange was officially established in London. Meanwhile, in the USA during the late 1700s, a small group of brokers made the Buttonwood Tree Agreement under the spreading boughs of a buttonwood tree, which paved the way for the establishment of the New York Stock Exchange (NYSE). Eventually, many other advanced countries developed their own stock exchanges which provided nurturing grounds for domestic companies to grow.

The Role of Stock Markets in Fostering Economic Growth

A stock market contributes towards a country's economic growth in many ways. The nexus between stock market development and economic growth is widely discussed in the literature. Making use of domestic financial resources and efficiently allocating them among growing sectors is an important role played by the stock markets in the economic development process. Stock markets create access to long-term finance from domestic sources and act as the foundation of the thriving corporate sector which in turn, will foster job creation and economic prosperity. In addition, the stock exchanges contribute to promoting good governance practices in listed corporates. Good governance in the modern days covers not only corporate governance practices but also covers aspects such as environmental and social aspects. Today's stock exchanges have a strong role to play in these areas which are vital to sustainable development. In addition, stock markets have been a crucial source of finance to riskier businesses and new business ventures. As these businesses are predominantly relying on intangible assets, human capital, research and development, it is difficult to raise funds from bank loans. Therefore, stock markets support innovation which is a key to achieving competitive advantage.

From a business perspective, the stock market acts as an important source of financing for firms. Without formal fundraising platforms such as stock markets, the business will be left to raise funds by reaching investors privately, which will be time-consuming and costly, which may discourage business expansion. Compared to the access to finance through the banking system, stock markets provide an attractive alternative that provides access to larger volumes of funding with longer maturities and potentially with lower funding costs. In addition, they help to diversify the sources of finance and reduce the dependency of corporates on the banking sector. This is crucial for business continuation even in a time when the banking sector is under distress where banks retrench credit facilities. Stock markets act as the main source of funding for riskier and more collateral-scarce businesses, which the formal financial institution sector is reluctant to serve. Further, the competitive nature of the stock market can enable the companies to improve their productivity and thrive in their sectors; through more transparency, better information dissemination, and good governance practices, to develop more innovative products and services.

From the investors' perspective, the stock markets act as a safe and secure platform to invest their money with relatively higher returns compared to bank deposits, albeit with a higher level of risk. Without formal platforms like stock exchanges, investors may tend to be at the mercy of unlicensed financial products with no regulatory oversight, which in turn, will put their investments at greater risk. In addition to offering investment opportunities, the stock market act as a risk management tool, especially for institutional investors such as pension funds. With a wide range of instruments, the stock markets can provide investors opportunities to diversify their portfolios and help manage their risks.

There is a wealth of studies which explainshow the country's sophisticated financial system, including a well-developed stock exchange has led country to prosper (World Federation of Exchanges, 2017). The stock exchanges in developed nations not only plays a significant role in country's economy, but also drives the global economy in today's highly inter-connected world. The New York Stock Exchange, National Association of Securities Dealers Automated Quotations (NASDAQ), Tokyo Stock Exchange, Shanghai Stock Exchange, Hong Kong Stock Exchange and London Stock Exchange which are some of the leading stock exchanges today, in terms of market capitalization and houses a number of multinational companies, which operates from all over the world. NASDAQ the second-largest stock exchange in the USA, differentiated itself by not possessing a physical place; instead comprising a network of computers that executes trades electronically. This made trades more efficient and resulted in a reduced the bid-ask spread.[3] The competition from NASDAQ has forced the stock markets all over the world to evolve into fully automated platforms. Today these leading stock markets, with innovative products and services, drives the global economy to new horizons.

Stock Exchanges in Developing Countries

While stock markets are advantageous to any country, the benefits that can be reaped by a developing country are much more prominent. By providing a source of funding for capital investment, stock exchanges help overcome one of the major challenges faced by developing countries; the lack of advanced capital instruments to channel funds towards business expansion and to trigger innovation in product development. At a time when human capital flight is also a blooming problem across developing countries, business expansion and innovation help create more job opportunities at home boostings the living standards of the people, which in turn, would help the country to retain the educated and skilled labour force.

Despite the major role the stock market plays in the development of a country, most economies continue to exhibit a very limited level of stock market development. In general, stock market development can be measured through attributes such as its size, access, depth and efficiency. In most developing economies, only a limited number of companies have listed themselves in the stock market to raise capital while the majority of the listed stock are not traded frequently, making the stock markets small in size and illiquid. As such, retail investors' participation remains low.

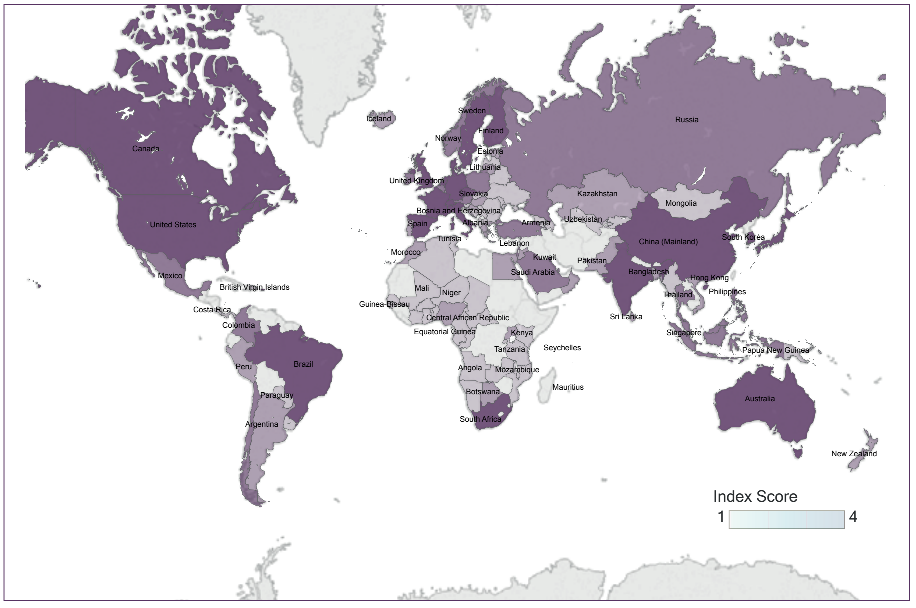
3 *bid-ask spread is the difference between the price bided by the potential buyer and the price asked by the potential seller* for *a specific stock.*

However, pension funds play a major role in developing countries' stock markets while other investors lag behind. The prevalence of investment opportunities such as mutual funds[4], and the level of financial literacy also play a major role in this regard. With the introduction of mutual funds, retail investors have started to show active participation in many countries. A low level of literacy has also been identified as an impediment to the flow of capital to the corporate sector in many developing countries.

ability to support new business and innovation will be curtailed.

On the other hand, the development of the capital markets including the share market also depends on the country's phase of the economic development. The causality between the development of the stock market and the economic development of a country is bidirectional. While stock market development leads to economic growth, economic growth also contributes to the further deepening of stock markets. Macroeconomic stability and a certain

Figure 1: Domestic Capital Markets Size, Access and Activity Index of IFC - Sub-Index Equity Markets



Source: International Finance Corporation (IFC), World Bank Group

Note: IFC computes an Index of Domestic Market Size, Access and Activity which is based on three sub-indices: the government bond market index, the corporate bond market index, and the equity market index. The equity market index depicted in the above figure reflect the equity market's actual size and depth. Source: World Bank Group, period: 2010-2017.

When the limited investments in developing countries are attracted by well-established companies and sectors, the stock exchanges'

degree of financial sector development including smooth functioning of financial infrastructure and a robust legal environment are prerequisites for the development of the stock markets. The pace of

4 *A mutual fund is a company that pools money from number of investors and invests them in in a range of securities such as stocks, and bonds.*

share market development is affected by domestic market shocks, exogenous events and global market conditions. Even if such negative events did not have a lasting economic impact, they can still have a significant adverse effect on the market participant's perception of financial markets and thereby, delay the expansion of the stock markets.

Measurements of Stock Exchange Performances

There are a number of indicators that are used to measure the performance, size, efficiency and the liquidity of a stock market or a particular investment. Price indices are one of the most widely used indicators. Dow Jones Industrial Average (DJIA) or the NASDAQ Composite Index are two of the most used benchmarks for stock market in United States. On the downside, these indices are composed using only few major listed stocks which are traded more frequently whereas the Standard and Poor's 500 Index, Wilshire 5000 and Russell 3000 captures the overall price movements of large number of stocks. Price indices with larger representation of stocks which gives a much more precise representation of the stock market. However, price indices with few major companies smartly outperform and is capable of capturing the dynamic nature of the frequently traded stocks. In Sri Lanka, S&P Sri Lanka 20 Index captures the movements of the 20 largest companies in terms of total market capitalization which are listed on the Colombo Stock Exchange (CSE) that meet minimum size, liquidity and financial viability thresholds, while the All Share Price Index (ASPI) captures the overall movements of the price changes in the market.[5]

5 *CSE is planning to revise d the calculation methodology of All Share Price Index (ASPI) by changing the constituent weighting method from full Market Capitalization to free floated adjusted Market Capitalization in 2022*

While the number of companies listed and number of shares listed can be utilized to determine the size of a stock exchange, Market Capitalization is the most common comprehensive measurement of value of the stock market. Market capitalisation is the total number of issued shares multiplied by their respective prices at a given time. Market capitalisation as a percentage of GDP is used as a relative measure to compare stock exchanges across countries. In addition to price indices and measures of size, market turnover is also a good measure of market liquidity. A liquid market enables investors to execute transactions efficiently with low transaction costs. In addition, Turnover Velocity Ratio[6] is also a popular measure of market liquidity and efficiency. In addition to these measurements of overall market performance there are a number of key ratios computed by investors while evaluating the stock exchange, a particular sector or a single stock. Price to Earnings Ratio (PER) [7] and Price to Book value (PBV)[8] is used to evaluate how attractive the current market price of the share is with regard to the earnings of the company and the book value of the company respectively. Further, key investor ratios such as beta[9] and alpha[10] ratios help investors to evaluate their risk and return of shares or investments relative to the market or a benchmark.

6 *Low turnover velocity implies higher cost of trading and low participation in the market.*

7 *Price to Earnings ratio – The ratio indicates how much investors are willing to pay for the earnings of a company. A higher P/E value could mean an overvalued stock.*

8 *Price to Book ratio – The ratio is used to compare the market value of a company with its book value. It seeks the value that the stock market places on a company's stock relative to the book value of the company.*

9 *The beta factor measures the volatility of an investment relative to the market or benchmark.*

10 *Alpha is measure used when assessing the performance of a fund or portfolio, and refers to the extent of any outperformance against its benchmark.*

Stock Market in Sri Lanka

CSE is the sole stock exchange of Sri Lanka. Although share trading in Sri Lanka dates back to 1896, the CSE was formed in 1985 following the amalgamation of two stock brokerage associations that prevailed at that time. CSE facilitates the raising of capital to domestic companies while extending investment opportunities to both local and foreign investors thereby strengthening the capacity of local companies, supporting job creation, and promoting economic growth of the country. In addition to acting as the exchange of equity, CSE facilitates the trading of debt instruments as well as provides several other related services such as settlement and safekeeping via its subsidiary Central Depositary System (CDS). The CSE currently operates as a limited-by-guarantee company, which is mutually owned by the founder stockbroking firms. However, the exchange is currently in the process of demutualizing which enables it to become a limited company.

