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## **Executive Summary**

This report intends to carry out a comprehensive strategic external environment analysis for the Sri Lankan banking industry. Both macro and industry environments have been considered to generate insights with respect to the growth, profitability and attractiveness of the industry. Key strategic auditing tools such as PESTEL and Porter's Five Forces have been utilized as the main theoretical models. Secondary data sources such as central bank reports, industry reports, magazines, web sources, etc. have been effectively used to generate insights. With the help of these auditing tools and data sources, it became evident that Sri Lankan banking industry has both positive and negative sentiments regarding the future growth and profit potential. The creativity and effectiveness of individual strategies used by the firms will largely determine the success.

## **1.0 Introduction**

The banking industry in Sri Lanka, as a stand-alone industry can be considered as one of the strongest in the Asian region. However, as a financial institution, the banking industry is closely knit with the financial environment in the country, and based on the recent financial environment evaluation, the industry is faced by a number of factors that causes uncertainty in the overall industry. In Sri Lanka, there are 25 licensed commercial banks and 70% of the total banking sector assets are owned by 5 leading banks. The Central Bank's tight controls are visible within the industry to safeguard the sustainability of the financial system. Domestically important banks which have an asset base over 500 billion rupees are subjected to tighter controls (CBSL, 2017).

The ad hoc implementation of policies (as seen by the sudden introduction of the 5% levy on foreign earnings that was recently implemented, although the policy was struck down a year ago by the courts) and the volatile tax regime of the country has tied the hands of the banking industry as a whole in order to deliver a superior customer experience. The Sri Lankan banking industry is highly regulated and gives little room for its players to deviate from the regulations, after a number of incidents that saw the collapse of financial institutions (i.e. Golden Key). The competition is strong and advanced, and there is very little differentiation in terms of the services provided. The services are all largely similar, and customers are mostly attracted to the brands and the levels of customer service. This understanding about the industry in the country will be useful in evaluating the external environmental factors with relevant to the industry.

## **2.0 PESTEL Analysis of the Sri Lankan Banking Industry**

The PESTEL analysis is used to evaluate the external environmental forces that affect the Sri Lankan banking industry.

### **2.1 Political environment**

The political environment of the country is highly volatile and unpredictable. The recent results of the elections were an unanticipated surprise. The financial decisions and policies are also highly dependent on the dominant political party and thus based on the political environment, the financial policies and practices also tend to change accordingly. This is a major risk factor for any bank that operates in the country as the political decisions can affect the bank in numerous ways that cannot be predicted. In addition, corruption in political environment is a major concern. The recent Central

Bank bond scam was a major incident which badly affected the overall banking industry. The short term interest rates increased unnecessarily as a side effect of this. Therefore, unstable political environment of the country will be less attractive for the long term growth and sustainability of the banking industry.

## **2.2 Economic environment**

The economic environment of Sri Lanka, based on the latest available information, is showing a stunted growth. The increase in cost of living followed by the increased foreign currency outflows have contributed to a devaluation of the rupee, and although the situation seems somewhat stable at the moment, the overall economic environment shows signs of a downward trend. The growth of interest rates for savings and fixed deposits have fallen, as well as increase in the loans taken. The rise of the GDP is only by an average of 3.1% for the year 2017, compared to an average growth that is at 5%. However, existing foreign investments, especially in the tourism industry has contributed towards a development in the sector, and from a banking perspective, the improvement in the tourism industry can prove to be a great foreign expenditure inducer. In addition, the youth of the country seem to show an increasing trend in terms of taking on entrepreneurship ventures as opposed to employment, leading way for banks to improve in the start-up and micro finance industry. Hence, new business opportunities will emerge within the SME sector over the next decade.

