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Impacts of Non-Performing Assets to the Performance of Banking Sector in Sri Lanka

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ABSTRACT

With the ending of 30 year old civil war, Sri Lanka was expecting an economic growth for which the banking sector of the country will play an essential role in largely working as a financial service provider, especially as a lender to meet working capital requirements of the rising small medium enterprises (SMEs), Corporates and other businesses.

However, during the period that the Nonperforming loans (NPLs) have increased while the key performance indicators of the banking sector such as profitability, liquidity, capital adequacy and loan books have deteriorated drastically.

Hence, the prime objective of the study is to determine effects of NPLs to the performance of banking sector of the country by addressing to different areas such as how sensitive the snowballing NPLs are being influential in changing the performance of the banking sector in Sri Lanka and what are the pivotal factors which can tiger NPLs in a bank and which sectors are more prone for defaults?. Further, how to overcome this situation and what are the mitigating factors with best methods to improve the lending quality of Sri Lankan banks. Also, downfalls in classifying NPL criteria with implementation of IFRS 9 in Sri Lanka.

Key Words: Banking sector performance, IFRS 9, ICAAP, NPLs, SMEs.

1. BACKGROUND AND CONTEXT REVIEW

1.1 Review on research context

The Banking and Finance sector of Sri Lanka has been one of the biggest contributor to the economy in the country. It is among the fastest growing sectors and attracted more competition and widened opportunities as a result. The industrial structure has evolved and now the industrial players are offering wide range of products and facilities to attract more business. Expansion in money markets and capital market, digitalization process and advanced steering of transactions have been some of the approaches taken by different players in the industry to try and create their unique selling points.

Sri Lanka's banking and Finance industry is regulated and governed by the Central Bank of Sri Lanka and it has been the key to smooth running of the financial system in the country. The industry is made of banks, non - banking financial institutions, foreign exchange & capital markets, contractual savings institutions and micro finance institutions.

Presently the banking and finance sector contains 48 licensed finance companies, 24 licensed commercial banks, 9 specialized banks and 10 leasing companies. Due to enormous rapid development in the sector, in terms of branch network, the asset book of the commercial banks in Sri Lankan has improved from LKR 5,438Bn in 2016 to LKR 6,087Bn in 2017 by expanding opportunities for public to obtain and full fill their financial expectations.

Even though there are several types of companies within the finance industry, commercial banks are dominating the industry and are the main fund providers to general public. With increase in competition among commercial banks, the banks are coming up with innovative products using new technology to stay on top of the game. Accepting deposits, granting loans, granting overdraft, providing corporate financing, treasury activities and cross border financing are some of the core functions of commercial banks which are modified by each banks within the allowed framework to attract more client base.

The over-all share of banking assets vis-a-vis to over-all finance sector assets (including non-banking sector) are reported as 70.4% and 69.7% in 2012 and 2013 respectively. Further, out of which licensed commercial banks are contributing for 48.7%. However, due to various factors the restraint in credit growth has contributed to decline of the share of loans and advances in total asset from 61.8% in 2012 to 57.7% in 2013.

Few economic activities and advancing to such economic activities have impacted greatly for the improvement of the asset portfolio in the sector. Further, from the total advances portfolio, construction industry holds a substantial (26%) followed by trading activities (21%), infrastructure development activities (20%), manufacturing industry (17%) and transport services (11%).

1.2 Non- Performing Loans of Sri Lanka banking industry

As per definition “Non-performing loans” (NPL) are amount of borrowed cash which the borrowers have failed to make the payment as agreed for at least 90 days. In other words NPLs are either loans or advances in default of close or being in defaults for a substantial period of time.

Sri Lankan banking sector’s credit risk has remained at controllable level in the recent years due to the availability of acceptable possessions in the form of capital. Credit growth of the banking industry has mirrored a modest trend from 21.1% in 2012 to 8.8% in 2013.The asset quality in 2013 showed a decreasing trend with 5.6% of NPL against a 3.2% previous year. This was mainly owing to inferiority in the gold loan portfolio and slower credit growth. The absolute value of Nonperforming assets has amplified by LKR 74Bn in 2013, out of which the nonperforming assets of pawning loans are contributing to massive LKR 56Bn.

As per the CBSL, the factors contributed to the increase in NPL are mainly due to the nonpayment of gold advances and increasing interest rates for such gold advances. The two state owned banks of Sri Lanka namely Peoples Bank (PB) & Bank of Ceylon (BOC) have had a hit of LKR 20 billion as credit losses during 2013. NPL of PB has augmented up to 5.3% in 2013 against 2.8% in 2012. Also the NPL ratio of BOC has augmented to 4.3% in 2013 against 2.76% previous year.

