Chapter 10

FINANCIAL SECTOR

10.1 Monetary Policy

The emphasis of monetary policy was on ensuring future price stability, while maintaining stability in financial markets and assisting the domestic economy to face the severe internal and external difficulties encountered in 2001. Accordingly, the Central Bank gradually reduced its key interest rates, which had been raised in the second half of 2000 and January 2001 to provide stability to the exchange market. These rates were reduced on six occasions with a larger reduction in the second half of the year. In addition, the Statutory Reserve Ratio (SRR) was also reduced with a view to reducing reliance on non-market oriented instruments in the conduct of monetary policy, improving downward flexibility in the interest rates of banks and augmenting rupee liquidity in the market. Meanwhile, the Central Bank's purchases of foreign exchange in 2001 entirely reduced the large rupee liquidity shortage in the money market that continued from 2000. In order to improve operational effectiveness in the conduct of monetary policy, particularly following the change in the exchange rate regime to an independent float, the institutional framework for monetary policy decision making was changed.

The Central Bank's key market interest rates were changed several times during the year. The tightened monetary policy stance followed in the second half of 2000 to arrest the deterioration in the balance of payments, and provide stability to the foreign exchange market was further strengthened in January 2001. The Bank raised its Repurchase (Repo) rate and Reverse Repurchase (Reverse Repo) rate by 300 basis points, to 20 per cent and 23 per cent, respectively, on 18 January 2001. However, with the stability in foreign and domestic money markets following the introduction of the independent float of the rupee and reductions in interest rates in major international markets, the Central Bank gradually reduced its Repo and Reverse Repo rates on six occasions since February 2001. The pace of relaxation was constrained by the rise in inflation in the first half of the year. As overall monetary and credit growth was within the projected levels, containing demand fuelled inflationary pressure, and the slowing down of the economy warranted such changes, a larger reduction to the Central Bank's key interest rates was effected during the second half of the year. After January, the Repo rate was reduced by 800 basis points to 12 per cent while the Reverse Repo rate was reduced by 900 basis points to 14 per cent by end 2001. The Bank Rate was reduced from 25 per cent to 23 per cent in July and further to 18 per cent in December 2001 to adjust it in line with the reductions in other market rates.

Some temporary precautionary measures that were introduced along with the change in the exchange rate regime in January 2001 were also phased out during the year, with the gaining of experience under the new exchange regime, and consequent improvement in stability in the money and foreign exchange markets. The period allowed for the settlement of export credit without incurring penalties on interest was increased from 90 days to 120 days, in cases where it was customary to grant a longer period of credit; limits on commercial bank foreign currency overbought positions were based on the capital and reserves of the banks instead of external trade credit, making them prudential guidelines; the 50 per cent margin deposit requirement imposed on foreign exchange forward transactions was reduced to 25 per cent in March and subsequently removed in July 2001; and the prevention of prepayments of import bills was withdrawn in August.

A turnaround in inter-bank liquidity conditions took place in 2001. The purchase of foreign exchange by banks from the Central Bank, large borrowings by the public sector from the banking system and the settlement of foreign public debt had resulted in a liquidity shortfall of around Rs.30 billion at the beginning of 2001. Commercial banks borrowed from the Central Bank through the Reverse Repo window to replenish the shortfall in interbank liquidity. However, injections of rupee liquidity by the Central Bank through the purchase of foreign currency from the market to build up its reserves and the purchase of the dollar proceeds of the Sri Lanka Development Bonds and the privatisation proceeds of the government improved domestic market liquidity. The reduction of the SRR too contributed to improve liquidity. As a result, the liquidity position turned to a surplus of Rs.1 billion by December 2001.

With the shift to an independently floating exchange rate regime, the role of the exchange rate as a nominal anchor has diminished. Accordingly, the Bank placed greater emphasis on reserve money, which is an intermediate target of monetary policy, consistent with the targeted level under the monetary programme, in achieving the price stability objective. The Bank also took measures to expand the scope of policy discussions on monetary policy by creating a Monetary Policy Committee within the Bank and to further improve dissemination of information with respect to monetary policy decisions and related information.

A matter of concern when making policy was the decision by the government to cancel certain agricultural loans, in view of the difficulties faced by these cultivators. It would have been far preferable to request banks to consider rescheduling such loans on a case by case basis, on the merits of each case. A general cancellation of this nature discriminates against borrowers who have paid their loans, affects the financial viability of banks and destroys the credit culture in the economy.

Monetary Policy Direction for 2002

Based on the overall macroeconomic outlook, monetary growth for the year 2002 is projected to be around 12 per cent. This is consistent with the forecasts for economic growth, inflation and the balance of payments. Reserve money is also projected to grow by approximately 12 per cent, reflecting a broadly constant money multiplier. This monetary growth would allow higher credit growth to the private sector, while avoiding excess pressure on prices. With underlying inflationary pressures expected to abate and public sector recourse to borrowings from the banking sector expected to decline, a reduction in interest rates is projected, with a larger part of the reduction expected in the second half of the year.

10.2 Money Supply

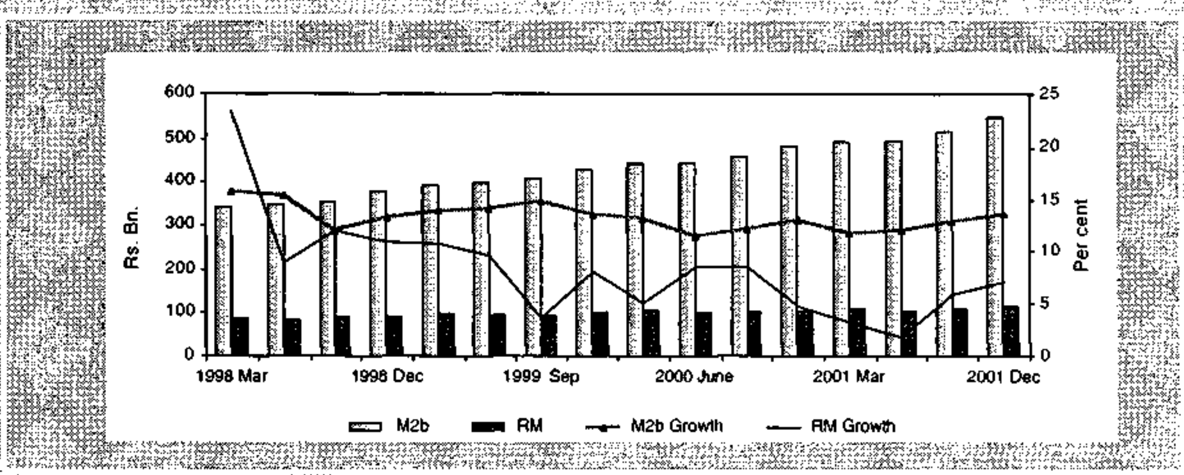
Monetary growth (M_{2b}), which results from the operation of the domestic banking units (DBUs) and domestic operations of the foreign currency banking units (FCBUs), remained around 13 per cent during 2001. The major contributory factor for the growth in broad money was the expansion in domestic credit, while the exchange rate depreciation too had an impact on monetary growth. The expansion of narrow money (M_1) declined largely due to a shift to interest bearing assets in view of the high opportunity cost of holding non-interest bearing assets. In addition, the slowdown in the economy was also a factor in reducing the demand for cash. Furthermore, as financial transactions become more technology oriented and the use of ATM cards, credit cards increases, there tends to be a reduction in narrow money. Meanwhile, broad money (M_4) based on the financial survey, which includes the operations of licensed specialised banks and finance companies, in addition to licensed commercial banks, grew by 13.6 per cent at end 2001 as against a growth of 12.7 per cent at end 2000.

TABLE 10.1
Summary Monetary Statistics

Item	End 2000 Rs. bn.	End 2001 Rs. bn.	Change 2000 Amount Rs. bn.	Change 2000 %	Change 2001 Amount Rs. bn.	Change 2001 %
Monetary Aggregates:						
Narrow Money Supply (M_1)	118.5	122.2	9.9	9.1	3.7	3.2
Broad Money Supply (M_2)	404.7	450.7	46.6	13.0	46.1	11.4
Consolidated Broad Money Supply (M_{2b})	483.4	549.1	55.1	12.9	65.7	13.6
Underlying Factors (a)						
Domestic Credit to :	549.9	639.0	117.0	27.0	89.1	16.2
Government (net)	147.3	201.4	53.4	56.8	54.1	36.8
Public Corporations	38.2	40.8	25.2	193.2	2.6	6.7
Private Sector	364.4	396.8	38.4	11.8	32.4	8.9
External Assets (net)	69.5	77.0	-32.6	-31.9	7.5	10.9
Other Items (net)	-136.0	-166.9	-29.4	-27.5	30.9	22.7
Reserve Money	105.1	112.5	4.7	4.7	7.4	7.0
Money Multiplier (M_{2b})	4.60	4.88				
Velocity (M_{2b})	2.79	2.76				

(a) In relation to M_{2b} *Source:* Central Bank of Sri Lanka

Chart 10.1
Monetary Aggregates – Growth and Levels
(Consolidated Broad Money and Reserve Money)



Although the major contribution to the expansion in monetary growth came from the growth in domestic credit, an expansion in net foreign assets (NFA) of the banking system also contributed, in contrast to the significant decline in NFA in 2000. Changes in the exchange rate have had an impact on the rupee value of foreign currency assets and the liabilities of the banking system, thus affecting monetary aggregates. If the exchange rate effect were excluded, the growth of M_{2b} would be 11.1 per cent at end December 2001 as against the 13.6 per cent recorded when the exchange rate effect is included.

The increase in net domestic assets was brought about by a large increase in public sector (*i.e.*, government and public corporations) credit and a moderate increase in private sector credit. The increased fiscal deficit, together with less than expected inflows from privatisation and foreign borrowings, caused the government to increase sharply its net borrowings from the domestic banking sector by Rs.54 billion, almost to the same level as in 2000. Some compositional shift was also seen in net credit to the government (NCG) with borrowings from the Central Bank, which constitute the creation of expansionary reserve money, being replaced by borrowings from commercial banks. NCG from the Central Bank declined with the reduction in the holdings of government paper, though provisional advances from the Bank increased. The reduction in the holdings of government paper was a consequence of a decline in injection of liquidity through reverse repurchase transactions, as market liquidity improved. NCG from commercial banks increased as overdrafts, sight bills, holdings of government paper including dollar denominated Sri Lanka Development Bonds and borrowings from FCBUs increased. The high level of public sector borrowing was a factor that led to interest rates not decreasing further.

Credit to public corporations increased, but at a slower pace, when compared with the large increase in 2000. The adjustment in the prices of petroleum products and the decline in oil prices in the world market enabled the Ceylon Petroleum Corporation (CPC) to improve its financial position and reduce its liabilities to the domestic banking system by Rs.6 billion in 2001, although the outstanding level was still high at Rs.19 billion by end 2001. However, credit utilised by the Ceylon Electricity Board (CEB) increased due to adverse weather conditions requiring it to opt for expensive thermal power, as well as due to the continuation of an average tariff rate that was below the average cost of power. The Co-operative Wholesale Establishment (CWE) increased its borrowings because of higher import prices.

Growth in credit to the private sector was moderate, reflecting a slowdown in economic activities. The annual growth of private sector credit declined from 12 per cent in 2000 to 9 per cent in 2001. In absolute terms, credit to the private sector increased by Rs.32 billion as against Rs.38 billion in 2000. The decline in credit growth was partly driven by the moderation in economic activity and the decline in business confidence. High interest rates, and the cautious approach taken by many banks to improve their risk management due to high levels of non-performing loans too would have contributed to this decline. The breakdown of private sector credit by economic activity reveals that the credit for consumption, housing and property development and services grew, while credit to industries, trade and agriculture sectors declined.

Reserve money or high-powered money increased by Rs.7.4 billion during the year, in comparison to an increase of Rs.4.7 billion in 2000. Effectively, a further Rs.3.7 billion was made available to the market with the reduction in the

TABLE 10.2
Monetary Aggregates 2000 – 2001 (a)

Rs. Billion

End of Period	Narrow Money Supply (M_1)						Broad Money Supply (M_2)						Consolidated Broad Money Supply (M_{2b})					
	2000	2001	Percentage Change				2000	2001	Percentage Change				2000	2001	Percentage Change			
			Point to Point		Moving Average				Point to Point		Moving Average				Point to Point		Moving Average	
			2000	2001	2000	2001			2000	2001	2000	2001			2000	2001	2000	2001
January	108	112	11.5	3.8	11.0	7.7	360	399	13.4	10.9	11.4	12.7	432	487	13.6	12.6	14.0	12.0
February	107	112	9.2	4.6	10.8	7.3	361	401	13.1	11.0	11.7	12.5	434	489	13.1	12.8	13.9	12.0
March	110	114	7.0	3.8	10.4	7.0	366	404	12.8	10.3	12.0	12.3	442	494	13.0	11.7	13.9	11.9
April	110	114	6.7	3.9	9.8	6.7	369	407	13.2	10.2	12.3	12.0	440	499	12.2	13.4	13.8	12.0
May	106	110	4.0	3.5	9.1	6.7	365	406	11.6	11.2	12.4	12.0	436	498	9.7	14.4	13.4	12.3
June	109	109	8.9	-0.2	8.9	5.9	371	406	13.1	9.4	12.6	11.7	443	496	11.4	11.9	13.2	12.4
July	108	109	8.0	1.1	8.9	5.4	374	410	13.1	9.8	12.8	11.4	446	502	10.9	12.7	12.9	12.5
August	109	110	9.4	0.7	8.9	4.6	376	413	13.7	9.8	13.0	11.1	451	510	12.4	13.0	12.7	12.6
September	112	112	9.4	0.4	8.9	3.9	384	421	13.6	9.9	13.1	10.8	458	516	12.1	12.8	12.5	12.6
October	113	111	11.7	-1.1	9.1	2.9	389	426	13.7	9.7	13.2	10.5	463	520	12.4	12.3	12.4	12.8
November	109	117	5.0	7.5	8.6	3.1	387	436	10.7	12.5	12.9	10.6	466	533	11.1	14.4	12.1	12.9
December	118	122	9.1	3.2	8.3	2.6	405	451	13.0	11.4	12.9	10.5	483	549	12.9	13.6	12.0	13.0
Monthly Average	110	113	8.3	2.6			376	415	12.9	10.5			449	508	12.1	13.0		

(a)Monetary data from 1990 have been classified to be consistent with 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 1999 – 2001 (a)

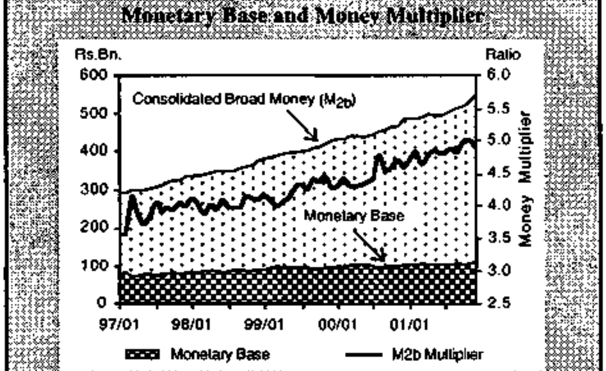
Rs. Million

Item	Dec. 1999	Dec. 2000	Dec. 2001	Change 2000 Amount (a)	Change 2000 Percentage	Change 2001 Amount (a)	Change 2001 Percentage
Monetary Aggregates							
Currency held by the public	58,481	62,647	65,536	4,166	7.1	2,889	4.6
Demand Deposits held by the public	50,073	55,830	56,674	5,757	11.5	844	1.5
Narrow Money Supply (M_1)	108,554	118,477	122,210	9,923	9.1	3,733	3.2
Time & Savings Deposits of the private sector held with com. banks	319,765	364,944	426,927	45,179	14.1	61,983	17.0
DBUs	298,158	341,776	395,071	43,618	14.6	53,295	15.6
FCBUs	21,607	23,168	31,856	1,561	7.2	8,688	37.5
Consolidated Broad Money Supply (M_{2b})	428,319	483,421	549,137	55,102	12.9	65,716	13.6
Underlying Factors							
Net Foreign Assets	102,092	69,529	77,077	-32,563	-31.9	7,548	10.9
Monetary Authorities	89,287	57,947	87,293	-31,340	-35.1	29,346	50.6
Commercial Banks	12,805	11,582	-10,216	-1,223	-9.6	-21,798	-188.2
DBUs	3,235	11,629	-1,117	8,394	259.5	-12,746	-109.6
FCBUs	9,570	-47	-9,099	-9,617	-100.5	-9,052	-19,259.6
Net Domestic Assets	326,228	413,892	472,061	87,664	26.9	58,169	14.1
Domestic Credit	432,888	549,927	639,009	117,039	27.0	89,082	16.2
Claims on Government (net)	93,915	147,304	201,444	53,389	56.8	54,140	36.8
Monetary Authorities	46,716	91,556	84,668	44,840	96.0	-6,888	-7.5
Commercial banks	47,199	55,748	116,776	8,549	18.1	61,028	109.5
DBUs	39,166	42,928	77,067	3,762	9.6	34,139	79.5
FCBUs	8,033	12,820	39,709	4,787	59.6	26,889	209.7
Credit to public corporations	13,046	38,254	40,811	25,208	193.2	2,557	6.7
DBUs	12,707	26,986	22,934	14,279	112.4	-4,052	-15.0
FCBUs	339	11,268	17,877	10,929	3,223.9	6,609	58.7
Credit to the private sector	325,927	364,369	396,754	38,442	11.8	32,385	8.9
DBUs	275,532	307,613	328,788	32,081	11.6	21,175	6.9
FCBUs	50,395	56,756	67,966	6,361	12.6	11,210	19.8
Other items (net)	-106,660	-136,035	-166,948	-29,375	-27.5	-30,913	-22.7
DBUs	-59,930	-78,406	-82,351	-18,476	-30.8	-3,945	-5.0
FCBUs	-46,730	-57,629	-84,597	-10,899	-23.3	-26,968	-46.8

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

Source: Central Bank of Sri Lanka.

Chart 10.2
Monetary Base and Money Multiplier



SRR, which had previously been sterilised by the Bank. The increase in net foreign assets of the Central Bank due to purchases of foreign exchange from the market to build up reserves, and the purchase of the proceeds from the sale of dollar bonds and privatisation proceeds, were the main contributory factors for the increase in reserve money.

The M_{2b} money multiplier, which was 4.60 at end December 2000, increased to 4.88 at end December 2001, reflecting the higher money creating ability of commercial banks. The reduction of the SRR by 1 per cent to 10 per cent on rupee deposit liabilities and a decline in the currency to deposits ratio were among the factors that led to this increase. Meanwhile, the average income velocity of money declined marginally from 2.79 in 2000 to 2.76 in 2001.

10.3 Financial Survey

The financial survey is designed to capture the transactions of other deposit taking financial institutions (*i.e.*, licensed specialised banks and finance companies), in addition to the monetary authority and licensed commercial banks, and thereby generate a more comprehensive set of monetary aggregates than the consolidated monetary survey. Thus, the

Chart 10.3
Monetary Aggregates, Velocity and Money Multiplier

Chart 10.3.1
Money Supply

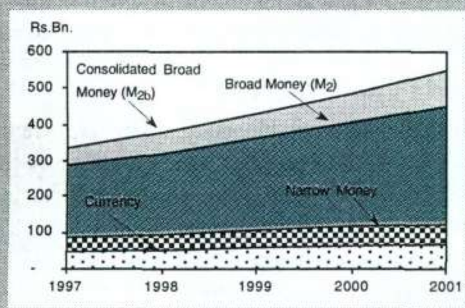


Chart 10.3.2
Domestic Credit

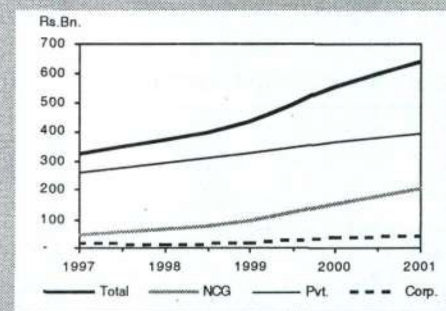


Chart 10.3.3
Net External Assets

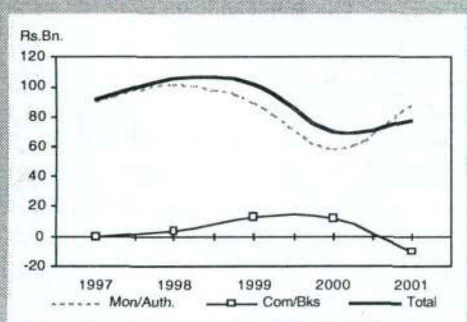
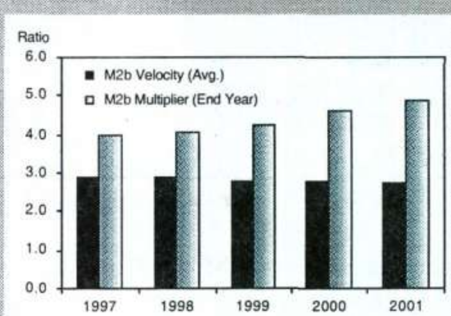


Chart 10.3.4
Income Velocity and Money Multiplier



measure of broad money (M_4) generated by the financial survey provides a broader measure of money. Similarly, the NFA of the financial survey conveys a more accurate assessment of the exposure of the financial sector to the rest of the world, while the components of domestic credit provide information on the credit made available to both the public sector and the private sector by financial organisations other than commercial banks as well.