Recent Dynamics of CSE

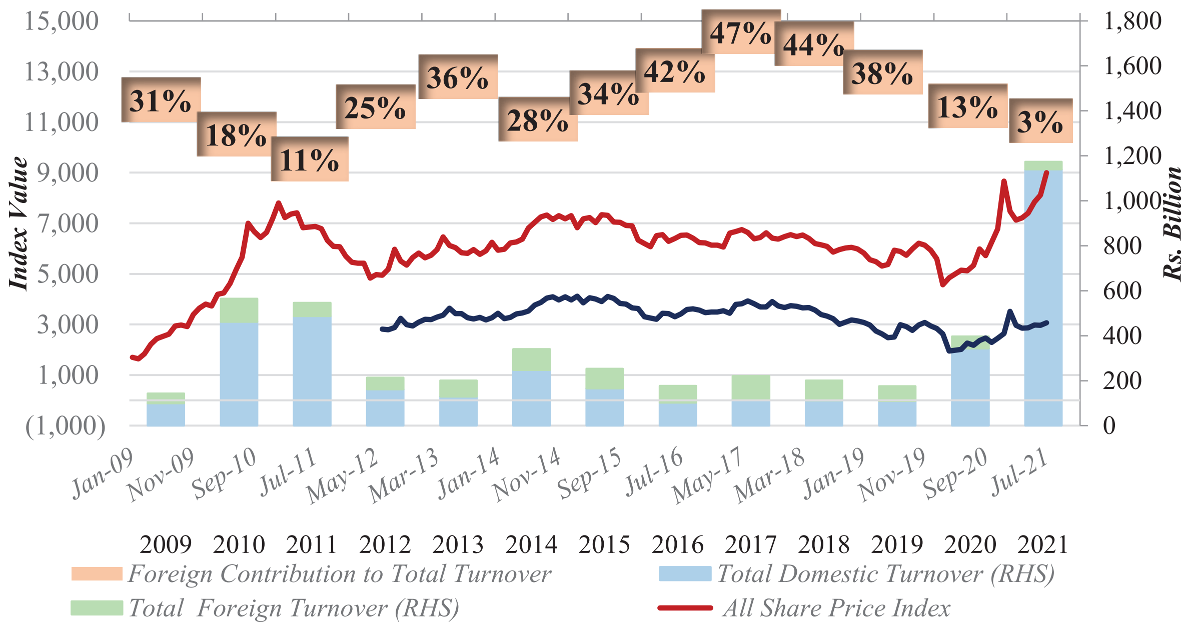
In reviewing the stock market developments during the recent past, it is noted that the CSE has achieved remarkable growth since May 2009 reflecting the positive market sentiment gained with the end of the prolonged civil conflict. The robust performance of the stock market was also supported by renewed investor confidence in an environment of declining inflation and relatively lower interest rates that prevailed in post-conflict period. Activity at the CSE rose to historically high levels in 2010 and ASPI[11] rose by 96 per cent. The market capitalization of the CSE recorded around 100 per cent expansion in both 2009 and 2010. This momentum in the stock market continued until mid-February 2011. Since mid-February 2011, a price correction was observed following restrictions imposed by the regulator; the Securities and Exchange Commission of Sri Lanka (SEC), on credit extended by brokers.

Although the performance of the stock market remained subdued during the first half of 2012, a positive recovery was observed during the second half of 2012 which continued into 2013. This was mainly owing to the gradual recovery of the exchange rate, policy interest rates reduction by the Central Bank, relaxation of rules by the SEC on broker credit & trading and the favorable impact of the gradual recovery of the global financial markets. Similarly, the year 2014 was also a positive year for CSE, and several indicators such as price indices, market capitalization and turnover improved surpassing the previous records.

CSE recorded a sluggish performance during the years 2015 and 2016 as reflected by the volatile movements in the price indices. Increased investor uncertainty, higher interest rates in both domestic and international markets, depreciation in the exchange rate and trend of reversal of capital flows from emerging markets have resulted in this setback. CSE recorded a comparatively healthier performance in the year 2017. The foreign investments at CSE in 2017, on a net basis, improved significantly compared to year 2016. This was partly due to the availability of fundamentally strong stocks at low prices. However, in 2018 a declining trend was observed responding to the adverse developments in the domestic and global environment. CSE witnessed continuous foreign outflows throughout the year, mainly driven by

11 *The base year for ASPI is 1985.*

Figure 2: Movements of price indices[12], Total Domestic and Foreign Turnover



Source: CSE

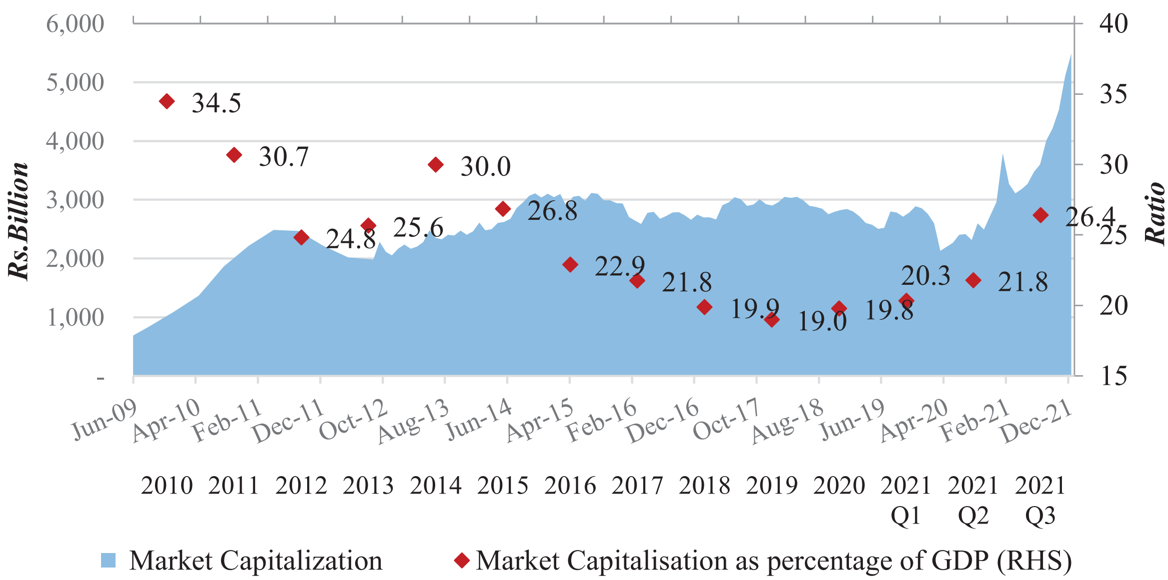
political uncertainty, pressure on the exchange rate and the shift in investor sentiments due to global developments with normalization of policy interest rates in the US. Subdued domestic economic activities, loss of investor confidence coupled with security concerns created by Easter Sunday attacks resulted in sluggish share market activities in 2019. Although signs of recovery were observed in market indicators aftermath of the Easter Sunday attacks, foreign outflows from CSE continued during 2019 due to impaired investor confidence with security concerns caused by Easter Sunday attacks and prevailed political instability.

Globally, investors sentiment shifted towards safe-haven assets and prices of riskier assets plunged with the spread of COVID-19 in early 2020. Similarly, sudden volatilities were observed in the Sri Lankan share market as domestic investors also sought more liquid and less risky assets. Index-based circuit breakers[13] were activated on several occasions due to excessive volatility in the market. However, with the low-interest rate regime maintained to support economic activities, yield-seeking investors gradually started to involve in share market activities. The CSE ended 2020 with a positive note amid unprecedented challenges created by the COVID-19 pandemic. The stock market improved significantly by the end 2020 from its lowest point reported around mid-May 2020. The ASPI on 12 May 2020 recorded its lowest point in over a decade but recovered recording a growth of 10.5 per cent by the end of 2020, the

12 *The S&P SL20 was introduced June 2012 which replaced the previously existed Milanka Price Index*

13 *Index based circuit breaker is a tool used to curtail market distortion during a time of higher volatility. Securities and Exchange Commission of Sri Lanka amended the regulations on index based circuit breakers in April 2020 to curtail excessive volatility in price indices in the face of challenges brought by COVID -19 pandemic.*

Figure 3: Trends in Market capitalization



Source: Department of Census and Statistics, CSE

highest annual increase since 2014. The CSE has become one of the fastest markets to recover from the impact of the COVID-19 pandemic in the Asian region with improved market indices and record-high turnover in 2020.

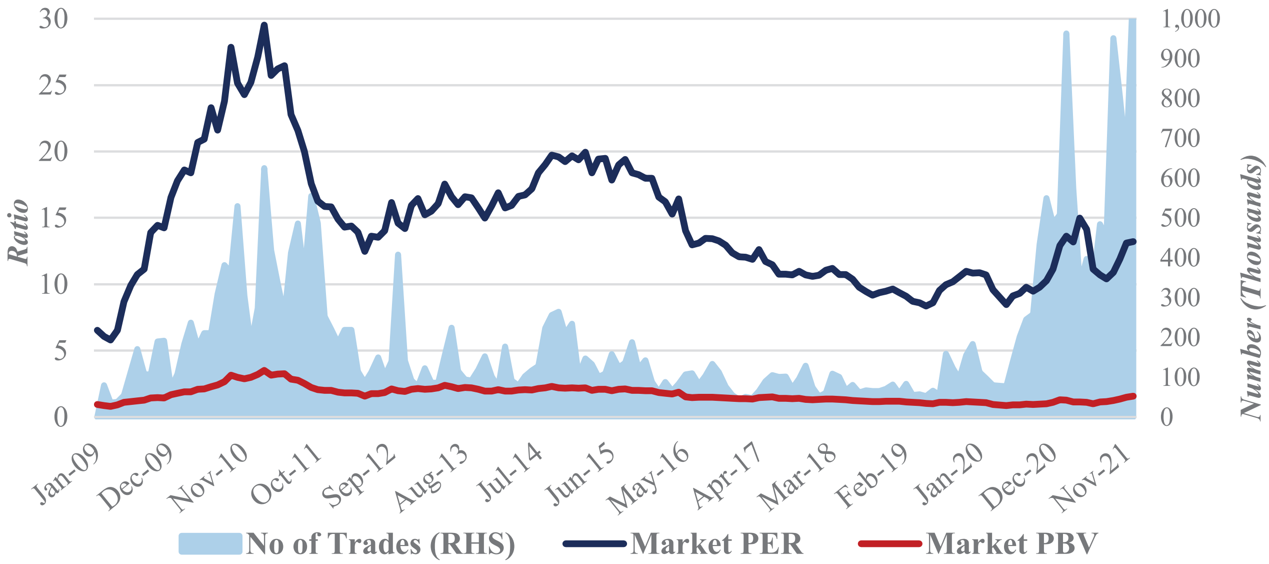
This recovery was mainly driven by domestic investors' preference shifting towards equity investments due to the prevailing low-interest rate regime, availability of excess credit through broker's credit & margin trading facilities and attractive market valuations such as PER & PBV[14]. Active participation of domestic retail investors in the market was reflected by a significant increase in CDS account openings in 2020 recording a 70 per cent growth compared to the year 2019. However, foreign investor participation was minimal during 2020. Although the net foreign outflows continued amidst the surge of COVID-19 in 2020, subpar foreign involvement in share market has been a major concern for Sri Lanka for many years. The CSE recorded Rs. 51.3 billion in foreign outflows from the secondary market during 2020, which remains a concern.

Similarly, the Colombo stock market recorded an exponential growth during the year 2021 as domestic investors increased their presence in the equity market. In wake of the low interest rates that prevailed, the investors' preferences shifted towards equity investments as both, the ASPI and S&P SL 20 indices recorded a growth of 80.5 per cent and 60.5 per cent respectively during the year 2021 while market capitalization recorded a growth of 85.4 per cent. However, investors may be compelled to withdraw their investments at the end of the monetary easing cycle.

Overall, Sri Lanka's share market faces numerous issues, led by the inadequate foreign participation as evidenced by the sustained foreign outflows.

