



SRI LANKA

TECHNICAL ASSISTANCE REPORT — GOVERNANCE DIAGNOSTIC ASSESSMENT

September 2023

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Governance Diagnostic Assessment

SEPTEMBER 2023

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Acronyms

AAC	Advisory Audit Committee
ACA	Anticorruption Act
ADR	Alternative Dispute Resolution
AG	Attorney General
AML/CFT	Anti-Money Laundering/Combating Financing of Terrorism
APG	Asia/Pacific Group on Money Laundering
ASYCUDA	Automated System for Customs Data
BASL	Bar Association of Sri Lanka
BCPs	Basel Core Principles for Effective Banking Supervision
BoI	Board of Investment
BSD	Bank Supervision Department
BSRI	Bank Sustainability Rating Index
CAO	Chief Accounting Officers
CAPC	Cabinet Appointed Procurement Committee
CBSL	Central Bank of Sri Lanka
CC	Constitutional Council
CDD	Enhanced customer due diligence
CIABOC	Commission to Investigate Allegations of Bribery or Corruption
CIGAS	Computerized Integrated Government Accounting System
CIR	Centre for Investigative Reporting
CIT	Corporate Income Tax
CMEC	China Machinery Engineering Corporation
COPA	Parliamentary Committee on Public Accounts
COPE	Parliamentary Committee on Public Enterprises
CRM	Compliance risk management
DMA	Department of Management Audit
DoFP	Department of Fiscal Policy
DPF	Department of Public Finance
DSIBs	Domestic Systemically Important Banks
DSNBFI	Department of Supervision of Non-Bank Financial Institution

EFF	Extended Fund Facility
EPF	Employee Provident Fund
ETF	Employee Trust Fund
FAD	Fiscal Affairs Department
FATF	Financial Action Task Force
FCID	Financial Crime Investigations Divisions
FCY	Translation of foreign currency
FIN	Finance Department
FIU	Financial Intelligence Unit
FMRA	Fiscal Management (Responsibility) Act 2003
FSAP	Financial Sector Assessment Program
FTRA	Financial Transactions Reporting Act 2006
GAMWSS	Gampaha, Attanagalla & Minuwangoda Integrated Water Supply Scheme
GDA	Governance Diagnostic Assessment
GIJN	Global Investigative Journalism Network
GVA	Total gross value added
HoCo	Holding Company
IAP	International Association of Prosecutors
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
INTERPOL	International Criminal Police Organization
IRA	Internal Revenue Act
IRD	Inland Revenue Department
IRG	Implementation Review Group
ISA	International Standards on Auditing
ITMIS	Integrated Treasury Management Information System
KMP	Key Management Personnel
LCBs	Licensed Commercial Banks
LEAs	Law enforcement agencies
LEG	Legal Department
LSBs	Specialised banks
MCM	Monetary and Capital Markets Department
MER	Mutual Evaluation Report

MFU	Macro Fiscal Unit
MLA	Monetary Law Act
MoF	Ministry of Finance
MoJ	Ministry of Justice
MOPAM	Department of the Ministry of Public Administration and Management
MTEF	Medium-term Expenditure Framework
MTFF	Medium-term Fiscal Framework
NAP	Sri Lankan National Anti-Corruption Plan
NBFI	The Non-Bank Financial Institutions
NPC	National Procurement Commission
NPD	Department of National Planning
NPLs	Non-performing loans
NRA	National Risk Assessment
PAB	Procurement Appeal Board
PBO	Parliamentary Budget Office
PED	Department of Public Enterprise
PEPs	Politically exposed persons
PFM	Public financial management
PG	Procurement Guidelines
PIM	Public investment Management
PIMA	Public Investment Management Assessment
PIP	Public Investment Program
PMLA	Prevention of Money Laundering Act
PPP	Public-Private Partnership
PRECIFAC	Presidential Commission of Inquiry appointed to investigate Serious Acts of Fraud and Corruption
PROMISe	Procurement Management Information System
PSC	Public Service Commission
PTA	Prevention of Terrorism Act
RAMIS	Revenue Administration Management Information System
RBS	Risk-Based Supervision
RBS	Risk-Based Supervision
RTIC	Right to Information Commission
SAI	Supreme Audit Institution

SDP	Strategic Development Projects Act
SIU	Special Investigations Unit
SOEs	State-Owned Enterprises
SRP	Supervisory Review Process
STRs	Suspicious transaction reports
TISL	Transparency International Sri Lanka
TF	Task Force
TOD	Treasury Operations Department
UNCAC	United Nations Convention against Corruption
UNODC	UN Office on Drugs and Crime
VAT	Value-Added-Tax

Preface

In response to a request from the Government of Sri Lanka, an International Monetary Fund (IMF) mission undertook a governance diagnostic assessment from March 9 to March 31, 2023. The mission was led by Mr. Joel Turkewitz and was comprised of Mr. David Robinson, Ms. Alice French, Ms. Jane Duasing, Ms. Cindy Negus, Ms. Ozlem Aydin, Mr. Sebastian Beer, Mr. Kris Kaufman, Mr. David Kloden, Mr. Jacques Loubert, Ms. Yara Gilchrist Sandakly, and Ms. Joanna Grochalska. The mission was assisted by a short-term expert, Mr. Asanga Abeyagoonasekera. The mission held over 80 meetings and met with the Chief of Staff of the President, the Governor, Deputy Governor and officials of the Central Bank of Sri Lanka, officials from the Ministry of Finance, Ministry of Justice, Ministry of Lands, Office of Auditor-General, Office of the Attorney General, Commission to Investigate Allegations of Bribery and Corruption, Sri Lanka Revenue Administration, Customs, Right to Information Commission, Financial Intelligence Center, Banking Association, and representatives of state and private banks. The mission also met with members of civil society and international partners working on governance and anti-corruption issues.

The report is based on information obtained during the March 2023 main mission. It does not capture reforms that have been introduced since March.

The mission wishes to express its sincere appreciation for the excellent support and cooperation given by officials and staff of these various agencies. The mission is also grateful to civil society and staff of international partners for sharing information and providing valuable insights. The mission appreciates the support provided by Mr. Peter Breuer, (IMF Senior Mission Chief for Sri Lanka), Ms. SarwatJahan (IMF Resident Representative in Sri Lanka), Ms. Manavee Abeyawickrama (Economist) and other IMF staff. The mission is thankful for the administrative and technical contributions provided by Ms. Alexandra Rajs and Ms. Jeahyun Nham and for the overall guidance and advice provided by Mr. Emmanuel Mathias.

Executive Summary

At the request of the authorities of Sri Lanka, an interdepartmental (LEG/FAD/MCM, FIN) Governance Diagnostic Assessment (GDA) mission was conducted during March 20 - March 31, 2023. In line with the IMF's 2018 Framework on Enhanced Fund Engagement on Governance,¹ the diagnostic assessment focused on corruption vulnerabilities and governance weaknesses linked to corruption in macroeconomically critical priority areas of: (i) the anti-corruption, anti-money laundering and combating the financing of terrorism; (ii) fiscal governance (e.g., public financial management, tax policy and revenue administration, state enterprise management, and public procurement); (iii) central bank governance; (iv) financial sector oversight; and (v) enforcement of contract and protection of property rights. Annex 1 provides additional information on the methodology and scope of the Governance Diagnostic.

Sri Lanka is an island nation that lies in the Indian Ocean off the coast of India and that is highly connected to the global market. The economy has begun the transformation from primarily agriculture to higher value-added industry and service sectors and has the potential to further diversify and upgrade its economic structure. As of now, the Sri Lankan economy relies primarily on tourism, tea export, clothing, rice, and other agricultural production.

In recent years, a confluence of shocks and policy missteps led to a deep economic and governance crisis. Two years of low tourism revenues due to COVID, loss of market access, deep reductions in tax revenues, and the debt service burden depleted reserves. The economic downturn was further exacerbated by a series of policy choices, many of which generated gains for private individuals while saddling the nation with debts. The country defaulted and FX shortages led to nationwide power cuts, shortages of essentials, and long queues for petrol. The rupee depreciated by about 40 percent (in dollar terms) between February and March 2022. Inflation soared and the economy contracted sharply while the banking sector was put under extreme stress by a state-granted moratorium of domestic debt repayment. The poverty level nearly doubled from its pre-pandemic level to about 25.6 percent of the population living below the USD 3.65 poverty line. Popular protests against government policies and widespread corruption, starting in March 2022, spotlighted the role of a small number of connected individuals who wielded enormous power and authority. President Rajapaksa resigned in July 2022, and H.E. Mr. Ranil Wickremesinghe assumed the Presidency later that month.

President Wickremesinghe has set out a reform program designed to stabilise the economy and country featuring a combination of steps to restore fiscal and debt sustainability, improve governance, and reduce corruption risks. The program includes measures to cut spending, raise revenues, and restructure debts, while maintaining necessary social programs to meet severe social needs. A raft of governance changes is also envisioned, including steps to strengthen the independence of the central bank, and enhance the country's ability to confront corruption and integrity issues. The IMF approved an Extended Fund Facility (EFF) Arrangement with Sri Lanka in March 2023 to support the implementation of reforms required to address critical balance of payment issues.

Sri Lanka continues to face severe economic, social and governance challenges. Despite tentative signs of macroeconomic stabilization with inflation moderating, exchange rate stabilizing, and the Central Bank of Sri Lanka (CBSL) rebuilding reserves buffers, social tensions remain high due to falling real incomes. Government measures

¹ IMF Framework on Enhanced Fund Engagement on Governance, 2018.

to address the balance of payment crisis, including tax reforms and cost-recovery pricing in the energy sector, have raised the cost of living while continued shortages of essentials, strong-arm measures against protestors, and the postponement of local government elections have been sources of popular discontent. Large fiscal deficit and elevated debt continued to weigh on the recovery prospects. The absence of visible progress on addressing corruption and holding officials to account for past behaviour raises popular concerns that officials will continue to enjoy impunity for their misconduct.

In this context, the authorities have requested IMF assistance to analyse governance weaknesses and corruption vulnerabilities that are macro-critical in their own right and stand in the way of achieving the objectives of the reform program. The recommendations provided are designed to align laws, institutions, and incentives towards more effective public sector performance and better outcomes. In keeping with the IMF's Framework for Enhanced Governance Engagement, efforts to address governance weaknesses and corruption vulnerabilities in Sri Lanka are approached as complements and essential to sustained progress on fiscal consolidation and inclusive social and economic growth. Analysis and recommendations exclusively concern the areas established in the 2018 Framework and do not capture governance concerns that are beyond these parameters.² The report is based on information gathered before and during March 2023, and does not capture reforms introduced since March. The publication of the Governance Diagnostic by the end of September 2023 is a structural benchmark in the Fund's program.

The GDA revealed systematic and severe governance weaknesses and corruption vulnerabilities across state functions, with particular macroeconomic impact in: budget credibility; expenditure control; public investment management and control of spending; public procurement; management and oversight of State-Owned Enterprises (SOEs); transparency of revenue policy and the integrity of revenue administration; the governance and legal frameworks of the Central Bank; the application of financial sector regulations; and clarity and security of land ownership and the integrity of the judicial sector. Corruption vulnerabilities are exacerbated by weak accountability institutions, including the Commission to Investigate Allegations of Bribery and Corruption (CIABOC) that have neither the authority nor competency to successfully fulfil their functions. Current governance arrangements have not established clear standards for permissible official behaviour, acted to deter and sanction transgressions, nor pursued individuals and stolen public funds that have exited the country. Regular civil society participation in oversight and monitoring of government actions is restricted by limited transparency, the lack of platforms for inclusive and participatory governance, and by broad application of counter-terrorism rules.

These weaknesses and vulnerabilities highlight several broader governance themes that need to be addressed for planned reforms to be sustained. Problematic structural issues that shape governance dynamics include the compromised independence of key governance institutions, critical gaps in the legal and regulatory infrastructure for managing and overseeing public resources, limited fiscal discipline and transparency, and a disorganised regulatory and legislative process that provides for insufficient review and engagement. Minimal progress has been made in integrating modern information technology into public sector operations and public-private interfaces, or in linking information to detect and correct inefficiencies and improprieties. These governance features form the basis for the substitution of informal mechanisms of control for rule-based system of accountability for performance and integrity over an expansive state. The impunity for misbehaviour enjoyed

² A large variety of governance diagnostics exist, reflecting different analytical frameworks and concerns. For example, the World Bank's Systematic Country Diagnostics provide an assessment of the constraints and drivers of progress towards the twin goals of ending poverty and boosting shared economic prosperity. The Bertelsmann Transformative Index measures the development status and governance of political and economic transformation processes. The Ibrahim Index of African Governance is a biennial survey-based assessment of the quality of governance relating to the provision of political, social, economic, and environmental goods that a citizen has the right to expect from the state. For Sri Lanka, the recently published "Civil Society Governance Diagnostic Report" provides an alternative governance perspective.

by officials undermines trust in the public sector and compounds concerns over limited access to efficient and rule-based adjudication process for resolving disputes.

Specific weaknesses in each area can be summarised as the following:

- Anti-corruption legal frameworks and institutional arrangements are in flux due to the very recent passage of the Anticorruption Act (“ACA”). The act substantially improved the legal environment for addressing corruption. Gaining full benefit of the improved legal framework hinges on the creation of a transparent and merit-based process, informed by input from acknowledged experts in governance and anticorruption, for selection of Commissioners of the Commission to Investigate Allegations of Bribery or Corruption (CIABOC), given their role in day-to-day operations. Improvement brought about by the passage of the ACA needs to be complemented by the drafting and enactment of a modern law on Asset Recovery. Rapid operationalizing of the ACA will be critical to address current corruption vulnerabilities associated with the lack of a functional system for receiving, publishing, and reviewing asset declarations by public officials, and procedural and competency issues in the investigation and prosecution of corruption cases. The ability of the current anticorruption arrangements to effectively prevent, identify, and sanction corrupt behaviour is further constrained by limitations on the sharing of information across institutions, such as among the Supreme Audit Agency, the Financial Intelligence Unit, and the Anticorruption Agency. Transparent standards for public officials, including a Conflict-of-Interest system, are lacking, and opportunities for public participation and oversight of official behaviour, including by civil society, are increasingly restricted.
- While anti-money laundering mechanisms can contribute to reducing corruption vulnerabilities, current approaches to Anti-Money Laundering/Combating Financing of Terrorism (AML/CFT) largely fail to support effective state action. Issues in legal definitions and processes to capture and share information on beneficial ownership of companies have not been addressed, since they were first observed in 2015. Current practices by financial institutions largely fail to identify suspicious transaction and prevent money laundering. At the same time, weaknesses in the legal framework, problems in domestic cooperation on corruption related issues between competent authorities, and issues in establishing effective protocols for collaboration with foreign jurisdictions impair sanctioning corrupt officials for money laundering offenses or recovering stolen assets.
- The lack of a robust legal framework and poor processes utilised in Public financial management (PFM) create corruption vulnerabilities due to limitations in the coverage of the budget, the lack of transparency in the process used for managing commitments, and for poor investment planning and management. The acceptance of unsolicited capital investment proposals in processes that lack transparency and competition have contributed to a large and growing portfolio of “problem” projects and raised corruption concerns. Substantial governance weaknesses exist across the management of state-owned enterprises, including a lack of clarity in the government’s portfolio, the absence of an explicit state policy to guide the management of its financial stake, and limited regulatory guidance and monitoring of the selection of executives and representatives of the state on Boards of Directors. The lack of oversight and transparency around the operation of state enterprises enhances exposure to corruption vulnerabilities, especially regarding procurement and other forms of contracting, and capital investments. Weaknesses in internal audit and control processes generate additional governance challenges and place an excessive burden on the Auditor-General to identify corruption risks. The absence of effective mechanisms to follow up on audit findings and observations contributes to the persistence of problematic procedural and managerial practices while restricting accountability for past actions.

- Corruption vulnerabilities in Public Procurement remain high. The absence of a public procurement law creates ambiguity in the legal framework, and has contributed to high-levels of political engagement in the selection of procurement winners, poor contract management, limited transparency and a lack of oversight of procurement processes and outcomes. Additional issues are generated by poor procurement planning, reliance on non-competitive means for contract awards, inadequate competition, and inconsistent attention to contract performance and the enforcement of contract terms. The lack of information on beneficial ownership of companies increases the risk of conflict of interest in the awarding of contracts.
- Governance risks are also generated by current Tax Policy practices. Sri Lanka has recently made marked progress in increasing the clarity of the legal framework around taxes, including reducing the number of tax incentives, and providing for integrity and oversight provisions. However, modifications of the tax laws occur frequently and with little notice or centralised consideration. Substantial corruption vulnerabilities are created through the granting of high-value and long-lasting concessions for investments determined to be of strategic importance in a process that lacks clarity and transparency. In a similar fashion, corruption risks stem from the Special Commodity Levy, which provides for excessive levels of ministerial discretion in granting tax changes relating to specific commodities with immediate effect. Concerns about the use of government authority relating to tax policy highlight limited government attention to protecting competition, including the lack of a competition policy agency on the one hand and extensive government control of markets in critical sectors, including agriculture and construction materials.
- The absence of clear mechanisms for information sharing among authorities responsible for tax policy and Revenue Administration limits the soundness of policy choices while it restricts the ability to identify and address shortfalls in expected revenue collection. Exposure to corruption in customs and tax administration is substantial, given the absence of effective systems for performance monitoring and detecting and sanctioning of officials for improper behaviour. The limited progress that has been made in digitizing processes in tax and customs requires users to maintain high levels of direct interaction with officials and reduces the ability to identify integrity issues through data analytics.
- Weaknesses relating to Central Bank governance arrangements under the recently repealed legal framework revolved around safeguards to the central bank autonomy and the conflict of interest created by the Central Bank of Sri Lanka's (CBSL) direct management of the Employee Provident Fund and Sri Lanka's Debt Management office. The enactment of the Central Bank of Sri Lanka Act is a critical step in addressing some of these issues, including by improving aspects of the CBSL's institutional, personal, and financial autonomy, as well as the appointment process and qualifications for the Governor of the Central Bank and other senior officials.
- The Central Bank has successfully worked to avoid a banking crisis and has established mechanisms to monitor compliance with core financial sector rules. At the same time, its ability to perform its function in Financial Sector Oversight has been constrained by the CBSL's own governance arrangement. The new CBSL, enacted in September 2023, improves the structure of governance, and is a significant step forward but governance weaknesses remain. Exposure to governance and integrity risks are generated by differences in regulations applied to state-owned banks and by corporate governance provisions, often defined in state bank statutes, that do not reflect good practice and international standards in areas like the competency and integrity of directors and the composition and role of the Board. Regulatory consistency is also hampered by the rules and regulatory practices applied to Non-Bank Financial Institutions (NBFI), which are not aligned with proportionality considerations. Oversight of prudential regulations around lending limits to borrowers is undermined by exemptions given in the "maximum

amount of accommodation,” regulation. The tendency for financial regulations to be applied in a somewhat fragmented manner encourages excessive focus on narrow compliance checking, without adequate attention to broader governance risks. Overall, the development of rigorous, independent, and arms-length financial sector oversight has been challenged by the weight of the public sector shareholding in the banking sector, which generates opportunities for influencing the behaviour of financial institutions through non-transparent means.

- Governance weaknesses associated with increased risks of corruption are present around *Contract Enforcement* and the *Protection of Property Rights* in ways that substantially constrain private sector development. Multi-year waiting times for the resolution of contract disputes prevent reliance on courts for effective and fair resolution of disputes and encourage disputants to find ways, not always legal, to speed up adjudication. Widespread confusion over the allocation of property rights and the lack of progress in digitizing property records generates extensive long-term legal disputes and similarly promotes resort to opaque means to influence the resolution of disputes. Corruption risks around state-owned land, estimated at approximately 80 percent of the country, are particularly severe due to the combination of lack of clarity around titles, the absence of a property registry, and ambiguity in processes for the divestiture of state property. Concerns about the integrity of the judiciary have grown over time, given the strong incentives of private parties to use illicit payments as a way to solve legal problems that have little chance of being resolved in the near term, and have focused attention on the need to strengthen the independence and competency across the legal sector.

The report highlights immediate and short-term measures to address key corruption issues, as well as structural reforms that require more time and resources but are essential to strengthen governance and initiate lasting change. A list of “priority” recommendations is provided below. They primarily focus on measures related to critical risks, including addressing gaps in existing legal frameworks and the public provision of essential information for oversight and monitoring. Priority recommendations are explored in more depth in the subsections of the report, which also contain more extensive recommendations, including structural and institutional measures to achieve more transparent and efficient governance that operates with integrity and in accordance with the rule of law.

The recommendations are designed as a coherent approach to improving governance through a focus on: clarity of authority and responsibility for core functions; financial and operational independence of essential accountability and law enforcement institutions; transparency in government practices and performance, especially relating to the planning, spending, and accounting for the use of public funds and assets; inclusive, accessible, and rule-based means to enforce private agreements and challenge official behaviour; and efficient mechanisms for making information public and holding organizations and individuals to account for their performance and behaviour. The combination of short-term actions to deliver concrete and observable improvements and long-term structural initiatives to change how the public sector functions in Sri Lanka is essential to achieving the social and economic aspirations of the country.

It is acknowledged that comprehensively addressing governance weaknesses would require medium – and long-term initiatives, significant resources, and prolonged efforts, including with support from Sri Lanka’s international partners. The recommendations coming out of this diagnostic will contribute to the formulation of governance and anticorruption policies and programs, improvement of the legal and institutional frameworks, as well as governance and anti-corruption reform measures agreed to in the Staff Level Agreement for an Extended Credit Facility Arrangement for Sri Lanka.

Table 1. Priority Recommendations

Measure	Authority	Objective	Timeline ³
1 By November 2023, establish an Advisory Committee, composed of independent experts on anticorruption to assist in the nomination of CIABOC Commissioners and the Director General.	Constitutional Council	Strengthen accountability and rule of law	ST
2 Publication of Asset Declarations for senior officials (President, Prime Minister, ministers) on a designated website in line with Anticorruption Law by July 2024.	CIABOC	Strengthen accountability and transparency	ST
3 Enact Proceeds of Crime legislation that is fully aligned with UNCAC and FATF standards by April 2024	Ministry Justice	Strengthen accountability and rule of law	ST
4 Amend the National Audit Act to enable the-the AuditorGeneral to levy surcharges on officers, including Chief Accounting Officers, for failure to properly discharge responsibility for oversight and accountability for use of public resources.	Auditor-General; Ministry Finance	Strengthen accountability and transparency of fiscal governance	ST
5 Finalise and implement regulations to support the provision of beneficial ownership information as required by the Companies Act and establish a public beneficial ownership registry by April 2024.	Ministry Industries	Strengthen accountability and transparency	ST
6 Enact a Public Procurement Law that reflects international good practice by December 2024.	Ministry Finance	Enhance transparency in fiscal governance	MT
7 In December 2024, publish report on a designated website on progress in increasing the proportion of competitive tendered procurement contracts in the 10 agencies determined to have the lowest level of competitive tenders in 2022.	Ministry Finance	Increased transparency in fiscal governance	MT
8 Starting in March 2024, publish on a designated website: (i) all public procurement contracts above LKR 1 billion, along with comprehensive information in a searchable format on contract award winners; (ii) a list of all firms receiving tax exemptions through the Board of Investment and the SDP, and an estimation of the value of the tax exemption; and (iii) a list of firms receiving tax exemptions on luxury vehicle import. Information to be updated every 6 months.	Ministry Finance ⁴	Strengthen transparency	ST/MT
9 Implement the SOE Reform Policy, ensuring that the holding company (HoCo) and the advisory committee are comprised of skilled, independent, and ethical staff.	Ministry Finance	Enhance transparency	ST/MT

³ The recommendations are classified as ST – Short Term to be implemented in up to twelve months from the publication of this report, MT – Medium Term that may require 13-24 months from its publication.

⁴ With oversight on information provision by the Right to Information Commission.

10	Abolish or suspend application of the Strategic Development Projects Act until promulgation of explicit and transparent process for evaluation of proposals and costing of investment promotion conditions.	Office of the President	Strengthen transparency	ST
11	Amend tax legislation to eliminate or restrict ministerial authority to introduce tax changes without prior parliamentary approval and ensure that such changes do not generate revenue losses	Ministry Finance	Strengthen rule of law	ST
12	Institute short-term anti-corruption measures within each revenue department to strengthen internal oversight and sanctioning processes and linkages with CIABOC and related criminal investigation and enforcement processes by Dec 2023 and issue a public report on steps taken and results obtained by Dec 2024.	Ministry Finance	Enhance accountability	ST and MT
13	Following a broad consultative process, produce a Cabinet policy paper by June 2024 on options for establishing new management arrangements for the Employee Provident Fund that terminates direct CBSL management.	Ministry Finance	Reduce conflict of interest.	MT
14	Revise legislation, regulations, and process relating to financial sector oversight in the banking sector, including strengthening corporate governance for banks with government ownership by improving the selection of executives and Board members.	Central Bank of Sri Lanka	Strengthen oversight	ST
15	By December 2024, establish an on-line digital land registry, and publish, on a designated website, report on progress in implementing published Plan for registering/titling all state land.	Ministry Lands	Strengthen transparency	MT
16	Establish and implement a plan to expand the resources and skills available to the Judicial Services Commission in order to enhance their ability to carry out their function and define potential options for modifying governance arrangements in the Justice sector to strengthen oversight, monitoring, and proper sector development.	JSC/Ministry of Justice	Enhance rule of law	MT

Section I. Severity of Corruption

1. Widespread and persistent popular protests in 2022 over the behaviour of top officials reflected a consensus that corruption had paved the way for the economic crisis. The subsequent resignation of President Gotabaya Rajapaksa in July 2022 emphasised that addressing the crisis required changes in governance as much as changes in economic policies. The role of civil society in demanding accountability carried an equally important message about the drivers of change.

2. The particular configuration of power under the Presidency of Gotabaya Rajapaksa created unique governance challenges. The excessive concentration of authority in the hands of a group of individuals tightly linked by familial ties served to emphasise the political power of a small elite and perhaps assisted in the coordinated improper use of public power.⁵ While the Rajapaksa Government lasted less than three years from its start in November 2019, its time in office featured catastrophic declines in tax revenues, the signing of investment agreements negotiated in opaque circumstances granting control over state property and extensive long-lasting concessions, as well as dramatic increases in external and domestic debt.

3. Concerns over the extent policies choices and government practices were driven by private interests were enhanced by the widespread undermining of public accountability and oversight. The passage of the 20th Amendment to the Constitution in 2020, abolishing the 19th Amendment, granted unfettered Presidential control over appointment processes in “independent” bodies such as the Central Bank, the Judiciary, and the Anticorruption Commission while eliminating regulatory bodies in Procurement and Auditing. Oversight bodies in Parliament, including the Parliamentary Accountants Committee and the Committee on Public Enterprises, proved unable to effectively monitor and discipline government actions. At the same time, laws on counter-terrorism were applied in ways that restricted public participation in monitoring and governance.

4. President Wickremesinghe has pledged to confront corruption and change the way the nation is governed. Government reform programs have been announced, including in areas such as fiscal and monetary policy, taxation, public financial management, and anticorruption. Government pronouncements and policy actions have consistently reflected the urgency of making visible progress in the fight against corruption and the appreciation that policy reforms are unlikely to be sustained without structural changes in how the government operates and the mechanisms by which public officials are held to account for their behaviour and performance. President Wickremesinghe has announced that his government is “committed to implementing anti-corruption practices through a government mechanism that emphasises accountability.”⁶

5. The quick passage of the 21st Amendment in September 2022, reimposing limits on the authority of the President, demonstrated the resolve to unwind the recent attacks on

⁵ Under the last Rajapaksa Government, ministerial portfolios of the Rajapaksa brothers accounted for 70% of the national budget.

⁶ Special Statement Delivered By President Ranil Wickremesinghe, June 1st 2023,

<https://www.colombotelegraph.com/index.php/special-statement-delivered-by-president-ranil-wickremesinghe-full-text/>

accountability and the rule of law. Efforts to simply restore past arrangements and institutions are, however, unlikely to be sufficient to address underlying systemic governance challenges and corruption issues that were broadly exposed in the last years.

6. Corruption issues have been at the forefront of the public dialogue on governance for years. The change of governments after the 2015 elections was associated with increasing popular concerns over rising levels of corruption. Notwithstanding, international assessments of governance and corruption, including Transparency International's Corruption Perception Index and the World Justice Project's Rule of Index, show little alteration in the country's performance across a range of governance issues. Sri Lanka's scores from 2016 through 2022 remain relatively unchanged on factors like control of corruption and the rule of law and place it close to average for the region and income group.⁷

7. A more granular level analysis of corruption reveals a more nuanced story. Results from a detailed survey and interview-based study of corruption conducted in 2019 found a consistent perspective that corruption was pervasive across the country.⁸ While slightly more than one-third of respondents had direct experience with corruption, over 85 percent of the interviewed indicated that corruption happened regularly in the hiring of government workers and the awarding of government contracts. Among those who had experienced or witnessed an act of corruption, the encounter happened with a government official in 36 percent of respondents and with a member of Parliament in 35 percent. Grand corruption was perceived to be slightly more frequent than petty corruption – a finding that is quite atypical as citizens' views on the frequency of corruption are often driven by their own experiences around accessing services (e.g., health care) or in the enforcement of law (e.g., traffic violations) and not related to the actions of higher-level bureaucrats. The incidence of corruption was understood to be similar for politicians and bureaucrats, a finding echoed by similarities in the perceived levels of corruption among ministers and parliamentarians.⁹ At the same time, until prompted, respondents did not view corruption as a critical problem, seemingly having accepted it as a regular part of governance in the country.

8. Perceptions of the pervasiveness of grand corruption in Sri Lanka may be influenced by extensively reported transgressions involving high-level officials and economic elites. Governmental reviews and investigations regarding specific cases, including Sri Lankan Airlines' interactions with Airbus, the decision to sharply reduce the import tax on sugar in 2020, and the events around the issuing of bonds in February 2015, produced extensive public information on incidents involving high-level officials. While each of these examples differs in important aspects, they share common features in that they involve multiple state entities, including the Central Bank, that generated extensive profits for private parties while simultaneously saddling the state with costly debts. While

⁷ Sri Lanka's performance on a host of governance indicators has declined since 2000, but the trend has been relatively mild and has continued to reflect a governance situation which is broadly in line with regional and economic comparators.

⁸ The study, performed by Verite Research, included surveys, and interview with focus group and key informants. See Bribery and Corruption in Sri Lanka: The Results of Two Public Opinion Studies, East-West Management Institute, 2020.

⁹ Grand corruption was viewed as common by 72% of respondents as compared to 67% who viewed petty corruption as common. Corruption was viewed as common among politicians (by 75%) and bureaucrats (76%), figures that closely align with the 78% who viewed corruption as common among ministers, and the 81% who viewed corrupt behaviour to be common among parliamentarians.

each case is distinct, in all instances, high-level officials escaped sanctioning for corruption, including in foreign jurisdictions in one case.¹⁰

9. Other data provides complementary indications of the prevalence of corruption consistent with perceptions and the information reported about high-level scandals. For example, a comparison of construction costs in Sri Lanka determined that highway construction costs per kilometre were three times global averages.¹¹ The explosion of domestic and external debt since 2005 has also closely tracked actions that have restricted the independence and competency of key institutions, increased the concentration of authority among closely connected individuals, and committed the state to financing mega-projects approved at the Cabinet level using opaque processes.

10. A set of common elements can be identified within the information available on the severity of corruption in Sri Lanka. High-value corruption issues appear strongly associated with state-owned enterprises and highlight the close relationships between public institutions and private firms, including in the financial sector. Multiple avenues exist by which officials influence and direct the actions of public and private parties, often in ways that lack transparency. High levels of discretion in the creation and implementation of policies, including in areas like public procurement, state contracting, and the granting of concessions for strategic investments, have contributed to corruption vulnerabilities, especially as state actions in these areas cannot be easily challenged. Opaque control over public activity is assisted by high-levels of organization fragmentation of authority, combined with extensive concentration of responsibility in the hands of a limited number of individuals, such as the practice of having the President of the nation also serve as Minister of Finance. Corruption appears to be less about actions around specific transactions and more about long-established relationships that bind together public and private elites.

11. Overall, current arrangements act to insulate top government officials from accountability. Government control over key enterprises limits the ability of market forces to discipline government policies and rent-seeking behaviour. Extensive government regulation in core sectors, such as agriculture, electricity, and construction, restricts market-based accountability and generates extensive opportunities for top officials to direct state resources to privileged private parties. Internal sources of accountability, such as regulatory bodies, inspectorates or internal audit functions, lack capacity and authority and are regularly circumvented by a high-degree of discretion afforded to high-level officials, and by extensive mechanisms for exerting informal influence on decision-making and the application of regulations. Government decisions relating to capital investments, high-value procurement, the granting of concessions for “strategic” investments, the marketing and payment of debt instruments, or the divestiture of state property occur through opaque processes at the highest level of government with limited oversight and contestation. External mechanisms of accountability, such as auditing and parliamentary oversight, have proven to be ineffectual in constraining

¹⁰ In response to detailed findings by the U.K. Serious Fraud Office, Airbus was fined 3 billion English Pounds for bribing officials in 20 countries to win contracts for the purchase of airlines, including Sri Lanka. The SFO found that US\$2 million had been provided in bribe payments out of a \$16.84 million promised bribe. See The Guardian, “Airbus to pay record 3 billion pounds in fines for ‘endemic’ corruption,” 31 Jan 2020. There have been instances where high-level officials in Sri Lanka have been sanctioned for corrupt practices.

¹¹ See Daily FT, 11 January 2019. For the study on road construction costs, see Collier, Kirchberger, and Soderbom, “The Cost of Road Construction in Developing Countries,” 2 March 2013.

questionable behaviour, in part due to the absence of effective follow-up mechanisms for actions that waste public resources. The absence of functional relationships with external law enforcement agencies enables officials to enjoy the profits of their illicit actions outside the country.

12. Governance and corruption issues have imperilled national and social well-being. The recent past has demonstrated the extent of impunity afforded top officials, even for ruinous behaviour. At the same time, civil society has proven its ability to organise and demand accountability as a last resort. Confronting corruption in Sri Lanka effectively requires short-term actions to address core vulnerabilities combined with more long-term actions to introduce structural changes in governance and accountability that address the underlying governance weaknesses. Dismantling current protections that afford officials immunity for their actions is fundamental to achieving and sustaining success.

Section II. Legal, Organizational, and Strategic Frameworks for Anti-Corruption

13. Effective anticorruption efforts require a limited number of core competencies. Those include: the capacity to identify key corruption risks and vulnerabilities; establish priorities for combating corruption; coordinate the implementation of policies to achieve core objectives; and monitor implementation and adapt practices based on the results achieved by earlier reforms. While each country's anticorruption efforts must be shaped by its institutional history and governance arrangements, most successful anticorruption efforts include work to prevent corruption, identify, investigate, and sanction corrupt behaviour, and establish and enforce clear standards of official behavior. Government action is essential but constructive anticorruption efforts are most often pursued through collaborative initiatives involving government, the private sector and civil society, with a strong focus on transparency and inclusive governance.

14. This section identifies the main legal and institutional constraints faced by Sri Lanka in fighting corruption. The measures suggested to address the shortcomings aim at strengthening the overall anti-corruption frameworks and supporting governance arrangements to reduce opportunities for corruption.

15. Corruption issues have persisted in Sri Lanka despite almost 50 years of anticorruption efforts. The Declaration of Assets and Liabilities Law enacted in 1975 signals that the country has long recognised the need to establish a legal framework for monitoring the integrity of public officials. The creation of the Commission to Investigate Allegations of Bribery or Corruption ("CIABOC") in 1994 established an independent agency to lead anticorruption efforts, including the investigation and prosecution of corruption-related offenses. A Financial Intelligence Unit, focused on confronting money laundering and the financing of terrorism was established in 2006, deepening the array of government institutions responsible for enforcing laws on the abuse of public authority for private gain.

16. However, the legal and organizational framework erected to confront corruption has struggled to fulfil its function. Legislation has prevented information sharing across accountability agencies in ways that have hamstrung collaboration and effectiveness. Institutional independence has been neutered by political control over the selection of senior officials, while competencies have been restricted by budgetary constraints. High-profile corruption cases have been repeatedly abandoned due to problems in coordinating the investigation and prosecution of individuals across multiple agencies, raising concerns about whether police and judicial officers have the requisite skills and incentives to sanction sophisticated parties, and possible direct political involvement in case resolution.

17. The experience of the Financial Crimes Investigation Division ("FCID") is instructive concerning the challenges faced in efforts to establish an outcome-oriented anticorruption effort. The FCID was formed in 2015 under the Sri Lanka Police Service and given direct responsibility for conducting investigations of serious financial fraud throughout the country and provided the authority to undertake investigations and arrest suspects without the prior approval of the Attorney General. With support from the Serious Fraud Office of the UK, the FCID actively delivered its mandate,

charging a number of ministers and other high-profile officials with corruption offences. The FCID's existence was challenged at the Cabinet level in 2019, and the division was subsequently brought under the direct control of the Criminal Investigation Department.

18. Recently, political considerations have often appeared to dominate work on confronting corruption. The 'Presidential Commission of Inquiry appointed to investigate Serious Acts of Fraud and Corruption (PRECIFAC)' was established by President Sirisena in 2015 to investigate large-scale acts of fraud and corruption between the years of 2010–2015 (during the tenure of the previous administration). The Commission concluded in its final report of 2018 that former President Rajapaksa and 12 others had committed the offence of corruption, conspiracy to commit corruption and other offences under Section 70 of the Bribery Act. However, CIABOC was prevented from lawfully pursuing these cases until 2019 when the Commissions of Inquiry (Amendment) Bill was approved in Parliament. The Rajapaksa Government that came to power at the end of 2019 quickly sidelined prosecutions, instead electing to establish its own special Commission of Inquiry into alleged corruption between 2015–2019 (during the term of the previous administration). In the end, high-profile special commissions on corruption served to highlight the severity of corruption, demonstrate the dysfunctionality of formal anticorruption structures, while failing to hold anyone to account for their behaviour.

A. Legal Framework for Anticorruption

19. The anticorruption framework is in the process of undergoing major changes. The recent adoption of the Anticorruption Act (ACAACA) introduced substantial improvements in the legal framework for anticorruption and organizational arrangements for confronting corruption. The Act will go far in aligning Sri Lanka's legal framework with international commitments and good practice standards.

20. Sri Lanka has been a party to the United Nations Convention against Corruption (UNCAC) since 2004,¹² which commits it to confront corruption across a broad spectrum of thematic topics. Past evaluations of Sri Lanka's compliance with UNCAC, undertaken in 2013 and 2017, identified a number of substantial deficiencies, including protection of whistleblowers, provision of mutual legal assistance, and procedures for stolen asset recovery and the management of frozen assets.¹³ Subsequent legal reforms have addressed some, but not all these gaps.¹⁴

¹² Sri Lanka ratified the Convention on 31st March 2004, and it came into force on 14th December 2005.

