8 FINANCIAL SECTOR PERFORMANCE AND SYSTEM STABILITY

8.1 Overview

The performance of the financial sector improved significantly with the continued expansion in economic activities, while the stability of the system was maintained. Credit growth accelerated during the year and the performance of financial institutions improved with enhanced growth in assets, healthy profitability, higher capitalisation and lower risk levels. The banking, finance, leasing, and insurance sectors expanded their branch network around the country, particularly in the Northern and Eastern Provinces, thereby increasing access to financial services. Money and credit markets were liquid and interest rates declined during the first three quarters of the year. However, liquidity became constrained towards the latter part of the year. The price indices of the stock market declined after the upsurge in the previous two years. At the same time, the volume of funds mobilized from the stock market through initial public offerings and rights issues recorded a substantial increase.

The regulatory and prudential framework governing the financial system was strengthened. The major reform during the year was the enactment of the new Finance Business Act aimed at further strengthening the regulation of finance companies and enhancing powers to combat unauthorized deposit-taking and finance business activities. The minimum capital requirements for finance companies were enhanced and corporate governance provisions relating to fitness and propriety of directors and senior management were also strengthened. New prudential requirements relating to capital adequacy and liquidity for leasing companies were introduced. The proposed amendments to the Banking Act with provisions to enable the consolidated supervision of banking groups and measures to facilitate mergers and acquisitions for consolidation and resolution were submitted to the Cabinet for approval. Directions on integrated risk management and customer protection were issued. Comprehensive amendments to the Regulation of the Insurance Industry Act also came into effect during the year. These relate to capital enhancement, fitness and propriety of directors, segregation of general and long-term insurance business and the appointment of institutional agents. With regard to the stock market, regulations relating to the provision of credit by brokers were introduced and a new Unit Trust Code was issued to provide for the regulation of exchange traded funds. Another important development was the issuance of guidelines for mobile payment mechanisms.

Financial stability continued to be strengthened in 2011, thereby providing conducive environment for effective financial intermediation and supporting the growth momentum, despite uncertain global growth prospects and turbulent conditions in international financial markets. However, there were risks emanating from the external environment due to the weakening pace of global recovery, renewed turbulence in global financial markets driven by the impact of the escalation of sovereign debt concerns in the euro area, rising oil prices, and volatility in short-term capital flows. Domestically, several policy measures were taken in February 2012 to contain the high credit growth and these measures, including the upward adjustment of policy interest rates, and the macroprudential measures, are aimed at ensuring some moderation of credit growth. These measures have started to take effect, and going forward, the developments in lending portfolios will continue to be closely monitored. In this context, financial institutions are required to enhance their risk management systems and be well capitalised to ensure that the financial sector plays a leading role as a key enabler of economic growth and remains stable. At the same time, innovative strategies will have to be adopted to improve efficiency and increase the capacity of the financial system to serve all sectors of the economy with a wider array of products. There is also a strong need for the development of a vibrant capital market, particularly the corporate debt market, to supplement financing from the banking sector. Developing the capital market is vital to meeting the additional funding needs of the economy.

Table 8.1 Total Assets of the Major Financial Institutions

	2010(a)		2011(b)	
	Rs. bn	Share in Total %	Rs. bn	Share in Total %
Banking Sector	4,527.3	68.8	5,367.8	69.7
Central Bank	976.7	14.8	1,123.4	14.6
Licensed Commercial Banks	2,974.6	45.2	3,575.3	46.4
Licensed Specialised Banks	576.0	8.8	669.1	8.7
Other Deposit Taking Financial Institutions	295.0	4.5	427.0	5.5
Licensed Finance Companies	233.6	3.6	352.0	4.6
Co-operative Rural Banks	54.7	0.8	67.6	0.9
Thrift and Credit Co-operative Societies	6.7	0.1	7.4	0.1
Other Specialised Financial Institutions	354.3	5.4	340.8	4.4
Specialised Leasing Companies	154.1	2.3	137.7	1.8
Primary Dealers	125.8	1.9	135.3	1.8
Stock Broking Companies	13.2	0.2	11.3	0.1
Unit Trusts / Unit Trust Management Companies	23.0	0.3	23.7	0.3
Market Intermediaries (c) (d)	37.0	0.6	31.2	0.4
Venture Capital Companies	1.1	0.0	1.5	0.0
Credit Rating Agencies	0.2	0.0	0.2	0.0
Contractual Savings Institutions	1,400.9	21.3	1,569.0	20.4
Insurance Companies	222.2	3.4	263.3	3.4
Employees' Provident Fund	899.7	13.7	1,020.1	13.2
Employees' Trust Fund	125.9	1.9	140.6	1.8
Approved Private Provident Funds	126.2	1.9	115.1	1.5
Public Service Provident Fund	26.9	0.4	29.9	0.4
Total	6,577.5	100.0	7,704.6	100.0

(a) Revised
(b) Provisional
(c) Market Intermediaries include Underwriters, Margin Providers and Investment Managers.
(d) Excluding the assets of Licensed Banks, Licensed Finance Companies and Specialised Leasing Companies which are registered as Market Intermediaries.

Source: Central Bank of Sri Lanka

8.2 Performance of Financial Institutions

Banking Sector

The banking sector is the dominant player in the financial sector accounting for 55 per cent of the total assets of the financial sector. The activities of the banking sector further accelerated through an extended banking network and credit expansion with strengthened risk management practices as depicted in the improved asset quality, healthy liquidity ratios, adequate profitability and high quality capital levels ensuring sufficient risk absorption capacity.

Banking Network: During the year, two more banks came into operation resulting in the number of banks in the sector reaching 33 by end 2011. Accordingly, the banking sector consists of 12 domestic licensed commercial banks, including 02 state owned banks, 12 foreign banks and 09 licensed specialised banks (Table 8.2). One of the new banks was established to offer Islamic banking services in Sri Lanka and is expected to introduce new mechanisms to further increase financial inclusion. The banking network increased to 6,122 outlets (including 12 overseas outlets) and 2,240 automated teller machines (ATMs). The total network expanded by 201 outlets, of which 150 were opened outside the Western Province. The banking network continued to expand in the former

BOX 14 Macroprudential Policy for Economic Stability

The recent financial crisis resulted in a credit crunch in financial markets across the globe thus affecting economic activity in many parts of the world. It resulted in several advanced economies contracting, which in turn led to a decline in global trade, thereby dampening growth prospects of emerging and developing countries. The crisis highlighted the inadequacy of supervision and regulation restricted to a microprudential policy framework aimed at ensuring the soundness of individual financial institutions. Policymakers the world over increasingly stress the need for a 'macro' perspective to the regulatory and supervisory framework. Macroprudential policies aim at fulfilling this requirement.

Macroprudential policy is characterised by reference to three defining elements[1]:

1. Its objective: to limit systemic risk – the risk of widespread disruptions to the provision of financial services that have serious negative consequences for the economy at large.
2. Its scope: the focus is on the financial system as a whole (including the interactions between the financial and real sectors) as opposed to individual components (that take the rest of the system as given).
3. Its instruments and associated governance: it uses primarily prudential tools calibrated to target the sources of systemic risk. Any non-prudential tools that are part of the framework need to clearly target systemic risk.

By promoting uninterrupted financial intermediation services2, macroprudential policy measures help maintain stability in economic activity and in turn, help stabilise the general price level in the economy as well as employment levels. Hence, macroprudential policy helps maintain economic stability.

Macroprudential policy interacts closely with other spheres of public policy as they impact on systemic risk. For example, the stance of monetary policy can affect risk-taking incentives while fiscal policy, particularly the level of public debt can be an important source of vulnerability for the financial sector. Macroprudential policy measures put in place to address these issues could in turn have macroeconomic effects. For example, the macroeconomic policy environment could change with the dampening of aggregate demand due to higher capital requirements imposed in relation to credit during a credit boom.

Framework for Macroprudential Policy

Given that the objective of macroprudential policy is to reduce systemic risk, macroprudential policy should address risks due to interlinkages between financial institutions, risks due to common exposures of all financial institutions, as well as risks due to the procyclicality of the financial system. Hence, there are two dimensions to a macroprudential policy framework: the 'cross-sectional dimension' and the 'time dimension'.

The 'cross-sectional' dimension of the macroprudential policy framework is concerned with how risk is distributed in the financial system at a given point of time. Policy measures dealing with this dimension of financial system stability help the relevant authorities to handle the risk of the simultaneous spread of destabilising or disruptive problems across the financial system due to some negative shock.

The 'time dimension' of the macroprudential policy framework is concerned with how the aggregated risk to financial system stability becomes amplified over time as a result of interactions among the different players in financial markets as well as feedback loops between the financial system and the real economy. In this regard, procyclicality of the financial system is a key focal point. As procyclicality of the financial system is associated with credit cycles, which are key drivers of macroeconomic volatility and are often associated with asset price cycles, many of the policy tools dealing with the time dimension of financial system stability help influence the supply of credit.

Macroprudential Policy Tools

Macroprudential tools help limit system-wide financial risk in two ways: firstly, by dampening the build-up of financial imbalances and building defences that contain the speed and sharpness of subsequent downswings and their effects on the economy and; secondly, by helping identify and address common exposures, risk concentrations, linkages and interdependencies that are sources of contagion and spillover risks that may jeopardize the functioning of the financial system as a whole.

Macroprudential policy tools can be broadly divided into 'automatic corrective tools' and 'discretionary corrective tools'. Automatic corrective tools are based on predictable rules and are usually governed by the principle: "build up buffers in good times which can

1 Financial Stability Board, IMF, and BIS Progress Report to G20, October 2011, "Macroprudential Policy Tools and Frameworks", p. 4.

2 Financial intermediation services constitute mainly of payment services, credit intermediation, and insurance against risk.

Table B 14.1 Commonly used Macroprudential Instruments[3]

Tools to address threats from excessive credit expansion in the system

- Time-varying capital requirements (e.g., risk weights)
- Dynamic provisions
- Ceilings on credit or credit growth
- Caps, possibly time-varying, on loan-to-value (LTV) ratio
- Caps, possibly time-varying, on debt service-to-income (DTI) ratio
- Minimum, possibly time varying, margin requirements
- Reserve requirements

Tools to address key amplification mechanisms of systemic risk

- Limits on maturity mismatches
- Caps on foreign currency lending
- Limits on net open currency positions or mismatches
- Levy on non-core funding

Tools to mitigate structural vulnerabilities and limit spillovers from stress

- Additional loss absorbency related to systemic importance
- Disclosure policy for markets and institutions targeting systemic risk
- Resolution requirements for systemically important financial institutions (SIFIs).

be drawn down in bad times". They help counteract procyclical trends in the financial system and thereby help avert a buildup of risks. Discretionary corrective tools are those tools which would be used on the basis of the assessments of the relevant authorities, to influence the decisions of economic agents so as to change the risk behavior in the financial sector with a view to boosting the resilience of the financial system. Many researchers argue that adopting a mix of automatic stabilizers and discretionary corrective tools would be the best way to ensure financial system stability, as it may not necessarily be clear to policymakers in some situations as to whether policy action should be taken. For example, at a time when an economy is undergoing significant change, it may be difficult for policymakers to determine whether credit expansion is due to fundamental changes taking place and therefore is justifiable or whether it is due to excessive expansion of aggregate demand.

As macroprudential policy tools encompass a large array of policy tools applicable to financial institutions carrying out different types of financial activity such as banking, insurance and securities trading, the authority responsible for implementing macroprudential policy in a country would have to coordinate policy initiatives and regulations with the regulators of different types of financial institutions. Generally, the central bank of a country has the capacity to take on the responsibility for macroprudential policy, given that it usually plays a central role in the key payment systems and also has the unique ability to provide liquidity to markets.

Conclusion

Traditionally, macroeconomic policy, namely, the combination of monetary policy and fiscal policy was expected to deliver the economic conditions necessary for economic stability and growth. The recent global financial crisis however, highlighted that financial system stability is crucial for economic stability and growth. Macroprudential policy measures address the gaps in the macroeconomic policy framework. The macroprudential policy framework of a country would ensure that the monetary policy decision-making body focuses not only on price stability but also on financial system stability. It would also ensure that fiscal policy, whilst promoting economic growth and public welfare, helps maintain financial system stability. Further, it would ensure that both current as well as potential macroeconomic developments are taken into consideration in regulating and supervising the financial sector, so that the financial system remains resilient to shocks.

