Chapter 8

FINANCIAL SECTOR DEVELOPMENTS AND SYSTEM STABILITY

8.1 Overview

The financial system remained resilient in 2009 weathering the domestic economic slowdown stemming from the global financial and economic crisis and the challenging business environment. Financial sector institutions were confronted by stresses caused by the spill-over effects of the global financial crisis and the consequent decline in demand in the domestic economy, which had an adverse impact on their business operations. The outflow of foreign investments from the government securities market, reduced demand for credit as a result of the slowdown in domestic economic activity and a reduction in foreign trade contributed to the stresses in domestic financial markets. Further, the loss of investor confidence and the liquidity constraints faced by several entities connected to banks and finance companies in the Ceylinco Group had an adverse impact on other companies in the finance and leasing sectors.

However, swift and decisive measures taken by CBSL and the Government contributed towards ensuring public confidence and continued stability in the financial system. CBSL successfully resolved the liquidity problems encountered by Seylan Bank, a systemically important commercial bank in the Ceylinco Group. Seylan Bank was recapitalised by issuing new shares, which strengthened the capital and liquidity level of the bank. It is currently carrying on normal business operations. With a view to resolving the liquidity constraints faced by certain distressed registered finance companies (RFCs) and specialised leasing companies (SLCs) and to restore public confidence in the sector, CBSL and the Ministry of Finance intervened with a series of measures to assist the distressed RFCs and SLCs. A Panel of Experts was appointed to advice and guide the recovery process of the distressed institutions. Further, CBSL in conjunction with the Ministry of Finance introduced a special stimulus package to assist troubled RFCs that were facing liquidity problems. In addition, CBSL introduced a credit guarantee scheme for bank loan facilities provided to RFCs and SLCs against specified assets as well as the securitisation of lease rental recievables. These measures were successful in facilitating the commencement of business operations and bringing stability to the sector.

Supported by the gradual recovery in the economy and improvements in market confidence, financial sector activities too

expanded towards the second half of the year. Bank lending, which contracted due to the global economic downturn and the decline in international trade and the risk aversion of banks is beginning to pick up. The stronger capital positions and improved risk management systems have facilitated this recovery process. Finance companies that experienced liquidity constraints are being resuscitated as a result of new plans and asset recovery strategies under managing agents appointed by CBSL. Increasing inflows of foreign exchange created greater stability in the foreign exchange market. The yield rates on government securities shifted downward in response to the easing of CBSL's monetary policy stance, higher investor participation and improvements in market liquidity, while the stock market rebounded achieving its best performance in 2009.

CBSL took several initiatives to further strengthen the regulatory and supervisory framework of the financial sector in 2009 to improve the soundness and resilience of the financial system. The proposed Finance Business Act will address several weaknesses in the present law that regulates institutions engaged in finance business and deposit taking. The present Banking Act will also be amended to enable the consolidated supervision of banking groups, facilitate the mergers and acquisitions of banks and strengthen the regulatory framework. In addition, amendments have been proposed to the Regulation of Insurance Industry Act to expand and strengthen the supervision of the insurance industry. A new law to regulate asset-backed securities (ABS) has been drafted to promote the developments of the securitisation market in a safe and sound manner. A law to regulate and supervise micro-finance institutions (MFIs) has been formulated to strengthen and realign the role of MFIs and to enable them to better serve the economy.

A number of concerns and issues on the performance and soundness of the financial sector remain requiring the attention of regulators and stakeholders. Issues relating to the banking sector such as the high cost of intermediation as reflected in the wide interest margins, sluggish private sector credit, rising non-performing loans and declining loan loss provisions need to be adequately addressed. The restoration of public confidence and business diversification in finance companies, recovery of assets and effective implementation of deposit repayment plans of troubled-finance companies are some issues that need to be addressed in relation to RFCs and SLCs. The stock market needs to be further developed by increasing new listing of companies and encouraging more initial public offers. Further, initiatives need to be taken to develop the private debt securities market, encourage the development of the financial derivatives markets and to enhance the financial literacy of the public.

8.2 Financial System Stability

The global financial system which was under severe stress at the beginning of 2009, stabilised gradually in response to wide-ranging public intervention policies, with the rebounding of financial markets and banking sectors in both advanced and emerging market economies. The global financial system faced the risk of systemic collapse in late 2008 and early 2009 following the failure or near failure of several large financial institutions in the USA and Europe primarily due to their exposure to toxic mortgage-linked securities. Capital flows, world trade and economic activity experienced contractions brought on by the severe stresses in financial institutions and the freezing of credit markets. The economic crisis in the advanced economies spread through trade and capital flow channels engendering a difficult environment for developing countries. Policymakers around the world responded to this crisis with unprecedented measures. Monetary policy was relaxed, financial markets were injected with liquidity, bank recapitalisation and rescue plans were adopted and fiscal stimulus packages were implemented. These extraordinary policy actions helped stabilise the global financial system. As conditions in funding markets eased and with banks becoming better capitalised, economic activity started to recover in the latter part of 2009. Investor risk appetite also returned enabling a rebound in financial markets. Equity markets worldwide recovered sharply, while capital flows, particularly portfolio flows to emerging markets, recommenced.

Domestic financial institutions were largely shielded from the global financial crisis due to a strong regulatory framework and capital account restrictions. The slower growth of the domestic economy resulting from second round effects of the global economic downturn and slump in world trade posed a challenge for banks and other financial institutions. Overall, financial institutions continued to be profitable and reasonably capitalised, although credit risk increased due to the tight market conditions. The performance of RFCs and SLCs were more adversely affected due to the loss of investor confidence and liquidity constraints faced by finance and leasing companies connected to the Ceylinco Group.

Financial markets became more liquid and stable with asset prices rising during the year. The easing of monetary policy and increased liquidity resulted in a gradual decline in interest rates and reduced volatility in the money market. The pressures evident in the foreign exchange market in the early part of the year subsequently subsided as investor confidence returned following the end of the conflict in May. The approval of the IMF Stand-by Arrangement in July, improved conditions further and resulted in increased foreign capital inflows particularly into the government securities market.

Table 8.1 **Selected Financial Soundness Indicators of Banking Sector**

Per cent

Indicator	2008(a)	2009(b)
Regulatory Capital to Risk Weighted Assets	14.5	14.9
Tier 1 Capital to Risk Weighted Assets	12.5	12.7
Non Performing Loans Net of Provisions to Capital Funds	18.5	25.5
Non Performing Loans to Gross Loans	6.3	8.0
Return on Assets (Before Tax)	1.9	2.1
Return on Equity (After Tax)	13.4	14.6
Interest Margin	4.4	4.5
Non-Interest Expenses to Gross Income	22.3	22.5
Statutory Liquid Assets Ratio	31.3	39.2
Liquid Assets to Total Assets	28.4	35.2
Provision Coverage Ratio (Total)	60.9	50.1
Net Open Position in Foreign Exchange to Capital Funds (Only for LCBs)	2.1	-1.5

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Consequently, the Sri Lanka rupee remained relatively stable against the US dollar during the year. Yield rates on Treasury bills and Treasury bonds declined sharply during the year due to the reduction in policy interest rates and increased foreign participation in the government securities market. The equity market surged upwards with the end of conflict and the Colombo Stock Exchange (CSE) became one of the best performing stock markets globally. The decline in inflation, lower interest rates and renewed investor confidence contributed to the robust performance of the equity market.

The banking sector maintained its profitability and stability in a challenging global and domestic environment. The banking sector maintained its soundness and profitability with increased levels of capitalisation and liquidity. Bank lending, which was declining due to the global economic downturn, the contraction of international trade and the cautious approach to lending by banks, is gradually beginning to pick up. The slowdown in economic activity resulted in some deterioration in the asset quality of banking institutions. However, the stronger capital positions and improved risk management systems supported by an enhanced regulatory and supervisory framework and oversight, has placed the banking sector on a stronger footing to absorb the impact of the economic slowdown.

CBSL intervened and successfully resolved the liquidity constraints faced by Seylan Bank and Ceylinco Savings Bank due to their connections with the Ceylinco group. CBSL brought Seylan Bank under the managerial supervision of the Bank of Ceylon with a new board of directors in December 2008. In 2009, CBSL took further action to encourage the recapitalisation of Seylan Bank, and a few state-owned financial institutions were invited to contribute to the capital of the bank. Accordingly, the Bank of Ceylon and the Sri Lanka Insurance Corporation acquired 10 per cent (Rs.455 million) and 15 per cent (Rs. 670 million) stakes, respectively in Seylan Bank. In addition, almost Rs.1.9 billion was

Box 13

THE CENTRAL BANK PREVENTING A BANKING CRISIS – THE RESCUE OF SEYLAN BANK PLC

Imminent financial distress to the Seylan bank PLC

The Seylan Bank PLC (SBP), is the fifth largest commercial bank in the country with a market share of 7 per centum in terms of assets, and was a part of the Ceylinco Group of companies. Towards the end of 2008, a crisis leading to a run on deposits was triggered in SBP due to the contagion effect of the collapse of one of the companies of the Ceylinco Group, the Golden Key Credit Card Company Ltd.

The sudden withdrawal of deposits resulted in a significant deterioration of the liquidity position of the bank. Being a systemically important bank, any failure of the bank to honour payments would have had a ripple effect on the entire financial system, perhaps, causing a systemic crisis.

Effective Execution of the Resolution Framework

The Resolution Framework that was already in existence was activated by the Central Bank of Sri Lanka (CBSL) to respond to the situation in order to avert a potential danger to the stability of the financial system. In terms of Section 30 (9) of the Monetary Law Act No.58 of 1949, a number of measures were immediately taken by the Monetary Board of CBSL:

- Dismissed the board of directors of the bank.
- Appointed a new board to continue the business of the bank.
- Allowed all employees to continue with their services to the bank without any interruption.
- Requested the Bank of Ceylon to provide managerial assistance to SBP in order to restore public confidence and to enable SBP to carry on its banking operations without any interruption.
- Informed the general public to continue with their normal financial transactions with the bank and assured of the safety of deposits and the stability of the financial system.
- Provided rupee liquidity under Central Bank reverse repo window as the bank was unable obtain the necessary funds even on fully secured (inter-bank repo) basis.
- Made arrangements to provide shortfalls of liquidity in foreign currency through collateralised borrowings from CBSL, the Bank of Ceylon and other counter parties and SWAP transactions.
- Required SBP to raise capital of around Rs 3.0 bn to further strengthen the capital, management and operations of the bank.

SBP continuing with its normal operations

The actions of CBSL, the BOC and the new board of SBP resulted in the formulation of appropriate strategies to rebuild customer confidence on the bank. The capital adequacy and liquidity levels of the bank have now significantly improved. It is currently carrying on normal operations under the direction of its board of directors appointed by the shareholders. It has commenced expanding its branch network by opening several banking outlets in the Northern Province.

The bank has successfully overcome the crisis and a year later has recorded a healthy financial performance to build a sustainable business for the future.

The swift and vital action of CBSL halted a crisis in the bank and enabled the bank to safeguard the interest of all stakeholders without public funds or any mode of nationalisation as reported in many countries including the UK and the USA.

mobilised through a public offering of new shares. Investor confidence in the bank was indicated by the share offer being snapped-up by investors and the offer being oversubscribed. Another Ceylinco group company, the Ceylinco Savings Bank (a licensed specialised bank) which became distressed due to losses on inter-group exposures was acquired by the Merchant Bank of Sri Lanka, which purchased a 78 per cent stake, with an initial capital contribution of Rs.100 million. Normal business activities are now continuing.

The RFC and the SLC sectors, which experienced stresses due to loss of investor confidence and liquidity constraints, began to rebound during the second half of the year. The crisis in the Golden Key Credit Card Company of the Ceylinco group in the latter part of 2008 affected depositor confidence in the regulated finance companies, many of which experienced severe liquidity problems due to panic withdrawals by customers. Although the financial indicators of the RFC sector initially weakened with higher interest

Table 8.2 **Selected Financial Soundness Indicators of Registered Finance Companies**

Per cent

Indicator	2008(a)	2009(b)
Regulatory Capital to Risk Weighted Assets	14.0	9.8
Tier 1 Capital to Risk Weighted Assets	12.3	8.6
Non Performing Loans Net of Provision to Capital Funds	15.9	32.3
Non Performing Loans to Gross Loans	6.7	10.2
Return on Assets (Before Tax)	1.8	-0.8
Return on Equity (After Tax)	8.4	-13.6
Net Interest Income to Total Assets	2.4	3.3
Net interest Income to Gross Income	20.6	17.4
Non-Interest Expenses to Gross Income	28.0	29.9
Provision Coverage Ratio (Total)	46.5	47.8

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

rate risk, credit risk and liquidity risk, the sector is now recovering with the expansion in economic activities in the latter part of 2009.

