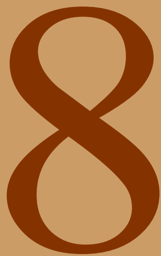


FINANCIAL SECTOR PERFORMANCE AND SYSTEM STABILITY

8.1 Overview

In 2010, reflecting the expansion of economic activity and supportive regulatory and supervisory measures, the financial sector showed improved performance, which in turn led to further strengthening financial system stability in the country. The financial sector performed well while resolving concerns and stresses that had arisen in 2008 and 2009 due to certain domestic and external shocks adversely impacting on public and investor confidence and business operations. The improved performance was reflected in all leading indicators of financial institutions, markets, payments systems and safety nets. With regard to financial institutions, the expansion of business operations supported by the recovery in credit/accommodation, improved profitability, enhanced capital adequacy and the reduced non-performing loan position with increased loan loss provision point to their better performance. Financial markets operated with high liquidity, and improved investor sentiment was reflected in the increased volume of operations. Rising stock prices resulting in higher capital gains, declining interest rates/yield rates and an appreciation of the rupee against the US dollar with greater stability in the exchange rate were the key market outcomes. Use of the payments systems expanded while the payments system infrastructure was upgraded. The financial safety net was further strengthened with the introduction of a mandatory deposit insurance scheme for licensed banks and finance companies to protect small depositors, the implementation of a number of regulations to encourage prudence in operations of financial institutions, several rules for stock trading in the Colombo Stock Exchange to promote healthy trading and resolution action on a number of distressed financial institutions. As a result of the improved performance of the financial sector, supported by macroeconomic recovery and an enhanced safety net mechanism, no major issues concerning financial system stability remained unresolved.

However, a number of concerns and issues relating to performance of certain individual institutions and the sector as a whole requiring attention of the regulators and other stakeholders continued to prevail. Amongst these issues are the high intermediation cost (as reflected in high interest margins of banks), excess liquidity in relation to certain commercial banking institutions, recovering of bad assets and the effective implementation of deposit repayment plans in respect of distressed-finance companies to boost confidence, combating Ponzi schemes operated through fraudulent investment proposals and prohibited schemes operated under the mask of multi-level marketing, the sustainability of the current stock price boom, marginal level of activity and primitive status of the corporate debt securities market, lack of initiatives taken by derivatives market participants for their further development, monitoring international capital flows to promote economically healthy flows of foreign capital and the conduct of suitable programmes to enhance financial literacy of the general public.

The stakeholders of the financial sector need to understand several key challenges to promote the financial sector with stability, especially in view of the lessons learned from various financial crises up to the global financial crisis of 2007-2009. First, possible emergence of financial institutions and conglomerates that would be too-big-to-fail should be managed prudently to prevent systemic stresses in the future. Therefore, the tendency or desire of financial institutions to expand in pursuit of economies of scale needs to be followed up with adequate caution. Second, the possible expansion of the segment of population consisting of middle-income earners and the expansion of financial markets will encourage commercial banks to diversify business into investment banking/ proprietary trading devices that are widely believed to be immediate sources of systemic risks. Third, market initiatives should emerge for setting up exchange-based derivatives markets in view of their role in promoting liquidity, price discovery and market risk management so as to facilitate further development of markets. Fourth, financial institutions should re-position themselves for financial innovation in products for intermediation, payments and fund transfers, financial market services, investments as well as fund management, to facilitate emerging economic activity without compromising consumer rights and protection, financial due-diligence and prudential regulations. Finally, the shadow banking system (i.e., non-banking financial intermediaries which may or may not be regulated) should be monitered and streamlined to prevent banking regulatory arbitrage that could lead to systemic risks.

Table 8.1 Total Assets of the Major Financial Institutions

	2009		2010(a)	
	Rs. bn	Share in Total %	Rs. bn	Share in Total %
Banking Sector	3,835.2	68.3	4,533.2	67.7
Central Bank	821.9	14.6	985.4	14.7
Licensed Commercial Banks	2,506.6	44.7	2,969.3	44.4
Licensed Specialised Banks	506.7	9.0	578.5	8.6
Other Deposit Taking Financial Institutions	315.7	5.6	400.9	6.0
Registered Finance Companies	185.3	3.3	233.6	3.5
Co-operative Rural Banks	124.5	2.2	160.6	2.4
Thrift and Credit Co-operative Societies	5.9	0.1	6.7	0.1
Other Specialised Financial Institutions	257.4	4.6	354.8	5.3
Specialised Leasing Companies	111.8	2.0	154.1	2.3
Primary Dealers	99.8	1.8	125.8	1.9
Stock Broking Companies	6.4	0.1	13.2	0.2
Unit Trusts / Unit Trust Management Companies	10.6	0.2	23.0	0.3
Market Intermediaries (b)	27.1	0.5	37.0	0.6
Venture Capital Companies	1.5	0.0	1.6	0.0
Credit Rating Agencies	0.2	0.0	0.1	0.0
Contractual Savings Institutions	1,205.5	21.5	1,401.5	21.0
Insurance Companies	181.0	3.2	221.7	3.3
Employees' Provident Fund	772.0	13.8	902.0	13.5
Employees' Trust Fund	107.3	1.9	125.9	1.9
Approved Private Provident Funds	121.9	2.2	126.2	1.9
Public Service Provident Fund	23.3	0.4	25.7	0.4
Total	5,613.8	100.0	6,690.4	100.0

(a) Provisional

Source: Central Bank of Sri Lanka

(b) Excluding the assets of Licensed Banks, Registered Finance Companies and Specialised Leasing Comapnies which are registered as Market Intermediaries.

8.2 Performance of the Banking Sector

Beign the most dominant and systermatically important sector in the financial system, the banking sector carried out an increased volume of transactions to facilitate the highest growth of the economy. The year 2010 was a high performance year in the last decade. Its high performance was reflected in the high rate of business growth,

improved credit quality with favourable credit-loss provision coverage, a high level of profitability, and the maintenance of capital adequacy ratios and liquidity ratios well above the statutory limits.

Business Growth

(a) Outreach: As at end of the year, the number of banks stood at 31 (reduced from 36 in 2009) comprising 22 licensed commercial banks (LCBs) and 9 licensed specialised banks (LSBs). The reduction was due to the vesting of the businesses of the state owned six Regional Development Banks with another newly incorporated state bank, Pradeshiya Sanwardana Bank. During the year, the banking network further expanded with the opening of 85 branches, 97 extension offices and 130 automated teller machines (ATMs). Accordingly, there were 1,932 branches, 965 extension offices, 2,977 other banking outlets and 2,006 ATMs by the end of 2010. Out of the new banking outlets, 67 branches and 77 extension offices were opened outside the Western Province, which included 21 and 27 banking outlets in the Northern and Eastern provinces, respectively. Accordingly, banking density remained at 9 branches per 100,000 persons during the year 2010.

(b) Assets: Total assets of the banking sector recorded a growth of 18 per cent by the end of 2010 in comparison to a somewhat lower growth of 12 per cent in 2009. This was mainly the result of the significant growth in loans by 23 per cent compared to the negative growth of 2 per cent in 2009. The growth of loans was mainly in respect of the agriculture, consumption, infrastructure, trade and construction sectors, with annual growth of 60 per cent, 36 per cent, 29 per cent, 28 per cent and 23 per cent, respectively. The negative growth of credit card advances continued and was at a negative 3 per cent (negative 7 per cent in 2009) while advances against pawning indicated a significant growth of 40 per cent (18 per cent in 2009). Further, overdrafts and term loans including housing loans recovered from the negative growth of 14 per cent and 11 per cent, respectively, reported in 2009 to a significant growth of 35 per cent and 24 per cent, respectively, by the end of 2010. The growth in

Table 8.2 Distribution of Banks and Bank Branches

Category	End 2009(a)	End 2010(b)
Licensed Commercial Banks (LCBs)		
I.Total No.of LCBs	22	22
Domestic banks	11	11
Foreign banks	11	11
II.Total No.of LCB Branches and Other Outlets	5,002	5,119
Branches	1,382	1,432
Domestic Bank Branches	1,338	1,386
Foreign Bank Branches	44	46
Extension Offices	832	898
Domestic Banks	662	728
Foreign Banks	170	170
Student Savings Units and Other Outlets	2,788	2,789
Automated Teller Machines	1,757	1,848
Licensed Specialised Banks (LSBs)		
I. Total No. of LSBs	14	9
Regional Development Banks (c)	6	1
National Savings Bank	2	2
Long-term Lending Institutions	2	2
Housing Finance Institutions	2	2
Private Savings and Development Banks	2	2
II. Total No. of LSB Branches and Other Outlets	676	755
Branches	465	500
Regional Development Banks	226	230
National Savings Bank	147	173
Long-term Lending Institutions	21	23
Housing Finance Institutions	28	28
Private Savings and Development Banks	43	46
Extension Offices	36	67
Student Savings Units and Other Outlets	175	188
Automated Teller Machines	119	158
Total No. of Bank Branches and Other Outlets	5,678	5,874
Total No. of Automated Teller Machines (ATM's)	1,876	2,006
Total No. of Electronic Fund Transfer Facilities at the Point of Sale Machines (EFTPOS)	24,977	27,588
Banking Density: No. of Bank Branches Per 100,000 Persons	9.13	9.35

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

Source: Central Bank of Sri Lanka

Table 8.3 Credit Card Operations by Licensed Commercial Banks

	2009	2010 (a)	% Change
Total Number of Credit Cards in use	840,509	778,549	(7.4)
Accepted only locally	58,302	58,771	0.8
Accepted globally	782,207	719,778	(8.0)
Outstanding Credit at end-year (Rs. mn)	32,159	31,168	(3.1)
Interest rates charged from customers (%)			
for Cash	33.00-48.00	21.96-36.00	
for Credit	30.00-48.00	21.96-26.60	
Commission from Dealers (%)	1.5-4.0	1.7-4.0	

(a) Provisional

Source: Central Bank of Sri Lanka

Table 8.4 Composition of Assets and Liabilities of the Banking Sector

Item	2009 Rs. bn	2009 % of Total	2010 (a) Rs. bn	2010 (a) % of Total	% Change 2009	% Change 2010
Assets						
Loans	1,596	53.0	1,959	55.2	(2.3)	22.7
Investments	929	30.8	1,081	30.5	38.0	16.4
Others	488	16.2	508	14.3	25.1	4.1
Liabilities						
Deposits	2,232	74.1	2,587	72.9	18.8	15.9
Borrowings	389	12.8	497	14.0	(15.0)	27.7
Capital Funds	243	8.1	293	8.3	11.2	20.5
Other	149	5.0	171	4.8	4.9	14.8
Total Assets/Liabilities	**3,013**	**100.0**	**3,548**	**100.0**	**11.7**	**17.7**

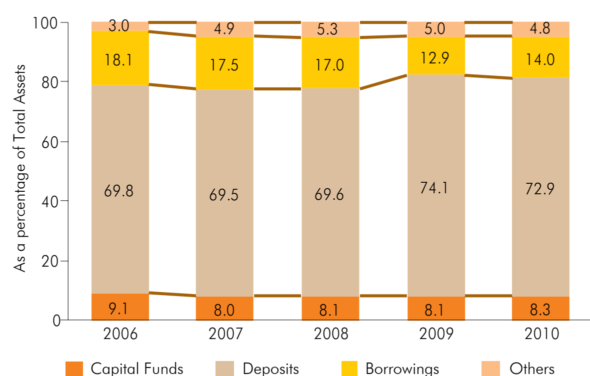
(a) Provisional

Source: Central Bank of Sri Lanka

investments decelerated from 38 per cent in 2009 to 16 per cent in 2010. Overall, the composition of assets changed marginally where the share of loans improved from 53 per cent in 2009 to 55 per cent in 2010 and the share of investments remained at 31 per cent.

