KPMG

Sri Lanka Banking Report

Issue 5
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KPMG in Sri Lanka

Contents

Foreword

The banking industry in Sri Lanka will continue to face further challenges, both financially and operationally in 2020 with the COVID-19 pandemic and nation wide lockdown to limit the spread. However, in such times, banks, the backbone of the economy, have a fundamentally important role to play as they provide liquidity to support businesses and individuals during this crisis.

As businesses and individuals struggle through this crisis, the Banking system of the country has to play a crucial role in the mobilization and better allocation of funds. In light of this, the Central Bank of Sri Lanka has imposed a number of measures to support borrowers with moratoriums and low interest working capital loans.

Together with these measures, CBSL has also provided flexibility to the commercial banks to enable them to withstand these moratoriums by allowing not to consider these as trigger for significant increase in credit risk (SICR) and therefore not necessitating a change in classification, increase drawdowns on capital buffers and defer meeting minimum regulatory capital requirements.

The COVID-19 pandemic is changing many things: the way people shop, the way they work, the nature of social interaction. It is also having a profound effect on businesses that are having to configure their workforces and operations very differently to cope with lockdowns and supply chain interruptions.

Although banks haven't had to close all their branches given the essential nature of their services, bank operations have nevertheless felt the impact of the pandemic. Staff shortages and the safety of employees, combined with less commerce occurring in general, have meant that around quarter of bank branches had to shut down for operations while bringing in significant pressure on operating branches, during the outbreak in Sri Lanka as many countries and territories. There is no doubt that, as the crisis passes, bank branches will open and be operational again and business will continue. But will it be the same, in the long run? I believe that the pandemic could potentially be a significant accelerator of trends that were already starting to gather. In this COVID-19 world when movement is so restricted for so many, we saw a huge level of growth in remote banking and there is no doubt that the trend will continue.

Ranjani Joseph
Partner
Head of Banking Services & Markets

Allied with these factors, and reinforcing them, is another trend that has already been taking hold – the move towards a 'cashless society'. The use of cash is already in decline as contactless payment cards and smartphone payments gain in adoption. To stay relevant and cater to the increasingly tech-savvy and demanding customer base, the financial sector should respond with digital-base customer experiences and smart banking which will soon outdate the current infrastructure in place such as physical branches and ATMs.

In addition to customer experience, we expect banks to aggressively upgrade workforce infrastructure such as secure connections and tokens, bandwidth, etc. to promote flexible working arrangements and streamline decision making. Financial Services institutions all over the world are making significant changes to working arrangements and this is helping them continue to deliver services to their customers.

Apart from the natural progression of Fintech, banks will need to reflect on the prevailing crisis with a business continuity vision to be able to face such inevitable adversity again. As the banks now operate in a very fast paced environment and are required to adapt to daily change the banks cannot avoid paying attention to its associated risks areas such as strategy, technology, operations, third parties, regulation, forensics, cyber, resilience, data leakage, and privacy. Adapting to implement these controls will be critical to its sustainability. The current economic environment can be the facilitator to increased focus on these areas.

This is the fifth issue of the Sri Lanka Banking Report we have produced. We have discussed the performance and trends last audited financial year .and key issues which we feel the sector could face due to COVID-19.

We will continue to find ways to support our clients in this era where the consequences of COVID-19 have not fully sunk in and we are yet to know the overall impact on the economy, corporates and society.

Executive

Economic growth during the year 2019 was impeded as the year began with continued political tensions from October 2018 followed by the Easter Attack in April 2019. Year 2020 has now come under more pressure with the catastrophic outbreak of COVID-19.

The COVID-19 crisis has dramatically gathered pace in recent days, with fresh developments almost by the hour. Many countries have declared national emergencies and are fighting to contain the virus' spread.

The CBSL took speedy measures to contain the economic crisis by further slashing the policy rates, introducing both interest and capital debt moratoriums to a broad set of sectors and restricting imports as a measure to stabilize the exchange rate amid a sharp decline in exports.

In this context, we expect the banking sector to continue to play a vital role as the backbone of the economy, funding liquidity to support businesses and individuals, and facilitating most of CBSL's measures via the banking system. We believe these are the right and necessary measures – but they could come to test some banks' capital strength.

The economy is expected to contract in 2020 following a year of existing weak economic growth of 2.3% in 2019 (versus 3.2% growth recorded in 2018). 2019 experienced frail economic growth due to the slow recovery of tourism and other related sectors in the aftermath of the Easter Attacks coupled with subdued investor and business sentiment on the back of political uncertainty.

The banking sector followed a similar momentum to that of the economy, recording a moderate asset and loan growth of 6.2%% and 5.6% in 2019 compared to 14.6% and 19.6% registered in 2018, respectively.

Interest rates were reduced on three occasions during 2019, resulting in a cumulative 100 bp reduction, and another 50 bps in Jan 2020 to facilitate credit growth. Despite these measures, CBSL reduced policy rates in four instances totaling to 100bps, each for SDFR and SLFR to 5.5% and 6.5% respectively and the SRR by 100 bps to 4.0% as relief measures in response to COVID-19.

In addition, the bank rate used for temporary liquidity purposes was also reduced by 550 bps to 9.5%. Prior to COVID-19, the LCBs were required to reduce their AWPLR by 31 December 2019, subject to a floor. As a result, the overall AWPLR fell 230 bps to 9.9% as at 31 December 2019 from 12.2% in April 2019, marking the first time since April 2016 that AWPLR dropped to single digits.

As a result, the overall AWPLR fell 230 bps to 9.9% as at 31 December 2019 from 12.2% in April 2019, marking the first time since April 2016 that AWPLR dropped to single digits.

These lending rate caps were imposed following a discontinuation of the previously imposed deposit rate caps. With the ongoing crisis of COVID-19, we expect the lending rates to remain at current levels or be reduced as a stimulus to economic growth.

The asset quality of loans deteriorated with gross NPLs increasing to 4.7% in 2019. However, with moratoriums imposed on SMEs in January 2020 and on other COVID-19 impacted sectors in March 2020 the full impact to asset quality will not be reflected immediately, but in 3 to 6 months time as the moratoriums conclude.

We expect the impact of COVID-19 to reduce interest and non interest income both due to the moratoriums offered, deferred debt repayment plans, reducing asset quality, and slow credit growth in the next 12 months.

This downturn is followed by reduced profitability on the back of lackluster economic and private sector credit growth. Furthermore, the rate cuts and imposition of interest rate caps are likely to suppress the sector's NIMs and spreads in the short term.

Summary

In particular, margins will be thin with around two thirds of most banks' income being derived from interest amidst a low interest rate environment.

CBSL's expansionary monetary and fiscal policies introduced at the commencement of 2020 such as the reduction in VAT and income tax in selected sectors including banking, removal of Debt repayment levies, WHT and PAYE for lower income brackets, aimed at boosting the sector's profitability, will not only be offset by the outbreak of COVID-19, but create a much larger negative impact on the banks' earnings.

In 2019, the banking sector was well capitalized with the sector maintaining minimum capital adequacy ratios at comfortably higher levels to the regulatory requirement of 8.5% and 12.5% for tier I and total capital ratios, respectively. Despite the stringent Basel III requirements, CBSL has allowed banks to increase drawdowns on capital buffers during this period of tight liquidity.

Smaller banks are expected to face severed stress on their capital buffers with profitability coming under pressure. Therefore, we expect industry consolidation as small banks may struggle to remain competitive amidst the current tumultuous economic conditions.

The banking sector was undergoing a phase of digital transformation over the recent past and this has now been accelerated with the need to be accessible during this crisis.

Banks are providing solutions to customer transactions while operating remotely thus creating opportunity to convert the traditional customer to a modern and digitally enabled one.

The banking sector can remodel their operations where branches will concentrate more on adding value towards selling products rather than dealing with transactions such as cash withdrawals or transfers between accounts.

It won't be a smooth sail off ahead as many businesses are likely to face severe difficulties in the coming weeks and months and will continue to exert pressure on banks too.

But the necessary steps are being taken by regulators and banks to bolster the system, weather the storm, and help stabilize the situation.

Short to medium term impact on the sector

The disruption caused by multiple factors will continue to shape how the banking industry will operate and thereby how the economy will bounce back. The overall impact to the banking sector in the short to medium term is shown below:

BANKING SECTOR OUTLOOK - NEGATIVE

- Sri Lanka's banking sector's outlook revised to negative by Fitch in March 2020.
- Earlier anticipated expansion in the economy and credit growth now stunted by the spread of COVID-19, which shows prolonged business disruptions resulting in severe pressure on the earnings and asset quality of banking institutions.
- The prevailing times stand as a testament to the importance of stress testing of banks as they determine whether the financial institutions have sufficient capital in order to withstand the impact of adverse economic conditions.

BANKS' PROFITABILITY UNDER PRESSURE

- Banks' profitability will be under pressure.
- Underlying reasons to be muted loan growth, risk of NPLs, a low interest rate environment and loss of fees.
- The moratoriums will ease the financial burden on certain sectors but will lower interest and non interest income to banks and narrow the NIMs and spreads in the next 12 months.

RISING NPL RATIOS

- The NPL ratios recorded an increasing trend in the past quarters, which may not continue due to the new moratoriums being introduced but will have an impact in 6 months.
- The adverse impact to net advances and impairment of the select sectors will come into light only once the moratorium period concludes.

RELIEF MEASURES BY CBSL

- Relaxed NPL classification rules.
- Extension to meet the increased minimum capital requirement to 2022.
- Increased allowance to drawdown on capital conservation buffers.

Short to medium term impact on the sector

CHANGE IN SECTOR EXPOSURES

- As some sectors, especially essentials and online tech platforms have been performing well in comparison to other sectors during the lockdown, there could be a potential shift in the bank's sector exposure in the short term.
- Going forward, we can expect more localization, especially with regards to the production of essential goods, resulting in potentially new credit lines extended to these sectors.

CONSOLIDATION OF BANKS

- Measures brought in by the regulator or market forces may lead to consolidation of a heavily fragmented sector.
- Consolidation will result in economies of scale and ease the burden on maintaining high capital and liquidity parameters stipulated by the regulator.

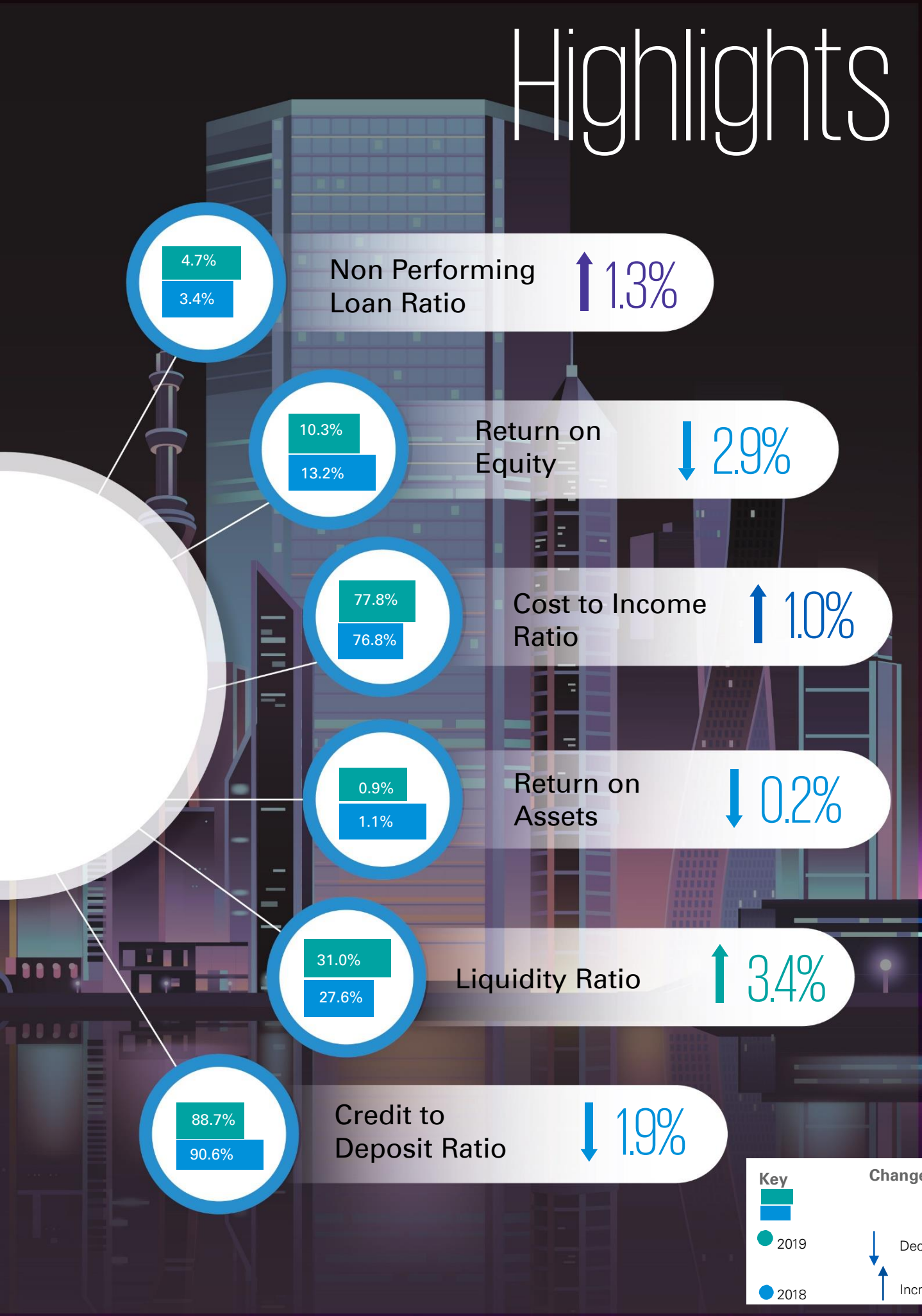
DIGITAL BANKING TO BECOME THE NEW NORM

- As social distancing measures and nationwide lockdowns were enforced, there has been a shift to digital payment channels by the banks and consumers both.
- Permanent shift of behavior towards digitization expected.
- Banks to increase investment and improve digital platforms.
- Increased opportunities for fintech solutions. Block chain technology may emerge post COVID-19 in Sri Lanka

