Sri Lanka banking perspectives 2018

Transforming horizons

May 2018

Foreword

Major developments in technology and regulation are likely to have a transformative effect on the current and future landscape of the banking sector in Sri Lanka.

In Sri Lanka as well as globally great leaps are being taken in the technology space, be it block chain, Fin Tech or digital transformation. Although, this makes transactions more efficient, the risk of cyber attacks has never been bigger than it is now. Not only individual companies but countries are at risk. As a result, there is a greater need for vigilance and continued focus on enhancing existing regulations and introducing new ones in response.

A fraud risk focused approach is necessary to mitigate the potential risk of fraud which may arise from previously benign channels. These efforts, together with existing international and local initiatives to improve the stability of the global financial system, require continued focus from both regulators and the banking sector. This gets more complicated for those with extensive operations across multiple jurisdictions.

The recent policy reforms affect the overall economy with a knock on effect on the banks, resulting in muted growth forecasts in the near term while the outlook remains positive in the mid to long term.

Against this backdrop, banks are assessing how they can use new and innovative technologies to differentiate themselves from their competitors.

Banks also find themselves having to invest to comply with ever more stringent and complex regulations and tax regimes.

KPMG Sri Lanka, has undertaken an analysis of the key financial indicators reported by the banking sector for the past year, and evaluated where we are in the roll-out of recently released legislation and regulations, mainly IFRS 9 which affects all of us this year.

This is the first Sri Lanka Banking Perspectives we have produced. It complements our historic expertise in this sector, and highlights some of the key financial trends, challenges and opportunities for the banking industry in the country.

As a team, we look forward to discuss these themes with you in the coming weeks, and continue to update you as these evolve.

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Ranjani is an audit Partner and counts over 20 years of experience, including as lead partner for a number of multinational & local banks. She recently served as the Audit Engagement Partner for the local operations of three multinational banks operating in Sri Lanka and also for the Audits of two of the largest listed Banks in the Colombo Stock Exchange.

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Executive summary

The Sri Lankan banking sector is in a healthy position, although more stringent regulations are being imposed in terms of risk and accounting. The increasing competition within the sector and from the non-banking financial institutions coupled with the tighter requirements on capital is expected to make banks more risk focused and innovative through technology. While the sector will improve its operational efficiency, mitigate risk, focus on sustainable earnings whilst enhancing customer experience, we expect the sector to consolidate to create larger and stronger banks.

We have seen various regulations being imposed over the last year ensuring a stronger banking sector, particularly in capital requirements and provision treatments. The **Basel III regulation** has led to more stringent regulation in capital, liquidity and leverage. The new and tighter regulations that have come into force or are coming in, are expected to have an impact on the core capital and bottom line of all banks in the sector. The requirement for more high quality capital, which has a larger loss-absorbing capacity has led the banks to raise rights issues in the last year and the remaining are now considering equity infusions in the near future.

International Financial Reporting Standard (IFRS) 9 came into effect for annual periods commencing 1 January 2018. Most of the banks technically have been able to meet the date of initial assessment, but we expect much more refinement of processes to take place before IFRS 9 will become business as usual. With the introduction of an expected credit loss model compared to the current incurred loss model, going forward we expect higher provisioning. This further has placed pressure on the capital levels and ratios of the banks.

Six Domestic Systemically Important Banks hold over 70% of the total banking sector assets. The higher capital requirement and severe competition is expected to threaten the small banks' performance over the medium term. Hence, we expect **consolidation** in the sector to further strengthen the overall banking system.

With increasing regulation, competition and the economic environment we expect the mid to large banks to move into **sustainable levels** of loan growth and return on equity. The economy is expected to attain its potential over the medium to long term with the implementation of envisaged structural reforms, receipt of expected inflows of foreign investment, a conducive low inflation environment coupled with a competitive exchange rate.

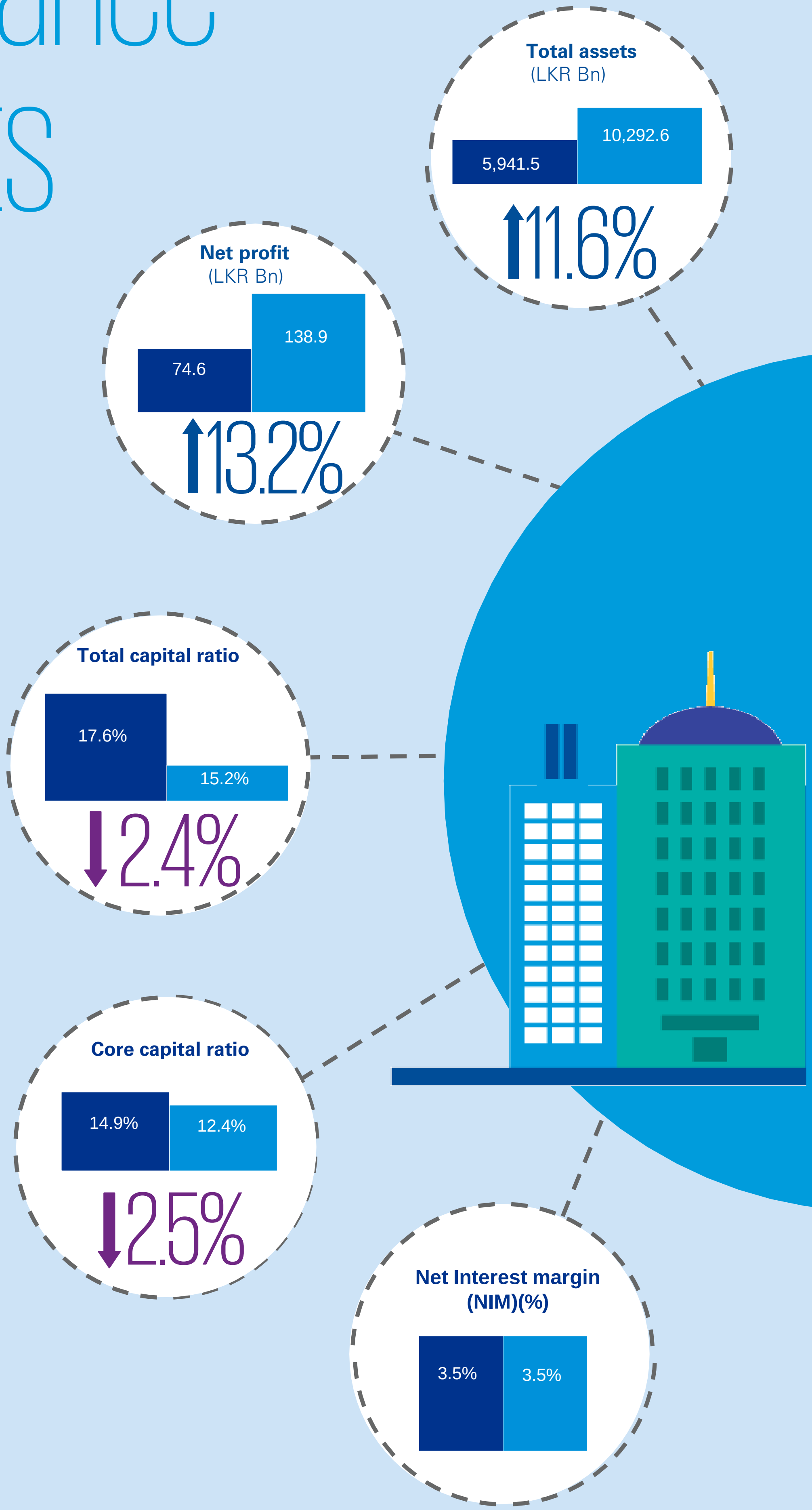
The **Inland Revenue Act (IRA)** effective from 1 April 2018 has been one of the major reforms the Government of Sri Lanka has implemented recently. The main objective of the new IRA is to simplify the tax system in order to create an investor friendly environment that would attract more FDIs. The IRA is expected to reduce the indirect taxes levied from the public from 80.0% to 60.0% whilst increasing the proportion of direct taxes within the next three years. Changes in tax treatment on some investment securities may have a positive impact on deposit growth of the banks.

The CBSL reversed the tight monetary policy stance it maintained since late 2015 by cutting the Standing Lending Facility Rate by 25 bps in April 2018. With this reversal the **loan growth** is expected to hover around 15% in the coming year, given the low GDP growth expectation and prevailing low inflation levels.

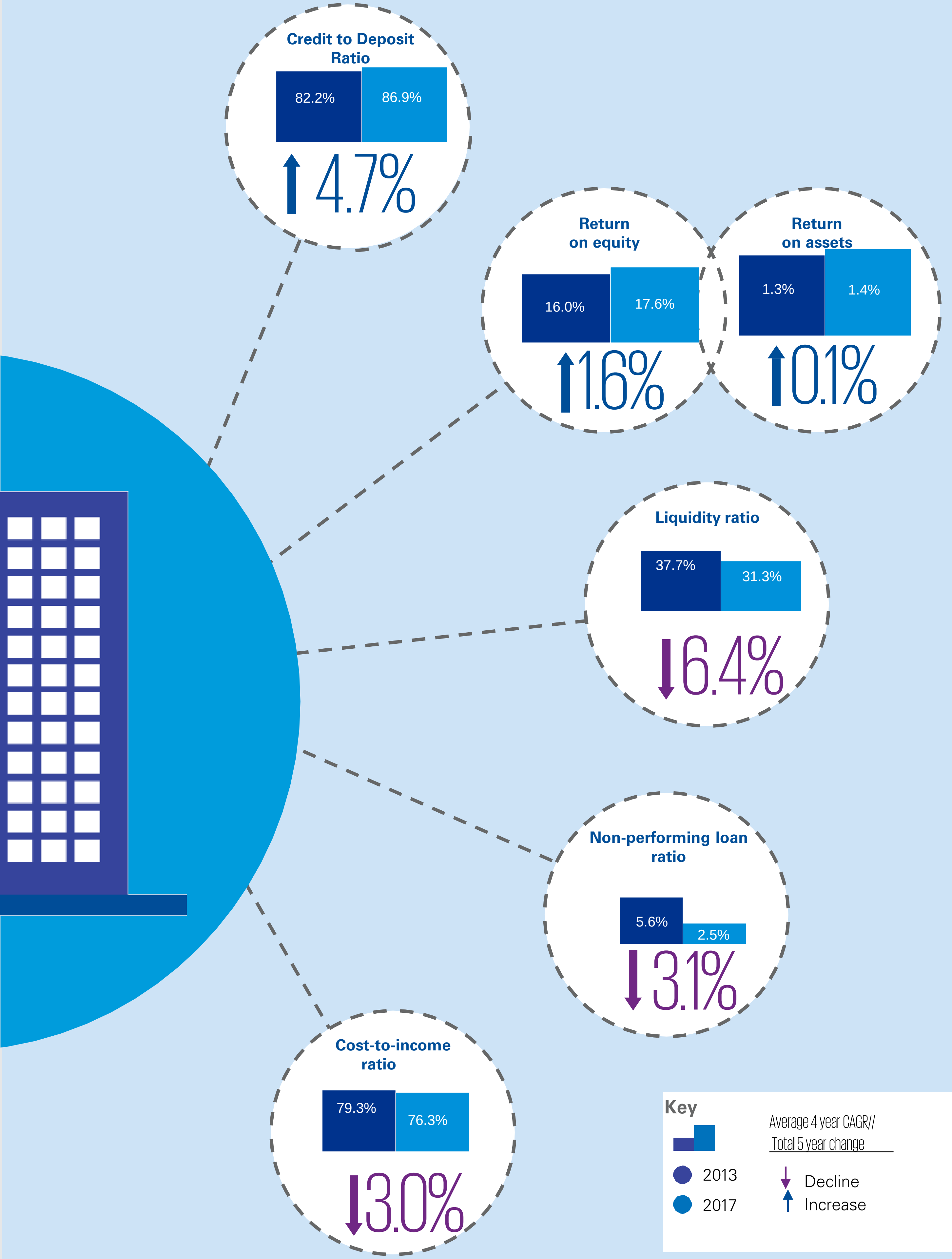
The debt repayment, domestically and externally, along with global developments is expected to refinance government debt at a higher cost which may put pressure on the **interest rates** starting late 2018. However, the net interest margins are expected to move in a narrower range with increased competition and less volatility in interest rates compared to the trends observed in the recent past.

