Chapter 8

FINANCIAL SECTOR DEVELOPMENTS AND STABILITY

8.1 Overview

Benefiting from the continued economic growth, financial sector activities expanded further, and the financial system remained resilient in 2004 amidst several internal and external shocks.[1] The array of financial services offered by financial institutions expanded, deepening financial sector activity in the economy. Trading volumes in financial markets increased in 2004 with some market indices reaching record levels. Several initiatives were taken in 2004 to strengthen the availability of financial facilities to micro-enterprises and small and medium enterprises (SMEs) and enhance access to finance. Financial infrastructure was improved and modernised with further reforms in the payment system by establishing a Scripless Securities Settlement (SSS) system and a Central Depositary system (CDS) for government securities and linking it up with the Real Time Gross Settlement (RTGS) system introduced in 2003. During 2004, the regulatory and supervisory framework was further strengthened to improve the soundness of the banking system, while moving further in line with international best practices. A number of legislative and regulatory reforms were implemented in 2004 to strengthen the legal and regulatory framework and promote efficiency and stability in the financial sector.

In 2004, an expansion in financial services was evidenced by increases in deposit mobilization, loans and advances granted, service outlets of the financial institutions, lease and hire purchase facilities, and insurance activities that which have been expanding under a healthy competitive market environment. Many financial institutions also expanded the array of financial services offered to their customers, introducing new value added services. Reflecting these developments, the total assets of the financial system in nominal terms expanded by 15 per cent in 2004. Similarly, the financial assets to GDP ratio increased from 134 per cent in 2003 to 135 per cent in 2004. Value addition of the financial services increased by 6.6 per cent in 2004. However, this was lower than the 10.6 per cent growth registered in 2003, due to the base effect of the higher growth in profits in 2003, the narrowing of the interest spread, which however is still high, and the reduction in capital gains from investments in bonds and securities.

Financial markets recorded a further expansion as seen in the trading volumes of many market segments. Activity in the short-term inter-bank call money market and the primary market for government securities increased further, but secondary market transactions in government securities declined in view of the uncertainties with regard to interest rates. The volume of transactions in the foreign exchange market increased, benefiting from expanded external trade activity in 2004. Equity market performance improved with the All Share Price Index, the number of transactions and market capitalisation reaching record levels in 2004. The nascent corporate bond market continued to suffer from high issue costs, insufficient awareness of market participants and the availability of alternative easily accessible bank financing, specially bank credit at attractive rates, particularly to blue chip companies.

To enhance efficiency, competitiveness, and resilience of the financial sector as well as to promote the soundness of the financial sector, several measures were taken to upgrade and strengthen the payments system and the regulatory system in 2004. Further developments of the payments and settlement systems was undertaken by linking up the RTGS system implemented in 2003 with the SSS system and the CDS for government securities to facilitate the settlement of government securities in scripless form. Meanwhile, the Registered Stock & Securities Ordinance (RSSO) and the Local Treasury Bills Ordinance (LTBO) were amended to facilitate the implementation of the SSS system.

The regulatory framework was further strengthened by taking measures such as applying the capital adequacy requirement on a consolidated basis covering the subsidiaries, streamlining provisioning requirements pertaining to non performing loans (NPLs), issuing guidelines restraining external auditors from undertaking non-audit services in banks simultaneously with the external audit and requiring banks to obtain credit ratings and publish the same by mid 2005. An amendment to the Banking Act was approved by the Parliament to strengthen the regulatory framework. A new Payment Systems bill Act has also been drafted to strengthen the legal framework governing the payment, clearing and settlement systems in Sri Lanka. The new Act would provide a comprehensive law for payment transactions.

The tsunami devastation at the end of 2004 has not posed a major challenge to the stability of the financial sector although there are several downside risks to maintaining financial system stability in 2005. The world economic environment, though favourable at present, could become uncertain due to several factors such as the slowing down of global economic growth, the continuing uncertainties with

1 A financial system is an integrated set of financial institutions, financial markets and payments and settlement infrastructure that function collectively, within a regulatory and supervisory framework, to provide a mechanism for payment and settlement, financial intermediation and risk sharing.

regard to petroleum prices, rising international interest rates with the gradual removal of policy stimuli, and the continuation of the significantly large twin deficits, i.e., the fiscal deficit and the external current account deficit, in the USA. The domestic economic environment could suffer from the continuing uncertainties in relation to inflation, aid flows, fuel prices, and the possible slowing down of international trade arising from the fall-out effects of the termination of the MFA, and threats to achieving fiscal consolidation. High credit expansion could also pose a threat to the stability of the financial system, if care is not taken to ensure asset quality. However, the sector will be able to manage those risks successfully with the continuous strengthening of the financial position and the improved risk management strategies, the strengthening of the regulatory and supervisory framework and the improvements in the payment and settlement systems.

Nevertheless, there are some issues and challenges that require attention. One of the main issues in the financial sector, particularly in the banking sector, has been the relatively high intermediation cost. Two of the major factors that contribute to the high intermediation cost, as measured by the interest spread, are poor credit management as reflected by high NPLs and high operating costs. Some of the other issues in the financial sector are the underdeveloped nature of the corporate bond market, low insurance penetration, the relatively low level of integration of financial markets, and market distortions caused by the taxation of some financial services. Though the objective of taxing financial services is to enhance the revenue of the government, due attention needs to be paid to maintaining the same tax treatment among different markets, which may otherwise distort financial intermediation. In addition, preparedness of the financial sector to face natural disasters needs to be looked into in view of the tsunami disaster that occured in December 2004.

8.2 Developments in Financial Institutions

In 2004, the total assets of the financial institutions expanded and the ratio of financial assets to GDP increased, reflecting further deepening of the financial sector. With respect to total assets, licensed commercial banks (LCBs) and licensed specialised banks (LSBs) continued to hold a dominant position in the financial sector, as reflected by the share of financial assets, which was over 50 per cent.

Table 8.1

Total Assets of the Financial System

	2003		2004(a)	
	Rs.bn	Share in Total %	Rs. bn	Share in Total %
Banking Sector	1,634.7	69.1	1,892.7	69.3
Central Bank	354.6	15.0	414.0	15.2
Licensed Commercial Banks (b)	994.2	42.0	1,161.4	42.6
Licensed Specialised Banks	285.9	12.1	317.3	11.6
Non Bank Deposit Taking Financial Institutions	83.6	3.5	105.9	3.9
Registered Finance Companies	54.0	2.3	66.2	2.4
Co -operative Rural Banks	24.4	1.0	33.5	1.2
Thrift & Credit Co-operative Societies	5.2	0.2	6.2	0.2
Other Specialised Financial Institutions	108.8	4.6	122.6	4.5
Primary Dealers	57.0	2.4	61.4	2.2
Leasing Companies	24.8	1.0	34.4	1.3
Merchant Banks	21.9	0.9	21.0	0.8
Unit Trusts	3.6	0.2	4.2	0.2
Venture Capital Companies	1.6	0.1	1.5	0.1
Contractual Savings Institutions	539.9	22.8	608.2	22.3
Employees' Provident Fund	339.0	14.3	379.4	13.9
Employees' Trust Fund	46.3	2.0	51.8	1.9
Other Provident Funds	94.4	4.0	104.8	3.8
Insurance Companies	60.2	2.5	72.2	2.6
Total	2,367.0	100.0	2,729.4	100.0

Source: Central Bank of Sri Lanka

(a) Provisional
(b) Consolidated assets of both DBUs and FCBUs of LCBs

Table 8.2

Distribution of Banks and Bank Branches

Category	End 2003	End 2004 (a)
Licensed Commercial Banks (LCBs)		
I.Total No.of LCBs	22	22
Domestic Banks	11	11
Foreign Banks	11	11
II. Total No.of LCB Branches and Other Outlets	1,817	1,890
Branches (b)	1,319	1,374
Domestic Bank Branches	1,285	1,342
Main Branches	1,048	1,099
ASC Branches	10	4
Kachcheri Branches	23	23
Extension/Pay Offices/Service Counters	197	209
Overseas Branches	7	7
Foreign Bank Branches and Other Outlets	40	38
Branches (c)	34	32
Collection Centres	6	6
Pawning Centres	188	188
Student Savings Units	310	328
Licensed Specialised Banks (LSBs)		
I. Total No. of LSBs	14	14
Regional Development Banks	6	6
National Savings Bank	1	1
Long-term Lending Institutions	2	2
Housing Finance Institutions	3	3
Private Savings and Development Banks	2	2
II. Total No. of LSB Branches and Other Outlets	402	406
Branches	370	374
Regional Development Banks	194	196
National Savings Bank	112	112
Long-term Lending Institutions	23	23
Housing Finance Institutions	26	27
Private Savings and Development Banks	15	16
Other outlets	32	32
Total Bank Branches and Other Outlets	2,219	2,296

Source: Central Bank of Sri Lanka

(a) Provisional
(b) Includes Head Offices, but excludes Pawning Centres and Student Savings Units
(c) Includes extension offices and sub branches

The Central Bank of Sri Lanka

The total assets of the Central Bank increased by 17 per cent in 2004. This increase was a net result of a sharp increase in the holdings of Treasury bills, an increase in provisional advances and a decline in foreign assets. Net Foreign Assets (NFA) of the Central Bank declined by Rs. 13 billion, mainly because the Central Bank had to provide US dollar liquidity in the domestic foreign exchange market in the context of excessive pressure in the market due to higher oil prices, until some short to medium BOP support was arranged by the government. The decline in international reserves was partly offset by the sale of the proceeds of the Sri Lanka Development Bonds (SLDBs) by the government to the Central Bank. The purchases of Treasury bills by the Central Bank to maintain market liquidity resulted in an increase in the Treasury bill holdings by Rs. 63 billion. Provisional advances to the government, which are provided by way of a revolving credit facility, increased by Rs. 4 billion in 2004.

On the liability side, the total currency issue of the Central Bank increased by 17 per cent (Rs.17 billion) reflecting the increased demand for currency for transactions purposes, while statutory deposits of commercial banks with the Central Bank also increased by 29 per cent (Rs. 12 billion) reflecting the growth in deposit liabilities of LCBs.

