Chapter 10

FINANCIAL SECTOR

10.1 Overview

The financial sector, supported by the broadbased recovery in economic activity in 2003, recorded an improved performance, raising its profitability and strengthening its resilience. The Central Bank reduced its policy rates further, taking into account the steady decline in inflation, lower inflationary expectations, decline in the borrowing requirement of the government, stability in the foreign exchange market and falling interest rates in international markets. With regard to monetary management, the Central Bank moved to more active Open Market Operations in March 2003 enabling it to manage market liquidity more effectively, while encouraging financial institutions to improve liquidity management. This helped to reduce the volatility of short term money market rates, while achieving the base money targets. Both rupee and domestic foreign exchange markets remained liquid throughout the year, which made possible a further decline in market interest rates. The Central Bank continued its efforts to make monetary policy operations more transparent, which improved credibility and predictability of the monetary policy stance. Meanwhile, measures were also taken to improve the stability and safety of the payments and settlement system with the establishment of a Real Time Gross Settlement (RTGS) system, which would help to minimise settlement risks and increase efficiency in money market activity. Background work on moving to a Scripless Securities Settlement (SSS) system in government securities continued during the year, in order to commence operations in 2004. Reflecting the faster recovery in the economy and the decline in interest rates, operations in the banking sector expanded, while the capital fund base of commercial banks improved. The soundness of the financial system also improved with the further strengthening of prudential regulations, reduction in non-performing assets, the resolution of difficulties in weaker banks and the dissemination of more information on banking and financial institutions. An upsurge in stock market activity, brought about by greater investor confidence, resulted in several key market indicators reaching record levels during the year, though some reversal of these trends was seen towards the end of the year due to market uncertainty as a result of political developments.

The business activities of non bank financial institutions such as leasing firms, finance companies, merchant banks, also recorded improved performance due to economic growth and improved confidence. The insurance industry also saw new developments that would contribute to raising the prevailing low insurance penetration in the country. Meanwhile the government has almost entirely moved out of direct involvement in the insurance industry. A number of legislative enactments relating to the financial sector were being drafted in order to improve regulatory oversight and facilitate greater competition while keeping abreast of market developments.

However, a concerted effort would need to be continuously made to further strengthen the resilience of the financial system. In particular, steps would need to be taken to reduce non-performing loans of banks as well as to reduce the high interest rate spread of the banking sector by promoting competition. Further, it would be necessary to improve the domestic bond market through greater competition and promote further deepening of the financial market.

10.2 Monetary Policy

Monetary policy in 2003 focussed on achieving a sustainable path of low inflation, while facilitating the recovery in economic activity. The economy experienced high inflation, coupled with negative economic growth in 2001. This adverse trend reversed to some extent in 2002 with moderation in inflation and positive economic growth. Hence, the challenge before the Central Bank in 2003 was to further strengthen the economic recovery, while bringing inflation to still further low levels. The monetary policy stance in 2003 was directed towards achieving this goal. Accordingly, key policy interest rates were cautiously lowered further in several steps during the year with a view to supporting the economic recovery, while preventing the build up of inflationary pressures. Also, the Central Bank moved to more active open market operations (OMO) in March 2003, further improving market orientation in monetary management.

The Central Bank, in keeping with its policy of containing inflation, cautiously reduced its Repurchase (Repo) and Reverse Repurchase (Reverse Repo) rates further by 275 - 325 basis points in 2003 and narrowed the margin between the Bank's Repo and Reserve Repo rates by 50 basis points. The reduction in policy rates in 2003 was preceded by a reduction of 225 basis points in these rates in 2002. A number of factors facilitated this continuous reduction in policy rates: the continuing decrease in inflation and inflationary expectations, the containment of the monetary expansion to the desired levels, the low growth in public sector borrowings, the availability of excess rupee liquidity, the relative stability in the foreign exchange markets, and the downward movements in some international interest rates. The Repo and Reverse Repo rates were reduced in four steps, in January, May, August, and October. The Bank rate (*i.e.*, the rate applicable for lending to commercial banks as the lender of last resort) was also reduced from 18.00 per cent to 15.00 per cent to keep it in line with the trends in the Central Bank's other policy rates. In view of the reduced volatility in money market rates, and the downward shifting of the interest rate structure, the width of the corridor formed by the Bank's Repo and Reserve Repo rates was reduced to 150 basis points from 200 basis points. The reduction in policy interest rates resulted in a reduction in all other market rates, although some lending rates were slow in adjusting, causing the interest rate spread to rise. A faster decline in inflation has resulted in a rise in some market interest rates in real terms. The Central Bank has taken measures to improve the interest rate pass-through in the banking industry (*see Box 19*).

The Central Bank has been taking steps to improve the effectiveness of its monetary policy. As a part of this process, the Bank moved to a more active system of open market operations (OMO), from 03 March, 2003. Under this system, the Central Bank would decide on the quantum of liquidity to be supplied or withdrawn, but the interest rates would be determined by the market forces. However, for the market to determine the appropriate rate, the interest rate corridor formed by the Bank's Repo and Reverse Repo rates would signal the direction of the policy stance. Active OMO are carried out through daily auctions to inject or absorb liquidity based on the monetary policy stance and the estimated market liquidity. This is in contrast to the earlier system, where the rate was fixed by the Central Bank, while the volume was determined by the market. Under the new active OMO, to help the market to operate smoothly, standing facilities are also available to market participants at Repo/Reverse Repo rates, so that they could square up any excess/shortfall in market liquidity. Under the new monetary policy management system there is greater public disclosure as the Bank's monetary policy stance is announced monthly as per an advance release calendar. These regular announcements have enhanced transparency and credibility of monetary management, while enhancing the predictability of the Bank's policy stance. This more active system of OMO has helped to achieve greater stability in money market rates (*see Box 4*).

Under the system of more active OMO, the CBSL took measures to absorb a part of the excess liquidity on a long-term basis, as this improves the effectiveness of OMO and helps to reduce transaction costs of banks in investing excess liquidity on an overnight basis. Accordingly, sales of Treasury bills were made by calling dealer bids directly and through auctions. As the CBSL holdings of government securities declined, the CBSL issued its own securities to absorb excess liquidity. CBSL securities worth a total of Rs.3.8 billion were issued in September 2003. The maturities of these securities were fixed between 60 to 91 days, as liquidity was expected to decline by December.

The method of computing the statutory reserves maintained by commercial banks with the Central Bank was changed with effect from 03 April 2003. The basis of computing required reserves was changed to the average value of deposit liabilities and vault cash during a week, instead of the balances on a single working day, as in the past. This change has helped to improve the effectiveness of the statutory reserve requirement as an instrument of monetary policy and enabled more accurate estimation of daily market liquidity, which is vital for the efficient working of OMO.

As an integral part of making its monetary policy operations more transparent, the Bank enhanced the dissemination of information on monetary policy to the market. A key change during the year was the publication of an advance release calendar, announcing the dates of changes in the monetary policy stance. With the commencement of active OMO, a monthly statement on the Central Bank's monetary policy stance has been made public, giving reasons for the policy decisions, in order to increase market awareness and improve financial market stability. In addition, monetary projections, along with the explanatory notes were posted on the Central Bank's website. The Bank continued to provide data on a regular basis to market participants to keep market participants better informed regarding monetary and other market developments.

The Central Bank continued to adopt a monetary targetting framework with reserve money as the main operating target. The greater stability in the foreign exchange market consequent on the implementation of an independent floating exchange rate regime from 2001 was helpful in conducting monetary policy more effectively. The limit on foreign currency net open positions (NOP) of commercial banks, based on capital funds, was increased, with a view to further improving the depth and flexibility of the foreign exchange market. Although there was a significant increase in net foreign assets, reserve money was maintained within the target with a compensating reduction in net domestic assets of the Central Bank. Changing the basis of computing SRR raised the level of reserve money.[1] Reserve money, however, was high throughout most of December, partly due to higher currency demand associated with market uncertainty. Monetary growth, which was around 12–13 per cent, until September, increased above the projected growth path towards the end of the year, posing some challenges to future monetary management.

1. The amount of vaule cash, eligible to be counted as a part of required reserves, declined when averaged, in comparison to the level maintained under the previous method, thereby raising the level of reserves to be maintained by banks at the Central Bank.

A number of policy initiatives were taken during the year to increase the efficiency, integrity and stability of the financial sector, which would improve the transmission mechanism of monetary policy. The CBSL took measures to establish RTGS/SSS systems to upgrade and expand the payment and settlement system, and thereby to minimise the risks involved in this system. The capital position of commercial banks improved as the minimum risk weighted capital adequacy ratios (CARs) were raised and banks were required to compute the CAR to cover the operations of foreign currency banking units (FCBUs) as well. Longer-term Treasury bonds were issued, which would facilitate developing a long-term or benchmark yield curve for pricing securities in other markets. As the development of the government securities market is essential for the conduct of market oriented monetary policy, the Colombo Stock Exchange (CSE) was given access to the SSS system. This would help enhance secondary market activity in government securities and facilitate secondary trading through a debt exchange. The CBSL actively engaged in conducting a public awareness campaign on the details of approved financial institutions and the type of financial services provided by these institutions. Several legislative enactments were drafted to further strengthen the financial sector legal framework.

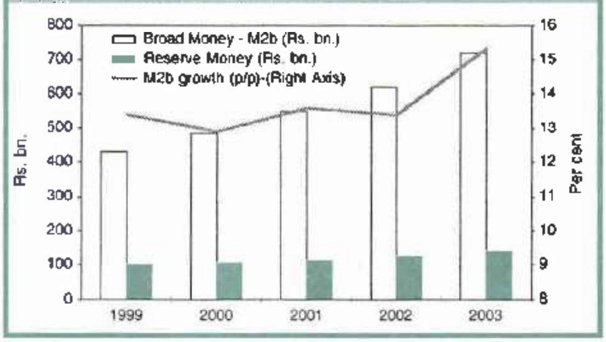
10.3 Money and Credit Aggregates

Reserve Money

Reserve money, was maintained within the projected targets throughout 2003 which in turn helped to maintain the money supply targets. The management of reserve money was facilitated by the introduction of active OMO, which also contributed to achieve greater stability in call market interest rates. During 2003, reserve money, which comprises currency notes and coins issued by the CBSL and deposits of commercial banks with the Central Bank, rose by Rs.15 billion (12 per cent), as compared to a little lower rise of Rs.14 billion (12 per cent) in 2002. The increase in reserve money was mainly reflected in the currency in circulation, which increased by Rs.10 billion. Increased transactions demand due to the improvement in economic activity, including new economic activities in the North and East that benefitted from the ceasefire agreement, was the main contributory factor for the rise in the demand for currency. The debit tax on deposit withdrawals is also likely to have encouraged greater holdings of currency to some degree. The other component of reserve money, *i.e.*, deposits of commercial banks with the CBSL, rose by Rs.5 billion, as a result of an increase in deposits of commercial banks, against which reserves are maintained.

As for the contributory factors for the increase in reserve money, it was exclusively due to an increase in CBSL's net foreign assets (NFA) partly offset by a reduction in its domestic assets. The rise in NFA due to increased foreign inflows amounted to Rs.47 billion. During 2003, the Net Domestic Assets of the CBSL declined due to the reduction of the Central Bank's holdings of Treasury bills by Rs.29 billion, in comparison to a decline of Rs.18 billion in 2002. Reserve money increased by Rs.15 billion and reached Rs.141 billion by end December, as against the target of Rs.143 billion.

Chart 10.1
Monetary Aggregates – Growth and Levels



Money Supply

Consolidated broad money (M_{2b}) recorded a moderate growth during most of the year but accelerated towards the year end mainly due to an increase in credit to the private sector and a growth in net foreign assets (NFA) of the banking system. The money supply growth was in a range of 12–14 per cent until September, and increased thereafter, to reach 15.3 per cent at end December 2003. Average monetary growth during 2003 was 13.2 per cent. This was mainly

TABLE 10.1
Summary Monetary Statistics

Item	End 2002 Rs. bn.	End 2003 Rs. bn.	Change 2002 Amount Rs. bn.	Change 2002 %	Change 2003 Amount Rs. bn.	Change 2003 %
Monetary aggregates:						
Narrow money supply (M_1)	139.4	161.6	17.2	14.0	22.3	16.0
Broad money supply (M_2)	510.4	580.7	59.7	13.2	70.4	13.8
Consolidated broad money supply (M_{2b})	622.5	717.9	73.4	13.4	95.4	15.3
Underlying factors (a)						
Domestic credit to :	680.4	731.9	41.5	6.5	51.5	7.6
Government (net)	193.0	176.2	(8.3)	(4.1)	(16.8)	(8.7)
Public corporations	43.0	36.2	2.2	5.4	(6.8)	(15.9)
Private sector	444.4	519.4	47.6	12.0	75.1	16.9
External assets (net)	110.6	167.1	36.5	49.3	56.5	51.0
Other items (net)	(168.5)	(181.1)	(4.7)	(2.9)	(12.6)	(7.5)
Reserve money	126.4	141.4	13.9	12.3	15.0	11.9
Money multiplier (M_{2b})	4.92	5.08				
Velocity (M_{2b}) (b)	2.70	2.65				

(a) In relation to M_{2b}
(b) During the year

Source: Central Bank of Sri Lanka

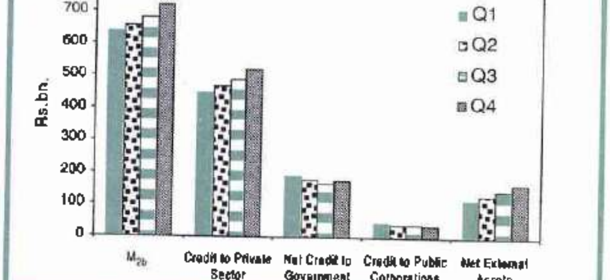
driven by higher net foreign assets of the banking system and higher private sector credit. The improvement in net foreign assets of the banking system benefitted from the BOP surplus, and the increase in private sector credit, was fuelled by a broad based recovery in all major economic sectors, improved consumer demand and the decline in interest rates. Meanwhile, narrow money (M_1), which comprises currency and demand deposits held by the public, increased at a slightly higher rate of 16 per cent by end December, due to increases in both currency and demand deposits.

Factors Affecting Monetary Growth – M_{2b}

The NFA of the banking system increased further in 2003, and was the major contributory factor to the growth in consolidated broad money supply (M_{2b}) (59 per cent of the overall expansion). NFA of the banking system rose by around Rs.56 billion during 2003 as a result of higher foreign remittances, increased receipts under services and capital flows to both the government and the private sector including the receipt of foreign grants and loans. The increase was largely (82 per cent) reflected in the NFA of the Central Bank, which rose by Rs.47 billion, reflecting the surplus of US dollars 502 million in the BOP. NFA of commercial banks too improved by Rs.9 billion, partly as a result of increased investment in foreign currency assets abroad, from the proceeds of the repayment of Sri Lanka Development Bonds (SLDBs) amounting to US dollars 158 million, which are treated as domestic assets in the monetary survey.

Net credit to government (NCG) from the banking system declined for the second consecutive year, reflecting improved fiscal management and commitment to fiscal consolidation. NCG declined by Rs.17 billion in 2003 following the decline of Rs.8 billion in 2002. The reduction in government liabilities to the banking sector was facilitated by the containment of the government's borrowing requirement, availability of foreign resources through programme and project loans, and the receipt of privatisation proceeds. The repayment of government borrowings which had been effected earlier in 2002 to the banking system was a commendable achievement since, it reinforced the monetary

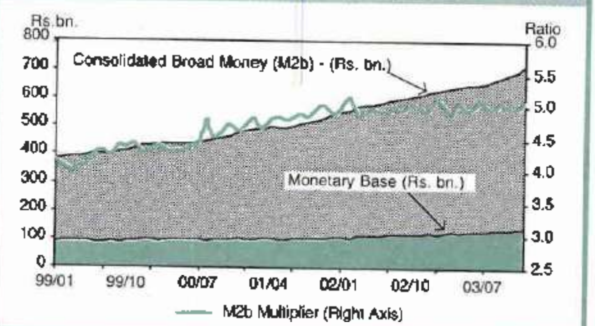
Chart 10.2
Movement in M_{2b} and its Counterparts – 2003



policy measures taken by the CBSL in containing inflation and releasing funds for use by the private sector to facilitate future economic growth. This was the first occasion in the recent past where both monetary policy and fiscal policy worked in tandem with each other. Of the US dollars 250 million raised in 2001 and 2002 through SLDBs, the government settled three tranches in November and December 2003, totalling US dollars 158 million. Rupee funds for this purpose were raised mainly through the issue of government paper. The holdings of government securities by commercial banks increased by Rs. 45 billion, although foreign bills declined by Rs. 12 billion.

Credit to public corporations which was a major destabilising factor as far as monetary management is concerned in earlier years, too declined by Rs.6.8 billion, with a reduction in credit to Ceylon Petroleum Corporation (CPC), Ceylon Electricity Board (CEB) and the settlement of liabilities of the Co-operative Wholesale Establishment (CWE) to the banking system through the issue of Treasury bonds by the government. Credit to CPC declined with some reduction in international oil prices by mid-year, automatic price adjustments improving CPC's cash flow and the receipt of a part of the privatisation proceeds from the sale of a part of CPC's assets to Lanka Indian Oil Company. Meanwhile, CEB was able to reduce its borrowings from the banking sector with the termination of the generation of some high cost thermal power, and an increase in the relative share of hydropower. However, the decline in credit to public corporations was lower than envisaged due to a slight delay in the receipt of the balance privatisation proceeds of the CPC, which were received in January 2004.

Chart 10.3
Monetary Base and Money Multiplier



The pick up in credit to the private sector from commercial banks that was seen in 2002 continued, and accelerated towards end 2003. Credit to the private sector increased by Rs.75 billion during the period under review, as against an increase of Rs.48 billion in 2002. Accordingly, the point to point growth of credit to the private sector rose by 17 per cent at end December 2003 as compared to 13.4 per cent by June 2003 and 12 per cent at end 2002. The growth in credit to the private sector was in response to the ongoing broadbased recovery in the economy, increased consumer demand and the decline in interest rates. Increased capital funds and some decline in NPLs provided a further cushion for banks to expand the supply of credit. Although the largest increase in credit has been from private domestic banks, there has also been an increase in credit by the two state banks, in contrast to a decline in such credit in the previous year, augmenting the overall credit growth. The increase in credit to the private sector was mainly from DBUs of commercial banks, which extended credit to the export and import trade, tourism, power and to individuals for housing and consumer durables and consumption purposes.

The money supply is the product of both the money multiplier (the number of times which commercial banks can create multiple deposits and credit) and reserve money (base money created by the CBSL through its operations). During 2003, both factors contributed to the growth in money supply. Reserve money increased by Rs.15 billion, while the money multiplier increased from 4.92 in 2002 to 5.08 in 2003. A rising relative share of foreign currency deposits and a declining ratio of currency to deposits enabled banks to create more deposits and credit thus becoming the major contributory factor for the rise in the money multiplier. As foreign currency deposits are not subject to SRR, the effective SRR decreases with an increase in the relative share of foreign currency deposits, resulting in a rise in the multiplier. In addition, the currency to deposit ratio also declined gradually during this period with the improvement in banking facilities and greater use of electronic payment methods. Meanwhile, the income velocity of money declined further during the year, due to a decline in inflationary expectations, an increase in financial assets with improved business and consumer confidence, and deepening of financial markets.

In terms of the composition of broad money supply from the demand side, all three components, *viz.*, currency, demand deposits and savings deposits, grew at a higher pace during the year, reflecting higher transaction demand with the improvements to economic activity. Within the deposits, the share of savings deposits increased further, with a corresponding decline in term deposits. The decline in interest rates and continued efforts of banks to mobilise savings deposits from different segments of the economy with added features could be key considerations in increased preference of the public for savings deposits over time deposits. Foreign currency deposits increased further by US dollars 139 million in 2003, following an increase of US dollars 117 million in 2002, increasing the total foreign currency deposit base to US dollars 1,415 million. The improvement in market confidence, stability in exchange rates, and home-bias in view of a favourable interest rate differential *vis-à-vis* international interest rates contributed to enhance the foreign currency deposit base.

10.4 Financial Survey

Monetary growth as measured by M_4, which includes activities of licensed specialised banks and finance companies in addition to licensed commercial banks recorded a slightly higher growth than M_{2b}. The higher growth in M_4 was mainly due to increased investment in government paper by licensed specialised banks (LSBs). On a point to point basis, growth in M_4 has been generally in a narrow range of 13-15 per cent in 2003, in comparison to a wider range of 13-18 per cent in 2002. On average, growth in M_4 was around 15 per cent during the 12 months ending 2003 while growth

TABLE 10.2

Monetary Aggregates : 2002 – 2003 (a)

End of Period	Narrow Money Supply (M_1)						Broad Money Supply (M_2)						Consolidated Broad Money Supply (M_{2b})					
	2002 Rs.bn.	2003 Rs.bn.	Percentage Change: Point to Point		Percentage Change: Moving Average		2002 Rs.bn.	2003 Rs.bn.	Percentage Change: Point to Point		Percentage Change: Moving Average		2002 Rs.bn.	2003 Rs.bn.	Percentage Change: Point to Point		Percentage Change: Moving Average	
			2002	2003	2002	2003			2002	2003	2002	2003			2002	2003	2002	2003
January	120	136	7.5	13.3	2.9	13.6	452	513	13.2	13.6	10.7	15.5	550	629	13.1	14.4	13.0	15.7
February	121	138	8.6	13.7	3.2	14.0	457	518	14.0	13.4	11.0	15.4	559	636	14.2	13.8	13.1	15.7
March	126	141	10.3	12.3	3.8	14.2	466	525	15.4	12.6	11.4	15.1	570	643	15.5	12.8	13.5	15.4
April	124	143	8.7	15.3	4.2	14.7	469	530	15.1	13.2	11.8	15.0	575	649	15.2	12.8	13.6	15.2
May	126	144	14.4	14.3	5.1	14.7	471	533	15.9	13.2	12.2	14.7	577	651	15.8	12.9	13.8	14.9
June	126	142	15.6	13.3	6.4	14.5	476	533	17.5	11.9	12.9	14.3	584	655	17.9	12.1	14.3	14.5
July	128	144	17.3	12.8	7.7	14.2	482	540	17.5	12.0	13.5	13.8	590	660	17.4	12.0	14.7	14.0
August	129	149	17.6	15.8	9.1	14.0	485	545	17.4	12.4	14.2	13.4	596	669	17.0	12.1	15.0	13.6
September	129	156	15.5	20.3	10.3	14.5	489	556	16.0	13.7	14.7	13.3	601	679	16.6	12.9	15.3	13.3
October	129	152	16.0	17.4	11.8	14.6	494	557	15.8	12.9	15.2	13.0	605	687	16.3	13.5	15.6	13.1
November	132	157	12.5	19.5	12.2	15.2	500	569	14.7	13.8	15.3	13.0	614	700	15.3	14.0	15.7	13.0
December	139	162	14.0	16.0	13.1	15.4	510	581	13.2	13.8	15.5	13.0	622	718	13.4	15.3	15.6	13.2
Monthly average	127	147	13.2	15.3			479	542	15.5	13.0			587	665	15.6	13.2		

(a) Monetary data from 1990 have been classified to be consistent with standard international practice. Please refer notes to Appendix Tables 115, 116 and 120.

