8

FINANCIAL SECTOR PERFORMANCE AND SYSTEM STABILITY

8.1 Overview

In 2015, the financial sector showed improved performance, reflecting the underlying economic performance and supportive prudential regulatory measures, which has led to further strengthening the financial system stability of the country. The improved performance was reflected in leading indicators of financial institutions, financial markets and payment and settlement systems.

As regards the financial institutions, the banking sector total assets increased by 15.9 per cent in 2015, against the 17.3 per cent growth in 2014, to record Rs. 8.1 trillion at the end of the year, while the off-balance sheet exposure showed a growth of 8.1 per cent to reach Rs. 3.4 trillion. Increased rupee lending activities of domestic banks, funded mainly through customer deposits, was the key of the asset growth. Assets quality of the sector improved further in 2015 as reflected by the non-performing loan (NPL) ratio falling to 3.2 per cent at the end of 2015 from 4.2 per cent in 2014. The operating profits showed a growth of 10.3 per cent and profitability as measured by Return on Assets (ROA) and Return on Equity (ROE) at levels in previous year. The Statutory Liquid Assets Ratio (SLAR) of the domestic banking sector at around 33 per cent continued to be much higher than the minimum statutory requirement of 20 per cent. Along with the growth in total assets, the total risk weighted capital adequacy ratio (CAR) of the sector declined to 14.2 per cent at the end of 2015 from 16.6 per cent in 2014. The licensed finance companies (LFCs) and specialised leasing companies (SLCs) sector showed 22.3 per cent sharp growth in its total assets to Rs. 996 billion at the end of 2015 with improved assets quality reflected in the NPL ratio, which decreased to 5.7 per cent from 6.9 per cent in 2014. The sector operated with lower market risk exposure and healthy levels of liquidity. As regards the profitability, sharp increase in operational costs during the year affected the ROA and ROE of the sector, which decreased marginally by 10 basis points and 170 basis points, respectively, to 3.0 per cent and 12.3 per cent, respectively. Total CAR of 11.2 per cent of the sector at the end of 2015 was a decrease from 13.5 per cent in 2014. The primary dealer industry showed 44.7 per cent growth in total assets and moderate increase in profit levels. The growth in contractual savings institutions sector secured a reasonable return as revealed mainly by the return on investments of 11.3 per cent of the Employees' Provident Fund (EPF) and 9.3 per cent of Employees' Trust Fund (ETF) in spite of the low market interest rates. Other non-banking financial institutions also recorded growth but mixed operating performances given their business models and the financial market conditions prevailed.

During the year, domestic financial markets operated with relatively high volatility consequent to monetary and balance of payment conditions emanated partly from global developments. The domestic money market recorded gradual decline in excess rupee liquidity to Rs. 105 billion at the end of 2015 from Rs. 331 billion in 2014 and the weighted average call money market rate behaved in the range of 5.80 – 7.00 per cent range in 2015 compared to 5.72 – 7.68 per cent range in 2014. The domestic foreign exchange market recorded decreased volumes where the excess volatility in the exchange rate of the rupee against the US dollar was stabilised through normal intervention supported by foreign reserves. However, increased demand for US dollar and subsequent to the policy decision in September 2015 to accommodate greater flexibility to the market in determination of exchange rate, the rupee depreciated by about 9.0 per cent against the US dollar. In the government securities market, the benchmark yield rate on 364 - day Treasury bills increased by 130 basis points at the end of 2015 from end 2014 as a result of substantial withdrawals of investments in Treasury bills and bonds by foreigners and also due to the increase of statutory reserve requirement by 150 basis points in December 2015. In the Colombo Stock Exchange (CSE), all share price index declined 5.5 per cent to 6,894 points by end 2015 from 7,299 points in 2014 while market capitalisation was dropped by 5.4 per cent to Rs. 2.9 trillion at the year end.

Meanwhile, large and retail value national payments systems of the country operated smoothly without any major disruption and stability concerns while facilitating the growing and changing payment needs of the financial sector with improved efficiency and safety. The total value of large value transactions settled through the Real Time Gross Settlement (RTGS) System increased by 41.8 per cent to Rs. 84.4 trillion while the value of retail transactions settled through retail value payment systems increased by 13.3 per cent to Rs. 11.1 trillion in 2015.

As regards the new prudential regulations, a number of regulatory policies were introduced in 2015 to further strengthen the risk management and public confidence in the financial sector. Implementation of Liquidity Coverage Ratio under Basel III Liquidity Standards for licensed banks, a maximum loan-to-value ratio

Table 8.1 Total Assets of the Financial System

	2014 (a)		2015 (b)	
	Rs. bn	Share (%)	Rs. bn	Share (%)
Banking Sector	**8,442**	**70.3**	**9,503**	**69.6**
Central Bank	1,471	12.2	1,426	10.4
Licensed Commercial Banks (LCBs)	5,884	49.0	6,974	51.1
Licensed Specialised Banks (LSBs)	1,087	9.1	1,103	8.1
Other Deposit Taking Financial Institutions	**857**	**7.1**	**1,042**	**7.6**
Licensed Finance Companies (LFCs)	743	6.2	915	6.7
Co-operative Rural Banks	103	0.8	116	0.8
Thrift and Credit Co-operative Societies	11	0.1	11	0.1
Specialised Financial Institutions	**441**	**3.7**	**544**	**4.0**
Specialised Leasing Companies (SLCs)	72	0.6	81	0.6
Primary Dealers	195	1.6	283	2.0
Stock Brokers	11	0.1	10	0.1
Unit Trusts / Unit Trust Management Companies	127	1.1	130	1.0
Market Intermediaries (c)	29	0.2	32	0.2
Venture Capital Companies	7	0.1	8	0.1
Contractual Savings Institutions	**2,275**	**18.9**	**2,573**	**18.8**
Insurance Companies	414	3.4	454	3.3
Employees' Provident Fund	1,487	12.4	1,665	12.2
Employees' Trust Fund	199	1.7	223	1.6
Approved Pension and Provident Funds	134	1.1	185	1.4
Public Service Provident Fund	41	0.3	46	0.3
Total	**12,015**	**100.0**	**13,662**	**100.0**

Source: Central Bank of Sri Lanka

(a) Revised
(b) Provisional
(c) Includes Underwriters, Investment Managers and Margin Providers

of 70 per cent in respect of loans and advances granted for the purpose of purchase or utilisation of motor vehicles by banks and LFCs and SLCs, and a new regulatory framework for opening, closure and relocation of branches and other outlets of LFCs and SLCs were the main regulatory policies introduced to the banking and LFCs and SLCs sectors. Issuance of a directives to all insurance companies to settle duly established insurance claims within 60 days, risk based solvency margin (capital adequacy) rules, and requirering all insurance brokers to maintain a minimum net capital were the other major regulatory policies.

8.2 Performance of the Banking Sector

As the systemically most important sector in the domestic financial system, the banking sector continued to expand its asset base, risk management capabilities and also the risk absorption capacities in line with prudential regulations of the Central Bank during 2015. The asset base of the banking sector, which reached Rs. 8.1 trillion by end 2015, expanded by 15.9 per cent in 2015, although at a slower rate than the 17.3 per cent reported in 2014. The increase in assets was mainly attributed to the increase in loans and advances, which accounted for nearly 74.2 per cent of the increase in total assets. The increase in assets was mainly funded by a growth in deposits accounting for 66.9 per cent of the liability base. Meanwhile, borrowings during the year, which accounted for 21.8 per cent of the total liabilities of the banking sector, primarily consisted of foreign borrowings from foreign sources. The banking sector managed to maintain its liquidity and capital at comfortable levels during the year, while prudently managing its credit, market, interest rate and liquidity risks.

Business Growth

(a) Outreach: The banking sector consisted of 25 Licensed Commercial Banks (LCBs) and 7 Licensed Specialised Banks (LSBs) by end 2015. There were

Table 8.2 Distribution of Banks and Bank Branches

Category	End 2014 (a)	End 2015 (b)
Licensed Commercial Banks (LCBs)		
I. Total No. of LCBs	**25**	**25**
Domestic banks	13	13
Foreign banks	12	12
II.Total No. of LCB Banking Outlets	**5,764**	**5,784**
Branches	**2,893**	**2,914**
Domestic Banks	2,672	2,694
Foreign Banks	221	220
Student Savings Units	**2,871**	**2,870**
Automated Teller Machines	**3,069**	**3,265**
Licensed Specialised Banks (LSBs)		
I. Total No. of LSBs	**9**	**7**
National Level Regional Development Bank	1	1
National Level Savings Banks	1	1
Long-term Lending Institutions	1	0
Housing Finance Institutions	2	2
Private Savings and Development Banks	4	3
II. Total No. of LSB Banking Outlets	**827**	**799**
Branches	**652**	**624**
National Level Regional Development Bank	255	255
National Level Savings Banks	219	223
Long-term Lending Institutions	21	0
Housing Finance Institutions	56	57
Private Savings and Development Banks	101	89
Student Savings Units	**175**	**175**
Automated Teller Machines	**270**	**293**
Total No. of Bank Branches and Other Outlets	**6,591**	**6,583**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

12 branches of foreign banks within the total number of LCBs. The banking sector continued its support to economic growth and development throughout the year by enhancing its banking services and expanding its network and accessibility throughout the island. Accordingly, 32 new banking outlets, including students savings units, were opened and 219 new Automated Teller Machines (ATMs) were installed in 79 locations during the year. By end 2015, there were 6,583 banking outlets and 3,558 ATMs spread throughout the island for efficient banking operations. During the year, DFCC Bank merged with DFCC Vardhana Bank to form DFCC Bank PLC, while MBSL Savings Bank Ltd., Merchant Bank of Sri Lanka PLC and MCSL Finance Services Ltd. amalgamated to form one Licensed Finance Company, namely, Merchant Bank of Sri Lanka & Finance PLC. Further, approval was granted to open a representative office of a Japanese bank in Sri Lanka, a foreign branch in Bengaluru, India and a

banking subsidiary in the Republic of Maldives. Meanwhile, one LCB commenced operations of its representative offices in Myanmar.

(b) Assets: The asset portfolio of the banking sector continued to expand during the year, reaching Rs. 8.1 trillion by end 2015. The asset portfolio mainly consisted of loans and advances, which accounted for 58.4 per cent of the banking sector assets. Loans and advances were extended to all major sectors with a higher concentration in construction, trading, manufacturing and agriculture & fishing sectors. The pawning portfolio contracted during the year due to subdued gold prices globally. Almost 85 per cent of the increase in the loan portfolio was attributed to rupee loans. The investments portfolio accounted for 29.1 per cent of the asset portfolio and grew at a rate of 21.8 per cent (Rs. 420.1 billion) during 2015. However, the loan portfolio contributed to the larger increase of the total asset portfolio increasing by 21.1 per cent (Rs. 820.7 billion) during 2015 compared to 13.7 per cent in the previous year.

(c) Liabilities: The asset portfolio was mainly funded by deposits, which accounted for 66.9 per cent of the total liabilities base. The deposit base of the banking sector increased mainly due to the increase in the term deposits denominated in Sri Lankan rupees due to higher interest rates offered for deposits of senior citizens and competitive pricing by banks. However, the share of term deposits as a percentage of total deposits declined marginally to 57.0 per cent from 57.7 per cent in 2015. Meanwhile, there was a notable increase in savings and current account deposits during the year growing at a rate of 18.3 per cent and 17.2 per cent, respectively. The increase in term and savings deposits was partly attributed to higher domestic real interest rates. The current accounts and savings accounts (CASA) ratio increased marginally in 2015. Borrowings were largely funded by foreign sources during the year. Foreign borrowing increased by Rs. 213 billion contributing to 69.0 per cent of the increase in total borrowings. This was partly due to the exemption of US dollars 50 million from the regulatory threshold of each bank for raising foreign funds to facilitate the budget proposal of 2013. Rupee borrowings were mainly through repo borrowings.

Table 8.3 Composition of Assets and Liabilities of the Banking Sector

Item	2014 (a)		2015 (b)		Change (%)	
	Rs. bn	Share (%)	Rs. bn	Share (%)	2014	2015 (b)
Assets						
Loans & Advances	3,895	55.9	4,715	58.4	13.7	21.1
Investments	1,928	27.6	2,348	29.1	13.7	21.8
Other (c)	1,149	16.5	1,014	12.5	40.2	(11.8)
Liabilities						
Deposits	4,686	67.2	5,403	66.9	12.4	15.3
Borrowings	1,448	20.8	1,758	21.8	42.6	21.4
Capital Funds	569	8.2	637	7.9	16.1	12.0
Other	269	3.8	279	3.4	0.7	3.9
Total Assets/ Liabilities	6,972	100.0	8,077	100.0	17.3	15.9

(a) Revised
(b) Provisional
(c) Includes cash and bank balances, placements, reverse repurchase agreements and fixed assets.

Source: Central Bank of Sri Lanka

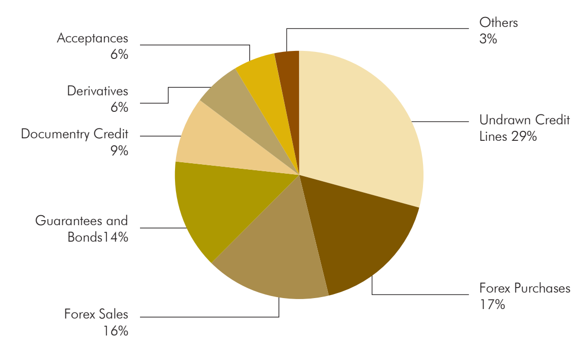
Table 8.4 Composition of Deposits of the Banking Sector

Item	Amount (Rs. bn)		Composition (%)	
	2014	2015 (a)	2014	2015 (a)
Demand Deposits	381	446	8.1	8.3
Savings Deposits	1,462	1,730	31.2	32.0
Time Deposits	2,704	3,080	57.7	57.0
Other Deposits	139	147	3.0	2.7
Total Deposits	**4,686**	**5,403**	**100.0**	**100.0**

(a) Provisional

Source: Central Bank of Sri Lanka

Chart 8.1 Off-Balance Sheet Exposures of the Banking Sector (as at end 2015)

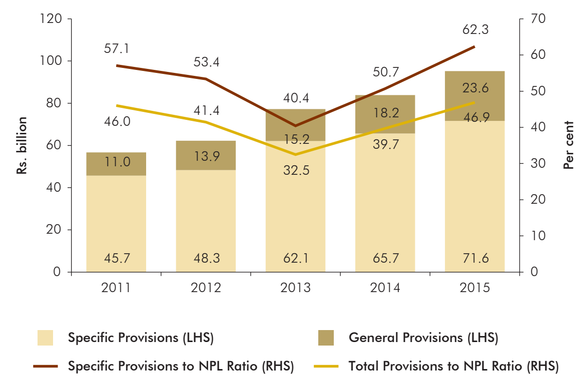


(d) Off-Balance Sheet Exposure: Off-balance sheet exposure increased by 8.1 per cent (Rs. 251 billion) during the year to Rs. 3,359 billion when compared to an increase of 4.5 per cent (Rs. 134 billion) during the previous year. The off-balance sheet exposure mainly consisted of undrawn credit lines (29.2 per cent), forward foreign exchange purchases (16.9 per cent) and sales (16.3 per cent), and guarantees and bonds (14.3 per cent), which collectively accounted for 76.7 per cent of the off-balance sheet exposures. Documentary credit, acceptances, derivatives, and other off-balance sheet exposures contributed to the remaining 23.3 per cent of the total off-balance sheet exposure.

Risks in the Banking Sector

(a) Credit Risk: Risk weighted assets for credit risk in the banking sector increased during the year with increased lending and expansion of the banks' loan portfolios. However, due to aggressive credit recovery policies adopted by the banks, including the recovery of non-performing pawning advances, the gross NPLs ratio declined to 3.2 per cent at the end of 2015 from 4.2 per cent in 2014 and such reduction was reflected in NPL ratios across major economic sectors. The volume of gross NPLs declined by Rs. 12.7 billion. Total loan loss provisions were increased by Rs. 11.3 billion mainly with an increase in the specific provisions made for NPLs in the loss category, leading to a specific provision coverage ratio of 46.9 per cent at the end of 2015 compared with 39.7 per cent at the end of 2014.

Chart 8.3 Provisioning for NPLs of the Banking Sector



However, there was no notable concentration risk in the credit portfolio with credit being primarily distributed among the construction (16.8 per cent), trading (14.8 per cent), manufacturing (10.7 per cent), and agriculture & fishing (9.1 per cent) sectors, which accounted for more than 51.4 per cent of the total credit portfolio.