References:

1. Caruana, Jaime, (2011), "Monetary policy in a world with macroprudential policy", Address to the SARCFINANCE Governors' Symposium, Kerala.
2. Financial Stability Board, IMF, and BIS Update to G20 Finance Ministers and Central Bank Governors, (2011), "Macroprudential policy toold and frameworks".
3. Financial Stability Board, IMF, and BIS Progress Report to G20, (2011), "Macroprudential Policy Tools and Frameworks".
4. Galati, Gabriele, and Moessner, Richhild, (2011), "Macroprudential policy – a literature review", BIS Working Paper No. 337.
5. Moreno, Ramon, (2011), "Policymaking from a "macroprudential" perspective in emerging market economies", BIS Working Paper No. 336.
6. Sveriges Riksbank, (2009), "Reducing the risk of future crises – a stronger macroprudential framework", Quarter 2 Financial Stability Report.

3 Source: Financial Stability Board, IMF, and BIS Progress Report to G20, October 2011, "Macroprudential Policy Tools and Frameworks", p. 11.

Table 8.2 Distribution of Banks and Bank Branches

Category	End 2010(a)	End 2011(b)
Licensed Commercial Banks (LCBs)		
I. Total No.of LCBs	22	24
Domestic banks	11	12
Foreign banks	11	12
II.Total No.of LCB Branches and Other Outlets	5,164	5,347
Branches	1,470	1,581
Domestic Bank Branches	1,424	1,533
Foreign Bank Branches	46	48
Extension Offices	905	978
Domestic Banks	735	807
Foreign Banks	170	171
Student Savings Units and Other Outlets	2,789	2,788
Automated Teller Machines	1,862	2,082
Licensed Specialised Banks (LSBs)		
I.Total No. of LSBs	9	9
Regional Development Banks (c)	1	1
National Level Savings Banks	2	2
Long-term Lending Institutions	2	2
Housing Finance Institutions	2	2
Private Savings and Development Banks	2	2
II.Total No. of LSB Branches and Other Outlets	757	775
Branches	500	511
Regional Development Banks	230	233
National Level Savings Banks	173	179
Long-term Lending Institutions	23	24
Housing Finance Institutions	28	29
Prirate Savings and Development Banks	46	46
Extension Offices	69	76
Student Savings Units and Other Outlets	188	188
Automated Teller Machines	158	158
Total No. of Bank Branches and Other Outlets	5,921	6,122
Total No. of Automated Teller Machines (ATM's)	2,020	2,240
Total No. of Electronic Fund Transfer Facilities at the Point of Sale Machines (EFTPOS)	27,588	27,073
Banking Density: No. of Bank Branches Per 100,000 Persons	9.5	10.0

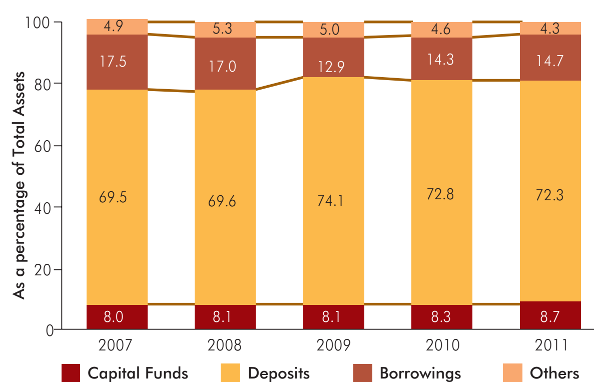
(a) Revised
(b) Provisional
(c) During 2010, businesses of 06 Regional Development Banks were vested with a new national level Bank

Source: Central Bank of Sri Lanka

conflict affected areas with 34 and 38 banking outlets being opened in Northern and Eastern provinces, respectively.

Assets: The asset base of the banking industry continued to expand and recorded a growth of 20 per cent against that of 18 per cent in 2010 (Table 8.4). The composition of the asset base indicated a significant shift. The share of loans and advances increased from 56 per cent at end 2010 to 61 per cent at end 2011 due to the significantly higher growth of loans and advances by 32 per cent in 2011 compared to the 24 per cent growth in 2010. Investments on the other hand, declined and recorded a negative growth of 2.5 per cent at end 2011.

Chart 8.1 Funding Structure of the Banking Sector



Liabilities: Deposits being the main funding source, recovered from its slow growth and indicated a higher growth of 19 per cent in 2011 compared to the 16 per cent growth in 2010 (Table 8.4). Further, the growth of borrowings declined from 30 per cent in 2010 to 23 per cent in 2011. Capital funds increased by 25 per cent in 2011 compared to the 21 per cent increase in 2010. Consequently, the composition of liabilities remained unchanged (Chart 8.1). The credit to deposit ratio rose from 76 per cent in 2010 to 85 per cent in 2011, indicating that deposit growth did not keep pace with loan growth.

Off-balance Sheet Exposures: Resulting from the increased trade related activity and higher foreign exchange forward transactions, the off-balance sheet exposures of the banking industry recorded a higher growth of 34 per cent in 2011 against the growth of 29 per cent in 2010. Accordingly, foreign exchange forward sales and purchases together

Table 8.3 Credit Card Operations by Licensed Commercial Banks

Item	2010(a)	2011(b)	Change (%)
Total Number of Credit Cards in use	778,549	862,340	10.8
Accepted only locally	58,771	61,320	4.3
Accepted globally	719,778	801,020	11.3
Outstanding Credit at end-year (Rs. mn)	31,168	38,544	23.7
Interest rates charged from customers (%)			
for Cash	21.96-36.00	24.00	
for Credit	21.96-26.60	24.00	
Commission from Dealers (%)	1.7-4.0	1.7-3.5	

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Table 8.4 Composition of Assets and Liabilities of the Banking Sector

Item	2010 (a)		2011 (b)		Change (%)	
	Rs. bn	Share (%)	Rs. bn	Share (%)	2010	2011
Assets						
Loans	1,975	55.6	2,604	61.4	23.7	31.9
Investments	1,081	30.4	1,054	24.8	16.3	(2.5)
Others	495	14.0	586	13.8	1.4	18.0
Liabilities						
Deposits	2,586	72.8	3,069	72.3	15.9	18.9
Borrowings	507	14.3	623	14.7	30.2	22.9
Capital Funds	295	8.3	369	8.7	21.2	25.4
Other	163	4.6	183	4.3	9.4	12.2
Total Assets/ Liabilities	3,551	100.0	4,244	100.0	17.8	19.5

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

accounted for 58 per cent of the growth of off-balance sheet exposures. Documentary credit and acceptances together accounted for 22 per cent of the growth of off-balance sheet exposures (Chart 8.2).

Risk Management

Credit Risk: During the year, credit quality of the banking industry improved significantly as reflected by the decline in the gross non-performing loans (NPL) ratio from 5.4 per cent in 2010 to 3.8 per cent in 2011 (Chart 8.3). The composition of NPLs did not change notably during the year 2011 (Chart 8.4). The provision coverage in respect of NPLs declined marginally from 58 per cent to 57 per cent (Chart 8.5). The net NPL to capital ratio continued to decline from 15 per cent at end 2010 to 12 per cent at end 2011 (Chart 8.6) indicating greater credit risk absorption capacity. The loans

Chart 8.2 Contribution to the Growth in Off-balance Sheet Exposures

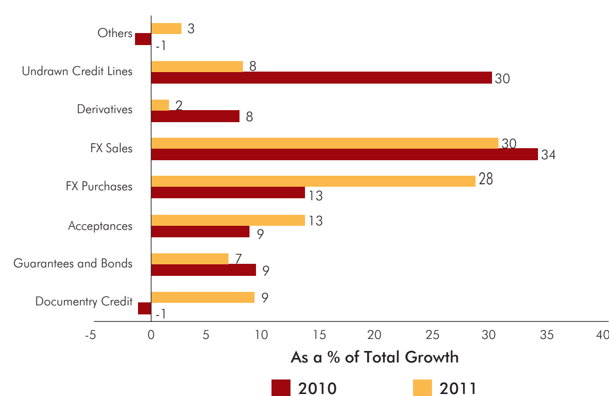
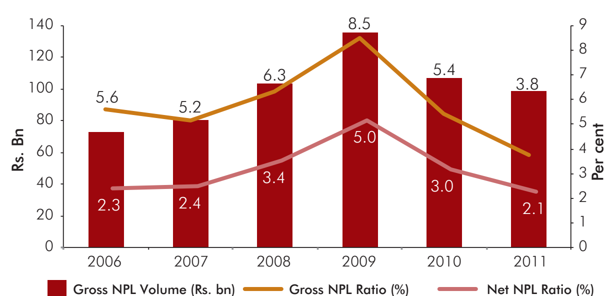


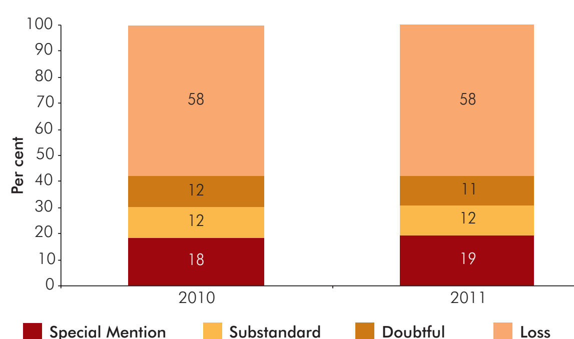
Chart 8.3 Non Performing Loans of the Banking Sector



and advances portfolio of the banking industry was mainly concentrated in five sectors, namely, construction (14 per cent), consumption (14 per cent), agriculture (13 per cent) , manufacturing (12 per cent) and trading (11 per cent). Credit quality of these sectors has improved over the past year as indicated by the declining NPLs and NPL ratios (Chart 8.7). Credit risk arising from investments was at a minimum level as more than 90 per cent of the investments were concentrated in government securities.

Market Risk: The lower interest rates during the year resulted in a decline in the interest margin by 40 basis points to 4.2 per cent at end 2011. High gains on government securities recorded in the previous year also petered out in 2011. The investments in the government securities remained unchanged in 2011 against a growth of 13 per cent in 2010. Trading in government securities indicated a decline of 9 per cent during the year. The exposure of the banking system to the share market was limited, as investments accounted for only 7 per cent of the capital base. The net exposure of foreign currency

Chart 8.4 Composition of NPLs of the Banking Sector



BOX 15 Integrated Risk Management in Banks

Introduction

Integrated Risk Management (IRM) is a continuous, proactive and systematic process to understand, manage and communicate risk from an organization-wide perspective. The banks are exposed to various risks which are highly interdependent. An event that affects one risk can have adverse implications on a range of other risk categories.

During the past, the banks were managing different risks through separate organizational units. The banks and bank regulators have now realized that the management of risks in an integrated manner is essential to promote soundness of the banking system. The inability for financial institutions to accurately measure the risks inherent in sophisticated financial products, especially in an integrated manner and disclose them to investors also contributed to the recent global financial crisis. International best practices such as Basel II Framework that requires banks to secure adequate capital in relation to their risk profiles is based on a comprehensive Integrated Risk Management Framework.

The major components of an Integrated Risk Management Framework

1. **Governance and Oversight** - The responsibility of understanding the risks assumed by the bank and ensuring that the risks are appropriately managed is vested with the Board of Directors (BOD). The BOD and the senior management should ensure that appropriate organisational policies, procedures, processes and controls have been established to measure and manage risks. Further, the monitoring of the overall risk management process of a bank should be assigned to an independent Integrated Risk Management Committee.

2. **Architecture of the risk management framework** – The IRM framework is bank specific, based on the size, complexity of functions, operating environment and technical expertise of staff. All factors that present a material source of risk are incorporated to an IRM framework. Quantitative approach forms the foundation of the risk measurement. Banks can use large historical databases of events such as defaults in credit risk and loss events in operational risk in their risk assessment tools. When there is a shortage of data, banks may rely more on the use of stress testing and scenario analysis. Where risks cannot be measured with quantitative tools, banks may use qualitative tools including experience and judgment, indicating the assumptions and limitations.

3. **Risk aggregation and diversification effects** – In order to integrate the risks across the entire bank, the banks should conduct risk aggregation among various risk types or business lines and understand the challenges in such aggregation. In other words, one type of risk can trigger other risks or a single transaction may lead to number of risks. All such risks must be viewed and assessed together.

4. **Disclosure** – The banks' risk information is provided in a meaningful manner to their stakeholders, disclosing the extent and nature of various risks that banks are exposed to and the effectiveness of their risk management practices. This would enable the stakeholders to make informed decisions. At the same time, the banks will be compelled to ensure that their internal policies and processes are in place to justify the disclosures made.

Direction on Integrated Risk management Framework

In view of the importance of managing risks in an integrated manner, the Central Bank has issued a Direction along with Guidelines on Integrated Risk Management Framework as a set of minimum guiding principles and standards for the licensed banks to adopt. The Guidelines broadly cover the management of credit, market, operational, liquidity and interest rate risks, and stress testing and disclosure requirements in an Integrated Risk Management Framework, based on standard market practices. However, in addition to the Guidelines, the banks are required to follow other market best practices in integrated risk management.

