Financial System Stability Review 2010

Central Bank of Sri Lanka

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Governor's Message

The Financial System Stability Review (FSSR), which is published by the Central Bank of Sri Lanka (CBSL) annually, presents an overall assessment of the risks and threats to the financial system and an evaluation of the capacity for coping with systemic disturbances. The report also includes an account of the regulatory policies and measures taken by the CBSL and the other financial regulators to safeguard the financial system and to strengthen its robustness.

The FSSR 2010 presents the collective assessment of the financial system by the Financial System Stability Committee which is chaired by the Deputy Governor, in charge of financial system stability and is generally based on the performance of the financial sector during the first nine months of 2010.

The FSSR is intended to provide information to financial market participants and interested parties to manage risks and promote awareness, understanding and debate on the issues affecting financial system stability.

Sri Lanka's financial system remained stable, while its resilience strengthened during the year, with the resurgence in domestic economic growth, significant improvement in macroeconomic fundamentals and the gradual recovery of the global economy. The financial intermediation revived, as credit growth picked up in 2010, from a contraction last year, to support the expansion in economic activities. Conditions in domestic financial markets improved, as interest rates decreased with the decline in inflation and the easing of monetary policy. The overall soundness of Sri Lanka's financial institutions was maintained with adequate capital and liquidity buffers and improvements in asset quality and earnings. The decline in interest rates and recovery in the domestic economy and international trade had a positive impact on risk levels in financial institutions. Consequently, credit risk, market risk and liquidity risk in the banking sector reduced during the year, while the level of capitalization increased. The systemically important payment and settlement system functioned with a very high degree of availability, efficiency and security and improvements were made with business continuity arrangements.

The regulatory and prudential framework of the financial sector was strengthened with focus on capital enhancements and improvements to corporate governance and risk management infrastructure in financial institutions. A financial safety net for depositors was introduced with the implementation of a CBSL operated mandatory deposit insurance scheme for banks and finance companies to protect small depositors. In view of the deficiencies in the existing law, a new law for the regulation of finance business has been finalized to combat unauthorized deposit-taking entities and to upgrade the regulation of finance companies. More intensive supervision of finance companies is being enforced. Progress has been made in resolving the problems of distressed finance companies through the adoption of restructuring and recapitalization programmes to enable these companies to continue business operations and meet their obligations to depositors. The proposed Microfinance Act was also finalized during the year which will provide for the establishment of a separate authority to regulate micro-finance institutions to ensure that appropriate standards of governance, accounting, prudence and disclosure are observed in order to strengthen their viability and to protect the interest of depositors and customers. The Banking Act is also being amended to enable consolidated supervision of banking groups and new provisions for mergers and acquisitions and bank resolution measures. An early warning surveillance system was also designed to alert the CBSL on developments which could trigger a negative effect on the financial system, so that preventive or risk mitigation measures could be taken.

Going forward, the financial sector needs to reposition itself to support the higher growth path of the economy. This will involve enhancing the capacity of financial system to serve all sectors of the economy with an increased array of products. The development of a vibrant capital market to supplement the banking sector will also be vital for meeting the financial needs of the economy. Therefore, considerable institutional building, financial innovation and financial infrastructure development, as well as progressive deregulation and more integration with the global financial system will be necessary. This will also pose considerable challenges for both financial institutions and regulators. Financial institutions would need to focus on maintaining high credit standards, improving their risk management mechanisms and being well capitalized, while the CBSL and other regulators would have to upgrade prudential and supervisory frameworks and be more vigilant to detect risks and take prompt action to ensure financial system stability and the achievement of the goals for the economy.

Ajith Nivard Cabraal
Governor

Financial System Stability and the Role of the Central Bank of Sri Lanka

Maintaining financial system stability together with economic and price stability are the core objectives of the Central Bank of Sri Lanka.

Financial system stability is defined as the ability of the financial system to perform its key functions of resource mobilization and allocation, risk management and the settlement of payments, effectively at all times and even under stressful circumstances.

Financial system stability is founded on the confidence of the public in the financial system. This in turn is based on the soundness, efficiency, robustness and safety of financial institutions, financial markets, financial infrastructure and financial regulation. The stability of the financial system depends on the resilience of its principal components to collectively withstand adverse disturbances and shocks.

The financial system in Sri Lanka consists of the following main components:

Financial institutions: Banks, finance companies, other credit providing institutions (including microfinance institutions), leasing companies, insurance companies, primary dealers, stock brokers/dealers, investment managers, margin providers, stock underwriters, unit trusts, provident and pension funds.

The financial system in Sri Lanka is dominated by the Licensed Banks that account for about two thirds of the total assets of the financial system.

Financial markets: Money market, bond market, foreign exchange market and the equity market.

Financial infrastructure: Payment and securities settlement systems, clearing systems and trading platforms. There are also infrastructure service providers, such as credit rating agencies, credit information registries and financial information providers.

Financial regulatory framework: The financial system is governed by a regulatory framework consisting of laws and rules which establish the bounds within which financial institutions, markets and systems must operate.

As the main components of the financial system are inter-connected, risks in one component can spread to another through a contagion effect causing instability in the entire financial system.

Financial system stability is maintained through three ways.

- **Regulation and supervision of individual financial institutions,** in terms of the regulatory framework to ensure their soundness. In this regard, Sri Lanka has a multiple regulator system. The Central Bank regulates and supervises the banks, finance companies, leasing companies and primary dealers, while the Securities and Exchange Commission is responsible for supervising the stock exchange and the depository system, stock-brokers/dealers, investment managers, margin providers, stock underwriters, unit trust management companies and credit rating agencies. The Insurance Board supervises insurance companies and brokers. The Central Bank is also responsible for the supervision of the payment, clearing and settlement systems. Micro-finance institutions will be brought under the purview of a separate regulatory authority when the proposed Microfinance Act is implemented. The Central Bank works closely with the other financial regulators to ensure that the financial institutions, markets and systems system are regulated and supervised.

- **Oversight of the whole financial system,** through continuous surveillance, taking into account its interaction with the real economy, to detect systemic risks and threats and implement policies to safeguard the financial system. This is the responsibility of the Central Bank and in carrying out its mandate, the Central Bank co-ordinates closely with the other financial regulators and the Ministry of Finance to ensure that the stability of financial system is preserved. The Central Bank's assessment of financial system stability is made known to the public through the Financial System Stability Review and other publications, as well as through press releases and notices.

- **Crisis management and resolution,** which relates to measures and safety nets designed to deal with crises in the financial system. Resolution measures include the rehabilitation and restructuring of problem financial institutions through suspension of operations, appointment of a new board of directors and recapitalization of the company. The deposit insurance scheme is a financial safety net which could be used compensate depositors of financial institutions that have gone into liquidation. In situations of imminent panic or crisis which directly threaten financial or monetary stability, the Central Bank, as lender of the last resort, may provide loans to banks that are facing liquidity problems against acceptable collateral.

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In pursuing its objective of maintaining financial system stability, the Central Bank of Sri Lanka conducts surveillance of the financial system to detect risks and threats to the financial system, to assess its capacity to cope with such threats and to implement policies to safeguard the financial system. The results are presented in the Financial System Stability Review (FSSR), which has been published annually since 2004. The purpose of the FSSR is to provide information to financial market participants and other interested parties to prepare for and to manage these risks, as well as to encourage awareness and debate on the issues affecting financial system stability.

FSSR 2010 is based on the performance of the financial sector during the first nine months of 2010, except as otherwise stated. The FSSR 2010 is divided into six chapters. **Chapter 1** presents the overall assessment of financial system stability, the potential risks and vulnerabilities that may arise in the future and the risk mitigating measures that should be implemented to address these risks. **Chapter 2** discusses the global and domestic macroeconomic developments and risks. **Chapter 3** deals with the recent developments in domestic financial markets. **Chapter 4** covers the performance of the banking sector, while **Chapter 5** deals with the developments in other financial institutions. **Chapter 6** provides an overview of the financial infrastructure, particularly the systemically important payment and settlement systems and changes in the regulatory framework relating to the financial sector.

Table A	Total Assets and Deposit Liabilities of the Financial System – September 2010 [a]

Financial Institution	Assets		Deposits	
	Rs. bn.	Share (%)	Rs. bn.	Share (%)
Central Bank of Sri Lanka (CBSL)	**975.4**	**15.2**	**n.a.**	**n.a.**
Institutions Regulated by the CBSL	**3,859.5**	**60.2**	**2,569.9**	**96.3**
Deposit Taking Institutions	3,577.6	55.8	2,569.9	96.3
Licensed Commercial Banks	2,808.5	43.8	2,018.6	75.7
Licensed Specialised Banks	553.2	8.6	413.8	15.5
Registered Finance Companies	216.0	3.4	137.5	5.2
Other Financial Institutions	281.9	4.4	n.a.	n.a.
Primary Dealers	146.6	2.3	n.a.	n.a.
Specialised Leasing Companies	135.3	2.1	n.a.	n.a.
Institutions Not Regulated by the CBSL	**1,579.0**	**24.6**	**98.3**	**3.7**
Deposit Taking Institutions	164.8	2.6	98.3	3.7
Rural Banks *(b)(c)*	158.5	2.5	94.6	3.5
Thrift and Credit Co-operative Societies *(b)*	6.3	0.1	3.7	0.1
Contractual Savings Institutions	1,345.5	21.0	n.a.	n.a.
Employees' Provident Fund	864.0	13.5	n.a.	n.a.
Employees' Trust Fund	121.7	1.9	n.a.	n.a.
Approved Private Provident Funds *(d)*	126.2	2.0	n.a.	n.a.
Public Service Provident Fund	23.9	0.4	n.a.	n.a.
Insurance Companies *(e)*	209.8	3.3	n.a.	n.a.
Other Financial Institutions	68.7	1.1	n.a.	n.a.
Stock Broking Companies *(f)*	17.3	0.3	n.a.	n.a.
Unit Trusts/Unit Trust Management Companies *(f)*	18.8	0.3	n.a.	n.a.
Market Intermediaries *(f)(g)*	29.6*	0.5	n.a.	n.a.
Credit Rating Agencies *(f)*	1.5	0.0	n.a.	n.a.
Venture Capital Companies	1.4	0.0	n.a.	n.a.
Total Assets	**6,413.9**	**100.0**	**2,668.2**	**100.0**

Source : Central Bank of Sri Lanka

(a) Provisional.
(b) Registered with the Department of Co-operative Development.
(c) Data as at end June 2010.
(d) Registered with the Department of Labour.
(e) Regulated by the Insurance Board of Sri Lanka.
(f) Regulated by the Securities and Exchange Commission of Sri Lanka.
(g) Market Intermediaries include Underwriters, Margin Providers and Investment Managers.
* Excluding the assets of Licensed Banks, Registered Finance Companies and Specialised Leasing Companies which are registered as Market Intermediaries.
n.a. – Not applicable

1. Overall Stability Assessment

1.1 Overview

Sri Lanka's financial system remained stable and resilient.

The stability of the financial system strengthened with the resurgence in domestic economic growth and the recovery in international trade, and underpinned by a more stable macroeconomic environment and improved investor confidence. The soundness and resilience of domestic financial institutions was maintained with adequate capital and liquidity buffers and improvements in asset quality and earnings, within a regulatory framework with prudential safeguards to mitigate excessive risk-taking. Overall, credit risk, market risk and liquidity risk in financial institutions declined during the year.

Conditions in domestic financial markets improved as interest rates have come down with the decline in inflation and the easing of monetary policy.

Financial markets also became more liquid largely due to an increase in capital inflows. The price indices, capitalization and turnover of the stock market soared to record levels. Prudential policies were introduced to address a possible build-up of an asset price bubble in the market. The systemically important payment and settlement systems operated smoothly and safely, with improvements to business continuity arrangements and the introduction of a new regulatory framework for electronic payment cards thereby further enhancing the security of the payment system. An early warning system covering the key financial sectors was also put in place to alert the Central Bank of Sri Lanka (CBSL) on developments that could trigger an adverse impact on the financial system.

The banking sector recorded an increase in credit growth and remained financially strong and resilient with a high capital position and lower risk levels.

Bank lending recovered and rose significantly in the first nine months of 2010 from negative growth in the previous year. The profitability of the banking sector improved, with the net interest margin being maintained at a stable rate for a number of years. The banking sector remained well capitalized with the predominant capital component being loss absorbing common equity. The capital adequacy ratios (CAR) have increased after migration to Basel II under the Standardised Approach for credit and market risk and the Basis Indicator Approach for operational risk in 2008. Both the total and Tier 1 CAR are well above the regulatory minimum requirements. The asset quality of the banking sector improved from mid 2010 signaling a decline in credit risk. The statutory liquid asset ratio of the banking sector comprised substantial holdings of government securities was almost double the required minimum, which provided an ample cushion to mitigate liquidity risk.

The credit to deposit ratio was at a comfortable level indicating that banks had a stable source of funds. The leverage ratio was also at an acceptable level demonstrating that banks were not unduly dependent on borrowings. The exposure to market risk was also not significant due to the low level of trading book activities. Stress tests indicated that the banking sector has sufficient capital and liquidity buffers and would be resilient to large credit risk, market risk and liquidity risk shocks.

The performance and soundness of other financial institutions improved.

The finance and leasing company sector recorded significant growth in accommodations and earnings, owing to the better macroeconomic environment. The financial soundness indicators of the two sectors, excluding the distressed companies, have shown an improvement. Directions on corporate governance and effective risk management systems have also been introduced. Measures were taken to restructure distressed companies (by bringing in strategic investors and converting a proportion of deposits into of shares) to enable them to continue business and repay depositors. Premium income of the insurance company sector rose notably, while soundness improved with an increase in profitability and solvency ratios. The soundness of the primary dealer industry was maintained at a high level. The net asset value of the unit trust industry increased significantly bolstered by the upturn in the equity market.

A safety net for depositors was introduced.

The CBSL will operate a mandatory Deposit Insurance Scheme for Licensed Banks and Registered Finance Companies under the provisions of the Monetary Law Act. All eligible demand, time and savings deposits will be insured under the scheme and banks and finance companies will be required to insure their deposit liabilities with effect from October 2010. The premium payable by banks is based on their CAR, while finance companies pay a uniform premium rate. Compensation will be up to a maximum of Rs.200,000 per depositor per institution and will be paid by the CBSL within six months from the date of suspension or cancellation of the licence/registration of the institution by the Monetary Board on or after January 2012. The Financial Ombudsman, under the auspices of the Sri Lanka Banks' Association, continued to resolve grievances of customers of banks. This service was extended to customers of finance and leasing companies. There is also an Insurance Ombudsman. A Credit Counseling Centre was set up by the Sri Lanka Bank's Association with the support of the CBSL to improve financial literacy and assist borrowers with repayment problems. A guideline on consumer protection setting out the minimum standards of conduct when dealing with customers, so as to reduce unfair and unethical business practices by banks is being prepared.

The regulatory framework of the banking sector is being strengthened.

The amendments to the Banking Act have been finalized with provisions to enable the consolidated supervision of banking groups, to facilitate mergers and acquisitions for the consolidation of the banking industry and to strengthen bank resolution measures. Directions on integrated risk management and Pillar II of Basel II which relate to additional prudential requirements following the supervisory process to further strengthen the capital planning process of banks, will be issued shortly. Furthermore, to strengthen the corporate governance in banks, the fitness and propriety criteria applicable to directors will be extended to executive staff performing key functions in banks. Bonuses and compensation packages of bankers is currently being examined to ascertain if excessive remuneration is being provided and limits may be imposed if considered necessary. Action is being taken to facilitate the adoption of Sri Lanka Accounting Standards (SLAS) 44 and 45 relating to fair value accounting of financial instruments, by banks. All private sector banks will also be required to list on the Colombo Stock Exchange by end 2011. The minimum capital requirements for banks have also been increased on a phased basis from 2011 to enable banks to expand their operations, in a sound manner.

A new law will be enacted to combat unauthorized deposit-taking.

A new Regulation of Finance Business Act will be introduced to strengthen the law against illegal and unauthorized finance businesses or deposit-taking entities. Stricter regulation and supervision of registered finance companies will also be enforced. In addition, it is mandatory for all registered finance companies to list on the Colombo Stock Exchange by June 2011 to enable these companies to mobilize capital funds and to improve market discipline. The minimum capital requirements for finance and leasing companies will also be enhanced on a gradual basis from next year. Legislation will also be introduced to regulate and supervise Micro-Finance Institutions through the establishment of a separate regulatory authority to protect the interest of depositors and customers of such institutions and to strengthen the viability and accountability of these entities.

The regulatory framework governing other financial institutions and financial markets is also being improved.

Comprehensive amendments to the Regulation of Insurance Industry law to upgrade the regulation and supervision of the entire insurance industry will be presented to Parliament shortly. Enhanced capital requirements for insurance companies and a risk based capital adequacy framework will be introduced. Composite insurance companies will be required to segregate life and general business into separate companies. Insurance companies will be permitted to appoint institutions as agents, thereby increasing market access. All insurance companies will be required to list on the stock exchange. A framework for the demutualization of the Colombo Stock Exchange to segregate ownership and management from the trading rights of members is being prepared, while a new automated market surveillance system will be in operation by the end of the year. A regulatory for exchange traded funds and new rules for margining and public float requirements will be introduced. A law to provide a regulatory framework for asset-backed securitization has also been prepared which will facilitate the development of this market in a safe manner.

The financial sector is required to play a leading role as a key enabler, catalyst and driver of economic growth.

This would entail reducing the cost and expanding the delivery of financial services to a wider population of enterprises and households. The tax rates on financial services were reduced significantly in the Budget 2011 thereby enabling financial institutions increase and retain a greater proportion of earnings for expansion purposes. Banks should ensure a steady flow of credit to the economy and should pass on the benefits of lower interest rates to their customers. The provision of continued access to credit to all segments of borrowers, in particular small and medium enterprises should be a priority and financial inclusion plans should be prepared and implemented. Opportunities exist for the expansion and diversification of the leasing industry, which caters mainly to small and medium enterprises, to develop the capital stock and enhance the productivity of the economy. The prospects for the expansion of the insurance sector are immense with the growth of the economy and incomes and given the current low penetration levels. In particular, there is potential for the development of life insurance products, such as retirement planning, annuities and personal investment products. As insurance companies need to invest in long-term assets to match their long-term liabilities, the development of the bond market is a necessary prerequisite for the growth of this sector.

A well functioning capital market as a supplement to the banking sector will strengthen the financial system through the diversification of credit and investment risk.

The development of the domestic capital market is another priority. The size and liquidity of the stock market has to be increased with the listing of new companies and public sector enterprises. There is also the need for the implementation of comprehensive public float rules and margining requirements to enhance liquidity and to reduce credit risks. New products, such as exchange traded funds and financial derivatives to hedge risk should also be introduced. It is proposed that a central clearing counterparty corporation will be established to reduce settlement risk in exchange transactions. The development of the corporate bond market is necessary in order to meet the long-term financial needs of the corporate sector, particularly in respect of infrastructure and other long-term investments. The establishment of a long-term government securities yield curve which is used as the benchmark for the pricing of corporate bonds will facilitate the development of the market. The issues relating to the tax treatment of corporate bonds have now been addressed. The recent decision to open the corporate bond market to foreign investors, with prudential safeguards, will expedite the development of this market. Other measures, such as enabling the repo facility for highly rated corporate bonds and the introduction of a reporting platform for non-exchange traded corporate debt securities to promote the growth and transparency of the market. The asset-backed securitization is another market that needs to develop to meet the funding needs of financial institutions and companies. The conditions are good for the expansion of the unit trust industry which can cater to a diverse group of retail, corporate and institutional investors depending on their investment focus.

The outlook for financial system stability is favourable given the high growth momentum of the domestic economy and the rebound in the international economy.

As financial institutions expand their operations, it is imperative that they also focus on maintaining high credit standards and improving efficiency, innovation, risk management and governance, in order to preserve the soundness and integrity of the financial system. The capital and prudential requirements of banks, finance, leasing and insurance companies and other financial institutions will be enhanced to facilitate this expansion in activities and to strengthen resilience. It is important that macroeconomic stability is maintained. However, new challenges will emerge, particularly with the easing of the capital account restrictions and financial innovation which warrant continued monitoring and intensive surveillance by the regulatory authorities. The Central Bank of Sri Lanka (CBSL) and other regulatory authorities will remain vigilant and stand ready to undertake the necessary measures to safeguard the stability of the financial system in Sri Lanka, to close cordinate.

Summary of the Stability Assessment

Global Macroeconomic and Financial Market Developments

Global economic recovery is strengthening in 2010 and will continue gradually in 2011, although downside risks remain elevated.

The world economy is forecast to expand by 4.8 per cent in 2010 and 4.2 per cent in 2011, from a contraction of 0.6 per cent in 2009, according to the latest estimates by the International Monetary Fund (IMF) - World Development Outlook. International trade has also rebounded and is estimated to grow by 11 per cent in 2010 and 7 per cent in 2011. The extent of the economic recovery differs across regions, with Asia in the lead. China is estimated to grow in GDP by 10.5 per cent in 2010 and 9.6 per cent in 2011, while India is estimated to grow by 9.7 per cent in 2010 and 8.4 per cent in 2011. Output growth in the advanced economies *i.e.,* USA, Euro Area, UK and Japan is sluggish and is projected to expand by 2.7 per cent in 2010 and 2.2 per cent in 2011. The growth in the advanced economies is expected to slowdown in the second half of 2010 and the first half of 2011 as the fiscal policy stimulus wanes. There is a possibility that this could affect the exports of emerging and developing economies, such as Sri Lanka. The global recovery was highly supported by unprecedented monetary and fiscal policies adopted by national governments and central banks, and fiscal vulnerabilities in advanced economies could expose the global recovery to vulnerabilities.

Inflationary pressures are generally expected to be low to moderate across the world in 2010 and 2011.

Inflation has remained low in advanced economies amid continued excess capacity and high unemployment, although the increase in commodity prices has raised consumer prices. Global inflation is projected to be in region of 1.5 per cent in 2010 and commodity prices remain stable in 2011. Emerging and developing economies have experienced higher inflation pressures due to increased domestic demand pressures and capacity constraints, particularly in some large countries like India and Brazil. In addition, the surge in capital inflows from advanced economies to emerging economies has led to worries of contribution to inflation and asset price bubbles. Nevertheless, on the whole, inflation is estimated to be in the region of 5–6 per cent in emerging and developing economies in 2010 and 2011. However, rising inflationary pressures in South Asian countries is a concern.

Conditions in global financial markets have eased somewhat, although uncertainty prevails due to sovereign debt problems in some countries in the Euro region.

After a period of stabilization, global financial markets came under renewed stress in second quarter of 2010 due to the public debt crisis in Greece and unease with the condition of public finances in certain other European countries such as Portugal, Spain and Ireland. This resulted in heavy selling of sovereign debt of vulnerable Euro area countries and a “flight to safety” by investors. This entailed severe difficulties for these countries and for European banks exposed to these countries to obtain funding from financial markets. The IMF and the European authorities put in place extensive support packages which helped to stabilize conditions. However, as problems of fiscal imbalances have created uncertainty about future developments, financial markets and institutions still remain under pressure. Hence, the global financial system remains vulnerable to downside risks because capital and liquidity buffers are still insufficient to uphold market confidence under any imminent stress.

Credit spreads on debt of emerging market economies narrowed significantly and there were increased portfolio capital inflows to these countries.

Emerging market economies were not affected by problems in the Euro region. Stock market in emerging market economies continued to rebound, as economic activity and trade begun to pick-up. Credit spreads on emerging market economies sovereign debt and investment grade corporate bonds narrowed significantly. This was evident when Sri Lanka successfully issued a sovereign bond in international markets at lower interest rates and which was heavily oversubscribed in October 2010. There was resurgence in portfolio capital inflows to the emerging market economies of Asia and Latin America due to their stronger economic recovery, expectations of appreciating currencies and lower interest rates in advanced economies. This has led to concerns about inflationary pressures and asset price bubbles in emerging economies which if it manifests would have to be addressed by a combination of macroeconomic and prudential policies.

The health of the global banks has generally improved amid continued deleveraging, normalizing markets and the recovering economy.

Although write-downs have reduced and capital needs have declined substantially, global banks will need more capital to refinance short-term financing and higher quality capital to satisfy the proposed more stringent regulatory requirements. In addition, banks will also have to change their business strategies to comply with the new regulations. All these factors are likely to put a downward pressure on bank profitability. The recovery in private sector credit is still subdued in advanced economies, as supply is constrained and credit demand is weak. Households and corporates need to reduce their debt levels and restore their balance sheets. Small and medium sized enterprises are mainly affected by the reduction in credit. Policy measures may be needed to address supply constraints in some countries.

The new Basel regulatory regime was agreed in September 2010 and transition to this regime has been extended to enable banks build resilience through improved capital and liquidity.

The Basel Committee on Banking Supervision in response to the global financial crisis has developed a reform programme to strengthen the regulation of banks in order to make the financial system safer and more resilient in times of stress. These new global standards referred to as Basel III have both a micro prudential and macro prudential focus to address bank-specific and broader systemic risks. The key elements of Basel III are

- raise the level of the minimum risk-weighted capital adequacy requirement, including an increase in the common equity requirement to 4.5 per cent of risk-weighted assets and a capital conservation buffer of 2.5 per cent of risk-weighted assets, bringing the total common equity requirement to 7 per cent;
- introduce a counter-cyclical capital buffer within a range of 0–2.5 per cent of risk-weighted assets, which would be built up during periods of rapid aggregate credit growth;
- introduce a new definition of Tier 1 capital ;
- eliminating Tier 3 capital (short-term marketable debentures);
- introduce a new capital instrument, referred to as contingent convertibles which are debt instruments that can be converted to equity during capital shortfalls;

- increase the capital requirements for trading book, complex structured products, derivatives and off balance sheet vehicles;
- introduce a non risk-based leverage ratio to 3 per cent of Tier 1 capital to total assets and off balance sheet items;
- introduce minimum liquidity standards consisting of both a short-term liquidity coverage ratio and a longer term net stable funding ratio;
- introduce additional standards for Systemically Important Financial Institutions (SIFIs) such as a systemic capital surcharge;
- raise the standards for supervisory review and public disclosures, with guidance in areas of sound valuation practices, stress testing, risk management, corporate governance and remuneration practices;

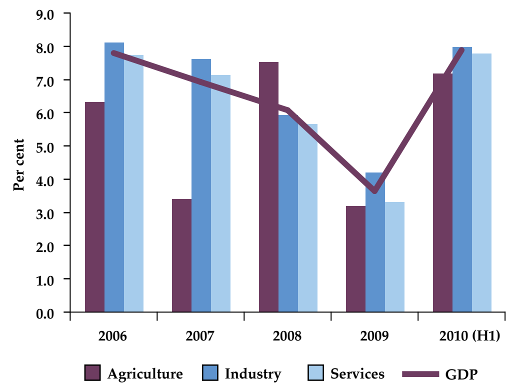
Agreement was reached on Basel III in September 2010 and it is planned to be implemented in a phased manner over 5 years from 2013. Basel III is a key part of an on-going wider financial regulation agenda coordinated by the recently formed Financial Stability Board to build a safer financial system and to ensure its resilience in periods of stress. It should be noted that the Sri Lankan banking sector is well positioned to comply with the Basel III standards in terms of its capital, leverage and liquidity requirements.

Domestic Macroeconomic Developments

Economic growth has rebounded and is expected to move to a higher growth path

The Sri Lankan economy is forecast to grow by 8 per cent for 2010 from 3.5 per cent in 2009, underpinned by the gradual recovery in international trade and an expansion in domestic economic activities and (reconstruction) after the end of the conflict output grew by

Chart 1.1 **Annual Growth Rate**



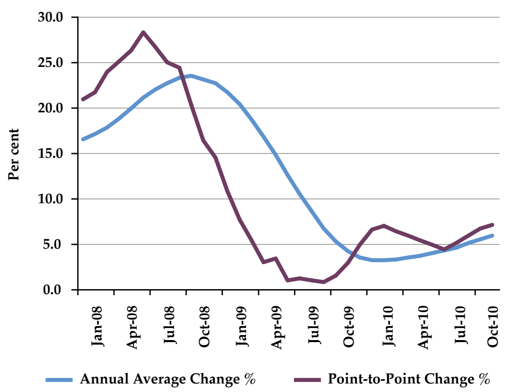
Source : Department of Census and Statistics

7.8 per cent in the first half of 2010, with higher growth in all major sectors – agriculture (7.1 per cent), industry (8.1 per cent) and services (7.8 per cent). The revival of exports and tourism and the upturn in transport, construction and manufacturing made a significant contribution towards the resurgence in economic growth. The higher growth momentum is expected to be sustained in the second half of 2010 and in 2011, with improved investor confidence, increased market access and public sector investments in infrastructure and other identified sectors. This will facilitate the growth of the financial services industry and strengthen financial system stability. The possible downturn in global growth and trade and hence a slowdown in exports remains a downside risk.

Inflation is expected to remain at single digit levels.

Inflation, as measured by the Colombo Consumer Price Index (CCPI) was broadly stable in 2010. The year on year inflation rate rose slightly to 6.6 per cent in October 2010. Inflationary pressures have been subdued due to moderate increases in imported commodity prices and benign demand pressures in the domestic economy. Inflation is expected to remain within single digit level in the forthcoming months and next year. However, inflationary pressures could strengthen if oil prices rise sharply in the event

Chart 1.2 Colombo Consumers' Price Index (2002=100)



Source : Department of Census and Statistics

that demand picks up in response to a rapid recovery in the global economy or if food prices increase markedly due to supply side constraints such as adverse weather conditions. The CBSL will continue to be watchful and implement monetary policy to control inflation rising in 2011.

Steps are being taken to reduce the fiscal deficit.

The overall budget deficit is estimated to be about 8 per cent of GDP in 2010. A further reduction in the fiscal deficit to about 6.8 per cent of GDP is expected in 2011. The decline in interest costs of servicing public debt and the proposed changes to the tax system taking into consideration the recommendations of the Presidential Tax Commission is expected to lower the fiscal deficit. An improvement in the public debt to GDP ratio to 82 per cent and external debt to external reserves to 258 per cent was recorded at 3Q/2010 and an improvement in other public debt indicators is expected this year, with the acceleration in the growth of the economy and the increase in export earnings and external reserves. The duration (weighted average maturity) of the domestic debt portfolio was 1.8 years at 3Q/2010 which was unchanged from last year. However, the duration is expected to increase in the 4Q/2010 by shifting the debt stock towards more medium and long term maturities. Foreign investment in government securities also contributed towards increasing the maturity structure and reducing the borrowing costs of public debt. In addition, a part of the proceeds of the recent international sovereign bond of US $ 1 billion was used to settle and retire high cost borrowings and debt stock. A prudent public debt risk management strategy to minimize funding costs at an acceptable level of risk is being actively pursued by the CBSL. Hence, public debt service obligations are not expected to exert elevated pressure on domestic interest rates in the near future.

The overall balance of payments is expected to record a surplus and the external reserve position has increased considerably providing a cushion against possible external shocks.

Export earnings increased by 11 per cent, while import expenditure rose by 37 per cent from January – September 2010. Although exports have recovered markedly this year, the sluggish recovery in the mature economies which are the main markets for Sri Lankan exports have constrained potential earnings. Consequently, the trade deficit widened significantly. Remittances continued to be robust and a surplus in services account through increased receipts from tourism and port services partially offset the trade deficit. Despite a higher current account deficit, increased foreign financial flows to the government in the form of long-term loans, investments in government securities, receipts from three tranches under the IMF Stand-By Arrangement (SBA) and the proceeds of the international sovereign bond led to a surplus in the overall balance of payments of amounting to US $ 1.4 billion at end October 2010. Foreign exchange reserves continued to build up during the year. Gross official foreign exchange reserves rose to US $ 6.8 billion at end October 2010, which is equivalent to 6.4 months of imports. The high level of external reserves is an important buffer against the downside external risk of a slowdown in exports and sudden capital outflows.

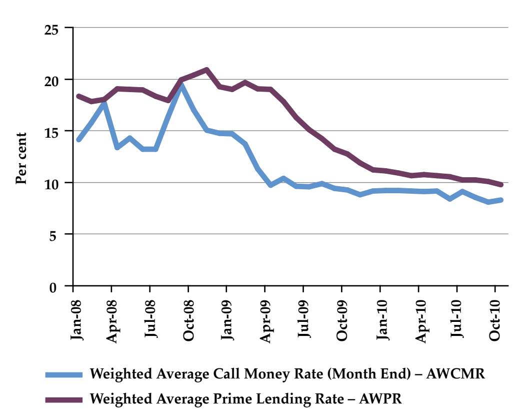
Developments in Domestic Financial Markets

Call Money Market

The money market was relatively stable with a high level of surplus liquidity.

There was low volatility in the inter-bank call money due to the excess liquidity position in the banking system during the first ten months of 2010. The surplus liquidity position was due to sterilization of foreign capital inflows and the moderate growth in bank lending. This resulted in a downward pressure on call money market rates during the year. As inflationary pressures remained subdued, the CBSL revised its policy rates downwards to 7.25 per cent and 9 per cent in July and August 2010. The weighted average call money market rate (WACMR) declined from 9 per cent at end 2009 to 8.1 per cent at end October 2010.

Chart 1.3 Weighted Average Call Money Rate and Weighted Average Prime Lending Rate

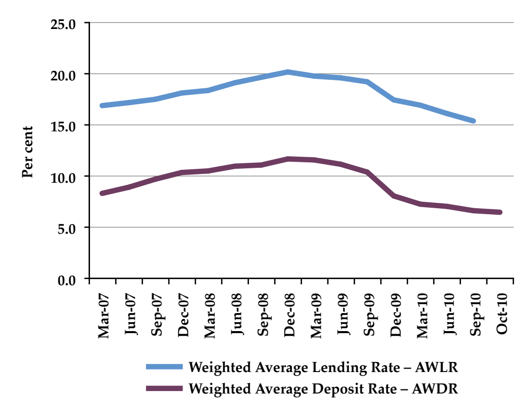


Source : Central Bank of Sri Lanka

Bank Retail Market

Bank deposit and lending rates declined due to lower inflation and the accommodative monetary policy stance.

Chart 1.4 Weighted Average Lending Rate (AWLR) and Weighted Deposit Rate (AWDR)



Source : Central Bank of Sri Lanka

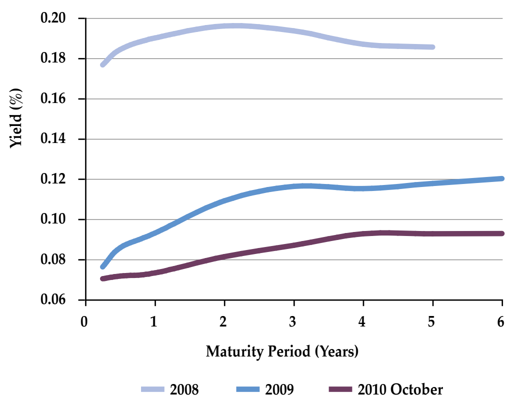
The average weighted deposit rate (AWDR) of commercial banks declined by about 160 basis points to 6.43 per cent, while a sharper decline of about 240 basis points was observed in the average weighted fixed deposit rate (AWFDR) to 8.48 per cent by end October 2010. In line with the reduction in cost of funds, the lending rates of banks have also declined. The average weighted prime lending rate (AWPR) which serves as a benchmark for other selected lending rates declined by about 145 basis points to 9.66 per cent by end October 2010. Following suit the average weighted lending rate (AWLR) of commercial banks declined by 206 basis points to 15.35 per cent at end September 2010.

Government Securities Market

Yield rates in the government securities also declined markedly, with increased trading in the Treasury bill market.

The downward trend in Treasury bill and bond yield rates which started in mid 2009 continued in 2010 with the further easing of the monetary policy stance, the rising level of market liquidity and increased foreign investment in the government securities market. With the declining interest rates, 6 year and 10 year Treasury bonds were issued during the year, thereby extending the yield curve. Yield rates in

Chart 1.5 Yield Curve for Government Securities in Secondary Market



Source : Central Bank of Sri Lanka

the government securities market ranged from 7.13 per cent to 9.3 per cent across the maturity spectrum of 3 months to 10 years at end October 2010 recording a decline of between 60 to 426 basis points on the different maturities from the end 2009. Secondary market trading in Treasury bills increased, while trading in Treasury bonds declined. A positive development is that the demand for medium and longer maturities has started to grow in the second half of the year.

Conditions are emerging for development of the long-term yield curve for government securities.

The anchoring of inflationary expectations would create conducive conditions for regular issues of medium and long term Treasury bonds. This would also benefit other financial institutions like insurance companies and contractual savings institutions that require long-term instruments for the development of products. A well established long-term yield curve for government securities would also serve as a benchmark for corporate borrowing and facilitate the development of the private debt securities market.

Corporate Debt Securities Market

The corporate debt securities market is small and undeveloped, but is expected to grow with the expansion in economic activities and a conducive macroeconomic environment.

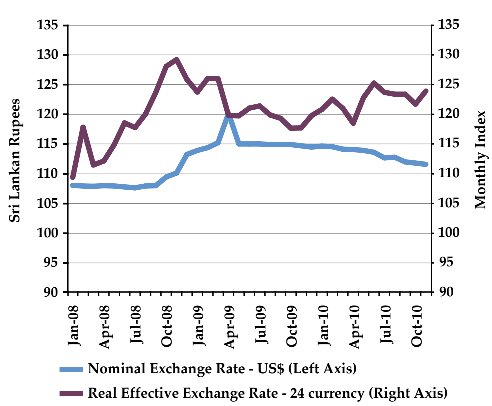
The commercial paper market was relatively inactive in the first nine months of the year, with a lower volume of issues than in the previous year. The high level of liquidity in the money market and the availability of bank credit at attractive rates of interest offered to prime customers would have reduced the need to mobilise funds through this instrument. Issues of corporate bonds were also low. In the past, banks have been the main issuers of debentures primarily to meet regulatory capital requirements. There were two issues of debentures this year and one was by a bank. The securitization market still remain in an incipient state. Trust Certificates is the main type of asset-backed securities that is currently being issued. This instrument is mostly used by finance and leasing companies to securitize lease receivables. The enactment of the proposed Regulation of Asset-backed Securitization law will facilitate the development of the securitization market with necessary safeguards. The development of the corporate bond market in particular will be beneficial to both private sector and public sector institutions as it will help to mobilize funds for medium and long term investment projects. Furthermore, the development of a domestic capital market as a supplement to the banking sector would also strengthen the financial system through the diversification of risk and funding sources. The decision to permit foreigners to invest in corporate debt securities within specified limits will broaden the investor base and add liquidity to the market. The problems with the treatment of withholding tax on corporate bonds have been addressed and this will facilitate secondary market trading.

