e JOURNAL
Quarter I 2018
Volume IV Issue I

ISSN: 25 13-3136
Bar Code:
9 772513 313007

THE PROFESSIONAL BANKER

ASSOCIATION OF
PROFESSIONAL BANKERS
SRI LANKA

OUR VISION

The power of Professionalism in Banking in Sri Lanka

OUR MISSION

To sustain the highest standards of professionalism and Integrity among Bankers

To Advance the Public Interest

To Influence the Achievement of the Highest Ethical Standards and Governance in Banking Industry

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EDITORIAL

The APB proudly presents this e-journal which is the first publication for the year 2018 and the third one issued by the present Publications Committee appointed for the period 2017/2018.

Banking & Finance Industry has turned extremely challenging and exciting with the ever changing macroeconomic dynamics taking effect both domestically and globally, coupled with the landscaping of regulatory changes and rapid technological advancements that are being introduced across the globe. As a result, the importance of professional skills development and knowledge sharing has been felt more than ever before, requiring the banking industry to prepare the banking professionals to meet such challenges. APB as the apex body of Professional Bankers of Sri Lanka has been proactive in this connection, thus have already embarked on discharging its obligations and the publication of e-journals being one of such initiatives.

As in our past e-journals, this publication too carries several useful articles, not only for Professional Bankers but also for other readers who are interested in the field of Banking and Finance. As a new feature, since the last e-journal, we are endeavouring to publish an interview with a CEO of a Bank operating in Sri Lanka, in order to provide a flavor of "CEO insights" to our readers. We have no doubts that the content of this e-journal would be of immense value and matters of interest to all our readers. The APB e-journal is intended for anyone who has a professional interest in development thus is presented to be accessible to any reader through the APB website.

We once again invite our members to contribute their articles to APB e-journals, which will be reviewed by an editorial panel consist of senior and veteran bankers, before being published.

Wishing all our readers all the very best !

Bhanu Wijayaratne
Chairman Publications Committee
Association of Professional Bankers- Sri Lanka

20th March 2018

MR. JONATHAN ALLES,
MD/CEO OF HNB PLC. SPEAKS TO ABP E-JOURNAL.....

Mr. Jonathan Alles, MD/CEO of HNB Plc. was interviewed by Mr. Bhanu Wijayaratne, Chairman, Publications Committee of APB.

The excerpts of the interview are as follows:

1) HNB is an oldest private Bank, which has successfully emerged as one of the largest and a leading private commercial Bank in the country today.
Can you tell us about the Bank's progression?

From a rural bank in the lush green hills of Sri Lanka, which catered to a very specific market segment, HNB has evolved to a financial powerhouse of national and systemic importance. As a bank, our reach spreads across a wide market segment, spanning micro finance, SME, retail, mid-market to top corporates in the country. The rich culture, heritage and traditions which we inherited from the inception has given us a solid foundation, whilst our futuristic vision, has prepared us well to embrace the digital future, providing a great client and employee experience.

2) Looking at the past few years, there is an excellent success story for HNB in terms of performance. Also, the Bank has been able to maintain it's position in the industry. What can you comment about this ?

Firstly, I wish to dedicate the success story to the relentless passion and zeal of our iconic Hatna family comprised of men and women across the island who worked with one common goal, unity and a set of shared values to serve our customers, often putting behind their own comforts and needs. Our staff have remained loyal to the Bank over the years, and today they are able to enjoy the fruits of their labour. Secondly, we have worked hard and smart, to strengthen our market share and mind share, as well as new market places, for the Bank's business. We have a strong vision and plan for the Bank and amidst many challenges, being unwaveringly committed to such vision, has been an integral part of our success.

3) What is your vision and strategy in taking HNB to greater heights?

We have formulated Vision 2020, which guides us in the way we do our business. Primarily enhancing customer and employee experiences has been a core strategy of the Bank. We created history in the banking industry by dedicating two senior roles to achieve this goal. The Customer Experience Officer and Chief Employee Experience Officer of the Bank have strong KPIs to deliver value in this space.

4) Banks are today faced with stringent regulatory requirements such as BASEL III, IFRS-9 etc. As a CEO of leading Bank, how would you look at these requirements ?

Industry regulation is critical for the long term sustainability and growth of the economy. It creates an even playing field within a strong governance framework. Consistent and clear regulatory frameworks will augur well for banks, industry and the economy as a whole.
In our part of the world, regulatory safeguards are necessary to insure the financial services industry against corruption and political interventions. In adapting to these requirements, banks need to manage the cost of compliance by proactive measures rather than merely pass it on to the end customer. If we over price ourselves in our solutions, we will end up driving our customers away to unregulated and unsafe financial solution providers, as well as make it much easier for digital disruptors to invade the marketplace.

5) The performance of Sri Lankan economy in the past few years has reconfirmed the necessity to address deep rooted structural issues, if the country is to progress towards higher growth trajectory, as envisaged. What are your thoughts on as to how the Banking Industry could support the Government and the Policy Makers in this connection

A coherent national policy agenda for development and growth sans party politics, needs to be instituted with serious commitment from successive governments to achieve the set milestones. In the past, this cohesion was non-existent, however we can see reasonable attempts being made towards this now. The economic and fiscal policies that stem from the national growth agenda need to be courted with fidelity. Banks form the nucleus of the economy and we will not hesitate to lend our fullest support at enterprise and industry level to the much needed private public partnerships for large scale physical and digital infrastructure development projects that our country is in dire need of. However, we are accountable to our stakeholders, so the government must help us back in terms of having good governance and transparency in these interactions.

6) You are a veteran Banker with extensive experience in Banking and Finance, not only in Sri Lanka, but overseas as well. Can you tell us the major differences which you have observed in the business models of Foreign Banks when compared to that of local Banks.
What are the lessons to be learnt by Local Banks for better performance?

Foreign banks operate in different market structures. For example, the interest rate environment is a complete contrast. This has propelled western banks to move into providing total financial solutions which go beyond basic transactions. Financial advisory, wealth management, retirement planning, estate and trust management etc are very evolved life cycle solutions in these countries and they have converged with insurance & healthcare companies to make it an end to end lifestyle solution. Investment banking and capital market advisory is highly sophisticated in these countries and banks provide corporates the necessary funding, as well as consultancy for business growth, market share expansion and off shoring across geopolitical regions.

Again back on the retail front, most countries have digitized their records, even India has gone a step ahead with the Adhar card, making the reach, client on boarding, AML/KYC compliance much easier. Our efforts to innovate products, pricing, place and promotion, are impeded by some of these larger limiting factors. That said, foreign banks rigorously adapt to the region specific risk parameters in doing business. This leaves larger market segments unbanked. Therein lies the opportunity for local banks to serve the nation.

7) Tell us something about your family life and how you manage the work-life balance ?

I'm married with three kids. My rock and anchor is my wife Shammi who understands that I have high work commitments and manages our home independently. I am very grateful to her for all the love, understanding and support. My kids often used to wonder why their dad is always busy, but as they grow up they've adapted to it. We find quality time together, be it in prayer or in family time. That said, this is one area I continually strive for improvement to achieve a better work life balance.

