Sri Lanka Banking Report

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Foreword

The pandemic has radically changed the environment in which financial services operate. Its catalytic impact has been obvious – super-charged digitization sparking new business models, redefined customer relationships; it ushered in an unexpected era of remote working and sharpened minds around the ESG agenda. Take a step back however, and the greatest impact has been the definition of *resilience and relevance* and how these two concepts underpinned the industry's response to COVID-19.

Responsibility for delivering the benefits of many emergency COVID-19 measures agreed by government, central bank and regulators fell on the banks. To alleviate the pressure and ensure that banks could continue to support customers, CBSL relaxed capital and liquidity requirements, extended reporting deadlines and reprioritised supervisory programmes, in some cases cancelling or postponing non-critical activities. However, as the pandemic evolves and banks continue to be called on to help, significant challenges to their profitability and future financial resilience are emerging.

These are pivotal times for retail banking. As the industry adjusts to the effects of COVID-19 and looks towards the future, the landscape is very different. Banks must negotiate a multitude of shifting factors — from changing customer behaviours to economic headwinds, intensifying competition, regulatory pressures and technological disruption. Driven by COVID-19, the social and economic landscape has been radically reshaped while customer needs and expectations continue to dynamically evolve. Value and price are becoming equals for customer loyalty. Consumer spending has been impacted by both a decrease in disposable income and the psychological impact of COVID-19.

In the wake of the COVID-19 pandemic, the cost agenda has been elevated to a new level of importance. A clear majority of banks are looking to intensify and accelerate their cost transformation programs, in many cases significantly. Those banks that are bold and successful in their cost transformation programs will be strongly positioned for success

Achieving cost efficiencies while still maintaining robust cyber security is a complex task at the best of times. COVID-19 has significantly impacted the complexity of this challenge. Not only are banks being faced with increased cost pressures, but they also had to quickly adapt to the changes required to their security framework to defend against adversaries, seeking to capitalize on new ways of working, namely employees working from home, and whose home systems may be less well protected.

As Sri Lanka begins to recover from the third wave and the distribution of vaccinations are picking up speed, the big question is whether there is light at the end of the tunnel? Despite the positive turn of events, there still remains much uncertainty regarding the changes this new reality will bring and whether the trends that arose from the pandemic will continue to remain.

We however believe that the banking sector capital strength is high that it will be able to make it through this crisis. The larger banks tend to be well-diversified across investment banking, wholesale and consumer lending as well as asset and wealth management.

But many smaller or mid-sized banks are less diversified. The crisis could become more challenging for them if it deepens further or carries on for an extended period.

Fintech and challenger banks may also potentially feel the pressure – as they will be unable to differentiate themselves by paying higher interest rates in the close to zero environment, while there could also be a 'flight to safety' as customers begin to place deposits with large established players instead.

As we begin to emerge from the pandemic and Sri Lanka's economy starts to turnaround, it is important to understand the role that banks and financial institutions will play in its recovery and in supporting other businesses, both large and small, as they attempt to find their footing once again.
As banks and financial institutions shift gear from response to recovery, they will have many key issues to consider. Resilience in the face of these concerns and challenges will determine who will prevail in the new reality. ***Leadership lives at the intersection of resilience and relevance.***

KPMG Sri Lanka brings to you the seventh issue of the Sri Lanka Banking Report with key discussions on the performance and trends of the 2nd Half of 2021, focusing on the implications of COVID-19 on the financial sector as well as the importance of ***"Driving Change for a stronger Future".***

To be the Clear Choice

Ranjani Joseph
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Executive Summary

Sri Lanka's economy in 2020 is a story of two halves, with the COVID-19 pandemic and the lingering effects of the Easter Sunday Attacks impacting 1H2020, alongside a rapid turnaround being displayed in 2H2020.

However, the third wave of the pandemic since April 2021 has caused the economy, especially in sectors such as tourism and international and domestic trade to have a late recovery in fully returning to pre-pandemic levels. Such happenings dampened initial positive sentiment that a recovery was fast approaching, which was encouraged by the activity in several sectors and the levels of confidence displayed throughout the latter part of 2020 and 1Q2021.

While the country's Gross Domestic Product (GDP) contracted 1.6% year-over-year (YoY) and 16.4% YoY in 1Q2020 and 2Q2020, respectively, this was offset by growth of 1.3% YoY each in 3Q2020 and 4Q2020, resulting in a full-year decrease of 3.6% YoY. Prior to the third wave, there was an uptick in economic growth in 1Q2021 recording 4.3% YoY.

The recovering economy was supported by a growing banking sector, which recorded improved results in 2H2020. Gross Loans and Advances rose 11.9% YoY in 2020 to reach LKR 9.1 Tn.

However, significant government borrowings remains a concern, with Government of Sri Lanka (GoSL) borrowings increased to LKR 4.5 Tn in 2020 and continuing strongly into 2021. Credit to the private sector, which grew at a modest 6.5% YoY in 2020, lent out LKR 374.0 Bn, higher that the LKR 235.5 Bn recorded in 2019.

The 21.6% YoY increase in deposits in 2020 came in despite policy rates being at historical lows, as spending restrictions caused individuals and businesses alike to limit spending plans. The build-up in deposits which has boosted liquidity levels in the banking sector is expected to provide tailwinds to support loan growth in 2021.

Total banking sector Net Interest Income (NII) declined by 2.2% YoY in 2020 mainly due to declining interest rates and the extension of debt moratoria, which saw a Phase 3 extension through to September 2021. The Net Interest Margin (NIM) continued to trend lower, falling to 3.1% in 2020 from 3.6% in 2019. With the advent of the third wave of the pandemic the CBSL provided another round of moratorium from 15 May 2021 for three and a half months to provide payment relief for the borrowers. This latest phase relief does not cover those in the passenger transport and tourism sectors, who continued to be covered via the phase 3 moratorium extension.

The burden on the banking sector was alleviated by timely fiscal and monetary support from the Central Bank of Sri Lanka (CBSL), as well as pent-up demand for funding. The pandemic highlighted banks' respective risk management strategies, reflected through capital and liquidity buffers which strengthened through 2020, re-iterating the flexibility and robustness of the banking sector.

Although higher provisions for loan defaults came into effect (Management Overlay), listed banks in Sri Lanka ended 2020 with higher earnings in 2H2020 versus 1H2020, evidence that the banking sector is a proxy for broader economic performance. The overall economy also rebounded in 2H2020, growing 1.3% YoY in 3Q2020 as well as 4Q2020, offsetting declines of 1.6% YoY in 1Q2020 and 16.4% YoY in 2Q2020. Sector gross NPLs declined slightly in 2020 (4.9% in 2020 compared to 4.7% in 2019), but we note that this needs to be viewed with caution given the extension of the moratorium.

As the virus took hold again from April 2021, the short-term outlook for GDP growth and the banking sector turned sour as the economic activities fell into semi-dormancy, of which the spillover effects would befall on the banking sector by way of softened growth, lingering impairments and deceleration in earnings from the original projections.

The delayed but gradual turnaround is likely to be supported by the expected economic recovery along with the aggressive vaccination drive, a low interest rate environment, improving business and consumer confidence, and the GoSL push towards industrial development.

Banking Sector Highlights

Sector looks past the pandemic for robust growth in 2021

Sri Lanka's banking sector emerged largely unscathed from 2020 after successfully navigating a period of economic turmoil brought on by the COVID-19 pandemic.

The banking sector benefitted from:

- Timely and proportionate assistance from the Central Bank of Sri Lanka (CBSL)
- The rapid, 'V'-shaped recovery of the economy in 2H2020, assisted by pent-up demand, and fiscal and monetary stimulus

The pandemic and its economic malaise showcased the sector's ability to withstand shocks. This was reflected by banks' capital and liquidity buffers, which gained strength rather than weakening, proving their resilience and shock-absorption capacity.

Although some risks persist, such as opaque asset quality and an uncertain path to full economic recovery, the banking sector -- as well as the broader economy -- was largely looking past the pandemic for better prospects before the restrictions were re-imposed from mid-April to contain the third wave of the virus

The sector expected better fortunes from 2021 onwards, stemming from:

- Growth in private loans due to the historically low interest rates.
- Economic policy tilt towards a domestic industrial renaissance (under the national policy framework, 'Vistas of Prosperity and Splendor')
- Improving business and consumer confidence.
- Political and policy stability

However, the resurgence of the virus from mid-April and its toll on the broader economy soured the sentiments, damaging the prospects for the sector but the sector would push ahead.

Banks flushed with liquidity ready to be unleashed as loans

Banking sector liquidity reached its highest level in 2020, with almost all banks reporting Statutory Liquid Asset Ratios (SLARs) much higher than the 20% minimum requirement.

While the regulatory reprieve received on categorizing certain assets under liquid assets gave some comfort to banks, the sharp spike in liquidity was the result of **three key factors** following the onset of the pandemic:

1. **Soaring deposits resulting from people and businesses stockpiling cash in bank accounts**
2. **Anemic loan growth**
3. **Capital augmentation – organic and inorganic**

Underlying reasons:

- Soaring deposits
- Anemic loan growth
- Capital augmentation (organic and inorganic) by banks
- Cheaper debt in LKR and foreign currency

All these factors helped buttress banks' liquidity profiles to achieve,

SLAR

31.0%
At end-2019

→

37.3%
At end-2020

Loan-to-Deposit Ratio

88.7%
In 2019

→

81.6%
In 2020

This indicates fewer loans amid rising deposits, albeit this decline reversed with the acceleration in loans during 1Q2021.

Banks remain growth hungry

Flushed with liquidity and possessing mostly stable capital profiles, the banking sector now stands ready to open lending spigots. LCBs have been looking for growth, which has largely evaded them since 2018 as a result of rising interest rates and weak borrowing sentiment.

What to expect in 2021

- CBSL has indicated that it expects a 14% increase in private sector credit, translating to over LKR 850.0 Bn in fresh credit.
- The banking sector has set its sights on expanding its lagging asset base.

Although the virus resurgence in the 2Q2021 prompted the CBSL to revise this target down to 12%, this remains a higher growth than in 2020, and appears achievable given the performance so far.

Asset quality fared better than expected, but caveats remain

Gross NPL ratio, performed better in 2H2020 than in 1H2020, signaling that the worst maybe over for the banking sector in terms of troubled loans.

However, concerns remain regarding the true picture of asset quality once the moratoria still applying to a section of the loan book comes to an end.

Despite back-to-back loan repayment holidays granted by the CBSL starting from April 2020, each subsequent reprieve was less broad-based and more targeted than the previous round. Asset quality further improved in 1Q2021 but the virus snag in 2Q2021 and its resultant stresses on borrowers could keep credit costs elevated through the remainder of the year, albeit at 2020 levels.

Earnings beat expectations to pull off record results, although……

Total banking sector earnings in absolute terms reached all-time highs

Earnings too recorded QoQ growth in every quarter between 1Q2020 through to 4Q2020, reflecting relative resilience despite the magnitude of the pandemic-induced economic shock. This was followed by a record high earnings season in 1Q2021.

The relative indicator of profitability in the sector, Return on Equity (RoE), which is also the barometer of how attractive the sector is to stockholders, climbed over the years.

Below 11% since December 2018 — 2018

11.3% in December 2020 — 2020

16.2% in1Q2021 — 2021

This strong performance was partly due to the growth in private sector credit which re-emerged in 2H2020, resulting in cumulative private sector credit at the figures below:

LKR 235.5 Bn — 2019

LKR 374.0 Bn — 2020

This growth further gained momentum in 1Q'21 with the LCBs disbursing nearly Rs.220Bn in fresh private credit.

Performance was also positively impacted by the improving margins, easing loss provisions and regulator removing taxes which were considered punitive on the sector, i.e. the Debt Repayment Levy and Nation Building Tax (NBT) on financial services.

....impairments were higher on account of loans and bond investments

During 2020, banks substantially increased provisions for possible loan defaults, referred to as Expected Credit Losses (ECL) in IFRS 09 parlance, as lockdowns and other restrictions took a heavy and lingering toll on the repayment capacity of individuals and businesses.

As a result, both Individual Impairments – the credit costs of individually significant loans – as well as Collective Impairments – the provisions made for the entire loan portfolio not captured under Individual Impairments – rose substantially as banks made significantly higher provisions to capture the impact on borrowers from the challenging economic conditions.

However, we expect that the economy's recovery momentum will result in a solvent clientele, especially small businesses, and trigger easing of impairments in 2021, providing tailwinds for the sector's bottom-line, which was already set for a surge from higher loan growth. However fresh stresses from the resurgence of the virus could cause impairments to remain elevated at levels seen in 2020.

Operational benefits shown with digitization and lockdowns

Despite its broader health and economic damage, the pandemic and the resultant social distancing requirements spurred the drive towards digitization.

It is assessed that the pandemic brought nearly five years of digital advancement in a single year.

Alongside this, banks were able to keep costs under check and reduce Cost-to-Income ratios across the board through the measures below which also resulted in economies of scale:

1. **Maintaining fewer brick-and-mortar operations during lockdowns**
2. **Implementing conscious cost-cutting**
3. **Holding off on investments in physical branches and seeing less depreciation**
4. **Implementing significant on-boarding of clients to digital platforms**

While this is already seen from the improved efficiency matrices through 1Q2021, repeated disruptions into in-person activity will add a tailwind to the current transition into digitalization.

Funding costs declined

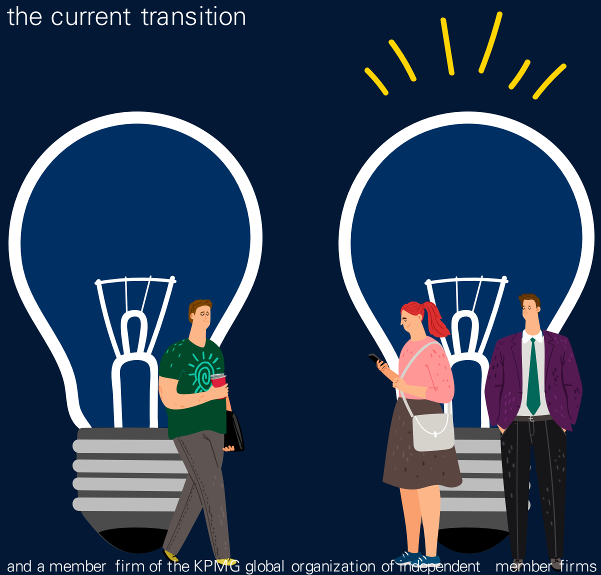
The banking sector's funding costs declined substantially, as a result of:

- Lowering interest rates on deposits and other sources of funds.
- The build-up of higher low-cost funds in the banking system.

While there was an increase in deposits, notably the Current and Savings Accounts (CASA) base improved, reversing a years-long decline in the low-cost deposit base.

Meanwhile, borrowings made in the local market as well as from DFIs were coming in at relatively lower yields, resulting in an overall decline in banks' cost of funds.

While the internal capital generation occurs with robust earnings, the banks continue to add more capital by way of diversifying their funding mix.



Economic Overview

Third wave delays Sri Lanka 2021 economic recovery

The third wave of the COVID-19 pandemic in May and June 2021 which led to the GoSL restricting the general public's movement is likely to lead to a delay in the initially anticipated economic recovery in the country.

Commencing May 2020, the COVID-19 pandemic and the inherent uncertainty surrounding it led to economic disruptions in Sri Lanka and around the world. Initial actions of GoSL to minimize the spread of infection included implementing full and partial lockdowns (March 2020 to May 2020), disallowing travel for foreigners and locals and restricting imports. Many consider the steps to have been successful, relative particularly to the impact of the pandemic in other countries. However, in October 2020, two major COVID-19 clusters were identified that saw localized restrictions being temporarily re-imposed, delaying a quick return to business as usual. As a result, in 2021 the country continues to operate under a 'new normal' that includes social distancing and the wearing of face masks.

Amid the pandemic, in August 2020 the country voted in a new government with a two-thirds majority, providing much needed political stability. The country's economic progress has been volatile over the past few years, as a result of a divided government since 2015, the Easter Sunday Attacks in April 2019 and the significant impact of the COVID-19 pandemic due to Sri Lanka's high dependence on global markets and the country's interconnected supply chains.

We feel an economic recovery is likely to commence towards the last quarter of the 2021 and in the early periods of 2022, stemming from economic turnaround in major global markets as a result of successful vaccine rollouts, but also due to a resumption in domestic trade, consumption and manufacturing as well as the local vaccine roll-out.

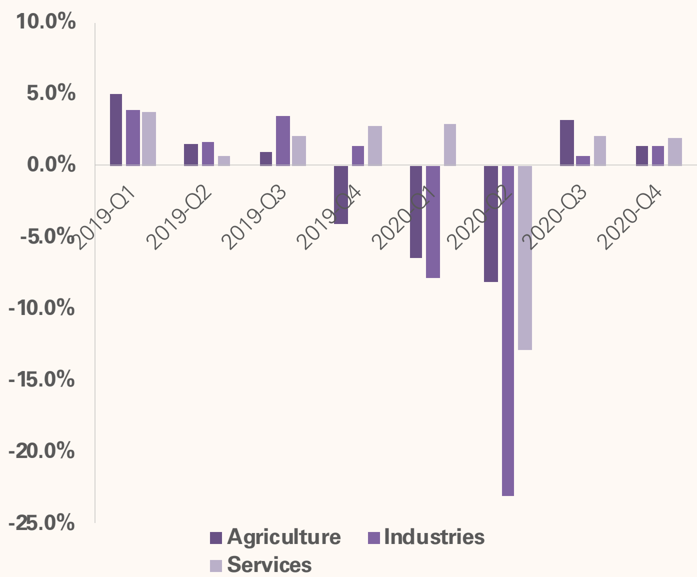
Improving domestic conditions and low interest rates to help recovery

The Sri Lankan economy contracted 3.6% YoY in 2020 and is indeed a story of two halves. In 1H2020, despite the fiscal stimuli introduced during the latter part of 2019 as part of the significant tax cuts (direct and indirect) introduced post the Presidential Election of November 2019, Sri Lanka's GDP contracted by 1.6% YoY in 1Q2020 and 16.3% during 2Q2020 due to the COVID-19 pandemic and the associated slowdown of the global economy. Agricultural production was also impacted by adverse weather conditions.

In 2H2020, however, with lockdowns easing, the country showed signs of a gradual recovery as GDP grew 1.3% YoY in 3Q2020 and 1.3% YoY in 4Q2020.

In terms of the performance of key sectors in 2020: Agriculture contracted 2.4% YoY and was the least affected, compared to the Services and Industry sectors, which contracted 1.5% YoY and 6.9% YoY respectively.

