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FINANCIAL SECTOR PERFORMANCE AND SYSTEM STABILITY

8.1 Overview

The financial sector performance in 2014 showed a momentum moderately higher than that in 2013 without causing any major macro-prudential concerns. Performance of banking sector improved in business operations and risk management as reflected in on and off-balance sheet operations, profit, risk indicators, liquidity and capital. Meanwhile, finance companies and specialized leasing companies sector also showed improving performance through the continuous business and financial recovery process that started in the recent years. The growth of contractual savings institutions was able to maintain a return and interest payment at level of last year, despite reduction in market interest rates consequent to relax monetary policy. Other financial institutions showed mixed performance, given their different business models. The domestic foreign exchange market showed increased volumes where the market pressure on the exchange rate of the Rupee against US dollar was greatly stabilized through normal intervention in the domestic foreign exchange market supported by the foreign reserves. As regards financial markets, money market remained highly liquid with falling interest rates consequent to monetary and balance of payments conditions whereas salient growth of activity in the stock market was reflected in almost all stock market indicators. As regard payments and settlements system, systems facilitated transactions in increased volumes without any major systemic risk. The preliminary work of the Common Electronic Fund Transfer Switch being the second phase of the common card and payment switch was completed and the bank members of the common ATM switch increased to nine with an ATM network of over 2,500. Performance of the financial sector was primarily led by the continuation of relaxed monetary policy and improved macroeconomic performance.

Meanwhile, a number of regulatory policies introduced in 2014 further strengthened the risk management and public confidence in the financial sector. Implementation of the

Table 8.1 Total Assets of the Major Financial Institutions

	2013 (a)		2014 (b)	
	Rs. bn	Share (%)	Rs. bn	Share (%)
Banking Sector	7,187.5	69.6	8,436.4	70.0
Central Bank	1,246.0	12.1	1,464.3	12.1
Licensed Commercial Banks	5,022.2	48.7	5,884.6	48.9
Licensed Specialised Banks	919.3	8.9	1,087.5	9.0
Other Deposit Taking Financial Institutions	756.4	7.3	892.0	7.4
Licensed Finance Companies	653.0	6.3	779.6	6.4
Co-operative Rural Banks	94.9	0.9	103.5	0.9
Thrift and Credit Co-operative Societies	8.5	0.1	8.9	0.1
Specialised Financial Institutions	378.0	3.7	439.9	3.7
Specialised Leasing Companies	64.5	0.6	73.6	0.6
Primary Dealers	213.6	2.1	191.1	1.6
Stock Brokers	10.3	0.1	11.3	0.1
Unit Trusts / Unit Trust Management Companies	55.8	0.5	128.6	1.1
Market Intermediaries (c)	29.5	0.3	29.1	0.2
Venture Capital Companies	4.4	0.0	6.2	0.1
Contractual Savings Institutions	1,998.3	19.4	2,272.9	18.9
Insurance Companies	360.4	3.5	411.7	3.4
Employees' Provident Fund	1,300.0	12.6	1,486.9	12.3
Employees' Trust Fund	178.5	1.7	199.1	1.7
Approved Pension and Provident Funds	123.0	1.2	134.2	1.1
Public Service Provident Fund	36.4	0.4	41.0	0.3
Total	10,320.2	100.0	12,041.1	100.0

Source: Central Bank of Sri Lanka

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

Standardized Approach for operational risks under Basel II, regulatory framework for valuation of immovable property, guidelines for information security management and increase of minimum capital requirement from 2016 were the main regulatory policies introduced to banking sector. Issuance of a directive to all unit trusts on the minimum number of unit holders for each fund at all times and a minimum number of unit holders at any initial public offering and increase in the minimum regulatory capital and preparation to introduce risk based capital adequacy framework and mandatory public listing by 2016 for insurance companies were other major regulatory policies. The financial sector consolidation programme implemented through mergers of banks and non-bank financial institutions regulated by the Central Bank was a major regulatory policy implemented during the year jointly by the Central Bank and the Government as announced in the Government Budget 2014. Accordingly, the plan envisaged to reduce the number of non-banking financial institutions to around 20 from 58 with regulatory support and tax incentives. As at end of 2014, 10 mergers were completed and 22 were in the process. Given several concerns raised in the process, the programme was put on hold pending the findings of the consolidation review committee appointed by the new Government.

8.2 Performance of Financial Institutions

Banking Sector

The banking sector remained robust during 2014 and continued to expand its asset base maintaining its lead role in the financial sector. Asset growth, which reflected a moderate growth during the early part of the year, gradually picked up during the last quarter, resulting in a marginal drop in the excess liquidity in the system. Credit growth, which was moderate during the early part of the year compared to the previous year, reported a steady growth during the latter part of the year. The banking sector continued its focus on prudent management of credit risk, market risk, equity risk, interest rate risk, exchange rate risk and liquidity risk. The banking sector experienced a declining level of NPLs mainly with the recovery of pawning NPLs particularly during the latter part of the year.

Business Expansion

The banking sector consisted of 34 licensed banks by end 2014 with Cargills Bank Ltd. commencing operations in April 2014. The total banking network included 25 Licensed Commercial Banks (LCB), of which 12 were branches of foreign banks, and 9 Licensed Specialised Banks (LSB). During 2014, the banking sector continued to support economic activities by enhancing accessibility and expanding the branch network throughout the island. The number of new banking outlets (including student savings units) opened

Table 8.2 Distribution of Banks and Bank Branches

Category	End 2013 (a)	End 2014 (b)
Licensed Commercial Banks (LCBs)		
I. Total No.of LCBs	24	25
Domestic banks	12	13
Foreign banks	12	12
II.Total No.of LCB Banking Outlets	5,667	5,727
Branches (c)	2,803	2,856
Domestic Banks' Branches	2,582	2,635
Foreign Banks' Branches	221	221
Student Savings Units	2,864	2,871
Automated Teller Machines	2,364	2,455
Licensed Specialised Banks (LSBs)		
I. Total No. of LSBs	9	9
National Level Regional Development Bank	1	1
National Level Savings Banks	2	2
Long-term Lending Institutions	2	2
Housing Finance Institutions	2	2
Private Savings and Development Banks	2	2
II. Total No. of LSB Banking Outlets	820	827
Branches (c)	645	652
National Level Regional Development Bank	255	255
National Level Savings Banks	240	240
Long-term Lending Institutions	11	11
Housing Finance Institutions	49	56
Private Savings and Development Banks	90	90
Student Savings Units	175	175
Automated Teller Machines	180	180
Total No. of Bank Branches and Other Outlets	6,487	6,554
Total No. of Automated Teller Machines (ATM's)	2,544	2,635
Total No. of Electronic Fund Transfer Facilities at Point of Sale Machines (EFTPOS)	27,955	34,904
Banking Density: No.of Bank Branches Per 100,000 Persons	16.8	17.0

(a) Revised
(b) Provisional
(c) All banking outlets excluding Student Savings Units

Source: Central Bank of Sri Lanka

during the year totaled to 67 and there were 91 automated teller machines (ATMs) installed in the same year. The banking sector penetrated outside the Western Province with 43 new banking outlets and 43 ATMs being established in the regions. Accordingly, by end 2014, the banking system was operating with 6,554 banking outlets and 2,635 ATMs.

Assets and Liabilities

Assets: Total assets of the banking sector increased by 17.3 per cent, year-on-year, to Rs. 7 trillion when compared to a growth of 16.5 per cent in 2013. The increase in banking sector assets during 2014 resulted mainly from rupee lending by the domestic private banks. However, due to a slump in consumer lending through pawning advances, improved performance in the corporate bond market

Table 8.3 Composition of Assets and Liabilities of the Banking Sector

Item	2013 (a)		2014 (b)		Change (%)	
	Rs.bn	Share (%)	Rs.bn	Share (%)	2013	2014 (b)
Assets						
Loans & Advances	3,427	57.7	3,895	55.9	8.8	13.7
Investments	1,695	28.5	1,928	27.6	39.2	13.7
Other (c)	819	13.8	1,149	16.5	12.2	40.3
Liabilities						
Deposits	4,170	70.2	4,687	67.2	15.0	12.4
Borrowings	1,015	17.1	1,448	20.8	26.2	42.6
Capital Funds	490	8.2	569	8.2	12.3	16.2
Other	266	4.5	268	3.8	14.8	0.6
Total Assets/ Liabilities	**5,941**	**100.0**	**6,972**	**100.0**	**16.5**	**17.3**

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

Source: Central Bank of Sri Lanka

and reduced borrowing from state owned enterprises (SOE) sector, credit growth moderated during the first half of the year. Credit growth gradually picked up during the latter part with increased lending to SOEs, recording an increase of 13.7 per cent in 2014, when compared to 8.8 per cent in 2013. Increase in lending during 2014 was primarily to the infrastructure, consumption and trading sectors contributing 28 per cent, 15 per cent and 15 per cent, respectively, to the annual increase. Investments grew only by 13.7 per cent compared to 39.2 per cent in 2013, representing a total share of 27.6 per cent of banking assets. Investments in Treasury bonds Held to Maturity (HTM) increased by Rs. 255.7 billion during 2014, while investments in the trading book decreased by Rs. 67.8 billion. There was a marked increase of 40.3 per cent in the other assets due to an increase in cash and due from banks of Rs. 346 billion, of which Reverse Repo agreements accounted for Rs. 221 billion arising from excess funds in the banking system.

Liabilities: The main sources of funding in the banking sector during 2014 continued to be deposits and borrowings. Even though deposits remained as the single largest source of finance (67.2 per cent), the year-on-year growth reduced from 15 per cent in 2013 to 12.4 per cent in 2014. There was a shift in the deposits portfolios from term deposits to

Table 8.4 Composition of Deposits of the Banking Sector

Item	Amount (Rs.bn)		Composition (%)	
	2013	2014 (a)	2013	2014 (a)
Demand Deposits	296.5	381.0	7.1	8.1
Savings Deposits	1,117.8	1,461.6	26.8	31.2
Time Deposits	2,637.8	2,704.3	63.3	57.7
Other Deposits	117.4	139.7	2.8	3.0
Total Deposits	**4,169.5**	**4,686.6**	**100.0**	**100.0**

(a) Provisional

Source: Central Bank of Sri Lanka

savings deposits during the year due to narrowing of the interest rate difference. Savings deposits accounted for 31.2 per cent of total deposits and accounted for 66.5 per cent of the increase in total deposits during 2014. The Current Accounts and Savings Accounts (CASA) ratio increased from 34.4 per cent in end December 2013 to 39.5 per cent by end 2014. Borrowings recorded a year-on-year growth of 42.6 per cent in 2014 from 26.2 per cent in 2013 and accounted for 20.8 per cent of total funding at the end of 2014. Rupee borrowings accounted for 51.6 per cent of the increase in total borrowings during 2014 and represented 40 per cent of total borrowings as at end 2014.

Off-balance sheet exposures: Off-balance sheet exposures increased by 5.2 per cent (Rs. 153.2 billion) to Rs. 3,127.6 billion during the year compared to an increase of 12.7 per cent (Rs. 336 billion) in 2013. Undrawn credit lines accounted for the largest share of off balance sheet exposure as at end 2014 with a contribution of 28 per cent. Exposure of foreign exchange (FX) sales (17 per cent) and purchases (16 per cent) together accounted for 33 per cent, while guarantees and bonds, documentary credit, acceptances and derivatives comprised the remaining share of off balance sheet exposure.

Risks in the Banking Sector

Credit Risk: Credit risk, which mainly depends on quality of loans and credit concentration, was well managed during the year. Asset quality improved during the year with the gross non-performing loans ratio (excluding interest in suspense) declining from 5.6 per cent in 2013 to 4.2 per cent in 2014. This was largely due to the decline in low quality assets such as pawning advances. The contraction in pawning advances also led to a decline in provisions for bad and doubtful debts. However, the provisions coverage ratio (specific) increased to 39.7 per cent from 32.5 per cent. This was primarily due to a lower provision reversal relating to reduced non-performing loans as their initial provisions were low, owing to the value of underlying collateral.

The credit portfolio of the banking sector was distributed among diverse economic sectors with increased lending to the trading (16 per cent),

Chart 8.1 Off-Balance Sheet Exposures of the Banking Sector (as at end 2014)

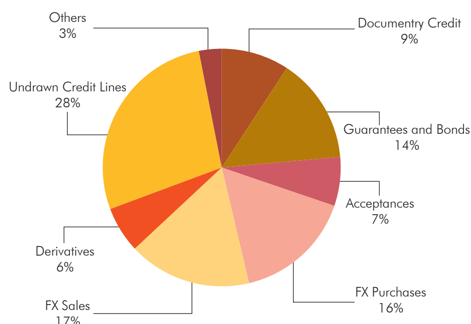


Chart 8.2 Non-Performing Loans of the Banking Sector

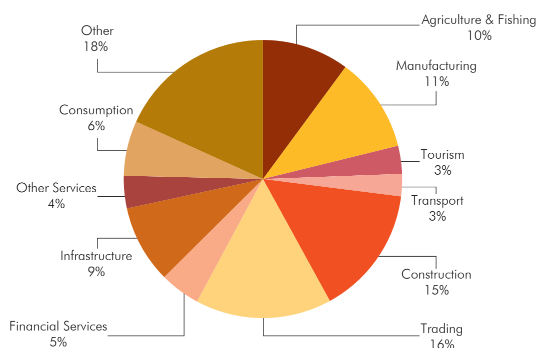
Chart 8.3 Provisioning for NPLs of the Banking Sector

construction (15 per cent), manufacturing (11 per cent), and agriculture and fishing (10 per cent) sectors as at end 2014. Accordingly, these four sectors together accounted for 52 per cent of the total credit portfolio.

Market Risk: During 2014, the risk weighted assets for market risk increased, due to the increase in holdings of gold stocks and foreign exchange, resulting in the capital charge increasing from Rs. 6.5 billion as at end 2013 to Rs.10.4 billion by end 2014. Accordingly, the percentage of risk weighted assets for market risk in total risk weighted assets had increased from 2.3 per cent as at end 2013 to 3 per cent by end 2014.

Interest Rates: Continuing the downward adjustment of interest rates during 2013, interest rates declined further during the year. Relaxation

Chart 8.4 Credit Exposure of the Banking Sector (as at end 2014)



of monetary policy and excess liquidity were the main drivers for this reduction in interest rates. As a result, investments in Treasury bills held for trading declined due to increased sales. Meanwhile, the sale of Treasury bonds realised a capital gain during the year due to the declining interest rates, which resulted in an increase in bond prices. This facilitated in minimising the re-pricing risk of the banking sector. Further, the cumulative rate sensitive gap of the banking sector, i.e. the gap between rate sensitive assets and rate sensitive liabilities as a percentage of rate sensitive assets, in the zero to one year time bucket widened from negative 6.59 per cent in 2013 to negative 12.01 per cent in 2014.

Price of Equity: The banking sector was exposed to a minimal equity risk during the year as investments in listed equity amounting to Rs. 22.3 billion, represented only 1.16 per cent of total investments and were a meagre 0.32 per cent of total assets of the banking sector.

Exchange Rates: The banking sector reported an increase in its foreign currency risk with increased foreign currency borrowings during the year. Foreign currency borrowing during the year accounted for 20.3 per cent of the increase in total assets. The aggregate net open position as a percentage of regulatory capital was 1.4 per cent as at end of the year. There was a net gain of Rs. 6.3 billion arising from foreign currency revaluation during the year.

Liquidity Risk: The banking sector operated with an excess liquidity position during the year. In December 2014, the Statutory Liquid Assets Ratio (SLAR) of the Domestic Banking Units (DBUs) and Offshore Banking Units (OBUs) were well above the statutory minimum of 20 per cent at 39.5 per cent and 33.6 per cent, respectively. The SLAR of DBUs increased marginally by 185

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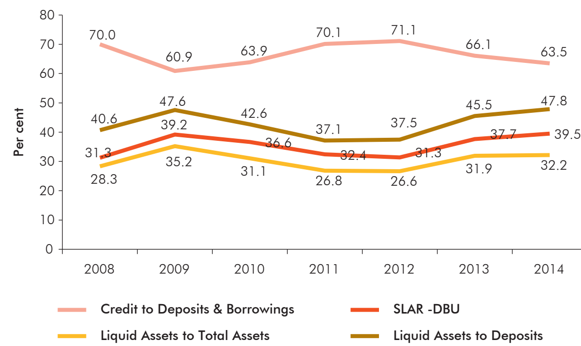
Chart 8.5 Liquidity Ratios of the Banking Sector



basis points during the year corresponding to the decrease in credit to deposits and borrowings ratio from 66.1 per cent in 2013 to 63.5 per cent in 2014.