(c) Liabilities: The growth of funds raised through deposit products declined from 19 per cent in 2009 to 16 per cent in 2010. However, deposits remained the main funding source accounting for 73 per cent of total liabilities. Total borrowing recorded a significant growth of 28 per cent in 2010 against the negative growth of 15 per cent in 2009 and the share of borrowings in total funds increased marginally from 13 per cent to 14 per cent. Capital funds also recorded a significant growth of 21 per cent by end 2010. However, the share of Capital funds in the total liabilities remained unchanged at 8 per cent.

Chart 8.1 Funding Structure of the Banking Sector

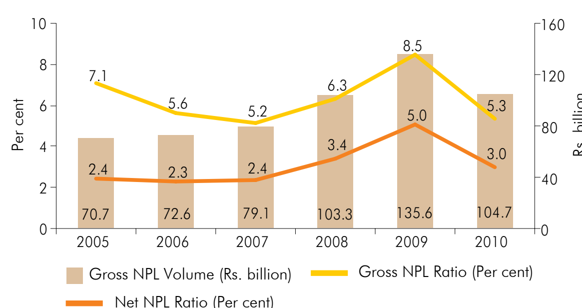


(d) Off-balance Sheet Exposures: The off-balance sheet exposures (contingencies and commitments) increased by 19 per cent against a negative growth of 4 per cent recorded in 2009, mainly due to the recovery in foreign trading activities. Consequently, the exposure of the off-balance sheet items as a percentage of total assets increased marginally from 37 per cent in 2009 to 38 per cent by end 2010. Forward sales and purchases of foreign exchange, guarantees, bonds and letters of credit were the most demanded types of off-balance sheet facilities.

Risk Management

(a) Credit Risk: Credit quality improved significantly as reflected in the decline in non-performing loans (NPLs). The amount of gross NPLs (without interest in suspense) declined from Rs. 136 billion in 2009 to Rs. 105 billion in 2010, a fall of 23 per cent by end 2010, against the significant increase of 31 per cent in 2009. The improvement was also indicated in the NPL ratios (the ratio of NPLs to total loans) where the gross NPL ratio and net NPL ratio (net of loan loss provision) declined from 8 per cent and 5 per cent, respectively, in 2009 to 5 per cent and 3 per cent, respectively, in 2010. The share of NPLs in the loss category increased from 47 per cent in 2009 to 56 per cent in 2010 where as a corresponding decline was recorded in the share of NPLs in the substandard category, which declined from 23 per cent in 2009 to 13 per cent in 2010. Further, the loan loss provision coverage improved from 53 per cent

Chart 8.2 Non-Performing Loans of the Banking Sector



in 2009 to 60 per cent in 2010. The decline in the ratio of net NPLs to capital from 26 per cent in 2009 to 14 per cent by end 2010 indicated a desirable movement of credit risk absorption capacity of the banking sector. Further, about 90 per cent of the investments of the banking industry were in the government securities, indicating a low credit risk in respect of investments.

(b) Market Risk: The movements of interest rates have not had a significant impact on the earnings of the banking sector during the year 2010. Despite the declining interest rates in the economy, the interest margin (net interest income as a per cent of average assets) of the banking sector remained unchanged at 4.6 per cent. As regards the foreign exchange risk, the banks' exposure was low with the foreign currency assets and liabilities remaining low around 11 per cent and 13 per cent (net liability position of 2 per cent), respectively, of total assets and liabilities. Meanwhile, commercial banks, as authorised dealers in foreign currency, maintained a low level in relation to the over-sold position in foreign currency, with a ratio of net open position to capital base of 1.2 per cent by end 2010 expecting an appreciation of the rupee against the US dollar. Accordingly, with an appreciation of the rupee by 3.1 per cent in 2010, commercial banks were able to report foreign exchange gains (net) of Rs. 12 billion accounting for 24 per cent of total non-interest income.

(c) Liquidity Risk: Liquidity risk was not a major concern in the banking sector in 2010. The cumulative gap between assets and liabilities based on the contractual maturity as a percentage of the cumulative liabilities, a key liquidity risk indicator, showed a negative gap (maturity of assets longer than the maturity of funds/liabilities) for all maturities up to 5 years indicating the fundamental liquidity risk involved in financial intermediation. Further, the negative gap widened towards the period of six months. However, this gap remained unchanged at around 19 per cent for maturity periods up to one year.

In addition, liquid assets maintained to meet financial obligations were at high levels. The overall statutory liquid asset ratio of the banking system was well above the stipulated minimum requirement (20 per cent of non-capital liabilities). This ratio was high at 36.6 per cent as at end 2010, although it tended to decline due to the increased utilisation of funds for lending business. The liquidity ratio in the specialised banking sector was excessively high due to the dominance of the National Savings Bank (NSB), which is required to invest a minimum of 60 per cent of its deposits in government securities. Investments in government securities by the banking sector accounted for nearly 76 per cent of the liquid assets consisting of investments in Treasury bills (34 per cent), Treasury bonds (32 per cent) and Sri Lanka Development Bonds (10 per cent). The balances with banks abroad (Nostro accounts) accounted for 8 per cent of liquid assets. Overall, liquid assets represented a larger share of 31 per cent in the total asset/liability base of the banking sector, which is above the cumulative negative gap at any maturity period. Accordingly, the banking system operated with a high capacity to meet any sudden liquidity requirements during the year 2010.

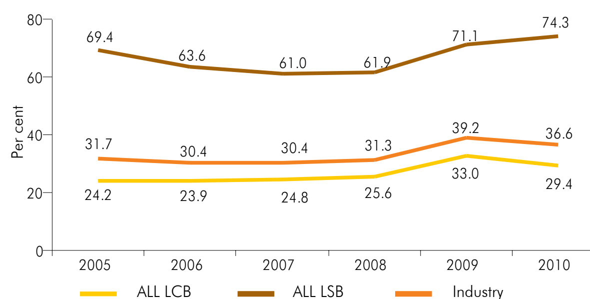
Table 8.5 Composition of Statutory Liquid Assets of the Banking Sector

Item	2009		2010 (a)		% Change	
	Rs. bn	% of Total	Rs. bn	% of Total	2009	2010
Treasury Bills	269.2	25.3	375.0	33.8	60.8	39.3
Treasury Bonds	319.1	30.0	350.5	31.6	75.4	9.9
Sri Lanka Development Bonds	160.8	15.1	106.8	9.6	96.1	(33.6)
Cash	39.5	3.7	47.3	4.3	12.8	19.7
Money at Call	37.5	3.5	53.0	4.8	(14.8)	41.4
Balances with banks abroad	98.2	9.2	90.3	8.1	22.9	(8.1)
Other	140.0	13.2	86.4	7.8	19.2	(38.3)
Total Liquid Assets	**1,064.4**	**100.0**	**1,109.3**	**100.0**	**39.4**	**4.2**

(a) Provisional

Source: Central Bank of Sri Lanka

Chart 8.3 Liquidity Ratios of the Banking Sector



Profitability and Capital

(a) Profitability: The banking industry achieved a considerably high level of profits in 2010. The profit after tax amounted to Rs. 57.5 billion during the year 2010, a 111 per cent growth in comparison to a profit of Rs. 27.2 billion in 2009. This was reflected in improved Return on Assets and Return on Equity ratios, which increased from 1.0 per cent and 11.8 per cent, respectively, in end 2009 to 1.8 per cent and 21.6 per cent, respectively, in end 2010. The significant growth in profitability was mainly attributed to a higher increase in fee-based income, a lower increase in non-interest expenses and the reversal of loan loss provisions due to reduced provisioning requirement. The interest margin (net interest income as a percentage of average assets) remained unchanged at 4.6 per cent, whereas the decline in non-interest expense and write-back of provisions contributed to the increased Return on Assets, while Return on Equity significantly improved from 11.8 per cent to 21.6 per cent.

(b) Capital: Overall capital funds of the banking sector improved, thus increasing the cushion available for absorbing risks. Total capital funds grew by 21 per cent from Rs. 243 billion as at end December 2009 to Rs. 293 billion by end December 2010. Internally generated capital (Rs. 10 billion) and fresh capital infusions in several banks (Rs. 7 billion) contributed to this increase. The ratio of capital funds to assets (leverage ratio) improved from 8 per cent in 2009 to 9 per cent in 2010, which was a considerably higher level compared with the 4 per cent regulatory minimum applied in some countries. Further, the Regulatory Capital Adequacy ratio (CAR) remained high at 15 per cent, well above the minimum requirement of 10 per cent, as at end 2010. As a result of high growth in loans, the CAR reported a decline from 16 per cent in the previous year, since the risk weighted assets against which capital should be maintained increased by 17 per cent compared to a reduction of 2.8 per cent in 2009. Meanwhile, the Core Capital ratio was at 13 per cent, well above the minimum requirement of 5 per cent. The composition of the regulatory capital in 2010 indicated a notable change where the share of retained profit in core capital increased from 28 per cent in 2009 to 30 per cent in 2010 and the share of general provisions in Tier II capital increased from 6 per cent in 2009 to 39 per cent in 2010. However, the share of subordinated term

Chart 8.4 Profitability Indicators of the Banking Sector

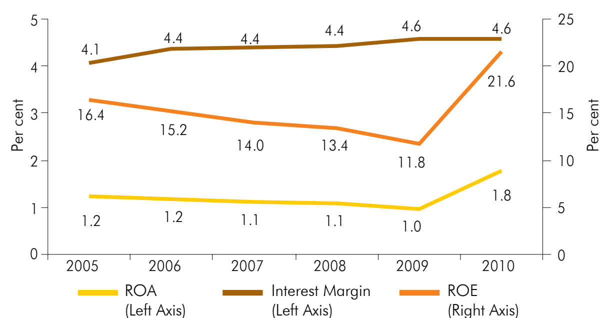


Table 8.6 Profit of the Banking Sector

Item	Amount (Rs.bn) 2009	Amount (Rs.bn) 2010 (a)	Growth 2009 Amount (Rs.bn)	Growth 2009 %	Growth 2010 Amount (Rs.bn)	Growth 2010 %
Interest Income	364.3	326.1	20.5	6.0	(38.2)	(10.5)
Interest Expenses	234.0	178.7	5.3	2.3	(55.3)	(23.6)
Net Interest Income	**130.3**	**147.4**	**15.2**	**13.2**	**17.1**	**13.1**
Non-Interest Income	59.2	66.8	4.7	8.7	7.6	12.9
Non-Interest Expenses	96.6	103.1	7.6	8.6	6.5	6.7
Staff Cost	44.9	45.6	5.3	13.5	0.7	1.6
Loan Loss Provisions (net)	21.5	(6.4)	9.7	82.6	(27.9)	(129.6)
VAT	19.2	28.6	3.3	20.6	9.4	48.7
Profit before Corporate Tax	**52.2**	**88.7**	**1.8**	**3.5**	**36.5**	**69.9**
Profit after Corporate Tax	**27.2**	**57.5**	**(0.5)**	**(1.9)**	**30.3**	**111.1**

(a) Provisional

Source: Central Bank of Sri Lanka

Table 8.7 Composition of Regulatory Capital of the Banking Sector

Item	Amount (Rs.bn) 2009	Amount (Rs.bn) 2010 (a)	Composition (%) 2009	Composition (%) 2010
Tier I Capital	**215**	**232**	**87.0**	**87.5**
Share Capital	85	89	34.4	33.6
Statutory Reserve Funds	12	12	4.9	4.5
Retained Profits	61	70	24.7	26.4
General and Other Reserves	57	52	23.1	19.6
Other	0	8	0.0	3.0
Tier II Capital	**32**	**33**	**13.0**	**12.5**
Revaluation Reserves	5	5	2.0	1.9
General Provisions	2	13	0.8	4.9
Subordinated Term Debt	25	15	10.1	5.7
Total Regulatory Capital Base	**247**	**265**	**100.0**	**100.0**

(a) Provisional

Source: Central Bank of Sri Lanka

BOX 15 Role of Banks in Consumer Well-Being

Banks play a significant role in facilitating day to day activities of the general public. The general public save their excess funds with banks, they borrow from banks to finance their needs and obtain other services from banks for payment transactions. The business of banks, therefore, crucially depends on trust and customer confidence. In turn, confidence depends on the extent of the safety of transactions, which requires prudence of banking operations as well as protection to customers.

