

Central Bank of Sri Lanka - 2020

1.1 Opinion

The audit of the financial statements of Central Bank of Sri Lanka (the “Bank”), which comprise the statement of financial position as at 31 December 2020, and the statement of income, statement of other comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies, was carried out under my direction in pursuance of provisions in Article 154(1) of the Constitution of the Democratic Socialist Republic of Sri Lanka read in conjunction with provisions of the National Audit Act No. 19 of 2018, Section 13(1) of the Finance Act, No. 38 of 1971 and Section 42(2) of the Monetary Law Act (Chapter 422). My comments and observations which I consider should be report to Parliament appear in this report. To carry out this audit, I was assisted by a firm of Chartered Accountants in public practice to examine the compliance with International Financial Reporting Standards.

In my opinion, the accompanying financial statements give a true and fair view of the financial position of the Bank as at 31 December 2020, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

1.2 Basis for Opinion

I conducted my audit in accordance with International Standards on Auditing (ISAs). My responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of my report. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my opinion.

1.3 Responsibilities of Monetary Board and Those Charged with Governance for the Financial Statements

Monetary Board is responsible for the preparation and fair presentation of the financial statements in accordance with IFRSs, and for such internal control as Monetary Board determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, Monetary Board is responsible for assessing the Bank's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Bank or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Bank's financial reporting process.

As per Section 16(1) of the National Audit Act No. 19 of 2018, the Bank is required to maintain proper books and records of all its income, expenditure, assets and liabilities, to enable annual and periodic financial statements to be prepared of the Bank.

1.3 Auditor's Responsibilities for the Audit of the Financial Statements

My objective is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes my opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with ISAs, I exercise professional judgment and maintain professional skepticism throughout the audit. I also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for my opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by Monetary Board.
- Conclude on the appropriateness of Monetary Board's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Bank's ability to continue as a going concern. If I conclude that a material uncertainty exists, I am required to draw attention in my auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify my opinion. My conclusions are based on the audit evidence obtained up to the date of my auditor's report. However, future events or conditions may cause the Bank to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

The scope of the audit also extended to examine as far as possible and as far as necessary the following;

- Whether the organization, systems, procedures, books, records and other documents have been properly and adequately designed from the point of view of the presentation of information to enable a continuous evaluation of the activities of the Bank, and whether such systems, procedures, books, records and other documents are in effective operation;
- Whether the Bank has complied with applicable written law, or other general or special directions issued by the governing body of the Bank;
- Whether the Bank has performed according to its powers, functions and duties; and
- Whether the resources of the Bank had been procured and utilized economically, efficiently and effectively within the time frames and in compliance with the applicable laws.

2. Financial Review

2.1 Financial Results

According to the financial statements presented, the operations of the Bank for the year under review had resulted in a net profit of Rs.63.4 billion as compared with the net profit of Rs. 55.6 billion in the preceding year, thus indicating an increase of Rs. 7.8 billion in the financial results. Increase of foreign currency investment income and net income from local currency financial assets were the main reasons attributed for this improvement.

2.2 Trend Analysis of major Income and Expenditure items

Analysis of major income items and major expenditure items of the Bank during the year under review, as compared with the preceding year are shown below.

	2020	2019	Variance	
			[Favorable/(Adverse)]	
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	Rs. Bn.	Rs. Bn.	Rs. Bn.	percentage
Income from Foreign Currency Financial Assets	56.3	76.9	(20.6)	(26.7)
Interest Income	26.2	32.9	(6.7)	(20.3)
Gain/(Loss) from Unrealized Price Revaluations	23.5	42.9	(19.4)	(45.2)
Gain/(Loss) from Realized Price Changes	6.5	1.1	5.4	490.9
Expenses on Foreign Currency Financial Liabilities	7.3	8.5	1.2	14.1
Interest Expense	5.3	8.3	3	36.1
Expected Credit Losses	2.0	0.2	(1.8)	(900.0)
Net Foreign Exchange Revaluation Gain/(Loss)	7.1	(14.6)	21.7	148.6
Total Net Income/(Expense) from Local Currency Financial Assets	16.9	14.2	2.7	19.0
Other Income	1.6	1.5	0.1	6.7
Operating Expenses	11.2	13.6	2.4	17.6
Tax	-	0.3	0.3	100.0
Profit/(Loss) for the year	63.4	55.6	7.8	14.0

