Chapter 8

FINANCIAL SECTOR DEVELOPMENTS AND STABILITY

8.1 Overview

- **The financial sector expanded and remained resilient in 2005 overcoming the shocks, which impacted on the economy, bolstering economic development.** Financial institutions reported improved performance, both in terms of profits and soundness during 2005. Their array of financial products and services broadened. Access to finance was further enhanced with financial institutions offering new facilities, and with the setting up of a new institution catering especially to small and medium scale enterprises (SMEs). Activities in financial markets surged to record high levels. This was particularly so in the foreign exchange and share markets, which benefited from economic and political stability and real sector growth. Financial sector infrastructure was further improved with measures being taken to increase efficiency of the payment and settlement systems, the introduction of new legislation to facilitate the smooth functioning of the financial system and improvements made to the regulatory and supervisory framework in line with international best practices.

- **During 2005, several measures were taken by the Central Bank to further improve the efficiency and strength of the payment and settlement systems.** The Payment and Settlement Systems Act No. 28, which was enacted in September 2005, provides for the Central Bank to oversee the payment and settlement systems and money service providers and to facilitate the electronic presentment of cheques. The operations of the Real Time Gross Settlement (RTGS) system and the Scripless Securities Settlement (SSS) system, were expanded and efficiency enhanced through wider access and improvements to these systems. Preparatory work for the introduction of the Cheque Imaging and Truncation (CIT) system was completed and it is to be operational in early 2006. The CIT system will improve the processing of retail and low-value payments effected primarily through cheques by reducing the cheque realization times throughout the country thus benefiting the general public.

- **The regulatory and legal framework was further improved with measures introduced to strengthen both bank and non-bank institutions.** The Central Bank continued its efforts in preparing banks for the adoption of Basel II, which is scheduled to be in place by 2008, which will help better manage the risks faced by financial institutions. The fit and proper criteria for selecting boards of directors of financial institutions were further strengthened. Financial institutions were requested to enhance capital, and new regulations have been issued in relation to the single borrower limit, related party transactions and disclosure of information. The Central Bank continued its public awareness campaign aimed at educating the public on the risks of investing in unregulated and fraudulent financial institutions. A number of statutes relating to the financial sector were amended to improve the efficiency of the financial sector while promoting high standards of risk management and stability.

- **Financial system stability was further strengthened in 2005 as reflected by the improvements in key performance indicators of systemically important financial institutions and the payment and settlement system, though some downside risks exist.** The impact of exogenous shocks have not dissipated fully yet. The rising oil prices could further widen the current account deficit. Achieving fiscal consolidation is critical in strengthening macroeconomic stability and hence supporting financial system stability. The growth in credit to the private sector is still high and this has the potential to impair credit quality. Nevertheless, continuous strengthening of the legal and regulatory framework, enhancement of capital of financial institutions, improved risk management practices, efforts of the government aimed at fiscal

Table 8.1

Total Assets of the Financial System

	2004(a)		2005(b)	
	Rs.bn	Share in Total %	Rs. bn	Share in Total %
Banking Sector	1,892.7	68.7	2,193.9	69.8
Central Bank	414.0	15.0	440.6	14.0
Licensed Commercial Banks (c)	1,161.4	42.1	1,448.9	46.1
Licensed Specialised Banks	317.3	11.5	304.4	9.7
Non Bank Deposit Taking Financial Institutions	97.1	3.5	119.2	3.8
Registered Finance Companies	66.2	2.4	87.5	2.8
Co-operative Rural Banks	25.8	0.9	26.5	0.8
Thrift and Credit Co-op. Societies	5.1	0.2	5.2	0.2
Other Specialised Financial Institutions	135.9	4.9	137.9	4.4
Primary Dealers	61.4	2.2	44.6	1.4
Specialised Leasing Companies	47.8	1.7	63.2	2.0
Merchant Banks	21.0	0.8	24.0	0.8
Unit Trusts	4.2	0.2	4.6	0.1
Venture Capital Companies	1.5	0.1	1.5	0.0
Contractual Savings Institutions	630.3	22.9	693.7	22.1
Employees' Provident Fund	379.4	13.8	424.0	13.5
Employees' Trust Fund	51.8	1.9	58.6	1.9
Private Provident Funds	104.8	3.8	106.2	3.4
Insurance Companies	94.3	3.4	104.9	3.3
Total	2,756.0	100.0	3,144.7	100.0

Source : Central Bank of Sri Lanka

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

consolidation, and continued market discipline would help mitigate and manage risks. A further measure taken towards this end is the publication of the Financial Stability Report by the Central Bank.

- **The resolution of several important issues in relation to the cost of intermediation, the supervision of conglomerates and improved corporate governance may further enhance the resilience and stability of the financial system.** The intermediation cost of banks represented by the interest spread has declined in the recent past, but still remains high relative to regional standards. Efforts need to be made by banks to improve efficiency and increase productivity to lower high operational costs which raise the intermediation cost. Recent issues relating to the concentration of share ownership of financial institutions, which undermine public and investor confidence, underscore the necessity of strengthening corporate governance in financial institutions. This has been visible in the cross shareholdings in financial conglomerates and the resulting conflicts of interest. The Central Bank has already taken initiatives to enhance corporate governance through the strict enforcement of the Banking Act, the imposition of market discipline and through greater disclosure.

8.2 Developments in Financial Institutions

- **Financial institutions expanded and improved further in 2005, enhancing the capacity and the capability of the financial sector to effectively support the financial needs of the economy.** The number of insurance and leasing institutions increased. Although the number of banks increased with the establishment of a government owned specialized bank, the SME Bank, the number of banks at the end of the year remained unchanged as a result of the merger of a licensed specialised bank with a licensed commercial bank. Total assets of financial institutions increased by 14 per cent mainly due to the sustained expansion in credit operations. Licensed commercial banks (LCBs) and licensed specialised banks (LSBs) hold a dominant position in the financial sector contributing about 56 per cent of the financial assets. Within the banking sector, LCBs continued to be the largest mobiliser of deposits. Notable developments in the banking sector were the measures taken to enhance the capital requirements and the preparatory work undertaken towards implementing the Basle II capital accord in 2008, which will help strengthen the risk management practices and the efficiency of the banking sector.

The Central Bank of Sri Lanka

- **The total assets of the Central Bank increased by 6.4 per cent in 2005 with a sharp increase in its net foreign assets (NFA).** Net domestic assets (NDA) of the Central Bank declined following the sterilisation of the liquidity created by the increase in NFA through aggressive Open Market Operations (OMOs).

- **The country experienced significant amounts of foreign inflows of funds through grants, loans, debt relief and remittances, which led to an overall improvement in the NFA and resulted in a BOP surplus.** The sale of foreign currency proceeds received by the government in the form of grants and loans from foreign sources and foreign currency borrowings from domestic foreign currency banking units, to the Central Bank led to the increase in NFA and consequently an increase in rupee liquidity in the market. The excess liquidity was absorbed through OMOs, leading to a decline in Treasury bill holdings of the Central Bank and a corresponding decline in NDA.

- **On the liability side, the total currency issue of the Central Bank increased by 14 per cent (Rs. 16.5 billion) reflecting the increased demand for currency for transactions.** The deposits of commercial banks held by the Central Bank for statutory reserve purposes increased by 19 per cent (Rs. 10 billion) along with the growth in deposit liabilities of commercial banks.

Licensed Commercial Banks

- **The activities of licensed commercial banks (LCBs) expanded with enhanced outreach, expanding the product**

Table 8.2

Distribution of Banks and Bank Branches

Category	End 2004 (a)	End 2005 (b)
Licensed Commercial Banks (LCBs)		
I.Total No.of LCBs	22	22
Domestic banks	11	11
Foreign banks	11	11
II.Total No. of LCB Branches and Other Outlets	2,540	3,100
Branches (c)	1,374	1,405
Domestic Bank Branches	1,341	1,368
Main Branches	1,090	1,106
ASC Branches	-	-
Kachcheri Branches	22	22
Extension/Pay Offices/Service Counters	219	229
Overseas Branches	10	11
Foreign Bank Branches and Othe Outlets	33	37
Branches (d)	27	30
Other Outlets	6	7
Pawning Centres	188	194
Student Savings Units	978	1,501
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	406	404
Branches	374	369
Regional Development Banks	196	197
National Savings Bank	112	114
Long-term Lending Institutions	23	11
Housing Finance Institutions	27	27
Private Savings and Development Banks	16	20
Other Outlets	32	35
Total No. of Bank Branches and Other Outlets	2,946	3,504

Source : Central Bank of Sri Lanka

(a) Revised
(b) Provisional
(c) Includes Head Offices. Excludes Pawning Centres and Student Savings Units.
(d) Includes extension offices and sub branches

range and improving service quality. The LCBs, numbering 22, expanded their services, through a network of 1,405 branches, and 1,695 other service outlets. Banking density, *i.e.*, the number of bank branches per hundred thousand persons, improved from 7.1 in 2004 to 7.2 in 2005, improving the accessibility of banking services in the country. The total number of automated teller machines and electronic fund transfer facilities at the point of sae (EFTPOS) increased to 901 and 7,013 in 2005 from 810 and 6,542, respectively, in 2004. A number of banks expanded their range of banking products, especially technology-based delivery products such as phone banking, e-banking, and credit cards. While some of these products had added features, banks also introduced new deposit schemes and loan schemes.

- **As commercial banking operations expanded and their financial strength improved, measures were taken to improve bank surveillance through enhanced prudential regulations and corporate governance.** Improvements were made to the disclosure requirements to enhance transparency of banks. Banks were required to disclose their key financial performance indicators, including non-performing loans (NPLs) and capital adequacy, to foster market discipline. Those measures are expected to make banks more conscious of the need to better manage their risks. Commercial banks also took several initiatives in this regard, especially in the areas of credit and operational risks. A number of banks had strengthened their bad loan recoveries and introduced credit scoring methods to retail customers. All banks had obtained credit ratings under the mandatory rating introduced in 2004, though the ratings of a few banks are yet to be published.

- **Developments in the Structure of Licensed Commercial Banks: The total assets of LCBs increased further by 22 per cent in 2005 compared to the 17 per cent growth in 2004. This growth was propelled by the sustained expansion in economic activity and the robust demand for credit from corporate and household sectors.** Within the banking sector, the highest growth of 36 per cent in assets was recorded in foreign banks, which was partly a result of the additional capital brought in to augment their asset base. This contributed to increasing the share of foreign banks' assets in total assets as well. Assets of domestic private banks, which recorded the next highest growth in terms of assets, rose by 23 per cent, increasing their share in total assets and competition in the banking sector. Accordingly, the share of the state banks in total assets declined further.