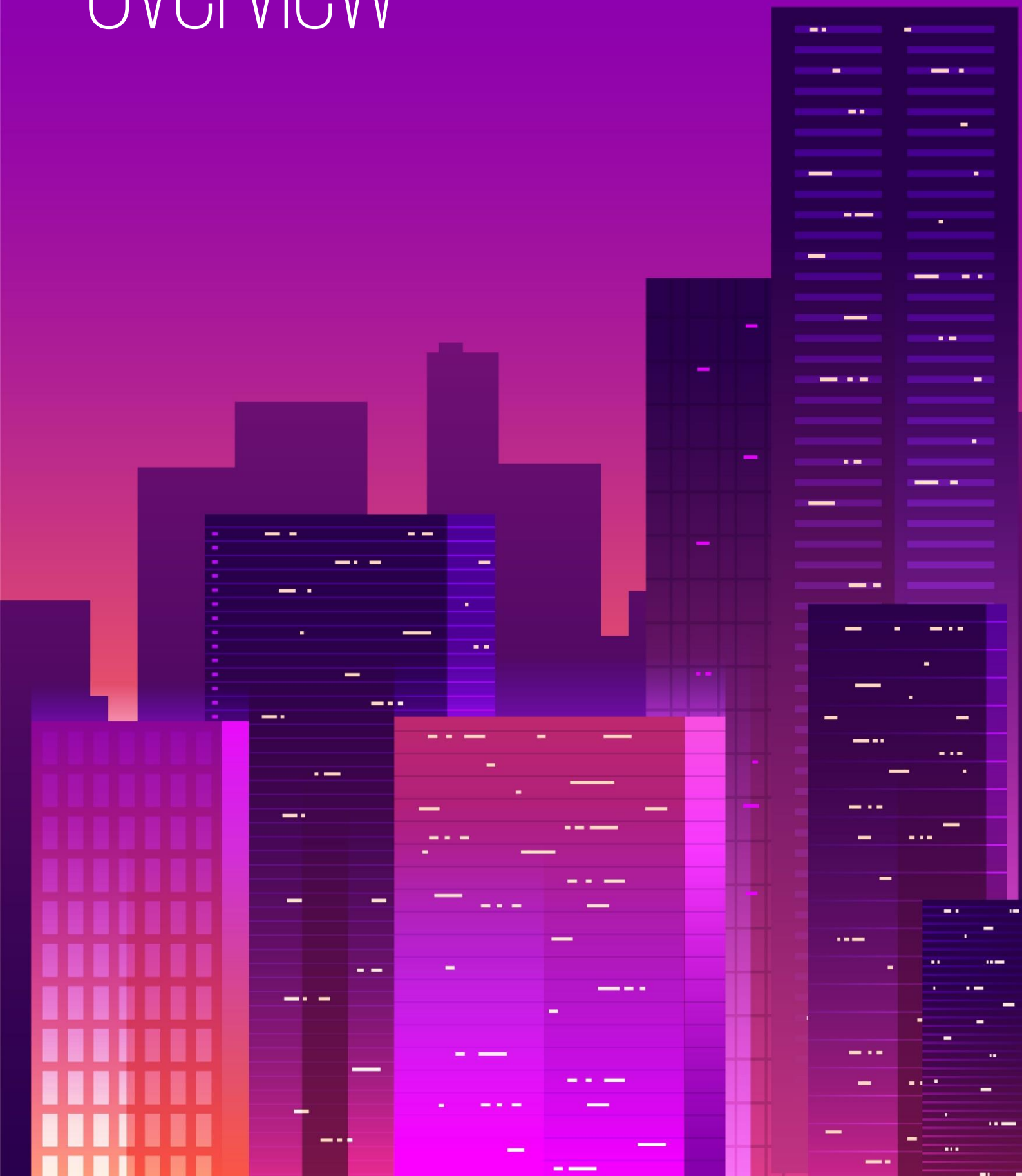
Performance

Total Assets (LKR Bn)	↑ 6.2%	12,522.7	11,793.9
Net Profit (LKR Bn)	↓ 11.7%	111.1	125.8
Core Capital Ratio	↑ 1.0%	13%	12%
Total Capital Ratio	↑ 1.4%	16.5%	15.1%
Net Interest Margin (NIM) (%)	0.0%	3.6%	3.6%

Highlights


4.7%
3.4%
Non Performing Loan Ratio
1.3%
10.3%
13.2%
Return on Equity
2.9%
77.8%
76.8%
Cost to Income Ratio
1.0%
0.9%
1.1%
Return on Assets
0.2%
31.0%
27.6%
Liquidity Ratio
3.4%
88.7%
90.6%
Credit to Deposit Ratio
1.9%
Key
2019
2018
Change %
Decline
Increase

Economic Overview



COVID-19 delays economic recovery of Sri Lanka

The Sri Lankan economy, after being negatively impacted by the Easter Attack in April 2019, was on track for a gradual recovery towards the year 2020. The COVID-19 pandemic which originated from Wuhan, China, quickly spread across the globe and triggered global lockdowns. Sri Lanka initiated curfews across the country resulting in the standstill on a majority of economic activities. Prior to the outbreak of the virus, CBSL estimated the economy to grow at a rate of 4.5-5.0% during 2020 in the backdrop of political stability following the presidential elections, which was revised to 1.5% in April 2020.

GDP and national output

- A widespread drought, which impacted agriculture in 2016 and 2017 drove economic growth downwards. The growth was further hindered during 2019 in the backdrop of Easter Sunday attacks. The services sector led by tourism, retail and financial services declined by 4.6%, compared to a growth of 5.7% the previous year.
- The economy is likely to face a contraction in 2020 due to many sectors being at a standstill. Most of the external agencies also have forecasted a contraction in GDP for 2020.

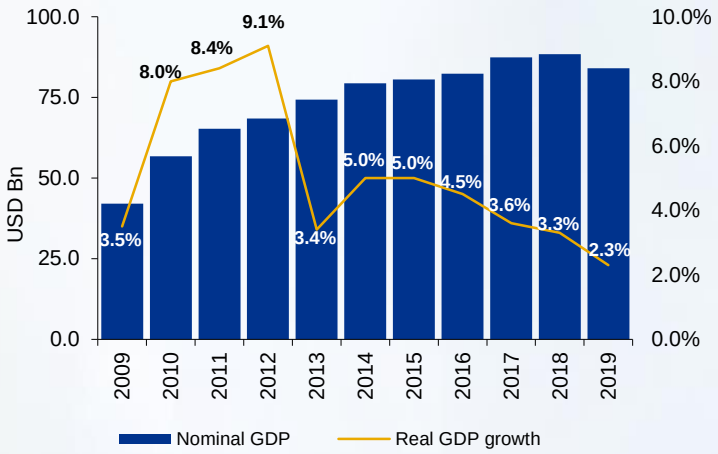
USD 84.0 Bn
GDP (Nominal) - 2019

USD 3,852
GDP (Nominal) per capita - 2019

Inflation and economic outlook

- In 2019, the inflation recorded of 4.3% was driven by high food prices due to supply shortages. The tax concessions introduced before the outbreak in early 2020 reduced pricing pressures. However, food prices in April rose with supply side disruptions while non-food inflation excluding essentials remained the same due to lockdown.
- Inflation is expected to remain within mid single digits in 2020 due to depressed demand. However, as CBSL pumps significant amount of liquidity into the system, as a safeguard measure to the COVID-19 crisis, this could threaten the price stability in the next 12 months.

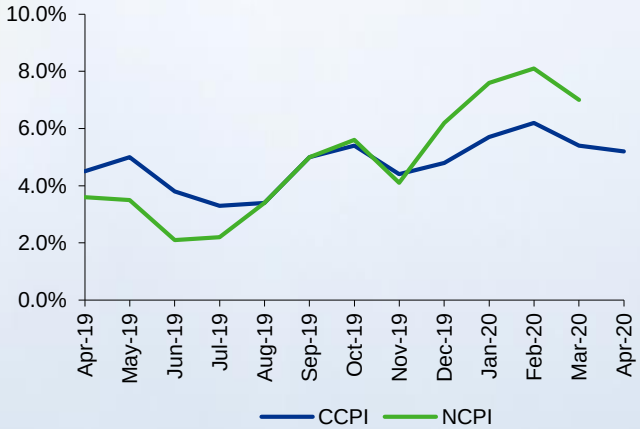
Gross domestic product



Deteriorating fiscal position

- The government revenue is expected to decrease, due to the tax cuts early this year and subdued economic downfall coupled with higher expenditure. Hence, the budget deficit as % of GDP is expected to widen to 8.0-9.5% in 2020 from 6.8% in 2019.
- In April 2020, Fitch ratings downgraded Sri Lanka's sovereign credit rating, while Moody's placed the B2 rating under review for a downgrade due to weak debt affordability and other risks stemming from the declining fiscal position. This is expected to further increase the cost of servicing foreign debt.

YoY inflation



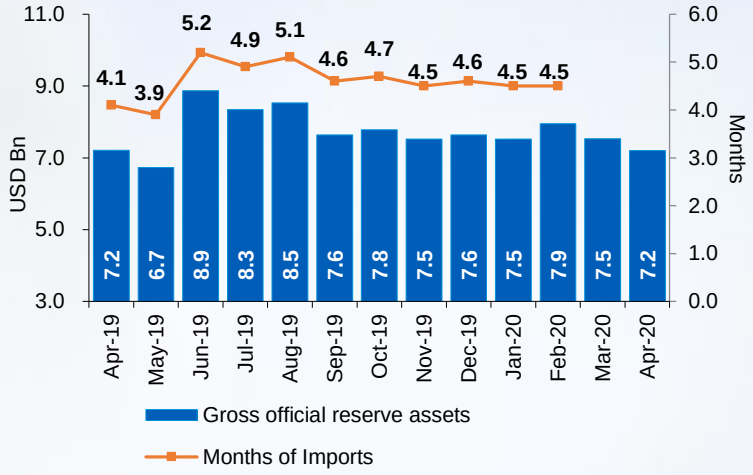
Source: CBSL, ADB, Fitch, IMF, KPMG analysis

Sri Lanka's foreign reserves under stress

External sector under pressure with COVID-19

- In 2019, the external sector remained resilient with a reduced current account deficit of 2.2% of GDP (despite the hit on tourism sector), improved financial account deficit coupled with a stable exchange rate.
- However, current account deficit is expected to expand to 3.3% of GDP in 2020 due to weaker exports dominated by apparel, reduced tourist earnings and worker remittances despite reduced fuel bill and restrictions on non-essential imports.
- Debt to GDP ratio stood at 86.8% as at end 2019 with foreign reserves amounting to USD 7.2 Bn as at end April. Sri Lanka has USD 1.0 Bn in ISBs due in October 2020 among a total of USD 4.8 Bn in external foreign debt due in 2020.

Gross official reserve assets



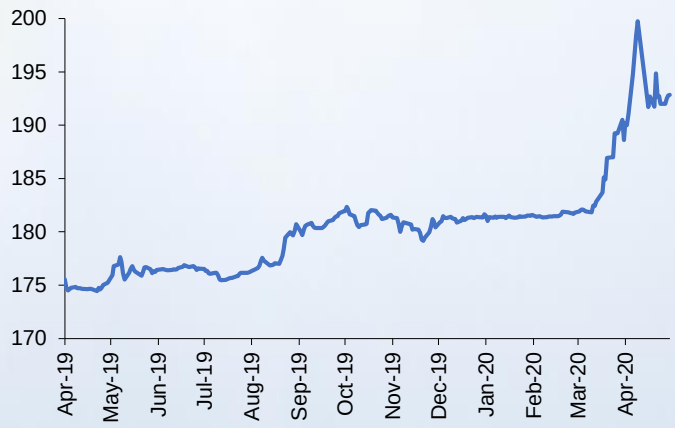
Confirmed foreign funding for the year

- In addition to the above, Sri Lanka is also in talks with the IMF to raise another USD 800.0 Mn under its Rapid Financing Facility and a further USD 700.0 Mn from China.
- The IMF has postponed its seventh review of it's Extended Fund Facility to Sri Lanka until a formal budget is to be presented by the Parliament.
- The dollar inflows from capital markets were seen under pressure in March and April both as Sri Lanka Development Bond (SLDB) auctions were heavily under-subscribed.

Exchange rate depreciation

- As investors flock towards safe havens such as gold and the USD, foreign outflows from local financial markets have caused the local exchange rate to depreciate significantly.
- To ease the pressure to the Balance of Payments during the COVID-19 crisis, CBSL has instructed all banks to suspend facilitating importation of motor vehicles and all non essential goods except medicine and fuel while restricting the ability of banks to purchase Sri Lanka sovereign bonds by commercial banks. Further, a 'Special Deposit Account' has been introduced with the view of facilitating the inflow of foreign currency deposits.

LKR per USD



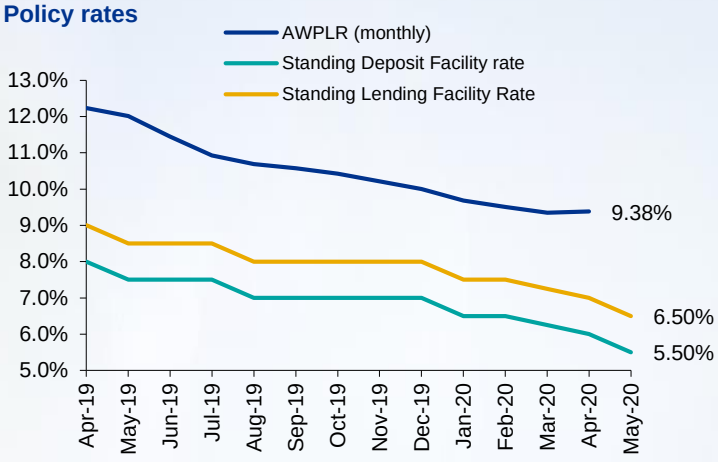
Source: CBSL, ADB, Fitch, IMF, KPMG analysis

Accommodative monetary policy to continue

Policy Rates

- As an emergency move to the COVID-19 crisis, CBSL reduced policy rates by an aggregate of 100 bps as of early May.
- CBSL also reduced the Statutory Reserve Ratio (SRR) by 100bps to 4.0% in March 2020, as a further response to the pandemic crisis, thereby providing additional liquidity in excess of LKR 65.0 Bn into the market. CBSL also reduced the bank rate by 550bps to 9.5% as a COVID-19 response.

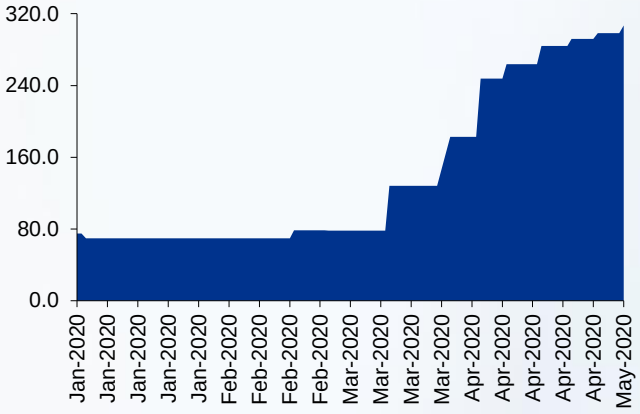
Policy rates



Market Liquidity

- CBSL has taken efforts to maintain a large surplus in the money market through open market operations in order to maintain sufficient liquidity to facilitate urgent financial requirements of the economy. As a result, the overnight market liquidity amounted to LKR 133.7 Bn, up from LKR 30.6 Bn as at 12th March, prior to lockdown.
- Furthermore, CBSL's holdings of government securities was significantly increased overtime to LKR 298.4 Bn by end of April, from LKR 78.0 Bn as at 12th March. Printing of money is expected to bring pressure in inflation and currency.