CBSL together with the government intervened and introduced a number of measures to assist troubled companies and rebuild confidence in the RFC and SLC sector. These included the appointment of Managing Agents to assist distressed finance companies and a Panel of Experts to advice on the recovery process. The Merchant Bank of Sri Lanka was appointed as the Managing Agent of four RFCs of the Ceylinco group, namely, The Finance Company, Asian Finance Ltd., Ceylinco Investment and Realty Ltd and the Finance and Guarantee Ltd. These RFCs are now implementing depositor repayment programmes as well as preparing plans to re-start their normal business operations. Accordingly, The Finance Company and Asian Finance Ltd. started mobilising new deposits and commenced new business operations.

The overall soundness and profitability of insurance companies was maintained despite a marginal decline in overall premium income as a consequence of the slower growth of the economy. The significant growth in investment income from government securities and equities bolstered the earnings of insurance companies. As a result, the overall profits of insurance companies rose significantly in 2009. Underwriting profits also increased despite a reduction in premium income on motor insurance, which is the largest category in the general insurance business. The solvency margin, which is the main indicator of financial soundness was maintained for both general and long-term insurance business.

The two major superannuation funds, the Employees' Provident Fund (EPF) and Employees' Trust Fund (ETF) managed their risks adequately, with a reduction in interest rate risk as a consequence of distributing their investment portfolio in securities of differing maturities and varying yields. The credit risk of the EPF and ETF was negligible, as over 90 per cent of their investment portfolio was held in default risk-free government securities. The funds are exposed to interest rate risk as a consequence of the high concentration of investments in fixed income securities. However, in the declining interest rate environment, the investment portfolios of these funds were subject to reinvestment risk which was mitigated to some extent by higher investments in equities which recorded substantial gains in 2009. The liquidity risk was manageable at present, as inflows in the form of contributions more than compensated for outflows in the form of refunds. A portion of the inflows was also invested in the Repo market in order to meet the liquidity requirement while earning significant returns.

The systemically important payments and settlements system operated with a high degree of availability and free from liquidity stresses, thereby facilitating the smooth functioning of the financial system. During the year, regulations were issued for Service Providers of Payment Cards to enhance the safety of electronic payment

Table 8.3 **Selected Financial Soundness Indicators of Specialised Leasing Companies**

Per cent

Indicator	2008(a)	2009(b)
Capital Funds to Total Assets	16.9	18.4
Total Borrowings to Capital Funds (Gearing ratio)	4.2	3.6
Non Performing Loans to Gross Loans	4.8	7.6
Return on Assets (Before Tax)	2.7	3.1
Return on Equity (After Tax)	10.5	9.3
Net Interest Income to Total Assets	5.0	5.5
Net Interest Income to Gross Income	24.5	27.3
Non-Interest Expenses to Gross Income	23.8	23.8
Provision Coverage Ratio (Total)	60.2	54.9

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

instruments. In terms of the regulations, companies providing electronic payment cards and mobile payment services are required to register with CBSL. In addition, improvements in business continuity arrangements and steps to further modernize the retail payment system were the notable actions taken to enhance the resilience and efficiency of the payments system and the convenience of customers.

The recovery of the global economy and international trade and the containment of domestic inflationary pressures and low interest rates will improve the prospects of the business sector and expand opportunities for financial institutions. Nevertheless, it is important that financial institutions practice good corporate governance and prudent risk management to improve their soundness and resilience. CBSL and other financial regulators will continue to strengthen prudential policies and enhance the regulation and supervision of financial markets and institutions to improve their efficiency and statbility.

8.3 Developments in Financial Institutions

Central Bank of Sri Lanka

The strength of the CBSL's balance sheet improved during 2009 with the improvement in inflows of foreign exchange to the country from around mid-2009. A large portion of these inflows were purchased by CBSL to prevent excessive volatility in the foreign exchange market and to build up the country's official reserves. Inflows of foreign investments into government securities meanwhile enabled the government to retire a part of the Treasury bills held by CBSL, as a result of which CBSL's holdings of Treasury bills declined significantly.

The total assets of CBSL increased by 37.3 per cent in 2009 to Rs. 819.8 billion. This was mainly due to an increase in the foreign currency denominated assets of the CBSL, as the Bank's domestic assets decreased primarily as a result of the decline in its holdings of Treasury bills.

The supply of foreign exchange during the first three months of the year to meet the market demand for foreign currency significantly contributed to change the composition of the balance sheet of CBSL in 2009. During the first three months of 2009, foreign assets of CBSL declined mainly due to the outflow of foreign investments from government securities, the intervention by CBSL in the domestic foreign exchange market to prevent excessive volatility of the external value of the rupee, and the decline in value of many reserve currencies against the US dollar. To offset the shortage in rupee liquidity which arose as a result of sales of foreign exchange by CBSL in the domestic foreign exchange market, CBSL took several measures to inject rupee liquidity. Amongst these measures was the purchase of Treasury bills in the primary market, as a result of which the Bank's domestic assets increased.

Given the significant inflows of foreign exchange to the country since May, following the ending of the decades long conflict in May and the subsequent securing of an IMF-SBA facility in July, CBSL absorbed foreign exchange from the domestic foreign exchange market to build up the country's foreign reserves. The receipt of an additional SDR allocation from the IMF in August further strengthened the country's foreign reserves. In October, the government received the proceeds from the international sovereign bond issue, which added further liquidity to the domestic foreign exchange market. Following these developments, CBSL was able to purchase more than US dollars 2 billion on a net basis, from the domestic foreign exchange market. Accordingly, foreign assets of CBSL increased significantly in 2009.

Domestic assets of CBSL declined during the second half of 2009. This was mainly the result of the government retiring Treasury bills held by CBSL amounting to Rs. 96.8 billion in August 2009, following the receipt of proceeds from a foreign investment in Treasury bonds, and the sale of Treasury bills under open market operations (OMO) by CBSL in order to absorb excess liquidity from the money market. Accordingly, Treasury bill holdings of CBSL net of repos, which amounted to around Rs.142 billion at end 2008, declined to Rs.37.5 billion by end 2009. A commensurate decline was seen in the total domestic assets of CBSL.

With respect to liabilities, currency in circulation increased from Rs.186 billion at end 2008 to Rs.217.4 billion at end 2009, an increase of 16.8 per cent. Deposits of commercial banks held by CBSL for statutory reserve purposes also increased to Rs. 86 billion by end 2009 from Rs. 82 billion at the end of the previous year. Another key item amongst the liabilities of CBSL at end 2009 was Central Bank Securities, amounting to Rs. 78 billion. Central Bank Securities were issued from around October 2009, to absorb a part of the excess liquidity in the money market as the CBSL's holdings of Treasury bills was inadequate to absorb the excess liquidity.

Licensed Commercial Banks

Overall, the performance of LCBs remained healthy due to improved profitability and the resultant strengthening of the capital position. Further, the enhanced risk management and corporate governance strengthened the risk absorption capacity of banks. The number of LCBs remained at 22 and operated through a network of 2,214 branches and 2,788 other banking outlets. This network was further strengthened by 1,757 ATMs indicating an increasing reliance on card based payment modes by the banking community.

The assets of LCBs grew at a slower pace in 2009, reflecting the lower demand for credit. The total assets of LCBs as at end 2009 stood at Rs. 2,500 billion, a growth of 10.8 per cent compared to a growth of 7.7 per cent in 2008. In view of the decline in demand for credit by the private sector, investment in government securities increased in 2009. The two state owned commercial banks recorded a growth of 14.8 per cent in total assets while the domestic private banks and foreign banks also recorded a growth of 8.9 per cent and 5.8 per cent, respectively, during 2009.

Table 8.4 Total Assets of the Major Financial Institutions

	2008(a)		2009(b)	
	Rs. bn	% Share of Total	Rs. bn	% Share of Total
Banking Sector	**3,294.6**	**68.0**	**3,832.0**	**68.3**
Central Bank	597.1	12.3	819.8	14.6
Licensed Commercial Banks (c)	2,259.9	46.7	2,503.1	44.6
Licensed Specialised Banks	437.6	9.0	509.1	9.1
Other Deposit Taking Financial Institutions	**285.9**	**5.9**	**315.1**	**5.6**
Registered Finance Companies	175.6	3.6	185.3	3.3
Co-operative Rural Banks	105.4	2.2	124.5	2.2
Thrift and Credit Co-op. Societies	4.9	0.1	5.3	0.1
Other Specialised Financial Institutions	**239.7**	**5.0**	**265.3**	**4.7**
Specialised Leasing Companies	109.9	2.3	111.9	2.0
Primary Dealers	84.4	1.7	97.8	1.7
Stock Broking Companies	3.2	0.1	6.4	0.1
Unit Trusts	6.8	0.1	10.0	0.2
Venture Capital Companies	1.4	0.0	1.6	0.0
Credit Rating Agencies	0.1	0.0	0.2	0.0
Other	33.9	0.7	37.4	0.7
Contractual Savings Institutions	**1,019.8**	**21.1**	**1,203.6**	**21.4**
Insurance Companies	155.2	3.2	179.7	3.2
Employees' Provident Fund	655.4	13.5	772.0	13.7
Employees' Trust Fund	92.4	1.9	107.3	1.9
Private Provident Funds	97.1	2.0	121.9	2.2
Public Service Provident Fund	19.7	0.4	22.7	0.4
Total	**4,840.0**	**100.0**	**5,616.0**	**100.0**

(a) Revised
(b) Provisional
(c) Consolidated assets of both DBUs and OBUs of LCBs

Source: Central Bank of Sri Lanka

The share of deposits in the composition of total liabilities increased from 69.0 per cent to 74.0 per cent while borrowings decreased from 18.0 per cent to 13.0 per cent. Total deposits of LCBs increased by 18.5 per cent to Rs. 1,849 billion as against 7.1 per cent in 2008 mainly due to the high interest rates that prevailed in the first three quarters of the year. However, borrowings recorded a decline of 18.2 per cent against 7.0 per cent increase recorded in 2008, mainly due to the sharp deceleration in foreign borrowings on account of the adverse impact of the global financial turmoil.

Loans and advances decelerated due to the lower demand for credit and the cautious approach taken by banks to expand lending in view of rising non performing loans. The total loans and advances portfolio of LCBs stood at Rs. 1,385 billion, recording a reduction of 4.9 per cent in comparison with the increase of 6.6 per cent recorded in 2008. Consequently, the share of loans and advances in total assets of LCBs declined from 64.5 per cent as at end 2008 to 55.3 per cent. Foreign banks reported the largest decline of

Table 8.5 **Distribution of Banks and Bank Branches**

Category	End 2008(a)	End 2009(b)
Licensed Commercial Banks (LCBs)		
I.Total No.of LCBs	22	22
Domestic banks	11	11
Foreign banks	11	11
II.Total No.of LCB Branches and Other Outlets	4,767	5,014
Branches	2,071	2,214
Domestic Bank Branches	1,857	2,000
Main Branches	1,289	1,338
Extension/Pay Offices/Service Counters	568	662
Foreign Bank Branches and Other Outlets	214	214
Branches	44	44
Other Outlets	170	170
Student Savings Units	2,684	2,788
Overseas Branches	12	12
Licensed Specialised Banks (LSBs)		
I. Total No. of LSBs	14	14
Regional Development Banks	6	6
National Savings Bank	2	2
Long-term Lending Institutions	2	2
Housing Finance Institutions	2	2
Private Savings and Development Banks	2	2
II. Total No. of LSB Branches and Other Outlets	660	689
Branches	448	465
Regional Development Banks	219	226
National Savings Banks	143	147
Long-term Lending Institutions	19	21
Housing Finance Institutions	28	28
Private Savings and Development Banks	39	43
Other outlets	37	49
Student Savings Units	175	175
Total No. of Bank Branches and Other Outlets	5,427	5,703
Total No. of Automated Teller Machines (ATM's)	1,654	1,876
Total No. of Electronic Fund Transfer Facilities at the Point of Sale Machines (EFTPOS)	23,447	24,977
Banking Density: No. of LCBs Branches Per 100,000 Persons	10.2	10.8

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

20 per cent, while domestic private banks also recorded a contraction of 6 per cent. However, the state owned banks recorded a marginal increase of 2 per cent. The deceleration in credit was mainly in trade related lending, overdrafts, credit cards, lease rentals and other medium and long term lending, while pawning advances to customers recorded a significant growth of 15.7 per cent despite the high rates charged by banks. Notwithstanding the continued deceleration recorded in credit, a positive rebound in loans granted by banks was witnessed during the last quarter of 2009 with the gradual recovery of the economy from the adverse impacts of the global financial turmoil and improved investor confidence with the end to the conflict.