Source: Central Bank of Sri Lanka

TABLE 10.3
Monetary Aggregates and Underlying Factors : 2001 – 2003 (a)

Rs. million

Item	Dec. 2001	Dec. 2002	Dec. 2003	Change 2002 Amount	Change 2002 Percentage	Change 2003 Amount (a)	Change 2003 Percentage
Monetary aggregates							
Currency held by the public	65,536	75,292	85,601	9,756	14.9	10,309	13.7
Demand deposits held by the public	56,674	64,069	76,034	7,395	13.0	11,965	18.7
Narrow money supply (m_1)	122,210	139,361	161,635	17,151	14.0	22,274	16.0
Time & savings deposits of the Private sector held with com. banks	426,927	483,134	556,220	56,207	13.2	73,086	15.1
DBUs	395,071	445,741	506,951	50,670	12.8	61,210	13.7
FCBUs	31,856	37,393	49,269	5,537	17.4	11,876	31.8
Consolidated broad money supply (M_{2b})	549,137	622,495	717,855	73,358	13.4	95,360	15.3
Underlying factors							
Net foreign assets	74,130	110,642	167,092	36,512	49.3	56,450	51.0
Monetary authorities	84,346	117,376	164,596	33,030	39.2	47,220	40.2
Commercial banks	-10,216	-6,734	2,496	3,482	34.1	9,230	137.1
DBUs	-1,117	-6,658	-11,765	-5,541	-496.1	-5,107	-76.7
FCBUs	-9,099	-76	14,261	9,023	99.2	14,337	18,864.5
Net domestic assets	475,009	511,852	550,761	36,843	7.8	38,909	7.6
Domestic credit	638,876	680,396	731,872	41,520	6.5	51,476	7.6
Claims on government (net)	201,311	192,994	176,236	-8,317	-4.1	-16,758	-8.7
Monetary authorities	84,535	70,934	42,149	-13,601	-16.1	-28,785	-40.6
Commercial banks	116,776	122,060	134,087	5,284	4.5	12,027	9.9
DBUs	77,067	82,237	101,295	5,170	6.7	19,058	23.2
FCBUs	39,709	39,823	32,792	114	0.3	-7,031	-17.7
Credit to public corporations	40,811	43,031	36,192	2,220	5.4	-6,839	-15.9
Dbus	22,934	28,010	28,879	5,076	22.1	869	3.1
FCBUs	17,877	15,021	7,313	-2,856	-16.0	-7,708	-51.3
Credit to the private sector	396,754	444,371	519,444	47,617	12.0	75,073	16.9
DBUs	328,788	367,397	430,575	38,609	11.7	63,178	17.2
FCBUs	67,966	76,974	88,869	9,008	13.3	11,895	15.5
Other items (net)	-163,867	-168,544	-181,111	-4,677	-2.9	-12,567	-7.5
DBUs	-79,270	-74,194	-87,144	5,076	6.4	-12,950	-17.5
FCBUs	-84,597	-94,350	-93,967	-9,753	-11.5	383	0.4

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

Source: Central Bank of Sri Lanka.

in M_{2b} was around 13 per cent during the same period. In absolute terms, broad money supply (M_4) increased by around Rs.131 billion in 2003 and stood at Rs.928 billion at end December 2003. The relative share of contribution to monetary growth from LSBs has increased slightly in 2003.

NFA in M_4 increased by around Rs.57 billion in 2003, in comparison to an increase of Rs.37 billion in 2002. The increase in NFA in 2003 was entirely due to an increase in NFA of the CBSL and commercial banks. In contrast, LSBs are net borrowers of foreign currency, as NDB and DFCC Bank borrow from international institutions for their rupee lending purposes.

NCG increased marginally by around Rs.4 billion in 2003 based on the financial survey, in contrast to a decrease of Rs.17 billion recorded in M_{2b} in 2003. This increase in NCG in the financial survey was mainly due to the substantial increase in investment in government paper by the NSB. The holdings of government securities by LSBs in 2003 increased

TABLE 10.4
Summary Statistics of Financial Survey (M_4)

Item	End 2002 Rs. bn.	End 2003 Rs. bn.	Change 2002 Amount Rs. bn.	Change 2002 %	Change 2003 Amount Rs. bn.	Change 2003 %
Monetary aggregates:						
Broad money supply (M_2)	510.4	580.7	59.7	13.2	70.4	13.8
Consolidated broad money supply (M_{2b})	622.5	717.9	73.4	13.4	95.4	15.3
Broad money supply (M_4)	797.6	928.3	97.6	14.0	131.0	16.4
Underlying factors (a)						
Net foreign assets	100.5	157.7	37.3	58.9	57.1	56.8
Domestic credit	911.5	1,004.4	71.2	8.5	93.0	10.2
Claims on government (Net)	299.0	303.1	15.7	5.6	4.1	1.4
Credit to public corporations	43.8	36.8	2.1	5.0	(7.0)	(16.0)
Credit to the private sector	568.7	664.5	53.4	10.4	95.8	16.8
Other items (net)	(214.3)	(233.8)	(10.9)	(5.3)	(19.1)	(8.9)

(a) In relation to M_4

Source: Central Bank of Sri Lanka

Chart 10.4
Monetary Aggregates, Velocity and Money Multiplier

Chart 10.4.1
Money Supply

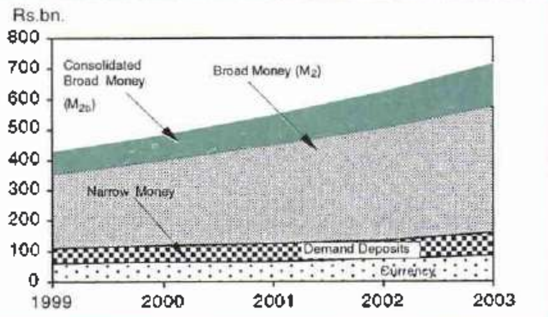


Chart 10.4.2
Domestic Credit

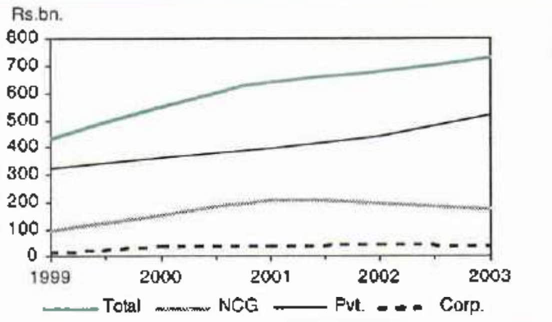


Chart 10.4.3
Net External Assets

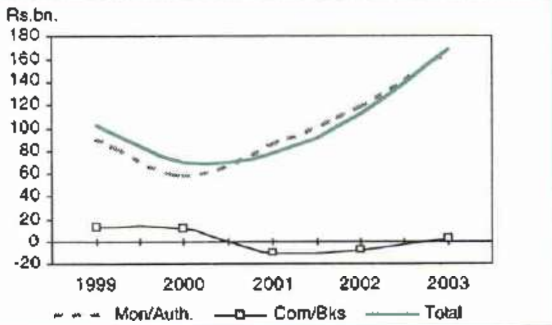
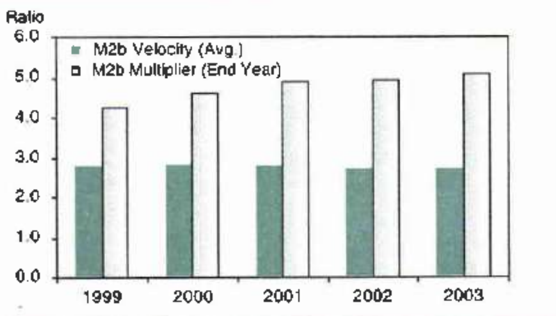


Chart 10.4.4
Income Velocity and Money Multiplier



by Rs.26 billion. However, this trend is not to create any adverse development since the NSB and other LSBs simply recycle private sector savings into the government sector without creating multiple deposits and credit.

A higher increase in credit to the private sector was seen in 2003, with increased credit from LSBs and finance companies. LSBs have granted loans mainly for agriculture, manufacturing, wholesale and retail trade and to financial institutions for equity financing and venture capital financing. Meanwhile, the major share of loans from finance companies has been extended for leasing in 2003. Credit to the private sector in the financial survey increased by around Rs.96 billion in 2003 as against an increase of Rs.53 billion in 2002. On a point to point basis, credit to the private sector increased by 16.8 per cent in M_4 at end December 2003, following an increase of 10.4 per cent increase recorded by end 2002. In comparison, the growth in credit to the private sector in M_{2b} was 16.9 per cent as at end 2003.

10.5 Interest Rates

The move towards a low interest rate regime from the legacy of high interest rates in the past continued further during 2003, reflecting the reduction in policy rates, excess market liquidity, decline in inflationary expectations, and the reduction in the domestic borrowing requirement of the government. With the commencement of more active open market operations of the Central Bank, an important development in the interest structure was the setting up of an interest rate corridor formed by the Repo and Reverse Repo rates, the changes of which would signal the direction of monetary policy and would guide short-term interest rates.

As commented earlier, the Repo and Reverse Repo rates were revised downward four times during the year. The Bank Rate was also reduced during 2003, in line with the reduction in other interest rates. These reductions in policy rates, together with the improved market liquidity, caused a fall in market interest rates. Short-term rates, such as call market rates and the prime lending rate, closely followed the reductions in the policy rates. These developments, together with reduced borrowing by the government and declining inflationary expectations, caused the yield rates on market oriented government securities to decrease. The yield curve for government securities by end 2003 was flatter and lower than the yield curve at end 2002, indicating market expectations of lower inflation in the medium-term. In spite of the fall in nominal rates, most real interest rates remained positive in 2003, as inflation continued to fall throughout the year. International market rates also continued to decline, particularly in the first half of 2003, causing interest rates on foreign currency deposits and lending to decline. Towards the end of the year, there was some reversal in the decline in domestic short-term interest rates due to market uncertainty. Yield rates on Treasury bills, as well as rates in the call money market, were affected due to these disturbances.

Although most lending rates declined somewhat faster than deposit rates in 2003, interest rate spreads still remained high. The high interest rate spreads are a symptom of inadequate competition in the financial markets, high operational costs and large costs involved in the modernisation of financial services and facilities. Relatively high non-performing loans of some commercial banks caused by unsound credit management practices, as well as delays in the legal process against defaulters, contributed to a significant part of the high spreads between deposit and lending rates.

Taxation of the financial sector has undergone a series of changes in the recent past, sometimes creating distortionary effects on the interest rate structure. Since 2002, new taxes such as the Debits tax and VAT had been introduced, while the stamp duty, turnover tax and the National Security Levy were abolished. Beginning March 2002, interest on government securities was also made subject to withholding tax at the rate of 10 per cent, to be charged at source. Subsequently a notional tax credit on investment in government securities was granted, creating some distortion in the money market. A change in the taxing principle related to interest earnings was announced in Budget 2004.

Chart 10.5
Interest Rates

Chart 10.5.1
Treasury Bills – Yeild Rates

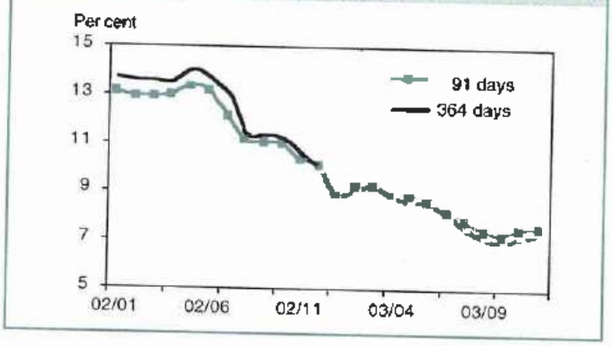


Chart 10.5.2
Deposit Rates

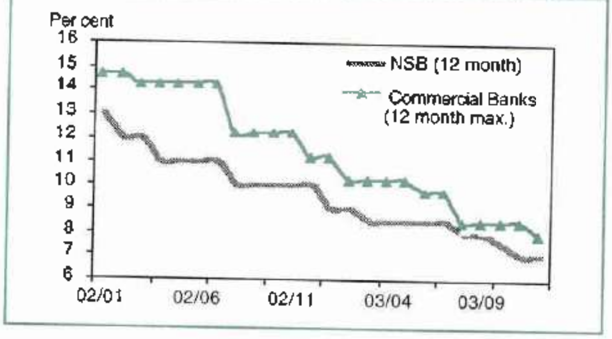


Chart 10.5.3
Lending Rates

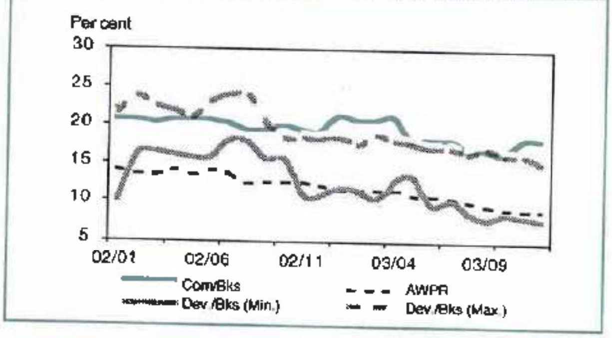
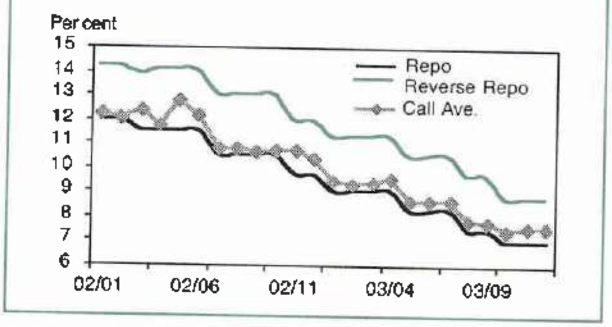


Chart 10.5.4
Policy Interest Rates and Call Money Rate



Accordingly, the present exemption limit of Rs.9,000 per month or Rs.108,000 per year for the withholding tax on interest income per deposit were applied to the total interest income from all deposits in any individual bank or financial institution made by a person or a corporate entity. Another significant fiscal measure was the introduction of a Debits tax on demand deposits and certificates of deposit with commercial banks. In Budget 2003, the coverage of the Debits tax was further extended to savings deposits with licensed commercial banks and licensed specialised banks, reducing the effective return on these deposits. Furthermore, government imposed a VAT on the financial sector, computed as 10 per cent of total net profits of commercial banks and financial sector institutions and emoluments paid to all the employees, which also may have negatively affected the reduction in interest rate spreads.

Central Bank Policy Rates

The Central Bank's key monetary policy rates are the Repurchase rate (Repo), the Reverse Repurchase (Reverse Repo) rate, and the Bank Rate. The first two are closely linked to market rates, while the latter 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 by pledging their own holdings of Treasury bills and Treasury bonds with the Central Bank.

Changes in Repo and Reverse Repo rates under the OMO are the Central Bank's signalling mechanism to indicate the expected direction of interest rates in the market. Moreover, with the commencement of more active open market operations in March 2003, these rates formed the corridor within which the overnight market operated, as standing facilities were made available to participants either at the Repo rate or Reverse Repo rate, depending on their liquidity requirements.

The Repo rate was reduced by 275 basis points, while the reduction in the Reverse Repo rate was by 325 basis points, during 2003, taking into account developments in inflation, lower borrowing by the government continued stability in money and foreign exchange markets, and the decline in international interest rates. The Repo rate and the Reverse Repo rate, which were 9.75 per cent and 11.75 per cent, respectively, at end 2002 were reduced by 75 basis points to 9.00 per cent and 11.00 per cent on 07 January 2003. Rates were reduced by a further 75 basis points on 09 May 2003. In the second half of the year, consumer price inflation continued to fall, creating room for the Central Bank to reduce the policy rates further. On 15 August 2003, the rates were reduced again by 75 basis points. On 16 October 2003, the rates were further cut by 50 basis points and 100 basis points respectively, bringing the rates down to 7.00 per cent and 8.50 per cent, and narrowing the interest rate corridor.

Furthermore, the Bank Rate, *i.e.*, the rate at which the Central Bank grants advances to commercial banks to meet their temporary liquidity requirements, which had remained unchanged at 18.00 per cent since December 2001, was also reduced to 15.00 per cent on 15 August 2003, to keep it in line with the changes in other interest rates.

Most international interest rates declined marginally from the levels at end 2002, which were already low. For example, the US Federal Funds rate, which was 1.25 per cent at the beginning of the year, was reduced to 1.00 per cent by July 2003. The European Central Bank (ECB) also reduced its policy rates by 50 basis points in March 2003 and by 25 basis points in June 2003. Accordingly, the rate on the main refinancing facility of ECB, which was 2.75 per cent at the beginning of the year, was 2.00 per cent by end 2003. The Bank of England reduced its Repo rate from 4.00 per cent to 3.75 per cent in February 2003, and further to 3.50 per cent in July 2003. However, it increased its Repo rate to 3.75 per cent in November 2003, to curtail possible inflationary impacts.

Money Market Rates

The money market remained liquid in 2003, as mentioned earlier. Market participants invested this excess liquidity in the Central Bank's Repo facility. Accordingly, call market rates closely followed the Central Bank's Repo rate throughout the year. Call market rates exhibited greater stability. The variation of call market rates, as measured by the standard deviation of the average call money rate, which was 4.2 per cent in 2001, declined to 0.8 per cent in 2002, and remained at that level in 2003. Call market rates, which were

TABLE 10.5

Changes in Policy Interest Rates

Per cent per annum

Date	Repo Rate	Reverse Repo Rate	Bank Rate
2002.11.22	9.75	11.75	18.00
2003.01.07	9.00	11.00	18.00
2003.05.09	8.25	10.25	18.00
2003.08.15	7.50	9.50	15.00
2003.10.16	7.00	8.50	15.00

Source: Central Bank of Sri Lanka

TABLE 10.6

Money Market Rates (a)

Per cent per annum

	CBSL Repo Rate	Repo Auction Rate	Weighted Average Call Money Rate	SLIBOR Overnight
Dec-02	9.75	–	10.39	10.67
Mar-03	9.00	9.13	9.42	9.61
Jun-03	8.25	8.30	8.63	8.65
Sep-03	7.50	7.58	7.83	7.92
Dec-03	7.00	7.04	7.59	7.73

(a) Month-end values. *Source:* Central Bank of Sri Lanka

Box 19

Interest Rate Spread in the Banking Sector

The Central Bank policy rates, *i.e.*, the Repurchase rate and the Reverse Repurchase rate, were revised downward in several steps from early 2001. They were reduced by 800 – 900 basis points in 2001, 225 basis points in 2002 and 275 – 325 basis points in 2003. Although both lending rates and deposit rates in the banking sector have declined following these revisions, the speed and the magnitude of the adjustments in market interest rates have been asymmetric. Deposit rates have generally declined more than lending rates, increasing the interest rate spread. Partly as a consequence of this, many banks have reported higher profits, with increases in net interest income in the past two years. Therefore, the high interest rate spread in the banking sector has received much attention at many fora in the recent past.

The Measurement of Interest Rate Spread

The interest rate spread is a measure of the cost of financial intermediation, and is generally identified as the difference between deposit and lending rates. It is, however, not easy to obtain a single direct measure of the cost of financial intermediation or the interest rate spread. Banks accept different types of deposits at different rates and offer many types of loan facilities at different interest rates. Moreover, in addition to accepting deposits, banks may also obtain funds such as borrowings and repos for which interest has to be paid. Similarly, banks could invest in debt instruments whereby banks could earn interest income other than from granting loans. Therefore, two alternative measures of the interest rate spread are considered to examine the movement of the interest rate spread.[1] A broad measure would be the difference between the average yield on earning assets and the average cost of interest bearing liabilities (method 1). A narrower measure would be the difference between the interest received on loans and the interest paid on deposits (method 2 - as a ratio defined below).

Effects of Higher Interest Rate Spreads

A high cost of intermediation or higher spread could have a number of adverse consequences on the economy. In economies like Sri Lanka, where capital markets are underdeveloped, banks are the key financial intermediaries[2] that allocate funds for new investments or provide external funding for business expansion. The higher cost of financing due to higher spreads may make it prohibitive for some potential borrowers to undertake new investment or expand existing businesses, thus reducing the future growth prospects of the economy. The higher spread also reduces financial deepening in the economy as there could be financial disintermediation if the banking sector is not effective in channelling resources from surplus units to deficit units. Further, the higher spreads could increase the credit risk of banks due to the problem of adverse selection, *i.e.*, it is mostly risky borrowers who are willing to borrow at high rates. This could, in turn, have an adverse impact on the viability of banks through an increased level of non-performing loans (NPLs) as well as have implications for systemic stability. Finally, changes in the monetary policy stance may not be efficiently transmitted to the economy as the policy changes could get absorbed into the high interest rate spread without an appreciable change in the interest rate structure.

