10. FINANCIAL SECTOR

10.1 Monetary Policy

A sharp fall in inflation, a significant deficit in the overall balance of payment, increased government borrowings and potential problems related to the Year 2000 date change were the major challenges faced in designing and implementing monetary policy in 1999. In this environment, monetary policy continued to focus on maintaining stability in the financial market. Further efforts were made to enhance the market orientation of the instruments of monetary policy.

Financial markets displayed some instability in the latter part of 1997 and in the first half of 1998 as a consequence of the uncertainties generated by the East Asian financial crisis. However, a significant degree of stability was achieved by the second half of 1998, and this relative stability generally continued into 1999. With the exception of a short period in April, when market uncertainty increased and interest rates fluctuated considerably as a result of elections and labour unrest, both the call market and the exchange market exhibited a healthy degree of stability. This stability and the continuous decline in inflation enabled the Central Bank to relax its monetary stance somewhat in the second half of the year. However, the relaxation was carried out cautiously, so as to avoid the possibility of a re-emergence of inflationary pressure or the possibility of instability in the foreign exchange market. The additional liquidity the market received through this relaxation served primarily to offset the drain of liquidity caused by the outflow in the balance of payments. The combination of several factors, viz., seasonal volatility, elections and the Year 2000 issue, presented challenges to policy markers in maintaining market stability in December. Open market operations continued to be the major tool for implementing monetary policy and the Central Bank's repurchase (repo) rate and the reverse repurchase (reverse repo) rate were the primary means of conveying signals to the market. As a further step in improving the market orientation of the monetary policy mechanism, by reducing the use of direct instruments, the statutory reserve requirement (SRR) was reduced in August. The Bank Rate was reduced, by one percentage point, to 16 per cent.

The Central Bank's views of the expected direction of interest rate movements were generally indicated to the market through the changes in its repo rate. The continuous sharp decline in inflation and the stability in the exchange market enabled the Bank to effect a 200 basis point reduction, in several steps, in the repo rate in 1999. The repo rate was reduced from 11.25 per cent at end 1998, to 9.25 per cent at end 1999. Some downward movement was seen in most market interest rates.

An important change in monetary policy was the reduction, in August 1999, of the SRR on rupee deposits and foreign currency deposits lent domestically from 12 per cent to 11 per cent. In addition to reducing the Central Bank's reliance on the SRR as a monetary policy tool, the reduction would also reduce the effective cost of funds of commercial banks and enable them to reduce their lending rates. This measure resulted in a release of around Rs.2,000-2,500 million of funds sterilised by the Central Bank to the market. The expansionary impact of this release was judged not to be adverse, as it primarily offset the contractionary effect of a deficit in the balance of payments on market liquidity. It had the added advantage of mitigating any crowding out effect that would result from the increased credit obtained by government from the banking sector.

Policy makers faced a challenging task in maintaining financial market stability in December. The combination of seasonal fluctuations, Presidential elections and the uncertainties connected with the Year 2000 issue created an environment where the possibility of market volatility, particularly in interest rates, was likely. The Central Bank used its operations in the primary market for Treasury bills and its operations in the secondary market to provide additional liquidity to the market. In order to avoid any excessive increase in interest rates due to market aberrations, the interest rate applicable to the Bank's reverse repurchase facility was maintained at a fixed level throughout the second half of December. In addition, the tenor of reverse repurchase transactions, which is usually restricted to one day, was extended upto 30 days. Further, the Bank purchased Treasury bills at the primary auctions. These measures achieved their objectives by providing confidence to the market and prevented any undue pressure on interest rates or excessive volatility in liquidity.

The Central Bank's own securities were available for mopping up operations or investment by commercial banks with surplus cash. However, as the Central Bank had sufficient government paper in its portfolio, these were not required by the market.

The policy of not granting refinance under the Medium and Long-Term Credit Fund or any other short-term facility was maintained, in order to avoid the market distorting effects of refinance. The outstanding amount of refinance granted in the past by the Central Bank declined from Rs.1,122 million at the end of 1998 to Rs.748 million at the end of 1999.

10.2 Money Supply

The growth in money supply was relatively stable and monetary aggregates moved within a comparatively narrow range in 1999 as faster growth in domestic assets was partly offset by a decline in net foreign assets. Consolidated broad money (M_{2b}), which includes the operations of foreign currency banking units (FCBUs), had a monthly point to point growth in the range of 13 - 15 per cent and ended the year at 13.4 per cent. Narrow money (M_1) moved in a slightly wider range of 8-14 per cent. The moving average growth was more stable, with M_{2b} moving within a range of 13.2 per cent to 14.2 per cent and M_1 within a range of 11-13 per cent. The greater volatility in M_1 was due to an increased demand for cash in April/May and November/December due to market uncertainties and seasonal factors discussed elsewhere.

TABLE 10.1
Summary Monetary Statistics

Item	End 1999	Change 1998		Change 1999	
	Rs.Bn.	Amount Rs.Bn.	%	Amount Rs.Bn.	%
Monetary Aggregates:					
Narrow Money Supply (M_1)	108.6	10.4	12.1	12.3	12.8
Broad Money Supply (M_2)	358.1	27.9	9.7	41.9	13.3
Consolidated Broad Money Supply (M_{2b})	428.3	44.1	13.2	50.6	13.4
Underlying Factors (a)					
Domestic Credit to :	432.9	46.5	14.4	63.4	17.1
Government (net)	93.9	19.4	42.8	29.3	45.3
Public Corporations	15.8	-3.8	-26.1	5.0	46.0
Private Sector	323.2	30.9	11.8	29.1	9.9
External Assets (net)	102.1	15.2	16.7	-3.6	-3.4
Other Items (net)	-106.7	-17.5	-22.0	-9.2	-9.5
Reserve Money	100.4	9.1	10.9	7.6	8.2

(a) In relation to M_{2b}

Source: Central Bank of Sri Lanka

Monetary expansion was held down by the decline in net foreign assets of the banking system. The deficit in the balance of payments was reflected in a reduction in the net foreign assets of the monetary authorities by approximately Rs.12.5 billion. In contrast, the commercial banks built up their foreign asset position. The FCBUs, in particular, reduced their foreign currency exposure to the domestic sector, thus improving their net foreign assets. Some increase in international rates, together with comparatively low domestic rates reduced the interest differential in favour of foreign currency lending in domestic entities. In addition, the uncertainties caused by the East Asian crisis have made banks cautious in lending in the region.

A sharp growth in net credit to the government (NCG) and credit to government corporations, together with continued credit expansion to the private sector, led to a considerable increase in net domestic assets. Lower than expected budgeted revenues, a shortfall in privatisation proceeds and reduced foreign borrowing caused the government to borrow more from the domestic banking system. The larger portion of growth in NCG was from the Central Bank as the Bank's holdings of government paper increased substantially by approximately Rs.17,500 million. Credit to government corporations increased sharply in 1999, in contrast to the decline in 1998. Increased international oil prices, a growth in the use of domestic funds for investment and expanded retail activity by some key state corporations were the main causal factors for this increase. Credit to the private sector showed a growth of around 10 -14 per cent during the year. The contraction in imports and exports and the slower overall growth in the economy tended to exert a dampening effect on the demand for credit. It should be noted however, that in addition to

Chart 10.1
Monetary Expansion

Chart 10.1.1
Monetary Growth - Moving Average

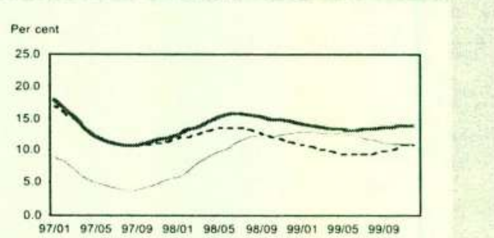


Chart 10.1.2
Monetary Growth - Point to Point

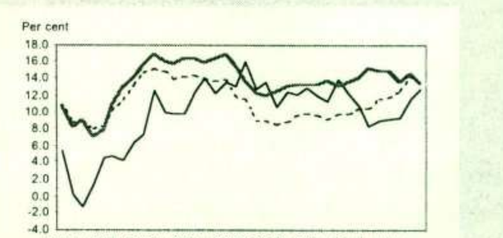


TABLE 10.2
Monetary Aggregates 1998 - 1999(a)

Rs Million

End of Period	Narrow Money Supply (M_1)						Broad Money Supply (M_2)						Consolidated Broad Money Supply (M_{2b})					
	1998	1999	Percentage Change				1998	1999	Percentage Change				1998	1999	Percentage Change			
			Point to Point		Moving Average				Point to Point		Moving Average				Point to Point		Moving Average	
			1998	1999	1998	1999			1998	1999	1998	1999			1998	1999	1998	1999
January	85,527	96,525	9.8	12.9	5.8	13.0	289,017	317,257	14.2	9.8	11.9	11.1	335,827	380,300	16.3	13.2	12.5	14.2
February	87,262	97,692	12.5	12.0	6.8	12.9	291,450	319,410	14.3	9.6	12.3	10.7	338,718	383,479	16.2	13.2	13.2	13.9
March	92,194	102,616	14.1	11.3	8.1	12.7	297,205	324,606	14.0	9.2	12.7	10.3	343,609	390,991	15.7	13.8	13.8	13.8
April	90,436	103,000	12.2	13.9	9.1	12.8	297,152	326,329	13.7	9.8	13.2	10.0	346,676	392,014	16.3	13.1	14.6	13.5
May	91,177	102,311	13.6	12.2	9.8	12.7	298,472	327,371	13.8	9.7	13.6	9.7	349,938	397,191	16.9	13.5	15.3	13.3
June	90,126	99,890	13.1	10.8	10.5	12.5	296,943	327,709	12.0	10.4	13.8	9.6	348,566	397,565	15.4	14.1	15.7	13.2
July	92,264	99,942	16.0	8.3	11.5	11.9	298,677	330,177	11.6	10.5	13.8	9.5	349,416	402,317	13.8	15.1	15.7	13.3
August	91,389	99,591	12.7	9.0	12.0	11.6	296,505	331,125	9.0	11.7	13.4	9.7	349,499	401,416	12.3	14.9	15.5	13.5
September	93,463	102,070	13.6	9.2	12.5	11.2	301,678	337,568	8.9	11.9	12.9	10.0	355,707	408,341	12.0	14.8	15.2	13.7
October	92,240	100,831	10.7	9.3	12.4	11.1	303,514	341,900	8.6	12.6	12.3	10.3	362,633	412,128	12.5	13.6	14.9	13.8
November	92,975	103,749	12.4	11.6	12.6	11.0	306,637	350,033	8.9	14.2	11.8	10.8	366,114	419,281	13.1	14.5	14.6	13.9
December	96,268	108,554	12.1	12.8	12.7	11.1	316,174	358,076	9.7	13.3	11.5	11.1	377,741	428,319	13.2	13.4	14.4	13.9
Monthly Average	91,277	101,398	12.7	11.1			299,452	332,630	11.6	11.1			352,037	401,112	14.5	13.9		

(a) Monetary data from 1990 have been reclassified to be consistent with the standard international practice. Please refer notes to Appendix Tables 105,106 and 110.

Source: Central Bank of Sri Lanka

TABLE 10.3
Monetary Aggregates and Underlying Factors 1997 - 1999 (a)

Rs. Million

Item	Dec. 1997	Dec. 1998	Dec. 1999	Change			
				1998		1999	
				Amount	Percentage	Amount	Percentage
Monetary Aggregates							
Currency held by the Public	45,680	51,767	58,481	6,087	13.3	6,714	13.0
Demand Deposits held by the Public	40,172	44,501	50,073	4,330	10.8	5,572	12.5
Narrow Money Supply (M_1)	85,852	96,268	108,554	10,417	12.1	12,286	12.8
Time & Savings Deposits of the Private Sector held with Com. Banks	247,816	281,473	319,765	33,657	13.6	38,292	13.6
DBUs	227,963	257,995	298,158	30,032	13.2	40,163	15.6
FCBUs	19,853	23,478	21,607	3,625	18.3	-1,871	-8.0
Consolidated Broad Money Supply (M_{2b})	333,668	377,741	428,319	44,074	13.2	50,578	13.4
Underlying Factors							
Net Foreign Assets	90,495	105,648	102,092	15,153	16.7	-3,556	-3.4
Monetary Authorities	89,930	101,744	89,287	11,814	13.1	-12,457	-12.2
Commercial Banks	565	3,904	12,805	3,339	591.0	8,901	228.0
DBUs	2,095	1,141	3,235	-954	-45.5	2,094	183.5
FCBUs	-1,530	2,763	9,570	4,293	280.6	6,807	246.4
Net Domestic Assets	243,172	272,091	326,228	28,919	11.9	54,137	19.9
Domestic Credit	323,046	369,517	432,888	46,471	14.4	63,371	17.1
Claims on Government (net)	45,250	64,618	93,915	19,368	42.8	29,297	45.3
Monetary Authorities	20,300	25,909	46,716	5,609	27.6	20,807	80.3
Commercial Banks	24,950	38,709	47,199	13,759	55.1	8,490	21.9
DBUs	26,065	32,682	39,166	6,617	25.4	6,484	19.8
FCBUs	-1,115	6,027	8,033	7,142	640.5	2,006	33.3
Credit to Public Corporations	14,658	10,835	15,816	-3,823	-26.1	4,981	46.0
DBUs	10,338	9,485	15,354	-853	-8.3	5,869	61.9
FCBUs	4,320	1,350	462	-2,970	-68.8	-888	-65.8
Credit to the Private Sector	263,138	294,064	323,157	30,926	11.8	29,093	9.9
DBUs	216,030	243,549	272,885	27,519	12.7	29,336	12.0
FCBUs	47,108	50,515	50,272	3,407	7.2	-243	-0.5
Other Items (net)	-79,874	-97,426	-106,660	-17,552	-22.0	-9,234	-9.5
DBUs	-50,944	-60,248	-59,930	-9,304	-18.3	318	0.5
FCBUs	-28,930	-37,178	-46,730	-8,248	-28.5	-9,552	-25.7

(a) Signs indicate the effect on M_{2b}.

Source: Central Bank of Sri Lanka

Box 8

Inflation Targeting as a Framework for Monetary Policy

The concept of inflation targeting has become increasingly popular in both academic and policy circles since its introduction in New Zealand in 1990. Since then, a number of other industrial countries have also adopted this framework for monetary policy, in most cases after unsuccessful attempts to target some monetary aggregate or the nominal exchange rate. Its increasing popularity has also been nourished by a growing consensus on the fact that there is no long-term trade-off between inflation and output and that price stability fosters economic growth.

In an inflation targeting framework the prime objective is the achievement of a specific inflation target which could be either a point target or a target band or could even be a ceiling (see Table below). The authorities typically set an inflation target for the medium term, often with annual intermediate targets. Regular forecasts of expected inflation are made and if the projected inflation over a medium term time horizon falls outside the announced range, a change in the monetary policy stance is indicated.

Inflation targeting is forward looking in nature and as such it is inherently non-transparent. This necessitates the need for compensating institutional features to ensure a high degree of transparency of monetary policy and accountability of the central bank.

In many countries, which have adopted inflation targeting, steps have been taken to explain clearly the goals of monetary policy and describe and justify the policy measures being taken. Explanations of the actual performance of monetary policy and the dissemination of information relating to decisions on monetary policy to the public have also helped enhance the transparency of monetary policy. Inflation targeting also provides a yardstick against which a central bank's action can be evaluated. This, together with efforts to enhance the degree of transparency of monetary policy, implies that central banks have naturally become more accountable for their actions under an inflation targeting framework.

There are several advantages of adopting inflation targeting as a framework for monetary policy over the targeting of monetary aggregates or the exchange rate. The main advantage is that an inflation targeting framework raises the probability of achieving and maintaining a low and stable rate of inflation, with potential beneficial effects on economic growth. This is facilitated by the reduced uncertainty among price and wage-setters about the future path of the inflation rate emanating from the explicit mandate of the central bank to achieve a target low inflation together with a high degree of transparency of monetary policy and accountability.

TABLE 1
Inflation Targeting: Country Profiles

Country	Date Introduced	Target Rate and Horizon	Price Index	Actual Performance in 1999
New Zealand	March 1990	0 – 3 per cent through the 5 year tenure of the Governor of the Reserve Bank	CPI excluding interest cost components, indirect taxes and subsidies, government charges and significant price effects from changes in the terms of trade	-0.1
Canada	February 1991	1 - 3 per cent	CPI excluding food, energy and the effects of indirect tax changes	1.7
UK	October 1992	2.5 per cent or less	Retail Price Index (RPIX) excluding mortgage interest payments	1.6
Sweden	January 1993	2 per cent ± 1 per cent in 1996 and beyond	CPI excluding indirect taxes government subsidies, house prices and mortgage interest payments	0.0
Austria	April 1993	Underlying inflation of 2 – 3 per cent	CPI excluding the impact of interest rates on mortgage and other interest payments, indirect tax changes and certain other volatile price items	0.6
Spain	November 1994	Less than 3 per cent by 1997 and 2 per cent by 1998	CPI	2.3
Czech Rep.	December 1997	3.5 – 5.5 per cent by 2000	CPI excluding regulated prices and prices affected by administrative measures	2.1

Box (contd.)

An inflation targeting regime could also lead to a better cyclical adjustment of the economy as a typical inflation targeting framework enables a central bank to conduct a discretionary monetary policy with a flexibility to deal with aggregate demand and supply shocks. An inflation targeting framework also reduces the vulnerability of the domestic exchange rate to speculative attacks as the monetary authority does not have a commitment to an exchange rate target and the exchange rate will be determined by market forces.

Another advantage is the greater flexibility in targeting inflation rate over other targeting mechanisms, which is achieved through several means. First, the price index on which the inflation targeting is based could be defined to exclude the effects of supply shocks. Second, the inflation target could be specified as a range rather than a point target (see Table above). This inflation target could be adjusted to accommodate the changes in the inflation rate due to supply shocks or other exogenous changes. The successful adaptation of an inflation targeting framework would eventually yield a more credible and sustainable policy approach over other alternative policy regimes. This could facilitate the operation of monetary policy itself and would also improve investor sentiments.

Yet, inflation targeting is not devoid of disadvantages. An inflation targeting framework does not guarantee that a central bank will successfully use its discretion for setting monetary policy appropriately, as inflation targeting is more complicated and difficult to implement than targeting money growth or the exchange rate. The success of inflation targeting depends heavily on the central bank's ability to forecast inflation accurately, and the availability of policy instruments that affect the inflation forecast with reasonable precision. In effect, the latter depends on the existence of well developed capital and money markets which facilitate the transmission of effects of policy actions to target variables.

Inflation targeting could also lead to inefficient output stabilisation, particularly in the event of large exogenous shocks. There could also be short-term output declines due to initial disinflation if the private sector does not consider the policy framework to be credible. These drawbacks however, could be reduced by introducing provisions to minimise such risks in the inflation targeting framework and also by targeting a sufficiently wide band rather than a point target. The question of policy credibility could be addressed by the government by explicitly endorsing the inflation targeting regime and taking efforts to consolidate fiscal policy so as to eliminate fiscal dominance of monetary policy.

In such a scenario how would Sri Lanka fit into an inflation targeting framework? As mentioned earlier, the prerequisites needed to adopt an inflation targeting framework for monetary policy include i) a fair degree of independence ii) absence of a commitment to target any other nominal variable, iii) absence of fiscal dominance of monetary policy iv) the ability of the central bank to forecast the inflation rate v) availability of policy instruments and vi) the existence of sufficiently developed capital and money markets.

At present, the Central Bank of Sri Lanka enjoys a fairly high degree of instrument independence, which enables it to use the policy instruments at its disposal in the pursuit of achieving the targeted inflation rate. Recently, Central Bank autonomy has been reiterated by the government, and action is being taken to amend the Central Bank law (the Monetary Law Act) to make price stability the prime objective of the Central Bank. These reflect the desire of both the government and the Central Bank to give priority to achieving price stability as a basis for sustainable economic growth. At present, the Central Bank targets the monetary aggregates in the context of a financial programming exercise. Interest rate become an intermediate target. The Central Bank also intervenes in the exchange market help maintain exchange rate stability as and when necessary. While the ultimate objective is supporting economic growth through the promotion of monetary and price stability, there is no explicit inflation targeting framework used in the conduct of monetary policy. If Sri Lanka is to adopt inflation targeting there would be a need to a clear commitment for the Central Bank to allow the exchange rate to float freely instead of the current managed float. Existing high fiscal deficits make it impractical to ignore the reality of the financing needs of the government in the conduct of monetary policy. While policy instruments should be effective in influencing the economy, money and capital markets must be sufficiently developed so as to react quickly to the use of such instruments. Questions however, remain as to whether the effects of policy actions could efficiently be transmitted to target variables in the somewhat rigid market conditions that prevail, particularly in respect of lending rates. This may call for further financial sector reforms prior to the adoption of inflation targeting in Sri Lanka.

There is also the need to develop a satisfactory forecasting framework and a forward looking

Box (contd.)

operations procedure to facilitate periodic assessments to expected inflation over the relevant time horizon, and systematic adjustments of monetary policy instruments to maintain the projected inflation rate in line with the target inflation. In this respect, the Central Bank has already taken steps to develop an econometric forecasting framework to guide its short term monetary policy objectives. It has been found that 60-70 per cent of the impact of money growth on inflation is felt with a lag of 8-9 months.

Country experiences suggest that the measure of inflation to target depends on individual country characteristics. While some countries have specified the inflation target in terms of 'headline' consumer price index (CPI), others have used some form of 'underlying' inflation measures. The wide acceptance of the 'headline' CPI among the public and the psychological impact of an unfamiliar underlying inflation make the headline inflation a plausible candidate as the measure of the inflation rate, at least until a measure of underlying inflation becomes publicly available and widely accepted. This, however, would not be best suited in the medium to long-run as it could be quite volatile and adversely affect the public perception on Central Bank credibility. The risk of not being able to meet the specific inflation target could be minimised by having a target band instead of a point target.