Effective implementation of an IRM framework enables banks to develop an organization-wide risk culture that recognizes the existence of risks in all levels, their interconnectedness and the need to manage risks proactively. This will enable the banks to enhance their resilience and sustainability thereby promoting the stability of the banking system.

Chart 8.5 Loan Loss Provisions of the Banking Sector

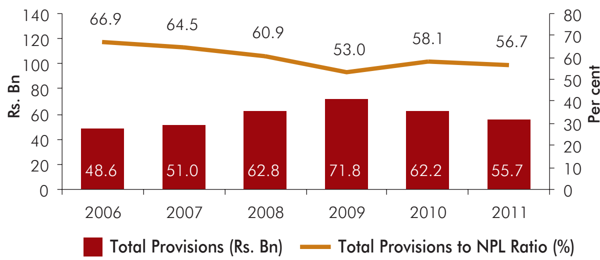
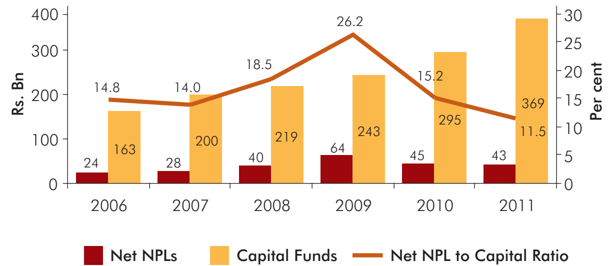


Chart 8.6 NPLs to Captial Ratio of the Banking Sector



was only 3 per cent of the capital base, indicating that the foreign currency exposure of the banking sector was at a manageable level during the year. Hence, the market risk due to price volatilities was at a minimal level in 2011.

Liquidity Risk: The Statutory Liquid Assets Ratio (SLAR) declined from 38 per cent at end 2010 to 32 per cent at end 2011 (Chart 8.8) due to rapid credit expansion. Further, the higher growth of deposit liabilities also contributed to the lower SLAR. The share of investments in government securities, including Treasury bills, Treasury bonds and Sri Lanka Development Bonds, declined marginally from 75 per cent at end 2010 to 71 per cent at end 2011 (Table 8.5). Nevertheless, SLAR of the banking industry was maintained well above the regulatory limits throughout the year. Further, the cumulative maturity gap as a percentage of cumulative liabilities for the period of less than one year was a negative 17 per cent at end 2011, an improvement from the negative 19 per cent recorded at end 2010 (Chart 8.9). The negative gap that prevailed upto the 3 year period had reduced by end 2011. Liquid assets of the banking industry represented 27 per cent of the total assets and were above the negative mismatches recorded in any maturity. Accordingly, the industry operated with adequate capacity to withstand any ad-hoc liquidity requirements during 2011.

Profitability: The total profit after tax of the banking sector increased to Rs. 64 billion in 2011 from Rs. 59 billion in 2010. However, a lower growth of profits that is, 9 per cent, was recorded during 2011 compared to exceptional profits during 2010 (117 per cent growth) which was mainly due to a few exceptional circumstances such as the reversal of provisions of a bank and high gains from trading securities/investments of a few banks. The lower

Chart 8.7 Sector-wise Credit Exposure of the Banking Sector

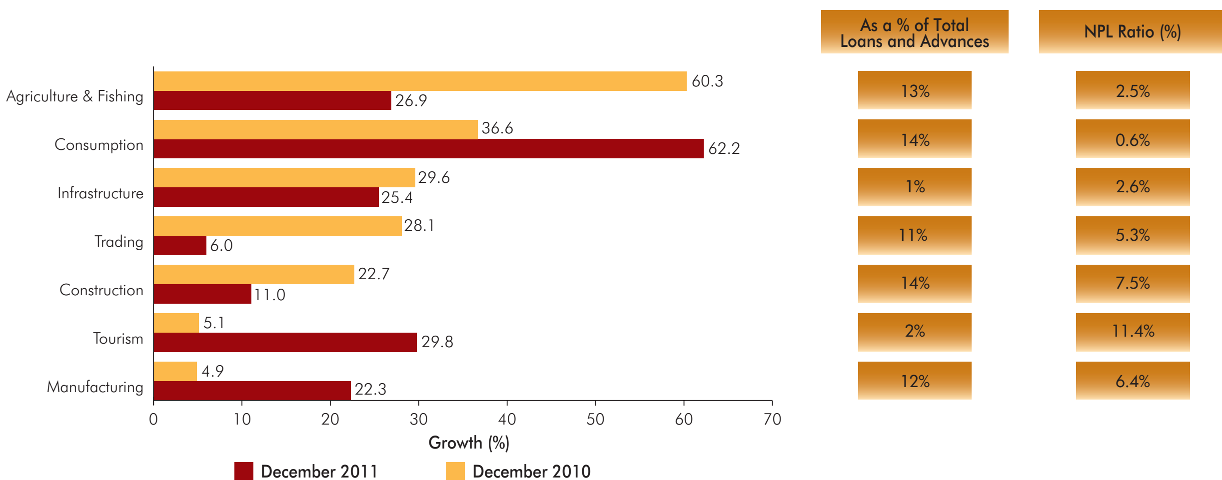


Table 8.5 Composition of Statutory Liquid Assets of the Banking Sector

Item	2010 (a) Rs. bn	2010 (a) Share (%)	2011 (b) Rs. bn	2011 (b) Share (%)	Change (%) 2010	Change (%) 2011
Treasury Bills	375.0	33.8	254.6	22.3	38.4	(32.1)
Treasury Bonds	350.5	31.6	377.9	33.1	9.7	7.8
Sri Lanka Development Bonds	106.8	9.6	174.3	15.3	(33.6)	63.2
Cash	45.1	4.1	60.7	5.3	13.6	34.7
Money at Call	53.0	4.8	46.1	4.0	40.2	(13.1)
Balances with banks abroad	90.3	8.1	87.1	7.6	(8.1)	(3.5)
Other	88.6	8.0	140.4	12.3	(35.5)	58.4
Total Liquid Assets	1,109.3	100.0	1,141.0	100.0	4.2	2.9

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

profits were also on account of the decline in the interest margin from 4.6 per cent in 2010 to 4.2 per cent in 2011. Further, the decline in non-interest income by 11 per cent in 2011 as against a growth of 14 per cent in 2010 also contributed to lower earnings. Accordingly, the profitability indicators of the banking sector i.e. return on assets (ROA) and return on equity (ROE), declined from 1.8 per cent and 22 per cent in 2010 to 1.7 per cent and 20 per cent in 2011, respectively (Chart 8.10).

Capital: The capital funds of the banking sector grew by 25 per cent in 2011 compared with the 21 per cent growth in 2010, indicating an improved capacity to absorb risks in the industry. In order to facilitate the high credit growth and cushion any potential risks, many banks in the industry strengthened their capital base through new capital infusions as indicated by the increase in share capital by Rs. 24 billion during the year. Further, several banks raised Tier II capital in the form of debentures which resulted in a significant growth of approved subordinated term debt, by 23 per cent,

Table 8.6 Profit of the Banking Sector

Item	Amount (Rs.bn) 2010(a)	Amount (Rs.bn) 2011(b)	Growth 2010 (a) Amount (Rs.bn)	Growth 2010 (a) %	Growth 2011 (b) Amount (Rs.bn)	Growth 2011 (b) %
Interest Income	330.1	357.2	(34.2)	(9.4)	27.1	8.2
Interest Expenses	180.3	192.5	(53.6)	(22.9)	12.2	6.8
Net Interest Income	**149.8**	**164.7**	**19.4**	**14.9**	**14.9**	**9.9**
Non-Interest Income	67.3	59.8	8.1	13.7	(7.5)	(11.1)
Non-Interest Expenses	105.8	115.7	9.3	9.6	9.8	9.3
Staff Cost	47.8	50.6	2.9	6.5	2.8	5.9
Loan Loss Provisions (net)	(6.2)	(3.4)	(27.7)	(129.0)	2.8	(45.7)
VAT	27.2	15.6	8.0	41.5	(11.6)	(42.8)
Profit before Tax (After VAT)	90.0	93.8	37.8	72.3	3.9	4.3
Profit after Corporate Tax	59.2	64.4	32.0	117.4	5.2	8.8

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

in 2011. Consequently, as at end 2011, 71 per cent of the regulatory Tier I capital consisted of share capital and retained earnings, which are considered as high quality capital under the Basel III Capital Accord (Table 8.7). Accordingly, capital funds to total assets ratio (leverage ratio) and the common equity ratio remained around 9 per cent and 8 per cent, well above the standard Basel III ratio of 4 per cent and 4.5 per cent, respectively. Further, the share of share capital in Tier I capital and the share of subordinated term debt in Tier II capital improved from 38 per cent and 76 per cent in 2010 to 43 per cent and 88 per cent in 2011.The capital adequacy ratio (CAR) of the banking industry was at 14 per cent at end 2011 compared with 16 per cent at end 2010, mainly due to the accelerated credit expansion (Chart 8.11). The core capital ratio also followed a similar trend and stood at 12 per cent at end 2011, declining from 14 per cent recorded at end 2010. Nevertheless, with the inclusion of the audited profits for the year 2011, the core capital

Chart 8.8 Liquidity Vs Credit Expansion of the Banking Sector

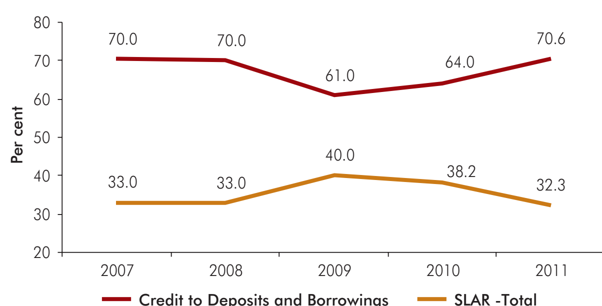


Chart 8.9 Maturity Gap Analysis of the Banking Sector

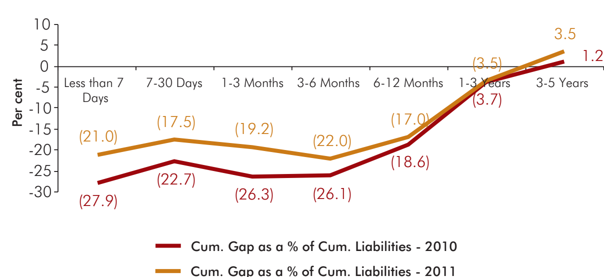


Chart 8.10 Profitability Indicators of the Banking Sector

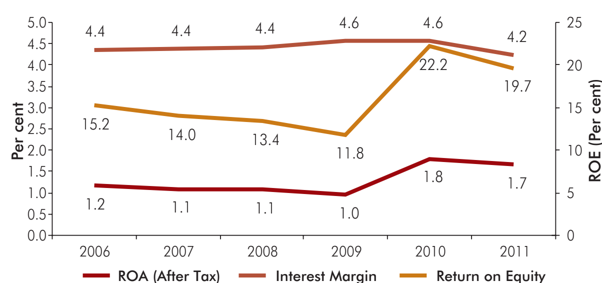
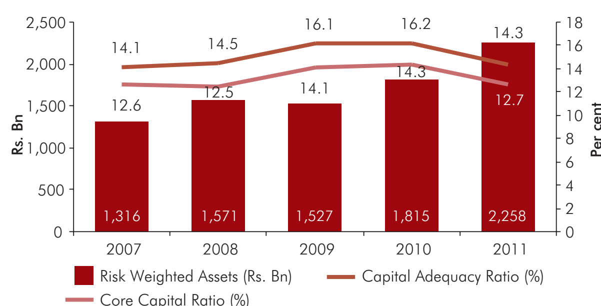


Chart 8.11 Capital Adequacy Ratio of the Banking Sector



ratio and CAR are expected to improve further to around 14 per cent and 16 per cent, respectively.

Supervisory and Regulatory Developments: During the year, the Central Bank further strengthened its supervisory and regulatory framework to improve the risk management systems in banks and customer protection. The details of these measures are given in Part II and Part III of this Report. In addition to the continued supervision through examination and problem resolution, several regulatory measures were introduced. Those include the issue of a Direction on Integrated Risk Management and a Direction on Customer Charter that require banks to have a customer charter. Considering the exposures to the stock market, Directions were also issued requiring boards of directors of licensed banks to set their internal limit on margin trading on shares based on tolerable levels in line with the bank's risk management framework and maintain the total exposure to margin trading within such limit. The Central Bank also issued Guidelines to licensed banks on the establishment and operations of an Investment Fund Account utilising tax savings in line with a 2011 Budget proposal; increased the licence fee of banks; issued draft Guidelines on statutory reporting by banks to the Central Bank under LKAS 32, 39 and SLFRS 7; and specified the Chinese Renminbi as a designated currency for foreign exchange transactions. Further, the Central Bank required licensed banks to expand the disclosures on interest rates and exchange rates and details of fees, commissions and other service charges. The Central Bank issued two banking licences and two Letters of Provisional approval for the establishment of banks in Sri Lanka, relaxed the qualifying criteria for SMEs for capital adequacy purposes with a view to facilitating the expansion of lending to SMEs, envisaging that banks will pass the benefit of the lower capital requirement to borrowers through reduced interest rates.