14 *Sri Lanka records one of the lowest PER within the region. Along with these attractive PER and PBV valuations, domestic investors started to invest in stocks with anticipation of gains in the future.*

Figure 4: Market Price to Earnings Ratio, Price to Book value and Number of Trades



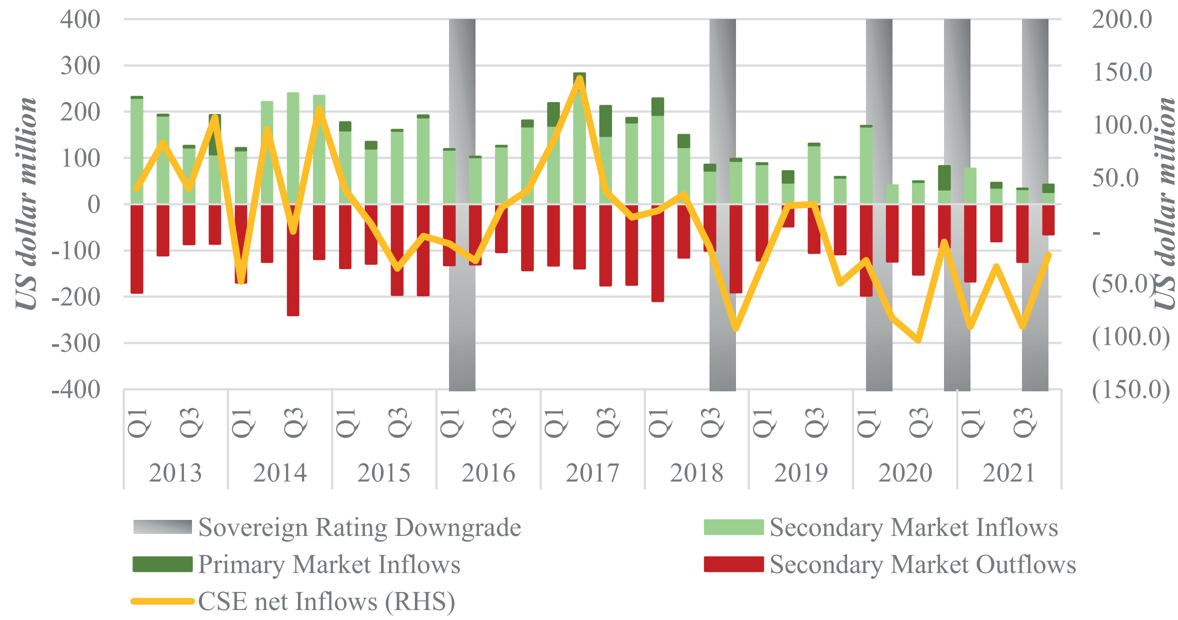
Source: CSE

This has been attributed to country-specific issues such as delayed and uncertain policy measures, depreciation of the local currency, the lack of diversified investment opportunities as well as other global factors.

Further, the size of the economy functions as a key determinant of market's potential and its ability to withstand shocks. The stock markets need a considerable number of listed corporates, investors and traders to get the advantages of economies of scale. The CSE remains small in terms of market capitalization, average daily turnover and the number of listed companies among its peers, limiting its competitiveness and making it more vulnerable to global shocks. The lower number of new listings, lack of investor confidence and pulling out of investments by foreign investors due to country-specific issues were some of the impediments to the expansion of the Sri Lankan share market. Market capitalization as a percentage of GDP has stagnated at around 20 per cent during recent years. However, in the years 2020 and 2021, CSE reversed this declining trend of market capitalization as a percentage of GDP which commenced in the year 2014. The improved market capitalization as a percentage of GDP was an outcome of both improved market performance amidst declining GDP due to COVID -19 related developments. In addition, market liquidity and efficiency of CSE are comparatively at a substandard level as reflected by the turnover velocity ratio, which remained significantly low compared to other stock exchanges in the region.

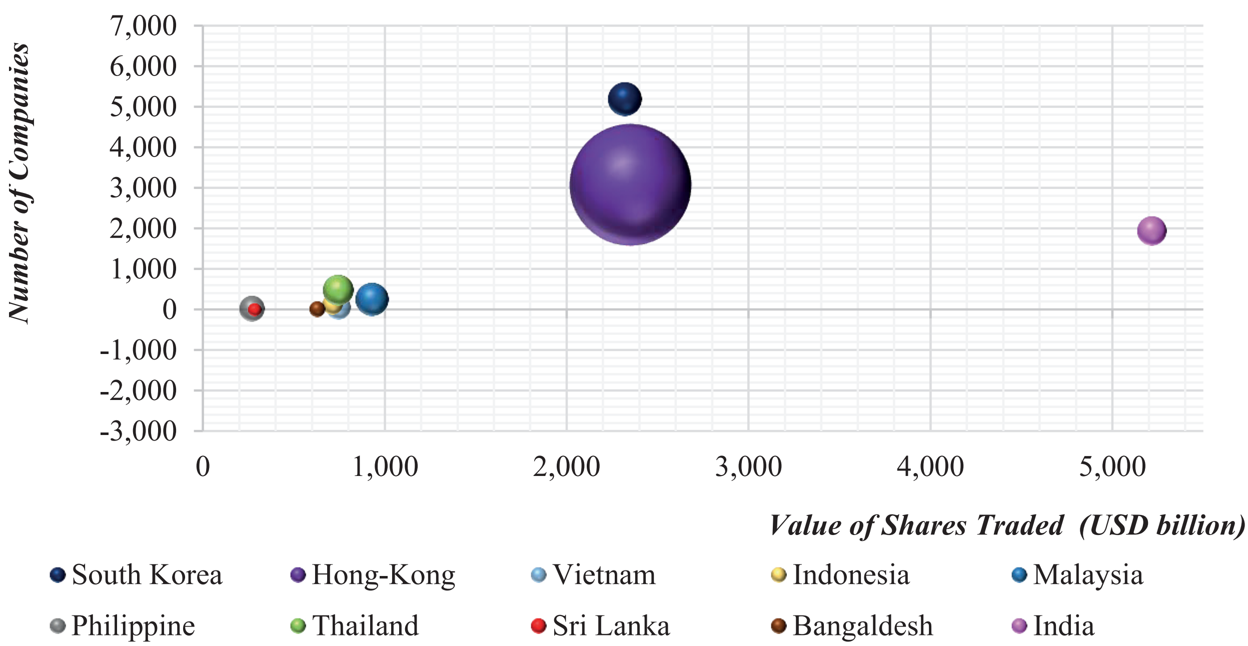
The CSE mainly features traditional instruments which have remained a bottleneck to enhancing the performance of the market. There are enormous possibilities of introducing new products including derivatives. Addressing the issue to some extent, initiatives were taken to introduce several products in the recent past, including Real Estate Investment Trusts (REITs) which enable investors to make investments in the real estate sector while opening

Figure 5: Net Foreign Flows to CSE



Source: CSE, Fitch Ratings, Trading Economics

Figure 6: Comparison of Global Stock Markets[15]



Source: World Bank

15 Values are as at end 2020. The size of the sphere is proportional to market capitalization as a percentage of GDP up new funding avenues for real estate developers. CSE currently has four product offerings: (1) Equity; (2) Corporate Debt; (3) Closed-end Funds[16] and (4) REITs. Lack of new listing or Initial Public Offerings (IPOs)[17] was also another major challenge. During the year 2020 and 2021, CSE together with SEC took several steps to promote new listings such as expanding the eligibility criteria for the initial listing of shares to enable a wider spectrum of companies for a listing. This initiative was taken to enable domestic companies to raise funds to expand further considering the multiple business models employed by the country's dynamic corporate sector.

A few of the main infrastructure-related drawbacks were also addressed during the recent years. The digitalization of the Sri Lankan stock market enabled all stakeholders to connect electronically, which brought substantial convenience to investors and yielded significant operational efficiencies to all stakeholders. In addition, SEC is in the process of finalizing the proposed Securities and Exchange Act. The Act was introduced to reduce ambiguity in existing laws and to ensure robust regulation in order to facilitate the development of the capital market.

Future of Stock Markets

The COVID-19 pandemic brought unprecedented challenges to the development of share markets all around the world. The COVID-19 pandemic has intensified economic challenges faced by developing countries such as Sri Lanka. The deterioration in the macroeconomic environment including further deepening of fiscal deficits, the decline in investor appetite due to uncertainty and heavy interventions by governments to support the economy are a few of the challenges to the smooth functioning of markets. Although these extraordinary measures taken by governments in the face of unprecedented challenges are vital to ensure the viability and investor confidence of the share market, long-term effects of these policy measures are still to be realized. Sudden changes in such measures may lead to drastic volatilities in the market. However, the COVID-19 pandemic enabled stock markets to develop and investment in sound infrastructure systems to ensure the smooth functioning of the market. The continuation of the COVID-19 pandemic poses a challenge for the performance of the stock market in Sri Lanka. The outlook remains uncertain and markets remain volatile. The speed of the containment of the COVID-19 pandemic locally and globally will help to restore macroeconomic balances, and the buildup of investor confidence, which in turn, will be vital for development of the Sri Lankan stock market in the near future.

Further, technological advances such as block chain technologies will open new paths to the modern stock exchanges. Well-developed exchanges such as London Stock Exchange has already built a platform on blockchain, adopting new and innovative technologies. This will enable the stock exchanges to thrive in the future by attracting the more technology savvy younger generation to achieve its objectives in a more efficient way.

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16 *A closed-end fund is a portfolio of pooled assets that raises a fixed number of shares through an initial public offering and then lists shares for trade on a stock exchange.*

17 *An initial public offering (IPO) is the process of offering shares of a private company to the general public for the first time through a new stock issuance.*

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The Drive for Financial Inclusion: Positioning Sri Lanka in the Global Context

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The vast destruction to lives and livelihoods caused by the World War II propelled Governments to rethink their policy objectives, wherein the pursuit of economic and financial development emerged as a core topic towards the late 20th century, which continues to dominate the agenda of policymakers around the world, even today. With the endorsement of financial inclusion as an integral part of the global development agenda, financial regulators and supervisors are now confronted with how to best adopt policies to promote financial inclusion among other distinct policy objectives of Financial Stability and Financial Integrity. The objective of this article is to discuss Sri Lanka's systematic approach/drive towards propagating financial inclusion in the country through the National Financial Inclusion Strategy that is bound to be beneficial for generations to come.

The Global Drive for Financial Inclusion

The drive to increase access to financial services has its roots in microcredit initiatives in Bangladesh and parts of Latin America in the mid-1970s, providing loans to the poor, who were generally excluded from formal channels of credit. Subsequently, those initiatives gained popularity in many low, middle and even high-income countries through replication. However, although micro-finance had some positive impact, particularly on women's empowerment, its impact on poverty alleviation has been less mainly due to high interest rates and financial malpractices, which in turn, resulted in high levels of over-indebtedness. Although the need for fundamental changes to the overall financial system was recognized since the early 2000s, much of the focus has been on improving access to credit, with limited impact on achieving the intended objectives.

"Financial Inclusion" is a relatively new concept, where the propagation of financial services are expected to generate broader development outcomes, and alleviate poverty. Overall, financial inclusion aims at integrating the unbanked population into the formal financial system, enabling them the opportunity to access financial services easily; including savings, payments and transfers to credit and insurance.[1] Over the past two and a half decades, international policy coordination for promoting financial inclusion reached notable heights, inspired by evidence-based contribution in sustainable and inclusive growth, along with poverty alleviation, reducing income inequality and financial stability. As such, leading international organizations took the

1 A. Hannig and S. Jansen, Financial Inclusion and Financial Stability: Current Policy Issues ADB Working Paper Series (2010).

important step to support financial inclusion and the key milestones include the following.

- The launch of the Alliance for Financial Inclusion (AFI) in 2008, as a policy leadership alliance owned and led by member central banks and financial regulatory institutions with the core mission to encourage the adoption of inclusive financial policies in developing and emerging economies to promote financial inclusion.
- The G20 Leaders recognized financial inclusion as one of the key pillars of the global development agenda and endorsed a Financial Inclusion Action Plan (FIAP) and principles for innovative financial inclusion at the G20 Summit in 2010. Subsequently, the Global Partnership for Financial Inclusion (GPFI) was launched in December 2010, as the main coordinating and implementing mechanism for the FIAP and serves as an inclusive platform for G20 countries and non-G20 countries for peer learning, knowledge sharing, policy advocacy and coordination on financial inclusion efforts.
- The Maya Declaration was adopted by AFI members in 2011, as the first global, measurable set of financial inclusion commitments by developing and emerging economies. The key objective was to encourage AFI member institutions for setting up firm goals for financial inclusion and implement in-country policy changes and to share progress updates.
- In 2015, the World Bank Group announced an ambitious global goal to reach universal financial access (UFA) by 2020. Accordingly, adults (15+) who were excluded from the formal financial system at the time, were expected to have access to a transaction account at a financial institution by 2020, to save money and to send and receive payments, enabling them to manage their financial needs.
- In September 2015, the General Assembly of the United Nations adopted the 2030 Agenda for Sustainable Development that included 17 Sustainable Development Goals (SDGs); where financial inclusion had been identified as an enabler for 7 of the 17 SDGs.
- In 2018, the Asia-Pacific Economic Cooperation (APEC) created a separate body to examine issues pertaining to financial inclusion. The Association of Southeast Asian Nations (ASEAN) has included the promotion of financial inclusion as a key objective under its framework on Equitable Economic Development. Further, the Asian Development Bank (ADB) actively supports microfinance projects in Asia and the Pacific.

