Central Bank of Sri Lanka

SUSTAINABLE FINANCE ROADMAP 2.0

Scaling-up Action for the Financial Sector of Sri Lanka

Acknowledgment

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About RM 2.0...

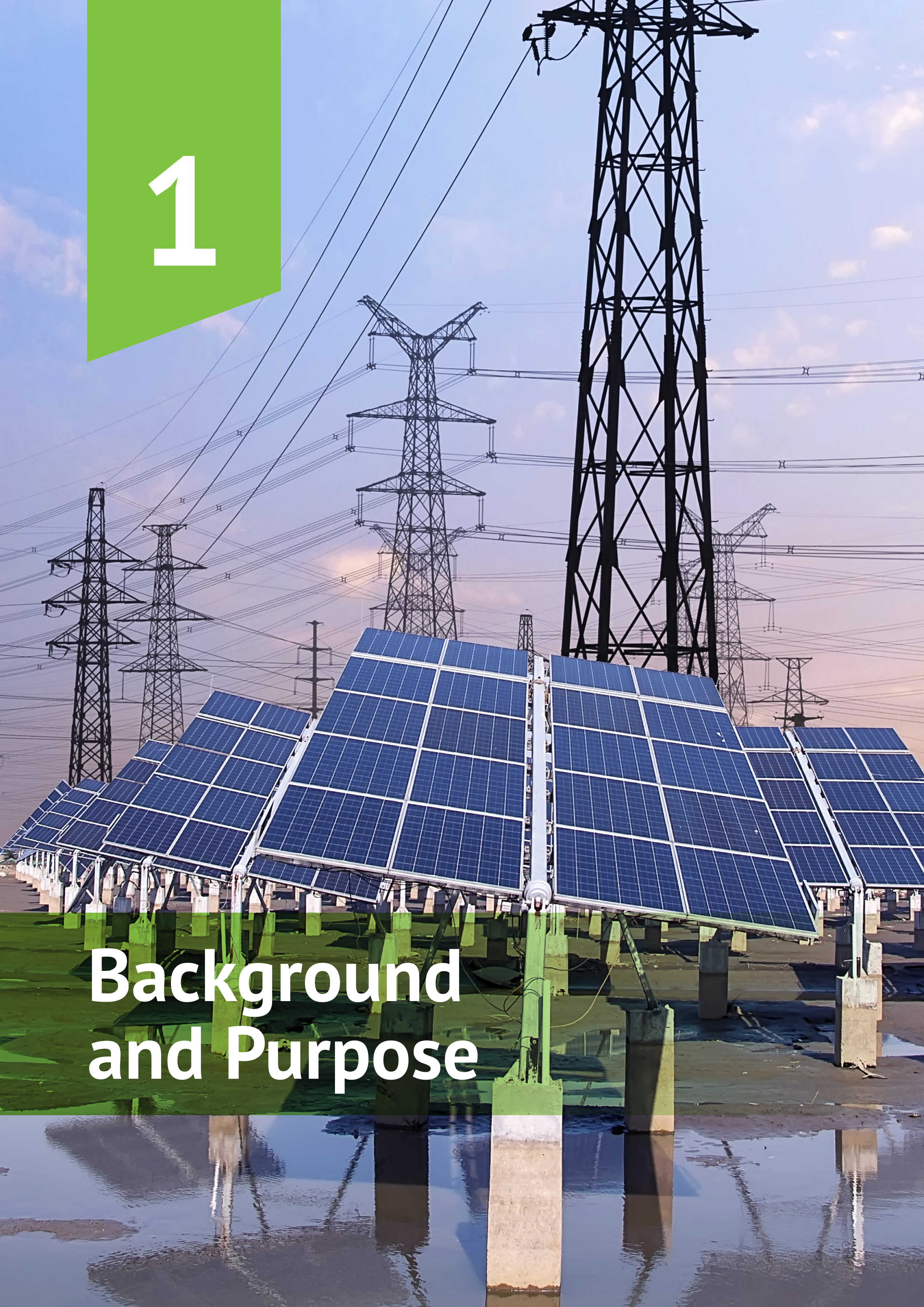
Having completed a majority of the tasks laid out in the first Roadmap, the Central Bank of Sri Lanka along with the other stakeholders, developed the Sustainable Finance Roadmap 2.0 to cater the emerging trends in sustainable financing at the global level and to address domestic market developments and stakeholder demand in line with the Central Bankś objectives of price & financial system stability, as well as its duty on enhancing financial inclusion among Sri Lankan society. Roadmap 2.0 extends its scope to the social aspect of sustainability covering a wider spectrum of economic activities aimed at addressing the need for financial inclusion. Priority actions of the Sustainable Finance Roadmap 2.0 are to be implemented by the Central Bank of Sri Lanka together with the financial sector stakeholders over a period of five years from 2025 to 2029.

Contents

Acronyms

BCBS	Basel Committee on Banking Supervision
CBSL	Central Bank of Sri Lanka
CSE	Colombo Stock Exchange
CSRD	Corporate Sustainability Reporting Directive
DFNS	Debt-for-nature swaps
ESG	Environmental, Social and Governance
ESMS	Environmental and Social Management System
ESRM	Environmental and Social Risk Management
EU	European Union
FCs	Finance Companies
FHA	The Finance Houses Association of Sri Lanka
FIs	Financial institutions
GCF	Green Climate Fund
GHG	Green House Gases
GRI	Global Reporting Initiative
ICASL	Institute of Chartered Accountants of Sri Lanka
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
IGF	Inclusive Green Finance
IRCSL	Insurance Regulatory Commission of Sri Lanka
ISSB	International Sustainability Standards Board
IUCN	International Union for Conservation of Nature
KPIs	Key Performance Indicators
LBs	Licensed Banks
LMFCs	Licensed Microfinance Companies
MSMEs	Micro, Small and Medium Enterprises
NAP	National Adaptation Plan
NBFIs	Non-Bank Financial Institutions
NCCRS	New Comprehensive Rural Credit Scheme
NDCs	Nationally Determined Contributions
NEAP	National Environmental Action Plan

NFIS	National Financial Inclusion Strategy
NGFS	Network for Greening the Financial System
NNDIS	National Natural Disaster Insurance Scheme
SBFN	Sustainable Banking and Finance Network
SDGs	Sustainable Development Goals
SEC	Securities and Exchange Commission
SFDR	Sustainable Financial Disclosure Regulation
SLBA	Sri Lanka Banks' Association
SLCCS	Sri Lanka Carbon Credit Scheme
SLCs	Specialized Leasing Companies
SLFRS	Sri Lanka Financial Reporting Standard
UN	United Nations
UNDP	United Nations Development Programme
UNEP-FI	United Nations Environment Programme - Finance Initiative
UNFCCC	United Nations Framework Convention on Climate Change



1 Background and Purpose

Sri Lanka faces a range of environmental and social challenges that must be addressed to put the country on a sustainable growth path. From the environmental perspective, climate change represents one of the major challenges. Sri Lanka faces significant exposure to climate change. If no action is taken, the losses related to natural disasters are projected to triple by 2050 to reach 1.2% of GDP (from 0.4% today – equivalent to $300 million).[1] Sri Lanka faces multiple environmental challenges, including pollution and deforestation. From 2010 to 2023, approximately 11.5 thousand hectares of natural forests were lost[2], leading to severe effects on biodiversity, livelihoods and vulnerability to climate change. Since 2000, close to 6% of Sri Lanka's tree cover has been lost. While the country has taken important steps towards addressing these vulnerabilities, especially under the National Adaptation Plan (NAP)[3,4] and with its target to halt and then revert deforestation, a lot still needs to be done. The country has also published the National Environmental Action Plan (NEAP) 2022-2030 to address diverse environmental challenges as a pathway to sustainable development.[5]

From the social perspective, Sri Lanka has significantly suffered from the multifaceted impact of the COVID-19 pandemic, affecting the country's economic stability, health system, education, and social dynamics. Reflecting the soaring inflation and the sharp contraction of the economy, the poverty rate more than doubled between 2019 and 2022, rising from 11.3% to 25.0%.[6] By 2023, approximately 7 million Sri Lankans - almost one-third of the population - were considered poor. Unemployment remains high in Sri Lanka, especially, with an unemployment rate that stands at approximately 22% among the youth and young graduates, compared to a global rate of 5%, in 2023.[7] Income disparity has also widened, with urban areas recovering faster than rural regions. A recent study by the Department of Census and Statistics[8] found that the highest 10% of the population accounted for 32.9% of total income, highlighting significant income concentration at the top. The COVID-19 pandemic and subsequent economic crisis also exacerbated several other challenges faced by the Sri Lankan society, such as increased strain on the health system and a rising gender inequality, with women, especially those in informal employment sectors, facing significant economic challenges.

At COP28, Sri Lanka indicated that it needs $100 billion to become a net zero emitter, roughly $4 billion per year from now up to 2050, or approximately 5% of the country's 2022 GDP. **To bridge this financing gap** – which does not include adaptation measures, other environmental actions and social initiatives – **the role of the financial sector is key**. Indeed, alternative sources of funding are limited: the contribution of domestic public finance will remain limited in the years to come in a context of fiscal constraints post-Covid-19 and restricted access to international financial markets after the country's standstill in 2022 and subsequent downgrading of its sovereign rating.

[1] Sri Lanka (2021). Nationally Determined Contribution to the United Nations Framework Convention on Climate Change. 30th July 2021.
[2] According to Global Forest Watch.
[3] Ministry of Mahaweli Development and Environment of Sri Lanka (2016). National Adaptation Plan for Climate Change Impacts in Sri Lanka. Climate Change Secretariat.
[4] The NAP for 2016-2025. NAP tracking tool | NAP Central
[5] An updated NAP and Provincial Adaptation Plans (PAPs) are being prepared.
[6] Ministry of Environment (2022). National Environmental Action Plan (NEAP) 2022-2030: Pathway to sustainable development, ISBN 978-624-5817-24-5. Source: World Bank
[7] According to the Department of Census and Statistics of Sri Lanka
[8] Source: https://www.statistics.gov.lk/Publication/SSR/DCSSSRVol1Issue2Article3?utm

Recognizing the significance of addressing climate-related risks to achieve its dual goals of price stability and financial system stability, the CBSL embarked on its sustainable finance initiative in 2016. The first Roadmap was launched in 2019 to address the need for incorporating environmental sustainability into the financial system to mitigate the adverse impacts of climate change by promoting policy cohesiveness across the financial sector regulators. Subsequent to the launch of the first Roadmap, initiatives such as Sri Lanka Green Finance Taxonomy and the Directions/ Guidelines for banking and NBFI sectors, which predominantly covered the green financing activities, were issued by the CBSL.

Yet, 5 years after the publication of Sri Lanka's first Roadmap for Sustainable Finance[9], **the contribution of financial institutions (FIs) to the country's sustainability targets remains small**. There is, therefore, an urgent need to support the financial ecosystem to better align its funding with not only environmental challenges but social challenges faced by Sri Lanka and to scale up its contribution to the sustainable development objectives of the country.