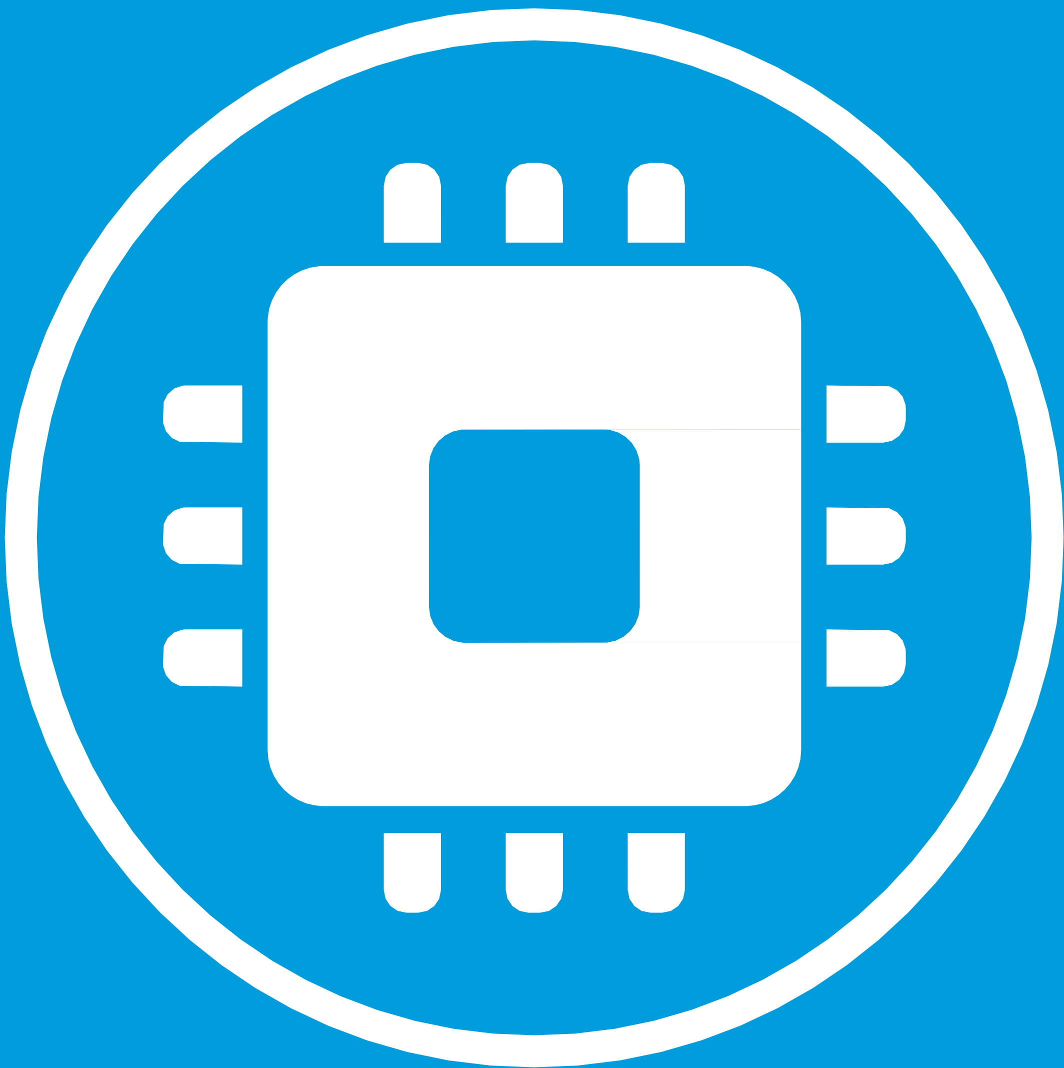
The strong competition in the sector has led banks to be innovative with its products and migrate to the digital platform. Globally, a wave of new **FinTech** players have emerged with solutions covering most of the complex aspects of the banking value chain. Domestically, some banks have identified the opportunity along with the strength of their resources and scale and ventured into the FinTech space.

Performance highlights



KPMG


Credit to Deposit Ratio
82.2%
86.9%
4.7%
Return on equity
16.0%
17.6%
1.6%
Return on assets
1.3%
1.4%
0.1%
Liquidity ratio
37.7%
31.3%
6.4%
Non-performing loan ratio
5.6%
2.5%
3.1%
Cost-to-income ratio
79.3%
76.3%
3.0%
Key
Average 4 year CAGR//
Total 5 year change
2013
2017
Decline
Increase



Cyber security

Cyber security: meeting the challenge

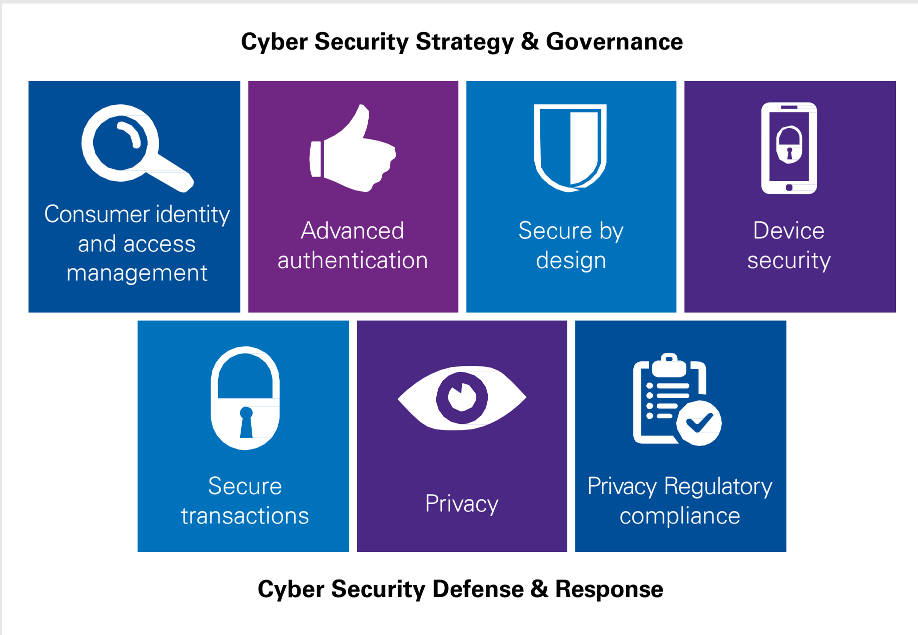
With the rapid growth of Financial Services technology and the adoption of electronic channels, money is increasingly moving in a digital manner. But along with these advances we have seen a marked increase in cyber-security breaches and fraud. Precautions which banks can take are explained Priyanka Jayatilake

The pace of technology-enabled innovation has increased exponentially over the last decade, resulting in new business opportunities in the banking industry, such as digital branding (via mobile and internet channels), augmented reality (AR) and virtual reality (VR)-based banking channels, blockchain-based transactions and the internet of things (IOT)- based payments. Transactions are being processed faster, free, and in a user-friendly manner.

These evolutions have fundamentally changed the way customers expect to interact with banks. They now demand a multi channel presence, improved client experience, secure transactions, and better control over privacy of their data to protect against fraud.

These issues have made cybersecurity one of the top ten priorities in the board rooms, as any breach could undermine the trust that customers have in their banks, and therefore affect the future profitability and sustainability of the organizations.

CBSL has always given great attention to cyber security: minimum guidelines are set and needs to be maintained by all banks and financial institutions regulated by CBSL. The present Governor, Central Bank, has been present at the Cyber Security Summits in the last two years, from the time he was appointed, to give prominence to the subject.



The financial services sector, being one of the most frequently targeted sectors globally, has taken a particular interest in this subject. In the financial sector in Sri Lanka we have noted that banks have invested significantly on cyber security.

IPGs are becoming more prevalent and needs to be secure to provide confidence to the users.

Based on our global expertise of delivering cyber-security solutions and our experience of creating digital solutions for banks, we believe there are seven key capabilities that are strategic to secure digital solutions for clients and build greater trust in the organization:

Cyber specifics

Cyber security strategy and governance and cyber security defense and response are the traditional blocks of security. These translate into a number of specific areas, as follows:

Consumer Identity and Access Management provides a single identity across multiple channels for users to access their accounts, manage their preferences, and manage their credentials in a secure manner. It also provides a mechanism to gather data to understand customer needs and preferences.

Changing technologies and increased security concerns have almost rendered passwords obsolete. In order to meet both security and customer requirements, multiple, advanced authentication options, such as biometrics and push notifications, will likely need to be offered. Higher assurance credentials can be leveraged to increase the security assurance of a user for higher risk transactions, such as balance transfers and trades.

New technologies, such as cloud and mobile, are driving customers wanting to access their accounts from any channel, at any time, from anywhere. This is resulting in significant changes in architecture. In order to adapt these changes, security ought to be designed into the architecture and the development lifecycle, across different channels and technologies.

The proliferation of different devices poses new security risks. Understanding and adapting the security requirements of different devices and digital interfaces that the consumer connects with are essential to minimize account takeover and malware introduction.

As digital financial transactions are becoming more common place, securing the mechanisms that enable each transaction is critical to successfully compete in the omni-channel and completely mobile environment.

Direct Impact to Banks

Banks handle a significant amount of personal information. Although regulations for handling this data vary from region to region, any personal information collected should be managed in accordance with the local regulations and only used with the consent of the owner of the information.