1.3 Sri Lanka’s Financial Sector Stability

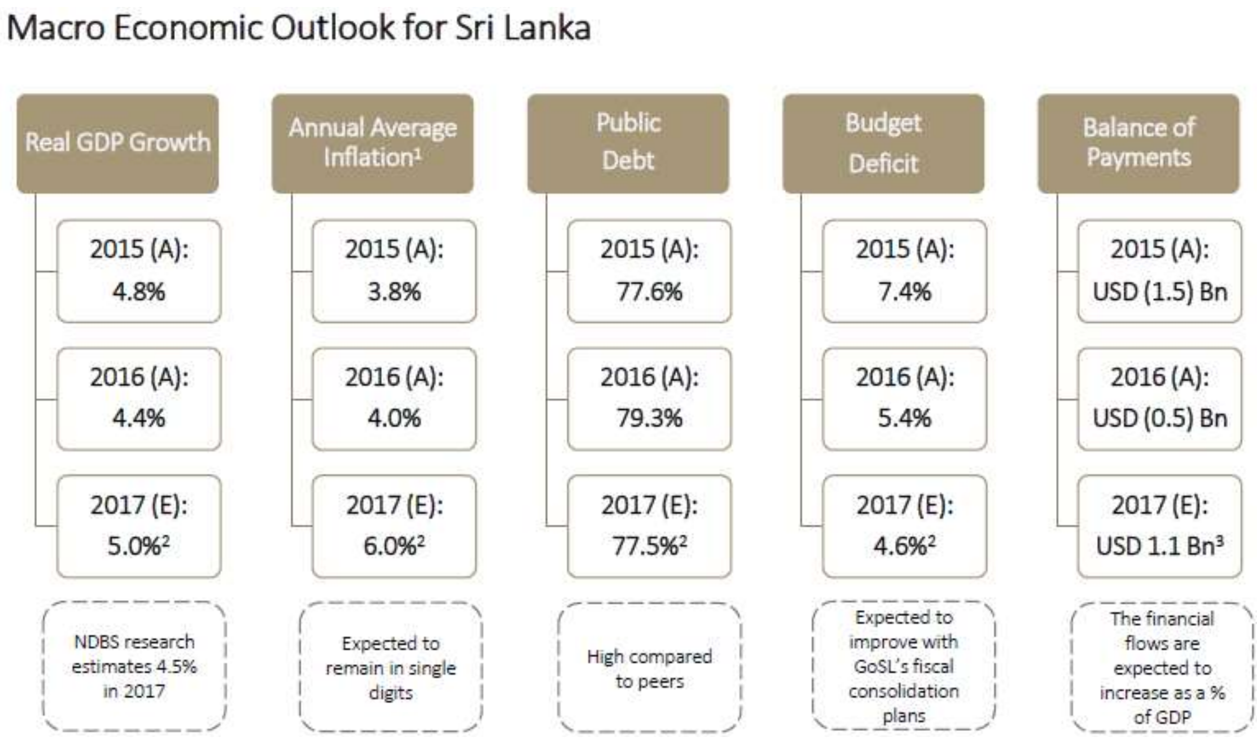
The changes in the global economy has affected many industries and financial industry is not an exception. With rapid changes in global market, Sri Lanka’s financial industry is also experiencing some uncertainty and difficulties in sustaining growth. The industry experienced an increase of non-performance of pawning loans and as a result it affected the quality of the asset base of financial institutions country wide.

Some steps such as robust capital and liquidity cushion and comprehensive risk management practices are put in place to try and save the financial institutions from further difficulties. The Central Bank of Sri Lanka (CBSL) was actively looking into this issue in order to regulate and closely monitor the performance of the institutions to safeguard them from further difficulties due to NPL.

The Central Bank encouraged the banks to open up new branch network especially out of Colombo to improve accessibility and convenience for the customers and reduce concentration of all banks within the capital. This resulted in a rapid growth of total assets in the sector in recent past.

As a result of the banks reaching out to the population throughout the country, the money market of Sri Lanka became very liquid and the foreign exchange market stayed stable during the recent years. There has been an improvement in the performance of corporate bond market and that resulted in improved debenture issuance and increased number of new reserves. The insurance sector has also experienced a steady growth with better asset base and improvement in income and key performance indicators.