Quarterly real GDP growth by sector, 2019-2020



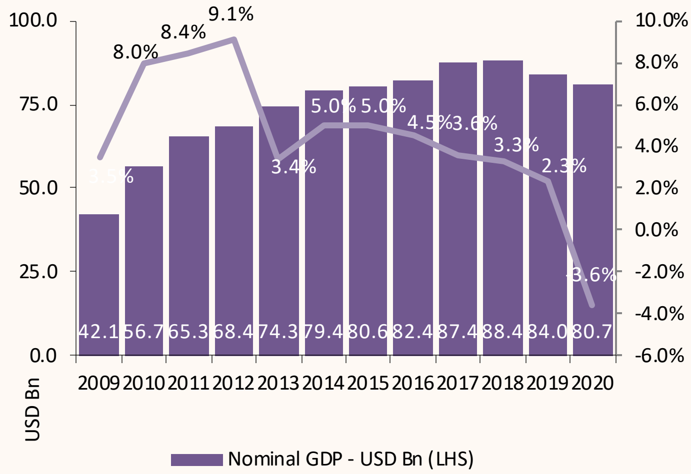
As a result, Sri Lanka is likely to remain ranked as a lower-middle income country (downgraded in July 2020), according to the World Bank classification, on account of GDP per capita declining to USD 3,852 in 2019 from USD 4,081 in 2018, on the back of currency depreciation outpacing economic growth.

Tourism activity, which had already seen a 31.5% YoY decline in 1Q2020 due to the prolonged impact of the Easter Sunday Attacks, worsened with the closure of the airport to minimise the spread of COVID-19. During January to June 2021 Sri Lanka welcomed only 16,908 tourist arrivals compared to 507,311 in 1Q2020. Sri Lanka closed it borders to international tourists during 2Q2020.

In January 2021, the country officially re-opened its borders to international travelers, resulting in 9,629 tourist arrivals in 1Q2021 compared to 507,311 in 1Q2020.

Unemployment rose steadily in 2020 compared to 2019, reaching a high of 5.8% in 3Q2020 before declining to 5.2% in 4Q2020 (4.5% in 4Q2019), as the labour force participation rate fell to 50.1% in 4Q2020 from 52.3% in 2019. This rate increased to 5.7% in 1Q2021.

Gross domestic product



This reflects the economic impact of the pandemic, with job losses as well as salary cuts affecting consumption, which is a key growth driver that accounts for about 70% of the economy.

Unexpected resilience in foreign worker remittances to Sri Lanka greatly supported the weakened country reserves. Remittances fell between March and May 2020 as a combined result of lockdowns, layoffs and poor economic performance, among others, but picked up over June-December 2020, with total inflows reaching USD 7.1 Bn in 2020, up 5.8 % YoY.

This trajectory continued into 2021, as cumulative worker remittances during January and May 2021 were up 18.2% YoY. Further, the CBSL maintains positive expectations as it forecasts remittances for 2021 to reach USD 8.0 Bn, up from a previous estimate of USD 7.5 Bn.

Providing such remittances an additional two LKR on each USD and encouraging workers to use formal channels of money transfers over previously used informal channels are seen to have contributed this growth.

The CBSL reduced policy rates and the Statutory Reserve Ratio (SRR) as part of its monetary easing measures to reduce costs of borrowing and improve market liquidity. Concessional credit schemes and debt moratoria were introduced to support Small and Medium Enterprises (SMEs) and individuals affected by the COVID-19 pandemic.

The consensus on outlook is that the country is expected to record positive growth in 2021, albeit lower than previously expected, on the heels of policy stimulus measures and an improved business outlook.

The onset of the third wave led to revisions in Sri Lanka's GDP growth for 2021. The CBSL currently indicates an economic growth of 5.0%, softening from the originally projected 6.0%, as large swaths of economy remained sub-dormant during 2Q2021 due to virus induced restrictions .

Other global agencies such as the Asian Development Bank and World Bank have offered more conservative projections at 4.1% and 3.4%, respectively. Moreover, in April 2020 the International Monetary Fund (IMF) lowered its forecast to 4.0% from 5.3%.

Inflation remains elevated as import restrictions and currency depreciation take effect while virus related restrictions caused supply chain disruptions

In 2020, inflation as measured by the National Consumer Price Index (NCPI) reached 6.2% YoY (measured as a 12-month moving average), notwithstanding lower consumption and import restrictions on select consumer and non-consumer goods.

As a consequence of restricting select food imports and disruptions to domestic supply chains, food inflation rose to 12.2% YoY, with the government having to step in to introduce controlled prices on several essential items, with little success in taming the rising prices.

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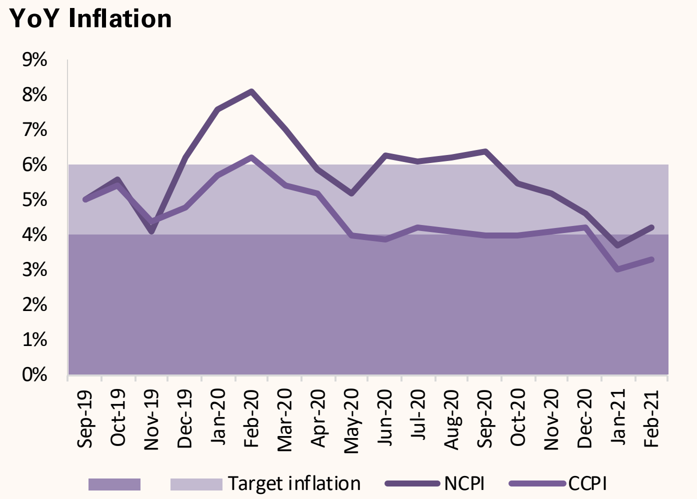
Since then, food inflation has dropped to 11.5% YoY in January 2021, further falling to 10.0% in May 2021. Non-food inflation remained tepid, at around 1.5%, yet rose to 1.7% in May 2021 on a weakening currency. A further uptick can be expected once the current ban on non-essential goods is lifted and the LKR adjusts to that demand-and-supply mechanism.

The CBSL is keen to keep average annual inflation within its desired range of 4 to 6% as they believe the recent bout of inflation is transitory and will not be persistent because it was driven predominantly by supply side disruptions, and not demand side pressures.



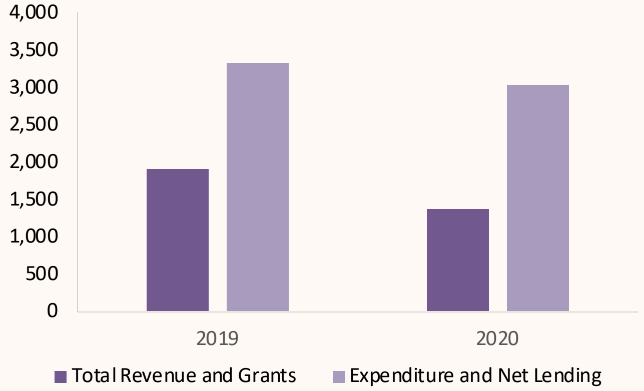
However, improvements in external conditions as well as in domestic aggregate demand conditions may briefly lead to higher inflation in the medium term. A further impact could come from the CBSL continuing to pump significant liquidity into the system to provide stimulus to the economy beset by the pandemic; but this could threaten price stability in the next 12 months. However, the Monetary Board has indicated that they stand ready to decelerate pace of stimulus if they see signs of sustained price pressures.

Declining tax revenues from tax cuts combined with lower economic activity result in widening budget deficit; all three major external rating agencies downgrade

The full impact of the pandemic and the post-Presidential Election 2019 tax cuts were reflected in tax revenue declining to LKR 1,216.5 Bn in 2020, down 29.9% YoY. As previously mentioned, import restrictions further impacted tax revenue, given that almost half of GoSL's tax coffers is made up of import-related taxes. Tax revenue in 2020 fell short of the CBSL estimate of LKR 1,305.0 Bn.

As expected, the combined effects of COVID-19 relief expenses, low tax revenue and rising recurring costs translated into an increase in the deficit to LKR 1,667.7 Bn over January-November 2020 (up 42.0% YoY).

Government Fiscal Operations 2019-2020



The CBSL projects that the budget deficit will widen to 8.8% of GDP in 2021 from the estimated 7.9% in 2020 due to the impact on revenue collection offsetting controlled expenses. However, with the loss of tax incomes during 2Q2021 due to restrictions on economic and public's activity, as well as the unexpectedly high expenditure on virus containment is likely to cause further increases in the budget deficit. Further tax incentives are proposed to stimulate the economy, mainly for the agriculture sector, as well as incentives to facilitate private investment.

Such measures include five-year income tax exemptions for those involved in farming (fisheries, livestock and agriculture), a seven-year tax holiday for the renewable energy sector, and a 10-year tax holiday for investment in select recycling sites to promote reuse of construction material.

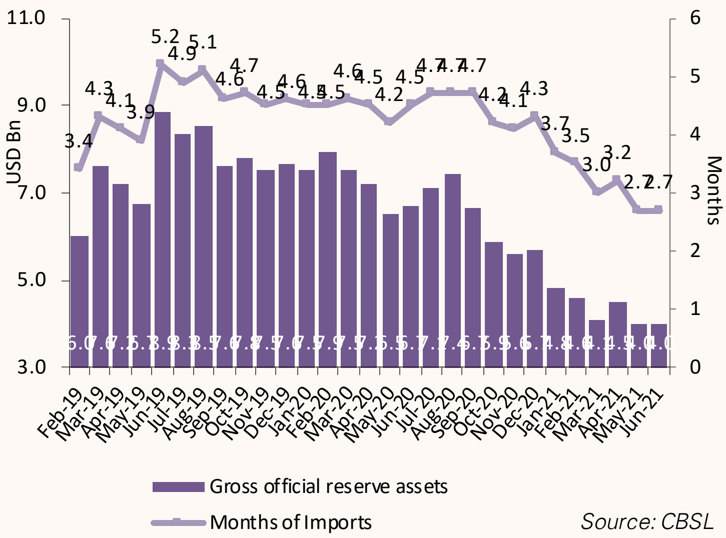
Reforms to tax collection are also being proposed. Moreover, a 40% tax is to be applied to businesses involved in betting and gaming, as well as the manufacture and sale, or import and sale, of alcohol. GoSL presented a medium-term macro-fiscal strategy that aims to contain the debt-to-GDP ratio at 75.5% by 2025 from 101.0% in 2020. However, the World Bank forecasts Sri Lanka's debt-to-GDP ratio will rise to 115% in 2021 and reach 119.6% by 2023.

In April 2020, Fitch Ratings downgraded Sri Lanka's sovereign credit rating, while in September 2020, Moody's Investors Service downgraded Sri Lanka's long-term foreign currency issuer and senior unsecured ratings to Caa1 from B2. This is expected to further increase the cost of servicing foreign debt. Further, in December 2020, S&P Global Ratings downgraded Sri Lanka's long-term credit ratings to CCC+/C from B-/B. It projected the fiscal deficit to be 10.2% of GDP in 2021.

Foreign reserves continued to deplete in 2020

At the end of 2020, gross official reserves were estimated at USD 5.7 Bn, falling to USD 4.0 Bn by June 2021. The steady decline in 2020 reserves was the result of Sri Lanka repaying a maturing USD 1.0 Bn sovereign bond in October 2020, instead of rolling the debt over.

Gross official reserve assets



Source: CBSL

The country's trade deficit significantly contracted in 2020 to USD 5,978 Mn compared to USD 7,997 Mn for 2019, as a drop in exports was offset by a greater decline in imports from GoSL measures to ban imports of non-essential items and restrict imports of select commodities as a means of bolstering domestic production and preserving the currency.

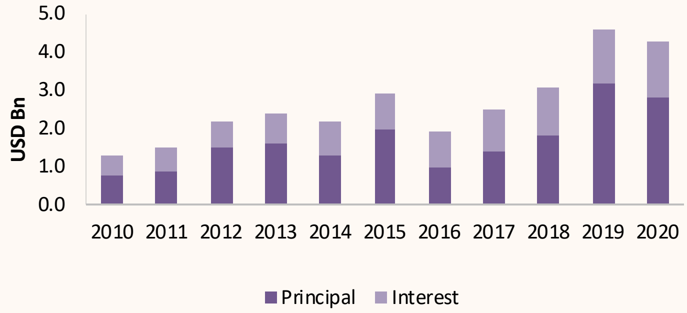
As a result, all three key categories of imports – consumer goods, intermediate goods and investment goods – declined, with the reduction in imports of fuel, textile and textile articles, personal vehicles, and building materials being key. The trade deficit is anticipated to expand to 3.3% of GDP in 2020.

Over January-December 2020, the external current account deficit narrowed to USD 910 Mn from USD 926 Mn for the same period a year earlier, mainly due to better-than-expected foreign worker remittances. The CBSL expects the external current account to record a USD 500 Mn surplus in 2021.

As at end-April 2021, the GoSL's outstanding foreign debt was USD 35.1 Bn. International Sovereign Bonds (ISBs) accounted for almost 46.7%, or USD 16.4 Bn, of the foreign currency debt stock. Total debt service payments for 2020 amounted to USD 4.3 Bn, of which USD 2.8 Bn was principal repayments and the balance USD 1.5 Bn interest payments.

The debt-to-GDP ratio stood at 101.0% at end-2020, with current and short-term fiscal pressure-induced borrowings likely to push the ratio over 110% by end-2021.

Government's external foreign currency debt servicing



However, in February 2021, the CBSL noted that the GoSL's debt service obligations had all been duly met to date. The CBSL also provided a medium-term objective of bringing down the public debt's foreign-to-domestic ratio from 43.57% to 33.67%.

Stability of currency to be supported by foreign funding

Foreign funding received in the past 12 months:

- April 2020: GoSL receives loan of USD 128.6 Mn from the World Bank.
- July 2020: GoSL reached an agreement with China Development Bank to obtain a USD 140 Mn loan in two tranches.
- July 2020: GoSL completed a USD 400 Mn debt swap with the Reserve Bank of India.
- Oct 2020: GoSL received a USD 90 Mn grant from China.
- March 2021: The GoSL and People's Bank of China entered into a bilateral currency swap agreement for ~USD 1.5 Bn, with the agreement valid for three years.
- April 2021: USD 500 Mn received as the second tranche of a USD 1.2 Bn Support from China. The first USD 500 Mn was released in 2020.

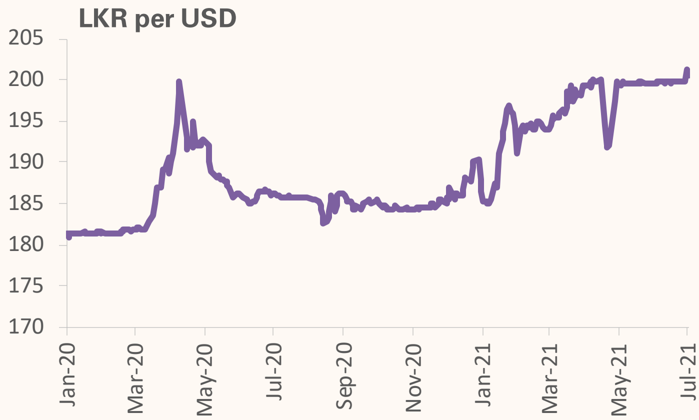
Furthermore, following funding is expected

- Standby SWAP agreement of ~USD 1.5 Bn with the People's Bank of China.
- Special SWAP facility of USD 1.0 Bn being negotiated with India.
- USD 250 Mn worth SWAP facility from the Bangladesh Bank expected in July 2021.
- USD 800 Mn under the IMF SDR allocation expected in August 2021.
- The SAARC Finance SWAP facility from the Reserve Bank of India valued at USD 400 Mn in August 2021

Pressure on exchange rate despite GoSL's protectionist measures

The exchange rate continued to experience intermittent volatility in 2020, particularly because of what the CBSL termed "speculative market behavior." Demand for gold continued, rising 28.4% in 2020 to reach LKR 353,596.8 per Troy ounce, which also put pressure on the currency.

Following a 2.6% YoY depreciation of the LKR versus the USD in 2020, the LKR depreciated at a higher 7.9% in 2021 up to 31 June 2021, rising rapidly to LKR 200 against the USD by 15 April 2021. Moreover, the Sri Lanka Rupee also depreciated against the Euro, Australian Dollar and Sterling Pound and Indian Rupee .



The Colombo Stock Exchange (CSE) recorded a net outflow, from both the primary and secondary market, of USD 225.0 Mn in 2020 compared USD 35.0 Mn in 2019. There was a cumulative net outflow of USD 553 Mn of foreign investment in the rupee-denominated government securities market in 2020.

To strengthen the exchange rate, GoSL in April 2020 introduced a Special Deposit Accounts (SDAs) with higher-than-market interest rates to encourage remittances from dual citizens, Sri Lankans and others. As at 7 April 2021, the SDAs had attracted deposits amounting to USD 360.3 Mn.

The CBSL extended the ban on Licensed Commercial Banks (LCBs) and National Savings Bank from purchasing sovereign credit bonds from 23 March to 23 April 2021. Subsequently the ban was lifted in June 2021.

In addition, the CBSL maintained the bank suspension on facilitating the import of motor vehicles and all non-essential goods except medicine and fuel. Further, the CBSL issued rules relating to the receipt of export proceeds into Sri Lanka, introduced in February 2021 and later revised.

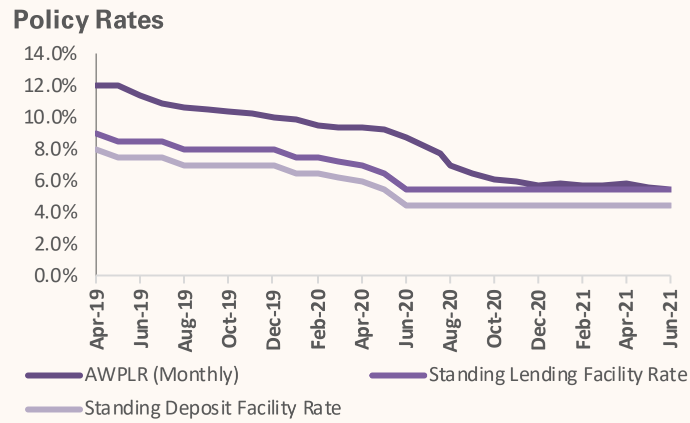
The key points:

- **Exporters are to repatriate their entire export proceeds within 180 days from the date of shipment. Also, within 30 days upon the receipt of such export proceeds into Sri Lanka, exporters are to convert 25% (with exceptions up to 10%) from and out of the total of said exports.**
- **In mid-2020, the CBSL brought into effect temporary regulatory measures on outward remittances for a period of six months. In January 2021, this was extended for a further six months from 2 January.**

CBSL's accommodative monetary policy stance' likely to extend into 2021

In 2020, the CBSL significantly relaxed its monetary policy and adopted numerous measures to support local businesses, including debt moratoria for individuals and businesses affected by the COVID-19 pandemic, and provided concessional credit schemes for SMEs. Commencing March 2020, policy rates and the SRR were reduced several times, lowering borrowing costs and bringing additional liquidity into the money market.

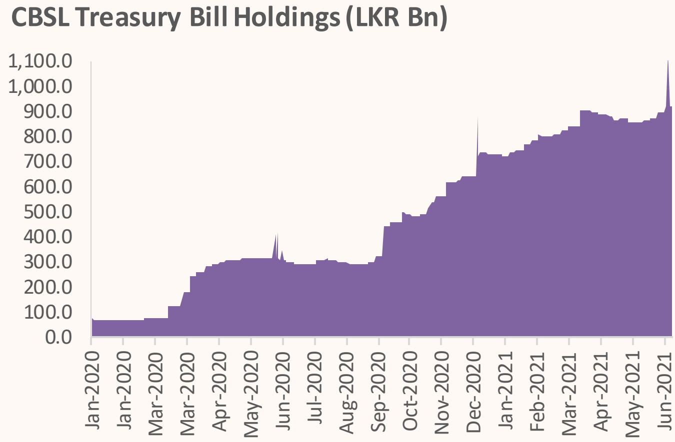
In June 2020, the CBSL further reduced the SRR to 2.0%, adding LKR 115 Bn to the domestic money market. This followed the SRR cut in March 2020, which saw LKR 65.0 Bn of additional liquidity injected into the market. As such, there was a notable decline in both lending rates and market deposit rates, with many market interest rates dropping to historically low levels.