The first Roadmap highlighted financial inclusion as a core pillar, but its actions were limited to developing the National Financial Inclusion Strategy (NFIS) for implementation. Over the past five years, **stakeholders have increasingly emphasized the importance of addressing the social aspects of sustainable finance**. Furthermore, the new CBSL Act enacted in 2023 acknowledges financial inclusion as a function of CBSL. Consequently, the Sustainable Finance Roadmap 2.0 (hereinafter referred to as the Roadmap) aims to address the social dimension of sustainability in a comprehensive manner, ensuring social justice for identified vulnerable groups and MSMEs to achieve financial inclusion.

Thus, this Roadmap strengthens the existing framework by **taking stock of the trends in sustainable finance and the progress made** since the publication of the first Roadmap, in 2019. These include: i) evolutions in reporting requirements and standards, with an emphasis on those aligned with the International Sustainability Standards Board - ISSB[10]; ii) improved guidance on environmental risk management for the financial sector, e.g. reflected in the recent publications of the NGFS (Network for Greening the Financial System) on climate and nature-related risks; iii) a stronger emphasis on biodiversity and nature finance following the adoption of the Kunming-Montreal Global Biodiversity Framework in 2022, which recognizes the key role of the financial sector in leveraging innovative financial schemes such as green bonds.[11]

Since 2019, the country has also experienced **changes to its policy, economic and environmental context**. For instance, new ambitious targets have been set on climate change : i) a carbon neutrality objective by 2050[13], ii) a scaling-up of renewable energy generation (to represent 70% of electricity generation by 2030[14] , iii) the commitment of no further support to capacity for coal power plants, and iv) an increase in forest cover from 29.7% to 32%.[15] Sri Lanka's updated NDC also highlighted important adaptation priorities, in particular for sectors that are highly exposed to climate change. Priorities include

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9 Central Bank of Sri Lanka (2019). Roadmap for Sustainable Finance in Sri Lanka. April 2019.
10 The IFRS Sustainability Disclosure Standards. .
11 See Target 19 of the Framework.
12 Conditional on international support.
13 2060, in the previous communication to the United Nations Framework Convention on Climate Change - UNFCCC
14 Sri Lanka's NDC, op. cit.
15 Global Carbon Budget.

increasing the resilience of the agriculture sector through the adoption of climate-smart practices, supporting costal protection, the preservation and enhancement of natural ecosystems and biodiversity, among others. With the publication of the NEAP[16], a comprehensive set of actions covering a broad range of environmental topics beyond climate change were highlighted, including ecosystems conservation, biodiversity, waste management, air quality and sustainable resources management.

The work conducted since 2019 on sustainable finance and sustainable development in general is also useful in assessing the progress made and identifying the remaining gaps. Relevant government-related initiatives, in which sustainable financing is a key component, include: i) Climate-Smart Green Growth Strategy & Investment Plan[17] (ongoing); ii) EU Green Recovery Facility (ongoing); iii) Accelerating Industries' Climate Response in Sri Lanka[18]; iv) Sri Lanka's SDG Investor Map[19].

From the socio-economic perspective, as already noted above, Sri Lanka has been profoundly affected by the Covid-19 pandemic and its aftermath, that exacerbated social and economic challenges that were already acute in Sri Lanka. The domestic financial sector must scale its contribution to addressing these social challenges through the provision of adapted products to low-income and vulnerable groups, including MSMEs which falls inline with the CBSL's financial system stability objective which is articulated in its intervention in upscaling financial inclusion, financial literacy and MSME financing.

This updated **Roadmap proposes a clear framework for action** to help accelerate and track progress, identifying priorities for action and determining the role of the financial sector and other stakeholders – such as policymakers – to ensure a successful implementation of these priority actions. This prioritized and phased action plan will allow to accelerate the implementation of the actions initiated by the first Roadmap and will also reflect new and updated priorities. The updated Roadmap emphasizes actions that will support Sri Lanka to position itself as "investment-ready" after its debt restructuring process, with the key guidelines and protocols in place. While acknowledging that scaling the contribution of the financial sector to the country's sustainable development requires a broad multistakeholder and multisectoral approach, this Roadmap primarily focuses on the actions that are under the mandate of the key financial sector regulators.

The rest of this document is structured as follows: Part 2 presents the thematic coverage of this Roadmap – making explicit the contribution of

[16] *Op. Cit.*
[17] Under the GCF Readiness & Preparatory Support Project for Sri Lanka.
[18] Funded by the EU under the GCCA+ initiative, implemented by UNIDO.
[19] Published by the Board of Investments (BOI) Sri Lanka, Sri Lanka Sustainable Development Council (SDC), UNDP, and SDG Impact in 2023. https://sdginvestorplatform.undp.org/country/sri-lanka

sustainable finance to social and environmental objectives. Part 3 investigates funding priorities, with a focus on improving uptake in sustainable financial products. Part 4 addresses the management of environmental and social risks in the financial sector, with a focus on climate risks. Reporting and disclosure is covered in Part 5, with an emphasis on the necessary alignment of FIs on internationally recognized reporting frameworks. Part 6 presents the operational framework for action, a sequenced implementation plan integrating continuing actions from the first period of implementation (2019-2024), and the monitoring strategy.

Key Points

1. Sri Lanka is **highly vulnerable to climate change** and faces several other environmental and social challenges, such as deforestation and its effects. It has taken ambitious environmental commitments, in particular to tackle climate change mitigation and adaptation, as well as deforestation.

2. Addressing these challenges involves considerable investments, which requires a scaling up of the contribution of the commercial financial sector as well as demand-side measures. **Financing needs for climate mitigation actions only have been estimated at roughly 4 billion US dollars per year**, only a small portion of which can come from domestic public finances.

3. CBSL as the apex financial institution took initiative in developing the Roadmap 2.0 with the twin objectives of price stability and financial system stability, which require **intervention for addressing the climate related financial risks (environment) and improving financial inclusion** among various groups of the society (social).

4. The objective of this updated sustainable finance roadmap is to propose a **clear, operational and realistic framework for action** that will support FIs in scaling up their contribution to the environmental and social goals of Sri Lanka.

2

Sustainable Finance: Scope and Priorities

The purpose of this section is to provide an operational definition of sustainable finance, to determine the scope of the Roadmap and to set the thematic priorities for 2025-2029.

2.1 Defining sustainable finance

The 2019 Roadmap defined sustainable finance as the process of "supporting investment across a broad set of sectors required to build an inclusive, economically, socially, and environmentally sustainable world". This new version of the Roadmap specifies further the concept of sustainable finance, by defining it as the process of taking environmental, social and governance (ESG) considerations into account when making investment decisions in the financial sector.[20] This Roadmap is also aligned with the Sustainable Banking and Finance Network (SBFN) definition of sustainable finance, which elaborates on how the integration of ESG considerations in investment decisions may be effectively operationalized, and the stakeholders involved in the process: "[Sustainable finance is] a diverse and evolving ecosystem of policies, regulations, and practices by regulators, supervisors, industry associations, and FIs to manage ESG risks and performance in financial sector activities – including climate and nature-related risks – and to encourage the mobilization of capital to assets, projects, sectors, and business activities that have environmental and social benefits." (SBFN, 2024).[21]

Taking stock of these definitions, this Roadmap considers that:

- Both environmental and social objectives should be explicitly considered and addressed in a sustainable finance strategy. Indeed, the social dimension is one of the 3 pillars of sustainability (along with the environment and economic dimensions) and is well represented across the 17 Sustainable Development Goals (SDGs).
- FIs must help address the main environmental and social challenges faced by Sri Lanka through adapted financial products, an adequate accounting of social and environmental risks in investment decisions and improved market transparency and confidence.
- The social and environmental dimensions of sustainable finance must be reflected in all the building blocks of a sustainable finance strategy: in its drivers (what are the challenges faced, the opportunities), in financial instruments (e.g., loans with social or environmental characteristics), risk management, as well as in reporting and disclosure.

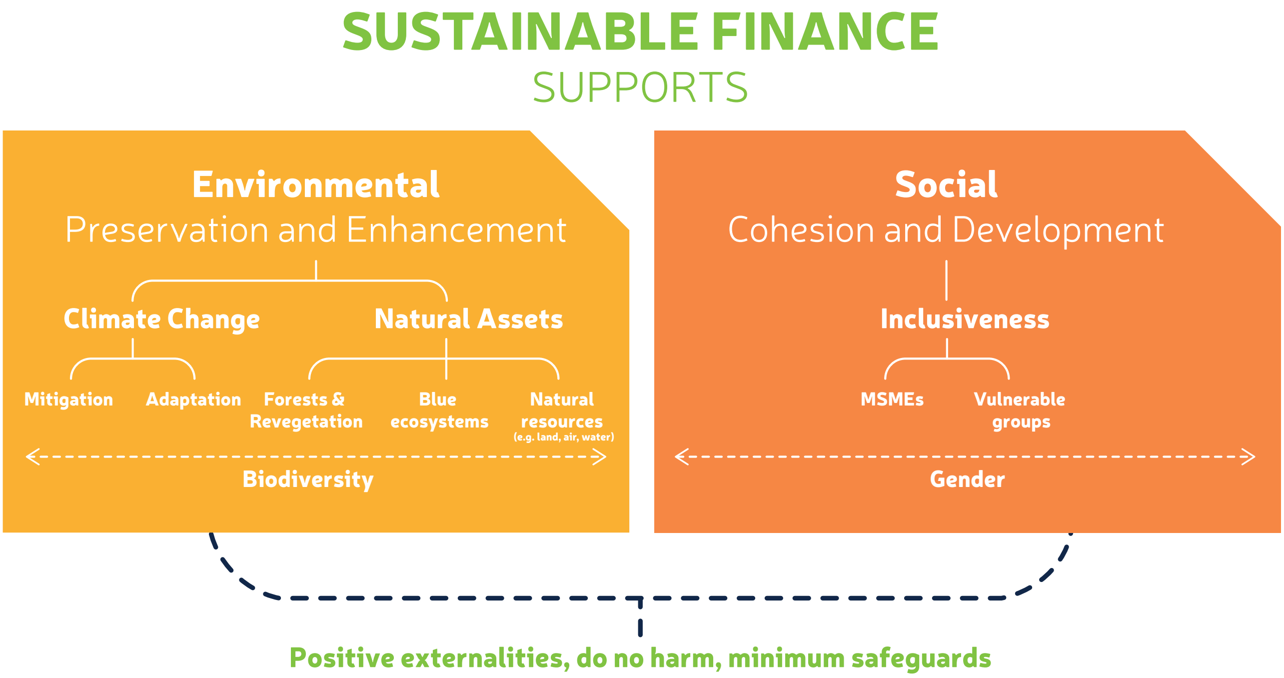
Elaborating on the breakdown of sustainable finance activities proposed in 2019, this Roadmap further specifies the environmental and social dimensions by (see Figure 1):

- Breaking down the environmental dimension into climate change (with mitigation and adaptation being two different sub-domains) and natural assets, with biodiversity as a transversal area.
- Making explicit the contribution of the social dimension to inclusiveness, through support to MSMEs and vulnerable groups (such as youth, elderly, women) along with gender equality with social justice mainstreamed across these different areas.
- Considering the environmental and social dimensions as closely connected and supporting initiatives aiming at leveraging positive synergies between these dimensions or, at minimum, that avoid penalizing the other.