Chart 10.2
Monetary Aggregates, Velocity and Money Multiplier

Chart 10.2.1
Money Supply

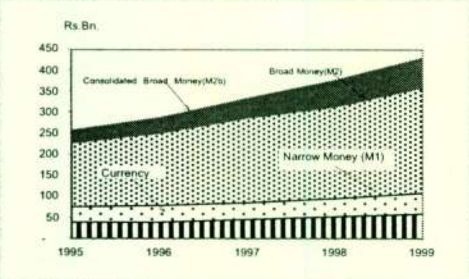


Chart 10.2.2
Domestic Credit

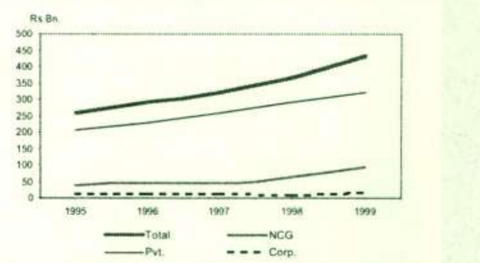


Chart 10.2.3
Net External Assets

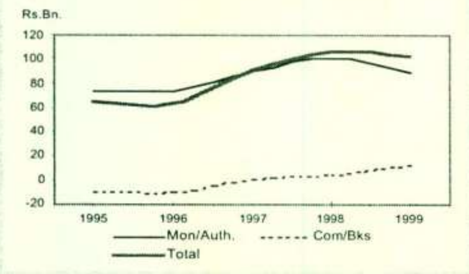


Chart 10.2.4
Income Velocity and Money Multiplier

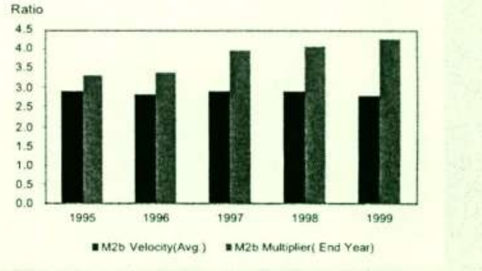
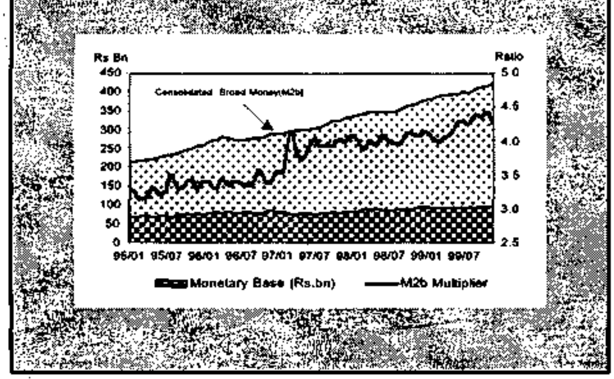


Chart 10.3
Monetary Base and Money Multiplier



the credit provided to the private sector by commercial banks, the two long-term lending institutions (i.e., NDB and DFCC Bank) also provided approximately Rs.6,400 million of credit to this sector. Foreign currency loans were less attractive to domestic borrowers and credit to the domestic sector from FCBUs declined in dollar terms. The reduced attractiveness was also seen in the smaller amount granted under the scheme of foreign currency loans to non-BOI exporters (US dollars 177 million in 1998 as against US dollars 124 million in 1999).

The Central Bank increased reserve money cautiously, to avoid the resurgence of inflationary pressures. However, a sufficient amount of reserve money was injected to provide adequate liquidity to ensure the smooth functioning of economic activity. Total reserve money increased by Rs.7,578 million in 1999, in comparison to Rs.9,130 million in 1998. The reduction of the SRR also helped to provide additional liquidity of around Rs.2,000-2,500 million to the market.

10.3 Interest Rates

Interest rates had relatively low volatility in 1999, and exhibited some downward movement. The reduction in interest rates was however, much less than the fall in inflation, resulting in an increase in real interest rates. The reduction in the SRR in August 1999 also helped to consolidate the stability of interest rates. The Central Bank's overnight repo rate and reverse repo rate served as the primary signalling mechanism for the expected direction of market interest rates and were instrumental in restraining volatility in the call money market. Over-subscriptions at all Treasury bill auctions, excluding one, and at all Treasury bond auctions reflected the improved liquidity conditions in the market throughout the year. This availability of liquidity partly caused by slower growth in private sector credit and declining inflation, helped to keep yields on government paper stable, despite increased borrowing by the government. The steady decline in inflation, enabled the Central Bank to reduce its overnight repo rate, which serves as a leading indicator in determining other interest rates in the market, in several steps in 1999.

Short-Term Interest Rates

Primary market yield rates on Treasury bills did not fluctuate greatly in 1999. A slight decline was seen, particularly around end of the third quarter of 1999. The 3-month Treasury bill rate, which was 12.01 per cent at end 1998, varied by less than 35 basis points in the first half of 1999 and then fell to 11.28 per cent by mid September 1999. A slight increase was seen in the third quarter, partly due to market uncertainties relating to the Year 2000 issue, and the 3-month yield rate rose to 11.79 per cent at end December 1999. In line with the same trend, the 6-month and 12-month Treasury bill rates decreased from 12.34 per cent and 12.59 per cent, respectively, at end 1998 to 11.79 per cent and 12.29 per cent at the beginning of September 1999, respectively, and then rose to 12.29 per cent and 12.77 per cent, respectively, at end 1999.

The other short-term rates, such as the discount rates and rediscount rates, repo and reverse repo rates offered by the Central Bank in the secondary market for its open market operations, which are generally linked to primary market interest rates varied within a relatively narrow range throughout the year. The 3-month discount rate was in a range of 11.13-11.86 per cent in 1999 while the 3-month rediscount rate varied in a range of 13.78-15.01 per cent. The maximum rates were witnessed at the beginning of the year 1999 while the minimum rates were recorded at mid September 1999. Following the same trend, the 12-month discount and rediscount rates fluctuated in narrow ranges during the year 1999. The 12-month discount rate, which was 12.41 per cent at the beginning of the year, declined gradually to 12.14 per cent in September, and then rose to 12.62 per cent at the end of the year, with slight fluctuations. Similarly, the 12-month Treasury bill rediscount rates also decreased to 14.79 per cent by early September 1999, before increasing to 15.27 per cent at end December 1999. The margin between the discount and the rediscount rate which was 3.15 per cent upto 06 May 1999, was reduced by 50 basis points to 2.65 per cent and was maintained at that level during the rest of the year.

In view of the declining interest rates and the stability of the foreign exchange market, the overnight repo rate, which is the Central Bank's main instrument for signalling the expected direction of the interest rates to the market, was reduced gradually several times during the year. The repo rate, which was 11.25 per cent at end 1998, was reduced by 25 basis points to 11.00 per cent on 06 January 1999 and then remained unchanged until 30 March 1999, when it was reduced by 10 basis points to 10.50 per cent. This level was maintained until mid June 1999. Following two downward revisions, 50 basis points on 30 July and 25 basis points on 17 November, it stood at 9.25 per cent at end December 1999.

The reverse repurchase rate was generally adjusted in line with the movement in the 3-month Treasury bill yield rate during the year. It stood at 15.00 per cent at the beginning of the year 1999 and decreased to its lowest level of 13.41 per cent by mid December 1999. The Central Bank's reverse repo facility generally provides only for overnight reverse repo transactions. However, with effect from 21 December 1999, the tenor of reverse repo transactions was extended upto 30 days, in order to provide further stability to the money market in the context of the uncertainties created by the problems associated with the Year 2000 issue. In addition, the overnight reverse repo rate was maintained at 13.48 per cent by the Central Bank after 15 December 1999 to add further stability to call market rates.

Despite the slight upward movement in the first week of April 1999, with a peak of 32 per cent on 08 April 1999 inter-bank call market rates were generally stable. The presence of the Central Bank's repo and reverse repo facilities was primarily responsible for the stabilisation of the rates in the inter-bank call money market. Call money market rates, which were in a range of 13.00-14.00 per cent at the end of 1998, varied in a range of 11.13-17.00 per cent during the first two months of 1999. However, some volatility of rates was witnessed particularly in March and April, owing to a temporary shortage of liquidity in the market. Seasonal factors and other factors such as a 'go slow' in the banking sector and Provincial Council elections contributed to the call market rates moving within a wider range of 11.00-32.00 per cent during March and April 1999. In some instances, the non-availability, in the deficit banks, of the necessary collateral (i.e. Treasury bills and Treasury bonds) to have access to funds from the Central Bank's reverse repo window caused the call market rate to exceed

Chart 10.4
Interest Rates

Chart 10.4.1
Treasury Bills

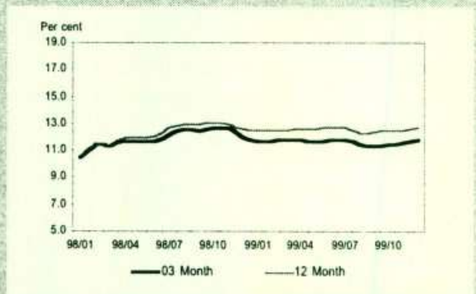


Chart 10.4.2
Deposit Rates

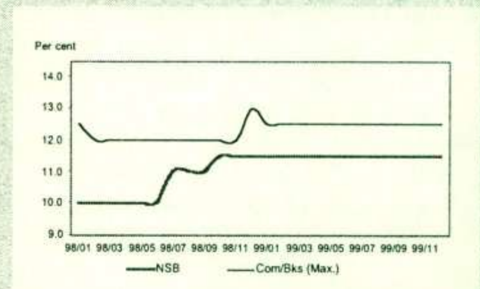


Chart 10.4.3
Lending Rates

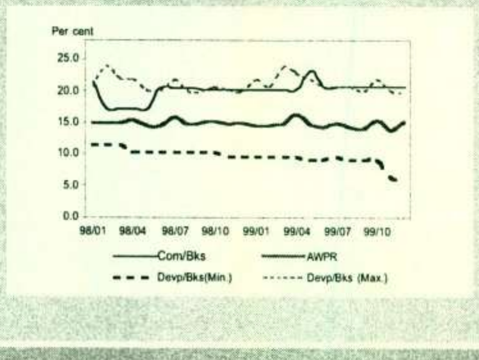
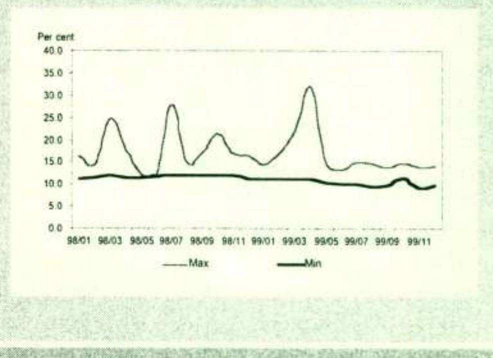


Chart 10.4.4
Call Market Rates



Box 9

Sri Lanka Inter Bank Offered Rates (SLIBOR)

Inter bank offer rates are published in leading international markets. The most well known and widely used are the London Interbank Offered Rates (LIBOR), European Interbank Offered Rates (EURIBOR) and Singapore Interbank Offered Rates (SIBOR). These rates are computed for different maturities and reflect the funding costs of leading banks. Although all these are offered rates, they are effectively used for many transactions, including determining the yield rates for many innovative financial instruments, and helped the development of financial markets. LIBOR values are computed for several different maturities, e.g. 1-month, 3-months, 6-months and 12-months, for the US dollar and the sterling pound. The values, computed each working day, are based on the offer rates made by 15 banks, operating in London, to their best commercial bank customers (i.e. prime banks). The LIBOR for any single maturity is the simple average of the middle nine offer rates of the rates quoted by those 15 banks. EURIBOR was introduced by the European Banking Federation to provide a benchmark rate for the euro. A representative panel of 57 prime banks provide daily quotes. EURIBOR is also computed as the simple average of the balance middle rates after eliminating the highest and the lowest 15 per cent of the rates quoted by these banks. EURIBOR rates too are quoted for several maturities. SIBOR is computed as the simple average of the rates quoted by seven banks in Singapore for different maturities of US dollar transactions.

The reason for eliminating some of the highest and the lowest rates is to avoid distortions that could be caused by extreme values. Further, by taking a simple average (rather than a weighted average), the dominance of the rate by the extra large banks is avoided. All these rates are offered rates rather than realised rates, and are published by 11.00 a.m.

The Central Bank of Sri Lanka commenced publishing the Sri Lanka Inter Bank Offered Rates (SLIBOR) with effect from 7 June 1999. Three rates, i.e., overnight, 7-days and 1-month, are currently published. These rates are based on the rates offered for rupee transactions among commercial banks in Sri Lanka.

Prior to the introduction of SLIBOR, there were no daily published average offered rates for rupee transactions in Sri Lanka. The best available indicator for offer rates on a daily basis was the interest rate in the inter-bank call market, which is a rate for realised transactions. This, however, varies during the day and is not published formally by any organisation in the form of a single rate relating to a given day. Therefore, suggestions were made by many interested parties that the Central Bank should compile and publish daily rupee interest rates to fill this lacuna. These rates are expected to reflect the most current lending rates among banks and therefore be good indicators of market liquidity. Over time, they would also serve as benchmark rates for many other transactions, as in other financial markets.

Although there are several average interest rates published in Sri Lanka such as the Central Bank's repurchase and reverse repurchase rates, the Average Weighted Prime Lending Rate (AWPR) and the Treasury bill and bond rates, the SLIBOR values have several distinctive features. All the other rates are realised rates generated after the event and hence reflect historical data. The SLIBOR however are forward looking. They also reflect the most current information available relating to liquidity in the inter-bank market. Further, as they relate to inter-bank transactions, the distortion caused by an in built risk premium would be minimal. Thus, except for risk free rates on gilt instruments, they would be the most appropriate benchmark rates for other market transactions.

In computing SLIBOR, the methodologies adopted in the computation of the EURIBOR, LIBOR and SIBOR have been broadly followed. The computation of the SLIBOR values is presently based on the offers made by 12 commercial banks which play a leading role in the interbank market in Sri Lanka. These comprise the two state banks, four large domestic private banks and six foreign banks. These 12 banks have been requested to provide their rates for three maturities; 1-day (overnight), 7-days and 1-month, between 8.30 a.m. and 9.30 a.m. on each working day. A simple average SLIBOR is computed for each of the three maturities. The three highest and the three lowest values are excluded in the computation of the SLIBOR to provide a more central indicator of the daily interest rates at which commercial banks in Sri Lanka would offer funds to other commercial banks. The rates are for transactions in Sri Lanka rupees and not foreign currency. The SLIBOR values are published daily by the Central Bank between 10.30 a.m. and 11.00 a.m. through the Central Bank's Website and Reuters News Agency.

Box 9 (contd.)

The behaviour of SLIBOR rates in 1999 are shown in Chart I. The overnight SLIBOR moved within a range of 9.82-14.50 per cent, while the SLIBOR values for 7-days and 1-month maturities moved within a range of 10.67-14.48 per cent and 12.25-14.50 per cent, respectively. The overnight SLIBOR values are very closely related to the realised weighted average rate for the daily transactions in the call market which moved in a range of 9.60-15.00 per cent in this period (Chart II). The correlation coefficient between the overnight SLIBOR rate and the realised Weighted Average Call Market Rate in this period was 0.97. Meanwhile, the movements of 7-day SLIBOR values appears to have a similar pattern to the Average Weighted Prime Lending Rate (AWPR), which is an interest rate computed weekly on the basis of the rates offered by commercial banks to their prime customers (Chart III). The AWPR is usually higher than the 7-days SLIBOR, as could be expected given the risk premium that banks would charge even their best non-bank customers. The correlation coefficient between the 7-day SLIBOR values (averaged for a week for comparability) and the AWPR was 0.95.

Currently, SLIBOR values are computed only for overnight, 7-days and 1-month maturities. Market sources indicate that SLIBOR values have been useful as indicators of market interest rates. The Central Bank expects to compute SLIBOR values for longer maturities in the future.

Chart I
SLIBOR : June-Dec. 1999

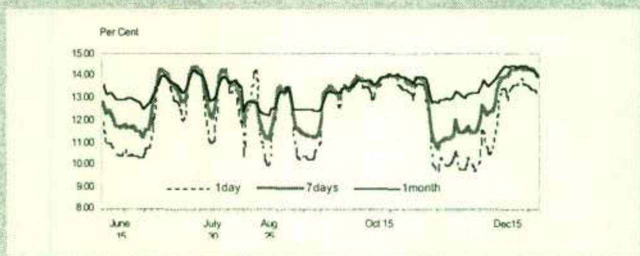


Chart II
SLIBOR : June-Dec. 1999

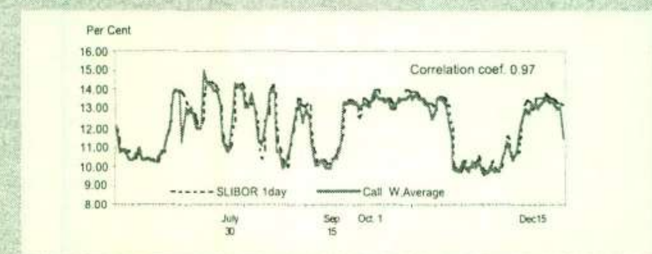
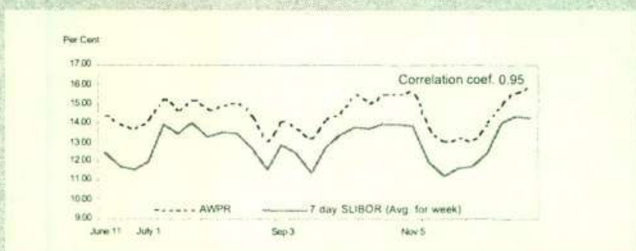


Chart III
SLIBOR : June-Dec. 1999



the Bank's overnight reverse repo rate. However, the volatility subsidised towards the end of April and the maximum rate remained below 15.00 per cent during the rest of 1999. The rates varied within a range of 9.75 - 14.25 per cent in December 1999 and within a range of 12.75 - 13.75 per cent at end December 1999.

Because of the availability of bills in the Central Bank's portfolio, there was no necessity to issue Central Bank securities for open market operations during 1999. However, these were available at rates linked to the 3-month Treasury bill rates.

Sri Lanka Inter Bank Offer Rates (SLIBOR), based on the rates offered for rupee transactions by 12 commercial banks, were published on a daily basis with effect from 07 June 1999 (see Box 9 for details). The overnight SLIBOR values varied within a range of 9.77-14.29 per cent, the 7-day rate in a range of 10.67-14.48 per cent and the 1-month rate in a rage of 12.25-14.50 per cent during the year.

Deposit Rates

In view of the steady decline in inflation rates and also the reduction in the SRR, which reduced the effective cost of funds of banks, commercial banks brought down their deposit rates marginally in 1999. However, these reductions were less than the fall in inflation, resulting in an increase in real deposit rates in 1999. Although the savings deposit rates in the commercial banks remained unchanged, at the level recorded at end December 1998, the maximum rate on 3-month deposits was brought down from 13.00 per cent to 11.50 per cent, while the maximum rate on 12-month deposits was reduced from 13.00 per cent to 12.50 per cent. The Average Weighted Deposit Rate (AWDR), which is based on all interest bearing deposits of commercial banks, declined gradually from 9.20 per cent at end December 1998 to 9.08 per cent at end December 1999. However, the Average Weighted Fixed Deposit Rate (AWFDR) stood at 10.72 per cent at end 1999, the same level as at end 1998, with slight changes during the year.

Interest rates on foreign currency savings deposits, which are based on international developments, moved upwards during the year, following changes in international rates. Savings deposit rates denominated in US dollars were in the range of 2.25-6.00 per cent in 1999 as against 2.50-5.50 per cent in 1998. Sterling deposits, which generally carry a higher deposit rate, varied within a range of 2.25-6.25 per cent. US dollar 1-year fixed deposit rates varied within a range of 4.00-6.25 per cent in the first half of 1999, and moved to a range of 4.25-6.13 per cent in the rest of 1999. In contrast, 1-year fixed deposits denominated in Sterling which were at 4.00-6.75 per cent in January 1999 fell to a range of 3.50-6.50 per cent in December 1999. Meanwhile, the rates offered by FCBUs on US dollar deposits were in a range of 4.75-6.00 per cent and on deposits in Sterling in a range of 5.00-6.50 per cent throughout the year.

Following market trends, the National Savings Bank (NSB) also revised its savings deposit rates from 10.50 per cent in December 1998 to 9.60 per cent in January 1999. This rate was further brought down to 9.20 per cent in July 1999 and was maintained at that level during the rest of 1999. However, rates on 12-month fixed deposit rates remained unchanged at 11.50 per cent, with a view to attracting more fixed deposits to the NSB.

Lending Rates

In line with the declining trend in short-term rates, a slight decline in general commercial bank lending rates was observed in 1999. The reduction of the SRR was partly responsible for pushing down lending rates of commercial banks by about 0.5-1.0 percentage points. The Average Weighted Prime Lending Rate (AWPR), which indicates the average lending rate applicable to the prime customers of commercial banks, which was 14.90 per cent at end December 1998, varied between 13.10 per cent and 17.10 per cent during the year and ended 1999 at 15.90 per cent. The Average Weighted Lending Rate (AWLR) based on the Quarterly Survey of Commercial Bank Loans and Advances declined from 19.60 per cent at end September 1998 to 19.10 per cent at end June 1999 and further to 18.90 per cent at end September 1999.

FCBU's lending rates to domestic customers did not show a significant change during the year. Lending rates in US dollars varied in a range of 4.00-9.00 per cent while interest rates charged for non-BOI exporters were in the range of 6.01-10.50 per cent in 1999 compared to the range of 6.18-10.50 per cent in the previous year.

Rates on commercial paper, which are unsecured promissory notes issued by the corporate sector and financial institutions to raise short-term funds, also showed some decline and were in the range of 11.50-16.25 per cent during the year in comparison to the range of 11.00-18.00 per cent in 1998. In addition, interest rates charged on outstanding balances on credit cards were in the range of 24.00-32.40 per cent.

Under the Civil Procedure Code (Amendment) Act No. 6 of 1990 and in terms of Section 23 of the Debt Recovery (Special Provisions) Act No.2 of 1990 the Central Bank publishes the legal rate of interest and the market rate of interest annually. Both rates for the year 1999 were 9.70 per cent, down from the 11.50 per cent in 1998.

Long-Term Rates

Long-term rates include interest rates on Rupee securities (Rupee loans) of the government, yield rates on Treasury bonds, lending rates of long-term credit institutions and debentures. The interest rates on Rupee loans, which are issued for the periods of 2 years, 7-8 years and 9-10 years were 12.00 per cent, 12.25 per cent and 12.50 per cent, respectively. These rates were in a range of 11.00-12.25 per cent in the previous year. These rates do not reflect market trends as they are administratively determined.

