



Sri Lanka Banking Report

2nd Half 2018

Issue 3
June 2019

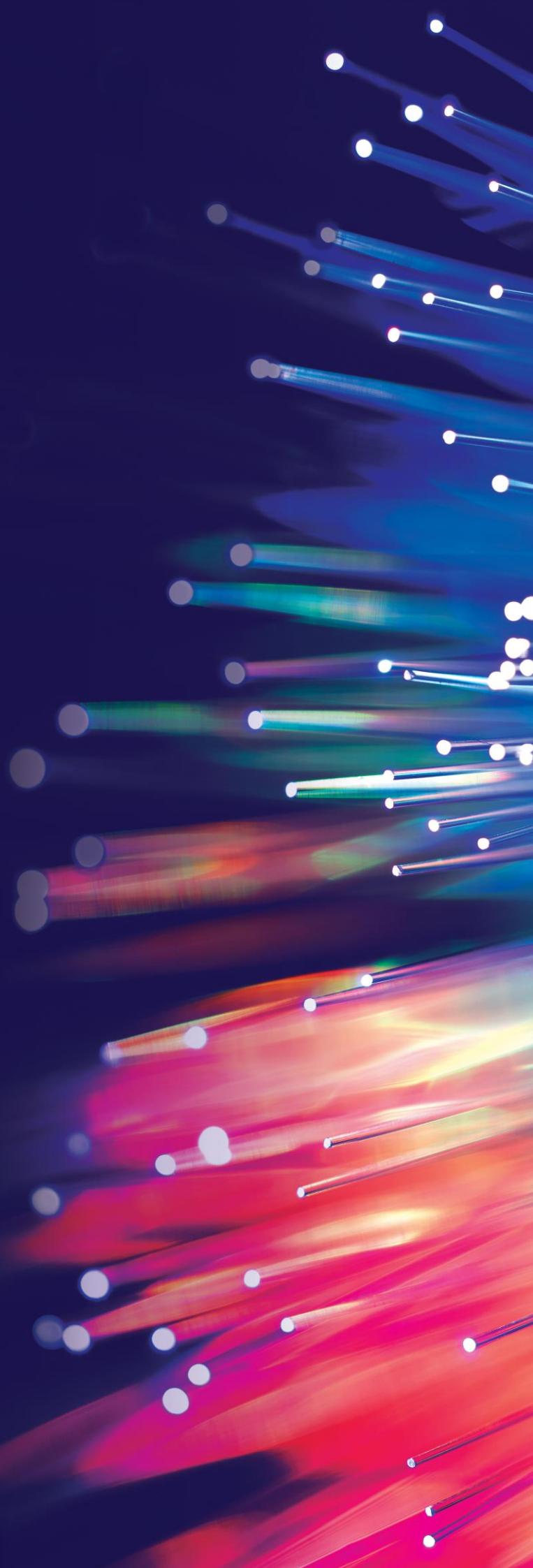




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Foreword

The banking industry in Sri Lanka tells a story of resilience and strength as the 2018 year came to a close. The geopolitics of the country have changed in unexpected and unforeseen ways during the year, as well as external pressures on operations such as Fed rate hikes and a sovereign downgrade by external credit rating agencies, amidst the challenges of implementing SLFRS 9 as well as complying with BASEL III requirements. Bankers had to deal with challenges from multiple fronts, social, economic and technological, during the year which would continue in the coming year as well and dynamic resilience is needed to navigate through these significant challenges / opportunities. Looking ahead would be a story of reconciliation, rebuilding and resilience as Sri Lankans, and the banking sector would have a vital role to play in this.

The proliferation of fintech and technology is a double edged sword which would give banks the necessary wherewithal to increase ever thinning margins, but would need regulatory and supervisory oversight to be safe and sustainable in the long term. In this issue we address the ever changing role of the banking boards in the future, as well as an interview with the Governor of the Central Bank of Sri Lanka to understand the regulatory perspective. We also feature discussions with the CEOs of the two largest private banks in the country in an effort to understand first hand their views on the future of banking.

This is the third issue of the Sri Lanka Banking Report we have produced. We have discussed in detail the key issues which we feel could have an impact on the sector this year and have analyzed the industry performance through a challenging 2018. I hope you enjoy our perspective on the sector in 2018, and would welcome the opportunity to discuss the banking results and the current industry landscape.

"The proliferation of fintech and technology is a double edged sword which would give banks the necessary wherewithal to increase ever thinning margins"



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Executive Summary

Sri Lanka's economic growth continued to be slower than potential in 2018 despite slight recovery in the agricultural sector and improved service sector performance - overshadowed by modest industrial sector performance due to contraction in construction and manufacturing activity. Fiscal discipline and monetary policy tightening had a short term impact on growth, as the Government of Sri Lanka (GoSL) and monetary authorities attempted to improve economic fundamentals and guide the economy to a sustainable path of growth. The policy stance taken by Central Bank of Sri Lanka (CBSL) in strengthening the fundamentals of the economy should be commended.

The effects of this transition phase was felt throughout the banking sector as private sector credit growth slowed, leading to industry wide slowdown in loans and advances.

CBSL resorted to a "wait and see approach", regularly exercising a neutral stance on policy rates. However, due to sluggish economic activity and rising lending rates, the CBSL was forced to inject liquidity to keep market rates suppressed.

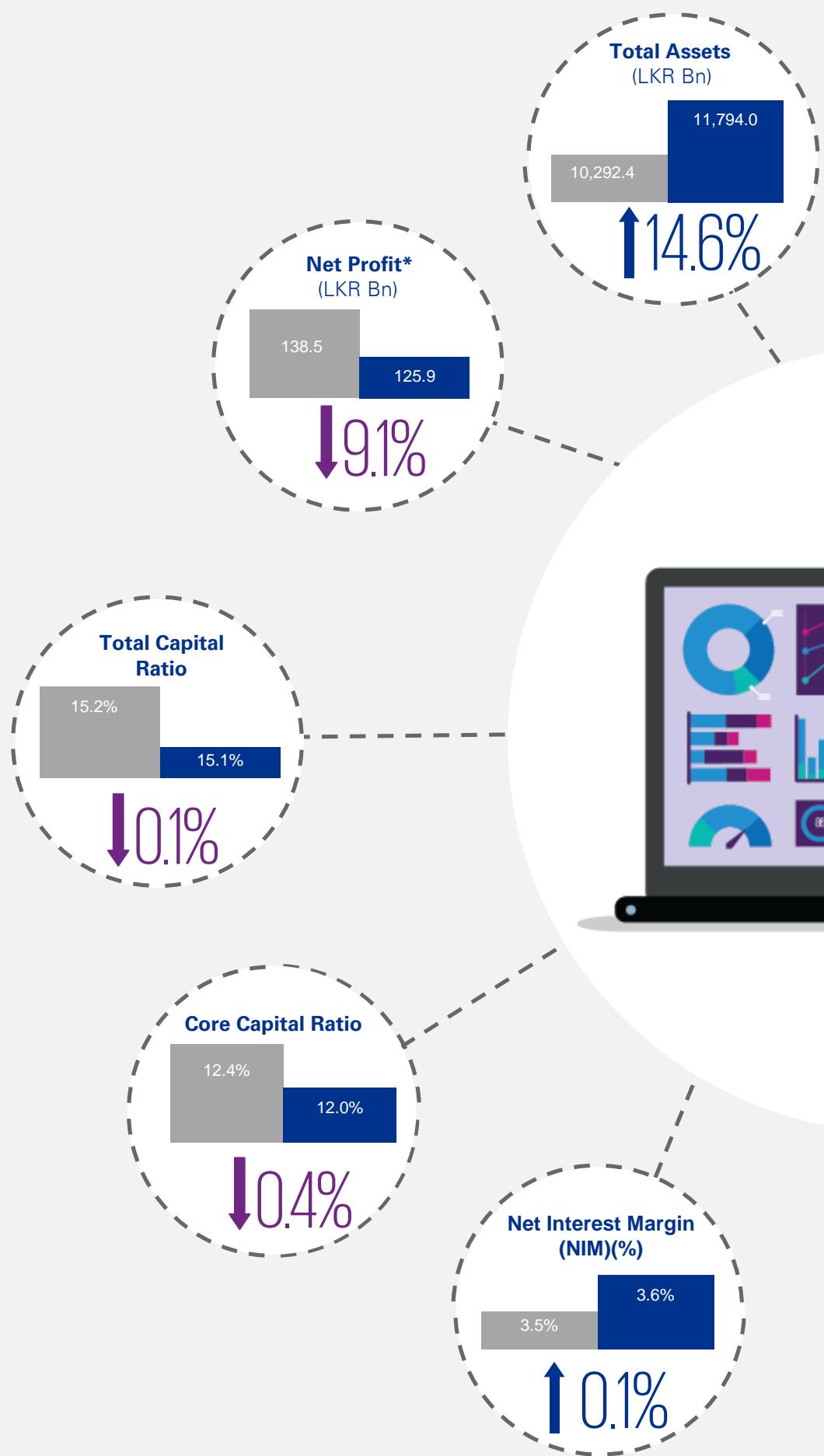
The implementation of SLFRS 9 and Basel III to improve the quality of the banking sector in the long term, proved challenging especially with the steep increase in Non-Performing Loans (NPLs) in the short/medium term. The banks of the future would need to increasingly consider automation and consolidation of operations to reduce operating costs to improve profitability in a business world which is moving towards digital transformation and digital disruption to be a way of life. In this context, the challenge for Bank CEOs in the next decade would increasingly be talent management to fit the changing face of banking. This would include realigning the existing skill sets of the talent pool by upskilling them in the shortest time possible while focusing on recruiting the right talent for long term succession. Culture of the organization would need to be managed to fit the changes in the skills required and this would be a challenge to the people standing at the helm of the ship.

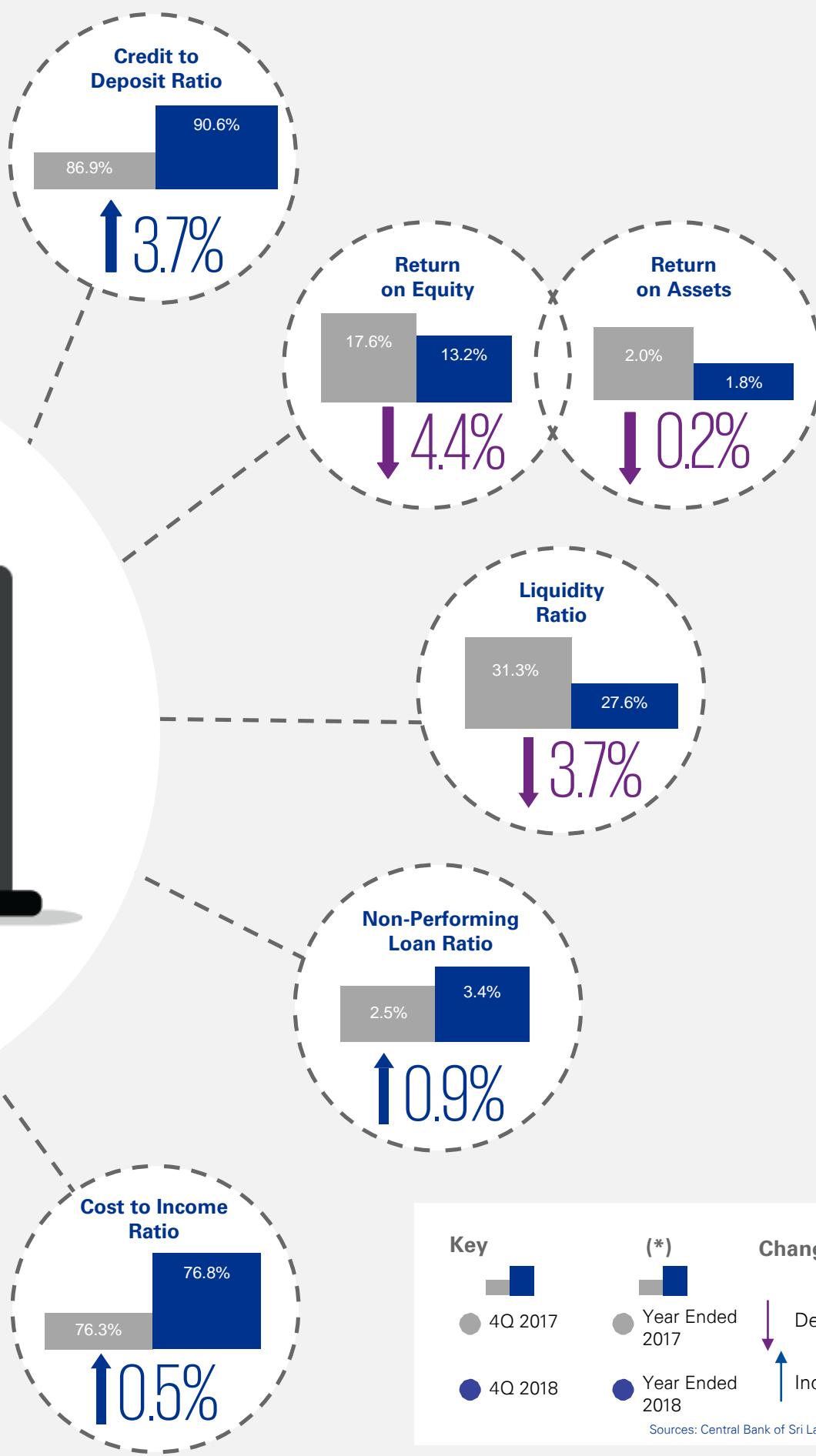
In the last two years, Sri Lankan capital markets saw increased activity as the banking sector issued several capital calls to meet Basel III requirements. In addition, introduction of the Debt Repayment Levy (DRL) exacerbated the situation as banking sector Return on Equity (ROE) declined.