(b) Market Risk: Total risk weighted assets for market risk in the banking sector was increased during 2015 to Rs. 124 billion from Rs. 104 billion as at end 2014 due to increase in foreign currency risk resulting in an increase in the capital charge.

Chart 8.2 NPLs of the Banking Sector

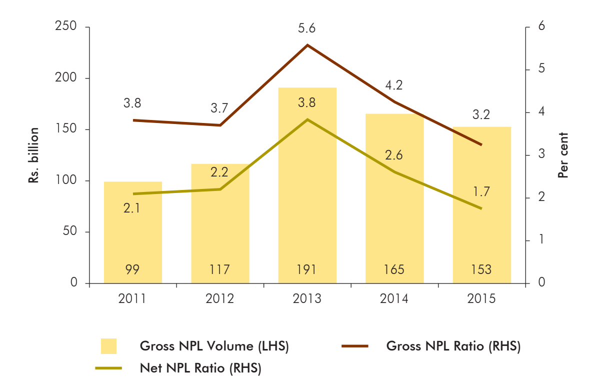
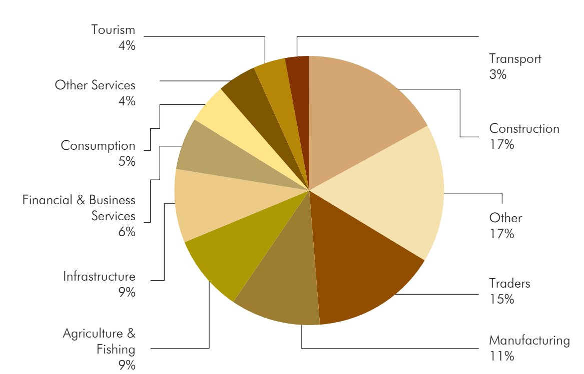


Chart 8.4 Credit Exposure of the Banking Sector (as at end 2015)



BOX 11 Cyber Risk Management in Banks

1. Introduction

Banks became heavy adopters of Information Technology (IT) during the latter part of the 20th century, with the aim of achieving significant improvements in efficiency through automation. The emergence of internet and cyber technologies enabled the extension of banking services to the customer's doorstep, allowing banks to make further gains in operational efficiencies. The reliance on IT and cyber space for delivery of banking services and the catastrophic impact on a bank during a failure, have raised the need for separate recognition and management of cyber risks.

2. Technology adoption in the banking industry

Key milestones of technology adoption in the banking industry are listed below:

- Introduction of computerized transaction processing, which moved transactions from hand written ledger books to computer based systems
- Use of automated teller machines (ATMs)
- Centralized core-banking systems, which are the back-end data processing applications used to provide banking services to customers and post end of the day balances to financial accounts
- Creation of information exchanges through which the banks and other lending institutions can gain insights about the credit-worthiness of potential borrowers
- Emergence of virtual banking with the introduction of internet and mobile banking systems and electronic payment platforms

3. What are cyber risks?

Cyber risk refers to the risk of financial loss, operational disruption or reputational damage due to some kind of failure in IT systems. Cyber risk is also defined as the risk connected to online activity, electronic systems, communication networks and electronic storage of personal data.

4. Main types of cyber threats

- **Hacking/Intrusion attacks:** In a hacking attack the hackers break into secure networks/systems to destroy, modify, or steal data; or to conduct unauthorized transactions through compromised systems.
- **Distributed Denial of Service (DDoS) attacks:** In this case, a targeted system is disrupted by directing a large flow of traffic to overwhelm it, thereby denying access to legitimate users.
- **Malware:** A malware attack involves the use of malicious software to control or disrupt the operations of a targeted system or device, malware can exist in many forms, such as viruses and worms, and can cause harm in different ways.
- **Social engineering:** Psychological manipulation of people into performing actions or divulging confidential information is referred to as social engineering.
- **Phishing:** One of the most common forms of social engineering attacks, phishing is the use of a fake website/email address to induce an unsuspecting user to divulge sensitive information.

5. How do cyber risks affect banks?

Banks can suffer different types of losses due to cyber risks. A direct financial loss will happen when attackers intrude in to the bank's computer network and execute unauthorised fund transfers. Another significant threat faced due to an intrusion is the leakage of confidential customer information available with the bank. A bank's whole IT infrastructure can become crippled in the face of a DDOS attack or even due to an internal failure, which can make all delivery channels of the bank inoperative. Further, a bank's inability to introduce effective counter measures to social engineering attacks can easily erode the trust of customers.

6. Major cyber risk incidents reported from banks

- **New York's Union Dime Savings Bank embezzlement in 1973:** One of the first cyber security incidents in banking and financial services is the 1973 embezzlement of over USD 1.5 million from the New York's Union Dime Savings Bank by a supervisor of tellers who manipulated accounts data in the bank's computer system.
- **Royal Bank of Scotland (RBS) IT meltdown:** In 2012, RBS banking group experienced a total IT meltdown due to a failed software update that lasted for more than 6 days. The meltdown kept more than 6.5 million customers without access to their accounts. The RBS group was later fined GBP 56 million for this incident by the UK financial regulators.
- **JPMorgan Chase data breach:** In 2014, the American bank JPMorgan Chase suffered a data breach due to a cyber-attack. The incident is believed to have compromised data associated with over 83 million customer accounts and was considered as one of the largest data breaches in history.

- **Carbanak attack:** In 2015, the Interpol and the Kaspersky Lab (a company specialising in computer security solutions) reported that up to US$ 1 billion were stolen from at least 100 banks in 30 countries, by a multinational gang of cybercriminals using an advanced persistent threat (APT) attack known as "Carbanak".
- **Bangladesh Central Bank attack:** In February 2016, hackers pretending to be officials of the Central Bank of Bangladesh, managed to transfer money worth USD 101 mn from the account of Bangladesh Bank held at the Federal Reserve Bank of New York to private bank accounts in Sri Lanka and Philippines. The hackers had attempted to effect 35 fund transfers amounting to USD 1 bn.

The experience of the Sri Lankan banking sector on cyber risks remains in line with the international experience. However, with wide scale technology adoption - specially in areas like internet banking and mobile banking, Sri Lanka has been fortunate to experience only a handful of serious cyber security incidents. Social engineering and phishing attacks have gained the top position in terms of the frequency of occurrence.

7. Cyber risk management systems

Individual banks as well as the Government and the Central Bank of Sri Lanka (CBSL) have been continuously implementing different cyber risk management procedures, including the following measures adopted in the recent past:

- **Baseline security standards:** In 2014, CBSL issued the Baseline Security Standards (BSS) on Information Security Management as a risk management directive to all licensed banks. The BSS is based on ISO 27001 standard on Information Security and covers 14 domains including Organization of Information Security Management, Information Security Policy, Information Asset Management, Operations Security and Information Security Incident Management.
- **Computer security incident response team:** In anticipation of increased cyber security incidents, Sri Lanka Computer Emergency Readiness Team | Co-ordination Center (SLCERT|CC) was established as Sri Lanka's National CERT, which is mandated to protect Sri Lanka from cyber risks. In 2014, CBSL together with SLCERT|CC and the banking sector established the Bank Computer Security Incident Response Team (BankCSIRT) which is now known as FinCSIRT and acts to assist banks and financial institutions in handling cyber risks.

8. Responsibilities of bank customers

It is the responsibility of customers to remain vigilant regarding all banking facilities obtained. They should at least ensure basic precautionary measures such as keeping the ATM card and personal identification number (PIN) secure and keeping their credit cards in safe custody and using them only for secure online transactions. Further, when subscribing to internet and email banking services, it is the customer's responsibility to evaluate the security features made available by banks before selecting a service and to safeguard user credentials. It is also important that customers verify the emails received from banks, since a large number of fake emails pretending to be from online banking services are used to steal customer credentials.

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1. https://www.theirm.org/
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Interest Rates: Market interest rates moderated during the year, increasing bond prices resulting in a net capital gain of Rs. 4 billion from the sale of Treasury bonds. This moderation helped to reduce the re-pricing risk in the banking sector. The cumulative rate sensitive gap of the banking sector, i.e. the gap between the rate sensitive assets and liabilities as a percentage of the rate sensitive assets up to 12 months' time bucket widened to negative 17.5 per cent at end 2015 compared to negative 13.0 per cent at end 2014.

Prices of Equity: Equity risk of the banking sector remained at low levels during the year as well as at the end of 2015 as the banking sector exposure to the equity market in the form of investments in listed shares was minimal at Rs. 30.9 billion. This accounted for only 6.2 per cent and 1.3 per cent, respectively, of total investments and total assets of the banking sector.

Foreign Currency Risk: The foreign currency risk of the banking sector increased during the year with expanded borrowings from foreign sources. The foreign currency borrowings were 61.3 per cent of total borrowings at end 2015 and the banking sector reported a positive foreign currency exposure of Rs. 9 billion. The aggregate foreign currency net open position as a percentage of the banks' regulatory capital continued to remain at 1.4 per cent at the end of 2015 and such exposure represented about 0.1 per cent of the total on-balance sheet assets of the sector by end 2015. The banking sector, with its positive net open position in foreign exchange, reported a net gain of Rs. 12 billion at the end of 2015 as a result of the depreciation of the rupee against the US dollar.

(c) Liquidity Risk: The excess liquidity in the banking sector witnessed in 2014 continued to remain high during 2015 amidst increasing lending activities of the sector. The statutory liquid assets maintained to meet financial obligations were at high levels. The Statutory Liquid Assets Ratios (SLARs) of the Domestic Banking Units (DBUs) and Off-shore Banking Units (OBUs) were maintained well above the minimum statutory level at 33.8 per cent and 41.1 per cent, respectively, at the end of 2015. However, SLAR of DBUs decreased by 566 basis points during the year as a result of increased lending activities and this was reflected in the loans to deposits ratio of the banking sector, which increased to 87.3 per cent at the end of 2015 from 83.1 per cent in 2014. Liquid assets to total assets decreased by 217 basis points while liquid assets to deposits decreased by 301 basis points during the year. Total liquid assets stood at Rs. 2.4 trillion mainly consisting of Treasury bills, Treasury bonds, Sri Lanka Development Bonds (SLDBs), balances with banks abroad and money at call contributing to 90.5 per cent of total liquid assets.

The cumulative maturity gap as a percentage of cumulative liabilities of the banking sector narrowed for the maturity time periods (buckets) less than 30 days and widened for maturity time periods greater than 3 months.

The Liquidity Coverage Ratio (LCR) for rupee liquidity requirements and all currency liquidity requirements of the banking sector stood at 237.1

Table 8.5 Composition of Statutory Liquid Assets of the Banking Sector

Item	2014 (a)		2015 (b)		Change (Rs. bn)	
	Rs. bn	Share (%)	Rs. bn	Share (%)	2014	2015 (b)
Treasury Bills	578	25.8	682	28.1	293	104
Treasury Bonds	792	35.3	680	28.1	368	-112
Sri Lanka Development Bonds	390	17.4	463	19.1	173	73
Cash	97	4.3	116	4.8	24	19
Money at Call	106	4.7	142	5.9	60	35
Balance with Banks	188	8.4	226	9.3	-22	38
Other	92	4.1	114	4.7	-12	22
Total Liquid Assets	**2,243**	**100.0**	**2,423**	**100.0**	**884**	**180**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Chart 8.5 Liquidity Ratios of the Banking Sector

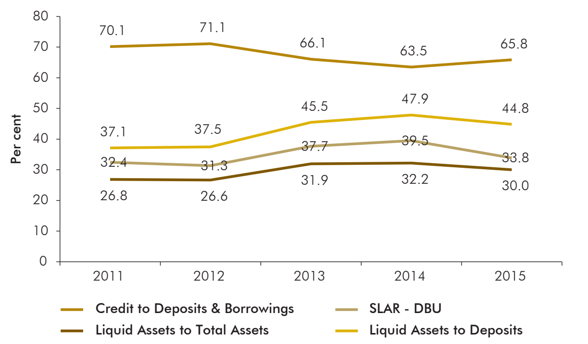
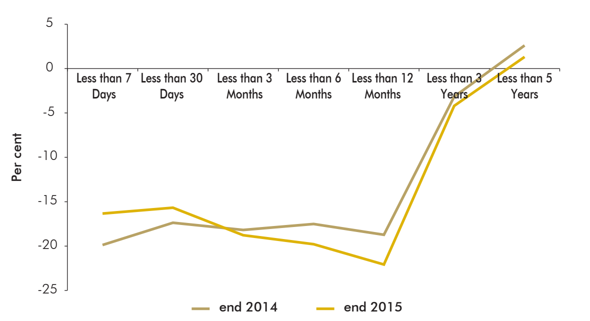


Chart 8.6 Cumulative Maturity Gap as a percentage of the Cumulative Liabilities of the Banking Sector



per cent and 157.0 per cent at end 2015, well above the stipulated statutory minimum requirement of 60 per cent.

Profitability and Capital Resources

(a) Profitability: The banking sector recorded increased level of profits in 2015 compared to the year 2014. Accordingly, the profit after tax of the sector amounted to Rs. 97.0 billion in 2015, an increase of 10.3 per cent from Rs. 88.0 billion recorded in 2014. However, the profitability ratios of the sector declined marginally during the year due to high increase in the assets base and capital base of the banking sector to meet the minimum regulatory requirements. Accordingly, ROA decreased by 10 basis points to 1.3 per cent from its 2014 level of 1.4 per cent, while ROE decreased by 50 basis points to 16.1 per cent from the 2014 level of 16.6 per cent. The growth in profits can be attributed to the healthy growth in net interest income (NII) of the banking sector, which increased by 20.1 per cent in 2015, mainly due to the decrease in interest expenses by 4.5 per cent, arising from declining interest expenses on deposits. However, NII as a per cent of average assets, i.e. net interest margin (NIM) remained unchanged during 2015. Net non-interest income in comparison to 2014 recorded a marginal decline in 2015 due to higher capital gains on Treasury bonds reported in 2014. However, non-interest expenses increased significantly by 11.3 per cent in 2015 due to increase in staff costs. In spite of the increased non-interest expenses, the efficiency ratio of the banking sector improved by 50 basis points in 2015.