- (a) As per Section 41 of the Monetary Law Act, foreign exchange revaluation gain or loss shall not be included in the computation of the annual profits and losses of the Bank. Therefore, the profit for the year under review was Rs.56.3 billion (excluding net foreign exchange revaluation gain of Rs. 7.1 billion) as compared with the gain of Rs. 70.2 billion (excluding net foreign exchange revaluation loss of Rs. 14.5 billion) in the preceding year, thus indicating a deterioration of Rs.13.9 billion in the profit. Decrease of income from foreign currency financial assets by Rs.20.6 billion was the main

reason attributed for this decrease in the profit.

(b) The distributable profit for the year under review as determined in terms of Sections 38 and 41 of the Monetary Law Act and profit distribution policy of the Bank approved by the Monetary Board (effective from 2018) was Rs.18.6 billion as compared with the distributable profit of Rs. 25.4 billion in the preceding year. Accordingly, a sum of Rs.15 billion or 80.6 per cent had been distributed to the Consolidated Fund out of the distributable profit for the year under review as compared with Rs.24 billion distributed to the Consolidated Fund in the preceding year.

3. Operating Review

3.1 Operational Inefficiencies

Audit Issue	Management Comment	Recommendation
<p>a The Financial Sector Consolidation Programme</p> <p>The Bank had unveiled the Master Plan on Financial Sector Consolidation on 17 January 2014 with the objective of developing a strong Banking/ Non-Banking Financial Institutions sector with enhanced resilience to internal and external shocks in order to cater to the growing demands of the economy. Accordingly, the 12 Consolidation Plans including Banks, Financial companies and Leasing companies had been completed as at 12 May 2021 by spending Rs.105.58 million. However, the Consolidation Plans with 4 institutions had not been completed as at 12 May 2021, though the Bank had incurred a sum of Rs.21.44 million in this regard.</p> <p>In addition to the above expenditure, the Bank had incurred an additional sum of Rs.59.25 million for preparing Information Memorandum, Due Diligence, Valuation reports and other matters relating to 19 institutions which were not completed as at 31.12.2021.</p> <p>Further to the above Consolidation Plan, a separate “Masterplan for consolidation of Non-Bank Financial Institutions” was</p>	<p>Under the financial sector consolidation program, due diligences were done on all Non-Bank Financial Institutions (NBFIs) with a view of finding suitable consolidation partners.</p> <p>The Bank facilitated the consolidation programme by incurring the cost related to professional mergers & acquisition services offered by the external auditors from the panel appointed by the Bank.</p> <p>12 NBFIs completed the consolidation transactions for which the Central Bank incurred Rs.105.58 mn as due diligence and transaction fees to the external auditors.</p> <p>Due to the changeover of the government in 2015, the policy on the consolidation programme also was amended and was made optional for NBFIs. This situation resulted in the Bank not being able to enforce the mergers and further acquisitions.</p>	<p>Need to expedite the consolidation process.</p>

commenced by the Bank in year 2020 and a sum of Rs. 21.68 million had been incurred as at 30 April 2021 for preparing Information Memorandum, Due Diligence, Valuation reports.

The merger process of Housing Development Finance Corporation Bank and State Mortgage and Investment Bank which was commenced in 2018 was not completed as at 31.12.2021.

Further, the merger process of Sri Lanka Savings Bank Limited which was initially proposed and finalized to continue as a subsidiary of National Savings Bank (NSB), with NSB is also not completed as at 31 December 2021.

transactions could not be concluded due to the policy change although the initial stakes were acquired by the acquirers.

Further, consolidation of 19 NBFIs were not successful due to absence of prospective buyers. However, the Bank incurred Rs. 59.25 mn to conduct due diligence (including valuations) through by external auditors with respect of these 19 NBFIs.