On a point to point basis, growth in broad money supply (M_4) as indicated in the Financial Survey was 13.6 per cent at end December 2001 in comparison to the growth of 12.7 per cent at end December, 2000. The growth in the broad money supply - M_4 as well as M_{2b}, has been generally in the range of 12-14 per cent throughout 2001. The major contributory factor for the growth in M_4 has been the increase in net domestic assets (NDA), as in the case of the growth in M_{2b}.

In absolute terms, broad money supply (M_4) increased by around Rs.84 billion in 2001 and stood at Rs.700 billion in December 2001. The broad money supply (M_4) was higher by Rs.151 billion than the consolidated broad money supply (M_{2b}) mainly due to a significant increase in the volume of public deposits placed with the National Savings Bank (NSB) and finance companies (FCs).

NFA of the broad monetary survey (M_4) increased by around Rs.8 billion during the 12 months ending December 2001 and stood at Rs.66 billion at end December, 2001. The improvement in NFA was primarily due to an increase in NFA of the Central Bank with the improvement in the balance of payments (BOP).

Net credit to government (NCG) increased by around Rs.62 billion from end December 2000 to end December 2001 and this was a significant causal factor in broad money expansion (M_4). NCG of the financial survey was substantially higher than the NCG in the consolidated monetary survey due to a significant amount of the holdings of government paper by Licensed Specialised Banks (LSBs), in particular, the NSB. The financial survey thus demonstrates even more clearly than the monetary survey, the absorption of funds by the public sector.

On a point to point basis, credit to the private sector in both M_{2b} and M_4 recorded a moderate growth and varied within a range of 10-12 per cent during the second half of the year except in December 2001. In absolute terms, credit to the private sector in the broad monetary survey (M_4) increased by Rs.40 billion and stood at Rs.515 billion at end December 2001.

TABLE 10.4

Summary Statistics of Financial Survey (M_4)

Item	End 2000 Rs. bn.	End 2001 Rs. bn.	Change 2000 Amount Rs. bn.	Change 2000 %	Change 2001 Amount Rs. bn.	Change 2001 %
Monetary Aggregates:						
Broad Money Supply (M_2)	404.7	450.7	46.6	13.0	46.1	11.4
Consolidated Broad Money Supply (M_{2b})	483.4	549.1	55.1	12.9	65.7	13.6
Broad Money Supply (M_4)	616.0	699.6	69.5	12.7	83.5	13.6
Underlying Factors (a)						
Net Foreign Assets	57.9	66.2	-31.5	-35.2	8.3	14.3
Domestic Credit	735.6	839.6	134.7	22.4	104.0	14.1
Claims on Government (net)	220.9	282.9	61.8	38.8	62.0	28.1
Credit to Public Corporations	39.2	41.7	25.2	179.1	2.5	6.2
Credit to Private Sector	475.4	515.0	47.7	11.2	39.5	8.3
Other Items (net)	-177.5	-206.2	-33.7	-23.4	-28.7	-16.2
Money Multiplier (M_4)	5.86	6.22				

(a) In relation to M_4

Source: Central Bank of Sri Lanka

The money multiplier in the broad monetary survey (M_4) stood at 6.22 at end December 2001, compared to 5.86 at end December 2000. This increase could be attributed to the decline in the currency to deposit ratio and the reduction in the SRR by 1 per cent on rupee deposit liabilities of commercial banks.

10.4 Interest Rates

Interest rates moved down significantly during 2001 in contrast to the rising trend in 2000. With greater stability in the domestic foreign exchange and money markets, declining international interest rates, and reduced inflationary pressures, the Central Bank reduced its key policy rates, *i.e.*, the Repo rate, Reverse Repo rate, and the Bank Rate, several times during the year, notably in the second half. These reductions, assisted by increases in market liquidity, resulted in a fall in short-term market rates. The prime lending rates of commercial banks and the yield on market oriented government securities fell commensurately. The general lending rates of commercial banks, however, declined less and at a slower pace, resulting in the real return of these general lending rates remaining still appreciably high. Some reduction in deposit rates was also seen. A downward shift in the yield curve of government paper was seen towards the end of the year. In addition, fiscal measures *i.e.*, withdrawal of the 1 per cent turnover tax on banking and financial products, reduction of the National Security Levy (NSL) from 7.5 per cent to 6.5 per cent, reduction of the stamp duty from 2 per cent to 1 per cent, which were introduced during the year, also had some impact on reducing the effective lending rates of commercial banks. The high level of borrowing by the public sector was a factor that worked against a faster and a larger decline in interest rates.

Central Bank Policy Rates

The Central Bank's key monetary policy rates are the Repo rate and Reverse Repo rate, which are closely linked to market rates, and the Bank Rate, which is more an indicative rate. The Repo rate is the rate at which commercial banks and primary dealers can invest their surplus funds in Treasury bonds and Treasury bills held by the Central Bank, while the Reverse Repo rate is the rate at which commercial banks and primary dealers can obtain funds from the Central Bank against the collateral of Treasury bills and bonds. Repo and Reverse Repo rates are the Central Bank's signalling mechanism to indicate the expected direction of interest rates in the market. The Repo and Reverse Repo rates had increased during the second half of 2000 as the Bank tightened monetary policy to provide stability to the exchange market. They were raised, as a temporary measure, by an additional 300 basis points each in January 2001 to reach a peak of 20 per cent and 23 per cent, respectively by the third week of January. Following the restoration of stability to the foreign exchange market and gaining of experience under the flotation of the rupee, the Repo and Reverse Repo rates were reduced by 100 basis points each in February, and 50 basis points each in April. More substantial reductions could not be effected in the first half as inflation began to increase. However, with the inflationary pressures declining and greater stability in the foreign exchange market, the rates were reduced on four occasions, during the period July to December 2001. Thus, during the second half of 2001, the Repo rate was reduced by 650 basis points and the Reverse Repo rate by 750 basis points to end the year at 12.00 per cent and 14.00 per cent, respectively. The Bank

TABLE 10.5

Changes in Policy Interest Rates of the Central Bank

% p.a.

Date	Repo Rate	Reverse Repo Rate	Bank Rate
30 Dec. 2000	17.00	20.00	25.00
18 Jan. 2001	20.00	23.00	25.00
26 Feb. 2001	19.00	22.00	25.00
03 April 2001	18.50	21.50	25.00
02 July 2001	16.00	19.50	23.00
02 Aug. 2001	15.00	18.50	23.00
03 Sep. 2001	13.00	15.00	23.00
17 Oct. 2001	12.00	14.00	23.00
27 Dec. 2001	12.00	14.00	18.00

Source: Central Bank of Sri Lanka

Rate, the rate at which the Central Bank grants advances to commercial banks for their temporary liquidity purposes, was revised twice during the year, by a total of 700 basis points, and stood at 18.00 per cent at end 2001.

Short-term Rates

High interest rates in the market in the early part of the year was accompanied by a shortage of rupee liquidity in the market. This shortage was met by funds released through the Central Bank's reverse repo facility. Consequently, call market rates closely followed the Bank's Reverse Repo rate throughout much of the year, and in some instances, even exceeded the Reverse Repo rate. Call market rates were in the range of 25.00 to 26.75 per cent by end January 2001 compared to a range of 22.50 to 32.00 per cent at end 2000. The peak in these rates was in January and April 2001 when the maximum rate rose to 29.00 per cent. Rates gradually declined thereafter and the average call market rate returned to the band between the Bank's Repo rate and Reverse Repo. By end June, call market rates had decreased to a range of 21.00 - 22.50 per cent. In the second half, with the reduction in the Bank's rates and the increase in market liquidity, call market rates fell substantially. By end December 2001, there was a small excess of rupee liquidity in the market, causing commercial banks to access the Central Bank's repurchase facility. As a result, the average call market rate moved towards the lower end of the Bank's Repo-Reverse Repo band. At end 2001, the average call market rate was 12.65 per cent, while the call market rate moved within the range of 12.50 - 13.00 per cent.

The Sri Lanka Inter Bank Offered Rates (SLIBOR), which are based on the rates offered for rupee inter bank transactions by 12 commercial banks, showed trends similar to the call market rates. The overnight SLIBOR reached a peak of 28.79 per cent in January, decreased to 21.38 per cent by end June, and fell further to 12.88 per cent by end 2001. The one-year SLIBOR rose from 22.67 per cent at end 2000 to a peak of 25.38 per cent in January and fell to 14.10 per cent by end 2001.

Chart 10.4
Interest Rates

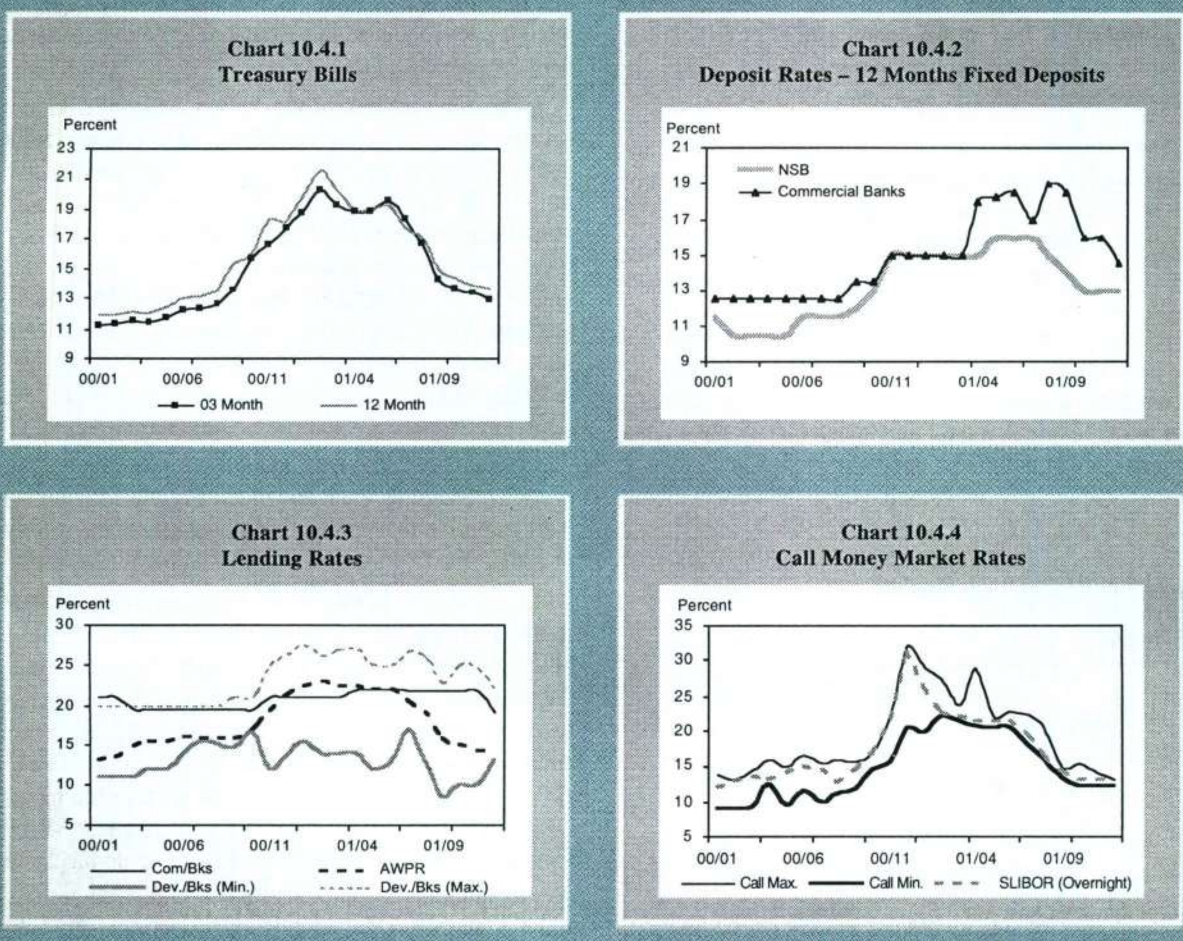


TABLE 10.6
Sri Lanka Inter Bank Offered Rates (SLIBOR) (a)

% p.a.

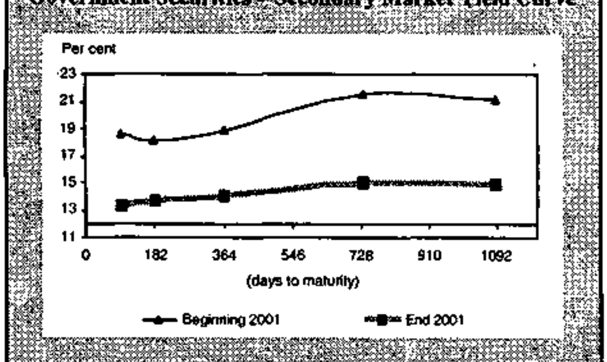
	2000 Dec.	2001 Mar.	2001 Jun.	2001 Sep.	2001 Dec.
Overnight	31.50	22.08	21.38	14.27	12.88
7 Days	26.00	22.50	21.38	14.35	13.11
1 Month	25.33	22.38	21.19	14.50	13.26
3 Month	24.00	22.00	20.88	14.42	13.38
6 Month	23.25	21.46	20.42	15.17	13.63
12 Month	22.67	20.58	20.04	15.46	14.10

(a) End of the month rates. *Source:* Central Bank of Sri Lanka

The yields on Treasury bills showed the same trend as other short-term market rates. The yield on 91-day and 364-day Treasury bills moved down from a peak of 20.20 per cent and 21.64 per cent at end February to 12.92 per cent and 13.74 per cent, respectively, at end December 2001. The weighted average prime lending rate (AWPR), which is the weighted average of commercial banks' lending rates to their prime customers, was 21.46 per cent at end 2000. It reached its highest value of 24.27 per cent during the third week of January, and came down to 14.31 per cent at end December 2001. The yield curve for Treasury bills and Treasury bonds, which was upward sloping out at end 2000, shifted downward and flattened. It had an upward slope at end of 2001, indicating a market perception that significant changes in yields were not immediately expected.

The Central Bank's discount and rediscount rates, which are the rates applicable to outright purchases and sales of Treasury bills by commercial banks and primary dealers through the Central Bank's secondary market window, moved with market interest rates. The margin between the Discount and Rediscount rates was reduced in December to keep the margin in line with the decline in the Central Bank's other policy driven interest rates. The margin between the discount and rediscount rates was brought down to 130 basis points from the previous level of 355 basis points, improving the consistency of monetary policy.

Chart 10.5
Government Securities – Secondary Market Yield Curve



Deposit and Lending Rates

Although a large reduction in short-term market rates was observed, deposit and lending rates of commercial banks, in general, declined at a much slower pace. Interest rates on savings deposits, which were, on average, around 9 per cent during the first several months of the year, came down to around 8 per cent during the latter part of 2001. One year fixed deposit rates, on average, came down from 15 per cent at the beginning of the year to 12.6 per cent at the end of the year. In general, lending rates of commercial banks came down by 200-400 basis points from the peak levels that prevailed in the first several months of the year. Lending rates on export financing facilities came down from 21 per cent at the beginning of the year to 17.5 per cent towards the end of the year. Rates on import finance facilities, on average, declined from 21 per cent to 19.6 per cent during the same period. The Average Weighted Deposit Rate (AWDR), which is based on the weighted average of all outstanding interest bearing deposits of commercial banks and the corresponding interest rates, reached its highest level (11.55 per cent) in June, and decreased to 10.78 per cent by December 2001. The Average Weighted Fixed Deposit Rate (AWFDR), which was 13.27 per cent in January, increased to 14.70 per cent in July and then decreased to 13.47 per cent in December. High interest rates continued in the banking system, indicating the need for corrective measures.

The deposit rates of the National Savings Bank, the premier savings organisation in Sri Lanka, were also reduced during the year, in line with market rates. The savings deposit rate, which was at 8.4 per cent at end 2000, increased to 10 per cent at the beginning of 2001 and remained at that level during the first seven months. Thereafter, it was gradually reduced to 8.4 per cent by the end of the year. The one year fixed deposit rate, which was 15 per cent at end 2000, increased to 16 per cent in May and was thereafter reduced to 13 per cent towards the end of the year, in several steps.

Interest charged by commercial banks for payment through credit cards, on average, was 33 per cent at the end of 2001 compared to an average of 32 per cent at the beginning of 2001.

Lending rates of long-term credit institutions, *i.e.*, DFCC Bank, National Development Bank (NDB) and State Mortgage and Investment Bank (SMIB) came down during the year, while lending rates of NSB remained unchanged. Lending rates of NDB decreased from 14.00-26.50 per cent at end December 2000 to 13.25-22.00 per cent in December 2001. Lending rates of DFCC Bank were in the range of 12-24 per cent at the end of the year, while NSB rates remained in the range of 16.00-17.50 per cent during the year.

Responding to the recession in industrial countries, interest rates in international markets declined substantially during 2001. Accordingly, commercial banks in Sri Lanka

Box 14

Interest Spread of Commercial Banks

Commercial banks as financial intermediaries accept deposits from individuals and institutions who have surplus funds and make loans available to investors who have deficits in their spending units. In this process of intermediation, banks raise funds at a certain rate and lend at a higher rate, keeping enough to cover administrative costs and earn a return for the risk assumed. The difference between the average lending rate and the cost of mobilised funds/loanable funds is the intermediation cost or the interest spread of a bank. In Sri Lanka, intermediation costs of commercial banks are considered to be high due to several reasons and are a major concern of the business community. The high intermediation cost of banks is likely to be a reflection of inefficiency in the financial system, which leaves both savers and investors worse off. When intermediation costs are high, the interest rate structure in the financial system becomes distorted, leading to an inefficient allocation of capital resources in the economy. Increased borrowing costs affect entrepreneurs and this may also have some impact on loan defaults. As such, high intermediation costs of banks have a significant adverse effect on economic activities in the country. Therefore, this is an issue of economic significance that needs to be addressed.

Loanable Funds

The core business of commercial banks is lending and, hence, the amount of loanable funds available is critical to the operations of a bank. Commercial banks can effectively use only a portion of their deposit base to carry out core business since they are subject to statutory reserves against their deposit liabilities. Other than deposits, banks use borrowings for lending purposes as and when required. Although a bank would also have capital funds, these would be small in magnitude in relation to deposits and borrowed funds. Therefore, loanable funds of a bank would primarily be deposits, net of reserves with the Central Bank, plus borrowings.

Cost of Funds

The cost of funds of a commercial bank includes interest costs, reserve costs and operating costs, which includes salaries, provisioning for non-performing loans and other overhead expenses. Interest cost is the cost of deposits and borrowings. This is also known as the financial cost of funds. In addition to the prevailing interest rates, the interest cost of deposits depends on the mix between interest and non-interest bearing deposits and the different types of interest bearing deposits. For example, a bank with a large demand deposit base, which is paid zero interest, enjoys a lower deposit cost than a bank with a lower demand deposit base.

The Statutory Reserve Requirement (SRR) on commercial banks imposed by the Central Bank as a monetary policy measure adds an additional opportunity cost as such reserves are placed with the Central Bank at zero return though these funds are mobilised by banks at a cost. The reserve cost is implicitly reflected in their lending rates. Non performing loans (NPLs) of commercial banks also generate an indirect cost for commercial banks. High NPLs, while reducing a bank's interest earnings, increase the banks provisioning, which affects the profitability of banks. Moreover, they reduce the availability of loanable funds in a bank by reducing collections. Other operating expenses of a bank also have an important bearing on the cost of funds of a bank since a certain portion of the operating cost is incurred in mobilising loanable funds. However, it is difficult to separate clearly the operating expenses between raising loanable funds and other activities, except provisioning for non-performing loans, which is directly related to the lending activities of banks. Although one can argue that operating expenses of banks could be disaggregated into expenses on mobilising loanable funds and other operating expenses by applying the ratio between interest income and non-interest income of commercial banks to total operating expenses, such a breakdown could be misleading because a certain portion of non interest income (*i.e.*, loan application processing fees, inspection and valuation charges *etc.*) is also earned from lending activities.