Potential recovery in private sector credit growth and lower market lending rates are positive signs and are expected to ease pressure on the sector. Normalized impact from impairments, steady recovery in agriculture, construction and manufacturing sectors should see banking profitability improve. External sector risk profile will depend on ability to service upcoming debt repayments. Strict fiscal discipline and timely monetary policy is of utmost importance as it can ensure a smooth transition to a sustainable path of growth.

The last few weeks has seen turbulence in a scale that was unprecedented but as an economy and a country we need to bounce back once again. Towards this there are several relief measures provided by the GoSL which include temporary debt moratorium and subsidized working capital for the tourism sector and relief in classification of loans to SME sector (within a stipulated threshold). We estimate the impact of these measures to be considerable for the Banking sector as a whole. Fiscal discipline and monetary policy in the near term would also need to consider these disaster recovery initiatives.

Performance Highlights





Supervisory and Business Outlook

01



“The Banking sector is
the Lifeblood of the Economy ”

Dr. Indrajit Coomaraswamy

02



Coffee with the CEO

Mr. S. Renganathan

Commercial Bank of Ceylon PLC

&

Mr. Jonathan Alles

Hatton National Bank PLC

"The Banking sector is the Lifeblood of the Economy"

stated Dr Indrajit Coomaraswamy, Governor of the Central Bank of Sri Lanka ("CBSL") in conversation with the KPMG team in April 2019

He elaborated that the outlook of the banking sector is reliant on the overall health of the economy. At present, Sri Lanka has an output gap and the CBSL is focusing on improving the growth rate as macro-economic stabilization has become crucial, while keeping Revenue enhancement based fiscal consolidation at the heart of it. Sri Lanka is prone to external economic shocks as imports remain approximately twice our exports which needs to be addressed immediately. There are several key initiatives taken to improve this and the country is beginning to see the improving trend: Sri Lanka has had a surplus in the budget only 3 years since 1955 with 2 of those years happening to be 2017 and 2018. Dr Coomaraswamy raised concerns of any undoing of the good work due to political scenarios leading up to the election.

Our revenue is approximately 14% of GDP which needs to ideally improve to 16-16.5% of the GDP to remain sustainable in the light of our expenditure running at the rate of 20% of GDP. He reiterated that the level of budget deficit that can be financed on a sustainable basis without worsening our debt dynamics is in the range of 3-3.5%. Several key initiatives need to be implemented to improve exports. Investment promotion, BOI being more focused, trade policies and agreements, trade facilitation, the Customs electronic window to bring down transaction costs, facilitating easy cross border movements are some of these. A move in the right direction would improve the economy and as a result improve the banking sector. Sri Lanka is a twin deficit country and although we have begun to make certain progress, it is very slow and could easily be derailed by the volatile political goalposts in the country. If the economy continues on this favorable path, we can reach 6% growth in the next 5-6 years which would clearly improve the outlook of the banking sector.

Reflecting on initiatives which need to be focused by the banking sector Dr Coomaraswamy stressed on the importance of shifting away from the preoccupation with collateral based lending to building capacity to facilitate lending against cash flows. He mentioned that although it is nearly a decade since the end of the civil war, the banks as well as the overall private sector have not fully realigned their risk appetite with the business models based on emerging trends. Presently, most of the investments are made on low risk short term industries/ projects and he commented on the need to recalibrate the risk appetite to be able to invest on long term industries with a long payback period such as manufacturing and construction. This would aid in the overall improvement of the exports of the country. When posed with the question of accountability of SMEs, which is a considerable portion of a bank's lending portfolio, Dr Coomaraswamy stated that the responsibility of enhancing corporate governance and accountability of SMEs lay equally with the government and the banks.



Another topic of the discussion was the importance of technology in the banking industry with the emerging global trends. As bricks and mortar based branch banking systems are becoming obsolete globally, CBSL has the daunting task of supporting the banks with the process of smooth transition from branch banking to technology driven channel/ digital banking without causing instability to the network. Cybersecurity poses a larger issue as well in this light with emergence of new digital based products to cater to the evolving customer requirements. Further, The Financial Intelligence Unit would increase focus on Anti Money Laundering and terrorism financing. The Central Bank of Sri Lanka is in the process of formulating a consultation paper on technological risk resilience and roadmap to guide the market on this path. He mentioned that The Payment and Settlement Department has a regulatory sandbox to test the viability of new technology such as digital wallets and other methods of electronic payments. These are some of the outcomes of two committees set up by CBSL to look into Fintech and Blockchain technology.

When discussing Fraud Risk Management and sanctions based inspections carried out in many developed countries, Dr Coomaraswamy indicated that the current Banking Act gives only limited authority for the regulator to take punitive action against wrongdoers. He stated that the Banking Act is being reviewed at present with the intention of strengthening the position of the regulator and to penalize recalcitrant financial institutions and senior officers with monetary sanctions.

Next the KPMG team inquired on the Exchange Rate and his outlook as the Governor of CBSL. Dr Coomaraswamy explained that the inflation differential between us and our trading partners if kept down lessens the pressure on the exchange rate. Further he stated that containing the Current Account is crucial. He mentioned that the Current Account deficit which can be financed without debt dynamics being challenged is approximately 2% and if this is achieved the currency can be depreciated at the ideal rate of 2-3% per annum and stay competitive. In 2018 the Current Account Deficit went up to 3.2% due to endogenous as well as exogenous factors but the CBSL anticipates that this year this would be brought down to a manageable and healthier 2.3%.

In closing the Governor mentioned about the critical role played by professional service providers, especially the auditors as well as regulators and emphasized on the formidable responsibility of oversight both have while maintaining professional independence in a turbulent market which is fairly small and relationships are intertwined in a myriad ways.



Coffee with the CEO

A discussion with

Mr S Renganathan of Commercial Bank of Ceylon PLC and Mr J. Alles of Hatton National Bank PLC



1. What are your views, as the CEO of a leading private bank in the country, on the future of the banking sector?

R: During my almost 4 decades of banking career, I have witnessed adding machines to basic calculators to calculators with paper rolls to computers. We have computed and credited interest manually. Gradually, with the technological involvement, we now have much sophisticated IT systems and are better geared to provide complexed products and financial solutions.

Customers have changing needs and in a world rapidly moving towards digitalization we need to look at our customers more specifically. As the first step towards this, we segment our customers in the traditional segmentation basis of retail, SME and corporate. Further, customer segments are classified as either digital natives or digital migrants. Our existing customers, the digital migrants, are going through the transformation of familiarization with non-traditional modes of banking through adoption of technology, whilst the new entrants to the market, millennials who are exposed to smart devices, and related technology from birth are looking at banking through the lens of innovation and ease of doing business.

The evolving customer requirements focus on convenience, overall experience and simplicity. In the future, the focus would be on banking and not banks per say, as customers move away from being loyal to one bank to “shop around” to satisfy their needs simply, conveniently and holistically. The way these requirements are defined would contrast from digital migrants to digital natives. Unlike digital natives, digital migrants still seek comfort in the traditional structure of a bank to a certain degree and this need should not be overlooked as the Sri Lankan customer base still constitutes of digital migrants as a majority, although digital natives are catching up. Therefore, ‘phygital’ banking which is a combination of physical and digital banking is still necessary. Looking at regional trends, India shows a sharp contrast where the digital migration has come full circle and the majority of their clientele have moved into digital platforms.

A: One of the most interesting dynamics that we see today, is the rapid change in customer lifestyles that is primarily driven by advances in technology. These dynamics are changing the face of banking around the globe and Sri Lanka is no exception to this phenomenon.

In Sri Lanka we have seen the introduction of alternative channels such as ATMs, CDMs and kiosks and in our experience these are platforms and services that are becoming increasingly popular. Many banks have launched their internet and mobile banking platforms and are upgrading the systems to provide even a better service to the customers as a result.

Although the penetration levels of the internet and mobile banking platforms still remain low relatively, we strongly believe that these alternate channels will play a key role in the future of the Sri Lankan banking industry. Notwithstanding, the importance of physical presence and relationships nurtured and maintained to drive business growth cannot be underestimated.

In order to remain relevant to the customers, it is essential to understand customer needs, design best solutions and launch products and services that cater to the changing needs and life styles of the customers. HNB Fit is one such product that enables the customer to earn a higher rate of interest on their deposit account based on the number of steps taken during a day. This offers the customers the dual benefits of higher income and a healthy lifestyle. This is the kind of innovation which positively integrates banking into a customer's lifestyle and is a reflection of our new style of transformative banking which HNB is working to drive moving forward.

The payment space is also being redefined through technology. The industry has seen the entry of products that eliminate the need to carry cash and even payment cards. HNB MOMO, our groundbreaking mobile point of sales (POS) device and the very recently launched SOLO digital wallet are further examples of innovations in the payment space in which HNB is leading the way.



We at Commercial Bank have studied this changing landscape and have built our long term strategies to address emerging trends and challenges. We believe, in the future, large size branch would not be necessary, and the days of the large plush branches are long gone. We have already begun the process of downsizing our branches through automating and centralizing repetitive tasks as much as possible with the view to optimize cost, while being customer centric. This would release our most valuable resource, the talent pool, to be retrained and reallocated to more productive and value adding roles.

Solo is designed with complete flexibility to handle any transaction anywhere whether it be purchasing from an established retail franchise or even a small stall or three-wheeler. The registration process is very simple and free and it is not required to walk in to any branch. Solo app could be downloaded and can be connected directly to any bank account, debit or credit card. Thereafter, the user can simply scan the SOLO QR code at any Solo merchant to complete any transaction through VISA, Master Card or JustPay platforms with just the press of a button and the swipe of a screen. HNB is in the process of offering further value additions through SOLO in the near future.

All of these efforts are part of a wider trend which is today often referred to as 'digital disruption'. Telcos and fintechs have already started encroaching the payment space while crowdfunding and peer to peer lending are challenging traditional banking so it is important for leaders in this space to also seek ways to disrupt the market, or risk losing relevance in the eyes of customers.