Foreign Exchange Market

The exchange rate was broadly stable and the appreciation of the REER was modest.

The Sri Lanka Rupee appreciated mode-rately against most major currencies during the year. The CBSL intervened in the foreign exchange market to limit the upward pressure on the Sri Lanka Rupee and to maintain the stability of the currency in the midst of higher foreign currency inflows. The Sri Lanka Rupee appreciated by 2 per cent against the US dollar in the first ten months of 2010. The Sri Lanka Rupee also appreciated against the Sterling Pound, Euro and Indian Rupee, while depreciating against the Japanese Yen. The Real Effective Exchange Rate (REER) appreciated by 4.5 per cent for the 5 currency basket and by 2.6 per cent for the 24 currency basket at end October 2010, thereby indicating a slight decline in the currency competiveness of exports.

Chart 1.6 Nominal Exchange Rate and Real Effective Exchange Rate



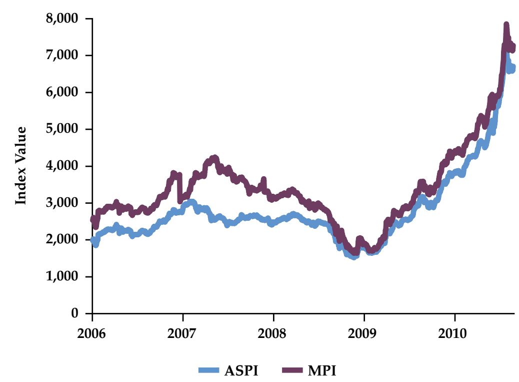
Source : Central Bank of Sri Lanka

Equity Market

The price indices and turnover levels of the stock market have surged upwards to record levels.

The All Share Price Index (ASPI) increased by over 90 per cent at end October, making the Colombo Stock Exchange (CSE) one of the best performing markets in the world. The upward trend in the equity market was driven by the improved domestic macroeconomic environment particularly lower interest rates and the upswing in growth, higher corporate earnings and investor confidence about future business prospects. Market capitalization doubled and increased to about 40 per cent of GDP. The average daily turnover quadrupled. The price indices of all sectors made gains, with the Banks, Finance and Insurance sector being one of the sectors which outperformed the ASPI. Funds mobilized by companies from the stock market increased, with higher Initial Public Offering activity. The number of new listings on the CSE also increased. The market price earnings ratio (PER) also rose sharply to 25 at end October 2010. Although the PER of major sectors reflect economic fundamentals, the PER of some shares may have become overvalued.

Chart 1.7 All Share Price Index and Milanka Price Index of CSE



Source : Colombo Stock Exchange

Measures are being taken to promote the growth of the stock market in a sustainable manner.

The stock market upturn was propelled largely by domestic investors with increased credit facilities provided by stock-brokers. Although foreign investment increased, foreigners were net sellers in the market. Given the small size of the market, the sharp rise in equity prices and PERs gave rise to concerns of overheating and the possibility of an asset price bubble, in the future. In order to contain speculative trading and in view of the large volume of credit facilities provided by stock-brokers which had increased their settlement risk, the Securities and Exchange Commission (SEC) issued a directive in September prohibiting stock-brokers from extending credit facilities from January 2011, with stock-brokers being given time till year end to clear outstanding debtors positions. Henceforth only margin providers would be permitted to provide credit facilities to investors. The market became subdued with price indices declining following this announcement. Consequently, the SEC has given stock-brokers time till end March 2011 to clear 50 per cent of debtors position and the balance 50 per cent by end June 2011. A number of stock brokers have also formed subsidiary companies to obtain a licence to be a margin provider. The SEC also propose to introduce more comprehensive margining requirements for share trading. Other measures being considered are requiring companies to maintain a minimum public float of shares, in order to increase the volume of shares available for trading and to improve the liquidity of the market. A new automated market surveillance system will also come into operation in late 2010.

Several initiatives to facilitate the development of the stock market and to reduce settlement risks are in progress.

The SEC proposes to introduce new products such as exchange traded funds and financial derivatives (futures and options) in the near future. The establishment of central counter-party clearing arrangements is a prerequisite for derivatives trading on an exchange and the CSE has initiated action to set up a central counter-party clearing corporation. The central counter-party clearing system will guarantee settlement and a delivery versus payment (DvP) system will eliminate the current settlement risk in market transactions. A comprehensive framework for the demutualization of the CSE is being prepared and the SEC Act will be amended to facilitate this reform.

Developments in Financial Institutions

Banks

Bank credit picked-up considerably with the recovery in the domestic economy and the decline in lending rates .

Lending by the banking sector increased by 12.5 per cent in the first nine months of 2010, in contrast with a decline of 2.5 per cent in the previous year. Credit extended by LCBs increased by 13 per cent, while that by LSBs increased by 5 per cent. Sectors that recorded high rates of credit growth economic sectors were agriculture and fisheries, construction and housing, trading, transport and financial services. Credit to the manufacturing and tourism sector declined. The decline in lending for manufacturing mainly reflects the contraction in credit to the apparel subsector due to the sluggish in this category. Within the consumption sector, lending for pawning increased, while lending for credit cards declined. Investments increased significantly, but at a lower rate than last year. The growth in deposits decelerated, while borrowings rose markedly. The credit to deposit ratio was 74 per cent at 3Q/2010 indicating that the deposit base was sufficient to fund lending activities.

The credit risk is declining and the asset quality of the banking sector is improving.

Credit risk is the main risk faced by banks. A positive development is that the volume of non-performing loans is trending downwards, which is indicative of an improvement in the repayment capacity of borrowers. Consequently, both the gross and net non-performing loans (NPL) ratios have declined. However,

Table 1.1 **Key Financial Soundness Indicators of the Banking Industry**

(Per cent)

Ratio	2007	2008	2009	2010 Sep.
Total Capital Adequacy Ratio	14.1	14.5	16.1	15.5
Tier 1 Capital Adequacy Ratio	12.6	12.5	14.1	13.4
Gross Non-Performing Loans Ratio	5.2	6.3	8.5	6.7
Return on Assets (Before Tax)	1.9	1.9	1.8	3.0
Return on Equity (After Tax)	14	13.4	11.8	23.4
Statutory Liquidity Ratio (DBU)	30.4	31.3	39.2	38.9
Liquid Assets to Total Assets	28.1	28.4	35.3	32.6

Source : Central Bank of Sri Lanka

the construction and housing, trading and manufacturing sectors have higher than average NPL ratios. Total provision coverage has increased marginally but is below the desired minimum level of 60 per cent. Hence, it is advisable to increase the loan loss provisions to this level in order to strengthen their resilience.

The sector concentration of bank lending is at acceptable levels, as a single sector does not dominate.

The sector-wise distribution of bank advances at end September 2010 shows that lending for construction and housing (17 per cent), trading (14 per cent), manufacturing (13 per cent) and agriculture (13 per cent) were the most significant. The Herfindahl Index which is used to measure sector concentration indicates that banking lending was moderately concentrated with a score of 0.16.

Liquidity risk was adequately managed.

Liquidity risk based on the maturity gap analysis between short-term asset and liabilities shows that the negative gap up to 6 months had increased. The increase in the negative gap was most marked in the 0–7 days bucket. This indicates that banks were more exposed to liquidity risk. Given the excess liquidity position in the money market and the stable rates that prevailed during the year, the higher liquidity risk did not pose a problem. However, banks need to manage the mismatches in the asset liability maturity profile more effectively in the future. The statutory liquid asset ratio (SLAR) require banks to maintain a liquid assets to deposit liabilities ratio of 20 per cent to safeguard against a liquidity shortfall. The SLAR of the banking sector was almost double the statutory requirement. The high SLAR reflects to a great extent the large portion of investments in government securities. The liquid assets to total assets ratio was also maintained at a high level.

Exposure to market risk was low.

Banks exposure to interest rate risk was not significant due to the low level of trading book activities. The exposure to foreign exchange risk is contained due to the limits imposed by the CBSL on both the long and short net open positions of LCBs. Banks maintain a capital charge for market risk to cover any losses that may arise on their trading portfolio due to adverse fluctuations in market prices.

The profitability of the banking sector was maintained.

The net interest income of the banking sector grew by 16 per cent at end 3Q/2010. The net interest margin of the banking sector has been stable over the last few years at around 4.5 per cent. There were some exceptional events relating to two banks which had a major positive impact on the non-interest income and loan loss provisions and hence the profits of the banking sector during the year. After adjusting for these events, the non-interest income of the banking sector increased by 8.5 per cent. Staff costs decelerated and net profits before tax increased by 24 per cent at end 3Q/2010. The profitability indicators, such as the after tax return on assets (ROA) and return on equity (ROE), improved marginally at end 3Q/2010. However, the growth in profitability was not widespread across the banking sector, as a number of banks recorded a negative growth in profitability.

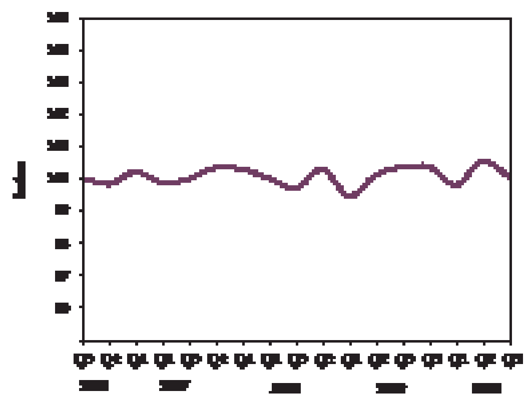
The banking sector maintained a high level of capitalization and improved soundness.

The overall capital funds position of the banking sector strengthened in 2009 increasing the buffer available for absorbing any risks. Capital funds of the banking sector increased by 14 per cent at end 3Q/2010 on account of retained earnings and fresh capital infusions by a few banks. The risk weighted total capital adequacy ratio (RWCAR) and the Tier I RWCAR under Basle II were maintained well above the international and domestic minimum regulatory standards. The leverage ratio (Tier1 capital to total assets) was 6.3 per cent was also at a comfortable level. The ratio of net NPL to capital funds declined to 20 per cent indicating a substantial improvement.

The Banking Soundness Index indicates that the soundness of the banking sector has been stable and sound over the medium term.

The Banking Soundness Index (BSI) is a simple aggregate indicator that can be used to assess the soundness of the banking sector over time. The BSI is based on selected financial soundness indicators representing capital, asset quality, profitability, liquidity and sensitivity to market risk. The financial indicators are weighted based on the market share of each bank. The BSI is

Chart 1.8 **Banking Soundness Index (2006/Q3 = 100)**



Source : Central Bank of Sri Lanka

shown in Chart 1.8. The BSI declined marginally to 100.02 in 3Q/2010 from 100.30 in 4Q/2011, on account of slight decreases in capital adequacy and liquidity ratios due to an increase in risk-weighted assets on account of the growth in bank lending in the third quarter of the year. The soundness of the banking sector was preserved as these indicators were at prudentially high levels. The BSI indicates that the soundness of the banking sector has stabilized during the period of 3Q/2006 to 3Q/2010.

Stress tests indicate that the banking sector is resilient to withstand shocks.

The CBSL conducts regular stress on banking institutions and the banking sector to assess its capacity to cope with extreme but plausible shocks. The stress tests using single factor sensitivity analysis were conducted for credit risk, market interest rate risk, foreign exchange risk and liquidity risk shocks to gauge the impact on banks' capital adequacy and liquidity ratios. The results of the tests indicate that the banking sector has adequate capital and liquidity buffers to withstand both moderate and extreme shocks.

A mandatory deposit insurance scheme for banks and finance companies will be implemented.

The CBSL announced a mandatory deposit insurance scheme for licensed banks and registered finance companies to protect small deposits and to strengthen the stability of the banking and finance company sector. The scheme will be implemented under the provisions of the Monetary Law Act by the CBSL and will come into operation from 2011. Deposits up to Rs.200,000 per depositor per institution will be insured. Banks and finance companies will be required to contribute to the deposit insurance fund by paying a premium.

Bank capital requirements will be enhanced to increase the soundness and resilience of the banking sector.

The directive was issued by the CBSL in July 2010 to increase the minimum capital requirements for banks. Accordingly, LCBs and LSBs are required to increase their core capital to Rs.5 billion and Rs. 3 billion respectively by end 2015 on a phased basis.

The regulatory and supervisory framework governing the banking sector is being strengthened.

The CBSL initiated amendments to the Banking Act to include powers to conduct consolidate supervision of banking groups, provisions to facilitate mergers and acquisitions of Licensed Banks, provisions to strengthen bank resolution measures and certain changes necessitated by the Companies Act. The proposed amendments have been discussed with the banking industry and have been submitted to the Ministry of Finance for Cabinet approval and submission to Parliament. The assessment of the Fitness and propriety of bank directors was further improved to enhance compliance with the Direction on Corporate Governance. The "fit and proper" criteria will also be extended to senior management performing key executive functions in banks and an assessment will be implemented in the near future. The draft guidelines on integrated risk management in banks will be finalized and guidelines will be issued on Pillar II of Basle II to further strengthen the capital planning process in banks and to encourage the internal ratings based approaches. A direction on outsourcing of activities was issued to mitigate any potential operational risk that may arise from this source. A direction on consumer on protection setting out minimum standards of conduct in order to reduce unfair and unethical business practices by banks is being prepared.

Finance Companies

The RFC sector has rebounded with an expansion in business activities and profitability has improved markedly.

The resurgence in domestic economic activity, lower interest rate environment and the return of public confidence has resuscitated the RFC sector. The reduction in import duties on motor vehicles and the expansion of business into the North and East of the country and the rural areas has also increased the business opportunities of the sector. Financial facilities provided by the RFC sector increased by 16 per cent in the six month period from March to September 2010. Hire purchase and finance leasing business accounted for 68 per cent of total accommodations, while pawning, real estate loans and other loans accounted for 9 per cent, 5 per cent and 15 per cent respectively. Net interest income of the RFC sector rose appreciably in the current year. Consequently, the profitability of the RFC sector moved into positive territory. However, a few companies continued to incur losses. The RFC sector, excluding the five distressed companies, recorded substantial improvements in profitability. The reduction in Value Added Tax on financial services will enhance the profits of the sector. In addition, the increase in capital allowances on machinery will encourage RFCs to diversify the leasing

Table 1.2 **Key Financial Soundness Indicators of Registered Finance Companies**

(Per cent)

Ratio	RFC Sector*					Excluding Distressed Companies RFC Sector*				
	2007	2008	2009	2010	2010 Sep.	2007	2008	2009	2010	2010 Sep.
Total Capital Adequacy Ratio	14.2	14.5	14.2	11.3	8.5	15.9	16.5	17.7	19.7	17.5
Tier 1 Capital Adequacy Ratio	13.1	12.5	12.6	9.8	7.4	14.8	14.5	16.2	17.4	15.7
Gross Non-Performing Loans Ratio	4.4	6.5	8.0	9.7	12.6	4.5	6.0	5.3	6.2	7.8
Return on Assets (Before Tax)	3.2	2.5	0.8	0.1	2.4	3.7	3.3	2.8	2.9	4.8
Return on Equity (After Tax)	17.8	12.5	1.3	-7.4	11.3	19.8	17.9	17.5	19.6	21.1
Liquid Assets to Short-Term Liabilities	17.2	14.9	13.8	14.1	11.3	17.8	20.9	20.0	19.5	14.8
Liquid Assets to Total Assets	9.1	10.9	8.0	9.0	7.2	8.3	10.2	10.5	11.5	8.7

* Financial year end March

Source : Central Bank of Sri Lanka

business and reduce sector concentration risks. The liquidity position of the RFC sector has stabilized as public confidence in the sector renewed, while the asset quality is showing signs of improving.

The capital position of the RFC sector needs to be strengthened and the proposed listing of companies on the CSE will help to infuse additional funds.

The CARs of the RFC sector (excluding distressed companies) was at a robust level. However, a few small companies need to enhance their capital levels. The listing of the all RFCs on the CSE by June 2011 will facilitate the injection of much needed capital funds into the sector. This is vitally important as RFCs require a strong capital base in order to expand their business. The minimum capital requirements for RFCs will be increased from Rs.200 million to Rs.500 million on the staggered basis from 2012.

Measures are being taken to restructure distressed RFCs.

There are five distressed RFCs (mainly from the Ceylinco Group) that are operating under the supervision of a Managing Agent appointed by the CBSL. An Expert Group was also appointed by the Cabinet to advise distressed companies to formulate business plans to revive their operations and to implement depositor repayment programmes. Most companies have commenced business operations and are making regular interest payments and partial capital repayments to depositors. The companies are currently finalizing restructuring plans which entail the infusion of new capital by a strategic investor and the conversion of a proportion of deposits into non-voting shares. Loans will also be converted into equity. A new board of directors will also be appointed to run the companies. The process is expected to be completed by the end of the year. A Credit Guarantee Scheme for distressed companies to obtain bank facilities and securitization against specified assets was introduced by the CBSL in 2010.

The new law to regulate finance business and to combat unauthorized deposit-taking will be introduced.

As the existing Finance Companies Act which has several limitations and lacunae, a new law for the regulation of finance business will come into effect from next year. The proposed law will make both unauthorized finance business and deposit-taking, an offence. The definition of "deposits" will be widened to cover a broad range of fund mobilisation activities. The powers of the CBSL relating to the investigation of unauthorised finance business and deposit-taking entities will be strengthened and offenses will carry more severe penalties. The establishment of companies with names or acronyms of RFCs will be prohibited. The proposed law will also enhance the reporting requirements of RFCs and the remedial measures required to be taken by RFCs who are not in compliance with the law. The winding up process is being revised, including a list of priority of claims whereby depositors would be paid on the basis of priority. The proposed law also provides for a mandatory deposit insurance scheme for RFCs. However, deposits of RFCs will be guaranteed under the recently announced mandatory deposit insurance scheme operated by the CBSL under the Monetary Law Act, up to Rs. 200,000 per depositor per institution.

Leasing Companies

The performance of the SLC sector also improved.

Total accommodations provided by SLCs increased by 11 per cent in September 2010 within the more conducive business climate prevailing in the country. The net interest income earned by SLCs on finance leasing and higher purchase business increased significantly in the declining interest rate environment. The asset quality and profitability of the SLC sector also improved. The gearing ratio of SLC sector was at an acceptable level. A few small companies mainly from the Ceylinco Group recorded losses and were unable to comply with the capital requirements. In order to ensure their viability, these companies would have to find means of recapitalising their businesses by bringing in new/strategic investors or through mergers with other companies.

The prospects for the SLC sector are favourable

As mentioned in the RFC section, the business opportunities for SLCs have expanded particularly in the micro, small and medium enterprises sector and the conflict affected areas. The import duty reductions on motor vehicles and the tax incentives for diversifying the leasing business have provided a constructive platform for the growth of the industry. The enactment of the Secured Transactions Act which provides for the establishment of registry for movable property at the Credit Information Bureau is another positive development for the expansion of finance leasing business. In order to ensure the growth of the SLC sector is an sustainable manner, the CBSL proposes to increase to minimum capital requirements of SLCs to Rs.200 million on a staggered basis from 2012.

Table 1.3 Key Financial Soundness Indicators of Specialised Leasing Companies

(Per cent)

Ratio	2007	2008	2009	2010 Sep.
Capital Funds to Total Assets	16.7	16.9	18.4	17.0
Gearing Ratio	4.2	4.2	3.6	4.0
Non-Performing Accommodation to Total Accommodation	4.3	4.8	7.6	5.3
Return on Assets (Before Tax)	3.5	2.7	3.1	2.8
Return on Equity (After Tax)	15.2	10.5	9.3	11.6
Liquid Assets to Total Short-Term Liabilities	8.6	10.6	17.4	14.4
Liquid Assets to Total Assets	6.0	7.5	11.5	9.7

Source : Central Bank of Sri Lanka

Insurance Companies

The insurance sector recorded a growth in premium income and maintained its soundness.

With the resurgence in economic growth, the total premium income of the insurance company sector rose by 13 per cent in the first nine months of 2010 in contrast with a decline of 3 per cent in the same period of 2009. Gross written premiums for long term and general insurance increased by 22 per cent and 7.5 per cent respectively. Underwriting profits increased as some of the large companies recorded underwriting profits. The overall profits also increased due to large gains in investment income. All insurance companies complied with the solvency margin requirement for both long-term and general insurance indicating that the soundness of the sector was maintained. The Insurance Board is working on a project to introduce a risk-based capital adequacy framework for insurance companies.

Market risk was well managed, while underwriting risk needs to be better managed.

The main risks faced by insurance companies are underwriting risk and market risk. Some insurance companies recorded underwriting losses which were offset through profits on the investment account. Hence, insurance companies need to focus on improving their underwriting results. The prospects for the insurance sector are good as insurance penetration is very low in Sri Lanka. The reduction in import duty on motor vehicles will also boost the motor insurance business. As economic growth accelerates, general insurance business will expand in many directions. As per capita incomes grow, the demand for a variety of life insurance products, such as annuities and personal investment products will also rise. In this regard, it is necessary that long term investment instruments such as government and corporate bonds are available for effective risk management. The decision to permit insurance companies to invest a portion of their assets abroad will help to structure new products and diversify their investments. The proposal to permit institutions to become insurance agents will also increase market access to insurance products.

Table 1.4 Key Financial Soundness Indicators of Insurance Companies

(Per cent)

Ratio	2008	2009	2010 Sep.
Life Insurance			
Solvency Margin Ratio*	5.0	4.8	7.2
Retention Ratio	96.0	96.4	96.7
Claim Ratio	26.6	31.9	50.6
Combined Operating Ratio	51.1	70.7	72.5
Premium Stability Ratio	3.7	0.7	21.9
General Insurance			
Solvency Margin Ratio*	2.7	2.8	3.3
Retention Ratio	70.5	74.0	74.6
Claim Ratio	64.9	63.2	64.8
Combined Operating Ratio	110.4	107.1	80.8
Profitability Ratio	6.8	1.5	12.0
Premium Stability Ratio	(4.4)	(3.1)	7.5
Underwriting Ratio	18.5	20.3	21.1

* Times

Source : Insurance Board of Sri Lanka

The regulatory framework for the insurance sector is being strengthened to protect the interest of policy holders.

The Regulation of Insurance Industry (RII) Act will be amended to cover the entire insurance industry. The Insurance Board of Sri Lanka (IBSL) will be empowered to stipulate capital requirements for insurance companies and brokers, make rules and determinations, engage in dispute resolution and prescribe a "fit and proper" criteria for boards of directors of insurance companies. Other proposed revisions include the appointment of institutions as agents of insurance companies and the requirement that long-term and general insurance business be conducted in separately incorporated companies, with existing composite insurers being given time to segregate business into separate companies. The proposed amendments to the law will be submitted to Parliament this year.

Primary Dealers

The primary dealer industry had low risk exposures.

Market risk was low in the declining interest rate environment, while the liquidity position was comfortable with the high level of liquidity in the money market. The financial soundness indicators of the primary dealer industry were strong. The risk-weighted CAR was at a high level due to retention of profits, while the leverage ratio was low. Profitability was also at a high but declined slightly due to reduction on revaluation and capital gains. Primary dealers are now permitted to diversify their business into approved activities.

Table 1.5 **Financial Soundness Indicators of Primary Dealers**

Ratio	2007	2008	2009	2010 Sep.
RWCAR	35.2%	16.5%	22.4%	19.2%
Tier 1 Capital (RWCAR)	34.0%	16.1%	22.3%	19.3%
Capital Leverage Ratio	7.3	10.5	6.4	5.8
Return on Assets (Before Tax)	2.0%	2.0%	7.3%	5.4%
Return on Equity (Before Tax)	18.4%	28.2%	79.4%	46.9%
Operating Expenses to Gross Income	4.5%	4.2%	2.7%	2.7%
Total Cost to Total Income	86.2%	83.6%	60.7%	59.9%
Duration of Assets & Liabilities	0.6	0.9	1.4	1.3

Source : Central Bank of Sri Lanka

Stock-brokers

The financial position of stock-broker companies strengthened.

With the boom in equity market activities, the stock broker companies recorded large increases in turnover and profits. The net capital position of these companies also improved. Stock-brokers provide credit facilities to customers under CSE Member Rules subject to certain prudential limits which are similar to those applicable to margin providers. The credit facilities provided by stock-brokers to customers rose markedly in 2010 which has exposed these companies to high credit risk. In order to preserve the stability of the stock broker system, the SEC made a regulatory policy decision that stock-brokers should not engage in lending activities. Accordingly, a SEC directive was announced in September 2010 prohibiting stock brokers from providing credit facilities to customers from January 2011. Consequently, credit facilities would be granted exclusively by margin providers who are also licensed and regulated by the SEC. In this regard, stock brokers could set up a separate company to engage in margin provider business. Stock brokers are also exposed to settlement risk in equity transactions, as securities are transferred at T+ 0 while payment is made in T+3. To limit this risk, the SEC proposes to bring in more comprehensive margining requirements next year. In addition the SEC is working with the CSE to establish a central counterparty clearing corporation to reduce settlement risk.

Unit Trusts

The performance of the unit trust sector improved considerably with the upturn in the stock market.

The net asset value (NAV) of the unit trust sector increased by 81 per cent at September 2010 reflecting gains made mainly through investments in the stock market. The share of equities in the investment portfolio of these funds rose to 71 per cent, while the share of government securities declined marginally to 16 per cent. The unit trusts faced a low level of market risk and liquidity risk during the year. The unit trust sector is relatively small, consisting of 19 funds of various types which are managed

Table 1.6 **Selected Data of the Unit Trust Industry**

Details	2007	2008	2009	2010 Sep.
Total Assets (Rs.Mn.)	6,332	6,801	10,003	18,079
Net Assets Value – NAV (Rs.Mn.)	6,295	6,781	9,952	18,005
Investments in Equities (Rs.Mn.)	3,649	2,589	6,036	12,797
Investment in Equities as a % of NAV	58	38	61	71
Total No. of Unit Holders	23,191	22,699	23,116	24,025
No. of Units in Issues (Mn.)	470	638	564	668
No. of Unit Trusts	14	17	18	19

Source : Unit Trust Association of Sri Lanka

by 5 management companies and supervised by the SEC. The unit trust industry has a investor base of about 23,500 unit holders. The prospects are good for the growth of the unit trust sector which can cater to a diverse group of retail and institutional investors depending on their investment focus. Several prospective funds are pending the approval of the SEC. The recent decision to permit foreign investment in all types of unit trusts within specified limits will expand the investor base and expedite the development of the industry.

Superannuation Funds

The two main superannuation funds managed their risks adequately

The risk profile of the Employees' Provident Fund (EPF) and the Employees' Trust Fund (ETF) are similar. The investment portfolios of both funds are predominately held in government securities and hence credit risk is negligible. The funds had ample liquidity, as contributions exceeded refunds and investments in repurchase agreements helped to manage liquidity requirements. The proposal to enable EPF members to withdraw 30 per cent of their EPF balances for housing, education and health purposes will not have a significant impact on the liquidity of the fund as measures have been put in place to limit withdrawals and funds have been set aside for this purpose. The main risk faced by the superannuation funds is market risk through their investments in government and corporate fixed income securities and equities. The interest rate risk on the fixed income securities portfolio has been minimized, as investments have been diversified in securities of differing yields and maturities.

Table 1.7 **Investment Portfolio of EPF and ETF**

Investments		At Sep. 2009		At Sep. 2010	
		Rs.bn.	Share (%)	Rs.bn.	Share (%)
EPF	Government Securities	632.2	89.1	757.1	90.2
	Rupees Loans to Government	56.6	8.0	40.9	4.9
	Corporate Debt	8.5	1.2	7.4	0.9
	Equity	7.4	1.0	33.3	4.0
	Repurchase Agreements	4.9	0.7	0.5	0.1
	Total Investments	**709.6**	**100.0**	**839.2**	**100.0**
ETF	Government Securities	90.4	92.5	104.8	90.4
	Equity	1.2	1.2	4.3	3.7
	Debentures	1.4	1.4	1.1	0.9
	Unit Trusts	0.1	0.1	0.1	0.1
	Other	4.7	4.8	5.6	4.8
	Total Investments	**97.7**	**100.0**	**115.9**	**100.0**

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

Investments in equities have performed well. In the current low interest rate environment, the funds would face some reinvestment risk, which could be mitigated to some extent by increasing investments in equities.

Payment and Settlement Systems

The systemically important payment systems – LankaSettle and the Cheque Imaging and Truncation System operated with a very high degree of availability and without disruption in 2010.

The LankaSettle system comprises of the Real Time Gross Settlement System (RTGS) and the LankaSecure and is operated by the CBSL. The RTGS system settles high value payments on a real time gross basis, while the LankaSecure system settles government securities transactions on a Delivery versus Payment basis. The RTGS system accounted for 87 per cent of non-cash payments and continued to be the main fund transfer system in Sri Lanka. As the LankaSettle is highly integrated with major retail clearing systems and all financial markets, the CBSL adopted measures to maintain the system with a high and consistent level of resilience and operated the system at 99.9 per cent availability during the first nine months of 2010. The LankaSettle system is substantially compliant with the 10 Core Principles for Systemically Important Payment and Settlement systems stipulated by the Bank of International Settlements and action was taken to improve the few partially compliant deficient areas.

Improvements were made to the Cheque Imaging and Truncation system and the Sri Lanka Interbank Payment System.

The Cheque Imaging and Truncation (CIT) system is the cheque clearing system operated by LankaClear (Pvt) which was introduced in 2006 to reduce the cheque realization time to T+1 island-wide. In order to achieve this target it became necessary to migrate the cheque image submission to compact disks and all commercial banks successfully fulfilled this requirement from July 2010. The Sri Lanka Interbank Payment System (SLIPS) clears pre-authorised low value payments through an off-line mechanism and is also operated by LankaClear (Pvt). The SLIPS was upgraded to an on-line submission of

Table 1.8 **Non-Cash Payments : Volume and Value of Transactions**

Payments System	2009		2010 (Jan – Sept)	
	Volume ('000)	Value (Rs.bn.)	Volume ('000)	Value (Rs.bn.)
Large Value Payment Systems	233	33,155	180	28,935
RTGS System	233	33,155	180	28,935
Retail Value Payment Systems	73,748	5,009	60,018	4,348
Main Cheque Clearing System	40,637	4,391	31,486	3,830
Rupee Draft Clearing System	n.a.	1	n.a.	0.5
Sri Lanka Interbank Payment System (SLIPS)	9,034	279	9,590	242
Credit Cards	16,627	65	12,004	53
Debit Cards	3,309	11	3,624	11
Internet Banking	3,819	247	3,135	201
Phone Banking	322	4	179	3.8
Postal Instruments	n.a.	1	n.a.	7
Total	73,981	38,164	60,198	33,283
US Dollar Cheque Clearing System	60	20	42	17

Source : Central Bank of Sri Lanka

SLIPS data to LankaClear (Pvt) and settlement of transactions on T+0 basis from September 2010.

Business continuity arrangements were being strengthened.

Given its systemic importance, the CBSL strengthened the security of the disaster recovery (DR) site of the LankaSettle system and tested its business continuity arrangements periodically to ensure operational reliability and uninterrupted system availability in the event of a disruption at the main site. During the year, the CBSL also conducted second-round inspections of the DR sites of the participant banks of the LankaSettle system to check whether the sites comply to standards set by the CBSL and recommendations were made for further improvements of business continuity plans (BCP) and DR sites. LankaClear has also updated its BCP and conducted live operations of all its systems from its DR site, and had ensure throughout the year a high leve of system availability for cheque clearing.

The CBSL is authorized to regulate and supervise payment card issuers and to monitor all new products relating to the payment card industry, in terms of the Service Providers of Payment Cards Regulations No. 1 of 2009.

The CBSL issued licenses to 17 financial institutions to operate as service providers of payment cards in 2010. In addition, the CBSL issued Credit Card Operational Guidelines in March 2010 and on site supervision to ensure compliance with the guidelines is scheduled to commence in 4Q/2010. Draft guidelines on mobile payments were posted on the CBSL Website for comments, while the final guidelines will be issued in early January 2011. Meanwhile, internet payment guidelines are being prepared and will be issued this year.

Common ATM & Card Switch for Licensed Banks

The CBSL, LankaClear (Pvt) Ltd., and the National Payments Council have initiated action to implement a Common ATM and Card Switch which will enable customers to make cash withdrawals and balance inquiries from the ATM of any bank and to carry out real-time fund transfers and payments in the retail payment system. The project is expected to be implemented by 2012.

Box 1

Reforming Financial Regulation – Global Initiatives

Introduction

The pre-crisis global financial system operated with too much leverage, inadequate liquidity buffers and insufficient levels of high quality capital. These were accompanied by poor governance, poor risk management and inappropriate incentives for risk taking, making the banking sector vulnerable to shocks. Thus, during the most severe period of the crisis, the public lost confidence in the solvency and liquidity of many banking institutions. These weaknesses in the banking sector were transmitted to the rest of the financial system due to the high degree of interconnectedness among financial institutions and exposure to similar shocks.

In order to remedy the weaknesses of the global financial system crisis, regulators across the globe have united to carefully scrutinize, drastically change and introduce new regulations to reshape the way banks and regulators conduct their affairs. Global consensus has been reached on a comprehensive set of measures, with the Basel Committee's reform package forming a cornerstone of the financial regulatory reforms.

Initiatives taken by the Basel Committee on Banking Supervision (BCBS)

BCBS has prepared a comprehensive package covering capital and liquidity reforms, to remedy the pre-crisis shortcomings and to promote a more resilient banking sector.

Capital reforms

Changing the definition of capital:

- Greater focus is placed on the core elements of capital, namely common equity and retained earnings, to improve the level, quality, consistency and transparency of the capital base to ensure the availability of high quality capital to absorb losses.

Enhancing the quality and quantity of capital:

- Banks are required to achieve a minimum common equity requirement and a Tier 1 capital requirement of 4.5 per cent and 6 per cent of risk weighted assets, respectively.
- All regulatory deductions will be made from common equity instead of Tier 1 capital, to ensure that banks do not rely on debt-like substitutes for capital.

Maintaining a capital conservation buffer:

- Banks are required to maintain a capital conservation buffer of 2.5 per cent of risk weighted assets above the minimum capital requirement, made up of common equity after regulatory deductions.
- This buffer requires banks to retain a greater proportion of earnings during good times, to ensure the availability of capital to support the bank's lending activities and on going operations during periods of stress.

Maintaining a countercyclical buffer:

- The countercyclical buffer will increase the capital conservation buffer by an additional 2.5 per cent and will comprise common equity or other fully loss absorbing capital.
- This buffer may be imposed at the discretion of national authorities when there is excess credit growth that may lead to a system wide build up of risk in the country.

The minimum requirements for the various components of capital and the time targets for achieving these requirements is summarised in the following table.

Box 1 (*Contd.*)

New Capital Rules under the Basel Reforms

Capital	Composition	Minimum Requirement as % of risk weighted assets		Remarks	Phase in by
		Current	New		
Core elements	Common equity (Highest form of loss absorbing capital)	2% before regulatory adjustments	4.5% after applying stricter adjustments		1 Jan 2015
Tier 1	Common equity and other qualifying financial instruments	4%	6%		1 Jan 2015
Total capital			**8%**	The difference between total capital and Tier 1 capital may be met with Tier 2 and higher forms of capital.	
Capital conservation buffer	Common equity after deductions		2.5%	If there is high credit growth, the conservation buffer may be phased in during a shorter time period.	1 Jan 2019
Total capital + conservation buffer	Common equity – 7% Tier 1 – 8.5%		10.5%	If bank meets minimum ratio but is below the 7% common equity target, should maintain prudent earnings retention policies to meet conservation buffer as soon as possible.	1 Jan 2019
Counter cyclical buffer	Common equity or other fully loss absorbing capital		0% – 2.5%	Will be an extension of the conservation buffer during periods of excess credit growth. The phase in period can also be reduced during such periods.	

Capturing all material risks:

- BCBS has introduced stronger capital standards for trading book exposures as well as for complex securitizations and off-balance sheet vehicles.
- The revised trading book framework requires banks to hold around three to four times the old capital requirements.
- BSBC is in the process of finalising rules to strengthen capital requirements and risk management standards for counterparty credit risk.

Controlling leverage:

- BCBS has proposed a non risk based leverage ratio as a supplementary measure, to curb excessive buildup of banking sector wide leverage.
- The proposed minimum Tier 1 leverage ratio of 3 per cent will serve as a basis for testing during the parallel run period commencing 1 January 2013.

Box 1 (*Contd.*)

A new liquidity framework

Introducing minimum global standards for liquidity:

- Minimum global standards for measuring and controlling liquidity risk are to be introduced to promote short term resilience of banks to potential liquidity problems and longer term structural liquidity mismatches.
- The Liquidity Coverage Ratio (LCR) will require banks to hold sufficient high quality liquid assets to withstand a 30-day stressed funding scenario specified by the supervisors.
- The Net Stable Funding Ratio (NSFR), a longer-term structural ratio designed to address liquidity mismatches, will supplement the LCR.
- The NSFR will cover the entire balance sheet and provide incentives for banks to use stable sources of funding.
- The refined LCR and NSFR are expected to be introduced in January 2015 and January 2018 respectively.

Systemic risk and interconnectedness

- BCBS intends to introduce measures to mitigate systemic risks stemming from the high level of interconnectedness and the perception of 'too-big-to-fail', in order to strengthen the resilience of the entire banking system.
- The measures being considered include a capital surcharge for the largest and most systemically important firms and the possible role of contingent capital (i.e., financial instruments that can be written off or converted to common shares under certain conditions) in meeting any systemic surcharge requirements.