As such, there was a notable decline in both lending rates and market deposit rates, with many market interest rates dropping to historically low levels.

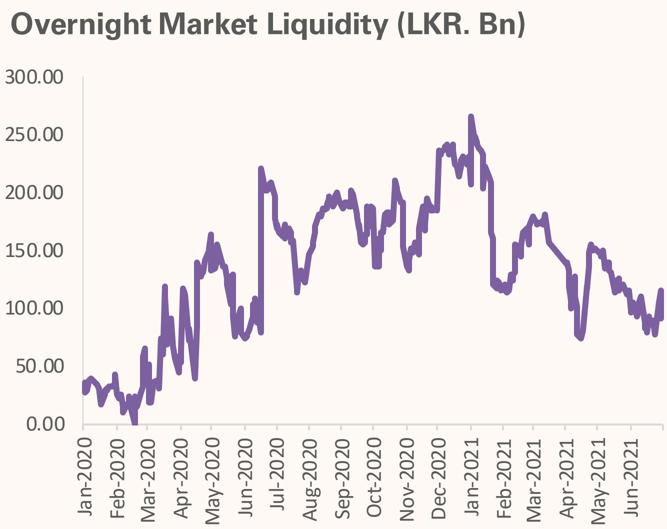
In June 2021, CBSL continued to keep the Standing Deposit Facility Rate (SDFR) at 4.5% and the Standing Lending Facility Rate (SLFR) at 5.5%. In comparison, as at 30 January 2020, the SDFR was 6.5%, SLFR was 7.5% and SRR was 5%.

While the CBSL does not expect deposit rates to decline further, taking into consideration the high levels of excess liquidity in the domestic money market and subdued inflationary pressure, it is of the view that there needs to be a sustained downward adjustment of lending rates to support economic growth.



Overnight market liquidity amounted to LKR 91.2 Bn as at June 2021, up from LKR 30.6 Bn as at 12 March 2020, prior to the first country-wide lockdown.

Further, the CBSL significantly increased its holdings in treasury bills to LKR 725.2 Bn as at end-2020 from LKR 78.0 Bn as at 12 March 2020, further increasing this to LKR 919.2 Bn as at June 2021.

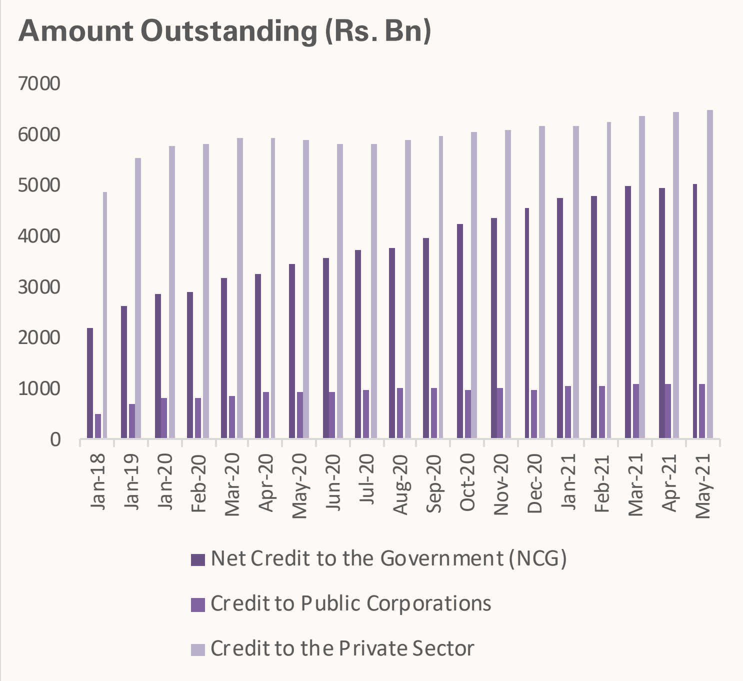


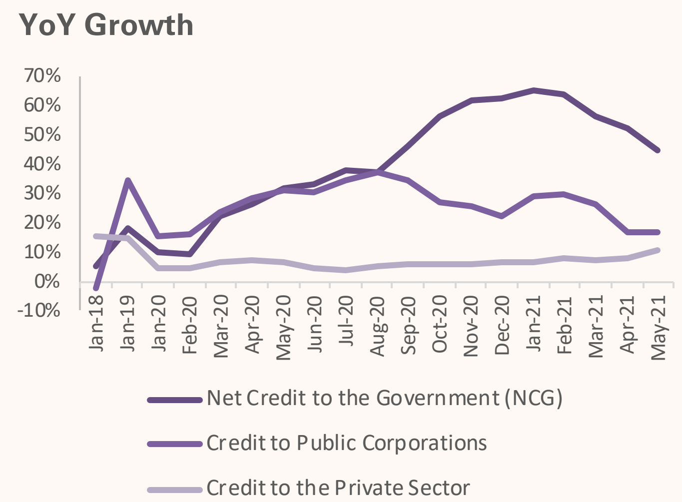
Moreover, the CBSL lowered banks' capital conservation buffer requirements to provide further liquidity and spur the economy.

Domestic credit growth driven by public sector

In 2020, there was a notable increase in domestic credit extended to the public sector, rising 22.5% YoY to LKR 1.0 Tn, to many entities we feel were loss-making state-owned enterprises.

Moreover, net credit to the government grew to LKR 4.5 Tn, up 64.4% YoY in 2020, as the GoSL borrowed heavily to fund pandemic-related and recurring expenditure, making good use of the prevailing low interest rate regime. Such borrowings continued in 2021, increasing 45.0% YoY in May 2021, compared to a 33.5% YoY rise in May 2020.





In March 2020, private sector credit hit a high of LKR 120.0 Bn before falling to LKR 13.0 Bn in April 2020. Thereafter, outstanding private sector credit among LCBs fell for a consecutive three months before staging a rebound in August 2020 that has continued.

Despite significant rate cuts, private sector credit growth only grew 6.5% in 2020, underscoring slow economic activity in 2020.

The modest growth of bank credit to the private sector was seen even before the impact of the pandemic. For instance, there was a deceleration in private sector credit growth in 2019 as a result of low business confidence, high lending rates and the economic impact of the Easter Sunday attacks of 2019.

Businesses appear to be cautious in tapping into bank credit even at low borrowing costs. Moreover, rising Non-Performing Loans (NPLs), which increased credit risk, appear to have made banks more cautious in lending to businesses. With the need to make more provision for loan losses, banks may not be able to reduce lending rates as expected.

While a similar sentiment was seen in January 2021, which recorded modest private sector credit growth of 6.9% YoY, private sector credit encouragingly picked up pace in April and May 2021, rising 8.2% YoY and 10.5% YoY respectively. Within the first five months of 2021, credit granted was about LKR 330.6 Bn closing in on the entirety disbursed in 2020 (LKR 374.1 Bn). However, the CBSL's initial projection of 14% YoY private sector credit growth was revised down to 12% in May 2021. This is likely to continue to grow, driven by excess liquidity in the money market coupled with low lending rates and more loans expected to be given to Micro, Small and Medium enterprises (MSMEs).

Bond yields witnessed a downward shift in 2020

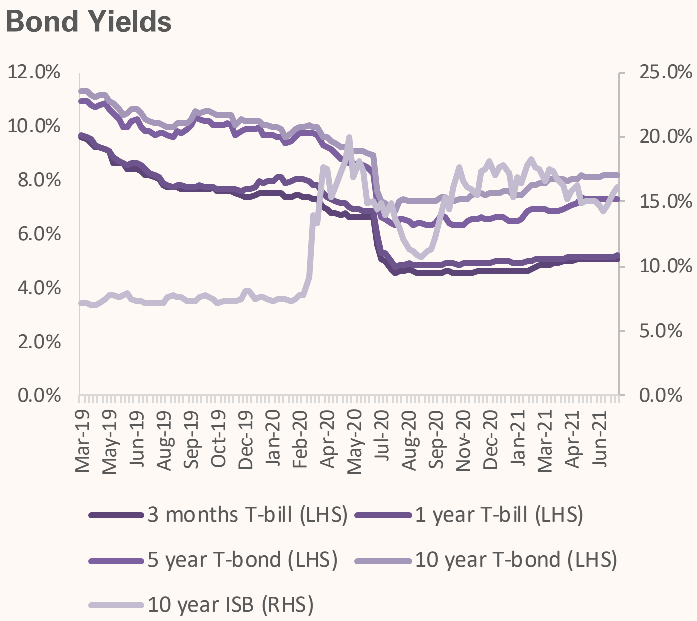
While bond yields trended slightly lower between March 2019 and March 2020, there was a notable decline between June 2020 and July 2020 as the CBSL implemented several measures to boost liquidity in response to the COVID-19 pandemic.

For instance, 5-year treasury bonds dropped from 8.55% on 3 June 2020 to 6.31% by 22 July 2020. Similarly, 10-year treasury bonds fell from 9.02% on 3 June 2020 to 6.85% by 22 July 2020.

The treasury bond market saw an exit of foreign investments amounting to USD 553 million in 2020. ISB yields rose significantly in 2020 and peaked in May as most foreign funds had to reallocate funds as a response to the financial effects of the pandemic.

While ISBs due in July 2021 recorded a 42.6% yield as at end-October 2020, this declined to 31.7% by end June 2021.

In February 2021, the yield on 1-year treasury bills (T-bill) passed 5.0% for the first time since July 2020. Similarly, the yield on 10-year treasury bonds passed 8.0% in March 2021 for the first time since June 2020.



To ease pressure on the exchange rate and taking into account possible outflows of foreign exchange by banks, with effect from 23 March 2021 National Savings Bank and LCBs were suspended to purchase Sri Lanka ISBs up until 23 April 2021. On 23 April 2021, this directive was extended until further notice. However, in June 2021 the ban was lifted, subject to conditions such as its purchase should be from fresh borrowings from overseas and it should be established to the satisfaction of the regulator.

Future of the Banking Sector through a Chairman’s lens

Exclusive discussion with Jegan Durairatnam – Chairman DFCC Bank PLC

Financial institutions across the world are monitoring and dealing with the effects of the COVID-19 pandemic and working towards to understand the immediate challenges to society and economies, and the long-term impact on the interconnected financial system. They are also using the expertise to help themselves and their customers to make good decisions in today’s highly volatile operating environment.

Banks are at the front-line of the economic disruption brought about by the COVID-19 pandemic. The impact has created major effects on the banking industry, and It won’t be an easy ride ahead and it is essential for banks to strengthen the operational resilience and business continuity planning to weather this storm.

To better understand the challenges faced by the banking industry and the key aspects which are driving change in the post-pandemic era, Jegan Durairatnam, Chairman, DFCC Bank PLC, shared his views on the future of the banking industry and the steps banks and regulators must take in order to stay afloat in the new reality and embrace the “new normal”.

Banks must wear two hats

We have seen the trend of specialised banks gradually transforming into commercial banking over the last few years.

He emphasised on the need to have banks which focus on long term project-based lending which was the role previously played by the specialised banks. He emphasised that DFCC, continues to recognise the importance of leveraging from its long-standing reputation and experience in the field of development banking despite the transition into the new business model as a one-stop shop by entering the commercial banking sphere.

When a bank is heavily focused on project-based lending it also needs to evaluate the associated long-term risks based on scenario analysis.

With first-hand experience of being in the driving seat, from his previous top management positions in the commercial banking sector, including the role as Chief Executive Officer, Jegan believes that for any bank in commercial banking space, being Street Smart is of utmost importance.

“Banks must wear two hats, while focusing on long term risks, the banks also need to be sensitive to the emerging trends and respond fast to customer behaviour”

In order to safeguard from this risk, Jegan stressed on the important role capital adequacy plays in safeguarding banks from long term risk by providing the financial stability and highlighted how all big players in the industry consider it to be a priority.

Steering through the pandemic

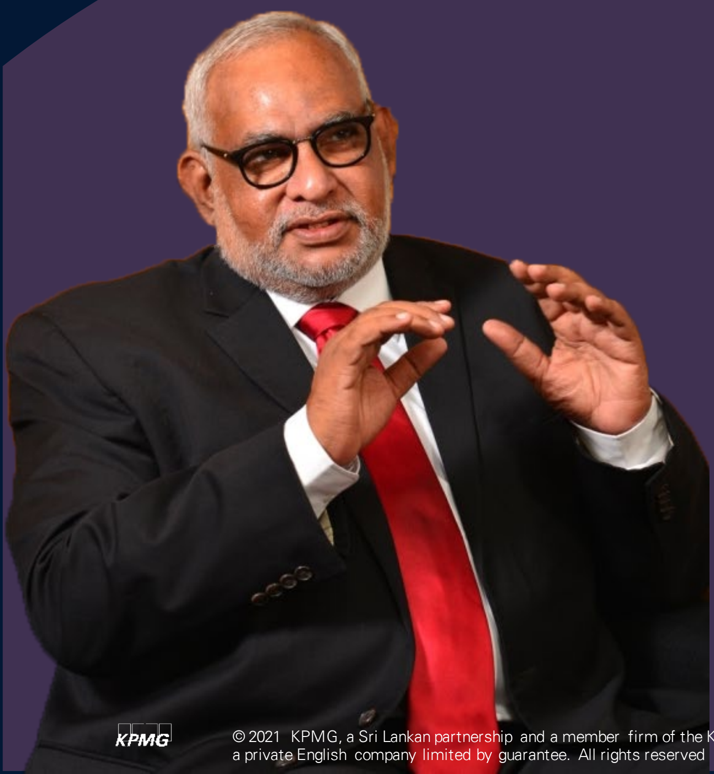
As we move through unchartered territory, banks struggle with understanding the best course of action to follow that would not only ensure their own survival but support the country with recovery of the economy.

"Banks and Financial institutions must draw their attention towards restructuring of operations and processes in order to facilitate increased cash flows to face the ongoing COVID-19 crisis", says Jegan. He pointed out that SME's and Entrepreneurs account for 75-80% of Sri Lanka's economy, therefore, making them key components in driving economic recovery is vital as we attempt to come out of the implications of the pandemic.

He emphasised that banks must keep this in mind and focus on supporting this sector by expanding service lines which cater to the unique needs of these businesses.

In light of the challenges faced by businesses and individuals in repaying loans as a result of the adverse effects of the pandemic, the Central Bank of Sri Lanka implemented a debt moratorium to provide some relief. Speaking on the impact that it has had on banks, Jegan expressed that while continuously extending the moratorium may benefit the public at large to an extent, it puts banks and financial institutions in a very challenging position. "Although the concept of the moratorium itself might not be harmful, extending it continuously without carefully planning for the future implications can be a real concern".

He also stated that the moratorium schemes should be differentiated, especially in terms of different industries based on the specific requirements of the respective industries.



Mr. Jegan Durairatnam
Chairman - DFCC Bank PLC

Going digital and being innovative

While digitalisation has been gaining momentum over the past few years, it has immediately shifted into high gear as COVID-19 forced individuals and businesses to resort to technology in order to survive. Jegan believes that is vital that Technology be Embraced. However, cultural change will not happen overnight, adopting new technology requires time and effort. He also mentioned that while digitisation poses a lot of benefits, it is important that it is also balanced with the human touch.

Banks must focus on innovative new products that cater to the new generation and allow current products to naturally fade away with time

> **“Digitisation needs to be a balanced with the human touch”**

In the face of digitisation, new players may overtake the existing incumbents in the industry. To maintain competitiveness among banks, Jegan’s view is that when adopting technology, processes of the bank must be transformed in a unified manner such that the customers should be able to receive all their services at the same bank as opposed to shopping around banks for different services.

Decisive and significant role of Regulators

COVID-19 has led to an upsurge in risk of cyber-attacks and security breaches for banks in Sri Lanka. In order to address this challenge, “Framing a national perspective on cyber security risk and money laundering is of utmost importance” says Jegan. The entire banking system in the country must unite in finding a centralised solution to this common challenge rather than working in isolation. The most important step being the introduction of standardised tools and central repository of information to mitigate cyber security and money laundering threats to all banks and financial institutions in the industry.

Digitalization will lead to a number of new players entering the field, which will bring in positive changes and will also expose the industry to a number of new risks. Accordingly, the regulators will have to play a Decisive and Significant role in mitigating these risks by introducing relevant national policies and procedures which will also ensure standardised processes and deliverables in the banking sector, says Jegan.

Although banks and financial institutions in Sri Lanka have shown keenness to adopt cloud technology, regulators have not yet given approval due to lack of relevant guidelines and regulations. Jegan believes that while regulators may have reasons for restricting access to cloud technology due to confidentiality etc, it is also important that solutions are found to address those concerns in order to allow banks to take advantage of this revolutionary technology.

Building cost resilience

In the face of the economic downturn, businesses have struggled to adjust their cost models. Many businesses have had to cut back on employee salaries and let go of staff in order to stay afloat. However, the banking sector has stood tall in the face of this crisis and found that survival was possible by building cost resilience, without needing to bid goodbye to employees who they believe have all been integral to the success of the banks.

Employees have had to adapt to new working environments, be it social distancing or working from home, but the banks have kept the momentum going despite all these changes and does not believe that they will face staff retrenchments in the foreseeable future.

Digitization of course will compel banks to redeploy some staff cadre to fit into the new working model of the banks. A continual asking of how things can be done better and more efficiently is very important and that requires a shift in mindset in most organizations. Cost optimization should not be seen as restricting activity or innovation, but rather as a commitment to continuous improvement.

The Role that Professional service firms need to play

When asked how professional firms could play a part in assisting banks to navigate through the unchartered territory, Jegan responded that one of the key issues banks currently face is absence of/ unreliable/ incomplete financial statements of SME's and Family businesses. Smaller scale companies are still struggling to present comprehensive financial statements, which leaves banks in a difficult position when evaluating cashflow projections and borrower's ability to repay. However, this sector is vital to Sri Lanka's economy and therefore providing financial assistance to this sector is a prime responsibility of the banking industry. Professional service firms should also appreciate the importance of this emerging sector and assist these businesses by assisting and guiding them in introducing the required processes, internal controls and thereby generating reliable and complete financial statements. This will in turn facilitate these businesses to obtain required credit facilities with ease and speed.

Become a source of disruption

Disruption is inevitable and unstoppable. Rather than resisting it, Banks and Financial institutions must strive to become a source of disruption. Jegan firmly believes in this concept and even goes on to say he would like to see banks "marrying" disruption. In his view, owning a space in disruption is the best way forward and the way to achieve this is to "create an environment within the bank that is welcoming to entrepreneurs, so that the bank is in the front seat viewing the new possibilities and trends these entrepreneurs hope to see in the future and therefore have first choice in selecting which force of disruption the bank wants to be a part of".