Understanding how regulations, such as the EU General Data Protection Regulation (GDPR) and others, play a part in the organization's digital strategy is essential in order to succeed and outpace competitors. Increasing regulatory pressure from the US, the UK, Europe and elsewhere require adjustments in technology configurations, and security requirements are increasingly being enforced. New global regulatory pressures are likely to play a significant role in how financial services institutions interact and collect data of their consumers. This needs to be aligned and understood with the overall organizational digital strategy.

In our 2017 Global CEO Outlook survey it was clear that chief executives would be paying more attention to – and investing more in – cyber security in the coming years. This will require finding staff with the appropriate skills; many CEOs report that human capital is currently one of the biggest challenges they face when it comes to tackling this issue. These CEOs, however, believe that such risks, if tackled adequately, can further prompt innovation in products and services.

We don't think there are many board meetings or executive meetings in Sri Lanka where the cyber threat isn't discussed. **If companies aren't concerned, they probably should be.**

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Priyanka was the engagement and quality assurance partner for IT Infrastructure and Security Review carried out in the year 2005 for a leading international bank. Priyanka is also the National IT Security Officer and Chief Knowledge Officer for KPMG Sri Lanka and Maldives.

He has lead many engagements related to core banking applications reviews in Sri Lanka

Priyanka has also lead an engagement on implementing Oracle E-Business Suite for a large listed commercial bank automating the back office functions of the bank including inventory, GL, accounts receivable, account payable and procurement

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"If companies aren't concerned, they probably should be"

Regulation

IFRS 9: refining initial implementation

Given the gravity of the impact of IFRS 9, implementation efforts are likely to continue as banks work on refining the infrastructure-supporting areas to ensure all aspects of the standard are applied with smooth transition. Ranjani Joseph comments on the important aspects here.

Most banks around the world would have completed the implementation projects involved with the International Financial Reporting Standards 9 – Financial Instruments (IFRS 9) over the last few months. The conceptual transition from incurred loss to expected credit losses is almost completed. Adoption of IFRS 9 has affected banks globally and has completely transformed how they approach and view the loan impairment process.

The standard has brought about significant changes in several areas such as financial reporting, risk management, capital management, regulatory reporting, data sourcing and collection, governance framework and IT systems. The standard has, in many ways, integrated the Risk, Finance and IT functions of banks.

The IFRS 9 on financial instruments, replaced the previous version of IAS 39 from January 1, 2018. The application of the standard is predicted to increase the impairment provisions reported by the banks to a great extent and this is likely to affect profits and capital as well. Consequentially, some of the banks might face challenges in meeting the increased capital ratios under BASEL III, which is due to come into full effect from January 1, 2019. CA Sri Lanka has issued guidance providing the option to issue quarterly statements adjusted to reflect the IFRS 9 impact from 1Q 2018 onwards. However the entities are required to apply IFRS 9 in the preparation of financial statements for the annual periods beginning on after 01st January 2018.

In general the initial impact of IFRS 9 is estimated to be roughly 40-50% increase in impairment provisions and an approx. 10% increase in recurring impairment charges. To avoid a breach of these minimum capital levels by banks, the Central Bank of Sri Lanka (CBSL) has requested banks to provide them with a reliable approximation of the effect on their capital augmentation plans.

In contrast to the "Incurred Loss Model" under the former IAS 39, where a bank assesses the need for provision, when a facility demonstrates signs of difficulty, the "Expected Loss Model" under IFRS 9 assumes a probable loss on the very first day the loan is granted. This will result in booking provision during the first year of the facility. Furthermore, when the facility presents a serious decline in the quality, it is required by the standard that the bank makes a provision for the lifetime of the facility. While the 'Expected Loss Model' under IFRS 9, is considered inherently subjective, it reduces the possibility to delay provisions or make inadequate provisions on possible bad loans.

In order to promote reliability and comparability, CBSL is in the process of issuing guidelines to be followed in the development of IFRS 9 expected credit loss models, including the definition of default, forward looking information, mapping of internal and external ratings definitions, significant increase in credit risk, low credit risk exemption and upgrading of accounts.

While most banks have been able to meet the date of initial assessment/implementation, we assume that it may take longer before IFRS 9 is fully implemented. Existing IT systems need to be significantly modified to account for the changes requested by IFRS 9 in the most cost-effective and scalable way possible while data sources and models need to be further enhanced.

Adequate infrastructure and systems must be provided for data. An example would involve the recording of collateral information, costs and details of recoveries used in Loss Given Default (LGD) calculation.
Constant monitoring is required for the models that have already been implemented to ensure a smooth transition now, while maintaining efficiency in the future. All these changes, will require a significant investment in terms of resources and time from the bank's perspective.

Reinforcing sound governance

The inter-dependency between the IT, Finance and Risk functions calls for a revised governance policy. Such a policy will require a sound structure comprising the board of directors, steering committee, working group committee and technical working group committee. The Basel Committee for Banking Supervision (BCBS) and Global Public Policy Committee (GPPC) and other such bodies under the Central Bank of Sri Lanka, have all recommended minimum standards of governance to support the proper implementation of IFRS 9. The implementation of these governance measures will need careful deliberation and time.

It is expected to bring changes to the way banks conduct business. IFRS 9 is likely to result in some of the business lines and the products becoming less feasible than others. Provisions under IFRS 9 are point-in- time, hence are closely linked to the economic cycle. It is likely that banks will reconsider lending to those sectors that are susceptible to changes in the economic cycle. Similarly, loans with a longer time period and bullet payments are also likely to come under increased pressure following the effect of expected credit loss (ECL). This will require the Portfolio strategy to be amended to avoid the increased volatility.

Profitability has been found to be affected at present and may continue to be so, in the future as well. Increased impairment provisions will result in a fall in profitability. The implementation of Basel III, alongside IFRS 9, will result in a higher cost of capital for banks as the capital adequacy ratio rises to 14% by 2019 with a supplementary capital conservation buffer.
Furthermore, the requirements for the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) will cause a rise in the cost of liquidity. This is likely to affect profitability and capital. This will affect product pricing, deal origination, maturity and the amortization of products offered.

Credit management

Credit management practices will also be affected in the future as banks may have to estimate forward-looking expected loss over the life of the financial facility and continuously check for ongoing credit-quality deterioration. Costs and recoveries will have to be captured and monitored frequently. As the credit benchmarks have become higher, more relevant costs and recoveries will need to be captured and regularly monitored.
Banks may also need to review and adjust performance indicators, incentives and compensation schemes to reflect for the associated changes in IFRS 9. The Collections and Recoveries teams will need to commence their work earlier, considering the 30 days past due (DPD) threshold for a considerable increase in credit risk (SICR). Shocks on the economy will call for vigorous monitoring and transferring of borrowers from stage 1 to stage 2. Such monitoring will lead to an increase in collection and recovery costs.

The relationship manager has a pivotal role in an IFRS 9 scenario. She or he has a role in structuring and pricing the product for the obligor, collecting the installments and being the first point of contact to obtain credit information from the customer.

The role of the business teams is likely to be more onerous with the incentive structures tied to an appropriate risk- adjusted profitability metric, such as return on risk-weighted assets, return on risk-adjusted capital or economic value added.

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Ranjani is an audit Partner and counts over 20 years of experience, including as lead Partner for a number of Multinational & local Banks. She most recently served as the Audit Engagement Partner for the local operations of three multinational banks operating in Sri Lanka and also for the Audits of two of the largest listed Banks in the Colombo Stock Exchange.
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Ranjani's responsibilities include: leading clients through emerging accounting challenges, specifically IFRS 9, advising on various accounting transactions, and guiding senior stakeholders on accounting matters.
Her focus is on the integration of the risk and financial data to achieve business outcomes while meeting compliance requirements.

Macro economic overview

Sri Lanka's economy expanded 3.1% in 2017

National accounts

Sri Lanka's economy expanded at a lacklustre 3.1% in 2017 in real terms compared to 4.5% in 2016. The adverse weather conditions that prevailed during the year contributed mainly to the slower growth.

In 2017, agriculture, services and industry sectors contributed their share to the GDP at 6.9%, 26.8% and 56.8% respectively.

Agricultural activities reported a negative growth of 0.8% in 2017 compared to a negative growth of 3.8% recorded in 2016. The contraction in agricultural activities was due to the continued impact of adverse weather conditions that prevailed during the period.

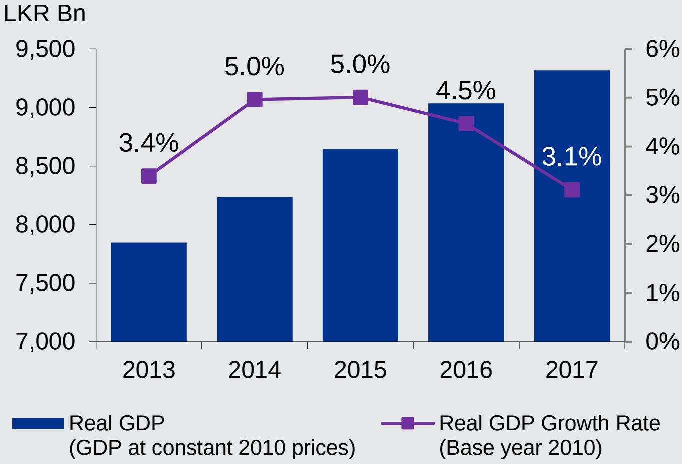
Industrial activities recorded a growth of 3.9% in 2017 compared to 5.8% recorded in 2016. Under the sub-activities construction activities grew 3.1%, manufacturing grew 3.9% whilst mining and quarrying grew 5.9%.

Services activities with the highest contribution to the overall GDP grew at 3.2% in 2017 compared to 4.7% in 2016.

The CBSL expects the Sri Lankan economy to have grown at 3.7% in 1Q2018.

ADB expects Sri Lanka's economy to expand at 4.2% in 2018 and 4.8% in 2019, whilst World Bank expects Sri Lanka's GDP to rebound in 2018 and continue around 4.5% in the medium term.

Real GDP and Real GDP growth rate

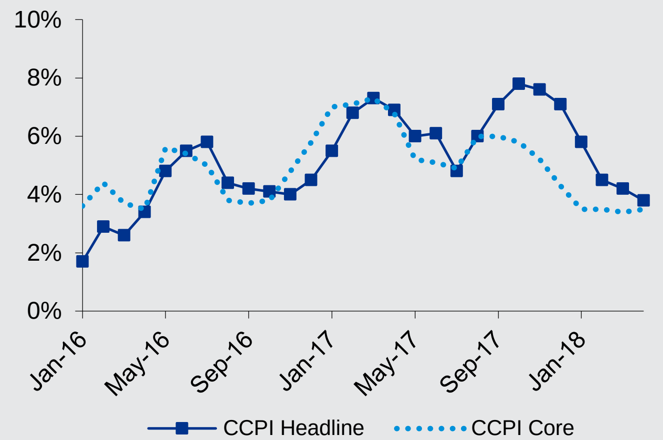


Source: Department of Census and Statistics

Inflation as measured by CCPI

The annual average inflation as measured according to CCPI (Colombo Consumer price Index – Base 2013) increased to 6.6% as of end 2017. However since January 2018 the inflation is on a downward trend falling to 3.8% in April 2018 from a 5.8% recorded in January.