Regulatory and Supervisory Reforms in Europe

In addition to embracing the reforms proposals of BCBS, discussions are underway for implementing further regulatory and supervisory reforms in Europe. The main areas of reform include:

- Reducing systemic impact:
  - The European Council (EC) has agreed that Member States of the European Union (EU) should introduce systems of levies and taxes on financial institutions to set incentives to contain systemic risk.
  - The EC aims to ensure that any contribution by financial institutions is consistent with regulatory requirements and that the increased cost of funding is not passed on to customers in the form of higher lending rates/fees or lower interest on deposits.
- Achieving global accounting standards:
  - A single set of high quality global and independent accounting standards is to be achieved by June 2011, in recognition of the need for high quality and convergent accounting standards for a sound regulatory framework.
- Enhancing the institutional framework for macro-prudential supervision:
  - The European Systemic Risk Board (ESRB) is to be established in January 2011, once the relevant legislation is passed.
  - ESRB will be responsible for the macro-prudential supervision of the EU financial system.
  - The primary role of ESRB will be to monitor, identify and assess risks to the stability of the EU financial system, across countries and financial sectors, in consideration of global developments.
  - ESRB will be required to issue risk warnings and make policy recommendations for remedial action, if significant risks are identified.
- Formulating a banking resolution framework:
  - An EU banking resolution framework is being developed to ensure the orderly winding down of systemic and failing banks including cross border financial institutions.
  - Legislative proposals in this regard are expected to be developed by 2011.

Box 1 (*Contd.*)

- Issuing new directives:
  - The regulations on mandatory registration and oversight of credit rating agencies adopted by the EU in 2009 are to be further modified to grant the European Securities and Markets Authority full supervisory powers over the credit rating agencies.
  - The EC has proposed a Directive on Alternative Investment Fund Managers, dealing with the oversight and registration of hedge funds, to ensure they have adequate risk management practices and to impose disclosure requirements.
  - The EC has issued a directive incorporating the 'Principles for Sound Compensation Practices' developed by the Financial Stability Board. The EU is actively involved in developing further implementation standards aligning compensation with long term value creation, whilst discouraging excessive risk taking in the short term.
- Developing financial market infrastructures:
  - Priority is being given to developing financial infrastructures in markets, such as the Over the Counter (OTC) derivatives markets, where they are not yet sufficiently used or available.
  - The use of central counterparties (CCPs) is being promoted to reduce counterparty and operational risk, whilst reporting of all trades to centralised trade registries is being mandated to enhance market transparency.
  - Several countries are in the process of developing legislation for OTC derivatives, CCPs and trade registries, in recognition of the need for globally consistent requirements to ensure the safety and soundness of financial infrastructure.
  - The international standards for financial market infrastructure are also being reviewed by the Committee on Payment and Settlement Systems and International Organization of Securities Commission.

Regulatory Reforms in the US

The Federal Reserve (FED) and other US agencies have made a significant effort to advance the goals of international regulatory reform. Meanwhile, changes to the domestic US regulatory and supervisory regime were signed into law as the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 on 21 July 2010.

The key features of the Act are:

- Establishes the FED as the systemic risk regulator and supervisor of all financial institutions that are considered 'too-big-to-fail'.
- Creates a Financial Stability Oversight Council, led by the Treasury Secretary, to coordinate the detection of risks to the financial system.
- Includes a new resolution mechanism empowering the government to liquidate any troubled company, irrespective of size or complexity, whose failure might threaten the stability of the financial system.
- Imposes prudential regulations on bank and non bank derivatives dealers and strengthens the resiliency of the financial market infrastructure by mandating increased central clearing and transparency for over the counter derivative transactions.
- Creates a powerful new regulator, the Consumer Financial Protection Agency, with rules to curb abusive lending and to oversee nearly all consumer financial products.

Future of global financial reforms

It is expected that the various initiatives for financial reforms initiated across the globe, both individually and collectively, will promote the adoption of strong, common regulatory standards to enhance financial stability, increase the exchange of information between international regulator and supervisors, whilst reducing opportunities for cross border regulatory arbitrage. Thus, it is hoped that international cooperation will be further reinforced towards achieving the common goal of global financial stability.

2. Macroeconomic Environment

- The global economic recovery is proceeding with Asia leading the recovery. However, some slowing down of global economic activity is anticipated during the second half of 2010 through the first half of 2011, with the economic recovery in the US now proceeding at a modest pace, while fiscal consolidation measures being put in place in some European countries are expected to dampen the pace of recovery in Europe.

- Advanced economies of North America and Europe continue to face a low inflation environment, given their resource slack. Emerging Asian economies as well as advanced economies in the Asian region that have benefited from the strong recovery of emerging Asian countries however, have begun to take monetary policy action to counter rising demand pressures alongside robust economic activity.

- Growth prospects for the Sri Lankan economy have shown a notable improvement following the commendable growth in the first half, which indicates the sustained growth momentum in the economy.

- International trade has remained buoyant and is expected to gather pace in tandem with the global economic recovery. The trade deficit was curtailed to a great extent by the robust inflows of inward remittances while foreign fund inflows to the government helped raise the surplus in the balance of payments.

- Credit flows to the private sector remain muted on account of subdued economic activity and stringent credit policies of banks to minimise non-performing loans. However, the decline in lending rates particularly following the recent measures to reduce lending rates of state banks, is expected to stimulate credit growth.

- The overall fiscal situation is expected to improve in 2010 as a result of the increase in government revenue with the pickup in domestic economic activity and international trade and prioritised government spending.

- Conducive credit conditions including the lower interest rates have fostered a sustained expansion in credit flows to the private sector.

- Inflation in Sri Lanka has remained broadly stable thus far in 2010 and is expected to remain at around 6 per cent in the forthcoming months.

2.1 World Economy

Economic Growth

The World Economic Outlook issued by the International Monetary Fund (IMF) in October 2010, has raised projections for global output in 2010 to 4.8 per cent. Economic activity continued to strengthen worldwide but the strong growth in emerging and developing countries anchored world economic growth while advanced economies indicated a moderate but sustained recovery. Emerging and developing economies are expected to grow by 7.1 per cent strongly supported by China and India while advanced economies are projected to expand at 2.7 per cent. Although growth projections for the euro zone have also been notched up, sovereign debt issues have raised downside risks.

Table 2.1 Economic Growth Prospects

(per cent)

Region / Country	2008	2009	2010 (Proj.)	2011 (Proj.)
World	**3.0**	**-0.6**	**4.8**	**4.2**
Advanced Economies	**0.5**	**-3.2**	**2.7**	**2.2**
USA	0.4	-2.4	2.6	2.3
Euro Area	0.6	-4.1	1.7	1.5
UK	0.5	-4.9	1.7	2.0
Japan	-1.2	-5.2	2.8	1.5
Emerging and Developing Economies	**6.1**	**2.5**	**7.1**	**6.4**
Developing Asia	7.7	6.9	9.4	8.4
China	9.6	9.1	10.5	9.6
India	6.4	5.7	9.7	8.4

Source : World Economic Outlook – October 2010

Inflation

Following the low inflation experienced in the previous year, prices firmed in 2010 in line with the tepid recovery in the global economy. However, in advanced economies, excess capacity continues to suppress demand pressures although inflation in these economies is expected to pick up from the near zero levels that prevailed in 2009. The currently projected global inflation rate at 1.4 per cent is below initial expectations on account of the fragile recovery. Developing Asia is experiencing higher price levels in 2010 alongside its robust economic recovery. India is already experiencing double digit inflation.

Table 2.2 Inflation Prospects

(per cent)

Region / Country	2008	2009	2010 (Proj.)	2011 (Proj.)
Advanced Economies	**3.4**	**0.1**	**1.4**	**1.3**
USA	3.8	-0.3	1.4	1.0
Euro Area	3.3	0.3	1.6	1.5
UK	3.6	2.2	3.1	2.5
Japan	1.4	-1.4	-1.0	-0.3
Developing Asia	**7.4**	**3.1**	**6.1**	**4.2**
China	5.9	-0.7	3.5	2.7
India	8.3	10.9	13.2	6.7

Source : World Economic Outlook – October 2010

Inflation Expectations

The disturbance in financial markets over the sovereign debt crisis in the euro zone has added fears of a possible deflation if it destabilised the recovery underway, especially in the advanced economies. Curbed global demand as a result of the uncertainties arising from the debt crisis reigned in prices of key commodities in the international market, thus delaying the build up of supply side pressures. In October, the IMF revised downwards its baseline projection for petroleum from US dollars 80 to US dollars 76.2 a barrel in 2010. However, supply side disturbances that subsequently came into being could exert some pressure on near term inflation. Although world cereal production remains at high levels, international cereal prices have taken an increasing trend, led by shortages in the wheat supply as crops of leading producers in the Commonwealth of Independent States were affected by adverse weather conditions. The Food Price Index compiled by the Food and Agriculture Organisation (FAO) have increased sharply in the third quarter following the trend in wheat prices as well as prices of sugar and oil seeds. These developments could lead to higher prices in the forthcoming months before improvements in supply would negate price pressures.

Inflation pressures overall, however, are expected to remain subdued in the advanced economies as normalcy is restored. Developing and emerging economies could foster an uptrend in inflationary pressures earlier as they experience more robust activity. Cautious implementation of monetary policy could therefore be expected in developing and emerging economies to rein in inflation and inflation expectations in the medium term.

Monetary Conditions

Monetary conditions remain varied in accordance with the progress of recovery in each economy. Central Banks of advanced economies continued with an accommodative monetary policy stance. However, many central banks, particularly in the Asian region, have commenced unwinding the extraordinary policy stimulus extended in support of economic activity in the face of deteriorating economic conditions during the preceding years.

The Bank of Japan implemented a comprehensive monetary easing strategy where amongst other measures, a virtually zero interest rate policy will be maintained. Several other advanced economies, including the United States and some European countries, continued to maintain a relaxed monetary policy stance on account of the fragile economic conditions and the passive outlook for inflation as spare capacity continues to exist in their economies. These countries are expected to continue with lax monetary conditions, thus supporting to uphold industrial production, consumer confidence and employment growth, which are yet to depict stability. In fact, the United States announced a fresh round of quantitative easing in November 2010 to further support the economy. Several other advanced economies such as Australia commenced tightening monetary policy from the latter part of 2009 as inflationary pressures became more pertinent. Since October 2009, Australia has increased the benchmark Cash Rate by 175 basis points.

Tightening of monetary policy was more visible across the Asian region where strong recovery set in possibilities of inflationary pressures emerging in the upcoming period. India, which continued to experience double digit inflation, raised its repo rate by 150 basis points in several steps in 2009 and 2010 to combat inflationary pressures as well as to anchor inflation expectations. Pakistan, also experiencing double digit inflation, revised its policy rate upward by 100 basis points during August-November 2010. Similar measures have been taken by South Korea, Malaysia and Thailand with the intention of restraining price pressures early on. In order to curb rising demand pressures, China also raised its statutory reserve ratios applicable to banks, at several occasions in 2010, thereby inducing increases in market interest rates.

Global Financial Markets

Gradual recovery underway in the global financial markets was hit by a fresh wave of instability as sovereign risk issues in the euro zone came into light. As credit risk heightened and investors' risk appetite dipped, banks showed a reluctance to lend, once more locking credit markets. As a result, the price of some financial assets has become volatile while recourse to traditional assets such as US Treasury Securities, German federal bonds and gold have, in turn, increased their value. Lower risk appetite of investors could also impede capital flows to emerging and developing economies, affecting their growth prospects.

Spreads of sovereign debt widened following the debt crisis. Spreads between the directly affected Greek, Portuguese and Irish sovereign debt and German debt widened substantially until the European Central Bank announced a securities purchase programme. However, as of late, a divergence has recurred as the effects of the intervention appears to be tapering off. Uncertainties about the degree of banks' exposure to sovereign debt have given rise to counterparty concerns and funding constraints. Stunted growth in lending would also give rise to fresh concerns over the progress of economic recovery. At the same time, the demand for short term dollar funding is high as money market funds in the US have curtailed their exposure to European financial institutions, thus trimming dollar inflows. The foreign exchange swap lines reinstated by the Federal Reserve could alleviate pressure to some extent. At a broader level, the policy challenges in the euro zone would need to be addressed with multifaceted solutions so that the economies would be kept buoyant while resolving the crisis and ensuring sustainability.

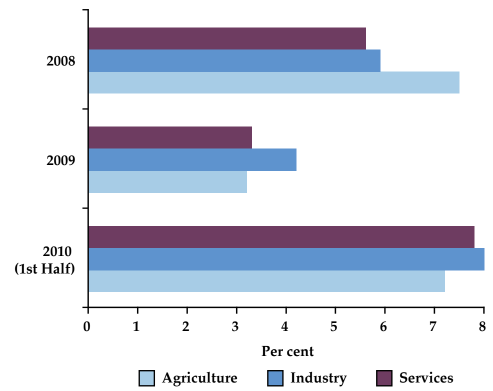
2.2 Domestic Macroeconomic Developments

Economic Growth

The Sri Lankan economy is projected to move to a higher growth path of about 8.0 per cent in 2010 over the slowdown in economic activity during 2009. During the first half of 2010, the economy grew by 7.8 per cent with higher growth in all major sectors. Further, the higher growth momentum is expected to continue during the second half of the year as well in the backdrop of the ending of the internal conflict and gradual recovery of the global economy.

The recovery in economic activity was witnessed in all major sectors during the first half of the year. The Agriculture, Industry and Services sectors recorded growth rates of 7.2 per cent, 8.0 per cent and 7.8 per cent, respectively, during the first half of 2010. The conducive environment

Chart 2.1 Sectoral Growth Rates



Source : Department of Census and Statistics

for economic growth with improved investor confidence, increased market access and public sector investment activities in identified sectors would pave the way in maintaining a higher growth momentum during 2010 and beyond.

External Sector Developments

The external sector remained buoyant during the first ten months of 2010 strengthened by the gradual recovery of the global economy, improved financial market conditions and increased investor confidence. Sri Lanka's ability to project itself strongly in the international financial and capital markets was enhanced with the graduation of the country into a middle-income emerging market status by IMF in January 2010.

The deficit in the current account in the first ten months of 2010 was mainly attributed to the widening trade deficit on account of the increase in import expenditure due to both higher volumes and prices, of which, the most notable was the price of oil. External trade, which was affected by the global economic crisis in 2009, rebounded during the first ten months of 2010. While the better investment climate and the removal of the war risk premium on re-insurance helped exporters, the slower recovery of global demand weighed down on export potential. Year-on-year earnings from exports grew by 13.2 per cent to US dollars 6,505 million during the first ten months of 2010 led by higher earnings from industrial exports. Earnings from agricultural exports also increased as tea, rubber and other agricultural crops continued to fetch higher prices in the international markets. Expenditure on imports increased by 34.1 per cent, year-on-year, to US dollars 10,970 million during the first ten months of 2010 due to the higher commodity prices in the international market, domestic policies such as the tariff revisions on imports of gold, electronic goods and motor vehicles which encouraged imports, and the reconstruction and rehabilitation activities in the Northern and Eastern provinces. As expenditure on imports exceeded the earnings from exports, the trade deficit expanded. Both, earnings from exports and expenditure on imports, are expected to increase towards the latter part of the year.

The deficit in the trade account was partially offset by the higher inflows of workers' remittances and surplus in the services account. Sharp revival in tourism, expansion of freight and port related activities sustained the upturn in the services sector. Facilitated by the measures taken by the government to enhance inward workers' remittances, these inflows constitute an important and stable source of external financing for Sri Lanka. Remittances in 2010 have increased notably, with inflows increasing by 21.9 per cent to US dollars 3.4 billion in the first ten months of 2010 compared to the corresponding period of 2009. The current account, which stood at a surplus of US dollars 339 million in the first nine months of 2009, recorded a deficit of US dollars 935 million by end September 2010.

Foreign fund inflows to the government in the form of loans, grants and investments in government securities increased during the first nine months of 2010. Improved outlook for the domestic economy coupled with lower international interest rates helped attract higher foreign inflows to the government securities. The positive investor sentiment was further strengthened with the approval of the third and fourth tranches simultaneously under the IMF-SBA facility in June 2010 and the fifth in September 2010. Thus, the higher inflows to the capital and financial account resulted in the overall Balance of Payments (BOP) recording a surplus of US dollars 0.9 billion by end-December, 2010. As a result, gross official reserves (excluding ACU receipts) increased by 37.2 per cent to US dollars 6.6 billion by end-December 2010 from US dollars 5.1 billion at end 2009. The receipts under the IMF-SBA facility in 2010, receipts of the cash component of project loans and grants, and net absorption of foreign exchange from the domestic foreign exchange market have contributed to the improvement in the level of official reserves. Further, the Central Bank has entered into foreign currency swap transactions with commercial banks for the purpose of managing excess rupee liquidity and the outstanding of such swaps by end-December 2010 was US dollars 97 million. Reserves, including those locally placed foreign currency swaps, amounted to US dollars 6.7 billion by mid-October 2010, which was equivalent to 6.2 months of imports.

The exchange rate policy in 2010 is aimed mainly at maintaining stability in the domestic foreign exchange market. The rupee continued to appreciate gradually against the US dollar during the year. In addition to the receipt of three tranches under the IMF-SBA in 2010, and inflows on account of the third sovereign bond issue maintaining macroeconomic, social and political stability was also instrumental in creating a positive market perception in support of the rupee in the foreign exchange market. Meanwhile, the rupee has been appreciating gradually against most major currencies except the Japanese yen. The Real Effective Exchange Rate (REER) also appreciated during 2010, resulting from the relatively higher inflation differentials between Sri Lanka and its trading partners and the moderate appreciation of the rupee.

Fiscal Sector Developments and Government Debt

According to the revised estimates for 2010, government revenue and grants is expected to increase by 14 per cent to Rs. 828 billion (14.9 per cent of GDP) and total expenditure and net lending is estimated to increase by about Rs. 73 billion to Rs. 1,275 billion (23 per cent of GDP). Accordingly, the overall budget deficit as a percentage of GDP is expected to decline to 8 per cent from 9.9 per cent in 2009.

During the first ten months of 2010, total government revenue increased by 15 per cent to Rs. 660.3 billion, from Rs. 575.8 billion recorded in the corresponding period of 2009. As a percentage of GDP, it remained at 11.9 per cent. Foreign grants received during the first ten months of 2010 were Rs. 11.6 billion compared with Rs. 21 billion in the same period of 2009.

Meanwhile, total government expenditure and net lending increased by 7 per cent to Rs. 1,048.7 billion during the first ten months of 2010, from Rs. 981.3 billion recorded in the same period of 2009. Recurrent expenditure grew marginally by 3 per cent to Rs. 787.4 billion, while capital expenditure and net lending increased significantly by 20 per cent to Rs. 261.3 billion during this period compared to the same period in the previous year. However, as a percentage of GDP, recurrent expenditure declined to 14.2 per cent during this period in 2010 from 15.8 per cent in the same period in 2009, while capital expenditure and net lending increased to 4.7 per cent in 2010 from 4.5 per cent in the previous year.

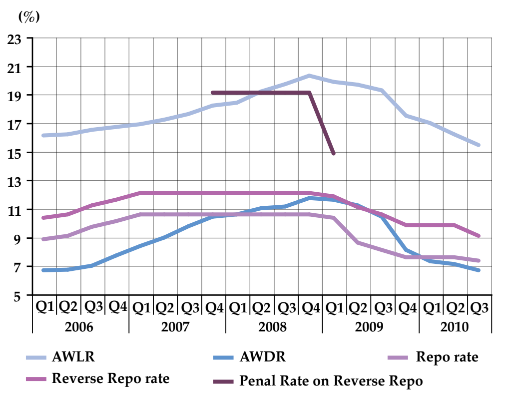
The overall budget deficit in the first ten months of 2010 is estimated to be Rs. 376.7 billion (6.8 per cent of GDP). This was financed with Rs. 162.1 billion from domestic sources and Rs. 214.6 billion from foreign sources. During this period, government borrowing from the banking sector amounted to Rs. 19.9 billion compared with the Rs. 48.2 billion recorded in the first ten months of 2009. The outstanding government debt increased by Rs. 414.2 billion to Rs. 4,575.6 billion by end October 2010 from December 2009. Domestic debt increased by Rs. 146.3 billion to Rs. 2,547.2 billion, while foreign debt increased by Rs. 267.9 billion to Rs. 2,028.4 billion during this period.

According to the budget for 2011, the overall budget deficit is expected to decline to 6.8 per cent of GDP from 8 per cent of GDP expected in 2010. Total government revenue and grants in 2011 is expected to increase by 19 per cent to Rs. 986.1 billion. As a percentage of GDP, government revenue and grants is expected to increase to 15.6 per cent in 2011 from the revised estimate of 14.9 per cent for 2010. Total expenditure and net lending is estimated to increase by 11 per cent to Rs. 1,419.9 billion in 2011 from Rs. 1,275 billion in 2010. However, as a percentage of GDP it is expected to decline to 22.4 per cent in 2011 from 23 per cent in 2010.

Monetary Sector Developments

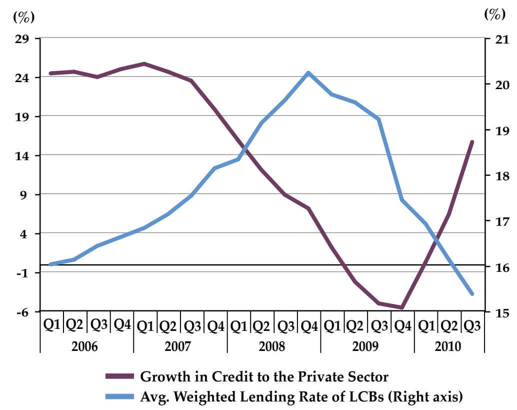
The Central Bank relaxed its monetary policy stance further in 2010, continuing with the monetary policy easing carried out in the previous year. Following the policy direction set by the revision in policy rates in 2009, market interest rates adjusted downwards in the first half of the year. The policy rates were brought down further in July and August, given the benign inflation pressures in the economy, to propel the downward adjustment in market rates. The Repurchase rate was reduced by 25 basis points to 7.25 per cent while the Reverse Repurchase rate was reduced by 75 basis points to 9.00 per cent, by end August 2010. Following the direction set by the policy rates, the market interest rate structure has moved downwards although some lending rates, in particular, have exhibited a sluggish adjustment. The Central Bank has urged financial institutions to adjust their lending rates to reflect a full adjustment to changes in the policy rates. This would enable the

Chart 2.2 **Policy Rates of the Central Bank and Deposit and Lending Rates of Commercial Banks**



Source : Central Bank of Sri Lanka

Chart 2.3 **Lending Rates and Performance in Credit to the Private Sector**



Source : Central Bank of Sri Lanka

public to enjoy the benefit of the low interest rate environment induced by a positive outlook for inflation while encouraging economic activity.

Domestic Credit

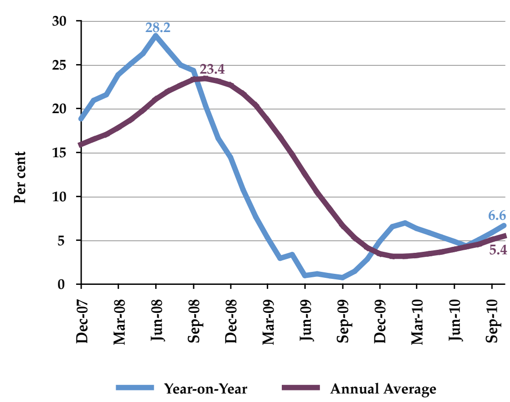
The improvement in credit conditions, supported mainly by the drop in market lending rates, together with the recovery in economic activity, which led to an increase in demand for credit, saw to a gradual improvement in credit flows. Credit flows, which contracted during much of 2009, turned around but growth remained weak during the early part of 2010. However, it gathered momentum towards the second quarter, recording a year-on-year growth of 20.3 per cent in October since recording a positive growth of 0.04 per cent in March 2010, thus asserting the sustained recovery. Current monetary conditions indicate scope for further expansion in credit and it is expected that credit would increase further in the forthcoming period with the pickup in economic activity.

Inflation

Inflation, as measured by the year-on-year change in the CCPI (2002=100), remained broadly stable in 2010 subsequent to the sharp decline in 2009. Year-on-year inflation, which was at 4.8 per cent at end 2009, was 6.6 per cent in October 2010. The continued absence of significant upward pressures from imported commodities in the aftermath of the global economic crisis as well as benign demand pressures in the domestic economy have caused inflationary pressures to remain subdued. As such, inflation is expected to remain within single digit levels, at around 6 per cent, in the forthcoming months.

A resurgence of upward pressures is, however, plausible as the world economy returns to normalcy and demand picks up. The Central Bank would be vigilant to these developments and implement its monetary policy cautiously to avoid such price pressures becoming broad based, thus avoiding the possibility of inflation rising in 2011.

Chart 2.4 **Movements in Inflation**



Source : Department of Census and Statistics

3. Financial Markets

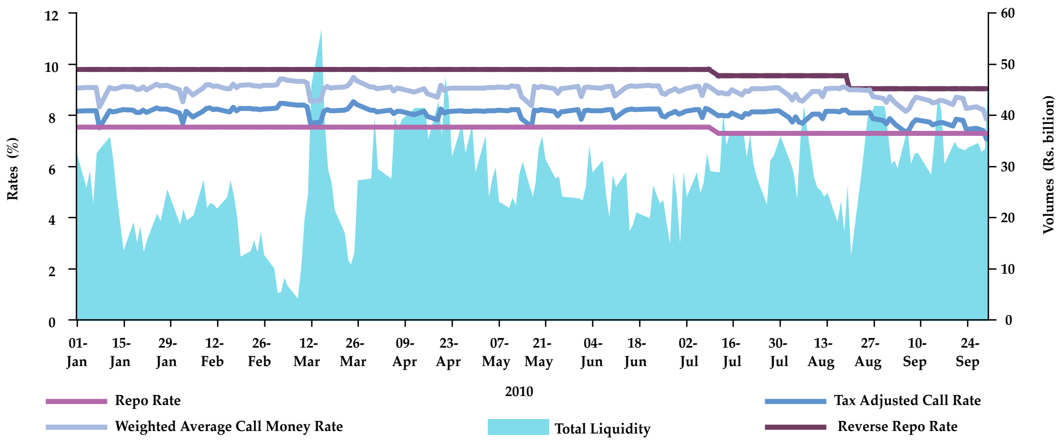
- Inter-bank call market interest rates were less volatile during the year despite persistent excess liquidity in the money market.
- The foreign exchange market witnessed a gradual appreciation of the Sri Lankan Rupee vis a vis the US$ and an appreciable build-up of external reserves.
- Yields in the government securities market showed a marked decline with the easing of monetary policy and decline in inflation.
- The equity market continued its upward momentum with a surge in price indices, enabling the Colombo Stock Exchange to maintain its ranking as one of the best performing market in the world. The market became volatile in the 4Q/2010 following a regulatory policy decision to prohibit brokers from providing credit facilities from 2011.

3.1 Inter-bank Call Money Market

The inter-bank call money market is extremely important in the financial system and plays a key role in the execution of monetary policy. It allows liquidity to be readily transferred from banks with a surplus to banks with a deficit. The interest rates in the call money market are highly sensitive to demand and supply factors and it is presumably the most closely watched variable in day-to-day conduct of monetary operations. Short-term interest rates serve as the main operational target for monetary policy implementation with the CBSL striving to maintain short-term interest rates along with the middle of the policy rate corridor. The stability of the money market is influenced by overall liquidity in the banking system, distribution of liquidity among banks, monetary policy decisions and operations of the Central Bank. Thus, a stable and orderly functioning money market is vital for minimizing the liquidity risk in the entire banking system. The call money market is a non-collateralized inter-bank dealer market for overnight funds and as such it involves credit risks.

During the first nine months of 2010, short-term interest rates were fairly stable, although persistent excess liquidity exerted downward pressure on the rates. Efficient liquidity management to absorb excess liquidity on a permanent and term basis, through overnight repurchase auctions, outright sale of government securities, issue of CBSL securities and Foreign

Chart 3.1 Volumes and Rates in the Money Market



Source : Central Bank of Sri Lanka

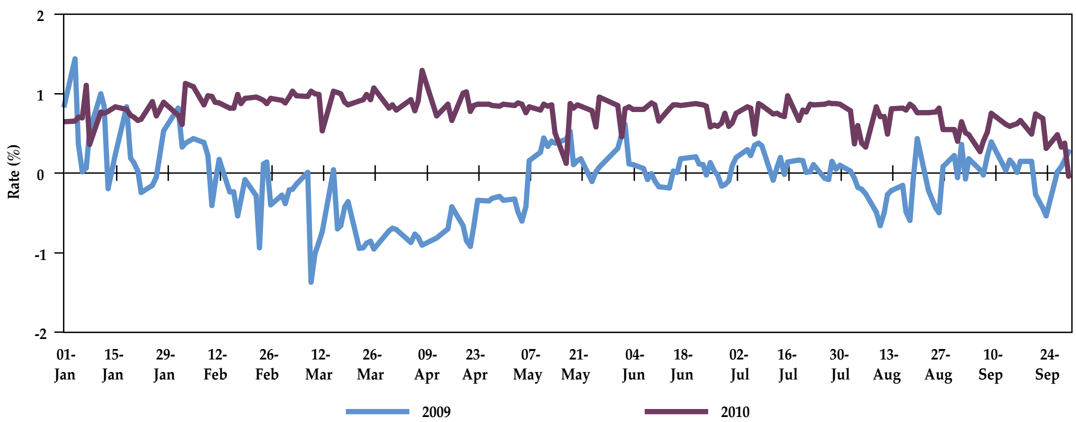
Exchange swaps, was mainly responsible for this development. However, liquidity management was constrained by the slow growth of private sector credit demand, idle investible funds in the banking system and continued foreign currency inflows that required sterilization by the CBSL to lessen the volatility in the value of the rupee.

Excess liquidity, a feature of the money market since June 2009, continued to persist in 2010. At the beginning of 2010, surplus liquidity in the market amounted to Rs. 33.05 billion. Daily excess liquidity varied from Rs. 4.42 billion to Rs. 57.06 billion with an average of Rs. 27.67 billion. The market experienced a liquidity surplus, even during the period of the Sinhala and Tamil New Year festive season, when the demand for currency was seasonally high. On a monthly basis, average daily liquidity in April at around Rs. 37.32 billion was higher than in other months. However, market liquidity reached its peak level in March. At the end of the first nine months, the total outstanding excess liquidity in the banking system was well above Rs. 132 billion. The transaction volumes of the call market, which were relatively low during the first half of 2010, were observed to be more active thereafter. The gross volume of inter-bank call money market transactions ranged between Rs. 0.06 billion and Rs. 9.08 billion during the year.

Call money market rates showed low volatility, moving between 7.97 per cent and 9.43 per cent with an average of 8.92 per cent, indicating the stability of the market during the first nine months of 2010. However, the tax-adjusted call money rate hovered around the lower quadrant of the interest rate corridor formed by repurchase and reverse repurchase rates. The policy rate corridor, which ranged between 7.50 per cent and 9.75 per cent during the first half of 2010, was revised downward to 7.25 per cent and 9.00 per cent in July and August. The spread between minimum and maximum call money rates, which was as high as 200 bps (basis points) on average during the first nine months of 2009, narrowed down significantly to 62 bps on average during the same period in 2010 reflecting the continued improvement of the stability in the money market as well as availability of adequate funds among all market players.

On average, the spread between the inter-bank weighted average call money rate and the weighted average overnight market repurchase rate was about 75 bps during the period up to September 2010 (Chart 3.2). This was mainly

Chart 3.2 Spread between Call Rates and Repo Rates – 2009 & 2010



Source : Central Bank of Sri Lanka

attributed to (*a*) skewness of excess liquidity towards the big players, (*b*) structural issues such as issue of commercial banks' internal limits on investment in government securities and (*c*) lack of interbank borrowers due to the availability of ample excess liquidity in the market compelling them to park their excess funds in the central bank. In contrast, this spread, which was mostly negative in first few months in 2009, turned to positive values thereafter reflecting fluctuating liquidity conditions and unexpected liquidity constraints of certain banks and resurgence of the market.

3.2 The Domestic Foreign Exchange Market

The gradual appreciation of the exchange rate of the Sri Lankan rupee commenced with the end of the conflict in mid July 2009 as a result of the increasing reserves arising from the IMF Standby facility and foreign investments in government securities and the equity market. This trend continued during the first nine months of 2010 as well. In order to mitigate the pressure arising from foreign exchange inflows to appreciate the Sri Lankan rupee, Central Bank of Sri Lanka had to intervene in the domestic foreign exchange market. The continuous intervention in the forex market has also contributed towards the increase in the reserve level of the country.

Inter-bank Foreign Exchange Market

Exchange Rate

The main factors influencing the performance of the inter-bank Foreign Exchange (FX) market during the first nine months of 2010 were the increase in worker remittances, foreign inflows to the government by way of loans and sale of Government Securities to non-residents and portfolio investments by foreigners through the share market. The monitoring of foreign currency transactions and overnight net open positions of commercial banks, moral suasion, prudential regulations and interventions in the domestic forex market were measures taken by the CBSL in order to maintain an orderly forex market.

CBSL purchased US dollar 647 million from the domestic forex market and sold US dollar 406 million resulting in a net purchase of US dollar 241 million during the first nine months of 2010.

The exchange rate of the Sri Lankan rupee in terms of US dollars reported as at 01.01.2010 was Rs.114.40 as compared to Rs.111.93 on

Chart 3.3 Movements of Rupee per USD (2005.01.01. – 2010.09.30)

Source : Central Bank of Sri Lanka

30.09.2010. Accordingly, the Sri Lanka rupee appreciated against the US dollar by 2.2 per cent during the first nine months of 2010. The Sri Lanka rupee appreciated against the Sterling Pound and the Euro, whereas it depreciated against the Indian Rupee and the Japanese Yen during the first 9 months of 2010.

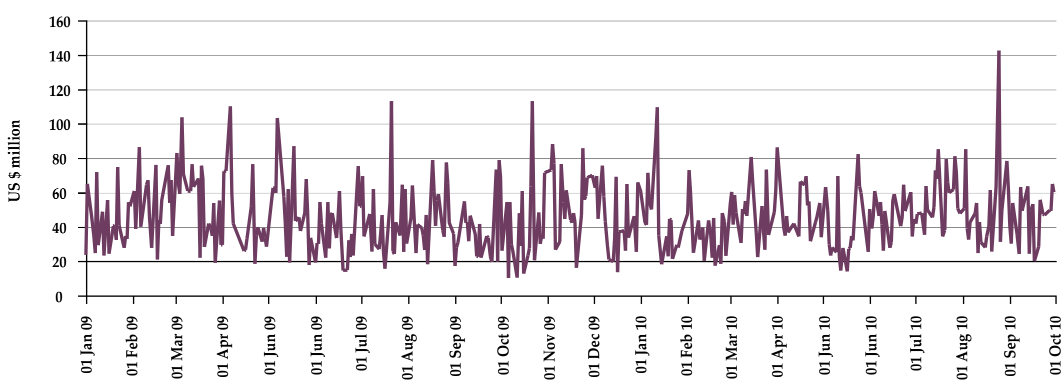
Trading Volume

The daily average turnover in the inter-bank FX market (including the forward market) was US dollar 47 million during the first 9 months of 2010, with a range of US dollar 14 million to US dollar 142 million. In the corresponding period of 2009, the daily average turnover was US dollar 45 million, with a range of US dollar 14 million and US dollar 113 million. The total volume of inter-bank FX transactions, including the forward market transactions, was US dollar 8,270 million in the first 9 months of 2010, in comparison to US dollar 8.088 million in the respective period of 2009 recording an increase of 2.2 per cent. The forward volume in the inter-bank FX market decreased to US dollar 2,831 million (34.4 per cent of total volume) during January to September 2010 from US dollar 3,366 million (41.6 per cent of total volume) in the corresponding period of 2009.

Foreign Reserve

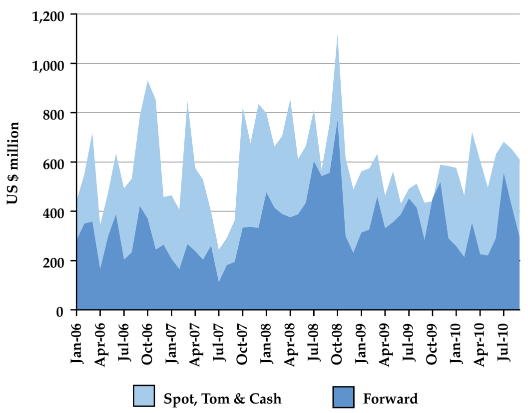
Maintaining a comfortable level of foreign reserves while mitigating excess volatility in the exchange rate has been a challenging task since major economies are still recovering from the difficulties faced due to the recent world economic crisis. However, CBSL was able to absorb foreign exchange from the domestic foreign exchange market, obtain two tranches of the IMF Standby arrangement and replenish the foreign reserves to a comfortable level during the first nine months of 2010. Accordingly, gross official reserves (without ACU funds) reached US dollar 5,989.2 million by end September 2010 recording an increase of 41.6 per cent over

Chart 3.4 Daily Inter-Bank FX Volume



Source : Central Bank of Sri Lanka

Chart 3.5 Monthly Inter-Bank FX Volumes



Source : Central Bank of Sri Lanka

US dollar 4,226.7 million reported during the corresponding period of 2009.

3.3 Treasury Bill Market

Treasury bills continued to be the most liquid and largely traded instrument operating in the financial market in 2010, reflecting their popularity as a repo market and short-term investment instrument. Interest rates in the Treasury bill market recorded a considerable reduction during the first ten months of 2010. Easing of the monetary policy, benign inflation, increased foreign investor participation in the Treasury bill market, excess liquidity position of the market and downward inflationary expectations could be cited as the main contributory factors lowering the rates in the Treasury bill market.

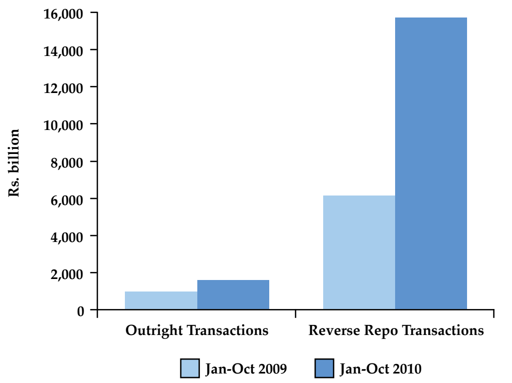
In the primary market, total gross Treasury bill issues amounted to Rs. 829.6 billion registering an increase of 17.8 per cent, while net issues at Rs. 61.8 billion rose by 76.1 per cent from a sum of Rs. 35.1 billion recorded in the same period of the previous year. The demand for short term maturities was higher during the beginning of the year given the highly speculative environment perceived by market participants. This trend was reversed during the latter part of the year with the shifting of the maturity profile of Treasury bill issues from 91 and 182 days to longer term one year Treasury bills. Consequently, at the end of October 2010, the maturity profile consisted of 72 per cent of 364 day bills, 25 per cent of 182 day bills and 3 per cent of Treasury bills less than 3 months old.