Mr. Jegan Durairatnam – Chairman
DFCC Bank PLC

Banking Sector Analysis

Overview of financial performance

Banking sector as at 31 December 2020

Licensed commercial banks (LCBs)

	Total assets (LKR Bn)***	Total assets (USD Bn)		Total assets (LKR Bn)***	Total assets (USD Bn)
Total LCBs	**12,828.8**	**68.8**			
State banks			**Foreign banks**		
1. Bank of Ceylon	2,983.0	16.0	14. The Hongkong & Shanghai Corporation Ltd	424.7	2.3
2. People’s Bank	2,230.1	12.0	15. Standard Chartered Bank	207.4	1.1
Local banks			16. Deutsche Bank AG	63.7	0.3
3. Commercial Bank of Ceylon PLC	1,736.2	9.3	17. Indian Overseas Bank	53.7	0.3
4. Hatton National Bank PLC	1,291.9	6.9	18. Citibank	50.9	0.3
5. Sampath Bank PLC	1,110.3	6.0	19. Bank of China	50.7	0.3
6. National Development Bank PLC	626.8	3.4	20. State Bank of India	33.7	0.2
7. Seylan Bank PLC	557.7	3.0	21. MCB Bank Ltd	32.2	0.2
8. DFCC Bank PLC	465.1	2.5	22. Public Bank Berhad	11.5	0.1
9. Nations Trust Bank PLC	337.6	1.8	23. Habib Bank Ltd	11.2	0.1
10. Pan Asia Banking Corporation PLC	176.9	0.9			
11. Union Bank of Colombo PLC	122.9	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	**1,837.4**	**9.9**			
1. National Savings Bank	1,363.8	7.3	4. Housing Development Finance Corporation Bank of Sri Lanka	60.8	0.3
2. Regional Development Bank	221.8	1.2	5. Sri Lanka Savings Bank Ltd*	61.9	0.3
3. Sanasa Development Bank PLC	123.6	0.7			

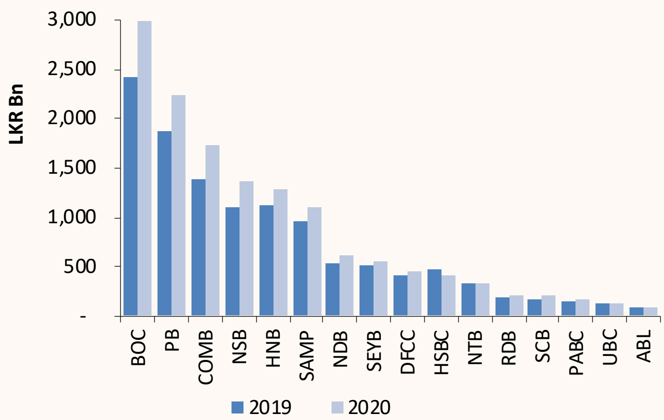
**Estimate*
*** LKR/USD rate at 31st December 2020 used to convert LKR values at 2020 year end.*
Note: Indian (operating), Axis & ICICI (ceased operations; CBSL approved for cancellation of license) banks have been excluded under foreign banks due to unavailability of data

Banking sector asset growth nearly tripled in 2020 from 2019 levels, increasing 17.1% YoY to LKR 14,666.3 Bn in assets with a net loan portfolio of LKR 8,817.2 Bn.

Domestic Systemically Important Banks (D-SIBs), comprising Bank of Ceylon (BOC), People’s Bank (PB), Commercial Bank (COMB) and Hatton National Bank (HNB), dominate Sri Lanka’s banking sector and accounted for 56.2% of industry assets as at end-2020, with the two state banks, BOC and PB, holding a combined 35.5% share of total industry assets.

This section analyses all listed LCBs and other banks with an asset size above LKR 200 Bn. These banks collectively accounted for approximately 88% of total industry assets as at end-2020.

Asset base comparison of select banks



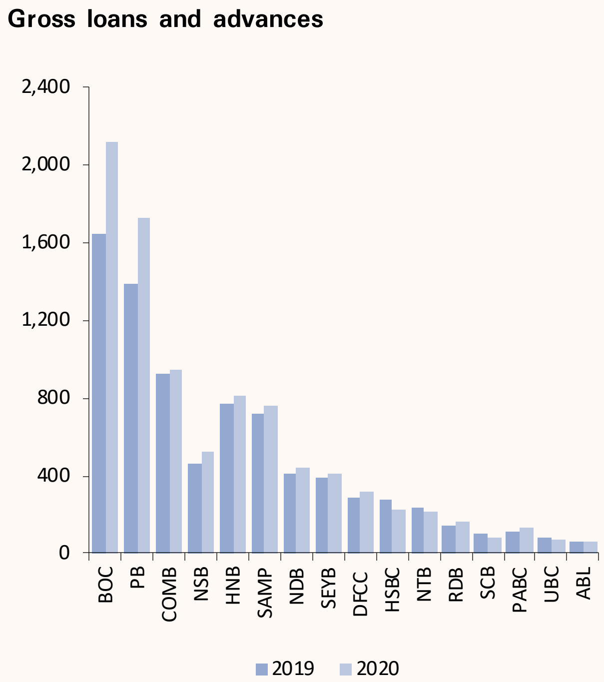
Banking sector analysis significant growth in loans and advances as GoSL funding requirements spike

Gross loans and advances reached LKR 9.1 Tn in 2020, up 11.9% YoY. Private sector credit accounted for about half the total amount but only grew 6.5% YoY. Net credit to the government reached LKR 4.5 Tn in 2020, up a staggering 62.7% YoY, as the Government of Sri Lanka (GoSL) borrowed to meet COVID-19 related and other recurring expenses. GoSL has continued to borrow heavily in 2021, with loans and advances increasing 63.1% YoY in January 2021 and 61.9% YoY in February 2021.

Gross loans and advances at LCBs rose by 12.6% YoY in 2020 (vs a five-year CAGR of 14.3% over 2015-2020) and were less affected than LSBs. LSBs accounted for about 8.8% of total gross loans and advances in 2020 and grew 5.5% YoY, significantly below the five-year CAGR of 11.9% over 2015-2020. This also led to the decline of the banking sector's Loan-to-Deposit ratio to 81.6% at end-2020 from 88.7% at end-2019.

We expect credit growth to drive bank income in 2021, as private sector credit increased by 10.5% or LKR 330.6 Bn in the first five months of 2021, despite the pandemic induced restrictions during 2Q2021. Based on our analysis, banks have budgeted for 10-15% asset growth in 2021 and, therefore, total banking sector assets could reach LKR 2.2 Tn more than current levels; private sector credit alone is estimated to contribute LKR 850 Bn, although this was revised down to LKR 750 Bn in May given the slowdown in the momentum during 2Q2021.

Steady economic growth is likely to generate demand for funds in the form of bank loans for consumption and investment. For example, the Index of Industrial Production (IIP), the Purchasing Managers' Index (PMI) and construction sector activities as measured by cement production have been improving since May 2020, creating demand for more bank financing for working capital, expansion and new investments.



Loans turned a corner in 2H2020 as banks opened their spigots

Gross Loans and Advances, private sector credit in particular, turned a corner in 2H2020 after remaining subdued from April 2020 through July 2020. Credit to the private sector grew 5.8% between June 2020 and December 2020, compared to only 0.6% in 1H2020.

The appetite for credit and the acceleration in disbursements were evident during the three months through March 2021 (1Q2021) when the credit consistently grew MoM before the restrictions were re-imposed from April.

This, together with improvement in margins and asset quality boosted the banking sector earnings to record its highest ever quarterly earnings performance in 1Q2021.

Key components of the economic revival plan included monetary stimulus in the form of consecutive cuts to key policy rates and a refinance scheme titled, 'Saubagya Covid - 19 Renaissance Facility' that released nearly LKR 178 Bn worth of CBSL liquidity by way of working capital loans at 4%, as well as money market liquidity at record high levels.

Other macro-prudential measures such as slashing rate caps on administrative loan products and setting lending targets on priority economic sectors also helped the banking sector to disburse more private sector loans than in 2019, despite the pandemic challenges of 2020.

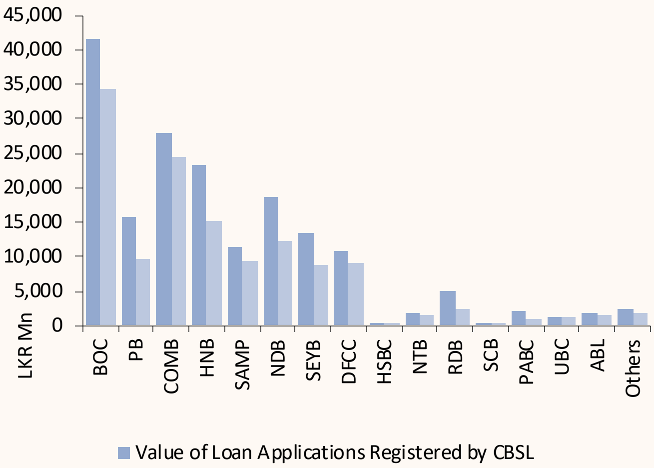
The twice upsized Covid-19 Refinance Facility received a three-month extension to its original six-month grace period, upon requests to provide further relief to borrowers affected by the second wave of the virus.

Saubagya COVID-19 renaissance facility supporting businesses

In 2020, the CBSL offered COVID-affected businesses a new refinancing facility for working capital titled 'Saubagya COVID-19 Renaissance Facility'.

The program saw high demand that led to the initial six-month refinancing facility of LKR 50.0 Bn being increased to LKR 150.0 Bn in June 2020, with the deadline extended to end-September 2020. Subsequently, due increase in loan applicants, the LKR 150 Bn limit was also dropped.

Loans applications vs loans disbursed under the Saubagya COVID-19 Renaissance Facility (as at 15 Oct 2020)



As at 15 October 2020, the Saubagya COVID-9 Renaissance Facility had approved LKR 177.9 Bn in total loans for 61,907 applicants, of which over LKR 133.2 Bn had already been disbursed among 45,582 applicants.

In 2020, LCBs expanded outstanding private sector credit by LKR 374.0 Bn, up 6.5% YoY compared to LKR 235.5 Bn in 2019 (up 4.2% YoY vs 2018). The latest data could well be a forerunner for solid private credit disbursements in the next few months.

In 2020, LCBs expanded outstanding private sector credit by LKR 374.0 Bn, up 6.5% YoY compared to LKR 235.5 Bn in 2019 (up 4.2% YoY vs 2018). The latest data could well be a forerunner for solid private credit disbursements in the next few months.

Growth in sectoral credit

Loans to the broader agriculture and fishing sectors showed signs of picking up pace starting January 2020, when the new administration slashed borrowing costs and unleashed a large stimulus package to aid domestic production. Agricultural and fishing sector loan growth, which had slumped to 0.2% YoY in December 2019, picked up over 2020 despite pandemic challenges to record 3.9% YoY growth in December 2020.

Loans to the industrial sector accounted for nearly 40% of total outstanding loans and advances in the system by end-2020. Loans to the industrial sector picked up through January to March 2020, before plateauing from April 2020 to June 2020 due to COVID-19 related economic restrictions. However, loans to the industrial sector started growing again from October 2020 through December 2020, rising 4.7% YoY, benefitting from government policies, tax cuts and low-interest loan schemes aimed at industries engaged in value-added exports.

Within the industrial sector, loans to the construction sector accounted for 21.1% of total outstanding loans and advances in the commercial banking system and reached LKR 1.3 Tn, up 12.6% YoY, benefitting from the low interest rate regime.

Loans to the second largest segment, the Services sector (28%), however, remained a sore spot, albeit representing the largest segment of the economy. After bottoming out in December 2019, services sector loans hit its first snag in April 2020 due to pandemic-related restrictions, which continued until June 2020. Although loans to the sector started picking up from July 2020 through September 2020, the October 2020 lockdown slowed down loan growth and resulted in only 1.4% YoY growth in December 2020 compared to 3.1% growth in December 2019.

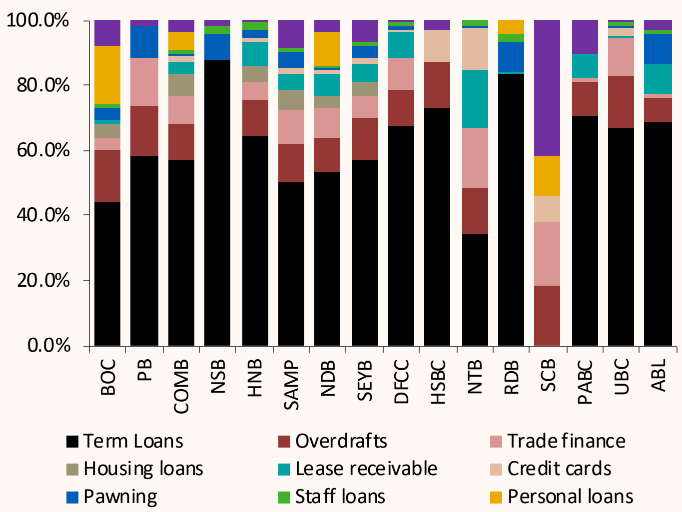
The services sector is highly susceptible to lockdowns, as it largely involves in-person dealings. Therefore, social distancing and the inability to engage in remote work adversely impacted sector performance. Personal Loans and Advances, accounted for 27% of total loans in the system by end-2020. Loans to the agriculture and fishing sectors accounted for only 7.7%, given that they are typically small-ticket loans.

Product-wise breakdown of gross loans and advances

A more granular analysis of the distribution of gross loans and advances based on product indicates that a significant share of each bank's outstanding loans is composed of 'Term Loans,' which typically have a broad definition and are therefore often clubbed together with several other products by some banks, making meaningful comparisons between banks difficult. However, there are clear signs of an increase in Housing Loans towards year-end, as well as a rise in Personal Loans, reflecting an increase in loans channeled into consumption fueled by low interest rates.

Term Loans and Overdrafts composed the largest share of gross loans (69.1% in 2020) and grew 13.8% and 7.3% YoY, respectively, in 2020 despite recording growth of 1.7% and 13.8% in 1H2020, compared to 2H2019. This was due to 11.9% growth in Term Loans and a 5.7% decline in Overdrafts in 2H2020 compared to 1H2020. Personal Loans showed the strongest growth, up 58.9% YoY in 2020, despite increasing only 4.3% in 1H2020 compared to 2H2019, reaffirming the pick-up in consumption. Trade Finance and Credit Card Loans witnessed the steepest declines in 2020, contracting 7.2% YoY and 3.3% YoY, respectively.

Composition of gross loans and advances - 2020



*Note: HNB, SAMP, SEYB, DFCC, HSBC, NTB, PABC, UBC, and ABL do not separately disclose personal loans. We expect these to be captured under term loans.

Outlook

The outlook for loans to the private sector remains favourable in 2021 after nascent growth in 2H2020, unless there is a complete shutdown of the economy as a result of a third wave. Further, all policies point towards unrestrained credit growth as the economy is still operating with significant slack. However, the two months long economic restrictions through June 21 to contain the virus spread and its lingering effects could soften the growth in loans, albeit that will still be higher than in 2020 and likely meet the revised private credit growth target of 12%, equivalent to about LKR 750 Bn for the full year.

In addition to the expected economic growth and regulatory support, several other factors could play a catalyzing role in bringing more vigor to loan growth.

These include:

- Historically low interest rates: The Monetary Board slashed the maximum interest rate on Housing Loans to 7% in December 2020 for salaried individuals
- Banks possessing substantial excess liquidity
- The 20% minimum lending growth target for the Micro, Small and Medium Enterprise (MSME) sector in effect since January 2021
- The domestic industrial and business policy tilt under the policy framework of the incumbent government.

Funding, capital and liquidity strengthened

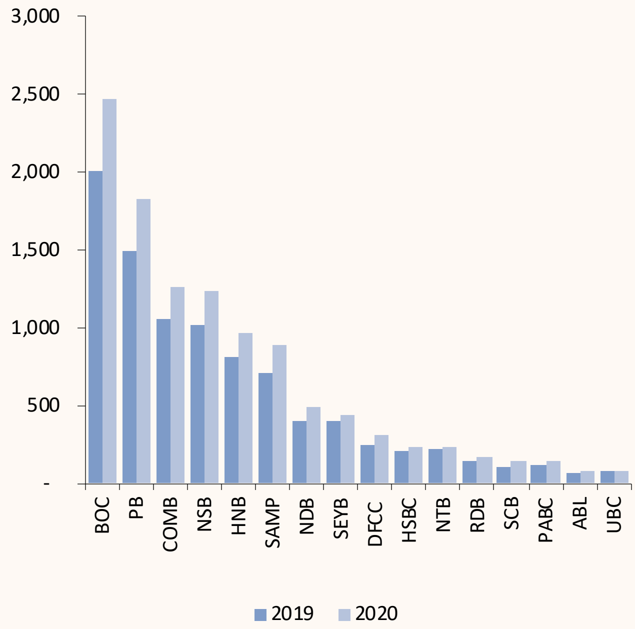
The funding profile of the banking sector remained solid in 2020, led by the record pile-up of deposits and new capital injections by way of equity and debt, cushioning capital and improving capital adequacy.

Deposits: CASA ratio increased due to limited opportunities

Deposits, the primary source of funding for LCBs, grew at a robust 21.6% YoY in 2020, or by LKR 1,978.7 Bn, almost double the growth in loans and advances in the system. Domestic and foreign currency deposits grew 21.5% YoY and 22.0% YoY, respectively, in 2020. 2014.

Deposits increased to 83.1% of total sector liabilities at end-2020 (compared to 81.6% at end-June 2020), the highest level recorded since

Total deposits

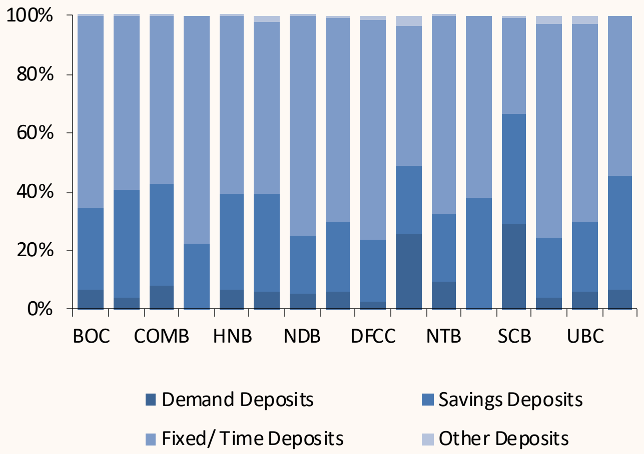


LSB deposits grew to LKR 1,553.6 Bn, with companies stockpiling cash as they rushed to build liquidity by way of deferred investments, held off on operational expenditure and expanded working capital cycles to conserve cash, resulting in a build-up of deposits in banks . This reflected growth of 21.6% YoY in 2020 (vs a five-year CAGR of 15.2% over 2015 to 2020). LSB deposit growth was also driven by reduced consumption from lockdown-influenced restrictions.