Liquid assets to total assets increased by 24 basis points, while liquid assets to deposits increased by 236 basis points. This relative growth in liquid assets further strengthened the liquidity position of the banking sector. Total liquid assets stood at Rs. 2,242 billion during the year with a notable increase in Treasury bonds.

The cumulative maturity gap as a percentage of cumulative liabilities for all maturity time periods (buckets) less than six months increased from negative 13.6 per cent to negative 17.5 per cent, while the ratio for a period less than one year increased from negative 13.6 per cent in 2013 to negative 18.7 per cent in 2014. This is indicative that the short term liabilities of the banks have increased during the year. The cumulative maturity gap ratio for less than five years decreased from 3.8 per cent to 2.6 per cent in 2014 with a decrease in the medium term liquid assets.

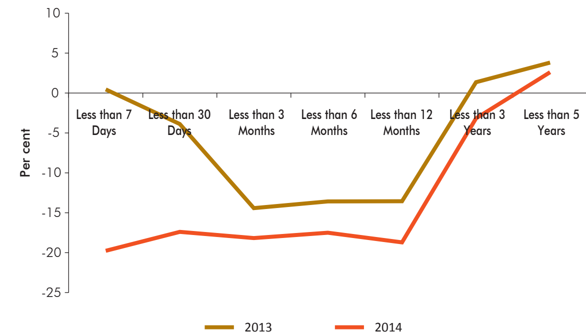
Table 8.5 Composition of Statutory Liquid Assets of the Banking Sector

Item	2013 (a) Rs.bn	2013 (a) Share (%)	2014 (b) Rs.bn	2014 (b) Share (%)	Change (Rs. bn) 2013	Change (Rs. bn) 2014 (b)
Treasury Bills	577	30.4	578	25.8	292	1
Treasury Bonds	599	31.6	792	35.3	176	193
Sri Lanka Development Bonds	362	19.1	390	17.4	145	28
Cash	84	4.4	97	4.3	10	13
Money at Call	44	2.3	106	4.7	(2)	62
Balance with Banks	148	7.8	188	8.4	(61)	40
Other	82	4.3	91	4.0	(22)	9
Total Liquid Assets	**1,896**	**100.0**	**2,242**	**100.0**	**538**	**346**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

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



Resources

Profitability: Despite thin Net Interest Margins (NIMs), the banking sector reported a profit after tax of Rs. 88 billion for 2014, compared to Rs. 74.6 billion reported for the previous year. Profitability, which decreased marginally during the first nine months improved towards the latter part of the year. Net interest income, which increased only marginally during the first nine months, reported an increase of 12.8 per cent for 2014. This was due to the gradual adjustment of the asset structure

Table 8.6 Profits of the Banking Sector

Item	2013 (a) Amount (Rs.bn)	2013 (a) As a % of Avg Assets	2014 (b) Amount (Rs.bn)	2014 (b) As a % of Avg Assets
Interest Income	591.2	10.6	562.0	8.8
Interest Expenses	394.7	7.1	340.4	5.4
Net Interest Income	**196.4**	**3.5**	**221.6**	**3.5**
Non-Interest Income	85.8	1.5	98.2	1.5
Foreign Exchange Income	16.4	0.3	18.8	0.3
Non-Interest Expenses	142.0	2.5	160.2	2.5
Staff Cost	70.5	1.3	77.0	1.2
Loan Loss Provisions	18.5	0.3	13.5	0.2
Profit before Tax (after VAT)	**104.5**	**1.9**	**126.4**	**2.0**
Profit after Tax	**74.6**	**1.3**	**88.0**	**1.4**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Chart 8.7 Profitability Indicators of the Banking Sector

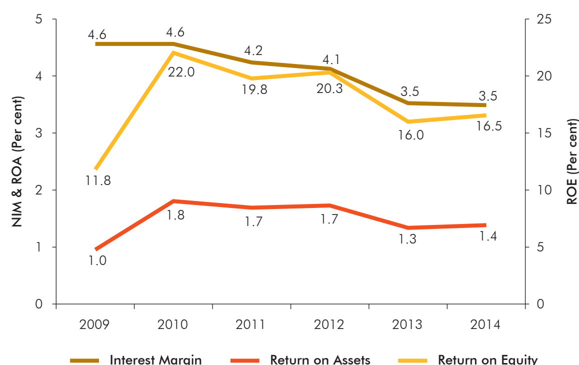
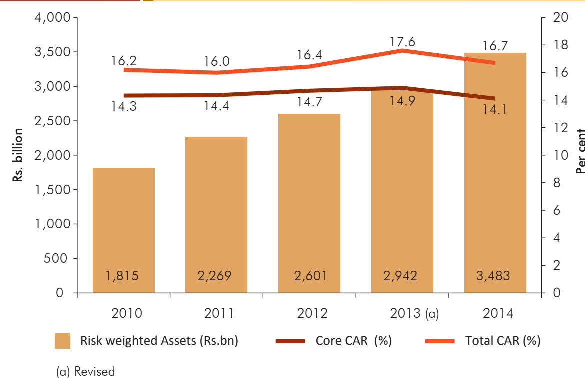


Chart 8.8 Capital Adequacy Ratios of the Banking Sector



arising from the narrowing interest rate difference, which reduced the cost of deposits. Hence, even in the face of declining interest earnings on lending, banks were able to increase net interest income owing to the 13.8 per cent decline in interest expenses of the banking sector during the year.

The NIM in 2014 remained unchanged from 2013 at 3.5 per cent due to the effective transmission of eased monetary policy exerting downward pressure on interest rates. Further, slower loan growth arising from low demand for loans and low yielding investments contributed towards thin NIMs of the banking sector.

The increase in non-interest income was mainly due to capital gains on Treasury bonds, charges on services and other commissions and fees. Further, the loan loss provisions declined by Rs. 5 billion due to the decline in Non - Performing Loans (NPLs) during 2014. Nevertheless, non-interest expenses increased during the year due to an increase in expenses relating to premises and equipment and establishment expenses. As a result of all these developments, other profitability indicators of the banking sector, i.e., Return on Assets (ROA) and Return on Equity (ROE), reported marginal increases of 5 basis points and 55 basis points, respectively, during 2014 from that of 2013. Meanwhile, the cost to income ratio decreased from 79.3 per cent in 2013 to 75.8 per cent in 2014.

Capital: During the year, the banking sector maintained capital at a healthy level. The total regulatory capital increased by 22 per cent largely owing to the increase in share capital, estimated profits and general and other reserves. Increase in share capital, profits and general and other reserves together comprised more than 85 per cent of the increase in regulatory capital during 2014. The banks actively engaged in the issuance of new shares and rights issues during the year and retained a share of internally generated profits, which enabled the banks to maintain their Core Capital Adequacy Ratios (Core CAR) much above the statutory minimum level. The increase in Tier II capital was mainly due to the issue of debentures, the increase in revaluation reserves and general provisions.

Table 8.7 Composition of Regulatory Capital of the Banking Sector

Item	Amount (Rs.bn)		Composition (%)	
	2013 (a)	2014 (b)	2013 (a)	2014 (b)
Tier I Capital	397.8	492.7	100.0	100.0
Share Capital	140.8	165.7	35.4	33.6
Statutory Reserve Funds	25.2	25.9	6.3	5.3
Retained Profits	114.6	166.5	28.8	33.8
General and Other Reserves	129.0	145.6	32.4	29.5
Other	11.6	14.0	2.9	2.8
Regulatory Adjustments	(23.3)	(24.9)	(5.9)	(5.1)
Tier II Capital	76.3	87.4	100.0	100.0
Revaluation Reserves	8.8	12.3	11.6	14.1
Subordinated Term Debt	69.7	75.7	91.4	86.6
General Provisions and Other	13.4	16.6	17.5	19.0
Regulatory Adjustments	(15.7)	(17.2)	(20.6)	(19.7)
Total Regulatory Capital Base	474.1	580.1	100.0	100.0

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

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At the end of 2014, the total capital adequacy ratio and the core capital adequacy ratio subsequent to the inclusion of estimated profits for 2014 after considering the proposed super gain tax and past dividend payout patterns are estimated to be around 16.7 per cent and 14.1 per cent, respectively. Sri Lanka is currently in compliance with Basel III capital requirements operating with a common equity ratio of around 14.14 per cent, well above the required minimum level of 4.5 per cent.

Supervisory and Regulatory Developments

During 2014, the Central Bank continued to initiate several prudential policy measures and regulations with a view to enhancing the safety and soundness of the banking sector. Accordingly, Guidelines on the Standardised Approach on computation of risk-weighted assets for Operational Risk under Basel II - Capital Adequacy Framework were issued for banks to adopt this approach with the prior approval of the Director of Bank Supervision.

Considering the implications of potential operational risks involved in automated banking practices and IT based platforms, the Baseline Security Standard for Information Security Management, which is based on the globally recognised ISO 27000 series of international standards, was introduced to banks. Further, guidelines on stress testing were issued to banks, outlining broad principles a bank should follow in developing and implementing its stress testing activities, and highlighting the importance of integrating stress testing to risk management and capital planning process.

Meanwhile, the Regulatory Framework on Valuation of Immovable Property was introduced to banks, requiring banks to adopt Board approved prudent policies and procedures on valuation of immovable property.

Two committees, one comprising Chairmen of banks and the other comprising Chief Executive Officers of banks, were appointed to review the Directions on Corporate Governance issued in 2007 and to make observations for amendments, if necessary. After analysing the observations made by the two committees and by an audit firm, and observing the global developments since the recent financial crisis, banks agreed to strengthen the current practices and processes remaining within the provisions of the existing Directions on Corporate Governance.

Further, steps were taken to rationalise and streamline existing regulations, based on the changing dynamics in the banking sector. Accordingly, a circular was issued to banks on the discontinuation of the operations of the Investment Fund Account, after the lapse of the stipulated time period of three years. Similarly, circulars issued on the recovery of accommodation to exporters were withdrawn, considering the positive developments of the country's external sector stability and the balance of payment. In addition, the Monetary Board increased the minimum capital requirements and determined the annual licence fee applicable for banks.

The existing Directions on Maximum Amount of Accommodation were amended to exclude accommodation granted by foreign banks utilising funds raised by its head office and/ or any branch of the particular bank outside Sri Lanka, when computing the maximum limit of accommodation and the aggregate limit of large accommodation. Further, in addition to accommodation granted to the government of Sri Lanka, accommodation granted by all banks in excess of the maximum limits of accommodation, with the approval of the Monetary Board, were also excluded when computing the aggregate limit of large accommodation.

Further, the Central Bank, with the concurrence of the Ministry of Finance and Planning, issued Guidelines pursuant to the amendments introduced

BOX 7 Recent Developments in the Global Regulatory and Supervisory Standards on Banks to Strengthen Financial System Stability

Following the global financial crisis in 2007-2008, global standard-setters on bank supervision and regulators have been actively involved in strengthening the existing regulatory and supervisory frameworks and introducing prudential regulations and standards, with a view to enhancing the resilience of the financial sector. Key regulatory reforms introduced in the recent past and the progress made on adopting such reforms in Asia are illustrated below:

1. Basel III - Liquidity Standards

Despite having adequate capital level to absorb losses, financial institutions with poor liquidity risk management experienced difficulties during the global financial crisis. This resulted in the regulators to change the perception over enhancing capital as a loss absorption mechanism and accordingly, Basel Committee on Banking Supervision (BCBS) issued 02 complementary liquidity standards to the existing capital adequacy framework.

(a)Liquidity Coverage Ratio (LCR): LCR aims to ensure that a bank has an adequate stock of unencumbered high quality liquid assets (HQLA) to meet its liquidity needs for a 30 calendar day liquidity stress scenario, which is computed as follows:

$$\text{LCR}=\frac{\text{Stock of high quality liquid assets}}{\text{Net cash outflows over a 30 day time period}}\geq 100\%$$

Accordingly, LCR promotes the short-term resilience of a bank's liquidity risk profile and supports to improve the banking sector's ability to absorb shocks arising from financial and economic stress, thus reducing the risk of spill over from the financial sector to the real economy.

The final standard on LCR was issued in January 2013 with the implementation to begin on 01 January 2015 with a minimum requirement of 60 per cent to reach 100 per cent by 01 January 2019.

Implementation in the region: Countries such as, India, China, Singapore, Hong Kong and Malaysia have already implemented LCR in their respective countries. The Central Bank of Sri Lanka (CBSL) issued the Consultation Paper on implementation of Basel III LCR for licensed banks in October 2014 and the final Direction was issued for implementation from Q2, 2015.

(b)Net Stable Funding Ratio (NSFR): NSFR requires banks to maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities. It is defined as the amount of available stable funding relative to the amount of required stable funding and the ratio which is computed as follows should be equal to at least 100 per cent on an ongoing basis:

$$\text{NSFR}=\frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}}\geq 100\%$$

A sustainable funding structure is intended to reduce the likelihood of disruption to a bank's regular sources of funding which will erode its liquidity position in a way that would increase the risk of its failure, and potentially lead to broader systemic stress.

Available stable funding is defined as the portion of capital and liabilities expected to be reliable over the time horizon considered by NSFR, which extends to one year. The final standard of NSFR was issued in October 2014 and it will be applicable by 01 January 2018. Countries in the region are making arrangements to implement NSFR in line with the international timeline.

2. Leverage Ratio Framework

Leverage ratio under Basel III was introduced by BCBS as a simple, transparent and a non-risk based tool that acts as a credible supplementary measure to the risk-based capital requirements. It is intended to restrict the build-up of excessive leverage in the banking sector and captures of both on and off-balance sheet sources of banks' leverage. It is calculated as follows:

$$\text{Leverage Ratio}=\frac{\text{Tier 1 capital}}{\text{Total on and off-balance sheet assets}}\geq 3\%$$

The leverage ratio is calculated by dividing the capital measure (e.g. Tier 1 capital) by the exposure measure (both on and off balance sheet assets). The minimum requirement for the leverage ratio is 3 per cent and BCBS will continue to monitor banks' leverage ratio data in order to assess the appropriateness of this measure over a full credit cycle and for different types of business models. The introduction of the leverage ratio prompted banks to reassess the balance sheet size and business expansion as the minimum ratio restricts assets expansion regardless of the relative risk of different assets classes.

Implementation in the region: Several countries in the region such as India, Singapore, Hong Kong and Malaysia have issued guidelines consistent with the requirements set out by BCBS on the leverage ratio. CBSL too expects to implement the leverage ratio in line with the international standards.

3. Dealing with Global Systemically Important Banks (G-SIBs) and Domestic Systemically Important Banks (D-SIBs)

In November 2011, BCBS issued a Framework on the Assessment Methodology and the Additional Loss Absorbency Requirements for G-SIBs to reduce cross-border negative externalities created by G-SIBs and enhance the going-concern loss absorbency of G-SIBs, thereby reducing their probability of failure.

The assessment methodology for G-SIBs focuses on areas such as size, interconnectedness, lack of readily available substitutes or financial institution infrastructure, global (cross-jurisdictional) activity and complexity. In July 2013, BCBS updated the assessment methodology for G-SIBs.

In October 2012, BCBS published its Framework for dealing with D-SIBs which focuses on the impact that a distress or failure of systemically important banks, including the impact of internationally active banks on the domestic economy. The Framework focuses on the assessment methodology of D-SIBs and establishment of high loss absorbency requirements that commensurate with the systemic importance of D-SIBs. The principles set out in the document focus on the higher loss absorbency requirement and more intensive supervision for D-SIBs.