Table 8.7 Composition of Regulatory Capital of the Banking Sector

Item	Amount (Rs.bn)		Composition (%)	
	2010 (a)	2011 (b)	2010 (a)	2011(b)
Tier I Capital	**259.9**	**286.2**	**100**	**100**
Share Capital	98.3	121.7	38	43
Statutory Reserve Funds	14.8	15.3	6	5
Retained Profits	77.0	80.4	30	28
General and Other Reserves	85.0	81.7	33	29
Other	3.4	6.7	1	2
Regulatory Adjustments	(18.6)	(19.6)	(7)	(7)
Tier II Capital	**34.1**	**36.5**	**100**	**100**
Revaluation Reserves	5.2	7.2	15	20
Subordinated Term Debt	26.1	32.2	76	88
General Provisions and Other	15.0	11.3	44	31
Regulatory Adjustments	(12.1)	(14.2)	(35)	(39)
Total Regulatory Capital Base	**294.1**	**322.7**		

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Non-Bank Financial Sector

The Non-Bank Financial (NBF) sector consisting of Licensed Finance Companies (LFCs)[1] and Specialised Leasing Companies (SLCs) continued its growth momentum during 2011. The main indicators in respect of capital, profitability, asset quality, credit growth and deposit base recorded impressive growths. However, a few LFCs continued to experience deterioration of capital and shortage of liquidity, which somewhat

[1] Registered finance companies (RFCs) have been termed as licensed finance companies as per the Finance Business Act, No. 42 of 2011, which repealed and replaced the Finance Companies Act, No. 78 of 1988.

Table 8.8 Branch Distribution of NBFIs by Province (net)

Province	December-2010	December-2011	Opened during the year
Western	192	224	32
Southern	76	86	10
Sabaragamuwa	45	54	9
North Western	61	67	6
Central	62	72	10
Uva	33	42	9
North Central	45	50	5
Eastern	54	63	9
Northern	32	46	14
Total	**600**	**704**	**104**

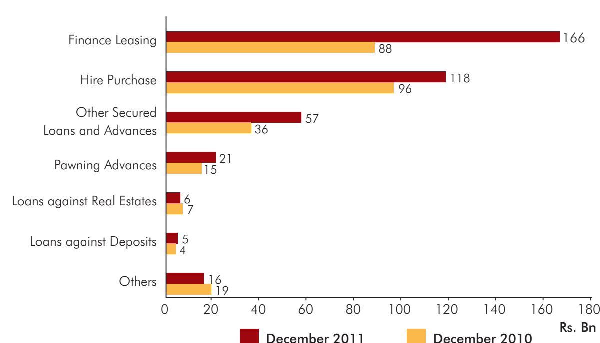
Source: Central Bank of Sri Lanka

deterred the overall performance of the NBF sector. During the period under review, the Central Bank diligently monitored the resolution measures implemented with regard to restructuring of several distressed Non-Bank Financial Institutions (NBFIs) to ensure financial stability within the sector.

Outreach: During 2011, two SLCs migrated to LFC status and the licences of three SLCs were cancelled. Consequently, the NBF sector comprises of 39 LFCs and 16 SLCs as at the end of 2011. Meanwhile, the branch network increased by 104 to 704 in 2011, out of which, 28 branches were opened in the Northern and Eastern provinces during 2011 reflecting the prominence given by the sector to the growth potential in these areas.

Assets: The total asset base of the NBF sector grew by 26 per cent during 2011 to Rs. 490 billion compared with a growth of 30 per cent in 2010. The main contributory factor in the expansion of the asset base has been the growth of the accommodations portfolio. Accommodations grew by 46 per cent to Rs. 388 billion as at end 2011, compared to a growth rate of 35 per cent during 2010. Finance leases, hire purchases and other secured advances were the major sources of the increase in accommodations accounting for 43 per cent, 30 per cent and 15 per cent, respectively of total accommodations. Among the products, finance leasing, other secured loans and pawning indicated high growth rates of 90 per cent, 58 per cent and 35 per cent, respectively. However, the investment portfolio of the sector has shown a decrease of 46 per cent, mainly due to the

Chart 8.12 Total Accommodation by Product of the NBFIs Sector



cancellation of the licence of a diversified leasing company, upon its migration to a holding company status.

Liabilities: Deposits were the major source of funding for the LFCs, while borrowings were the major source of funding for the SLCs, representing 38 per cent and 35 per cent, respectively of the total NBF liabilities. Deposits grew by 27 per cent to Rs.186 billion as at end 2011, compared with the 22 per cent growth in 2010, reflecting the regaining of confidence in the LFC sector. Deposit mobilization was mainly through time deposits, which accounted for nearly 97 per cent of the total deposits. LFCs have raised funds through borrowings as well. The total borrowing in the NBF sector, as at end 2011 reached Rs. 172 billion, an increase of 24 per cent compared to the growth rate of 49 per cent recorded in 2010. Out of this, 54 per cent of the total

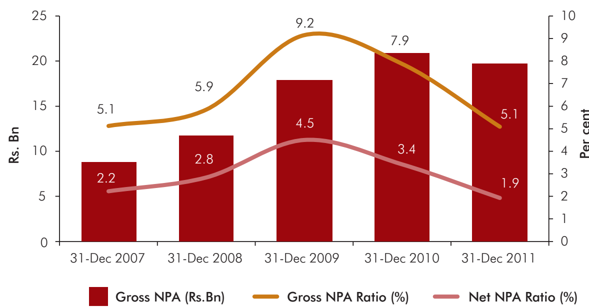
Table 8.9 Composition of Assets and Liabilities of NBFIs Sector

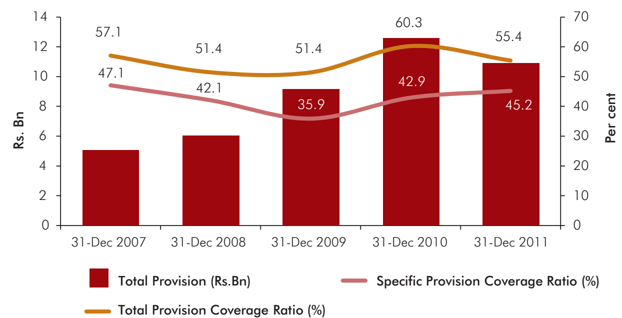
Item	2010 (a)		2011 (b)		Change (%)	
	Rs. bn	Share (%)	Rs. bn	Share (%)	2010	2011
Assets						
Accommodation	265.5	68.4	388.4	79.3	35.3	46.3
Finance Leasing	87.5	22.6	166.1	33.9	35.7	89.8
Hire Purchase	96.0	24.7	118.4	24.2	37.2	23.3
Investments	25.2	6.5	13.5	2.8	130.6	(46.4)
Others	97.2	25.1	88.0	18.0	8.1	(9.5)
Liabilities						
Total Deposits	146.1	37.7	186.0	38.0	22.0	27.3
Total Borrowings	138.9	35.8	171.6	35.0	49.3	23.5
Capital Elements	48.1	12.4	77.0	15.7	16.8	60.1
Total Funds	**333.2**	**85.9**	**434.6**	**88.7**	**31.1**	**30.4**
Other	54.7	14.1	55.3	11.3	27.2	1.1
Total Assets/Liabilities	**387.9**	**100.0**	**489.9**	**100.0**	**30.6**	**26.3**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Chart 8.13 Non - Performing Advances and Provision Coverage of the NBFIs Sector





borrowings have been made by the SLC sector as it is their major source of funding. Capital increased by a robust 60 per cent to Rs.77 billion as at end 2011, compared to an increase of 17 per cent in 2010. Sustained profitability and the revival of the distressed companies have been instrumental in strengthening the capital funds of the sector.

Risk Management

Credit Risk: The total amount of non-performing accommodations (NPAs) decelerated by 6 per cent during 2011 to Rs.20 billion from Rs.21 billion in 2010. The LFC sector accounts for 81 per cent of the NPAs, which mainly relate to the distressed companies. Further, the exposure to NPAs relative to the total loans outstanding declined to 5.1 per cent as at end 2011 from 7.9 per cent as at end 2010 mainly due to the growth of accommodations. When the loan loss provision is considered, the net NPA ratio was 1.9 per cent as at end 2011. The total provision coverage for NPAs decreased marginally to 55 per cent as at end 2011 from 60 per cent as at end 2010 due to increased risk weighted assets.

Market Risk: The single digit interest rate regime coupled with increased business volumes of the NBF sector continued to have a favourable impact on the earnings during 2011. The interest margin (net interest income as a percentage of total assets) of the sector improved to 6.4 per cent for the twelve month period ending December 2011 from 6 per cent in the corresponding period in 2010. The net interest income of the sector increased by 33 per cent to Rs. 31 billion during 2011, from Rs. 23 billion in 2010.

Liquidity Risk: Until 2011, only the LFC sector was required to maintain liquid assets. As per the new direction issued in 2011, SLCs are also required to maintain liquid assets from 2012. Liquid assets of the LFC sector recorded an increase of 52 per cent to Rs.22 billion as at end 2011 from Rs.15 billion as at end 2010, having decreased by 22 per cent in the previous year. The overall statutory liquid assets available in the LFC sector by end 2011 was a surplus of Rs. 3.5 billion compared to the stipulated minimum requirement of Rs. 19 billion (i.e. 10 per cent of time deposits and certificates of deposits and 15 per cent of savings deposits). This can be directly attributed to the few distressed companies which faced severe liquidity constraints, having been turned around with their respective revival plans, and increased sector earnings.

Earnings: Profitability of the NBF sector continued to improve during 2011 mainly due to the prevailing business environment. The NBF sector has also benefited from the single digit interest rates that prevailed since 2010. The sector posted

Chart 8.14 Compliance with Liquid Assets Requirement of the NBFIs Sector

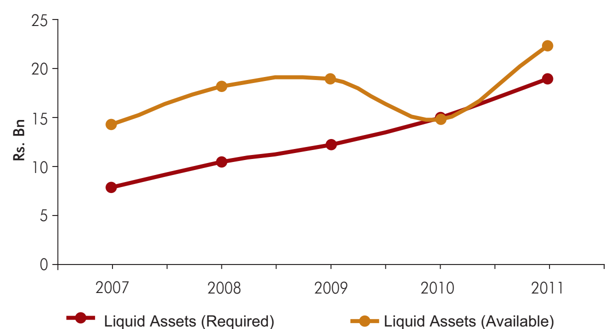


Table 8.10 Composition of Income and Expenses of NBFIs Sector

Item	Amount (Rs.bn)		Growth 2010 (a)		Growth 2011 (b)	
	2010(a)	2011(b)	Amount (Rs.bn)	%	Amount (Rs.bn)	%
Interest Income	53.3	64.9	5.0	10.4	11.6	21.8
Interest Expenses	29.9	33.7	(6.2)	(17.2)	3.8	12.8
Net Interest Income	**23.4**	**31.1**	**11.3**	**93.2**	**7.8**	**33.2**
Non-Interest Income	12.3	14.7	3.2	35.8	2.4	19.9
Non-Interest Expenses	20.3	25.0	4.2	26.3	4.7	23.2
Staff Cost	6.7	8.4	1.6	31.2	1.7	24.8
Loan Loss Provisions (Net)	4.5	(1.5)	0.8	21.6	(5.9)	(132.5)
Profit before Tax	**10.8**	**22.3**	**9.5**	**737.6**	**11.5**	**106.7**
Tax	5.9	6.4	3.5	142.4	0.5	9.1
Profit after Tax	**4.9**	**15.8**	**6.0**	**522.5**	**11.0**	**224.7**

(a) Revised
(b) Provisional
Source: Central Bank of Sri Lanka

a remarkable profit after tax of Rs. 16 billion during 2011 compared to a profit of Rs.5 billion in 2010. This was mainly attributed to the improvement in net interest income due to the growth of core business of NBFIs, and the reversal of loan loss provisions due to reduced provisioning requirements and recoveries. The increase in profits was reflected in improved Return on Assets and Return on Equity which stood at 5 per cent and 25 per cent, respectively, in 2011 compared to 3 per cent and 11 per cent, respectively in 2010.