Conventionally, regulators have been concerned mainly about prudence, as prudent banking will finally promote customer protection. However, as a result of the recent financial crises, the regulator's attention is also increasingly drawn to explicit customer protection and rights of customers in relation to their transactions with banks.

In promting customer protection the following would need to be looked into,

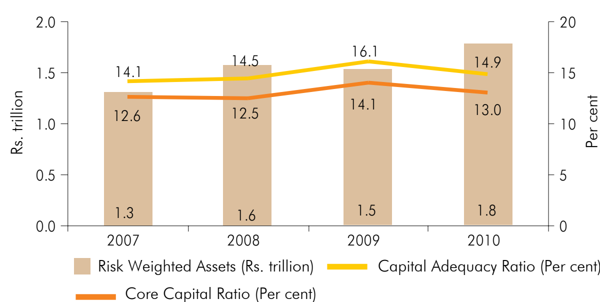
- **Availability of documents on all products/services, separately**: Separate Key Facts Document containing all relevant information in the form of a brochure/leaflet written in plain language for each and every product/service should be available when making an offer or recommendation to a customer.
- **Clear terms and conditions in all agreements**: Clear statements, terms and conditions minimise disputes and help customers take informed decisions.
- **Sufficient time and complete information for decision making**: Sell products/services after providing proper explanations regarding the products/ services and allowing sufficient time for customers to make decisions.
- **Prior and timely notice before withdrawal/termination of products/services**: Withdraw/terminate a product/service already in contract with reasonable notice and exit compensation.
- **Ethical advertising in the media**: The public generally tends to believe in advertisements and expects the results/benefits in the same manner as revealed in the advertisement. Ethical advertising with actual facts, ultimately enhances public confidence in the bank.
- **Display information in all banking outlets**: Displaying information such as interest rates applicable to deposits and advances, exchange rates and details of the Financial Ombudsman etc. in the branches and other outlets of the bank, can accelerate customers in taking early decisions.
- **Changes in 'Terms and Conditions' and other transaction details in statements**: Timely information on changes in the 'Terms and Conditions' and other transaction details (i.e., statements) should be provided to the customers.
- **Healthy sales promotion and recovery methods by collecting agents**: This will protect the integrity of customers, leading to confidence building in relation to the performance of the entire industry.
- **Proper grievance-resolution mechanism**: An efficient and effective internal mechanism to handle customer complaints needs to be established.

Regulatory intervention to safeguard customers' interests

In Sri Lanka, at present, the Financial Ombudsman Scheme helps in resolving customer complaints. Parallel to the development of the banking industry in Sri Lanka, the protection of the customers of banks is also considered to be an area that requires the regulator's intervention. Accordingly, the Central Bank of Sri Lanka plans to launch a 'Customer Charter' with the primary objective of introducing rights and obligations of customers and fair banking practices. The Charter would also mandate banks to develop a Code of Conduct for its officers which could be made available for customers as well.

debt in Tier II capital declined significantly from 78 per cent in 2009 to 45 per cent by end 2010. The Core Capital ratio of 13 per cent of risk weighted assets and the share capital (high quality capital to absorb unexpected losses) of 5 per cent were already above the prudential limits of 6 per cent and 4.5 per cent respectively, recommended under international standards of Basel III.

Chart 8.5 Capital Adequacy Ratios of the Banking Sector



Supervisory and Regulatory Developments

During the year, the Central Bank further strengthened its supervisory and regulatory framework to improve the safety net and risk management systems of banks. The details of these measures are given in Part II and Part III of this Report. In addition to the continued supervisory measures through examination and problem resolution, several regulatory measures were introduced. Those included increasing the minimum capital that LCBs and LSBs are required to maintain from Rs. 2.5 billion and Rs. 1.5 billion, respectively, to Rs. 5 billion and Rs. 3 billion, respectively, on a staggered basis from 2010 to 2015, the implementation of a mandatory deposit insurance scheme, the relaxation of classification of loans as non-performing loans, the reduction of the general loan loss provision to be maintained from 1 per cent to 0.5 per cent by 31 December 2011, by reducing at a rate of 0.1 per cent per quarter commencing from the quarter ending 31 December 2010, the application of the assessment of the fitness and propriety to officers performing executive functions, requiring unlisted locally incorporated private banks to list on the Colombo Stock Exchange by 31 December 2011 and the issue of directions on outsourcing of activities. Further, work was in progress in relation to new directions to restrict credit exposure of banks through margin trading of shares, integrated risk management and the customers' charter.

8.3 Performance of Non-Banking Financial Institutions

Registered Finance Companies

Registered Finance Companies (RFCs) gradually recovered in 2010 after experiencing liquidity problems since 2009. The growth of accommodations and deposits, improved credit quality and increased profits were the favourable indicators. However, deterioration of capital and shortage of liquidity continued in a few RFCs. The resolution measures implemented by the Central Bank could boost depositor confidence in the sector and investor interest in the liquidity-threatened RFCs.

Business Growth

(a) Outreach: As at the end of the year, along with the issuance of two new licences, the total number of RFCs in business increased to 37. Meanwhile, the branch network increased by 98 to 376 during the year.

(b) Assets: The asset base increased substantially in 2010. The total assets stood at Rs. 234 billion, showing a growth of 26 per cent compared to the marginal 6 per cent growth reported in 2009. The key contributory factor was the increase in accommodations. Hire purchase, finance lease and pawning were the major sources of accommodations accounting for 35 per cent, 30 per cent and 10 per cent, respectively. The growth of total accommodations was 38 per cent. The increased portfolio of leasing

Table 8.8 Composition of Assets and Liabilities of RFCs

Item	2009		2010 (a)		% Change	
	Rs.bn	% of Total	Rs.bn	% of Total	2009	2010
Assets						
Loans & Advances	113.5	61.2	156.2	66.9	1.5	37.6
Investments	15.2	8.2	20.7	8.9	3.8	35.9
Others	56.6	30.6	56.7	24.3	15.2	0.0
Liabilities						
Deposits	119.8	64.6	146.1	62.6	15.8	22.0
Borrowings	19.2	10.4	34.2	14.7	(26.8)	78.2
Capital	20.6	11.1	21.6	9.3	(18.4)	4.8
Total Funds	***159.6***	***86.1***	***202.0***	***86.5***	***3.0***	***26.5***
Others	25.8	13.9	31.6	13.5	25.0	22.6
Total Assets/Liabilities	185.4	100	233.6	100	5.6	26.0

(a) Provisional

Source: Central Bank of Sri Lanka

and hire purchase contributed 57 per cent to this growth. Pawning advances doubled during the year to be the fourth largest category of accommodations. However, there was a 15 per cent decline in loans against real estate.

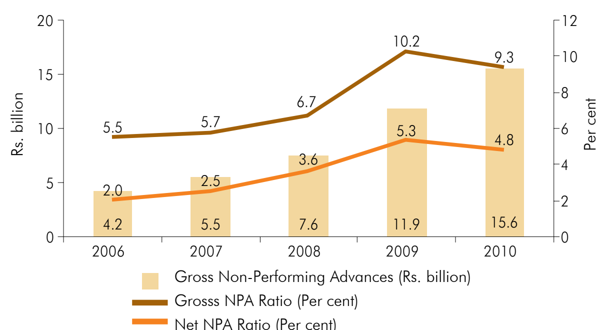
(c) Liabilities: The increase in the growth of deposits from 16 per cent in 2009 to 22 per cent in 2010 reflected the improved depositor trust in the RFC sector. Deposits were the major source of funding representing 72 per cent of the fund base and 63 per cent of the total liabilities. Deposit mobilisation was primarily through time deposits which accounted for nearly 96 per cent of total deposits. The borrowings also rose significantly by 78 per cent compared to a decline of 27 per cent in 2009, reaching 17 per cent of the funding base. Meanwhile, capital funds increased marginally by 5 per cent reversing the negative growth of 18 per cent reported in the previous year.

Risk Management

(a) Credit Risk: A major improvement in credit risk management was not reported during the year. The total amount of non-performing accommodations continued to increase. However, the exposure to non-performing accommodations relative to total accommodations outstanding declined, as shown in the reduction in the ratio of non-performing accommodations to total accommodations from 10 per cent in 2009 to 9 per cent in 2010. When provisions for non-performing accommodations were considered, the net exposure was 5 per cent of total accommodations. Accordingly, the total provision coverage for non-performing accommodations increased from 49 per cent in 2009 to 54 per cent in 2010. The non-performing ratios of leasing and hire purchase were low at 6 per cent and 5 per cent, respectively, whereas non-performing pawning was almost zero.

(b) Market Risk: The movements in interest rates have had a significant favourable impact on the earnings during the year 2010. Despite the declining interest rates in the economy, the interest margin (net interest income as a percentage of total assets) has widened considerably to 5 per cent in 2010 from 3 per cent in 2009. Accordingly, the net

Chart 8.6 Non-Performing Accommodations of RFCs



interest income of the sector increased by 132 per cent to Rs. 10.6 billion in the year 2010 from Rs. 4.6 billion in 2009.

(c) Liquidity Risk: The liquidity position tended to improve, but liquidity shortfalls of several RFCs were reported. The total value of statutory liquid assets by end 2010 indicated a marginal deficit of Rs. 0.1 billion when compared with the amount required for meeting the minimum statutory liquid assets ratios (i.e., 10 per cent of time deposits and certificates of deposits and 15 per cent of savings deposits).

Profitability and Capital

(a) Profit: Benefitting from the decline in interest rates in 2010 and improved economic activity, profitability of the RFC sector re-emerged in 2010 with the sector posting a before-tax profit of Rs. 2.2 billion compared to a loss of Rs. 1.2

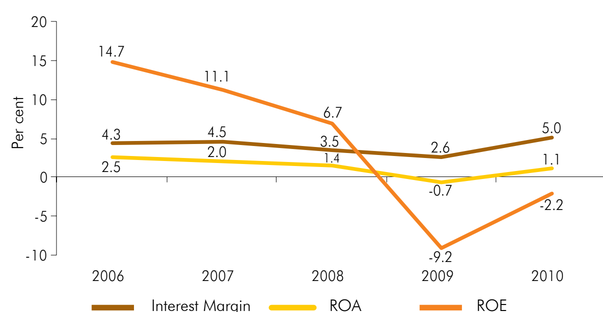
Table 8.9 Profit of RFCs

Item	Amount (Rs.bn)		Growth			
			2009		2010	
	2009	2010 (a)	Amount (Rs.bn)	% Change	Amount (Rs.bn)	% Change
Interest Income	22.4	26.0	0.5	2.3	3.6	16.0
Interest Expenses	17.8	15.4	1.5	9.3	(2.5)	(13.8)
Net Interest Income	**4.6**	**10.6**	**(1.0)**	**(18.0)**	**6.1**	**132.4**
Non-Interest Income	3.8	5.1	(1.3)	(25.4)	1.2	32.3
Non-Interest Expenses	7.8	10.4	0.3	3.5	2.6	33.2
Loan Loss Provisions (net)	1.7	3.0	0.9	110.4	1.3	75.2
Profit before Tax	**(1.2)**	**2.2**	**(3.5)**	**(150.2)**	**3.4**	**291.5**
Tax	0.8	2.6	0.1	10.1	1.8	228.2
Profit after Tax	**(2.0)**	**(0.4)**	**(3.6)**	**(223.5)**	**1.6**	**79.8**

(a) Provisional

Source: Central Bank of Sri Lanka

Chart 8.7 Profitability Indicators of RFCs



billion in 2009. A considerable increase in net interest income mainly contributed to the increase in profits. The increase in profits was reflected in improved Return on Assets and Return on Equity ratios, which stood at 1 per cent and negative 2 per cent, respectively, in 2010 compared to negative 1 per cent and negative 10 per cent respectively, in 2009. However, profitability of the sector remained at a very low level. The low profitability was a result of 6 distressed RFCs, which accounted for 26 per cent of the total assets of the sector, and thus, is expected to improve in the coming years consequent to the resolution of these companies.