Implementation in the region: Countries such as India, Indonesia, Malaysia and Singapore have introduced varying capital surcharges for D-SIBs. CBSL expects to appropriately implement the Framework on D-SIBs identified and assessed based on the relative size/ market share of banks.

4. External Audits of Banks

In March 2014, BCBS issued guidance on the external audit of a bank, describing supervisory expectations on audit quality, work of external auditor and the bank's audit committee. Implementation of the principles and the guidance is expected to improve the quality of bank audits and enhance the effectiveness of prudential supervision. The Guidelines primarily focus on the following:

- Reinforce the role of the board's audit committee in promoting quality bank audits through effective communication with the external auditor and robust oversight of the external audit process.
- Highlight areas of common interest between the external auditor and banking supervisors and how the two can effectively interact.
- Describe the expectations and recommendations on how internationally accepted auditing standards should be tailored to an audit in response to risks and issues specific to banks.

Implementation in the region: In August 2014, Malaysia issued a policy document outlining the qualifications of an external auditor to be appointed by a financial institution and sets out the supervisory requirements regarding the terms of an audit engagement, application procedures and reporting obligations to be observed by a financial institution. In Sri Lanka, the said principles are largely covered under the Banking Act Directions on Corporate Governance of licensed banks.

5. Corporate Governance

In October 2014, BCBS issued a consultation paper on Guidelines on Corporate Governance Principles in banks. Effective corporate governance is critical to the proper functioning of the banking sector and the economy as a whole. While there is no single approach to good corporate governance, the Committee's revised principles provide a framework within which banks and supervisors should operate to achieve robust and transparent risk management and decision-making and, in doing so, promote public confidence and uphold the safety and soundness of the banking system. The Consultation Paper primarily focuses on,

- Strengthening guidance on risk governance, including the risk management roles played by business units, risk management teams, and internal audit and control functions (the three lines of defence).
- Expanding guidance on the role of the board of directors in overseeing the implementation of effective risk management systems.
- Emphasising on capacity building of directors and the obligation on individual board members to dedicate sufficient time to their mandates.
- Provide guidance for bank supervisors in evaluating the processes used by banks to select board members and senior management.

In Sri Lanka, during 2014, two committees comprising of bank Chairmen and Chief Executive Officers were appointed to review the existing Directions on Corporate Governance in line with new international regulatory developments and best practices in Corporate Governance following the global financial crisis.

6. Sound Management of Risks related to Money Laundering and Financing of Terrorism

In January 2014, BCBS issued guidelines describing how banks should include risks related to money laundering and financing of terrorism within their overall risk management framework. These Guidelines are consistent with the international standards issued by the Financial Action Task Force (FATF) in 2012 and supplement their goals and objectives.

Implementation in the region: In India, 'Know Your Customer' guidelines have been revisited in the context of the recommendations made by FATF on anti-money laundering standards and combating financing of terrorism. Accordingly, banks are advised to implement a Board approved policy framework on 'Know Your Customer' and anti-money laundering. In July 2014, Monetary Authority of Singapore too has issued a consultation paper on Prevention of Money Laundering and Countering the Financing of Terrorism.

Bibliography: The related documents published by
Basel Committee on Banking Supervision

to the provisions of the Inland Revenue Act, No. 10 of 2006 and the Value Added Tax Act, No. 14 of 2002 to facilitate the financial sector consolidation process.

In addition to the supervisory framework, the Sri Lanka Deposit Insurance and Liquidity Support Scheme also constitutes a key element of the safety net available to the general public in relation to financial services. As at 31 December 2014, the scheme comprised 82 member institutions, i.e., 34 banks and 48 finance companies, and had assets amounting to approximately Rs. 18 billion. Subsequent to the proposal announced in the Budget 2015 to increase the deposit insurance cover by fifty per cent, the Sri Lanka Deposit Insurance and Liquidity Support Scheme increased its deposit insurance coverage per depositor per institution from Rs. 200,000 to Rs. 300,000, with effect from 01 January 2015.

Policy initiatives and prudential regulatory measures have contributed to enhance the resilience of the banking sector by providing a robust foundation for effective supervision and surveillance. Similarly, future policy actions will envisage to further improve the effectiveness of the existing regulatory mechanism, in line with the international regulatory environment and the demands of the Sri Lankan economy**.**

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

LFC and SLC sector, which represented 7 per cent of Sri Lanka's financial system, has also played a vital role in the financial sector in 2014. LFC and SLC sector asset growth moderated during 2014 due to lower demand for credit, particularly during the early part of the year. However, the demand for credit picked up during the second half of 2014. The lower interest rate scenario helped to improve credit demand and to maintain the rising non-performing loans at a manageable level. Mergers and acquisitions during the year helped to build up resilience and improve the soundness of the sector. Further, in line with the developments in the economy, several measures were adopted to strengthen risk management and build the capacity of the LFC and SLC sector to facilitate better absorption of risks.

Table 8.8 Distribution of Branches of LFCs and SLCs by Province

Province	End 2013	End 2014 (a)	Movement during the year
Western	344	369	25
Southern	119	125	6
Sabaragamuwa	78	83	5
North Western	112	118	6
Central	118	128	10
Uva	51	60	9
North Central	75	86	11
Eastern	87	88	1
Northern	76	75	(1)
Total	**1,060**	**1,132**	**72**

(a) Provisional

Source: Central Bank of Sri Lanka

Business Growth

Outreach: This sector comprised of 48 LFCs and 8 SLCs by end 2014. During 2014, the LFC and SLC sector branch network expanded by 72 to 1,132, out of which, 47 were opened outside the Western Province.

Assets and Liabilities

Assets: The total asset base of the LFC and SLC sector grew by 18.9 per cent in 2014 to Rs. 853 billion compared to a growth of 20.3 per

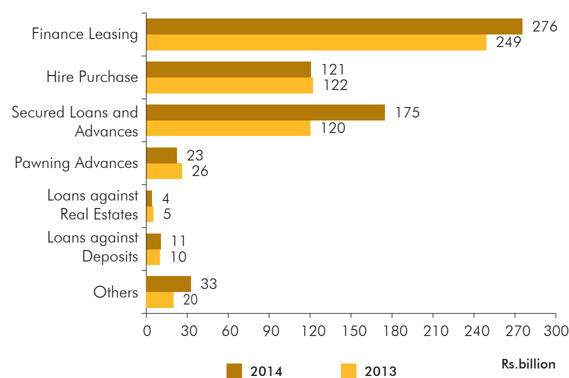
Table 8.9 Composition of Assets and Liabilities of the LFC and SLC Sector

Item	2013 (a)		2014 (b)		Change (%)	
	Rs.bn	Share (%)	Rs.bn	Share (%)	2013	2014 (b)
Assets						
Accommodation	553.1	77.1	641.4	75.1	17.3	16.0
Investments	29.8	4.1	41.6	4.9	1.3	39.6
Others	134.8	18.8	170.3	20.0	41.0	26.4
Liabilities						
Total Deposits	337.3	47.0	414.0	48.5	32.7	22.7
Total Borrowings	192.3	26.8	217.1	25.4	9.3	12.9
Capital Elements	97.4	13.6	117.2	13.7	2.6	20.3
Total Funds	**627.0**	**87.4**	**748.3**	**87.7**	**19.4**	**19.3**
Others	90.6	12.6	105.0	12.3	26.5	15.9
Total Assets/Liabilities	**717.6**	**100.0**	**853.3**	**100.0**	**20.3**	**18.9**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

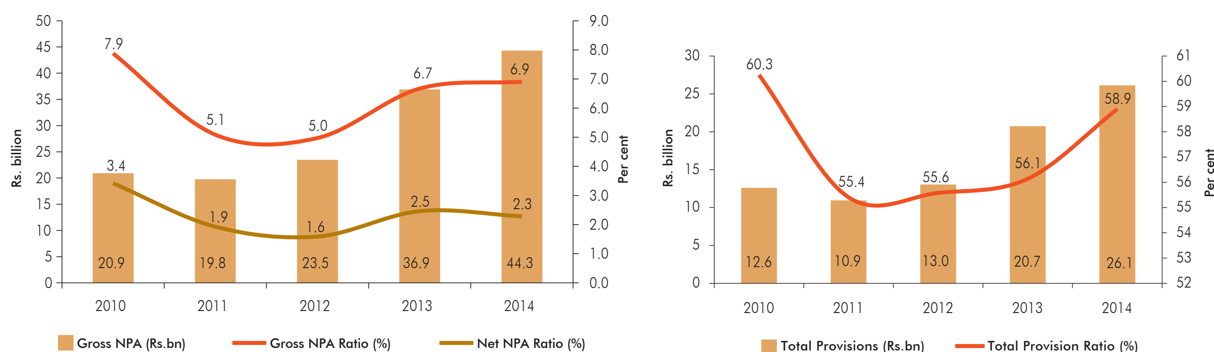
Chart 8.9 Product-wise Accommodations of the LFC and SLC Sector



cent in 2013. The main contributory factor for the expansion of the asset base was the growth in the accommodations portfolio and liquid assets. Accommodations recorded a modest growth of 16 per cent to Rs. 641 billion as at end 2014, compared to a growth rate of 17.3 per cent during 2013. Finance leases, hire purchases and secured advances were the major sources of accommodation accounting for 43 per cent, 27 per cent and 19 per cent, respectively. Among the accommodation products, secured loans and finance leases recorded growth rates of 46 per cent and 11 per cent, respectively. The pawning business exposure as a percentage of the total loan portfolio of LFC and SLC sector has reduced to 3.5 per cent (Rs. 22.6 billion) in 2014 from 4.8 per cent in 2013. The investment portfolio of the sector, which comprised of equity and debt investments recorded a notable increase of 39.6 per cent during 2014 to Rs. 42 billion albeit a lower base on account of increased performance at the Colombo Stock Exchange (CSE) during 2014. Other assets mainly comprised of liquid assets, trading stocks and fixed assets showed a steady growth mainly on account of increased liquid assets in the form of Treasury bills.

Liabilities: The share of deposits among the funding sources of the sector increased to 48.5 per cent in 2014 from 47 per cent recorded in 2013, while the share of borrowings decreased to 25.4 per cent in 2014 from 26.8 per cent in 2013 indicating the shift towards lower cost of short term deposits from borrowings. The deposits grew by 22.7 per cent to Rs. 414 billion as at the end of 2014, compared to a 32.7 per cent growth in 2013. This was mainly on account of relatively higher deposit rates offered by LFCs compared to banks in the current lower interest rate regime. The deposit mobilisation was mainly through time deposits accounting for 96 per cent of the total deposits. The total borrowings in the sector reached Rs. 217 billion, an increase of 12.9 per cent as at end 2014 compared to the growth rate of 9.3 per cent recorded in 2013. The capital elements of the sector increased by 20.3 per cent to Rs. 117 billion as at end 2014, compared to a marginal increase of 2.6 per cent in 2013 mainly on account of profits made during 2014.

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



Risk Management

Credit Risk: The total amount of non-performing accommodations (NPAs) increased by 19.9 per cent during 2014 to Rs. 44.3 billion from Rs. 36.9 billion in 2013. The high lending interest rates that prevailed during 2012/2013 and gold price fluctuations that affected the business of pawning resulted in increased NPAs. However, the NPAs relative to the total loans outstanding increased only marginally to 6.9 per cent as at end of 2014 from 6.7 per cent in 2013. When the loan loss provision is considered, the net NPA ratio decreased marginally to 2.3 per cent as at end of 2014 when compared to 2.5 per cent in 2013. The total provision coverage for NPAs increased to 58.9 per cent in 2014 from 56.1 per cent in 2013.

Market Risk: The assets and liabilities in the sector are in the process of being re-priced in the current lower interest rate regime. This re-pricing process has positively impacted the net interest income of the sector mainly derived from the ability to obtain lower cost deposits. The net interest income of the sector increased by 40.9 per cent to Rs. 62.2 billion during 2014, from Rs. 44.1 billion recorded in the previous year. The interest margin which is net interest income as a percentage of total assets of the sector, increased to 8.0 per cent for the year 2014 when compared to 6.6 per cent recorded in the previous year. However, the LFC and SLC sector's risk arising from the volatilities in prices of equity and exchange rates was minimal due to lower exposure to equity markets and foreign currency transactions.

Liquidity Risk: The overall statutory liquid assets available in the LFC and SLC sector by end 2014 were a surplus of Rs. 29.5 billion from the stipulated minimum requirement of Rs. 52.8 billion. The liquid assets to total assets ratio increased to 9.6 per cent in 2014 from 8.0 per cent in 2013. This is directly attributed to the steady growth in sector deposits relatively to the moderate credit growth of the sector. The excess liquid assets were invested in Treasury bills and in deposits with licensed banks which were low income earning assets. The liquid assets of the sector increased by Rs. 25 billion in 2014 compared to a similar increase in the previous year.

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

Item	Amount (Rs.bn)		Growth			
			2013 (a)		2014 (b)	
	2013 (a)	2014 (b)	Amount (Rs.bn)	%	Amount (Rs.bn)	%
Interest Income	117.3	131.3	24.5	26.4	14.0	11.9
Interest Expenses	73.2	69.2	20.7	39.3	(4.1)	(5.5)
Net Interest Income	**44.1**	**62.2**	**3.8**	**9.5**	**18.1**	**40.9**
Non-Interest Income	17.2	20.8	3.9	29.2	3.6	21.2
Non-Interest Expenses	39.3	48.2	9.3	30.8	8.8	22.4
Staff Cost	13.6	17.5	2.6	23.5	3.9	28.8
Loan Loss Provisions (Net)	8.1	11.8	6.6	436.3	3.7	45.3
Profit before Tax	**13.8**	**23.0**	**(8.8)**	**(38.9)**	**9.2**	**66.6**
Tax	6.1	9.2	(0.3)	(5.2)	3.1	50.2
Profit after Tax	**7.7**	**13.9**	**(7.2)**	**(48.4)**	**6.2**	**79.6**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Resources

Profitability: During 2014, the LFC and SLC sector profits recorded an increase, mainly due to increased net interest income despite the increased operational costs and provisioning requirements. The sector posted a profit after tax of Rs. 13.9 billion for 2014 compared to a profit of Rs. 7.7 billion during 2013. The loan loss provision increased by Rs. 3.7 billion in 2014 when compared to an increase of Rs. 6.6 billion in 2013. The profitability indicators of the sector i.e. ROA and ROE increased to 3.0 per

Chart 8.11 Profitability Indicators of the LFC and SLC Sector

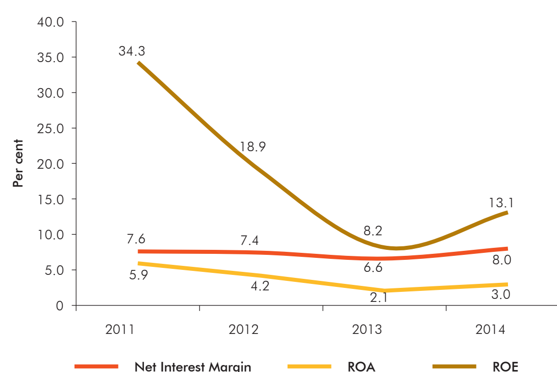


Table 8.11 Composition of Regulatory Capital of the LFC and SLC Sector

Item	Amount (Rs.bn)		Composition (%)	
	2013 (a)	2014 (b)	2013 (a)	2014 (b)
Tier I: Core Capital	76.1	83.4	100	100
Issued and Paid-up Ordinary Shares/ Common Stock (Cash)	53.8	64.8	71	78
Non-Cumulative, Non-redeemable Preference Shares	1.8	0.1	2	0
Share Premium	0.2	0.2	0	0
Statutory Reserve Fund	8.1	10.8	11	13
General and Other Free Reserves	18.0	21.0	24	25
Other	(5.7)	(13.5)	(8)	(16)
Tier II: Supplementary Capital	9.4	9.1	100	100
Eligible Revaluation Reserves	2.6	2.2	28	24
General Provisions	0.2	0.2	2	2
Eligible Approved Unsecured Subordinated Term Debt	5.8	6.5	62	72
Other	0.8	0.2	8	2
Regulatory Adjustments	(1.6)	(4.6)		
Total Regulatory Capital Base	83.7	87.9		

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

cent and 13.1 per cent, respectively, in 2014 from 2.1 per cent and 8.2 per cent in 2013.