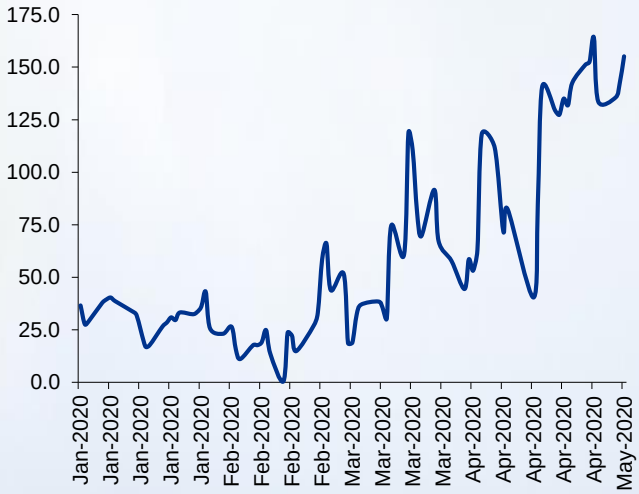
CBSL Treasury Bill Holdings (LKR Bn)



Other measures

- Furthermore, in an effort to increase liquidity and stimulate the economy, CBSL lowered capital conservation buffer requirements of the banks and provided debt moratoriums and concessionary loans via the banks and NBFIs as a relief measure for businesses and individuals affected due to the lockdowns.

Total Overnight Market Liquidity (LKR Bn)

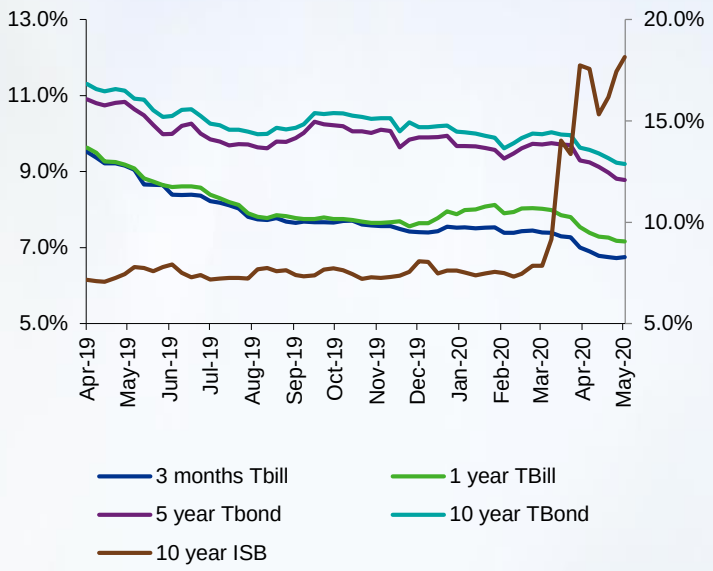


Private sector credit to remain subdue

Bond yields

- Various measures taken by CBSL as a response to the COVID-19 crisis resulted in a parallel downward shift in the domestic yield curve.
- The treasury bond market saw an exit of foreign investment since early January 2020, as investors left for safer alternatives.
- Yields of ISBs significantly rose in the last few months due to liquidity concerns, foreign selling pressure and fears of default. However, GoSL is confident that no defaults will take place as new funding lines are under discussion along with foreign reserves available as backups.
- In particular, ISBs falling due in October 2020 saw yields going all the way up to 91.9% in early April, which has now reduced and settled within 35%-45% at the end of April.

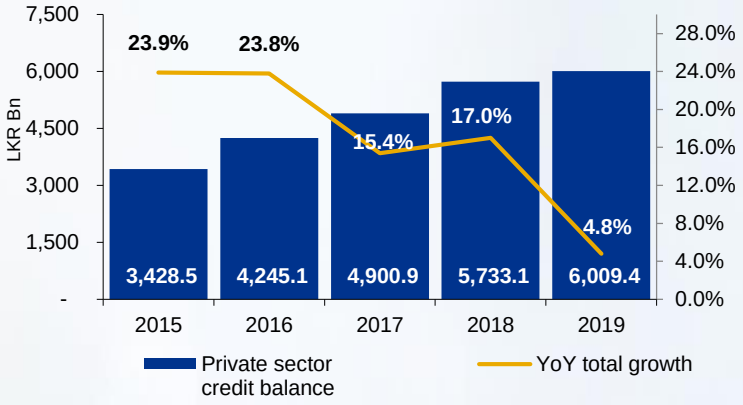
Bond yields



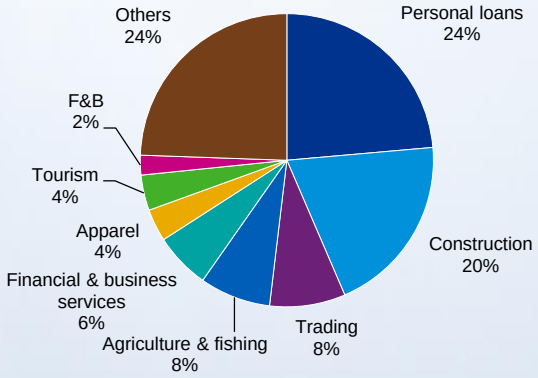
Performance of private sector credit

- Credit extended to the private sector by the Sri Lankan financial system stood at ~51.9% of GDP, as at end 2019, which is well below the regional peers such as Thailand, Malaysia and Vietnam that ranges within 120-161%.
- The growth in private sector credit decelerated significantly during 2019 amidst weak economic activity which prevailed due to Easter attacks, high market lending rates and weak business confidence.
- We do not expect a recovery in private sector credit growth as the economy currently undergoes a severe demand, supply and market shock, both locally and globally.

Private sector credit



Sector distribution of private sector credit



Source: CBSL, ADB, KPMG analysis

Banking sector performance

Financial Performance

The Banking sector remains to be a vital component of the economy in providing liquidity and relief to all businesses and individuals, as multiple shocks being absorbed by the country are increasing in magnitude over time.

While we expect the banking system to be resilient towards this COVID-19 crisis as it has been in the past through various other crisis the country has faced, we cannot under estimate the unique situation where the COVID 19 has impacted the entire world.

The sector continues to be concentrated with large banks, namely, Domestic Systemically Important Banks (D-SIBs[1]), comprising of BOC, PB, COMB and HNB accounting for a 53.8% of industry assets as at end 2019, with the two state banks (BOC and PB) accounting for a 34.2% share of total industry assets.

The banking sector of Sri Lanka, with a total asset base of LKR 12,522.7 Bn (USD 69.2 Bn[2]) and a net loan portfolio of LKR 7,922.9 Bn (USD 43.7 Bn[2]) as at 31st December 2019, has come under immense pressure as the pandemic proliferates across the globe and impacts various sectors. Sri Lanka's banking sector is predominantly exposed to the consumption, construction, wholesale and retail trade and the manufacturing sectors which accounted for 18.4%, 15.6%, 14.2% and 10.6% of total loans disbursed respectively in 2019.

These sectors are some of those which are heavily exposed to the lockdowns triggered by the COVID-19 pandemic.

The D-SIBs are sufficiently capitalized and have maintained liquidity to remain resilient through the aftermath of COVID-19, despite an expected negative impact on asset quality and profitability.

The smaller banks are expected to bear the brunt of the pandemic as they are less able to withstand the implications of moratoriums, NPLs and liquidity crunch.

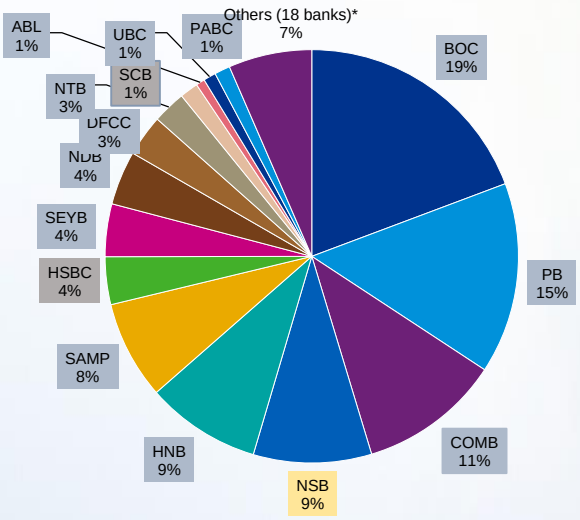
The GoSL has implemented several measures to offer regulatory forbearance on areas such as capital adequacy requirements, minimum capital levels, recognition of NPLs and impairment.

The declining profitability is expected to cause stress on capitalization levels across the next 12 months.

CBSL has also provided some breathing space in the form of extending the deadline to meet the minimum capital requirement for LCBs of LKR 20.0 Bn and for LSBs of LKR 7.5 Bn, by two years to 31st December 2022 which would have otherwise proven to be challenging for the banks who have not met the criteria in the current circumstances.

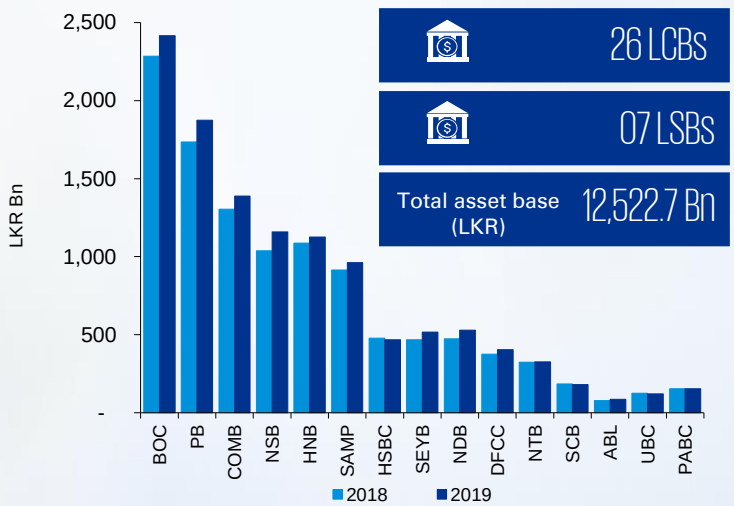
This section analyzes a selected number of banks, which collectively account for ~93% of total industry assets as at end 2019.

Asset Base (December 2019)



The banking sector assets grew by 6.2% YoY during 2019 compared to 14.6% YoY experienced during 2018.

Composition of Total Assets of the Banking Sector[3] – December



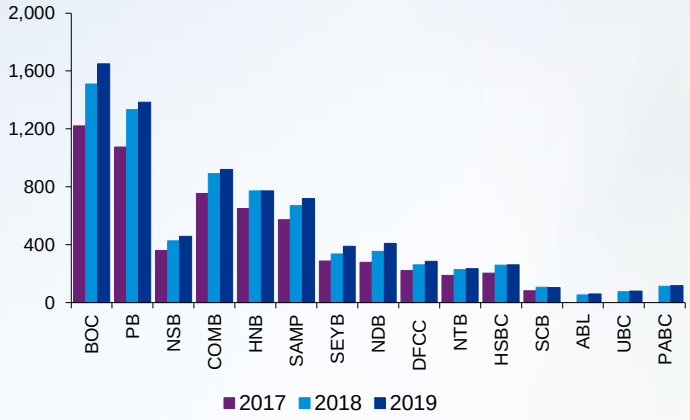
The growth in 2019 was driven mainly by its 2H2019 performance which saw assets grow by 5.2% compared to only a 0.9% growth in 1H2019.

Source: Company Annual Reports

1. D-SIBs are identified banks whose failure will have a larger impact on the financial system due to size (40% weighting in assessment), interconnectedness (20% weighting), lack of sustainability (20%) and complexity (20%) and requires maintaining Higher Loss Absorbency Requirements (HLA), as per the new framework introduced by CBSL in Dec 2019.
2. Converted at USD/LKR exchange of LKR 181.12 as of 31.12.2019
3. We have considered all the listed LCBs, all LSBs and unlisted LCBs with an asset base exceeding LKR 250.0 Bn. The Banks under analysis accounted to a total of ~93.0% of total banking sector assets and ~96.0% share of total gross loans as at end 2019. Note, CBSL has permitted Axis Bank Ltd and ICICI Bank Ltd to close down their business operations in Sri Lanka at the request of their parent banks. Accordingly, these two banks are not permitted to carry on banking business. The banking licenses will be cancelled once the winding-up of operations are completed.

Loans and advances

Gross loans and advances (LKR Bn)



The sector saw a revival of gross loans and advances disbursed in 2H2019 with gross loans increasing by 6.1% during the period compared to a 0.5% decline experienced during 1H2019, averaging the 2019 credit growth at 5.6%, recording the slowest increase in gross loans in 10 years. This was significantly lower compared to 19.6% YoY growth in gross loans recorded during 2018 due to reduced economic activity amidst political uncertainty and lack of investor confidence following the Easter Sunday attacks.

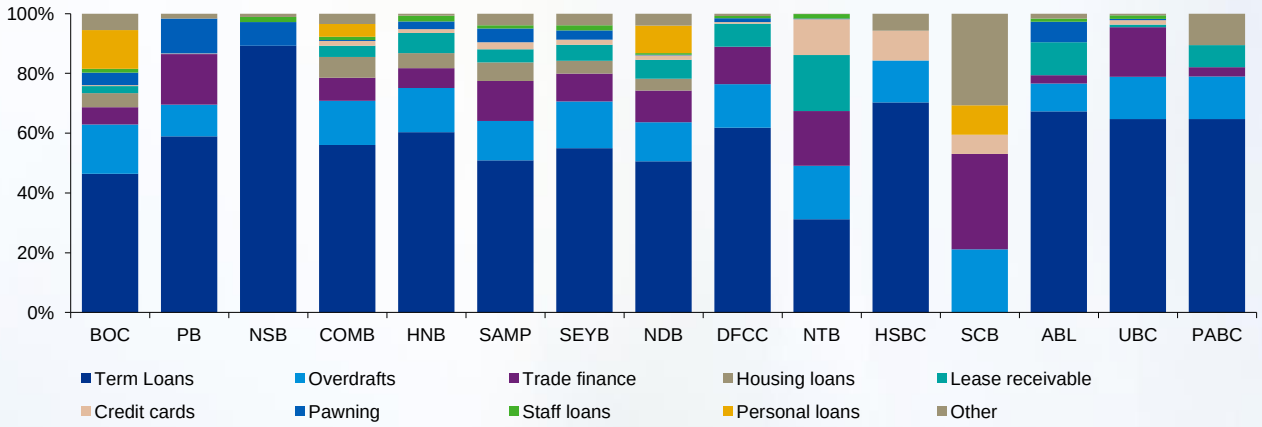
Domestic currency loans recorded a 5.4% YoY growth during 2H2019. These accounted for 79.9% of total industry loans and advances as at 31st December 2019. The 2H2019 improvement in disbursements was mainly attributable to the economy exhibiting a momentum towards recovery with a GDP growth of ~2.5% during 2H2019.

The demand for credit is expected to cripple in 2020 owing to a weaker economic outlook on the backdrop of COVID-19. Sectors such as tourism, consumption, trading, manufacturing and construction are to be significantly impacted due to weaker demand, restricted supply resulting in lower or no revenue and reduced spending power due to lower earning or unemployment.