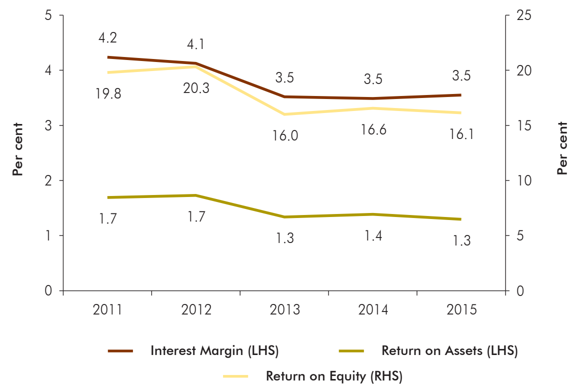
Table 8.6 Profit of the Banking Sector

Item	2014 (a) Amount (Rs. bn)	2014 (a) As a % of Avg Assets	2015 (b) Amount (Rs. bn)	2015 (b) As a % of Avg Assets
Interest Income	561	8.8	591	7.9
Interest Expenses	340	5.4	325	4.3
Net Interest Income	**221**	**3.5**	**266**	**3.5**
Non-Interest Income	98	1.5	97	1.3
Foreign Exchange Income	19	0.3	27	0.4
Non-Interest Expenses	160	2.5	178	2.4
Staff Cost	77	1.2	89	1.2
Loan Loss Provisions	13	0.2	19	0.3
Profit before Tax (after VAT)	**126**	**2.0**	**140**	**1.9**
Profit after Tax	**88**	**1.4**	**97**	**1.3**

(a) Revised
(b) Provisional

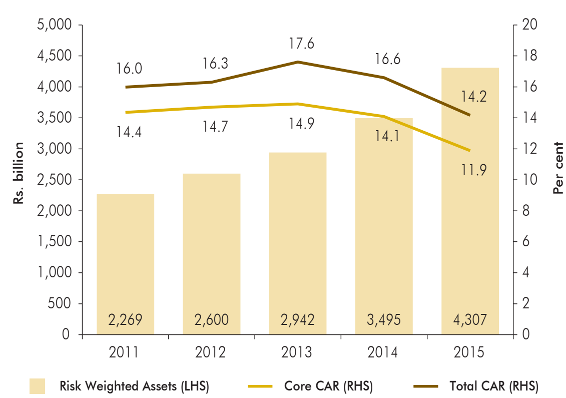
Source: Central Bank of Sri Lanka

Chart 8.7 Profitability Indicators of the Banking Sector



(b) Capital: Overall capital funds of the banking sector improved during 2015, thus increasing the cushion available in the sector for absorbing risks arising from adverse shocks. The Capital Adequacy Ratios (CAR) of individual banks were at a level higher than the minimum regulatory requirements. The core CAR and total CAR, inclusive

Chart 8.8 Capital Adequacy Ratio of the Banking Sector



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FINANCIAL SECTOR PERFORMANCE AND SYSTEM STABILITY

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Table 8.7 Composition of Regulatory Capital of the Banking Sector

Item	Amount (Rs. bn)		Composition (%)	
	2014 (a)	2015 (b)	2014 (a)	2015 (b)
Tier I Capital	512	512	100.0	100.0
Share Capital	166	166	32.3	32.4
Statutory Reserve Funds	29	35	5.7	6.8
Retained Profits	196	170	38.3	33.3
General and Other Reserves	146	148	28.5	28.9
Other	0	18	0.0	3.4
Regulatory Adjustments	-25	-25	-4.8	-4.8
Tier II Capital	88	99	100.0	100.0
Revaluation Reserves	13	14	14.6	14.2
Subordinated Term Debt	77	80	87.6	81.5
General Provisions and Other	15	20	17.2	20.5
Regulatory Adjustments	-17	-16	-19.4	-16.2
Total Regulatory Capital Base	600	611	100.0	100.0

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

of estimated profits for 2015, and also considering past dividend pay-out patterns, are estimated at about 11.9 per cent and 14.2 per cent, respectively. The regulatory capital was composed of Tier I and Tier II capital of which Tier I capital contributed to nearly 83.8 per cent of the total regulatory capital. Tier I capital constituted primarily of equity capital, i.e. share capital, retained earnings, and general and other reserves. Almost 81.5 per cent of Tier II capital comprised subordinated term debt, while the revaluation reserve represented a lower share of 14.2 per cent. The banking sector was strengthened due to infusion of new capital in the form of subordinated term debts and retained earnings to maintain capital at a sustainable level as per the prudential regulatory requirements.

Supervisory and Regulatory Developments

The Central Bank further strengthened its supervisory and regulatory framework for banks to improve the safety and soundness and also the risk management systems in banks. In addition to continued supervisory measures through examination and resolution of regulatory issues of individual banks, the Central Bank took regulatory measures in 2015 to further strengthen the liquidity risk management of banks while continuing to engage in its consultative process with banks to strengthen the risk absorbing capacity of individual banks. Accordingly, Directions on LCR under Basel III Liquidity Standards for licensed banks were issued requiring individual banks to maintain a minimum LCR of 60 per cent against the estimated net cash outflow in the next 30 calendar days, commencing 01 April 2015 and also to increase the minimum LCR up to 100 per cent by 01 January 2019 on a staggered basis. Further, a consultation paper on implementation of Basel III minimum capital requirements and leverage ratio was issued to banks for their observations and the final standard on the same is expected to be issued in due course. Considering the potential impact of delayed inflow of export proceeds into the banking system, the charge of enhanced interest on accommodation to exporters was re-imposed with the interest rate reduced from 10 per cent to 5 per cent in the new circular. With a view to avoid any excessive risk accumulation, a maximum loan-to-value ratio of 70 per cent was imposed on loans and advances granted by licensed banks for the purpose of purchase or utilisation of motor vehicles, commencing from 01 December 2015. In the meantime, the Central Bank continued its effort to enhance access to banking in line with the proposals outlined in the Interim Budget-2015. Accordingly, licensed banks were apprised to focus on enhancing access to banking by way of opening branches in remote areas, making efforts to initiate bank accounts for all citizens and simplifying lending operations.

BOX 12
New Regulatory and Supervisory Approaches in Ensuring the Safety and Soundness of Banks

1. Introduction

The bank regulators seek to promote the safety and soundness of banks and the banking system, through regulation and supervision. The Global Financial Crisis and the subsequent European Crisis emphasized the need to factor in the build-up of risks and concentrations during economic booms and its subsequent effects during economic slowdowns. The impact of such effects amplified due to interconnectedness among financial institutions, financial markets and the real economy. Neither market oversight nor microprudential supervision was able to stem excessive risk-taking or take into account the interconnectedness of the activities of financial institutions and markets. This was due to fragmented regulatory structures, legal constraints on information sharing nationally and internationally, and regulatory arbitrage. The introduction of new banking business models and extensive employment of information and communication technology have amplified regulatory challenges.

As a result, an increasing number of countries are progressing towards introducing macroprudential supervision, risk-sensitive and proactive regulations and supervisory methodologies based on business models, measures to strengthen crisis preparedness and resolution planning, and supervisory cooperation.

2. Progressing from microprudential supervision to a macroprudential approach

(a) Addressing systemic risk in the financial system

In addition to risks and vulnerabilities of individual financial institutions, imbalances and concentrations may build up within the financial system as a result of interactions between financial institutions, financial markets, financial infrastructure and the real economy. Hence, purely a microprudential perspective to regulation and supervision which focuses on risks in individual firms in isolation without regard to spill over and feedback effects would not be sufficient to maintain financial system stability.

(b) Emergence of macroprudential supervision

Accordingly, a macroprudential approach to regulation and supervision, which focuses on the soundness of the financial system as a whole is required for mitigating systemic risk. The regulatory reforms that followed the recent financial crisis, in particular Basel III, have emphasized the linkages between macroprudential and microprudential approaches.

- Tools such as the leverage ratios, time-varying capital requirements such as counter-cyclical buffers, liquidity buffers such as the Liquidity Coverage Ratio and Net Stable Funding Ratio under Basel III and varying terms and conditions such as loan-to-value ratios and margin requirements have been introduced to address the time dimension of systemic risk.
- Tools to limit risk concentration and interconnectedness to address the cross section dimension of systemic risk includes stringent capital rules for potentially high-risk activities, limiting the scope of permissible activities of financial institutions E.g. in The United Kingdom (UK), the 'Vicker's Proposal' seeks to 'ring-fence' retail banking from investment banking.
- Regulators have focused more on systemically-important banks through intensified supervision and regulation and requiring higher levels of capital.
- Regulators have also started to employ tools such as network analysis and simulation exercises to model inter-linkages among different components of the financial system and conduct stress-testing exercises to determine the financial health of banks.

3. Addressing changes in the risk profile of banks

(a) Emergence of new risk paradigms

Changes to risk perceptions, new regulatory frameworks and persistently low interest rates in advanced economies have shaped the post-crisis behaviour and business models of banks. As a result, the risk profiles of banks have undergone significant change, new hidden risk areas have emerged and have gained newfound importance.

- With increasing pressure to improve profitability with rapidly thinning margins, importance of strategic risk has heightened.
- Similarly, banks are facing challenges in managing cyber risk, the nature of which continues to evolve. While damage from cyber-attacks to date has been relatively limited, the potential for long-term threats to emerge remains high.
- The importance of areas such as model risk, money laundering risk, market conduct risk and legal and compliance risk have also increased.

(b) Strengthening supervisory methodology to be more risk-sensitive and business-model based

Supervisors have moved away from reactive, 'light touch' supervision which operated on the presumption that self-preservation of well-governed firms would be sufficient to safeguard the financial system.

- A shift from compliance-based supervisory methodology to a more risk-based methodology is being adopted by regulators to enhance the efficient management of supervisory resources and proactively initiate necessary supervisory action.
- With the view of ensuring that financial institutions operate efficiently and sustainably, supervisory

approaches have become futuristic, stringent and dynamic and have been re-designed to conduct tailor-made supervision based on the risk profile and business models of banks.

4. Enhanced coordination among regulators

The emergence of large global financial conglomerates and interconnectedness among different components of the financial system have prompted regulators to enhance inter-regulatory coordination, both nationally and internationally.

(a) Single supervisory structure vs. multiple supervisory structure

Certain countries believe that a single supervisor is more effective than multiple supervisors in monitoring risks across financial institutions and responding to real or potential threats that may undermine the stability of a financial system. For example, countries such as UK, Germany, Ireland, China, Bhutan etc. have adopted a single supervisory structure.

- Such mechanisms are relatively effective in conducting consolidated supervision of financial conglomerates and minimizing regulatory arbitrage.
- However, proponents of multiple supervisory structure argue that specialized agencies may be better prepared than a single agency to recognize and address the unique characteristics of respective financial intermediaries.
- Countries that have opted for a multiple supervisory structure are increasingly establishing effective mechanisms to ensure communication and policy coordination among supervisory agencies. These efforts include establishing inter-regulatory bodies with representatives from individual supervisory agencies, establishing working groups on common issues, strengthening laws on information sharing and entering into memoranda of understanding (MOUs) on sharing information.

(b) Enhanced supervisory coordination in the aftermath of recent financial crises

- European Union (EU): Post-European Crisis studies have revealed how rapidly and forcefully issues in the financial sector of one country can spread to another, especially in a monetary union. As a result, the Single Supervisory Mechanism (SSM) was established in November 2014, comprising the European Central Bank (ECB) and national supervisory authorities of participating countries.
- UK: The Financial Services Authority was replaced with two new regulators, namely the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). PRA, a fully-owned subsidiary of the Bank of England, overseeing prudential regulation and supervision of financial intermediaries, and FCA is an independent body that handles consumer protection and market conduct related matters. The Financial Policy Committee (FPC) was established under the Bank of England to identify, monitor and take action to address any systemic risks.

(c) Cross-border information sharing and home host relationships

Rapid geographical expansion of banking groups has escalated the complexity of supervising cross-border banking groups and implementing resolution mechanisms during crisis situations.

- Supervisors have been engaged in improving home-host relationships by sharing information and cooperating for effective supervision of banking groups, and effectively handling crisis situations. Informal or formal arrangements (such as MOUs) are in place to enable the exchange of confidential information.
- Establishment of supervisory colleges: The home supervisors establish bank-specific supervisory colleges for banking groups with material cross-border operations to enhance its effective oversight and relevant host supervisors are included in the college. Such supervisory colleges act as vehicles through which supervisory activities are coordinated (E.g. G-20 countries, EU, India and Singapore).

5. Crisis preparedness and resolution mechanisms

In response to the loss of confidence among the general public observed during the global financial crisis, many countries have strengthened financial safety net mechanisms such as deposit insurance schemes and recovery and resolution measures for banks, and have encouraged banks to develop comprehensive crisis preparedness plans.

- Countries such as US, UK, Hong Kong, Germany, Malaysia and Singapore have increased their deposit insurance coverage in line with these global reforms.
- An increasing number of countries are carrying out crisis simulation exercises focusing on initiating prompt supervisory corrective actions, including emergency liquidity assistance, financial institution failure resolution, depositor and investor protection and formal contingency planning.
- In 2012, Basel Committee on Banking Supervision identified recovery and resolution plans as a precondition for effective supervision. This has prompted regulators to formulate and adopt different recovery and resolution tools depending on the nature of the crisis situation.

6. Upgrading consumer protection mechanisms and market conduct of financial institutions

In the aftermath of the global financial crisis and many widely popularized market misconduct scandals, regulators are tightening consumer protection laws. New institutional arrangements have been introduced by regulators across the globe to make financial markets safer places for consumers, such as FCA in UK, Consumer Financial Protection Bureau in US. Many regional countries such as India, Malaysia and

Singapore have also strengthened frameworks on transparency and integrity in financial markets, fair treatment, disclosures and financial education.

7. **Evolution of the role of the regulator in Sri Lanka**

- **Supervisory coordination and sharing of information:** Sri Lankan financial sector is regulated by multiple regulators and many efforts have been taken to improve coordination among these different regulatory authorities. For example, the Inter Regulatory Institutions Council (IRIC) was formed in 2007, consisting all financial sector primary regulators with the objective of ensuring appropriate policy directions for the orderly development of the financial sector and strengthening financial system stability. In order to facilitate this, a proposed Act on 'Sharing of Information among Financial Sector Regulators' has been approved by the Cabinet of Ministers and is being drafted. IRIC was reconstituted in 2015 as the Financial Sector Oversight Committee to emphasize its financial system oversight role. The Central Bank of Sri Lanka (CBSL) has entered into MOUs with the State Bank of Pakistan, the Reserve Bank of India, the Insurance Board of Sri Lanka and the Securities and Exchange Commission of Sri Lanka.
- **Strengthening macroprudential supervision:** CBSL further strengthened macroprudential surveillance to identify any systemic risks by developing the Banking Soundness Index, Financial Soundness Indicators, Financial Market Stability Indicators, and Macro-economic Stability Indicators to help detect and assess systemic risks. Moreover, macro stress tests are conducted periodically to assess resilience of the financial system to extreme, yet plausible macro-economic shocks. Proactively responding to any systemic build-up of risks, CBSL has introduced macroprudential regulations such as the Loan-to-Value, ceilings on credit growth, imposition of margin requirements on imports, etc. from time to time.
- **Implementation of Basel III Capital and Liquidity Standards:** In line with the current regulatory developments, the Liquidity Coverage Ratio under Basel III was implemented in Sri Lanka in 2015 and the Basel III Capital Standards will be implemented in line with international timelines.
- **Upgrading the supervisory framework:** During 2015, the current supervisory approach for banks and non-bank financial institutions was improved to be more risk sensitive and proactive. The new futuristic approach focuses on the business model of banks to identify potential risks that may affect the efficiency and sustainability of banks. The need for the Board of Directors and Board-appointed sub-committees to actively engage in resolving supervisory concerns was stressed by CBSL during this period.

Accordingly, CBSL will continuously review and enhance the regulatory and supervisory framework for banks in line with international developments and the evolving needs of the financial sector and the real economy, to ensure the safety and soundness of the banking sector in Sri Lanka.

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Basel Committee on Banking Supervision

8.3 Performance of Non-Banking Financial Institutions

Licensed Finance Companies (LFCs) and Specialised Leasing Companies (SLCs) Sector

The performance of the LFC/SLC sector remained robust during 2015 in terms of the expansion of both business volume and outreach, reflecting the extended economic activities, appropriateness of policy initiatives and supportive regulatory and supervisory measures in place.

Business Expansion

(a) Outreach: This sector comprised of 46 LFCs and 7 SLCs by end 2015. The branch network of LFC/SLC sector expanded further in 2015 by 84 to 1,216 branches with emphasis placed on areas outside the Western Province. The ratio stood approximately at 1:2 reflecting greater outreach to outside the Western Province.

Table 8.8 Distribution of Branches of the LFC/SLC Sector by Province

Province	End 2014	End 2015 (a)
Western	369	394
Southern	125	134
Sabaragamuwa	83	92
North Western	118	129
Central	128	139
Uva	60	61
North Central	86	89
Eastern	88	98
Northern	75	80
Total	**1,132**	**1,216**

(a) Provisional — *Source:* Central Bank of Sri Lanka

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(b) Assets: Total assets of the LFC/SLC sector expanded in 2015 at a higher pace. Total assets of the sector grew by 22.3 per cent or Rs 181.6 billion in 2015 compared to a growth of 19.0 per cent or Rs 130.0 billion in 2014. The growth of assets was largely supported by the increase in borrowings by 44.6 per cent or Rs. 96.9 billion and deposits by 16.1 per cent or Rs 66.5 billion. Funds mobilised were largely utilised in granting loans and advances. Throughout 2015, the sector experienced a strong demand for credit on vehicle leasing and other secured loans. Credit growth accelerated as indicated by loans and advances which robustly grew by 31.8 per cent or Rs 192.1 billion to Rs. 795.8 billion at end 2015, compared to a growth of 15.8 per cent or Rs 82.4 billion during 2014 due to high growth in other secured loans and finance leases. The investment portfolio comprises of investment in equities, capital market debt instruments, government securities and investment properties, recorded a negative growth of 9.2 per cent or Rs 10.1 billion in 2015 compared to 111.9 per cent growth recorded in 2014. Other assets mainly comprised in the form of cash, balances with banks and financial institutions, trading stocks and fixed assets showed a marginal increase during 2015.