Colombo Consumer Price Index (CCPI)



Source: Department of Census and Statistics

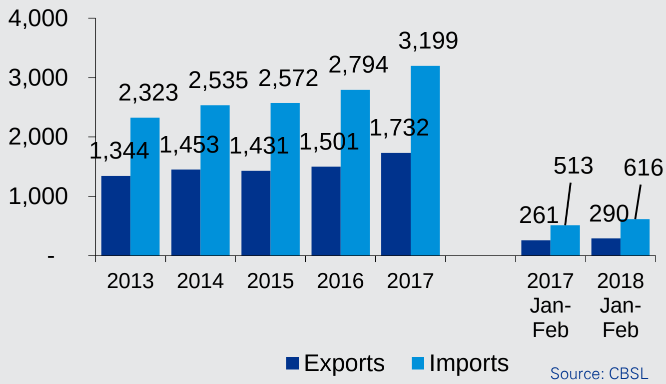
Trade deficit widened in 2017 as a higher fuel bill weighed on imports

The trade deficit expanded to 11.0% of GDP in 2017 compared to 10.9% of GDP in 2016 due to increased import of fuel, rice and gold.

Adverse weather related conditions slumped domestic rice production creating the need for higher rice imports during 2017, while fuel imports increased to replace the loss in hydro power generation.

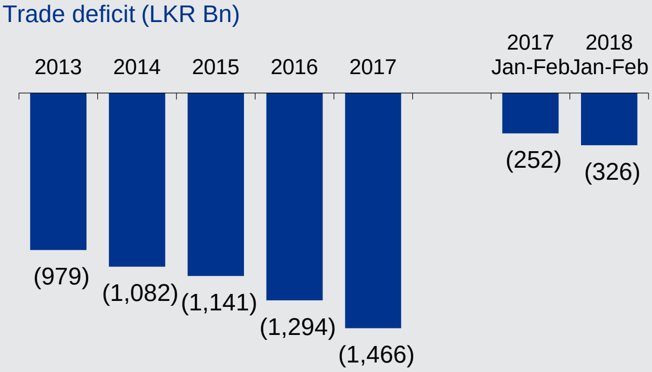
In the first two months of 2018, the trade deficit expanded to LKR 325.9Bn (USD 2.1Bn) compared to LKR 252.3Bn (USD 1.7Bn) a year before as expenditure on imports offset the increase in export earnings.

Exports vs. Imports (LKR Bn)



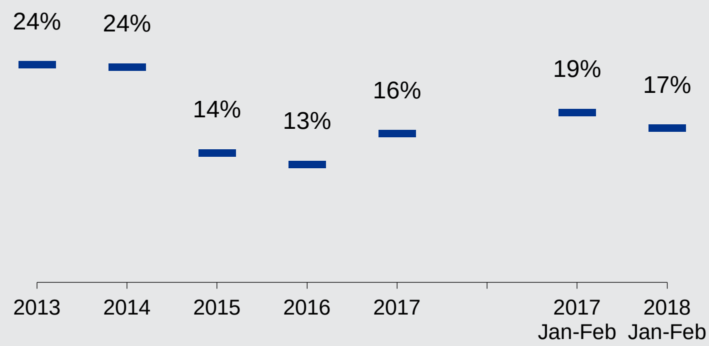
Source: CBSL

Trade deficit (LKR Bn)



Source: CBSL

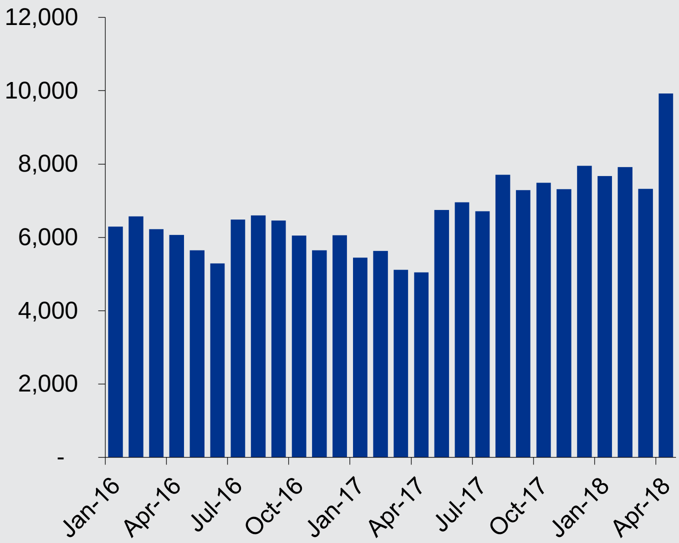
Fuel imports as a percentage of total imports



Source: CBSL

Gross official reserves improved to USD 9.9Bn by April 2018 from USD 8.0Bn as at end 2017

Gross official reserves (USD Mn)

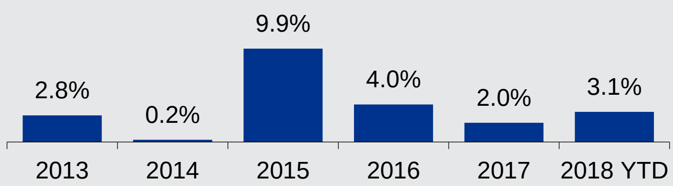


Source: CBSL

Sri Lanka's gross official reserves reached USD 9.9Bn in April 2018 from USD 8.0Bn as at end 2017 aided by issuance of international sovereign bonds and foreign exchange purchases by CBSL. The 8-year syndicated loan the government accepted recently from China Development Bank will further strengthen the reserve position.

The strong importer dollar demand coupled with the USD strengthening in global markets caused the LKR to depreciate against the USD during the year. Furthermore, during the last 18 months CBSL has been following a flexible market oriented exchange rate policy.

LKR depreciation against USD



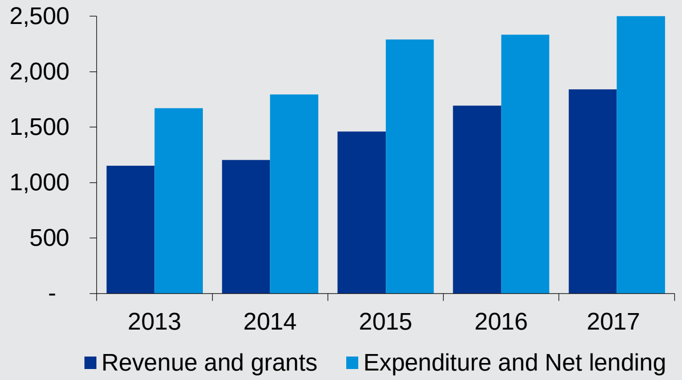
Source: CBSL, KPMG analysis

New Inland Revenue Act (IRA) to aid fiscal consolidation

Government revenue as a percentage of GDP declined to 13.8% in 2017 from 14.2% in 2016 due to a reduction in non-tax revenue (dividends transfers by State Owned Business Enterprises) during the year.

Expenditure and net lending reduced to 19.4% of GDP in 2017 compared to 19.6% of GDP in 2016 reflecting a reduction in recurrent expenditure (subdued growth in salaries and wages, and current transfer payments).

Governments fiscal operations (LKR Bn)



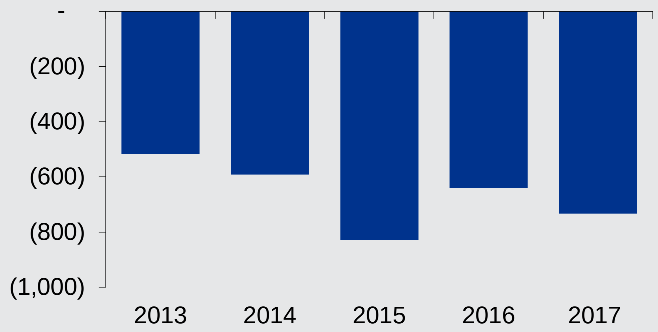
Source: Ministry of Finance

The fiscal deficit as a percentage of GDP increased to 5.5% in 2017 compared to 5.4% in 2016 as a result of higher interest payments and disaster relief measures coupled with the fall in non tax revenue in 2017.

Sri Lanka's new Inland Revenue Act (IRA) took effect from 1 April 2018 with the main objective of simplifying the tax system in order to create an investor friendly environment that would attract more FDIs.

The IRA is expected to reduce the indirect taxes levied from the public from 80% to 60% and increase the direct taxes from 20% to 40% within the next three years.

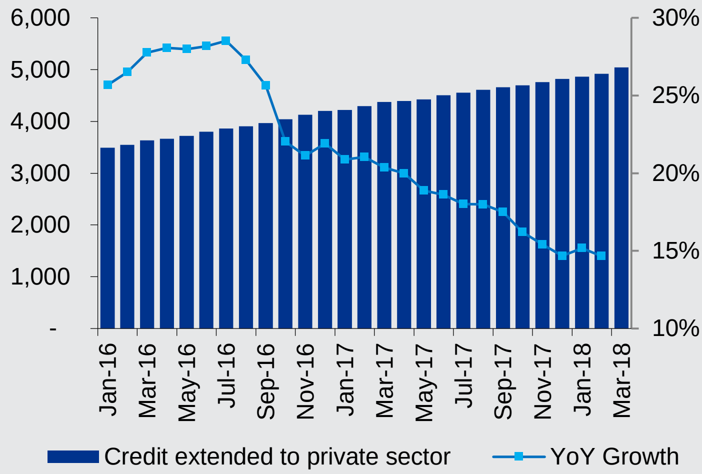
Fiscal deficit (LKR Bn)



Source: Ministry of Finance

The policy rate changes slowed credit growth

Credit extended to private sector (LKR Bn)