8) You have been a good sportsman during your school days. How have the lessons learnt by you whilst playing the game has helped you in learning of books and learning of men?

Playing cricket has molded me and given me resilience and tenacity to face life in both good times and bad. First of all, getting to captain the first eleven cricket team at St Joseph's and managing my duties as head prefect required a lot of self-discipline. This has stuck with me throughout my life. Understanding at a young age, that all players are not equal, they bring different skills and values to a team, makes me a better leader today in my role as CEO. Injustices and unfairness can happen, to you, your team in sports. Holding the head up high in the face of adversity is another lesson I learnt through sports.

9) You have been a member of APB for a considerable period of time and have also participated in it's activities in many different ways. What are your views about the role played by APB for the betterment of the Banking Industry in Sri Lanka?

I wish to commend APB for being a proactive organization in bringing relevant and timely topics for discussion among the banker community. APB conventions are knowledge packed and feature credible industry experts and the continuous CPD programmes provide informal learning and networking opportunities.

I would like the APB to get more involved in lobbying with the regulator towards expediting new rules and laws, especially on the digital frontiers. These would help the banking industry to forge ahead within a competitive landscape.

10) As a leading Banker in the country today, what is your message to up and coming young Bankers?

Banking has never seen more exciting times. Digital disruption, crypto currencies, cyber risk, talent war have converged to provide the millennial generation a solid career opportunity. Gone are the days when a single qualification in banking or a bachelors would see you through the day. As the industry evolves, newer and more interesting qualifications, certifications, licenses are becoming relevant to be a successful banker. Most of all, remember to enjoy life as a responsible young adult while you pursue your dreams and goals.

ENHANCED MONETARY POLICY FRAMEWORK IN SRI LANKA

Vincent Mervyn Fernando
Ex-Director and Senior Economist, Central Bank of Sri Lanka
Ex- Visiting Lecturer – University of Sri Jayawardenepura
Lecturer – Institute of Bankers of Sri Lanka (IBSL)

Introduction

The Central Bank of Sri Lanka (CBSL) is currently improving in its monetary policy framework and increasingly aligning it with a Flexible Inflation Targeting (FIT) framework. The CBSL is entrusted with the task of maintaining price stability. Price stability remains a key fundamental in fostering an environment conducive for sustained growth and securing rising living standards for the people. The introduction of an effective FIT framework will improve capacity to deliver price stability. This will provide a more propitious will environment for growth employment generation.

Under the proposed FIT framework, the CBSL will aim to preserve price stability of economy by targeting an inflation range of 4-6 percent. The period starting from 2018 will be vital in laying out required reforms to facilitate a smooth transition to a FIT framework. The main objective of this article is to explain the concept of Flexible Inflation Targeting with three important pillars as the building blocks for adopting a FIT framework. Before that we prevent here general overview of modifications to framework in Sri Lanka since 1950-2018. Monetary Policy.

Modifications to Monetary Policy Framework in Sri Lanka

The CBSL has taken progressive steps over the past sixty six years to increase its effectiveness in maintaining price stability and financial system stability to create a stable macroeconomic environment. Distinct phases can be summarized in the focus of monetary policy in the past sixty six years as given in the following table.

Distinct Phases of Monetary policy; 1950-2016 **Table 1**

Period	Main policy objectives	Main policy tools
1950- 1960	Stabilization	Open Market operations (OMO)
1960 -1977	Development	Direct controls, OMO and statutory reserve requirement (SRR)
1977-1989	Stabilization + Development	OMO + SRR
1990-2002	Stabilization	Bank rate+ SRR
2002- 2016	Economic and price stability	Policy rates + OMO + SRR

During the period 1950 -1977, the Exchange Rate Targeting (ERT)played a key role in anchoring inflation expectations.Exchange Rate Targeting (ERT) is suitable for a range of economies from small open economies with large amounts of reserves to economies where Central Banks have been unsuccessful in achieving domestic price stability under other frameworks.

During the early 1980s, the CBSL adopted Monetary Aggregate Targeting (MAT) as its monetary policy framework.MAT or MT is based on Fischer's Quantity theory of money which states that assuming constant velocity of money, monetary growth should match with nominal GDP growth. In line with the global tendency for Central Banks to move away from MT frameworks. The CBSL has also been improving its monetary policy framework and increasingly aligning it with a FIT framework.

Inflation Targeting- IT is a theoretical framework, where the CB defined an inflation target, and varies its policy instruments to achieve the target without any concern of real sector stability.
Flexible Inflation Targeting- FITis considered the practical method of implementing Inflation Targeting. A number of countries have adopted this framework including of countries New Zealand, Sweden, UK, Australia etc. FIT defines an inflation target or a target range, and uses policy instruments to achieve target in a medium term horizon.

A unique advantage of inflation targeting is that it comprises a framework for monetary policy that combines elements of both "Rules" and "discretion". Therefore, the inflation target provides a rule-like framework on which economic stakeholders can anchor their expectations about future inflation. Whilst the Central Bank couldbe exercise its discretion in reacting to shocks.

Three Important Pillars for Adopting A FIT Framework
• Strong Central Bank mandate and credibility
• Effective monetary policy conduct
• Strong fiscal policy support and commitment

Now let me discuss some key elements and building blocks of FIT

• Strong Central Bank mandate and credibility is essential for successful adoption of FIT. There is considerable evidence from around the world that weak legal mandates together with inadequate autonomy of central banks hinder the success of FIT. In this context, Sri Lanka will also have to introduce considerable changes to the existing mandate of the central bank through necessary legal reforms. The current framework is hampered by the focus on non- core activities, monetary financing and inadequate autonomy. These factors are structural impediments in the transition path towards FIT. Amending the Monetary Law Act (MLA) is, therefore, imperative to enhance the focus of the mandate as well as Central Bank autonomy, governance, transparency and accountability. These mandates would broadly include strengthening the mandate of price stability, separating the monetary and fiscal functions, strengthening the Central bank's autonomy, and introducing institutional arrangements for setting inflation targets and maintaining accountability.

• Effective monetary policy conduct as a vital building block for maintaining low inflation under the FIT, we need to establish a sound, forward- looking decision making process, based on reliable microeconomic forecasts and projections. In this connection, the central bank has already improved technical capacity in modelling and forecasting of key macroeconomic variables. The Central Bank and the IMF have jointly developed a structural model- based forecasting and policy analysis system (EPAS), which encompasses near team and medium term model based projections. The current policy formulation process is gradually being aligned with the analysis based on FPAS. This supporting the monetary policy formulation process in a more proactive and forward- looking manner. The Central Bank will continue to improve model based projections through building sound technical infrastructure for inflation forecasting and macroeconomic analysis. With regard to monetary operations, the domestic money market is being actively managed through OMO to steer the Average Weighted Call Money Rate (AWCMR) in line with the monetary policy stance of the Central bank.

As the conduct of monetary policy is dependent on an effective and prudent exchange rate policy, the Central Bank has introduced a more market based exchange rate system. It has allowed more flexibility in determining the exchange rate based on the market conditions and has intervened only to smoothen volatility and t build up reserves. It is noteworthy that there has been a build up of non–debt creating international reserves during 2017, with minimal impact on the exchange rate.

