

**A STUDY OF THE NON-BANKING FINANCIAL
INSTITUTION SECTOR IN SRI LANKA**

BY

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12TH FEBRUARY 2018

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List of Abbreviations

AGM	Annual General Meeting
CBSL	Central Bank of Sri Lanka
CEO	Chief Executive Officer
ICASL	Institute of Chartered Accountants of Sri Lanka
LFCs	Licensed Finance Companies
LTV	Loans to Value Ratio
MSMEs	Micro, Small and Medium Enterprises
NBFIs	Non-Banking Financial Institutions
NPLs	Non-Performing Loans
SEC	Securities and Exchange Commission of Sri Lanka
SLCs	Specialized Leasing Companies

EXECUTIVE SUMMARY

Non-banking financial institution (NBFI) sector is a fast growing component in Sri Lanka's financial system as reflected in its strong increase in size and growing interconnectedness with the banking sector. Total assets of this sector grew by 21.66% from 2015 to 2016 in comparison to the total asset growth of Sri Lanka's financial system which was 11.36% for the same period. As a result, policy makers have proceeded in gaining a better understanding of the nature and the role of NBFIs and their potential impact on economic growth.

This study examines the role of Non-Banking Financial Institution sector and its contribution to the Sri Lankan economy. This report addresses the performance of NBFIs in terms of advances, deposits and clients; contribution of NBFIs to Sri Lankan economy; value distribution of them in comparison with banking sector, and voluntary corporate governance disclosure levels in the sector.

Out of 51 NBFIs registered with Central Bank of Sri Lanka as at 30th April 2017, only 25 companies participated in this study and they represented an 89.14% of total assets of the NBFI sector. Time frame for the study is from financial year 2012/13 to 2016/17. Advances, Deposits and number of clients show an increasing trend over the last five years even though dominance of Big NBFIs can be observed. However, small and medium NBFIs were grown at a faster rate compared to their big peers in last five years. NBFIs have contributed to the Sri Lankan economy in many significant ways. One of them is important contribution to the financial inclusion of the country where NBFIs are mobilizing deposits from Western Province to other provinces in form of advances. Creation of employment opportunities is also a

highlighted aspect where their staff growth exceeded total labour force growth in the country. NBFIs depicted a higher growth in value distribution to employees, government and capital providers over last five years. Further, NBFIs' voluntary compliance to the corporate governance disclosure levels is satisfactorily improving from 2012/13 to 2016/17. It can be concluded that Sri Lankan NBFIs play a vital role in the economy based on above findings.

Section 1

Introduction

1.1 Industry Overview

Constituting Licensed Finance Companies (LFCs)/ Specialized Leasing Companies (SLCs), the Non-Banking Financial Institutions (NBFIs) sector is playing a major role in uplifting the Sri Lankan economy through providing means of finance to the developing sectors of the economy. This sector has recorded a strong performance in terms of asset growth and branch network expansion during 2017 amidst a challenging business environment. Graduating from its core business of vehicle financing it has matured into a number of other loan products. A noteworthy significant characteristic of the NBFIs is their discipline in ensuring that risk remained under control, as reflected in healthy level of non-performing loans (NPLs) and comfortable liquidity and capital levels (Central Bank of Sri Lanka [CBSL], 2016), undeterred by the high growth, vis-à-vis the other organizations in the industry.

1.1.1 Evolution of the NBFIs Sector

The birth of the NBFIs could be traced back to the finance companies of the 1930s. In order to regulate and supervise the financial institutions, the Bank Supervision Department of Central Bank of Sri Lanka (CBSL) was established in 1950. However, up to the year 1977, some of the finance companies, which were found to be unauthorized ones, failed. This was attributed to the inadequacy of the role of the Bank Supervision Department to properly regulate the banking and NBFI sector. Consequently, in order to regulate and ensure proper functioning of this sector, the Finance Companies Act No. 27 of 1979 was enacted. A byproduct of the

liberalization of the economy in 1977 is the mushrooming of a number of finance companies, with most of the funds invested in hire purchase and leasing businesses (CBSL, 1998). There were 72 finance companies registered with the CBSL at the end of 1989. The CBSL introduced new reforms including stringent regulations to ensure the viability of finance companies after some of them failed even in the 1980s. The new regulations led to a drastic reduction in the number of finance companies to 24 by the end of 1996. With the expansion of the economy sequel to the end of the ethnic conflict in 2009, the CBSL allowed expansion in this sector, issuing new licenses to meet the increasing demand for financial services in the country. Simultaneously, the Parliament of Sri Lanka introduced the Finance Business Act, No. 42 of 2011 to further tighten the regulation and supervision of the finance companies and to ensure stability of the financial sector here. In addition to regulating the functions through the Acts, CBSL has also taken initiatives to effectively supervise the banks and the NBFIs through the Bank Supervision Department and the Department of Supervision of NBFIs. There are 45 LFCs and 6 SLCs registered with the CBSL as at 30th April 2017. They are referred as NBFIs commonly throughout this report.

1.1.2 Role of NBFIs in the Economy

In the Sri Lankan economy, financial inclusion could not be called even a partially successful story, without considering the role of the NBFIs. The NBFIs provide financial services to the citizens at the grass root level. The banking system in the country does not cater to these people. Thus, the poor people do not have access to banks. The NBFi sector, by largely targeting them, contributes to raise the standard of living of the poor segment of the population by providing specialized credit via microfinance. This noble deed, albeit not being intended, of providing financial

facilities to the less benefited segments, would discourage them from the scourge of unauthorized finance businesses, carried out by unscrupulous financial sharks, presenting themselves as the saviours of these helpless people. Furthermore, NBFIs also enhance the economic growth of this segment of the populace, through finance leasing and hire purchasing, while generating employment opportunities designed for about 30,000 employees (CBSL, 2016).

1.1.3 Scope of the Financial Facilities Provided by the NBFIs Sector

The NBFIs sector has extended its services to the areas otherwise served by the regular banks, viz., the variety of facilities to diverse trading and industrial sectors, which include agriculture and fishing, manufacturing, tourism, transport, construction, housing, trades, telecommunications, finance and business, education, development and health services. In other words, the NBFIs provide a variety of facilities to its customers such as microfinance facilities to individuals and businesses via leasing facilities, and housing loan facilities.

1.1.4 Current Status of the NBFIs Sector

The customer base of the NBFIs, including both depositors and borrowers is a whopping 2.5 million in 2015. The total asset base of the sector grew from 2015 to 2016 by 21.7%. Loans and advances, the main component of assets grew by 21% from 2015 to 2016. During this period, investments and other assets grew by 12.1% and 36.6%, respectively. The increased assets were funded mainly through deposits (43.8%) and the balance through borrowings (36.2%), capital elements (12.1%) and other liabilities (7.9%) (CBSL, 2016)

There was a slowdown of credit growth of the NBFI sector during the first quarter of 2016, sequel to the macro prudential measures implemented with respect to the lending on motor vehicles, particularly in the form of a loan to value ratio (LTV). However, with the increased focus on other lending products, the credit growth accelerated during the second half of 2016. This caused an overall expansion of credit by 21.0% (or Rs.166.8 billion), reaching a value of Rs. 962.7 billion, as at end 2016. The growth rate, however, has been a high value of 31.8% (Rs. 192.1 billion), during 2015. Around 73.1% of this credit growth was mainly through other loan products such as term loans, revolving loans, microfinance, factoring and draft loans, while 23.7% was through finance leases and hire purchases (CBSL, 2016).

The investment portfolio, comprising investments in equities, corporate debt instruments, government securities and investment properties, recorded a growth of 12.1% in 2016, which is certainly a remarkable performance when compared to a decline of 9.2% in 2015. This was mainly on account of increased investments in short-term government securities. Other assets consisted of cash, balances with banks and financial institutions, trading stocks and fixed assets, showed an increase of 36.6% in 2016. This is largely due to increased placements in banks and financial institutions (CBSL, 2016). The composition of assets and liabilities of the NBFI sector is illustrated in Table 1.1.

Table 1.1: *Asset and Liability Composition of the NBFIs Sector*

	2015		2016		Growth 2015 - 2016 (%)
<u>Assets</u>	Value (Rs. billion)	Share (%)	Value (Rs. billion)	Share (%)	
Loans and advances	795.80	79.89	962.70	79.44	20.97
Investments	99.60	10.00	111.70	9.22	12.15
Other	100.70	10.11	137.60	11.35	36.54
	996.10	100.00	1,212.00	100.00	21.66
<u>Liabilities</u>					
Total deposits	480.60	48.25	531.00	43.81	10.49
Total borrowings	314.30	31.55	438.70	36.20	39.58
Capital elements	123.10	12.36	146.10	12.05	18.68
Other	78.10	7.84	96.20	7.94	23.18
	996.10	100.00	1,212.00	100.00	21.66

Source: Central Bank of Sri Lanka

Over the past two years, the sector's reliance on retail deposits has been very much mitigated as a result of a gradual shift towards borrowings from banks, augmented by the flexibility and cost factor in the latter. This has radically changed the overall funding structure of the sector, by increasing the share of borrowings to 36.20% in 2016 vis-a- vis 31.55% in 2015. The share of deposits, however, has decreased to 43.81% in 2016 from 48.25% in 2015 (See Table 1.1).

The deposits recorded a moderate growth of 10.5% to Rs. 531.0 billion in 2016, compared to a 16.1% growth in 2015. This had a further growth to 590 billion by the mid of 2017. The deposit mobilization was mainly through time deposits accounting for 95.6% of the total deposits, whilst the residual was mainly from savings deposits. The capital elements of the sector increased by 18.7% to Rs. 146.1 billion as at end 2016, mainly on account of internally generated profits (CBSL, 2016).

1.2 Objective of the Study

The main objective of this study is to examine the role of Non-Banking Financial Institution sector and its contribution to the Sri Lankan economy. Moreover, this study analyzes:

- the performance, in terms of advances, deposits and number of clients of NBFIs which participated in the study,
- how NBFIs contributed to the Sri Lankan economy and society,
- the NBFIs sector as opposed to the commercial banking sector, in the perspective of value distribution, and
- the corporate governance framework, such as best practices and compliance to the voluntary disclosure of corporate governance, of the different NBFIs.

1.3. Data

There were 51 NBFIs registered with CBSL as at 30th April 2017. Out of these, only 25 participated in this study. Data of the participating companies, over a period of 2013 – 2017, were used in the analysis. In order to validate the study, the size of NBFIs was measured using three yardsticks, viz total assets, revenue and market capitalization. The 25 companies cover 89.14% out of total assets of the NBFIs sector as at the end of financial year 2016/17. Further, they contributed 89.83% and 88.86% of total revenue and total market capitalization respectively of this sector. It could, therefore, be logically concluded, that the companies which participated in this study largely represent the entire NBFIs sector in Sri Lanka. The list of these 25 companies, together with their total assets, revenues and market capitalization, is given in Appendix 1.

Further, it is noted that the companies within the NBFIs considerably differ in size within their sector itself. Prudence dictates that the effort and cost in pooling all the NBFIs together could not be justified since it would not generate a commensurate quality in the analysis. The 25 NBFIs were, therefore, classified, based on their total assets, in order to overcome this issue, especially when analysing the performance of NBFIs sector described in Section 2 of this report. NBFIs are classified as big NBFIs when total assets exceeded Rs. 50 billion and medium NBFIs when the total assets are between Rs. 10 billion and Rs. 50 billion. Rs. 10 billion, are classified as small NBFIs. A complete list of this classification is given in Appendix 2 of the report. Main data sources used in the study were the Finance Houses Association of Sri Lanka and published reports of the Central Bank of Sri Lanka.