- **The major share of loans has been granted by domestic private banks followed by the state banks.** With their increased resources, the highest growth in credit to the private sector was recorded in foreign banks, though they contributed only 14 per cent of overall credit. The next highest growth was

Table 8.3

Assets and Liabilities of Licensed Commercial Banks

Rs. million

Item	End 2004	End 2005 (a)	Change 2004 Amount	Change 2004 %	Change 2005 Amount	Change 2005 %
Assets						
Liquid Assets	275,756	331,066	29,982	12.2	55,310	20.1
Cash on Hand	16,240	18,366	3,056	23.2	2,127	13.1
Due from Central Bank	54,664	69,880	16,765	44.2	15,216	27.8
Foreign Currency Denominated Assets	118,677	137,020	42,018	54.8	18,343	15.5
Treasury Bills	38,234	36,750	(3,328)	(8.0)	(1,484)	(3.9)
Treasury Bonds (b)	31,929	53,099	(30,098)	(48.5)	21,170	66.3
Commercial Bills	16,013	15,950	1,570	10.9	(63)	(0.4)
Loans and Overdrafts	634,651	753,521	120,228	23.4	118,870	18.7
Loans	499,604	608,181	104,909	26.6	108,577	21.7
Overdrafts	135,048	145,340	15,319	12.8	10,293	7.6
Fixed and Other Assets	139,126	161,822	(94,901)	(40.6)	22,696	16.3
Liabilities						
Capital Accounts	77,220	103,088	2,023	2.7	25,868	33.5
Total Deposits	842,932	1,002,381	142,440	20.3	159,449	18.9
Demand Deposits	110,900	145,082	16,779	17.8	34,181	30.8
Time & Savings Deposits	732,031	857,300	125,661	20.7	125,268	17.1
Borrowings	41,528	50,318	363	0.9	8,790	21.2
Local Borrowings	33,946	42,303	(2,237)	(6.2)	8,357	24.6
Foreign Borrowings	7,583	8,015	2,600	52.2	433	5.7
Other Liabilities	199,740	257,143	22,369	12.6	57,403	28.7
Total Assets/Liabilities	**1,161,420**	**1,412,930**	**167,195**	**16.8**	**251,510**	**21.7**

Source: Central Bank of Sri Lanka.

(a) Excluding assets/liabilities of NDB which merged with NDB Bank with effect from August 2005.
Total assets/liabilities at end 2005 including NDB was Rs. 1,448,900 million.

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

Table 8.4
Credit Card Operations by Commercial Banks

	2004(a)	2005(b)	% Change
Total Number of Credit Cards issued	507,591	637,326	25.6
Local	79,158	73,243	-7.5
Global	428,433	564,083	31.7
Outstanding Credit at End Year (Rs.mn)	11,111	15,009	35.1
Local	722	2,331	222.9
Global	10,389	12,678	22.0
Overdues(as a % of Outstanding Credit)	18.88	8.20	-56.6
Pastdues(as a % of Outstanding Credit)	10.54	7.10	-32.6
Commission from Dealers(%)	0.25-3.5	0.25-3.5	-

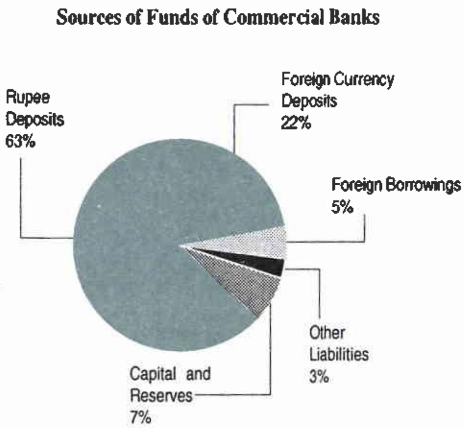
(a) Revised
(b) Provisional

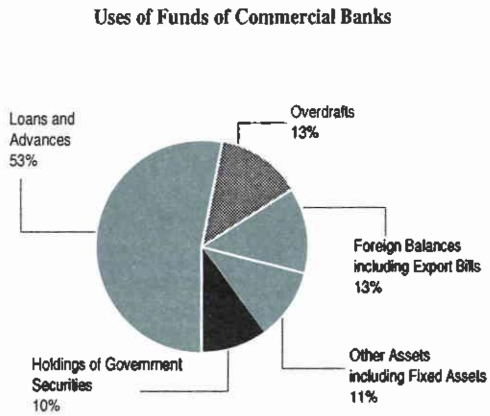
Source: Central Bank of Sri Lanka

seen in credit extended by domestic private banks that contributed the largest share of 48 per cent of the total credit extended by LCBs. Credit growth of state banks was 17 per cent, contributing 38 per cent of the total credit.

- **The profitability of both domestic private banks and state banks increased.** In contrast, the profitability of foreign banks declined in 2005, reducing their Return on Assets (ROA) and eturn on Equity (ROE). The decline in profitability ratios was mainly due to the additional capital brought in in 2005 and the reduction in foreign exchange income with the appreciation of the rupee against the US dollar.
- **Sources and Uses of Funds of LCBs: The resource base of the LCBs consisting of deposits, capital funds and borrowings, recorded a healthy growth during the year.** The deposits consisting of both rupee and foreign currency deposits, increased further contributing 63 per cent of the total resources mobilised in 2005. Within the rupee deposits, non-interest bearing demand deposits, which contribute 14 per cent of the total deposits, grew by 31 per cent, while time and savings deposits which contribute 86 per cent grew by 17 per cent. The higher growth in deposits is partly a reflection of the higher disposable income of households following the continued expansion in economic activity. The foreign currency deposits, which grew by 13 per cent contributed 20 per cent of the total deposits mobilised. Total deposits grew by 19 per cent in 2005.
- **The contribution from capital and reserves to the total growth of funds was 10 per cent, compared with the 1.2 per cent growth in 2004.** This is a reflection of the measures taken by banks to increase capital in response to the higher capital requirement imposed by the Central Bank. Borrowings, which include rupee and foreign borrowings by commercial banks increased by 25 per cent and contributed 5 per cent of the total resources mobilised.
- **The bulk of the resources mobilised by LCBs in 2005, amounting to Rs. 252 billion was utilised mainly for the expansion of lending and investment activities.** Of the total resources mobilised, about 47 per cent was accounted for by the increases in loans and advances, given the strong demand for loans from the private sector. Investment in government securities and loans to the government accounted for about 24 per cent of the increase in resources. About 7 per cent of the increase in resources was maintained in the form of foreign balances. In 2005, commercial bank reserves with the Central Bank increased by about Rs.15 billion, reflecting the increase in deposit liabilities of commercial banks.
- **Lending to the private sector continued to be mainly for external and domestic trading, housing, agriculture, industry, financing, tourism and consumption.** Credit for trading,which absorbed the largest share of credit (35 per cent), grew by 15 per cent in 2005. Credit for consumption and housing purposes, both of which grew at a higher rate of around 32 per cent during the year, contributed 17 per cent and 15 per cent, respectively, to the total growth in credit. Within the consumption category, the outstanding credit in respect of credit cards grew by 35 per cent and stood at Rs. 15 billion along with an increase in the number of active credit cards. Reflecting the relatively low real interest rates charged on loans compared with overdrafts, loans grew at 21.7 per cent compared with the growth in overdrafts of 7.6 per cent.
- **The overall exposure of commercial banks to the public sector increased entirely as a result of an increase in credit provided to the government. Commercial banks' credit to public corporations declined.** Net credit to the government (NCG) increased by about Rs.60 billion, which consisted mainly of FCBU loans extended to the government, an increase in Treasury bond holdings and overdrafts to the government. Meanwhile, government deposits with commercial banks increased by Rs.7 billion in 2005. Even though the NCG from commercial banks increased sharply, NCG from the overall banking system increased only by Rs.26 billion in 2005 as NCG from the Central Bank declined by Rs.33 billion entirely due to a decline in Treasury bill holdings. Credit to public corporations from commercial banks declined by about Rs.24 billion, helping to contain the commercial banks' exposure to the public sector.
- **Key Performance Indicators: All key performance indicators of commercial banks improved in 2005. This indicated improved resilience of the LCBs.** The profitability of LCBs increased with pre-tax profits increasing by 42 per cent due to a higher increase in net interest income, whereas non-interest income declined over the previous year due mainly to a reduction in foreign exchange income. Profitability in terms of ROA and ROE also increased. The asset quality of LCBs improved as reflected by the further decline in NPLs. This improvement was a net result of an expansion in lending portfolios, strong recoveries and some banks writing off bad debts. Liquidity in the banking system too remained at a comfortable level mainly due to improved liquidity in the money market as a result of the higher foreign inflows. The capital adequacy ratio improved and was above the minimum regulatory standard of 10 per cent of risk weighted assets with the further capital injections made by some banks to meet

Chart 8.1
Sources and Uses of Funds of Commercial Banks (As at End 2005)





enhanced prudential regulations. Furthermore, the provisions for non-performing loans too remained at comfortable levels, strengthening the resilience of the banking sector.

- **Although the interest spread, defined as the difference between the average interest yield on interest earning assets and the average interest cost on interest bearing liabilities, declined in 2005, it is still high compared to regional standards.** A gradual decline in the interest spread was observed during this year as well, mainly due to the increase in deposit rates. However, a further decline could be expected when the banking system (i) improves its operational efficiency, (ii) enhances risk management and (iii) takes measures to expand fee-based income to reduce dependence on net interest income.
- **Restructuring of State Banks: The strategic plans formulated by the state banks under the guidance of the Strategic Enterprise Management Agency (SEMA) were implemented further.**
- **Bank of Ceylon (BOC): The bank was able to achieve its targets in the specified areas such as branch automation, capital enhancement, management information systems and human resource development during the year.** In terms of the strategic plans formulated in 2004, the Bank was given benchmark targets in the areas of asset reconstruction, systems upgrading, human resource development and capital augmentation through internal generation of funds, to be achieved within a two-year period. With regard to automation, the BOC expanded the number of branches linked on-line to 165, enhancing its ability to provide efficient and high quality services, in a highly competitive banking industry and commensurate with its position as the market leader.
- **People's Bank (PB): Under the business restructuring plan (BRP), PB has made commendable progress by posting a positive net worth of approximately Rs. 4 billion, wiping out its negative net worth of approximately Rs. 6 billion reported in 2001.** The five-year BRP, formulated by the Bank under the supervision of SEMA, envisages an infusion of Rs. 8.5 billion through an ADB line of credit of US dollars 65 million to the government during this period. The success of the plan is linked to the achievement of benchmark targets in terms of staff, productivity, asset reconstruction and credit risk management, which are aimed at ensuring PB's long term viability and competitiveness. In December 2005, PB received a capital infusion of Rs. 2.0 billion under the above plan, consequent to its meeting some of the benchmark targets set. Action is being initiated to establish a separate division for the transfer and management of NPLs of the bank. The NPL ratio has improved from 14 per cent to 11 per cent in 2005. Forty branches were fully automated under the Core Banking system introduced in 2005.