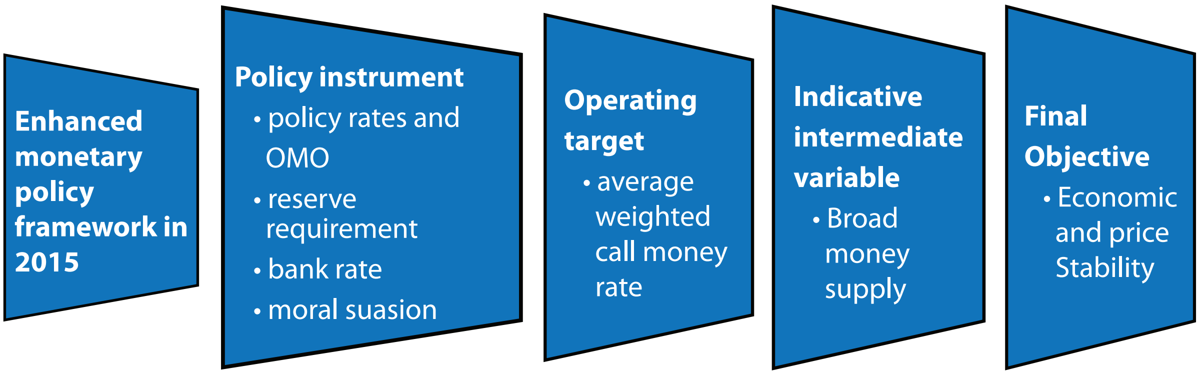
The Central Bank cannot implement a successful FIT framework alone. As we have emphasized in the past, the continued said and strong commitment of the government will be of paramount importance.

It is coughing that the government has already recognized the Central Bank's move towards FIT as the future framework for monetary policy, in its policy document "Vision 2025- A country Enriched"

• Continued strong said and strong commitment of the government greater fiscal discipline and stronger fiscal outcomes remain key to the successful adaptation of FIT. I particular, the government is expected to maintain its commitment to medium – term fiscal consolidation, which is embedded in the IMF- EFF arrangement. The improved fiscal space through continued fiscal consolidation will create a better enabling environment for the effective and independent conduct of monetary policy.

This whole effort requires the government's commitment to remain on the trajectory of fiscal consolidation it has enunciated in its medium- term budgetary framework. The new inland revenue act, enacted with the aim of simplifying and rationing the existing income tax structure; the VAT reforms; and improvements in tax administration are worthy achievements. Further, the government expects to strengthen fiscal consolidation by revising the Fiscal Management (Responsibility) Act to include binding fiscal targets. This would institutionalize its commitment to fiscal discipline, which is essential given the country's external debt dynamics and exposure to rating agencies and international capital markets.

Several key milestones need to be reached over the next three years through the joint efforts and the commitment of the government and the Central Bank to fulfill the key prerequisites of the FIT framework. Legal amendments, continuation of fiscal consolidation, institutionalization of the required changes to the monetary and fiscal policy processed, and building awareness and the confidence of the general public are the priorities in the near future before the official transition to the FIT framework by 2020.



At present, as an interim arrangement. The CBSL conducts the monetary policy within an enhanced monetary policy framework as in Figure 1, with features of both MT and FIT frameworks. Under the enhanced monetary policy framework, the CB focuses on stabilizing inflation in mid- single digit over the medium term, while supporting the growth objectives and flexibility in Exchange rate management. Although the CB does not announce any monetary targets explicitly, broad money aggregates would continue to remain as the indicative intermediate variable to guide the conduct of monetary policy. Moreover, instead of reserve money, CB currently uses Weighted Average Call Money Rate.

ABOUT THE AUTHOR

VINCENT MERVYN FERNANDO Has graduated with a master degree in Economics at University of Manchester, United Kingdom, after his B.A special degree in Economics at University of Sri Jayawardenepura in Sri Lanka. His professional global training experiences cover Money and Banking in IMF, Washington, USA, Central banking in Malaysia, Germany and Switzerland. Management in India, Philippine and Singapore during his employing period at Central Bank of Sri Lanka (CBSL) as a Senior Economist in Economic Research Department, as an Accountant in Banking Development Department, as a Director in Regional Development Department and as a Lecturer in at Center for Banking Studies. Since 1980 he was delivering lectures as a Visiting Lecturer at university of Sri Jayawardenepura.

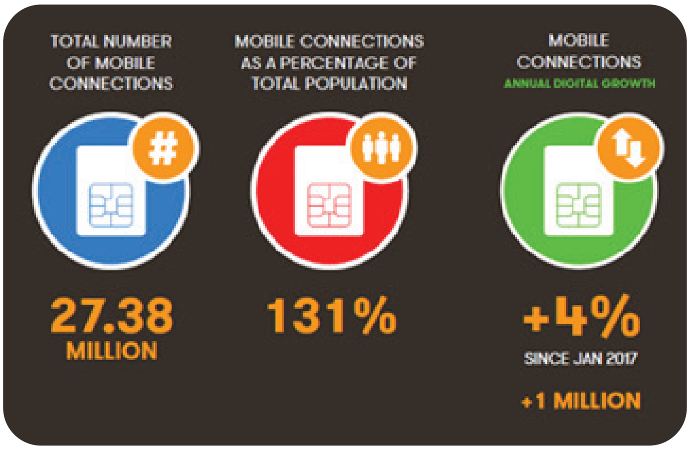
Presently, he is a Permanent Lecturer at the Institute of Bankers of Sri Lanka, CBSL.
Mervyn Fernando has written fifty Eight comprehensive books for Economics and Business Studies in both languages Sinhala and English medium. His books are highly recommended for University students, Bankers, G.C.E Advanced Level students in Commerce Stream in order to score with best marks.

This new Economics Q & A book is especially for the students who are studying Economics in Grade 12 and 13 classes in medium of English.

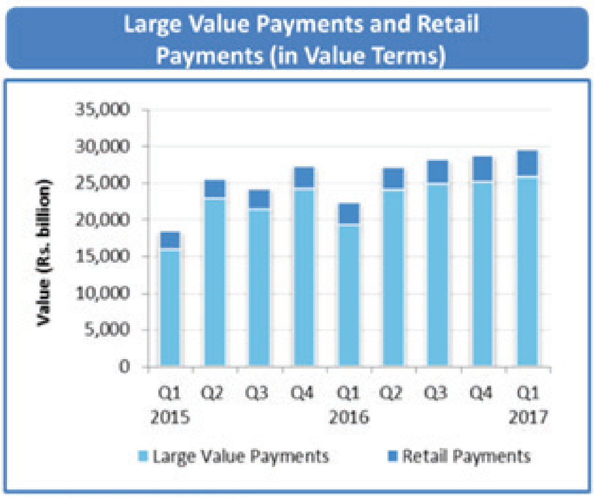
Envisioning A DISRUPTIVE Mobile-Based Digital Platform For The Transformation of Sri Lanka's financial Ecosystem

Viraj Mudalige
Group Director/ Chief Executive Officer of
Epic Technology Group

Mobile payments will go mainstream in the near future. The active Mobile Devices have risen from 96% in 2012 to 131% in 2017 (according to a TRCSL report), and the said figure is expected to grow further. Electronic payments via mobile devices will become more commonplace than ever before. When compared with the available e-payment channels such as EDC/POS, ATM, IPG, etc., mobile devices could be considered the most viable and resilient payment channel for effective financial services delivery. The proliferation of mobile phones makes it evident that it has greater potential to catalyse and evolve to the next generation of electronic payments. However, mobile payment infrastructure, as it is today, is cost-prohibitive and requires complex integrations with a multitude of back-end systems to process a payment. With this approach, it shall not propagate to the extent of EDC/POS deployments in the nation without having to expend enormous capital. Thus there is no formalized and viable platform which enables both consumers and merchants alike to make and receive payments via their mobile phones. Moreover, the Central Bank of Sri Lanka (CBSL) findings indicate that a significant portion of transactions are cash-based and also falls into the low-value category. According to CBSL estimates, over Rs. 1 Trillion worth of transactions are conducted island-wide each month and are less than Rs. 2000 and consist of payments made for simple goods and services.



