KPMG

Sri Lanka Banking Report

Issue 6
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KPMG in Sri Lanka

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Foreword

COVID-19 has dramatically reshaped the world in which we live, with tumultuous economic and financial effects running alongside the public health emergency.

At the height of the outbreak, banks across the globe played, and continue to play, a fundamentally important role supporting businesses and families by administering government- backed loans, providing additional liquidity and rapidly installing forbearance measures. In many ways trust in banks is at an all-time high.

The financial institutions aren't just weathering the storm or waiting for good weather. They are turning the experience to their advantage and building the capabilities they require to thrive in the new reality.

Rightfully so, the first reaction to COVID-19 was to protect employees and customers and this must remain a central tenet of the business strategy – not only for business continuity purposes, but also as a way to shape and enhance organizational culture.

Whilst moving towards the "New Normal", the banks are focusing on five key priorities as they plan their path to recovery.

- Reconnecting with customers.
- Creating vibrant ecosystems and partnerships
- Productivity improvement and technology enablement.
- Improving risk management and agility.
- Embedding social responsibility and purpose.

During the phase of various instabilities and the COVID-19 outbreak, the banking sector as the backbone of the economy, had to undergo various changes as response to the demands of the macro economy.

The Central Bank of Sri Lanka (CBSL), the spearhead of the banking sector is playing a key role in taking necessary measures towards revival of the economy during the pandemic.

CBSL took measures to provide debt moratoriums via financial institutions as relief measures for businesses and individuals during the various economic shocks that occurred in the country. These moratoriums are expected to be extended.

In response to COVID 19, banking industry in Sri Lanka has enabled alternative working models and serving customers in many ways with the use of modern technology. COVID-19 has also forced businesses of all types to fundamentally rethink their traditional operating models, business models and customer value propositions.

For the financial services industry, the transformation will be challenging; but it will also be necessary as change is coming and coming fast .

The new normal would compel banks to embrace continual reinvention of their business models and solutions. Hence it is increasingly clear that the entire banking ecosystem and the way consumers associate with financial institutions are being realigned with the new normal.

The significant change in CEOs' priorities over the past six months is a clear indication that businesses have had to pivot at breakneck speed to deal with the challenges of the pandemic. Business leaders the world over are seeking to manage uncertainty with decisiveness.

I believe the financial services markets of the future will largely be shaped by those organizations that are able to anticipate tomorrow while delivering on the priorities of today.

They are the ones that are turning the COVID-19 experience to their advantage and building the capabilities they require to thrive in the new reality.

KPMG in Sri Lanka brings to you the sixth issue of the Sri Lanka Banking Report with key discussions on the performance and trends of the 1st Half of 2020, focusing on the COVID-19 implications on various areas of the businesses and the importance of the approach to **"Anticipate tomorrow, but deliver today".**
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With Passion and Purpose

Ranjani Joseph
Partner - Head of Banking Services & Markets
KPMG in Sri Lanka

Executive Summary

Sri Lanka's economy continues to be impacted by the COVID-19 pandemic, with several key sectors of the economy, such as tourism, trade and consumption yet to return to normalcy. The initial month of the pandemic (March 2020) resulted in 1Q2020 Gross Domestic Product (GDP) contracting by 1.6% Year-over -Year (YoY). With lockdown and curfews lasting for seven weeks through to 2Q2020, the key rating agencies expect Sri Lanka's economy to contract between 1.0 - 6.0% in 2020.

The drag on the economy was reflected in the domestic banking sector, with weak results in 2Q2020. Gross loans and advances increased by just 0.7% Quarter-on-Quarter (QoQ) in the period, with contractions in credit extended to the private sector in May and June 2020, contributing towards this performance.

Banking sector's Net Interest Income (NII) declined by 3.3% YoY in 1H2020 due to slow credit growth, declining interest rates and debt moratoriums imposed. Net Interest Margin (NIM) continued to trend lower, falling to 3.2% in 2Q2020, from 3.4% in 1Q2020, a further decrease from 3.6% recorded in 2019.

As at 15th October 2020, under the Saubagya COVID -19 Renaissance Facility, LKR 177.9 Bn was approved in total loans, benefitting 61,907 applicants

The CBSL also decided to go beyond the LKR 150 Bn limit on the facility, which it had previously increased from LKR 100 Bn, due to the large number of applications received.

Policy rates were further lowered in July 2020, marking the fourth reduction since the start of the COVID-19 pandemic. The Bank Rate was also lowered to 8.5% in July 2020. All such efforts of the CBSL combined, released LKR 459.4 Bn of liquidity into the domestic economy between February and June 2020.

There is however, a significant risk that these measures, whilst supportive in the short-term, are expected to impact the profitability and asset quality of domestic banks, particularly following the expiry of the loan moratorium (end-September 2020 except for tourism related loans).

We expect to see a rise in Non-Performing Loans (NPLs) as default risk increases toward the end of 2020 with significant increase in credit risk. Provisioning levels are also anticipated to grow as the flexibility in impairment recognition for regulatory and financial reporting purposes, which was previously granted by the CBSL throughout the period of the moratorium which concluded by end-September 2020.

However, in the recent months, up until the second wave of COVID-19 hit in October 2020, there was an uptick in positive business sentiment in the country, as there was minimal community transmission due to successful containment efforts by Government of Sri Lanka (GoSL). We expect in the coming quarters, this momentum to continue and as a result private sector credit growth to slowly pick up in 2021, as GoSL has indicated that they do not opt for a prolonged lockdown as earlier, under the current economic situation.

CBSL has taken several measures to revive the economy, since March 2020 with policy revisions, liquidity injections, loan moratoriums, as well as curtailment in imports and foreign currency investments to push towards an economic recovery. As a result, to ease pressure on the exchange rate, CBSL has issued a directive, suspending the import of selected motor vehicles and specific non-essential goods, as well as in the purchase of Sri Lanka International Sovereign Bonds until end September.

Moreover, in August 2020, the CBSL imposed interest rate caps on selected lending products offered by licensed banks and also extended the loan moratorium to the tourism sector, up to 31st March 2021.

It is noteworthy to mention that the banking sector has maintained healthy capital adequacy ratios (CAR) throughout 2020, reporting a Tier 1 CAR of 13.1% and a total CAR of 16.4% at end-June 2020. This was well above the minimum regulatory requirements.

With increasing regulatory requirements, there is a likelihood of consolidation within the industry as smaller banks that are faced with more challenging operating conditions and greater profitability pressures may not be able to maintain competitiveness.

A positive change witnessed during the pandemic has been the progress of digital banking, which has been accelerated, due to the increasing need to serve customers remotely and efficiently. This creates opportunities to remodel banks' operations, focusing more on value addition and quality of service delivery.

In conclusion, due to relief measures aimed at boosting the banking system, it is yet to fully recognise the impact of the pandemic. The end of the moratorium will determine how the sector is likely to progress in the months ahead.

Performance

		1H/ Jun 2019	1H/June 2020
Total Assets (LKR Bn)	↑ 12.3%	11,901.5	13,367.8
Net Profit (LKR Bn)	↑ 14.9%	51.3	59.0
Core Capital Ratio	↓ 0.3%	13.5%	13.1%
Total Capital Ratio	↓ 0.2%	16.7%	16.4%
Net Interest Margin (NIM) (%)	↓ 0.4%	3.6%	3.2%

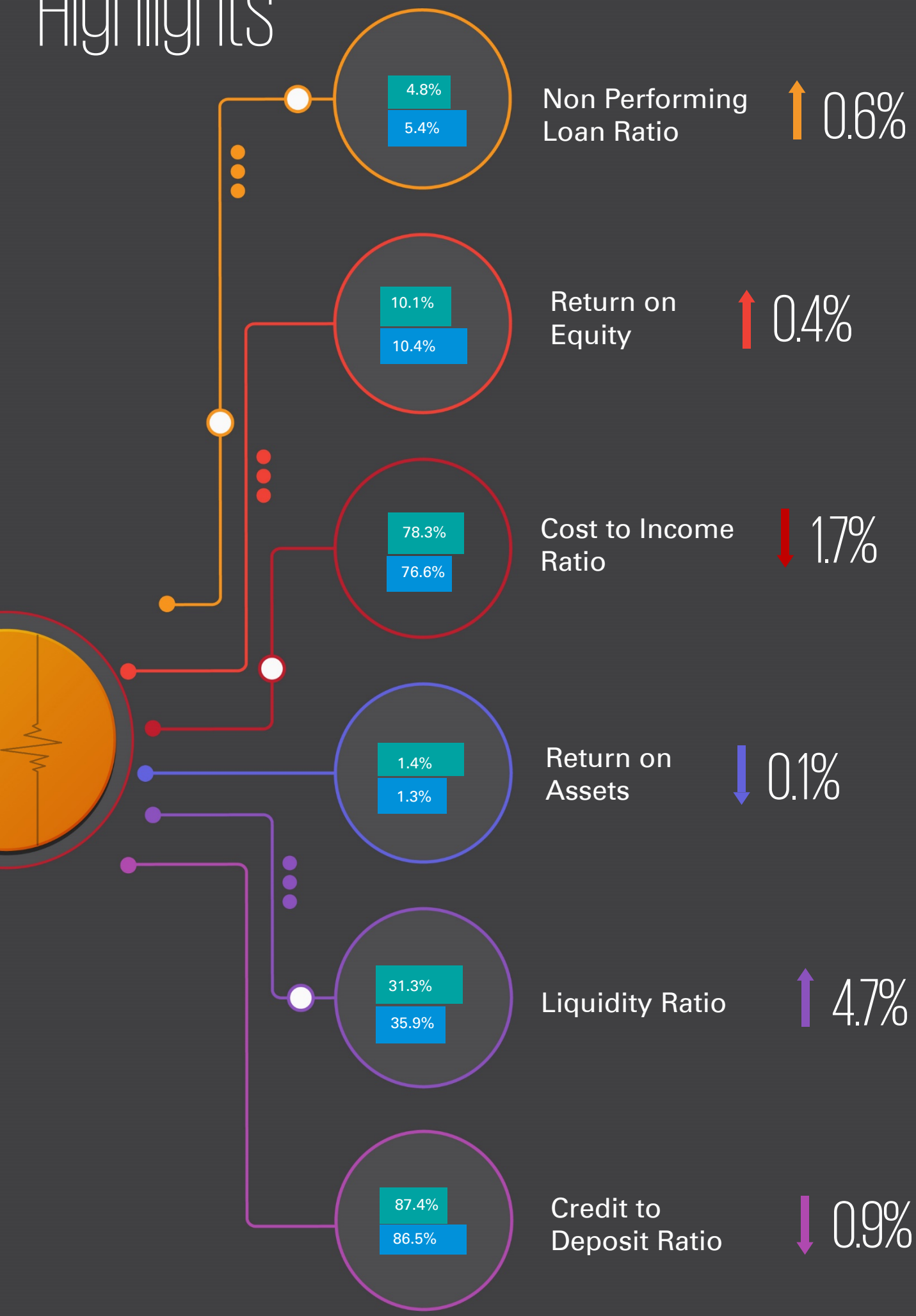
Key

- 1H/ Jun 2019
- 1H/June 2020

Change %

- ↓ Decline
- ↑ Increase

Highlights



Source: CBSL

Banking Sector Highlights

Short to medium-term impact on the sector

The COVID-19 pandemic caused and continues to have a multi-faceted impact on the banking sector's operations. The sector's recovery is strongly correlated with the rebound of the Sri Lankan economy. High-level assessment of the overall impact on the banking sector in the short to medium-term is covered in this section:

Banking sector outlook remains negative

In May 2020, Fitch revised down the operating environment (OE) score for banks in Sri Lanka to B- (lka) from B (lka). The outlook on the OE score is negative, same as the outlook on Sri Lanka's long-term issuer default rating, which was downgraded to B- in April 2020. The prolonged impact of COVID-19 has caused ripples in the domestic economy, leaving a substantial responsibility on the banking sector to provide support. This has resulted in significant pressure on banks' asset quality and profitability.

The Moody's banking sector risk is at "baa," which also reflects similar potential risks to the sector, namely, asset quality and capital adequacy from a weak operating environment.

Profitability to come under pressure with higher impending provisioning requirements

Banking sector profitability is anticipated to remain under pressure given the low interest rate environment, subdued loan growth, restrictions on non-interest income and the risk of higher NPLs.

The modification methods under SLFRS 9 resulted in recognition of day-one loss arising from the GoSL-mandated loan moratorium which is being recorded against the interest income of banks, further contributing to the decline in NII in 1H2020.

In the short-term, increasing impairment requirement due to the expiration of the loan moratorium in September 2020, as well as, reclassifications of loans and NPLs are likely to affect banking sector profitability.

NPL ratios to rise following expiry of moratorium

Although NPLs increased in 1H 2020, the full impact of asset quality deterioration is masked by the loan moratorium in effect until September 2020, as well as by the flexibility granted by CBSL as well as CA Sri Lanka towards impairment recognition for regulatory and financial reporting.

CBSL relief measures provide some comfort

July 2020 marked the fourth policy reduction during the COVID-19 period. Liquidity worth LKR 459.4 Bn was injected into the banking system between February and June 2020. This included a second reduction in the SRR in June 2020 by 200bps.

Other measures include relaxed rulings on NPL classifications and deadlines to meet the increased minimum capital requirements.

Recent initiatives include the New Credit Guarantee and Interest Subsidy Scheme. Added to this, in August 2020, the CBSL introduced interest rate caps on selected credit facilities offered by licensed banks, along with the extension of moratoriums to certain sectors, such as tourism. Increased allowance for banks to draw down on capital conservation buffers will inject liquidity into the system.

Regulatory changes in the banking sector could result in consolidation of banks

The banking sector in Sri Lanka remains heavily fragmented. We still believe that regulatory measures and market forces could lead to consolidation within the banking sector, resulting in more efficient banking operators and economies of scale. Smaller banks, in particular, are more vulnerable given the pressure on their capital buffers as well as profitability.

Digital banking becoming the new norm

Banks are compelled to invest in and improve their digital systems and platforms for a smoother customer experience, which, to an extent, will be driven by customer demand as well as the competitive pressure to offer the best digital solutions.

As a result, from the digital technology side, majority of customers using internet banking, mobile banking, wallet products etc and from the infrastructure side, centralization initiatives of the banks, redefining the role of the branches, outsourcing non-core activities etc are becoming the norm.

In October 2020, a further initiative was made with National LANKAQR, a collaboration between the CBSL, licensed financial institutions and LankaClear (Pvt.) Ltd being launched. Using payment apps of LANKAQR certified financial institutions, customers can make payments directly from their bank accounts to accounts of merchants or the service provider.

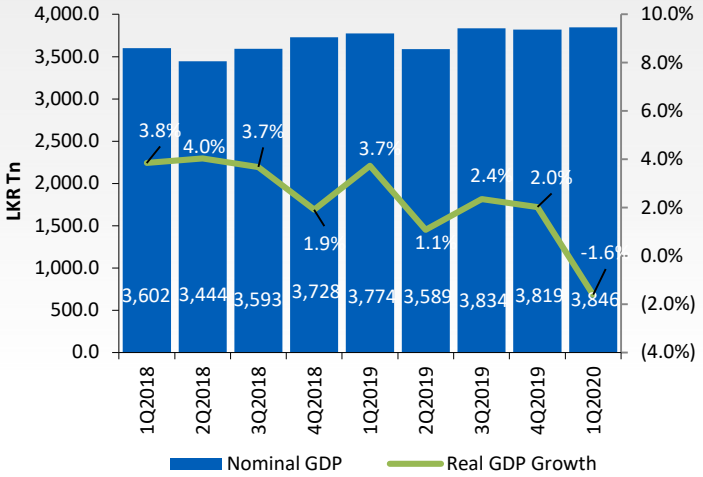
Economic Overview

COVID-19 delays Sri Lanka's economic recovery

Following the negative economic impact from the April 2019 Easter attacks, Sri Lanka was progressing towards a gradual recovery in early 2020. However, occurrence of the COVID-19 pandemic halted such progress, with the economy now likely to experience further downward pressure, as the global economy, as well as the country's main export markets, are yet to fully recover.