Through this structured approach, Sri Lanka aligns with best practices observed in other countries like Indonesia and follows frameworks recommended by international or multilateral organisations such as the European Commission or the IFC.[22]

[20] https://finance.ec.europa.eu/sustainable-finance/overview-sustainable-finance_en
[21] SBFN (2024). SBFN Measurement Framework, 2024.
[22] Refer in particular to: IFC (2023). Sustainable MSME Finance Reference Guide.

Figure 1 - Thematic Scope of the Sustainable Finance Roadmap



Source: *Authors, adapted from various sources (incl. EU and IFC, 2023)*

By channelling resources to any of these areas, the financial sector will directly contribute to address some of the most pressing social and environmental challenges faced by Sri Lanka. These new or improved investment areas also provide further diversification opportunities to investors, national or international, eager to support projects driven by social or environmental impact.

2.2 Priority areas

Considering the environmental and social challenges faced by Sri Lanka, the initiatives taken and progress made so far, as well as the international commitments of the country (SDGs, Nationally Determined Contribution to the UNFCCC[23]), the following priority areas have been identified for this Roadmap (2025-2029)[24]:

- **Climate change mitigation.** Sri Lanka has defined an ambitious target of increasing the share of renewable energies[25] in the energy mix to 70% by 2030[26], to support its objective of 14.5% reduction in GHG emissions by 2030 and net zero by 2050.[27] Actions aiming at mitigating climate change also contribute to inclusiveness and social objectives, particularly those that support access to sustainable energy and sustainable transport. For example, decentralized thermal energy generation from sustainable biomass, such biochar or pellets, may offer access to cleaner energy for cooking, lighting or air-conditioning to populations and MSMEs located in remote areas. Support to cleaner transportation modes, such as electric vehicles, can foster mobility while contributing to the country's climate goals, air quality, and other environmental dimensions.

- **Climate change adaptation.** As a country highly exposed and vulnerable to the effects of climate change, the National Adaptation Plan of Sri Lanka[28] has identified a series of actions to raise the resilience of communities and ecosystems to climate change, reducing their vulnerability and capturing any opportunities arising from this transition. Sri Lanka's updated NDC has also identified a broad set of adaptation actions covering a wide range of sectors and themes, including agriculture, health, urban planning and tourism, among others. While the updated NDC did not provide a full prioritization of these actions, it did flag investments in new technologies, climate-smart practices, and efficient water management as key to support agriculture productivity, food security and income, and greater resource management efficiency (water, land, food processing and preservation). The updated NDC also highlighted that leveraging traditional knowledge in crop types, cropping systems, water management, food preparation and preservation will be important to build resilience in key sectors such as agriculture and food security, water and forestry. The contribution of the financial sector to these objectives is critical considering the magnitude of the financing needs which, as emphasized in the updated NDC, cannot be born solely through public investment or through financing from climate funds, bilateral and multilateral agencies.

- **Forests and other critical natural assets.** The reversal of deforestation targeted by 2030 (increase of forest cover from 29.7% to 32%) requires the funding of ambitious long-term reforestation and forest conservation projects. Facilitated access to alternative funding sources, such as carbon and biodiversity markets, would support the financing of these long-term projects. The Sri Lanka Carbon Credit Scheme (SLCCS)[29] could be leveraged for that purpose. The enhancement of forests and other natural assets has many benefits, including on climate change mitigation (through increased carbon storage), biodiversity (habitat protection), livelihoods (preservation of agrobiodiversity and its products) and the creation of new sustainable economic opportunities. Regarding the latter, the preservation and promotion of Sri Lanka's blue ecosystems, one of the country's major natural assets, could be better leveraged for sustainable growth, for example through improved marine and coastal management as well as sustainable tourism.

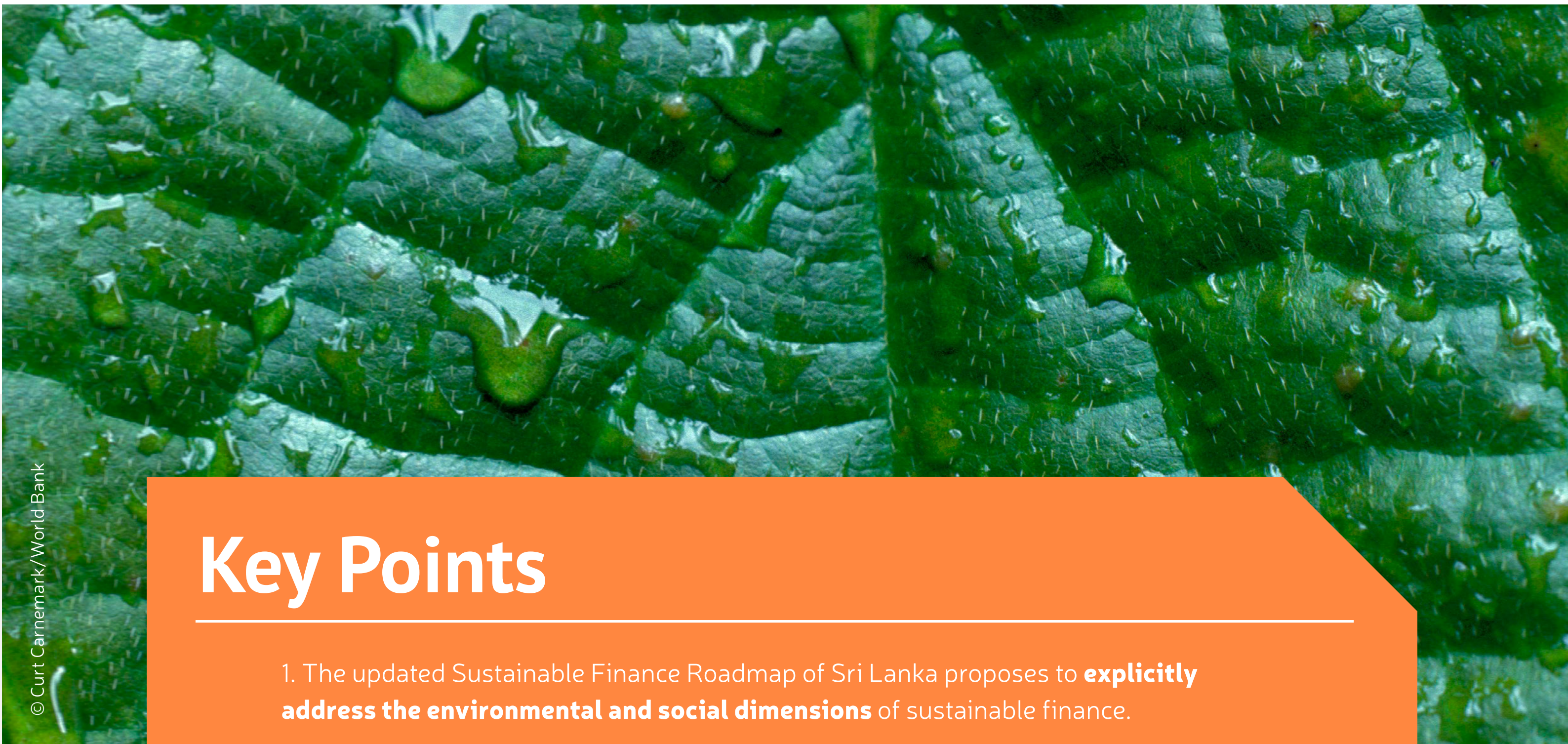
- **Inclusiveness.** The transitioning of Sri Lanka to a middle-income economy requires addressing the socio-economic challenges faced by the most vulnerable segments of its population and economy. In that respect, providing access to the

[23] Sri Lanka (2021). Nationally Determined Contribution to the United Nations Framework Convention on Climate Change. 30th July 2021.
[24] These priority areas emphasize sectors and areas where the country has binding commitments, e.g. through the updated Nationally Determined Contributions (NDCs), the National Adaptation Plan (NAP), and the Technology Need Assessment (TNA) and Technology Action Plan (TAP) to address climate change. This does not mean that other areas will not be addressed or that areas not explicitly mentioned here will not be given priority in future versions of the Roadmap and implementation periods.
[25] Renewable energy sources may include solar, wind, tidal, hydro, geothermal and hydrogen.
[26] Nationally Determined Contributions of Sri Lanka, op. cit.
[27] Both targets are conditional on international support.
[28] op. cit.
[29] https://www.climatefund.lk/slccs.html

formal financial sector to MSMEs, low-income households, youth and women is necessary to support equitable economic growth. As emphasized in the National Financial Inclusion Strategy (NFIS)[30], this requires working on an enabling environment and infrastructure, for example through the development of secure and efficient digital payments, raising financial consumer protection standards, as well as increasing financial literacy among target groups. The second phase of the NFIS[31] will address new policy initiatives aimed at promoting Inclusive Green Finance (IGF), with a particular emphasis on MSMEs.

Beyond financial inclusion, different policies and frameworks adopted by Sri Lanka emphasize the need to mainstream social justice and inclusion in environmental strategies and actions. For example, the updated NDC highlights the importance of mainstreaming gender and social safeguards into adaptation priorities. It also states that adaptation strategies should enable contribution by women as well as provide equal access to benefits, which requires investing in gender-responsive training, promote more entrepreneurial skills among women and facilitate their access to technology and finance.

[30] Central Bank of Sri Lanka (2021). National Financial Inclusion Strategy for Sri Lanka (2021-2024).
[31] The first phase covered 2020-2024.



Key Points

1. The updated Sustainable Finance Roadmap of Sri Lanka proposes to **explicitly address the environmental and social dimensions** of sustainable finance.

2. The environmental dimension is decomposed into 2 sub-dimensions: **climate change and natural assets**.

3. The social dimension explicitly aims at supporting **inclusiveness**, through initiatives targeting MSMEs, gender inequality and vulnerable groups of population.

4. The Roadmap considers as **priorities for 2025-2029** the following areas:
   - Climate change mitigation, through increased renewable energy generation and access to clean energy.
   - Climate change adaptation, through improved resilience and climate-proofing of infrastructure.
   - Forests and other critical natural assets.

3

Funding Sustainable Development

The purpose of this section is to discuss how the supply and demand of sustainable finance products could be incentivized to support a more efficient contribution of the financial sector to the social and environmental priorities of Sri Lanka.

3.1 Market instruments

While Sri Lanka has made progress in developing policy frameworks for sustainable finance, through the 2019 Roadmap, the development of the Green Finance Taxonomy, the Green and Social Bond Framework for the corporate sector, among others, renewed efforts are needed to translate these policies into tangible outcomes. Discussions between CBSL and industry stakeholders, as well as various studies, suggest that the comparatively low adoption of sustainable finance in Sri Lanka can be attributed to several factors. These include a lack of common understanding of sustainable finance, limited awareness among financial institutions (FIs) and end-clients regarding sustainable funding opportunities, and inadequate incentives.