Such universal interventions and influences encouraged many developing economies to endorse financial inclusion as an important part of their overall development strategies to achieve inclusive and sustainable growth.

Definition of "Financial Inclusion" and Its Dimensions

Definition of financial inclusion has evolved over the years, and it has been defined in many ways by different bodies in literature. Due to its multidimensional nature, it is not easy to define or measure; hence, there is no common or single definition. However, there is a consensus among international organizations on the key elements to be considered in defining financial inclusion and their definitions are broadly accepted as a guidance. These definitions not only demonstrate the multidimensional nature of financial inclusion, but also covers both, the supply and demand-side aspects of financial products and services.

The World Bank defines the financial inclusion as "individuals and businesses have access to useful and affordable financial products and services that meet their needs – transactions, payments, savings, credit and insurance – delivered in a responsible and sustainable manner". According to the ADB, it is the provision of "ready access for households and firms to reasonably priced financial services". The Global Partnership for Financial Inclusion (GPFI) and the Consultative Group to Assist the Poor (CGAP) define financial inclusion as, "a state in which all working age adults, including those currently excluded by the financial system, have effective access to the financial services provided by formal institutions including credit, savings (defined broadly to include current accounts), payments and insurance".

The degree of financial inclusion is not limited to the "Access" dimension, but also consider the "Usage" and "Quality" dimensions of financial services, to instill a deep understanding of the financial inclusion landscape in an economy. The usage dimension describes how consumers use financial services, through indicators such as the frequency and duration of usage of the financial product/service over time. The quality dimension basically focuses on the attributes of financial products and services, that demonstrate how far they could satisfy customer needs. Financial education and consumer protection have been identified as key catalysts for enhancing the quality dimension, as consumers could reap maximum benefit of financial products and services, if they understand them properly, with trust. In addition to above three key dimensions, "Wellbeing" was proposed by the Alliance for Financial Inclusion (AFI) as the fourth dimension, considering the positive economic and social impact that a financial device or service has had on the lives of consumers.

Standard definitions generally connect all these aspects of financial inclusion, implying that financial products and services would have to be designed appropriately to ensure that they benefit people by fulfilling their financial needs. Even though, there is no single or universal definition, international organizations provide guidance for its members to develop their own definitions according to their country specific conditions. Many countries have developed and used their own country specific definitions in advocating and promoting financial inclusion at the national level. Differences among country level definitions tend to reflect specific characteristics of its financial sector and its Financial Inclusion related conditions. More importantly, such an official national definition acts as a basis for a shared vision and supports in setting goals and mapping out the framework for achieving the targets.

In Sri Lanka, financial inclusion has been defined as "a state where all individuals and enterprises in Sri Lanka can access high-quality, appropriate, secure and affordable financial services based on their needs and informed choice and use these services efficiently and effectively to support their economic activities and improve the quality of their lives".[2]

The Sri Lankan definition encompasses all recognized dimensions of financial inclusion, while emphasizing that Access, Usage and Quality aspects should be based on consumer needs and informed choices, leading to positive economic and social impacts, in line with the fourth dimension of wellbeing, as proposed by AFI.

Measuring Financial Inclusion

Amidst the greater recognition of financial inclusion as a key enabling element in reaching the

2 National Financial Inclusion Strategy (NFIS) of Sri Lanka

goal of inclusive economic development, nations have been more focused on financial inclusion policies and initiatives. Meanwhile, the importance of having reliable data and common indicators on financial inclusion was recognized to ensure the effective design of national policies and their implementation by setting targets and monitoring progress. The leading international organizations started to improve the quality and quantity of data at international level and subsequently, started supporting the member and non-member countries to strengthen their capacities on developing policies for financial inclusion and their implementation.

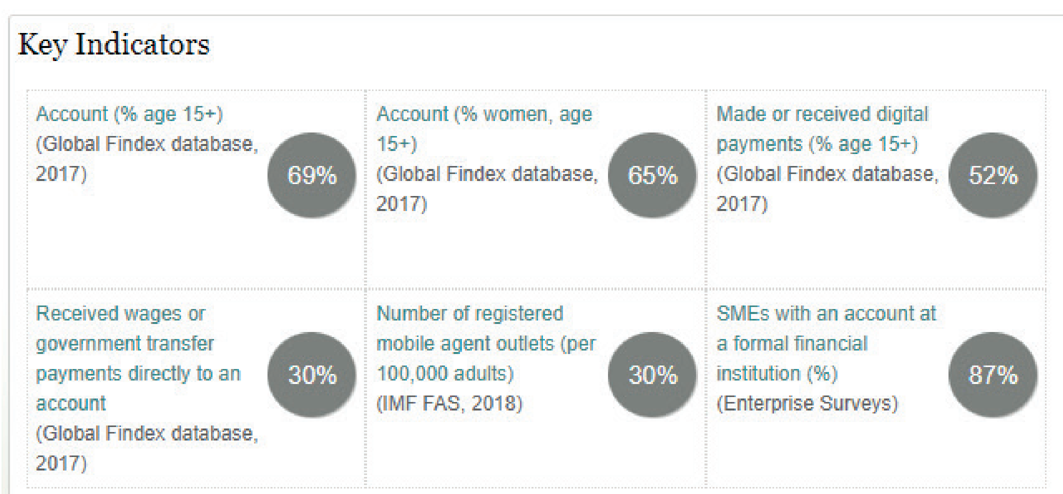
The GPFI developed a basic set of financial inclusion indicators, which were endorsed by the G20 leaders in 2012. These indicators were then expanded by the GPFI in 2013, to include financial literacy, and the use and quality of financial services, to deepen the understanding of the financial inclusion landscape. Again in 2016, some new indicators were endorsed to measure the use of digital payments and access to digital infrastructure. The existing set of G20 indicators aim to measure financial inclusion covering the three key dimensions of access, usage and quality of the products and the service delivery.

On the international stage, the World Bank Global Findex, International Monetary Fund (IMF) Financial Access Survey, Gallup World Poll, OECD National Financial Literacy and Inclusion Surveys, OECD SME Scoreboard and the World Bank Global Payments Systems Survey provide data in line with G20 financial inclusion indicators.

The IMF basically collects supply-side data, which facilitates measuring the level of financial access, focused on the financial infrastructure and the different distribution channels for the various financial products. In contrast, the World Bank gathers information on usage from the demand-side, taking into account information on the number of individuals that have at least one type of financial saving, credit, insurance or payment system product, their frequency of usage and the duration of use over time. Further, the IMF and the Word Bank are designing and conducting surveys in various countries enabling comparisons between countries and different regions.

The AFI (2011) has proposed standard indicators for measuring the access and usage dimensions of financial products and also has emphasized the need of having standard framework of reference

Figure 1: G20 Financial Inclusion Indicators



Source: https://datatopics.worldbank.org/g20fidata/

for measuring the quality of access and usage. The AFI Data Portal (ADP) is an integrated global database of financial inclusion policies, regulations and outcomes, built by policymakers, which was launched in 2016. The ADP holds and manages data on financial inclusion from over 60 countries in the AFI network. Users can view their country's progress over time and compare their positions with their peers across the whole network. The ADP is an effective and efficient tool for benchmarking and analyzing progress on implementation of policies.

Although the scope of above international indicators is comprehensive enough to provide a holistic assessment, it requires countries to collect and compile their own and new data on areas of specific relevance to the country. Such country-level data and diagnostic assessments are of vital importance in designing policies to promote financial inclusion, as they serve as baseline information to set policy targets and to monitor the impact of policy initiatives over time. Data have a fundamental role in establishing an in-depth understanding of the current state of financial inclusion. At the national level, reliable data can be used by regulators to identify trends and risks to design evidence-based regulatory frameworks. For policymakers, data can be used to identify gaps, fix new policy targets or modify policies to promote financial inclusion and to monitor changes and measure the impact of such policies. Financial institutions can use them to better understand market opportunities and to develop new products and services to meet consumer demand.

Following the rule of thumb, Sri Lanka conducted its first ever national Financial Inclusion Survey in 2018, to lay down the foundation for developing its policy framework to promote financial inclusion with the objective of understanding the general landscape of financial inclusion. This survey measured the dimensions of access, usage and understanding of financial services among public giving emphasis on savings, borrowings, digital finance and payments and some other aspects, i.e., investments, insurance and consumer protection.[3] The findings of this survey was used as the baseline information in developing the policies and setting up targets in a forward-looking strategic framework.

The National Financial Inclusion Strategy (NFIS) of Sri Lanka

A "Financial Inclusion Strategy" can be broadly defined as a roadmap of actions defined at the national level to provide a long-term, comprehensive, standardized and well-coordinated approach that is agreed by all stakeholders to move forward in one common direction towards improving the financial inclusiveness. More than 55 countries across the world have launched National Financial Inclusion Strategies as of early 2020, and about 34 countries are currently in the process of developing strategies to achieve financial inclusion commitments.[4] Many of these countries have followed the Financial Inclusion Support Frameworks or the Policy Models developed by international organizations as guidance for developing and operationalizing the National Financial Inclusion Strategies of their countries.

Given this background, Sri Lanka initiated actions to develop its national level policy framework for financial inclusion in early 2018. The designing and development of the NFIS for Sri Lanka was a multi-stakeholder effort advocated by the Central Bank of Sri Lanka (CBSL), with the technical assistance of the International Finance Corporation (IFC), a member of the World Bank

3 The key findings of the survey are available at https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/NFIS%20Summary_%20English_2.pdf

4 Lessons from Implementing a National Financial Inclusion Strategy, World Bank Group

Group (WBG). The strategy has followed the Financial Inclusion Strategy Framework introduced by the World Bank that contains six main building blocks i.e. Data and Diagnostics, Targets and Objectives, Leadership and Coordination, Strategy Formulation, Strategy Implementation, Monitoring and Evaluation.

NFIS of Sri Lanka : 2021-2024, was launched in early 2021, with the motto "Better quality inclusion for better lives" encapsulating its vision. This strategy is considered to be the country's first comprehensive attempt to promote financial inclusion. It aims to ensure that all individuals and enterprises in Sri Lanka have well-informed, fair and equitable access to a range of high-quality, appropriate, secure and affordable financial products and services that they can use to contribute to economic growth and improve their standard of living.

This four-year strategy, which runs until 2024, has clearly defined a set of specific outcomes. It is being implemented through its action plan, which spreads over four key focus areas; (I) Digital Finance and Payments, (II) MSME Finance, (III) Consumer Protection and (IV) Financial Literacy & Capacity Building. Support to achieve desired outcomes under key focus areas, core enablers have been identified to provide the enabling data, infrastructure, policy tools and regulatory environment for the financial sector.

Figure 2: Desired outcomes of the NFIS

Digital Finance and Payments
Existence of a well-established digital finance and payments system in the country, to encourage the availability, access and usage of a greater variety of appropriately designed, quality digital financial products and services with increased digital finance uptake and payments from both supply and demand sides.

MSME Finance
Eliminate obstacles faced by MSMEs in accessing appropriate and affordable financial products and services to meet their expectations.

Consumer Protection
Well-designed regulatory frameworks and measures to secure financial consumer protection.

Financial Literacy and Capacity Building
High level of financial literacy among individuals and MSMEs to increase the uptake and usage of financial products and services enabling them to reap the benefits of financial inclusion.

Data: Availability of comprehensive and robust data to develop evidence-based policies and monitor and evaluate the effectiveness of financial inclusion initiatives.

Infrastructure: Strong financial infrastructure which enables financial service providers (FSPs) to effectively evaluate customers, provide affordable products and to reach out remote customers via low-cost channels.

Policy Tools and Regulatory Environment: Strong policy tools and a balanced regulatory framework to help FSPs to be flexible and innovative whilst mitigating risks to consumers and the overall financial stability of the country.