The Central Bank increased the maturity of Treasury bonds issued to the market by issuing 5-year and 6-year bonds in 1999. Treasury bonds, which were first issued in 1997, hitherto had maturities of 2, 3 and 4 years. This move further assists building up a longer-term yield curve in the financial market by providing risk free medium-term benchmark rates. The coupon rates for the respective maturities were in the range of 11.00 - 12.25 per cent, with the longer maturities carrying higher rates. The bonds are sold by auction. The weighted average yield rate on 2-year bonds was in the range of 12.64-13.42 per cent, while the yield on 3-year bonds, varied in the range of 12.79-13.95 per cent. Meanwhile, yield rates on 4-year and 5-year bonds were in the ranges of 13.21-14.02 per cent and 13.30-13.97 per cent, respectively. The yield rate on 6-year Treasury bonds was 13.65 per cent, at the single auction held for that particular maturity in 1999. The relatively flat yield curve appears to indicate that the market's expectations of rising inflation are gradually receding.

Interest rates charged by long-term lending institutions including Licensed Specialised Banks, other than the State Mortgage and Investment Bank (SMIB), the National Housing Development Authority (NHDA) and the National Savings Bank (NSB), declined slightly during the year. These rates were reduced particularly in the second half of 1999. Rates charged by the SMIB, the NHDA and the NSB remained unchanged in the ranges of 15.00-18.00 per cent, 10.00-16.00 per cent and 14.00-15.00 per cent, respectively, as in the previous year. Long-term lending rates of DFCC Bank were reduced from 13.00-20.50 per cent in December 1998 to 10.00-19.00 per cent in December 1999. The minimum lending rates charged by National Development Bank (NDB) were brought down from 9.60 per cent to 6.30 per cent in 1999.

Two private domestic commercial banks, one licensed specialised bank and three other financial institutions issued debentures during the year. A 5-year guaranteed redeemable debenture by Mercantile Leasing Ltd. in February 1999 was the first debenture issue by way of a rights issue by an institution. This debenture carried an effective annual interest rate of 14.49 per cent. People's Merchant Bank issued a 5-year guaranteed redeemable debenture in April listed on the Colombo Stock Exchange at an effective annual interest rate of 14.20 per cent. Vanik Incorporation Limited issued 3-year unlisted unsecured redeemable debentures with an effective annual interest rate of 17.55 per cent in May. Sampath Bank Ltd. issued 5-year unsecured subordinated redeemable debentures in July, with three interest rate options; 13.50 per cent per annum payable quarterly (effective rate of 14.20 per cent per annum), 14.20 per cent per annum payable annually or a floating rate of 1 per cent over the simple average of the three month Weighted Average Treasury bill rate at the previous four primary auctions (subject to a minimum of 12.00 per cent and a maximum of 16.00 per cent per annum), payable quarterly. In September NDB issued 5-year quoted unsecured subordinated redeemable floating rate debentures, carrying a floating interest rate of one per cent over the simple average of the one year Weighted Average Treasury bill yield at the previous four primary auctions, subject to a floor of 12.50 per cent per annum and a cap of 16.00 per cent per annum, payable annually. In November Seylan Bank Ltd. issued 5-year unsecured subordinated redeemable debentures with two interest rate options, either 13.35 per cent per annum payable monthly or 14.20 per cent per annum payable annually.

10.4 Commercial Banking

The total assets/liabilities of the domestic units of commercial banks registered a moderate growth in 1999, while those of FCBUs declined. The slowing down in external trade, uncertainties related to elections and a cautious approach taken by banks on Y2K related issues were responsible for the relatively slow growth in domestic banking units. The lower demand for credit in foreign currency, in view of the reduction in international trade, lower domestic interest rates and uncertainties in the international markets, tended to reduce the operations of the FCBUs. The total assets of the domestic units grew by 13.8 per cent as compared to 13 per cent in the previous year. However, the total assets of the FCBUs declined by 9.3 per cent in comparison to a decline of 9 per cent in 1998.

A rise in foreign balances and domestic credit supported the increase in the assets of the domestic units. Significant increases were seen in credit extended to government corporations and to the government. Rising international prices of fuel, increased activity and higher levels of investment caused government corporations to increase their borrowing levels. This is in contrast to 1998, when increased profits enabled government corporations to reduce their liabilities to banks. Net credit to the government from commercial banks increased in 1999. Increased government expenditure, partly in respect of capital projects, and reduced inflows of foreign funds led to the government having greater recourse to the domestic banking system to obtain funds. In terms of total value, the largest growth in assets was increased provision of credit to the private sector.

The increase in liabilities, corresponding to the increase in assets, came about mainly through an increase in deposits, in other liabilities and in borrowings. Commercial banks maintained their growth in deposits at a level similar to the growth in advances, resulting in a relatively stable credit to deposit ratio. Within deposits, time and savings deposits increased at a faster rate compared to demand deposits. Reflecting the reduced attractiveness of obtaining credit in foreign currency, credit granted by FCBUs to the private sector declined. Similarly, foreign currency loans extended by commercial banks to non-BOI exporters declined in comparison to 1998. Meanwhile the government repaid a portion of the syndicated loan of US dollars100 million obtained from the FCBUs in 1998.

The net foreign asset position of the domestic banking units, as well as the FCBUs, improved during the year. Caution on the part of banks in increasing their foreign currency exposure to the domestic sector and reduced demand for foreign currency credit mentioned above led to foreign assets of commercial banks recording a larger increase than foreign liabilities, resulting in an improvement in the net foreign asset position.

With the reduction in the Statutory Reserve Requirement (SRR) and in inflation, both deposit rates and lending rates of commercial banks declined marginally. However, the net interest income rose by 2 per cent in 1999. Fee based activities are becoming an increasingly more important source of income for banks, and in 1999, accounted for 17 per cent of the total income. Foreign banks have a higher proportion of their income from fee based activities than domestic banks.

Structure of Assets and Liabilities of Commercial Banks

Total resources of domestic units of commercial banks increased by Rs. 69,173 million (13.8 per cent) in 1999, in comparison to the Rs. 58,892 million (13.3 per cent) in 1998. Increases in private sector credit, credit to the government, credit to public corporations and foreign assets

TABLE 10.4

Selected Items of Assets and Liabilities of Commercial Banks (a)

Item	Change			
	98 Dec/97 Dec		99 Dec/98 Dec	
	Amount (Rs. Mn.)	%	Amount (Rs. Mn.)	%
Assets Category				
1. Liquid Assets	19,306	16.2	19,261	13.9
Cash on Hand	865	11.6	3,409	41.0
Due from Central Bank	2,303	7.9	-2,966	-9.5
Foreign Currency on Hand	10,596	25.5	17,626	33.7
Treasury Bills	-6,938	-33.9	-1,925	-14.2
Treasury Bonds (b)			2,495	49.8
Commercial Bills	7,472	36.4	622	2.2
Local Bills	-66	-85.6	-3	-25.5
Import Bills	7,687	57.1	977	4.6
Export Bills	-150	-2.1	-352	-5.2
2. Investment	-3,193	-9.0	559	1.7
Treasury Bills	-6,938	-33.9	-1,925	-14.2
Other Government Securities	2,733	104.5	2,243	41.9
Other Investment	1,012	8.2	241	1.8
3. Total Loans and Advances	33,588	14.6	41,039	15.6
Loans	15,869	11.5	30,685	20.0
Overdrafts	10,247	14.2	9,733	11.8
Commercial Bills	7,472	36.4	622	2.2
4. Fixed and other Assets	8,786	10.3	5,957	6.4
Liability Category				
1. Capital Accounts	5,851	13.2	1,351	2.7
2. Total Deposits	37,214	12.3	50,242	14.8
Demand Deposits	4,528	8.6	6,901	12.1
Time & Savings Deposits	32,686	13.1	43,342	15.4
3. Borrowings	4,630	16.9	5,175	16.2
Local Borrowings	4,242	17.6	4,420	15.6
Foreign Borrowings	388	12.0	755	20.8
4 Other Liabilities	11,197	16.3	12,404	15.5
Total Assets/Liabilities	58,892	13.3	69,173	13.8

(a) Includes only the operations of domestic banking units.
(b) With effect from 18 May 1998 Treasury bonds are considered as part of liquid assets of commercial banks.

Source: Central Bank of Sri Lanka

were primarily responsible for growth in commercial bank assets. Total loans and advances, including commercial bills, expanded by 15.6 per cent and contributed 59 per cent to the total growth of commercial bank assets. However, there was a substantial slowing down in the growth in commercial bills, including local bills, import bills and export bills, a result of the decline in international trade in 1999. The increase in foreign assets of the commercial banks contributed 25 per cent of the growth in total assets, in comparison to 18 per cent recorded in 1998.

Within the liquid assets category, there was a significant increase in cash holdings of banks due primarily to banks holding additional cash as a precautionary measure in view of the uncertainties relating to the Year 2000 problem. Cash on hand grew by 41 per cent in 1999 as against 12 per cent in the previous year. However, the decline in deposits with the Central Bank and in commercial bills more than offset the increase in cash on hand. The ratio of total liquid assets to total assets decreased from 33 per cent in 1998 to 28 per cent in 1999.

Within the liabilities category, deposit liabilities, which grew by 14.8 per cent, contributed to 73 per cent of the increase in total liabilities in 1999. This increase was 12.3 per cent in 1998. Indicating public preference to hold interest bearing assets, time and savings deposits grew by 15.4 per cent as compared to the growth in demand deposits of 12.1 per cent. Meanwhile, reflecting improved liquidity in the banking system, and increased activity among banks, interbank borrowing grew by 15.6 per cent in 1999 in comparison to 17.6 per cent in 1998. In line with the slight reduction in most other market interest rates, the weighted average interest rate in the inter-bank market declined by 0.5 percentage points to 12.5 per cent in 1999 from 13.0 per cent in 1998.

Balances in the capital account grew marginally by 2.7 per cent (Rs. 1,351 million) in 1999, compared to the 13.2 per cent (Rs. 5,851 million) increase in 1998. However, two domestic banks issued debentures to strengthen the overall capital adequacy and to match the long-term asset base. The banks were made aware that, in order to strengthen the soundness of the banking system, the Capital Adequacy Ratio (CAR) applicable on Tier II capital would be raised from 8 per cent to 10 per cent, while the CAR on Tier I capital would be raised from 4 per cent 5 per cent, in 2001.

Commercial banks improved their net foreign assets position in 1999 as they sought to reduce their foreign currency exposure and foreign currency borrowing became less attractive to domestic customers. A growth was seen in both foreign assets and liabilities. However, the growth in assets was faster, leading to a net improvement. Foreign assets of domestic units grew by 29.3 per cent in 1999 (21.5 per cent in 1998). Within these assets, deposits with banks abroad rose by 28.8 per cent (25 per cent during 1998), while placements with FCBUs increased by 38.2 per cent. However, other foreign assets, mainly export bills, declined. Over 90 per cent of the foreign liabilities of domestic banking units arise from foreign currency deposits in the non resident foreign currency (NRFC) and resident non national foreign currency (RNNFC) accounts, resident foreign currency (RFC) accounts and foreign currency deposits of exporters. These increased by 34 per cent in 1999. Domestic units continued to place the bulk of their foreign currency deposits with the FCBUs.

Twenty five FCBUs continued to operate in 1999. However, operations of the FCBUs further contracted during the year with total assets/liabilities decreasing by US dollars 143 million (9 per cent). The major sources of resources for FCBUs continued to be investment by DBUs of their foreign currency deposits and deposits by BOI enterprises. Investments with non-resident enterprises and loans and advances to BOI enterprises were the main areas where FCBU funds were deployed. With the decline in domestic interest rates and some contraction in the growth of exports, credit extended by FCBUs to BOI enterprises declined from US dollars 728 million in 1998 to US dollars 680 million 1999. FCBUs granted a syndicated loan of US dollars 100 million to the government in November 1998, of which US dollars 18 million was repaid in 1999. The FCBUs too improved in their net foreign asset position to record a net surplus of US dollars 133 million at end 1999. As in the case of domestic units, a decline in liabilities compared to assets of non-residents led to the net improvement.

The decline in the total gross assets of FCBUs was seen in claims of non-residents and resident categories. During the year, placement with banks abroad declined by 8 per cent, while claims on non-banks increased by 10 per cent. Total lending to the private sector by FCBUs amounted to US dollars 697 million at the end of 1999, an 6 per cent decline in comparison to the previous year. Of the total FCBU credit to the private sector, two thirds were provided by FCBUs of domestic banks.

Within the assets, the major share of loans have been granted to BOI enterprises. However, reflecting the slower growth of Sri Lankan exports, the credit granted to BOI enterprises declined by 6 per cent in 1999. Credit to other approved residents also decreased.

Also reflecting the reduced attractiveness of obtaining credit in foreign currency, the credit extended under the special facility to non-BOI exporters was lower in 1999 than in 1998. A sum of US dollars 124 million was granted in 1999, as against a sum of US dollars 177 million in 1998. Of this credit, only US dollars 25 million has been granted through FCBUs.

On the liabilities side of the FCBUs, the decline was a combined outcome of a decline in non-resident liabilities (US dollars 132 million) and resident liabilities (US dollars 32 million) and an increase in internal accounts (US dollars 21 million). The major portion of resident liabilities was through placements of funds by domestic units.

Sources and Users of Funds of Domestic Units of Commercial Banks

With the higher rate of growth in assets and liabilities seen in 1999 in comparison to 1998, a corresponding increase in available resources was also recorded. The total net availability of resources to the commercial banks grew by 10.2 per cent to Rs.17,451 million in 1999. On a net basis, private sector and other assets and other liabilities were the major sources of funds, while the government and government corporations were the major users of funds. Taken together, the domestic private sector and other assets and other liabilities category contributed 90 per cent of the net increase in funds. The government sector was the sector which absorbed the largest proportion of the funds (84 per cent - government 37 per cent and government corporations 47 per cent).

In contrast to the previous year, the use of funds as reserves with the Central bank declined with the decline in the reserve requirement. The CBSL, which absorbed 20 per cent of funds during 1998, absorbed only a negligible portion (under one per cent) of the increase in resources in 1999. In contrast to 1998, the foreign sector became a net user of funds as the domestic units of commercial banks built up their net foreign asset position.

Continuing the trend observed in previous years, the other assets and liabilities category was a net provider of funds. Increases in capital and reserves of commercial banks enhanced resource availability. In addition, other liabilities too were a source of funds, partly due to inflows from the debentures issued by the banks. The domestic private sector continued to be a source of funds as in 1998. This sector provided a net sum of Rs.8,506 million in 1999, compared to the Rs.1,229 million in 1998.

Government and government corporations were major users of funds, as seen in the growth in credit to these sectors. Government corporations absorbed 47 per cent of the total increase in commercial bank resources in 1999. Corporations were net users through both an increase in credit obtained and a reduction in their deposits with banks.

Commercial Bank Loans and Advances[1]

As revealed by the Quarterly Survey of Commercial Bank Loans and Advances, the outstanding amount of total loans and advances provided to the private sector by commercial

TABLE 10.5

Sources and Users of Resources of Commercial Banks (a)

Rs. Million

Category	Change (b) 1998 Sources	1998 Users	1999 Sources	1999 Users
1. Government Sector		**6,618**		**6,483**
Holdings of Govt Securities	4,205			318
Deposits		2,083	1,021	
Import Bills		9,414		1,429
Short-Term Credit		901		214
Overdrafts	1,576			5,542
2. Central Bank		**3,129**		**85**
Borrowings	39		358	
Reserves		2,303	2,966	
Investment in Central Bank Securities				
Till Cash		865		3,409
3. Government Corperations		**4,301**		**8,258**
Deposits		5,153		2,389
Advances	853			5,868
4. Co- operatives		**482**	**184**	
Deposits		332		20
Advances		150	204	
5. Other Domestic Private Sector	**1,229**		**8,506**	
Deposits (c)	27,667		37,831	
Local Bills	383			446
Import Bills	1,460		212	
Overdrafts		10,966		4,541
Loans		17,234		24,523
Investments in Securities & Bonds		1,013		241
Debentures	930		215	
6. Inter-Bank Transactions		**1,300**	**1,523**	
Balance With Domestic Banks		5,291		2,790
Deposits & Borrowings With Domestic Banks	3,991		4,313	
7. Foreign Sector	**7,376**			**2,825**
Borrowings	388		755	
Deposits	17,434		13,894	
Foreign Balances Including Export Bills		**10,447**		17,274
8. Other Assets & Other Liabilities	**7,225**		**7,238**	
Capital & Reserves	5,851		1,351	
Fixed Assets		1,821		2,047
Long Term Govt. Bonds			1,000	
Restructuring Bonds				
Other Assets		6,965		4,910
Other Liabilities	10,160		11,844	
Total Net Sources/ Uses	**15,830**	**15,830**	**17,451**	**17,451**

Source: Central Bank of Sri Lanka

(a) *Includes only the operations of domestic banking units.*

(b) The bold figures indicate whether each sector is a net source or a net user of resources.

(c) Includes long- term deposits mobilised by the two state banks under special savings schemes.

banks recorded a 12.4 per cent growth from end September 1998 to end September 1999, in comparison to a 12.1 per cent growth in the 12 months ending September 1998 and a 10.5 per cent growth during the first half of 1999. The pick up in economic activity which is evident from the higher growth in the Gross Domestic Product (GDP) by 4.0 per cent in the third quarter of 1999, compared to a 3 per cent growth in the first half of 1999 is reflected in the increase in credit.

The commercial sector, which accounted for the largest portion (41 per cent) of credit outstanding, experienced a relatively slow growth in credit (8 per cent from end September 1998 to end September 1999) due to the slowing down of exports and imports. However, in the second quarter and in the third quarter, reflecting some improvement, credit extended for the export of processed coconut products and handicrafts grew by 58 per cent, 55 per cent, respectively while credit for gem and garment exports grew each by 11 per cent. Similarly, with the increase in some categories of imports e.g., motor vehicles, machinery and equipment, building materials, consumer durables and intermediate goods such as raw-materials, credit to these sectors rose. The reduction in the international prices of petroleum products in 1998 resulted in a smaller import bill and a greater profitability of the Petroleum Corporation, enabling it to reduce its commitments to banks. Consequently, a considerable decline was observed in credit provided for the import of petroleum products until end second quarter 1999. However, the subsequent sharp increase in international prices of petroleum products is reflected in growth in credit provided for importing petroleum products in the third quarter 1999.

Commercial banks' credit to the housing sector has increased and several banks raised long-term funds for this purpose. The housing and property development category, the second largest absorber of total credit, accounting for 13 per cent of total credit outstanding, recorded a growth rate of 8 per cent on a point to point basis from end September 1998 to end September 1999. A substantial portion (81 per cent) of the credit granted for housing and property development purposes was accounted for by personal housing.

At end September 1999, of the total credit given by commercial banks, about 11 per cent was absorbed by the consumption category. In that category, a large portion (93 per cent) of credit was absorbed by individuals for their personal needs. Meanwhile, a significant growth was observed (31 per cent point to point growth) in credit provided through credit cards, reflecting the increased use of credit cards in response to aggressive marketing campaigns conducted by some commercial banks. The industrial sector too accounted for a share of 11 per cent in total credit outstanding. Although credit provided to the overall industrial sector showed a comparatively slow growth, credit provided for the engineering and building trade had grown significantly by end September 1999 in comparison to a decline recorded from end September 1997 to end September 1998. Credit to other manufacturing industries recorded a growth of 5 per cent at end September 1999. Among these industries, the sectors which recorded notable increases in utilisation of credit were food and beverages, leather industries, chemicals and petroleum.

In terms of sectoral distribution of credit, the highest growth in credit was recorded by the financial sector (44 per cent) and the services sector (35 per cent), although each of these sectors absorbed only around 5 per cent of total credit outstanding. Around 85 per cent of the total credit to the financial sector was absorbed by financial institutions and leasing companies. The growth in credit to the services sector was clearly reflected in the GDP, where the growth in value added in services grew from 2.4 per cent in the first half of 1999 to 4.1 per cent in the third quarter. In that sector, a large portion of credit was absorbed by passenger transport and commercial transport sub sectors.

The agriculture sector and the 'other' sector each absorbed around 6 per cent of total credit outstanding. Out of the total credit provided to the agricultural sector, the highest portion of credit was absorbed by the tea sector. Some recovery was seen in credit provided to the tourism sector, which grew by 9 per cent from end September 1998 to end September 1999. The continued increase in tourist arrivals has stimulated activities in this sector as seen from the increase in credit obtained for the construction of tourist hotels.

In terms of the maturity pattern, a large portion of loans and advances by the commercial banks continued to be in the form of short-term credit. At the end of September 1999, short-term credit (less than one year) accounted for 64 per cent in total credit while the shares of medium-term (2-5 years) and long-term (over 5 years) credit were 22.8 per cent and 13.3 per cent, respectively. This pattern generally holds for all sectors, except housing and property development and tourism. In the case of credit for housing purposes, 41 per cent was long-term and 36 per cent medium-term. For tourism, 38 per cent was in the form of long-term credit.

It is observed from the classification of loans and advances by security, that the proportion of credit given against different types of security is relatively stable. Approximately 26 per cent of credit was given against immovable property, plant and machinery. Personal guarantees and promissory note, other securities and

1 The description in this section depends on the information obtained through the Quarterly Survey of Bank Advances and Deposits and is based on domestic banking unit data upto end September 1999.