Reasons for Higher Interest Rate Spread

The core business of a bank is to provide intermediary service to both savers and borrowers and banks incur a cost when they engage in financial intermediation. A part of the costs reflects in the risk premium added to interest rates to cover various risks such as credit risk, market risk, liquidity risk and operational risks faced by banks. In addition, a combination of factors, of which some are bank specific and others structural and

$$\text{Interest Spread (method 1)} = \frac{\text{interest received}}{\text{all interest bearing assets}} - \frac{\text{interest paid}}{\text{all interest bearing liabilities}}$$

$$\text{Interest Spread (method 2)} = \frac{\text{interest received from loans and advances}}{\text{loans}} - \frac{\text{interest paid on deposits}}{\text{deposits}}$$

1. All banks do not necessarily follow the same approach in determining the spectrum of interest rates. Banks may offer different types of deposits with added benefits and could charge different fees and commissions for different loans. More disaggregated measures could therefore be considered, but are not attempted here, due to non-availability of data.
2. The total assets of the banking sector accounted for about 60 per cent of financial assets at end 2003.

Box 19 (contd.)

macroeconomic, affect the determination of interest rates by banks and thus, the interest rate spread. Some of the key factors are indicated below.

- ***High operational costs:*** The operating costs of many banks are high. Heavy investment in IT, high expenditure on salaries and emoluments, as well as security, and under performing branches contribute to raising operational costs. The operating costs could also increase due to the type of market segment on which a bank concentrates. For instance, if a bank relies more on small scale customers or retail customers, that bank would need a larger number of branches, personnel and equipment, all of which raise the operational costs.
- ***Non-performing loans:*** The non-performing loans (NPLs) which are non earning assets remain high in many banks, requiring higher provisions.
- ***Long-term deposits mobilised at fixed rates:*** In general, banks offer fixed rate time deposits. Some banks have contracted long-term deposits at higher rates, which restricts flexibility in reducing lending rates.
- ***Heavy reliance on interest earning activities as a major source of income:*** At present, commercial banks in Sri Lanka derive the major share of their income from fund based activities.[3] Securities market activity, trading in financial products and securitisation operations, which would have provided alternative sources of income, are not developed.
- ***Market structure:*** A few banks hold a very large share of banking assets indicating that the sector is still not adequately competitive, and hence may not be efficient in pricing. Even if the market structure is competitive, there are switching costs for customers to move from one bank to another due to the lack of information. Further, banks are the dominant source of external finance for firms due to the under-developed nature of capital markets. There is little competition to banks, which would have forced a reduction in spreads.
- ***Legal and other procedural bottlenecks:*** There are legal and other procedural bottlenecks, which cause long delays in loan recovery.
- ***Market stability:*** The uncertainty of the macroeconomic environment is another factor that adds a risk premium to the interest rate structure.
- ***Taxes and other costs:*** Taxes on financial instruments and the operations of banking institutions as well as the statutory reserve requirement (SRR) also contribute to the higher spread.

Trends in Interest Rates and the Spread

As shown in Figure 1, deposit rates as well as lending rates have declined following the changes in policy rates. During the period February 2001 to December 2003, the Central Bank's Repo rate was reduced by 13 percentage points. The average weighted deposit rate (AWDR) has declined by 14 percentage points. The average weighted prime lending rate (AWPR), based on lending to prime customers of commercial banks, has also declined by 14 per cent during the period. However, the Average Weighted Lending Rate (AWLR), based on all lending by commercial banks, has declined only by 3.2 percentage points (up to third quarter 2003), showing the relative stickiness in the reduction of general lending rates. However, lending rates declined more in 2003 than in 2002.

Interest rate spreads computed using the alternative methods described above, for the period January 2002 to December 2003, are in Table 1 and Figure 2. Both

Figure 1
Repo, Average Lending Rate, AWDR and AWPR

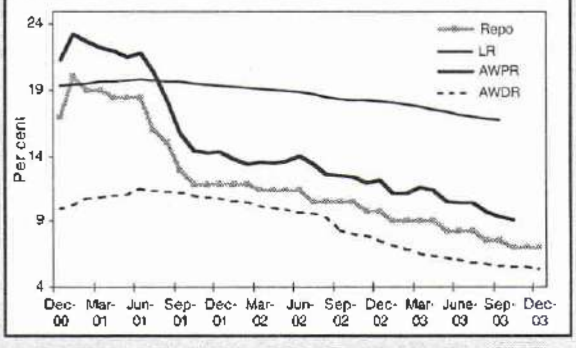


TABLE 1 (a)

Item	2002				2003			
	1 Q	2 Q	3 Q	4 Q	1 Q	2 Q	3 Q	4 Q
Interest Spread (Method 1), %	3.2	3.9	4.2	4.6	4.4	4.5	4.5	4.0
Interest Spread (Method 2), %	5.2	6.5	6.7	7.3	6.5	6.6	7.0	6.8

(a) Compiled by Bank Supervision Department, based on data sent by commercial banks

Source : Central Bank of Sri Lanka

3. Fee based income contributed 20 per cent of total income in 2003. This share was 17 per cent in 2002.

Box 19 (contd.)

measures show that spreads increased compared to the levels that prevailed at the beginning of 2002. The interest spread according to method 2, *i.e.*, taking into consideration only loans and deposits, is found to be greater than the overall interest spread. The main reason for this difference is that the reduction in the interest expenses is greater than the reduction in the interest income.

A noteworthy development is that the interest spread has declined in the fourth quarter of 2003. However, interest rate spreads still vary significantly depending on the definition adopted. The interest spread based on method 1 varies between 2–6 per cent while the spread based on method 2 varies between 2–10 per cent for different banks. With respect to factors that affect interest rate spreads, NPLs account for about 1.1 percentage points, the SRR for another 0.5–0.6 percentage points of the spread, and taxes may account for a further 0.2–0.3 percentage points, totalling about 2 per cent, when data for all commercial banks are considered. In addition, the interest spread covers costs on account of operating expenses, loan loss provisions, as well as a profit margin.

In comparison to the spreads in many countries in the region, the interest spread in the Sri Lankan banking system is high. For instance, the interest rate spreads in India, Pakistan and Malaysia ranged between 3–4 per cent. Therefore, there is further room for narrowing of the interest rate spread in Sri Lanka.

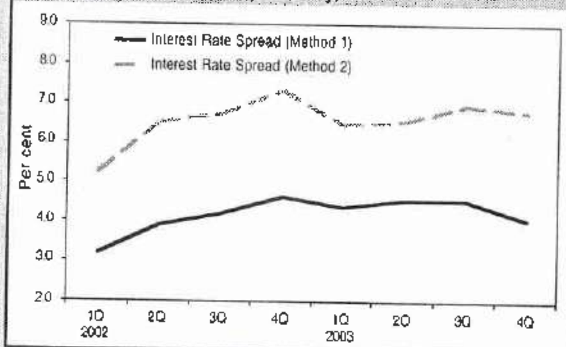
Internationally changes in interest rate spreads are more closely correlated with the loan rates than with the deposit rates.[4] In Sri Lanka, however the decline in interest cost is higher than the decline in interest income, confirming the general downward stickiness in lending rates. Data in relation to the repo rate, the prime lending rate and the AWLR show that the degree of pass-through from policy rate to money market rate is high, but from short-term rates to other lending rates it is very low.

An important question is whether the share of advances given at different interest rates have been declining over time. The outstanding loans in different interest rate slabs, reported for the Quarterly Survey of Bank's Deposits and Advances, show that there is some reduction in loans given under the higher slabs. This is also confirmed by the net interest income of commercial banks, which recorded a lower growth of 19 per cent in 2003 as compared to 23 per cent in 2002, in spite of the increase in the loan portfolio. However, major share of outstanding lending is still at high rates.

Measures to Reduce the Interest Rate Spread

One important development with respect to the interest rate spread was its reduction in the fourth quarter of 2003. This may be attributed to maturing of older loans at higher rates, and increased competition, through improved awareness of interest rates. Concerted action may be required from the banks, authorities and regulators to reduce the interest rate spread further. The CBSL has already put in place several measures. Among these, the reduction of the margin between the Repo and Reverse Repo rates, publication of interest rates of banks for the information of the general public, dissemination of information on key macroeconomic aggregates and discussions with market participants, are the major steps. The CBSL has also taken measures to further develop the payment system, which would reduce the risks in payments and settlement, and increase market efficiency and market integration. In addition, banks have been asked to display interest rates and charges for various services at their places of business which would enable customers to obtain a better idea of the cost of borrowing. Progress in financial market reforms and improving competition would also help reduce the interest rate spread further. Measures to promote the corporate bond market and the setting up of asset management companies too would help this process. Also banks could improve their credit evaluation, take measures to reduce operational costs and undertake project based lending and evaluating risk properly. In addition, banks could offer floating rates on deposits and loans. In this respect, consistency in economic policies that is, a policy environment that improves macroeconomic stability which would reduce the risk premia in loan pricing, is also important.

Figure 2
Interest Rate Spread of Licensed Commercial Banks - All Banks (Quarterly)



4. E.g., Brock and Suarez, 'Understanding the Behaviour of Bank Spreads in Latin America', JDE Vol. 63 (2000), pp.113-134.

in the range of 10.00 - 11.25 per cent at end 2002, declined continuously until October. By end October, call market rates were between 7.25 and 8.50 per cent. The lowest average call market rate of 7.46 per cent was recorded on 21 October 2003. These rates started to show some signs of volatility and marginal increases in November and December 2003, due to the disturbances on the political front as well as the seasonal demand in December. By the end of the year, call market rates were between 7.38 and 8.50 per cent, and the average rate was 7.59 per cent.

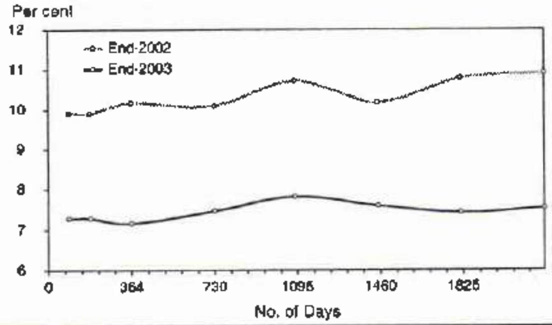
In view of the excess liquidity in the market, the Central Bank conducted repurchase auctions throughout the year. The average weighted rate at the daily Repo auctions remained close to the Central Bank Repo rate. The average weighted rate, which was 9.26 per cent on 03 March, declined to 9.13 per cent by end March, and with the reduction of policy rates, declined to 8.30 per cent by June, 7.58 per cent by September, and to 7.04 per cent by December 2003. Market participants also continued to access the Repo standing facility, while there were a few Reverse Repo transactions as well, reflecting the existence of some institutional limitations in the market.

The Central Bank's discount and rediscount rates, *i.e.*, 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 down with market interest rates. The discount margin between the primary market yield and the CBSL Repo rate was reduced to 25 basis points from 125 basis points, with effect from 28 January 2003, and further to 5 basis points on 11 February. However, with the commencement of active OMO in March 2003, these rates became non-operative.

The Sri Lanka Inter Bank Offered Rates (SLIBOR), which are based on the rates offered for rupee inter bank transactions by 12 commercial banks, also declined with the reduction in Repo rate and showed a downward trend similar to that of the call market rates. The overnight SLIBOR, which was 10.67 per cent at end 2002, reached its lowest level of 7.55 per cent on 17 October 2003, and was 7.73 per cent by end year. The one-year SLIBOR declined from 11.33 per cent at end December 2002 to 7.84 per cent at end December 2003.

By end 2003, the secondary market yield curve for government securities was flatter and was positioned lower than the yield curve at end 2002, indicating market expectations of lower inflation in the medium term. The decline in yield rates is attributed to the reduced supply of government securities, with the continuation of fiscal consolidation in 2003, market appetite for long tenor government securities and market expectations of a further decline in yield rates. Meanwhile, the government issued 10-year, 15-year and 20-year Treasury bonds in 2003, developing a benchmark yield curve.

Chart 10.6
Government Securities – Secondary Market Yield Curve



Lending and Deposit Rates

In line with the changes in the Central Bank policy rates and other market interest rates the deposit and lending rates of commercial banks also declined. Although some lending rates, rates on lending to prime customers in particular, declined faster than deposit rates, the lending rates as a whole were not reduced as much as anticipated. Rates on overdrafts of corporate clients and personal clients declined sharply, while rates on export financing facilities and on import financing facilities in 2003 also declined. The weighted average prime lending rate (AWPR), the weighted average rate of commercial banks' mostly short-term lending to their prime customers, which was 12.24 per cent at end 2002, declined to its lowest level of 8.80 per cent by mid December, but similar to previous years, increased during the Christmas season. The AWPR was 9.26 per cent by end 2003.

Interest rates on savings deposits and fixed deposits also declined during the year. The average weighted deposit rate (AWDR), which is a weighted average of the rates on all outstanding interest bearing deposits of commercial banks, declined from 7.47 per cent in December 2002, to 6.00 per cent by June 2003, and to 5.27 per cent by December 2003. A similar pattern was observed in the average weighted fixed deposit rate (AWFDR), which declined from 10.17 per cent in December 2002 to 7.11 per cent in December 2003.

Following the decline in market rates, the National Savings Bank (NSB) reduced its savings deposit rate three times to be in line with the rest of the market. The savings deposit rate, which was 6.00 per cent at the end of 2002, was in fact increased to 6.5 per cent in August 2003. It was reduced to 6.00 per cent in October and further to 5.00 per cent in November 2003.The one-year fixed deposit rate, which was 9.00 per cent in December 2002, was reduced gradually in four steps to 7.00 per cent by end 2003. However, in view of the reduction in deposit rates, NSB as well as the two state banks introduced special deposit schemes for senior citizens and retirees, where such persons receive a higher rate of interest on deposits.

Interest rates charged by commercial banks on outstanding payments through credit cards, which were in a range of 21-33 per cent at end 2002, remained basically unchanged at end 2003. A few banks, however, did reduce their rates on outstanding payments through credit cards. However, this is not to be viewed as an outlier from the rest of the interest rate structure, since it is only a penal rate on those who do not settle their balances even after the one month's interest free credit provided to credit card holders.

A decline was seen in the lending rates of long-term credit institutions, *i.e.*, DFCC Bank, National Development Bank (NDB), State Mortgage and Investment Bank (SMIB) and NSB. The lending rates of DFCC Bank were reduced from 11.50-19.00 per cent in December 2002 to around 9.50-16.00 per cent at end 2003, while the lending rates of NDB had come down from 10.81-18.35 per cent to 8.23-16.00 per cent during the same period. The lending rates of SMIB and NSB, which were in the ranges of 15.00-16.50 per cent and 14.00-16.50 per cent, respectively, at end 2002, were 12.00-13.25 per cent and 10.00-12.00 per cent, respectively, by end 2003.

Following the declining trend in international market rates, commercial banks in Sri Lanka reduced their interest rates on foreign currency deposits and on foreign currency lending. At end 2003, interest rates on US dollar denominated savings accounts were in the range of 0.40 to 1.75 per cent, while on sterling pound denominated savings accounts it was 1.50 to 4.00 per cent. The interest rates applicable to lending in US dollars were in the range of 2.20 to 8.00 per cent, while on lending in sterling pounds, rates charged were between 3.50-6.80 per cent.

Rates on Short-Term Government Paper

The general declining trend in interest rates was observed at the weekly Treasury bill auctions as well. The weighted average yields (excluding tax) on Treasury bills fell below the CBSL Repo rate of 9.75 per cent at the auctions in January, indicating market expectations of a further reduction in CBSL rates. However, the market corrected itself and in February, the yield on Treasury bills increased marginally. The yields on 91-day, 182-day and 364-day Treasury bills moved down from 9.92, 9.89 and 9.91 per cent, respectively, at end December, 2002, to their lowest levels of 7.06, 7.03, and 6.98 per cent, by the first week of November. The reductions in policy rates, a reduced budget deficit, increased liquidity in the market, and the reduction in other market rates were factors that contributed to this decrease. However, the yields on 91-day, 182-day and 364-day Treasury bills increased to 7.35, 7.30, and 7.24 per cent, respectively, by the end of the year, due to some changes in market perceptions after the developments in the political sphere.

Rates on Medium- and Long-Term Government Paper

Treasury bonds with shorter maturities were issued less frequently in 2003. In contrast, taking advantage of the prevalent low interest rates, 4,5 and 6-year bonds, were issued more frequently, while the long-term risk free yield curve was extended further with the commencement of the issue of 10-year and 15-year bonds in January 2003, and 20-year bonds in October 2003. This also facilitated the programme for reducing the bunching of debt repayment by the government.

With the reduction in policy rates, and the decline in inflationary expectations, Treasury bond rates also decreased throughout the year. Rates, which were close to 11.00 per cent at end 2002, declined across all maturities to single digit levels by end January 2003. By end September, rates were less than 7.50 per cent, and had declined further when the government borrowing programme ended in November, 2003.

Rupee loans with call options, which carried high yield rates, were recalled as a cost reduction strategy of the government, while the first three tranches of the dollar denominated Sri Lanka Development Bonds amounting to US dollars 158.5 million were retired upon maturity, in November and December 2003. Rupee loans with maturity periods ranging from 2-5 years were issued during 2003. Interest rates on Rupee loans, which are administratively determined, were 13.00 per cent at the beginning of the year, but were brought down to around 8.00 per cent by end 2003.

Rates on Corporate Debt securities

Rates on commercial paper, a short-term debt instrument, which were in the range of 10.50-16.50 per cent in 2002, came down to a range of 7.25-13.00 per cent in 2003. Commercial Bank of Ceylon Ltd. issued listed debentures on two occasions during the year. One issue carried an interest rate of 10 per cent, while the other had a floating rate.

The Legal Rate and the Market Rate

The Legal Rate and the Market Rate applicable for the following year are published in the Government Gazette by the Central Bank at the end of each year. The Legal Rate is defined under the Civil Procedure Code (Amendment) Act, No. 6 of 1990 and is applicable to any action for the recovery of a sum of money. The Market Rate is defined under the Debt Recovery (Special Provisions) Act, No. 2 of 1990. The Market Rate is applied only in relation to actions instituted by lending institutions for the recovery of debt exceeding Rs.150,000 arising out of commercial transactions, where there is no agreed rate of interest. Both the Legal Rate and the Market Rate are computed based on the monthly average weighted deposit rates of commercial banks. Accordingly, for 2004, the Legal Rate and the Market Rate are 6.30 per cent per annum compared with 9.58 per cent per annum in 2003, and 11.11 per cent per annum in 2002.

10.6 Commercial Banking

The commercial banking sector continued to grow during 2003 reflecting the recovery in the economy. Although activity in both the domestic banking units (DBUs) and the foreign currency banking units (FCBUs) grew in 2003, the growth in activity of domestic banking units was much higher. In contrast to the slow growth in 2002, both deposits and advances of commercial banks grew substantially in 2003. An increase in utilisation of banking sector resources by the private sector, particularly towards the end of the year, was seen, while the dependence of the public sector on banking resources decreased. The main contributory factors that led to the growth in credit to the private sector were the continuation of the ceasefire, the general reduction in market interest rates, an improvement in business confidence and a satisfactory growth in external trade. Foreign currency inflows to the commercial banks also increased with the increase in tourist earnings, inflows to the stock market, increase in private remittances and the expansion in foreign currency deposits. Consequently, foreign currency resources of commercial banks improved and they were able to sell part of the foreign currency inflows to the Central Bank. This, and the settlement of some liabilities of the government to the commercial banks resulted in an increase in the excess rupee liquidity in the market. There was about Rs.8-10 billion excess liquidity in the market throughout the year, which was mopped up through OMO by the Central Bank.

The total number of commercial banks operating in Sri Lanka declined from 23 at end December 2002 to 22 at end December 2003 with the absorption of the branch of one foreign bank by another foreign bank during the year. Accordingly, the number of foreign banks declined to 11, while the number of domestic banks remained at 11 at end December 2003.

Both the interest and non-interest income of commercial banks continued to increase during the year. This resulted from the improvement in banking activity noted above, as well as the increase in the interest rate margin of banks with a reduction in deposit rates at a faster rate than the reduction in lending rates. Accordingly, profits of the commercial banks increased by about 31 per cent in 2003, in comparison to the increase in profit of 60 per cent in 2002.

Total assets/liabilities of DBUs of commercial banks grew by 12.3 per cent in 2003, in comparison to the 6.3 per cent growth recorded in 2002. Total assets/liabilities of FCBUs of commercial banks grew by 1 per cent in US dollar terms in 2003, in contrast to the decline of 7 per cent recorded in 2002. As the risk weighted capital adequacy requirement (CAR) of commercial banks was increased from 9 to 10 per cent as a ratio of total capital and from 4.5 to 5 per cent as a ratio of core capital with effect from January 2003, some commercial banks issued debentures during the year to meet the new CAR.

Liabilities of the government to the DBUs increased by Rs.19 billion, whereas liabilities to the FCBUs declined by Rs.7 billion in 2003, resulting in a net increase of Rs.12 billion on a consolidated basis. In comparison, government liabilities to the commercial banks increased by Rs.5 billion in 2002. The increase in 2003 was mainly a net outcome of an increase in holdings of government securities by DBUs due to repurchase transactions with the Central Bank using excess liquidity of banks and settlement of Sri Lanka Development Bonds amounting to US dollars 158.5 million (around Rs.15 billion), held by both the DBUs and FCBUs.

Meanwhile, outstanding credit to public corporations from commercial banks declined by Rs.6.8 billion, though the decline was lower than expected at the beginning of the year. This decline was a net outcome of an increase of Rs.0.9 billion from DBUs and a decline of Rs.7.7 billion from FCBUs. The decline was in three major public corporations, *viz.*, Ceylon Petroleum Corporation (CPC), Co-operative Wholesale Establishment (CWE) and the Ceylon Electricity Board (CEB). It was expected that a substantial amount of CPC's liabilities would be settled through privatisation proceeds during 2003. However, it could repay only Rs.1.3 billion of its loans as the full payment of the privatisation proceeds from the second player of the CPC operations (Lanka Indian Oil Company Ltd) was not received during 2003. The CEB settled only Rs.0.8 billion of its liabilities as its cash flow improved only marginally. Meanwhile, liabilities of CWE to commercial banks declined by about Rs.5 billion, mainly due to the issue of government Treasury bonds to commercial banks, amounting to Rs.4.4 billion, replacing part of the CWE's liabilities.