Licensed Commercial Banks

During the year, the number of LCBs operating in the country remained unchanged at 22, while the branch network and other service outlets expanded from 1,817 at end 2003 to 1,890 by end 2004. The banking density, defined as the number of bank branches per hundred thousand persons in the population, improved from 6.9 in 2003 to 7.1 in 2004. The total number of automated teller machines (ATMs) operated by LCBs increased to 810 from 710 at end 2003, while the number of electronic fund transfer facilities at the point of sale (EFTPOS) increased to 6,542 from 4,794 during the same period.

The expansion in commercial banking operations was reflected in significant increases in deposits, loans and advances as well as an expansion in banking services. Commercial banks also took several initiatives to better manage their risks through improving risk identification, risk measurement and risk mitigation. Reflecting these developments, financial soundness indicators improved in 2004. Namely, an increase in capital funds, a decline in NPL ratios and an improvement in provisioning were seen in 2004. Meanwhile, several LCBs had published credit ratings by end 2004, which would become mandatory in 2005.

Table 8.3

Assets and Liabilities of Licensed Commercial Banks

Rs. million

Item	End 2003	End 2004	Change 2003 Amount	Change 2003 %	Change 2004 Amount	Change 2004 %
Assets						
Liquid Assets	245,774	226,657	39,242	19.0	(19,117)	(7.8)
Cash on Hand	13,184	16,240	168	1.3	3,056	23.2
Due from Central Bank	37,899	54,664	(2,319)	(5.8)	16,765	44.2
Foreign Currency denominated Assets	76,660	69,578	7,081	10.2	(7,082)	(9.2)
Treasury Bills	41,562	38,234	15,642	60.3	(3,328)	(8.0)
Treasury Bonds (a)	62,027	31,929	29,103	88.4	(30,098)	(48.5)
Commercial Bills	14,442	16,013	(10,432)	(41.9)	1,570	10.9
Loans and Overdrafts	514,423	634,651	63,376	14.1	120,228	23.4
Loans	394,695	499,603	55,404	16.3	104,908	26.6
Overdrafts	119,728	135,048	7,972	7.1	15,319	12.8
Fixed and Other Assets	234,027	139,126	(2,358)	(1.0)	(94,901)	(40.6)
Liabilities						
Capital Accounts	75,197	77,220	23,427	45.3	2,023	2.7
Total Deposits	700,492	842,931	89,846	14.7	142,440	20.3
Demand Deposits	94,122	110,900	13,745	17.1	16,779	17.8
Time and Savings Deposits	606,370	732,031	76,100	14.4	125,661	20.7
Borrowings	41,166	41,528	(2,580)	(5.9)	363	0.9
Local Borrowings	36,183	33,946	(4,737)	(11.6)	(2,237)	(6.2)
Foreign Borrowings	4,983	7,583	2,157	76.3	2,600	52.2
Other Liabilities	177,371	199,740	(10,433)	(5.6)	22,369	12.6
Total Assets/Liabilities	**994,225**	**1,161,420**	**100,260**	**11.2**	**167,195**	**16.8**

(a) With effect from 18 May 1998 Treasury bonds are considered as a part of liquid assets of licensed commercial banks

Source: Central Bank of Sri Lanka

Table 8.4

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

Rs.billion

Sector	End 2002	End 2003	End 2004	As a % of Total End 2004	Change % 2003	Change % 2004
Commercial	141.8	157.3	186.1	35.7	10.9	18.3
of which: Exports	35.9	38.4	50.5	9.7	6.9	31.4
Imports	48.4	57.3	63.7	12.2	18.5	11.1
Financial	12.4	17.8	25.0	4.8	44.5	39.9
Agricultural	17.7	19.1	19.8	3.8	8.1	3.7
Industrial (b)	43.7	46.7	52.3	10.0	6.9	12.0
Tourism	5.1	5.8	7.0	1.3	14.7	20.7
Housing	52.8	60.0	74.4	14.3	13.6	24.1
Consumption	47.0	60.4	85.0	16.3	28.5	40.7
Services	35.4	36.4	38.1	7.3	2.8	4.6
Other	19.9	23.5	33.1	6.3	18.1	40.8
Total	**375.7**	**427.1**	**520.8**	**100.0**	**13.7**	**21.9**

Source : Central Bank of Sri Lanka

(a) Advances include loans, overdrafts and bills discounted, but exclude cash items in the process of Collection

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

Structure of Assets and Liabilities of LCBs: The structure of assets/liabilities of LCBs changed with a faster increase in foreign assets and liabilities in comparison to domestic assets. Foreign assets of domestic banking units (DBUs) and foreign currency banking units (FCBUs) increased by 35 per cent, while domestic assets rose only by 8 per cent. Similarly, foreign liabilities of DBUs and FCBUs rose by 19 per cent whereas the growth in domestic liabilities was 13 per cent. Accordingly, the share of foreign assets in total assets increased from 29 per cent in 2003 to 36 per cent in 2004.

The total assets of LCBs increased by 17 per cent in 2004, due to the increase in both foreign assets and domestic assets. The increase in foreign assets was mainly due to the increase in private remittances, an increase in foreign currency holdings as a result of the increase in foreign currency deposits and an increase in borrowings by some banks to meet the liquid asset requirement, which now has to be maintained in terms of foreign currency, an increase in discounted export bills and service related inflows including earnings from tourism. In addition, the increase in the holdings of foreign assets of market participants in view of the uncertainty in the foreign exchange market, could be another reason. The increase in domestic assets was a result of the robust growth in credit to the private sector.

Credit to the private sector, which increased at a high rate of 22 per cent, was a major causal factor for the higher than anticipated growth of the monetary aggregates in 2004. The expansion in credit from DBUs and FCBUs contributed to this overall expansion. The continued expansion in many sectors fuelled by low interest rates contributed to expand credit to the private sector at a higher pace. A higher growth in credit was seen in the commercial sector that includes import and export trade, finance, housing and consumption. Credit categorized under the commercial sector was mostly short-term credit in 2004. Within credit to the private sector, loans, which constitute 69 per cent of the total private sector credit, increased by a higher rate of 27 per cent in view of the relatively low interest rates, as compared to overdrafts, which increased by 13 per cent. The outstanding amount of credit in respect of credit cards grew by 37 per cent and stood at Rs.11.1 billion at end 2004, along with an increase in credit cards.

The overall exposure of commercial banks to the public sector declined in 2004 with the reduction of the holdings of Treasury bills and Treasury bonds by commercial banks, which surpassed the net increase of commercial bank investments in SLDBs and the increase in credit to public corporations. However, net credit to the government (NCG) from the banking sector increased in 2004, due to increased holdings of Treasury bills by the Central Bank. Commercial bank holdings of Treasury bills and Treasury bonds declined by Rs.33 billion, mainly due to a decline in Treasury bond holdings as banks disposed of their holdings in view of the expectations of an

Table 8.5

Credit Card Operations by Commercial Banks

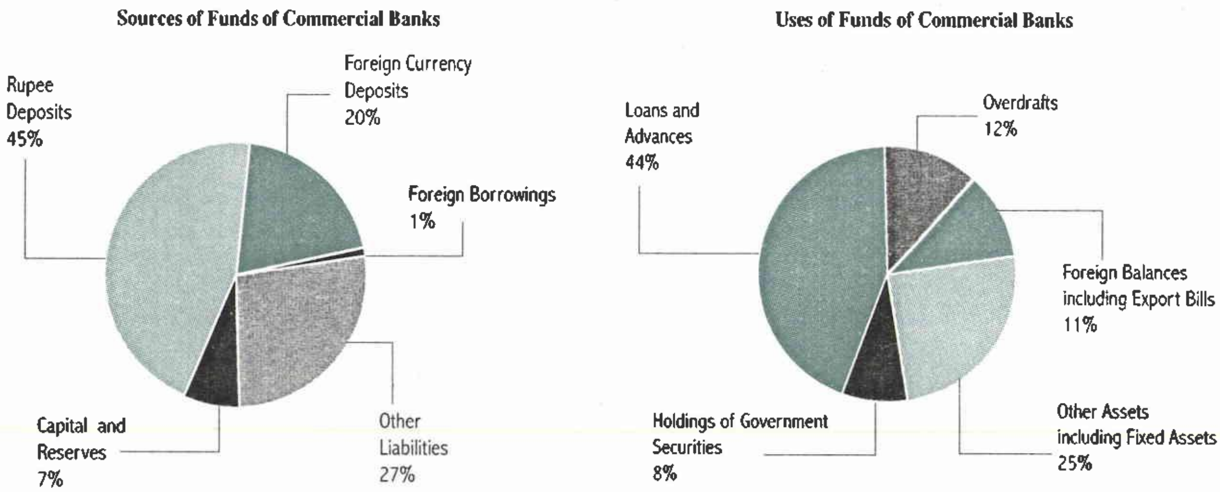
	2003 (a)	2004 (b)	% Change
Total Number of Credit Cards Issued	393,854	507,591	28.9
Local	78,034	79,158	1.4
Global	315,820	428,433	35.7
Outstanding Credit at End Year (Rs.mn)	8,125	11,111	36.8
Local	693	722	4.2
Global	7,432	10,389	39.8
Overdues(as a % of Outstanding Credit)	10.33	18.88	-
Pastdues(as a % of Outstanding Credit)	7.83	10.54	-
Commission from Dealers (%)	0.25-3.50	0.25-3.50	-

Source: Central Bank of Sri Lanka

(a) Revised

(b) Provisional

Chart 8.1
Sources and Uses of Funds of Commercial Banks (As at End 2004)



increase in interest rates. Meanwhile, credit to public corporations (i.e., mainly to the Ceylon Petroleum Corporation (CPC)) from commercial banks increased by Rs. 5 billion, in contrast to a decline expected at the beginning of the year.

On the liability side, deposits mobilised by LCBs grew by 20 per cent in 2004 in comparison to 15 per cent in 2003, reflecting increased economic activity and the multiplication of deposits and loans along with the expansion of reserve money. Foreign currency deposits recorded a higher increase of 24 per cent, which was partly due to attractive interest rates offered by banks in Sri Lanka. The increase in rupee deposits was primarily due to the increase in the time deposits category, which grew by 22 per cent. Savings deposits, which account for 45 per cent of the total deposits, grew by 18 per cent. Meanwhile, borrowings under Repurchase transactions grew by about 12 per cent.