Sri Lanka seems have been less affected by the pandemic than its regional and global peers. However, the country's high dependence on global markets and its interconnected supply chains, as well as the fact that key regions such as the West Asia region are yet to fully return to "business as usual", are likely to strain Sri Lanka's resources in the short-term.

Gross domestic product



GDP estimated to contract in 2020

Impacted by the initial stages of the pandemic, the Sri Lankan economy contracted by 1.6% YoY in 1Q2020, with the agriculture and industrial sectors declining 5.6% and 7.8% respectively, offset by the services sector which grew 3.1%.

The situation hindered GoSL's plans for a strong economic recovery, driven by significant tax cuts (direct and indirect) introduced post the Presidential Elections in November 2019. Instead, fiscal performance deteriorated further due to the effects of COVID-19 .

With the magnitude of the second wave looming large in the horizon since October 2020, the country's citizens' consumption power, by either one or a combination of factors, mainly through unemployment, salary reductions, loss of domestic /export orders for businesses and decline in foreign remittances from overseas could be further impacted.

Increase in unemployment to 5.4% in 2Q2020 (4.9% in 1Q2019) reduced from 5.7% in 1Q2020 and lockdown-induced salary cuts affected consumption; a key driver accounting for about 70% of the economy. We feel consumption will continue to be impacted in 2H2020, as declining incomes cause many households to focus on essential purchases in the short-term, perhaps extending this practice into the medium-term.

Significant slowdown in March and April 2020 caused worker remittances declined 8.9% YoY in 1H2020 with CBSL estimating a 14.6% YoY decline in 2020. This comes on the back of the wide-scale salary and job cuts across West Asia, from where about one million foreign workers send the bulk of Sri Lanka's approximately USD 7.0 Bn annual remittances. However post 1H2020, remittances in July and August 2020 reached a cumulative USD 1.37 Bn, up 19.5% YoY.

As a result, the economy is likely to contract in 2020, where CBSL is projecting 1.7% negative growth, amidst 2Q2020 results not been released yet. The other agencies such the World Bank, Asian Development Bank and Fitch Ratings, are also forecasting the Sri Lankan economy to contract by 5.5%, 6.7% and 3.7%, respectively in 2020 with a recovery in 2021, along with other South Asian countries.

In July 2020, the World Bank downgraded Sri Lanka to lower-middle income country status from upper-middle income as a result of a decline in GDP per capita in 2019,which was due to the economic growth rate being lesser than the currency depreciation. Given the possible contraction in the economy in 2020, Sri Lanka is likely to remain in this classification.

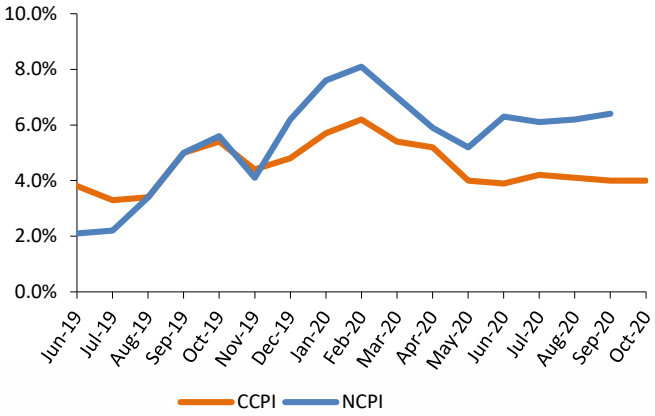
Sources: Central Bank of Sri Lank (CBSL), Department of Census and Statistics (DCS)

Inflation to remain in mid-single digits for 2020 led by depressed demand

Inflation, as measured by the National Consumer Price Index (NCPI), reached 6.3% YoY in June 2020, with food prices growing at a significantly higher rate (13.6% YoY in June 2020 and 12.9% in July 2020) due to import restrictions.). Furthermore, food inflation increased 12.9% YoY, 13.2% YoY, and 12.7% YoY in July 2020, August 2020, and September 2020, respectively.

Non-food inflation remained constant at 0.8% YoY in June 2020, impacted by the GoSL's policy to temporarily disallow imports of non-essential items, coupled with the lockdown translating to lower fuel consumption on Sri Lanka's roads and hence lower oil imports. Non-food inflation ticked up to 1.0% YoY, 1.1% YoY and 1.4% YoY in July 2020, August 2020, and September 2020, respectively, showing early signs of a gradual trend towards normalcy, albeit in an environment of select import restrictions. Pricing pressure was lowered due to tax concessions that were introduced in early 2020, prior to the escalation of COVID-19.

YoY inflation



Whilst overall inflation is expected to remain within mid-single digits, food inflation is likely to continue its current upward trajectory. This is mainly due to challenges faced in the collection of domestic produce and supply-side issues at country's import locations. For example on 14th September 2020, India suddenly announced the ban on onion exports, which is now partially lifted, is likely to add to Sri Lanka's food inflation pressure in the near-term.

Non-food prices may see an uptick once the non-essential import ban is lifted and the LKR adjusts to that demand-and-supply mechanism.

CBSL continues to infuse significant liquidity into the system as it attempts to limit the impact of the COVID-19 crisis. Between February and June 2020, it supplied LKR 459.4 Bn. To limit the impact of price instability, CBSL is likely step in to drain the excess liquidity in the market. However, its efforts to safeguard the financial system in the wake of the COVID-19 crisis could threaten price stability in the next 12 months.

Fiscal position to deteriorate further as budget deficit widens

The onset of the pandemic and post-Presidential Election 2019 tax cuts, resulted in 1H2020 tax revenue falling to LKR 580.8 Bn (down 28.4% YoY), decreasing to 3.7% of GDP in 1H2020 from 5.4% a year earlier. This decline, coupled with the impact of COVID-19 caused certain reversals in abolished taxes, mainly the re-introduction of Pay as You Earn (PAYE) in April 2020, now known as Advanced Personal Income Tax (APIT).

Additionally, import restrictions will further impact potential tax revenue, given that almost half of the GoSL's tax coffers is made up of import-related taxes. As a result, it is likely that tax revenue in 2020 will fall short of the CBSL estimate of LKR 1,305.0 Bn.

The combination of low tax revenue and increasing recurring expenditure, as well as pandemic relief costs, is estimated to widen the budget deficit as a percentage of GDP to more than 8.0% in 2020 from 6.8% in 2019.

In September 2020, Moody's Investors Service downgraded Sri Lanka's long-term foreign currency issuer and senior unsecured ratings to Caa1 from B2. Increasing concerns over the country's debt affordability, high budget deficits and limited room for reforms, stemming from the COVID-19 pandemic were the underlying reasons for the downgrade. This follows Fitch Ratings' downgrade of Sri Lanka's sovereign credit rating in April 2020. This is expected to further increase the cost of servicing foreign debt. The risks are continued to be highlighted, as the second wave of the pandemic hit Sri Lanka in October 2020.

Source: CBSL, DCS

Sri Lanka's foreign reserves under pressure due to growing Debt-to-GDP

Foreign reserves continue to be under threat in 2020, falling to USD 6.7 Bn in September 2020 from USD 7.9 Bn in February 2020. Recently reserves improved on the receipt of USD 500 Mn from the Reserve Bank of India in July 2020 as part of a swap arrangement.

In October 2020, Sri Lanka repaid the maturing USD 1 Bn sovereign bond, thus impacting reserves. It is noted that at least another USD 1-1.5bn of debt payments are outstanding for 2020.

Reserves are to remain under pressure given the debt repayments due over the next twelve months. Sri Lanka has a funding gap of USD 9 Bn through to August 2021.

The current account deficit narrowed to USD 161 Mn in June 2020, with the cumulative trade deficit coming in at USD 3.3 Bn in 1H2020 compared with USD 3.6 Bn in 1H2019. In spite of restrictions imposed on non-essential imports and lower oil prices leading to reduced fuel bills, the trade deficit is anticipated to expand to 3.3% of GDP in 2020. This is expected to result from lower exports, particularly from hard-hit sectors such as textile and garments, which saw exports contract 30% YoY in 1H2020.

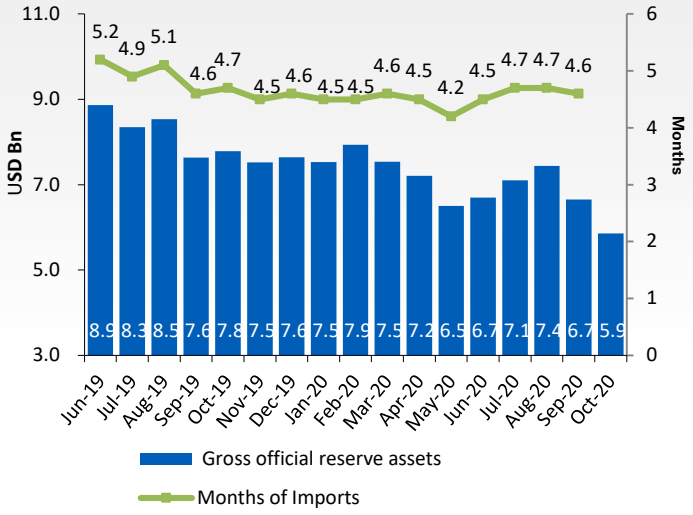
The debt-to-GDP ratio stood at 86.8% at end-2019, with current and short-term fiscal pressure-induced borrowing likely to push the ratio over 90% by end-2020.

Stability of currency to be supported by foreign funding

Foreign funding received:

- A USD 140 Mn loan from China Development Bank, agreed in July 2020, which will be drawn in two tranches of USD 70 Mn each
- A USD 400 Mn debt swap completed with the Reserve Bank of India in July 2020
- USD 128.6 Mn from the World Bank
- A USD 90 Mn grant from China in Oct 2020

Gross official reserve assets



Funding lines in discussion:

- A further USD 1 Bn under a special bilateral swap agreement with the Reserve Bank of India
- Renewal of a 10 Bn yuan (~USD 1.5 Bn) swap *with* China
- A USD 500 Mn concessional loan from a "China financial institute
- A USD 700 Mn syndicated loan from China
- A USD 300 Mn facility from the Asian Development Bank
- A USD 1 Bn Repo Facility from the Federal Reserve Bank of New York, for which the GoSL has already completed the enrolment request
- The International Monetary Fund, to raise another USD 800 Mn under its Rapid Financing Facility
- Sri Lanka is also negotiating with China's Asian Infrastructure Investment Bank and France for additional budget support.

Dollar inflows from capital markets recovered as the Sri Lanka Development Bond (SLDB) auction in July 2020 was over-subscribed. This follows two heavily under-subscribed SLDB auctions in March and April 2020, during the peak of the pandemic.

Source: CBSL

Exchange rate to stabilize with the GoSL's protectionist measures

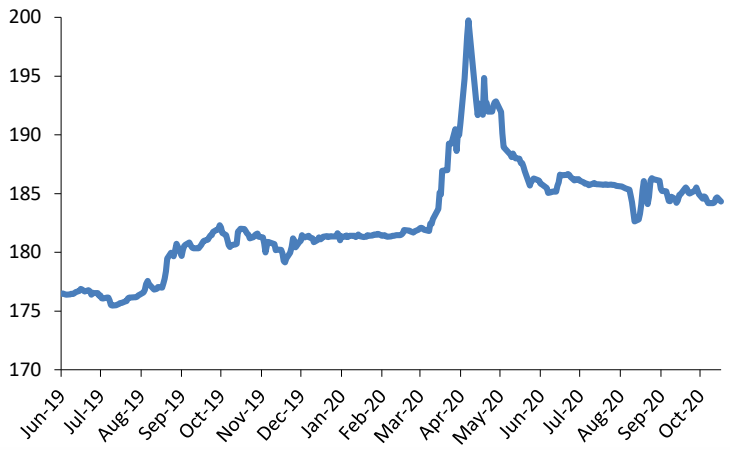
As seen during the beginning of the year, investors continued to gravitate towards gold, which reached USD 2,036.58 per ounce in August 2020, (up 33.2% since late-March 2020, when COVID-19 was first deemed to be widespread).

Net foreign outflows of foreign investments from the LKR-denominated government securities market was recorded at USD 515 Mn during January to June 2020.

Moreover, net foreign outflows from the Colombo Stock Exchange (primary and secondary markets) amounted to USD 129 Mn during the first seven months of 2020.

This enhanced demand for gold, as well as foreign investors choosing to leave Sri Lankan markets, resulted in the LKR depreciating to a high of LKR 199.75 against the USD on 9th April 2020, before recovering to pre-pandemic levels. As of the 30th of October 2020, the LKR has depreciated 1.6% year-to-date and was recorded at LKR 184.3 against the USD.

LKR per USD



To ease the pressure on the Balance of Payments during the height of the COVID-19 crisis, the CBSL instructed all banks to suspend facilitating the import of motor vehicles and all non-essential goods except medicine and fuel, while restricting the ability of banks to purchase Sri Lanka sovereign bonds.

Further, a 'Special Deposit Account' was introduced to facilitate the inflow of foreign currency deposits. However, since its introduction in April 2020 to midway through July 2020, the scheme had only attracted about USD 87.0 Mn. This led to further incentivizing individuals to use this facility.

Easing import restrictions is likely to put pressure on the LKR, with pent-up demand and December orders coming in together.

Moreover, CBSL brought into effect temporary regulatory measures on outward remittances for a period of six months.

Source: CBSL

CBSL to continue accommodative monetary policy stance

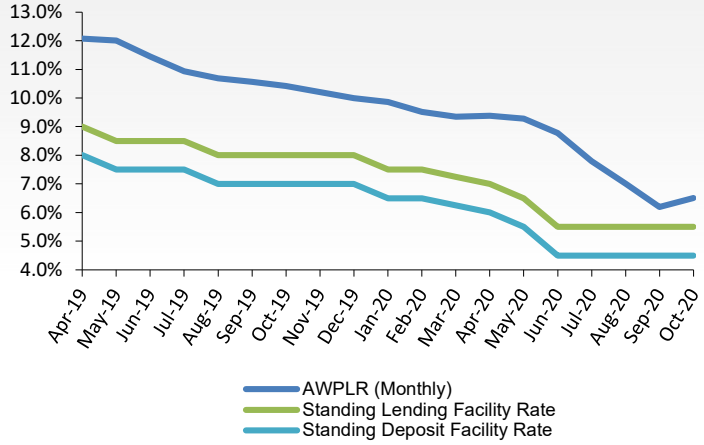
Policy rates lowered in July for the fourth time since March 2020

In July 2020, CBSL further reduced policy rates by 100bps, marking the fourth time it had resorted to such measures since 16th March 2020. Accordingly, SDFR and SLFR were lowered to 4.5% and 5.5%, respectively. However, there were no policy rate changes made in August, September and October 2020.

Further, in line with the policy rate reductions in July 2020, CBSL automatically adjusted the Bank Rate with the SLFR, lowering the Bank Rate another 100bps to 8.5% in July 2020.

In June 2020, CBSL also reduced the Statutory Reserve Ratio (SRR) by 200bps to 2.0%, enabling the injection of a further LKR 115.0 Bn, in addition to the LKR 65.0 Bn pumped into the market with the March 2020 SRR cut.

Policy rates



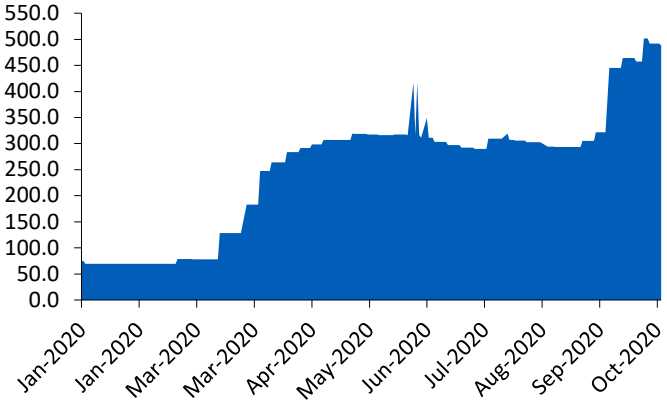
Domestic economy sees significant injection of market liquidity during COVID-19

Overnight market liquidity amounted to LKR 153.1 Bn as at 31st October 2020, up from LKR 30.6 Bn as at 12th March 2020, prior to the country-wide lockdown, as CBSL kept up its efforts to maintain sufficient liquidity in the system.