Deposit mobilisation of commercial banks grew at a higher rate (13.6 per cent) in 2003 in comparison with 2002 (10.5 per cent), reflecting the recovery in the economy and improved business confidence. From this expansion, about 21 per cent came through foreign currency deposits. The growth in deposits, achieved even under a relatively low interest rate regime and continued fiscal measures such as the debit tax on demand deposits and a withholding tax on interest income on deposits, is partly a reflection of the lack of alternative investment avenues, due to the under developed nature of the domestic capital market.

Credit to the private sector from commercial banks grew at a higher rate during the second half of the year, reaching an overall growth slightly higher than anticipated in the original monetary programme. The high growth in credit was a reflection of increased credit demand for commercial, consumption and investment purposes. Meanwhile, the ratio of gross non-performing loans to total loans and advances of commercial banks (DBUs and FCBUs), declined to 12.6 per cent in 2003 from 14.2 per cent in 2002, while net NPLs declined to 4.7 per cent from 6.3 at the beginning of the year.

The credit to deposit ratio of the DBUs of commercial banks declined marginally as deposits grew at a slightly higher rate of 13.4 per cent, in comparison to the growth in total advances of 11.4 per cent.

Structure of Assets and Liabilities of Commercial Banks

Domestic Banking Units

The total resources of commercial banks improved substantially by Rs.97,024 million (12.3 per cent) in 2003 compared to Rs.46,870 million (6.3 per cent) in 2003. Some change in the composition of the portfolio of assets was seen, reflecting economic growth. On the assets side, about 50 per cent of the growth came through an increase in total loans and advances, in comparison, to about 12 per cent in 2002. Investments and fixed and other assets contributed 42 per cent and 17 per cent, respectively. Loans, overdrafts and purchases of commercial bills, which are the components in the total loans and advances, loans and overdrafts, grew by 21 per cent and 7 per cent, respectively, while commercial bills declined by 42 per cent in 2003. The decline in commercial bills entirely came through a decline in import bills purchased and discounted as both the local bills and export bills increased. The decline in import bills could be attributed to the availability of suppliers' credit from importers abroad at low interest rates in the international market.

The growth in investments of commercial banks decelerated in 2003 to 40 per cent compared to 69 per cent in 2002. This could be attributed to both an increase in demand for credit by the private sector and a containment of the absorption of funds by the government.

Liquid assets of commercial banks expanded further in 2003 (12.0 per cent), though at a slower pace than in 2002 (17.8 per cent). The holdings of government securities and

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

Item	Change			
	2002 Dec / 2001 Dec		2003 Dec / 2002 Dec	
	Amount (Rs. Mn.)	Percentage	Amount (Rs. Mn.)	Percentage
Assets category				
1. Liquid assets	36,336	17.8	28,930	12.0
Cash on hand	1,991	18.1	168	1.3
Due from Central Bank	1,483	3.8	(2,319)	(5.8)
Foreign currency on hand	3,455	3.5	(3,231)	(3.1)
Treasury bills	16,226	167.4	15,642	60.3
Treasury bonds (b)	13,805	72.2	29,103	88.4
Commercial bills	(624)	(2.4)	(10,432)	(41.9)
2. Investment	41,792	69.5	40,630	39.9
Treasury bills	16,226	167.4	15,642	60.3
Other government securities	23,069	98.2	20,933	45.0
Other investment	2,497	9.3	4,056	13.8
3. Total loans and advances	5,690	1.5	48,757	12.7
Loans	34,281	16.1	51,217	20.7
Overdrafts	(27,968)	(20.0)	7,972	7.1
Commercial bills	(624)	(2.4)	(10,432)	(41.9)
4. Fixed and other assets	1,901	1.7	16,284	14.1
Liabilities category				
1. Capital account	7,250	16.3	23,427	45.3
2. Total deposits	54,407	10.5	77,995	13.6
Demand deposits	(3,997)	(4.7)	13,745	17.1
Time & savings deposits	58,404	13.4	64,250	13.0
3. Borrowings	(18,986)	(30.3)	(2,580)	(5.9)
Local borrowings	(16,896)	(29.2)	(4,737)	(11.6)
Foreign borrowings	(2,090)	(42.5)	2,157	76.3
4. Other liabilities	4,199	3.6	(1,818)	(1.5)
Total assets / liabilities	**46,870**	**6.3**	**97,024**	**12.3**

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

Source: Central Bank of Sri Lanka

cash on hand of DBUs expanded at a slower rate in 2003 while dues from the Central Bank, foreign currency on hand and commercial bills declined over the previous year. The ratio of total liquid assets to total assets remained at 31 per cent, as in 2002. The excess liquidity in the market at end 2003 was around Rs.10 billion compared with about Rs.11 billion at end 2002.

On the liabilities side, deposit liabilities grew by 13.6 per cent in 2003 in comparison to a 10.5 per cent growth in 2002. Both demand deposits and time and savings deposits increased during the year. Demand deposits increased by 17 per cent, in contrast to the 4.7 per cent decline in 2002, while time and savings deposits grew by 13 per cent in comparison to 13.4 per cent growth in 2003. As total borrowings of the commercial banks declined particularly due to the decline in local borrowings during the year, the growth in total liabilities was less than the growth in deposit liabilities. Deposit liabilities as a ratio of total liabilities increased marginally to 74 per cent from 73 per cent in 2002.

Reflecting excess liquidity in the banks, the declining trend in inter-bank borrowings continued, although the decline was less in 2003. Also, the exposure of commercial banks to external financing increased marginally as some commercial banks borrowed from banks abroad.

An improvement in the capital accounts of banks by Rs.23 billion (45 per cent) in 2003 has been recorded in comparison to a Rs.7 billion increase in 2002. Two major reasons for this were the increase in profits of banks and the issue of debentures by some commercial banks to raise capital to meet the increased CAR.

With the continued ceasefire and the growth in economic activity, business confidence improved throughout much of the year with a positive impact on foreign currency inflows to the country. Foreign currency inflows to the banking system grew substantially with increases in inflows through private remittances, tourism, the stock market and foreign currency deposits. DBUs placed a part of their foreign currency resources with FCBUs for their operations, while about US dollars 377 million were sold to the Central Bank. From the perspective of DBUs, the net outcome was a decline in NFA of DBUs by about Rs.19 billion. However, NFA of the consolidated banking system (including both DBUs and FCBUs) increased by about Rs.9 billion in 2003, partly because half the non-resident foreign currency deposits (NRFCs) are regarded as being effectively domestic liabilities, rather than foreign liabilities, for computing overall NFA.

About 95 per cent of the foreign liabilities of DBUs arose from foreign currency deposits in the NRFC, RNNFC, RFC accounts and Foreign Currency Accounts of Exporters. Balances in foreign currency accounts grew by 13 per cent in 2003 compared to 15 per cent in 2002.

Foreign Currency Banking Units

Total assets / liabilities of FCBUs increased by US dollars 21 million (1 per cent) to US dollars 1,795 million in 2003, in contrast to the US dollars 129 million (7 per cent) decline in 2002. About 34 per cent of the resources of FCBUs in 2003 came from DBU placements of foreign currency deposits (US dollars 620 million) and deposits by BOI enterprises (US dollars 458 million). Placements of DBU funds with FCBUs declined marginally, while deposits of BOI enterprises increased substantially by about 33 per cent in 2003. Resources from non-national sources accounted for around 15 per cent of total resources (US dollars 276 million) in 2003, in comparison to 19 per cent of total resources (US dollars 330 million) in 2002.

Loans and advances to BOI enterprises, credit to the government and public corporations and investment in non-resident enterprises were the main areas where FCBU funds were utilised. Reflecting the recovery in foreign trade, credit extended to the BOI enterprises increased from US dollars 770 million to US dollars 870 million. As the government settled maturing Sri Lanka Development Bonds, which were partly held by FCBUs, the utilisation of FCBUs resources by the government declined from US dollars 416 million in 2002 to US dollars 343 million in 2003. Meanwhile, credit extended to public corporations declined by US dollars 80 million as the CPC settled a part of its loans outstanding during the year.

Sources and Uses of Funds of Domestic Units of Commercial Banks

In the financial system of the country, commercial banks play a major role in mobilising funds from surplus units and providing funds to deficit units. The government, public corporations and the general public, as well as foreign entities, transact with commercial banks. Depending on the circumstances, these units could be sources of funds or users of funds of commercial banks. The net availability of funds to the commercial banks is a result of the aggregation of the changes in assets and liabilities of commercial banks with these units.

Total assets and liabilities of commercial banks increased substantially in 2003 resulting in a significant growth in resources and their utilisation on a gross basis. However, the net sources / uses of resources was lower in 2003 than in 2002 reflecting low inter-sectoral dependence of funds. The total net sources / uses of funds at the end of 2003 was Rs.29,110 million in comparison to Rs.26,787 million at end 2002. On net basis, the foreign sector, the Central Bank, capital and reserves and the domestic private sector were the sources of funds of commercial banks while on a net basis major users of funds were the government, public corporations and other banks.

In 2003, as in 2002, the largest source of funds of DBUs, on a net basis, was the foreign sector, reflecting an expansion in foreign currency deposits and borrowings from foreign sources. The contribution of the growth in foreign currency resources to the total net sources of funds of banks was about

TABLE 10.8

Sources and Uses of Resources of Commercial Banks (a)

Rs. million

Category	Change (b) 2002 Sources	2002 Uses	2003 Sources	2003 Uses
1. Government sector		**5,169**		**19,058**
Holdings of govt. securities		39,296		36,575
Deposits		11,796	1,900	
Import bills		173	12,510	
Short-term credit	11,623		1,381	
Overdrafts	34,472		1,726	
2. Central Bank		**1,435**	**4,038**	
Borrowings	48		1,719	
Reserves		1,483	2,319	
Investment in Central Bank securities				
3. Government corporations		**2,815**		**5,911**
Deposits	2,261			5,042
Advances		5,076		869
4. Co-operatives	**675**		**68**	
Deposits	447		84	
Advances	228			16
5. Other domestic private sector	**7,234**		**228**	
Deposits (c)	47,195		64,828	
Local bills		79	58	
Import bills	521			348
Overdrafts		4,393		9,577
Loans		34,390		49,239
Investments in securities & bonds		497		4,056
Debentures		1,123		1,438
6. Inter-bank transactions		**17,367**		**4,141**
Balance with domestic banks		1,576	890	
Deposits & borrowings with domestic banks		15,791		5,030
7. Foreign sector	**11,333**		**19,449**	
Borrowings		2,090	2,157	
Deposits	16,264		16,069	
Foreign balances including export bills		2,860	1,223	
8. Other assets & other liabilities	**7,545**		**5,328**	
Capital & reserves	7,250		23,427	
Fixed assets		1,192		4,651
Other assets		709		11,633
Other liabilities	4,187			1,648
Till cash		1,991		168
Total net sources / users	**26,787**	**26,787**	**29,110**	**29,110**

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.

67 per cent in 2003, in comparison to 42 per cent in 2002. The Central Bank was the second largest source of funds mainly due to the decline in reserves of commercial banks with the Central Bank towards the end of the year. However, on average, reserves were higher during the year in comparison to 2002 as the deposit base of the commercial banks increased in 2003. The other assets and other liabilities category also contributed to the sources of funds of commercial banks, particularly due to increases in capital and reserves of commercial banks, reflecting increase in the profits of most banks and debenture issues by some commercial banks. The net contribution of the private sector as a source of funds was low, although gross values were high, as the growth in utilisation of banking resources by the private sector (source of funds) was almost similar to the growth in deposits in 2003.

On a net basis, the government was the major user of funds of commercial banks though at a lower level, as commercial banks invested part of their resources in government securities. Secondly, government corporations were users of funds of the DBUs on a net basis, as deposits of corporations declined over the previous year by a larger amount than the increase in borrowings. Meanwhile, the dependence of commercial banks for funds in the inter-bank money market was lower in 2003 than in 2002.

Commercial Banks' Loans and Advances[2]

The quarterly survey of loans and advances of domestic banking units (DBUs) of commercial banks for the 12 months ending September 2003 indicated a 14.9 per cent growth in credit provided to public corporations and the private sector by commercial banks, in comparison to a 8.1 per cent growth recorded at end September 2002. In terms of sectors, credit extended to the financial sector recorded the highest growth, while the consumption and tourism categories recorded the second and the third highest growth rates, respectively. The main factors that led to the growth in credit to private sector were the firm recovery in many sectors in the economy along with a decline in interest rates and improved investor confidence, and the improvement in consumption spending due to the recovery in economic activity and the continuation of the ceasefire.

The commercial sector, which has the highest contribution to the total credit outstanding (37 per cent), recorded a moderate growth (9 per cent) on a point to point basis at end September 2003. Following the improvement in exports and imports, credit provided for the export of garments and fabrics, processed rubber and gem and import of food and beverages, private and commercial vehicles increased. In line with an export growth of 11.2 per cent in US dollar terms (12.9 per cent in rupee terms) during the first nine months of the year, credit given to the export category grew by 9.2 per cent during the 12 month ending September

2. Based on the Quarterly Survey of Commercial Banks' Loans and Advances as at end September 2002.

2003. Imports have improved by 10.2 per cent in rupee terms during the first nine-month of the year, while credit provided for imports improved by around 8 per cent. A comparatively lower growth in credit extended for imports could have been partly due to suppliers' credit given by overseas buyers since international interest rates too were low.

The consumption and housing and property development categories, which accounted for 14-15 per cent each in total credit, grew by 36 per cent and 13 per cent, respectively. An increased demand for personal housing, consumer durables and some recovery in real estate activities with the picking up of economic growth and downward movement in interest rates, led to the increase in demand for credit in these sectors. In the consumption category, credit given through credit cards has also shown an expansion, reflecting the growing use of credit cards. The total number of cards issued increased by 23 per cent, while the total outstanding balances which amounted Rs.6.4 billion as at end 2002 increased to Rs.8.1 billion in 2003.

The growth in credit outstanding in the industrial sector increased by around 12 per cent at end September 2003, in comparison to an 11 per cent growth recorded in the 12-months ending September 2002. A growth in credit to processed tea, rubber, coconut and other agricultural exports and an improvement in credit to other manufacturing exports such as textiles, and leather products were seen. This is consistent with the expansion of industrial activity recorded in 2003.

On a point to point basis, growth in credit to the services sector grew by 2 per cent, a lower rate than the credit growth in September 2002. However, if the two main sectors that recorded higher growth, namely tourism and financial services (which are, in fact, classified under the services sector when compiling the national accounts), were included, the growth in credit to services would be 18 per cent as at end September 2003. The credit provided to the tourism sector increased by 20 per cent during the period under review, reflecting a high growth momentum in the sector. Growth in credit to the financial sector increased by 67 per cent at end September, 2003 mainly due to an increase in credit given to financial institutions for the provision of equity finance and funding for leasing companies, along with an increase in the activities in these subsectors with the recovery in the economy. An increase in credit for equity finance may also be attributed to the improvements in stock market activities, including margin trading. Credit provided for leasing has also shown an improvement along with an improvement in lease finance activities in the areas of passenger transport and goods transport.

Credit extended to the agricultural sector also increased by 20 per cent during the 12 months ending September 2003 particularly due to the credit extended to the tea, coconut and minor export crops. The overall improvement in credit to the agricultural sector reflected the increase in agricultural sector activities, supported by the good weather conditions that prevailed in the country during the first three quarters of 2003.

Credit provided for pawning by commercial banks increased substantially during the period under review. The total credit provided for pawning by major commercial banks has increased by around Rs.14 billion during the 12-months ending 2003, which was around 11 per cent of the total credit outstanding of these major commercial banks. Accordingly, the growth in credit to pawning activities grew by 58 per cent in 2003 as against the 38 per cent growth recorded in 2002. Meanwhile, the interest rates charged on pawning by commercial banks have declined considerably from a range of 19.00-27.00 per cent in December 2002 to a range of 15.00-18.00 per cent.

In terms of credit given against various types of securities, more than fifty per cent of the credit was against immovable property, plant and machinery, personal

TABLE 10.9

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

Category	End Sep 2002 Rs. bn.	End Sep 2003 Rs. bn.	As a % of Total Sep 2003	Percentage Change	
				Sep 2002	Sep 2003
Commercial	140.1	152.2	37.0	3.6	8.7
Exports	35.8	39.1	9.5	8.2	9.2
Imports	46.3	50.0	12.1	9.8	7.8
Financial	10.5	17.5	4.3	-9.1	67.4
Agricultural	16.5	19.9	4.8	6.7	20.2
Industrial (b)	37.0	41.5	10.1	11.1	12.2
Tourism	4.7	5.6	1.4	6.2	20.4
Housing	51.3	58.1	14.1	13.6	13.2
Consumption	43.8	59.6	14.5	15.7	36.0
Services	34.2	34.8	8.5	29.7	2.0
Other	20.1	22.1	5.4	-7.8	9.9
Total	**358.1**	**411.4**	**100.0**	**8.1**	**14.9**

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.

TABLE 10.10

Distribution of Outstanding Credit Based on Interest Rates

Per cent per annum

Interest Rate	2001	2002	2003 Jun	2003 Sep
10-15	12.8	20.8	25.9	28.0
16-20	34.1	35.0	32.8	30.2
21-25	23.5	18.1	18.6	15.9
25 and above	18.0	15.8	10.0	8.8

Source: Central Bank of Sri Lanka

guarantees and fixed savings. The Average Weighted Lending Rate (AWLR) declined from 19.6 per cent at end September 2002 to 18.2 per cent at end December 2002 and further to 16.4 per cent at end September 2003, reflecting some reduction in general lending rates during the period. Although the decline in the AWLR was much slower than the decline in other market rates, the AWLR declined by a higher amount in 2003 than in 2002. The AWLR, which declined by 1.1 per cent in 2002, declined further by 1.8 per cent during the three quarters in 2003. Lending rates discussed in the section on interest rates (Section 10.5) decreased in the fourth quarter of 2003.

The amount of credit provided at higher rates of interest by commercial banks recorded a decline. As shown in Table 10.10, there has been a slow and gradual reduction in lending rates from 2001 to September 2003.

10.7 Central Banking

The operations of the Central Bank in 2003 were mainly focussed on the management of liquidity in the market at an appropriate level to achieve the monetary policy objective of economic and price stability. The system of more active open market operations as the main instrument of monetary management helped to manage market liquidity effectively by using the Central Bank's policy interest rates. There was a substantial improvement in foreign inflows to the Central Bank in 2003, and it resulted in a change in the composition of the balance sheet with a larger increase in foreign assets and a corresponding decline in domestic assets of the Central Bank.

A substantial increase in foreign currency inflows to the country was recorded in 2003 as indicated in the improvement in the BOP. As the government sold its foreign currency receipts from foreign loans to the Central Bank, and also a substantial amount of foreign exchange was purchased by the Central Bank from the commercial banks, rupee liquidity in the market increased. This excess liquidity was absorbed through the open market operations of the Central Bank and consequently, holdings of government paper shifted from the Central Bank to commercial banks. As the Central Bank holdings of Treasury bills declined from around Rs.55 billion at the beginning of 2003 to about Rs.16 billion by the third quarter, the Central Bank issued Rs.5 billion worth of its own securities in September to mop up the excess liquidity in the market. These were issued for a period of less than three months and had been settled by the end of the year.

Structure of Assets and Liabilities of the Central Bank

The value of total assets and liabilities of the Central Bank increased by 17 per cent during 2003. On the assets side, the increase was entirely in foreign assets reflecting the increase in foreign reserves of the Central Bank which more than offset the decline in domestic assets. The increase in foreign assets mainly came through funds received under the PRGF facility of the IMF, sales of foreign exchange receipts of the government to the Central Bank and purchases of foreign exchange by the Central Bank from the commercial banks. Total net foreign assets of the Central Bank increased by 40 per cent (Rs.47 billion). In comparison, the improvement in net foreign assets in 2002 was 39 per cent (Rs.33 billion).

In contrast, net domestic assets of the Central Bank declined by Rs.32 billion, particularly due to the decline in net holdings of government securities by Rs.28 billion to Rs.11.5 billion at end December 2003. Provisional advances to the government which are provided through the revolving credit facility, increased only marginally in 2003.

On the liabilities side, the total currency issue of the Bank increased by Rs.10 billion (11.9 per cent): the issue of currency notes increased by 12 per cent and coins by 7 per cent. Deposit liabilities of the Central Bank increased by 21 per cent particularly due to deposits of international organisations which include the drawings from the IMF. Deposits of commercial banks increased (12 per cent), which was due to an increase in the statutory reserve requirement (SRR) on increased commercial banks deposit liabilities.

10.8 Banking Development

The total number of Licensed Commercial Banks (LCBs), operating in the country decreased to 22 (11 domestic banks and 11 branches of foreign banks) at end 2003 from 23 at end 2002, as a result of the absorption of the operation of Standard Chartered Grindlays Bank by Standard Chartered Bank. Meanwhile, the total number of licensed specialised banks (LSBs) rose to 14 at end 2003 from 13 at end 2002 with the registration of Housing Development Finance Corporation (HDFC) as a LSB. In addition, one LSB, Pramuka Savings and Development Bank, was under resolution by the Central Bank in terms of statutes.

Branch Expansion

The local branch network of commercial banks increased from 1,163 at end 2002 to 1,191 at end 2003. The increase was mainly in domestic banks which opened 26 branches during the year. Foreign bank branches increased from 35 at end 2002 to 37 at end 2003. Continuing the trend seen in 2001, the banking density, *i.e.*, the number of commercial bank branches per 10,000 people recorded a marginal increase from 0.61 in 2002 to 0.69 in 2003. The branch network of LSBs increased by 41 to 370 at end 2003, mainly as result of HDFC which has a branch network of 20, being registered as a LSB. Of the total number of LSB branches, around 83 per cent were accounted for by NSB and RDBs.