Licensed Specialised Banks

- **Amongst licensed specialised banks (LSBs) are diverse banking institutions, which include development banks, savings banks and regional development banks (RDBs).** The total assets and profits of the LSBs (excluding the NDB) grew by 13 per cent and 6 per cent, respectively. Excluding the the NDB, the deposits of LSBs still showed an increase of 6 per cent since NDB was not dependent on deposits. The National Development Bank of Sri Lanka (NDB) was converted to a commercial bank after the merger with the NDB Bank in August 2005. Consequent to the merger, the asset share of LSBs in the financial sector declined from about 13 per cent in 2004

Box 16

An Update on the Regional Comparison of Interest Spread and Interest Margin

Annual Report 2004 presented a regional comparison of interest spread and interest margin in Box Article 2, demonstrating that the intermediation cost in Sri Lanka in 2003 was the highest in the region mostly due to high operational costs in the domestic banking system.[1] Updated data with information for 2004 show that the margin has declined somewhat in Sri Lanka, but still it is the highest in the region. However, the decline may not be sustained unless the banking system improves the operational efficiency, enhances risk management and expands fee-based income sources to reduce dependence on net interest income.

Table B16.1

Interest Spread and Interest Margin of Commercial Banks : 2002 - 2004

(% of Asset)

	India	Pakistan	Bangladesh	Sri Lanka
Interest Spread				
2002	2.2	1.8	0.5	3.8
2003	2.6	2.2	1.6	4.7
2004	2.9	2.1	1.2	4.2
Interest Margin				
2002	2.8	3.1	1.0	3.8
2003	3.1	3.0	1.9	4.2
2004	3.1	2.9	2.0	3.9
Operational Cost				
2002	2.2	2.7	1.9	3.8
2003	2.4	2.5	1.8	4.2
2004	2.3	2.4	1.8	4.2
Return on Assets				
2002	1.0	0.8	0.5	0.9
2003	1.2	1.2	0.5	1.1
2004	1.0	1.3	0.7	1.1
Return on Equity				
2002	17.5	14.3	12.4	20.5
2003	19.0	20.5	10.6	21.8
2004	14.1	19.8	14.3	18.4

Source : Central Bank of Sri Lanka

1 $$\text{Interest Spread (\%)} = \left[\frac{\text{Interest income}}{\text{Average of (Interest Earning Assets + NPLs + Statutory Reserves with Central Bank + Cash in Hand)}}\right](\%) - \left[\frac{\text{Interest expenses}}{\text{Average Deposits and Borrowings}}\right](\%)$$

$$\text{Interest Margin} = \frac{\text{Interest Income - Interest Expenses}}{\text{Average Assets}} \ (\%)$$

Table 8.5

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

Rs million

Sector	2004	2005 (b)
Total Loans Approved During the year	**48,639**	**42,422**
Agriculture	1,492	965
Industry	8,642	7,065
Tourism	757	292
Commercial	2,939	4,448
Financial	10,101	9,759
Housing	10,524	12,210
Redemption of Debt	111	56
Other Loans	14,073	7,626
Loans Disbursed (c)	**46,633**	**47,811**
Total Loans Disbursed as a Percentage of Total Loans Approved	96	113

Soruce : 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.

to 10 per cent in 2005. The total number of LSBs however remained at 14 due to the entry of the SME bank during the year. The branch network of LSBs contracted to 369 in 2005, with the exit of the NDB.

- **Lending by the LSBs was concentrated in the housing, industrial and financial sectors. These three sectors accounted for 69 per cent of the loans approved during the year.** The housing sector has received the highest share of loans since several LSBs, namely, State Mortgage and Investment Bank (SMIB), HDFC Bank, and National Savings Bank (NSB) cater mainly to this sector. However, the composition of assets of LSBs differs significantly from that of LCBs, with investments in government securities accounting for about 53 per cent of the total assets in comparison to the 25 per cent share in LCBs. Profits of LSBs declined, when compared to 2004, in view of the capital losses incurred due to the rise in interest rates. The total outstanding loans and deposits of LSBs at end 2005 were Rs. 113 billion and Rs. 230 billion, respectively. Meanwhile, the total profits of the sector decreased to Rs. 6.6 billion from Rs. 7.9 billion in 2004.

Registered Finance Companies

- **Registered Finance Companies (RFCs) recorded a healthy performance in 2005, with increases in their lending and deposit activities, an expansion in their branch network and an improvement in their financial soundness.** With a view to broadbasing the financial resources available to RFCs and providing an altrernative avenue to savers, the RFCs were permitted to accept savings deposits from the public in 2005 subject to the prudential requirements stipulated by the Central Bank.
- **Total assets of RCFs grew by about 32 per cent in 2005 in comparison to the 23 per cent growth in 2004.** Although the share of total assets of RFCs is relatively small, the sharp increase in their assets indicates that RFCs are an important financial service provider to a segment of the population, specially those who have different risk profiles. There were 28 RFCs operating in Sri Lanka by end 2005. They concentrated their business activities mainly in leasing, hire purchase and real estate activities.
- **Of the main areas of business of RFCs, namely hire purchase, leasing and real estate development, hire purchase showed a significant expansion** due to the absence of VAT on second hand vehicles that were funded through hire purchase. Loans and advances granted by RFCs increased by about 34 per cent as against the growth of 25 per cent in 2004. Hire purchase and leasing activities accounted for about 50 per cent of the total assets and about 70 per cent of the total loans and advances portfolio of RFCs in 2005. Although real estate development activities of RFCs have increased at a higher rate, the growth has decelerated to a certain extent over the previous year in a rising interest rate environment.
- **Deposits continued to be the main source of funds for RFCs, in addition to capital funds and bank borrowings.** Deposits which accounted for about 65 per cent of the total external funds of RFCs, grew by about 23 per cent (Rs. 9 billion) in 2005 compared to the 14 per cent (Rs. 5 billion) growth recorded in the previous year. The higher deposit rates offered by RFCs relative to banks may have contributed to this increase in deposits. Even though RFCs were permitted to accept savings deposits from the public from February 2005, the savings deposits mobilised by them have yet to expand. In contrast, their borrowings from banks increased significantly by around 110 per cent in 2005. These accounted for about 17 per cent of the total sources of funds obtained from all sources. Capital funds of RFCs grew by around 43 per cent due mainly to the increase in reserves through the retention of profits, and were 18 per cent of the sources of funds obtained from all sources in 2005.

Other Financial Institutions

- **Primary Dealers (PDs): The rise in market interest rates adversely affected primary dealers, resulting in a decline in their profits, assets and capital levels.** In order to reduce the revaluation losses arising from marking to market in the context of rising interest rates, PDs reduced their trading portfolios in government securities and increased their reverse repo positions. However, their total assets declined from Rs.61.6 billion at end 2004 to Rs. 45.5 billion at end 2005. With the withdrawal of one bank PD in June 2005, the number of PDs operating in the market declined by one to eleven.
- **Although the total assets and total investment portfolios of PDs declined as a result of asset revaluation losses, their financial position remained at a satisfactory level.** The capital base of the industry decreased by Rs. 376 million to Rs. 4.3 billion in 2005 due to capital losses and the exit of one PD. However, all the PDs maintained capital adequacy ratios above the minimum level of 5 per cent of total assests. The capital leverage of the industry declined to 8.5 times compared to 12.1 times in 2004. In 2005, the ROA and ROE of the industry were 0.6 per cent and 7.3 per cent, respectively, compared to 1.1 and 14.7 per cent in 2004. The total portfolio of the PD industry decreased from Rs. 56 billion at end 2004 to Rs. 45 billion at end 2005. A portfolio concentration towards short-term instruments such as repos was seen in the light of rising interest rates.
- **The Central Bank took measures to improve the financial strength of PDs during the year.** These included enhancement of the minimum capital requirement, strengthening of the special risk reserve and restrictions on dividend distribution to mitigate risks. The minimum capital of PDs was increased on 1 July 2005 to Rs 250 million from Rs. 200 million. This minimum requirement would be further increased to Rs. 300 million from 1 July 2006 along with the introduction of a risk weighted capital adequacy framework. Further, the Central Bank carried out stress tests on a monthly basis to evaluate the market risk exposure of the PDs. With a view to popularising government securities among the investors and to increase awareness, the PDs and the Central Bank continued to hold investor awareness programs in different parts of the country.
- **Specialised Leasing Companies (SLCs): Improved corporate performance and competitive financing packages offered to customers led to a further expansion of leasing activity.** By end 2005, 68 financial institutions i.e., 20 SLCs, 13 LCBs, 7 LSBs, and 28 RFCs had been registered with the Central Bank to carry on leasing business. The total assets of SLCs grew by 32 per cent to Rs. 63 billion, while the total leases outstanding increased to Rs. 38 billion in 2005 from Rs. 31 billion in 2004. The total leases granted by all registered finance leasing establishments increased to Rs. 98 billion in 2005 from Rs. 80 billion in 2004.
- **Passenger and commercial vehicles were the main categories which absorbed the bulk of finance leases with the continued growth in the trade and transportation**

sectors. A major share (70 per cent) of the finance leases granted were on account of passenger and commercial vehicles. Another area in which leasing is increasingly being used as a source of funds is office equipment which accounted for 16 per cent of leases granted in 2005.