¹³ [Chapter III and IV Exec Summary](#)

¹⁴ Further to the UNCAC review recommendations, a number of laws were enacted, including:

- Assistance to and Protection of Victims of Crime and Witnesses Act No 4 of 2015 (addressing the deficiency in witness protection and whistleblower provisions)
- Right to Information Act no 12 of 2016 (giving effect to the constitutionally provided right to information (Art 14A))
- Mutual Assistance in Criminal Matters (Amendment) Act no 24 of 2018 (addressing reciprocity issues identified in the UNCAC review)

21. The new Act replaces the Bribery Act (Chapter 26), the Commission to Investigate Allegations of Bribery or Corruption Act No. 19 of 1994, and the Declaration of Assets and Liabilities Law No. 1 of 1975.

22. Rapid and steadfast progress in implementing the ACA is critical to demonstrate commitment to achieving real improvement in confronting corruption and building momentum for reform. The first order of business is, therefore, to get CIABOC up and running, and to begin standing up core systems and processes elaborated in the law.

23. CIABOC is at the centre of the new legal and organizational architecture. While CIABOC has been in existence for over twenty years, the ACA vests the organization with new and extensive responsibilities relating to the development of anticorruption strategies, the prevention, investigation, and prosecution of corruption offences, and the establishment of mechanisms to coordinate anticorruption efforts across the whole of government. The extent to which the ACA will contribute to reducing corruption vulnerabilities is directly related to the ability of CIABOC to fulfil its expanded mandate.

24. The effectiveness of CIABOC hinges on the selection and appointment of vigorous and dedicated Commissions who have the expertise, experience, and qualities needed to fulfil the organizational mandate. The ACAACA establishes the Agency as an independent entity. The extent to which it acts as such and serves its ambitious function will be heavily influenced by the manner in which senior CIABOC officials, including the Director General and the Commissioners, are selected and appointed. The selection process for the Director General and the Commissioners must ensure that suitably qualified and experienced candidates are appointed and that the process is free from external interference, whether political or otherwise.¹⁵ There cannot be any question that these processes are fair, above-board, and transparent. A failure to ensure any of this will lead to charges of bias, improper influence and, inevitably, will impair the Commission's reputation – and crucial public faith and trust in its functions.

25. Current arrangements for the appointment of senior staff in CIABOC are insufficient to support the selection of the best possible candidates. Applicable legislation vests responsibility for the selection of Commissioners with the Constitutional Council. The involvement of the Constitutional Council provides a measure of protection against capture of the process, given the multistakeholder composition of the body.

26. However, the Constitutional Council runs the risk of not having sufficient expertise and information to select the most qualified individuals for the critical senior positions. The ACA itself provides very broad guidance on the qualifications required by of Commissioners and the DG in

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- Judicature Act (Amendment) No 9 of 2018 (creating a new judicial jurisdiction to hear serious financial crimes and corruption cases)
 - Amendment Act no 22 of 2018 (amending the Bribery Act to allow filing of corruption cases in the High Court – previously they could be files only in the lower (Magistrates') Court)
 - National Audit Act no 9 of 2018 (creating the National Audit office, headed by the Auditor-General)
 - Prevention of Offences relating to Sports Act no 24 of 2019 (concerning match fixing, manipulation and illegal betting).

¹⁵ This applies as much to the reappointment and removal process as it does selection.

Section 4(1): "The Commission shall consist of three members appointed by the President on the recommendation of the Constitutional Council from among the persons who have expertise, reached eminence and have at least twenty years of experience in:

- a) law; and
- b) one or more the following fields:
 - i) forensic auditing;
 - ii) forensic accounting;
 - iii) engineering;
 - iv) international relations and diplomatic services;
 - v) management of public affairs; or
 - vi) public administration."

27. The Commissioners play a significant role in the decision-making process that pertains to the criminal investigation and prosecution of suspects whose cases the Commission considers.

Despite this, there is no requirement in s.4(1) that the persons recommended by the Council ought to have experience in criminal law, criminal practice, or criminal investigation, nor intelligence gathering and analysis. The only other requirements set out in the Act are in s.4(2), which concerns the nationality of the Commissioners, and a standard need in such roles for significant integrity and particularly good character.

28. The members of the Constitutional Council are not, themselves, experts in issues relating to corruption and criminal investigation, or fully cognizant of the experience and skill mix among Commissioners that would lead to the best results.

The Constitution has provided the CC with broad discretion to develop rules and procedures to carry out its function.¹⁶

29. The CC should establish an Advisory Committee to assist it in the selection of appropriate candidates for CIABOC Commissioners and the DG.

In doing so, it would make use of the positive experience of countries such as Indonesia, Ukraine, and Moldova, which have established multi-stakeholder advisory mechanisms to strengthen the selection of Anticorruption Commissioners. Establishing an Advisory Committee to the CC for selection of CIABOC leadership would demonstrate deep commitment to a fair and transparent selection process oriented towards identifying the best possible candidates for the positions.¹⁷ The selection process would be further strengthened by publishing the names of qualified candidates as determined by the Advisory Committee. In keeping

¹⁶ At Art.41E (6), the Constitution provides the CC with broad discretion to create its own mechanism for arriving at recommendations to be made to the President: "The procedure in regard to meetings of the Council and the transactions of business at such meetings shall be determined by the Council, including procedures to be followed in regard to the recommendation or approval of persons suitable for any appointment under Article 41B or Article 41C." And at Article 41G (3): "The Council shall have the power to make rules relating to the performance and discharge of its duties and functions. All such rules shall be published in the Gazette and placed before Parliament within three months of such publication."

¹⁷ The Advisory Committee could be a collective body composed of five reputable and qualified members representing diverse sectors of Sri Lankan society. It could for instance include two representatives from anti-corruption civil society organizations and two law enforcement officers with experience in investigation and prosecution of corruption cases (including in other countries). Advisory committee members would be appointed by the Constitutional Council.

with its authority, the work produced by the CommitteeCommittee would be exclusively advisory in nature, and the CC could select candidates that are not on the list.

30. Early reporting on progress in operationalizing the ACA is also important to demonstrate the Government’s resolve to implement the law and gain its expected benefits. The law contains a wealth of new provisions, including the creation of a Conflict of Interest system and an Asset Declaration system, as well as expanding the criminalization of corruption-related offences.

31. Defining and publishing a time-bound Action Plan for implementation is vital for coordinating activities within CIABOC and across other agencies. It is also essential to establish a phased-in approach to system development, so that concrete and visible progress in system implementation can take place in the near term, even as implementing the full system may require an extended period of time. An initial 18-month Action Plan could usefully focus on establishing: (i) the Asset Declaration and Conflict of Interest Systems; (ii) more effective investigation and prosecution of corruption; and (iii) enhancing mechanisms for recovering stolen assets, including such mechanisms as non-conviction-based confiscation. Regular reporting on progress in implementing the Action Plan on a designated CIABOC website will serve to increase transparency in CIABOC and invite public monitoring and accountability for performance.

32. The development of an action plan is also an essential input for effective budgetary and organizational planning. The law provides CIABOC with the ability to directly submit budgetary requests to Parliament as a way of establishing financial independence. Estimating annual financial and human resource requirements requires a clear definition of organizational strategies, along with the elaboration of protocols for managing implementation and proper oversight of spending.

33. It should be noted that the ACAACA does not cover issues relating to the recovery of stolen assets/or the management of assets that have been frozen. Legislation in this area is critical to creating a comprehensive legal framework for addressing corruption. The discussion of stolen asset recovery can be found in the next section on Anti-money Laundering and Counter-Terrorism Financing.

Table 2. Recommendations: Improving the Legal Framework for Anticorruption

Measure	Authority	Implementation Timeline
1. Establish an Advisory Committee composed of reputable and qualified individuals with expertise in anticorruption to assist in the identification of candidates for CIABOC leadership positions.	Constitutional Council	November, 2023
2. Nominate the Director General and the Commissioners using a process that promotes independence of CIABOC and selects individuals with the experience, expertise, and integrity required to lead the agency.	Constitutional Council	December, 2023
3. Establish and publish on a government website an 18-month action plan to implement the ACAACA, with allocation of authority, responsibility, and accountability for managing implementation and clear milestones for operationalizing the Law.	CIABOC	February 2024

4.	Publish first report on progress in implementing the Action Plan on a government website, and publish subsequent reports every 6 months	CIABOC	December; 2024
5.	Develop, publish, and submit a CIABOC budget, aligned with the Action Plan, and report on budget implementation at least every 6 months on a designated website.	CIABOC	March 2024

B. Anti-Corruption Strategy

34. A Sri Lankan National Anti-Corruption Plan (NAP) was developed for the first time in 2019 (spanning 2019-2023). It was a potentially important step indicating Government awareness of the cost of corruption and the need for a more strategic and inclusive approach to combatting it. A wealth of data has demonstrated that well-designed National Anticorruption Strategies can assist in coordinating actions to confront corruption and strengthen governance, establishing authority and responsibility for implementation, and enabling inclusive monitoring of implementation progress and corruption trends.¹⁸

35. The NAP is both broad in span and deep in application. Its provisions cover five pillars of activity:

- A) Prevention Measures – including the establishment of a Corruption Prevention Division at CIABOC
- B) Value-Based Education and Community Engagement
- C) Institutional Strengthening of CIABOC and other Law Enforcement Agencies
- D) Law and Policy Reforms
- E) Monitoring and Evaluation

36. The primary burden of its implementation was assigned to CIABOC, although the implementation matrix set out in the NAP does identify other responsible agencies. Ideally, there would be a more detailed matrix assigning responsibility to particular departments or divisions within each agency, in order to avoid confusion or duplication of effort. While key performance Indicators are also set out, the timeline for implementation is vague, often identified as only ‘short-term’, medium-term’ or ‘long-term’.

37. The progress made in implementing the plan is unclear as limited public information has been provided. The years covered by the strategy have witnessed large-scale fluctuations in governance and economic conditions. There is little indication that the NAP succeeded in driving change or operated as a platform for collaboration among state institutions or across state and non-state actors.

¹⁸ See UNODC, National Anti-Corruption Strategies: A Practical Guide for Development and Implementation, 2015 for an overview and guidance on National anticorruption strategies.

38. Government officials should consider revising or updating the NAP in consideration of the lapse of time and new conditions. The development of a new NAP could provide the opportunity for a dialogue among key stakeholders regarding strategic priorities in fighting corruption. The new strategy could assist in setting out a comprehensive engagement plan, that extends far beyond efforts to enforce criminal penalties for corrupt behaviour by individuals. Processes for achieving defined objectives could equally provide platforms for collaboration across stakeholders, including but not limited to CIABOC and other government agencies. The plan could form the basis for regular reporting on the status of reform, provide opportunities to recognise and celebrate successes as well as the chance to demand better performance and recalibrate approaches.

Table 3. Recommendations on Establishing an Anticorruption Strategy

Measure	Authority	Implementation Timeline
Develop a National Anticorruption Plan for 2025-2029 on the basis of inclusive consultation, with clearly defined objectives, responsibilities, management and oversight arrangements, and public reporting requirements.	CIABOC	December 2024

C. Prevention of Corruption

39. Prevention of corruption is the bedrock for effective anticorruption efforts, given limitations on the number of individuals who can be prosecuted for corruption and the high cost of addressing corruption after it has taken place. Preventing corruption, and corresponding efforts to build integrity in the public sector, takes place across an array of cultural, institutional, and social mechanisms that are far too broad for this report to cover. Targeted efforts to prevent corruption in the public sector feature: (i) development of systems to direct and oversee the behaviour of public officials (e.g. Codes of Conduct, Asset Declaration); (ii) identification and correction of organizational risks caused by processes and managerial practices (e.g. internal and external audits); (iii) transparency in the provision of public information, and opportunities for non-state participation in governance and oversight; (iv) clarification and standardization of processes to reduce opportunities for corruption (e.g. tax administration, with increasing reliance on digitization; and (v) eliminating non-essential regulation and state involvement in the economy to eliminate corruption possibilities. The discussion of prevention in this section will focus on strengthening oversight and transparency. Subsequent sections of the report will emphasise addressing governance weaknesses associated with corruption risks generated by policies and organizational practices.

40. Existing mechanisms for overseeing individual and organizational behaviour are limited and are largely inadequate to achieve their function. While systems and procedures often exist on paper, they operate in a partial manner, without sufficient attention to ensuring their application or that remedial steps are taken when problems are observed. Marginal attention has been placed on transparency, within government and to the public, and limited opportunities have been established to enable active public participation in monitoring and oversight.

1. Directing and Overseeing the Behaviour of Public Officials

Conflict of Interest

41. Conflict of Interest (“Col”) systems can establish behavioural standards for public officials and assist officials in managing conflicts in ways that support trust and integrity.

Well-designed Col systems include definitions of what constitutes conflict of interest, identify who is subject to Col rules, establish mechanisms for declaring a conflict, and rule for how to manage such situations. When effective, Col systems help government officials increase the transparency of their actions, and enable them to recuse themselves from situations where corruption risks, or the appearance of corruption, is high.

42. Sri Lanka’s Col system is poorly defined. The concept of conflict of interest is set out in Chapters XLVII and XXIX of the Establishment Code.¹⁹ Public officials are instructed to “not do anything which will bring his private interests into conflict with his public duty, or which compromises his office.”²⁰ The Code provides no additional definitions of critical terms – such as “private interests” or “public duty” or the broad term “anything.” Officials are required to declare conflicts to management committees established in each agency and await instructions on how to address the situation. Each institution is required to formulate its own conflict of interest policy and manage its implementation.

43. There is no evidence that conflict of interest mechanisms are operative. CIABOC published a handbook on Conflict of Interest in 2019 to provide additional guidance to agencies and officials.²¹ No centralised mechanism exists to record and report on the number of conflicts brought to management committees or the disposition of those cases. Likewise, no mechanism exists to determine whether officials have submitted their mandatory asset disclosure forms, or to sanction officials for either failure to disclose assets, or failure to declare the existence of a conflict.

44. The new ACAACA contains provisions to strengthen the Col system, with a particular focus on strengthening the mechanisms for asset declaration. While these steps are critical, and will be reviewed in greater detail below, accurate asset declaration mechanisms are only one element of an effective Col system. Equal attention must be placed on clarity in elaborating a definition what constitutes a conflict (which may extend well beyond ownership of assets), training officials in their obligations and responsibilities, and establishing procedures to provide rapid and consistent guidance on how to manage a conflict once it has been declared. Public reporting on system performance is necessary to demonstrate the probity of officials, and officials found to have acted in non-conformity with Col requirements must be appropriately and visibly sanctioned.

Asset Declaration

¹⁹ The Establishment Code was first issued by the Ministry of Public Administration in 1972. One part of the Code was updated in 1985, and a second part was updated in 2013.

²⁰ Establishment Code, Chapter XLVII, Sec. General Conduct Sub Sec 1.5

²¹ Conflict of Interest Handbook, CIABOC, 2019

45. Asset Declaration systems require a certain group of public officials to periodically submit information to a government authority on income, assets, liabilities, and interests.

Approximately 90% of jurisdictions have legislation requiring some form of asset disclosure due to their potential value in helping promote a culture of integrity. Less evident is the fact that asset disclosures can also help public officials build trust in their work and, therefore, in public institutions. Finally, asset disclosure systems can promote key partnerships with civil society and journalists.

46. Several international instruments, including the United Nations Convention Against Corruption, include references and provisions on disclosure by public officials, making it a widely recognised tool.

Additionally, regional, and international documents have provided valuable guidance for implementation. Notably, G-20 members endorsed common principles on financial disclosure (2012) and conflict of interest (2018).

47. Sri Lanka has had laws requiring asset and liability declarations since the 1970s.²² CIABOC

has been responsible for administering the system starting in the 1990s. The laws require that within three months of taking office, parliamentarians, judges, public officials of government departments, ministries, local authorities, chairpersons and staff of public corporations, candidates for elected public office, and elected officials declare their assets and liabilities, as well as those of their family members. However, serious shortcomings in verifying disclosures and addressing non-compliance were identified. Systems problems remain largely unaddressed, despite the passage of twenty years from the enactment of the laws.

48. Between 2019 and 2021, CIABOC – in collaboration with Transparency International Sri Lanka (TISL) and other NGOs – attempted to establish an effective asset declaration system.

This aimed to increase public officials' asset transparency by establishing an Office of Asset Disclosure, publishing an annual report on relevant prosecutions, and creating and publicising an online asset declaration portal. It built on a previous commitment with limited implementation, which aimed to amend the Declaration of Assets and Liabilities Act. Unfortunately, no progress was made in establishing an online public portal for asset declaration, an Office of Assets Disclosure, or annual reports on prosecutions related to asset declaration verification.

49. While the Government proved unable to inform the public about its plans, TISL ran a highly visible information campaign on asset declaration.

These included writing to members of parliament, publishing articles in the press, posting billboards, and creating social media campaigns. This brought asset declaration into the public discourse, generating demand for asset declaration among relevant civil society organisations and political parties. As a result, by February 2021, 12 individual parliamentarians had voluntarily published their asset declarations. This was a positive step, but the remainder of Sri Lanka's 225 parliamentarians did not follow suit.

50. The ACA will substantially improve the legal framework concerning asset and liability declarations.

In addition to expanding the scope of application to public servants subject to its provisions, it also allows for the submission and verification of assets and liabilities to be made through a new centralised electronic system. The Commission is required to establish and maintain a new

²² Declaration of Asset and Liabilities Act No 1 of 1975.

database to secure information in electronic form concerning assets and liabilities. Provisions also require the Commission to review each declaration of assets and liabilities to detect *prima facie* proof of illicit enrichment and conflicts of interest. Publication of asset declarations is required, after a limited list of sensitive information is redacted. The ACA also creates criminal offenses connected to failure to provide a declaration of interest and providing false information in, or omitting relevant information from, a declaration of interest.

51. The potential impact of improvements to the Asset Declaration system can be magnified by the implementation of complementary reforms. The effectiveness of the Asset Declaration system in monitoring wealth accumulation by officials stands to be increased by steps made to increase the provision of beneficial ownership information of companies, and to enhance oversight of the award of procurement contracts. It is important for policy makers and other stakeholders to recognise the extent to which these reforms work together to strengthen integrity and accountability.

52. Effective system implementation is required to translate improvements in the legal framework for asset declarations into more effective monitoring of public officials and prevention of corruption. CIABOC will need to establish a clear, detailed, and time-bound action plan, with regular and consistent oversight of plan implementation, and regular public reporting on the progress that has been obtained. The action plan will need to be properly budgeted, including provisions for IT development and capacity building in entering and submitting data, and data analytics.

53. To avoid delays, Sri Lanka should establish a phased approach to implementing new asset declaration requirements, emphasising early publication of asset declarations of prominent officials followed by the building out of the entire system. A delay of several years in the publishing of asset declarations, as CIABOC works to design and operationalise a new digital system and deal with the sheer volume of submissions, would undermine the dynamics of governance change and endanger the momentum of the reform process. Priority should be given to receiving and publishing comprehensive Asset Declarations of senior officials in the short term, even in advance of the creation of a fully digitised process. Demand for verified electronic information for an expanded number of public officers will increase pressure on officials to fully implement the sequenced action plan in the near term.

Table 4. Recommendations on Establishing Effective and Transparent Asset Declaration and Conflict of Interest Systems

Measure	Authority	Implementation Timeline
1 Enact regulations to operationalise the Col rules set out in the ACA, including those concerning: i) defining conflict of interest; ii) guidance on declaring a conflict and managing a declared conflict; iii) sanctioning officials for failure to declare a conflict and/or failure to implement guidance provided; and iv) public reporting on system performance.	CIABOC	March 2024
2 Establish and publish on a CIABOC website an 18-month action plan for implementing the Col system.	CIABOC	April 2024
3 Issue the first annual report on Col system performance by December 2024, including information on the progress in implementing the defined action plan.	CIABOC	December 2024
4 Enact regulations to operationalise the Asset Declaration system set out in the Anticorruption Law, including those on : i) who is required to file a declaration; ii) the assets to be declared and the form to be used to make a declaration; iii) the process of filing a declaration; iv) publication, validation, and storage of asset declarations; v) the process and sanctions to be applied for failure to file an asset declaration and/or provision of false or incomplete information; and vi) public reporting on system performance.	CIABOC	January 2024
5 Establish and publish on a CIABOC website an 18-month action plan for implementing the Asset Declaration system which provides for phased-in implementation of the AD system.	CIABOC	April 2024
6 Make Asset Declarations of Senior Officials publicly available in line with regulatory requirements on a government website	CIABOC	July 2024
7 Issue the first annual report on Asset Declaration system performance by December 2024, including information on the progress in implementing the defined action plan	CIABOC	December 2024

2. Identification and Correction of Organizational Risks²³

54. There is strong consensus in the literature that effective public sector auditing can detect and deter corrupt practices.²⁴ Internal audit and external audit each have a specific but complementary essential role in monitoring and controlling practices and risks. Internal audit consists of identifying organizational practices that generate risks that entities will not comply with the law and waste public resources. It aims to help governing bodies recognise and adjust practices to achieve better results, higher levels of compliance and fewer opportunities for corruption. The external

²³ In addition to internal and audit functions, a number of entities, engage in monitoring organizational practices for compliance and control deficiencies. Please see Section IV on Fiscal Governance for a discussion of other internal control and oversight mechanisms.

²⁴ <https://www.u4.no/topics/auditing-and-financial-control/agenda>

audit examines the implementation of policies, including financial management policies, and makes observations, findings, and recommendations on the problems it has identified and on actions to address them. It may also raise concerns with the competent authorities regarding specific transactions.

55. While the internal audit function is generally poorly developed in Sri Lanka, external audit has increasingly played a significant role in oversight and accountability. The Supreme Audit Institution (SAI) of Sri Lanka is the National Audit Office (NAO), headed by the Auditor-General (AG), which traces its history back to 1799. The 2018 Audit Act sets out the responsibilities of both the Auditor General and the Audit Office. The 2018 Act also established an Audit Service Commission, with responsibilities for securing the human and financial resources of the NAO, supporting improved performance, and reporting on NAO findings relating to fraud, negligence, misappropriation, or corruption. The Commission was abolished by the 20th Amendment, in 2020, and reinstated by the 21st Amendment, in 2022.

56. The brief and relatively turbulent history of the the Audit Service Commission points to recurring concerns around the ability of the NAO to audit all state authorities, and the follow-up of audit findings and observations. Legally, the NAO mandate extends to all state entities, but it has encountered issues with gaining access to records and cooperation with powerful agencies and state-owned enterprises.

57. There are also concerns that the link between auditing and accountability is too attenuated given limitations on the sharing of information between the Auditor-General and enforcement agencies, and relatively constrained follow-up of audit observations, findings, and recommendations. Section 9 of the National Audit Act effectively prevents the Auditor General from sharing information obtained during the course of an audit that raises corruption suspicions to law enforcement bodies in real time, preventing possible investigations and arrests from taking place – S.9(2) of the Act in fact creates an offense of sharing information in (the very limited) circumstances other than those set out in s.9(1)(a)-(c).

58. Without recourse to sharing information directly with enforcement agencies, the impact of NAO's work is reliant upon the efforts of the Sri Lankan Parliament. NAO audit reports are submitted to Parliament for scrutiny by the Committee on Public Accounts (COPA) and the Committee on Public Enterprise (COPE). There have been issues, however, over the composition of the committee and the speed at which it functions. As is the case in most jurisdictions that follow the 'Westminster' model, the COPA and COPE should be chaired by a member of the opposition, to ensure fairness, and the appearance of fairness, in the scrutiny process. However, this principle has not always been followed, recently. A further issue is that the Committee only sits when Parliament sits. President Rajapaksa's decision to dissolve parliament during the COVID crisis brought into stark relief the impact of current rules on parliamentary oversight of accountability. To remedy this issue – and the resulting backlog of reports – COPA and COPE should be constituted as permanent bodies.

59. Follow-up of audit findings and establishing a more immediate link between auditing and accountability could be advanced through application of "surcharges" to officials, including Chief Accounting Officers, for failure to ensure proper stewardship of public resources. Part IV of the 2018 Act assigned the Audit Service Commission with responsibility for reporting instances

where a transaction undertaken by an audited entity in contravention of a law creates a deficiency or losses to the state due to fraud, negligence, misappropriation, or corruption.

60. The Report is filed with the Chief Accounting Officer of the entity being audited for the imposition of a surcharge on the value of the deficiency or loss in each of the entity's transactions. Amending this provision to allow for the direct reporting and imposition of surcharges by the Auditor-General would address the current procedural challenges that have interfered with the effective utilization of this power. It appears that since the 2018 Act came into force, no officials have been made subject to surcharges, despite its significant promise for holding personally – *financially* – accountable for failure to prevent or remedy actions associated with fraud and corruption.

61. Enabling the NAO to fulfil its function is likely to require more effective utilization of financial and human resources. Historically, the Auditor-General has had little control of the hiring, promotion, and firing of officers, as well as limited involvement in budget setting and allocation. The creation of the Audit Service Commission was intended to strengthen resource management, but the intended impact remains to be felt.

Table 5. Recommendations on Strengthening the role of the Auditor-General in Accountability

Measure	Authority	Implementation Timeline
1 Amend s.9 of the Audit Act to allow the Auditor-General to share findings, preliminary or otherwise, with law enforcement bodies for the purposes of possible criminal investigation into fraud and corruption revealed by the audit(s) in question, prior to the full report being tabled in Parliament.	Ministry of Justice	December 2023
2 Strengthen the capacity of the Auditor-General to conduct its function, and establish regular reporting, at least every 6 months, on follow-up of audit findings and recommendations	Auditor-General	March 2024
3 Amend the National Audit Act to enable the-the AuditorGeneral to levy surcharges on officers, including Chief Accounting Officers, for failure to properly discharge responsibility for oversight and accountability for use of public	Auditor-General; Ministry Finance	March 2024
4 Constitute COPA and COPE as permanent bodies, with the committee to be chaired by a member of the opposition party	Parliament	September 2024

D. Investigation, Prosecution, and Sanctioning of Corruption

62. A properly functioning anti-corruption authority (with prosecution function) should have the following in place if it is to deliver on its potential.²⁵

- a) sufficient *legal powers* to effectively investigate and prosecute complex corruption-related cases;
- b) *Proper funding* for equipment and staff resources to ensure that cases do not fail at court for want of expertise, lack of adequate equipment or other related reasons;
- c) Data gathering and analysis from ongoing and concluded cases to ensure that patterns in case failure and success are recognised and lessons learned;
- d) Clear communication between the investigative and prosecutorial arms of the authority, including effective joint working and understanding of what each arm requires in order to fulfil its function properly, including the consistent use of 'Points to Prove' guide for each of the commonly investigated and charged offenses;
- e) Clear, monitored policies concerning the *prioritization* of cases, including the decision to pursue an investigative or intelligence lead;
- f) Clear, monitored policies concerning the *decision to charge* suspect(s) and the nature and number of charges to pursue;
- g) Effective *delegation of powers* and functions to prevent caseload bottlenecks and to minimise corruption risks inherent in giving powers and functions to a single individual (or a very limited number of individuals);
- h) The ability to communicate and collaborate effectively with *international partners* when the case requires it - whether through formal (Mutual Legal Assistance) or informal (police to police) means;
- i) *Proper funding* for equipment and staff resources to ensure that cases do not fail at court for want of expertise, lack of adequate equipment or other related reasons;
- j) Data gathering and analysis from ongoing and concluded cases to ensure that patterns in case failure and success are recognised and lessons learned.

63. Under the ACA, CIABOC has adequate legal powers to gather intelligence, investigate and prosecute corruption-related criminality. However, it lacks dedicated personnel and equipment.²⁶ A very substantial number of the Commission's investigative staff are seconded from the Sri Lankan Police, raising fundamental questions of independence, particularly when the investigations are into police conduct.

²⁵ In accordance with the Articles of the UN Convention against Corruption, guidance from the International Association of Prosecutors, the OECD guide to the investigation and prosecution of corruption offenses, amongst others.

²⁶ It also has the power to consult with the Attorney General in cases where it considers it appropriate to do so.

64. The secondment of capable and experienced police officers provides the Commission with valuable expertise. However, stronger steps must be taken to ensure the autonomy of this crucial element of the Commission’s function. The Commission must be given the means and capability to recruit and train its own officers, within a parallel promotional and ranking structure to that of the Sri Lankan Police.

65. Equally important is to ensure that the Commission is resourced sufficiently well to have meaningful access to relevant investigative and analytical equipment and training. Defendants in large corruption cases typically have powerful defence teams with ready access to modern equipment and methods. There must be an equality of arms in such cases and presently the Commission operates with significant staff shortages, lack of training in some respects, and lack of reliable access to modern sophisticated equipment. These issues alone could mean the difference between a case being successful or not.

The Commission’s performance

66. A limited amount of data relevant to performance is provided on the Commission’s website.²⁷ While the number of corruption cases investigated is not insignificant, the number of those progressed to a successful prosecution is substantially smaller. See Table 6

Table 6. Disparity between cases files and convictions achieved.

Year	Total Number of Cases Filed	Total Number of Cases Disposed	Number of Convictions
2014	64	58	22
2015	108	52	15
2016	87	34	15
2017	73	89	57
2018	52	110	64
2019	46	94	45
31.08.2020	36	43	22

67. There is risk when metrics such as these are used to measure an agency’s performance. When agencies or individuals know they will be evaluated according to such metrics, they have incentives to behave in ways that improve performance on those metrics but that might not actually represent meaningful and substantive improvement on the dimension of performance that the metric is supposed to measure. So, if a law enforcement unit, such as CIABOC, is evaluated according to how

²⁷ <https://www.ciaboc.gov.lk/>

many successful convictions it secures, it might spend considerable resources on low-level, easily proved violations to improve its performance in terms of number of convictions (or conviction rate), even if those cases are not important.²⁸

68. There have been some significant successes. A five-judge bench of the Supreme Court recently (January 2023) upheld the 2019 convictions for bribery of the former President’s Chief of Staff, and the former Chairman of the State Timber Corporation. Similarly, in 2020, the Commission was effective in prosecuting the former Parliamentarian Sarana Gunawardena – who was at the time serving as the Chairman of Development Lotteries Board – for corruption-related offending.²⁹

69. But such cases are not common and are unlikely ever to be common. There are good reasons for this, including that most criminality does not occur at this higher level and when it does, the sophistication of these suspects means it can be difficult to amass sufficient evidence to progress a case beyond the investigation phase.³⁰ Large complex cases like this can take many years to investigate and then prosecute effectively, even in highly developed jurisdictions with access to an array of sophisticated equipment and case management functions such as the USA and the UK. It could also be that smaller cases are being prioritised at the cost of larger cases.

Prioritization of cases

70. The above issue is linked to a popular narrative that the Commission ‘goes after the small fish’ because bigger, perhaps more politically connected, individuals place pressure on the Commission not to proceed with investigations and/or prosecutions. The available statistics do suggest that the majority of CIABOC investigations and prosecutions focus on defendants who do not occupy (or did not previously occupy) senior positions within government.

71. There are solid, justifiable, reasons for pursuing ‘lower level’ cases: they are easier to prove; they are concluded more quickly and do not place the long-term demands on staff that more complex and serious cases frequently do. There are also solid, justifiable reasons for pursuing ‘high level’ cases; they usually represent the loss to the state of significant amounts of money; serious criminal acts should always be pursued not least to ensure that perceptions of impunity are not allowed to grow.

72. But in the absence of a clear policy which sets out the principles on which the Commission makes its decisions about which cases to prioritise, and an absence of data and analysis as to whether and why cases are successful, it is inevitable that speculation grows. The

²⁸ See UNODC (2015), National Anti-Corruption Strategies: A Practical Guide for Development and Implementation, p.44

²⁹ The former case was something of a landmark for CIABOC, following a complex and well-organised ‘sting’ operation. The Fund understands that other ‘large’ investigations are currently underway. These take substantial resources to mount, yet more to prosecute effectively, so the Commission must be supported effectively if organizational progress made in these larger, more high-profile cases, is not to be lost.

³⁰ It is no doubt frustrating to Commission investigators to see potentially serious allegations of criminality involving senior officials not proceeding to charge because of the insufficiency of evidence to prove the offenses alleged. What the Commission should not do is to commence legal proceedings regardless of the state of the evidence; what some call the ‘let the court decide’ approach.

Commission must establish those principles to ensure consistency and transparency of decision making and make public those principles (on its website).

The significant analysis gap that hinders CIABOC

73. It is universally recognised that corruption-related offending can be difficult to prove. But it is important to ensure that cases are not failing for reasons that may be preventable. This requires data to be gathered and analysed from cases that extends beyond information concerning whether a case is investigated, charged, prosecuted and whether a conviction is the result. Of far greater importance is the data concerning *why* a case has been successful or not; why it hasn't proceeded to conviction, whether that is because a not guilty verdict was arrived at. Was the prosecution case rejected after a defense submission of no case to answer? Did the prosecution withdraw the case before the trial commenced? None of this data is captured by the website because it either isn't currently recorded by the Commission or in those instances where it is recorded it isn't subject to proper and meaningful analysis.³¹

74. Trends and patterns revealed by the analysis of such data are critical to ensure the Commission addresses identifiable shortcomings in the investigative and prosecutorial processes. Without it, the Commission is unable to establish why cases are failing, and the corresponding needs for personnel, equipment, or training. Presently, the Commission is unable to identify specific needs with proper evidence-based justification. It will be in a far stronger position to ask for additional, targeted, funding when it has the analysis to support it.

75. CIABOC needs to ensure: 1) that all future cases have recorded on the file jacket (or if held electronically, within the case management system) the detailed reasons for the case not proceeding to charge/being withdrawn once proceedings are commenced/dismissed by the court/why it is unsuccessful following trial;³² 2) that dedicated staff resources are provided to establish a back catalogue of data from concluded cases, or those undergoing the appeal process, ensuring that the above data is captured; 3) that all of the captured data is analysed for trends and patterns that could reveal shortcomings in investigative or prosecutorial approach and which may be remedied through provision of more or better facilities, training or greater consistency of approach.³³

Two-stage prosecution test

76. There is currently no clear and consistent policy in place at the Commission which determines when a case meets the legal and evidential burdens for proceeding to charge, and assessing whether it is likely to result in conviction. Such a policy ensures consistency of decision-making and ensures cases are not sent to court before they are evidentially ready. With the proper

³¹ Of similar import is the need to record those cases which are successfully appealed by the defendant, and the reasons provided by the judge as to why the conviction was overturned. The detailed reasons for these outcomes must be recorded.

³² e.g. (and this is not an exhaustive list) witnesses not coming up to proof, failing to appear; admissibility issues or other points of law and procedure.

³³ For example, are cases more likely to be successful or unsuccessful in some courts rather than others? Are more cases discontinued/dismissed/withdrawn for some reasons than others – e.g., evidential /admissibility arguments?

review process to supplement its use, it also allows for analysis that links strongly with the suggestions made above as to when cases fail *and why* they fail.

77. To remedy this, a Code for Commission Prosecutors should be created and implemented.

Such a Code is a mechanism adopted in a number of common-law jurisdictions³⁴ and has met with considerable success. The Code will consist of a two-stage process that requires the prosecutor to consider:

- 1) Is there sufficient reliable and credible evidence to provide a realistic prospect of conviction? Prosecutors must consider what the defence case may be, and how it is likely to affect the prospects of conviction. A case which does not pass the evidential stage must not proceed, no matter how serious or sensitive it may be.
- 2) Is it in the public interest to proceed with the charge? This consists of seven considerations. a) How serious is the offense committed? b) what is the level of culpability of the suspect? c) what are the circumstances of and harm cause to the victim? d) what was the suspect's age and maturity at the time of the offense? e) what is the impact on the community? f) is prosecution a proportionate response? g) do sources (e.g. informants) require protecting?

Through consistent application of the Code, the Commission will ensure consistency and transparency of its decision-making processes.

Points to Prove guide

78. To further assist with the first stage of this process, a 'Points to Prove' (P2P) guide for each of the most common corruption-related offenses should be created.

Taking individual offenses, the P2P should identify each of the component parts of the offense and set out examples of how each of those component parts – or points – can be established evidentially. This ensures that all of the evidence necessary to establish the complete offense is adduced in court, creating greater certainty about the proceeding with the case further, and in the event the case goes to trial, ensuring that no gaps are left for the court to question.

79. A P2P guide also ensures that there is effective communication between the investigative and prosecutorial arms of the authority

because it ensures that there is common understanding about what investigative leads ought to be prioritised and why it is necessary to gather certain pieces of evidence and not others.

An independent prosecution service?

80. It has been suggested by some that all prosecutions in Sri Lanka should be delivered through an independent prosecutor's office, which sits outside of the Commission and indeed outside of the Attorney General's Office. Sri Lanka would not be alone if it adopted this approach –

³⁴ England & Wales, Canada, Australia, Kenya, Tanzania, Jamaica, Trinidad & Tobago, Barbados, Guyana, amongst others.

many common-law jurisdictions have independent bodies responsible for prosecution of crime.³⁵ There are a number of advantages to this system – operational independence being one of the most significant,³⁶ thereby helping to address public concerns about possible political influence over the decision-making process.

81. While the Commission does have its own power to prosecute corruption cases, in some cases it seeks the assistance of the Attorney General’s Office, which has very experienced lawyers and in such cases advises and supports the Commission. But it is in those same cases (sometimes high profile and complex) that the accusation of political influence is often levelled at the Commission. Because the Attorney-General is a government appointee and acts as government’s chief legal advisor, his function as chief prosecutor, it is said, cannot be truly independent. Nor is there any clarity as to when and in what circumstances the AG’s Office is consulted in such cases, as there is no public record. In matters where the AG’s Office is asked for early assistance in a case, the process by which significant investigative and prosecutorial decision-making occurs is opaque as is the extent of involvement the AG’s Office or the AG.

82. It is for these and related reasons that other jurisdictions have chosen to create independent prosecutor’s offices with a chief prosecutor (often coining a ‘Director of Public Prosecutions’) who has no other government role. The Attorney Generals’ function in these jurisdictions is to ‘superintend’ the work of the prosecution service, as it is the AG who is accountable to Parliament. The AG is not, for the most part, involved in prosecution decision-making.

83. The creation of a new independent prosecutor’s office would involve a legislative process, and a substantial commitment of time and resource; however, if implemented using (a suitable adapted version of) one of the models adopted in other common law jurisdictions, it would address a significant number of the challenges identified above. This is explored in more detail in the accompanying Annex 2 ‘Concerning the creation of an independent prosecution service for Sri Lanka’. While this option may be worth considering, the current report does not include a recommendation that such a step be taken in the near term..

Case-flow management & delegation of responsibility

84. Currently, it is only the Director-General of the Commission who has the power to institute criminal proceedings, upon recommendation of the Commission.³⁷ The Commission’s recommendation concerning any case is based on its view of the case submitted to it by the Commission’s staff.

85. Consideration must be given to streamlining the decision-making process given the increasing volume of cases expected. Concentrating the power to institute proceedings in the hands of a single individual or a limited number of individuals also adds significantly to managerial risks, as well as corruption risks, in the decision-making process.

³⁵ For example, the Crown Prosecution Service of England & Wales.

³⁶ The independence of the prosecutor is central to the criminal justice system of a democratic society.

³⁷ At least two of the three-member Commission must agree, depending on other circumstances.

86. Section 25(1) of the new Bill specifically provides for the Director General of CIABOC to delegate any 'power function or duty' to a competent officer. This provision should be read to include the power to authorise prosecution, set out under s.18(a) of the same bill. If that is indeed the case, it would alleviate an existing problem with throughput of cases and address perceptions of independence around the decision to charge.