Lending Rates

Lending rates are based on the cost of funds and risk premiums. The risk premium depends on the collateral, creditworthiness of customers, purpose of lending, maturity of the loan etc. Lending rates of commercial banks vary mainly depending on the type of securities against which loans are granted and the creditworthiness of customers. Lower lending rates are generally offered on those loans which are fully collateralised and have little risk of default, while the rates would be higher on loans such as temporary overdraft facilities, and unsecured loans and advances. Also, relatively lower rates are offered to prime customers. The effective lending rate could be sometimes significantly higher than the quoted

Box 14 *(Contd.)*

lending rate as the borrowers have to pay other charges such as application processing fees and inspection charges, in addition to interest. Lending rates are also influenced by interbank rates, the return on government and other securities, liquidity in the market and inflationary expectations. If the intermediation costs were high, the lending rates would be high, irrespective of the financial cost of funds.

Interest Spread

In general, the difference between the average deposit rate and the average lending rate is known as the nominal interest spread of a bank. This is sometimes known as the intermediation cost of commercial banks. However, the effective spread of a bank, in lending, would be different since the deposit cost itself does not show the effective cost involved in generating funds. Hence, the interest spread of a bank represents the difference between the average interest rate earned and the average interest rate paid on funds. The spread of a bank, in lending, covers reserve cost, cost for provisioning for non-performing loans, other operating expenses and profit margins.

TABLE 1
Interest Spread of Commercial Banks – 2000

As a % of total loanable funds

	2 State Banks (Avg.)	Domestic Private Banks (Avg. of 4 largest banks)	Foreign Banks (Avg. of 7 banks)
Interest Income	11.8	14.3	15.3
Interest cost of funds (with reserve cost)	7.7	8.9	8.3
Interest spread	4.1	5.4	7.0
Made up of :			
Loan Loss Provisions	1.2	0.7	1.7
Administrative Cost and Profit margins	2.9	4.7	5.3

Note: Loanable funds = Deposits + Borrowings – Reserves with the Central Bank

The interest spread of commercial banks, *i.e.*, the difference between the interest income as a percentage of loanable funds and interest expenses as a percentage of loanable funds, for the year 2000, is computed based on audited accounts (DBUs and FCBUs). This analysis covers a sample of 13 commercial banks, which includes the 2 state banks, 4 domestic private banks and 7 foreign banks.

The interest cost of funds (including reserve cost) of state banks and domestic private banks were, on average, 7.7 per cent and 8.9 per cent of total loanable funds, respectively. For foreign banks, the interest cost, on average, was 8.3 per cent of loanable funds. The interest cost of the two state banks is relatively low due to their large demand deposit base, which is paid zero interest.

The interest income of the two state banks is lower than that of other banks. This may be due to two reasons. First, lending to the government by the two state banks is high and the return on these loans is lower than that of lending to private sector. Secondly, high non-performing loans of the two banks lower the interest income.

Loan loss provisions as a percentage of total loanable funds are higher in foreign banks than in domestic private banks and state banks. Though loan loss provisions are purely on account of lending business of a bank, other operating expenses which include personal expenses, expenses on premises, equipment and establishment, fees and commissions paid etc. cannot be separated between lending business and non lending business of the bank. The profit margin of a bank also cannot be separated between the two types of activities.

Though the interest cost is low in state banks, as interest income is also lower, these two banks enjoy thin margins compared to other banks. The interest margins of the two state banks are on average 4.1 per cent, while it is 5.4 per cent for the domestic private banks. Foreign banks have margins that are on average 7.0 per cent. Also, it should be noted that the two state banks in total have negative profits, which lowers the interest spread of the two state banks.

It is often alleged that interest rate spreads are high because of the underlying opportunity cost imposed on banks by the SRR, a measure implemented by the Central Bank as a part of its monetary policy. The argument is based on the zero return on such reserves kept with the Central Bank. However, the reserve requirement is applicable only to the rupee deposits of commercial

TABLE 2
Reserve Cost of Commercial Banks – 2000

	2 State Banks (Avg.)	Domestic Private Banks (Avg. of 4 largest banks)	Foreign Banks (Avg. of 7 banks)
Interest cost as a % of loanable funds	7.7	8.9	8.3
Interest cost as a % of deposits and borrowings	7.4	8.2	7.6
Estimate of Reserve Cost	0.3	0.7	0.7

Box 14 (Contd.)

banks, though total loanable funds of a bank includes rupee borrowings, foreign currency borrowings and foreign currency deposits in addition to rupee deposits. Hence, the effective reserve cost is significantly lower than the stated SRR and the claims made by critics. Data for 2000 indicate that the reserve cost of state banks is less than a half of that of domestic private banks and foreign banks. This may be attributed to the fact that the two state banks have high borrowings (25 per cent of total loanable funds) compared to domestic private banks (9 per cent of loanable funds) and foreign banks (13 per cent), which do not require reserves. Hence, the claim that SRR has raised the lending rates of banks unduly to a high level is not substantiated by facts.

Hence, the main areas that banks need to be concerned about in narrowing down high interest spreads are reducing non-performing loans and operating expenses while keeping reasonable profit margins. Banks should raise the quality of their loans so as to lower the high NPLs.

At present, commercial banks derive the major share of their income from fund based activities. As at end 2000, around 80 per cent of their income is derived from fund-based activities and the balance from fee-based activities. Hence, banks should increase the share of the fee-based income by engaging in new value added products and services, which reduce their dependence on interest income as the major source of profit. This income mix will help them to reduce the interest margins. Development of the bond market in Sri Lanka would also have some impact on reducing the interest spread of commercial banks through increased competition in the financial system and also creating new fee income avenues for banks.

adjusted their interest rates on foreign currency deposits and foreign currency lending downward, particularly during the second half of the year. The US Fed Funds Rate, which was 6.50 per cent in December 2000, was gradually reduced to 1.75 per cent in December 2001. The 12-month LIBOR rate came down from 6.20 per cent to 2.44 per cent during the same period.

Rates on Medium and Long-Term Government Paper

During the year, Treasury bonds with maturities of 2-3 years were issued. Yield rates on these bonds came down towards the end of the year. Yield rates on 2-year Treasury bonds varied in the range of 14.94-22.21 per cent and 3-year Treasury bonds were in the range of 14.50-18.60 per cent during the year. The Government of Sri Lanka floated dollar denominated Sri Lanka Development Bonds amounting to US dollars 108.5 million in November 2001 and US dollars 50 million in December 2001. The first issue was with a put option at the end of the first year, while the rate applicable was 6-month LIBOR plus 175 basis points in the first year and 6-month LIBOR plus 225 basis points in the second year. The second issue was without a put option and the interest rate applicable was 6-month LIBOR plus 200 basis points per annum.

Rupee loans with maturity periods ranging from 2 years to 6-8 years were issued during 2001. Interest rates on Rupee loans, which are administratively determined, varied in the range of 13-15 per cent per annum.

Rates on Corporate Debt Securities

Rates on commercial paper, a short-term debt instrument, varied in the range of 17.50-23.00 per cent during the greater part of the year and came down to a range of 14.30-15.24 per cent towards the end of the year. Three listed corporates, Eagle Insurance Co. Ltd., Seylan Bank Ltd. and Apollo Hospitals Ltd., issued listed debentures during the year. Interest rates on these debentures varied from 15-23 per cent, depending on the type of debenture, maturity period and frequency of interest payments. The rates on debentures issued towards the end of the year were around 15 per cent.

The Legal Rate and the Market Rate

The Legal Rate and the Market Rate are published by the Central Bank annually. The Legal Rate is defined under the Civil Procedure Code (Amendment) Act, No.6 of 1990 and is applicable to any action for a sum of money. The Market Rate is defined under the Debt Recovery (Special Provisions) Act, No.2 of 1990. The Market Rate applies only in relation to actions instituted by lending institutions for the recovery of debts exceeding Rs.150,000 arising out of commercial transactions, where there is no agreed rate of interest. The Legal Rate and the Market Rate were 9.21 per cent in 2001, as compared to 9.10 per cent in 2000.

10.5 Commercial Banking

The total number of commercial banks operating in Sri Lanka declined from 26 at end 2000 to 25 at end 2001. Activities of the commercial banking sector grew at a slower pace in 2001 when compared with 2000, reflecting the slowing down of economic activity. Also, relatively high interest rates, particularly during the first half of the year, discouraged demand for credit by the private sector, although some recovery was seen towards the end of the year. Credit extended to the government however, exceeded the initially expected level.

Total assets/liabilities of the domestic banking units (DBUs) of commercial banks grew by 9.4 per cent in 2001 in comparison to the 18.7 per cent growth in 2000. Total assets of the FCBUs grew by 39.0 per cent, compared to the 27.5 per cent growth recorded in the previous year. However, the growth in 2001 was largely a reflection of exchange rate depreciation and when adjusted for that effect, the growth was 20 per cent, in comparison to the 15 per cent growth in 2000.

Credit extended by DBUs to the government increased significantly as the financing requirement of the government from banks was higher than originally anticipated. Meanwhile, the growth in credit to public corporations was slower in 2001 than in 2000. This was mainly due to repayments made by the Ceylon Petroleum Corporation, following the improvement in its financial position.

The credit to deposits ratio of the DBUs of commercial banks declined due to a higher growth in deposits (16.2 per cent) than in advances (11.1 per cent).

Credit extended by FCBUs to the government also increased substantially, while the growth in credit to corporations decelerated in comparison to the previous year. Credit to the private sector indicated only a slight improvement. Expansion in credit to the government reflected the extension of loans, on a net basis, amounting to US dollars 159 million, and investments of approximately US dollars 110 million in the dollar denominated Development Bonds.

Reflecting the expansion of banking facilities and competitiveness in the banking sector, deposit mobilisation of commercial banks grew at a somewhat higher rate (16.2 per cent) than in the previous year (14.2 per cent). Credit extended to the private sector by commercial banks grew only moderately as a consequence of the slowing down of economic activities. Meanwhile, the ratio of non performing loans to total loans and advances of commercial banks increased from 15 per cent at end 2000 to 16.8 per cent at end 2001, reflecting the impact of external shocks on real economic activity, particularly tourism related activities, agriculture and manufacturing sectors.

Structure of Assets and Liabilities of Commercial Banks

Domestic Banking Units

The growth in total resources of DBUs of commercial banks was lower than in the previous year. Total resources increased only by Rs.63.5 billion (9.4 per cent) in 2001 in comparison to Rs.106.8 billion (18.7 per cent) increase in 2000. On the assets side, this was reflected mainly in the slowdown in credit extended, the acquisition of foreign assets and holdings of commercial bills. Total loans and advances, which include loans, overdrafts and purchases of commercial bills, increased by 6 per cent in 2001 compared to the 17 per cent increase in 2000. The contribution of the growth in total loans and advances to the growth of total commercial bank assets fell from 49 per cent in 2000 to 34 per cent in 2001. Though the overdrafts provided to the government increased substantially, reflecting the increase in the government's financing requirement during the year, a decrease in the overdrafts to the private sector has been recorded. Holdings of commercial bills, both import and export, declined substantially reflecting the slowing down in international trade. Meanwhile, the growth in foreign assets of commercial banks declined from 27 per cent in 2000 to 12 per cent in 2001.

Investments of commercial banks, including holdings of government securities, increased substantially (98 per cent) compared with a decline (7 per cent) last year. This was

TABLE 10.7
Selected Items of Assets and Liabilities of Commercial Banks (a)

Item	Change			
	00 Dec / 99 Dec		01 Dec / 00 Dec	
	Amount (Rs.mn.)	%	Amount (Rs.mn.)	%
Assets Category				
1. Liquid Assets	15,552	9.9	30,789	17.8
Cash on Hand	-1,060	-9.0	356	3.3
Due from Central Bank	492	1.7	9,862	34.2
Foreign Currency on Hand	19,179	27.5	10,926	12.3
Treasury Bills	-4,225	-36.3	2,292	31.0
Treasury Bonds (b)	-260	-3.5	11,876	164.0
Commercial Bills	1,426	5.0	-4,522	-15.1
2. Investment	-2,396	-7.3	29,749	97.9
Treasury Bills	-4,225	-36.3	2,292	31.0
Other Government Securities	-260	-3.4	16,161	220.4
Other Investment	2,089	15.4	11,295	72.2
3. Total Loans and Advances	51,848	17.0	21,573	6.0
Loans	22,702	12.3	6,048	2.9
Overdrafts	27,720	30.1	20,047	16.8
Commercial Bills	1,426	5.0	-4,522	-15.1
4. Fixed and Other Assets	16,753	16.8	-2,720	-2.3
Liability Category				
1. Capital Accounts	237	0.5	7,288	14.1
2. Total Deposits	55,963	14.4	73,155	16.4
Demand Deposits	6,309	9.8	13,931	19.8
Time & Savings Deposits	49,654	15.3	59,224	15.8
3. Borrowings	35,381	95.1	-9,864	-13.6
Local Borrowings	33,810	103.0	-8,828	-13.2
Foreign Borrowings	1,571	35.9	-1,036	-17.4
4. Other Liabilities	15,245	16.5	7,470	6.9
Total Assets / Liabilities	106,826	18.7	63,474	9.4

Source: Central Bank of Sri Lanka.

(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.

partly a reflection of the slower growth in demand for loans and advances and partly due to increased market liquidity, which reduced the need for banks to engage in reverse repurchase transactions using government paper. The rupee liquidity shortage in the market, which was around Rs.30 billion at the end of 2000, came down during the year and, by end 2001, there was a liquidity surplus of around Rs.1 billion.

Commercial banks improved their liquidity position during the year. Total liquid assets increased by 18 per cent compared to the 10 per cent growth in 2000, largely due to the increase in cash on hand, balances due from the Central Bank, and the holdings of Treasury bills and Treasury bonds. The ratio of total liquid assets to total assets increased from 25 per cent in 2000 to 27 per cent in 2001.

Within the liabilities category, the growth in deposit liabilities (16.4 per cent), was higher than the growth in total liabilities. The relatively high deposit rates assisted deposit mobilisation. In comparison, deposit liabilities grew by 14.4 per cent in 2000. Deposit liabilities as a ratio of total liabilities increased to 70 per cent at end 2001 from 66 per cent at end 2000. Demand deposits as well as time and savings deposits of DBUs grew during the year.

Reflecting the improvement in liquidity of banks and the relatively low demand for credit, inter-bank borrowings declined by 13.2 per cent in comparison to a 103 per cent growth in 2000. Similarly, the exposure of commercial banks to external financing was lower as foreign borrowings of commercial banks declined by 17.4 per cent compared with a 35.9 per cent growth in 2000.

Balances in capital accounts declined by 14 per cent (Rs.7,288 million) in 2001, compared to a marginal growth (Rs.237 million) in 2000, as some banks made significant provisions for bad debt during the year.

Net foreign assets of the banking system shifted in composition. Foreign assets moved from commercial banks to the Central Bank during the year, particularly due to the sales of foreign exchange, amounting, on a net basis, to US dollars 126 million to the Central Bank. Commercial banks (particularly FCBUs) invested in dollar denominated bonds issued by the government during the last quarter of the year. Both foreign assets and foreign liabilities of DBUs of commercial banks increased with the growth in liabilities being faster than the growth in assets. Foreign assets grew by 10 per cent in comparison to a 28.2 per cent growth in 2000. The growth was largely reflected in an increase in placements with FCBUs by 39.4 per cent, foreign currency holdings by 37.3 per cent and foreign currency loans by 12.3 per cent. In contrast, deposits with banks abroad declined by 17.5 per cent and export bills discounted declined by 10 per cent (these items inceased by 44.4 per cent and 35.9 per cent, respectively, in 2000).

Over 90 per cent of the foreign liabilities of the DBUs arise from foreign currency deposits in the Non-Resident Foreign Currency (NRFC) accounts, Resident Non-National Foreign Currency (RNNFC) accounts, Resident Foreign Currency (RFC) accounts and foreign currency deposit accounts of exporters. Balances in foreign currency accounts grew by 19 per cent in 2001 compared to the growth of 17 per cent in 2000.

Foreign Currency Banking Units

The number of FCBUs operating in 2001 declined to 25 from 26 in 2000 as one foreign bank was closed down during the year. Total assets/liabilities of FCBUs increased by US dollars 314 million (20 per cent) to reach US dollars 1,903 million in 2001. In comparison, total resources increased by US dollars 206 million (15 per cent) in 2000. About 52 per cent of the resources of FCBUs came about through DBU placements of foreign currency deposits (US dollars 691 million) and deposits by BOI enterprises (US dollars 309 million). Resources from non-national sources accounted for around 27 per cent of total resources (US dollars 519 million). In 2001, resources from both resident and non-resident categories increased in comparison to 2000.

Loans and advances to BOI enterprises, credit to the government and public corporations and investment with non-resident enterprises were the main areas where FCBU funds were utilised. Credit extended to BOI enterprises increased from US dollars 690 million to US dollars 702 million. FCBUs lent a net amount of US dollars 159 million to the government in 2001. The government made a repayment of US dollars 41 million in settlement of a syndicated loan obtained in 1998. The US dollars 100 million syndicated loan obtained in 2000 was rolled over for another year. Meanwhile, US dollars 200 million was borrowed as new loans from FCBUs during the year, of which US dollars 100 million represented funds obtained through a foreign syndicated loan facility, on lent to the government. In addition, FCBUs invested US dollars 110 million in Sri Lanka Development Bonds issued by the government in November and December 2001. Meanwhile, credit extended to public corporations increased by US dollars 51 million. This was partly due to a portfolio shift with a transfer of credit from the DBUs to the FCBUs.

Sources and Uses of Funds of Domestic Units of Commercial Banks

Reflecting the growth in assets and liabilities of commercial banks, resources available to commercial banks increased during the year. The total net availability of resources to commercial banks grew by 70 per cent (Rs.45.4 billion) in 2001, in comparison to the growth of 71 per cent (Rs.26.7 billion) in 2000. On a net basis, the domestic private sector, other banks, the foreign sector, government corporations, other assets and other liabilities, were the major sources of funds for DBUs (approximately 99 per cent of the total),

TABLE 10.8
Sources and Uses of Resources of Commercial Banks (a)

Rs. Million

Category	Change (b) 2000 Sources	Change (b) 2000 Uses	Change (b) 2001 Sources	Change (b) 2001 Uses
1. Government Sector		**3,763**		**34,139**
Holdings of Govt. Securities	4,485			18,459
Deposits	490		13,150	
Import Bills	3,695		2,478	
Short-term Credit		1,842		12,393
Overdrafts		10,591		18,920
2. Central Bank	**1,284**			**11,293**
Borrowings	715			1,075
Reserves		492		9,862
Investment in Central Bank Securities				
Till cash	1,060			356
3. Government Corporations		**14,549**	**1803**	
Deposits		270		2,449
Advances		14,279	4,052	
4. Co-operatives	**68**		**378**	
Deposits	129		287	
Advances		61	91	
5. Other Domestic Private Sector	**10,739**		**25,726**	
Deposits (c)	42,760		45,342	
Local Bills		1,360	290	
Import Bills		1,763	922	
Overdrafts		13,894		1,314
Loans		12,916		16,868
Investments in Securities & Bonds		2,089		4,295
Debentures			1,650	
6. Inter-Bank Transactions	**14,607**		**8,985**	
Balances with Domestic Banks		18,524	18,508	
Deposits & Borrowings with Domestic Banks	33,130			9,523
7. Foreign Sector		**6,897**	**5,829**	
Borrowings	1,571			1,036
Deposits	13,037		16,939	
Foreign Balances including Export Bills		21,504		10,075
8. Other Assets & Other Liabilities		**1,489**	**2,911**	
Capital & Reserves	237			7,268
Fixed Assets		984		1,709
Long term Govt. Bonds				
Restructuring Bonds				
Other Assets		15,769	4,430	
Other Liabilities	15,027		7,478	
Total Net Sources / Uses	**26,697**	**26,697**	**45,432**	**45,432**

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.

while loans to the government and deposits with the Central Bank were the major items with regard to the use of funds.

In 2001, the largest source of funds of the DBUs, on a net basis, was the private sector, reflecting an expansion in the deposit base and a decline in overdrafts during the year. Investments made by the private sector in bank debentures also contributed towards improving the availability of resources to commercial banks. The contribution of the private sector to the total resources of banks was about 57 per cent. In comparison, 40 per cent of the total resources were provided from this source in 2000. Local inter-bank borrowings contributed about 20 per cent compared to 55 per cent in 2000. The decline in inter-bank borrowings of commercial banks was a reflection of the improvement in the liquidity position of banks, particularly during the latter part of the year.