According to the sector-wise distribution of credit, consumption activities, including pawning advances and credit cards (28 per cent), manufacturing including apparel products (16 per cent), trading (15 per cent) and construction including housing and property development (15 per cent) accounted for the largest proportion of total credit. Lending to agriculture, tourism and trading activities are showing signs of picking up partly due to the end of the conflict and continued efforts taken by CBSL to expand private sector credit to the economy. Requests made to banks by CBSL to grant several concessions to institutions in the tourism industry and continuous monitoring of the agriculture lending target of 10 per cent were a few of such efforts. The proportion of credit to manufacturing, transport and construction sectors has declined marginally from the levels that prevailed as at end 2008.

Earnings of LCBs increased marginally due to the significant improvements achieved in operational efficiencies of LCBs leading to greater productivity. Profit (before tax) of the LCBs reached Rs. 27.6 billion for the year ended 2009 while registering a growth of 9.3 per cent as against 18.1 per cent in the previous year. This is a result of the continuous efforts taken by such banks in managing their costs. Operational expenses recorded a growth of 5.0 per cent during the year as against 17.9 per cent recorded in 2008. Staff cost also increased at a lower pace by 9.3 per cent in comparison to 19.5 per cent in the previous year. In terms of cost efficiencies, the efficiency ratio, measured as total operating expenses to total operating income, has further improved over the period to 54.9 per cent from 56.1 per cent in end 2008. In addition, the cost to income ratio measured as total costs to total income has also improved to 77.3 per cent from 79.0 per cent in end 2008. Meanwhile, net interest income from core lending activities recorded an increase of 10.0 per cent, while net interest margin stood at 4.7 per cent. The contribution of fee based income also grew by 4.0 per cent. Out of LCBs, domestic private banks were the main contributor to the growth in profits of the sector, which is nearly 50.0 per cent.

Table 8.6 **Assets and Liabilities of Licensed Commercial Banks**

Rs. million

	End 2008(a)	End 2009(b)	Change 2009/2008 Amount	%
Assets	**2,259,914**	**2,503,126**	**243,211**	**10.8**
Liquid Assets	**713,259**	**999,448**	**286,189**	**40.1**
Cash on Hand	35,196	38,818	3,622	10.3
Due from Central Bank	87,163	88,730	1,567	1.8
Treasury Bills	87,325	201,792	114,468	131.1
Treasury Bonds	194,367	273,405	79,039	40.7
Other Assets	309,209	396,703	87,494	28.3
Loans and Advances (Net of Interest in Suspense)	**1,459,158**	**1,385,056**	**-74,103**	**-5.1**
Less: Provisions	57,577	57,121	-455	-0.8
Net Loans & Advances	1,401,581	1,327,934	-73,647	-5.3
Fixed and other Assets	**145,074**	**175,743**	**30,669**	**21.1**
Liabilities				
Capital Funds	179,050	205,284	26,234	14.7
Total Deposits	**1,560,247**	**1,849,569**	**289,322**	**18.5**
Demand Deposits	166,164	199,385	33,221	20.0
Time & Savings Deposits	1,326,598	1,583,873	257,275	19.4
Others	67,484	66,311	-1,174	-1.7
Borrowings	**400,130**	**327,397**	**-72,734**	**-18.2**
Local Borrowings	272,259	238,748	-33,511	-12.3
Foreign Borrowings	127,872	88,649	-39,223	-30.7
Other Liabilities	**120,487**	**120,876**	**389**	**0.3**
Total Assets/Liabilities	**2,259,914**	**2,503,126**	**243,211**	**10.8**

(a) Revised
(b) Provisional

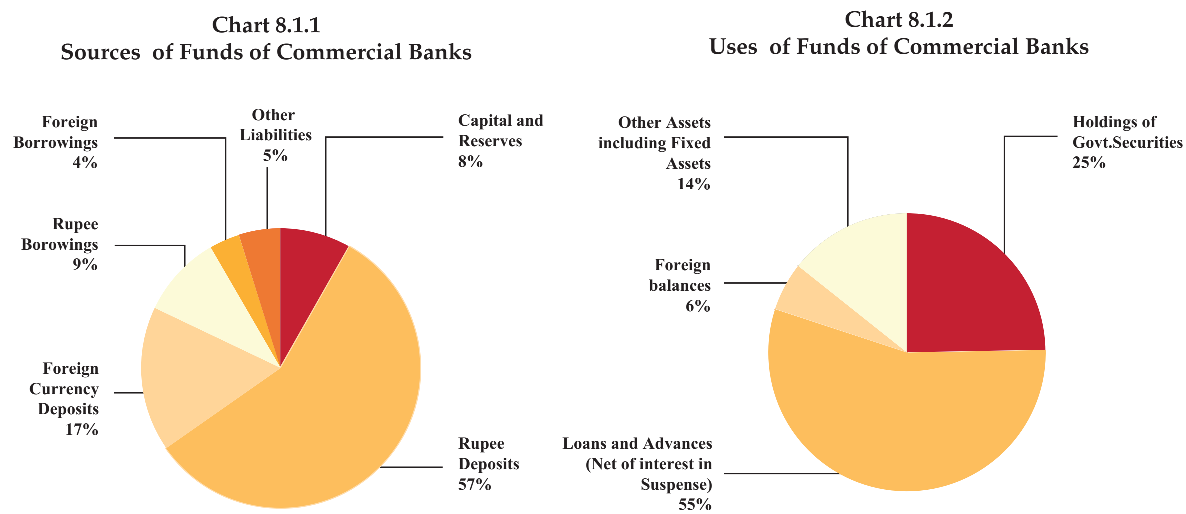
Source: Central Bank of Sri Lanka

The key financial soundness indicators of LCBs continued to remain at healthy levels. The capital adequacy ratio (CAR) under Basel II has been maintained at around 14.0 per cent, well above the required ratio of 10.0 per cent throughout the year. The CAR of the LCBs stood at 14.2 per cent in end 2009 compared to 13.8 per cent in 2008. Profitability, in terms of return on assets of the LCBs, both before tax and after tax were maintained at 2.0 per cent and 1.2 per cent, respectively. However, return on equity showed a slight drop to 14.4 per cent as against 14.8 per cent in 2008 due to the increase in capital funds. The overall liquidity position of LCBs remained stable and the statutory liquid asset ratio stood at 32.0 per cent as against the minimum requirement of 20.0 per cent. The gross NPL ratio, which indicates the quality of assets of LCBs, stood at 7.6 per cent as at end 2009 in comparison to 6.0 per cent in the end of 2008. This is mainly a result of the lagged effect of expansion in lending during 2007/2008 and the deterioration in the repayment ability of the borrowers coupled with the contraction in the total loan portfolio in 2009.

Licensed Specialised Banks

A higher growth in deposit mobilisation of LSBs was observed in 2009. The number of LSBs remained at 14 as at end 2009 operating through a network of 465 branches. The total assets of LSBs grew by 15.3 per cent during 2009, compared to 7.8 per cent in 2008. The deposits and capital funds also grew by 18.7 per cent and 13.9 per cent, respectively. However, the lending activities of LSB sector recorded a slower growth increasing by 4.5 per cent, compared to 6.3 per cent growth recorded in 2008. With the increase in deposits, holdings of Government securities by LSBs

Chart 8.1 Sources and Uses of Funds of Licensed Commercial Banks (as at end 2009)



grew significantly by 26.0 per cent as against 7.0 per cent in 2008.

The overall financial soundness indicators of LSBs were maintained. Earnings and profitability displayed a healthy growth during 2009. Pre- tax profits of LSBs for 2009 amounted to Rs.10.9 billion compared to Rs. 6 billion in 2008, recording a growth of 80 per cent as against a decline of 7.6 per cent recorded in the previous year. This growth was mainly facilitated by net interest income and other income. Consequently, return on assets and return on equity ratios also recorded a commendable improvement, while pre-tax return on assets and return on equity stood at 2.3 per cent and 15.2 per cent, respectively. Meanwhile, the cost efficiency of the sector measured by efficiency and cost to income ratios also showed an improvement from 51 per cent at end 2008 to 40.3 per cent and from 83.6 per cent at end 2008 to 80 per cent, respectively. LSBs also maintained the statutory liquid assets ratio at over 70 per cent mainly due to increasing investments in government securities. The capital adequacy ratio was also maintained significantly above the minimum requirement of 10 per cent and stood at 19.2 per cent by end 2009. The asset quality of the sector deteriorated marginally due to the increase in NPLs and stood at 10.9 per cent against 8.9 per cent in the previous year.

Table 8.7 Credit Card Operations by Licensed Commercial Banks

	2008(a)	2009(b)	% Change
Total Number of Credit Cards issued	917,418	840,509	-8.4
Local (accepted only locally)	57,641	58,302	1.1
Global (accepted globally)	859,777	782,207	-9.0
Outstanding Credit at End Year (Rs.mn)	34,212	31,375	-8.3
Local (accepted only locally)	856	762	-11.0
Global (accepted globally)	33,356	30,613	-8.2
Overdues (as a % of Outstanding Credit)	6.9	6.3	-9.3
Pastdues (as a % of Outstanding Credit)	8.8	10.4	
Commission from Dealers(%)	1.5 – 4.0	1.5 – 4.0	

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Regulation and Supervision of Banks

CBSL issued directions and guidelines to further strengthen the risk management in banks. With a view to standardising and strengthening the foreign exchange risk management systems of banks, Directions were issued on risk management relating to foreign exchange business of licensed commercial banks. A draft guideline on integrated risk management of banks was issued for industry comments. Directions were also issued on the identification, reporting, transferring and maintenance of abandoned property with a view to safeguarding unclaimed assets of bank customers.

Box 14

Response of Standard Setters to the Global Financial Crisis: Changes to Basel II Cpital Framework and International Accounting Standards

Changes to the Basel II Capital framework

Basel Committee on Banking Supervision (BCBS), the global standard setter on bank supervision, has observed a number of reasons for the global financial crisis. The main reasons are excessive on and off-balance sheet exposures of banks to unregulated businesses and complex structured products markets, a gradual erosion of the quality of the banks' capital and many banks holding insufficient liquidity buffers. Therefore, the banking system was not able to absorb trading and credit losses. In response to the lessons learned from the financial crisis, BCBS has decided on several changes to the current regulatory capital framework with a view to promoting globally, a more resilient banking business.

a) **Package of measures approved by BCBS in July 2009 to enhance the three Pillars of Basel II Capital Adequacy Framework:** These measures are aimed at introducing new standards to strengthen the quality of bank capital, promoting the build-up of capital buffers that can be used in periods of stress and introducing a leverage ratio as a supplementary measure to Basel II. The proposed Basel II enhancements are as follows:-

Pillar 1 (Minimum Capital Ratios)

- Higher risk weights for securitisation exposures (collateralised debt obligations of asset backed securities) to better reflect the inherent risk in such products.
- Prevents a bank recognising ratings that are based on guarantees or similar support provided by the bank itself.
- Need for a bank to perform its own due diligence (credit analysis) without relying on credit rating of rating agencies in order to use the specified risk weights for securitisation.
- Higher credit conversion factor (50 per cent) in risk weighting for short-term liquidity facilities to off-balance sheet exposures.
- Removal of the favourable capital treatment afforded to liquidity facilities that are available on the event of a general market disruption.