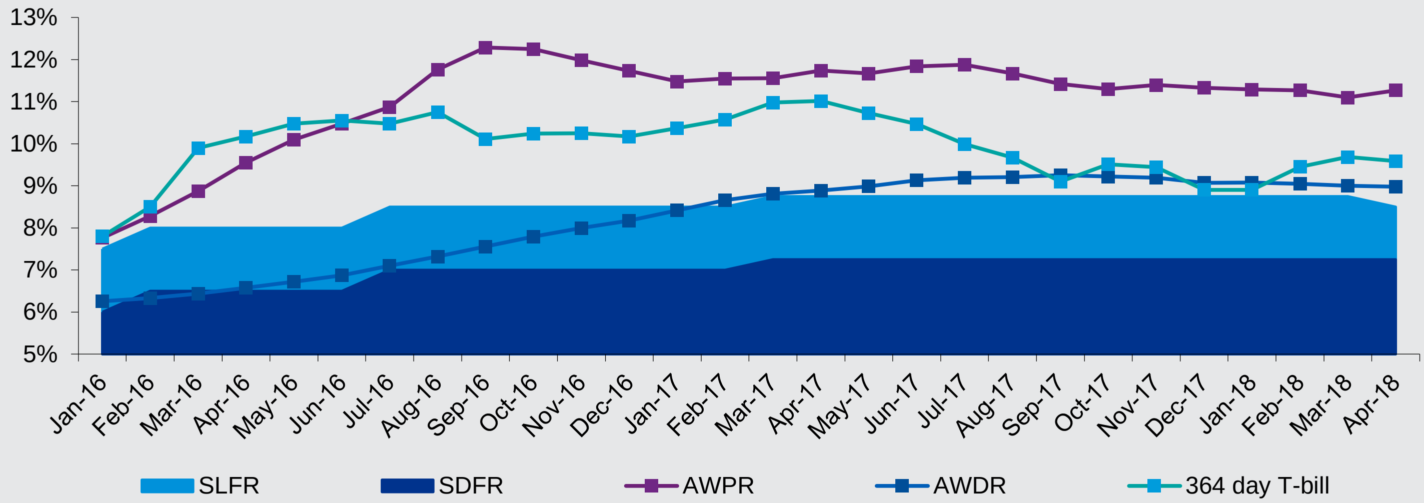


Source: CBSL

The CBSL reversed the trend of tightening monetary policy in April 2018 by reducing 25bps off the Standing Lending Facility Rate (SLFR). This was after considering the favorable developments in inflation and inflation outlook. The CBSL maintained a tight monetary policy stance since early 2016 in order to curtail adverse inflationary pressure through excessive monetary and credit expansion.

The policy rates were increased by 25bps in March 2017 in addition to the 100bps increase in policy rates in 2016 (Both SLFR and SDFR increased by 50bps each in February 2016 and in July 2016) and 150bps increase in Statutory Reserve Ratio in January 2016. Further, macro prudential measures like the imposition of Loan to value (LTV) ratios on lease of motor vehicles contributed to a tighter monetary policy.

Movement in key interest rates



Source: CBSL

Key Banking Indicators

Sector at a glance

Companies in the banking sector- 31 December 2017			
Licensed commercial banks			
	Total asset base (LKR Bn)		**Total asset base (LKR Bn)**
State banks		**Foreign banks**	
1.Bank of Ceylon*	1,952	14.The Hongkong & Shanghai Corporation Ltd	435
2.People's Bank*	1,467	15.Standard Chartered Bank	162
Local banks		16.MCB Bank Ltd	29
3.Commercial Bank of Ceylon PLC*	1,143	17.ICICI Bank Ltd	26
4.Hatton National Bank PLC*	955	18.Public Bank Berhad	8
5.Sampath Bank PLC*	795	19.Deutsche Bank AG	N/A
6.Seylan Bank PLC	408	20.Citibank	N/A
7.National Development Bank PLC	383	21.Indian Overseas Bank	N/A
8.DFCC Bank PLC	333	22.Axis Bank Ltd	N/A
9.Nations Trust Bank PLC	267	23.State Bank of India	N/A
10.Pan Asia Banking Corporation PLC	139	24.Indian Bank	N/A
11.Union Bank of Colombo PLC	119	25.Habib Bank Ltd	N/A
12.Amana Bank PLC	64	26.Bank of China (Banking operations are yet to commence)	
13.Cargills Bank Ltd	33		
Licensed specialized banks			
	Total asset base (LKR Bn)		**Total asset base (LKR Bn)**
State banks		**Private banks**	
1.National Savings Bank*	1,012	5.State Mortgage & Investment Bank	42
2.Pradeshiya Sanwardhana Bank	171	6.Sri Lanka Savings Bank Ltd	N/A
3.Sanasa Development Bank PLC	82	7.Lankaputhra Development Bank Ltd	N/A
4.Housing Development Finance Corporation Bank of Sri Lanka	50		

**Domestic Systematically Important Banks (D-SIBs) – Banks with asset bases higher than LKR 500Bn*

Introduction

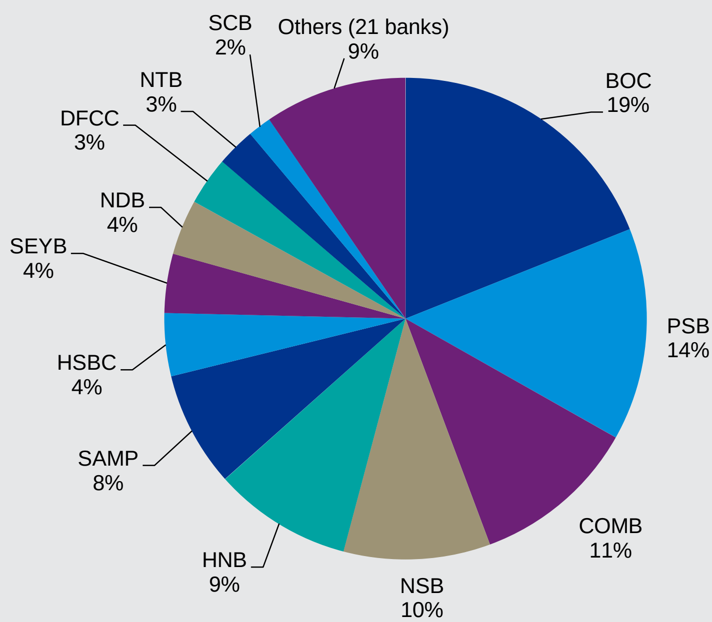
The banking sector consisted of 25 Licensed Commercial Banks (LCBs), including 12 branches of foreign banks, and 7 Licensed Specialized Banks (LSBs) by end of 2017.

The total asset base of the banking sector was recorded at LKR 10.3Tn by end 2017 compared to LKR 9.0Tn in 2016.

With the establishment of Bank of China in Sri Lanka, the number of banks in the banking sector increased to 26 as of 16th March 2018.

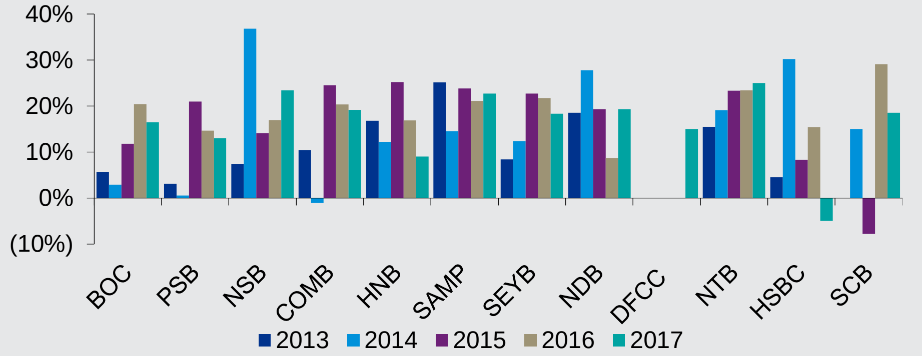
The report further analyses banks that currently account (according to latest available financial information) for total assets of more than LKR 250 Bn.

Composition of total assets of the banking sector (December 2017)



Sources: Company reports, CSE

Growth in loans and advances (Gross)



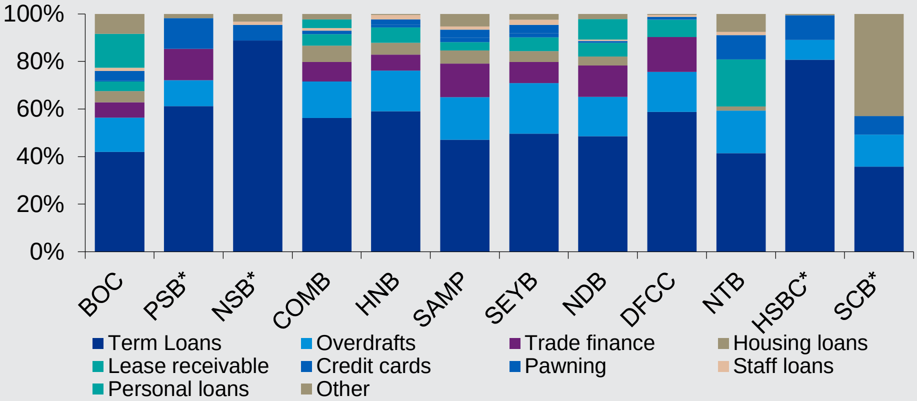
*DFCC – Results after amalgamation of DFCC Bank & DFCC Vardhana Bank

Sources: Company reports, CSE, KPMG analysis

Total gross loans and advances of the banking sector increased by 16.1% in 2017 to LKR 6.4Tn compared to LKR 5.5Tn in 2016.

Credit growth moderated during the latter part of 2017 owing to the tightening of monetary policy.

Composition of gross loans & advances (as at 31 March 2018)



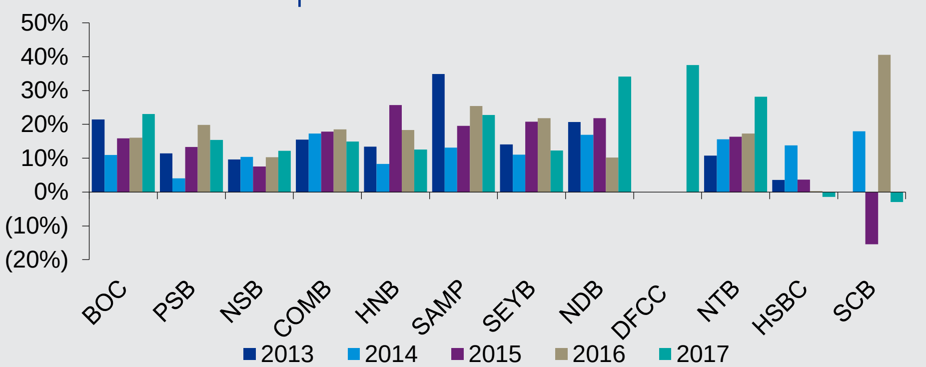
*as at 31 December 2017

Sources: Company reports, CSE, KPMG analysis

As at 2017 consumption and other sector accounted for 20.7% of loans extended by the banking sector followed by construction sector at 18.4%, trading sector at 14.5% and manufacturing sector at 11.2%

During 2017 lending extended to manufacturing sector increased by 21.9% (the largest growing sector) followed by trading sector at 19.8%, construction sector at 19.5% and consumption and other sector at 15.8%.