Sources and Uses of Funds of LCBs: On the source side, the main contribution came from deposits, which constituted 85 per cent of the total resources mobilised, while the growth in deposits was 20 per cent in 2004. The contribution of foreign currency deposits to the total growth in deposits was about 27 per cent. Meanwhile, capital and reserves and foreign borrowings contributed to about 1.2 per cent and 2 per cent, respectively, of the growth in sources of funds in 2004.

About 73 per cent of the resources mobilised in 2004 was utilised to grant loans and advances. About 25 per cent of the increase in resources was in the form of foreign balances. Meanwhile, investments in government securities declined by about Rs. 18 billion. Commercial banks' reserves with the Central Bank increased by Rs. 17 billion, reflecting the increased statutory reserve requirement with the increase in deposit liabilities of commercial banks.

Of the total resources available to commercial banks as at end 2004, the major share came from deposits (65 per cent), which include both rupee and foreign currency deposits. A large part of the funds (44 per cent) has been utilised to grant loans and advances.

Key Performance Indicators: In 2004, several key performance indicators exhibited continued resilience of the banking sector. Capital funds in the banking sector improved over the previous year. Although the rate of increase in capital funds was lower than in the previous year, capital in relation to asset and net NPL ratios have increased. The overall profits recorded an increase in 2004, but at a lower rate of around 8 per cent compared with the growth of 36 per cent recorded in 2003. This was partly due to the reduced growth in profits earned from capital gains in comparison to the previous year and a marginal decline in the interest rate spread. As profit growth was not commensurate with the expansion in the asset base, there was some decline in the return on assets (ROA) and the return on equity (ROE) in the overall banking sector during the year. With the recognition of such risks, many banks focussed on risk identification and risk measurement in 2004, whereby they improved the credit granting process and the follow up process, along with an enhancement of the credit management information systems.

The interest spread, measured by the difference between the interest yield and the interest cost, which is an indicator of the efficiency of financial intermediation, was considered high at around 4 percentage points in 2004, although it had declined marginally from the previous year. The high interest spread in the banking sector was the result of high operational costs, high non-performing assets, mobilising long-term deposits at fixed rates, heavy reliance on interest earning activities as a major source of income as opposed to fee based activities, legal and other procedural bottlenecks in dispute resolution, taxes and statutory costs as well as rigidities in the market structure. In order to reduce the interest spread by improving market awareness, the Central Bank continued publishing lending and deposit rates of banks and other main fees and commissions charged by banks, which would help the public to negotiate the best terms with banks. In addition, banks were requested to display lending rates and deposit rates at their places of business. Another major contributory factor to the high interest rate spread has been high NPLs in the banking system. The resolution of NPLs is often impeded by lengthy and cumbersome legal procedures, which also involve high costs in addition to unsavoury political interference. Accordingly, the implimentation of the necessary legal reforms and a more effective institutional framework, perhaps with the setting up of an asset management company as done in several countries, would be useful. Other possible measures include offering competitive lending rates based on the prospects of projects and by properly assessing the quality of collateral, and promoting and developing the corporate bond market, given that the bond market could exert pressure on banks to reduce their lending rates through increased competition in financial intermediation.

Restructuring of the Two State Banks: The Government, in Budget 2005, has committed itself to the restructuring of the two state banks to put them on a sound financial footing and make them commercially viable institutions in recognition of their predominant position in the financial system of Sri Lanka by virtue of their sizeable market share and systemic importance.

Both institutions have, accordingly, been brought under the direct control of the Strategic Enterprises Management Agency (SEMA), which is responsible to the government for their restructuring programme.

Bank of Ceylon (BOC) – A strategic plan has been formulated by BOC, which outlines a restructuring programme over a two year time frame for the achievement of certain benchmark targets in the key areas of asset reconstruction, system upgrade, human resource development and capital augmentation through internal generation of funds.

The key areas identified are a dynamic management information system (MIS) through the information technology upgrade and human resource development.

BOC, intends to fill the void in its skills gap by recruiting skilled personnel in the areas of treasury risk management, internal audit and marketing and establish a solid structure for succession at the senior management level. Towards this end, BOC is in the process of implementing three fully integrated information technology systems, which are expected to enhance the standards of service and operations of the bank. The roll-out to the branches has already commenced and will be completed by mid 2006, resulting in the entire branch network being linked to an on-line, real time, state of the art, technology system.

People's Bank (PB) – A business restructuring plan (BRP) has been formulated by PB over a 5 year time horizon. This plan is drawn up on the basis of a capital infusion programme of a sum of US dollars 65 million through an ADB funded credit line to the government.

As an integral part of its restructuring programme, PB has developed a five-year BRP under the supervision of SEMA, which has been approved by the Cabinet. The primary focus of the BRP is on the infusion of capital amounting to Rs. 8.5 billion over a period of 05 years commencing from June 2005 on a staggered basis. The success of the plan is linked to the achievement of certain benchmarks in terms of staff and business productivity in order to make PB commercially viable, through the implementation of several measures to improve the credit risk management process of the bank and through asset reconstruction.

In order to make PB commercially viable, the bank intends to divest the large hardcore NPLs either to an externally funded asset management company (PBAMC) or to a special assets division within PB.

In addition, the plan targets the establishment of management autonomy and the building up of a motivated and productive workforce to retain its competitive edge within the system.

Licensed Specialised Banks

LSBs consist of a diverse set of institutions including savings banks, housing banks, development finance institutions (DFIs) and regional development banks (RDBs). By end 2004, there were 14 LSBs with a network of 406 branches, possessing 17 per cent of the total banking sector assets. The operations of LSBs expanded further during 2004, although at a lower rate than in 2003, with total assets increasing by 11 per cent in 2004.

Table 8.6

Sectoral Distribution of Loans Approved by Licensed Specialised Banks (a)

Rs million

Sector	2003	2004 (b)
Total Loans Approved During the Year	**50,387**	**48,639**
Agriculture	1,320	1,492
Industry	9,350	8,642
Tourism	249	757
Commercial	4,053	2,939
Financial	8,970	10,101
Housing	7,845	10,524
Redemption of Debt	174	111
Other Loans	18,425	14,073
Loans Disbursed (c)	**38,507**	**46,633**
Total Loans Disbursed as a Percentage of Total Loans Approved	76	96

Source: Central Bank of Sri Lanka

(a) Excludes Regional Development Banks, but includes National Housing Development Authority

(b) Provisional

(c) Includes loans approved in previous years but disbursed during the period under review

Around 60 per cent of the loans approved were for housing, industrial and financial sectors. Of these, the largest share of credit was for housing purposes, in view of the increased amount of credit granted by some LSBs, which mainly cater to housing needs. The share of medium and long-term loans (with a maturity of more than one year) increased from about 80 per cent to 89 per cent during the period, partly because of the higher growth in housing loans granted.

The activities of the National Savings Bank (NSB) expanded in terms of deposits mobilized and loans granted. The deposit base of NSB stood at Rs 180 billion, accounting for 17 per cent of the combined total deposits of LCBs and LSBs. Although the two specialsed banks i.e., DFCC Bank and NDB still held a dominant position with respect to loans granted, the share of loans approved declined to 45.3 per cent of the total loans approved in 2004 from 52.5 per cent in the previous year. NSB became the first LSB to receive the approval of the Central Bank to accept NRFC and RFC accounts.

The total credit outstanding of LSBs increased by 15.6 per cent to Rs. 111 billion by end 2004, with their, total advances growing at a higher rate in 2004. However, profits declined in 2004 as against the considerable growth of profits in 2003.

Finance Companies

Finance companies (FCs) continued to concentrate their activities on hire purchase, leasing and lending for real estate development. Total assets of FCs grew by 23 per cent (Rs. 12 billion) in 2004 in comparison to the 20 per cent (Rs. 9 billion) growth in 2003.

In 2004, loans and advances granted by FCs increased by 25 per cent. Hire purchase and leasing accounted for about two thirds of the overall resources raised in 2004. Hire purchase activities grew at a faster rate in 2004 than leasing because of the tax advantage on hire purchase. As a result, the growth of credit in relation to leasing activities decelerated to 8 per cent in 2004, compared with a growth of 21 per cent in 2003.

With respect to the sources of funds of FCs in 2004, deposit mobilisation accounted for about 37 per cent and the growth in deposits was 14 per cent (Rs.5 billion). The higher interest rates offered by finance companies for deposits in comparison to the interest rates offered by commercial banks and the rates of return pertaining to government securities, and savers' preference to diversify their investments among different institutions with different risk profiles, contributed to this increase. Capital funds of FCs grew by around 24 per cent and were 14 per cent of the sources of funds in 2004, while borrowings from commercial banks accounted for around 13 per cent of the funds.

Other Financial Institutions

Primary Dealers: The number of primary dealers (PDs) increased to 12 in 2004, with the addition of another non-bank primary dealer. At present, the primary dealer system includes licensed commercial banks as well, since banks were permitted to become PDs in 2002. The total investment portfolio of the primary dealer companies grew by 12 per cent in 2004 as against a growth of 38 per cent in 2003. The growth in 2004 was the result of the growth of the investment portfolio; the trading portfolio declined during the year.

At the end of 2004, capital funds of all PDs amounted to Rs.4,922 million. The capital leverage ratio for all PDs was 11.6 at end 2004, compared to the maximum permissible ratio of 20, indicating a healthy contribution by them to market development. The return on equity for all PDs taken together, which was high in 2003, at 63.5 per cent, mainly as a result of capital gains due to the continuous decline in interest rates, decreased to 14.5 per cent in 2004, as the declining trend in interest rates reversed from around the end of November 2003. Meanwhile, in order to improve investor awareness and popularise government securities, PDs conducted several awareness programmess in different parts of the country during the year.

Specialised Leasing Companies: There were 65 leasing companies registered with the Central Bank by end 2004. Of these, 18 were specialised leasing companies, which are registered with the Central Bank exclusively for leasing business. The total outstanding leases of all registered leasing firms increased to Rs. 80 billion from Rs. 66 billion at end 2003. The total assets of the specialised leasing companies increased to Rs. 34 billion from Rs. 25 billion at end 2003, while the total leases granted in 2004 increased to Rs.18.2 billion from Rs.14.5 billion in 2003, which may be attributed to the low interest rate regime. Though the finance leases are the popular category of leasing, a few institutions engaged in operational leasing as well.