Capital: Capital funds increased by 20.9 per cent to Rs. 114 billion as at end of 2014, compared to an increase of 9.6 per cent in 2013 mainly due to internally generated funds, that is profits. The capital adequacy ratios of the sector remained above the required minimum levels although it decreased due to growth in the risk weighted assets. The total capital adequacy ratio (as a percentage of risk weighted assets) decreased to 13.5 per cent as at end of 2014 from 14.8 per cent as at end of 2013. The core capital ratio (as a percentage of risk weighted assets) too decreased to 13.0 per cent in 2014 from 13.5 per cent in 2013. Similarly, the ratio of capital funds to total deposits of LFCs also decreased marginally to 22.9 per cent in 2014 from 23.3 per cent recorded as at end of 2013.

Action against Unauthorised Conduct of Finance Business

The Department of Supervision of Non-Bank Financial Institutions (SNBFI) of the Central Bank carried out investigations on institutions allegedly engaged in finance business without authorisation while assisting Courts with respect to pending litigation issues. During 2014, awareness campaigns were conducted to educate the public on the risk of investing in unauthorised finance institutions by way of country-wide seminars/workshops. Further, public awareness was channelled through radio advertisements, posters, leaflets and press notices published in newspapers in all three languages.

Supervisory and Regulatory Developments

As per the mandate given to SNBFI, on-site and spot examinations were conducted with a risk based approach as the main supervisory mechanism on LFCs and SLCs and the relevant companies have been instructed to implement the recommendations that are made based on the findings of the examinations, within a stipulated time period. In addition, continuous off-site surveillances, internal risk rating model and an early warning system were implemented to identify risks and to take preventive measures on a timely manner.

During 2014, the Central Bank designed and implemented the financial sector consolidation programme targeting to create a financial sector which comprises of a smaller number of large financial institutions with enhanced resilience to internal and external shocks, which will also be fully compliant with the Central Bank's regulatory framework. For this purpose, the "Financial Sector Consolidation Unit" was established with members representing Bank Supervision Department and SNBFI. One-on-one meetings were held with all banks and LFCs and SLCs to discuss and to facilitate smooth progress on their respective consolidation plans. The panel of external auditors approved by the Central Bank was appointed to prepare relevant Information Memoranda and carryout Due Diligence and valuation of the

BOX 8 Developing a Strategy for Financial Inclusion in Sri Lanka

1. INTRODUCTION

There is growing evidence that developing financial institutions and financial markets and improved access to finance has a strong impact on economic development, poverty alleviation and economic stability. An inclusive financial system is able to reduce poverty, boost shared prosperity and support inclusive and sustainable development. Theoretical and empirical research has found increasing evidence of the role of finance in economic growth. According to Levine (2005) a well-functioning financial system would remove financial constraints faced by industries and firms and improve access to finance that is required for economic growth. Realising the importance of finance for growth many countries are pursuing active strategies to develop their financial institutions and markets as well as improving the access to financial services and products for a wider segment of the population, particularly for low income groups.

Financial inclusion can be broadly defined as the access to appropriate financial products and services at an affordable cost by all sections of society in general and to low income groups in particular who are underserved or have been excluded from formal financial services. Financial inclusion aims to, broaden the reach of financial services to those who do not currently have access, to deepen financial services for those who have minimal access and to increase financial literacy and consumer protection so that those who are offered financial products can make an informed choice

Financial inclusion facilitates greater participation by different segments of the population in the formal financial system. The presence of a large informal sector could affect the transmission of monetary policy as a large number of economic agents would base their financial decisions independent of the monetary policy actions of the central bank. However, with greater financial inclusion, the share of households and small businesses in the formal financial sector increases, thereby improving the transmission of monetary policy and the effectiveness of monetary policy.

2. FINANCIAL INCLUSION IN SRI LANKA

Based on generally accepted measures of financial inclusion, Sri Lanka has done well. The number of bank branches and banking density has steadily risen and there has been a significant increase in Automated Teller Machines (ATMs) and electronic fund transfer facilities at point of sales (EFTPOS) machines (see Table B 8.1).

Table B 8.1 Selected Indicators of Financial Inclusion

	2005	2010	2013
No. of bank branches [1/]	3,685	4,911	5,522
Banking density (No. of bank branches per 100,000 persons)	18.8	23.8	27.0
Total no. of ATMs	918	2,222	3,122
No. of ATMs per 100,000 persons	4.7	10.8	15.2
Total no. of electronic fund transfer facilities at point of sales machines (EFTPOS)	7,013	27,588	27,955
Total no. of credit cards	628,989	769,182	951,625
Credit cards per 100,000 persons	3,202	3,724	4,646

Source: Central Bank of Sri Lanka

[1/] Includes outlets of licensed commercial banks, licensed specialised banks and district co-operative rural banks but excludes student savings units.

However, in relation to indicators of financial depth such as money supply as a percentage of GDP, financial sector contribution to GDP, private sector credit as a ratio of GDP, Sri Lanka has a low level of financial depth compared to other emerging nations (see Table B 8.2). Sri Lanka's broad money supply to GDP ratio is around 40 per cent which is similar to the level in Indonesia (40 per cent) and the Philippines (59 per cent) but significantly lower than that of Singapore (138 per cent), Malaysia (142 per cent), Thailand (125 per cent) and South Korea (144 per cent). A similar trend is observed in the ratio of private sector credit to GDP. Measures such as stock market capitalisation and outstanding government debt and corporate debt securities as a percentage of GDP indicates further need for development in the capital market. Insurance penetration which measures the level of insurance activity is only 1.2 per cent in Sri Lanka. This is relatively low given the size of the Sri Lankan economy and compared to the average for Asia which is 5.2 per cent and 6.1 per cent for the world. Further, insurance density which is the ratio of insurance premiums to the total population was only US dollars 36 in Sri Lanka compared to the average of US dollars 295 for Asia and US dollars 645 for the world.

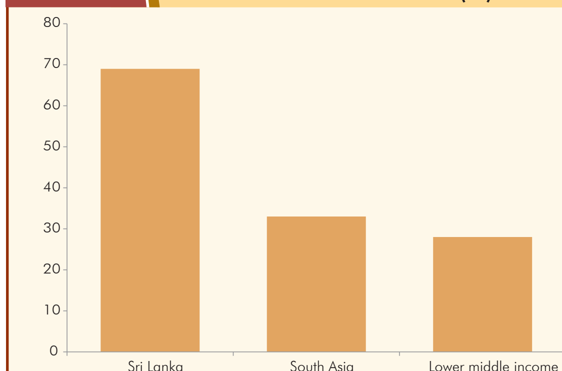
Table B 8.2 Selected Indicators of Financial Depth

	2005	2010	2013
Depth - Financial Institutions			
Broad Money (as a % of GDP)	32.2	37.3	39.4
Total Financial Sector Assets (as a % of GDP)	129.0	119.4	118.9
Private Sector Credit by Commercial Banks (as a % of GDP)	29.0	26.6	29.2
Depth - Financial Markets			
Stock Market Capitalisation (as a % of GDP)	7.1	39.4	28.4
Outstanding domestic private debt securities (as a % of GDP)	n.a.	1.5	0.9
Outstanding government debt securities (as a % of GDP)	27.0	42.8	41.8
Insurance Penetration and Density			
Insurance Penetration (as a % of GDP)[1/]	1.59	1.22	1.15
Insurance Density (premiums per capita US$)[2/]	17.9	29.7	36.3

Sources: Central Bank of Sri Lanka, Department of Census and Statistics, Colombo Stock Exchange, Swiss Re

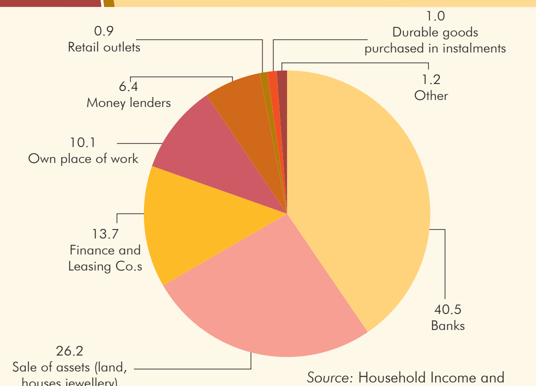
[1/] Insurance penetration is the total insurance premium as a percentage of GDP
[2/] Insurance density is the ratio of insurance premiums to the total population

Chart B 8.1 Adults with an Account at a Formal Institution (%)



Source: Global Findex Database, World Bank 2013

Chart B 8.2 Source of Loans Obtained (%)



Source: Household Income and Expenditure Survey 2009/10

According to the Global Financial Inclusion (Global Findex) database[1] despite being categorised as a lower middle income country, Sri Lanka has a relatively high account penetration rate (69 per cent) (see Chart B 8.1) compared to the average for South Asia (33 per cent) and for lower middle income countries (28 per cent). Based on the Household Income and Expenditure Survey 2009/10 conducted by the Department of Census and Statistics which obtained information on household indebtedness[2], 62 per cent of households surveyed had obtained at least one loan and out of the loans obtained, 54 per cent were from banks and finance and leasing companies (see Chart B 8.2).

3. POLICIES & STRATEGIES TO ADVANCE FINANCIAL INCLUSION

The penetration of banking services into rural areas has helped promote banking habits among the people. Developments on the technological front have also helped expand the reach of financial services in the country. The introduction of ATM cards, the adoption of electronic banking systems, such as internet banking, mobile phone based banking have further helped expand banking activities. The advances in IT and payment systems throughout the country have reduced fees and charges relating to banking services and has helped increase the receipt of foreign remittances through formal banking channels. More recently, approval was given to commercial banks to carry out agency banking through mobile phones. The widespread coverage of the mobile phone network in the country provides an opportunity to further expand access to financial services in the remotest parts of the country through the use of electronic retail payment methods, such as payment cards and mobile phone based payment mechanisms. Institutional and legal reforms have also contributed significantly to the expansion of financial services in the country. Recognising that lack of awareness is one of the key reasons for financial exclusion, the Central Bank has initiated various financial literacy programmes to disseminate information on financial services to various groups ranging from school children to farmers, women, small and medium entrepreneurs and self-employed persons.

While significant progress has been made towards enhancing the level of financial inclusion, some policies and strategies are needed to further advance financial inclusion in the country.

1. Develop a Formal Strategy for Financial Inclusion: A formal strategy for financial inclusion needs to be developed to take the country to the next decade. A strategy for financial inclusion would include developing surveys to collect data to better understand the baseline or starting point in terms of key indicators of financial inclusion that would help policymakers and financial institutions to better design products and delivery mechanisms. A national level taskforce may need to be set up to coordinate and monitor the implementation of the strategy. A mechanism to monitor the progress of the strategy and the achievement of the set targets for financial inclusion would also need to be established.

2. Establish a Credit Guarantee Corporation: Considering the important role that small and medium scale enterprises (SMEs) play in the economy, a credit guarantee corporation could be set up to reduce the financial constraints faced by SMEs that do not have sufficient collateral to obtain credit from formal financial institutions. The risk weight for lending to SMEs is 75 per cent according to Basel regulations. However, if these loans are provided with a credit guarantee the risk weighting assigned would be lower, providing an incentive to banks to lend to this sector.

3. Develop Appropriate Products: Financial institutions need to be encouraged to develop products that suit the needs of the poor. The products whether they are savings products, instruments of borrowing or insurance products should be easily accessible and be available at low cost.

1 Based on a survey conducted by the World Bank which includes only formal financial institutions.

2 Information was collected on the indebtedness of households to formal financial institutions such as banks and finance companies, and informal arrangements such as loans from money lenders, retail outlets etc.

4. Strengthen the Regulatory Environment: One of the important lessons from the recent global financial crisis was that financial instability has a disproportionate effect on the poor, as people with low levels of income and savings have less ability to mitigate risk. Hence, countries with low levels of income need to pay special attention to preserving financial stability even as they seek to deepen and broaden their domestic financial sectors, while increasing their integration with the global financial system. In the microfinance sector although some institutions are regulated under different legislations, a large number of microfinance institutions remain outside the regulatory framework. However, growth in this sector may not be possible without further capital, and investors and lenders are more comfortable providing funds to regulated entities. Since ensuring adequate protection to savers and borrowers is vital to ensure confidence in the financial system and to encourage more participation in the formal financial sector, it may be necessary develop a regulatory framework for the microfinance sector.

5. Develop a Database of Microfinance Borrowers: Financial institutions both domestic and international have many times been found guilty of over-extending credit to customers. This risk is particularly acute in the case of microfinance institutions due to the availability of a large number of microfinance lending institutions and products. A database similar to what is maintained by the Credit Information Bureau (CRIB) could be established covering all loans provided by microfinance institutions (MFIs) so that lending institutions are aware of the loans outstanding to individuals before they approve further loans. Issuing directions to MFIs that a single borrower at any given time may obtain a loan from a maximum of two MFIs may also be proposed to curb possible over borrowing by individuals.

6. Encourage Secured Transactions (Lending) based on Moveables: One of the serious constraints faced by SMEs in Sri Lanka in accessing credit from the formal financial sector is the non-availability of acceptable collateral. Significant default and enforcement risk, double collateralisation of the same asset to multiple lenders and high transaction costs associated with these forms of assets have deterred banks from accepting moveable assets as collateral and significantly increased the cost of funds secured against these forms of assets. Given that moveable assets are the main type of collateral available to SMEs the need for establishing a moveable collateral registry has been recognised. Although a Secured Transactions Act was enacted in 2009, registration is currently voluntary. Countries that have implemented this measure find that mandatory registration of moveable assets is an effective tool for improving access particularly of SMEs to finance from the formal sector.

7. Improve Financial Literacy: All users of financial services, from the financially excluded poor, to the middle income groups and high net worth individuals, who are associated with the financial system need to be financially literate, albeit to different degrees and in different aspects.

8. Maximise the Use of Technology: The role of information technology (IT) in advancing financial inclusion is well documented. IT can be used to develop comprehensive and reliable credit information systems which are vital for efficient credit delivery and credit pricing. IT can also be used to develop products that are tailored to particular segments of the population and to reach underserved areas. IT can also play a significant role in educating customers by disseminating information. Leveraging on the power of IT and optimising the use of the existing financial infrastructure would be necessary to increase the level of financial inclusion going forward.

9. Encourage wholesale funding by banks to financial institutions engaged in lending to small and medium scale enterprises: Commercial banks should be encouraged to make available wholesale funding to financial institutions engaged in microfinance activities so that they could on-lend those funds to segments of the market that are outside the reach of commercial banks. This would provide financial institutions that are lending to SMEs access to low cost funds, while providing access to finance to a segment of the market that is currently excluded from the formal financial sector. Since this could expose banks to over financing in the sector, banks could be encouraged to lend to microfinance institutions by way of consortiums thereby reducing individual risk.

4. CONCLUSION

Sri Lanka's progress in relation to financial inclusion has been impressive. Since the 1950s the Central Bank and the government have undertaken various policy measures to enhance the level of financial inclusion in the country. Based on general measures of financial inclusion, such as account penetration, which measures the ownership of accounts at financial institutions, the level of financial inclusion in Sri Lanka is very high for a country categorised as a lower middle income country. However, in relation to other measures such as borrowing from the formal sector, the use of electronic forms of payment and the use of insurance products for health care and agriculture there is still much room for improvement. The rationale for promoting financial inclusion is not only due to equity considerations, access to affordable financial services is also required for inclusive growth. Given the important role that financial inclusion can play in realising sustainable development, reducing poverty and boosting shared prosperity, it is necessary to continue to strive to improve the level of financial inclusion in the country.

Reference;

Demirguc-Kunt, Asli and Leora Klapper, (2012), "Measuring Financial Inclusion: The Global Findex Database" Policy Research Working Paper No. 6025, World Bank, Washington D.C.