On a net basis, government absorbed about 75 per cent of resources of the commercial banks, in comparison to 14 per cent last year, reflecting the expansion of the government's financing requirement from the banking system. In contrast to the previous year, government corporations became a net source of funds in DBUs as some corporations made repayments during the year.

The Central Bank became a net user of funds during the year, as the increase in bank deposits led to an increase in the statutory reserve requirement that had to be maintained with the Central Bank, even though the SRR was reduced by 1 per cent.

Commercial Banks' Loans and Advances[1]

The quarterly survey of commercial banks' loans and advances revealed that the growth rate in the outstanding amount of total loans and advances provided to the non government sector (public corporations and private sector) by commercial banks declined from 15.9 per cent for the 12-month period ending September 2000 to 9.9 per cent in the subsequent 12-month period ending September 2001. This deceleration in the credit growth was also reflected in the contraction of the overall economy.

During the period under review, credit to the financial and industrial sectors declined, while credit to the services, housing and property development and commercial sectors increased but at a decreasing rate. The substantial credit growth (44 per cent) in the services sector was mainly attributed to the large volume of credit extended to the Ceylon Electricity Board (around Rs.7 billion) by the two state banks. The second and the third highest growth rates (13 per cent and 19 per cent), were recorded by the housing and property development sector and consumption, respectively. Each of these two sectors absorbed around 11-14 per cent of the total credit outstanding.

1. Based on the Quarterly Survey of Commercial Banks' Loans and Advances as at end September 2001.

The commercial sector accounted for the highest portion of credit outstanding (41 per cent). Within this sector, exports and imports absorbed 56 per cent of the credit granted to that sector. In the exports sector, credit provided for processed coconut, processed rubber and, gems and jewellery recorded a decline reflecting the slowing down of these categories of exports. Similarly, in the import sector, credit provided for machinery, private and commercial vehicles and electronic items recorded a drop, reflecting the deceleration in such categories of imports.

The housing and property development category, the second largest absorber (14 per cent) of the total credit outstanding, recorded a 13 per cent growth from end September 2000 to end September 2001. A large portion (80 per cent) of the credit outstanding in this category was for the construction of residential houses.

TABLE 10.9
Sectoral Distribution of Commercial Banks' Loans and Advances (a)

Category	End Sep. 2000 Rs. Bn.	End Sep. 2001 Rs. Bn.	As a % of Total Sep. 2001	Growth (%)	
				Sep. 2000	Sep. 2001
Commercial	127.4	135.3	40.8	18.4	6.1
Exports	30.6	33.1	10.0	20.8	8.2
Imports	6.0	9.8	3.0	30.2	-9.6
Financial	13.0	11.5	3.5	7.3	-11.5
Agricultural	15.3	15.5	4.7	14.7	1.3
Industrial (b)	34.4	33.3	10.1	20.2	-3.0
Tourism	4.1	4.4	1.3	-2.3	7.3
Housing	40.1	45.2	13.7	20.0	12.7
Consumption	31.9	37.8	11.4	9.1	18.6
Services	18.3	26.3	8.0	31.8	43.7
Other	16.7	21.8	6.5	0.4	30.5
Total	301.4	331.2	100.0	15.9	9.9

Source: Central Bank of Sri Lanka

(a) Advances include loans, overdrafts and bills discounted and exclude cash items in process of collection.

(b) Includes advances granted for engineering and building trade, mining and fishing.

The consumption category, which grew by 19 per cent, absorbed 11 per cent of the total credit outstanding. The highest portion of the credit outstanding in the consumption category (76 per cent) was absorbed by individuals for their personal needs.

Credit to the industrial sector dropped by 3 per cent during the 12-months ending September, 2001. This was reflected in a contraction of the manufacturing sector of the GDP by 0.7 per cent in the second quarter and by 10.5 per cent in the third quarter of 2001.

Of the total outstanding amount of credit to the agricultural sector, more than 60 per cent was absorbed by tea, rubber and farming. In this sector credit extended to rubber, coconut, minor food crops and farm mechanisation declined, though credit given to paddy and minor export crops and dairy farming increased. The decline in credit in most of the sub sectors in this sector was also consistent with a contraction in the agricultural sector in GDP during the second quarter by 1.2 per cent and by 1.3 per cent in the third quarter.

In terms of the maturity pattern, short-term credit (less than one year) accounted for 61 per cent of total credit from commercial banks. Medium-term (2-5 years) and long-term (over 5 years) credit accounted for 23 per cent and 16 per cent, respectively. Short-term credit dominated all the sectors, except tourism and housing and property development, where a large portion of credit was on a long-term basis.

In terms of the security obtained, the proportion of credit given against different types of securities was slightly changed at end September 2001 compared with the position as at end September 2000. The relative importance of credit extended against immovable property, plant and machinery increased by 1 per cent to 29 per cent from end September 2000 to end September 2001, while the relative importance of credit extended against personal guarantees and pro-notes declined by 2 per cent to reach 12 per cent. Meanwhile, the relative importance of credit given against fixed, savings and other deposits declined marginally (1 per cent) to 9 per cent at end September 2001. Credit given against other securities increased from 16 per cent at end September 2000 to 17 per cent at end September 2001. The share of credit extended without securities also increased from 14 per cent at end September 2000 to 17 per cent at end September 2001.

The proportion of credit provided at higher rates of interest by commercial banks recorded an increase during the period under review. The percentage share of total credit given at interest rates over 25 per cent increased from 13 per cent at end September 2000 to 19 per cent at end September 2001, while the proportion of credit at interest rates ranging between 21-25 per cent increased from 21 per cent to 25 per cent during the same period. The share of credit outstanding at interest rates ranging between 16-20 per cent decreased from 38 per cent at end September 2000 to 33 per cent at end September 2001, while the share of credit outstanding at interest rates ranging from 10-15 per cent also decreased from 17 per cent to 11 per cent during the period under review.

10.6 Central Banking

The Central Bank focussed its operations on providing stability to domestic financial markets. Two particular activities within this overall framework, namely, the building up of official reserves and the provision of rupee liquidity, had considerable impact on the structure of its assets and liabilities. Following the independent flotation of the rupee in January 2001, the need to support the announced foreign

Box 15

An Evaluation of Parate Execution in Sri Lanka

Parate execution, which is a Roman – Dutch Law principle, is defined as the right of a creditor to sell movable or immovable mortgaged property without recourse to courts of law. This is not of recent origin, as this right has been in existence in Sri Lanka from as far back as 1939. This principle was first introduced to Sri Lanka with the passage of Amending Ordinance, No.24 of 1939 to the Ceylon State Mortgage Bank Ordinance, No.16 of 1931. The right of Parate execution was gradually extended to other government owned financial and non financial institutions such as Bank of Ceylon, People's Bank, National Savings Bank, National Housing Development Authority and National Development Bank, by the specific statutes under which these institutions were established. Therefore, there was no single statute governing Parate execution until the introduction of the Recovery of Loans by Banks (Special Provisions) Act, No.4 of 1990, as amended by Act, No.24 of 1995, which extended the power of Parate execution to all Licensed Commercial Banks (LCBs) as defined in the Banking Act, No.30 of 1988.

Prior to the introduction of the special debt recovery laws, there was no distinction between lending institutions and other persons, as far as recovery of debt was concerned. The legal provisions governing the recovery of debts due to persons and lending institutions, which were engaged in the business of lending as a commercial activity, were contained in the Civil Procedure Code. It provides a "summary procedure" for liquid claims for recovery of monies due on cheques, promissory notes etc. In addition, the Mortgage Act, No.6 of 1949, introduced Hypothecary Action, (an action to obtain an order declaring the mortgaged property to be bound and executable for the payment of the moneys due upon the mortgage and to enforce such payment by a judicial sale of the mortgaged property) for the recovery of monies due upon a mortgage property to any approved credit agency as defined in Section 333 of the Companies Ordinance. However, under both these pieces of legislation, the legal proceedings were lengthy, costly and slow.

Under liberalised economic policies introduced after 1977, the demand for loanable funds increased, due to opening up of new business opportunities. Banks responded by increasing their lending activities and gradually the recovery of bad debts became a problem for banks, since the legal procedures governing the recovery of debt were slow and protracted. While the right of Parate execution was available to a few institutions mentioned above, it was rarely used due to political and social pressures as well as less competition in the banking industry. In the early 1980s, it was brought to the attention of authorities that delays in the recovery process had the adverse effect of raising the cost of borrowing from banks and other lending institutions and that delays resulted partly from the outmoded laws and partly from the procedural deficiencies. In 1985, the Justice Wimalaratne Commission made far-reaching proposals to speed up the bad debts recovery procedure. On these recommendations, the Government, in 1990, passed into law a package of 14 debt related laws, one of which was the Recovery of Loans by Banks (Special Provisions)) Act, No.4 of 1990. This was not entirely a new law, because it merely repeats the provisions that were in existence under, the Ceylon State Mortgage Bank Ordinance, 16 of 1931 as amended by Ordinance No.24 of 1939.

The Recovery of Loans by Banks (Special Provisions) Act, No.4 of 1990, laid down a set of specific procedures to be followed by banks in the exercise of Parate execution. The steps, in summary, are passing of a board resolution, publication in the Government *Gazette*, publication in the local newspapers, determination of auction date and holding of auction, all of which take about three months. However, the opportunity available for borrowers to obtain a court injunction even on frivolous grounds has somewhat weakened the effectiveness of Parate execution.

Everyone has a right to obtain credit. At the same time there is an obligation that accompanies that right, to repay what is borrowed. However, if there is no effective legal system to help the recovery of bad debt, that would have serious repercussions. The absence of a speedy and efficient legal framework for the recovery of bad debts has the following consequences on the banks, borrowers, depositors and the economy.

(*a*) The slow process and long delays connected with outmoded and deficient debt recovery laws result in banks having to incur an additional cost in the form of legal fees, staff cost and loss of productive time. Banks, in turn, like any other business, pass on these additional costs to customers by increasing their product (lending) prices (interest rates), raising the burden on borrowers observing good loan repayment practices.

Box 15 *(Contd.)*

(*b*) Delays and difficulties cause an accumulation of bad debt in the banking system, which in turn adds another layer of cost to the bank. Banks lend money collected from their depositors, and hence their primary liability is towards them, as eventually, banks not only have to service the depositors but also to pay back whenever a demand for withdrawal is made. Non performing advances basically give rise to connected issues for the bank and the borrower. One is an erosion of the banks' income stream, since only a part of the total assets is earning an income. Therefore, in order to cover its cost, particularly the interest cost of deposits, banks need to increase the price of their products, that is, the rate of interest charged to borrowers.

(*c*) Further, as a prudential measure, banks are required to make provisions from their profits, for the amount of loans categorised as non performing. This is required, as the bank does not receive a part of the money lent. A distinctive feature of a bank is the relatively small capital base compared to a manufacturing company, and its dependence on depositors for money to be lent. Therefore, heavy losses resulting from loan defaults have to be met with additional charges incorporated into lending rates.

(*d*) Higher intermediation costs of banks, resulting from bad debts distort the interest rate structure. These distortions have a negative impact on investment. Also, investment is adversely affected as banks become conservative in lending and avoid risky market segments, which reduces finances for investment.

(*e*) The interest rate is the price or the opportunity cost of money that anybody has to pay, in order to obtain funds. The interest rate applicable to lending is basically composed of three elements, *i.e.*, cost of funds, risk premium and profit margin. The risk premium depends mainly on the probability of loan default. The higher the default rate, the higher the risk premium. The larger portion of loan defaults is by wilful defaulters. Higher lending rates as a result of a higher risk premium, fall not only on wilful defaulters, but also on genuine borrowers.

(*f*) The higher intermediation cost resulting from the effect of higher NPL also has a bearing on interest paid to depositors. One way to account for higher intermediation costs is to keep interest rates paid on deposits low. Therefore, deposit rates may show stickiness, even when other interest rates in the market rise. Then it may be the case that depositors' real return is negative and that the value of money deposited erodes over time. That may discourage depositing savings in banks.

(*g*) NPL can cause even an instability in the banking system and through it, in the financial system, in the event of a serious erosion of depositors' trust in the banking systems' ability to meet their obligations.

These factors underline the need for an efficient legal system that facilitates the recovery of bad debts fast and at a lower cost.

However, the business community alleges that banks resort to Parate execution extensively and that it kills the entrepreneurial sprit in the economy. It is therefore useful to examine this claim using the data available on Parate execution. A summary of data relating to Parate execution carried out by 26 licensed commercial banks is given in Table 1. Of the total number of Parate cases, auctions were held by banks, in 1999 and 2000, only for 8.3 per cent and 12.3 per cent of the cases, respectively. Furthermore, the ratio of cases with regard to which auctions were carried out to the total number of loans outstanding was 0.006 per cent at the end of 2000. The total number of loans was 4,286,024. Furthermore, of the total Parate cases carried out, only 37 per cent of the cases had less than a year lapsed from the date of default. This testifies to the fact that banks resort to Parate execution only as a last resort, after waiting for more than a year, in the majority of the cases.

TABLE 1

Summary 1999 – 2000

Year	No. of outstanding loans (1)	No. of Resolu-tions (2)	No. of Auctions (3)	(3) as a % of (2)	(3) as a % of (1)
1999	4,190,682	1,911	159	8.3	0.004
2000	4,286,024	2,039	248	12.3	0.006

Source: Central Bank of Sri Lanka

The publication of board resolutions in the newspapers and the Government *Gazette* has had a positive impact on the collection process. The figures show that close to 90% of defaulters pay up their debts between the resolution and the auction date. Borrowers are however able to frustrate the banks' effort to recover bad debts by obtaining court injunctions against Parate execution.

Box 15 *(Contd.)*

The question arises as to why these borrowers did not repay their debts before the start of the Parate execution process. One of the reasons is the poor credit culture in the country whereby many borrowers appear to think that money borrowed does not have to be repaid. This category of borrowers termed as wilful defaulters do not settle debts, not due to their inability, but due to unwillingness. Those borrowers whose properties were auctioned may be the ones who were genuinely unable to repay.

A purpose-wise break down of defaulted loans which were subject to Parate execution shows that trade related activities accounted for 54 per cent of the total cases in 2000 (see Table 2). Other activities such as agriculture, manufacturing, and services, had less than 10 per cent each. Therefore, the claim that manufacturing industries are most affected is not substantiated by data.

TABLE 2

Purpose-wise Break-down of NPL subject to Parate execution – 2000 (a)

	Agriculture	Trade	Const., Real Estate, Renting	Service	Manufac-turing	Others	Total
No. of Parate execution	55	483	91	64	58	151	902
Per cent	6	54	10	7	6	17	100

Source: Central Bank of Sri Lanka

(a) The data cover only a part of the total number of Parate executions in 2000, because some of the banks have not reported such detailed information.

Business failure is not an uncommon phenomenon in a dynamic market economy. There are a host of internal and external factors that affect the success or the failure of a venture. Business closures imply that resources are being transferred from non-viable and inefficient units to viable and productive units. The data given in Table 3 on company registrations and cancellations amply testify to the fact that the number of new business ventures begun is higher than the number of closures.

Business failures lead to default on debt owed to banks. Some potential business failures could be identified at the credit evaluation stage, if an effective credit analysis is carried out. Therefore banks must share the blame for the relatively high level of NPLs as loans become non-performing due to reasons such as not undertaking rigorous loan appraisal, lack of training of

TABLE 3

Registration and Cancellation of Registrations of Companies

Type of Company	Registration			Cancellation (a)		
	1998	1999	2000	1998	1999	2000
Private Companies	2,450	2,456	2,380	24	34	133
Public Companies	47	58	50	1	3	12
Associations	84	72	71	–	2	8
Peoples Companies	12	32	22	–	–	–
Public Guarantees Companies	5	7	04	–	–	–
Foreign Companies	44	36	38	–	–	–
Off Shore Companies	2	3	2	–	–	12
Total	2,644	2,664	2,567	25	39	165

Source: Department of the Registrar of Companies

(a) There could be under reporting of cancellations.

staff and expanding the branch network without the required manpower.

In general, however, a bank would resort to the sale of collateral only as a last resort. It would attempt, wherever possible, to support the borrower by rescheduling or restructuring the loan, as this would be in the bank's own interest. A rehabilitated borrower brings business to banks.

The recovery of debt due to banks is important, because it has implications for banks' lending rates, deposit rates, investment, re-lending capacity, depositors money and finally the overall stability of the banking industry. Borrowers need to realise that it is not only their money that is at stake, but also the money of depositors towards whom banks have a fiduciary responsibility. Banks engage in a business and they have a fundamental responsibility to their shareholders. The data available do not suggest that banks use the power of Parate executions extensively to the detriment of entrepreneurs. Yet, banks should be prudent in the use of Parate execution powers against genuine borrowers facing difficulties in repaying their loans, particularly due to reasons beyond their control. Some of the businesses could be rejuvanated by rescheduling their loans, lowering penal rates or giving a moratorium. However, if there is an unusually high number of business failures, the solution lies not in the abolition of Parate execution or change in debt recovery laws, but in addressing the real causal issues that affect such failures.

exchange band by sales from the Central Bank to commercial banks was removed, thereby reducing the drain on the Bank's foreign resources. As the foreign exchange market became relatively stable, the Central Bank was able to purchase foreign currency from commercial banks. The government sold its foreign receipts to the Central Bank, particularly proceeds from privatisation and the receipts from Sri Lanka Development Bonds. These transactions increased the Bank's foreign assets. The injection of rupee liquidity to the market reduced the need for commercial banks to access the Central Bank's reverse repurchase window to obtain liquidity. Consequently, the Bank's holdings of government paper declined.

Structure of Assets and Liabilities

The total assets and liabilities of the Central Bank increased by 14 per cent to Rs.247.5 billion in 2001, compared to an 8.3 per cent growth in 2000.

On the assets side, the increase was entirely reflected in an increase in foreign assets, which included receipts of the first tranche of the SBA facility of the IMF, purchase of foreign exchange from commercial banks and sales of foreign exchange receipts of government to the Central Bank.

Accordingly, total international reserves of the Central Bank increased by 45 per cent (Rs.34.7 billion), as reflected in the surplus in the balance of payments in 2001. In contrast, foreign assets declined by 29 per cent in 2000.

In contrast to the increase in foreign assets, domestic assets of the Central Bank declined by 3 per cent (Rs.4.4 billion) particularly due to the decline in holdings of government securities to Rs.58.3 billion in 2001 from Rs.67 billion in 2000, as a result of improved market liquidity. However, loans and advances to the government through the revolving credit facility increased by Rs.3 billion.

On the liabilities side, the total currency issue of the Bank increased (4.4 per cent), reflecting increases in both the issue of currency notes (4.3 per cent) and coins (7.2 per cent). Meanwhile, the deposit liabilities of the Central Bank increased, particularly liabilities to international organisations, reflecting the liability of SDR 103 million of the first tranche of the IMF SBA facility. Deposits of commercial banks increased (Rs.4.1 billion) despite the reduction in SRR by one percentage point, as a result of the increased statutory reserves on the expanded deposit base of commercial banks. Meanwhile, deposits of the government with the Central Bank increased by Rs.1.1 billion.

10.7 Banking Development

A newly established domestic private bank, NDB Bank Ltd. acquired the business of a foreign bank, ABN-Amro Bank, while another foreign bank, Nova Scotia Bank ceased its operations in Sri Lanka and was absorbed by Citibank during 2001. Consequently, the total number of commercial banks operating in the country decreased to 25 (11 domestic banks and 14 branches of foreign banks) at end 2001 from 26 at end 2000. The total number of Licensed Specialised Banks (LSBs) increased to 14 with the establishment of NDB Housing Bank Ltd. and Ceylinco Savings Bank Ltd.

Branch Expansion

The branch network of commercial banks increased from 1,096 at end 2000 to 1,128 at end 2001, further expanding the availability of banking facilities. The increase was mainly in domestic banks which opened 31 new branches during the year. The banking density, *i.e.*, the number of commercial bank branches per 10,000 people, increased marginally from 0.59 to 0.60 in 2001. The branch network of LSBs increased by 12 and stood at 327 at end 2001. The total number of LSB branches includes 187 branches of six RDBs, and 101 branches of National Savings Bank.