1.4 Report Structure

The objective described above is addressed using a mix of secondary literature review, evidence provided from consultations with stakeholders and data analysis, thereby providing quantitative and qualitative results. The overall structure of the report is described below. Section two describes the performance of NBFIs sector in three major aspects, which are advances, deposits and number of clients. Third section figures out the contribution of NBFIs to the Sri Lankan economy, analysed with several macroeconomic variables, such as economic growth, total savings, investment, and the growth of the labor force. The fourth section presents a comparison of NBFI sector with the commercial banking sector, in Sri Lanka. Even though there are different ways of comparing the two sectors, this study takes a value distribution approach among different stakeholders. The fifth section evaluates the improvement in corporate governance practices and disclosures followed by the

NBFIs over a period of five years from now. This evaluation was mainly conducted with reference to the Code of Best Practice on Corporate Governance – 2013, jointly issued by the Securities and Exchange Commission of Sri Lanka (SEC) and the Institute of Chartered Accountants of Sri Lanka (ICASL). Section six presents the conclusion of the study.

Section 2

Performance of NBFIs

2.1 Introduction

This Section discusses the performance of the Sri Lankan NBFIs from 2012/13 to 2016/17 on several key aspects. They are advances, deposits taken and number of clients served by the NBFIs participated in the study.

2.2 Advances

This sub-section focuses on the advances granted by NBFIs from financial year 2012/13 to financial year 2016/17. Key aspects of advances discussed here are; value of advances, number of advances and value of advances per contract (average loan size). As shown in Table 2.1, the total value of advances granted has grown from Rs. 173.41 Billion in 2012/13 to Rs. 598.97 Billion in 2016/17 with an average annual growth of 37.13% over the period of five years. Advances granted by the big NBFIs have grown from Rs. 129.44 Billion in 2012/13 to Rs. 371.44 Billion in 2016/17 with an average annual growth of 30.63% over the five year period (Table 2.1). The five-year average growth rate for small NBFIs is 81.70% which is much higher than the medium NBFIs and big NBFIs with growth rates of 52.73% and 30.63% respectively.

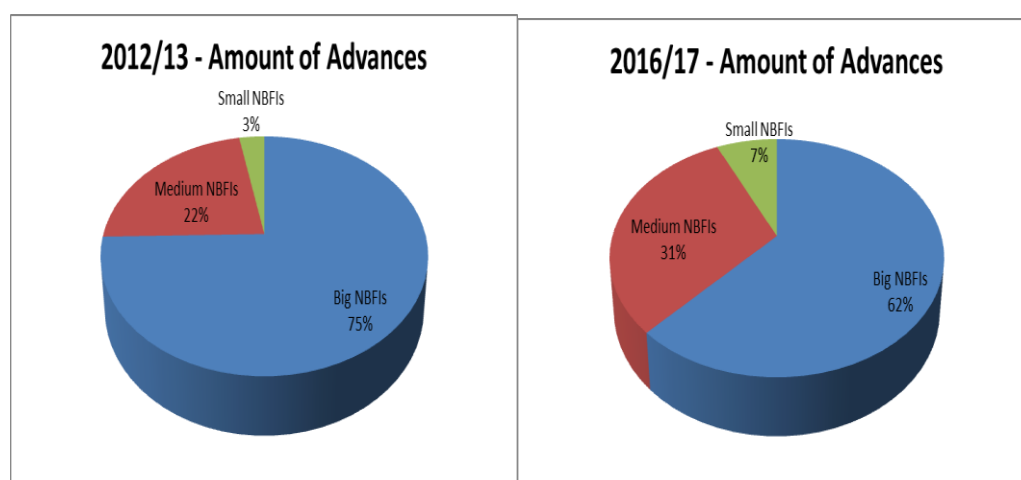
Table 2.1: *Total Value of Advances by NBFIs (2013 -2017)*

Year	Big NBFIs		Medium NBFIs		Small NBFIs		Total Sample	
	Amount (Rs. Bn)	Growth (%)	Amount (Rs. Bn)	Growth (%)	Amount (Rs. Bn)	Growth (%)	Amount (Rs. Bn)	Growth (%)
2013	129.44		38.82		5.15		173.41	
2014	182.26	40.81%	47.06	21.23%	16.19	214.39%	245.51	41.58%
2015	249.60	36.95%	96.06	104.11%	21.60	33.42%	367.25	49.59%
2016	329.72	32.10%	168.35	75.26%	32.14	48.81%	530.21	44.37%
2017	371.44	12.65%	185.69	10.30%	41.84	30.18%	598.97	12.97%

Source: Finance Houses Association, Sri Lanka

Further, the largest share of total value of advances granted is dominated by big NBFIs which is 62% in 2016/17 (see Figure 2.1). However as per Figure 2.1, their share is reduced by 13% where they possessed 75% out of total value of advances granted by NBFIs considered for this study in 2012/13. This indicates that major share of total loan portfolio granted by NBFIs is vested with big NBFIs even though their small and medium peers are penetrating faster to gain a considerable portion of the NBFI loan portfolio.

Figure 2.1: *Composition of Value of Advances*



Source: Finance Houses Association, Sri Lanka

Second aspect considered on the advances granted by NBFIs is, the number of advances or how many loan contracts were granted during the five year period considered for the study. The relevant figures are summarized in Table 2.2. According to the Table, the number of loan contracts generated by the total sample in 2012/13 was 679,864 and the number has grown to 2,070,677 in 2016/17 by an average annual growth of 33.83% over five years. Similar to the value of advances, number of advances has grown for medium NBFIs by 52.09% and small NBFIs by 80.61% exceeding the growth rate of 18.97% of big NBFIs. This is due to more stagnant growth in the number of advances granted by big NBFIs in last three years.

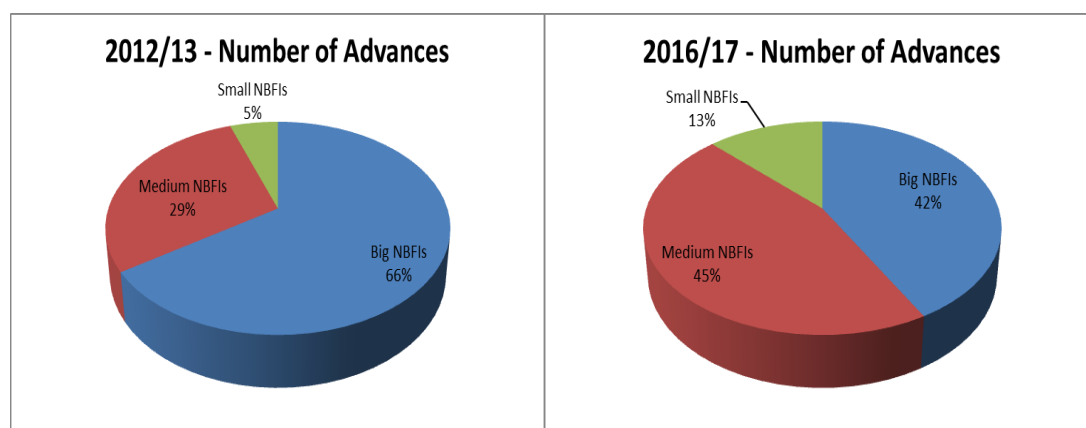
Table 2.2: Total Number of Loans for NBFIs (2013-2017)

Year	Big NBFIs		Medium NBFIs		Small NBFIs		Total Sample	
	No. of Loans	Growth (%)	No. of Loans	Growth (%)	No. of Loans	Growth (%)	No. of Loans	Growth (%)
2013	446,172		197,138		36,554		679,864	
2014	585,560	31.24%	324,534	64.62%	117,619	221.77%	1,027,713	51.16%
2015	779,376	33.10%	634,667	95.56%	208,441	77.22%	1,622,484	57.87%
2016	779,335	-0.01%	937,221	47.67%	220,158	5.62%	1,936,714	19.37%
2017	869,351	11.55%	941,919	0.50%	259,407	17.83%	2,070,677	6.92%

Source: Finance Houses Association, Sri Lanka

When considering the composition of number of advances granted in 2012/13 and 2016/17, dominance displayed by big NBFIs has decreased by 24%. As per Figure 2.2, big NBFIs had a share of 66% of the total number of loans granted in 2012/13 and it has reduced significantly to 42% in 2016/17. Similar pattern can be observed in the value of advances granted too by analysing the 2012/13 and 2016/17 loan composition.

Figure 2.2: Composition of Number of Advances Granted



Source: Finance Houses Association, Sri Lanka

Advance amount per contract or average loan size is the third aspect considered by this section. According to Table 2.3, the average loan size per contract ranges between Rs. 200,000 and Rs. 300,000. Further, the loan size has grown by an average rate of 3.75% over the last five years. However, the average loan size of big NBFIs is Rs. 427,264 for year 2016/17 with an average growth of 10.82%, during past five years.

Five year average growth rates in average loan size for medium and small NBFIs are 1.61% and 6.09% respectively. Average loan size is substantially lower for the medium and small NBFIs. Average loan size is Rs. 161,278 for small NBFIs for year 2016/17, while that for the big NBFIs is more than twice that of the small NBFIs.

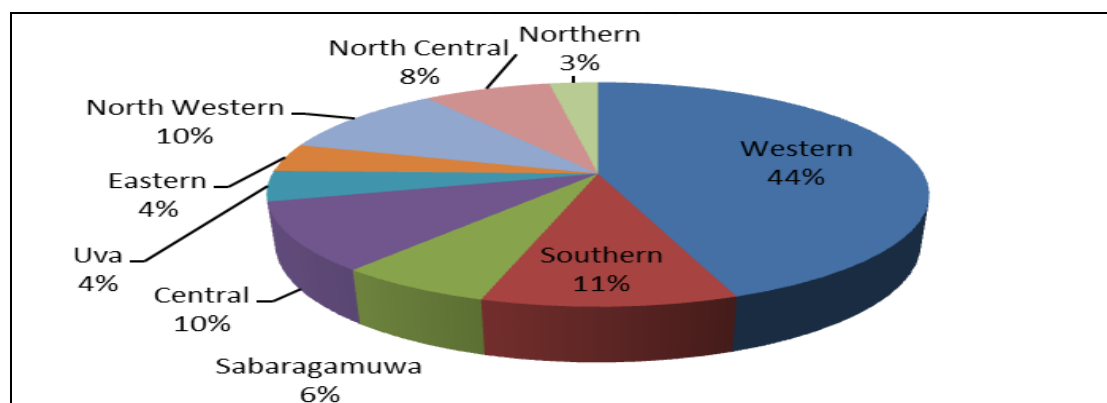
Table 2.3: *Average Loan Size in NBFIs (2013-2017)*

Year	Big NBFIs		Medium NBFIs		Small NBFIs		Total Sample	
	Average loan size (Rs)	Growth (%)	Average loan size (Rs)	Growth (%)	Average loan size (Rs)	Growth (%)	Average loan size (Rs)	Growth (%)
2013	290,115		196,916		140,851		255,065	
2014	311,262	7.29%	145,009	-26.36%	137,620	-2.29%	238,889	-6.34%
2015	320,256	2.89%	151,348	4.37%	103,610	-24.71%	226,351	-5.25%
2016	423,076	32.11%	179,625	18.68%	145,980	40.89%	273,766	20.95%
2017	427,264	0.99%	197,141	9.75%	161,278	10.48%	289,263	5.66%

Source: Finance Houses Association, Sri Lanka

Geographical distribution of advances is depicted in Figure 2.3. Western Province achieved the highest share of advances amounting to 44% in 2016/17. However, it is relatively low compared to the deposits which are concentrated in the Western Province with a share of 74% (see Figure 2.3). It can, therefore, be concluded that NBFIs are net lenders in all other provinces except the Western Province.

