

The Sri Lankan Banking Sector

Special Report

Dominated by Government Banks: The Sri Lankan banking sector is concentrated and dominated by public-sector banks. About half of sector assets are with the public sector, including the three largest banks. The six largest banks (including three private banks), classified as "systemically important" by the regulator, accounted for 64% of sector assets at end-2010.

Macro Prudential Indicator: The performance of the Sri Lankan banking sector rebounded in 2010 after suffering from a challenging economic environment in 2008 and 2009. However, Fitch Ratings remains concerned about the system's ability to manage a sustained level of above-average loan expansion. Sri Lanka's Macro Prudential Index (MPI) – an indicator of potential stress in the banking system – was revised to '3' (high) from '1' (low) in December 2011, triggered by high credit growth and the increase in equity prices.

Strong Loan Expansion: Fitch notes the surge in lending experienced by Sri Lankan banks in 2010 and through 2011. The agency notes the absence thus far of a policy response from the authorities to high credit demand, but would expect a tightening of the monetary policy stance should inflation increase.

Largely Corporate Lending: Just over half of Sri Lankan bank loans comprise lending to corporates (including small and medium-sized enterprises (SMEs)). However, banks have increasingly been focusing on retail lending, and pawning (gold-backed) advances in particular, while lending to SMEs is likely to increase in search of higher net interest margins to counter the effects of increasing competition and rising deposit costs.

Mostly Deposit Funded: Sri Lankan banks benefit from a substantial share of customer deposit funding, reflecting their strong domestic franchises. Historically, deposits have funded over 70% of bank assets. Increased lending and competition have driven up funding costs with diminishing liquidity. Fitch believes that while banks should remain primarily deposit funded, the share of non-deposit funding could increase.

Sector Capitalisation Inadequate: The profitability and internal capital generation of Sri Lankan banks are likely to benefit from lower credit costs and a reduction in tax rates. Banks' capital adequacy ratios have remained above the regulatory minimum. However, Fitch views the sector's capitalisation in terms of equity/assets (8.4% at end-2010) as low in light of moderate loan loss coverage ratios (60% of gross NPLs at end-2010) and strong lending.

Significant Challenges Remain: In Fitch's view, key challenges facing the Sri Lankan banking sector include: managing asset quality and accessing capital in the face of rapid expansion; enhancing risk management capabilities; implementing changes in accounting standards in line with international norms; and managing the impact of global market instability.

Stable Outlook: The Outlook on the National Long-Term Ratings of most Sri Lankan banks is Stable. This reflects the fact that the post-war growth in the domestic economy has improved the earnings prospects of banks as well as the government's capacity to support the banking system. However, the rapid pace of loan growth that began in mid-2010, if it continues, will test banks' risk management systems and funding profiles.

Related Research

[2012 Outlook: Sri Lankan Banks](#)
(January 2012)

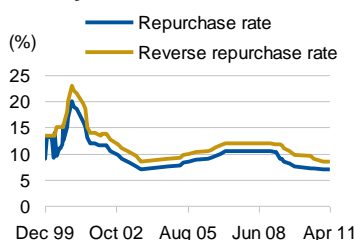
Analysts

Rukshana Thalagodapitiya
+94 11 2541 900
rukshana.thalagodapitiya@fitchratings.lk

Ananda Bhoumik
+91 22 4000 1720
ananda.bhoumik@fitchratings.com

Figure 1

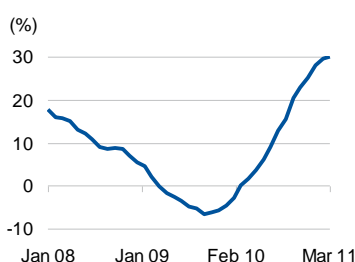
Policy Rates



Source: CBSL, Fitch

Figure 2

Private Sector Credit Growth



Source: CBSL, Fitch

Operating Environment

On 4 October 2011, Fitch upgraded Sri Lanka's Long-Term Local- and Foreign-Currency IDRs to 'BB-' from 'B+' with a Stable Outlook in July 2011 (see [Fitch Upgrades Sri Lanka to 'BB-' Outlook Stable](#)). The agency also upgraded the Country Ceiling that captures the transfer and convertibility risk to 'BB-' from 'B+'. The upgrade reflected the stabilisation and recovery of the economy under the IMF programme and increased efforts to address the chronic budget deficit position.

Following the end of the prolonged civil war in 2009, economic growth rebounded significantly. This was reflected in an increase in real GDP growth to 8% in 2010 from 3.5% in 2009. Domestic output is dominated by the services sector (59.3% of GDP in 2010). The contribution of the banking, insurance and real estate subsectors has been steady (8.9% of GDP in 2010). Strong growth momentum continued into 2011, with real GDP growth of 7.9% in Q111, 8.2% in Q211 and 8.4% in Q311. Fitch forecasts real GDP growth in Sri Lanka of 8% in 2012.

