SECTOR OVERVIEW

A. Banking Sector

1. Banks accounted for 55.1% of the assets of Sri Lanka's financial system at the end of 2011. The banking sector comprises 24 licensed commercial banks (LCBs) and nine licensed specialized banks (LSBs).[1] As of the end of 2011, LCBs accounted for 46.4% of total financial system assets and 66.6% of banking sector assets. The country's banking sector remains concentrated. The six largest LCBs have been identified as systemically important—Bank of Ceylon, People's Bank, Commercial Bank of Ceylon, Hatton National Bank, Sampath Bank, and Seylan Bank. These six banks accounted for 64% of sector assets, 74% of sector loans, and 68% of sector deposits at the end of 2010. Just over half the assets of the banking sector are with the public sector. The two largest LCBs and the largest LSB are state-owned.[2]

2. The banking sector has continued to grow since the civil war ended in 2009. Total loans rose 31.5% during 2011 to SLR2,597 billion from SLR1,975 billion at the end of 2010. The growth rate in 2010 was 23.7%. Total deposits in the banking sector grew 18.9% in 2011 to SLR3,074 billion from SLR2,589 billion at the end of 2010, up from the 2010 growth rate of 15.9%. Deposit growth lagged loan growth, and the loan–deposit ratio increased from 76.4% at the end of 2010 to 84.5% at the end of 2011. The banking sector is well capitalized. As of the end of 2011, the total capital adequacy ratio (CAR) under Basel II was 15.9%, compared with 16.2% in 2010. Tier 1 core CAR was unchanged at 14.3%. Total CAR declined in 2011 due to rapid credit expansion. Nonetheless, both total CAR and Tier 1 CAR remain well above the minimum regulatory requirement of 10% for CAR and 5% for Tier 1 core capital. During 2011, many banks strengthened their capital base through capital infusions. Sector-wide capital funds (core and Tier II) grew 25.7% in 2011, compared with 21.2% in 2010, indicating an improved capacity in the industry to absorb risks.[3]

3. Profitability in the sector declined in 2011, partly due to exceptional one-time gains that many banks had enjoyed in 2010.[4] In addition, the net interest margin narrowed from 4.6% in 2010 to 4.3% in 2011. Due to competition in the sector, non-interest income fell 9.6% in 2011, compared with the 13.7% growth experienced in 2010. Return on assets decreased from 1.8% in 2010 to 1.7% in 2011. Return on equity also dropped, from 22.2% to 20.0% (footnote 3).

4. Asset quality improved. The gross nonperforming loans (NPL) ratio declined from 5.4% at the end of 2010 to 3.8% at the end of 2011 (It had stood at 8.5% in 2009).[5] The NPL provision coverage ratio decreased slightly from 58.1% at the end of 2010 to 57.0% at the end

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[1] The Central Bank of Sri Lanka issues banking licenses for two categories of banks: licensed commercial banks and licensed specialized banks. Licensed commercial banks are permitted to accept demand deposits from the public and can act as authorized dealers in foreign exchange, which entitles them to engage in a wide-range of foreign exchange transactions. Licensed specialized banks cannot do either of the transactions mentioned above.

[2] Fitch Ratings. 2012. *The Sri Lanka Banking Sector Special Report.* Colombo (January).

[3] Central Bank of Sri Lanka (CBSL). 2012. *Annual Report 2011.* Colombo; CBSL. Financial Performance Indicators for the Banking Industry. http://www.cbsl.gov.lk/htm/english/08_stat/s_6.html (accessed 9 October 2012).

[4] The exceptional 117% gains during 2010 were mainly due to a few exceptional circumstances, such as the reversal of the loan provisions of one bank and the high gains from trading securities and investments of a few banks.

[5] Under Sri Lanka's Banking Act Direction No. 3 of 2008, classification of NPLs is based on the nonperformance time period and potential risk. Classification of NPLs by time period can be generally summarized as (i) "special mention" (equal to or greater than 90 days but less than 180 days past due), (ii) "substandard" (equal to or greater than 180 days but less than 360 days past due, (iii) "doubtful" (equal to or greater than 360 days but less than 540 days past due), and (iv) "loss" (equal to or greater than 540 days).

of 2011 (2009: 53.0%).[6] However, the net NPL-to-capital ratio improved from 15.2% (2010) to 11.5% (2011). It was 26.2% at the end of 2009. This indicated that the sector had a growing capacity to absorb risk. Loans were concentrated in five industry sectors: construction (14%), consumption (14%), agriculture (13%), manufacturing (12%), and trading (11%). Credit quality in all five industry sectors improved in 2011, with absolute NPLs and NPL ratios declining.[7]

5. Credit exposure from investments was minimal. More than 90% of these investments were in government securities. The banking sector's exposure to the securities market was limited and such investments accounted for 7% of its capital base when 2011 ended. Net foreign currency exposure was low—3% of the capital base at the end of 2011. The statutory liquid assets ratio declined from 36.6% at the end of 2010 to 32.4% at the end of 2011 but remained above the regulatory minimum of 20%. Overall liquidity in the sector declined due to rapid credit expansion, and liquid assets represented 27% of total assets at the end of 2011. In addition, Sri Lanka's fiscal situation is characterized by high public debt and a heavy interest burden, and weak external liquidity is exacerbated by external debt that is already moderately high and increasing. Selected financial indicators are provided in the table below (footnote 7).