87. Adopting the practice of delegation of powers to institute proceedings to a limited number of senior staff, such a power to institute proceedings would address a particular bottleneck. Such delegation would be particularly appropriate in the cases at the lower level of severity, and is a mechanism used in other jurisdictions. For example, while certain very serious or sensitive offenses in England & Wales require the permission of the Director of Public Prosecutions to institute proceedings; the vast majority do not. Were it not for this arrangement, the system would collapse under its own weight because of the sheer number of cases requiring the decision of a single individual.

88. It should be noted that the above-mentioned suggestion of a Code for Commission prosecutors would assist significantly in ensuring consistency of decision making of those with the delegated powers.

Collaboration with other jurisdictions - Mutual Legal Assistance

89. Section 34(3) of the ACA makes the Commission the central authority for Mutual Legal Assistance matters relating to offenses under the Commission's mandate, meaning it sits outside the Central Authority which is contained within the Ministry of Justice.³⁸

90. The mutual legal assistance function of the Commission and the Central Authority will need to be strengthened in order to facilitate the transnational component of its expanded mandate under the new provisions. Past experience has demonstrated that larger corruption cases frequently involve multiple jurisdictions and establishing effective mechanisms for international collaboration is essential. CIABOC has the legal power to engage in intelligence sharing and is already a member of one large international network.³⁹ It is important for CIABOC to build working

³⁸ It isn't clear from the provision how in practice MLA requests made by requesting jurisdictions to the CIABOC will be dealt with distinctly from other requests. Will they initially be sent to the Ministry of Justice, which is the existing Central Authority for MLA requests, and then to the CIABOC? If the purpose of the provision is to ensure independence of the Commission.

³⁹ The Global Operational Network of Anti-Corruption Law Enforcement Authorities (GLOBE Network), launched in 2021, offers a platform for information exchange between anti-corruption law enforcement practitioners. It is a virtual hub which has a secure communications channel. The International Anti-Corruption Coordination Centre (IACCC) could also be of considerable assistance to the Commission. During the 2016 Global Anti-Corruption Summit, the participants committed to establishing the IACCC, which has been operational since 2017. It is hosted by the UK's National Crime Agency (NCA) but has specialist operational officers embedded in the Centre from Interpol, the USA (FBI and DHS), Canada (RCMP), Australia (Federal Police), New Zealand (Serious Fraud Office) and Singapore (CPIB). The IACCC engages in intelligence sharing with member countries and disseminates intelligence packages to other jurisdictions. It also receives referral grand corruption cases from external jurisdictions and takes new members. A greater involvement with the IACCC would be beneficial not only for the Sri Lankan authorities but also for the IACCC, as it continues to build a global picture of grand corruption.

relationships with police and enforcement bodies in other countries, and to build up expertise in asking for and utilizing the help of others to bring justice and accountability to Sri Lanka.

91. To further this relationship, embedding officers from the Commission in the FIU and vice versa would be a helpful strategy.

Table 7. Recommendations to Strengthen Investigation and Prosecution of Corruption Cases

Measure	Authority	Implementation Timeline
1. Define 18-month action plan for improving investigation and prosecution of corruption cases	CIABOC	April 2024
2. Establish staffing rules, procedures for recruitment, etc. – align with budget for CIABOC	CIABOC	April 2024
3. Establish and implement rules and protocols on the filing and information required for each case file	CIABOC	March 2024
4. Establish Data analytics to identify performance constraints	CIABOC	April 2024
5. Establish protocols and rules for determination of whether to proceed with prosecution of case – including Code for Commission Prosecutors	CIABOC	April 2024
6. Establish guidance on building an effective case – through Points to Prove Guide	CIABOC	May 2024
7. Establish rules for case flow management – including delegation of responsibility	CIABOC	March 2024
8. Strengthen Mutual Legal Assistance	CIABOC	June 2024
9. Communications – publish statistics on website, and mechanisms for receiving information	CIABOC	September 2024
10. Design and initiate staff capacity building program	CIABOC	June 2024
11. Issue CIABOC Annual report on a government website.	CIABOC	December 2024

E. Transparency and participatory and Inclusive governance

92. As recent experience has shown, civil society has a vital role to play in demanding accountability from public officials and directly contributing to better governance and integrity. Effective governance arrangements work to enable non-state parties to participate in monitoring public sector performance, through inclusive and participatory processes. Until now, this chapter has largely focused on anticorruption efforts led by, and largely involving state actors. Anticorruption efforts are unlikely to achieve their objectives unless they also encompass initiatives designed and led by groups outside of government who are committed to rule-based inclusive economic and social progress.

93. Transparency in public processes and the provision of reliable and timely information are essential for participatory governance. Government policies, rules, and practices are often opaque. A number of weaknesses regarding the transparency of anticorruption practices have already been noted in this section, and additional transparency issues are noted in each of the subsequent chapters. In many of these instances, the lack of transparency is particularly damaging to trust in official practices, as observers are left to speculate on how government functions. In these cases, the appearance of conflict can have dramatic consequences for the willingness of individuals to follow rules (like paying taxes) or invest in formal economic activities.

94. Sri Lanka has taken important steps in establishing the right to information and creating an institutional framework for protecting those rights. The Right to Information Commission ('RTIC') was created by the Right to Information Act, No. 12 of 2016 ('RTI Act'), to hear complaints of non-compliance by public authorities of their disclosure obligations, and to recommend disciplinary actions against offending officials. It also has the power to prosecute those who commit offenses defined in the RTI Act. Given this mandate, it plays an important role in championing the right to information and fostering an (embryonic) culture of transparency among public authorities. It builds upon the information infrastructure established by the Ministry of Media and works closely with the Ministry on outreach. Experience to date has demonstrated the Commission's ability to require government agencies to disclose a wide variety of information requested by individuals.⁴⁰

95. The work of the RTIC is particularly consequential for anticorruption efforts since many of the requests for intervention come from groups that are traditionally most exposed to corruption and the abuse of public power, including women and minority groups. The extent to which the RTI is relied upon as an effective means of seeking redress demonstrates the effectiveness of its outreach and the value associated with the information obtained based on its interventions.

96. Enhancing and enlarging the ability of the RTIC to fulfil its mandate is vital for inclusive governance. However, a number of recent proposed bills have the potential for constraining the ambit of the Commission, excluding "sensitive" matters from the Commission's jurisdiction. Great care needs to be taken that the Commission's reach is not limited by future legislation. These concerns are particularly acute around antiterrorism and privacy legislation but have also been raised around certain provisions in the Anticorruption Law. It will be important to establish policies and rules that properly balance protection of vital information rights with the state's equally justifiable interest in protecting its security, the privacy of individuals, and the confidentiality of its investigations. If not, there is a significant risk that this outstanding example of transparency is stripped of its effectiveness.

97. There is also a pressing need to expand the amount of information that is proactively disclosed and regularly provided by the public sector. The RTI Act contains useful principles about the provision of public information, but implementation of these principles remains uneven. This chapter has already included a number of recommendations that CIABOC and others can adopt to

⁴⁰ Recently, it was involved in a landmark case adjudicated by the Court of Appeal which upheld a directive by the Commission to the Sri Lanka Parliament to release information on MPs who have submitted their Declarations of Assets. The Court agreed with the Commission on all points and upheld that the RTI Act of Sri Lanka supersedes the 1970's Declarations of Assets and Liabilities Act of Sri Lanka.

increase information flows, including in areas like asset declaration. In addition to agency-specific efforts, a government-wide effort will be needed to create and maintain a Transparency Portal with reliable and updated information essential for holding government accountable for performance. The Ministry of Media also has a vital role to play in supporting more proactive and consistent disclosure of information.

98. The bridge between public access to information and greater accountability for behaviour and performance is built through platforms for public engagement in governance.

Rules promoting a responsible and free press are one example of such a platform since such rules provide investigative journalists the space to carry out their important work in identifying and publicising official misbehaviour. Sri Lanka has benefitted greatly from its robust and noisy media space, and institutions like the Centre for Investigative Reporting (CIR). It is vital for that civic space to be respected and protected, building upon existing efforts such as the inclusion of work with the CIR envisaged in the National Action Corruption Plan.

99. A more direct platform for engagement in anticorruption work are the rules relating to the treatment of anticorruption whistleblowers – individuals who share information relating to corrupt acts of officials.

International experience, including that in the United States, has repeatedly demonstrated the importance of whistle-blowers for anticorruption efforts. Private information sources are particularly vital in identifying corruption, especially given the lengths that parties go to hide their behaviour and co-opt official monitors. Well-defined principles exist to support appropriate treatment and protection of these information sources.

100. Sri Lanka does not currently have a fully functioning dedicated whistleblowing scheme for public officers.

Following the first review cycle of the UNCAC, recommendations were made by UNODC that Sri Lanka introduce additional measures within the domestic legal system to ensure that persons reporting information on corrupt practices are protected against unjustified treatment (as required by Article 3 of UNCAC). These provisions would also support the better protection of witnesses and victims of crime under the 'Assistance to and protection of victims of crime and witnesses Act' No 4 of 2015. Under the provisions of that Act, a person is protected if s/he makes a complaint to a law enforcement agency, but it does not provide for instances of whistleblowers.

101. The ACA provides for the protection of the identity of informers, whistleblowers, and witnesses and other assisting the Commission.

In addition, the Commission has the power to take any measures necessary to ensure the safety of any person assisting the Commission, such as requiring the police to provide physical protection to the person. However, the law also contains a number of provisions which imperil whistleblowing. Section 119 will allow for the prosecution of persons who make false allegations to the Commission 'knowing such allegation to be false or having reason to believe that such allegation does not constitute an offense'. Similarly, section 122 creates an offense of 'knowingly giving false or misleading information to the Commission.' Section 122, in particular, is widely drafted, meaning it could be used inappropriately whereby someone who provides 'misleading information' (which is not further defined in the Bill) could be prosecuted by the very agency to which they are seeking to provide information about the wrongdoing of others.

102. It is not good practice to criminalise such acts, as this can have a chilling effect on the legitimate desire to disclose by those who are unsure of their legal position (e.g., they do not

know whether the matters they wish to disclose constitute an offense). It will be important for CIABOC, the entity responsible for enforcing the law, to establish clear implementation rules that encourage and protect whistle-blowers, relying upon available guidance and information. (See, for example, the OECD guide ‘Committing to Effective Whistleblower protection” (2016)). In the future, it may be prudent to modify the legislation in order to signal the value placed on individuals coming forward to share information on wrongdoing.

Table 8. Recommendations on Enhancing Right to Information

Measure	Authority	Implementation Timeline
1. Explore ways to strengthen the RTI Act and ensure that its scope is not inappropriately restricted by future legislation	RTIC	March 2024
2. Action plan to strengthen the RTIC and enhance capabilities and competencies.	RTIC	June 2024
3. Create Transparency Portal and the mechanisms to ensure it continues to be updated	Ministry Finance, President	March 2024
4. Define plan to expand proactive provision of information	RTIC	March 2024
5. Produce a report on ways to strengthen protection of free and responsible media	RTIC, CSOs, Ministry Media	December 2024
6. Implementation of regulations relating to whistleblowers	Ministry of Justice	March 2024
7. Consider amending law to more effectively protect whistle-blower rights	Ministry of Justice	July 2024

Section III. AML/CFT

103. The AML/CFT framework is an important tool to fight corruption. An effective AML/CFT regime can contribute to prevention, detection, and prosecution of corruption, as criminals and corrupt actors would often seek to launder the proceeds of corruption. Corruption and bribery have been identified in 2015 Mutual Evaluation Report⁴¹(MER) as one of the top two proceeds-generating crime in Sri Lanka. Nevertheless, the MER also highlighted that investigation, prosecution, and conviction of corruption related money laundering cases was not forthcoming in line with corruption as a higher risk area. In September 2023, Sri Lanka finalized its updated National Risk Assessment (NRA) report and published a sanitized report on its website. Outreach activities with the banking institutions has been organisedorganized to inform the sector on the key findings of the updated NRA. Corruption and bribery are expected to remain as some of the highest proceeds-generating crimes.

104. Sri Lanka is a member of the Asia/Pacific Group on Money Laundering (APG), a FATF-style regional body that promotes adoption and implementation of the international standards for AML/CFT in the Asia-Pacific region.⁴² Sri Lanka's compliance with the international standards and effectiveness of its AML/CFT regime were assessed by APG in 2014. The corresponding MER, adopted in 2015, assessed Sri Lanka to be Partially Compliant or Non-Compliant in 28 out of the 40 FATF Recommendations, with low effectiveness in 9 out of 11 Immediate Outcomes.⁴³ Since then, Sri Lanka has taken steps to improve its technical compliance with the FATF standards. As of October 2021, Sri Lanka has largely rectified its key shortcomings on the technical compliance and assessed to be Partially Compliant or Non-Compliant on remaining 8 out of 40 FATF Recommendations.⁴⁴ The next comprehensive mutual evaluation on Sri Lanka by the APG is expected to take place during 2025/2026.

AML/CFT Legal and Institutional Framework

105. The legal and institutional framework for AML/CFT is broadly in place in Sri Lanka. The AML/CFT legislations comprising the Prevention of Money Laundering Act (PMLA),⁴⁵ Convention on the Suppression of Terrorist Financing Act (CSTFA)⁴⁶, Financial Transactions Reporting Act 2006 (FTRA) and the respective implementing regulations, as well as the Code of Criminal Procedure Act, provide the legal framework for the AML/CFT regime in Sri Lanka. These laws provide AML/CFT measures that could help mitigate governance vulnerabilities and support anti-corruption efforts such as transparency of beneficial ownership of legal persons, enhanced customer due diligence (CDD) requirements for politically exposed persons (PEPs) and reporting of suspicious transactions. The

⁴¹ See Mutual Evaluation Report of Sri Lanka (July 2015), <https://apgml.org/includes/handlers/get-document.ashx?d=2d67b884-6021-48aa-8b24-bb1a641c5d1c>.

⁴² Refers to FATF Recommendations 2012 to combat money laundering, terrorist financing and the financing of proliferation: <https://www.fatf-gafi.org/publications/fatfrecommendations/documents/fatf-recommendations.html>

⁴³ FATF Methodology for Assessing Technical Compliance with the FATF Recommendations and the Effectiveness of AML/CFT Systems, Updated October 2021

⁴⁴ 6th Follow-Up Report, Mutual Evaluation of Sri Lanka, <https://apgml.org/includes/handlers/get-document.ashx?d=eee56a36-c7ba-4c21-b92d-4f570637c20a>

⁴⁵ PMLA was enacted in 2006 with subsequent amendments in 2011.

⁴⁶ CSTFA was enacted in 2005 with subsequent amendments in 2011 and 2013.

AML/CFT competent authorities⁴⁷ comprised of the Sri Lanka Financial Intelligence Unit (FIU), various regulatory and supervisory bodies including the Central Bank of Sri Lanka (CBSL), and law enforcement authorities responsible for investigation and prosecution of ML/TF related cases. There are still gaps in its legal framework which prevent Sri Lanka from being fully compliant with FATF standard.

106. Inadequate resources and skills present ongoing barriers for an effective AML/CFT regime in Sri Lanka. While the legal framework is broadly in place, operational issues concerning inadequate resources and skills across competent authorities hinder effective implementation of the AML/CFT framework. Until recently, legal barriers did not vest CIABOC with the power to investigate money laundering cases prevented it from proactively sharing information with other law enforcement agencies due to the secrecy requirements under its legal framework. This legal barrier has been addressed through the passage of the ACA.

107. The experience of the FCID demonstrates that Sri Lanka can effectively investigate serious financial crimes, including money laundering, when given appropriate space and resources. The formation of an adequately resourced and empowered investigative division under the Sri Lanka Police Service provided the necessary catalyst for identifying and charging a number of senior officials with corruption and financial crimes. This experience indicates that the capacity to aggressively pursue money laundering and corruption offenses exists in the country and can achieve impressive results when organised and led effectively.

Investigation and prosecution of corruption-related money laundering offenses.

108. There is still a lack of successful corruption-related money laundering investigations, prosecutions, and convictions, which could help deter and mitigate the laundering of the proceeds of corruptions. While there have been investigations and prosecutions on corruption as the predicate offense, the related money laundering offenses were not actively pursued commensurate with the country's corruption risk. While the CIABOC is the investigation authority for corruption, the Criminal Investigation Division of the Sri Lanka Police is the designated investigation authority for money laundering. The 2015 MER indicated that CIABOC completed 4206 investigations (2010 – 2015) on bribery and corruption, however only one led to money laundering investigation by the police which did not lead to convictions.

109. Legal barriers prevent effective sharing of information and coordination to pursue corruption related money laundering cases. As discussed earlier (paragraph [4]), the current Bribery Act does not provide power to CIABOC to pursue money laundering cases in parallel with corruption cases. The Commission to Investigate Allegations of Bribery or Corruption Act and the Bribery Act accorded CIABOC a duty to maintain utmost secrecy and prevented CIABOC from disclosing any information to relevant stakeholders, such as the police that has power to conduct money laundering investigation on a timely basis. It is noted that ACA provided CIABOC with the mandate to pursue both money laundering and corruption investigations.

⁴⁷ See Sri Lanka MER 2015, p.32, for the list of competent authorities.

110. While higher-level coordination and information sharing is present, there is an absence of clear strategy and technical coordination mechanisms to pursue money laundering investigation in parallel with corruption investigation. While the legal barrier under the current legal framework is presently a challenge to effective implementation, Sri Lanka also does not have a clear national strategy and coordination mechanisms to pursue parallel corruption and money laundering investigations that could help identify solutions notwithstanding the legal barriers. Exchange of information appears to be generally on an ad-hoc basis. Access by police to information held by CIABOC has been restricted until very recently due to legal constraints. Information provided by the FIU to the CIABOC was largely a one-way sharing without useful feedback received. Lack of technical competencies of law enforcement agencies to investigate and prosecute money laundering cases relating to corruption is also one of the contributing factors to low level of successful money laundering conviction relating to corruption.

Asset Recovery

111. Measured against international standards, substantial gaps exist in the current legal framework of Sri Lanka concerning the identification, recovery and return of proceeds of crime. Sri Lanka currently relies on the PMLA, the Mutual Assistance in Criminal Matters Act and the Criminal Procedure Code for the confiscation and recovery of assets. The 2018 report by the Implementation Review Group (IRG) of the UNCAC⁴⁸ on Sri Lanka acknowledged progress made by Sri Lanka on requirements relating to UNCAC Chapter V on Asset Recovery. However, the IRG provided additional measures that need to be adopted to ensure Sri Lanka's legal framework is fully aligned with UNCAC requirements, as well recommendations to adopt global good practices in this area. Under the FATF standards, Sri Lanka is still assessed to be *Partially Compliant* in relation to its technical compliance to Recommendation 4 on Confiscation and Provisional Measures. This is largely due to the lack of confiscation measures relating to third parties and lack of mechanisms for managing or disposing of property frozen, seized and confiscated. Sri Lanka is currently working on establishing a comprehensive framework for asset recovery through the proposed Proceeds of Crime Act.

112. The low level of successful asset recovery and return relating to corruption reflects the low level of parallel investigations, the existence of complex court processes and the lack of technical expertise. While the PMLA provides the necessary power to forfeit stolen assets, implementation of this power is still largely ineffective particularly in the country's higher risk areas such as corruption. The low rates of parallel investigation and prosecution of money laundering offenses translates to lower confiscation of proceeds of crime. This indicates that criminals are not being prevented from profiting from the proceeds of crime. Pursuing confiscation of proceeds of crime under the PMLA also requires meeting numerous court application requirements which can be time consuming. Delays in court processes has further added to the challenges for an effective asset recovery system. Lack of technical expertise and staffing resources of law enforcement agencies had also limited the ability to pursue asset recovery.

⁴⁸ See:

https://www.unodc.org/documents/treaties/UNCAC/WorkingGroups/ImplementationReviewGroup/ExecutiveSummaries2/V1803684_e.pdf

113. Sri Lanka does not have well-articulated national strategies and policy objectives for pursuing the proceeds of crime in relation to corruption. This lack of a strategy, combined with limited attention to the issue and technical issues concerning the pursuit have all contributed to the creation of the current ineffective system. The MER 2015 also highlighted absence of relevant and reliable statistics relating to asset confiscation as an additional challenge in aligning policies and practices to effectively recover stolen assets and deter corruption.

Beneficial Ownership of Legal Persons

114. Since the 2015 MER, Sri Lanka has yet to address the deficiencies relating to transparency of beneficial ownership of legal persons⁴⁹ in its legal framework. This includes the absence of requirement for companies or company registry to obtain or hold up-to-date information of the companies' beneficial owners. Further, the concept and definition of beneficial ownership is not included in the Companies Act.⁵⁰ There is also no mechanism to facilitate timely access by competent authorities to beneficial ownership information. To this end, the Registrar General of Companies working together with the FIU and other relevant authorities, has formulated draft amendments to the Companies Act to fully align its legal framework for legal persons with the FATF standards. These draft amendments are pending final review by the authorities for submission to Parliament for approval and adoption.

115. Law enforcement agencies currently access beneficial ownership information through records maintained by financial institutions. While the Companies Registrar maintains basic legal information on companies, given the current legal gaps, beneficial ownership information is not widely available through the Registrar. Information provided by the Companies Registrar to the law enforcement agencies is mainly limited to basic, legal information of companies. Law enforcement agencies also have access to records held by financial institutions. Nevertheless, given the gaps in the current Companies Act, information provided by companies to their financial institutions on beneficial ownership might not be comprehensive or accurate.

116. Sri Lanka plans to develop implementing regulations once amendments to the Companies Act are adopted, but lack of operational capacity may hinder effective implementation. The authorities have yet to formulate a clear mechanism for the collection and verification of, and access to the beneficial ownership information to be maintained at the Companies Registrar, in line with the changes to be introduced through amendments to the Companies Act. The Registrar General of Companies intends to leverage the existing electronic registration system, but existing operational issues in the electronic system still need to be addressed for that to be feasible. The lack of competent and adequate resources at the Registrar, particularly on beneficial ownership requirements and awareness, pose a challenge to effective implementation of the beneficial ownership framework in Sri Lanka.

⁴⁹ Sri Lanka was assessed as "Non-Compliant" for Recommendation 24: Transparency and Beneficial Ownership of Legal Persons in the 2015 MER.

⁵⁰ Nevertheless, the concept and definition of beneficial owner are stipulated in the Customer Due Diligence (CDD) Rules 2016, applicable on all financial institutions (except for the insurance sector which is provided under the CDD Rules 2008 for insurance sector).

AML/CFT Risk-Based Supervision

117. AML/CFT supervision, which is jointly carried out by the FIU, CBSL, SEC and IRCSL on financial institutions⁵¹, has adopted a risk-based supervisory framework, although lack of resources may hinder effective implementation of the framework. ML/TF risk data collection template and risk management questionnaires are disseminated to all financial institutions on an annual basis. Further, SEC and IRCSL conducts risk assessment and prepare the onsite supervisory plan for securities and insurance sectors respectively, and the FIU for banks, finance companies, restricted dealers with the DFE, MVTs providers and primary dealers. Data and information obtained from these tools are used to inform onsite supervisory plan. The FIU has issued guidance notes on beneficial ownership (2018), suspicious transactions reporting (2018) and PEPs (2019) to improve compliance by financial institutions. Thematic reviews on implementation of PEPs and beneficial ownership requirements by banks were conducted within the past three years. The COVID-19 pandemic had impacted the number of onsite inspections carried out on financial institutions in 2020 (11 onsite) and 2021 (5 onsite). As the pandemic situation improved, the authorities were able to conduct more onsite inspections in 2022 (38 onsite). Nevertheless, lack of resources, particularly at the FIU, limits the supervisory activities on AML/CFT, given that the FIU is also responsible for AML/CFT supervision of designated non-financial businesses and professions, including Casinos, Real Estate Agents and Gem and Jewelry Dealers.

118. Supervisory enforcement actions and sanctions have been imposed on financial institutions. The FIU has a range of sanctions that could be utilised, including warning letters, show cause letters and monetary penalties which have been imposed for AML/CFT violations. Prioritization of supervisory activities towards areas of higher risks as informed by the findings of the NRA as well as past findings of onsite inspections, could alleviate the pressure from constraint in adequacy of supervisory resources, while positioning its AML/CFT supervision to be appropriately risk-based.

Financial Intelligence Unit

119. There is lack of receipt and dissemination of financial intelligence to support investigation and prosecution of corruption-related money laundering cases, commensurate with the corruption risk of Sri Lanka. The number of suspicious transaction reports ('STR's) relating to potential corruption remains very low, despite multiple outreach activities by the FIU. (**Table 9**). This has led to an extraordinarily low number of disseminations of financial intelligence reports to law enforcement agencies on corruption-related cases, which appears severely at odds with the reported incidence of corruption in the country. (**Table 10**). This may reflect the low level of understanding by reporting entities on corruption-related risks, as well as the absence of sanctions for non-reporting. There is also lack of clear understanding on how proceeds of domestic corruption is laundered, or whether Sri Lanka's financial institutions are vulnerable to being used as conduits for moving proceeds of corruption originated in foreign jurisdictions.

⁵¹ CBSL is the supervisor for banks and non-banks financial institution.

Table 9: Number of corruption related STRs received by the FIU.

	Year	Corruption	Bribes	PEPs
1	2016	-	5	1
2	2017		2	4
3	2018	2	3	8
4	2019	2	2	7
5	2020	1	2	8
6	2021	2	1	2

Table 10. Number of financial intelligence reports disseminated to law enforcement agencies (LEAs) by the FIU

	Year	No of cases referred to LEAs
1	2016	4
2	2017	
3	2018	6
4	2019	7
5	2020	7
6	2021	4

120. Lack of effective domestic cooperation on corruption related issues between competent authorities and law enforcement agencies hampered sound understanding of risks to better inform AML/CFT strategies. While key competent authorities, such as the FIU and police, may have sound understanding of ML/TF risks in general, this understanding did not connect adequately with threats posed by corruption to better inform AML/CFT strategies. The legal barriers are one of the key contributing factors preventing CIABOC from actively sharing information with the FIU and police on corruption related cases.

Table 11. Recommendations: Strengthening the role of Anti-money Laundering in the fight against corruption.

Measure	Authority	Implementation Timeline
1. Enact the Proceeds of Crime legislation fully aligned with requirements under the UNCAC and FATF standards.	Ministry of Justice	April 2024
2. Operationalise the provisions of the Proceeds of Crime legislation, and issue first annual report on a government website on progress and performance.	Ministry of Justice, CIABOC	December 2024
3. Strengthen identification of PEPs and reporting of suspicious transactions by financial institutions through enhanced supervision by AML/CFT regulators, production of guidance notes and training, and application of dissuasive and proportionate sanctions in a timely manner.	FIU, CBSL	Initiate by March 2024
4. Enact amendments to the Companies Act relating to the requirements on beneficial ownership measures fully aligned with the FATF standards.	Ministry of Justice, Registrar General of Companies, FIU	June 2024
5. Formulate and adopt the implementing regulations to support the amendments to the Companies Act on beneficial ownership. Regulations should provide clear mechanism for timely access by competent authorities to the beneficial ownership information, including other relevant public authority such as the public procurement authority. The regulations should allow access to the beneficial ownership information by reporting institutions with AML/CFT obligations. To increase transparency and advance the fight against corruption, Sri Lanka should consider establishing a public beneficial ownership registry.	Ministry of Justice, Registrar General of Companies, FIU	September 2024
6. Conduct strategic analysis to better understand how proceeds of crime from corruption activities are laundered through banks, vulnerabilities in the banking sector, and involvement of other relevant actors in the laundering process. Disseminate findings to the banking sector and other relevant actors including law enforcement agencies. Identify risk mitigation measures that banks need to adopt.	FIU	December 2024
7. Formulate and implement policies and strategies on corruption-related money laundering investigation, prosecution, and conviction, in line with the new power accorded to CIABOC to pursue money laundering offense under the Anti-Corruption Bill. This should include establishing mechanism for CIABOC to coordinate and cooperate with the FIU and other relevant law enforcement agencies and improve the collection and of statistics and successful cases related to corruption-related money laundering. Strategies should also include considering	CIABOC, FIU, Police, and other relevant law enforcement authorities	December 2024

	adopting new arrangements to ensure effective organization and leadership of money laundering investigations and prosecutions.		
8.	Strengthen protocols and relationships to enhance mutual legal assistance to assist in the prosecution of cases involving money laundering and corruption and the recovery of stolen assets	CIABOC and FIU	December 2024
9.	Develop national strategies and policy objectives relating to asset recovery, in line with the objectives of the Proceeds of Crime legislation.	Authorities with power for asset confiscation (e.g., Police, CIABOC, FIU, etc.)	June 2025

Section IV. Fiscal Governance - Public Financial Management

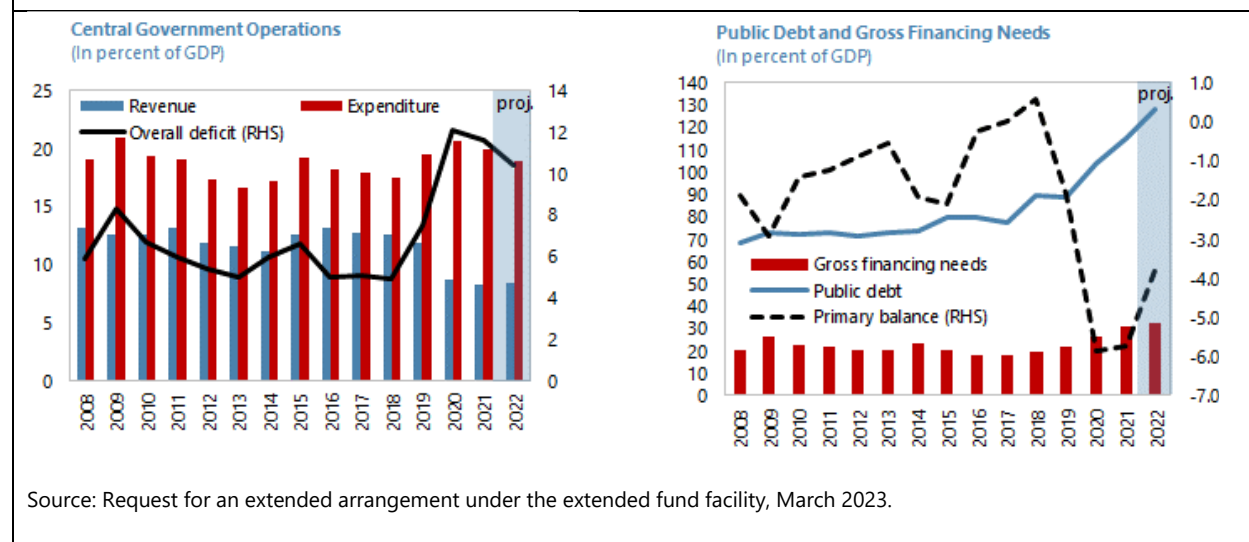
A. Fiscal Governance in Sri Lanka

121. This section discusses key issues of strengthening governance in managing public finances with a particular focus on addressing weaknesses that are associated with corruption risks. Good fiscal governance including a sound public financial management (PFM) system is an important driver of integrity, transparency, and accountability and reduced vulnerabilities to corruption. This section focuses on “hotspots” where governance weaknesses in PFM have created distinct corruption vulnerabilities. This emphasis should not detract from the overall understanding that a strong PFM system generally helps to reduce corruption and other fiduciary risks and therefore the broader PFM reform agenda for Sri Lanka is highly relevant to reducing corruption.

122. The recent crisis has placed great stress on Sri Lanka’s fiscal position. A series of external shocks combined with questionable policy choices in 2019 left the country with a very tight fiscal space. The effects of the COVID pandemic, ratcheted up emergency spending needs at the same time that decisions on tax policy and investments drastically reduced public revenues. Fiscal deficits reached 12.1 percent of GDP in 2020 and 11.6% of GDP in 2021. This deteriorating fiscal position during Covid led to Sri Lanka’s debt raising to unsustainable levels, which together with depletion of foreign initial resulted in large-scale direct lending to the government by the Central Bank of Sri Lanka (CBSL) and culminated in the suspension of debt servicing in 2022.

Figure 1. Central Government Operations

Figure 2. Public Debt and Gross Financing Needs



123. The crisis has served to highlight long-standing underlying fiscal governance issues that have constrained performance and exposed the nation to high levels of corruption risks. Despite the Fiscal Management (Responsibility) Law, the government has struggled to maintain fiscal discipline due to a combination of overly positive revenue forecasts and challenges in reigning in spending in a context of weak accountability for the adherence to fiscal rules. Weaknesses in budget coverage and

commitment controls have led to extensive cash rationing, often done in opaque processes with little oversight. Large public projects have multiplied but many projects have been approved that circumvent the formal evaluation process and the country has struggled to get a positive return on its investments. Processes for approving investments and public procurement are similarly opaque and raised concerns over fiduciary probity and integrity. State-owned entities continue to play a large role in the economy, but management and oversight are weak, with limited transparency and poor financial performance. While external and unique circumstances drove many of the specifics of the crisis, the foundation of the fiscal crisis was largely home grown with deep structural and institutional roots.

Source: IMF FAD Technical Assistance Report, *Fiscal Rules and the Public Financial Management Bill*, March 2023

Box 1. PFM Legal Reform Areas in Sri Lanka

Laws currently in force

1. The Finance Act No.38 of 1971 (Part II)
2. National Audit Act No.19 of 2018
3. Central Bank Act 2023 (passed in August 2023; repeals Monetary Law Act (Chapter 422))
4. FM(R)A No.3 of 2003 (expected to be repealed and replaced by the PFM Act)
5. Monetary Law Act (Chapter 422) (expected to be repealed by the new Central Bank Act)
6. Foreign Loans Act No. 29 of 1957
7. Parliamentary Budget Office Act (recently passed in June 2023)
8. Accounting and Auditing Standards Act No. 15 of 1995

Laws being developed/to be developed

1. Draft Central Bank Act (currently with the Parliament, repeals Monetary Law Act (Chapter 422))
2. Draft Public Financial Management Act (currently being developed)
3. Public Debt Management Act (currently being developed)
4. SOE Restructuring Act (currently being developed)
5. National Planning Act (to be developed)
6. Procurement Legal Framework (to be developed)
7. Public Asset Management Act (to be developed)

124. The legal framework for PFM in Sri Lanka is dispersed among the Constitution and several pieces of primary and secondary legislation. The Constitution establishes important principles for the management of public finances such as giving Parliament “full control” over public finances, establishing the Consolidated Fund, and providing a mandate to the Auditor-General. The *Fiscal Management (Responsibility) Act 2003* (FMRA) is the main law for fiscal planning and responsibility. The *Finance Act 1971* regulates public corporations, including aspects of budget preparation processes, borrowing powers, dissolution, and auditing standards. The Annual Appropriation Acts authorise the Executive to spend public funds each fiscal year, including authorizing domestic and external loans. Finally, the Financial Regulations 1992 provide detailed rules and procedures for PFM, including the preparation of expenditure and revenues estimates, authorization for expenditure, accountability arrangements, rules for virements, details on the use of the Contingencies Fund, and financial reporting requirements. There is no overarching law on public

finance that governs the important areas of fiscal policy making and budget process, specifies the responsibilities of the key actors, and codifies key principles for transparency and accountability.

B. Weaknesses in fiscal governance and public financial management

I. Budget credibility and coverage convergence

125. An effective budget process supports sound fiscal planning and sets the foundation for effective control as well as transparency. To enable sound fiscal planning, the budget should be based on a medium-term fiscal framework that is informed by reliable forecasts and analysis of risk. The budget should comprehensively cover all of the general government sector to ensure full transparency of fiscal planning and other policy interventions. The budget should be prepared through a defined, transparent and timely process to respect the authority of Parliament to approve the budget and to hold budget entities to account for use of resources. Deviations from those principles increases fiscal governance and corruption risks.

126. The government conducts an annual budget process which follows a regular pattern that is well understood by participants. This is a traditional budget process where spending units are provided an opportunity to compete for funding but, in the absence of a performance framework or a multiyear perspective, the budget is largely incremental in nature. The budget process results in a set of estimates being submitted to Parliament with sufficient time for approval prior to the start of the respective budget year. The annual Appropriation Act effectively limits cash releases from the Consolidated Fund, thereby meeting a fundamental and Constitutional requirement of good financial management.

127. A major concern related to fiscal governance is the inability of the Government to realize revenue projections and comply with expenditure limits in its annual budget, which has contributed to breaches of existing fiscal rules. Systemic under-realization of budget revenue estimates has undermined the credibility of the budget. Since 2014, total revenue has been over-estimated in every year, with an average annual forecast error of 16.9 percent.⁵² Primary expenditure exceeded the budget forecast in 2019, 2020 and 2022 by an average of 6.3 percent, but came within budget estimates in other years since 2014. This has historically resulted in larger than planned deficits and a larger call on sources of financing. Indeed, as set out in figure 3, Sri Lanka has not been able to achieve a deficit of less than 5 percent as required by its fiscal rule. In an environment where deficits are planned but revenue targets are not met and external financing is constrained, expenditure arrears have accumulated. Financing constraints led to the size of the stock of unpaid bills reaching LKR 106 billion (0.5 percent of GDP) at end-December 2022, of which LKR 60 billion were older than 90 days.⁵³ In addition, Sri Lanka has arrears in debt service payments to creditors. While economic conditions during the pandemic contributed to their size, arrears have been an ongoing systemic problem (for example, having been identified as a systemic issue in the IMF's Public

⁵² Source: IMF FAD Technical Assistance Report on Fiscal Rules and the PFM Bill, March 2023

⁵³ IMF Sri Lanka Request for an Extended Arrangement Under the Extended Fund Facility, 2023.

Investment Management Assessment of 2017). There is also a lack of discipline during the planning of the expenditure side of the budget, where a major contributing factor is large adjustments being made to the budget by Parliament just prior to its approval, without prior analysis (of cost benefits and feasibility) and insufficient regard to the impact of such changes on the budget deficit.

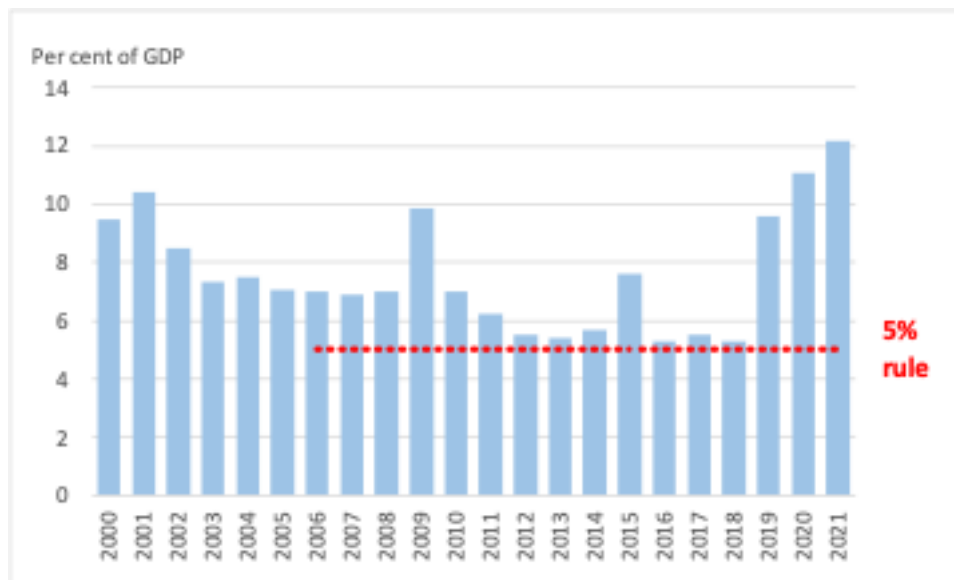
128. Corruption risks emerge when the budget is not credible. Risks are generated if the executive arm of government is able to spend in excess of budget limits. In such conditions, projects and activities can be funded without due consideration of costs and benefits, and without external scrutiny and oversight by the Parliament. Where there is consistent overestimation of revenue, this typically results in pressure being applied to enhance revenue collections via administrative actions, which can result in deviations from tax policy and collection procedures, creating an environment conducive to subjective actions by tax assessors that raises corruption risk. Where expenditure allocations in the budget are not aligned with underlying cost structures this results in the need for administrative level adjustments during budget execution, where associated approval requirements create a corruption risk. In addition, unrealistic expenditure plans in budgets can create situations whereby payments are rationed by the executive due to a lack of liquidity, creating a situation in which suppliers are required or encourage to offer bribes in order to have their payments prioritised.