The Central Bank of Sri Lanka (CBSL) has repeatedly cut policy rates, reflecting its accommodative monetary policy stance, and has held rates steady since January 2011. Private-sector credit growth has rebounded, turning positive in April 2010, and reaching 33.5% yoy by November 2011. Should there be signs of overheating with rising demand-driven inflation, Fitch would expect the authorities to tighten their monetary policy stance.

Macro Prudential Index (MPI)

In December 2011, Sri Lanka's Macro Prudential Index (MPI) – an indicator of potential stress in the banking system – was revised to '3' (high) from '1' (low). The MPI identifies the build-up of potential stress in banking systems due to rapid credit growth associated with bubbles in housing or equity markets. Credit growth in Sri Lanka in 2010 and 2011 has been amongst the highest in emerging markets and, together with an increase in equity prices, has triggered the increase in the MPI.

Banking Sector Structure

The banking sector accounted for 53% of financial system assets at end-2010 and comprises Licensed Commercial Banks (LCBs) and Licensed Specialised Banks (LSBs). The distinction between LCBs and LSBs lies in the scope of activities they can undertake. LSBs are licensed to conduct specialised banking business and are not authorised to accept demand deposits and deal in foreign currency. LSBs include specialised savings banks and development banks, while LCBs have a broader scope.

At end-2010, there were 31 licensed banks including 22 LCBs and nine LSBs. Half of the LCBs were foreign bank branches, four of which were branches of Indian banks. The number of LSBs had fallen from 14 to nine due to the vesting of the six state-owned regional development banks with another newly incorporated state-owned bank during 2010.

The number of LCBs increased to 24 in 2011 with the granting of licences to Amana Bank Ltd and Axis Bank (of India). Fitch rates 19 banks in Sri Lanka: all 11 local LCBs (at end-2010), three foreign bank branches, and five LSBs. Together, these rated banks accounted for about 96% of total banking sector assets at end-2010.

The Sri Lankan banking sector remains concentrated. The six largest local LCBs identified as being systemically important – Bank of Ceylon (BOC), People's Bank (PB), Commercial Bank of Ceylon Plc (CB), Hatton National Bank Plc (HNB), Sampath Bank Plc (SAMB) and Seylan Bank Plc (SEYB) – accounted for 64% of sector assets, 74% of sector loans and 68% of sector deposits at end-2010. Just over half the assets of the banking sector are with the public sector, with the two largest LCBs and the largest LSB being state-owned. Foreign ownership is relatively low at 12%, although the largest foreign bank branch (HSBC Sri Lanka) accounted for 5% of sector assets at end-2010.

Figure 3

Sector Composition

End-2010	Number of banks in sector	Share of sector assets (%)
LCBs	22	84
Local	11	72
State	2	36
Private	9	36
Foreign	11	12
LSBs	9	16
State ^a	7	14
Private	2	2

^a Housing Development Finance Corporation Bank of Sri Lanka is considered to be a state bank due to 51% state ownership
Source: CBSL, Fitch

Related Criteria

[Global Financial Institutions Rating Criteria \(August 2011\)](#)

Customer reach is still largely through the traditional "brick and mortar" model – ie, through branches and outlets – as use of alternate delivery channels remains limited. The geographical dispersion of branches indicates a concentration in the Western Province. After the cessation of the civil war, most banks also established a presence in the Northern and Eastern Provinces. The level of banking sector assets relative to GDP was 69% from 2000-2009, although the ratio was well below this at 63% in 2010.

Performance and Trends

Lending and Asset Quality

Loan growth was stagnant in 2009 in the wake of the economic downturn, which dampened credit that year. However, from about the last quarter of 2010, lending across banks rebounded, spurred by more favourable economic conditions and increased private-sector credit demand. The system posted loan growth of about 24% (annualised) in 6M11 and 23.7% in 2010, compared with a contraction of 2.3% in 2009. Consequently, the proportion of loans increased to 56% at end-2010 from 53% at end-2009, with a gradual shift away from investments in government securities.

The dominant positions of the two state-owned banks, BOC and PB, are unlikely to be challenged over the foreseeable future, given their wide presence across the country and ability to source business from the state sector (Government of Sri Lanka- and state-owned entities), which accounted for 27% of the loans of these banks and 13% of LCB loans at end-2010. Together, these banks accounted for 41% of total banking system loans at end-2010.

The composition of LCBs' loans indicates that the distribution of loans remained broadly the same in 2010 as in 2009. In the absence of significant financial disintermediation, bank loans remain the main source of finance for corporates, which represent the largest customer segment. Corporates include SMEs, which Fitch expects to be a growth segment in the current economic environment, although this could present challenges in the form of a further upgrade of risk management processes and systems.

Fitch notes that total banking sector pawning advances grew by 40% in 2010 (18% in 2009) and accounted for 21% of the increase in loans in 2010. The growth in pawning advances during this period could be attributed to the deliberate focus by some banks on growing this product given its attractiveness in terms of low credit risk, zero risk-weight and relatively high yields. Consequently, pawning advances accounted for 14% of sector loans at end-2010 (12% at end-2009). Pawning advances generally carry a maturity of one year or under, and Fitch notes that loan/value ratios (LTVs) vary widely among banks, with later entrants advancing more against the value of a gold sovereign.