Capital: Capital funds increased by a robust 57 per cent to Rs.68 billion as at end 2011, compared to an increase of 9 per cent in 2010. The improvement in profitability and the revival of the distressed companies have been instrumental in strengthening the capital funds of the sector. The NBFI sector was bolstered by capital worth Rs.27 billion through IPOs and Rights Issues amounting to Rs.9 billion, strategic investments worth Rs. 5.3 billion, private placements amounting to Rs. 7 billion and deposit conversions amounting to

Chart 8.15 Profitability Indicators of the NBFIs Sector

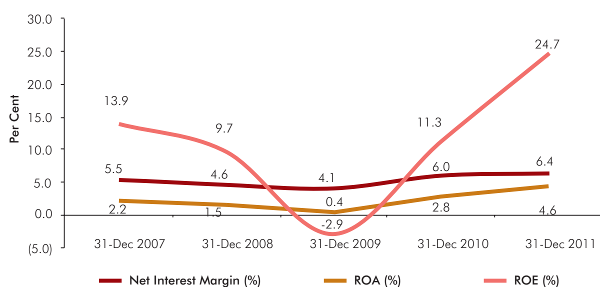


Table 8.11 Composition of Capital Elements of NBFIs Sector

Item	Amount (Rs.bn) 2010 (a)	Amount (Rs.bn) 2011 (b)	Composition (%) 2010 (a)	Composition (%) 2011(b)
Share Capital	21.8	48.2	45.3	62.6
Non-cumulative, Non-redeemable Preference Shares	0.0	2.5	0.1	3.2
Share Premium	0.5	1.0	0.9	1.3
Statutory Reserve Funds	3.9	4.4	8.2	5.7
General Reserve and Other Free Revenue Reserves	11.4	11.9	23.8	15.4
Reserves Originated from Capital Gains	0.2	0.6	0.3	0.7
Revaluation Reserves	6.5	3.9	13.6	5.0
Other Reserves	1.3	2.1	2.8	2.7
Published Retained Profits	8.0	4.1	16.7	5.3
Hybrid (Debt-Equity) Capital Instruments	0.1	0.1	0.1	0.1
Prior years Retained Profit / (Loss)	(9.0)	(15.3)	(18.7)	(19.8)
Current year Profit / (Loss)	3.3	13.6	6.9	17.7
Total Capital Elements	**48.1**	**77.0**	**100.0**	**100.0**

(a) Revised
(b) Provisional
Source: Central Bank of Sri Lanka

Rs. 5.8 billion. The statutory capital adequacy ratios of the NBFIs sector remained above the required minimum levels. The core capital ratio (as a per cent of risk weighted assets) decreased to 15 per cent at the end 2011 from 19 per cent at end 2010 (required minimum is 5 per cent) due to rapidly growing risk weighted assets. Further, the total capital ratio increased to 14 per cent by end 2011 from 6 per cent at end 2010 (required minimum is 10 per cent) due to SLCs being issued with a capital adequacy direction during 2011. The ratio of capital funds of LFCs to total deposits increased to 20 per cent by end 2011 from 11 per cent at end 2010 (statutory minimum level is 10 per cent).

Restructuring of Distressed Companies: During 2011, the CBSL implemented the business revival plans and continued to diligently monitor the progress of distressed companies. Despite the notable improvement in the performance of the NBFI sector, a few distressed companies needed extra vigilance as these companies were severely affected during 2009. As resolution measures, the CBSL appointed Managing Agents to oversee operational activities of these companies while powers exercised by the incumbent directors of those companies were either restricted or removed. Further, the CBSL continued to obtain consultative support from the Panel of Experts to implement and review the revival process of these companies. Consequent to the implementation of these restructuring strategies, by the end of 2011,

five distressed NBFIs have been able to commence normal business operations and the Managing Agents have been released. Strategic investors have been identified for seven distressed companies and six of them have infused investments amounting to approximately Rs. 5.4 billion, paving the way to reconstitute the respective Boards of Directors of these companies. The balance sheets of these companies were restructured by way of converting deposits and debt into equity worth approximately Rs. 6 billion. Subsequent to the above restructuring steps, almost all distressed companies are expected to revitalize their businesses and obtain public listings during 2012.

Supervisory and Regulatory Developments: The Finance Business Act No. 42 of 2011 was enacted in November 2011 to strengthen the regulation of finance companies. The new law which replaces the Finance Companies Act has broadened the definition of "deposits" and "finance business" and has empowered the regulator with more investigative powers and enhanced penalties for offences. Three new directions were issued to LFCs, with respect to assessment of fitness and propriety of directors and officers performing executive functions; reporting requirements, introducing sanctions for non-compliances; and increasing the minimum core capital to Rs.400 million. All LFCs were required to list on the Colombo Stock Exchange (CSE) by 30 June 2011. As at end 2011, 28 LFCs were listed. In addition, all NBFIs were advised to consider listing any future debenture issues on the CSE for better market transparency. New directions were also issued to the SLC sector, relating to the introduction of the statutory liquid asset requirement of 5 per cent and 10 per cent of total liabilities by 01.01.2012 and 01.01.2013; maintaining capital adequacy ratios from 01.07.2011; and prior approval for structural changes in companies. Guidelines for the establishment and operation of the Investment Fund Account in NBFIs were also issued. During the year, 23 on-site examinations of NBFIs were completed and the relevant companies have been instructed to implement the recommendations within a stipulated time period. In addition, 15 NBFIs were examined on a limited scope basis, selecting critical areas such as liquidity, credit administration, asset portfolio, capital adequacy and system controls.

Action against Unauthorized Conduct of Finance Business: Investigations into institutions allegedly engaged in finance business without authorisation continued while assisting courts with respect to pending litigation issues. In parallel, the CBSL continued to carry out public awareness campaigns on the risk of investing in unauthorised finance institutions by way of country-wide seminars/ workshops as well as advertisements. During 2011, 53 public awareness programmes were conducted in rural areas by way of seminars and radio broadcast. A short film named 'Paninnata Pera' showing the risk of investing in unauthorised finance businesses was telecast over several Sinhala and Tamil TV channels. Further, posters containing lists of Licensed Banks and LFCs have been distributed among Grama Niladharis in 16 districts. Leaflets containing lists of Licensed Banks and LFCs with other useful information were distributed among the public, while lists of institutions authorised to accept deposits were published in the newspapers in all three languages. The new Finance Business Act will provide more investigative powers to the CBSL to curb unauthorised finance business. Measures are being taken to regularize the activities of one company, while several other unauthorised companies have agreed to repay the deposits mobilized. Legal action was initiated against one company for engaging in finance business in contravention of the provisions of the Finance Business Act.

Microfinance Institutions: The CBSL was involved in preparing legislation for the regulation of microfinance institutions. There are several categories of microfinance institutions that are registered under various laws, but are not regulated or supervised according to prudential criteria. Hence, to safeguard the interest of depositors and customers and also to strengthen the governance and service delivery of these entities, it was decided

BOX 16 The Finance Business Act, No. 42 of 2011

Background

The Finance Business Act, No.42 of 2011 (FBA) was enacted on 09. 11. 2011 repealing and replacing the Finance Companies Act, No. 78 of 1988 (FCA) to further strengthen the regulation and supervision of Licensed Finance Companies (LFCs) and to curb unauthorised finance businesses. Due to the significant developments that have taken place in the financial sector over the past two decades, there has also been an immense need for a new legislation to address the lacunas of the FCA to ensure the safety and soundness of the financial system.

Salient features of the Finance Business Act

- **Definition for deposits**

Under the FCA, carrying on "finance business" without authority was an offence. In order to prove carrying on of finance business, three aspects of the business had to be ascertained, i.e. acceptance of money as deposits, payment of interest thereon and lending/ investment of monies so accepted. In practice, it was extremely difficult to find substantial evidence with regard to lending/investment of such deposits. This resulted in various unlawful shadow banking activities being carried out under various guises.

Hence, in the FBA, mobilizing public deposits without authority has been made an offence. The FBA defines the term "deposit" as a "sum of money paid on terms under which it will be repaid, with or without interest or a premium and either on demand or at a time or in circumstances agreed to by or on behalf of the person making the payment and the person receiving it". There are however, instances that have been exempted from this definition of a deposit, such as money paid to an insurer under the regulation of the Insurance Industry Act, bonds or debentures fully secured by assets of the company and listed debt instruments.

In addition, abetting to mobilize public deposits without authority has been made an offence. Hence, any person who places a deposit with an entity / person who has no authority to accept deposits will also be guilty of an offence.

- **Identifying a finance company by its name**

In the past, any company in Sri Lanka could use the words 'finance' 'financing', or 'financial' as part of its name, which led to confusion. The general public could not distinguish the entities which had authority to take deposits from those that did not have authority. Hence, the FBA has stipulated that only LFCs could use terms 'finance' 'financing', or 'financial' in their company names while all other institutions are prohibited from using such words or any of its derivatives or its translations or their equivalent in any other language in their names or description without the prior written approval of the Monetary Board. Hence, all entities other than LFCs currently using one of the above terms are required to delete these words from their names within six months from the date of commencement of the FBA. Further, the FBA prohibits the use of the name, abbreviated name or acronym of a LFC by any other company in any of its advertisements promoting its business.

- **Advertising on accepting deposits**

The FBA bans advertisements soliciting deposits by entities that do not have such authority and requires the media institutions to verify whether the advertiser has authority to accept deposits before publishing such advertisement. Hence, publishing of advertisements to mobilize deposits by entities with no authority is an offence for the publisher as well as the advertiser.

- **Moral hazard on the regulator**

In order to enable the regulator to monitor and take effective action to combat any unauthorised finance business, the FBA has empowered all employees of licensed banks and LFCs to inform the Director of the Department of Supervision of Non-Bank Financial Institutions of the Central Bank of Sri Lanka of any person whom they have reasonable suspicion of accepting deposits without authority from the public.

- **Legal implications or sanctions**

The FBA has imposed stringent penalties for organizations and individuals who are found to have conducted finance business without authority or accepted deposits without authority or abetted such activity. Such organizations or individuals will be convicted after a trial before the High Court with imprisonment not exceeding five years, fine not exceeding five million rupees or both.

Accordingly, the FBA has addressed the lacunas of the previous legislation in order to ensure smooth functioning of the finance company sector and to curb unauthorised deposit taking businesses, thereby promoting the soundness and stability of the financial system.

to bring them under a common regulatory umbrella. Accordingly, the proposed law will provide for the establishment of a separate regulatory authority for microfinance institutions.

Primary Dealers in Government Securities

The Primary Dealer (PD) industry showed mixed results during the year. Key financial indicators of the PDs were maintained at healthy levels, though the profitability of the industry declined with the rise in interest rates towards the latter part of 2011.

Assets and Liabilities: Total assets increased by 6 per cent to Rs. 135 billion during the year in comparison to the high growth of 27 per cent in 2010. The portfolio of government securities in trading, investment and reverse repos accounted for almost 99 per cent of total assets of PDs. The trading portfolio and the reverse repo portfolio recorded increases of 23 per cent and 35 per cent, respectively, in 2011, while the investment portfolio had shown a significant decline of 37 per cent over the previous year. Repo liabilities which represents 73 per cent of total liabilities increased by 17 per cent to Rs. 88 billion at the end of 2011 from Rs. 75 billion, following a growth of 3 per cent, in 2010.

Risk Management

Market Risk: The exposure of the industry as well as individual PDs to market risk has been increasing mainly due to the increased proportion of the trading portfolio and also due to the pressure on market yields to increase from around the last quarter of 2011. The trading component of the total government securities portfolio stood at 69 per cent at the end of 2011 compared to 59 per cent in 2010. The stress test results reveal that the PDs can withstand fairly substantial increases in yield rates, while being able to maintain the minimum capital requirement of Rs. 300 million and also maintain the risk weighted capital adequacy ratio (RWCAR) above the minimum level of 8 per cent, in a range of scenarios.