Around the globe institutions are investing in blockchain technology especially with regard to payments. The possibility of using robotics to improve processes is also being considered by many. In this new era of banking, it is important that our regulatory framework is also refined in order to embrace the full potential of these promising technologies that are already sweeping the world.



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2. How do you attract the right talent?

R: We have embarked on formulating a Road Map for a complete Digital Transformation of the Bank at present. We understand our changing needs of our customers and are in the process of building more interactive platforms to address these in a structured manner. The main focus of the Road Map is on how to move from a product centric approach to a customer centric approach. This would enable us to deploy our talent pool more productively.

If I am to elaborate on this in broad strokes, we have categorized our talent pool into 3 segments; namely, the digital natives, digital migrants and the non-digital adopters. The digital natives would drive the future growth and direction of the bank, whilst the digital migrants would be able to empathize with their counterparts in the customer base and assist them to adopt new technologies comfortably. The non-digital adopters, who are a minority would be redeployed for back office functions where reengineering would be done to improve process efficiency.

2. How do you align your staff to changing dynamics?

A: Our most valuable resource is our family of employees so naturally, HNB places an extremely strong emphasis on enhancing our overall value proposition for employees. Talent is identified at an early stage and groomed to take over higher leadership positions through designed development programs. This ensures the continuity of skilled leadership through effective succession planning at every level of the bank. In our opinion, this is paramount to ensure the sustainability and success of the bank in the long run.

We believe in creating a holistic employee experience as a preferred employer that is not limited to the physical environment we create for our staff. The processes and systems are simplified and automated to enable a better user experience ultimately leading to an enhanced customer experience. Digital champions are appointed at each branch to assist our valuable customers in this digital transformation journey and programs are being designed to drive the mind set change starting from the top team.





3. How will you maintain your margins?

R: The goal post has moved. The days where banks enjoyed high margins are long past. Increasing tariffs is not a long-term solution. Therefore, engaging the client in more cost effective ways is becoming important for sustainable growth. We feel fintech offers an opportunity for collaboration and sustainable growth in the long term and should be nurtured.

A: Deteriorating asset quality of the industry due to stressed market conditions squeeze margins and the higher tax structure set by the Government further aggravates this situation and hamper internal capital generation. We consider nontraditional forms of banking to control cost and encourage market proliferation to compensate shrinking margins. New product development which focuses on customer convenience is integral for survival and automation / business process re-engineering which focus on maintaining positive margins, is critical for cost optimization in the future.

We strive to create an eco-system where suppliers, buyers and the general public have ease of access and seamless 'plug and play' where we power the platform. This is the key to revenue growth and maintaining profitability in the future. Therefore, although we presently have legacy systems and the costs of transition are considerable, we are committed to invest on digital transformation.

In this journey I feel collaboration with Fintechs are important rather than treat them as rivals or competitors. We believe in understanding what we do best and doing it whilst we allow our partners to do the same; which would empower us to truly co create an exceptional customer experience.

One restriction to this truly digital banking experience is the eKYC which is still not enabled in Sri Lanka. This is pending till the digital NIC is rolled out which is long overdue. Once this is complete the entire experience can be made truly digital.

4. What are the challenges you face with SLFRS 9?

R: We faced many challenges prior to the implementation; such as getting accurate past data and lack of system support, but we have moved forward and have had a successful implementation cycle. At present, there are several areas which requires attention, such as subjectivity in computation, re-computing branch performance based on ECSL provisions, realignment of business practices, etc.

We also feel that there should be a clear plan as to how to align CBSL provisioning basis and SLFRS 9 provisioning methodology to avoid duplication of tasks to maintain separate documentation. It is also important to bring more clarity on tax implications.

A: When SLFRS 9 was introduced in 2018, the interest rates were high, economic growth was low, many industries were experiencing debt collection issues and as a result, our industry saw a deterioration in asset quality. In this background, the introduction of SLFRS 9 compounded the impact on impairment charges, which had a notable effect on bottom-line performances across the industry, and hindered internal capital generation.

Hence, the challenges we faced with SLRFS 9 were significant, and common to the entire banking industry. While HNB and the industry as a whole has shown impressive resilience in the face of these difficulties, it is important to keep in mind that the banking industry plays an absolutely critical role in enhancing wealth and moving capital to sectors in the economy that require it the most.

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5. Do you foresee any challenges the sector may face with introduction of BASEL III and will that result in consolidation?

R: As a big bank the implications of BASEL 3 are minimal to our bank, but even when looking at the smaller banks, I feel that BASEL 3 on its own may not encourage consolidation as most of the banks either fulfill the enhanced capital adequacy requirement comfortably or have a plan to meet the requirements in a structured manner. Consolidation in the banking sector is a progressive step but should be carried out with strategic focus with the regulator enabling it via objectively designed shareholder limits for instance, whilst mitigating risks of certain parties dominating the banking sector.



6. How has the new provisioning methodology affected your SME sector and what are your views on growth of the SME lending portfolio under the current economic conditions?



A: As mentioned, many industries are faced with debt collection issues, and after the tragic event of 21st April in particular the tourism sector and the industries in this value chain have been severely affected. The moratorium program by the government to support the affected would ease out the pressure on impairment provisions to a certain extent. We believe that even in the aftermath of such terrible losses, our industry and nation will bounce back even stronger.

Despite the challenges we face at present, we also remain confident that over the medium to long term it is the domestic SME sector that will emerge as the key driver of growth in Sri Lanka, and our efforts are aligned accordingly.



7. What are your thoughts on the steps taken by CBSL to amend the Banking Act to provide more authority to the Regulator to take action against non-compliance?

R: This is a welcome move as it would strengthen the banking sector as a whole, but needs to be approached carefully and objectively. Provisions for penalty and fines should be exercised prudently and not target different factions. Controls should be put in place to eradicate risks of subjectivity in the exercise of any such provisions.

A: Under the present Banking Act the Central Bank of Sri Lanka imposes penalties on non-compliance, mainly through the Foreign Exchange Department and the FIU (Financial Intelligence Unit). The prerequisite in taking any such action under the present Act or a new enhanced Banking Act is to define a clear objective framework for such action that does not target particular factions nor is seen to be biased. If implemented prudently, I feel this would be a welcome move for strengthening and stabilizing the financial system.

8. Lastly, what are your expectations from professional services providers such as KPMG?

R: We see the professional firms also expanding the range of services they offer to meet the emerging client requirements which is a welcoming change. We expect the professional services firms we work with to be our partners in our journey of transformation with focus on resilient growth and proactively provide professional guidance by understanding our evolving business models and provide necessary support whilst maintaining independence and acting within a stringent ethical framework.

A: One key aspect would be to work hand in hand in improving and rectifying concerns identified from an early date. This would help to take appropriate action at an initial stage to improve the business and its operations.

Another area in which professional service providers could support would be by lobbying together with the clients for causes impacting the industry. For example, to ensure that appropriate policies and frameworks are in place to move in to the new era of banking.

Banking Board of the Future

01

Risk proofing the future

02

Digital Transformation





The Banking board of the future

What does the banking board of the future look like? That's a pressing question today among banks, their leaders and supervisors, as headwinds of change rewrite the rules for success in the global banking industry. As organizations have entered the digital era, IT governance gains importance. An increase in fraud through the proliferation of the network and overall cyber security has become a major concern.

The rise of data, robotics and artificial intelligence pose bold challenges. Customer expectations are evolving at an accelerated pace and there is increased awareness on data protection and concerns on privacy. The digital era is indeed redefining global banking and challenging the role of boards with bewildering speed. Banks and their boards are also feeling the pressure of increased regulatory scrutiny and new requirements that focus on enhanced risk-management and governance skills, board composition and diversity, and clearly defined board responsibilities in the interconnected digital economy.

Regulators in various jurisdictions are prompting banks and their boards to take a critical look in the mirror — voluntarily or otherwise. In Sri Lanka, A New Banking Act has been drafted and being finalized and it is expected that this publication will go to press with presumably more stringent regulation on board oversight and governance.

As explained in the KPMG Global publication *Frontiers in Finance*, Europe's banks are facing an array of regulatory requirements concerning the skills of board members and their responsibilities. The European Central Bank's (ECB's) 2016 SSM supervisory statement on governance and risk appetite articulates specific requirements concerning the expected skills of banking board members. The ECB also requires clearer separation between first and second line of defense, addressing lending activities and risk control. The ECB's SSM supervisory statement notes that today's banks "face economic, financial, competitive and regulatory headwinds" demanding heightened focus on "sound governance and risk management practices within a clearly articulated risk-appetite framework. "In this environment banking boards, need to challenge, approve and oversee management's strategic objectives, governance and corporate culture.

IT governance is the structure, oversight and management processes which ensure the delivery of the expected benefits of IT in a controlled way. Our view is that traditional operational risk factors have changed with the proliferation of technology and banks have become technology dependent. CBSL (The Central Bank of Sri Lanka) should be commended on proactively setting up a technology sandbox to better understand the fintech environment and the regulatory requirements of enabling business through fintech and not to disable technology with archaic regulation, while maintaining regulatory oversight.

Australia's banks, meanwhile, are encountering close scrutiny from that nation's Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. The ongoing inquiry has a spotlight firmly trained on boards and governance practices. The commission is raising questions concerning the need for boards to:

- set a highly visible 'tone from the top' on culture
- address board skills, expertise and diversity
- remain sufficiently engaged on dealings with regulators
- determine accountability and expectations on corporate misconduct
- provide greater oversight of operational detail and non-financial risk
- gain insights into 'knowing what they don't know' on non-financial risk for enhanced governance oversight.

Australian financial services industry has been through a period of introspection to understand where they too may need to raise risk management standards. The increased expectations on the board, recalibration and improvement in the lines of defense, enhancing nonfinancial risk reporting and the impact of remuneration on risk management are some of the areas that most organizations will need to address in the near future.

As supervisory, technological and economic forces combine to exert new pressures on banking boards to evolve, more regulatory directives and initiatives can be expected. It remains to be seen how far — or quickly — banks around the world will move to modernize their boards for the digital economy — or if they will wait until regulators impose directives. Our view is that banks should not waste any time implementing real change in their boardrooms to meet emerging challenges in the fast-evolving and increasingly complex global environment in which they operate — as regulators in the EU and Australia are making abundantly clear.

Risk proofing the Future



It is increasingly vital for banks to do all they can to build boards that will deliver future success. Doing so will require boards to possess the following key capabilities. They will:

- Include informed and highly proactive board members who have a clear understanding of emerging risks and issues that transcend *financial* factors to include the *non-financial* spectrum.
- Be equipped to consistently address *all* of today's — and tomorrow's — risks, including: cybersecurity, automation, data privacy, compliance, legal issues, customer service, integrity and reputation, and the quality of new products and services.
- Be prepared to address strategy and related risks that come with the interconnected ecosystem of new partnerships and alliances today's banks are forming to deliver innovative services to customers. Board members will need the acumen to understand these challenges — and to deliver the insights and skills needed to effectively manage them.
- Include board members with non-industry experience who can bring valuable new insights to issues and risks amid the changing operating environment, including the impact of digitization in areas such as data analysis, customer experience, product development and external communications. Non-industry members can contribute to boards' collective knowledge, competencies and experience while also challenging traditional approaches.
- Create and sustain modern cultures and values for their organizations. Tomorrow's boards will ideally promote a healthy 'decision culture' within the organization, one that provides opportunities to challenge risk decisions from diverse management perspectives.

While the watchword for boards has traditionally been oversight, the future of boards will inevitably require an informed new focus on oversight and insight and the time to change perspective is not in the future but in the present.