The GoSL has mandated moratoriums on loans to some of the sectors affected by the COVID-19 pandemic (Refer Appendix A), which includes a 6 month capital deferment. However, we expect a short term increase in loans due to the LKR 50.0 Bn six month refinancing facility provided by CBSL to businesses and individuals affected by COVID-19 (Refer Appendix A for more details on the facility).

Furthermore, the capacity to lend has also been increased by LKR 400 Bn with drawdowns allowed from banks' capital conservation buffers.

Composition of gross loans and advances - 2019



Term loans and overdrafts accounted for 69.1% of total gross loans as at December 2019. Trade finance, which is the third largest contributor to the sector loan portfolio (accounting for 9.3% share of total loans), experienced a strong decline of 14.3% during 2019, primarily due to the slowdown in the trading business owing to subdued economic growth. We expect this to further decline with CBSL suspending the importation of vehicles and non-essential goods until mid-July and the reduced purchasing power to reduce earnings

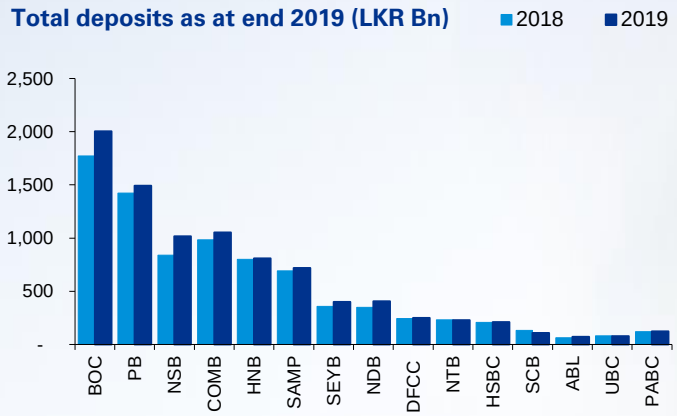
Pawning and personal loans segments which accounted for 4.5% and 4.0% of sector loan book, grew by 12.6% and 7.5% respectively over the same period.

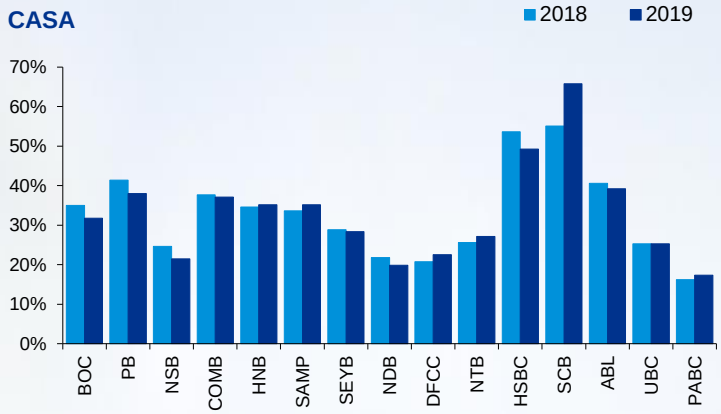
Loan growth is expected to slow down in the next 12 months although in the beginning of 2020, the monetary and fiscal expansionary policies[4] implemented was expected to support credit growth.

Source: Company Annual Reports

4. Policy rates were cut down by 50bps in January 2020 and corporate tax rates on the banking industry was reduced to 24% along with the abolishment of DRL (7%) and NBT (2%).

Deposits





Total deposits grew by 7.9% YoY to reach LKR 9.1 Tn as at end 2019 with domestic and foreign currency deposits[5] growing by 8.4% and 5.3% respectively. Deposit growth during 2H2019 was 4.6% compared to a 3.1% growth recorded during 1H2019.

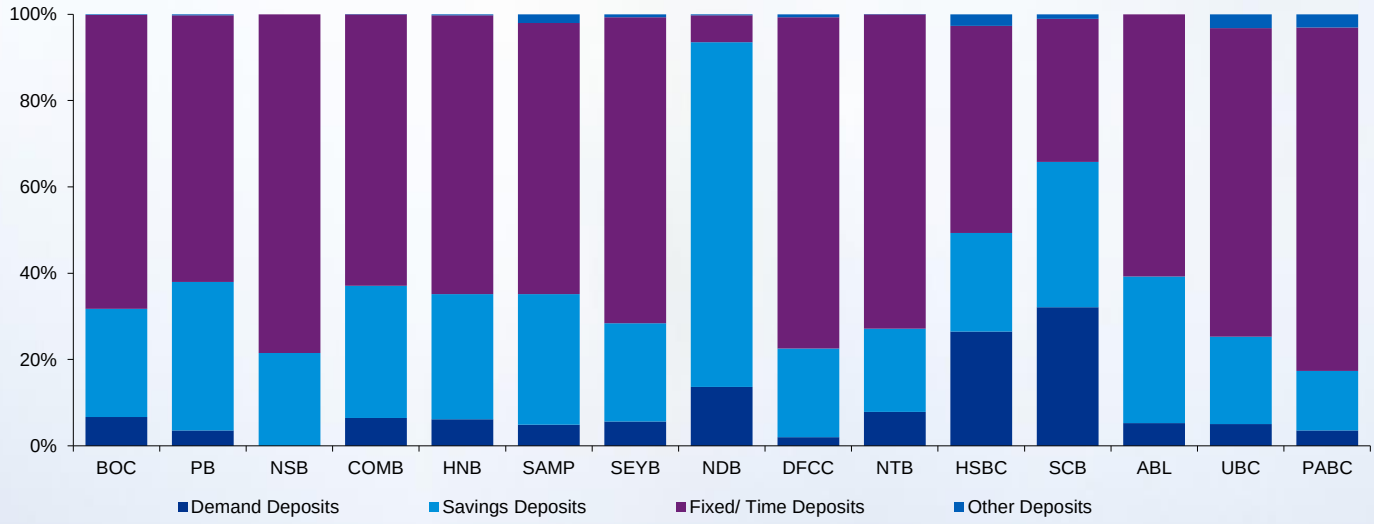
Deposits increased to 80.4% of total sector liabilities, highest recorded since 2014, indicating the sector's increased reliance on deposits over borrowings. Furthermore, as of 2019, domestic denominated deposits accounted for 83.5% of total deposits.

As at the end of 2019, 23.0% of the sector's funding came in the form of foreign currency, out of which 14.0% were foreign currency deposits and 9.0% were foreign borrowings.

The share of higher cost time deposits increased to 68.4% in 2019 compared to 67.7% as at end 2018. The CASA ratio reached a decade low which resulted in reduced NIMs and spreads, thereby impacting profitability. Due to the prevailing COVID-19 situation, the banking system is expected to have high levels of cash withdrawals, as earnings are reduced at a corporate and retail level. However, currently the larger banks are experiencing high CASA levels due to an immediate halt in spending on non-essential goods by the public

COVID-19's impact on countries with a significant number of Sri Lankan migrant workers and travel restrictions in place could dampen remittance inflows and thereby the foreign currency deposit base of banks. Also, drawing foreign currency loans could be difficult with the funding availability on a global level coupled with exchange rate pressure.

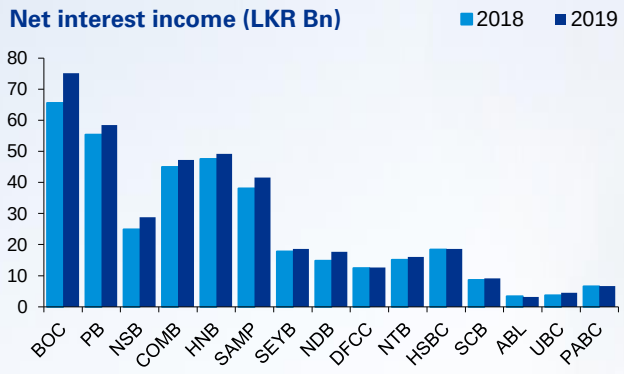
Composition of Deposits as at 31 December 2019

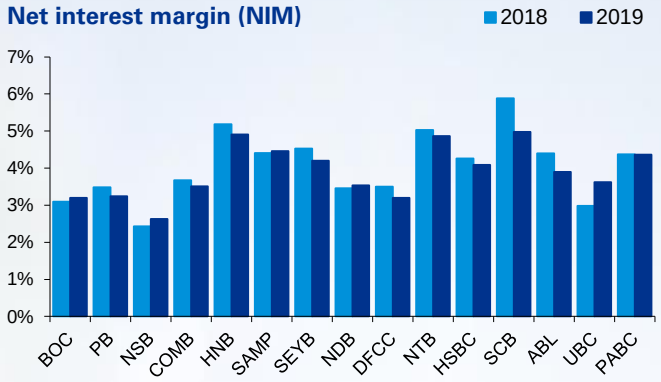


Source: Company Annual Reports

5. LKR appreciated marginally by 0.8% during 2019, due to import measures that came in place post the Easter attacks together with receipt of sovereign bond proceeds, IMF extended fund facility drawings and reduction in the trade deficit helped to achieve this outcome.

Income and margins





The overall banking sector's Net Interest Income (NII) increased by 8.1% YoY to reach LKR 1.34 Tn as at end 2019, driven by a 9.1% YoY increase in interest income and a 9.6% YoY increase in interest expenses recorded during the same year.

The expansionary monetary policy measures, on account of COVID-19, adopted by the regulator in April 2020 is expected to add margin pressure in the short term. The rate cuts and the moratoriums could significantly lower the sector's interest income in the short term.

The non-interest income including fees recorded by the banking sector could decrease with relief measures given on credit cards until September 2020 and restrictions imposed on imports until July 2020.

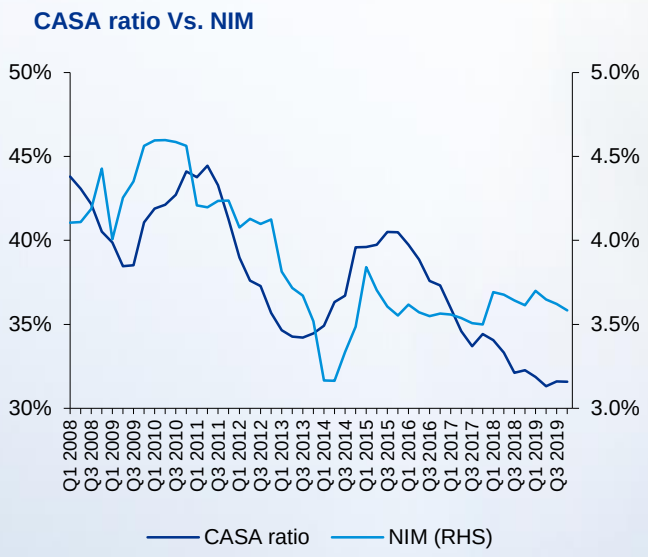
Furthermore, some banks, may report marked to market losses on International Sovereign Bonds ("ISB") in the short term due to significant yield increases.

Similarly, banks with exposures to equity portfolios too would have reported marked to market losses in the first quarter of 2020 due to significant prices drops, if not for the interim relief given for the banks to use December 2019 market prices.

NIMs have been under pressure due to reduced credit growth, declining interest rates and a contracting CASA ratio

Due to the increased reliance on deposits and increased exposure on time deposits, the deposits are not repriced as fast as the loans, negatively affecting NIMs as spreads contract in the short term.

The rescheduling of current NPLs with no additional interest under the moratorium facilities given to companies in identified sectors as well as subsidized working capital loans in the short term will further tighten NIMs and spreads. In the medium term, we expect NIMs to continue to be under pressure with low credit growth, while any credit extended will be dominated by low credit risk borrowers who will pay very low interest rates.



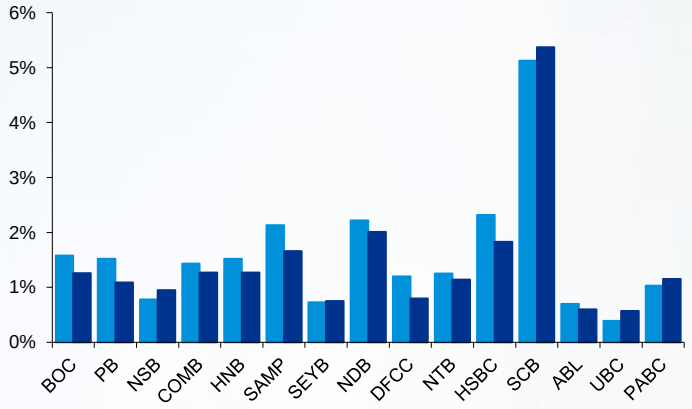
Source: Company Annual Reports

Profitability

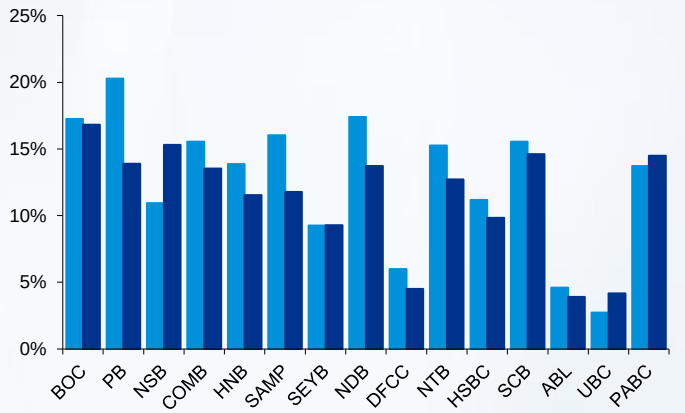
The banking sector ventured into 2020 with a positive outlook following the recent tax reforms in the form of removal of the DRL (7%), NBT (2%) and reduction in the corporate tax rate (to 24%) coupled with a 50bps policy rate cut announced in January 2020.

This positive impact on profitability was expected to translate to higher ROEs for the sector. However, these benefits are likely to be offset by the COVID-19 relief measures to borrowers as well the worsening credit conditions in the economy.

Return on Assets (ROA)



Return on Equity (ROE)

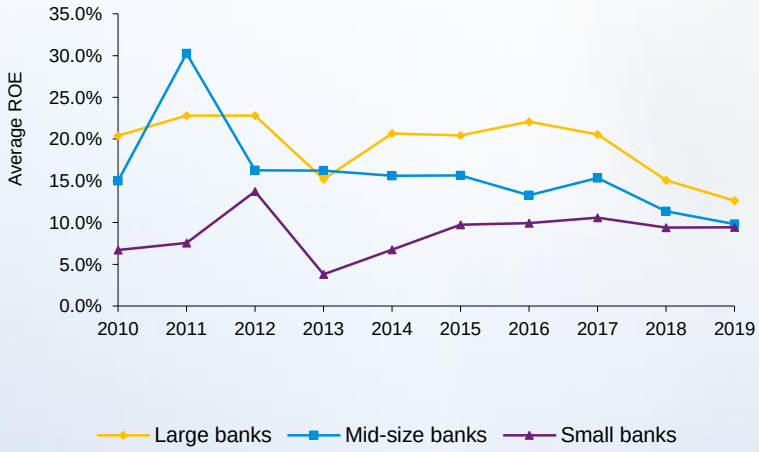


The reduction in earnings coupled with an increase in the asset base led to the banking sector reporting an ROA of 1.4% during 2019, as opposed to 1.8% achieved in 2018. Most local banks reported YoY decline in ROAs during 2019, mainly driven by implications of Easter attack, higher impairment charges and declining asset quality (higher NPLs).