Figure 4
Lending

	End-2009	End-2010
Assets/GDP	62.3	63.4
Gross loans/ GDP	33.0	35.3
Gross loans/ assets	53.0	55.6

Source: CBSL, Fitch

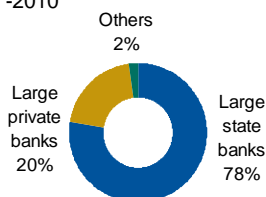
Figure 6
Segmentation of Loans of LCBs

	End-2009 (%)	End-2010 (%)
Loans to corporates	57	55
Personal loans, of which	32	33
Housing	10	9
Pawning (excludes advances classified under agriculture and fishing)	8	10
Credit cards	2	2
Total LCB loans to the private sector	88	87
Loans to government of Sri Lanka- and state-owned enterprises	12	13
Total LCB loans	100	100

Source: CBSL, Banks, Fitch

The sectoral composition of LCB loans to the private sector at end-2010 reveals concentrations to industry (36.2%), of which textiles & apparel and construction (excluding personal and staff housing) accounted for 5.6% and 4.9%, respectively. The largest subsector exposure was 7.2% to wholesale and retail trade, included under the service sector (21.2%). Exposure to the agricultural sector accounted for 14.3%, above the regulatory 10% minimum, of which tea

Figure 5
Pawning Advances
% of sector pawning advances at
End -2010



Source: CBSL, Banks, Fitch

accounted for 3%. In May 2008, the CBSL required that all banks have exposure to the agriculture sector of 10% of their loan portfolios by end-2009 and that banks that did not comply contribute the shortfall to a refinancing fund operated by the CBSL to be drawn on by other banks. Fitch notes that the definition of agriculture is broad, encompassing direct and indirect finance to the agriculture sector.

Fitch observes that borrower concentrations in relation to equity tend to be high (for the five largest local LCBs, the top five exposures ranged from 78% to 733% of equity at end-2010) reflecting the under-developed local corporate debt securities market. Concentrations generally face regulatory limits that vary depending on the credit rating of the bank and borrower and the capital adequacy ratio of the bank, although banks may exceed the regulatory limit subject to approval in certain circumstances.

The level of foreign-currency-denominated lending is limited, accounting for about 16% of sector loans at end-2010. Foreign-currency lending is generally funded by foreign-currency deposits and generally limited to companies deriving revenues in foreign currency or Board of Investment of Sri Lanka-approved companies.

Off-balance-sheet exposure of Sri Lankan banks in the form of commitments and contingencies accounted for 40% of assets at end-2010 and largely related to the facilitation of trade-related transactions for customers.

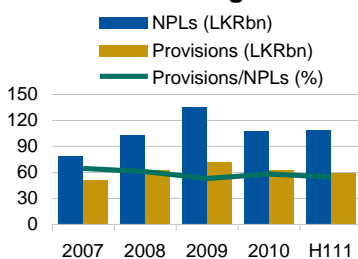
The Sri Lankan banking system's loan quality deteriorated in 2009 on account of the difficult operating environment, marked by high inflation and interest rates. The gross NPL ratio for the system peaked at 8.8% in September 2009, impacted by the contraction in loans. However, in 2010, system NPLs fell by 21% yoy and the gross NPL ratio declined to 5.4% at end - 2010, also supported by loan growth. The decline in NPLs, while largely driven by improved economic conditions, was also a function of a greater focus in general on the control of NPL accretion and recoveries of NPLs at banks.

The tightening of classification rules caused an uptick in NPLs during Q111. In particular, all credit facilities extended to a borrower had to be classified as non-performing when one or more facilities have been classified as non-performing and in aggregate exceeds 30% of the total credit facilities extended to the borrower. Further, classification criteria for overdrafts and loans repayable in instalments were revised. Fitch notes that strong loan growth could mask NPL ratios, understating the future level of NPLs that could appear. The knock-on effects of a potential slowdown in global economic activity could adversely affect the asset quality of the local banking sector.

Fitch estimates that the combined gross NPL ratio of the two state LCBs at end-2010 would increase from 4.2% to about 5.7% if loans were adjusted for state sector exposure, which is generally not classified as non-performing. Fitch further estimates that the system's gross NPL ratio adjusted for pawning advances, which carry low credit risk, would be about 6.3% at end-2010.

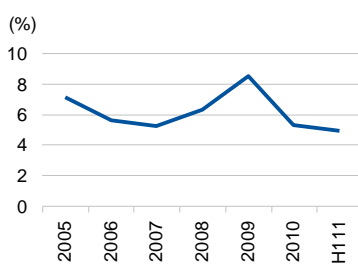
The increase in NPLs across the banking sector during 2009 prompted most banks to reschedule repayments on performing loans in a bid to ease asset quality pressure through slippage. A regulatory dispensation effected from May 2010 until June 2011 allowed banks to restructure NPLs by permitting them to grant loans for the repayment of NPLs, and report these loans as performing (for the five largest local LCBs, restructured performing loans were 1.7% of total loans at end-2010). Assessing the extent to which banks may have granted new loans to borrowers experiencing difficulties with repayment to avoid reporting them as non-performing is difficult, given the practicality of tracking each loan granted by a bank once it has been disbursed.