Banking Facilities

The commercial banks continued their effort at maintaining and improving their competitive edge by concentrating on product innovation and product differentiation in view of the

TABLE 10.11

New Commercial Banking Facilities – 2003

Bank	Deposit Scheme	Lending Schemes	Other Services
Bank of Ceylon	1. *Ethera Thilina* Savings Account: For migrant workers. An interest rate of 0.5 per cent above ordinary savings is paid. 2. Senior Citizen Fixed Deposit Scheme. An interest rate of 1 per cent above annual fixed deposit rate is paid	1. *Ransumiithuru*: Special Credit Scheme for Small Enterprises 2. Southern Province Regional Economic Advancement Project (SPREAP) *DHASUNA* 3. Government of Sri Lanka Housing Finance for Low & Middle Income Households 4. Relief Scheme to provide financial assistance to customers of the bank affected by floods/earth slips	06 ATMs installed.
People's Bank	1. *YES* Accounts 2. *Vishrama Suvaya* (Savings & Fixed deposits scheme)	1. *Jana Jaya* (Education) 2. *Jana Jaya* (Consumption) 3. *Jana Jaya* (Housing) 4. *Jana Jaya* (Pensioners)	03 ATMs installed.
Hatton National Bank	–	1. Government Sponsored Housing Loan Scheme 2. *Danuma* Educational Loan Scheme for professional and postgraduate studies.	1. 12 ATMs installed 2. *HotShots* - Special credit cards for teenagers 3. *Hatna i* – Internet banking facility 4. *Hatna SMS*
Commercial Bank of Ceylon Ltd.	–	–	1. 20 ATMs installed 2. *Com bank e-Exchange. An instant money transfer facility* 3. Same day cheque realization facility 4. *e-Access* - Self service banking kiosk
Sampath Bank Ltd.	–	*Sahanya* Loan scheme for development purposes	12 ATMs installed
Seylan Bank Ltd.	–	1. *Viyana* Housing Loan Scheme for ETF contributors 2. Affordable Housing Finance for Low & Middle Income households	08 ATMs installed
Union Bank Ltd.	–	*Apara* Loan scheme: for migrant workers	–
Pan Asia Bank Ltd.	1. FD Fortune 2. FD Premium	–	12 ATMs installed
Nation's Trust Bank	–	–	08 ATMs installed
NDB Bank	Minor Savings account	–	01 ATM installed
Citi Bank Ltd.	CitiJunior – Foreign currency savings account for minors.	–	1. 01 ATM installed 2. Cash management services on collections and payments
Deutsche Bank Ltd.	–	–	*DB-Recon*: An electronic account reconciliation system for Internet banking customers
HSBC	–	Car loan scheme	01 ATM installed
Standard Chartered Bank Ltd.	–	–	01 ATM installed

Sources : Commercial Banks

TABLE 10.12
Distribution of Bank Branches

Category	2001	2002	2003(a) End Dec
1. Licensed commercial banks			
I. Total no. of commercial banks	**25**	**23**	**22**
Domestic banks	11	11	11
Foreign banks	14	12	11
II. Total no. of commercial bank branches (b)	**1,130**	**1,274**	**1,319**
Domestic bank branches	1,084	1,240	1,285
Main branches	951	1,024	1,048
Asc branches	11	10	10
Kachcheri branches	23	23	23
Extension/pay offices/ service counters	95	178	197
Overseas branches	4	5	7
Foreign bank branches (c)	46	34	34
Pawning centres	188	188	188
Students savings units	194	218	225
2. Licensed specialised banks (d)			
I. Total no. of licensed specialised banks	**14**	**13**	**15**
Regional Development Banks	6	6	6
National Savings Bank	1	1	1
Long-term lending institutions	2	2	2
Housing finance institutions	2	2	3
Private savings and development banks	3	2	3
II. Total no. of licensed specialised bank branches	**328**	**332**	**370**
Regional Development Banks	188	190	194
National Savings Bank	101	103	112
Long-term lending institutions	22	23	23
Housing finance institutions	5	5	26
Private savings and development banks	12	11	15

Source: Central Bank of Sri Lanka

(a) Provisional.
(b) Includes Head offices. Excludes pawning centres and students 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).

difficulty in price competition in the service-oriented banking industry. The popularity and use of non-cash based modes of payments such as credit cards, debit cards, EFTPOSs, Internet banking and tele-banking *etc.*, increased during the year. The number of credit cards issued by commercial banks recorded a 23 per cent growth from approximately 321,150 at end 2002 to 393, 850 at end 2003. Of the total credit cards issued, the majority (80 per cent) were global cards, accepted for both local and foreign transactions. The total number of ATMs operated by commercial banks in the country increased to 705 at end 2003 from 622 at end 2002, while the number of EFTPOS increased from 4,256 to 4,732 during the same period. Another emerging trend seen in the commercial banking sector is the increased use of e-banking services and e- payment services such as tele banking, internet banking, e-learning and e-channelling by banks. There were 9 commercial banks offering Internet banking facilities at end 2003, with a total customer base of 214,650 and a total value of transactions amounting to Rs.81 billion.

10.9 Credit Information Bureau of Sri Lanka

The Credit Information Bureau of Sri Lanka (CRIB) was established under the Credit Information Bureau of Sri Lanka Act, No. 18 of 1990 (later amended by Act No. 8 of 1995), with the objective of collecting and collating information on borrowers and to furnish such information to shareholding lending institutions. At present, 82 institutions, including all licensed commercial banks, licensed specialised banks, registered finance companies, registered leasing establishments, and the Central Bank, are shareholders of CRIB.

CRIB currently collects information on regular advances of Rs.500,000 and over, and irregular advances of Rs.100,000 and over. The number of credit reports issued during the year increased to 389,171 from 285,269 in 2002, reflecting higher demand for credit with the recovery in economic activity and also demonstrating that credit information is used as an important risk management tool by lending institutions. This increased demand for credit information contributed to a sharp increase in the Bureau's profits, to Rs.32.9 million in 2003, from Rs.24.5 million in 2002.

The number of advances recorded in the database amounted to 159,500 in 2003, compared with 139,500 in 2002. Of the number of advances in 2003, 106,000 advances were regular, while 53,500 were irregular advances (advances which are more than six months in default). The value of irregular advances in the database was about Rs.103 billion compared with about Rs.99 billion in 2002. Of the total irregular advances, 74 per cent were accounted for by the corporate sector, while the balance was accounted for by individual borrowers. More than 90 per cent of these irregular advances were advances over one million rupees.

TABLE 10.13
Credit Cards Issued by Commercial Banks

Category	2002 (a)	2003 (b)	% change
Total number of credit cards issued	321,145	393,854	22.6
Local	69,437	78,034	12.4
Global	251,708	315,820	25.5
Outstanding credit at end year (Rs.mn.)	6,390	8,125	27.2
Local	618	693	12.1
Global	5,771	7,432	28.8
Overdues (as a % of outstanding credit)	10	10.3	-
Past dues (as a % of outstanding credit)	9	7.8	-
Commission from dealers (%)	0.25-3.5	0.25-3.5	-

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

10.10 Rural Banking and Credit

Overall Trends and Developments

Several measures were taken during 2003 to strengthen microfinance activities and the microfinance sector of the country. Banks and other financial institutions further expanded their credit programmes to the North and the East with the peaceful environment that prevailed in those areas. Cultivation loans granted under the New Comprehensive Rural Credit Scheme (NCRCS) picked up substantially in these areas particularly, in the districts of Ampara, Batticaloa and Trincomalee. Following the declining trends in the interest rates, the on lending interest rate on loans granted under NCRCS was reduced from 12 per cent to 8 per cent per annum, while the interest subsidy paid by the government to lending banks on these loans was also reduced from 10 per cent to 8 per cent. The Forward Sales Contract System (FSCS) introduced in 1999 was further expanded in 2003. The pilot project introduced in 2002 by the Central Bank with funding assistance from the World Bank to promote the FSCS was successfully completed in 2003 and steps were taken to explore the possibility of establishing a futures market for agricultural commodities.

A major development in the policy area was the signing of a project agreement between the Asian Development Bank (ADB) and the Government of Sri Lanka for the development and strengthening of the rural finance sector in the country. The Rural Finance Sector Development Project (RFSDP) is designed to contribute to promoting economic growth and poverty reduction. The objective of the project is to strengthen key sector institutions for the provision of training in rural finance services, efficient service delivery by rural finance institutions (RFIs), rural finance sector supervision and outreach expansion. The project will support the restructuring plans of Cooperative Rural Banks (CRBs) and Regional Development Banks (RDBs), the National Development Fund's (NDTF) Corporate Plan and the Samurdhi Institutional Strengthening Plan. These reforms emphasise good governance of RFIs, efficient delivery of rural finance services and increased demand for such services. A legal and regulatory framework will be introduced for the regulation and supervision of RFIs, which

TABLE 10.14
Loans Granted Under the New Comprehensive Rural Credit Scheme
(Position as at 31 December, 2003)

Rs. million

Season	State Banks			Domestic Private Banks (a)			Regional Development Banks			Total Loans (Amount)		
	Paddy	Subsidiary Food Crops	Total	Paddy	Subsidiary Food Crops	Total	Paddy	Subsidiary Food Crops	Total	Paddy	Subsidiary Food Crops	Total Loans Granted under NCRCS
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	68	32	100	34	25	59	68	45	113	170	102	272
Cultivation Year 2001	191	71	262	101	50	151	129	96	225	421	217	638
2001/2002 Maha	81	75	156	41	21	62	38	36	74	160	132	292
2002 Yala	19	232	251	43	109	152	45	66	111	107	407	514
Cultivation Year 2002	100	307	407	84	130	214	83	102	185	267	539	806
2002/2003 Maha (b)	116	157	273	87	195	282	100	82	182	303	434	737
2003 Yala (b)	83	221	304	161	325	486	88	62	150	332	608	940
Cultivation Year 2003 (b)	199	378	577	248	520	768	188	144	332	635	1042	1,677

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

Source : Central Bank of Sri Lanka

do not come under Central Bank supervision. The reforms will also support the establishment of a Rural Economic Resuscitation Trust Fund for expanded skills, technical and marketing support to enable the rural poor to use access to rural finance services efficiently. With a view to building rural finance sector capacity, the project will support the strengthening of the Centre for Banking Studies of the Central Bank of Sri Lanka as a centre of excellence in rural finance training.

The two microfinance programmes implemented by the Central Bank, namely, the Small Farmers and the Landless Credit Project (SFLCP – ISURU) and the Poverty Alleviation Microfinance Project (PAMP) continued their operations in the project districts in 2003. The projects use a self-help approach in developing necessary social capital at the grassroots level for alleviating poverty through income generation. The SFLCP was in operation in the districts of Matara, Galle, Kandy and Puttalam, while the PAMP was in operation in the districts of Badulla, Hambantota, Kalutara, Kurunegala, Matale and Nuwara Eliya. Initiatives were taken to expand the PAMP to the districts in the North and East through commercial banks, namely, Bank of Ceylon, Hatton National Bank and Seylan Bank, which will be the implementing agencies. With a view to ensuring the long-term sustainability of the project, the district level ISURU Development Societies (IDSs) of the SFLCP districts were registered as peoples companies and they were amalgamated into a national level ISURU Federation.

As an initial step in RDB reforms, a part of the shares of RDBs held by the Central Bank were transferred to the Ministry of Finance and as a result, the Central Bank holding of RDB shares was reduced to 20 per cent in each RDB.

Forward Sales Contract System (Govi Sahanaya)

As a market based solution to the problems of farmers in marketing their agricultural produce, the Forward Sales Contract (FSC) System was initiated in 1999 by the Central Bank. Under the Forward Sales Contract System, the producers and the buyers are encouraged to enter into contracts with an agreed price at the time of cultivation of their crops. The FSC system will ensure a fair price for the farmers' produce, minimising the impact of rapid fluctuations in prices realised by the farmers.

This programme was supported by the World Bank by providing necessary funds under its Development Market Place Project and it was implemented from April, 2002 to June, 2003. The Central Bank implemented the project with the participation of Bank of Ceylon, People's Bank, Seylan Bank, Commercial Bank, six RDBs and Sarvodaya SEEDS as facilitators of the contracts. This pilot project, aimed at promoting sales contract systems among farmers, buyers, bankers, policy makers and the general public, was successfully completed in 2003. Under the project, 2,384 awareness programmes were held in all major agricultural areas of the country with the participation of 121,000 persons. In addition to the meetings and workshops, booklets, posters and documentaries were prepared in Sinhala, Tamil and English to propagate the concept of the Forward Sales Contract System.

Under the project, in addition to awareness/publicity programmes, the participating institutions were provided with motorcycles and computers for promotion of the system in the respective areas. The progress of the FSC System is summarised in Tabel 10.16.

TABLE 10.15

Savings Mobilised and Advances – Selected Rural Sector Institutions

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	
	2002	2003(a)	2002	2003(a)	2002	2003(a)	2002	2003(a)	2002	2003(a)	2002	2003(a)
Total deposits (b)	**18,688**	**20,052**	–	–	**4,175**	**4,490**	**547**	**752**	**65**	**69**	**1,495**	**1,696**
Savings	13,477	14,371	–	–	1,228	1,326	486	636	28	29	380	578
Special savings	–	–	–	–	1508	1,689	16	28	17	20	6	4
Fixed deposits	5,211	5,681	–	–	599	629	45	88	1	1	943	939
Shares	–	–	–	–	840	846	–	–	19	19	166	175
Total loans granted (c)	**3,327**	**4,206**	**6,285**	**8,133**	**2,768**	**2,921**	**991**	**1,250**	**382**	**432**	**648**	**1,161**
Agriculture	850	207	1,438	2,325	436	462	101	131	308	343	7	7
Animal husbandry	101	273	64	92	90	101	29	39	–	–	–	–
Fisheries	33	27	47	70	–	–	–	–	15	16	–	–
Small industries	280	112	912	919	138	249	192	252	29	31	12	22
Building construction, electrification and water supply	185	1,877	–	–	1,114	1080	353	452	–	–	58	250
Projects / commerce	226	396	499	732	285	302	186	209	–	–	209	521
Others	1,652	1,314	3,325	3,995	705	727	130	167	30	42	362	361

(a) All figures for 2003 are provisional.
(b) Total savings at the end of the year.
(c) Total loans granted during the year.

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

TABLE 10.16
Forward Sales Contracts – 2003

Crop	No. of Agreements Signed	No. of Farmers Benefited	Forward Price Determined (Rs. per kg.)
Maize	6,322	6,967	14-18
Paddy	11,192	12,220	13-14
Finger Millet	1,925	2,245	20-22
Soya	5,222	5,830	27-30
Green gram	5,291	6,002	45-50
Other crops	8,055	9,110	25-65
Total	38,007	42,374	–

Source: Central Bank of Sri Lanka

The National Convention of all the stakeholders of the FSC project was held in 2003 to review the progress of the project and to decide on the future course of action to promote the forward sales system in the country. The Convention resolved that the promotion of the FSC System should be further strengthened, while exploring the possibility of moving to a futures contract system for selected agricultural commodities. The Convention also approved the appointment of a Task Force to examine the possibility of establishing a commodity exchange required for effective implementation of the futures contract system.

New Comprehensive Rural Credit Scheme (NCRCS)

The Central Bank continued with the implementation of the NCRCS under which short-term cultivation loans are provided on concessionary terms for paddy and 27 subsidiary food crops. A sum of Rs.443 million was granted in Maha 2002/2003 and Rs.493 million in Yala 2003 under the scheme. The amounts were higher than in the previous cultivation year, where Rs.308 million was granted for Maha and Rs.406 million for Yala. The favourable weather

TABLE 10.17
Performance of Selected Microfinance Institutions / Schemes : 2003 (a)

Institute / Programme	Legal Status	Funding Source	Governance System	Total Membership / Borrowers	Loans granted in 2003 (Rs.mn.)	Total loans granted as at 31.12.2003 (Rs.mn.)
Samurdhi Programmes	Samurdhi Authority of Sri Lanka Act, No. 30 of 1995	Government and Members' Savings	Samurdhi Authority of Sri Lanka	2,018,096(b)	2,186	11,393
Farmers' Banks	Agrarian Development Act, No. 46 of 2000	Government and Members' Savings	Department of Agrarian Development	n.a.	362	1,192(d)
Gemi Pubuduwa Scheme	Banking Act, No 30 of 1988	Hatton National Bank	Hatton National Bank	40,000(c)	340	2,000
Rural Banking Innovative Project (RBIP)	Banking Act, No. 30 of 1988	People's Bank and GTZ	People's Bank and GTZ	3,420(c)	91	307
Sarvodaya SEEDS	Companies Act, No. 17 of 1982.	Donor Funds, NDTF and Members' Savings	SEEDS Guarantee Ltd.	n.a.	1,250	6,757(e)
Kantha Ran Divi Maga	Banking Act, No. 30 of 1988	Bank of Ceylon	Bank of Ceylon	1,244(c)	1	22
Janashakthi Banking Societies	Society Ordinance and Voluntary Social Services Organisation (Registration and Supervision) Act, No. 31 of 1980	Donor Funds, NDTF and Members' Savings	Women Development Federation - Hambantota	n.a.	432	1,077
Co-operative Rural Banks (CRBs)	Co-operative Societies Law, No. 5 of 1972	NDTF and Members Savings	Co-operative Dept. & Multi-purpose Co-operative Socities (MPCSs)	614,497(c)	4,206	n.a.
Thrift and Credit Co-operative Societies (TCCSs)	Co-operative Societies Law, No. 5 of 1972	NDTF and Members' Savings	SANASA Federation	n.a.	2,921	8,447
Small Farmers and the Landless Credit Project (SFLCP)	Administrative Agreement with GOSL by CBSL	Revolving Funds	CBSL	89,189(b)	182	1,110
Povery Alleviation Microfinance Project (PAMP)	Administrative Agreement with GOSL by CBSL	Donor Funds, GOSL, JBIC and Revolving Funds	CBSL	46,536(b)	207	291

(a) Provisional
(b) Members
(c) Borrowers
(d) Cumulative from 1998 Maha
(e) Cumulative from 1998

Sources : Samurdhi Authority, Ministry of Agriculture, Women Development Federation (Hambantota), Dept. of Co-operative Development, People's Bank, Bank of Ceylon, HNB, TCCS, SEEDS conditions that prevailed in agricultural areas during the year, the substantial increase of cultivation loans granted in the Eastern Province and the reduction of the interest rate on cultivation loans from 12 per cent to 8 per cent per annum with effect from Yala 2003 were the main factors that contributed to the increase. A similar trend could be observed in respect of loans granted for purchase of agricultural produce directly from the farmers under the FSC System of the NCRCS. The loans granted for purchase of paddy, maize, soya, green gram and finger millet (kurakkan) showed substantial increases. In Maha 2002/2003, the loans granted under FSCS for purchase of paddy and other agricultural crops amounted to Rs.292 million and in Yala 2003 to Rs.466 million, compared to Rs.77 million and Rs.279 million granted during the corresponding seasons in the previous cultivation year. The government paid Rs.66 million to lending banks as interest subsidy in respect of loans granted under NCRCS in 2003. A sum of Rs.78 million was paid under the scheme to lending banks as credit guarantee indemnity against the cultivation loans defaulted during 1994 – 1998.

Crop Insurance Schemes

The Agricultural and Agrarian Insurance Board (AAIB) continued to provide insurance cover for 14 selected crops, livestock and post-harvest activities. Ceylinco Insurance Company Limited (CICL) also provided insurance cover for the same crops and livestock under their scheme. In 2003, the AAIB added two more crops, namely, banana and ginger under its crop insurance scheme. CICL implemented special insurance schemes, namely, the Post Harvest Crop Insurance Scheme for paddy and the Ceylinco Seylan Govi Rakawaranaya, which offered special life and health insurance cover for crop credit customers.

The extent of paddy land insured by the AAIB and CICL in 2003, amounted to 8,400 hectares and 25,293 hectares, respectively. The area covered by the AAIB has more than doubled, while the area insured by CICL increased by 5,601 hectares when compared to the area covered in 2002. The indemnities paid by AAIB and CICL to affected policy holders amounted to Rs.0.8 million and Rs.2.9 million respectively.

Microfinance Schemes

Various microfinance institutions, as given in the table below continued to provide microfinance services that included savings, credit and other financial services to assist the poor and low-income persons for their economic empowerment. Many institutions adopted the self-help groups approach in reaching the poor effectively and minimising the cost of providing such financial services. Social mobilisation of target groups occupied high priority in their microfinancing approaches. The organisation of microfinance clients into village level, district level and national level networks strengthened their capacity in obtaining financial services and integration with wider markets for their products. The two microfinance schemes implemented by the Central Bank of Sri Lanka, namely the SFLCP and the PAMP, showed considerable progress in the project districts during 2003. The first national convention of the national level ISURU Federation was held in 2003. A major objective of the Convention, and the trade fair that followed the convention, was to bring the scattered small producers into a marketing network among the member societies and to link them with established buyers in the formal sector, while strengthening the institutional structure of the project to ensure long-term sustainability of the project.

National Development Trust Fund (NDTF)

The National Development Trust Fund (NDTF), formerly known as the Janasaviya Trust Fund, is a non-profit organisation established in 1991 under the Trust Ordinance. Its main function is to implement a programme of micro-credit for the poor segments of the society with a view to alleviating poverty in the country. One of the major strengths of the NDTF has been its ability to use NGOs as conduits to grant loans to the poor without collateral.

TABLE 10.18

Performance of the National Development Trust Fund (NDTF) – Microfinance Component

Rs. million

Partner Organisation (PO)	No. of POs		Disbursement of Refinance		Recovery of Capital		Outstanding Loan Balance as at 31.12.2003	Recovery Percentage as at 31.12.2003
	2002	2003	2002	2003	2002	2003		
Non-governmental organisations (NGOs)	131	148	163	153	103	117	231	76
Thrift & credit co-operative societies (TCCSs)	15	17	13	5	17	17	118	32
Regional Development Banks (RDBs)	6	6	76	126	69	118	132	100
SANASA Development Bank	1	1	34	0	25	36	23	100
Other banks	4	4	1	1	5	2	1	100
Co-operative societies	32	39	3	7	7	6	27	55
Total	189	215	290	292	226	356	532	79

Source : National Development Trust Fund

Poverty focussed microfinance programmes which are facilitated by the NDTF have adopted a participatory approach to achieve the objective of poverty reduction by

- forming small groups, increasing awareness and mobilising and transforming them into an economically active segment of the community;
- encouraging sustainable economic activities which will improve the standard of living; and
- building capacity of community-based volunteer organisations.