Treasury bill volumes traded in the secondary market increased during the first ten months of 2010 in comparison to the same period of the previous year. Secondary market transactions in Treasury bills amounted to Rs. 1,542 trillion for outright transactions and Rs. 15,681 trillion for repurchase transactions as at end October 2010. While the volume of outright transactions rose by 69 per cent during January – October 2010 in comparison to the corresponding period of the previous year, the volume of repo transactions increased by 157 per cent during the period under review in 2010. This increase was largely due to the shifting of maturity profile towards the shorter end and extending the forward dated transactions from 30 days to 364 days in the LankaSecure system.

The yield rates of Treasury bills in the primary market showed an overall declining trend during the year. Although the weighted average yield rates for all maturities increased from January to April 2010, yield rates began to decline thereafter up to October 2010. The primary market weighted average yield rates for 91 days, 182 days and 364 days Treasury bills which were 7.73 per cent, 8.73 per cent and 9.33 per cent at the beginning of the year, declined to 7.13 per cent, 7.25 per cent and 7.37 per cent respectively at end October 2010. The secondary market yield rates followed suit.

Foreign investments in Treasury bills recommenced after May 2009 as investor confidence built up with the end of the 30 year war, improvement in the macroeconomic conditions and the receipt of the IMF Standby arrangement facility. The total foreign investment

Chart 3.6 Secondary Market Transactions (Treasury Bills)



Source : Central Bank of Sri Lanka

in Treasury bills, in gross face value terms, increased by Rs. 13 billion during the first ten months of 2010.

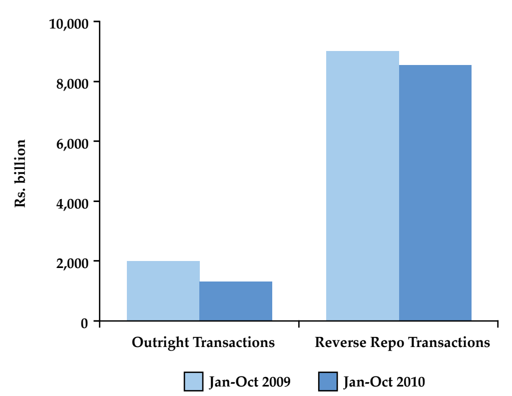
The Public Debt Department (PDD) continued to use fund mobilization techniques such as pre-funding arrangements, forward funding arrangements, reducing auction size, and issuing Treasury bills with odd maturities in addition to conventional maturities, to fund the Treasury cash flow operations during the first ten months of 2010. These strategies enabled the Central Bank to service the Treasury cash flow smoothly during the period under review.

3.4 Treasury Bond Market

Interest rates in the Treasury bond market s howed a significant downward movement during 2010. Primary auction yield rates for 2 and 4 year bonds were 9.55 per cent and 9.78 per cent at the beginning of 2010 as compared to 21.00 per cent and 20.10 per cent for 2 and 3 year bonds at the beginning of 2009. The decline can be attributed to the easing of monetary policy, lower inflation, increased foreign investor participation in the Treasury bond market and the liquidity surplus position that prevailed in the market during the first ten months of the year. Foreign investments in Treasury bonds recorded the highest level of Rs. 182.6 billion on a face value basis as at 31st October 2010, with an inflow of Rs. 37.9 billion during the first ten months of 2010. During this period, market players recorded a considerable marked-to-market gain arising from holding long-term bonds in a declining interest rate scenario. With these developments, the extension of the yield curve up to a 10 year horizon was witnessed, reflecting the long term investment view of the market.

Treasury bond volumes traded in the secondary market decreased during the first ten months of 2010 compared with the volumes traded in the same period in 2009, reflecting lower inflationary expectations. This decrease was observed in both outright transactions as well as repo and reverse repo transactions. Treasury bond repo and reverse repo transaction volumes in the secondary market at Rs. 8,522 trillion during the first ten months of 2010 decreased by 5 per cent over the corresponding period in 2009. Treasury bond outright transaction volumes in the secondary market declined to Rs. 1,299 trillion in the first ten months of 2010 from Rs. 1,980 trillion recorded in the same period in 2009. The decrease in repo transactions was partly due to the highly speculative environment experienced at the beginning of 2010 in the government securities market.

Chart 3.7 Secondary Market Transactions (Treasury Bonds)



Source : Central Bank of Sri Lanka

3.5 Corporate Debt Securities Market

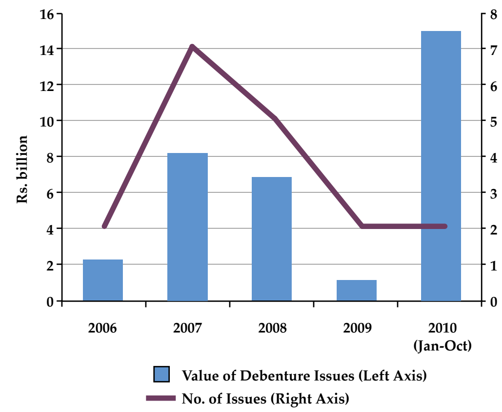
Commercial Paper Market

The corporate debt securities market was sluggish during the first nine months of the year. The total value of commercial paper issued with the support of banks amounted to Rs. 9 billion in the first nine months of 2010 in comparison with Rs. 18 billion in the same period of 2009. The interest rates declined significantly and varied between 9 to 14 per cent in the current year compared with the range of 13 to 36 per cent in the previous year. Commercial paper with a maturity of 3 months accounted for 84 per cent of the market, while the share of commercial paper with a 6 month and 12 month maturity were 14 per cent and 2 per cent respectively. The total outstanding value of commercial paper amounted to Rs. 4 billion as at end July 2010, compared with Rs. 6 billion at end September 2009.

Corporate Bond Market

The activities in the corporate bond market were also relatively limited due to narrow issuer and investor base. There were two issues of debentures during the first ten months of 2010.

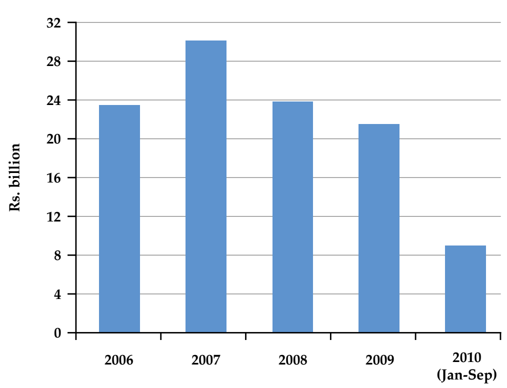
Chart 3.9 **Listed Debenture Issues**



Source : Colombo Stock Exchange

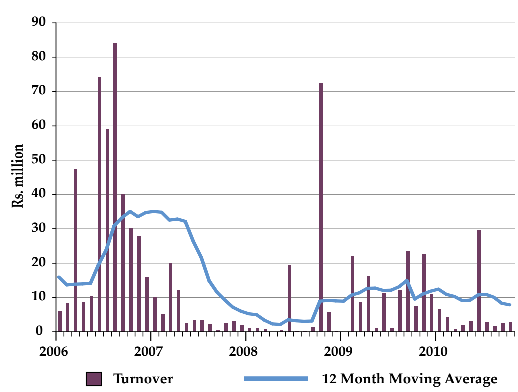
The Bank of Ceylon issued a 5 year debenture and mobilized Rs. 5 billion at a fixed rate of 11.5 per cent and a current floating rate of 10.67 per cent, in June 2010. The Urban Development Authority (UDA) also issued a 5 year debenture and mobilised Rs. 10 billion at a fixed rate of 11/10 per cent and a current floating rate of 8.47 per cent in October 2010. The turnover of debentures listed on the Debt Securities Trading System (DEX) of the Colombo Stock Exchange declined to Rs. 56 million during the first ten months of 2010 from Rs. 103 million in the same period of the previous year. There is a huge potential for the corporate bond market to grow and it is expected to develop with the declining

Chart 3.8 **Commercial Paper Issues by Commercial Banks**



Source : Central Bank of Sri Lanka

Chart 3.10 **Listed Corporate Bond Market (Monthly Turnover)**



Source : Colombo Stock Exchange

trend in market interest rates and the expansion in economic activity.

The asset securitization market which is also small has shown signs of growth. Trust Certificates are a popular instrument for the securitization of finance leasing and hire purchase receivables. There were 31 issues of Trust Certificates amounting to Rs.13 billion for the year up to October 2010 as compared to 26 issues and Rs. 6 billion mobilized in 2009.

3.6 Share Market

Sri Lanka's stock market continued to surge upwards in 2010, being a one of the best performing markets in the world. Investor sentiments were bullish during the year, propelling the market to record high levels. The price indices, market price earnings ratio and turnover of the Colombo Stock Exchange (CSE) rose markedly, particularly from April 2010 on the back of improved corporate earnings, continued stability on the political front, favorable trends in key macroeconomic variables such as GDP growth, interest rates, inflation and the exchange rate and increasing investor confidence in the prospect of future business expansion. The stock market upturn was driven largely by domestic investors with increased credit facilities provided by brokers and margin traders.

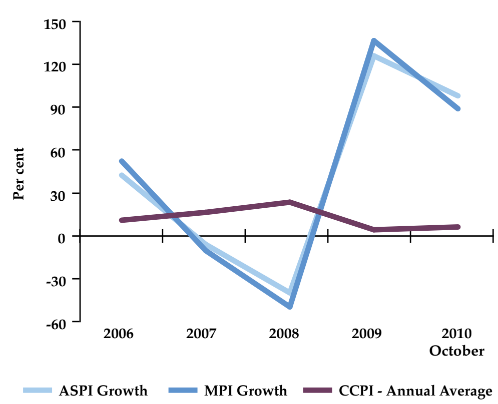
The All Share Price Index (ASPI) rose by 97 per cent and the Milanka Price Index (MPI), which is composed of the 25 most traded stocks, increased by 88 per cent at end October 2010. Both indices peaked in September 2010 and reached the 7,000 mark. The growth of the ASPI in the current year far exceeded its average annual growth rate of 24 per cent for the period 1999 – 2009. The market volatility of both price indices declined in 2010 compared with the previous year.

The price indices of all sectors made gains. Of the large sectors, the price indices of Banks, Finance & Insurance, Diversified Holdings, and Beverage Food & Tobacco out-performed the ASPI. The smaller sectors that made large gains were Trading, Stores Supplies, Motors, Services, Oil Palms, Plantations, Footwear & Textiles, Chemicals and Hotels & Travels.

The market capitalisation of the CSE more than doubled to Rs. 2.2 trillion at end October 2010 from the Rs.1 trillion at end 2009. The market capitalisation of the CSE (238 companies listed) has risen to about 42 per cent of GDP at end October 2010 from 23 per cent at end 2009. The size of the CSE is relatively small by regional standards (Table 3.1). The Banking, Finance & Insurance sector accounted for the largest share of market capitalisation at 23 per cent, while the share of Diversified Holdings was 22 per cent, Food Beverage & Tobacco was 12 per cent and Hotels and Travels 10 per cent. The five largest companies accounted for 75 per cent of the market capitalisation.

The market price earning (PE) ratio of the CSE rose to 28 in September 2010 from 16.5 at end 2009 and declined to 25 at end October 2010. The current market PE is significantly above its long term average annual of 10 for the period 1999–2009. The current market PE ratio of the CSE is similar to those of other Asian stock exchanges such as the Dhaka Stock Exchange (26) and the Bombay Stock Exchange (23).

Chart 3.11 ASPI, MPI and CCPI Growth Rate



Source : Colombo Stock Exchange

Table 3.1 **Market Capitalisation to GDP Ratio and Market Turnover Velocity Ratio Selected Asia-Pacific Countries**

Exchange	Market Capitalisation as % of GDP		Market Turnover Velocity Ratio	
	2009	2010 (September)	2009	2010 (September)
Hong Kong Exchange	1,095	1,118	79	45
Singapore Exchange	255	262	67	40
Taiwan Stock Exchange	168	157	180	103
Malaysia Stock Exchange	146	153	34	24
Bombay Stock Exchange	102	101	27	14
Korea Stock Exchange	91	98	241	132
Tokyo Stock Exchange	65	60	119	83
Thailand Stock Exchange	65	79	90	70
Philippine Stock Exchange	52	67	20	15
Shanghai Stock Exchange	54	42	231	119
Indonesia Stock Exchange	36	46	51	27
Colombo Stock Exchange	23	42	18	27

Sources : World Federation of Exchanges
World Economic Outlook Database, October 2010
- International Monetary Fund

The higher market PE in 2010 reflects a number of factors; higher earnings potential of companies in the post-war era; higher investor interest in the stock market due to the lower interest rate environment; the small size of the market; and the limited number of shares available for trading. The PE ratios of most sectors in the CSE increased in 2010. Although, the PE ratios of the major sectors reflected economic fundamentals, a few sectors had very high PEs indicating that some price correction was likely in the future.

Market turnover rose markedly in 2010. The average daily turnover of the CSE increased to Rs. 2.5 billion during the first ten months of 2010 compared to Rs. 594 million in 2009. Domestic investors accounted for about 81 per cent of the turnover, 96 per cent of transactions and 89 per cent of shares traded on the CSE. Total foreign purchases amounted to Rs.80 billion, while total foreign sales were Rs.106 billion. This resulted in net foreign sales of Rs. 26 billion at end October 2010 as compared with net foreign purchase of Rs.2 billion for the same period in 2009, largely due to profit-taking by foreigners in September and October this year.

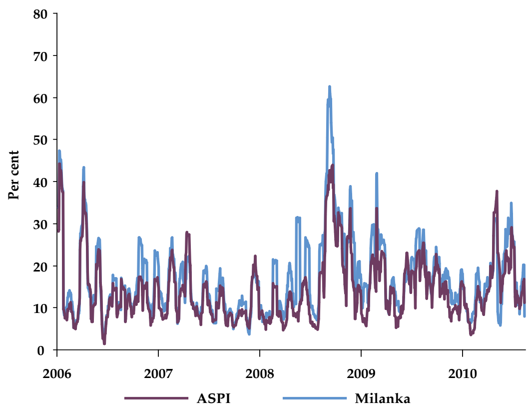
Table 3.2 **Sector Price Indices and Price Earning Ratios of Major Sectors of CSE [(a)]**

Sector	Price Indices			Price Earning Ratios (PERs)		
	2009 December	2010 October	Growth (%)	2009 December	2010 October	Growth (%)
Bank, Finance & Insurance	6,595	16,807	155	11	20	91
Diversified Holdings	1,133	2,299	103	22	32	43
Beverages, Food & Tobacco	5,363	10,791	101	15	22	45
Hotels Travels	2,843	5,263	85	73	106	46
Telecommunications	159	202	27	19	230	1,092
Manufacturing	2,014	3,303	64	19	20	3
Oil Palms	41,598	96,996	133	49	32	(35)
Investment Trusts	32,250	37,296	16	16	25	54
Plantations	636	1,287	102	12	20	71
Motors	7,215	25,676	256	37	66	80

(a) At end period

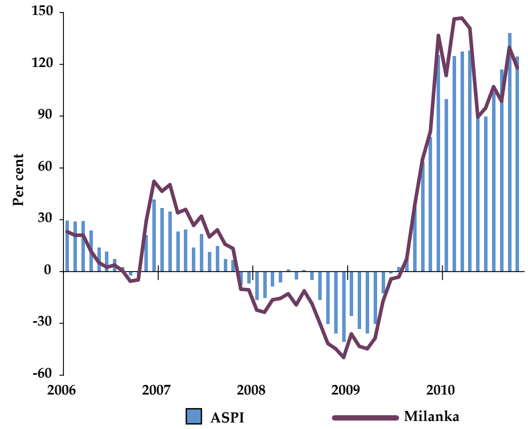
Source : Colombo Stock Exchange

Chart 3.12 Volatility in the Equity Market (CSE)



Source : Colombo Stock Exchange

Chart 3.13 Annual Growth in CSE Price Indices



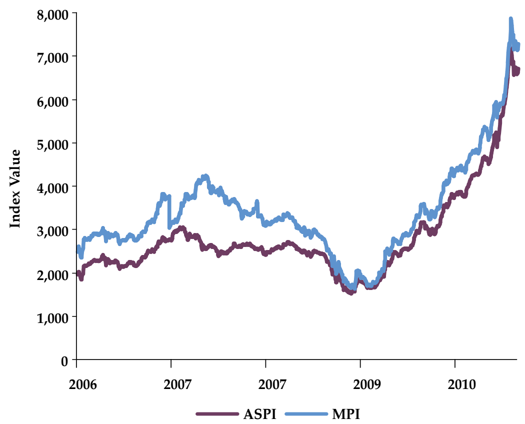
Source : Colombo Stock Exchange

The turnover velocity (the ratio of total turnover to average market capitalisation) was around 32 per cent in the first ten months of 2010. This is relatively low in comparison with other exchanges in the region (data on other stock exchanges). Low turnover velocity implies higher impact cost of trading and low participation levels. Market liquidity can be improved by increasing the volume of shares available for trading, introducing more products and expanding the investor base.

Another positive development was the significant increase in the quantum of funds raised by companies in the CSE. There were twenty (20) rights issues and eight (8) Initial Public Offerings (IPO) of shares, which raised Rs. 18 billion and Rs. 4 billion respectively in the first ten months of 2010.

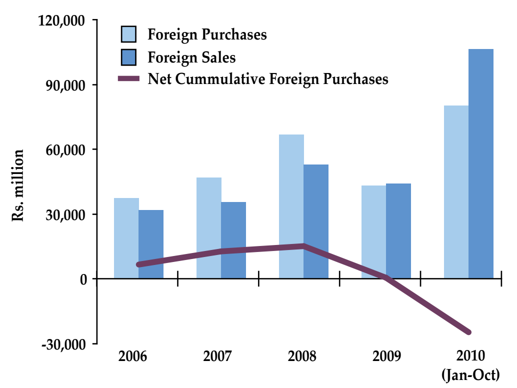
The Securities and Exchange Commission (SEC) introduced a number of measures to promote the growth of the stock market in a sustainable manner. In order to contain speculative trading, the SEC imposed a 10 per cent upward and downward "price band" on all listed securities within any trading day. The "price band" was subsequently revised to apply only to certain securities based on a formula relating to the price volatility of shares.

Chart 3.14 All Share Price Index and Market Capitalisation of CSE



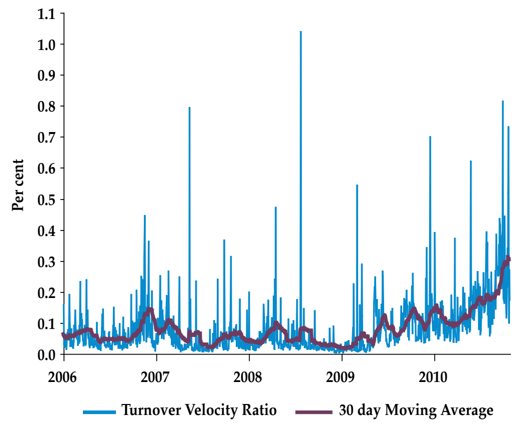
Source : Colombo Stock Exchange

Chart 3.15 Foreign Participation in the CSE



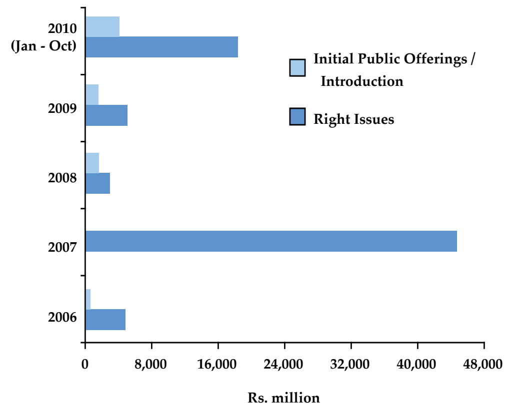
Source : Colombo Stock Exchange

Chart 3.16 Equity Market Turnover Velocity Ratio



Source : Colombo Stock Exchange

Chart 3.17 Funds Raised from the Colombo Stock Exchange (CSE)



Source : Colombo Stock Exchange

In addition, in order to tighten credit provision and to reduce settlement risk, the SEC announced that stock- brokers should refrain from extending credit facilities to customers beyond T+3, from January 2011. Other measures included the reduction in transaction costs, reduction in the tick-size of trades and increasing the crossings threshold.

In order to increase the volume of shares available for trading and to improve the liquidity of the market, the SEC is considering requiring companies to maintain a minimum public float of shares, at all times. A new automated market surveillance system will be introduced by the SEC in late 2010, which will improve the detection of manipulations by traders. Rules for the dematerialization of listed securities are also being prepared, for the Central Depository System (CDS) to achieve the status of full-dimaterialization by end of 2011.

The CSE issued internet trading guidelines to brokers to streamline internet trading procedures and to set out minimum standards that should be followed by brokers when enabling customers to trade through the internet. The Central Depository System of the CSE presently engages the services of four commercial banks for the purpose of settling secondary market transactions. The SEC maintains a Settlement Guarantee Fund to cover a potential settlement failure of a participant.

The SEC is involved in several initiatives to facilitate the development of the capital market. The draft bill for the Regulation of Asset Backed Securitization is awaiting passage through Parliament. The SEC also proposes to introduce new products such as Exchange Traded Funds (ETF) and financial derivatives in the form of futures and options. The establishment of a central counter-party clearing corporation is a prerequisite for derivatives trading on an exchange and the CSE has initiated action to set up the clearing and settlement arrangements. The central counter-party clearing system which will guarantee settlement and a delivery versus payment (DvP) system will also eliminate the settlement risk in market transactions. A comprehensive framework for the demutualization of the CSE is being prepared and the SEC Act will be amended to facilitate this reform. The demutualization of the CSE will segregate ownership and management from the trading rights of members of the exchange.

Box 2

Importance of Monitoring Land Prices

Introduction

Land is one of the assets where price behavior has a significant impact on the financial sector and real sector. The behaviors of assets prices are studied and monitored with a view to preventing asset bubbles. Interest rates, assets prices, wealth of the public and balance sheets of financial institutions are inter-connected. Interest rates and asset prices are considered to be negatively correlated. When interest rates are low, asset prices tend to inflate. Conversely, when the monetary policy is tightened with raising of interest rates to address high demand pressure due to low interest rates and credit expansion, asset prices tend to fall. During asset price inflation, financial institutions make profit through value gains, whereas demand in the economy increases due to the wealth effect on consumers. When the asset prices fall, financial markets, investors and financial institutions are adversely affected and such instances may even lead to financial crises and economic downturn. Therefore, monitoring of asset prices is one of the areas of the financial system stability framework. For this purpose, various asset price indices are monitored.

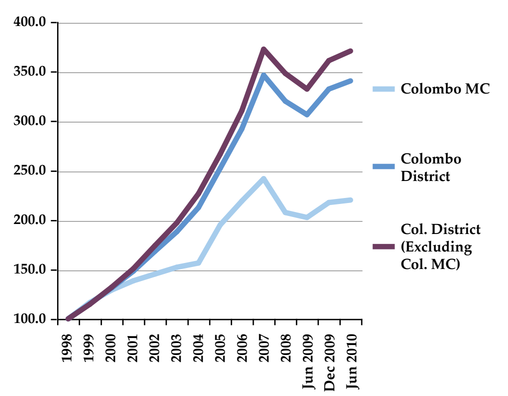
Land price indices for Sri Lanka

The CBSL initiated work on constructing land price indices using price data provided by the Valuation Department for Divisional Secretary (DS) divisions in the Colombo District. Accordingly, indices have been computed for the period from 1998 to June 2010, covering five DS divisions in the Colombo District. Land price data were collected from about 50 centers under these DS divisions. The indices are computed as an average of price relatives of the individual areas for which prices have been provided. In order to maintain homogeneity, three different types of indices, namely, residential, commercial and industrial lands, were computed separately, and are used for the analysis.

According to the computed indices, in general, over the last decade all type of land prices have increased substantially until 2007. Price increases in areas outside the Colombo Municipality have been significantly sharper, although price levels of these areas still remain well below that of the Colombo Municipality.

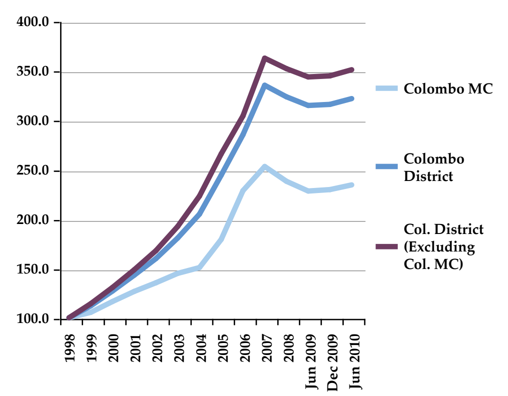
Residential land prices, which declined sharply after reaching a peak in 2007, have started to

Chart B2-1 Index for Residential Lands (1998=100)



Source : Central Bank of Sri Lanka

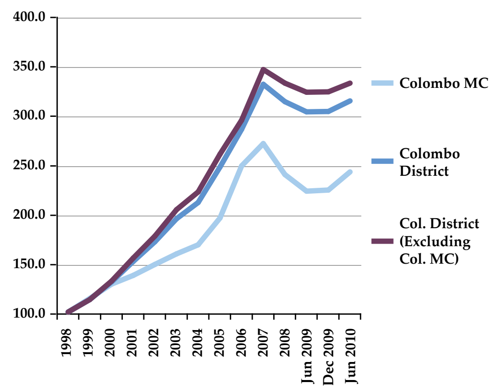
Chart B2-2 Index for Commercial Lands (1998=100)



Source : Central Bank of Sri Lanka

Box 2 (*Contd.*)

Chart B2-3 **Index for Industrial Lands (1998=100)**

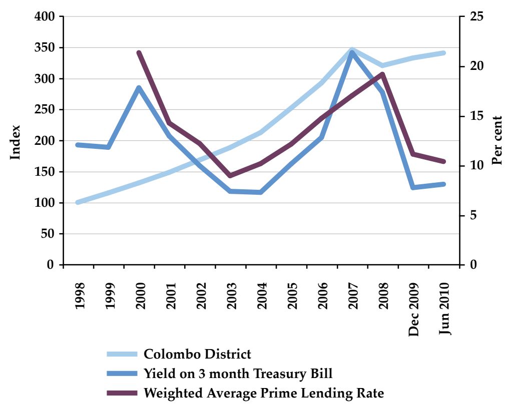


Source : Central Bank of Sri Lanka

rise again since June 2009. Industrial land prices also peaked in 2007 and have begun to increase since June 2009 in the Colombo Municipal area. It is observed that the recent price increases in industrial lands in the Colombo District as a whole are much less pronounced than in the Colombo Municipality in contrast to the situation that exists with regard to residential land. Prices in both residential and industrial land in the Colombo Municipal area remain below the peak levels achieved in 2007. Commercial land prices after declining during the period 2007 to June 2009 have only increased marginally since then.

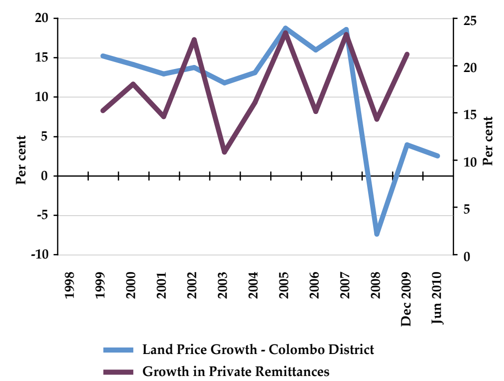
Chart 4 below indicates the movements in the Residential Land Price Index for the Colombo District and interest rates during the period 1998 and June 2010. It is clear that the reversal of the upward trend in land prices occurred when interest rates reached peak levels in 2007. On the other hand, Chart 5 which compares the growth rate in remittances with the growth in the Land Price Index also indicates that when private remittances increase the Residential Price Index also in general increases. As the interest environment is likely to be benign in 2011 an increase in a Land Price Index could be expected. Further, remittance income is expected to be robust during the next year as well and this would also push up the Land Price Indices. Accordingly Land Price Indices are unlikely to decline in the near future.

Chart B2-4 **Trends in Residential Land Price Index and Interest Rates**



Source : Central Bank of Sri Lanka

Chart B2-5 **Trends in Residential Land Price Index and Growth in Private Remittances**



Source : Central Bank of Sri Lanka

4. Banking Sector

- The Sri Lankan banking sector remained stable and resilient during the first nine months of 2010, with the key financial soundness indicators being improved or maintained at healthy levels.
- Strong capital and liquidity levels, sustained earnings, improved risk management systems and a strengthened regulatory framework supported the stability of the banking sector.
- Total assets of the banking sector depicted a year on year growth of 14.3 per cent in September 2010.
- Credit growth picked up considerably during 2010 displaying a growth of 12.9 per cent in comparison to a negative growth of 0.5 per cent in September 2009.
- The gross and net non performing loan ratios stood at 6.7 per cent and 3.2 per cent by September 2010 displaying an improved trend in quality of assets.
- Deposits displayed a slower year on year growth of 12.5 per cent in September 2010 in comparison to a growth of 17.5 per cent during the corresponding period of the preceding year.
- During 2010, banks placed a greater reliance on share capital and borrowings as sources of funding with year on year growth rates of 22.6 per cent and 15.9 per cent, respectively, due to the lower supply of funding in the form of deposits.
- Overall, the banking system's exposure to credit, market, liquidity and operational risks has been maintained at a manageable level.
- Strengthening the fit and proper assessment of Directors and extending the assessment of fitness and propriety to officers performing executive functions of banks, issue of directions on outsourcing activities of banks.
- Implementation of a Deposit Insurance Scheme and taking measures to curtail activities of unauthorised deposit taking institutions and prohibited schemes are expected to further strengthen overall risk management and reinforce the resilience of the banking sector.

Table 4.1 Composition of the Banking Sector as at 30 September 2010

Type of Bank	Number of Institutions	Number of Main Branches	Total Assets	
			Rs. Bn	Market share of Industry (%)
Licensed Commercial Banks	**22**	**1,408**	**2,809**	**83.5**
– State banks	2	640	1,156	34.4
– Private domestic banks	9	722	1,248	37.1
– Foreign banks	11	46	405	12.0
Licensed Specialised Banks	**9**	**468**	**553**	**16.5**
– State banks	6	405	470	14.0
– Private banks	3	63	83	2.5
Banking Industry	**31**	**1,876**	**3,362**	**100.0**

Source : Central Bank of Sri Lanka

4. The Banking Sector

The banking sector accounting for 52 per cent of the financial system's total assets continued to dominate the financial sector. The number of banks decreased from 36 to 31 comprising 22 licensed commercial banks (LCBs) and 9 licensed specialised banks (LSBs) due to the vesting of the businesses of the six Regional Development Banks with the new bank "Pradeshiya Sanvardhana Bank" incorporated by the Government. The composition of the banking sector is indicated in Table 4.1.

4.1 Business Operations / Developments

Outreach

The banks' outreach was further expanded with 29 branches and 34 other outlets being opened during the first nine months of this year, thus increasing the total number of banking outlets in the country to nearly 6,000. In addition, there were 1,972 ATMs in operation by end September 2010. In order to encourage opening of more branches outside the Western region, banks are required to establish two branches outside the Western province for each branch established within the Western province. A key feature was the focus of expansion activities in the newly liberated provinces, with a total of 7 branches and 9 extension offices being opened in the Eastern province and 16 branches in the Northern province.

Products and Services

Banks continued to offer a wide range of products and services, customised to cater to the specific needs of different categories of customers. These ranged from current accounts, savings products, term deposits, foreign currency deposits, trade finance, leasing, factoring, personal lending, pawning, housing loans, credit/debit cards, inward remittances, investments in Government Securities, fund management, project finance and special lending schemes for areas such as fisheries, agri business and small and medium enterprises. Some major developments were as follows:-

Foreign Remittances

A significant emphasis was placed by banks on promoting foreign direct investments and inward foreign remittances, in view of the expected rapid expansion in the economy in an effort to double the per capita income to USD 4,000 by 2016. Among the new initiatives taken by banks were the introduction of various remittance schemes to exclusively cater to the

Sri Lankan expatriate community. Accordingly, several banks had teamed up with either a bank in another country or a company engaged in fund transfer services to enable Sri Lankans to send money to their families in a convenient, fast and efficient method. Many banks have already made arrangements to commence remittance products in the near future. In addition, banks granted incentives for remitting money through banking channels and had also commenced discussions with Sri Lanka Missions Abroad to formulate a mechanism to enable the Sri Lankan Diaspora to remit money to Sri Lanka.

Mobile Phone Remittances

Action has been initiated to popularise mobile phone remittances and introduce incentives for sending money through banking channels. A mobile phone provider has developed a scheme for foreign remittances obtained through the normal banking channels to be converted to the domestic currency and then transferred to an individual's 'e- wallet' for carrying out domestic transactions via the mobile phone. A bank will act as the Custodian Bank and the scheme can be expanded to include other banks as well. Further, to facilitate such efforts, the Central Bank issued draft 'Mobile Payment Guidelines' for domestic mobile payment schemes.

Pawning

Banks displayed a preference for lending through pawning advances, whilst customer demand for pawning products was also high. This was reflected by the number of new pawning products introduced by banks, the significant share of pawning advances within the consumer lending portfolio and the continuous growth over the past few years. The new variations of pawning products include a pawning equivalent lending product specially catered to provide flexibility and convenience to the business class.

The share of pawning advances in total loans of the banking industry had increased from 8.1 per cent as at end 2009 to 9.3 per cent as at September 2010. Further, the growth in pawning activities had improved noticeably to 28 per cent during the corresponding period due to banks reducing the high rates of interest charged for pawning advances.

Credit Cards

Credit cards continued to be a popular source of personal credit, with banks developing various schemes to promote greater usage. As at end September 2010, the number of banks granting advances through credit cards remained unchanged at 11, whilst the number of active cards depicted a decrease. Thus, credit card advances recorded a noticeable negative growth of 7.6 per cent during the first nine months of 2010, resulting in the credit card portfolio reducing to Rs. 29.7 billion by end September 2010. This was mainly owing to the low demand for credit cards due to relatively high rates of interest attached to the product and the availability of alternate sources of borrowings at lower interest rates. Credit card operations were observed to carry a higher credit risk as indicated by the relatively high credit card non performing ratio of 7.7 per cent in the banking industry.

Specialised Products / Services

Many banks also introduced various specialised services to exclusively cater to high net worth customers. These prime exclusive benefits include preferential interest rates and charges for deposit and lending products; hassle free banking with dedicated officers for providing personalised service; gold credit cards with waiver of joining fees and first year annual fees; island wide ATM access; branded and personalised cheque books and debit cards etc. Further, a payment guaranteed cheque was introduced by a bank for selected customers depending on their credit history with the bank. The payment on such cheques will be guaranteed by the bank up to a maximum value decided by them. Thus, this feature grants special treatment to high net worth customers in recognition of the good relationship with the bank and the customer's credit worthiness. Similarly, another bank initiated a scheme of Standby Managers Cheques for selected statutory beneficiaries. These cheques are pre-signed, partially pre-printed, indicating a maximum value and an expiry date. This reduces the processing time for clients and enables quicker turnaround for transactions.

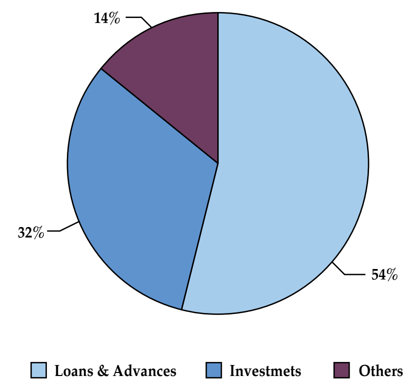
Other new products/services introduced by banks during the year 2010 include a six month lending facility (Gold Loan) secured against gold bars or jewellery; a loan scheme to purchase jewellery; educational loans; introduction of 'Ijarah' an Islamic Banking product with an extended period of 4 to 5 years; an account receivable credit programme for purchasing the account receivables of export clients and financing the receivables upfront; and mobile banking for collection of deposits in the field with the help of mobile IT equipment *etc*. Further, one bank engaged in a marketing initiative of producing and telecasting a one of a kind reality quiz show in a bid to engage the public more fully and increase awareness of the products/ services offered through the bank.

Assets, Liabilities and the Funding Structure

Assets

Total assets of the banking sector recorded a significant year on year growth of 14.3 per cent in

Chart 4.1 Composition of Assets



Source : Central Bank of Sri Lanka

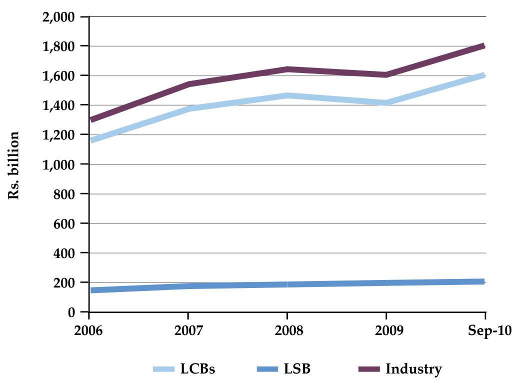
September 2010 in comparison to a lower growth of 8.8 per cent in September 2009 (Table 4.2). This could be attributed to the significant year on year growth of 25.7 per cent in investments (including investments in subsidiaries and associates), which accounted for around 32 per cent of the total banking sector assets by end September 2010 (Chart 4.1). Meanwhile, loans and advances, which represented the major portion of 53.4 per cent of banking sector assets, also displayed a significant year on year growth of 12.9 per cent (Chart 4.2). Rupee loans (LKR) depicted a significant growth and represented around 83 per cent of the total loan portfolio as at end September 2010, whilst the proportion of foreign currency loans had decreased (Chart 4.3).