TABLE 10.10

Distribution of Bank Branches

Category	1999	2000	2001(a)
LICENSED COMMERCIAL BANKS			
i. Total No. of commercial banks	**25**	**26**	**25**
Domestic banks	9	10	11
Foreign banks	16	16	14
ii. Total No.of commercial bank branches (b)	**1,055**	**1,096**	**1,128**
Domestic bank branches	1,013	1,051	1,082
Main branches	908	931	950
ASC branches	11	11	11
Kachcheri branches	23	23	23
Extension/Pay offices/ Service Counters	67	82	94
Overseas branches	4	4	4
Foreign bank branches (c)	42	45	46
Pawning centres	188	188	188
Student Savings Units	125	165	193
LICENSED SPECIALISED BANKS (d)			
i. Total No. of Licensed Specialised banks	**12**	**12**	**14**
Regional Development Banks	6	6	6
National Savings Bank	1	1	1
Long-term Lending Institutions	2	2	2
Housing Finance Institutions	1	1	2
Private Savings and Development Banks	2	2	3
ii. Total No. of Licensed Specialised Bank branches	**311**	**315**	**327**
Regional Development Banks	177	181	187
National Savings Bank	100	100	101
Long-term Lending Institutions	20	20	22
Housing Finance Institutions	3	3	5
Private Savings and Development Banks	11	11	12

Source: Central Bank of Sri Lanka

(a) Provisional

(b) Includes Head Offices. Excludes pawning centres and Student Savings Units

(c) Includes extension offices and sub branches

(d) Includes Financial Institutions which have been issued with a licence under the Banking Act to operate as a Licensed Specialised Bank (LSB).

TABLE 10.11
New Commercial Banking Facilities – 2001

Bank	Deposit Schemes	Lending Schemes	Other Services Introduced
People's Bank	'Jaya Sri II' campaign for Jana Jaya Accounts relaunched.	Small and Micro Industries Leader and Entrepreneur Promotion Project II (SMILE II); to provide facilities for industrial, manufacturing and service sub sectors. A credit scheme for granting loans to most affected industries in the North.	Structured a derivative product, *viz.* Interest Rate Swap. 12 ATMs installed.
Bank of Ceylon	18 + youth Savings Account NRFC Silver Jubilee Account	Estate sector self employment revolving fund credit scheme; to provide financial assistance to the estate youth to set up, expand or to improve self employment investments. SMILE II Scheme to provide credit assistance to small and medium-sector industries. Credit Scheme for improvement of locally produced rice to international standards. Credit scheme for the supply of Solar Lighting Systems. Credit scheme for Samurdhi employees. Scheme for Financial Assistance to inventors/innovators. Big Buy Loan Scheme to purchase agricultural and domestic equipment and accessories. Indian line of credit facilities to Sri Lankan importers of products of Indian origin.	29 ATMs installed.
Commercial Bank of Ceylon Ltd.	Repackaging of a progressive saver account.	SMILE II Scheme to provide credit assistance to small and medium-sector industries.	30 ATMs installed. Mobile phone banking to all customers through Dialog GSM. Issue of a Corporate Card; a credit card issued to employees of a company on a gurantee given by the company.
Hatton National Bank Ltd.	Divishakthi Saving Scheme. Minor Accounts for new born babies.	SMILE II Scheme to provide credit assistance to small and medium-sector industries.	11 ATMs installed. Insurance activities through a subsidiary company.
Sampath Bank Ltd.	'Sampath Double "S"; a special bonus scheme for savings accounts.	SMILE II Scheme to provide credit assistance to small and medium-sector industries. 'Hiru Kirana'; Leasing scheme for consumer durables.	Sampath Visa Web Card for the use of transactions carried out on the internet. Internet Payment Gateway (IPG) to make payments via internet for purchasing goods and services from selected companies. E-catalog to display bank's products on the internet. E-chanelling facility to consult doctors. E-Wallet. Visa Electronic Credit Card. WAP (Wireless Application Protocol) PORTAL facility to allow mobile phone users to pay utility bills. 7 ATMs installed.
Seylan Bank Ltd.	Merit Rewards Scheme for current and savings account holders.	SMILE II Scheme to provide credit assistance to small and medium-sector industries. Indian line of credit facilities to Sri Lankan importers of products of Indian origin.	9 ATMs installed.
Nations Trust Bank Ltd.	Certificate of Trust/ Thirasara Sahathikaya.	Student loan scheme for professional courses.	An ATM was installed Sale of Gold Coins
Standard Chartered Grindlays Bank Ltd.			An ATM was installed.
Hong Kong & Shanghai Banking Corporation Ltd.	E-Saver; a savings account operated through HSBC ATM network.		HSBC Premier; A priority personal banking services for best customers. Safe deposit lockers. Personal Banking Call Centre Service. Corporate employee privilege scheme for employees of HSBC's corporate customers to provide special benefits from HSBC products and services. An ATM was installed.

Sources: Respective Commercial Banks

Banking Facilities

Commercial banks continued to expand the facilities and services provided to its customers. A number of banks introduced new types of deposit schemes and lending schemes. The application of modern technology increased. The total number of automated teller machines (ATMs) operated by commercial banks increased by 98 in 2001, bringing the total number of ATMs in operation to 474 at end 2001. Six commercial banks, including five domestic banks, offer Internet banking facilities. The total number of credit cards (net of cancellation) issued increased from approximately 205,000 at end 2000 to 256,000 at end 2001. Of the total cards issued, the majority (78 per cent) were global cards, which can be used for both international and local transactions.

TABLE 10.12

Credit Cards Issued by Commercial Banks

	2000 (a)	2001 (b)	% Change
Total Number of Credit Cards Issued	205,324	255,584	24.5
Local	51,727	57,154	10.5
Global	153,597	198,430	29.2
Outstanding Credit at end year (Rs. mn.)	3,738	5,128	37.2
Local	403	483	19.9
Global	3,335	4,645	39.3
Overdues (as a % of outstanding Credit)	9	12	–
Past Dues (as a % of outstanding Credit)	8	10	–
Commission from Dealers (%)	0.25-4.5	0.25-3.5	–

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

10.8 Credit Information Bureau of Sri Lanka

The Credit Information Bureau of Sri Lanka, established under the Credit Information Bureau of Sri Lanka Act, No.18 of 1990 (as amended by Act, No.8 of 1995), completed its eleventh year of operations in May 2001. It continued to perform its statutory functions of collecting and collating credit information on borrowers of recognised lending institutions, maintaining a properly updated data bank and providing the information thus collected to its shareholder lending institutions. Presently, the database of the Bureau consists of all types of advances, including local currency loans, overdrafts, foreign currency loans, finance leases and credit card facilities.

Activities of the Bureau have improved both qualitatively and quantitatively since its inception in 1990. The number of credit reports issued by the Bureau increased by 10 per cent to 186,020 during the year, from 169,088 reports issued in 2000. Currently, credit reports are issued within an hour, while the coverage of the reports is comprehensive. Reflecting the improved performance of the Bureau, the net profit more than doubled to Rs.13.4 million in 2001 from Rs.6.5 million in 2000. As a result, a dividend of 15 per cent from profits was declared to shareholders. The major shareholders of the Bureau are the Central Bank of Sri Lanka and 12 licensed specialised banks including regional development banks. In addition, registered finance companies, regional development banks and some leasing companies and merchant banks are also shareholders.

10.9 Rural Banking and Credit

Overall Trends and Developments

The system of Forward Sales Contracts for agricultural commodities introduced by the Central Bank in 1999 to ensure stable prices for farmers was vigorously promoted by the Bank with the assistance of lending banks as facilitators, the Ministry of Agriculture, Department of Agriculture, co-operative sector and government sector agencies, non-governmental organisations (NGOs) and private sector entrepreneurs. The forward sales contract system (FSCS), which was initially introduced in a few districts in 1999, was expanded to other districts in 2001. The system is becoming increasingly popular among farmers as well as the buyers of agricultural products in Hambantota, Polonnaruwa, Matale and Badulla districts where major crops like paddy, maize, soya, sesame and big onion are grown. Forward prices that are determined by mutual agreement between the farmer and the buyer proved to be realistic and were treated as a base price by many farmers and buyers in the areas where forward sales contracts were popular. This mechanism has, therefore, prevented sharp fluctuations of prices of crops in major producing areas.

Widening the scope of the New Comprehensive Rural Credit Scheme (NCRCS) to include new eligible investment activities, and writing off of loans less than Rs.20,000 granted for paddy and banana cultivation during four consecutive seasons commencing from the 1999/2000 Maha season were the major policy decisions taken during the year in respect of cultivation loans. Under the widened scope of NCRCS, new eligible investment activities for loans, such as manufacturing of seed and planting materials on a commercial scale by individuals and companies and purchasing and storage of agricultural produce, were included under the FSCS. The objective of the government decision on writing off of loans was to provide relief to farmers whose cultivation was affected by the severe drought that prevailed in major agricultural areas. Accordingly, two state banks, six Regional Development Banks and the Co-operative Rural Banks have taken steps to write off loans amounting to approximately Rs.187 million. However, the more prudent policy option is the rescheduling of loans in such temporary difficult situations as the practice of writing off loans would not only result in unequal treatment of the borrowers who

Box 16

The Role of Credit Rating in Developing the Private Debt Securities Market

Developing the private debt securities market becomes more important as countries move to adopt more market oriented economic policies and the leading role of economic development shifts from the public sector to the private sector. Limitations of governments in meeting financial resource requirements pertaining to large infrastructure projects, privatising public sector enterprises and promoting financial dis-intermediation through securitisation for example have resulted in a high demand for long-term funds in private debt securities markets. Credit rating plays a major role in the development of private debt securities markets as it assists both investors and borrowers by providing information to the market on the creditworthiness of both the instrument and the borrower. This helps ordinary investors to make informed investment decisions, while simultaneously helping the borrowers to obtain better terms for their borrowing.

Private sector enterprises have two basic means of obtaining funds, other than from within the enterprise or in the form of equity. These are:

1. Borrowing from banks;
2. By issuing debt securities in capital markets.

In most developing countries including Sri Lanka, banks continue to play the key role of financial intermediary by obtaining funds from surplus units (savers) and providing these funds to deficit units (borrowers). However, the ability of banks to provide long-term financing on a large scale is limited as the bulk of their funds are short-term deposits and hence, providing long-term financing would lead to a time mismatch in their assets and liabilities. Further, banks usually tend to demand collateral in the form of land, buildings and equipment, and guarantees from third parties, when granting loans. This acts as a constraint to the borrowers who may not be able to provide acceptable collateral. Hence, there is a growing demand for private sector bond markets, where credit rating could play an important role by helping investors to take prudent investment decisions.

The development of private sector bond markets would provide a number of benefits, amongst which the most important are:

1. Supply long term funds for long-term needs;
2. Provide long-term investment products for long-term savers;
3. Endow financial products with flexibility to meet the specific needs of investors and borrowers;
4. Diffuse stresses on the banking system by diversifying credit risks across other investment entities and individuals;
5. Greater competition in the market, leading to more flexibility in interest rates.

A debt securities market has two components, *viz.*, the government debt securities market and the private debt securities market. In developed economies, the private debt securities market plays a greater role in providing capital funds for economic development, and is often larger than the equities market. In Sri Lanka, the private debt securities market is very small, with listed debentures accounting only for about 0.4 per cent of the GDP at end 2001 when compared with the government debt securities market which accounts for about 10 per cent of the GDP. The market capitalisation of listed debt securities at the Colombo Stock Exchange is about Rs.7 billion (US dollars 0.07 billion) in comparison to the market capitalisation of Rs.112 billion (US dollars 1.2 billion) in the stock market. Therefore, in the context of the growing need for private capital for economic development, the expansion of the private debt securities market becomes extremely important. However, one area of concern in developing this market is the quality of the debt instruments being offered.

Traditionally, banks perform the task of intermediating funds between savers and borrowers. Banking activities are supervised by the Central Bank through its off-site and on site surveillance system in order to safeguard the depositors. Banks, through long years of practice, have gained expertise in evaluating the quality of their borrowers. In the case of bond or the debenture market however, there is no intermediary and funds are obtained directly from savers. This process, called financial "dis-intermediation", has helped a more efficient allocation of funds and has become a growing global phenomenon. The crucial aspect of the bond market, in comparison to the banking system, is the responsibility devolved on investors for evaluating default risks. However, due to the lack of information, it is rather difficult to differentiate the low risk issuers of securities from the high risk issuers, (known in Economics as the problem of 'Adverse Selection'). In addition, there could be a risk of 'Moral Hazard', that is, the risk that issuers of securities may use the proceeds for a completely different

Box 16 *(Contd.)*

purpose than the one announced. Therefore, credit rating plays an important role in reducing the risk in investment. Credit ratings provide an opinion on the ability of an entity or of a securities issuer to meet financial commitment such as interest, preferred dividends, or repayment of principal on a timely basis. This reflects a careful and independent assessment of the issuer's ability and willingness to service the promised interest and the principal obligations on a timely basis. The credit rating agency has the expertise and the information that ordinary investors would not usually possess, to make such an evaluation. Any fixed income product or an institution mobilising public funds could be rated by a credit rating company. However, it should be noted that credit rating is not a guarantee of the performance of a rated company. It is an assessment made by the rating company based on the information available to it and hence investors should have to use such information carefully.

The first, and only credit rating company in Sri Lanka, known as Duff & Phelps Credit Rating Lanka Ltd. (DCR Lanka), was set up in October 1999. DCR Lanka became Fitch Ratings Lanka (FRL) subsequent to the merger of its principal shareholder Duff & Phelps (DCR), USA with Fitch IBCA and the formation of Fitch, the international rating agency. The Central Bank of Sri Lanka and the International Finance Corporation (IFC) promoted FRL to promote investment in Sri Lanka and thereby achieve higher economic growth. FRL is a joint venture of Fitch Inc., New York USA, the International Finance Corporation (IFC) USA, the Central Bank and a number of leading financial institutions in Sri Lanka.

Credit ratings are issued in the form of a universal language, which facilitates understanding of the credit worthiness of various fixed income borrowers. International long-term ratings within the range 'AAA' - 'BBB' and short-term ratings within the range of 'F1' – 'F3,' indicate a relatively low probability of default and are defined as "investment grade" ratings. International long-term ratings within the range of 'BB' – 'D' and international short-term ratings within the range of 'B' – 'D', either signal a higher probability of default or that default has already occurred and are defined as "non-investment grades" or "speculative" ratings. FRL also provides ratings on this basis. So far, 15 ratings have been issued by FRL whereas only nine ratings have been published, whose details are given in the table below.

The advantage to an issuer of a debt instrument in obtaining a rating is that it would help lower the rate of interest offered to investors, as uncertainties faced by investors would be reduced, which is a major concern of investors when taking investment decisions. The cost of obtaining a rating depends on the extent of the size of a company and its activities. On average, in Sri Lanka, the cost for an institutional rating is in the region of Rs.400,000 – Rs.800,000, while the cost of an instrument rating is based on the value of the issue and is in the region of 0.1 - 0.4 per cent of the value.

Entity Ratings

Date	*Description*	*Rating*
Feb 2002	Senkadagala Finance Company Ltd.	SLBBB
Oct 2001	Hayleys Ltd.	SLAA+
Mar 2001	Commercial Bank of Ceylon Ltd.	SL AA+
Aug 2000	John Keells Holdings Ltd.	SL AAA

Instrument Ratings

Date	*Description*	*Rating*
Nov 2001	Aitken Spence & Co. Ltd. – Debentures	SLAA
Aug 2001	Singer (Sri Lanka) Ltd. – Debentures	SLA
May 2001	Singer (Sri Lanka) Ltd. – Short-term debt	SL F-1
Feb 2001	Lanka Orix Leasing Co.Ltd. – Commercial Paper	SL F-1
Dec 1999	Sri Lanka Telecom – Debentures	SLAA+

settled their loans even under difficult situations, but also have adverse implications on credit culture. Such a policy also discourages the development of market based financing facilities to the agricultural sector, hindering the long-term growth prospects of farmers.

A Technical Assistance (TA) Agreement was signed by the government with the Asian Development Bank (ADB) on Rural Financial Sector Development Project. The objectives of the TA are to define the main constraints to improving the income and living standards of the rural people, to identify the main constraints to developing a responsive and effective rural financial system, and to design practical and sustainable projects that increase income and employment opportunities in the rural sector.

Operations of credit schemes funded by donor agencies, government and both state and private banks continued during the year under review. Cultivation loans under the NCRCS continued to be provided by participating banks out of their own funds. The scheme is backed by the government's interest subsidy of 10 per cent per annum. The interest rate for loans granted under the scheme remained unchanged at 12 per cent per annum. Microfinance programmes, focussed on reducing poverty through building social capital, continued during the year under review. Many of these programmes were based on the self-help group concept in establishing a 'cost effective credit delivery mechanism' with credit plus approach. The Small Farmers and the Landless Credit Project, which is the pioneering project in which the group approach has been adopted, continued to be operated in the Kandy, Puttalam, Galle and Matara districts by the Isuru Development Societies. The project was jointly monitored by the Central Bank and the RDBs in the respective regions. This project has been replicated by other institutions that are engaged in credit activities in the rural sector. The Poverty Alleviation Microfinance Project (PAMP), funded by the Japan Bank for International Co-operation (JBIC), is a major project that replicated the same approach in microfinance activities in six other districts.

A competitive fee-based agriculture extension system in respect of agriculture extension services was launched in 2001 for the first time in Sri Lanka under the ADB funded Second Perennial Crops Development Project with the signing of agreements with three private sector service providers by the Ministry of Agriculture. Initially, the private sector service providers charged fees from borrowers who obtained loans under the Project for which the extension services were obtained from them. Subsequently, in November 2001, the Project Office too commenced charging fees from borrowers for the services rendered by it in the districts where the private service providers were not providing those services. This system was introduced as a pilot project under the Ministry of Agriculture and was monitored by the Pilot Project Monitoring Unit to ensure the continuous provision of this service to farmers even after the termination of the foreign funded project and to accustom farmers to obtain fee-based services instead of depending on free services from the government.

TABLE 10.13

Cultivation Loans Granted Under the New Comprehensive Rural Credit Scheme (Position as at 31 December, 2001)

Rs. Million

Season	State Banks			Domestic Private Banks (a)			Regional Dev. Banks			Total Loans		
	Paddy	Subsidiary Food Crops	Total	Paddy	Subsidiary Food Crops	Total	Paddy	Subsidiary Food Crops	Total	Paddy	Subsidiary Food Crops	Total
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	75	23	98	10	29	39	25	20	45	110	72	182
Cultivation Year 1999	224	47	271	40	51	91	54	47	101	318	145	463
1999/2000 Maha	176	34	210	44	21	65	58	46	104	278	101	379
2000 Yala	83	39	122	45	31	76	53	43	96	181	113	294
Cultivation Year 2000	259	73	332	89	52	141	111	89	200	459	214	673
2000/2001 Maha	123	39	162	67	25	92	61	51	112	251	115	366
2001 Yala (b)	68	32	100	34	25	59	68	45	113	170	102	272
Cultivation Year 2001 (b)	191	71	262	101	50	151	129	96	225	421	217	638

(a) Hatton National Bank, Seylan Bank and Sampath Bank only.
(b) Provisional

Source: Central Bank of Sri Lanka

TABLE 10.14

Savings Mobilised and Advances – Selected Rural Sector Institutions (a)

Rs. Million

	Co-operative Rural Banks (CRBs)		Regional Development Banks		Thrift and Credit Co-operative Societies (SANASA)		Sarvodaya (SEEDS)		Janashakthi Bank Hambantota		SANASA Development Bank	
	2000	2001 (b)	2000	2001 (b)	2000	2001 (b)	2000	2001 (b)	2000	2001 (b)	2000	2001 (b)
Total Savings (c)	14,807.0	15,923.0	3,485.8	4,162.5	4,205.2	4,602.7	627.0	849.0	64.2	78.6	1,177.0	1,361.0
Savings	10,870.0	11,717.0	2,227.3	2,477.9	1,718.3	1,876.1	n.a.	n.a.	21.4	25.8	194.0	262.0
Special savings	–	–	590.1	728.9	917.1	962.9	n.a.	n.a.	25.6	32.5	12.0	9.0
Fixed deposits	3,937.0	4,206.0	668.5	955.7	729.3	802.2	n.a.	n.a.	0.6	0.5	810.0	929.0
Shares	–	–	–	–	840.5	851.5	n.a.	n.a.	16.6	17.7	161.0	161.0
Total Loans Granted (d)	5,151.0	5,672.0	4,413.6	4,324.8	2,844.6	2,863.8	487.0	618.0	103.9	58.1	387.0	616.0
Agriculture	941.0	931.0	544.0	509.0	268.7	295.6	87.1	73.0	35.9	27.5	4.0	3.0
Animal husbandry	122.0	169.0	53.5	83.5	81.7	98.9	14.1	22.0	–	–	–	–
Fisheries	19.0	18.0	39.1	63.1	–	–	–	–	0.4	2.6	–	–
Small industries	274.0	299.0	391.0	339.0	156.1	195.1	30.8	62.0	2.1	9.3	10.0	8.0
Building construction, electrification and water supply	2,991.0	3,006.0	377.0	443.0	1,427.7	1,284.9	–	–	2.5	6.4	14.0	8.0
Projects/Commerce	182.0	180.0	603.0	522.0	273.3	300.7	94.0	269.0	57.7	11.1	139.0	223.0
Others	622.0	1,069.0	2,406.0	2,987.0	637.0	688.5	261.0	194.0	5.4	2.1	220.0	388.0

(a) This does not include Agrarian Service Centre (ASC) Branches of Bank of Ceylon as most of these branches have been upgraded to full branches and contribution of the remaining ASC branches to total savings and advances of rural sector institutions is insignificant.