(c) Liabilities: The share of deposits in total funding decreased to 48.2 per cent in 2015 from 50.8 per cent in 2014. However, there was a steady growth in deposits as the sector continued to attract depositors due to relatively high deposit rates offered by LFCs compared to those of banks. Total deposits grew by 16.1 per cent or Rs 66.5 billion to Rs 480.6 billion in 2015 at a lesser magnitude, compared to a 22.8 per cent growth in 2014. The deposit mobilisation was mainly through time deposits accounting for 95 per cent of the total deposits whilst a slight increase was shown in the savings deposit base. The total borrowings recorded a notable increase of 44.6 per cent or Rs 96.9 billion to reach Rs. 314.3 billion by end 2015 compared to 12.6 per cent in 2014 and the share of borrowings increased to 31.6 per cent in 2015 from 26.7 per cent in 2014. High growth in borrowings was largely due to funds obtained from the banking system and debenture issues. The capital elements of the sector increased marginally by 5.4 per cent to Rs. 123.1 billion at end 2015, mainly on account of internally generated profits made during the year.

Risks in the LFC/SLC Sector

(a) Credit Risk: Assets quality of LFC/SLC sector improved in 2015 compared to 2014 as evident by improved NPLs and provision coverage ratios. Gross and net NPLs ratios decreased to 5.7 per cent and 1.6 per cent, respectively, in 2015 from 6.9 per cent and 2.3 per cent, respectively, in 2014, mainly due to higher growth of loan portfolio. Meanwhile, the increase in NPLs of Rs. 3.3 billion in 2015 was not significant when compared to 7.1 billion in 2014.

Table 8.9 Composition of Assets and Liabilities of the LFC/SLC Sector

Item	2014 (a)		2015 (b)		Change (%)	
	Rs. bn	Share (%)	Rs. bn	Share (%)	2014 (a)	2015 (b)
Assets						
Loans and Advances	604	74.1	796	79.9	15.8	31.8
Investments	110	13.5	100	10.0	111.9	-9.2
Other	101	12.4	101	10.1	-9.3	-0.4
Liabilities						
Total Deposits	414	50.8	481	48.2	22.8	16.1
Total Borrowings	217	26.7	314	31.6	12.9	44.8
Capital Elements	117	14.3	123	12.4	20.3	5.1
Total Funds	**748**	**91.8**	**918**	**92.2**	**19.3**	**22.7**
Other	67	8.2	78	7.8	14.9	17.9
Total Assets/Liabilities (net)	**815**	**100.0**	**996**	**100.0**	**19.0**	**22.3**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Chart 8.9 Product wise Loans & Advances of the LFC/SLC Sector

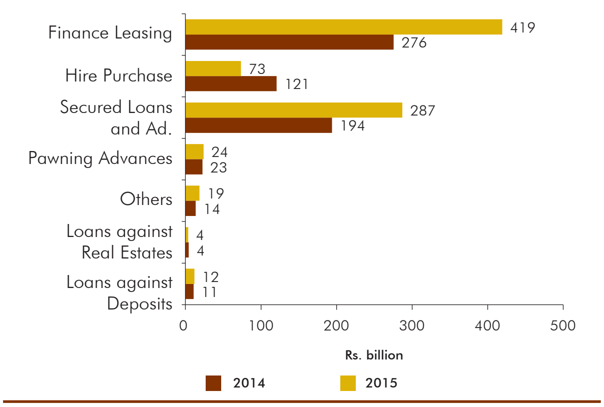
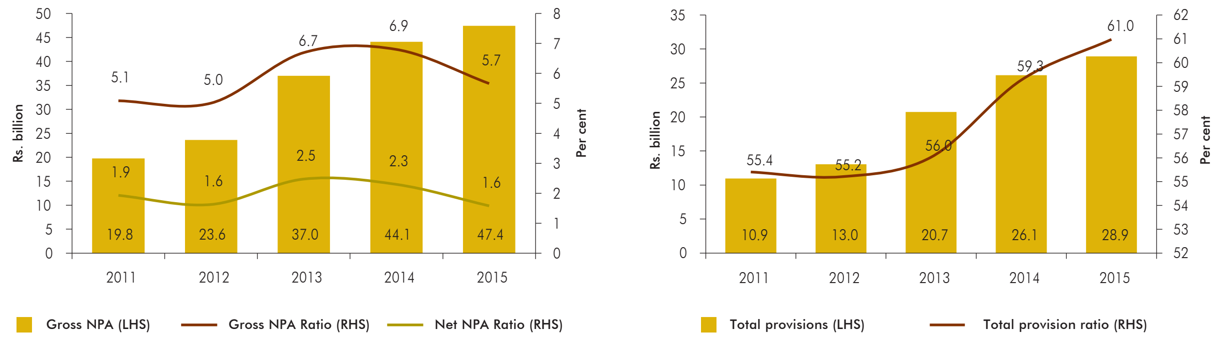


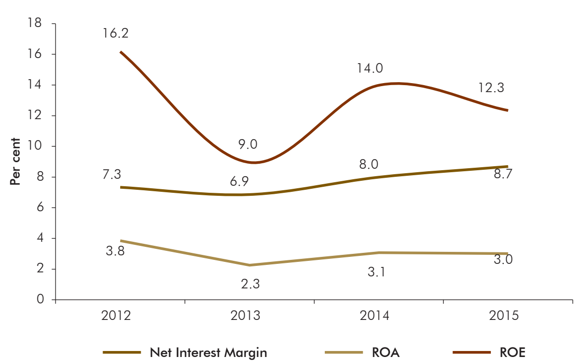
Chart 8.10 Non-Performing Loans and Provision Coverage of the LFC/SLC Sector



(b) Market Risk: The LFC/SLC sector continued to experience a minimal market risk due to the lower exposure to trading portfolio and foreign currency transactions. Also, interest rate risk decreased mainly due to low interest rate environment prevailed during the year, which resulted in an improved margin due to the negative mismatch in the maturity profile of interest bearing assets and liabilities of the sector.

(c) Liquidity Risk: The LFC/SLC sector operated with an excess liquidity position during the year. The overall statutory liquid assets available in LFC/SLC sector by end 2015 recorded a surplus of Rs. 13.7 billion compared to the stipulated minimum requirement of Rs. 65.7 billion. Further, the liquid assets to deposits ratio was well above the statutory minimum of 10 per cent of time deposits and 15 per cent of savings deposits. The liquid assets to total assets ratio decreased to 7.6 per cent in 2015 from 9.6 per cent in 2014 as a result of robust credit growth in the sector.

Chart 8.11 Profitability Indicators of the LFC/SLC sector



Profitability and Capital Resources

(a) Profitability: During 2015, the LFC/SLC sector recorded a profit after tax of Rs. 15.2 billion compared to Rs. 14.8 billion in 2014. Despite the improvements of core business operations, sharp increase of operational costs mainly contributed to moderation of profits. The net interest income picked up notably by 32 per cent to Rs. 82 billion due to expansion of credit portfolio, particularly due to increasing higher yields on micro-finance lending and of finance lease portfolios. This has resulted in improving the net interest margin to 8.7 per cent in 2015 from 8.0 per cent in 2014. The marginal increase of non-interest income recorded in 2015 was due to increased revenue from

Table 8.10 Composition of Income and Expenses of the LFC/SLC Sector

Item	2014 (a)		2015 (b)	
	Amount (Rs. bn)	%*	Amount (Rs. bn)	%*
Interest Income	131.2	16.9	150.4	15.9
Interest Expenses	69.1	8.9	68.2	7.2
Net Interest Income	**62.1**	**8.0**	**82.2**	**8.7**
Non-Interest Income	20.4	2.6	22.8	2.4
Non-Interest Expenses	47.6	6.1	67.0	7.1
Loan Loss Provisions (Net)	11.0	1.4	9.5	1.0
Profit before Tax	**23.9**	**3.1**	**28.5**	**3.0**
Profit after Tax	**14.8**	**1.9**	**15.2**	**1.6**

(a) Revised
(b) Provisional
* as a percentage of average assets

Source: Central Bank of Sri Lanka

Table 8.11 Composition of Regulatory Capital of the LFC/SLC Sector

Item	Amount (Rs. bn)		Composition (%)	
	2014 (a)	2015 (b)	2014 (a)	2015 (b)
Tier I: Core Capital	**85**	**88**	**100.0**	**100.0**
Issued and Paid-up Ordinary Shares/ Common Stock (Cash)	65	61	76.4	69.0
Non-cumulative, Non-redeemable Preference Shares	0	0	0.1	0.1
Share Premium	0	0	0.3	0.2
Statutory Reserve Fund	10	12	12.0	13.3
General and Other Free Reserves	21	23	24.9	25.6
Other	-12	-7	-13.7	-8.2
Tier II: Supplementary Capital	**9**	**15**	**100.0**	**100.0**
Eligible Revaluation Reserves	2	2	24.5	14.4
General Provisions	0	0	2.5	0.8
Eligible Approved Unsecured Subordinated Term Debt	7	13	73.5	85.0
Other	0	0	-0.6	-0.3
Regulatory Adjustments	**-6**	**-10**		
Total Regulatory Capital Base	**88**	**93**		

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

default charges and service charges. The provisions made on drop in market values of investments and increased staff costs were among the main reasons for the increased non-interest expenses. The loan loss provisions made against NPLs was lower by Rs.1.5 billion during 2015 when compared to Rs 11.0 billion made in 2014. The profitability indicators of the sector, i.e. ROA and ROE, marginally decreased to 3.0 per cent and 12.3 per cent, respectively, in 2015 from 3.1 per cent and 14.0 per cent in 2014.

(b) Capital: During the year, total regulatory capital increased by 5.8 per cent to Rs. 92.8 billion due to retention of profits. The total CAR decreased to 11.2 per cent at end 2015 from 13.5 per cent at end 2014 and the core capital ratio decreased to 10.5 per cent in 2015 from 12.8 per cent in 2014. The reduction of capital ratios was largely due to greater increase of risk weighted assets. However, both ratios remained above the minimum required level.

Supervisory and Regulatory Developments

(a) New Regulations: An acceleration in the credit demand for vehicle leasing facilities was observed by the Central Bank in 2015. With a view to pre-empt this trend, which may develop into a system-wide risk to the financial sector, the Central Bank imposed a maximum LTV of 70 per cent in respect of loans and advances granted for the purpose of purchase or utilisation of motor vehicles by banks and LFC/SLC. Further, a new regulatory framework was designed to strengthen and streamline the existing policies and practices in respect of the opening, closure and relocation of branches and other outlets of LFC/SLC.

(b) Action against the Conduct of Finance Business without Authority: The Central Bank continued to carry out investigations on institutions allegedly engaged in finance business without authorisation while assisting courts with respect to pending litigation issues. Awareness campaigns were conducted to educate the public on the risk of investing in unauthorised financial institutions by way of country-wide seminars/workshops and through radio advertisements, posters, leaflets and press notices published in electronic and print media in all three languages.

Primary Dealers in Government Securities

Primary Dealer (PD) industry, consisted of 8 PD Units of Licensed Commercial Banks (Bank PDs) and 8 Standalone PDs including 2 PDs owned by LCBs, recorded strong financial performance in terms of assets growth and profitability in 2015. However, liquidity issues faced by one PD during the fourth quarter of 2015 necessitated regulatory intervention by the Central Bank on its business activities. The resolution measures implemented by the Central Bank restored the investor confidence in the sector and facilitated uninterrupted operations in the government securities market.

Assets and Liabilities

The total assets of PD industry increased substantially in 2015. Total assets increased by 44.7 per cent to Rs 282.6 billion at the end of 2015 in comparison to Rs. 195.3 billion in 2014. government securities accounted for 98.4 per cent of

Table 8.12 Performance of Primary Dealers

Rs. billion

Item	2014 (a)	2015 (b)	Annual Growth Rate (%)	
			2014 (a)	2015 (b)
Total Assets	195.3	282.6	-8.2	44.7
Total Portfolio	**192.5**	**278.1**	**-8.7**	**44.4**
Trading Securities	119.0	132.8	-17.0	11.6
Investment Securities	30.0	47.8	-38.7	59.4
Reverse Repo	40.7	44.1	143.0	8.3
Available for sale	2.8	53.4	37.4	1,776.3
Equity and Liabilities	195.3	282.6	-8.2	44.7
Total Capital (c)	9.2	13.5	39.3	46.3
Repo	123.9	179.3	-2.0	44.8
Profit before Tax	8.7	8.8	0.9	2.0
Profit after Tax	7.8	8.4	-2.1	7.8
Return on Assets (%)	4.4	3.7	0.4	-0.8
Return on Equity (%) (c)	39.4	46.1	11.0	6.6
Risk Weighted Capital Adequacy Ratio (%) (c)	21.8	25.5	3.4	3.7
Leverage Times (c)	7.2	4.8	-0.2	-2.5
Dealings	14,045.7	17,873.1	-3.5	27.2
Primary Market Dealings	1,982.4	2,459.5	-12.0	24.1
Secondary Market Dealings	12,063.3	15,413.6	-1.9	27.8

(a) Revised
(b) Provisional
(c) Standalone PDs only

Source: Central Bank of Sri Lanka

the total assets of the industry. The total portfolio of government securities, consisting of trading, available for sale, investment and reverse repo, amounted to Rs. 278.1 billion at end 2015, recording an increase of 44.4 per cent over 2014. Increases in the investment portfolio and the available for sale portfolio were the main contributory factors for above increase in the total portfolio. The trading portfolio increased to Rs. 132.8 billion by end 2015, from Rs.119.0 billion at end 2014. The investment portfolio increased by 59.4 per cent to Rs.47.8 billion during 2015 compared to Rs. 30.0 billion at end 2014. Lending under reverse-repurchase agreements increased by 8.3 per cent during 2015 compared to the portfolio held at end 2014. Borrowing under repurchase agreements (Repo), which was the major source of funding for PDs, increased by 44.8 per cent to Rs.179.3 billion at end 2015, from Rs.123.9 billion at end 2014.

Risks in PD Industry

(a) Market risk: Securities held for trading purposes continued to be the major source of market risk of the industry. However, compared to increased assets base of the PDs industry, the relative share of the trading portfolio in the total portfolio decreased from 61.8 per cent at end 2014 to 47.8 per cent at end 2015, and was considered to be a positive development.

(b) Liquidity risk: The liquidity risk exposure of PD industry increased towards end 2015 as reflected in the widening over-night negative mismatch in the maturity profile of assets and liabilities, which increased to Rs. 7.1 billion or 37.2 per cent of the overnight liabilities at the end of 2015, from Rs. 23.3 million or 0.4 per cent at the end of 2014. However, considering highly marketable nature of the risk free government securities portfolio held by PDs and also the ability to use such government securities as collaterals for obtaining funds to bridge any unforeseen liquidity gaps, the liquidity risk profile of PDs industry as well as individual PDs, except for one PD who was facing liquidity issues since fourth quarter 2015, remained low. Further, 8 out of 16 PDs, which represent more than 75 per cent of the PDs industry, continued to be fully owned units of LCBs and such PD units continued to enjoy unconditional liquidity support from respective banks. The balance 8 standalone PDs, on the other hand had stand-by contingency funding arrangements from the banking sector to bridge any unexpected liquidity gaps.

Profitability and Capital Resources

There was no concern over the capital and profitability of Bank PD units as their parent banks were subject to stringent prudential regulatory requirements, including high standards of capital and liquid assets ratios, while such banks continued to record increased profits and profitability in 2015. In the case of 8 standalone PDs, the total capital base increased to Rs. 13 billion at end 2015 from Rs. 9.2 billion at end 2014 as a result of retained profits. Accordingly, the risk weighted CAR of these 8 primary dealers improved to 25.5 per cent at the end of 2015 from 21.8 per cent recorded in the previous year. At the same time, they also recorded very high, yet increasing profitability in 2015 as depicted by ROE of 46.1 per cent and ROA of 3.7 per cent in 2015 compared to 39.4 per cent ROE and 4.4 per cent ROA in 2014.

Market Participation: High effective participation rate of 70.7 per cent by Bank PDs at the Treasury bill auctions was recorded during 2015. The effective participation of Standalone PDs and Employees' Provident Fund (EPF) for Treasury bills auctions remained at 28.4 per cent, and 0.9 per cent, respectively, during 2015. Primary auctions for Treasury bonds were also subscribed mainly by the Bank PDs, contributing for 38.8 per cent of the total issuances during the year. Secondary market transactions in government securities increased significantly by 27.8 per cent to Rs. 15,413.6 billion during 2015 compared to Rs. 12,063.2 billion in 2014, of which, repo transactions accounted for 76.6 per cent of trading volumes in 2015.