About 70 per cent of lease finance was absorbed by the trade, services and transportation sectors. Passenger and commercial vehicles were the main category of assets financed by leasing, though its share in the total leasing granted declined to 70 per cent in 2004 from 77 per cent in 2003. Meanwhile, the share of leases for office equipment increased from 2 per cent in 2003 to 7 per cent in the current year.

Table 8.7

Specialised Leasing Companies
Sectoral Classification of Leasing Facilites

Rs. million

Sector	During 2003	During 2004(a)
Agriculture	499	609
Industry	1,270	1,484
Trade	4,882	4,949
Transportation	2,810	3,853
Construction	501	1,109
Services	3,010	4,425
Others	1,546	1,810
Total	**14,518**	**18,239**

(a) Provisional

Source: Central Bank of Sri Lanka

Lease securitisation is one way in which long-term funds are raised. However, the lease securitisation market is not well developed, due to several factors such as legal impediments and tax related issues. The proposed amendments to the Finance Leasing Act may help overcome some of these difficulties.

Merchant Banks: The performance of merchant banks, which generally specialise in fee based investment banking activities, was adversely affected as a result of a few merchant banks recording declines in profits and assets. Their total assets decreased to Rs.21 billion from 22 billion at end 2003, while their total income decreased from Rs. 2.8 billion to Rs. 2.4 billion in 2004. In 2004, more than 60 per cent of their total income was derived from leasing, lending and investments in government securities. There were 10 merchant banks operating in Sri Lanka by end 2004.

Unit Trusts: The unit trust industry witnessed a widening of its product range as a result of the entry of a money market fund and a regulatory change permitting the establishment of close-ended funds.[2] With the establishment of the money market fund introduced by National Assets Management Ltd. (NAMAL), the total number of funds, managed by five institutions, increased to 13, and the types of funds, i.e., growth, balanced, indexed, income and money market, expanded to five.

The net asset value of unit trusts grew by 16.7 per cent, supported by an appreciation of the value of investments and an increase in the number of units in issue. As a result, net assets per unit increased by 9 per cent over the previous year, i.e., from Rs.11.23 to Rs. 12.24. The main factor that contributed to the increase in the net asset value was the bull run in the stock market, which appreciated the value of the equity portfolio. The equity portfolio accounted for about 70 per cent of the total investments. The share of investments in Treasury bills, the other main investment asset, increased due to the entry of the money market fund, which primarily invests in Treasury bills. During the year, the total number of unit holders decreased while the number of units in issue increased, indicating a marginal concentration of ownership in units.

Venture Capital Firms (VCFs): VCFs, which are primarily engaged in providing equity capital to high risk projects, recorded a marginal drop in total assets, i.e., from Rs. 1.6 billion to Rs. 1.5 billion, as a result of many firms exiting from their projects, with the boom in the stock market. The share of the VCFs was very small in terms of the total financial sector assets. The firms had invested Rs. 680 million in 694 projects, covering the agriculture, services and industrial sectors, at end 2004. Since the development of venture capital services is important as an alternative source of funding and expanding investment, a package of incentives was granted through the government Budgets for 2003 and 2004 to revitalize the venture capital industry. These included a five-year tax holiday and the setting up of a fund to develop the venture capital industry.

Contractual Savings Institutions

Superannuation Funds: The total amount of savings collected by superannuation funds, which include the Employees' Provident Fund (EPF), the Employees' Trust Fund (ETF), the Public Service Provident Fund (PSPF), the Contributory Pension Fund (CPF) and approved private provident funds amounted to Rs. 34 billion during the year, in comparison to Rs. 30 billion moblised by LCBs, LSBs and finance companies collectively.

Assets of the funds recorded a 11.7 per cent increase in 2004 due to the combined effect of the general increase in wages, net additions to the membership and the net investment income.

The EPF, the largest retirement benefit fund in the country, expanded in terms of total assets, the membership base, investments and contributions received. The total investment portfolio of the EPF was Rs. 359 billion by end 2004, with a major share of the portfolio consisting of Treasury bonds (70 per cent). The net inflow of funds continued to be positive, indicating that there is hardly any liquidity risk in meeting members' requests for refunds. A return of 9.5 per cent, on the member balances, was declared, as against 12 per cent in 2003, which is higher than the commercial banks' one year fixed deposit rates of around 7.00 - 8.00 per cent and the one-year Treasury bill rate prevalent during the same period.

The ETF recorded a similar pattern in investment, asset growth and contributions received. The fund had a net inflow of funds during the year as a result of contributions received being higher than refunds, despite its relatively flexible refund policy, where a member is able to withdraw his/ her balance once in every 5 years when he/ she quits a job. The investment portfolio, which is composed of government securities (91.4 per cent), equities (3.7 per cent) and private sector debt instruments (4.9 per cent), has undergone a portfolio rebalancing in favour of government securities as a result of investments in debentures maturing during the year. A return of 10 per cent was declared by the ETF, on member balances, as against 11 per cent in 2003.

The total assets of the PSPF, the CPF and private provident funds amounted to Rs. 105 billion at end 2004.

Insurance Companies: Both life and general insurance business expanded significantly as a result of increased competition, improved marketing and rising national income. The number of insurance companies at end 2004 remained at 13. During the year, Sri Lanka Insurance Corporation obtained an AA- (sri) credit rating for its ability to meet policyholders' obligations and benefits, becoming the first insurer to do so. It was also given an A+(sri) national rating for its long term debt. The total premia collected increased from Rs. 19.3 billion in

2 As against an open-ended fund, a close-ended fund is a time bounded fund with a fixed number of units in issue, which are not traded until the lapse of the time specified. Since a close-ended fund is a form of a long-term investment, the only exit mechanism available for an investor is through the stock exchange, provided that the fund is listed in the stock exchange.

2003 to Rs.24.4 billion in 2004, supported by deregulation, product innovation and increasing per capita income levels in the country. The total assets too increased by 20 per cent to Rs. 72 billion. Insurance penetration, measured in terms of the total gross premium as a percentage of GDP, improved from 1.4 per cent at end 2003 to 1.5 per cent at end 2004, while insurance density or the per capita premium increased from Rs.1,240 to Rs.1,511 over the year, supported by both an increase in the number of policy holders and the raising of premia for value added products. Despite these improvements, insurance penetration is still lower in Sri Lanka, when compared with the average insurance penetration of 3.6 per cent for emerging market countries.

The insurance industry had paid Rs. 14.3 billion as compensation, with respect to the tsunami related claims. Of the amount paid, Rs. 11 billion was reclaimed from reinsurance companies. The total number of claims received in this regard under all categories of insurance was 6,600. One negative fallout of the tsunami disaster with regard to the insurance industry could be a possible increase in the reinsurance premium in the future, with the heightened natural disaster risk.

On the policy front, there were two regulatory changes, namely, the imposition of a minimum solvency margin on general insurance and initiating action to remove the limit on fire insurance premia. The solvency margin is a prudential measure aimed at ensuring that a minimum level of capital is maintained by insurance firms, whereas the removal of tariff restrictions was to facilitate innovation and quality improvement by allowing tariffs to be determined by market forces. The deregulation of limits on premia has led to increased competition, resulting in the introduction of innovative products to suit the needs of different segments of the market.

8.3 Developments in Financial Markets

Inter-Bank Call Money Market

The inter-bank call money market, which mainly serves commercial banks in meeting their immediate liquidity needs and reserve deficiencies, continued to remain liquid. The market liquidity surplus, which averaged around Rs. 7 - 8 billion in December 2003, declined to about Rs. 3 - 5 billion by August 2004, particularly due to increased foreign exchange sales by the Central Bank in order to contain excess volatility in the domestic foreign exchange market. However, market liquidity improved again during the second half of the year with purchases of Treasury bills by the Central Bank and the sale of the proceeds of SLDBs and foreign loans to the Central Bank by the government.

Activity in the inter-bank call money market increased significantly during the second half of 2004, mainly due to the increased liquidity needs of some banks with the higher expansion of domestic credit. The total volume of lending (or borrowing) in the call money market increased from Rs. 183.4 billion in the first quarter of the year to Rs. 456.5 billion in the fourth quarter. The average daily call money volume increased from Rs. 2.1 billion in the first quarter of 2004 to Rs. 7.0 billion in the fourth quarter of 2004. The average daily inter-bank transactions increased from Rs. 3.9 billion in 2003 to Rs. 5.6 billion in 2004.

Table 8.8

Money Market Operations 2002 - 2004

Rs.million

	Call Money Market	Primary Treasury Bill Market			
	Total Lending/ Borrowings	Amount Issued	Amount Purchased		
			Central Bank	Commercial Banks	Others
2002					
1st Qtr.	417,684	70,831	6,998	36,614	27,219
2nd Qtr.	319,288	102,299	21,900	50,648	29,751
3rd Qtr.	275,764	90,845	29,050	37,702	24,094
4th Qtr.	263,457	78,698	35,900	30,988	11,810
2003					
1st Qtr.	253,086	75,298	8,948	46,182	20,168
2nd Qtr.	250,010	84,870	7,876	54,351	22,643
3rd Qtr.	233,449	90,144	0	57,427	32,717
4th Qtr.	199,220	92,535	32,556	43,864	16,115
2004					
1st Qtr.	183,377	103,970	29,917	48,904	25,149
2nd Qtr.	372,607	104,683	20,000	62,929	21,754
3rd Qtr.	350,969	136,022	35,550	72,623	27,849
4th Qtr.	456,537	125,298	47,790	58,468	19,040

Source: Central Bank of Sri Lanka

As a result of the increased demand for liquidity by some banks, the structural rigidities in the money market, the rise in inflation expectations, measures taken by the Central Bank to absorb excess liquidity more aggressively in an attempt to contain the expansion in monetary aggregates and the increase in the Central Bank policy rates, call money market rates rose during the year, and in some instances moved above the upper bound of the interest rate corridor.