World Bank, (2012), "Financial Inclusion Strategies Reference Framework", Prepared by the World Bank for the G20 Mexico Presidency.

World Bank, (2014), Global Financial Development Report 2014: Financial Inclusion. Washington, D.C.

businesses of LFCs and SLCs. Further, continuous discussions were held with the Securities and Exchange Commission of Sri Lanka, Colombo Stock Exchange and Registrar of Companies to facilitate the companies in the consolidation programme to fast track the process. Press releases at the end of each month commencing from January 2014 were issued to update all stakeholders involved in the consolidation process as well as the general public. The Inland Revenue (Amendment) Act, No. 8 of 2014 and Value Added Tax (Amendment) Act, No. 7 of 2014 have been enacted by the Parliament giving effect to the budget proposal on financial sector consolidation. In this endeavor, 10 LFCs and SLCs completed their respective consolidation plans whilst 22 LFCs and SLCs were progressing on the agreed consolidation plans. However, this consolidaition programme is under review by a committee appointed by the government.

During the year, weak companies were closely monitored through regular meetings held with Boards of Directors, Senior Management, Managing Agents and prospective investors. The Central Bank granted Rs. 6 billion funding support through the Sri Lanka Deposit Insurance and Liquidity Support Scheme to a restructured LFC and reconstituted the Board of Directors of this company. Further, another weak LFC was capitalised by its parent company and the Board of Directors was reconstituted subsequently.

Further, the Central Bank introduced several policy measures and regulations during 2014. The maximum limit on rates of interest that could be offered by LFCs on time deposits, non-transferable Certificates of Deposits and debt instruments were revised. The application, registration and annual licensing fees applicable for Registered Finance Leasing Establishments were revised while the requirement to maintain an Investment Fund Account (IFA) was withdrawn with effect from 01 October 2014.

Primary Dealers (PDs) in Government Securities

2014 had been a remarkably successful year in terms of the activities in the primary and secondary markets and the operational efficiency of PDs. The downward shift in the primary and secondary market yield curves was witnessed in the fourth quarter of 2014, as a result of the moderation in inflation and also due to prudential debt management, continued at an accelerated phase during the first three quarters of 2014. As a result, both the value and the volume of secondary market transactions in long-dated Treasury bonds increased substantially during the year under review. The aforementioned favourable macroeconomic developments provided much needed opportunity for the primary dealers to be engaged in their market making function for government securities in an effective and efficient manner. Accordingly, in 2014, PDs had been able to turn around their trading portfolios in a faster manner while enhancing the efficiency of assets and capital employed. In this encouraging market exercise, PDs have used a portion of their securities held to

Table 8.12 Performance of Primary Dealers

Rs.million

Item	2013 (a)	2014 (b)	Annual Growth Rate (%)	
			2013 (a)	2014 (b)
Total Assets	212,765	191,085	32.9	(10.2)
Total Portfolio	**210,950**	**186,955**	**32.3**	**(11.4)**
Trading Securities	143,287	115,144	64.6	(19.6)
Investment Securities	48,835	32,748	(1.7)	(32.9)
Reverse Repo	16,755	36,242	(10.9)	116.3
Available for sale	2,073	2,822	(46.3)	36.1
Equity and Liabilities	212,765	191,085	32.9	(10.2)
Total Capital (c)	6,615	9,500	20.8	43.6
Repo	126,411	118,820	21.4	(6.0)
Profit before Tax	8,588	8,665	194.8	0.9
Profit after Tax	8,005	7,877	215.0	(1.6)
Return on Assets (%)	4.0	4.3	2.2	0.3
Return on Equity (%) (c)	28.4	44.1	10.7	15.7
Risk Weighted Capital Adequacy Ratio (%) (c)	18.4	21.8	(3.7)	3.4
Leverage Times (c)	7.4	6.6	(0.1)	(0.8)
Dealings	14,554,616	13,165,064	39.9	(9.5)
Primary Market Dealings	2,252,438	1,982,400	(12.6)	(12.0)
Secondary Market Dealings	12,302,178	12,063,287	57.1	(1.9)

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

Source: Central Bank of Sri Lanka

maturity as well to fund growing trading activities. Accordingly, Primary Dealer Industry, has recorded a substantially high profitability while reducing the overall size of the government securities portfolio in 2014. Continuing the objective of increasing the competition among individual PDs and also the total subscriptions at the primary auction of government securities, Licensed Commercial Banks were allowed to become PDs in government securities without having to maintain a dedicated capital that is required by standalone PDs. Accordingly, Union Bank of Colombo was appointed as a Primary Dealer in government securities increasing the total number of PDs to 16. Accordingly, the industry consisted of 8 Primary Dealer Units of LCBs (Bank PD Units) and 8 standalone PDs by end 2014.

Assets and Liabilities: The total assets of PD industry in 2014 declined by 10.2 per cent to Rs. 191.1 billion compared to Rs. 212.8 billion at the end of 2013. However, the total assets increased by 32.9 per cent in 2013. Government securities, mainly Treasury bills and Treasury bonds, accounted for 97.8 per cent of the total assets of the industry. The total portfolio of government securities of the PD industry, consisting of trading, available for sale and investment portfolios together with such securities held under agreements to sell back (reverse repo), amounted to Rs. 187.0 billion at end 2014, recording a decrease of 11.4 per cent over Rs. 211.0 billion held in 2013. Decrease in the securities held for trading had been the main contributory factor for the decrease in the total government securities portfolio held by PDs. The trading portfolio declined by Rs. 28.1 billion (19.6 per cent) to Rs.115.1 billion at the end of 2014, from Rs.143.3 billion at end of 2013. The decline in the total volume of government securities held by PDs is a clear indication of the improved efficiency in the intermediary role played by PDs in market making for government securities. The investment portfolio, declined by Rs.16.1 billion (32.9 per cent) to Rs. 32.7 billion by end 2014 from Rs. 48.8 billion held at the end of 2013, mainly driven by the part of maturity proceeds on investing in Treasury bills and Treasury bonds that have not been rolled over. The usage of funds so generated through downsized trading and investment portfolios by PDs was partly reflected in lending under reverse-repurchase transactions, which increased by Rs. 19.5 billion (116.3 per cent) from 16.8 billion to Rs 36.2 billion at the end of 2014 and partly in the reduction in the borrowings under repurchase agreements, which has been the major source of funding for PDs. Borrowings under repurchase agreements declined by 6 per cent to Rs. 118.8 billion at the end of 2014, from Rs. 126.4 billion at end 2013.

Capital: The capital base of the standalone PDs increased to Rs. 9.5 billion in 2014 from Rs. 6.6 billion in 2013. The Risk Weighted Capital Adequacy Ratio (RWCAR) of standalone PDs also increased to 21.8 per cent at end 2014 from 18.4 per cent at end 2013, with the increase in their capital base. All standalone PDs were in compliance with the minimum regulatory capital requirement of Rs. 300 million or an equivalent of 8 per cent of the risk weighted assets, whichever is higher, at the end of 2014. Capital leveraging of Standalone PDs was maintained at a moderate level of 6.6 times at end 2014 compared to 7.4 times of 2013.

Profitability: As per unaudited data, the overall efficiency of the industry and the efficiency of capital increased in 2014. The ROA, which is the single point indicator of overall efficiency of the industry further improved to 4.3 per cent in 2014 from 4 per cent in 2013, signifying higher return on assets, less operating expenses and substantial appreciation in value of the trading portfolio. The ROE of standalone PDs, which is an indication of the efficiency of the capital being employed, increased to 44.1 per cent in 2014 from 28.4 per cent in 2013. The improvement in profitability of PDs could mainly be attributed to the increased

primary and secondary market trading volumes and also the appreciation in value of the trading portfolio resulting from the downward shift in the market yield rates. Benign macroeconomic conditions, low and stable inflation level and the favourable liquidity levels in the market, resulted in a continuous gradual downward shift in the secondary market yields throughout 2014, enabling the sector to earn higher capital gains on trading portfolios.

Exposure to Risks and Risk Management

Market risk exposure declined: The market risk exposure of the PD industry as a whole, as well as individual PDs decreased during the year as a result of downsizing of the trading portfolio and also due to the gradual downward shift of the primary and secondary market yield rates of government securities during 2014. Individual PDs have built adequate reserve buffers to face any losses arising from the adverse movements of market yield rates without a significant impact on their capital base. Further, the stress tests carried out by the Central Bank indicated the ability of each PD to withstand such losses well within the additional capital maintained by PDs over and above the minimum statutory requirements stipulated under the prudential directions issued by the Central Bank.

Liquidity risk exposure improved: The overall liquidity risk exposure of PD industry decreased due to the improved maturity profile of assets and liabilities in 2014. Accordingly, the overnight negative mismatch in the maturity profile of assets and liabilities of the industry decreased significantly to Rs. 23.3 million or 0.4 per cent of the total overnight liabilities at end 2014, from Rs. 7.4 billion (Rs. 7,379.5 million) or 76.9 per cent at end 2013. Further, as 97.8 per cent of the total assets of the industry was held in highly liquid risk-free government securities, which could be liquidated or pledged as collateral for meeting any unforeseen funding needs of the industry. Furthermore, the standalone PDs continued to have sufficient standby funding arrangements from banking institutions while there have been irrevocable funding support for bank PD units from such banks to bridge any unforeseen liquidity gaps.

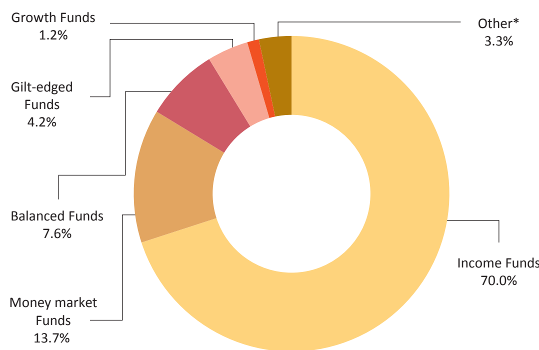
Market Participation

The 'Bank PD Units' continued to be the major participants at the primary auctions of Treasury bills while the standalone PDs were the major participants at the primary auctions in Treasury bonds. Bank PD Units recorded a 67.9 per cent effective participation rate at the Treasury bill auctions in 2014, while the effective participation of both standalone PDs and EPF at the Treasury bill auctions in 2014 continued to remain low around 31.9 per cent, and 0.2 per cent respectively. The effective participation of standalone PDs at the primary auctions of Treasury bonds in 2014 was about 50.2 per cent of the total issuances during the year. Meanwhile, secondary market transactions in government securities decreased marginally by 1.9 per cent during 2014 compared to 2013 but increased significantly in tenure of longer maturities of 5 year and longer compared to 2013. Repo transactions accounted for 68.2 per cent of the total volume of secondary market transactions in 2014.

Unit Trusts (UTs)

The Unit Trust sector, which accounted for 1.1 per cent of the financial sector assets continued to expand with encouraging performance in 2014. With the launch of 10 new funds, the total number of UTs operating in the sector increased to 63 UTs and the total number of Unit Trust Management Companies also increased to 14 at the end of 2014 from 13 in 2013. Of these 63 UTs, 62 were open-ended funds while one UT was a closed- end listed equity growth fund. There were 10 types of UTs according to their investment focus, 19 income funds, 10 money market funds,

Chart 8.12 Categorisation of the Unit Trust Sector in terms of the Net Assest Value



*Other : Equity Funds 1.9%, Index Funds 0.2% IPO Funds 0.01%, Coporate Debt Funds 0.02% and Equity Growth Funds 1.1%

9 gilt-edged funds, 7 balanced funds, 6 equity funds, 4 growth funds, 4 index funds, 2 IPO funds, 1 corporate debt fund, and 1 Dollar bond fund, at the end of 2014.

Business growth: The total assets under management, comprising investments in government securities (Rs. 56.1 billion), and investments in equities (Rs. 13.6 billion) of the sector increased more than double to Rs. 126.5 billion at the end December 2014, from Rs. 54.3 billion at the end 2013. This was mainly due to the setting up of a number of new funds, those with significant investments in government securities, corporate debt securities and equities, sustained performance of the equity market, and the concessions and incentives provided for the sector as per the Budget 2014. Accordingly, the net asset value per unit marginally increased to Rs. 13.43 by end December 2014, compared with Rs. 13.27 in 2013. The total number of units outstanding at the end of December 2014 increased to 9,382 million from 4,103 million at the end of December 2013, while the number of unit holders increased to 32,584 as at end December 2014 from 29,940 at end December 2013.

Table 8.13 Performance of the Unit Trust Sector

Details	2013 (a)	2014 (b)
No. of Unit Trusts	53	63
Total No. of Unit Holders	29,940	32,584
No. of Units in Issue (million)	4,103	9,382
Total Assets (Rs. million)	54,323	126,531
Net Asset Value-NAV (Rs. million)	54,448	125,985
Investments in Equities (Rs. million)	9,486	13,575
Share of Total Assets (%)	17	11
Investments in Government Securities (Rs. million)	17,363	56,146
Share of Total Assets (%)	32	45

(a) Revised
(b) Provisional

Source: Unit Trust Association of Sri Lanka

Investment: Investment in government securities (Treasury bills, Treasury bonds, and Reverse Repos in government securities) by UTs increased significantly, while the relative share of investment in equities by UTs continued to decline in 2014, in spite of the encouraging performance in the equity market. The value of investment in government securities increased to 44.5 per cent as at end December 2014 from 32.1 per cent as at end December 2013. New UTs which entered the sector in 2014 preferred investments in government securities, mainly due to the desire for higher capital gains in a declining interest rate regime, had been the reason for higher relative share of investments in government securities by the UTs. The relative share of investment in equities in the investment portfolios of UTs declined to 10.8 per cent at the end of 2014 from 17.4 per cent in 2013. The share of investment in corporate debt securities too declined to 45.1 per cent of the total investments by end December 2014 from 50.2 per cent in 2013.

Supervisory and Regulatory Developments: With a view to enhancing the Unit Trust sector, SEC issued a directive for all UTs to maintain a minimum of 50 unit holders for each fund at all times. In addition, UTs were also requested to obtain a minimum of 50 unit holders at any IPO. In July 2014, the country's first ever dollar bond fund was introduced by a unit trust management company under the approval of the Securities and Exchange Commission (SEC). This fund is an open-ended fund that offers US dollar returns by investing in Sri Lanka Sovereign bonds, banks and corporate dollar bonds.

Insurance Companies

Despite moderate growth, the insurance sector, which accounts for 3.4 per cent of the financial sector assets, maintained its stability in 2014. There were 21 insurance companies operating in Sri Lanka, which are registered with the Insurance Board of Sri Lanka (IBSL). Out of the 21 insurance companies in operation, 12 companies are composite insurance companies carrying on both long-term insurance business and general insurance business, 6 companies engage exclusively in general insurance business and 3 companies conduct only long-term insurance business. By the end of the year, there were 58 companies, engaged in the insurance brokering business concentrating mainly on general insurance businesses. Moreover, there were about 36,518 insurance agents at the end of 2014, through whom most of the insurance business was distributed throughout the country. Seven insurance companies were listed on the Colombo Stock Exchange (CSE) and the balance is required to be listed on the CSE by February 2016.

The level of expansion of the insurance sector in the country is relatively slow as reflected by low penetration and density. Insurance penetration, that is total premium as a percentage of GDP, was 1.05 per cent in 2014 with 0.45 per cent penetration for long-term and 0.60 per cent for general insurance. Insurance penetration for Asia was 5.18 per cent with 3.56 per cent for long-term and 1.62 per cent penetration for general insurance. The low insurance penetration was mainly due to several factors such as attitudes of the general public towards insurance, lack of adequate awareness, inefficiencies in policy management and lack of appreciation for the concept and benefits of insurance. Insurance density that is the ratio of total premium to total population was Rs. 4,962 million (US$ 38 million) in 2014 compared to Rs. 4,613 million (US$ 35 million) in 2013.