Pillar 2 (Supervisory Review Process)

BCBS has provided a supplemental guidance to address several weaknesses in risk management practices revealed during the crisis. Such guidance is aimed at assisting the banks and supervisors in better identifying and managing risks and in appropriately capturing risks in the internal assessments of capital adequacy. Some key aspects of the guidance are as follows:-

(i) A sound risk management system should have the following key features:
  - active board and senior management oversight;
  - appropriate policies, procedures and limits;
  - comprehensive and timely identification, measurement, mitigation, controlling, monitoring and reporting of risks;
  - appropriate management information systems (MIS) at the business and firm-wide level; and
  - comprehensive internal controls.

(ii) A bank should have in place effective internal policies, systems and controls to identify, measure, monitor, manage, control and mitigate its risk concentrations in a timely manner. An appropriate level of capital for risk concentrations should be incorporated in a bank's Pillar 2 assessment.

(iii) All risks arising from securitisation, particularly those that are not fully captured under Pillar 1, should be addressed in Pillar 2. These risks include:
  - credit, market, liquidity and reputational risk of each exposure;
  - potential delinquencies and losses on the underlying securitised exposures;
  - exposures from credit lines or liquidity facilities to special purpose entities; and
  - exposures from guarantees provided by protection providers (insurers) and other third parties.

(iv) Supervisors should determine whether a bank has in place a sound firm-wide governance and risk management framework that enables it to define its risk appetite and recognise all material risks, including the risks posed by concentrations, securitisation, off-balance sheet exposures, valuation practices and other risk exposures. These should be adequately incorporated into a bank's risk management system and considered under Pillar 2, as they are not fully captured by Pillar 1.

Pillar 3 (Market Discipline)

Additional disclosure requirements for securitisations, off-balance sheet exposures and trading activities to reduce market uncertainties about the strength of balance sheets on capital market activities.

b) Package of proposals approved by BCBS for consultation in December 2009 (comments accepted till April 2010):

- Strengthen the capital requirements for counterparty credit risk exposures arising from derivatives, repos and securities financing activities.
- Apply regulatory adjustments to common equity to raise the level of quality and consistency of Tier 1 capital. The predominant form of Tier 1 capital must be common equity. Eligibility criteria for categorizing as Tier 2 capital is simplified and Tier 3 capital is abolished.
- Require all elements of capital to be disclosed along with a detailed reconciliation to improve transparency of capital.
- Introduce a leverage ratio (Tier - 1 capital as a percentage to 'adjusted assets') as a supplementary measure to Basel II with a view to incorporating in Pillar I, based on appropriate review.

BCBS is also reviewing the need for additional capital measures to reduce externalities created by systemically important institutions.

Changes to the International Accounting Standards

The recent financial crisis has challenged some key components of the existing accounting standards. Illiquid markets for financial instruments have led to issues in relation to estimation of fair value. Incurred loss model of the existing Standards which is a timing and quantitative approach has led to provisions being too little and too late. Lack of convergence between rules of different accounting standards setters has created an unlevel playing field and has resulted in issues in relation to regulatory arbitrage and comparability of financial statements. Non- availability of relevant and useful disclosures associated with structured credit products and off-balance sheets have also resulted in poor decision making.

In response to these issues, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) are reviewing the existing Accounting Standards on classification and measurement of financial instruments and intend to create a single standard. Overall, the proposed changes are expected to enhance the quality of information available about institutions' risk profiles, risk management practices and related gains/losses thereby enhancing the market confidence.

Proposed changes and their objectives

(a) Classification and measurement of financial assets

- Currently, International Accounting Standard (IAS) 39 deals with the recognition and measurement of financial instruments under which the financial instruments fall into four categories, i.e., financial assets at fair value through profit or loss, held to maturity investments, loans and receivables and instruments available for sale.
- With a view to reducing the complexities of the Standard, IAS 39 will be replaced. In the proposed International Financial Reporting Standard (IFRS) 9, the financial instruments will be classified into two categories for measurement purposes, i.e., amortised cost and fair value. This classification will be driven by the business model of the entities and the contractual cash flow characteristics of the financial assets.

(b) Impairment methodology

- Under the current incurred loss approach, impairment loss is recognized only when the loss occurs and the impact can be readily estimated. The expected losses are not recognized before they are triggered and as such, interest income is overstated (front-loading) in financial reporting.
- It is, therefore, proposed to move to expected cash flow approach to recognize the impairment losses early, eliminate front-loading of interest revenue and better reflect the underlying nature of transactions to aid better pricing of instruments.
- The main features of this approach are:
- interest revenue is recognissed on the basis of expected cash flows;
- impairment results from an adverse change in credit loss expectations;
- reversal of expected loss when expectations change favourably; and
- re-estimation of expected cash flows at the end of each period.

(c) Accounting for off-balance sheet vehicles

The IASB is currently reviewing the accounting for off-balance sheet vehicles/entities as some entities had not accounted for certain entities they control. IASB aims to tighten the definition of control and improve disclosure requirements to provide users with more information about an entity's exposure to the risk of transferred financial assets.

The Banking Act will be amended to strengthen the regulatory and supervisory framework. The proposed amendments relate to strengthening bank resolution measures, including the appointment of managing agents, undertaking consolidated supervision of banking groups, expanding the provisions on mergers and consolidation, expanding the criteria to determine "material interest", expanding the provisions on offences and penalties for non-compliance with prudential requirements, reducing the time period for disclosing financial statements to the public, introducing provisions to higher capital charge for individual banks depending on their risk profile and aligning with the provisions of the Companies Act, No. 7 of 2007.

Registered Finance Companies

The decline in demand for new credit and the failure of several entities connected to banks and finance companies in the Ceylinco Group, significantly hindered the normal business activities of the sector. As a consequence, the performance of the RFC sector, in terms of profitability, earnings and capital adequacy was adversely affected. Despite the severe stresses encountered by some companies, RFCs sector continued to make an important contribution, especially in the area of vehicle financing by catering to a diverse and important customer base that have no easy access to bank finance. The total number of RFCs in operation increased from 34 to 35, with one SLC becoming registered as an RFC under the Finance Companies Act No. 78 of 1988 in 2009. The total number of RFCs branches has increased to 289 as at end December 2009, from 248 as at the end 2008.

The growth of total assets slowed down due to stresses experienced in some RFCs. Accordingly, during the year 2009, total assets of RFCs grew by 5 per cent, to Rs. 185 billion when compared with 23 per cent growth recorded for the year 2008. The market share of the two largest RFCs, which accounted for approximately 46 per cent of the total assets of the industry in 2008, reduced to 37 per cent as at end 2009. The largest nine RFCs accounted for approximately 73 per cent of the total assets of RFCs, whereas eighteen medium size RFCs accounted for only 24 per cent of total assets.

The growth of accommodation to some sectors slowed down. Hire purchase and lease facilities for vehicle financing accounted for about 63 per cent of the RFC industry's assets as at end 2009. In view of the rising delinquent loans, most RFCs took steps to curtail lending and adopted a relatively conservative approach when expanding their accommodations. As a result, total accommodations granted by RFCs increased marginally by 3 per cent as at end 2009 to Rs. 116 billion compared to the 17 per cent increase recorded in 2008. Despite the slight increase in accommodations portfolio, lease facilities decreased by 1.3 per cent, while hire purchase facilities increased marginally by 0.3 per cent in 2009. Furthermore, owing to the current depression in the real estate market, loans against real estate declined considerably by 22.4 per cent to Rs. 8.3 billion in 2009. On a related note, the RFCs that had a greater percentage of real estate in their asset portfolio were exposed to greater liquidity risks due to the inability to dispose of such assets in the short term. Meanwhile, pawning advances increased considerably by 36 per cent to Rs. 7.5 billion.

The major source of the industry's funding requirements continued to be from public deposits. Bank borrowings became increasingly difficult to obtain, the relative share of deposit liabilities increased to 65 per cent of total funding needs during the period from 59 per cent in the previous year. Accordingly, the relative share of bank borrowings reduced to 10 per cent of total funding as at end 2009 from 17 per cent as at end 2008. However, growth of deposit liabilities slowed down to 16 per cent in 2009, when compared with 32 per cent growth recorded in 2008. The sector benefited by the gradual reduction in interest rates during the latter part of the year, as bank interest rates for public deposits declined considerably. Furthermore, on account of heavy losses recorded by some large RFCs, the relative share of capital funds also decreased to 11 per cent of total funding in 2009 with compared to 14 per cent in the previous year.

Profitability of RFCs was severely affected due to the slowdown of business activities during the year. As many of the RFCs scaled down their businesses to face the liquidity crisis coupled with the higher interest expenses on deposits and borrowings, the sector reported a before tax loss of Rs. 1.1 billion as at end 2009, compared with the before tax profit of Rs. 2.3 billion in 2008. Nevertheless, the sector's profitability has been largely influenced by the significant losses incurred by a few RFCs. However, some RFCs performed well even during the crisis, due to their well adopted business practices and good governance.

Capital funds of the RFC sector eroded, on account of the reported losses. Capital funds of the sector declined by 16 per cent to Rs. 21 billion from Rs. 25 billion as at end 2008. As the RFC sector was better capitalised to absorb the economic shocks and unexpected crisis situations, despite the deterioration of capital funds, the regulatory capital ratios of the RFC sector remained above the required minimum levels. Meanwhile, CBSL continued to take necessary action to strengthen and enhance the capital position of RFCs during the year. Consequently, out of 35 RFCs, 27 RFCs were compliant with the minimum core capital requirement of Rs. 200 million and it is expected that the remaining RFCs will meet the requirement shortly in an environment of enhanced investor confidence.

The stability of the RFC sector was preserved primarily through the timely intervention, stringent regulation and supervision of CBSL. CBSL has taken several steps to restore the public confidence in the sector, appointed managing agents to assist distressed finance companies, appointed a panel of experts to advice on the recovery process, introduced a Special Stimulus Package in April 2009, in conjunction with the Ministry of Finance and Planning, as a measure of assisting RFCs and SLCs that were experiencing liquidity constraints and introduced a guarantee scheme in respect of loan facilities provided by banking institutions to RFCs and SLCs, so that they could obtain credit facilities from banking institutions to conduct their normal business operations, without interruptions.

The regulatory framework relating to RFCs is being strengthened. In order to make the Board of Directors of RFCs responsible and accountable for the companies' performance and risk management, compliance with the Finance Companies (Corporate Governance) Direction was closely monitored. Furthermore, listing on the Colombo Stock Exchange was made compulsory for RFCs by end June 2011 to broadbase the share ownership structure and to improve transparency. The Finance Companies (Reporting Requirement) Direction No. 5 of 2009 was imposed to grant more powers to CBSL ro regulate RFCs. More importantly, to prevent further financial scams arising from the misconduct of unauthorised players, the Finance Business Act is to be enacted, which will replace the current Finance Companies Act (FCA). The major revisions proposed in the draft Finance Business Act are: to make the acceptance of deposits without authority an offence; to provide a clear definition of the term 'deposits'; to enhance powers for examinations and investigations to curb unauthorised finance/deposits taking businesses; to enhance public disclosure; and to empower the Monetary Board to establish a mandatory deposit insurance scheme.

Action against unauthorised conduct of finance business continued. In terms of the provisions of the (FCA), the Department of Supervision of Non-Bank Financial Institutions continued its investigations of entities allegedly engaged in finance business without authorisation. As a consequence of the findings the Monetary Board determined that a certain institutions as having engaged in unauthorised finance business and requested them to comply with the requirements of the FCA within a specified period and to apply for registration. However, as these persons/institutions failed to comply with the directions within the stipulated period, necessary regulatory actions were taken under the FCA.

Repayment schemes initiated through the court process were facilitated. Some depositors/ investors of institutions (that collected public funds in various ways and had defaulted on repayment to the investors), filed Fundamental Rights Applications at the Supreme Court to recover their dues. In response, the Supreme Court has ordered the Monetary Board of CBSL and the special committee appointed to take various actions to safeguard the interest of such investors. Further, CBSL facilitated the special committee to carry on their administrative function and assisted the court to resolve issues relating to repayment schemes proposed to safeguard the interests of the investors.