Economic stability report of the country in a dashboard



Source: NDB securities: June 2017

2. PURPOSE OF THE STUDY AND METHODOLOGY

The approach to research is considered as one of the most pivotal factor. Hence, researchers usually practice one of the two commonly accepted research approaches such as either deductive or inductive approach.

As explained by Gratton and Jones (2009), the deductive reasoning is about testing of a pre-determined theory, description or hypothesis. Deductive reasoning will help the researchers to determine a hypothesis by using existing theories. In other words an existing information is dissected to accept or reject hypothesis to achieve a research goal (Gill and Johnson, 2010).

Hence, this study fallows a deductive approach in which arguments and explanations are mainly supported by empirical evidences and associated theoretical contents. Author reviewed journal articles, financial sector performance reports from central bank of Sri Lanka, annual reports of Sri Lankan banks, and other industry publications to review the trends, reasons and effects of NPLs to banking sector performances. Accordingly, literature review was employed as the main research tool.

As per statistics published by Central Bank of Sri Lanka (CBSL) & Institute of bankers of Sri Lanka (IBSL), the Gross NPL ratio of the sector has increased up to 2.8% (1.4% net) in 2017 (Q3) from 2.6% (1.2% net) previous year end while the Net interest margins of the banking sector has declined up to 3.1% compared to 3.5% previous year.

Further ROE after tax has also weakened from 18.2% in Q2- 2017 to 17.5% in Q3-2017, which tigers a doubt among the researcher whether the increasing Nonperforming assets of the industry has a direct impact of the bottom line of the banking sector (CBSL, statistics, financial sector).

This study attempted to discuss the underlining factors of banking sector stability of the country to emphasize the importance of maintaining a sound risk weighted asset portfolio among the banks for better economic soundness of the country as a whole. Author highlight some industry specific issues and case evidences whilst specific concern is made on Sri Lankan banking industry practices and new regulatory and accounting standards which may lead to further deterioration of the performances if asset qualities of the sector does not improve. Paper is organized as a concept paper whilst arguments were empirically supported with direct empirical arguments, and accordingly this paper provides future directions. Finally, author discuss and conclude the paper by suggesting future research directions in line with the synthesized discussions.

3. SIGNIFICATION OF THIS STUDY

After the end of civil war in the country, Small Medium Enterprises (SME's) is the new emerging market for the banks which opens up new opportunities for financial institutions. However the banks are experiencing some difficulties in granting quality credit to those SME businesses. Some of the key reasons for the problem are considered as manipulated financials provided, lack of a common and proper credit scoring system in the country, insufficient assets for collateral, high competition among banks leads to take high risk to retain/ capture clients, poor succession plans or no proper management strategies executed by business, willful defaulters and poor credit evaluation due to lack of expertise in sector wise lending (Eg. Agriculture, Industry, Service, Trading etc.)

The banking industry is mainly dependent on the interest income it is generating by lending to businesses and customer segments. When it comes to business lending the main focus of the banks in the recent years has been the SME and mid corporate businesses. This encourages banks to come up with different strategies and attractive products to try and grab more client base. The competition among banks in this regard is high. The banks are under pressure to attract more and more SME businesses to stay competitive in the industry.

The banking industry is experiencing an increase in losses due to impairment provision methods as per IFRS 9. The performance of banks have deteriorated in the recent years that is visible throughout the industry in the country and this is raising concerns among the banks. They start to suspect that there may be a direct link between the increase in NPL and the performance of the industry.

According to the chart above, the ROE and PAT have decreased, however the NPL has increased in the same years. In 2011 there was an improvement in the NPL position despite the same trend (reduction in ROE) during the year.

As per the financial system stability review for 2013 by CBSL, there are several factors that has affected the profit of the banking industry. Other than the losses made by making provision for bad loans, the following contributors have been identified by CBSL.

- Deterioration in interest earnings from credit granted (decline in NIM)
- Credit growth percentage has become moderate in the recent past
- Increase in the share of high cost time deposits in total deposits
- Increase in the provisions and write offs
- Increase in the share of lower yielding assets.

4. THEORETICAL REVIEW

Theory on Banking

As per literature there are three commonly accepted theories of banking, which were elaborated as below:

(1) *The financial intermediation theory of banking:* As per this theory banks act as an intermediator who collect deposits from excess liquid individuals & business entities and then lend to those who are short of liquid. The charges made for intermediating such facilities of the banks are called net interest margin which is considered as their profits.

(2) *The fractional reserve theory of banking:* As per this theory, banks as an individual is considered as a financial intermediary who doesn't have the ability to create money, however as a collective the banking system is able to generate money via the process of 'multiple deposit expansion' (the 'money multiplier').