(b) Capital: Although capital funds in the balance sheet improved marginally, the regulatory capital defined for the maintenance of capital adequacy ratios continued to erode during the year. Total regulatory capital declined from Rs. 15 billion by end 2009 to Rs. 12 billion as at end 2010. Significant losses posted by distressed companies caused this erosion of funds. However, the statutory capital adequacy ratios mostly remained above the required minimum levels. The ratio of regulatory capital funds to total deposits, which was 16 per cent as at end 2009 declined to 12 per cent as at end 2010 (statutory minimum level of 10 per cent). The core capital ratio (as a percentage of risk weighted assets) declined from 9 per cent to 5 per cent (required minimum is 5 per cent). Meanwhile, the total risk weighted capital ratio deteriorated below the required minimum of 10 per cent to 7 per cent at end 2010.

Supervisory and Regulatory Developments

(a) New Regulations: In order to prevent unhealthy competition for deposit-taking business and ensure public confidence and sustainability, regulations were issued setting maximum rates of interest to be offered by RFCs. The draft of the Finance Business Act to replace the current Finance Companies Act was finalised with the approval of the Cabinet of Ministers to be presented to the Parliament in 2011.

(b) Resolution of Distressed RFCs: During the year, efforts were made to rehabilitate six RFCs affected by the liquidity crisis that erupted at the end of 2008. Major measures included the appointment of a managing agent, new investors to infuse capital and take-over the management, the conversion of deposit liabilities and debt into equity, rescheduling of deposits and interest, the disposal of real estate properties and fast tracking the recovery of non-performing assets. In addition, the Central Bank Credit Guarantee Scheme was in place to support the granting of credit to RFCs through licensed banks. Accordingly, three RFCs were able to commence normal business operations while the managing agent was released from two RFCs. One RFC concluded the public issue of shares successfully while another has been able to convert deposits into equity as planned. Strategic investors were identified for two RFCs while prospective investors for other RFCs were under the review and due diligence process. All distressed RFCs will be able to revive their businesses fully during 2011.

(c) Action against the Conduct of Business without Authority: Investigations into institutions allegedly engaged in finance business without authority were continued while assisting courts with respect to pending litigation. The total number of such institutions and parties was 50 and the number under litigation was 15. Parallel to these measures, public awareness programmes by way of country-wide seminars/workshops as well as advertisements were carried on to educate the public on the risks of investing in unregulated institutions.

BOX 16 Regulations for the Microfinance Sector

Microfinance

The microfinance sector comprises of a variety of entities including savings associations, rotating savings clubs, credit associations, funeral or death benefit societies, and other such savings and credit clubs/groups. A microfinance institution has been defined as *"a credit methodology that employs effective collateral substitutes to deliver and recover short-term, working capital loans to micro entrepreneurs"* and as a poverty reduction strategy (Consultative Group to Assist the Poorest (CGAP), 2003). In terms of operational activities, it provides various financial services; including loans, savings, insurance, remittances and other services (advisory and technical services) that target low income clients, particularly, people living in poverty who were traditionally neglected by the formal banks/financial institutions. As such, microfinance is expected to expand and improve the income generation activities and capacities of the low income earners. The most popular model is the lending through self-help groups. This model has been successfully used as a credit delivery mechanism in the microfinance sector.

Microfinance Sector in Sri Lanka

- The microfinance sector in Sri Lanka consists of a large number of institutions that are different in size, activities, operating areas, operational mechanisms, institutional structures and funding methods adopted. In terms of the legal provisions, Micro Finance Institutions (MFIs) have been registered under various legal statutes, i.e., Finance Companies Act, Finance Leasing Act, Co-operative Societies Law, Samurdhi Authority of Sri Lanka Act, Agrarian Development Act, Companies Act and Voluntary Social Services Organization (Registration and Supervision) Act.
- Some MFIs operate as financial intermediaries, mobilizing funds as savings or sometimes as borrowings, mainly from its members or non-members for lending, while others operate only as lending/credit institutions. The lending/credit-only institutions mobilize funds from international or local donors or borrow from the formal sector. In terms of the activities, some operate as profit-making institutions while others are non-profit oriented. When microfinance institutions engage in deposit-taking in order to mobilize household savings, they become financial intermediaries. These institutions, if not regulated or supervised, pose concerns to the authorities/regulators as there is a responsibility to safeguard the depositors and other creditors and to protect the consumer right of the poor.
- Informal or non-institutional microfinance providers include savings associations, rotating savings clubs or credit associations, funeral or death benefit societies, traders, moneylenders, input suppliers and relatives.

Importance of Microfinance

Most of the low income people lack access to basic financial services. Hence, the challenge of providing financial services to them still remains. Increased access to finance among the low income population would contribute towards income generation activities, and thereby improve savings habits as well as their living standards. Further, *"the microfinance services helps people fight poverty on their own terms, in a sustainable way"* (CGAP, 2006). Therefore, microfinance is a powerful instrument for the poor, in the form of financial services directed specifically towards poverty reduction, enabling the poor to build assets, increase their income, and reduce their vulnerability to economic stress. As a result, the poor can improve their living conditions, while taking an active role in economic activities.

Need for a Regulatory Mechanism for Microfinance

- To ensure an effective microfinance sector, it is necessary to have a set of sound MFIs to carry out operations in a sound and professional manner. When any institution mobilizes deposits, such institution should be subject to prudential regulation and supervision in order to safeguard the depositors. With the expansion of such MFIs, the authorities have become more concerned about the safety of the poor people's savings being mobilized, as these MFIs are currently not subject to proper regulation and supervision under any legal statute. Regulation refers to a set of rules that the MFIs would be subject to and supervision is the process of

enforcing compliance with the rules. Lack of regulation could also be a reason why some donors/funding agencies are reluctant to provide financial assistance to the MFIs as they too believe that effective regulation and supervision is essential, in order to ensure significant outreach of the industry in an effective manner while maintaining sustainability.

- As observed in many other countries, the microfinance sector in the country currently suffers from weak corporate governance, poor repayment rates, high lending rates, unethical recovery methods, high transaction costs, recurring losses and significant deficiencies in regulation and supervision. Therefore, the presence of an effective regulatory mechanism which would help streamline the operations of MFIs is essential for transmiting the real benefits accruing from the operations of MFIs to society, effectively. A regulatory mechanism would contribute towards ensuring the soundness of the sector, building up of public confidence and enhancing even wider access to funding sources. This would also discourage the emergence of fraudulent financial activities.

Proposed Regulatory Mechanism

- Under the proposed regulatory mechanism an authority will be established for the regulation and supervision of microfinance businesses, whereas, the Monetary Board of the Central Bank of Sri Lanka will be empowered to set regulations, principles and standards. The Board of the authority will consist of five members; i.e., an officer of the Ministry of Finance nominated by the Secretary to the Treasury, an officer of the Central Bank of Sri Lanka (CBSL) nominated by the Monetary Board of the CBSL, three members appointed by the Minister of Finance, one of whom shall be a person representing a professional accounting body, and the other two from among persons who have academic or professional qualifications in finance, banking, economics, law, management or any other related field together with relevant experience.
- The authority would be empowered to grant licences to carry on microfinance business, issue directions to the MFIs (licensed/registered) on capital requirements, liquid assets, granting accommodation and acceptance of deposits. Further, it can call for information and cause examinations of MFIs and take supervisory actions including cancellation of the licenses.

Specialised Leasing Companies

Specialised Leasing Companies (SLCs) continued to grow in terms of business in 2010 with improvements in credit quality and favourable provisioning for bad and doubtful accommodations.

Business Growth

(a) Outreach: As at the end of 2010, the number of institutions registered under the Finance Leasing Act was 70 of which 15 were licensed banks, 34 were RFCs and 21 were SLCs. The SLC sector's branch network further expanded to 224 with the opening of 44 branches, compared to 180 in 2009. Of the new branches, 15 were opened in the Northern and Eastern provinces.

(b) Assets: During 2010, the total assets of SLCs grew significantly by 38 per cent to Rs. 154 billion compared to a lower growth of 1 per cent in 2009. The high growth of accommodations, at 32 per cent, compared to the negative growth of 10 per cent reported in 2009, was the key contributory factor. The growth of accommodations was mainly in relation to finance leases and hire purchases which recorded an annual growth of 36 per cent and 50 per cent, respectively. However, the share of accommodations in total assets declined to 68 per cent with a commensurate increase in investments. Three SLCs continued to dominate the sector accounting for 72 per cent of the sector's total assets.

(c) Liabilities: Borrowing, which is the major funding source of SLCs, increased by 42 per cent from Rs. 74 billion in 2009 to Rs. 105 billion in 2010. While debt instruments retained its share in funding, other borrowings increased. Capital funds increased by 29 per cent with its share in total funding reducing marginally to 17 per cent.

Table 8.10 Composition of Assets and Liabilities of SLCs

Item	2009 Rs.bn	2009 % of Total	2010 (a) Rs.bn	2010 (a) % of Total	% Change 2009	% Change 2010
Assets						
Accommodations	80.0	71.7	105.4	68.4	(10.3)	31.9
Finance Leases	29.5	26.4	40.2	26.1	(32.7)	36.3
Investments	6.3	5.6	16.8	10.9	16.9	166.7
Others	25.3	22.7	31.8	20.7	62.8	26.0
Liabilities						
Debt Instruments	24.0	21.4	32.7	21.2	14.5	36.6
Other Borrowings	49.9	44.7	72.0	46.7	(11.1)	44.3
Capital Funds	20.5	18.4	26.5	17.2	10.8	28.9
Other	17.1	15.5	22.9	14.8	21.4	31.8
Total Assets/Liabilities	**111.5**	**100**	**154.1**	**100**	**1.4**	**38.2**

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

Risk Management

The exposure to credit risk declined as shown by the reduction in both non-performing accommodations (NPA) volume and ratio. The NPA ratio declined to 5 per cent by end 2010 from 8 per cent at end 2009 while the NPA amount declined to Rs. 5.4 billion from Rs. 6.0 billion. A significant improvement of provisioning from 57 per cent of NPA to 78 per cent was a risk mitigation factor. The exposure to investments was high as investment in shares of subsidiaries/related companies amounted to 53 per cent of capital funds of the sector. The SLC sector benefited from the declining market interest rates as indicated by the improvement in the interest margin from 5 per cent in 2009 to 7 per cent in 2010. The sector maintained liquid assets amounting to Rs. 15 billion as at end December 2010, indicating a marginal increase of 15 per cent, compared to the increase of 127 per cent in 2009. These liquid assets stood at 14 per cent of total borrowings as at end 2010.