At present, more than 400,000 poor individuals have been covered under the programmes of the NDTF. The NDTF operates through a network of some 209 Partner Organisations comprising non-governmental organisations (NGOs), RDBs, co-operative societies and commercial and specialised banks spread throughout the country. The NDTF is managed by a Board of Trustees representing the government and non-governmental organisations covering micro-credit, gender, nutrition, academic research and human resources.

The NDTF extends assistance to its registered Partner Organisations to undertake skills development programmes among the poor with a view to developing their creditworthiness in the long run. The NDTF will be able to provide more funds for micro credit and capacity building of Partner Organisations with the assistance of the funds made available through donor agencies under two new projects to be implemented in 2004, namely, the Rural Finance Sector Development Project (RFSDP) and the Aquatic Resources Development Project.

Under the RFSDP, the NDTF is responsible for co-ordinating and monitoring the credit delivery system and administrative functions associated with refinance applications and loan disbursement requests by the PFIs. The project will assist NDTF with capacity building, including provision of training to the Partner Organisations and will facilitate vulnerable communities access to micro credit through group formation and community organisation. In particular, vulnerable communities will be assisted by implementing partner NGOs in identifying viable livelihood activities in fisheries, aquaculture, agriculture, agro-forestry, eco-tourism and a range of micro enterprise development opportunities based on nontraditional activities. Business advisory and technical support services in relation to livelihood and micro-enterprise development will also be provided to potential borrowers.

Regional Development Banks (RDBs)

The Central Bank of Sri Lanka was initially the main shareholder of the six RDBs with over 50 per cent of the total issued share capital of each RDB. However, the Central Bank subsequently reduced its shareholding of each RDB to 20 per cent by transferring the balance to the government.

The subject of RDBs, which was under the Ministry of Finance, was brought under the Ministry of Rural Economy with effect from 28 February 2003. The Ministry of Rural Economy introduced several credit schemes such as 'Athamaru', 'Diriyalanda' and 'Gemira' to be implemented through RDBs in order to diversify the microfinance services offered by them. The Ministry has also introduced the Production Specialised Villages Programme with a view to enhancing the productive capacity of people in selected villages that specialise in a particular product by using the resources available in those villages. The cost of the economic infrastructure development of these villages, as identified under the programme, is to be borne by the Rural Economic Resuscitation Trust Fund of the Ministry, while the RDBs are expected to provide necessary microfinance services in those villages.

A large segment of lower and middle income groups live in semi-urban and rural areas in the Colombo District, which do not enjoy the facilities provided by the RDBs. In addition, a considerable number of the urban poor and lower-middle income earners living in urban areas are in need of banking facilities for improvement of their economic activities. With the objective of expanding banking facilities to these people, the administrative district of Colombo was included in the region of the Sabaragamuwa Development Bank (SDB) with effect from 15 September 2003, increasing the total number of districts served by the RDBs to eighteen. The first branch in the Colombo District was opened in Homagama in December 2003.

10.11 Other Financial Institutions

Savings Institutions

The National Savings Bank (NSB) continued to offer new products and expand its distribution network during the year, in its endeavour to maintain a competitive edge in the industry. The bank became the first Sri Lankan bank to be awarded SL AAA credit rating by a local credit rating agency. It introduced a new deposit product titled 'Gaurawa' for the benefit of persons over 60 years of age to provide a cushion to their purchasing power. The bank launched a new lending scheme, 'Alankara Home Loan', to provide loans for the modernisation of houses. Another service introduced by the bank was the provision of a life insurance cover with a ceiling of Rs.300,000, for all savings account holders between 18 and 70 years of age, who maintain an average balance of Rs.10, 000 in their account for three months immediately prior to death.

The bank has obtained the services of a consulting agency for the purpose of connecting all the branches and ATMs under its three year IT strategy. At end 2003, the bank had a network of 112 branches, with 39 branches providing services during the weekends and one branch providing a 24-hour service.

The deposit base of the bank increased to Rs.161 billion in 2003 from Rs.135 billion in 2002, a growth rate of 19.2 per cent. The total loans outstanding too increased from Rs.26 billion at end 2002 to Rs. 31 billion at end 2003, with loans over 5 years accounting for about 36 per cent of the total outstanding loans. Total loans disbursed during the year amounted to Rs.23 billion, of which the major share was accounted for by loans to financial institutions and housing. In terms of size, 91 per cent of loans disbursed during the year fell into the category of loans above Rs.500,000. The rate of interest charged by the bank on its loans ranged between 5-20 per cent. The majority of loans (86 per cent) have been granted at rates between 8 – 12 per cent. The bank's investments were mainly in government securities (88 per cent) in addition to other forms of investments such as debentures, fixed deposits and commercial paper.

Contractual Savings Institutions

The major contractual savings institutions are the provident funds, which are designed to provide members with superannuation benefits, other than insurance companies. There were four state controlled provident funds, *viz.*, Employees Provident Fund (EPF), Employees' Trust Fund (ETF), Public Service Provident Fund (PSPF) and Contributory Pension Fund (CPF) and around 190 other approved private provident funds operating at end 2003, with the EPF accounting for the major share of resources. In 2002, the government introduced a contributory pension fund for new entrants to the public service with a view to creating a sustainable pension scheme for employees who join the Public Service, Local Government Service and Provincial Public Service on or after 01 January 2003. In 2003, legislation was amended to provide provident fund benefits to persons holding non pensionable posts in the government service, to cover all employees who are paid other than on a monthly basis. In addition, a bill was drafted for the creation of a Commission to register, regulate and supervise superannuation funds

The total contribution to the EPF, the largest provident fund and the single largest investment fund in Sri Lanka, increased due to the combined effect of an increase in the contributing membership during the year and increased salaries and wages. The total investments of the EPF grew by 13.1 per cent to Rs.320 billion at end 2003 from Rs.283 billion at end 2002. The share of investments in government securities has increased from 97.5 per cent at end 2002 to 98.3 per cent at end 2003, as a result of the maturing of investments in corporate debt papers, lack of new corporate debt issues, and diversification of investments into long terms assets (primarily Treasury bonds) in order to reduce maturity mismatches. A substantial increase in capital gains resulting from a booming share market and a declining interest rate regime during the year enabled the EPF to record a rise in the realised annual average return on its investment portfolio to 13.71 per cent in 2003 from 13.61 per cent in 2002. The total net assets of the EPF increased by 14.5 per cent from Rs.296 billion at end 2002 to Rs.339 billion at end 2003.

The ETF, which is an employer contributory fund, too recorded an expansion. The total contributions to the ETF rose to Rs.3.7 billion in 2003 from Rs.3.5 billion in 2002, reflecting both an increase in the number of contributors and a general rise in wage levels during the year. The total refunds made during the year amounted to Rs.3.1 billion as against Rs.2.5 billion in 2002. Meanwhile, the outstanding balances of around 5 million members in the fund rose to Rs.45 billion at end 2003 from Rs.40 billion at end 2002. The total investment portfolio of about Rs.44 billion consisted of government securities (89 per cent) and other investments including equities, debentures and bank deposits. The share of government securities in the investment portfolio

Chart 10.7
Employees' Provident Fund

Chart 10.7.1
EPF Contributions and Refunds

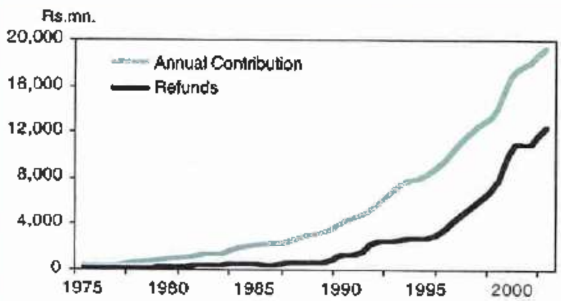
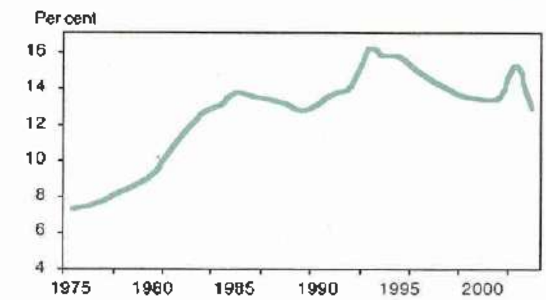


Chart 10.7.2
Rate of Return on Investment



increased by about 9 per cent over the previous year, possibly due to profit taking by sale of equity holdings towards the end of the year and the lack of long-term financial instruments other than Treasury bonds, which are suited for the liability structure of the Fund.

The coverage of the Public Service Provident Fund (PSPF), operated by the state, was extended to all non-pensionable employees of the government, whether paid monthly or otherwise. At end 2003, there were approximately 166,036 members with an estimated active membership base of around 50,000, the majority of whom belong to the Reserve Police Service. The number of new entrants to the Fund during the year was 1,562. The total assets of the Fund stood at Rs.9.3 billion at end 2003, from Rs.8.1 billion at end 2002. The total contributions received during the year, consisting of Rs.169 million from government and Rs.244 million from members, amounted to Rs.413 million, while the total refunds made during the same period stood at Rs.144 million.

The private sector provident funds (PPF), numbering about 190, had a membership base of around 143,000 as at the year end. The total assets of the fund increased to Rs.85 billion at end 2003 from Rs.80 billion at end 2003.

TABLE 10.19

Provident Funds: Selected Indicators

Item	As at End - 2002	As at End - 2003
Total number of member accounts ('000)	**14,585**	**14,934**
EPF	9,378	9,725
ETF	4,900	4,900
PSPF	166	166
PPF	141	143
Total assets (Rs. billion)	**426**	**480**
EPF	297	339
ETF	41	46
PSPF	8	9
PPF	80	85
Total Investments	404	453
During the year (Rs. billion)		
Total contributions	28	29
Total refunds	18	23

Source : Central Bank of Sri Lanka

Long-Term Lending Institutions

The operations of the long-term institutions showed a significant improvement both in terms of loan approvals and loans granted during the year. The institutions considered under this category are selected Licensed Specialised Banks (8), *i.e.*, DFCC Bank, National Development Bank (NDB), State Mortgage and Investment Bank (SMIB), National Savings Bank (NSB), HDFC Bank and three private savings and development banks and the National Housing Development Authority (NHDA) which is a non-bank specialised institution established to promote housing.

Reflecting the conducive environment for investment following the improved business confidence and reduction in lending rates, the total loans approved by these institutions in respect of agriculture, industry, tourism, housing, finance and commerce sectors, grew by 55 per cent to Rs.50.4 billion at end 2003 from Rs.32.4 billion. The two key institutions in this category *viz.*, DFCC Bank and NDB, contributed 73 per cent of the increase in loans approved. The total loans disbursed out of loans approved in both current and previous years increased by 38 per cent from Rs.28 billion at end 2002 to Rs.39 billion at end 2003. Although all the major sectors showed positive credit growth, the bulk of the increase (88 per cent) in loans approved was accounted for by industry, finance, housing and infrastructure sectors.

The share of long-term loans in the total outstanding loans recorded an increase from 30 per cent at end 2002 to 39 per cent at end 2003, possibly as a result of borrowers' attempts to lock into the lower long-term lending rates that prevailed during the year. In terms of the maturity distribution, the shares of short-term (less than one year), medium term (between 1–5 years) and long-term loans (above 5 years) in the total loan portfolio at end 2003, were 19 per cent, 42 per cent and 39 per cent, respectively.

The two Development Finance Institutions (DFIs), DFCC Bank and NDB, which grant a major share of loans for large enterprises as well as the SMI sector, showed positive growth in both loans approved and loans disbursed with almost a two-fold growth in loans approved. The weighted average lending rates of DFIs decreased from a range of 13–16 per cent in 2002 to 12–13 per cent in 2003, in line with the downward movement in general interest rates in the country. The share of loans granted by the DFIs at interest rates below 12 per cent was about 53 per cent of all loans in 2003 in comparison to 28 per cent in 2002.

A major constraint faced by DFIs is the decline in the concessional long-term financing from multilateral agencies. In recognition of the difficulties faced by DFIs, the original single product development bank model is being changed by allowing DFIs to expand their product range through diversification and consolidation. This would provide the DFIs not only with adequate flexibility in securing sources of funds for project lending but also diversity in income which would enhance their risk management ability.

The loans approved for the housing sector by all institutions during the year grew by about 27 per cent and amounted to Rs.7.8 billion, while loans approved by the four housing institutions increased by 25 per cent to Rs.4.8 billion. The lending rates among the four housing institutions also saw a downward adjustment during the year. The weighted average lending rates among these institutions ranged between 11–15 per cent in 2003 as compared to 13–17 per cent in 2002.

Box 20

Need for Developing Housing Financing in Sri Lanka

Housing is a basic need. According to the Ministry of Housing and Plantation Infrastructure the overall shortage of houses in Sri Lanka could reach 650,000 units by 2010 from the current level of around 400,000 units. Housing financing is an integral part of developing the availability of houses. In Sri Lanka although there are satisfactory primary housing financing institutions, their activities are hindered by a shortage of funds.

Sri Lanka has traditionally concentrated on state-sponsored and funded housing development strategies. This system has become unsustainable on account of diminishing availability of funds due to general budget constraints, underlying moral hazard and adverse selection problems, and the inability to meet the growing needs. Hence, it is necessary to develop a housing financing market to provide a self-sustaining housing sector in the country.

The housing finance process begins with a borrower contacting a mortgage lender for financing the purchase or construction of a house. The lender uses either deposit funds or borrowed funds to grant the loan with property as security to ensure payment. This process outlines four major aspects of housing financing; origination, funding, accepting various risks, and servicing. If the lender holds the loan in his portfolio, the transaction remains in the primary mortgage market. In some countries, the lender sells the loan to other investors, either as debt or as a mortgage-backed security, thus invoking secondary mortgage market activities. In this process the lender avoids both interest rate and credit risks, and acquires financing for lending to more borrowers.

The phenomenal growth in housing financing in countries like the United States (US) is attributed to developments in the secondary market. In the absence of secondary market activities, it is difficult to find long-term funds for mortgage financing. This hinders not only housing financing, but also a whole network of related economic activities such as construction, property valuation, insurance and other infrastructure activities. In view of this, many countries have established special institutions to develop secondary market activities.

The major change that the secondary market brings to housing financing is by the 'unbundling' of four major aspects of housing finance: origination, funding, accepting various risks [such as legal risk, credit (default) risk, interest rate risk, operations risk and liquidity risk], and servicing. While mortgage lenders deal with origination and servicing, investors provide funding and share risks. Secondary market institutions absorb most of the risks. Unbundling, however, gives rise to a new problem, the principal-agent problem, where an originator could be lax in checking creditworthiness of a borrower, since he will pass on the credit risk to the secondary market players. Nevertheless, secondary market housing financing institutions have been very profitable in the US as well as in other countries.

Sri Lanka has a conducive macroenvironment and well-developed institutional infrastructure to undertake the function of granting loans for housing purposes. However, in view of the difficulties those institutions face in securing long-term funding, and the extent of economic activities hindered by these difficulties, there is a clear need for establishing institutions specialised in securitisation, *i.e.*, special purpose vehicles (SPVs). Their role would be to make mortgage funds available to institutions in Sri Lanka by developing mortgage-backed securities and by selling them to the public, by linking capital markets to the mortgage market, and bringing the benefits of the secondary mortgage market to develop the bond market in Sri Lanka.

The success of these SPVs would depend on strengthening land ownership rights, strengthening principles for valuing properties backed by trained personnel, strengthening foreclosure laws enabling mortgage lenders to realise their mortgage collateral and taking steps to recover their debt within a reasonable period, establishing generally accepted and properly adhered to underwriting standards, and further strengthening prudential regulation of banks. While those are being addressed, establishment of SPVs will play a catalytic role in developing housing financing and capital markets in Sri Lanka.

TABLE 10.20

Purposewise Classification of Loans Approved by Long-Term Credit Institutions

Rs. million

Purpose	LSBs(a)		HFIs (b)		Total	
	2002	2003(c)	2002	2003(c)	2002	2003(c)
Agriculture	1,048	1,320	0	0	1,048	1,320
Industry	6,939	9,350	0	0	6,939	9,350
Tourism	162	249	0	0	162	249
Commercial	2,580	4,053	0	0	2,580	4,053
Financial	4,370	8,970	0	0	4,370	8,970
Housing	4,476	6,921	1,720	924	6,196	7,845
Redemption of debt	68	174	14	0	82	174
Other loans	10,850	18,425	231	0	11,081	18,425
Total (approved) during the year	30,493	49,463	1,965	924	32,458	50,387
Loans granted (d)	26,197	38,019	1,576	488	27,773	38,507
Total loans granted as a percentage of total loans approved	86	77	80	53	86	76

Source : Central Bank of Sri Lanka.

(a) Selected Licensed Specialised Banks excluding Regional Development Banks.

(b) National Housing Development Authority is included under Non-bank housing financial institutions.

Housing Development Finance Corporation of Sri Lanka was registered as a licensed specialised bank during 2003. Hence it has now been included under LSBs.

(c) Provisional.

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

Finance companies

Finance companies continue to play an important role as financial intermediaries, particularly to a segment of the market which has difficulties in accessing funds from the commercial banks. The activities of finance companies grew in 2003 as evidenced by the increase in their mobilisation of deposits and in the provision of advances. In 2003, the total assets of finance companies rose by 20 per cent (Rs.9 billion) over the previous year. This growth was mainly in the areas of loans and advances and fixed assets. In the case of loans and advances, leasing operations accounted for around two-thirds of the entire loans and advances granted by finance companies, growing by 21 per cent (Rs.3.7 billion) in 2003. Leasing facilities were mainly provided to the passenger and goods transportation sector. Although the real estate business did not see any significant growth in 2003, it was the second largest sector serviced by finance companies. The increase in hire purchase activity that took off in mid 2002 with the tax advantage afforded by the introduction of the VAT, continued in 2003, recording a growth of 56 per cent (Rs.1.2 billion). The lending rates of finance companies declined in 2003, reflecting the fall in other market rates, although they continued to remain high. The high cost of funds of finance companies due to the relatively high interest rates paid on deposits, as well as the high risk profile of their borrowers, were some of the reasons cited by finance companies for their inability to reduce lending rates further.

The increase in the assets of finance companies was mainly funded by deposit mobilisation, accounting for around two-thirds of the total sources of funds. Total deposits mobilised by finance companies grew by 18 per cent in 2003 over the previous year. The decline in interest on government securities and commercial bank deposits continued to attract deposits to finance companies. Capital funds grew by around 17 per cent and accounted for around 13 per cent of the sources of funds. The most significant growth was in the area of borrowings from commercial banks. Finance companies have been seeking to diversify their funding sources and reduce the mismatch between their lending and deposit bases. Some companies have obtained medium-term loans from commercial banks by mortgaging their lease receivables. Although finance companies have the potential to engage in securitisation of their leasing portfolio, there are impediments, which are currently being addressed through a proposed amendment to the Finance Leasing Act. Debt securities would be another source of funding for finance companies in the future. One finance company has already obtained a credit rating and, given the proposal in Budget

TABLE 10.21

Assets and Liabilities of Registered Finance Companies (a)

Rs. million

Item	As at 31 Dec 2002	As at 31 Mar 2003	As at 30 Jun 2003	As at 30 Sep 2003	As at 31 Dec 2003(b)
Assets					
1. Loans & advances	30,479	32,239	33,881	35,396	37,125
1.1 Hire purchase	2,129	2,349	2,623	2,989	3,321
1.2 Leasing	17,419	18,421	19,424	20,323	21,150
1.3 Real estate	4,274	4,947	4,555	4,260	4,395
2. Equity and other investments	2,120	2,049	2,205	2,446	2,440
3. Treasury bills	4,146	4,190	4,396	4,186	3,939
4. Cash and bank balances	1,015	1,185	1,235	1,591	2,057
5. Fixed assets	3,580	3,727	4,066	4,531	4,784
6. Other assets	3,571	3,464	3,751	4,003	3,636
Total	44,910	46,854	49,534	52,152	53,980
Libilities					
1. Capital account	6,173	6,232	6,577	6,859	7,205
2. Fixed deposits	27,153	28,486	30,127	31,565	32,608
3. Certificate of deposits	1,474	1,492	1,402	1,362	1,285
4. Borrowings	2,780	2,788	2,900	3,591	4,067
5. Provisions	2,208	2,460	2,655	2,924	3,000
6. Other liabilities	5,123	5,395	5,873	5,852	5,815
Total	44,910	46,854	49,534	52,152	53,980
No. of finance companies	26	26	26	26	26

Source : Finance Companies

(a) Unaudited

(b) Provisional

2003 that requires any leasing company that raises funds by the issuance of debt instruments to obtain a rating by 01 January 2005, more finance companies could be expected to do so in the future.

As a means of reducing risk and strengthening the balance sheets of finance companies, the Central Bank required finance companies to maintain a risk weighted capital adequacy ratio of 10 per cent, with a minimum core capital ratio of 5 per cent. They were also required to maintain capital funds at a level not less than 10 per cent of their deposit liabilities. Companies have been given two years within which to comply with these directions.

10.12 Specialised Financial Institutions

Merchant Banking

The broad-based recovery in economic activity has benefited the merchant banking industry as reflected by the growth of total assets and profits during the year. The total assets grew by 4 per cent and stood at Rs.22 billion at end 2003 as against Rs.21 billion at end 2002. In line with the improvement in the total income for the year by 54 per cent from Rs.2.0 billion in 2002 to Rs.3.0 billion in 2003, the profitability of the industry increased to Rs.84 million in 2003 from a loss of Rs.723 million. The reduction in losses in one firm and the increase in capital gains received from debt securities were the main contributory factors for the improvement in the profitability. Interest income from loans and debt securities, capital gains, dividend income and income from leasing were the main sources of income for the industry. The number of merchant banks decreased to 11 in 2003 following a company moving out of merchant banking activities.

