PART II

PART II

ACCOUNTS AND OPERATIONS OF THE CENTRAL BANK OF SRI LANKA

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1. Accounts and Finance

Summary of Significant Accounting Policies

1.1 Reporting Entity and Statutory Base

These are the financial statements of the Central Bank of Sri Lanka ("Bank" or "CBSL"), the institution established under the Monetary Law Act No 58 of 1949 of Sri Lanka as amended ("MLA"), as the authority responsible for the administration supervision and regulation of monetary, financial and payment system of Sri Lanka. Central Bank of Sri Lanka is domiciled in the Democratic Socialist Republic of Sri Lanka and situated at No: 30, Janadhipathi Mawatha, Colombo 01.

1.2 Basis of preparation

The financial statements are prepared on the historical cost basis, except for land & building and certain financial assets that have been measured at fair value as identified in specific accounting policies below.

1.3 Reporting Format

The Bank presents financial assets and financial liabilities, and their associated income and expense streams, by distinguishing between foreign currency and local currency activities. The Bank considers that this reporting approach provide appropriate reporting of the Bank's activities which are more fully described in 1.26 of the summary of significant accounting policies

1.4 Adoption of IFRSs during the year

Following revised standards have been adopted during the year and comparative figures have been amended as required.

- IAS 1 Presentation of Financial Statements;
- IAS 2 Inventories;
- IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors;
- IAS 10 Events after the Balance Sheet Date;
- IAS 24 Related Party Disclosures;
- IAS 28 Investments in Associates;
- IAS 32 Financial Instruments: Disclosure and Presentation;
- IAS 39 Financial Instruments: Recognition and Measurement;

1.5 Statement of Compliance

These financial statements of Central Bank of Sri Lanka for the year ended 2005 have been prepared in accordance with International Financial Reporting Standard (IFRS)

1.6 Currency of Presentation

All amounts in Sri Lanka Rupees are expressed in thousands, unless otherwise stated.

1.7 Significant Accounting Judgments and Estimates

In the process of applying the accounting policies, the bank has made the following judgments apart from those involving estimations, which have the most significant effect on the amounts recognized in the financial statements.

(a) Impairment Losses on Loans

The Bank reviews loans given to other institutions to assess impairment yearly. In determining whether an impairment loss should be recorded, the bank makes judgments on observable data indicating impairment. The methodology and assumption used for such assessment is reviewed regularly.

(b) Impairment of Available for Sale Investment

The Bank determines that Available for Sale Investments are impaired when there has been a significant or prolonged decline in the fair value below its cost. This determination of what is significant or prolonged requires judgment

1.8 Foreign Currency Conversions

Bank's functional and presentation currency is Sri Lanka Rupees. Transactions in foreign currencies are initially recorded in the functional currency ruling at the date of transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the rate of exchange ruling at the balance sheet date. All differences are taken to the Income Statement. For the purposes of retranslation the following Sri Lanka rupee exchange rates for major currencies were used:

	2004	2005
Australian Dollars	81.5448	74.6987
Canadian Dollars	86.8704	87.7484
Euro	142.3203	120.9629
Japanese Yen	1.0179	0.8661
Special Drawing Rights (SDR)	162.4520	145.9530
Sterling Pounds	201.3699	175.9428
United States Dollars	104.6050	102.1172

1.9 Financial Assets and Liabilities

The Bank presents financial assets and liabilities, and the associated income and expense streams, by distinguishing between foreign currency and local currency activities. Foreign currency activities mainly arise from the Bank's foreign reserves management function. Local currency activities mainly reflect the assets and liabilities associated with monetary policy implementation, issuing currency and banking activities.

The separate reporting of these activities is considered to provide a better presentation of the Bank's financial position, financial performance and risk profile. The Bank considers that the combined reporting of foreign and local currency activities

CENTRAL BANK OF SRI LANKA

Income Statement

For the Year ended 31 December 2005

	Note	2005 Rs. 000	2004 Rs. 000
Operating Income:			
Income from Foreign Currency Financial Assets			
Interest Income	14	6,924,471	6,021,254
Gain (Loss) from Unrealised Price Revaluations		(90,502)	185,631
Gain (Loss) Realised from Price Changes		768,660	1,769,157
Total Income from Foreign Currency Financial Assets		7,602,629	7,976,042
Expenses on Foreign Currency Financial Liabilities			
Interest Expense	15	(1,799,733)	(1,236,140)
Total Expenses on Foreign Currency Financial Liabilities		(1,799,733)	(1,236,140)
Net Foreign Exchange Revaluation Gain (Loss)		(12,955,088)	18,453,354
Foreign Currency Investment Income (Loss)		(7,152,192)	25,193,256
Income from Local Currency Financial Assets			
Interest Income	14	6,138,433	4,339,104
Interest Expense	15	(839,599)	(506,938)
Total Income from Local Currency Financial Assets		5,298,834	3,832,166
Other Income	16	1,101,691	813,015
Total Net Operating Income (Loss)		(751,667)	29,838,437
Operating Expenses:			
Personnel Expenses	17	(2,208,455)	(1,547,872)
Depreciation		(458,876)	(359,677)
Cost of Inventory		(1,273,044)	(1,089,207)
Administration	18	(976,044)	(522,612)
Bad & Doubtful Debts and Net Sundry Write Offs		(8,209)	(46,753)
Total Operating Expenses		(4,924,628)	(3,566,121)
Profit (Loss) Before Income Tax		(5,676,295)	26,272,316
Income Tax		(570,182)	(589,029)
Net Profit (Loss) for the Year		(6,246,477)	25,683,287

CENTRAL BANK OF SRI LANKA

Balance Sheet

As at 31 December 2005

	Note	2005 Rs. 000	2004 Rs. 000
ASSETS			
Foreign Currency Financial Assets			
Cash & Cash Equivalents	1	146,128,811	143,510,890
Financial Assets:			
- Securities at Fair value through Profit or Loss	2	104,937,757	44,768,751
- Securities Denominated in Gold at Fair value through Profit or Loss	2	8,743,882	7,620,907
- Available for sale Investments	2	13,992,948	21,377,058
Other Foreign Receivables		163,667	151,423
IMF Related Assets	3	60,491,555	67,177,196
		334,458,620	284,606,225
Local Currency Financial Assets			
Investments Portfolio - Sri Lanka Government Securities		51,806,545	82,839,235
Loans to Government	4	39,746,300	34,791,100
Loans to Other Institutions	5	2,468,989	29,878
Other Local Receivables		678,665	696,755
Investments in Financial and Other Institutions	6	45,248	501,641
Other Assets		558,140	-
		95,303,887	118,858,609
Other Assets			
Inventories	7	1,351,677	950,789
Gold Inventory		59,766	59,766
Sundry Assets		1,590,099	1,399,073
Property, Plant & Equipment	8	7,832,895	8,238,062
		10,834,437	10,647,690
		440,596,944	414,112,524
LIABILITIES AND EQUITY			
Foreign Currency Financial Liabilities			
Amount Payable to Bank and Financial Institutions	9	15,630,980	4,758,324
Amount Payable to Asian Clearing Union		28,285,643	37,899,263
IMF Related Liabilities	10	102,635,004	101,645,332
Other Foreign Liabilities		1,326,619	128,346
		147,878,246	144,431,265
Local Currency Financial Liabilities			
Balances with Banks and Financial Institutions		65,483,580	55,051,087
Balances with Government and Governmental Entities	11	931,592	892,435
Securities Sold Under Agreements to Repurchase		14,107,000	7,213,000
Balances with Employee Benefit Plans	12	199,344	7,525
Other Local Deposits & Payables		838,397	717,364
		81,559,913	63,881,411
Other Liabilities			
Currency in Circulation		132,436,496	115,908,969
Deferred Government Grants		278,660	429,459
Pension and Other Post Employment Benefit Plans		974,983	465,334
Miscellaneous Liabilities		333,013	99,464
		134,023,152	116,903,226
Equity			
Contributed Capital & reserves	13	77,135,633	88,896,622
		440,596,944	414,112,524

OPINION OF THE AUDITOR-GENERAL

The accounts of the Central Bank of Sri Lanka for the year ended 31 December 2005 were audited under my direction in pursuance of provision in Article 154 of the Constitution of the Democratic Socialist Republic of Sri Lanka read in conjunction with Section 13 of the Finance Act, No.38 of 1971 and Section 42(2) of the Monetary Law Act (Chapter 422).

I am of opinion so far as appears from my examination and to the best of my information and according to the explanations given to me, the financial statements have been prepared and presented in accordance with the International Financial Reporting Standards and the stated accounting policies as set out in Notes 01 to 22 to the financial statements and give a true and fair view of the financial position of the CBSL as at 31 December 2005 and the financial results and cash flow for the year then ended.