Chart 8.8 Non-Performing Advances of SLCs

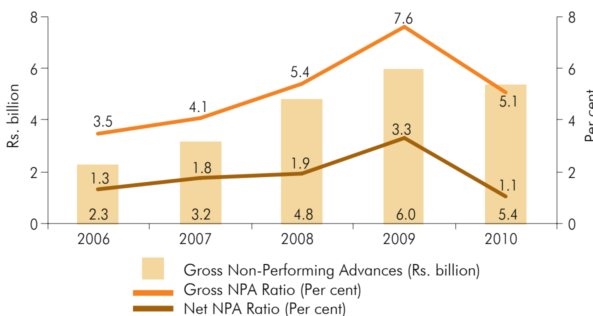


Table 8.11 Profit of SLCs

Item	Amount (Rs.bn) 2009	Amount (Rs.bn) 2010 (a)	Growth 2009 Amount (Rs.bn)	Growth 2009 %	Growth 2010 Amount (Rs.bn)	Growth 2010 %
Interest Income	13.4	15.3	(1.5)	(9.8)	1.9	14.4
Interest Expenses	8.8	7.4	(1.8)	(17.0)	(1.4)	(16.2)
Net interest Income	**4.6**	**7.9**	0.3	8.0	3.3	72.6
Non-Interest Income	**3.2**	**4.0**	0.6	21.8	0.8	26.0
Profit before Tax	**2.6**	**5.8**	0.3	12.6	3.2	123.1
Profit after Tax	**1.5**	**4.0**	**0.0**	**(2.5)**	**2.5**	**158.1**

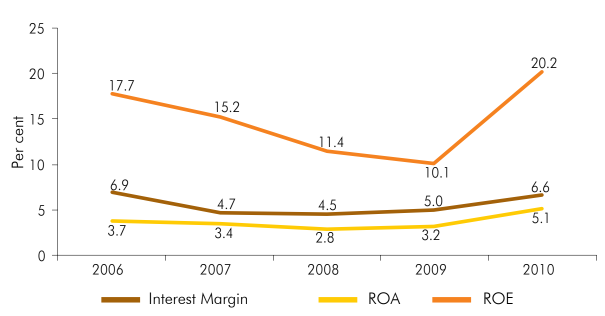
(a) Provisional *Source:* Central Bank of Sri Lanka

Profitability and Capital

(a) Profit: Profitability improved towards the pre-2008 level. The profit after tax increased to Rs. 4 billion during the nine-month period ending December 2010, recording a 167 per cent growth compared to a negative growth in the previous year. The significant growth of profitability was reflected in the ROA (pre-tax) and ROE of 5 per cent and 20 per cent, respectively, in 2010. The ROA and ROE were 3 per cent and 10 per cent, respectively, in 2009.

(b) Capital: Capital funds of the sector improved by 29 per cent to Rs. 26 billion from Rs. 21 billion as at end December 2009, mainly on account of retained profits. However, the ratio of capital to assets marginally decreased. When compared with the gearing ratio of 7 times the capital funds required under prudential regulation, maintaining it at 4 times showed the ability to manage risks with a greater level of capital.

Chart 8.9 Profitability Indicators of SLCs



BOX 17 Distress Resolution: The Case of Non-bank Financial Institutions

Overview

Non-bank financial institutions generally engage in deposit-taking at high rates of interest and offer financial facilities that include hire purchase, leasing and real estate development, which involve a relatively higher risk profile. Beginning November 2008, most in the non-banking sector comprising of 58 institutions (registered finance companies and leasing companies) started confronting depositors' unrest due to certain shocks that resulted from local and global financial conditions. While a large number of non-banks were able to cope with the situation prudently, 8 institutions which belonged to two business groups suffered a crisis of outflow of deposits consequent to weak risk management practices that prevailed in those institutions. As usually observed in crisis-affected financial institutions, they started confronting severe liquidity problems and ended up facing insolvency due to large losses and poor recovery of assets. However, the crisis did not have any contagion effect on the financial sector and therefore, the Central Bank as the regulator adopted a specific resolution mechanism to promote customer confidence and rehabilitation of businesses of those institutions.

Distress Resolution - Policy and Measures

Although the Central Bank had diverse statutory powers to intervene in distressed companies for the purpose of resolution, such as taking over the management and business, reconstitution of the board of directors, suspension of the business and liquidation, it adopted a market-based mechanism to rebuild public confidence and rehabilitate the institutions without resorting to public funds and direct involvement in management. This was specially followed from the lessons the Central Bank learned from its resolution action in relation to thirteen failed finance companies in the early 1990s.

Accordingly, the specific measures implemented by the Central Bank to resolve the distressed institutions in 2008-2009 were as follows:

- Appointment of Managing Agents with state's stakes to manage the distressed companies during the interim period in order to regain depositor confidence and to perform as an agent to implement the decisions of the Monetary Board.
- Executive powers of directors were removed, while requiring the directors to remain on the boards and making them responsible for their affairs in the past.
- The remuneration of employee directors and executives was restricted.
- A ceiling on total deposit liabilities was imposed to prevent the transfer of liabilities from related entities which engaged in deposit-taking without authority.
- A Stimulus Package was introduced with the help of the Government to enable the companies to raise funds using their marketable assets.
- A Credit Guarantee Scheme was launched to provide access to funds from banks.
- A panel of four experts representing business and legal professionals was appointed to advise the distressed companies on business restructuring.
- In order to improve the capital position and lessen the deposit repayment difficulties, deposits and debts were converted into equity with the consent of the depositors and creditors.
- Certain deposits were rescheduled with new repayment periods and reduced interest rates to ease the liquidity problems.
- In circumstances where directors were not co-operative and effective, they were removed statutorily where their fitness and propriety to hold positions in the financial sector would be questioned.
- Strategic investors were invited to infuse fresh capital and take over the management control.
- Once the balance sheet was restructured with deposit/debt conversion into equity, fair valuation of assets, provisions for rebuilding a healthy financial condition and initial capital infusion, new share issues were made to augment capital further. In this regard, the unlisted institutions were required to list their shares on the stock market to facilitate rehabilitation with the participation of new shareholders and strengthen corporate governance.

As a result, 3 companies were able to recommence business with new capital and strategic investors. New boards of directors were also appointed to drive the companies towards new business models. Other companies are nearing completion of restructuring as planned.

Supervisory and Regulatory Developments

To facilitate future growth with prudence, the required minimum core capital was increased from Rs. 75 million to Rs. 100 million to be effective from 01 January 2012 with further increases to Rs. 150 million, Rs. 200 million, Rs. 250 million and Rs. 300 million in 2013, 2014, 2015 and 2016, respectively. Meanwhile, the minimum capital a public company is required to have to qualify for registration was also increased to Rs. 100 million from 01 January 2011 with an annual increase of Rs. 50 million to reach Rs. 300 million by 01 January 2015. Two new Directions on reporting requirements and opening/closing/ relocating branches/business places were issued. Favourable depreciation allowances in relation to equipment, to be permitted from April 2011 when calculating tax will be beneficial to the leasing business and its profitability.

Primary Dealers in Government Securities

Key financial indicators of the primary dealers showed improved performance during 2010. Risk management indicators were also maintained within prudent levels by Primary Dealers.

Assets and Liabilities:

Total assets at end of 2010 amounted to Rs. 125.8 billion, which was an increase of 26 per cent over 2009. As government securities in trading, investment in government securities and reverse repos, accounted for almost 98 per cent of total assets Primary Dealers confirmed to their authorised business. The significant increase in the trading portfolio by 76.7 per cent was the main contributory factor in the increase in the total portfolio as both the investment portfolio and the reverse repo portfolio declined by 15.2 per cent and 48.7 per cent, respectively. Repos amounting to Rs.74 billion, which accounted for 73.2 per cent of total liabilities in 2009 and 58.8 per cent of total liabilities in 2010, were their key liability.

Table 8.12 Performance of Primary Dealers in Government Securities

Rs. million

Item	2009	2010(a)	Annual Growth (%) 2009	2010
Total Assets	99,810	125,773	18.3	26.0
Dealing Securities	54,015	95,423	18.8	76.7
Investment Securities	17,616	14,943	(7.7)	(15.2)
Reverse Repo	24,976	12,824	56.2	(48.7)
Equity and Liabilities	99,810	125,773	18.3	26.0
Total Capital	9,958	13,417	61.9	34.7
Repo	73,032	74,001	16.0	1.3
Profit before Tax	6,215	5,455	266.5	(12.2)
Profit after Tax	4,594	4,292	308.8	(6.6)
Return on Assets %	6.2	4.3	4.2	(1.9)
Return on Equity %	46.4	35.4	27.7	(10.9)
Risk Weighted Capital Adequacy Ratio %	22.4	22.6	5.9	0.1
Leveraging Times	7.4	5.5	(29.5)	(25.2)
Dealings	7,982,339	7,950,922	15.1	(0.4)
Primary Market Dealings	1,522,649	1,508,645	20.1	(0.9)
Secondary Market Dealings	6,459,690	6,442,277	14.0	(0.3)

(a) Provisional

Source: Central Bank of Sri Lanka

Risk Management

(a) Market Risk: Market risk continued to be the main risk as the trading portfolio consisted of 76 per cent of total assets. However, the combined effect of higher capital levels, a shorter duration of the trading portfolio and a downward shift in the yield curve during the second half of the year lowered the market risk. The stress test conducted at end December 2010 revealed that an increase of 100 basis points in yield rates would cause a loss of capital amounting to Rs.1,245 million and a reduction of the capital adequacy ratio by 2.1 per cent. This is an increase in market risk exposure compared to the corresponding results for 2009 (Rs. 853 million in capital and 0.9 per cent reduction in the capital adequacy ratio).

(b) Liquidity Risk: Liquidity risk also remained low and manageable. The cumulative negative maturity mismatch for overnight, up to one week and up to one month were 4.4 per cent, 13.5 per cent and 20.1 per cent, respectively, at the end of 2010. When compared with the corresponding levels of 3.2 per cent, 7.4 per cent and 31.5 per cent as at end of 2009, liquidity risk had increased marginally up to the one week category by end 2010. However, the management of liquidity risk of primary dealers poses no concern as 98 per cent of their assets comprise highly liquid government securities.

Capital and Profit

Risk management was further supported by a high capital cushion. The total capital base stood at Rs. 13.4 billion at the end of the year, recording an increase of 34.7 per cent through retained profits. Accordingly, the risk weighted Capital Adequacy ratio was maintained at a high level of 22.6 per cent, covering the high level of capital required for the increased trading portfolio. While high profitability was recorded during 2008-2009 due to declining and volatile interest rates. In 2010, profitability declined to a moderate level in response to low and stable interest rates. As a result, profits before tax declined to Rs. 5,455 million that is, by 12.2 per cent, from Rs. 6,215 million in 2009. Accordingly, the Return on Assets (ROA) as well as Return on Equity (ROE) declined to 4.3 per cent and 35.4 per cent, respectively, in 2010, from 6.2 per cent and 46.4 per cent, respectively, reported in 2009.

Market Participation

During 2010, the primary dealer units of banks reported the highest participation levels in respect of both Treasury bill and Treasury bond auctions, recording 69.1 per cent and 31.5 per cent, respectively, as compared to the participation rates of 60.9 per cent and 41.2 per cent, respectively, in 2009. Participation by non - bank primary dealers declined to 7.6 per cent in relation to Treasury bills and 7.1 per cent in relation to Treasury bonds, in 2010, from the corresponding rates of 12.6 per cent and 17.5 per cent in 2009. Total secondary market dealings remained high and stable at 81 per cent of total dealings.