The sector ROE fell significantly to 10.3% during 2019, compared to 13.2% achieved during 2018. The declining earnings together with an increased equity base led to the decrease in sector ROEs.

SAMP (LKR 12.1 Bn), SEYB (LKR 4.4 Bn) and DFCC (LKR 2.8 Bn) undertook some of the major rights issues during the year.

Average ROE across varying asset bases[7]



The ROEs across the board have been declining since 2014, with larger banks outperforming the small and mid-sized banks despite issuing more equity in the period. The decline may be attributed to slow credit growth that resulted from various economic shocks and rights issues made in response to increased Basel III requirements. The scale of operations and corresponding higher cost structures of small and mid-sized banks may have added further pressure.

Source: Company Annual Reports'

6. Please note that historical earnings have not been adjusted for rights issues, stock splits and scrip dividends. ROE data unavailable for SCB for the period 2010-2011 and for HSBC for the period 2010-2013. Large scale banks have been classified on the basis of banks with an asset base exceeding LKR 500 Mn as at end 2019 consist of BOC, PB, COMB, HNB, SAMP, SEYB and NDB. Mid-sized banks with an asset base in the range of LKR 250 Mn to LKR 500 Mn as at end 2019 consist of DFCC, HSBC and NTB. Small sized banks have been considered on the basis of banks with an asset base less than LKR 250 Mn as at end 2019, which consist of SCB, Amana, PABC and UBC.

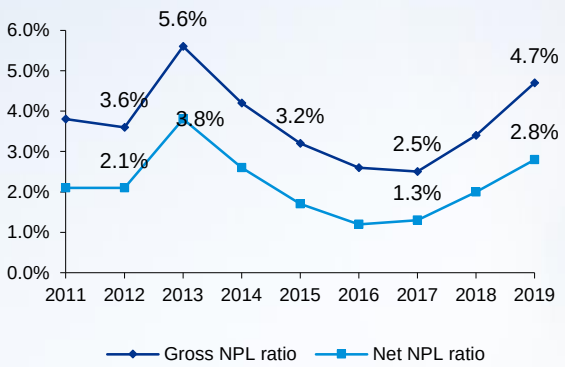
DuPont Analysis of the Banking Sector

DuPont Analysis as of 2019

	BOC	PB	NSB	COMB	HNB	SAMP	SEYB	NDB	DFCC	NTB	HSBC	SCB	ABL	UBC	PABC
(a) Return on Equity	16.8%	13.9%	15.3%	13.5%	11.5%	11.8%	9.3%	13.7%	4.5%	12.2%	9.9%	14.6%	3.9%	4.2%	14.2%
(b) Return on Assets	1.0%	0.7%	0.6%	1.3%	1.3%	1.2%	0.7%	1.0%	0.5%	1.1%	1.3%	2.8%	0.6%	0.6%	1.1%
(d) 1-effective tax rate	57.4%	45.2%	42.8%	57.7%	53.2%	50.1%	46.8%	50.8%	45.7%	42.6%	62.1%	53.5%	33.5%	37.3%	51.4%
(e) Pre ROA	1.7%	1.6%	1.4%	2.2%	2.4%	2.4%	1.6%	2.0%	1.2%	2.5%	2.1%	5.3%	1.7%	1.5%	2.2%
(f) Contribution to Assets	2.5%	1.9%	1.5%	3.0%	3.3%	3.7%	2.4%	2.8%	1.6%	3.5%	2.3%	5.6%	2.0%	1.9%	3.0%
(h) Operating Income to Assets	4.0%	4.0%	2.9%	5.1%	5.4%	6.1%	5.0%	4.7%	3.6%	6.9%	5.2%	8.2%	5.2%	5.0%	5.9%
(j) Net Int Inc to Assets	3.2%	3.2%	2.6%	3.5%	4.5%	4.4%	3.8%	3.5%	3.2%	4.9%	3.9%	5.0%	3.9%	3.6%	4.3%
(k) Non Int Inc to Assets	0.8%	0.7%	0.3%	1.6%	1.0%	1.6%	1.2%	1.2%	0.3%	2.0%	1.3%	3.2%	1.3%	1.4%	1.6%
(i) Cost to Income	37.3%	51.9%	49.3%	40.4%	40.0%	38.8%	52.2%	39.9%	55.3%	49.3%	56.0%	31.5%	60.9%	63.2%	50.3%
(g) Impairment to Assets	0.8%	0.3%	0.1%	0.8%	0.9%	1.3%	0.8%	0.8%	0.4%	1.0%	0.2%	0.4%	0.4%	0.3%	0.7%
(c) Leverage = Assets/Equity	17.12	19.38	25.09	10.70	9.09	9.91	12.41	13.46	8.54	11.44	7.48	5.17	6.98	7.26	12.49

Impairment analysis

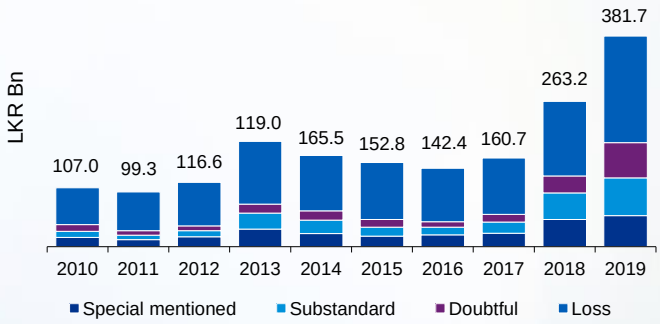
Banking sector gross NPL vs net NPL



The banking sector saw its NPLs trending upwards since 2017 with the gross NPL and net NPL reaching highs of 4.7% and 2.8% respectively as at end of 2019. This is amidst moratoriums provided post the Easter attacks, which did not require some of the restructured loans to be identified under NPLs.

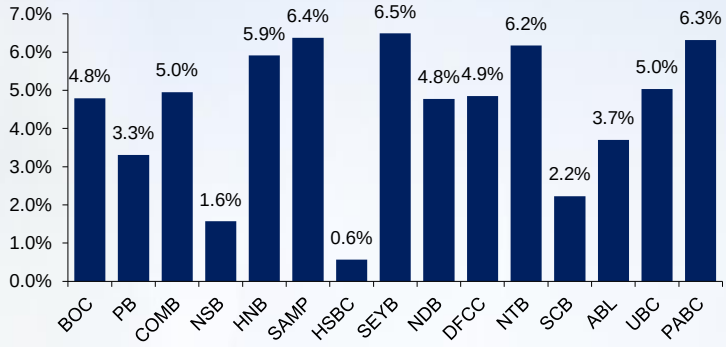
With the COVID-19 outbreak and the moratoriums offered on capital and interest for 6 months for selected sectors, the negative impact on the NPLs and asset quality are not likely to be substantial until 3Q and 4Q2020 when the moratoriums end and the repayments commence.

Composition of non performing loans



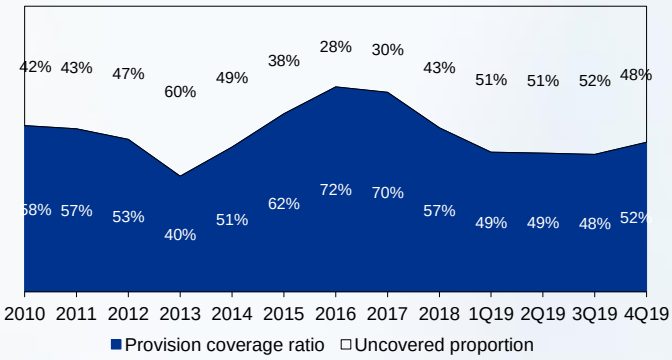
Since 2017, the sector's asset quality has deteriorated sharply with the cumulative share of special and substandard categories widening to 32.6% share of NPLs compared to 24.9% recorded as at end 2016, and doubtful share of NPLs doubled to 16.8% as at end 2019, from 6.9% recorded as at end 2016. However, the industry loss share (indicating the share of loans with loan installments, where principal or interest or both have been deferred over 360 days) has been contained to 50.6% compared to a high of 68.2% recorded as at end 2016.

Gross NPL Ratio of licensed banks – December 2019



This is because the deferment of repayment and rescheduling of facilities under moratorium may not automatically be considered as significant increase in credit risk and accordingly there will be no movement from existing stage in the model.

Provision coverage ratio of the banking sector (%)

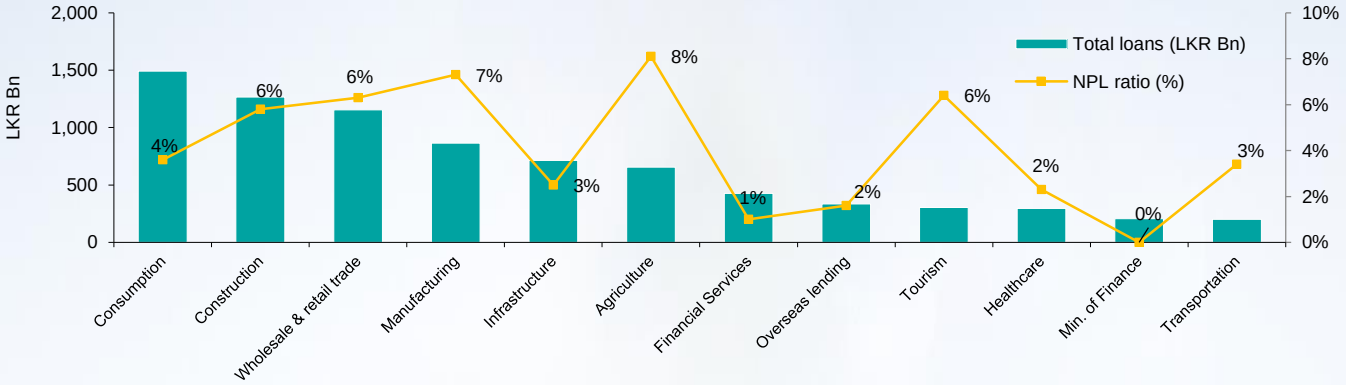


The provision coverage ratio has been on a decreasing trend since 2017 and have shown a slight increase since 3Q19 to 52% as at end 2019. It is evident that the banks have been proactive in increasing the provision coverage ratio to 52% by 4Q2019 from 48%-49% recoded in the previous 3 quarters as a result of deteriorating asset quality amid the loan growth rebounding towards the last quarter of 2019. In terms of the moratorium provided for COVID-19 to affected parties, reclassification may occur once the moratorium period expires towards Q3 of 2020, accordingly provisioning of NPLs may not be affected in the near term.

Source: Company Annual Reports

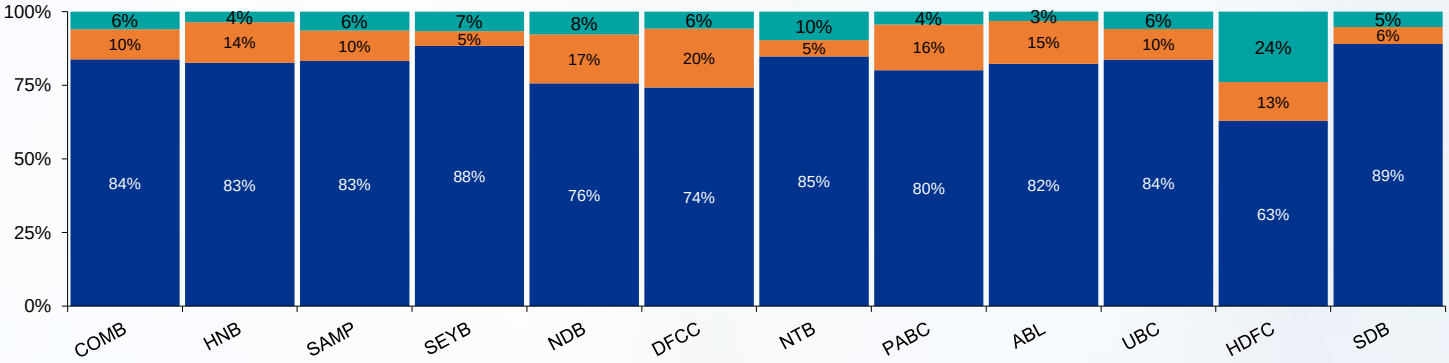
Vulnerability of NPLs

Banking sector NPLs by sector - 2019

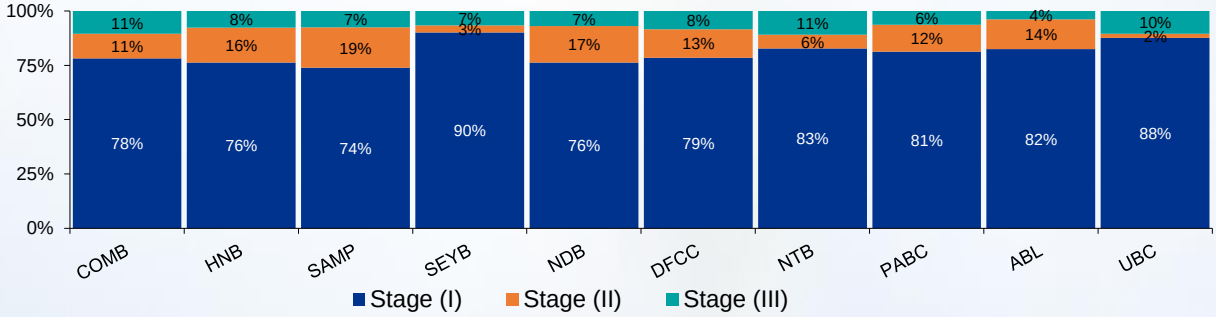


We expect the NPL ratios recorded in the manufacturing, construction and tourism sectors to remain high in comparison to the other sectors through 2020, given the disruptions caused to business activity on account of the nation-wide lockdown. The tourism industry is especially looking bleak amidst the pandemic taking its toll globally as well as locally.

Stage-wise Loans - 2018



Stage-wise Loans - 2019



Many banks, namely, COMB, HNB, NTB, PABC, and SAMP have recorded an increase in the loan exposure to stage II and III illustrating an increased credit risk. This was attributed to an industry-wide deterioration in credit quality due to lackluster economic performance in 2019. Among the above banks, SAMP reflected the highest share of Stage II and Stage III loans in its loan portfolio as at end 2019.

DFCC and Seylan have reported an increase in the loan exposures in stage I which may have been due to application of the rebuttal of presumption of 30 days for SICR for SME loans and Tourism loan moratoriums granted after Easter attack.

* 2019 annual reports were not available as of the date of publishing this report

Capital adequacy and liquidity

Throughout 2019, the banking sector remained resilient amidst a challenging macro environment, supported by healthy CARs ("Capital Adequacy Ratio"), maintained well above the regulatory minimum requirement.

The Sri Lankan banking sector completed its BASEL III capital phase-in arrangement by January 2019, where banks were required to raise minimum CAR on a staggered basis.