However, as the economy returns to normal operating conditions, cash deposits are likely to be utilised for retail spending such as fashion, entertainment, travel and leisure, and all types of activities that were put on hold in 2020 – driving consumption and the economy. This expectation is supported by an increasing Consumer Confidence Index (CCI), which rose from the 41 recorded in December 2020 to 44 in March 2021. However, the CCI remains below the 68 recorded in July 2020.

Another notable development in the deposit build-up of 2020 was that the banks were able to reverse the years-long decline in low-cost deposits, measured through the CASA ratio.

Composition of deposits - 2020

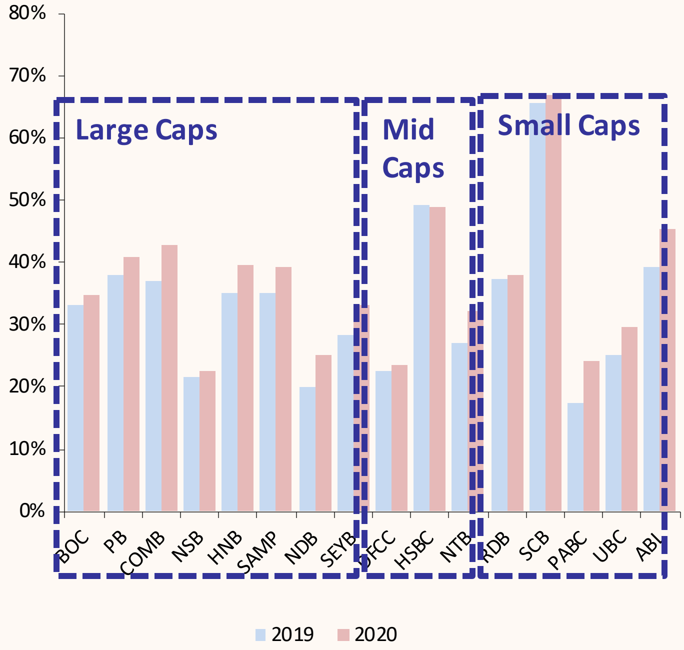


This was due to salaried individuals' monthly pay-check being left in their savings accounts during the lockdown, while companies' cash balances were also building up in their current accounts. As people stockpiled their earnings in banks, unspent salaries typically went into a savings account each month. Similarly, companies preserved their liquidity as they.

As a result, the banking sector CASA ratio improved to 34.8% by end-2020 from 31.6% at end-2019. The CASA ratio of the small-caps averaged 41.5% at end-2020 compared to 36.9% recorded at end-2019. The CASA ratio of mid-caps increased slightly to an average 34.9% at end-2020 compared to 33.0% at end-2019. Large-caps showed an average CASA ratio of 34.8% at end-2020 compared to 31.0% a year ago.

The rising CASA is a boon for the banks at a time of declining margins, as it allows the sector to maintain low funding costs despite lending rates that have descended to all-time lows.

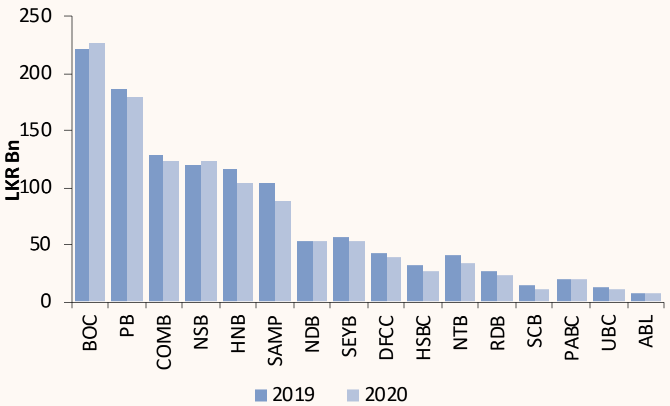
Current Account Savings Account (CASA) ratio



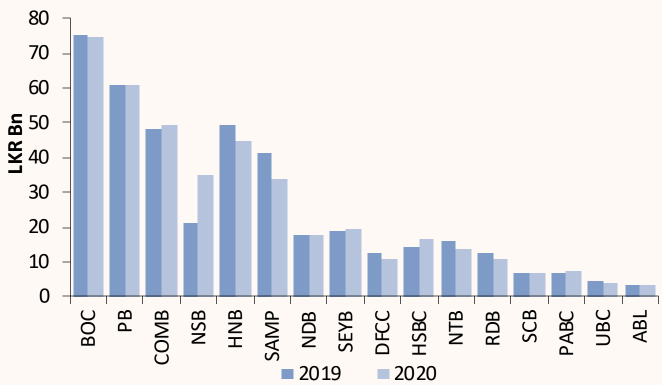
Net interest margin continued to decline with rates at their lowest but improves in 2021 with deposit re-pricing

Net Interest Income (NII) for the overall banking sector declined 2.2% YoY in 2020 to LKR 1,042.4 Bn. The situation was more pronounced in 2Q2020 and 3Q2020, which saw NII fall by 3.3% and 3.9% YoY, respectively.

Interest income



Net interest income



The poor performance in NII can be attributed to the following reasons:

- Payment holidays and/or the moratorium on loans granted from 1 April 2020 (there was already a segment of loans under moratorium prior to the pandemic, for the tourism sector on account of the Easter Sunday attacks in 2019).

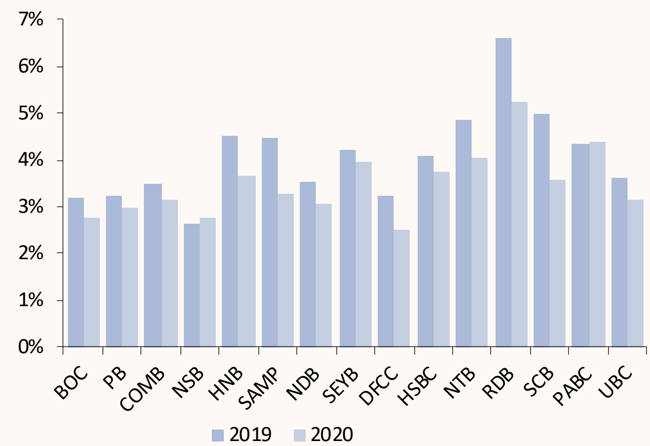
* (See Special Notes on Treatment of Moratorium on page 45)

- The decline in lending rates throughout 2020 to historically low levels in response to massive monetary stimulus (the monthly AWPLR fell 418 basis points in 2020 to 5.82%). This was partially due to modification methods under SLFRS 9, requiring the day-one loss arising from the loan moratorium to be recorded against interest income.
- A rapid decline in the yields of government securities as significant assets (excess liquidity) were placed in treasury bills and bonds earnings, resulting in only a nominal yield.
- The introduction of interest rate caps in August 2020 on select administratively managed loan products such as Credit Cards, Housing Loans, Overdrafts and Gold-backed Loans.
- Interest in Suspense on account of delinquent loans, which rose slightly compared to 2019.

The impact on LCBs was significantly greater than on LSBs. NII at LCBs declined by 3.3% YoY in 2020 (vs a five-year CAGR of 10.5% over 2015-2020), as opposed to LSBs, which grew 5.8% YoY (in line with the five-year CAGR over 2015-2020).

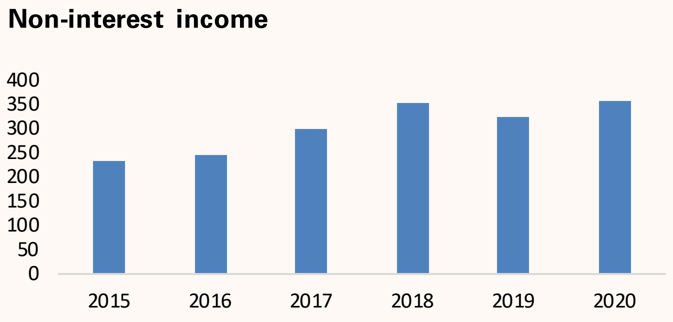
While it is not atypical for NII and the NIM to come under pressure when interest rates are on a fast descent, 2020 has been abnormal for the sector due to payment holidays which had to be extended to a large swathe of loans, foregoing interest income. In addition, loan growth did not pick up as quickly as expected in response to the historically low interest rates, as the pandemic-induced shock reverberated throughout the economy for a prolonged period. As a result, the banking sector's NIM slipped to 3.1% in 2020 from 3.6% in 2019

Net interest margin (NIM)



Non-interest income

Non-interest income, of which the larger share is net fee and commission income, rose 10.7% YoY in 2020 to LKR 358.1 Bn.



Non-interest income increased mainly due to net other operating income, which strengthened due to net gains from de-recognition of financial assets such as debt securities. The gains were also supported to a lesser degree by foreign exchange gains from spot and forward contracts, and foreign currency reserve revaluation gains.

Net fee and commission income bore the brunt of the pandemic-induced challenges, with the exception of fee incomes generated from increased digital banking as individuals and businesses shifted to remote banking due to movement restrictions, as well as trade-related fee incomes to a lesser degree.

The de-recognition of financial assets such as treasury bills and bonds accumulated through parking excess liquidity in government securities helped these assets to record higher capital gains in 2020 as falling interest rates enabled banks to book higher capital gains.

However, in a more recent development January 2021, the CBSL decided to suspend banks from entering forward contracts of foreign exchange for a period of three months to prevent parties from over-speculating on the LKR-USD exchange rate, which has witnessed undue pressure since the beginning of 2021.

Causes for fee incomes to decline in 2020:

- Regulatory mandated suspension (or refunding) of fee and commission incomes to provide relief to customers affected by the pandemic, as instructed in March 2020.
- Slowdown in overall credit growth, as loans largely drive fee income.

As a result, net fee & commission incomes, which otherwise partly offsets pressure on NII, could not play that role in 2020 due to the unique circumstances created by the pandemic.

Outlook

We expect the NIM to show a slight improvement, or at least settle at 3.5% through 2021, considering the deployment of excess liquidity as loans and re-pricing in deposits under low rates. As loan growth starts to gain pace, NII is expected to fare better in 2021, providing much-needed heft at the topline for the banking sector.

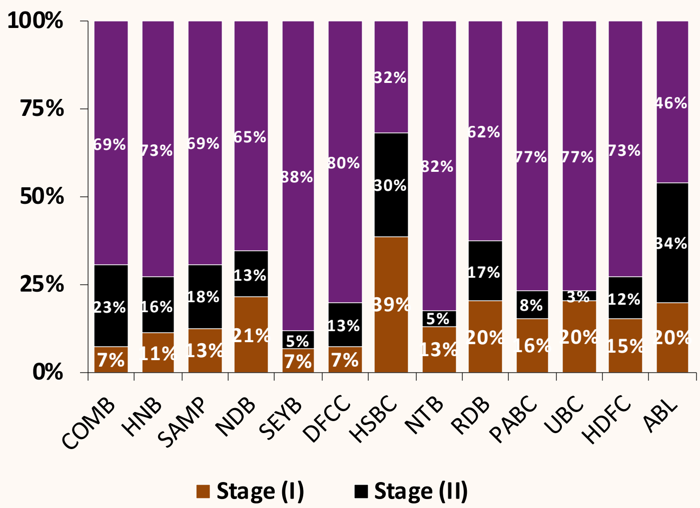
The banking landscape is expected to shift to a high-volume, low-margin model as the Sri Lankan economy is operating in a historically low interest rate environment.
Meanwhile, non-interest income will also gather pace with the restoration of fee and commission income as economic activity gains momentum as seen from the interim reports of almost all listed banks for 1Q2021.
However, banks being made to maintain restraint on financing imports amid the current crunch on foreign liquidity could slow the fee and commission incomes as well as other forex related incomes during 2021.

Provisions peaked in 2020

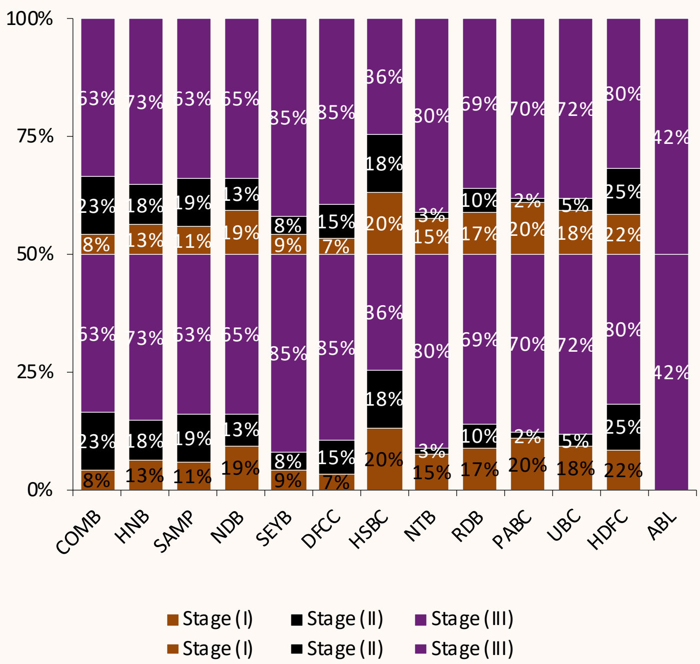
In 2020, provision for Bad and Doubtful Debts and Loan Write-offs rose by a substantial 55.0% (reaching a total LKR 222.5 Bn), due to the bleak economic outlook created by the pandemic and the downgrade of the sovereign rating by international rating agencies.

If there was a single line item which weighed heavily on banks earnings in 2020, it was 'impairment,' coming as a double whammy – through loans, as well as through SL-ISBs and SLDBs held by the banks.

Impairment charge on gross loans & advances - 2019



Impairment charge on gross loans & advances - 2020



Provisions attached to loans and advances stemmed from:

- Stringent evaluation of individually significant borrowers for signs of trouble, whether or not under a payment holiday.
- All banks assuming the worst-case scenario for the macroeconomy under the Economic Factor Adjustment (EFA) under Collective Impairment of ECL, resulting in higher impairments.
- Downgrading of loan segments operating in high-risk industries (such as tourism, passenger transport and other industries affected by a prolonged pandemic impact) through Stage-wise brackets (from Stage 1 to Stage 2 to Stage 3), resulting in heavier provisions and Non-Performing Loans (NPLs) in the worst case. If a customer descends to Stage 3, considering their increase in Probability of Default (PD), the banks recognise further impairment on account of loans under moratorium, assuming potential negative implications once the moratorium expires. This is referred to as 'Management Overlay'.

The situation was exacerbated by banks having to book higher impairments on their investments in dollar-denominated bonds – Sri Lanka International Sovereign Bonds (SLISBs) and Sri Lanka Development Bonds (SLDBs) – as they were required to apply a higher loss rate under the PD specified by Moody's Investors Service after the rating agency downgraded Sri Lanka by two notches to Caa1 from B2 at the end of September 2020. Risk of holding such bonds further rose in 2Q2021 with the increase in the foreign currency funding and liquidity risks facing the Sri Lankan sovereign.

As a result, provision cover measured by the Total Provision Coverage Ratio 1 in the banking sector reached 61.3% in 2020 from 52.3% in 2019, the highest since December 2017, while the same for the LCBs climbed to 64.7% in 2020 (54.0% in 2019), the highest since March 2018.

Meanwhile, the Specific Provision Coverage Ratio of the banking sector surged to 51.7% in 2020 from 42.4% in 2019.

Non-performing loans

The banking sector's Gross NPL ratio ended 2020 only slightly weaker YoY, at 4.9% compared to 4.7% at end-2019 and dropping steadily from 5.4% in June 2020 and 5.3% in September 2020.

While the asset quality as measured by the Gross NPL ratio further improved to 4.6% at the end of the 1Q2021 due to improving economic conditions, credit costs are likely to be on par with 2020. This would be due the expiry of relief measures affecting asset quality as well as concerns on borrower's solvency. CBSL launched a fourth round of moratorium on loans from 15 May 2021 to provide payment relief to the affected borrowers.

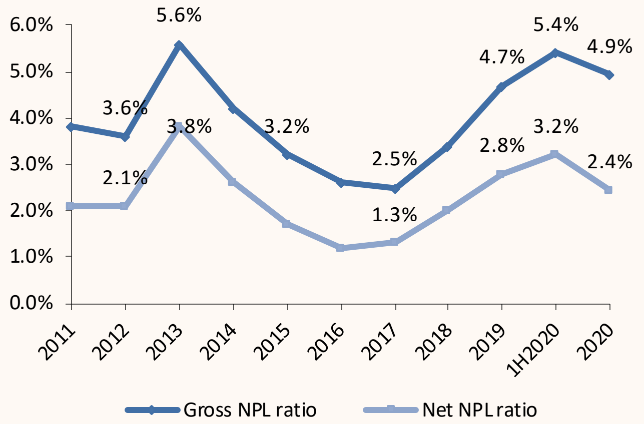
NPLs peaked in 1H2020 but moderated during the second half of the year, in what appears to be the result of the regulator intervening to launch broad-based payment holidays in the financial system.

LCBs fared even better in containing delinquencies, with an NPL ratio of 4.7% by end-2020 compared to 4.6% in 2019. On an absolute basis, however, Gross NPLs rose by 15.7% YoY in 2020 .

LSBs, which typically carry relatively higher NPLs than LCBs, recorded 6.9% compared to 5.5% in 2019.

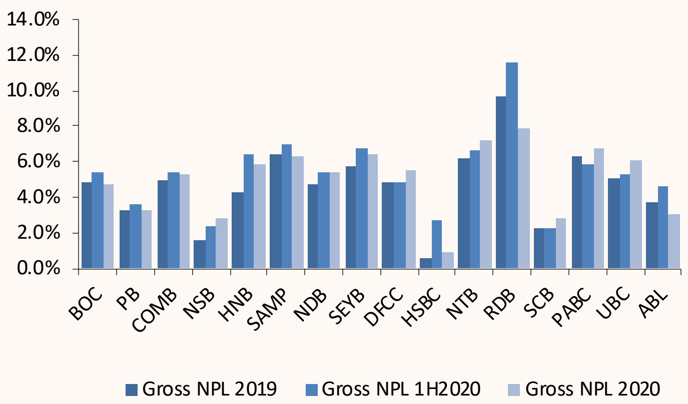
1. Total provision coverage ratio is the ratio of specific provisions and general provisions to non-performing advances net of interest in suspense.
2. This was implemented via Circular No. 04 of 2020, titled 'Relief Measures to Assist COVID-19 affected Businesses and Individuals' and subsequent extensions, part of a wide-ranging relief package to arrest the economic fallout from the pandemic.

Banking sector NPL



NPLs sector-wide as at end-September 2020 (latest available) were reported, with the manufacturing sector recording the highest NPL ratio at 8.7%, followed by trade at 7.4%, agriculture at 6.9%, tourism at 6.8% and construction at 6.4%.3.

Gross NPL of banks – 2019-2020



After the first round of moratoria phased out in September 2020, banks did not record a sharp increase in NPLs, perhaps indicating that borrowers had started servicing their loans. Moreover, reflecting the gradual return to 'normal' business activity, there was a drop of as much as 50% in moratorium applications for the second round of relief extended in October 2020. Therefore, although asset quality in 2020 was only slightly weaker versus 2019, reported NPLs could mar the true picture as a section of loans remain under payment holidays or moratorium, while another section was either restructured or rescheduled by the banks.