Insurance Companies

The insurance sector, which consisted of 19 insurance companies, 48 insurance broking companies and about 37,000 insurance agents showed improved performance in 2010, as reported by several key indicators. The increase of total assets by 22 per cent, income by 40 per cent and pre-tax profit by 262 per cent shows the expansion of insurance business. The asset composition tended to increase towards equities and cash/deposits while government securities remained to be the dominant asset. While both premium and investment income continued to register considerably high increases, the share of investment income tended to increase considerably from 19 per cent in 2008 to 35 per cent in 2010, with a corresponding decline in the share of premium income. Reflecting the high growth of profit, both return on equity and return on assets increased by 37 per cent and 18 per cent respectively, for general insurance, while, return on assets rose to 2.6 per cent in respect of life insurance.The solvency margin, which measures the adequacy of capital to meet obligations, improved for life insurance, and both insurance business lines complied with the minimum solvency margin requirements.

Action was taken to strengthen the regulatory framework of insurance companies. The proposed amendments to the Regulation of Insurance Industry Act to strengthen prudential regulation and supervision, in order to protect the interests of policyholders, was presented to the Parliament in 2010. The Act will empower the Insurance Board of Sri Lanka to stipulate capital requirements for insurance companies and brokers, make rules and determinations in realation to the conduct of insurance business,

Table 8.13 Key Financial Indicators of Insurance Companies

Rs. million

Item		2008	2009	2010 (a)
Total Assets		155,994	181,045	221,736
Government Securities		64,361	78,083	89,642
Equities		16,352	22,108	32,696
Cash & Deposits		14,168	14,412	25,790
Total Income		71,902	76,213	105,060
Premium Income		58,166	57,252	68,493
Investment Income		13,736	18,961	36,567
Profit Before Tax		2,775	4,994	16,563
Solvency Margin Ratio	- Life Insurance	5.0	4.9	5.1
	- General Insurance	2.7	2.8	2.6
Retention Ratio (%)	- Life Insurance	96.0	96.4	97.0
	- General Insurance	70.5	72.7	75.7
Claims Ratio (%)	- Life Insurance	26.6	43.6	38.3
	- General Insurance	64.9	63.2	61.8
Combined Operating Ratio (%)	- Life Insurance	51.1	69.7	60.4
	- General Insurance	110.4	91.0	86.0
Return on Assets (ROA) (%)	- Life Insurance	8.4	2.4	2.6
	- General Insurance	5.4	4.0	18.1
Return on Equity (ROE) (%)	- General Insurance	2.6	8.9	36.9
Underwriting Ratio (%)	- General Insurance	18.5	21.0	32.0

(a) Provisional

Source: Insurance Board of Sri Lanka

engage in dispute resolution and prescribe the "fit and proper" criterion for the appointment of directors and brokers. The Act also provides for the requirement in accordance with which long-term and general insurance business are to be conducted by separately incorporated companies, with existing insurers being given time to segregate business. All insurance companies will be required to list on the stock exchange. The removal of the war risk premium for Sri Lanka by the London Joint Cargo Committee in June 2010 and the reduction of the premium for terrorism cover by the National Insurance Trust Fund by 75 per cent in April 2010 will reduce the cost of insurance to policyholders.

Unit Trusts

The unit trust (UT) sector expanded as indicated by three new entrants, a substantial growth in net asset value (NAV), investors and the number of units in issue in 2010. As at end 2010, there were 21 UTs under six management companies. The total number of unit-holders increased by 6.6 per cent to 24,640 with the total number of units in issue almost doubling to 1.16 billion. The NAV grew by 122 per cent to Rs. 22 billion at end 2010. Although considerable increases in investments in equities and government securities were reported, the share of equities in the investment portfolio fell to 53 per cent while the share of government securities increased to 34 per cent. The improved profitability was reflected in the increase in dividends (estimated weighted average) paid to unit holders from Rs. 0.96 to Rs. 1.21. However, the improvement of net asset value per unit was only marginal from Rs. 18 to Rs. 19. One of the budget proposals for 2011 was to exempt foreigners and foreign funds from exchange control restrictions on investments in UTs and, therefore, the UT sector will be another attractive investment avenue in the future.

Table 8.14 Selected Indicators of the Unit Trust Industry

Details	2007	2008	2009	2010
No.of Unit Trusts	14	17	18	21
Total No.of Unit Holders	23,191	22,699	23,116	24,640
No.of Units in Issue (Mn.)	470	638	564	1,159
Total Assets (Rs.Mn.)	6,332	6,801	10,004	22,176
Net Asset Value-NAV (Rs.Mn.)	6,295	6,781	9,952	22,060
Investments in Equities (Rs.Mn.)	3,649	2,589	6,036	11,743
% of Total Assets	57.6	38.1	60.3	53.0
Investments in Government Securities (Rs.Mn.)	808	2,575	3,008	7,532
% of Total Assets	12.8	38.0	30.2	34.1
NAV per Unit (Rs.)	13	11	18	19
Dividend per Unit (Weighted Average) (Rs.)	1.33	1.01	0.96	1.21

Source: Unit Trust Association of Sri Lanka

Superannuation Funds

Superannuation funds consisted of three state-managed funds and 170 privately managed approved provident and pension funds. The size of the sector estimated in terms of assets increased by 15 per cent to Rs. 1,180 billion as at end 2010 from Rs. 1,024 billion as at end 2009. The two state funds, Employees' Provident Fund (EPF) and Employees' Trust Fund (ETF) operating under specific Acts, accounted for 89 per cent of total assets of the industry. Both funds maintained high profitability to pay interest on member balances at 12.5 per cent, which was well above the market interest rates.

The EPF, which is the largest fund accounting for 76 per cent of the total assets recorded a growth of 16 per cent and stood at Rs. 902 billion at end 2010. Total net contribution (contribution less refunds of benefits) continued to improve to Rs. 20 billion in 2010 compared with Rs. 17 billion in 2009. The investment portfolio was predominately held in government securities in view of maintaining long-term safety of the fund and the non-availability of alternative avenues for safe and liquid investments of large scale. The share in government securities at 94.1 per cent as at end 2010 showed a decline, with the EPF increasing its portfolio of equity investments during the year. The overall return on investments marginally declined by 100 basis points due to declining interest rates in the market although the net profit amount available for distribution increased by 9.6 per cent. In line with the decline in return on investment, the interest rate paid on member balances too declined by 125 basis points to 12.5 per cent in 2010. The ETF, which accounted for 11 per cent of the sector also showed

BOX 18 Investments by Employees' Provident Fund in the Stock Market

The Employees' Provident Fund (EPF) is the largest superannuation fund with an asset base of Rs. 900 billion which accounts for 14 per cent of the total assets of Sri Lanka's financial system. The investment policy of the EPF continued to be focused on obtaining a positive real return on a sustainable basis to its members while ensuring the safety of the Fund. With the rapid growth of the Fund, the available investment opportunities need to be expanded to enhance the return to its members while managing the risks of such investments.

EPF's Investments in the Stock Market

Sri Lanka's stock market recorded substantial gains during the past two years with the end to the three-decade-long conflict in May 2009 and the resulting renewed investor confidence. The price indices of the four major sub-sectors in terms of market capitalization, i.e., Diversified Holdings; Bank, Finance and Insurance; Food, Beverage and Tobacco; and Hotel and Travel sectors have increased significantly during the past two years. Within this milieu, the EPF increased its investments in the equity market during the past two years, by investing in fundamentally sound companies in these sectors. Since a major portion of the equity investments by the EPF were made with a long-term focus, considerable gains are expected to be realized in the future.

During 2010, equity investments by the EPF have been able to generate a sizeable income which included both capital gains and dividends. In addition, the EPF also received a substantial amount of unrealized gains from its equity portfolio. As a result of these investments, the EPF members were able to reap the benefits of the stock market boom and at the same time, EPF will continue to be able to pay interest at a higher rate to its members on their balances. Further, a great majority of the public including members of the EPF, do not possess the knowledge or the capacity to invest and benefit from share market activity individually. Hence, the EPF's investments in the share market have enabled its members to indirectly own a stake in some financially stable, fast growing companies and benefit from the country's economic development.

The government has planned to reduce the budget deficit to GDP ratio from 8 per cent in 2010 to 6.8 per cent in 2011. One percentage point reduction in the budget deficit will lower the government borrowing requirement by about Rs.60 billion. Since the budget deficit is expected to decline further in the medium to long-term resulting in reduced borrowing by the government, shifting a part of the funds of the EPF to other profitable investment avenues such as listed and unlisted equities, debentures and mortgage backed securities, is a prudent investment strategy in managing the funds of the EPF.

EPF's Contribution to Capital Market Development

The presence of large institutional investors is crucial for the development of our capital market. In many markets, institutional investors such as pension funds, unit trusts and mutual funds, play a significant role in the stock market when compared to individual investors. Unlike the retail investors, large institutions invest with a long-term focus and are not affected by the short-term price fluctuations. Since their investment capacity is relatively high, institutional investors can correct the stock market inefficiencies such as speculative actions thereby stabilizing the market in the long-run. In addition, the presence of large local institutional investors in the equity market is critically important to build investor confidence among the retail and foreign investors. Hence, as a large institutional investor, the EPF has supported the development of our capital market through its equity investments by creating long-term market stability and building investor confidence.

similar performance. The growth of assets by 17 per cent, a decline in the share of government securities in investments by one percentage point, a decline in the return on investment by 130 basis points and the payment of interest on member balances at 12.5 per cent were the key performance indicators. The Public Service Provident Fund managed by the Department of Pensions for about 242,500 members owned assets amounting to Rs. 26 billion with investments of Rs. 23 billion compared to assets of Rs. 22.7 billion as at end 2009. Total assets of the 170 privately managed approved provident and pension funds covering about 157,500 members increased to Rs. 126 billion from Rs. 122 billion in

Table 8.15 Key Indicators of EPF and ETF

Details	EPF		ETF	
	2009(a)	2010(b)	2009(a)	2010(b)
Total Assets (Rs.bn)	772.0	902.0	107.3	125.9
Total Member Balance (Rs.bn)	752.5	869.0	103.1	119.9
Number of Member Accounts (mn)	12.8	13.3	8.9	9.1
Number of Active Member Accounts (mn)	2.1	2.3	2.1	2.1
Number of Employers contributing	61,396	62,000	61,237	62,731
Total Contributions (Rs.bn)	48.7	54.8	8.7	9.8
Total Refunds (Rs.bn)	31.9	34.9	6.4	6.4
Total Investments Portfolio (Rs.bn)	738.1	867.1	101.0	118.9
o/w : Government securities (%)	97.1	94.1	91.4	90.5
Gross Income (Rs.bn)	109.8	121.3	14.5	15.5
Profit Available for Distribution (Rs.bn)	101.7	111.5	14.2	14.6
Return on Investments (%)	16.0	15.0	15.2	13.9
Interest Rate paid on Member Balances (%)	13.8	12.5	13.0	12.5

(a) Revised
(b) Provisional

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

2009 with investments amounting to Rs. 107 billion at end 2010. The need for the establishment of a regulator for provident and pension funds for the purpose of prudential regulation and supervision to ensure the safety and soundness of these funds has been recognised and appropriate action in their regard will be initiated in the near future.

8.4 Performance of Financial Markets

Money Market

In 2010, the money market continued to remain highly liquid with excess liquidity in the commercial banking system. At the beginning of the year, the commercial banks' liquidity surplus stood at around Rs.109 billion and increased to Rs. 124.3 billion towards the end of the year. Accordingly, the total call money transactions volume declined by almost half in 2010 compared to the 6 per cent increase in 2009, while the inter-bank overnight call money rates declined considerably to a range of 7.83-9.43 per cent. However, inter-bank Repo transactions (based on government securities) remained almost unchanged at the 2009 level, but with a noticeable decline in Repo interest rates to a range of 7.05 per cent, to 8.53 per cent, which was lower than the range of call money rates. Further, transactions at the Central Bank's Repo window rose, due to both the excess liquidity and the Central Bank's continued action to mop up the excess liquidity. The Central Bank's Reverse Repo window stayed dormant.