Unit Trusts

The unit trust (UT) sector continued to expand in 2015 as indicated by the launch of 11 new funds, increased net assets value (NAV), total number of investors and the number of units outstanding at the end of 2015. Total number of UTs operating in the sector increased to 74 by end 2015 from 63 of previous year. Of the 74 UTs, 71 were operated as open-ended funds, 2 as closed-end listed equity growth funds and 1 as a dollar bond fund. According to the investment focus, there were 9 types of UTs namely, income funds (19), gilt-edged funds (15), money market funds (13), balanced funds (11), growth funds (8), equity funds (6), index funds (2), Initial Public Offers (IPOs) funds (2) and dollar bond fund (1), at the end of 2015.

Business growth: The total assets under management, comprising investments in government securities (Rs. 29.4 billion), and investments in equities (Rs. 14.4 billion) of the sector increased by Rs. 3.8 billion to Rs. 130.3 billion at end 2015, from Rs. 126.5 billion at end 2014. This positive performance was mainly due to the setting up of 11 new funds, increased investment in equities on the back of low interest rates environment prevailed in most of 2015. The total number of unit holders increased to 38,008 by end 2015 from 32,584 reported at end 2014.

Investment: Investment in government securities, i.e., Treasury bills, Treasury bonds, and Reverse repos in government securities declined in 2015, while the relative share of investment in equities by UTs increased. The value of investment in government securities declined to 22.6 per cent of total assets by end 2015 from 44.4 per cent reported at the end of 2014. In view of the preference of

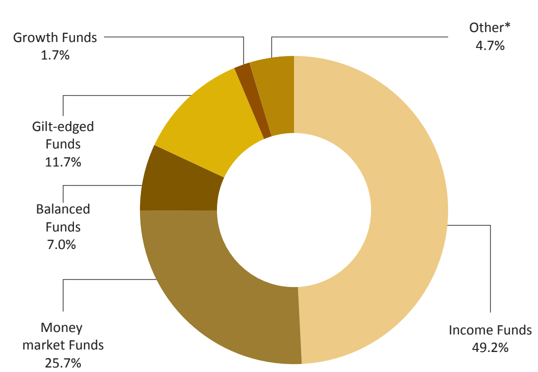
Table 8.13 Performance of UT Sector

Details	2014 (a)	2015 (b)
No. of Unit Trusts	63	74
Total No. of Unit Holders	32,584	38,008
No. of Units in Issue (mn)	9,382	8,766
Total Assets (Rs. mn)	126,531	130,302
Net Asset Value - NAV (Rs. mn)	125,985	129,398
Investments in Equities (Rs. mn)	13,575	14,407
Share of Total Net Assets (%)		
Investments in Government	10.8	11.1
Securities (Rs. mn)	56,146	29,405
Share of Total Assets (%)	44.4	22.6

(a) Revised
(b) Provisional

Source: Unit Trust Association of Sri Lanka

Chart 8.12 Categorisation of the UT Sector in terms of the Net Asset Value



*Other : Equity Funds 3.19%,Index Funds 0.16%, IPO Funds 0.01%, Corporate Debt Funds 0.01%, Equity Growth Funds 1.05% and Dollar Bond Fund 0.27%

new UTs to have a relatively higher investments in equities, the relative share of investment in equities in investment portfolios of UTs increased to 11.1 per cent by end of 2015 compared to 10.8 per cent at end 2014.

Insurance Sector

Insurance sector maintained its growth momentum without major prudential concerns and recorded a relative share of 3.3 per cent in terms of total assets of the financial sector at end 2015. There were 28 insurance companies operating in Sri Lanka, which are registered with Insurance Board of Sri Lanka (IBSL). Out of the 28 insurance companies, 3 operated as composite insurance companies carrying on both long-term insurance business and general insurance business, 13 operated as exclusive general insurance companies, and 12 as exclusive long-term insurance business companies. There were 57 companies engaged in insurance brokering business, concentrating mainly on general insurance business, at the end of the period under consideration.

The level of expansion of the insurance sector in the country in 2015 was relatively slow as reflected in marginal improvement in penetration and density. Insurance penetration, i.e. total premium as a percentage of GDP, continued to be low at 1.0 per cent at the end of 2015. The penetrations for long-term and general insurance were 0.5 per cent and 0.6 per cent respectively by end 2015 in comparison to 0.4 per cent and 0.5 per cent by end of 2014. The low insurance penetration can be attributed to the lack of awareness of the general public on insurance and its benefits, and inefficiencies in policy management. Insurance density was Rs. 5,768 per person at end 2015 compared to Rs. 4,808 per person by end of 2014.

Business Growth: Total assets of the sector grew by 9.7 per cent by the end 2015 compared to 13.4 per cent growth during 2014 and amounted to Rs. 453.6 billion against Rs. 413.6 billion of 2014. Total assets of long-term insurance business sub-sector increased to Rs. 305.4 billion at end 2015, accounting for 67.3 per cent of the total assets of the insurance sector compared to 60.3 per cent or Rs. 249.8 billion at end of 2014. However, the relative share of the general insurance business sub sector declined to 32.6 per cent of the total assets of the insurance sector at end 2015. The gross written premium (GWP) of Rs. 120.9 billion of the sector in 2015, an increase of 21.1 per cent over 5.1 per cent growth in 2014, was mainly due to the substantial growth in motor and marine insurance activities witnessed during the period. GWP for general insurance grew by 21.9 per cent during the period under consideration and amounted to Rs. 67.3 billion or 55.7 per cent of total GWP at the end of 2015. Similarly, GWP for long-term insurance, registered a growth of 20.1 per cent and amounted to Rs. 53.6 billion or 44.3 per cent of the total GWP. The GWP for motor insurance, increased by 22.7 per cent in 2015 to contribute for 63.7 per cent of the total GWP of general insurance industry, when compared to the increase of 5.4 per cent in 2014.

Table 8.14 Performance of the Insurance Sector

Rs. billion

Item		2014 (a)	2015 (b)
Total Assets		413.7	453.6
Government Securities		137.7	167.5
Equities		55.1	53.4
Cash & Deposits		62.8	58.9
Total Income		134.2	152.1
Premium Income		99.9	120.9
Investment Income		34.3	31.2
Profit Before Tax		8.2	12.9
Solvency Margin Ratio	- Life Insurance	9.7	7.6
	- General Insurance	2.4	2.3
Retention Ratio (%)	- Life Insurance	97.1	96.2
	- General Insurance	83.3	80.0
Claims Ratio (%)	- Life Insurance	48.4	40.7
	- General Insurance	65.4	65.7
Combined Operating Ratio (%)	- Life Insurance	100.1	86.5
	- General Insurance	109.7	105.9
Return on Assets (ROA) (%)	- Life Insurance	1.9	2.7
	- General Insurance	2.4	3.5
Return on Equity (ROE) (%)	- General Insurance	4.1	5.7
Underwriting Ratio (%)	- General Insurance	13.3	16.4

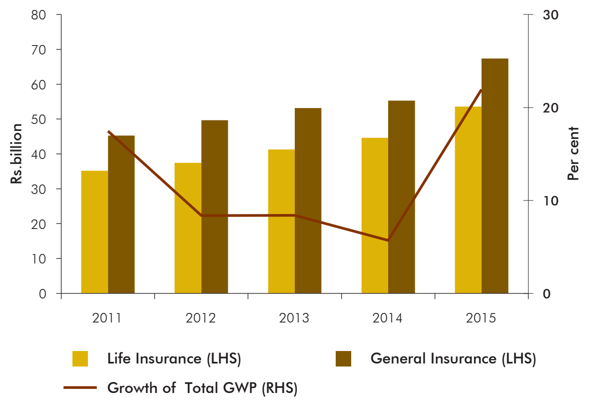
(a) Revised
(b) Provisional

Source: Insurance Board of Sri Lanka

Earnings: Total profits earned by the sector in 2015 increased mainly due to sharp increase in premium income and underwriting profits. Total investment income of insurance companies declined by 9.0 per cent to Rs. 31.2 billion in 2015, in contrast to the increase of 18.3 per cent in 2014 mainly due to low interest rates in the market. Total claims in general insurance sector, on the other hand, increased by 12.3 per cent to Rs. 28.9 billion, while the claims for long term insurance increased by 0.7 per cent to Rs. 20.8 billion by end 2015. The underwriting profits from general insurance increased by 37.9 per cent to Rs. 8.1 billion in 2015 from Rs. 5.9 billion in 2014. Accordingly, the aggregate profit (before tax) of the sector increased by 55.4 per cent to Rs. 12.9 billion in 2015 from Rs. 8.3 billion in 2014. Consequently, ROE and ROA for general insurance improved to 5.7 per cent and 3.5 per cent, respectively, from 4.1 per cent and 2.4 per cent, respectively, in 2014. ROA of long-term insurance also improved to 2.7 per cent by end 2015 from 1.9 in 2014.

Capital and Investment : All insurance companies met the statutory solvency margin requirement for general and long-term insurance at end 2015. However, the ratio of capital to total assets declined to 55.0 per cent at end 2015 from 60.0 per cent at the end of 2014. Similarly, the solvency margin ratio for general and long-term insurance declined to 2.3 times and 7.6 times, respectively at the end of 2015 from 2.4 times and 9.7 times at the end of 2014. In regard to investments at the end of 2015, 44.8 per cent of long-term insurance assets and 20.7 per cent of general insurance assets were held in government securities. The share of equity in the total investment of general insurance decreased to 20.4 per cent at the end of 2015 from 20.6 per cent in 2014. Investments in corporate debt securities reported a share of 8.1 per cent in the total investments of general insurance at the end of 2015, compared to a share of 6.6 per cent in 2014.

Chart 8.13 Gross Written Premium of the Insurance Sector



Supervisory and Regulatory Developments: In 2015, IBSL adopted regulatory measures to ensure claimant safety and protection, improve the safety and soundness of insurance companies and also the solvency of insurance brokers and to streamline canvassing of business by insurance agents. Accordingly, a Directive was issued to all insurance companies in respect of their claim settlements requiring every insurer to pay the claim amount due, in respect of claims arising out of policies of insurance issued, within sixty days of the admission of liability and upon establishment of the identity of the claimant. Further, a Regulation was issued to all Insurance Brokering Companies requiring them to maintain at least a minimum net capital of Rs. 1.125 million from 30 September 2015 and a minimum net capital of Rs. 2.5 million from 30 September 2016. IBSL also granted permission to insurance agents to canvass insurance business for insurance companies carrying on long-term and general insurance business, subject to strict compliance with requirements specified by the regulator. IBSL also issued Solvency Margin (Risk Based Capital) Rules in 2015, effective from 01 January 2016.

Superannuation Funds

The superannuation funds sector consisted of three state-managed funds, namely the Employees' Provident Fund (EPF), the

Employees' Trust Fund (ETF) and the state sector Public Service Provident Fund (PSPF) and 155 privately managed funds approved and monitored by the Department of Labour. The total assets of the sector grew by 13.9 per cent in 2015 to Rs. 2,120 billion and accounted for 15.7 per cent of total assets in the overall financial sector by end 2015 in comparison to around 15.5 per cent in 2014.

Employees' Provident Fund

Employees' Provident Fund (EPF) is the largest superannuation fund for the private sector employees in Sri Lanka. In terms of the EPF Act. No. 15 of 1958, the Monetary Board is entrusted with the custodianship of EPF, while the Commissioner of Labour is entrusted with the general administration of the Fund. The total assets of the Fund reported a growth of 12 per cent to Rs. 1,664.9 billion accounting for about 78.5 per cent of the total assets in the superannuation funds sector by end 2015 in comparison to Rs. 1,486.9 billion of total assets representing 80 per cent of total assets of the sector reported at end 2014. This increase was due to the combined effect of the net contributions of the members (contributions less refund payments) and the income generated through the effective and prudent management of the Fund. Total liability to the members, including accrued interest to members, stood at Rs. 1,625.5 billion at the end of 2015, recording a 12.5 per cent increase from Rs. 1,445.5 billion in 2014. The net contribution decreased to Rs. 24.7 billion in 2015 compared to Rs. 24.9 billion in the previous year. The total amount of refunds made to the members and their legal heirs in 2015 was Rs. 77.8 billion, recording an increase of 19.5 per cent over 2014 mainly due to the utilisation of the 30 per cent withdrawal facility by the members.

The net income of the Fund increased by 4.1 per cent to Rs. 156.9 billion in 2015 from Rs. 150.7 billion in the previous year. The Fund earned a total investment income of Rs. 171.5 billion in 2015, recording an increase of 5.1 per cent compared to previous year. Interest income was the major source of income (83.4 per cent of the total income) to the Fund. Interest income grew by 12.2 per cent to Rs. 143.1 billion in 2015 from Rs. 127.5 billion in 2014. However, Capital gains from government securities decreased to Rs. 1.2 billion in 2015 from Rs. 4.1 billion in 2014 whereas capital gain from equity investments also decreased to Rs. 0.6 billion from Rs. 2.3 billion. However, dividend income grew by 5.8 per cent to Rs. 3.5 billion in 2015. The total investment portfolio (book value) of the Fund grew by 11.6 per cent from Rs. 1,437.7 billion at end 2014 to Rs. 1,604.2 billion at end 2015. The investment policy of the Fund continued to focus on providing a long-term positive real rate of return to the members, while ensuring the safety of the Fund and maintaining a sufficient level of liquidity to meet refund payments and other expenses of the Fund. Accordingly, the investment portfolio consisted of 92.7 per cent in government securities, 5.5 per cent in equity and 1.6 per cent in corporate debentures, commercial papers and trust certificates. The remaining 0.2 per cent was invested in highly liquid assets such as reverse-repos of government securities to maintain day to day liquidity requirements.

Employees' Trust Fund

Employees Trust Fund (ETF) reported a healthy growth in 2015. ETF is administrated by the Employees' Trust Fund Board of the Ministry of National Policies and Economic Affairs. ETF operated its functions

Table 8.15 Performance of EPF and ETF

Item	EPF		ETF	
	2014 (a)	2015 (b)	2014 (a)	2015 (b)
Total Assets (Rs. bn)	1,486.9	1,664.9	199.1	223.5
Total Member Balance (Rs. bn)	1,445.5	1,625.5	193.9	200.5
Number of Member Accounts (mn)	15.8	16.0	12.0	12.5
Number of Active Member Accounts (mn)	2.4	2.4	2.4	2.4
Number of Employers contributing	69,683	72,917	74,276	76,674
Total Contributions (Rs. bn)	90.0	102.5	15.9	18.1
Total Refunds (Rs. bn)	65.1	77.8	13.9	11.5
Total Investments Portfolio (Rs. bn)	1,437.7	1,604.2	185.9	210.7
o/w : Government Securities (%)	89.6	92.7	90.4	91.1
Gross Income (Rs. bn)	163.9	171.9	18.8	19.9
Profit Available for Distribution (Rs. bn)	150.8	157.2	17.7	19.1
Return on Investments (%)	12.1	11.3	10.0	9.3
Interest Rate Paid on Member Balances (%)	10.5	10.5	10.0	9.0

(a) Revised
(b) Provisional

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

effectively in 2015, reflecting positive growth in its asset base, income and investments, thereby increasing the capacity to distribute higher return among members. ETF held about 12.5 million accounts at end 2015, including about 2.4 million active accounts. The total outstanding member balances in ETF rose by 3.4 per cent to stand at Rs. 200.5 billion by end 2015 from Rs. 193.9 billion at end 2014. During the year, total contributions of the Fund increased to Rs. 18.1 billion from Rs. 15.9 billion in the previous year enabling a net positive contribution to the Fund, after paying Rs. 11.5 billion as member benefits in 2015. The total assets of ETF amounted to Rs. 223.5 billion at end 2015, recording an increase of 12.3 per cent over 2014. Investments in government securities represented the bulk of its total assets. Total investment portfolio of ETF rose by 13.3 per cent to Rs. 210.7 billion at end 2015 and 91.1 per cent of such investment were made in government securities. Investments in equity and corporate fixed income securities accounted for 5.4 per cent and 0.9 per cent, respectively, of the total investments. The effective rate of return on member balances of ETF was 9.3 per cent in 2015 in comparison to 10.0 in 2014.