TABLE 10.22

Progress of Activities of Merchant Banks

Rs. million

	2002 (a)	2003 (b)
1. Earned income on leasing	609	696
2. Interest on discounting trade bills	169	151
3. Financial and marketing consultancy services	77	120
4. Insurance commissions	7	13
5. Interest on margin trading	13	25
6. Profit / loss on investment in shares	177	4
7. Interest on Treasury bills	223	619
8. Interest on loans	262	285
9. Dividends	68	470
10. Other income	406	678
11. Total income	2,009	3,062
12. Pre tax profits/loss	-723	84
13. Total assets (end period)	21,166	22,023
No. of merchant banks	12	11

(a) 2002 data have been revised according to latest information received from Merchant Banks

(b) Provisional

Source : Central Bank of Sri Lanka

Leasing Companies

There were 56 finance leasing establishments registered with the Central Bank at end 2003, consisting of commercial banks, specialised banks, finance companies and other specialised leasing companies. A surge in leasing activities was recorded during the year as reflected in the growth in both total assets and the leasing portfolio.

The number of institutions engaged in leasing, excluding the categories of banks, finance companies and merchant banks, increased to 11 in 2003 from 10 in 2002. The total assets of these institutions grew by 43 per cent from Rs.16.6 billion in 2002 to Rs.23.7 billion in 2003, while the total lease portfolio recorded a substantial growth of 49 per cent over the pervious year. Leasing facilities granted for commercial and passenger vehicles continued to account for about 75 per cent of total leases, though recording a decrease over the previous year. Sector-wise, trade, transportation and services accounted for 73 per cent of leases granted, with the trade sector receiving the highest share of 33 per cent. The interest rates charged by individual firms in the industry decreased from about 18 – 30 per cent in 2002 to about 12 – 30 per cent in 2003. Bank borrowings, lease securitisation, issue of debentures and commercial paper are the most frequently used sources of financing of firms in the industry. With a view to diversify funding sources, Lanka Orix Leasing Company (LOLC) took measures in 2003 to obtain a dollar denominated loan from a foreign source and issued a 'Bull and Bear Commercial Paper' linked to a stock market index. The total leasing facilities provided by commercial banks, specialised banks, finance companies and specialised leasing firms during the year amounted to about Rs.54 billion.

Some of the constraints faced by the industry are the higher cost of funds incurred by non-bank leasing firms relative to bank affiliated firms and legal impediments to securitisation of leases through assignment. The underdeveloped nature of corporate debt market and the non availability of securitisation options due to legal constraints has made non bank leasing firms heavily dependent on commercial banks for their funding. This has resulted in the

TABLE 10.23

Specialised Leasing Companies
Sector-wise Classification of Leasing Facilities

Rs. million

Sector	2002	2003 (a)
1. Industry	874	1,291
2. Agriculture	536	532
3. Trade	3,553	4,881
4. Transportation	2,410	2,834
5. Construction	340	502
6. Services	1,774	3,018
7. Others	568	1,614
Total	10,053	14,672

(a) Provisional

Sources : Specialised Leasing Companies maturity mismatches in asset and liabilities of these firms and higher cost of funds for these institutions.

Venture Capital Companies

Funding by Venture Capital Companies, which are engaged in providing capital to high risk innovative projects has not reversed its decline in 2003, despite fiscal incentives such as a 5 year tax holiday for new firms and partial exemption from income tax, granted by the Budget for 2003. Both the total equity participation and total assets of the industry recorded a drop of about 13 and 38 per cent respectively, with hardly any new projects being funded during the year. Some of the factors that have been identified as hindering the industry are the small average size of new projects, higher failure rates in small and medium scale industry sector, difficulties for exit and some sector specific factors. Even in IT related sectors, there are a number of issues such as the firms' staying power - *i.e.*, ability to get orders on a sustainable basis, size of the domestic market, foreign competition and manpower, which affects the success of projects.

The total number of venture capital companies decreased to six as a result of one firm moving out of the venture capital industry. The total asset base of the venture capital firms declined to Rs.1,490 million at end 2003 from Rs.2,395 million at end 2002, while the equity participation in projects too declined from Rs.1,081 million to Rs.940 million during the same period. The total number of projects financed dropped to 699 at end 2003 from 705 at end 2002.

Insurance Companies

Two new firms, Life Insurance Corporation (Lanka) Ltd., and All Lanka Mutual Organisation Ltd., entered the insurance industry during the year, bringing the total number of firms in the industry to 13 at end 2003 from 11 at end 2002. Of the 13 companies, two are engaged in life insurance and the other companies are engaged in both life as well as general insurance. A significant event during the period under review was the divestiture of a 90 per cent stake in the Sri Lanka Insurance Corporation Ltd., (SLIC) by the government in April 2003 for a sum of Rs.6,050 million to a consortium led by Distilleries Company of Sri Lanka Ltd. and Aitken Spence & Co. Ltd. ING Inc, an insurance company with a global presence, is the technical partner for both life and non-life insurance activity, in addition to providing management support. With the privatisation of SLIC, the government has almost entirely moved out of direct involvement in the insurance industry. The government had owned close to 68 per cent of the total assets of the insurance industry prior to the divestment of SLIC in 2003.

The performance of the insurance industry improved in terms of asset growth, total premium collected, new policies written, branch expansion etc. The total asset base of the industry grew by 10 per cent from Rs.55 billion at end 2002 to Rs.61 billion at end 2003, with two firms accounting for about 81 per cent of the total assets. The branch network increased from 462 in 2002 to 480 in 2003. Although many companies recorded an increase in profits over the previous year, the industry profit for the year was affected negatively by a lower level of profits in the dominant company.

A positive growth performance was evident in all classes of insurance, *i.e.*, life, motor, accident, marine and fire. The total value of life assurance funds stood at Rs.42.7 billion, a growth of 20 per cent over the previous year. Meanwhile, the total premia collected and sums insured in respect of new life business grew by 26 per cent The total number of new policies amounted to 269,000. The total benefit payments under endowment, death and disability, surrender and other, increased by 52 per cent to Rs.3.6 billion in 2003. The net premia for policies in force in the general insurance category, which cover all categories of insurance excluding life, increased by 29 per cent in 2003. Of all non life insurance sub sectors, the general and motor insurance sectors account for about 90 per cent of the total premium collected.

The average life insurance penetration (premium as a percentage of gross domestic product) increased from 0.5 per cent in 2002 to 0.6 per cent in 2003, while the total average insurance penetration too showed a similar trend by increasing from 1.3 per cent to 1.4 per cent during the same period. Insurance penetration is low in Sri Lanka, indicating the potential for expansion in the industry. The average life and total insurance penetration respectively are 2.2 per cent and 3.6 per cent for emerging countries and 5.4 per cent and 8.4 per cent for industrialised countries. Meanwhile, the insurance density (per capita premium) increased to Rs.1,240 (12.7 US dollars) during the year from Rs.1,050 (10.9 US dollars) in 2002.

The strategy being adopted by some new companies of marketing small value policies at a lower premium would facilitate the spread of the concept of long-term insurance at the grass roots level, by making insurance affordable to them and hence improve the level of insurance penetration in the country.

10.13 Financial Markets

Money and Foreign Exchange Markets

Money and foreign exchange markets remained liquid through most of 2003. The Central Bank's purchase of foreign exchange to build up its official reserves increased rupee liquidity. In order to maintain reserve money at the targeted level, the excess liquidity was continuously absorbed through the OMO of the Central Bank. Due to the excess liquidity in the system and a better distribution among banks, trading volumes in the call market declined. Interest rates at the short end of the money market followed the changes in the Central Bank's policy rates, declining gradually through the year and remaining close to the lower bound of the interest rate corridor (*i.e.*, the Repo rate) formed by the Central Bank's two policy rates.

In the government securities market, the lower domestic borrowing requirement of the government and the excess liquidity in the system saw the primary auctions being heavily oversubscribed. This, together with the reduction in policy rates and decline in inflation expectation, shifted down the government securities yield curve.

The inflow of foreign exchange through remittances, higher earnings from tourism and port activity and the lower trade deficit, as well as higher capital inflows, kept the foreign exchange market relatively liquid, increasing trading activity and stabilising the rupee *vis-à-vis* the US dollar. Although the money market and the foreign exchange market remained relatively liquid and stable throughout 2003, a brief period of volatility was witnessed towards the end of the year reflecting negative market sentiments caused by political events.

A significant milestone in the reform of the payments system was the introduction of a Real Time Gross Settlement (RTGS) system by the Central Bank. The RTGS system will facilitate large value fund transfers and settlement in real time rather than at the end of the day as was done previously. It is expected to boost activity in the money market. This is an important development in the payments system as it reduces settlement risk and enhances the stability and reliability of the payments system. The Central Bank has also taken steps to introduce a Scripless Securities and Settlement (SSS) System in early 2004. This is also expected to encourage activity in the money market and the secondary market for government securities.

Inter Bank Call Money Market

The money market continued to remain liquid during 2003. The excess liquidity in the system reduced the volumes traded in the inter bank market. The average daily volumes in the call market in 2003 decreased by around 27 per cent to Rs.936 million, from a year ago. The call market rate continued to fall, in line with the reductions in the Central Bank's policy rates, declining from 10.39 per cent at end December, 2002 to 7.59 per cent at end December, 2003. Introduction of a more active open market operations system in March 2003 encouraged banks to manage their liquidity more effectively and helped to reduce the volatility in the call money market.

Primary Treasury Bill Market

The lower borrowing requirement of the government and the excess liquidity in the market saw the primary auctions of government securities heavily oversubscribed. These factors, together with the gradual reduction in policy rates and lower inflationary expectations, caused the yields on government securities across all maturities to fall, until the latter part of the year, when yields began to rise marginally, as a consequence of the uncertainty in the market. The decline in yields on Treasury bills was 325 basis points on 364-day Treasury bills and 281 basis points on 91-day Treasury bills. The total value of bills sold by the government in 2003 amounted to Rs.342.8 billion, almost the same amount as in 2002. Of these issues in 2003, Rs.313.4 billion were reissues, while the rest (Rs.29.5 billion) were new issues. A portion of the new issues were used to settle the dollar denominated Sri Lanka Developments Bonds (SLDBs). The majority of bills issued were in the category of 364-day bills (42 per cent of total bills issued) and 91-day bills (36 per cent of total bills issued). The Central Bank's purchases of Treasury bills from the primary market declined significantly during the first three quarters of 2003, although some of the bills at the last

TABLE 10.24

Money Market Operations : 2001 - 2003

Rs. million

	Call Money Market	Primary Treasury Bill Market						Secondary Market (Central Bank)							
	Total Lending/ Borrowings	Total Outstanding	Amount Accepted (purchases)					Treasury Bill Re-purchase (Repo)				Reverse Repo			
			Amount Issued	Central Bank	Commercial Banks	Others	Total	Discount (Sales)	Rediscount (Purch.)	Sales	Maturity	Treasury Bill Purch.	Treasury Bill Matu.	Treasury Bond Purch.	Treasury Bond Matur.
2001															
1st Qtr	294,051	134,995	46,207	1,180	26,800	18,227	46,207	2,808	596	8,427	9,010	144,251	142,406	1,714,557	1,711,451
2nd Qtr	263,931	150,420	64,221	38,643	15,457	10,121	64,221	4,009	–	10,228	9,969	101,449	104,271	1,492,124	1,502,694
3rd Qtr	427,901	160,420	61,289	35,470	15,882	9,937	61,289	7,924	126	13,408	13,648	15,552	15,721	993,363	1,000,058
4th Qtr	510,734	170,995	76,295	44,238	15,763	16,294	76,295	6,947	42	23,428	21,689	964	1,190	318,149	331,543
2002															
1st Qtr	417,684	174,245	70,831	6,998	36,614	27,219	70,831	19,151	938	252,649	253,545	300	106	28,291	25,601
2nd Qtr	319,288	201,995	102,299	21,900	50,648	29,751	102,299	16,484	87	80,418	78,287	3,844	4,038	121,367	125,557
3rd Qtr	275,764	206,295	90,845	29,050	37,702	24,094	90,846	7,997	104	310,310	307,984	170	170	680	680
4th Qtr	263,457	210,995	78,698	35,900	30,988	11,810	78,698	2,839	–	432,719	427,752	52	52	–	–
2003															
1st Qtr	253,086	210,995	75,298	8,948	46,182	20,168	75,298	672	–	666,684	669,119	50	50	–	–
2nd Qtr	250,010	201,795	84,870	7,876	54,351	22,643	84,870	–	–	595,458	588,266	67	67	7,340	7,340
3rd Qtr	233,449	201,295	90,144	–	57,427	32,717	90,144	2,365	–	744,155	746,438	–	–	–	–
4th Qtr	199,220	219,295	92,535	32,556	43,864	16,115	92,535	–	–	438,223	430,827	–	–	–	–

Source : Central Bank of Sri Lanka

few auctions in the year were taken up by the Central Bank to meet the expected seasonal demand for liquidity. Total Treasury bills purchased by the Central Bank in 2003 amounted to Rs.49 billion, significantly lower than the purchases in 2002 (Rs.94 billion). The Central Bank also used its stock of Treasury bills for OMO. The net effect of these transactions was that the holdings of government paper by the Central Bank declined by Rs.29 billion to Rs 11 billion at end 2003.

Central Bank Repo and Reverse Repo Market

The continuous excess liquidity in the market resulted in the Central Bank conducting mainly repurchase transactions to absorb the excess. Total repo transactions increased to Rs.2,445 billion in 2003 from Rs.1,076 billion in 2002. The repurchase facility was mainly on an overnight basis although a few repos with longer maturities were conducted through direct deals in order to absorb liquidity on a more long-term basis. Reverse repurchase transactions were conducted on a few days during the year when market liquidity was short. The total volume of reverse repurchase transactions amounted to Rs.7.3 billion, significantly lower than in 2002 (Rs.154 billion).

Secondary Market for Government Securities

A significant rise in volumes traded has been observed in 2003 with the interest rates declining and a growing popularity of secondary trading in government securities. The largest increase has been in repos, which have increased by over 60 per cent to Rs.1,058 million, as indicated by returns submitted by primary dealers on secondary market transactions, where the primary dealer is one party to the transaction . There was a gradual decline in yield rates in the secondary market across all maturities, reflecting the trend in the primary market.

During the year, several measures were taken to deepen market activity. A Bloomberg Bond Trading System was commenced, where the Primary Dealers (PDs) could make two-way quotes, which would improve the transparency of trading. The CBSL and PDs conducted several investor awareness programmes. In addition, measures were also taken to reduce the number of series of Treasury bond issues. This is expected to increase the liquidity of the issues and facilitate benchmarking. The trading in the secondary market is expected to further improve with the introduction of a Scripless Securities Settlement (SSS) System and the implementation of a trading platform for government securities at the Colombo Stock Exchange in early 2004.

Central Bank Securities

Given the highly liquid state of the market and the significant decline in the Central Bank's stock of government paper, the Central Bank issued its own securities in September, 2003 to mop up excess liquidity. The total value of Central Bank securities issued in 2003 amounted to Rs.5 billion. The maturity period of these securities was 91 days or less, given that the Central Bank usually operate at the short end of the market. Consequently, by end 2003, all Central Bank securities had been repaid.

Commercial Paper

Commercial paper which is another avenue for short-term borrowing by large corporates continued to provide investors with alternative investment opportunity. However, the issues of commercial paper declined significantly in 2003, reflecting higher liquidity in the market and the increasing competitiveness in bank lending rates. Total issues of commercial paper declined by over 50 per cent in 2003 to Rs.11.1 billion. The majority of commercial paper were supported by commercial banks.

Foreign Exchange Market

Large foreign exchange inflows from worker remittances, earnings from tourism and higher capital inflows provided the liquidity needed to stimulate the foreign exchange market. The higher inflow of foreign exchange enabled the Central Bank to purchase around US dollars 375 million during the year to enhance its foreign exchange reserves. Greater activity was also witnessed in the foreign exchange market with trading volumes in the inter bank market increasing by around 44 per cent over the volumes in 2002 to US dollars 3.6 billion in 2003. The turnover increased to an average of US dollars 304 million per month in 2003 from US dollars 212 million in 2002. The introduction of the US dollar clearing facility at LankaClear (Pvt) Ltd., has increased the efficiency and reduced the cost of clearing cheques and drafts denominated in US dollars. With a view to further deepening the foreign exchange market the net open position of banks was raised to 20 per cent of capital and reserve funds from the current 15 per cent for banks with the required capital adequacy ratio. A significant development in 2003 was the rise in forward transactions by over 48 per cent to US dollars 1,401 million. Reflecting the stability in the market and market developments, there was a shift towards forward contracts of longer maturity and a decline in forward premia.

Capital Market

Stock Market

The upward trend in market activity at the Colombo Stock Exchange (CSE) seen since the last quarter of 2001 continued in 2003, with performance improving further during the year. Both primary and secondary market activity picked up during the year, with key market indicators reaching record levels by October. Foreign investors were net buyers at the Colombo Stock Exchange for the second consecutive year in 2003, despite a large foreign sale involving strategic purchases by a domestic corporate, amounting to nearly Rs.4 billion in

September. Corporate profits, which increased in 2002, improved further in 2003 and were a principal contributory factor to the improvement in share market activity. The continued stability on the political front, following the cessation of hostilities in 2002, was a key factor that impacted positively on the market, while the favourable trends in key economic variables such as GDP growth, interest rates, inflation and the exchange rate, also contributed to the improvement in market activity. A tax amnesty granted by the government, which was effective till August, may have been another contributory factor to the increased market activity during 2003.

Earlier in the year, however, a downturn in market activity was seen around March, due to fears of the war against Iraq negatively impacting upon Sri Lanka's exports, and inward private remittances, and therefore the exchange rate. Market activity picked up thereafter. Progress in the government's privatisation programme, namely, the divestiture of Sri Lanka Insurance Corporation in April, was

TABLE 10.25
Share Market Indicators

	2001	2002	2003
1. Market capitalisation (Rs.bn.) (a)	124	163	263
2. Value of shares traded (Rs. mn.)	13,905	30,183	73,657
3. No. of shares traded (mn.)	747	1,220	2,255
4. Price earnings ratio	7.5	12.1	11.1
5. Initial public offers/offers for sale (No.)	–	5	4
6. Net foreign purchases (US $ mn.)	-11.0	25.0	2.4
7. Price indices (a)			
All Share Price Index (1985=100)	621.0	815.1	1,062.1
Milanka Price Index (1998=1,000)	1,031.0	1,374.6	1,897.8

(a) End of the year

Source : Colombo Stock Exchange

cited by market analysts as a contributory factor to the positive turn in market sentiment. During the seven months from April, there was a marked improvement in key market indicators. While daily turnover crossed the Rs.1 billion mark on several occasions during this period, the highest ever turnover for a month (Rs.16.5 billion) was recorded for September. On 23 October, the All Share Price Index of the CSE closed at 1,423.5, its highest level so far, while the Milanka Price Index closed at 2,584.2, its highest level so far, on 31 October.

However, a reversal of these trends was seen from around the first week of November, mainly due to market uncertainty as a result of political developments. The proposed capital gains tax on stock market transactions in the Budget 2004, to be effective from 1 April 2004, was cited by market analysts as another factor that negatively impacted on market performance towards the latter part of the year. By end 2003, however, despite this decline in market activity, most market indicators were significantly above the end-2002 levels.

With respect to market developments, the CSE opened its second branch in Kandy on 4 June 2003. Another positive development towards the end of the year was that the CSE reduced transaction fees applicable to secondary market equity transactions with effect from 1 December 2003. The fee applicable to transactions up to Rs.1 million was reduced from 1.4 per cent to 1.225 per cent and the fee for transactions over Rs.1 million was reduced from 1.15 per cent to 1.025 per cent. In December 2003, meanwhile, the CSE announced that it would publish a total return index series in addition to the price indices, from 2004. Accordingly, the All Share Price Index, the Milanka Price Index and the sector indices would be published daily based on both price changes and total returns, *i.e.*, price changes and dividend income, commencing 02 January 2004.

Primary Market

Primary market activity continued to be buoyant during much of 2003. Amongst the shares issued during the latter part of 2002 and subsequently listed on the CSE in January were those of Sri Lanka Telecom (SLT), the largest corporate to be listed on the CSE. The listing of SLT raised market capitalisation of the CSE by Rs.27 billion to Rs.198 billion on 14 January. While several companies raised capital on the CSE in 2003, the total raised during the year by way of initial

TABLE 10.26
Shares Offered by Companies during 2003 (a)

Name of Company	List opened for Subscription	No. of Shares ('000)	Par Value (Rs.)	Premium (Rs.)	Value of Shares on offer (Rs. mn.)	No. of Shares Taken up by Underwriters ('000)	No. of Shares Subscribed by Public ('000)
1. Commercial Bank of Ceylon Ltd. (Preference Shares)	May	100,000	10.00	–	1,000.0	–	100,000
2. Ceylon Leather Products Ltd.	July	2,500	10.00	–	25.0	–	2,500
3. Seylan Bank Ltd. (Non-voting)	August	40,000	10.00	15.00	1,000.0	–	40,000
4. Ceylon Hospitals Ltd. (Non-voting)	October	4,500 6,375	10.00 10.00	15.00 10.00	112.5 127.5	– –	4,500 6,375
5. Hemas Holdings Ltd.	September	12,000	10.00	40.00	600.0	–	12,000
6. HNB Assurance Ltd.	November	10,000	10.00	2.50	125.0	–	10,000

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

Source : Colombo Stock Exchange

TABLE 10.27

Category-wise Distribution of Shares Traded in the Secondary Market in 2003

Category of Investment	No. of Transactions	No. of Shares ('000)	Value (Rs. mn.)
Banks, finance & insurance	154,861	614,393	26,751
Beverage, food & tobacco	39,719	196,187	4,830
Chemicals & pharmaceuticals	4,242	7,900	451
Construct & engineering	3,756	21,568	565
Diversified	38,828	143,922	14,577
Footwear & textiles	4,727	18,518	136
Hotels & travels	79,562	459,736	10,440
Investment trusts	3,569	5,158	170
Land & property	17,851	120,915	707
Manufacturing	57,911	196,298	6,348
Motors	3,232	11,356	498
Oil palms	182	67	11
Plantations	17,835	88,863	1,120
Services	528	431	48
Stores & supplies	3,552	12,826	102
Trading	6,635	13,815	306
Power & energy	1	–	–
Health car	11,273	63,438	1,045
Information technology	181	335	4,276
Telecom	34,509	279,771	5,510

Source : Colombo Stock Exchange

Chart 10.8
Share Market Indicators

Chart 10.8.1
Share Price Indices

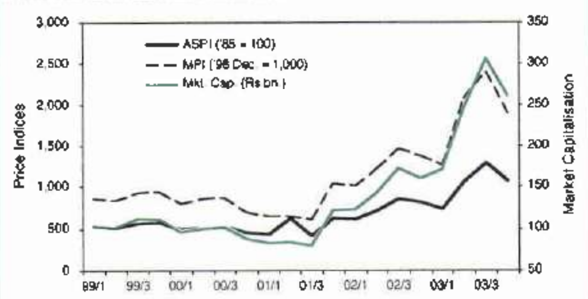
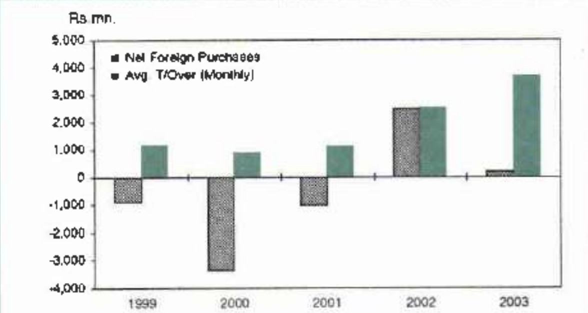


Chart 10.8.2
Turnover and Non-National Participation – CSE



public offers and offers for sale was Rs.4.8 billion. Meanwhile, 18 companies made rights issues during the year, raising Rs.6.4 billion. With the improvement in corporate profitability, 14 companies made bonus issues during the year, amounting to Rs.1.3 billion. Although eight companies obtained listings on the CSE during the year, the number of listed companies at end-2003 was 244, in comparison to 238 at end-2002, as two companies were de-listed during the year. Three companies obtained listings on the CSE by way of introductions in 2003.