Outlook

While the outlook remained largely positive for provisions for credit and other assets in the 1Q2021, conditions turned dour as the virus related restrictions from April third week took a heavier toll on the borrowers while delaying the recovery in the MSME sector which forms the bulk of the moratoria.

However, a faster-than-anticipated economic recovery, coupled with a restoration of the cashflows disrupted by the pandemic in economic segments related to tourism, entertainment, exports and other in-person services, could soften the provisions.

Capital: Borrowings and Equity

Borrowings

Borrowings by way of corporate debentures, call borrowings and refinance borrowings in the rupee market surged by little under LKR 99.4 Bn in 2020 compared to a decline of LKR 47.0 Bn in 2019. This may be due to the larger banks in particular seeing significant growth in deposits due to inflows from finance companies and smaller banks.

Given the lower interest rate environment, there were 8 primary debt issuances in 2020, lower than the 11 in 2019.

Net foreign currency borrowings declined by LKR 86.6 Bn in 2020 due to foreign currency settlements by banks. Even though foreign currency borrowings from DFIs gathered momentum following the lockdowns, settlements outpaced fresh borrowings.
.

Foreign borrowings by banks include:

- A USD 60.0 Mn medium-term funding line raised by Hatton National Bank by Proparco, the private sector funding arm of the French Development Bank Agence Française de Développement (AFD) in October 2020.
- USD 35.0 Mn raised by National Savings Bank from a consortium of Indian banks in January 2021.
- Nations Trust Bank accessing USD 25.0 Mn from IFC as a loan facility for on-lend to pandemic-affected businesses.

A few other banks are already in discussion with several Development Financial Institutions (DFIs) for further funding in foreign currency as the banks leverage their own balance sheet strength to raise money.

Equity

A few banks also raised equity through private placements and equity-like bonds in 2020. In October 2020, USD 50 Mn (~LKR 9.2 Bn) was raised by Commercial Bank of Ceylon PLC, for a 10.5% stake in the bank to a consortium of three investors led by IFC.

Bank of Ceylon raised LKR15.0 Bn in BASEL III-compliant Perpetual Bonds, which qualifies under Additional Tier I Capital, through two issuances in June and November 2020.

In June 2020, National Savings Bank, announced the issuance of a similar bond to raise LKR 5.0 Bn to bolster its capital and sought a rating on the instrument from ICRA Lanka Limited. The momentum is expected to continue, as seen from the announcement by NDB in March 2021 of the investment of USD 3 Bn by Norfund, the Norwegian Development Finance Institution, in return for a 9.99% stake in the bank via a private placement. Norfund has also stated that it would participate in NDB's LKR 8.0 Bn right issue should there be any unsubscribed rights.

The banking sector's ability to generate higher earnings in 2020 also enabled the sector to cushion its equity base in 2020, providing further heft to the capital, with 11% of capital funds being supported by improved earnings.

Capital adequacy and liquidity positions remain stable, backed by the regulator

Despite pandemic-induced shocks, the banking sector maintained itself above the minimum capital adequacy requirements. The sector's total Capital Adequacy Ratio (CAR) was 16.5% at end-2020, consistent with 1H2020 and end-2019 levels. Meanwhile, the Tier 1 Capital ratio remained at 2019 levels of 13.0%, albeit slightly lower than the 13.1% reported in 2018. Meanwhile the two ratios improved in 1Q2021 to 16.6%, and 13.3% respectively reflecting stronger earnings.

Revised Capital Adequacy Requirement

	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%

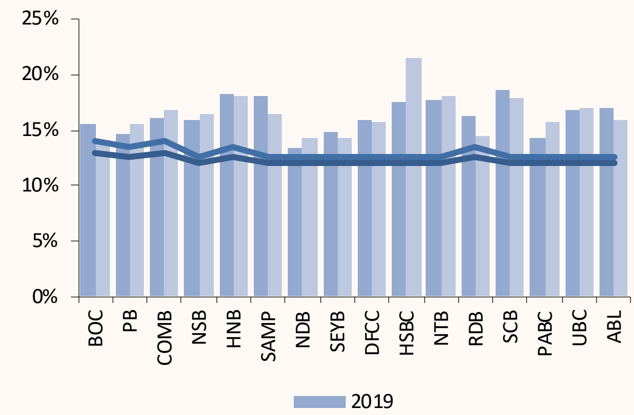
LCBs and LSBs have been granted an additional two years until December 2022 to meet their minimum core capital requirements of LKR 20.0 Bn and LKR 7.5 Bn, respectively. This extension has helped some of the small banks but did not have an impact on mid-sized and larger banks that already met this criteria.

In a further move to support the banks' capital, in September 2020 CBSL-permitted banks were allowed to sell up to 20% (to be gradually reduced to 15% within 10 years) of their shares to multilateral financiers such as IFC and Asian Development Bank, while others could do so with the approval of the Monetary Board.

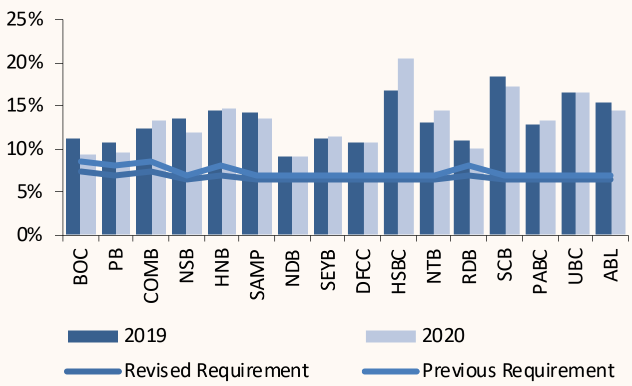
These interventions to preserve capital, alongside anemic growth in loans or risk-weighted assets, substantial retained earnings and new capital raising, helped the banks to remain above their minimum Capital Adequacy levels through 2020, as required under their respective buckets re-classified by the CBSL: D-SIB (Bucket 1), D-SIB (Bucket 2) and Domestic N-SIBs.

However capital adequacy depletes with the reduction in value in foreign currency denominated government securities such as ISBs, as there is a capital charge against the increased credit and market risk of holding them amid increase sovereign risk.

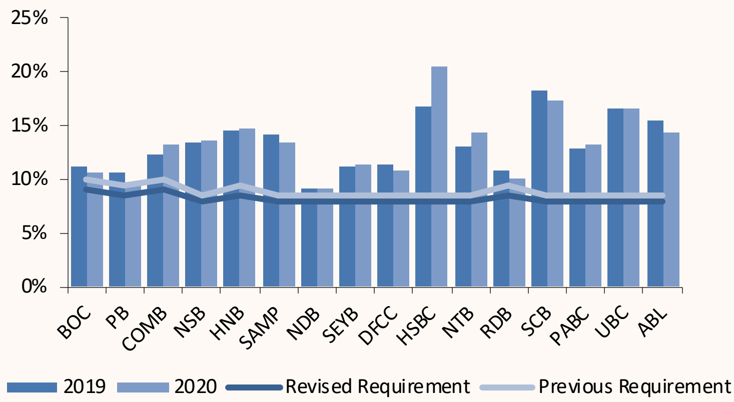
Total capital adequacy ratio



CET 1 ratio



Tier 1 capital adequacy ratio



Liquidity

In 2020, several factors supported the banking sector to build up liquidity beyond the level required by the regulator:

Lowered policy rates

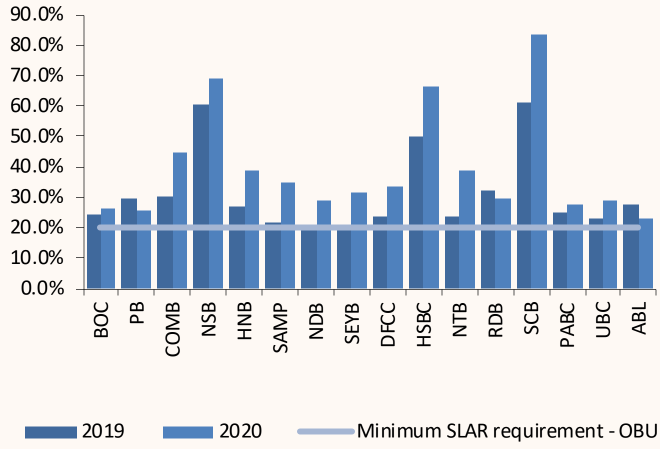
- Reduction in the daily reserve requirement to 20% in April 2020 from 90%, with the aim of allowing LCBs to comfortably manage their respective overnight liquidity requirements.
- Lowering of the SRR in June 2020; this released LKR 115.0 Bn in additional liquidity into the domestic economy.
- Changes 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.
- Lowering of the minimum requirement for the Net Stable Funding Ratio to 90% in May 2020 from 100% previously.
- Restricted discretionary payments of LCBs in May 2020 until end-2020, including declaration of cash dividends and repatriation of profits.

Furthermore, slow growth in loans in 2020 led to a reduction in the Credit-to-Deposits and Borrowings ratio by 407 basis points over the year, increasing sector liquidity.

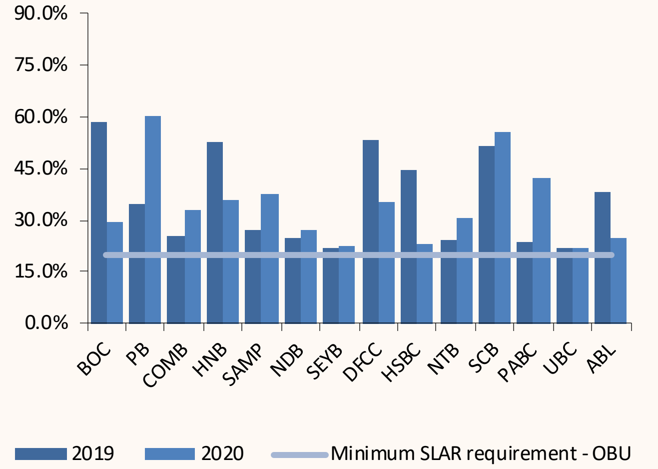
These factors combined to result in the banking sector reporting a SLAR of 37.3% by end-2020 (under the Domestic Banking Unit), up from 31.0% in 2019, compared to the 20% minimum requirement.

In the Offshore Banking Unit, the SLAR reached 43.2% in 2020, down from 47.1% in 2019, as banks retired part of their foreign currency liabilities in 2020.

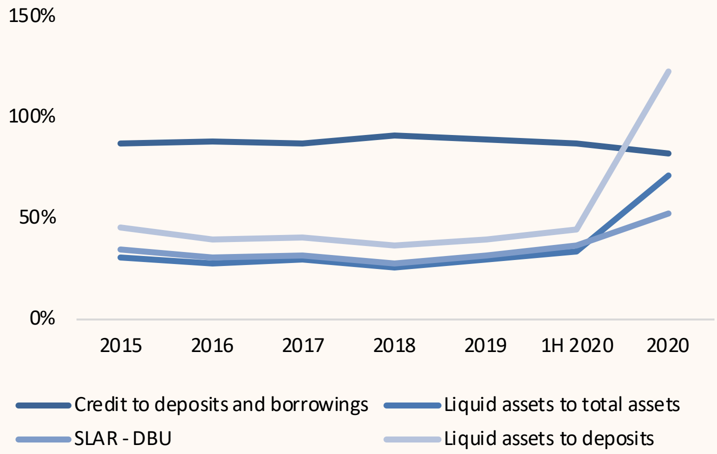
SLAR (DBU)



SLAR (OBU)



Liquidity ratios of the banking sector



Outlook

Banks are expected to continue to remain well capitalized in 2021 as they continue to seek avenues to bolster capital buffers. Organic capital growth also remains a possibility, through capitalizing earnings, which are expected to be substantially higher than in 2020 due to the improved earnings potential amid accelerated loan growth.

While the excess liquidity in the system is anticipated to come down from 2020 levels through deployment as relatively high-yielding loans and advances, banks are unlikely to come under any undue pressure to maintain sufficient liquidity in 2021.

Several banks have already announced capital augmentation plans for 2021 commensurate with their growth targets, and hence sector liquidity will continue to remain at comfortable levels, as the current excess liquidity appears to be more than required to meet the projected growth in private sector credit and broader growth in loans and advances in 2021.

Banks significantly reduce cost-to-income ratios

The sector's CIR declined in 2020, a result of limited branch operations during lockdowns and bank-wide cost rationalization measures instituted as soon as the conventional banking business model was disrupted. Other contributing factors included lower utility expenses, inter-regional visit cancellations due to COVID-19, and digitization of most transactions.

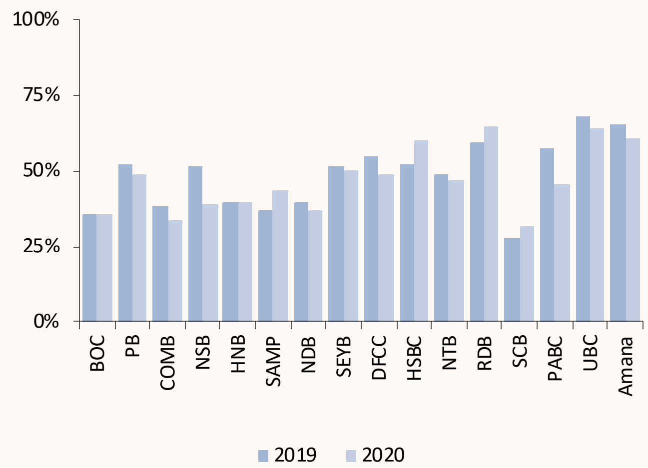
With movement restrictions and the need to work and conduct business from home, individuals and small businesses turned to digital platforms for banking services. This was reflected clearly in digital fee incomes, which rose by double digits, as well as in overall Net Fee & Commission Incomes, which fell due to regulatory mandated fee waivers and relatively slow activity.

Meanwhile, data showed that internet-based payment volumes increased by 56.8% YoY in 3Q2020. Operating expenses declined by 3.9% YoY in 2020, resulting in the Cost-to-Income ratio declining to 75.7% in 2020 from 77.8% in 2019, buttressing earnings.

Banks have broadly decided to roll back earlier plans for brick-and-mortar expansion in response to the reasonably successful adoption of digital banking platforms by clients. This will hold off most of the moneys earmarked for new branches, new staff and systems, thus saving overheads.

The prevalent work-from-home and flexible working arrangements would lower operational cost as banks adapt to the emerging new working arrangement after a reasonably successful experiment during lockdowns. The repeated disruptions into in-person activities should further embolden the banks' shift to virtual platforms improved levels of efficiency.

Cost-to-income ratio



Banks recorded profits supported by a resurgent economy and regulatory support

Despite the substantially higher provisions for possible loan defaults necessitated by the pandemic and the 'Management Overlay,' listed banks recorded higher earnings in 3Q2020 and 4Q2020 versus the first half of the year.

Banks largely mitigated the vagaries of the pandemic to deliver their best earnings performance in 2020, translating into a 17.8% YoY increase in profit after tax. In 2020, Return on Equity (RoE) reached an average 11.3% (10.3% in 2019). before shot up to 16.0% in 1Q'21 on even stronger earnings.

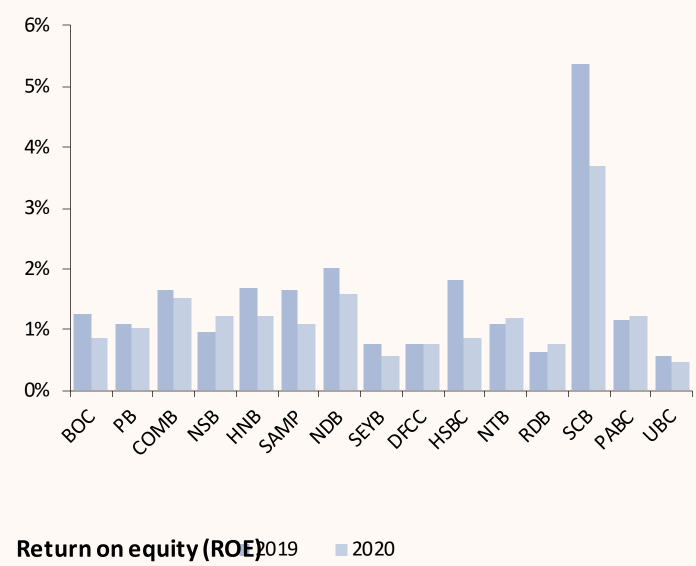
RoE was in decline since 2018 due to the sustained build-up of capital by the banking sector to stay in line with mandated minimum capital levels. This situation was exacerbated by the slowdown in earnings growth due to subdued loan growth.

The higher earnings and RoE in 2020 were predominately supported by:

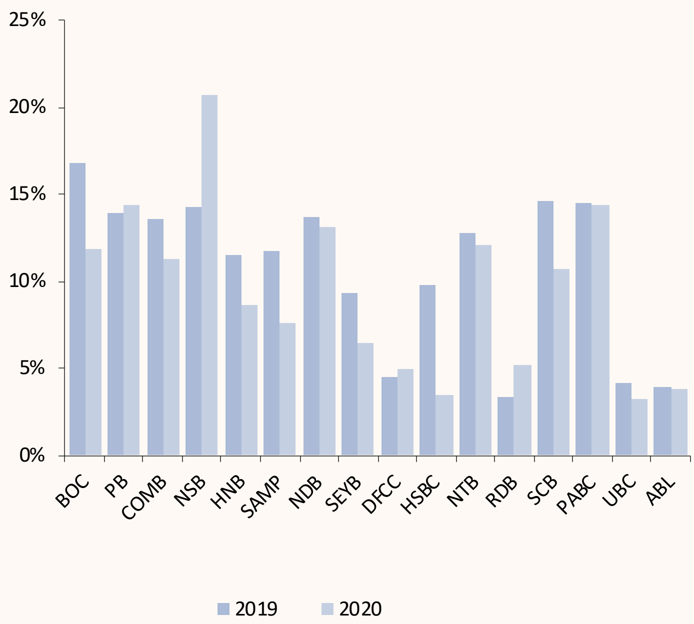
Removal of the 7% Debt Repayment Levy and the 2% Nation Building Tax (NBT) on Financial Services, resulting in a lower Effective Tax Rate for banks, Decline in operating expenditure, Higher pre-impairment profits, resulting from the increase in private sector credit and other operating incomes.

Return on Assets (RoA), another measure of profitability and efficiency, remained flat at 1.4% between 2019 and 2020 before sharply rising to 2.0% in 1Q2021, reflecting higher efficiency in utilizing assets.

Return on Assets (ROA)



Return on equity (ROE)



Outlook

As provisions for credit losses are expected to soften in 2021 on the back of the resurgent economy, earnings could gather further momentum from end-2020 levels.

This was amply evident from 1Q2021 listed banks' earnings which soared by 70% YoY and 33% QoQ to LKR.24.9 Bn, a record high.

This growth would be in addition to higher NII and Fee and Commission Incomes stemming from accelerated new loan growth in 2021. However, with the resurgence of the virus and its lingering impacts could slowdown the pace of earnings growth in the year, although the earnings would still be higher than in the FY20 from higher margins and higher loans.