21 April 2006
Auditor-General's Department
Colombo 7.

S. C. Mayadunne
Auditor-General

S. Mendis
Governor

K M A N Daulagala
Acting Chief Accountant

CENTRAL BANK OF SRI LANKA

Cash Flow Statement

For The Year Ended 31 December 2005

	Note	2005 Rs. 000	2004 Rs. 000
Cash Flow from Operating Activities:			
Source:			
Interest Received - Foreign Currency		6,399,379	6,429,721
Interest Received - Local Currency - Others		48,895	43,641
Liquidity Management and Trading Income		768,660	1,769,157
Realised Exchange Gain / (loss)		1,703,091	(35,947)
Other Income Received		145,767	304,009
		9,065,792	8,510,581
Disbursements:			
Interest Paid - Foreign Currency		1,652,955	1,166,276
Interest Paid - Local Currency		840,641	335,991
Payments to Employees		1,326,591	989,528
Payments to Suppliers		2,659,687	3,525,649
Income Tax Paid		538,943	567,029
		7,018,817	6,584,473
Net Cash Flow from Operating Activities	19	2,046,975	1,926,108
Cash Flows from Investing Activities:			
Source:			
Net (Increase) / Decrease in Other Local Currency Financial Assets		(749,609)	(75,484)
Principal recoveries from the Loans and Advances to Other Institutions		(2,356,411)	79,258
Disposal / Redemption of Investments in Financial and Other Institutions		474,764	119,685
Sale of Property, Plant and Equipment		16,582	267
Income on Investments in Financial and Other Institutions		35,633	86,412
Net Increase in Securities Purchased under Agreement to Re-sell		6,894,000	(13,761,201)
		4,314,959	(13,551,063)
Disbursements:			
Net Increase / (Decrease) in Foreign Currency Securities		56,826,530	(77,194,471)
Net Increase / (Decrease) in Other Foreign Currency Financial Assets		131,617	(58,635)
Net Increase / (Decrease) in Other Foreign Currency Financial Liabilities		(2,050,609)	(18,507,734)
Net Increase / (Decrease) in Other Local Deposits & Payables		(191,819)	144,643
Purchase of Property, Plant and Equipment net of Grants		53,708	42,421
Net Increase/(Decrease) in Gold Inventory		93,810	74,272
		54,863,237	(95,499,504)
Net Cash Flow from Investing Activities		(50,548,278)	81,948,441
Cash Flows from Financing Activities:			
Source:			
Issue of Circulating Currency		151,998,690	115,993,628
Withdrawal of Circulating Currency		(135,471,163)	(98,869,295)
Net Issue of Circulating Currency		16,527,527	17,124,333
Less:			
Net Issue / (Withdrawals) of Circulation Currency on Government Transactions	20	(32,265,077)	49,237,087
Net Issue / (Withdrawals) of Circulation Currency on Bank and Financial Institutions Transactions	21	(11,613,517)	(12,409,516)
Net Issue / (Withdrawals) of Circulating Currency		(43,878,594)	36,827,571
		60,406,121	(19,703,238)
Disbursements:			
Repayment of Foreign Currency Term Liabilities		(10,970,720)	11,456,546
Payments of Surplus to Government		5,000,000	1,000,000
		(5,970,720)	12,456,546
Net Cash Flow from Financing Activities		66,376,841	(32,159,784)
Net Increase in Cash and Cash Equivalents		17,875,538	51,714,765
Exchange Rate Effect on Cash and Cash Equivalents		(15,257,617)	13,855,896
Cash and Cash Equivalent at January 2005		143,510,890	77,940,229
Cash and Cash Equivalent at 31 December 2005	22	146,128,811	143,510,890

CENTRAL BANK OF SRI LANKA

Notes to the Financial Statements

As at 31 December 2005

	2005 Rs. 000	2004 Rs. 000
1. Cash and Cash Equivalents		
Balances with Overseas Banks	2,487,257	1,070,545,
Foreing Notes & Coins Account	0.	1,611
Time Deposits with Overseas Banks	112,950,743	96,686,319
Fixed Deposits Contracted in	14,244,836	4,485,742
Repurchase Agreement Account with FRB	16,445,975	41,266,672,
	146,128,811	143,510,890
2. Financial Assets		
Securities at Fair Value through Profit & Loss	104,937,757	44,768,751
Securities Denominated in Gold at Fair Value through Profit or Loss	8,743,882	7,620,907
Available-for- Sale Investments	13,992,948	21,377,058
	127,674,587	73,766,716
3. IMF Related Assets		
Holding in Special Drawing Rights	154,585	19,539
IMF Quota	60,336,970	67,157,657
Total IMF Related Assets	60,491,555	67,177,196
4. Loans to Government		
Revolving Credit	39,746,300	34,791,100
Total Loans to Government	39,746,300	34,791,100
5. Loans to Other Institutions		
Capital Outstanding	2,461,951	2,547,400
Receivable under Susahana Tsunami Loan Scheme	2,441,860	-
Interest Receivable	5,100,696	4,732,762
Gross Receivable	10,004,507	7,280,162
Less: Allowance for Doubtful Receivables	(2,434,822)	(2,517,522)
Suspended Interest	(5,100,696)	(4,732,762
Net Receivable	2,468,989	29,878
6. Investments in Financial and Other Institutions		
Regional Development Banks	-	430,113
Credit Information Bureau Ltd	12,248	12,278
National Development Bank Ltd	-	26,250
Fitch Ratings Lanka Limited	3,500	3,500
Lanka Clear (Pvt) Limited	29,500	29,500
	45,248	501,641
7. Inventories		
Notes for Circulation	1,126,682	518,834
Coins for Circulation	213,702	184,325
Coins in Transit	43,627	287,501
	1,384,011	990,660
Less: Allowance for slow moving items	(55,300)	(64,700)
	1,328,711	925,960
Stationery and Sundry Inventory	22,966	24,829
Total inventories at lower of cost and net realisable value	1,351,677	950,789

8. Property Plant and Equipment

Carrying Value	Land and Buildings (Rs. '000)	Plant & Plant Integrals (Rs. '000)	Furniture & Equipment (Rs. '000)	Others (Rs. '000)	Total 2005 (Rs. '000)	Total 2004 (Rs. '000)
At 1st January, net of Accumulated Depreciation and Provision for Impairment	7,569,370	0	193,343	475,349	**8,238,062**	8,554,160
Additions	0	76	25,290	121,616	**146,982**	42,421
Disposals, net of Accumulated Depreciation	0	0	0	0	**0**	(61)
Net Effect of reclassification/written off	(1,072,833)	934,043	48,541	(3,024)	**(93,273)**	0
Reversal of Allowance for Impairment	0	0	0	0	**0**	1,219
Depreciation charge for the year	(91,776)	(52,267)	(46,428)	(268,405)	**(458,876)**	(359,677)
At 31st December net of Accumulated Depreciation	6,404,761	881,852	220,746	325,536	**7,832,895**	8,238,062

	2005 Rs. 000	2004 Rs. 000
9. Amount Payable to Bank and Financial Institutions		
Payable to Banks	**15,226,975**	4,485,742
Payable to other Financial Institutions	**404,005**	272,582
	15,630,980	4,758,324
10. IMF Related Liabilities		
Foreign Currency IMF Related Liabilities		
Interest bearing Loans – non current	**23,704,228**	26,548,718
Interest bearing Loans – current	**15,232,384**	4,197,354
Allocation of Special Drawing Rights	**10,343,397**	11,512,648
Other Amounts Payable to IMF	**30,390,652**	30,552,522
Quota liability	**22,964,343**	28,834,090
	78,930,776	75,096,614
Total IMF Related Liabilities	**102,635,004**	101,645,332
11. Balances with Government and Governmental Entities		
Government Deposits	**372,485**	522,673
Government Agencies and Funds	**559,107**	369,762
	931,592	892,435
12. Balances with Employee Benefit Plans		
Provident Fund	**153,160**	2,701
Pension Fund	**40,393**	2,067
Widows/Widowers & Orphans Funds	**5,791**	2,757
	199,344	7,525
13. Equity		
Contributed Capital	**15,000**	15,000
Medium and long term credit Reserve	**9,425,000**	4,925,000
Surplus & Control Account Reserve	**42,584,950**	14,011,728
Capital Contribution Account	**577,859**	577,859
Fixed Assets Revaluation Account	**662,382**	662,382
Market Valuation Reserve-Securities Available for Sale	**(135,077)**	(185,717)
Profit/(Loss) for the year	**(6,246,477)**	25,683,287
International Reserve Revaluation	**30,251,996**	43,207,083
	77,135,633	88,896,622

	2005 Rs. 000	2004 Rs. 000
14. Interest Income from Financial Assets		
Interest Income from Foreign Currency Financial Assets		
Cash & Cash Equivalents	3,912,533	2,656,598
Financial Assets	2,925,756	3,302,531
IMF Related Assets	86,182	62,125
Total Interest Income from Foreign Currency Financial Assets	6,924,471	6,021,254
Interest Income from Local Currency Financial Assets		
Investment Portfolio – Sri Lanka Government Securities	6,080,552	4,254,941
Investment in Financial and Other Institutes	14,209	40,522
Other Loans and Advances	43,672	43,641
Total Net Interest Income from Local Currency Financial Assets	6,138,433	4,339,104
Total Interest Income from Financial Assets	13,062,904	10,360,358
15. Interest Expense on Financial Liabilities		
Interest Expense on Foreign Currency Financial Liabilities		
Amount Payable to Asian Clearing Union	548,417	179,811
IMF Related Liabilities	1,249,248	1,054,075
Other	2,068	2,254
Total Interest Expense on Foreign Currency Financial Liabilities	1,799,733	1,236,140
Interest Expense on Local Currency Financial Liabilities		
Securities Sold Under Agreements to Repurchase	839,599	506,938
Total Interest Expense on Local Currency Financial Liabilities	839,599	506,938
Total Interest Expense on Financial Liabilities	2,639,332	1,743,078
16. Other Income		
Dividend Income	25,343	45,890
Gain on Disposal of Property, Plant & Equipment	16,583	207
Gain on disposal of Investments in Financial and other Institutions	612,776	21,797
Amortisation of Deferred Grant	218,676	159,730
Miscellaneous Income	228,313	585,391
Total Other Income	1,101,691	813,015
17. Personnel Expenses		
Wages and salaries including PAYE paid by the employer	911,107	854,362
Pension costs	715,288	413,413
Other Defined Benefit Plan Costs	432,892	148,860
Defined Contribution Plan Costs	149,168	131,237
	2,208,455	1,547,872
18. Administration Expenses		
Repairs and Maintenance	312,417	272,048
Information	70,088	77,322
Operational Travel	23,009	21,630
Rental Expenses	349	-
Printing	15,645	32,326
Audit Fees	8,200	9,300
Remuneration to members of the Monetary Board	437	795
Medical Benefits to Pensioners	20,519	34,985
Write-off of Property, Plant & Equipments	93,049	-
Interest Expense on CBSL Provident Fund	155,178	28,839
Miscellaneous	277,153	45,367
	976,044	522,612
19. Reconciliation of Operating Profit with Operating Cash Flow		
Reported Net Profit from Operating Activities	(6,246,477)	25,683,287
Add (Subtract) Non-Cash Items		
Depreciation	458,876	359,677
Interest Received – Local Currency – Investment Portfolio	(6,080,552)	(3,239,803)
Bad debt Write-Off/ (Written Back)	(82,700)	(79,258)
Net Provision for Defined Employee Benefits Plans	1,148,180	358,252
Net Unrealised Foreign Exchange (Gain) Loss	14,658,179	(18,489,302)
Other Provision	(277,325)	(906,932)