This section addresses market awareness by presenting the major sustainable finance instruments – within the scope of action of the financial regulators – to stimulate their adoption by local FIs, building on the experience of frontrunners in Sri Lanka that have already issued or subscribed some of these instruments (e.g. green loans) and on successful international experiences. The starting point is to agree on a simple and operational definition of sustainable financing: **any type of financing that includes agreed-upon social or environmental eligibility or use of funds criteria.**

Reflecting the interconnection between social and environmental objectives and the necessity to mainstream social aspects into environmental policies and actions, sustainable finance products should seek to leverage synergies between social and environmental outcomes, for example by restricting eligibility or use of funds to projects combining these two dimensions. This could be achieved by combining eligibility conditions (e.g., on income and/or location) with use of funds criteria to ensure that funding supports both environmental and social benefits (for example, the purchase of solar panels for households with income below a given threshold). At minimum, sustainable finance products should contain safeguards preventing harmful impacts on the other dimensions (e.g. social safeguards in environmental projects and vice versa). These safeguards, that apply to all sustainable finance products, should be aligned with recognized international standards, such as the IFC Performance Standards, or the UN Guiding Principles on Business and Human Rights, among others. A comprehensive sustainable finance taxonomy, covering inclusiveness and social dimensions, is an efficient tool to develop the supply and uptake of sustainable finance products and ensure that funding is effectively channelled to projects with social and environmental benefits. Further details are provided on this in Section 5.2.

The sustainable finance instruments with the highest potential for Sri Lanka and within the scope and mandate of CBSL are discussed below.

i) Sustainable loans, deposits and leasing

Sustainable loans are a form of financing that enables borrowers to use the proceeds to exclusively fund projects that make a substantial contribution to environmental and social objectives. These sustainable loans may be directly funded by the proceeds of sustainable deposits, which consist of financial products that enable individuals and organizations to direct their funds to banks and NBFIs (Non-bank financial institutions) to finance sustainable projects. For the purposes of this Roadmap, NBFIs comprise entities regulated by CBSL, finance companies (FCs), licensed microfinance companies (LMFCs) as well as one specialized leasing company (SLC), and also insurance companies, regulated by the Insurance Regulatory Commission of Sri Lanka (IRCSL). Sustainable leasing schemes fund the purchasing of physical assets that generate sustainability benefits, such as electric vehicles, solar panels, and energy-efficient equipment.

Sustainable loans - generally called green loans in Sri Lanka - are one the most common sustainable finance instrument and are already offered by most commercial banks in Sri Lanka. So far, these loans have mostly funded energy efficiency improvements as well as off- or on-grid power generation from renewable sources. This said, some FIs, have started to expand their green loan schemes to other sustainable activities, such as the funding of the local manufacturing of organic fertilizer, pesticides and herbicides. Other thematic priorities for sustainable lending and leasing in Sri Lanka include the funding of climate-smart infrastructure (both retrofitting existing infrastructure and new investments), water management and recycling as well as blue ecosystems, for example through coastal reforestation, revegetation, agroforestry, and sustainable aquaculture.

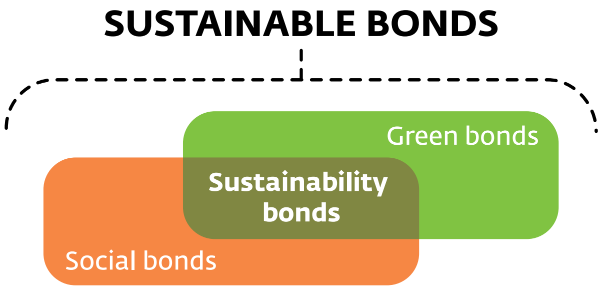
Scaling-up loans or leasing schemes with a social lens, or with combined social and environmental objectives, contributes to improving incomes and access to basic services for vulnerable segments of the population. As noted by the NFIS, scaling-up MSME lending with a specific focus on green and sustainable finance is a necessity to reach social and environmental goals. But these funding instruments remain a challenge for the issuers as they typically rely on subsidized interest rates models. To lower the cost of funding, these subsidized funding sources may be accompanied by risk mitigation mechanisms, alternative credit scoring and eligibility criteria for informal and low-income workers (for example, on income thresholds and tenure) and product innovation (incremental housing loans, for example). Sectors with a high prevalence of MSMEs may be targeted by these actions, such as farming, aquaculture, fishing or tourism, with an emphasis on investments that maximize positive environmental and social benefits (for example, the funding of solar panels for households or small businesses, purchase of electric vehicles for MSMEs, etc.).

To encourage FIs to broaden the scope of green loans and leasing schemes to other sustainable activities and to propose conditions (maximum amounts, tenure) aligned with the characteristics of sustainable investments, further clarity should be provided on the financial risks and opportunities associated with environmental transition. This could be supported by the issuance of directions/ guidelines on sustainable loans, leasing and deposits, and accompanied by awareness-raising and capacity-building actions among target groups to improve the uptake of these products.

ii) Labelled bonds

Green bonds, social bonds, and sustainable bonds constitute the three main families of labelled bonds, also often referred to as sustainable bonds. Green and social bonds aim to raise capital to fund projects with environmental or social benefits, respectively, while sustainable bonds finance projects with both positive social and environmental outcomes. Other labelled bonds can generally be grouped under one of these three families. These include, SDG bonds, a type of sustainability bond that aims at channelling funds to address specific Sustainable Development Goals (SDGs), and Climate bonds, a special type of Green bond, to name a few (see Figure 2).

Figure 2 - Defining labelled or Sustainable bonds



	Social bonds	Green bonds	Sustainability bonds
Use of proceeds	New and existing projects with **positive social outcomes**	New and existing projects with **positive environmental outcomes**	New and existing projects with **positive environmental and social outcomes**
Examples	Improving food security and access to education, health care, and financial services	Climate change adaptation and mitigation, ecosystem protection, etc.	A combination of social and green use of proceeds criteria
Sub-categories	Covid-19 bonds, Gender bonds, etc.	Climate bonds, Blue bonds, Forest bonds, Wildlife bonds, etc.	SDG bonds

	Sustainability-Linked Bonds (SLBs)
Sustainability element	SLBs are performance-based bonds: The bond's financial and/or structural characteristics are linked to the **issuer's achievement of predefined Sustainability Performance Targets** (SPTs)
Examples	Supporting transitioning to renewable energy and improving energy efficiency, using KPIs such as CO_2 emissions; Green construction (KPIs such as % of certified buildings); etc.
Sub-categories	SDG-linked bonds, Social SLBs, Environmental SLBs, etc.

Source: *Authors*

Sri Lanka possesses a regulatory framework for corporate green bonds since 2023[32] and the uptake in these funding instruments is starting to materialize, despite a complicated macroeconomic context. Several of the country's major banks have established their own green or sustainable bond framework, indicating possible issuances in the coming months or years. A bank has issued in July 2024 the country's first green bond (aligned with 2023's green bond framework) for up to LKR 2.5 billion (Sri Lankan rupee denominated bond, unsecured) to finance or refinance green projects in sectors such as waste management, renewable energies or clean transportation, among others. In March 2025, SEC approved the Social Bond Framework for Sri Lanka.

To better position itself in a dynamic market (forecasted to rise by 10% in 2024 - to reach 260 billion USD in issuances in Asia-Pacific[33]), Sri Lanka may develop a more comprehensive **sustainable corporate bond framework** to support issuances for a wider range of environmental and social objectives. This sustainable corporate bond framework must be connected with the updated Green Finance Taxonomy to identify eligible activities for funding.

iii) Debt-for-nature swaps

Debt-for-nature swaps (DFNS) are agreements whereby creditors accept to provide debt relief in exchange for environmental investments. DFNS - which tend to focus on the low and middle-income countries that are the most vulnerable to environmental threats - free up fiscal resources that countries can allocate to environmental projects, without weighing on public debt. This non-traditional source of financing may regain interest in the current global environment, characterized by high geopolitical pressures and economic challenges (post Covid-19 financial impact, high interest rates, inflation and food prices), that are increasing the pressure on sovereigns. DFNS may be further explored as a source of financing for environmental conservation projects in Sri Lanka, in a context of costly access to financial markets and limited fiscal resources.

iv) De-risking instruments

Environmental projects typically have long-term horizons, higher structuring and monitoring complexity, and are often perceived as riskier ventures. This is especially the case for much needed projects involving land-use or primary activities, such as

[32] Securities and Exchange Commission of Sri Lanka (2023). Green Bond Framework. October 2023. Social Bond Framework, March 2025.
[33] According to S&P Global.

fisheries, agriculture, reforestation and environmental conservation in general or new technologies (e.g. carbon capture, hydrogen etc.). A more widespread adoption of de-risking mechanisms, such as credit guarantees or blended finance structures, would facilitate private investment in projects that otherwise would not be considered as commercially or financially viable.

For example, FIs could explore blended finance mechanisms, that combine relatively small amounts of risk-tolerant capital ("concessional capital") with capital seeking market-rate returns to rebalance the risk-reward profile of environmentally and socially focused investments which otherwise would not be attractive for private investors. Blended finance solutions can be structured as debt, equity, risk-sharing, or guarantee products with different characteristics in terms of rates or tenor, for example. The context in Sri Lanka could be conducive for the development of blended finance with the existing regulatory framework on sustainable finance.

v) Sustainable insurance

Sustainable insurance includes insurance against environmental-related risks as well as schemes specifically targeting vulnerable segments of the population and economy which tend to be excluded from the traditional insurance market, such as MSMEs. The most common type of sustainable insurance addresses climate-related risks, such as climate-induced disasters (e.g. flooding) or other events (high temperatures, low precipitations, etc.). These products support the economic viability of projects in fields such as agriculture, fisheries, tourism as well as for other activities or assets (e.g. infrastructure) that are highly exposed to climate and weather-related risks, by reducing the commercial and financial risk of these ventures.

The 2019 Roadmap noted the importance to encourage industry players to create innovative climate and disaster insurance products, such as home insurance to protect farmers and homeowners against the loss of crops and damage to property due to natural disasters. Considering the vulnerabilities as well as the opportunities of the Sri Lankan economy, the development of climate insurance products should be a priority in sectors such as agriculture and fisheries. Beyond climate-related risks, the 2019 Roadmap also highlighted the potential for pollution liability insurance to reduce the risk profile of environmentally sensitive investments.

But the adoption of sustainable insurance products, even of the most basic climate-related insurance schemes such as crop insurance, remains very low. This is largely due to a lack of awareness on these products, a lack of transparency in loss assessments, an underestimation of indemnity payments, and the general indemnity-based nature of the insurance schemes. Improved risk assessments and underlying data should support the offer and pricing of commercial climate-related insurance products, and contribute to improve existing public schemes, such as the National Natural Disaster Insurance Scheme (NNDIS). In that perspective, **insurers and regulators should be exposed to training on climate change data and risk modelling**, leveraging the expertise residing among development partners, industry associations, networks as well as recent work in this field.[34]

The improvement of the regulatory framework on climate insurance and disaster risks is also needed to support the development and uptake of market-oriented risk financing and insurance. The Insurance Regulatory Commission of Sri Lanka, together with industry stakeholders, should **assess the potential for**

[34] For example: Stimson (2022). CORVI Risk Assessment: Western Province, Sri Lanka

adoption of innovative climate insurance products, such as index-based insurance[35], which may improve coverage against major risks and lower entry costs for vulnerable population groups. This work could lead to the development of a fully-fledged **disaster risk finance strategy** based on a risk layering approach and the formulation of **regulations and policies for catastrophe pools, index-based insurance and microinsurance**, focusing on the most exposed sectors such as fisheries and tourism. These regulations should guide FIs on how insurance schemes could be made more accessible to the poorest households as well as to MSMEs, which are also the most exposed to the effects of climate change but are unable to afford the premiums. **Raising awareness on the benefits of insurance** among the most vulnerable groups is a necessity to improve the adoption of insurance products.