## **2.3 Social Environment**

The demographic information of the country shows a major trend that affects all the industries as a whole. The rise of the aging population in Sri Lanka can be spotted as a major demographic trend. Sri Lanka's population, in 10 years' time is predicted to be a higher percentage of the elderly, creating way to a greater popularity of retirement plans and senior citizen banking services in years to come. In addition, the contribution of women to the workforce is at an increasing trend, paving way for more "female centric" banking products. The society in terms of culture is still at stage where saving is considered to be "safe", however the millennial population shows trends of preferring to spend and experience than to save. They also show trends of not wanting own assets, indicating a possible decline in loan schemes for housing and vehicles and a preference towards travel loans.

## **2.4 Technological Environment**

The smartphone penetration rate of the country is at an all-time high and in comparison, to the south Asian region, the technological environment of the country is strong. The introduction of new technologies happen at a relatively fast pace and the adaptation of the customers to these new technologies is also relatively fast. The competition seems to be keeping pace with the advancements as well, and at all times the technological arena is growing and changing in a very dynamic manner. Almost all the banks in the country have gone digital with banking apps and technologies that makes banking faster and more convenient. There is an increasing trend towards locating people towards relationship roles and transferring the transactional roles to the machines. This shows immense technological potential for the automation and digitalization of the banking industry in the country.

## **2.5 Environmental Factors**

The people in the country are showing trends of greater awareness towards environmental and energy conservation, the demand for solar power and energy efficient technologies are on the rise, and the focus on this environmental aspect is reflected in the purchase decisions made by consumers such as the switch to electric cars, avoidance of polythene etc. The people are also becoming more vocal about the role of corporates in environmental conservation and are not afraid to voice their concerns about the same. The new concepts such as paper less banking will receive more attention in years to come. Further, banking industry players will have to actively participate in sustainability endeavours as a competitive tool to get the customer preference.

## **2.6 Legal environment**

The legal environment of the country is largely linked to the political environment of the country and is thus equally volatile based on which party is in power. The banks are all under the purview of the central bank of Sri Lanka and are governed and regulated by the same. Banks fall under strict legal restrictions in terms of employment and leadership as well as service and product offerings. Thus, we can conclude to say that the country has a well-regulated legal environment when it comes to the banking industry but the same is highly volatile based on the political environment and resulting changes in regulations. Therefore, complications may arise based on the so called volatilities and political party changes.

### **3.0 Analysing the Sri Lankan Banking Industry**

The anticipated industry growth, rivalry, profitability and industry competition will be briefly explained within this section.

#### **3.1 Anticipated Industry Growth**

The industry growth highly relies upon the intensity of the Central Bank Regulations and related capital and liquidity requirements. The increased capital and liquidity requirements have significantly reduced the banks' ability to lend aggressively. This can be identified as a major challenge faced by the industry. The full implementation of this new requirement will be fully implemented on 2019 and it will further worsen the situation (NDB securities, 2017). Therefore, the overall industry growth is questionable from a regulatory perspective. However, when considering the growth in tourism and SME sectors, new lending opportunities will emerge in years to come.

#### **3.2 Industry Profitability and Rivalry**

Sri Lanka will slowly move towards the upper middle income category within the next 5-10 years (CBSL, 2017). This will have a positive impact on the banking industry as many consumers will better understand the different services offered by the bank. Thus, industry profitability is expected to grow within the next few years. However, this is largely dependent on other macroeconomic factors. In future, banks will slowly deviate from collateral based banking to cash flow based banking. Further, transparent fee structures and new IT infrastructure may have a significant influence on the competitiveness. These new developments may positively influence the profitability of the banking industry.

#### **3.3 Industry competition**

Introduced by Michael Porter, this model helps us understand the industry competition and attractiveness of the banking sector in Sri Lanka.

##### **3.3.1 Bargaining Power of Suppliers - High**

In the banking industry, the supplier is the customer. The banking industry trades with money, and the supplier will be the individuals who opt to take loans from the bank. Evaluating the banking environment of Sri Lanka, this bargaining power of the customer is very high considering the fact that the number of institutions offering loan options are very high. Thus, the supplier has greater choice in deciding whom to supply to. However, the supplier decision will not be based, to a great deal on the price (which is the interest paid for loans) as the rates are capped, but on his / her customer experience and convenience.