	2005 Rs. 000	2004 Rs. 000
Add (Subtract) Movements in Other Working Capital Items		
(Increase) / Decrease in Inventories	(400,888)	(453,299)
(Increase) / Decrease in Interest Receivable	(523,788)	(647,192)
Increase / (Decrease) in Miscellaneous Liabilities	(5,583)	(483,074)
Increase / (Decrease) in Interest Payable	145,736	262,810
Increase / (Decrease) in Other Receivable	46,330	(26,213)
Add (Subtract) Investing and Financing Activities		
Income from Investments	(622,913)	(67,893)
Dividend Received	(25,343)	-
Gain on Sale of Property, Plant & Equipment	(16,582)	-
Net Unrealised Market Value Changes	90,502	(185,630)
Deferred Government Grants	(218,676)	(159,322)
Net Cash Flow From Operating Activities	2,046,975	1,926,108
20. Issues / (Withdrawals) of Circulation Currency on Government Transactions		
Maturity of Government of Sri Lanka Securities Portfolio	(133,512,344)	(78,680,476)
Purchases of Government of Sri Lanka Securities for Investment Portfolio	102,127,387	127,281,072
Interest Received – Local Currency – Investment Portfolio	(5,728,286)	(3,199,282)
Increase / (Decrease) in Loans and Advances to GOSL	4,955,200	3,587,200
(Increase) / Decrease Balances with Government and Government Entities	(39,157)	248,573
Government Grant Received	(67,877)	-
	(32,265,077)	49,237,087
21. Net Issues / (Withdrawals) of Circulation Currency on Bank and Financial Institutions Transactions		
(Increase) / Decrease in Balances with Banks and Financial Institutions	(1,181,024)	(9,387,516)
(Increase) / Decrease Intra-day Liquidity Facility to Banks and Financial Institutions	(10,432,493)	(3,002,000)
	(11,613,517)	(12,409,516)
22. Closing Cash & Cash Equivalents		
Foreign Currency Assets		
Cash Balances with Other Foreign Banks	146,128,811	143,510,890
Closing Cash & Cash Equivalents	146,128,811	143,510,890

would weaken the informational value of the financial statements.

All investments are initially recognised at cost, being the fair value of the consideration given and including acquisition charges associated with the investment. After initial recognition, subsequent measurement bases are described below. All regular way purchases and sales of financial assets are recognised on the trade date. Regular way purchases or sales are purchases or sales of financial assets that require delivery of assets within the time frame generally established by regulation or convention in the market place.

(a) Securities at Fair Value through Profit or Loss

Financial assets classified as held for trading are included in the category securities at fair value through profit or loss. These securities are subsequently valued at quoted market prices. Changes in market value are recognised as an increase or decrease in the value of the trading securities in the Balance Sheet while resulting gains and losses are recognised in the Income Statement.

Where the security is still owned, the gain or loss is reported as Gain (Loss) from Unrealised Price Revaluations. Where the gain or loss has been realised (through selling the security), this is reported as Gain (Loss) Realised from Price Changes.

(b) Foreign Currency Available-for-Sale Investments

Foreign currency available-for-sale investments are subsequently valued at quoted market prices. Changes in market value are recognised as an increase or decrease in the value of the available for sale securities in the Balance Sheet under reserves.

Gains and losses arising from changes in the market value of foreign currency available-for-sale investments are recognised on a separate component of equity (shown under Reserves in the Balance Sheet) until the investment is sold, collected or otherwise disposed of, or until the investment is determined to be impaired, at which time the cumulative gain or loss previously reported as equity is included in income.

(c) Securities denominated in Gold

Gold securities held with foreign counterparties is initially stated at cost.

Gains and losses arising from changes in the market value of Gold are recognised in the Income Statement. Where the Gold is still owned, the gain or loss is reported as Gain (Loss) from Unrealised Price Revaluations. Where the gain or loss has been realised (through selling the Gold), this is reported as Gain (Loss) Realised from Price Changes.

(d) International Monetary Fund (IMF) Related Balances

The Bank transacts with the International Monetary Fund (IMF) in its own right rather than as an agent for the Government of Sri Lanka. All transactions by the Bank with the IMF have been included in these financial statements on that basis.

Quota with the IMF is recorded by the Bank as an asset and the amount payable to the IMF for quota is recorded as a liability of the Bank. The cumulative allocation of SDRs by the IMF is treated as a liability. Exchange gains and losses arising on revaluation of IMF assets and liabilities at the exchange rate applying at balance sheet date as published by the IMF are recognised in the Income Statement.

All other charges and interest pertaining with balances with the IMF are recorded immediately in the Income Statement.

(e) Cash and Cash Equivalents

Cash and cash equivalents comprise cash at foreign banks and financial institutions and short-term deposits.

As a part of local currency activities CBSL generates certain income and incurs expenses, which do not involve in movement of cash. Those activities result in certain assets and liabilities and mainly comprise the transactions with GOSL and transactions with domestic banks and financial institutions. Transactions with the Government of Sri Lanka (GOSL) basically represents the purchase of un-subscribed portions of Treasury bills and bonds that are issued by the Government by the Bank as a monetary policy mechanism . Such purchases, disposals or interest thereon are reflected as mere book entries in the records of CBSL. These are disclosed separately in Note 20 and Note 21 to these Financial Statements.

As the sole statutory authority, CBSL issues currency to the public in line with the Monetary Law Act. Currency issued by CBSL represents a claim on the bank in favour of the holder. This is a liability on the part of the CBSL while it is an item of cash in the hands of the holder. Movement in circulation currency is included as part of financing activities in line with prevailing industry practice among those central banks which present cash flow statements.

CBSL through the cash/pay order process disburses cash in the form of Notes and Coins or cheques drawn on CBSL, to various drawees including suppliers and employees for goods and services obtained, which is either added to the currency in circulation liability or Balances with Commercial Banks. Such forms of utilisation of currency for the purposes of CBSL's payments form part of cash outflows of CBSL.

For the purposes of the Cash Flow Statement, cash and cash equivalents consist of cash and cash equivalents as defined above, net of cash/payorder outflows.

(f) Repurchase and Reverse-Repurchase Transactions

Securities sold under agreements to repurchase continue to be recorded as assets in the Balance Sheet. The obligation to repurchase (Securities Sold Under Agreements to Repurchase) is disclosed as a liability. The difference between the sale and repurchase price in repurchase transactions and the purchase price and sale price in reverse-repurchase transactions represents an expense and income respectively and recognised in the Income Statement.

Securities held under reverse-repurchase agreements are recorded as an asset in the Balance Sheet (Securities Purchased Under Agreements to Re-sell). Both repurchase and reverse-repurchase transactions are reported at the transaction value inclusive of any accrued income or expense.

(g) Investment Portfolio – Sri Lanka Government Securities

The Bank's investment portfolio consists of treasury bills and bonds purchased from Government of Sri Lanka. The portfolio is recorded in the Balance Sheet at amortised cost since they represent loans provided to the GOSL.

(h) Loans to Government

Loans to Government represents direct provisional advances made to Government of Sri Lanka under Section 89 of the Monetary Law Act No 58 of 1949 of Sri Lanka, as amended.

(i) Loans to Other Institutions

Loans granted to Other Institutions are recognised and carried at the original granted amount less an allowance for any uncollectible amounts. An allowance for doubtful debts (for loan impairment) is established if there is objective evidence that the Bank will not be able to collect all amounts due. The amount of the allowance is the difference between the carrying amount and the estimated recoverable amount. Bad debts are written off when identified.

(j) Foreign Currency Term Liabilities

Foreign currency term liabilities are subsequently reported at the amortised cost of the liabilities. Changes in the value of these liabilities are recognised as an increase or decrease in the value of the term liabilities in the Balance Sheet. Gains and losses arising from changes in value of foreign currency term liabilities are recognised immediately as expenses in the Income Statement. Where the liability is still owed, the gain or loss is reported as (Gain) Loss from Unrealised Price Revaluation. Where the gain or loss has been realised (through repayment of the liability), this is reported as (Gains) Losses Realised from Price Changes.

(k) Derivative Instruments

The Bank's involvement in derivative instruments is mainly in forward foreign exchange contracts. Such derivative financial instruments are stated at fair value. The fair value of forward exchange contracts is calculated by reference to current forward exchange rates for contracts with similar maturity profiles.

All derivative instruments in a gain or loss position, if any, are reported within the balance of foreign currency trading or available for sale securities in the Balance Sheet.

(l) Other Financial Assets and Liabilities

Local and foreign currency cash, deposits and short-term advances are recognised on trade date.

(m) Impairment of Financial Assets

The Bank assesses at each balance sheet date whether a financial asset is impaired for.

(i) Assets carried at amortised cost

If there is objective evidence that an impairment loss on loans and receivables carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (ie the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognised in the income statement.

The Bank first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant. If it is determined that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, the asset is included in a group of financial assets with similar credit risk characteristics and that group of financial assets is collectively assessed for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed. Any subsequent reversal of an impairment loss is recognised in the income statement, to the extent that the carrying value of the asset does not exceed its amortised cost at the reversal date.

(ii) Available-for-sale investments

If an available-for-sale asset is impaired, an amount comprising the difference between its cost (net of any principal payment and amortisation) and its current fair value, less any impairment loss previously recognized in profit or loss, is transferred from equity to the income statement. Reversals in respect of equity instruments classified as available-for-sale are not recognised in profit. Reversals of impairment losses on debt instruments are reversed through profit or loss, if the increase in fair value of the instrument can be objectively related to an event occurring after the impairment loss was recognised in profit or loss.

1.10 Investments in Associates

The Bank's investments in associates, together with the ones that are held for subsequent disposals are accounted for under cost method.

1.11 Gold Inventory

Gold inventory which is a highly liquid commodity is carried at cost.

1.12 Inventories

Inventories are carried at lower of cost and net realisable value. Cost is determined on a weighted average basis. Allowance is made for slow moving inventories.

1.13 Property, Plant and Equipment

Property, Plant and Equipment is stated at cost, excluding the costs of day-to-day servicing, less accumulated depreciation and accumulated impairment in value. Such cost includes the cost of replacing part of such Property, Plant and Equipment when that cost is incurred if the recognition criteria are met. Land and buildings are measured at fair value less depreciation on Buildings and impairment charged subsequent to the date of the revaluation.

Except for the freehold land, Depreciation is calculated on a straight line method over the following estimated useful lives.

Class of Asset	Useful Life
Buildings on Freehold Lands	Over 50 Years
Leasehold Land & Buildings	Over the lease period
Plant & Plant Integrals	20 Years
Furniture & Equipments	10 Years
Motor Vehicles	5 Years
Computer Hardware & Software	4 Years
Reading Materials	3 Years

The carrying values of plant and equipment are reviewed for impairment when events or changes in circumstances indicate that the carrying value may not be recoverable. Following initial recognition at cost, land and buildings are carried at a revalued amount, which is the fair value at the date of the revaluation less any subsequent accumulated depreciation on buildings and subsequent accumulated impairment losses.