Figure 2.3: *Geographical Distribution of Advances in 2017*

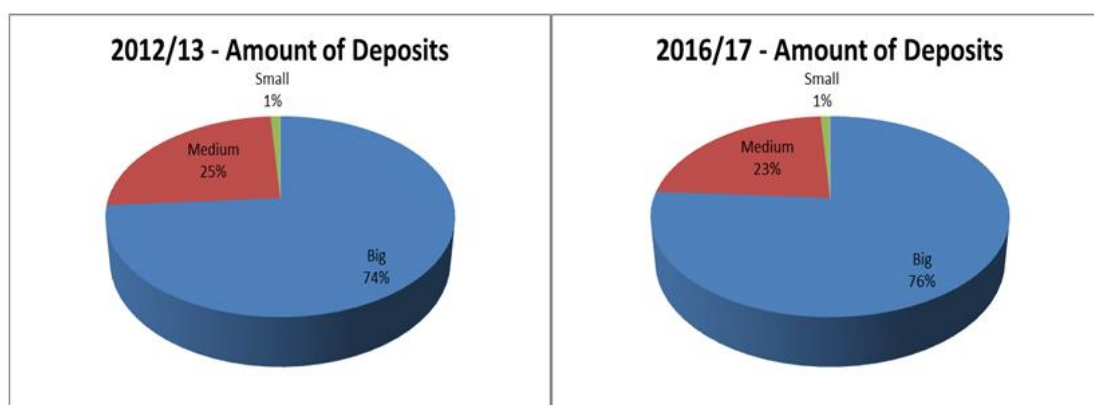


Source: Finance Houses Association, Sri Lanka

2.3 Deposits

According to the Table 2.4, total deposits of the 25 NBFIs which participated in this study amounts to Rs. 428.30 billion by 2017. As per the Figure 2.4, big NBFIs hold 76% of the total deposit. Medium NBFIs account for 23% of the total deposits and the remaining 1% is held by small NBFIs. This pattern of share in the deposit between the three categories of NBFIs has remained consistent every year, during the period from 2013 to 2017.

Figure 2.4: *Total Deposit Value Composition*



Source: Finance Houses Association, Sri Lanka

As per the Figure 2.5, deposits of customers in the Western Province represent 74% of the total deposits of the sector by 2017, whereas the customers in North Western (7%), Central (6%) and Southern (5%) Provinces contribute 18% of the total deposit. Table 2.4 indicates that total deposits of NBFIs sector maintained a healthy growth over the last five years. The main contributor for this growth is the big NBFIs followed by medium and small NBFIs during 2012/13 – 2016/17 periods. An unusual pattern is observed where the growth in deposits of both medium and small NBFIs has marked negative values in 2017. Another notable feature is that the total deposits of NBFIs during 2014 have notched a remarkably high growth compared to the growth of deposits in other years (Table 2.4). This could be due to a favourable response from

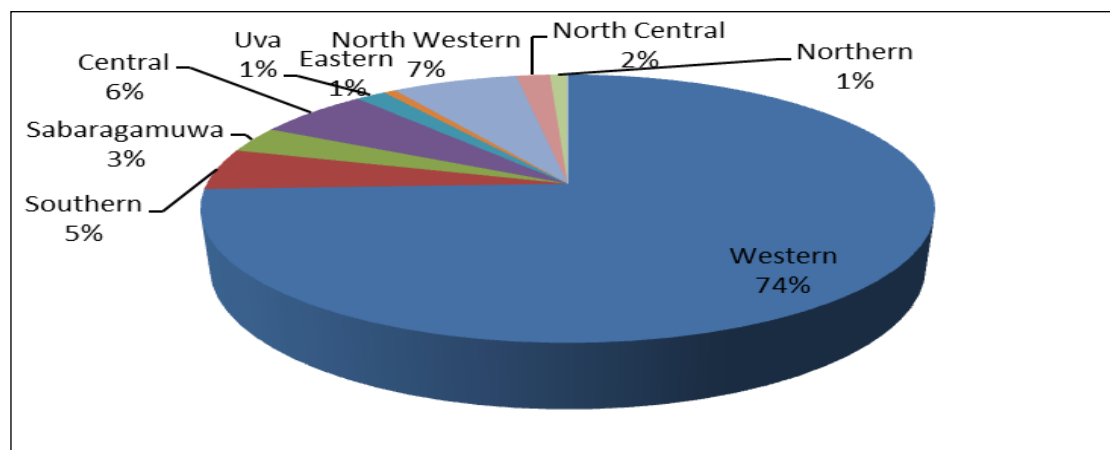
customers who expected a higher yield from a higher interest rate for deposits in 2013. Table 2.4 discloses evidence for a lower growth of deposits of big NBFIs in 2015, which could be a consequence of lower interest rates during that time.

Table 2.4: *Total Deposits and Deposits Growth of NBFIs (2013 -2017)*

Year	Big NBFIs		Medium NBFIs		Small NBFIs		Total	
	Amount (Rs. Bn)	Growth (%)	Amount (Rs. Bn)	Growth (%)	Amount (Rs. Bn)	Growth (%)	Amount (Rs. Bn)	Growth (%)
2013	150.49		51.23		2.20		203.92	
2014	217.28	44.38	64.52	25.94	2.82	28.18	284.62	39.57
2015	234.22	7.80	85.90	33.13	3.98	41.13	324.10	13.87
2016	276.27	17.95	104.79	21.99	5.54	39.19	386.60	19.28
2017	325.70	17.89	98.19	(6.29)	4.41	(20.39)	428.30	10.78

Source: Finance Houses Association, Sri Lanka

Figure 2.5: *Geographical Distribution of Deposits Taken by NBFIs in 2017*

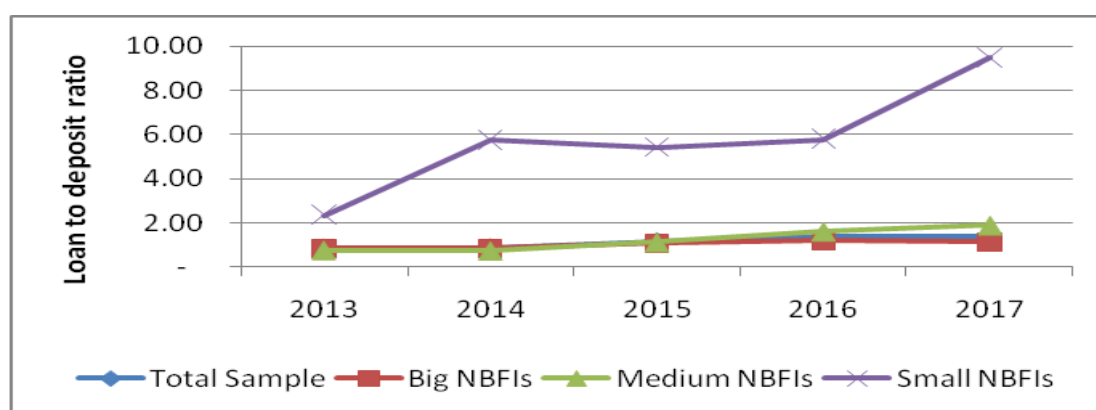


Source: Finance Houses Association of Sri Lanka

Figure 2.6 presents the behaviour of loan to deposits ratio of selected NBFIs for this study during 2013 – 2017. Further the Figure is useful for understanding how NBFIs utilized their available deposits to grant loans. An observation of loan to deposit ratio of the sector indicates that they managed to lend total loans of approximately 100% of their deposits during the period of 2013 to 2015. Perhaps a considerable growth of deposits in 2014 (see Table 2.4) assisted the sector to maintain such a ratio during that period. However, the ratio has increased drastically by 2017 (i.e., big NBFIs to 130%, medium NBFIs to 190% and small NBFIs to 950%). Less growth of deposits of ‘Big

NBFIs' in 2015, considerable decline of deposits of both medium and small NBFIs in 2017 (see Table 2.4) and lending advances using external borrowings during 2016 – 2017 could be highlighted as the underlying reasons for this behaviour. Low level of customer deposits and continuously relying on external borrowings to source advances are the reasons behind a very high percentage of loans to deposit ratio of small NBFIs.

Figure 2.6: *Loan to Deposit Ratio in NBFIs*



Source: Finance Houses Association, Sri Lanka

2.4 Number of Clients

The NBFIs sector has recorded a fast growth of their client base during the past few years. Positioning NBFIs business operations to support the anticipated high growth momentum in the economy can be observed. On the other hand, finance companies fit into a particular niche in the Sri Lankan financial services, mainly serving the unbanked population. Sri Lanka's non-bank sector is attractive and is a convenient arm of financing the rural community by facilitating a diversified range of products at the grass root level of the economy, with its primary focus on the small and medium scale enterprises.

The total number of client distribution over the last five years, according to data gathered from Finance Houses Association of Sri Lanka, is presented in Table 2.5

below. Table 2.5 depicts how the total number of clients of NBFIs had a quantum jump over the short five-year sample span, from 2013 to 2017. It clearly establishes the fact that the client base has steadily grown over the last five years. It was a fair 983,724 in 2013 and expressed a sharp increase to 2,492,534 in 2017, which amounts to a 150% rise. This underwrites the growing importance of this sector, in the economy.

Table 2.5: *Number of Clients*

Year	Big NBFIs	Medium NBFIs	Small NBFIs	Total Sample
2013	517,518	433,023	33,183	983,724
2014	649,003	597,345	32,571	1,278,919
2015	885,527	972,129	59,269	1,916,925
2016	990,333	1,201,632	92,816	2,284,781
2017	1,158,460	1,252,926	81,148	2,492,534

Source: Finance Houses Association, Sri Lanka

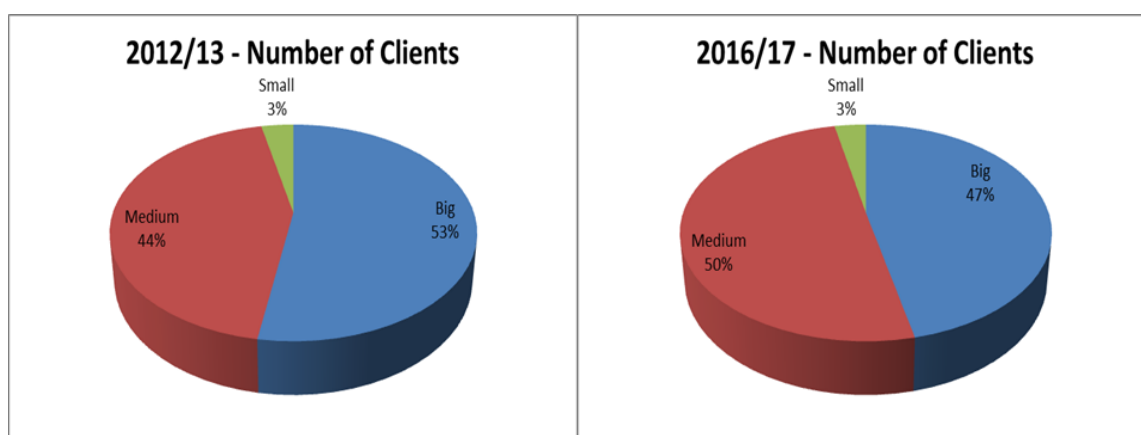
The above Table 2.5 represents the pattern of the aggregate number of clients under each group over the sample period of five years. Among these three groups, it is observed that there is a stable rise in number of clients for big companies, throughout the period. Moreover, it substantiates the fact that the clients are growing in numbers smoothly. It began from 517,518 in 2013, rising to 649,003 in 2014, 885,527 in 2015, and 990,333 in 2016 and finally reaching a high 1,158,460 in 2017. This indicates that big players in NBFI sector contribute to serve the particular segment of the population, who have been left out by the banking sector. This is definitely a singular, significant contribution to the financial inclusion in the country.