Table 4.2 Trend in Composition of Assets

Item	Sep-2009		Sep-2010		% Change	
	Rs. Bn	% of Total	Rs. Bn	% of Total	Sep 08-09	Sep 09-10
Assets						
Loans and Advances	1,590	54.0	1,795	53.4	-0.5	12.9
Investments	867	29.5	1,090	32.4	30.5	25.7
Others	485	16.5	477	14.2	9.8	-1.6
Total Assets	**2,942**	**100.0**	**3,362**	**100.0**	**8.8**	**14.3**

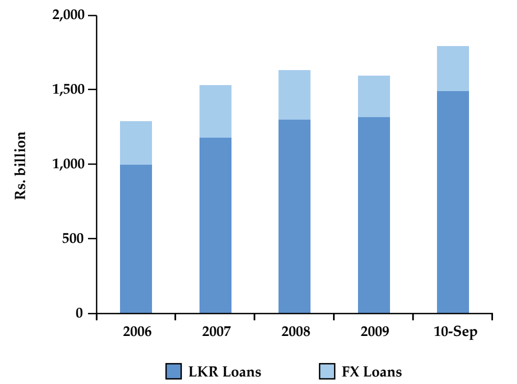
Source : Central Bank of Sri Lanka

Chart 4.2 Loans and Advances



Source : Central Bank of Sri Lanka

Chart 4.3 LKR Vs. Foreign Currency Loans & Advances

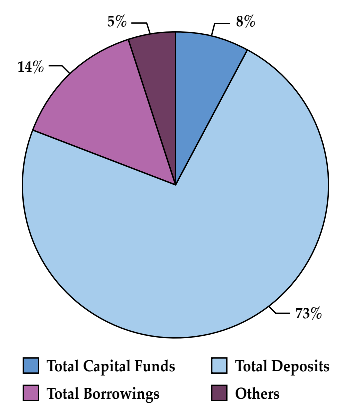


Source : Central Bank of Sri Lanka

Liabilities

Deposits continued to be the main source of funding in the banking sector accounting for 74 per cent of total liabilities (Table 4.3 and Chart 4.4). However, the year on year growth in deposits decreased to 12.5 per cent in September 2010 compared to 17.6 per cent in September 2009 (Chart 4.5). Rupee denominated deposits indicated a significant growth, which accounted for 82 per cent of the total deposit base as at end September 2010 (Chart 4.6). Meanwhile, in terms of types of deposits, time deposits accounted for the major portion of 55 per cent of the total deposit base (Chart 4.7). The share of borrowings in the total funding structure remained unchanged at 13.4 per cent. Nevertheless, borrowings of the industry recorded a considerable year on year growth of 22.6 per cent amounting to an increase of Rs.88.7 billion in 2010, in contrast to the negative growth of 21.6 per cent in 2009. Capital funds recorded a significant year on year growth of 15.9 per cent

Chart 4.4 Composition of Liabilities



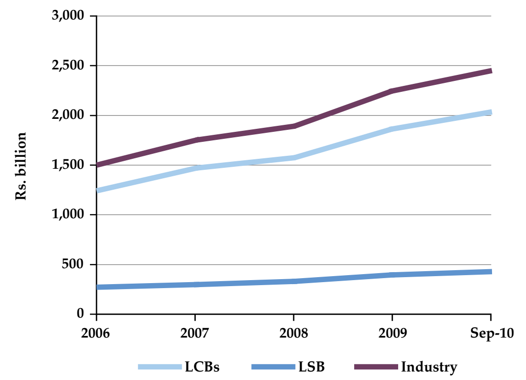
Source : Central Bank of Sri Lanka

Table 4.3 Composition of Liabilities

Item	Sep-2009		Sep-2010		% Change	
	Rs. Bn	% of Total	Rs. Bn	% of Total	Sep 08-09	Sep 09-10
Liabilities						
Capital Funds	240	8.2	278	8.5	10.7	15.9
Deposits	2,163	73.5	2,432	73.0	17.6	12.5
Borrowings	392	13.3	480	13.4	-21.6	22.6
Others	147	5.0	170	5.0	-0.5	16.0
Total Liabilities	**2,942**	**100.0**	**3,362**	**100.0**	**8.8**	**14.3**

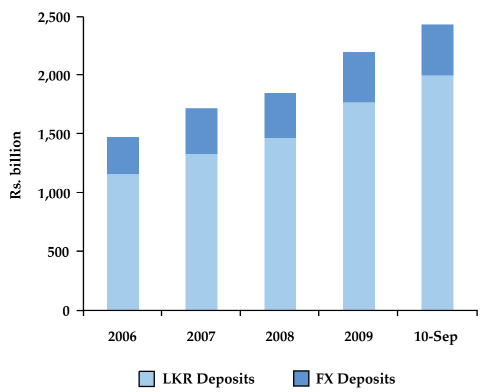
Source : Central Bank of Sri Lanka

Chart 4.5 **Deposits**



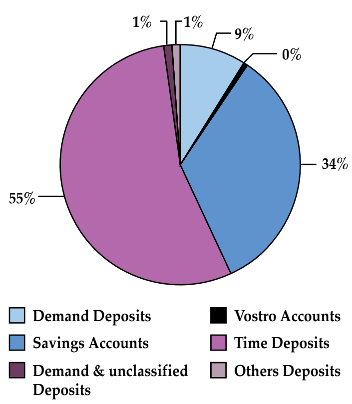
Source : Central Bank of Sri Lanka

Chart 4.6 **LKR Vs. Foreign Currency Deposits**



Source : Central Bank of Sri Lanka

Chart 4.7 **Composition of Deposits**



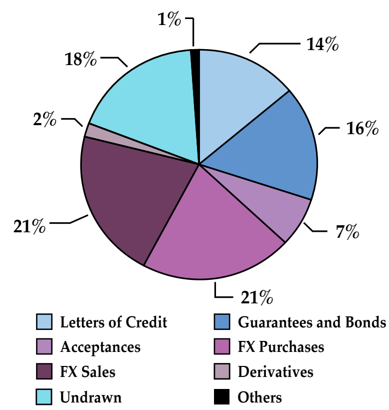
Source : Central Bank of Sri Lanka

resulting in the share of capital funds in the total funding structure increasing from 8.2 per cent in 2009 to 8.5 per cent in 2010.

Off-balance Sheet Exposures

The declining trend in the off-balance sheet exposures witnessed during the preceding year reversed noticeably during 2010. Thus, contingencies and commitments of the industry increased by 19 per cent against a negligible growth of 0.5 per cent recorded in 2009. This was mainly due to the gradual growth in trading activities with the recovery of global economic conditions. Foreign exchange sales and purchases, guarantees, bonds and letters of credit were the most demanded types of off-balance sheet credit facilities (Chart 4.8).

Chart 4.8 **Off-Balance Sheet Exposures**



Source : Central Bank of Sri Lanka

4.2 Assessment of Banking Risks

The main soundness indicators of the banking industry are summarised in Table 4.4.

Credit Risk

Credit risk can be defined as the risk of default due to a counterparty to a transaction not

Table 4.4 **Banking Sector Soundness Indicators**

Indicator	2006	2007	2008	2009	2010 Q3
Licensed Commercial Banks					
1. Capital Adequacy Ratio – Tier 1 Capital Ratio (%)	11.3	11.9	11.1	12.9	12.3
2. Capital Adequacy Ratio – Total Capital Ratio (%)	12.7	13.6	13.8	15.4	14.8
3. Gross Non-Performing Assets as a % Total Loans	5.5	5.0	6.0	8.2	6.3
4. Net Non-Performing Assets as a % of Capital Funds	13.0	11.9	16.7	25.3	19.0
5. Return on Assets (%) (before tax)	1.9	1.9	2.0	1.7	2.7
6. Return on Equity (%)	16.2	15.0	14.8	11.0	21.3
7. Liquidity Ratio, %	23.9	24.8	25.7	33.0	32.1
8. Net Open Position (NOP), % of Capital Funds	0.7	1.2	2.1	-1.4	-2.0
Licensed Specialised Banks					
1. Capital Adequacy Ratio – Tier 1 Capital Ratio (%)	20.7	21.2	25.6	23.6	23.8
2. Capital Adequacy Ratio – Total Capital Ratio (%)	19.8	20.6	21.0	22.0	22.1
3. Gross NPA as a % Total Loans	6.7	6.7	8.9	10.4	9.9
4. Net NPA as a % of Capital Funds	21.9	23.0	26.7	30.4	23.8
5. Return on Assets (%)	2.0	1.7	1.4	2.4	4.1
6. Return on Equity (%)	11.7	10.0	6.9	15.1	32.0
7. Liquidity Ratio (%)	63.6	61.0	61.9	71.1	73.6

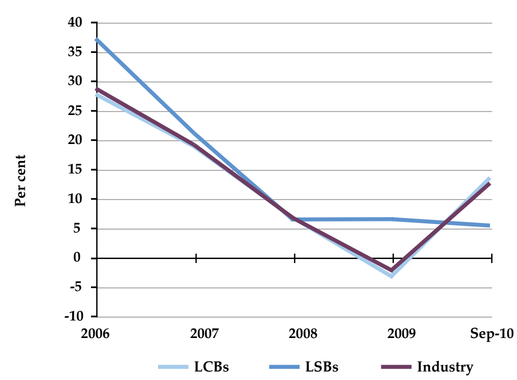
Source : Central Bank of Sri Lanka

fulfilling its financial obligations in a timely manner. As such, it has a direct influence on the earnings and solvency of banks. In the Sri Lankan context, credit risk continues to be the major risk in the banking sector as lending operations account for the major share of the banking sector assets.

Credit Growth

Excessive credit growth has the potential to lead to a system wide build up of credit risk in a country. As such, the Central Bank pays due attention to the level of credit growth within the banking industry to monitor areas of potential risk. As at end September 2010, the level of credit growth in the banking industry was not expected to pose a threat to the stability of the financial system. As stated earlier, the overall credit in the banking industry recorded a year on year growth of 12.9 per cent (Chart 4.9) as against a negative growth of 0.5 per cent reported in the previous corresponding period.

Chart 4.9 **Rate of Credit Growth**

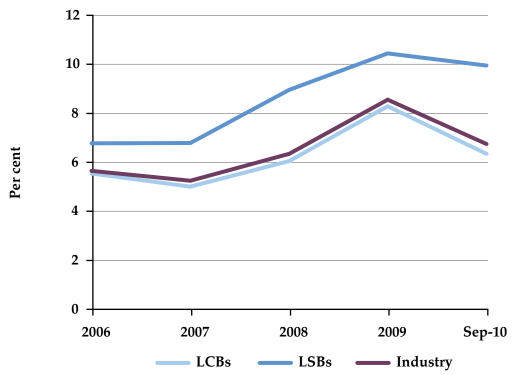


Source : Central Bank of Sri Lanka

Non-Performing Loan Ratios

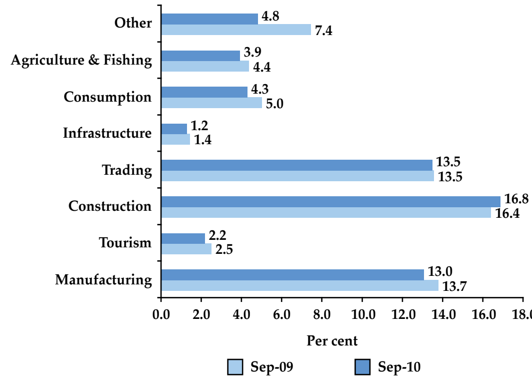
In order to ensure that banks recognise the loans and advances that have a potential risk of being defaulted in advance, banks are required to classify any facilities where the repayments are delayed or irregular, as non-performing loans (NPL). Any income accrued in respect of such NPLs should be suspended. Depending on

Chart 4.10 NPL Ratio



Source : Central Bank of Sri Lanka

Chart 4.12 Sector-wise NPLs

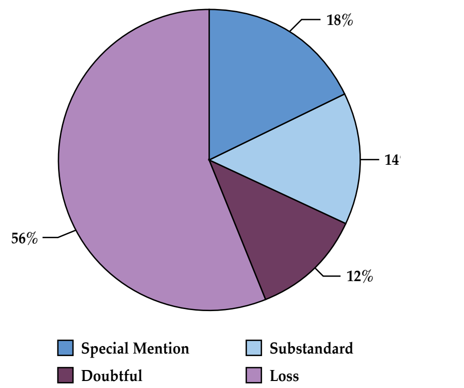


Source : Central Bank of Sri Lanka

the periodicity of default and the potential risk, banks are further required to categorise NPLs as sub standard, doubtful and loss.

As at end September 2010, the quality of assets had improved and did not appear to pose a significant threat to the banking industry. The gross NPL ratio recorded a significant improvement from 8.5 per cent in end 2009 to 6.7 per cent by end September 2010 (Chart 4.10). The composition of NPLs indicated that around 56 per cent of the gross NPLs were in the loss category (Chart 4.11). Manufacturing, trading and construction sectors recorded higher levels of NPLs (Chart 4.12).

Chart 4.11 Classified Loans & Advances (Gross)



Source : Central Bank of Sri Lanka

Banks should endeavour to continuously strengthen their credit risk management measures to curtail the level of NPLs. As such, it is essential for banks to carefully evaluate new credit applications and closely monitor the repayment capacity and cash flow of the borrowers to ensure that credit expansion will not pose a threat to the stability of the banking system.

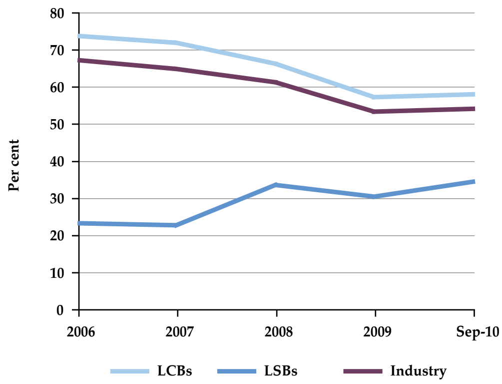
Provisions for Non Performing Loans

When assessing a bank's level of credit risk, it is crucial that due attention is given to the credit risk mitigation tools within the bank's risk management framework. Banks are required to make both specific and general provisions to mitigate their credit risk.

As at end September 2010, the total provision cover of the industry was 53.7 per cent in comparison to 53 per cent as at end 2009 (Chart 4.13). The provision cover also contributed to the net NPL ratio of the banking industry indicating an improvement, reducing from 4.2 per cent to 3.2 per cent over the corresponding period (Chart 4.14).

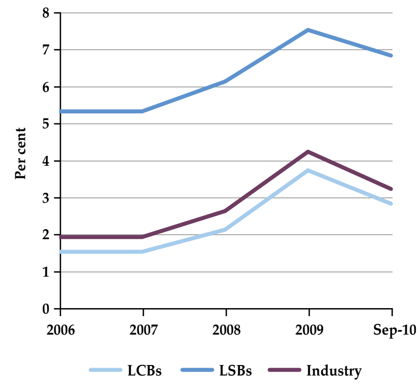
An analysis of the provision cover for the different categories of NPL classification indicate that NPL in the loss category have been fully provided as required under the Central Bank Direction on

Chart 4.13 **Ratio of Loan Loss Provisions to NPL**



Source : Central Bank of Sri Lanka

Chart 4.14 **Ratio of Net NPL to Total Advances**



Source : Central Bank of Sri Lanka

Classification of Loans and Advances, Income Recognition and Provisioning. Meanwhile, the provision cover for NPL classified as substandard and doubtful stood at approximately 17 per cent and 34 per cent, respectively as at end September 2010.

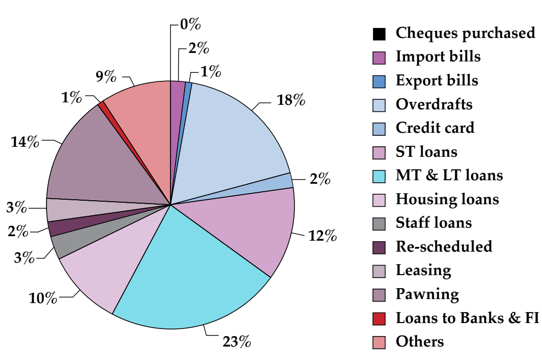
Distribution of Credit

Concentration of credit to a few business sectors/ customers/type of products may expose banks to a risk. As at end September 2010, banking sector credit was well distributed thus, posing no threat to the stability of the system. In terms of the types of loans and advances, credit was primarily distributed among term loans (35 per cent), overdrafts (18 per cent) and pawning facilities (14 per cent) (Chart 4.15).

Around two thirds of the banks' lending activities were concentrated towards five major sectors, namely construction (including housing), trading, manufacturing, agricultural lending and consumer lending with lending within these sectors being diversified amongst the subsectors (Chart 4.16 and Table 4.5).

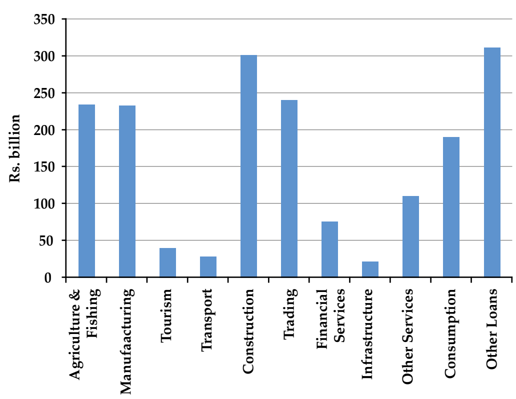
In terms of the Budget proposals of 2006, banks were mandated to lend 10 per cent of the total lending and advances to the agriculture

Chart 4.15 **Types of Loans and Advances**



Source : Central Bank of Sri Lanka

Chart 4.16 **Sector-wise Loans & Advances**



Source : Central Bank of Sri Lanka

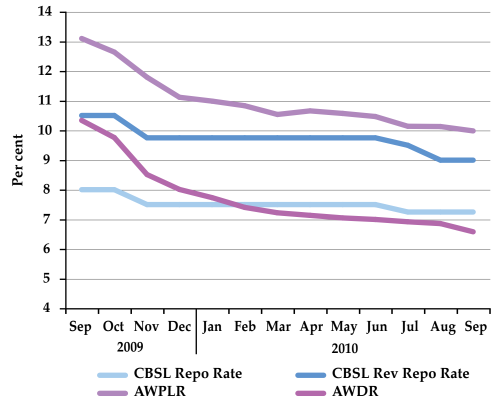
Table 4.5 Sectoral Distribution of Credit

Per cent

Indicator	2006	2007	2008	2009	2010 Q3
Agriculture & Fishing	4.1	4.9	8.9	10.4	12.7
Construction	15.1	17.9	16.8	16.6	16.8
Consumption	5.5	10.8	8.5	10.2	10.9
Manufacturing	15.1	16.1	17.2	15.2	13.0
Trading	13.1	12.6	12.8	13.3	13.4
Financial Services	5.3	6.1	5.6	3.8	4.5
Other Services	4.0	4.6	5.7	4.7	5.3
Tourism	2.1	2.1	2.4	2.6	2.1
Transport	1.6	2.1	2.1	1.6	1.6
Other	34.1	22.8	20.0	21.6	19.6

Source : Central Bank of Sri Lanka

Chart 4.17 CBSL Policy Rates and Bank Interest Rates



Source : Central Bank of Sri Lanka

sector by end 2009. As at end September 2010, banks were in compliance with the mandatory lending requirement, with lending to agriculture representing 12.7 per of the advances portfolio (Table 4.5).

Large Exposures

The banking sector's exposure to large group of companies is monitored to identify potential vulnerabilities and restrain any adverse shocks that may arise from such credit exposures. As at September 2010, the banking sector's exposure to large groups of companies, numbering 70, amounted to Rs. 353 billion representing 20.4 per cent of total outstanding credit of banks. A detailed study on the banks' exposure to subsidiaries, associates, other investee entities and top 20 groups/customers as at 31 March 2010 shows that a total of Rs. 925 billion, accounting for nearly 372 per cent of capital funds and 30 per cent of banking sector assets were concentrated towards these parties.

To limit the large exposures, the Central Bank has issued prudential directions on maximum amount of accommodation restricting the banks' exposure to an individual customer or a group of customers based on the capital base of the bank and the status of risk management in terms of the capital adequacy ratio and the external credit ratings of the borrower and the bank.

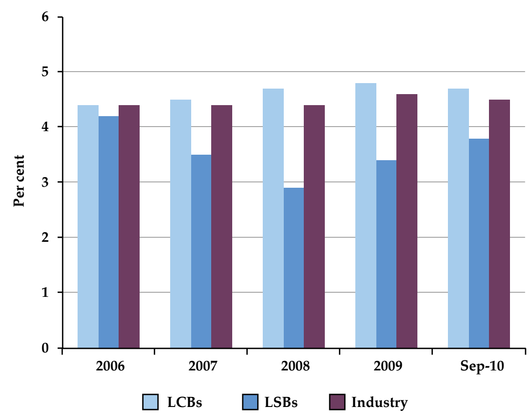
Market Risk

Market risk can be explained as the risk of losses due to adverse movements in interest rates, prices of investments and exchange rates.

Interest Rates

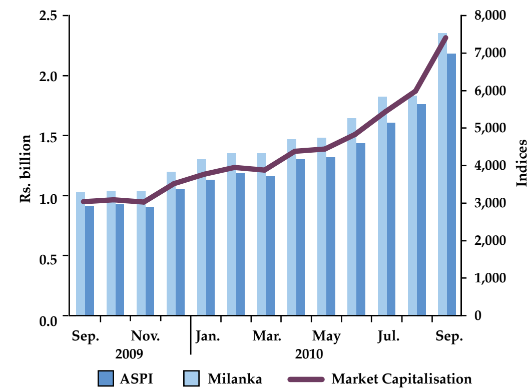
Banks tend to be more susceptible to the volatility of interest rates due to their role as financial intermediaries and the resultant high dependence on interest income. The overall interest rates structure of the banking sector depicted a downward shift, with the Central Bank policy rates (*i.e.*, Repurchase and reverse repurchase rates) and the banks' prime lending and deposit rates continuously declining during the period from September 2009 to September 2010 (Chart 4.17). Despite this declining interest rate scenario, the net interest margin of the banking industry has remained fairly stable, declining only marginally from 4.6 per cent as at end 2009 to 4.5 per cent by end September 2010 (Chart 4.18). As a consequence, the volatility in the interest rates has not had a significant impact on the earnings of the banks during the year 2010.

Chart 4.18 **Net Interest Margin**



Source : Central Bank of Sri Lanka

Chart 4.20 **Share Market**



Source : Colombo Stock Exchange

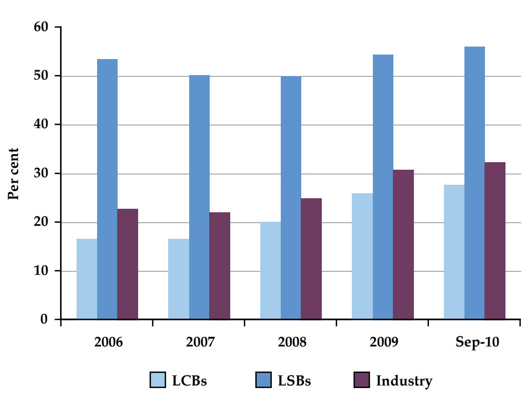
Prices of Investments

The banking sector's exposure to debt and equity markets displayed a year on year growth of 25.7 per cent in September 2010. As a consequence, total investments, including gilt-edge securities, increased to 32.4 per cent of the total assets at the end of September 2010 from 29.5 per cent during the corresponding period of 2009 (Chart 4.19).

The share market recorded significant gains during the year 2010, with the All Share Price Index and the Milanka Price Index crossing several important milestones (Chart 4.20). Banks also displayed a preference for investing in shares of other banks, financial institutions and large conglomerates, for trading purposes. The volatility in share prices could impact the earnings of the banks. However, the prudential requirements to invest only in shares of listed and/or public companies within stipulated limits would minimise any adverse impact on the industry.

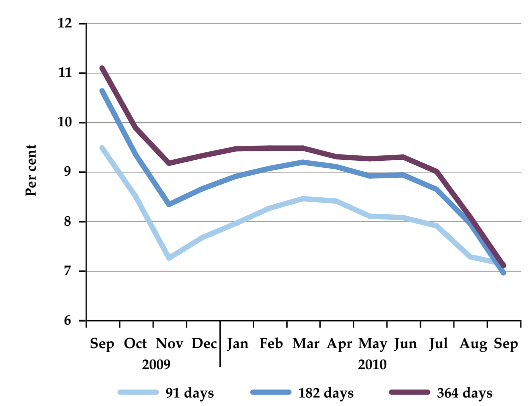
Meanwhile, interest rates on 3 month, 6 month and 1 year Treasury Bills decreased gradually since end December 2009, to converge at a rate of about 7 per cent by end September 2010 (Chart 4.21). Interest rates on Treasury Bonds also depicted a declining trend.

Chart 4.19 **Investment to Total Assets Ratio**



Source : Central Bank of Sri Lanka

Chart 4.21 **Treasury Bill Rates**



Source : Central Bank of Sri Lanka

The Central Bank has imposed Directions on Prudential Norms for Classification, Valuation and Operation of the Investment Portfolio, in order to ensure prudent valuation of the bank's investment and trading portfolios and to require provisioning for any impairment in values. As such, despite the volatility in share prices and the decrease in interest rates of gilt-edged securities, the banking sector's exposure to market risk on account of these investments appeared to have been maintained at a manageable level.

Exchange Rates

The risk arising from movements in the exchange rates is another source of market risk, especially if banks operate with large open positions in foreign currency assets and liabilities including contingent items and commitments such as forward contracts.

During the year 2010, all of the designated currencies for foreign exchange transactions experienced a fair amount of volatility, while the LKR appreciated against the three major currencies, *i.e.,* USD, GBP and Euro, during the period from September 2009 to September 2010. The overall position of the foreign currency denominated assets and liabilities of the banking industry is given in Table 4.6.

As at September 2010, the banks' exposure to foreign exchange appeared to be at manageable levels with the foreign currency assets and liabilities representing around 16 per cent and 18 per cent, respectively, of total assets and liabilities. As such, the exposure of banks operating in Sri Lanka to exchange rate risk does not appear to be significant and is not expected to affect the stability of the banking system.

Further, exposure to exchange rate risk is limited to a considerable extent in the Sri Lankan context due to the Central Bank imposing limits on net open positions of LCBs, based on the capital base of the bank and other related factors. Any unhedged exposures of LCBs are captured in the net open position reported to the Central Bank. In addition, prudential Directions on Financial Derivative Products and Directions on Risk Management relating to Foreign Exchange Business of LCBs issued by the Central Bank, aim to limit banks' exposure to foreign exchange risks. Accordingly, banks are prohibited from using foreign exchange contracts and derivative products for speculative purposes, whilst derivatives contracts should be covered on a back-to-back basis.

Table 4.6 **Foreign Currency Assets and Liabilities**

Item	Sep-2009		Sep-2010	
	Rs. Bn	% of FX Assets / Liabilities	Rs. Bn	% of FX Assets / Liabilities
Assets				
Cash	2.5	0.4	2.7	0.5
Placement with CBSL, banks and FIs	155.7	27.1	91.6	16.6
Investments	159.3	27.7	170.5	30.9
Loans and Advances	257.6	44.8	286.5	52.0
Total Assets	**575.1**	**100.0**	**551.3**	**100.0**
Liabilities				
Deposits	433.8	76.4	430.3	75.3
Borrowings	132.2	23.3	139.5	24.4
Other Liabilities	**1.9**	**0.3**	**1.5**	**0.3**
Total Liabilities	**567.9**	**100.0**	**571.3**	**100.0**

Source : Central Bank of Sri Lanka

In comparison to LCBs, the exposure of LSBs to exchange rate risk is very low. This is due to only a limited number of LSBs being authorised to undertake restricted transactions in foreign currency. The Central Bank continuously requires banks to strengthen their internal controls, especially the limit structures, to mitigate exchange risks.

Capital Charge for Market Risk

The Central Bank requires banks to maintain a capital charge for market risk to cover any losses that may be incurred by banks on their trading portfolio due to adverse fluctuations in market prices. As at September 2010, a capital charge of Rs.8.5 billion, accounting for about 9 per cent of the capital base available to meet market risk was made by the banks.

Liquidity Risk

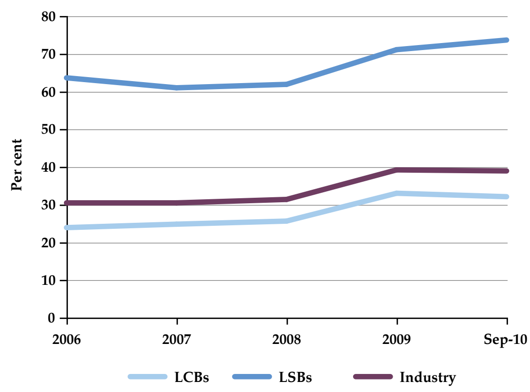
Liquidity risk may be defined as the risk of not having sufficient cash or liquid assets to meet the demands of borrowers and depositors. Banks are exposed to an inherent liquidity risk since the business of banking entails engaging in maturity transformation by relying on short term customer deposits to fund medium and long term assets.

Statutory Liquid Assets Ratio (SLAR)

The banks are required to maintain a liquid assets ratio of not less than 20 per cent. This provides a reasonable safeguard against any liquidity shortfall. However, it is the responsibility of each bank to evaluate specific liquidity needs and maintain an appropriate level of liquidity.

In general, a surplus liquidity position was observed in the market throughout the year 2010. An analysis of the composition of the liquid assets of banks as at September 2010 indicated that about 78 per cent of the liquid assets comprised of investments in Treasury bonds (36 per cent), Treasury bills and government

Chart 4.22 Statutory Liquid Assets Ratio



Source : Central Bank of Sri Lanka

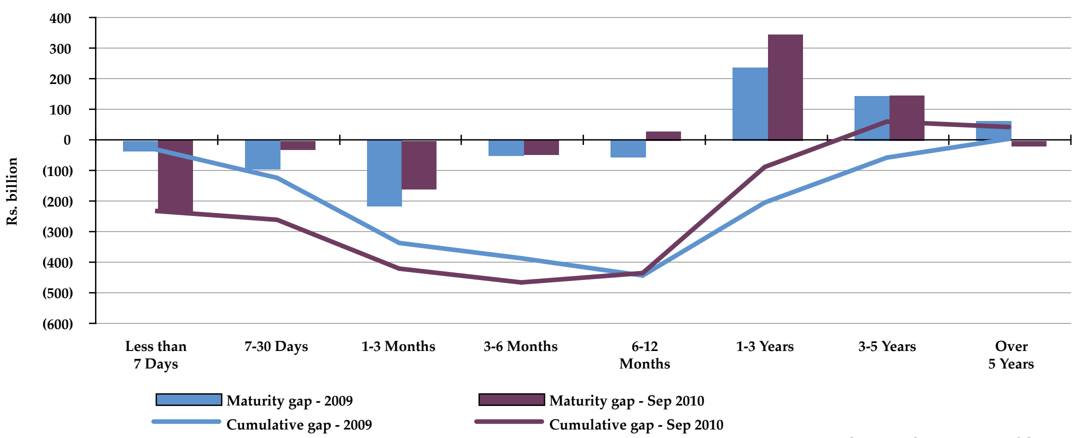
securities (32 per cent) and investment in Sri Lanka Development Bonds (10 per cent). In these circumstances, the overall liquidity ratio of the banking industry was well above the stipulated minimum requirement, with the domestic banking units (DBUs) SLAR standing at 38.9 per cent as at end of September 2010 (Chart 4.22).

Policies for Liquidity Management and Asset and Liability Management

In addition to maintaining SLAR at healthy levels, it is essential to develop bank specific liquidity management and asset and liability management policies with appropriate maturity mismatch limits. These should be supported by reliable management information systems for effective implementation of such limits. In this context, it was observed that while the negative gap between assets and liabilities of the banking industry maturing within 7 – 30 days and 1 – 3 months reflects an improvement, the cumulative negative gaps between assets and liabilities maturing within 7 days, 7 – 30 days and 1 – 3 months have increased (Chart 4.23).

Obtaining a clear understanding of the behavioral patterns of the inflow and outflow of funds is the key to effective liquidity risk management. However, Sri Lankan banks are yet to develop adequate systems of tracking

Chart 4.23 Maturity and Cumulative Gap of Assets and Liabilities of the Banking Industry



Source : Central Bank of Sri Lanka

these behavioral patterns. In an effort to mitigate these shortcomings and to provide a basic framework, the Central Bank has already issued draft Guidelines on Integrated Risk Management, inclusive of guidelines on Liquidity Risk Management. However, banks will be responsible for developing their own methodology to reasonably estimate and manage the unique nature of their liquidity risk.

During the crisis period, even banks with well developed liquidity management systems encountered liquidity problems due to general market conditions leading to an inability to utilise liquid assets for much needed funding. Thus, it is essential that banks evaluate their liquidity profiles, by conducting appropriate liquidity stress tests under bank specific and general market conditions and develop contingency plans to overcome such situations.

Operational Risk

The growing complexity and interconnectedness of systems, financial products, information technology solutions and outsourcing of support services are exposing banks to substantial operational risks. In recognition of the growing importance of operational risk, the Basel II capital standards specify a separate capital charge to cover these risks, whilst also increasing the expectations for managing operational risk. Banks are expected to widen the scope of their risk management framework to include operational risk and improvements are expected in the internal governance framework.

In keeping with the Basel II Capital Accord and international best practices, the Central Bank of Sri Lanka issued guidelines requiring banks to adopt the Basic Indicator Approach for computing regulatory capital for operational risk. Thus, a capital charge of Rs. 21 billion, representing 8 per cent of the total capital base, has been set aside by banks as at end September 2010, to cover the operational risks. The advanced approaches for computing capital for operational risk will be introduced in the future, in consideration of the need to place greater attention to operational risk management.

The Direction on Corporate Governance for Licensed Banks issued by the Central Bank emphasises the need for board level involvement in strategic policy directions and active discharge of the Board of Directors' oversight responsibilities, as well as the need for the bank's management to provide adequate leadership. Accordingly, the Direction requires the Board of Directors to report on the bank's internal control mechanism confirming that the financial reporting system has been designed to provide reasonable assurance on the reliability of financial reporting. Further, it requires banks to publish the external auditors' certification on the effectiveness of the internal control mechanism in their annual reports, with respect to financial statements prepared or published after December 2008. This aims to ensure that the banks have adopted robust internal control mechanisms, regulations and supporting framework for mitigating operational risk that may arise from breakdowns in internal controls and corporate governance. During the period under review, the Central Bank has held discussions with banks to ensure compliance with this requirement.

Banks have increasingly adopted the practice of outsourcing activities in order to reduce costs and achieve strategic objectives. However, increased reliance on outsourcing hampers the banks' ability to adequately manage operational risks and monitor compliance with regulatory requirements, which increase the operational risk.

The Central Bank covers operational risk management of banks within the scope of its statutory examinations and places significant emphasis on developing proper business continuity plans and disaster recovery plans in banks.

4.3 Adequacy of Resources to deal with Potential Risks

The banking sector regained from the sluggish phase and improved its capacity to mitigate risks through healthy levels of profits and capital. In addition, the Central Bank implemented certain prudential measures to ensure the resilience of banks. These include further enhancing the minimum capital requirement of existing as well as new banks on a staggered basis, and close monitoring of the compliance with draft Directions on Integrated Risk Management and Corporate Governance to ensure that the liquidity and solvency of the banking industry are maintained.

Table 4.7 **Profit and Loss Account**

Item	Sep-2009		Sep-2010	
	Rs. Bn	% of Avg. Assets	Rs. Bn	% of Avg. Assets
Interest Income	269.9	12.1	241.7	10.2
Interest Expenses	177.6	8.4	134.5	5.7
Net Interest Income	**92.3**	**4.4**	**107.2**	**4.5**
Non-Interest Income	43.6	2.1	52.4	2.2
Foreign Exchange Income (Net)	9.3	0.5	8.4	0.4
Non-Interest Expenses	67.8	3.2	73.7	3.1
Staff Cost	31.8	1.7	33.9	1.6
Loan Loss Provisions	8.9	0.4	-3.8	-0.2
Profit Before Tax (After VAT)	44.6	2.1	69.8	2.9
Profit After Taxes	25.5	1.2	45.5	1.9

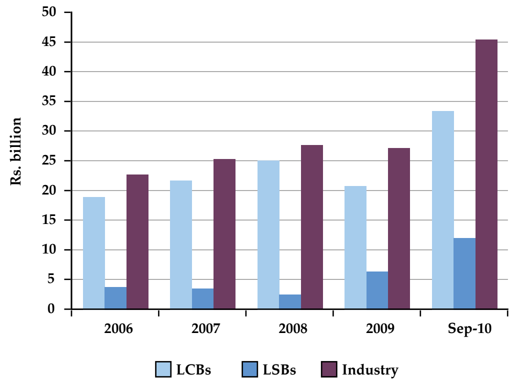
Source : Central Bank of Sri Lanka

Profitability

The banking industry achieved a healthy level of profits, with profit after tax amounting to Rs. 45.5 billion during the nine months ending September 2010, in comparison to Rs. 25.5 billion during the corresponding period of 2009 (Chart 4.24). Meanwhile, the net interest income as at September 2010 displayed a year on year growth of 16 per cent in comparison to a growth of 12 per cent during the corresponding period of 2009.

The distribution of total income of the industry shows that the interest income received from borrowers continued to be the banks' primary source of income representing 82 per cent of the total income (Table 4.8). However, the percentage share of interest income had decreased in comparison to 85 per cent recorded

Chart 4.24 **Profit (After Tax)**



Source : Central Bank of Sri Lanka

in 2009, owing to an increase in the share of income generated through non interest based sources. Meanwhile, foreign exchange income represented a share of 16 per cent of the total non-interest income.

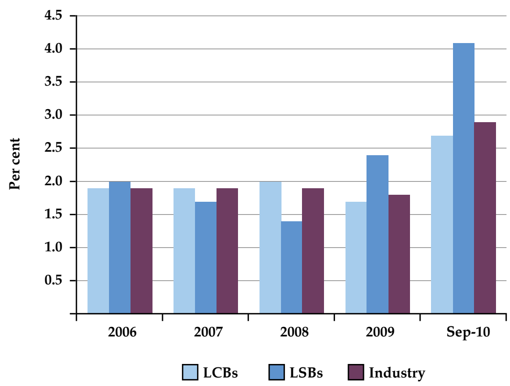
Interest expenses remained the highest use of income. However, the share of income paid to depositors and creditors (interest payments) has reduced, while the income to shareholders (dividends) and government (taxes) has increased correspondingly (Table 4.8).