At the end of 2019, the total CAR of the banking sector stood at 16.5%, which is above the regulatory minimums stipulated for D-SIBs and non-SIBs of 13.5%-14.0% and 12.5% respectively.

Capital Adequacy

The CBSL made downward revisions to minimum capital requirements maintained by LCBs and LSBs in order to provide additional liquidity to the banks to increase loan disbursement capacity.

The CBSL permitted D-SIBs and non D-SIBs to draw down their capital conservation buffers by 100bps and 50bps respectively in order to facilitate smooth credit flows.

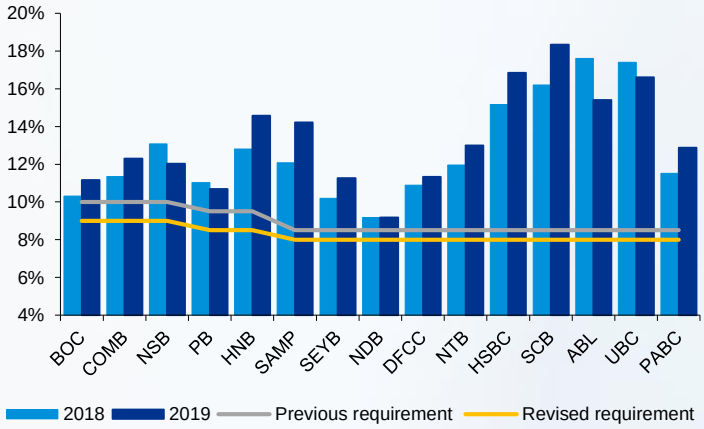
Revised capital adequacy requirements

	CET - I requirement	Tier I requirement	Tier I + II requirement
D-SIBs (Bucket 1)	7.0%	8.5%	12.5%
D-SIBs (Bucket 2)	7.5%	9.0%	13.0%
Non D-SIBs	6.5%	8.0%	12.0%

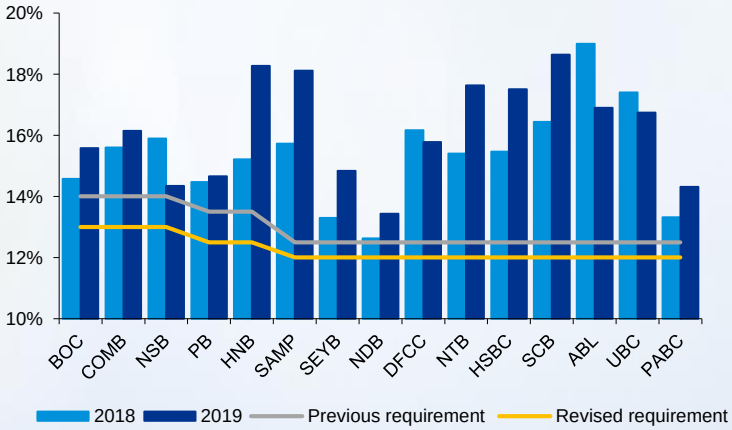
However, in the next 12 months, banks will face challenges in maintaining these levels of capital adequacy as profitability comes under pressure.

CET 1 Ratio

Tier 1 Capital



Total (Tier I + II) Capital Ratio



Source: CBSL, Company reports

Liquidity of the banking sector

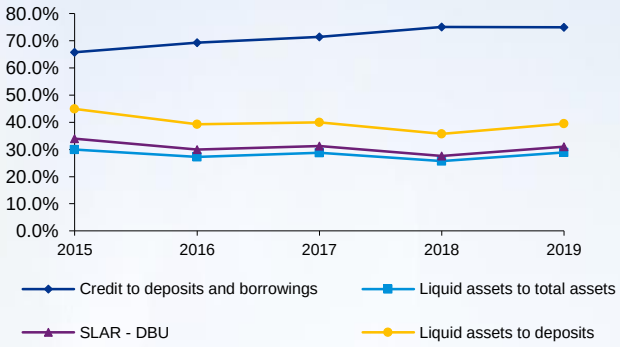
As at end 2019, the liquid assets of the banking sector was dominated by treasury bonds and bills (57.3%), followed by SLDBs (15.7%) and other assets. The LKR and all currency liquidity coverage ratio (LCR) of the banking sector as at the end of 2019 was at 212.8% and 178.2%, respectively, well above the regulatory minimum of 100% by end 2019. The high buffer maintained indicates that the banks had high quality liquid assets to meet the next 30 day cash outflows.

The Statutory Liquid Asset Ratio (SLAR) of the domestic banking unit (DBU) and the offshore banking unit (OBU) increased by 340bps and 170bps respectively from end 2018 to 2019. These ratios were well above the regulatory requirement of 20% in LKR and USD for DBU and OBU respectively. Furthermore, lower credit expansion during 2019 resulted in a decrease in the credit to deposits and borrowings ratio by 10bps increasing liquidity.

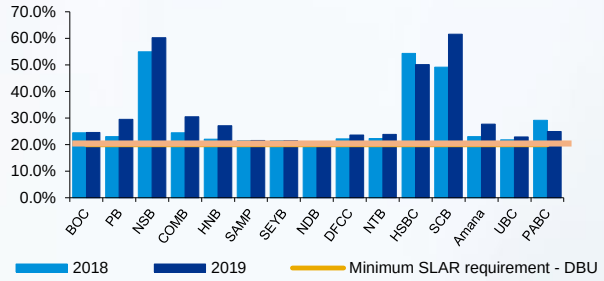
The net stable funding ratio (NSFR) under Basel III introduced in 2019 required banks to maintain sufficient stable funding sources. The NSFR stood at 130.1% as at the end of 2019, well above the regulatory requirement of 100.0%.

We expect liquidity of banks to come under pressure mainly due to debt moratorium and other reliefs. As a measure to dampen the liquidity requirements amid COVID-19 crisis, CBSL reduced the minimum requirement of the LCR and NSFR to 90.0%, to be effective until 30 June 2021. Additionally, the criteria for SLAR was also relaxed to give relief to the banks. Accordingly, subject to conditions, loans to SOEs backed by the GoSL guarantees, fixed deposits held by banks in other banks, interest subsidy due from the GoSL on senior citizen deposits, receivables from EPF for certain loans, etc. are allowed to be considered as liquid assets for SLAR, until 30 June 2021. Furthermore, CBSL has restricted discretionary payments of banks including declaring cash dividends to ease liquidity pressure until 31 December 2020.

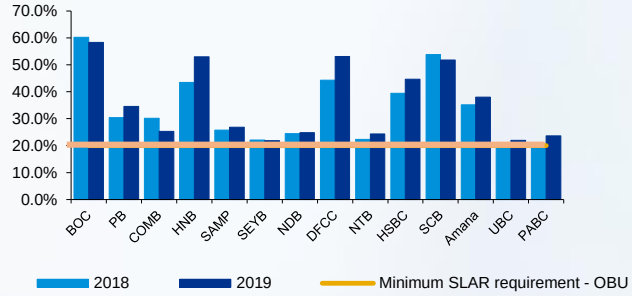
Liquidity ratios of the banking sector



SLAR - DBUs



SLAR - OBUs



Source: CBSL, Company reports

Emerging risks with providing relief on loans

Operational risk
Challenges in processing the large volumes of applications coming to the banks with regard to moratoriums and concessionary loan facilities offered by CBSL in an emergency move to support businesses and individuals, along with different type of accounting treatment (modification/derecognition) based on the structure of loan

Regulatory and compliance risk
Pressure involved in carrying out necessary due diligence in short period of time with limited resources may lead to lapses in documentation required by regulations

Technology risk
Due to limited resources and restricted hours, banks may compromise on the routine controls which are now in place for transactions and introduction of more digital base services without adequate testing

Credit risk
Although, moratoriums are granted under the instructions of GoSL and with guidance from CBSL the credit risk will continue to be with the banks. Therefore , the will need to assess the potential impact due to credit risk after the moratorium period is over

Stress testing loan portfolios in times of crisis

Quickly identify vulnerable credit and sectors

Loan portfolios may be abruptly impacted due to the coronavirus outbreak, which could lead to correlated increases in default risk, higher provision rates, and an overall increase in credit risk. Although specific guidance on targeted stress tests due to the outbreak has not been issued by the regulator[1].

We would recommend banks to run targeted stress tests to identify vulnerable credit, sectors and supply chains, and then take proactive action.

Step 01

Stress loan portfolios

- Design scenarios (i.e. travel bans, supply chain shocks, retail shocks)
- Stress underlying cashflow and debt service ratios for all obligors
- Transmit impact to loan level probability of default (PD)
- Calculate expected loss and RWA for each loan
- Re-run simulation based on a range of scenarios and aggregate results

Step 02

Simulate impact on SLFRS 9 loan loss provisions

- Simulate stage transfers due to increases in credit risk
- Input updated macroeconomic forecasts into SLFRS 9 models
- Update PDs and loss given default (LGD) based on simulation results
- Calculate SLFRS 9 ECL for each loan

Step 03

Identify vulnerable credit and sectors

- Individually assess any loans where obligors appear highly vulnerable to hemorrhage cash as per the stress test results
- Sector analysis reviewing aggregated impact on RWA and SLFRS 9
- Contagion impact and supply chain analysis for large corporates that appear more vulnerable, potentially leveraging new Banking Exposure Limit Rules analytics

Step 04

Take early action preventative measures

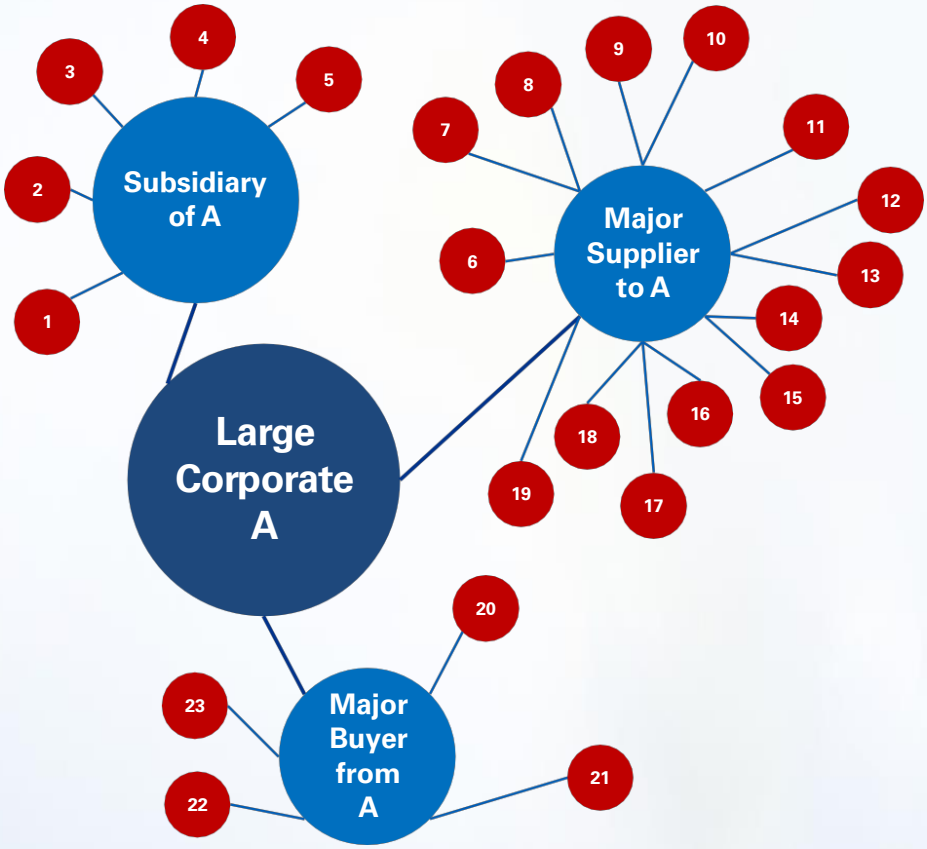
- Proactively target customers and sectors that have shown to be weaker as per the stress test results
- Further refine relief measures based on target groups

Impact on supply chains could be highly correlated and severe

Disruptions to supply chains could last for many months according to some experts. It is important that the stress tests assist banks to identify vulnerable obligors that might be linked up to and reliant upon an entire supply chain ecosystem.

These tests can be leveraged in the stress tests to identify which obligors in a given supply chain the bank has exposure to and how severe the impact might be.

Supply chains are highly integrated and codependent



First Order Impacts

- The first order impacts from the stress test will identify larger corporates (or sectors) that may be more vulnerable
- Review and conduct more thorough analysis on these obligors (or sectors) to understand the exposure profile

Second Order Impacts

- Conduct a thorough analysis on all large subsidiaries, suppliers, and buyers related to 'A'
- Review which of these entities the bank has direct or indirect exposure to

Third Order Impacts

- Analyze suppliers and buyers to second order entities to get a complete picture of potential contagion
- Identify those 3rd order entities that are major suppliers or buyers in the supply chain that the bank may have exposure to

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Raditha counts over 10 years of experience in audit assignment both in Sri Lanka and in the Maldives. He is an Associate Member of the Institute of Chartered Accountants of Sri Lanka (ACA).

Scaling Security in a post COVID-19 World

Scaling security for remote working

COVID-19 has forced enterprises to rapidly adapt to new working models. Furthermore, COVID-19 has driven radical change in businesses. Your offices are empty; your business is under pressure; and your employees are adapting to the new mode of working. How do you ensure your security is scaling with your remote working infrastructure?

1

Shine a light on shadow IT infrastructure

Your business team leaders and employees need ways to communicate and collaborate when they can't be in the office together. Many will ask for digital solutions you've not approved as a team. Embrace those solutions. Encourage the business to purchase enterprise licenses for those solutions and be part of the procurement and digital integration discussions. Help roll out those solutions, but make sure security advice and secure configurations are in place to help manage access, functionality and data loss prevention controls. If you don't, they will happen anyway and you'll have shadow IT issues.

2

Access controls are more critical than ever

Multi-factor authentication or at least strong password controls are essential for remote access to enterprise IT systems. Also, consider conditional access/Cloud Access Security Broker (CASB) solutions which allow you to limit access to your enterprise systems to those corporate devices or Bring Your Own Device (BYOD) with an endpoint or mobile device management solution in place. Strong passwords or passcodes are also important for end-user devices ideally, encourage staff to separate their personal and work activities using different devices, unless you are forced to adopt BYOD solutions. Multi-factor authentication should be in place for all privileged access. However, you should also ensure that delegates are in place and where necessary "break glass" arrangements if key individuals are not available. Don't just assume a single delegate is sufficient.

3

Keep up your data loss prevention controls

Data loss prevention helps to both preserve enterprise IP and uphold legal personal data privacy requirements. Ensure that Mobile Device Management (MDM) tooling and endpoint Data Loss Prevention (DLP) solutions are suitable for remote working at scale and explore options for managing personal devices if they must be used for business purposes. Disable or restrict access to insecure home printers, monitors and removable media devices. Do staff really need USB media access at home?