Digital Transformation of the Banking Landscape

For the last decade, banks have been extending their services to new channels, devices and touchpoints – delivering banking apps to check balances and pay bills anywhere, anytime. They are beginning to provide real-time approvals and instant access to credit via credit card apps; and offering online mortgage apps via smartphones, laptops, watches and voice-assisted devices.

The result: an exponential increase in the number of customer touchpoints.

As customer interactions increase, bank executives are seeing revenue decrease due to the number of channels required for service. For example, banks have added phone apps with mobile deposits; yet, their customers still need automated teller machines (ATMs) and branches. Under this scenario, the promise of reducing channel costs by adding digital services has not been realized.

To compete more effectively, capture the inherent value in digital channels and reduce the cost to serve of traditional channels, banks must better organize themselves by removing organizational silos and seamlessly aligning the entire organization around the customer. This goes far beyond front-office and customer-facing functions. It involves aligning five key stakeholder groups: customers; employees; partners and alliances; front-, middle- and back-office functions; and the broader digital ecosystem.

Why? KPMG commissioned Forrester Consulting to conduct a study to gain a better understanding of success factors in delivering against a company's customer agenda. Our research shows that when companies move away from the limitations of operating in functional silos and toward what KPMG defines as a connected enterprise — an organization that is connected and aligned across businesses, functions and channels — they outperform their competitors.



80%

of banks cite connected enterprise as a top or high priority



or fewer are getting a strong or acceptable return on any single omni ROI metric

Most banks have already begun the journey in some way; so, the goal is not necessarily to start anew, but rather to keep going. Mature firms lead in large part by focusing on five capabilities: customer experience, technology architecture, data and advanced analytics, digital products and partner ecosystems. To achieve sustainable growth, banks need to invest in all these. By consolidating their investments into a single strategy that leverages all eight capabilities, banks can create a comprehensive plan for sustainable growth.

Today's investment in these fundamental capabilities will widen the gap tomorrow, which will mean the difference between gaining a loyal customer and losing a dissatisfied one.

The research found that, while eight in ten banks were placing a high or top priority on being connected, too many banks are just "checking the box" when it comes to customer centricity, focusing on multi-channel tactics masquerading as a connected enterprise strategy. For those banks investing in a more customer-centric approach, four in ten indicated it had positive returns on their return on investment (ROI) metrics and for most, it exceeded expectations.

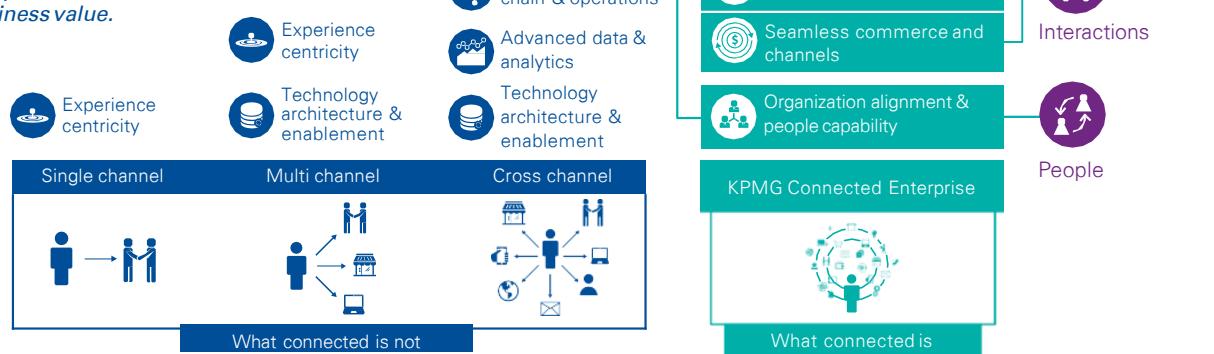
The need for customer centricity is now being felt across the C-suite. KPMG International's 2018 Survey of Global CEOs in the Banking Sector found that less than half believe they are achieving ROI from their investment in customer experience. In a separate survey of more than 3,000 global CIOs and other IT executives conducted by KPMG and Harvey Nash in 2018, 55 percent cited "enhancing customer experience" as a top business priority.

The KPMG Connected Enterprise framework can help financial institutions identify the capabilities required to understand, communicate, and deliver against changing customer expectations. It helps to identify the steps leaders can take to build these capabilities and create sustainable value — all resulting from becoming customer centric.

The KPMG Connected Enterprise evolution

Evolving technology and consumer behavior over time have forced brands to change the way they operate to deliver the desired customer experience.

Many organizations are “checking the box” when it comes to customer centricity, deploying a series of multi-channel tactics disguised as strategy. For mature organizations, it is much more than a channel harmonization and integration effort. They’re investing in a connected enterprise, an architecture of eight fundamental capabilities that aligns people, operations, systems and processes around the customer to capture business value.



Source: KPMG International, 2016

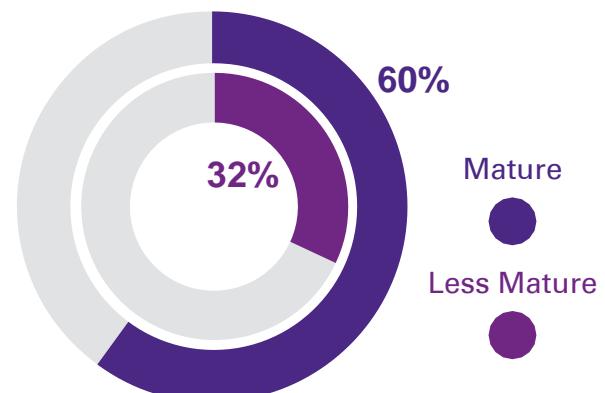
The race for growth is on

Mature banks around the globe who invest across eight connected capabilities are nearly twice as likely to see success with the connected enterprise.

KPMG Connected Enterprise success metric: Customer experience exceeds expectations, successful execution of one or more connected objectives and ROI achieved on one or more metrics.

Base: 72 professionals at banking firms investing in all eight omnichannel capabilities and 178 professionals at banking firms not investing in all eight.

Source: Commissioned study conducted by Forrester Consulting on behalf of KPMG, July 2016

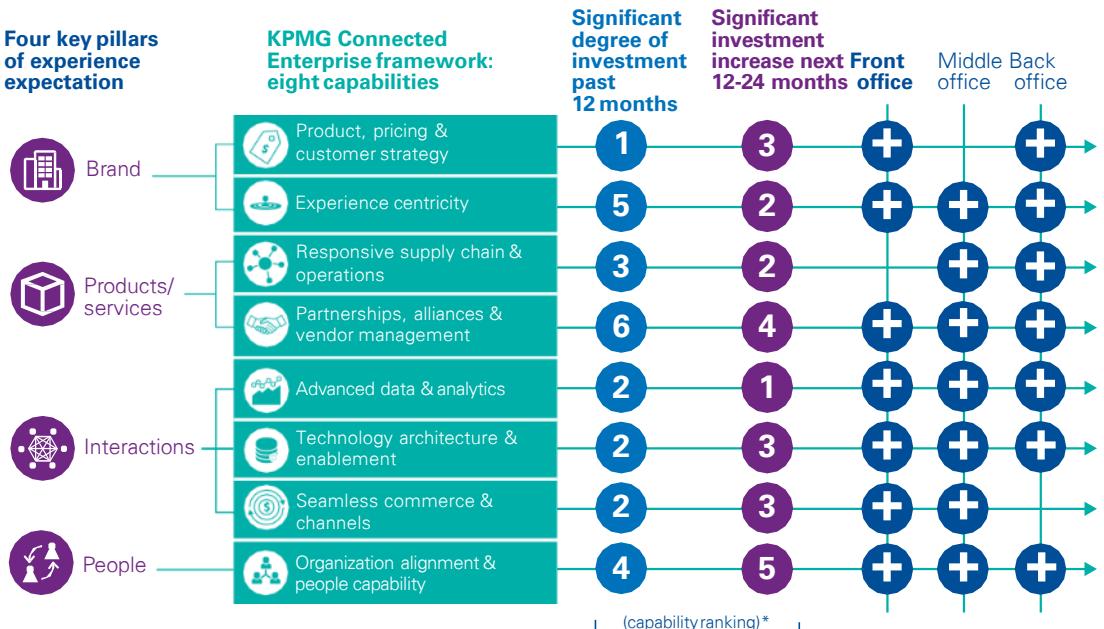


Investment in a connected enterprise

Investment in the eight capabilities spans the entire organization, from customer-facing interactions through to back-office operations.

Base: 250 professionals involved with omnichannel strategy decisions at banking organizations

Source: Commissioned study conducted by Forrester Consulting on behalf of KPMG International, August 2016



Digital Transformation of the Banking Landscape

All companies face challenges as they plan and implement a connected enterprise strategy; but, these plans can be especially difficult for banks. Ongoing regulatory pressures, new regulations and compliance issues make coordinating technologies and services across all possible touchpoints incredibly problematic.

In the KPMG commissioned Forrester Consulting study, six challenges stand in the way of creating a truly connected enterprise

1 Technology. As consumer banks expanded feature functionality to meet their customer's needs for multichannel interactions, they often bolted new technology platforms onto legacy systems simply to get to market. These point-to-point solutions, embedded with custom code to support multiple systems and platforms, have only added to IT expenses. To maintain, support and expand a multi-channel strategy demands a modern architecture developed with an integration layer philosophy and infrastructure.

2 Data. One-third of bank professionals say one of the top obstacles to connected enterprise success is access to customer data. Because customer data and prospect data are housed in different databases, analysis and forecasting is time consuming and resource intensive. The challenges of data housed in multiple locations is compounded by legacy systems — cited by more than one in four respondents.

3 Info/cyber security. Data security and regulations regarding the stewardship and storage of consumer data, as well as the issues around sharing data with third parties as part of ecosystem-based solutions, are at the forefront of bankers' concerns globally. Customer data protection is high on banking regulators' agendas. In our study, three in ten banking professionals cite concerns around complying with regulatory data requirements.

4 Regulatory & compliance. The regulatory environment is going to get more complex and there are not enough resources to support them. Two in ten respondents cite the lack of a company-wide engagement strategy and poor executive sponsorship as hurdles that must be overcome. If investments don't keep pace with need, the gap between relatively mature firms and those lagging will become a chasm, largely driven by the current and future efforts of leading banks today.

5 People/process alignment (misalignment). Nearly one-third of banking professionals surveyed say internal processes are not in alignment with the overall strategy, making it difficult to achieve strategic breakthroughs. One-quarter of respondents cite lack of alignment with third-party partners as a major obstacle, while almost as many cite lack of qualified staff and poor communications with partners. Other obstacles include employees' lack of incentive to collaborate and a lack of cross-functional teams.

6 Strategy misalignment and business silos. In an era of ongoing expense management, it is not surprising that one-third of respondents point to insufficient investments and executive support. Business lines in retail banking continue to focus on specific needs rather than enterprise investments. One-third of banking professionals cite a lack of visibility in real-time or near real-time data across channels and businesses to support marketing and sales decisions and investments. Strategy misalignment and business silos inhibit the prioritization of strategic investments. This challenge leads businesses to make decisions in a silo, ignoring connected enterprise goals.

Overcoming these challenges will help banks identify and deliver on customer expectations to enable a connected enterprise. Addressing each of the eight capabilities from the outside in will help enable organizations to understand and meet customer expectations holistically.

Top six obstacles for success

 1 Technology <ul style="list-style-type: none"> — Legacy systems — Maintain, support and expand a multi-channel strategy demands a modern architecture 	 2 Data <ul style="list-style-type: none"> — Customer data is housed in multiple databases 	 3 Info/cyber security <ul style="list-style-type: none"> — Concerns around data security and privacy 	 4 Regulatory & compliance <ul style="list-style-type: none"> — Regulatory requirements/compliance — Lack of resources to support more complex regulations 	 5 People/process alignment <ul style="list-style-type: none"> — Internal processes are not in alignment with strategy — Lack of alignment with third-party partners 	 6 Strategy misalignment & business silos <ul style="list-style-type: none"> — Insufficient investments and executive support in an era of ongoing expense management — Strategy misalignment results in siloed decision-making
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Getting to Success

The majority of banks have an enormous task ahead of them.