Despite a significant improvement in the banking industry's efficiency ratios, costs incurred on account of operational expenses had been maintained at almost the same levels as in the preceding year, thus having no significant impact on the profits as at September 2010.

The Return on Assets (ROA) of the banking industry had escalated from 1.8 per cent in 2009 to 2.9 per cent in September 2010 (Chart 4.25). The Return on Equity (ROE) displayed a similar trend increasing from 11.8 per cent to 23.3 per cent over the corresponding period (Chart 4.26).

Despite the improved profits and favourable profitability indicators, it is important that banks place greater emphasis on generating earnings through stable sources of income, improving

Chart 4.25 **Return on Assets (Before Tax)**



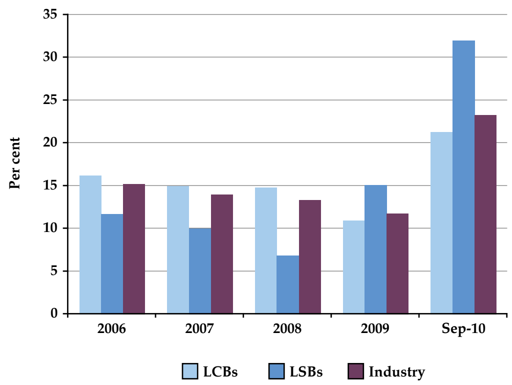
Source : Central Bank of Sri Lanka

Table 4.8 **Distribution of Total Income of Banking Industry**

Item	Amount (Rs. Bn.)			As a % of Total Income		
	Sep-09	2009	Sep-10	Sep-09	2009	Sep-10
Sources of Income						
From Borrowers – Interest Income	261	343	246	85	85	82
Others – Non-Interest Income	45	59	52	15	15	18
Total	**306**	**402**	**298**	**100**	**100**	**100**
Users of Income						
Depositors and Creditors	178	234	134	58	58	45
Employees	37	52	39	12	13	13
Bank	31	44	35	10	11	12
Government	35	44	45	11	11	15
Shareholders	26	27	46	8	7	15
Total	**306**	**402**	**298**	**100**	**100**	**100**

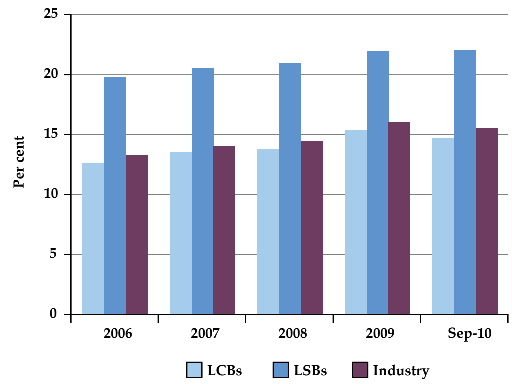
Source : Central Bank of Sri Lanka

Chart 4.26 Return on Equity



Source : Central Bank of Sri Lanka

Chart 4.27 Capital Adequacy Ratio



Source : Central Bank of Sri Lanka

operational efficiencies and efficiently managing the banks' assets and liabilities to optimise the benefits and reinforce the capital positions.

Capital Funds and Capital Adequacy

Overall capital funds of the banking sector improved, thus increasing the cushion available for absorbing any risks encountered by banks. Accordingly, total banking sector capital funds grew by 14.5 per cent, increasing from Rs. 243 billion as at end December 2009 to Rs. 278 billion by end September 2010. The main contributors to this growth were the high level of profits earned during the period and fresh capital infusions by a few banks for the purpose of meeting the minimum capital requirement (Chart 4.27).

The Capital Adequacy Ratio (CAR) of the banking sector remained robust at 15.6 per cent, well above the minimum requirement of 10 per cent, as at end September 2010. Meanwhile, the Core Capital ratio of 13.5 per cent was also well above the minimum requirement of 5 per cent.

The capital position of the banking sector is expected to be reinforced in the future due to banks complying with the enhanced levels of minimum capital and the requirements of the Basel II Capital Accord. Accordingly, a few banks may need to infuse further capital to enhance the capacity to absorb capital charges on account of operational risk and to comply with any additional capital requirements imposed by the regulator under the supervisory review process. In addition, it is essential that banks should factor the envisaged growth in the banking books to their capital augmentation plans and take steps to fine tune the methodologies for maximising the efficient usage of capital through measures such as tracking the SME portfolios, residential loans and institutional businesses to obtain credit ratings.

Management

The International Accounting Standards defines key management personnel as those who are in a position to: (*a*) significantly influence the policy; (*b*) direct activities; (*c*) exercise control over business activities, operations and risk management. Based on this definition, the composition of officers performing key executive functions in banks is as indicated in the Table 4.9.

Based on these figures, approximately 50 per cent of those performing key executive functions were in the position of Assistant General Manager and above. Thus, it appears that banks were well equipped with officers in key management

Table 4.9 Officers Performing Executive Functions in Banks

Designation / Positions	No.	%
Additional General Manager / Senior General Manager	9	2
Deputy General Manager & Assistant General Manager	251	49
Consultants / contract basis	50	10
Other: Chief Accountant, Chief Risk Officers, Chief Internal Auditors, Head of Legal, Board Secretary *etc.*	200	39
Total	**510**	**100**

Source : Central Bank of Sri Lanka

positions to manage the operations of the banks.

Further, during the year 2010, many banks had effected changes in the Board of Directors and also appointed independent directors in keeping with the requirements of the Directions on Corporate Governance, thus strengthening the management of the banks.

4.4 Policy Measures and Regulations

The Central Bank of Sri Lanka initiated several policy measures during the year 2010, in keeping with its core objective of maintaining financial system stability.

- *Increase in minimum capital requirement* – With a view to ensuring the existence of a strong and sound banking system, the minimum capital requirements of LCBs and LSBs were enhanced to Rs. 5 billion and Rs. 3 billion, respectively, on a staggered basis as indicated in the Table 4.10.
- *Implementation of a Deposit Insurance Scheme* – The Sri Lanka Deposit Insurance Scheme for licensed banks and registered finance companies was implemented with effect from 1 October 2010, to protect small depositors and to strengthen the stability of the banking system.
- *Improving asset quality of banks* – Banks were required to strengthen credit administration and the recovery process to improve the asset quality.
- *Relaxation of requirements in the direction on loan classification, income recognition and provisioning* – In view of the importance of expanding credit to revive businesses and to encourage borrowers to undertake new viable projects, the direction on loan classification, income recognition and provisioning was temporarily amended till June 2011, to permit banks to provide credit facilities to borrowers for the repayment of non-performing loans and for business purposes, without requiring the new facility to be classified as non-performing subject to certain conditions.
- *Reducing the general loan loss provision* – In November 2006, the Central Bank required licensed banks to maintain a general loan loss provision of 1 per cent against performing loans and loans in the special mention category as a proactive prudential measure. However, in view of the improved domestic economic conditions, the Central Bank decided to reduce this general provision requirement to 0.5 per cent by 31 December 2011, to encourage credit expansion. Accordingly, banks may reduce general provisions at a rate of 0.1 per cent per quarter, over each of the five quarters commencing with the quarter ending 31 December 2010.

Table 4.10 The New Minimum Capital Requirement of LCBs and LSBs

Existing banks (Effective Date)	New Banks (Year)	Licensed Commercial Banks (Rs. Bn.)	Licensed Specialised Banks (Rs. Bn.)
31.12.2011	2010	3.0	2.0
31.12.2013	2012	4.0	2.5
31.12.2015	2014	5.0	3.0

Source : Central Bank of Sri Lanka

- *Reduction in lending rates* – Since the existing macro economic conditions and stability warranted a reduction in risk premia added to lending rates, the Central Bank guided the banks to reduce lending rates for certain types of loan products. Accordingly, banks were requested to reduce interest rates on housing loans and credit card advances to 14 per cent and 24 per cent, respectively, and rates on all other advances by 1–2 per cent.

- *Assessment of Fitness and Propriety officers* – The assessment of the fitness and propriety of the banks' Directors was further improved to enhance compliance with the provisions of the Directions on Corporate Governance, with effect from September 2010. Accordingly, Directors are required to submit additional details pertaining to exposure to related parties to assess any potential sources of conflict. Further, the fit and proper assessment was extended to officers performing executive functions of banks with effect from November 2010. The assessment will cover officers currently in office and new appointments, including renewal of employment contracts. The categories of officers whose fitness and propriety will be assessed include:

  – Additional General Manager, Senior Deputy General Manager , Deputy General Managers, Assistant General Managers, Chief Operating Officer, Chief Risk Officer, Chief Accountant, Chief Financial Officer, Chief Internal Auditor, Compliance Officer, Head of Treasury, Head of Legal, Head of Information Technology and Board Secretary, Officers serving as consultants or advisors to the Board or bank, and Any other officers falling under the definition of section 3(1)(i)(f) of the Banking Act, Directions No. 11 and 12 of 2007 on Corporate Governance for Licensed Banks in Sri Lanka.

- *Directions on Outsourcing of activities* – Many banks enter into outsourcing arrangements with external service providers that possess specialised resources or skills for performing activities or processes connected with the operations of the banks. Thus, the Central bank issued directions relating to outsourcing of activities to facilitate banks in mitigating any potential operational risks that may arise from this source. Accordingly, the direction provides a definition of outsourcing and its applicability; specifies the operations that may be outsourced by a bank; requires banks to develop a comprehensive policy on outsourcing, requires outsourcing arrangements to be included in the bank's business continuity plans and contains guidelines on monitoring, control, marketing and recovery relating to outsourcing operations.

4.5 Global Regulatory Reforms

On the global front, a trend towards increased regulations is evident subsequent to the global financial crisis. Among the many global initiatives for reforming financial regulations, the key reforms include the Basel III reforms package which aims to increase both the quality and quantity of capital and introduce minimum global standards for liquidity (Please refer box article 1 for details). In addition, regulators are also taking measures to improve their institutional framework for supervision of financial institutions, introduce a banking resolution framework, separate banking from engaging in risky and unregulated financial services such as investment banking, address the moral hazard associated with the institutions considered as 'too-big-to-fail', achieve global accounting standards by requiring all countries to move towards common accounting standards, improve governance practices and introduce remuneration policies that link remuneration to the risk taking on business activities.

Box 3

Deposit Insurance as a Financial Safety Net Tool

1. Overview

- The objective of deposit insurance is to protect the interest of small depositors from the failure of financial institutions and thereby to contribute to the stability of the financial system.
- Globally, deposit insurance has evolved to play a major role as a financial safety net instrument for both crisis prevention and crisis management. In the face of global financial integration, financial crises are contagious and are not predictable. The global experience has shown that a mandatory deposit insurance as a form of safety net is effective in managing individual bank failures as well as systemic failures that lead to financial crises.
- Presently, there are nearly 105 countries with deposit insurance systems of various forms. Further, another 19 countries are in the process or consideration of implementing deposit insurance. In some countries, there is more than one scheme in operation and in some others there are schemes that cover deposits of more than one country.

2. Advantages and disadvantages

Advantages

- *Financial stability and public confidence:* Financial system stability largely depends on the public confidence on the safety of deposits. Therefore, a deposit insurance scheme (DIS) as a safety net contributes to the financial system stability by helping to preserve public confidence on regulated financial institutions. Financial system stability has become a necessary condition for maintaining economic and price stability due to the significant economic and fiscal cost of financial crisis to an economy.
- *Reduced commitment of the State:* The financial crisis that the western economies experienced in the recent past reaffirmed the enormity of the impact of a financial crisis. A DIS can limit the governments' implicit contingencies to depositors as it explicitly insure deposits.
- *A consumer protection mechanism:* Particularly, small depositors who are less sophisticated and with low financial literacy could be protected by repaying them in the event of failures of financial institutions.
- *Promotion of market discipline:* In many DISs, it is a common feature that small depositors are being covered. This will encourage the large depositors to monitor the soundness of the operations of the banks and financial institutions and thereby to promote market discipline.

Disadvantages

- *Moral Hazard:* Moral hazard is the human behaviour that tends to take more risks if external safety net is available. To the extent that depositors are protected, they have less incentives to monitor the performance of financial institutions and depositors would tend to maintain deposits at high interest rates offered by risky financial institutions. Financial institutions may also tend to engage in lending activities with high risk customers as deposits are protected by DIS.
- *Adverse selection:* This refers to the potential for weakest or the riskiest institutions to join the system if participation is voluntary.
- *Increase in interest spread:* Since financial institutions tend to pass on the cost of the insurance premium to customers via increased lending rates or reduced deposit rates, the interest spread (difference between lending rates and deposit rates) could widen, impacting

Box 3 (*Contd.*)

on increased cost of financial intermediation. However, with the introduction of a DIS, the risk premium added to the interest rates by financial institutions would also be reduced due to diminution of market uncertainties faced by such institutions.

3. Mechanism and types of DIS

General mechanism of operation of DIS

- *Insurable deposits:* Only selected categories of depositors will be insured. State deposits, investment deposits and member deposits are often excluded.
- *Determination of premium*: Insurance premium could be levied as flat rate premium or risk-based premium.
  - **Flat rate premium** – It is the single rate levied from all member institutions.
  - **Risk based premium** – The premium will be levied based on the risk profile of the member institutions. Higher the risk, the higher will be the premium.
- *Compensation:* Repayment, in the event of identified risk event, will be subject to a maximum amount per depositor. Suspension or cancellation of the license of the institutions are the risk events.

Types of DIS

- *Narrow mandated DIS:* A DIS which only pays out insured deposits of insured institutions up to a threshold, functioning as a deposit "pay-box", at the time of liquidation.
- *Broad mandated DIS:* DIS is empowered to regulate and supervise insured financial institutions and to initiate actions for resolving and restructuring of insolvent or insolvency-threatened insured institutions.

4. Implementation of a mandatory DIS in Sri Lanka – Sri Lanka Deposit Insurance Scheme

Implementation in mandatory nature

- In Sri Lanka, a voluntary DIS had been established in 1987 for banks and co-operative societies, in terms of the Monetary Law Act. Although some banks and co-operative societies joined in the scheme in early years, except for one co-operative society, all other eligible institutions were not members due to its voluntary nature.
- Considering the importance of the existence of a mandatory DIS, the Sri Lanka Deposit Insurance Scheme is implemented with effect from 01.10.2010 by the Central Bank under the provisions of the Monetary Law Act, Finance Companies Act and the Banking Act.

Salient features of Regulations on DIS

- *Member Institutions and coverage:* All licensed banks and registered finance companies are members of DIS and deposits up to Rs. 200,000 per depositor are insured.
- *Excluded deposits:* Deposits of shareholders, directors, key management personal and related parties of member institutions; deposits of member institutions, government and government institutions' and deposits held as collateral against any accommodation will be excluded from DIS. Additionally, deposits falling within abandoned property transferred to the Central Bank under the Banking Act will also be excluded.
- *Computation of premium:* This largely based on systemic risk and varies on the capital adequacy ratio of licensed banks. However, premium is calculated based on a flat rate for registered finance companies.
- *Repayment:* Compensation will be made per depositor basis within six months from the date of cancellation or suspension of registration/license.
- *Insurance Fund:* A fund consisting of remaining money with the voluntary DIS, premium, proceeds of banks' abandoned property, dormant deposits of finance companies, contributions, borrowings and investment income is maintained separately. Fund will be managed according to the regulations and invested in government securities mainly.

5. Other Financial Institutions

- The registered finance company and specialised leasing company sector showed signs of recovery with an improvement in its financial performance in terms of profitability, liquidity and capital adequacy.
- Progress was made in resolving the problems of the distressed finance and leasing companies in the Ceylinco group with the adoption of restructuring and recapitalisation schemes, recovery of dues from related companies and the introduction of the Credit Guarantee Scheme by the Central Bank.
- The insurance industry showed signs of recovery with enhanced premium income and profitability.
- The stability of Primary Dealers (PDs) strengthened with an increase in their capital base and low levels of market, liquidity and operational risks
- The unit trust industry performed well on the back of a vibrant and bullish stock market.
- Superannuation funds managed their risks adequately.

5.1 Registered Finance Companies

Registered Finance Company (RFC) sector, which was affected by the liquidity problems in 2009 showed signs of gradual recovery in 2010, with the sector performing satisfactorily and expanding its total branch network. The number of RFCs in operation increased to 36 as at end September 2010, with one new company obtaining the RFC license in 2010. During the period, the branch network of RFCs increased by 78 to 362, out of which, 34 new branches were opened in the Northern and Eastern provinces.

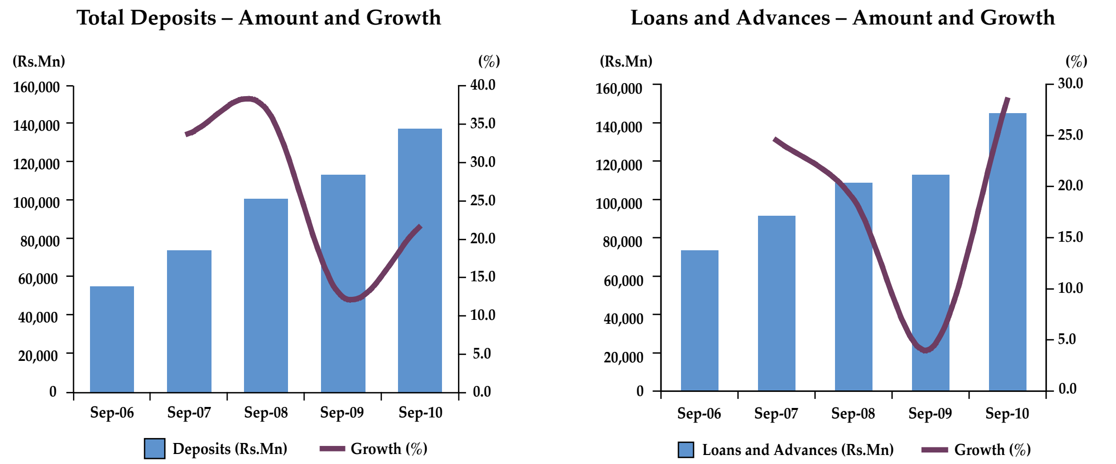
Total assets of RFCs increased by 19.1 per cent (annual growth) to Rs.216 billion by end September 2010 compared to a 5.6 per cent growth recorded in the corresponding period in 2009. Total assets of RFCs and their market share are given in Table 5.1. Although the number of RFCs in the large group increased, their percentage share in terms of assets decreased due to the relatively larger growth by the small and medium category RFCs. The market share of the two largest RFCs, in terms of total assets

Table 5.1 **Market Share of the RFCs (in terms of the total assets)**

RFC Category	No. of RFCs (End September)		Total Assets (Gross) Assets End September (Rs. Mn.)		Share (%)	
	2009	2010	2009	2010	2009	2010
Small (Assets < Rs.1,000 mn)	8	7	2,486	3,856	1.4	1.8
Medium (Assets between Rs. 1,000 mn. and Rs. 5,000 mn.)	18	19	41,457	55,243	22.9	25.6
Large (Assets > Rs. 5,000 mn.)	9	10	137,382	156,847	75.8	72.6
All Companies	**35**	**36**	**181,326**	**215,946**	**100.0**	**100.0**

Source : Central Bank of Sri Lanka

Chart 5.1 **Total Deposits, Loans and Advances of RFCs**



Source : Central Bank of Sri Lanka

Table 5.2 **Key Financial Indicators of RFCs**

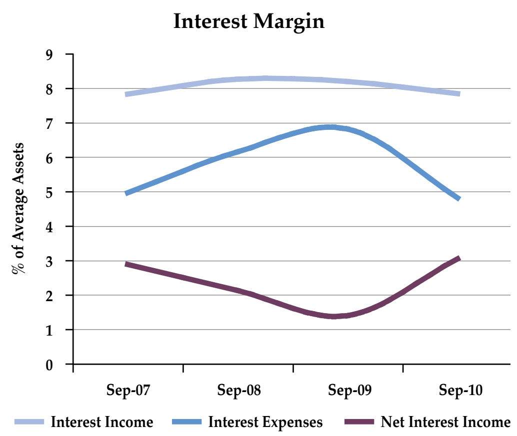
Per cent

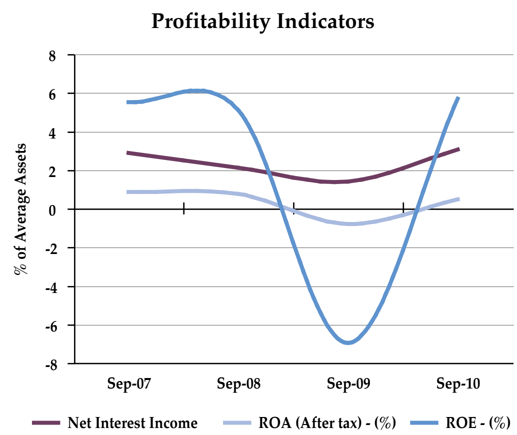
Ratio	2006 End March	2007 End March	2008 End March	2009 End March	2010 End Sept.
Capital Funds / Total Assets Ratio	15.0	15.6	15.3	12.9	8.1
Capital Funds / Deposit Liabilities Ratio (minimum requirement 10 per cent)	28.0	29.2	27.2	22.3	12.7
Core Capital Ratio (minimum requirement 5 per cent)	14.7	13.1	12.5	12.6	7.3
Total Capital Ratio (minimum requirement 10 per cent)	16.5	14.2	14.5	14.2	8.5
NPAs / Total Accommodations Ratio	5.9	4.4	6.5	8.0	12.1
Provisions made / Total Accommodations Ratio	4.9	3.0	3.1	3.4	5.0
Provisions made / NPAs Ratio	83.4	68.1	47.2	43.2	45.1
Return on Equity (ROE)*	22.0	17.8	12.5	1.3	5.7
Return on Assets (ROA)*	3.3	3.2	2.5	0.8	1.2

* Annualised

Source : Central Bank of Sri Lanka

Chart 5.2 Interest Margin and Profitability of RFCs





Source : Central Bank of Sri Lanka

also declined notably to 30 per cent in 2010 from 39 per cent in 2009.

The liquidity position of the sector improved gradually with most RFCs carrying on their normal business activities through mobilizing deposits without much difficulty. As a result, loans and advances of RFCs grew by 28.4 per cent (annual growth) to Rs.145 billion as at September 2010 compared to 4 per cent (annual growth) growth recorded in the corresponding period in 2009. Hire purchase and finance leasing were the major areas of finance business which accounted for around 35.5 per cent and 28.4 per cent of total advances, respectively. Loans and advances accounted for 67 per cent of RFC sector assets. Total deposits increased by 21.1 (annual growth) per cent to Rs.137 billion which accounted for 63.7 per cent of RFC funding.

The performance of RFCs improved considerably. For the year ending September 2010, the total interest income increased by 6.2 per cent to Rs.31 billion and the net-interest income increased by 87.3 per cent to Rs.11.1 billion. This is largely due to the reduced funding costs. Consequently, the sector's profitability increased substantially recording a profit before tax of Rs.3.6 billion compared to Rs.1.6 billion loss (before tax) recorded for the same period in 2009. Accordingly, corresponding ROA and ROE increased considerably from negative figures of 0.9 per cent and 12.1 per cent to positive figures of 1.7 per cent and 5.8 per cent, respectively. However, irrespective of the improved profitability, Capital Adequacy Ratio (CAR) of the sector has decreased on account of the higher rate of growth of risk weighted assets than the rate of growth of profitability of RFCs. As such, by end September 2010, CAR of the sector decreased to 8.5 per cent from 11.5 per cent, when compared to the same period in the previous year.

Risk Assessment

Most of the RFCs were able to continue their business activities at comfortable levels withstanding the recent liquidity problems due to strong internal controls and risk mitigation measures. However, a few RFCs still face liquidity constraints and have been slow in commencing normal business operations. The poor performance of the companies with liquidity constraints has largely undermined the overall performance of the non-bank financial sector.

Credit Risk

Despite the improved profitability, RFCs are still exposed to credit risk as the asset quality of the sector remains considerably weak. In terms of the NPA ratio, a credit risk indicator which shows non-performing advances as a percentage of total advances, the sector's asset quality further deteriorated as the NPA ratio increased to 12.1 per cent at end September 2010 from 10.4 per cent as at end September 2009. However, with improved macroeconomic conditions, the asset quality of the sector is expected to improve with normalizing recovery and expanding loan portfolio.

Liquidity Risk

The overall liquidity position of the sector has stabilized due to the restored public confidence on the sector. RFCs benefited largely by reduced interest rates on deposits in the banking sector thus attracting more deposits to this sector. The rapid deposit growth has enabled RFCs to enhance their liquidity position while increasing lending. Most RFCs were able to maintain the regulatory liquidity requirement at end September 2010, while a few RFCs need to build up their liquidity buffers to more comfortable levels.

Policy measures by the CBSL

The CBSL has taken several policy measures to improve the public confidence in the sector and to improve the liquidity position of the distressed companies. As a result, most RFCs have been able to carry on their normal business activities. During the first nine months of 2010, following actions were taken by the CBSL to strengthen the RFC sector.

- Imposition of limits on deposit liabilities of some RFCs (distressed companies).
- Introduction of a Credit Guarantee Scheme in January 2010 in respect of loan facilities provided by banks to distressed RFCs and SLCs.
- Removal of executive powers of certain Directors of some RFCs while requiring all such Directors to continue as members of the respective boards thereby holding them responsible for the overall risk management of the companies concerned.
- In addition, the Monetary Board of the CBSL issued a direction to distressed RFCs to recapitalize the company by way of a fresh issue of ordinary shares.
- In order to strengthen the regulatory framework and overcome existing deficiencies in the Finance Companies Act (FCA), substantial amendments to the FCA were identified and proposed to the Ministry of Finance and Planning to introduce new legislation in the name of Finance Business Act, repealing and replacing the FCA, to regulate finance business. The Cabinet of Ministers granted approval to introduce new legislation. These changes are expected to be finalized by 2010. The introduction of comprehensive statutory provisions will enable to regulate and supervise licensed finance companies and to curb unauthorized deposit taking businesses, effectively. This in turn will foster public confidence in finance companies and the financial system as a whole.
- In order to set-up a mechanism to regulate and supervise micro finance institutions in the country, it was proposed to the Ministry of Finance and Planning to establish an independent regulatory and supervisory authority to regulate and supervise MFIs. The Cabinet at its meeting held in July 2010 has granted approval to instruct the Legal Draftsman to draft necessary legislation to establish an independent authority for regulation and supervision of MFIs.

- Encourage all RFCs to register with the Colombo Stock Exchange before end June 2011 in order to improve the capital requirement.

5.2 Registered Finance Leasing Establishments

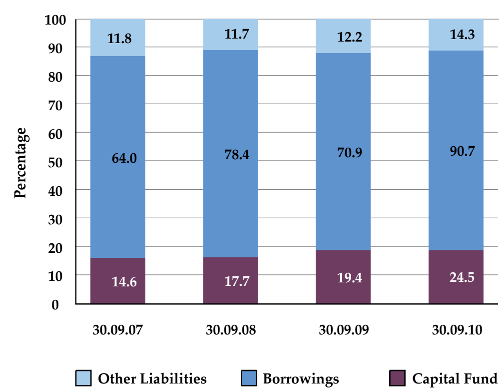
Specialized Leasing Companies (SLCs) continued to provide a notable contribution to the economy by catering to a diverse customer base that does not have easy access to banks. There were 70 finance leasing establishments registered under the Finance Leasing Act, No. 56 of 2000 (FLA) at end September 2010. Leasing establishments consisted of 15 licensed banks, 34 RFCs and 21 SLCs. Close monitoring of SLCs continued through off-site surveillance and on-site examinations, during the period under review.

The outstanding total finance lease portfolio of all Registered Finance Leasing Establishments increased to Rs. 125 billion at end September 2010 from Rs 116 billion at end September 2009, recording a growth of 8 per cent. Licensed banks accounted for 40 per cent of the finance lease portfolio while RFCs and SLCs accounted for 33 per cent and 27 per cent, respectively

The total assets of SLCs significantly increased by 26.3 per cent to Rs. 135.2 billion at end September 2010 while the capital funds of SLCs rose by 26.5 per cent to Rs. 24.5 billion at end September 2010 from Rs.19.4 billion at end September 2009. The number of branches of SLCs increased from 157 to 164 during this period. The market share of SLCs in terms of the total assets is given in Table 5.3.

Six companies in the large group accounted for 86 per cent of total assets of the industry. However, the sector continued to be dominated by two companies, representing more than 79 per cent of the total assets and 40 per cent of total branch network. Selected key financial indicators are given in Table 5.4.

Chart 5.3 Financial Portfolio of SLCs



Source : Central Bank of Sri Lanka

Table 5.3 Distribution of Total Assets of SLCs

Category in terms of Assets	No. of SLCs		Total Assets: Amount (Rs. bn)		Total Assets: Market Share (%)	
	30.09.2009	30.09.2010	30.09.2009	30.09.2010	30.09.2009	30.09.2010
Over 5 billion	4	6	80.1	116.9	74.9	86.4
3 to 5 billion	4	1	13.5	3.8	12.6	2.8
1 to 3 billion	5	6	10.5	10.8	9.8	8.0
Below 1 billion	8	8	2.8	3.7	2.6	2.7
Total	**21**	**21**	**107.1**	**135.2**	**100.0**	**100.0**

Source : Central Bank of Sri Lanka

Table 5.4 **Selected Key Financial Indicators of SLCs**

Category	2009 End Sept.	2010 End Sept.
Financial Data (Rs.bn)		
Capital Funds	19.4	24.5
Total Borrowings	70.8	90.7
Total Accommodations	78.8	95.2
Total Assets	107.1	135.2
Profits for the period	1.1	2.6
Ratios (%)		
Capital Funds to Borrowings (Gearing)	3.7	3.7
Total Accommodations to Total Assets	73.6	70.4
NPAs	7.5	5.3
Return on Assets (ROA)	3.2	5.6
Return on Equity (ROE)	11.0	21.7

Source : Central Bank of Sri Lanka

Leasing and hire purchases, which accounted for more than 74 per cent of total accommodations at end September 2010, are the major business activities of SLCs. As SLCs are not permitted to accept deposits from the public, they mainly depend on funds raised through issue of debt instruments. Accordingly, total borrowings rose by 28.1 per cent to Rs.90.7 billion at end September 2010 from Rs.70.8 billion reported at end September 2009. In terms of the financial portfolio, outstanding borrowings represented 67 per cent of the total liabilities of the SLCs while capital funds represented only 18 per cent.

Total interest income increased to Rs.9.7 billion during the six months ending September 2010 from Rs.8.8 billion during the six months ending September 2009. The net interest income increased by 87 per cent to Rs.5.1 billion from Rs.2.7 billion for six months ended September 2010 while non-interest income increased from Rs.2.4 billion to Rs.2.7 billion. Net profit after tax significantly increased by 148 per cent to Rs.2.6 billion from Rs.1.1 billion, largely due to low cost of borrowings.

Risk Assessment

The SLC sector has shown an improvement under the current favourable business environment, maintaining a healthy profitability and quality of assets. The profitability of most of the companies increased during nine months ending September 2010, mainly due to increase in net interest income. The industry NPA ratio at 5.3 per cent in September 2010 has decreased from 7.5 per cent reported at end September 2009. Even though SLCs have obtained licenses from the CBSL to carry on finance leasing business, some SLCs had concentrated more on direct lending and hire purchase businesses than finance leasing business due to the imposition of a ceiling on the claimable input value added tax on finance leases. It is noted that risk management practices in the sector are relatively weak and have not been addressed with a view to improving management information systems, credit appraisal techniques and streamlined recovery procedures.

Policies adopted by CBSL for SLCs

During the first nine months of the year, following actions were taken by the CBSL to strengthen the financial stability of the industry.

- The CBSL issued the Finance Leasing (Corporate Governance) Direction with effect from 01 January 2010 in order to make the Boards of Directors of finance companies responsible and accountable for the companies' performance and risk management.
- The CBSL introduced prudential measures to mitigate specific risks. These included a direction to prohibit lending to directors, their relatives and related companies. In addition, a direction was also issued to restrict business transactions with directors and their relatives.

- The introduction of a Credit Guarantee Scheme in early 2010 in respect of loan facilities provided by banks to distressed SLCs.

Unauthorised Finance Institutions

The CBSL continued its investigations on institutions allegedly engaging in finance business without authorization and has taken legal action against such institutions while continuously educating public of the risk of investing in unauthorized finance business. The CBSL noted a reduction in the number of customer complaints received regarding unauthorised institutions in 2010 compaired with the previous year, suggesting a decrease in such unauthorised activities. Greater awareness among the public on unauthorized finance businesses would also have helped to reduce this activity.

During the year, the CBSL regularized the activities of "Ceylinco Grameen Credit Company Ltd." which was carrying on finance business without authority under the new name of "Grameen Micro Credit Company Ltd". While continuing the legal action against the institutions carrying out finance business without authority and for violating of the provisions of the Finance Companies Act, the CBSL has been assisting the judiciary to safeguard the interests of depositors / investors who have filed fundamental rights applications at the supreme court (04 cases) against the institutions which have collected funds from the public in various manner and had defaulted repayment. The CBSL facilitated the Special Committee appointed by the Supreme Court to complete the Phase I of the repayments to the security deposit holders of the Golden Key Credit Card Company Ltd. Accordingly Rs.788 million had been paid to 8,020 security deposit holders of the Golden Key Credit Card Company Ltd.

5.3 Insurance Companies

There are nineteen insurance companies registered by the Insurance Board of Sri Lanka (IBSL) under the Regulation of Insurance Industry Act (RII Act). Twelve companies are composite insurers offering both general and long-term (life) insurance, while five companies are engaged only in general insurance business and two companies conduct only long-term insurance business. Seven of the composite insurance companies are listed on the Colombo Stock Exchange and six companies have foreign collaboration. One insurance company was suspended from engaging in new business.

The insurance industry is highly concentrated, with the two largest companies accounting for 64 per cent of total assets and the largest five companies accounting for 92 per cent of total assets as at end September 2010. The state-owned composite insurance company accounts for 41 per cent of total assets and 42 per cent of composite insurance assets. All the major players are composite insurers. There were 48 insurance brokering companies, mainly involved in general insurance business and about 37,000 insurance agents who play a key role in marketing life insurance products, at the time of renewal of registration for 2010.

The insurance company sector accounts for about 3 per cent of financial sector assets. Insurance penetration (total premium as a percentage of GDP) measures the level of insurance activity relative to the size of the economy. Insurance penetration in Sri Lanka was 1.2 per cent in 2009 consisting of 0.7 per cent in general insurance and 0.5 per cent in long-term insurance business. Insurance density (the ratio of premiums to total population) was 24.4, with general insurance density being 14.3 and long-term insurance being 10.1. Sri Lanka's position *vis-a-vis* other Asian countries with respect to insurance penetration and density is shown in Table 5.5. Insurance penetration and density in

Table 5.5 Insurance Penetration and Density in Selected Countries of Asia – 2009

	Insurance penetration (in per cent)			Insurance Density (US Dollars)		
	Total Business	Life	General	Total Business	Life	General
Japan	9.9	7.8	2.1	3,979.0	3,138.7	840.4
Singapore	6.8	5.1	1.7	2,557.6	1,912.0	645.6
India	5.2	4.6	0.6	54.3	47.7	6.7
Malaysia	4.4	2.9	1.6	321.8	206.9	115.0
Thailand	4.0	2.4	1.6	154.4	91.7	62.7
PR China	3.4	2.3	1.1	121.2	81.1	40.0
Philippines	1.5	1.0	0.5	26.1	17.0	9.1
Sri Lanka*	1.2	0.5	0.7	24.4	10.1	14.3
Indonesia	1.3	0.9	0.4	31.7	22.0	9.6
Pakistan	0.7	0.3	0.4	6.6	3.0	3.6
World	**7.0**	**4.0**	**3.0**	**595.1**	**341.2**	**253.9**

* The indicators for Sri Lanka have been calculated based on actual data (2009) obtained from Insurance Board of Sri Lanka and CBSL.

Source : Swiss Re, Sigma No. 2/2010

Sri Lanka is low in comparison to other Asian countries and therefore there is great scope for the expansion of the industry.

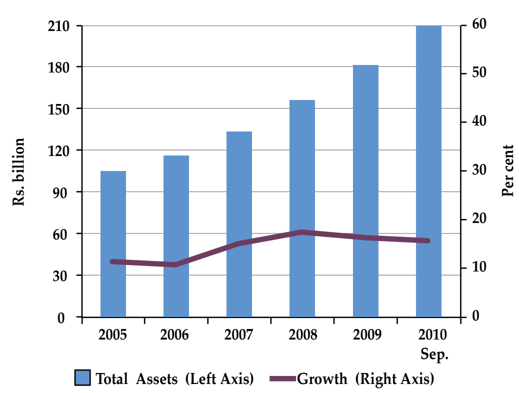
Total assets of insurance companies amounted to Rs.209 billion as at end September 2010 registering an increase of 16 per cent from the end of 2009. The total assets of the long-term insurance business stood at Rs.140 billion at end September 2010, accounting for 67 per cent of total insurance company assets. The total assets of the general insurance business amounted to Rs.69 billion at end September 2010, accounting for 33 per cent of the total assets of the industry. Insurance companies recorded an annual average asset growth of 21 per cent in the last five years.

Total gross written premium (GWP) of insurance companies increased by 13 per cent to Rs.48 billion in the first nine months of 2010 as against a decline of 3 per cent in the first nine months of 2009 and an annual decline of 1 per cent in 2009. This indicates a recovery in premium income of the insurance sector in 2010. The average annual growth of GWP for the period 2002-2008 was about 19 per cent.

The GWP for long-term insurance (which accounted for 44 per cent of total GWP) grew by 22 per cent to Rs.21 billion in the first nine months of 2010, compared with an increase of 1 per cent in the first nine months of 2009. The annual growth of GWP for long-term insurance was 2 per cent in 2009, while the average annual growth was 18 per cent for the period 2002-2008.