- Having considered the existing regulatory arrangements in respect of other categories of registered finance leasing establishments with a view to promoting sound operations and stability of SLCs, a set of prudential norms covering minimum capital, provision for bad and doubtful debts, single borrower limit, gearing ratio, accrued interest and maintenance of a reserve fund were issued in December 2005.
- **Merchant Banks: The merchant banking sector continued to expand supported by a significant increase in fund based activities.** Leasing, investments in financial instruments and lending activities have become the main lines of business for merchant banks, due to the lack of opportunities in the equity and debt markets for investment banking activites. The total income of the industry increased by 14 per cent, from Rs. 21 billion to Rs. 24 billion. There were 10 merchant banks in operation by end 2005.
- **Unit Trusts: The unit trust industry performed well in the backdrop of the upturn in the Colombo bourse.** The total assets of the industry increased by 8.7 per cent to Rs. 4.5. billion, which represents about one per cent of the total assets of the financial system. The total number of funds, managed by five institutions, as well as the types of funds (growth, income, balanced, indexed and money market) remained unchanged at 13 and 5 respectively. During the year, two funds managed by the Vanik Asset Management Co. Ltd. were bought over by Ceylon Investment Management Co. Ltd.
- **Supported by the appreciation of the equity portfolio, the net asset value of the industry increased by about 8 per cent to Rs. 4.5 billion at end 2005**. Consequently, the net asset value per unit increased by about 9 per cent from Rs. 12.20 in 2004 to Rs. 13.39 in 2005. This was reflected in the corresponding increase in the average buying and selling prices by about one per cent to Rs. 14.37 and Rs. 14.59, respectively. However, the total number of unit holders and the total number of units at issue continued to decline, possibly as a result of many retail investors opting to exit at a profit. The total number of unit holders and units at issue at end 2005 stood at 21,495 and 336 million, respectively. Although equity investments still account for about 65 per cent of the total investments, a marginal change in the portfolio composition in favour of short-term government securities, was seen.

Table 8.6

Specialised Leasing Companies
Sectoral Classification of Leasing Facilites

Rs. million

Sector	During 2004(a)	During 2005(b)
Agriculture	1,677	2,030
Industry	699	1,220
Trade	4,890	6,126
Transportation	4,146	4,106
Construction	1,215	1,172
Services	4,276	5,921
Others	1,830	2,551
Total	**18,732**	**23,126**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

- **Venture Capital Firms (VCFs): The venture capital industry continued to be afflicted by poor performance, with some companies shifting to new areas of business.** The six firms in the industry had funded 40 projects with a total investment of about Rs.0.7 billion by end 2005. Some firms had moved into housing development activities due to the lack of investment opportunities and difficulties encountered in monitoring of projects.

Contractual Savings Institutions

- **Superannuation Funds: The superannuation funds sector expanded due to the increase in salaries and wages and an increase in new employment. Consequently, there was an increase in the level of savings in the country.** The total assets of all funds, i.e., Employees' Provident Fund (EPF), Employees' Trust Fund (ETF), Public Service Provident Fund (PSPF), Contributory Pension Fund (CPF) and Private Provident Funds (PPF) grew by 9.8 per cent to Rs. 589 billion which represented 18.6 per cent of financial system assets at end 2005. Meanwhile the total savings mobilised by the Funds increased to Rs. 38 billion from Rs. 34 billion in 2004, in comparison to the total increase in deposits collected by banks and finance companies, of about Rs. 110 billion
- **The EPF, the main retirement benefit fund for the private sector, expanded with an increase in the net inflow of funds and investment income.** The total assets of the EPF, which account for about 72 per cent of the superannuation funds in the country, grew by 11.2 per cent to Rs. 422 billion at end 2005. The total contributions and refunds during the year amounted to Rs. 25 billion and Rs. 17 billion, respectively. The total investment portfolio of Rs. 405 billion consisted mainly of government securities, (98.5 per cent). The Fund earned a gross income of Rs. 41.8 billion for the year which represented a rate of return of 10.9 per cent. An effective rate of return of 8.8 per cent was declared on member balances, as against 9.5 per cent in 2004. This is higher than the annual weighted average deposit rate of 5.64 per cent and the annual weighted average fixed deposit rate of 8.26 in 2005.
- **Expanding the range of benefits to EPF members, a new housing loan scheme was introduced during the year.** This scheme named " Shramodha Home Loan Scheme" was launched in December 2005 to grant housing loans up to a maximum of Rs. 300,000 to eligible EPF members meeting specified criteria, at a concessionary rate of 4 per cent, through the HDFC Bank and the SMIB. One issue in relation to the housing loans granted against the EPF balances as security is the high default rate. Ultimately lending institutions recover the

loan from the EPF balance. Hence, this results in an erosion of the retirement benefits of members who default housing loans. The EPF redesigned its website (www.epf.lk) and updated it regularly to facilitate the provision of information to the public in Sinhala, Tamil and English.

- **The ETF, the employer contributory retirement benefit scheme in the country, too witnessed an increase in its asset base with increased net contributions and income from investments made.** The assets and contributions of the ETF increased by 13.1 per cent and 16 per cent in 2005 to Rs. 58.6 billion and Rs. 5 billion, respectively. The fund had a net inflow of funds despite its more flexible refund policy of allowing members to withdraw their balances once in 5 years whenever they leave their jobs. As in the case of other funds, the investment portfolio was heavily concentrated in government securities, providing it a zero credit risk and higher liquidity. The composition of the portfolio, which consisted of government securities (93.2 per cent), equities (2.8 per cent) and corporate debt and other assets (4.0 per cent) recorded a marginal decrease in investments in equities and private debt instruments at end 2005, possibly due to the sale of equities to realize capital gains at the year end and maturing of debt instruments held. Private provident funds numbering about 200 , the PSPF and the CPF collectively had an asset base of Rs. 106 billion at end 2005.

- **Insurance Companies: Despite the impact of the tsunami, the insurance industry recorded a significant growth in premia, profits and assets in 2005.** The insurance industry, which consists of 15 firms, engaged in both life and general insurance business activities, and accounted for 3.3 per cent of the total assets of the financial system. The total asset base of the industry grew by 11.2 per cent to Rs. 105 billion in 2005. The industry is heavily concentrated with the two biggest firms accounting for more than 64 per cent of the assets. Six large firms account for about 97 per cent of the assets. Insurance penetration, i.e., the ratio of total gross premia to GDP, increased from 1.5 per cent to 1.6 per cent during the year, while insurance density, i.e., per capita premium, increased from Rs. 1,511 to Rs. 1,921 billion in 2005. Meanwhile, a sum of Rs. 13 billion has been paid by the industry as compensation under tsunami related claims, of which Rs. 9 billion or 70 per cent has been recovered from re-insurers.

- **Reflecting the increased insurance penetration brought about by deregulation and greater competition, the premium income of the industry increased significantly in 2005.** As at end 2005, the total net premium income, consisting of long term (Rs. 14.9 billion) and general insurance (Rs.15.4 billion) income, was Rs. 30.3 billion. This reflects a growth rate of 26.3 per cent as against a 24.3 per cent growth in 2004. Product innovation and an increased number of promotional campaigns, which could be attributed to competition and the deregulation of the industry, have been contributory factors to this higher growth. Life and motor insurance, which accounted for 83 per cent of the total gross premia, grew by 22 per cent, and 25 per cent, respectively.

- **In line with the policy focus on promoting strong institutions within the financial sector, the capital requirements of insurance companies were revised upward during the year.** Accordingly, the capital requirement for new entrants to the insurance industry was increased to Rs. 100 million from Rs. 25 million and Rs. 50 million, respectively, for life and general insurance business, with effect from October 2005. At end 2005, the total paid up capital of the industry amounted to Rs. 8.1 billion, registering a growth rate of 222 per cent, while profits of the industry increased by 36 per cent to Rs. 2.5 billion during the year. The solvency margin, a measure of soundness of the industry, ranged between 20–50 per cent and 5 – 6 per cent for general and life insurance, respectively. An enhanced minimum solvency margin of 20 per cent in respect of general insurance will come into effect by 2007. Currently, the minimum solvency margin for life and general business are 5 per cent and 10 per cent, respectively.

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 in 2005, mainly due to Central Bank purchases of the foreign currency inflows to the government.** Market liquidity was high at the beginning of the year as the Central Bank discontinued temporarily its OMOs following the tsunami disaster. Later the Central Bank conducted OMOs aggressively to absorb excess liquidity from the market.

- **The inter-bank call money market volumes declined in 2005 due to comfortable liquidity conditions in banks.** The volume of inter-bank transactions was seen declining from a level of Rs. 311 billion during the first quarter to Rs. 233 billion in the last quarter of 2005. Similarly, the average daily inter-bank call money transactions declined from Rs. 5.6 billion in 2004 to Rs. 4.5 billion in 2005.

- **Call money market rates, however, increased in 2005 along with the upward revision of policy interest rates of the Central Bank and with the continuation of high demand for credit.** However, the temporary suspension of the conduct of OMOs by the Central Bank to facilitate the smooth functioning of financial markets resulted in a decline in call money market rates during January to March 2005. The weighted average call money rate declined from 9.73 per cent at end 2004, to 7.50 per cent by end March 2005 and then gradually increased to 10.73 per cent at end 2005. The structural rigidities in the money market as a result of the high concentration of liquidity among certain banks and the tax differentials associated with inter-bank call money transactions as opposed to government securities resulted in the weighted average call money rate exceeding above the upper band of the interest rate corridor during the latter part of 2005.

Domestic Foreign Exchange Market

- **Activity in the inter-bank foreign exchange market expanded significantly as a result of large foreign currency inflows to the government and the private sector in respect of tsunami relief and rehabilitation work, export proceeds, benefits of the debt moratorium and increased inflows of private remittances.** Consequently, the rupee stabilized vis-à-vis the US dollar despite a significant outflow on account of large import bills due to the oil price hike.
- **The stability in the inter-bank forex market led to an increase in forward market activities during 2005.** The average inter-bank spot transactions in 2005 increased significantly to US dollars 25 million in 2005, from the US dollars 14 million recorded in 2004 while the forward transactions increased from US dollars 4.2 million in 2004 to US dollars 7.8 million. The average US dollar buying and selling rates of commercial banks for telegraphic transfers decreased from Rs.104.16 and Rs.105.14, respectively at end 2004, to Rs.99.98 and Rs.101.29, respectively by end 2005, registering an appreciation of 4.2 per cent and 3.8 per cent, respectively. The weakening of other major currencies in the international market vis-à-vis the US dollar led to a relatively larger appreciation of the Sri Lanka rupee against other reserve currencies, namely, the euro (by around 18 per cent), the British pound (by around 14 per cent) and the Japanese yen (by around 18 per cent).
- **The Central Bank operated on both sides of the market with a view to reducing the excessive volatility in the foreign exchange market.** The Central Bank purchased US dollars 290 million from commercial banks and sold US dollars 464 million to commercial banks.