Specialised Leasing Companies

The activities of Registered Finance Leasing Establishments (RFLEs) moderated during 2009, due to the tight market conditions for sourcing funds and the decline in overall demand for new loans . There were 78 finance leasing establishments registered under the Finance Leasing Act, No. 56 of 2000 (FLA) by end 2008, and this number reduced to 74 in 2009, consisting of 19 licensed banks, 34 RFCs and 21 Specialised Leasing Companies (SLCs). The registration of four licensed banks under the FLA was cancelled due to the failure to commence finance leasing business within twelve months of registration under the FLA. One SLC was registered as a finance company under the FCA in 2009. The total assets of the SLCs increased by 1.8 per cent to Rs. 112 billion during the year, compared to Rs. 110 billion in 2008. The growth in total outstanding accommodations slowed down significantly by end of 2009. The total outstanding accommodations stood at Rs. 80 billion at end 2009 against Rs. 89 billion in 2008.

The assets of the industry were concentrated within a few companies. At end December 2009, 89 per cent of total assets of SLCs were reported from 8 companies. This could be observed both in the leasing portfolio, as well as borrowings. The SLCs cater primarily to lower income groups and less creditworthy customers who do not have easy access to credit facilities from banks. Finance leasing and hire purchase are the major businesses of SLCs which accounted for more than 71 per cent of total accommodations. Hire purchase facilities, which accounted for 33.9 per cent of total accommodations, grew by 7 per cent while, finance leasing, which accounted for 38.3 per cent of total accommodation, recorded a decline of 12.4 per cent. The imposition of a ceiling on the claimable input Value Added Tax on finance leases led to a decrease in the demand for lease facilities. As SLCs are not permitted to accept deposits from the public, they depend mainly on funds raised through the issue of debt instruments and commercial bank loans. Total outstanding borrowings of SLCs decreased by 3.9 per cent to Rs. 74 billion in 2009 from Rs. 77 billion in 2008.

The SLCs experienced a growth in profitability, mainly due to favourable interest margins in their main lines of business. Net operational profit of SLCs (before tax) increased by 17.2 per cent to Rs. 3.4 billion in 2009 from Rs. 2.9 billion in 2008. Interest income of SLCs decreased by 3.7 per cent, while interest expenses also decreased by 10.2 per cent, increasing the net interest income. Credit quality of SLCs deteriorated, as reflected by the increase in the NPA ratio by 7.6 per cent at end 2009 from 4.8 per cent at end 2008. In terms of the FLA, new Directions were issued to SLCs, relating to the stimulus package, corporate governance, lending and business transactions with Directors and their relatives during the year 2009. Further, to overcome the unfavourable situation faced by SLCs, CBSL has adopted several policy measures to strengthen the industry.

Other Financial Institutions

Primary Dealers

The Primary Dealer (PD) industry performed exceptionally well during 2009, with the decline in yield rates in the government securities market. The total capital of the industry was recorded at Rs.11 billion, which is an increase of 82 per cent over the previous year. The total portfolio of the industry increased to a record level surpassing Rs.100 billion during the year and

Box 15

Deposit Insurance as a Financial Safety Net Tool

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 100 countries with deposit insurance systems of various forms. Further, another 20 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.

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 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 on increased cost of financial intermediation.

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.

Sri Lanka is heading towards implementing a mandatory DIS

In Sri Lanka, a voluntary DIS, which came into operation in 1987 for banks and co-operative societies, is currently in non-active status. Although some banks and co-operative societies joined in the scheme in early years, except for one co-operative society, all other eligible institutions are not members due to its voluntary nature.

Considering the importance of the existence of a mandatory DIS, the Central Bank has initiated action to formulate a mandatory DIS. It is also proposed to in-built a liquidity support scheme to provide licensed/registered financial institutions with immediate financial support to prevent imminent financial distresses. However, in case of systemic crisis situations a DIS may not have adequate resources to deal with large scale deposit outflows and would require the state support.

settled at Rs.94 billion at the end of the year. The PD industry recorded audited pre-tax profits of Rs. 7 billion, which was a remarkable upturn over the past five years. The profitability indicators of the PD industry were very impressive at the end of the year with Return on Assets at 7.3 per cent and Return on Equity at 79.4 per cent compared to corresponding figures of 2.0 per cent and 26.6 per cent respectively in 2008. The risk weighted capital adequacy ratio of the industry stood at 22.4 per cent relative to the minimum regulatory requirement of 8 per cent. The analysis of stress tests, which is used as a risk management tool to evaluate the market risk positions of the PDs, shows that the PD industry would lose 7.6 per cent of its capital if the interest rate increased by 100 bps from its level at end 2009.

Since the PDs operated in a single product market, it was identified that the PD industry was exposed to a considerable market risk due to the lack of business diversification. Therefore, a policy decision was taken to allow the PDs to diversify their activities. The first phase of diversification was implemented during the latter part of the year with the necessary amendments to Registered Stock and Securities Ordinance and the Local Treasury Bills Ordinance. Under the first stage, PDs can engage in fee- based activities and invest in shares and debentures of its own group companies. In the second stage, PDs would be permitted to invest in quoted shares, debentures, bonds or commercial paper in accordance with limits imposed by CBSL and to act as a broker in quoted corporate bonds /debentures. With a view to promoting safety, soundness and stability of the PD system and to build up the PD capital base, a direction was issued to PDs restricting the dividends declaration to a maximum of 50 per cent of the realised profits (after deducting revaluation gains) for the year.

Unit Trusts

The performance of the unit trust industry improved considerably with the upturn in the stock market. There were five unit trust management companies managing 18 funds of which 13 were open-ended funds, while 5 are closed-ended funds. Of these funds, 6 were income funds, 5 were growth funds, 4 were balanced funds, 2 were money market funds and 1 was an index fund. A new closed-ended balanced fund (Namal Acuity Value Fund) was set up in 2009 which was listed on the Colombo Stock Exchange. The net asset value (NAV) of the unit trust industry increased by 47 per cent to Rs. 9.9 billion at end December 2009 due to an appreciation in the value of investments, particularly on account of the surge in the prices of equities and government securities. The share of equities and government securities in the investment portfolio of unit trusts rose to

8

FINANCIAL SECTOR DEVELOPMENTS AND SYSTEM STABILITY

Table 8.8 Selected Data of the Unit Trust Industry

	2006	2007	2008	2009(a)
Total Assets (Rs.mn)	5,380	6,332	6,801	10,003
Net Asset Value-NAV (Rs.mn)	5,353	6,295	6,781	9,952
Investments in Equities (Rs.mn)	3,691	3,649	2,589	6,036
Investments in Shares as a % of NAV	69	58	38	61
Total No.of Unit Holders	23,424	23,191	22,699	23,117
No.of Units in Issues (mn)	356	470	638	564
No.of Unit Trusts	13	14	17	18

(a) Provisional

Sources : Unit Trust Association of Sri Lanka
Securities and Exchange Commission

61 per cent and 27 per cent respectively, while the share of other fixed income securities declined to 12 per cent. The total number of unit holders increased marginally to 23,117 while the total number of units issued also dropped to 564 million. The unit trust management companies are supervised by the Securities and Exchange Commission (SEC). The SEC strengthened the regulation of unit trusts during the year. New directives were issued relating to the independence of trustees from managing companies, investment restrictions and minimum net capital requirements for unit trust management companies, financial capacity of trustees and disclosure requirements for trustees and management companies.

Insurance Companies

The insurance companies recorded a marginal decline in total premium income. The insurance sector consists of eighteen companies, of which eleven firms are composite insurers (engaging in both long-term and general insurance business), while five firms conduct only general insurance business and two firms engage solely in long-term insurance business. Seven insurance companies were listed on the Colombo Stock Exchange and six companies have foreign collaboration. In addition, there were 43 insurance broking companies involved mainly in general insurance business and about 25,000 insurance agents who market mainly life insurance products. The insurance industry is highly concentrated, with the two largest companies accounting for about 65 per cent of the total assets of the industry, while the largest five companies account for 93 per cent of total insurance assets. Two new companies obtained registration in 2009. The total premium income of insurance companies declined by 1 per cent in 2009 compared with an increase of 12 per cent in the previous year, on account of the slower growth of the economy. The premium income for general insurance declined by 3 per cent, while the premium income for long-term insurance increased by 2 per cent. Premium income on motor insurance, which is the largest category in general insurance, fell by 5 per cent and was largely responsible for the decline in general insurance premiums. However, investment income of insurance companies increased by 38 per cent, shoring up the financial performance in the insurance sector. The total assets of insurance companies grew by 16 per cent to Rs. 180 billion as at end December 2009. Insurance companies were able to retain around 73 per cent of gross premiums on general insurance, while 27 per cent was ceded as reinsurance premium to cover for large risk. Motor insurance continued to maintain the highest retention ratio of 97 per cent compared to other classes. The overall claims ratio of the industry was 62 per cent in 2009.The majority of insurance companies made both underwriting and overall profits in 2009.

Investments in government securities and equities recorded growth. Investments in government securities and equities by insurance companies increased by 13 per cent and 60 per cent, respectively in 2009. However, the share of government securities declined marginally to 27 per cent of general insurance assets and

Chart 8.2 Gross Premium of Insurance Companies

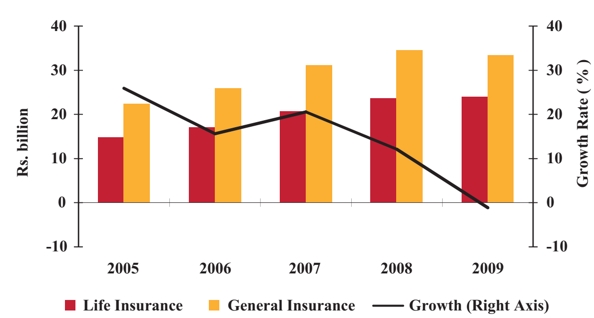
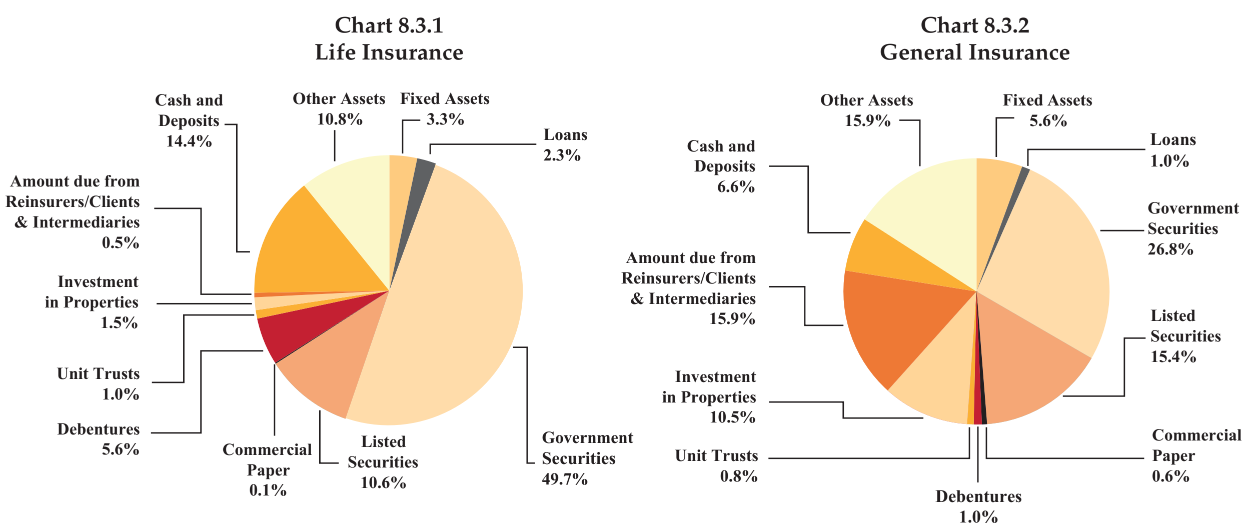


Chart 8.3 Distribution of Assets of Insurance Companies



50 per cent of long-term insurance assets, while the share of equities increased to 15 per cent of general insurance assets and 11 per cent of long-term insurance assets. Insurance companies were compliant with the statutory requirement of holding a minimum of 20 per cent of technical reserves of general insurance and 30 per cent of long-term funds in government securities.