The Domestic Foreign Exchange Market

In view of the foreign currency inflows, the Sri Lanka rupee appreciated gradually during the year. The rupee appreciated against the US dollar by 3.09 per cent from Rs. 114.38 to Rs. 110.95. The appreciation of the rupee against the euro and the Sterling pound were at 10.95 per cent and 6.03 per cent, respectively. However, the rupee depreciated against the Indian rupee and the Japanese yen by 0.73 per cent and 8.80 per cent, respectively. The average US dollar buying and selling rates of commercial banks for telegraphic transfers decreased to Rs. 110.20 and Rs. 112.02, respectively, at the end of 2010, from Rs. 113.61 and Rs. 115.15 recorded at the end of 2009.

The total inter-bank foreign exchange transactions during 2010 increased to US dollars 11,066 million from US dollars 10,959 million in 2009. The daily average volume was US dollars 46.3 million compared with US dollars 45.4 million in 2009. As in the past, the Central Bank continued to intervene in the domestic foreign

Table 8.16 Money Market Transactions

Market	Volume (Rs. billion)			Interest/Yield Rates		
	2008	2009	2010	2008	2009	2010
Call Money	1,927	2,040	996	12.52-21.13	8.58-15.54	7.83-9.43
Inter-bank repo	932	1,162	1,128	12.03-21.76	8.29-15.01	7.05-8.53
Central Bank repo	851	1,786	10,723	10.50-15.94	7.50-10.90	7.25-8.25
Central Bank reverse repo	905	907	-	12.00-19.00	9.75-19.00	9.75 -9.00
Central Bank Securities	176	1,781	1,467	10.50-16.25	7.50-9.62	7.25-8.85

Source: Central Bank of Sri Lanka

exchange market to prevent any excessive volatility in the exchange rate. During 2010, the Bank bought US dollars 753.2 million from the domestic foreign exchange market. However, the Central Bank had to sell US dollars 819.80 million mainly towards the latter part of the year as a result of the increase in import bills mostly due to oil bills following the rise in crude oil prices in the international market. This resulted in net sales of US dollars 66.6 million in 2010 when compared to the net purchases of US dollars 2,291.9 million in 2009. Reflecting improved foreign investor confidence, the net inflow of foreign investments through defferent financial instruments such as equities, government securities and deposits amounted to Rs. 51.8 billion (US dollars 458 million) in 2010. This position was reflected in inflows and outflows through Securities Investment Accounts (SIAs), which are the rupee accounts required to be maintained under exchange control regulations in order for foreign investors to route their financial investments. These accounts reported an inflow of funds amounting to Rs. 215.9 billion and an outflow of funds for repatriation of investments, dividends/ income, etc., amounting to Rs. 164.1 billion.

Several exchange control relaxation measures coupled with prudential safeguards, were implemented in 2010 to further improve the convertibility of the rupee for international transactions. These related to the introduction of Securities Investment Accounts for foreigners to route financial investments, permission for foreign investments in corporate debentures up to 50 per cent, expedited approval for foreign borrowing by companies and sole proprietorships, permission for foreign companies to open places of businesses in Sri Lanka and Sri Lankan companies and partnerships to open places of business outside Sri Lanka, permission for pre-payment of import bills, removal of the 100 per cent margin requirement in respect of imports of selected consumer items, increasing the limit on advance payments for imports from US dollars 10,000 to US dollars 50,000, further relaxation of forward contracts in foreign currency by banks with eligible customers, foreign currency accounts for international service providers and their employees, permission for individuals, companies and partnerships in Sri Lanka to invest in shares of foreign companies and sovereign bonds issued by foreign governments and governmental institutions up to certain annual limits and permission for certain types of Sri Lankan residents such as exporters to maintain accounts with banks outside Sri Lanka. These measures, coupled with surveillance, are expected to promote foreign investor confidence and stable capital flows, which will facilitate the mobilisation of resources competitively from global markets to finance the domestic savings-investment gap to secure a high rate of economic growth.

Government Securities Market

The issues of government securities in the primary market as well as trading in the secondary market indicated increased activity. Although the total of Treasury bills and Treasury bonds issued through primary dealers remained almost unchanged at Rs. 1.5 trillion in 2010, with respect to the composition issues of Treasury bills increased as a per cent of the total issues. Secondary market transactions almost doubled to Rs. 41.2 trillion. It was noticed that activity in the secondary market for Treasury bills surpassed that of Treasury bonds. The number of investor accounts at LankaSecure (Depository System) also increased by 13 per cent to 73,396. With the easing of the monetary policy stance and improved market liquidity, yield rates moved downwards in 2010. Further, the range within which the yield rates changed during the year also narrowed significantly. The yield rates of Treasury bills, which were in a range of 7-19 per cent in 2009 declined to a range of 7-9 per cent in 2010. The corresponding

Table 8.17 Market Volumes of Government Securities

Rs. billion

Item	2008	2009	2010
Issued in the Primary Market	1,268.3	1,522.6	1,508.6
Treasury bills	779.6	821.2	1,000.1
Tresury bonds	488.7	701.4	508.6
Trading in the Secondary Market (as recorded in LankaSecure)	17,562.7	20,542.5	41,250.0
Treasury bills	7,566.0	8,048.6	21,379.7
Tresury bonds	9,996.8	12,493.9	19,870.3
No. of Investor Accounts at LankaSecure	56,041	64,680	73,396

Source: Central Bank of Sri Lanka

Table 8.18 Market Yield Rates of Government Securities

Per cent per annum

Item	Primary Market			Secondary Market		
	2008	2009	2010	2008	2009	2010
Treasury bills						
91 day	16.46-21.30	7.25-17.31	7.02-8.52	16.33-19.33	7.33-17.70	6.62-8.57
182 day	17.45-19.99	8.33-18.57	6.95-9.24	17.54-19.37	8.27-18.53	6.89-9.14
364 day	18.34-19.96	9.17-19.12	7.10-9.47	18.35-19.51	9.12-19.16	7.06-9.48
Treasury bonds						
2 yrs	17.79-20.53	9.55-21.00	8.27-9.60	17.50-20.86	9.56-20.25	7.53-10.68
3 yrs	16.90-20.34	12.83-20.10	8.15-9.78	17.19-20.00	9.81-19.70	7.78-11.48
4 yrs	16.89-19.09	9.78-18.10	9.09-9.80	16.21-20.25	9.69-20.08	8.18-12.01
5 yrs	17.00	10.32-13.00	8.76-9.90	16.00-19.74	9.99-19.67	8.79-12.05
6 yrs		9.92-16.50	8.93-9.92	15.61-19.50	10.05-19.67	8.87-12.25
10 yrs		13.09-13.74	9.30-9.80	14.63-18.19	10.08-18.63	9.04-12.61

Source: Central Bank of Sri Lanka

decline in the rates pertaining to Treasury bonds was from a range of 10-20 per cent in 2009 to a range of 8-13 per cent in 2010.

During the year 2010, the government was able to raise US dollars 1,000 million through its third international bond issue which was listed on the Singapore exchange at a comparatively attractive rate of 6.25 per cent. The previous 5-year international sovereign bond was issued at a weighted average yield rate of 7.40 per cent, in 2009. Consequently, the yields of the two previous international sovereign bonds of US dollars 500 million each raised in 2007 and 2009 too declined by about 180 bps. Foreign investment in Treasury bills and Treasury bonds also reached the ceiling of 10 per cent of the total outstanding. Foreign investments in Treasury bills amounted to Rs. 57 billion in while foreign investments in Treasury bonds amounted to Rs. 184 billion by end 2010.

Colombo Stock Market

Activity at the Colombo Stock Exchange (CSE) rose to historically high levels in 2010. The CSE thus became one of the best performing stock exchanges in the world. The All Share Price Index (ASPI) rose by 96 per cent and the Milanka Price Index (MPI) increased by 83 per cent in 2010. All sub sector price indices increased contributing to the upward trend of the ASPI and the MPI. The number of shares traded increased by four times and the average daily turnover rose by more than three times. The market price earnings ratio increased further in 2010 and reached 25.2 as compared to 16.6 in 2009. The market capitalisation of the CSE, which more than doubled in 2009, doubled again in 2010 reaching Rs. 2.2 trillion by end 2010. The five largest sub-sectors in terms of market capitalisation, i.e., (i) Banking, Finance and Insurance, (ii) Diversified Holdings, (iii) Beverage, Food and Tobacco (iv) Hotel and Travel and (v) Telecommunications sectors, which accounts for 74 per cent of the total market capitalisation, were the main contributors to the boom in the stock market during 2010. Net foreign sales increased to Rs. 242.3 billion driven by the realisation of capital gains amidst high price increases of many stocks. New share issues also rose during 2010 with eight new Initial Public Offers (IPOs) being announced which were significantly over-subscribed, reflecting positive investor sentiment. More than Rs. 4.3 billion was raised through IPOs during the year. Further, 28 companies made Rights Issues and raised a total of Rs. 24.3 billion.

Several regulatory measures were introduced to facilitate the conduct of stock market activity in a healthier manner. In order to address sharp upward movement in share prices and excessive speculative trading activity, the Securities and Exchange Commission (SEC) imposed a 10 per cent upward and downward "price band" on all stocks in August 2010. This "price band" was replaced in September 2010 by a revised 10 per cent upward and downward "price band" imposed on selected stocks according to a formula based on

Table 8.19 Colombo Stock Market Selected Indicators

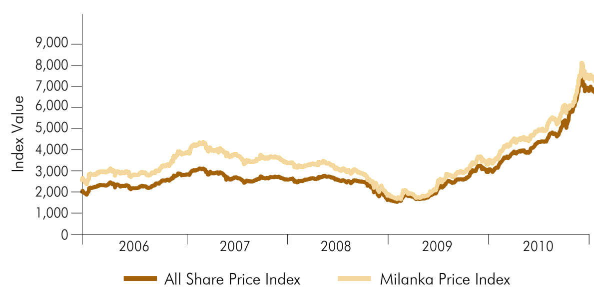
Item	2008	2009	2010
All Share Price Index (a)	1,503.0	3,385.6	6,635.9
Year-on-year change (%)	(40.9)	125.3	96.0
Milanka Price Index (a)	1,631.3	3,849.4	7,061.5
Year-on-year change (%)	(50.5)	136.0	83.4
Market Capitalisation (Rs.bn.)(a)	488.8	1,092.1	2,210.5
As a percentage of GDP (%)	11.4	22.9	39.4
Market Price Earnings Ratio (a)	5.4	16.5	25.2
Turnover to Market Capitalisation (%)	22.6	13.0	25.8
Average Daily Turnover (Rs.mn)	465.0	593.6	2,396.3
Value of Shares Traded (Rs.bn.)	110.4	142.5	570.3
Number of Shares Traded (mn.)	3,155	4,929	18,489
Number of Companies Listed	235	231	241
Introductions (b)	1	0	2
Number of Initial Public Offers/Offers for Sale (b)	2	3	8
Number of Rights Issues	9	14	31
Amount Raised through Rights Issues and Initial Public Offers(Rs.mn.)	4,409	6,205	28,669

(a) End of the year

Source: Colombo Stock Exchange

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

Chart 8.10 Share Price Indices



the price volatility and volume traded of the stock. From January 2011 stockbrokers were prohibited from extending credit beyond T+3 to investors for buying shares and credit beyond T+3 since then can be extended only by margin providers. Stockbrokers were also required to reduce their existing debtor positions by 50 per cent by end March 2011 and by 100 per cent by end June 2011. Further, stockbrokers were mandated to force-sell stocks of investors who are in default of settlement by T+5. The brokers were also mandated to obtain a minimum of 50 per cent of the settlement value upfront from the investors who wish to purchase stocks subject to the price band. The two band fee structure inclusive of brokerage fees and other government levies relating to equity trades, i.e., 1.425 per cent for value of transactions up to Rs. 1 million and 1.225 per cent for value of transactions from Rs. 1 million up to Rs. 100 million, was removed with effect from 30 June 2010. The reduced new fee structure for transactions up to Rs. 50 million is 1.020 per cent and the threshold level for negotiated brokerage was reduced to Rs. 50 million. The tick size, which is the incremental change of the share price that can be quoted when buying or selling, was also reduced to 10 cents with a view to increasing the number of transactions in the market. In the event a listed company is transferred to the Default Board for not submitting financial reports/accounts, the directors of such listed company are prohibited from trading in the shares of that company as they have unpublished price sensitive information. With effect from 1 January 2011, all new issues should be in de-mat form and a one year transition period has been permitted for all existing securities.