Other Superannuation Funds

Other superannuation funds comprised of Public Service Provident Fund (PSPF) and approved provident funds. The active member accounts of the PSPF increased to 232,793 at end 2015 from 230,837 in 2014. Total contributions to the PSPF, increased by 65.4 per cent to Rs. 2,470 million in 2015 from Rs. 1,493 million in 2014. Total refunds made by the Fund to its members in 2015 increased by 92.7 per cent to Rs. 734 million. Accordingly, the net contributions to the Fund also increased by 56.1 per cent to Rs. 1,736 million in 2015 compared to Rs. 1,111 million in 2014. The total assets of PSPF increased by 10 per cent to Rs. 46 billion at end 2015 from Rs. 41 billion at end 2014. Government securities accounted for 99.7 per cent of total investments of the Fund at end 2015.

There were 155 privately managed provident and pension funds monitored by the Department of Labour with a total membership of 168,840 persons at the end of 2015. The total assets of private provident and pension funds rose by 37.8 per cent to Rs. 185 billion. However, total investments of these funds declined by 14.2 per cent to Rs. 103 billion in 2015.

8.4 Performance of Financial Markets

Money Market

Excess liquidity in the commercial banking system, which remained substantially high during previous year declined in 2015. The rupee liquidity surplus of about Rs. 331 billion prevailed in the domestic interbank market at the beginning of 2015 decreased to Rs. 105 billion by the end of the year. The decline in market excess liquidity commenced in December 2014 continued up to end February 2015 despite Treasury bills purchases by the Central Bank, and a sharp decline was observed since then mainly due to foreign exchange supply by the Central Bank in the domestic foreign exchange market and also due to retirement of Treasury bills held by the Central Bank. Thereafter, excess rupee liquidity, though continued to increase, remained lower than the levels seen in the previous year. However, there had been occasional fluctuations in excess rupee liquidity in the market during the second half of 2015 as a result of purchases of SLDB proceeds, supply of foreign exchange by the Central Bank in the domestic foreign exchange market and purchases of Treasury bills and a part of sovereign bond proceeds by the Central Bank.

Average Weighted Call Money Rate (AWCMR) remained relatively stable in 2015 despite some intermittent increases. AWCMR

Table 8.16 Money Market Transactions

Market	Volume (Rs. bn)		Weighted Average Interest Rate (Min-Max) - %	
	2014	2015	2014	2015
Call Money	2,198	2,828	5.72-7.68	5.80-7.00
Inter-Bank repo	2,246	1,962	5.29-7.02	5.00-6.91
Central Bank Repo	4,299	750	5.59-7.09	5.86-6.42
Central Bank Reverse Repo	6	44	6.72-8.50	6.15-6.30
SDF	4,340	17,990	-	-
SLF	8	23	-	-

Source: Central Bank of Sri Lanka

showed some volatility beginning from January until mid-April 2015. Prevalence of high call money rates during first few days of the month and low rates during the remaining part of the month was observed since the introduction of special Standing Deposit Facility (SDF) rate of 5 per cent in September 2014. Under this arrangement, the access to the SDF of the Central Bank, at then applicable SDF rate of 6.50 per cent, was limited to a maximum of three times per calendar month, and any deposits at SDF window exceeding three times by an Open Market Operation (OMO) participant was accepted at a reduced interest rate of 5.00 per cent per annum. However, the special standing facility rate was removed in March 2015 with a view to stabilising the overnight interest rates within the policy rate corridor. Consequently, AWCMR increased and settled around 6.70 per cent until the downward revision of policy interest rates by 50 basis points in mid-April 2015. As a result, AWCMR also declined and remained around 6.10 per cent to 6.20 per cent. With the reduction in market liquidity in the second half of the year an upward pressure on AWCMR was built up. However, in the latter part of the year, AWCMR was settled largely closer to the lower bound of standing rate corridor. However, by December 2015 there was an upward movement in AWCMR.

AWCMR moved in a narrow range in 2015. AWCMR ranged between 5.8 per cent and 7.0 per cent and call money market volume ranged between Rs. 0.3 billion to Rs. 31.5 billion. Few banks resorted to borrowing from inter-bank market persistently as a funding source for their lending activities. In terms of the volume distribution of call transactions, around 63 per cent of the total borrowing was accounted for by three banks which borrowed most whilst around 45.2 per cent of total lending was done by three banks which lent most. In terms of the frequency of resorting to call market, that is, total number of days of trading in call market by all banks, three banks which resorted to borrow most number of days in call market accounted for 49.1 per cent of total number of days of such borrowing. Further, three banks which lent most number of days in the call market accounted for 24.6 per cent of total number of days by all banks. The market repo interest rate, which is closely associated with and moves in line with the call money interest rate, exhibited intermittent volatility due to the structural and taxation issues in the market. Accordingly, margin between the call money interest rate and the market repo interest rate ranged between 0 and 131 basis points during the year.

Money market liquidity was largely absorbed on an overnight basis. Compared to the previous year, a lesser number of OMO auctions were conducted during 2015 in line with the prevailing monetary policy stance and rapid decline of excess rupee liquidity. Since the Central Bank held adequate government securities to cover repo auctions and as auctions were not conducted on a daily basis, there were lesser requirement to borrow securities under the government security borrowing programme during the year.

Domestic Foreign Exchange Market

Sri Lankan rupee depreciated significantly against the US dollar during 2015. Overall depreciation of Sri Lankan rupee against US dollar was 9.0 per cent from Rs. 131.0 to Rs. 144.1. The pressure on the exchange rate increased during the year 2015 mainly due to withdrawal of foreign investment held in Treasury bills and Treasury bonds, equity and seasonal imports. Furthermore, the decision taken by the Central Bank on 4 September 2015, to accommodate greater flexibility in the determination of exchange rate resulted in the depreciation of Sri Lankan rupee against the US dollar. In-line with the overall depreciation of the Sri Lankan rupee, the average US dollar buying and selling rates of commercial banks for telegraphic transfers were recorded at Rs. 141.9 and Rs. 146.2, respectively, at end 2015 whilst comparative figures at end 2014 were Rs. 130.4 and Rs. 133.4, respectively. During the year, Sri Lankan rupee depreciated against other major currencies such as sterling pound, Japanese yen and Indian rupee by 4.5 per cent, 8.2 per cent and 4.6 per cent, respectively. On the other hand, Sri Lankan rupee appreciated against euro by 1.3 per cent.

During 2015, trading volumes in the domestic foreign exchange market decreased by 12.2 per cent compared with the previous year. Transaction volumes in foreign exchange in the domestic market decreased to US Dollars 13,593 million in 2015 from US dollars 15,478 million in 2014. The daily average volumes in the inter-bank foreign exchange market too recorded a similar decrease to US dollars 57 million in 2015 from US dollars 64 million in 2014.

The Central Bank was a net seller in the domestic foreign exchange market in 2015 due to its intervention in the domestic foreign exchange market during the period under review with the intention of curbing excess volatility. During the year, the Central Bank absorbed US dollars 179 million from the market and injected US dollars 3,429 million to the market. The Central Bank injected US dollars 2,060 million before 4 September 2015 out of which US dollars 782 million on account of withdrawals by foreign investors from their holdings of Treasury bills/ bonds and the balance US dollars 1,278 million for the market. Similarly, after 4 September 2015, US dollars 1,369 million was injected out of which US dollars 562 million for Treasury bills/bonds and US dollars 807 million for the market. Overall, the Central Bank was a net seller of US dollars 3,250 million in the domestic foreign exchange market in 2015.

Government Securities Market

The Treasury bill yield rates, which remained stable during the first two months moved upwards towards March-April period due to removal of restrictions placed on the access to the SDF with effect from 2 March 2015. However, the yield rates again started to move down with the policy rate reduction by 50 basis points on 15 April 2015. The debt management strategies to sustain and maintain low interest rate environment were supported by borrowings from international capital markets to curb any undue pressure on domestic interest rates. Accordingly, International Sovereign Bonds have been issued in June 2015 for US dollars 650 million at a coupon rate of 6.125 per cent and in November 2015 for US dollars 1,500 million at a coupon rate of 6.85 per cent. Despite these efforts, foreign holdings of Treasury bills and Treasury bonds declined during the latter part of 2015, mainly due to investors' optimistic views on rise in US policy rate. However, the Public Debt Department was able to minimise the roll-over risk through the extension of the Average Time to Maturity (ATM) of the Government debt portfolio. Further, the longer end of the risk free yield curve was activated continuously in 2015 to set an effective benchmark to create a conducive environment for fund raising activities. Nevertheless, as a result of foreign outflow and due to the Monetary Board's decision to raise

Table 8.17 Primary Market Treasury Bond Issuances

Year	Amount Issued (Rs. Billion)		
	Auction	Placements	Total
2013	201	816	1,017
2014	28	833	861
2015	712	158	870

Source: Central Bank of Sri Lanka

Table 8.18 Primary Market Weighted Average Yield Rates of Treasury Bills

Per cent per annum

Year	Maturity			Overall Average
	91-days	182-days	364-days	
2011	7.28	7.21	7.41	7.31
2012	10.72	12.29	12.14	11.81
2013	7.54	7.85	8.29	8.20
2014	6.58	6.57	6.73	6.68
2015	6.32	6.5	6.6	6.46

Source: Central Bank of Sri Lanka

the Statutory Reserve Requirement (SRR) rate by 150 basis points in December, the benchmark yield rate on 364 day Treasury bills recorded an increase of 130 basis points by end 2015 from that of end 2014. The Treasury bill rates for 91 day, 182 day and 364 day maturities as at end December 2015 stood at 6.38 per cent, 6.69 per cent and 7.11 per cent, respectively.

Following major policy change in issuing Treasury bills and Treasury bonds in 2015, the primary market auction based issuances increased substantially compared to the previous years. Accordingly, the volume of Treasury bills issued through primary auctions in 2015 amounted to Rs. 1,006 billion in comparison to Rs. 760 billion in 2014. The primary market issuances of Treasury bonds are given in the table 8.17.

Despite the adoption of appropriate debt issuance strategies, the upward movement in short-term interest rates have pushed,

Table 8.19 Yield Rates of Government Securities

Per cent per annum

Item	Primary Market		Secondary Market	
	2014	2015	2014	2015
Treasury Bills				
91 Days	5.74-7.42	5.74 - 7.10	5.47-7.52	5.72 - 7.00
182 Days	5.83-7.53	5.86 - 7.31	5.64-7.83	5.85 - 7.12
364 Days	5.89-7.95	6.00 - 7.37	5.82-8.27	6.03 - 7.30
Treasury Bonds				
2 Years	6.15-8.70	6.70 - 8.14	5.97-8.86	5.95 - 7.75
3 Years	6.20-8.80	7.18 - 8.70	6.45-9.05	6.93 – 9.02
4 Years	6.40-9.06	8.15 - 9.50	6.50-9.54	7.13 - 9.42
5 Years	6.48-9.29	8.11 - 9.79	7.09-10.29	7.24 - 9.63
6 Years	6.64-9.42	8.87 - 9.90	7.41-10.37	7.45 - 9.85
10 Years	7.78-10.15	7.88 - 10.94	7.79-10.89	7.93 - 10.43
15 Years	8.50-10.91	9.67 - 10.96	8.28-11.60	7.65 - 10.71
30 Years	8.85-11.80	11.73	9.27-11.24	9.27-11.60

Source: Central Bank of Sri Lanka

the Treasury bond yields also on an upward trajectory towards end 2015. The foreign investor preference for Treasury bills have declined considerably during 2015. The Treasury bills and Treasury bonds holdings by foreign investors amounted to Rs. 303.8 billion as at end December 2015. In the Budget - 2016, the government revised the exposure on government securities for non-residents from existing 12.5 per cent to 10 per cent of the total outstanding stock of Treasury bills and Treasury bonds, with the objective to mitigate the undue strain on external reserves with the sudden withdrawal of funds by non-residents as witnessed in the recent past.

Enhanced investor preference for Sri Lanka Development Bonds (SLDBs) enabled PDD to raise US dollars 2,491.37 million against the maturing amount of US dollars 835.57 million in SLDB during 2015. This improved investor preference for SLDBs facilitated the strategic reduction of foreign investments in Treasury bills and Treasury bonds to an appropriate level during 2015 to mitigate the risk arising from external factors. Further, inflows through SLDBs eased the quantity of rupee denominated securities required to finance the Government borrowing programme enabling to stabilise the interest rates in the domestic market.

During 2015, the ATM of the overall domestic public debt portfolio improved further and recorded 6.28 years by end December 2015 compared to 5.75 years in the previous year. The ATM of outstanding Treasury bond portfolio at end December 2015 increased to 7.36 years from 6.98 years at end December 2014. The increase in the ATM in the Treasury bond portfolio was made possible mainly due to the issuance of a large volume of longer tenor Treasury bonds during 2015.

Corporate Debt Securities Market

The Commercial Paper (CP) and debenture markets, which are an important and integral part of the corporate debt securities market

in Sri Lanka, were relatively active in 2015 than in 2014. The total value of CP issued with the support of banks, amounted to Rs. 7.9 billion in 2015, recording a decrease of Rs. 0.3 billion compared to Rs. 8.2 billion in 2014. The interest rates pertaining to CPs varied in a range of 7.0 - 12.0 per cent in 2015 compared to 2014 and did not show much volatility. CPs with a maturity up to 3 months accounted for 65.5 per cent of the total new issuances, while the shares of CPs with 6-month and 12-month maturities were 19.4 per cent and 15.1 per cent, respectively. The total outstanding value of CPs amounted to Rs. 4.5 billion at the end of 2015 compared to Rs. 3.5 billion in 2014.

The country's listed debt securities market marked a record fund raising of Rs. 83.4 billion in 2015, 53.9 per cent higher than the Rs. 54.2 billion recorded in 2014. According to CSE, this performance was achieved through 25 debenture issuances in 2015, the highest ever number of listed corporate debt issuances, compared to 20 issues in 2014, and the financial sector led such debt issuances in 2015. The desire of corporate to make their debt issuances in 2015 to gain benefit from the tax exemption on interest earned by investors in corporate debt, which was announced in 2015 budget, also contributed to the high volume of new debt issuances in 2015. The highest amount of listed corporate debt in 2015 of Rs. 9.0 billion was issued by National Development Bank PLC, followed by Bank of Ceylon with Rs. 8 billion, Sampath Bank PLC with Rs. 7 billion People's Leasing and Finance PLC with Rs. 6.0 billion.

Colombo Stock Market

CSE recorded a sluggish performance under volatile movements in the price indices in 2015. The All Share Price Index (ASPI) declined by 5.5 per cent to 6,894 points and S&P SL20 index declined by 11.3 per cent to 3,626 points at end 2015 with compared to 7,299 and 4,089, respectively, as at end 2014. Increased investor uncertainty resulting from delayed policy directions along with political changes, increasing interest rates, depreciation in the exchange rate and reversal of capital flows from emerging markets have resulted in significant foreign outflows from the equity market during 2015. As a result, the price indices pertaining to main sub-sectors, namely banks, finance & insurance, diversified holdings, hotels & travels and telecommunication declined substantially by 5.3 per cent, 12.2 per cent, 5.1 per cent, 13.3 per cent, respectively, during the year.

Market capitalisation of CSE declined in 2015. A drop of market capitalisation by 5.4 per cent to Rs. 2.9 trillion at end 2015 was experienced and this was equivalent to 26.3 per cent of GDP compared to 29.7 per cent in 2014. In terms of market capitalisation, the first three largest sectors namely; banks, finance & insurance, beverage, food & tobacco and diversified holdings sectors accounted for 23.8 per cent, 19.2 per cent and 17.9

Chart 8.14 ASPI, S&P SL20 Index and Daily Turnover at the CSE

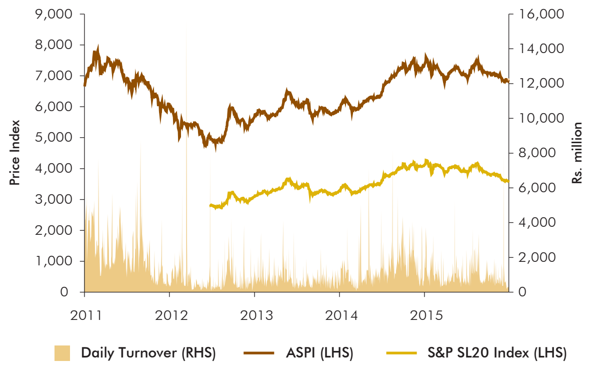


Chart 8.15 Foreign Participation at the CSE

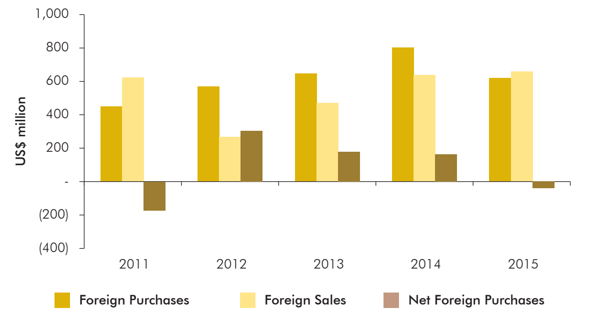


Table 8.20 Selected Indicators of CSE

Item	2014	2015
All Share Price Index (1985=100) (a)	7,299.0	6,894.5
Year-on-Year Change (%)	23.4	5.5
S&P SL 20 Index (17.12.2004=1000) (a)	4,089.1	3,625.7
Year-on-Year Change (%)	25.3	11.3
Market Capitalisation (Rs. bn) (a)	3,104.8	2,937.9
As a Percentage of GDP (%)	29.7	26.3
Market Price Earnings Ratio (a)	19.7	18.0
Turnover to Market Capitalisation (%)	12.3	8.6
Average Daily Turnover (Rs. mn)	1,415.0	1,059.6
Value of Shares Traded (Rs. bn)	341.0	253.3
Number of Shares Traded (mn)	16,722	9,414.7
Number of Companies Listed	294	294
Introductions (b)	5	2
Number of Initial Public Offers/ Offers for Sale (b)	5	27
Number of Rights Issues	13	14
Amount Raised Through Rights Issues and Initial Public Offers (Rs. bn)	14.4	100.2

(a) End of the year
(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.