(3) The *credit creation theory of banking*: This is a fairly old theory which excludes the view point of a banks being a financial intermediator who mobilize deposits for the purpose of facilitating loans as explained in the previous theories. In contrast this theory argues that any bank have the ability to create credit and generate new money to the system whenever they granting a loan to a customer (International Review of Financial Analysis, Vol-46 2016).

5. LITERATURE

5.1 Introduction to concept of banking

Bank is an establishment for custody of money, which pays out customers in order (oxford dictionary).

It is believed that term bank is adapted from the Italian word "*banca*" and the French word "*banque*" which gives the meaning a "**Bench**" or **money exchange table**". The banking was first commenced by the European lenders and money changers who display coins of different currencies on benches with the view of granting credits or exchanging with local currencies.

However, the first regular institution which has a resemblance to present banking sector begins its operation approximately seventeen hundred years ago in Venice to resource republicans who were facing severe financial crises due to an ongoing war at that time (Richard Hildreth, 2001).

Presently banks pay a pivotal role in stabilizing the economy of the country. In other words banks are now engaged in all key financial activities in any economy and the stability of a country's economy relies on the banking industry.

Few of the key activities that banks are engaged are accepting deposits, grant credit, investment activities, cheque clearing process, act as an intermediary for financial transactions, act as an intermediary for foreign currency transaction and act as an intermediary for international trade.

Banks come with a verity of names, and each bank can function as several or different types according to their business type. Over twenty different types which includes Private Banks, Commercial Banks, Savings Banks, Investment Banks, Islamic Banks, Offshore Banks, Merchant Banks, etc.

5.2 Changing Role of Banking Sector

Currently the banking sector of Sri Lanka is evolving and adapting to new changes in the global market. It is modifying its traditional approach to banking with more broader and innovative and global approach. The banks are offering wider range of products and venturing into new areas of the business to expand the reach and capture wider customer base. Most of the development banks in the country are now focusing on an inclusive banking with serving various purposes. The banks now have various business range such as consumer banking, investment banking, fee-based activities, venture capitals, fund management and stock brokering to name a few.

As the technology develops drastically, all the industries worldwide are becoming more aware and making use of the trend. Banks are also adapting and improving their operations to reflecting the change in technology. This is in turn is expected to result in enhanced efficiency and convenience to the customers. Electronic Teller Machines, Internet Banking, Mobile Banking, and integrated developed software are some of the features used by various banks to make use of the technology. (M. Boyagoda, The changing Role of Banks and Sri Lanka's Re-structuring Effort)

The banking industry is also dependent on introduction of alternative channel and value adding activities to maximize performance and to have a balance between costs and benefits derived from their business activities.

The risk of return in banking industry has increased due to the cost incurred to implement new technology and alternate channel products. This in return reduced the return on equity (ROE). These risks are linked to one another.

Further, in general in banking, the performance is the state of activities characterized by stability decisions, monitoring, regulative and prudential coordination "of the banks" (Bolocan, 2011).

5.3 Review concept of NPL

There is no definition of non-performing loan found which is globally accepted and understood. However there are different definitions available to explain nonperforming loans in terms of the classification system, the scope, and contents. The loans or credit outstanding and the accrued interest component for the outstanding are not repaid for a considerable period of time are called Nonperforming loans or bad loans. Using the pseudo panel base model Hippolyte Fofack (2005) finds that macroeconomic factors such as Economic growth, Real interest rate, Appreciation of real exchange rate, Interbank borrowings and Net interest margins have a significant impact on the Nonperforming loans of a country.

These types of loans are also called as "Problem Loans" (Berger and De young - 1997). The classifications of NPLs are vary from country to country since some countries use quantitative criteria such as number of days in arrears, where the others depend on more qualitative criteria such as financial status of the customers to repay or the management decisions about future repayments payments(Bloem and Gorter,2001).

As per research done by (Selvarajah and Vadivalagan, 2013 of Anna University, Chennai), "Nonperforming loans are made by banks or finance companies on which the capital repayments or interest payments are not being made on time". They further elaborate that the loans are classified as NPLs once the payments are overdue for a period of 90 days or more.

As per the journal article by Zhanna Mingslleva, Myrzabike Zhumabayeva & Gulzhan Karimbayewa on the subject of "Reasons for NPL & perspective on economic growth", the NPL is understood as loans or advances which have failed to meet their original conditions or covenants. In other words delay in repaying the interest or capital on stipulated time as agreed at the time of granting the facility.