129. To enhance the credibility of the Budget, Sri Lanka should improve the quality of the analytics supporting the development of the Medium-term Fiscal Framework (MTFF). In this regard, it is noted that a new Macro Fiscal Unit (MFU) has been established, which is understood to have responsibility for enhanced forecasting of economic and fiscal variables as well as the analysis of fiscal risks. In order to fulfil its functions, the new MFU will require enhanced technical capabilities and appropriate systems for revenue forecasting.

130. A change to fiscal rules could strengthen fiscal governance by avoiding an incentive to make unrealistic revenue forecasts and prevent changes to the size of the budget during the approval phase. IMF FAD has been working with the Government to review existing fiscal rules to better promote fiscal sustainability. The fiscal rule should be applied in determining the MTFF with Parliamentary engagement regarding the fiscal envelope at the start of the budget process, thus limiting the need for adjustments at the end of the process.

Figure 3. Sri Lanka's Fiscal Deficit and the 5 Percent Rule

Source: IMF FAD Technical Assistance Report on Fiscal Rules and the PFM Bill, March 2023



131. The limited coverage of the budget also undermines effective fiscal governance. There exists a range of funds outside of the Consolidated Fund which are not covered by the budget. The budget, therefore, provides incomplete information on the use of all public funds, fiscal policy setting, and equally incomplete transparency regarding public revenue and spending. The risk of corruption is exacerbated as off-budget funds are typically not subject to standard internal control procedures, have limited transparency and do not receive the same level of external oversight as applied to budget entities.

132. To enhance both transparency and fiscal management, the coverage of the budget should be expanded to include all funds within the general government sector. This would include all entities and funds which are under the control of the government, but excluded those commercial enterprises which operate in commercial markets.⁵⁴ All general government entities should be presented, along with the accompanying budget documentation, which should ideally include tables which differentiate between spending estimates based on the various sources of funds.

⁵⁴ According to IMF Government Finance Statistics Manual, the nonfinancial corporations sector consists of resident institutional units that are principally engaged in the production of market goods or non-financial services. A market producer is an institutional unit that provides all or most of its output to others at prices that are economically significant.

Table 12. Recommendations on Enhancing Budget Formulation and the Fiscal Framework

Measure	Authority	Timeline
1 Submit to Parliament a new Public Financial Management Law to strengthen the fiscal responsibility framework, budget formulation and execution.	Ministry of Finance	February 2024
2 Improve the quality of analytics in the Medium-Term Fiscal Framework	Ministry of Finance	June 2024
3 Include in budget documents a presentation of the planned sources and uses of all funds for each entity within the GFS General Government Sector	Ministry of Finance	October 2024

II. Public Investment Management

133. Some elements of the public investment management (PIM) process reflect principles of good practice. The Department of National Planning (NPD) reviews investment projects proposed by line ministries and includes them in a rolling four-year Public Investment Program (PIP) to align public investment with the government’s policy priorities. The PIP for 2021-2024 has been prepared and published with an aim to provide a medium-term perspective to the Government’s capital budget and directs the process of annual budget preparation. One of the nine key policy cornerstones of the PIP 2021-2024 is “Country Free from Corruption”. Capacity exists for oversight by the MoF of the implementation of major projects, including a project reporting/tracking framework and a policy for evaluation. The Department of Project Management and Monitoring monitors and evaluates investment projects and has issued several operational documents to guide the government agencies such as a detailed operational manual on project submission format and criteria to select the priority projects. It also furnishes a quarterly monitoring report to the Cabinet of Ministers in support of appropriate strategic and policy decisions related to mega-scale development projects. The government has in place a national agency for public-private partnerships to consider opportunities for private-sector investment in public-sector entities and initiatives.

134. Despite these improvements, governance and corruption vulnerabilities exist in all stages of PIM mostly due to a lack of transparency, accountability, and competitiveness. The 2018 Public Investment Management Assessment (PIMA) underlined several key weaknesses which remain in the country’s PIM system.⁵⁵ In the planning and budgeting stage, the main issues are a lack of realistic and effective expenditure ceilings and weak project appraisal and selection. The PIMA indicates that there are major delays and cost overruns due to the lack of proper preparation, evaluation, or prioritization of major projects. The lack of standard appraisal methodology, as well as the absence of robust review of appraisal results have led to the selection of low-quality, under-costed projects, which often are not ready (e.g., the land is not secured).

135. The planning framework does not effectively support strategic screening or prioritization of major projects, and PIP is not constrained by fiscal space. Projects funded in the budget are not those that were proposed in PIP. This practice opens the door to misusing scarce

⁵⁵ IMF/WB Sri Lanka Public Investment Management Assessment, May 2018.

resources for non-priority projects at the same time that it encourages the use of non-transparent manipulations to get projects funded. The Department of Management Audit points out that one of the common internal audit findings is the implementation of investment projects without feasibility studies. In 2019, the MoF issued guidelines to rationalise both project identification/submission and appraisal processes to identify the most relevant projects.⁵⁶

136. The Guidelines require all project proposals utilizing the Consolidation Fund to be submitted to the NPD where there undergo preliminary and detailed appraisal before moving to the funding arrangement stage. However, these procedures were not followed in all cases. In 2020, the MoF Circular⁵⁷ restated the procedural requirements. The Circular points out that a significant number of project proposals are directly submitted to the Cabinet for approval skipping appraisal by the NPD entirely. Approval of the projects without NDP's appraisal and recommendations creates major deviations such as duplication of similar projects by different institutions, inability to prioritise development initiatives, and mismanagement of constrained fiscal space.

137. Poor planning and project preparation results in a large percentage of problems in the implementation of major projects. The Progress of the Mega Scale Development Projects Report (Fourth Quarter -Year 2022) prepared by the Department of Project Management and Monitoring indicated that only 22 (10 percent) out of 261 ongoing projects were implemented by the end of 2022. There were 29 projects that were halted due to the inability to resolve issues. Another 129 projects were classified as poorly performing projects requiring serious attention (See Table 13). The report highlights several issues that caused the projects to deviate from the expected targets. The most common issue affecting project implementation is identified as 'delays in receiving allocation and imprest, which proves that the projects have commenced without appropriate budgetary allocations in the annual budget. Another highlighted issue is 'delays in land acquisition' again showing that projects are initiated without actually being ready. Other issues include procurement-related matters, the absence of performance indicators and outputs, and poor performance of contracts. The MoF lacks basic information on projects, including the expected revenues, and the potential cost of early termination given the limited data provided on projects and problems accessing necessary data.

⁵⁶ "Guidelines for Submitting Development Project Proposal for Public Investment" MoF Circular No. MNPEA 02/2019. The Guidelines require all project proposals utilizing the Consolidation Fund to be submitted to the NPD to undertake the preliminary appraisal. After completing the preliminary appraisal, NDP is required to carry out a detailed appraisal with a feasibility study in the second stage. After considering the merits and acceptability of projects, the NDP submits its recommendations to the External Resources Department for external funding arrangements and the Department of National Budget for domestic funding arrangements.

⁵⁷ MoF Circular No. MFEPD 01/2020

Table 13. Classification of progress of Capital Investment Projects, 2022⁵⁸

	Category of progress	Color Code	Number of Projects in 2022	
			Third Quarter	Fourth Quarter
1	Completed		20	29
2	Being implemented successfully		08	04
3	Being implemented properly		24	18
4	Expected results could be achieved through interventions		37	18
5	Need special attention		59	30
6	Critical projects		95	133
7	Halted projects		17	29

Source: The MoF Department of Project Management and Monitoring Progress of the Mega Scale Development Projects Fourth Quarter – Year 2022

138. The inconsistent treatment of unsolicited capital investment proposals undermines effective governance and generated substantial corruption risk. The Guidelines on Government Tender Procedure Part II⁵⁹ for private sector infrastructure projects allow unsolicited proposals for Public-Private Partnership (PPP) projects, but expressly states that “no decision should be taken solely on the basis of unsolicited offers without inviting proposals/bids through public advertisement”. Nevertheless, for urgent and exceptional circumstances, Cabinet can deviation from this rule. The PPP process is operating independently of the public investment process and its implementation is subject to large discretion, particularly in regard to the obligation to conduct competitive bidding.⁶⁰ There is also a lack of a cost comparison between traditional procurement and PPP procurement requirement leaving a high-level of discretion to policy makers in determining the form of financing to be used, and the subsequent procedures to be followed.

139. PPPs are mostly initiated without having been included in the PIP and often result from unsolicited proposals. Projects which are initiated through unsolicited proposals are not part of the implementing agency’s investment plan or priority. Therefore, PPP prioritization is not driven by policy considerations, and projects are approved outside the budget process without assessing their fiscal implications. Typically, unsolicited proposals result in a single bidder because the manner of market testing does not encourage competing bids. For public funded projects, the Procurement Guidelines 2006 are silent on unsolicited proposals, whereas these proposals are still accepted by procuring agencies (see Box 2 for Gampaha, Attanagalla & Minuwangoda Integrated Water Supply Scheme (GAMWSS)).

⁵⁸ Data on implementation of capital investment project drawn from 2022 should be taken with care, given the crisis experienced in that year.

⁵⁹ Amended by the Public Finance Circular No. 02/2019)

⁶⁰ World Bank Group (2022)

Box 2. The case of Gampaha, Attanagalla & Minuwangoda Integrated Water Supply Scheme (GAMWSS)

The contract for GAMWSS was awarded to the China Machinery Engineering Corporation (CMEC) for USD 229.5 million in 2013, upon the approval of the Cabinet of Ministers, after the submission of an unsolicited proposal. The contract award subsequently attracted the attention of several parties, including Auditor-General and Attorney General.⁶¹ The Auditor-General pointed out that the contract was awarded through a non-competitive process at a price 33.4% higher than the cost estimate to a company that lacked experience in water projects. The Attorney General⁶² requested the MoF to assess the case and based on the evidence, take legal action against the officials who were involved in squandering public funds. It also requests the MoF to lodge a written complaint with CIABOC, as the available material discloses an “element of corruption by public officials.”⁶³

Source: “The lure of Chinese loans: Sri Lanka’s experiment with a special framework to finance its infrastructure investments”, Subhashini Abeysinghe...[et al.], ed. by Venya de Silva., Colombo, Verite Research, 2022

140. Weak oversight of public investment by SOEs also poses significant governance vulnerabilities. A significant proportion of public investment is undertaken through SOEs, but their oversight is fragmented. The MoF, through its Public Enterprises Department, reviews the investment plans as well as financial performance reports of key SOEs, but as flagged in the 2018 PIMA Report, the value of the MoF’s review is not clear. The MoF does not prepare consolidated reports of the SOEs’ financial performance and investment activities and does not undertake a systematic risk analysis of their operations.

141. Sri Lanka should address these governance weaknesses to boost public investment efficiency, reduce corruption risks and support fiscal discipline. All projects implemented by the government should be included and prioritised in the PIP. Adopting a medium-term fiscal framework will strengthen budget preparation (see above) and public investment by providing multiyear guidance and help in coordinating public investment. The country should also continue to implement the reforms recommended by the 2018 IMF PIMA, focusing on strengthening the processes for project appraisal and selection.

⁶¹ See the case study in “The lure of Chinese loans: Sri Lanka’s experiment with a special framework to finance its infrastructure investments”, Subhashini Abeysinghe...[et al.], ed. by Venya de Silva., Colombo, Verite Research, 2022.

⁶² The Attorney General’s letter to the MoF dated 16th May 2018

⁶³ Auditor-General’s Department, ‘Audit of the Financial Statements of the Gampaha, Attanagalla and Minuwangoda Integrated Water Supply Scheme for the year ended 31 December 2015’, 2017 at http://www.auditorgeneral.gov.lk/web/images/audit-reports/upload/2015/Projects_2015/4-xv/Gampaha-Attanagalla-and-Minuwangoda-E.pdf; The lure of Chinese loans : Sri Lanka’s experiment with a special framework to finance its infrastructure investments”, Subhashini Abeysinghe...[et al.], ed. by Venya de Silva., Colombo, Verite Research, 2022.

Table 14. Recommendations on addressing Governance Weaknesses in Public Investment Management

Measure	Authority	Timeline
<p>1 Submit to Parliament a new PFM Law, with an integrated PIM section with provisions that:</p> <ul style="list-style-type: none"> - Establish a unified approach to prioritizing capital investment projects based on explicit criteria early in the budget process. - Require the Ministry of Finance to ensure that all projects included in budget documents are from the list of assessed and prioritised projects 	Ministry of Finance	February 2024
<p>2 Establish an enhanced regulatory framework for treatment of unsolicited proposals including the manner in which such proposals can be received and evaluated</p>	Ministry of Finance, NPC	March 2024
<p>3 Publish on a government website a list of funded projects that have originated as unsolicited proposals every 6 months, along with information on lead contractor for the proposals, contract cost, and implementation progress</p>	Ministry of Finance	March 2024

I. Procurement

142. The authorities recognise that public procurement remains an area of governance weakness, with associated corruption vulnerabilities, despite attempts to improve its effectiveness. Public procurement plays a vital role in managing public finance to ensure value for money and integrity in public expenditure. Procurement of goods and works constitute a major share of the Sri Lanka government expenditure as the largest buyer of goods, services and works in the domestic market. In 2017, Sri Lanka’s spend on public procurement constituted 5.3 percent of GDP.⁶⁴ According to the 2022 Interim Budget Speech, one of the key spending items causing the increase in expenditure in the revised budget 2022 was procurement cost escalation (food, medicine, fuel etc.). The size and scale of public procurement means that even relatively minor weaknesses could be associated with substantial corruption risks.⁶⁵

143. Several procurement irregularities have been identified by different parties in the government. The reports of the MoF, the Auditor-General’s Department, and the Department of Management of Audit indicate malpractices have led to inefficiencies and waste of scarce resources of the Government in the context of tight fiscal space.⁶⁶ These issues include lack of procurement planning, not using relevant procurement procedures stipulated by the Procurement Guidelines, inadequate competitiveness in the selection procedure, accepting unsolicited proposals for high value projects, poor contract management, lack of knowledge and capacity of the officials in procurement,

⁶⁴ [How governments spend: Opening up the value of global public procurement](#), Open Contracting Partnership, 2020.

⁶⁵ E-Government Procurement: Enabling Business through Efficient Systems, Verite Research Report, 2017.

⁶⁶ Ministry of Finance, Annual Report 2021; Auditor-General’s Department reports on ‘Special Audit on Procurement of Petroleum Products by the Ceylon Petroleum Corporation during the period from 1 June 2011 to 30 June 2012’, ‘Special Audit Report on Evaluation of the Procurement Process of Purchasing Coal for the Lakvijaya Coal Power Plant in Norochcholai for the Period of 2022-2025’, ‘Special Audit Report on Procurement of 96,000 Metric Tons of Organic Fertilizer’; The State of State Owned Enterprises, 2022, Chapter 7 COPE inquiries into SOEs, <https://soe.lk/>

poor monitoring and weak external oversight, and the incomplete coverage of independent complaints mechanisms. These malpractices have led to inefficiencies and waste of scarce resources of the Government in the context of tight fiscal space (See, for instance, the case of Lak Wijaya Coal Power Plant in Box 3)

Box 3. The case of Lak Wijaya Coal Power Plant

The Auditor-General's Department conducted a special audit regarding the evaluation of the procurement process for the purchase of coal for the Lak Wijaya Coal Power Plant in Norochcholai for the period of 2022-2025.

The Audit report found that the coal procurement process that had been followed when awarding a tender to the Black Sand Commodities company had not been in line with the Government's tender procurement procedure guidelines and violated the objective of providing fair and equal opportunities to interested parties (the coal supply tender has continually awarded to the same supplier during 2009-2015).⁶⁷ The audit reports also reveal that bidding documents had been repeatedly modified and that the executing agency had made repeated spot purchases from a limited list of suppliers without following applicable rules.

Accordingly, the Committee on Public Enterprise (COPE) ordered the implementation of the recommendations presented in the Auditor-General's report and announced that a loss of RS 1.1 billion had been incurred as a result of not specifying the quantity of coal required when calling for tenders for the purchase of coal by the Ceylon Coal Company (Pvt) Limited.⁶⁸

Source: Auditor-General's Department reports on Special Audit on Procurement of Petroleum Products by the Ceylon Petroleum Corporation. Also see, "How dirty is our coal supply?" Manjula Fernando & Rukshana Rizwie, available at <http://archives.sundayobserver.lk/2016/07/31/fea12.asp> and The State of State-Owned Enterprises, Advocata Research Institute, 2022, p 57.

Weak Institutional and Regulatory Framework

144. Sri Lanka currently lacks a formal legislative basis for procurement. There is no public procurement law in Sri Lanka. All government procurement must be carried out in line with Cabinet approved guidelines, the Procurement Guidelines (PG) 2006, which set out various procurement methods, bidding procedures, and rules for awarding contracts. Along with the PG, detailed manuals for the procurement of goods and works and standard bidding documents have also been issued.

145. The ad hoc and frequent revisions of the Procurement Guidelines and Manual with no unified, updated version of the guidelines undermine the transparency and predictability of the

⁶⁷ The Supreme Court ruling (SC FR No. 394/2015) has found procedural flaws in a tender process for the procurement of coal for the Lakvijaya Power Plant and called for fresh bids in terms of the law, for the supply of Coal for the said power plant following competitive Bidding procedure.

⁶⁸ Parliament of Sri Lanka - Committee News – "COPE directs the implementation of the Auditor-General's recommendations regarding the purchase of coal Committee News, One Billion Rupee Loss on the Purchase of Coal,".

procurement process.⁶⁹ The guidelines are extensive, but they generate uncertainty on the use of different procedures and give excessive discretion to Cabinet to decide on high value contracts (see below). They lack strong legal underpinning and need updating and comprehensive consolidation.

146. There have been also frequent revisions to the institutional framework. The National Procurement Commission (NPC) was first established under the 19th Amendment to the Sri Lankan Constitution (2015) to serve as a regulatory and monitoring body. Between 2015–2020, both NPC and the Department of Public Finance (DPF) were involved in the procurement process until the NPC was abolished in October 2020 with the 20th Amendment.⁷⁰ The 21st Constitutional Amendment of 2022 has reinstated the NPC and once again vested it with responsibility for oversight of public procurement. The NPC is mandated to formulate transparent, competitive, and cost-effective procedures and guidelines for procurement and monitor their implementation, but the Commission is yet to be appointed and begin to function. The delay in restoring and strengthening the NPC prevented the development of the procurement law, while enabled deviations from prescribed practices, such as the awarding of contracts on a non-competitive basis, go unobserved and unpunished.

147. Establishing an adequate legal framework with clear transparency, accountability, and oversight rules is a key step to limiting corruption opportunities in public procurement. The absence of a functioning regulatory body with necessary authority and competency has delayed the modernization of the legal framework including the enactment of a Public Procurement Law. Without updating, the current guidelines fail to reflect international good practices (guided by common principles, including integrity, transparency, competition, fairness, objectivity, efficiency, and professionalism). International experience is that a strong public procurement legal framework is positively associated with better outcomes, especially in countries with limited public sector capacity.

A high degree of executive discretion in decision-making

148. The procurement process is fragmented among three layers in the central government: departmental, ministerial, and cabinet levels with no mechanisms for ensuring procedural consistency, efficiency, or integrity. Sri Lanka currently operates a highly decentralised procurement system. The responsibility for executing procurement is vested with secretaries of respective line ministries. Technical and bid evaluation committees are set up per the delegation of authority at the line ministry and Cabinet level.⁷¹ The PG requires a Cabinet Appointed Procurement Committee (CAPC) to undertake procurements above certain limits⁷² and empowers Cabinet to decide on the successful bid based on the CAPC recommendations. However, procuring agencies usually seek Cabinet approval and make commitments for proposals without having conducted the proper evaluations; Cabinet uses

⁶⁹ Verite Research points out that there have been 37 supplements and 25 circulars are applicable to PG and PM 2006 while not all are currently in force due to significant overlaps. See “Opportunities to protect public interest in public infrastructure: review of regulatory frameworks in Sri Lanka,” Uween Jayasinha et al., ed. By Subashini Abeysinghe et al., Colombo, Verite Research, 2021.

⁷⁰ Ibid.

⁷¹ Each procurement action involves the appointment of the following committees, as applicable, by the relevant procuring entity for overseeing components of the procurement process: Procurement Committees; Technical Evaluation Committees; and Consultants Procurement Committees.

⁷² According to the 35th supplement to the Procurement Manual 2006, locally funded projects above LKR 500 million and foreign funded projects LKR 1,000 million require the establishment of a Cabinet Appointed Procurement Committee (CAPC).

a high degree of discretion in award decision-making and the PG does not expressly require the Cabinet to accept CAPC recommendations in awarding the contract. The Court of Appeal decision in 2006 (Daewoo Engineering and Construction Co. Ltd V Amarasekara CA 251/06) ruled that Cabinet decisions on the allocation of contracts are not bound by the PG and the guidelines do not specify how the Procurement Appeals Board report is to be used to inform Cabinet-level decision-making. The decision seems to confirm Cabinet's unconstrained discretion when deciding matters relating to public procurement.

Lack of monitoring and independent review

149. The governance and corruption risks associated with complex and opaque procurement procedures are exacerbated by a lack of compliance monitoring, adding further incentives and opportunities for rent-seeking, and creating significant delays and inefficiencies in procurement. Procurement is not systematically monitored either by the Department of Public Finance or the NPC. Monitoring of procurement practices is particularly weak in the first two levels (departmental and ministerial levels). While the Ministry of Finance gathers procurement monitoring data, there is no central database to produce standard analytical reports and analyses of the effectiveness of procurement. This lack of a mechanism to monitor adherence with the PG often results in violations of the rules and financial losses, which are only revealed when there is an ex-post audit by the AG's Department.

150. The appeals mechanism for most procurements is not independent, yet many procurements are subject to appeal and court proceedings. Complaints can be lodged with the NPC, the Procurement Appeals Board, or the Supreme Court. The setup is open to vulnerabilities e.g., conflict of interest, high degree of executive influence, and lack of independent review. For instance, at the ministerial level, the appeal mechanism requires bidders to submit complaints to the relevant Ministry Secretary. At the Cabinet level, the Procurement Appeal Board (PAB) has been established since 2005. However, the three members of the PAB are appointed by Cabinet, on recommendation of the President and the findings of the PAB do not need to be considered by the Cabinet (see above Daewoo Engineering and Construction Co. Ltd V Amarasekara CA 251/06).

151. Corruption practices in SOE procurement are another significant issue. The Parliamentary Committee on Public Enterprises (COPE) identified significant issues with the bidding processes such as failure to follow a competitive bidding process.⁷³ The Procurement Guidelines provide ethical standards, general prohibitions on corrupt activities, conflict of interest, and the acceptance of gifts or inducements, however, these processes are not being practiced consistently. The lack of national procurement performance standards and a performance assessment system for officials involved in procurement decision-making, implementation, and the administration of contracts hamper good public procurement management and timely delivery.

⁷³ For instance, in 2021, the COPE directs the Ministry of Industries to investigate the sale of 85,000 MT of Ilmenite immediately and submit a report on the tender awarded by Lanka Mineral Sands Limited for the sale of 85,000 metric tons of ilmenite at USD 147 per ton to the third-place bidder instead of the buyer who had offered the highest price of USD 165 per ton of ilmenite. Available at <https://www.parliament.lk/committee-news/view/2096>

Uncompetitive practices

152. Public procurement also features a number of anti-competitive practices that give rise to severe corruption vulnerabilities. The default method for the award of contracts under the procurement Guidelines is use of competitive tenders but it is difficult to ascertain the extent of non-competitive selections, in the absence of comprehensive data. Integrity risks in the procurement process are particularly high when executing agencies elect to use non-competitive procedures, availing themselves of possible exemptions provided for in the PR (e.g., direct contracting to a pre-identified supplier or service provider, emergency procurement). Furthermore, the practice of accepting unsolicited proposals for large infrastructure projects (see above Public Investment Management) creates significant corruption risks due to the lack of transparency and competitiveness.

Limited transparency

153. There is very limited transparency and oversight of procurement processes and outcomes. Timely availability of accurate, relevant, and complete procurement statistics is very limited. The absence of consolidated procurement plans, and a fully functioning e-procurement system contribute to this lack of data. The government has little information on the progress of procurement or the factors that cause its delays. There is also no information available to the public on the award of contracts. There appears to be an ad-hoc mechanism to publish information about defaulted suppliers/contractors. Lack of comprehensive rules for blacklisting was identified as a gap in Sri Lanka's regulatory framework by World Bank, in 2003.

154. Inadequate procurement planning limits competition and transparency of the procurement processes. There is no consolidated procurement plan that would enhance the integration of procurement and budgeting. The NPC's Annual Performance Report of 2019⁷⁴ indicates that many of the ministries and institutions do not follow a standard format for procurement plans and action plans and these documents were not always approved by the Chief Accounting Officer. There are frequent major amendments to the initial Action Plans and Procurement Plans throughout the year. It was also recognised that there is little monitoring of the compliance between procurements in the Procurement Plan with activities in the Action Plan, which creates opportunities for the institutions to misuse funds and make subjective decisions.

155. Although there have been some encouraging developments in the organization of public procurement, such as developing PROMISE, much remains to be done for competitive and well-regulated public procurement. The Procurement Management Information System (PROMISE) is being developed but is currently in a pilot phase. PROMISE has the potential to be a key tool for improving the integrity of public procurement by enabling better processing, tracking, recording, reporting, and publicising procurement actions and outcomes. However, its impact on addressing corruption vulnerabilities will depend on the manner in which it is deployed, the competencies of

⁷⁴ Available at <https://www.parliament.lk/uploads/documents/paperspresented/performance-report-national-procurement-commission-2019.pdf>

officials and private sector users.⁷⁵ The extent to which the introduction of e-GP will drive performance improvements will also depend on complementary reforms, including those related to the transparency and frequency of audits, and the strength of mechanisms to hold institutions and individuals to account for their behaviour.

156. The PROMISe system currently has a limited coverage (only shopping procurements), although the government plans to use it for all procurement matters (including the submission of bids, the payment of procurement-related fees, complaints and appeal handling module, and contract administration and project monitoring) in the future and expand it to large infrastructure projects.⁷⁶ The low capacity of the staff responsible for executing procurement and for managing the switch to PROMISe will be another key enabler to generating the expected impact of e-GP on corruption and the actual results. It is recognised that a rule-based procurement system, supported by an e-procurement platform, is associated with high performance and low levels of corruption.⁷⁷

Limited procurement expertise

157. Procurement expertise is limited across the government, including the capacity for collecting, analysing, and disseminating procurement information. There is no dedicated position of “procurement officer”. Responsibility for procurement lies with the secretaries of the respective line ministries, who act in the capacity of Chief Accounting Officers (CAO) of the ministries. Staff who manage and handle procurement usually lack detailed knowledge of procurement guidelines or how to structure contracts to achieve the greatest benefit. Capacities are further limited in provincial authorities as they have limited experience and exposure to good procurement practices, especially in conditions where markets may be shallow. The composition of technical evaluation and procurement committees also does not reflect an appropriate skill mix. Proper evaluation of bids often requires staff with appropriate technical expertise as well as managers with expertise in implementing similar projects. Members are involved in procurement actions in addition to the regular responsibilities of their substantial positions, causing delays in procurement decision-making. Cumbersome procedures and the lack of capacity and empowerment (which elevates procurement decisions to senior management) are also identified as reasons for significant delays by donors.⁷⁸

⁷⁵ World Bank (2020) “Enhancing Government Effectiveness and Transparency: The Fight Against Corruption”, World Bank, Washington, DC. <http://documents.worldbank.org/curated/en/235541600116631094/Enhancing-Government-Effectiveness-and-Transparency-The-Fight-Against-Corruption>

⁷⁶ Verite 2021. Verite research indicated that the Public Finance Circular No 08/2019 (PF 08/2019) mandated all procuring entities to register with PROMISe before 31 January 2020.62. As of 24 December 2020, there are 1,032 confirmed registered vendors and 121 confirmed registered procuring entities. Verite 2021.

⁷⁷ Ibid.

⁷⁸ The World Bank identifies that the Procurement data from World Bank-funded projects show a time lag of up to one year between the invitation for bids and the contract signing. See World Bank Group (2022), “Sri Lanka Systematic Country Diagnostic Update”. Available at <https://documents1.worldbank.org/curated/en/720711651501449116/pdf/Sri-Lanka-Systematic-Country-Diagnostic-SCD-Update.pdf>

Table 15. Recommendations on addressing vulnerabilities in Public Procurement

Measure	Authority	Timeline
1 Operationalise the NPC, with a clear mandate, authority, and responsibilities, including oversight of unsolicited proposals, and an 18-month Action Plan for standing up the agency	Ministry of Finance	January 2024
2 Enact a Public Procurement Law that reflects international good practice	Ministry of Finance	December 2024
3 By March 2024, publish on a designated website: (i) information on all public procurement contracts above LKR 1 billion, (ii) a list of contracts above a designated threshold that were assigned without a competitive tendering process. Information to be updated every 6 months.	NPC	March 2024
4 In December 2024, publish report on a designated website on progress in increasing the proportion of competitive tendered procurement contracts in the 10 agencies determined to have the lowest level of competitive tenders in 2022.	NPC	December 2024
5 Move all public procurement transactions to an e-Government Procurement System by the end of 2025	NPC, Ministry of Finance	December 2025

II. Cash Management

158. The cash management function of a government should involve ensuring that funds are available to meet financial obligations as they fall due, and any surplus funds are used efficiently. Governance weaknesses exist when cash management mechanisms do not enable prompt payment of all obligations. Integrity risks around cash management emerge when the rationing of scarce cash resources is done without procedural clarity, transparency, and oversight.

159. The Treasury Operations Department (TOD) has developed its capability to undertake cash flow forecasting. An MS Excel based tool is used to make projections of future balances based on analysis of patterns in prior revenue and expenditure transactions. TOD forecasts balances for each day for the following month and the closing balance of each month remaining in the fiscal year. A high-level cash management committee is engaged in directing cash management. Chaired by the Secretary of the Treasury, the committee includes representatives of the treasury operations, budget, fiscal policy and debt management teams. To control cash flows, the TOD manages the timing and value of the release of funds to the bank accounts from which each line ministry processes its payments (following ex-ante controls). Key elements of a Treasury Single Account structure are in place. Revenues are collected via agent banks and flow to a main revenue account of the Treasury on a daily basis. In addition, the balance of funds in the transaction account of line ministries are swept to the main account of the Treasury at the end of each day. While the Treasury holds accounts at the Central Bank of Sri Lanka, which is also the fiscal agent of the government, transactional banking of the government is undertaken by two state owned banks.

160. Issues with the credibility of the budget result in cash rationing which undermines effective governance over budget execution. As a result of systemically larger-than-anticipated budget deficits and limited access to financing, the government cannot ensure that cash is available to meet payments as they fall due. The government is in arrears on its payments to suppliers, estimated by the TOD to be in the order of LKR 126 billion as at March 2023. As the budget cannot be executed in full, the executive arm of government (principally the TOD) is deciding what budgeted transactions are actually funded (and what is not). This effectively means that it is not the Parliament determining how funds in the Consolidated Fund are utilised, which is a key feature of the Constitution, but rather the Treasury. This not only undermines a key element of constitutional democracy but also creates a severe corruption risk (as suppliers desperate for payment may seek to facilitate prioritization of their payments with bribes).

161. Cash rationing is exacerbated by an absence of effective commitment control. Finance Regulations provide that no commitments shall be incurred unless financial provision exists in the Annual Estimates and all commitments must be recorded. However, these instructions are not followed by all spending units and, those that do, perform such task manually. Commitments are not recorded when the event occurs that gives rise to the obligation to pay. The event giving rise to an obligation to pay usually occurs outside the system. Experience shows that ministries are frequently late in recording their commitments and do so only when a payment must be made. As such, there is no opportunity for the Treasury to exercise any meaningful control over commitments.

162. Introduction of effective commitment control should be a priority in addressing the issue of arrears. Primarily, the issue of arrears is an issue of lack of credibility of the budget and should be addressed by implementing new fiscal rules and enhanced capacity for medium term fiscal planning. However, effective commitment control is a necessary element in managing the timing (if not the quantum) of payments during the execution of the budget. Box 4 outlines the operation of an effective commitment control mechanism. Note that such commitment controls, while avoiding arrears, still requires the Treasury to define rules to determine the prioritization of commitments. Effective protocols involve: (1) ensuring transparent prioritization criteria (preferably determined by Parliament) and/or ideally, (2) addressing the issue of poor macro-fiscal management which allows a situation to develop whereby funds cannot be raised to meet budgeted payment obligations as they fall due.

Box 4. Commitment Controls

Commitment Control: Effective control over budget execution should involve the following main control steps:

1. **Appropriations** control release of funds from the Consolidate fund.
2. **Warrants** release the appropriations periodically during the year (based on cash flow forecasts and spending plans of line ministries, which confirm future availability of cash to meet the planned timing of payments associated with planned commitments).
3. **Commitments**, in the form of purchase orders recorded in the ITMIS prior to executing a contract, are controlled against the available warrant.
4. **Payments** are controlled against the commitment (payment vouchers are controlled against the purchase order in the ITMIS).

Where effective commitment control is in place, the Treasury has the possibility to govern the timing of payments to avoid payment arrears. The Treasury should receive budget execution (cash flow) plans from line ministries which indicate the timing of commitments and associated payments. It can then compare these to their own cash flow projections to determine whether the timing of planned commitments is likely to result in cash shortages. In such situations the primary response should be to raise additional funds to ensure availability of cash, for example by borrowing. However, (and only) where additional financing cannot be raised to the ensure availability of funds, the value and timing of the release of warrants can be managed to ensure that commitments are only established when there is sufficient cash forecast to be available to meet associated payments. By controlling commitments in this way, payment arrears can be avoided in those situations where financing is not available to meet cash shortfalls.

163. Commitment control is a feature of the budget execution controls embedded in modern FMIS systems. Implementation of a new financial management information system, the Integrated Treasury Management Information System (ITMIS) (based on a commercially-acquired software suite) has been ongoing for a decade and has faced challenges of resourcing and reform commitment. The software can be configured to perform commitment controls as described above. Currently the ITMIS is rolled out to 3000+ licensed users but is understood to suffer from system speed performance issues that limit its utility. As a result, the ITMIS is being run in parallel to the existing Computerized Integrated Government Accounting System (CIGAS). In practice, neither system is currently supporting commitment control processes.

164. To avoid the need for cash rationing, the MoF should operationalise the commitment control functions. This includes the timing of the incurrence of contractual obligations for discretionary spending can be managed so that the ensuing payments, associated with each commitment, occurs when cash is forecast to be available. To operationalise such commitment control, the ITMIS project of the MoF should ensure that the commitment control function of software, including anticipated payment dates relating to approved commitments, are configured in the system and that the system (or appropriate alternative) is rolled out to users and any outstanding performance issues are resolved.

Table 16. Recommendations on strengthening expenditure controls

	Measure	Authority	Timeline
1	Define a time bound roll out of the ITMIS project commitment control function of software, including anticipated payment dates relating to approved commitments	Ministry of Finance	December 2023
2	Report, on a public website progress in implementing the roll-out plan	Ministry of Finance	Sept 2024

III. Internal Controls and External Oversight

165. An effective internal control system is essential for creating an environment that ensures appropriate decision-making regarding the use of public resources, with clear accountability for such decisions, including via administrative structures, as well as external oversight by a supreme audit institution and the legislature. A continuous improvement approach to internal control should be promoted by having a reliable internal audit function that is a trusted source of advice to management. These internal control and accountability structures are essential for the prevention of corruption.

166. The internal control and audit function of the Government of Sri Lanka is governed by the Finance Regulations and the Audit Act. The Finance Regulations assign Chief Accounting Officers (who are the Secretaries of Ministries) and Accounting Officers (i.e., heads of departments) as being responsible for establishing an effective internal control environment (F.R.127 & 128), which includes the establishment of an internal audit unit in each department (F.R. 133). This requirement is reflected in the National Audit Act (No.18 of 2019), which specifies that the internal audit function reports to the Chief Accounting Officer (CAO), and be guided by an Audit and Management Committee, which also reports to the CAO. These requirements extend to ministries, provincial councils and public corporations.

167. A Department of Management Audit (DMA) is establishing within the MoF to guide the development of the internal audit function across government. The DMA has authority to issue circulars and guidelines to promote effective and consistent internal audit processes. The DMA advises that the types of audits performed include financial and performance audits as well as systems audits and special investigations. Existing information does not allow a determination of whether functioning internal audit units exist across government, or the competencies and capabilities of officials tasked with internal audit responsibilities. DMA receives a copy of all internal audit reports from across government, but the extent to which management reacts and addresses internal audit findings and recommendations is unclear. There is no publicly available information regarding either the internal audit reports or follow-up. The DMA has prepared a set of draft guidelines that reflect a modern risk-based approach to internal audit which seeks to promote improvements to internal control of the respective entity according to an agreed entity-specific audit charter. These guidelines should be formally issued by the DMA as soon as possible.

168. As discussed in section II, an External Audit body was established according to the Constitution and is largely fulfilling its function. According to article 152 of the Constitution, the Auditor-General (A-G) is appointed by the President and reports to the legislature. The A-G is responsible for the audit of all public entities, including ministries, departments, local government and public corporations. Audits are conducted according to Sri Lankan standards that are aligned with international standards, reports are tabled in the Parliament and published. Audit coverage of Public Corporations is an ongoing issue as less than one-half of public corporations submit their financial statements on time, and the A-G is blocked from accessing a number of subsidiary entities (which is the subject of ongoing legal action).

169. There are links between internal and external audit. The A-G receives a copy of all internal audit reports and is invited to observe meeting of the Audit and Management Committee of respective government entities. CAOs are required by law to identify remedial actions in response to the findings of a report by the A-G. The draft guidelines for internal audit instruct audit and management committees to follow-up that remedial actions have been taken, but there is no indication that current practices feature such actions.