Table 8.12 Performance of Primary Dealers in Government Securities

Rs. million

Item	2010(a)	2011(b)	Annual Growth (%)	
			2010(a)	2011(b)
Total Assets	127,248	135,307	27.5	6.3
Total Portfolio	**125,024**	**133,549**	**29.4**	**6.8**
Trading Securities	74,339	91,688	37.6	23.3
Investment Securities	36,813	23,179	109.0	(37.0)
Reverse Repo	13,872	18,682	(44.5)	34.7
Equity and Liabilities	127,248	135,307	27.5	6.3
Total Capital	13,516	14,173	35.7	4.9
Repo	75,297	87,971	3.1	16.8
Profit before Tax	4,916	1,700	(20.9)	(65.4)
Profit after Tax	4,594	1,454	0.0	(68.4)
Return on Assets %	3.9	1.2	(2.4)	(2.7)
Return on Equity %	34.0	10.2	(12.4)	(23.8)
Risk Weighted Capital Adequacy Ratio %	22.6	23.3	0.2	0.7
Leveraging Times	5.6	6.2	(1.8)	0.6
Dealings	7,950,922	8,951,533	(0.4)	12.6
Primary Market Dealings	1,508,645	1,767,521	(0.9)	17.2
Secondary Market Dealings	6,442,277	7,184,012	(0.3)	11.5

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Liquidity Risk: The PD industry is exposed to a high level of liquidity risk due to the negative mismatch in the assets and liabilities maturity profile which widened during the year. The overnight negative mismatch increased to Rs. 14,191 million or 16 per cent of the outstanding repo liability at the end of 2011, from to Rs. 5,186 million or 7 per cent at end 2010, mainly due to lack of term funding in the domestic market. Even though the primary dealer industry had a relatively high negative mismatch in its assets and liabilities maturity profile, its liquidity risk remains low due to the availability of contingency funding arrangements.

Capital: The capital base of the PD industry increased by 5 per cent to Rs. 14 billion in 2011 from Rs.13.5 billion in 2010. All PDs were in compliance with the regulatory minimum requirement to maintain capital funds above Rs. 300 million. Further, the RWCAR of the industry increased from 22.6 per cent as at end 2010 to 23.3 per cent as at end 2011 in line with the aforesaid increase in capital base. All PDs maintained RWCAR above the minimum regulatory requirement of 8 per cent. Capital leveraging of the industry was maintained at a moderate level of 6.2 times as at end 2011.

Profitability: The profitability of the industry declined drastically during the year 2011. The ROE and ROA have shown a decline from 34 per cent and 4 per cent, respectively in 2010 to 10 per cent and 1 per cent, respectively in 2011, mainly due to mark-to-market losses which arose during the fourth quarter with the increase in market yield rates.

Market Participation: The bank PD units continued their highest effective participation of 74.2 per cent at Treasury bill auctions during the year. The participation of both bank PD companies and non-bank PDs had decreased during 2011 compared to the previous year. The expectation of an increase in interest rates has reduced the demand for long-term Treasury bonds. The Treasury bond auctions were mainly subscribed by the EPF, which subscribed 80 per cent of the total issues in 2011. Secondary market transactions increased by 12 per cent to Rs. 7,184 billion in 2011 from Rs. 6,442 billion in 2010, mainly due to an increase in repo transactions. Repo transactions in government securities increased by 18 per cent to Rs. 5,916 billion in 2011 from Rs. 4,993 billion in 2010. The ratio of repo transactions to total secondary market transactions was 82 per cent in 2011 compared with 78 per cent in 2010. The total number of PDs increased to 12, with the appointment of Wealth Trust Securities Limited as a PD in August 2011.

Unit Trusts

The unit trust industry expanded with the formation of new funds. There were 6 unit trust (UT) management companies managing 25 funds by the end of 2011. Of these UTs, 21 are open-ended funds, while 4 are close-ended funds. In terms of investment focus, 8 UTs are income funds, 6 UTs are growth funds, 4 UTs are balanced funds and 7 UTs are specialised funds (money market, equity index linked, tourism, finance and Sharia). One close-ended fund is listed on the Colombo Stock Exchange. The net asset value (NAV) of the UT industry increased by 2 per cent to Rs. 23 billion at end December 2011 from Rs. 22 billion as at end December 2010. Funds with significant investments in equities were somewhat affected by the decline in prices of listed shares during the year. However, these funds were able to perform better than the CSE price indices on account of portfolio management and diversification. The share of equities in the investment portfolio of UTs declined to 42 per cent of NAV, while the share of investments in government securities (Treasury bills and bonds and Reverse Repos) rose to 48 per cent of NAV at end December 2011. The share of other fixed income securities declined to 9 per cent at end December 2011. The total number of unit holders and the number of units issued increased to 26,560 and 2,059 million, respectively as at end December 2011, indicating a positive development in the industry. In order to promote the participation of retail investors in the stock market, the Securities and Exchange Commission issued a direction that 10 per cent of shares of all Initial Public Offerings should be allocated to unit trusts. In addition, the decision to permit foreign investment in all types of unit trusts will expand the investor base and facilitate the development of the industry. In order to strengthen the regulatory framework for Exchange Traded Funds (ETFs), a new Unit Trust Code came into effect in 2011.

Table 8.13 Selected Data of the Unit Trust Industry

Item	2008	2009	2010 (a)	2011 (b)
No.of Unit Trusts	17	18	22	25
Total No.of Unit Holders	22,699	23,116	24,642	26,560
No.of Units in Issue (mn)	638	564	1,308	2,059
Total Assets (Rs.mn)	6,801	10,004	22,328	22,674
Net Asset Value-NAV (Rs.mn)	6,781	9,952	22,211	22,547
Investments in Equities (Rs.mn)	2,589	6,036	11,743	9,549
Share of Total Assets (%)	38	60	53	42
Investments in Government Securities (Rs.mn)	2,575	3,008	7,556	10,975
Share of Total Assets (%)	38	30	34	48

(a) Revised
(b) Provisional

Source: Unit Trust Association of Sri Lanka

Insurance Companies

There are 21 insurance companies registered with the Insurance Board of Sri Lanka (IBSL). Of these, 12 companies are composite insurers engaged in both long-term and general insurance business, while 6 companies are only in general insurance business and 3 companies are only in long-term insurance business. There are 7

insurance companies listed on the Colombo Stock Exchange (CSE). The National Insurance Trust Fund (NITF) which was established in terms of the National Insurance Trust Fund Act was brought under the purview of the IBSL. In addition, there were 45 insurance broking companies involved mainly in general insurance and about 65,000 insurance agents who market mainly life insurance products.

The insurance company sector recorded steady growth in premium income in the improved business environment, while maintaining its soundness. The total gross written premiums (GWP) of insurance companies rose by 18 per cent to Rs.80 billion in 2011 compared with an increase of 20 per cent in 2010. The GWP for long -term insurance increased by 13 per cent to Rs. 35 billion, while the GWP for general insurance increased by 22 per cent to Rs. 45 billion. Premium income on motor insurance, which is the largest category in general insurance rose significantly by 29 per cent. Total investment income of insurance companies declined by 38 per cent to Rs. 22 billion during the year (as against an increase of 83 per cent in 2010), on account of the decline in stock market prices and yields on government securities. Consequently, the total income of insurance companies declined by 2 per cent to Rs. 103 billion in 2011. The total assets of insurance companies grew by 19 per cent to Rs. 263 billion at the end December 2011. Insurance companies held a large proportion of their assets in government securities (41 per cent). The total share of equities and corporate debt securities in the total assets of insurance companies amounted to 15 per cent and 5 per cent, respectively. The overall profit from general insurance declined due to an increase in claims and a decline in investment income, while the overall profit from long - term insurance has increased mainly due to a decline in claims. Consequently, the return on equity (ROE) and the return on assets (ROA) in relation to general insurance declined to 11 per cent and 6 per cent, respectively, while the ROA in respect of long-term insurance increased to 5 per cent. As reflected by the increased combined operating ratio, the underwriting profit from general insurance declined by 4 per cent to Rs. 8 billion. The industry solvency margin ratio in respect of long-term insurance increased to 6.4 and while it declined to 2.1 in relation to general insurance. All insurance companies met the statutory solvency margin requirement pertaining to both general and long-term insurance, in 2011.

The regulatory framework applicable to the insurance sector was strengthened with the enactment of amendments to the Regulation of Insurance Industry (RII) Act in January 2011. The main features include empowering the IBSL to stipulate capital requirements for insurance companies and brokers, stipulation of fitness and propriety criteria for the board of directors of insurance companies, bringing the National Insurance Trust Fund under the purview of the insurance regulator, appointment of institutional agents and the requirement that long-term and general insurance business should be segregated into separate companies, with existing composite insurance companies being given four years to comply with this requirement. Directions were also issued to amend the solvency margin rules, particularly with regard to the valuation of assets. The focus in 2012 is to strengthen risk-based supervision, while a risk-based capital adequacy framework will be implemented in the medium term.

Table 8.14 Key Financial Indicators of Insurance Companies

Rs. billion

Item	2009	2010 (a)	2011 (b)
Total Assets	181.0	222.2	263.3
Government Securities	78.1	89.6	108.6
Equities	22.1	32.7	39.9
Cash & Deposits	14.4	25.8	36.1
Total Income	76.2	104.3	102.7
Premium Income	57.3	68.5	80.5
Investment Income	19.0	35.8	22.2
Profit Before Tax	5.0	16.6	12.1
Solvency Margin Ratio - Life Insurance	4.9	5.1	6.4
- General Insurance	2.8	2.6	2.1
Retention Ratio (%) - Life Insurance	96.4	97.0	96.4
- General Insurance	72.7	75.5	78.4
Claims Ratio (%) - Life Insurance	43.6	38.3	33.0
- General Insurance	63.2	61.6	60.1
Combined Operating Ratio (%) - Life Insurance	69.7	60.4	59.0
- General Insurance	91.0	75.4	82.3
Return on Assets (ROA) (%) - Life Insurance	2.4	2.6	4.6
- General Insurance	4.0	18.1	5.6
Return on Equity (ROE) (%) -General Insurance	8.9	36.9	11.1
Underwriting Ratio (%) - General Insurance	21.0	32.0	24.5

(a) Revised
(b) Provisional

Source: Insurance Board of Sri Lanka

Superannuation Funds

The superannuation fund sector is dominated by the Employees' Provident Fund (EPF), which accounts for 78 per cent of the assets in the sector. Superannuation funds sector consists of three publicly managed funds and about 170 privately managed approved provident and pension funds. The EPF has a total of about 13.6 million accounts, of which 2.3 million are active accounts. Total contributions increased by 13 per cent to Rs. 62 billion, while refunds rose by 36 per cent to Rs. 47 billion, in 2011, resulting in a net contribution (contribution less refunds) of Rs.15 billion, which was slightly below the amount recorded in the year 2010. The total assets of the EPF increased by 13 per cent to Rs. 1,020 billion as at end December 2011. Total liability to members increased by 13 per cent to Rs. 986 billion at end December 2011. The total investment portfolio of the EPF increased by 14 per cent to Rs. 988 billion as at end December 2011. The share of government securities was 91 per cent, while equities accounted for 8 per cent. Investment income declined marginally by 4 per cent to Rs. 116 billion during the year, due to lower market interest rates and the decline in the stock market returns. The effective rate of return on member balances was 11.5 per cent for the year.

The Employees' Trust Fund (ETF), which accounted for about 11 per cent of assets in the superannuation fund sector recorded a similar performance to that of the EPF. The ETF has about 9.5 million accounts, of which about 2.1 million are active accounts. The ETF had 67,041 employers contributing to the fund at the end of December 2011. Total contributions increased by 13 per cent to Rs.11 billion, while superannuation benefits paid to members increased by 22 per cent to Rs.8 billion during the year. The net contribution of the ETF declined by 4 per cent to Rs. 3.3 billion in 2011. Total assets of the ETF increased by 12 per cent to Rs. 141 billion at end December 2011. The outstanding members' balances (after allocating proposed interest and dividends) in the ETF increased to Rs. 136 billion as at end December 2011 from Rs. 120 billion at the end of 2010 . As in the case of the EPF, the investment portfolio was heavily concentrated in government securities which accounts for 90 per cent of the total portfolio. Investment in equities and corporate debt securities accounted for 5 per cent and 1 per cent, respectively, of the total portfolio at end 2011. The proposed rate of return on member balances is 10 per cent for 2011.

Table 8.15 Key Indicators of EPF and ETF

Item	EPF		ETF	
	2010(a)	2011(b)	2010(a)	2011(b)
Total Assets (Rs.bn)	899.7	1,020.1	125.9	140.6
Total Member Balance (Rs.bn)	869.2	986.0	119.9	135.5
Number of Member Accounts (mn)	13.4	13.6	9.3	9.5
Number of Active Member Accounts (mn)	2.1	2.3	2.1	2.1
Number of Employers contributing	62,295	66,350	62,731	67,041
Total Contributions (Rs.bn)	54.8	61.9	9.8	11.1
Total Refunds (Rs.bn)	34.9	47.3	6.4	7.8
Total Investments Portfolio (Rs.bn)	867.1	988.0	118.9	134.1
o/w : Government securities (%)	94.1	90.8	90.5	90.0
Gross Income (Rs.bn)	121.3	116.0	15.5	13.4
Profit Available for Distribution (Rs.bn)	111.5	107.5	14.6	12.4
Return on Investments (%)	15.1	12.5	13.9	9.6
Interest Rate paid on Member Balances (%)	12.5	11.5	12.5	10.0

(a) Revised
(b) Provisional

Sources: Central Bank of Sri Lanka
Employees' Trust Fund Board

The Public Service Provident Fund (PSPF) and Approved Provident and Pension Funds (APPFs) accounted for 12 per cent of assets in the superannuation fund sector. The PSPF had 228,626 active members. The total contributions and refunds of the PSPF during the year 2011 amounted to Rs. 1.5 billion and Rs. 656 million, respectively. The total assets of PSPF increased by 11 per cent to Rs. 30 billion, while investments increased by 14 per cent to Rs. 25 billion. There are 171 APPFs with 167,000 active members, which are registered with the Commissioner of Labour. The investments of the APPFs amounted to Rs. 104 billion registering a decline of 3 per cent, while total assets declined by 9 per cent to Rs. 115 billion at the end of 2011.