Domestic Foreign Exchange Market

While the volume of transactions in the foreign exchange market increased, the exchange rate became volatile in 2004. Trade related transactions and net inflows under the services and current transfers accounts increased during the year. Consequently, average daily inter-bank transactions, which amounted to around US dollars 15 million in 2003, increased further to around US dollars 17 million in 2004. However, the widening of the trade deficit and delays in receipts of some foreign loans as well as privatisation proceeds resulted in significant pressure on the exchange rate. With regard to the US dollar, the average buying and selling rates of commercial banks for telegraphic transfers increased from Rs.96.26 and Rs. 97.16, respectively, at end 2003, to Rs.104.16 and Rs.105.14, respectively, by end 2004, indicating a depreciation of 7.6 per cent.

Government Securities Market

A notable development in the government debt securities market was the implementation of the SSS system for government securities in February 2004, facilitating the issuance of government securities and the recording of transactions in scripless form, thereby improving the efficiency and reducing the risks involved.

The amount raised in the primary Treasury bill market increased at a higher pace due to investor preference shifting to short-term government securities and an increase in domestic borrowing by the government. During the year, net issues of Treasury bills amounted to Rs. 24 billion as against Rs. 8 billion in 2003. With respect to Treasury bills, the market demonstrated a greater preference for 91-day Treasury bills. The outstanding Treasury bills, which was Rs. 219 billion by end 2003 also increased to Rs. 244 billion by end 2004.

During 2004, Treasury bonds of 2-year and 3-year maturities were issued regularly. As there were a large number of bond series in the market disturbing market development, auctions were held to issue Treasury bonds on a remaining maturity basis to reduce the number of series in the market. Continuing the process of market orientation of the issue of government securities, Rupee loan issues in 2004 was limited to Rs. 564 million, while action was taken to retire callable Rupee loans, which carried a relatively higher rate of interest.

The government raised US dollars 250 million through the issuance of SLDBs with a maturity period of two years in 2004. These bonds were heavily oversubscribed and carried an interest rate of six months LIBOR + 179 basis points.

Due to the expectations of high interest rates, secondary market activitiy in government securities declined, especially during the first seven months of the year. Secondary market transactions of primary dealers in 2004 recorded a decline of 10.5 per cent over the previous year. Primary dealers adopted a rather risk averse position, which resulted in an increase in market transactions in the short end, limiting transactions in the long end. By end 2004, the secondary market yield curve for government securities had shifted upwards compared with the yield curve in 2003.

Corporate Debt Securities Market

Commercial Paper (CP): The total amount of CP issued with the support of LCBs and LSBs amounted to Rs.14.5 billion in 2004, compared with Rs. 11.1 billion in 2003.[3] There was, however, a drop in the volumes of CP issued, following the imposition of the witholding tax in November 2002 and the decline in interest rates. The withholding tax, which was applicable to interest-bearing or discounted debt instruments including bonds, notes and mortgages, will cease to be effective from April 2005. From April 2005, only the final tax will be retained. This is likely to boost market activity in relation to CP.

Corporate Bonds: There were two public issues of corporate bonds during 2004, which were subsequently listed on the Colombo Stock Exchange (CSE). While Merchant Bank of Sri Lanka raised Rs.163.35 million in March by way of an issue of four-year debentures, Sampath Bank raised Rs.1.5 billion in June by way of an issue of five-year debentures, mainly to fulfill capital adequacy requirements. In comparison, during 2003, a much higher amount of Rs.4.5 billion was raised by way of issues of debentures, which were subsequently listed on the CSE. .

Sri Lanka Telecom (SLT) raised US dollars 100 million in November 2004 by way of an international bond issue. These bonds, issued on 30 November 2004, and subsequently listed on the Singapore Stock Exchange, will mature in a single bullet at the end of five years from the date of issue. They carry a fixed semi-annual coupon of 6.875 per cent per annum. This is the first dollar denominated fixed rate bond issue by a local company. SLT obtained ratings from both Fitch Ratings and Standard & Poor's for its foreign currency bond, prior to the issue, which were both B+, denoting a stable outlook. While US dollars 50 million from the money raised was used by SLT to settle loans it had obtained from the government, SLT expects to expand its subsidiary Mobitel's network with the balance funds.

Share market

Market activity at the CSE improved significantly during 2004. This improvement was seen mainly during the latter half of the year, after some volatility in market activity till around May, due to political uncertainty. The continued improvement in corporate profits, reflecting the improvement in economic activity, stimulated secondary market activity at the CSE. Initial public offers (IPOs) made during the year, which attracted both domestic funds and significant inflows of foreign

Table 8.9

Share Market Indicators

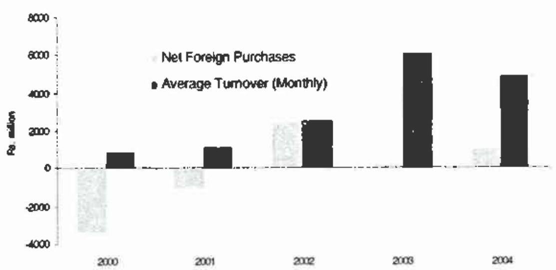
	2003	2004
All Share Price Index (a)	1,062.1	1,506.9
Year-on-year Change (%)	30	42
Milanka Price Index (a)	1,897.8	2,073.7
Year-on-year Change (%)	38	9
Market Capitalisation (Rs.bn.)(a)	263	382
As a percetage of GDP (%)	15	19
Market Price Earnings Ratio (a)	11.1	10.8
Turnover to Market Capitalisation (%)	28	15
Value of Shares Traded (Rs.mn.)	73,837	59,052
Number of Shares Traded (mn.)	2,255	2,752
Number of Companies Traded	236	241
Number of Companies Listed	244	242
Introductions (b)	3	3
Number of Initial Public Offers/Offers for Sale (b)	4	2
Number of Rights Issues	18	25
Amount raised through Rights Issues (Rs.mn.)	6,425	65,945

Source: Colombo Stock Exchange

(a) End of the year
(b) Resulting in new listings of companies

3 A bank may accept, endorse, guarantee, underwrite, purchase, be the issuing agent or the paying agent, in respect of commercial paper.

Chart 8.2
Turnover and Foreign Particiaption at CSE



investment, also contributed to this improvement. The low interest rate regime was another factor that impacted positively on share market activity.

Following these developments, by 22 December 2004, the All Share Price Index (ASPI) reached 1,580.7, the highest up to then, while market capitalisation exceeded Rs.400 billion for the first time. During the last week of December 2004, however, key market indicators retreated, which was partly attributed by some market analysts to panic selling by investors considering the damage caused by the tsunami in economic terms.

With respect to sectoral performance, profits of companies classified under most sectors improved significantly during the year, having benefited from the continued growth momentum in the domestic and external economies. The sector index for Diversified Holdings, the largest sector, which accounted for 23 per cent of the market capitalisation by end-2004, increased by 63 per cent in 2004, reflecting the significant improvement in the financial results posted by companies classified under the sector. A significant development during the latter part of the year was that, information with regard to the tourism industry, which indicated strong performance by the industry in 2004, led to increased buying interest in shares classified under the Hotels and Travel sector. In the Power and Energy sector, shares of Lanka IOC Ltd. were listed in December 2004, following its IPO in November 2004, the biggest IPO in Sri Lanka up to now.

A significant increase in the ASPI from around June 2004 raised doubts as to whether there was a build up of an asset bubble. However, this increase was in line with corporate profitability and other developments in the macroeconomy. Hence, the developments in the stock market cannot be considered an asset bubble.

8.4 Development Finance and Access to Finance

Development Finance

During 2004, measures were taken to strengthen the micro, small and medium scale industries and enterprises of the country through awareness programmes and the improvement of the credit delivery mechanism. The Rural Finance Sector Development Project (RFSDP) funded by the Asian Development Bank (ADB) commenced its operations during the year. In the first phase of the project, it was expected to create a conducive environment for rural finance sector institutions to carry out sustainable operations by assisting them through training, consultancy and introducing changes to the legal structure.

Other key areas identified to be addressed by the Project are strengthening of the Rural Finance Institutions (RFIs), supervision of RFIs and outreach expansion. Banks and other RFIs continued to expand their micro credit operations in the North and the East during the year. Two commercial banks joined the Central Bank to expand micro credit programmes to the North and the East with the assistance of Japan Bank for International Co-operation (JBIC) in the latter part of the year.

Microfinance delivery systems were improved with the involvement of a large number of lending institutions in the sector and by linking Microfinance Institutions (MFIs) with formal banking institutions. The microfinance schemes were implemented by the leading domestic private banks using their own funds and with the support of donor funds, during the year. The operations of the two microfinance programmes implemented by the Central Bank; the Small Farmers and the Landless Credit Project (SFLCP – ISURU) and the Poverty Alleviation and Microfinance Project (PAMP), covering 10 districts, continued through a network of leading microfinance delivery institutions. Cultivation loans granted under the New Comprehensive Rural Credit Scheme (NCRCS) showed a remarkable expansion throughout the country. During 2004, the interest subsidy provided to lending banks by the government under the NCRCS was reduced from 8 per cent to 6 per cent while the on lending rate remained unchanged at 8 per cent per annum. The government, recognizing the Forward Sales Contract System (FSCS) as a successful mechanism to ensure a remunerative price for farmers, enhanced the upper limit of the marketing loans under the FSCS, from Rs.5 million to Rs.25 million per borrower.

During the year, all six RDBs registered a satisfactory performance in all the important areas of financial intermediation while maintaining single digit net non-performing loan ratios. Furthermore, all RDBs became profitable ventures and provided funds to micro and small enterprises in their respective regions.

Enhancement of Access to Finance

With a view to enhancing income generating activity through capacity building, measures were taken to enhance access to finance of SMEs and low-income groups. The Financial Sector Cluster (FSC) appointed in July 2004 under the National Council of Economic Development (NCED) was in the process of initiating, formulating and implementing programmes to enhance financial outreach to local entrepreneurs, SMEs and the rural sector, by making available finance at a reasonable cost and enhancing the formal financial sectors' accessibility to sectors with potential for growth.