170. There are common themes across the findings and recommendations of internal and external audit reports. The DMA reports that common findings of internal audits include weaknesses in cash management, contract management, revenue collection and procurement as well as deficiencies in the management of assets, including in relation to management of advances, physical assets and investment projects. These issues are also reflected in the findings contained within reports by the A-G which include: failure to follow procurement rules, assets not being identified and valued appropriately, weaknesses in contract management, potential conflicts of interest in the management of pension funds, as well as weaknesses in the oversight and governance of public corporations.

171. A key weakness of the existing internal control environment is that the findings of internal and external audit are repeated regularly. This indicates a failure of Accounting Officers and the MoF to create the changes in the internal control environment necessary to avoid re-occurrence of negative findings. As an example, the FMIS, which is a key element of the internal control environment, is not fully operational after 10 years of development (despite being an off-the-shelf solution), and the procedures, business processes and systems are not adequate to support the effective accounting for, and management of, government assets. There is an urgent need for the Treasury to develop an action plan with specific responses to addressing the most common adverse findings of internal and external audit reports.

172. Effectiveness and accountability of public expenditures could be strengthened by improving the capacity and functions of the National Audit Office. As discussed in section II, the Auditor-General could be provided with specific powers, and indeed a requirement to submit evidence of corrupt practice to law enforcement and/or anti-corruption entities with appropriate investigative authority. The recent expansion of the Auditor-General's functions beyond financial audit and compliance to include performance matters is an important development. The Auditor-General could also be given an explicit mandate under the Audit Act to review PPPs. Expanding expectations for the Auditor-General would require corresponding increases in financing and building institutional competency to take on new tasks.

173. The creation of a Parliamentary Budget Office (PBO) will enhance the efficient and transparent use of public finance and reduce the influence of political bias on public finance decisions. The control over public finances is vested in the Parliament by article 148 of the Constitution. The Parliament carries out its role in budgeting through its deliberation on the annual budget and its oversight of public expenditure. The Parliament carries out its oversight of the budget through the work of the Committee on Public Accounts (COPA) and the Committee on Public Enterprises (COPE). These two committees review financial statements, and reports by the Auditor-General, and provide oversight on the managerial efficiency and financial discipline of the government and SOEs.

174. Parliament has recently passed the Parliamentary Budget Office Law, which establishes the PBO.⁷⁹ The PBO will assist Parliament in fulfilling its public finance responsibilities through the provision of independent economic and financial analysis. The introduction of the PBO is an important step in promoting fiscal transparency and oversight. It will be essential for the PBO to establish transparent and merit-based processes for managing its resources, staff, and work in order to serve its function in an impartial and independent manner with financial and operational independence, as well as a high degree of professional.

Table 17. Recommendations on enhancing internal controls and external oversight

Measure	Authority	Timeline
1 Adopt Guidelines for internal audit, and take steps to strengthen the competency and capacity of internal audit units to fulfil their function	Ministry of Finance	January 2024
2 Publish on a government website an annual report on the operations of internal audit, including a review of main findings and observations, the interactions between internal and external audit, and the steps that have been taken by management to address internal audit recommendations.	Ministry of Finance	June 2024
3 Establish a requirement, of the Auditor-General to submit evidence of corrupt practice to law enforcement and/or anti-corruption entities with appropriate investigative authority.	Ministry of Finance, National Audit Office	March 2024

⁷⁹The Parliamentary Budget Office Bill has been published in the government gazette dated April 28, 2023, and it should be submitted for the approval of Parliament to fulfil the legal requirements.

IV. SOE Governance and Oversight

175. International experience suggests that state-owned enterprises are an area of potential governance weaknesses and corruption risks. Governments establish and maintain ownership of public enterprises in order to ensure the supply of goods and services in markets which it considers not well served by private providers, often due to actual or perceived market failure. However, global experience indicates that, if SOEs are not well governed and transparent, they can be a very significant source of fiscal risk, contribute to poor service delivery outcomes for citizens, and be breeding grounds for corrupt activities.

176. The Government of Sri Lanka maintains ownership and control over somewhere between 300 and 500 entities that it characterises as Public Corporations.⁸⁰ A Public Enterprises Division is established within MoF which collates the budgets, business plans, and financial reports of 52 SOEs – those which it considers to be the most strategically important. The Government is considering multiple options to improve oversight and performance of state-owned entities. As of the writing of this report, operative PFM rules vest responsibility and accountability for management of individual SOEs with the secretary of the respective line ministry. SOEs are required to apply employment, procurement and financial controls defined for the central government, and are subject to audit by the Auditor-General.

Main weaknesses and vulnerabilities:

177. There is no clarity within the legal framework as to what formally constitutes a State-Owned Enterprise. The Constitution defines a Public Corporation as “any corporation, board or other body which was or is established by or under any written law other than the Companies Ordinance, with funds or capital wholly or partly provided by the Government by way of grant, loan or otherwise”. However, the Constitution, in defining a Public Institution, also differentiates between public corporations and statutory institutions. There is no specific law that provides additional clarity regarding what constitutes or categorises the different forms of public corporations. There is no practical distinction between those entities created by legislation which operating in commercial market to make a profit and those which pursue purely non-market activities. Indeed, the mission team undertaking this governance assessment received various descriptions and conflicting data as to the number and typology of public corporations and those which operate on a commercial basis, but no list of such entities was provided.

178. Corporate governance and transparency of SOEs is weak. The process of appointing directors to boards is largely unregulated, highly politicised, and not aligned with selecting people with the proper expertise, experience, and integrity to manage valuable state assets. While the Department of Public Enterprises (PED) has issued detailed guidelines on the selection of Chief Executive Officers, that guidance is often poorly followed by politicised Boards of Directors.⁸¹ Basic information on the identity and background of executives and directors is not available, and there is no process or mechanism to hold executives or directors accountable for performance since most

⁸⁰ There is no definitive list of SOEs and a high degree of uncertainty over the exact portfolio.

⁸¹ The Operations Manual for all SOEs stipulates the process to be used in the selection of a Chief Executive Officer in section 3.4.

appointments are on a permanent basis. Fewer than one-half of enterprises provided required financial data on time. Moreover, a recent study by Advocata (a non-government think tank) found that only 52 regularly publish financial data, and of these only one had tabled its mandated annual report to Parliament in each of the last 5 years. The annual reports that are produced do not provide content required by the PED, and SOEs provide little information pertaining to access to information required by RTI. SOEs that are audited frequently receive a qualified audit, (or disclaimer).⁸² While the PED is understood to collate data from the SOEs, it publishes no consolidated data or analysis of SOE performance.

179. The legal framework provides representatives of line ministry, the MoF and political leaders with the ability to intervene in the day-to-day operations of SOEs. Part II of the Finance Act, No. 38 of 1971 provides that each corporation's budget must be approved by its board but that any capital expenditure in that budget above a value of 500,000 rupees must be approved by the minister responsible for Planning and the Minister of Finance as well as the respective shareholding Minister. In addition, in accordance with the Financial Regulations, during the execution of their budgets, SOEs are subject to government rules regarding procurement and are subject to internal controls over transactions which require ministry approval for recruitment and purchasing decisions. Managers of SOEs indicate there is a lack of clarity regarding whether they report to their governing board or their responsible shareholding minister and/or the ministry of finance.

180. There is evidence of the central government intervening inappropriately in the operation of SOEs. CSOs, media and audit reports, as well as interviews with SOE management, suggest that appointments to SOE boards are politically motivated, that there is political interference in staffing and recruitment decisions, that there are inappropriate (corrupt) interventions in SOE procurements processes. Facilities and services of SOEs are understood to have been used inappropriately for personal and political gain. Due to the nature of the legal framework, which is weak in relation to corporate governance yet provides for direct control by central government, there is little possibility of entities operating at arms-length from government to avoid these interventions.

181. The central Government has also imposed unfunded quasi-fiscal operations on SOEs which have impacted severely on their financial sustainability. Several of the largest SOEs, including those in the energy and petroleum sector, have operated at significant financial loss due to the government setting regulated prices at well below cost-recovery level. As a result, these entities are required to borrow from the Treasury or from state-owned banks, under protection of letter of support or guarantee from the Treasury, to provide a minimum level of liquidity. The largest SOEs have not been able to provide financial returns to the government in the form of dividends and have also accumulated large payment arrears to suppliers, including other SOEs. Recent reforms, supported by the EFF, to have cost-reflective pricing in energy and petroleum SOEs is a step in the right direction which needs to be reflective in policies applied across SOEs.

182. The corollary to the inappropriate operational and financial intervention in SOEs by the central government is a major deficiency in SOE transparency and accountability. While the central government is required to approval SOE budgets, they do not analyse the planned performance

⁸² Advocata Research Institute, 2022, The State of State-Owned Enterprises 2022.

of these entities. Information on the SOE budgets are not presented to Parliament on either a stand-alone or consolidated basis or as supplementary information with the central government's budget documentation. While the Operations Manual for SOEs provides rules to be applied in determining the allocation of dividends or investment decisions that should guide the behaviour of the representatives of the state on boards, there are no mechanism to monitor compliance, and no process to sanction non-compliance. Instructions on a range of issues, from the use of performance contracts, the role of Audit Committees, and the use of performance contracts have been enunciated but there is limited evidence that SOEs follow those instructions amidst a wealth of competing interests and authority.⁸³

183. The central government, with technical assistance from the IMF, had previously sought to implement a governance regime for SOEs which required each entity to prepare a formal *statement of corporate intent* that included operational and financial performance targets. However, these have not been utilised in recent years. SOE management indicates that there is no engagement from government regarding their budgets and business plans and key performance targets are not required (unless by their board). Beyond the preparation of financial statements, there is no requirement for reporting of performance against plans. There is also no evidence that periodic within-year reporting by SOEs to the central government are scrutinised and they are not consolidated or made public.

184. To ensure appropriate governance arrangements, the Government should distinguish between non-commercial statutory bodies and commercial SOEs. A separate legal basis should be established for:

1. those *statutory bodies* that are intended to remain under government ownership and which do not operate on a commercial footing. Universities, regulatory agencies, culture and professional bodies established by law are examples of such entities. These would be categorised under the General Government sector within the IMF's Government Finance Statistics (GFS).
2. *State-owned enterprises* that are intended to operate on a commercial basis in markets that are (or intended to) operate on a competitive basis. Sri Lankan Airlines is an example of such an entity. These would be categorised under the Public Non-Financial Corporations sector as defined within GFS.

185. Non-commercial statutory bodies should engage closely with the central government in terms of financial management. For those statutory bodies (such as universities and regulatory agencies) that pursue non-commercial activities and remain under government ownership, the PFM legal framework should ensure a minimum level of management autonomy (as implied by the establishing act), but with a requirement to ensure that internal controls are maintained - which are akin to those that operate within the central government. The governing board of such entities should be accountable for the aforementioned internal control regime (as opposed to the secretary of the

⁸³ Guidelines on Corporate Governance for SOEs and Operational Manual for SOEs were introduced on November 16, 2021, through the Public Enterprises Circular No. 01/2021 signed by the Secretary to the Treasury.

respective ministry). Given that these entities are typically reliant on government grants, it is appropriate that these statutory bodies engage with the public financial management framework in the following ways:

- participate in the planning and budget process of the central government (even where the funds of these entities reside outside the consolidated fund),
- prepare budget estimates to be included within the central government's budget documentation (for information rather than approval),
- undertake financial and performance reporting similar to a ministry,
- maintain an operational internal audit function,
- be subject to audit by the Auditor-General,
- require approval of the Minister of Finance in advance of any significant transaction involving specified financial risks (borrowing, investments etc).

For such entities, the existing central government control framework over the execution of the approved budget should serve as a reference point only.

186. The Government has recently approved a State-Owned Enterprise Reform Policy which will could potentially address most of the governance weaknesses presented here. The Policy envisages the passage of a modern Law on State-Owned Enterprises, along with the creation of a State Holding Company (HoCo), that will drive comprehensive reforms of state enterprises, the management and governance of state enterprises, and the state's portfolio of enterprises. Included among the many reforms envisioned in the policy document are a shift to the following principles:

- All commercial SOEs shall be registered under the Companies Act;
- All commercial SOEs shall comply with the tenets of Good Corporate Governance;
- All Commercial SOEs will compete on a level playing field with market competitors;
- HoCo and all commercial SOEs will, subject to a time bound exit strategy ease, and then cease, dependence on State assisted borrowing;
- All Commercial SOEs, where this is the case, will unbundle Regulator and Operator Functions; and
- All Commercial SOEs that are required to provide a public service obligation (PSO) will have the costs of this service provision financed by way of transfers from the Treasury.

187. The Government expects to promulgate a SOE Act in the coming months to give legislative authority and operational effect to this policy. The principles elaborated in the reform policy broadly align with good practice and, if realised, should result in improved fiscal and governance outcomes from commercial SOEs. While commercialization should help in removing line ministries from management of state-owner firms, the success of the approach is very much reliant on the independence, capability and diligence of the holding company board and its management and the oversight of the holding company itself. Of concern is a sentence in the reform policy which suggests that the holding company will be responsible for the "ongoing operational management" of its subsidiary SOEs. It is essential that the holding company set appropriate governance policies and performance-oriented governance arrangements for its subsidiaries but not engage in their operation. The HoCo should be careful to avoid diluting the responsibility and accountability of the board and

management of individual subsidiary SOEs to establish and maintain appropriate internal controls over finances and human resources.

188. The success of the holding company model will depend upon the effectiveness of its governance and is not without risk. There is a risk that, if the HoCo is not well structured and governed, its existence will only add a further layer in the governance structure of SOEs and therefore further undermine their transparency and accountability. Under the SOE reform policy, there is a critical role for an “advisory committee” in the appointment and oversight of the HoCo. The proposed Articles of the HoCo provides for the appointment of the Advisory Committee devoid of political influence. Adopting these Articles will be a critical step in establishing a competent and independent Advisory Committee which in turn will contribute to the proper governance of the HoCo and its subsidiary SOEs.

189. The Cabinet and Parliament should, in drafting and approving the proposed SOE Law, ensure appropriate composition and strong mandate of the advisory committee overseeing the HoCo. It will be essential for the HoCo, working in concert with the PED, to define clear and rigorous rules for the appointment of boards of directors, and to establish rigorous mechanisms for monitoring and enforcing compliance with the rules. There is equally a strong need to establish model performance contracts to support more effective leadership of state companies. All commercial SOEs should publish quarterly accounts and an annual report similar to listed entities. In addition, SOEs should continue to appear before COPE as is done now. Extending the capacity of PED to consolidate SOE data and its ability to analyse and report on SOE sector performance will contribute to more effective governance of both HoCo and SOEs.

Table 18. Recommendations on reducing corruption vulnerabilities in the management of State-Owned Enterprises.

Measure	Authority	Timeline
1 Publish an authoritative list of all public entities, that clearly distinguish those public corporations which are statutory bodies serving non-commercial public policy purposes from those SOEs which are (or intended to be) commercial entities operating in a competitive market.	Ministry of Finance	December 2023
2 Implement the SOE Reform Policy, including associated government policies ensuring that the HoCo and the Advisory Committee are comprised on skilled, independent, and professional staff. The policies of the HoCo should prevent it from intervening in non-strategic operational decisions.	Ministry of Finance	March 2024
3 Publish the names of the Chief Executive for the 52 largest SOEs, and the names of all Board Members of those SOEs by December 2023. Ensure publication of the names of all executives and directors for all commercialised state-owned companies.	Ministry of Finance	December 2023
4 Establish regulations for the selection of General Directors and Board members that reflect principles of good practice in nominating qualified individuals with appropriate expertise, experience, and integrity to fulfill their function.	Ministry of Finance	March 2024

5	Establish within the PFM legal framework an appropriate governance framework for non-commercial public entities, including rules for fiscal planning, performance management, internal controls, and reporting.	Ministry of Finance April 2024
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Section V. Tax Policy

A. Governance and corruption vulnerabilities within tax policy

Introduction

190. Total tax revenue collections have historically been below average and deteriorated significantly following the implementation of major tax cuts in 2020. Total tax revenue amounted to 11 percent of GDP, on average, between 2007 and 2019 in Sri Lanka, which was consistently below the average of both comparator groups (Figure 4).⁸⁴ However, the gap between Sri Lanka and its comparators started to widen significantly in 2020 following the implementation of major tax cuts. While average collections remained at around 15 percent among comparator groups, Sri Lanka's tax to GDP ratio plummeted to 7.5 percent, following the implementation of major tax cuts.

Figure 4. Total tax revenue (in percent of GDP) over time



191. While most of the tax cuts have been fully or partly reversed, more fundamental changes in the tax policy process will be necessary to secure sustained revenue generation. Sri Lanka's tax system has been suffering from constant change, driven by shifting beliefs about potential prospects of certain business sectors or taxpayers, leading to a multitude of sector- and taxpayer-specific exemptions (see Box 5). Policy makers have introduced repeated tax amnesties while imposing additional tax, sometimes retrospectively, on compliant taxpayers. Such a system undermines the trust of taxpayers, reduces predictability of the tax system with detrimental effects on long-term investment, distorts decisions, and complicates administration. The government implemented an aggressive upward adjustment of the PIT rate schedule and eliminated many sectoral incentives under the CIT in 2021 by amending the law. Withholding taxation of several income types has been made non-final,⁸⁵ and new indirect taxes have been introduced (such as the Social Security Levy – a substitute for the Nation Building Tax) or increased (such as on betting and gaming or an

⁸⁴ The ratio is also low compared to estimates of Sri Lanka's tax capacity—a measure of how much a country with similar conditions, such as income levels, could raise. Fenochietto and Pessino (2013) estimate Sri Lanka's tax capacity at 22 percent of GDP, suggesting that there is much room for revenue increases. On average, Asia-Pacific countries reach 60 percent of their tax capacity, if Sri Lanka were to achieve that level, a revenue ratio to GDP of 13 percent would be reached.

⁸⁵ This may bring more revenue if the final tax obligation exceeds the withheld amount, but it also poses challenges for IRD, which has no systems in place to pay refunds.

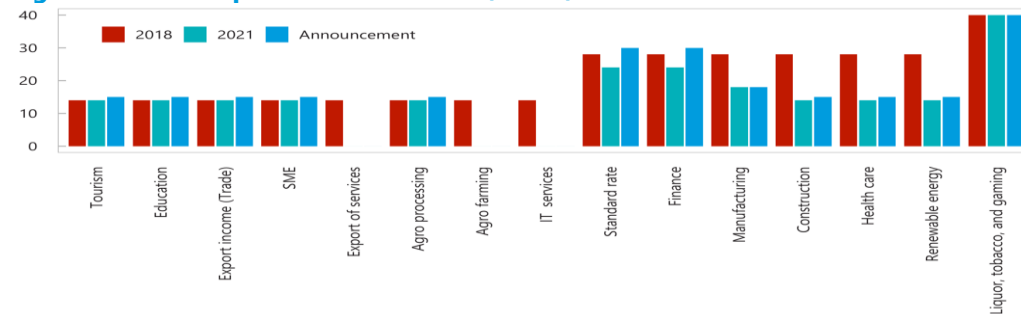
increase in the financial VAT). In the short run, fiscal consolidation through base broadening is a priority, but improving revenue collection in the long run will require a rules-based tax system that builds on the principles of simplicity, fairness, and efficiency.

Box 5. Variation in Corporate Income Tax Rates

Besides resulting in sizeable revenue losses, the tax cuts of 2020 increased the variation of CIT rates across sectors, facilitating tax avoidance, complicating administration, and aggravating economic distortions. The IRA of 2017 (effective from 2018) left the standard rate at 28 percent but had granted sector-specific rates for tourism, education, export-income, small and medium-sized enterprises (SMEs), and agriculture. In 2020, some of those reduced rates were further cut to zero (export of services, Agro-farming, IT-services) while introducing additional reduced rates for construction, health care and renewable energy (Figure 5).

An economies' resources should be allocated such that the marginal return of those resources to society is equalised. Otherwise, reallocation could increase total output while leaving costs unchanged. The tax system drives a wedge between a taxpayer's marginal net return and the marginal return to society. Where sectors are subject to different rates, those wedges differ across sectors, too, leading to resources misallocation: too much capital and labor is used in undertaxed sectors and too few resources are used in overtaxed sectors. The resulting efficiency losses increase in the variation of marginal effective tax rates. In addition, the rate variation implies social costs due to increased avoidance opportunities (for instance, due to multi-sector companies) and associated administrative costs (to curb domestic profit shifting).

Figure 5. Sector-Specific Rates in 2018, 2021, and announced in 2021



Source: IRA 2017 and consolidated IRA of 2021, IMF staff computations

192. Transparency and simplicity of the tax system are key to containing corruption vulnerabilities. Where multiple taxes and fees apply without palpable rationale on different taxpayers, and where large parts of the taxpayer population benefit from tax incentives, the motivation for the tax treatment of a particular individual is obscure. Complex tax systems thus attract rent seeking and open room for the abuse of power. Moreover, the negative repercussions of a complex and inefficient tax system go beyond corruption: unpredictable, untransparent, and short-lived policy interventions that selectively increase or decrease the tax burden on taxpayers, erode tax certainty, and drag on investor confidence, irrespective of the underlying intent. In contrast, when only a few taxes apply uniformly to all taxpayers, and where the rules of the tax system are simple and widely understood, opportunities to trade authority against personal benefit are more limited. To curb corruption vulnerabilities, it is critical that the tax system is rules-based and grounded in clear, easily understood principles.

193. An important component of structural change will be the inclusion of safeguards in all major tax Acts to strengthen anti-corruption efforts. The rewritten and modernised IRA, which took effect in 2018, contains modern provisions reflecting international good practice to better ensure the effective and efficient operation of the tax administration. This includes removing discretions (e.g., to grant tax incentives) and exposing tax avoidance and corrupt acts to appropriate penalties (e.g., by imposing stricter penalties on taxpayers – see, for example, Chapters XVII and XVIII of the IRA, as well as on tax officials for taking bribes, aiding tax avoidance – see, for example, section 192 of the IRA). However, other tax Acts do not contain similar provisions necessary to effectively deter corruption.

B. Importance of centralised and principle-based decision making within the Ministry of Finance

194. Tax system design and administration are fragmented across various government bodies. The Department of Fiscal Policy (DoFP) is a focal point in shaping the tax system, guiding the reform of most taxes, except for the special commodity levy and customs duties, which are under the authority of the Department of Investment and Trade. The amendment of existing taxes (and change of tax incentives) is typically a consultative process, with different tax administrators being involved. These include the Inland Revenue Department (IRD), which is administering the collection of most domestic taxes, the Excise Department, which is responsible for the issuing of alcohol licenses and the collection of excises, the Customs Department, which is collecting taxes on imports, and the Board of Investment, which is responsible, among other things, for the administration of incentives related to the Strategic Development Projects (SDP) Act.

195. The fragmentation and lack of centralised decision making is a major obstacle to implementing a principle-based taxation system. The objectives of the different government departments and agencies often compete, leading to complex policy and administrative trade-offs. Importantly, sustained revenue mobilization is not the key priority for all stakeholders and there is no centralised tax policy unit equipped with sufficient authority to evaluate and explain the rationale behind all tax policy changes. However, an impartial, data-driven, and knowledge-based evaluation of tax policy proposals is necessary to uncover cases where social welfare is not the main driver of granting special treatment. The DoFP formulates and implements the medium-term fiscal strategy, and it already plays a central role in the tax system design. It is thus best positioned to clarify the tradeoffs involved in tax reform in an impartial manner while ensuring the government budget is given due consideration.

196. The reliance on Gazette notifications for implementing major policy changes further increases the opacity of tax system design and raises corruption vulnerabilities. In principle, the primary tax Acts (as enacted by Parliament) should contain all the necessary substantive provisions to ensure taxes can be calculated and collected fairly and efficiently, with all subsidiary instruments (such as Ordinances, Gazette notifications or other regulations) merely performing a supporting role with respect to those primary tax Acts (e.g., by providing additional technical details to assist with the application of the substantive provisions—details which would not be appropriate to include in the primary tax Acts themselves—to ensure the effective administration of the tax laws). This is not the

case for Sri Lanka: tax rates and the scope of existing taxes (such as the special commodity levy, excises, or customs duties), and the granting of tax incentives can be implemented through Gazette notifications.

197. Revenue losses caused by discretionary policy changes of the special commodity levy are a case in point. The special commodity levy is a very unusual type of tax: when it applies, no other indirect taxes (such as excises or the VAT) are due. Moreover, the levy's scope (and hence the scope of all other indirect taxes) and applicable rates can be changed overnight by signature of the Minister of Finance. Gazette notifications and approval by Parliament are only required as soon as convenient, which seems to create a tension with Sri Lanka's constitution, requiring that Parliament have full control of public finances. In October 2020, the finance minister reduced the levy on several goods, including sugar, from RS 50 to Rs 0.25 overnight. Subsequently, an unusually large amount of sugar was imported by a well-connected entrepreneur. As the consumer price of sugar remained unchanged, the levy reduction led to large windfall gains for the importer. The Auditor-General quantified revenue losses within the first 5 months at LKR 16 billion, raising questions on the intent of the policy change.

198. The DoFP should guide the design process of all taxes that form part of the government budget, including customs duties and the special commodity levy. The amendment of laws is more robust against corruption vulnerabilities, as new provisions are evaluated from various stakeholders (see Box 6). To increase transparency in tax law, change through updated regulations, the prior approval by the DoFP should become a prerequisite before the publication of ordinances in the official Gazette. For new tax Acts, the DoFP should be required to at least issue an opinion. The design of customs duties, the granting of customs-related incentives, and the special commodity levy are currently under the authority of other departments of trade and investment policy. Since those taxes contribute to the general government budget, their design needs to be consistent and coordinated with the broader tax system: a shortfall in any of those taxes will require increases in other taxes to ensure stable revenues. The DoFP thus needs to be involved in any tax policy changes that are deliberated at border-imposed taxes. In the medium term, the special commodity levy should be replaced by transparent and stable taxes.

Box 6. Processes to Change Tax System Parameters

The tax system can be changed in two ways: law amendments (including the drafting of new Acts) and the updating of regulations (Ordinances or Gazette notifications). While the DoFP is in most cases an integral component in the formulation of amendments, there is less consistency and oversight in tax law change through Gazette notifications. Notably, there is no standardised process that ensures the revenue implications of tax law changes are consistently evaluated. Whether a given provisions can be updated through regulations is typically specified in the underlying Act.

Law amendments, which typically take several months, usually (but not always) go through the following phases:

1. Quality control: Once a tax law change has been proposed, either by a government department, business chambers, or the public, the proposal is evaluated by DoFP and IRD in consultation with all other government agencies involved in the design and administration of taxes (such as the Board of Investment). The proposal is then shared with the Treasury Secretary and his advisors.

2. Legal drafting process: If both the Minister and the Cabinet approve, the drafting of the legal provisions begins. A first draft is prepared by divisions within DoFP and IRD, which is then shared with the legal draftsmen department in the Ministry of Justice. Once the legal draftsmen have finalised a first draft, the Bill is then sent back to DoFP for final clearance and if approved, passed on to the Attorney General for constitutional clearance.

3. Enactment: Once all clearances have been received, the new provision needs to be approved by the Cabinet upon which the Bill is published in the official Gazette. After 7 days from the publication in the Gazette and on request of the Minister, the Bill is presented to Parliament. If approved by Parliament (possibly with amendments), the Bill then becomes an Act upon endorsement of the Speaker on the Bill.

The process for updating regulations is much shorter: after an Ordinance is signed by the Minister, it becomes law upon publication in the Gazette. Depending on the Act, the Gazette notification is then presented to Parliament within a specified period, or as soon as convenient. Crucially, the first phase of quality control, where the tax law change is discussed between various departments, is not part of this process.

C. Design, management, and evaluation of tax expenditures⁸⁶

199. Sri Lanka has made commendable progress in unifying the tax treatment of most companies. Until 2022, the tax system was fragmented by a multiplicity of sectoral exemptions and reduced rates that applied to different activities. These differences likely contributed to a misallocation of resources, as capital and labor was attracted to sectors and activities with low taxation rather than with high productivity. With effect from April 2023, most companies are subject to a 30 percent corporate income tax. Moreover, incentives granted under the Board of Investment (BoI) Act have been restricted to import tariff exemptions since 2016 and companies that still benefit from tax exemptions

⁸⁶ Tax incentives are provided under the Internal Revenue Act (IRA) and three dedicated acts. These are the Board of Investment (BoI) Act, introduced in 1978, the Strategic Development Projects (SDP) Act of 2008, and the Colombo Port City Act of 2021.

have recently been published on a government website to increase transparency.⁸⁷ To address governance and fiscal leakage concerns, the modernised IRA, which took effect in 2018, included a provision stating that tax exemptions provided under any other laws or agreements after the commencement of the new IRA would have no legal effect if not specifically provided for by the IRA (see subsection 9(2) of the IRA).

200. However, the Strategic Development Projects (SDP) Act continues granting wide-ranging tax exemptions without scrutiny. Strategic development projects are selected by the Bol and approved by the Investment Ministry in consultation with the Ministry of Finance. Projects for the Port City (which is itself an SDP project) will be selected by a dedicated Commission, which will recommend those projects to the President or Minister (if the Port City should be assigned to a Minister). There is no definition of what criteria need to be satisfied for a project to be of strategic relevance, and the revenue forgone from such projects is not systematically contrasted against their potential benefit in a transparent process. Crucially, the DoFP is not involved in the selection or evaluation of projects, and any data that may exist is not shared with the department. While the specific concessions given to companies benefitting from provisions of the SDP Act differ, the revenue consequences are likely significant.⁸⁸

201. The SDP Act should be abolished or suspended until the structures and processes are in place to evaluate the effectiveness of the offered incentives. Deciding whether a specific project is viable and whether the potential benefit exceeds its social costs – which include revenue forgone, an increase in administrative costs, market distortions, and potentially perceptions of unfairness – requires a holistic, impartial, and transparent analysis. While the Bol is likely well-positioned to understand the investment potential of specific projects, it lacks an understanding of the wider fiscal framework and budgetary needs which are necessary to evaluate the net social value of a specific project. The DoFP should evaluate and guide the design of all tax incentives, including those based on the SDP Act and the Port City Act. Preparing the necessary structures, including data sharing protocols and legal documents that assign authority to the DoFP will take time and no further projects should be approved until then.

202. The budgetary impact of all tax expenditures should be systematically quantified and published on a government website. Understanding and transparently reporting on the revenue impact of tax expenditures is a requirement for comprehensive fiscal reporting (IMF, 2018) and the starting point for any policy debate on their appropriateness (Heady and Mansour, 2019). Tax expenditures should be computed for all provisions of the IRA on a regular basis.⁸⁹ The costings should use all available information and be based on a thorough understanding of how different taxes work:

⁸⁷ The Bol offered tax holidays for 3 to 15 years for a variety of sectors, but the authority to provide those concessions has been removed in 2016, and most companies' tax holidays have been run out by now.

⁸⁸ The concessions given to the existing 17 companies or projects differ, but all projects receive a corporate income tax exemption for 10 to 25 years, typically followed by time-bound reduced rates and exemptions from many other taxes and fees.⁸⁸ Moreover, three projects established under the SDP Act – a pharmaceutical manufacturing zone, a textile manufacturing zone, and Colombo Port City - are given authority to grant tax concessions to companies operating in these zones. The Port City Act will grant wide ranging exemptions for up to 40 years to offshore financial services, information technology and communication operations, and the tourism sector.

⁸⁹ An incomplete tax expenditure report for Sri Lanka was published once in 2019, but no documentation on underlying calculations exists and public expenditures for providing tax concessions has not been quantified or reported since.

for instance, costing of VAT exemptions need to consider that input credits will be paid back to registered taxpayers, which was not factored into the only tax expenditure report done. Once tax expenditure estimates are available, all deviations from a clean CIT system should be subject to evaluations that seek to assess whether the benefits of a tax expenditure exceed its costs.

203. Such tax expenditure reports can form the basis for an evaluation of their effectiveness.

Most tax expenditures aim at changing behaviour or supporting redistribution. Effectiveness refers to the extent that the desired impact is directly or indirectly accomplished. This needs to be qualitatively or quantitatively assessed against a counterfactual outcome that would have been observed in the absence of the tax expenditure. To illustrate, Agro-farming has benefited from a reduced rate since 2018, but the tax exemption and associated policies likely had a limited impact since then. For instance, gross value added in Agro-farming as a percentage of total gross value added (GVA) seems to have remained quite stable since 2017. When using GVA in wholesale and retail — one of the few sectors not benefitting from a reduced rate — as a control, the relative increase in GVA in Agro-farming seems negative.

204. To enable an efficient and impartial guidance on tax policy matters, better data sharing arrangements will be needed.

The analysis of taxpayer-level data is critical for tax policy decisions. Such analysis allows understanding distributional aspects of any changes to the tax law, their revenue implications, and potential behavioural responses. The DoFP has currently insufficient access to data. While some data can be made available (such as from the IRA), often with a substantial delay, other data, such as on the profits generated by firms that still benefit from Bol tax holidays, are not shared at all. Data sharing protocols needs to be established between DoFP and all tax administrators – including Customs, Excise Department, IRA, Bol – that allow DoFP to analyse taxpayer level data in a timely manner. To secure taxpayer confidentiality, robust anonymization procedures should be put in place.

Table 19. Recommendations to Increase Transparency and Address Corruption Risks in Tax Policy

Measure	Authority	Implementation Timeline
1. Enact a Tax Administration Act that applies to all taxes and that contains provisions that effectively deter corruption by imposing stricter penalties (including criminal charges) on taxpayers as well as on tax officials for taking bribes or aiding tax avoidance.	Ministry of Finance	March 2024
2. Require that the DoFP issues and post on a government website an opinion on each tax law amendment or new tax Act.	Ministry of Finance	December 2023

3	Make prior approval by DoFP a prerequisite for any substantive change in the scope or rate of a tax that is implemented through updated regulations.	Ministry of Finance	December 2023
4	Transfer authority for the design of customs duties and the special commodity levy to the DoFP.	Ministry of Finance	March 2024
5.	Consider replacing the Special Commodity Levy with other, more stable, taxes in the medium term.	Ministry of Finance	January 2025
6.	Amend tax legislation to eliminate or restrict ministerial authority to introduce tax changes without prior parliamentary approval and ensure that such changes do not generate revenue losses	Ministry of Finance	June 2024
7.	Report the revenue forgone for each SDP project on a yearly basis on a public website.	Ministry of Finance	December 2023
8.	Abolish or suspend the SDP Act until explicit criteria are established to evaluate all proposals, including the provision of public information on projected benefits and costs, and a transparent process is defined to apply the criteria.	Ministry of Finance	
9.	Require the DoFP to independently quantify the costs of all existing tax expenditures in a transparent and coherent manner and report them, in a disaggregated format annually on a public website.	Office of the President	January 2024
10.	Establish regulatory requirement to produce and publish a review of the effectiveness of incentives on a regular (at least every 2 year) basis, along with potential alternative approaches.	Ministry of Finance	June 2024
11.	Establish a Competition Agency with mandate to identify and require the elimination of illegitimate barriers to competition that serve to reduce growth and public revenue generation.	Ministry of Finance	September 2024

Section VI. – Revenue Administration – Tax and Customs

Fiscal Governance – Revenue Administration

Governance Weaknesses and Corruption Vulnerabilities in Sri Lankan Revenue Administration

205. Sri Lankan revenue administration has a reputation of being highly prone to corruption and rent-seeking. Such perceptions are acknowledged by both insiders and external stakeholders to have progressively worsened in recent years, given the impunity of action against unethical and corrupt behavior. Three separate revenue collection departments of the Ministry of Finance (Inland Revenue, Customs, and Excise) operate within the government framework of the public service commission (PSC). Despite responsibility for an overlapping pool of taxpayers/traders, each revenue department broadly operates separately with little interaction other than the sharing of import/export data by Customs with Inland Revenue.

206. Corruption vulnerabilities occur at points of interaction between revenue officials and the public. This is magnified when revenue officials exercise discretion without adequate safeguards with opportunities when assessing income or expenses, classifying goods and tax rates, or granting concessions. Cumbersome procedures that are open to abuse, along with collusion between officials⁹⁰, create strong incentives in an environment of few, if any, consequences for a taxpayer to offer and/or for a revenue official to solicit a bribe. Such deals benefit the colluding corrupt parties at the expense of government and wider society. Revenue collection agencies internationally are renowned to be some of the most corruption-prone government institutions. Countering this risk requires an explicit policy of high integrity and zero-tolerance to corruption supported by robust institutional arrangements to enforce and reinforce such a culture. These characteristics are mostly absent in Sri Lanka; an observation confirmed by the business community and accounting profession.

207. While corruption vulnerabilities appear to permeate Sri Lankan revenue administration, there appears to be little, if any, accountability, or consequence for such actions. There is virtually no culture of integrity observed, with corruption allegedly found at every level – including top management. In fact, promotions are almost exclusively based on seniority with no regard to merit, skill, or leadership ability, or whether the person has compromised integrity in any way. The revenue departments are predominantly closed institutions with little if any employment mobility into and out of the departments. While this policy is justified by the specialised nature of revenue administration, it acts as a binding constraint that has led to very inward-looking institutions that are reluctant to change, particularly given strong union influences. Furthermore, the revenue departments are hamstrung from building skills and expertise needed for the modern economy, with Inland Revenue Department (IRD) unable to recruit specialist information technology staff and data analysts needed to move away from the corruption-prone embedded work practices. Revenue department leadership is also affected. The

⁹⁰ Corruption was described by the business sector as a team effort between colluding Inland Revenue officials.

Customs Department is currently (and has previously been) led by senior government executives from outside Customs, whereas IRD Commissioners-General have always been internally appointed from the next most senior official, typically with an average tenure of around one year. Very short duration leadership appointments are hardly conducive to tackling complex multi-year reforms and likely explains the institutional inertia and lack of urgently needed for IRD modernization.

208. Both Customs and IRD officials acknowledge the rampant state of corruption in their institutions with little risk or consequence of exposure, and similarly few if any consequences when corruption allegations are made. With more than 2,000 staff in each of the Customs and IRD departments, no cases against corrupt tax officials have been made or reported in recent years. The 2021 Customs Department report noted 11 preliminary disciplinary cases being investigated but not concluded and two formal cases similarly still under investigation. With very few if any internally investigated corruption cases, unsurprisingly, few cases involving revenue officials are subject to the independent investigation of CIABOC which acknowledges revenue related cases are relatively rare.

209. Little effort or resources are devoted by the revenue departments to promote integrity and address corruption vulnerabilities. The three revenue departments operate within the constraints of the civil service system overseen by the PSC with respect to the overall scheme of human resource management including recruitment, minimum academic qualifications, promotion, and administrative discipline including issues of integrity. Departments set their own incentive schemes and staff rotation policies. For example, Customs remuneration is augmented by the proceeds of seizures, and IRD operates a complex and likely counter-productive incentive scheme that supplements base salaries for meeting revenue and other operational targets. Promotion is driven by seniority and satisfying academic requirements, with merit or performance having little relevance, and indeed, poor performance including integrity suspicions not being an impediment to advancement. Internationally, Customs and tax administrations usually have small dedicated Internal Affairs units to investigate alleged cases of staff malfeasance. The Human Resources departments of the Sri Lankan revenue agencies have responsibility for initial action along with administrative discipline issues like absenteeism. Corruption allegation cases must be referred to the PSC for resolution, but this rarely occurs. A Revenue Taskforce reports directly to the Customs Director-General and investigates certain staff integrity cases, including some of the 45 active cases currently under consideration. Ad hoc investigation committees may be appointed by the IRD Commissioner-General. Customs officials are expected to comply with a Code of Ethics while IRD developed a comprehensive Code of Ethics and Conduct in 2005 that has not been operationalised.