Figure 7
NPLs, Provisions, and Provision Coverage



Source: CBSL, Fitch

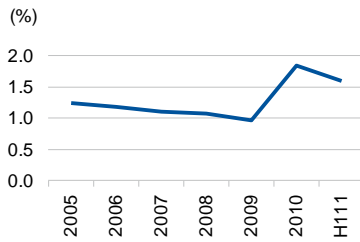
Figure 8
Gross NPL Ratio



Source: CBSL

Figure 9

Return on Assets



Source: CBSL, Fitch

NPLs are categorised as special mention, substandard, doubtful and loss based on their age (for credit card advances, the classification under these categories is accelerated). At end-2010, 14% and 68% of NPLs of the five largest local LCBs were classified in special mention and loss categories, respectively. Minimum regulatory provisioning takes place once the NPL is in the substandard category, while a deduction is allowed for the value of collateral. Provision coverage (including both specific and general provisions) for the banking sector decreased to 53% at end-2009 before increasing to 58% at end-2010. Provision coverage has progressively decreased as general provisions are being reversed to 0.5% of performing and special-mention loans in 2012. Fitch considers the sector's loan loss coverage to be moderate.

Fitch notes that collateral is widely used by Sri Lankan banks to mitigate credit losses supported by extra judicial foreclosure rights (known as Parate execution rights) awarded to most banks, although the recovery of collateral still tends to be difficult, due to legal impediments placed by borrowers, while the realisation of collateral can prove challenging, particularly in an economic downturn. At end-2010, only 11.1% of LCB loans and advances (booked in the domestic banking unit and excluding NPLs, export bills purchased and foreign-currency lending) were unsecured, while 25.5% were secured by immovable property, plant and machinery and a further 19.2% by gold and other precious metals under pawning. The agency believes that the recent amendment to the Recovery of Loans by Banks Act could be a deterrent to lending for ticket sizes below a certain threshold (see *Other Developments*).

Fitch is of the view that ensuring prudent management of loan growth should be an important aspect of Sri Lankan banks' performance in 2011 and beyond as rapid loan growth could present a challenge for the banking system. The agency notes that the regulator has thus far not placed restrictions on the level of bank lending or exercised moral suasion to rein in credit growth in the system and that policy measures to counter inflationary pressures have been implemented so as not to dampen credit demand.

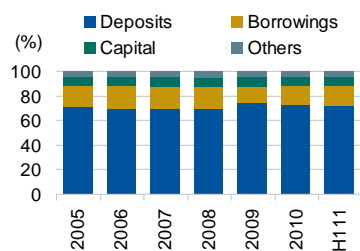
Profitability

The Sri Lankan banking system experienced a strong upturn in profitability in 2010, with ROA increasing to 1.8%, significantly above the 1.1% average in 2000-2009, largely due to a reduction in credit costs. However, profitability decreased in 2011, with the sector posting an ROA of 1.6% for 6M11, largely due to the contraction in net interest margins (NIMs) with intensifying competition.

Reflecting their model of traditional commercial lending, Sri Lankan banks continue to be dependent on interest income; net interest income accounted for 69% of total operating income in 2010. In general, Fitch observes that banks that had higher retail and/or SME exposure have benefited from higher net interest margins (defined as interest income/average interest-bearing assets). However, the agency notes that lending rates across all customer segments have been driven down largely by lower market interest rates and increased competition with the revival of loan growth. Fitch further notes that funding costs have trended upwards as competition increases and liquidity diminishes alongside credit growth. Consequently, the agency expects NIMs to continue to come under pressure. To compensate for the pressure on NIMs, Sri Lankan banks are likely to focus on increased lending volumes.

Figure 10

Funding Profile

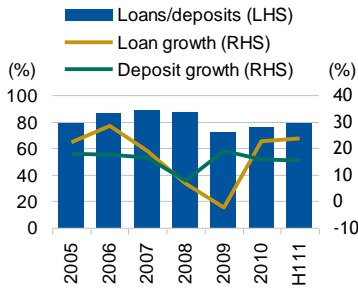


Source: CBSL

Historically, the contribution of non-interest income has been moderate. The contribution of foreign exchange income to non-interest income reduced in 2010 with rupee appreciation. However, fee and commission income is expected to increase with higher transaction volumes. Fee and commission income and foreign exchange income accounted for 43% and 12% respectively of the non-interest income of the five largest local LCBs in 2010 (38% and 20% in 2009). Non-interest income for some banks in 2009 and 2010 was boosted by mark-to-market and capital gains on equities and government securities.