(b) Provisional

(c) Total Savings at the end of the year

(d) Total loans granted during the year

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

Ceylinco Insurance Company Ltd., which is the only private sector insurer working in the field of crop insurance, developed and introduced a new insurance scheme for post-harvest crop insurance for paddy in 2001 as a pilot insurance scheme. This will be operated for Yala 2002. The idea of having post-harvest insurance emerged from members of farmer organisations, who have signed forward sales contract agreements with buyers, to protect their harvest from unforeseen risks until they are able to fulfil their contracts. This development can be viewed as a further step towards a farmer friendly insurance system, as well as a market-oriented development from the point of view of the farmers.

Lending rates, as well as refinance rates, of several ADB funded credit schemes were increased in the second half of the year, due to the increase in AWDR, as those rates were linked to AWDR. As a result of the increase in the cost of funds in the market, many banks increased their lending under the refinance schemes or schemes backed by government interest subsidies, which had relatively lower interest rates. Therefore, credit disbursements under the donor funded and government-funded schemes increased considerably. However, there was a slowing down of lending activities under the schemes operated by both private and state banks out of their own funds due to the high cost of funds.

The Dambulla Dedicated Economic Centre (DDEC) that was developed by the government in 1999 continued to operate as the largest fruit and vegetable selling centre. The Norochcholai and Keppetipola Economic Centres commenced operations during the year under review. The Central Bank also continued its activities in arranging some preliminary infrastructure facilities required for setting up a forward exchange at DDEC.

Forward Sales Contract System (*Govi Sahanaya*)

During the year under review, the Bank promoted the concept of forward sales by way of contracts agreed between the sellers and buyers to sell major agricultural crops such as paddy, maize, soya, sesame, big onion, green gram and some vegetables.

It has been observed that farmers, particularly in major agricultural districts, as well as buyers, have gradually

TABLE 10.15

Forward Sales Contracts – 2001

Crop	No. of Agreements	No. of Farmers Benefited	Forward Price Determined (Rs. per kg.)
Maize	1,667	3,450	10 - 15
Paddy	3,855	4,600	12 - 14
Sesame	953	953	40
Big Onion	1,145	1,145	24
Soya	320	320	20 - 27
Vegetables	37	37	10 - 21
Other Crops	569	569	25 - 350
Total	**8,546**	**11,074**	**–**

Source: Central Bank of Sri Lanka

increased their interest in joining the FSCS. Farmers were encouraged by the better prices ensured under the contracts for their produce while buyers were encouraged by the prospects of regular supplies and better quality. It was also observed that farmers, in order to obtain a better price, have attempted to improve the quality of their produce while the availability of a better price for their crop, in turn, encouraged farmers to increase production. Therefore, while the FSCS encourages the farmers to invest more in agriculture, buyers can plan their investments with assured availability of high quality agricultural produce at reasonable prices, so that both parties benefit by entering into forward sales contracts. These sales agreements served to facilitate the bankers in the supply of credit to small farmers and the buyers who agreed to purchase these commodities at a pre-determined price.

New Comprehensive Rural Credit Scheme (NCRCS)

The New Comprehensive Rural Credit Scheme (NCRCS) continued to operate throughout the country during the year under review, with expanded scope. The total value of credit disbursed by the Participatory Credit Institutions (PCIs) out of their own funds under the NCRCS in 2001 amounted to Rs.638 million. Of the total credit disbursed, a sum of Rs.366 million was disbursed during Maha 2000/2001 and the balance Rs.272 million in Yala 2001. This reflected a decrease of Rs.35 million (5 per cent) over the previous year's disbursements. Due to the adverse effects of writing off of cultivation loans, banks were reluctant to issue new loans anticipating more defaults by farmers.

The Central Bank continued the payment of the government interest subsidy to PCIs for loans granted under NCRCS. The objective of granting an interest subsidy to PCIs is to cover the possible losses to PCIs due to their having to lend below the cost of funds. An interest subsidy amounting to Rs.25 million was paid by the government to PCIs during 2001 in respect of loans granted in three cultivation seasons *i.e.,* 1999/2000 Maha, 2000 Yala, 2000/2001 Maha.

Crop Insurance Scheme

In 2001, the Agriculture and Agrarian Insurance Board (AAIB) and Ceylinco Insurance Company Ltd. (CICL) continued to provide agricultural insurance coverage for paddy, subsidiary food crops, livestock, etc. At present AAIB is operating 14 such crop insurance schemes. CICL has also broadened its scope by introducing new schemes.

The total extent of paddy land insured by AAIB and CICL in 2001 amounted to 3,233 hectares and 7,545 hectares, respectively. The extent insured by AAIB has decreased by 1,404 hectares whereas that by CICL has increased by 3,332 hectares during the year. As in the previous year, the total area insured under paddy by both institutions as a percentage of area cultivated was less than 2 per cent in 2001. The decrease in the area insured by AAIB has mainly been due to the limiting of paddy insurance by AAIB in Wet Zone districts and suspending of their operations in Mannar, Mullaitivu, Kilinochchi and in uncleared areas of Jaffna and Vavuniya districts. The area insured under other crops by AAIB increased from 1,077 hectares in 2000 to 2,561 hectares in 2001. The increase has been mainly due to the increase in the extent of area covered under the export-agriculture crop insurance scheme. CICL has also reported an increase in the extent of other crops insured. Both AAIB and CICL paid considerably higher amounts as indemnities for crop damages due to the drought that prevailed during the year. Both insurers continued to provide livestock insurance during 2001.

Microfinance Schemes

Samurdhi Development Credit Schemes

Samurdhi Banking Societies (SBSs), which act as credit and savings associations of the Samurdhi Movement, continued to mobilise savings, grant loans and provide other services to Samurdhi members during the year under review. At end 2001, 970 SBSs had been set up in 278 Divisional Secretariat divisions, including additional 30 new SBSs opened during the year. The high rate of women's participation is the key feature in this programme. At end 2001, the total number of shareholders of SBSs stood at 1,703,366, an increase of 132,166 shareholders during the year. The value of paid-up capital of SBSs amounted to Rs.1,386 million reflecting an increase of Rs.400 million (40 per cent) over the previous year. The average size of a deposit account stood at Rs.1,025 at end 2001. There were 3,035,233 member and non-member savings accounts with SBSs (including compulsory savings of Samurdhi beneficiaries) with total savings of Rs.3,111 million at end 2001. The total amount of loans granted under the SBSs to their members for self employment activities and consumption purposes during the year stood at Rs.2,764 million. The on-time recovery rate of loans granted under the scheme was 107 per cent in 2000 and it remained unchanged in 2001.

TABLE 10.16
Samurdhi Credit Programmes
Progress as at 31.12.2001

Name of Programme	No. of Loans	Amount Rs. Mn.	Recovery Rate %
Loans granted by SBSs	813,334	5,553	107
SASANA	84,247	514	82
SAVANA	13,682	343	76
Leasing	740	169	51
Accelerated Samurdhi Animators / Credit Programmes	285,984	279	98
PANA	355	129	101
SABA'DA	506	53	102
Total	**1,198,948**	**7,040**	

Source: Samurdhi Authority of Sri Lanka

Farmers' Banks Pilot Project (FBPP)

The Farmers' Banks (Govi Jana Banks) Pilot Project was launched by the Ministry of Agriculture and Lands with the objective of improving the living standards of small farmers by timely supply of credit, farm requirements and services. Inculcating the savings habit among farmers was another objective. At end 2001, 452 Farmers' Banks (FBs) had been established at Agrarian Services Centres (Govi Jana Kendra) with 219,254 farmers as shareholders. This reflects an increase in membership by 37 per cent. A member farmer is required to buy at least 1 share of Rs.100 of the FBs. The share capital of the FBs stood at Rs.22 million at end 2001 compared to Rs.16 million in 2000. Individual savings of the farmers stood at Rs.38 million, of which Rs.14 million had been mobilised during the year. Loans to the value of Rs.80 million each had been disbursed to farmers for paddy and cash crops during 2000/2001 Maha and 2001 Yala seasons with relatively low recovery rates of 78 and 57 per cent, respectively. The FBs expanded the credit facilities for farmers to purchase two-wheel and four-wheel tractors and introduced a loan scheme to enable the farmers to keep their harvest until the market price goes up. The scheme is known 'Vee Surekum'. Under the scheme, a farmer is given a loan at the rate of Rs.10 per bushel to meet his immediate consumption needs until the stock of paddy is sold.

Gami Pubuduwa Scheme (GPS)

The GPS, a rural finance scheme, implemented by HNB with the objective of uplifting the living standards of the rural and semi urban population, completed its twelfth year of operation in 2001. The Scheme is implemented through its wide branch network with 106 delivery units located in both rural and semi-urban areas. A special field officer, called a 'Gami Pubuduwa Upadeshaka', provides the operational link between the borrower and the bank. The scheme provided loans for 40,000 self-employment projects during the entire project period. The value of loans granted at end 2001 had increased to Rs.1.6 billion from Rs.1.4 billion in 2000 whereas the amount outstanding stood at Rs.430 million, compared to Rs.380 million in 2000 covering over 10,000 current projects. HNB has collected savings in the rural sector through the scheme. The amount stood at Rs.950 million as at end 2001, compared to Rs.850 million in 2000. HNB could maintain an average recovery rate close to 97 per cent throughout the project period indicating the importance of social mobilisation, effective supervision and close relationship built with the borrowers.

Sarvodaya Economic Enterprise Development Services (SEEDS)

SEEDS, which is the enterprise arm of the Sarvodaya Movement providing microfinance operations, continued its activities during the year under review. SEEDS established 534 Sarvodaya Development Banks (SDBs) in 18 districts by end 2001. SEEDS provides credit facilities to members of village level Sarvodaya Sramadana Societies for establishing small and micro enterprises. Total amount of loans granted during 2001 was Rs.617 million and the average size of a loan was Rs.16,900. It was also involved in the operation of the World Bank Energy Service Delivery Project under which loans are granted for purchase of solar power systems for their members. SEEDS, at end 2001, had disbursed loans amounting to Rs.153 million to 4,861 clients for the purchase of solar systems. SEEDS also functioned as a Participating Agency of the Small Farmers and Landless Credit Project and Poverty Alleviation Micro-finance Project (PAMP). SEEDS introduced two new savings products namely 'Singithi Rakawarana' and 'Sahasra Wasana' during the year. Total mobilisation of savings of SEEDS increased from Rs.627 million in 2000 to Rs.850 million in 2001. The average size of a savings deposit was Rs.1,078. The recovery rate of loans granted under the SEEDS credit schemes stood at 93 per cent as at end 2001, almost the same level achieved in the previous year.

Credit and Savings Schemes for Women in Micro-Enterprise Development

Kantha Ran Divimaga

Many credit and savings products for women, designed by state banks and private banks, continued to be operated in 2001. The target group of many of these credit schemes were rural women. Among these schemes, the Kantha Ran Divimaga Loan Scheme, which has a link with Kantha Ran Ginum compulsory savings scheme, was launched by the Bank of Ceylon in August 1997, in collaboration with the Women's Bureau of Sri Lanka (WBSL) continued its activities. The objective of the scheme was to uplift socio-economic standards by enhancing income levels of women by providing credit up to a maximum of Rs.100,000 at the rate of 17.5 per cent per annum and inculcating the savings habit among women. The target group of the scheme were members of women's societies who were registered with WBSL. At end of 2001, 1,180 loans to the value of Rs.21 million had been granted to borrowers under the scheme indicating an increase of 15 per cent over the previous year. The recovery rate was 81 per cent.

Janashakthi Banking Societies (JBSs) in Hambantota

Janashakthi Banking Societies (JBSs), which were set up under the Women's Development Federation (WDF) in the district of Hambantota, completed its twelfth year in operation in 2001. The objectives of the scheme were to empower rural women in the district by providing credit and other related services, inculcating savings habits and banking practices, developing sanitation and nutritional practices, providing skill development training etc. The target group of the Scheme were women in poor families whose monthly family income was less than Rs.1,500. At end 2001, there were 67 JBSs. The membership of the JBSs has grown from

28,168 in 2000 to 29,170 in 2001. The amount deposited by members by way of normal deposits, special deposits and fixed deposits stood at Rs.59 million whereas the value of shares issued to the members stood at Rs.18 million as at end 2001. The average deposit size of a member savings account stood at Rs.1,347, whereas the average loan size stood at Rs.5,095. Total loans granted to members during the year stood at Rs.58 million. The cumulative recovery rate of loans granted under the JBSs stood at 97 per cent at end of the year 2001.

Microfinance Activities of the Co-operative Sector

Co-operative Rural Banks (CRBs)

CRBs function as the banking entity of the Multi-purpose Co-operative Societies (MPCSs). At the end of 2001, 1,507 CRBs were in operation throughout the country showing an increase of 31 branches during the year. CRBs operate under the Co-operative Development Department (CDD) with the objective of mobilising savings and granting loans to their member borrowers for agriculture, fisheries, animal husbandry, trade and commerce and related activities. Granting loans against pawning of jewellery remained an important area of business of CRBs. Services such as collection of utility bills, and payment of pensions to farmers were also rendered by CRBs.

The number of deposit accounts of CRBs stood at 5,801,516 as at end 2001 with an increase of 276,765 new accounts. Total deposits stood at Rs.16.6 billion indicating an increase of Rs.1.8 billion compared to the previous year. This substantial increase came mainly from the newly introduced deposit schemes, namely, 'Wimana' and 'Tikiri', and attractive deposit packages introduced during the festival season. With regard to loans, CRBs had an outstanding balance of Rs.5,906 million at end 2001. The cumulative recovery rate of loans granted by CRBs, however, remained relatively low at 65 per cent as at the end of 2001.

The District Co-operative Rural Banking Unions (DCRBUs), which were the apex bodies of the MPCSs at district level, collected excess funds of the CRBs and provided working capital loans for MPCSs. As the end 2001, as in the previous year, 14 DCRBUs were in operation.

Thrift and Credit Co-operative Societies (TCCS)

TCCSs and SANASA Development Bank (SDB) continued with the mobilisation of savings and granting of loans to their members and customers for agriculture, animal husbandry, small industries, rural electrification, trading and commerce etc. during the year. The TCCSs had mobilised a sum of Rs.3,741 million from members and granted loans to the value of Rs.2,864 million to their members and issued shares to the value of Rs.861 million as at end 2001. The total savings mobilised by SDB from their members and customers amounted to Rs.1,200 million and issued shares to members amounted to Rs.161 million as at end 2001. The cumulative recovery rate of loans granted by TCCSs was 88 per cent during the year.

10.10 Other Financial Institutions

Savings Institutions

A salient feature in the institutional development was the entry of the private sector into the savings banking field with the commencement of the operations of Ceylinco Savings Bank. Despite this, the National Savings Bank (NSB) continued to be the premier savings institution in Sri Lanka. The deposit base of NSB was further strengthened in 2001 through a number of measures: introduction of new deposit schemes, customer oriented banking, aggressive marketing campaigns, adjustment of interest rates in line with market trends and increased automation of operations. The total deposits of the NSB grew by 13 per cent to Rs.119 billion at end 2001, while the total assets grew at the same rate to reach Rs.130 billion.

NSB introduced new deposits and loan schemes in order to provide more facilities to its customers. With a view to mobilising savings from Sri Lankans employed in the Middle East, the Bank introduced a rupee deposit scheme named 'Rata Ithuru', which is linked to a loan scheme. Moving away from its traditional activities, NSB introduced pawning facilities, privilege cards for 'Hapan' and 'Punchi Hapan' account holders, a co-branded credit card with the Standard Chartered Grindlays Bank, and safe deposit locker facilities to customers. Further, two Savings Shops were opened and 10 ATMs installed during the year in order to attract more depositors to the bank.

In line with the movements in market interest rates, NSB revised its deposit rates during the year. The rate on savings deposits, which was at 10 per cent in January 2001, was reduced to 8.4 per cent by end December in two steps. The one year fixed deposit rate was raised to a peak of 16 per cent in May, from 15 per cent at end 2000, but revised downward to 13 per cent by end December 2001.

The total loans outstanding with NSB at Rs.20 billion did not show a significant increase compared to the previous year. The lending rates too remained unchanged at 16.0-17.5 per cent throughout the year. Total investments at end 2001 were Rs.102 billion, recording an increase of 14 per cent during the year. The bulk of the investments were in government paper, although investments in corporate debt instruments such as debentures, commercial paper, shares and unit trusts, also increased during the year.

Contractual Savings Institutions

The major category of contractual savings institutions other than insurance companies, are the provident funds, which are designed to provide members with superannuation benefits. Three state controlled provident funds, Employees' Provident Fund (EPF), Employees' Trust Fund (ETF), and Public Service Provident Fund (PSPF) and about 200 other approved

Chart 10.6
Employees' Provident Fund

Chart 10.6.1
EPF Contributions and Refunds

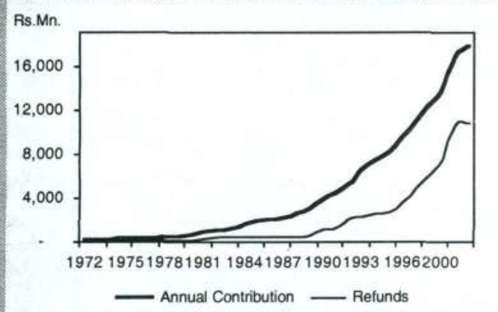
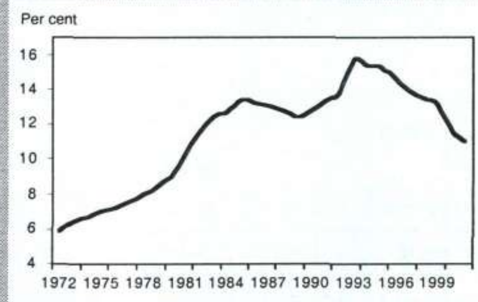


Chart 10.6.2
Rate of Return on Investment



private provident funds were operating in Sri Lanka at end 2001.

In spite of the moderation of economic activities in 2001, the total contributions to the EPF, the largest provident fund, during the year amounted to Rs.17.7 billion, which is an increase of 5 per cent over 2000 due partly to an increase in the membership by 18,712. The total investments by the EPF grew by 14 per cent, to Rs.246 billion. The investments of the Fund (98 per cent) are mainly in government securities. However, the EPF has been diversifying its investment portfolio gradually over the past few years. The total investments in listed equities amounted to Rs.1,264 million, at end 2001. Meanwhile, the realised gross rate of return on the portfolio was 13.1 per cent in 2001. The comparable rate in 2000 amounted to 12.9 per cent.

The contributions to the ETF, the second largest provident fund, rose by 7.5 per cent and the outstanding member balances rose further to Rs.33.1 billion by end 2001 from Rs.29.6 billion in 2000. Meanwhile, benefits paid to members during the year amounted to Rs.1.6 billion as compared to Rs.1.4 billion in 2000. Total investments by the fund, which includes investment in government securities, equity market, and private sector debentures increased to Rs.33.8 billion, showing an increase of 16 per cent. Within the investment portfolio, there was a decline in equity investments from Rs.2.2 billion to Rs.2.1 billion in view of the sluggish conditions in the equity market. However, investments in debentures and other corporate securities increased from Rs.4.0 billion in 2000 to Rs.4.7 billion in 2001.

The Public Service Provident Fund, the third fund operated by the state, is for the benefit of certain non-pensionable employees of the government. At end of 2001, there were approximately 50,000 active members of the Fund, the majority of whom belong to the Reserve Police Service. The total size of the fund amounted to approximately Rs.6 billion by December 2001.