Similar to big companies, medium players also show a notable growth over the years. According to Table 2.5, the number of clients has, to some extent, grown fairly well from 2013(433,023) to 2014(597,345), while it suddenly shot up to 972,129 in 2015. Thereafter, it got almost stabilized at 1,201,632 and 1,252,926 in 2016 and 2017

respectively. This may be due to the fact that medium players are getting stabilized with the increased number of clients served. It appears the medium NBFIs have saturated their resources and are stabilizing at this customer base, since the increase from 2016 to 2017 is quite marginal. This mindset, thus, differs from that of the big players. Overall, the medium players are continuing to add value, by providing relatively equal contribution as the big players, by providing financial services and support at a relatively higher level, to strengthen the financial sector of the country's economy.

On the contrary, the total number of clients served by the small companies during the last five years is very small and also depicts an inconsistent growth. This may be due to their small size, coupled with a dearth of expertise affordable to their bigger counterparts, made worse by the comparatively low level in recognition and financial history within the sector. Only 33,183 clients were served by the small NBFIs in 2013, while it slightly dropped by 612 users in 2014. Subsequently, in 2015 and 2016 there was a remarkable upturn to 59,269 and 92,816 respectively. However, again in 2017, it went down to 81,148. This underwrites their vulnerability to the small changes in performance by the medium and big NBFIs vis-à-vis the fortunes in the market. The following Figure 2.7 shows a snapshot view of the number of clients, over past five years.

Figure 2.7: *Composition of Clients of NBFIs*



Source: Finance Houses Association, Sri Lanka

A marked difference in the pattern is clearly visible where the number of people served by the big NBFIs, strangely, descended precisely by 6% from the year 2012/13 to 2016/17. This drop, however, is exactly offset by the medium sized NBFIs, thus ensuring that none of the customers of the total NBFIs were left out due to this drop in the big NBFIs. It ascertains the fact that business growth is evidenced by medium players in the sector, while big players suffered a slight loss of their customers. Small NBFIs' position, however, remains the same in this sector.

Overall improvement of the client base of NBFIs is undoubtedly witnessed during the last five years. The NBFI sector as a whole, catering to the total number of people, is significantly developing on an average annual growth of 27.04%, during the last five years, viz., from 2012/13 to 2016/17. Within the sector, medium sized NBFIs are growing at the highest average rate of 32.14%, with the small NBFIs close on their heels at 31.04%. Further, the big NBFIs also recorded an annual growth, though at a lower level of 22.67%. This underwrites a positive signal to the entire NBFI sector, which is gradually progressing well in providing financial services to the non-bank served people in the economy, in turn leading in the reinforcement of the financial system of the country.

2.5 Conclusion

Loans, deposits and clients, the three key aspects considered in the NBFIs, have grown steadily during the past five years. However there are notable differences between big, medium, and small NBFI categories. Further a larger share of NBFIs' advances is dominated by big NBFIs, even though their significance has marginally reduced, over the past five years. Composition of deposits also indicates a similar

analysis. Further, NBFIs play a role of net depositors in Western Province while they act as net lenders in all the other provinces.

Section 3

Contribution of NBFIs to Sri Lankan Economy

3.1 Introduction

In order to promote economic development, there is a pronounced need to ensure that available resources are used most productively and the financial services are developed further. NBFIs can play a role in developing financial services and through this promote economic development. Thus, it is essential to see how NBFIs contribute to the development of the country.

The commercial banking industry and NBFIs have been changing rapidly over the last two decades in Sri Lanka. These changes have occurred in the structure of the industry as well as with innovations in the delivery of financial services to both individuals and firms. Easy transaction methods including innovations in mobile and electronic banking in addition to large number of automated teller machines around the country have increased the opportunities for financial services to be delivered smoothly. Further, to survive the intense competition, NBFIs try to expand their operations and provide more financial services to people all across Sri Lanka. NBFIs have supported local economic development and growth by supplying funds by channeling savings towards investment across the country.

This section shows how NBFIs contribute to the economy by looking at the macroeconomic factors. At first this section will look at how NBFIs have expanded their operations in the country and as a result of this expansion how NBFIs generate new employment opportunities. This is then followed by looking at how NBFIs

contribute to investments and savings in Sri Lanka. Finally how NBFIs contribute to the economic growth is discussed.

3.2 Branch Expansion of NBFIs - Contribution to Financial Services Expansion in Sri Lanka

NBFIs are financial intermediaries engaged primarily in the business of accepting deposits, and lending advances. NBFIs supplement the role of banking sector in meeting the increasing financial needs of the corporate sector, small businesses, and consumers who are dispersed all over Sri Lanka. This creates the need for NBFIs to expand their services to all provinces in Sri Lanka. This section analyses to what extent this has occurred.

Table 3.1: *Financial Services (Banking and NBFI) Branches in Sri Lanka*

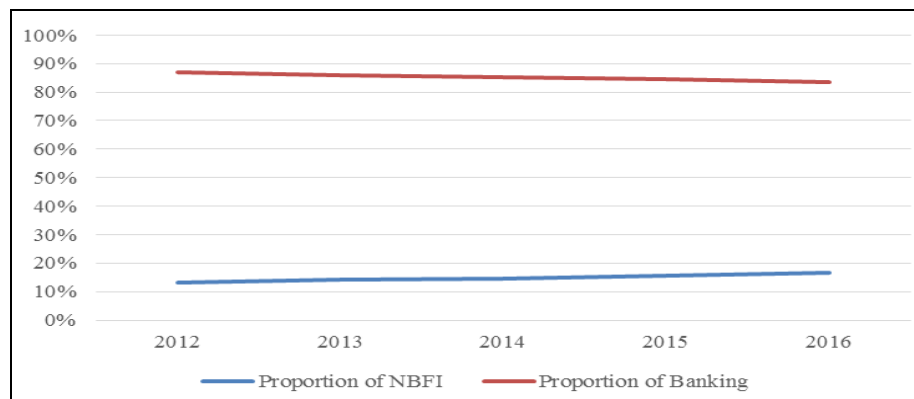
	2012	2013	2014	2015	2016
NBFI Branches*	972	1,060	1,132	1,216	1,313
Total Banking Outlets	6,398	6,487	6,591	6,594	6,659
Total Branches	7,370	7,547	7,723	7,810	7,972

Source: CBSL Annual Reports

Note: *This represents the entire NBFI sector of the country.

As per the Table 3.1, it can be seen that the total number of NBFI branches has expanded by 35% from 2012 to 2016 (972 to 1,313) while the number of banking outlets has grown only by 4% (6,398 to 6,659) over the same period. Although the banking sector still dominates the financial services, NBFIs, as an emerging sector, seems to expand at a faster rate than banks, indicating that the significance of NBFIs is increasing. This is evident in Figure 3.1 as proportion of NBFI branches from the total (banking and NBFIs) has increased from just above 10% in 2012 to just below 20% in 2016.

Figure 3.1: *Total Number of NBFI Branches*



Source: Central Bank of Sri Lanka

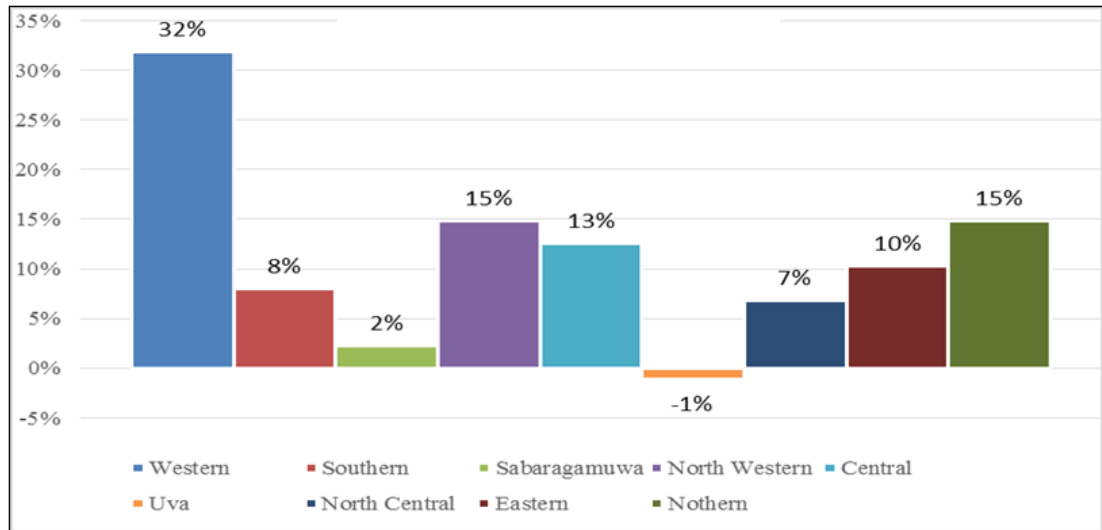
It is important to see how this expansion of branches is distributed across Sri Lanka, as it is important that financial services are developed across all the provinces in Sri Lanka, without being concentrated in one or few. As per Table 3.2 the province with the most number of branches is the Western Province through-out the period. However when looking at the total expansion, it appears that approximately 66%-68% of the expansion is outside the Western Province during the period thus promoting provision of financial services across Sri Lanka (as shown in Figure 3.2)

Table 3.2: *Distribution of Branches across Provinces*

Province	2012	2013	2014	2015	2016
Western	316	344	369	394	427
Southern	112	119	125	134	144
Sabaragamuwa	76	78	83	92	105
North Western	99	112	118	129	140
Central	107	118	128	139	147
Uva	52	51	60	61	66
North Central	69	75	86	89	95
Eastern	78	87	88	98	108
Northern	63	76	75	80	81
Total	972	1,060	1,132	1,216	1,313

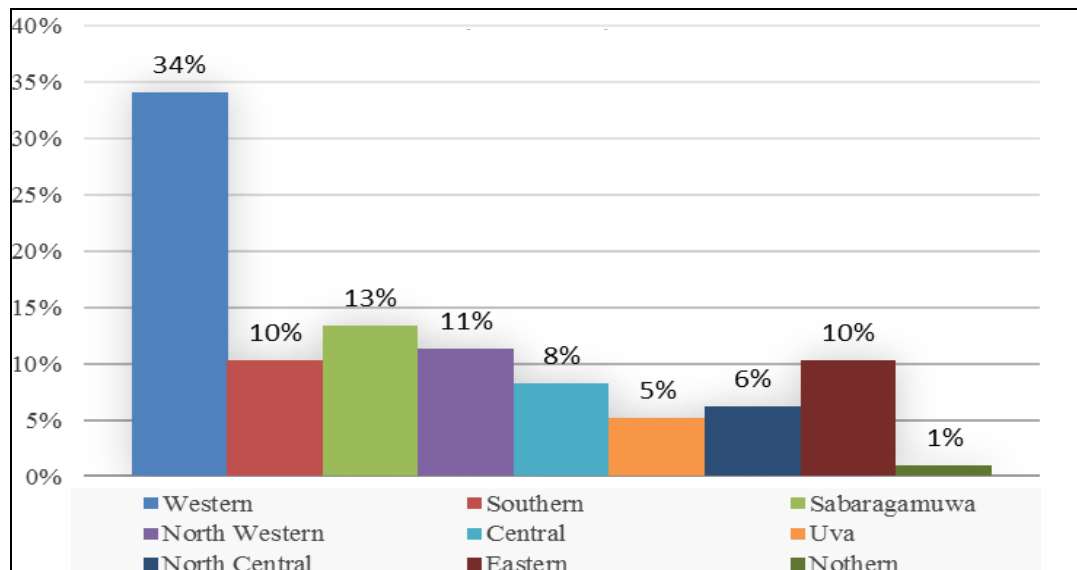
Source: Central Bank of Sri Lanka

Figure 3.2: *Branch Expansion Growth in 2013*



Source: CBSL Annual Reports

Figure 3.3: *Branch Expansion Growth in 2016*



Source: Central Bank of Sri Lanka

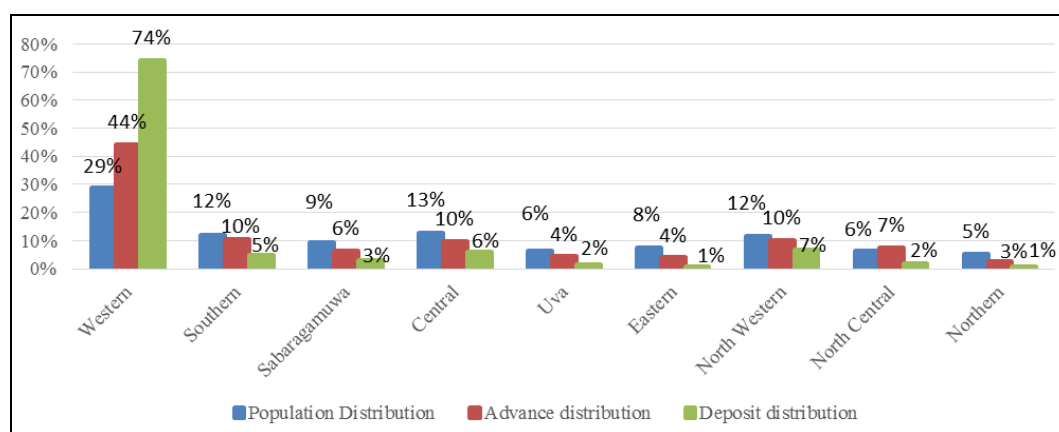
From the above Figure 3.2 and 3.3, it can be seen that branch expansion across provinces in 2016 has become more uniform across provinces (other than Western Province) compared to 2013.