### **3.3.2 Bargaining Power of Customers – High**

A customer of a bank is someone who opts to save his money in the institution. Considering the number of investment opportunities available in the country such as mutual funds, fixed deposits, stock market investments, micro investment schemes etc., as well as alternatives for excess money such as real estate investment and even consumption, the options for the customers are unlimited. Thus, the bargaining power of the customer in the banking industry in Sri Lanka is also high.

### **3.3.3 Rivalry between Existing Players – High**

There are over 50 registered financial institutions in the country providing a myriad of services. However, almost all of them provide the basic savings schemes and loans. In this context, the existing industry rivalry is very high, paving way to higher regulations in terms of interest. This has created an oligopolistic environment, where the players compete on factors other than price (interest).

### **3.3.4 Threat of Substitutes - Medium**

The threat of substitutes can be considered to be medium. The largest threat comes from financial institutions other than banks, investment schemes that offer better returns and micro funds that promise greater flexibility. However, since the higher returns come with a risk and the local customer base can be considered to be risk averse, the substitute risk can be managed by excellent customer relationships and increasing the confidence and reliability of the brand.

### **3.3.5 Threat of New Entrants - Low**

The threat of new entrants to the industry can be considered to be low, based on the legal and regulatory control processes that potential entrants have to go through to enter the industry. In addition, confidence and security plays a great role in the success of a financial institution, giving the potential new entrants a very difficult market to approach.

When looking at the above factors, it is evident that overall industry competition of the Sri Lankan banking industry is high. Therefore future attractiveness of the industry will heavily depend on the creativity of the strategies employed by the banks in uplifting customer convenience and service levels. Customer service, relationships, better use of technology and customer convenience can be identified as the key elements of competitiveness within the Sri Lankan banking industry.

#### **4.0 Critical Success Factor Analysis**

Key success factors can be identified as the most important strategic imperatives which are vital to remain competitive within the industry (Johnson and Scholes, 2008). When it comes to the Sri Lankan banking industry following key success factors can be identified. Most of these factors came out from the above environmental analysis.

- Customer Service and Convenience

When looking at the competitive landscape of the industry, customer service and convenience play a major role in winning customers. This is the main reason why most of the private banks came up strongly against the well-established government banks which overruled the industry in few decades back (NDB Securities, 2017). Many foreign banks such as HSBC and Standard Chartered acquired an immense growth within a short period of time with the help of their quality service and streamlined systems. With the increased busy lifestyles, modern banking customer worry less about age old brands rather they always prefer the banking partner which offers them convenience with trust.

- Personal Customer Relationships

Many recently developed private banks were largely successful due to the quality of their customer relationship management practices. The sales force and front line staff have a key role to play within this aspect. It's not the name of the bank that matter, but the name of the customer service agent and how effective he is in handling customer problems.

- Advanced technologies to optimize the customer value

In this hyper competitive industry, the technological leadership and innovation will help the industry players to achieve an unbeatable competitive position against their rivals. Therefore, banks who will invest in right technologies will undoubtedly take the lead in the industry.

#### **5.0 Summary of the Key Findings**

The above strategic environmental analysis covered both macro and industry environments with respect to the Sri Lankan banking industry. When it comes to the macro audit, most of the factors were against the growth of the industry, especially political and economic factors were identified to have a negative impact on the overall industry performance. However, the growth in tourism and SME sector identified as positive forces. The technological penetration of the country has been accelerated by the income growth and this will also open up all kinds of interesting possibilities for the industry players. According to the industry analysis, it became evident that industry competition is fierce and therefore future profit sentiments will



largely depend on the quality of strategies utilized by the individual firms. With the presence of 25 licenced commercial banks along with the emerging non-banking financial sector have made the industry very high. However, due to the high entry barriers and high regulatory controls the threat of new entrants can be identified as quite low. Overall, it can be concluded that Sri Lankan banking industry has both positives and negatives, but when looking at the future economic growth and development opportunities, the country may require a more advanced banking industry and this is the potential of the industry growth.

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