Table 8.7

Money Market Operations 2003 - 2005

Rs.million

	Call Money Market	Primary Treasury Bill Market			
	Total Lending/ Borrowings	Amount Issued	Amount Purchased		
			Central Bank	Commercial Banks	Others
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
2005					
1st Qtr	310,678	98,810	29,923	45,349	23,538
2nd Qtr	230,345	108,231	27,943	63,213	17,075
3rd Qtr	283,380	147,252	35,209	72,568	39,475
4th Qtr	232,835	131,476	13,034	77,927	39,515

Source: Central Bank of Sri Lanka

Government Securities Market

- **The Government securities market improved in terms of primary market volume, tenor of the bonds and with the introduction of index linked bonds.** With the tightening of monetary policy and the continuation of high credit demand, the yield rates increased and in the secondary market there was a preference for short-term instruments. A web based account verification system was developed which allows account holders of the system to view their security holdings and earnings through the Internet.
- **Total issues of Treasury Bills in the primary market increased during 2005 in comparison to 2004.** However, the net issues of Treasury bills declined in 2005, with repayments during the year exceeding the total issues of Treasury bills. Net issues of Treasury bills in 2005 amounted to Rs. 9.7 billion, compared to Rs. 24 billion in 2004. At the primary market auctions, market preference for short-term instruments was reflected in the relatively higher volumes of bids for 91-day Treasury bills. The outstanding Treasury bills declined slightly from Rs. 244 billion at end 2004 to Rs. 234 billion by end 2005. The weighted average yield rates of Treasury Bills increased gradually during the year, along with the upward revision of the Central Bank's policy interest rates.
- **The tenor of the Treasury Bonds at the primary market increased from the recommencement of the issues of 5 and 8-year tenors for the first time after October 2003.** Treasury Bonds with 3 and 4 - year tenors amounted to issued regularly in 2005. However, market preference was for shorter maturities. The net issues of Treasury bonds in 2005 were Rs. 108 billion, in comparison to Rs. 160 billion in 2004 as the government resorted to foreign currency borrowings. Yields on Treasury bonds also rose following the upward movement of short-term rates.
- **The government issued its first series of Index Linked Bonds in December 2005 with a maturity period of 3 years in the process of converting the overdraft with the state banks to Treasury bonds.** The coupon rate for the first year was fixed at 11.2 per cent and the coupon rates for the 2nd and 3rd year will be based on the average annual inflation rate measured by the changes in the annual moving average of the CCPI during the immediate previous six months plus a margin of 1 per cent. This issue of Index Linked bonds amounting to Rs.22 billion was made by way of a private placement.
- **Transactions in Treasury bills in the secondary market increased in 2005 in comparison to 2004, while transactions in Treasury bonds declined.** This was due to investors' preference for shorter maturities, with financial markets expecting interest rates to rise further. The total outright transactions of Treasury bills in the secondary market increased from Rs. 390 billions in 2004 to Rs. 443 billion in 2005, while

the Treasury bill Repo transactions increased from Rs.559 billion in 2004 to Rs.652 billion in 2005. However, both the outright transactions and Repo transactions of Treasury bonds in the secondary market recorded a decline in 2005. The yield curve for government securities in the secondary market shifted upward along with the increase in primary market rates. It became shorter by end 2005 as the long-term market became inactive.

Corporate Debt Securities Market

- **Commercial Papers (CPs): Commercial paper market activity remained relatively sluggish despite incentives granted in the form of the elimination of withholding tax in 2005.** Commercial papers issued with the support of licensed commercial banks and licensed specialised banks amounted to Rs. 10.9 billion at end 2005, in comparison to Rs.14.5 billion in 2004. The interest rate on CPs increased to a range of 8.90- 14.25 per cent in 2005 from 7.75-14.00 per cent in 2004. One reason for the decline in the CP market volumes could be the fact that borrowing at the prime lending rate, which ranged between 9.53 per cent to 12.42 per cent during the year, was cheaper for many blue chips. The total outstanding value of CPs as at the year end amounted to Rs. 2.8 billion. A major share of CPs issued was of less than 3 month maturity.
- **As proposed in the Budget for 2006, the withholding tax on corporate debt securities will be reintroduced with effect from April 2006, remove the discriminatory treatment between interest income from banks and interest income from corporate debt securities.** At present interest income from bank deposits are charged at 10 per cent, while interest from corporate debt securities is taxed at the standard marginal income tax rates ranging from 5 to 30 per cent.
- **Corporate Bonds: The activities in the corporate bond market continued to be subdued in 2005 due to uncertainties with respect to interest rate behaviour.** During the year two new issues of debentures were listed on the Colombo Stock Exchange. These mobilised Rs. 350 million. Seylan Merchant Leasing Ltd. raised Rs. 100 million in July 2005, at interest rates ranging from 10.25- 12.5 per cent, while Senkadagala Finance Co Ltd. raised Rs. 250 million in October 2005 at a fixed interest rate of 14.00 per cent and a floating rate of the 91-day Treasury bill yield plus 275 basis points. There were 19 issues of debentures outstanding with a total market capitalisation of Rs. 11.9 billion at end 2005 . The total turnover during the year amounted to about Rs. 207 million
- The underdeveloped nature of the private debt market, particularly the corporate bond market, is attributed to several factors, such as a lack of institutional investor base, availability of bank credit at attractive rates for high net worth companies, high cost of debt issues, lack of investor awareness, lack of investor information on the quality of debt and non-availability of a longer term bench mark yield curve.

Share Market

- **The Colombo Stock Exchange recorded another positive year of performance with key market indicators including the All Share Price Index (ASPI) and the Milanka Price Index (MPI) reaching record levels by mid-November 2005.** However, a part of the gains posted during the first ten months of 2005 dissipated towards the end of the year with the escalation of tensions in the North and the East, which led to panic selling. This caused sharp declines in the share price indices as well as in market capitalisation. The robust performance of the share market during much of 2005 was driven by strong corporate earnings. Yields on fixed income securities, which were low or negative in real terms particularly during the early part of 2005, also impacted positively on stock market performance. Another factor that contributed positively to share market activity in 2005 was the stability of the exchange rate. Net foreign inflows to the Colombo Stock Exchange (CSE) amounted to US dollars 62 million in 2005, the highest for a year, so far. Further, the inclusion of Sri Lanka by the California Public Employees' Retirement System

Table 8.8

Share Market Performance

	2004	2005
All Share Price Index (a)	1,506.9	1,922.2
Year-on-year change (%)	41.9	27.6
Milanka Price Index (a)	2,073.7	2,451.1
Year-on-year change (%)	9.3	18.2
Market Capitalisation (Rs.bn.)(a)	382	584
As a percetage of GDP (%)	18.8	24.7
Market Price Earnings Ratio (a)	10.8	12.4
Turnover to Market Capitalisation (%)	15.5	19.6
Value of Shares Traded (Rs.mn.)	59,052	114,599
Number of Shares Traded (mn.)	2,752	5,218
Number of Companies Traded	241	242
Number of Companies Listed	242	239
Introductions (b)	3	3
Number of Initial Public Offers/Offers for Sale (b)	2	3
Number of Rights Issues	25	18
Amount Raised through Rights Issues (Rs.mn.)	65,945	3,501

Source: Colombo Stock Exchange

(a) End of the year

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

Chart 8.2

Turnover and Foreign Particiaption at CSE

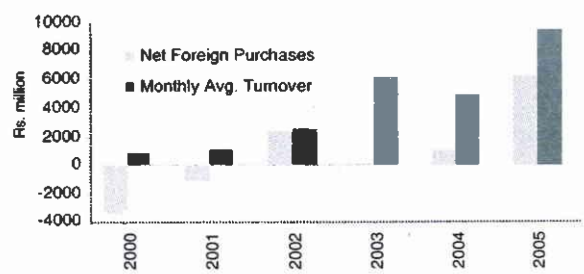


Table 8.9
Non-cash Payments: Volume and Value of Transactions

Payment Systems	2004 (a) Volume ('000)	2004 (a) Value (Rs.bn.)	2005 (b) Volume ('000)	2005 (b) Value (Rs.bn.)
Large Value Payment Systems	138	13,701	150	17,543
RTGS System	138	13,701	150	17,543
Retail Value Payment Systems	51,946	3,174	58,078	3,654
Main Cheque Clearing System	37,690	2,965	40,068	3,385
Rupee Draft Clearing System	n.a	5	n.a	6
Regional Cheque Clearing Systems	1,302	53	1,376	64
Sri Lanka Interbank Payment System (SLIPS)	2,411	60	3,097	87
Credit Cards	9,759	33	12,352	42
Debit Cards	355	1	419	1
Internet Banking	365	40	688	52
Phone Banking	64	5	78	5
Postal Instruments	n.a	12	n.a	12
Total	52,084	16,875	58,228	21,197
US Dollar Cheque Clearing System	102	14	106	16

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

(CALPERS), the largest public pension fund in the USA, in its emerging markets investment eligibility list, also impacted positively on stock market activity.

- **The strong performance in the secondary market aided primary market activity.** There were three successful initial public offerings (IPOs) during the year, namely, those of Dialog Telecom, HDFC Bank and Sierra Cables. Among them, Dialog Telecom, which was the largest IPO in the history of the CSE, attracted both domestic funds and significant inflows of foreign funds. The HDFC bank is the first government owned financial institution that made a public offering of shares.
- **Share prices and profits of companies of most sectors improved significantly during the year. This was due to the continued growth momentum in the domestic and external economies.** The sectoral indices for Telecommunications, Diversified Holdings and Bank, Finance and Insurance, which together account for 68 per cent of market capitalisation, increased by 74 per cent, 21 per cent and 38 per cent, respectively. A few sector indices retreated during the year. Amongst these were Power and Energy (-22 per cent), Construction and Engineering (-5 per cent), Chemicals and Pharmaceuticals (-4 per cent), Hotels and Travels (-2 per cent) and Footwear and Textiles (-1 per cent).
- **The opening of the third branch of the CSE in Kurunegala early in the year was another positive step towards market development.** It will help expand local investor participation at the CSE.