Growth in deposits of banks under review

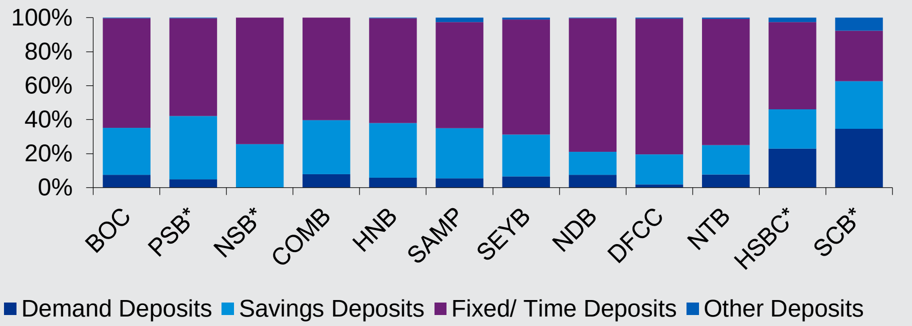


*DFCC – Results after amalgamation of DFCC Bank & DFCC Vardhana Bank

Sources: Company reports, CSE, KPMG analysis

Total deposits of the banking sector increased by 17.5% in 2017 to LKR 7.4Tn compared to LKR 6.3Tn in 2016.

Composition of deposits (as at 31 March 2018)



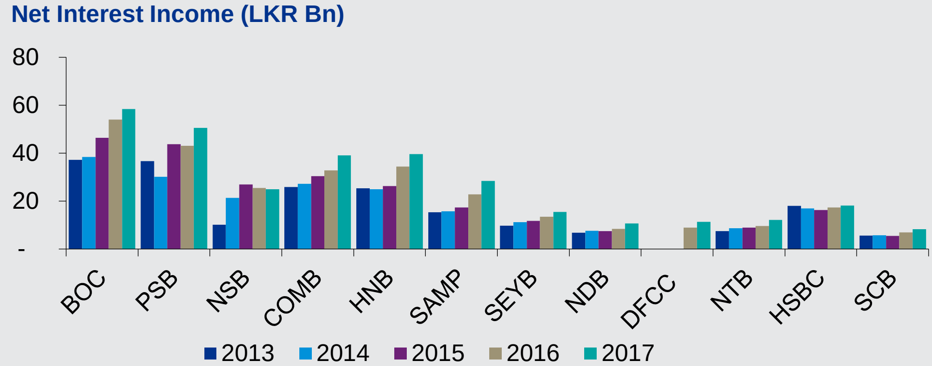
*as at 31 December 2017

Sources: Company reports, CSE, KPMG analysis

Due to the increase in interest rates during 2017, the share of term deposits increased to 63.6%.

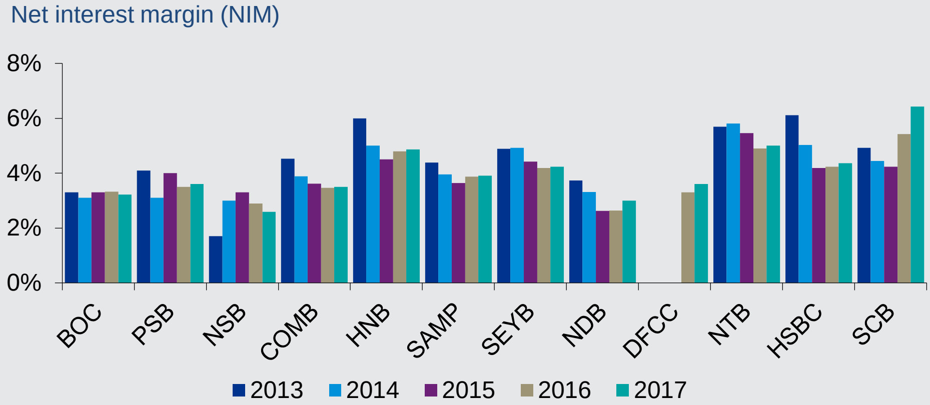
The CASA Ratio decreased from 37.1% in 2016 to 33.2% by the end of 2017.

Growth in Interest Earnings



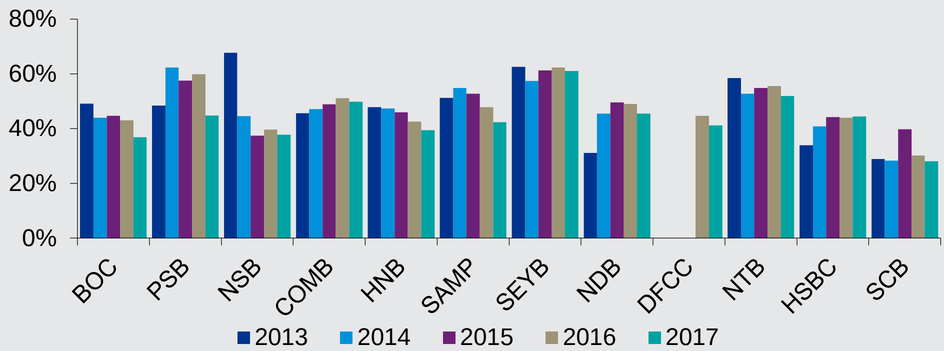
Sources: Company reports, CSE

Higher growth in interest expenses (39.1%) was witnessed compared to the growth in the interest income (28.3%). Thus caused a marginal decrease in NIM to 3.5% by the end of 2017, from 3.6% during 2016. Tightening of monetary policy implementation in the previous years also led to a slight decrease in the NIM of the sector.



Sources: Company reports, CSE

Cost to income ratio

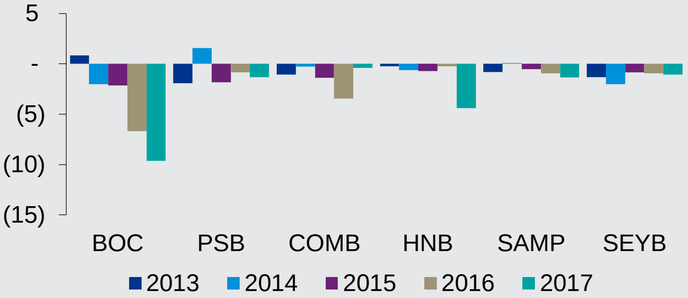


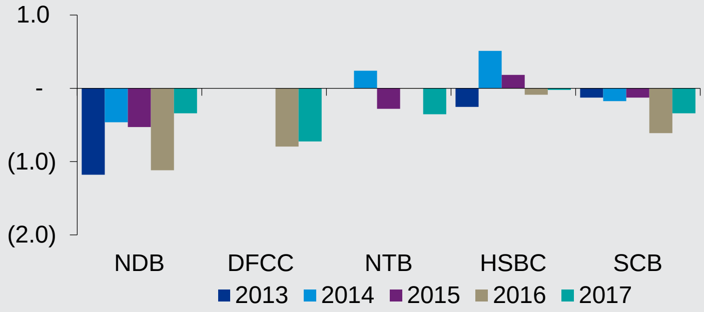
Sources: Company reports, CSE

Most banks have concluded their aggressive branch expansion which was observed post war. In particular banks are concentrating more on digital banking whilst consolidating its physical branch network which has eased cost to income ratios.

Impairments

Individual Impairment (LKR Bn)

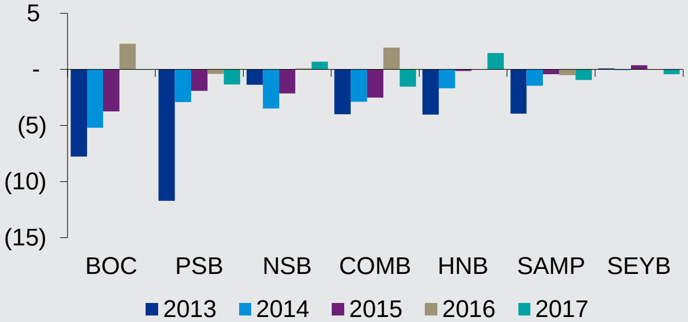




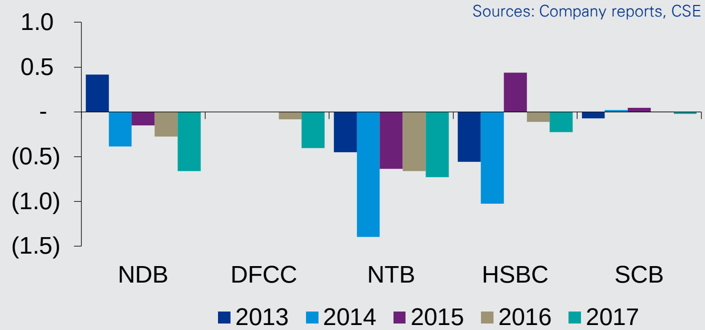
**No Individual impairment charge for NSB*

Sources: Company reports, CSE

Collective Impairment (LKR Bn)



Sources: Company reports, CSE



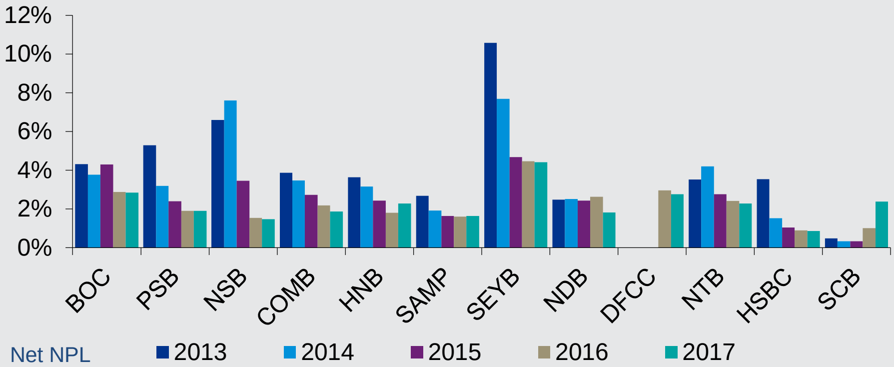
Sources: Company reports, CSE

IFRS 9 (SLFRS 9) is effective for annual periods beginning from 1 January 2018. It is expected that with the implementation of IFRS 9, impairments of banks will increase in FY18 due to the introduction of Expected Credit Loss (ECL) model compared to the current Incurred loss model.

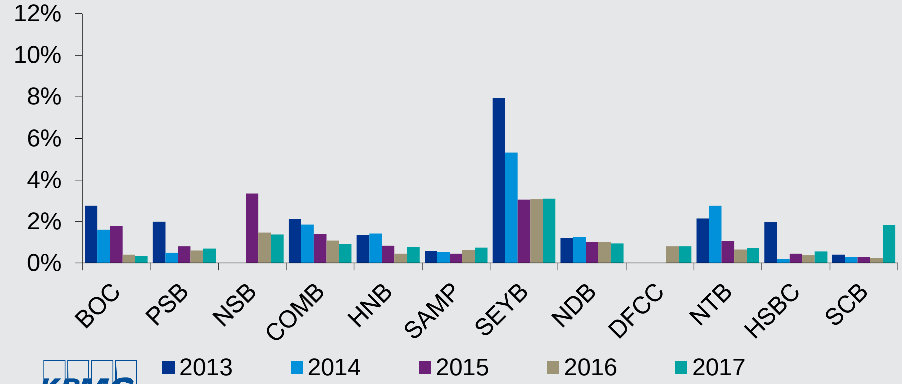
On average the initial impact is estimated to be a 40% to 50% increase in collective impairment and an approximate 10% increase recurring impairment charges.