Valuations are performed frequently enough to ensure that the fair value of a revalued asset does not differ materially from its carrying amount.

Any revaluation surplus is credited to the Revaluation Reserve included in the equity section of the Balance Sheet, except to the extent that it reverses a revaluation decrease of the same asset previously recognised in Income Statement, in which case the increase is recognised in Income Statement. A revaluation deficit is recognised in Income Statement, except that a deficit directly offsetting a previous surplus on the same asset is directly offset against the surplus in the Revaluation

Reserve. Upon disposal, any revaluation surplus relating to the particular asset being sold is transferred to retained earnings. An item of Property, Plant and Equipment is derecognised upon disposal or when no future economic benefits are expected from its use or disposal. Any gain or loss arising on derecognition of the asset (calculated as the difference between the net disposal proceeds and the carrying amount of the asset) is included in the Income Statement in the year the asset is derecognised. The asset's residual values, useful lives and methods are reviewed, and adjusted if appropriate, regularly.

1.14 Receivables

Receivables are carried at expected realisable value after making due allowance for doubtful debts, based on objective evidednce.

1.15 Sundry Assets

Sundry assets are carried at expected realisable values.

1.16 Provisions

Provisions are recognised when the Bank has a present obligation (legal or constructive) as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. Where the Bank expects a provision to be reimbursed, the reimbursement is recognised as a separate asset but only when the reimbursement is virtually certain.

1.17 Currency in Circulation

Currency issued by the Central Bank of Sri Lanka represents a claim on the Bank in favour of the holder. The liability for Currency in Circulation is recorded at face value in the Balance Sheet.

1.18 Pension and Other Post Employee Benefit Plans

Defined Benefit Plans

The Bank operates defined benefit schemes for Pension, Widow's and Orphan's Pensions (W&OP), Widower's and Orphan's Pensions (WR&OP), Retirement Gratuity and Post Employment Medical Benefits. Contributions are made, by the Bank and eligible beneficiaries to separately administered funds in respect of the first three schemes while Retirement Gratuity and Post Employment Medical Benefits schemes are unfunded, all others are funded. The cost of providing benefits under the defined benefit plans is determined separately for each plan using the projected unit credit actuarial valuation method. Actuarial valuations are carried out once in every three years. Actuarial gains and losses are recognised as income or expense when the cumulative unrecognised actuarial gains or losses for each individual plan exceed 10% of the higher of defined benefit obligation and the fair value of plan assets. The gains and losses are recognised over the expected remaining working lives of the employees participating in the plans.

The Past service cost is recognised as an expense on a straight-line basis over the average period until the benefits become vested. If the benefits are already vested immediately following the introduction of, or changes to, a benefit plan, past service cost is recognised immediately.

Defined Contribution Plans

Employees are eligible for Employees' Provident Fund and Contributions and Employees' Trust Fund Contributions in line with respective statutes and regulations. The Bank contributes 24% and 3% of employees' gross emoluments to Employees' Provident Fund and Employees' Trust Fund respectively which are separately administered defined contribution plans.

1.19 Grants

Grants recognised at their fair value (where there is a reasonable assurance that the grant will be received and all attaching conditions, if any, will be complied with) are shown under equity. When the grant relates to an expense item it is recognised in the Income Statement over the periods necessary to match them to the expenses it is intended to compensate on a systematic basis. Where the grant relates to an asset, the fair value is credited to a deferred government grant account and is released to the Income Statement over the expected useful life of the relevant asset on a systematic basis consistent with the depreciation policy of the related asset.

1.20 Personnel Expenses

Personnel Expenses include the full cost of all staff benefits. Salaries, related expenses and leave accrued at year-end are included in other local payables.

1.21 Operating Leases

Where the Bank is the lessee, the lease rentals payable on operating leases are recognised in the Income Statement over the term of the lease on a basis consistent with the expected benefits derived from the leased assets.

1.22 Income Tax

The income of the Bank is exempt from tax under section 118 of the Monetary Law Act 58 of 1949 as amended.

1.23 Trust and Custodial Activities

Amounts administered by the Central Bank of Sri Lanka under custodial and administration arrangements are not included in these financial statements.

1.24 Revenue & Expenses

Revenue is recognised to the extent that it is probable that the economic benefits will flow to the Bank and the revenue can be reliably measured. Expenses are recognised in the income statement on the basis of a direct association between the cost incurred and the earning of specific items of income. All expenditure incurred in the running of the business and in maintaining the property, plant & equipment in a state of efficiency has been charged to income in arriving at the profit for the year.

The following specific recognition criteria must also be met before revenue and expenses are recognised:

(a) Interest

Interest income and expense are recognised in the income statement for all interest bearing instruments on an accrual basis using the effective yield method based on the actual purchase price unless collectibility is in doubt. Interest income includes coupons earned on fixed income investments and securities and accrued discount and premium on treasury bills and other discounted instruments. Interest income is suspended when loans become doubtful of collection. Such income is excluded from interest income until received.

(b) Dividends

Dividend income is recognised when the shareholder's right to receive the payment is established.

(c) Miscellaneous

Miscellaneous income and expenses are recognised on an accrual basis.

Net Gains and losses of a revenue nature on the disposal of property, plant & equipment have been accounted for in the income statement, having deducted from proceeds on disposal, the carrying amount of the assets and related selling expenses. On disposal of revalued property, plant & equipment, any amount remaining in Revaluation Reserve relating to that asset is transferred directly to Accumulated Profit.

Gains and losses arising from incidental activities to the main revenue generating activities and those arising from a group of similar transactions which are not material, are aggregated, reported and presented on a net basis.

1.25 Contingent Liabilities and Commitments including Off Balance Sheet Items

All guarantees of indebtedness, forward foreign exchange transactions and other commitments which represents off balance sheet items are shown under respective headings recognised as off balance sheet items

1.26 Nature and Extent of Activities

The Monetary Board of the Central Bank of Sri Lanka shall, in addition to determining the policies or measures authorized to be adopted or taken under Monetary Law Act No 58 of 1949 of Sri Lanka as amended, be vested with the powers, duties and functions of the Central Bank and be generally responsible for the management, operations and administration of the Bank. The Bank is primarily responsible for the administration supervision and regulation of monetary, financial and payment system of Sri Lanka and also acts as the fiscal agent of the Government. The activities of the Bank mainly include:

- Implementing monetary and exchange rate polices.
- Issuing of currency.
- Facilitating free competition and stability in the financial system.
- Licensing and supervision of defined financial institutions.
- Organisation and management of the inter-bank settlement system and promotion of the smooth functioning of the payments system.
- Providing loans and advances to the Government, Bank's and financial institutions under various facilities.
- Acting as a depository of the Government under specific arrangements with Government and agencies acting on behalf of the Government.

The activities carried out in order to achieve its objective of economic, price and financial system stability with a view to encouraging and promoting the development of the productive resources of Sri Lanka, can be broadly segregated into foreign currency and local currency activities.

(a) Foreign Currency Activities

Foreign currency activities result mainly from the Central Bank of Sri Lanka's holdings of foreign currency assets under its foreign reserves management function. The foreign reserves management portfolio comprises foreign currency assets held for foreign exchange intervention purposes ("foreign reserves") and other foreign currency assets held for trading purposes.

The foreign currency assets are held in various currencies. The majority are denominated in United States dollars, Euros, Sterling pounds and Japanese yen. The financial instruments held within these foreign currency portfolios consist mainly of sovereign securities, securities held under reverse-repurchase transactions or balances held with other central banks, commercial banks and settlement institutions.

The Central Bank of Sri Lanka also holds, from time-to-time, foreign currency assets and liabilities that arise from international market operations.

(b) Local Currency Activities

Local currency activities arise as follows:

(i) Liquidity management operations. Liquidity management largely involves the Central Bank of Sri Lanka offsetting the daily net flows to or from government or market by advancing funds to or withdrawing funds from the banking system. Most of this business is undertaken through daily open market operations.

(ii) Holding an investment portfolio comprising Sri Lanka government securities to support the liability for currency in circulation. The Bank's policy is to hold these investments for monetary operations and not for trading

2. Bank Supervision

The regulatory and supervisory function of the Central Bank relating to banks licensed by the Monetary Board of the Central Bank is carried out by the Bank Supervision Department (BSD), with a view to ensuring the safety and soundness of the banking system and safeguarding the interests of depositors and other creditors. As at end of 2005, 36 licensed banks, i.e., 22 licensed commercial banks (LCB) and 14 licensed specialized banks (LSB), were in operation under the regulation and supervision of the Central Bank. The operations of the BSD in 2005 mainly included the following:-

2.1 Issue of Prudential Regulations

The BSD issued several new prudential regulations and guidelines as well as amendments to existing prudential requirements to the licensed banks in 2005. Details of these regulations and guidelines are at part III of this report. The new requirements were with regard to the bank authorization process, facilitation of Islamic banking, capital strengthening, corporate governance, risk mitigation and market disclosure, as follows:-

(a) Bank directors to submit an affidavit and declaration that they are fit and proper persons to hold such positions in terms of Section 42 of the Banking Act (Amendment) in 2005.

(b) Permitting banks to offer banking products based on Islamic principles subject to compliance with existing prudential requirements.

(c) Minimum equity capital requirement. The minimum capital was raised from Rs.500 million to Rs.2,500 million for LCBs and from Rs.200 million to Rs.1,500 million for LSBs excluding Regional Development Banks with a view to encouraging the consolidation of the banking sector with the presence of strong banks. Existing banks were given the time till December 2007 to meet the increased capital, provided that 50 per cent of the shortfall of capital is met by end of 2006.

(d) Accommodation to related parties. The maximum limit of accommodation granted by a bank to a director or a close relation of a director was determined as Rs.500,000 against the approved securities and Rs.500,000 in respect of credit cards without requiring securities.

(e) Single Borrower Limit (SBL). Regulation on SBL was revised to ensure uniformity among all banks by prescribing the SBL at 30 per cent of capital and to exempt from the SBL (a) facilities secured by a guarantee issued by "A" rated international and local banks or by an undertaking/guarantee issued by the Head Office in case of foreign banks and (b) facilities granted to infrastructure development projects provided that such project is funded at least 50 per cent by sources outside Sri Lanka or by a consortium of LCBs and/or LSBs excluding the bank granting the accommodation.