Table 8.10

Non-cash Payments: Volume and Value of Transactions

Payments System	2003 Volume ('000)	2003 Value (Rs.bn.)	2004 Volume ('000)	2004 Value (Rs.bn.)
Large Value Payment Systems				
CBSL Current Account Settlement System (a)	103	12,749.8	-	-
RTGS System (b)	38	4,210.0	138	13,701
Retail Payment Systems				
Main Cheque Clearing System	36,483	2,676.6	37,690	2,965.2
Rupee Draft Clearing System	n.a.	4.4	n.a.	5.1
Regional Cheque Clearing Systems	1,342	50.6	1,302	52.6
Sri Lanka Interbank Payment System (SLIPS)	2,017	979.3	2,411	60.0
Credit Cards	7,676	23.2	9,759	33.3
Debit Cards	238	0.7	355	0.9
Internet Banking	188	80.9	439	110.0
Phone Banking	88	1.5	64	4.7
Postal Instruments	n.a.	11.1	n.a.	11.5
Total	48,173	20,788.1	52,158	16,944.3
US Dollar Cheque Clearing System	86	10.7	102	14.0

(a) From 01 January to 05 September 2003
(b) From 08 September to end December 2003

Source: Central Bank of Sri Lanka

There were 14 micro finance and other credit schemes operated by the Central Bank with an outstanding loan balance of Rs. 9.6 billion as at the end of 2004. In addition, there was a number of micro finance schemes being operated by banks and non-governmental organizations.

Several policy measures were implemented in 2004 to improve the financial system and to enhance the access to finance. During the year, a license was granted to a government-owned SME bank to operate as an LSB to specially cater to the needs of the small and medium enterprises sector. The SME Bank, a proposal in the Budget 2005, was set up in March 2005. The Central Bank launched a concessionary refinance credit scheme "Susahana" with an initial funding allocation of Rs. 5 billion to assist micro, small and medium scale enterprises affected by the tsunami disaster.

Action has been taken to amend the Credit Information Bureau Act to enable it to maintain credit information of SMEs and micro enterprises. In order to enhance the mobilization of rural savings, it has been proposed to link the postal savings outlets (4,048 outlets at present) on-line to the branches of the NSB. Banks have been requested by the FSC to set up project consultancy units to assist SMEs in obtaining credit facilities from the banking system.

8.5 Financial Infrastructure

Payments and Settlement System

A developed payments and settlement system improves the efficiency of the financial sector by improving the speed of financial transactions, integrating financial markets and reducing settlement risks. The Central Bank has therefore embarked on developing and strengthening the Payments and Settlement System in addition to overseeing the payments systems.[4] The RTGS system was implemented in 2003 and "LankaSecure", which comprises of the Scripless Securities Settlement (SSS) system and the Scripless Securities Depository system, was successfully integrated with the RTGS system on 3 February 2004. In addition, the Automated General Ledger System and the Treasury Dealing Room Management System (TDRMS) of the Central Bank were completed in 2003.

LankaClear (Pvt.) Ltd. (LCPL) initiated a Cheque Imaging and Truncation (CIT) Project in 2004. This is an image-based cheque clearing system, which would replace the physical cheque flow, with an electronic information flow throughout the clearing cycle. This process eliminates the actual cheque movements, thereby reducing the delays associated with the movement of cheques. The CIT project will increase efficiency, reduce the operational cost and expedite the clearing process.

To strengthen the legal infrastructure relating to retail payments and the acceptance of electronic presentment of cheques, the Central Bank initiated the drafting of a Payments and Settlement Systems law in 2004. The draft law is expected to be presented to the Parliament in 2005.

Real Time Gross Settlement (RTGS) system: The high value inter-bank payments and settlement system in Sri Lanka known as the RTGS System, completed its first year of operations successfully during the year under review.

During the year, the RTGS system settled 138,119 transactions worth Rs.13,701 billion (as high as 7 times the GDP), among direct participating institutions (including the

4 In 2004, as a part of the modernisation process of payments systems, the Central Bank in collaboration with the BIS published a report on the payment systems in Sri Lanka, known as the Red Book, thus becoming the 3rd country in the Asian region to do so after Singapore and Korea.

Box 9

Cheque Imaging and Truncation

In modern money economies, cheque is the most commonly used mode of payment, apart from cash. In Sri Lanka, cheques are used for effecting low value retail payments and clearance is done by an automated clearing house operated by LankaClear Ltd. In the clearing process, physical cheques presented to banks are sent to LankaClear, which in turn sorts and distributes the same to the receiving bank/branch, in addition to effecting the payment and settlement. This process takes around 1-7 days (upto 7 in uncleared areas in the Northern and Eastern provinces) depending on the locations of the presenting and receiving banks due to the time taken for transporting the cheques using courier services.

Any efficient cheque payment system should reduce the delays, associated transaction costs and operational and systemic risks to a minimum level. In this sense, the present physical cheque transfer system needs further substantial improvements. The suggested solution has been to resorting to a cheque imaging and truncation system.

In cheque imaging, the image of the physical cheque is captured and will be converted to a digital form that a computer can read through conversion of differences in colouring and shading on the surface of the cheque. The physical cheque will be held at the image capturing point, a regional collection centre or at the presenting bank/branch if the images are sent directly to the Central Processing Management Unit. The images captured is transmitted through communication lines to the main clearing centre for sorting of images instead of the present practice of the physical cheque being sorted at LankaClear, thus truncating its physical movement at the source itself which is either the Regional Centre or the presenting bank. The sorted images will be transmitted to the receiving banks through the same communication lines which will significantly reduce the time taken, an improvement of the present system.

LankaClear has embarked on a Cheque Imaging and Truncation Project(CITP) which is expected to be implemented by September 2005. The project is jointly handled by LankaClear and Central Bank of Sri Lanka. Accordingly, the Hardware for the project is funded by Central Bank of Sri Lanka while the software is funded by LankaClear.

Under the new system, ten regional clearing centres for collection of physical cheques and for image capturing purposes. The Regional Service Bureaus will be located in Jaffna, Anuradhapura, Ampara, Badulla, Kandy, Polonnaruwa, Kurunegala, Nuwaraeliya, Rathnapura, Matara and Colombo. Hence, it is envisaged that the cheque clearing process for all regions will be reduced to one day (T+1 or in some cases, T + 2 where T = Date of presentation to LankaClear).

The following changes will take place to the present cheque clearing system:

(i) Image Friendly Cheques

A lighter plain background colour has been introduced to the cheque leaf to ensure readability of the image as the physical cheque will not be available for presentation. Banks have already commenced distribution of image friendly cheques to customers.

(ii) Cheque Size

The present practice of having two sizes of cheques separately for corporate and personal customers will be replaced with a single size at 7" x 3 1/2". There will be no change in the format of the Magnetic Ink Character Recognition (MICR) line. The Image of both front and the back of the cheque will be captured through the system.

(iii) Image Return Document (IRD)

IRD will replace the original cheques for the purpose of re-presentment for clearing under the CIT system and will serve as the notice of dishonour. IRD includes the image of the returned cheque and all other relevant information along with the reason for rejection. The receiving banks will identify the images of cheque returns and transmit the images to the Main Clearing centre, which will forward the return images to the presenting Regional Centre or the bank. For all returned cheque images, IRD will be printed at the point of capturing of the image, which is either the Regional Centre or the presenting bank. An IRD could be presented only up to a maximum of 2 times within a period of 6 months after the first presentation. IRD will completely eradicate the physical flow of the paper based cheque which is truncated at the presenting bank/branch or at Regional Centre level.

Benefits of CIT

Introduction of CIT will generate benefits to both banks and to customers. It will reduce risks, delays, loss of cheques in transit and facilitate electronic validation of information in the cheque. Further, it will significantly reduce the realisation time for outstation cheques. Ability to centrally archive the images will reduce retrieval time of past information and expedite query handling. The banks will also benefit through efficiency of cheque clearing operations, reduction of costs associated with physical handling and transportation of cheques, automatic posting of accounts and signature verifications. This will also reduce the opportunity for frauds and enable banks to centralise their operations.

Central Bank) and customer-to-customer, through direct participating institutions. They included transactions in the call market, the government securities market and the foreign exchange market (rupee leg); the Central Bank OMO; inter-bank net clearing obligations/claims under cheques and SLIPS clearing systems; and regional cheque clearing conducted by the regional offices of the Central Bank.

Considering the possible liquidity constraints of participants, the Central Bank provided the Intraday Liquidity Facility (ILF) against the collateral of government securities and on an interest-free basis, since the commencement of the RTGS System. In 2003, participants used this facility heavily as a precautionary measure, but both the value of the ILF taken and the number of users declined in 2004. The maximum value of the ILF taken in a single day in 2004 was Rs.6.2 billion, while the average value of the ILF taken was Rs.2.8 billion during the year. On average, per day, 7 participants obtained the ILF during 2004.

Scripless Securities Settlement (SSS) System: The activities of the SSS system commenced operations on 03 February 2004. All the new issues of Treasury bills and Treasury bonds were in scripless form since 30 January 2004 and a majority of government securities that had been issued in scrip form were converted to scripless form. The total value of scripless securities held in LankaSecure reached Rs.796 billion by the end of 2004. These securities comprised of Treasury bills amounting to Rs. 240 billion and Treasury bonds amounting Rs. 556 billion. The total number of beneficiary accounts relating to the portfolios of individual and corporate customers maintained at LankaSecure through direct participants at the end of 2004 was 23,377.

Legislative Reforms

In order to keep pace with the developments in the financial markets, the Central bank continued its efforts to review the existing legal framework, while introducing new legislation. In 2004, the Central Bank introduced a system for the electronic issue, transfer and recording of government and Central Bank securities and an electronic real time gross settlement system for large value payments between banks and other participants in the system.

Legislative changes required to implement the real time gross settlement system were introduced by amending the Monetary Law Act in 2002. Extensive changes in the RSSO and the LTBO were requird to implement the SSS system. These changes were introduced in 2004 by way of amendments to the two Ordinances.

The legal issues that arose in transiting from scrip based government securities to electronic securities included issues relating to recording and transfer of title and modes of carrying out other transactions (e.g. pledges). Additionally, as all records are maintained electronically, the legal validity of such records had to be strengthened. Accordingly, the changes introduced to the RSSO and the LTBO in 2004 provide for, among others, the establishment and the maintenance of a central depository in the Central Bank to maintain records of title and other interests in scripless securities, strengthening the legal validity of electronic records and the increase of fines applicable to offences committed under the Act to enable such fines to be based on the monetary gain made or loss incurred on account of the offence.