4

Put your security operations on guard

Threat groups are exploiting the enormous workload on IT and security teams, and are launching enterprise-level ransomware attacks, crypto-mining operations and denial of service attacks. Security operations center (SOC) and disaster recovery teams may not be used to, or able to, work remotely or with only a few members on-site at a given time. Now more than ever, detection and rapid response to cyber threats matter. Ensure adequate staffing and that staff members are well-practiced in handling attacks whilst working remotely. Put in place and test alternative measures to communicate with and access data centers, restore systems from physical backups, and failover/failback to resilience servers. Most importantly, ensure you have deputies for key personnel in business continuity and crisis management teams, in case team members fall ill or are unavailable due to travel restrictions.

5

Sanity check your privileged users

For employees with privileged business access or system administrative rights, regular chats can help identify any stress or other behavior issues that raise concerns. They can also improve their wellbeing, team relations and productivity.

6

Keep your employees informed about threats

Malicious actors and threat groups are exploiting the COVID-19 pandemic by deploying tailored phishing campaigns. These campaigns target employee or business financial assets. They attempt to solicit account credentials or release malware (including ransomware) onto enterprise networks. Follow threat updates from reliable threat intelligence sources and ensure these are communicated to your employees regularly as an integral part of your COVID-19 communications strategy. Help staff to recognize phishing scams. Ask employees to report suspicious emails or files (and make it easy for them – ideally, a single button on your email client). Share what you see with the security community; everyone is at risk.

7

Deal with wear and tear

It's not possible to be sure how long employees will be out of the office; during this time, employees will have issues with IT systems and work devices. If you're used to on-site IT teams managing issues with employees' devices and systems, consider how to facilitate phone assistance or remote management of devices securely. Put in place mechanisms and guidance to allow faulty IT equipment to be securely returned for maintenance, and new IT equipment to be shipped and securely configured

8

Monitor your employees' cyber hygiene

Recognize that your employees are working in unfamiliar ways with unfamiliar systems. Encourage them to seek help if they are unsure and avoid a culture of blame. Line managers need to keep in touch with their teams to build team spirit and watch out for employees who may be feeling isolated or may be acting in ways that raise concerns. Ensure employees also have ways to raise concerns over working practices, helping IT and security work to securely facilitate their roles and pre-empt "workarounds," which may cause security issues.

9

Look after your joiners, movers, leavers controls

Organizations are facing financial pressures during this period, leading to potential redundancies among staff and contractors. In other areas, organizations may be on-boarding emergency third party support, building team capacity for critical processes, or restructuring teams to support other business units and roles. Security teams need to work closely with HR and IT to manage the high volume of joiners, movers and leavers through the organization. All of these processes need to be performed remotely, and you will need to agree on approaches to securely provision accounts quickly, even if you need to manage risk by limiting access initially. Given the absence of personnel and supervision of the office space during remote working, activities such as revoking physical access cards are particularly important

10

Reach out to the community

Surviving the COVID-19 pandemic requires businesses to reach out to peers, regulators, trusted partners and supply chain contacts to improvise novel solutions. Work with your ecosystem; share your experiences and ensure you are well supported. This is a time of stress for everyone as we all try to be superheroes.

COVID 19, a catalyst for the adoption of Fintech in Sri Lanka

Adoption of Fintech

The COVID-19 pandemic is having a profound effect on businesses and workplace configurations as social distancing is expected to prevail in the coming months. Although banks continue with its operations given the essential nature of their service, its operating environment has felt the impact as most branches operate at minimal staff levels.

The banks who have adapted and embraced fintech over the recent past is reaping its benefits, as the nationwide lockdown has made consumers compelled to use online banking in order to meet their liquidity requirements. A similar trend is observed globally, on other essential businesses as well, where a 2 year digital transformation is now witnessed in just 2 months.

With an internet penetration of 62% and mobile penetration of 149% with 71% of those mobile connections being broadband (3G – 5G) in Sri Lanka, it can be deduced that Sri Lanka's customer base is embracing digital transformation, enabling banks and financial institutions to rapidly expand its digital platform.

A new competitive landscape

The change in consumer behavior in digital transactions is here to stay, thereby, reinforcing the fact that the banking sector has to invest in upgrading their digital product and service offerings to meet increasing consumer demands.

Digital banking will result in a virtual expansion of a banks' footprint, thereby easing the cost burden, in terms of investment, maintenance and staffing, on an already increasing cost to income ratio experienced throughout the sector.

Move towards a cashless society

Electronic payment tools such as cards and mobile wallets will become the new norm. In particular, mobile wallets has seen tremendous growth in the last 2 months in peer countries. As online payments come to the forefront, fintech solutions and blockchain technology would be promoted by the regulator in Sri Lanka as well.

The nation-wide lockdown saw customers getting accustomed to remote banking…

…Providing an ideal opportunity to invest in digital banking

However, pre Covid-19 ,CBSL was making efforts to speed up Sri Lanka's journey towards becoming a cashless society. Among the many initiatives taken by CBSL were the retail level campaign aiming to draw the public to use digital payment methods such as mobile applications, LankaQR code, and credit and debit cards, the establishment of FinTech regulatory sandbox, to provide innovators a safe space to test their services and the appointment of several committees on FinTech developments to focus on new innovations such as digital payment platform, open application programming interface and virtual banking, etc.

Framework for adaption in place

In order to facilitate a seamless transition from working in office spaces to remote working, financial institutions will have to scale up in terms of infrastructure and cyber security. While increasing remote access to employees, banks must ensure that secure configurations are in place to help manage access, functionality and data loss prevention, given the sensitive nature of the business of banking. Business continuity and disaster recovery is at the forefront of planning for the future. With the threat of enterprise-level ransomware attacks increasing as the digital space expands with an enormous number of employees working remotely, detection and rapid response to cyber attacks have become vital.

A new norm going forward

The way forward for financial institutions would be to collaborate with fintech companies and provide consumers with novel instruments and tech-based financial products which will overshadow the current legacy systems in place. Organizations that ignore the shake-up not only risk falling short of customer expectations, but also open the door for peers to claim market share and establish stronger customer relationships.

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Regulation and supervision of fintech

Summary

Fintech is already delivering significant benefits to consumers and investors; to financial services firms and financial market infrastructure; and to financial stability and financial inclusion.

However, the increasing use of fintech solutions and emerging technologies also bring risks, to which regulators and supervisors are responding.

Consumers and investors are benefitting from both the emergence of new fintech solutions and the evolution of existing financial services providers.

This has generated a wider range of financial products and services being delivered more efficiently and effectively, with competitive pressures on banks to adopt a more consumer-centric approach.

The regulatory and supervisory response to fintech has evolved through three stages.

Initially, the response was to focus on the benefits of fintech and on supporting the growth and adoption of new fintech solutions.

Regulatory intervention was limited to little more than fine-tuning to take account of the impact of fintech on the ways in which financial services were provided.

In the *second stage*, regulators and supervisors began to worry increasingly about the risks arising from fintech.

These risks can be characterized as risks to:

- Consumers and investors;
- Financial services firms; and
- Financial stability.

In the *third stage*, regulators and supervisors have been taking specific actions in response to these risks.

This included the development of international standards, the implementation of increasingly detailed and prescriptive national rules and guidance, and shifts in supervisory priorities.

These initiatives cover a wide range of areas, including technology risk, cyber security and operational resilience more generally; data privacy; consumer protection; banks' governance and risk governance; and amendments to anti-money laundering requirements.

The emerging international standards have mostly taken the form of high-level principles, leaving national implementation (both regulation and supervision) to diverge considerably across jurisdictions and across different financial services sectors.

Financial services institutions need to be able to demonstrate not only that they are in compliance with the growing array of fintech-related regulatory requirements but that they have considered and taken into account the various risks posed by fintech more generally.

Successful well-managed banks will adopt a proactive response to emerging risks and to evolving regulation and supervision, not a purely reactive response as and when regulatory and supervisory reactions are finalized.

Fintech
"Technologically enabled financial innovation that could result in new business models, applications, processes or products with an associated material effect on financial markets and institutions and the provision of financial services."
Financial Stability Board

Implications for banks

Organizations entering the fintech space – established financial institutions, established non-financial corporates and start-ups need to factor the ever-changing nature of regulation and supervision into their strategies, business planning, governance and risk management.

OVERALL APPROACH

As with all business and operational developments, financial services institutions need to consider the wide range of risks arising from the use of fintech and ensure that these risks are properly captured within a firm's risk governance structure and procedures.

Banks should also be aware of, and responsive to, the different ways in which regulation and supervision might affect their businesses, and to build this assessment into their strategic planning and risk mitigation activities.

This needs to be a proactive process, led by the bank itself, thinking in advance about how it can address and mitigate fintech-related risks, not a purely reactive response to regulatory and supervisory initiatives as and when they emerge.

Established financial institutions that adopt fintech may – at least initially – face different types of regulation and supervision to established fintech- enabled non-financial corporates and start-ups entering the financial services sector, but over time these differences are likely to diminish

REDRAWING THE REGULATORY PERIMETER

Regulators are redrawing the regulatory perimeter to take account of new or changing products and services emerging as a result of fintech solutions and emerging technologies..

GOVERNANCE

Ever-expanding regulations and supervisory expectations are being introduced to require the Boards and senior management of firms to understand, oversee and manage effectively the risks arising from the development and adoption of fintech solutions and emerging technologies.

RISK GOVERNANCE FRAMEWORK

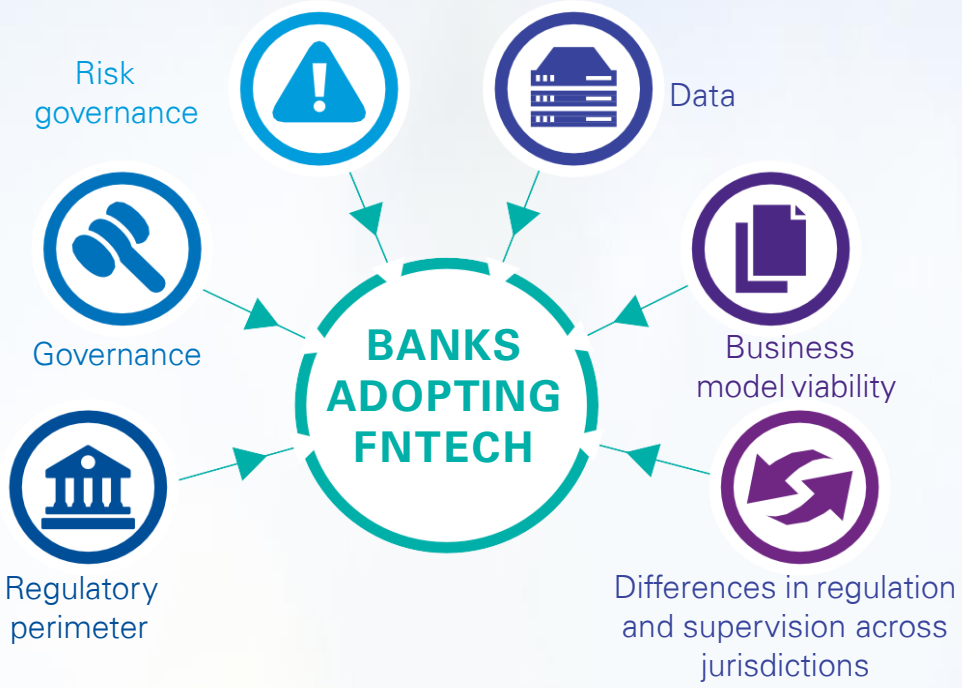
Regulators and supervisors are focusing on how fintech affects the core risk governance competencies of identifying, managing, measuring and controlling risks across the three lines of defense, and having the appropriate resources, skills and expertise to deliver this effectively.

Depending on the business activities and fintech applications adopted by a firm, this is likely to cover at least the development of new products and services, outsourcing, the use of artificial intelligence and the automation of both front and back office tasks, technology risk, cyber security, operational resilience, AML and conduct risk.

REGULATORY AND SUPERVISORY PRESSURES ON FRMS GOVERNANCE

- Board and senior management level awareness and understanding of fintech applications and fintech-related risks.
- Active board level engagement on issues such as cyber security, outsourcing, and operational resilience more generally.
- Clarity of senior management responsibilities and accountabilities for fintech applications.
- Board level consideration of the implications of fintech developments for the substance and viability of a bank's strategy and business model.

Regulatory and supervisory pressures on banks adopting Fintech



DATA

While banks are expected to meet existing data protection requirements, they also need to take a proactive approach to the possibility that fintech developments may lead to a fundamental re-thinking of data privacy, security and protection by financial services regulators and by data protection authorities more generally.

DIFFERENT APPROACHES ACROSS JURISDICTIONS

Divergences across jurisdictions in the regulation and supervision of fintech activities are an important consideration for banks in deciding where to locate these activities. This could result in regulatory arbitrage where banks are attracted by lower regulatory requirements, but equally there have been examples of banks wanting to promote their fintech activities on the basis that they are regulated and supervised to high standards

BUSINESS MODEL

Current and prospective regulation and supervision may have an impact on a bank's strategy and business model. Some business opportunities may be constrained by regulators and supervisors intervening to prevent or limit what banks can do (for example, restrictions on sales of some products to more vulnerable and less sophisticated consumers and retail investors), while in other cases banks may need to adjust their product and service offerings in response to the costs of meeting regulatory requirements.

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Operational resilience in financial services

Seizing business opportunities

Credit liquidity and operational resilience will be key banking tools in the COVID-19 crisis.

Operational resilience is usually defined as the ability of an organization to adapt rapidly to changing environments.

This includes both the resilience of systems and processes and more generally the ability of the bank to continue to operate its business in the event of disruptive events.

Operational resilience and business continuity planning have always been an important area of focus for financial institutions and their regulators and supervisors.

Regulators have been pressing banks on these areas – now they will really come into play with the outbreak of COVID 19 .This focus has sometimes been confined to a narrow set of risks (for example IT security and outsourcing), or to an emphasis on preventing operational disruptions rather than on responding to and recovering from disruptions when they occur.

More recently, the emerging approach of regulators globally has taken a broader view of operational resilience, covering all risks to the provision of key business services and focusing increasingly on how the continuity of key business services could be preserved in the event of disruptions occurring

There will clearly be costs to organizations in meeting these evolving regulatory requirements. But this should not be seen as purely a compliance exercise. There are also opportunities for organizations to strengthen their operational resilience in a way that brings business benefits.

Taking a more explicit end-to-end view of key business services should enable organizations to drive more than operational resilience. It should also enable them to:

- Generate synergies across strategic, financial and operational resilience;
- Generate better customer outcomes and enhance customer trust and loyalty; and
- Innovative virtual banking services
- Reduce their operational risks and the costs of disruption
- Be better positioned for mergers, acquisitions and moves into new areas of business or new ways of doing business
- Allocate resources more effectively and efficiently.

Banks are already implementing a wide range of measures ranging from working arrangements for staff to enhanced remote banking facilities

Cost and opportunities

Financial institutions are already subject to a wide range of regulatory requirements and supervisory expectations relating to their operational resilience.

A broader view of operational resilience by regulators and supervisors would however place more emphasis on the ability of banks not only to control their operational risks but also to manage disruptions when they do occur in order to preserve the continuity of key business services.