According to (Hohankumar, Sing, 2012), "in India prior to March 2004, if the borrower does not pay dues in form of principal and interest for over a period of 180 days, such assets will be classified as NPLs". However, since March 2004 same has revised to 90 days.

However, as per EY report 2014 in "Impairment of financial instruments under IFRS-9", the concept of NPL and the provisions made for bad debts are totally relooked in a different concept since as per "International Accounting Standards Board (IASB)" the previously accepted standard of "IAS 39 of incurred loss model" only look at the actual credit loss and will not recognize the loss until the actual credit loss is occurred. Further, as per the article, in November 2009, the IASB issued an Exposure Draft (ED) Financial Instruments: Amortized Cost and Impairment, which recommended an impairment model based on expected losses rather than incurred losses model, for all financial assets recorded at amortized cost.

Also they further explain as in Sri Lanka "if any advances or credit facilities grated by a bank to a borrower falls under the category of NPL, any other credit facilities granted to the same borrower by the same bank should be treated as nonperforming despite the fact that there may be having performing status", (Hohankumar, Sing, 2012).

According to the regulatory requirement of Central bank of Sri Lank, when the interest payment of overdraft or excess payment on a current account is in due more than period of 90 days, the said account will be classified as a Non performing account. However, when a loan installment or interest payable for a loan installment is in arrears for a period of more than three consecutive installments, the said loan will be classified as nonperforming loan.

All other assets that are related to the above mentioned account will also get categorized as non - performing assets as it is a requirement by Central Bank of Sri Lanka to do so. The performance of bank will be worsen by increase in non - performing loans. As a result of that the credit expansion and overall economic growth will be slower. The increase in NPL could be caused by the factors such as poor management of credit, lack of sound credit policy, inadequate credit analysis, error in documentation, fraudulent Practices, political instability, economic depression, abnormal competition and undue emphasis on profitability at the expense of loan quality

Further according to Aurangzeb in his article "Contributions of a banking sector in economic growth", the banking sector has a heavy impact by increase in non-performing assets which are mostly either written off or provisioned. Hence, his NPLs are influential in depicting the efficiency of the sector. (Aurangzeb, 2012).

5.4 Credit Risk in Banking Sector

Credit risk in the banking sector mainly arises from a default by the customers of counterparties due to inability or unwillingness to meet monetary commitments pertaining to loans or related transactions (L.Ranawala, 2013). The new Basel II had assigned 75% of the weight in capital adequacy to credit risk.

The major risk faced by the banking industry in recent past has been credit risk and is caused by major earning asset in the credit portfolio. There is a high risk that of not managing the credit portfolio properly and it could even lead to the collapse of the bank. Depositors' funds are one of the major sources of lending and if those invested landings are bad, non-realizable or not repaid according to plan, the banks will fail to meet its obligations to depositors. Hence, to eliminate/ reduce the credit risk, the portfolios must be managed properly and regularly updated to comply with relevant framework and requirement. There are clear guidance provided by regulators and CBSL with regards to portfolio management and facility management.

Measuring credit risk management includes three kinds of policies. The 1st set of policies aimed to minimize credit risk, such as policies on concentration and large exposure, adequate diversification, lending to connected parties, or over-exposure. The second set includes policies of asset classification which rendering a bank to credit risk. The third set comprise policies of loss provisioning but also on other assets that are sensitive to losses.

As per (Rajan, 1994 - *herd behaviour*) due to stiff competition and loss of market share and profitability to competition, the bank managers are prepared to finance even non-viable projects during expansions. Credit mistakes are judged more leniently if they are common to the whole industry. Hence, due to said pressures the actual credit risk involved in the projects or facility is overlooked or taken softly which may lead to a underperforming or non-performing assets in future for the banks.

5.5 Ownership of NPL

There are ample reasons for loans are being defaulted by customers. Macro-economic factors and specific factors such as insufficient cash flows/ income generated are few of the key contributors for increasing trend nonperforming loans at present (Fofack, 2005).

However, as per Jin-Li Hu, Yang Li, and Yung-Ho Chiu (2006) main contributor for increasing NPLs are divided into three factors such as; political lobbying, civil corruption and Joint ownership of interest set of people engaged in political lobbying with the intention of affecting the administrative decisions.

Further, the above research further explains that "In countries where the private banking sector dominates the market, private banks easily become a family-owned business, purposely granting high risk credits to enterprises controlled by the same family circle".

In a developing third world country such as Sri Lanka, a combination of above all plays a pivotal role in increasing NPLs in the recent history.