Under the phase I of 2020 master plan for consolidation of non-bank financial institutions, the Bank has identified 11 NBFIs (based on regulatory non-compliances with capital requirements) as target entities for merger with a strong and stable NBFIs.

b Regulation and Supervision of Licensed Finance Companies

The Monetary Board had issued a direction to the licensed commercial banks and licensed specialized banks to reduce interest rates on credit card advances and pawning advance given by them with effect from 24 August 2020. However, direction had not been issued to finance companies registered under Finance Business Act No. 42 of 2011 which are providing credit card advances and pawning advances.

Licensed Finance Companies (LFCs) have been imposed with maximum interest rates on deposits and debt instruments, and this was the reason for not imposing maximum interest rates on lending rates as it was imposed on the licensed banks.

Need to consider the requirement

c Winding up process

Winding up process (Appointment of a liquidator) of the four finance companies whose licenses were cancelled by the Monetary Board of the Bank in the year 2018, 2019 and 2020 have not been initiated even up to the end of year 2021. A direction was made to a finance company whose license was cancelled with effect from 05 March 2018 to initiate

The Bank was of the view that preferential claims set out in the Ninth Schedule of the Companies Act, No. 7 of 2007 is not adequate to fulfill the winding up requirements of LFCs and accordingly, it was decided to issue a new regulation on priority of claim in winding up of LFCs in

Ned to expedite the process.

winding up process within 30 workings days from the date of cancellation and the said company failed to initiate winding up process within the said time frame. Also, a direction was made to another finance company whose license was cancelled with effect from 25 July 2018 to initiate the winding up process within 30 workings days from the date of cancellation and the said company failed to initiate the winding up process within the said time frame.

terms of the Section 33 of Finance Business Act No. 42 of 2011.

Subsequently, Finance Minister Gazetted the Finance Business (Priority of Claims in a winding up of finance company) Regulations No. 01 of 2019 on 31 May 2019 and thereafter Director of the Department of Supervision of Non Bank financial institutions initiated to file applications for winding up of LFCs without any delay.

d Regulating and Supervising of Leasing Companies

As per the provisions included in the Finance Leasing Act, No.56 of 2000, all benefits such as possession of the equipment, recovered money and if any recovered damages whether or not the lessee has paid the due amount as scheduled under finance lease are entitled to the lessor and overall responsibilities under finance lease are assigned to the lessee. Therefore, it may be required to review the Act for identifying the necessity to do any amendments to the Act. As a response to the Auditor General Report for the year 2019, it was mentioned that Bank is examining amendments to the respective acts in line with the current market developments and international best practices. However, such amendments were not taken place as at end of year 2021.

Department of Supervision of Non-Bank Financial Institutions established a technical and steering committee for drafting of the amendment of Finance Leasing Act and submitted for stakeholder observations. Proposals were received from two Associations and the Bank will examine provisions and will do the amendments, if necessary.

Need to amend the Act if necessary.

e The Licensing, Regulation and Supervision of Companies carrying on Microfinance Business

The Licensing, Regulation and Supervision of Companies carrying on Microfinance Business are carried out by the Monetary

To license, regulate and supervise entities engaged in the businesses of microfinance and money

Need to expedite the process of enacting the Act

Board of the Bank under the Microfinance Act No. 06 of 2016 (Act) with effect from 15 July 2016. Companies which are accepting deposits and providing financial services mainly to low-income persons and micro enterprises (Micro Finance Business) should obtain a license under the Act. Accordingly, only four companies had obtained the licenses to carry on microfinance business from the effective date of the aforesaid Act to 30 June 2021. Companies which are not accepting deposits but providing financial services to low-income persons and micro enterprises in the country do not require to obtain a license under the Act. Therefore, those companies are not regulated and supervised by the Monetary Board of the Bank under the Act. As a response to Auditor General Report for the year 2019, it was mentioned that a Credit Regulatory Authority will be established to license, regulate and supervise entities engaged in the business of micro finance and money lending through a separate Act and draft of the said proposed act was forwarded to the Ministry of Finance on 26 November 2019. However, it has not been enacted as at end of year 2021.

lending, it has been proposed to establish the Microfinance and Credit Regulatory Authority through an Act of Parliament namely Microfinance and Credit Regulatory Authority Act (proposed Act). The Bank is in the process of finalizing the draft Bill with the Legal Draftsman and the Ministry of Finance. It is expected that the proposed Act will be enacted in the year 2022.

f Public Debt Management

i According to Section 113 of the Monetary Law Act, the Central Bank of Sri Lanka is responsible for the management of public debt. However, the Monetary Law Act or any other written law does not define the types of debt that public debt includes, or the definition of public debt, the purposes and functions of public debt management.