8.4 Development Finance and Access to Finance

Development Finance

- **Development finance and rural financial sector institutions expanded in 2005.** The Central Bank introduced three credit schemes and the National Development Trust Fund (NDTF) introduced one credit scheme in 2005 for the resumption of micro, small and medium scale enterprises (MSMEs), which were damaged by the tsunami in 2004. Furthermore, the Central Bank in consultation with the government introduced two credit guarantee schemes to encourage banks to grant facilities to tsunami affected enterprises, and to the apparel sector, which suffered from the termination of the MFA. The government assisted the state banks to reschedule long outstanding loans granted to rice millers in the agricultural districts with a view to rehabilitating the milling industry by developing its capacity to absorb the increased paddy production in the country. Under the Rural Finance Sector Development Project funded by the Asian Development Bank (ADB), preliminary arrangements were finalized for restructuring the Regional Development Banks (RDBs) and Cooperative Rural Banks (CRBs) in the country. The Central Bank has also undertaken the task of developing an enabling legal environment for rural financial sector institutions for sustainable outreach and viable operations of the sector.
- **Microfinance schemes were continued with the assistance of the Central Bank and several other banks.** The Central Bank continued to operate the Small Farmers and Landless Credit Project (SFLCP) and the Poverty Alleviation and Microfinance Project (PAMP) with the assistance of the Government of Sri Lanka (GOSL) and the Japan Bank for International Cooperation (JBIC) in ten districts of the country in 2005. Three more districts, Jaffna, Trincomalee and Batticaloa, were brought under the PAMP in 2005. Further, the New Comprehensive Rural Credit Scheme (NCRCS) was introduced to Jaffna, Kilinochchi and Vavuniya districts in 2005. Short-term production loans granted under the NCRCS reported a significant growth of Rs.1.6 billion in 2005. Loans granted under Forward Sales Contracts for purchasing

agricultural commodities also increased to 1256 loans totalling Rs.2.4 billion in 2005. Bank of Ceylon, People's Bank, Hatton National Bank, Seylan Bank, Sanasa Development Bank and six Regional Development Banks continued their own micro credit programmes with the assistance of Community Based Organizations (CBOs) and Rural Finance Institutions (RFIs) in 2005.

Enhancement of Access to Finance

- **The efforts to enhance access to finance were continued with the implementation of several measures during the year.** These included the introduction of micro finance schemes, the establishment of the SME Bank, permitting the acceptance of foreign currency deposits by the NSB and undertaking preparatory work on a legal framework for the regulation of micro finance institutions. .
- **The provision of credit facilities to micro, small and medium scale industries expanded during the year.** A significant event was the establishment of the SME bank to cater to the SME sector in the country. The Central Bank continued to operate the Small Farmers and Landless Credit Project (SFLCP) and the Poverty Alleviation and Microfinance Project (PAMP) covering 10 districts. Two commercial banks joined the Central Bank to expand the micro credit programmes to the North and the East with assistance from the Japan Bank for International Co-operation (JBIC) in the latter part of the year. Activities of the New Comprehensive Rural Credit Scheme (NCRCS) were further expanded during the year.
- **Measures were taken to expand the channels for savings mobilisation and fund transfers in the rural sector, expand the current postal outlets and set up service centres, especially to expand financial facilities for micro and small lending for cottage industries and migrant worker families.** Branches of the NSB are expected to be linked on-line to the postal outlets comprising over 4,048 outlets covering the entire country. The combination of the two institutions would be of use to enhance access to finance. The proposed set up would facilitate migrant worker remittances through post offices and encourage micro and small lending for cottage industries. Furthermore, permission was granted to NSB to accept foreign currency deposits enabling migrant workers to remit foreign funds directly to their dependents at the grass root level. The granting of direct access status to NSB through SLIPS would enable public servants to remit salaries to their accounts maintained at NSB and to introduce housing loan products to them on the strength of their salary remittances. Banks have been asked to set up service centres to encourage SMEs, provide project consultancy services and minimise difficulties faced by SMEs in accessing finance. It has also been proposed to upgrade the present Credit Information Bureau (CRIB) by increasing its capabilities to build up a database for SMEs and micro enterprises and by providing positive credit information on the sector to lending institutions. Action has been taken to amend the CRIB Act and upgrade its IT system.

8.5 Financial Infrastructure

Payment and Settlement Systems

- **As an efficient and reliable payment system contributes to improve the soundness of the financial system, the Central Bank took further measures to strengthen the payment and settlement systems while minimising the risks involved.** With a view to providing wider powers to the Central Bank to oversee the payment and settlement systems and money service providers and to facilitate electronic presentment of cheques, the Payment and Settlement Systems Act No. 28 was enacted in September 2005.
- **The Central Bank performs three key roles in the payment and settlement systems by overseeing payment systems, operating systemically important payment and settlement systems and inducing changes for the further development of the payment services.** In addition to the Central Bank, the main providers of payment services are the licensed commercial banks. The settlement of securities is handled by Lankasecure, which clears government securities while the Central Depository System (Pvt.) Ltd., a fully owned subsidiary of the CSE, handles equity settlements. Banking institutions, taking advantage of the improvement in information technology, enhanced their services further by offering credit cards and debit card facilities with added features, home banking and internet banking, expanding the type of payment modes available to their customers. The number of ATMs and EFTPOS too have increased increasing convenience and access to banking facilities and payments.
- **With the intention of broad-basing the benefits derived from the development of the payment systems to the retail end of the market, LankaClear is in the process of introducing a cheque imaging and truncation system.** This would improve the processing of retail and low-value payments effected primarily through cheques by reducing significantly the cheque realization times throughout the country thus benefiting the general public. Under this, eleven regional centres have been set-up by LankaClear around the island. The system is expected to commence live operations in mid-2006.
- **The Real Time Gross Settlement System (RTGS), which was introduced in 2003, continued to be the main inter-bank fund transferring system in Sri Lanka for urgent and high value payments.** The RTGS covered 83 per cent of the total value of non-cash payment instruments. During the year, total transactions settled through the RTGS increased by 8 per cent to 149,627 transactions while the total value of such settled transactions increased by 28 per cent to Rs. 17,543 billion. The share of transactions with a value less than Rs. 50 million by size represented 68 per cent of the total number of transactions. The share of transactions over Rs. 1,000 million accounted for 35 per cent of the total value of RTGS transactions. The

majority of the RTGS payments were in relation to transactions in the call money market, the government securities market, the foreign exchange market (rupee leg), Central Bank OMOs, the settlement of net clearing obligations and urgent payments of customers.

- **The Central Bank continued to provide the intra-day liquidity facility (ILF) to participating institutions in the RTGS system against the collateral of government securities.** The use of this facility declined with improved liquidity management by market participants as a result of experience gained in estimating the required liquidity to settle transactions. The daily average value of ILF taken was Rs 2.3 billion in 2005 in comparison to Rs. 2.7 billion in 2004.
- **Inter-Bank Clearing Systems Operated by LankaClear - the main Cheque Clearing System.** The total value of cheques cleared through the main cheque clearing system of LankaClear represented 16 per cent of the total value of non-cash payments. The total number of cheques cleared by LankaClear increased by 6 per cent to 40.1 million in 2005 from 37.7million in 2004 and the total value of cheques cleared increased by 14 per cent to Rs.3,385 billion from Rs. 2,965 billion in 2004.
- **Scripless Securities Settlement (SSS) System:** During the year, all the new issues of Government Treasury bills and Treasury bonds were in scripless form. The total value of scripless securities held by LankaSecure at the end of 2005 amounted to Rs.958 billion. This accounts for 97.3 per cent of the total value of Treasury bills and Treasury bonds outstanding. These scripless securities consisted of Rs.234 billion Treasury bills and Rs.724 billion Treasury bonds. At the end of 2005, LankaSecure maintained 24,411 accounts through direct participants, relating to the portfolio of individuals and corporate customers.
- **The activities of the Sri Lanka Inter-bank Payment System (SLIPS), which is the major offline inter-bank retail payment system where only electronic instructions are issued to effect payments, expanded further.** This system facilitates the transfer of funds directly by LCBs and the Central Bank as well as customers of LCBs. SLIPS operated by LankaClear cleared Rs. 87 billion worth of transactions in 2005 recording a 45 per cent increase when compared with 2004.

Legislative Enactments and Reforms

- **The Central Bank continued its efforts to review the existing legal framework while introducing new legislation to facilitate the smooth functioning of the financial system.** Addressing many uncertainties and lacunae that existed in the Banking Act, No. 30 of 1988 and widening the scope of regulatory control, the Banking (Amendment) Act No. 2 of 2005 was passed in February 2005. The most significant provisions introduced by this amendment are the 'fit and proper' criteria for directors, strengthening of provisions to minimise the concentration of ownership of licensed banks and strengthening of the governance aspects of licensed banks. The definition of the term 'deposit' was also expanded with these amendments in order to strengthen depositor protection. These amendments have also played a significant role in safeguarding the stability of the financial system of Sri Lanka.
- **Another important development is the enactment of the Payment and Settlement Act, which will strengthen the legal framework governing payment services.** This carries provisions for the regulation of the payment, clearing and settlement systems, for the regulation of providers of money services and for the electronic presentment of cheques.
- **Enabling the leasing companies to securitise their lease portfolios, the Finance Leasing Act was amended.** This would enable the finance leasing companies to finance their working capital needs, which, in turn, would ease their issues relating to liquidity shortfalls. Broader issues relating to securitisation in general are also under consideration with a view to developing more generic legislation on the subject.
- **Another recent development around the world is the recognition of the risks posed to the financial sector by financing of terrorism and money laundering.** Sri Lanka joined the global effort to combat money-laundering and terrorist financing by passing the Prevention of Terrorist Financing Act in mid 2005. The Anti-Money Laundering Bill and a Financial Transactions Reporting Bill were presented to the Legislature in 2005 and was passed in January 2006. Currently, the FIs are directed to adopt 'Know Your Customer' (KYC) principles to identify possible and questionable transactions involving money laundering.