Commercial Paper and Debenture Markets

Both markets continued to record low activity during the year 2010. The total value of commercial paper issued with the support of banks such as credit lines, declined to Rs. 12 billion in 2010 when compared with Rs. 22 billion in 2009. Interest rates also declined significantly to a range of 7 to 16 per cent from a range of 9 to 36 per cent in 2009. Nearly 97 per cent of the commercial paper had a maturity period up to 3 months. The total outstanding value of commercial paper reduced from Rs. 6 billion as at end December 2009 to Rs. 4 billion as at end December 2010. There were only two issues of debentures during the year 2010, i.e., 5 year debentures issued by Bank of Ceylon for Rs. 5 billion and by the Urban Development Authority for Rs. 10 billion. The trading turnover of debentures listed on the Debt Securities Trading System (DEX) of the CSE declined from Rs.137 million in 2009 to Rs. 72 million in 2010. With a view to broadening the investor base and improving liquidity in the secondary market, exchange control regulations were relaxed to permit foreigners to invest in rupee denominated debentures issued by local companies up to 50 per cent of the issue.

8.5 Financial Infrastructure

Payment and Settlement Systems

During the year 2010, the usage of payment systems improved in terms of both volume and value of transactions. The total volume of payments through the Real Time Gross Settlement System (RTGS), the Cheque Imaging and Truncation System (CITS), the Sri Lanka Inter-Bank Payment System (SLIPS), as well as through Credit Cards and Debit Cards increased by 10.8 per cent with a 41.4 per cent increase in the total value of payments.

In February 2010, the procedure of granting the Intra-day Liquidity Facility (ILF) to institutions participating in the RTGS was upgraded to providing ILF at their discretion, deviating from providing ILF only on request. Further, a mechanism was introduced to the LankaSettle system to deal with daily transactions in the event of special holidays being declared. SLIPS was upgraded to provide online connectivity to the participating institutions. The upgraded system also enables any participant to transmit multiple outward files to the operator (LankaClear (Pvt) Ltd) during one session, and the usage of digital signatures for authentication of inward and outward files and multiple settlements of net balances through the RTGS. Accordingly, SLIPS was advanced to a payment system with same day settlement (T+0) for transactions submitted to the operator before 12.00 noon. Subsequent to the upgrade, SLIPS has a capacity of handling 1.2 million transactions during a normal business day. To eliminate the time lag associated with the practical issues in the movement of physical cheques from bank branches to LankaClear regional centers and subsequently transmitting cheque images from regional centers to LankaClear (Pvt) Ltd. and as well as the cost of maintaining such centers, participating banks were instructed to capture the cheque images at the branch level and submit those images to LankaClear (Pvt) Ltd in Compact Discs (CD). All banks were able to successfully implement this CD submission system connecting all their branches online to the head offices. Subsequently, regional centers were terminated in 2010.

Regulatory Improvements

Under the Service Providers of Payment Cards Regulations No. 1 of 2009, fourteen licensed commercial banks, two registered finance companies and one licensed specialised bank were issued licences to operate as service providers of payment cards under five categories, namely, card issuer, financial acquirer, operator of payment system, operator of clearing system and operator of settlement system, based on their business activities. Further, Credit Card Operational Guidelines No. 01 of 2010 was issued to payment card service providers who engage in credit card business. Having observed the need to broaden the regulatory framework of payments and settlements systems to ensure safety, efficiency and stability of the emerging electronic fund transfer mechanisms, mobile payments guidelines were prepared and will be released to the banking system in the near future. Further, guidelines for internet payments were also under drafting to be finalised during the second half of 2011.

Table 8.20 Transactions Through Payments Systems

System	Volume (000)			% Change		Value (Rs. billion)			% Change	
	2008	2009	2010	2009	2010	2008	2009	2010	2009	2010
Real Time Gross Settlement System	229	233	247	1.7	6.0	25,131	33,155	47,806	31.9	44.2
Cheque Imaging and Truncation System	44,550	40,637	42,795	(8.8)	5.3	4,693	4,391	5,346	(6.4)	21.7
Sri Lanka Interbank Payment System	7,845	9,034	12,530	15.2	38.7	236	279	332	18.2	19.0
Credit Cards	18,866	16,627	16,451	(11.9)	(1.1)	73	65	75	(11.0)	15.4
Debit Cards	2,174	3,309	5,340	52.2	61.4	6	11	16	83.3	45.5
Total	**73,664**	**69,840**	**77,363**	**(5.2)**	**10.8**	**30,139**	**37,901**	**53,575**	**25.8**	**41.4**

Source: Central Bank of Sri Lanka

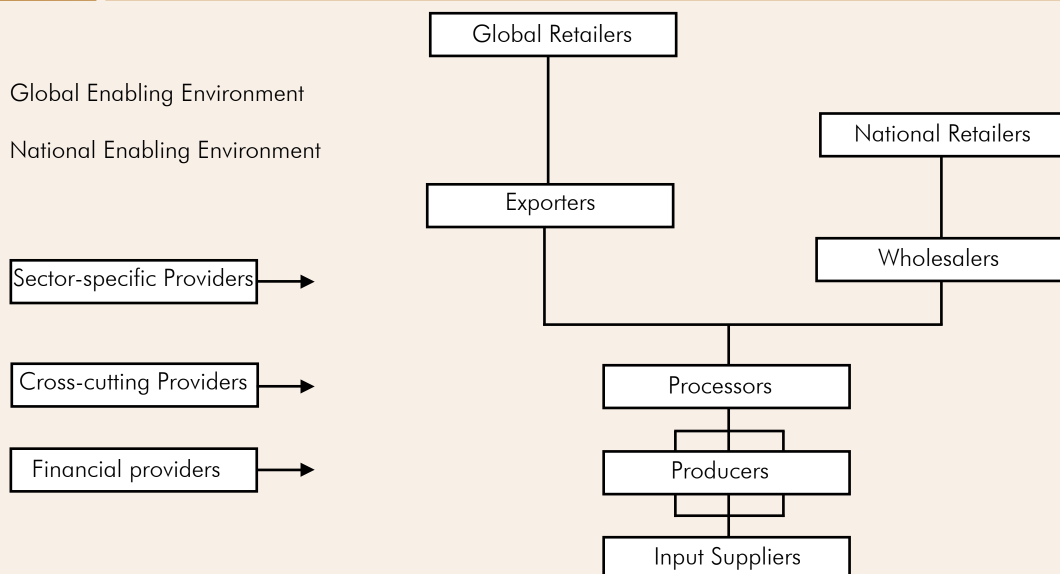
BOX 19 Value Chain Approach: An Alternative Way of Small Enterprise Development

Over the years, income generating projects, aimed at increasing the well-being of poor and disadvantaged people, have provided a package for their beneficiaries that includes short-term job oriented training and a loan to commence self-employment. This short-term training is insufficient to develop needed technical and entrepreneurial skills and, furthermore, the poor and disadvantaged are the least able to bear the risk of starting a new venture. Most of these beneficiaries, without market analysis, choose activities such as poultry farming, retailing, food processing and tailoring that have low entry cost. The low rate of return of these activities coupled with the low level of productivity, often fails to uplift the living standards of those self-employed.

Recent experiences in poverty reduction strategies implemented all over the developing world have clearly emphasised two realities: Poverty alleviation cannot be sustained in the absence of economic growth, and economic growth cannot be sustained in non-competitive industries. The concept of the value chain approach focuses on industries employing a large number of disadvantaged people and/ or industries with high levels of micro and small enterprise (MSE) participation, with the potential to become and remain competitive in national and global markets. It is argued by the proponents of the value chain approach that the best way to support the poor, over the long run, is to support the industries in which they participate.

A value chain refers to all the activities and services that bring a product (or a service) from conception to end use in a particular industry. It includes input suppliers, producers, processors, wholesalers and retailers that produce, transform, store, transfer and market the product, adding to its value at each step in the chain. The value chain approach views the value chain in the backdrop of the market system in its totality. It comprises the firms that operate in the industry from input suppliers to end market buyers, the support markets that provide technical, business, and financial services to the industry, and the business environment (this includes laws, regulations, policies, international trade agreements and public infrastructure) in which the industry operates (See Figure B 19.1). The value chain approach envisages improving the competitiveness and efficiency of the selected industries, addressing the major opportunities and constraints faced at the various levels of the value chain, in order to increase the well-being of the poor and deprived communities.

Chart B 19.1 Value Chain Structure



In some industries, large firms, which have the potential to be competitive or remain competitive in national or global markets, obtain raw materials or semi-processed products from sector and/or employ a large number of poor and disadvantaged people. The value chain growth strategy insists on providing technical assistance and required services to the MSE sector and those employed in these industries in a way that directly meet the requirements of such large firms. This will increase the value of the poor and disadvantaged people as suppliers or employees in the industry.

Careful identification of appropriate value chains is crucial to achieve the expected advantages from the value chain approach. Having chosen a value chain, it is necessary to analyse the inter-firm relationships to evaluate how and where the development agencies should intervene in order to facilitate production and market efficiencies and to promote the competitiveness in the industry. The value chain approach also examines the other factors influencing the chain's performance including, the legal, regulatory and policy environment, the availability and quality of support services such as financial services, business management services and information technology and, the availability of required infrastructure.

In conclusion, the final goal of the value chain approach is achieving economic growth through enhanced private sector participation based on the market mechanism while creating opportunities for the poor and disadvantaged people to reap the benefits of economic growth. In 2011, the Central Bank of Sri Lanka will commence activities of the National Agribusiness Development Programme (NADeP), an enterprise development project, funded by the International Fund for the Agricultural Development (IFAD). This programme will use the value chain approach as the strategy to accomplish its objectives. The NADeP will invite reputed firms to work with it, in order to provide opportunities to the MSE sector to work with the organized private sector. The NADeP will assist farmers to processes their products for a market that offers a fair price and a stable demand, thus enabling them to earn a higher income.

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Credit Information

Acitivities of the Credit Information Bureau (CRIB) also indicated increased lending by financial Institutions. The CRIB had 89 reporting credit institutions as its members and issued 1,580,782 credit reports in 2010 compared with 864,619 reports in 2009. The CRIB made several improvements in 2010. The on-line Credit Information Management System (CRIMS) provided an enhanced service to users. Self Inquiry Reports (iReports) facilitated the prospective borrowers to request their own credit information. The details on "Cheque Returns" were introduced in credit reports. A "Customer Help Desk" was set up to assist the public in applying for credit and interacting with lenders. CRIB also initiated work on establishing a "Secured Transactions Registry" for movable assets which would promote and facilitate lending against movable property.