The Bank is required to perform an agency function with respect to public debt management as per the Monetary Law Act (MLA) in terms of Section 113. It is reckoned that MLA does not sufficiently elaborate on the purposes and the functions of public debt management entrusted with the Bank. In view of certain observations over the debt management functionality, an exercise in forming a single debt management office was

To take necessary actions to define the types of debt that public debt includes, the definition of public debt, the purposes and function of public debt management.

initiated a few years ago in consultation with the Treasury and the Bank and with technical assistance from an International agency but was not continued further. A fresh dialogue to further establishing clarity in respect of the purposes and functions of public debt management assigned to the Bank could be initiated among relevant stakeholders.

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| ii | <p>The Bank reports the outstanding Central Government debt using the loan information on the issuances of government securities and the loan information received from the Ministry of Finance and other relevant Departments of the Bank on the other loans which are obtained on behalf of the government by the respective parties. However, it was not observed that the Bank had obtained the confirmation the accuracy of bank overdrafts balances and outstanding foreign loans other than outstanding international sovereign bonds in compiling outstanding Central Government debt balance.</p> | <p>The Bank compiles details of public debt directly from its own sources and through secondary sources. All details, where primary source is the Bank are compiled and shared with stakeholders promptly. There are few components of public debt where the primary source is the Ministry of Finance and reporting to the Central Bank periodically. It is expected other agencies reporting data to the Bank do report such data accurately and a need to verify such data by CBSL does not arise.</p> | <p>To take necessary actions to confirm the accuracy of bank overdrafts balances and outstanding foreign loans other than outstanding international sovereign bonds.</p> |
| iii | <p>As per the Direction on primary issuance of Treasury Bonds dated 24 July 2017, for the phase III (mandatory allocations to the primary dealers at weighed average yield rate determined in phase I) of the Treasury bond auction to take effect, 60 percent from the offered amount must have been accepted under the phase I. This clause had been revised to 70 percent in force from 09 July 2019 and further increased to 80 per cent while limiting execution of Phase iii only for treasury bonds with remaining maturity period of 5 years or below with effect from 23 September 2021 by the Superintendent of Public Debt. It was observed that raising the 60 per cent limit</p> | <p>The Monetary Board (MB) at its meeting held on 20.07.2021, approved to enhance the minimum acceptance level to 80 per cent from 70 per cent while limiting the activation of Phase III for T-bonds with a remaining maturity of 5 years or below. These improvements were implemented to further enhance the establishment of a market cleared price/ yield under Phase I as well as considering the feedback from the market participants on activation of Phase III.</p> | <p>To take all efforts to raise fund to the government at the lowest possible cost consistent with a prudent degree of risk.</p> |

to 80 per cent would further limit the availability of fund raising to the government at the lowest possible cost consistent with a prudent degree of risk.

iv Limitations of Lanka Settle System which is facilitated for the fund settlements, scripless securities settlement and recording the ownership of the Government securities transactions observed during the audit are as follows.

- Difficulty in identifying the beneficiary of coupon proceeds and maturity proceeds paid by the Bank on the securities recorded under CRP security account. As per subsection 3 under section 9 and 10 of the Local Treasury Bills Ordinance and subsection 3 under section 21D and 21E of the Registered Stocks and Securities Ordinance, the sum due as principal, interest and redemption proceeds of scripless government securities is payable to the Direct Participant or Dealer Direct Participant. Such payments are credited to respective accounts of the customers by the Dealer Direct Participants. Need to consider the possibility of doing this.
- Not being recorded relevant information such as expected amount, return date and return price of Repo transactions between the primary dealer and their customers in Lanka Secure System. To capture more attributes of transactions carried out in the Government securities market (secondary market) and to improve the transparency, participants are required to record information including settlement value, price and interest rate of relevant transactions in the Scripless Securities Settlement System with effect from 01st January 2020 (circular issued on 01 October 2019). Participants are required to report all secondary market Government Securities trades Central Bank effective from 01 April 2021. Need to continue the improvements.