CBSL extended the moratorium and introduced other measures

Phase I: Moratorium (1 April 2020 to 30 September 2020)

Under the 'Modification Method' prescribed in IFRS 9, banks recognised a 'Modification Loss' against interest income as the Day 1 impact of the Phase I Moratorium on both capital and interest kicked in from 1 April 2020 through to 30 September 2020. In this phase, banks were advised by the CBSL to recover the capital of those loans under moratorium at the end of the loans' tenure by adding an extended tenure equal to the period of the moratorium (six months) and to charge interest of a maximum 7%, or a rate agreed on with the borrower, for this extended period. This mechanism applied to those loans categorised as 'Equal Monthly Instalments, (EMI) Loans, which are facilities with a specific instalment value, due on a specific date of the month. These include term loans, personal loans, lease rentals and housing loans.

For credit facilities not included under EMI Loans, such as overdrafts, the banks converted the capital and interest due during the period of the moratorium into a new term loan.

Phase II: Moratorium (1 October 2020 to 31 March 2021)

For the Phase II Moratorium, starting 1 October 2020, banks did not recognize the 'Modification Loss,' as they were allowed to recover interest at the original Effective Interest Rate (EIR) during the moratorium period.

Therefore, banks converted the capital and interest due during the Phase II Moratorium into a term loan, repayment of which will commence from 1 July 2021. The tenure of the new loan would generally be two years, but the specific terms and conditions can be agreed upon between the borrower and the bank.

Phase III: Moratorium (1 April 2021 to 30 September 2021)

In a more targeted round of relief, banks are to accommodate payment holidays for leases on vehicles engaged in the passenger transport sector, including the tourism sector, and for facilities in the broader tourism sector, given the lingering negative effects of the pandemic on these sectors.

Banks will hold off on collecting the capital and interest components of these leases and other facilities for six months starting 1 April 2021. The moratorium on leases is only recoverable from April 2023, unless along with the existing lease instalments falling due during this period for facilities ending before April 2023, financial institutions can recover interest upon the completion of the remaining tenure of the lease facility.

Phase IV : Moratorium (15 May 2021 to 31 August 2021)

The CBSL provided another round of moratorium from 15 May 2021 for three and a half months to provide payment relief for the borrowers affected by the third wave of the pandemic.

Going **Digital**, Faster

"The pace and the degree of digital transformation is accelerating in the wake of COVID-19, with ever greater pressure to meet customers wherever they are. This calls for flexible, 'commerce everywhere' business models, and a renewed focus on employee experience to drive an enhanced customer experience."

Gaining a digital edge

To compete in the digital, post-COVID-19 age, organizations must attain the capability to connect digitally with customers, suppliers and employees. This means addressing five key challenges:

Digital Acceleration

Rapidly build a digital technology infrastructure, to connect front, middle and back offices, encompassing HR, IT, finance, operations, procurement, marketing, sales and customer service.

Customer behavior

Create customer-centric business models where customers buy and engage through integrated digital channels - increasingly with little or no physical contact. The customer experience must be relevant, personalized, differentiated and competitive. To understand customer needs and preferences, data and analytics should inform customer strategies and tactics across the converging front office of marketing, sales, service and commerce. This can help achieve the appropriate customer experience economics.

Supply Chain and operations

Supply chain and operations must become more reliable and responsive. By digitally connecting and working more closely with suppliers and service providers, companies improve flexibility to respond to fast-changing customer needs. Suppliers become an extension of the business and are involved in strategy and product development, thus blurring organizational boundaries. Indeed, the roles of varying players in the operations/supply chain may change continually up or downstream, as the chain becomes more modular in nature. By using internal and external data, available in real time, operations/supply chain leaders can use analytics to assess both demand and cost to serve, pick up early warning signals from the market and take swift, decisive action. Over time, decision-making should be enhanced by ever more advanced technologies and cognitive capabilities. The result? Greater operational resilience to ensure continued access to products, materials, people and services.

Ways of working

The way in which work gets done has changed and organizations must adapt, to become nimbler, scaling up or down swiftly, entering new markets and exiting old ones. COVID-19 has reinforced the need for efficient remote working, but companies also need to 'shape' their workforces, to ensure they can access the skills they need — when they need them. Many enterprises recognize the need to radically change their shape, size, and structure, and to acquire a range of new skills. Through strategic reskilling initiatives, and by embracing the professional 'gig' economy, they can benefit both workers and employers. Additionally, shared services, partnerships, alliances and strategic use of retired staff, brings access to vital talent on a short-to-medium term basis. The 'workforce of the future ecosystem' is becoming more and more digital, increasingly augmented by automation as well as contingent workers.

Resilience

COVID-19 has demonstrated that the 'digitally enabled' enterprise is in fact the 'resilient' enterprise; digitally enabled organizations have the capabilities to withstand the impact of pandemics (and other shocks) and should be far more agile on their path to recovery. And, because they benefit from enhanced insights, these organizations are less dependent upon manual intervention, location and market forces.

Short-term priorities call for long-term, digital solutions

COVID-19 has caused leaders to rethink their priorities, with an emphasis on immediate challenges. The leaders we surveyed highlight significant challenges like falling revenues, security concerns and interrupted supply chains, which have focused minds on the here and now and demand immediate action. In addressing these concerns, they are also starting to realize that the inexorable shift to digital has become today's — rather than tomorrow's — priority.

Top 5 COVID-19-related priorities

01 Loss of revenue

02 Increased security risk

03 Supply chain delays/breakdown

04 Development of new channels to serve customers

05 Modified service delivery arrangements to accommodate health and safety requirements

Strategic priorities amplified since COVID-19

- Driving revenue
- Improving customer experience
- Adding new digital capabilities
- Creating a digital business model
- Building new digital products and services
- Building digital platforms for customer-facing systems

Customer behaviour - The driver for centricity

There are **three defining characteristics** of customer-centric, digitally connected businesses

1. They think **'outside-in'** and intimately understand the evolving consumer and the marketplace
2. They create **engaging customer experiences** wherever the customer may be
3. They **execute seamlessly**, by connecting the whole enterprise and delivering as one.

The COVID-19 difference… rising customer centricity

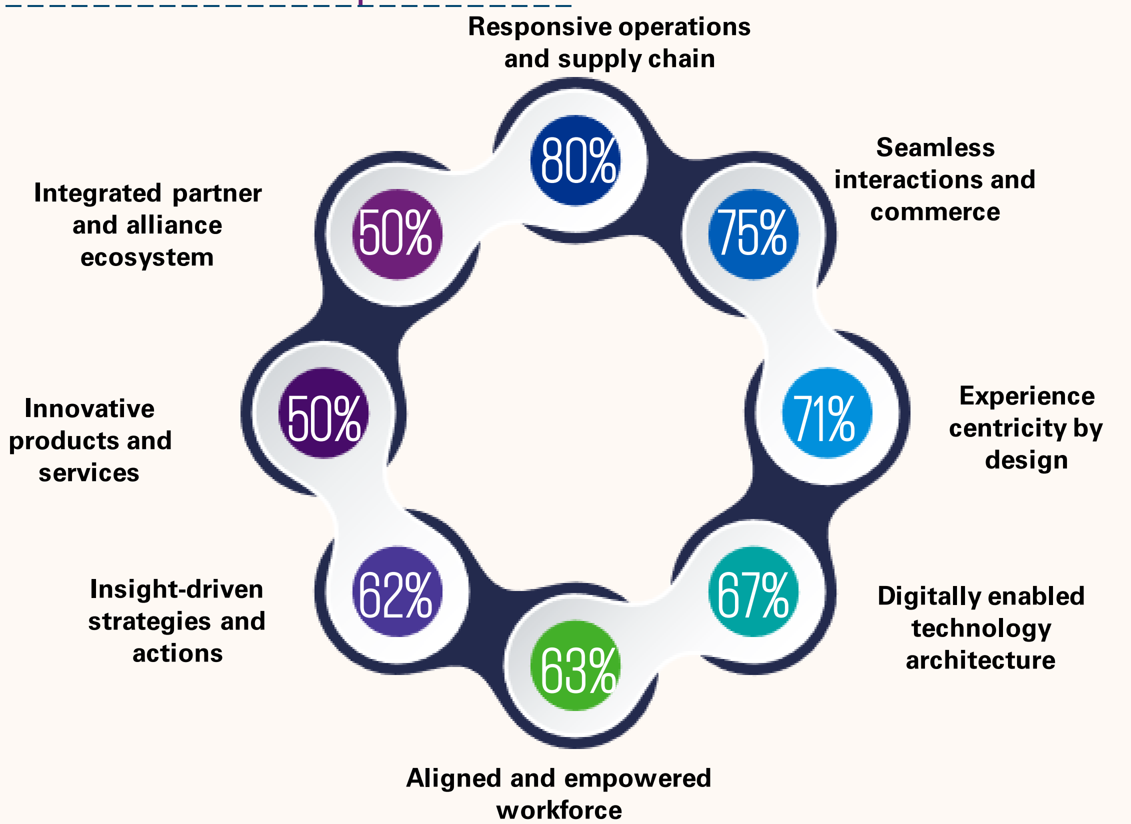
COVID-19 has focused minds even more keenly on customers, with a significant majority of respondents saying their organizations are accelerating such initiatives.

Among top digital transformation objectives pre-COVID-19	Proportion of respondents accelerating these initiatives
28%	44% Staying connected to market dynamics and digital signals
32%	58% Creating a customer-centric digital commerce system
46%	67% Improving the customer experience

The COVID-19 difference… the future of work

- 49% Employees incentivized/ mandated to wear personal protective equipment at work
- 47% Increased physical distance between workspaces
- 46% Mandatory temperature checks and travel histories for visitors prior to workplace entry
- 43% Increased need of tech support as employees return to the office
- 41% Maintain restrictions on noncritical business travel
- 39% Limit the number of people in each in-person meeting
- 35% Onsite workplaces brought back at reduced capacity to support social distancing
- 35% Employees allowed to work from home until they're comfortable returning onsite
- 30% Employees brought back to work in stages to reduce financial risk
- 26% Permanent move to a partial or full work-from-home operating model

Digital transformation priorities across the eight capabilities of a connected enterprise



Five actions you can take now

Operations/supply chain

Invest in real-time, predictive models, rethink the roles of each player in the supply chain, and introduce a more collaborative relationship with suppliers, to increase innovation and flexibility.

Customer

Put your customers first — at the heart of strategy. Become insight driven — know your customers at a deep and profound level. Practice customer foresight - to anticipate customer needs and become organized around the customer and able to meet the customer wherever they are.

Digital acceleration

If you're not digitally transforming at pace, the chances are you'll be left behind. Converge digital with broader strategy, to swiftly adopt new technologies and flexible, modular — in some cases virtual — organizational structures.

Ways of working

Focus on the capabilities you need in a future connected enterprise, and plan how to access these resources via permanent, gig economy or other partnerships, while investing in upskilling — especially in digital skills. Rethink the balance between physical and virtual assets and human resources, embracing automation.

Resilience

Consider the technologies that can get you closer to the customer, and help you manage a constant, heightened risk environment, particularly cyber security, governance and ethics. Your technology investments should be aligned with your wider strategic goal of customer centricity — which means focusing on the eight capabilities of a connected enterprise.

At the Intersection of **Resilience** and **Relevance**

"As financial services firms emerge from the initial disruption of the pandemic, many will be asking whether they are resilient and relevant enough to thrive in the new reality."

The pandemic has radically changed the environment in which financial services operate. Its catalytic impact has been obvious. It accelerated digitization by at least 5 years. It sparked new business models and technologies. It ushered in an unexpected era of remote working and decentralized workplaces. It sharpened minds around the Environmental, Social and Governance (ESG) agenda.

It changed the relationship between financial services firms and their customers. In the space of months, it did all of this and more.

Take a step back, however, and what starts to become clear is that the greatest impact of the pandemic has been on the definition of resilience and relevancy in the financial services space. It is the rapid evolution of those two concepts that have underpinned financial services organizations' responses to the pandemic. And it is those two concepts that will drive the strategy going forward.

A new reality emerges

Resilience and relevance have always been the cornerstones of the financial services industry. From the very earliest days, customers wanted resilience and relevance. Over the centuries, the definition of 'resilience' and 'relevance' continued to evolve as social expectations and market realities changed.

Now the definition has changed once again. Hitherto, most conversations about resilience in the financial services sector gravitated around financial resilience. Since the pandemic, this focus has rapidly broadened to include a wide range of **operational and market resilience** considerations.

Regulators, customers and executives all want to know that financial services organizations (and their wider ecosystems) are able to withstand a much broader basket of risks than simply financial ones.

The definition of relevance has also rapidly changed. In the past, market presence was tantamount to relevance; if you built a robust financial services infrastructure, customers would eventually come. Yet that is no longer true in today's environment. Customers have a wide range of alternatives and options when it comes to their money and their finances. Market presence and brand name are no longer enough to secure loyalty.

Find the intersections

The key to defining your future strategy as a financial institution, therefore, rests in your ability to remain resilient and relevant on an ongoing basis, adapting your strategy and activities as the definition of the two changes.

There are a handful of ‘intersection’ points where resilience and relevance coalesce. These are the areas where, perhaps, most financial services executives should be focusing first.

The impact that people, values and culture have on both resilience and relevance.

Customers want service providers that share their values (relevance). Employees want to work for companies that stand for more than just making shareholder profits (relevance and resilience). And, according to a recent survey of Financial Services CEOs by KPMG International, purpose also leads to more confident decision-making in a crisis (resilience).

How digital drives both relevance and resilience.

Digital enabled the rapid shift to the new reality workforce, delivering unprecedented resilience when the sector needed it most. Digital also enables the creation of new and innovative business models, products and channels which enhance relevance for customers and stakeholders.

Management of costs

Lower costs enhance resilience and lead to new operating models which enhance relevance, customer focus leads to more relevant products and services as well as a more resilient customer base, or even risk management which has an obvious impact on resilience but, when approached holistically, can also enhance relevance.

What should you do now?

The financial services executives and leaders should start by looking at your organization's present and future through the lens of resilience and relevancy. Consider the intersection points and how the definition of the two concepts are changing. Take the time to understand your stakeholder and customer needs related to resilience and relevance. Think about whether your organization is meeting those needs.

Time to get real

Unfortunately, not every financial Institution will be able to make the jump. Indeed, many will undoubtedly start to recognize they lack sufficient skills, resources, technologies or capabilities to achieve the types of changes they require in order to remain resilient and relevant into the future. Organizations and executives will need to be very honest about what they can practically achieve with the resources at their disposal.

Over the coming year, expect to see massive changes in the market as players start to grapple with – and eventually overcome – these challenges. Some of the largest and most innovative will double down on their efforts to build their own market-leading capabilities that drive resilience and relevance.

The vast majority of financial institutions, however, will likely choose to either leverage new technologies, tap into managed service models or enter into new alliance relationships in order to bridge existing gaps and secure the capabilities they require to remain resilient and relevant in the new reality. We will also see a significant number of organizations succumb to the pressure. Expect to see an uptick in merger and acquisition activity around the world as some organizations realize the gap is too wide (or the effort too exacting) for them to win in their chosen markets.

Future of **Retail** Banking

> *"Becoming a Connected Bank takes commitment and determination. Achieving it has become more important than ever before. It is the key to providing consumers with the enhanced customer experience that is fundamental to future success."*

Signals of change

Retail banking faces a more complex environment than perhaps ever before. Driven by COVID-19, the social and economic landscape has been radically reshaped while customer needs and expectations continue to dynamically evolve.

Customer

The global impact of COVID-19 has accelerated consumer expectations and shifted priorities. Those banks that are able to deliver seamless and personalized experiences to their customers, based on relevant data and insights will be best placed to grow market share.

Competitive

Incumbent banks are being challenged from all sides for market by a combination of neo banks and non-traditional participants. Longer term, customers will turn to alternative providers if their needs can be met more effectively.

Economic

The adverse economic headwinds of COVID-19 will challenge retail banking margins. Traditional profit pools are under threat causing retail banks to rethink their business and operating models in order to achieve profitable growth.

Regulatory

Globally, regulators will take an interventionist approach to increase competition, drive greater enterprise resilience, increase cyber security, protect data and support vulnerable customers. Retail banks will need to remain agile in their risk management approach.

Technological

Technology will continue to redefine the relationship between customer and retail bank. Banks need to prioritize their investment in current technologies in order to enable profitable growth and future agility, as well as to substantially reduce the cost of operations through automating manual, paper-based processes.

Key purchase drivers

- **Value for money**
- **Ease of buying**
- **Trust in the brand**
- **My personal safety**
- **Customer experience**
- **Range of products and services**
- **Staff/people policy**
- **Direct communications**
- **Brand's values match my own**
- **Support for local communities**
- **Brand's social conscience**
- **Brand's approach to the environment**
- **Personalization**

Competitive signals

Incumbent banks are being challenged from all sides for market share by a combination of neo banks and non-traditional participants. Globally, the market has been flooded with a new wave of growing neo banks. Unburdened by legacy technology and operating with greater agility, neo banks are able to offer personalized experience and seamless interaction craved by a generation who demand a smart digital experience.

Incumbents are also being challenged by a series of **non-traditional players**. In Asia, social media platforms such as WeChat have enjoyed success in offering banking services. Similar well-established online retailers such as Alibaba have begun to offer banking services drawing on their advanced technology and well-established customer base. The market has also seen the introduction of more **specialist providers**, operating in previously unexplored areas of the market. In Africa and Asia, **micro-financing** providers like Paytm are enabling unbanked customers to transfer funds using a telephone network without the complexity and fees of bank accounts. These are significant threats for **incumbent banks** who have been able to rely on direct customer relationships to ensure 'stickiness' and an opportunity to sell additional products and services. However, it is not all bad news for the incumbent banks.

Neo banks are still not widely used as a primary banking service. This is likely due to customer inertia or feeling that there is a lack of trusted viable alternative especially in light of the recent pandemic. However, we believe over the longer term, customers will turn to alternative providers if their needs can't be more effectively met.

Neo banks may defer profitability for scale and move towards larger, more exclusive customer base, thus challenging retail banks. Retail banks need to decide where to emulate competitors or band together to form partnerships to retain competitive advantage.

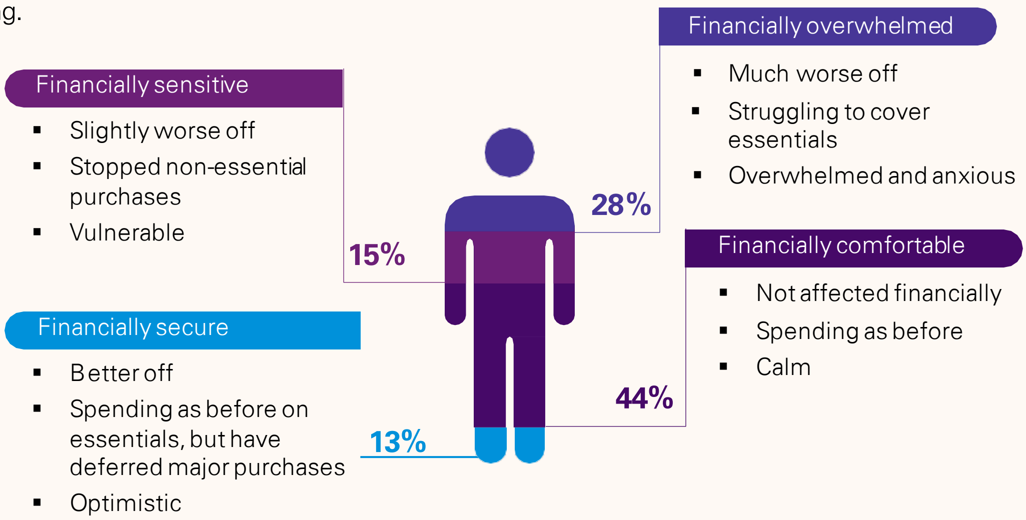
Economic signals

The adverse economic headwinds of COVID-19 will challenge retail banking margins. With traditional profit pools under threat, retail banks need to consider changes to their business and operating model. Digital transformation has become an imperative for retail banks' success.