From the perspective of financial inclusion, it is interesting to note that Sri Lanka has an approximate cumulative volume of 15 million registered Current Accounts and Savings



Source: Central Bank of Sri Lanka

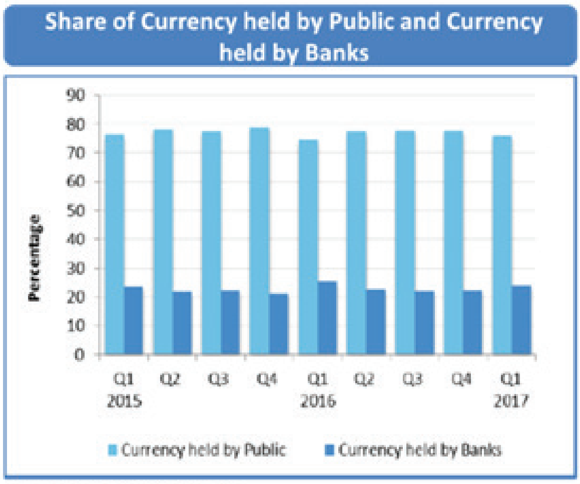
Accounts (CASA) instruments at registered banks and financial institutions. In order to service the cash-based payment requirements of consumers, the banks need to avail ATMs and bank branches to support customers' cash demand. However, this incurs huge financial burdens in deploying these services (ATMs, Branches, Kiosks, Self-Service Counters, etc.) due to immense capital expenditure as well as operational overheads. In this highly competitive industry, it is essential for Banks and Financial Institutions to consider novel ways to render services to their customers through innovative channels and disruptive technologies while minimizing operational overheads.

When considering the merchant landscape in the country, there are approximately 300,000 registered merchants of which only a limited segment is terminalized. As per CBSL statistics, the number of transactions performed from an EDC/POS Terminal averages to 3 or 4 per day, leaving very limited grounds for Banks to justify the costs of terminalizing and quantifying the Return on Investment (ROI) for a majority of the merchants that do not process large volumes. Even though the value of payment transactions at middle-tier and grass-root level merchants is found to be much lower, their volumes are substantial. Thus Banking and Financial Institutions need to actively consider various approaches in bringing these remaining non-terminalized merchants to the financial radar. Moreover, with the higher costs involved in setting up and maintaining conventional purpose-built EDC/POS Terminals for certain mid-tier merchants, particularly SMEs or Micro Enterprises who have low retail volumes, there exists a greater demand for an effective platform for profitable electronic commerce via mobile devices. It is inevitable that as the platform advances, the Bring Your Own Device (BYOD) approach would predominantly lead to great cost reductions which in turn would nurture Sri Lanka's financial eco-system to a significant extent.

The payment ecosystem in the country is unevenly fractured and there exists a tangible divide across the various strata:

- substantial volumes of transactions are cash-based especially at the grass-root levels due to the lack of proper and consistent e-payment infrastructure and poor awareness among the general public on electronic advancements
- e-payment infrastructure is cost-prohibitive and does not provide a justifiable ROI to Banks
- Banks have to incur heavy expenses in the provision of ATMs, Bank branches, etc. to deliver cash services to consumers
- wide-spread technology such as mobile infrastructure not fully utilized to deliver financial services to the citizens

Therefore as a nation, it is our prime duty to find and implement new ways of mobile driven electronic payments which would eliminate conventional and time consuming payment modes. Even though the shift towards mobile money is often talked of, its growth and implementation is at a snail's pace due to the lack of trust among the general public. Having felt the importance of setting up a payment platform in order to convert cash-based transactions for sundry payments to a cashless digitised practice, the nation's Cheque Clearing House – Lanka Clear has rolled out JustPay, a technology by which customers can make everyday payments, and most importantly merchants can accept payments using their Current Accounts and Savings Accounts right from their mobile device under an extremely low tariff scheme. Sri Lanka spends nearly around 1.5 percent of its Gross Domestic Product (GDP) on minting physical currency each year, where JustPay platform simply facilitates the electronic movement of funds from one account to another without any physical payment instrument. It is envisaged that this platform shall reduce the dependency on the paper-based currency and facilitate an e-payment landscape across the socio-economic pyramid. Needless to say, Banks are highly benefitted from this revolutionary initiative where the end result would assist Banks to be highly competitive and extremely well placed by being able to cater to all potential merchant segments cost effectively and thereby delivering an effective and sustainable e-payment infrastructure to support the national economy.



Source: Central Bank of Sri Lanka

We are living in an era where wearable devices and Internet of Things (IoT) have started to govern our lifestyles. The much anticipated shift towards mobile money has been rooted within us with the firm belief that these e-payment platforms have the capability to accelerate financial inclusion, improve accountability, and increase transparency. Mobile phone scan evolve as merely another payments delivery channel augmenting existing financial instruments to facilitate a host of transactions and services which could include but not limited to retail payments, person-to-person fund transfers, cash in/out transactions, top-ups within registered instruments, inbound international remittances, transaction history, balance inquiry, mini statement, promotions and offers based on preferences, social media integration, utility payments and location wise information etc., thereby gearing Sri Lankans towards the evolving set of payment transactions. Mobile-enabled person-to-person payments or mobile money transfer services are experiencing rapid adoption in many markets, in response to the steady growth in remittances and the worldwide ubiquity of mobile devices. It is also equally important to progress towards embracing more diverse set of financial instruments to the mobile platform with the objective of addressing financial inclusion more effectively.

The Central Bank of Sri Lanka (CBSL), being the principal financial regulator in the country has formulated a common baseline security standard after having recognized the rapid adoption of mobile technologies in the financial sector in the recent years. Thus, it is of paramount importance that all Application vendors operating, facilitating or providing payment services related mobile applications adhere to the 'Guideline No. 01 of 2018 - Minimum Compliance Standards for Payment related Mobile Applications' as per the directive of the Monetary Board of the CBSL.