Long-Term Lending Institutions

As in the past, LSBs such as DFCC Bank, National Development Bank (NDB), State Mortgage and Investment Bank (SMIB), National Savings Bank and other private savings and development banks and two non-bank housing finance institutions (HFIs) provided medium and long-term credit. Loan approvals by these two categories of institutions amounted to Rs.28,215 million (94 per cent by LSBs excluding Regional Development Banks and 6 per cent by HFIs), in 2001, a decrease of 14 per cent over the previous year. This was mainly due to a large reduction in lending by the National Housing Development Authority due to a decrease in its funding sources from the government in 2001 and a considerable reduction of credit approvals by the large development banks consequent on the reduced demand for credit. The total loans granted by these institutions declined by 9 per cent to Rs.21,816 million in 2001. While the two main development banks, namely, DFCC Bank and NDB, mainly assisted the industrial sector of the economy, SMIB, NDB Housing Bank Ltd. and the two non-bank HFIs provided facilities to the housing sector. NSB's investments were mainly in government securities, while its loan portfolio was dominated by the housing sector. Meanwhile, private savings and development banks including SANASA Development Bank and Pramuka Savings and Development Bank provided finance facilities mainly to the commercial sector.

Finance Companies

The number of finance companies registered with the Central Bank remained unchanged at 25 as at end of 2001. The total assets of finance companies registered a 10 per cent growth

TABLE 10.17
Purposewise Classification of Loans Approved by Long-Term Credit Institutions

Rs. Million

Purpose	LSBs (a)		HFIs (b)		Total	
	2000	2001 (c)	2000	2001 (c)	2000	2001 (c)
Agriculture	1,895	1,191	–	–	1,895	1,191
Industry	10,634	9,518	–	–	10,634	9,518
Tourism	238	760	–	–	238	760
Commercial	2,118	3,340	–	–	2,118	3,340
Financial	3,212	1,846	–	–	3,212	1,846
Housing	3,776	3,209	4,052	1,320	7,828	4,529
Redemption of Debt	38	52	7	8	45	60
Other Loans	6,780	6,722	170	249	6,950	6,971
Total (Approved)	**28,691**	**26,638**	**4,229**	**1,577**	**32,920**	**28,215**
Loans Granted (d)	22,017	20,707	1,961	1,109	23,978	21,816
Loans Granted as a percentage of total loans approved	77	78	46	70	73	77

(a) Licensed Specialised Banks excluding Regional Development Banks

(b) Non-bank Housing Financial Institutions; National Housing Development Authority and Housing Development Finance Corporation of Sri Lanka

(c) Provisional

(d) Includes loans approved in previous years and disbursed during the period under review.

Source: Central Bank of Sri Lanka

TABLE 10.18
Assets and Liabilities of Licensed Finance Companies (a)

Rs. Million

Item	As at 31 December 2000	As at 31 March 2001	As at 30 June 2001	As at 30 September 2001	As at 31 December 2001 (b)
ASSETS					
1. Loans & Advances	22,306	22,317	22,765	23,201	24,049
1.1 Hire Purhcase	1,762	1,742	1,680	1,637	1,612
1.2 Leasing	13,718	13,707	13,750	13,880	14,159
1.3 Real Estate	2,108	2,028	2,245	2,448	2,672
2. Equity Investments	2,038	2,010	1,959	1,959	1,964
3. Treasury Bills	2,605	2,839	2,905	2,948	3,078
4. Cash and Bank Balances	706	806	825	1,011	1,248
5. Fixed Assets	2,738	2,792	2,875	3,108	3,113
6. Other Assets	3,173	3,271	3,344	3,373	3,492
Total	**33,566**	**34,034**	**34,672**	**35,600**	**36,944**
LIABILITIES					
1. Capital Account	4,947	5,149	5,229	5,380	5,549
2. Fixed Deposits	18,619	19,930	20,568	22,242	23,329
3. Certificate of Deposits	2,194	1,425	1,405	1,099	1,092
4. Borrowings	2,433	2,106	1,934	1,250	1,258
5. Provisions	1,576	1,718	1,770	1,782	1,810
6. Other Liabilities	3,797	3,705	3,766	3,848	3,906
Total	**33,566**	**34,034**	**34,672**	**35,600**	**36,944**
No. of Finance Companies reporting to the Central Bank	25	25	25	25	25

(a) Unaudited

(b) Provisional

Source: Central Bank of Sri Lanka

over the previous year, with such items as cash and bank balances, investments and loans and advances and fixed assets accounting for the growth in total assets. The growth in total assets had entirely been funded by money raised though deposits. Borrowings from other sources such as commercial and investment banks had been reduced significantly. The higher interest rates prevailing in the commercial banks would have contributed to the reduction in such borrowings. The total capital funds had grown by about 12 per cent, mainly due to an increase in the reserves. The change in the funding mix is further evident from the fact that borrowings as a ratio of total liabilities declined to 3 per cent from 7 per cent in the previous year, while the ratio of fixed deposits increased to 63 per cent in 2001 from 55 per cent in 2000.

The liquid assets, which are composed of cash, demand deposits and time and savings deposits, showed an improvement as a ratio of total assets. The increased investment in debt instruments, particularly in government debt securities, was the major contributory factor for the growth in total investment, since the equity investments had not shown any significant variation. Investment in government paper increased due to their attractive yields and weak private sector demand for loans, hire purchase and leasing. The loans and advances portfolio had recorded a 8 per cent growth, as a result of increases in real estate loans and leasing activities. Real estate loans accounted for a large share of the increase in the total loan portfolio. Meanwhile, hire purchase loans decreased by about 8 per cent.

10.11 Specialised Financial Institutions

Merchant Banking

Activities of merchant banks slowed down during the year with the downturn in economic activities. As reported by 12 merchant banks, the total assets decreased by 20 per cent

TABLE 10.19

Progress of Activities of Merchant Banks 2000 – 2001

Rs. Million

	2000 (a)	2001 (b)
Earned Income on Leasing	750	698
Interest on Discounting Trade Bills	71	107
Financial and Marketing Consultancy Services	52	36
Underwritting Commissions	...	
Insurance Commissions	3	4
Interest on Margin Trading	36	18
Profit /Loss on Investment in Shares	-3	21
Interest on Treasury Bills	273	64
Interest on Loans	390	364
Dividends	72	148
Other Income	338	394
Total Income	1,982	1,854
Pre Tax Profits/Loss	-1,603	-951
Total Assets	18,246	14,536
No. of Merchant Banks Reporting	12	12

Source: Central Bank of Sri Lanka

(a) 2000 data have been revised according to new information received from merchant banks

(b) Provisional

during 2001 and stood at Rs.14,536 million as at the end of the year. The total income of merchant banks too fell by Rs.128 million. However, the losses of the industry, as a whole, were brought down during the year, mainly because the institutions that had incurred heavy losses in the past were able to reduce them to a certain extent, even though the majority of merchant banks still continued to suffer losses. The major income sources of merchant banks were leasing, interest on loans, dividends and income on discounting trade bills.

Leasing Companies

The Finance Leasing Act, No.56 of 2000, which was passed in Parliament in August 2000, came into effect in August 2001. Under the Act, leasing institutions that carry on finance leasing activities need to be registered with the Central Bank and their activities will be supervised by the Central Bank. The regulations concerning the minimum paid up capital, application fees and the annual registration fees payable by institutions engaged in the finance leasing business have been issued by the Central Bank.

TABLE 10.20

Specialised Leasing Companies Sector Analysis of Leasing Facilities

Rs. Million

Sector	2000	2001 (a)
Industry	773	753
Agriculture	193	199
Trade	1,964	2,101
Transportation	1,089	1,423
Construction	169	169
Services	1,047	732
Others	92	160
Total	**5,327**	**5,537**

(a) Provisional

Sources: People's Leasing Co. Ltd.
Commercial Leasing Co.Ltd.
Ceylease Financial Services Ltd.
Lanka Orix Leasing Co. Ltd.
Mercantile Leasing Co. Ltd.

As in the previous year, there were five specialised leasing companies operating in Sri Lanka. Of the five, three are subsidiaries of domestic commercial banks. The total lease finance facilities provided by specialised leasing companies, as a whole, increased by 4 per cent in 2001. The major sectors that received leasing finance facilities were trade and transportation, accounting for 38 per cent and 26 per cent, of total facilities, respectively. The majority of lease finance facilities during the year was for the lease of commercial vehicles and passenger vehicles. The total assets of these five leasing companies dropped by 2.3 per cent during the year.

High borrowing costs, dearth of long-term funds, competition arising from other institutions that provide leasing facilities, delayed repayments or loan defaults due to adverse economic conditions, specifically in the tourist industry, and GST on lease rentals, have been identified major problems as faced by the leasing industry.

Venture Capital Companies

The total number of venture capital companies (VCCs) remained at seven during the year. The total assets of VCCs dropped by 7 per cent and stood at Rs.2,712 million at end 2001. Following the same trend, the total funds invested also decreased by 6 per cent and stood at Rs.1,470 million. VCCs provided financial facilities for the commencement of new businesses, expansion of existing ventures, and acquisitions and buyouts. The total number of projects assisted in 2001 was around 440 which includes a large number of self employment projects funded by a single company. The majority of funds were utilised by the manufacturing sector.

Insurance Companies

The total number of insurance companies increased to 10 in 2001 with the establishment of HNB Assurance Ltd., a subsidiary of Hatton National Bank Ltd. The new company commenced general insurance business during the latter part of 2001, while its life insurance activities were to be commenced in 2002. The private sector participation in the insurance sector increased further with the government divesting 51 per cent of the shares of National Insurance Corporation Ltd. to Janashakthi Insurance Company Ltd. during the year. The total branch network of insurance companies also rose as the industry expanded. A growth was seen in the industry in terms of profits and assets. The total gross assets of companies rose by 13 per cent and stood at Rs.35,213 million at end 2001.

Both life and general insurance activities expanded during the year. The total value of life assurance funds stood at Rs.29,143 million, an increase of 22 per cent over the previous year. The total premia collected and sums insured in respect of new life business also followed the same trend during the year. The total number of new policies approximately amounted to 230,000. Total benefit payments on maturity, death and disability, surrender and others increased by 16 per cent to Rs.2,166 million in 2001.

The general insurance activities included fire insurance, general accident insurance, marine insurance and motor insurance. Net premia for policies in force in the general insurance category rose by 7 per cent in 2001. Net premia in the motor insurance sector which is the biggest in the general insurance sector also increased during the year.

As a part of the liberalisation of exchange control regulations and the financial sector, Budget 2002 proposed to remove existing restrictions on foreign investments in the insurance sector. As a result, the limit of 90 per cent on foreign investment in insurance companies will be raised to 100 per cent.

10.12 Money Market

Overall Trends

The shortage of rupee liquidity in the market at end 2000 continued during most of 2001, reaching a peak in April 2001. The shortage was met through injections through the Central Bank's reverse repurchase facility. Hence, throughout much of the year, the main factor that influenced the call money market was the Central Bank's Reverse Repo rate. In the second half of the year, the rupee liquidity shortage gradually declined following the permanent injection of rupee liquidity by the Central Bank through the purchase of foreign currency and government paper, together with the reduction in the SRR. By the end of the year, the liquidity shortage had disappeared entirely and was replaced by a surplus of around Rs.1 billion.

Inter-Bank Call Money Market

Reflecting the liquidity shortage, the inter bank call money rates too remained at higher levels, particularly in the first

TABLE 10.21
Money Market Operations 1999 – 2001

Rs. Million

Period	Call Money Market		Primary Treasury Bill Market						Secondary Market (Central Bank)					
				Amount Accepted (Purchases)					Treasury Bill		Re-purchase (Repo)		Reverse Repo Treasury Bill/ Treasury Bond	
	Total Lending/ Borrowings	Out-standing at end period (a)	Total Out-standing (a)	Amount Issued	Central Bank	Commercial Banks	Others	Total	Dis-conts (Sales)	Redis-counts (Purchases)	Sales	Maturity	Purchase	Maturity
1999														
1st Qtr	226,659	3,025	121,996	48,714	5,193	30,684	12,837	48,714	2,141	318	149,679	153,451	19,991	18,394
2nd Qtr	228,935	3,811	123,996	54,103	10,886	30,482	12,735	54,103	1,581	490	56,147	54,784	85,770	87,647
3rd Qtr	244,090	6,131	123,996	54,272	10,682	29,447	14,143	54,272	2,184	593	44,925	45,710	42,830	42,790
4th Qtr	255.370	6,520	124,996	57,201	12,964	33,877	10,360	57,201	920	25	56,885	55,885	51,999	51,409
2000														
1st Qtr	336,470	6,045	124,996	49,269	7,440	32,052	9,777	49,269	6,268	333	73,907	75,863	36,716	35,824
2nd Qtr	281,150	10,465	124,996	43,799	16,089	18,209	9,501	43,799	3,536	200	7,070	7,141	294,937	286,994
3rd Qtr	409,243	11,743	131,996	48,548	23,176	14,381	10,991	48,548	1,409	103	20,129	19,957	222,827	223,292
4th Qtr	338,358	30,339	134,996	40,426	6,724	19,138	14,566	40,428	3,734	1,429	9,301	8,429	1,162,712	1,141,286
2001														
1st Qtr	294,051	5,638	134,995	46,207	1,180	26,800	18,227	46,207	2,808	596	8,427	9,010	1,858,808	1,853,857
2nd Qtr	263,931	4,760	150,420	64,221	38,643	15,457	10,121	64,221	4,009	0	10,228	9,969	1,593,573	1,606,965
3rd Qtr	427,901	7,802	160,420	61,289	35,470	15,882	9,937	61,289	7,924	126	13,408	13,648	1,008,914	1,015,779
4th Qtr	510,734	9,132	170,995	76,295	44,238	15,763	16,294	76,295	6,947	42	23,428	21,689	319,113	332,733

(a) As at end of last week of the quarter

Source: Central Bank of Sri Lanka

half of the year, with the weighted average rates ranging between 20 per cent and 25 per cent. However with the improvement in liquidity, and the reduction in Central Bank rates, call market rates came down to around 12-15 per cent in the latter part of the year. The total turnover for the year increased by 10 per cent, from Rs.1,365 billion in 2000 to Rs.1,497 billion in 2001.

Primary Treasury Bill Market

Treasury bills continued to be the government's primary means of raising short-term funds. The limit on the outstanding level of Treasury bill, approved by Parliament, which stood at Rs.135 billion at the beginning of 2001, was raised to Rs.175 billion in April 2001. The yields on Treasury bills of all maturities rose in January and February, as the Central Bank raised its rates and liquidity was tight. The rates continued to be high throughout the first half of the year. However, the yield rates declined to about 13–14 per cent, in the second half of the year, following the reduction in the Central Bank policy rates and the government increasing its foreign currency borrowings. Owing to the relatively high yields and lower demand for credit by the private sector, all the Treasury bill auctions were heavily over subscribed during the year.

The total value of Treasury bills issued in 2001 increased to Rs.248 billion from Rs.182 billion in 2000. Of these issues, the Central Bank purchased Rs.120 billion (48 per cent) either through reservations to its own portfolio or through purchases at the primary market auctions, to inject liquidity to the market, particularly in the first half of 2001. A substantial portion of these purchases were 91-day and 182-day bills, reissued during the year, which did not affect the net holdings of the Central Bank. The Central Bank's stock of Treasury bills increased from Rs.38 billion at end 2000 to Rs.57 billion at end 2001, but its holdings of all government paper declined by Rs.8.6 billion to Rs.58.2 billion.

There were twenty new issues of Treasury bills totalling to Rs.45.6 billion and three retirements to the value of Rs.9.6 billion during the year under review. The total outstanding value of Treasury bills amounted to Rs.170 billion at end of the year, from Rs.135 billion in the previous year.

Central Bank Discount and Rediscount Market for Treasury Bills

The value of the total outright sales (discounts) during the year amounted to Rs.21.7 billion, which was a 45 per cent increase over the previous year. The falling yields on Treasury bills in the primary market in the second half of the year encouraged market participants to buy from the Bank's holding of bills. In contrast, the outright purchases or rediscounting of Treasury bills significantly dropped from Rs.2.1 billion in 2000 to Rs.0.8 billion in 2001. The capital loss that could have resulted if the participating institutions opted to rediscount their Treasury bills in secondary market, due to the higher re-discounting rate compared to the yields in the primary market, encouraged banks to use the reverse repurchase facility to meet their short-term liquidity requirements rather than rediscount their holdings.

The discounting and rediscounting rates followed the yield rates in the primary market. The discount rate declined from 18.96 per cent at end 2000 to 12.69 per cent at end 2001, while the rediscount rate declined from 21.72 per cent to 14.99 per cent.

Central Bank Repurchase (Repo) Market

Given the shortage of rupee liquidity in the market throughout the early part of the year, commercial banks and primary dealers who have access to the Central Bank's' repo facility rarely used it, except towards the end of the year. As a result, the total volume transacted through the Bank's repo facility amounted to only Rs.55.5 billion in 2001, a 51 per cent drop from the Rs.110.4 billion in 2000. However, with the improvement in rupee liquidity towards the end of the year, repo activity increased and a total volume of Rs.11.8 billion was recorded in December. The repo rate was raised to 20 per cent in January. It had been reduced to 12 per cent by end 2001, with 650 basis points of the decline being in the second half.

Central Bank Reverse Repurchase (Reverse Repo) Market

The high liquidity shortage, particularly in the first two quarters, in the inter bank money market was reflected in the substantial increase in transactions in the reverse repo market, with a total reverse repo turnover, both in Treasury bills and Treasury bonds, reaching Rs.4,780 billion during the year. This was a 178 per cent increase over the previous year. Of the two instruments used for reverse repo transactions, Treasury bonds were more popular, accounting for about 95 per cent of the total turnover. Reverse repo rates too were reduced in six steps, by 900 basis points, from 23 per cent at the start of the year, to 14 per cent as at the year end.

Domestic Foreign Exchange Market

The most significant event during the year in the domestic foreign exchange market was the independent float of the rupee with effect from 23 January. Under this system, the exchange rate is allowed to be determined by the market forces of supply and demand. With the introduction of the independent float of the exchange rate, the Central Bank ceased its daily pre-announcement of buying and selling rates for the dollar, and instead actively participated in the forex market, in order to smooth out excessive fluctuations in the exchange rate and to build up official external reserves.

During the year under review, the Bank participated in the inter bank forex market by buying US dollars 179 million and selling US dollars 52 million. Of the total sales, 63 per cent was during January, as the Bank sought to stabilise the foreign exchange market under the crawling exchange band system. In comparison to the previous year, the Bank's spot market transactions recorded substantial growth in volume.

Much of the forex purchases had been carried out in the second half of the year, in order to build up reserves. During the year, the Bank operated only in the spot market for foreign exchange. The spread in the foreign exchange market declined and remained around 60 cents per dollar.

Commercial banks, which operate in all markets from cash up to 6 months forward, had a turnover of US dollars 1,037 million in the spot market. The forward transactions of commercial banks were concentrated in the less than one month category. The total value of forward transactions amounted to about US dollars 253 million. The Central Bank had imposed a 50 per cent margin on forward foreign exchange contracts (subsequently reduced to 25 per cent and then abolished) earlier in the year and had limited the maximum maturity of forward transaction up to six months, as precautionary measures to prevent unwarranted volatility in the forex market, following the independent float of the rupee. These measures, though helping to provide stability to the foreign exchange market, greatly reduced activity in the forward market.

Commercial Paper (CP)

Commercial paper is a type of short term money market instrument issued by companies to raise funds to meet working capital requirements. CP gives both borrower and lender a better rate of return than that offered by traditional banking products. This instrument is increasing in popularity.

The total value of CP issues during the year was Rs.23.3 billion, with the bulk (95 per cent) of issues being supported by commercial banks. This was double the amount of funds raised during previous year. The commercial paper market was heavily concentrated (88 per cent) in the three month maturity, with CPs of six month duration accounting for almost all of the balance. The outstanding value of CPs at year end was Rs.6.5 billion. The higher interest rates that prevailed in the first part of the year are likely to have made CPs attractive to borrowers, because of lower borrowing costs, compared to commercial banks' overdraft facilities.

10.13 Capital Market

Activity at the Colombo Stock Exchange (CSE) continued to be subdued until well into the fourth quarter of 2001, reflecting the slowdown in economic activity. High interest rates on fixed income securities, particularly in the first half of 2001, also contributed to poor turnover levels at the CSE. The imposition of a 20 per cent surcharge on corporate income tax with effect from April 2001, for a period of one year, was another factor that adversely affected share market activity. The last quarter of the year 2001, however, saw a reversal in market trends, with all key market indicators recording significant improvements. Despite improved market sentiment towards the end of the year, foreign investors were net sellers for the year as a whole, but with a lower net outflow compared with the previous year. Meanwhile, the Colombo Stock Exchange introduced 'Stock Borrowing and Lending', in September 2001, which could stimulate trading in otherwise dormant assets. The corporate bond market further expanded during the year as three companies issued debentures, with one of them obtaining a listing. The year also saw the introduction of a new instrument in the bond market, with the government issuing US dollar denominated 'Sri Lanka Development Bonds' in the last two months of the year.