TABLE 10.6
Commercial Bank Advances by Purpose and Maturity (a)

Category		Short-Term		Medium-Term		Long-Term		Total	
		(1) Amount Rs. Mn.	(2) (1) as % of (7)	(3) Amount Rs. Mn.	(4) (3) as % of (7)	(5) Amount Rs. Mn.	(6) (5) as % of (7)	(7) Amount Rs. Mn.	(8) (7) as % of Grand Total
1. Trading									
1998	September	73,453	73.6	21,204	21.2	5,142	5.2	99,799	43.1
1998	December	74,874	72.7	22,515	21.9	5,545	5.4	102,934	42.7
1999	September	80,252	74.5	21,490	20.0	5,923	5.5	107,665	41.4
2. Financial									
1998	September	5,878	67.2	1,894	21.7	974	11.1	8,745	3.8
1998	December	8,208	72.6	2,153	19.0	944	8.4	11,305	4.7
1999	September	8,652	68.6	2,668	21.2	1,291	10.2	12,611	4.8
3. Agricultural									
1998	September	7,811	64.0	3,257	26.7	1,144	9.4	12,211	5.3
1998	December	8,174	62.5	3,720	28.5	1,181	9.0	13,075	5.4
1999	September	9,006	63.5	3,667	25.9	1,505	10.6	14,177	5.5
4. Industrial (b)									
1998	September	19,245	72.0	5,401	20.2	2,080	7.8	26,725	11.6
1998	December	19,547	70.8	5,561	20.2	2,483	9.0	27,591	11.4
1999	September	19,698	68.7	5,952	20.8	3,025	10.5	28,675	11.0
5. Tourism									
1998	September	1,563	40.5	830	21.5	1,462	37.9	3,855	1.7
1998	December	1,706	41.5	887	21.6	1,515	36.9	4,108	1.7
1999	September	1,746	41.6	880	21.0	1,573	37.5	4,198	1.6
6. Housing									
1998	September	7,820	25.3	10,951	35.5	12,095	39.2	30,866	13.3
1998	December	7,761	24.8	10,742	34.4	12,746	40.8	31,249	12.9
1999	September	7,870	23.5	11,982	35.8	13,608	40.7	33,460	12.9
7. Consumption									
1998	September	14,977	64.2	4,678	20.0	3,685	15.8	23,340	10.1
1998	December	14,594	62.6	4,821	20.7	3,893	16.7	23,308	9.7
1999	September	18,720	64.1	5,540	19.0	4,950	16.9	29,209	11.2
8. Other Loans									
1998	September	17,397	67.5	5,615	21.8	2,768	10.7	25,780	11.1
1998	December	18,819	67.8	6,759	24.3	2,186	7.9	27,764	11.5
1999	September	20,456	68.0	7,010	23.3	2,626	8.7	30,092	11.6
9. Total									
1998	September	148,142	64.0	53,829	23.3	29,350	12.7	231,321	100.0
1998	December	153,683	63.7	57,158	23.7	30,493	12.6	241,335	100.0
1999	September	166,400	64.0	59,188	22.8	34,500	13.3	260,087	100.0

Source: Central Bank of Sri Lanka

(a) Advances include loans,overdrafts and bills discounted and exclude cash items in the process of collection.
(b) Includes advances granted to the Engineering and Building Trade, Mining and Fishing.

unsecured credit accounted 16 per cent, 17 per cent and 14 per cent, respectively. The share of advances given against fixed, savings and other deposits was around 10 per cent at end September 1999, while the relative importance of credit extended against shares of joint stocks companies, bonds and debentures declined from 2 per cent at end September 1998 to 1 per cent at end September 1999. This can be attributed to depressed stock market prices and the consequent low value of shares that are used as collateral. Similarly, credit given against trust receipts also declined from 5 per cent to 3 per cent during the same period. Stock in trade (7 per cent) was the other important form of security.

Keeping with the declining trend in other market interest rates, the Weighted Average Lending Rate, dropped from 19.6 per cent at end September 1998 to 19.1 per cent at end June 1999, and further to 18.9 per cent by end September 1999. The amount of credit granted at higher rates of interest continued to decline. The percentage share of total credit provided at interest rates above 25 per cent

TABLE 10.7
Advances by Type of Security (a)
September 1998 - September 1999

Security	30 Sep. 1998		31 Dec. 1998		30 Sep. 1999	
	Amount Rs. Mn.	% of Total	Amount Rs. Mn.	% of Total	Amount Rs. Mn.	% of Total
1. Documentary Bills	6,398	2.8	6,590.3	2.7	7,176	2.8
2. Government Securities	3,608	1.6	3,909.8	1.6	3,943	1.5
3. Shares & Joint Stock Companies, Bonds, Debentures and Sundries including Cash Value of Life Policies	3,448	1.5	3,430.8	1.4	3,147	1.2
4. Fixed, Saving & Other Cash Deposits and CDs	24,974	10.8	24,449.4	10.1	26,429	10.2
5. Stocks in Trade	17,494	7.6	17,299.0	7.2	17,353	6.7
6. Immovable Property, Plant and Machinery	60,522	26.2	64,228.3	26.6	68,038	26.2
7. Personal Guarantees and Pro Notes	37,874	16.4	37,606.3	15.6	40,844	15.7
8. Trust Receipts	10,585	4.6	9,136.9	3.8	6,974	2.7
9. Hire Purchase Agreements	1,118	0.5	1,468.4	0.6	2,137	0.8
10.Tractors and Motor Vehicles	2,798	1.2	3,759.8	1.6	3,372	1.3
11.Other Securities	35,621	15.4	38,903.8	16.1	43,270	16.6
12.Unsecured	26,881	11.6	30,551.6	12.7	37,404	14.4
TOTAL	231,321	100.0	241,335	100.0	260,087	100.0

Source: Central Bank of Sri Lanka

(a) Excludes cash items in the process of collection and advances granted for financing purposes under the Guaranteed Price Scheme.

dropped by 6 per cent from the level at end September 1998, while the percentage share of credit outstanding granted at interest rates ranging between 21-25 per cent declined by 1 per cent. The proportion of total outstanding loans and advances provided at interest rates ranging between 16-20 per cent increased from 14 per cent at end September 1998 to 21 per cent at end September 1999.

10.5 Central Banking

The Central Bank's operations continued to focus on maintaining stability in financial markets. As a part of the ongoing process to move towards more market oriented operations, the statutory reserve requirement was reduced. The Bank Rate was also reduced. In monetary policy operations, the Bank continued to use the repurchase facility and the reverse repurchase facility extensively. In the foreign exchange market, the Bank continued to quote daily buying and selling rates for the US dollar, the intervention currency, for transactions with commercial banks. These rates were determined primarily by market developments. The Bank does not enter into forward foreign exchange transactions. The Central Bank introdued several measures in the latter part of the year to ensure that issues related to the year 2000 problem would not destabilise the market. these measures and the close links maintained wih the commercial banks ensured that the year 2000 issue was dealt with no untoward incidents.

Structure of Assets and Liabilities

The total resources of the Central Bank increased by 6.3 per cent (Rs.11,913 million) to Rs.200,586 million during the period compared to a 2.6 per cent (Rs.4,774 million) growth in 1998.

When the assets side is taken into consideration, the increase was entirely due to the rise in domestic assets of the Central Bank. The total international reserve of the Central Bank declined by Rs. 18,954 million (14.9 per cent) reflecting the deficit in the BOP in 1999. This is in contrast to the increase in foreign assets by 15 per cent (Rs.15,755 million) in 1998.

Meanwhile, domestic assets of the Central Bank increased significantly by Rs30,886 million (50.2 per cent) in comparison to the Rs.3,401 million (5 per cent) decrease in 1998. Loans and advances to government through the revolving credit facility increased by Rs.2,777 million (13.3 per cent). In order to offset the impact of shortage of liquidity resulting from the outflow in the balance of payments and the need to ensure adequate liquidity in the market to facilitate economic activity, the Central Bank provided liquidity through its operations in the primary and secondary markets for government securities. Consequent on this and the desire on the part of commercial banks to hold higher cash balances at the end of the year, largely due to Y2K related issues, the Treasury bill holdings of the Central Bank increased significantly by Rs.16,933 million in 1999.

In comparison, the increase in Treasury bill holdings in 1998 amounted to Rs.1,885 million.

On the liabilities side, the deposits with the Central Bank declined by 3 per cent (Rs.2,061 million), in comparison to the decline of 5 per cent (Rs3,701 million) in 1998. This was due to a decline in both government deposits and commercial bank deposits with the Central Bank. The deposits of commercial banks declined by 8 per cent when compared with 1998, as a result of the reduction of the statutory reserve ratio by one percentage point. However, the deposits of international institutions, international banks etc. increased by 3 per cent (Rs. 1,229 million).

The total currency issue of the Bank during the year in 1999 increased by 16.8 per cent (Rs.10,123 million) compared to a 13.2 per cent increase recorded in 1998. This was partly due to the usual growth in the demand for currency for economic activity and partly due to the desire of commercial banks to hold higher cash balances for precautionary purposes due to Y2K related problems at the end of 1999. The issue of currency notes increased by 17.5 per cent in 1999 compared to the 13.8 per cent recorded in the previous year, while the issue of coins increased by 10.8 per cent in 1999 in comparison to 12.3 per centincrease in 1998. The efforts taken by the Central Bank and commercial banks to reassure the public with regard to the possibility of problems arising as a consequence of the Y2K issue were successful, and the increase in currency held by the public in this regard was much less than originally anticipated.

10.6 Banking Development

The total number of commercial banks in operation at end 1999 was 25, comprising 9 domestic banks and 16 foreign bank branches (excluding the Colombo branch of Societe Generale, which ceased operations with effect from 31.12.1999). In comparison, at the end of 1998, there were 8 domestic banks and 18 foreign bank branches. During 1999, the Colombo branch of Korea Exchange Bank ceased its operations while a Canadian bank, viz., Nova Scotia Bank, established a branch in Colombo during the year. The business of the Colombo branch of the Overseas Trust Bank was transferred to the Nations Trust Bank, a domestic private bank which commenced operations in mid 1999.

Another significant development that took place in the banking sector during the period was the completion of the restructuring programme of Regional Rural Development Banks (RRDBs) by setting up Regional Development Banks (RDBs), which commenced in 1998. All RRDBs operating in the country have now been absorbed into RDBs under the provisions of the Regional Development Bank Act No.6 of 1997. The Wayamba Development Bank, the Sabaragamuwa Development Bank and the Uva

TABLE 10.8

Distribution of Bank Branches

Category	1997	1998	1999(a)
1.No. of Institutions	**44**	**39**	**32**
Commercial Banks	26	26	25
Domestic Banks	8	8	9
Foreign Banks	18	18	16
Savings Banks(b)	1	1	1
RRDBs(c)	17	9	
RDBs (d)		-	3
6 2. No.of Bank Branches(e)	**1,273**	**1,314**	**1,331**
Commercial Banks	998	1,038	1,054
Domestic Banks	956	993	1,012
Main Branches	858	889	906
ASC Branches	14	12	12
Kachcheri Branches	23	23	23
Extension/Pay Offices	57	65	67
Overseas Branches	4	4	4
Foreign Bank Branches(f)	42	45	42
Pawning Centres	167	185	185
NSB Branches	99	100	100
RRDB Branches	176	96	-
RDB Branches	-	80	176

Source: Central Bank of Sri Lanka

(a) Provisional
(b) Excludes the Colombo Branch of Sociee Generale which ceased operations with effect rom 31.12.1999.
(c) Regional Rural Development Banks(RRDBs) established under the Regional Rural Development Bank Act No. 15 of 1985. All RRDBs had been taken over by RDBs by end 1999.
(d) Regional Development Banks(RDBs) established under the RDB Act no.6 of 1997.
(e) Includes Head Offices, but excludes pawning centres.
(f) Includes Sub-branches

Development Bank were established during the period, bringing the total number of RDBs in operation to 6. The banks have been issued licences as Specialised Banks under the Banking Act. This resulted in increasing the total number of licensed specialised banks to twelve.

Branch Network

The total branch network of commercial banks including main branches, Agrarian Service Centre (ASC) branches, kachcheri branches, extension offices and overseas branches (but excluding 185 pawning centres) increased from 1,038 at end 1998 to 1,054 at end 1999. Hatton National Bank Ltd. and Commercial Bank of Ceylon Ltd. opened 6 branches each. Sampath Bank Ltd. opened 2 branches, while Pan Asia Bank Ltd. and Seylan Bank Ltd. opened a branch each. The total number of extension offices and pay offices increased from 65 per cent and 67 per cent at end 1999, while the number of ASC branches and kachcheri branches of Bank of Ceylon remained unchanged. These changes, together with setting up of Nations Trust Bank, resulted in increasing the total number of branches of domestic banks by 19 to 1,012 at end period. In addition, Hatton National Bank Ltd. set up 27 Student Saving Units in schools during the year. The total number of foreign bank branches decreased from 45 to 42 at end 1999. This resulted from the closure of the branch of Korea Exchange

Bank, the branch of Societe enerale and two extension offices of Mashreq Bank and Indian Bank, the opening of a branch of Nova Scotia Bank and the take over of the branch of the Overseas Trust Bank by Nations Trust Bank. Meanwhile, Citibank opened a counter at the US embassy. The total number of persons served by a commercial bank branch (excluding pawning centres) decreased from 18,086 persons at end 1998 to 18,067 persons at end 1999. The total number of RDB branches was 176 at end 1999. The National Savings Bank opened two mini branches (Savings Shops) during the year.

Banking Facilities

Commercial banks increased the provision of facilities through the introduction of new products and the use of rapid advances in technology. Banks expended considerable efforts to ensure that they were Y2K compliant.

Standard Chartered Bank introduced the concept of 'Room Service'. Under this facility, when a prospective customer wishes to open an account, an officer from the bank visits the person and provides assistance in opening the account. In addition, cheque books are also delivered to customers under this scheme. The 'Royalty Banking' concept was introduced by Hatton National Bank, under which special banking facilities are provided for high networth individuals. Pan Asia Bank introduced a new service, named 'Speed Service (Door to Door) Spot Cash' which offers same day delivery of foreign remittances channelled through the bank.

People's Bank introduced a savings scheme, named 'Videsika', to encourage Sri Lankans employed abroad to save their foreign exchange earnings. Seylan Bank Ltd. launched three deposit schemes namely, a Three year fixed deposit scheme, the 'Tikiri Prasada' Children's Certificate Scheme and the 'Ranliya' Savings Scheme for women. Commercial Bank of Ceylon Ltd. introduced a three year fixed deposit scheme, named 'Full Option Fixed Deposits'. Muslim Commercial Bank Ltd. commenced a new deposit scheme named 'Ranmuthu' Investment Savings Scheme, with maturities of 3, 6, 12 months. A new deposit scheme for children titled 'Pubudu Children's Savings Scheme' was introduced by Sampath Bank Ltd. Pan Asia Bank introduced a deposit scheme named 'Peramaga Students Progress Account' for students, while Standard Chartered Bank launched a 'Young Savers' Deposit Scheme' for minors.

A housing loan scheme named 'Piyasa Suva Nivasa' for medical professionals and a loan scheme for disabled persons named 'Senehevanthayo' were introduced by Seylan Bank. Hongkong Bank introduced a housing loan scheme during the year, while Commercial Bank of Ceylon also introduced a personal loan scheme. Nations Trust Bank introduced two term loan schemes, i.e., a personal loan scheme for educational purposes, to purchase consumer durables and for investment purposes, and a home loan facility. Pan Asia Bank introduced a pawning scheme named the 'Ransika' loan scheme. Bank of Ceylon and People's Bank each introduced a credit scheme named 'Samurdhi Small Industries Development Programme' to promote small industries through micro enterprises under the Samurdhi Movement. The maximum loan granted under this scheme is Rs.25,000 with an interest rate of 10 per cent per annum. Bank of Ceylon has implemented concessionary schemes for some defaulters of agricultural loans. Several new loan schemes, namely, 'Sahan Eliya', a credit scheme to purchase consumer durables, 'Randiriya', a pawn broking scheme, and a cultivation loan scheme were introduced by Sampath Bank in addition to launching refinance credit schemes under the second perennial crops development project, the ADB Tea Development Project and the Environmental Friendly Solutions Fund.

Eleven commercial banks installed 44 new ATMs during the year, thus raising the total number of commercial Bank ATMs operating in the country to 311. Use of credit cards in Sri Lanka shows a gradual increase since their introduction in the early 1980s. Initially, cards were issued only for local transactions. However, with the liberalisation of the current account following acceptance of Article VIII status of the IMF by Sri Lanka in 1994, banks began to issue global access cards as well. Six domestic banks and two foreign banks presently issue credit cards under well known international trade names, such as VISA and Master Card. Several cards, 'Classic', 'Global', 'Apsara' and 'Business' are issued by these banks.

The total number of credit cards issued by end 1999 was 122,911, an increase of 43 per cent over the previous year. Of these, 33,719 were local cards while 88,192 were global cards. The total outstanding amount of credit granted through

TABLE 10.9

Credit Cards Issued by Commercial Banks

	1998	1999(a)	% Change
Total Number of Credit Cards Issued	85,964	122,911	43
Local	26,921	34,719	29
Global	59,043	88,192	49
Outstanding Credit at end year (Rs. Mn.)	1,483	2,365	59
Local	318	358	12
Global	1,165	2,007	72
Overdues (as a % of Outstanding Credit)	19	11	-
Past Dues (as a % of Outstanding Credit)	7	8	-
Commission from Dealers (%)	0.2 - 5.0	0.3 - 4.5	-

(a) Provisional

Source: Relevant Institutions

cards at end December 1999 was Rs.2,365 million, a 59 per cent growth over the value at the end of 1998. Credit cards are a convenient facility for customers and their use is a normal development as financial markets mature. Yet they have the potential to create a debt trap for some consumers, as has been the experience in some countries. Thus, it becomes necessary to monitor developments relating to credit obtained through these cards. In this regard, the substantial reduction in the proportion of credit in the overdue category is a healthy development, though the slight increase in the past due category warrants attention.

10.7 Credit Information Bureau of Sri Lanka

The Credit Information Bureau of Sri Lanka, which was established by Credit Information Bureau Act No.18 of 1990, has been operative since May 1990. During this brief period, the year 1999 can be described as the most successful year in which the Bureau for rhe first time recorded an operational profit of Rs.185,442 while the net profit for the year was 5,392 million. This is a 46 per cent increase compared to a profit of Rs. 3,683 million earned in the year 1998. The Bureau achieved this target without increasing its fees for credit reports since March 1996.

This increase in overall profit is attributed to the upsurge in the demand for credit reports from shareholding lending institutions. The Bureau issued 155,243 credit reports during 1999, a 23 per cent increase compared to 125,928 credit reports issued in 1998. This trend reflects the increasing patronage of the Bureau by its clientele.

The Bureau has been able to increase its coverage by collecting information for 138,930 borrowers which include 33,008 irregular advances of Rs.100,000 and over and 42,712 regular advances of 500,000 and over as at 31.12.1999.

The Bureau endeavours to collect as much information as possible on borrowers and also to increase its membership with a view to providing up-to date and complete credit information to its members.

All Regional Development Banks have been enrolled as members of the Bureau in terms of Section 43(a) of the Regional Development Bank Act No.6 of 1997.

In terms of Section 29(g) of the Credit Information Bureau of Sri Lanka (Amendment) Act No.8 of 1995, two private Licensed Specialised Banks, four leasing Companies and a Merchant Bank have been enrolled as new members of the Bureau. The Bank of Nova Scotia became a member as a Licensed Commercial Bank. As a result, Bureau's membership has increased to 69 which comprise of the Monetary Board of Central Bank of Sri Lanka, 26 Commercial Banks, 25 registered Finance Companies, 6 Licensed Specialised Banks, 6 Regional Development Banks and 4 Leasing Companies and a Merchant Bank.

10.8 Rural Banking and Credit

Overall Trends and Developments

The conventional solution to the perennial problem of fluctuating prices of agricultural produce from season to season has been to introduce floor price schemes and establish government marketing institutions. Both these solutions have proved to be failures in the long run. Hence, it was necessary to approach the problem of price fluctuations through a market based mechanism that would sustain itself in the long run. Accordingly, a system of forward sale contracts was introduced in 1999 on a trial basis (see Box 2 for details).

This forward market contract system was introduced to the agricultural sector, while pursuing the rural credit policy stance followed in recent years. The key features of this policy stance were the following: encouraging the establishment of a widespread rural banking network at grassroots levels to make credit more accessible to rural people, promoting the setting up of people-based organisations to establish cost effective credit delivery systems and providing credit plus services to the rural populations so that they could effectively use credit funds for income generating self-employment activities.

The formation of people based organisations as conduits to provide micro-finance was continued during 1999. More Samurdhi Bank Societies were formed, while the Isuru Development Societies were strengthened. Farmers' organisations also continued to be formed under the Agrarian Services Act. Action was also taken to set up farmers' companies as people's companies under the Companies Act to engage in agri-business activities.

The year under review also witnessed the establishment of 3 new Regional Development Banks (RDBs), viz., Wayamba, Sabaragamuwa and Rajarata, bringing the total of such banks to 6 by the end of 1999.

The existing agricultural credit scheme, i.e., the New Comprehensive Rural Credit Scheme (NCRCS) and the self-employment oriented micro-credit scheme (Surathura Phase II) continued to be funded by lending banks with an interest subsidy from government. The interest rates on loans granted under NCRCS and Surathura Phase II remained unchanged at 12 per cent per annum and 10 per cent per annum, respectively. A special agricultural credit guarantee fund was set up in the Central Bank with funds provided by the government to extend credit guarantee cover upto 60 per cent in respect of loans in loss under NCRCS. Loans granted under the ADB funded Second Perennial Crops Development Project and the Tea Development Project, which came into operation in the year under review, were also made eligible for credit guarantees from the Agricultural Credit Guarantee Fund.

TABLE 10.10
Cultivation Loans Granted Under the New Comprehensive Rural Credit Scheme (Position as at 31 December 1999)

Rs. Million

Season	State Banks			Domestic Private Banks (a)			Regional Rural Dev. Banks (b)			Total Loans		
	Paddy	Subsidiary Food Crops	Total	Paddy	Subsidiary Food Crops	Total	Paddy	Subsidiary Food Crops	Total	Paddy	Subsidiary Food Crops	Total Loans Under NCRCS
1994/95 Maha	516	182	698	18	18	36	37	22	59	571	222	793
1995 Yala	179	131	310	8	23	31	34	22	56	221	176	397
Cultivation Year 1995	695	313	1,008	26	41	67	71	44	115	792	398	1,190
1995/96 Maha	265	76	341	18	28	46	25	33	58	308	137	445
1996 Yala	71	33	104	3	12	15	14	8	22	88	53	141
Cultivation Year 1996	336	109	445	21	40	61	39	41	80	396	190	586
1996/97 Maha	233	59	292	18	28	46	24	36	60	275	123	398
1997 Yala	72	35	107	20	32	52	16	13	29	108	80	188
Cultivation Year 1997	305	94	399	38	60	98	40	49	89	383	203	586
1997/98 Maha	177	24	201	21	20	41	32	13	45	230	57	287
1998 Yala	74	24	98	12	30	42	24	17	41	110	71	181
Cultivation Year 1998	251	48	299	33	50	83	56	30	86	340	128	468
1998/99 Maha	149	24	173	30	22	52	29	27	56	208	73	281
1999 Yala (b)	75	23	98	10	29	39	25	20	45	110	72	182
Cultivation Year 1999 (b)	224	47	271	40	51	91	54	47	101	318	145	463

(a) Hatton National Bank, Commercial Bank of Ceylon and Seylan Bank only.
(b) Provisional.