6. EMPIRICAL EVIDENCE

6.1 Overview of the Sri Lankan banking sector

The financial system of Sri Lanka is constructed with banks, nonbanking financial institutions (Finance and leasing companies), Specialized Financial Institutions (prime dealers in government securities and unit trust) and contractual savings institutions (employee provident fund and insurance companies). Out of the entire financial system, banks are the dominant player and the key financial strength of Sri Lanka.

Sri Lanka's banking sector is largely dominated by the Public sector banks such as Bank of Ceylon PLC and Peoples Bank PLC. However, the sector comprises of 25 licensed commercial banks & 9 specialized banks (including the recently established M/S. Cargills Bank limited) with over 6,470 branches and other banking outlets and over 2,511 ATM networks (IBSL annual report 2012-13) island wide.

Banking sector of Sri Lanka comprised 25 Licensed Commercial Banks (LCBs) and 9 Licensed Specialized Banks (LSBs). LCBs lead the financial service system accounting market share of 49 per cent of the entire financial system's assets and 84% of the banking sector's assets. The LSB sector sounds 9% in entire financial system's assets and 16% within the banking sector's assets (Dissanayake & Ismail, 2015). This denotes foresaid two banking categories play a vital role in local economy. Banking sector is a noted context in Sri Lanka as a researchable area other than service quality perhaps performance perspectives (Dissanayake & Wanninayake, 2007).

Contribution to loan growth/ book of the country is dominated by five banks, namely Bank of Ceylon, Peoples Bank, Commercial Bank of Ceylon, Hatton National Bank & Sampath Bank who's contributions are accounting for 70% of the entire banking sector's loan book as at end of 2016 (Banking Sector Review, NDB Securities, June 2017)

In FYE 2016, financial services grew by 4.2% with a contribution of over 56.5% of the total GDB of the country. However, which is a slight contraction compared to the, the post war economic growth is also dominated by the service sector with a contribution of over 59.3% of the real GDB of the country in 2010. However, contribution from financial services sector has improved upto 12.4% in 2016 compared to 8.9% of the GDB in year 2010 (Banking Sector Review, NDB Securities, June 2017 and Sri Lankan Banking Sector, Fitch rating, 2012).

As there a rapid growth of the country's economy it attracts more investments. As a result of the increased investment in many sectors such as construction and hotel etc, the demand for credit is also growing in both public and private sectors. This creates more opportunities for banks to improve portfolio.

Hence, with the proper guidance and the encouraging policies of the Central Bank of Sri Lanka (CBSL), banks were given the opportunity to aggressively lend specially to Corporates and growing Small Medium Enterprises (SME's).

However, despite a significant growth of credit to private sector during the period of 2015, 2016 & 2017 in absolute numbers from 4,620 billion, 5,438 billion 6,087 billion respectively, the YOY growth ratio has declined upto 11.93% in 2017 compared to 17.72% previous year. (CBSL, statistics)

As per the research work done by (Fitch, 2012) the banking sector contributed for 53% of the financial system assets at the end of year 2010. In Sri Lanka there are two types of banks which are regulated and govern by the CBSL, described as follows.

- Licensed Commercial Banks (LCBs) – Banks which are allowed to mobilize demand deposits, in other words maintain current accounts and also authorized to deal in foreign currency.
- Licensed Specialized Banks (LSBs) – Banks which are not allowed to mobilize demand deposits or deal in foreign currency but established for the other specialized activates (e.g. development banks, development banks, etc)

6.2 Sector Concentration

The sector is predominantly dominated by six large scale local banks of the country which comprise of two state owned banks such as Ceylon (BOC), Peoples Bank (PB) and four private sector banks Hatton National bank (HNB), Commercial Bank of Ceylon (CB), Sampath Bank PLC (SAMB) and Seylan Bank PLC (SEYB) with a sector loan book of over 75% and deposit book of over 68% (Sri Lankan Banking Sector, Fitch rating, 2012)

As per the Fitch rating annual 2012 & 2013, the following six banks namely Bank of Ceylon (21%), Peoples Bank (18%), Commercial Bank (12%), Hatton National Bank (10%), Sampath Bank (8%) & Seylan Bank (4%) are contributing for 64% to the sector total asset and 73% to the loan book of the sector. Hence, it is clear that the sector loan book is heavily concentrated by the main six banks and out of which the two states own banks holds 39% as at end of financial year 2013. In 2010 75% of market share was dominated by the main six banks and in 2013 the trend was reduced to 73% while other small banks have also involved in contributing to the loan book of the country (Sri Lankan Banking Sector, Fitch rating, 2012 & Annual reports for 2013).