The time is now for us all to join hands in this journey of revolutionizing the retail payments landscape in the country by making it possible for the payments technology to be enjoyed by all levels in the society. To further expand the horizons of the platform, it could be engineered to be an evolving technology which shall also provide support for card payments without incurring significant investments: the disruptive platform enabling consumers to make merchant payments using ON-US (same bank) Cards as well as OFF-US (other bank) Cards by employing novel tokenization mechanisms exploiting the services of mVisa and Masterpass. Thus, it can truly stand to redefine the payment ecosystem at a national level and propel our country to the international arena for implementing disruptive innovations and enabling future-ready technologies while building bridges across the socio strata to unify all citizens in a digital payment ecosystem.

ABOUT THE AUTHOR

Industry veteran &, well known payment solution architect Viraj Mudalige counts over 20 years experience in the fields of Electronics Engineering and Information Technology. He has designed and successfully implemented several award winning and Internationally acclaimed software solutions in Secure Electronic Payments, Information Systems Security and Mobile Enterprise Automation.

An old boy of Richmond College Galle, Viraj is a Chartered Engineer (EC-UK) by profession. He also holds a MBA in Information Systems Management from Sikkim Manipal University in India. Further he received his MSc from Asia e University of Malaysia. He received his graduate award in Electrical and Electronics Engineering from the United Kingdom and also holds the National Diploma in Technology in Electrical Engineering from the University of Moratuwa, Sri Lanka.

Viraj is the pioneer to introduce secure electronic payment devices and solutions in Sri Lanka several decades back. His major national initiatives include the contribution in developing the national guideline for electronic payments and a comprehensive world class solution to combat credit card frauds. Viraj was a member of the first expert panel for Electronic Payments and Detection of Frauds appointed by His Excellency the President of Sri Lanka. He is also a regular contributor and resource person for the defence authorities and state agencies for his internationally acclaimed domain expertise. Viraj is a sought after speaker at several regular annual international forums in electronic payments and information security where his presentations have been translated to many different languages.

Viraj considers winning the first ever Gold award for Sri Lanka for a locally developed commercial software at the Asia Pacific ICT Awards 2008 as the most memorable achievement in his professional career. He has been the architect of an array of breakthrough technology platforms that has brought an unprecedented number of over 60 national and international accolades to Epic Technology Group so far.

Viraj is Group Director/ Chief Executive Officer of Epic Technology Group.

CHALLENGES OF INTERNAL RATING BASED APPROACHES.....

Ruwan Manjula Samarakkody
Chief Manager- Risk Management Division- Bank of Ceylon

"Internal models should allow for more accurate risk measurement than the standardised approaches developed by supervisors. However, incentives exist to minimise risk weights when internal models are used to set minimum capital requirements. In addition, certain types of asset, such as low-default exposures, cannot be modelled reliably or robustly. The reforms introduce constraints on the estimates banks make when they use their internal models for regulatory capital purposes, and, in some cases, remove the use of internal models "

Reforms Basel III in December 2017

The major criticism for Basel I (1988) is it has not provided to reduce capital charge for credit risk through advanced, developed risk management techniques and Credit risk models. Single methodology for calculate credit risk weighted assets which is standardized approach (one-size-fits-all approach) has provided by Basel I guideline. Four broad risk weighting categories i.e. 0%, 20%, 50%,and 100 % was provided by the methodology and it has not more risk sensitive.
Therefore, Basel committee recognised the issue and provided three different methods for calculate Credit risk capital charge in BASEL II (July 2006) guidelines. i.e Standardised approach, Foundation Internal Rating Based (F-IRB)approach and Advanced Internal Rating Based approach(A-IRB).
Standardised approach which is more simplified approach like Basel I , regulator has provided broad risk weights based on external ratings and credit risk mitigation (CRM) and also not considered internal risk level and risk management practices of the particular bank. Standardised approach spell out in detail how to calculate capital requirements on the basis of prudential algorithms "supervisory models".

The IRB approaches (Foundation and Advanced) rely on a bank's own assessment of its counterparties and exposures to calculate capital requirements for credit risk. Capital requirements for credit risk represent banks' Unexpected Loss(UL) relating to the credit portfolio. Risk weights, and thus capital requirements, are calculated using banks' estimates of risk parameters in accordance with complex formulas prescribed by the IRB Approach. These formulas are based on modern risk management techniques that involve quantitative assessment of risk. The mechanics of calculating capital requirements varies depending on the type of exposure (i.e. corporates, sovereigns including central governments and central banks, banks, retail, equity, securitisation, and non-credit obligation assets).The IRB Approach recognises the benefits of eligible credit risk mitigation (CRM) when calculating capital requirements for corporate, sovereign, bank and equity exposures.

Internal Rating Based (IRB) approaches (F-IRB and A-IRB) has facilitate to reduce the credit risk capital charge through strengthening the internal risk management techniques as well as risk management practices of the banks. IRB approach tries to ensure that banks have adequate capital against unexpected loss portion of Credit VaR at 99.9% confidence level with one year horizon. Two-dimensional (separate borrower rating for calculate Probability of Default (PD) and facility rating for calculating Loss Given Default (LGD)) to be included to the bank's rating system.

In F-IRB – Probability of Default (PD) and Maturity (M) based on bank's own assessment and other factors given by regulator. In A-IRB – Probability of Default (PD), Loss Given Default (LGD), Exposure at Default(EAD)and Maturity (M) based on bank's own assessment. All risk parameters totally depend with the bank's own assessments. The "self-assessment" of capital regulation creates a lot of expectations and responsibilities are cast on the bank and their management that they will develop better risk management systems and practices. Banks can use their own risk management structure and their own calibrations for the risk factors. The improvement in risk and capital management, which should be realized from implementing an internal model, is deemed to outweigh the significant effort in building and maintaining one. The internal model route is particularly advantageous for firms that already have an established enterprise risk management (ERM) system in place. By construction, an internal model should more accurately capture the risk profile of the entity. It also provides an opportunity for firms to take credit for any risk mitigation strategies that they have implemented.

The Basel Committee on Banking Supervision explained the rationale for adopting this approach in a consultative paper issued in 2001. According to the committee it has two primary objectives -

1. Capital requirements based on internal estimates are more sensitive to the credit risk in the bank's portfolio of assets (Risk sensitivity)

2. Banks must adopt better risk management techniques to control the credit risk in their portfolio to minimize regulatory capital (Incentive compatibility)

However, the implementation of IRB approaches guidelines and time frame to be provided by the regulator. In Sri Lanka, final guidelines for move to IRB approach have not been issued yet.
Not only the guidelines but also each and every bank to be complied with prescribed minimum conditions, disclosure requirements and approval from their regulator to use this IRB approach in estimating capital for various exposures. In practice, this means that an IRB approach bank must have an economic model that is appropriate for its activities, effective for risk management purposes, and which can be validated by back-testing against live data.

IRB approach process:

Risk estimates of IRB approaches should be forward looking and based on empirical evidence and it should not usually be based purely on judgment or expert opinion.
IRB approaches and results to be completed with followings:

• Understanding of assumptions, equations and logic of the same
• Interpretation of output¸ relevance, reliability and stability¸ potential and limitation

IRB Models refer to a quantitative method, system, or approach that applies statistical, economic, financial, or mathematical theories, techniques and assumptions to process input data into quantitative estimates of real world.