Source : National Financial Inclusion Strategy of Sri Lanka

Figure 03 : Key Objectives under Focus Areas

NFIS Focus Area	Key Objectives
Digital Finance and Payments	1) Institutional management of the country's digital economy policy 2) Digitize government schemes and services 3) Streamline KYC process to ensure standardization 4) Develop an enabling regulatory environment 5) Support the development of the fintech ecosystem with specific emphasis on financial inclusion 6) Generate more demand to expand the use of mobile and electronic means of payments 7) Enhance the supply of digital payments 8) Strengthen the development of digital infrastructure
MSME Finance	1) Build capacity of formal financial sector to scale-up lending to MSMEs and expand the range of high-quality products with a special focus on green and sustainable finance as well as vulnerable groups including women, the poor and individuals with low educational background 2) Improve and coordinate government supported MSME finance approaches and MSME support programs
Consumer Protection	1) Address gaps in legal mandate for regulators covering all financial services offered in Sri Lanka 2) Ensure comprehensive legal requirements for financial consumer protection across all providers, products and services 3) Further strengthen financial consumer protection supervision 4) Enhance existing EDR mechanisms to ensure accessible, affordable, independent, well-resourced, fair, accountable, timely and efficient channels for dispute resolution for all financial consumers
Financial Literacy and Capacity Building	1) Assess the level of financial literacy of the population and identify key gaps 2) Improve coordination of financial literacy efforts 3) Increase financial literacy among consumers, particularly vulnerable groups, including women, the poor and individuals with low educational background 4) Increase capacity of MSMEs 5) Improve effectiveness and efficiency of delivery channels for financial literacy
Enabler: Data	1) Develop harmonized and consolidated approach to data collection
Enabler: Infrastructure	1) Improve credit information system 2) Improve secured transactions framework, particularly for movables 3) Improve communications infrastructure (internet coverage, smartphone penetration) 4) Operationalize governance structure for implementation of the NFIS
Enabler: Policy Tools and Regulatory Environment	1) Finalize legal framework for data privacy and protection 2) Further encourage providers to expand services in underserved areas

Source: National Financial Inclusion Strategy of Sri Lanka

A set of strategic objectives have been identified within each focus area to set up priority initiatives in the Action Plan of the NFIS. Figure 03 highlights these key objectives within each of the NFIS Focus Areas.

Guided by the abovementioned strategic objectives, the Action Plan of the NFIS has incorporated impact-oriented policy actions along with the responsible entity(ies) and timelines for implementation. All actions were developed through a consultative process, supported by stakeholder suggestions and diagnostic recommendations, identifying obstacles and opportunities in the baseline assessment. The Action Plan sets out the actions to be implemented within an agreed upon timeframe to promote greater focus and accountability under each of the key focus areas of the strategy. Therefore, it provides a road map to advance the financial inclusion pathway and the effective collaboration and partnership of all stakeholders.

As a national strategy, the implementation of the NFIS involves a wide range of stakeholders of the government and the private sector. To ensure that the entire strategy is carried out as planned and adjusted as necessary to achieve the desired outcomes, a strong governance structure has been established by outlining the key roles and responsibilities of different governance entities for the monitoring, reviewing, evaluating, and communicating the implementation of the NFIS. The National Financial Inclusion Council (NFIC) is at the top level in the structure to provide overall policy guidance relevant to the implementation of the NFIS. The Management Committee of NFIS is entrusted with the responsibility to oversee the day-to-day implementation of the NFIS and to provide regular updates to the National Council. Working Groups have been established to serve as a consultation forum for a NFIS focus areas, which are comprised of members from a range of stakeholders, who have technical expertise in the respective areas of focus. The NFIS Secretariat is established at the CBSL to provide permanent technical and administrative support to the NFIC, the Management Committee and the Working Groups.

Currently, the NFIS Action Plan is actively in operation, supported by continuous coordination, monitoring and evaluation by NFIS Secretariat, while facilitating and encouraging stakeholders to achieve set targets. The Monitoring and Evaluation (M&E) system of the NFIS acts as an accountability tool that facilitates track progress of the NFIS implementation. Under the M&E system, a national results framework has been established including key performance indicators (KPIs) and targets aligned with the policy objectives of the NFIS. These indicators represent national-level targets adapted for the Sri Lanka, aligned with the AFI Core Set of Financial Inclusion Indicators and G20 Financial Inclusion Indicators.

The NFIS of Sri Lanka has been designed to be a dynamic and open framework providing space for existing and new parties to create new initiatives. As a part of the responsibilities of the governance entities, necessary revisions and updates are expected to be introduced to the NFIS and its action plan to address the changing landscape due to political, economic and financial sector developments. Further, the strategy to be realigned with shifting priorities of national policy and international best practices to ensure the NFIS remains relevant over time.

Conclusion

In examining the national policy front of financial inclusion in the international context, it is noteworthy that the recent policy developments on financial inclusion are considerably in alignment with global policy initiatives. However, the implementation phase of NFIS would be more challenging than the developing phase. Some countries have failed to achieve the expected outcomes of their strategies due to their inability to bind the efforts of all responsible stakeholders in implementation. This motivated the need for a national-level effort that involved identifying binding constraints among a range of stakeholders, who are responsible for the implementation of the NFIS. Securing adequate resources is another critical element to support implementation of NFIS to continue.

The scope of the NFIS is expected to be broadened in response to the impact of current economic issues in the country. In the current phenomena, where people become more financially vulnerable, the role of financial inclusion is significant in strengthening resilience and economic recovery, particularly targeting the needy segments that are adversely affected by the prevailing economic crisis. Among the trending policy priorities of financial inclusion across countries, green finance has been recognized as a prominent requirement. Strengthening the sustainable and green financing among the MSMEs in Sri Lanka, will be imperative in the recovery process. Such initiatives would be highly beneficial in both economic and social terms towards more inclusive and sustainable growth.

However, more attention would need to be given to the potential trade-offs among the objectives of financial inclusion, financial stability and integrity. It is essential to create a regulatory framework that allows proportionate application of global standards to facilitate financial inclusion, whereby countries could accommodate a diverse range of financial systems and providers of financial services to reach financially excluded and underserved segments of customers and to pursue financial inclusion alongside financial stability, as well as financial integrity and consumer protection.

The continued affiliation with peer countries to share experiences in the area of promoting financial inclusion would be helpful in keeping up-to-date with strategies to overcome common issues and challenges encountered by peer countries. Further, the national level representation in the international policy arena would be supportive to showcase national achievements in financial inclusion, providing an effective and efficient tool for benchmarking and analyzing progress on policy implementation.

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Debt Sustainability and Economic Growth in Sri Lanka

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Debt sustainability is the ability of a government to maintain public finances at a credible and serviceable position over the long-term to support strong, lasting, and equitable growth (World Bank 2019). However, following the Global Financial Crisis (GFC) and the COVID-19 pandemic situation, debt sustainability has become a key issue that has dominated policy discussions in both, developed and developing countries. Countries with escalating public debt are most prone to deviate away from the path of sustainable debt policy because of large spending by governments during the current COVID-19 pandemic. There is a pressing need for governments to achieve sustainable public debt positions over the short- and long-term horizons to avoid the dangers posed by large budget deficits to the economy.

Why does High Public Debt Cause Concern?

There are several reasons why high public debt a cause for concern is. The high levels of debt-to-GDP ratio could cause macroeconomic instability, mainly through loss of investor confidence amidst investment uncertainty. The rising demand for loanable funds could add pressure on the interest rates to rise, while the higher interest payments on debt could crowd out private investment, which in turn, increases future taxes and adds pressure on the government to reduce vital social and welfare spending. In some instances, governments with high public debt levels have reacted by printing money, which has consequently resulted in high inflation. Higher public debt levels tend to impede economic growth, which in turn greatly undermines any sense of a balanced budget based on the 'vicious cycle' relationship between public debt and budget deficit (Rajakaruna, Suardi and Perera 2021). This issue has garnered much attention in policy circles in Sri Lankan economy following the liberalization and pro-market policies adopted in the 1980s and amidst the Asian Financial Crisis (AFC) in 1997-98, and the subsequent liberalization of the capital account. When government debt is financed by foreign sources and if foreign investors lose confidence in the economy and sell their debt suddenly, the impact could be magnified with the depletion of foreign reserves. The resulting Balance of Payments crisis could trigger the depreciation of the national currency. On the other hand, it could negatively affect the current account deficit by decreasing net exports[1]. Finally, if a country defaults on its debt service obligations, it loses its social, economic, and political stature in the global arena.

Nevertheless, public debt helps to improve the living standards of a nation's people when it is successfully used to improve productivity through investments in public services like education, transportation, and health. It makes it possible for a government to build infrastructure facilities, and improve social and welfare services, especially in developing market economies, like Sri Lanka. In addition, public debt helps countries obtain additional funds to invest in their economic growth in the short-term. The traditional "Golden Rule" of fiscal policy stipulates that for public debt to be beneficial for future generations, governments should borrow money only to fund investments while the ongoing day-to-day expenses must be covered by income taxes (Groneck 2011).

The public debt can fund investments and infrastructure improvements leading to higher economic growth in the long run. Further, government borrowings can help economic recovery and reduce unemployment. Thus, as the benefits accrue across generations, it is the future taxpayers who are responsible for servicing government debt, with capital and interest payments, regardless of whether they benefit from current government borrowings. According to debt dynamics, if national debt increases faster than real GDP, then government borrowing may require higher taxes to service it. Therefore, high debt levels directly affect future generations, by paying the interest on outstanding debt each year entirely by issuing new domestic or foreign debt.

With the accumulation of debt, the cost of debt servicing has also been rising rapidly due to higher interest rates and the relatively shorter maturity periods for non-concessional debt; both of which have been highlighted as major factors affecting the growth rate of output.

Debt Sustainability and Economic Growth in Sri Lanka

A country's public debt is considered sustainable if the government is able to meet all its current and future repayment obligations in full without exceptional financial assistance, or without altering the contractual terms of the debt or rendering them irrelevant, via default, restructuring, or hyperinflation" (IMF 2022). Moreover, sustainability, reflects a country's solvency, liquidity, and adjustment capacity[2].

The debt sustainability analysis of the World Bank and IMF mainly considers the capacity of a country to meet its debt obligations under different circumstances including various shock scenarios. Debt sustainability is positively and strongly correlated with the country's fiscal policy. A country with long-standing fiscal deficits would have to be financed through continuous borrowing.

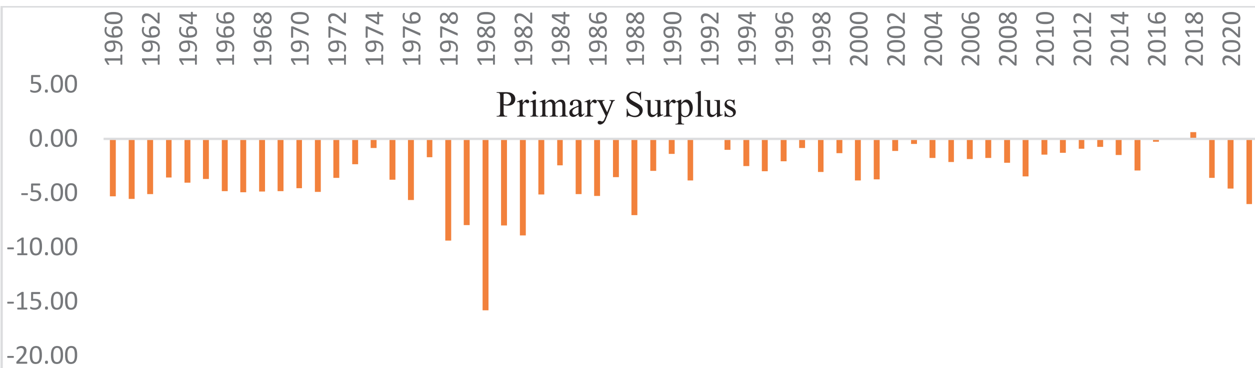
1 The decreasing net exports (decrease in exports and an increase in imports) will lead to greater current account deficits.

2 Solvency: A government is solvent if the present value of its income stream is at least as large as the Present Value of its expenditure plus any initial debt.
Liquidity: A government is liquid if it is able to rollover its maturing debt obligations in an orderly manner
Adjustment capacity: Debt sustainability also captures the notion that there are social and political limits to adjustments in spending and revenue that determine a country's willingness to pay.

It is always essential for a government to maintain a prudent fiscal policy which is also supported by a proper tax policy, revenue policy, and expenditure policy to foster economic growth while also maintaining debt sustainability. Debt sustainability plays a pivotal role in maintaining the political and social stability of a country.