Business Growth: The total assets of insurance companies recorded a healthy growth of 13.2 per cent as at end 2014 compared to 13.0 per cent growth in 2013 and amounted to Rs. 411.7 billion against Rs. 363.8 billion at the end of 2013. Total assets in respect of long-term insurance business increased to Rs. 249.9 billion as at the end of 2014, accounting for 61 per cent of the total assets of the insurance sector from 60 per cent or Rs. 217 billion at the end of 2013. However, the relative share of the general insurance business sector declined to 39 per cent of the total assets of the insurance sector at the end of 2014, even though, the total assets of the sector increased to Rs. 161.9 billion from Rs. 146.8 billion at the end of 2013. The gross written premium (GWP) of the insurance companies grew by 8.6 per cent during 2014, as against the 8.4 per cent growth in 2013, reversing the continuous moderation since mid-2011. Relatively high growth in premium income of general insurance sector, particularly, motor insurance and fire segments have largely contributed toward the higher growth of GWP in the insurance sector. However, the intense price competition that prevailed in the general insurance sector has negatively affected to the growth of the motor insurance premium. The GWP for general insurance, which accounts for 57.5 per cent of the total GWP, grew by 10.9 per cent to Rs. 59

Chart 8.13 Gross Written Premium of the Insurance Sector

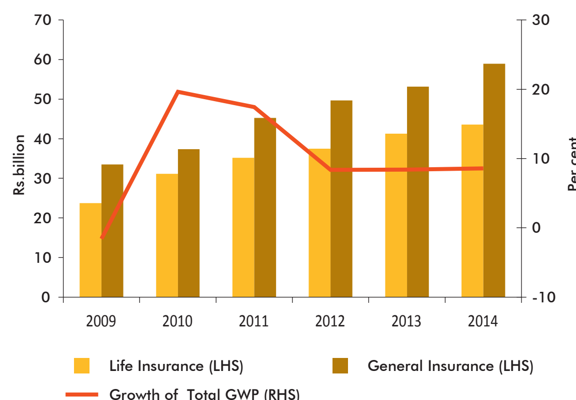


Table 8.14 Performance of the Insurance Sector

Rs.billion

Item	2013 (a)	2014 (b)
Total Assets	363.8	411.7
Government Securities	121.6	137.7
Equities	40.1	54.9
Cash & Deposits	62.6	62.3
Total Income	123.5	135.9
Premium Income	94.5	102.6
Investment Income	29.0	33.3
Profit Before Tax	13.5	9.7
Solvency Margin Ratio - Life Insurance	8.9	9.8
- General Insurance	2.6	2.4
Retention Ratio (%) - Life Insurance	96.0	96.5
- General Insurance	83.5	81.0
Claims Ratio (%) - Life Insurance	46.2	47.8
- General Insurance	58.7	63.3
Combined Operating Ratio (%) - Life Insurance	93.7	98.3
- General Insurance	101.7	107.5
Return on Assets (ROA) (%) - Life Insurance	3.1	2.8
- General Insurance	5.1	3.2
Return on Equity (ROE) (%) - General Insurance	9.1	5.2
Underwriting Ratio (%) - General Insurance	20.8	16.3

(a) Revised
(b) Provisional

Source: Insurance Board of Sri Lanka

billion in the period. In comparison, the GWP for long-term insurance, which accounts for 42.5 per cent of the total GWP, increased by 5.6 per cent to Rs. 44 billion. However, there is a huge potential for the growth of long-term insurance business with the introduction of different product strategies, such as life insurance, single premium insurance (annuities), unit linked insurance products, pension and capital redemption. The availability of a steady supply of long-term investment instruments, such as government and corporate bonds would facilitate the growth of a greater variety of these insurance products. Moreover, the GWP for motor insurance, which accounts for 61.3 per cent of the total GWP of general insurance, increased by 9.1 per cent in 2014 when compared to the increase of 4.6 per cent in 2013.

Earnings: The profitability of the insurance sector declined in 2014 with the moderation of total investment income and low underwriting profits. The aggregate profit before tax of the insurance sector declined by 27.9 per cent to Rs. 9.7 billion in 2014 from Rs. 13.5 billion in the previous year. Consequently, the ROE and ROA for general insurance decreased to 5.2 per cent and 3.2 per cent, respectively during the period from 9.1 per cent and 5.1 per cent, respectively in 2013. The ROA of the long-term insurance declined to 2.8 per cent in 2014 from 3.1 per cent in 2013. The total investment income of insurance companies increased by 14.9 per cent to Rs. 33.3 billion during 2014, in contrast with the increase of 23.3 per cent in 2013. The significant performance of the equity market and higher investments in corporate debt securities positively affected the investment income of the insurance sector, while low interest rates in government securities and deposits have had a negative effect. Underwriting profits from general insurance decreased by 15.1 per cent to Rs. 7.4 billion in 2014 from Rs. 8.8 billion in 2013.

Capital and Investment: Insurance companies maintained their soundness during the year. All insurance companies, except one, met the statutory solvency margin requirement for general and long-term insurance as at end 2014. The solvency margin ratio for general insurance marginally decreased to 2.4 times at end 2014 from 2.6 times at end 2013, while the solvency margin ratio for long-term insurance increased to 9.8 times at end 2014 from 8.9 times at end 2013. Further, insurance companies are required to invest a minimum of 20 per cent of the technical reserves in respect of general insurance and 30 per cent of the long-term funds in government securities. Accordingly, 47 per cent of long-term insurance assets and 22 per cent of general insurance assets were invested in government securities as at end 2014. The share of equity investment in the total investment portfolio of insurance companies increased to 15.5 per cent as at end 2014 from 13 per cent as at end 2013. Corporate debt securities had a share of 13.6 per cent in the total investments of insurance companies as at end 2014, compared to a share of 12.6 per cent by end 2013. Reflecting

improved capital levels in the insurance sector, the ratio of capital to total assets increased to 63 per cent as at end 2014 from 57 per cent as at end 2013.

Supervisory and Regulatory Developments: The regulatory and supervisory framework of the insurance sector was further enhanced to promote efficient capital allocation, corporate governance and better risk management. The minimum regulatory capital of insurance companies has been increased to Rs. 500 million from Rs. 100 million. However, a newly formed insurance company that complies with the segregation process can maintain a capital of Rs. 100 million at the time of its segregation as an insurer. It must thereafter increase the capital to Rs. 500 million on or before February 2015. The proposed risk based capital (RBC) adequacy framework will replace the current rule-based solvency requirement by 2016. The change of this capital regulation has already encouraged better discipline in the investment function in the sector and this will result in greater precision in measurement of capital on a risk-adjusted basis and promote better risk management. In addition, the mandatory public listing by 2016 provides greater transparency and promotes better governance, thereby improving policyholder protection.

Superannuation Funds

The superannuation funds sector recorded relatively healthy growth in 2014 and accounted for around 15.5 per cent of total assets in the overall financial sector in the country at the end of 2014 in comparison to around 15.9 per cent in 2013. This sector consists of three publicly managed funds, namely the Employees' Provident Fund (EPF), the Employees' Trust Fund (ETF), and the state sector Public Service Provident Fund (PSPF) and privately managed 157 Approved Pension and Provident Funds (APPFs).

The EPF, the largest of all the superannuation funds for the private sector in Sri Lanka, reported a growth of 14.4 per cent in its value to Rs. 1,487 billion at the end of 2014, and accounted for 80 per cent of the total assets of the superannuation funds sector in comparison to the fund value of Rs. 1,300 billion or the relative size of 79 per cent of the total assets of the sector at the end of 2013.

The EPF is administrated by the Commissioner of Labor, while the responsibility for the management of the funds is vested with the Monetary Board of the Central Bank of Sri Lanka. The total number of member accounts in the fund increased to about 15.4 million at the end of 2014, including about 13.0 million non-contributing member accounts and about 2.4 million active contributing member accounts, from about 15.2 million in 2013. The fund recorded a healthy financial position at the end of 2014 and satisfactory operating performance for the year 2014. Accordingly, the total book value of the fund increased by 14.4 per cent to Rs. 1,486.9 billion at the end of 2014 from Rs. 1,300 billion in 2013. Total contributions received by EPF in 2014 increased moderately by 12.3 per cent to Rs. 90 billion compared to Rs. 80.2 billion in 2013. However, total refunds rose significantly by 29.7 per cent to

Table 8.15 Performance of the EPF and the ETF

Item	EPF		ETF	
	2013 (a)	2014 (b)	2013 (a)	2014 (b)
Total Assets (Rs.bn)	1,300.0	1,486.9	178.5	199.1
Total Member Balance (Rs.bn)	1,281.9	1,445.5	174.3	193.9
Number of Member Accounts (mn)	15.2	15.4	10.0	12.0
Number of Active Member Accounts (mn)	2.4	2.4	2.2	2.4
Number of Employers contributing	69,148	71,000	72,145	74,276
Total Contributions (Rs.bn)	80.2	90.0	14.4	15.9
Total Refunds (Rs.bn)	50.2	65.1	9.6	13.9
Total Investments Portfolio (Rs.bn)	1,257.3	1,437.7	168.0	185.9
o/w : Government Securities (%)	92.5	91.2	88.9	90.4
Gross Income (Rs.bn)	136.7	163.9	16.5	18.8
Profit Available for Distribution (Rs.bn)	125.7	150.8	15.8	17.7
Return on Investments (%)	11.5	12.1	10.1	10.0
Interest Rate paid on Member Balances (%)	11.0	10.5	10.0	10.0

(a) Revised
(b) Provisional

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

Rs. 65.1 billion in 2014 against the Rs. 50.2 billion in 2013. Consequently, the net contributions of the fund decreased by 17.0 per cent to Rs. 24.9 billion in 2014 from Rs. 30.0 billion in 2013. The total investment portfolio of the EPF increased by 14.3 per cent to Rs.1,437.7 billion in 2014 from Rs. 1,257.3 billion in 2013. The return of investment and the growth of member contributions have positively contributed to the improvement in the investment portfolio of the fund. As in previous years, investments in government securities continued to be the major investment of the Fund. Total investments in government securities represented 91.2 per cent of the total investment portfolio at the end of 2014 in comparison to 92.5 per cent at the end of 2013. A higher concentration on government securities in the total investment portfolio is maintained to have a long-term positive real rate of return to the members while ensuring the safety of such investments with adequate liquidity for member benefit refunds. Investments in corporate debt and listed and unlisted equities accounted for 1.5 per cent and 6.7 per cent respectively, of the total investment portfolio, against 1.2 per cent and 5.8 per cent respectively, at the end of 2013. The gross income of the fund increased by 19.9 per cent to Rs. 163.9 billion in 2014 compared with Rs. 136.7 billion in 2013. This was mainly due to the interest income and capital gains on investments in government securities during the period under consideration. The rate of return declared on member balances was 10.5 per cent in 2014 compared to 11.0 per cent in 2013.

The Employees' Trust Fund (ETF), the employer contributory retirement benefit scheme, which accounted for about 10.8 per cent of the superannuation funds sector at the end of 2014, reported a healthy growth in 2014. The ETF is administrated by the Employees' Trust Fund Board of the Ministry of Policy Planning, Economic Affairs, Child, Youth and Cultural Affairs. Similar to the EPF, the ETF operated its functions successfully in 2014 recording an increase in its asset base, income and investments, in spite of the significant decline in net contributions during the year. The ETF had about 12 million accounts at the end of 2014, including about 2.4 million active accounts. The total outstanding member balances in the ETF rose by 11.3 per cent to stand at Rs. 193.9 billion at the end of 2014 from Rs. 174.3 billion at the end of 2013. Although the total contributions of the fund increased at the relatively low rate of 10.1 per cent to Rs. 15.9 billion from Rs. 14.4 billion in 2013, the Fund paid out Rs. 13.9 billion as member benefits in 2014, an increase of 44.8 per cent from Rs. 9.6 billion in 2013. Accordingly, the net inflow to the fund decreased by 58.7 per cent to Rs. 1.99 billion in 2014 from Rs. 4.83 billion in 2013. The total investment portfolio of the ETF rose by 10.6 per cent to Rs. 185.9 billion at the end of 2014. The total assets of the ETF amounted to Rs. 199 billion at end 2014, recording an increase of 11.5 per cent over the 2013 balances. ETF too had most of its investments (90.4 per cent) in government securities. Investments in equity and corporate fixed income securities accounted for 4.8 per cent and 0.7 per cent respectively of total investments. The effective rate of return on member balances of ETF was 9.97 per cent in 2014.

The Public Service Provident Fund (PSPF), which is managed by the Department of Pensions had 230,837 active members at the end of 2014. Total contributions of the fund, increased by 11.4 per cent to Rs. 1,493 million during 2014 from Rs.1,340 million in 2013. During the year, total refunds of the fund increased by 13.5 per cent to Rs. 381 million. Consequently, the net contributions to the fund increased by 10.7

per cent to Rs. 1,111 million during 2014 from Rs. 1,003 million in the previous year. The total assets of the PSPF increased by 12.5 per cent to Rs. 41 billion as at end 2014 from Rs. 36.4 billion as at end 2013. With respect to its investments, investments in government securities had a share of 99.9 per cent as at end 2014.

Privately managed provident and pension funds, which are monitored by the Department of Labour, had about 157 funds by end 2014 with a total membership of 170,460 persons. The assets of private provident and pension funds rose by 9.1 per cent to Rs. 134.2 billion, while investments increased by 14.2 per cent to Rs. 120.4 billion at the end of 2014.

8.3 Performance of Financial Markets

Money Market

The excess liquidity condition witnessed in 2013 continued in 2014 as well. The domestic money market has been experiencing sustained excess liquidity condition since end August 2013. The excess liquidity position of the domestic money market started to buildup in a rapid phase since the beginning of 2014 with the utilisation of the proceeds of the international Sovereign bond issued in January and stood at Rs. 204 billion on 03 February 2014. This was augmented further due to purchases of Treasury bills by the Central Bank, FX-SWAP transactions of the Central Bank with commercial banks, and foreign currency purchases by the Central Bank aimed at smoothing the exchange rate volatility. Consequently, the excess liquidity rose in excess of Rs. 350 billion by August, 2014 and remained at these high levels during the balance period of the year. In order to curb the spillover effect on the monetary policy emanating from the high excess liquidity position in the market, the Central Bank conducted Open Market Operations (OMO) regularly to maintain inter-bank call money rate at desired levels to support steering short term interest rates to suit the monetary policy stance in 2014. Accordingly, in 2014 overnight repurchase (repo), regular short term repo and long term repo auctions were conducted as appropriate. Overall monthly excess liquidity absorbed by the regular short term repo and long term repo auctions remained above 80 per cent of the total excess liquidity that prevailed in the market most of the time during the year. However, an overnight reverse repurchase auction was conducted to supply liquidity to the market when the overnight market experienced a liquidity shortage. Standing facilities were also offered on a daily basis creating the floor and the ceiling for the OMO.

Table 8.16 Money Market Transactions

Market	Volume (Rs.billion)		Weighted Average Interest Rate (Min-Max) - %	
	2013	2014	2013	2014
Call Money	2,079	2,198	7.61-9.84	5.72-7.68
Inter-Bank repo	3,422	2,246	6.97-9.08	5.29-7.02
Central Bank Repo	5,677	4,299	6.50-8.55	5.59-7.09
Central Bank Reverse Repo	187	5.8	8.10-9.50	6.72-8.50
SDF	-	4,340	-	-
SLF	-	7.9	-	-

Source: Central Bank of Sri Lanka

Liquidity management in the money market was further strengthened in 2014. Standing Rate Corridor (SRC) was established in place of the policy rate corridor in January 2014. Accordingly, overnight repo rate and overnight reverse repo rates were renamed as Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR), respectively. The SLFR was revised downward from 8.50 per cent to 8.00 per cent while maintaining SDFR unchanged at 6.50 per cent, thereby compressing the SRC to 150 basis points from 200 basis points. With effect from February 2014, Standing Deposit Facility (SDF)was uncollateralised. Interest on such deposits was exempted from the

requirement of Withholding Tax (WHT) from 24 April 2014 removing any distortion caused to the short term interest rate structure. In the midst of lower holdings of government securities by the Central Bank, Government Security Borrowing Programme continued to absorb a greater share of excess liquidity from the market.