Banks are already undertaking multiple risk management activities under the broad umbrella of operational resilience.

Cyber security and third party risk management are but two of the most prevalent recent examples of such risk management activities that are common across many banks and jurisdictions.

However, to a large extent these risk management activities have taken the form of vertical operational risk frameworks focusing primarily on individual systems and processes, and on reducing the probability or risk of a disruption occurring.

Similarly, although banks also have long experience of business continuity planning and incident management, these have often been somewhat narrowly focused on responding to a limited range of disruptions.

A wider view of operational resilience would augment, rather than duplicate, the existing operational risk management and business continuity planning approach by taking a more horizontal, end-to-end view of the continuity of a bank's key business services.

The efforts to manage the COVID-19 pandemic have forced banks to rapidly adapt to new working models. At the heart of this is a complex and fast changing web of digital infrastructure.

As IT teams scramble to implement changes within weeks that before might have taken years, security teams need to be an enabler, not a blocker to change

RESPONSES TO REGULATION

In response to regulators and supervisors taking a broader view of operational resilience organizations will need to:

- Embark on a transformative programme, overseen by senior management and the Board, to embed a culture of resilience, shape the bank's strategic agenda and investment decisions from a resilience perspective, identify priority business services, and set impact tolerances
- Establish clear accountability structures for operational resilience
- Adapt and develop approaches that go beyond traditional contingency planning, disaster recovery, incident management, operational risk management and third party risk management, to focus through a business lens on managing disruption, whatever the cause, and on delivering the continuity of key business services. Operational resilience should not be treated as just another compliance exercise
- Assume that operational disruptions will occur, and develop coordinated response and recovery mechanisms to such disruptions, including the definition of escalation paths and decision-making procedures, and effective internal and external communication plans which will provide timely information for customers, other market participants and the regulator
- Define recovery plans that enable the resumption of key business services within threshold tolerances when disruptions occur, and use severe but plausible scenarios to conduct end-to-end testing of the bank's operational resilience.

This may require a major shift in approach for many banks.

Turning operational resilience into a business opportunity

The evolving regulatory approach to operational resilience could also bring significant benefits to organizations. These benefits – and the costs of meeting regulatory requirements in this area – will depend to a large extent on the ability of the organizations to drive down costs and to boost efficiency and effectiveness through the more effective leveraging of data, data models and systems architecture.

Improved operational resilience often requires convergence, simplification and an end to duplication of regulatory, risk and control frameworks; and rationalizing service and process overlaps. Such gains have the potential to enable headcount rationalization and to unlock a broad range of efficiency savings.

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Emerging approach to operational resilience: expectations on financial institutions

BOARD LEADERSHIP

Take a top-down integrated view of operational resilience, led and driven by the board and senior management : boards and senior management will need to ensure that they have sufficient expertise and information on operational resilience, and that they establish enterprise-wide operational resilience procedures with appropriate staff and budget.

OPERATIONAL RESILIENCE CULTURE

Embed a resilience culture and use operational resilience considerations to drive investment decisions.

END-TO-END BUSINESS SERVICE APPROACH

Continue to focus on the "prevent" aspects of operational risk management - avoiding disruption to systems or processes contributes to operational resilience but is not enough in itself. Establish and manage operational resilience across key business services, and focus on business service continuity as an outcome for the end-customer, rather than solely on a collection of disparate systems and other inputs. Identify the people, data, systems and processes that support key business services, and map these services across functions and entities, including external suppliers.

SPECIFY TOLERANCES

Establish impact tolerances (using specific outcomes or metrics) from a consumer, business and financial stability perspective, for example for the length of time that a key business service could be unavailable priorities efforts on those services that if disrupted may cause customer harm, imperil the viability of the bank, or undermine financial stability.

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TESTING

Establish rigorous end-to-end testing programmes which challenge the firm's ability to remain within tolerances in severe but plausible scenarios, and which identify the interactions and interdependencies required to deliver services

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RECOVERY AND RESPONSE

Assume that disruptive events will occur so that the focus is on planning for what happens when a disruption occurs
Focus on responses to a disruptive event, such as the ability to identify rapidly the scale of the impact. Focus on the ability to recover from a disruptive event, through robust and well-tested (through severe but plausible scenarios) recovery plans based on adaptability or substitutability to enable the continuity or resumption of key business services within agreed tolerances.

EFFECTIVE COMMUNICATION

Communicate effectively internally, including upward reporting and effective decision making, and externally with those affected (customers, other financial institutions) and other stakeholders to manage expectations and restore confidence.

CONTINUOUS IMPROVEMENT

Take action where necessary to improve prevention, response or recovery capabilities.

Annexures

Appendix A

Relief measures provided by the CBSL via the Banking system (1/2)

Drawing down the Capital Conservation Buffers	▪ Banks would be able to extend their lending capacity by LKR 400.0 Bn, with D-SIBs and non-SIBs being permitted to draw down their CCBs by 100bps and 50bps respectively, thereby facilitating smooth credit flows to the economy.
Relaxations on classifications of loans and advances and foreign currency denominated loan recovery	▪ Removed the requirement to classify all credit facilities disbursed to a borrower as non-performing when the aggregate amount of all outstanding NPLs exceeded 30% of total credit facilities extended. ▪ Borrowers who aren't eligible for any other concessions are given an additional 60 days period to settle loans and advances becoming due past March 2020. ▪ Changes made to payment terms and loan contracts for the period ranging 16 March 2020 to 30 June 2020, due to challenges faced by customers amidst COVID-19, to be considered as 'modifications/ derecognition' to loans and advances as opposed to restructuring of loans and advances which would have resulted in loan classification and increased impairment. ▪ In instances where the recovery of foreign currency loans look bleak, as final resort, banks are permitted to convert such loans to LKR denominated loans, provided certain conditions are met.
Timeline extended on meeting minimum capital requirement	▪ In 2017, CBSL laid out terms where LCBs and LSBs had to comply with a minimum capital requirement of LKR 20.0 Bn and LKR 7.5 Bn respectively, by 2020. Given current conditions, the timeline to meet the requirement has been extended till end of 2022.
Resetting timelines to address supervisory concerns	▪ Banks are permitted to reset timelines based on severity/importance of the findings. In circumstances where a bank is required to meet timelines to address supervisory concerns/findings during the period up to 30 May 2020, such banks are given a further 3 month period for rectification of the findings.
Extended deadlines for submission and publication of statutory returns and financial statements	▪ The reporting period for submission of statutory returns to the Bank Supervision Department has been extended by 2 weeks and the publication of quarterly financial statements has been extended by a month.
Facilitating application of accounting standards	▪ CBSL and CASL will monitor any developments both locally and globally and provide guidance on practical applications to banks on the application of SLFRS 9 especially on the ECL methodology, taking into consideration the extraordinary situations arising from the outbreak of the pandemic.

Relief measures provided by the CBSL via the Banking system (2/2)

Moratoriums	▪ A 6 month debt moratorium on sectors such as SMEs engaged in manufacturing, services, agriculture, construction, value addition and trading businesses, tourism, self-employed businesses and foreign currency earners whose business has been negatively affected and have to repay loans in foreign currency. ▪ A six-month debt moratorium on the leasing rentals of all three wheelers, school vans, lorries, small goods transport vehicles and buses, and related assets such as motor bikes and taxies operated by the self employed/ owners. ▪ A debt moratorium until 30.05.2020 on personal loans granted to all private sector non-executive employees. ▪ A three-month debt moratorium for all personal loans and leasing rentals of value less than LKR 1 Mn.
Working capital loans	▪ The working capital purpose loan facility shall be granted to eligible performing and non-performing borrowers in Rupees not exceeding LKR 25 Mn per bank per borrower and LKR 10 Mn per other financial institutions per borrower or 2 months working capital requirement whichever is higher, based on the requirement for working capital cycle. Such loan shall be repaid over two years at an interest rate equal to 4% p.a. CBSL will subsidize interest cost up to 4% for licensed banks and up to 7% for other financial institutions as a rebate. ▪ A moratorium for a period 25.03.2020 to 30.09.2020 will be granted for both working capital loans and investment loans.
Credit cards	▪ Financial institutions to stop charging for cheque returns, stop payments and late payment fees on all credit cards and other credit facilities during the period up to 30.09.2020. ▪ Interest on local credit card transactions of value of up to LKR50,000 capped at 15%, minimum monthly payments reduced by 50%, repayment of credit card balances below the limit of LKR50,000 to be extended until end-April 2020

Appendix B

COVID 19 Implications on Financial Reporting (1/2)

Key Features of Temporary Practical Expedients issued by CA Sri Lanka

I. Impairment Provisioning as per ECL Methodology in terms of Section 5.5 of SLFRS 9	
PDs and LGDs and EFA and resulting modeling	• PDs and LGDs and EFA used in 31 December 2019 (audited figures) may be used for the reporting on 31 March 2020 (or latest till 30 September 2020) after exercising professional judgement on the sufficiency of the availability of the required information to make any adjustments. • On EFA, it is expected that weightage assigned to worst case scenario has to be increased by transferring the weightage from base case/ best case scenario to worst case scenario in the 31 March 2020 reporting or at the latest from the reporting cycle for 30 June 2020 onwards.
Cash flow assumptions used in Dec 2019 for recovery period for computation of individual significant loans	• Cash flow assumptions used in Dec 2019 for recovery period may be used for computation of individually significant loans in the 31 March 2020 reporting, if adequate information is not available to assess the cash flow forecasts • Industry wide benchmarking on the recovery period on the affected sectors need to be developed and followed by the lending banks and financial institutions for this purpose adjusting the cash flow assumptions for computation of ECL for individually significant loans from at least for the reporting cycle for 30 June 2020 onwards.
Staging of the loans (including the elevated industries	• An entity may continue the same staging that exists as at 31 December 2019 till 30 September 2020, which is end of the debt moratorium period. It is expected that the lending institutions would do the risk assessment and the resulting adjustments; monitor customer payment patterns and reflect in the staging and assess the staggering of the cash flows due to moratorium. Further, weightage assigned to worst case scenario need to be increased from 30 June 2020 reporting onwards. • The above approach shall not be used to upgrade facilities unless improvement in credit risk is clearly established. This means the restructuring and rescheduling based on debt moratorium cannot be used to upgrade facilities
Objective evidence triggers due to COVID 19	• An entity may not consider the objective evidence triggers due to COVID 19 in the assessment of impairment provisions till 30 September 2020. However, such objective evidence triggers need to be considered when the information become available.
Exclude write offs, arising from COVID 19, in computing LGDs	• COVID 19 related implications on impairment may not be incorporated into the ECL models until end of September 2020 if information is not available. Accordingly, write off due to COVID 19 need not result in adjustments to LGDs used by the lending institutions, However, in December 2020 reporting, the resulting impact needs to be reflected in the LGD computations.

COVID 19 Implications on Financial Reporting (2/2)

Key Features of Temporary Practical Expedients issued by CA Sri Lanka

Impairment provisioning on Sri Lanka Development Bonds (SLDB)	• In the event, there is lack of access to reasonable and supportable information including the rating, an entity may use the same PD used as at 31 December 2019 and the LGD as well for the impairment computation during the 31 March reporting. However, required adjustments will have to be made to PDs from 30 June reporting onwards
II. Reclassification in terms of Section 4.4 of SLFRS 9	
Reclassification of debt and equity portfolios	• As a result of COVID 19 if an entity decides to change its business model as at 1 January 2020, a one off option (no further reclassification thereon) is provided to reclassify equity portfolio. Accordingly, if the equity portfolio is reclassified to FVTOCI, the gain or loss on disposal will also be recognised in OCI. There will not be an option given for subsequent reclassifications. • Similar reclassification may be made for the debt portfolios as well based on the change in business model following SLFRS 9.4.4.1.
III. Fair value measurement of quoted Equity investments and Government foreign currency bonds	
Fair value of financial instruments at level I	• The COVID 19 pandemic has significantly affected financial markets in the first quarter of 2020. Stock markets have declined sharply and volatility has been increased. • It is permitted to apply an appropriate valuation technique to measure the fair value of financial assets. However, such values calculated and used as the fair value in the financial statements for the period 2019/2020 by using different valuation techniques are not expected to exceed the market value reported as at 31st December 2019. Specifically, the rates considered in 31 December 2019 financial statements may be continued to be use in the 30 March 2020 reporting for the government foreign currency bonds . • Alternative method of valuations could be applied to acquisitions made subsequent to 31 December 2019 provided that the fair value arrived so do not exceed the volume weighted prices as at 31 December 2019

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About KPMG

KPMG Global

KPMG is one of the world's top global networks of professional services firms. We provide, audit, tax and advisory services with quality, integrity and excellence as fundamental pillars that have marked our work over our more than 140 years of history.

Global Revenue

29,750 million USD

9,110	20,040
Financial sector services	Rest of services

Revenue figures 2018/2019

153 Countries

985+ Offices

219,281 Professionals

KPMG Sri Lanka

KPMG is one of the largest professional services firms in Sri Lanka and is also the oldest Chartered Accountancy firm in the country spanning over a century since inception in 1897.

6 Offices
Including one in Maldives

Over 1,400 Professionals
Our clients value the breadth of skills and experience KPMG professionals bring to every client engagement

Audited 45% of Listed Entities in Sri Lanka
As indicated in the LMD Auditors League 2016.

842	178	272
Professionals in **Audit**	Professionals in **Tax**	Professionals in **Advisory**

Recognition | KPMG in Sri Lanka

Awarded first in the financial services category

Most Respected 2019 - LMD

First in the Auditors League in Sri Lanka

LMD 100 - 2017

Best Deal Advisory Firm in Sri Lanka

Global Banking and Finance Review 2015

Best Advisory Firm in Sri Lanka

The International Finance Magazine 2016

Sri Lanka Tax Firm of the Year

Asia Tax Awards 2017

Highlighting the significance of KPMG's impact in the marketplace, KPMG in Sri Lanka received a number of accolades including being the 'Best Deal Advisory Firm in Sri Lanka' by The Global Banking and Finance Review for its outstanding achievements in Deal Advisory, being ranked among the 'Most Respected' entities in the country for 2016 and being ranked first in the 2015/2016 Auditors League as indicated in the LMD 100. Recently the firm also won the Tax Firm of the Year at the Asia Tax Awards 2017.

KPMG Leadership - Banking

Reyaz Mihular

Managing Partner

Audit

Suren Rajakarier
Partner, Head of Audit

Tax

Shamila Jayasekara
Partner, Head of Tax & Regulatory

Advisory

Priyanka Jayatilake
Partner, Head of Advisory

Ranjani Joseph

Partner,
Head of Banking Services and Markets,
Deputy Head of Audit

Chamara Abeyrathne
Partner, Audit

Suresh Perera
Principal - Tax & Regulatory,
Deputy Head of Markets

Shiluka Goonewardene
Principal - Head of Deal Advisory,
Deputy Head of Markets

Upul Karunaratne
Partner, Audit

Raditha Alahakoon
Partner – Accounting
Advisory Division

Jagath Perera
Partner, Internal Audit Risk & Compliance
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Thamali Rodrigo
Partner, Audit

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