As evident in Figure 1 displaying Sri Lanka's primary surplus-to-GDP ratios from 1960 to 2021, Sri Lanka has always recorded a primary deficit, except in 2017 and 2018. Although Sri Lanka reached a primary surplus in these two years, the overall deficit has never recorded a positive figure, largely owing to the higher interest cost on government debt. Following the economic liberalization policies in the 1980s, the primary deficit increased with the highest budget deficit occurring in 1980 which was at 19 per cent of GDP.

Figure 1. Primary Balance (1960-2021)

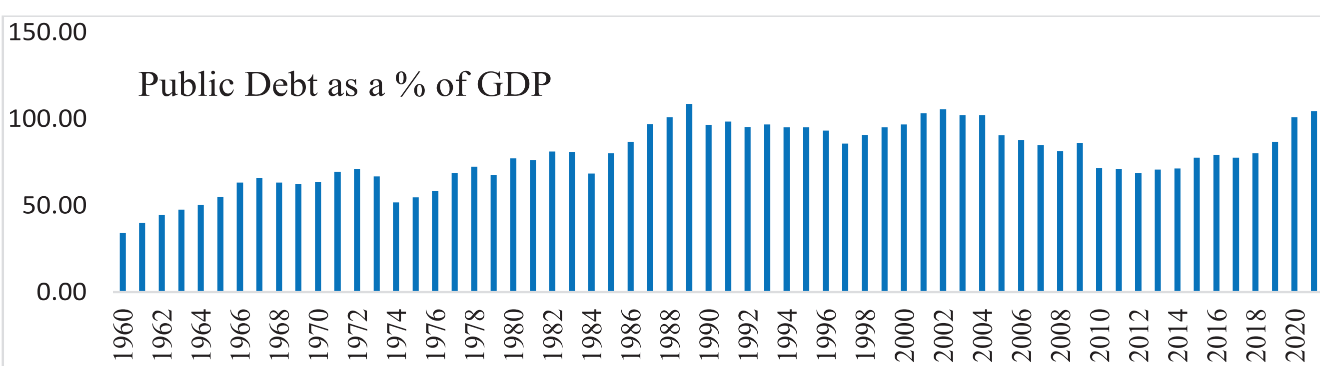


Source: Central Bank of Sri Lanka

As depicted in Figure 2, the debt-to-GDP ratio rose on a continuous basis from 1985-2009 mainly owing to the massive military expenditure incurred during the civil war.

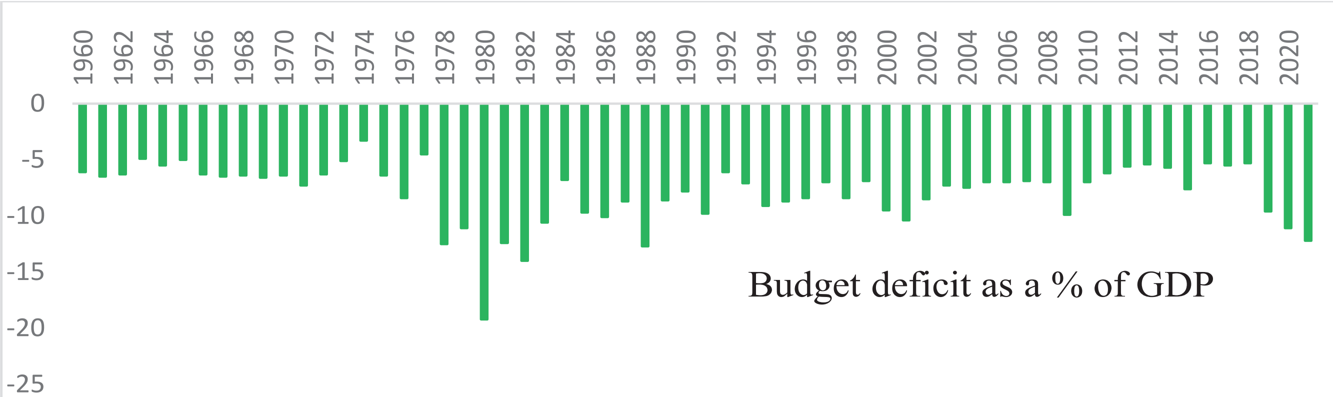
As shown in Figure 3, the budget deficit has widened in 2021 as a result of increased government spending amidst declining revenues. High budget deficits over the last 3 years have resulted in mounting public debt. The COVID-19 pandemic made a challenging situation worse, triggering debt sustainability concerns. Due to the economic contraction and the higher budget deficit during COVID-19, the debt to GDP ratio has increased to 104.6 percent in 2021. Moreover, high budget deficits emanated from pandemic driven

Figure 2. Debt-to-GDP ratio (1960-2021)



Source: Central Bank of Sri Lanka

Figure 3. Budget Balance (1960-2021)

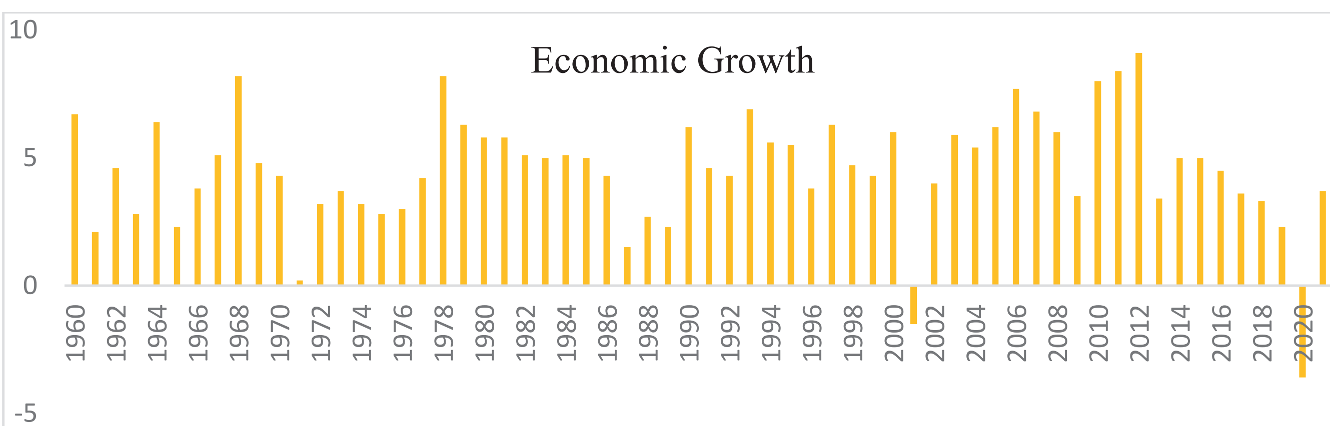


Source: Central Bank of Sri Lanka

uncertainties added to the already large Government debt, thereby challenging the fiscal targets in the near term. The pandemic has significantly constrained economic growth and revenue mobilisation, while several stimuli measures undertaken to cope with the pressing economic and health related issues have significantly increased Government expenditure further escalating the Government debt profile in 2021.

The negative GDP growth rate was recorded in 2001 mainly because of the terrorist attack on the airport. In addition, failure to in address the security situation in a timely manner prolonged the civil war which had a dampening impact on the GDP growth rate. The GDP growth rate was negative in 2020, reflecting the impact of the global coronavirus pandemic (Figure 4).

Figure 4: Economic Growth (1960-2021)



Source: Central Bank of Sri Lanka

Sri Lanka's economy demonstrates both, fiscal unsustainability and poorer economic growth for the period 1980 to 1990 mainly due to the government's resistance to curtail social welfare amidst the propagation of liberalization policies and the significant expenditures incurred to maintain security in the country amidst insurgencies and civil war. Moreover, Sri Lanka lost its competitiveness in the international market mainly because of insufficient exchange rate adjustments on a timely basis that went hand-in-hand with economic liberalization. In addition, weakening terms of trade, economic inefficiencies and crises of governance resulted in falling growth rates in Sri Lanka.

Way forward

Accommodating a higher public debt level to support economic growth is not a prudent policy option because it would exert pressure on the interest rates to increase. In order to address the debt servicing costs and the economic challenges concurrently, the debt-to-GDP level should be maintained at a sustainable level. In addition, reducing financial support in terms of generic subsidies could help create fiscal space within the budget, while at the same time, supporting the poorer segments of the population by directing the subsidies to targeted groups. To achieve debt sustainability in the long run, the Government of Sri Lanka should manage the public debt levels better by developing financial markets and reducing the cost of borrowings. Furthermore, it is important to control government expenditure and generate revenue efficiently, to achieve lower debt levels. Hence, policymakers should understand the debt-growth nexus to formulate sound macroeconomic policies to enhance future growth prospects.

Policymakers are currently dealing with massive challenges brought by the COVID-19 and the subsequent debt crisis; that they would need to consider innovative policies to help us recover from this situation. There is a dilemma in that the economy had to take a beating to pave the way for the country's public debt to deviate from an unsustainable path to a more sustainable one. It is important to keep the public debt sustainability through fiscal prudence and debt restructuring / debt relief initiatives. However, high budget deficits would continue to add to public debt, thus compromising debt sustainability. The pandemic drastically reduced economic growth and tax revenues, while fiscal stimulus had to be undertaken to cope with the sharp fall in demand, which aggravated the public debt situation further. The high budget deficit and rising public debt level could further deteriorate the debt dynamics and negatively impact market sentiments. Sri Lanka lost access to the international sovereign bond market at the onset of the pandemic. In addition, Real GDP contracted by 3.6 percent in 2020, mainly due to a loss of tourism receipts and the pandemic driven lockdown measures.

As a result of the continued deterioration of debt statistics, IMF in their country report on Sri Lanka (the Article IV Consultation) concluded that Sri Lanka's public debt is no longer sustainable, in March 2022. In mid-April 2022, the Ministry of Finance announced that the policy of the Sri Lankan Government was to suspend normal debt service on external debt, for an interim period pending an orderly and consensual restructuring of those obligations in a manner consistent with an economic adjustment programme supported by the IMF, as the country's economy was badly affected by the coronavirus pandemic and the war in Ukraine which have hurt tourism revenue and driven up commodity prices. However, new credit facilities and disbursements under existing credit facilities, after the announcement are not subject to this policy and shall be serviced normally. In the meantime, the Government is obtaining legal and financial advice from leading international financial advisors and legal consultants with experience in advising sovereigns in managing their external debt in a sustainable manner having engaged in liability management.

Moreover, the Government is seeking financial help from multilateral and bilateral partners to alleviate the suffering of the people that this extraordinary economic situation has imposed. In the meantime, the Central Bank, the Ministry of Finance, and the

Government continue to engage with investment and lending partners to secure foreign financing and remain committed to honouring foreign currency debt service obligations, in the future.

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Disaster Recovery Loan Scheme for Coping with Climatic Shocks in Sri Lanka

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1. Introduction

Natural disasters are becoming a widespread phenomenon globally and their impact is seen to be increasing rapidly in the recent past; mainly due to the higher frequency of occurrence, the larger magnitude of impact, and the unpreparedness of disaster-stricken countries. These disasters induced by climate change pose a growing threat to the economies and lives of millions of people around the world. It is often the poor people, the small farmers, the fishing community, and Micro, Small, and Medium Enterprises (MSMEs) that are most vulnerable to natural disasters; Since most natural disasters cannot be avoided, it is best to address the issue through the establishment of a disaster recovery loan schemes among other coping mechanisms to develop resilient communities.

2. Climatic Shocks: Global Context

The Disaster Risk Management Overview (DRMO 2022) of the World Bank states that the total damages caused by natural hazards globally increased more than 800 percent, from US dollars 18 billion a year in the 1980s to US dollars 167 billion a year in the last decade. Further, over the past 40 years, the lives of more than 2.4 million people and assets worth almost US dollars 3.7 trillion have been lost due to disasters caused by natural hazards globally (DRMO 2022), as a result of which the livelihoods of these communities were severely affected, with significant and long-lasting implications on poverty. A World Bank report funded by the Global Facility for Disaster Reduction and Recovery (GFDRR), shows that climate change threatens to push an additional 100 million people into extreme poverty by 2030 unless rapid, inclusive, and climate-informed development is envisaged in the short-run (Hallegatte et al., 2016). The climate change which is the long-term shifts in temperatures and weather patterns, primarily due to burning fossil fuels like coal, oil and gas (United Nations - Climate Action) increases the frequency of the natural disasters. In a working paper by Thomas & LLpez, (2015) on increase in climate-related disasters, suggest a connection between the increasing number of natural disasters and man-made emissions of greenhouse gases in the atmosphere casing climate change.