Between March and June 2020, the CBSL measures to boost liquidity, such as money printing and SRR cuts injected about LKR 459.4 Bn into the domestic economy. However, printing of money is expected to put pressure on both inflation and the currency.

Further, the CBSL significantly increased its holdings in government securities to LKR 311.5 Bn by end-June 2020, from LKR 78.0 Bn as at 12th March 2020.

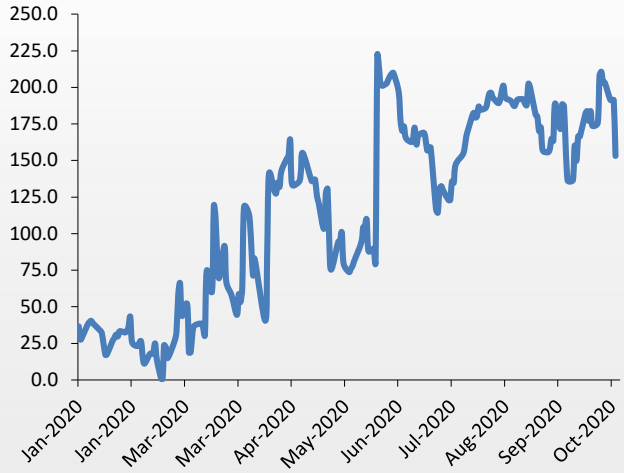
CBSL Treasury Bill Holdings (LKR Bn)



Other measures to increase liquidity flow

In addition to providing loan moratoriums, concessionary loans via banks and Non-Banking Financial Institutions (NBFIs) for businesses and individuals impacted by the COVID-19 lockdown, the CBSL lowered banks' capital conservation buffer requirements to further provide liquidity and spur the economy.

Total Overnight Market Liquidity (LKR Bn)



Source: CBSL

Private sector credit growth to remain muted

Bond yields

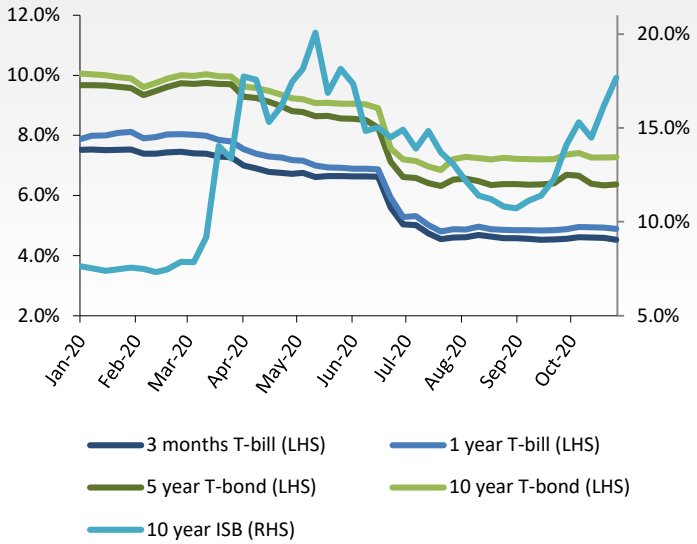
The domestic yield curve witnessed a downward shift from March 2020 as the CBSL implemented several measures to boost liquidity in response to COVID-19.

Since early-March 2020 to August 2020, the Treasury bond market saw an exit of foreign investments as investors switched to safer locations.

Concerns over liquidity, fears of default and foreign selling pressures led to International Sovereign Bond (ISB) yields rising significantly in the first few months of 2020. However, with a new stable government (since August 2020), the GoSL being confident of meeting upcoming debt repayments with available foreign reserves, and new funding lines under negotiation, ISB yields have since lowered.

Yields on the ISBs due in October 2020 ranged within 23-25% at the end-August 2020, having peaked at 91.9% in early-April 2020. However, recently the yields were seen an increasing trend, where the ISB due in July 2021 recorded a 42.3% yield as at end October 2020.

Bond yields



Slower private sector credit growth witnessed between March to June 2020

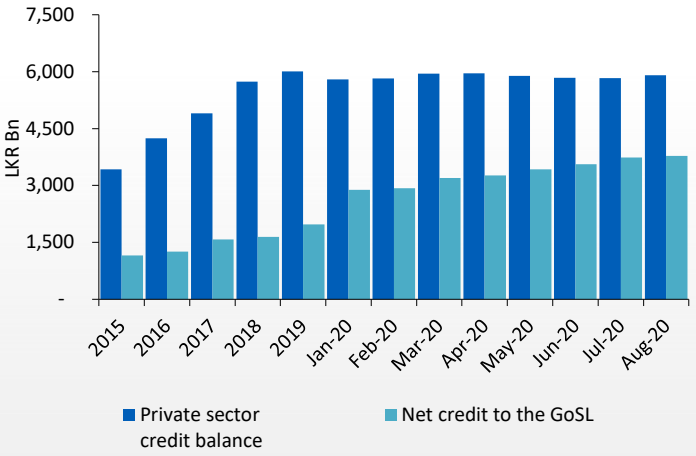
Despite significant rate cuts credit extended to the private sector by the Sri Lankan financial system grew at only 4.3-7.6%,YoY during March 2020 and June 2020, highlighting the slow economic activity in the country.

In 2019, growth in private sector credit decelerated significantly, amid slow economic activity resulting from the Easter Attacks, high lending rates and weak business confidence.

We do not expect a recovery in private sector credit growth, as the economy is currently undergoing severe demand, supply and market shocks, both locally and globally.

Increased funding requirements by the GoSL to mainly deal with the pandemic led to a rapid growth in credit extended to the public sector. Between March 2020 and June 2020, such credit grew in the range of 22.4-33.5% YoY. This compares to a 14.3% Compound Annual Growth Rate (CAGR) between 2015-2019.

Credit extended by commercial banks



Source: CBSL

Banking Sector Analysis

Overview of financial performance

Banking sector as at 30th June 2020

Licensed commercial banks (LCBs)

	Total assets (LKR Bn)	Total assets (USD Bn)		Total assets (LKR Bn)	Total assets (USD Bn)
Total LCBs	**11,688.5**	**62.8**			
State banks			**Foreign banks****		
1.Bank of Ceylon	2,680.7	14.4	14. The Hongkong & Shanghai Corporation Ltd	433.5	2.3
2.People's Bank	1,978.9	10.6	15. Standard Chartered Bank	186.4	1.0
Local banks			16. Deutsche Bank AG	61.1	0.3
3. Commercial Bank of Ceylon PLC	1,543.6	8.3	17. Indian Overseas Bank	48.9	0.3
4. Hatton National Bank PLC	1,169.8	6.3	18. Citibank	48.1	0.3
5. Sampath Bank PLC	1,005.3	5.4	19. Bank of China	43.2	0.2
6. National Development Bank PLC	562.1	3.0	20. MCB Bank Ltd	29.7	0.2
7. Seylan Bank PLC	526.1	2.8	21. State Bank of India	28.8	0.2
8. DFCC Bank PLC	435.2	2.3	22. Public Bank Berhad	10.0	0.1
9. Nations Trust Bank PLC	342.9	1.8	23. Habib Bank Ltd	9.2	0.05
10. Pan Asia Banking Corporation PLC	163.7	0.9			
11. Union Bank of Colombo PLC	128.6	0.7			
12. Amana Bank PLC	94.2	0.5			
13. Cargills Bank Ltd	46.5	0.2			

Licensed specialised banks (LSBs)

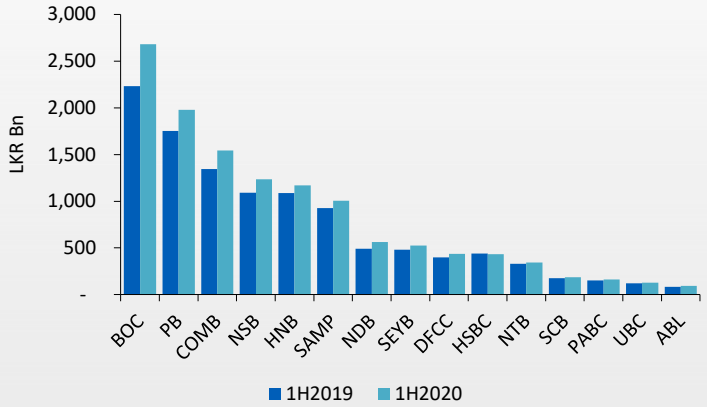
	Total assets (LKR Bn)	Total assets (USD Bn)		Total assets (LKR Bn)	Total assets (USD Bn)
Total LSBs	**1,679.3**	**9.0**			
1.National Savings Bank	1,236.2	6.6	4.Housing Development Finance Corporation Bank of Sri Lanka	59.7	0.3
2.Pradeshiya Sanwardhana Bank	204.5	1.1	5.Sri Lanka Savings Bank Ltd*	8.7	0.05
3.Sanasa Development Bank PLC	115.1	0.6			

* *Data as at March 2020*

** *Indian (operating) , Axis & ICICI (ceased operations; CBSL approved for cancellation of license) banks have been excluded under foreign banks due to unavailability of data*

The performance of Sri Lanka's banking sector in 1H2020 was significantly impacted by the COVID-19 pandemic and lockdown (March 2020 to June 2020). The sector assets, which accounts for roughly 83% of GDP (as at Dec 2019), remains a critical element of the economy especially during this time, as it is the key implementer of the GoSL mandated relief measures, as well as ensuring adequate liquidity remains in circulation.

Comparison of asset base of select banks



The sector remains concentrated with Domestic Systemically Important Banks (D-SIBs), comprising BOC, PB, COMB and HNB, accounting for 60.0% of industry assets as at end-June 2020; the two state banks, BOC and PB, accounted for a 40.2% share of total industry assets.

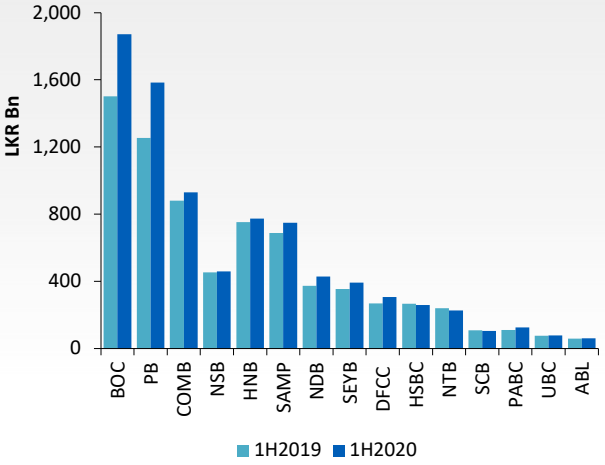
Sri Lanka's banking sector, with a total asset base of LKR 13,367.8 Bn (USD 71.7 Bn) and a net loan portfolio of LKR 8,348.1 Bn (USD 44.8 Bn) as at end-June 2020, remains under pressure as COVID-19 continues to affect the local economy.

This section analyses a selection of banks, which collectively accounted for ~93% of total industry assets as at end June 2020. Total assets within the domestic banking sector increased to LKR 13.4 Tn at end-June 2020, reflecting a 12.3% YoY increase and 6.7% YTD growth in 2020. Asset growth seen in 1Q2020 (5.1% QoQ) was significantly dragged down to 1.5% QoQ in 2Q2020.

Sources: CBSL, Company Interim Reports

Loans and advances remain constant in 2Q2020 as credit to private sector slows down

Gross loans and advances



Gross loans and advances reached LKR 8.6 Tn in 1H 2020, growing 12.4% YoY and up by 5.9% versus end-2019. However, it grew by only 0.7% in 2Q2020, evidenced by a decline in private sector credit in the quarter over 1Q2020, as the effect of the lockdown and restrained economic activity in the country took full effect.

Private sector credit growth slowed to 6.4%, 4.3%, and 4.2% YoY in May 2020, June 2020 and July 2020, respectively. This offset the 6.5% and 7.6% YoY growth witnessed in March 2020 and April 2020, respectively.

In absolute terms, credit to the private sector contracted by LKR 70.0 Bn in May 2020, LKR 54.0 Bn in June 2020, and LKR 3.6 Bn in July 2020.

An improvement was seen in August 2020, with private sector credit increasing by LKR 78.3 Bn, reflecting growth of 5.2% YoY.

1H2020 loan and advances growth declined more than 500 bps compared to the five year CAGR of 17.5% experienced during 1H2014 to 1H2019.

Gross loans and advances at LCBs rose by 13.5% YoY in 1H2020 (vs. five year CAGR of 17.8% during 1H2014 to 1H2019) and was less affected than LSBs. LSBs, which in 1H2020 accounted for about 8.8% share of total gross and advances, grew only 1.9% YoY, significantly below its five year CAGR of 15.1% during 1H2014 to 1H2019. This has also led to decline of loan to deposit ratio of the banking sector to 83.9% in 2Q2020 from 86.5% in 4Q2019.

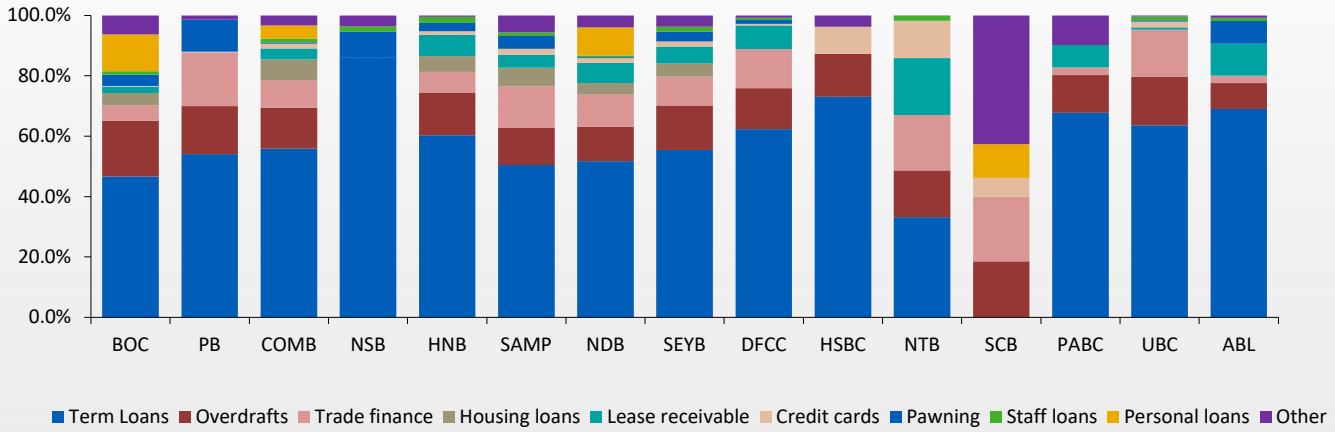
Composition of Gross Loans and Advances

As at June 2020, term loans and overdrafts accounted for 69.0% of total gross loans and advances, with both segments growing by 4.5% and 13.8%, respectively, between end-2019 and end-June 2020.

Furthermore, the banking sector is mainly exposed to the consumption, construction, wholesale and retail trade, and manufacturing sectors, which accounted for 18.4%, 15.6%, 14.2% and 10.6%, respectively, of total loans disbursed in 2019.

Impacted by the COVID-19 pandemic, trade finance (9.8% of gross loans and advances as at end-June 2020) grew by 15.3% between end-2019 and end-June 2020, as the economic slowdown during 2Q2020 resulted in more businesses seeking financing assistance. Meanwhile, pawning facilities (4.3% of gross loans and advances) grew by 4.8%, whilst credit card facilities declined by 3.6% in the period, as the pandemic and lockdown led to a decline in non-essential spending.