It consists of 3 components:

• Information input – inputs assumptions and data
• Processing – transforms inputs into estimates
• Reporting or output – translates estimates into business information

Challenges in Implementation of IRB approaches:

• Increasing operational cost of banking industry
Without finalizing clear and specific guidelines number of banks in Sri Lanka has been invested huge amount of money regarding IRB consultancy services and software vendors. The guidelines have changed rapidly and the investments have not been optimised.
Not only the internal model development process but also Model and process validation process incurred heavy cost to the Banking system. Software/Hard ware for data management and data structuring process have also incurred heavy cost to the banking industry.

• Receive approval from the regulator
A significant burden attached to internal models is the requirement to receive approval from the supervisor. An applicant bank must demonstrate to the satisfaction of the relevant regulator that the following standards are met:

►The bank's rating systems provide for a meaningful assessment of obligor and transaction characteristics, a meaningful differentiation of risk, and accurate and consistent quantitative estimates of risk;

►Outputs to be used in the calculation of capital charge as well as decision-making process;

►The bank has an independent credit risk control unit responsible for its rating system;

►The bank collects and stores data to credit risk measurement and management process;

►The bank documents its rating systems (rationale for their design) and has to be validated;

►the bank has assigned and continues to assign each exposure in the range of application of a rating system to a rating grade or pool of this rating system;

• Slow response to external shocks
External ratings more sensitive to the external shocks, since external macro-economic factors highly linked with the primary criteria which have used in rating agencies. Also data base and historical data used for customer credit rating of rating agencies considerably higher than the data which have used by the banks.

• Model risk

Model may have fundamental errors; in design and implementation, in simplifying or approximating real world problems, the integrity and reliability of outputs may be compromised, in quality of input data and assumptions leading to incorrect outputs. Model may be used incorrectly or inappropriately .e.g. Using existing models to new products or markets.

• Maintaining Independency

Maintaining functional independency of business units responsible for rating systems and those responsible for loan origination is challenging task for the banks. If it has failed to maintain the independency of this task is harmfully impacted to the bank.

• Internal Models can be easily manipulated through complexity

Models are still criticised as being too error-prone, suitable only for use in "fair-weather" conditions, too variable in their results when analysing identical risks, insufficiently transparent for investors and manipulated by banks, with the tacit acceptance of supervisors, with the aim of reducing their capital requirements. Some banks create higher complexities through internal models e.g. State bank of India has used 16 borrower rating models and 16 facility rating models.

• Enhancing Transparency

Banks could disclose their Modelling methodologies in greater detail, and explain why changes made to their models have resulted in reduced capital charges. Transparency of this kind will significantly benefit informed experts and analysts. These experts will then be faced with the difficult challenge of preparing their analyses in such a way as to be accessible to the general public. Way forward of IRB approaches:

According to the reforms of Basel III , which have been issued In December 2017 by Basel Committee on Banking Supervision (BCBS) following changes has been included to the capital charge calculation through IRB approaches .

Exposure class	Methods available under the new credit risk standards	Change in available methods relative to current credit risk standard
Banks and other financial institutions	SA or F-IRB	A-IRB removed
Corporates belonging to groups with total consolidated revenues exceeding EUR 500m	SA or F-IRB	A-IRB removed
Other corporates	SA, F-IRB or A-IRB	No change
Specialised lending	SA, supervisory slotting, F-IRB or A-IRB	No change
Retail	SA or A-IRB	No change
Equity	SA	All IRB approaches removed

SA - Standardised Approach F-IRB - Foundation Internal Ratings-Based Approach A-IRB -Advanced Internal Ratings-Based Approach

Several Indian banks have been implemented their own IRB models align with the guideline and road map which have been issued by Reserve Bank of India. However, any single bank in India has not been obtained an approval for calculate their capital charge using their own models. Still South Asian regulators or any other regulators of developing countries have not been approved for IRB approaches for capital calculation purpose. High NPA levels (i.e. India 9.2%, European Union 4.4%, and South Asia 9.6%) and possible manipulation issues have also been impacted to the regulators unfavourably to IRB approaches.

ABOUT THE AUTHOR

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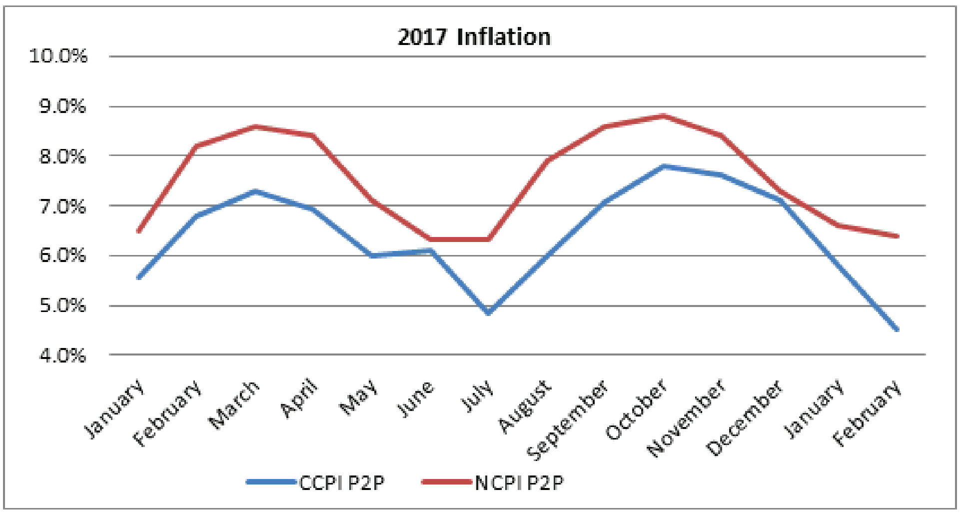
MARKET UPDATE – OCTOBER TO DECEMBER 2017

Ravinda Gunawardena, CFA
Fixed Income Securities Manager at DFCC Bank Treasury

The Sri Lankan economy recorded a growth of 3.3 percent during the third quarter of 2017. This is compared to the 4.0 percent growth recorded in the second quarter of 2017. Economic growth in the third quarter was mainly driven by the moderate expansion in the Industry and Services sectors, while the Agriculture sector continued to record a negative growth on account of weather related disruptions.

Analysts expect Sri Lanka's economic growth to fall slightly below 4 percent for the year 2017. In 2016 Sri Lanka recorded a Real GDP growth of 4.4 percent. The Central Bank of Sri Lanka (CBSL) anticipates that the economy would recover in 2018 due to continuous surge in exports and investments and will record a growth around 5 percent to 5.5 percent.
Meanwhile, the International Monetary Fund (IMF) completed the third review of the three-year Extended Fund Facility (EFF) obtained by Sri Lanka, enabling the disbursement of the fourth tranche to the value of approximately US dollars 251.4 million. With this disbursement, a total of US dollars 759.9 million has been received thus far by Sri Lanka on account of the EFF. The EFF supported economic programme is expected to improve macroeconomic stability of the country and bolster market confidence while strengthening external resilience in a challenging global environment.