Source: Colombo Stock Exchange

per cent, respectively. The ten largest companies listed on CSE accounted for 36.1 per cent of total market capitalisation compared to 38.0 per cent in 2014.

The daily average turnover of the CSE declined by 25.1 per cent to Rs. 1,060 million in 2015 from Rs. 1,415 million in 2014, reflecting moderate performances during the year. Foreign investors accounted for 28.1 per cent of the total turnover while the balance was from local investors. Cumulative foreign purchases amounted to Rs. 85.0 billion, while cumulative foreign sales was Rs. 90 billion, resulting in a net outflow from the market in 2015. However, the primary market remained active throughout the year and raised over Rs. 100 billion through 27 Initial Public Offerings (IPOs) in both equity and debentures, 14 right issues and 2 public placements in 2015.

The Securities and Exchange Commission (SEC) developed a capital market development master plan in 2015. This master plan was formulated in consultation with key stakeholders comprising of senior representatives from the securities industry, CSE and SEC to provide strategic policy direction. The major areas covered under the aforesaid master plan include; amendments of SEC Act, implementation of risk management system, development of corporate bond market, new products and the UT industry, enhance public education and awareness on capital market, increasing new listings, both public and private sectors, attracting new funds, both local and foreign and development of infrastructure, such as Broker Back Office (BBO), Delivery Versus Payment (DVP) and Central Counter Party (CCP) systems, etc. Further, several initiatives were taken by CSE to enhance their performance to a globally accepted level by adopting the Global Industry Classification Standard (GICS) to classify its listed companies, joining with the United Nations Sustainable Stock Exchanges (SSE), a partnership among United Nations, United Nations-supported organisations, stock exchanges, investors, companies, regulators and governments around the world, aiming to promote sustainability initiatives, etc.

8.5 Development Finance and Access to Finance

In 2015, the Central Bank continued to engage in activities promoting access to finance with a view to enhancing financial inclusiveness and balanced growth in the economy. In order to achieve these objectives, the Central Bank coordinated credit delivery through refinance schemes and interest subsidy/credit guarantee schemes, and delivered credit supplementary services to strategic sectors of the economy. In this process, 13 credit schemes were operated through Participating Financial Institutions (PFIs) to provide credits for needy business ventures and people in the Agriculture, Livestock and Micro, Small and Medium scale enterprises (MSMEs) sectors. Through these credit schemes, loans amounting to Rs. 16,678.8 million were disbursed to 141,298 beneficiaries in 2015. Of the total lending, 67.9

per cent was directed towards the Agriculture, Livestock Sector, while SME and microfinance sectors received 19.3 per cent and 12.8 per cent, respectively. From a policy perspective, a number of measures were taken to relax certain terms and conditions of the loan schemes implemented by the Central Bank, with a view to further improving the access to finance and financial inclusion of the country. These policies mainly focused on reducing the lending rates, increasing eligible loan limit to produce project appraisals and the maximum grace period of loans granted under the credit schemes implemented by the Central Bank.

As in the previous years, the Agriculture and Livestock sector continued to dominate in receiving a greater proportion of concessionary credit facilities provided by the Central Bank. These loans were channelled through the New Comprehensive Rural Credit Scheme (NCRCS), Commercial Scale Dairy Development Loan Scheme (CSDDLS), Tea Development Programme (TDP) and Working Capital Loan Scheme for Tea Factories (WCLSTF). Under these schemes, total loans amounting to Rs. 11,319.9 million were disbursed among 92,081 farmer entrepreneurs in this sector. NCRCS, the principal concessionary loan scheme for the Agriculture sector, dominated by granting the highest amount of Rs. 7,137.5 million among 90,533 farmers to meet their working capital requirements to produce 32 short-term crop varieties. The Scheme alone contributed 63.0 per cent of loans granted to the Agriculture Sector. The total disbursements under NCRCS increased in 2015 compared to that in 2014, in contrast to the continued declining trend observed in the previous years due to bad weather conditions. Of the total disbursements, the Anuradhapura district (19.1 per cent) received the highest amount of loan disbursements, followed by Polonnaruwa (12.4 per cent), Hambantota (9.6 per cent), Badulla (8.7 per cent) and Matale (7.9 per cent) districts. Among the crop items, paddy received the highest proportion of 66.0 per cent of the total loan disbursements. In order to address the collateral issue faced by farmer entrepreneurs, the Central Bank introduced the Warehouse Receipts Financing System under NCRCS. Through this system, it was expected to enable the small farmers to obtain short-term credit from the registered financial institutions, by pledging the warehouse receipts issued by the government owned warehouses, as a collateral.

The disbursements under CSDDLS continued to increase in 2015 as well. Considering the importance of achieving self-sufficiency in milk production, CSDDLS was in operation island-wide to facilitate the transformation of the subsistence level dairy production in to a viable commercially oriented activity. Under the scheme, Rs. 1,229.8 million was granted by PFIs among 1,424 dairy farmers and entrepreneurs in 2015 for the purposes of dairy related activities covering dairy farm development, processing, transportation, storing and marketing. Of the disbursements, the Kurunegala District (21.9 per cent) received the highest amount of loans followed by Puttalam, Anuradhapura and Hambantota, respectively. Since some dairy businesses require a period longer than 6 months to generate income, the grace period of the loans granted under CSDDLS was extended to 12 months from 6 months with effect from January 2016.

The Central Bank also involved in implementing the interest subsidy component of WCLSTF, which was newly introduced by the government in August 2015. It was initiated to assist the registered tea factories to meet their working capital requirements. Accordingly, the interest subsidy of 2 per cent is provided for two years by the Central Bank to PFIs from the funds allocated by the government. By end 2015, loans totalling Rs. 2,943.8 million were disbursed to 79 borrowers under the Scheme.

Providing credit to promote high potential and promising Small and Medium Sector Enterprises (SMEs) was given priority in 2015.

The Central Bank continued to assist SME sector, considering its strategic importance in fostering inclusive economic growth, employment generation, reducing inequality and poverty and stimulating entrepreneurship. In this respect, there were five credit schemes, namely, the Saubhagya Loan Scheme (SLS), Self-Employment Promotion Initiative Loan Scheme (SEPI), Small Holder Plantation Entrepreneurship Development Program (SPEnDP), Dry Zone Livelihood Support and Partnership Programme (DZLiSPP-RF) and Awakening North Loan Scheme – Phase II (ANLS - II). These schemes together disbursed loans amounting to Rs. 3,219.3 million for 14,832 beneficiaries. Of this total, the SLS, the flagship scheme, which operates island-wide to provide loans to SME Sector, disbursed Rs. 2,889.6 million loans among 12,317 entrepreneurs engaged in manufacturing and service related activities during 2015. It alone contributed 89.8 per cent to the total disbursements of the SME sector. From the policy front, a number of measures were taken to relax the terms and conditions of the Operating Instructions hitherto applied under SLS. Among those measures, removing the requirement of minimum number of employees that needed to be eligible under the Scheme, extending the grace period for the cultivation of perennial crops up to 12 months from 6 months, increasing the eligible loan limit for which project appraisal is needed to Rs. 1 million from Rs. 500,000 were some key changes. These measures were instrumental in popularising SLS and addressing issues faced by both PFIs and beneficiaries. Under the Awakening North–Phase II Loan Scheme (ANLS-Phase II), 1,721 loans amounting to Rs. 203.6 million were disbursed in 2015. The Scheme was concluded after its successful operation for more than 6 years and consolidated with SLS in November 2015. Further, SEPI, SPEnDP and DZLiSPP disbursed a total of Rs. 126.0 million to 794 borrowers. Considering the prevailing low interest rate environment, the rate of interest applicable for loans granted under SPEnDP was reduced to 7.0 per cent per annum from 9.0 per cent per annum.

Four microfinance loan schemes were in operation with a view to broadening the financial outreach among the masses and promoting poverty alleviation. These loan schemes, namely, Poverty Alleviation Micro-Finance Project II-Revolving Fund (PAMP II–RF), Poverty Alleviation Micro-Finance Project-Revolving Fund (PAMP-RF), Poverty Alleviation Micro-Finance Project – II (PAMP II) and Small Farmers and Landless Credit Project – Revolving Fund (SFLCP-RF) together disbursed loans amounting to Rs. 2,139.5 million among 34,385 beneficiaries, during the year. Of the total disbursements, 52.3 per cent of loans were granted for the Small Industries and the Agriculture sectors, followed by Livestock (18.3 per cent), Trade and Services (21.4 per cent), and Fisheries (8.1 per cent) sectors. In November 2015, the rate of interest for sub loans granted under the PAMP II and PAMPII-RF was reduced to 10.0 per cent per annum from 12.0 per cent per annum, with a view to passing-through the benefit of prevailing low interest rates in the market to end borrowers.

The Credit Guarantee Scheme for Pawning Advances (CGSPA), which was introduced on 17 June 2014, was concluded by the end 2015, considering the monetary developments and movement of gold prices in the domestic and international markets. From the inception of the scheme, pawning advances totalling Rs. 29,248.1 million disbursed by PFIs were guaranteed by the Central Bank. Pawning advances disbursed under the Scheme in 2015 amounted to Rs. 17,757.9 million.

Under the strategic objective of skill development and capacity building, the Central Bank continued to conduct a number of programmes and workshops to promote financial literacy and inclusiveness of the country. These programmes mainly covered the areas of financial literacy, entrepreneurship development and training of trainers and project appraisal workshops for entrepreneurs. Formation of Self Help Groups and

BOX 13 Main Findings of the Survey on Microcredit

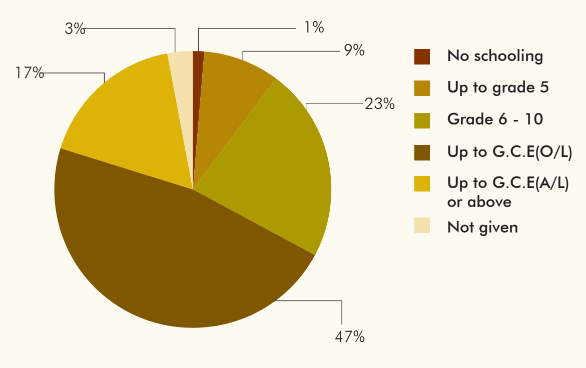
A survey on microcredit was conducted by the Central Bank of Sri Lanka (CBSL) with the objective of understanding the developments in the microcredit sector and assessing the status of financial literacy and financial inclusion of microcredit beneficiaries in the country. The survey sample was 1,588 microcredit beneficiaries selected from institutions registered with Lanka Microfinance Practitioners' Association (LMPA) and Non Bank Financial Institutions (NBFIs) distributed among fifteen districts, namely, Ampara, Anuradhapura, Badulla, Gampaha, Hambanthota, Jaffna, Kalutara, Kandy, Kurunegala, Mannar, Matale, Matara, Monaragala, Polonnaruwa and Trincomalee covering eight provinces.

Survey Findings

1.1 Respondents Profile

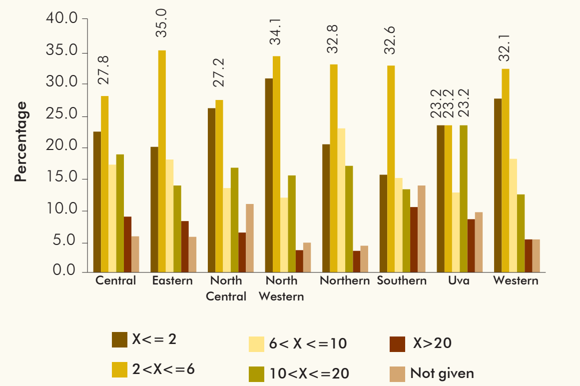
From the total sample, 96 per cent of the respondents were females and the majority was in the age category of 31 to 40 years. The education level of the respondents was satisfactory as 64 per cent of respondents were educated up to or beyond GCE (O/L) and only a meager one per cent respondents were with no organised education. The total number of loans obtained by microcredit beneficiaries surveyed was 4,274 resulting around three loans on average per respondent.

Chart B 13.1 Education Level of Microcredit Beneficiaries



Among the respondents, around 84 per cent were engaged in Agriculture, Industry or Services related business activities. Considering the provinces, Northern province indicated the highest involvement in Agriculture sector related business activities while Western province had the highest involvement in Services and Industry related business activities. The length of these business activities revealed that most of the businesses had been operating for 2 to 6 years. A similar pattern was observed in all the provinces except in the Uva province where businesses operating for less than 2 years, 2 to 6 years and 10 to 20 years were equally prominent, possibly signalling that the status of business activities in the Uva province have not graduated to an elevated status or have remained at the same status for prolonged periods.

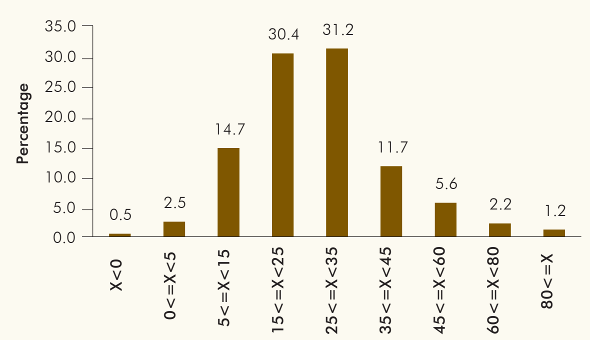
Chart B 13.2 Provincial Breakdown of Duration of Business in Years (X)



1.2 Loan Profile

Out of the total number of 4,274 loans obtained by the respondents, the majority (44 per cent) were in the value range of Rs. 25,000 to Rs. 50,000. The loans were obtained for purposes of business activities, personal usage or to settle another loan and these accounted for 80 per cent, 18 per cent and 2 per cent, respectively. As per the distribution of the calculated interest rate, more than half of the loan interest rates were in the range of 15 per cent to 35 per cent of which 30 per cent falls within 15 per cent to 25 per cent while another 31 per cent falls within the 25 per cent to 35 per cent interest rate range.

Chart B 13.3 Distribution of Calculated Interest Rates (X)



The sources of funds used to repay the loans were different in business and personal loans. Findings suggest, 58 per cent of business loans were repaid through the business income, while 42 per cent of personal loans were repaid by funds obtained from family members.

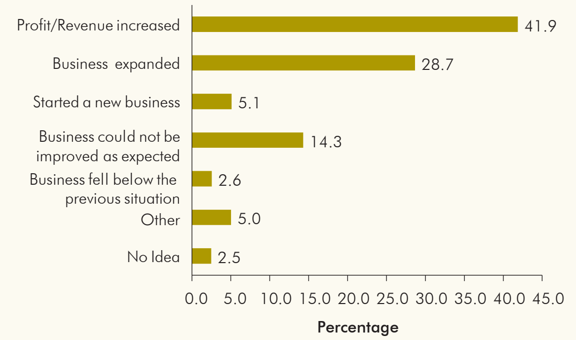
The most prominent repayment frequency of loans obtained from Non Bank Financial Institutions (NBFIs) was weekly while other institutitons were more focused towards monthly repayments. Micro Finance Institutitons (MFIs) and NBFIs were processing loan applications within short periods, with more than 70 per cent of loans having been processed in less than three weeks. Licenced Commercial Banks and Licenced Specialised Banks (LCB/LSBs) and Other Formal Institutions[1] have taken longer processing periods of three weeks or more to process loan applications. The majority of the loans granted by LCB/LSBs and Other Formal Institutions supplemented their loans with a compulsory micro-saving account and the MFI/NBFIs loans were offered with a micro-insurance facility.