(f) Disclosure of financial statements. With a view to enhancing market discipline and risk assessment, the prescribed format for publication of quarterly financial statements of banks in the press was revised to include selected key performance indicators such as non-performing loans, capital adequacy, liquidity, interest margin, operational expenses and profitability.

In addition, the BSD introduced to the banking industry, a road map for the implementation of the Basel II Capital Accord through the Standardized Approach in 2007/08. Banks were requested to make a self-assessment for implementation of Basel II. A Committee consisting of representatives from banks and the BSD was set up to resolve implementation issues that may arise. The framework for implementation of the capital charge for market risk with effect from March 2006, was finalized and awaited the views of the banking industry. The Central Bank hosted two international seminars in Colombo on "Preparation of Implementation of Basel II in the Asia Pacific Region" and "10th SEACEN-FSI Regional Seminar on Basel II and Operational Risk".

2.2 Approvals for Banks, Branches and Other Banking Outlets

During the year 2005, the BSD continued to process requests for banking licenses and for the opening, closing and relocation of bank branches and other banking outlets in terms of the Banking Act. A license was issued to the SME Bank Ltd. to operate as a LSB. License to operate as a LCB was issued to the National Development Bank Ltd., which was incorporated by vesting the operations of National Development Bank of Sri Lanka, a LSB, and subsequently took over the business of NDB Bank Ltd, a LCB. The letter of provisional approval for ICICI Bank Ltd. in India to commence operations as a LCB in Sri Lanka was issued. During the year, approvals were granted for 50 new branches, relocation of 85 branches, 93 other banking outlets such as extension offices, pawning centers and student savings units, 17 relocations and 6 up-grading of banking outlets, 38 off-site Automated Teller Machines (ATMs) and one relocation of ATM. Accordingly, there were 1,507 branches, 2,314 other banking outlets and 836 ATMs in operations as at the end of 2005.

The supervisory function of the BSD has a two pronged approach – The continuous monitoring of the health of the banks through off-site surveillance and the on-site examination of banks within a defined statutory period.

2.3 Off-Site Surveillance of Licensed Banks

This function entails an analysis of the financial condition of LCBs and LSBs on the basis of periodic financial information provided by the banks to the BSD. An assessment of the risk exposure of individual banks and of the banking system as a whole is carried out. The off-site surveillance serves as an early warning system in identifying significant and critical changes in the financial condition of banks which require further investigation and examination. A new on-line web-based reporting system is currently being developed through a central database in the Central Bank covering the banking industry and registered finance companies. The new system was launched on a test basis in 2005 and will be fully implemented in 2006.

2.4 Statutory On-site Examinations of Licensed Banks

In terms of the provisions of the Monetary Law Act and the Banking Act, all LCBs and LSBs are subject to statutory examinations, at least once during each examination period as determined by the Monetary Board, which at present is two years. The BSD has adopted an on-site examination process which is risk-based and which focuses on identification of banking risks, the management of these risks and the assessment of the adequacy of resources to mitigate the risks. In 2005, the BSD undertook 22 statutory examinations which included 12 examinations that commenced in 2005 and the completion of 10 examinations that commenced in 2004. The examinations of 8 banks out of 12 that commenced in 2005 were completed and 4 examinations await completion. Accordingly, the BSD completed 18 examinations in 2005.

2.5 Resolution Action on Pramuka Savings and Development Bank Ltd (PSDB)

Following the suspension of the business of PSDB in October 2002, the Monetary Board, on 18th December, 2002, decided to cancel the banking license of the PSDB and to issue an order in terms of the provisions of the Monetary Law Act to the Director of Bank Supervision to take action to wind up the PSDB. However, in terms of subsequent judgments of the Court of Appeal and the Supreme Court on cases filed by groups of depositors and the management of the PSDB, challenging the decision of the Monetary Board, the Central Bank considered further, the options to resume the business of the PSDB in terms of the law. In this regard, several parties expressed interest in restructuring the PSDB with a view to resume business. The Central Bank evaluated proposals/concept papers with the assistance of an independent consultant, i.e., Messrs Ernst and Young, and found that none of the proposals to recapitalise and restructure PSDB to protect the interest of depositors and other creditors were feasible. Therefore, the Monetary Board decided on 3rd August, 2004 to suspend the business of the PSDB in terms of Section 76M(1) of the Banking Act and to cause the Director of Bank Supervision to make application to the competent court to wind up PSDB under Section 30(3) of the Monetary Law Act and to cancel the banking license of PSDB in terms of Section 30(10)(b) of the Monetary Law Act. Accordingly, the Director of Bank Supervision filed action bearing no. 168/CO in the District Court of Colombo for the winding-up of PSDB. Subsequently, a depositor of the PSDB filed action bearing no. 1955/2004 in the Court of Appeal seeking to quash the decision of the Monetary Board to liquidate the PSDB and to cancel its license. An interim order was issued by the Court of Appeal staying the winding up proceedings until the hearing and final determination of the Court of Appeal application. The arguments for the case were concluded in June 2005 and the judgment is awaited. In December 2005, the Government expressed its intention to restructure PSDB in the interest of depositors and other creditors and a Committee was appointed to make appropriate recommendations to the Hon. Minister of State Bank Development on a feasible proposal. Accordingly, in January 2006, the Government approved of a proposal for setting up a new state bank which will take over the liabilities and good assets of PSDB while the bad assets of PSDB will be transferred to an Asset Management Company proposed to be established for this purpose.

2.6 Financial Safety Net - Administration of the Deposit Insurance Scheme

The BSD continued to administer the voluntary Deposit Insurance Scheme, which commenced operations in 1987. This scheme was opened to banking institutions licensed by the Central Bank and co-operative societies registered under the Co-operative Societies Law No.5 of 1972, which accept deposits. In 2005, only one Multi-Purpose Co-operative Society had obtained insurance cover under the scheme in respect of deposit liabilities of its rural banks. The deposit insurance fund consisting of the premium collected and Rs.50 million allocated by the Central Bank in 1997 stood at Rs.186 million as at 31 December 2005. These funds have been invested in government securities with a face value of Rs.201 million. The proposal for a mandatory deposit insurance scheme approved in principle by the Monetary Board, to replace the existing voluntary scheme was discussed at financial reform fora and its feasibility was examined. A team of consultants from the International Monetary Fund reviewed the feasibility of the proposal and recommended a two-track approach, i.e., developing the scheme while implementing policies to improve financial system stability to support the scheme. Accordingly, a decision was taken to propose necessary legislation to implement the scheme.

2.7 Common Banking Forum

The institutional arrangements to provide a common forum within the Central Bank for the debate and discussion of banking issues are primarily through –

(a) The monthly meetings of the Governor with Chief Executive Officers of Banks: These meetings serve as a forum for exchange of views on issues and policies relating to banking operations and helps to establish a rapport between the banks and the Central Bank. Some of the major issues discussed were the implementation of the Susahana Refinance Credit Scheme to assist small and medium enterprises affected by the Tsunami, implementation of a capital charge for market risk in the capital adequacy requirement, preparation for the implementation of the Basel II Capital Accord, unauthorized use of international credit cards for network marketing pyramids and adherence to "know your customer rules", the high cost of intermediation in the commercial banking sector and the need to increase deposit rates in line with market interest rates, revision of the format for quarterly disclosure of financial statements in the press and amendments to several prudential requirements. In addition, the CEOs were regularly apprised of economic and monetary developments in the country to facilitate more informed business decisions by banks.

(b) Meetings of the two Committees on Financial System Stability and Reforms

   (i) Financial Sector Cluster (FSCL): The FSCL has been set up under the National Council for Economic Development (NCED) appointed by the former H.E. The President in June 2004 under Article 33 of the Constitution. The NCED consists of six members chaired by the Secretary to the Treasury. 24 Clusters under the NCED have been appointed to assist the NCED in reviewing and identifying the necessary reforms and to make appropriate recommendations. The other clusters of the NCED cover subjects such as Taxation, Capital Market, Legal, Apparel, Telecommunication, Small and Medium Enterprises, Exports, Transport, Tourism and Trade and Tariffs. Each cluster is co-chaired and consists of experts/ professionals in the respective fields as members. The clusters are expected to look into the practical difficulties faced when implementing government policies and take action to accelerate the projects/ programmes ensuring their benefits cascade to the targeted layers of the economy without hindrance.

   Two key objectives of the FSCL were the formulation of policies to promote financial stability and to increase access to finance by local entrepreneurs, Small and Medium Enterprises (SMEs) and the rural sector. The FSCL, co-chaired by the Deputy Governor of the Central Bank and Deputy Secretary to the Treasury, has 11 members. The FSCL had 7 meetings in 2005. Activities of the FSCL focused on a feasibility study of the proposed mandatory deposit insurance scheme, increased access to finance through the reform of the postal savings units of the National Savings Bank and follow up on pending financial legislation.

   (ii) Financial Stability Committee (FSC): The remit of the FSC of the Central Bank is the assessment of risks and vulnerabilities leading to major financial system instabilities in the country and recommending policies to promote financial system stability which is one of the two statutory objectives of the Central Bank. As at end of 2005, the FSC's membership consisted of 13, i.e., two Deputy Governors and 11 other members of the senior management whose functions have a direct bearing on financial system stability. The FSC had 4 meetings in 2005. During the year 2005, the FSC released the first Financial Stability Review and four pamphlet series of publications, i.e., Objectives, Functions and Organization of the Central Bank of Sri Lanka, A Guide to Foreign Exchange Transactions, Price Stability and Financial System Stability, for the enhancement of public awareness on the financial system. In addition, with the approval of the Monetary Board, the FSC arranged to appoint a working group consisting of regulatory authorities in the financial system to assess and monitor risks arising from operations of financial conglomerates in the country. Other areas of focus of the FSC were with regard to the proposal for a mandatory deposit insurance scheme as a financial safety net instrument, implementation of a central database for monitoring on-line information of banks and finance companies and oversight of the payments system and the business continuity and disaster recovery plans of financial institutions.

2.8 Public Awareness of the Financial System

In 2005, the BSD issued two publications in newspapers with a view to increasing public awareness about the financial system, i.e., one-page paper advertisement on *"A Guide to Interest Rates of Banks"* and a half-page press notice titled *"Institutions Legally Permitted to Accept Deposits from the Public."* Through these publications, the BSD advised the public to assess and be cautious of the risks and return on their transactions with financial institutions.