The GWP for general insurance (which accounted for 56 per cent of total GWP) increased by 8 per

Chart 5.4 Total Assets of Insurance Companies



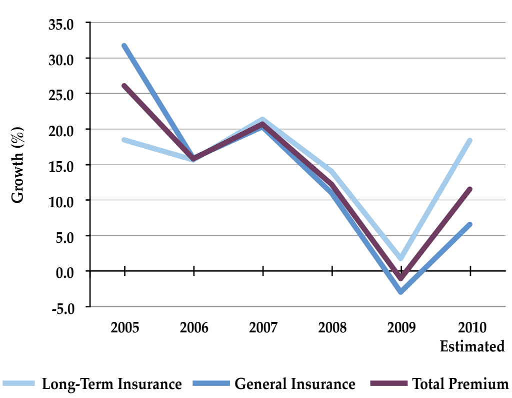
Source : Insurance Board of Sri Lanka

cent to Rs.27 billion in the first nine months of 2010, as against a decline of 5 per cent in the first nine months of 2009. GWP for general insurance declined by 3 per cent in 2009, while the average annual growth was 21 per cent for the period 2002-2008.

All the major sub-classes of general insurance sector except fire insurance contributed to the growth in 2010. The premium income of motor insurance, which is the largest segment of general insurance (with a share of 56 per cent) increased by 13 per cent. The prospects for the expansion of the motor insurance business were boosted with the reduction in import duty on motor vehicles in June 2010. The premium income of marine insurance (share of 5 per cent) and miscellaneous insurance (share of 21 per cent) grew by 35 per cent and 1 per cent respectively, while fire insurance (share of 18 per cent) declined by 4 per cent, respectively, during the first nine months of 2010.

Net premium (GWP minus reinsurance premium) for the insurance sector increased in the first nine months of 2010. Net premium for general insurance increased by 13 per cent in the first nine months of 2010. Net premium for all classes of general insurance, except fire insurance increased. The net premium for long-term insurance increased by 22 per cent in the first nine months of 2010

Chart 5.5 Premium Growth of Insurance Companies



Source : Insurance Board of Sri Lanka

The retention ratio (the ratio of net premium to total GWP) for the insurance sector was 76 per cent, while 24 per cent was ceded as reinsurance premiums to cover for large risks in the first nine months of 2010. Motor insurance continued to maintain the highest retention ratio of 98 per cent. The retention ratios for miscellaneous insurance and marine insurance were 76 per cent and 55 per cent respectively. Fire insurance had the lowest retention ratio of 14 per cent. The retention ratio for long-term insurance was 97 per cent.

Earned premium (GWP adjusted by the unearned premium provisions at the beginning and end of the accounting period.) for the insurance sector increased in the first nine months of 2010. The earned premium for long-term insurance increased by 44 per cent in the first nine months of 2010. Earned premium for general insurance declined by 8 per cent in the first nine months of 2010. Earned premium for all classes of general insurance, except motor insurance declined.

The claims ratio for general insurance (claims to earned premium) increased to 65 per cent in the first nine months of 2010 from 63 percent in 2009, primarily due to higher claims recorded for fire and motor insurance. The claims ratio for motor insurance increased slightly to 63 per cent in the first nine months of 2010 from 60 per cent in the first nine months of 2009. The claims ratio for long-term insurance increased from 40 per cent to 48 per cent.

The combined operating ratio measures the core profitability of an insurance company; it is the result of adding a company's claim ratio with its management expense ratio. The combined operating ratio for general insurance declined to 81 per cent in the first nine months of 2010 from 89 per cent in the first nine months of 2009. The combined operating ratio for long-term insurance increased to 72 per cent in the first nine months of 2010 from 69 per cent in the same period of 2009, reflecting the significant increase in claims.

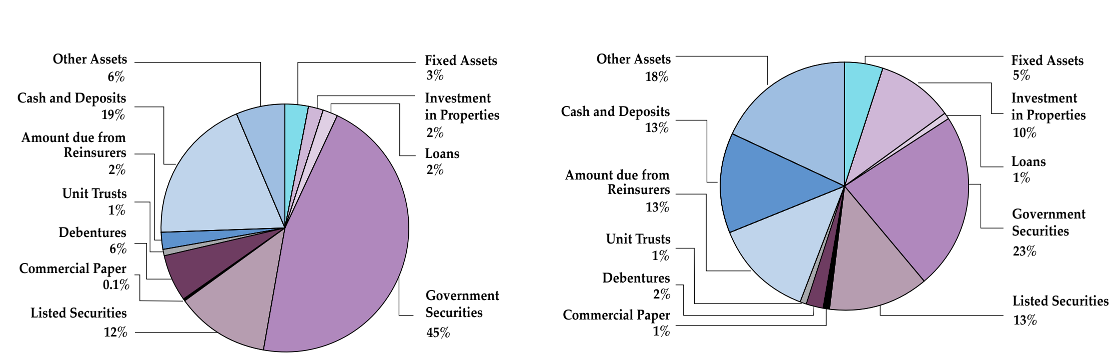
Total investment income of insurance companies grew by 96 per cent in the first nine months of 2010 due to the favourable conditions in the capital market. Consequently, the ratio of investment income to net premium income rose to 57 per cent at September 2010 from 34 per cent at end September 2009. Investments in equities increased by 39 percent, while government securities increased by 9 per cent in the first nine months of 2010. The share of government securities and equities in the total assets of the insurance companies was 38 per cent and 12 per cent, while corporate debt securities amounted to 4 per cent.

In terms of the RII Act, insurance companies are required to invest a minimum of 20 per cent of technical reserves of general insurance and 30 per cent of long-term funds in government securities. All insurance companies complied with this regulation. On an industry-wide basis, 23 per cent of general insurance assets and 46 per cent of long-term insurance assets were invested in government securities at end September 2010. The share of equity investments amounted to 13 per cent for general insurance and 12 per cent for long-term insurance.

The overall profits of the insurance company sector increased by 71 per cent in the first nine months of 2010, mainly due to higher investment income. The majority of companies made overall profits. This included the five largest companies which accounted for over 89 per cent of the profits of the sector. A few small and mainly recently established entities recorded losses. The underwriting profits of the insurance company sector increased by 14 per cent in the first nine months of 2010 as some of the large companies incurred underwriting profits. The majority of companies made underwriting profits. However, the intense price competition particularly in general insurance in the nascent economic recovery conditions that prevailed in the first nine months of 2010 affected underwriting performance. The return on equity (ROE) of insurance companies (general insurance) increased to 11.2 per cent in the first nine months of 2010 from 8.7 per cent in the first nine months of 2009.

The main risks facing insurance companies are underwriting risk and market risk. With regard to underwriting risks, insurance companies have to focus on expanding their core business in the growing economy. As business expanded there will be greater opportunities for the growth of general insurance business. In addition, there is huge potential for the growth of life insurance products, such as single premium insurance policy, unit link insurance products, pension retirement planning, annuity and takaful insurance. The availability of a steady supply of long term investment instruments,

Chart 5.6 **Distribution of Assets of Insurance Companies**

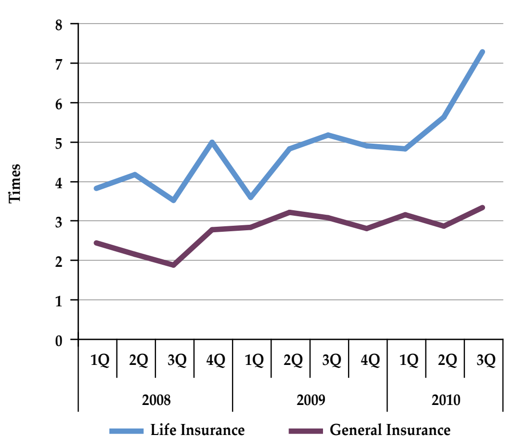


Source : Insurance Companies

such as government and corporate bonds will facilitate the growth of a greater variety of life insurance products. Insurance companies are exposed to market risk on their investments. In past few years, the favourable conditions in the government securities market and lately in the stock market have enabled insurance companies to make significant gains on their investments and to manage market risk adequately. The growth of the government and corporate bond market in the future will provide insurers with more options to diversify their investments. However, in the low interest rate environment and moderation in growth in equity prices in the future, insurance companies will need to more actively manage their portfolios and match the duration in their asset and liabilities structure, in order to effectively manage market risk.

The solvency margin is the main indicator of soundness of insurance companies, as it measures the adequacy of capital to meet obligations. All insurance companies met the statutory solvency margin requirement for both general and long-term insurance. The industry overall solvency margin ratio for long-term insurance and general insurance increased to 7.2 and 3.3 respectively at the end of September 2010. All insurance companies were able to meet their claims in 2010. The IBSL requires

Chart 5.7 **Solvency Ratio of Insurance Companies**



Source : Insurance Board of Sri Lanka

insurance companies to obtain a rating of Insurers' Financial Strength (IFS) indicating their ability to pay claims from a recognized rating agency. The IBSL also administers the Policy Holders Protection Fund which is funded from a cess collected from insurance companies and invested in government securities.

All insurance companies met the minimum regulatory capital requirements for both general and life insurance. Shareholder funds of the insurance sector increased to Rs.30 billion as at September 2010 from Rs.26 billion as at end September of 2009. The ratio of shareholder funds to total assets was 14 per cent at end September of 2010 and is at an adequate level. The IBSL has initiated a project to move to a risk-based capital adequacy framework for insurance companies. The risk-sensitive capital model will apply different capital requirements for different risk profiles based on the asset structure and business mix of companies.

The prospects for the growth of the insurance sector are favourable in the last quarter of 2010 and 2011. The strengthening of economic growth and the increase in per capita incomes will stimulate the demand for both general and long-term insurance products. The removal of the war-risk premium by the London Joint Cargo Committee in June 2010 and reduction in the premiums for terrorism cover by the National Insurance Trust Fund (NITF) by 75 per cent in April 2010 will boost general insurance business and have a positive impact on underwriting profitability through lower reinsurance costs. The reduction in import duties on motor vehicles will lead to a growth of motor insurance. There is also huge potential for the introduction of new life insurance products, such as pensions, annuities and personal investment products.

The proposed amendments to the RII Act to strengthen the prudential regulation and supervision of the entire insurance industry in order to protect the interest of policyholders, has been presented to Parliament and is expected to be enacted soon. The revisions to the law will increase the powers of the IBSL to issue directions to insurance companies, brokers and loss adjusters. The IBSL will also be empowered to stipulate capital requirements for insurance companies and brokers, make rules and determinations and engage in dispute resolution and prescribe "fit and proper" criterion for boards of directors of insurance companies and brokers. Other proposed revisions include the appointment of institutions as agents of insurance companies and the requirement that long-term and general insurance business be conducted in separately incorporated companies, with existing composite insurers being given time to segregate business into separate companies. All insurance companies will also be required to list on the stock exchange. Further proposed amendments include the registration of re-insurers and micro insurance providers.

5.4 Primary Dealers

Primary Dealers (PDs) performed well in terms of risk management recording acceptable levels of risk for indicators such as the repo to assets ratio, capital leverage and risk weighted capital adequacy ratio, reflecting improved stability of the sector. The PD capital base increased due to the high retention level of profits earned during the period under consideration and the enhanced portfolio arising from the increase in the trading portfolio. However, PDs showed a setback in profitability during the first nine months of the year, over the corresponding period in the previous year. The key profitability indicators of the PD industry such as Return on Assets (ROA) and Return on Equity (ROE) showed a decrease mainly due to reductions in revaluation gains and capital gains earned during the period, compared to the first nine months of the previous year. State owned PDs dominated the Treasury bond auctions while non-state sector PDs dominated the Treasury bill auctions held during the first nine months of the year. The first stage of the PD diversification programme was implemented from December 2009 with PDs given permission to engage in fee based activities and invest in shares or debentures of its own group of companies in the banking and finance sector.

Table 5.6 **Selected Financial Data and Indicators of Primary Dealers**

Data / Indicator	Unit	Jan. – Sept. 2009	Jan. – Sept. 2010
Total Assets	Rs.Mn	105,390	146,596
Total Portfolio	Rs.Mn	102,724	143,510
Net Profit Before Tax	Rs.Mn	5,703	5,024
RWCAR	%	24.9	19.2
Tier 1 Capital (RWCAR)	%	24.7	19.3
Capital Leverage Ratio	Time	7.6	5.8
Return On Assets (Before Tax)	%	8.1	5.4
Return On Equity (Before Tax)	%	70.4	46.9
Operating Expenses to Gross Income	%	2.8	2.7
Total Cost to Total Income	%	59.2	59.9
Duration of Assets & Liabilities	%	1.1	1.3

Source : Central Bank of Sri Lanka

Market Development Activities

Primary Market

Both state and non-state sector PDs effectively participated at primary auctions held during the first nine months of the year. Compared to the corresponding period of the previous year, non state owned PDs increased their participation at Treasury bill auctions from 55 per cent to 64 per cent while state owned PDs increased their participation at Treasury bond auctions from 58 per cent to 74 per cent during the first nine months of 2010.

Secondary Market

Total secondary market transactions through the PD system marginally decreased to Rs.4,691.1 billion during the first nine months of 2010 from Rs.4,692.7 billion recorded in the same period of 2009. However, compared to the corresponding period of 2009, Treasury bill transactions increased by 4 per cent while Treasury bond transactions decreased by 2 per cent up to end September 2010. Outright transactions for Treasury bills increased by 15 per cent while outright transactions for Treasury bonds significantly decreased by 37 per cent. In contrast, repurchase transactions for Treasury bills decreased by 2.5 per cent while repurchase transactions for Treasury bonds increased by 10 per cent.

Assessment of Risks

Market Risk

The market risk of PDs was very low during the first nine months of 2010 due to the downward trend in the interest rates for government securities. The outcome of the stress test, which measures the sensitivity of the trading portfolio and the capital base of PDs to a change in interest rates, indicates that 12 per cent of capital of the PD industry would be eroded, if interest rates move upward by 100 bps. The impact of such a change on the portfolio value is estimated to be a loss of Rs.1,621 million. The market risk for PDs arose only from changes in interest rates for government securities as PDs, which were allowed to engage in diversified activities to mitigate market risks, did not engage in any other activities due to certain practical issues. The modified duration of the trading portfolio increased to 1.52 by end September 2010 from 1.06 recorded at end September 2009 revealing a positive trend in the market to invest in longer term maturities.

Liquidity Risk

PDs were comfortable with their liquidity position during the first nine months of 2010 as shown by the frequent usage of the Open Market Operation (OMO) window for repo transactions. However, an assessment of liquidity risk through a detailed maturity structure analysis, which measures the level of mismatch between the assets and liabilities of PDs at different maturity periods (overnight, one week and one month), revealed a mismatch of assets and liabilities in the overnight maturities with liabilities exceeding assets by Rs, 6,609 million at end September 2010. The overnight portfolio, however, accounted for only 5 per cent of the total industry trading portfolio.

Operational Risk

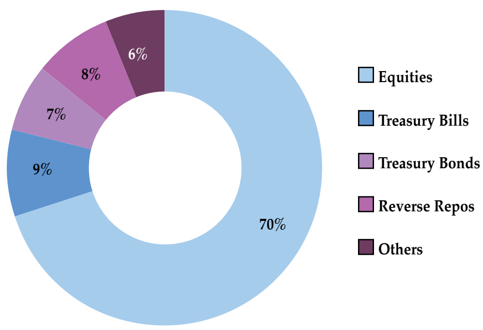
Operational risks, arising from failed internal processes, inappropriate human resource practices and external events, can result in losses to enterprises. In order to mitigate operational risks of PDs, the Central Bank conducted regular off-site survellance and on-site examinations and assessed the adequacy of internal control systems, audit functions and Business Continuity Plans. Further, the Central Bank periodically reviewed PD disaster recovery sites which are a requirement for PDs.

5.5 Unit Trusts

There are 19 unit trust (UT) funds, which are managed by 5 UT management companies. Of these funds, 14 are open- ended funds and 5 close-ended funds. These funds can also be categorized according to their investment focus. Accordingly, there are income funds (7), growth funds (5), balanced funds (4), money market funds (2) and index funds (1). One closed – ended fund is listed on the Colombo Stock Exchange (CSE).

The UT industry performed exceptionally well in the favourable stock market conditions. The net asset value (NAV) of the UT industry increased by 81 per cent to Rs.18 billion at end September 2010 from the level recorded at end 2009, reflecting gains made through investments in

Chart 5.8 **Investment Portfolio of Unit Trusts**



Source : Unit Trust Association of Sri Lanka

the share market. The share of equities in the investment portfolio of unit trusts increased to 71 per cent at end September 2010, while the share of government securities declined to 16 per cent at end September 2010. The other fixed income securities also increased to 14 per cent at end September 2010.

The total number of unit holders and units issued increased to 24,025 and 668 million respectively as at end September 2010. The investment climate and prospects for the growth of the UT industry are very good. UTs can cater to diverse groups of investors (retail investors, pensioners, companies and institutional investors) because of the different investment focus of funds. UT is particularly suitable to investors that do not have time or resources to manage their portfolios effectively and for companies and institutional investors for investment diversification purposes. UT management companies should mount popularization campaigns throughout the country to educate investors on UTs and attract investment and expand their distribution channels.

The total assets of the five UT management companies increased by 11 per cent to Rs. 689 million at end September 2010 from Rs.621 million at end September 2009. The net profits (profits before tax) of the companies increased significantly to Rs.101 million in the first nine months of 2010 from Rs.71 million in the first nine months of 2009.

The unit trust management companies are supervised by the Securities and Exchange Commission (SEC) which monitors the exposure levels of unit trusts in accordance to the investment guidelines and limitations set out in the relevant Trust Deeds and the Unit Trust Code. The SEC strengthened the regulation of UT management companies during the year. Directives were issued relating to the revisions of the existing rule on investment restrictions (single entity exposure) and the current definition of short term debt instruments.

5.6 Superannuation Funds

The superannuation fund sector consists of two major publicly managed funds – the Employees' Provident Fund and the Employees' Trust Fund, the Public Service Provident Fund and about 170 privately managed provident and pension funds. The superannuation fund sector, which accounts for about 18 per cent of the total assets of the financial system, is dominated by the Employees' Provident Fund, which accounts for about 14 per cent of the total financial system assets.

Employees' Provident Fund (EPF)

The EPF is administered by the Commissioner of Labor, while the responsibility for the management of the fund lies with the Monetary Board of the Central Bank. The EPF has a total of about 12.8 million accounts, of which 2.2 million are active accounts. Total contributions increased by 10 per cent to Rs.40 billion in the first nine months of 2010, while refunds rose by 5 per cent to Rs.25 billion at end September 2010, resulting in a net contribution (contribution less refunds of benefits) of Rs.15 billion compared to Rs.13 billion in the corresponding period of 2009.

Table 5.7 Key Indicators of Major Superannuation Funds (as at end September 2010)

	EPF	ETF
Number of Accounts (mn.)*	12.8	9.1
o/w; Active Accounts (%)*	17.2	2.1
Total Contributions (Rs. bn.)	40.1	7.3
Total Refunds (Rs. bn.)	25.1	4.7
Total Assets (Rs. bn.)	864.0	121.7
Total Investments Portfolio (Rs. bn.)	839.3	116.0
o/w : Government securities (%)	95.1	90.4
Gross Income (Rs.bn.)	84.9	11.7

* Estimated

Source : Central Bank of Sri lanka
Employees' Trust Fund Board

The total assets of the EPF stood at Rs.864 billion at end September 2010, recording an annual growth of 18 per cent. The increase in both the income and member contributions accounted for the growth of the fund. The total liability to members rose by 17 per cent to Rs.763 billion at end September 2010, accounting for a substantial portion of the fund.

The EPF investment portfolio consisting of government securities, listed and unlisted shares, corporate debt securities, trust certificates and reverse repos, amounted to Rs.839 billion at end September 2010. The investment income increased by 56 per cent to Rs.84 billion in the first nine months of 2010. Interest income accounted for 98 per cent of investment income.

The financial performance of the EPF indicates that the fund was able to manage its risks adequately in the first nine months of 2010. The main risks faced by the EPF are credit risk, liquidity risk, market risk and operational risk.

The credit risk of the fund is negligible, as 95 per cent of the investment portfolio has been invested in the default risk-free government securities. Another 1 per cent of the portfolio was invested in corporate debentures that have investment grade ratings.

The liquidity risk of the EPF was also negligible, net contributions increased by 17 per cent reflecting an increase in liquidity. As the receipts of contributions are higher than the payment of refunds, no risk arises in settling liabilities. Investments in reverse repos have also helped meet liquidity requirements. The proposal to enable EPF members to withdraw 30 per cent of their EPF balances for housing and other essential purposes will not have a significant impact on the liquidity of the fund as measures have been put in place to limit withdrawals and funds have been set aside for this purpose.

The EPF portfolio is exposed to interest rate risk as the majority of investments is held in interest sensitive government securities. The interest rate risk is minimized as the portfolio is diversified in securities with different yields and maturities. Investments in equities have risen to 4 per cent of the portfolio which helped to lessen the impact of the volatility in interest rates. In the current low interest rate environment, the EPF portfolio would also face some reinvestment risk in the form of lower interest rates. The reinvestment risk can be mitigated to some extent by increasing investments in the equity market and by actively managing the portfolio.

Operational risk has been reduced through the implementation of a comprehensive internal auditing process, new member accounting system, segregation of duties and the introduction of authority limits for transactions and close supervision.

Employees' Trust Fund (ETF)

The ETF is administrated by the statutory Employees' Trust Fund Board and comes under the purview of the Ministry of Finance. The ETF has about 9.1 million accounts, of which about 2.1 million are active accounts. The number of employers contributing to the fund increased to 61,695 in September 2010 from 60,857 in September 2009. Total contributions increased to Rs.7 billion in the first nine months of 2010, recording a growth of 13 per cent. Superannuation benefits paid to members during the first nine months of 2010 amounted to Rs.5 billion, registering a growth of 1 per cent over the comparable period of the previous year. The ETF had a net inflow of funds during the period under review, as contributions received exceeded refunds.

The total assets of the ETF increased by 18 per cent to Rs.122 billion at the end of September 2010. The outstanding on account of member balances was Rs.139 billion, while the investment portfolio amounted to Rs.116 billion. The risk profile of the investment portfolio of the ETF is similar to that of the EPF, with the majority of investments in government securities (90 per cent). Corporate debt securities and equities accounted for 4 per cent and 1 per cent respectively of the portfolio.

Public Service Provident Fund (PSPF)

The PSPF which is managed by the Department of Pensions had about 234,127 active members at the end of September 2010. The total assets of the PSPF stood at Rs.24 billion at end September of 2010. Total contributions and refunds during the first nine months of 2010 amounted to Rs.1,292 million and Rs.285 million respectively.

Approved Provident and Pension Funds (APPF)

There are about 170 privately managed APPF, which are registered and monitored by the Department of Labour. These funds have about 157,500 members. The total assets of the APPFs increased at an annual rate of 30 per cent to Rs.126 billion at end September of 2010. Total investments amounted to Rs. 107 billion at end September 2010.

The absence of a prudential regulator and supervisor for the privately managed superannuation funds sector has been identified as one of the gaps in the regulation of the financial system. This factor has also stunted the growth and development of this sector. The main advantages of effective regulation and supervision of privately managed superannuation funds is that members' contributions would be better safeguarded, more professionally managed and their returns enhanced. The growth of the superannuation fund sector would facilitate the development of the capital market, as such funds are key institutional investors in the medium and long term securities markets. Hence, work is in progress to have the privately managed superannuation funds supervised by a financial regulator.

Box 4

A Regulatory and Supervisory Mechanism for Microfinance in Sri Lanka

1. The importance of microfinance in Sri Lanka

Microfinance may be defined as a package of financial services to economically active poor and micro-enterprises for income and employment generation. These financial services should include not only loans but savings, advisory and technical services, financial literacy services, *etc*. The importance of microfinance is that it helps alleviate poverty and enhance the liquidity to the poor who lacks credit worthiness to access the formal financial institutions. Furthering access to finance among the low income population would contribute towards income generation activities and thereby improve savings habits as well as their living standards.

2. Need of a regulatory mechanism

In order to ensure the microfinance sector in Sri Lanka operates effectively, it is necessary to have a set of sound Microfinance Institutions (MFIs) to carry out such operations in a professional manner. Some MFIs operate as financial intermediaries by mobilizing funds as savings (accepting deposits) and providing credit facilities while some others operate only as lending/credit institutions. When any institution mobilizes deposits, it becomes essential that it does so within a prudential framework which ensures the safety of such deposits. Hence, a regulatory and supervisory mechanism for MFIs scattered throughout the country accepting deposits from the public has been a long felt need. Even globally, many concerns such as high interest rates, unethical recovery practices, malpractices in relation to granting of credit call for regulation and supervision of microfinance in the interest of the poor.

The presence of an effective regulatory mechanism to streamline the operations of MFIs would address issues of mismanagement, lack of transparency, poor accounting practices and any possible unethical activities of MFIs, thus ensuring the soundness of the sector, building public confidence and wider access to sources of funding. This would also discourage the emergence of unauthorized and fraudulent financial activities.

3. Proposed Regulatory mechanism

Under the proposed regulatory mechanism, an independent authority will be established for the regulation and supervision of microfinance businesses which are not currently regulated or supervised, *i.e.*, companies, non-governmental organizations and societies carrying on microfinance business. Further, under the proposed mechanism, the Monetary Board is empowered to set principles and standards to the regulators of MFIs.

3.1 Proposed Microfinance Regulatory and Supervisory Authority

(a) Members of the Authority

- an officer of the Ministry of Finance, nominated by the Secretary to the Treasury;
- an officer of the Central Bank of Sri Lanka nominated by the Monetary Board of the Central Bank of Sri Lanka;
- three members appointed by the Minister, one of whom shall be a person representing a professional accounting body and other two from among persons who have academic or professional qualifications in finance, banking, economics, law, management or any other related field together with relevant experience.

(b) Objectives of the Authority

- licensing and registering of companies, non-governmental organizations and

Box 4 (*Contd.*)

societies carrying on microfinance business,

- strengthening and developing MFIs licensed/registered under the Authority by enhancing their viability and accountability,
- ensuring that microfinance business is carried on with integrity and in a transparent, professional and prudent manner,
- maintaining confidence of the depositors and the customers and
- minimizing risk of losses to the depositors by establishing and enforcing effective standards of governance, accounting and disclosure.

(c) Powers of the Authority

- issue directions to MFIs licensed/ registered under the Authority on capital requirements, liquid assets, lending operations and acceptance of deposits, *etc*.
- determine the minimum amount of core capital or net assets a MFI would require to carry on business at different levels such as National Level, Provincial level in an Administrative district or in a Divisional Secretary's Division,
- callforinformationandtocauseexamination on MFIs and to take supervisory actions on MFIs,
- take supervisory actions on MFIs licensed/ registered under the Authority,
- cancel the licences/certificates of registration of MFIs licensed/registered under the Authority.

(d) Funding needs of the Authority

Funding needs for the first two years of the proposed Authority is estimated to be around Rs. 400 million, (Rs. 225 million for the first year and Rs. 175 million for the second year), which would be met by the Government.

3.2 Licensing / registration procedure:

(a) Licensing

- An eligible institution *i.e.*, a company/ Non-governmental Organization/ society will be required to be licensed by the proposed Authority to carry on microfinance business at National Level or at Provincial level. Under the proposed structure, the "Provincial Level" is not limited to an Administrative Province but an Administrative Province or any two or three Administrative Districts in different Provinces. National Level would mean more than three Administrative Districts in different Provinces.
- Only public companies registered under the Companies Act would be eligible to be licensed to carry on microfinance business at National Level. However, all categories of eligible institutions (companies, Non-governmental Organizations, societies) are eligible to be licensed to carry on microfinance business at Provincial Level.

(b) Registration

Registration would be the requirement to carry on microfinance business in an Administrative District or in a Divisional Secretary's Division. Registration will require a lesser degree of regulations and supervision in comparison to licensing.

3.3 Permitted activities

The following main activities will be permitted under the proposed Act and the Authority will also be authorized to determine from time to time any other form of business that a microfinance institution may carry on by way of a gazette notification.

- to provide financing facilities for all types of economic activities including housing, but excluding business in foreign exchange transactions;
- to accept time and savings deposits excluding, however, the carrying on of banking business as defined in the Banking Act, No. 30 of 1988;

Box 4 (*Contd.*)

- to provide credit to buy, sell and supply industrial and agricultural inputs, livestock, machinery and industrial raw materials, and to act as an agent for any organization for the sale of such goods or livestock;
- to invest its money in economic activities;
- to provide storage and safe custody facilities;
- to provide professional advice to its customers regarding investments in small businesses, self employment projects and cottage industries ;
- to render managerial, marketing, technical and administrative advice to customers and assisting them in obtaining services in such fields;
- to provide financial and technical assistance and training to micro enterprises.

3.4 Exempt categories

Licensed Commercial Banks, Licensed Specialized Banks, Registered Finance Companies, Co-operative Societies, Samurdhi Societies and Farmers Organizations formed in terms of the Agrarian Development Act do not require to be licensed or registered under the proposed mechanism to carry on microfinance business.

3.5 Role of the Central Bank

Under the proposed mechanism, the Monetary Board would be empowered to set principles and standards to all regulators of MFIs i.e. Microfinance Regulatory and Supervisory Authority, Commissioner of Co-operative Development, Samurdhi Authority of Sri Lanka and Commissioner General of Agrarian Development.

The Monetary Board would be also empowered to call for quarterly, semi-annual or annual consolidated financial data of MFIs from the regulators of MFIs.

6. Financial System Infrastructure and the Regulatory Framework

- The key payment and settlement systems, the LankaSettle system and the Cheque Imaging and Truncation (CIT) system, operated without disruption and recorded a very high degree of system availability, with further improvements to business continuity arrangements.
- The Sri Lanka Inter-Bank Payment System (SLIPS) which is a pre-authorised retail payment system was upgraded to an on-line payment system which facilitates settlements on a T+0 basis.
- As regulator and supervisor of the payment system, the CBSL issued licences to financial institutions to operate as service providers of payment cards in 2010. In addition, the CBSL issued Credit Card Operational Guidelines to the licensed institutions and will commence on-site supervision to ensure compliance will commence shortly.
- In order to provide a secure environment for electronic fund transfers, the CBSL has prepared draft guidelines for mobile payments which have been posted on the website. Guidelines on internet payments will be issued in early 2011.
- The regulatory framework relating to the financial sector continues to be strengthened. Several new laws and amendments to existing laws have been finalized, such as the Regulation of Finance Business law, the Regulation of Microfinance Institutions law and Regulation of Asset-backed Securitization law and amendments to the Banking Act and the Regulation of Insurance Industry Act.

6.1 Payment and Settlement Systems

The Central Bank of Sri Lanka (CBSL), under the Payments and Settlement Systems Act (PSSA), No. 28 of 2005, is authorized to supervise and regulate payment and settlement systems and implement a national payment system policy in Sri Lanka. Maintaining a secure, reliable and efficient payment and settlement system is a necessity for achieving stability in the financial system. Therefore, the CBSL, as the responsible authority, has adopted measures to maintain payment and settlement system stability to ensure financial system stability.

With the modernization of information and communication technology, new advanced and efficient payment instruments are introduced to the financial markets and usage of these payment methods have increased over the years. With these developments, methods of settling transactions have migrated from conventional paper based payment instruments to electronic payment instruments. Hence the CBSL strengthened its regulatory and supervisory activities to reduce risks and to ensure safety, efficiency and stability in the national payment and settlement systems. The CBSL strengthened legal provisions to regulate electronic payment systems in order to promote electronic fund transfer systems as safe and efficient means of effecting payments.

The CBSL continued oversight activities to ensure continuity of operations in the systemically important payment and settlement systems. Since the safety and timely settlement are of paramount important in systemically important payment systems, business continuity arrangements of the providers of retail payment and settlement systems were strengthened to maintain a high level of operational reliability and security to minimize risks and to ensure public confidence in these payment instruments.

LankaSettle System

The LankaSettle system, which comprises of two tightly integrated systems, *i.e.,* the Real Time Gross Settlement (RTGS) system and the LankaSecure system, continued to provide a safe and reliable mechanism for efficient settlement of transactions in the country. The RTGS system settles high value payments on a real time gross basis while the Lanka Secure system settles securities transactions on a Delivery versus Payment (DvP) basis. The value of transactions of RTGS system accounted for 87 per cent of non cash payments and continued to be the main fund transfer system in Sri Lanka. The daily average value of transactions was Rs.163 billion and daily average volume of transactions was 1,010 during the period of January – September 2010. Since the LankaSettle system is highly integrated with all financial markets and major retail clearing systems, the CBSL adopted measures to maintain the system with a high and consistent level of resilience and operated the system at 99.9 per cent availability during the period of January – September 2010.

Considering the systemic importance of the LankaSettle system, the CBSL strengthened the security of the disaster recovery site and tested its business continuity arrangements periodically to ensure operational reliability and uninterrupted system availability in an event of a disruption at the main site.

In March 2009, the CBSL carried out self assessment of the LankaSettle system against the 10 Core Principles for Systemically Important Payment and Settlement (CPSIPS) system put forward by Bank for International Settlements. LankaSettle system was closer to observing all 10 CPSIPS and action was taken to improve the few deficient areas. Accordingly, LankaSettle system rules, which govern the operations of the LankaSettle system, was amended incorporating all the changes made over the years. In order to provide a corrective measure to another deficient area identified at the self assessment, the CBSL revised the procedure of granting Intraday Liquidity facility (ILF) to its Participating Institution (PIs) of the RTGS system. ILF is provided to facilitate temporary liquidity shortfall of PIs during the day enabling them to settle transactions on real time in the RTGS system. Initially, the PIs had to pledge government securities at the beginning of the day and obtain ILF. The ILF requirements during the day were provided only by the CBSL on the request of a PI at the beginning of the day. Any additional requirements were provided only by the CBSL after the initial allocation. However, with the implementation of the new system, PIs have the full freedom to manage their own ILF requirement without intervention of the CBSL. However, the CBSL is provided with a facility to monitor the usage of ILF by all PIs during the day.

LankaSecure

The LankaSecure System consists of the Scripless Securities Settlement System (SSSS) and the Central Depository System (CDS) for scripless Government Securities. The total value of scripless securities held by LankaSecure as at 30 September, 2010 amounted to Rs.2,337 billion, accounting for 99.8 per cent of the total value of Treasury Bills and Treasury Bonds outstanding. These scripless securities consisted of Rs.543 billion Treasury bills and Rs.1,794 billion Treasury bonds. Accounts maintained by the LankaSecure through dealer direct participants, covering corporate as well as individual investors has increased by 14 per cent to 72,419 in 2010 from 63,534 in 2009. In comparison with the past three years the gradual increase of the value of the secondary market transactions is clearly evident. The value of the securities transacted during the first three quarters of 2010 was at Rs. 32,244 billion that indicates a 33 per cent increase with comparison to the same period in 2009.

With the purpose of ensuring the investors on transactions and outstanding balances in their accounts and increasing the confidence level of the investor base, three types of official statements, (Transaction Summary, Payment Statements and Statement of Holdings) are issued by LankaSecure to investors. The total number of LankaSecure statements sent to investors during the first three quarters in 2010 amounted to 153,473. LankaSecure facility is another free service provided by LankaSecure, providing online access to the investors' CDS account to view their balances of Government Securities held at the CDS. It would lead to increase the confidence of investors since they are in a position to monitor and ensure their investments at CDS accounts as soon as their investments have taken place.

Participants of "LankaSecure" are further benefited as the system provides facilities to carry out Customer Repo repositioning transactions which was introduced in February 2007, with Rs.2.0 million or below and increased up to Rs.5.0 million in September 2009. This facility enables each participant to exchange securities within their internal accounts free of charge though CBSL Wide Area Network (CBSL WAN) facility. Further, the LankaSecure system has provided easy access for Open Market Operations (OMO) transactions without any delay to acquire excess liquidity to fulfill liquidity requirements of the participants, called Intra Day Liquidity Facility (ILF) from February 2010.

Retail Payment and Settlement Systems

Due to the development and innovations in information and communication technology, retail payment systems have undergone rapid change with new payment systems and transaction types being introduced. As a result, usage of electronic fund transfer systems have increased considerably during recent years. New electronic payment methods such as payment cards, mobile and internet banking have become popular methods of settling transactions. The CBSL, realizing the importance of a safe and efficient national payment system, adopted measures to reduce risks associated with such payment systems.

Cheque Imaging and Truncation System

Cheque Imaging and Truncation (CIT) system was introduced in 2006 with the objective of increasing efficiency of cheque clearing by reducing the cheque realization time island wide from 10 days to T+1 where T is the day on which LankaClear (Pvt) Ltd. (LCPL) receives the cheque for clearing and 1 is the following business day. The CBSL issued a Direction on CIT system to commercial banks on formulating procedures and norms on cheque collection, crediting cheque proceeds to customers' accounts and the modalities of handling customer complaints. The CBSL monitored the adherence of commercial banks to the Direction and observed that the T+1 rule was not adhered nationwide as expected. Therefore, on the instructions of the National Payment Council (NPC) the CBSL conducted a survey to obtain customers' views on cheque clearing process and assess the achievement of objectives of the CIT system. The customer survey covered 1,233 account holders in the entire country except the Northern and Eastern Provinces. The survey revealed that the awareness on T+1 rule on cheque realization process was low with only around 46 per cent of the sample being aware of it. Accordingly, the CBSL strengthened its awareness campaign and instructed commercial banks to educate their customers on the cheque realization process.

Elimination of the movement of physical cheques from the entire clearing cycle is a requirement to obtain maximum efficiency of the cheque clearing process under CIT system. The NPC paid attention to this matter and decided to migrate cheque image submission mode to Compact Disks (CD) by terminating its image capturing operations at LCPL's Regional Centres and requested commercial banks to capture the images at the respective branch itself. All commercial banks successfully migrated to CD submission mode from 1st July 2010 and LCPL closed operations at its regional centres from August 2010.

It was observed that the high percentage of cheque returns recorded in 2008/2009 was a risk to the smooth functioning of the CIT system. On the instructions of the NPC, the CBSL evaluated the cheque returns and observed that the major reason for cheque returns was the unavailability of funds in respective accounts of the issuer. Therefore, the NPC instructed the Sri Lanka Banks' Association to take necessary actions to reduce cheque returns due to lack of funds. Furthermore, considering the impact of cheque returns on the CIT system and to develop a culture among cheque issuers to ensure issuing of valid cheques and for banks to accommodate only trustworthy customers, the Credit Information Bureau (CRIB) Act was amended in 2009 to facilitate recording details of cheque returns due to unavailability of funds from January 2010. This has shown a marked decline in the cheque returns and the ratio has currently declined to 3.78 per cent from 5.32 per cent in 2009.