The branch expansion in all provinces helps to mobilize savings across Sri Lanka and also to transfer funds from developed regions to regions which need development for

investment. Thus it is important to see how savings and advances are distributed across the provinces in Sri Lanka.

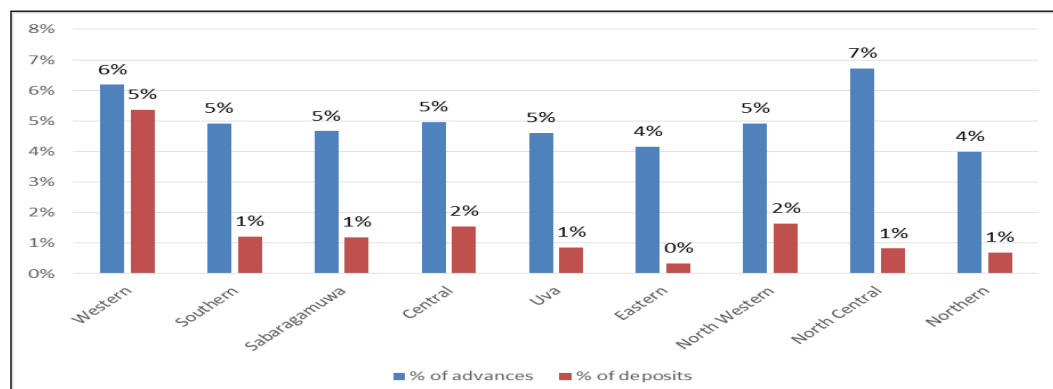
As per Figure 3.4 when looking at the population distribution and how savings and advances are distributed across the provinces, 30% of the population are in the Western Province and they generate approximately 75% of deposits in NBFIs while approximately 45% of advances are also in the Western Province. However in other provinces more advances have been distributed in comparison to the savings. This indicates that savings from the Western Province are used to support lending in other provinces. Thus transferring surplus funds from developed regions to other regions help the less developed regions reducing the disparity between provinces.

Figure 3.4: *Population, Saving, and Advance Distribution across Provinces*



Source: Central Bank of Sri Lanka

Figure 3.5: *Per Capita Advances and Deposits, Proportion of Annual Per Capita Income in 2016*

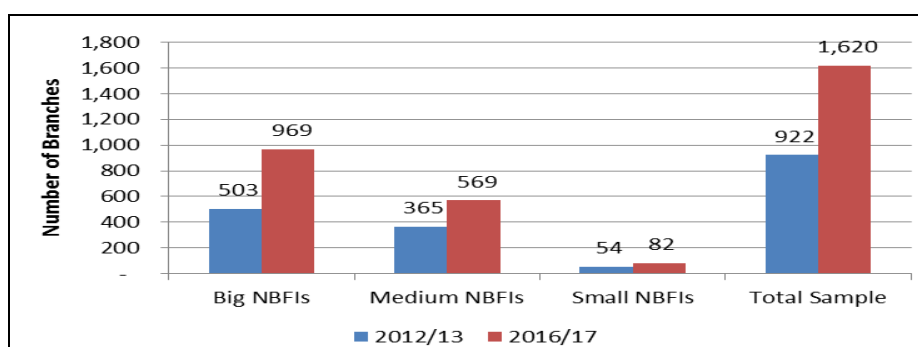


Source: Central Bank of Sri Lanka

Figure 3.5 shows a similar pattern as in the Western Province, compared to other provinces a higher proportion of per capita income is kept as deposits in NBFIs (just above 5%) whereas in other provinces it is just around 2%. However, advances as a proportion of per capita income is much higher in other provinces compared to the savings. This too shows that NBFIs have provided advances in these provinces even without obtaining sufficient savings. This could indicate that comparatively poor households (as the savings are low) have access to financial services, which helps to alleviate poverty in Sri Lanka. Overall, this helps to promote development in these provinces.

There are 1,620 NBFIs' branches, operated by the 25 NBFIs that participated in this study, scattered across the country by 2017 (Figure 3.6). This is approximately a 76% increase compared to 922 branches that existed in 2013. 'Big NBFIs' own 60% of the existing branch network whereas 'Medium NBFIs' and 'Small NBFIs' operate in 35% and 5% of total branches, respectively.

Figure 3.6: *Branch Network among Different Categories of NBFIS**



Source: Finance Houses Association, Sri Lanka

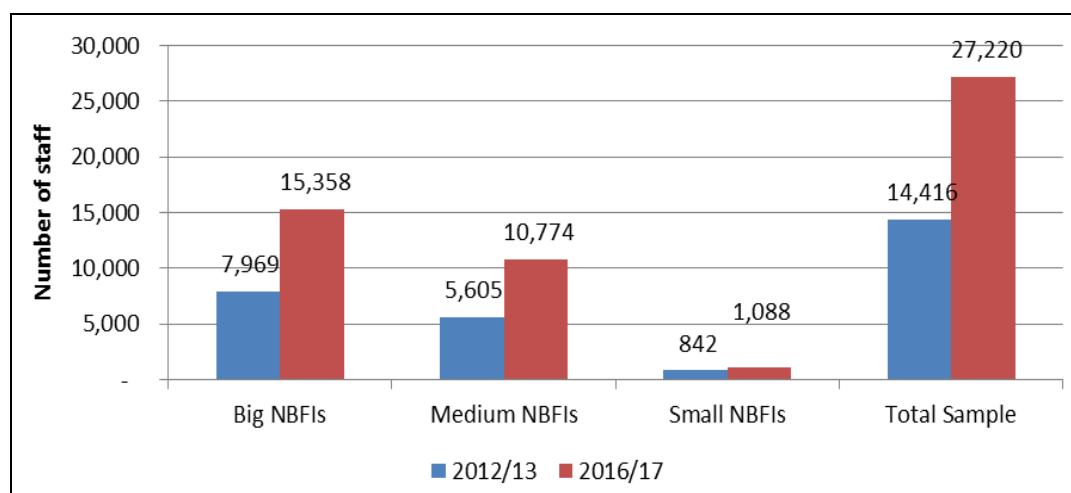
*This includes only the branches of 25 NBFIs that participated in the study.

3.3 Employment Generation by NBFIs

The NBFIs sector employs 27,220 people. This is approximately a 90% increase compared to the number of employments provided by the sector in 2013 (see Figure

3.7). Out of the total direct employments ‘Big NBFIs’ are accountable for 56%, ‘Medium NBFIs’ for 40% and the remaining 4% by the ‘Small NBFIs’.

Figure 3.7: *Direct Employment Generated by NBFIs**

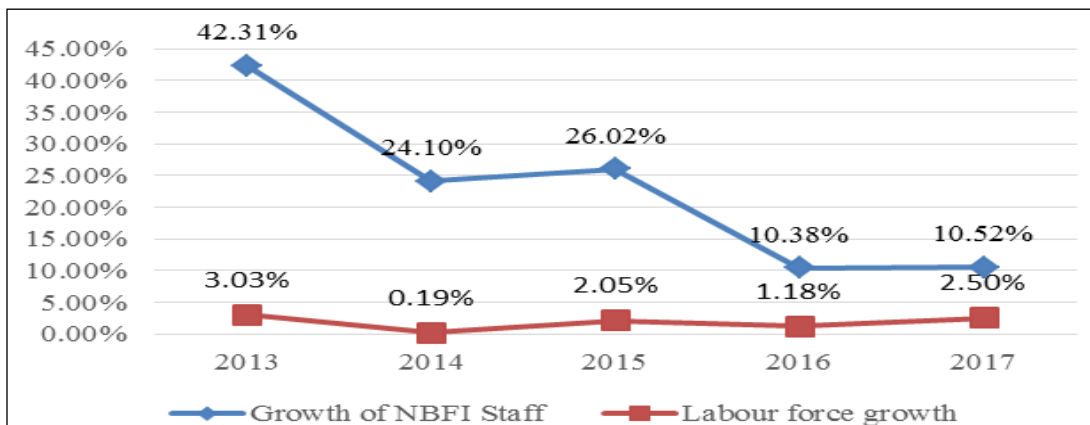


Source: Finance Houses Association, Sri Lanka

*This includes only the branches of 25 NBFIs that participated in the study.

To ensure economic development, generating employment opportunities is essential. The labour force growth in the entire economy has ranged from 1% to 3% over the last five years. As per Figure 3.8, this increase in labour force is supported by NBFIs. The increase in the branches appears to be the major contributor to the increase in the staff in NBFIs between 42% and 10%. Thus the NBFIs support the generation of new employment opportunities for the economy.

Figure 3.8: *Country's Labour Force Growth and Growth of NBFIs Staff*

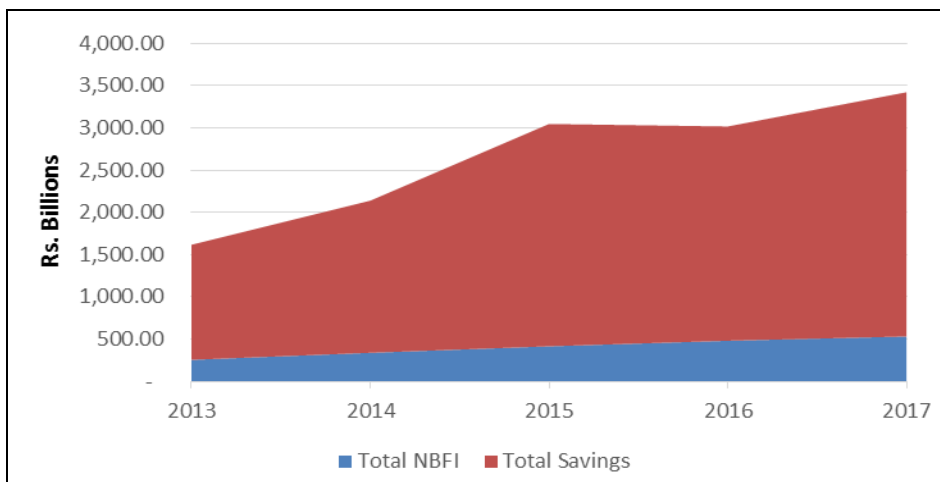


Source: Central Bank of Sri Lanka

3.4 NBFIs' Advances, Investment and Economic Growth in Sri Lanka

For the economy to grow it is essential there is investment. For investments there should be savings. NBFIs contribute to this task by collecting savings and giving out advances. Thus, it is important to see how NBFIs contribute to savings and investments in Sri Lanka.