Composition of gross loans and advances – as at June 2020



Source: Company Interim Reports

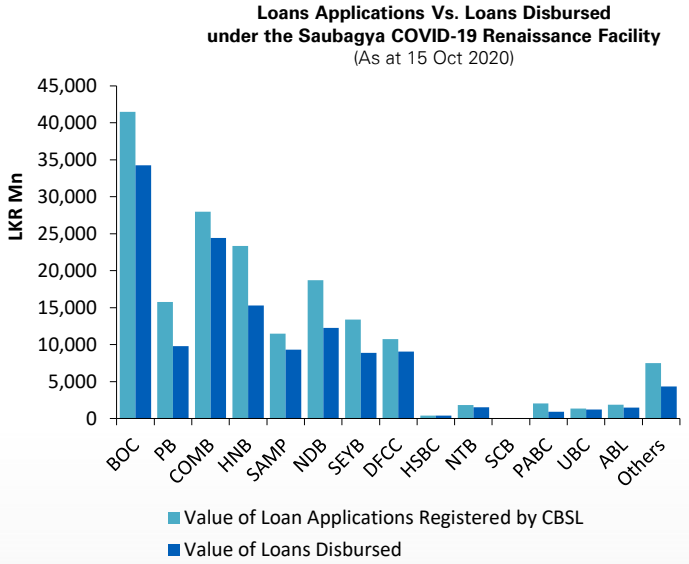
Saubagya' COVID -19 Renaissance Facility, a key component of Sri Lanka's revival plans

CBSL introduced several measures to increase liquidity and facilitate borrowings via reductions in key policy rates and other extraordinary regulatory measures.

A key facility introduced under the title 'Saubagya Covid -19 Renaissance Facility', through which businesses affected by COVID-19 are offered a new refinancing facility for working capital purposes.

Due to high demand, the initial six-month refinancing facility worth LKR 50.0 Bn was increased to LKR 150.0 Bn, with an extended deadline to end September. Due to the significant number of loan applicants the LKR 150 Bn limit was also abandoned.

As at 15th of October 2020, the Saubagya COVID -19 Renaissance Facility had approved LKR 177.9 Bn in total loans, benefitting 61,907 applicants, of which over LKR 133.2 Bn had already been disbursed amongst 45,582 applicants.



In addition, the implementation of the Credit Guarantee and Interest Subsidy Scheme, launched on 1 July 2020, was expected to accelerate lending by banks to businesses severely affected by COVID-19. Under this scheme, banks will receive a 50-80% credit guarantee from CBSL, allowing them to extend loans to vulnerable businesses to address their working capital requirements.

Banks are expected to use their own funds, particularly the additional liquidity of close to Rs. 180 billion provided by the Central Bank through the cumulative reduction in the Statutory Reserve Ratio (SRR) of 300 basis points thus far during the pandemic period, to grant loans at 4 per cent to businesses. CBSL will provide an interest subsidy of 5 per cent to cover the cost of funds of banks.

Further, in August 2020, CBSL lowered the interest rate caps on credit cards, overdrafts and pawning facilities. These initiatives could prove favourable for credit growth in these sectors.

Future outlook on loan growth

A gradual increase in private sector credit is expected towards the latter part of the year as economic activity picks up and business improves. However, with key sectors such as tourism, apparel and consumption yet to fully recover, loan growth is likely to remain subdued in the near future as market volatility and uncertainty surrounding the impact of the pandemic delay investments by individuals and businesses.

CBSL also increased banks' capacity to lend by LKR 400Bn with drawdowns allowed from banks' capital conservation buffers.

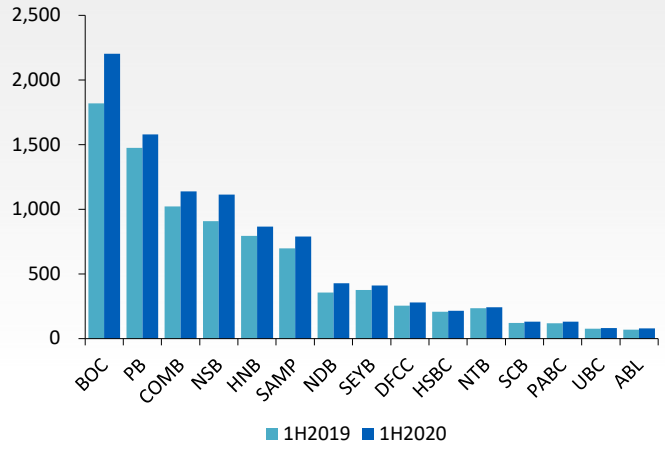
Concessionary measures pushed through the banks at the insistence of the CBSL, as well as deteriorating credit profile of existing customers of some banks', is likely to see such institutions becoming more conservative in their lending behaviour.

Banks vulnerability stems from the industries their clients are in and/or how efficiently these businesses are operated. For example, private sector credit granted to the tourism sector reached LKR 252.6 Bn as at March 2020, up by 31.2% YoY and accounting for 4.1% of all outstanding loans. Banks with a high exposure to this sector, whose riskiness has now increased due to the indefinite postponement of opening of the Bandaranaike International Airport (BIA), would require a review of their business model, perhaps strategizing to further diversify their portfolio.

Source: CBSL

Deposits: CASA ratio increases in 1H2020

Total deposits (LKR Bn)

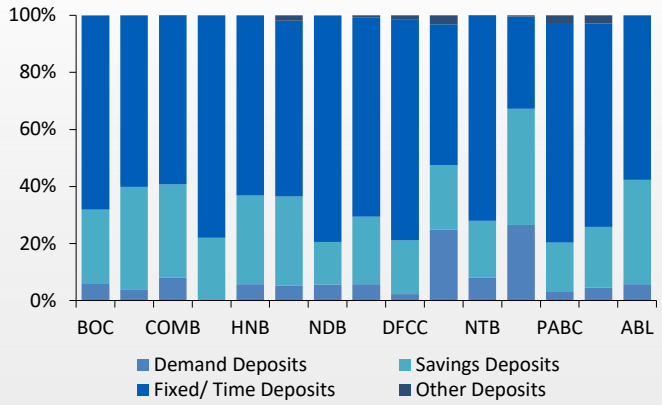


Total deposits grew 13.6% YoY to reach LKR 9.9 Tn as at end-June 2020, with domestic and foreign currency deposits growing 14.0% and 11.2%, respectively. Deposit growth was 8.5% between end-2019 and end-June 2020. Deposits increased to 81.6% of total sector liabilities at end-June 2020, the highest level recorded since 2014, indicating the sector's increased reliance on deposits.

1H2020 deposits grew by 130 bps lower than the five year CAGR of 14.9% during 1H 2014 to 1H2019. Segmentally, deposits at LCBs rose by 12.5% YoY in 1H2020 (vs. five year CAGR of 15.4% during 1H2014 to 1H2019).

However, LSBs saw their deposit portfolio rise to LKR 1.3 Tn, growing 20.3% YoY, (vs. five year CAGR of 11.9% during 1H2014 to 1H2019) due to higher deposit rates on offer, particularly to senior citizens, where one year deposit rates at selected LSBs were 15% vs. 6-8% that offered by LCBs. As a result LSBs' share of total deposits reached a four-year high of 14.1% in 1H2020, up from 13.9% in 2019 and 13.3% in 1H2019.

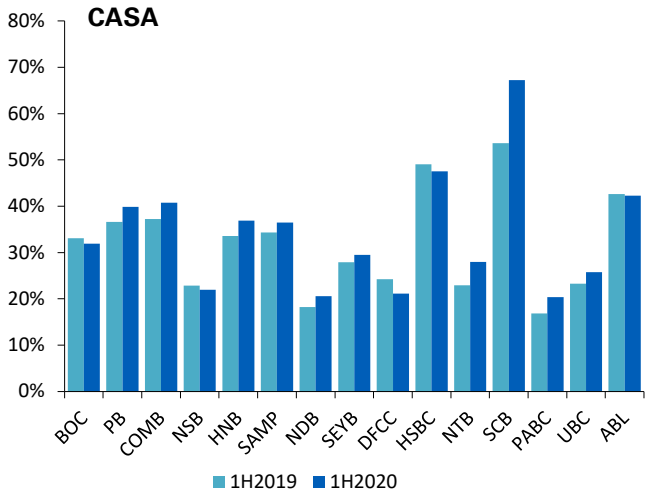
Composition of deposits as at 30 June 2020



Deposit growth may be affected in the near-term due to lower household savings and historically low deposit rates.

Further, low deposit rates may discourage depositors, mainly persons dependent on interest income for household expenditure (e.g. pensioners, low to mid wage workers, workers with pay cuts) from placing their funds with banks and instead consider relatively riskier asset classes such as unit trusts, equities etc., as well as NBFIs. Such movement can already be somewhat seen, with LSBs' deposit base significantly rising during 1H2020.

As at end-June 2020, domestic denominated deposits accounted for 83.9% of total deposits. 21.7% of the sector's funding came in the form of foreign currency at end-June 2020, of which 13.1% was foreign currency deposits and 8.6% was foreign borrowings.



The CASA ratio of the banking sector was 32.4% at end-June 2020, remaining almost the same as 32.5% recorded at end-March 2020, but an increase from 31.3% at end-June 2019 and 31.6% at end-2019.

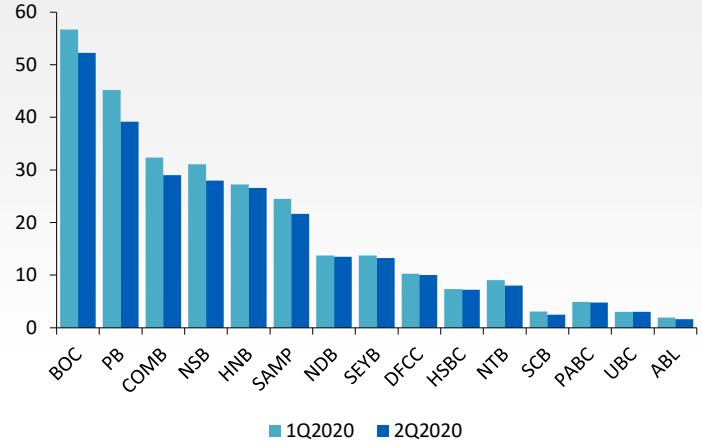
The CASA ratio of the small-caps averaged at 38.9% at end-June 2020, significantly higher from 33.9% recorded at the end-2019 and 34.1% at end-June 2019, increasing the proportion of cheaper source of funding. Meanwhile, the CASA ratio of mid-caps remained consistent at around 32.0% through the 12-month period to June 2020. Large-caps saw a 155 bps increase in the CASA ratio from end-2019.

The increase in the CASA ratio reflects the economic realities of the impact of the pandemic, as retail and corporate clients are likely to have lowered non-essential spending.

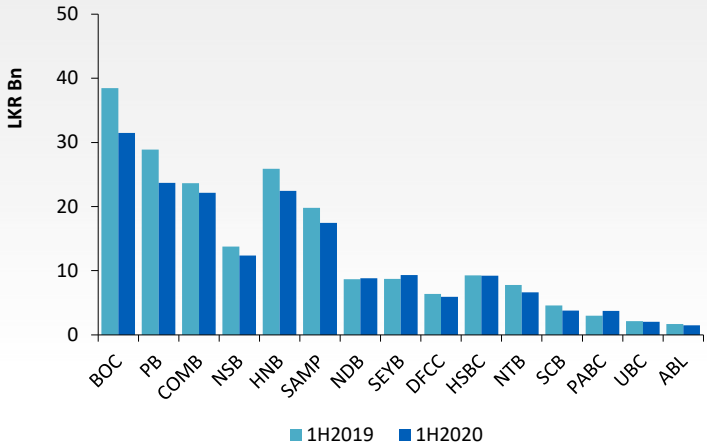
Source: Company Interim Reports

Contracting NIMs

Interest Income



Net interest income



NII for the overall banking sector declined to LKR 203.9 Bn in 1H2020, down 3.3% YoY. The situation was more pronounced in 2Q 2020, which saw NII fall by 6.4% YoY, significantly higher than the 0.2% reduction seen in 1Q 2020. Previously, NII reached LKR 210.9 Bn in 1H 2019 increasing at a five year CAGR of 17.6% during 1H2014 to 1H2019.

The impact on LCBs was significantly greater than LSBs. NII at LCBs declined by 4.4 % YoY in 1H2020 (vs. five year CAGR of 17.9% during 1H2014 to 1H2019), as opposed to LSBs, which experienced a growth of 4.6% YoY (vs. five year CAGR of 15.5% during 1H2014 to 1H2019).

Impact of the moratorium and CBSL policy

The reduction in policy rates, to the lowest levels in history and the impact of the loan moratorium granted to customers have taken their toll on banking sector income.

Interest income showed a marked decline across the LCBs, falling by 3.2% YoY in 1H2020, compared to a 0.2% YoY decrease in 1Q2020.

As per the modification methods under SLFRS 9, the day-one loss arising from the loan moratorium was recorded against the interest income, contributing further to the decline in NII.

The CBSL also announced the extension of moratorium facilities (principal and interest) to the tourism sector, for a further six-months, which will place with further pressure on interest income.

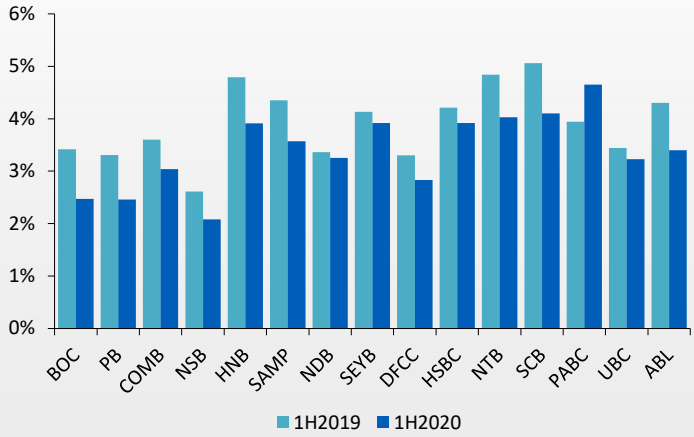
Further, in August 2020, CBSL lowered the caps on credit cards, overdrafts and pawning facilities, with maximum interest rates on these now at 18.0%, 16.0%, and 10.0%, respectively. This is expected to additionally compress the interest income. Despite increasing risk profile of existing customers as well as new customers, these caps mean that banks will not be able to pass on such credit risk of these borrowers through higher interest rates.

The NIM of Sri Lanka's banking sector declined to 3.2% in 2Q2020, compared with 3.4% in 1Q2020 and 3.6% in 2019. This was due to a combination of contracting credit growth, declining interest rates and low yields on surplus liquidity resulting in margin pressure, particularly during 2Q2020.

It is likely that these factors will continue to cause headwinds in the coming months.