The report of the United Nations (United Nations Office for the Coordination of Humanitarian Affairs (OCHA), 2022 highlights that 77 percent of the world's disaster-affected people live in Asia and the Pacific region. Accordingly, disasters affected 700 million people across the region from 2015 to 2019, resulting in 44,000 deaths, while 3.5 million people lost their homes, and the damage to property totaled US dollars 286 billion. By 2020, 69 percent of the global population who were newly displaced by disasters, lived in Asia and the Pacific region; including 4.4 million people temporarily displaced in the Philippines due to natural disasters. As per the Global Humanitarian Overview 2022, heatwaves, droughts, floods, and tropical cyclones are becoming increasingly frequent and intense, as a result of climate change.

According to the World Meteorological Organization (WMO), the weather-related disasters have increased over the past 50 years, causing more damage to the economy, but resulting in fewer deaths (WMO, 2021b). A disaster related to weather, climate, or water hazard occurred every day on average over the past 50 years; killing 115 people and causing US dollars 202 million in economic losses daily. (WMO, 2021a). According to the said report, the number of disasters has increased by a factor of five over the 50 years, driven by climate change, more extreme weather conditions, and improved reporting. However, the number of deaths caused by such disasters have decreased almost three-fold; owing to the improved early warning and disaster management protocols and practices (WMO, 2021a).

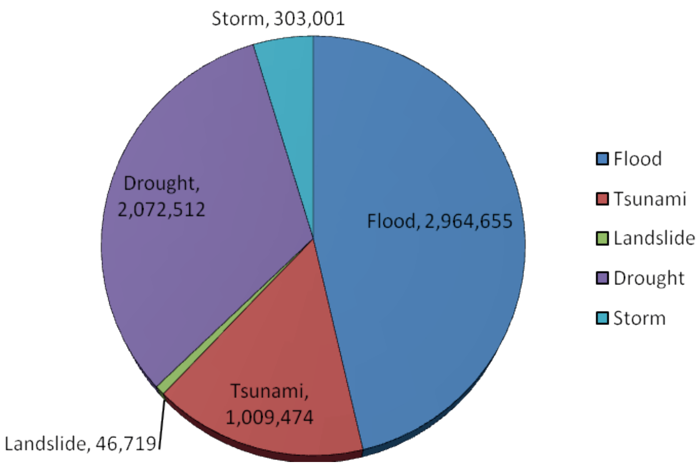
3. Climatic Shocks: Sri Lankan Context

According to the World Bank, Sri Lanka ranked second amongst the countries most affected by extreme weather conditions in 2017. The World Bank has estimated that Sri Lanka is expected to experience a 1.2 percent loss in annual Gross Domestic Production (GDP) by 2050 due to extreme weather conditions brought about by climate change. According to this report, the flood conditions that prevailed in the country during the period from 2010 to 2018, had impacted around 14 million people while the drought conditions that prevailed in the country affected around 12 million people (The World Bank, 2019).

The Hazard Profile of Sri Lanka, prepared by the Ministry of Disaster Management, indicates that Sri Lanka, being an island in the Indian Ocean, is affected by weather-related hazards most often due to the monsoon rains. The floods resulting from excessive rain during the monsoon season, and droughts resulting from the absence of monsoon rains, were the most common hazards experienced in Sri Lanka. However, the highly unpredictable weather patterns tend to result in torrential rainfalls amidst severe flash floods in the urban and suburban regions of the country. This is partly due to the unorganized constructions that have taken place in the urban areas. Further, Sri Lanka is also prone to hazards such as landslides, lightning strikes, coastal erosion, epidemics, and the effects of environmental pollution.

Based on the information available on the people affected by natural disasters during the period 1974 to 2004 (is given in the figure below) floods, drought, tsunamis, storms, and landslides have been identified as the most common natural disasters that occurred in Sri Lanka.

Figure 1 – Number of people affected by different disasters in Sri Lanka (1974-2004)



Source: Ministry of Disaster Management

The deadly tsunami in the Indian Ocean affected almost two-thirds of the Sri Lankan coast belt damaging properties of the coastal areas and claiming the lives of 35,000 people in 2004. More than 400,000 people were left homeless while around 250,000 families lost their means of support according to the World Bank (The World Bank, 2014). The Government estimated the tsunami to be the most devastating natural disaster in Sri Lanka's history that resulted in losses of over US dollars 1 billion in assets and affected US dollars 330 million in potential output. According to a report from the World Bank, the damages included 110,000 houses, of which 70,000 were destroyed (The World Bank, 2014). This incident highlighted the country's vulnerability to low-frequency but high-impact events.

The disaster situation summary reports from 2016 – 2021 of the National Disaster Relief Services Center (NDRSC) reveal that despite the increase in the number of affected families and persons during the years 2016 – 2017, the situation has eased out since 2019.

According to a World Bank study, the floods and landslides that occurred in May 2017 affected 15 districts in Sri Lanka, and resulted in 213 deaths, caused partial or full damages to 88,000 houses, and displaced more than 100,000 people; culminating in total economic losses of about Rs. 70 billion. Further, the drought conditions that prevailed in 2016 and 2017 affected 1,927,069 people in 17 districts in Sri Lanka and affected 50,615 hectares of paddy out of 612,224 hectares cultivated in the Maha season (The World Bank, 2017).

MSMEs in the Colombo district were also severely impacted by the devastating floods in mid-2016. This research found that from an economic perspective, loss or damage of equipment was the highest damage caused by the flood in the short run. While around two-thirds of MSMEs completely lost/damaged their equipment, the loss of records had a lesser impact. Disrupted cash flow and loss

Table 1: Families and Persons affected due to Disasters 2016 – 2021

Year	No. of Families affected	No. of Persons affected
2016	530,963	1,850,308
2017	1,415,650	5,074,061
2018	744,693	2,673,243
2019	511,036	1,823,560
2020	310,742	1,149,945
2021	247,750	930,992

Source: Disaster Situation Summary Reports, National Disaster Relief Services Center of income streams affected MSMEs most in the long run caused by structural damages to buildings (Samantha, 2018).

Approximately 12 percent of those affected were poor, nearly twice the national average of 6.7 percent. In the case of the landslides, the 11 affected Divisional Secretary Divisions tend to be poorer than the national average. Overall, those affected by the floods were also disproportionately poor, with an estimated poverty rate of 8.7 percent. Both, the direct and indirect impacts of natural disasters are devastating to business activities and the continuity (Samantha, 2018). According to Samantha (2018), these catastrophic events have created a significant negative impact on most business entities including MSMEs in the recent years.

4. The importance of a disaster recovery loan scheme to Sri Lanka to cope with climatic shocks

The frequent occurrence of natural disasters and the increased severity of such disasters in the recent past increases the significance and the need for a disaster recovery loan scheme to support the small farmers, fishing communities, and MSMEs in the country. The financial assistance provided by such a loan scheme will facilitate the faster recovery of the affected small farmers, fishing community, and MSMEs, from the impact of such natural disasters. The financial assistance will also improve the recoverability of other production-related loans of the affected borrowers in the future.

5. The disaster recovery loan schemes introduced in Sri Lanka

Considering the impact on the livelihood of those affected by natural disasters, there were ten loan schemes introduced with funding from the Government, the Central Bank of Sri Lanka (CBSL), and several Donor Agencies. As Sri Lanka was one of the affected countries due to the Indian Ocean Tsunami on 26 December 2004, there were seven loan schemes introduced after the disaster to cope with the destruction. The schemes, collectively, have provided loans amounting to Rs. 9,000 million to facilitate the resumption of activities of the MSMEs affected by the Tsunami and for the post Tsunami reconstruction work.

The Post-Disaster Economic Activity Recovery Loan Scheme (PEARL) was introduced by CBSL in 2018 under the National Agribusiness Development Project with the funding of the International Fund for Agriculture Development (IFAD) to support disaster-affected economic activities to resume operations. This project was concluded after providing credit facilities of Rs. 135 million.

The "Athwela"- Resumption of Economic Activities affected by Disasters (READ) Loan Scheme was introduced in 2017 to provide concessionary financial facilities to resume any economic activity affected by any disaster as informed by the Government of Sri Lanka (GOSL). The GOSL, CBSL and the Participating Financing Institutions (PFIs) are the parties collaborating to set up the loan scheme. The GOSL continued to provide the funding for the project and disaster regions will also be demarcated by the Government. The loan provides a special focus on the small-scale business and self-employed businesses affected by natural disasters.

During the year 2018, Rs. 1,500 million was disbursed compared to Rs. 100 million in the 4 months of operations in 2017. During the year

Table 2: Loan Schemes introduced to cope with natural disasters in Sri Lanka (Concluded)

Name of the Project	Total Allocation of the Fund (Mn.)	Purpose of the Loan	Refinance Granted to PFI s (LKR Mn.)
Susahana Loan Scheme - Finance & Leasing Company	LKR 353	To provide credit facilities to the resumption of enterprises affected by the Tsunami.	351
Small Business Revival Programme	LKR 2,656	To provide credit facilities for the resumption of Small and Medium Enterprises (SMEs) affected by the Tsunami.	2,663
Small Business Revival Programme – Revolving Fund	LKR 150	To provide credit facilities for the resumption of SMEs affected by the Tsunami	123
EIB Contract B Loan Scheme	EUR 10	To reconstruct SMEs directly affected by Tsunami	1,553
Susahana Loan Scheme	LKR 3,000	To provide credit facilities to resume MSMEs affected by Tsunami	2,750
Susahana Loan Scheme - Phase II	LKR 500	To provide credit facilities to resume MSMEs affected by the Tsunami	106
Construction Sector Development Project	EUR 9	To strengthen the financial and technical capacities of private local businesses to effectively participate in construction and public work in post Tsunami reconstruction.	1,400
Post-Disaster Economic Activity Recovery Loan Scheme (PEARL)	LKR 135	To support borrowers in the post-disaster recovery efforts of the business/small enterprises affected by floods/drought by providing the fund requirements to resume their businesses or income-generating activities.	135

Source: Annual Report 2020 – Central Bank of Sri Lanka

Table 3: Loan Schemes introduced to cope with natural disasters in Sri Lanka (Ongoing)

Name of the Project	Total Allocation of the Fund (LKR Mn.)	Purpose of the Loan	Refinance Granted to PFIs (LKR Mn.)
Saubagya Loan Scheme[1]	32,061	To extend credit to MSMEs and disaster-affected MSMEs	32,061
Athwela Loan Scheme (READ)	2,000	To provide financial facilities to eligible sub-borrowers to resume any economic activity affected by any disaster as informed by the GOSL.	1,688

Source: Annual Report 2020 – Central Bank of Sri Lanka

1 The main objective of the scheme is to start up or expand any MSME. However, in the past the loan scheme was used to finance any MSME affected by disasters as well.

2019 loans amounting to Rs. 303 million were disbursed. The loans are granted at a maximum interest rate of 2 percent per annum and the amount of the loan is capped at Rs. 500,000. The maximum loan maturity period is 3 years including a 6-month grace period.

The details of the concluded and ongoing schemes are provided in Tables 2 and 3.

6. The way forward: How we can improve disaster recovery loan schemes in Sri Lanka

There is a grave need for a properly designed disaster recovery loan scheme to help small farmers, the fishing community and the MSMEs affected by the increasing number of natural disasters in the country. Almost all the schemes introduced in the past have been linked to a specific natural disaster or a calamity (E.g.: Tsunami in 2004). However, natural disasters take on different forms; through floods, drought, storms, landslides, tsunami, lightning strikes, coastal erosion, epidemics, and effects of environmental pollution. Although the Government Budget has allocated contingent funds to cover the recovery efforts and to pay compensation to the victims of an incident, as and when they occur, there is no fund to cover all disasters, on an ongoing basis. The prevailing initiatives to provide disaster recovery loans have many issues, such as the ad-hoc nature of their responses and the delayed response times, arising mainly from the fact that they are not going concerns. Thus, a loan scheme should be designed to operate on a continuing basis, with the regular allocation of funds from the government or any other donor agency, preferably with annual allocations, enabling the loan scheme to continue as perpetuity on a rollover basis. The disaster recovery loan scheme introduced by the Philippines can be considered a good example (Please refer to Box below).