Inflation



Source: Department of Census and Statistics

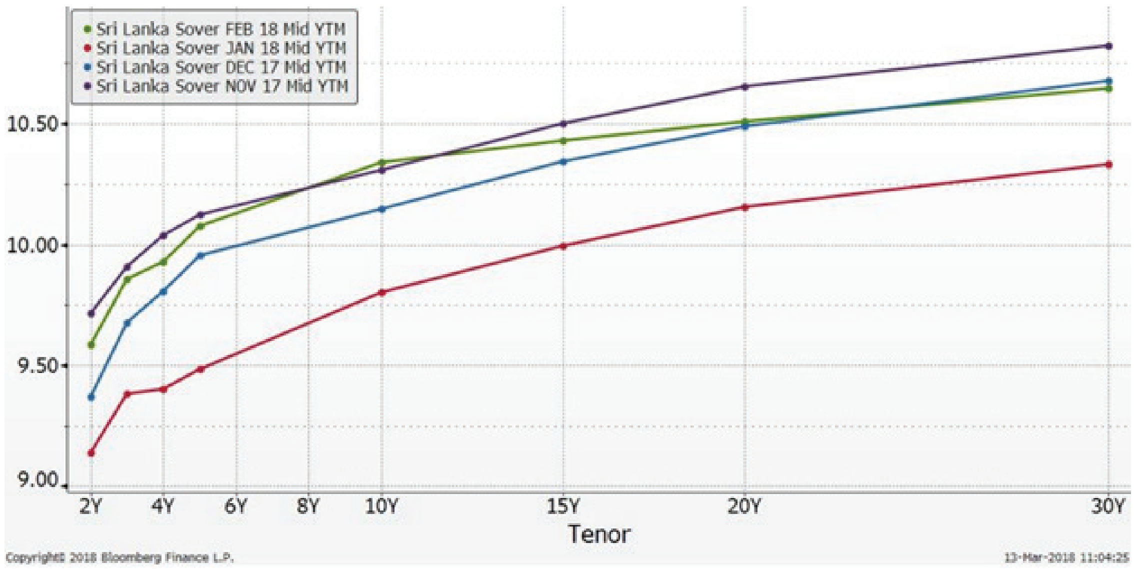
Inflation based on both the Colombo Consumer Price Index (CCPI) and National Consumer Price Index (NCPI) dropped consecutively during the last three months of 2017. The CCPI for the month of December was 7.1 percent which is higher than the center point of 5.5 percent set by the IMF Quantitative Performance Criteria for the month of December. However, since this increase is mainly due to the base effect and due to tax revisions and supply disruptions, it is unlikely that the CBSL would tighten Monetary Policy immediately, provided that credit growth remains at desirable levels. The effect of the base is expected to negate in the year 2018 and inflation is expected remain at mid-single digit levels during the year 2018.

Interest Rates

The Monetary Board, at its meeting held on 27 December 2017, was of the view that the current monetary policy stance is appropriate and decided to maintain the policy interest rates at their current levels. Accordingly, Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR) were kept at their current levels of 7.25 percent and 8.75 percent, respectively.

According to CBSL data the growth in broad money supply has slowed down substantially in November 2017 caused mainly by the deceleration in the growth of private sector credit extended by commercial banks, responding to the tight monetary policy stance. Meanwhile, the yields on government securities have adjusted downward from the peak levels, correcting some disparity that existed between the policy rates and the yields on government securities. Other market interest rates are also expected to adjust further downwards in line with the yield rates.

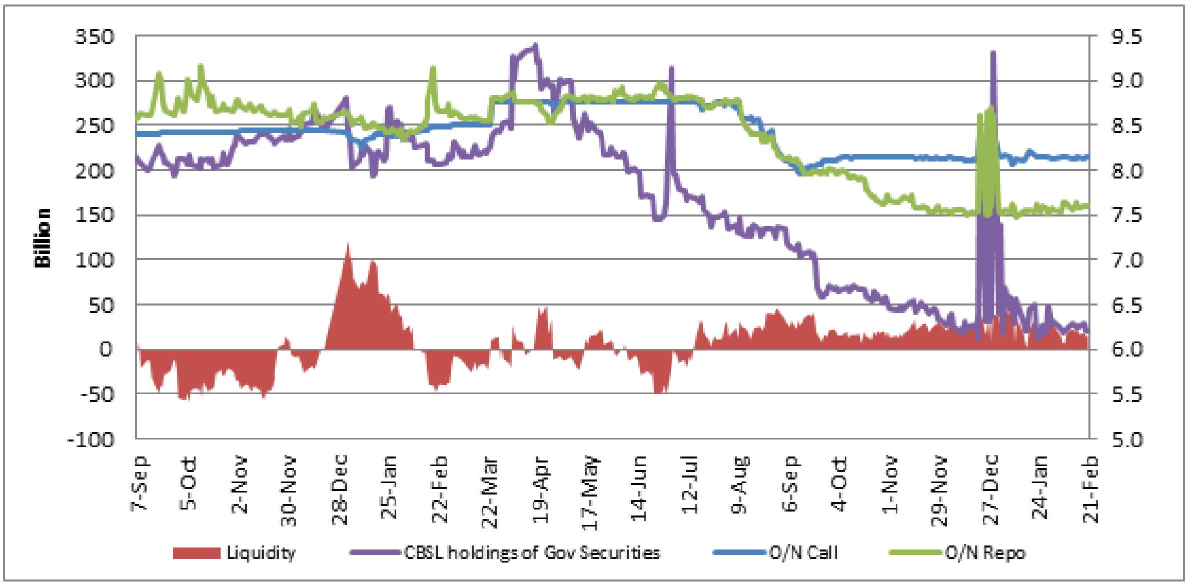
The downward trend of the yield curve of government securities during the fourth quarter of 2018 is shown in the table below. This trend can be attributed to the increased demand by both foreign and local investors and limited supply of government securities in primary auctions.



Source: Bloomberg

Deposit and lending rates of commercial banks appear to have stabilized, partly in response to the recent decline in yields on government securities.

The current trend in the yield curve is expected to continue, mainly supported by the projected fiscal consolidation based on stronger revenues backed by the new Inland Revenue Act (IRA). However, this situation could change from unforeseen internal and external changes or shocks to the current system.

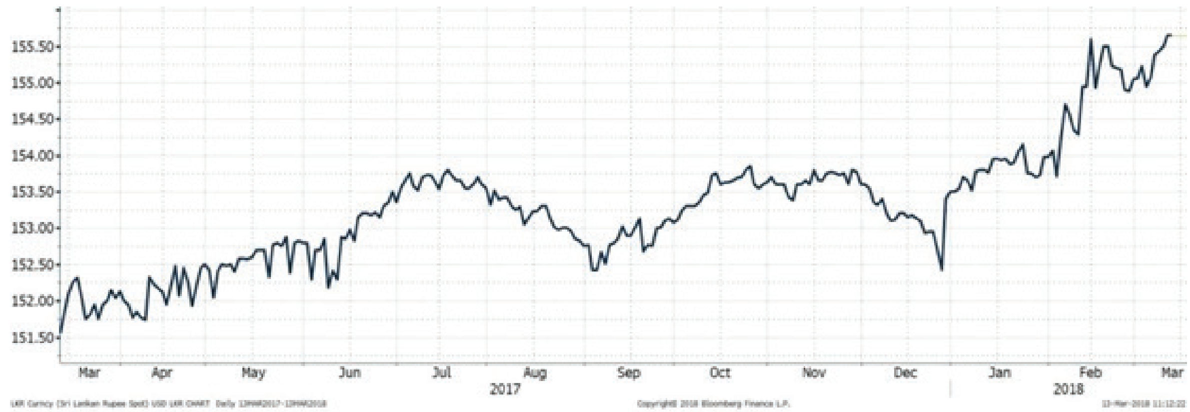


Source: CBSL Data

The inter-bank money market liquidity remained in positive territory helping the inter-bank Repo and Call money rates to remain stable during the fourth quarter of 2017. By end December the weighted average Call money market rate stood at 8.15 percent, while the Repo rate was at 7.59 percent. The CBSL holding of government securities fell gradually and stood at 25.6 billion Rupees by end December.