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

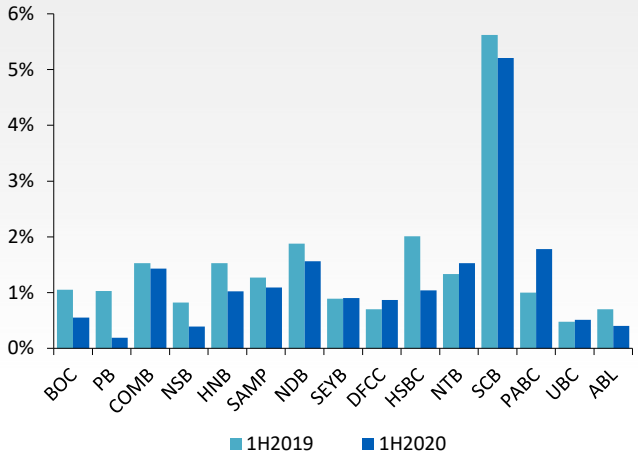
Net interest margin (NIM)



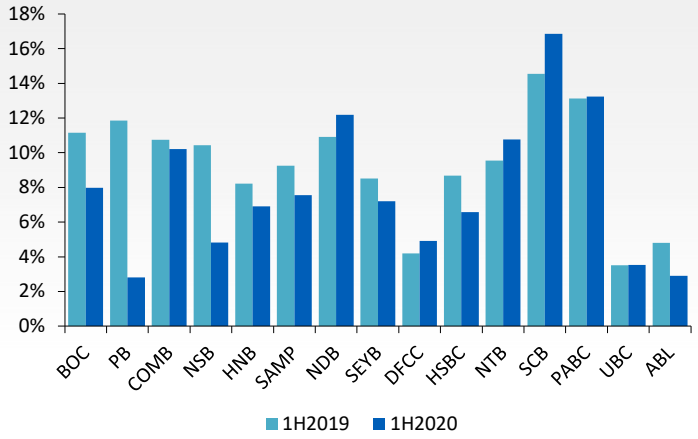
Source: Company Interim Reports

Profitability impacted by slower loan growth and squeezed margins

Return on Assets (ROA)



Return on Equity (ROE)



Banking sector profitability was helped by tax reforms introduced in December 2019, in the form of removal of the debt repayment levy (7%) and nation building tax (2%). Although announcement was made that corporate income tax will be reduced from 28% to 24%. However, the impact is not reflected in the current tax and deferred tax computation during the 1H2020 due to the pending enactment.

Most banks holding Sri Lankan ISBs considered the active market yields as at end February 2020, instead of June 2020 resulting in a lower marked to mark losses in their portfolios. This was due to yields as at June 2020 not reflecting a fair value due to the volatility in the financial markets coupled with significant decrease activity levels, since March 2020.

However, the pandemic curtailed the positive impact, due to weakened asset quality resulting in impairments, slow credit growth and declining NIMs.

At the height of the pandemic in 2Q2020, banking sector profitability is likely to be impacted by an expected increase in impairment costs associated with the application of SLFRS 9.

ROA continued to decline, falling to 1.3% in 2Q2020, from 1.4% in 2019, impacted by decreasing earnings and an increasing asset base. However, ROA held steady compared to 1Q2020.

The sector ROE improved to 10.4% in 2Q2020 from 10.1% in 1Q 2020 and 10.3% in 2019. The increase in earnings was mainly helped by the tax cuts, which were offset by a steady growth in the equity base.

Staff expenses account for about 45% of operating expenditure. The curtailment of banking operations resulting in salary reductions and lay offs, led to declining staff costs of LKR 56.4 Bn in 1H2020, down 3.0% YoY. In prior periods, such expenses had risen at a CAGR of 11.3% during 1H2014 to 1H2019.

The impact of the pandemic on operating expenditure was clearly seen, as it declined to LKR 122.1 Bn in 1H2020, a decline of 6.6% YoY, and a decline of 29.4% QoQ in 2Q2020 due to limited banking operations. This is in contrast to its steady increase at a CAGR of 11.4% during 1H2014 to 1H2019.

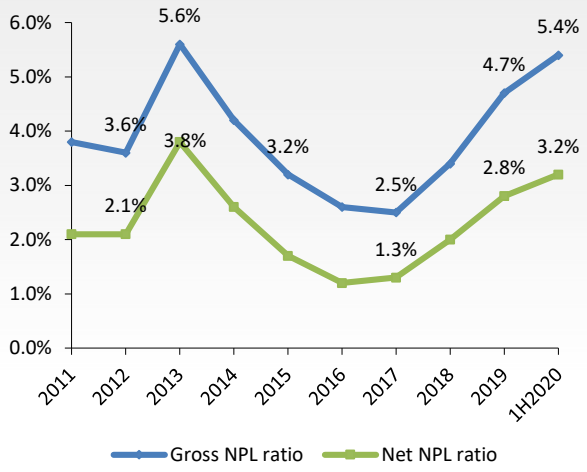
Furthermore external rating agencies such as Moody's have noted that the COVID-19 pandemic will cause an increase in bad loans and reduction in profits of banks in Sri Lanka and India, which will be among the hardest hit in the Asia Pacific region.

DuPont Analysis as of 1H 2020

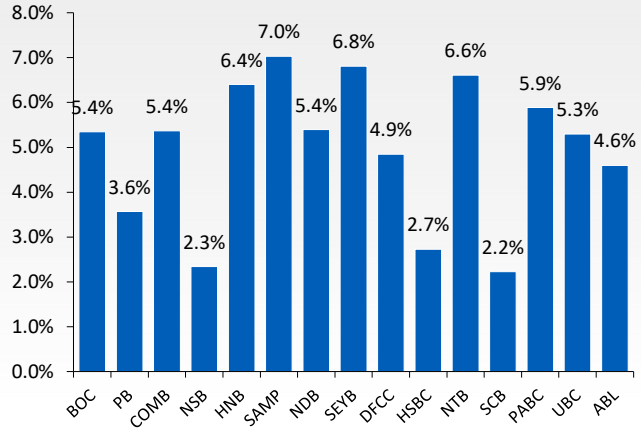
DuPont Analysis as of 1H 2020	BOC	PB	COMB	NSB	HNB	SAMP	NDB	SEYB	DFCC	HSBC	NTB	SCB	PABC	UBC	Amana
(a) Return on Equity (6m)	4.0%	1.4%	5.3%	2.4%	3.6%	3.8%	7.2%	3.6%	3.0%	3.2%	5.1%	8.4%	6.6%	1.9%	1.4%
(b) Return on Assets = Profits/Assets	0.2%	0.1%	0.6%	0.1%	0.4%	0.4%	0.5%	0.3%	0.3%	0.5%	0.5%	1.7%	0.6%	0.3%	0.2%
(d) 1-effective tax rate	64.6%	40.0%	56.5%	30.8%	59.0%	58.1%	59.1%	52.1%	53.0%	82.9%	50.8%	64.4%	50.4%	44.9%	41.9%
(e) Pre ROA	0.4%	0.2%	1.0%	0.3%	0.7%	0.7%	0.9%	0.6%	0.6%	0.6%	1.0%	2.6%	1.1%	0.6%	0.4%
(f) Contribution to Assets	1.0%	0.5%	1.7%	0.5%	1.5%	1.4%	1.5%	1.1%	1.0%	1.2%	1.3%	2.8%	1.6%	0.8%	0.6%
(h) Operating Income to Assets	1.6%	1.5%	2.8%	1.1%	2.4%	2.5%	2.4%	2.4%	1.9%	2.5%	2.8%	3.9%	3.0%	2.4%	2.0%
(j) Net Int Inc to Assets	1.2%	1.2%	1.8%	1.0%	2.0%	1.8%	1.6%	1.8%	1.4%	2.1%	2.0%	2.1%	2.4%	1.6%	1.6%
(k) Non Int Inc to Assets	0.4%	0.3%	1.1%	0.1%	0.5%	0.7%	0.7%	0.6%	0.5%	0.5%	0.8%	1.9%	0.6%	0.8%	0.4%
(i) Cost to Income	39.9%	63.0%	38.6%	57.8%	40.5%	41.7%	36.2%	52.6%	45.9%	52.9%	52.7%	29.6%	47.4%	66.0%	71.1%
(g) Impairment to Assets	0.6%	0.4%	0.7%	0.2%	0.8%	0.8%	0.6%	0.5%	0.4%	0.6%	0.4%	0.2%	0.4%	0.2%	0.1%
(c) Leverage = Assets/Equity	17.59	20.34	9.19	27.17	9.32	9.40	13.26	11.35	8.75	6.61	10.53	5.02	11.49	7.01	7.57
(l) Return on Equity - Annualized	8.0%	2.8%	10.6%	4.8%	7.2%	7.6%	14.4%	7.2%	6.0%	6.5%	10.2%	16.9%	13.1%	3.8%	2.9%

NPLs to increase with challenging economic conditions

Banking sector gross NPL vs net NPL



Gross NPL of Banks - June 2020



Banking sector NPLs continued their upward trajectory, with gross NPL and net NPL reaching 5.4% and 3.2% respectively by end-1H2020, compared to 4.7% and 2.8% at end-2019. Asset quality also worsened on a YoY basis, as gross and net NPLs in 1H2019 were lower at 4.8% and 3.0%, respectively.

The deterioration in asset quality is attributed to difficult operating conditions facing the banking sector coming into 2020, that have only been exacerbated by the onset of COVID-19.

Provisional data of the Sri Lankan banking sector for July 2020 indicated an increase in gross NPLs to 5.5%.

Impact of the moratorium

The full impact of the asset quality deterioration (NPLs) will not be fully realised until the loan moratorium lapses (except for the tourism sector for which moratorium has been further extended) in September 2020, as well as by CBSL's and CA Sri Lanka's flexibility granted in impairment recognition for regulatory and financial reporting.

Moving beyond 2020, should the economy not rebound as expected, asset quality is likely to deteriorate further.

On the stage assessment of the loans subject to moratoriums, most banks considered the loan status as prior to granting of the moratorium unless additional information was available on significant increase in credit risk to follow.

Despite the insufficient information available under the current volatile situation, individual banks took different approaches in order to capture the impact of the pandemic in estimating Expected Credit Losses (ECLs), where most of them, increased weightages assigned for the worst case scenario inbuilt in the collective impairment model and called it management overlay. Also, some banks reassessed Probability of Default (PD) as at June 2020 to estimate ECLs, whilst some did not, as permitted by CA Sri Lanka.

Provision coverage

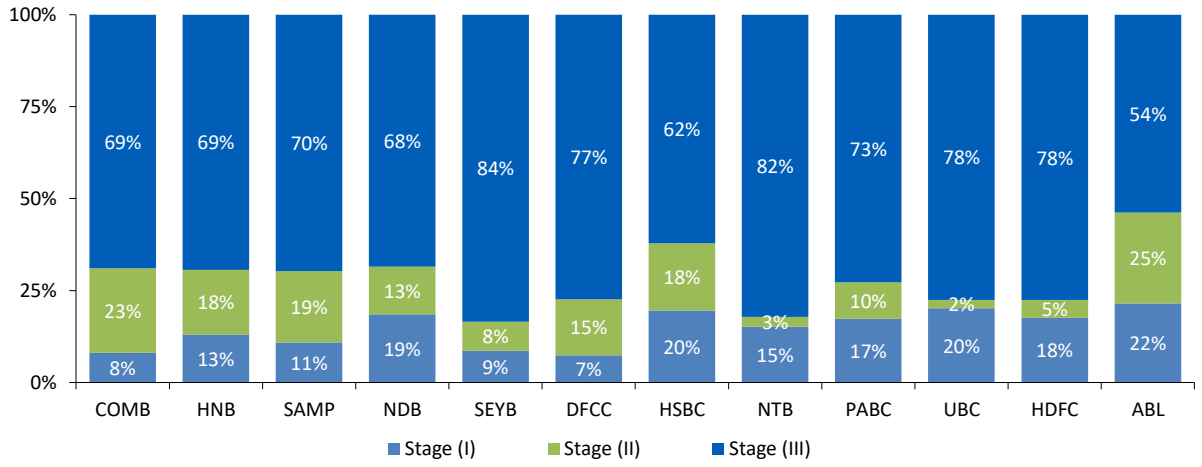
The provision coverage ratio of Sri Lanka's banking sector increased to 53.8% at end-June 2020, compared with 52.3% at end-2019. The expiry of the ongoing loan moratorium across most sectors in September 2020 is likely to see an increase in provisioning, as reclassifications of loans and NPLs are likely to occur.

LCBs' provision coverage ratio rose to 56.4% at end-June 2020, from 50.6% a year earlier, while LSBs provision coverage ratio increased to 34.2% from 32.2% for the same period..

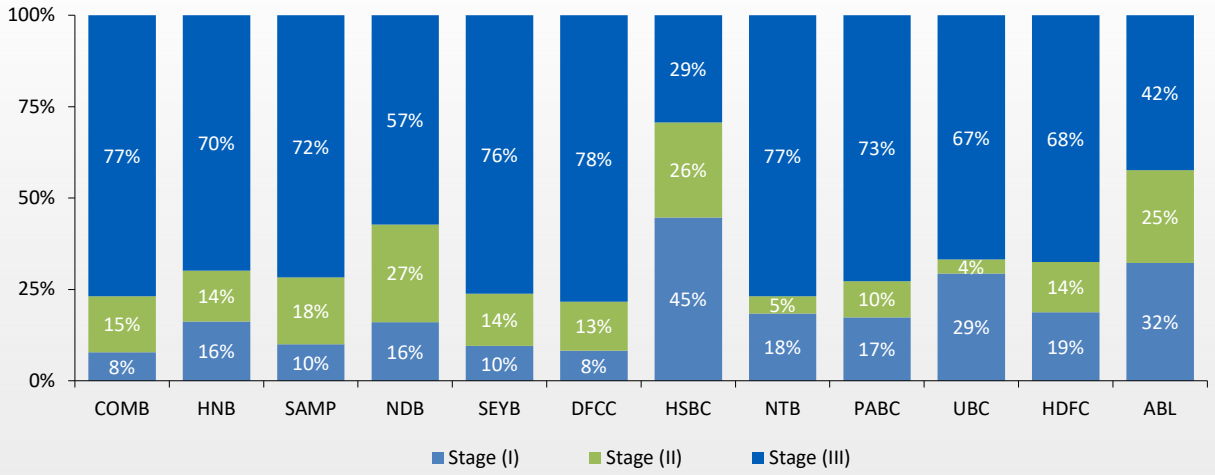
Provision for Bad and Doubtful Debts and Loan Write-offs (net) was a staggering LKR 55.8 Bn in 1H2020, up 83.6% YoY, with LCBs accounting for about 96.0% of this value.

The end of the moratorium will see an increase in delinquencies, and hence we can expect an increase in the Stage II and Stage III impairment during 4Q2020.

Breakdown of Impairment Charge on Gross Loans & Advances (stagewise) - 1H2020



Breakdown of Impairment Charge on Gross Loans & Advances (stagewise) - 1H2019



Source: Company Interim Reports

Capital adequacy and liquidity positions remain stable with CBSL support

Throughout the COVID-19 crisis, the banking sector has maintained a Capital Adequacy Ratio (CAR) above regulatory minimum levels, providing resilience against short-term sector risks.

At end-June 2020, the Tier 1 CAR of the domestic banking sector was 13.1%, while the total CAR for the sector was 16.4%.

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

To increase loan disbursement capacity among LCBs and LSBs, in order to inject liquidity into the economy, the deadline to meet the minimum capital requirement of LKR 20.0 Bn and LKR 7.5 Bn for LCBs and LSBs, respectively was been extended by two years by the CBSL to 31 December 2022. This provides some comfort, particularly to those banks that have not met this criteria, as this would have otherwise proven extremely challenging given the current unfavourable operating conditions within the banking sector.

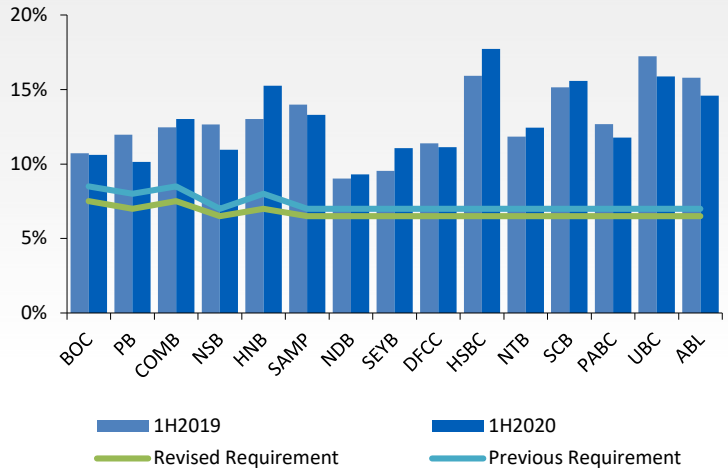
Revised capital adequacy requirements

	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%

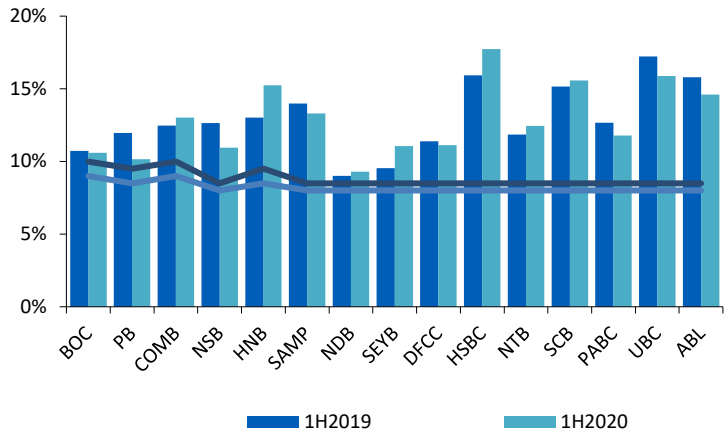
In this regard, D-SIBs and non-D-SIBs were permitted to draw down on their capital conservation buffers by 100bps and 50bps, respectively, allowing for the facilitation of smooth credit flows.