To succeed, they need to take a page from their more mature peers and evolve to a holistic connected enterprise, encompassing all eight key capabilities. Firms failing to transform their multi-channel strategies to the connected enterprise risk losing revenue from missed sales and cross-sell opportunities, increased cost to serve from the use of inefficient channel-by-channel spending and siloed investments and lost market share to firms that have already evolved. For many banks, the most immediate actions should center on four key steps.

— Prioritize investments based on connected enterprise capability maturity

To avoid disjointed initiatives and wasted investment, banks should conduct an objective assessment of their maturity level for each of the eight connected enterprise capabilities. Identify where they are doing well, any gaps between current and desired state and where they need to focus to close those gaps. Then, they should prioritize initiatives and investments based on this assessment and develop a roadmap to deliver a compellingly differentiated experience across the customer journey.

— Plan and iterate digital product innovations

Banks need to focus more on innovation. Over the past few decades, they have done an admirable job of serving customers and prospects through new channels; now it's time to do more. Digital product innovation requires new thinking and innovative ways to add value and enrich people's lives.

— Design and build partner ecosystems

Banks need to move away from a request for proposal-driven system of selecting vendors as new technology needs pop up. Instead, firms need to design partner ecosystems using open platforms and application program interfaces (APIs) to enable flexible, dynamic engagement with external partners.

— Integrate back-end systems and put a laser focus on technology architecture

Many bank executives call these efforts foundational digital initiatives—essentially a prerequisite for future customer-centric success. But the future is now. It's time for banks to create high-performance technology architectures to better meet customer and business expectations. Agile development strategies and cloud and software-as-a-service models go a long way to wean banks off the legacy environments that are impeding their success in a connected enterprise world.

Banking sector Outlook



Overview

Turbulent economic and geopolitical conditions, transition to SLFRS 9 and Basel III requirements made 2018 a reasonably challenging year for the banking sector. Sri Lanka's economic growth remained below expectation with a moderate GDP growth of 3.2% in 2018. The agricultural sector was handicapped by adverse weather conditions, the industrial sector was docked with higher production costs due to depreciation of LKR and rising global commodity prices due to a brewing trade war between US and China. These indirectly exerted pressure on bankers bottom-line due to growing impairment. Monetary and fiscal policies continue to be mired as their importance was understood in the context.

The CBSL maintained its tightening policy stance during 2017. In support of ongoing fiscal consolidation, CBSL tightened monetary policy during 2018. However, following the favorable reduction in inflation levels and widening output gap, CBSL decided to revise the trend through reducing the Standing Lending Facility Rate (SLFR) by 25 basis points to 8.50% in April 2018. The rate cut was also supported by an increase in short term interest rates and corresponding volatility. Market liquidity declined following attempts by CBSL to accumulate foreign reserves and reduce private sector credit growth to desirable levels, leading to upward pressure on market lending rates despite efforts made by the regulator to keep rates down. However, in maintaining neutral policy stance, Standing Deposit Facility Rate (SDFR) was raised by 75 basis points to 8.0% and the Standing Lending Facility Rate (SLFR) by 50 basis points to 9.0% by the end of 2018. In November 2018, the Statutory Reserve Ratio (SRR) applicable on all rupee deposits was reduced from 7.5% to 6.0% to increase market liquidity and artificially reduce market rates.

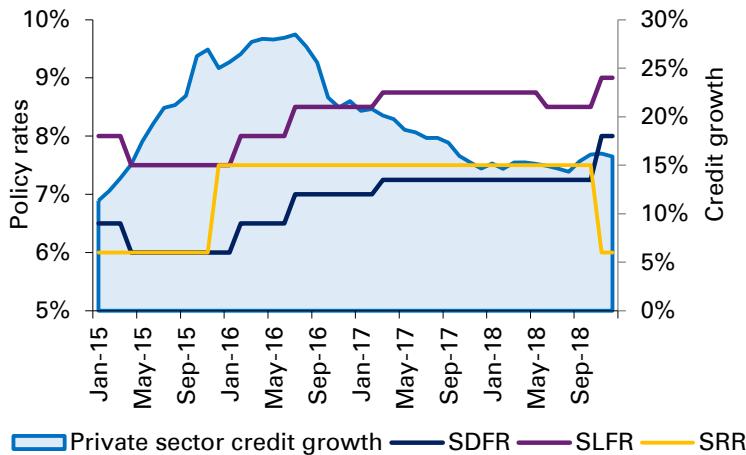
Monetary tightening in advanced economies led to significant outflows from emerging markets in the latter half of 2018. The impact on the LKR was exacerbated by a cluster of upcoming debt repayments in 2019. Rapid depreciation of the exchange rate and imminent import curtailing policies announced by the regulator prompted higher private sector credit growth in September 2018. The events that transpired in late October 2018, effectively derailed GoSL efforts in improving economic fundamentals and investor confidence. International credit agencies downgraded sovereign debt spiraling the economy into deeper crisis.

Deteriorating investor confidence led to further fund outflows from the country. In addition, the ongoing Extended Fund Facility (EFF) program with IMF which has been a key pillar in all reforms made over the past 3 years was suspended due to the political crisis, later reinstated in March 2019.

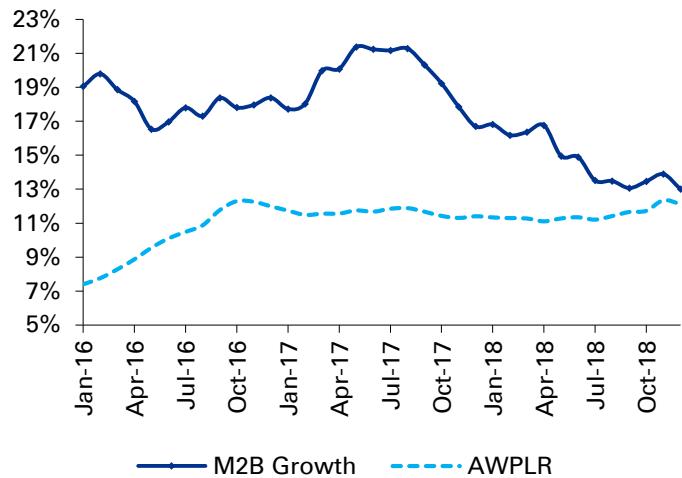
Although CBSL maintained its tight monetary policy stance for much of the year, it resorted to Open Market Operations (OMO) to control market liquidity. Market interest rates consolidated at higher levels for majority of the year. As a result, credit extended to the private sector by commercial banks decelerated in 2018. In May 2018, private sector credit recorded 15.0% growth, achieving desired levels of CBSL and further declined to 14.3% in August 2018. In 2H 2018, with the objective of curtailing excessive import expenditure, 200.0% LC margin on vehicle imports was imposed while lowering the Loan to Value (LTV) ratio of the same. In addition, 100.0% cash margin requirement was imposed on imports of selected consumer durable goods from October 2018. The anticipation of these policies prompted acceleration of credit growth which increased to 16.2% in November 2018 and closed 2018 at 15.9%.

Banking Sector

Private Sector credit growth vs. Policy rates



Money supply vs Prime lending rate



Source: CBSL

In order to maintain the current trend in credit growth, the CBSL is likely to either reduce benchmark policy rates or reduce the margin between benchmark rates and the average prime lending rate (AWPLR). However given the current trends in global financial markets, trade balance and well anchored inflation and inflation expectations it is more likely that CBSL would opt for a policy interest rate reduction in the period ahead.

In 2018, directions were issued on the adoption of SLFRS 9 and Basel III requirements where pillar 1 requires banks to comply with increased minimum capital requirements and buffers. Licensed Commercial Banks (LCBs) with assets over LKR 500Bn should have Common Equity Tier (CET) I, Tier I and Tier I + II capital ratios of 8.5%, 10.0% and 14.0% respectively as at 01 January 2019. LCB's with assets less than LKR 500Bn should maintain CET I, Tier I and Tier I + II capital ratios at 7.0%, 8.5% and 12.5% respectively as at 01 January 2019.

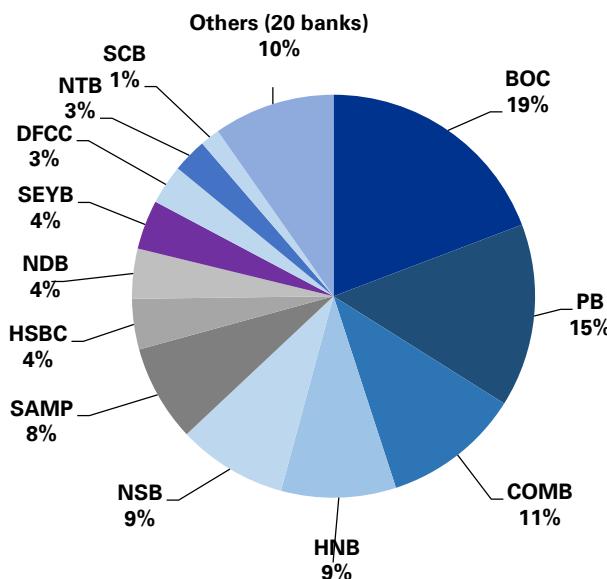
Amidst the pressure from external factors, the total assets of the banking sector expanded by 14.6% in 2018 to LKR 11.8Tn, reflecting convincing growth in comparison to 13.8% growth in 2017. Gross loans and advances grew by 19.6% in 2018 compared to 16.1% in 2017 mainly due to growth in term loans and overdrafts. Nevertheless, the banking sector experienced significant deterioration in asset quality during the year evident by the increase in gross and net non-performing loan (NPL) ratios to 3.4% and 2.0% respectively from 2.5% and 1.3% a year ago. NPL ratio of 5.3% was reported from agriculture, forestry and fishing, 5.2% from manufacturing, 4.7% from tourism, 4.7% from wholesale retail trade and 4.6% from information technology & communication services as at end 2018.

Banking sector deposit growth moderated to 14.8% in 2018 from 17.5% in 2017. Due to the widening interest rate gap between current accounts and savings accounts (CASA) compared to time deposits, banking sector CASA ratio declined to 32.3% in 2018 from 34.4% in 2017. Banking sector net interest income expanded by 16.3% in 2018 due to higher market interest rates growing at a faster pace than deposit rates. However, banking sector profits came under significant pressure from additional impairment provisions coupled with an increased tax burden from the implementation of the new Inland Revenue Act effective from April 2018 and the introduction of Debt Repayment Levy effective from October 2018. Overall, banking sector profits declined by 9.1% in 2018 compared to significant growth of 18.9% in 2017. Further the sector ROE's are likely to remain subdued and unattractive to investors due to capital raising efforts made by banks in meeting and exceeding capital requirements.



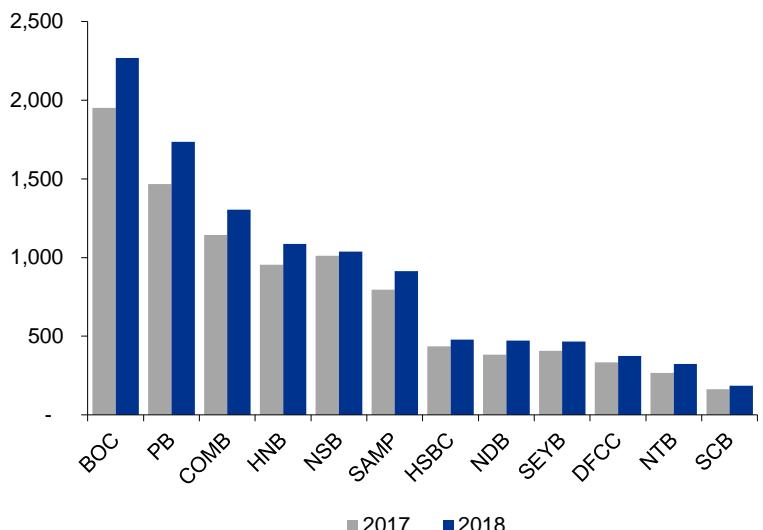
Asset Base

Composition of total assets



The banking sector consisted of 25 Licensed Commercial Banks (LCBs), and 7 Licensed Specialized Banks (LSBs) as at 31 December 2018. The growth in assets of the banking sector in 2018 outpaced that of the corresponding period in 2017.