Regulation and Supervision

The Central Bank, which supervises and regulates all major institutions in the financial sector, focused more on the risk management aspects to improve stability of the financial sector. The institutions supervised and regulated by the Central Bank include LCBs, LSBs, registered finance companies and PDs. The Central Bank also oversees the payments and settlement system and registers and monitors finance leasing establishments. In addition, the Central Bank regulates money changers and manages the EPF. The Securities and Exchange Commission (SEC) is responsible for licensing and regulating the stock exchange, stock brokers and unit trust companies. The SEC also registers underwriters, margin providers, credit rating agencies, investment managers and securities clearing houses. The Insurance Board of Sri Lanka (IBSL) regulates the insurance industry with a view to safeguarding the interests of the policy holders.

The Central Bank supervises and regulates financial institutions through both off-site surveillance and on–site examinations, based on a risk-based supervisory approach, to identify the risks faced by these institutions and monitor their risk management strategies, in order to ensure that the risks undertaken by these institutions are commensurate with their resource profiles. These activities were further strengthened through continuous dialogue with market participants. With regard to the banking sector, a number of prudential directions and guidelines were issued in 2004 to strengthen further the regulatory and supervisory framework. The major changes implemented were the computation of the capital adequacy ratio on a consolidated basis, the issuing of guidelines to external auditors, requiring statutory liquid assets to be maintained in US dollars in respect of the FCBU separately, removing restrictions in relation to the payment of interest by commercial banks where more than four withdrawals have been made during a month and improving the classification of bad and doubtful advances for provisioning purposes. Further, measures were also taken to create awareness about the new Basel Capital Accord among the banking institutions

Although, new regulations were not issued in relation to the operations of finance companies, two directions were issued in relation to the activities of the PDs. A direction was issued to PDs to prevent short selling of securities, i.e., selling of securities without actually holding the relevant securities in their portfolio, to counteract high market volatility. Another direction was issued to prevent PDs from having adjusted trading or using away prices for recording their transactions.

Box 10

The New Basel Capital Accord

The new capital accord formulated by the Basel Committee titled "International Convergence of Capital Measurement and Capital Standards: a Revised Framework (Basel II)", includes new options available to supervisors and banks for assessing capital adequacy. Basel II incorporates much of the latest "technology" in the financial arena for managing risk and allocating capital to cover risk. The new accord is more extensive and complex than the existing accord, which has been in force since 1988. The ultimate goal of Basel II is to strengthen financial systems, both in the Basel Committee member countries and elsewhere. The revised framework offers a range of options from which supervisors may choose. The most sophisticated options require extensive preparation and adequate resource allocation on the part of both banks and their supervisory authorities. The New Accord, will be introduced from year 2007.

The new Accord is based on three 'pillars': capital requirements, supervisory review, and market discipline. In Pillar I, the capital requirements are based on banks' own measurement of risks. The new framework is based on the premise that discipline by the markets and by supervisors is beneficial.

Basel II not only promotes improvements in risk management and regulatory capital allocation but also raises a variety of implementational challenges for both supervisors and banks. The banking supervisory community has been focusing a great deal in the recent past on changes to the existing capital accord (Basel I). The new Accord, while affecting capital regulation, will also influence the way in which banking supervision is conceived and conducted. Basel II is also based on the understanding that minimum capital requirements are in themselves not enough to ensure a safe and sound banking system. The new framework will be more comprehensive and sensitive to banking risks than the current Capital Accord. The emphasis will be put on banks' own assessments of risks, and incentives will be provided to banks to further improve their risk measurement and management systems. To achieve these goals, Basel II is structured on three mutually reinforcing pillars as mentioned above.

Pillar I: Minimum capital requirements include capital charges for credit risk and operational risk, in addition to the capital charges for market risk established in 1996. Pillar I provides an evolutionary structure for the calculation of these capital charges; that is, banks with a greater level of sophistication are allowed to use increasingly advanced methodologies. For credit risk, this evolutionary structure includes the standardized approach, conceptually similar to the 1988 Capital Accord, although allowing a greater degree of risk weight differentiation based on external ratings, and the internal ratings-based (IRB) approach, which relies on banks' internal assessment of the components that define the risk of a credit exposure.

The IRB approach, in turn, comprises two different methodologies: the foundation and advanced IRB approaches, depending on the sophistication of risk management systems of the banks. A similar structure applies for operational risk. This new, risk-sensitive framework is strengthened with the introduction of rules for wider recognition of credit risk mitigation techniques and new rules for the treatment of asset securitization.

The new capital adequacy proposals are geared to broadly maintaining the current level of regulatory capital in the global financial system, and do not intend to raise or lower the overall level of capital requirements. However, these may increase or decrease for individual banks depending on their risk profiles. As the proposals are more finely attuned to banking risks, banks with good risk management systems and/or low risk profiles, may have lower capital requirements, and is thus an incentive to move towards better risk management systems and practices.

Pillar II: The supervisory review process, closely linked to the Basel Core Principles, goes beyond verifying that banks comply with minimum capital requirements, and ensures that banks' capital is aligned with their level of risk and degree of sophistication. Pillar II is based on four principles: (i) the bank is primarily responsible for calculating and maintaining a proper level of capital; (ii) supervisors have the ability to evaluate banks' internal capital adequacy measures; (iii) supervisors have the ability to require banks to hold capital above the minimum when they estimate that capital levels are not adequate; and (iv) supervisors have the ability to intervene at an early stage and enforce remedial actions if bank capital falls below prudential levels.

Pillar III: Market discipline is a powerful tool that introduces strong incentives for banks to put in place safe and sound risk management policies and practices. Pillar III focuses on the core disclosures relevant to exercise effective market discipline: asset quality, amount of capital, risk profile and capital adequacy, as well as information on the details of internal systems of banks adopting the IRB approach.

Pillar II implies significant additional responsibilities for supervisors, including, for instance, evaluating banks' internal capital assessment processes or selecting which credit rating agencies are acceptable.

Box 10 (Contd.)

Pillar III puts increased emphasis on market discipline and requires banks to disclose more information. Supervisors will need adequate powers to ensure that banks' management disclose appropriate and accurate information.

Much of the complexity of the new accord stems from the diversity existing in the real world. By providing a range of options the new Accord tries to align the regulatory framework to each bank's risk profile. In developing Basel II, the Basel Committee sought to balance simplicity and risk sensitivity. This balance is particularly difficult in an industry like banking, where a culture of constant innovation makes it a tall order for regulators to develop simple rules that fit all banking products and services.

Compatible with the Central Bank of Sri Lanka's goal to have consistency and harmony with international standards and its approach to adapt to a pace that is appropriate in the context of country specific needs, the Central Bank has accepted, in principle, to adopt the new capital accord. Banks in Sri Lanka have been required to do a self-assessment on the implications of Basel II on their respective banks for a plan of migration by January 2007. The Central Bank will be closely monitoring the progress made by banks in this direction. At a minimum all banks in Sri Lanka, to begin with, will adopt the Standardized Approach for credit risk together with an explicit capital charge for market risk and operational risk. After adequate skills are developed, both in banks and at the supervisory level, some banks may be allowed to migrate to the IRB Approach.

Among the banks in Sri Lanka, the degree of sophistication in terms of risk management practices differs with banks from G-10 countries. The degree of readiness for Basel II compliance among banks in Sri Lanka differs widely. Some banks have initiated the process of collecting risk data and even have some years of risk data in place while, others are still to commence their preparation for Basel II.

Credit Rating and Credit Information

The Budget 2004 made it mandatory for all deposit taking institutions operating in Sri Lanka to obtain an entity rating from an approved credit rating agency and publish such rating. Credit ratings are also now mandatory for issues of all varieties of debt instruments where the value exceeds Rs. 100 million except for those issued by the government.

Banks operating in Sri Lanka have been advised to obtain and publicise a rating before end June 2005. By end-February 2005, 20 financial institutions had published credit ratings obtained from Fitch Ratings Lanka Ltd., which continues to be the only credit rating company operating in Sri Lanka. Among these were 11 commercial banks, including one foreign bank, 6 specialised banks one finance company, one primary dealer and one leasing company. Most foreign banks operating in Sri Lanka had submitted the rating obtained by the parent bank.

The Credit Information Bureau of Sri Lanka (CRIB) collects and collates information on borrowers and furnishes such information to its shareholding institutions. Its major shareholder is the Central Bank, which holds 49 per cent of the issued share capital, while commercial banks, specialised banks, regional development banks, registered finance companies, leasing companies and the National Development Trust Fund hold the balance share capital. While the CRIB continued to collect information on regular advances of Rs. 500,000 and over and irregular advances of Rs. 100,000 and over, there were 89 reporting institutions by 2004.

The CRIB issued 501,176 credit reports in 2004, an increase of 29 per cent in comparison to the 389,171 reports issued in 2003. While this increase reflects the higher demand for credit along with the continued recovery in economic activity, it also demonstrates that credit information is used as an important risk management tool by lending institutions.

It has been proposed to amend the CRIB Act to enable the use of credit information more widely and effectively in order to improve access to finance and reduce credit risk.

8.6 Financial System Stability

Financial stability encompasses stability in the macroeconomic environment, soundness of the users of the financial system and the systemically important financial institutions (SIFIs) and stability in markets and soundness of infrastructure. A stable financial system fosters a stable payments and settlement system, facilitating the smooth functioning of economic activities of a country. Maintaining financial system stability is one of the two major objectives of the Central Bank following the amendments made to the Monetary Law Act in 2002.

In 2004, domestic and external macroeconomic developments did not pose major risks to the maintenance of stability in the financial system. However, increased imbalances on the monetary and fiscal fronts as reflected by the high private sector credit growth, rising inflation and excessive government borrowing from the domestic market could have an impact on the risk levels in the future.

Box 11

The Economic Impact of Pyramid Schemes

The operation of Pyramid Schemes in various guises has been a common feature in many financial markets. They normally gain popularity among gullible members of the public by promising unbelievably high stakes through well orchestrated propaganda and targeted marketing. Since pyramids cannot continue to expand indefinitely sooner or later the schemes are bound to collapse with profits for early members and losses for others. In early 1990s, certain economies like Albania, suffered the negative economic implications of pyramid schemes and the collapse of such schemes created widespread social unrest and economic dislocation. The adverse experiences gained by countries in this respect signify the danger of permitting such schemes to continue to operate in a country.