Figure 11

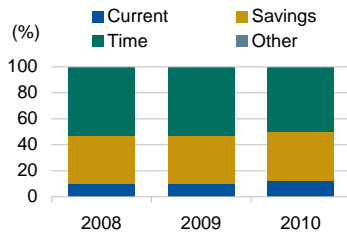
Loans and Deposits



Source: CBSL, Fitch

Figure 12

Deposit Mix



Source: Banks, Fitch

Credit costs reduced alongside the improvement in asset quality and the progressive reversal of mandatory general provisions. Provisions against disputed oil derivative contracts affected the profitability of two large local LCBs in 2008 and 2009.

Operating cost efficiency among banks has been improving. Operating costs (excluding provisions)/average assets was 3.2% in 2010 (3.4% in 2009), while the cost/income ratio was 49% in 2010 (51% in 2009). Fitch notes that cost efficiency varies widely among banks. Personnel costs continue to be the largest cost component for banks, accounting for 45% of total costs in 2010. Personnel costs at some banks are revised every three years (the last revision being in 2009), in line with the collective agreement signed with the Ceylon Bank Employees Union. Retirement benefits accounted for 14% of the total personnel costs of the five largest local LCBs in 2010 and include provisions for defined benefit pension plans. The agency expects operating costs to increase given the capacity expansion under way at most banks in the post-war era.

Sri Lankan banks are liable for income tax as well as value-added tax (VAT) on financial services. Consequently, the banking sector has been subjected to a significant tax burden, with an effective tax rate of 46% at end-2010. However, the tax burden on banks has reduced, following the trimming of income tax and VAT to 28% from 35% and to 12% from 20%, respectively, which will boost net income. However, banks are required to transfer 8% of the profit calculated for the payment of VAT on financial services and 5% of the profit before tax calculated for the payment of income tax to an investment fund account. Funds in this account can be utilised for investment in long-term government securities and long-term lending subject to the fulfilment of certain conditions.

Funding and Liquidity

Sri Lanka's banking system remains primarily deposit-funded. Deposits are viewed as relatively "sticky" and are generally subject to rollover. As such, Fitch assesses Sri Lankan banks to have fairly stable funding profiles, stemming from their strong domestic deposit franchises and modest dependence on wholesale market funds.

Deposits funded 73% of assets at end-2010. Current and savings accounts (CASA) of the five largest local LCBs accounted for 53% of their total deposits at end-2010, reflecting the narrowing of the interest rate differential between savings and time deposits with a decline in interest rates. Foreign-currency deposits accounted for 18% of LCB deposits at end-2010, with this base supported by retail deposits through the channelling of worker remittances to Sri Lanka and by deposits placed by institutional depositors.

The three large state-owned banks accounted for 52% of total banking system deposits at end-2010. Fitch believes the larger banks are better positioned to compete for customer deposits, given their stronger franchises and wider footprint.

Deposit growth decreased to 15.8% in 2010 following a surge in deposit growth to 18.8% in 2009. The crisis that permeated registered finance companies in 2009 benefited some of the systemically important banks due to a flight to safety at the expense of some of the smaller banks and deposit-taking non-bank financial institutions.

Banks' holdings of liquid assets increased significantly in the wake of muted loan growth, resulting in strong statutory liquid assets ratios reported across the sector in 2009 and 2010. Fitch notes that the sector's loans/deposits ratio (LDR) increased to 76.1% at end-2010, after falling sharply to 71.5% at end-2009, but remained relatively low. However, as banks continue to expand their loan books amid favourable economic conditions, the LDRs of banks are likely to creep up and cause excess liquidity to diminish. By H111, the LDR for the sector had reached 79%. The agency believes that the share of non-deposit funding in bank funding could increase to support strong loan growth. Borrowings accounted for about 15% of total funding at end-2010 and end-H111.

A very high proportion of deposits are contractually short-term in nature, given that CASA are generally classified under the "up to three months" maturity bucket, while the majority of time deposits tend to carry maturities of up to 12 months. Given the differing residual maturity profiles, negative gaps between interest-bearing assets and liabilities are not uncommon across the sector. As such, interest rate risk is the main source of market risk faced by Sri Lankan banks, with little use of derivative instruments to mitigate this risk. However, fixed-rate pricing of loans tends to be limited, and the majority of loans are short-term, while some banks have sourced medium-term wholesale funding in the form of debentures and credit lines.

Capital

The composition of capital is of relatively high quality, with core capital accounting for 87.5% of the total capital base. Fitch views the planned regulatory increase in minimum capital to LKR5bn and LKR3bn for LCBs and LSBs, respectively, by end-2015 as a positive measure. Subordinated term debt accounted for 45% of Tier 2 capital at end-2010. By regulation, Tier 2 capital is capped at 50% of Tier 1 capital.

Tier 1 and Total capital adequacy ratios (CARs) stood at 14.3% and 16.2% at end-2010, above the respective required regulatory minimums of 5% and 10%. CARs in both 2009 and 2010 were bolstered by excess liquidity. Adjusted for excess liquid assets assigned a zero risk weighting, Fitch estimates that Tier 1 and Total CARs would have been about 10% and 11.5%, respectively, at end-2009, and 9.8% and 11.2% at end-2010. Tier 1 and Total CARs declined to 13.4% and 14.9% at end-H111 due to asset growth and in the case of most banks the exclusion of profits earned during 2011 in calculating CARs until audited.