Source: Central Bank of Sri Lanka

Two major policy changes were made in the area of agricultural insurance and agricultural extension services during the year under review. The government repealed the Agriculture Insurance Law No.27 of 1973 and enacted new legislation - the Agriculture and Agrarian Services Act No.20 of 1999 (See Box 3 for details). Second, for the first time in the history of agrarian services in the country, steps were taken to rely on the private sector to provide extension services for the agricultural sector. This was to be achieved as a pilot scheme under the Second Perennial Crops Development Project funded by the ADB. The objective of the new policy measure was to provide a more effective extension service to farmers through a 'user payee' system, thereby developing a market based extension service in the country.

New Comprehensive Rural Credit Scheme (NCRCS)

During the year under review, the New Comprehensive Rural Credit Scheme (NCRCS) continued to operate throughout the country, providing short-term cultivation loans for farmers for the cultivation of paddy and other subsidiary food crops. The Participating Credit Institutions (PCIs) granted loans amounting to Rs.464 million in respect of 23,271 farmers. Since the refinance scheme was withdrawn in April 1994 and replaced by an interest subsidy scheme, the PCIs have granted cultivation loans out of their own funds at an interest rate of 12 per cent per annum with an interest subsidy of 10 percentage points per annum made available by the government. The interest subsidy was intended to cover the possible losses to PCIs due to their having to lend at rates below cost of funds. In view of the short production cycle, the maximum period given to farmers for repayment of NCRCS loans was 270 days and PCIs could, therefore, claim an interest subsidy only for that duration. During 1999, a sum of Rs.12 million was paid by the government on this count.

The Farmers' Relief Scheme, which was introduced in 1994 by government to provide relief to farmers who had failed to re-pay their cultivation loans, was continued in 1999. Under this scheme, eligible farmers could have their outstanding loans written off by paying 25 per cent of the amount in default including accumulated interest. The balance 75 per cent was to be shared by the Central Bank (37.5 per cent), lending banks (18.75 per cent) and the government (18.75 per cent).

At end 1999, a cumulative total of 63,500 farmers had benefited under this Scheme. During the year under review, the PCIs were compensated with a sum of Rs.68 million by the government as its share, while a sum of Rs.117 million was paid by the Central Bank under the provisions of its Credit Guarantee Scheme. The cumulative amount of compensation paid by both the government and the Central Bank upto end 1999 under the Relief Scheme amounted to Rs.342 million.

TABLE 10.11

Deposits - Selected Rural Sector Institutions (a)

Rs. Million

Institution		1998	1999 (b)			
			1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
Co-operative Rural Banks (CRBs)	Total	11,233.6	11,446.0	11,611.2	12,242.5	12,914.7
	Savings	7,857.5	7,959.0	8,631.8	9,154.9	9,545.7
	Special Savings	0.0	0.0	0.0	0.0	0.0
	Fixed Deposits	3,376.1	3,487.0	2,979.4	3,087.6	3,369.0
	Shares	0.0	0.0	0.0	0.0	0.0
Bank of Ceylon Sub- offices at Agrarian Services Centres	Total	257.2	237.1	241.3	253.3	280.9
	Savings	210.8	191.7	193.5	201.7	226.6
	Special Savings	17.1	17.6	17.9	20.4	22.0
	Fixed Deposits	29.4	27.7	29.9	31.2	32.3
	Shares	0.0	0.0	0.0	0.0	0.0
Regional Development Banks	Total	2,730.5	2,654.6	2,665.4	2,765.5	2,964.4
	Savings	1,790.5	1,737.8	1,741.6	1,823.1	1,999.5
	Special Savings	312.1	226.1	226.9	241.8	269.7
	Fixed Deposits	627.6	690.0	692.3	699.9	694.3
	Shares	0.3	0.7	4.6	0.7	0.8
Sarvodaya Economic Enterprises Development Services(Guarantee) Ltd. (SEEDS)	Total	292.5	323.4	358.6	388.0	425.1
	Savings	227.1	250.8	278.7	301.8	329.2
	Special Savings	65.4	72.6	79.9	86.2	95.9
	Fixed Deposits	0.0	0.0	0.0	0.0	0.0
Janashakthi Bank - Hambantota	Shares	0.0	0.0	0.0	0.0	0.0
	Total	40.0	51.0	52.3	51.5	46.1
	Savings	12.8	18.6	16.3	16.6	17.2
	Special Savings	11.8	16.5	18.4	19.1	12.7
	Fixed Deposits	0.7	0.9	0.7	0.6	0.6
SANASA Development Bank	Shares	14.7	14.9	17.0	15.2	15.6
	Total	679.0	613.3	688.5	832.1	965.8
	Savings	114.9	122.2	114.5	136.0	169.2
	Special Savings	1.3	5.6	7.1	8.3	10.3
	Fixed Deposits	410.4	331.2	409.7	529.6	626.5
	Shares	152.4	154.3	157.2	158.2	159.8

(a) Total deposits at the end of the reported period
(b) Provisional

Sources : Co-operative Development Department
Bank of Ceylon
Regional Development Banks
Sarvodaya (SEEDS)
Women's Development Federation - Hambantota
Sanasa Development Bank

Crop Insurance Schemes

The Agricultural Insurance Law was repealed and the Agricultural and Agrarian Insurance Board (AAIB) was established under Agricultural and Agrarian Insurance Act (see Box 3). While continuing its former business, steps were taken by the new AAIB to design new insurance schemes for seed farms, model farms, seed stores, livestock, fisheries, floriculture and coconut. The insurance schemes designed by the AAIB on the request of the Perennial Crops Development Project for perennial crops, Department of Export Agriculture for export agriculture crops, Southern Development Authority for maize cultivation in the Southern region and the Tea Research Institute and Tea Small Holding Development Authority for smallholder tea plantation continued to be in operation during the year under review. Ceylinco Insurance Company Ltd. (CICL), which is the only private insurer operating in the agricultural sector, expanded its services to various sectors including life insurance for farmers during 1999 after the enactment of the new Act.

The extent of paddy land insured by the AAIB in 1999 amounted to 11,000 hectares when compared to 14,000 hectares in 1998. This reduction has mainly been due to the difficulties in providing coverage for paddy lands in the Northern and Eastern parts of the country and a fall in the volume of loans granted under the NCRCS. Out of the districts in the Northern and Eastern provinces, AAIB could cover only a limited land area in the districts of Jaffna, Ampara, Batticaloa and Vavuniya. Insurance coverage for paddy and subsidiary food crops in the other parts in these districts was not provided by the AAIB. Therefore, the insurance premia collected and indemnities paid under paddy stood at Rs.6.7 million and Rs.1.5 million, respectively, during the year. The area insured under other crops by the AAIB stood at 2,138 hectares. The premia collected in this field was Rs.1.3 million. The amount of indemnities paid for other crops was Rs.0.3 million. The CICL insured an extent of 2,672 hectares of paddy land and collected premia to a value of Rs.2.4 million. The payment of indemnity for paddy farmers stood at Rs.0.4 million. In

TABLE 10.12

Advances-Selected Rural Sector Institutions (a)

Rs. Million

Institution		1998(b)	1999(c) 1st Quarter	1999(c) 2nd Quarter	1999(c) 3rd Quarter	1999(c) 4th Quarter	1999(b)(c)
Co-operative Rural Banks (CRBs)	Total Loans Granted	3,487.4	872.3	840.0	1,114.6	669.5	3,496.4
	Agriculture	351.0	72.6	68.0	62.0	66.2	268.8
	Animal Husbandry	394.0	140.4	152.6	161.0	165.0	619.0
	Fisheries	100.0	27.0	28.4	32.0	29.5	116.9
	Small Industries	66.0	14.0	12.0	13.6	9.0	48.6
	Building Construction, Electrification and Water Supply	662.0	231.0	241.6	245.4	296.0	1,014.0
	Projects/Commerce	319.0	68.0	69.4	73.2	22.0	232.6
	Others	1,595.4	319.3	268.0	527.4	81.8	1,196.5
Bank of Ceylon Sub-offices at Agrarian Services Centres	Total Loans Granted	153.0	26.6	28.3	30.9	28.2	114.0
	Agriculture	57.0	8.8	8.8	7.9	8.0	33.6
	Animal Husbandry	0.8	0.1	0.1	0.3	0.1	0.6
	Fisheries	0.0	0.0	0.0	0.0	0.0	0.0
	Small Industries	26.2	5.5	5.0	4.6	3.9	19.1
	Building Construction, Electrification and Water Supply	1.3	0.7	0.4	0.8	0.3	2.3
	Projects/Commerce	23.6	4.1	4.8	5.7	5.8	20.4
	Others	44.2	7.5	9.0	11.5	10.1	28.1
Regional Development Banks	Total Loans Granted	2,400.0	2,301.8	2,255.8	2,212.3	2,512.0	9,281.9
	Agriculture	279.0	253.8	248.1	234.5	268.5	1,004.8
	Animal Husbandry	99.0	76.6	54.8	36.8	33.4	201.6
	Fisheries	117.6	112.4	108.2	20.7	19.4	260.6
	Small Industries	135.9	138.0	153.3	167.0	184.0	642.4
	Building Construction, Electrification and Water Supply	27.0	28.3	33.7	46.3	70.1	178.4
	Projects/Commerce	516.6	504.4	476.1	434.0	475.0	1,889.4
	Others	1,224.9	1,188.4	1,181.6	1,273.0	1,461.7	5,104.7
Thrift and Credit Co-operative Societies (TCCSs)	Total Loans Granted	11.9	0.4	0.0	2.1	1.9	4.4
Sarvodaya Economic Enterprises Development Services (Guarantee) Ltd. (SEEDS)	Total Loans Granted	341.5	133.0	100.7	90.3	180.2	504.1
	Agriculture	45.7	13.2	23.8	15.7	29.7	82.4
	Animal Husbandry	10.4	4.3	1.4	2.0	2.8	10.5
	Fisheries	0.0	0.0	0.0	0.0	0.0	0.0
	Small Industries	8.5	3.0	2.1	8.4	1.9	15.4
	Building Construction, Electrification and Water Supply	0.0	0.0	0.0	0.0	0.0	0.0
	Projects/Commerce	21.0	9.8	3.4	6.6	10.6	30.3
	Others	255.8	102.7	70.0	57.6	135.2	365.5
Janashakthi Bank - Hambantota	Total Loans Granted	178.1	51.2	60.1	57.6	59.5	228.4
	Agriculture	0.0	0.0	0.0	0.0	0.0	0.0
	Animal Husbandry	0.0	0.0	0.0	0.0	0.0	0.0
	Fisheries	28.0	7.7	10.6	11.0	11.5	40.8
	Small Industries	93.6	26.7	32.6	28.6	29.5	117.5
	Building Construction, Electrification and Water Supply	55.3	16.2	16.2	17.2	17.7	67.2
	Projects/Commerce	0.0	0.0	0.0	0.0	0.0	0.0
	Others	1.3	0.6	0.7	0.8	0.8	2.9
SANASA Development Bank	Total Loans Granted	411.3	103.8	74.5	75.1	71.1	324.6
	Agriculture	13.4	2.9	2.0	0.9	0.6	6.4
	Animal Husbandry	0.6	0.0	0.1	1.0	0.0	1.2
	Fisheries	0.5	0.1	0.7	0.1	0.0	0.9
	Small Industries	104.0	32.5	28.4	19.6	11.2	91.7
	Building Construction, Electrification and Water Supply	43.4	6.7	9.2	3.5	3.3	22.7
	Projects/Commerce	117.3	39.4	15.9	28.6	32.8	116.6
	Others	132.0	22.2	18.2	21.5	23.3	85.2

Sources: Co-operative Development Department
Bank of Ceylon
Regional Development Banks
SANASA Federaion
Sarvodaya (SEEDS)
Women's Development Federation - Hambantota
Sanasa Development Bank

(a) Total loans granted during the reporting period
(b) Annual total figures
(c) Provisional figues

respect of other crops, CICL has insured an area of 3,099 hectares and collected premia of Rs.2.1 million. The indemnity paid by CICL against such crops was Rs.0.9 million.

Both the AAIB and CICL have provided increased coverage for livestock during the year under review. The total premia collected by AAIB in the sector was Rs.3.7 million as against the coverage provided for 10,296 animals, whereas the indemnities paid amounted to Rs.1.1 million. The CICL also extended its coverage in the livestock sector by giving coverage for 1,829 animals. The premia collected stood at Rs.0.6 million, while the indemnities paid were Rs.0.3 million.

Micro-finance and Savings Schemes

Samurdhi Development Credit Schemes

The Samurdhi Bank Societies (SBSs), which were set up as an integral part of the Samurdhi Movement, continued to focus on mobilising savings from and granting loans to Samurdhi members during the year under review. At end 1999, 840 SBSs had been established throughout the country. The paid up capital of the shareholders, numbering 1,198,167, amounted to Rs.548 million at end 1999. The value of other deposits made by the members amounted to Rs.656 million. The SBS had granted 182,695 loans to a value of Rs.805 million to members to start small-scale businesses in agriculture, agro-processing, petty trading, fisheries and meet consumption requirements. So far, there have been no reports of defaults of Samurdhi loans by borrowers.

TABLE 10.13

Samurdhi Credit Programmes

Name of Pogramme	Number of Loans	Amount Rs. Mn.	Recovery Rate (%)
Loans granted by SBSs	182,695	805	104
SASANA	79,784	493	71
SAVANA	9121	233	75
Leasing	655	152	55
Associated Samurdhi Animators Credit Programmes	126,330	105	94
PANA	11(a)	4	100
Total	387,596	1,792	-

Source: Samurdhi Development Authority of Sri Lanka

(a) Number of beneficiaries covered under the 11 loans was 523

In addition to the loans granted to Samurdhi members, other Samurdhi credit programs, viz., Samurdhi Development Credit Programme (SASANA), Samurdhi Animators Credit Programme, Refinance Credit Programme (PANA) and leasing programmes were also in operation during the year under review. The value of loans granted under all types of schemes including loans granted by SBSs stood at Rs.1,792 million in respect of 387,596 loans, at end 1999.

Thrift and Credit Co-operative Societies (TCCS) Credit Scheme

Mobilisation of savings from and granting of loans to the TCCS members were continued by both the Sanasa Development Bank (SDB) and the TCCS during the year under review. The SDB, which was established in 1997, provided loans to TCCS members and other customers under several loan schemes designed by the SDB. The total savings of the SDB at end 1999 stood at Rs.966 million. It had also granted loans to a value of Rs.324 million during 1999.

Janashakthi Banking Societies at Hambantota

Janashakthi Banking Societies (JBSs) were first set up in 1989 as informal savings and loan associations by the Women's Development Federation (WDF), a non-governmental organisation operating in the Hambantota District, with a vision to empower women in poor families in the area to become both socially and economically self-reliant. This vision was to be realised by employing a multi-pronged approach: participatory association, mutual help, inculcating awareness and education, and microfinance to commence income generating activities.

With regard to the development of target women into self-reliant and socially recognised individuals, JBSs have undertaken a number of programmes such as creating awareness of the value of nutrition, education of children and helping elders. These programmes were supported by action programmes that included mobile libraries to promote reading habits, home-gardening, dairy farming and anti-drug campaigns. The beneficiaries are taken through a social mobilisation programme that help them to develop habits of thrift and leadership capabilities and achieve both social and human development through a participatory approach. The microfinance programme that provided small loans with minimal procedures, but on market interest rates, helped the beneficiary women to free themselves from the clutches of the village money lenders.

JBSs increased both savings and lending in 1999. Savings mobilised in the form of deposits by members increased from Rs.40 million in 1998 to Rs.46 million in 1999. Similarly, loans granted increased from Rs.178 million during 1998 to Rs.228 million during 1999. The loan portfolio far exceeded the savings mainly on account of the external funding which JBSs received from donors, a sign that they would face a serious problem of funding in the future, if such external fund flows dry out.

Even though the JBSs are a commendable experiment at developing a viable community-based approach toward self-improvement, these societies requires managerial expertise, sound accounting practices and reliable fund flows in order to sustain them as prudent and viable savings and loan associations in the long run.

Sarvodaya Economic Enterprise Development Services (SEEDS)

Sarvodaya Economic Enterprise Development Services (SEEDS), the enterprise arm of the non-governmental organisation 'Sarvodaya', continued its microfinance activities during the year under review. SEEDS, with its new mandate as a limited liability company by guarantee, provided a package of microfinance services to target groups, viz., the rural and semi-urban poor. The main objective of SEEDS was to uplift the living standards of the rural poor by supplying timely credit and credit plus services so as to enable them to commence viable and sustainable micro-enterprises. SEEDS had disbursed Rs.504 million as micro-credit at end 1999 and mobilised Rs.425 million in savings.

Gami Pubuduwa Scheme (GPS)

The GPS, which was introduced by Hatton National Bank (HNB) as a mechanism to reach out to a wider section of the rural population, completed its tenth year of operation in 1999. The scheme operates through the HNB branch network with 98 delivery units located in both rural and semi-urban areas. The objective of the GPS is to develop the potential micro scale borrowers and provide financial facilities to strengthen their existing economic activities and create new avenues for income generation. The total cumulative amount of loans granted under the scheme upto the end of 1999 amounted to Rs.1.2 billion covering 32,505 small and micro projects throughout the country. The outstanding loan balance at end 1999 stood at Rs.283 million in respect of 9,876 current projects. The scheme has maintained a recovery rate of 97 per cent, a very satisfactory record for a high risk micro-finance activity. The GPS also mobilised savings to a value of Rs.700 million during the entire project period.

Farmers' Banking Societies (FBSs)

Farmers' Banking Societies (FBSs), which are informal credit and savings associations, continued to be established by the Department of Agrarian Services at the Agrarian Centres (Govi Jana Kendras), during 1999. At end 1999, there were 452 such FBSs set up throughout the country. The objective of establishing FBSs was to ensure the provision of timely credit and other services to small farmers under one roof, thereby reducing their transaction costs. The farmers in this category own less than 1 hectare of paddy land and account for about 40 per cent of the farming population.

FBSs adopt a participatory approach in lending and providing other services. The fund base of FBSs consists of the following: equity participation by farmers at the rate of Rs.100 by each farmer, savings mobilised from farmer members, grants provided by the government from time to time through voted expenditure, and funds available in the Agricultural and Marketing Development Fund (a revolving fund) established in 1992 in the Ministry of Agriculture and Lands. At end 1999, 88,788 farmers had joined FBSs providing a capital base of Rs.9 million. The savings mobilised upto the end of 1999 amounted to Rs.8 million. The government grant for the year 1999 was Rs.25 million. The funds available in the revolving fund amounted to Rs.125 million. The total value of loans granted since the inception of FBSs in 1998 amounted to Rs.60 million. The FBSs charge an interest of 10.5 per cent from farmers for loans and are reported to have maintained a recovery rate of 85 per cent during 1999.

Delivery of Rural Credit through the Co-operative Movement

Co-operative Rural Banks (CRBs) have been an important retail banking agency operating in Sri Lanka for decades. These banks were primarily the banking arms of the Multi-Purpose Co-operative Societies (MPCSs), which had spread their business activities to almost all the sectors in the economy. Since the establishment of People's Bank in 1962, CRBs were nurtured by that Bank providing a host of services, banking facilities, supervision of activities, training of personnel and absorption of surplus funds. Hence, CRBs continued to play a vital role in retailing agricultural credit among rural farmers as a junior partner of People's Bank until the early 1990s. However, this relationship came under strain after People's Bank gradually moved into commercial banking proper, leaving CRBs in a state of isolation. Hence, to fill the vacuum, it was necessary to set up some kind of an apex institution to lead CRBs to play their role as viable retail banking institutions.

Having recognised this need, beginning from 1992, District Co-operative Rural Banking Unions (DCRBUs) were set up as apex bodies of CRBs in each district under the auspices of the Co-operative Development Department. By the end of 1999, 14 such DCBUs had been formed in 14 districts representing 242 MPCSs. The functions of DCBUs are to accept deposits from MPCSs, grant loans to MPCSs and invest their excess funds in suitable investments. Loans were granted to MPCSs for both working capital and investment capital purposes. The working capital loans were granted for settling bank loans, promoting customer activities, purchase of paddy etc. Investment capital loans were granted for the purchase of buildings, vehicles and equipment. The average interest rate charged from MPCSs stood between 12 per cent and 14 per cent, a concessionary rate when compared with prevailing market rates.

At end 1999, total deposits mobilised by DCRBUs from MPCSs amounted to Rs.55 million while advances remained at Rs.9 million. Accordingly, the excess funds which DCBUs placed in other types of commercial investments amounted to Rs.46 million.

Meanwhile, MPCSs continued to operate their banking units through CRBs. CRBs have spread themselves over the entire rural areas making them readily accessible to the rural population. During 1999, 1,418 such CRBs operated in the country under 299 MPCSs. The main activities of the CRBs were mobilisation of savings, extension of credit, engagement in pawning activities, collection of utility bills such as electricity bills, payment of salaries to school teachers and payment of pensions to farmers. At end 1999, CRBs had over 5.3 million savings accounts recording an increase of 12 per cent during the year. The deposits of CRBs also increased, by 15 per cent, from Rs.11,234 million in 1998 to Rs.12,914.7 million in 1999. Though the total deposit base showed an appreciable increase during 1999, the fixed deposit component remained more or less stagnant due to the failure of CRBs to compete effectively with other financial institutions which offered more attractive long term savings products.

During the year under review, the value of loans granted by CRBs amounted to Rs.350 million, as in 1998. Thus, the cumulative outstanding balance increased to Rs.4,409 million at end 1999. The CRBs have been able to maintain the same credit momentum in 1999 through the introduction of better extension and recovery services by the DCRBUs. The pawning activities of the CRBs increased significantly from an outstanding level of Rs.2,332 million in 1998 to Rs.2,824 million in 1999, an increase of 21 per cent during the year.

CRBs, as in the past, continued to serve the very micro-level depositors and borrowers in rural areas. The depositors numbering 5.3 million had maintained a total deposit level of Rs.12,900 million, i.e., on average, a micro deposit of Rs.2,420 per depositor. On the loan portfolio side, a similar picture was also shown, with 1.2 million borrowers receiving an average loan size of Rs.5,874 per borrower. Though it is encouraging for CRBs to cater to the lowest stratum of the depositors and borrowers in the rural areas, the high administration costs of handling such a voluminous number of accounts will undoubtedly erode the viability and solvency of CRBs in the long run.