It is likely, however, that banks will face challenges in maintaining these required levels of capital adequacy over the next twelve months, as profitability remains pressured.

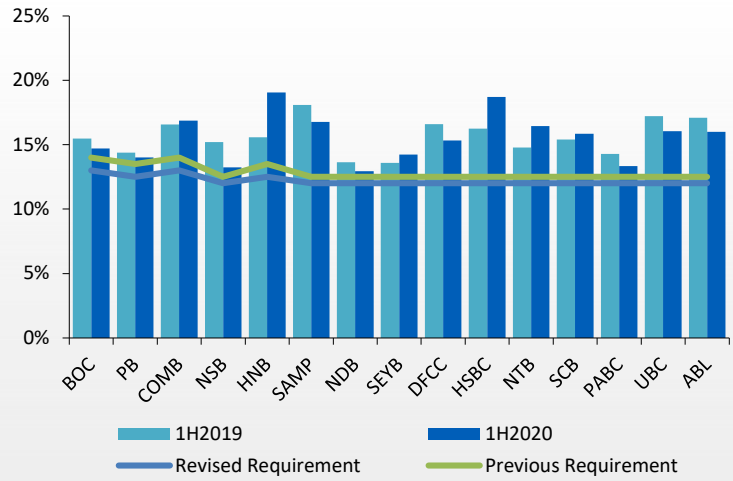
CET 1 Ratio



Tier 1 Capital adequacy ratio



Total Capital adequacy ratio



Source: Company Interim Reports, Moody;s

Liquidity

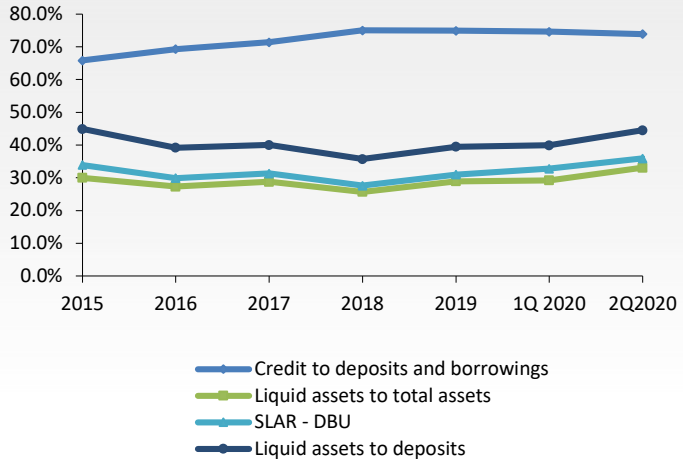
The Statutory Liquid Asset Ratio (SLAR) of the Domestic Banking Unit (DBU) increased by 495 bps from end-2019 to end-June 2020, to reach 35.9% whilst that of the Offshore Banking Unit (OBU) decreased by 604 bps falling to 41.0% in the same period. Both ratios remained comfortably above the regulatory requirement of 20% in LKR and USD for DBU and OBU respectively.

Furthermore, lower credit expansion during 2020 on account of COVID-19, led to a 100 bps decrease in the credit to deposits and borrowings ratio from end-2019 to end-June 2020, thereby increasing liquidity.

Since the outbreak of COVID-19 in March 2020, CBSL has taken a host of measures to ensure sufficient liquidity within the banking sector, including:

- Lowering policy rates
- Reducing the daily reserve requirement to 20% from 90% in April 2020, with the aim of allowing LCBs to comfortably manage their respective overnight liquidity requirements.
- Lowering the SRR in June 2020. This released LKR 115.0 Bn in additional liquidity into the domestic economy.
- Changes in the definition of liquid assets used for the computation of the Statutory Liquid Assets Ratio.
- Reduction in the LCR to a minimum requirement of 90% in May 2020 from 100% previously.

Liquidity ratios of the banking sector

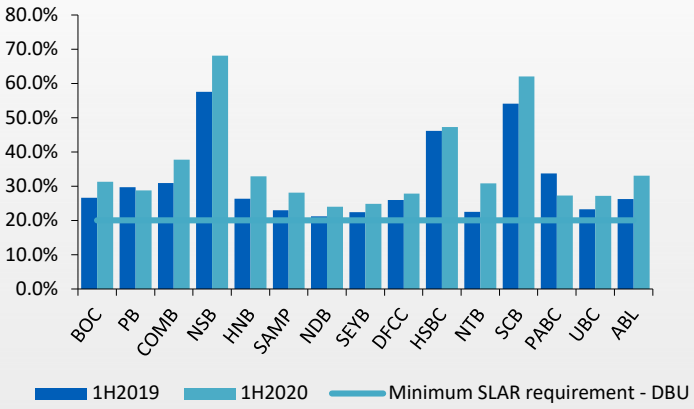


- Lowering the minimum requirement for the Net Stable Funding Ratio to 90% in May 2020 from the previous requirement of 100%.
- Restricted discretionary payments of LCBs in May 2020 until the end of 2020, including declaration of cash dividends, repatriation of profits, etc.

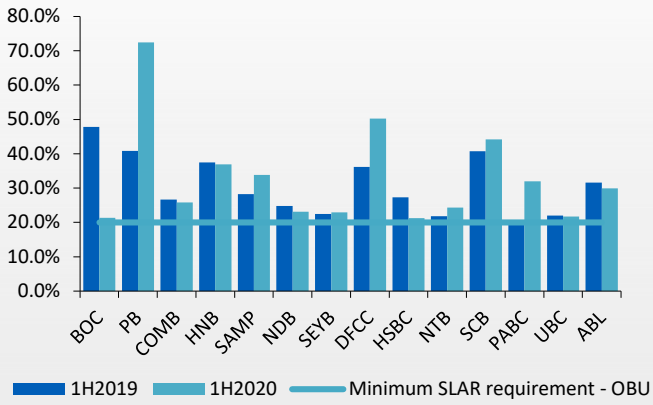
In September 2020, CBSL announced amendments to the Banking Act to facilitate increased shareholding in LCBs and LSBs by Multilateral Financial Organizations (MFO). Accordingly, material interest not exceeding 20% of issued capital carrying voting rights in LCBs and LSBs could be acquired by MFOs, which will need to be reduced to 15% within ten years from the date of stipulation.

To be allowed on a case-by-case basis, we feel this is a positive move, as it will not only inject liquidity into banks, but also help to further improve its operations.

SLAR (DBU)



SLAR (OBU)



Predictions of a new reality for banks

In the new reality of a COVID-19 world, the distribution landscape for banking will look very different.

The pandemic substantially accelerated trends that were already in play – a move away from branch-based banking, with digital becoming the default. Branches that remained open saw greatly reduced traffic and few cash transactions or deposits.

As a result of lockdowns, customer use of digital banking services rocketed: Cash usage plummeted amidst hygiene concerns.
Customers turned to card and contactless payment methods; retail outlets encouraged this as a safer means of transacting.

Branch networks will be slimmed down and undergo significant change

There is an urgent imperative (and opportunity) for banks to reimagine their branch networks. Due principally to declining customer demand, we expect there will be fewer branches in the future, which are also likely to become smaller and more digitally-enabled.

Instead of focusing on serving customers with transactional business, they will become more advisory, assisting customers with more complex products and financial decisions.

Digital channel functionality will develop rapidly and at scale

Customers were already widely embracing digital banking before COVID-19, but the trend will become even more accelerated now. Customers will expect and demand the ability to self-serve or be remotely served (e.g., through an online chatbot or digital assistant) across a bank's entire product range.

Banks will need to accelerate and scale their own infrastructure programs to drive digital functionality, fulfilment and personalization – which will often be in partnerships or joint ventures with agile, innovative fintech players. Banks will need to continue to utilize sophisticated data & analytics information to target the right products and services to individual customers, with the right frequency, through the right media.

Call centers will be re-evaluated and re-purposed

Call centers will also need to be re-thought. With customers more able and willing to self-serve, the call center role, like branches, will potentially shift to become more advisory rather than fielding routine transactional queries and requests. Fuelled by the explosion in popularity of video conferencing during the pandemic, we could see a new breed of financial video advisors.

Meanwhile, there may be a trend to move all or parts of existing offshore service center functions to near-shore locations instead, to ensure greater operational resiliency – which was an issue during COVID-19 in some cases.

Banks will introduce new integrated e-commerce suites to bring more small businesses online

Many small and micro businesses were heavily cash-based prior to COVID-19 – taxi drivers, barbers, tradespeople, some small retailers. There will be an opportunity for banks to redesign and enhance their merchant services offerings – often in partnership with payment service providers – to bring these businesses online. We will see a growth in new, integrated solutions and e-commerce packages.

Cash may stage a partial recovery but is on a terminal decline

How far will cash come back? As societies emerge from lockdowns and people begin to move around more freely again, cash usage is likely to increase, especially as some may have hoarded cash at home when the pandemic began or as a result of retail stores reopening.

However, any rebound is likely to be limited and temporary. Card and contactless payment services have usurped physical currency.

Take action now:

Rapidly assess branch networks and call centers

A small window of time exists now for experimentation and review, before a new normal template begins to appear. Clearly defining the role of branches and contact centers is one of the critical questions facing banking in the new reality.

Accelerate digital infrastructure development

Programs to extend and improve digital delivery – through customer facing digital channels and the associated functionality, core banking platforms, IT systems and the cloud - need to be accelerated and scaled beyond individual products or channels to become enterprise-wide.

Bolster data & analytics capabilities

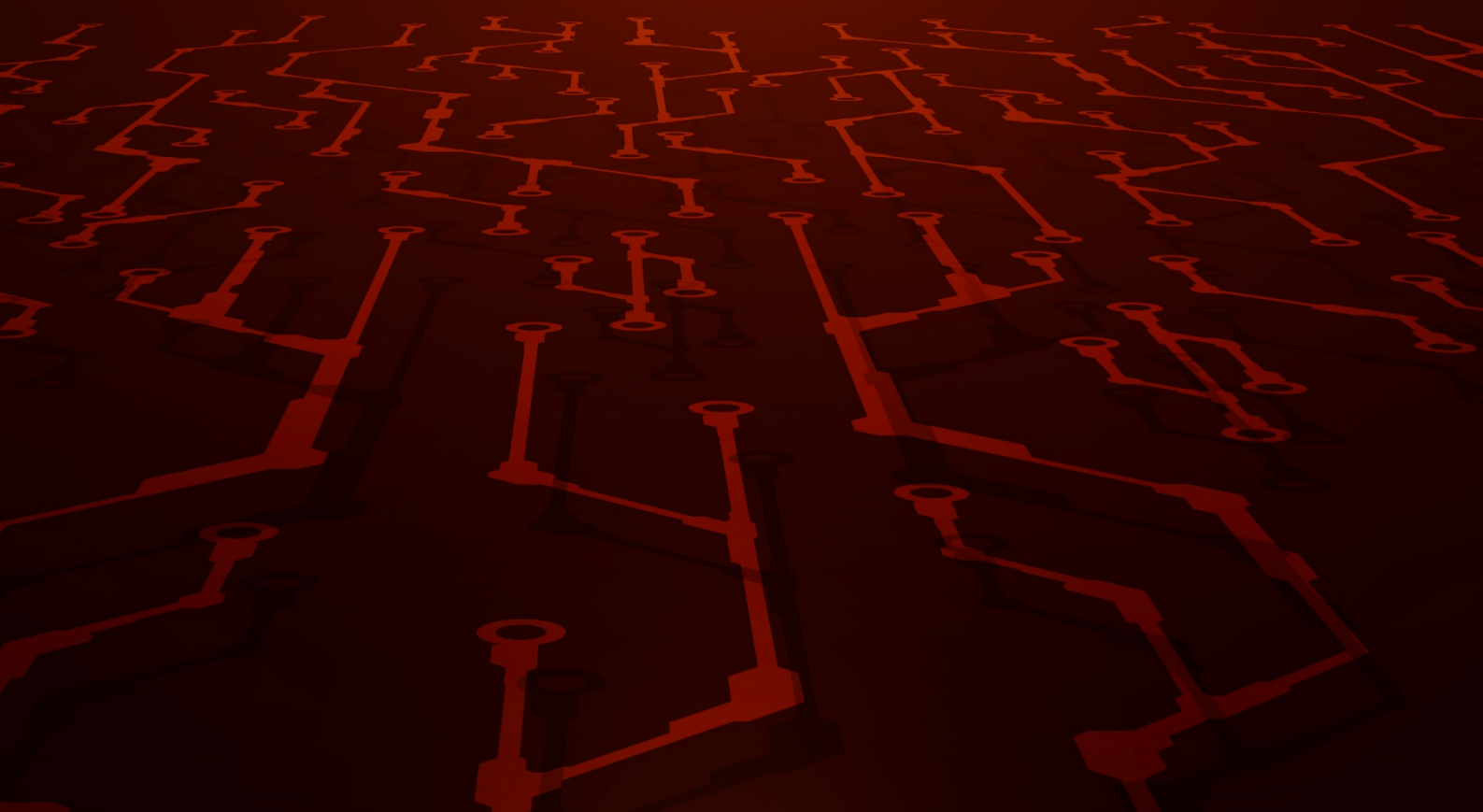
With so much more data in circulation through the 'digital default', it is essential to have the right data & analytics tools in place to leverage the information. Machine learning and AI capabilities will be needed to drive effective personalization and customer engagement.

COVID-19 putting a spotlight on banks' payment operations

COVID-19 has posed huge and sudden challenges to society and businesses, disrupting old ways of living and working.

For financial institutions, key priorities have been to ensure that service and support are maintained for customers in difficult times and that emergency loans and payment holidays are in place for those who need it.
But another priority has been to maintain payment operations. COVID-19 reveals the need for more resilient and agile systems in the future.

After all, an effective payments system is the lifeblood of the financial system itself.



Physical operations pose challenges

The fact is that, while electronic payments happen systemically through various automated payment rails, banks still rely on large co-locations of people to run payment operations. This includes the processing of physical instruments like cheques and cash, and running highly secure wire transfer operations. Across both electronic and physical payments, teams of people are also needed to deal with exception processing and to ensure compliance with critical regulatory requirements such as anti-money laundering and fraud checks or the investigation of payments that may be to or from sanctioned entities or jurisdictions.

The good news is that to date, a great majority of personal and business customers will have noticed no difference to payment processing speed and efficiency due to COVID-19.

Faster and electronic payments have continued unaffected, contactless and mobile payment services have continued to work, and salaries have been credited through payroll processing as normal.

However, the reality is that, behind the scenes, the disruptions created by COVID-19 have spawned some significant issues for payment operations to deal with. Cheque processing is a case in point. While usage of cheques are showing a declining trend they are still widely used.

Processing them promptly - and minimizing the risk of fraudsters trying to intercept or redirect payments - is therefore a matter of great importance.

But, despite all the automation that has been introduced to the origination, printing and distribution of cheques, there inevitably remains a significant manual component accompanied with a higher probability for misuse and fraud.

Teams of people need to work in relatively close confinement to process them. This has to continue with appropriate distancing and hygiene controls introduced.