Pyramid Schemes

A "Pyramid Scheme" is defined as a plan, scheme or any program of action under which a person makes an investment to get the right to recruit others into the scheme for which he receives a consideration (money or anything of value); and, the new recruits also make an investment to get the right to further recruit and receive consideration for getting others to participate. Such a scheme is called a pyramid scheme because; over time a hierarchy of participants resembling a pyramid is formed with the introduction of new and large layers of participants to the scheme.

The Operation of Pyramid Schemes

Pyramid schemes exploit the greed of individuals with limited knowledge of business who are duped to believe that they could get rich quickly with minimum effort earning incomes that would grow exponentially with the expansion of the pyramid as indicated below:

Suppose a person recruiting 10 new participants at the first level receives a payoff of Rs.10 and continues to receive payoffs with the growth of the pyramid, the pyramid will have the following structure:

Level	Multiples	Participants
01	1 x 10	10
02	10 x 10	100
03	100 x 10	1,000
04	1,000 x 10	10,000
05	10,000 x 10	100,000
06	100,000 x 10	1,000,000
07	1,000,000 x 10	10,000,000
	Total Participants	11,111,111

As the promoters of such a pyramid scheme explain once this process goes on to 7 layers, the top person would receive a pay-off of Rs.11,111,110. However, at the 7th layer the number of recruits have already reached 10 million. Given a country of the size of Sri Lanka it is unlikely that such a pyramid would go to seven layers. Even so, the 10 million persons at the bottom of the pyramid will not be in a position to recruit the required 100 million persons within Sri Lanka to continue the pyramid and it would automatically collapse. Even if the pyramid can be continued in a foreign country, the ultimate collapse of the pyramid is inevitable for the following reasons:

i. The number of potential participants are finite and limited and therefore before long, the scheme collapses for want of new markets to sustain it further.

ii. No new wealth is created, the only wealth gained by a participant is wealth lost by other participants who join the scheme at the later laps.

Economic Impact of Pyramid Schemes

Due to adverse impact of pyramid schemes on the economy, many countries have taken steps to prohibit such schemes by law. One of the dangers to the economy where there is wide scale participation in these schemes is that the wealth distribution is drastically altered with a few persons receiving huge payoffs. The widespread unearned income in this manner promotes rent seeking desires of individuals which are considered as directly unproductive economic activities. In addition, a pyramid scheme which is operated from abroad would result in a large capital outflow causing either a depreciation of the currency or a drop in official reserves. Finally and perhaps the most important from the point of view of a central bank, is the danger of persons using borrowed funds (including funds drawn through credit cards) to participate in pyramid type schemes with the expectation of paying back loans from their returns. The collapse of pyramid schemes would result in large scale default by borrowers and could **destabilize the financial sector.**

Prevention of Pyramid Schemes

In the absence of any preventive legal status, the Central Bank of Sri Lanka took upon itself the task of educating the public of the risk and futility of joining pyramid schemes when there was evidence that one such scheme was operating in the country in the guise of a network marketer. The provisions of the Exchange Control Act were also used to deter individuals from using credit cards to make out payments. While this was successful in containing the spread of scheme, legal status was afforded to the Bank by amending the Banking Act by prohibiting the engagement in pyramid schemes as follows:

No person shall directly or indirectly initiate, offer, promote, advertise, conduct, finance, manage or direct a scheme where benefits earned by the participants to such a scheme are largely dependent on -

(a) increase in the number of participants

(b) increase the contributions made by the participants in the Scheme

Table 8.11

Soundness Indicators of Selected Financial Institutions

Per cent

Institution and Indicator	2003	2004 (a)
Licensed Commercial Banks		
Non Performing Loans to Gross Loans	13.7	10.0
Non Performing Loans net of Provisons to Capital	66.7	41.1
Regulatory Capital to Risk Weighted Assets	10.4	9.1
Return on Assets (ROA)	1.4	1.2
Return on Equity (ROE)	21.9	16.4
Interest Margin to Gross Income	36.8	39.1
Non Interest Expense to Gross Income	37.6	42.6
Liquidity Ratio (DBUs)	26.2	26.2
Licensed Specialised Banks		
Non Performing Loans to Gross Loans	12.4	10.9
Non Performing Loans net of Provisons to Capital	24.9	22.3
Regulatory Capital to Risk Weighted Assets	24.9	16.6
Return on Assets (ROA)	3.2	2.6
Return on Equity (ROE)	22.8	17.8
Interest Margin to Gross Income	35.6	41.7
Non Interest Expense to Gross Income	18.6	22.5
Liquidity Ratio	60.3	69.4
Finance Companies		
Non Performing Loans to Gross Loans	8.1	9.7
Non Performing Loans net of Provisons to Capital	5.0	5.1
Regulatory Capital to Risk Weighted Assets	12.1	15.2
Return on Assets (ROA)	1.3	2.3
Return on Equity (ROE)	26.7	24.3
Interest Margin to Gross Income	21.4	28.1
Non Interest Expense to Gross Income	28.2	28.6
Liquidity Ratio	15.4	15.9

(a) Provisional Source: Central Bank of Sri Lanka

SIFIs, which include LCBs, LSBs, FCs, and the EPF, hold about 72 per cent of the financial assets. Their financial health remained satisfactory in 2004 as reflected by major indicators.

Major risks impacting on SIFIs are credit or default risk, liquidity risk, market risk and operational risk. The stability and soundness of the SIFIs strengthend, reducing the overall systemic risk. This was reflected in the decline in non performing loans, increases in capital funds, loan loss provisions and the level of liquid assets. The credit risk, as measured by the NPL ratio of LCBs, declined to 10 per cent in 2004 from 14 per cent in 2003. The credit risk further declined as the level of loan loss provisions improved to 61 per cent of total NPLs from 58 per cent in 2003.

Generally, capital and earnings reflect the capacity of an institution to absorb external shocks. Capital and pre-tax profits of the SIFIs recorded an improvement in 2004. However, the after tax profits of LCBs decreased in 2004, as a result of a decline in the interest spread, an increase in non interest expenses, and a decline in non-interest income as a result of capital losses from government security holdings. The profitability of LCBs, as measured by the Return on Assets (ROA) and Return on Equity (ROE), too declined. Profitability of LSBs also declined as a results of a significant decline in non-interest income, i.e., by 29 percent, arising from capital losses on government security trading, despite the gains from a 13 per cent increase in interest income and the lower increases in non-interest expenses and loan loss provisions.

Meanwhile, in 2004, capital funds of LCBs increased in absolute terms. The rate of increase in capital funds was 22 percent in 2004 as against 41 percent in 2003. The ratio of capital to net NPLs (NPLs net of provisions) increased significantly over the previous year, providing a greater capacity to absorb losses. However, the Capital Adequacy Ratio (CAR), the ratio of capital funds to risk weighted assets, declined from 10.4 percent as at end 2003 to 9.1 per cent as at end 2004, mainly due to the effect of the negative net worth of one bank. It was below the regulatory minimum for CAR of 10 per cent, but above the international minimum of 8 per cent. Furthermore, the core CAR, which mainly consists of owners' capital, was 8.2 per cent, compared to the regulatory minimum of 5 per cent. As these requirements are the minimum, it is prudent for banks to improve further their capital in order to meet potential adverse shocks successfully. However, capital funds of LSBs increased by 16.2 per cent in 2004 as against a 23.5 per cent increase in 2003, despite the decline in profits. Similarly, the level of capital in relation to assets, loans, NPLs and deposits too improved in LSBs. As at end 2004, capital funds were adequate to cover 32 per cent of the total loan portfolio and more than twice the level of NPLs, implying a lower risk in relation to external shocks. Registered finance companies also recorded an improvement in terms of profits and capital in 2004.

Financial sector infrastructure, consisting of payments and settlement systems, the supervisory and regulatory regime, and the legal framework, further improved in 2004. With regard to the payments and settlement system, the newly introduced RTGS would help reduce settlement risks. The supervisory and regulatory framework too strengthened with the imposition of new prudential regulations. The legal system relating to the financial sector was reformed with a view to improving the stability of the financial sector.

As almost the entirety of the investments of the EPF was in government securities, the EPF faces a relatively low risk level. Moreover, since its receipts continued to be greater than the cash outflows, it did not face a liquidity risk. However, with the new accounting policy of the fund, it now faces an increasingly high interest rate risk, which has to be mitigated by appropriate measures such as building up reserves.

Within financial markets, although the stock market grew at a higher pace, it would not pose a threat to stability. The substantial increase in prices in the share market was consistent with the fundamentals of the corporate sector and hence did not indicate a risk of an asset price bubble situation.

During the year, the Central Bank took several legal and regulatory measures to improve and strengthen the soundness and stability of the financial system. They include increasing the minimum capital to 10 per cent of risk weighted assets, the imposition of a mandatory credit rating requirement, the consolidation of the liquid asset ratio at 20 per cent, the tightening of the requirements in relation to external auditors and the imposition of an additional provisioning requirement to cover tsunami affected loans. To strengthen the legal infrastructure relating to retail payments and the acceptance of electronic presentment of cheques, the Central Bank initiated drafting a Payments and Settlement Systems bill in 2004. Furthermore, the amendments to the Banking Act, which were passed in Parliament in 2004, will help strengthen financial stability through a further tightening of prudential regulations and the removal of legal deficiencies. The risks in the payments system were reduced with the establishment of a payments system oversight unit for the supervision of the RTGS, and the preparation of the business continuity plans for LCBs.

There are several downside risks, which could affect financial system stability in 2005. The world economic environment, though favourable at present, could become uncertain with the slowing down of global economic growth, the continuing uncertainties in relation to petroleum prices, international interest rates moving upward with the removal of policy stimuli, and the continuation of the significantly large destabilising twin deficits, i.e., the fiscal and the external current account deficits, in the USA. The domestic economic environment would face the risks of continuing uncertainty in relation to inflation, aid flows, fuel prices, and international trade, arising from the fall out effects of the termination of the MFA, and difficulties in achieving fiscal consolidation as required. The high credit expansion could also become a threat, if appropriate measures are not taken to ensure the accepted levels of asset quality. However, the sector will be able to manage those risks successfully with the continuing strengthening of the financial position and the improved risk management strategies, the strengthening of the regulatory and supervisory framework and the improvements in the payments and settlement systems.