Financial Performance Indicators for the Banking Industry

Item	2009	2010	2011
Assets and Liabilities			
Assets	3,013,256	3,550,515	4,240,463
Gross loans and advances[a]	1,596,446	1,975,360	2,597,279
Gross nonperforming advances[a]	135,579	107,044	98,994
Provision for bad and doubtful advances	58,041	48,522	45,355
Capital funds [c]	243,176	294,632	370,328
Deposits	2,231,575	2,586,032	3,074,876
Borrowings	389,343	506,913	621,582
Earnings/Profitability			
Interest expenses	233,969	180,333	193,213
Net interest income	130,311	149,758	165,583
Non-interest income	59,173	67,295	60,840
Non-interest expenses	96,579	105,849	117,316
Provision for bad and doubtful advances	26,415	2,375	5,401
Profit before tax	52,213	89,968	93,695
Profit after tax	27,226	59,191	65,361
Financial Performance Ratios			
Core capital (Tier 1 Capital) adequacy ratio	14.1	14.3	14.3
Total capital adequacy ratio	16.1	16.2	15.9
Gross nonperforming advances ratio[a]	8.5	5.4	3.8

[6] Under Sri Lanka's Banking Act Directions No. 3 of 2008 and No. 3 of 2010, banks are required to maintain specific provisions on NPLs on the amount outstanding, net of realizable security value and interest suspended, according to NPL classification: (i) "special mention"—0%; (ii) "substandard—20%; (iii) "doubtful"—50%; and (iv) "loss"—100%. In addition, there is a general provision amounting to 0.5% of total outstanding of performing loans and the total outstanding of Special Mention NPLs net of interest in suspense.

[7] Central Bank of Sri Lanka. 2012. *Annual Report 2011*. Colombo (March); and Financial Performance Indicators for the Banking Industry. http://www.cbsl.gov.lk/htm/english/08_stat/s_6.html (accessed 9 October 2012).

Item	2009	2010	2011
Specific provisions to net nonperforming loans ratio	42.8	45.3	45.8
Return on assets after tax	1.0	1.8	1.7
Return on equity	11.8	22.2	20.0
Efficiency ratio	56.3	47.2	52.5
Interest margin	4.6	4.6	4.3
Liquid assets ratio[c]	39.2	36.6	32.4
Credit to deposit ratio	71.5	76.4	84.5

(a) Net of interest in suspense.

(b) Capital funds reported in the balance sheet.
(c) Estimated in terms of statutory liquid assets requirement.

Source: Central Bank of Sri Lanka

6. **Bank regulator.** The regulation and supervision of banks licensed by the country's Monetary Board is carried out by the bank supervision department of the Central Bank of Sri Lanka (CBSL). The supervision of banks is based on internationally accepted standards set out by the Basel Committee for Banking Supervision. Under the off-site surveillance system, the financial condition of LCBs and LSBs is monitored through periodic information provided by banks on their operations. Sri Lanka's banks adopt the basic approach for credit, market, and operational risk under Basel II.

7. In a monetary policy review in February 2012, the CBSL directed commercial banks to moderate their credit disbursements to ensure that their overall credit growth in 2012 did not exceed 18% of their loan books outstanding at the end of 2011. Credit growth of up to 23% was to be allowed for those banks that financed an excess of up to 5% of credit growth from foreign funding.[8] All banks modified their growth plans to keep within these limits.

B. Small and Medium-Sized Enterprise Sector

8. **Role of small and medium-sized enterprises.** Small and medium-sized enterprises (SMEs) have an important role to play in the economies of the developing member countries of the Asian Development Bank (ADB). SMEs are key economic drivers, add to gross domestic product, and help reduce poverty by generating employment and raising individual incomes. SMEs constitute 80%–90% of all business establishments in Sri Lanka and create 20% of value added by industry.[9] SMEs account for 63% of employment in the business sector.[10] The country has an estimated 40,000 SMEs, most of which are in the Western Province.[11]