Sri Lankan banks adopt the basic approach for credit, market and operational risk under Basel II. Some banks have begun to lay the groundwork for an eventual shift to an internal ratings-based approach for credit risk. Fitch understands that banks have also been issued guidance by the regulator to shift to more advanced approaches for the calculation of operational risk charge under Basel II. Furthermore, the agency believes that transition to Basel III is unlikely in the near term.

Capitalisation in terms of capital funds/assets has remained at about 8% with an equity/asset ratio of 6.2% for the five largest local LCBs at end-2010. Fitch considers the sector's overall level of capital to be low in light of moderate loan loss coverage ratios and increased credit growth. In particular, the agency notes the relatively thin capitalisation in terms of equity/assets of the state LCBs, given their size and systemic importance. Asset growth of the five largest local LCBs of 21.5% in 2010 outstripped internal capital generation of 13.8%, with a dividend payout of 35% of net income. Hence, Fitch is of the view that profit retentions and capital infusions will be required to withstand capital pressures.

Other Developments

Changes to Accounting Standards

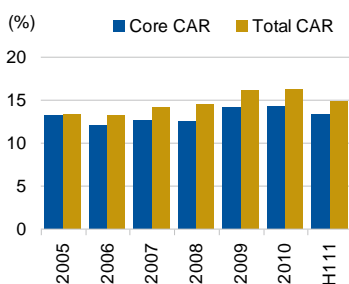
As part of the convergence of local accounting standards with international standards, banks are required to adopt fresh local accounting standards pertaining to financial instrument presentation, financial instrument recognition and measurement, financial instrument disclosures and share-based payments for periods beginning 2012. These accounting standards were to be adopted for periods beginning 2011. While banks have not publicised the estimated impact of the adoption of these standards, Fitch understands that some banks are in the process of evaluating their impact and preparing for their implementation.

Deposit Insurance

From October 2010, the CBSL introduced a mandatory deposit insurance scheme according to which all banks, including foreign bank branches, are required to be participating members as licensed deposit-taking institutions. All eligible demand, savings and time deposits are to be insured under this scheme.

Figure 13

Capital Ratios



Source: CBSL

The premium levied on banks is determined by their CAR at the end of the preceding financial year-end; ie, a 0.1% annual premium for banks with a CAR of 14% and a 0.125% annual premium for other banks payable on a quarterly basis. The fund is permitted to invest in government securities and in secured loans to member institutions in the event of a severe liquidity crisis, if in the opinion of the Monetary Board, the loan will help to avoid imminent financial panic in the member institution or in the financial system as a whole.

Compensation up to a maximum of LKR200,000 per depositor per institution (or the equivalent in the case of foreign-currency deposits) would be paid by the CBSL within six months of the date of suspension or cancellation of the licence/registration of the member institution. However, given that depositors would only be paid compensation after the bank's licence is revoked, Fitch believes that it is unlikely that a situation would occur in which the fund would be unable to meet its obligations.

Amendments to Recovery of Loans by Banks (Special Provisions) Act

The Recovery of Loans by Banks (Special Provisions) Act confers on banks Parate execution rights (ie, the right to initiate action to sell or take possession of mortgaged property with the authority of a resolution passed by the Board of Directors for the recovery of a loan in the event of default of a borrower). The Act was amended such that, in the event of default on loans with an original disbursement value of LKR5m secured by property, banks cannot initiate action to recover dues. Fitch believes that this amendment is likely mostly to affect those banks that have substantial small-ticket loans secured by property, such as banks providing housing loans to low- and middle-income segments that have average values of under LKR1m.

Exposure to the Stock Market

With a view to preventing excessive exposure of banks to the share market, in 2011, the CBSL restricted banks' exposure to loans granted for margin trading to 5% of total loans outstanding as at the end of the preceding quarter. Banks are required to be compliant with this maximum limit by end-March 2012. The maximum margin that can be provided on a margin trading facility is 50% of the market value of the customer's share portfolio at the each of each trading day, while all shares purchased utilising the margin trading facility should be pledged to the bank. Banks are required to report their exposure to the stock market to the CBSL on a quarterly basis.

Furthermore, the CBSL limited the guarantees issued by banks for the purchase of shares from an initial public offering (IPO) to 50% of the value of the IPO. Guarantees issued against cash deposits can be exempted from this limit subject to the fulfilment of certain conditions. Fitch believes that this was prompted by substantial oversubscriptions for recent IPOs, which effectively reduced the number of shares allotted to retail investors.

Credit Risk Management

The focus of risk management has been partly an outcome of a need to adhere to regulatory requirements and banks' own recognition of this need. Banks have independent risk management divisions headed by a chief risk officer as well as board risk management committees.