Regulation and Supervision

- **The Central Bank, which is responsible for regulating and supervising all major financial institutions, undertook several regulatory and supervisory initiatives in 2005 to enhance the soundness and efficiency of the financial system.** The institutions supervised and regulated by the Central Bank include LCBs, LSBs, finance companies and primary dealers. The Central Bank is also assigned with the responsibility of overseeing payment and settlement systems, registering and monitoring leasing establishments and regulating money changers. In addition, the Central Bank manages the EPF. The Securities and Exchange Commission (SEC) is responsible for licensing and regulating the stock exchange, stock brokers and unit trusts. It also registers underwriters, margin providers, credit rating agencies, investment managers and securities clearing houses. The Insurance Board of Sri Lanka (IBSL) regulates insurance companies with a view to safeguarding the interests of the policyholders. The Central Bank also took the initiative in 2005 to establish coordination with the other regulatory agencies to enhance the regulation and supervision of domestic financial conglomerates.

Box 17

Implementation of Basel II Capital Adequacy Standard in Sri Lanka

The First Basel Capital Accord: Basel I

Basel I, introduced in 1988 by the Basel Committee on Banking Supervision based in the Bank for International Settlements, Basel, Switzerland, is the current international standard framework for assessing capital adequacy of banks. Capital adequacy is the key measure of the soundness and stability of banks. Under Basel I, the minimum capital adequacy ratio is prescribed and calculated as the ratio of regulatory capital (Capital defined for regulatory purposes) to the measured risk exposure, i.e., the risk-weighted assets (RWA). Basel I was initially introduced to assess capital, mainly in relation to credit risk (the risk of loss due to the failure of a counter party to meet its obligations) and was revised in 1996 to explicitly take into account of the market risk (the risk of loss due to a change in market prices, such as equity prices, interest rates or exchange rates) in trading accounts.

The New Basel Capital Accord: Basel II

The Basel Committee finalised and published Basel II in June 2004. It is to be implemented by internationally active banks in G10 countries commencing 2007, replacing Basel 1. The key features of Basel II are the incorporation of a capital charge for operational risk and three mutually reinforcing pillars in the maintenance of capital adequacy, viz. (1) minimum capital requirements, (2) supervisory review process and (3) market discipline.

- *Pillar 1:* **The calculation of the minimum capital requirements on the basis of calculated RWA, taking into account credit risk, market risk and operational risk -** A menu of approaches varying from the crude but penal, to the sophisticated and more generous, is offered for the calculation of each of the risk categories. The options for calculating credit risk are the standardized approach and two internal-ratings-based (IRB) approaches – the foundation approach and the advanced approach. The three options for calculating operational risk, which is a new feature in Basel II, are the basic indicator approach, the standardised approach, and the advanced measurement approach (AMA). For the measurement of market risk, two broad approaches, namely, the standardized measurement method and the internal models approach are prescribed. The capital charge for operational risk and options available to calculate risk exposure are the new explicit features introduced in Basel II.

- *Pillar 2:* **The supervisory review process to ensure that banks maintain adequate capital to mitigate all attendant risks** - The additional risks that should be considered by the regulators under Pillar 2 are those that are not fully captured or specifically addressed under the Pillar 1 calculation process, e.g., credit concentration risk, interest rate in the banking book, liquidity risk and strategic and reputational risks. Accordingly, the regulators have the option of prescribing additional capital to mitigate such additional risks.

- *Pillar 3:* **Promotion of market discipline by requiring banks to publicly disclose key information regarding their risk exposure, risk appetite and performance indicators -** Because Basel II offers banks greater discretion in calculating their own capital requirements, it is anticipated that the disclosure will allow market participants to better assess the safety and soundness of the respective banks and thus exert stronger market discipline by both banks and customers.

Preparation for Basel II in Sri Lanka

When Sri Lanka adopted Basel 1 in 1993, only the credit risk was captured in the calculation of capital adequacy. At present, the minimum capital adequacy ratio stipulated in Sri Lanka is 10% as against the Basel's recommendation of 8%.

The Central Bank of Sri Lanka has decided to adopt Basel II for all banks in Sri Lanka with effect from January 2008. The Standardised Approach will be adopted for calculating credit and market risks and the Basic Indicator approach will be adopted for calculating operational risk. The Central Bank may consider allowing some banks to migrate to Internal Ratings Based (IRB) approaches after adequate skills have been developed, both in banks and at the supervisory level. The implementation progress is as follows:

- The Central Bank is working closely with a Sub-Committee of the Sri Lanka Banks Association (SLBA) in order to finalize the modalities for implementing Basel II.

- At the request of the Central Bank, banks have made their self-assessments based on the Basel II methodology.

- As a precursor to the implementation of Basel II, the Central Bank has introduced the capital charge for market risk, based on the standardized measurement method, with effect from 31.03.2006. The methodology was developed in consultation with the banking industry. To facilitate this, guidelines on the 'Classification of Investment Securities' have also been issued, which is deemed to be a pre-requisite for the calculation of market risk.

- The regulations in terms of the legal provisions for the implementation of Basel II will be issued in 2006. The banks will be required to have a parallel application of the

Box 17 (Contd.)

new rules commencing from the first quarter of 2006. Test calculations in respect of Basle II on the financial position of banks as at 31 December 2005 have been carried out. A time table for migrating to the IRB approaches for the banks that are capable of adopting advanced methods will be communicated to the banks for preparedness.

Overall Benefit from Basel II

Basel II in its present form is a formidable regulatory tool, which would insulate banks against a broad spectrum of risks. Maintenance of capital under Basel II relies heavily on the internal risk management systems of banks. Therefore, it is necessary to develop a risk management culture in order to reap the benefits of Basle II. The banks should view risk management not as an exercise in complying with regulatory requirements, but rather as a means for greater opportunities where the differentiation of risks afforded under Basle II would lead to greater price competition through the level of capital allocated to each risk. In this context, therefore, Basle II calls for a radical change in the credit culture from one that is predicated on collateral to a culture that is intrinsically hinged on information.

- **Moving further in line with international best practices, a road map for the implementation of the Basel II Capital Accord through the standardized and basic indicator approaches in 2008, was issued to the banking industry.** Banks were initially requested to make a self-assessment of Basel II. A Committee composed of representatives from banks and the Central Bank was set up to resolve implementation issues. The framework for the implementation of the capital charge for market risk with effect from March 2006 was finalized.
- **With respect to the regulation of banking institutions, several new prudential requirements were issued,** (i) requiring bank directors to submit an affidavit and a declaration that they are fit and proper persons, (ii) permitting banks to offer banking products based on Islamic principles subject to compliance with existing prudential requirements, (iii) raising the minimum capital requirement, (iv) specifying the accommodation to related parties, (v) specifying the single borrower limit (SBL) on a uniform basis for all banks, and (vi) requiring banks to enhance disclosure of financial statements.
- **The supervisory function continued with a two pronged approach, i.e., the continuous monitoring of the health of banks through off-site surveillance and on-site examination of banks within a defined statutory period i.e., once in two years.** The timeliness of the assessment of the risk exposure of individual banks, and of the banking system as a whole improved through off-site surveillance, which serves as an early warning system in identifying significant and critical changes in the financial condition of banks, which require further investigation and examination; and a new on-line web-based reporting system, which was launched on a test basis, which will be fully implemented in 2006. The on-site examination process focused on the identification of banking risks, the management of these risks and the assessment of the adequacy of resources to mitigate the risks.
- **The programme for improving public awareness of the financial system continued through the issue of press releases, press advertisements and a series of pamphlets.** Through these publications, the public was advised to assess and be cautious of the risks and return on their transactions with financial institutions.
- **Several directions were issued covering the operations of specialised leasing companies to promote their soundness.** These included minimum capital requirements, provision for bad and doubtful debts, single borrower limit, maintaining debt/equity ratios (gearing ratios), provisioning for accrued interest and building of a reserve fund.

Credit Rating and Credit Information

- **The first ever sovereign rating by the government of Sri Lanka was obtained in 2005. This will facilitate the raising of finance particularly from the international market.** Fitch Ratings assigned a long-term foreign and local currency ratings of 'BB-' (BB minus) while Standard and Poors assigned B+.
- **The number of credit rating agencies operating in Sri Lanka increased to two, with a Malaysian credit rating agency being set up in 2005.** Following the Budget 2004 proposal mandating all deposit taking institutions to obtain and publish credit ratings, the Central Bank advised all banking institutions to obtain credit ratings from independent rating agencies and publish them to further improve investor confidence in the financial system. By end December 2005, 20 financial institutions had obtained and published credit ratings. Altogether, 10 banking institutions had submitted the rating obtained by the parent bank.
- **The Credit Information Bureau (CRIB), which collects and collates information on borrowers and furnishes such information to shareholding lending institutions, recorded an increase in the number of credit reports, catering to**

increased demand. With the high expansion in private sector credit, lending institutions have been making increased use of credit information as a primary risk management tool. The CRIB has issued 607,990 credit reports during 2005 compared to 501,141 credit reports in 2004.

- **The Bureau continues to collect positive information (regular) of Rs. 500,000 and above and negative information (irregular) on advances of Rs. 100,000 and above and of credit cards of Rs.5,000 and above.** CRIB has fixed these reporting thresholds for the collection of information due to the prevailing technological constraints. CRIB is in the process of upgrading its ICT system with a view to reducing the current thresholds and improving the coverage, under a modernization project. It is expected to service all segments of the credit market.