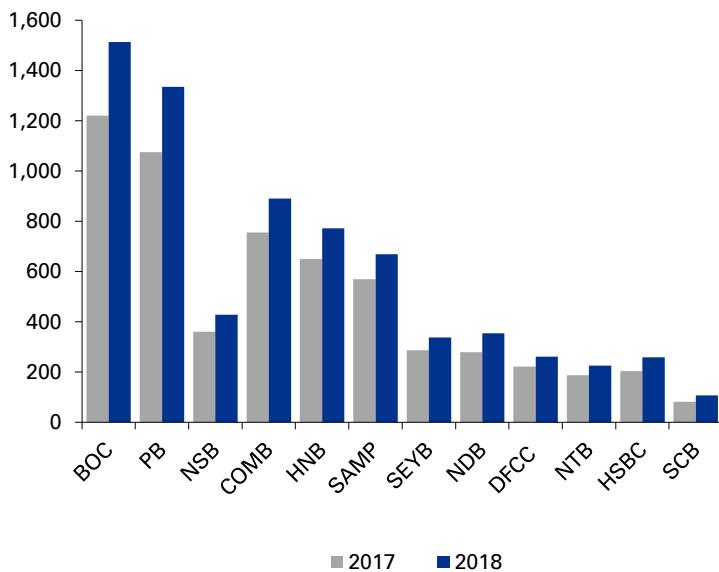
Total asset base of banks under review (LKR Bn)



The total asset base of the banking sector increased by 14.6% over the past year from LKR 10.3Tn in 2017 to LKR 11.8Tn by the end of 2018. Domestic Systemically Important Banks (DSIBs) held 62% of total sector assets as at the end of 2018.

Loans and advances

Gross loans and advances (LKR Bn)



Total gross loans and advances of the banking sector grew by 19.6% to LKR 7.6Tn reflecting a significant increase from 16.1% growth in 2017. A major portion of the said increase was generated by the 2 large state banks.

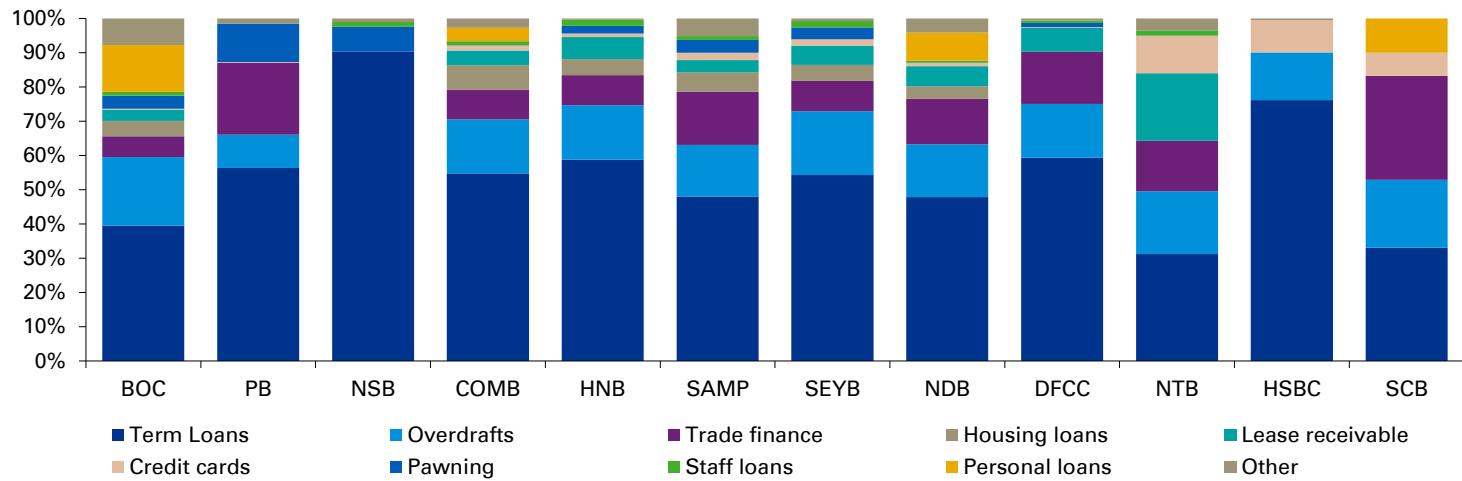
Domestic currency loans and advances accounted for 80.0% of total loans and advances, growing at 17.2%.

We expect sector loans and advances to grow at a slower pace in 2019 due to sluggish economic conditions and slower private sector credit growth.

Source: CBSL, Company reports

Banking Sector

Composition of gross loans & advances - as at 31st December 2018

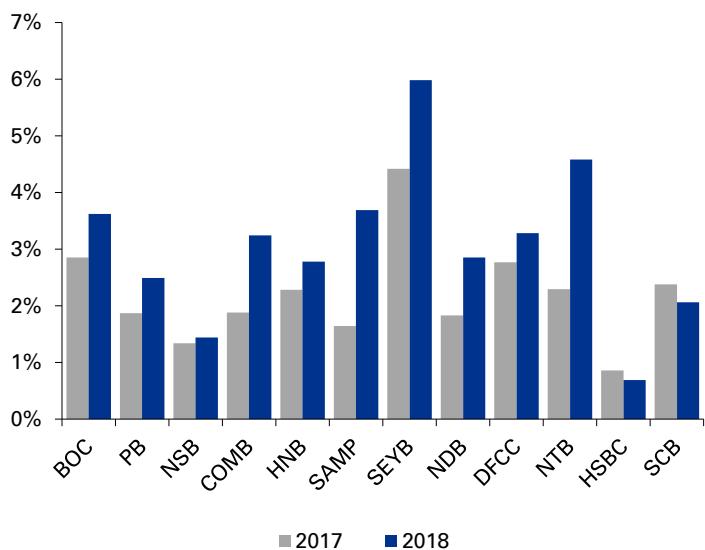


Term loans and overdrafts contributed the most to credit growth. These loans accounted for 66% of total DSIB loans and advances amounting to LKR 3.6Tn.

Trade finance contributed an increased share of credit growth, accounting for 12% of DSIB loans and advances.

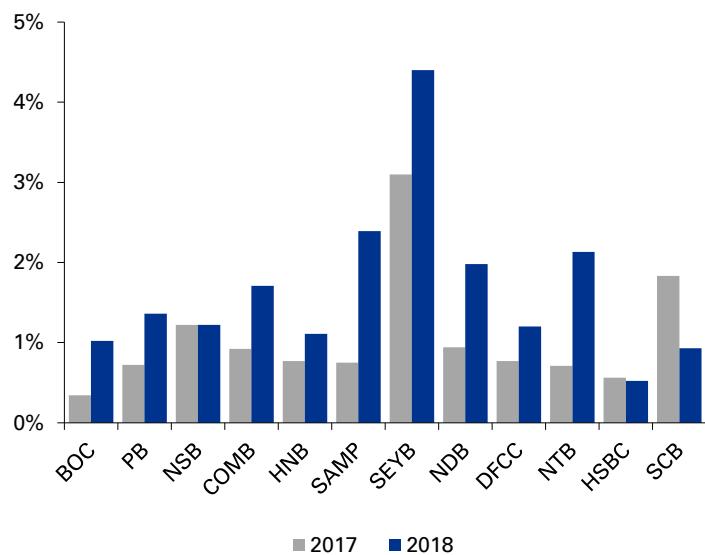
Non Performing Loans (NPL)

Gross NPL



The gross NPL ratio of the banking sector accelerated throughout the year in 2018. Gross NPL ratio increased to 3.4% in 2018 from 2.5% in 2017. This was largely arising from the construction industry related advances and implementation of SLFRS 9 standard.

Net NPL



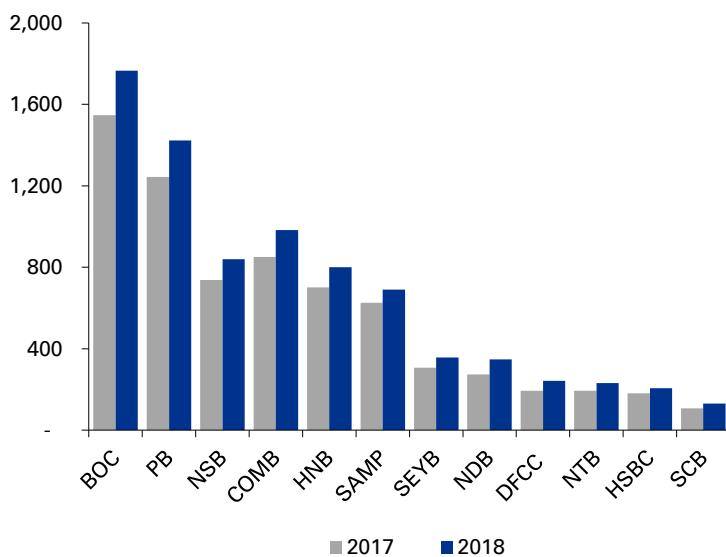
We expect credit quality to remain under pressure as the economy struggles to post a turnaround in activity.

Source: CBSL, Company reports



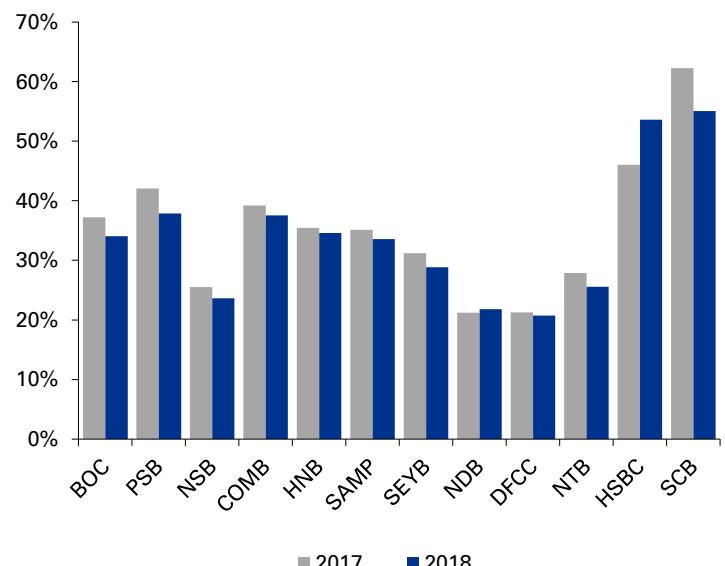
Deposits

Total deposits (LKR Bn)



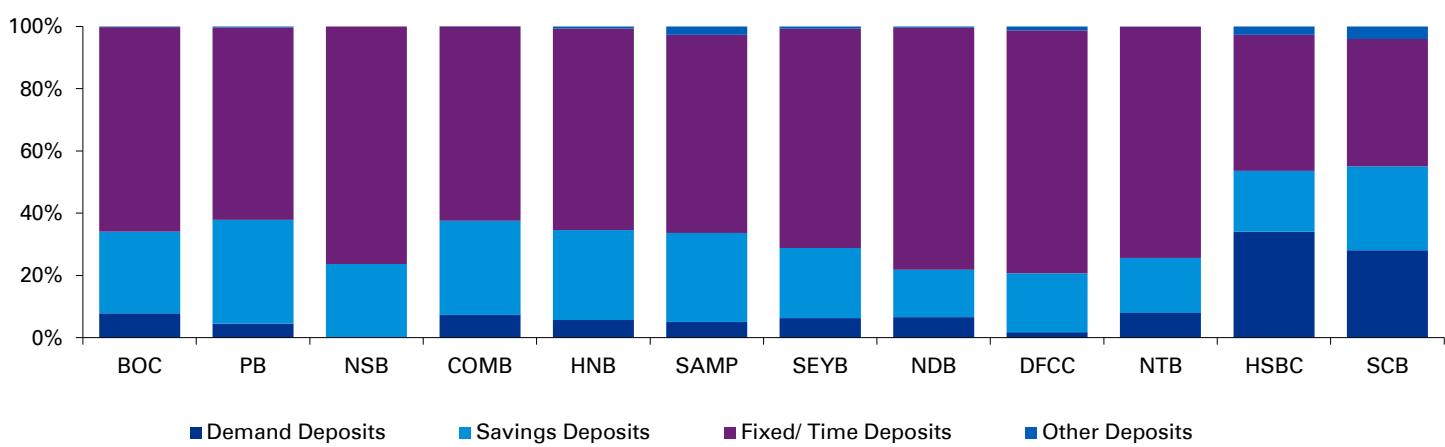
Total deposits of the banking sector increased by 14.8% in 2018 to LKR 8.5Tn. This reflects moderated growth compared to 17.5% observed in 2017. LKR deposits grew by 13.3% compared to 18.6% growth in 2017.