The overall solvency margins of insurance companies were maintained. The solvency margin is the key indicator of insurance company soundness. Insurance companies are required to maintain a solvency margin requirement in respect of both long-term and general insurance business. The overall solvency ratio of insurance companies for long- term and general insurance was 4.8 and 2.8 respectively, at end 2009, similar to last year's level. All long-term and general insurers in operation met the minimum solvency requirement.

Sri Lanka war risk rating was lowered by international underwriters. The London Joint Cargo Committee (JCC) lowered the risk rating from 3.4 to 2.9, in effect changing the status from "severe" to "high" in 2009. In addition, air-war/ strikes and air-war risks have been removed, while risks on marine war and ground war strikes have been retained. The reduced war risk rating has resulted in lower prices of goods imported to Sri Lanka due to a lower surcharge on ships carrying cargo to Sri Lanka.

The regulatory framework of the insurance sector is being strengthened. The Regulation of Insurance Industry Act will also be revised to strengthen the supervisory framework of the entire insurance industry. 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 policyholders. 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 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. The proposed amendments were finalized and submitted to the Ministry of Finance in 2009. The IBSL revised the solvency margin rules of insurance companies to accommodate new investment instruments, such as asset-backed securities, deposits with registered finance companies and gold. A project has been initiated to introduce a capital adequacy framework for insurance companies. The IBSL is also preparing a framework for the regulation of micro-insurance.

Superannuation Funds

The superannuation funds sector accounted for about 18 per cent of total financial sector assets. The sector is dominated by the EPF which accounted for 76 per cent of the assets of the superannuation funds sector. The EPF is administrated by the Commissioner of Labour, while the responsibility for the management of the funds is with the Monetary Board of the CBSL. The EPF has about 12.7 million accounts, of which 2.0 million are active accounts. The difference is primarily on account of some members having multiple accounts. The total assets of the EPF increased by 18 per cent to Rs. 772 billion at the end of 2009. Total contributions increased by 6 per cent to Rs. 49 billion, while total refunds rose by 23 per cent to Rs. 32 billion, indicating a decrease in net inflows, partly due to the slower growth in employment opportunities in the economic downturn. The total investment portfolio of the EPF increased by 17.5 per cent to Rs. 737 billion in 2009. The investment in government securities accounted for 97 per cent, while investments in corporate debt and equities accounted for 1.1 per cent and 1.3 per cent, respectively. The EPF earned a gross income of Rs. 109.6 billion in 2009 compared with Rs. 79.5 billion in 2008. The effective rate of return declared on member balances increased to 13.75 per cent in 2009 from 13.44 per cent in 2008.

The ETF, the employer contributory retirement benefit scheme, which accounts for about 10 per cent of the superannuation funds sector, similar to the EPF recorded an increase in its asset base and investments, while net contributions decelerated. The ETF which is managed by a statutory board of trustees, has about 8.9 million accounts, of which about 2.1 million are active accounts. The total outstanding member balances in the ETF rose by 16 per cent to stand at Rs. 103 billion at the end of 2009. Total contributions increased by 5 per cent to Rs. 8.8 billion, while benefits paid out increased by 31 per cent to Rs. 6.4 billion, indicating a decrease in the net inflow of funds during the year. The total investments of the ETF rose by 16 per cent to Rs. 101 billion at the end of 2009. The total assets of the ETF amounted to Rs. 107 billion at end 2009. The investment profile of the ETF is similar to that of the EPF with the majority (91 per cent) of its investments in government securities. Investments in equity and corporate fixed income securities accounted for 2.7 per cent 1.4 per cent, respectively, of total investments. The rate of return on member balances was 13 per cent for the year.

Table 8.9 Key Indicators of Major Superannuation Funds

	EPF		ETF	
	2008	2009(a)	2008	2009(a)
Number of Accounts (mn)	12.5	12.5	8.0	8.9
o/w; Active Accounts (%)	18.4	18.4	26.3	23.7
Number of Employers contributing	62,625	60,000	58,446	61,237
Total Contributions (Rs.bn)	45.9	48.7	8.3	8.8
Total Refunds (Rs.bn)	25.9	31.9	4.9	6.4
Total Outstanding Balance of - Member Accounts (Rs.bn)	645.0	752.2	88.9	103.1
Total Assets (Rs.bn)	655.4	772.0	92.4	107.3
Total Investments Portfolio (Rs.bn)	627.2	737.1	87.3	101.2
o/w; Government securities (%)	96.9	97.1	90.0	91.1
Gross Income (Rs.bn)	79.5	109.6	11.5	14.5
Interest Rate paid for Member Accounts (%)	13.44	13.75	12.00	13.00

(a) Provisional

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

Privately managed provident and pension funds, which are monitored by the Department of Labour, numbered 171 with a total membership of 157,453 persons. The assets of private provident and pension funds stood at Rs. 122 billion, while investments were Rs. 107 billion at the end of 2009. The Public Service Provident Fund (PSPF) which is managed by the Department of Pensions had 232,779 active members at the end of 2009. The assets of the PSPF stood at Rs. 22.7 billion at end 2009.Total contributions and refunds during the year amounted to Rs. 1.3 billion and Rs. 271 million respectively.

8.4 Developments in Financial Markets

Inter-bank Call Money Market

The liquidity shortfall observed in the inter-bank call money market at the beginning of the year turned into a significant surplus position with the continued foreign currency inflows to the country and the purchase of the same by CBSL. The CBSL took steps to address the issue of liquidity shortfall in the market through continued open market operations (OMO). In addition, the Statutory Reserve Ratio (SRR) was reduced by 75 basis points to release around Rs.9 billion worth of liquidity into the market during this period. However, the liquidity position has turned into a surplus and recorded a daily average surplus of Rs.22 billion in the second half of the year. Consequently, the daily average volume of inter-bank call money transactions has declined from Rs.11.7 billion in the first half to Rs.5.4 billion in the second half, reflecting the change in market liquidity from a shortage to a high surplus in the second half of the year. The daily volume of inter-bank call money transactions recorded a marginal increase from that of the previous year to an average of Rs.8.5 billion in 2009. Initiative by the CBSL to absorb the excess foreign currency liquidity in the domestic market to contain the excess volatility in the exchange rates and to build up international reserves of the CBSL, have contributed to the increased rupee market liquidity in the second half of 2009.

During the year, call money rates gradually declined with the easing of monetary policy and increased liquidity in the market. The call money market rates ranged between 9.47 per cent to 15.54 per cent in the first two quarters of the year. The reverse repo facility offered at Penal rate was gradually reduced from 19 per cent to 13 per cent by April 2009. Subsequently, CBSL removed the Penal rate on reverse repo facility at as well as the restrictions imposed on overnight reverse repo standing facility. As a result, the interest rate corridor was re-established and call market rates were allowed to fluctuate within the interest rate corridor formed by the Bank's policy rates, showing a low level of volatility. Easing of monetary policy by the CBSL and the increased liquidity in the interbank market resulted in a considerable reduction in call market rates to a range of 8.58 – 10.33 per cent during the second half of the year.

Table 8.10 Money Market Operations 2007 – 2009

Rs. million

	Call Money Market: Daily Average Volume	Primary Treasury Bill Market: Amount Issued	Amount Purchased: Central Bank	Amount Purchased: Primary Dealers	Amount Purchased: Others (a)
2007 1st Quarter	7,555.3	141,804	35,051	89,069	17,684
2nd Quarter	6,274.1	239,165	78,726	98,530	61,909
3rd Quarter	7,220.8	212,007	68,138	94,253	49,616
4th Quarter	7,592.4	224,212	40,946	106,606	76,660
2008 1st Quarter	6,295.2	201,330	8,156	92,186	100,988
2nd Quarter	6,208.7	212,181	17,139	78,232	116,810
3rd Quarter	5,579.0	164,368	10,262	57,746	96,360
4th Quarter	9,657.8	201,697	148,170	24,432	29,095
2009 1st Quarter	12,422.9	209,988	73,967	66,848	69,173
2nd Quarter	8,014.2	202,922	58,250	106,400	38,272
3rd Quarter	5,761.3	230,451	36,835	128,218	65,398
4th Quarter	4,628.1	177,850	21,274	114,691	41,885

(a) Amount issued through placements.

Source: Central Bank of Sri Lanka

OMO by CBSL were instrumental in re-aligning the market interest rates with the desired interest rate path. In the second half, surplus liquidity in the market offered a greater challenge for smooth behaviour in the market interest rates. This, together with a significant decline in CBSL's traditional instrument for conducting OMO, which is Treasury bills, demanded innovative and non-traditional measures to address the issue of increasing liquidity surplus in the domestic money market. As a result, resorted to issuing Central Bank Securities for OMO. The CBSL also introduced foreign exchange swaps (FX swaps) as an instrument for absorbing excess liquidity in the rupee market and to limit the volatility in short-term interest rates. Although the liquidity position in the rupee market remained high in the latter part of 2009, strategic adoption of the above instruments in OMO has effectively maintained the stability of the short-term interest rates during the period under review.

Domestic Foreign Exchange Market

Greater stability of the Sri Lanka Rupee exchange rate against the US Dollar was evident during 2009. The exchange rate depreciated during the first three months of the year due to the payments made for import commitments, while appreciating during the second half of the year, in line with foreign exchange inflows mainly due to the end of the war and the resulting positive investor sentiment. The IMF Stand-By Arrangement facility and special SDR allocation received by the country and increased investments in government securities by foreigners also assisted in further building up the foreign exchange reserves of the country. The Sri Lankan rupee depreciated by 1.09 per cent against the US dollar in 2009. The depreciation rates of Sri Lanka rupee against the euro, the pound sterling and the Indian rupee were 2.60 per cent, 10.16 per cent and 4.13 per cent respectively. However, Sri Lanka rupee has appreciated against Japanese yen marginally by 0.89 per cent.

The total value of inter-bank foreign exchange transactions in 2009 decreased to US dollar 11 billion as against US dollars 14 billion in 2008. The daily average value of inter-bank foreign exchange transactions has decreased from US dollars 59 million in 2008 to US dollars 45 million in 2009, reflecting a decline of 22 per cent. The total value of foreign exchange purchased during the year from the inter-bank foreign exchange market was US dollars 3.1 billion as against the total sales of US dollars 830 million to the market, resulting in a net purchase of US dollars 2.3 billion. This is a significant improvement in the absorption of foreign exchange in the domestic market, as there have been no net purchases since 2003.

Government Securities Market

Yield rates in the government securities market moved downwards significantly during the year. Treasury bill and bond yield rates dropped appreciably in 2009 in line with monetary policy measures adopted by the CBSL, declining inflation, lower inflationary expectations, improved liquidity and renewed foreign investor participation in the government securities market. Yield rates on Treasury bills and bonds in the secondary market declined by a range of 550 to 990 basis points. However in the latter part of the year, the yield rates at the shorter end (3 months, 6 months and 1 year) increased marginally. Taking advantage of the positive market developments, a new 10 year Treasury bond series was issued, thereby extending the yield curve and enabling financial market participants to invest in long term securities. Secondary market trading activity increased, particularly in the Treasury bond market mainly driven by foreign investors. Foreign investment in the government securities market rose significantly from around Rs. 3 billion in March 2009 to Rs. 185 billion in December 2009.

Corporate Debt Securities Market

Commercial Paper

The level of activity in the commercial paper (CP) market declined with the slowdown in demand for new credit. The total value of CP issued guaranteed by banks amounted to Rs. 21.5 billion in 2009 in comparison with Rs. 23.8 billion in 2008. The interest rates varied between 9 to 36 per cent in 2009 compared with a range of 17 to 36 per cent in the previous year. Commercial paper with a maturity of 3 months or less accounted for 90 per cent of the market, while the share of commercial paper with a 6 month maturity was 9 per cent. The total outstanding value of commercial paper amounted Rs. 5.8 billion at the end of 2009 compared with Rs. 4.1 billion at the end of 2008.