10.9 Other Financial Institutions

Savings institutions

The National Savings Bank (NSB) expanded its activities during the year. This was accompanied by a high growth in deposits and investments as well as in total resources. The total resources of the NSB grew by 11 per cent during the year compared to a growth of 9 per cent in the previous year. The NSB expanded its deposit base through its efforts in mobilisation deposits with new deposit products, opening 'savings shops', branch computerisation, aggressive advertising campaigns and also by adjusting interest rates in response to market forces in a competitive manner. Diversification of the NSB's investment portfolio continued with significant increases in investments in market based government debt instruments, investments in shares and unit trusts, debentures, commercial paper and zero coupon bonds.

The total deposits of the NSB increased by 11 per cent during the year and stood at Rs.93,272 million at end 1999. In comparison, savings and fixed deposits of commercial banks increased by 15 per cent in 1999. Savings deposits of the NSB increased by 10 per cent, fixed deposits by 11 per cent, and other deposits including National Savings Certificates, premium savings bonds, and the NSB pension scheme, by 15 per cent. The NSB introduced two new deposit schemes, the 'Prarthana Savings Account Scheme' for children and 'Ithuru Mithuru Savings Scheme' for youth during the year.

The NSB reduced its interest rates several times during the year in line with market trends. The savings deposit rate was reduced from 10.5 per cent at end December 1998 to 9.2 per cent at end December 1999. The rate on 12-month fixed deposits was maintained at 11.5 per cent throughout the year. This enabled the NSB to mark a faster rate of growth in fixed deposits than commercial banks.

Investments of the NSB increased by 10 per cent during the year and was accompanied by a diversification of its investment portfolio towards more market oriented debt instruments. Investments in Treasury bonds, which accounted for 22 per cent of total investments at end 1999, increased by 94 per cent during the year. Investments in Treasury bills, which accounted for a share of 8 per cent of total investments, increased by 17 per cent. Meanwhile, investments in other government securities increased only marginally by 0.1 per cent. Investments in debentures and unit trusts and shares increased by 26 per cent and 41 per cent, respectively. In addition, the NSB invested in commercial paper, and zero coupon bonds issued by a leasing company.

The country's main superannuation fund, the Employee's Provident Fund (EPF) recorded an increase in its activities in 1999. The total contribution received by the EPF amounted to Rs.13,600 million during the year, an increase of 13 per cent over the level in the previous year. The total member balances of the EPF increased by 15 per cent to reach Rs.172,000 million at end 1999, while the refunds paid to members amounted to Rs.7,500 million in 1999. The total value of EPF investments at end 1999 stood at Rs.188 billion. The EPF is the largest single investor Fund in the country. It has invested the major share of its funds in government paper.

The country's second superannuation fund, the Employee's Trust Fund (ETF), also recorded significant growth in 1999. Total assets of the ETF increased by 7 per cent to reach Rs.24,350 million at end 1999. Total

Chart 10.5
Employees' Provident Fund

Chart 10.5.1
Contributions and Refunds

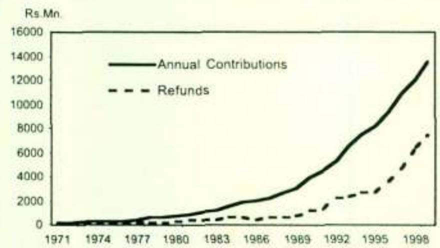


Chart 10.5.2
Rate of Return on Investments

contributions received increased from Rs.2,272 million in 1998 to Rs.2,374 million at end December 1999. Total investments increased by Rs.3,303 million to Rs.25,243 million at end 1999. The bulk of these investments was in government securities, which accounted for 70 per cent of total investments compared with a 71 per cent in the previous year. Investments in Treasury bonds and Rupee securities rose by 89 per cent and 53 per cent, respectively, while investments in Treasury bills decreased by 25 per cent. Time and savings deposits with commercial banks showed a four fold increase. Other investments, including investments in debentures, shares, unit trusts, commercial paper and corporate bonds, decreased by 10 per cent in 1999.

Long-Term Lending Institutions

Reflecting some slowing down in the lending activities of DFCC Bank in 1999, the value of loans approved decreased by 17 per cent to Rs.7,005 million in 1999. The number of loans approved during the year also fell from 1,418 in 1998 to 1,163 in 1999. However, the total amount of loans disbursed increased by Rs.1,294 million to Rs.5,571 million. The total loans outstanding also increased by Rs.1,541 million to Rs.15,054 million at end 1999. The majority of loans disbursed during the year were to the financial sector (45 per cent) and for industrial purposes (40 per cent). The agriculture sector absorbed 10 per cent of total loans granted. The tourism sector, housing sector and commercial sector utilised 2 per cent, 1 per cent and 0.1 per cent of total loan disbursements, during the year, respectively. Of the total loans granted, loans granted for other purposes including community and social services, electricity, gas and water, and transport services accounted for 2 per cent of total loan disbursements. DFCC Bank provided Rs.137 million for equity financing during the year. A major share (84 per cent) of equity financing was to the industrial sector.

Of the total loan outstandings, 33 per cent were long-term, 49 per cent were medium-term and 18 per cent were short-term. Of total loans outstanding 91 per cent were above Rs.1 million and the majority were secured loans. Meanwhile, 88 per cent of total loan disbursements in the year were at an interest rate in the range of 13-19 per cent per annum.

The main sources of funds of DFCC Bank during the year were lease amortisation (22 per cent), repayment of loans by customers (18 per cent), NDB refinance (13 per cent), IDA, ADB Credit Lines (12 per cent) and sale of shares (11 per cent).

The other major long-term lending institution National Development Bank (NDB) also showed a downturn in its lending activities. The total value of loans approved dropped significantly from Rs.21,903 million in 1998 to Rs.12,411 million in 1999. Following the same trend, the total loans granted during the year dropped by 19 per cent and stood at Rs.11,760 million, while the total loans outstanding decreased by 6 per cent to reach Rs.20,584 million at end 1999.

As in the previous year, the industrial sector received the largest portion of credit from the NDB and accounted for 47 per cent of total loans approved during the year. The commercial sector, the housing sector and the tourism sector accounted for 14 per cent, 7 per cent and 5 per cent of total loans approvals, respectively. The agriculture sector received 4 per cent of total loan approvals. Loans for other purposes, including electricity, gas and water, transport, shipping and warehousing accounted for 23 per cent of total

Table 10.14
Loans Approved and Granted by Long-term Credit Institutions by Purpose

Rs. Million

Purpose	DFCC Bank		NDB(a)		NSB		SMIB		HDFC		NHDA		PSDBs (c)		Total		% of Total Loans Approved	
	1998	1999	1998	1999	1998	1999	1998	1999	1998	1999	1998(b)	1999	1998	1999	1998	1999	1998	1999
Agriculture	1,153	714	2,864	490	-	-	13	9	-	-	-	-	44	37	4,074	1,250	8.9	4.1
Industry	5,114	4,564	15,035	5,772	-	-	-	-	-	-	-	-	283	211	20,432	10,547	44.6	33.8
Tourism	126	61	782	668	-	-	-	-	-	-	-	-	10	49	918	778	2.1	2.5
Commercial	591	-	1,429	1,758	-	-	-	-	-	-	-	-	1,082	938	3,102	2,696	6.8	8.6
Financial	766	1,345	340	70	5,240	1,120	-	-	-	-	-	-	21	28	6,367	2,563	13.9	8.2
Housing	-	149	275	828	679	1,584	1,540	1,598	684	540	1,765	2,140	152	70	5,096	6,909	11.1	22.1
Redemption of Debt	-	-	-	-	59	32	17	18	-	-	-	-	19	1	94	50	0.2	0.2
Other Loans	728	172	1,177	2,825	3,286	2,975	19	54	-	-	-	-	478	386	5,688	6,412	12.4	20.5
Total (Approved)	8,478	7,005	21,902	12,411	9,264	5,711	1,589	1,679	684	540	1,765	2,140	2,089	1,720	45,771	31,205	100.0	100.0
Loans Granted (d)	4,277	5,571	14,536	11,760	7,960	5,587	1,248	1,736	530	525	860	1116	2,081	1,720	31,491	28,015		
Loans Granted as a percentage of total approved	50	80	66	95	86	98	79	103	77	97	49	52	100	100	69	90		

(a) Includes refinance and equity investments
(b) Revised to exclude grants
(c) PSDB-Private Savings and Development Banks.
(d) Includes loans approved in previous years and disbursed during the period under review.

Sources: DFCC Bank
National Development Bank (NDB)
National Savings Bank (NSB)
State Mortgage and Investment Bank (SMIB)
SANASA Development Bank
Pramuka Savings and Development Bank
Housing Development Finance Corporation (HDFC) of Sri Lanka
Naional Housing Development Authority (NHDA)

loan approvals of the year. Compared with the previous year, total loan approvals to the agriculture sector, industrial sector, tourism sector and financial sector showed a decline, while total loan approvals to the commercial sector, housing sector and other sectors indicated an improvement. All loan approvals were loans below Rs.1 million and 98 per cent loans were with interest rates in the range of 12-19 per cent. Of the total loans outstanding 80 per cent were medium-term, 16 per cent were long-term and 4 per cent were short-term. The main sources of funds of the NDB were the issue of debentures (37 per cent), the repayment of loans by customers (29 per cent), and international credit lines (12 per cent).

The State Mortgage and Investment Bank (SMIB), which focusses mainly on housing finance, increased its long-term lending activities during the year. Total loan approvals increased by 6 per cent to Rs.1,679 million, while loans granted during the year also rose from Rs.1,248 million to Rs.1,736 million. Total loan approvals to the housing sector, which accounted for 95 per cent of total loan approvals, increased by 4 per cent during the year. Of the total loan approvals, 87 per cent of loans were long-term (i.e. over 5-years) and 12 per cent loans were medium-term. The majority of loan approvals were above Rs.100,000 and secured against land and property. The total deposits of the SMIB increased from Rs.2,516 million to Rs.3,093 million at the end of 1999. The one year fixed deposit rate offered by the SMIB, which was 12 per cent at the beginning of the year, was increased to 12.5 per cent in February 1999. Lending rates remained at 15-17 per cent during the year. The total assets of the SMIB increased to Rs.7,459 million, an increase of 12 per cent during the year. The main sources of funds of the SMIB were repayment of loans by customers (67 per cent) and fixed deposits (25 per cent of total sources of funds).

Loans approved and granted by the two private savings and development banks (PSDBs) decreased to Rs.1,720 million, a decrease of 18 per cent over the year. The major recipients of credit were the commercial sector (55 per cent), industrial sector (12 per cent) and housing sector (4 per cent). Of the total loan oustandings, 68 per cent were medium-term, 27 per cent were short-term and 5 per cent were long-term. The majority of loans were above Rs.1 million loans and carried an interest rate above 20 per cent. The main sources of funds of the PSDBs were deposits and repayments of loans by customers and new capital contributions.

The Housing Development Finance Corporation of Sri Lanka (HDFC), whose primary function is to provide loans for housing development in Sri Lanka, approved 3,115 loans to the value of Rs.540 million in 1999. In comparison, 4,908 loans to the value of Rs.684 million were approved in 1998. The total value of loans disbursed during the year was Rs.525 million, a marginal decrease from the previous year. The term structure of loans indicates that 97 per cent of loans were long-term. The majority of loans were above Rs.100,000 and were secured against a property mortgage and carried an interest rate of 16-19 per cent. The major source of funds for the HDFC were recovery of interest, repayments of loans by customers and new capital contributions. The National Housing Development Authority (NHDA) also continued to engage in providing credit facilities for housing activities. The NHDA approved Rs.2,140 million in 1999. Total loans granted increased from Rs.860 million to Rs.1,116 million. All the loans granted were below Rs.50,000 and carried an interest rate of 10-16 per cent.

Finance Companies

The total assets/liabilities of finance companies (FCs) expanded at a slightly higher rate in 1999 (17.7 per cent) than in 1998 (17 per cent). In comparison, total assets of commercial banks increased by 14 per cent in 1999 and 13 per cent in 1998. Finance company assets amount to approximately 5 per cent of the assets of the domestic units of commercial banks.

Loans and advances form the most important component of assets (65 per cent), followed by investments (14 per cent), and fixed assets (8 per cent). Although slight variations are seen, this composition has remained stable. On the liabilities side, fixed deposits accounted for 59 per cent of the total in 1999, while capital and reserves provided 15 per cent, other liabilities 12 per cent and borrowings accounted for 7 per cent. Borrowings increased in importance as a source of funds in 1998 and have remained approximately at the same level in 1999. Although provisions for bad and doubtful debt recorded a moderate growth in 1999, the bad and doubtful debt as a percentage of total assets remained unchanged at a 3 per cent level in 1999. Capital and reserves have increased as a proportion of total liabilities. This is a healthy development in that it increases the stability of the sector by increasing its ability to withstand short-term fluctuations in profitability.

Loans and advances, the major category of assets of FCs, recorded a slightly lower growth in 1999 (17 per cent)

TABLE 10.15
Assets and Liabilities of Licensed Finance Companies

Rs. Million

Item	As at 31 December 1998	As at 31 March 1999	As at 30 June 1999	As at 30 September 1999	As at 31 December 1999
Assets					
1.Loans and Advances	17,175	17,880	18,587	19,124	20,041
Hire Purchase	2,355	2,187	2,101	1,950	1,807
Leasing	9,807	10,509	10,965	11,645	12,187
Real Estate	2,151	2,142	2,295	2,087	2,157
2.Equity Investments	1,875	1,990	1,870	1,906	2,043
3.Treausry Bills	1,949	2,079	2,214	2,268	2,242
4.Cash and Bank Balances	781	966	883	893	939
4.Fixed Assets	2,288	2,387	2,468	2,612	2,501
5.Other Assets	2,021	2,722	2,941	2,838	2,942
Total	26,089	28,024	28,963	29,641	30,708
Liabilities					
1. Capital Account	3,769	4,504	4,613	4,603	4,700
2. Fixed Deposits	15,195	15,968	16,711	17,568	18,124
3. Certificate of Deposits	881	964	1169	937	986
4. Borrowings	1910	2066	1836	1,766	2,008
5. Provisions	1,059	1,106	1,154	1,228	1,143
6. Other Liabilities	3,275	3,416	3,480	3,539	3,747
Total	26,089	28,024	28,963	29,641	30,708
No. of Finance Companies reporting to the Central Bank	25	25	25	25	25

Source: Central Bank of Sri Lanka

than in 1998 (18 per cent). In comparison, credit to the private sector from the domestic banking units of commercial banks was 13 per cent in 1998 and 12 per cent in 1999. Some diversification has been seen in the structure of the portfolio of loans and advances. The share of credit given for leasing has increased at the expense of credit for hire purchase and real estate development though the finance companies face stiff competition in leasing activities from some commercial banks and other specialised institutions in this field. The imposition of the Goods and Services Tax (GST) has affected the hire purchase business, as customers are required to bear the GST for the total market value of the vehicle without regard to the amount of the refinance facility, when a hire purchase contract is entered into with a FC. The reduced lending for real estate development is attributed to the prevailing sluggish market conditions in real estate activity.

The portion of investments in FCs assets amounted to 14 per cent, of which more than one half is invested in government paper. However, investments in government paper slowed down in 1999. Other assets of FCs increased by 46 per cent in 1999, in comparison to the 9 per cent growth recorded in 1998, attributed mainly to an increase in trading activities in some imported goods, resulting in the holding of increased stocks. Meanwhile, cash and bank balances of FCs rose by 20 per cent in 1999, in comparison to a drop by 22 per cent in 1998.

Total deposits of FCs (including fixed deposits and certificates of deposit), the major component of liabilities, increased at a faster rate in 1999 (19 per cent) than in 1998 (14 per cent). Correspondingly, the growth in borrowings slowed down, although borrowings remained a more important source of funds than in 1997. Meanwhile, provision for bad and doubtful debt of FCs increased by 14 per cent in 1999, in comparison to a drop by 34 per cent in 1998. The capital base of FCs increased by 25 per cent in 1999, with a surge in undistributed profits.

10.10. Specialised Financial Institutions

Merchant Banking

The total number of merchant banks remained at 10 in 1999. A mixed performance was seen among the companies, with the industry as a whole recording a net loss on operations, although a growth in total assets was experienced. The downturn in economic activity in the first half of the year and the depressed stock market affected merchant bank profitability adversely. The total assets of the 10 merchant banks increased by 11 per cent to reach Rs.21,830 million. The total income of merchant banks stood at Rs.1,940 million, an increase of 30 per cent in 1999. The major sources of income were leasing, interest on Treasury bills, interest on discounting trade bills and interest on loans. Given the lacklustre performance of the share market, merchant banks focussed their operations and funds on other activities and investments. Consequently, the growth in income was mainly through increased income from leasing and interest on Treasury bills. Profits on investment in shares however, amounted to Rs.21 million in 1999, in contrast to a loss of Rs.431 million in 1998. Decreases were recorded in dividends received, income from financial and marketing consultancy services, interest on discounting trade bills and interest on loans. The pre-tax profit of merchant banks declined further during the year, from a loss of Rs.40 million in 1998 to a loss of Rs.503 million in 1999. Of the 10 merchant banks in operation, five incurred losses. One had a substantial loss, accounting for more than 75 per cent of the total pre-tax loss in the industry.

Leasing Companies

Five specialised leasing companies engaged in leasing activities during the year. A growth in the industry was seen as evident from the growth in total lease finance provided and total assets. The total assets of the leasing industry reached Rs.12,308 million, an increase of 23 per cent over the previous year. The total lease finance provided by the companies increased by 16 per cent and stood at Rs.5,417 million at end 1999. As in the previous year, lease finance was mainly for commercial vehicles (56 per cent) and passenger vehicles (20 per cent). Lease financing for commercial vehicles and passenger vehicles increased but decreased for plant and machinery and for office equipment.

TABLE 10.16

Progress of Activities of Merchant Banks 1998-1999

Rs. Million

	1998(a)	1999(b)
1 Earned Income on Leasing	472	532
2 Interest on Discounting Trade Bills	256	216
3 Financial and Marketing Consultancy Services	110	48
4 Underwritting Commissions	..	4
5 Insurance Commissions	1	1
6 Interest on Margin Trading	25	27
7 Profit on Investment in Shares	-431	21
8 Interest on Treasury Bills	91	243
9 Interest on Loans	268	212
10 Dividends	182	66
11 Other Income	514	571
12 Total Income	**1,488**	**1,940**
13 Pre Tax Profits	-40	-503
14 Total Assets	19,685	21,830
No of Merchant Banks reporting	10	10

(a) 1998 data have been revised according to new information received from merchant banks
(b) Provisional

Source: Central Bank of Sri Lanka

In terms of the sectorwise classification, as in the previous year, the trading sector received the major portion of finance provided (40 per cent) and showed an increase of 54 per cent over the previous year. Leasing facilities to the services sector, which accounted for 19 per cent of total finance, showed a 5 per cent decrease in 1999. Finance facilities to the transport sector and industry sector, which accounted, respectively, for 18 per cent and 16 per cent of total lease financing provided, increased by 1 per cent and 10 per cent, respectively. Lease financing to the agriculture sector and other sectors showed a decline in 1999.

Leasing companies indicated that the industry faced problems such as the high cost of funds, non-availability of long-term funds, increased overdues, and GST imposed on leases. The need for a regulatory and legislative framework governing the leasing industry was also noted.

Venture Capital Companies

The total number of venture capital companies (VCCs) operating in the country remained seven in 1999. Activities of the venture capital companies showed some setback during the year. Funds used for investment purposes decreased by 15 per cent. VCCs continued to provide long-term capital for the commencement of new business, expansion of existing ventures, acquisitions and buyouts, in addition to investing in shares and other financial instruments. Investments in equity came down from Rs.1,639 million in 1998 to Rs.1,327 million in 1999. Equity investment for commencement of operations, which holds the major share (57 per cent) of equity investments, decreased by 68 per cent during the year. Financing for expansion of ventures stood at Rs.322 million, an increase of 3 per cent over the previous year. Provision of funds for acquisition and buyouts increased from Rs.84 million to Rs.162 million in 1999. The total number of projects assisted by the VCCS increased from 136 in 1998 to 232 projects in 1999. The increase of 96 was accompanied by a large number of projects under the Graduate Entrepreneurs Loans Programme and the Non-Graduate Educated Youth Programme. In terms of the sectors that received funds, the manufacturing sector and the services sector were the major recipients of funds. Total assets of the VCCS grew by 1 per cent during the year.

VCCs are required to invest in specified risk ventures under Inland Revenue Department guidelines, if they wish to obtain certain tax advantages. The Budget for the year 2000 introduced a proposal to amend the Inland Revenue Department guidelines to enable approved venture capital companies to opt out of the tax holiday during the balance part of the tax holiday period and to expand investments in diversified activities such as in the priority sectors, and the software industry.

Insurance Companies

The insurance industry became more competitive in 1999 with the establishment of two new insurance companies, thereby increasing the total number of insurance companies to nine. The two new companies are the Co-operative Insurance Co. Ltd. and the Asian Alliance Insurance Co. Ltd. The activities of the insurance institutions increased during the year in the midst of intense competition. Growth was seen in the total assets base. Total assets of insurance companies (excluding Asian Alliance Insurance Co. Ltd. which commenced its business activities in January 2000) increased by 2 per cent to reach Rs.26,375 million at end 1999. However, net profits decreased by 1 per cent in 1999. The total branch network increased from 270 to 285 at end 1999, while the total employment in the industry was 7,075 as at end 1999. Life insurance activities as well as general insurance activities showed an improvement during the year.

The life assurance fund increased by 19 per cent to Rs.19,353 million at end 1999. The total premium collected in respect of new business increased to Rs.1,438 million, an increase of 9 per cent during 1999. The sums insured for new business also rose by 13 per cent. Meanwhile, the total number of policies of business in force increased to 903,000 at end 1999. The total sums insured and the total premium collected in respect of business in force rose by 12 per cent and 13 per cent, respectively. Total benefit payments on maturity, death and disability, surrender and others increased from Rs.1,309 million to Rs.1,701 million as at end 1999.

Net premia for policies in force with regard to general insurance increased by 9 per cent to Rs.4,969 million. Motor insurance and general accident insurance were the biggest sectors in general insurance category. Net premia on motor insurance and general accident insurance rose by 13 per cent and 7 per cent respectively. Net premia for fire insurance rose from Rs.561 million to Rs.577 million at end 1999. Following the same trend net premia on marine insurance rose by 4 per cent during the year.