The global economy remains in recession with the timing and path to recovery unclear. Consumer confidence is low, with redundancies commonplace. With the route to economic recovery uncertain, value for money has become the single most important factor in customer decision-making.

Half of respondents across all global markets feel this is more important now than pre-COVID-19.Income will be reduced due to an increase in bad debt and low interest rates limiting the capital available to retail banks for more profitable lending activity and applying further pressure to margins. We see some international banks retrenching from global markets and putting greater focus on their home markets. This is likely to have implications for customers. The viability of existing credit models within banks will be reduced, leading to a tightening of credit and limiting the appetite to lend until confidence is restored

"Just over half of consumers feel financially comfortable or secure versus 43 percent who feel overwhelmed or vulnerable"



Regulatory signals

Globally, regulators are likely to take an interventionist approach to increase competition, drive greater enterprise resilience, increase cyber security, protect data and support vulnerable customers. Regulators will also need to balance the need for banks to extend credit to support economic recovery efforts.

During the ongoing COVID-19 pandemic, many governments have provided stimulus funding to protect consumers and the wider economy. We expect this interventionalist approach to continue with regulators given sharper teeth to push forward with the regulatory agenda.

A growth in cyber attacks — for criminal gain or as disruptive weapon — will result in an increased regulatory focus on **security and cyber** controls. How these operate in a cloud-based environment will become a particular area of scrutiny.

Regulators will continue to drive competition through intervention, reducing barriers to entry and targeting incumbents with 'open banking' style requirements to open up APIs to access account information and payment functionality. Open Data ecosystems will create broader and more complex interactions with players from different sectors where the regulatory landscape is not level. Compliance with these regulations will not only present an increased overhead for banks, but will also challenge their top line growth as new 'digital first' competitors flood the market.

Unfortunately, the lasting financial impacts of COVID-19 will lead to a higher number of **vulnerable customers**. Banks will need to have a clear and justifiable approach to identifying and managing diverse types of vulnerable customer, supporting them in appropriate ways.

Data privacy regulation will accelerate. Regulation will focus on collection and ownership of personal and biometric data in the context of emerging technology. Additionally, it will be critical to balance privacy with the introduction of various forms of open banking/finance occurring in many markets. Increased clarity of requirements coupled with greater enforcement by local regulators will be needed to underpin customer trust.

The disruptive impact of COVID-19 will mean that **enterprise resilience** remains a top priority for regulators globally. Requirements will focus on providing continuity of technology systems and business services, with clear business interruption a planning to manage incidents.

"Retail banks need to consider how well they are organized to efficiently fulfil their significant regulatory and compliance obligations."

Technological signals

Technology will continue to redefine the relationship between customers and retail banks. Our research indicates efforts around a digitally enabled technology architecture, experience centricity, and insight-driven strategies and actions will be among banks' top priorities to support their digital transformation moving forward.

Retail banks continue to invest in technology to achieve cost reduction, process improvement and efficiency. Cloud solutions, for example. are replacing the traditional use of data centers at some banks looking for increased security, greater resilience and scalability. Seventy-five percent of our survey respondents said they are leveraging cloud computing to enable their digital transformation.

The growth in the power of data & analytics and the increase in the volume of data available has enabled greater personalization of all customer interactions from marketing through to sales, on-boarding and servicing. Seventy-one percent of our survey respondents said it is a key priority to support their digital transformation moving forward.

“Retail banks need to decide which combination of technologies to invest in to enable profitable growth and future agility.”

However, many incumbent banks may not currently be using the information as effectively as they could. Furthermore, open banking/open data is reshaping global ecosystems and creating new business models that banks should evaluate.

Leading banks are already systematically deploying automation solutions such as RPA and chat bots to increase efficiency and leverage insights. This will become the default approach in the bank of the future.

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

It will also be key that banks have an unrelenting focus on the operational resilience and security of their services, particularly against cyber attacks, as more services move online and to digital. In the middle and back offices, it will be crucial to leverage new technologies to move processes onto a more digital footing, replacing manual and paper-based operations with greater levels of automation and straight-through processing.

New technology has given rise to a set of new interaction channels such as APIs which are being embraced by leading financial services firms to reach new customers. Technology will continue to evolve at pace and emerging concepts such as augmented reality and distributed ledger technology will further redefine the nature of banking services.

The above technologies will combine to redefine the bank-customer relationship, making banking more personalized across customer devices.

Now, with low code development, ease of integration capabilities and cloud, the technology element of digital transformation is no longer the difficult part. It is within the other signals where the challenges lie.

Business models in the market today

There are five main types of retail banking business models we see in the market today.

Full service banks

These are banks that provide the full range of banking services across broad customer segments, from retail and business banking to commercial and investment banking. Most of these banks already provide bancassurance or wealth management related products and services.

Specialist banks

Specialist banks focus on retail and small business customers and tend to have a strong understanding of the needs of their target customer segment. The bulk of their revenue tends to be interest income from products such as mortgages. This category also includes the small digital neo banks.

E.g., DBS, Equitable Bank, Monzo

Consumer credit providers

Consumer credit focused banks mainly target under-served sections of the community. These banks often started out as non-bank financial institutions such as auto loan providers, subprime credit card providers or gold lenders, but have since taken deposits to reduce their funding costs.

E.g., American Express, Mastercard

Money transfer providers

These banks have the main objective of furthering financial inclusion. They usually have a limited range of basic banking products, such as deposit accounts and remittances, but have a widespread network either through branches or networks provided by others such as retailers or post offices.

E.g. Western Union, PayPal

Digital wallet providers

Banks that employ the wallet model focus on the customer experience in digital transactions. They are typically born from fintech companies that interface with social media platforms, and have expanded to provide deposit and lending services.

E.g., WeChat Pay, Ant Financial, Paytm

The signals of change are driving an evolution across the retail banking sector, and our research tells us that in order to achieve profitable growth and better manage the impacts, banks will need to pivot to business model ecosystems to succeed in the future.

Banking business models of the future

In the future, we believe three retail banking models are more likely to dominate the market, including a new type of ambient bank. The customer will be core to the strategies of all three models.

Universal banks

Universal bank **margins are being squeezed on both ends**, with high operating costs and downward pressure on transaction fees and interest income. Consequently, universal banks need to be data driven and develop ecosystems of their own drawing on their large customer base. This will enable them to **expand into new profit pools**, such as helping consumers and households save in major spend categories, like utilities, groceries, telco/internet, etc. The ability to utilize transaction data will be key to this, to enable a deeper understanding of customer behavior and opportunities to support them.

Universal banks will **retain some of their branch network**, whether to serve high margin customer segments that desire in-person interaction, or rural communities that lack digital proficiency and access. Despite this, the operating model will need to be as **automated** as possible to drive cost efficiency.

Transaction-focused banks

Transaction-focused banks are **primarily payment service providers** by nature. They are heavily focused on **unit economics**, having to ensure that the unit cost of transactions can be covered by revenue to guarantee sustained profitability. They adopt a highly focused model and target specific customer segments, constantly innovating on those sets of customer needs to expand their services.

With large customer bases and benefiting from rich customer transaction history data, the success of these banks will be facilitated by **open banking** — which could also enable big tech companies to take a slice of the action and perform an increasing number of banking transactions for their customers.

Ambient banks

Ambient banks don't act as standalone entities, but rather are the 'invisible' agents embedded within everyday **Internet of Things (IoT)** devices to facilitate transactions. Having access to data from many IOT devices also will give the bank a deeper understanding of customers' spending habits and credit needs.

The ambient bank is an **enabler of ecosystems** such as those of Samsung and Microsoft. As a result, the focus is on building and providing APIs, micro services and modular based technology architecture.

Some traditional banks are exploring the ambient bank model. FINN by ING Bank, for instance, allows smart devices to make autonomous payments on behalf of the user. Goldman Sachs has launched an API portal for developers, seeing itself as an API producer in the ecosystem.

We believe one key attribute of the banking business models of the future will be a greater resilience to economic shocks such as those resulting from COVID-19.

Strategic themes

There are five strategic themes that we believe will significantly impact all three business models.

Strategic theme	I. Universal banks	II. Transaction-focused banks	III. Ambient banks
1. Identifying and serving customer needs	B2B and B2C model — **experience-centricity** is crucial and universal banks have to leverage their large volumes of transactional data to create **digitally enabled, insight driven strategies**.	B2B and B2B2C models — transaction-focused banks interface with multiple ecosystems and have to provide **seamless interactions and commerce** with them.	B2B model — ambient banks are part of everyday IOT devices and will create **innovative products and services** on the back of the growth of smart, connected technologies'.
2. Focusing on and driving cost efficiency	Cost pressures result in universal banks reducing their branch network and achieving operational efficiency by **creating responsive operations and supply chains**.	High emphasis on automation as transaction costs need to be lower than revenue. There is a need to invest in **digitally enabled technology architecture** to drive process efficiency.	Minimal employee costs as focus is almost entirely on provision of technological infrastructure such as APIs.
3. Adopting new ways of working	Evolution of front office workforce towards millennials means universal banks need to embrace new ways of working to create an **aligned and empowered workforce**. Agility comes from skilled workforce and technology. Bank employees shift their focus to managing strategic policies and escalation.	Front office is more technology oriented and the workforce is focused on back office activities rather than customer interactions. Agility comes from technology and automation, with bank employees shifting their focus to manage strategic policies and escalation.	Front office is more technology oriented and workforce is focused on back office rather than customer interactions. Agility comes from technology and automation. Escalations are managed by AI as data scientists build strategic direction into algorithms.
4. Complying with increased volume of regulatory driven change	**Risk and regulatory framework already fully developed,** with pace of regulatory change increasing. Full set of established banking risks and regulations apply.	**Evolving risk and regulatory framework**, with some cross-sector regulations applicable (e.g. e-commerce). Fraud risk and incorrect transactions can represent a large proportion of total costs.	**Risk and regulatory framework still nascent**. High levels of cyber and tech risks from IOT as each product and device becomes a potential cybersecurity vulnerability.
5. Identifying role within wider ecosystems	Universal banks act as the anchor of ecosystems, creating **integrated partner and alliance networks**.	**Participants of as many ecosystems as possible,** in order to increase volume of transactions and therefore revenue.	**Embedded in ecosystems as enablers**. They are part of services and products, within IOT devices such as televisions, refrigerators or cars.

Standing firm on shifting sands

"COVID-19 will be a catalyst for greater digitization of the banking and finance industry as we expect a permanent shift from customers to digital services and channels. We predict M&A activity to rise as incumbents make larger strategic investments and pursue bolder M&A deals to accelerate their transformation efforts."

COVID-19 Overall impact on the banking sector

Profitability and credit management/cost of risk

The low interest rate scenario, along with the significant impact of the COVID-19, is reducing the core banking profitability in mature markets. Financial institutions are thus shifting towards commission-based income from the likes of payments and tech businesses.

One of the immediate effects of the health emergency on the real global economy is the increased credit risk of corporate and retail clients of the banks. In order to continue financing the real economy and support its recovery, banks are called to distinguish between purely temporary phenomena, destined to reabsorbed in a short time, and longer lasting impacts which would require actions of management and reclassification.

The primary aspects to be considered are:

- **The forward-looking information update** — in particular, the way in which new information must be incorporated into risk parameters needs to be carefully analyzed, given the peculiar nature of COVID-19. This may last for a lesser time than cyclical downturns induced by economic-financial causes.
- The update of the **'default rates'** which needs to take into account any waivers granted by the authorities in relation to only temporary phenomena of expiry of the creditworthiness.
- The definition of the most appropriate timescales for updating **the 'recovery rates'** in order to be able to factor in the positive effects — albeit inevitably in the medium term — deriving from the credit recovery policies which could introduce forms of deferred payments or agreements on longer maturities (restructuring debt, etc.).

The contraction in economic activity is having adverse consequences on credit quality as banks are increasing loan loss provisions.

Securitization landscape

The corrective actions of governments aims to mitigate the risk profiles through further incentives for disposals.

It is likely that the future market of synthetic securitizations may require a revitalization after recent developments and important economic impacts that could come as a result.

Over the past few years, several European banks have finalized important disposal operations of impaired loans, contributing to a significant reduction of the NPL ratio. Among the prominent evolutionary trends in the market, it is possible to identify the strong interest on the unlikely-to-pay (UTP) loans, the birth of a fervent secondary market for bad debts and the amalgamation of homogeneous large-ticket asset classes in the construction of portfolios intended for the market i.e. so-called single names.

Customer relationship and commercial models

Although COVID-19 may lead to a crisis in the overall economy, the impact on the banking system and on the bank-customer relationship can also be defined as a 'positive discontinuity' for the purpose of digitization of the sector and the ability to offer an excellent customer experience.

Banks, even the most territorial and branch-centric ones, are forced to encourage the use of channels that have never been their strategic priority. This phase would be particularly complex, which banks need to address by demonstrating real proximity with their customers.

The clear understanding by banking operators of their gap in the provision of services, becoming more tangible than ever before with COVID-19, could make them even more inclined to accelerate the digital transformation path through partnerships and collaborations within the fintech community.

Operational resilience and business continuity management

The provision of technological innovation can play an important role in guaranteeing the business continuity of the banks: the activation and enhancement of robotics solutions or artificial intelligence (e.g., Advanced BOTs that support the processes of adoption of the technologies displayed on the channels direct) and mobility (e.g., platforms for the management of promoters and systems authorizations), if applied to critical processes, would allow for an easier protection in case of absence of staff.

Given the necessity to have an unpredictable availability of infrastructural resources, there is a clear opportunity also for the financial sector to evaluate the benefits of applicable Cloud technologies.

COVID-19 eight impacts on banking M&A

After a period of record M&A activity over the past decade, the banking industry is now facing unprecedented disruption.

M&A activity was down compared with that of the previous year. In terms of deal activity:

- Some acquisitions and divestitures have still been completed, particularly those near to signing and/or closing, and some others have accelerated to overcome additional disruption from COVID-19.

- Some deals have been put on hold due to the high volatility in the financial market, as well as uncertainty over business resilience, while a few others have been canceled.

Within this context, we expect banking M&A activities to increase in the future, primarily driven by domestic consolidation aimed at improving bank efficiency and at creating larger scale in order to compete with international peers.

In addition, acquisition of fintech and digital solutions capabilities will have a key role in the M&A landscape to help banks re-design their business models in order to survive in the long run in a low interest environment.

Acceleration in global domestic consolidation
Domestic consolidation is likely to pick up pace with the objective of increased operating efficiency at the national level in order to compete worldwide.

Rescue and restructuring deals to soar
Troubled banks may face rescue, restructurings and nationalizations deals as governments/central banks inject liquidity.

NPL growth may overtake loan growth
Banks with high exposure to stressed industries (hotels, restaurants, travel, oil & gas, etc.) are likely to face an increase in NPLs and a worsening of the asset quality. This could serve as potential opportunity for asset management companies and PE investors.

PE firms to reassess their investment plans

Distressed valuation in the banking space may represent a good entry point for some PE firms that are currently evaluating areas to invest their liquidity.

Fintech acquisition by traditional players

As funding sources dry up, struggling fintech firms with limited market experience (especially online lenders) may be forced to seek collaboration or acquisition by traditional financial institutions and PE funds.

Revival of distressed M&A

There could be several opportunities for distressed investors given the deep discount that financial institutions are facing in the stock market. Moreover, buyers having surplus funds could take advantage of low prices in the current scenario.

Specialty finance and challenger-banks

Specialty finance and challenger-banks are the new business model with a strong potential for superior profitability; this new banking model is likely to get the opportunity to acquire market shares in the lending space and could be involved in potential M&A transactions.

Boost for digital solutions

COVID-19 represents an opportunity to foster greater use of digital capabilities. Fintech and digital solution players, such as payments solutions and instant lending companies, are likely to get involved in M&A transactions with traditional banks to increase their operational efficiency.

Key deal drivers under the lens

Top 3 picks

01 Fintech to roar

- Fifty-six percent of key markets expect fintech startups to have either a steady or strong impact.
- India, Indonesia, South Africa and Chile are markets to watch.

02 Regulators eyeing deals

- Forty-eight percent of key markets expect either a steady or strong impact by regulatory agencies/bodies.
- China, India, Australia, Indonesia, Italy, and Luxembourg are markets to watch.

03 NPL markets in full swing

- Non-performing loan portfolio sales- . Thirty-six percent of key markets expect either a steady or strong impact by NPLs.
- China, Japan, India, Singapore, Thailand, Italy and Chile are markets to watch.

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Dhinali Peiris
Associate Director
Corporate Finance, Deal Advisory

Kasun Gunawardhana
Manager
Corporate Finance, Deal Advisory

Maheshini Senanayake
Senior Manager
Sales and Markets

Aadil Sulaiman
Senior Executive Digital Marketing
Sales and Markets

About KPMG

Professionals in KPMG Sri Lanka

1,400+
People locally

21
Partners

Part of
147
Countries in the
Global Network

Combined Global Revenues
$28.96
USD in Billions

Established in
1897
The oldest
Chartered Accountancy
firm in the country

Celebrating,
124 years
of excellence

Audit	842
Tax	178
Advisory	272

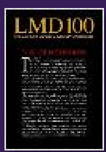
KPMG Recognitions

KPMG Sri Lanka renewed its **ACCA Platinum Employer Status for Training and Professional Development** up to 2021

Sri Lanka Tax Firm of the Year **Asia Tax Awards 2018**

First in Financial Services Category **LMD Most Respected 2019**

Best Advisory Firm in Sri Lanka **The International Finance Magazine 2016**



First in the Auditors League in Sri Lanka **LMD 100 - 2017**

Recognized for Professionalism and Integrity **LMD Most Respected 2017**

Best Deal Advisory Firm in Sri Lanka **Global Banking and Finance Review 2015**

KPMG Leadership - Banking

Reyaz Mihular
Managing Partner

Audit

Suren Rajakarier
Partner, Head of Audit

Tax

Shamila Jayasekara
Partner, Head of Tax & Regulatory

Advisory

Priyanka Jayatilake
Partner, Head of Advisory

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

Chamara Abeyrathne
Partner, Audit

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

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

Upul Karunaratne
Partner, Audit

Raditha Alahakoon
Partner – Department of
Professional Practice (DPP)

Jagath Perera
Partner, Internal Audit Risk & Compliance
Services & Forensic Services

Thamali Rodrigo
Partner, Audit

Contact us

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