Corporate Bonds

The corporate bond market was relatively dormant in 2009. Two Licensed Commercial Banks listed on the Colombo Stock Exchange issued debentures which raised Rs. 1.1 billion in 2009 compared with five issues totalling Rs. 6.8 billion in 2008. The Seylan Bank PLC mobilised Rs. 630 million at fixed rates (20.5 per cent and 21.5 per cent) and floating rates for 5 year maturities and the Nations Trust Bank PLC mobilised Rs. 500 million at the fixed rate of 20.5 per cent for 4 year maturities. The turnover of debentures listed on the Debt

Trading System of the Colombo Stock Exchange was Rs. 129 million in 2009 compared with Rs. 103 million in 2008. The corporate bond market is expected to expand in the future, with the decline in interest rates and the recovery in domestic business activity.

Equity Market

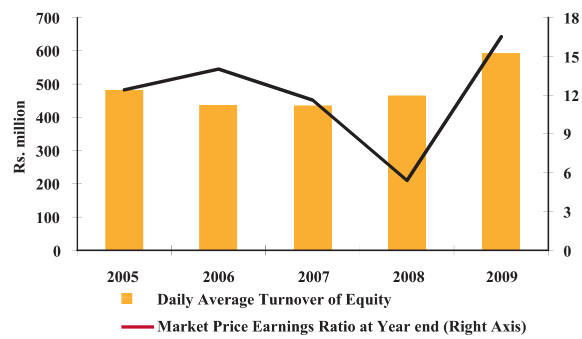
The Colombo Stock Exchange (CSE) recorded its best year in history overcoming the challenges experienced in 2008 and 2007. The equity price indices having experienced some volatility during the first four months of the year, surged upwards from May 2009 reflecting the positive market sentiment following the end of the war. The robust performance of the share market was also due to the sharp decline in inflation, lower interest rate environment and renewed investor confidence consequent to securing the IMF Stand-By Arrangement. The All Share Price Index (ASPI) rose by 125 per cent in 2009 (in contrast to a decline of 41 per cent and 7 per cent in 2008 and 2007, respectively), surpassing the previous record of an increase of 118 per cent in 1991. The performance of the CSE in 2009 made it the second best performing market in the world according to Bloomberg Newswire. The Milanka Price Index (MPI) also increased by 136 per cent exceeding the previous record of 52 per cent in 2006. The price indices of all twenty sub-sectors of the CSE recorded positive gains for the year. The indices of the five largest sub-sectors in terms of market capitalisation, i.e., Diversified Holdings, Banks, Finance & Insurance, Telecommunications, Beverage, Food & Tobacco and Hotels & Travels increased by 212 per cent, 134 per cent, 36 per cent, 114 per cent, and 199 per cent, respectively, at end 2009. The market price earnings ratio (PER) which was 5.4 at end 2008 moved up to 16.5 at end 2009.

The market capitalisation more than doubled and crossed the Rs. 1 trillion mark. As at end 2009, the market capitalisation of the CSE increased to Rs. 1,092 billion from Rs. 489 billion at end 2008, which was about 23 per cent of the country's GDP. In terms of sectoral composition, the Diversified Group accounted for 22 per cent of total market capitalization, while the share of Banks, Finance & Insurance and Telecommunications was 18 per cent and 13 per cent, respectively. The ten largest companies in the CSE accounted for 46 per cent of total market capitalization. The CSE also achieved the highest turnover in a given year by generating Rs. 142 billion in 2009. The average daily turnover was Rs. 594 million in 2009 compared with Rs. 465 million in 2008. Domestic investors accounted for 69.5 per cent of the total turnover of the CSE, while the share of foreign investors was 30.5 per cent.

Net foreign flows recorded an outflow with a major foreign investor exiting the market. The total foreign purchases and total foreign sales were Rs. 43.1 billion and Rs. 43.8 billion, respectively, resulting in a net foreign outflow of Rs. 789 million in 2009 compared with a net foreign inflow of Rs. 13.9 billion in 2008. This was mainly due to the sale of significant holdings in several blue chips companies by a foreign fund management company that was winding down its investments. However, these divestments were easily absorbed by domestic investors without an adverse price impact. There were rights issues by fourteen companies and three Initial Public Offering (IPO) of shares, which raised Rs. 5 billion and Rs. 1.5 billion, respectively, during 2009. In addition, the first closed-ended unit trust was listed on the CSE with an IPO of Rs. 500 million.

Several market development measures were introduced during the year. The Listing Rules of the CSE were revised with effect from April

Chart 8.4 Daily Average Turnover of Equity and Market Price Earnings Ratio



8

FINANCIAL SECTOR DEVELOPMENTS AND SYSTEM STABILITY

Table 8.11 **Share Market Performance**

	2008	2009
All Share Price Index (a)	1,503.0	3,385.6
Year-on-year change (%)	-40.9	125.3
Milanka Price Index (a)	1,631.3	3,849.4
Year-on-year change (%)	-50.5	136.0
Market Capitalisation (Rs.bn)(a)	488.8	1,092.1
As a percentage of GDP (%)	11.4	22.9
Market Price Earnings Ratio (a)	5.4	16.5
Turnover to Market Capitalisation (%)	22.6	13.0
Value of Shares Traded (Rs.mn)	110,454	142,463
Number of Shares Traded (mn)	3,155	4,763
Number of Companies Traded	232	231
Number of Companies Listed	235	231
Introductions (b)	1	0
Initial Public Offers/Offers for Sale (b)	2	4
Number of Rights Issues	9	14
Amount Raised through Rights Issues (Rs.mn)	2,891	4,985

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

Source: Colombo Stock Exchange

2009 incorporating changes arising from the new Companies Act. The eligibility criteria to list equity and debentures of a company have been revised to promote new listings. New rules have also been introduced to list units of closed-ended funds, scrip dividends, re-purchase of shares, redemptions, minority buy-outs and the further issue of shares by public subscription by listed companies. Rules relating to right issues, capitalisation of reserves, share swaps and warrants have also been revised. The CSE also developed an Information Dissemination Policy in order to improve the efficiency and the effectiveness of dissemination of corporate announcements/information to the market. Consequently, corporate announcements and financial statements of listed companies are

Chart 8.5 **Net Foreign Purchases at the Colombo Stock Exchange (CSE)**

published in the CSE website. The transaction costs pertaining to CSE, CDS and SEC charges were reduced by 50 per cent on transactions over Rs. 100 million and the minimum brokerage fee of 0.1 per cent was introduced for such transactions. A separate fee structure for transactions in close ended funds was also introduced.

Initiatives were undertaken to strengthen the monitoring and surveillance of the stock market. The CSE introduced a market-wide indexed based circuit breaker to halt trading of equity securities for 30 minutes in the event the MPI falls by more than 5 per cent from the previous day's close in order to provide a "cooling off" period when there is an unusual movement in the index. As sellers of equities are exposed to counterparty risk as settlement takes place on T+3, the CSE has initiated a project to establish a clearing house which will take up the obligation of guaranteeing settlement through a settlement guarantee fund. A Delivery Vs Payment (DVP) mechanism will also be introduced to address the asset commitment risk prevalent in the market. Under the DVP system securities will remain with the seller until settlement day and will be delivered by to the buyer only on settlement day on receipt of funds. The risk of a single settlement bank for inter-participant settlement of secondary market transactions on the CSE has been reduced with the implementation of a multiple settlement bank system. The Central Depository System (CDS) appointed four banks to function as settlement banks of the CDS.

The regulatory framework of the securities market was strengthened to facilitate the development of the capital market. The Securities Exchange Commission (SEC) is the regulator of the CSE and also the main securities market regulator. The SEC Act was amended to include changes to the composition of the Commission Board to increase the level of private sector representation in order to achieve a balanced representation of public and private sector interests. Other revisions related to empowering the SEC to issue directives to listed public companies to protect the interests of investors and to ensure that professional standards are maintained in the capital market and to facilitate regulation of derivatives such as futures and options. The Regulation of Asset Backed Securitisation Bill was presented to Parliament. The proposed new law provides the legal framework for the establishment of Special Purpose Vehicles (SPVs) for securitisation, transferring assets to the SPV and issuing asset backed securities by the SPV. The regulation of persons involved in securitisation transactions such as originators and trustees is also covered by the law. Appropriate measures to ensure investor protection and to promote transparency and accountability in these transactions will be introduced.

8.5 Development Finance and Access to Finance

During 2009, the outreach of the banking sector improved with the expansion of the branch network of both LCBs and LSBs. There was a notable increase in the number of bank branches established outside the Western Province. The number of new bank branches opened by LCBs was 49, of which 38 were outside the Western Province. Further, out of the 49 new bank branches 17 branches were opened in the Eastern Province while 10 branches were opened in the Northern Province. In the case of LSBs, only one branch was opened within the Western Province out of the 17 new branch openings during the year. Further, 45 extension offices were opened by the LCBs, for the purpose of facilitating main bank branches, of which 41 were established outside the Western Province. The LSBs also opened 23 new extension offices. A large number of bank branches functioning outside the Western Province reflects the growing demand for financial services in the regions at a faster rate than in the past.

In line with the declining interest rates, in order to maintain the effectiveness of provision of subsidized lending to the agriculture sector, lending rates pertaining to the schemes implemented by the CBSL were adjusted downward, from 12 per cent, in concurrence with the Government of Sri Lanka (GOSL). The intention of the reduction in the interest rates was to encourage new investment in the agricultural and animal husbandry sectors. This will serve the government's objective of achieving the country's food security and uplifting the livelihood and the income levels of the farmer community. However, as this revision was announced at the end of the year, the positive impact of the move will be reflected in the agricultural production from year 2010.

Consistent with the robust growth in the agriculture sector experienced in the recent past, the demand for funds for many agriculture and allied activities increased substantially. Loan disbursement under the New Comprehensive Rural Credit Scheme (NCRCS), for crop cultivation increased by 23.6 per cent in 2008/2009 Maha season over the previous Maha season to reach Rs. 1,943 million. Paddy represents over 60 per cent of the loans provided under the NCRCS. Farmers continued to enter into Forward Sales Contracts (FSC) to protect against volatile prices in agriculture commodities. The value of loans given for the purchase of agricultural produce under FSC for Maha 2008/2009 increased to Rs. 4,673 million from Rs. 3,915 million in 2008, while that for Yala 2009 declined to Rs. 3,223 million from Rs. 3,857 million in the previous year. In addition, credit was also provided at an interest rate of 8 per cent under the Krushi Navodaya scheme for improving agricultural activities, processing of agricultural commodities, animal husbandry, purchase of equipment for the development of agriculture and allied activities, agro-based and agro related industries, developing micro irrigation and drip irrigation and distribution systems, enhancing storage facilities, development of protected agriculture, organic farming, production of organic fertilizer and extension services for agriculture etc.

The Agro-Livestock Development Loan (ALDL), which was announced in the Budget 2008 continued its operations in 2009 as well. This scheme was mainly aimed at promoting liquid milk production in the country and finance the activities along the value chain of the dairy industry by providing loans at a concessionary rate of 8 per cent for small scale dairies while providing loans at a rate of 12 per cent to milk processing industries in the country. Under the ALDL, agro-processing units, which have entered into FSCs to purchase the farm produce from 1000 – 10,000 farmers are also eligible to finance at concessionary conditions. In 2009, PFIs were able to grant Rs. 519.3 million among eligible recipients reflecting an increase of 14 per cent over the previous year's performance. In order to facilitate the PFIs to grant a concessionary rate, government provides interest subsidies at 6 per cent to PFIs under the scheme.

Small and Medium Enterprises (SMEs) continued to receive loans at concessionary interest rates under the special credit schemes operated by the CBSL during the year. Loan disbursement under the Construction Sector Development Project (CSDP) progressed satisfactorily during the year. Funds disbursed under European Investment Bank (Contract – B) for the rehabilitation of tsunami affected SMEs was Rs. 605.5 million. Meanwhile, Susahana Loan Scheme (Phase II), which aimed to assist micro, small and medium scale enterprises (MSMEs) affected by the tsunami to resume business, continued its activities in 2009. The Sabaragamuwa Intergrated Rural Development Project Revolving Fund (SIRDP–RF) scheme and the Matale Regional Economic Advancement Programme Revolving Fund Scheme (MREAP-RF) were also in operation in the relevant districts in 2009. The main objective of these two schemes is raising the income of rural and farm families by providing funds for SMEs in the respective districts.