Box: The Disaster Recovery Loan Scheme in the Philippines

In the Philippines, considering the gravity and the nature of risk associated with the production of crops, poultry, livestock, and fishers, the Department of Agriculture (DA) and Agricultural Credit Policy Council (ACPC) of the Philippines has designed and introduced a combination of two schemes in support of small farmers and fishing community. The two schemes were Production Loan Easy Access (PLEA) and Survival and Recovery (SURE).

For easier credit access, PLEA and SURE uses grassroots level organizations such as Corporatives, Corporative Banks, Associations, Rural Banks, and NGOs/Micro Finance Institutions as lending conduits/channels.

Production Loan Easy Access (PLEA) is a loan facility to finance the production of crops, poultry, livestock, and fishers operating at the margin and small scale farming and fishing communities. The PLEA primarily focuses on unbanked and underbanked areas and other priority areas identified by DA. The other features of the PLEA loan scheme are as follows.

- *Interest rate – 6 percent p.a. / 0.5 percent p. m.*

- *non-collateralized loan*

- *Loan maturity depends on the crop type*

- *Free insurance cover from Philippine Crop Insurance Corporation*

- *The borrower needs to go through a financial literacy program*

The Survival and Recovery (SURE) is a loan facility designed to finance requirements in rehabilitating farming, and fishing livelihood activities of marginal and small farmers and the fishing community. The SURE program aims to: Support the government's goal of helping agricultural households in calamity-affected areas regain their capacity to earn a living; and provide immediate relief to small farmers and the fishing community through loan and emergency assistance packages.

The key features of the SURE are as follows.

- *Interest rate – 0 percent p.a.*

- *Repayment up to 3 years (based on the capacity)*

- *The program focuses on areas "under a state of calamity"*

- *One-year moratorium on loan payments for existing borrowers having loans under ACPC programs*

In developing a disaster recovery loan scheme, the following key aspects need to be considered.

- A disaster recovery loan scheme should consider providing both survival assistance and recovery assistance to the farmers, fishing community, and MSMEs affected due to a disaster.
- Quick response time to provide financial assistance: One of the key features to consider when developing a disaster recovery loan scheme is the response time. A timely response to the needs of the victims, by providing the financial assistance to fulfil the basic survival needs is a must. The recovery will be faster and steady when the survival needs of the victims are met promptly.
- Twofold financial assistance to victims:

a) Grant Assistance: financial assistance to be provided to the victims as a grant to fulfil the emergency and immediate needs such as food, shelter, and sanitation.

b) Credit Support: financial assistance as a loan to recover from the disaster and a loan moratorium for existing loans. In addition a predetermined grace period is to be provided for the loan repayments.

- A disaster recovery loan scheme should consider providing loans at 0 percent or a very low-interest rate.
- Additionally, a grace period can be provided for other loans of affected borrowers by adding back the amount due to the back end of an existing loan.

7. Conclusion

Sri Lanka has been considered a highly vulnerable country that is likely to be affected by extreme weather conditions and ranked second among the countries most affected in 2017. Further, while the economic impact of such climatic shocks seems to be rising, the ongoing urbanization process will further increase the number of people affected by these adverse weather conditions. Samantha (2018) highlights that MSMEs need external support to get back to their usual business. Therefore, the Government should act as an initiator in this process. In this context, while continuing to battle against the climatic shocks by developing more resilient farmers, fishing communities, and MSMEs, who can recover relatively faster pace from these adverse scenarios by introducing disaster recovery loan schemes, supported by more concrete measures to protect the environment and proper early warning systems to mitigate the losses to the economy and the people.

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PRINCIPLES OF CONSOLIDATED SUPERVISION AND POSSIBLE APPLICATIONS IN THE SRI LANKAN CONTEXT

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Introduction

The Basel Committee on Banking Supervision (BCBS) is the primary global standard setter for the prudential regulation of banks and provides a forum for regular cooperation on banking supervisory matters. BCBS, was set up in 1974. The Committee, headquartered at the Bank for International Settlements in Basel, was established to enhance financial stability by improving the quality of banking supervision worldwide, and to serve as a forum for regular cooperation between its member countries on banking supervisory matters.

As per the BCBS, an important aspect of banking supervision is the supervision of banking groups on a consolidated basis, enabling the adequate monitoring of all aspects of the business conducted by the banking group worldwide and applying prudential standards, as appropriate, A banking group includes the holding company, the bank/s and its branches, subsidiaries, affiliates and joint ventures, branches, both domestic and foreign. These companies may or may not be in the financial sector. Increasingly, financial conglomerates with complex structures have emerged all over the world, especially in developed countries, requiring banking supervisors around the world to use tools such as Consolidated Supervision (CS) to understand the risks to banking groups due to risks emanating from one entity.

CS could also be defined as a comprehensive approach to evaluate the strength of an entire banking group considering all the risks, that may affect a bank and the other entities in the group, regardless of whether these risks are booked in the bank, or in affiliated entities. The group risks mentioned above emanate from financial and non-financial relationships of the bank with the parties that make up its broader group.

Group Structures

Complex structures of large groups of companies make it difficult to understand their interrelations, which makes them difficult to supervise. Group-wide supervision is difficult as it requires multidisciplinary skills, dedicated resources and a comprehensive risk assessment process. Most of all, it requires an independent supervisor with strength to withstand political pressure and interferences. Implementing group-wide supervision requires understanding the structure of the corporate group in which a bank is integrated. Supervisors should not allow complex structures, if it ultimately obscures the identity of the actual persons who are controlling the banking entity. There are a variety of approaches to conduct a group assessment and reach a conclusion about the risk profile of a group. The bottom-up approach is probably the most common and least advanced. In this approach, each sectoral supervisor assesses risks in the entities for the sectors they are responsible for, and the assessment for each sector is combined by a lead or coordinating supervisor for the group which is, most often, the banking regulator. This approach gives rise to a host of issues ranging from the level of convergence in risk regulations to the supervisory styles. Although the top-down approach is probably the most advanced, it is the least common among emerging and developing countries . In this approach, the group supervisor assesses risk activities and central control functions from a top parent group perspective, to get a wholistic view of what is happening in the parent as well as the subsidiary and associate companies. The results are used to determine the business lines and units that would require further on-site assessments by the sector and risk specialists.

Reasons for Consolidation

There may be several possible reasons for consolidation of entities. Financial innovation, competition, mergers in the industry, avoidance of regulatory involvement are some of them. Further, the regulatory objectives on consolidated entities are also different. As an example, for banks, regulator's objective is the safety and soundness of the institution/ protection of the depositor. For securities firms, the regulator's objective is aligned with market disclosures, adequate reporting and protection of investors.

Therefore, in some instances, persons having a controlling interest in groups attempt to mislead regulators through consolidating companies in different industries so that they will be subject to the purview of different regulators. In such instances, it is very difficult to supervise such entities as a consolidated entity.

Main steps in Consolidated Supervision (CS)

Different regulators may follow slightly different approaches to CS. However, the approach adopted by the U.S Federal Reserve, which supervises many banking groups is considered as a best practice in the world. The first step is to prepare an institutional overview of the group. This may include Business Strategy, Financial Profile including Capital Structure, Funding Sources and Credit Ratings. The institutional overview also covers Corporate Governance, including information pertaining to the Board of Directors and key management personnel and details of their foreign operations. The next step is to prepare a consolidated risk assessment including Credit, Market, Liquidity, Operational and Legal/ Compliance risks. Based on this information, a supervisory plan is prepared and on-site reviews are carried out for the bank holding company and its material foreign operations. Holding company structures may include many different legal entities supervised by different regulators. For example, in the United States, the Federal Reserve supervises State Member Banks, while the Office of the Comptroller of Currency supervises National Banks and the Securities Commission supervises securities dealers. Arrangements for sharing reports, ratings assessments and information from continuous supervision activities and coordination of reviews and leveraging resources to achieve efficiencies and limit regulatory burden should be undertaken.

Further, home-host supervisory relationships are very important in CS as some banking groups may have holding companies or subsidiaries overseas.

Basel Core Principle 13 on Home-Host Relationships covers this requirement on supervision. Host supervisor should share appropriate information on a timely basis with home supervisor, including material risks, risk management practices, host supervisors' assessments of entities under their jurisdiction. Further, host supervisors should coordinate and plan supervisory activities or undertake collaborative work on common areas of interest with the home supervisor.

CS for Foreign Banking groups

Similarly, for Foreign Banking groups, the first step involves the preparation of an institutional overview of the group.

Then, it is essential for the regulators to obtain an understanding of the home country supervisory and financial system

Next, information such as material risks and financial performance of the bank locally from home supervisors should be obtained through Supervisory colleges, Memorandum of Understandings (MoUs) and meetings.

Ratings used by the US Federal Reserve for CS of Banking Groups

The ROCA rating which considers Risk Management, Operations, Compliance, and Asset Quality is prepared for individual foreign branches and agencies of each foreign bank branch. The CAMEL (Capital, Asset quality, Management, Earnings and Liquidity) rating which is widely used all over the world is used to rate the banking operations of the group. Then, a rating is used to assess the bank holding company. This rating is known as LFI or a Large Financial Institution rating which is used for large Intermediate Holding Company (IHC) with total assets (excluding assets of its subsidiaries) of $50 billion and more. Criterion such as capital, liquidity and governance are used to assess this rating. For smaller non-complex financial institutions which are holding companies, a rating called RFI (Risk, Financial Condition and Impact) is used to rate the holding company.

Finally, a combined rating for all US operations abbreviated as CUSO (Combined US Operations) rating is prepared for all US banking and non-banking operations.

The preparation of rating takes into account the risks, risk management tools, financial conditions and impact of non-banking entities on the banking group.

Risk Integration for Financial Groups

As indicated above, the most important aspect of CS is the assessment of risk for individual banks, other financial entities and combine them as a common risk indicator. To achieve this, a consolidated risk matrix needs to be prepared. A risk matrix summarises the inherent risks and risk mitigants for each type of risk. For each risk type, the inherent risk and risk mitigants should be tabulated to give the result which is the net risk.

Common types of risk categories are Credit Risk, Operational Risk, Market Risk, Liquidity Risk

Compliance/Regulatory Risk and to a lesser extent, Strategic Risk, Legal Risk, Reputational Risk and Model Risk. The inherent risk and risk mitigants should be rated to give the final 'net' risk result. Different assessment criteria would be used to assess each risk type. For example, loss data and scenario analysis are used to assess operational risk. For market risk, indicators such as Value at Risk (VaR), marked to market losses are used. It is not a straightforward exercise since some risks such as credit and market risks are entwined. Then, this 'net' risk should be used to calculate the different ratings mentioned above such as ROCA, RFI… etc. Supervisory activities and resources should focus on Risk Management and Internal control factors that are considered less than satisfactory, particularly where they relate to relatively higher inherent risks. Such areas are also likely to be addressed in both, the risk assessment and the supervisory plan. Enterprise Risk Management (**ERM**) is vital in CS. ERM is a methodology that looks at risk management strategically from the perspective of the entire firm or organization. It is a top-down strategy that aims to identify, assess, and prepare for potential losses, hazards, and other potentials for harm that may interfere with an organization's operations and objectives and/or lead to losses. Costs and technology are some barriers to introduce **ERM** for firms.

A similar rating assessment should be undertaken for the other components of the rating such as Capital, Liquidity, Financial Condition…etc. For these types of indicators, the ratings may be as very strong, strong, adequate, weak…etc. Finally, all the ratings should be combined to arrive at the consolidated rating.

The supervisory plan for each consolidated entity should be prepared mainly taking into consideration the risk assessment process.

CS in the Sri Lankan context

CS is a relatively new concept in the local context. Sri Lanka does not currently have large financial groups. However, there are few groups which have either a bank or a Licensed Finance Company (LFC) as a subsidiary or more commonly, a bank acting as the holding company of one or more LFC. Further, few licensed banks have established foreign branches. Also, some financial groups have insurance firms, fund management companies and other non-financial companies in its group. In recent developments related to CS in Sri Lanka, Bank Supervision Department of Central Bank of Sri Lanka (CBSL) has initiated conducting Statutory Examinations of Licensed Banks on a consolidated basis during 2020 and two Statutory Examinations extending the scope to CS were completed during 2020. CBSL is also in the process of introducing a new Banking Act, which is expected to address the concept of CS of financial groups in Sri Lanka.

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