9. **Profile.** According to a 2006/2007 survey by the IFC of the SME market in Sri Lanka, most SMEs are engaged in such traditional businesses as rubber, gems and jewelry, coconut-based products, and tea. SMEs also operate in the construction, commercial transport, deep sea fishing, and printing sectors. Almost 50% of the SMEs surveyed had 20 or fewer employees. Only 14% employed more than 100 people and almost 70% of the SMEs were more than 10 years old. More than 67% of the SME entrepreneurs were 40–60 years of age and

8 *The Nation.* 2012. Bank profits to tumble this year? 26 February.
9 IFC. 2007. *The Results of the Banking Survey of the SME Market in Sri Lanka 2006/07.* Colombo. The survey defined SMEs as enterprises with an annual turnover of SLR5 million–SLR150 million.
10 http://www.asiantribune.com/news/2011/02/26/sri-lankas-icasl-acca-enlighten-ceos-access-finance-sme%E2%80%99s
11 R. Athukorala. 2010. SMEs generate US$30 b+ to Sri Lankan Economy. *Sri Lanka Daily FT.* 9 November.

fewer than 5% were under 30. The younger entrepreneurs were engaged most often in such emerging SME sectors as construction. More than 33% of the SME entrepreneurs had no formal education beyond middle school and only 12.5% had studied beyond high school.[12]

10. This survey showed that most SMEs remain small relative to their age. More than 66% were sole proprietorships and partnerships. It also demonstrated that SMEs in Sri Lanka had low productivity relative to their high labor absorption rate and made a comparatively small contribution to industrial value addition. This is due to several constraints on their growth.[13]

11. **Definition.** The government and banks in Sri Lanka do not have a standard definition for an SME at present. When Sri Lanka has received SME assistance from multilateral development agencies such as ADB, the World Bank, ADB, Japan Bank for International Cooperation and KFW, the agencies have defined SMEs according to their value of an enterprise's assets or of the investment in the enterprise. Currently, the CBSL defines SMEs according to annual turnover. For the purposes of a SME credit line provided by the World Bank in February 2011, SMEs were defined as enterprises with an annual turnover of less than SLR350 million. However, as part of a taxation incentive program for 2012, the government budget defined a "small industry" as an enterprise with less than SLR25 million in total investments. The CBSL defines SMEs as commercial enterprises incorporated as sole proprietorships, partnerships, or limited liability companies with an annual business turnover of less than SLRs600 million (footnote 12). Most financial institutions, including Nations Trust Bank, follow this definition.[14]

12. **Access to financial services.** Access to financial services is extremely limited in Sri Lanka. The IFC estimates that 59% of SMEs in Sri Lanka have no bank (footnote 13). Bank loans and loans from informal sectors are their main sources of financing. Nonetheless, despite the difficulties in lending to SMEs, banks are increasingly viewing the sector as a potential way to diversify their lending portfolios and widen their interest margins. Some international financial institutions have supported growth in bank lending to SMEs by offering commercial banks funds and technical assistance. However, SMEs are expected to face a growing financing shortfall due to rising demand resulting from growth in the sector and the limited avenues available to banks to raise medium- and long-term funds.[15]

13. Greater financial support, particularly in the form of this medium- and long-term funding, is essential to enable SMEs to invest in the technology and infrastructure they need to become more productive and competitive. Sri Lanka relies heavily on foreign remittances to finance development. This is particularly true of informal SMEs. However, remittances from overseas have been falling due to the global economic slowdown and are expected be a less reliable source of SME funding in the future.[16]

14. Other constraints to the overall growth of the SME sector include the collateral requirements of banks, which often create barriers for entrepreneurs at the expense of opportunity and innovation. Banks often prefer land as collateral but this is an obstacle for SMEs generally and those in rural areas in particular because they either own none or lack clear title. This problem is compounded by the SMEs' lack of financial records and proper business plans, which reinforces bank perceptions that they present higher than normal risks. Other

[12] A. L. Somarathe. 2012. Access to finance by SMEs in Sri Lanka Part 1. *The Island Daily News*. 13 August.
[13] IFC. 2011. *Sri Lanka Country Profile. Summary of Enterprise Survey Indicators. Enterprise Survey.* Colombo.
[14] Per NTB Management and ADB meetings with other banks.
[15] IFC. 2011. *Sri Lanka Country Profile. A Snapshot of the Business Environment . Enterprise Survey.* Colombo.
[16] External shocks threaten economic growth targets. http://www.sundaytimes.lk/120129/Columns/eco.html

issues include the challenges of insufficient technical and management skills and the difficulty of attracting managerial talent that SMEs, which are mostly family-owned businesses, usually face. SMEs also face marketing constraints due to an absence of effective value chains in industry sectors. Inadequate infrastructure facilities, unreliable and costly electricity, and outdated technology often contribute to the poor quality of their products and their higher costs of production (footnote 9).