Credit risk is the largest risk that Sri Lankan banks face. Fitch understands that improvements to risk management in this area have largely been centred on tightening underwriting standards, reduction of approval authority limits delegated to branches, early identification of problem credits and revamping of collection recovery processes. This has been supported by enhancements to the information available from the Credit Information Bureau. Internal customer risk ratings are carried out by most of the larger banks, although Fitch notes that they are not necessarily factored into pricing or capital allocation.

Listing of Banks

The CBSL requires all locally incorporated private banks to be listed on the Colombo Stock Exchange by 31 December 2011. The objective of the listing requirement is to broaden banks' ownership bases.

Consolidation

Mergers and acquisitions have been rare within the Sri Lankan banking system. Acquisitions have largely been limited to the absorption of the local operations of foreign banks upon their exit from Sri Lanka.

Fitch is of the view that consolidation has been impeded by regulations pertaining to the ownership of banks. In 2007, the CBSL imposed a restriction on the ownership of LCB shares carrying voting rights to 10%, although a maximum holding of 15% may be permitted, subject to CBSL approval. The CBSL granted shareholders a maximum period of five years (to 2012) to comply with this direction. Some banks had shareholders breaching this limit and as such the latter were required to reduce their holdings accordingly.

While the increase in the minimum capital requirement is in itself not sufficient to prompt consolidation, Fitch understands that proposed amendments to the Banking Act may contain provisions to facilitate a smoother amalgamation of operations subsequent to granting approval for the consolidation of banks. The agency is of the view that consolidation should strengthen the banking system, provided it is accompanied by continued improvements in corporate governance and risk management.

Appendix 1

Figure 14

Fitch Ratings of Sri Lankan Banks

	National long-term rating	Outlook
Citibank N.A. - Colombo Branch	AAA(Ika)	Stable
HSBC Sri Lanka Branch	AAA(Ika)	Stable
National Savings Bank	AAA(Ika)	Stable
Standard Chartered Bank, Sri Lanka Branch	AAA(Ika)	Stable
Bank of Ceylon	AA+(Ika)	Stable
People's Bank (Sri Lanka)	AA(Ika)	Stable
Commercial Bank of Ceylon PLC	AA(Ika)	Stable
DFCC Bank	AA(Ika)	Stable
National Development Bank PLC	AA(Ika)	Stable
DFCC Vardhana Bank Ltd	AA-(Ika)	Stable
Hatton National Bank PLC	AA-(Ika)	Stable
Sampath Bank PLC	AA-(Ika)	Positive
Nations Trust Bank PLC	A(Ika)	Stable
Seylan Bank PLC	A-(Ika)	Stable
Regional Development Bank	BBB+(Ika)	Stable
Housing Development Finance Corporation Bank of Sri Lanka	BBB+(Ika)	Stable
Pan Asia Banking Corporation PLC	BBB(Ika)	Stable
Union Bank of Colombo Ltd	BB+(Ika)	Negative
Sanasa Development Bank Ltd	BB+(Ika)	Stable

Source: Fitch

Appendix 2

Figure 15
Financial System Assets

	End-2009		End-2010	
	(LKRbn)	(%)	(LKRbn)	(%)
Banking sector	3,835.2	68.3	4,533.2	67.8
CBSL	821.9	14.6	985.4	14.7
LCBs	2,506.6	44.7	2,969.3	44.4
LSBs	506.7	9.0	578.5	8.6
Other deposit taking institutions	315.7	5.6	400.9	6.0
Registered finance companies	185.3	3.3	233.6	3.5
Co-operative rural banks	124.5	2.2	160.6	2.4
Other	5.9	0.1	6.7	0.1
Other specialised institutions	257.4	4.6	354.8	5.3
Specialised leasing companies	111.8	2.0	154.1	2.3
Primary dealers	99.8	1.8	125.8	1.9
Other	45.8	0.8	74.9	1.1
Contractual savings institutions	1,205.5	21.5	1,401.5	20.9
Employees' provident fund	772	13.8	902	13.5
Employees' trust fund	107.3	1.9	125.9	1.9
Insurance companies	181	3.2	221.7	3.3
Approved private provident funds	121.9	2.2	126.2	1.9
Other	23.3	0.4	25.7	0.4
Total	5,613.8	100.0	6,690.4	100.0