The average weighted call money rate (AWCMR) reflected a downward trend during the year 2014. The monthly average AWCMR, which stood at 7.44 per cent in January, declined and hovered around 7.00 per cent until mid-July 2014. Responding to the increasing excess liquidity in the market, the AWCMR descended gradually thereafter and stabilised around the lower bound of the SRC, i.e. 6.50 per cent. With effect from 23 September 2014, SDF was rationalised to further encourage credit creation by limiting the access to the SDF of the Central Bank at 6.50 per cent to a maximum of three times per calendar month, while any deposit exceeding three times was accepted only at 5.00 per cent per annum. As a result, AWCMR declined further and settled around 6.00 per cent towards the remaining period of the year.

Domestic Foreign Exchange Market

Sri Lankan rupee depreciated marginally against the US dollar but appreciated against several major currencies during 2014. Overall depreciation of Sri Lankan rupee against the US dollar was 0.23 per cent, i.e., from Rs. 130.7530 to Rs. 131.0486. Sri Lankan rupee recorded an appreciating trend against the US dollar during the first eight months of the year mainly on account of the receipt of proceeds from the International Sovereign Bond issue, other foreign inflows to the government and private sector, worker remittances and inflows from tourism. This trend reversed during the period from August to December 2014 due to the outflows of foreign currency through withdrawals of investments in Treasury bills and Treasury bonds by foreigners, equity and seasonal imports. In-line with the overall depreciation of the Sri Lankan Rupee, the average US dollar buying and selling rates of commercial banks for telegraphic transfers were recorded at Rs. 130.36 and Rs. 133.37, respectively in 2014 whilst comparative figures for 2013 were Rs. 129.44 and Rs. 132.34, respectively.

During 2014 trading volumes in the domestic foreign exchange market increased by 12.93 per cent compared with the previous year. Transaction volumes in foreign exchange in the domestic market increased to US dollars 15,477.74 million in 2014 from US dollars 13,705.32 million in 2013. The daily average volumes in the inter-bank foreign exchange market too recorded a similar increase to US dollars 63.96 million in 2014 from US dollars 56.40 million in 2013.

Upward revision in the daily net open position in foreign currency of licensed commercial banks took place in 2014. Accordingly, the daily net open position in the foreign currency of Commercial Banks was revised upwards from US dollars 120 million to US dollars 189 million with effect from 01 July 2014. This was done in anticipation of improved economic activities and also to allow commercial banks more flexibility to engage in their foreign exchange transactions.

Government Securities Market

The Treasury bill yield rates recorded a downward movement in 2014. The declining interest rate was due to a combination of factors, including the relaxation of monetary policy, the

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Table 8.17 Annualised Primary Market Weighted Average Yield Rates of Treasury Bills

Per cent per annum

Year	Maturity			Overall Average
	91-days	182-days	364-days	
2010	7.86	8.42	8.43	8.32
2011	7.28	7.21	7.41	7.31
2012	10.72	12.29	12.14	11.81
2013	7.54	7.85	8.29	8.20
2014	6.58	6.57	6.73	6.68

Source: Central Bank of Sri Lanka

implementation of prudent debt management strategies and the prevalence of excess liquidity level in the market. At the same time, the proactive debt management strategies to sustain and maintain low interest rate environment were supported by tapping international capital markets at appropriate times to curb any undue pressure on domestic interest rates, strategically maneuvering and reducing the foreign investments in Treasury bills and Treasury bonds to mitigate the risk arising from external factors, minimizing the roll-over risk through the extension of the average time to maturity (ATM) of the government debt portfolio, and arranging prefunding to even out concentration of roll-over requirement which contributed to the overall declined trend of yield rates in the market. Further, the longer end of the risk free yield curve was activated continuously in 2014 to set an effective benchmark to create a conducive environment for fund raising activities by the corporate sector. As a result, the benchmark yield rate on 364 day Treasury bills recorded a decrease

Table 8.18 Yield Rates of Government Securities

Per cent per annum

Item	Primary Market		Secondary Market	
	2013	2014	2013	2014
Treasury Bills				
91 Days	7.54-9.91	5.74-7.42	7.52-10.12	5.47-7.52
182 Days	7.85-10.99	5.83-7.53	7.83-11.26	5.64-7.83
364 Days	8.29-11.38	5.89-7.95	8.27-11.72	5.82-8.27
Treasury Bonds				
2 Years	-	6.15-8.70	8.53-11.65	5.97-8.86
3 Years	10.87-10.98	6.20-8.80	9.05-11.75	6.45-9.05
4 Years	-	6.40-9.06	9.54-11.95	6.50-9.54
5 Years	10.64-11.17	6.48-9.29	10.26-12.01	7.09-10.29
6 Years	10.97	6.64-9.42	10.37-11.99	7.41-10.37
10 Years	11.76-11.80	7.78-10.15	10.88-12.30	7.79-10.89
15 Years	11.90-12.21	8.50-10.91	11.14-12.72	8.28-11.60

Source: Central Bank of Sri Lanka

of around 229 basis points by end 2014 from that of end 2013. The Treasury bill rates for 91-day, 182-day and 364-day maturities as at end December 2014 stood at 5.74 per cent, 5.84 per cent and 6.00 per cent, respectively. The foreign investor preference for Treasury bills largely remained intact during 2014. Accordingly, the Treasury bill holdings by foreign investors amounted to Rs. 55.5 billion at end December 2014.

In line with the downward movement in short-term interest rates together with appropriate debt issuance strategies adopted, the Treasury bond yields also adjusted downward during 2014. Accordingly, the Treasury bond yields in the primary market decreased by around 231 basis points to 180 basis points across the terms structure (2–30 years) by end 2014 from that of 2013.

Enhanced investor preference for dollar denominated government securities enabled the Central Bank to raise US dollar 731.5 million against the maturing amount of US dollar 571 million in SLDB during 2014. This improved investor preference for Sri Lanka Development Bonds (SLDBs) facilitated the strategic reduction of foreign investments in Treasury bills and Treasury bonds to a desired level during 2014 to mitigate the risk arising from external factors. Further, SLDB inflows eased the quantity of rupee denominated financial in the government borrowing programme enabling to stabilize the interest rates in the domestic rupee market.

During 2014, the ATM of the overall domestic public debt portfolio improved further and recorded 5.75 years by end December 2014 compared to 4.82 years in the previous year. The ATM of outstanding Treasury bond portfolio at end December 2014 increased to 6.98 years from 5.97 years at end December 2013. The increase in the ATM in the Treasury bond portfolio was made possible mainly due to the issuance of a large volume of long dated Treasury bonds during 2014.

BOX 9 Real Estate Investment Trusts (REITs)

Introduction

A Real Estate Investment Trust (REIT) is a collective investment vehicle that invests in a diversified pool of professionally managed, investment grade real estate. REITs deal mainly in commercial real estate assets such as office buildings, commercial and residential buildings and apartments, hospitals, shopping malls and complexes, hotels and resorts, cinema halls and multiplexes and warehouses. There are, three main categories of REITs, namely, Equity REITs, Mortgage REITs, and Hybrid REITs. Equity REITs, which are the most common and popular type of REITs, invest in properties as well as own properties, and their revenues are generated mainly in the form of rental collections. Mortgage REITs invest in real estate and mortgage-backed securities. Their revenues are generated primarily in the form of interest income, which they earn on the mortgage loans. Hybrid REITs combine the investment strategies of equity REITs and mortgage REITs by investing in both properties and mortgages.

While the income generated by REITs reflects the performance of real estate in the long–term, REITs generally offer high yields to those investing in them as most of their income is paid directly to investors as dividend on a regular basis and they also very often receive favourable tax treatment. Units of the REITs are traded like shares on stock exchanges, and the dividend income earned from investments in REITs is usually quoted as a yield, being a percentage of the market price of the trust's units. In contrast to direct investments in real estate, investments in REITs are liquid assets. However, as in the case of other investments, REITs too have certain inherent risks. Units of REITs are typically subject to some short-term volatility due to stock market vulnerability and therefore, they offer less diversification benefits if held alongside listed stocks.

REITs in the Global Context

REITs have a fairly long history and they have been successful in countries where they have operated. REITs, which were initially started in the USA in the 1960s, are now successfully operating in more than 30 countries around the world. The leading REIT markets are the United States of America (60% of the global market share), Australia (6%), Japan (6%), France (5.5%) and the United Kingdom (5%). REITs have been established in several Asian countries including Singapore (1999), Japan (2000), South Korea (2001), Malaysia (2002), Hong Kong (2003), Taiwan (2003) and Thailand (2007). Legislation is being put in place in several other countries to enable the operation of REITs, while China and India are considering the establishment of REITs in their countries. Globally, there are over 600 REITs with a total market capitalisation of nearly US$ 1.4 trillion[1].

The Asian REITs market accounts for around 12 per cent of the global REITs market with around 130 REITs. They have a total market capitalisation of over US$ 140 billion. REITs in Asian countries have also been successful and they have been beneficial to investors as they provide the option of investing in relatively less risky real estate backed assets. Moreover, REITs provide a regular and reliable income stream to the unit holders, attract significant flows of foreign direct investment (FDI) to the real estate sector, and thereby provide liquidity to cash-strapped property developers, whilst making a considerable contribution to the national GDP of these countries.

Benefits accrued from the operation of REITs

- **Liquidity -** REITs are listed and their units could be traded. Trading in units of REITs involve substantially lower transaction costs when compared with direct investments in real estate. They constitute a very effective financial instrument to retail investors who wish to invest in commercial real estate without the added risk of illiquidity.
- **Attractive dividend yield** – Investments in REITs generally earn yields that are more attractive than those delivered by other types of shares, which have a capital growth focus. A further reason for investments in REITs earning attractive yields is the mandatory distribution of their earnings.
- **Achieving effective portfolio diversification** Diversification is a key component in an investment strategy of retail investors. REITs offer significant portfolio diversification benefits.
- **Strong corporate governance -** REITs are required to maintain standards relating to corporate governance and financial reporting in line with guidelines issued by stock exchanges on which they are listed. The fact that they are an investment product approved by the Securities Regulator helps build confidence on the part of retail investors.
- **Access to high quality commercial real estate assets -** REITs invest in high quality income producing real estate in different sectors. By investing in REITs, retail investors could invest in these real estate assets, whilst also being able to diversify their investments in the real estate sector.
- **Tax Transparency -** Any taxes to be paid on REITs are usually payable only at individual REIT shareholder level. This results in REIT markets being tax transparent.
- **Low debt levels -** REITs have relatively low debt levels in comparison to listed real estate companies and other sectors of the stock market.

1 Global REIT Survey 2014, European Public Real Estate Association.

- **Limit the relatively higher risk associated with real estate development activities -** REITs are subject to regulatory restrictions that limit the relatively higher risk associated with investing directly in real estate development activities of the listed real estate companies.
- **Professional real estate managers -** REITs generally employ professionals of high caliber for fund management, portfolio management, asset management and property management.
- **Other benefits -** Low entry cost; divisibility; disclosure of movements in real estate prices to the market at regular intervals by the stock markets; effective hedging facility against inflation given that units of REITs are similar to asset backed securities where real estate constitute the assets; and job creation are amongst other major benefits.

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Corporate Debt Securities Market

Commercial Paper

The market for commercial paper was relatively less active in 2014 compared to the previous year. The value of commercial paper (CP) issued with the support of banks amounted to Rs. 8.2 billion in 2014 in comparison to Rs. 28.3 billion in 2013. The interest rates pertaining to CPs varied in a range of 6.4 – 12.5 per cent in 2014 in comparison to a range of 8.5 – 22 per cent in 2013. CPs with a maturity of up to 3 months accounted for 65.5 per cent of the market, while the shares of CPs with 6-month and 12-month maturities were 19.4 per cent and 15.1 per cent, respectively. The total outstanding value of CPs amounted to Rs. 3.5 billion as at end of 2014 compared to Rs. 10.6 billion as at end December 2013.

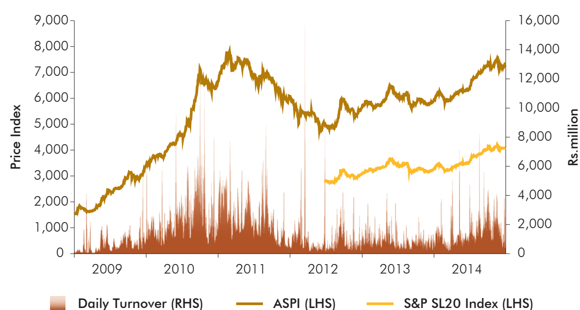
Corporate Bonds

The corporate bond market continued to be developed as an active alternative source for raising funds by the corporate sector. With the removal of withholding tax on the interest of corporate debt securities by the government in 2013, fund raising through the corporate bond market surged in 2013 and 2014. On the other hand, said tax removal has enhanced the demand for corporate bonds among local retail and institutional investors. As a result, the CSE recorded 46 corporate debenture issues by 20 companies during the year 2014, through which, a total of Rs. 54.2 billion was raised compared to 83 debenture issues in 2013, which raised a total of Rs. 69.1 billion. With respect to the companies that issued debentures in 2014, 15 were banks and finance companies and they raised Rs. 45.7 billion. Debentures issued in 2014 carried both fixed and floating rates of interest and they varied in a range of 7.75 to 15.50 per cent. The trading turnover of debentures listed on the Automated Trading System (ATS) of the CSE was seen increasing at Rs. 7.1 billion in 2014, compared to Rs. 2.2 billion in 2013.

Equity Market

The Colombo Stock Exchange (CSE) recorded a sustained growth in 2014, surpassing several previous records. The All Share Price Index (ASPI) increased by 23.4 per cent to 7,299 points and S&P SL20 index rose by 25.3 per cent to 4,089 points as at end 2014. This continuous growth was on the back of 4.8 per cent growth in ASPI and 5.8 per cent increase in the S&P SL20 index during the year 2013. The significant progress of the CSE could be attributed to the benign macro-economic condition, including low domestic interest

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



rates, improved growth prospects, continued foreign purchases, relatively better corporate earnings and several steps taken to attract foreign investors. The price indices of all sub-sectors of the ASPI, except one, increased in 2014. The indices pertaining to the five largest sub-sectors, that is, Banks, Finance & Insurance (40 per cent), Telecommunication (42 per cent), Diversified Holdings (19.7 per cent), hotels and travels (9 per cent) and Beverage, Foods and Tobacco (5 per cent) increased substantially during 2014.

Market capitalisation of the CSE increased considerably in 2014. Market capitalisation increased by 26.2 per cent to Rs. 3.1 trillion as at end 2014, which was equivalent to 31.7 per cent of GDP. In terms of market capitalisation, the first three largest sectors namely; the Banks, Finance & Insurance, Diversified Holdings and Beverage, Food & Tobacco sectors accounted 24.3 per cent, 18.8 per cent and 17.4 per cent, respectively. The ten largest companies listed on the CSE accounted for 38 per cent of total market capitalisation.