The rally at the CSE in the last quarter of the year had significant implications for all key market indicators. Market capitalisation, which had declined to Rs.80 billion at the end of the third quarter from Rs.89 billion at the end of the year 2000, increased to Rs.124 billion by end-2001. The All Share Price Index (ASPI) and the Milanka Price Index (MPI), which had declined by 10 per cent and 13 per cent, respectively, during the first three quarters of the year, recorded gains of 38.7 per cent and 47.6 per cent, for the year as a whole. By end-2001, the ASPI, which closed at 621, had recorded the highest annual growth rate since 1993 (61.7 per cent), while the MPI, which was introduced in 1999, reached an all time high of 1,164 on 10 December 2001 and closed the year at 1,031. The highest daily turnover recorded on the CSE of Rs.867 million was also recorded on 10 December 2001. Meanwhile, the average daily turnover for December 2001, which was Rs.258 million, was the highest during any month since February 1994. The increase in market activity at the CSE in the last quarter 2001 was primarily accounted for by domestic retail traders, and was attributed to a change of market sentiment, following the election of a new government. Despite the turnover at the CSE increasing to record levels, foreigners remained net sellers in 2001 as in the previous year, with many of them making significant profits whilst exiting the market, following the rally. The net outflow in 2001 was US dollars 11 million, compared with US dollars 44 million in 2000, with purchases and sales by foreigners amounting to US dollars 23 million and US dollars 34 million, respectively. In contrast to these developments at the CSE, most international markets recorded declines in their indices for the year 2001.

High interest rates reduced activity in the bond market in 2001. Issues of Treasury bonds in 2001 amounted to Rs.47.1 billion, whereas in 2000, Treasury bond issues amounted to Rs.125.3 billion. Further, only two-year and three-year Treasury bonds were issued in 2001. In comparison, market

TABLE 10.22

Share Market Indicators

	1999	2000	2001
Market Capitalisation (Rs.bn.)(a)	112.8	88.8	124.0
Number of New Issues (No.)	5	2	–
Total Number of New Shares Issued (Mn.)	38	6	–
Value of New Shares Issued (Rs.mn.)	537	60	–
Number of Shares Traded (Mn.)	486	449	747
Value of Shares Traded (Rs.mn.)	14,293	10,624	13,905
Price Indices(a) – CSE All Share	572.5	447.6	621.0
Milanka	937.5	698.5	1,031.0

(a) End of the year *Source:* Colombo Stock Exchange

Chart 10.7
Share Market Indicators

Chart 10.7.1
Share Price Indices

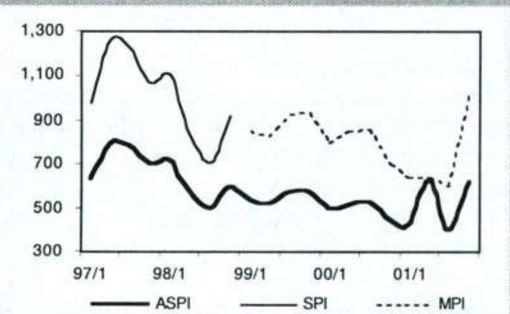


Chart 10.7.2
Stock Market Transactions

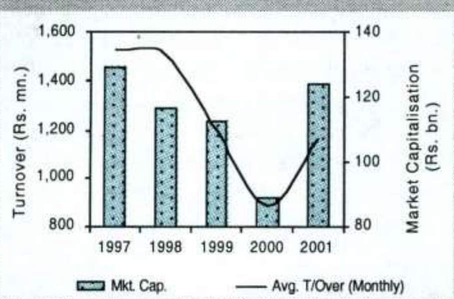
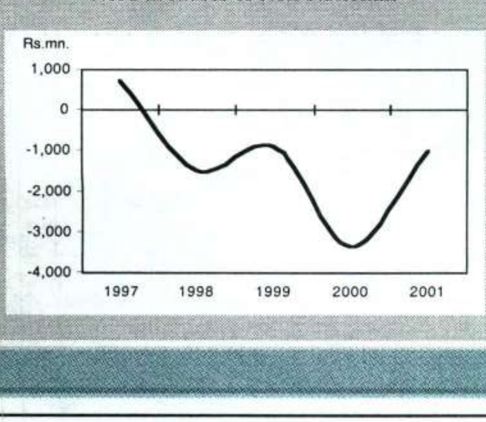


Chart 10.7.3
Net Purchases of Non-Nationals



based government bonds issued during the previous year had maturities varying from 2 to 6 years. The total amount raised by way of Treasury bonds was lower in 2001 when compared with the previous year, as funds mobilised through Rupee securities increased. The government also raised an additional sum of US dollars 158.5 million in 2001 through the issue of US dollar denominated 'Sri Lanka Development Bonds'.

Primary Market

There were no initial public offers in 2001. Commercial Bank of Ceylon Ltd. made an offer for sale for fifty million preference shares (par value Rs.10), with an option of offering a further fifty million preference shares in the case of over-subscription. While the initial issue was over subscribed, the total number of preference shares subscribed for was 90,655,500. Meanwhile, the conversion of debentures into equity resulted in 6,315,789 shares of Hapugastenne Plantations Ltd. and 2,298,850 shares of Udapussellawa Plantations Ltd. being subscribed for in 2001. The total value of bonus issues made by nine companies during the year was Rs.472 million, while rights issues made by five companies amounted to Rs.213 million. In comparison, the total value of bonus issues made by 15 companies during the previous year was Rs.2,541 while the value of rights issues made by 8 companies was Rs.713 million. The declines reflected reduced profitability in the corporate sector due to the slowdown in economic activity. The debt securities market expanded further in 2001. While Eagle Insurance Ltd. issued dividend debentures (Rs.90 million), Seylan Bank Ltd. (Rs.539 million) and Lanka Hospital Corporation Ltd. (Rs.400 million) raised capital by way of debenture issues.

Secondary Market

As market activity increased significantly towards the end of the year, the daily average turnover, which was Rs.29 million for the first nine months of the year, increased to Rs.150 million for the fourth quarter. The significant increase in share prices towards the end of the year, particularly those of blue chip companies, resulted in the market price earnings ratio increasing to 7.5 by end 2001 from 5.2 at the end of the previous year. While the ASPI and the MPI increased, along with the increase in the volume of turnover, share prices and market capitalisation, sectoral indices also reflected these improved market conditions. All sectoral indices, with the exception of the Stores & supplies index, recorded improvements by the end of the year. However, information on corporate sector performance in the first three quarters of the year indicate a decline in profits of many listed companies, when compared with the corresponding period of the previous year. For example, of the top 30 companies by market capitalisation, which accounted for 62 per cent of the market capitalisation by end 2001, twenty recorded declines in profits. Of the top 10 companies ranked by market capitalisation, which accounted for 37 per cent of the market capitalisation by end 2001, profits declined in eight. Although domestic participants were bullish about market

TABLE 10.23
Category-wise Distribution of Shares Traded in the Secondary Market in 2001

Category of Investment	No. of Transactions	No. of Shares ('000)	Value (Rs. mn.)
Banks, Finance & Insurance	55,745	280,936	5,494
Beverage, Food & Tobacco	13,413	58,404	977
Chemicals & Pharmaceuticals	2,236	2,898	79
Construction & Engineering	3,800	15,821	247
Diversified	15,952	54,194	2,717
Footwear & Textiles	655	3,378	15
Hotels & Travels	10,272	159,910	1,097
Investment Trusts	1,277	2,447	76
Land & Property	4,042	19,592	131
Manufacturing	27,017	86,079	1,688
Motors	853	1,822	44
Oil Palms	53	930	477
Plantations	19,271	38,379	419
Services	2,742	12,827	341
Stores & Supplies	521	4,365	11
Trading	1,874	4,978	83

Source: Colombo Stock Exchange

performance towards the end of the year, foreign investors remained net sellers in 2001, with their sales during the year, at Rs.3,137 million, exceeding their purchases by Rs.1,025 million.

Major International and Regional Stock Markets

Most international stock markets recorded declines by the end of the year. The economic decline in the U.S.A. since March 2001, which was further aggravated by the September 11 attacks, resulted in the Dow Jones Industrial Average sliding by 18 per cent by the end of the third quarter, from the level recorded at the end of the year 2000. However, signs of a gradual economic recovery in December 2001 saw the index gaining somewhat towards the end of the year, to end the year with a 7 per cent decline when compared with end-2000. In London, the Financial Times Stock Exchange 100 closed the year 16 per cent lower than the end-2000 level, although it recovered from the steep decline in September in the aftermath of the terrorist attacks in the U.S.A. Meanwhile, the decade long economic slowdown in Japan continued to put downward pressure on Tokyo's Nikkei, which declined by 24 per cent during the year as a whole.

In the South Asian region, although the year as a whole saw a decline in the indices of the Bombay and Karachi Stock Exchanges, both saw an upturn in their indices towards the end of the year. The Bombay BSE Sensitive Index, which declined by 16 per cent in March following a stock market scandal which reportedly involved insider trading, recovered with the Securities and Exchange Board of India instituting a series of reforms, including the separation of trading and management functions of the Bombay Stock Exchange, which until then was owned and run by brokers. However, by the end of the third quarter, having been subjected to the contagion effects of September 11, the Bombay BSE Sensitive Index had declined by 29 per cent when compared with the end-2000 level. It recovered in November and December, which investors attributed to technology and industry stocks gaining ground as well as low interest rates. Meanwhile in Karachi, the KSE-100, which declined over much of the year, regained in the last quarter, as domestic retail and institutional investors, particularly the state-run mutual funds bought key shares, amidst mounting anticipation of debt relief by western donors and the central bank taking steps to bring down interest rates. The KSE-100, which had declined by 25 per cent from end-2000 to end September, closed the year with an overall decline of 16 per cent.

Chart 10.8
Stock Prices

Chart 10.8.1
Comparison with Major International Markets
(2000 Dec. = 100)

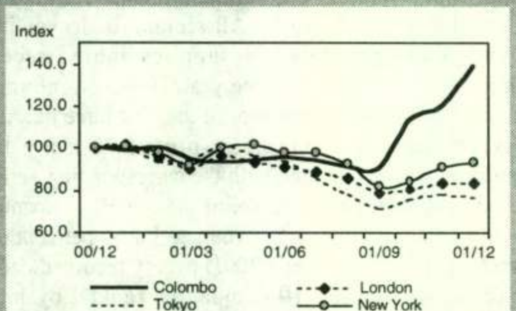


Chart 10.8.2
Comparison with South Asian Markets
(2000 Dec. = 100)

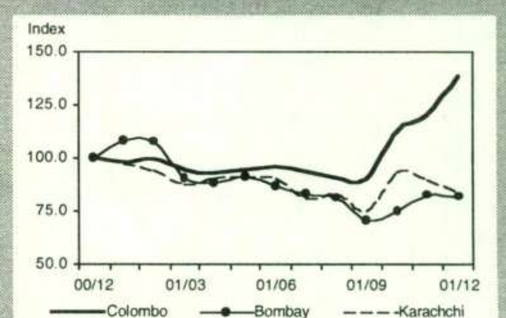


TABLE 10.24

Share Price Indices of Regional and Major International Markets

	End - 2000	End - 2001
New York (DJIA)	10,787	10,022
London (FTSE100)	6,223	5,217
Tokyo (Nikkei 225)	13,786	10,543
Bombay (BSE Sensitive)	3,972	3,262
Karachi (BSE Sensitive)	1,508	1,273
Seoul (Kospi)	505	694
Taipei (Weighted Price)	4,745	5,551
Bangkok (SET)	269	304
Hong Kong (Hang Seng)	15,096	11,397
Singapore (Straits Times)	1,921	1,624
Manila (Composite)	1,495	1,168
Jakarta (Composite)	416	392
Kuala Lumpur (Composite)	680	696
Sydney (All ordinaries)	3,155	3,360
Wellington (NZSE-40)	1,901	2,053

Source: Wall Street Journal

Amongst other Asian stock markets, South Korea's Korea Composite Stock Price Index (KOSPI) and Taiwan's Taipei Weighted Price Index recovered strongly towards the end of the year, with the rebound in demand for electronics in South Korea, and hi-tech exports, in the case of Taiwan. Another market that performed well was Thailand, attributed mainly to stronger corporate earnings. The Stock Exchange of Thailand's Bangkok SET increased by 12.9 per cent. In contrast, the Hang Seng Index of Hong Kong declined by 24.5 per cent during the year. With the Singaporean economy contracting by an estimated 3 per cent during the year, Singapore's Straits Times Index also declined by 15.7 per cent. Amongst other markets that declined were the Philippines (21.8 per cent) and Indonesia (5.8 per cent), with declines in both markets being attributed to political instability. Malaysia's Kuala Lumpur Stock Exchange Composite Index rose by 2.4 per cent, while Australia's All Ordinaries Share Index increased by 6.5 per cent and New Zealand's benchmark NZSE-40 Capital Index increased by 8 per cent.

Developments in the Market

In September 2001, the CSE introduced a new instrument: Stock Borrowing and Lending (SBL). 'Stock Lending' refers to a collateralised loan of securities for a specified period of time, whereby the securities are transferred to a borrower, with an agreement to have them replaced with identical securities. The Central Depository System (CDS) is the facilitator for SBL, while participants of the CDS would act as intermediaries for SBL. One transaction was recorded during the year, with respect to SBL.

The Securities and Exchange Commission of Sri Lanka (SEC) signed a Memorandum of Understanding with the Sri Lanka Accounting and Auditing Standards Monitoring Board during the year. Accordingly, the SEC monitors listed companies in relation to compliance with the Companies Act. It also deals with issues relating to corporate governance of these companies. The Sri Lanka Accounting and Auditing Standards Monitoring Board monitors listed companies in relation to compliance with accounting standards which are set by the Institute of Chartered Accountants of Sri Lanka.

Several companies obtained ratings during the year from Fitch Ratings Lanka Ltd., the only credit rating company in Sri Lanka. The companies that were issued entity ratings and published them are Commercial Bank of Ceylon Ltd. (SL AA+), Hayleys Ltd. (SL AA+), and John Keells Holdings Ltd. (SL AAA). Issue ratings were obtained by four companies during the year. These were Lanka Orix Leasing Co. Ltd., for an issue of commercial paper (SL F-1), Singer Sri Lanka Ltd., for short-term debt (SL F-1) and an issue of debentures (SL A), and Aitken Spence & Co. Ltd., for an issue of debentures (SL AA).

Medium and Long-term Government Securities

Treasury Bonds

In view of the relatively high interest rates, especially in the first half of the year, Treasury bonds with shorter maturities were issued during the year. Whereas Treasury bonds with maturities ranging from 2 to 6 years were issued in 2000, in 2001 only 2 and 3 year bonds were issued. The yield on bonds of both maturities declined during the year, in line with market trends in interest rates. All issues of Treasury bonds were oversubscribed, given the relatively high yield, particularly in the first half of the year, and the reduced demand for credit from the private sector. However, the amount raised by way of issues of Treasury bonds declined sharply when compared with the previous year, as the government raised more funds through Rupee loans and foreign currency based borrowing.

Treasury bond issues during the year amounted to Rs.47,100 million, compared to a total of Rs.125,322 million in 2000. Jumbo issues accounted for Rs.21,588 million. A total of Rs.3,596 million was raised by way of special issues made to institutional investors, namely, the Employees' Provident Fund and the National Savings Bank. While Treasury bonds totalling Rs.22,050 million matured during the year, compared to a total of Rs.26,065 million maturing in 2000, the value of outstanding Treasury bonds increased to Rs.229,174 million by end 2001 from Rs.204,124 million at the end of the previous year.

TABLE 10.25

Treasury Bond Issues during 2001

Maturity Period	Coupon Rate (a) (% per year)	Weighted Average Yield to Maturity (a)	Issues (Rs. Mn.)	Outstanding Amount at end Year (Rs. Mn.)
2 Year	12.25-13.00	14.50-22.20	28,066	86,387
3 Year	12.25-13.25	14.50-16.75	19,034	73,433
4 Year			–	33,304
5 Year			–	20,550
6 Year			–	15,500
Total			47,100	229,174

Source: Central Bank of Sri Lanka

(a) Applicable to Treasury Bond issues during 2001.

Along with the downward revision of Central bank rates and the accompanying decline in market rates, the coupon rate on 2-year Treasury bonds was reduced from 13.00 per cent at the beginning of the year to 12.50 per cent by end-2001. The weighted average yield on 2-year bonds in the primary market declined by 727 basis points during the year, that is, from 22.21 per cent to 14.94 per cent. Meanwhile, a special issue of 2-year Treasury bonds amounting to Rs.500 million was made in November, for which, the applicable coupon rate and yield rate were 12.25 per cent and 14.50 per cent, respectively. Treasury bonds with a tenor of 3 years were issued in the latter part of the year, beginning May 2001. While the coupon rate on 3-year Treasury bonds was reduced from 13.25 per cent to 12.25 per cent by end 2001, the weighted average yield on these bonds in the primary market declined by 410 basis points to 14.50 per cent by end-2001. Special issues of 3-year Treasury bonds were also made in 2001 amounting to Rs.3,096 million.

Sri Lanka Development Bonds

In view of the shortfall in privatisation proceeds and other foreign financing, US dollar denominated Sri Lanka Development Bonds were floated by the government in November and December 2001, whereby the government was able to raise a total of US dollars 158.5 million. They were issued in two tranches. The first tranche of US dollars 108.5 million carried an interest rate of 6 month LIBOR plus a margin of 175 basis points per annum in the first year and 6 month LIBOR plus a margin of 225 basis points per annum in the second year, payable every six months. The tenor was 2 years, with a put option which could be exercised one year from the date of issue. The second tranche of US dollars 50 million also had a tenor of 2 years, but without a put option, and carried an interest rate of 2 percentage points over the 6 month LIBOR, per annum, payable every six months.

Rupee Loans

With 16 Rupee securities floated during the year, contributing 19 per cent of the total reserves raised from domestic sources, Rupee securities were an important source for medium and long-term government borrowings in 2001.

Total subscriptions increased to Rs.50,910 million in 2001 from Rs.42,211 million in 2000. Rupee loans are sold at par and carry a fixed rate of interest, which is administratively determined, based on market trends in interest rates. The Employees' Provident Fund (65 per cent), the National Savings Bank (19 per cent) and the Employees' Trust Fund (11 per cent) were the major subscribers to Rupee securities in 2001, with other subscribers accounting for only 5 per cent of the total subscriptions. While Rupee loans amounting to Rs.21,985 million were repaid at maturity during the year, the outstanding stock of rupee loans increased to Rs.292,813 million by end 2001 from Rs.263,888 million at the end of the previous year.

TABLE 10.26
Rupee Loans Floated during 2001

Maturities (Years)	Volume (Rs. Million)	Interest Rates (% p.a.)
2	19,500	15.00
2 – 5	13,900	15.00
2 – 5	13,100	13.00
6 – 8	4,410	13.00
Total	50,910	13.00-15.00

Source: Central Bank of Sri Lanka

Unit Trusts

The total number of Unit Trust Funds managed by five different management companies remained at 12, and consisted of three growth funds, four balanced funds, one index fund and four income funds. There was a reversal in the declining trend in both total assets and net assets that were observed since 1997, mainly due to the rise in prices in the stock market at the end of the year. The value of investments in the equity market by Unit Trusts rose to about 63 per cent of their total investment as against about 53 per cent in the previous year. Treasury bills and Treasury bonds were the next major category of investments accounting for about 16 per cent of the investment. However, this represented a drop of investments in government paper over the prior period, as a result of possible changes in portfolio allocations in keeping with the decline in yields on government securities in the last quarter of the year. The investment in the repo market showed an increase over the previous corresponding period, as a result of some funds, particularly income funds, preferring to lock in their funds in the very short repo market, expecting a change in interest rates in their favour.

TABLE 10.27
Unit Trust (a)

	1997	1998	1999	2000	2001(b)
1. Total Assets (Rs.Mn.)	3,097	2,687	2,652	2,173	2,875
2. Net Assets Value (Rs.Mn.)	3,072	2,675	2,639	2,162	2,794
3. Investments in Equities (Rs.Mn.)	2,244	1,773	1,660	1,109	1,806
(3) as a Ratio of (2)	73	66	63	51	65
4. Total No. of Unit Holders	26,441	27,709	27,536	26,863	25,936
5. No. of Units in Issue (Mn.)	392	393	392	387	380
6. No. of Unit Trusts	10	10	12	12	12

(a) At end December
(b) Provisional

Source: Unit Trusts

Both the number of units in issue and the number of unit holders declined, continuing the trend in the past few years. However, net assets per unit increased due both to the fall in the number of units in issue and the rise in the value of equity investments.