Disbursement of finance for poverty alleviation also continued during the year 2009. The Poverty Alleviation Microfinance Programme Revolving Fund Scheme (PAMP-RF), which is financed out of the loan recoveries of the former Poverty Alleviation Micro-finance Programme (PAMP), continued its operations in 2009. The PAMP-RF covers most of the vulnerable Divisional Secretariat divisions throughout the country. In January 2009, PAMP II scheme funded by the Japan International Cooperation Agency (JICA) commenced its operations with the objective of improving the income level of the poor and enhance an inclusive formal financial service for them by providing credit for income generating activities and increasing income generating and skill development opportunities for beneficiaries. PAMP II covers 14 Districts, including all Districts of the Northern, Eastern, North Central and Uva Provinces and the Puttalam and Ratnapura Districts. PAMP II together with PAMP – RF serves the needs of the poor islandwide.

CBSL, which inititated a comprehensive loan schemes for the Eastern Province in 2008, developed a scheme for the Northern Province as well to boost livelihood development. The "Awakening North" programme, which operates in the Northern Province, provides financial assistance for the resumption of economic activities in agriculture, livestock, fisheries, micro and small enterprises and trade and other self-employment projects in the Province. Under the scheme, a total sum of Rs. 3,000 million has been allocated to be disbursed among eligible borrowers at a concessionary rate of 9 per cent per annum through PFIs operating in the Province. The CBSL provides refinance facilities to PFIs and borrowers are entitled to obtain loans up to Rs. 200,000 per borrower from the PFIs. This scheme provides facilities to Internally Displaced Persons (IDPs) to commence/restart their livelihood and income generating activities after resettlement. In the Eastern Province, in addition to the existing loan programmes, a revolving fund loan scheme will also operate through PFIs with refinance support from the GOSL for the resumption of economic activities of the IDPs in the Province. This scheme provides refinance facilities up to 100 per cent of the eligible loans to a maximum limit of Rs. 250,000 per borrower. Loans are given at a concessionary rate of 9 per cent with a grace period of six months for eligible borrowers.

8.6 Financial Infrastructure

Payments and Settlement Systems

Payment and settlement systems (PSSs) are fundamental elements of the financial infrastructure of any country. A core function of PSSs is to facilitate the settlement of monetary liabilities arising from business activities in the

Table 8.12 Non - Cash Payments: Volume and Value of Transactions

Payment Systems	2008(a)		2009(b)	
	Volume ('000)	Value (Rs.bn)	Volume ('000)	Value (Rs.bn)
Large Value Payment Systems	**229**	**25,131**	**233**	**33,155**
RTGS System	229	25,131	233	33,155
Retail Value Payment Systems	**77,084**	**5,221**	**73,748**	**5,009**
Main Cheque Clearing System	44,550	4,693	40,637	4,391
Rupee Draft Clearing System	n.a	1	n.a.	1
Sri Lanka Interbank Payment System (SLIPS)	7,846	236	9,034	279
Credit Cards	18,866	73	16,627	65
Debit Cards	2,174	6	3,309	11
Internet Banking	3,310	197	3,819	247
Phone Banking	338	4	322	4
Postal Instruments	n.a	11	n.a.	11
Total	**77,313**	**30,352**	**73,981**	**38,164**
US Dollar Cheque Clearing System	**71**	**26**	**60**	**20**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

market. More importantly, effective implementation of monetary policy towards achieving financial system stability depends on the maintenance of a safe, efficient and sound PSS. The CBSL is entrusted with the responsibility of providing guidance and leadership for the establishment and development of payment, clearing and settlement systems in Sri Lanka, by the Payment and Settlement Systems Act No. 28 of 2005. In discharging the assigned responsibilities, the CBSL adopted further measures during the year to strengthen the payment and settlement systems and minimise the risks involved, thereby, improving the soundness of the financial system. At the same time, the CBSL took steps to set up a more secured environment for transactions and settlement of electronic payments that have seen a tremendous increase due to the modernization of information and communication technology and the user preference for such modes of payment. Strengthening of the security of systems was required to increase the public confidence on electronic payment instruments.

Systemically Important Payment Systems

A payment system is considered as systemically important when a failure of one participant of the system to meet its financial obligations causes other participants to be unable to meet their obligations and thereby creating significant liquidity and credit problems in the system. This may threaten the stability of the entire financial system. There are two systemically important payment systems identified in Sri Lanka, namely, the LankaSettle System operated by the CBSL and the cheque imaging and truncation system operated by the LankaClear (Pvt.) Ltd.(LCPL), which are benchmarked to internationally accepted payments and settlement systems. Introduction of the LankaSettle System in 2003 was a landmark in the development of PSS in the country. With this development, two well integrated systems, namely, the Real Time Gross Settlement (RTGS) System which settles high value payments on real time gross basis and the LankaSecure System which settles securities transactions on Delivery versus Payment (DvP) basis, came in to being.

The CBSL continued to ensure the adherence of the two systemically important payment systems to internationally accepted core principles put forward by the Bank for International Settlements (BIS). The LankaSettle System remains closer to observing all 10 Core Principles of Systemically Important Payment Systems (CPSIPS). In order to improve the deficient areas of the system, the LankaSettle System Rules were updated and published in 2009. Further, steps were taken to facilitate provisioning of Intra-day Liquidity Facility (ILF) at the participant's discretion deviating from the current practice of each participant requesting ILF from the CBSL at the beginning of the day or at designated times. In updating the System Rules, attention was paid to incorporate amendments made to the system during the last five years, addition of selection criteria for LankaSettle participants, and documenting contingency events and dispute resolution procedures. With the implementation of the above, the LankaSettle system will fulfill all 10 CPSIPS stipulated by the BIS.

The Real Time Gross Settlement System

The RTGS System settles inter-bank high value and time critical Sri Lanka rupee transactions on a real time basis. The system accounted for 87 per cent of the total value of non-cash payments and continued to be the main interbank funds transfer system in the country. Recognising the effectiveness of the system by the banking community, the total value of transactions settled through the RTGS system increased by 32 per cent in 2009. The RTGS system settles transactions relating to the interbank call money market, the government securities market, the foreign exchange market (rupee leg), open market operations, urgent payments of customers of commercial banks and settlement of net obligations under the clearing systems operated by LCPL. Being the operator and the final settlement body of the system, the CBSL continued to provide intraday liquidity facility (ILF) for participating institutions in the RTGS system, against the collateral of government securities, to facilitate smooth settlement of transactions in the System. The daily average value of ILF requested by participants was Rs. 11.3 billion out of which Rs. 7.9 billion was utilized by participants.

The LankaSecure System

The LankaSecure system consists of the Scripless Securities Settlement System and the Central Depository System for scripless government securities. The total value of scripless securities held by LankaSecure at the end of 2009 amounted to Rs. 2,140 billion accounting for 99.9 per cent of the total value of Treasury bills and Treasury bonds outstanding. These scripless securities consisted of Rs. 481 billion Treasury bills and Rs. 1,659 billion Treasury bonds. As at end 2009, LankaSecure maintained 64,680 accounts through dealer direct participants, covering corporate as well as individual customers.

Cheque Imaging and Truncation (CIT) System

The Cheque Imaging and Truncation (CIT) System was introduced in 2006 with the objective of increasing efficiency of cheque clearing, by reducing the island-wide cheque realization time from 10 days to one day i.e., T+1 (where T is the day on which LCPL receives the cheque for clearing and 1 is the following business day). The CBSL continued monitoring of the adherence of participating institutions to the General Direction issued in 2007 in terms of Section 44 of the Payment and Settlement Systems Act No.28 of 2005. Having observed that T+1 rule is not observed nation-wide, the National Payment Council (NPC), the highest decision making body relating to PSS, decided to conduct a customer survey on cheque realization, in order to understand the concerns from the customers' point of view and to obtain the general view of the public on the cheque clearing process.

Having observed an increasing trend in cheque returns towards the end of 2008, CBSL has taken appropriate action to reduce cheque returns. The analysis of statistics obtained from LCPL on cheque returns revealed that 88 per cent of cheque returns were due to unavailability of sufficient funds in respective accounts, even though banks have taken several measures to reduce cheque returns at branch level. Accordingly, the CBSL instructed the Sri Lanka Banks' Association to investigate the matter and take necessary action to reduce the cheque returns due to unavailability of funds in accounts. As an additional control, all banks were requested to report to the Credit Information Bureau (CRIB) the details of cheques returned due to lack of funds, commencing January 2010. Further, the LCPL in consultation with the

CBSL made necessary arrangements with banks to implement the CD submission mode for CIT System with the objective of overcoming the delays in delivering images to the banks/branches and reducing system errors due to technical faults.

Sri Lanka Inter-bank Payment System (SLIPS)

SLIPS operated by LCPL is a major offline inter-bank retail payment system where electronic instructions are issued to effect payments. This system facilitates the transfer of funds directly by the CBSL and commercial banks to their customers. SLIPS operations expanded further during the year and the value of transactions cleared increased by 18 per cent to Rs. 279 billion. As in the previous years, this was mainly due to the increase in salary payments being channelled through the SLIPS.

Payment System Policy and Oversight

The CBSL continued to strengthen the oversight framework by adopting necessary mitigating measures to minimize the risks involved in the payment system and thereby ensuring stability, safety and efficiency of the payment system. The CBSL issued the Service Providers of Payment Cards Regulations No. 01 of 2009 with effect from 31 July 2009. The purpose of the regulation is to enhance the safety of the payment card industry by ensuring that all service providers of payment cards observe international standards and best practices and thereby reducing the risks of credit card frauds and increasing public confidence in card based electronic payments. All service providers of payment cards were required to obtain a licence from the CBSL to carry out business relating to credit cards, debit cards, charge cards and stored value cards including devices that include a code or any other means of access to an account.

The payment industry in the country has advanced towards greater efficiencies with the adoption of advanced technologies in payments and settlement systems area and as a result, the risks of information security and electronic fraud also have increased. Therefore, under the guidance of the CBSL, LCPL launched Sri Lanka's first Certification Authority under the brand name of 'LankaSign' with the objective of promoting public confidence, integrity and reliability of data messages, electronic documents, and electronic records or other communications during transmission from one financial institution to another.

Evaluating the Business Continuity Plans (BCP) and Disaster Recovery (DR) sites of LankaSettle participants continued in 2009 to improve the operational robustness of the LankaSettle System, in accordance with the guidelines issued by the CBSL. BCP and DR site of the Lanka Financial Service Bureau, which was established to provide SWIFTNet connectivity to participants of the LankaSettle system and management and data processing services to SWIFT users at a lesser cost, were also evaluated in 2009 and corrective measures were recommended to improve their BCP and equip the DR site to face any disruptions.

The CBSL monitored the adherence to T+1 cheque realisation time by commercial banks by reviewing the half yearly statements submitted by the banks. Further, the CBSL conducted the island-wide survey during the fourth quarter of 2009. The survey sample consisted of 1200 current account holders from 100 cities covering the entire country except the Northern and Eastern provinces. The statistical analysis of the survey is expected to be finalised in January, 2010 and based on the results, corrective measures will be taken to ensure that all banks fully adhere to the T+1 rule.

Credit Information

The Credit Information Bureau (CRIB) provides credit information reports on borrowers to member institutions. The CRIB issued 864,619 credit reports in 2009 compared with 817,887 reports in 2008. The new on-line system, Credit Information Management System (CRIMS) launched in 2008 provided an enhanced service to over 4000 registered users. The data base contained information on about 3 million borrowers and almost 5 million loans. CRIB issued an average of 4,400 credit reports per day in 2009. The number of reporting credit institutions was 93 in 2009. A new service was started in December 2009 which facilitates any individual or corporate entity to request a "Self Inquiry Credit Report" or an "i Report" from the Bureau through any branch of a LCB.

Several measures are being taken to expand the services and improve the coverage of CRIB. CRIB plans to extend its service to diverse user groups and new economic sectors, such as insurance and telecommunications. CRIB also proposes to expand its activities and develop value added CRIB products (credit scoring), integration of non-financial credit granting sectors (telecommunications and utility services), the setting up of the Secured Transactions Registry, the inclusion of Returned Cheque details in credit reports and new products and tools for credit decision making, loan recoveries, application processing, portfolio reviews and market/product analysis.