210. Revenue administration integrity can be strengthened by proactive measures instituted by the individual revenue departments. This could begin with a strongly articulated internal campaign to emphasise strict staff integrity expectations and zero tolerance to corrupt behaviour. Such messaging needs to come from the top, and cascade down through all layers of management to all staff levels. A recent series of CIABOC delivered workshops to IRD staff is a good start. The departmental codes of conduct need to be simplified and updated, and staff should be compelled to attend integrity/ethics training every two to three years and make an annual affirmation of familiarity and compliance with the code. Ignorance of ethical expectations of being a revenue official cannot be countenanced. Small *Internal Affairs* units could be established in each department reporting to the department head to investigate allegations of corruption for referral to the PSC and/or CIABOC action as appropriate. Timely and meaningful actions against corrupt behaviour are essential for the revenue

departments to gradually build reputations of integrity. As progress advances, messaging should turn to external stakeholders – taxpayers, traders, and the public – to emphasise each departments’ commitment to fighting corruption and imploring stakeholders to not offer or respond to bribe requests and to do their part by reporting inappropriate behaviour through a secure and confidential mechanism. Furthermore, the revenue departments should emphasise their commitment to governance and integrity through annual reporting and other communication channels including via their websites and transparently provide details of anti-corruption measures including details of detected cases and post-investigation outcomes.

211. Effective digitization can reduce corruption vulnerabilities. This has been increasingly demonstrated through the Automated System for Customs Data (“ASYCUDA”) - supported import clearance processes, with all entries and payments made electronically, and with the increasing use of risk management for inspection selection. Conversely, Excise operations are entirely based on antiquated and vulnerable manual processes. Since 2014, IRD has been developing the Revenue Administration Management Information System (RAMIS). While plagued by delays and problems, RAMIS was objectively assessed by FAD experts in March 2023 as providing a solid future foundation once pending functionality is delivered and a strategy is executed to transfer operational responsibility from the foreign vendor to local capacity that is appropriately resourced. Most importantly, a review and streamlining of various business processes that RAMIS was programmed to automate is urgently needed to reverse the unintended consequences of the original design that resulted in even more discretion and interaction between revenue officials and taxpayers, and a misutilization of scarce IRD resources. Furthermore, opportunities for stronger separation of duties with fewer rent seeking opportunities were not instituted given union objection. For example, the same audit officials interact with assigned taxpayers across multiple administrative functions that should be separated to embed a division of responsibilities and reduce vulnerabilities.

212. Rent seeking vulnerabilities are magnified by cumbersome tax return and refund assessment processes that entails unnecessary interactions between taxpayers and IRD officials who exercise too much discretion in the absence of compliance risk management (CRM) protocols. Principles of self-assessment are undermined by time-consuming manual verification and cross-checking processes by IRD officials when tax returns are filed and refunds are requested – this is leading to multiple exchanges and discretionary negotiations between auditors and taxpayers, often delaying finalization of assessments that can compromise their enforcement and divert scarce audit resources away from higher value-added activities that can deliver better revenue outcomes that are macro critical. Excessive transactional data must be submitted with tax returns (e.g., schedules of all purchase and sales invoices and import entries for VAT) which are subject to detailed manual cross-matching regardless of materiality.

213. Improvements to online tax return filing can reduce human interaction between taxpayers and tax officials and reduce corruption vulnerabilities. Tax returns can be electronically filed via an Internet portal and is mandated for corporate income tax and all large taxpayers. Take-up by other taxpayer segments and tax types needs to accelerate to reduce human interaction in the filing process. However, the current user interface for on-line filing onerously replicates complex tax return design features rather than being reengineered and simplified from the perspective of the majority of users. For example, many individuals would only need to provide a handful of data points for their personal income tax return but must unnecessarily navigate the complexity of all possible elements of

the paper-based tax return. Streamlining the online filing experience would be a relatively quick and inexpensive undertaking according to the RAMIS vendor, and if instituted could justify a policy of mandating electronic tax return filing for all taxpayers with commensurately fewer interactions with IRD officials.

214. Tax expenditure (exemptions, tax holidays, concessions) management is fragmented, prone to misuse, with little, if any oversight. While IRD advise that they are duly informed of exemptions approved by the MoF, the MoF has advised that all exemptions are communicated to the IRD via the Board of Investment (BoI) and gazette publishing suggesting there is no clarity or process for information. IRD has no apparent system to record and track exemptions, per se, other than within individual taxpayer files. As such there is currently no way to quantify exemptions, have consistent approaches, and ensure that they are permitted according to the parameters they were granted (i.e., what are the expiry dates, what do concessions apply to, who is entitled to get them). Furthermore, there are revenue and corruption vulnerabilities for businesses with a mix of concessional and non-concessional operations. Some BoI approved firms may sell up to 20 percent of their production into the local market but subject to non-concessional tax treatment (VAT, CIT on portion of profits attributed to local sales).

215. Effective fiscal analysis and tax policy formulation is undermined by unnecessary restrictions (unjustly determined by IRD) on the sharing of anonymised taxpayer data by IRD with the MoF Fiscal Policy Department. Evidence-based monitoring of the outcomes resulting from the implementation of tax policy measures is macro-critical to ensure delivery of the revenue-driven fiscal adjustment commitments under the EFF. The ability to fine-tune and adjust tax policies in response to changing economic circumstances is predicated on reliable and timely taxpayer data. Furthermore, MoF oversight of IRD performance is essential to monitor revenue and compliance outcomes to identify causes of revenue leakage including from integrity vulnerabilities. IRD should be fully engaged in fiscal forecasting. Section 100 of the Inland Revenue Act 2017 mandates strict secrecy provisions in the administration of taxpayer data, but s. 100(b) empowers the Minister of Finance to grant these powers within the MoF in the supervision of the IRD that would be further safeguarded through the anonymization of any taxpayer-specific information for analytical purposes.⁹¹

216. The working relationship between the Fiscal Policy Department and IRD has broken down and become dysfunctional. As noted, Inland Revenue has been reluctant to share vitally needed tax data with the MoF that can be readily overcome. While primacy for formulation of tax policy rightly resides in the MoF, it should not be developed unilaterally but should benefit from the input and views of the revenue departments who ultimately must administratively implement the policies. They are best placed to explain the administrative and compliance challenges that may be encountered by any new or changed policy. Revenue forecasting similarly should be developed with inputs from the revenue departments to take account of their knowledge of taxpayer compliance in

⁹¹ S100: "(...) every person having a duty under this Act or being employed in the administration of this Act, shall regard as secret and confidential all information and documents the person has received in an official capacity in relation to a specific taxpayer, and may disclose that information only to the following persons:- (a) the employees of the Department and of the Customs Department in the course, and for the purpose, of carrying out their duties; (b) the Minister in charge of the subject of Finance in the course, and for the purpose, of carrying out supervision of the Department (...)"

the current economic climate. Furthermore, effective revenue administration requires the three revenue departments to cooperate and work together more collaboratively, not just through enhanced data sharing but through inter-departmental operations that target serious non-compliance of taxpayers/traders that are clients across multiple departments.

217. As a line department of the Ministry of Finance, Inland Revenue should be accountable to and subject to robust government oversight. It is evident that IRD operates autonomously and is subject to insufficient scrutiny for the revenues it collects (or doesn't collect). While the Revenue departments rightly seek to shield their management, staff, and operations from political interference, they are crucial fiscal institutions that must be accountable to the Ministry and Minister of Finance, the relevant parliamentary oversight committees, and external scrutiny from the Auditor-General. As noted elsewhere for other government agencies, the revenue departments must be accountable to act on the findings of the Auditor-General, particularly for recurring issues and recommendations that have been repeated over multiple years. The private sector is also calling for measures to improve accountability, transparency, and a voice in tax administration. They have proposed creation of a Tax Ombudsperson, and development and implementation of a Taxpayer Charter. Effective revenue administrations seek productive engagement and business community input to foster a system of voluntary compliance that these measures could enhance. IRD could also consider commissioning an objectively undertaken baseline survey of taxpayer perceptions, including corruption. It would then be periodically repeated to gauge changing perspectives from implemented reforms and to build transparency and tax morale that is undermined by the opacity of current processes and limited channels for taxpayer engagement.

Table 20. Revenue Administration Recommendations

Measure	Authority	Timeline
<p>1 Minimise interactions between taxpayers/traders and revenue officials to reduce discretionary opportunities and corruption vulnerabilities.</p> <ul style="list-style-type: none"> Restrict revenue official interactions with taxpayers to narrowly defined and fully documented circumstances, and assign different officials to interact on different issues (e.g., filing-compliance, audit, collection, appeals, and interpretations/rulings); Streamline and overhaul tax return assessment processes to accept returns as filed without extensive pre-assessment cross-checking and data matching, and limit auditor engagement to cases selected on a compliance risk management basis; Simplify and mandate online tax return processing. 	<p>IRD Commissioner-General (accountable to Secretary to the Treasury)</p>	<p>Sept 2024</p>
<p>2 Institute short-term anti-corruption measures within each revenue department:</p> <ul style="list-style-type: none"> Launch high-profile anti-corruption programs advocated by revenue department heads that emphasise zero-tolerance; Update and operationalise staff Codes of Conduct (Ethics) with regular training and annual written confirmation of understanding/compliance by every staff member; Establish <i>Internal Affairs</i> units in each revenue department to investigate staff corruption allegations transmitted via secure and confidential reporting channels with links to CIABOC. 	<p>IRD Commissioner-General DG Director-General Customs Director - General Excise</p>	<p>December 2023</p>

	<ul style="list-style-type: none"> • Launch internal/external outreach programs with anti-corruption messaging. 		
3	<p>Strengthen Revenue Department oversight and inputs to revenue forecasting and tax policy and strengthen revenue department oversight and transparency;</p> <ul style="list-style-type: none"> • Ensure Inland Revenue provides the MoF anonymised tax data for fiscal modelling; • Invite and include revenue department views and analysis for MoF revenue forecasting and for development of tax policy considerations and options; • Strengthen MoF Revenue Department supervision and Auditor-General oversight; • Improve information flow of approved tax concessions and develop a robust Inland Revenue monitoring/reporting capacity for tax expenditures; and • Improve tax morale by creating a Tax Ombudsperson and a Taxpayer Charter. 	IRD Commissioner-General (accountable to Secretary to the Treasury)	March 2024

Section VII: Central Bank Governance and Operations

A. Legal Framework and Autonomy

218. The current outdated legal framework, the Monetary Law Act (the MLA), was reformed through a Bill of amendments approved by Parliament in July 2023. This resulted in a new central bank law, i.e., the CBSL Act of 2023 (CBSL Act). The MLA dated back to 1949 with limited amendments since. Shortcomings pertained to, *inter alia*, inadequate safeguards for aspects of autonomy, such as through the voting representation of the Government on the Monetary Board and the lack of eligibility criteria for members of decision-making bodies. While these factors were not direct enablers of corruption, their absence weakened the governance safeguards in this area. Furthermore, the CBSL mandate, which included a development objective without priority to price stability, could have engaged the central bank in non-core operations. Attempts to reform the MLA were made in 2019, with technical assistance from Fund staff but were not enacted owing to the lack of political support at the time. The CBSL Act now strengthens the CBSL mandate with primacy given to price stability, the bank's autonomy, governance framework, as well as its accountability requirements.

219. It is expected that the CBSL Act will strengthen the safeguards relating to the CBSL's autonomy and the related governance arrangements. The central bank Board, i.e., the Monetary Board, will be renamed to Governing Board and restructured. Government's voting representation at the Board will be removed — a welcome development to strengthen the CBSL's institutional autonomy. The amendments also improve the provisions that prohibit all members of decision-making bodies and employees from seeking and taking instructions from third parties.

220. Gaps in the legal protection of the personal autonomy of key officials are addressed in the CBSL Act. The double veto appointment procedure for non-executive Board members has been retained and now extends to the appointment of the Governor, whereby the appointments are made by the President on the recommendation of the Minister and with the approval of the Constitutional Council. This ensures objectivity with the involvement of separate, independent entities in the appointment decisions. Eligibility criteria for the appointment of members of the CBSL's decision-making bodies have been enhanced to include relevant professional or academic experience. Discretionary or subjective criteria for dismissal of members of decision-making bodies have been removed and the removal process has been enhanced with a required hearing of the affected person. Lastly, safeguards for remuneration are explicitly set out, whereby the remuneration for members of decision-making bodies will not be reduced during their terms of office.

221. Risks to the CBSL's financial autonomy have materialised during the ongoing economic crisis. Specifically, the CBSL equity position has deteriorated, partly due to the exposure to the government through significant financing, but also due to the depreciation of the domestic currency and the depletion of foreign reserves. The CBSL Act introduces important safeguards in this regard. First, the prohibition on monetary financing, including purchases of government securities on the primary market, is being established. Second, an improved structure for the capital framework is proposed to include stronger recapitalization and profit distribution requirements. In the medium-

term, the CBSL Board should approve a plan to strengthen the central bank's financial position to ensure its continued ability to fulfil its mandate.

B. Governance Arrangement and Oversight

222. The governance structure of the CBSL will be amended under the CBSL Act. Under the repealed MLA, the Monetary Board (the Board) comprised the Governor (chair), the Secretary to the Treasury, and three non-executive members. The new Board – the Governing Board – is expected to retain a non-executive majority to facilitate independent oversight and, as noted above, the government representative is expected to be removed. The Governor will be the chairperson and the Board will also have six non-executive members. The Board is empowered to establish specialised boards and sub-committees to better carry out its functions. In practice, some specialised Boards committees already existed (e.g., for audit, risk management, and ethics) and should be retained. To this end, the Governing Board should have requisite collective expertise on matters related to their mandate, including finance, economics, risk management, financial reporting, legal, and information technology.

223. To support quality governance practices at the Board, the CBSL should align their secondary legal documents to the CBSL Act. The Board and the committees' charters would need to be updated or developed (as needed). These should reflect references to conflict-of-interest requirements for board members and the related enforcement mechanisms. A requirement for periodic self-assessment of the full Board and its committees should also be in place to ensure that they fulfil their oversight mandate, have the requisite expertise, and maintain independence.

224. At the executive level, the current practice provides for collegial decision-making through several dedicated committees. Such collegial decision-making supports checks and balances that may mitigate the risks of concentration of powers that could enable corruption. The committees are chaired by the Governor or Deputy Governors responsible for the relevant functions. Top executive consultations and decisions are conducted through the Corporate Management Committee. Other committees cover *inter alia*: Financial System Stability, International Reserves, Information Technology Oversight, Non-Financing Risk Management, and Training. The amendments enshrine these *de facto* collegial decision-making practices into the law. They specifically provide for the Governor to carry out day-to-day operations and implement policy decisions in consultation with the Deputy Governors.

225. The policy making and oversight responsibilities of decision-making bodies are clarified in the CBSL Act. The law establishes a separate Monetary Policy Board tasked with formulating monetary policy. Under the MLA, the Board was responsible for determining the policies and general management and administration of the CBSL, and the CBSL Act explicitly sets out the Governing Board's oversight functions including (i) approving the budget of the central bank; (ii) overseeing financial reporting, (iii) risk management; (iv) compliance; and (v) security and internal controls of the CBSL.

226. The CBSL governance bodies face conflict of interest with regards to some functions that are bestowed upon the Monetary Board and/or the central bank. These are only partially addressed by the amendments.

Debt Management office – The CBSL has been subject to public criticism on the management of the government securities operations, which undermines the credibility of the CBSL. This results in institutional arrangement whereby domestic borrowings are executed from within the central bank which is not in line with leading practices. This is because of a perceived conflict of interest in the central bank managing both monetary policy and fiscal policy operations. While the amendments only remove this function from the central bank, without a concrete alternative to achieve this transition.⁹² Sri Lanka has committed under the Memorandum of Economic and Financial Policies of the EFF to improve its debt management by completing necessary legislative requirements and establish a public debt management agency by December 2023, and 2024, respectively.

- *Employee Provident Fund (EPF)* – The Monetary Board carries out governance and decision-making roles in the management of the EPF that are entrusted to it pursuant to the Employees' Provident Fund Act. Consequently, some governance decisions and responsibilities – such as investment decisions or the review of the EPF financial statements are with the Board and the CBSL's Advisory Audit Committee (AAC), respectively, which could create a conflict-of-interest risk and a time commitment that may divert their attention from central bank matters. There is also a risk or the appearance of a risk of conflict of interest when the EPF invests in equity of banks or other financial institutions under the supervision of the CBSL.

C. Accountability and Transparency

227. External audit and financial reporting mechanisms are based on international standards.

The external audits, assigned to the Auditor-General, are subcontracted to international audit firms with appropriate capacity and expertise. The audits are conducted in accordance with International Standards on Auditing (ISA) with unmodified (clean) audit opinions, and the financial statements are prepared under International Financial Reporting Standards (IFRS). Audited financial statements are published on the CBSL's website.

228. Internal accountability is assured through the internal audit and risk management functions at the CBSL. The internal audit is independent, and its practices follow a risk-based approach under international professional standards. Further, the risk management function benefited from the World Bank technical assistance and has progressed in implementing several elements of the risk management process, including establishing a policy with appropriate governance structures and systems. Both functions need to continue evolving, including to ensure adequate capacity and expanded coverage of financial risk management.

229. The AAC conducts audit and control oversight. The committee comprises one member of the Board and two external experts. Currently, the two experts have audit and accounting background – one is a former member of an IFAC committee and the second is the Director General of Sri Lanka's audit oversight body. The AAC meets very frequently and is active in the oversight of internal and

⁹² A transitional provision in the CBSL Act provides for the CBSL to "continue to act as agent of the Government (...) in respect of the management of public debt, until such date as the relevant law relating to public debt management agency or office comes into operation."

external audits, as well as financial reporting. The AAC publishes an activity report in the CBSL’s annual report on the discharge of its function.

Box 7. Major changes to the Central Bank Law [from a governance perspective]

- **Removal of government representative from the Board.** This reduces the risk of government influence in the CBSL’s decision-making. Further, all persons are prohibited from influencing the members of the CBSL’s decision-making bodies or its employees from performing their powers, functions or duties.
- **Strengthened appointment process for the Governor.** The involvement of the Constitutional Council in the appointment process provides a “check and balance” and strengthens the personal autonomy of the Governor. This appointment process i.e., recommendation by the Minister, approval by the Constitutional Council and appointment by the President, also applies to non-executive Board members.
- **Introduction of eligibility criteria and increase in the number of non-executive Board members.** The Board is given explicit oversight powers and is responsible for overseeing the administration and management of the affairs of the CBSL, including financial reporting, risk management, compliance, IT, security and internal control systems of the CBSL. Eligibility criteria for non-executive Board members include accounting and auditing, law or risk management, which would be necessary to carry out its oversight function. Disqualification criteria include where the person is a member of Parliament, is a public officer or judicial officer or official of a political party. There is a clear non-executive majority - the number of non-executive Board members has been increased from three to six to ensure sufficient oversight over executive management.
- **Prohibition of monetary financing and phasing out of non-core activities.** Subject to transitional provisions, this protects the CBSL’s financial autonomy and ensures the central bank is not required to finance the government budget. Further, the phasing out of non-core activities, such as guaranteeing loans granted to small-scale enterprises, would prevent any conflict with the CBSL’s mandate.
- **Removal of debt management function.** To prevent any conflict of interest, the responsibility for the management of the public debt by the CBSL as agent of the government will be transferred to a public debt management agency or office.
- **Collegial decision-making in executive management.** To ensure executive management decisions are not concentrated on one person, the Governor is required to carry out his or her duties in consultation with the Deputy Governors.

Table 21. Proposed Recommendations to Strengthen Central Bank Governance

Measure	Authority	Implementation Timeline
Following a broad consultative process, produce a Cabinet policy paper by June 2024 on options for establishing new management arrangements for the Employee Provident Fund that terminates direct CBSL management	Ministry of Finance	June 2024.

Section VIII. Financial Sector Oversight

230. This Section provides analysis of key governance weaknesses in the financial sector oversight (FSO) which have the potential to constrain supervision of banks and non-bank financial institutions and to be associated with corruption. Financial sector oversight in this report considers the governance of the Central Bank of Sri Lanka (CBSL) in its role as banking supervisor, its supervisory oversight of corporate governance in the banking and non-banking financial sector, and of other governance-related prudential frameworks. The governance framework for FSO is drawn from the Basel Core Principles for Effective Banking Supervision (the BCPs), which are the international standards for banking supervision, and focuses on those elements that relate to governance issues. As the Governance Diagnostic Assessment is a forward-looking exercise, the section focuses on FSO governance weaknesses which have the potential to be associated with corruption.

231. Despite the progress made by Sri Lanka in aligning its legal and regulatory framework with international standards, the CBSL is still facing constraints in performing its oversight function effectively. Certain supervisory decisions require the approval or concurrence of the Ministry of Finance, which may impair⁹³ the independence of the CBSL. Similarly, the Finance Business Act No 42 of 2011 allows the Minister to issue general or special directions to the CBSL Monetary Board, which further impairs the CBSL powers and independence. In addition, banking and non-bank supervision remains not fully effective due to insufficient human resources in terms of both number and capacity. Finally, specific risks and vulnerabilities for banks and Non-Bank Financial Institutions with Government direct or indirect ownership require more attention: such institutions are typically subject to political influence over their operations, which could potentially increase vulnerabilities to corruption.⁹⁴ This is of the utmost importance in the context of the sharp rise of NPLs observed in state-owned banks portfolios mostly due to loans granted to connected or related parties, and the fact that SOE lending has not always been classified as NPLs despite non-performance.

232. The governance-related prudential framework needs to be further aligned to international standards and best practices. In addition to strengthening the regulatory framework for banks' corporate governance, Sri Lanka needs to further enhance supervisory oversight in these areas through the development of a comprehensive supervisory methodology and addressing the capacity constraints. Similarly, in addition to aligning with international standards, the regulatory and supervisory frameworks of banks' transactions with related parties, fit and proper assessment of banks' board members and senior management need to be further strengthened. The adoption, in September 2023, of the CBSL has introduced significant improvements in the governance arrangements and the analysis of governance weaknesses and corruption vulnerabilities would need to be revisited in order to determine whether the implementation of new practices has succeeded in changing behavior.

⁹³ In addition to the Government's representation on the Monetary Board, the governing body of the central bank deciding on every regulatory and supervisory matter, the Banking Act sets that banking licences are issued by the Monetary Board with the approval of the Minister.

⁹⁴ See the IMF paper "*Regulating, Supervising, and Handling Distress in Public Banks*" at <https://www.imf.org/en/Publications/Departmental-Papers-Policy-Papers/Issues/2022/04/28/Regulating-Supervising-and-Handling-Distress-in-Public-Banks-511609>

A. Financial Sector Oversight

Overview of the financial sector and on-going reforms

233. The Sri Lankan banking sector accounts for 72% of the total financial sector assets⁹⁵ and is dominated by state-owned banks. Except for the license of Bank of China in 2017, no new licence has been granted in the last ten years. Although several requests to set-up banks/branches were evaluated, they were not considered favorably having regard to the interest of the national economy, including, and the banking needs of Sri Lanka. The banking sector comprises 24 Licensed Commercial Banks⁹⁶ (LCBs) and 6 Licensed Specialised Banks (LSBs).⁹⁷ The two largest commercial banks are state-owned, they represent 36.1% of the assets of the banking sector and are considered as Domestic Systemically Important Banks (DSIBs).

234. The State also has indirect influence in banks and other financial institutions given the substantial portfolios of state-managed funds, including the Employee Providence Fund (EPF), or the Employee Trust Fund (ETF), or the state-owned Sri Lanka Insurance Corporation.⁹⁸ This is the case for the two largest private banks, considered as DSIBs. The largest privately-owned commercial bank, representing 12.5% of the assets of the banking sector, has almost 19% of state-related ownership. The second largest privately-owned bank, representing 9% of the assets of the banking sector, has almost 26% of state-related ownership.⁹⁹

235. While the CBSL has made efforts to strengthen the regulatory and supervisory frameworks, the non-performing loans (NPLs) have risen since 2019. Since the mid-2010s, the CBSL increased and upgraded capital and liquidity requirements based closely on the Basel III standards, implemented the International Financial Reporting Standard 9, and enhanced some supervisory elements moving towards a risk-based approach. However, in the recent years, the banking sector operated under challenging business conditions commencing from the Easter attacks in 2019, continuing with the COVID-19 pandemic and the adverse macro-economic factors in 2022. With the deterioration in credit quality, the banking sector had to continue to implement moratoriums and concessions to affected borrowers, while operating with tight liquidity and capital buffers. Growth in assets and liabilities during 2022 was mainly due to the translation of foreign currency (FCY) denominated assets and liabilities into LKR with the depreciation of exchange rate.

⁹⁵ The non-bank sector consists mainly of deposit-taking finance companies, pension funds, and insurance companies. Other financial institutions, such as leasing companies, microfinance institutions, stockbrokers and fund managers, and venture capital firms, are small and do not play a significant role in financial intermediation.

⁹⁶ In addition to the two large state-owned banks, there are 11 privately-owned domestic banks and 11 branches of foreign banks.

⁹⁷ LSBs are licensed under the Banking Act, are regulated, and supervised similarly to LCBs, they are not permitted to take demand deposits or undertake foreign currency business. Two are 100% state-owned savings banks (the smallest one is in the process of being absorbed by the largest one), one is 100% state-owned development bank, one is a 100% state-owned mortgage bank, and one is a 51% state-owned housing bank. Except for the largest savings bank that is considered as a DSIB and represents around 8% of the assets of the banking sector, none of them represent more of 1% of the assets of the banking sector.

⁹⁸ The authorities have indicated that they do not agree with the characterization of indirect influence of the state due to the portfolio of the EPF, based on extensive regulatory provisions on the management of the fund.

⁹⁹ Three others have state-related ownership between 32.5% and 26.5% and represent between 4.3% and 2.9% of the banking sector assets. The others have state-related ownership comprised between 21% and 5% and represent between 6.8% and 0.7% of the banking sector assets.

236. The Non-Bank Financial Institutions (NBFI) comprised 36 License Finance Companies (LFCs) licensed under the Finance Business Act No 42 of 2011 and one Specialised Leasing Company (SLC) licensed under the Finance Leasing Act No 56 of 2000. They are only permitted to take savings and fixed term deposits and represent 5.2% of the total assets of the financial sector, with finance leases representing 41.6% of the total loans and advances. Most banks owned a LFC. Although the regulatory and supervisory frameworks for LFCs were strengthened, it remains lighter than those for banks and the performance of the LFCs has been weaker than that of banks. Since 2020, following the announcement of a Masterplan for the LFCs/SLCs with the objective to build a resilient and well-performing sector of 25 LFCs, the Department of Supervision of Non-Bank Financial Institution (DSNBFI) has cancelled several LFC licences or encouraged through moral suasion the amalgamation of several LFCs.

237. There are specific risks and challenges for banks and other non-bank financial institutions with Government ownership, including excessive lending to SOEs, some of them being insolvent. In Sri-Lanka a large share of the financial sector is under public ownership. In addition to direct ownership in financial institutions, the weight of the portfolio of the EPF, ETF, and the state-owned insurance company across the commercial banking system can be a force for indirectly shaping behavior.¹⁰⁰ State-owned financial institutions are often exposed to increased risk of political influence over their operations. In Sri Lanka, while the state-owned banks are in principle subject to the same laws and regulations as the other commercial banks, some provisions may suggest otherwise.¹⁰¹ As some vulnerabilities could be associated with board nominations, it should be noted that the annual reports published on the website of the banks with state-related ownership do not provide much information on the role of the state-related shareholders in the nomination of directors in those banks. In addition, it should be noted that the banking expertise and experience of SOB Boards and executive management varies widely.¹⁰²

238. To promote the safety and soundness of banks and Non-Bank Financial Institutions with Government ownership and reduce potential exposure to illegitimate business practices, banking supervisory processes should be strengthened following international good practices in supervising public banks as highlighted in the IMF Paper. In particular, supervisory processes should be developed to ensure that: (i) there is no supervisory forbearance; (ii) specific risks and challenges that arise from state ownership are identified and addressed timely, and (iii) ensure effective implementation of the good corporate governance framework and practices, in particular regarding

¹⁰⁰ The authorities indicated that EPF is not a State-Owned Enterprise but a separate independent entity owned by its members and that there is no conflict of interest between the bank supervision function and EPF.

¹⁰¹ Section 7 of the Banking Act No30 of 1988 stipulates "Nothing contained in the provisions of section 6 shall be construed so as to restrict the Bank of Ceylon or the People's Bank, established under the Bank of Ceylon Ordinance (Chapter 397), the Peoples Bank Act, No. 29 of 1961, respectively and any Regional Rural Development Bank established under the Regional Rural Development Bank Act, No. 15 of 1985, in the exercise of the powers conferred on each such bank by and under the aforesaid statutes applicable to each of such banks, respectively."

¹⁰² The authorities indicated that SOBs are governed by their specific Acts, where the number of minimum directors is less than the regulatory requirement in certain instances. Ministry of Finance (MoF) has been requested to address this concern, by incorporating the necessary amendments to the specific Acts. In the recent past, MoF has been requested by CBSL to reconsider the appointments of several directors in consideration of the qualifications, integrity, experience, and composition of the Board. Subsequently MoF took certain actions to replace such appointments with more suitable directors.

the board's composition, the processes for nominating and appointing the directors and senior managers,¹⁰³ the fit and proper assessment of directors and key management personnel (KMP) of these institutions, and the assessment of the individual and collective performance of the board. The regulatory framework that applies to public banks should be no less stringent than the one that applies to private banks.¹⁰⁴ Ownership arrangements should be designed to avoid conflict of interest.¹⁰⁵

Governance of Supervisory Agency

239. While Sri Lanka has made progress in aligning its legal and regulatory framework with international standards, the revision of the Banking Act 1988 is a necessity to address identified constraints in performing the oversight function effectively. Under the past Monetary Law Act No 58 of 1949, the CBSL was empowered to conduct continuous and periodical examination of banks and the law required the Monetary Board of the CBSL to establish and maintain a Department of Bank Supervision.¹⁰⁶ The Banking Act No 30 of 1988 further empowers the Monetary Board of the CBSL with the licensing of the banks and issuance of regulatory and prudential regulations. However, the Banking Act sets that banking licences are issued by the Monetary Board with the approval of the Ministry of Finance. Such provisions, in addition to the Government's representation on the Monetary Board, the central bank body deciding on every regulatory and supervisory matter, may impair the independence of the Central Bank. Similarly, while the Finance Business Act No 42 of 2011 gives full discretion to the Monetary Board to take licensing, regulatory and supervisory decisions on Licensed Finance Companies, it has provisions¹⁰⁷ that may also impair the power of the Monetary Board.

240. There is a need to further foster the independence of the central bank as the supervisory authority. The amendments to the 1988 Banking Act are still pending fundamental revision, although the Government has indicated its intention to introduce amendments in early 2024.¹⁰⁸ "Operations" Going forward, it is important that the Government's voting representation be removed from the Monetary Board and a prohibition imposed on all members of decision-making bodies and CBSL employees from seeking and taking instructions from third parties.

241. A revision of the Banking Act 1988 is an opportunity to further enhance the independence of the Central Bank as the supervisory agency. It is suggested to remove from the

¹⁰³ BCP 14 EC3 requires that "The supervisor determines that governance structures and processes for nominating and appointing Board members are appropriate for the bank and across the banking group. Board membership includes experienced non-executive members, where appropriate. Commensurate with the risk profile and systemic importance, Board structures include audit, risk oversight and remuneration committees with experienced non-executive members.."

¹⁰⁴ [Regulating, Supervising, and Handling Distress in Public Banks \(imf.org\)](https://www.imf.org)

¹⁰⁵ The authorities indicated that the BSD has initiated a process of reviewing the Banking Act Directions on Corporate Governance with the Basel Guidelines of 2015, that proposed amendments to the Banking Act may strengthen the corporate governance practices of SoBs and that the SOB Acts are proposed to be amended to strengthen the corporate governance practices.

¹⁰⁶ While the Monetary Law Act has been revised many times (the 8th revision took place in 2014) it only mentions two departments, the Department of Economic Research, and the Department of Bank Supervision. However, section 33 authorises the central bank to "establish and maintain such other departments as it may consider necessary for the proper and efficient conduct of the business of the Central Bank".

¹⁰⁷ Section 68 of the Finance Business Act stipulates that "The Minister may give to the Board general or special directions in writing for the purpose of giving effect to the principles and provisions of this Act and the Board shall give effect to such directions.."

¹⁰⁸ The authorities indicated that cabinet approval was received in principle for the areas proposed to be amended in June 2023 and amendments to the Banking Act are expected to be implemented in January 2024

Banking Act the provision regarding the approval or concurrence from MoF for licensing or transfer of ownership of banks,¹⁰⁹ and from the Finance Business Act the possibility for the MoF to give general or special directions to the CBSL as a supervisory authority.

242. The fundamental revision of Banking Act should be an occasion to harmonise the regulatory and supervisory requirements for banks and non-bank deposit-taking financial institutions.¹¹⁰ Currently, there are different sets of regulations for each type of financial institution. For instance, while the regulatory and supervisory framework for commercial banks and specialised banks are similar, they require the CBSL to issues different set of directions and circulars for each type of bank.¹¹¹ Similarly, since banks and LFCs conduct similar type of operations they should be subject to similar regulatory and supervisory requirements. Not only, this will avoid the possibility of regulatory arbitrage, but it will ensure an adequate level-playing field between financial institutions. Considering that larger and more sophisticated financial institutions should be subject to tighter regulatory and supervisory requirements, that could be achieved by adopting some proportionality in the regulation of non-bank deposit taking to cater to their simpler business models and smaller size and considering the size, complexity, risk profile and business model of each financial institution.

243. For several years the CBSL has been evolving towards a more risk-based supervision approach of banks. Following implementation of Pillars 2 and 3 of the Basel frameworks, the CBSL decided to implement a Supervisory Review Process (SRP) to assess each year the capital adequacy of the banks through the review of the Internal Capital Adequacy Assessment Process (ICAAP) that each bank needs to produce on an annual basis. To support the work of the supervisors, the Banking Supervision Department (BSD) has developed an Operation Manual, to be updated on an annual basis, covering the role and responsibilities of the BSD divisions, in particular the Continuous Supervision Division (i.e., Off-site function) and the Examination Division (i.e, On-Site function). Each bank has a focus point within the CSD who has the responsibility to review the prudential returns produced by the banks and identify the supervisory risks using risk profile indicators primarily based on a CAMEL framework.¹¹² Based on the BSD manual, it is the Examination Division that uses the BSRI (Bank Sustainability Rating Index), the in-house risk assessment tool developed by the CBSL to assign supervisory ratings to the banks based on a combination of quantitative and qualitative indicators. Based on the overall BSRI, the Examination Division will decide the scope and frequency of the on-site examination and establishes an Annual Examination Plan.

244. While moving toward a risk-based approach of supervision, CBSL supervision remains largely compliance-based. Reading through the BSD manual it appears that the role of the

¹⁰⁹ The authorities indicated that the proposed draft amendments to the Banking Act will remove the requirement to obtain concurrence of MoF except for licensing of new banks, opening of branches outside Sri Lanka and to determine designated foreign currencies.

¹¹⁰ While non-bank deposit taking institutions are not covered in the Banking Act and the Finance Business Act No.42 of 2011 is being amended to reduce the regulatory arbitrage, the revision of the Banking Act could be an opportunity to further harmonize the different regulatory frameworks.

¹¹¹ The authorities indicated that since 2015, regulations are being issued as a single regulation covering both LCBs and LSBs and that provisions on the principles of proportionality may be included in the proposed amendments of the Banking Act.

¹¹² The authorities have indicated that current off-site surveillance is not limited to CAMEL and that it covers comprehensively all underlying risks and resource factors, including management but the mission team is unable to validate that this risk has been eliminated.

Continuous Supervision Division is limited to compiling ratios and indicators rather than conducting substantive qualitative review.¹¹³ It is also putting emphasis on the monthly and quarterly analysis of ratios (e.g., assets, liquidity, etc.). A further move towards Risk-Based Supervision (RBS) would entail the off-site function of the CBSL to conduct more qualitative analysis of the corporate governance and risk management framework and practices in the banks and other financial institutions, starting, for instance, with a thorough review of the detailed annual reports produced by the banks.

245. The organization of the BSD seems relatively complex to achieve the objective of implementing a Risk-Based Supervision (RBS) approach. The BSD has adopted a so-called Hybrid organization where most of staff is allocated in the two main divisions in charge of off-site (Continuous Supervision division) and on-site (Examination) and five Deputy Directors¹¹⁴ have each a dual responsibility over the management of their division and the supervision of the teams in charge of the on-site examination of banks. This organization aims to provide more diversity in the role of each of the Deputy Directors but organizational complexity may hamper effective RBS.¹¹⁵ While there is no preferred model to organise supervisory activities, it could be considered for more effective supervision to group the banks in clusters of banks with similar risk profiles (DSIBs, State-Owned, medium private, small private, Islamic, foreign, etc.) given the shortage in experienced staff. Interestingly, the DSNBFI which is mainly staffed with former staff from BSD has kept a more traditional organization of On-Site Examination and Off-Site Surveillance without the Hybrid model of the BSD.

246. Resource constraints continue to limit the effectiveness of supervision. Despite the same observation made in each of the previous assessments (i.e., FSAP Update in 2016 and FSSR in 2019) and the growing pressure on the regulatory and supervisory function, there has been still no change in the number and capacity of the supervisory resources. The Banking Supervision Department has only 48 staff compared to a budget of 80. Moreover, among the 41 who are supervisors, 15 have less than 3 years of experience and 11 less than five years, meanwhile some have experience from other regulatory departments of the CBSL. The DSNBFI has more resources (58) but similarly to the BSD, 15 of the 46 supervisors have less than three years of experience and 7 less than 5 years. In the context of strict budget constraints, it seems that the CBSL has no possibility to increase the staff allocated to its financial supervisory function. Since there is no possibility to transfer staff from other departments to the BSD or the DSNBFI, the CBSL is envisaging to contract staff from accounting firms to some supervisory functions. Considering the confidentiality of information circulating in the BSD and DSNBFI, the CBSL should consider international standards.¹¹⁶

¹¹³ While the manual does not provide more than what is described in the report, the authorities indicated that the role of CSD is not limited to compiling ratios and indicators, and that a detailed analysis of all risks, resources and governance issues are assessed in an ongoing basis. The mission team was unable to validate current practices. The authorities agreed that the move towards RBS would be fruitful in improving the qualitative side of analysis, but limited human capital restrains from implementing it in the near future.

¹¹⁴ Besides Continuous Supervision and Examination, there are three other divisions in BSD for Banking Policy, Corporate Services and Database unit.

¹¹⁵ The authorities indicated that none of the officers perform dual functions, that only the deputy directors are assigned with dual responsibility with respect to the banks that are coming under their purview, that it provides them an overall understanding of the respective banks that they supervise for informative and effective decision making, and that it is not considered overly complex for effective RBS approach.