Source: CBSL

Appendix 3

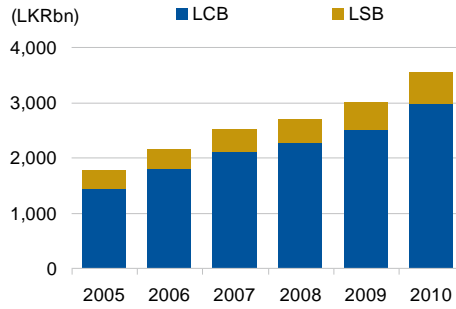
Figure 16

Sector Structure and Key Indicators

	Sri Lanka 31 Dec 10	India 31 Mar 10	Indonesia 31 Dec 10	Malaysia 31 Dec 10	Thailand 31 Dec 10
Sector structure					
Number of banks	22	83	122	34	17
State-owned banks/sector (%)	51.1	73.7	45.0	48.3	17.5
Foreign-owned banks/sector (%)	9.6	7.2	31.0	19.2	7.1
Privately owned banks/sector (%)	39.3	19.1	24.0	32.5	75.4
Five largest banks/sector (%)	66.2	37.6	50.3	66.1	73.9
Assets/GDP (%)	63.2	96.7	46.8	201.9	99.3
Key indicators (%)					
Impaired loans/gross loans	5.3	2.4	2.6	3.4	4.6
Reserve coverage of impaired loans	59.8	51.5	-	88.9	88.2
Return on average assets	1.8	1.0	2.1	1.1	1.2
Return on average equity	22.4	14.3	19.5	12.4	11.6
Customer deposits/GDP	46.1	76.3	36.4	148.9	69.1
Gross loans/customer deposits	76.1	74.5	75.5	77.4	98.3
Equity/assets	8.4	7.1	10.9	9.3	10.2
Total CAR	15.8	14.5	17.2	14.8	16.7

Source: Fitch

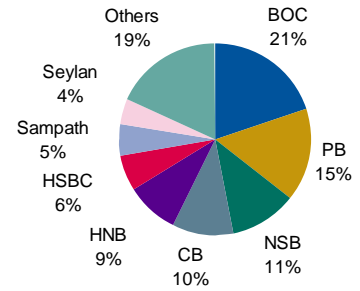
Share of Sector Assets



Source: CBSL

Market Share by Total Assets

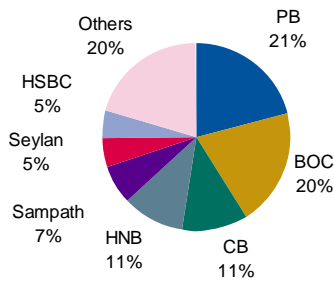
As at end 2010



Source: Banks, Fitch

Market Share by Loans

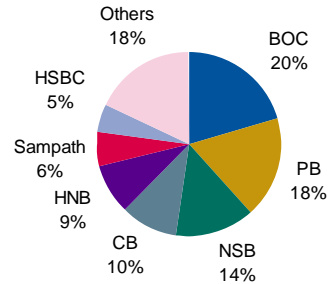
As at end 2010



Source: Banks, Fitch

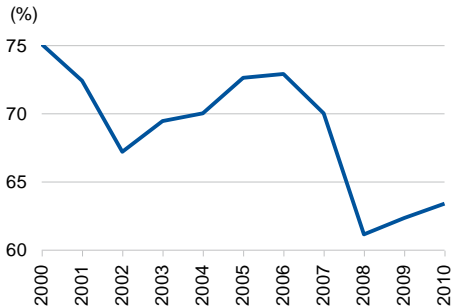
Market Share by Deposits

As at end 2010



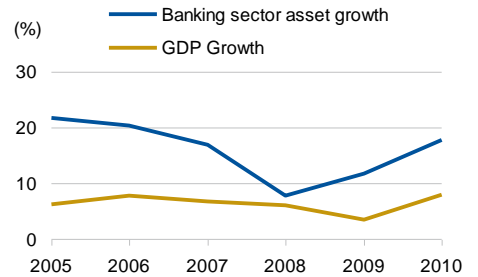
Source: Banks, Fitch

Total Assets/GDP



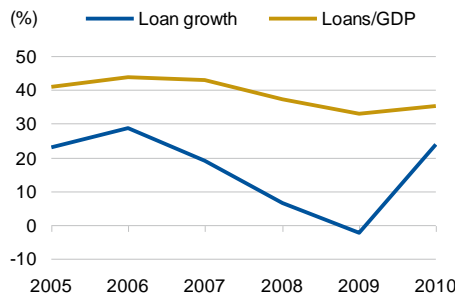
Source: CBSL, Fitch

Sector Asset Growth and GDP Growth



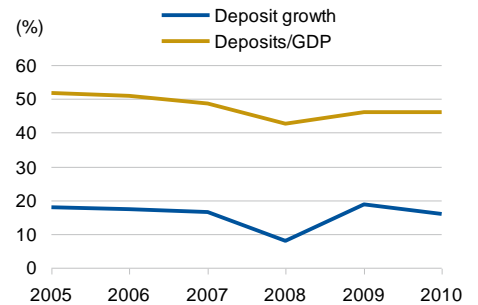
Source: CBSL, Fitch

Loan Growth and Loans/GDP



Source: CBSL, Fitch

Deposit Growth and Deposits/GDP



Source: CBSL, Fitch

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: [HTTP://FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS](http://FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS). IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT WWW.FITCHRATINGS.COM. PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE.

Copyright © 2012 by Fitch, Inc., Fitch Ratings Ltd. and its subsidiaries. One State Street Plaza, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings, Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings can be affected by future events or conditions that were not anticipated at the time a rating was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion is based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at anytime for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of Great Britain, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.