(circular issued on 26 March 2021). These requirements are to further strengthen under the Capital Market Development Project which is expected to go live by 2023.

- No any restriction in Lanka Secure System to avoid removing allocated securities without substituting another security for Repo transactions.

Imposing restrictions in the LankaSecure system for allocation of securities is technically not feasible. However, the movements of securities in the case of repurchase transactions are being scrutinized as part of the supervision role conducted by the Bank. Further, any unauthorized action by the part of Dealer Direct Participant such as removing allocated securities from customer accounts without substitution will lead to regulatory action taken by the Bank.

Need to take all efforts to protect investors.

- v Section 2.2 of Lanka Settle System Rules Version 2.1 (2013) which was issued for the operations of the Lanka Settle System by the Bank stated that fines can be imposed against Primary Dealers when a Primary dealer violates rules and regulations that they are required to follow. Further, as per the Section 8 of the Registered Stock and Securities Ordinance and Local Treasury Bills Ordinance Direction No. 01 of 2019 dated 20 December 2019 (Repurchase and Reverse Repurchase Transactions), penalties can be imposed against Dealer Direct Participants (DDP) for non-compliance with the said direction. However, fines/penalties had not been imposed against any Primary Dealer or DDP as the Bank was unable to enforce the said provisions.

The Legal and Compliance Department of the Bank has raised concerns over the legality of imposing penalties through subordinate legislation (i.e. Regulation and Direction issued based on the Acts under reference) in the absence of explicit empowerment to impose such penalties directly through the said Acts. In this regard, the Bank will consider alternative arrangements to address the said matter.

Need to expedite the process

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| vi | <p>The Monetary Board instructed the PDD in September 2015 to develop an appropriate framework to impose fines against Primary Dealers who act against the interest of customer. However, such appropriate framework had not been completed even up to the end of year 2020.</p> | <p>Registered Stock and Securities Ordinance and Local Treasury Bills Ordinance Direction No. 01 of 2019 on Repurchase and Reverse Repurchase transactions of Dealer Direct Participants on Scripless Treasury Bills and Treasury Bonds, was issued on 20.12.2019, to strengthen the current regulatory framework on penalty provisions in government securities market. However, relevant Acts need to be amended to incorporate the penal provisions in order to make them more resilient in the legal arena. The Bank is contemplating on several approaches at present to address the said matter.</p> | <p>Need to expedite the process</p> |
| vii | <p>As per the Section 4 of the Registered Stock and Securities Ordinance No. 07 of 1937 as amended, the Minister in charge of the subject of Finance shall, in respect of each loan (issuance of treasury bonds) to be raised under this Ordinance, specify by Order published in the Gazette. However, such kind of order for the year 2018, 2019 and 2020 had not been published in the Gazette even up to the end of December 2020. Further, order for the year 2008 to 2017 had been published in the Gazette at the following year of each respective year based on the actual results of the issuance of Treasury Bonds in contrary to the Section 4 of the Ordinance.</p> | <p>Relevant amendments to the Registered Stock and Securities Ordinance have been proposed to the Ministry of Finance. The order papers for 2018 and 2019 for the signature of the Minister of Finance and the schedules were forwarded to the Ministry of Finance and CBSL awaits the duly signed Order Papers to make necessary arrangements for the publication of the Gazette for T-bond issuances in 2018 and 2019. The Gazettes for T-bond issuances during 2020 would be made available in 2021 with the orders of the relevant Minister of Finance.</p> | <p>Need to expedite the process.</p> |

g Investments made by the departments of the Bank which handle internal funds.

A loss of Rs. 2,586 million was occurred as at 10.12.2018 to the funds managed by four departments of the Bank due to investment in unsecure Reverse Repo with a particular primary dealer. The total amount of investment which was reclassified as Receivable from the said primary dealer as at 18 September 2020 was Rs. 2,953.6 million.

At present, the Bank has initiated legal actions to recover the due amount from the particular primary dealer.

Since early 2016 onwards, the investment departments of the Bank have taken measures in order to strengthen the investment process of Internal Investment Funds.

Need to recover the loss.