Sri Lanka Interbank Payment System

Sri Lanka Interbank Payment System (SLIPS) operated by the LCPL clears pre-authorized low value payments through an off line mechanism. The volume of SLIPS transactions grew by 46 per cent in the first nine months of 2010 over the reference period in 2009 and the value of SLIPS transactions grew by 20 per cent during this period largely due to payment of salaries and the 20 per cent bonus interest to senior citizens through SLIPS. During the year, the LCPL enhanced the SLIPS to address the issues of increasing transaction volumes and to reduce the risks inherent to an off-line payment system. The upgrade was aimed facilitating greater security in transaction completion by providing on-line submission of SLIPS data to LCPL and settlement of transactions on T+0 basis. The LCPL completed migration to the new system in September 2010.

Business Continuity Plans

Considering the risk that can be caused by an operational failure of a Participating Institutions (PIs), the CBSL strengthened its supervisory and oversight activities to ensure the preparedness of each PI to continue critical operations in an emergency. CBSL after completion of the supervision of the Disaster Recovery Sites (DRS) and the Business Continuity Plans (BCPs) of the PIs and recommending improvements, commenced evaluation of the DR sites again to ensure that the recommendations were implemented. Furthermore, test runs also were conducted from the respective DR Sites. During the first half of 2010, DR sites of 7 PIs were inspected and recommendations were made for further improvements of BCPs and DR sites.

BCP and DR site of the Lanka Financial Services Bureau (LFSB), which was established to provide SWIFTNet connectivity, management and data processing services to participants of the LankaSettle system at a lower cost was also evaluated in December 2009 and corrective measures were recommended to improve the BCP and equip the DR site to deal with any contingency event. LFSB operations are currently being audited by the SWIFT in order for LFSB to obtain certification.

LCPL has updated its BCP and conducted its operations from the DR sites successfully in several occasions during the year. In order to ensure its readiness for contingency events LCPL conducted all activities, *i.e.,* CIT system, SLIPS, Rupee draft clearing and US Dollar Cheque clearing from its DR site in May, 2010. In addition, the CIT system was operated from DR site for 6 continuous days in July 2010.

Regulations

Payment cards have become a convenient, secure and cost effective method of settling both local and international transactions. Even though the popularity of payment cards increased over the years, there were no legal provisions in Sri Lanka to protect the rights of card holders and to regulate the payment card industry. Therefore, having considered the risks associated with the existence of non regulated businesses and their negative impact on the financial system, the CBSL issued the Service Providers of Payment Cards Regulation No.01 of 2009, as per the authority given under the Payment and Settlements Systems Act, No.28 of 2005. Under the Regulations, the CBSL is authorised to regulate and supervise the payment card issuers and to monitor all new products relating to the payment card industry before they are introduced to the market. Through this regulation, the CBSL is empowered to issue circulars, directions, guidelines and operating instructions to streamline the operations of payment card industry in Sri Lanka. As per the provisions given in the Regulations, all service providers of payment cards engaged in payment card businesses were required to obtain a licence to engage in the business. After evaluating the applications submitted by the service providers of payment cards, licences were issued to 17 financial institutions to operate as service providers of payment cards.

The CBSL also issued the "Credit Card Operational Guideline No.1 of 2010" which was effective from 1st March, 2010. The guideline provides operational and technical instructions to card issuers to operate in line with the best international standards and practices to promote the credit card as a safe, secure and efficient payment instrument and to protect the interests of the card holders. The CBSL expects to begin on-sight supervision of payment card issuers, to ensure compliance with the guideline, during the fourth quarter of 2010.

In order to facilitate the functions of other electronic fund transfer mechanisms in a secure environment, the CBSL is in the process of preparation of mobile payment guidelines and internet payment guidelines which are expected to be issued by the end of 2011.

6.2 Regulatory Framework

The regulatory framework governing the financial sector is being continually upgraded to improve prudential safeguards and to keep pace with innovations relating to products, technologies and processes introduced to the market and to manage risks that may arise in connection with these developments. Some of the important regulatory directives, amendments to existing legislation and proposed new laws are described below.

Regulation of Banks

Enhanced minimum capital requirements for banks were announced in 2010. The CBSL has raised the minimum core capital requirements for Licensed Banks on a staggered basis to enable banks to expand their operations and to improve soundness and resilience of the banking sector. New Licensed Commercial Banks (LCBs) would be required to have minimum capital of Rs. 3 billion from 2010, Rs. 4 billion from 2012 and Rs.5 billion from 2014, while existing LCBs would be required to have minimum capital of Rs. 3 billion by end 2011, Rs. 4 billion by end 2013 and Rs. 5 billion by end 2015. The minimum capital for new Licensed Specialised Banks (LSBs) would be Rs. 2 billion from 2010, Rs. 2.5 billion from 2012 and Rs. 3 billion from 2014, while existing LSBs would be required to have Rs. 2 billion by end 2011, Rs. 2.5 billion by end 2013 and Rs. 3 billion by end 2015.

A mandatory deposit insurance scheme was established for banks and finance companies to provide a safety net for depositors and to promote stability of the financial system. The Sri Lanka Deposit Insurance Scheme (SLDIS), a mandatory deposit insurance scheme for Licensed Banks and Registered Finance Companies was introduced in October 2010 under the provisions of the Monetary Law Act. The main objectives of the SLDIS are to protect small depositors and to offer liquidity support for member institutions in imminent distress with a view to strengthening the stability of the financial system. According to the SLDIS, in the event of a cancellation of the licence or registration of a member institution, depositors will be compensated up to a maximum of Rs.200,000 per depositor, per institution. The members of the scheme, comprising all Licensed Banks and Registered Finance Companies, participated in the scheme from 1 October, 2010. Depositors will be entitled to benefits after 1 January, 2012. The premium for this scheme, to be paid by member institutions on a monthly/quarterly basis, will range between 0.10 per cent and 0.15 per cent per annum. With the implementation of the scheme, small depositors will be safeguarded and public confidence in financial institutions will be enhanced, while the commitment of the government in the case of a failure of a financial institution will be significantly reduced.

Amendments to the Banking Act were finalized during the year. The proposed amendments include powers for the regulator to conduct the consolidated supervision of banking groups, provisions to facilitate consolidation through mergers and acquisitions of Licensed Banks, provisions to strengthen the bank resolution measures and certain changes necessitated by the new Companies Act. The CBSL discussed the proposed amendments with the banking sector and the revisions are expected to come into effect in 2011.

Directives to encourage bank lending were issued. A direction permitting banks to grant credit facilities for the repayment of non-performing loans without requiring the new facility to be classified as delinquent was issued to stimulate bank lending to the economy. The general provision on performing loans and loans in the special mention category was reduced from 1 per cent to 0.5 per cent on the staggered basis.

Assessment of the fitness and propriety of the key executives of banks. To improve the standards of corporate governance in banks, the CBSL decided to extend the fitness and propriety criteria, which is currently applicable to directors of banks, to the senior management performing key executive functions in banks.

Directions on outsourcing of activities were issued. Many banks enter into outsourcing arrangements with external service providers that possess specialised resources or skills for performing activities or processes connected with the operations of the banks. The directions which were issued by the CBSL in November 2010 relate to outsourcing of activities by banks with a view to mitigating any potential operational risks that may arise from such arrangements. The directions apply only to activities that are directly related to the provision of financial services, while excluding certain operations such as Treasury functions, risk management, asset and liability management and acceptance of deposits from being outsourced.

A direction on integrated risk management will be issued. The CBSL intends to finalise the draft guidelines on integrated risk management with a view to further strengthening risk management in banks. As banks are exposed to various risks such as credit, liquidity, interest rate, foreign exchange rate, operational, legal, regulatory and reputational risk, which are highly interdependent, the proposed direction will require banks to develop an integrated risk management process that appropriately reflects the interaction of risks across all activities of the bank.

The further implementation of Basel II is progressing. The CBSL proposes to issue guidelines on Pillar II of Basel II which relate to additional prudential requirements following the supervisory process to further strengthen the capital planning process in banks and to encourage the internal ratings based approaches in the future.

A direction on customer protection for banks is being prepared. The CBSL proposes to issue directions to reduce unfair and unethical business practices, whilst enhancing the customers' confidence in the banking sector. Banks will be encouraged to adopt higher standards of conduct for customer protection as these directions will serve as a minimum requirement.

Work is in progress to prepare banks for the adoption of the Sri Lanka Accounting Standards 44 and 45 relating to fair value accounting of financial instruments. This would entail classification of and measurement of financial instruments, including impairment of loans and receivables. Banks are engaged in capacity building and putting in place systems and procedures to adhere to these standards which will come into effect in 2012.

Regulation of Finance Business

The new Regulation of Finance Business Act to combat the problem of unauthorized deposit taking and to strengthen the regulation and supervision of Registered Finance Companies will be introduced. As the existing Finance Companies Act has several limitations and lacunae, a new Regulation of Finance Business Act will replace it. The proposed new law will make the acceptance of deposits without authority an offence. The definition of "deposits" will be widened to cover a broad range of fund mobilisation activities. The powers of the CBSL relating to the investigation and examination of unauthorised deposit-taking entities will be strengthened and offenses will carry more severe penalties. The establishment of companies with names or acronyms of Registered Finance Companies will be prohibited. The proposed law will also enhance the reporting requirements of Registered Finance Companies and the remedial measures required to be taken by those that are not in compliance with the law. The proposed law also provides for a mandatory deposit insurance scheme for Registered Finance Companies by the Monetary Board.

The minimum capital requirements of finance and leasing companies will also be increased. Registered Finance Companies and Specialised Leasing Companies will be required to increase their minimum capital from Rs. 200 million to Rs. 500 million and Rs. 75 million to Rs. 200 million, respectively, on the phased basis over three years.

Regulation of Micro-finance Institutions

A law to regulate and supervise micro-finance institutions will be enacted. The different categories of micro-finance institutions are currently registered under various laws but are not regulated or supervised according to prudential standards. A separate body called the Microfinance Regulatory and Supervisory Authority will be established to license, regulate and supervise companies, non-government organizations, societies and co-operative societies carrying on micro-finance business. The objectives of authority will be to strengthen the viability and accountability of micro-finance institutions and to ensure that their operations are conducted in a transparent, professional and prudent manner with a view to safeguarding the interests of depositors and customers. Appropriate and effective standards of governance, accounting and disclosure will be enforced. The board of the authority will include representatives of the Ministry of Finance, Central Bank and a professional accounting body.

Regulation of the Insurance Sector

Comprehensive amendments will be made to the Regulation of Insurance Industry (RII) Act to strengthen the regulation and supervision of the entire insurance sector. The powers of the regulator, the Insurance Board of Sri Lanka (IBSL) to issue directions to insurance companies, brokers and loss adjusters will be strengthened to protect the interest of policy holders. The IBSL will also be empowered to stipulate capital and other prudential requirements for insurance companies and brokers, make rules and determinations, engage in dispute resolution and prescribe a "fit and proper" criteria for boards of directors of insurance companies and brokers. Other proposed revisions include the appointment of institutions as agents of insurance companies and the requirement that long-term and general insurance business be conducted in separately incorporated companies, with existing composite insurers being given time to segregate business into separate companies. A risk-based capital adequacy framework for insurance companies is also being formulated.

Prevention of Money Laundering and the Countering the Financing of Terrorist

The Financial Intelligence Unit (FIU) continued its operations in terms of the Financial Transactions Reporting Act. Accordingly, Licensed Banks, Registered Finance Companies, Insurance Companies and Stock-Broking Companies are required to report any suspicious transactions or cash transactions and electronic fund transfers exceeding the threshold of Rs. 1 million or its equivalent in foreign currencies, to the FIU. These transactions are reported through an on line data submission system known as "LankaFIN". During the year, the FIU signed Memorandum of Understanding (MOUs) with five relevant agencies in India, Australia, Belgium, Solomon Islands and Bangladesh. The FIU is in the process of updating the three existing laws governing anti-money laundering and combating terrorist financing *i.e.*, the Prevention of Money Laundering Act, the Suppression of Terrorist Financing Act and the Financial Transactions Reporting Act.

Regulation of the Stock Exchange

Measures were taken to mitigate risks in the stock market. In view of the large volume of credit facilities provided by stock-brokers to customers which has increased their credit risk significantly, the Securities and Exchange Commission (SEC) will permit only margin providers to extend credit facilities to customers from 2011. To reduce the volatility of share prices on the Colombo Stock Exchange (CSE), the SEC introduced "price bands" which limits movements in prices of selected shares either way within a day. A new automated market surveillance system will be introduced by the SEC in late 2010 which will improve the detection of manipulations by traders.

Several regulatory policies and initiatives are being implemented to develop the stock market. A regulatory framework for exchange traded funds is being prepared and it is proposed that the rules will be *gazetted* in the first quarter of 2011. In order to increase the volume of shares available for trading and to improve the liquidity of the market, the SEC is considering requiring companies to maintain a minimum public float of shares, on a continuous basis. Rules for the dematerialization of listed securities will also be introduced. All new public issues will be in scripless form from 2011 and existing paper securities will be dematerialised by 2012 to facilitate trading. Comprehensive margining requirements for shares will also be introduced in 2011.The SEC and the CSE have initiated action to set up a central counter-party clearing corporation to facilitate the introduction of new products like exchange traded derivatives, such as futures and options. The central counter-party clearing arrangement would guarantee settlement thereby mitigating settlement risk and facilitate the move to a Delivery versus Payment system.

A framework for the demutualization of the Colombo Stock Exchange is being prepared. This will involve conversion from a company limited by guarantee to a public company limited by shares. The demutualization of the Colombo Stock Exchange will segregate ownership and management from the trading rights of members of the exchange and the Securities and Exchange Commission Act will be amended to facilitate this reform.

Regulation of Asset-Backed Securitization

The new law to regulate asset-backed securitization has been prepared. The proposed Regulation of Asset-Backed Securitization Act will enable the formation and operation of Special Purpose Vehicles/Qualified Securitization Trusts for the issuance of asset backed securities, stipulate minimum standards of disclosure for the protection of investors and introduce regulations for originators, trustees and facilitators. The proposed law will provide an impetus for the development of the asset backed securities market in a safe manner.

Box 5

Credit Card Operational Guidelines

Introduction

Over the past few years, the usage of credit cards as a payment instrument has increased significantly mainly due to the growing preference of customers to use electronic payment methods. This increase has been further driven by the customer convenience provided through the access given by card issuers to cardholder to use extra funds in addition to their owned funds in hand or bank accounts. Moreover, increase in the electronic point of sales outlets and reward and incentives schemes offered by credit card issuers through their promotional campaigns also have contributed to the increased usage of credit cards in Sri Lanka.

Credit Card Operations

Year	No. of Credit Cards in use	Volume of Transactions ('000)	Value of Transactions (Rs. Mn)
2003	406,130	7,676	23,239
2004	508,177	9,759	33,300
2005	628,989	12,352	42,323
2006	810,179	16,392	54,948
2007	905,551	18,261	67,091
2008	929,112	18,867	72,749
2009	840,509	16,627	65,315
2010 (a)	816,521	12,004	53,396

(a) Up to September

Source : Central Bank of Sri Lanka

Although the popularity of credit cards increased over the years, there were no legal provisions to regulate the credit card business. Furthermore, practices followed by some card issuers such as accepting deposits without permission and providing unlimited credit facilities to cardholders resulted in losses to customers and a threat to the integrity and stability of the financial system in Sri Lanka. Therefore, having considered the timely requirement of improving the security of electronic payment mechanisms and at the same time ensuring customer protection, the Central Bank of Sri Lanka (CBSL), through the legislative mandate entrusted by the Payment and Settlement System Act, No. 28 of 2005 formulated the "Service Providers of Payment Cards Regulations No. 1 of 2009" (Regulations) on 31 July, 2009. In terms of the provisions of the Regulations, institutions that are eligible to engage in credit card business were required to obtain licenses from the CBSL and the CBSL was empowered to issue Directions, Circulars and Guidelines to efficiently implement, administer and enforce the provisions of the Regulations. Accordingly, the Bank issued Credit Card Operational Guidelines No. 1 of 2010 (Guidelines) in March 2010 to ensure safe, secure and efficient operation of the credit card industry.

Salient Features of the Credit Card Operational Guidelines

Marketing Practices

The Guidelines require credit card issuers to adhere to the following practices in marketing cards:

- Disclose the official identity of the marketing staff in promotional campaigns.
- Communicate the terms and conditions, benefits, incentives and rewards clearly to prospective cardholders.
- Refrain from engaging in aggressive and hard selling marketing practices.
- Disclose their code of conduct and institutional policy during the marketing process to enable prospective cardholders to understand their rights and obligations and measures that could be adopted to protect their interests.
- Conduct regular training programmes for marketing staff.

Box 5 (*Contd.*)

Eligibility criteria for credit cardholders

The Guidelines specify the eligibility criteria for credit cardholders, which are as follows.

- An individual who is a resident of Sri Lanka, above 18 years of age and has independent financial means.
- A non-resident who maintains a Non-Resident/ Resident/ Resident Non-National Foreign Currency Account or an Off Shore Banking Unit Account provided that all dues are settled in foreign currency through such accounts.

Application process

- Prospective cardholders should submit a signed application form along with necessary supporting documents to obtain a credit card.
- The card issuer should ascertain the credit worthiness of the prospective cardholders by analyzing the self declarations and credit information obtained from the Credit Information Bureau.

Terms and conditions

- The card issuer shall notify the cardholder of information such as rights, liabilities and obligations of the cardholder, applicable fees, charges, method of calculation of interest and dispute resolution mechanisms in simple language and in writing when a credit card is issued to an individual.
- The same information shall also be published in the official web site of the card issuer.

Supplementary cards

The procedure to be followed by card issuers when issuing a supplementary credit cards are also set out in the Guidelines.

Interest rates and charges

- The card issuer must specify the applicable annual interest rates and service charges for the purchase of goods or services and cash withdrawals, separately. It was observed that some card issuers specify only the monthly interest rate which may mislead cardholders.
- Card issuers are required to inform the cardholder of any revisions in the interest rates, fees and charges.

Billing Statement

The billing statement has been streamlined.

- Information such as transaction date, name of the merchant, currency and billed amount, calculation method of interest and other charges, minimum amount to be paid and the due date, acceptable modes of payment and exchange rate for foreign currency transactions should be included in the billing statement.
- Card issuers were also required to make comprehensive and convenient arrangements for cardholders to pay due amounts conveniently, on time.
- With regard to complaints of non- receipt of the billing statement, the card issuer is required to dispatch a billing statement within 10 days of receipt of the complaint.

Collection and recovery of defaulted credit card payments

Card issuers are instructed to conduct the recovery process prudently.

- Unethical practices by card issuers, including verbal or physical harassment or threats to cardholders and their family members are prohibited.

Confidentiality

- Card issuers are required to maintain confidentiality of cardholder information.

Dispute Resolution

- The dispute resolution mechanism should be disclosed by card issuers on their official web site to enable the cardholders to initiate action on disputed transactions promptly.

Outsourcing

- Card issuers are permitted to outsource certain functions such as marketing, recoveries and courier services to third party service providers.
- Card issuers shall maintain confidentiality of the information of cardholders.

Appendix Tables

Appendix Table 1

Financial Soundness Indicators – All Banks

		2007	2008	2009	2010 September
1.	**Capital Adequacy**				
1.1	Regulatory Capital to Risk Weighted Assets (RWCAR)	14.1	14.5	16.1	15.5
1.2	Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	12.6	12.5	14.1	13.4
1.3	Net Non-Performing Loans to Total Capital Funds	14.1	18.5	26.2	20.0
1.4	Debt to Capital Funds	220.0	209.4	157.6	172.9
1.5	Capital to Assets Ratio	8.0	8.1	8.1	8.3
2.	**Asset Quality**				
2.1	Gross Non-Performing Loans (NPL) to Total Gross Loans (w/o Interest in Suspense)	5.2	6.3	8.5	6.7
2.2	Gross Non-Performing Loans (NPL) to Total Gross Loans (with Interest in Suspense)	6.8	8.1	10.7	8.8
2.3	Net Non-Performing Loans to Total Gross Loans	1.9	2.6	4.1	3.2
2.4	Provision Made against Gross Loans	3.3	3.8	4.5	3.6
2.6	Provision Coverage Ratio (Total)	64.5	60.9	53.0	53.9
2.5	Provision Coverage Ratio (Specific)	55.3	47.6	42.9	40.7
2.7	Sector-wise NPL to Total Sector Loans				
	Agriculture & Fishing	6.4	7.1	4.2	3.9
	Manufacturing	8.3	8.3	11.4	11.1
	Tourism	4.4	3.7	5.3	7.6
	Transport	6.5	7.4	6.7	6.2
	Construction	5.6	8.6	12.5	10.0
	Traders	8.0	10.1	10.9	9.2
	New Economy	1.8	3.1	4.4	4.1
	Financial and Business Services	2.1	2.3	4.4	3.4
	Infrastructure	2.0	3.1	5.5	4.3
	Other Services	3.3	2.1	6.3	6.0
	Other Customer	3.3	3.3	5.5	3.6
2.8	Sectoral Distribution of Loans to Total Gross Loans				
	Agriculture & Fishing	4.9	5.2	10.7	13.3
	Manufacturing	16.1	17.3	15.1	13.3
	Tourism	2.1	2.4	2.7	2.2
	Transport	2.1	2.1	1.6	1.6
	Construction	17.9	16.8	17.2	17.1
	Traders	12.6	12.9	13.8	13.7
	New Economy	2.3	1.3	1.4	0.9
	Financial and Business Services	6.2	5.6	4.1	4.3
	Infrastructure	1.3	1.3	1.3	1.3
	Others Services	4.7	5.7	4.9	5.4
	Other Customer	29.8	29.4	27.2	26.9
2.9	Provision Made against Total Assets	2.0	2.3	2.4	1.9
2.10	Total Loans (Gross) to Total Assets	61.3	60.6	53.1	53.3
2.11	Investments to Total Assets	22.1	25.0	30.8	32.5
2.12	Total Income to Total Assets	12.7	14.8	14.0	11.7
2.13	Net Interest Income to Total Assets	4.1	4.3	4.3	4.3
2.14	Operating Income to Total Assets	5.7	6.3	6.2	6.3
3.	**Earnings & Profitability**				
3.1	Return on Equity (ROE) – After Tax	14.0	13.4	11.8	23.4
3.2	Return on Assets (ROA) – Before Tax	1.9	1.9	1.8	3.0
3.3	Return on Assets (ROA) – After Tax	1.1	1.1	1.0	1.9
3.4	Interest Income to Gross Income	87.4	86.3	86.0	82.2
3.5	Net Interest Income to Gross Income	31.9	28.9	30.5	36.5
3.6	Non-Interest Income to Total Income	12.6	13.7	9.9	17.8
3.7	Non-Interest Expenses (Operating Expenses) to Total Income	23.7	22.3	22.9	25.1
3.8	Staff Expenses to Non-Interest Expenses	44.2	44.5	46.5	45.9
3.9	Personnel Expenses to Total Income	10.5	9.9	10.6	11.5
3.10	Provisions to Total Income	3.6	4.2	6.2	0.0
3.11	Total Cost to Total Income	79.2	79.8	78.4	70.8
3.12	Efficiency Ratio	55.6	55.6	56.5	44.3
3.13	Interest Margin	4.4	4.4	4.5	4.5
4.	**Liquidity**				
4.1	Liquid Assets to Total Assets	28.1	28.4	35.2	32.6
4.2	Statutory Liquid Assets Ratio – DBU	30.4	31.3	39.2	38.9
5.	**Assets / Funding Structure**				
5.1	Deposits	69.5	69.6	74.2	72.5
5.2	Borrowings	17.6	17.0	12.7	14.3
5.3	Capital to External Funds	9.2	9.4	9.3	9.5
5.4	Credit to Deposits	88.1	87.0	71.6	73.5
5.5	Credit to Deposits & Borrowings	70.3	70.0	61.1	61.4
5.6	Credit to Deposits & Borrowings & Capital	64.4	64.0	55.9	56.1

Source : Central Bank of Sri Lanka

Appendix Table 2

Financial Soundness Indicators – Licensed Commercial Banks

		2007	2008	2009	2010 September
1.	**Capital Adequacy**				
1.1	Regulatory Capital to Risk Weighted Assets (RWCAR)	13.6	13.8	15.4	14.8
1.2	Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	11.9	11.1	12.9	12.3
1.3	Net Non-Performing Loans to Total Capital Funds	11.9	16.7	25.3	19.0
1.4	Debt to Capital Funds	231.2	223.5	166.0	188.4
1.5	Capital to Assets Ratio	7.7	7.9	7.9	8.0
2.	**Asset Quality**				
2.1	Gross Non-Performing Loans (NPL) to Total Gross Loans (w/o Interest in Suspense)	5.0	6.0	9.9	6.3
2.2	Gross Non-Performing Loans (NPL) to Total Gross Loans (with Interest in Suspense)	6.6	7.8	10.5	8.4
2.3	Net Non-Performing Loans to Total Gross Loans	1.5	2.1	3.7	2.8
2.4	Provision Made against Gross Loans	3.6	4.0	4.7	3.6
2.5	Provision Coverage Ratio (Total)	71.5	65.9	56.9	57.6
2.6	Provision Coverage Ratio (Specific)	61.6	53.4	47.6	44.9
2.7	Sector-wise NPL to Total Sector Loans				
	Agriculture & Fishing	6.3	6.7	3.7	3.4
	Manufacturing	8.5	8.3	11.2	10.8
	Tourism	4.2	3.3	4.9	7.3
	Transport	6.6	7.1	6.3	5.4
	Construction	3.8	6.8	10.3	8.6
	Traders	8.1	10.2	10.9	9.2
	New Economy	1.1	2.4	3.9	4.2
	Financial and Business Services	2.3	2.3	4.7	3.4
	Infrastructure	0.2	4.1	7.3	5.7
	Other Services	3.3	2.0	6.2	5.9
	Other Customer	3.5	3.5	5.9	3.9
2.8	Sectoral Distribution of Loans to Total Gross Loans				
	Agriculture & Fishing	5.2	5.4	11.6	13.9
	Manufacturing	16.9	17.9	15.7	13.7
	Tourism	2.2	2.6	2.9	2.3
	Transport	2.3	2.2	1.7	1.6
	Construction	16.4	14.6	14.6	14.7
	Traders	13.6	13.8	14.9	14.7
	New Economy	1.1	1.1	1.3	0.9
	Financial and Business Services	5.5	4.9	3.3	4.2
	Infrastructure	0.9	1.0	1.0	1.0
	Others Services	4.9	6.0	5.2	5.7
2.9	Provision Made against Total Assets	2.3	2.6	2.6	2.1
2.10	Total Loans (Gross) to Total Assets	65.1	64.5	56.3	56.8
2.11	Investments to Total Assets	16.6	20.1	26.0	27.7
2.12	Total Income to Total Assets	12.8	14.7	13.9	11.2
2.13	Net Interest Income to Total Assets	4.2	4.6	4.5	4.4
2.14	Operating Income to Total Assets	5.9	6.6	6.5	6.2
3.	**Earnings & Profitability**				
3.1	Return on Equity (ROE) – After Tax	15.0	14.8	11.0	21.3
3.2	Return on Assets (ROA) – Before Tax	1.9	2.0	1.7	2.7
3.3	Return on Assets (ROA) – After Tax	1.1	1.2	0.9	1.7
3.4	Interest Income to Gross Income	86.5	86.1	85.8	83.6
3.5	Net Interest Income to Gross Income	32.9	30.9	32.7	39.1
3.6	Non-Interest Income to Total Income	13.5	14.0	10.2	16.4
3.7	Non-Interest Expenses (Operating Expenses) to Total Income	25.2	23.9	24.6	28.2
3.8	Staff Expenses to Non-Interest Expenses	42.9	43.5	45.5	45.4
3.9	Personnel Expenses to Total Income	10.8	10.4	11.2	12.8
3.10	Provisions to Total Income	4.0	4.6	7.2	-0.4
3.11	Total Cost to Total Income	78.7	79.0	77.7	73.0
3.12	Efficiency Ratio	56.7	56.1	59.2	47.3
3.13	Interest Margin	4.5	4.7	4.8	4.7
4.	**Liquidity**				
4.1	Liquid Assets to Total Assets	25.4	25.4	32.0	28.2
4.2	Statutory Liquid Assets Ratio	24.8	25.7	33.0	32.1
5.	**Assets / Funding Structure**				
5.1	Deposits	69.4	69.0	74.0	71.9
5.2	Borrowings	17.8	17.7	13.1	15.0
5.3	Capital to External Funds	8.8	9.1	9.1	9.2
5.4	Credit to Deposits	93.8	93.4	76.1	79.0
5.5	Credit to Deposits & Borrowings	74.7	74.3	64.6	65.4
5.6	Credit to Deposits & Borrowings & Capital	68.6	68.1	59.2	59.9

Source : Central Bank of Sri Lanka

Appendix Table 3

Financial Soundness Indicators – Licensed Specialised Banks

		2007	2008	2009	2010 September
1.	**Capital Adequacy**				
1.1	Regulatory Capital to Risk Weighted Assets (RWCAR)	20.6	21.0	22.0	20.7
1.2	Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	21.2	25.6	23.6	22.3
1.3	Net Non-Performing Loans to Total Capital Funds	23.0	26.7	30.4	24.0
1.4	Debt to Capital Funds	172.4	146.0	120.8	109.0
1.5	Capital to Assets Ratio	9.4	9.1	9.0	9.9
2.	**Asset Quality**				
2.1	Gross Non-Performing Loans (NPL) to Total Gross Loans (w/o Interest in Suspense)	6.7	8.9	10.4	10.1
2.2	Gross Non-Performing Loans (NPL) to Total Gross Loans (with Interest in Suspense)	8.0	10.5	12.2	11.9
2.3	Net Non-Performing Loans to Total Gross Loans	5.3	6.1	7.5	6.8
2.4	Provision Made against Gross Loans	1.5	3.0	3.2	3.5
2.5	Provision Coverage Ratio (Total)	22.4	33.3	30.1	34.6
2.6	Provision Coverage Ratio (Specific)	17.6	15.7	15.4	18.8
2.7	Sector-wise NPL to Total Sector Loans				
	Agriculture & Fishing	8.5	14.4	20.0	13.2
	Manufacturing	6.0	9.7	13.8	15.7
	Tourism	8.0	13.6	18.1	16.7
	Transport	4.8	12.9	12.3	13.4
	Construction	13.8	15.5	19.5	14.7
	Traders	6.6	8.4	9.5	10.7
	New Economy	3.7	5.5	6.8	2.2
	Financial and Business Services	1.6	2.6	3.5	3.7
	Infrastructure	5.4	0.6	1.1	1.0
	Other Services	3.6	4.0	8.8	8.3
	Other Customer	0.3	0.4	0.6	0.5
2.8	Sectoral Distribution of Loans to Total Gross Loans				
	Agriculture & Fishing	3.1	3.1	3.0	8.0
	Manufacturing	11.8	10.8	9.7	8.8
	Tourism	1.0	0.9	0.9	0.8
	Transport	0.8	1.4	1.0	1.6
	Construction	35.2	38.8	39.6	40.7
	Traders	5.2	4.4	3.9	3.9
	New Economy	4.1	3.2	2.1	0.3
	Financial and Business Services	12.7	12.9	10.5	5.1
	Infrastructure	4.3	3.9	3.9	4.1
	Others Services	2.6	2.7	2.5	2.6
	Other Customer	19.1	18.0	23.0	24.0
2.9	Provision Made against Total Assets	0.6	1.2	1.2	1.2
2.10	Total Loans (Gross) to Total Assets	41.3	40.7	37.4	35.2
2.11	Investments to Total Assets	50.2	50.1	54.5	56.6
2.12	Total Income to Total Assets	12.5	14.9	14.6	14.2
2.13	Net Interest Income to Total Assets	3.3	2.8	2.9	3.7
2.14	Operating Income to Total Assets	4.3	4.6	4.8	7.0
3.	**Earnings & Profitability**				
3.1	Return on Equity (ROE) – After Tax	10.0	6.9	15.3	32.4
3.2	Return on Assets (ROA) – Before Tax	1.7	1.4	2.4	4.1
3.3	Return on Assets (ROA) – After Tax	0.9	0.6	1.4	3.0
3.4	Interest Income to Gross Income	92.2	87.8	86.8	76.7
3.5	Net Interest Income to Gross Income	26.2	18.6	19.9	25.8
3.6	Non-Interest Income to Total Income	7.8	12.2	13.2	23.3
3.7	Non-Interest Expenses (Operating Expenses) to Total Income	15.7	14.4	14.8	12.6
3.8	Staff Expenses to Non-Interest Expenses	54.9	53.4	54.0	51.1
3.9	Personnel Expenses to Total Income	8.6	7.7	8.0	6.5
3.10	Provisions to Total Income	1.6	2.0	1.7	1.7
3.11	Total Cost to Total Income	81.7	83.6	81.6	63.6
3.12	Efficiency Ratio	47.7	51.0	41.3	25.8
3.13	Interest Margin	3.5	2.9	3.4	3.8
4.	**Liquidity**				
4.1	Liquid Assets to Total Assets	42.0	43.7	51.2	54.6
4.2	Statutory Liquid Assets Ratio	61.0	61.9	71.1	73.7
5.	**Assets / Funding Structure**				
5.1	Deposits	70.1	72.7	75.1	75.5
5.2	Borrowings	16.2	13.3	10.8	10.8
5.3	Capital to External Funds	10.9	10.6	10.4	11.5
5.4	Credit to Deposits	58.9	56.1	49.8	46.7
5.5	Credit to Deposits & Borrowings	47.9	47.4	43.5	40.9
5.6	Credit to Deposits & Borrowings & Capital	43.2	42.9	39.4	36.7

Source : Central Bank of Sri Lanka

Appendix Table 4

Financial Soundness Indicators – Registered Finance Companies

		2007 *	2008 *	2009 *	2009	2010 September
1.	**Capital Adequacy**					
1.1	Regulatory Capital to Risk Weighted Assets (RWCAR)	14.2	14.5	14.2	11.3	8.5
1.2	Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	13.1	12.5	12.6	9.8	7.4
1.3	Capital Funds to Assets Ratio	15.6	15.3	12.9	9.6	8.1
1.4	Capital Funds to Deposits Liabilities	29.2	27.2	22.3	195.0	12.7
1.5	Non-Performing Loans Net of Provisions to Capital Funds	6.4	14.9	22.9	35.9	60.0
2.	**Asset Quality**					
2.1	Non-Performing Accommodation (NPA) to Total Accommodation	4.4	6.5	8.0	9.7	12.6
2.2	Provisions to Non-Performing Accommodation	68.1	47.2	43.2	55.6	45.1
3.	**Earnings & Profitability**					
3.1	Return on Assets (ROA) – Before Tax	3.2	2.5	0.8	0.1	2.4
3.2	Return on Assets (ROA) – After tax	2.8	1.9	0.2	-0.7	0.9
3.3	Return on Equity (ROE) – After Rax	17.8	12.5	1.3	-7.4	11.3
3.4	Net Interest Income to Gross Income	31.9	26.4	19.9	22.2	32.5
3.5	Net Interest Income to Total Assets	5.4	4.9	4.1	4.2	6.1
3.6	Non-Interest Expenses (Operating Expenses) to Income	30.9	30.8	29.1	30.8	34.1
3.7	Staff Expenses to Non-Interest Expenses	40.6	35.9	34.1	36.6	36.2
3.8	Total Cost to Total Income	77.5	84.6	92.3	99.7	87.1
4.	**Liquidity**					
4.1	Liquidity Assets to Total Assets	9.1	10.9	8.0	9.0	7.2
4.2	Liquidity Assets to Short-Term Liabilities	17.2	14.9	13.8	14.1	11.3
5.	**Assets / Funding Structure**					
5.1	Deposits	53.2	56.4	57.6	63.9	63.7
5.2	Loans & Advances	70.8	65.9	65.1	63.7	67.1
5.3	Investments	2.3	2.0	1.7	2.5	2.9
5.4	Credit to Deposits	133.0	117.0	113.0	99.7	105.4
6.	**Lending**					
6.1	Total Accommodation Growth	37.5	16.1	10.4	9.5	15.7

* As at end of the financial year (March)

Source : Central Bank of Sri Lanka

Appendix Table 5

Financial Soundness Indicators – Specialised Leasing Companies

		2007	2008	2009	2010 September
1.	**Capital Adequacy**				
1.1	Capital Funds to Total Assets	16.7	16.9	18.4	17.0
1.2	Total Borrowings to Capital Funds (Gearing)	4.2	4.2	3.6	4.0
2.	**Asset Quality**				
2.1	Non-Performing Accommodation (NPA) to Total Accommodation	4.3	4.8	7.6	5.3
2.2	Provisions to NPA	58.9	60.2	54.9	80.6
2.3	Total Advances to Total Assets	81.5	80.5	71.4	70.4
2.4	Total Advances to Total Borrowings	116.3	114.1	108.3	105.0
2.5	Provision Made against Total Advances	2.5	2.5	4.3	6.1
3.	**Liquidity**				
3.1	Net Loans to Total Borrowings	113.4	111.2	103.6	98.5
3.2	Liquid Assets to Total Assets	6.0	7.5	11.5	9.7
3.3	Liquid Assets to Total Borrowings	8.6	10.6	17.4	14.4
4.	**Earnings**				
4.1	Net Profits Before Tax to Total Assets (ROA)	3.5	2.7	3.1	2.8
4.2	Operating Profit Before Provision to Total Assets	4.4	3.1	4.3	3.3
4.3	Profit After Tax to Capital Funds (ROE)	15.2	10.5	9.3	10.8
4.4	Interest Income to Interest Expenses	156.7	140.3	150.0	206.6
4.5	Net Interest Income to Gross Income	30.4	24.5	27.3	40.7
4.6	Net Interest Income to Total Assets	5.5	5.0	5.5	6.9
4.7	Net Interest Income to Net Profit Before Tax	156.1	190.6	177.1	121.7
4.8	Operating Cost to Net Interest Income	73.2	94.0	87.1	67.0
5.	**Assets / Funding Structure**				
5.1	Bank Borrowings	70.1	70.1	66.0	67.1
5.2	Investments	3.4	4.9	5.8	8.7
6.	**Lending**				
6.1	Total Accommodation Growth	17.0	14.2	-10.0	11.4

Source : Central Bank of Sri Lanka