6.3 Soundness of the Banking Sector

As per CBSL the banking system remained sound and stable in 2013 compared to previous years except for few major areas such as Liquidity & Profitability. The "management soundness" indicator improved YOY from 98 points in 2010 to 99 points, 100 points respectively & stands at a satisfactory 101 points as of 2013 due to improvement in the sector in terms of bank wise ratings on corporate governance. However, Liquidity position has shown a drastic fall from 100 points in 2010 to 97.5 points in 2011 & further down to 97 points in 2012. However, same has slightly improved upto 97.5 points in 2013 when compared to previous year. Further, as indicated by the soundness report of the banks by CBSL, asset quality (from 101 points in 2010 to 98 points in 2013) and the profitability (100 points in 2010 to 96.8 points in 2013) has declined as a result of reduction in credit growth and increase in nonperforming loans, which consequently impacted to deteriorate ROA, ROE and the Net interest margin of the sector (Financial System Stability review 2013, soundness map).

6.4 Sector Profitability

Profitability indicators of the finance sector have deteriorated YOY during the six year period of 2008 to 2013, especially in both the Return on Assets (ROA) and the Return on Equity (ROE). ROA of the banking sector has declined from 2.4% in 2012 to 1.9% in 2013 while the ROE has declined from 20% to 16.5% in the same period under review (CBSL, Financial system stability review, 2013). The profitability of Non-banking financial sector which comprises of Licensed Finance Companies and Specialized Leasing Companies have also declines due to increased operational cost and provisioning requirements (Financial System Stability review 2013).

Further, decline in interest earned from credit, decline in credit growth, decline in net interest margins (NIM), market volatility, decline in low cost funds (demand deposits, CASA) and increase in NPLs and provision are considered as few of the key factors contributing to above deterioration in banking sector's profits and performances.

Bad and doubtful debt provision and also written off loans have increased substantially from LKR 6.3bn in 2012 to LKR 18.4bn in 2013. However the operating expenses of the industry has not shown a significant increase due to positive approaches adopted by banks in managing their expenses.

6.5 Sector Capital Adequacy

The overall capital adequacy and the core capital adequacy ratio of the banking sector have increased during 3rd quarter by expanding more room to absorb risk in the sector. In 3rd quarter of 2017, the equity ratio has improved to 15.2% compared to 14.1% and the tire I ratio to 12.3% compared to 11.7% on the 3rd quarter previous year. Hence, presently the banking sector is maintaining well above the minimum requirement of 10.5% and 6% as per Basel – III (Financial System Stability –CBSL 2013, 14, 15, 16 & 17).

Capital Structure of the Banking Sector

Profits contributed largely to the improvement of 11.7% in base capital of the entire banking sector in year 2013. Further, out of the rest 22.8% are contributed by following while statutory reserves and reserves encompassing retained earnings are accounted for the balance.

Factors contributed to increase in capital

- New capital infusions
- Increase in the share capital by IPOs
- Rights issues
- Employee share ownership schemes
- Script dividends
- Reserve capitalization

6.6 Sector Liquidity and Solvency

The Banking sector maintains a strong liquidity position during the year 2013 and fluctuating YOY. The statutory liquid asset ratio is reflected as at end of 2013 is 37.7% which is an excess of 11.3 % over the minimum requirement of 20% which the bank should maintained. However, same further improved to 39.5% in 2014 then again drastically come down to 33.9% and 29.9% in year ended 2015 & 2016 respectively. However, as per latest central bank statistics the ratio has improved to 31.1% in the 3rd quarter of 2017.

Main contributing factor for the above volatility is the volatility in treasury bills, treasury bonds rates and Sri Lanka Development Bonds. Further, political instability of the country may have been another contributing factor for above volatility in the liquidity position of the Banks.

6.7 Credit & Assets Quality

With the favorable economic growth of the country due to ending of 30 year old civil war, lending across the entire banking sector is rebounded to cater the increasing private and public sector credit demands.

In the first half of 2011, the loan books of the banks have grown by 24% (annualized) and 23.7% in 2010, compared to a contraction of 2.3% previous year (Sri Lankan Banking Sector, Fitch rating, 2012, page 3).

Further, due to a significant absence in financial disintermediation, bank borrowings have become the main mode of finance for the corporates and large scales SME's of the country.