3. Currency

3.1 Currency Issue

The Central Bank of Sri Lanka as the sole currency issuing authority in Sri Lanka, continued to perform the function of issuing legal tender currency for the use of domestic transactions during the year 2005. The volume of currency notes and coins in circulation by the end of 2005 stood at Rs.132 billion , as against Rs.116 billion at the end of 2004. This has been the highest ever recorded currency circulation in the country. Notes in circulation comprised 97 per cent of the total currency in circulation. The quantity of coins issued to commercial banks during the year amounted to 115 million pieces with a total value of Rs.250 million compared to previous year's 112 million pieces with a total value of Rs.272 million. The quantity and value of coins issued to commercial banks during the period 2000 - 2005 are given in Table II - 3.

3.2 New Series of Circulation Coins

A new series of circulation coins were introduced by the Bank in fulfilling a long felt need to reduce the size and weight of coins, together with emphasis on reducing the coin minting cost. With the introduction of the new coin series, the Bank was able to save around Rs. 600 million from its year 2005 coin indent. The new series consists of Rs.5, Rs.2, Re.1, Cts.50 and Cts.25, which were issued for circulation on 14th December 2005. Obverse and reverse designs of the new coins are identical to the existing circulation coins of same denominations. The size and the colour of the new Rs.5 and Rs.2 coins remained unchanged while the weight and alloy were changed. Re.1, Cts.50 and Cts.25 coins are smaller in size and lighter in weight compared to the existing coins of similar denominations and are minted in different alloys and colours for easy identification purposes. These new coins will be circulated along with the existing circulation coins.

3.3 Detection of Counterfeit Notes

The Department also continued to work in close cooperation with the Counterfeit Currency Bureau of the Criminal Investigation Department to contain and minimize counterfeiting attempts. The number of counterfeit notes detected in the country and referred for certification to the Central Bank as required by the Monetary Law Act increased from 4.5 notes per million notes in circulation in 2004 to 11.8 notes per million notes in circulation in 2005.

3.4 Destruction of Unserviceable Notes

During the year the two currency verification, counting and sorting (CVCS) machines processed 130.7 million serviceable and unserviceable notes. The department was able to destroy the backlog of 168 million soiled currency notes which remained in the vaults since 1996 using incinerator facilities available with external agencies.

3.5 Sale of Commemorative Notes and Coins

The Department continued to sell commemorative notes and coins to numismatists and collectors. The selling prices of gold and silver commemorative coins are displayed at the counter section of the Currency Department. The Central Bank web site provides the updated details of these coins. Details of other commemorative notes and coins available for sale at the Central Bank together with their selling prices are given in Table II - 4.

3.6 Training and Awareness Programmes

The Currency Department conducted awareness programs on bank notes with special reference to the identification of counterfeit notes, clean note policy and the introduction of the new coin series for bank officers, police officers, school children, government employees and general public through public lectures, seminars, electronic and print media. Articles to newspapers and Journals were written on the issue of new coin series and bank notes and counterfeiting aspects of currency.

Six seminars were conducted with the auspices of Royal Mint, UK on introduction of the new series of coins for the Central Bank and commercial bank officers at the Bank's head office in Colombo and Kandy, Matara and Anuradhapura organised by banks' three regional offices.

One seminar was conducted with the auspices of De La Rue, UK on identification of counterfeit notes for the Central Bank and commercial bank officers and 14 seminars were conducted by the Currency Department for commercial bank and

TABLE II-3

Quantity and Value of Coins Issued to Commercial Banks 2000 - 2005

Year	Coin Denomination and Quantity (No of coins, in thousands)											Total Value
	Rs.10	Rs.5	Rs.2	Re.1	Cts.50	Cts.25	Cts10	Cts.05	Cts.02	Cts.01	Total quantity	(Rs. in thousands)
2000	10,693	15,413	16,186	4,876	6,936	4,320	1,955	1,287	75	430	62,171	226,057
2001	6,136	20,726	22,668	19,328	4,286	5,996	2,380	399	60	205	82,184	233,557
2002	10,965	16,820	19,968	11,991	8,466	5,752	1,770	396	185	425	76,738	251,553
2003	5,735	23,512	27,187	29,160	8,276	5,964	2,905	294	195	220	103,448	264,384
2004	5,670	24,677	25,218	34,093	9,220	9,184	2,785	549	105	80	111,581	271,829
2005	1,601	27,983	21,543	43,297	11,374	8,396	152	225	280	15	114,866	250,126

TABLE II-4
COMMEMORATIVE COINS & NOTES AVAILABLE FOR SALE

Item No.	Description	Year of Coin	Face Value (Rs.)	Metal/ Material	Selling Price (Rs.)
1	3rd Anniversary of the Induction of President R Premadasa (Capsule)	1992	1	Cupro / Nickel	250
2	50th Anniversary of the UNO (Capsule)	1995	5	Nickel Brass	200
3	50th Anniversary of Independence of Sri Lanka (Folder)	1998	200	Polymer Note	400
4	50th Anniversary of Sri Lanka Army - Proof (Pr.Box)	1999	1	Nickel Plated Steel	400
5	50th Anniversary of Sri Lanka Navy - Proof (Pr.Box)	2000	1	Cupro / Nickel	500
6	50th Anniversary of Sri Lanka Navy - Brilliant Uncirculated (Pr.Box)	2000	1	Nickel Plated Steel	200
7	250th Anniversary of Syamopali Maha Nikaya (Coin Folder)	2003	Rs.5x10	Nickel Brass	100

police officers in Colombo, Kandy, Matara, Kegalle, Kurunegala, Nuwaraeliya, Kalutara, Vavuniya, Anuradhapura and Matale districts during the year.

The department also participated in the following exhibitions with a view to enhancing public awareness on currency handling.

(a) 245th Mahapola exhibition organized and conducted by the Ministry of Finance and Planning held in Kegalle from 26th April to 1st May 2005.

(b) Commerce Day celebration held at St. Anthony's College Wattala on 1st August 2005.

(c) 'Agayamu Lamaviya' exhibition organized and conducted by the Ministry of Information and Media held at BMICH from 30th September to 2nd October 2005.

(d) 'Thurunu Shakthi' Exhibition organised and conducted by the Ministry of Finance and Planning held in Ruwanwella from 2nd to 6th November 2005.

(e) Exhibition organized and conducted by the Department of Economics of the Kelaniya University held from 6th to 8th December 2005.

The Central Bank stall at all these exhibitions was well patronized by school children and members of the public.

4. Domestic Operations

The Domestic Operations Department continued to perform its dual function of implementing the Bank's monetary policy mainly through Open Market Operations (OMO) and enforcing Statutory Reserve Requirement (SRR), and functioning as the banker to both commercial banks and the government. In addition, as an ancillary service, the department continued to provide Intra day Liquidity Facility (ILF) to commercial banks and primary dealers to ensure the smooth functioning of LankaSettle, the Real Time Gross Settlement system of the country.

4.1 Implementation of Monetary Policy

(a) Open Market Operations (OMO)

The department continued to conduct OMO within the framework of market based monetary policy operations introduced in 2003. Under this framework, OMO included several operations: (a) conducting daily auctions either for repurchase (Repo) transactions to absorb excess liquidity or reverse repurchase (reverse Repo) transactions to inject liquidity, if there is a shortage of liquidity, on a daily basis, (b) provisions of Repo and Reverse Repo facilities under standing facilities and (c) outright sales of Treasury bills or purchases of both Treasury bills (in the primary and secondary markets) and Treasury bonds (in the secondary market only) at the discretion of the Central Bank to absorb or inject liquidity on a long term basis. Monetary policy operations were conducted within a corridor of interest rates formed by the Repo rate and the reverse Repo rate of the Central Bank. Treasury bills were used as collateral for repo transactions, while both Treasury bills and bonds were used for reverse Repo transactions. All commercial banks and primary dealers continued to be participating institutions (PIs) under the system.

During the year, the money market remained well liquid with an excess liquidity of around Rs. 10.5 billion on average. During the first four months of the year, excess liquidity was much higher at an average of Rs. 15.5 billion and remained within a range of Rs. 7 billion–26 billion. This high volume of excess liquidity was largely due to net inflows of foreign exchange, particularly following the Tsunami devastation, which were sold to the Central Bank. As such a high volume of excess liquidity would fuel credit expansion which was considered already high, the Central Bank commenced outright sales of Treasury bills out of its holdings, in April 2005 to reduce excess liquidity on a permanent basis, while absorbing, on a daily basis, almost the entire excess liquidity through the daily auction. Immediately after the Tsunami devastation, it was considered prudent to allow the banking system to operate with a high volume of excess liquidity to ensure smooth operations of the country's payments and settlements system.

(i) Daily Auction Under OMO

Repo Transactions

In line with the decision to allow the market to remain well liquid during the first few months, the absorption of excess liquidity through the daily auction was initially reduced to about

50 per cent of the estimated excess liquidity and suspended during 5 January-21 February 2005. The daily auction was recommenced on 21 February 2005 and the amount absorbed through the auction was gradually increased almost to the entire estimated liquidity surplus by early March 2005.

The excess liquidity recorded on most days during March-December 2005, was absorbed on a daily basis through the daily auction by selling Treasury bills on a repurchases basis. On average about Rs. 10 billion was offered to the auction and it amounted to around 97 per cent of the estimated excess liquidity. The value of bids received and the amount accepted were around 97 per cent and 92 per cent, respectively of the amount offered. The daily auction was not conducted on five days in May, eight days in June and five days in December as liquidity in the banking system was broadly in balance.

The weighted average yield rate at the auction which was 7.88 per cent on 24 December 2004, the last business day prior to Tsunami, declined to 7.59 per cent at the recommencement of the auction on 21 February 2005 and remained closer to the lower bound of the corridor (7.50 per cent), till about end March 2005, mainly due to the absorption of a lesser amount of excess liquidity through the auction. Despite the absorption of almost the entire excess liquidity through the daily auction since early March, 2005 the yield rate continued to remain low initially as PIs were rather cautious in their bidding at the auction. However, rates moved up gradually, towards the middle of the interest rate corridor, particularly with the commencement of outright sales of Treasury bills in April 2005 to absorb liquidity on a permanent basis.