Non performing loans and advances

Gross NPL



Net NPL



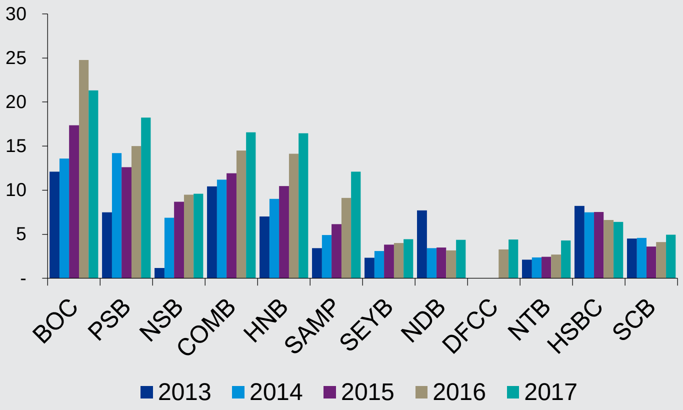
Sources: Company reports, CSE

The gross NPL ratio of the banking sector declined marginally to 2.5% in 2017 compared to 2.6% in 2016 reflecting the improvement in credit quality within the year. This was despite an increase in NPLs in absolute terms by LKR 18.3Bn during 2017.

NPL ratios are managed by the banks by precise diversification of the portfolio and avoiding over-concentration on any one sector. Most banks maintained NPL ratio well below sector average apart from a few banks by the end of 2017.

However, the slowdown in economic growth coupled with the recent adverse weather conditions may cause pressure on the NPLs going forward.

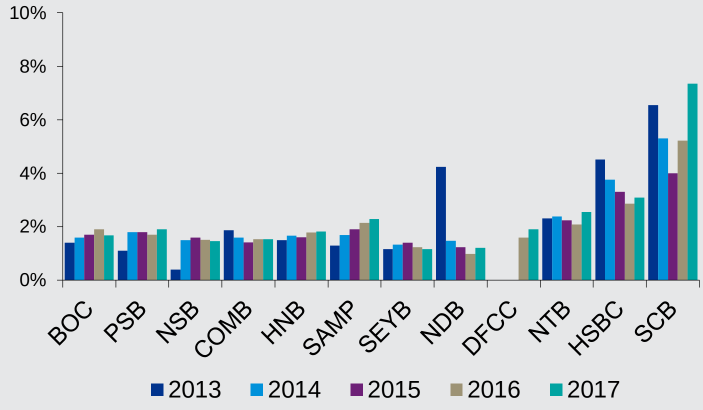
Profit after tax (LKR Bn)



Sources: Company reports, CSE

Net earnings of the Banking sector improved 19.2% YoY in 2017 to LKR 138.9Bn compared to LKR 116.5Bn in 2016.

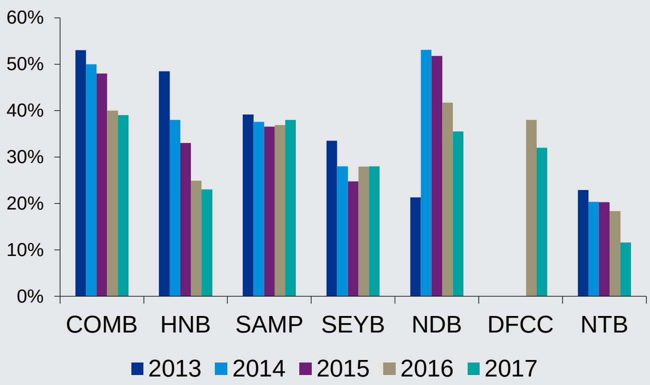
Return on Assets (ROA)



Sources: Company reports, CSE

Banking sector ROA increased by 6bps from 2016 to 1.4% in 2017.

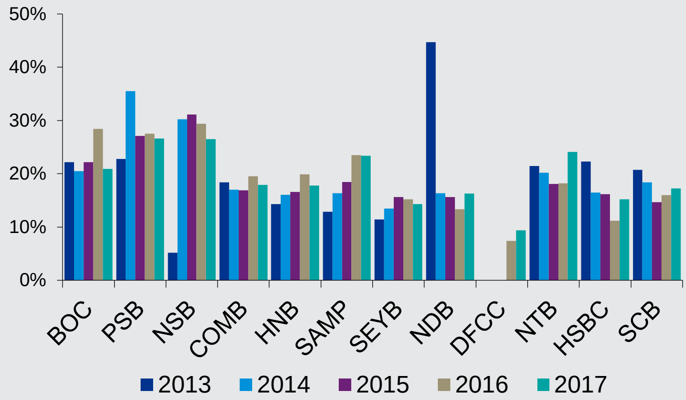
Dividend payout ratio



Sources: Company reports, CSE

Most banks pay dividends in the form of cash and scrip, with most banks favoring the latter due to tighter capital requirements.

Return on Equity (ROE)

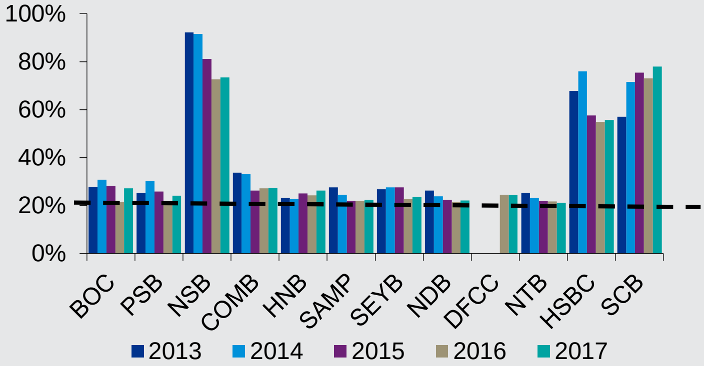


Sources: Company reports, CSE

Banking sector ROE increased by 28bps from 2016 to 17.6% in 2017. Due to introduction of BASEL III, several banks raised rights issues which impacted their ROEs during 2017. Hence, we expect banks to record sustainable ROE's around 15%.

Liquidity

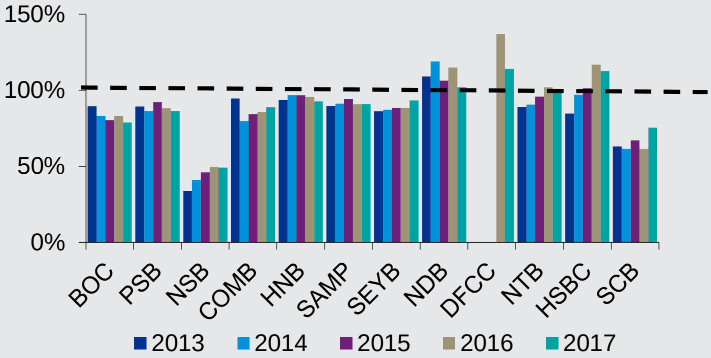
Statutory liquid asset ratio (domestic banking units)



Sources: Company reports, CSE

The Statutory Liquid Asset Ratio (SLAR) of domestic banking units (regulatory minimum of 20.0%) increased to 31.3% as at end 2017 compared to 29.9% in 2016.

Credit to deposit ratio

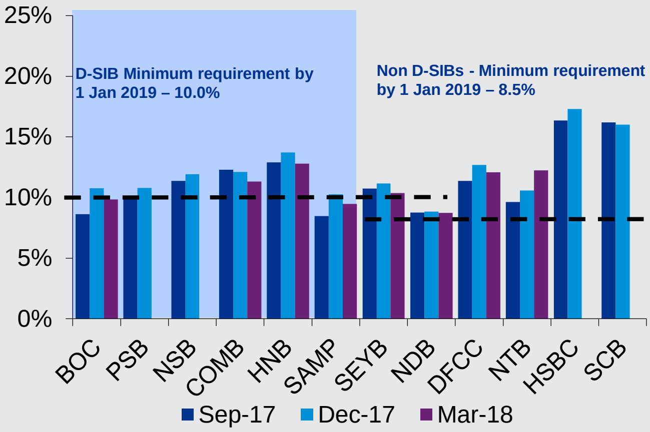


Sources: Company reports, CSE

Most of the branches operate below 100% of credit to deposit ratio. However, NDB and DFCC, which were earlier development banks are now converted to LCBS. As a result their credit to deposit ratios have gradually decreased.

Capital adequacy ratio

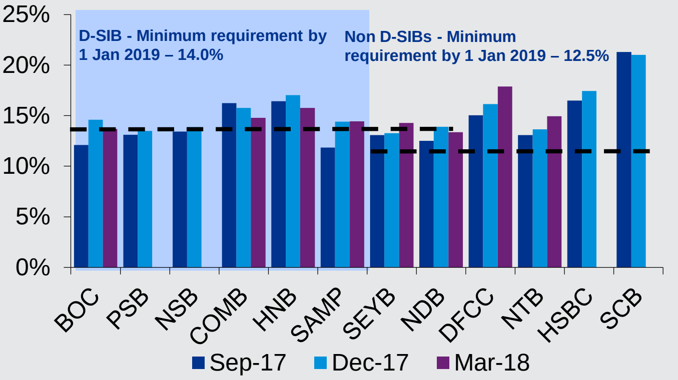
Tier 1 Capital adequacy ratio



Shaded in blue – D-SIBs as at end 2017

Sources: Company reports, CSE

Total capital adequacy ratio



Shaded in blue – D-SIBs as at end 2017

Sources: Company reports, CSE

In view of Basel III capital adequacy requirements, the CBSL issued a wave of regulations and directions with which banks must comply.

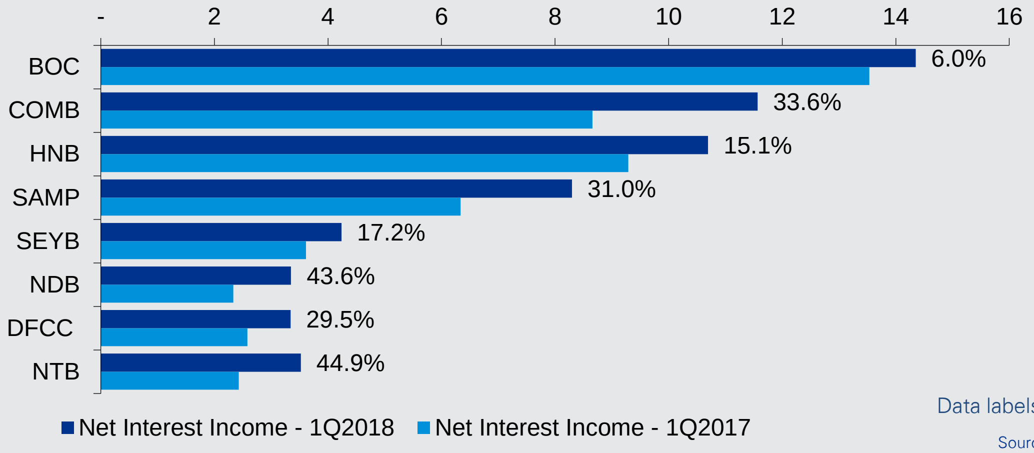
This required banks to increase their Capital adequacy ratios on a staggered basis starting from 1 July 2017 with D-SIBs having to maintain higher ratios compared to Non D-SIBs.