¹¹⁶ BCP 9 EC 11 states that “The supervisor may make use of independent third parties, such as auditors, provided there is a clear and detailed mandate for the work. However, the supervisor cannot outsource its prudential responsibilities to third parties. When using third parties, the supervisor assesses whether the output can be relied upon to the degree intended and takes into consideration the biases that may influence third parties.”

247.

The CBSL needs to further improve the public accountability and transparency of its supervisory mandate. Accountability is essential for the transparency, legitimacy and independence of supervisory decisions and can help prevent corruption and abuse. The CBSL published its 2021 Road Map (on its 70th anniversary) in which it presented the analysis of the situation and presented the initiatives going forward: strengthening the financial sector through non-banking sector consolidation, reducing the dependence on state-owned banks, encouraging the State-Owned Business Enterprises (SOBES) to diversify their borrowing sources, stop funding certain losses in SOBES by state banks, maintain adequate levels of capital and liquidity buffers, improve operational risk resilience. The CBSL website provides information on the regulatory and supervisory framework as well as its organization, and news on appointments and promotions. It is important that the positive steps that have been taken be continually reinforced with additional details on steps to enhance transparency and ensure that materials are clear and provide the type of information of greatest interest.

Banks' Licensing, Corporate Governance and Related Parties

248. Sri Lanka has a formal structure in place for the licensing of banks and NBFIs and the licensing process is broadly in line with generally accepted practices. Although no bank has been licensed for almost 10 years, except for the license of Bank of China in 2017, the CBSL has been active regarding the NBFi sector, with the cancellation of licence for LFCs, either for non-compliance issues or completion of the amalgamation process with another LFC. The Banking Act No. 30 of 1988 consists of provisions on licensing, regulation, and supervision functions of the licensed banks of Sri Lanka, with the Bank Supervision Department (BSD) being responsible for carrying out the due diligences during the licensing process for commercial banks (LCBs) and specialised banks (LSBs) with the approval of the Monetary Board and the Minister. Similarly, the NBFi Department is responsible for carrying out the due diligences during the licensing process for finance companies.

249. The proposed revision of the Banking Act 1988 should be an opportunity to strengthen governance-related prudential framework. For instance, the revisions should introduce provisions that would contribute to reinforcing the corporate governance practices in the financial system, such as provisions setting that: (i) the duty for the board is to oversee the governance framework and the management of the bank; (ii) the board is ultimately responsible for ensuring that the business of the bank is carried on in compliance with all applicable laws and consistent with safe and sound banking practices; (iii) the appointment, election or nomination of a director of a bank should not take place without the prior written approval of the CBSL; (iv) the number of members of the board of a bank could be determined by the Monetary Board notwithstanding to the contrary in any other written law; (v) the independent directors shall be not less than one third of the board; (vi) the chairperson shall be a non-executive director and may be an independent director.¹¹⁷

¹¹⁷ The authorities indicated that that these requirements, except (iii), are more or less covered in the Corporate Governance Direction and are proposed to be included in the amendments to the Banking Act, which is expected to be finalized by Jan 2024.

250. While the CBSL is playing an important role in strengthening corporate governance in the Sri Lankan banking and NBFIs sectors, the implementation could be further enhanced. It is often observed that when institutions fail, the root cause of the problem was weaknesses in corporate governance, including inadequate oversight of the financial institution and of their subsidiaries by the board of directors. The absence of sufficient Board oversight has enabled management to take excessive and imprudent risks. It is essential that the board is empowered to set the bank's strategy, objectives, and overall direction, and that senior management is accountable to the board for the day-to-day running of the institution and their NBFIs subsidiaries. The oversight roles include reviewing the performance of the management and the achievement of its objectives and monitoring and ensuring the integrity of financial information as well as the soundness and effectiveness of the risk management and internal controls of the bank and their NBFIs subsidiaries.

251. However, the CBSL would benefit from reviewing the corporate governance framework to ensure that it contains the key elements of the *Basel Principles for effective corporate governance for banks issued in 2015*.¹¹⁸ The corporate governance framework for financial institutions should be aligned with those principles, through key provisions in the Banking Act and amending secondary legislation, with a specific focus on board qualification,¹¹⁹ composition and selection, risk governance and culture, independence of directors, implementation of the three lines of control model. The CBSL issued, in application to Section 46 of the Banking Act 1988, the Corporate Governance Directions No 11 of 2007 for LCBs and No 12 of 2007 for LSBs, prior to the issuance of the Basel Corporate Governance Principles for Banks 2015. The current provisions cover many aspects of governance, such as the responsibilities, composition and committees of the board, the fit and proper criteria, and disclosures. However, despite those directions having been amended several times, they do not include many important principles set by the Basel Committee, such as the three lines of controls/defence model with the independence of the three control functions (risk management, compliance, and internal audit). In fact, while the Corporate Governance regulatory framework for banks has not been aligned with the 2015 Basel Principles, the Direction No 5 of 31 December 2021 under the Finance Business Act No 42 of 2011 for NBFIs incorporates more of those 2015 Basel principles. While licensing criteria may differ depending on the activities and lines of business of the financial institutions, corporate governance arrangements should be similar for LCBs, LSBs, or NBFIs, independently of the type of their activities. Since the CBSL is recommended to review the corporate governance framework for banks, it should consider harmonizing the different provisions.

The CBSL should also consider the principle of proportionality to ensure that governance arrangements are commensurate and consistent with the size, complexity and individual risk profile and business model of the bank or financial institution.¹²⁰ In the course of the supervisory work, either from an off-site (continuous supervision) or on-site perspective, the CBSL

¹¹⁸ See the Basel Committee on Banking Supervision Guidelines "*Corporate Governance Principles for Banks*" published at <https://www.bis.org/bcbs/publ/d328.pdf>

¹¹⁹ The authorities indicated that provision on qualification would be strengthened in the amendments to the Banking Act as follows:

*"that such person possesses academic or professional qualifications, and effective experience in banking, finance, **economics, accounting, business administration, information technology, risk management, law** or any other relevant discipline, as may be determined by the Central Bank"*.

¹²⁰ The authorities indicated that with the successful completion of NBFIs sector masterplan, NBFIs sector will comprise of large and stable LFCs and that the proposed amendments to the Banking Act may include principles on proportionality.

should also ensure that banks and other financial institutions consider their size, their internal organisation and the nature, scale and complexity of their activities when developing and implementing policies and processes for corporate governance and risk management. Currently in Sri Lanka boards should not have less than 7 and more than 13 directors. As a result, the largest state-banks have in theory 7 directors, when tiniest banks have sometimes 13. Reading through the Annual Reports published by the banks on their website, directors are spread into too many committees, which may question their capacity to allocate enough time to their responsibilities.¹²¹

252. The CBSL should monitor the process of appointment of directors and ensure that banks and other financial institutions have succession planning for both directors and management, including the heads of the control functions.¹²² Except for unavoidable circumstances, since the end of the mandates of members of the board and key management personnel is known well in advance, the CBSL should ensure that due diligences are completed in due time by banks and other financial institutions and there is no vacancy in the boards.¹²³

253. One important 2015 BCBS principle is related to the role of supervisors in the guidance to be provided to financial institutions to ensure that banks and other financial institutions have robust corporate governance policies and practices. Therefore, in addition to the Corporate Governance directions, the CBSL should issue guidelines to provide clarification on some notions, to be considered both at the time of the nomination process but also when assessing the individual and collective suitability and performance of the directors. In that regard, guidance should be provided not only on time commitment, adequate individual and collective knowledge, diversity in skills and experience, but also on notions such as honesty, integrity, and independence of mind. Guidelines would help to establish harmonised criteria for the assessment of suitability of individual directors and overall boards but also of Key Management Personnel (KMP). Beyond providing guidance on expectations, the CBSL could share good practices observed in the banks and other financial institutions they supervised. For instance, it was observed that one bank has decided that even their major shareholders will not nominate directors, but that directors would be proposed to the Annual General Meeting by a Nomination Committee responsible for ensuring that the above-mentioned criteria (diversity in skills, knowledge, time commitment, etc.) are satisfied.

254. The fitness and propriety process used by the CBSL to review the affidavits appears relatively formal and should be focusing on qualitative reviews of the elements provided by the applicant from a risk-based analysis. In application to Section 12 (1B) of the Banking Act 1988, when granting approval for an acquisition of a material interest of a licensed bank to an individual or a corporate body, the Monetary Board must determine whether the individual or the directors of such corporate body are fit and proper persons considering the criteria set out in Section 42 of the Banking Act (mostly academic or professional expertise, experience, absence of finding of fraud, dishonesty,

¹²¹ While mandatory requirement is only four Board Sub-committees (i.e., Risk, Audit, Nominations, and Human Resources & Remuneration), some banks have additional committees.

¹²² The authorities indicated that the adequacy of succession planning procedures for senior management, including for the heads of control functions, is reviewed by the on-site examinations in line with the applicable Corporate Governance Directions. However, given the prevailing market conditions, implementation of such procedures at times is challenging.

¹²³ At the time of Governance Diagnostic Assessment, it was observed that some of the largest state-owned financial institutions had only 2 or 3 directors for months, due to the delay in submitting names and proper documental by the banks for fit and proper assessment by the CBSL, with boards seats of the banks left unattended for extended periods of time.

etc.). Similarly, Sections 42,43 and 44(A) of the Banking Act 1988 require an assessment of the suitability of the bank's board members and senior management, both on a new and on ongoing basis. Section 3(3) of the Banking Act Direction No 11 and 12 of 2007 on Corporate Governance for LCBs and LSBs and Banking Act Direction No 8 of 2019 provide instructions for the fitness and propriety assessment of directors, CEOs and KMPs. However, the assessment takes the form of the review of an affidavit that appear more formal than substantial. Since strong senior managers in financial institutions can help to safeguard the integrity of the financial sector and minimise opportunities for corruption, the fit and proper framework for assessing the suitability of members of the board of directors, CEOs and KMPs needs to be strengthened to be more aligned with international standards. It should also include the assessment of potential conflict of interests (personal, professional, financial, and political).

255. Section 3(1) xvi of Directions No 11 of 2007 for LCBs and No 12 of 2007 for LSBs require the board to publish in the bank annual report a corporate governance report setting out the compliance with the Corporate Governance Directions. Banks publish in their Annual Report an assessment showing that they “comply” with the requirements of the Direction. To comply with the CBSL requirements, banks put a lot of efforts in providing detailed information on the board composition, the board committees, as well as the biographies and activities of their directors and senior management. As a result of those detailed and lengthy descriptions of the formal compliance of the banks with the regulatory requirements of the CBSL, it is relatively difficult to find in the annual reports essential information, such as information on the shareholders. Rather than focusing on detailed information in the Annual Report, the CBSL should adopt a more risk-based approach of the corporate governance information published in the annual report with more emphasis on the qualitative rather than the quantitative aspects of corporate governance, such as the Board assessment of its collective and individual contribution to the oversight of the bank, its management, and its risks.

256. In addition to developing guidelines for the financial institutions, the CBSL needs to provide to the supervisors a methodology to conduct comprehensive assessments of the corporate governance framework and practices in a financial institution. The checks done during on-site examinations, or the fit and proper assessment, are mostly on formality and compliance issues not on the substance to achieve a comprehensive assessment of the effectiveness of the board in the oversight of the management.¹²⁴ Such assessments should not only be done during on-site examination, but also from an off-site perspective through appropriate questionnaire and returns. Since the review of the compliance, as stated in the annual report of the financial institution, cannot be considered as adequate, the CBSL should develop a comprehensive methodology following the structure of the Basel Principles 2015 with specific guidance for each topic, describing the objective of the assessment, the issues that the supervisor may come across, providing detailed assessment template with potential observation or conclusion to be drawn from the findings. In addition to that guidance, the CBSL need to build capacity to conduct these assessments with supervisors developing an expertise in this area.

¹²⁴ While no evidence was provided to the mission, the authorities indicated that many qualitative factors are considered in assessing the fitness and propriety of directors and that additional checks are carried out referring to other relevant regulators on an annual basis or when the need arises.

257. To prevent abuses arising from transactions with related parties, the regulatory framework and supervisory oversight of banks' policies and practices in this area should be enhanced. The FSSR 2019 reported that international standards were not met but that there were prospects for change with the revision of the Banking Act. While there is no pre-defined limit to related party transactions, related party credit exposures must be reported by banks and other financial institutions on a quarterly basis, including the amount, rate of interest and securities values and are examined by the CBSL during on-site examinations. The CBSL should add to its prudential framework limits on related party exposures.

258. Some provisions of the draft amendments to the Banking Act 1988 could reinforce the regulatory framework on related party transactions. Based on a preliminary reading of the suggested legal amendments, the provisions on 'related party' are expected to be strengthened, with a broadening of the coverage of 'related party transactions'.¹²⁵

259. The definition of related party should be widened. In Sri Lanka, related party means " *any person that maintains any of the following relationships with respect to a bank; director or key management personnel; a substantial shareholder; a subsidiary, affiliate, holding company, parent company, and any party (including their subsidiaries and affiliates) that the licensed bank exerts control over or that exerts control over the licensed bank; director or key management personnel of a related party; a close relative of a natural person described above; a concern in which a shareholder, director or any of their close relations has material interest.*".

260. However, to be in line with international standards, the related-party framework could be further strengthened by adding in the regulatory framework the concept of arm's length and some governance requirements.¹²⁶ International standards require that: i) the transaction with related party should be made on the same terms and conditions as for comparable transactions with non-related counterparties; ii) the transaction should only be completed with a formal board approval; iii) the transactions should be monitored with periodic reporting to the board; and iv) board must provide oversight of these transactions. In doing this, the CBSL should pay particular attention to the loans granted by state-owned banks where a sharp rise of NPLs has been observed banks portfolios mostly due to loans granted to connected or related parties.

261. There is no definition of the beneficial owner in the Banking Act 1988. The identification of ultimate beneficial owners of banks is very important from a related party perspective. The Guidelines 04/2018 from the Financial Intelligence Unit provides guidance to the financial institutions on the rationale and need to identify the beneficial owner. Those guidelines should be incorporated in

¹²⁵ The contemplated definition would be: "any type of accommodation by a bank or any entity within the banking group to any related party; an exposure of the bank or any entity within the banking group to any related party of the bank including creation of liabilities of the bank in the form of deposits, borrowings, and investments; provision of services by a related party of the bank, whether financial or otherwise, to the bank or any entity within the banking group or receiving any such service from the bank or any entity within the banking group; creation or maintenance of reporting lines and information flows between the bank or any entity within the banking group and any related parties, which may lead to the sharing of potentially proprietary, confidential or otherwise sensitive information that may give benefits to such related parties."

¹²⁶ The authorities note that regulatory and statutory provisions covering these areas exist.

the supervision manual of the BSD and DSNBFI so the examiners could ensure that the financial institutions are incorporating this requirement in the scope of their examinations.

22. Recommendations on Financial Sector Oversight:

Measure	Authority	Implementation Timeline
<p>1</p> <ul style="list-style-type: none"> • Enhance the governance of the CBSL in its role as banking supervisor¹²⁷ <ul style="list-style-type: none"> ○ Strengthen the independence of the CBSL as financial sector supervisor by: <ul style="list-style-type: none"> - remove the Government voting representative from the Monetary Board (amendments to the Monetary Act) <i>Short-term</i> - eliminate from the Banking Act the provisions regarding the approval or concurrence from the MoFMOF for licensing or transfer of ownership of banks, and the authority for the MoFMOF to give general or special directions to the CBSL as a supervisory authority. <i>Short-term</i> - remove from the Finance Business Act the provisions providing the MoFMOF with authority to give general or special directions to the CBSL as a supervisory authority. <i>Short term</i> ○ Adequately staff the supervision departments for banks and NBFIs in terms of numbers and capacity to ensure that the supervisory departments of the CBSL have the capability to implement a risk-based approach of supervision, in general, and specifically undertake comprehensive assessments of banks' corporate governance and practices regarding related parties, with more qualitative analysis in addition to the monitoring of quantitative ratios and indicators. <i>Medium-term</i> ○ Align the regulatory framework for banks and NBFIs. <i>Short term</i> <p>Initiate consolidated/conglomerate supervision by the CBSL. <i>Short term</i></p> <p style="text-align: right;"><i>Medium term</i></p>	<p>Ministry of Finance/CBSL</p>	
<p>2</p> <ul style="list-style-type: none"> • Continue to make progress in strengthening the governance-related prudential regulatory and supervisory frameworks by aligning them closer with international standards and good practices. <ul style="list-style-type: none"> ○ Align the corporate governance framework for financial institutions (banks and NBFIs) with the Basel Principles for Corporate Governance for banks 2015 by including key <i>Short-term</i> 	<p>CBSL</p>	

127 A number of these elements have been addressed in CBSL Law enacted in September 2023

	<p>provisions in the Banking Act and amending secondary legislation, specifically focusing on board qualification and composition, risk governance and culture, independence of directors, implementation of the three lines of control model.</p> <ul style="list-style-type: none"> ○ Harmonize on the one hand the prudential and regulatory requirements between the different categories of financial institutions and apply on the other a principle of proportionality based on the size complexity, risk profile, business model and activities. ○ Through increase of on-site inspections targeted on bank and NBFIs governance and off-site reviews of specifically designed returns, enhance supervisory oversight to ensure that all banks and non-bank financial institutions properly implement the best practices in corporate governance, regarding effective board oversight, conflicts of interest, corporate governance and risk culture, and disclosure and transparency. ○ Strengthen the CBSL capacity and supervisory methodologies to ensure it can conduct comprehensive assessments of corporate governance and risk management framework and practices. ○ Strengthen the fitness and propriety framework for the suitability assessment of members of the board of directors and senior management to ensure boards of banks and NBFIs are collectively and individually adequately composed - 	<p><i>Short-term</i></p> <p><i>Medium-term</i></p> <p><i>Medium-term</i></p>
<p>3</p>	<ul style="list-style-type: none"> ● Further enhance the the Corporate Governance framework and practices for banks and non-bank financial institutions. ○ Make the nomination process for senior management and board members of public banks transparent. ○ Ensure that directors and senior managers are made accountable for failure to undertake their duties effectively to ensure implementation sound business and/or governance principles. ○ Prevent government officials from intervening in day-to-day operational decisions. ○ Give the supervisors clear authority to evaluate corporate governance in public banks. ○ Ensure that board members have the necessary independence, professional skills, and experience by strengthening board qualification criteria and modernising supervisory fit and proper assessment regime. 	<p>CBSL</p> <p><i>Short-term</i></p> <p><i>Medium-term</i></p> <p><i>Short-term</i></p> <p><i>Short-term</i></p> <p><i>Medium-term</i></p>

	<ul style="list-style-type: none"> ○ Ensure that banks' and NBFIs board members and senior management appointments and dismissals are well-established, and merit based by prioritising this area and intensifying supervisory activities. 		Medium-term
	<ul style="list-style-type: none"> ○ Ensure that boards are accountable for the bank's and NBFIs business strategy, financial soundness, and key personnel decisions and are fully capable of flagging and addressing problems in the bank's operation by amending corporate governance regulation and intensifying off-site and on-site supervisory activities in this area 		Medium-term
4	<ul style="list-style-type: none"> ● Strengthen the regulatory framework and supervisory oversight of transactions with related parties, to ensure that: <ul style="list-style-type: none"> ○ definitions of "related parties" and "related party transactions" are in line with Basel standards. ○ transactions with related party are made on the same terms and conditions as for comparable transactions with non-related counterparties (on arm's length basis). ○ transactions are only completed with a formal board approval. ○ transactions are monitored with periodic reporting to the board. ○ boards are providing regular oversight of these transactions. 	CBSL	Short-term

Section IX: Rule of Law¹²⁸

A. Background

262. This section assesses the strength of the legal and institutional framework for the protection and enforcement of contractual and property rights, while highlighting the vulnerabilities to corruption in the system. Rule of law is one of the state functions under the Fund's *Framework for Enhanced Fund Engagement in Addressing Governance Vulnerabilities* in member countries¹²⁹ and pays particular attention to aspects of the judicial system that effect macroeconomic performance. A well-functioning judiciary is of paramount performance to the economic system both in terms of private sector mobilization, fluidity of credit market and stimulation of international investment.

263. While performance data is relatively meagre in the justice sector, international governance indicators of the country's rule of law have been largely unchanged in the last decades. In 2019, the World Bank CPIA rated Sri Lanka 3.0 in terms of rules-based governance and property rights¹³⁰, which has fluctuated between 3.5 and 3.0 the past decade (1=low, 6=high). According to the World Justice Project indicator on regulatory enforcement, Sri Lanka has slipped marginally from 0.49 in 2019 to 0.48 in 2022.¹³¹ Sri Lanka performed worst in its performance around administrative procedures. Of greater concern, the World Bank reported in 2017, that the average time for a court-adjudicated enforcement of a contract was more than 1300 days.

264. The Sri Lankan court system suffers from poor resources, an overwhelming backlog of cases, and the limited capacity of legal personnel. The system is unable to keep up with the flow of cases entering the system due to antiquated processes and a general failure to make use of technology to assist in case management. Judges are consumed by the administrative tasks of running the court and do not have the required time to adjudicate on cases. Problems handling new cases adds to the extraordinary backlog of older cases, making the system relatively unusable for protecting contract and property rights. Problems in the adjudication of disputes are further exacerbated by the complexity of the land registration system. The absence of data and publicly accessible registries also creates clear vulnerabilities to corruption. Land disputes are regularly cited as the source of the most numerous and protracted cases.

265. The Constitution does not explicitly express the separation of powers and guarantee of judicial independence. A UN Special Rapporteur assessment on the independence of judges was conducted in 2017 and found that some aspects of safeguarding judicial independence could be

¹²⁸ This section has greatly benefited from discussions with the ADB, regarding on-going work in the justice sector. We greatly appreciate the access they provide to their draft "Assessment & Strategic Action Plan: Commercial, Contract, and Investment Law Enforcement."

¹²⁹ See Review of 1997 Guidance Note on Governance - A Proposed Framework for Enhanced Fund Engagement available at <https://www.imf.org/en/Publications/Policy-Papers/Issues/2018/04/20/pp030918-review-of-1997-guidance-note-on-governance>

¹³⁰ [Country Policy and Institutional Assessment | DataBank \(worldbank.org\)](http://www.worldbank.org/ida). World Bank Group, CPIA database (http://www.worldbank.org/ida).

¹³¹ [WJP Rule of Law Index | Sri Lanka Insights \(worldjusticeproject.org\)](http://www.worldjusticeproject.org)

enhanced and there has been pressure applied on the judiciary by the Executive during certain periods.¹³²

266. Justice reform is being implemented by multiple donors and coordinated by the Ministry of Justice.¹³³ An official legal reform strategy, defining core policy priorities, would be useful in ensuring alignment of efforts and moving in a consistent direction.

B. Foundations of the rule of law – stability of the legal framework

267. In recent times, Sri Lanka’s rule of law system has been under increasing scrutiny given concerns about its performance and fluctuations in adherence to fundamental principles. The introduction of the 18th amendment to the Constitution in 2010 removed a number of established legal constraints on the exercise of political power and authority. Among other things, the amendment reduced the independence of key institutions, including the judiciary. Fortunately, the 19th amendment restored many of the provisions of the 17th amendment to the constitution, such as enabling the Constitutional Council to set up independent commissions. However, the 20th amendment of the constitution in 2020 again saw significant eroding of the constitutional constraints on authority with appointments through executive and unchecked power. The 22nd amendment in 2022 then reinstated the Constitutional Council.

268. The frequent changing and amending of the constitution calls into question the legal certainty and rule of law more broadly in the country. As discussed in the different sections of the report, steps that have served to reduce legal certainty have been paralleled by the movement of decision-making into poorly regulated and opaque processes. The combined effect of these trends is a reduction in the rule and authority of law, which bodes poorly for integrity and Sri Lanka’s economic and social development.

269. Sri Lanka’s legal system is steeped in tradition, but the operative legal framework is subject to substantial amendment, often introduced in an ad-hoc manner that gives scarce room for public consultation. This dynamic process risks introducing fragmentation and inconsistencies in the law and promotes an environment of legal uncertainty. The multiple amendments to the constitution being the prime but not the only example of extreme fluctuations.

270. Key legislation is subjected to multiple revisions, often indicating a lack of planning and sufficient review and consultation in formulating drafts. In addition, secondary legislation and

¹³² See, Sri Lanka: Parliamentary action undermines independence of the Judiciary, International Commission of Jurists, icj.org

¹³³ The Asian Development Bank provided technical assistance in “Strengthening the Efficiency of the Justice Sector with a focus on Commercial Law, Investment, and Contract Enforcement” which provided an in-depth assessment to produce a strategic action plan. The strategic action plan has been accepted by the Secretary of Justice and will shortly go for approval before the Cabinet of Ministers. The MoJ has already commenced work on some of the recommendations based on interim reports (e.g., requiring sector institutions to revise their Vision and Mission statements). The EU is supporting the big justice sector reforms program (EU JURE program of 18mEuro) is now into its second year (1st year of operations). There is high enthusiasm from the government to implement this and the activities are a mixture of short-term activities (e.g., judges training and awareness raising) and policy related activities (e.g., commercial law reforms). UNDP is implementing some of the EU initiatives for example in developing a national sentencing policy to promote uniformity and to ensure that judges are compelled to adhere to guidelines. USAID are also assisting the Ministry of Justice in ADR among other justice sector programming.

regulations are issued in a disorganised manner, often without proper consideration on whether it is harmonised with existing legislation. As of the end-March 2023, there were 54 amendments or new Acts being processed, 38 policy approvals received, 4 amendments/Bills at Parliament being Gazetted and 2 pending at Cabinet. In 2022, there were 29 new or amendments, rules and orders. While some effort is made towards public consultation of legislation, each line ministry has substantial discretion as to the level of public consultation provided for each legislative proposal and practices vary widely. Increased meaningful stakeholder participation in the formulation of policy and legislation could mitigate the need for subsequent amendments and revisions of legislation once introduced.

C. Functioning of the judiciary – case backlog, court processing, statistical record keeping

271. Sri Lanka’s court system is comprised of a Supreme Court, a Court of Appeal, High Courts (such as the commercial high court), Municipal Courts, and Primary Courts. Sri Lanka has 203 Courts of first instance (33 District Courts, 54 magistrates’ courts, 52 DC/MCs, 25 Circuit Magistrate courts and 39 Labor Tribunals). There has also been a Commercial High Court established and a Small Claims court, which had not been established as of March 2023.¹³⁴ There is a Court of Appeal and 22 civil appellate high courts, 34 high courts and 2 special high courts giving a total of 59 courts. Original jurisdiction over most civil matters lies with the relevant District Court, which are the Courts of first instance for civil cases. Sri Lanka has 54 judicial districts. Judges of the District Courts are appointed by the Judicial Service Commission, which has the power to dismiss and maintain disciplinary control over the District Court judges. As of the 31st of December 2022, there are 241 judges of first instance, 111 appeal court judges, 17 Supreme Court judges, and 29 Presidents of Labor tribunals.

The effectiveness of the Judiciary – (a) Case Backlog

272. Backlog is the most pressing issue faced by the Court system and creates problems for the business community. The immense backlog of cases on the court system restricts the clearing of current cases which in turn contributes to added backlog.¹³⁵ The pressure on the system creates inordinate delays and means that the private sector and banks generally try to avoid reliance on the court system to enforce credit agreements. The perception of international investors and the financial sector is that it is unattractive to do business in Sri Lanka, citing absence of a functioning judiciary as the key sticking point.¹³⁶ At the District Court of Colombo (where most financial institutions are based) there are 45,000 pending cases involving the recovery of money from broken contracts. On average, 10,000 such cases are registered each year at this court with currently 10 judges handling each 2000 cases, at any given time. The table below shows the combined case flow for municipal and district courts. As shown, the case backlog is overwhelming and is creating a pull-down effect in the ability to process incoming cases within a specified time frame.

¹³⁴ [Sri Lanka: Legal Research and Legal System - GlobalLex \(nyulawglobal.org\)](https://www.nyulawglobal.org/globalex/sri-lanka.html).

¹³⁵ The Minister of Justice stated in 2020 that at that time there were 800,000 pending cases, which would take 15 years to clear at the current rate of resolution.

¹³⁶ See, U.S. Investment Climate Report, Sri Lanka – U.S. Department of State.

Table 23. Inflow and Outflow of cases (by type)

Municipal and District Courts

	Brought forward cases (as at 01.01.2022)	Inflow as at 30.09.2022	Outflow as at 30.09.2022	Pending as at 30.09.2022
1 Civil cases	222,352	49,252	43,998	227,606
2 Land cases	33,937	3,580	2,915	34,602
3 Criminal cases	770,943	520,104	512, 220	778, 827
4 Tax Cases	1,906	0	106	1800

Commercial court

	Brought forward cases (as of 01.01.2022)	Inflow as of 30.09.2022	Outflow as of 30.09.2022	Pending as at 30.09.2022
Commercial Cases	7,723	6,292	5,786	8,229

Source: Ministry of Justice, March 2023

273. Clearing the backlog of cases could be addressed through the establishment of a special court dedicated to the task. The issue currently is that cases dating back to 2012 are being taken up now and fresh cases postponed indefinitely. The backlog could first be defined as cases prior to a pre-determined date which would be handled by a separate process with heavy utilization of Alternative Dispute Resolution (ADR) mechanisms such as mediation, conciliation and arbitration. The present cases can then be handled by the current system allowing time standards and guidelines for disposal to be respected.

The effectiveness of the Judiciary – (b) Court process delays due to caseload and lack of effective judicial administration.

274. The heavy workload of judges is increased by heavy court administration procedures. The lack of resources in the judiciary is clear with the Ministry of Justice (MoJ) citing the ratio of approximately 15 judges per million population.¹³⁷ The workload for District judges is around 2000 cases per year and magistrates handling over 5000 cases per year. In addition to the case load, judges are also being consumed with running administrative matters at court which could be managed by court administration personnel so that judges can focus on adjudication. The judges of first instance courts are the directors of the courts and, therefore, are responsible for approving budgets for minor court purchases and scheduling issues, which could be outsourced to registrars and administrators. In addition, for enforcing court orders, Registrars are functioning as Deputy Fiscals which is taking time from their other duties and responsibilities. For example, there are only 10 Registrars/Deputy Fiscals in

¹³⁷ For comparison, India has around twenty-one judges per million population.

Colombo, and they often have to travel long distances to execute the order (as the defendants are often not residents of Colombo). Therefore, in reality this process of enforcement often gets delayed, which limits the impact of court orders.

275. There is a clear lack of adequate staff to assist in the court administration and judicial research, especially in the Commercial High Court. Workload in the Commercial Court is high as this court handles Intellectual Property issues, commercial and company matters with a value over 50mLKA in addition to handling arbitration. Much of the commercial litigation needs to be conducted in English and therefore requires competent staff who can handle matters in English. Currently, there are only 3 research assistants for all 4 courts/judges (1 roll court and 3 trial). Caseload is heavy at the commercial court and there is significant backlog; the majority of cases are older than 5 years.

Table 24. Commercial High Court Case Numbers

Commercial High Court Case Numbers as of March 31, 2023		
Court no. at Commercial High Court	Pending trials	Calling Matters ¹³⁸
1	159	283
2	341	733
3	439	441
4	12	6057 (mainly arbitration)

Source: High Commercial Court of Colombo (during Governance Diagnostic mission March 2023)

The effectiveness of the Judiciary – (c) Court process delays due to lack of simplified process

276. It takes on average 6-7 years to enforce a contract in Sri Lanka and severe delays are the norm.¹³⁹ A 2014 national survey of the Bar Association of Sri Lanka (BASL) highlighted court delays, procedure, and corruption as “extremely serious” and impact Sri Lanka’s attractiveness to foreign direct investment. Although Sri Lanka is moving towards more court specialization, there is still a need to develop this further in order to appreciate the efficiency gains from specialization of expertise and procedures. Many of these objectives are highlighted by the “Enforcing Contract Task Force” in an Action Plan designed to enhance the business enabling environment.¹⁴⁰ The Presidential Secretariat is leading the work of the Task Force related to enforcement of contracts, including monitoring the justice ministry roadmap, while there is a parliamentary committee dedicated to complementary work. The Task Force has a very ambitious plan which will be challenging to implement and is currently undergoing endorsement of key stakeholders.

¹³⁸ ‘Calling Matters’ are cases that have not reached the trial phase but are listed for hearings.

¹³⁹ Scoping mission 13th March 2023

¹⁴⁰ Business Enabling Environment (BEE) Action Plan 2022-2023, Enforcing Contract Task Force, Ministry of Justice, Update as of 31.01.2023.

277. Key action items have been identified to make processing of commercial litigation more effective such as establishment of civil pre-trial court houses and to enhance the specialization event further by establishing an investor dispute high court as a specialist division of the Commercial High court. Currently, large commercial disputes are referred to the Commercial High Court that deal with disputes arising from commercial transactions with a value over LKR50Mn.¹⁴¹ A recent increase in the monetary limit of Commercial High Court matters from 20mn to 50mto ensured that the value is in par with the current market values. A specialised Court has also been established to adjudicate claims such as card claims below the threshold of Rs1.5Mn.¹⁴² Civil commercial action is regulated by the Civil Procedure Code and the archaic rules coupled with a tradition of very litigious culture in Sri Lanka cause severe delays in enforcing contracts.

278. Money recovery matters are the most common cases in the High Court (see Table 23 showing breakdown of category of cases in two of the courts) and Alternative Dispute Resolution mechanisms (ADR) could be utilised more systematically in contract cases involving the recovery of credit to ease the pressure on the courts. ADR methods could be used to resolve the estimated 70 percent of cases that exclusively involve interest payments and the mode of calculation.¹⁴³ Simple cases involving recovery of credit could be mandated to be first referred to a panel (for example, a panel of accountants and banking professionals) and proceed to the court system only if the matter cannot be resolved in that forum. Such a reform would require an amendment to the civil procedure code to constitute a panel.

Table 25. Number of cases at 2 of the 4 courts in the High Commercial Court by breakdown of case category

Category	Court 1		Court 2	
	Trial cases	Calling cases	Trial cases	Calling cases
1 Money recovery	141	182	304	604
2 IP	6	24	15	39
3 Company matters	8	41	22	78
4 REM (shipping)	4	36	0	5
5 Arbitration	0	0	0	3
Total	159	283	341	733

Source: High Commercial Court of Colombo (during Governance Diagnostic mission March 2023)

279. Case Management practices are generally weak, and standards are not respected. Although there are guidelines on time limits for filing cases and processes (for example, in the recent Small Claims Court 33/2022), they are often not respected. Lawyers too easily request adjournments

¹⁴¹ the High Court of Provinces (Special Provisions) Act No. 10 of 199

¹⁴² Enactment of Small Claims Courts' Procedure Act No. 33 of 2022 (17/11/2022)

¹⁴³ Interview with High Court, March 2023.

and are often insufficiently prepared, having too much control over court scheduling. Adjournments are not regulated for and there is a lack of specific guidelines and requirements as to when they are valid. This adds tremendous pressure on the court system where adjournments cause at least 3-month postponements having a knock-on effect which adds to the already existing backlog. Similarly, although there has been the introduction of pre-trial conferencing, it has not been sufficiently and comprehensively administered in the way it was intended, to reduce pressure on the courts. There has not been sufficient clarification in the pre-trial conferencing procedure or sensitization among stakeholders to fully take advantage of the efficiency gains. Interim appeals clog up the appellate courts, drawing out the time for a case to be concluded. The long duration of these processes impacts at different levels by generating increased fee costs while decreasing the value of the guarantees (depending on whether the loan is secured or unsecured, what type of guarantee and according to the type of process either individual or bankruptcy).

280. The judiciary has taken steps to try and streamline the court process. Seventy percent of the cases filed in District Court are small claims (<1.5m Rp). The Small Claims Act provides for specific timeliness where the time from the defendant coming to court to when the case is concluded should not exceed 18 months. Sri Lanka has also introduced a pre-trial procedure of 2017 as an amendment to the Civil Procedure Act providing for specific timeliness (3 weeks to fix pre-trial, 2 months for the pre-trial and 4 months to finish the pre-trial) with a separate court for pre-trial with a dedicated pre-trial judge.¹⁴⁴ The pre-trial procedures attempt to incorporate alternative dispute resolution into court proceedings and encourage early settlement of cases. However, the pre-trial procedure is currently not very effective as lawyers must only file their admissions and issues in writing, and there is a lack of serious motive at the pre-trial stage to attempt to reach early settlement. The ceiling was also increased in the commercial high court. Sri Lanka also has introduced provisions in the High Commercial Court for arbitration of cases. However, arbitration is being conducted almost in the same manner as court cases, so it is not relieving as much pressure on the court system as intended.

281. Court processes should be comprehensively reviewed and revised to incentivise early settlement and reduce trial time in addition to enhancing the availability of ADR mechanisms. The pre-trial conferencing 2017 procedure could be amended to include requirements for not only filing but setting a strict timetable and determine the number of witnesses. This would more effectively make use of the pre-trial conferencing to free up court deliberations. In addition, there should be a judicial circular specifying guidelines for adjournments, and even a mechanism to impose cost for adjournment. This would disincentivise lawyers requesting adjournments for no valid reason or unpreparedness.

282. Additional amendments to the civil procedure code such as introduction of summary trial, and provisions for interim payments on court orders would speed up the clearance of cases and incentivise parties to settle. The MoJ has been encouraged to establish a minimum value for *arbitration cases* at the High Commercial Court to reduce the number of cases involving small values.

283. Systematic use of ADR mechanisms (in particular mediation and conciliation) could greatly contribute to reducing the pressure on the court system and clearing the backlog of

¹⁴⁴ PL005082 Civil Act (Cov).pmd (srilankalaw.lk)

older cases. ADR is currently used as a separate procedural process, but it could also be incorporated formally into court procedure to facilitate early settlement and reduce cost of litigation. Introduction of an overarching legislative framework for encouraging and formally incentivizing use of multitude ADR mechanisms would be important to improve speed of settlement by resolving some cases and freeing up resources in the courts.

The effectiveness of the Judiciary – (c) Inadequate statistical collection and professionalization of the sector

284. The Judicial Service Commission (JSC) is to a large extent responsible for the professionalization of the sector, but its' capacity is limited. The JSC is responsible for appointment of judges of first instance (i.e., magistrates, districts), and determines their promotion, transfer and disciplinary control. The JSC also makes recommendations to the President on the nomination of judges to the High Court.

285. The absence of clear and transparent procedures for selection and appointment of senior judges encourages resort to non-transparent methods in the appointment process.¹⁴⁵ There is no system to evaluate the performance of judges of first instance courts or documented criteria to support promotions, transfers and career progression. The JSC is staffed by three justices, all from the Supreme Court, and one secretary, vesting extraordinary responsibilities and discretion on a very limited number of people.

286. The JSC has the power of investigation and currently, the JSC has 2 indictments pending against High Court judges, 13 pending for District Judges and magistrates (with a further 8 concluded but not yet tabled) and 50 pending against court staff. However, there is no code of conduct to establish clear standards and expectation of appropriate behaviour. The absence of such a code creates problems for disciplinary proceedings, while reducing public confidence in the integrity of judges and judicial personnel.¹⁴⁶ There is no separate law or constitutional provision on the sanctioning and dismissal of judges, which again adds to the impression that judges are afforded a high degree of impunity for their actions.