Wire transfers have been another challenging area. These are key to the flowing of liquidity in the market, with trillions of dollars being transferred daily. The controls in place to process these are necessarily very rigid, taking place in a highly controlled physical environment. Banks responses have varied here, with some being able to move their entire wire operations to a virtual model, while others have simply not been able to.

Remote working requires workarounds

Many banks have therefore continued to physically staff both cheque and wire operations, but on a reduced basis with perhaps 25 percent of the normal workforce on-site at any one time, and with new policies and procedures introduced to balance operational effectiveness with safety requirements. Most have opted for a split team approach, alternating the groups of people that come in.

Organizations have also struggled to adapt to the need to deal with payment exceptions and regulatory controls remotely, with increased cycle times and inefficiencies across operations and customer support.

With staff now working apart and accessing systems through remote desktops or Virtual Private Networks (VPNs), the time-consuming manual activities and virtual handoffs required (i.e. emails between team members, workflow approvals) have led to elongated Service Level Agreements (SLAs) and have challenged traditional governance, control and data protection mechanisms.

The monitoring and tracking of payments against fraud and other financial crimes has also become significantly more difficult and time-consuming.

Regulators have generally taken a sympathetic stance, temporarily lowering some requirements during this first phase of the outbreak response – but have underlined that this can be only a short-term measure.

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New approaches needed for the future

It has become clear that banks need long-term solutions that move aspects of their payment operations onto a stronger and more resilient footing so that they are able to withstand the shocks and emergencies of the future. This may mean new approaches to business continuity planning that cover larger, more frequent and globally simultaneous events. With payment operations frequently running across multiple, ageing legacy systems, it is also likely to mean investing in new technology fit for today's more digital demands; as well as a re-evaluation of the location of servers and data amid the potential for more frequent disruptive events.

It is also likely to lead to the greater automation of operations, together with enhanced digital processes to enable staff to function more effectively in a redistributed workforce model.

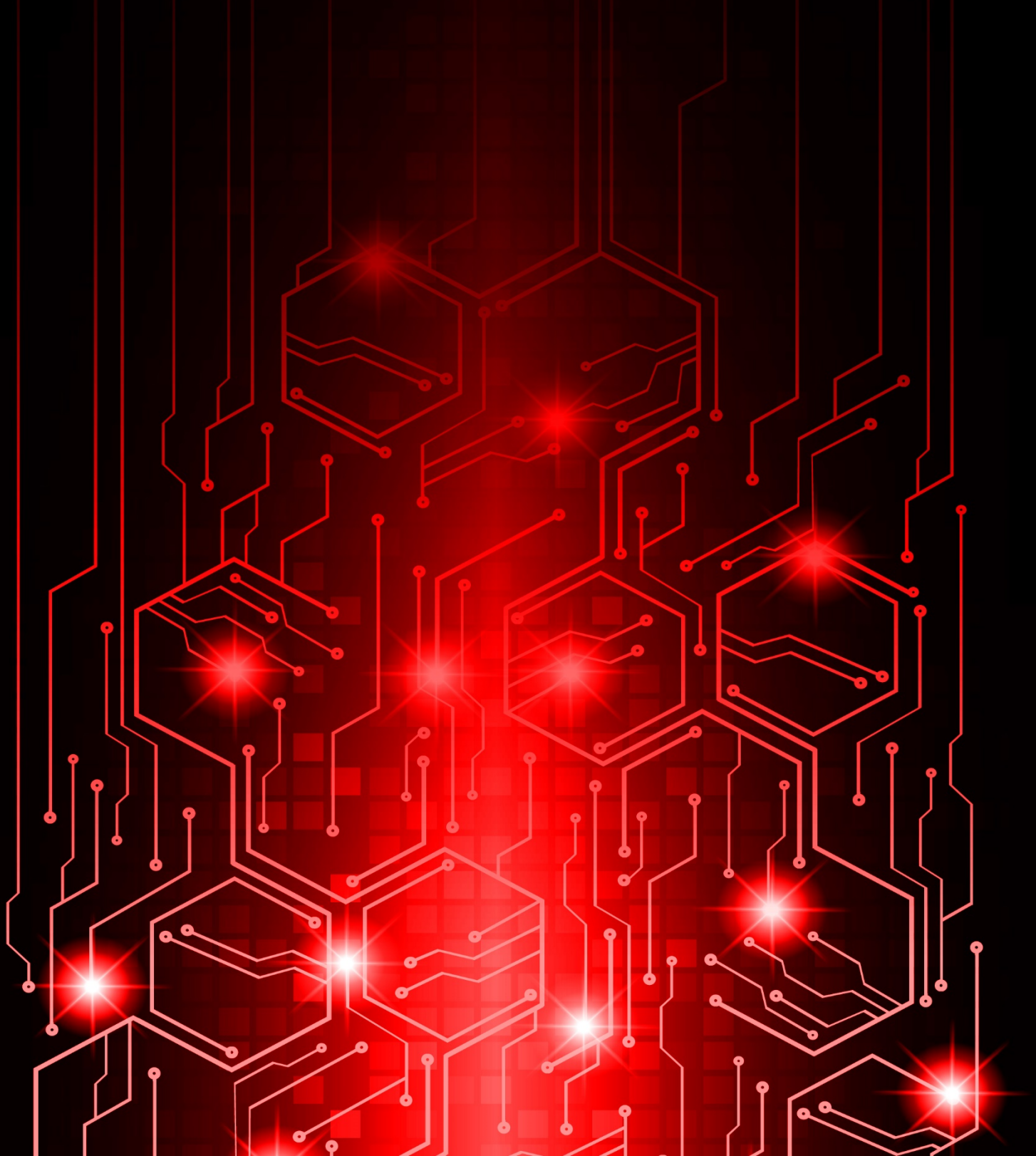
We can also expect to *see* a near term rise in the use of managed services. This had already been growing before COVID-19, both to support customer service functions and, in some cases, to run parts of payment operations. Since the outbreak began, this has increased further and is proving a useful fall-back to support enquiries coming in – exception queries, disputed transactions, claims for refunds, etc.

Overall, given the unprecedented scope and scale of the knock-on effects of COVID-19, banks' payment operations have stood up well. But at the same time, COVID-19 has revealed some clear fault lines that need to be addressed.

It has created an almost unique opportunity to invest in new processes, technology and organizational structures to support more resilient and flexible payment workforces and systems in the future.

Banks balance surge in SME business loans

Banks balance the speed of loan processing with compliance checks.



The COVID-19 pandemic is creating new challenges for societies and economies on an almost unprecedented scale. The knock-on effects of the virus are seemingly endless.

Banks are at the front-line of the economic disruption. Suddenly they are having to deal with issues that simply weren't on the horizon a few months ago. They are being almost overwhelmed with inquiries and applications for support from both personal and corporate customers.

With so many business sectors severely challenged – and in some cases facing a complete suspension of business – the demand for business loans and financing is immense, particularly for Small Medium Enterprises (SMEs).

Our Government similar to other governments around the world, has launched several support packages for small and medium sized businesses, but of course, it falls to the banks to actually administer and originate the loans.

Banks are pulling out the stops to do this, but it is significantly stretching their capacities. They are faced with a difficult balancing act between making credit available quickly, and performing the checks that are needed.

The whole situation is presenting banks with a number of risks that they are having to manage at almost breakneck speed.

Firstly, **there is operational risk**. Any bank whose systems fall over or is perceived to be slow to process applications faces a potential backlash and bad press. But with the number of applications and contacts coming in – not only from corporate customers but from personal customers too – this is no easy matter. There are signs of the strain systems are coming under, with some application portals advising customers to try again later, while call center waits are far beyond normal service times.

This operational risk leads into the **Second area of reputational risk**. At a time of such pressure, customers will likely remember how they were treated. Those who receive fast service and effective turnarounds are likely to feel a deeper loyalty and positivity about their bank. But for those customers that experience frustration and delay it will be the reverse. How banks manage now, and how well their systems stand up, could have long-term implications for future customer relations.

However, processing the loan applications is not simply a matter of administration. There is the **Third area, the regulatory and compliance risk** that needs to be managed too. Banks are required to gather certain documentation and validate it. If they don't do this appropriately, then they could be exposing themselves to liability risk. In most cases, the businesses coming to them will be existing customers so the KYC (know your customer) checks should already have been carried out.

But banks need to refresh these checks every few years, depending on the risk category of a customer. For some customers, there is a risk of relying on KYC checks that haven't been refreshed. Due diligence can't be sacrificed for the sake of speed. It's a challenging proposition.

The fourth risk relates to forbearance, and is tied up with the regulatory risk. Government may guarantee only some loans made to small businesses, leaving the banks exposed for the rest. Banks, therefore, need to assess the potential credit risk and loss implications when granting loans to risk elevated sectors in the current context .

Right now, banks are completely focused on the origination of loans and managing the volumes of requests coming at them. But if they don't handle the process appropriately, we could see forbearance and liability issues surfacing further down the line.

It is a challenging time. Banks have never had to deal with anything quite like this before. Their value to the functioning of the economy has probably never been clearer. But the stakes have never been higher either. Getting it right while meeting the short term financial needs of the SMEs is everything.

Banks overcome pressing cost challenges to be fit for the future

As cost pressures mount due to COVID-19, clear governance around cost management, transformation execution and decision making is essential for banks.

As we are trying to emerge from the worst of the COVID-19 pandemic while the magnitude of wave 2 looming large in the horizon, banks are confronted by a landscape that looks and feels very different from before. There is a real risk of global or national recessions, even depression and an ultra-low interest rate environment means that net interest margins are wafer thin.

In short, banks' top line revenue is looking challenged. This makes it more imperative than ever to bring costs down.

COVID-19 drives costs up

The changed dynamics that COVID-19 has dramatically ushered in will unfortunately, drive banks' cost bases up rather than down.

Our analysis indicates an appreciable uplift for the average retail/commercial bank in the short run by the myriad effects of COVID-19 on security, usage patterns and other factors.

The factors behind this increase include: a likely higher level of arrears and collections requiring additional staff; increased on-shoring and multi-sourcing of suppliers to bolster operational resilience; lower staff productivity through reduced demand for traditional accounts and products; higher insurance and telecoms costs with more staff working from home; and higher fraud costs.

If banks are fleet of foot, they may be able to offset some of these increases through savings from lower product demand, reduced property running costs, increased digitization and automation, reduced paper costs, and lower cash and ATM usage.

But these savings may not be sufficient to cover the cost increases elsewhere – there will still be a net increase for many.

The combination of this rise with the sickly look of the income side could make for a painful double whammy that will simply have to be addressed.

The search for double digit savings

We expect most banks to be looking for double digit cost improvements as a minimum. For some non-traditional newer banks, the goal may be even more ambitious: to become 'digital only' and slash cost bases by a third or more – a complete re-engineering.

Significant strides had already been made by many financial institutions with cost optimization before COVID-19 – but the pandemic has now shifted the game and significantly raised the requirement.

Nevertheless, the pandemic has shifted some factors in a positive direction – *the customer migration to digital, lower branch usage, lower cash handling.* These gains must be retained, locked in, and then the window of opportunity used to push further. The resilience, agility and digital transformation adopted through the initial COVID-19 response must be harnessed to achieve sustainable cost optimization and reinvent operating models.

Everything on the table

This means that everything should be on the table. Property, people, technology, external services – all will come under review.

Corporate real estate will likely be downsized, branch networks trimmed. Workforce sizes are likely to move on a downward trend, while people roles will shift and become ever more focused on adding value to the customer experience.

The technology agenda will assume massive importance – with more digitized customer journeys and greater levels of self-service.

But for all the unprecedented nature of COVID-19, in many senses banks have been here before.

They already spend a significant amount of their cost base on transformation and change delivery and there will have been numerous cost optimization programs at almost every bank in the past.

There will be a shift in priority from '*cost' to 'cost plus resilience*'.

Ingredients for success

So what can make the difference this time? How can banks make transformation stick? KPMG firms' experience indicates that these initiatives often fail because there is too much management 'fog' to allow ruthless cost management. Without rigorous clarity and simplicity, many banks have ambitious executives each re-interpreting the overall vision into their own individual implementation strategies.

Our message is therefore to focus **firstly on clarity**. Clear governance, accountability and transparency around cost management, transformation execution and decision making is essential.

There is often a significant difference in cost reduction results between banks with real clarity and cost management discipline and those without it.

Instill this clarity and book the quick wins it brings. Then move on to matters of 'design' (business model, operating model) and 'engineering' (core systems, digital, cloud).

It requires stamina – sustainable cost re-engineering cannot happen overnight. It also requires strong leadership direction to drive and embed a culture of cost consciousness across the bank.

The path ahead looks challenging for much of the financial sector. But those institutions that truly grasp the opportunity can reinvent themselves for the new reality and become the banks of tomorrow.

A new operating model

Every business which intends on meeting the connected customer on equal terms will have to find its own way to reconfigure their marketing, sales, and services functions into an effective whole.

Specially amidst an unprecedented time such as this, banks certainly have their hands full in light of the novel coronavirus outbreak and need to have a plan in place to protect employees and customers from the spread.

Being the apex financial institution of the country, the Central Bank of Sri Lanka (CBSL) took a series of measures to help banks including reducing reserve ratios to improve liquidity of banks.

The reductions in regulatory ratios and guidelines relating to moratorium loans provided by the regulator have reduced the burden carried by commercial banks during this time of uncertainty to some extent, thereby providing the freedom for banks to focus on a new, dynamic operating model.

While solutions reflect organization-specific attributes, industry and markets; we believe six common capabilities will power every effective front office of the future.

All six are informed by "**systems thinking,**" which embraces a multi - disciplinary approach to customer-centricity and pays attention to interdependencies during periods of major change.

Data

Customer data is the most valuable asset any front office owns. Leaders understand today's data innovation is tomorrow's table stakes, and are willing to continually invest in new data technology and data skills. Ethically informed data governance will define what data has value, how it will be captured, how its quality will be assured, and how privacy will be protected.

Banks having completed their SLFRS 09 transition, its requirements in terms of classifications, measurement, ECL calculation, impairment calculations and reporting, were expected to make changes to the way they do business with high consideration to data management.

To manage the end to end process of SLFRS 09, banks invested in data management and centralized data effectively from numerous resources. Effectively addressing this will enable banks to make forward – looking strategic decisions and help in understanding the evolving nature of risk in the banking business in the post COVID 19 uncertain environment.

Automation

Automated internal and customer-facing tasks will allow banks to resource for improved effectiveness, efficiency and cost-savings.

The streamlined workflows supported by end-to-end automation free up their human resources to attend to higher-value activity – including the ideation and implementation of new ways to communicate with and serve customers.

Analytics

New forms of advanced analytics such as AI, machine learning, and neural networks bring great value and raise two important clusters of questions. The **first covers the right matching of specific analytic capabilities** — the spectrum from 'artificial intelligence' to 'augmented intelligence' to 'human intelligence' – to the customer-engagement task at hand.

The second is ethical: with the growing power of advanced analytics applications comes increased responsibility.

Moreover with the increasing of the usage of online banking platforms and continued interaction with the online world, it is paramount for banks to capture and analyze behaviors and trends of the digital consumer in order to improve customer experience as well as the perception of the bank.

Metrics

All digitally integrated front offices require a shared set of performance metrics to maintain co-ownership and alignment. Some traditional metrics – based on internal priorities – will need to be retired. New metric frameworks will emerge, including balanced scorecards which embed customer-centric priorities such as developing and maintaining customer trust, effective partnership management and innovation agility. COVID 19 has abruptly changed how banks perform their activities with rapid shift to remote working, increased online transactions, changes in policies and interest rates. With that, banks have an immediate call to action to drive digitization to gain post COVID-19 competitive advantage and this allows banks to make greater use of technology to obtain new data to create relevant and advance performance metrics.