1.3 Financial Literacy

In measuring the financial literacy of the respondents, the survey on microcredit focused on beneficiary's knowledge on loan details, facilities offered by banks[2] and other microcredit granting institutions and how beneficiaries have benefitted from access to finance. Of the total number of loans, respondents were able to mention the interest rate only for 48 per cent of the loans. However, for 95 per cent of the loans, respondents were able to state the details of their installments or brought their loan books which carried the details to compute the installments. When analyzed for reasons for not obtaining loans from the LCB/LSBs, a reasonable percentage of loans (7 per cent) were not requested by microcredit beneficiaries from LCB/LSBs as they were not aware of the financial facilities offered by the banking sector and for a similar percentage of loans, respondents mentioned that there were no such institutions (banks) nearby.

Apart from the loan profile detailed above, 80 per cent of loans were obtained for business purposes and out of this, the majority of the loans (38 per cent) were completely utilised for the business purpose it was requested. However, 16 per cent of business loans were reported with no idea of its utilisation. When considering the outcome of the business loans obtained, 42 per cent of beneficiaries who accessed business loans were able to increase their revenue while 17 per cent could not improve their business as expected or became worse off even after obtaining the business loans.

Chart B 13.4 Outcome of Business Loans



Conclusion

The findings of the survey supports that majority of microcredit loans were concentrated among females. Basic financial inclusion observed among microcredit beneficiaries remained strong on the basis of possessing a bank account and reasonably higher frequency of transactions conducted. Basic financial literacy in terms of knowing the interest rates was also reflected across half of the beneficiaries and for 95 per cent of the loans, respondents were able to state the details of their installments or had documentary evidence in support of repayment. The majority of the loans were used for business purposes and respondents were able to increase their profit/revenue while another significant segment could not improve their businesses even with access to microcredit. Monitoring the loans granted by banks and other financial institutions, major share of the loans were granted by NBFIs whereas LCB/LSBs granted a fair share of higher value loans. The average number of loans accessed by a beneficiary is around three loans and a higher percentage of loans were concentrated in the range of Rs. 25,000 to Rs. 50,000. The annual interest rate for the majority of loans falls in the range of 25 to 35 per cent charged mainly by NBFIs and MFIs, while LCB/LSBs extend loans in favour of lower interest rates. Shorter processing periods were observed across loans extended by NBFIs and other lenders such as money lenders, relatives, friends, etc. Further the survey highlighted that accessing LCB/LSBs or not accessing them for financial facilities were mainly due to collateral considerations and the difficult and time consuming application process.

1 Co-operative Rural Bank, Samurdhi Bank, SANASA Society, etc.

2 Licensed Commercial Banks (LCBs) and Licensed Specialized Banks (LSBs)

educating them about financial management were also given priority. Further, information on banking and finance was disseminated to the general public through the print and electronic media.

8.6 Financial Infrastructure

Payment & Settlement Systems

The Central Bank continued its efforts towards ensuring a well-functioning national payment and settlement system to facilitate economic activities of the country and to enhance the efficiency and stability of the financial system. The LankaSettle System, which consists of the Real Time Gross Settlement (RTGS) System, the only large value national payment system of the country and the LankaSecure System, in combination with the retail payment systems, operated smoothly without any major disruption and thereby efficiently catered to the payment needs of the country. The Central Bank continued to perform its role as a regulator and as a catalyst to facilitate the changing and growing payment needs during 2015 as well through promoting electronic payment mechanisms and enhancing efficiency and safety of the national payment infrastructure. Accordingly, during the year, the Central Bank initiated several policy measures in the areas of payments and settlements.

The LankaSettle System, one of the systemically important payment systems in the country, continued to provide an efficient payment and settlement infrastructure for institutions and individuals to effect large value and time critical payments and scripless government securities transactions through its components, i.e. RTGS System and the LankaSecure System. The RTGS System facilitates rupee denominated payments related to inter-bank call money market, government securities market, open market operations, rupee leg of foreign exchange market and customer transactions whilst effecting final settlement of multilateral net clearing balances of the Cheque Clearing System, Sri Lanka Interbank Payment System, Common ATM Switch and Common Electronic Fund Transfer Switch which are operated by LankaClear (Pvt.) Limited (LCPL).

During the year under review, the aggregate value of RTGS transactions accounted for 88 per cent of the non-cash payments recorded. When compared with the previous year, in 2015, the total volume of RTGS transactions grew by 1.4 per cent to 322,234 while the aggregate value of RTGS transactions increased remarkably by 41.8 per cent to Rs. 84,432 billion. The Central Bank, as a measure of mitigating the liquidity risk of RTGS System, continued to provide the Intra-day Liquidity Facility (ILF) for RTGS participants who experienced liquidity problems, and during the review period the daily average ILF utilised by the participants was recorded as Rs. 23.3 billion.

In 2015, with a view to promote electronic payments among the general public, the Central Bank initiated regulatory action to minimise costs incurred by customers in effecting electronic payments. As a result, a maximum limit was imposed on the fees charged by RTGS participants from customers effecting fund transfers through RTGS System. Simultaneously, the operator charge levied by the Central Bank as the operator of RTGS System was reduced from Rs. 600 to Rs. 450 per transaction.

Table 8.21 Transactions through Payment Systems

Payment System	2014 Volume ('000)	2014 Value (Rs. bn)	2015 (a) Volume ('000)	2015 (a) Value (Rs. bn)
Large Value Payment Systems				
RTGS System	318	59,551	322	84,432
Retail Value Payment Systems				
Main Cheque Clearing System	48,052	7,640	49,326	8,434
Rupee Draft Clearing System (b)	1.0	0.1	-	-
Sri Lanka Interbank Payment System (SLIPS)	20,421	894	23,279	1,169
Credit Cards	23,632	135	26,335	154
Debit Cards	22,699	62	30,686	83
Internet Banking	10,818	984	13,736	1,207
Phone Banking	732	9	1,993	12
Postal Instruments	-	7	-	7
Total	**126,673**	**69,282**	**145,677**	**95,499**
US Dollar Cheque Clearing System	**60**	**33**	**62**	**34**

(a) Provisional
(b) Rupee draft clearing is done through main cheque clearing system from July 2014

Source: Central Bank of Sri Lanka

The total value of scripless securities held by LankaSecure amounted to Rs. 4,363.2 billion (Face Value) consisted of Treasury bills of Rs. 663.3 billion and Treasury bonds of Rs. 3,699.9 billion as at end December 2015.

During the year under review, the Cheque Clearing System, which is the other systemically important payment system of the country operated by LCPL, cleared 49 million cheques amounting to an aggregate value of Rs. 8,434 billion. In comparison to the previous year, the aggregate volume and value of cheques cleared through the Cheque Clearing System grew by 2.7 per cent and 10.4 per cent, respectively, in 2015. In terms of transaction volume, the total cheques cleared through the Cheque Clearing System accounted for 33.9 per cent of the country's non-cash payments recorded in 2015.

Sri Lanka Interbank Payment System (SLIPS), the interbank payment system operated by LCPL to facilitate retail payments in the nature of credit transfers and direct debit transfers, processed 23 million transactions with an aggregate value of Rs. 1,169 billion. With the intention of rapidly moving towards the use of electronic retail payments from using cash, the Central Bank in 2015, imposed a maximum limit on per transaction fees that can be charged by SLIPS participants from customers effecting fund transfers through SLIPS. This will reduce the cost for the customer and increase the utilisation of excess capacity of retail electronic payment systems.

In 2015, the Central Bank continued to provide assistance to establish the Common Card and Payment Switch (CCAPS), which is being operated by LCPL under the brand name "LankaPay". CCAPS is an integrated electronic payment system consisting of multiple domestic payment networks namely Common ATM Switch (CAS), Common Electronic Fund Transfer Switch (CEFTS), Shared ATM Switch, Common Point of Sale (POS) Switch and Common Mobile Switch. CCAPS will enhance retail electronic payments in Sri Lanka through seamless connectivity of diversified systems of member financial institutions, customer convenience and cost efficiency in facilitating secure real time payments.

CAS which was launched in 2013 as the first phase of CCAPS, processed 19 million transactions with an aggregate value of Rs. 90 billion in 2015. At end 2015, 2,673 ATMs were integrated with CAS. Further, in August 2015, revolutionising the domestic interbank electronic fund transfers in Sri Lanka, CEFTS was launched as the second phase of CCAPS to provide the facility to effect fund transfers of retail nature, on a real time basis. At end 2015, 7 financial institutions had joined CEFTS, in order to offer their customers the convenience and efficiency of using multiple payment channels, when executing retail fund transfers on real time basis. With the objective of promoting efficient electronic retail payments among the general public and enhancing the utilisation of CEFTS the Central Bank issued a Circular on CEFTS in 2015 imposing upper limits on fees that can be charged from customers, when effecting fund transfers through CEFTS. Further, to reap the maximum benefits of CCAPS by the general public as well as by financial institutions, the Central Bank imposed timelines for licensed banks to join the sub switches of CCAPS.

The Central Bank continued its regulatory and supervisory activities with regard to payment cards and mobile payment systems, in terms of the Payment Cards and Mobile Payment Systems Regulations No. 1 of 2013, in order to minimise the risks associated with payment cards and mobile payment systems. Accordingly, two financial institutions were licensed during the year to function as issuers of debit cards while another financial institution was granted a licence to function as a financial acquirer of payment cards, in terms of the Regulations.

In 2015, the membership of the National Payments Council (NPC) was expanded. This was done with a view to include more representation from the banking sector and the mobile payments sector, as a measure of streamlining the national level decision making process relating to payments and settlements, and to promote payment system developments whilst minimising risks. Further during the year, NPC initiated action to develop a roadmap to guide the medium term developments in payment and settlement systems.

Credit Information

Credit Information Bureau (CRIB) continued to engage in collecting and collating credit and financial information on borrowers and prospective borrowers of lending institutions. It provided such credit information on request to shareholder lending institutions and simultaneously to borrowers to whom such information relate and to instil credit discipline in the financial sector. Undertaking research and training projects for shareholder lending institutions is another service provided by the CRIB. It also operates a filing office to register the security interests of movables with a view to facilitate the distribution of credit to all sectors of the economy and in particular, to the informal sector.

A significant growth in demand for credit reports from the CRIB was witnessed in 2015, reflecting expanded credit related activities by both banks and non-bank financial institutions. CRIB issued 6,890,270 credit reports on corporate and individual borrowers during 2015 compared to 4,756,418 reports in 2014. Of these reports, 97 per cent were consumer credit reports, which recorded an increase of 37 per cent on a year-on-year basis. CRIB had a total of 86 reporting credit institutions as its members by end 2015 and it had more than 7 million individual and corporate borrowers.

BOX 14

Implementation of a Risk-Based Approach to Anti Money Laundering and Countering the Financing of Terrorism

The Rule-Based Approach and the Risk-Based Approach (RBA) are adopted in the implementation of the Anti Money Laundering and Countering Financing of Terrorism (AML/CFT) system and to ensure the compliance with the AML/CFT measures by different countries across the world today. However, recent developments in international standards on AML/CFT have determined a convergence towards a RBA to AML/CFT in addressing loopholes of Rule-Based Approach.

Considering the increasing trend and pressure on narcotic related Money Laundering (ML) in the early 1980s, G7 Leaders Summit in Paris in 1989 has created the Financial Action Task Force (FATF) to co-ordinate, formulate and develop policies/recommendations to collect, analyse and investigate financial intelligence while monitoring the implementation of recommendations to mitigate money laundering activities worldwide. Accordingly, forty recommendations on ML were initially developed in 1990. After the September 11, 2001 (9/11) incident in the USA, the FATF mandate was widened to include terrorist financing, and FATF issued 9 special recommendations on terrorist financing in October 2001. Therefore, FATF financial intelligence scope was expanded to 40+9 recommendations on Money Laundering (ML) and Terrorist Financing (TF) since end of 2004. However, the revisions and amalgamations carried out in February 2012 brought the current AML/CFT framework to consist of forty recommendations. These revisions were aimed at further strengthening the integrity of the financial system by providing stronger tools to combat financial crimes. Consequent to the revisions, the RBA became the essential foundation and core pillar of the AML/CFT framework, and replaced the Rule-Based Approach.

Under the RBA, countries, regulatory authorities and financial institutions are required to identify, assess and understand the ML/TF risks to which they are exposed and take AML/CFT controlling measures in order to mitigate those risks effectively. The Rule-Based Approach demanded equal attention and resources for all types of customers and products, leading to resources being utilised irrespective of the measure of risk involved. In contrast, under the RBA, financial institutions are able to ensure that controlling measures on ML/TF are commensurate with the risks identified. Hence, the RBA allows resources to be allocated efficiently as resources are directed in accordance with prioritized risk factors of the financial institutions.

The Financial Intelligence Unit of Sri Lanka (FIU) as the focal point of countering ML/TF in Sri Lanka, introduced RBA in striking a fine balance between the efficient use of resources to identify ML/TF risks prevailing and meeting the global regulatory requirements ensuring financial system stability. Under Section 2 of the Financial Transactions Reporting Act, No. 06 of 2006 (FTRA), the FIU issued the Financial Institutions (Customer Due Diligence) Rules, No. 01 of 2016 through a Government Gazette No. 1951/13, dated January 27, 2016, to serve the dual objectives of providing guidance for the RBA for the financial institutions of Sri Lanka and also satisfying the requirements set out to be fulfilled by Sri Lanka, as per the recommendations provided by the Asia Pacific Group on Money Laundering (APG), the regional affiliated body of the FATF. All financial institutions in Sri Lanka too, are required to adopt the RBA replacing the Rule-Based Approach where the relevant regulatory authority specifically prescribes the instances and procedure to be observed. Thus, Sri Lanka was able to report to the APG satisfactory progress achieved in AML/CFT compliance of the country by the timeline of January 31, 2016.

The Rules are applicable to all financial institutions, i.e. all institutions, which engage in finance business as defined under the FTRA. According to the Rules, the financial institutions are expected to follow the RBA. The RBA requires each financial institution to analyse and understand about how the ML/TF risks that are identified affect its operations. In conducting a comprehensive risk assessment to evaluate ML/TF risks, every financial institution should have an internally developed system to identify the risk profiling of individual customers. When conducting customer risk profiling, a financial institution should consider the factors relevant to the situation, such as customer category, occupation, source of income, geographical location of business or country of origin of the customer, products used, delivery channels of the customer, nature and purpose of accounts, linked accounts, business activities and other customer-oriented risk indicators in determining the overall level of ML/TF risk involved with the customer. Then, the policies and procedures for customer acceptance, Customer Due Diligence (CDD), and ongoing monitoring of the business relationship should be in line with such risk profiling of the customer.

Provisions for application of Simplified Customer Due Diligence (SCDD) and Enhanced Customer Due Diligence (ECDD), identification of beneficial ownership, money or value transfer service providers would strengthen Sri Lanka's AML/CFT framework. Further, regulatory provisions on due diligence on politically exposed persons (PEPs), adaptation toward new technologies, real engagement by senior management of financial institutions, dealing with wire transfers, CDD measures pertaining to 'occasional transactions' - a cash or electronic fund transfer conducted by any person through an account of another, enforcement of administrative sanctions and sanctions for non-compliance have been addressed based on local and international requirements.

It is important that the customer acceptance policy is not so restraining that it results in denying customers' access to banking and other services. Thus, the RBA would encourage the financial inclusion of underserved groups without compromising the measures that exist for the purpose of combating financial crimes. Similarly, when the ML/TF risk is higher, financial institutions should take enhanced measures to mitigate and manage these risks. For instance, enhanced CDD may be essential for a customer who is planning to maintain a large account balance and conduct regular cross-border wire transfers without any rationale.

The primary objective of the implementation of the RBA to AML/CFT is to protect financial systems being misused by criminals. Further, the RBA also contributes to improve financial inclusion. Hence, the RBA helps to maintain the stability of the country's financial system and of the economy as a whole.

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