287. Lack of transparency, and adequate regulation of the justice sector extend to both court and non-judicial court officials. The Bar Association does not have a disciplinary function and does not actively engage in overseeing and regulating the behaviour of legal professionals. The JSC is not able to pro-actively monitor and oversee the performance of Deputy Fiscal Registrars in executing court orders given resource constraints which contributes to concerns about the effectiveness and integrity of this function. The JSC and the Bar Association should ensure the existence and observance of criteria for hiring, promotion and dismissal of judicial officers, including the disbarment of attorneys found to have violated professional codes of conduct. Their independence should be guaranteed so that they may regulate the sector effectively.

¹⁴⁵ [A_HRC_35_31_Add-1-EN.pdf](#)

¹⁴⁶ United Nations, Report of the Special Rapporteur on the independence of judges and lawyers on her mission to Sri Lanka, 6-23 June 2017 [A_HRC_35_31_Add-1-EN.pdf](#)

288. The JSC is largely unable to collect and analyse data on the performance of the sector or on individual performance. Limitations relate both to capacity and the existence of established systems for recording and maintaining data, as well as protocols for data analysis and reporting.

289. There is limited publicly available and verifiable court statistics to inform decision making. Although some data is collected quarterly by the MoJ from various courts (such as case load, case type at a high level) and used to prepare progress and performance reports tabled in Parliament,¹⁴⁷ the data collected is sparse and interpretation of this data has currently limited use for analysis in evaluating bottlenecks, efficiency gains or in wider policy making. There is currently no breakdown of data by category of types of cases and hard data on clearance rates, case turnover ratio and other valuable data to allow for identification of causes for delays in commercial cases. For example, while each court maintains a record of court order executions, there is currently no centralised database where all the information can be collated and analysed for performance metrics. In general, access to information is limited of legal information as it is currently dispersed and not widely accessible in a useable format to help advance the legal literacy of the general public.

D. Enforcement of property rights

290. Enforcement of property rights is weak in Sri Lanka and the land administration system gives rise to multiple vulnerabilities to corruption. Reports have consistently found that access to land, and in particular access to State land, is among the key challenges in improving Sri Lanka's competitiveness. These challenges include the dual system of land titling and registration resulting in a complex and opaque system open to land grabbing and uncertainty. Issues with the functioning of the system are further exacerbated by a cumbersome legal and institutional landscape for granting approvals for land for investment projects. The process of obtaining permits and grants is also an overly cumbersome and non-transparent process with approvals taking on average 18 months which has a negative impact on Sri Lanka's appeal for investment.¹⁴⁸ The key weaknesses in enforcement of property rights are as follows:

- a) Unclear Land policy with overly complicated legislation and institutional fragmentation of land administration present barriers in the enforcement of property rights.**

291. There is a lack of clear and decisive land policy with multiple agencies responsible for certain aspects of the land administration process governed by their own acts and regulations (see Table 24). The Ministry of Tourism and Land plays a key role along with the Land Commissioner's General Department, Land Title Settlement Department, Survey Department, Land Use and Policy Planning department and Land Reforms Commission. Around 82% of land is administered by government institutions e.g., Sri Lanka Railways Department, Sri Lanka Forestry Department, Mahaweli Development Authority, Urban Development Authority etc.

¹⁴⁷ See Progress Reports, moj.gov.lk

¹⁴⁸ Scoping Mission

Table 26. Legal Provisions incorporated in land administration.

Institution	Laws and Enactments
1 Land Commissioner General’s Department	State Land Ordinance No. 08 of 1947 Land Development Ordinance No. 19 of 1935 Land Grant (Special Provisions) No. 43 of 1979 Land Redemption Ordinance No. 61 of 1942 State Land (recovery of possession) No. 07 of 1979
2 Survey Department	Survey Ordinance of 1875
3 Land Reforms Commission	Land reform law No 01 of 1972
4 Land Title Settlement Department	Title Registration Act No. 21 of 1998 Land Title Settlement Ordinance of 1931
5 Ministry of Lands	Land Acquisition Act No. 09 of 1950
6 Land Use Policy Planning Department	Land Use Policy

292. There is no legally empowered land use policy. Sri Lanka has a complex legal environment for the administration of land, with laws promulgated at the national, regional and institutional levels. Multiple sources of law exist with no clarity on the devolution of responsibilities among different authorities. The process of administering land, therefore, requires consultation of multiple laws often introduced at the time of independence and in absence of a uniform and clear legal framework practiced by all institutions.

b) Lack of land data, coordination among institutions involved and data sharing issues.

293. There is no clear procedure currently for systematic data collection. Land data repositories are fragmented across the different agencies involved in land administration and there is no common platform to integrate or access data. Each agency keeps their data in silos, often replicated and not verified and therefore not useful in decision making processes. Each agency is proprietary over its data and unwilling to share effectively with related institutions – for example the Registrar’s office contains deeds and titling information but this information is not shared in an accessible format with related institutions nor to the public and there are anecdotal reports of documents ‘going missing’ and then ‘reappearing’ indicating the presence of clear rent-seeking opportunities.

c) Dual system of land titling and registration of immovable property creates lack of clarity in securing property rights.

294. Currently, there are 50 district land registries¹⁴⁹ managed by the Registrar General's Department of the Ministry of Public Administration and Management (MOPAM) who play a key role registering land rights under both the deeds and title registration systems. There are around 2 million land transactions registered per year in the deed system. However, there are multiple deficiencies – one being that registration of deeds does not actually prove title to the land. Therefore, registration is not accepted as evidence for collateral purposes by reputable financial institutions who would require title reports attested by an accredited lawyer. What this means in practice is that there is no legal certainty that a registered deed is valid and therefore there are instances of duplicate records being made on the same plot of land, multiple fake deeds in circulation, land grabbing and bribes and rent-seeking behaviour is reported.

295. The Registration of Title Act (1998) was introduced and implemented by the Survey and Land Settlement Departments, to regulate the process of land titling and formalise and provide certification of land title and ownership rights. The intention was to establish a comprehensive database of land resources in the country administering transparent land management replacing the deed registration system. However, it has not made sufficient progress and both systems are still operating.¹⁵⁰ Out of the full cadaster system of 2 million plots, around 800,000 titles have been certified.¹⁵¹ The first deficiency of the Registration of Title Act is that there is no mandate for titling land and therefore the two systems of titling and deed registration co-exist and theoretically you could have a situation in which both processes are being conducted in parallel for the same plot of land. This creates a myriad of legislation with deed registration process following its own set of regulations and procedures affecting the titling procedure.

296. In one study it was found that there are, in addition, around 65 acts and regulations that are influencing the titling process to some degree,¹⁵² with multiple agencies able to influence the process. The lack of a comprehensive legal approach¹⁵³ with multiple institutions involved in the process (surveying, conveyance and registration being spread across different institutions) results in inefficiencies and delays with a lack of data and information access and sharing. In addition, there are concerns of transparency and stakeholder participation in the land titling process.¹⁵⁴

d) Land disputes take a very long time to resolve.

297. Land disputes are frequent in Sri Lanka and involve both state and private land, with many of them are in regard to documentation and registration issues. Property rights disputes on average take 10-20 years to resolve. In the District Court of Colombo there are 650 pending cases in the Land Court with some cases 40+ years old.

¹⁴⁹ The Land Registry records deeds, mortgages, leases, and other documents on land and property.

¹⁵⁰ The Ministry of Land and Land Development implemented the titling Bim Saviya Program and had expected completion by 2020 covering the whole country (Bimsaviya, 2012). [Influential+Factors+on+the+Effectiveness+of+Land+Title+Registration+Program+in+Sri+Lanka.pdf](#)

¹⁵¹ Mission findings with the Ministry of Tourism and Lands (03/29/2023)

¹⁵² [kirubananthan.pdf \(utwente.nl\)](#).

¹⁵³ Rubasingha, 2010.

¹⁵⁴ [kirubananthan.pdf \(utwente.nl\)](#).

298. The Mediation Boards Act No. 72 of 1988 institutes Mediation Boards¹⁵⁵ which have addressed and successfully resolved a range of community disputes including land disputes. In 2015, Sri Lanka introduced a joint effort with the Ministry of Justice and the Ministry of Lands to set up special land mediation boards to settle dispute in districts that were highly affected by the 30-year civil war.¹⁵⁶ The Land Acquisition Act No. 09 of 1950 provides a limited grievance redress mechanism where issues relating to compensation can be referred to a Board of Review. This Act is presently under review and if implemented correctly, in a transparent and accountable manner, could theoretically ease some of the court backlog on issues of land disputes.

299. While there have been efforts made to simplify and harmonise the land administration system, a serious overhaul of the current land administration practices is necessary. A Land Use Policy has been drafted and a committee appointed for formulation of the Land Policy. The Land Development Ordinance and the Regulations of State Lands Ordinance has been amended in 2022. Sri Lanka is currently in the process of amending the Land Acquisition Act and the Land Title Registration Act. However, it is necessary for the entire system of land administration ecosystem to be streamlined both in terms of legal framework and institutionally and a land policy formulated with respect to state lands to enhance legal certainty, efficiency, and transparency in the process for registering property.

300. Collating in a central publicly accessible place, all related data would allow for more accurate and efficient use of land data to the general public and would minimise the current rent-seeking risks that exist by having the consolidated information publicly accessible. Since the Ministry of Lands and related agencies already have established and implemented separate information systems, it would be important to establish an integrated automated database system which could be publicly accessible and easily disseminated. A proposal has been submitted to Cabinet to establish an interoperable database integrating and harmonizing the existing data to create a comprehensive and accessible system of land and geospatial records. An effective land registration system enhances confidence by the public, government and institutions to increase stability in the country and a transparent database will minimise the opportunities for corruption. It will be necessary that the implementation of such a database (if using funds from foreign investors) will be in accordance with the Government of Sri Lanka’s national priorities, legislation and governance safeguards to ensure no land grabbing.

Table 27: List of Recommendations for Rule of Law

Recommendation	Responsible Party	By When	Priority
1 Introduce specific procedure for adequate public consultation of new legislation with relevant stakeholders to avoid repeat legislative amendments and unexpected implications of new legislation/regulation	Attorney General’s Office/Ministry of Justice	December 2023	Long-term

¹⁵⁵ There are 329 mediation Boards in Sri Lanka.

¹⁵⁶ Districts of Jaffna, Kilinochchi, Trincomalee, Batticaloa and Anuradhapura. Enforced by Gazette Extraordinary No. 1904/41 (March 4, 2015).

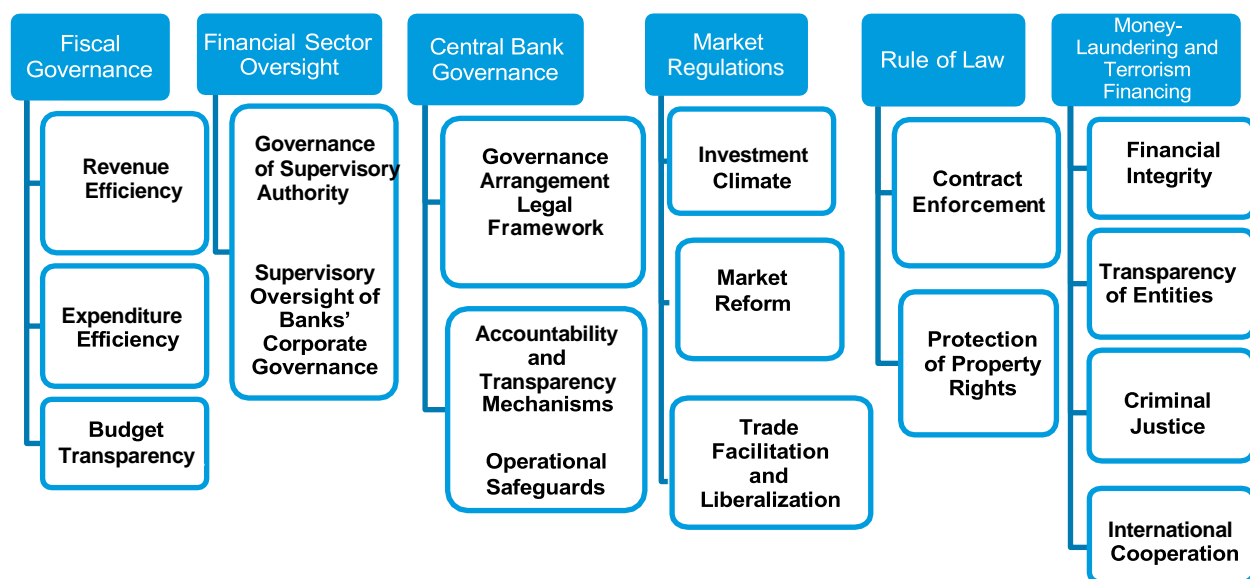
2	Set up a specialised court for clearing backlog of cases.	Ministry of Justice	January 2024	Short-term
3	Establish and implement a plan to expand the resources and skills available to the Judicial Services Commission in order to enhance their ability to carry out their function and define potential options for modifying governance arrangements in the Justice sector to strengthen oversight, monitoring, and proper sector development.	Ministry of Justice/JSC	December 2024	Medium-term
4	Introduce mechanisms areas to improve efficiency of commercial claims including by reviewing current court processes and amend to encourage early settlement when appropriate	Ministry of Justice	April 2024	Short-term
5	By December2024, establish an on-line digital land registry, and publish, on a designated website, report on progress in implementing published Plan for registering/titling all state land.	Ministry of Lands	December 2024	Long-term

Annex 1 Overview of Governance Diagnostic Assessments

Recognizing the importance of good governance and anti-corruption in supporting macroeconomic stability, IMF adopted the Framework on Enhanced Fund Engagement on Governance in 2018. The Framework aims to promote more systematic, effective, candid, and evenhanded engagement with member countries regarding governance and corruption that are critical to macroeconomic performance.

Governance diagnostics are designed to assess the severity of corruption risks, identify governance weaknesses associated to corruption vulnerabilities in key state functions provided by the 2018 Framework, propose concrete reform measures to advance governance, integrity, and the rule of law, and produce a public report.

Six Key State Functions in the 2018 Framework¹⁵⁷



Diagnostics also consider the soundness and alignment of the legal and organizational arrangements for fighting corruption with international standards and good practice, and the appropriateness of the anticorruption strategies in light of the corruption risks that are present in key state functions.

Governance diagnostics are forward-looking exercises focused on identifying ways to strengthen governance and integrity in order to support strong, stable, and inclusive economic development. The analysis and recommendations of diagnostics do not cover individual corruption cases or allegations, but structural policy issues, near and longer-term reform measures.

¹⁵⁷ Please note that the Market Regulation was not analyzed in the Sri Lanka Governance Diagnostic.

Since the adoption of the 2018 Framework, 14 governance diagnostic assessments have been completed with the issuing of a final report, with 7 more assessments underway. Nine out of the 14 completed reports have been published, with the approval of participating governments.

Annex 2. Concerning the creation of an independent prosecution service for Sri Lanka

This annex provides information relevant to the consideration of the option of establishing an independent prosecution service in Sri Lanka. It is provided for informational purposes only and does not advocate for the adoption of the organizational arrangement.

*"The independence of the prosecutor is central to the criminal justice system of a democratic society. Prosecutors should be independent from persons or agencies that are not part of the prosecution decision-making process. Prosecutors must be free to carry out their professional duties without political interference and must not be affected by improper or undue pressure or influence from any source"*¹⁵⁸

So says the current webpage of the Crown Prosecution Service of England & Wales. But this well-respected organization is not alone in considering that the prosecutor holds such a critical place in the functioning of a democratic state. The United Nations, at its Eighth Congress on the Prevention of Crime and the Treatment of Offenders in 1990, adopted Guidelines on the Role of Prosecutors¹⁵⁹ and made similar comments; as has the International Association of Prosecutors (IAP) which was established in June 1995 and has almost 180 jurisdictions in its membership.¹⁶⁰

This need for independence is more critical when prosecutors are called upon to deal with the alleged illegal behaviour of State actors, such as senior government officials. Prosecutors should "control State actions by bringing to the attention of the courts any instance of unlawful or corrupt behaviour by agents of the State or other officials in positions of authority and by prosecuting such offenders to the full extent of the law. In cases involving corruption, abuse of power, grave human rights violations, and other crimes committed by public officials, the role of prosecutors is particularly important and delicate"¹⁶¹.

Prosecutors not only perform a vital public role in ensuring that offenders are brought to justice and victims and witnesses have their rights upheld, but they also contribute meaningfully to a democratic society in other respects, for example through support to the functioning of the social compact between individuals and the State, which is particularly vulnerable when senior government officials or 'political elites' are suspected by the population at large to operate with impunity.

'Prosecutorial independence'

Broadly stated, prosecutorial independence can mean two distinct things: the independence of the prosecution institution from other organs of the state, or the functional independence of the individual

¹⁵⁸ Taken from the website of the Crown Prosecution Service of England & Wales - <https://www.cps.gov.uk/publication/code-crown-prosecutors> - accessed 07/18/2023.

¹⁵⁹ <https://www.ohchr.org/en/instruments-mechanisms/instruments/guidelines-role-prosecutors> - accessed 07/18/2023.

¹⁶⁰ [International Association of Prosecutors - About: International Association of Prosecutors \(iap-association.org\)](https://www.iap-association.org) - accessed 07/18/2023.

¹⁶¹ Addressing Inefficiencies in the Criminal Justice Process, Dandurand, 2009 <https://www.publicsafety.gc.ca/lbrr/archives/cnmcs-plcng/cn29635-eng.pdf> - accessed 07/18/2023.

prosecutor. Even where the prosecution service as an institution is independent, the prosecution function may be organised along hierarchical lines, so that the individual prosecutor may be subject to instructions from more senior colleagues. In other systems the prosecution is modelled on, and may even be a part of, the judiciary.

In this context, we are focused upon the importance of the prosecutor's independence from the Executive, as in Sri Lanka there is no independent prosecution service. We will discuss this further later.

International guidance

The International Association of Prosecutors (IAP) has set out best practice international standards and provided guidance to a wide variety of jurisdictions when considering their prosecutorial arrangements. In 1999, the IAP produced the 'Standards of Professional Responsibility and Statement of the Essential Duties and Rights of Prosecutors', which serves as an international benchmark for the conduct of individual prosecutors and of prosecution services.¹⁶²

Article 2 of that document (headed 'Independence') is instructive. It reads:

2.1 The use of prosecutorial discretion, when permitted in a particular jurisdiction, should be exercised independently and be free from political interference.

2.2 If non-prosecutorial authorities have the right to give general or specific instructions to prosecutors, such instructions should be:

- transparent;
- consistent with lawful authority;
- subject to established guidelines to safeguard the actuality and the perception of prosecutorial independence.

2.3 Any right of non-prosecutorial authorities to direct the institution of proceedings or to stop legally instituted proceedings should be exercised in similar fashion."

Article 3 (concerning Impartiality) goes on to add:

Prosecutors shall perform their duties without fear, favour, or prejudice. In particular they shall:

3.1 carry out their functions impartially;

3.2 remain unaffected by individual or sectional interests and public or media pressures and shall have regard only to the public interest.

Even in common law 'hierarchical' systems, within a separate prosecution service arrangement, the guidelines envisage the possibility of a role for senior government officials (i.e., an Attorney General) in some limited aspects of the prosecution service but that – crucially – for this to be acceptable there must a high degree of transparency in the process, and effective guidelines must be in place 'to safeguard the actuality and the perception of prosecutorial independence'.

In the Sri Lankan system, the Attorney General and his office are frequently involved in these matters, and there is little, if any, transparency in the process. Nor are there any guidelines in place to safeguard independence (or consistency) of decision-making. This absence of transparency – and independence

¹⁶² See [https://www.iap-association.org/getattachment/Resources-Dokumentation/IAP-Standards-\(1\)/IAP_Standards_Oktober-2018_FINAL_20180210.pdf.aspx](https://www.iap-association.org/getattachment/Resources-Dokumentation/IAP-Standards-(1)/IAP_Standards_Oktober-2018_FINAL_20180210.pdf.aspx) - accessed 07/18/2023.

(whether actual or perceived) – may be one of the reasons why there have been repeated calls from eminent observers and the Sri Lankan public for the establishment of a national independent prosecution service.¹⁶³

Sri Lanka's current prosecution arrangements

Prosecutions in Sri Lanka are conducted by prosecutors of the Attorney General's Department (Criminal Division), the Commission to Investigate Allegations of Bribery or Corruption (only relating to bribery, corruption, assets, and asset declaration related offenses) and, for minor offenses, officers from Sri Lankan police and other government departments.

There is no independent national prosecution service in Sri Lanka.

The Attorney General

The Attorney-General of Sri Lanka is, amongst other things, the Island's chief prosecutor. Unlike the Attorney General of the United States, the AG of Sri Lanka does not have any executive authority; those functions are performed by the Minister of Justice. However, he is appointed by the President of Sri Lanka, upon advice of the Constitutional Council,¹⁶⁴ and delivers a number of significant government functions (such as acting as the government's chief legal advisor on a wide range of matters and advising government on the Constitutionality of proposed Bills before Parliament). For instance, while expected to act as the legal officer of the State, State Agencies, and Departments, the Attorney General is simultaneously the chief prosecutor and also in several instances acts as the defender of the official positions of government in Court.

In addition, the Attorney General's Department is (since 2015) a Department of the Ministry of Justice, thereby linking the Department, and crucially the Attorney General himself, closely to the Executive branch.¹⁶⁵

The Attorney General has the sole power to decide whether to issue indictments against individuals, other than of course the limited power exercised by the Commission to Investigate Allegations of Bribery and Corruption. The Attorney General cannot be directed to file an indictment against any person; it is at his sole discretion.

The other inherent power of the Attorney General is the *nolle prosequi* or the decision to discontinue criminal proceedings before a High Court in respect of a suspect. This is a non-delegable power

¹⁶³ From 'Authority without Accountability – The Crisis of Impunity in Sri Lanka' – International Committee of Jurists, 2012: <https://www.refworld.org/pdfid/50ae365b2.pdf> - accessed 07/20/2023 - accessed 19/07/2023; see also <https://www.colombotelegraph.com/index.php/the-role-of-the-attorney-general-in-sri-lanka/>; and 'Rethinking the Attorney General's Department in Sri Lanka; ideas for reform' – Center for Policy Alternatives, 2020; <https://www.cpalanka.org/wp-content/uploads/2020/11/AGs-Dept-Final.pdf> - accessed 19/07/2023

¹⁶⁴ As per Article 61E of the Constitution of Sri Lanka – see <https://www.parliament.lk/files/pdf/constitution.pdf> - accessed 07/19/2023.

¹⁶⁵ Note that between 2005 and 2015, the Attorney General's Department came within the purview of the Presidential Secretariat, an even closer tie to the Executive function.

enjoyed exclusively by the Attorney General and is distinct from a prosecuting officer's right to withdraw an indictment.¹⁶⁶ It is the only way in which the Attorney General can decide to discontinue criminal proceedings without the permission of the Court and without recording any reasons for the discontinuance of the prosecution. The *nolle prosequi* is entered as a matter of policy, although in the Attorney General's opinion, the material against the accused justifies a criminal prosecution.¹⁶⁷

The Attorney General as the Chief Prosecutor plays an autonomous and conclusive role in relation to initiating, maintaining, and withdrawing prosecutions, as discussed above. While there are supposed safeguards in place to ensure the good character and integrity of the office holder, in a context where the existing framework places the Attorney General in constant contact with political actors, the functioning of his department will always be open to criticisms of political bias, no matter the character or integrity of individual holders of the office.

This wide discretion enjoyed by the Attorney General side by side with this close political association inherent to the nature of his office has resulted in the real or perceived issues of politicization, conflict of interest, and issues relating to the administration of justice, and has been subject to extensive criticism from a number of sources.

The then Special Rapporteur on the Independence of Judges and Lawyers, Monica Pinto, on her mission to Sri Lanka (in 2016) studied the role of the Attorney General's Department in her Preliminary Observations and Recommendations.¹⁶⁸ She expressed her concern over the dual role played by the Attorney General as the chief legal adviser of the Government and the head public prosecutor. Commenting on the role of the Attorney General she stated that 'the Attorney General is also the Chief Legal Prosecutor and, as such replaced the position of the Independent Prosecutor which existed in the past. In such a capacity, the Attorney General should issue clear and proper guidelines for the investigation and prosecution of crimes. She further noted the fact that the Attorney General acting as representative of the State, creates the impression that the Attorney General represents the Government's interests foremost and not the public interests. This in turn undermines the independence and credibility of the prosecution, particularly in politically sensitive cases.'¹⁶⁹

The Attorney General's Department in Sri Lanka has been seen by some as a means by which the incumbent government has exerted pressure on the justice system, due to the fact that the Attorney General's Department comes within the direct control of the Executive.¹⁷⁰

More recently (2019), studies that have been carried out into the need to introduce a Public Prosecutor's Office to Sri Lanka have highlighted the fact that the establishment of such an office

¹⁶⁶ Palitha Fernando P.C., Former Attorney General "The Role Of The Attorney General Of Sri Lanka And The Rule Of Law; With Special Reference To The Criminal Justice System", (2016) Oration Delivered at the 3rd Death Anniversary of the Late Mr. C. R. de Silva, accessible at http://www.sundaytimes.lk/161113/palitha_orations.pdf

¹⁶⁷ Ibid.

¹⁶⁸ See 8 Human Rights Council (2016) 'Report of the Special Rapporteur on the independence of judges and lawyers on her mission to Sri Lanka' p.11 - <https://www.refworld.org/docid/593945584.html> - accessed 07/20/2023.

¹⁶⁹ Ibid.

¹⁷⁰ Rethinking the Attorney General's Department in Sri Lanka – Ideas for Reform; Centre for Policy Alternatives, 2020; <https://www.cpalanka.org/wp-content/uploads/2020/11/AGs-Dept-Final.pdf> - accessed 07/19/2023.

would result in a stronger perception by the Sri Lankan population of independence in prosecution, and that this is of particular importance in the context of corruption-related criminality by members of the Executive.¹⁷¹

Other research on the topic concludes that there need only be a legislative amendment to introduce the office of a Public Prosecutor in Sri Lanka.; a constitutional amendment is not necessary.¹⁷²

The move away from the AG having a dichotomous role is an international one; for example, there have been relatively recent (2016) calls by Transparency International for the adoption in Malaysia of a more independent system – separating the functions of the Attorney General with that of the Public Prosecutor (in Malaysia, one person holds both roles). These calls are to address weak accountability, lack of transparency of decision-making and the need to ensure that prosecution decisions are made without fear or favour and are protected from political interference.¹⁷³

The relevance of CIABOC

As described previously in this [Report] the Commission to Investigate Allegations of Bribery or Corruption (CIABOC) is Sri Lanka’s dedicated Anti-Corruption agency and has both investigative and prosecutorial powers. The decision to prosecute is made for the most part by the Commissioners, based on cases prepared for their consideration by the CIABOC investigators and prosecutors. The Commission may, and does, require the Director-General to institute criminal proceedings in those cases where the Commissioners consider that proceedings are justified.¹⁷⁴ There is, however, no published policy setting out the basis on which the Commission arrives at these decisions.

CIABOC can, and does in some cases, exercise its power to seek the view of the Attorney General and ask the department for assistance in the conduct of prosecutions.¹⁷⁵ It appears that many of the prosecutions that CIABOC undertakes in the senior courts of Sri Lanka are assisted by officers from the Attorney General’s Department. There is no published policy setting the basis on which the Commission arrives at a decision to involve the Attorney General or his officers.

It is of relevance and importance that in these examples there is no published policy setting out the circumstances in which the Commission will engage the Attorney General to conduct prosecutions, or otherwise involve an external (and, importantly in this context, Executive) body to become involved in its work. There is no means, then, for the public to establish– and so possibly challenge – the basis of the Commission’s decision-making in this important area.

¹⁷¹ Fonseka, B. & Linstrum-Newman, M. (2019) ‘Prosecuting International Crimes in Sri Lanka: The Need for a Public Prosecutor’s Office’ p.180 in Sri Lanka’s Time to Try: Prosecuting Conflict Related Abuses by Dr. Isabelle Lassée (2019) (eds.) South Asian Centre for Legal Studies

¹⁷² Jayasinghe, U & Lassée, I ‘Establishing an Office of the Public Prosecutor in Sri Lanka’ p. 195 in Sri Lanka’s Time to Try: Prosecuting Conflict Related Abuses by Dr. Isabelle Lassée (2019) (eds.) South Asian Centre for Legal Studies.

¹⁷³ <https://www.transparency.org/en/press/separate-powers-of-attorney-general-and-public-prosecutor-to-restore-trust> - accessed 07.19.2023

¹⁷⁴ See s.18 of the Anti-Corruption Act no. 1 of 2023.

¹⁷⁵ See ss.65(7) and 69 and of the Anti-Corruption Act no.1 of 2023.

This, unfortunately, is in keeping with an absence of published guidance that the Commission ought to follow concerning prosecution charging standards for typical matters before the courts (e.g., the legal and/or evidential tests applied),¹⁷⁶ or whether there is a public interest consideration applied and if so in what circumstances. The absence of such guidance and standards is observed across the entire range of the investigative and prosecutorial functions of the Commission.

The Commission has been unable to point to any internal (i.e., non-published) guidance on any of these issues. These policies – which should shape how the Commission makes decisions concerning some of its most important functions – do not feature in any of its publications, or on its website, and may not exist at all. In the absence of such policies, it is difficult to see how the Commission is able to arrive at consistent and clear decisions. Even in the absence of such guidance, there appears to be no data collected (or indeed any records of) the basis for these decisions being made. This is a significant absence of transparency, in an area of critical decision-making and, as referenced by the IAP guidance, clarity in this area is of particular importance when government officials (such as the Attorney General) are involved in prosecutorial functions of the State.

Lessons from other jurisdictions?

The conflict in the roles of the Attorney General as political advisor and criminal prosecutor has been recognised and resolved in numerous other jurisdictions.¹⁷⁷

Of the common law jurisdictions with notably similar legal traditions and practices as Sri Lanka, the following three are instructive:

*England & Wales*¹⁷⁸

The Prosecution of Offences Act 1985 ('POA') created a national prosecution service – the Crown Prosecution Service of England & Wales, headed by a chief prosecutor – the Director of Public Prosecutions ('DPP') Prior to this, prosecutions had largely been conducted by police officers, with little nationwide commonality of approach to prosecution decision making. Police officers frequently sought support from the independent Bar in larger more serious cases.

The POA was passed to modernise and improve the transparency of prosecution arrangements in England & Wales, de-linking the Attorney General from prosecutorial decision-making which,

¹⁷⁶ The test is of fundamental importance because, amongst other things, it shapes how many cases are filed with the court, and what stage of file development. This may, or may not, be a solid reflection of the investigative and preparatory work that has been conducted prior to that point.

¹⁷⁷ Antigua & Barbuda, Australia, Bahamas Islands, Barbados, Belize, Botswana, Canada, Cayman Islands, Dominica, Finland, Ghana, Grenada, Guyana, Ireland, Jamaica, Kenya, Malawi, Mauritius, Namibia, Norway, Scotland, South Africa, St Kitts & Nevis, St Lucia, St Vincent & the Grenadines, Tanzania, Trinidad & Tobago, Turks & Caicos Islands, Uganda, Zambia. Note also that Zimbabwe recently (2013) split the prosecuting and government advisory roles of the Attorney-General under the new Constitution, creating the new role of the Prosecutor General, head of the National Prosecuting Authority, and (reflecting public debate at the time) – see <https://www.hrforumzim.org/5497-2/>) expressly stating in the Constitution (at Art. 260) that the Prosecutor General 'is independent and is not subject to the direction or control of anyone'; (see https://www.constituteproject.org/constitution/Zimbabwe_2013) – accessed 07/19/2023

¹⁷⁸ Population over three times that of Sri Lanka.

following a series of poorly handled criminal cases, and an investigative Royal Commission examining alternatives, was considered imperative.

The UK Home Secretary at the time when the POA was being debated made it plain that, while there would be considerable resource implications of the new Act, change was badly needed, and so the cost was worth it.¹⁷⁹ Sri Lanka faces an economic challenge of greater scope and depth than did the British government of the time, but it is nonetheless crucial that Sri Lanka's institutions are afforded the greatest opportunity to recover significantly frayed public trust. This need to reassure the public of the true independence of the chief prosecutor was one of the critical factors in the decision-making process for the UK government¹⁸⁰ and arguably has been for very many other jurisdictions that have considered this separation of government function.

*Kenya*¹⁸¹

The Office of the Director of Public Prosecutions (ODPP) is Kenya's national prosecuting authority. The Office was delinked from the Attorney General's Office in 2011 after the promulgation of the Constitution in 2010 and operates independently under the guidance of the Director of Public Prosecutions (DPP). It was recognised by the Kenyan people when considering the 2010 Constitution, that there must be actual, and perceived, independence of the chief prosecutor, particularly in the context of previous ethnic violence and alleged government corruption,¹⁸² and because the AG was seen as "not just complicit in, but absolutely indispensable to, a system which has institutionalised impunity in Kenya."¹⁸³

*Trinidad & Tobago*¹⁸⁴

The Director of Public Prosecutions, head of the Office of the DPP, is a position created by Chapter VI of the Constitution of Trinidad and Tobago, and has been in place since 1976, when the country first became a republic. The establishment of this position stemmed from the need – recognised early by the people of Trinidad & Tobago – for a constitutional post that would always be independent of political and stakeholder involvement in the prosecution of criminal matters.

It is of relevance to this Annex that the Office of the DPP, which though functionally independent of the Attorney General's Office in T&T (the AG plays no role in the decision-making processes of the DPP's office) is not financially independent of it – an issue which the T&T DPP has frequently raised before Parliament as problematic.¹⁸⁵

¹⁷⁹ <https://www.gov.uk/government/speeches/the-case-for-the-prosecution-independence-and-the-public-interest> - accessed 07/18/2023.

¹⁸⁰ <https://www.gov.uk/government/speeches/the-case-for-the-prosecution-independence-and-the-public-interest> - accessed 07/18/2023.

¹⁸¹ population over twice that of Sri Lanka.

¹⁸² Akech, M. 'Abuse of Power and Corruption in Kenya: Will the New Constitution Enhance Government Accountability' (2011); Indiana Journal of Global Legal Studies - [Abuse of Power and Corruption in Kenya: Will the New Constitution Enhance Government Accountability \(indiana.edu\)](#) p.387 in particular – accessed 07/19/2023.

¹⁸³ Human Rights Council, GAOR, Report of the Special Rapporteur on Extrajudicial, Summary or Arbitrary Executions, 30, U.N. Doc. A/HRC/11/2/Add.6 (May 26, 2009).

¹⁸⁴ population less than 1/10th of Sri Lanka

¹⁸⁵ https://trinidadexpress.com/news/local/dpp-claims-interference-by-ag/article_040905a8-df1c-11ed-8cb8-8b717e215531.html - accessed 07/19/2023.

Any independent prosecutions office in Sri Lanka must have a significant degree of financial independence, subject to appropriate scrutiny, e.g., through a Parliamentary committee process.

Although vastly different in size and geography, each of the above jurisdictions follows the common-law approach and has in many respects very similar legal practices and traditions to Sri Lanka, with the very notable exception of the function of the public prosecutor. As highlighted above, the majority of common law jurisdictions have wrestled with this issue and then created independent prosecution services. Sri Lanka is, in this important respect, something of an outlier.

The way forward for Sri Lanka?

When considering whether Sri Lanka needs to have an independent Public Prosecutor's Office, it is important to note that Sri Lanka did have an office of a Director of Public Prosecutions (DPP), created under the Criminal Procedure Code (Amendment) Bill in 1972. However, this was not an 'independent authority' but functioned instead as a delegated entity under the Attorney General.¹⁸⁶ The DPP was accountable to both the Attorney General and Ministry of Justice. The Supreme Court was also empowered by writ to direct the Director of Public Prosecutions to act. However, this office was abolished in 1978 after it came under direct political pressure.¹⁸⁷

The wide prosecutorial discretion vested with the Attorney General's Department can easily become subject to political interference, due to the nature of its close political association. It is in this light, that – even if a national prosecution service was not created – the AG's discretion must be structured and exercised subject to pre-determined and established criteria. The structuring of the prosecutorial discretion of the Attorney General through clearly established guidelines regarding the institution, maintaining and withdrawing of cases could resolve many of the issues highlighted in this Annex, mainly political interference and issues pertaining to the administration of justice. This would be in keeping with the spirit of the IAP guidelines mentioned at the beginning of this Annex.

As mentioned previously, the Crown Prosecution Service of England & Wales, while looking into cases that have been investigated by the police and other investigative mechanisms, remains independent of the police and government. It functions through the establishment of detailed guidelines on a wide variety of aspects related to prosecution, primarily captured in the "Code for Crown Prosecutors"¹⁸⁸ – a document mentioned earlier in this report. The guidelines attempt to provide objective criteria, focusing on independence and fairness. For example, the Code prescribes the "Full Code Test" or in the alternative the "Threshold Test" for the prosecution of crimes by the Crown. The manner and criteria for the disposals of cases are also clearly identified and defined, ensuring the independence and impartiality of the Service.

In summary, the current situation in Sri Lanka is highly problematic, given the lack of clarity concerning essential investigative and prosecutorial processes, in particular the opacity of the relationship between CIABOC and the Attorney General's Department. CIABOC is the centrepiece of the new Anti-Corruption Act of 2023 and will be central to the effort to disrupt corrupt practices in Sri Lanka. But that will only succeed if there is meaningful clarity of its functional relationships with other government bodies, in particular the Attorney General's Department. We have seen that a lack of transparency leads to sub-optimal results and a significant lack of public trust. That trust must now be rebuilt if Sri Lanka is to effectively free itself of the significant burden of the past and move forward meaningfully with its new agenda of transparency and effectiveness.

¹⁸⁶ International Committee of Jurists (2012) 'Authority without Accountability: The crisis of impunity in Sri Lanka' <http://www.refworld.org/pdfid/50ae365b2.pdf> - accessed 07/20/2023.

¹⁸⁷ Pinto- Jayawardena, K. (2010) 'Still Seeking Justice in Sri Lanka: Rule of Law, the Criminal Justice System and Commissions of Inquiry since 1977, p.135 http://humanitariansrilanka.org/newchapdf/IHR/Sri%20Lanka_final_3.pdf – accessed 07/20/2023.

¹⁸⁸ Accessible at <https://www.cps.gov.uk/publication/code-crown-prosecutors>

One possible means of tackling this - and as a minimum recommendation - is the introduction of a comprehensive series of guidelines which might help to address the ongoing public perception of opacity and political influence in the prosecutorial function of the AG's Department in Sri Lanka. These steps to improve the transparency of existing arrangements should be taken immediately, as they respond to a pressing need not only to rebuild public trust but to attempt to improve the effectiveness of the AG's Department.

A second, and preferable, means of addressing the problem in the Sri Lankan context would be to create an independent prosecution service such as those adopted in the vast majority of common law jurisdictions and as outlined above. Sri Lanka really is a significant outlier when compared with its common law cousins, who have all recognised the need to address independence but also crucial public perception through removing the prosecution function from the Attorney General. Provided it is Sri Lanka-specific and tailored effectively to the country context, such a move would improve not only the functionality of the relationship between CIABOC and the prosecution agency but would also go some considerable way to ease public concerns that the 'new CIABOC' - regardless of its new remit and powers - will remain shackled to the past and unable to reach its potential because it remains subject to the political influence of the Attorney Generals' Department.