Industry wise advances composition in the private sector

Industry wise advances composition in the private sector of LCBs in 2013		
Industry	In LKR Mn	In %
Agricultural Lending	304,922	12%
Industries	899,620	36%
Services	616,628	24%
Other (Personal loans, Credit cards, Pawning, etc)	713,826	28%
Total	2,534,996	

Source: Economics and Social Statistics of Sri Lankan Banking, 2014

Additional Review and Discussion on the Sector Context.

As per CBSL statistics 2013, major part of bank lending is concentrated in five key

areas of economic activity such as Trading, Construction, Agri., Consumption & Manufacturing. Further, trading activities accounted for 15.6% of the total banking sector bank lending portfolio, while construction sector, agriculture and fishing sector, consumption and manufacturing sector accounting for a significant portion of 14.5%, 12.2%, 11.4% and 11.3% respectively (CBSL, Financial system stability review, 2013).
Further, above large concentration of lending to a few selective sectors can expose a bank to credit risk at a crisis situation connected with one of the above mentioned key sectors. Hence, NPLs associated with these sectors should also to be taken into consideration by the banks when granting credits further credits to them to safeguard the bank's interest. These concentration risks are now partly mitigated with implementation of "Internal Capital Adequacy Assessment Process" (ICAAP) in 2018, which emphasize banks to maintain additional capital as a buffer in case of any such risk arise.

However, as per latest stats available the contribution for GDP from the local agriculture sector has a negative growth of 4.2% in 2015 (State of Economy, CBSL-2016) which is a concern for the banks since they are compelled to maintain a minimum composition of 10% of their asset book in Agri. Hence, despite the default risk in this segment has increased drastically due to deteriorated performance in the recent past increased bank lending to the segment (statutory requirement) which may increase the NPL books of the banks in years to come.

IFRS 9 is aimed at helping banks in managing the portfolios by monitoring and keeping a close relationship with clients with the aim of reducing the effect of the non – performing loan in the bank's sustainability and growth. With The adaption of IFRS 9 in Sri Lanka from 2017 the banks are required to provide a certain percentage of assets to meet the expected loss in contrast to the previous requirement of incurred loss model. This provision is expected to be a cushion to meet the circumstances when the client default on the payment.

The banks should be in a position to mitigate their credit risk and reduce the risk arising by NPL classification by following IFRS 9 and following the regulatory requirement imposed by Central Bank of Sri Lanka.

6.8 NPLs, Provisions and Provision Coverage

The net NPL ratio of the Sri Lankan banking system has hit a rocket height of 4.2% in 2009 due to adverse economic conditions of the country. However, with the post war economic growth, positive recovery mechanisms adopted by the banks and increased regulatory measures of the CBSL, the ratio has declined up to 2.3% in 2010 (IBSL performance report 2012-2013). Also, it has further declined to 1.7 in 2011 and 1.8 in 2012.

Apart from the above a strong loan growth, revoke of credit ceiling & aggressive lending has also contributed towards decline in NPL as a ratio than actual decline in absolute figures.

However, same has again raisin up to an unsatisfactory level of 3.4% by end of 2013 mainly due to gold advances and commodity market fluctuations. However, ratio stands at 2.8% and 2.6% in 2016 & 2017 respectively (CBSL, Financial system stability review, 2013 to 2017).

NPLs segregated into sector wise

As per CBSL reports, the main contributing factor for increased NPLs in the history are consumption sector which contributes to massive 15.5% of total NPLs especially gold loans and pawning advances followed by the tourism sector by 8.5% in year 2013. Further, agriculture and fishing & construction industry are the other key sectors who are contributing for increase in NPLs.

7. CONCLUSION

The future outlook of the banking industry in Sri Lanka is looking brighter than it has ever been in the past with more opportunities for growth and it is there to help the country's economic growth. With careful management of portfolios and mitigation of risk and improvement of skills and technological advancement, the industry is to grow and serve the country. Subject to proper management of its risk weighted assets with minimum default payments. Unlike previous years banks may have to allocate more capital for mitigating the expected losses with the implementation of IFRS 9. With these changes in regulations and macro factors the banks are now adopting "Internal Capital Adequacy Assessment Process" (ICAAP) which act as a mitigation tool which will inform the board and other key stake holders about the ongoing assessment of the bank's risks and the ways of mitigation for those risks and whether the current capital of the bank is sufficient to meet those risks and if not how much more capital needed to mitigate them in future when risk actually arise.

Hence, a further comprehensive research is a must in these subjects to have an in-depth view point of the present developments of the Sri Lankan banking sector and the direction it might lead to with this ever changing economic conditions of the country.

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