Figure 3.9: *Deposits in NBFIs and Total Savings in Sri Lanka*

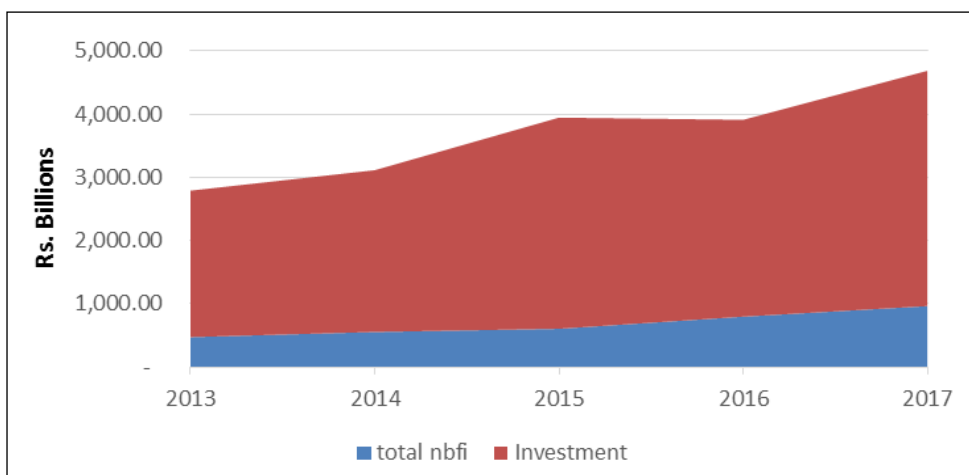


Source: Central Bank of Sri Lanka

From the above Figure 3.9 it could be seen that deposits maintained at NBFIs grow along with the total savings in the Sri Lankan economy. This shows that the savings need of the economy are indeed supported by NBFIs. When looking at advances it

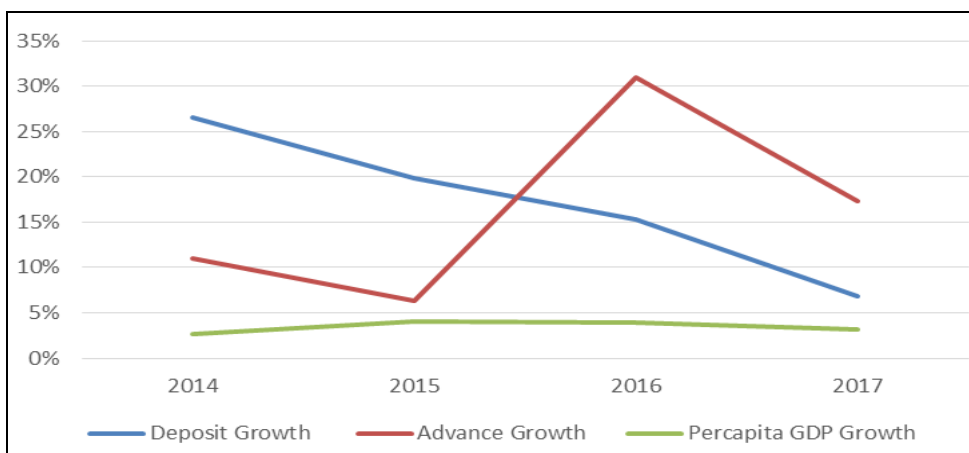
can be observed as per Figure 3.10 that advances given by NBFIs are also growing with the total private investments in Sri Lanka. This shows that NBFIs support the investment needs of the country.

Figure 3.10: *Total Advances by NBFIs and Total Private Investments*



Source: Central Bank of Sri Lanka

Figure 3.11: *NBFIs' Savings, Advances, and Economic Growth*



Source: Central Bank of Sri Lanka

In Figure 3.11 the growth in deposits and advances are in real terms (growth in deposit and advances adjusted for inflation). It can be seen that the deposit growth in NBFIs show a declining trend, from above 25% in 2014 to approximately 7% in 2017. Advances on the other hand show a significant growth in 2016 reaching 30% but reducing to approximately 17%. After 2015 advances growth far exceeds the growth in deposits. This seems to support the findings in Section 2 where NBFIs show a trend

of funding their advances from borrowings. Overall growth in advances contributes to the promotion of investments. These in turn help to sustain economic growth, which appears to be stable at just under 5%, over the period.

3.5 Conclusion

Based on the above analysis it can be observed that NBFIs have expanded during the period. An observable important feature here is that this expansion is not limited to a particular province. Further, the NBFIs also support to transfer savings from Western Province (the more developed province with more saving) to other provinces in Sri Lanka. In addition, this expansion also has supported the generation of employment opportunities for Sri Lankans. Another noteworthy role of the NBFIs is their support to the Sri Lankan economy as a whole, as NBFIs account for a substantial proportion of both the total savings as well as the investments in Sri Lanka. The expansion in these services helps to sustain economic growth in Sri Lanka. Thus NBFIs certainly play a role in enhancing macroeconomic performance in the country.

Section 4

Comparison with Banking Sector: Value Distribution Perspective

4.1 Introduction

This section of the report elaborates on the value distribution of the NBFIs compared to the banking sector. At the outset it explains the operationalization of the value distribution concept. Then it moves on to compare the value distribution of the NBFIs and commercial banks during the period under consideration. Finally, the section concludes with a comparison of the growth of the value distributed to different parties of NBFIs and commercial banks.

4.2 Value Distribution

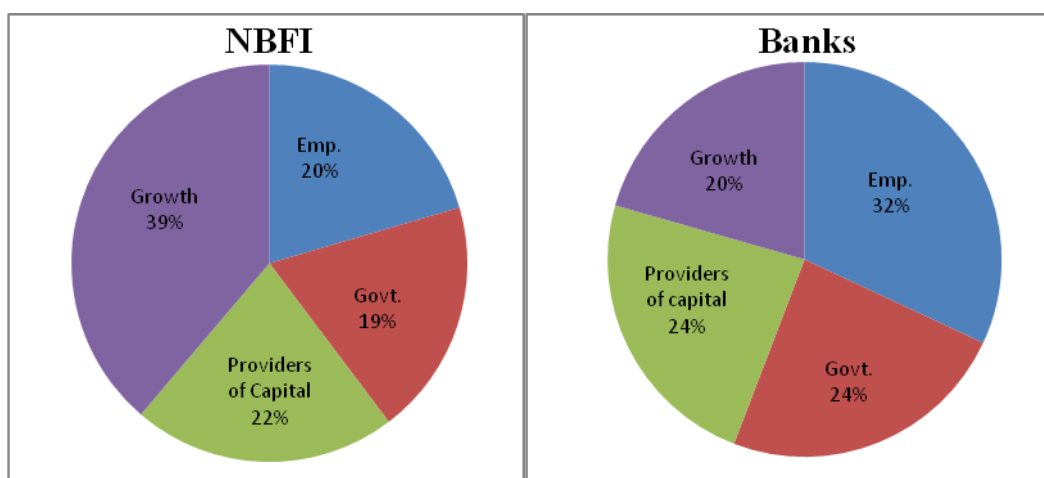
The value created through the business operations can be mainly distributed among four avenues. They are employees, government, providers of capital and the future growth of the firm. The value distributed to employees was calculated based on different payments made to employees. Normally, this includes the salaries and other employee related costs incurred by the institution. The tax paid on the business operations of the institutions was used to calculate the value distributed to the government. Mainly, this includes income tax and value added tax on financial services. The value distributed to the providers of capital was calculated from two perspectives. They were, value distributed to the shareholders and long term debt holders. The value distributed to the shareholders was calculated based on the dividends paid, while the interest payments to long term debt holders were used to calculate the value distributed to providers of capital. The value allocated for the

future expansion decisions of the institution was used to calculate the value distributed to the growth purposes of the institutions. This calculation includes the summation of retained earnings and the amortization based on the depreciation in each year. As explained earlier in this report (see Section 1), the data of over five years (from 2012/13 to 2016/17) from the 25 NBFIs that participated was used for the purpose of value distribution calculations. In order to compare the value distribution of the NBFIs with the banks, eleven (11) licensed commercial (local) banks were used for the aforementioned period. Appendix 3 depicts the list of banks that was used for the comparison.

4.3 Composition of Value Distribution

As per the Figure 4.1, NBFIs distributed more value towards the growth/expansion purposes (39%) compared to the banks (20%) during the 2012/2013 period. It further depicts that, the banks were slightly ahead of the NBFIs in terms of percentage contribution of value to the government and providers of capital during the same period.

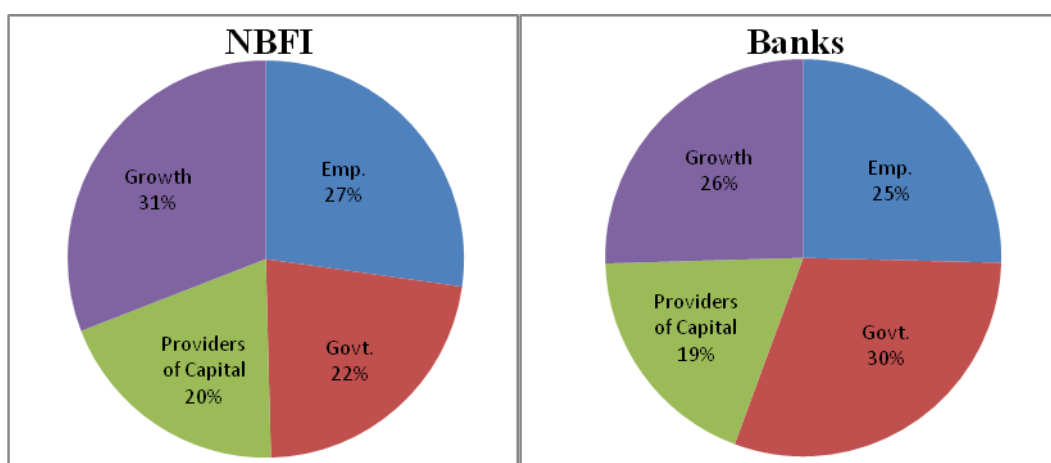
Figure 4.1: *Value Distribution 2012/13*



Source: NBFIs and Banks Annual Reports

In contrast, during the 2016/17 period NBFIs managed to strike a balance in percentage distribution of the value where NBFIs have outperformed the banks in all aspects except for the value distributed to the government (see Figure 4.2). According to the Figure 4.2, NBFIs managed to distribute a higher proportion of value to employees, providers of capital and growth purposes compared to the banks in 2016/17, whereas the latter managed to distribute a significantly higher proportion of value to the government in terms of paying taxes during the same period, compared to the NBFIs. A further comparison of the value distribution of the NBFIs and banks over the period of last five years is summarized in the Table 4.1.

Figure 4.2: *Value Distribution 2016/17*



Source: NBFI and Banks Annual Reports

Table 4.1: *Proportion of Value Distribution by NBFIs and Banks*

NBFIs	2012/13	2013/14	2014/15	2015/16	2016/17
Employees	20%	24%	27%	27%	27%
Government	19%	18%	15%	19%	22%
Providers of capital	22%	27%	28%	20%	22%
Growth	39%	31%	30%	34%	31%
Banks					
Employees	32%	30%	30%	28%	25%
Government	24%	23%	26%	29%	30%
Providers of capital	24%	26%	22%	20%	19%
Growth	20%	21%	22%	23%	26%

Source: NBFIs and Banks Annual Reports

4.4 Growth of Value Distribution

4.4.1 Employees

As per Table 4.2, NBFIs have managed to maintain the growth of the proportion of value distributed to the employees in 2016/17 compared to 2013/14 period (27%). The statistics show that the NBFIs performed better than banks during the last five years in terms of distributing value to their employees. This fact is further proven through the evidence demonstrated in Section 3 of the report where the NBFIs generated more employment opportunities during the last five years period.