Reverse Repo Transactions

Since the introduction of the present system of monetary policy operations, the first auction for reverse repurchase transaction was held on 20 June 2005, the date on which there was a liquidity shortfall of around Rs. 3.7 billion. The auction was fully subscribed and the amount offered, Rs. 2 billion, was accepted at 9.00 per cent, which happened to be the interest rate in the middle of the interest rate corridor.

(ii) Standing Facilities

Standing facilities were continued to be an avenue for those PIs which were unable to manage their short term liquidity fully through transactions in the inter bank money market and at the daily auction under OMO. These facilities were provided at the Repo rate and the reverse Repo rate of the Central Bank, which were increased by 125 basis points in four steps to 8.75 per cent and 10.25 per cent, respectively by December 2005.

Repo Transactions

During the first three months of the year, there was a heavy volume of Repo transactions under standing facilities (about Rs. 9 billion per day on average) as the absorption through the daily auction was either suspended or reduced. However, during the rest of the year, as excess liquidity was absorbed primarily through the daily auction Repo transactions under standing facilities were limited to about Rs. 1 billion per day on average.

Reverse Repo Transactions

Usually PIs obtain funds from the Central Bank through reverse repurchase transactions when there is a shortage of liquidity in the banking system. However, even when the liquidity is broadly in balance or the market operates with relatively a small surplus in liquidity, there has been reverse repurchase transitions under standing facilities. This development was a reflection of a rigidity in the market arising from self imposed limits of banks on their lending to other PIs, which made it difficult for some PIs to raise funds in the inter bank market. Accordingly, reverse Repo transactions under standing facilities helped contain the volatility in the money market. On average, there were reverse Repo transactions of around Rs. 1.5 billion per day under standing facilities on fifty-four days during the year.

(iii) Total Volume of Repo and Reverse Repo Transactions

Total volume of repo transactions under both the daily auction and standing facilities amounted to Rs. 2,507 billion in 2005, an increase of 56 per cent from Rs. 1,602 billion in 2004. Total volume of reverse Repo transactions increased from Rs. 37 billion in 2004 to Rs. 80 billion in 2005.

(iv) Outright Transactions

In order to absorb excess liquidity on a permanent basis, in April 2005, Central Bank commenced conducting auctions to sell Treasury bills outright, out of its own portfolio. During the year, eighteen auctions were held and thirteen of them were well over-subscribed. One auction was totally rejected as the bids received were at unacceptably high yield rates. The total value of Treasury bills sold was Rs. 37.2 billion which was around 85 per cent of the amount offered for sale. These Treasury bills were very short term with number of remaining days to maturity ranging from 7 to 58 days (the majority between 32-45 days). These sales were at yield rates, which were below the rates comparable with the prevailing weighted average yield rate for 91 day Treasury bills in the primary market at the time of each out right sale.

(b) Statutory Reserve Requirement (SRR)

The Department continued to enforce SRR which remained at 10 per cent of deposit liabilities of commercial banks, denominated in Sri Lanka rupees.

c) Bank Rate

The Central Bank's rate of interest (Bank rate) on short term advances to licensed commercial banks, stipulated under Section 87 of the Monetary Law Act, remained unchanged at 15 per cent. However, this rate was inoperative since no bank resorted to borrow from the Central Bank at the bank rate.

CHART II-1
OMO REPO AUCTIONS-2005
(Monthly Averages)

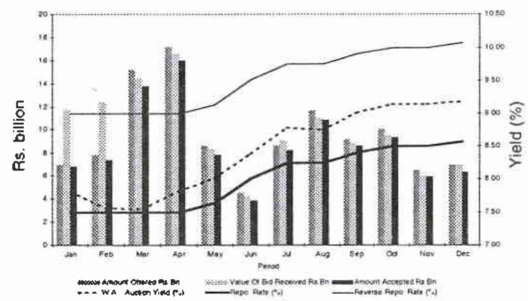


CHART II-2
MONTHLY REPO VOLUMES
(2004 and 2005)

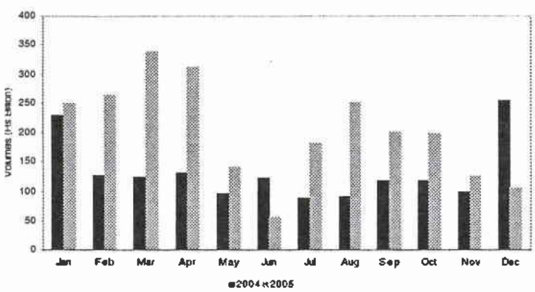
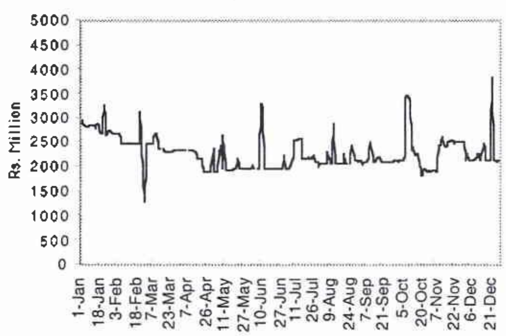


CHART II-3
ILF DRAWN IN 2005



4.2. Functioning as Banker to Commercial Banks and the Government

(a) Accounts of Financial Institutions

Facilitating the Central Bank to operate as the Banker to banks, the Department continued to provide current account facilities to commercial banks and primary dealers to ensure an efficient inter bank payment and settlement system. These accounts were operated on a Real Time Gross Settlement basis within the automated general ledger system of the Bank.

(b) Government Accounts

Facilitating the Central Bank to serve as the Banker to the government, the department continued to maintain accounts of government departments, government agencies and institutions and certain statutory boards, providing them with required banking facilities. The total number of such accounts maintained by the bank stood at 33 at end 2005. During the year, six new accounts were opened and 28 accounts were closed at the request of the government. In terms of Section 89 of the Monetary Law Act, the Bank continued to provide provisional advances to the government. The limit on such advances (10 per cent of the estimated government revenue) was increased by Rs. 5.6 billion to Rs. 41.2 billion in 2005. There was no interest charged on these advances.

4.3 Provision of Intra Day Liquidity Facility

The department continued to provide intra day liquidity facility (ILF), to commercial banks and primary dealers to ensure smooth and efficient operations of LankaSettle. The discharge of this responsibility included prompt dealing with requests of participating institutions for intra day liquidity and their reversals and promptly charging default interests on those who failed to settle ILF before the close of business of LankaSettle on the same day. ILF was continued to be provided free of charge against the collateral of government Treasury bills and bonds. Securities were valued at their current market prices with a sufficient 'hair cut' to cover possible variations in prices during the day.

The total value of ILF drawn during the year was Rs. 543 billion. This amounted to ILF drawings of Rs. 2.3 billion per day on average, which was slightly lower than the average of Rs. 2.7 billion drawn in 2004. There were no ILF defaults by participants in 2005. The measures in place, including penalty interest at the Bank Rate and the suspension of the facility for repeated defaults has ensured the prompt reversal of ILF before the close of business of LankaSettle.

5. Economic Research

Economic Research Department (ERD), functioning under the provisions of Section 25 of the Monetary Law Act, prepared data and conducted economic research for the guidance of the Monetary Board and the management of the Central Bank in formulating, implementing, and executing monetary policy while disseminating the information to the public.

The preparation of data was conducted on a daily, weekly, monthly, quarterly, bi-annual and annual basis on all important economic frontiers. Some of the important economic data compiled by ERD included the monetary survey, interest rates, the balance of payments, exchange rates and exchange rate indices, foreign reserves position, trade indices, export proceeds monitoring, budgetary outturn, industrial production index, agricultural production index, and Greater Colombo Housing Approval Index.

Research activities were focused primarily on the formulation and implementation of monetary policy, followed by the appropriate design and implementation of other domestic and external sector policies. In this regard, emphasis was placed on further strengthening of the monetary policy decision making framework. The department played a vital role in facilitating the Monetary Policy Committee (MPC) deliberations by providing comprehensive economic analysis and inputs monthly on the continuation of or variations to the monetary policy stance, later submitting the reports incorporating views and concerns of the MPC to the Monetary Board. The Monetary Board decisions on the monetary policy stance were disseminated to the market through press releases, as per the pre-announced calendar. In addition to those, ERD staff continued to undertake research in subjects of contemporary importance. Some of the research studies were published in the two volumes of "Staff Studies" edited by ERD.

The staff of ERD was also engaged in conducting joint research with international organizations, such as the SEACEN Centre, SAARCFINANCE and UN ESCAP. Several senior officers of ERD served on various important committees, both within and outside the Bank. Some of those are the preparatory meetings on trade agreements with SAARC as a whole as well as with individual countries such as Pakistan and the US, and working on negotiations on a Comprehensive Economic Partnership Agreement (CEPA) with India. They also served on the Boards of Directors of several institutions, and as resource persons in training programmes conducted by the Centre for Banking Studies (CBS) and other foreign and local organizations. The department provided inputs and participated in the deliberations of various committees within the Central Bank such as the Market Operations Committee (MOC), the Domestics Debt Management Committee (DDMC) and the Foreign Reserves Management Committee (FRMC) during the year. The senior research officers of the department provided assistance in the training of postgraduate degree aspirants of the Central Bank and guided them on their research work. The stabilization funds for tea, rubber and coconut have been managed since its inception by the ERD as the Director of Economic Research is the Chairman of these funds. However, all credit balances of these funds were transferred to the General Treasury as per a request made by the Treasury in 2005.

Preparing Bank's statutory reports and other special reports in all three languages is a primary responsibility of the ERD. The department coordinated the publication of the Bank's Annual Report for 2004, Recent Economic Developments – Highlights of 2005 and Prospects for 2006, and the monthly bulletins in 2005. In addition, ERD was responsible for the preparation of statutory reports which the Central Bank is required to submit to the Minister of Finance under the MLA.

The department continued to disseminate information through its statutory publications, publications of weekly and monthly selected economic indicators, Central Bank website, and through press releases. ERD continued to issue monthly press releases on International Trade and quarterly press releases on Balance of Payments in 2005. ERD continued to improve data dissemination through improving the quality, coverage and timeliness as well as widening the access.