Major changes are being effected in the policies relating to the insurance industry, including legislation which would lead to basic changes in the regulatory framework. The Budget for the year 2000 proposed permitting non-nationals to participate more in financial sector activities in the domestic economy. As a part of this process, the present restrictions on foreign equity holdings in insurance companies will be relaxed by allowing foreign ownership of upto 90 per cent in insurance companies.

10.11 Money Market

Overall Trends

Financial market stability was maintained throughout the year, despite some uncertainty resulting from factors such as elections, labour unrest, increased government borrowing and the Year 2000 issue. Although some volatility in call market rates were observed in March and April due to Provincial Council elections and labour unrest, the call money market and foreign exchange market were stable with the call market rates fluctuating within a relatively narrow range. The call market was generally liquid in 1999. Towards the latter part of the year the Central Bank took several steps to ensure the availability of liquidity in the market to counter any destabilising effects that could arise due to the Year 2000 problem. These measures achieved their intended purpose and the money market experienced no untoward developments in December.

Inter Bank Call Money Market

The improved liquidity situation in the market, particularly in the early part of the second half of 1999 due to the reduction of the SRR, and increased inter-bank activity led to a rise in the total turnover in the call money market from Rs.880,567 million in 1998 to Rs.955,054 million in 1999. Apart from some volatility of call market rates observed in March and April 1999, call market rates varied within a relatively narrow band of around 9.25-17.00 per cent throughout the year. The stability arose mainly because of the open ended repo and reverse repo facilities maintained by the Central Bank.

Primary Treasury Bill Market

Primary market yield rates on Treasury bills were generally stable throughout the year, compared to the slight rise in Treasury bill yield rates experienced, particularly in the second half, in 1998. The availability of liquidity in the market led to the over-subscriptions at all Treasury bill auctions, excluding one held in June. The total value of Treasury bills offered in the primary market was Rs.186,490 million in 1999 compared to Rs.217,022 million in 1998. The total outstanding level of Treasury bills increased from Rs.119,966 million at end 1998 to Rs.124,996 million in 1999. The current limit on government borrowing through Treasury bills, approved by Parliament, stood at Rs.125,000 million.

As a part of its monetary policy operations, and on one occasion, due to the under-subscription at the auction, the Central Bank purchased Rs.34,725 million worth of Treasury bills at the primary market auctions as against purchases of Rs.25,999 million in 1998. These purchases included Treasury bills reserved for the Central Bank, amounting to Rs.22,800 million in 1999 compared to Rs.11,600 million, in 1998, at the primary Treasury bill auctions. There were three special issues amounting to Rs.5,000 million, which were purchased entirely by the Central Bank. These operations resulted in the book value of the Central Bank's holdings of Treasury bills increasing from Rs.8,233 million at end 1998 to Rs.25,165 million at end 1999. It should be noted that a significant portion of this increase was in December, as the Bank injected liquidity into the market to provide stability in the context of the Year 2000 problem.

A new day count formula for Treasury bills, based on international norms, was introduced with effect from 20

TABLE 10.17
Money Market Operations 1997-1999

Rs. Million

Period	Call Money Market		Primary Treasury Bill Market						Secondary Treasury Bill Market (Central Bank)	
					Amount Accepted (Purchases)					
	Total Lending/ Borrowings	Outstanding at end period	Total Outstanding	Amount Issued	Central Bank	Commercial Banks	Others	Total	Total Sales	Total Purchases
1997										
1st Quarter	303,208	4,811	124,996	56,629	9,304	30,179	17,146	56,629	7,222	4,027
2nd Quarter	275,508	5,830	124,996	38,609	7,863	22,452	8,294	38,609	4,373	4,433
3rd Quarter	224,566	1,853	114,996	46,676	3,886	25,776	17,014	46,676	5,936	1,563
4th Quarter	212,175	3,599	114,996	68,973	4,245	44,906	19,822	68,973	1,289	7,197
1998										
1st Quarter	210,509	4,141	112,996	56,717	7,175	32,321	17,221	56,717	2,218	10,491
2nd Quarter	196,668	2,734	114,996	50,086	6,398	28,254	15,434	50,086	4,062	4,143
3rd Quarter	241,206	5,759	117,996	53,542	6,924	32,825	13,793	53,542	3,373	123
4th Quarter	232,184	4,272	119,996	70,338	5,502	44,740	20,096	70,338	1,738	105
1999										
1st Quarter	226,659	3,025	121,996	48,714	5,193	30,684	12,837	48,714	2,141	318
2nd Quarter	228,935	3,811	123,996	54,103	10,886	30,482	12,735	54,103	1,581	490
3rd Quarter	244,090	6,131	123,996	54,272	10,682	29,447	14,143	54,272	2,184	593
4th Quarter	255,370	6,520	124,996	57,201	12,964	33,877	10,360	57,201	920	25

Source: Central Bank of Sri Lanka

October 1999. Accordingly, Treasury bills were issued thereafter with 91 days, 182 days and 364 days of day counts to maturity instead of the 3-month, 6-month and 12-month Treasury bills issued upto 15 October 1999. This is intended to bring about uniformity with regard to day count without any time lag. Moreover, no 3-month Treasury bills were offered at the auctions on 22 September, 29 September and 06 October 1999, in order to reduce the amount of bills maturing towards the end of December 1999, as a precautionary measure to address any shortage in market liquidity arising from the Y2K issue.

Central Bank Secondary Market for Treasury Bills

The sales (discounting) of Treasury bills from the secondary window of the Central Bank declined substantially from Rs.11,390 million in 1998 to Rs.6,826 million in 1999. Similarly, purchases (rediscounting) of Treasury bills also fell significantly from Rs.14,862 million to Rs.1,426 million during the period under review reflecting the improved liquidity in the market.

Discount and rediscount rates in the secondary window of the Central Bank followed the trends witnessed in the primary market rates. With a view to encouraging the open market operations, the spread between the discount and rediscount rates, which was 3.15 percentage points at the beginning of the year was adjusted downward to 2.65 percentage points on 07 May and was maintained at the same level during the rest of the year.

Central Bank Repurchase (Repo) Market for Treasury Bills

During 1999, the major instrument of monetary policy continued to be open market operations, and as such, the Bank's repo and reverse repo windows were used extensively for these operations. Most commercial banks, and to a smaller extent non bank Primary Dealers, who also have access to the Central Bank's repurchase window, continued to make use of this facility to invest their short-term funds.

In view of steady decline in inflation and stable foreign exchange market, the overnight repo rate was gradually adjusted downward in several steps in 1999 and stood at 9.25 per cent at end 1999 compared to 11.25 per cent at end 1998.

Repo sales amounted to Rs. 307,636 million in 1999 in comparison to Rs.728,335 million in 1998.

Central Bank Reverse Repurchase (Reverse Repo) Market for Treasury Bills

The Central Bank's reverse repurchase facility was reintroduced in 1998. It is generally restricted to overnight transactions, but is open ended. Commercial banks and Primary Dealers are permitted to obtain liquidity, provided they have the required collateral, i.e., Treasury bills and bonds. High volumes were transacted particularly in April and December 1999, due to the temporary shortage of liquidity that prevailed during that period. This resulted in reverse repurchase sales in 1999 of Rs.124,956 million when compared with Rs.1,065 million in 1998. The reverse repo rate is linked to the yield on 3-month Treasury bills. The overnight reverse repo rate which was 15.00 per cent at end 1998, moved in a range of 13.41-15.00 per cent during 1999 and was 13.48 per cent at end December 1999.

From the mid December 1999, the Central Bank extended the maturity period for reverse repo transactions from overnight to 30 days and maintained the reverse repo rate at a fixed level, to reduce volatility in the call market rates, due to uncertainties and aberrations caused by the Y2K issue.

Domestic Foreign Exchange Market

The Central Bank continued to operate in the domestic foreign exchange market, by trading its intervention currency, the US dollar, against Sri Lanka rupee. The Bank quotes daily spot buying and selling rates for the US dollar for transactions with commercial banks. The spread between the spot buying and selling rates which was revised upward in 1995 from 1 per cent to 2 per cent, was maintained at the same level. The Central Bank middle rate depreciated by 6.0 per cent from Rs.67.7800 per US dollar at the end of 1998 to Rs.72.1150 per US dollar at the end of 1999. Purchases by the Central Bank from commercial banks declined from US 61.1 million in 1998 to US dollars 0.4 million in 1999. Meanwhile, sales of foreign exchange by the Central Bank to commercial banks was also low in 1999, amounting to US dollars 58.2 million, in comparison to US dollars 214.8 million in 1998. Hence, net purchases of foreign exchange from the Central Bank by commercial banks declined from US dollars 154 million in 1998 to US dollars 57.8 million in 1999. Total inter-bank turnover amounted to US dollars 2,382 million in 1999 compared to US dollars 4,409 million in 1998. The inter-bank forward transactions declined from US dollars 696 million in 1998 to US dollars 458 million in 1999.

With a view to providing exporters with relatively low cost funds to improve their international competitiveness, a scheme was introduced with effect from January 1997, permitting commercial banks to grant foreign currency loans to non-BOI exporters either from their domestic units or from their FCBUs. Under this scheme, a gross sum of US dollars 124.1 million (approximately Rs.8,754 million) was granted as credit during 1999 as against US dollars 177 million (approximately Rs.11,425 million) granted in 1998. This resulted from the decline in attractiveness of domestic borrowers obtaining foreign currency loans. Under this scheme, a gross sum of US dollars 555.4 million (approximately 35,195 million) had been granted upto end 1999. The outstanding level of credit stood at US dollars 34.6 million at end December 1999.

Central Bank Securities

In view of availability of government paper in the Central Bank's portfolio for open market operations, there was no necessity to issue Central Bank securities in 1999.

Commercial Paper (CP)

Commercial paper continued to be issued during the year as a way of meeting short-term liquidity requirements of corporates at attractive rate of interest. Listed companies as well as merchant banks issue commercial papers with maturity periods of 3-6 months. Such paper can be supported by commercial banks, subject to the guidelines issued by the Central Bank.

The gross issues of commercial paper, including reissues, in 1999 was Rs.16,203 million compared to Rs.16,457 million in 1998. (This value relates only to CP issued with the involvement of either commercial banks or merchant banks). During 1999, merchant banks issued Rs.642 million of commercial paper on their own account, while they supported companies to issue commercial paper totalling Rs.1,337 million. However, the bulk of commercial paper, amounting to Rs.14,224 million (88 per cent), was issued with the support of the commercial banks. The outstanding value of commercial paper at end 1999 was Rs.4,356 million. During the year, the yield on commercial paper varied within a range of 11.50-18.00 per cent per annum.

10.12 Capital Market

Although some improvements in stock prices were seen at the Colombo Stock Exchange (CSE) in some months of 1999, the year as a whole saw an overall decline in share prices. Many Asian and international markets improved during the year as the East Asian countries recovered from the financial crisis in 1997 and 1998. However, a corresponding improvement was not seen in the Sri Lankan market. Market sources attributed this to the uncertainty associated with elections and the poor performance of some major listed companies during the first half of the year. Of the 16 sectors in the market, only 5 sectors showed an improvement in prices during the year. The All Share Price Index declined by 4.2 per cent and the new price index, the Milanka Price Index, introduced in place of the Sensitive Price Index (SPI) with effect from 4 January 1999 (1998=1000), declined by 6.2 per cent. However, the decline in prices was less than in 1998, which recorded a 15 per cent decline in the ASPI and a 13 per cent decline in the SPI. Foreign investors continued to be net sellers, with the net outflow amounting to US dollars 13 million, compared with a net outflow of US dollars 23 million in 1998. Meanwhile, market capitalisation decreased by 3 per cent in 1999. There were 4 new listings and 7 delistings of companies during the year, resulting in the number of companies listed on the CSE declining to 237 at the end of 1999, from 240 at the end of 1998. Three plantation companies, a bank and a hotel sector company made Initial Public Offers (IPO). Only two of these offers, were over-subscribed.

A positive feature of the capital market was a further development in the corporate debt market during the year. Five listed debenture issues were made by five companies, viz., two commercial banks, a merchant bank, a development bank and a leasing company, during the year. The total value of issues amounted to Rs.1,770 million. In contrast to the equity IPOs, all debenture issues were over-subscribed. By end 1999, the market capitalisation of listed debenture amounted to Rs.4.6 billion compared to Rs.3.7 billion at the end of 1998. This expansion in listed corporate debt instruments is encouraging as it broadens the capital market and provides an alternative avenue of investment for savers, while helping companies to raise funds.

A continued expansion in market based government bond issues was seen during the year. The issue of market oriented Treasury bonds commenced in 1997 and by end 1998 issues had been made for three maturities, i.e., 2, 3 and 4 years. During 1999, 5-year and 6-year bonds were also introduced. Treasury bonds carry a coupon rate and are sold by auction. The total issue of new Treasury bonds, which amounted to Rs.10,000 million in 1997, rose to Rs.38,915 million in 1998 and Rs. 63,452 million in 1999.

Primary Market

During 1999 five IPOs were made by three plantation companies, (Metropolitan Resource Holdings Ltd. and Namunukula Plantations Ltd. and Talawakele Plantations

TABLE 10.18

Share Market Indicators

	1997	1998	1999
1. Market Capitalisation (Rs.Mn.)	129,428	116,660	112,800
2. Number of New Issues (No.)	5	6	5
3. Total Number of Shares Issued (Mn.)	50	28	38
4. Value of New Shares Issued (Rs.Mn.)	456	349	537
5. Number of Shares Traded (Mn.)	515	634	486
6. Value of Shares Traded (Rs.Mn.)	18,315	18,130	14,293
7. Price Indices - CSE All Share (as at 31st Dec.)	702.2	597.3	572.5
- CSE Sensitive (as at 31st Dec.)	1,068.0	923.0	
- Milanka (as at 31st Dec.)	-	1,000.0	937.5

Source : Colombo Stock Exchange

Ltd.), a commercial bank, (Nations Trusts Bank Ltd.) and a hotel sector company (Ruhuna Hotels & Travels Ltd.). Four companies were subsequently listed on the CSE in 1999. The par value per share of all five issues was Rs.10, while Namunukula Plantations Ltd. (premium Rs.5), Metropolitan Resources Holdings Ltd. (premium Rs.15) and the Nations Trust Bank Ltd. (premium Rs.2) issued shares at a premium. The issues made by Nations Trust Bank Ltd. and Talawakele Plantations Ltd. were over-subscribed. The total value of shares subscribed by the public and the underwriters was Rs.441 million. The total value of rights issues made during 1999 was Rs.1,008 million compared with Rs.1,960 million during 1998. Meanwhile, bonus issues were made by 17 companies to the value of Rs.858 million.

The debt securities market saw a further development with five listed debentures being issued during the year. These issues were made by 5 listed companies, viz., Mercantile Leasing Ltd., People's Merchant Bank Ltd., Sampath Bank Ltd., National Development Bank and the Seylan Bank Ltd. The maturity period of the debentures varied from 4-5 years, while they carried interest rates ranging from 13.5 per cent to 16.0 per cent per annum. The National Development Bank offered a floating rate of interest. All the issues were over-subscribed and the total amount raised through these issues was Rs.1,770 million.

TABLE 10.19
Number of New Share Issues by Type of Investment

Type of Investments	1997	1998	1999
Banks Finance & Insurance	1	-	1
Beverages Food & Tobacco	-	-	-
Chemicals & Pharmaceuticals	-	-	-
Constructions & Engineering	-	-	-
Diversified	-	-	-
Footwear & Textile	-	-	-
Hotels & Travels	2	1	1
Investment Trusts	-	-	-
Land & Property	-	-	-
Manufacturing	-	-	-
Motors	-	-	-
Oil Palm	-	-	-
Plantations	2	5	3
Services	-	-	-
Store & Supplies	-	-	-
Trading	-	-	-
Total	5	6	5
Number of shares offered (Mn.)	50	28	38
Value of shares offered (Rs. Mn)	583	349	537

Source: Colombo Stock Exchange

Chart 10.6
Share Market Indicators

Chart 10.6.1
Share Price Indices

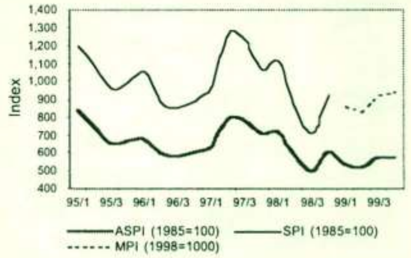


Chart 10.6.2
Stock Market Transactions

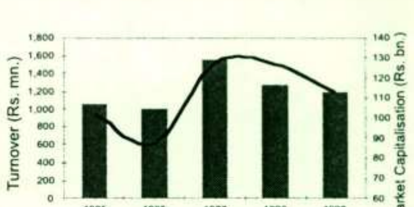
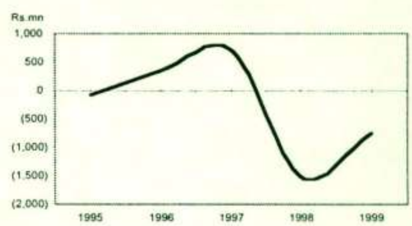


Chart 10.6.3
Non-National Participation



Secondary Market

Share prices at the CSE declined in 1999, though not as much as in 1998. Some improvements in prices were seen in July and December. However, for the year as a whole, prices declined by 25 index points (4.2 per cent) in the ASPI and 62 index points (6.2 per cent) in the MPI and

TABLE 10.20
New Share Issues of Companies during 1999 (a)

	Name of Company	Date of Opening List	No. of Shares (Thousands)	Par Value (Rs.)	Premium (Rs.)	Value of Shares on Offer (Rs. Mn.)	No. of Shares Subscribed for by Public (Thousands)	No. of Shares Taken up by Underwriters (Thousands)
1	Namunukula PlantationS Ltd.	10.0399	4,000	10	5	60	3,998	2
2	Ruhunu Hotels & Travels Ltd.	10.03.99	4,500	10	-	45	2,404	-
3	Metropolitan Resource Holdings Ltd.	12.03.99	6,285	10	15	158	278	3,028
4	Nations Trust Bank Ltd	19.03.99	19,500	10	2	234	19,500	-
5	Talawakelle Plantations Ltd.	09.11.99	4,000	10	-	40	4,000	-

(a) Based on the date of issue to the public

Source: Colombo Stock Exchange

reached 572.5 and 937.5 respectively, at the end of the year. This decline was attributed mainly to investor caution due to uncertainty generated by elections and the poor performance recorded by many major listed companies during the early part of the year.

Market capitalisation of the CSE fluctuated during the year, reflecting the movements of share prices. Following some improvement in prices, the highest level of market capitalisation recorded during the year, Rs.113,600 million, was seen in July. The lowest level during the year was recorded in March (Rs.104,900 million). For the year as a whole, market capitalisation declined by 3 per cent and stood at Rs.112,800 million at the end of December 1999. Nearly 40 per cent of market capitalisation in Sri Lanka comes from 10 institutions, namely, John Keells Holdings, Ceylon Tobacco, DFCC Bank, HNB, NDB, Commercial Bank, Hayleys, Aitken Spence, Nestle Lanka and Coca Cola. Four of these are financial institutions, including two commercial banks.

TABLE 10.21
Category-wise Distribution of Shares Traded in the Secondary Share Market in 1999

Category of Investment	No of Transactions	No. of Shares ('000)	Value (Rs. Mn.)
Banks, Finance & Insurance	47,291	127,603	4,368
Beverages, Food & Tobacco	15,711	46,714	816
Construction & Engineering	5,373	13,086	237
Chemicals & Pharmaceuticals	2,376	2,665	64
Diversified	8137	30,426	4,099
Footwear & Textiles	1,826	4,330	13
Hotels & Travels	11,259	79,798	950
Investment Trusts	571	1,209	14
Land & Property	3,491	7,446	49
Manufacturing	31,438	97,932	2,148
Motors	2,381	11,635	501
Oil Palms	19	3	1
Plantations	72,587	58,944	922
Services	1,026	898	29
Stores & Supplies	325	205	3
Trading	1,948	2,926	77

Source : Colombo Stock Exchange

Total turnover too declined, from Rs.18,130 million in 1998 to Rs.14,294 million in 1999. The average daily turnover decreased from Rs.75 million in 1998 to Rs.59 million in 1999. The highest monthly turnover, amounting to Rs.2,109 million, was recorded in July while the lowest turnover, Rs.481 million, was recorded in April. The largest share (30 per cent) of the total turnover was in the banks, finance and insurance sector. The market price earnings ratio (PER) remained at a low level. During January-May 1999, it was in the range of 8-9, but declined to 5.8 in June, the lowest level recorded during the year. Thereafter, it saw a slight improvement and remained in the range of 6-7. PER at the end of December was 6.6.

Foreign investor participation at the Colombo Stock Market continued to be at a low level during the year. Although major regional and international stock markets recovered from the adverse impact of the Asian crisis and recorded healthy returns in 1999, a net foreign outflow continued to be recorded at the CSE. Overall foreign transactions during the year recorded a net foreign outflow of Rs.902 million (US dollars 13 million), although this was much less than the net outflow of Rs.1,517 million (US dollars 23 million) recorded in 1998. As in 1998, foreign participation accounted for approximately 35 per cent of the total turnover during 1999.

Sectoral Performance

Sectoral price indices saw declines in prices for most sectors during the year. Of the 16 sectors, price decreases were recorded in 11 sectors. The trading sector was the biggest loser with prices decreasing by 18 per cent. Among the other sectors which had significant decreases in prices were construction and engineering, footwear and textile, banks, finance and insurance, manufacturing, beverage, food and tobacco and services. The oil palms sector indicated the highest growth in prices (41.2 per cent). Motors, hotels and travel, stores and supplies and diversified also achieved price improvements during the year.

Regional and Major International Stock Markets

Most regional and Western stock markets performed well in 1999. Among the regional markets significant improvements in prices were seen in Singapore (73 per cent), Seoul (65 per cent), Jakarta (64 per cent), Hong Kong (63 per cent), Bombay (61 per cent), Karachi (48 per cent) and Kuala Lumpur (45 per cent). Among others, Bangkok, Sydney, Taipei and Manila recorded improvements in price indices.

In the developed markets, the Dow Jones Industrial Average Index for the New York Stock Exchange recorded a 30 per cent growth, while the Nikkei Stock Exchange Index for Tokyo and the Financial Times Stock Exchange Index for London recorded 29 per cent and 21 per cent increases, respectively.