Table 4.2: *Growth of Value Distributed - Employees*

	2013/14	2014/15	2015/16	2016/17
NBFIs	27%	28%	33%	27%
Banks	-6%	10%	17%	3%

Source: NBFI and Banks Annual Reports

4.4.2 Government

Even though as discussed earlier in this section, the NBFIs distributed lower proportion of value created to the government in terms of paying taxes compared to the banks, NBFIs have managed to achieve a higher growth over the last five years. Table 4.3 depicts that the NBFIs were able to improve their proportionate contribution

of the value created to the government from 4% (2013/14) to 45% in 2016/17. Whereas the banks only managed to achieve a growth of 22% in 2016/17 compared to a 5% decline recorded in 2013/14.

Table 4.3: *Growth of Value Distributed - Government*

	2013/14	2014/15	2015/16	2016/17
NBFIs	4%	-8%	75%	45%
Banks	-5%	29%	31%	22%

Source: Computed based on NBFI and Banks Annual Reports

4.4.3 Providers of Capital

Table 4.4 depicts that the NBFIs outperformed the banks in terms of the growth of the proportionate distribution of value created to the providers of capital during the period under consideration except for 2015/16. However, a slight drop in this growth was reported in 2016/17 compared to 2013/14 with respect to the NBFIs.

Table 4.4: *Growth of Value Distributed – Providers of Capital*

	2013/14	2014/15	2015/16	2016/17
NBFIs	37%	19%	-5%	22%
Banks	7%	-3%	11%	7%

Source: NBFIs and Banks Annual Reports

4.4.4 Growth

Both the NBFIs and banks depicted a negative growth in value distributed for the growth purposes in 2013/14 period (see Table 4.5). However, both the sectors achieved a gradual improvement thereafter. Despite the fact that the NBFIs distributed a proportionately higher value for the growth purposes in 2016/17 period (see Figure 4.2), the statistics in Table 4.5 show that the banks achieved a higher growth in the proportionate distribution of the value for the growth purposes compared to the NBFIs during the 2016/17 period. This might be due to the fact that the banks distributed more value for growth purposes in 2016/17 period compared to the 2015/2016 period

where a reduction in the value distribution for the growth purposes can be identified with respect to the NBFIs during the same period (see Figure 4.2).

Table 4.5: *Growth of Value Distributed – Growth*

	2013/14	2014/15	2015/16	2016/17
NBFIs	-15%	16%	47%	14%
Banks	-2%	21%	27%	26%

Source: NBFIs and Banks Annual Reports

4.5 Conclusion

Based on the above analysis it can be concluded that the NBFIs focused more towards expanding their business operations by distributing higher percentage of their value for the growth purposes. Hence, it indicates that the NBFIs are attempting to promote the financial inclusion by expanding their business operations (as elaborated in Section 3). Further, as a direct result of this, a higher growth in terms of distributing the value to the government, employees and providers of capital can be expected in the future.

Section 5

Corporate Governance of NBFIs

5.1 Introduction

When focusing on the NBFIs sector in Sri Lanka, it was observed that several Acts and rules govern their corporate governance. Accordingly, it was observed that the Companies Act No. 07 of 2007 (mandatory), Corporate Governance Direction No. 03 of 2008 issued by the Central Bank of Sri Lanka (mandatory), Listing Rules of the Colombo Stock Exchange (mandatory), The Code of Best Practice on Corporate Governance issued jointly by Securities and Exchange Commission of Sri Lanka and The Institute of Chartered Accountants of Sri Lanka (voluntary), and Securities and Exchange Commission of Sri Lanka Act No. 36 of 1987 (mandatory) act as major external steering instruments. Based on the available information the study is focused to review to what extent the NBFIs are adhering to these Acts and rules which are mandatory.

5.2 The Level of Corporate Governance Compliance in NBFIs

In order to explore the adherence to corporate governance practices of NBFIs, two check lists were prepared based on the guidelines of the Code of Best Practice on Corporate Governance issued jointly by Securities and Exchange Commission of Sri Lanka and The Institute of Chartered Accountants of Sri Lanka. Appendix 4 illustrates summary of the workings in calculating the percentage of compliance in each sub section of the major section and the percentage of compliance in that major section from the overall code. When focusing on the analysis which appears in Appendix 4, it was observed that the NBFIs experienced an improvement in adhering

to the Code of Best Practice in Corporate Governance when compared with the compliance level of 2012/13 with 2016/17.

5.2.1 The Level of Compliance in Each Subsection from the Major Section of the Code

In the first evaluation, the improvement in the level of compliance to the Code was checked comparing 2012/13 compliance level with that of 2016/17.

5.2.1.1 Activities of Board of Directors

Accordingly, the first section of the Code, Section (A) on Directors was analysed. The compliance level for the practices in this section was above 80% in 2016/17, except Sub Section A 5, board balance (see Appendix 4). It was identified that there was an improvement in the level of compliance with the best practices on (improvement as a percentage in parenthesis after each practice), board activities (6.45%), clear division of the two positions of chief executive officer (CEO) and chairman (9.67%), chairman ensuring that the board proceedings are conducted in a proper manner (3.23%), board balance (22.66%), appointments to the board (12.11%), re-election (0.90%), appraisal of board performance (24.73%), disclosure of information (3.23%), appraisal of CEO's performance (9.68%) from 2012/13 to 2016/17. What was also noted was that during the period there was 100% compliance to the best practices of, the board having sound financial acumen, and supply of information (see Appendix 4).

5.2.1.2 Directors' Remuneration

The Section (B) on Directors' Remuneration reported a level of compliance above 70% in 2016/17 (see Appendix 4). Further analysis revealed that there was an improvement in the level of compliance with the best practices of, setting a proper

remuneration procedure (9.03%), the level and make-up of the remuneration (19.36%), adhering to the disclosure requirements (9.58%) from 2012/13 to 2016/17 (See Appendix 4).

5.2.1.3 Relations with Shareholders

When focusing on Section (C) on relations with shareholders, it was observed that the level of compliance was above 80% in 2016/17, except Sub Section C 1, where a very marginal drop, almost negligible, is observed in the constructive use of AGMs (see Appendix 4). It can also be seen that there is an improvement in the level of compliance with the best practices of, constructive use of annual general meetings (7.09%), communicating with shareholders (48.38%), from 2012/13 to 2016/17. There was a 100% compliance to the practice of disclosing major and material transactions during the period (See Appendix 4).

5.2.1.4. Information on Accountability and Audit

In Section (D) which reveals information on Accountability and Audit, there was above 90% level of compliance, except Sub Section D 4, code of business conduct and ethics. Further, there was an improvement in the level of compliance with the best practices of, financial reporting (5.07%), internal controls (1.08%) and code of business conduct and ethics (19.36%) from 2012/13 to 2016/17. There was a 100% compliance with the corporate governance disclosure. What was also noted was that there was a 1.61% decline in informing and proper functioning of audit committee, which was resulted from the failure to adhere to the duties of the audit committee and non-compliance issues raised in relation to audit committee report (see Appendix 4).

5.2.1.5 Institutional Investors and Sustainable Reporting

When focusing on section (E) on Institutional Investors, it was identified that the level of compliance was lower than 65% (see Appendix 4), with the best practices of, shareholder voting (19.35%) and adhering to governance disclosures (21.81%) from 2012/13 to 2016/17. Furthermore, Section (F) on Other Investors reveals that the level of compliance was above than 85% except Sub Section F 2, shareholder voting (see Appendix 4). Further there was an improvement in the level of compliance with the best practices of, investing divesting decision (22.58%) and a decline in shareholder participation in AGMs (6.45%). When analysing section (G), it was revealed that the level of compliance was 45% (see Appendix 4). It was seen that the level of compliance improved by of 35.48% in sustainability reporting when comparing 2012/13 data with 2016/17.

5.2.2 The Level of Compliance in Each Subsection from the Overall Code

The second evaluation on corporate governance, attempted to identify the improvement or percentage of decline in the level of compliance in each subsection of the Code from the overall code.

5.2.2.1 Activities of Board of Directors

Accordingly Section (A) on Directors' activities were analyzed. In terms of the activities of the board of directors there was a 0.63% improvement of compliance to the overall code. Further under the criteria of the clear division of the two positions of the CEO and chairman, chairman's assurance that the board proceedings are conducted in a proper manner, the board balance, the appointments to the board, re-election procedure, appraisal of board performance, disclosure of information and

appraisal of CEO's performance the level of improvement in compliance to the overall code were observed to be 0.13%, 0.05%, 2.05%, 0.5%, 0.04%, 1.05%, 0.05% and 0.14% respectively. Further under the sections which assures that the board is sound financial acumen and the ability of the board in supplying information to the board it was observed that all the companies reached the perfect level of adherence to the code in 2012/13 and 2016/17.

5.2.2.2 Directors' Remuneration

Under Section (B) on Directors' Remuneration it was identified that there was an improvement in compliance to the overall code of 0.64%, 1.36% and 0.14% under remuneration procedure, the level and make up of remuneration and improvement in adhering to the disclosure requirement respectively.

5.2.2.3 Relations with Shareholders

When focusing on Section (C), Relations with Shareholders, it was observed that there is an improvement of 0.5% to the overall code in constructive use of AGMs, 1.37% improvement in communicating with shareholders to the overall code and 100% compliance in disclosing major material transactions in 2012/13 and 2016/17.

5.2.2.4 Information on Accountability and Audit

Section (D) which reveals information on Accountability and Audit, there was an improvement in compliance to the overall code of 0.49%, 0.05% and 0.54% in terms of financial reporting, adherence to internal controls, and adherence to code of business conduct and ethics and it was observed that there was 100% compliance in corporate governance disclosure in 2012/13 and 2016/17 years. Furthermore it was also identified that there was a 0.09% decline in adherence to the overall code under

complying with the audit committee requirements. It was observed that this has resulted due to non-adherence and non-disclosure of audit committee related matters.

5.2.2.5 Institutional Investors and Sustainable Reporting

When focusing on Section (E) on Institutional Investors, it was identified that there was an improvement in compliance to the overall code of 0.27% and 0.37% in shareholder voting and adherence to governance disclosures. Furthermore, Section (F) on Other Investors reveals that there is a 0.31% improvement in compliance to the overall code under investing divesting decision but it was observed that there is a decline of 0.09% in compliance to the overall code under shareholders' participation in AGMs. And finally when analyzing Section (G) it was revealed that there was an improvement in compliance to the overall code of 0.50% in sustainability reporting. When considering the overall improvement of compliance to the Code of Corporate Governance, it was observed that the overall improvement in compliance amount to 11.00% which illustrates the increase of adherence from 76.87% in 2012/13 to 87.87% in 2016/17.

5.3 Conclusion

It was observed that the concept of corporate governance of NBFIs sector is directed by different acts and codes of best practices. Through the analysis it was observed that NBFIs experienced an improvement in adhering to the Code of Best practice in corporate governance when comparing the compliance level of 2012/13 with that of 2016/17. Furthermore, the subsections of the corporate governance code such as directors' activities, directors' remuneration, relations with shareholders, information on accountability and audit, institutional investors, information on other investors and

sustainability reporting reflected an overall improvement in compliance with the code when comparing the compliance level of 2012/13 with that of 2016/17.

Section 6

Conclusion

This study on NBFIs sector comprised four key sections which are dedicated to analyse; the performance, contribution to the Sri Lankan economy, comparison with the banking sector in the perspective of value distribution, and evaluation of corporate governance disclosures.

The second section focused on three main performance aspects which are advances, deposits, and number of clients. Advances in terms of value and number of contracts have increased during the past five years from 2012/13 to 2016/17. Small and medium NBFIs have shown a higher growth, compared to big NBFIs, even though the latter are still at the top, based on value figures. Average loan size of big NBFIs is approximately twice the average loan size of medium sized NBFIs. Total deposit value of big NBFIs has shown an increasing pattern due to the contribution of big NBFIs. However, the growth of total deposits of medium and small NBFIs became slightly negative in the year of 2016/17. Loan to deposit ratio for small NBFIs was very high compared to their peer categories, indicating that they have granted more loans per unit of their deposits. Number of clients has increased in all the categories of NBFIs throughout the five year period of study. Based on the geographical distribution of deposits and advances, NBFIs proved to be taking more deposits from the Western Province and lending more to the other provinces.