8.6 Financial System Stability

- **Maintaining financial system stability is one of the two major objectives of the Central Bank in terms of the amendments made to the Monetary Law Act in 2002.** Financial stability is heavily dependent on stability in the macroeconomic environment, the soundness of the users of the financial system and systemically important financial institutions (SIFIs), the stability of markets and the soundness of infrastructure. A stable financial system fosters a stable payment and settlement system, facilitating the smooth functioning of economic activities of a country.
- **The financial sector remained resilient, despite several major shocks which impacted on the economy especially in early 2005.** The tsunami disaster did not have a material impact on the financial system. On the contrary, significant contributions from the financial sector helped mitigate the impact of the tsunami disaster on the economy. Both money and capital markets remained liquid during the recovery in early 2005 due to the efforts of the Central Bank and other financial institutions. The continuing expansion in private sector credit, particularly in relation to consumption and housing, and the continuation of high oil prices raised concerns about financial stability.
- **Systemically important financial institutions (SIFIs), which include major LCBs, LSBs, FCs, and the EPF, hold about 72 per cent of financial assets. Their financial situation remained healthy in 2005 as reflected in their key indicators.** Improvements were seen in capital levels, NPL ratios, provision coverage for losses, and profits. The credit risk declined with falling NPL ratios. Liquidity levels remained above the statutory minimum level of 20 per cent. Although the market risks, particularly the interest rate risk, increased with the rise in market interest rates, the risk absorptive capacity, as reflected by the availability of adequate capital, profits and other risk managements tools, improved. Both profits and equity increased, improving the resilience of financial institutions. Resilience will improve further with the implementation of business continuity plans (BCP) and disaster recovery sites (DRS), as required by the Central Bank.
- **The EPF managed to mitigate risks as a large part of the investments of the EPF was in government securities.** Since its receipts continued to remain above the cash outflows, it did not face a liquidity risk in 2005. The credit risk in the EPF is negligible since almost all its funds are invested in risk free government securities. Although the interest rate risk increased with the increase in market rates, it was mitigated considerably, given the high level of liquidity and as most funds are held in the form of investments. However, it is desirable to take measures to face future risks in the face of changing accounting practices, which may require investments to be evaluated at market prices.
- **Financial sector infrastructure, consisting of payment and settlement systems, the supervisory and regulatory regime, and the legal framework, further improved in 2005.** A road map for the implementation of the Basel II Capital Accord in 2008 was issued to the banking industry. Accordingly, the standardised and basic indicator approaches will be used in assessing the capital requirements in terms of the credit and operational risks, under the new Accord. A capital charge for the market risk will be implemented in 2006. Risks in the payment and settlement systems were further reduced with the introduction of BCP and DRS for participants, the enactment of the Payment and Settlement Act and the imposition of a default charge on delayed payments. The stability of the

Table 8.10

Soundness Indicators of Systemically Important Financial Institutions

Per cent

Institution and Indicator	2004(a)	2005(b)
Lisensed Commercial Banks		
Non Performing Loans to Gross Loans	9.3	7.0
Non Performing Loans net of Provisons to Capital	32.5	18.6
Regulatory Capital to Risk Weighted Assets	10.3	12.4
Return on Assets (ROA)	1.4	1.7
Return on Equity (ROE)	18.4	17.8
Interest Margin to Gross Income	37.6	39.7
Non Interest Expense to Gross Income	37.2	34.5
Statutory Liquidity Ratio (DBUs)	26.3	24.2
Licensed Specilised Banks		
Non Performing Loans to Gross Loans	10.4	8.9
Non Performing Loans net of Provisons to Capital	21.7	26.2
Regulatory Capital to Risk Weighted Assets	19.3	20.1
Return on Assets (ROA)	2.7	2.1
Return on Equity (ROE)	17.7	13.1
Interest Margin to Gross Income	41.9	38.9
Non Interesst Expense to Gross Income	22.8	16.6
Statutory Liquidity Ratio	69.4	69.4
Finance Companies		
Non Performing Loans to Gross Loans	9.7	5.9
Non Performing Loans net of Provisons to Capital	5.1	4.3
Regulatory Capital to Risk Weighted Assets	15.2	16.5
Return on Assets (ROA)	2.3	2.6
Return on Equity (ROE)	24.3	18.6
Interest Margin to Gross Income	28.1	30.5
Non Interest Expense to Gross Income	28.6	30.3
Statutory Liquidity Ratio	15.9	17.8

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Box 18

Rationale for Establishing Ownership Restrictions in Banks

Ownership restrictions complement the efforts of regulation and supervision of banks. Banking firms are regulated and supervised for three major reasons. First, the banking industry in many countries is an oligopoly. The entry into the industry is not free, and is constrained by licensing requirements, entry capital requirements, economic needs tests, fit and proper tests of owners and senior management etc. The exit of a banking firm is also not simple and straightforward. Second, the body of consumers of the services of the banking industry could be constrained in the choice of a banking firm by appropriate restrictions on capital account transactions, such as restrictions on cross border trade in financial services. Hence, the domestic industry enjoys privileges of serving a captive body of consumers. Third, the banking industry acquires contingent liabilities, develops serious inter-connections among various firms in the industry and firms and households in the entire economy. Hence, in the absence of sufficiently strict and effective regulation and supervision coupled with weak enforcement of banking laws, there are possibilities that an owner could run the banking firm in ways that are harmful to the depositors and the country as a whole. Thus, these three considerations require establishing rules, effective regulation, and supervision that ensure smooth functioning of the banking industry displaying sound corporate governance practices. The extent of those rules, regulatory and supervisory norms and practices are diverse among countries.

Objectives of ownership restrictions are to have a well-diversified ownership, which could minimise the risk of misuse or imprudent use of leveraged funds. Meanwhile, low levels of ownership may not provide adequate incentives for owners to employ sufficient attention to the banking firm. It should also be emphasised that ownership restrictions are not substitutes for effective supervision and regulation. Further, the fit and proper criteria, on a continuing basis, have to be the over-riding consideration in the path of ensuring corporate governance. Ownership restrictions have to be complemented with adequate equity investments, appropriate restructuring and consolidation in the banking sector.

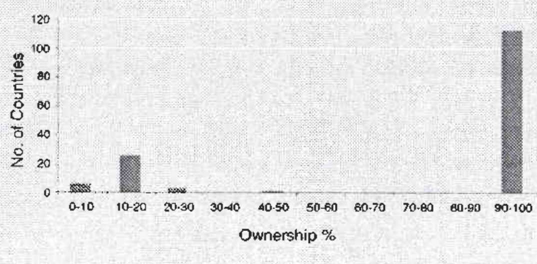
The World Bank conducts surveys on features of financial sectors in its member countries. As per the 2003 survey, out of 157 countries, 112 countries do not have any ownership limitations.[1] Majority of those countries have efficient financial systems, low capital account restrictions, and are at a higher level of economic development. The remaining 45 countries impose restrictions ranging from 5-50 per cent. However, some of those countries are at a lower level of economic development, displaying weak regulation and supervision, and are at low degrees of financial system efficiency. Those countries have preferred to impose restrictions to establish 'rules' on ownership which are effective in replacing weak supervision and regulation, and as an alternative to weak enforcement of regulatory norms on good governance. The ownership structure could be categorised into three, those with no restrictions, those requiring at least two owners, and those with ownership limits mostly in the range of 5-20 percent (Chart B18.1).

Chart B18.2 shows that the degree of financial system efficiency does not have any relationship with ownership.[2] However, most efficient countries generally do not have any restrictions. Chart B18.3 further shows that the per capita income does not correlate well with ownership.

Sri Lanka has restricted single ownership to 10 per cent in the Banking Act, but has allowed increases through a direction permitting up to 15, 20 and 25 per cent for specified entities. In the case of Sri Lanka, the two major concerns that arise in the context of corporate governance in banks and which need to be addressed are (i) the concentration of ownership and (ii) the type of people who control the bank i.e. the fit and proper status of major shareholders and directors. There are unique corporate governance challenges posed where the bank ownership structure either lacks transparency or where there are insufficient checks and balances on inappropriate activities or influences of controlling shareholders.

Further measures are needed to support the effective supervisory mechanism currently in place. Among them, major measures are adequate legal force to strengthen enforcement action, well developed public infrastructure covering contract enforcement, a general insolvency regime,

Chart B18.1
Distribution of Ownership



1 World Bank, 2003, Database on Bank Supervision and Regulation.

2 Efficiency of the financial sector is measured in the competitiveness index compiled by the World Economic Forum.

Box 18 (Contd.)

Chart B18.2
Efficiency and Ownership

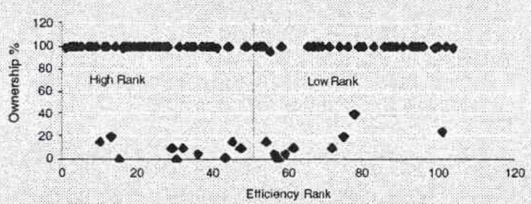
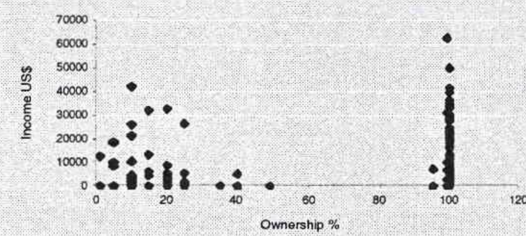


Chart B18.3
Per Capita Income (PPP) and Ownership



an accounting framework, a corporate governance regime, market discipline based on transparency and disclosure procedures for effective resolution of problem banks, and a mechanism for providing either an appropriate level of systemic protection or a public safety net.

payment system received a boost with RTGS and Lanka Secure being certified as compliant with the ten core principles of systemically important payment and settlement systems and international best practices, as set out by the Bank for International Settlements (BIS) and the International Organization of Securities Commissions (IOSCO).

- **Financial market stability was improved in 2005.** Although the stock market grew at a relatively high pace, it did not pose a threat to the stability of the financial markets. The increases in prices were consistent with the fundamentals of the corporate sector.
- **The legal and regulatory system was further strengthened to support the resilience of the financial system.** The introduction of provisions relating to the 'fit and proper test' for boards of directors, the interpretation of the term 'deposit', Islamic banking, and governance aspects of banks, provide greater clarity for regulatory puroposes. Similar clarity was introduced to the regulation of the payment, clearing and settlement systems and the regulation of money changers and electronic cheques. Further, an amendment was made to the Banking Act to prohibit fraudulent net-work marketing practices.
- **Financial system stability is maintained, but several downside risks exist.** The rising oil prices could further worsen the current account deficit thereby impacting on stability in the economic environment, which is necessary for financial stability. Fiscal consolidation has not yet been achieved and high fiscal deficits could have an impact on the performance of institutions and markets. Another perennial issue in the financial sector is the need for improvements in access to finance. In this regard, the government's intervention through the setting up of specialised financial institutions to enhance access to finance in specific areas is a positive development. However, there could be sustainability issues if a long term vision for these entities is lacking, making it difficult for them to face competition effectively in the future. The growth in credit to the private sector is still high, and it could impair credit quality. With the implementation of the capital charge for market risk in 2006, a need for the infusion of fresh capital by some banks could arise. The issues of ownership and financial conglomerates have to be resolved thereby improving corporate governance in banks. Nevertheless, continuous strengthening of the legal and regulatory framework, enhancement of capital of financial institutions, improved risk management practices, efforts of the government in fiscal consolidation, and continued market discipline would help mitigate and manage these risks.