CASA



LKR time deposits accounted for 66.2% of total LKR deposits, an increase from 63.8% in 2017 – indicative of the higher market interest rates.

Composition of deposits – as at 31st December 2018



Foreign currency deposits increased with 22.8% growth, up from 12.2% growth in 2017, mainly driven by surge in time deposits.

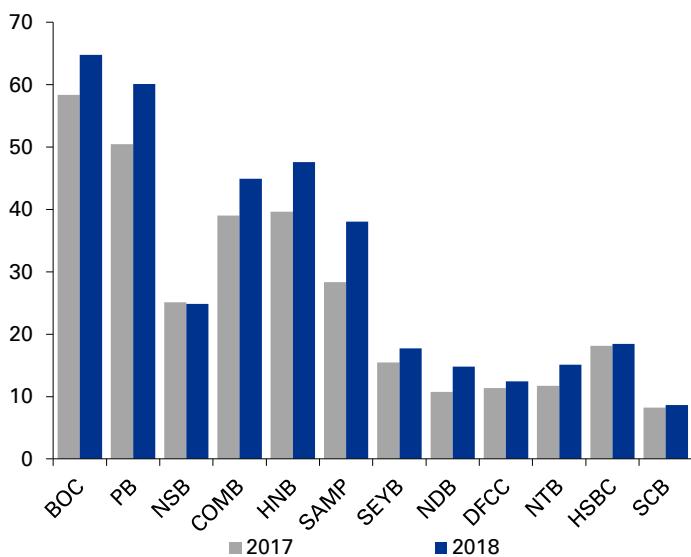
Accordingly, with a transfer of deposits to high cost brackets like time deposits, banking sector CASA ratio declined to 32.3% in 2018 from 34.4% in 2017.

Source: CBSL, Company reports

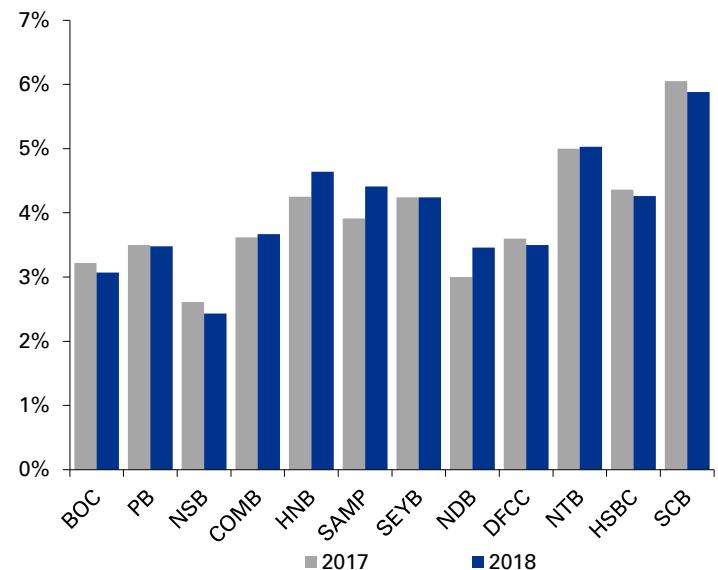
Banking Sector

Financial Performance

Net interest income(LKR Bn)



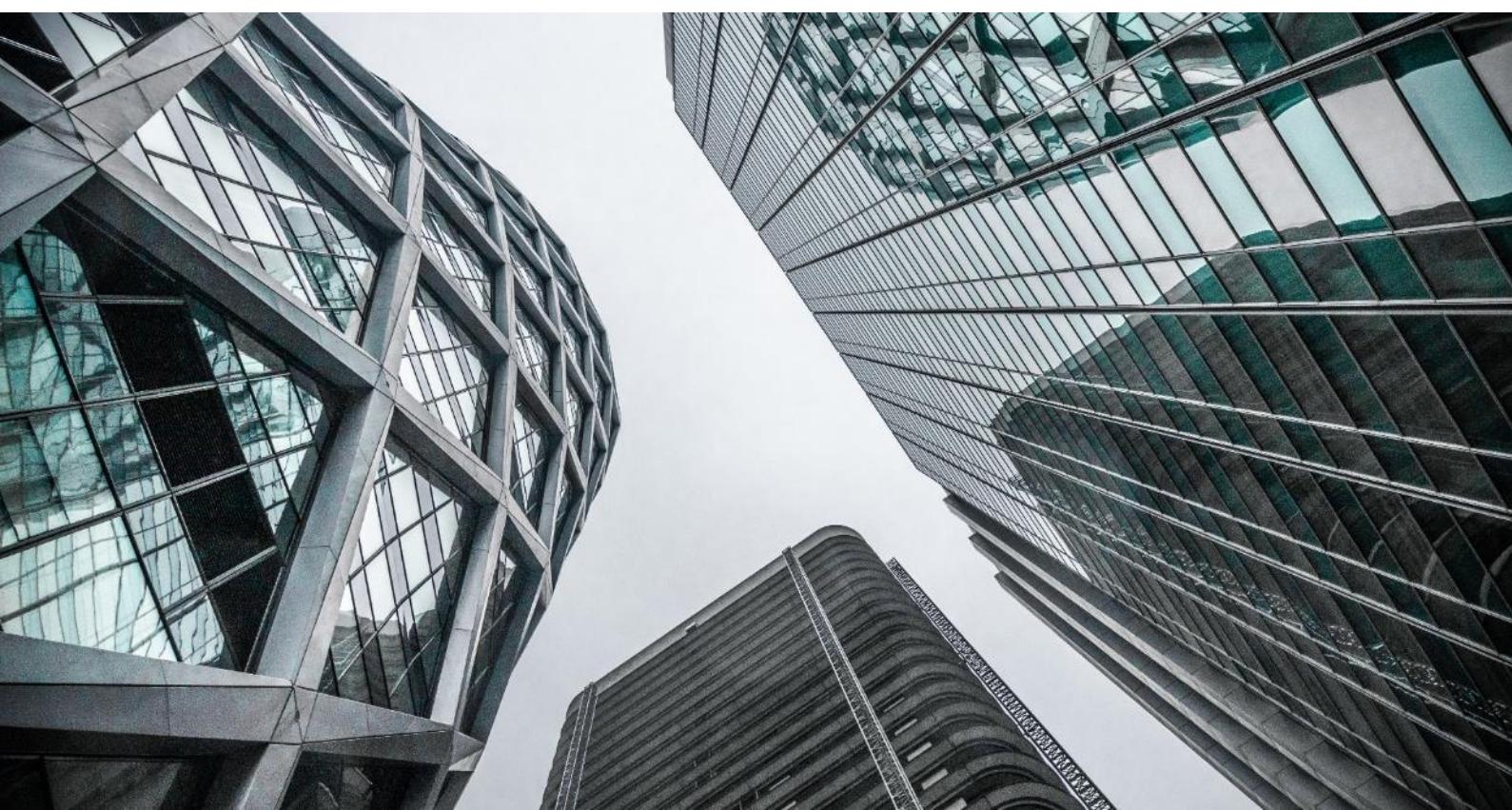
Net interest margin (NIM)



Source: CBSL, Company reports

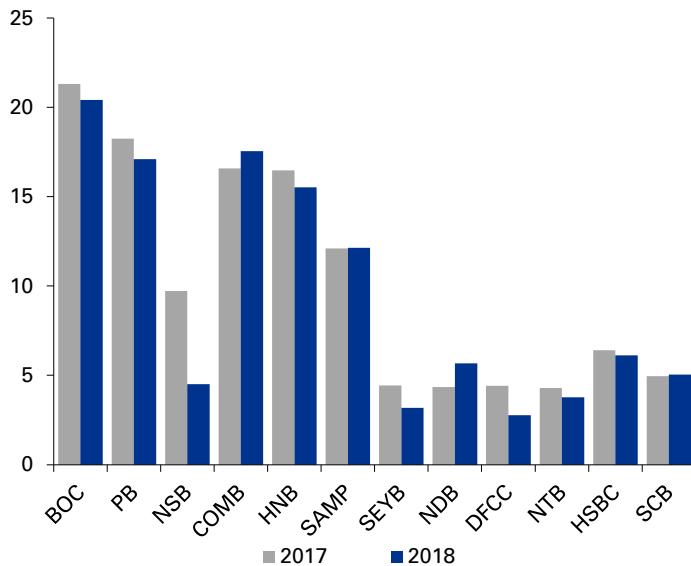
The overall banking sector saw Net Interest Income (NII) increase of 16.3% in 2018, resulting from a 14.0% increase in interest income and a 12.8% increase in interest expenses. The sector Net Interest Margins (NIMs) improved marginally to 3.6% in 2018 from 3.5% in 2017, amidst high interest rates during 2018.

Out of the banks under review, NDB, SAMP, NTB recorded the highest increments in NII in 2018 growing at 37.7%, 34.2% and 28.8% respectively. Timely repricing of asset and liability portfolios coupled with growth in loan books supported this growth. However, NSB saw it's NII decline by 1.0% in 2018 as higher increase in interest expense over interest income exerted pressure on margins.