3.2 Incentivizing sustainable finance

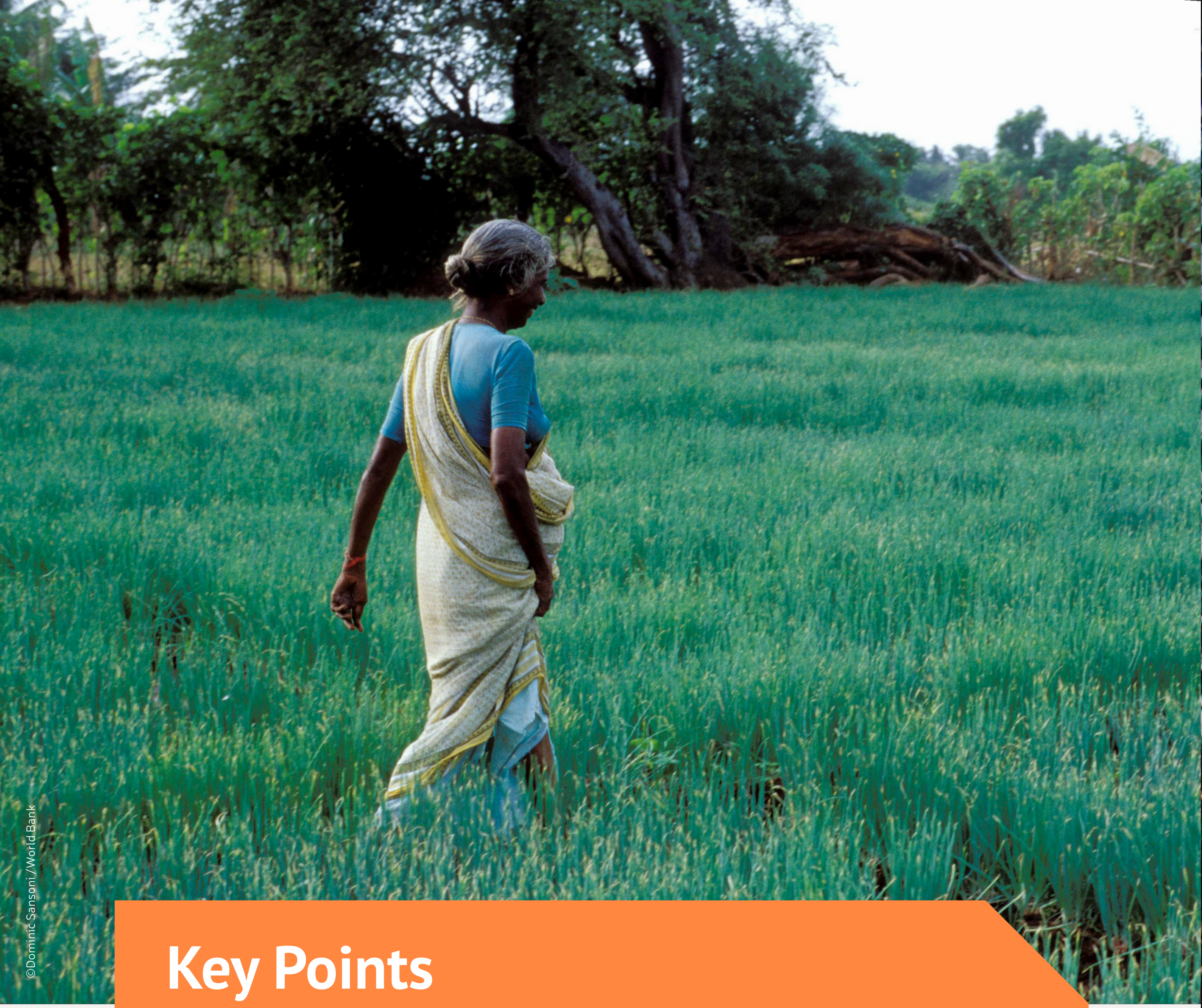
To boost the adoption of sustainable finance products, adapted incentives are needed both for FIs and borrowers or end-clients to increase the attractiveness of these products and compensate for their high perceived risk or structuring and reporting.

Given the current monetary, fiscal and sovereign context in Sri Lanka, the room for introducing new economic incentives or expanding existing mechanisms is limited in the medium-term. Rather, the focus could be placed on greening and improving the inclusiveness of existing incentive schemes - such as introducing or reinforcing green and social eligibility criteria in the New Comprehensive Rural Credit Scheme (NCCRS), on regulatory incentives and on alternative incentive schemes (e.g. reward and recognition).

Regarding **regulatory incentives**, the progressive inclusion of sustainability metrics or requirements in the macroprudential regulation could be envisaged to incentivize the expansion of sustainable portfolios among commercial banks. A flexible approach should be adopted, in particular in terms of FI size or sectoral focus, as some corporate banking business models may restrict lending to specific sectors, e.g. potentially excluding MSMEs or other sustainable investments. A first step could consist **conducting of a comprehensive study on regulatory incentives**, reviewing experiences and best practices in the region, **followed by an industry consultation**.

Reward and recognition schemes also provide incentives for market actors to raise their targets and achievements. Different types of schemes could be envisaged for FIs: i) Industry awards, for example, recognize companies that excel in sustainable finance practices and motivate FIs to adopt more sustainable practices; ii) Sustainability disclosure awards, recognizing firms that excel in transparency and reporting on sustainability metrics, contribute to raise the overall quality of disclosures. This requires prior harmonized guidelines or regulatory framework on sustainability reporting (see Section 5.1 for further details); iii) Sustainability-linked compensation packages for executives that reflect the achievement of sustainability targets which foster the integration of sustainable finance at leadership level, trickling-down to the rest of the organization. This is one of the disclosure requirements of sustainability standards such as IFRS/ ISSB (S1 and S2) or GRI; iv) Sector-wide competitions to develop innovative sustainable finance solutions, spur financial innovation and commitment to sustainability among market participants. Sustainability ratings and performance evaluations must be verified by accredited independent third parties to ensure the objectivity and credibility of the scheme. As a preliminary step, best practices in the region could be assessed.

[35] Also known as parametric insurance.



Key Points

1. The market for green loans in Sri Lanka is growing and maturing, with most commercial banks proposing this type of instrument. However, FIs must be encouraged to scale up their offer **by expanding the scope of existing green loans to other sustainable activities** and to propose conditions aligned with the characteristics of sustainable investments and adapted to MSMEs. This can be achieved through a strengthening of the regulatory framework on sustainable lending.

2. **Raising awareness on existing schemes and improving the capacity of FIs to develop innovative financial products and mechanisms** adapted to the local market, including new insurance products and other de-risking mechanisms, is necessary.

3. **Developing and introducing a coherent incentives package** that do not require fiscal or monetary support, combining regulatory, economic and reward and recognition schemes, is critical to improve the uptake of sustainable finance products, at present.

4. **Strengthening the policy and regulatory framework on sustainable insurance**, especially on climate insurance, to support the adoption on innovative instruments such as index-based insurance.

4

Managing Environmental and Social Risks

The purpose of this section is to discuss how FIs could improve the identification, assessment and management of social and environmental risks, especially those related to climate change.

4.1 The importance of effectively managing environmental and social risks

Managing environmental and social (E&S) risks is critical for FIs to ensure sustainable operations, maintain their reputation, and align with regulatory requirements.

This is not just a regulatory obligation or a desirable ethical practice but a strategic necessity. By integrating E&S practices in their business and corporate procedures, FIs can not only mitigate risks but also capitalize on opportunities in sustainable finance and support their financial performance. Solid E&S practices help align with the growing market for ESG-compliant financial products, reduce credit default risks (e.g. from environmental damages or social disputes), preserve asset value (e.g. from climate-related events that affect the value of physical assets), and reduce operational risks associated with reputation or legal liabilities arising from the involvement of FIs in the financing of controversial activities.

Before supporting FIs introducing adapted environmental and social risk management (ESRM) frameworks and procedures, the knowledge gap on climate and E&S risks in the financial sector, including at regulatory level, must be addressed.

4.2 Strengthening knowledge on environmental and social risks

Sri Lanka is exposed to a wide range of environmental and social risks. Being a tropical island in the Indian Ocean, Sri Lanka is a one of the countries with the highest exposure to climate change. While climate change is already severely affecting the country, its adaptative capacity and resilience is lagging. The Sri Lankan economy - and its FIs - are therefore exposed to a range of other environmental risks that must also be identified, characterized and assessed. These reflect the dependence of the economy on critical natural assets, such as biodiversity, the availability and quality of groundwater resources, soils and the wide range of services provided to the economy by healthy ecosystems (water filtration, coastal protection, prevention of soil erosion etc.). Social risks, which are often even more difficult to characterize, assess and quantify, are highly relevant as well. They refer to the impact on the economy of high poverty levels and high inequality rates.

Much needed investments in sustainable projects, for example in critical resilience-building activities in sectors such as coastal protection, climate-smart agricultural practices, biodiversity and ecosystem conservation, are constrained by a poor understanding of the exposure to different classes of risks (physical and transition risks[36]) and a lack of integration of these risks in project evaluation and in the overall processes of FIs.

Despite their importance for the financial sector in Sri Lanka, there is limited insights and detailed analysis of environmental risks, especially of physical climate-related risks. Several regional climate risk assessments have been conducted recently in Sri Lanka by different institutions[37], but more coherent methodological frameworks (data and models) are needed to provide relevant nation-wide insights on climate risks. In particular, **local expertise on climate risks that is specific to Sri Lanka must be developed** to strengthen risk assessments and allow adequate responses by FIs and supervisors. As noted earlier, improving access to data on natural disasters and strengthening the capacity of FIs on climate risk models,

[36] Physical risks consist in the exposure of the balance sheets of FIs to assets and activities that may be heavily disrupted by environmental or social conditions, such as climate change, in critical sectors such as tourism, infrastructure, housing or agriculture. Transition risks arise from the need to progressively shift towards a more sustainable economy, which implies transitioning from activities with high negative impacts (e.g. fossil fuel energy generation) to those with less negative or more positive contributions (e.g. renewable energies). This process entails specific physical, financial, legal as well as reputational risks for FIs that must be managed.

[37] For example: Capacity Development of Local Governments and UNDP (2023). Climate Vulnerability Risk Assessment in Uva Province, op. cit.

climate scenario analysis and catastrophe assessments is a necessity.

Internal capacity among supervisors on environmental risks – and climate risks in particular - is also limited and must be strengthened, with a focus on developing modelling capacity and stress-tests that account for climate factors. A major output would be the development of a climate risk analysis covering the entire financial sector. This would constitute a foundational element for a system-wide supervisory response on E&S risks and would support outreach and further capacity building among FIs, along with the necessary technical assistance.