8.3 Performance of Financial Markets

Money Market

In 2011, the excess liquidity in the inter-bank money market that was brought forward from the previous years gradually declined. Daily inter-bank liquidity fluctuated between a surplus of

Table 8.16 Money Market Transactions

Market	Volume (Rs. bn)			Interest/Yield Rates		
	2009	2010	2011	2009	2010	2011
Call Money	2,040	996	2,434	8.58-15.54	7.83-9.43	7.57-9.40
Inter-bank repo	1,162	1,128	1,099	8.29-15.01	7.05-8.53	6.88-8.34
Central Bank repo	1,786	10,723	14,490	7.50-10.90	7.25-8.25	7.00-7.58
Central Bank reverse repo	907	-	141	9.75-19.00	9.75-9.00	7.25-9.00
Central Bank Securities	1,781	1,467	-	7.50-9.62	7.25-8.85	-

Source: Central Bank of Sri Lanka

Rs. 129.44 billion and a short position of Rs. 5.38 billion during the year with an annual average of Rs. 59.8 billion. The monthly average liquidity surplus, which was over Rs. 123 billion in January dropped sharply to Rs. 13.9 billion by December 2011. The upward revision of the Statutory Reserve Ratio during the first part of the year resulted in the reduction of excess liquidity in the banking system. The purchase of Treasury bills worth Rs. 217.6 billion by the Central Bank in the primary market and the conversion of a part of the proceeds from the US dollar 1 billion Sovereign Bond issuance into rupees, contributed largely to enhance market liquidity during the second half of 2011. However, the supply of foreign exchange to the market to contain pressure in the domestic foreign exchange market as a resulting a widening of the trade deficit contributed to a gradual reduction in rupee liquidity in the market. The gross volume of daily transactions in the call market has shown a rising trend varying between Rs. 1.62 billion and Rs. 21.7 billion, showing an inverse relationship to the diminishing excess market liquidity.

The weighted average call money rate fluctuated within the policy rate corridor almost during much of the year, but increased to a level above it by year-end. The tax adjusted overnight call rate hovered within the corridor, mostly below the middle rate, throughout the year. However, with volatile market liquidity, there was increased pressure on call market rates by the end of November. In the midst of rising credit demand, the money market encountered a rather skewed liquidity distribution among commercial banks while structural issues associated with them restricted liquid banks from lending in the inter-bank market. Consequently, the call rate surpassed the upper bound of the policy rate corridor towards the end of the year. A similar trend was seen in the inter-bank repo market with the weighted average repo rate ranging from 6.88 per cent to 8.34 per cent. However, this pressure was managed successfully by the Central Bank through the injection of adequate liquidity through Open Market Operations. The weighted average call rate varied between 7.57 per cent and 9.40 per cent with an average of 8.02 per cent, having reached its peak on 21 December.

Domestic Foreign Exchange Market

The domestic foreign exchange market remained active. There were increased inflows of funds, on account of foreign direct investments, inward private remittances, proceeds from an international bond issue and an increase in exports during the year. The total value of inter-bank foreign exchange transactions in 2011 increased to US dollars 16,442 million as against US dollars 11,066 million in 2010. The daily average volume of inter-bank foreign exchange transactions was US dollars 68.5 million in 2011 as against US dollars 46.30 million in 2010, resulting in an increase of 48 per cent.

The rupee depreciated slightly against the US dollar in 2011. The Sri Lanka rupee appreciated slightly against the US Dollar during the first ten months of the year with the inflow of funds. However, during the last two months of the year, the pressure on the exchange rate increased on account of the foreign exchange outflows mainly arising from the import of petroleum at high prices that prevailed in international markets which resulted in a depreciation of the rupee. Overall, the rupee depreciated during the year against the

US dollar to Rs. 113.90 recording a 2.6 per cent depreciation from Rs. 110.95 at end 2010. The rupee appreciated against the euro and the Indian rupee by 0.1 per cent and 15 per cent, respectively. However, the Sri Lanka rupee depreciated against the Sterling pound and the Japanese yen by 2.3 per cent and 7.2 per cent, respectively. The average US dollar buying and selling rates of commercial banks for telegraphic transfers increased to Rs. 113.01 and Rs. 114.88, respectively, at the end of 2011 from to Rs. 110.20 and Rs. 112.02 recorded at the end of 2010.

The Central Bank continued to intervene in the domestic foreign exchange market in 2011, to contain excessive volatility in the exchange rate and reduce pressure in the domestic foreign exchange market. During the year, the Central Bank absorbed US dollars 343 million and injected US dollars 3,183 million. This resulted in a net supply of US dollars 2,840 million in 2011 when compared to the net supply of US dollars 67 million in 2010.

Government Securities Market

The yield rates of Treasury bills in the primary market showed an overall declining trend during the first nine months of 2011. The primary market weighted average yield rates for Treasury bills with maturities of 91 days, 182 days, and 364 days were 7.24 per cent, 7.33 per cent and 7.55 per cent at the beginning of the year, which declined to 7.15 per cent, 7.23 per cent and 7.31 per cent, respectively at end September 2011. However, market interest rates started to move upwards beginning the fourth quarter due to a shortage in liquidity in the money market. As a result, the benchmark yield on the 91 day primary market Treasury bills increased by 153 bps to 8.68 per cent, while the yields on 182 day and 364 day Treasury bills increased by 148 bps to 8.71 per cent and 200 bps to 9.31 per cent respectively, by end December 2011.

Table 8.17 Market Volumes of Government Securities

Rs. billion

Item	2009	2010	2011
Issued in the Primary Market	1,522.6	1,508.6	1,767.5
Treasury bills	821.2	1,000.1	1,164.6
Tresury bonds	701.4	508.6	603.0
Trading in the Secondary Market (as recorded in LankaSecure)	20,542.5	41,250.0	53,679.1
Treasury bills	8,048.6	21,379.7	25,023.7
Tresury bonds	12,493.9	19,870.3	28,655.4
No. of Investor Accounts at LankaSecure	64,680	73,396	76,286

Source: Central Bank of Sri Lanka

Interest rates in the Treasury bond market remained flat during the course of the first nine months of 2011. However, as market liquidity conditions started to strain during the later part of the year, Treasury bond yields also shifted upwards in line with the movement in short-term interest rates in the market. During the first nine months of 2011, the PDD was able to issue a Treasury bond with a maturity of 15 years at a yield rate of 9.30 per cent. This enabled the extension of the benchmark yield curve up to 15 years. During this period, a large volume of long dated securities was issued, as a result, of which the weighted average maturity of debt issuance during this period increased to 5.64 years from 3.90 years during the previous year.

Table 8.18 Market Yield Rates of Government Securities

Per cent per annum

Item	Primary Market 2009	Primary Market 2010	Primary Market 2011	Secondary Market 2009	Secondary Market 2010	Secondary Market 2011
Treasury bills						
91 day	7.25-17.31	7.02-8.52	6.97-8.68	7.33-17.70	6.62-8.57	6.97-8.63
182 day	8.33-18.57	6.95-9.24	7.05-8.71	8.27-18.53	6.89-9.14	7.05-8.75
364 day	9.17-19.12	7.10-9.47	7.25-9.31	9.12-19.16	7.06-9.48	7.23-9.29
Treasury bonds						
2 yrs	9.55-21.00	8.27-9.60	7.77	9.56-20.25	7.53-10.68	7.55-9.56
3 yrs	12.83-20.10	8.15-9.78	7.99	9.81-19.70	7.78-11.48	7.97-9.87
4 yrs	9.78-18.10	9.09-9.80	8.20-8.30	9.69-20.08	8.18-12.01	8.18-9.99
5 yrs	10.32-13.00	8.76-9.90	8.50-8.60	9.99-19.67	8.79-12.05	8.38-10.15
6 yrs	9.92-16.50	8.93-9.92	8.50-8.85	10.05-19.67	8.87-12.25	8.48-10.18
10 yrs	13.09-13.74	9.30-9.80	9.00-9.15	10.08-18.63	9.04-12.61	9.01-11.13
15 yrs	-	-	-	-	-	8.76-10.75

Source: Central Bank of Sri Lanka

Corporate Debt Securities Market

Commercial Paper

The level of activity in the commercial paper (CP) market increased marginally during the year. The total value of CP issued with the support of banks amounted to Rs. 14 billion in 2011 in comparison with Rs. 12 billion in 2010. The interest rate on CPs varied between 8 per cent and 13 per cent in 2011. CPs with a maturity of 3 months or less accounted for 81 per cent of the issues, while the shares of CPs with 6 month and 12 month maturities were 7 per cent and 11 per cent, respectively. The total outstanding value of CPs amounted to Rs. 7.7 billion at the end of December 2011 compared to Rs. 4.3 billion at the end of December 2010.

Corporate Bonds

The corporate bond market was relatively inactive in 2011. There was one issue of debentures amounting to Rs. 1 billion listed on the Colombo Stock Exchange (CSE) in 2011.The issue was offered at both fixed (11.60 per cent and 11.80 per cent) and floating interest rates. In addition, four debentures were issued in the market by way of introduction, which will also be listed. The trading turnover of debentures listed on the Debt Securities Trading System (DEX) of the CSE rose to Rs. 2.7 billion in 2011 from Rs. 72 million in 2010, mainly due to the listing and the subsequent trading in UDA debentures which were issued in the previous year.

Equity Market

The price indices of the Colombo Stock Exchange (CSE) declined during 2011 following an upsurge in the previous two years. The All Share Price Index (ASPI) and the Milanka Price Index (MPI) dropped by 9 per cent and 26 per cent, respectively, by end 2011. Equity prices rose to an all-time high in mid-February 2011 and moved downward thereafter, due to restrictions on credit extended by brokers, continued net foreign outflows, a liquidity drain on account of several Initial Public Offerings (IPOs), Rights Issues (RIs) and Private Placements as well as the impact of the global financial markets. The decline in the price indices resulted in a market correction following the upsurge in prices since mid-2009. The price indices of the majority of sectors declined in 2011. Consequently, the market price to earnings ratio (PER) of the CSE declined from 25 at end 2010 to 16 at end December 2011.

Chart 8.16 CSE - Share Price Indices

A positive development was the rise in IPO activity. There were 13 IPOs through which Rs.19 billion was raised and 22 rights issues through which Rs. 28 billion was mobilised during the year. The number of companies listed on the CSE increased by 30 to 272 by end December 2011. Market capitalisation, having increased to Rs. 2,214 billion at end 2011 was equivalent to 34 per cent of GDP. In terms of sectoral composition, the Banks, Finance & Insurance sector and the Diversified Holdings sector each accounted for 22 per cent of market capitalisation, while the Beverage, Food & Tobacco sector accounted for 14 per cent. The ten largest companies listed on the CSE accounted for 37 per cent of total market capitalisation. The equity turnover of the CSE declined in 2011 when compared with the previous year and stood at Rs. 546 billion. Consequently, the average daily turnover declined marginally to Rs. 2.3 billion in 2011 from Rs. 2.4 billion in 2010. Domestic investors accounted for about 89 per cent of the turnover, 97 per cent of transactions and 95 per cent of the number of shares traded on the CSE. Of them, retail investors accounted for around 55 per cent of the total turnover.

Table 8.19 Share Market Performance

Item	2009	2010	2011
All Share Price Index (a)	3,385.6	6,635.9	6,074.4
Year-on-year change (%)	125.3	96.0	(8.5)
Milanka Price Index (a)	3,849.4	7,061.5	5,229.2
Year-on-year change (%)	136.0	83.4	(25.9)
Market Capitalisation (Rs.bn)(a)	1,092.1	2,210.5	2,213.9
As a percentage of GDP (%)	22.9	39.4	33.8
Market Price Earnings Ratio (a)	16.5	25.2	15.8
Turnover to Market Capitalisation (%)	13.0	25.8	24.7
Average Daily Turnover (Rs.mn)	593.6	2,396.3	2,285.6
Value of Shares Traded (Rs.bn)	142.5	570.3	546.3
Number of Shares Traded (mn)	4,929	18,489	24,543
Number of Companies Listed	231	242	272
Introductions (b)	0	2	16
Number of Initial Public Offers/Offers for Sale (b)	3	8	13
Number of Rights Issues	14	31	22
Amount Raised through Rights Issues and Initial Public Offers (Rs.bn)	6.2	28.7	47.2

(a) End of the year

Source: Colombo Stock Exchange

(b) There are 3 methods to obtain a listing: i.e an introduction where no public issue is required, an offer for sale where already existing shares are issued to the public and an offer for subscription where new shares are issued to the public.