Developments in the Market

The Colombo Stock Exchange, expanded its activity beyond Colombo opening its first Investor Services Centre (ISC) in Matara in June 1999, with the objective of improving the domestic investor base. The ISC will provide investors in the Southern Province with facilities similar to those enjoyed by investors in Colombo, such as access to online trading, share prices and online information, stock broking services and other connected facilities, including the opening of accounts in the Central Depository System

TABLE 10.22
Listed Debenture Issues During 1999

	Issuer	Date	Maturity Period	Type of Debenture	No. of Debentures	Price per Debenture	Amount Rs. (Mn.)	Interest Rate	Over subscribed/ Under subscribed
1	Mercantile Leasing Ltd.	08.02.99	5 yr	Guaranteed Redeemable Debentures	2,200,000	100	220	14% p.a. (payable half yearly)	Over subscribed
2	People's Merchant Bank	22.04.99	4 yr	Guaranteed Redeemable Debentures	1,500,000	100	150	13.5% p.a. (payable quarterly)	Over subscribed
3	Sampath Bank	08.07.99	5 yr	Unsecured Subordinated Redeemable Debentures	500,000	1000	500	14.2% p.a. (payable quarterly)	Over subscribed
4	National Development Bank	07.09.99	5 yr	Unsecured Subordinated Redeemable Debentures	500,000	1000	500	12.5% -16% p.a. (payable quaterly)	Over subscribed
5	Seylan Bank Ltd.	09.11.99	5 yr	Unsecured Subordinated Redeemable Debentures	400,000	100	400	14.2% p.a. (payable quarterly) 13.35% p.a. (payable monthy)	Over subscribed
	Total				5,100,000		1,170		

Chart 10.7
Stock Prices

Chart 10.7.1
Comparison with Major International Markets
(98 Dec=100)

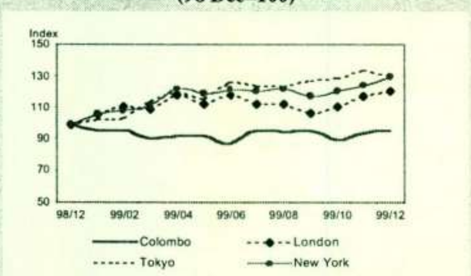
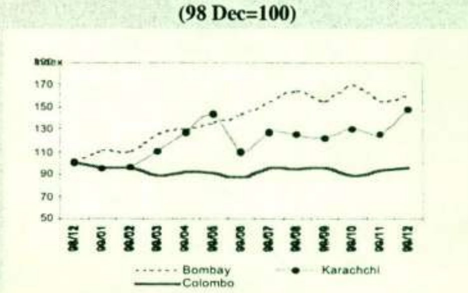


Chart 10.7.2
Comparison with South Asian Markets
(98 Dec=100)



(CDS) and deposits of share certificates. The ISC will also act as an information centre for market information and listed company information and will conduct awareness programmes for the benefit of investors and other interested parties on the activities of the capital market.

A new price index, the Milanka Price Index (MPI), was introduced on 04 January 1999 in place of the Sensitive Price Index (SPI). Its base value was set at 1000 on 31 December 1998. In selecting companies to be included in the MPI, the major criteria used were market size, which is measured by market capitalisation, and liquidity, which is the frequency of transactions. In addition, the returns on shares, which is the difference between the nominal price and market price, the dividend record of the company and the earnings per share have also been taken into consideration. Based on these factors, 25 companies are included in the MPI. The sectors represented in the MPI include banks, finance and insurance, beverages, food and tobacco, construction and engineering, diversified, hotels and travels, manufacturing and plantations. These 25 companies account for approximately 10 per cent of all listed companies and 55 per cent of the total market capitalisation. The CSE plans to revise the companies included in the MPI annually. According to a study done by the CSE, the correlation between the ASPI and the MPI is 99.5 per cent, which shows that the MPI reflects the movement of the market.

The Merchant Bank of Sri Lanka Limited (MBSL) introduced a new share price index named the 'Midcap Index' in September 1999 to measure the price movements of medium size companies. This index is based on 25 stocks, selected on the basis of market size, liquidity and the profitability. The base index was set at 1000 at 31 December 1998. The index increased by 0.6 per cent to reach 1006 at the end of December 1999.

The Securities and Exchange Commission (SEC) also plans to permit brokers to engage in margin trading and dealing activities to provide stock brokers additional ways of generating revenue. At present, the only source of revenue of stock brokers is the transaction commissions. With effect from November 1999, the SEC introduced a set of new rules to activate the debt market.

Duff and Phelps Credit Rating Lanka Limited (DCR Lanka), the first credit rating agency in Sri Lanka, was established during the year as a public limited liability company. Duff and Phelps Credit Rating Company, USA (DCR USA),which is a global rating agency, is the major shareholder and is also the technical partner in DCR Lanka Limited. (See Box 10).

Medium and Long-term Government Securities

Treasury Bonds

The issue of Treasury bonds, which commenced in 1997, continued to expand in 1999, giving signals to the market on the expected direction of medium-term interest rates. The issue of these bonds provides the private sector with medium-term benchmark interest rates and also provides a risk free yield for a period of beyond the one year provided by the Treasury bills. Reflecting the popularity of Treasury bonds among the public, all auctions were over-subscribed. It also appears that customers at the reverse repurchase window at the Central Bank prefer to use Treasury bonds rather than Treasury bills as collateral. This is possibly due to these bonds currently being held mainly as long-term investments.

Another major development in the Treasury bond market in 1999 was the issue of longer maturities of Treasury bonds, viz., 5-year and 6-year Treasury bonds, in March 1999 and in September 1999, respectively. This was a further step in providing a medium-term risk free yield curve. The coupon rates for these issues were 11.75 per cent and 12.00 per cent, respectively. Jumbo issues which were introduced in 1998, continued in 1999 with the issues of 18 series of Treasury bonds. These issues comprised 4 series of 2-year bonds (13 issues), 6 series of 3-year bonds (24 issues), 5 series of 4-year bonds (17 issues), 2 series of 5-year bonds (7 issues) and 1 series of 6-year bonds (one issue) during the year. In contrast to the rising trend observed in 1998, yield rates on Treasury bonds were relatively stable in 1999. The yield on 2-year, 3-year, 4-year and 5-year Treasury bonds were in the ranges of 12.64-13.42 per cent, 12.79-13.95 per cent and 13.21-14.02 per cent and 13.30-13.97 per cent, respectively. The yield on 6-year bonds at the single auction held for that maturity was 13.65 per cent. The total gross value of Treasury bonds issued under the different series amounted to Rs.63,452 million in 1999, while Treasury bonds are gradually replacing Rupee loans as the means by which the government borrows long-term. New Treasury bond issues, which amounted to Rs.10,000 million in 1997, were Rs.28,915 in 1998 and Rs.55,952 in 1999. At end 1999, the total value of outstanding Treasury bonds stood at Rs.113,822 million. Reverse repo transactions in Treasury bonds at the Central Bank secondary window increased substantially from Rs.381 million in 1998 to Rs.75,634 million in 1999.

Meanwhile, a special issue of 3-year Treasury bonds amounting to Rs.1,500 million was made in May, 1999. This issue enabled the Sri Lanka Insurance Corporation Ltd. to reinvest its maturing rupee loans amounting to Rs.1,500 million. Moreover, no bids were accepted at the auction held on 07 October 1999, owing to bid rates being unacceptably high.

Rupee Loans

Under the Rupee loan programme, government obtains medium-and long-term funds to finance its expenditure. In

Box 10

Credit Rating

Credit rating is an assessment of the creditworthiness of an issuer of a debt or equity instrument. The issuer could be a firm or a sovereign government. Credit rating is a product that has developed in the market to counter problems of asymmetric information[1]. Asymmetric information is the term used to describe a situation where, when two parties are involved in a transaction, one party may have more information than the other about factors affecting the performance of the market, such as the product quality and the nature of the market. The existence of asymmetric information could give rise to two problems, 'adverse selection' and 'moral hazard'[1].

Adverse selection refers to a situation where, in a selection process, those with higher than average risk get selected. Adverse selection occurs before a transaction takes place. Adverse selection arises since it is difficult at the outset to distinguish between good and bad credit risks. In the financial field potential bad credit risks are the ones who most actively seek out loans. Thus, the parties who are the most likely to produce an undesirable outcome are those that are the most likely to want to engage in the transaction. Because adverse selection increases the chances that a loan might be made to a bad credit risk, lenders may decide not to make any loans, even though there are good credit risks in the market place[1].

Moral hazard refers to a situation where a individual or firm takes advantage of special knowledge, while engaging in socially uneconomic behaviour. Moral hazard arises after the transaction occurs. The lender runs the risk that the borrower will engage in activities that are undesirable from the lender's point of view because they make it less likely that the loan will be paid back. Thus, lenders may decide that they would rather not make a loan[1].

Asymmetric information problems could lead to market failure as illustrated in the seminal work by Akerlof[2]. Akerlof showed that any doubts or lack of information on the quality of goods could lead to demand suppression. Thus, buyers of goods are only willing to pay a lower price. However, suppliers with good quality products are not willing to supply at those prices. Thus, the absence of any mechanism to verify the quality will lead to the failure of the market.

One of the solutions to the asymmetric information problem is the production of private information. Credit information and credit rating provide information on the repayment capability of borrowers and avoids the adverse selection problem to a large extent. Since the beginning of the nineteenth century, individuals and organisations have been engaged in producing private information in the United States of America. For example, in 1909 John Moody (1868-1958) published Moody's Manual of Industrial and Corporate Securities. Duff and Phelps Corporation has provided credit rating services to its research clients since 1932.

The production and dissemination of private information on a formal basis began in Sri Lanka in 1990 when the Credit Information Bureau was established. The Bureau provides credit information on borrowers to banks. DCR Lanka Credit Rating Company established in 1999 provides credit rating, i.e. information on the financial strength and risks associated with corporate borrowers including banks[3].

Credit rating is an opinion of a rating company on the creditworthiness of an issuer of a debt or equity and the risk involved with such an instrument. The most creditworthy issuer and the least risky instrument is rated AAA. The least creditworthy issuer and most risky instrument is rated DDD. However, different rating agencies could use different symbols as illustrated in Table 1. Borrowers with lower credit ratings would generally have to offer an additional premium to cover the increased risk of default.

1 Mishkin, F.S. 1995, 'The Economics of Money, Banking and Financial Markets', Fourth Edition, Harper Collins, New York

2 Akerlof, G., 1970, 'The Market for Lemons: Quality Uncertainty and Market Mechanism', Quarterly Journal of Economics, 89:488-500

3 DCR was registered as a limited liability company under the Companies Act in August 1999 and commenced operations in October 1999. It is a joint venture company of the DCR of the USA (45 percent of share holding), the International Finance Corporation (20 per cent of share holding), the Central Bank of Sri Lanka and several institutions with minority shares. Those institutions are Bank of Ceylon, People's Bank, National Development Bank, DFCC Bank, State Mortgage and Investment Bank, Hatton National Bank Ltd, Commercial Bank of Ceylon Ltd., Sampath Bank Ltd., Employees Provident Fund, Employees Trust Fund Board, Sri Lanka Insurance Corporation Ltd., National Insurance Corporation Ltd., Union Assurance Ltd and Central Finance Company Ltd. The Board of Directors of DCR Lanka comprises seven members, of whom three are nominees of DCR USA and DCR Lanka and will not be subject to direction by the Board of Directors. Each of the minority shareholdings is limited to a maximum share of 4 per cent to avoid any undue influence by a shareholder on credit rating.

Box 10 (contd.)

Although there are many rating agencies operating in the world, the four major ones are, Moody's, Standard and Poor, Duff and Phelps and Fitch IBCA. The two agencies, DCR and Fitch IBCA merged in March 2000. A company or a sovereign nation could attain ratings from one or more rating agencies. Generally, the ratings given by different agencies for the same institution or country tally closely, though there could be differences at times.

Credit ratings are provided on business firms as well as on sovereign governments. Sovereign ratings are usually provided at the request of sovereign governments. Often, when governments have a need to raise funds by issuing debt instruments in international capital markets they obtain sovereign ratings. According to the DCR Rating Company, long-term debt instruments issued by many developed countries are rated AAA, whereas debt instruments of middle income countries are rated BBB. These are indicative of sovereign ratings of those countries. Sri Lanka has not yet obtained a sovereign rating. Any corporate issuer in a country is rated in relation to the domestic market situation. For example, a debt instrument in a country could be rated AAA in the domestic market, although the sovereign rating could be BBB. However, the international rating of the domestic debt is conducted by taking into account the sovereign rating. Rating scales adopted in Sri Lanka are given in Table 2.

The rating process adopted by DCRL relies on an exchange of ideas between DCRL and the management of the firm requiring the rating. The process begins when a firm formally requests a rating and provides necessary preliminary information. Discussions are held with the management to obtain a thorough understanding of the issuer's operational, financial and strategic goals. Once a rating is formulated, it is presented to the Credit Rating Committee for discussion of relevant issues. The Rating Committee comprises the chief executive officer of DCRL, DCR regional heads and industry specialists and is independent of the Board of Directors of DCR. The rating is then communicated to the firm along with the key rating considerations. If the firm disagrees with the rating, there is an appeal process whereby the firm is able to provide additional information. Subsequently, the final rating is announced, and a detailed credit analysis is made available to the public. The firm may keep the rating private, if it so wishes. The first debt market issue rated by DCRL was a listed debenture issue by Sri Lanka Telecom for Rs. 2 billion. This issue was rated AA+.

DCRL will continue to monitor economic, industry and corporate events to ensure that the offered rating is an accurate reflection of the firm's credit risk at all times. A long term approach is adopted with regard to revision of any ratings. If a significant change occurs in the underlying fundamental credit strength of the firm or specific debt issue, then the ratings may be placed under review.

The availability of credit rating will enhance financial market efficiency through investor confidence and market transparency. It encourages issuers of debt instruments to be cautious and disciplined. It dissipates the adverse selection problem and the continuous re-assessment of rating may also discourage moral hazard. Efficient and transparent financial market will further encourage channelling funds from domestic savers to investors, and will also encourage foreign investment. This will enhance the capital formation of a country, which formation will help a developing country like Sri Lanka to realise catch-up growth and enhance the degree of economic development.

However, it should be clearly understood that a credit rating is not a guarantee of the performance of the rated company or country. It is an assessment made by the rating company based on the information available to it. Thus, though investors could certainly benefit from such ratings, it would be unwise for investors to following ratings blindly.

Many countries, which regularly raise funds in international debt/capital markets, obtain sovereign ratings from at least two major rating agencies, mainly from Moody's and Standard and Poor. Some countries have obtained ratings from three or more rating agencies. Similarly, most international debt/capital market issues by non-sovereign borrowers, i.e. major companies, are rated by those rating agencies. Rating is costly. In addition to the initial rating fee, regular borrowers in international debt markets are required to pay an annual fee for the review and maintenance of rating. Sometimes these fees are waived or are subject to concessions, depending on the frequency of debt issues. There are also other fees, generally linked to the size of the issue.

Box 10 (contd.)

TABLE 1
Comparison of Rating by Major Agencies

	DCR	Fitch IBCA	Moody's	Standard & Poor
Investment grade				
Overwhelmingly high credit quality	AAA	AAA	Aaa	AAA
	AA+	AA+	Aa1	AA+
	AA	AA	Aa2	AA
	AA-	AA-	Aa3	AA-
Strong credit quality	A+	A+	A1	A+
	A	A	A2	A
	A-	A-	A3	A-
Satisfactory credit quality	BBB+	BBB+	Baa1	BBB+
	BBB	BBB	Baa2	BBB+
	BBB-	BBB-	Baa3	BBB-
Sub Investment Grade				
Moderately speculative	BB+	BB+	Ba1	BB+
	BB	BB	Ba2	BB
	BB-	BB-	Ba3	BB-
Highly speculative	B+	B+	B1	B+
	B	B	B2	B
	B-	B-	B3	B-
Substantial risk of default	CCC	CCC	Caa	CCC
Default Grade	DDD	DDD	Ddd	DDD

TABLE 2
Long - Term Debt Rating Scale for Sri Lanka

Rating	Definition
SL AAA	Highest credit quality. The risk factors are negligible, being only slightly more than for risk-free Sri Lankan Government debt (Treasury bonds).
SL AA+ SL AA SL AA-	Very high credit quality. Protection factors are strong. Risk is modest but may vary slightly from time to time because of economic conditions.
SL A+ SL A SL A-	Protection factors are average but adequate. However, risk factors are more variable and greater in periods of economic stress.
SL BBB+ SL BBB SL BBB-	Below average protection factors but still considered sufficient for prudent investment. Considerable variability in risk during economic cycles.
SL BB+ SL BB SL BB-	Below investment grade but deemed likely to meet obligations when due. Present or prospective financial protection factors fluctuate according to industry conditions or company fortunes. Overall quality may move up or down frequently within this category.
SL B+ SL B SL B-	Below investment grade and possessing risk that obligations will not be met when due. Financial protection factors will fluctuate widely according to economic cycles, industry conditions and/or company fortunes. Potential exists for frequent changes in the rating within this category or into a higher or lower rating grade.
SL CCC	Well below investment grade securities. Considerable uncertainty exists as to timely payment of principal, interest or preferred dividends. Protection factors are narrow and risk can be substantial with unfavorable economic/industry conditions, and/or with unfavorable company developments.
SL DDD	Defaulted debt obligations. Issuer failed to meet scheduled principal and/or interest payments.

Source: DCR Credit Rating Company, Sri Lanka

TABLE 10.23

Treasury Bond Issues during 1999

Maturity Period	Coupon Rate (% per year)	Weighted Average Yield to Maturity	Outstanding Amount at end Year (Rs. Mllion)
2 Year	11.00	12.64 - 13.42	36,165
3 Year	11.25	12.79 - 13.95	36,898
4 Year	11.50	13.21 - 14.02	24,804
5 Year	11.75	13.30 - 13.97	6,000
6 Year	12.00	13.65	1,000
Total			104,867

Source: Central Bank of Sri Lanka

1999, subscriptions for these loans amounted to Rs.22,985 million compared to Rs.52,300 million in 1998. These loans are sold at par and carry a fixed rate of interest which is administratively determined, taking the trends in market interest rates into consideration. As in the past, the Employees' Provident Fund (EPF) and the National Savings Bank (NSB), which together accounted for 70 per cent of total subscriptions, were the major subscribers to the Rupee loan programme in 1999. The interest rates on these loans were in the range of 12.00-12.50 per cent, while the maturity periods were 2-years, 7-8 years and 9-10 years.

Unit Trusts

The total number of Unit Trusts (UTs) increased to 12 in 1999, with the commencement of operations of two new UTs, Vanik Sashrika Index Fund and Vanik Sashrika Income Fund, in May 1999. Although income funds performed relatively well, a slight setback was seen in the performance of the industry as a whole as the activities of growth funds recorded a downturn.

The combined Net Asset Value (NAV) dropped by one per cent in 1999, in comparison to a decline of 13 per cent in 1998. The proportion of investments in equities declined by 5 per cent in 1999, compared to the 21 per cent drop recorded in 1998. The number of unit holders and the number of units in issue also dropped marginally by one per cent each in 1999. Meanwhile, the NAV per unit declined from Rs. 6.77 in 1998 to Rs. 6.72 in 1999.

The combined NAV of growth funds dropped by 3 per cent in 1999, compared to the 19 per cent drop recorded in 1998. In contrast, the combined NAV of income funds moved up by 20 percent in 1999, compared to a three fold increase recorded in 1998. Correspondingly, the NAV per unit of growth funds, which was in the range Rs.5.18-9.14 in 1998, dropped to a range of Rs.4.82-8.50 (excluding Vanik Sashrika Index Fund) in 1999. This downturn in the NAV per unit in growth funds is mainly attributed to the decline in share prices in the stock market in 1999 as more

TABLE 10.24

Rupee Loans Floated during 1999

Maturities (Years)	Volume (Rs. Million)	Interest Rates
2	7,486	12.00
7 - 8	8,500	12.25
9 - 10	7,000	12.50
Total	22,986	12.00-12.50

Source: Central Bank of Sri Lanka

than 70 per cent of their total investment portfolio is in shares. The All Share Price Index in the Colombo Stock Exchange (CSE) declined by 4 per cent in 1999, in comparison to a drop of 15 per cent in 1998. The NAV per unit in income funds was approximately in a range of Rs.10.60-11.20 in both 1998 and 1999. Out of the total investment of income funds, 57 per cent was invested in Treasury bills and 41 per cent in other fixed income instruments, particularly in debentures, commercial paper and asset backed notes, in 1999.

The maximum buying price per unit of growth funds moved in a range of Rs.5.22-12.00, while that of income fund was in a range of Rs. 10.27-11.22 during 1999. The minimum selling price per unit of growth funds in 1999 was in a range of Rs.4.79-10.26, while for income funds it remained within Rs.10.12-10.31. The total number of unit holders of growth funds dropped by 2 per cent while the units in issue also dropped by 1 per cent at end 1999. In contrast, the total number of unit holders and the number of units in issue of income funds moved up by 48 per cent and 20 per cent, respectively, in 1999.

In response to the developments in the market, fund managers of growth funds have taken steps to diversify the investment portfolio with a view to minimising possible

TABLE 10.25

Unit Trusts (a)

	1995	1996	1997	1998	1999(b)
1. Total Assets - Rs. Mn.	2,881	2,652	3,097	2,687	2,649
2. Net Assets Value - Rs. Mn.	2,855	2,637	3,072	2,675	2,639
3. Investments in Equities - Rs. Mn.	1,762	1,599	2,244	1,773	1,680
4. (3) as a percentage of (2)	61.7	60.6	73.0	66.3	63.7
5. Total Unit Holders	22,251	25,240	26,441	27,709	27,536
6. No. of Unit Trusts	4	5	10	10	12

Source : Unit Trusts

(a) Values are as at 31 December
(b) Provisional

losses to the unit holders. The share of investments in equities, which was around 75 per cent of total investments in 1998, has been reduced to around 71 per cent at end 1999, while the share of investments in debt market instruments such as Treasury bills, debentures and commercial paper has been increased from 25 per cent in 1998 to 28 per cent in 1999. Growth funds are not only concerned about the changes in the overall investment portfolio but also about the changes in the sectors of equity investments of these funds. Accordingly, the proportion of equity investments in the banking, finance and insurance and plantation sectors has been reduced, while increased investments are seen in the diversified holdings, motors, trading, hotels and travel and manufacturing sectors.

Given the downturn in the stock market, and the usefulness of unit trusts, some measures are taken to promote the activities of the industry. Accordingly, the possibility of opening investments in Unit Trusts to non-nationals, with some precautionary limits, was being considered.