With respect to other environmental risks, regulators, FIs, and key government partners may consider connecting with key international initiatives, such as ENCORE[38] (led by UNEP-FI) or under the Network for Greening the Financial System (NGFS)[39], to **gain some exposure to nature-related risk assessment frameworks and their implications for financial regulators**.

4.3 Supporting the integration of environmental and social risks in FI processes

To support a better alignment of the financial system in Sri Lanka with the country's sustainability priorities, FIs must be supported to develop and implement procedures that explicitly account for environmental and social risks in their business and operational processes, starting with the development of organization-level ESRM frameworks outlining the overall approach of FI's to E&S considerations and detailing how E&S criteria will be embedded into:

- Credit-granting and investment processes, for example through adapted credit scoring models;
- Due diligence and monitoring processes, through the use of social and environmental safeguards or do-no-harm criteria aligned with international best practices, such as the IFC Performance Standards, the Equator principles or the UN Principles on Responsible Banking;
- Corporate governance and internal processes, for example through the creation of dedicated E&S teams, capacity-building programs;
- Financial (e.g. prudential ratios) and non-financial reporting and disclosure practices, supporting the alignment with industry standards (e.g. IFRS/ISSB, see Section 5.1). These processes may be supported by the use of specific resources, such as ESG rating systems or external client databases to screen client risks, or technological tools such as remote-sensing or geospatial analysis to assess deforestation or other environmental risks.

Regulators may support this process by **strengthening the policy framework on E&S risk management in the financial sector.** This includes preparing general policy guidelines outlining the approach to E&S management in the financial sector, as well as sector-specific guidelines for high-risk activities, such as tourism, agriculture and fisheries or energy. Best practices and guidelines, such as those recently published by the Basel Committee on Banking Supervision (BCBS), could be leveraged for that purpose.

[38] https://encorenature.org/en
[39] NGFS (2024). Nature-related Financial Risks: a Conceptual Framework to guide Action by Central Banks and Supervisors. July 2024.

Sri Lankan FIs should also be encouraged to leverage (and be trained on) the several international frameworks, policies and operational guidelines that exist on this topic to develop their own ESMSs or to benchmark and improve their existing systems. These include (among others):

- IFC's FIRST (Financial Institutions: Resources, Solutions and Tools) for Sustainability knowledge portal, that follows the IFC Performance Standards.
- IUCN's Environmental and social management system , which is more geared towards project evaluation.
- The Global Environmental Facility's policy on environmental and social safeguards ;
- The Green Climate Fund's Environmental and social management system.

Since the publication of the Sustainable Banking Initiative in 2015 , signed by 18 Sri Lankan banks, which included as its first principle environmental and social risk management, significant progress has been made by the financial sector in Sri Lanka on E&S integration. Most signatory banks – and beyond (e.g. insurance companies) – have introduced ESMS systems or sustainability frameworks. 10 years after the adoption of the sustainable banking principles by all the major FIs of Sri Lanka, it is advisable to conduct a **sector-wide study on the degree of implementation of E&S risk management practices** and to identify the main challenges encountered. Based on this assessment, **a relevant capacity-building plan can be developed** by the regulators to address these challenges and support the sector to align with international best practices. NBFIs, such as insurers and licensed microfinance institutions, should receive special attention in this assessment given the nature of their loan portfolio - with overrepresentation of MSMEs and vulnerable segments of the population - and their comparatively high-risk exposure to social and financial risks. **E&S risk management considerations could be strengthened in the regulatory framework**, by upgrading the existing directions and regulations issued to licensed banks, finance companies and licensed microfinance companies issued under the Banking Act, Finance Business Act and the Microfinance Act, respectively. The introduction of E&S requirements in financial regulations requires a progressive approach, starting with basic disclosure requirements and progressively working towards integrating environmental and social risks in macro-prudential indicators and ratings. A pilot-testing phase may be conducted with selected FIs to identify relevant metrics and testing strategies.

Key Points

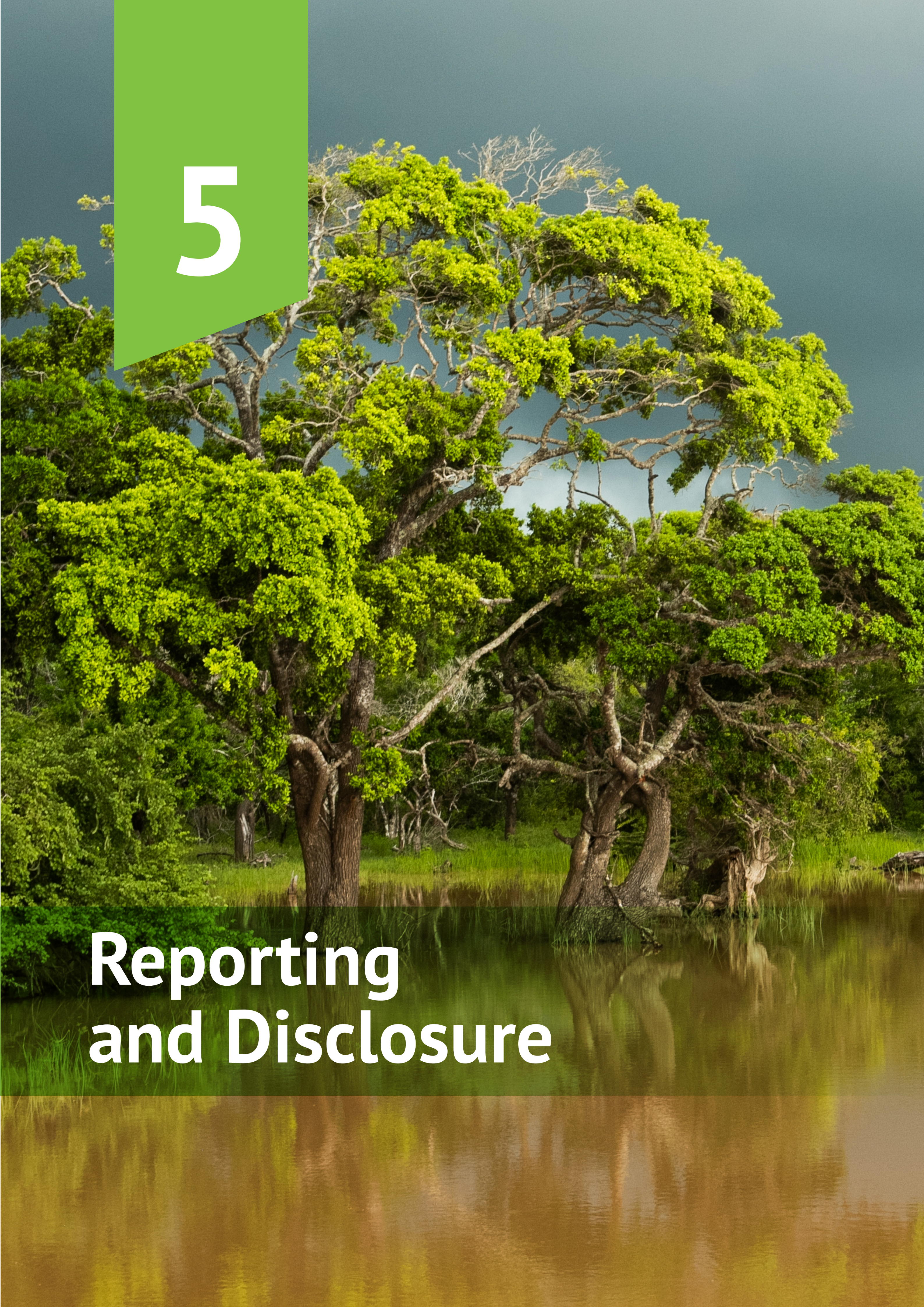
1. **Sri Lanka is among the countries most highly exposed to the impacts of climate change**, such as extreme weather events, as well as to other nature-related risks.

2. **Capacity of supervisors and FIs needs to be strengthened on E&S risks**, and particularly on climate risk analysis and modelling to support the assessment of the exposure of the financial sector to climate risks.

3. It is necessary to **take stock of the progress made during the past 10 years in developing and implementing ESMS frameworks** in the financial sector, to identify the remaining needs and challenges that must be addressed, e.g. through targeted capacity-building actions.

4. **A strengthening of policy and regulatory frameworks on E&S risks** is required to support their integration in the business and corporate processes of FIs.

5. **The assessment and management of E&S risks should be aligned with international ESRM standards** like the IFC Performance Standards or the Equator Principles, and good practice for 'do no significant harm' and minimum social safeguards criteria.



5

Reporting and Disclosure

The purpose of this section is to address the actions supporting quality disclosures on environmental and social risks and impacts, improving market transparency and the alignment of the financial sector with international best practices.

Enhancing non-financial disclosure at both corporate and portfolio-level is critical to improve transparency and confidence in sustainable finance, to minimize the risks associated with social or greenwashing, and to increase the uptake of sustainable finance by investors, lenders and end-clients. Investors and FIs need adequate information on pricing, risks (e.g. climate) and impacts to efficiently align their capital with sustainability objectives.

Disclosure requirements typically cover the management of E&S risks and opportunities, as well as the social and environmental impacts of the organization through its functioning (footprint) and business activities (e.g. of its portfolio).

5.1 Reporting and disclosure standards aligned with international best practices

Comprehensive and systematic non-financial reporting and disclosure is not yet mandatory for all companies in Sri Lanka. In the past couple of years, regulators and industry bodies have made progress on developing guidance for the sector. For example:

- CBSL encourages licensed banks and finance companies to disclose environment and social impact generated from business activities using internationally recognized frameworks, such as the Global Reporting Initiative (GRI) and the recommendations of the Taskforce on Climate-related Financial Disclosures.[45]
- The Colombo Stock Exchange (CSE) amended its listing rules to require all listed companies to have an ESG policy on their website as of 2023 .[46]
- CSE has also published sustainability reporting guidelines, to support listed companies communicate their sustainable performance in a clear, systematic and coherent way.[47]
- The Institute of Chartered Accountants of Sri Lanka (ICASL) has issued localized versions of the latest IFRS Sustainability Disclosure Standards, designated as SLFRS S1[48] and SLFRS S2[49], which will progressively enter into force from January 1, 2025.

Reflecting this evolving and complex landscape (e.g. many reporting standards available, new ones emerging regularly, lack of interconnection between standards), the uptake of ESG reporting and disclosures in the Sri Lankan financial sector (and beyond) remains limited. In a recent survey conducted by the GRI, only 92 companies prepared and disclosed sustainability reports in 2023.[50] To provide clarity on reporting and disclosure in view of the progressive rolling-out of SLFRS S1 and S2, which will become mandatory for all major listed licensed commercial banks, **clear supervisory guidance is needed on how FIs can effectively implement these standards in the financial sector**. This will support the necessary alignment of reporting and disclosure standards for listed licensed banks, and NBFIs with SLFRS S1 and S2 and, beyond, contribute to a widespread adoption of sustainability reporting best practices among FIs in Sri Lanka. Likewise, building on the capacity-building program on SLFRS S1 and S2 currently being developed by ICASL in collaboration with CBSL, training should be extended to FIs to support the effective implementation of these standards, including on background data and information required to support the reporting process.