The third section focuses on the significant contribution of NBFIs to the Sri Lankan economy. Branch network has expanded for the NBFIs sector at a growth rate higher than that of the banking sector, as well as the total number of branches in the whole

financial system in Sri Lanka. This finding is well connected with the concept of financial inclusion in Sri Lanka. Further, this section has investigated savings and advances distribution of NBFIs among the nine provinces of Sri Lanka, together with macroeconomic variables such as population distribution, proportion of annual per capita income, total savings, total private investments, economic growth rate. Findings show that the NBFI deposits and advances have a higher growth compared to the growth of the above mentioned macroeconomic variables. Further, NBFI sector has created more job opportunities outperforming total labour force growth in Sri Lanka.

Even though there are number of ways to compare the NBFI sector with the banking sector, this report has opted for the value distribution approach. This analysis elicited the fact that in 2012/13 the NBFIs distributed a relatively lower share to employees, government, and capital providers vis-à-vis the banking sector. However, NBFIs depicted a higher growth in value distribution for those segments, except the government, during the period under review. Further, their share to the growth purposes of the own firm is higher compared to the banking sector.

The last section evaluates the corporate governance disclosure level of NBFI sector from 2012/13 to 2016/17 in terms of the voluntary compliance to the Code of Best Practices on Corporate Governance 2013. Evaluated disclosure levels are the number of directors, their remuneration, relationship with shareholders, accountability and audit, institutional investors, other investors, and sustainability reporting. It is found that there is a significant improvement in corporate governance disclosure level from 2012/13 to 2016/17.

Overall, this study clearly indicates that there is a gradual improvement in the sector in terms of advances, deposits, and number of clients. This mirrors the higher financial inclusion in the country. Further, this study proves the contribution, though marginal, to the economy, in terms of employment generation, economic growth, and poverty reduction. In this manner, the NBFIs' contribution to the economy underwrites the country's necessity to have them.

The NBFIs sector is a rapidly growing segment of the financial system, albeit it being a small part of the overall financial sector. However, they play a very vital role in catering to a segment of the population, which is not adequately, if not hardly, served by the banks. NBFIs, by providing alternative avenues for investments, play a significant role as financial intermediaries. This creates a source of liquidity in the financial system. It augurs well for the economic growth, by mobilising resources from the savings to the deficit units in the economy.

NBFIs have the ability to meet the diverse financial requirements of business enterprises; especially in microfinance. This is also a growing business for many NBFIs, though it remains under-regulated in the country. They are providing microcredit, gold loans and working capital loans to micro, small and medium enterprises (MSMEs), which constitute the backbone of the economy. By enhancing the opportunities for the MSMEs, the lives of many individuals and communities could be improved. Through this, NBFIs play a vital role in raising the living standards of the less benefitted segments of the population.

However, a quantum development of both, the banks and non-bank financial institutions, is necessary for assuring a strong and stable financial system, for the country as a whole. On the other hand, the major challenges faced by this sector are in

terms of the absence of a clear long term vision as well as a proper policy. Despite the government's intervention and strong presence in the financial system, it has failed to identify the needs of the NBFI sector and uplift it to enrich the niche services offered by them. The lack of standardised practices and poor level of sharing information dampen the potential of this sector. Therefore, there is a strong need for legacy and advocacy role that should be initiated by this sector under the umbrella of the prevailing governance systems.

Data Sources

- Annual Reports from 2012 to 2016 of the Central Bank of Sri Lanka
- The Database of the Finance House Association of Sri Lanka
- The Code of Best Practices on Corporate Governance 2013 jointly issued by the Securities and Exchange Commission of Sri Lanka (SEC) and the Institute of Chartered Accountants of Sri Lanka (ICASL)
- Annual Reports of NBFIs (list in Appendix 1 and 2) from 2012/13 to 2016/17
- Annual Reports of licenced commercial banks (local) (list in Appendix 3) from 2012 to 2016.

Appendices

Appendix 1: NBFIs Participated in the Study and Their Size

In Sri Lankan Rs.

Company	Total Assets as at 31/03/2017	Revenue as at 31/03/2017	Market Capitalization* as at 31/12/2016
1.Abans Finance PLC	7,486,207,457	1,620,506,380	1,675,132,936
2.Alliance Finance Company PLC	30,153,883,226	5,448,105,866	2,180,131,200
3.Arpico Finance Company PLC	11,111,787,324	1,871,249,993	1,337,262,500
4.Associated Motor Finance Company PLC	17,518,039,446	3,108,332,337	2,579,282,465
5.Brac Lanka Finance PLC	12,899,694,788	3,395,013,466	983,498,864
6.Central Finance Company PLC	84,427,254,000	18,145,869,000	21,675,888,800
7.Citizens Development Business Finance PLC	54,233,452,853	8,703,067,323	3,240,945,610
8.Colombo Trust Finance PLC	1,297,776,847	174,117,753	562,882,840
9.Commercial Credit and Finance PLC	82,854,513,000	20,924,522,000	17,907,586,750
10.Commercial Leasing and Finance PLC	88,890,701,072	16,479,306,576	21,046,446,861
11.HNB Grameen Finance Limited*	14,375,830,213	4,485,107,633	-
12.Kanrich Finance Limited*	12,055,666,000	4,369,960,000	-
13.LOLC Finance PLC	122,623,091,840	20,838,393,957	7,280,000,000
14.LB Finance PLC	102,763,035,000	19,363,428,000	17,456,428,500
15.LOLC Micro Credit Ltd**	62,361,638,148	13,985,769,379	-
16.Mercantile Investments & Finance PLC	37,492,664,000	5,645,533,000	7,756,381,800
17.Merchant bank of Sri Lanka & Finance PLC	33,641,437,000	6,099,998,000	2,253,754,219
18.Orient Finance PLC	19,450,029,000	3,309,736,000	1,998,247,995
19.Peoples Leasing & Finance PLC	157,363,397,000	27,732,754,000	27,173,634,690
20.Sarvodaya Development Finance Limited	4,872,892,976	1,096,432,113	-
21.Singer Finance (Lanka) PLC	12,698,479,000	2,610,297,000	3,174,400,013
22.Softlogic Finance PLC	22,189,376,547	4,312,018,690	2,008,413,592
23.The Finance Company PLC	21,821,000,000	3,925,000,000	382,577,131
24.Trade Finance & Investments PLC	3,725,188,536	941,362,186	1,533,610,800
25.Vallibel Finance PLC	30,685,096,000	5,114,694,000	2,509,656,240

Notes: * - Financial information for these companies was not available as at 31/03/2017. Therefore previous year information (31/03/2016) was used for these companies only for this table.

** - This company was not a registered LFC or SLC. However due to the similarity of business functions performed by the company, LOLC Micro Credit Limited was included to the study.

Appendix 2: Classification of NBFIs Based on Total Assets

In Sri Lankan Rs.

Company Name	Total Assets*
Big Companies (Total assets more than Rs. 50 Billions)	
1.Peoples Leasing & Finance PLC	157,363,397,000
2.LOLC Finance PLC	122,623,091,840
3.LB Finance PLC	102,763,035,000
4.Commercial Leasing and Finance PLC	88,890,701,072
5.Central Finance Company PLC	84,427,254,000
6.Commercial Credit and Finance PLC	82,854,513,000
7.LOLC Micro Credit Ltd	62,361,638,148
8.Citizens Development Business Finance PLC	54,233,452,853
Medium Companies (Total assets between Rs. 10 Billions and Rs. 50 Billions)	
9.Mercantile Investments & Finance PLC	37,492,664,000
10.Merchant bank of Sri Lanka & Finance PLC	33,641,437,000
11.Vallibel Finance PLC	30,685,096,000
12.Alliance Finance Company PLC	30,153,883,226
13.Softlogic Finance PLC	22,189,376,547
14.The Finance Company PLC	21,821,000,000
15.Orient Finance PLC	19,450,029,000
16.Associated Motor Finance Company PLC	17,518,039,446
17.HNB Grameen Finance Limited	14,375,830,213
18.Brac Lanka Finance PLC	12,899,694,788
19.Singer Finance (Lanka) PLC	12,698,479,000
20.Kanrich Finance Limited	12,055,666,000
21.Arpicco Finance Company PLC	11,111,787,324
Small Companies (Total assets less than Rs. 10 Billions)	
22.Abans Finance PLC	7,486,207,457
23.Sarvodaya Development Finance Limited	4,872,892,976
24.Trade Finance & Investments PLC	3,725,188,536
25.Colombo Trust Finance PLC	1,297,776,847

Appendix 3: Licensed Commercial Banks (Local)

- Bank of Ceylon
- Commercial Bank of Ceylon PLC
- DFCC Bank PLC
- Hatton National Bank PLC
- National Development Bank PLC
- Nations Trust Bank PLC
- Pan Asia Banking Corporation PLC
- People's Bank
- Sampath Bank PLC
- Seylan Bank PLC
- Union Bank of Colombo PLC

Appendix 4: Summary of Level of Compliance in Corporate Governance Disclosures

	2012/13		2016/17	
	% of Compliance			
Corporate Governance Index	In major section	From overall code	In major section	From overall code
SECTION I - THE COMPANY				
A. DIRECTORS				
A 1 Board	88.02	8.68	94.47	9.31
A 2 Chairman and Chief Executive Officer (CFO)	87.10	1.23	96.77	1.36
A 3 Chairman's Role	96.77	1.36	100.00	1.41
A 4 Financial Acumen	100.00	1.41	100.00	1.41
A 5 Board Balance	56.05	9.04	78.71	11.09
A 6 Supply of Information	100.00	2.82	100.00	2.82
A 7 Appointments to the Board	69.89	2.95	82.00	3.45
A 8 Re-election	87.10	1.23	88.00	1.27
A 9 Appraisal of Board Performance	63.44	2.68	88.17	3.73
A 10 Disclosure of Information in respect of Directors	96.77	1.36	100.00	1.41
A 11 Appraisal of CEO's performance	90.32	1.27	100.00	1.41
B. DIRECTOR'S REMUNERATION				
B 1 Remuneration Procedure	81.94	5.77	90.97	6.41
B 2 The level and makeup of remuneration	54.19	3.82	73.55	5.18
B 3 Disclosure of Remuneration	77.42	1.09	87.00	1.23

C. RELATIONS WITH SHAREHOLDERS				
C 1 Constructive use of AGMs	72.26	5.09	79.35	5.59
C 2 Communication with Shareholders	48.39	1.36	96.77	2.73
C 3 Major and Material Transactions	100.00	1.41	100.00	1.41
D. ACCOUNTABILITY AND AUDIT				
D 1 Financial Reporting	90.32	8.91	95.39	9.40
D 2 Internal Control	98.92	4.18	100.00	4.23
D 3 Audit Committee	100.00	5.63	98.39	5.54
D 4 Code of Business conduct and Ethics	46.77	1.32	66.13	1.86
D 5 Corporate Governance Disclosures	100.00	1.41	100.00	1.41
SECTION II - THE SHAREHOLDERS				
E. Institutional investors				
E 1 Shareholder Voting	41.94	0.59	61.29	0.86
E.2 Evaluation of Governance Disclosures	19.35	0.27	45.16	0.64
F. Other Investors				
F.1 Investing Divesting Decision	38.71	0.55	61.29	0.86
F.2 Shareholder Voting	93.55	1.32	87.10	1.23
G. Sustainability Reporting	9.68	0.14	45.16	0.64
Overall Improvement		76.87		87.87