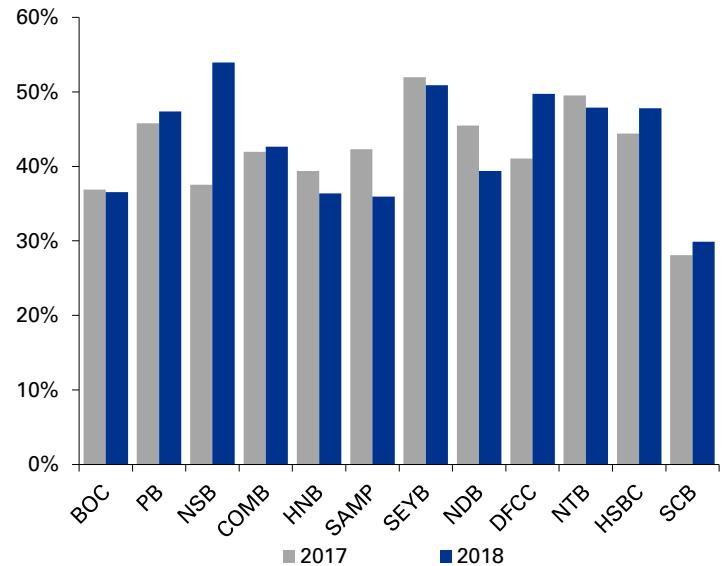




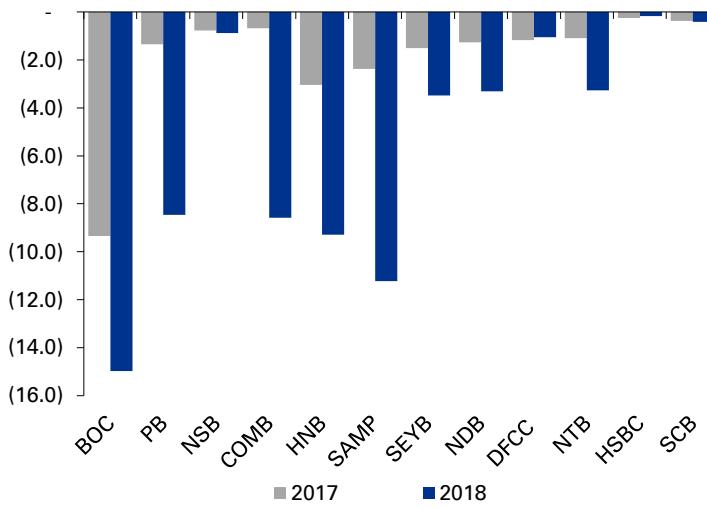
Profit after tax (LKR Bn)



Cost to income ratio



Total Impairment (LKR Bn)



Profit after taxation (PAT) of the sector fell 9.1% in 2018 as a result of higher impairment provisions and increased tax burden from the new Inland Revenue Act weighing down on earnings.

The shift in provisioning models from 'Incurred Credit Loss Model' to 'Expected Credit Loss Model' as per SLFRS 9 - Financial Instruments, from January 2018 onwards saw the impairment expense of banks increasing significantly. Further, the deterioration of asset quality during the period added on to higher impairments.

The implementation of the Debt Repayment Levy from October 2018 on value added basis further damped earnings of the sector.

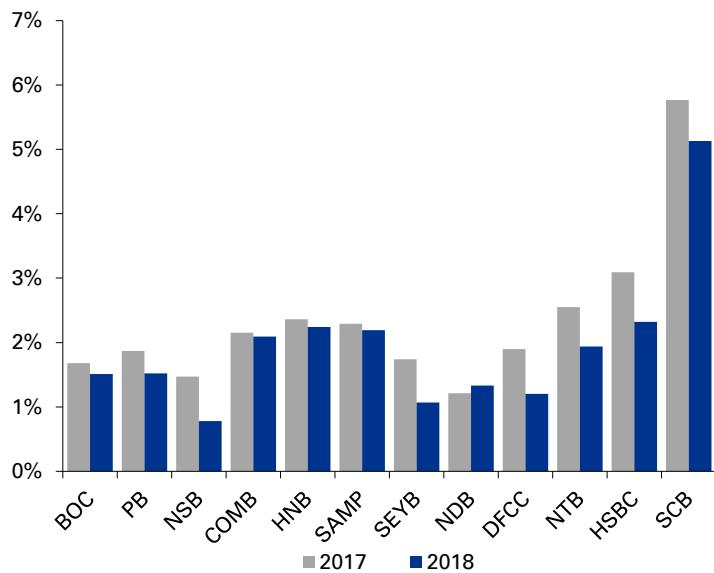
Source: CBSL, Company reports



Banking Sector

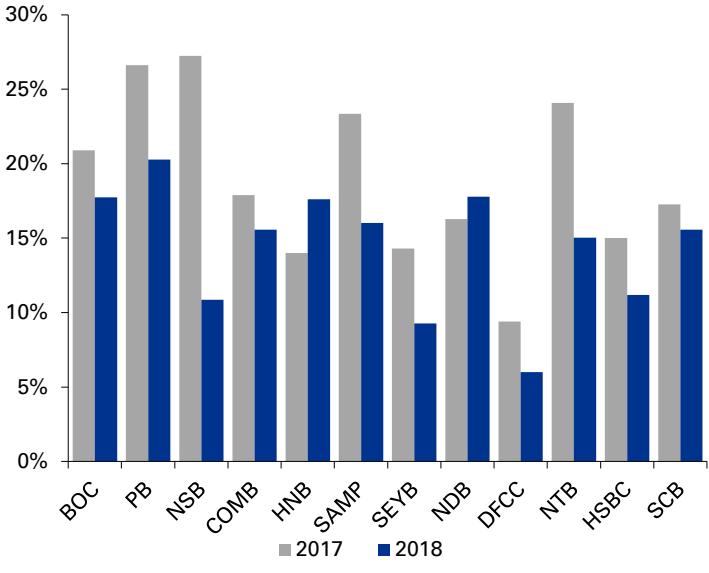
Profitability

Return on Assets – before tax (RoA)



The fall in sector earnings coupled with the increase in asset bases of banks resulted in overall banking sector RoA (before tax) fell to 1.8% by end 2018 compared to 2.0% a year earlier.

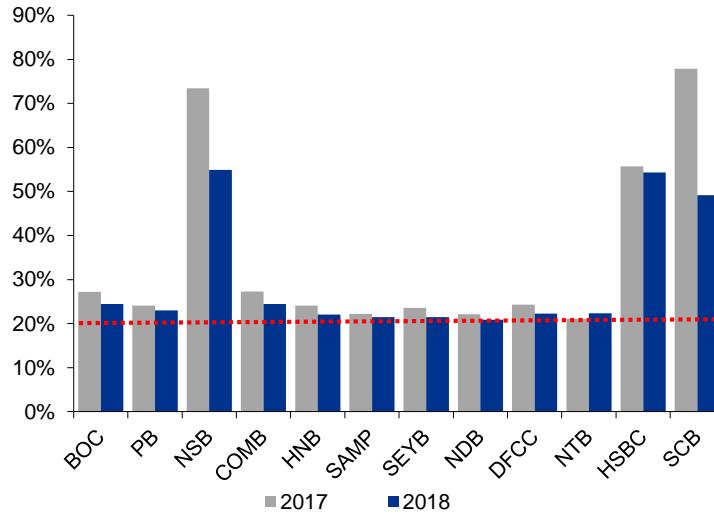
Return on Equity (RoE)



On a similar note, the falling earnings coupled with increased equity bases (due to increased capital adequacy requirements) saw the sector RoE falling significantly to 13.2% as at end 2018 from 17.6% a year earlier.

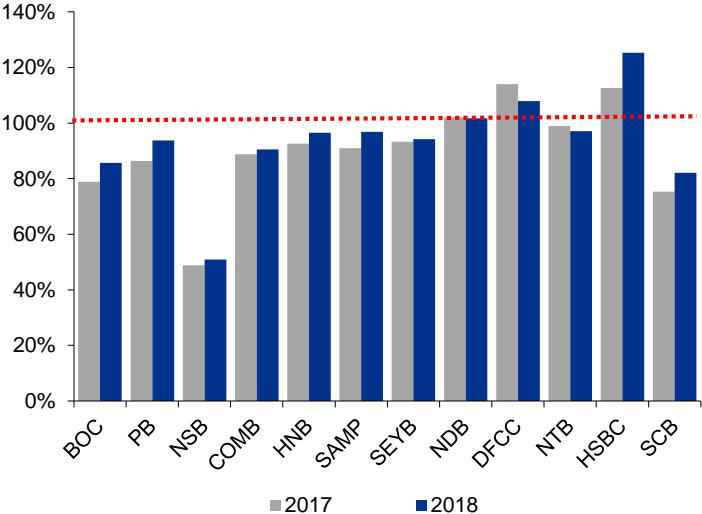
Liquidity

Statutory liquid asset ratio



The statutory liquid Asset Ratio (SLAR) of domestic banking units reduced to 27.6% as at end 2018 from 31.3% as at end 2017. However the sector SLAR is still higher than the regulatory minimum of 20.0%.

Credit to deposit ratio



The credit to deposit ratio of the sector increased to 90.6% as at end 2018 compared to 86.9% as at end 2017. Local banks excluding NDB and DFCC (which transformed from being development banks to LCBs) maintained credit to deposit ratios below 100%.

Source: CBSL, Company reports

ACKNOWLEDGEMENTS

The following KPMG staff have made significant contribution towards the development of this publication.



Sashi Dharmadasa
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About KPMG

KPMG Global

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



Global Revenue

28,960 million USD

9,090 19,870

Financial sector services

Rest of services

Revenue figures 2017/2018



153
Countries



985+
Offices



207,050
Professionals

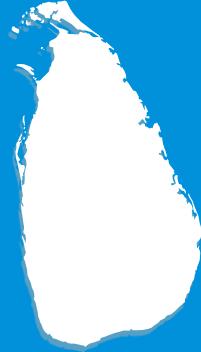
KPMG Sri Lanka

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



6 Offices

Including one in Maldives



Over 1,400 Professionals

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



Audited 45% of Listed Entities in Sri Lanka

As indicated in the LMD Auditors League 2016.

683

Professionals in
Audit



178

Professionals in
Tax

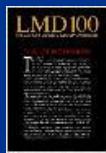


272

Professionals in
Advisory



Recognition | KPMG in Sri Lanka



First in the Auditors League in Sri Lanka



Recognized for Professionalism and Integrity



Best Deal Advisory Firm in Sri Lanka



Best Advisory Firm in Sri Lanka



Sri Lanka Tax Firm of the Year

LMD 100 - 2017

LMD Most Respected 2017

Global Banking and Finance Review 2015

The International Finance Magazine 2016

Asia Tax Awards 2017

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

KPMG service offerings



Audit

High quality, independent financial statement audits are essential to maintain investor confidence.

Our audit professionals are committed to the public interest. They seek to challenge assumptions and unlock valuable insights based on a thorough understanding of an organization's business and industry, and innovative audit methodologies and approaches.

Understanding the financial performance of any business must be placed in the context of strategic priorities, risk appetites and competitive positioning. Our technology-enabled audit approach applies extensive data analytics to provide the necessary evidence confirming that critical controls and disclosures uphold the highest level of integrity.

Management Consulting

Our high capability teams offer deep industry and technical knowledge, and market-leading tools to deliver solutions across every business and industrial sector.

Our consultants assist clients to make better decisions that may reduce costs, enhance organizational effectiveness and develop appropriate technology strategies.

Risk Consulting

Our risk consulting practice combines the knowledge and expertise of over 50 partners, directors and professionals. We help organizations transform risk and compliance efforts into competitive advantage by applying a risk lens to corporate strategy. This improves risk intelligence and decision making, protects financial and reputational assets, and enhances business value.

Deal Advisory

Our experienced investment professionals skilfully assess how opportunities to buy, sell, partner, fund or fix a company can add and preserve value. Our teams combine a global mind-set and local experience with deep sector knowledge and superior analytic tools to support clients. From assisting to plan and implement strategic change to measurably increasing portfolio value, we deliver tangible results.

Tax

A business's approach to tax is increasingly subject to public scrutiny and is now a major reputation driver. From company set-up to cross-border and transfer pricing solutions, we work with a wide range of national and multi-national organizations to deliver effective tax solutions. Our tax professionals combine international experience with local knowledge to provide leading edge commercial tax strategies tailored to specific client needs.

- Audits of financial statements
- Audit-related services
- Audit data & analytics
- Accounting Advisory

- People & Change
- Customer & Analytics
- Financial Management
- Operations
- Strategy & Economic Advisory
- IT Advisory
- Supply Chain

- Forensic
- Business Process Management
- Accounting Advisory Services
- Internal Audit & Risk Compliance

- Valuations
- Debt Advisory
- Transaction Solutions
- Mergers & Acquisitions
- Corporate Restructuring
- Real Estate Advisory

- Inbound & indirect taxes
- Transfer pricing
- Tax management consulting
- Corporate Tax
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KPMG Leadership - Banking



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Social Media;



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