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[45] Banking Act Direction No.5 of 2022, 8.2
[46] Colombo Stock Exchange (2023). Listing Rules, Section 9.
[47] Colombo Stock Exchange (2023). CSE Sustainability Reporting Guide.
[48] Institute of Chartered Accountants of Sri Lanka (2024). Sri Lanka Sustainability Disclosure Standard S1 (General requirements for disclosure of sustainability-related financial information).
[49] Institute of Chartered Accountants of Sri Lanka (2024). Sri Lanka Sustainability Disclosure Standard S2 (Climate-related disclosures).
[50] As of Sep. 30, 2023. GRI (2023). Sustainability Reporting in Sri Lanka 2023: Connecting the dots.

A working group involving supervisors, relevant line ministries and associations (e.g. chartered accountants) may be set-up to monitor developments on sustainability disclosures and provide updated guidance and capacity-building to stakeholders in the financial sector. Initiatives that may be reviewed and monitored by this working group include - among others - IFRS Sustainability Disclosure Standards (S1 and S2), GRI, EU's Corporate Sustainability Reporting Directive (CSRD) and its two connected regulations: The Sustainable Finance Taxonomy Regulation and the Sustainable Financial Disclosure Regulation (SFDR). Other initiatives such as the IFC's transparency toolkit may also provide inputs for capacity-building actions.

5.2 Expanding the scope of the Green Finance Taxonomy

A sustainable finance taxonomy is an efficient tool to develop the supply and uptake of sustainable finance products. By identifying the activities that can be considered as sustainable by the regulator, clarity is provided to the market on what is and what is not sustainable, reducing the risk of social or green washing and improving overall confidence in sustainable finance. The taxonomy also supports the development of sustainable finance products: a climate loan, for example, can simply be defined as a loan that funds activities falling under one of the climate mitigation or adaptation categories of the taxonomy and respecting potential technical criteria and minimum safeguards (e.g. social).

CBSL has published a Green Finance Taxonomy[51] in 2022, which constitutes a milestone in the development of sustainable finance in the country. This taxonomy covers a wide range of environmental activities and sectors (e.g. forestry, agriculture, energy, transport, tourism, etc.). There is now a need to conduct an **industry-wide study on the adoption of this Taxonomy to identify the issues and gaps encountered** during this first phase of implementation. Based on the findings of this study, the Taxonomy may be revisited, to better align it with this updated Roadmap. First, **its thematic scope could be expanded by including key social activities** and ensuring that critical environmental activities are adequately reflected, for example those related to climate change adaptation. Second, the further elaboration of do-no-harm or minimum safeguards criteria could also be considered.[52] Third, improving the interoperability of the Sri Lankan taxonomy with those of major partners and investors, such as the EU Sustainable Finance Taxonomy, would also be useful to ease reporting, support comparability and improve the attractivity of Sri Lankan FIs for international sustainable capital.

[51] op. cit.
[52] Beyond the general principles already mentioned in the current version of the taxonomy.

5.3 Enhancing ESG tools and systems to support reporting

Quality ESG reporting relies on the availability of relevant frameworks, data, tools and systems. In that area, a useful action would be to support a **systematic tagging of loans and underlying asset collateral** according to their sustainability attributes (e.g. green, climate, social, etc.), using the Green Finance Taxonomy as reference for the categorization. This would generate data and insights to improve the tracking of sustainable portfolios within FIs, to streamline and improve reporting (for example, the computation of prudential metrics covering climate or other environmental risks), and to support further impact measurement at portfolio level. This action was already highlighted in the background report of the Green Finance Taxonomy[53]: "Banks are required to refer to the taxonomy to "identify and tag" their green-loan assets, which aggregate to their green credit or loan statistical data at the bank level, before submitting the information to financial regulators to track their annual performance". Sri Lanka could build on existing initiatives from large EU banks, among other initiatives. In Nigeria, for example, a review of green tagging in the banking sector has been conducted as a follow-up to its sustainable finance roadmap published in 2018.[54] **An initial scoping and feasibility study could be conducted on green or sustainable tagging**, especially looking at the practical implications of these systems for Sri Lankan banks. This study may be followed by a pilot-phase with selected voluntary FIs, before a progressive roll-out to the entire sector, which would require the preparation of specific guidelines or an update to existing E&S and disclosure requirements.

On the longer term, leveraging the possibilities offered by Fintech could be explored, particularly in relation to: i) standardization and automatization of ESG scoring procedures; ii) creation of ESG indexes; iii) environmental impact calculations (e.g. carbon accounting); iv) automatic matching of investments/projects with social and green taxonomies, and; v) efficient matching between project supply and demand, for example through e-platforms. These innovations could be tested at small-scale, before an eventual scale-up.

5.4 Beyond compliance: reporting on impact

The financial sector is starting to move beyond ESG risk management and disclosure **to measuring and reporting on sustainability impact**. While this involves higher complexity and costs, as it requires detailed information sources and solid skills in impact measurement and modelling, encouraging these initiatives could further improve market transparency and support the positioning of FIs in Sri Lanka as frontrunners on sustainable finance.

[53] Central Bank of Sri Lanka (2022). Sri Lanka Green Finance Taxonomy – Background Report.
[54] CBI et al. (2022). Nigeria Tagging Green Banking Review. February 2022.

This, in turn, contributes to attract further funding - including international capital - to address the country's social and environmental goals e.g. through sustainable bonds or blended finance structures.

Examples of impact metrics include company-wide sustainability indicators, such as ESG indexes, carbon footprint assessments (including through the accounting of Scope 3 emissions) as well as portfolio-level impact assessment (e.g. on GHG or biodiversity), among others. These initiatives are generally conducted by FIs that have clear sustainability targets (e.g. net zero etc.) and commitments to report on those to their clients, shareholders and internally. In Sri Lanka, very few FIs have conducted a comprehensive assessment of their carbon emissions, in support to carbon-neutrality targets.[55] Elsewhere, examples of FIs that are leading in this field include ABN AMRO (among others), which assessed the impact of its activities and investments on biodiversity.[56] It is also worth mentioning that the SBFN is currently developing a list of Key Performance Indicators (KPIs) to support FIs measure, track and report on their impact.

These more sophisticated impact measurement and reporting initiatives may be reviewed at a later stage, leveraging best practices from frontrunners in Sri Lanka and assessing the extent to which they could be extended to the rest of the financial sector through guidance documents and capacity-building.

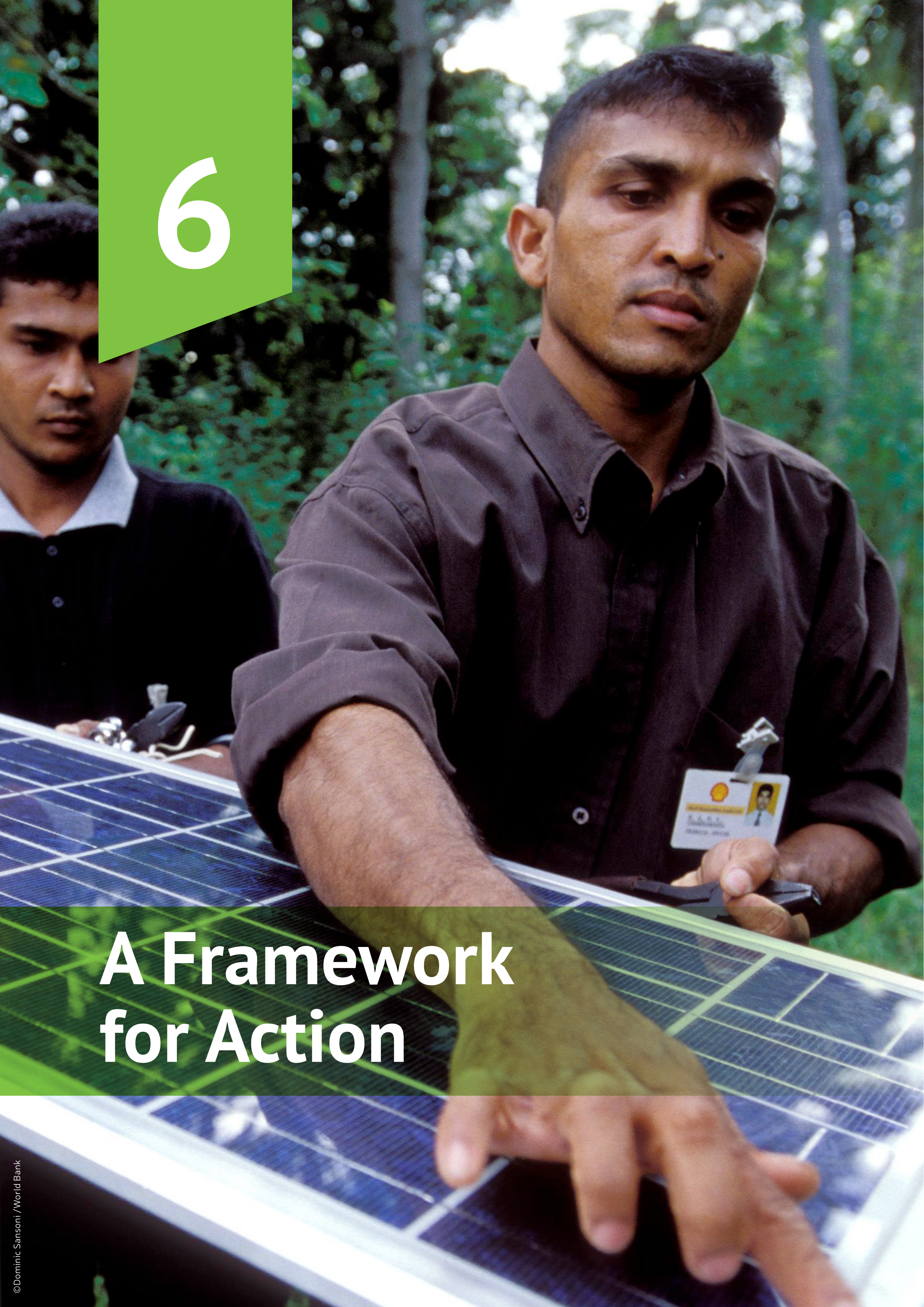
[55] BOC is one of the few FIs that conducted such an assessment, covering Scope 1, 2, 3 and 4 emissions and meeting the requirements of ISO 14064-1:2018.
[56] ABN AMRO (2021). ABN AMRO's impact on biodiversity.

Key Points

1. Clear **supervisory guidance is needed on how FIs can effectively implement SLFRS S1 and S2 standards** to accompany them in the progressive roll-out of these new sustainability disclosure standards aligned with international best practices (IFRS).

2. The Green Finance Taxonomy is a key tool for ESG reporting and disclosure. Based on the findings of an assessment study covering its first few years of implementation, the Taxonomy could be strengthened by **expanding its scope to social categories**, enhancing guidance on **do-no-harm criteria or minimum safeguards** and improving **interoperability and comparability with taxonomies in major markets.**

3. A **scoping and feasibility study on sustainable or green tagging of loans and underlying asset collateral** could be conducted, followed by a pilot-phase and guidelines on sustainable tagging, to foster the adoption of the Green Finance Taxonomy and the generation of data and insights on sustainable finance.