Foreigners were net sellers in the market, and net foreign purchases continued the downward trend which started in the latter part of 2009. Total foreign purchases and total foreign sales were Rs. 50 billion and Rs. 69 billion respectively, recording a net foreign outflow of Rs. 19 billion for the year, compared with a net foreign outflow of Rs. 26 billion in 2010.

Several measures were introduced to facilitate the smooth functioning of the stock market. In view of the large amount of unregulated credit extended by stockbrokers, the SEC introduced measures to restrict the provision of credit by stock brokers from 2011. Accordingly, stock-brokers were prohibited from providing credit to investors and were required to sell securities in arrears at T+5 days from January 2011. In addition, stockbrokers were required to clear outstanding debtor positions by 50 per cent by end March 2011 and by 100 per cent by end June 2011. The time period for clearing debtor balances was subsequently extended to end September 2011 and end December 2011. In August 2011, the SEC relaxed the prohibition on provision of stockbroker credit subject to certain prudential requirements, due to the difficulties faced by retail investors. Accordingly, stockbrokers were permitted to extend credit to investors over T+3 days based on the computation of liquid assets less obligations, maintaining leverage at zero level. Other regulatory changes included the reduction of the number of days a security is captured in the 10 per cent price band to 5 market days from 10 market days. Further, in order to promote the participation of retail investors in the stock market, the SEC implemented a policy as per which IPOs should allot a minimum of 40 per cent of the offered shares to the retail individual investors and another 10 per cent to Growth and Balanced Unit Trusts. In addition, a new Unit Trust Code has been gazetted by the SEC setting out the regulatory framework for Exchange Traded Funds (ETFs) and the CSE is working with Standard and Poor (S&P) to introduce a CSE - S&P Index to facilitate the operation of ETFs.

The CSE revised the listing rules relating to the eligibility criteria for companies listed on the Main Board and the Diri Savi Board. The capital requirement for companies listing on the Main Board was increased from Rs. 100 million to Rs. 500 million and that for the Diri Savi Board was increased from Rs. 35 million to Rs. 100 million. In addition, companies listed on the Main Board should have positive net assets for 2 years and net profits after tax for 3 years, while companies listed on the Diri Savi Board should have positive net assets for 1 year. The minimum public holding of shares was also increased to 25 per cent of issued shares for the Main Board and 10 per cent for the Diri Savi Board.

8.4 Financial Infrastructure

Payments and Settlement Systems

The LankaSettle System, operated by the Central Bank and the Cheque Imaging and Truncation (CIT) System, operated by LankaClear (Pvt.) Ltd (LCPL), are the two systemically important payment systems in Sri Lanka. The LankaSettle System consists of the Real Time Gross Settlement (RTGS) System, which facilitates real-time settlement of large value and time critical payment obligations; the LankaSecure System, which provides technological infrastructure to settle transactions in scripless government securities on Delivery versus Payment

(DvP) basis; and the Central Depository System (CDS), which is an electronic registry for recording the ownership of scripless government securities. The number of participating institutions in the LankaSettle System increased to 34 with two new Licensed Commercial Banks and one Primary Dealer obtaining membership in the system during the year.

The RTGS System continued to be the main large value inter-participant fund transferring system in the country. In terms of total transaction value, the share of RTGS transactions in non-cash payments accounted for 89 per cent. Transactions settled on a real time basis through the RTGS system included rupee payments relating to the inter-bank call money market, the government securities market, the foreign exchange market (rupee leg), open market operations, time critical third party (customer) transactions, the final settlement of net clearing balances of the cheque clearing system and the Sri Lanka Inter-bank Payment System. The total volume and value of transactions settled through the RTGS system increased by 8 per cent and 21 per cent, respectively, in 2011 when compared with the respective figures in 2010. The Central Bank continued to extend the interest-free Intra-day Liquidity Facility (ILF) to participating institutions of the RTGS system against the collateral of government securities, to support participants to meet their liquidity requirements, and in turn, reduce the liquidity risk of the system.

Table 8.20 Transactions Through Payment System

Payment systems	2010		2011 (a)	
	Volume ('000)	Value (Rs.bn)	Volume ('000)	Value (Rs.bn)
Large Value Payment Systems	**247**	**47,806**	**267**	**57,790**
RTGS System	247	47,806	267	57,790
Retail Value Payment Systems	**81,664**	**6,054**	**91,069**	**7,079**
Main Cheque Clearing System	42,795	5,346	46,012	6,202
Rupee Draft Clearing System	n.a	0.7	n.a	0.5
Sri Lanka Interbank Payment System (SLIPS)	12,530	332	12,443	422
Credit Cards	16,451	75	18,609	93
Debit Cards	5,340	16	8,346	24
Internet Banking	4,319	269	5,461	321
Phone Banking	229	5	198	5
Postal Instruments	n.a	10	n.a	11
Total	**81,911**	**53,860**	**91,336**	**64,869**
US Dollar Cheque Clearing System	57	24	55	25

(a) Provisional

Source: Central Bank of Sri Lanka

In 2011, the daily average value of ILF drawn by participants was Rs. 11.6 billion, while only Rs. 7.6 billion on average, per day was utilized.

The total value of scripless securities held by LankaSecure at end 2011 amounted to Rs. 2,680 billion accounting for 99.8 per cent of the total value of outstanding Treasury bills and Treasury bonds. These scripless securities consisted of Treasury bills of Rs. 661 billion and Treasury bonds of Rs. 2,019 billion. The LankaSecure System maintained 76,286 accounts through Dealer Direct Participants, including accounts of the corporate investors.

In 2011, the total volume of cheques cleared by the CIT system increased by 7.5 per cent to 46 million cheques and the value of cheques cleared increased by 16 per cent to Rs. 6,202 billion. The volume of cheque payments as a percentage of the total volume of non-cash payments stood at 50.4 per cent in 2011.

The Sri Lanka Interbank Payment System (SLIPS) was upgraded to a payment system with T+0 (same day) settlement in 2010. The total value of transactions cleared through SLIPS amounted to Rs. 422 billion in 2011, recording a 27.2 per cent increase over the previous year. The transaction volume of SLIPS declined marginally by 0.7 per cent to 12.4 million in 2011. In January 2011, with the intention of ensuring the efficient functioning of the system, the Central Bank issued the General Direction on Sri Lanka Interbank Payment System No. 01/2011, which relates to the responsibilities of the operator, i.e. LCPL and participants of SLIPS, and arrangements for business continuity and dispute resolution.

In order to ensure safety, efficiency and stability of mobile payment mechanisms, the Central Bank as the regulator, issued two separate sets of guidelines in March 2011. The Mobile Payments Guidelines No. 1 of 2011 for the bank-led mobile payment services and Mobile Payments Guidelines No. 2 of 2011 for custodian account based mobile payment services specified standards to be maintained by the mobile payment service providers with regard to the operations of

BOX 17

Developments in Scope of the Financial Intelligence

1. Overview

Financial Intelligence generally focuses on gathering information on financial transactions of individuals or institutions to detect transactions suspicious of, engaged in or facilitating criminal activities. It is an integrated regulatory and supervisory element to fight various unlawful activities such as drugs trafficking, corruption and bribery, money laundering and terrorist financing which are harmful to the general society. Financial intelligence mainly involves the collection of information on financial transactions, analysis of such information to detect suspicious transactions, investigation and dissemination of such information to law enforcement authorities and regulators for further investigation and regulatory action. The financial intelligence is conducted based on international recommendations, standards and best practices recommended by the Financial Action Task Force (FATF) created by G7 Summit in Paris in 1989. Financial intelligence has therefore, evolved to fight criminal/unlawful activities falling into three major categories as indicated below and a dedicated entity called "Financial Intelligence Unit" (FIU) has been operative in many countries (over 180 countries) to carry on financial intelligence.

2. Three Major Categories of Unlawful Activities

Money Laundering (ML), the first major category is the process which is used to introduce illegally earned money into the formal (financial) system to conceal its origin. Considering the increasing trend and adversity of narcotics related money laundering in early 1980s, the FATF has introduced 40 recommendations on ML in 1990 to mitigate money laundering activities worldwide. Considering the nature, trend and typologies (methods) of ML, these recommendations were revised in 1996, 2003 and 2012, respectively. After the September 11 incidents in USA in 2001, the mandate of the FATF was widened to include fight against terrorist financing, the second major category. The FATF has therefore, introduced 8 special recommendations on terrorist financing in October 2001. The ninth special recommendation was added in 2004. Hence, the FATF as well as financial intelligence scope was expanded to 40+9 recommendations on money laundering and terrorist financing since end of 2004. Considering the latest threats to the global security, the FATF took initiatives to revise 40+9 recommendations into 40 recommendations at the end of 2011. Accordingly, the mandate of the FATF was further widened to include the financing of the proliferation of weapons of mass destruction, the third major category while strengthening the fight against money laundering and terrorist financing since February 2012. The proliferation is identified as a most serious security concern globally and, therefore, the FATF has adopted a new recommendation (recommendation 7 under revised recommendations) aimed at ensuring effective implementation of sanctions declared by the United Nations Security Council.

3. Revision of FATF Recommendations

In February 2012, the FATF re-classified existing 40+9 recommendations into 40 recommendations. Further, 40 recommendations were classified into 7 categories to cover; (a) Policies for anti-money laundering/combating financing of terrorism and co-ordination; (b) Money laundering and confiscation; (c) Terrorist financing and financing of proliferation; (d) Preventive measures; (e) Transparency and beneficial ownership of legal persons and arrangements; (f) Powers and responsibilities of competent authorities and other institutional measures; and (g) International co-operation.

In addition, the risk-based approach introduced in 2007 as against the traditional rule-based approach in complying with anti-money laundering and countering the financing of terrorism, was strengthened to enable financial institutions to focus more on areas involving higher risk of money laundering and terrorist financing. The FATF revised recommendations further strengthened the methods to identify Corruption and Politically Exposed Persons (PEPs-who may represent higher risk of corruption in terms of the position they hold). The existing requirements which were applied only to foreign PEPs were expanded to cover domestic PEPs, family and close associations of all PEPs and PEPs from international organizations. The list of unlawful activities under money laundering has also been expanded to include serious tax crimes with revised recommendations. The smuggling offences has also been classified to include offence related to customs, excise duties and taxes.

4. Benefits of Compliance

From February 2012, all FATF members and the members of the FATF Styled Regional Bodies (FSRBs) such as Asia Pacific Group on Money Laundering (APG) are required to implement the revised 40 recommendations. The FSRBs will monitor compliance of member countries in terms of revised recommendations and the progress achieved in each member country is reported to the FATF. The identification of high risk and non-cooperative countries by FATF will be made on the basis of such reports. The decision of the FATF on particular countries will be published at the end of each FATF meeting (held in February and June each year) and the countries with low progress will face counter measures by fellow member countries. Accordingly, the financial intelligence has evolved/developed towards fighting against activities connected with money laundering, financing of terrorism and proliferation which are carried on with global links. Therefore, financial intelligence is instrumental in promoting and protecting the socio-economic well-being of the general public.

the mobile payment systems, including registration of customers, customer education, appointing and supervising agents, information security and business continuity arrangements.

In 2011, with the intention of standardizing the practices of credit card issuers, the Payment Card Industry Association of Sri Lanka (PCIASL) issued a common code of conduct for the card issuers, in consultation with the Central Bank. In addition, the Central Bank initiated action for the establishment of a Common Card and Payment Switch (CCAPS) which will provide a national level platform for clearing and settlement of electronic retail payments. CCAPS will improve efficiency through reducing transaction clearing and settlement time. It will also enable retail payment system operators to share payment system infrastructure such as Automated Teller Machines (ATMs) thereby reducing transaction costs.

Credit Information

The Credit Information Bureau (CRIB) provides credit information reports on borrowers to member institutions. The CRIB had 93 reporting credit institutions as its members in 2011, with a database containing information on about 4 million borrowers. The CRIB issued 2,275,924 credit reports in 2011 compared with 1,580,782 reports in 2010. The CRIB expanded its operations by establishing a registry for movable property under the provisions of the Secured Transaction Act in 2011. This would facilitate borrowing against movable assets as collateral and would be particularly beneficial for the small and medium enterprise sector.