By 1 January 2019 D-SIBs are required to increase their Tier 1 capital adequacy ratio and Total capital adequacy ratio to 10.0% and 14.0% respectively, whilst Non D-SIBs are required to increase the same to 8.5% and 12.5% respectively.

Further, directions relating to Net Stable Funding Ratio (NSFR) which relates to assets and off-balance sheet activities are expected to be issued by the CBSL in the second half of 2018.

1Q2018 performance

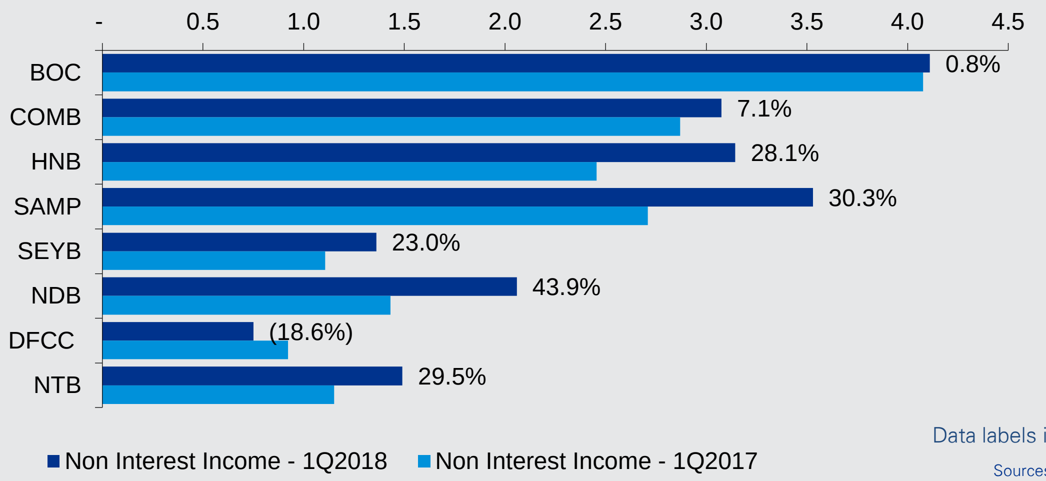
Net interest income (LKR Bn)



Data labels indicate YoY growth

Sources: Company reports, CSE

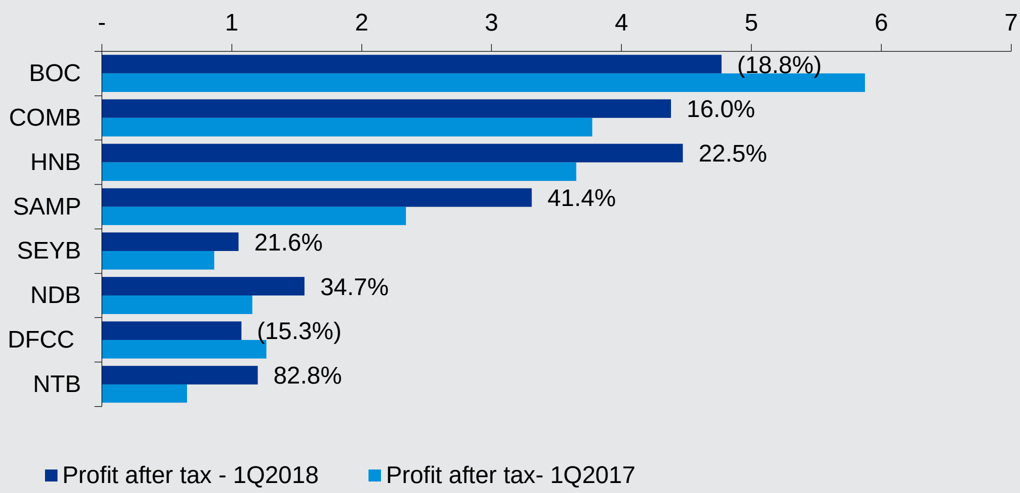
Non interest income (LKR Bn)



Data labels indicate YoY growth

Sources: Company reports, CSE

Profit after tax (LKR Bn)



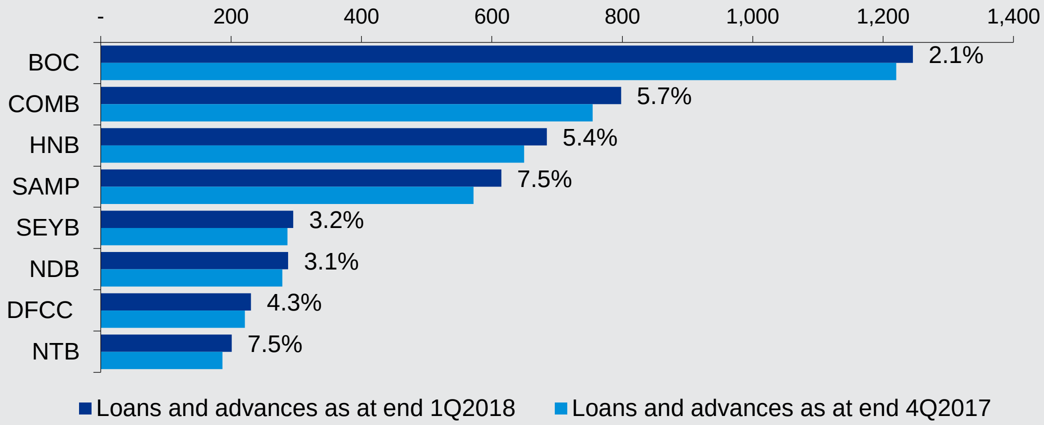
Data labels indicate YoY growth

Sources: Company reports, CSE

**PSB,NSB,HSBC & SCB 31 March 2018 quarter results not available*

1Q2018 performance

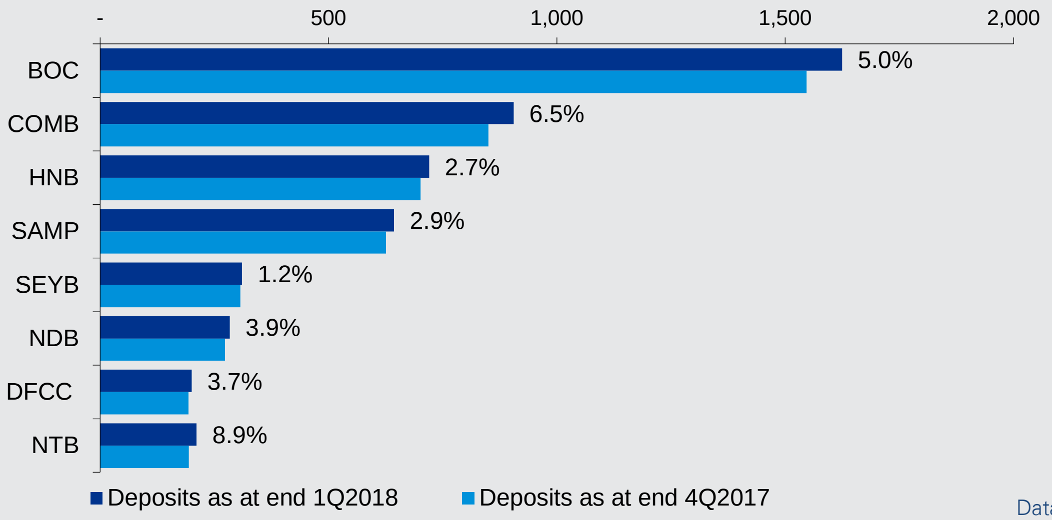
Loans and advances (LKR Bn)



Data labels indicate quarterly growth

Sources: Company reports, CSE

Deposit (LKR Bn)



Data labels indicate quarterly growth

Sources: Company reports, CSE

**PSB, NSB, HSBC & SCB 31 March 2018 quarter results not available*

KPMG at a glance

Office

Part of KPMG global network

Established in,

1897

The oldest Chartered Accountancy firm in the country

Celebrating,

120 years

Service

KPMG is expanded in,

6 districts

KPMG value proposition,

- **Our Values**
- **Our Credentials**
- **Proven Methodology**
- **Experienced Core Team**

Professional Service Provider

Audit **Tax** **Advisory**

People

18
Partners

1,150
People Locally

197,263
People globally

Lifelong learning

Is our global citizenship priority

Dedicated to Learning & Development

Committed to developing a continuous learning culture

- **Technical training,**
- **Coaching,**
- **Mentoring,**
- **Industry secondments and**
- **Skill-building programs**

Global Opportunities

3,000 people on Global Mobility assignments

Achievements

KPMG named **"Best Deal Advisory Firm in Sri Lanka 2015"**

by Global Banking and Finance Review

KPMG named **"The Best Advisory Firm – Sri Lanka 2016"**

by International Finance Magazine

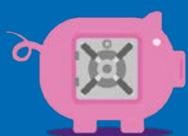
KPMG named **"Tax Firm of the Year - 2017"** by International Tax Review, Asia Tax Awards 2017

KPMG named **"Tax Disputes & Litigation Firm of the Year – 2017"** by International Tax Review, Asia Tax Awards 2017

Most Respected 2017 - LMD

KPMG was ranked among the most respected in the latest LMD rankings becoming first in the financial service category

Customers



1,500+
Clients

KPMG Industry Base

Top client base

Hatton National Bank
Access Engineering PLC
Hayleys PLC
Sunshine Holdings PLC
Brown & Company PLC
Toyota Lanka
Cargills Ceylon PLC
Lion Brewery Ceylon PLC
Sri Lankan Airlines Limited
Commercial Bank
Diesel & Motor Engineering PLC
John Keells PLC
Ceylon Biscuits Limited
Nestle Lanka PLC
Dilmah

KPMG service offerings

Audit

High quality, independent financial statement audits are essential to maintaining 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.

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

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.

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

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.

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

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.

- Valuations
- Debt Advisory
- Transaction Solutions
- Mergers & Acquisitions
- Restructuring

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.

- Inbound & indirect taxes
- Mergers, acquisitions and restructuring
- International tax services
- Transfer pricing
- Tax management consulting
- Global mobility services
- Automatic exchange of information

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