External Sector

The trade deficit has widened during the first ten months of 2017, largely on account of the notable increase in import expenditure, offsetting the positive impact of improved performance in export earnings. However, sustained inflows to government securities market and Colombo Stock Exchange (CSE) have eased the pressure on external accounts to a certain extent. According to CBSL data, gross official reserves are estimated to improve to around US dollars 7.8 billion by end December 2017. The Sri Lankan Rupee depreciated against the US dollar by 1.9 per cent as at end December 2017. This movement of the currency is illustrated in the table below.



Source: Bloomberg

The above commentary is with reference to Q4 of 2017, while the graphs has been updated up to Feb 2018.

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Ravinda currently works as the Fixed Income Securities Manager at DFCC Bank Treasury. He is a CFA charter-holder. He is also charter-holder of Chartered Institute of Management Accountants (CIMA) and Chartered Global Management Accountants (CGMA).

APB EVENTS

Kandy Regional Quiz

APB conducted a quiz program at Okrin Hotel Kandy on January 26, 2018 which was participated by 14 banks fielding 22 teams comprising staff from Kandy and the surrounding regions. Quiz master was Mr Parama Dharmawardena, member of the advisory board of APB.

Hatton National Bank emerged as the champions.


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The quiz program was followed by an evening presentation on "EMOTIONAL INTELLIGENCE AT WORK" delivered by Dr Chandana Jayawardena, Senior Lecturer, Department of Agricultural Extension - University of Peradeniya

A summary of the address delivered for the Association of Professional Bankers in Kandy on January 26, 2018

Organisational capabilities form the core component of business architecture. Organizations are interested in employees with high intelligence and skills levels. Research findings suggest that human intelligence is inherently involved in intellectual capital and in each and every component of it. In other words employees have become the major factor behind organizational performances. Thus scholars and practitioners have been experimenting on the components of human intelligence. 'IQ' has been considered as the ultimate yardstick of measuring human intelligence. Interests in 'emotional intelligence' (EI) research got prominence since mid-1990's. EI looks into how well a person manages his/her emotions and the relationship with others in a given situation, say with other employees at work. Empirical findings attach EI as a potentially powerful key to occupational success. The interest in exploring concept of EI grew dramatically by a popularization of the topic through Goleman's best-selling book, 'Emotional Intelligence' in 1995, exposing the 'business costs of emotional inaptitude'. EI has generated a great interest among many. The enthusiasm surrounding the identification of this 'new intelligence' has generated many EI enthusiasts and wide-spread claims. Research in the anatomy of human brain has strongly established the existence of EI with numerous supportive evidences. These findings have scientifically validated the existence of EI, as a distinct human faculty. In other words, people displaying superior performances and mastery at work have better control of their brains' emotional centres.

However, there are inconsistencies in EI research findings mainly due to the issues in measuring EI. Two main theoretical approaches exist in assessing EI. One approach is known as the ability model ('cognitive-emotional ability') framework. The other approach is known as the mixed-model framework measuring a combination of cognitive, personality and affective attributes. There are differences of opinions about the measurement methods based on above EI approaches.

Research findings have proven the benefits of EI in many facets of life. People having higher EI are linked with higher levels of leadership, job performance, career success, career satisfaction, and social acceptance. Benefits of EI also linked with academic performances and personal life including the family well-being. Benefits of EI are many in the world of banking. Relationship with subordinates and peers is greatly enhanced through EI. Banking has become demanding than ever before. Maintaining higher levels of customer happiness is facilitated through better management of emotional situations at customer service. Emotional styles drive the moods and behaviours of others. Emotions influence decision making that can make the difference between success and failure in the world of business. They also implicate the overall effectiveness of an organization as a team. EI also has a grey area that allows people to manipulate emotions to their advantage. There is no doubt that IQ is still the main determinant of career success. However, intellect loses its power to differentiate at a particular stage (threshold). That is where we see different behavioural patterns among even high IQ employees. Those who handle themselves and their relationships better emerge more successful in this context and EI adds definite value. However, the research findings are still insufficient for us to conclude the impact of EI in the world of work.

APB Completes its CSR Project in Kelinkanda

Association of Professional Bankers – Sri Lanka (APB) embarked on a CSR project, consequent to the floods and landslides which occurred last year in the Kukule Ganga area of the Kalutara District. The Kelinkanda Primary School which is the only primary school available for the children from Palindanuwara area in Agalawaththa suffered a major setback as the only well which provided water for the school was fully covered by mud due to alandslide. As a result, the students and teachers of the school had to undergo severe hardships to find water even for drinking purposes,leave alone other sanitation facilities.This school was selected for the CSR Project with the assistance of Mr. LalDissanayake, the Zonal Director of Education - Mathugama.

The members of the APB Council visited the school at the inception to assess the requirement and estimate the costs to be incurred on the project. Members of the Council of the APB and its Council of Advisors and APB members came forward with generous voluntary contributions to finance the project. The members of the tutorial staff and the parents of the school children made a major contribution by assisting in the digging operations thereby saving on costs.

Since the location of the existing well was prone to further landslides, it was decided to dig a well at a different location. The project was started in November 2017 and in spite of a few spells of bad weather was completed within a period of 3 months by completing the construction of the well and restoring the water supply system covering the entire school premises by laying new pipelines where necessary. The water pump was also serviced to ensure that there will be no disruption to the water supply. A boundary wall was built around the well to ensure the safety of the schoolchildren.

A simple ceremony was held at the school on 5th January 2018 for the Association of Professional Bankers – Sri Lanka to hand over the new water system to the students of Kelinkanda Primary School. This was preceded by a Bodhi Pooja at the nearby temple to fulfill a vow made by the school authorities. The schoolchildren had a variety entertainment show to mark the occasion.

Mr. K B SenerathBandara, President,APB, in his address at the ceremony, thanked all APB members who generously contributed towards the successful completion of the project. He also acknowledged the contribution made by some members of the tutorial staff and the parents of some of the schoolchildren by helping in the digging of the well. He further added that "APB was keen in carrying out a CSR Project of this nature for needy school children in remote parts of the country, as a worthy cause". The Zonal Director of Education - Mathugama, as well as the Principal of the school also addressed the audience, which included the Director Planning of the Zonal

Educational Office, Mathugama, representatives of APB, tutorial staff, parents, students and well-wishers

Thank You

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