Organization structure

Technology and process change bring implicit challenges to behaviour and culture with them. Leaders will be willing to put aside functional definitions that no longer apply or that hinder strategic growth opportunities. That in turn may require the rethinking of existing reporting lines, recruiting, professional development and incentives. Entirely new roles will emerge in some businesses, such as Chief Customer Data Officer, AI Specialist, Analytics Lead, Data Ethics Lead

Culture

Technology and processes are as strong as the people who use them. If new customer-centric operating models are only to successfully "take hold," organizations will need to pay close attention to the behavioural drivers of technology and process adoption.

Leaders will invest in a mix of hard and soft skills training – not only data literacy and technology mastery, but also emotional competencies that help all front office professionals think like their customers.

Organizations will need to cultivate a culture of customer "empathy." The outbreak of COVID 19 has forced the adoption of new ways of working, thus banks must reimagine the way they work and the role of the offices in creating productive and safe working environment.

Further this has witnessed an increased necessity for agile business culture that quickly pivot to meet the needs of employees and customers in order to deliver business as usual.

The traditional customer is slowly but surely transforming into a modern customer and the pandemic is the clear catalyst of this change. The increasing amount of digital customers would make banks re-think of the branches spread across the island. Banks will have to make decisions on under utilized branches.

Fraudsters never waste a good crisis

Naturally, we focus on the downsides of COVID-19, but for some there has been an upside.

How does Supplier payments fraud work ?

How does supplier payments fraud work?

Essentially, the fraudster's objective is to reroute a due payment to another bank account. Such fraud may originate externally by a deceitful individual or business, or it may be committed by an employee within the victim organization. The preferred method used by external fraudsters is fake emails and social engineering to impersonate a supplier.

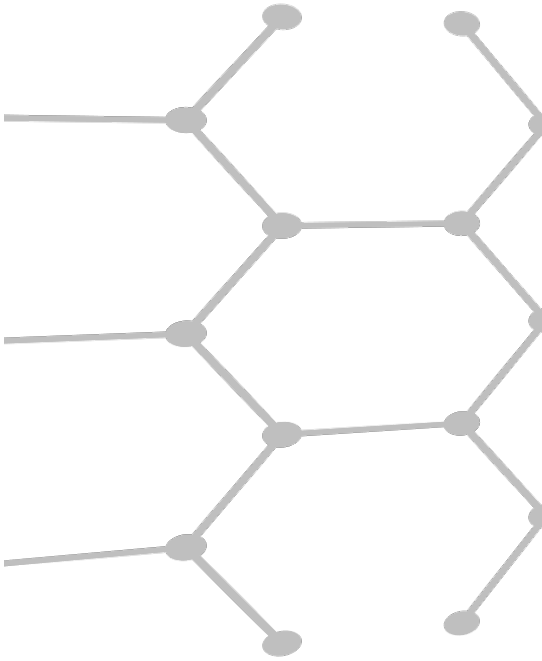
Hacks into email accounts to intercept and modify invoices, as well stealing user credentials to impersonate employees, are increasingly popular. While requiring a more competent attacker, we've also seen specialized malware targeting Enterprise Resource Planning systems. Meanwhile, malicious insiders might abuse their access to commit fraud, and their familiarity with the environment to bypass controls and cover their tracks.

A recent cybercrime investigation by a KPMG member firm found a fake business email asking the company to remit payment to a different supplier bank account. On receiving the email, the company did not suspect the request to be unusual, despite the bank account being in a foreign country, with the request in an uncharacteristic writing style from an incorrect sender email domain.

In this case the company did not call the supplier to verify the change in details. Perhaps most interesting was the method used to perpetrate the fraud.

The fraudster first hacked into the email account of the customer's procurement associate. While intercepting an incoming legitimate invoice, the attackers were able to modify and resend the falsified invoice, asking to change the bank account details.

The result: hundreds of thousands paid to the fraudster. In another high profile case, an international corporation was defrauded using a spoofed voice mail generated by DeepFake AI, as a follow up reminder to a spoofed email allegedly from that same person.The result: a multimillion loss sustained through a single transaction.



Why does it work?

Analyzing numerous cases, key patterns become clear:

Humans do not always follow procedures: Be it lack of awareness, knowledge or discipline, the sad fact is employees do not always act according to the defined manual controls.

Tech-powered attacks bypass manual controls: Cyber attacks where accounts or systems are hacked can circumvent manual controls.

A hyper-connected, fast-paced workplace that stresses our attention span is fertile soil for well-crafted social engineering attacks.

Organizational silos create gaps: Procurement and finance teams as business process owners, accountable for payments fraud prevention, may be well aware of the problem but lack the technical knowledge of how such cybercrime attacks might materialize.

IT Security professionals, on the other hand, possess the technical understanding yet focus on generic infrastructure defense rather than on specific business processes. Fraudsters exploit this disconnect, attacking business processes with technical means.

How has COVID-19 affected supplier payment fraud controls?

The rapidly changed work environment, forced by COVID-19, has amplified opportunities, allowing supplier payments fraud to be on the rise:

Social distancing means remote, virtual and digital interactions with suppliers and colleagues. Coupled with the accelerated switch to electronic, faster payments, this increases the risk of human misjudgment and rushed approvals, resulting in undetected fraud.

Changes in supply chain which are driven by changing needs, struggling suppliers, or cost containment measures overload procurement and finance teams, limiting time and attention they can apply to suppliers due diligence.

Heightened insider fraud risk at times where personal or financial stress due to restructuring, pay cuts, suspended bonuses or forced unpaid leave can lead to a heightened rationalization to commit fraud, while relaxed controls present a tempting opportunity.

The gap between business and IT security just got wider, with companies' IT focused on enabling work from home, while business teams struggle to adapt to modified business processes.

Fraud attempts have increased in double- and triple-digit percentage, exploiting times of personal stress and interest in content related to the pandemic to deploy tailored phishing and malware attacks.

At the same time, **attacks hit rates** are on the rise, for example click rate by non-suspecting victims five times its level before the virus outbreak.

What can you do?

Assess and test your existing controls from the attacker's point of view. Threat modeling and simulated fraud testing will help you understand your true controls effectiveness (or lack thereof).

Apply automated business process controls to reduce manual intervention, ensure controls coverage and increase confidence in the controls effectiveness. Validation of supplier bank account details would be a great first step, applying new and automated approaches or auto-triggered managed services.

Avoid a single point of failure. Take a defense-in-depth approach, mitigating different fraud methods at multiple points along business processes.

For example, automated checks embedded in supplier onboarding or change process are effective against external attacker, social engineering and impersonation; while checking every payment during a payment run addresses malicious insiders or malware attacks that modify banking details for existing suppliers.

The time is now

Financial resilience and cash flow have always been important, more so in times of macro and micro economic stress. Focusing on fraud risk mitigation during the COVID 19.

Key cyber risks for banks during COVID-19

Cyber and anti-fraud controls are paramount for banks during COVID-19 and beyond.

It's an unfortunate fact that fraudsters tend to prey on unexpected events or challenges. When normality becomes disrupted, they see an opportunity they can exploit.

It shouldn't be a surprise, therefore, that the COVID-19 pandemic has brought with it a significant increase in fraudulent activity.

For many people, life has become suddenly very different and unusual, making them potentially more susceptible: working from home instead of the office, juggling childcare, worrying about finances and the future.

Businesses too are facing some significant worries over cash flow and revenues, with companies applying for emergency loans or government-backed support.

All these make personal and corporate banking customers a natural target for fraudsters. Banking clients have told us that there has been a significant rise in the number of 'phishing' emails connected to COVID-19 being sent to customers – emails which look as if they sent from the bank offering financial support in the wake of the pandemic. However, these are actually a way of asking customers to provide or validate their account or identity information.

Other emails may contain malware that downloads onto a customer's system once a link is clicked.

There has also been an increase in call center fraud. Fraudsters may engage in what we call social engineering – posting innocent looking 'fun' questions on social media platforms such as 'what was the name of your first pet?' in order to gather information from individuals that they can use to impersonate them with their bank or to make a false insurance claim.

These ploys are nothing new, but the volume of such attempts has certainly spiked. Banks are proactively working to raise awareness amongst customers and providing guidance on the basics of good security. Some are taking enterprising approaches – for example, replacing on-hold music at call centers with recorded tips and advice on staying safe.

The staff remote connection challenge

However, it's not only customers that banks are having to work hard to protect: there is an increased risk with staff as well. It is perhaps one of the unintended consequences of the mass migration to working from home that fraudsters have been handed a new and very tempting field of play. Employees could be more vulnerable to phishing emails and other scams.

The threat is what we call the 'hostile home network': in a household, multiple family members could be logging in on the same network and clicking on links and content of many different kinds, potentially exposing devices to malware that could then enter the bank's enterprise if the right endpoint controls are not in place.

There has also been a huge rise in the use of video conferencing facilities. But some of these have been shown to have sub-optimal security standards, with suspected instances of uninvited parties eavesdropping or even hijacking the conversations.

Banks of course have sophisticated and established connectivity and IT systems and already enable many staff to work remotely when needed

But the huge jump in the number of staff at all levels of the bank needing remote access has created an initial challenge even for them.
Some staff may have lacked the hardware or software needed to access the bank's Virtual Private Network (VPN), leading to IT teams loosening some controls in the short term.

What COVID-19 has created is effectively a huge monitoring challenge. Banks (and indeed all businesses) need to ensure that remote users are who they say they are, and that their behavior is consistent with what would be expected. This is difficult when users may be logging in not only from bank issued laptops but also their personal phones, tablets and other devices. Usual Bring Your Own Device (BYOD) protocols that allow remote access only from one device may need to have been relaxed.

In addition, staff are most likely not following their usual work patterns (logging on at 9am, logging out at 5pm) but may be working in bursts across different hours due to child care and other duties. So, how do monitoring systems spot 'unusual' patterns of activity and flag it for further investigation?

Priorities for the future

Looking forward, we see two key trends arising out of this experience. **Firstly**, with levels of remote working likely to remain higher than they were pre-COVID-19, banks may need to 'reset' some of their protocols and policies around access management, finding ways to increase flexibility without compromising security.

They are also likely to look for more secure video conferencing services.

Secondly, we anticipate an increase in banks moving parts of their IT operations to cloud environments. For this move to happen, cloud operators will need to meet the very specific and stringent extra security requirements that banks are likely to have.

But we expect the will to be there on both sides to make it work. It may be phased and gradual, but is likely to be a trend over the coming years.

Alongside all the other pressing issues of supporting customers and providing liquidity, cyber security will remain a top priority for banks for the future.

A new risk management playbook for banks

Five predictions as banks re-evaluate their resiliency across all aspects of risk in the new reality.

As we deal with the near- and long-term effects of the pandemic, banks will need to re-evaluate their resiliency across all aspects of risk.

Our observations during Covid-19

The increased capital and liquidity buffers that banks hold due to regulatory requirements in the wake of the global financial crisis stood them in good stead – even if, inevitably, liquidity and market risk management were highly challenging during the peak of COVID-19 related volatility. Many corporate clients drew heavily on their existing revolving credit facilities to bolster their cash and liquidity positions as the crisis began.

On the credit risk side, banks needed to take immediate action to manage their balance sheet risks in an extremely dynamic and fluid situation. This meant reducing the size of the 'credit box' by ceasing certain types of lending and rapidly assessing portfolio risks. Banks also moved quickly to introduce forbearance measures for customers. There is also a significant operational task in administering moratorium and government-backed loans

Risk functions came under extreme pressure from the reporting requirements both internally to boards and externally to regulators, a situation exacerbated by models which simply could not compute the extreme and unprecedented unknowns and variables caused by COVID-19.

Predictions of the new reality for banks

Banks' risk models will need to be continuously reviewed and recalibrated, while credit portfolios will need to be dynamically managed

The effects of COVID-19 were so rapid, wide ranging and interconnected that banks' liquidity, market and credit risk models could not adequately reflect them.

Unemployment, for example, shot up massively almost overnight in many countries and jurisdictions when in a 'normal' recessionary period it climbs slowly over a longer period.

Assumptions behind models therefore had to be rapidly reviewed. In many cases, banks had to make 'free style' assessments of their credit portfolios and apply qualitative judgments alongside their model outputs – and this will need to continue while fixes are built from the learnings of the crisis.

Credit portfolios, which had to be re-weighted away from challenged sectors such as airlines, leisure and corporate real estate, will continue to dynamically evolve in the aftermath of the pandemic.

Lending criteria in personal markets are likely to become more stringent.

However, opportunities could also arise as changes to consumer behavior create new types of credit demand.

Data availability and quality will need to be improved across the risk function and with related functions such as finance

Many risk functions across banks struggled to access sufficiently up to date and granular data in order to report 'in the moment' to the board and regulators.

Significant amounts of data are still held in disparate databases, and information is not always consistent or comparable. Enhanced efforts will be needed to improve data availability and accessibility across the enterprise. Reporting must also become more sophisticated, moving away from static slide decks or spreadsheets to enable real-time sharing, discussion and feedback.

Data availability and quality will need to be improved across the risk function and with related functions such as finance

Many risk functions across banks struggled to access sufficiently up to date and granular data in order to report 'in the moment' to the board and regulators.

Advanced data & analytics and AI will hold the keys to value

Advanced data analytical capabilities will be critical, including cloud-based AI and predictive modeling techniques combining internal with external data to give a truly robust view. One of the key learnings from COVID-19 is that internal data alone is not sufficient. To provide real value, data must connect to inputs from outside the bank.

Aspects of operational risk will remain under the microscope, and robust cyber security will be critical

Banks successfully maintained operations through the height of the COVID-19 pandemic, but some fault lines appeared. The template for offshore service center usage will come under review. Some IT systems struggled to handle a huge increase in traffic as operations (and customer transactions) moved to digital, and will need to be upgraded if a truly end-to-end environment is to be a reality. More systems may be moved to the cloud, while use of 'low code' systems that can easily and quickly be built on top of existing infrastructure will also proliferate.

In a more digital environment, maintaining and continually updating cyber defenses will be a pre-requisite.

Banks will also need to ensure that they have robust mechanisms in place for monitoring compliance and adapt their internal control mechanisms for a significant portion of their workforce working remotely. This remote environment is particularly challenging for trading environments and trader surveillance.

In a tough economic, trading and lending environment, growth and acquisition opportunities may present themselves to those banks with the strongest risk management regimes

With the world entering a likely recessionary period, levels of credit default are sure to continue to rise at the same time as bank profitability will be challenged. Some banks can be expected to be hit by loan losses and markdowns, reducing their market capitalizations. This may present acquisition opportunities for those banks with strong risk management who preserve capital and liquidity for strategic plays.

Take action now:

Invest in technology and data

Better data availability and quality, enhanced analytical capabilities informed by AI and machine learning, and faster reporting – these must be the hallmarks of a risk function of the future.

Credit risk management must be at the forefront.

In a potentially worsening economic environment, credit portfolios must be actively managed on a disaggregated basis.

Banks must be able to understand where not only business sectors but individual corporate clients and personal customers are in their own post-COVID-19 journeys, what their cash flow and recovery projections are, and the risks they represent. Risk functions must be integrally connected with the operational and sales sides of the bank.

New models for operational risk and resiliency to cope with the unexpected

Banks proved their resiliency through the height of COVID-19 – and must be able to cope with whatever the future brings. With further lockdowns on a local or even national level very much a possibility, operations must be able to flex between physical and virtual footprints or a hybrid of the two. In a more digital world, cyber security and the protection of customer data will become more important than ever key issues on which a bank's reputation could depend.

Keep attuned to opportunities for growth, not just risk mitigation

Dynamic, predictive models to better understand customers and the associated risks could also drive opportunities to create competitive advantage and growth. Corporately, strategic acquisition opportunities could also arise as the fallout from COVID-19 unfolds.

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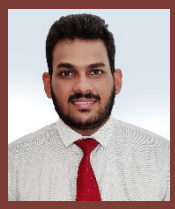

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About KPMG

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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

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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
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Our clients value the breadth of skills and experience KPMG professionals bring to every client engagement

Audited 38% of Listed Entities in Sri Lanka
As indicated in the LMD Auditors League 2018/19.

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

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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 2018

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 2018.

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