With respect to primary market activity in respect of listed debentures, Commercial Bank of Ceylon Ltd., raised Rs.2.2 billion by way of an issue of debentures during the year, in order to raise capital to expand its activities as well as to meet the more stringent requirements relating to capital adequacy. These debentures were listed in May 2003. Seylan Bank Ltd., raised Rs.1.5 billion in December 2003 by way of an issue of debentures, also to meet capital adequacy requirements. The debentures of Seylan Bank Ltd. were listed in January 2004. While Hatton National Bank Ltd., raised Rs.2 billion in July 2003 by way of an issue of debentures, they are to be listed in 2004.

Secondary Market

With turnover increasing to record levels in the third quarter of 2003, daily average turnover in 2003 increased to Rs.301 million from Rs.128 million in 2002. The All Share Price Index (ASPI) and the Milanka Price Index (MPI) increased by 30 per cent and 38 per cent, respectively, during the year to 1,062.1 and 1,897.8, respectively, by 31 December 2003. Market capitalisation, which increased with the listing of the shares of Sri Lanka Telecom in January, increased further during the year to Rs.262.8 billion by end 2003. While there was active participation by foreign investors at the CSE, net cumulative foreign purchases in 2003 amounted to Rs.209 million. The market price earnings ratio however, was 11.0 at end 2003, in comparison to 12.1 at end 2002.

Many sector indices also increased during the year: Bank Finance and Insurance (33 per cent), Diversified Holdings (50 per cent), Telecom (12 per cent), Hotels and Travels (61 per cent), Beverages Food and Tobacco (21 per cent), and Manufacturing (15 per cent). These sectors together, account for approximately 85 per cent of the market capitalisation. Of the twenty sectors, five indices declined during the year Information Technology declined by 46 per cent, in contrast to major markets where technology stocks, having been re-classified as recovery stocks, increased with the economic recovery. Construction and Engineering (-31 per cent), Healthcare (-10 per cent), Plantations (-3 per cent) and Chemicals and Pharmaceuticals (-0.4 per cent) also declined. With respect to the plantations sector, although prices of natural rubber improved, tea prices were adversely affected by the war against Iraq earlier in the year, while tea production was affected by adverse weather

Chart 10.9
Stock Prices

Chart 10.9.1
Comparison with Major International Markets
(2002 Dec = 100)

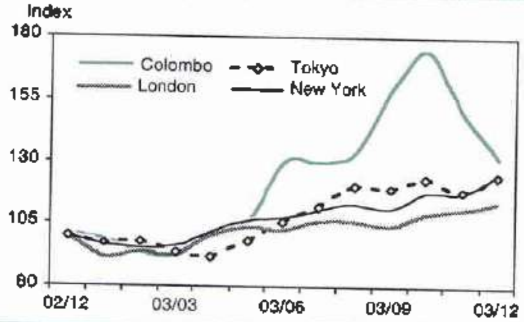
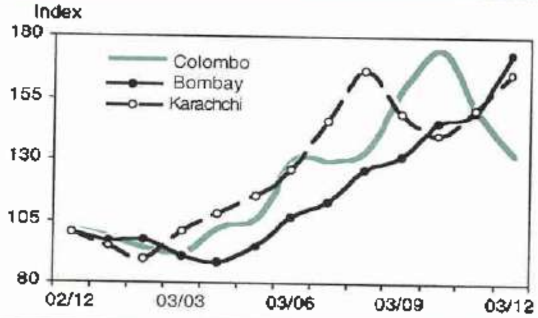


Chart 10.9.2
Comparison with South Asian Markets
(2002 Dec = 100)



conditions mid year and towards the end of the year. The Diversified Holdings sector, with a market capitalisation accounting for 20 per cent of the total, had the highest correlation of 0.99 with the ASPI for 2003, while the Bank Finance and Insurance sector, which accounted for 22 per cent of market capitalisation at end-2003, had the second highest correlation of 0.97.

Credit Rating

Deposit taking institutions are required to obtain a credit rating and publish the rating obtained as per the Budget 2003. By end-February 2004, Fitch Ratings Lanka Ltd., had published 10 entity ratings given to financial institutions. It had also published 3 other entity ratings given to corporates. It is also now mandatory to obtain a credit rating for issues of all varieties of debt instruments, except for those issued by the government, where the value exceeds Rs.100 million. Amongst the issue ratings published up to February 2004 were the five year debentures of Sri Lanka Telecom Ltd. issued in 2000 and listed on the CSE (SL AA+), the issue of 100 million preference shares of Rs.10 each of Commercial Bank of Ceylon Ltd. issued in 2003 and listed on the CSE (SL AA-), the five year debentures of Commercial Bank of Ceylon Ltd. issued in 2003 and listed on the CSE (SL AA), Rs.400 million debentures of Aitken Spence & Company Ltd. issued in 2002 and listed on the CSE (SL AA), and the three year debentures of Singer Sri Lanka Ltd. issued in 2002 (SL A). Fitch Ratings Lanka Ltd., is the only rating company operating in Sri Lanka, at present.

TABLE 10.28

Entity Ratings – as at April 2004

Entity	Rating
Citibank, Sri Lanka Branch	SL AAA
National Savings Bank	SL AAA
Commercial Bank of Ceylon Ltd.	SL AA+
Hayleys Ltd.	SL AA+
John Keells Holdings Ltd.	SL AA+
DFCC Bank	SL AA
Bank of Ceylon	SL AA
State Mortgage and Investment Bank	SL A+
First Capital Treasuries Ltd.	SL A
Hatton National Bank Ltd.	SL A-
Nations Trust Bank Ltd.	SL A-
Hayleys – MGT Knitting Mills Ltd.	SL BBB+
Senkadagala Finance Co., Ltd.	SL BBB+

Medium and Long-term Government Securities

Treasury Bonds

In line with the debt management strategy of moving to market-oriented tradable debt instruments, net issues of Treasury bonds were increased in 2003. Further, along with the decline in policy rates and market interest rates, increased reliance was placed on Treasury bonds, as borrowing through short-term debt instruments, namely Treasury bills, was reduced. A key development during the year was that Treasury bonds with 10-year, 15-year and 20-year maturities were issued, thus elongating the yield curve for government securities and establishing benchmark yield rates for long-tenure debt instruments. Meanwhile, the yield curve for Treasury bonds shifted further downwards during the year, following the decline in 2002.

The introduction of the Bloomberg Bond Trading System for Primary Dealers at the initiative of the Central Bank was another important development, in relation to market infrastructure in the government securities market. Meanwhile, necessary steps were taken during the year to facilitate trading in the beneficial interest of government securities on the Colombo Stock Exchange and, on 21 January 2004, the Colombo Stock Exchange commenced the operation of the debt securities trading system. With these new developments, there is now increased transparency with respect to transactions in government securities in the secondary market. Also, with work being carried out during the year in relation to the Scripless Securities Settlement (SSS) System and the Central Depository System (CDS) for Treasury bills and Treasury bonds being completed, operations in relation to the SSS System and the CDS commenced in February 2004.

TABLE 10.29

Treasury Bond Issues during 2003

Maturity Period	Coupon Rate (% per year) (a)	Weighted Average Yield to Maturity (a)	Issues (Rs.mn.) (a)	Outstanding Amount at end year (Rs.mn.)
2 Year	12.50-8.00	10.12	3,000	24,422
3 Year	10.25-7.90	10.34-7.44	20,250	117,094
4 Year	10.00-7.80	9.97-9.10	35,600	64,821
5 Year	11.75-7.70	10.79-7.07	43,700	109,420
6 Year	11.50-7.60	10.89-6.67	68,000	127,000
10 Year	8.50-7.50	9.00-6.65	33,950	33,950
13 Year	0.00	0.00	4,397	4,397
15 Year	8.50	9.08	4,900	4,900
20 Year	7.00	6.08	1,000	1,000
Total			214,797	487,004

(a) Applicable to Treasury bond issues during 2003.

Source : Colombo Stock Exchange

Rupee Loans

The Rupee loan programme is being phased out, given the bank's policy stance of moving to tradable debt instruments, with the objective of improving debt market competitiveness. Though, the gross issues of Rupee loans increased in 2003, net issues of Rupee loans were reduced during the year, as there was a significant increase in repayments. Meanwhile, callable Rupee loans amounting to Rs.33.4 billion, which carried interest rates of 13 per cent and above were retired during the year in order to reduce the interest cost of existing debt.

TABLE 10.30

Rupee Loans Floated during 2003

Year	Maturities (Years)	Volume (Rs. mn.)	Interest Rate (% p.a.)
2003	2-5	20,675	13.00
	2-5	23,700	11.00
	2-6	1,200	9.25
	2-6	4,788	8.00
2002	2-5	38,419	13.00
2001	2	19,500	15.00
	2-5	1,399	15.00
	2-5	13,100	13.00
	6-8	4,410	13.00

Source : Central Bank of Sri Lanka

Unit Trusts

Unit trusts, a type of pooled investment funds, had a strong record in terms of rates of return in 2003. The number of unit trust being managed by five institutions, decreased to 12 at end 2003 from 13 at end 2002, following the redemption of units in a time-bound fund that was started in 2002. There were three growth funds, three balanced funds, one index fund and five income funds. Due to relatively heavy redemptions, both total assets and net assets of the industry, however, declined by 24 per cent from Rs.4.4 billion in 2002 to Rs.3.6 billion in 2003. The boom in the share market and the appreciation in the value of investments in fixed income securities as a result of falling interest rates, caused a rise in unit prices of some funds, motivating investors, particularly institutional investors, to redeem at a profit the investments made at the inception of some funds. The average unit price, as measured by the per unit net asset value increased by 17 per cent over the previous year to Rs.11.23. The relatively large redemptions by unit holders and the termination of a fund were the contributory factors for the decline in the industry in terms of assets, number of unit holders and the number of units issued.

The investment portfolio deceased to Rs.3.6 billion at end 2003 from Rs.4.4 billion at end 2002, while the buying and selling prices ranged between Rs.7.50–19.50 and Rs.8.00–21.00, respectively. The share of equity investments in the portfolio increased while the that of government securities decreased, due to funds reallocating their portfolios in favour of equities, in the expectation of higher returns from the booming share market.

Although unit trusts are in a position to provide investors with the benefits of diversification, the industry has not been able to grow at a satisfactory rate due to number of factors, among which are the relatively high volatility in the equity market, lack of a broader range of financial assets and investors' appetite for short-term quick gains.

TABLE 10.31

Unit Trusts (a)

	1999	2000	2001	2002	2003(b)
Total assets (Rs.mn.)	2,652	2,173	2,874	4,432	3,586
Net assets value (Rs.mn.)	2,639	2,162	2,794	4,415	3,565
Investments in equities (Rs.mn.)	1,660	1,109	1,806	2,443	2,348
(3) as a ratio of (2)	63	51	65	55	66
Total no of unit holders	27,536	26,863	25,936	25,291	24,067
No. of units in issue	392	387	380	459	317
No. of unit trusts	12	12	12	13	12

(a) At end December
(b) Provisional

Source : Unit Trusts

10.14 Financial System Stability

During the year, a number of measures were taken to further promote financial system stability, which is one of the two core objectives of the Bank. The Central Bank focussed on strengthening the resilience of the banking sector, which accounts for about 60 per cent of the assets of the financial sector. Action was also taken to develop the infrastructure in payments and settlement systems and the government securities market in order to enhance the efficiency, and the stability of the sector. Further legal reforms relating to the financial sector were also initiated to improve regulatory oversight to be in line with international best practices, while facilitating greater competition among financial institutions. The Central Bank also introduced a code of best practices for financial institutions in 2002, which is expected to improve their corporate governance and contribute to greater accountability and better risk management practices.

Strengthening Prudential Supervision for Risk Mitigation

The CBSL has taken the initiative to enhance the resilience of banks to risks by expanding the scope of prudential supervision through the imposition of higher regulatory standards. Accordingly, the minimum capital adequacy ratio (CAR), which stood at 8 per cent in relation to risk-weighted assets in keeping with international norms, was progressively increased to 9 per cent in January 2001 and to 10 per cent by January 2003. During 2003, the key prudential requirements, which were hitherto applied only to commercial banks' domestic banking operations, were extended to encompass the operations of the off-shore banking units as well, thus ensuring that prudential limits were followed with respect to the operations of the entire bank. Thus, capital adequacy ratios, statutory liquid assets ratios and large credit exposure limits are now applied to the offshore units as well. In addition, in keeping with Basel Core Principles on effective bank supervision, compliance with CAR on a consolidated basis, along with 'Bank only' or 'Solo basis' was also introduced.

Lending by banks in Sri Lanka is heavily collateral-oriented. Consequently, heavy reliance is placed on collateral as a credit risk mitigant rather than on improving risk management in credit approvals by paying due attention to the viability of projects and their cash flow projections, while building up reserves to cover any potential losses, through the more prudent banking concept of the allocation of reserves out of profits for loan losses. As a consequence, the valuation of collateral has a significant impact on the level of loan loss provisions set aside by banks. In order to induce more prudent accounting for loan losses, a new direction requiring the application of a progressive discount on the value of collateral for provisioning purposes on advances classified as loss, where there was no hope of recovery, was introduced and is to take effect from 01 January 2004.

In order to enhance the level of transparency, ensure appropriate dissemination of information to the public and promote discipline through market forces, CBSL has required that all banks publish their quarterly accounts with minimum disclosure requirements in the press, in addition to publishing the audited annual accounts.

Risks and Capital Adequacy

Credit risk mitigation in the banking sector was enhanced with increased levels of provisioning against credit defaults. This was largely seen in the state bank sector, where between 65-75 per cent of some banks non-performing assets (NPA) have been provisioned for. However, within the banking sector, there is heavy reliance on collateral values as a credit risk mitigant, which need to increase its provisioning, to further improve its resilience.

The level of provisions for loan losses have seen a gradual increase across the board over the past few years and represented nearly 51 per cent of the NPL portfolio in the industry by 2003. As a result, the NPL ratio net of provisions, was approximately equivalent to half the gross NPL ratio for 2003. It is envisaged that the introduction of the haircut for the valuation of collateral for provisioning purposes, with effect from January 2004, would increase loan loss provisions required in 2004. The increasing tendency for reliance on collateral for credit risk mitigation would be discouraged from 2004 when progressive discounts will be required on such collateral, necessitating increased provisioning across the board.

Capital should serve as a buffer against unexpected losses, reflecting the risk profile of a bank. Capital funds in the industry have indicated an increasing trend, especially over the last two years, primarily on account of the internal generation of capital through improved profitability. The infusion of market capital through the issue of debt and equity by banks has been another contributory factor, that has helped to strengthen the capital position of banks.

The average capital adequacy ratio (CAR) for the industry has displayed some fluctuation, with the gradually increasing trend in 2002 turning to a decreasing trend in 2003. The decrease was mainly attributed to the application of the minimum regulatory capital adequacy ratio to the Foreign Currency Banking Units (FCBUs) of banks with effect from 2003. The industry average CAR was below the statutory minimum of 10 per cent imposed by the CBSL. Although this was above the international norm of 8 per cent stipulated by the Basel Committee, the levels of capital need to be improved to support the potential risk profiles of the major banks in the industry.

Box 21

Should there be a Financial Safety Net?

The number and frequency of bank failures in the world have increased rapidly in the recent past. The experience in East Asia and elsewhere has brought to the fore the importance of the stability of financial systems for ensuring the sustainability of openness in invigorated economic growth.

The hallmark of a sound and stable financial market is investor confidence. A financial safety net for ensuring investor confidence includes mechanisms that have the following dual objectives: (*a*) containing the disruptive consequences of financial distress once it arises (crisis management), and (*b*) instilling confidence in the financial system so as to limit the risks (crisis prevention). A financial safety net, thus, covers four main elements: emergency liquidity assistance (Lender-of last resort facility from the central bank), deposit protection schemes, exit policies and prudential regulation and supervision of financial institutions. In the absence of such safety net arrangements, financial failures impose enormous costs on individual investors and the economy as a whole. Deposit insurance is one such safety mechanism with which the losses of the so-called "unsophisticated" depositors in banks can be minimised, albeit to a stipulated limit, in case banks fail, and thereby help arrest the cataclysmic impact of bank runs. However, providing of deposit insurance alone is neither a necessary, nor a sufficient condition for ensuring financial stability. Deposit insurance poses moral hazard risks that can invite imprudent behaviour by bank management or poor choices by depositors. Therefore, what is of importance is to ensure that deposit insurance is provided on efficient lines and does not guarantee complete reinstatement.

As Mr. Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System recently pointed out, a safety net, along with improved understanding of the use of monetary and fiscal policies, has played a critical role in eliminating bank runs and in assuaging financial crises, and reducing the frequency and amplitude of economic contractions. Deposit Insurance, the discount window, and access to central bank emergency liquidity provide depository institutions and financial market participants with safety and liquidity. There are however costs of such safety net arrangements in the form of distortions in price signals used to allocate resources, excessive risk-taking and greater government supervision and regulation.

Insured depositors may be simply indifferent, and other creditors too often less sensitive than they would be to the risks taken by banks because of both the reality and the perception of their own safety under a deposit insurance scheme. Market discipline in one form or another has been the major governor of bank risk-taking. By deterring liquidity panics, deposit insurance could shield the economy from some of the worst effects of instability in the banking system. The safety net enables banks to accumulate larger, riskier asset portfolios than would be possible in an intermediation process driven solely by market forces. In the absence of a safety net, these higher lending risks would have to be reflected in some combination of higher deposit costs, more liquid asset holdings, or a larger capital base. Or, conversely, these adjustments would constrain the risk-taking by banks. But, with the safety net, lower interest rates and higher credit availability are accorded to riskier borrowers, benefiting speculative and riskier ventures at the expense of sounder ones.

The moralhazard costs of a safety net are significant. Nonetheless, safety nets, by providing access to real resources, has become capitalised into a broad spectrum of asset values. To lessen the moral hazard of the safety net and to improve supervision and regulation, public policy should attempt to simulate, in so far as possible, what markets alone might do, or at least to create market-type incentives. Clearly one of those steps would be better pricing of safety-net access.

There are a few countries like Singapore, South Africa, New Zealand and Australia that do not have any sort of deposit insurance system. It is worth examining how these countries have managed without a formal deposit insurance system, while many other countries have them in place.

New Zealand does not have a deposit protection scheme in any shape or form. The New Zealand banking supervisory regime differs from the more conventional approaches to financial regulation by placing greater reliance on market discipline through an elaborate public disclosure system. Under this system, each bank is required to issue public disclosure statements every quarter covering the bank's credit rating, capital ratios, exposure concentration, exposure to related parties, asset quality, profitability, a summary of the prudential regulations imposed on the bank by the regulator etc. This extensive disclosure system is meant to induce prudent

Box 21 (contd.)

and responsible behaviour from bank management. With information on the banks' financial performance and risk positions available frequently and in a detailed manner, the markets can react to developments affecting their financial conditions, rewarding those banks that are well managed and penalising those that are not, contributing to the development and maintenance of a sound and stable financial system. An important benefit, which the authorities seek to derive from a market-based regulatory system, is the reduction of pressure on the government to rescue banks in distress, given the development of a perception that the directors alone have the responsibility for the management of banks. Sophisticated depositors exert this discipline by demanding higher deposit rates from weaker banks in compensation for the higher risk of loss that they accept. In other circumstances, depositors may withhold funds entirely from a particularly troubled bank.

An important issue that needs to be addressed in the context of establishing a financial safety net is how to ensure that individual banks govern themselves according to the best practices in corporate governance. This involves according utmost importance to prudent business practices, such as, developing an effective internal control system, identifying, measuring and managing the financial and commercial risks, instituting an effective system of asset liability management and maintaining a proper cushion in the form of capital reserves. Apart from capital adequacy standards, the new international norms of banking regulation and supervision require a more pro-active role for the regulator in enforcing an effective mechanism for evaluating, monitoring and managing risks in the financial system. This in turn would need stricter accounting, valuation and reporting norms on the part of banks. Transparency and accountability demand realistic valuation of assets, public disclosure policies and prudential reporting by banks to help depositors and investors form an informed opinion about the status of the financial system, thereby enabling them to react in an orderly fashion to asset price changes.

Since the use of safety net instruments always implies some element of moral hazard, even sensible policies formulated to reduce damage arising from financial instability may have less desirable longer-term consequences. Policymakers continue to face a dilemma with regard to the implementation of financial safety net arrangements.