6

A Framework for Action

The purpose of this section is to present a clear, realistic, prioritized and phased implementation plan. This section also exposes the approach proposed to effectively monitor the implementation of the priority actions.

6.1 Priority actions and implementation plan

The priority actions presented here were identified based on:

- **Relevance:** actions that contribute to key sustainable development priorities of Sri Lanka.
- **Impact:** actions through which FIs can have a significant impact or contribution.
- **Measurability:** actions that can be effectively tracked by the relevant stakeholders.
- **Readiness:** especially at local level, as the effective implementation of the actions is critically determined by the local context. This criterion can be broken down into 1) Technology and market readiness, 2) Data and information readiness, and 3) Capacity readiness (human, infrastructure and other resources).

The implementation plan proposed here covers the period 2025-2029.

FUNDING SUSTAINABLE DEVELOPMENT

Actions		Action Items	Status	Key Stakeholders	2025	2026	2027	2028	2029
1	Develop the regulatory framework on sustainable lending	a. Prepare guidelines for FIs on sustainable loans, deposits and leasing	Ongoing	**CBSL**	●	●			
		b. Conduct awareness-raising and training sessions for FIs on sustainable lending products	New	**CBSL,** SLBA, FHA		●	●		
		c. Promoting Inclusive Green Finance (IGF), with particular emphasis on MSMEs (Implementation of National Financial Inclusion Strategy - Phase II)	New	**CBSL**	●	●	●	●	●
2	Support the development of the sustainability segment of capital markets	a. Develop a framework for sustainable corporate bonds issuances	Ongoing	**SEC**	●				
		b. Provide training and capacity-building to FIs on ICMA-aligned sustainable bond issuances	Ongoing	**SEC**	●	●			
		c. Conduct a scoping study on sustainability indices for the stock market	Ongoing	**SEC**	●	●			
3	Prepare a package of incentives for sustainable finance	a. Conduct a study on the opportunity of introducing regulatory incentives for sustainable lending	New	**CBSL**, SEC		●			
		b. Explore and propose incentive schemes for sustainable bond issuances	Ongoing	**SEC**			●		
		c. Conduct a review of best practices on reward and recognition schemes for sustainable finance	New	**SLBA,** FHA		●			
4	Develop the regulatory and policy framework on sustainable insurance	a. Conduct a scoping study on innovative environmental insurance products, such as index-based climate insurance	Ongoing	**IRCSL**		●			
		b. Develop a disaster risk strategy for insurance sector	New	**IRCSL**				●	
		c. Prepare regulations on sustainable insurance against natural risks	New	**IRCSL**				●	●

MANAGING E&S RISKS

	Actions	Action Items	Status	Key Stakeholders	2025	2026	2027	2028	2029
1	Develop guidance on E&S risk management	a. Conduct a situational study on E&S risk management and identify capacity-development needs	New	**CBSL,** SEC, SLBA, FHA					
		b. Upgrading or issuing new regulations to reflect strengthened E&S guidelines and requirements for relevent entities	Ongoing	**CBSL,** SEC, SLBA, FHA					
2	Support the capacity to identify and manage E&S risks	a. Conduct training on climate change data, risks and modelling (with support from relevant partners/networks)	New	**CBSL,** SEC, SLBA, FHA					
		b. Conduct training on the implementation of E&S tools and procedures (e.g. ESMS)	Ongoing	**CBSL,** SEC, SLBA, FHA					
3	Develop the regulatory framework on E&S management	a. Prepare a strategy for a progressive introduction of E&S metrics in the supervisory framework for relevent entities	New	**CBSL,** SEC, SLBA, FHA					
		b. Upgrading of the Banking Act Regulations to reflect strengthened E&S guidelines and requirements	New	**CBSL,** SLBA					

REPORTING AND DISCLOSURE

	Actions	Action Items	Status	Key Stakeholders	2025	2026	2027	2028	2029
1	Improve the Green Finance Taxonomy	a. Conduct an industry-wide study on the adoption of the Green Finance Taxonomy to identify the issues and gaps encountered	New	**CBSL, SEC, IRCSL, SLBA**					
		b. Expand the existing Green Finance Taxonomy to cover social activities, to provide further guidance on DNSH and minimum safeguards, as well as interoperability with other taxonomies	Ongoing	**CBSL,** SEC, IRCSL					
2	Support the capacity of FIs in adopting reporting and disclosure practices aligned with international standards	a. Provide guidance for FIs on the implementation of SLFRS S1 and S2 standards	New	**CBSL,**SEC, CSE, IRCSL					
		b. Introduce E&S disclosure guidelines	Ongoing	**CBSL,** CSE, IRCSL					
		c. Require to disclose the sustainable finance strategies and E&S data at corporate or asset level on regular basis	Ongoing	**CBSL,** CSE, IRCSL					
3	Support data and procedures for quality reporting and disclosure practices	a. Conduct a scoping and feasibility study on sustainable or green tagging of loans and underlying asset collateral	New	**CBSL, SLBA**					
		b. Introduce a statistical system and procedures to track sustainable finance flows	Ongoing	**CBSL**					
		c. Conduct a scoping study of the Fintech solutions that could support the development of sustainable finance	New	**CBSL**					

GOVERNANCE AND COORDINATION

	Actions	Action Items	Status	Key Stakeholders	2025	2026	2027	2028	2029
1	Reconstitute the current stakeholder committee on the implementation of SF RM in Sri Lanka to oversee the implementation of the roadmap, its monitoring, coordinate actions, communicate and share knowledge among FIs	a. Develop TOR of the committee reconstituted	New	**CBSL**					
		b. Recognize key contact points representing key stakeholders identified in the SF RM	New	**CBSL**					
2	Set up thematic working groups that will oversee the implementation of actions and coordinate capacity-building actions across the different themes.	a. Develop TOR for Thematic WG # 1: Products and Innovation	New	**CBSL,** relevant stakeholders					
		b. Develop TOR for Thematic WG # 2 : ESG & Climate Risks	New	**CBSL,** relevant stakeholders					
		c. Develop TOR for Thematic WG # 3 : Reporting and Disclosure	New	**CBSL,** relevant stakeholders					

6.2 Progress monitoring system

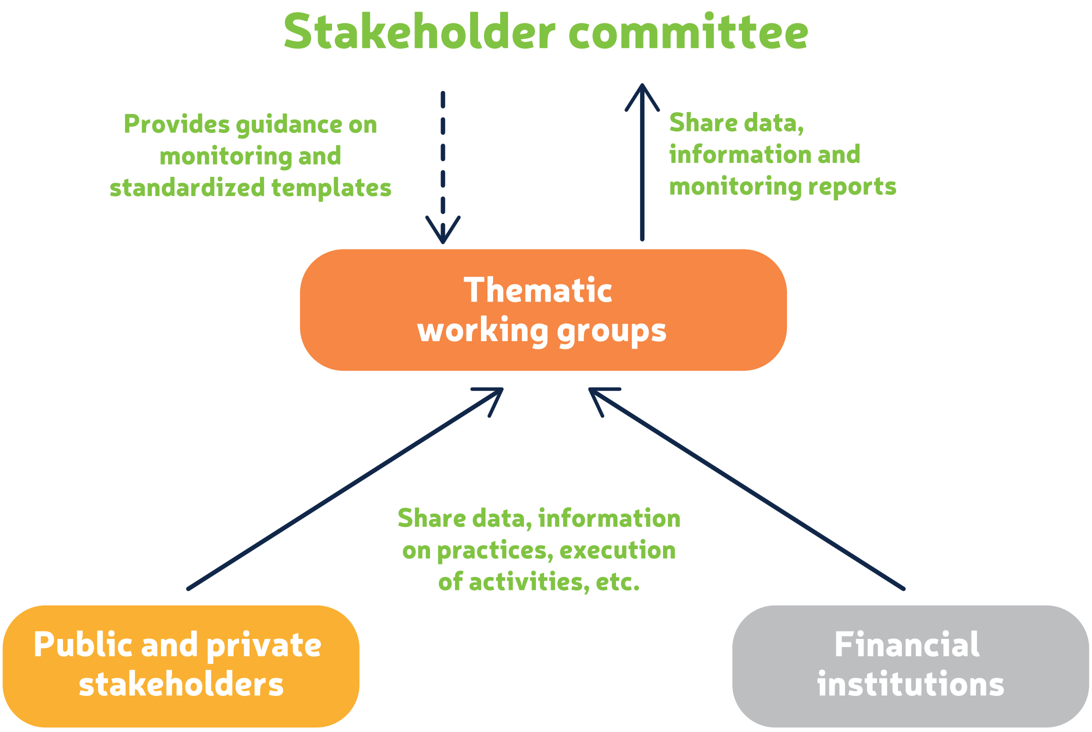
The proposed monitoring framework adopts a nuanced traffic-light system (red – yellow – light green – green) to better reflect the different levels of implementation which are difficult to capture using a 1/0 binary approach. This approach allows to efficiently track the execution of the activities as well as to reflect the potential challenges and innovations that will emerge along the way and feed the implementation through a continuous learning process. A streamlined data collection system is also proposed, leveraging the use of common templates and standardized procedures.

The proposed frequency for the monitoring is every 6 months and the following responsibilities have been identified for the different process:

- **Overall coordination:** Stakeholder committee on the implementation of the Sustainable Finance Roadmap in Sri Lanka (see Action 1 – Governance and Coordination), under the leadership of CBSL.
- **Drafting of monitoring reports:** Thematic working groups (see Action 2 – Governance and Coordination), every 6 months. The monitoring reports for actions on Governance and Coordination will be drafted directly by the Stakeholder committee.
- **Data compilation:** Thematic working groups, mostly through online forms and direct exchanges with relevant entities, at least every quarter.
- **Monitoring meetings:** at least on a quarterly basis for the thematic working groups, bi-annually between the Stakeholder committee and thematic working groups.

The overall information flow for the monitoring process is illustrated by the diagram below:

Figure 3 - Monitoring process



An illustration of monitoring report is given below:

Actions		Responsible	Due date	Level of completion	Assessment	Further actions
1	Conduct a situational study on E&S risk management within FIs and identify capacity-development needs	**CBSL**	**2025**		The study has been conducted, leading to useful insights on existing ESG practices and the gaps that remain to be addressed.	None
2	Conduct trainings on climate change data, risks and modelling for FIs (with support from relevant partners/ network)	**CBSL**	**2027**		A clear capacity-building plan on climate risks has not been developed and trainings not scheduled yet.	Identify key capacity building needs from the situational study.
3	Conduct training on the implementation of E&S tools and procedures, such as Environmental and Social Management Systems (ESMS) within FIs	**CBSL**	**2028**		Only one training has been conducted so far, while the capacity-building plan indicated two per year.	Prepare an adjusted capacity-building plan incorporating the missing trainings.

The signification of the colour codes are detailed below:

- The action is on track and no issues/challenges have been identified.
- The action has started but there is a need to address specific issues to ensure it can be completed as planned.
- The action should have started but hasn't. Quick action is needed to ensure completion on time.
- The action has not been conducted. The taskforce must assess if there is a need to postpone/reprogram, or if it must be dropped.

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