During the year, total market turnover surpassed the total annual turnover of Rs. 200.4 billion in 2013 and was recorded at Rs. 341.0 billion, reflecting increased investor participation. Foreign investors accounted 31 per cent of the total turnover while the balance was from local investors. The daily average turnover increased by 71 per cent over the previous year from Rs. 828 million to Rs. 1,415 million in 2014. In 2014, the

Table 8.19 Performance of the Share Market

Item	2013	2014
All Share Price Index (1985=100) (a)	5,912.8	7,299.0
Year-on-year Change (%)	4.8	23.4
S&P SL 20 Index (17.12.2004=1000) (a)	3,263.9	4,089.1
Year-on-year Change (%)	5.8	25.3
Market Capitalisation (Rs.billion) (a)	2,459.9	3,104.9
As a Percentage of GDP (%)	28.4	31.7
Market Price Earnings Ratio (a)	15.9	19.7
Turnover to Market Capitalisation (%)	8.7	12.3
Average Daily Turnover (Rs.million)	828.0	1,415.0
Value of Shares Traded (Rs.billion)	200.5	341.0
Number of Shares Traded (million)	9,054	16,722
Number of Companies Listed	289	294
Introductions (b)	1	2
Number of Initial Public Offers/ Offers for Sale (b)	1	5
Number of Rights Issues	9	13
Amount Raised Through Rights Issues and Initial Public Offers (Rs.billion)	26.0	14.4

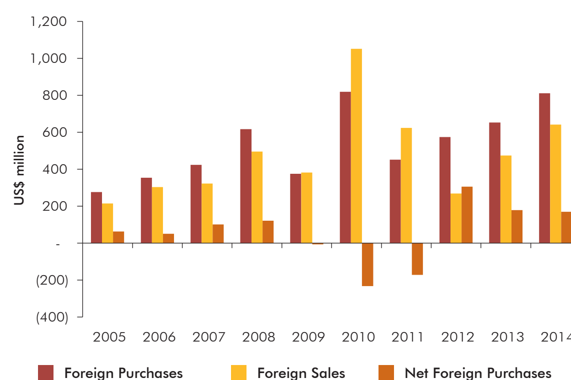
(a) End of the year
(b) There are 3 methods to obtain a listing: i.e an introduction where no public issue is required, an offer for sale where already existing shares are issued to the public and an offer for subscription where new shares are issued to the public.

Source: Colombo Stock Exchange

turnover velocity (the ratio of total turnover to average market capitalisation) increased to 12.2 per cent from 8.6 per cent in 2013. High turnover velocity implies low impact cost of trading, high investor participation levels and higher liquidity.

The most notable improvement in the CSE was the continued foreign inflows to the market during 2014. The cumulative foreign purchases have been the highest in the history, a record Rs. 105.8 billion (US dollars 799 million) while the

Chart 8.15 Foreign Participation at the CSE



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cumulative foreign sales was Rs. 83.7 billion (US dollars 638 million) in 2014. The country's improved macroeconomic fundamentals and the initiatives taken by SEC as being the regulator together with other market participants to organize overseas investor forums and continued strategies of attracting high net-worth foreign investors to the market contributed to increased foreign investor participation in 2014. Further, steps taken by the SEC to increase market liquidity through introducing minimum public holding criteria for listed companies have also positively affected this market performance. Banking, Finance & Insurance, Food, Beverage and Diversified sectors continued to attract much of the foreign interest during the year.

The primary market remained active during 2014 with over Rs. 3.3 billion being raised through IPOs of equity, right issues and public placements. During the year 2014, a total of Rs. 14.4 million was raised through 13 right issues and 5 IPOs.

The SEC and the CSE commenced a series of initiatives to develop the stock market and have taken steps to develop market infrastructure. The SEC conducted listing promotion forums for corporates in the country to raise funds by listing on CSE. The CSE listing rules were amended pertaining to the related party transactions, dealings by directors and CEOs of listed companies and minimum public float requirement. In order to make the regulatory system more proactive, the SEC and the CSE are continuing its capital market development master plan, which includes 10 key strategies to further enhance investor confidence and develop the capital market in the country.

8.4 Development Finance and Access to Finance

The Central Bank continued to execute concessionary development lending programmes through the Participating Financial Institutions (PFIs) in 2014. Under these programmes, Rs. 15,946 million loans were disbursed to over 162,222 beneficiaries in the Agriculture and Livestock sector, and Micro, Small and Medium Scale Enterprises (MSMEs). These schemes were expected to enhance the access to finance, thereby increasing production of goods and services, helping to achieve inclusive and equitable regional development in the country. From a policy perspective, the rates of interest of loan schemes implemented by the Central Bank were adjusted downward in line with the prevailing low interest rate environment, with a view to passing-through its benefits to end borrowers. In addition, the scale for each individual loan of several credit schemes was increased.

As in the past few years, this year too, the Agriculture and Livestock sector continued to receive the majority of concessionary lending facilities provided by the Central Bank through PFIs. More emphasis was given to this sector to achieve the objectives of food security requirements of the country and to uplift the livelihood of the farming community. Accordingly, loans totaling Rs. 7,714 million were granted to 86,815 borrowers in the Agriculture and Livestock sector in 2014. Of the total, a sum of Rs. 6,749 million or 87 per cent was disbursed among 86,143 farmers under the New Comprehensive Rural Credit Scheme (NCRCS), the principal concessionary loan scheme implemented by the Central Bank for the Agriculture sector, which grants loans through PFIs to farmers in order to meet their working capital requirements to produce 32 short-term crops. However, NCRCS recorded a set back during the year due to low demand for credits resulted from severe drought condition prevailed in the country during the latter part of 2013 and the first half of 2014. As a result, both the value and the number of loans disbursed in 2014 declined by 17 per cent and 11 per cent, respectively, compared to that in 2013. As in the past three years, the Jaffna district continued to

be the single district which claimed the highest amount and the share (19 per cent) of the NCRCS loan disbursements during the year. It was followed by Anuradhapura (14 per cent), Hambantota (10 per cent), Ampara (10 per cent) and Polonnaruwa (9 per cent) districts, respectively. The Commercial Scale Dairy Development Loan Scheme (CSDDLS) was in operation to achieve the objective of milk self-sufficiency in Sri Lanka, especially by attracting entrepreneurs who could invest in hi-tech dairy farming. Under the scheme, Rs. 951 million was granted by PFIs among 604 dairy farmers and entrepreneurs for the dairy related activities covering dairy farm development, processing, transportation, storing and marketing in 2014. The spread of foot-and-mouth disease among cattle in several districts since the beginning of 2014 resulted in a slowing down of the demand for credit for dairy related activities.

The Central Bank continued to provide concessionary financing to the SME sector. During 2014, the total loan disbursements to viable SMEs at concessionary interest rates amounted to Rs. 5,254 million. These loans were granted to 27,675 beneficiaries engaged in manufacturing, agri-based industries and service related activities. Saubagya Loan Scheme, the flagship scheme for the SME sector, disbursed Rs. 3,280 million among 13,590 beneficiaries engaged in manufacturing and service related activities during 2014. Total disbursements under the Saubagya loan scheme, which accounted for 62 per cent of total disbursements to the SME sector, declined marginally in 2014 compared to the previous year. Under the Awakening North–Phase II Loan Scheme (ANLS-Phase II), 6,520 loans amounting to Rs. 719 million were disbursed, while 5,026 loans amounting to Rs. 1,000 million were disbursed under the Resumption of Economic Activities in the Eastern Province – Phase III loan scheme (REAEP-Phase III), before its conclusion in November 2014. Further, the Self Employment Promotion Initiative (SEPI), Small Holder Plantation Entrepreneurship Development Programme (SPEnDP) and Dry Zone Livelihood Support and Partnership Programme (DZLiSPP) disbursed a total of Rs.255 million to 2,539 borrowers.

Several loan schemes were in operation to uplift the income level of low income earners by providing them with credit facilities for income generating activities. The principal loan schemes, which were in operation for this purpose were Poverty Alleviation Micro-Finance Project – Revolving Fund (PAMP-RF), Poverty Alleviation Micro-Finance Project II (PAMP II) and Poverty Alleviation Micro-Finance Project II - Revolving Fund (PAMP II–RF) and Small Farmers and Landless Credit Project - Revolving Fund (SFLCP-RF). Under these schemes, a total of Rs. 2,674 million was disbursed among 44,744 beneficiaries. The special loan scheme for the Repair of Damaged Houses in the North and East, under which credit facilities were provided for repairing the houses damaged during the conflict in the Northern and Eastern provinces, disbursed Rs. 304 million among 2,988 borrowers during the year.

The Credit Guarantee Scheme for Pawning Advances (CGSPA), which was introduced in June 2014 for the period ending 31 December 2014, operated successfully during the implementation period. The Scheme was introduced to reduce the risk exposure of PFIs due to the sharp decline in gold prices in line with the trends in the international market and to increase the volume of pawning advances which adversely affected the credit growth of the economy. Under the scheme, pawning advances amounting to Rs. 11,290 million were disbursed by PFIs up to the year-end 2014. Since January 2015, the operation

of the Scheme was further extended for a period of 6 months, up to end June 2015 and was open for Licensed Finance Companies as well.

Promoting financial inclusiveness has also been given high priority in 2014 by the Central Bank. Formation of self help groups, educating them about financial management and providing them with loans to commence income generating activities were continued with the aim of promoting financial inclusiveness. The Central Bank also continued to conduct programmes on financial literacy, entrepreneurship development, post-harvest technology, training of trainers (TOT) and workshops for beneficiaries and other stakeholders. Further, information on the availability of concessionary credit facilities for the specific sectors was disseminated to the general public using print and electronic media.

8.5 Financial Infrastructure

Payment and Settlement Systems

The national payment infrastructure continued to facilitate the economic activities of the country in 2014, through effectively catering for individual and institutional payment needs. The large value and retail payment systems operated smoothly during the year, while several system developments and regulatory improvements were implemented with a view to enhancing the efficiency and soundness of the national payment and settlement system. Continuing the trend that was evident during the past few years, financial and non-financial institutions introduced innovative electronic retail payment products, and clearing and settlement mechanisms which promote interoperability. In this context, the Central Bank implemented several policy and regulatory measures to promote developments in the national payment system and address associated risks, as a part of discharging its responsibilities as the regulator and facilitator of payment and settlement systems operating in the country.

The LankaSettle System and the Cheque Clearing System, which are designated as the systemically important payment systems of the country in consideration of their importance in maintaining financial system stability, accounted for the largest aggregate transaction value and volume of non-cash payments respectively, during the year under review. The Real Time Gross Settlement (RTGS) System and the LankaSecure System, which are the two main components of the LankaSettle System continued to accommodate increasing transaction volumes, uninterruptedly. In 2014, the RTGS System, the country's only large-value electronic payment system, settled 317,940 payment transactions amounting to an aggregate value of Rs. 59,551 billion. In comparison to the previous year, the aggregate volume and value of the RTGS transactions grew by 3.6 per cent and 10.1 per cent respectively, during the review period. In terms of total transaction value, the RTGS transactions accounted for 86 per cent of the non-cash payments executed in 2014. In order to ensure that the operations of the RTGS system is not adversely affected by liquidity issues of the participating institutions, the Central Bank, as the

Table 8.20 Transactions through Payment Systems

Payment System	2013		2014 (a)	
	Volume ('000)	Value (Rs.bn)	Volume ('000)	Value (Rs.bn)
Large Value Payment Systems				
RTGS System	307	54,070	318	59,551
Retail Value Payment Systems				
Main Cheque Clearing System	47,876	7,049	48,052	7,640
Rupee Draft Clearing System	2	0.3	1 (b)	0.1 (b)
Sri Lanka Interbank Payment System (SLIPS)	17,122	702	20,421	894
Credit Cards	21,623	121	23,632	135
Debit Cards	16,292	46	22,693	62
Internet Banking	8,942	772	10,818	961
Phone Banking	300	6	732	9
Postal Instruments	-	7	-	7
Total	**112,464**	**62,773**	**126,667**	**69,259**
US Dollar Cheque Clearing System	**58**	**30**	**60**	**33**

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

Source: Central Bank of Sri Lanka

operator of the system, continued to provide the interest free Intra-day Liquidity Facility (ILF). During the year, the participants utilized an average ILF value of Rs. 21.3 billion in a business day.

The total value of scripless securities held by LankaSecure amounted to Rs. 4,092.0 billion (Face Value) consisting of Treasury bills of Rs. 750.3 billion and Treasury bonds of Rs. 3,341.7 billion as at end December 2014. LankaSecure maintained 86,944 registered accounts through dealer direct participants by end December 2014, covering corporate as well as individual customers.

During the year under review, the Cheque Clearing System operated by LankaClear (Pvt.) Limited (LCPL) cleared a total volume of 48 million cheques registering an increase of 0.4 per cent when compared with the previous year, while the aggregate value of cheques cleared recorded an increase of 8.4 per cent. In terms of total transaction volume, the share of payments made through cheques in non-cash payments accounted for 38 per cent in 2014, reflecting the continuing popularity of cheques in effecting retail payments. Considering the declining trend in the usage of rupee drafts and as a measure of streamlining the operations of the clearing systems operated by LCPL, in July 2014, the Rupee Draft Clearing System was integrated with the Cheque Clearing System, resulting in rupee drafts being cleared through the main cheque clearing system.

Sri Lanka Interbank Payment System (SLIPS), the inter-bank retail payment system operated by LCPL has recorded a gradual growth since its launch. The SLIP system provides the facility to execute low-value fund transfers both in the nature of credit transfers and direct debit transfers. In 2014, the aggregate volume of SLIPS transactions grew by 19.3 per cent to 20 million whilst the aggregate value grew by 27.2 per cent to Rs. 894 billion, in comparison to the previous year.

The Central Bank, in accordance with the licensing regime specified in the Payment Cards and Mobile Payment Systems Regulations No. 1 of 2013, issued licences to six institutions to operate in the payment card industry, during the review period. Further during the year, a keen interest was displayed by the licensed service providers to introduce innovative payment products and to expand the scope of their operations. Accordingly, with a view to enhancing access to mobile phone based e-money schemes, a licensed operator of a mobile phone based e-money scheme was granted approval to extend its system to subscribers of other mobile network operators while permission was also granted to extend the single purpose stored value transport card and fare collection system introduced in the Western Province to other public transport service providers. These expansions will enable more and more people to reap efficiency and convenience benefits of electronic retail payment mechanisms.

Considering the importance of minimizing the security risks associated with card payments in order to promote user confidence, financial acquirers were instructed by the Central Bank to implement appropriate measures to ensure that the merchants do not engage in the act of swiping the payment cards of customers in data capturing devices other than the Point-of-Sale (POS) terminals provided by the financial acquirers. The practice of swiping payment cards in data capturing devices other than POS terminals, which mostly aimed at obtaining information on consumer spending patterns, have made payment cards vulnerable to fraud through payment card information being stored unsafely. During the period under review, financial acquirers and merchants took action collaboratively to discontinue this practice.

The initiation of a landmark development in the payment and settlement infrastructure of the country took place in 2014, with LCPL as the operator and the Central Bank as the regulator

collectively completing the preliminary work of Common Electronic Fund Transfer Switch (CEFTS). CEFTS is the second phase of the Common Card and Payment Switch (CCAPS), which is the national payment switch of the country being operated under the brand name "LankaPay". This switch provides a common infrastructure for switching and clearing domestic interbank fund transfers initiated from various electronic payment channels (e.g. automated teller machines, mobile banking, internet banking), enabling users to effect real-time fund transfers. The launch of the CEFTS will take place in 2015 and is expected to contribute immensely in popularizing electronic payments through facilitating rapid fund settlement and interoperability among multiple payment channels. Further, the common ATM Switch, which was launched as the first phase of CCAPS, marked a remarkable progress with six licensed commercial banks integrating with the switch during the year, and thereby increasing the total number of members to nine. Currently, the common ATM network consists of over 2,500 ATMs.

Credit Information

A significant growth in demand for credit reports from the Credit Information Bureau (CRIB) was witnessed in 2014, reflecting expanded credit related activities by both banks and non-bank financial institutions. CRIB issued 4,756,418 credit reports on corporate and individual borrowers during 2014 compared with 3,117,316 reports in 2013. Of these reports, 96 per cent were consumer credit reports, which recorded an increase of 37 per cent on an year-on-year basis. The CRIB had a total of 90 reporting credit institutions as its members by end 2014.

Even though, the Credit Information Management System (CRIMS), which is the core technology infrastructure supporting the CRIB activities, was successfully able to meet the growing demand for credit information services during the year, it is in the process of evaluating an infrastructure upgrade to reposition the remaining operational models with enhanced capacity, emerging market requirements and future demand for credit information services. Furthermore, the CRIB has taken steps to strengthen the present legislative framework of its newly established Secured Transaction Registry System (StrS). The StrS recognized 4,853 transactions reported by member institutions that are currently active in the system. The CRIB also continued with its user awareness and educational programmes among credit officers and other staff of reporting lending institutions as well as the general public to provide a better understanding of the CRIB's role in the credit market and to enable prudent interpretation of credit reports for risk management purposes.