ERD continued to coordinate relationships with international multilateral financial organizations. ERD coordinated Sri Lanka's relations with the IMF, especially the Article IV consultations, the inter governmental Group of Twenty Four (G-24), the SEACEN Centre for Research and Training, the SEANZA group and the SAARCFINANCE grouping of Central Bank Governors and Finance Secretaries. In 2005, ERD assisted the Ministry of Finance to coordinate work with the World Bank, the Asian Development Bank and other multilateral and bilateral donors. ERD was primarily responsible for organizing the SEACEN Executive Committee (Exco) meeting in January 2005 and SAARCFINANCE seminar on 'Combating Pyramid Schemes' in June 2005.

ERD continued to train its officers in the areas of its core functions, using programs available both locally and overseas with a view to improving staff skills. ERD staff attended weekly and monthly seminar series of the Central Bank as well as important seminars and workshops held outside. The staff also conducted special weekly seminar series in the department to discuss topical subjects of interest and to share knowledge gained by fellow officers from training programmes that they have attended.

6. Employees' Provident Fund

In terms of the EPF Act, the Monetary Board is responsible for receiving contributions, surcharges, and income from investments, maintaining accounts of registered employments, members and the Fund, investing of excess monies in suitable investments, and paying benefits to the members of the Fund. These activities were carried out during 2005 in the close co-ordination with the EPF Division of the Department of Labour.

6.1 System Improvements

Efficiency improvements were brought into various aspects of the Fund's operations. Emphasis was placed on promoting the process of collecting member contribution data through electronic media. The target is to enroll the employers with more than 150 employees into this mechanism within the first half of 2006, so that about 75 per cent of contributing members will be covered. A special project was established in 2005 to collect updated information relating to non-contributing members of the Fund. The purpose of this task is to send the annual statements to members with regard to their non-contributing accounts also in the future. (Currently, EPF sends the semi-annual member statements only to the contributing members). This is an important step towards the improved member disclosure policy of the Fund. The EPF website (www.epf.lk) was redesigned in order to provide a better interaction with stakeholders. All forms relavent to EPF matters can now be downloaded by the EPF members and employers from the web site. A tender was awarded to procure, install and commission an accounting and investment package where the installation would be completed during the second quarter of 2006. This computer package would ensure the efficiency and accuracy of general accounting, investment and risk management functions of the EPF.

The annual member statements for 2004 and the semi-annual member statements for the first half of 2005 were issued to members through their employers during 2005. Efficiency improvements, which have already been brought in to the operations, enabled the EPF to issue these statements 2-3 months earlier than the previous year.

6.2 Public Awareness and Member Disclosures

The awareness programme continued in 2005 focusing on all stakeholders of the Fund. The Help Desk continued to gain popularity among members in attending to member inquiries promptly. During the year, eleven mobile services were conducted in the estate sector, which provided real-time solutions for the discrepancies in the EPF databases. A series of seminars were held for the employers to help them follow an error-free process of EPF remittance and promote the electronic media data submission. A manual on EPF operations named 'Sevaka Arthasadaka Aramudale Athpotha' was also published in 2005.

6.3 Capacity Building in the EPF

The skills development activities of the EPF staff were continued. The participants shared their knowledge and experience gained from local and foreign training mainly through seminars and articles. An environment to practice the acquired knowledge was also provided. After the successful completion of the fund management training programme of two years, thirteen young professionals were recruited to the various units of the Fund Management Division. The purpose of these capacity-building activities is to enrich the Fund with competent human resources, to bring service excellence.

6.4 Housing Loan Facilities

A facility is available for EPF members from 1988 to obtain a loan for housing purposes from approved lending institutions keeping their EPF balances as collateral. During 2005, EPF issued 14,600 member balance certifications for a total approved credit amount of Rs.2,766 mn. A second loan is also available upon the successful settlement of the first loan. However, although the lending institutions charge a penal rate of about 36 per cent per annum on the amounts defaulted, the members tend to default the repayment of the loans. Since the defaulted amount together with a penal interest is deducted from the relevant EPF member's account and paid to the lending institution by the EPF. In these instances, the members' retirement savings get eroded. Further, defaulters are not entitled for a second loan or a loan at 4 per cent interest rate under Shramodha Home Loan Scheme. Table II – 5 shows the increasing trend of the housing loan details.

6.5 Shamodha Home Loan Scheme for EPF Members

A new housing loan scheme named " Shramodha Home Loan Scheme" was launched in December 2005 with the initiation of the Ministry of Labour Relations and Foreign Employment, 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. Housing Development Finance Corporation (HDFC) and State Mortgage and Investment Bank (SMIB) are the participating credit institutions. In granting the loan, the participating credit institution would ascertain the repayment capacity of the EPF members, based on their own credit evaluation guidelines. In case of default of a loan obtained under this scheme, the lending institution would acquire the property. Accordingly, no payment will be made from the member's EPF balance. However, defaulters of the EPF pledged loan scheme is not entitled for a loan under the new scheme. This concessionary rate housing loan scheme would facilitate the members to possess a house or property of their own at an affordable cost while minimizing the defaults of the EPF pledged loan scheme.

TABLE II-5

Details of Housing Loan Facility for the EPF Members

Year	Member balance certificates issued (No.)	Amount of credit approved (Rs. million)	Housing loans defualted (No.)	Amount paid by EPF on housing loan defaults (Rs. million)
2000	12,938	1,648	19,944	262
2001	16,066	2,091	24,202	381
2002	19,502	2,673	31,574	541
2003	18,689	2,792	40,085	670
2004	14,307	2,452	43,108	735
2005	14,600	2,766	47,000(a)	750(a)

(a) Estimates

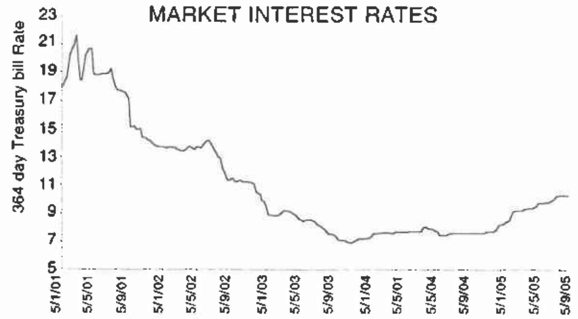
Source : Employees' Provident Fund

6.6 Investment Activities and Returns

During the year, the total investment portfolio of the Fund grew by 12.5 per cent, recording a value of Rs 405 billion as at end 2005. Sustaining the last 8-year trend, the investments in Treasury Bonds - a long-term marketable investment instrument, further increased to 83 per cent of the total investment portfolio as at end 2005, as against 77 per cent in the previous year. The investments in Government Rupee securities – a non-marketable instrument, were further reduced to 14 per cent of the portfolio from 20 per cent as at end 2004.

In EPF 97.8 per cent of its total portfolio was invested in government securities as at end 2005. The rate of return of the EPF's investment portfolio and the rate of interest payable to EPF members depend on the government securities rates prevailed in the market, as EPF continues to invest majority of its portfolio in government securities. The market rates of Treasury bonds prevailed at a low level of 8-11 per cent in 2004 and 2005 compared with a range of 15-22 per cent in 2001. Chart II-4 shows the movemant in the government securities rates during last four years. Therefore, the realizable rate of return of the EPF portfolio in 2005 further declined in line with the long-term market interest rate trend.

CHART II-4



Overall, the long-term bullish trend in the equity market that commenced in 2001 continued during the year under review also, despite the short-term fluctuations. The market continued to gain momentum and the ASPI reached an all time high of 2551 points in mid November. Tension emerged in peace front caused the overall market to decline by 27 per cent by the latter part of 2005, which, however, eased at the beginning of 2006. EPF could build up its listed equity portfolio with long-term profit potential investments while realizing short-term profits also from temporary market fluctuations. The total realized return by EPF from its equity investments during 2005 amounted to Rs 908 million or 39 per cent from the average equity investment (Table II-6). During the entire investment period of eight years from 1998 to 2005, EPF could earn a healthy return of 23 per cent on average from the equity investment portfolio. Equity investment however, amounted only to 0.7 per cent of the total EPF portfolio as at end 2005.

TABLE II - 6

EPF: Performance of equity portfolio during 2005

Rs. million

Item	2004	2005
Average Portfolio	1,064	2,335
Total Dividend Income	112	91
Total Capital Gains	318	817
Total Dividends & Capital Gains	**430**	**908**

Source: Employees' Provident Fund

TABLE II - 7

EPF: Secondary Market Activities during 2005

Rs. million

Item	Volume Purchased		Volume Sold **		Capital Gain	
	2004	2005	2004	2005	2004	2005
Treasury Bonds	13,311	5,188	20,094	11,433	1,225	774
Treasury Bills	2,572	196	6,634	381	5	0.12
Equity Shares	824	2,703	380	1,628	318	817
Total	**16,707**	**8,087**	**27,108**	**13,442**	**1,548**	**1,591**

** At cost values Source: Employees' Provident Fund

Capital gains realised from government securities declined in 2005 compared to 2004 due to non-conducive market situation. However, the equity portfolio generated a capital gain of Rs. 817 million in 2005, which is an increase of 150 per cent from Rs. 318 million recorded in 2004. The performance of the equity investments could compensate the drop in capital gains from the government securities and enabled the EPF to realise a total capital gain of Rs. 1,591 million in 2005 which is Rs. 43 million higher than the total capital gain of 2004 (Table II-7).

6.7 Total Member Balance and Rate of Interest for 2005

The total member balance of EPF grew at 12 per cent during 2005 to record a value of Rs 418 billion as at end 2005, after

TABLE II - 8

EPF: The Salient Features

Item	2004	2005 *
Total Number of Members Accounts	10,307,477	10,778,876
Currently Contributing Members Accounts (CCMA)	1,973,601	2,045,000
Currently Non-contributing Members Accounts (CNMA)	8,333,876	8,733,876
Contributing employers	53,567	56,067
Total Contributions (Rs.mn.)	23,330	27,315
Total Refunds (Rs.mn.)	16,617	17,024
Number of Refunds	98,666	93,841
Total Investment Portfolio (Rs.mn.)	360	405
Government Securities Investments as a % of Total Investments (%)	98.2	97.8
Private Sector Investments as a % of Total Investments (%)	1.8	2.2
Realized Rate of Return on Average Portfolio (%)	11.56	10.92
Total Members Balance (Rs.bn.)	373	418
Total Gross Income (Rs.mn.)	39,315	41,818
Income Tax (Rs. mn.)	4,735	3,201
Administration Expenses (Rs.mn.)	360	418
Administration Expenses as a % of Gross Income (%)	0.9	0.9
Annual Interest Rate Declared on Member Balances (%)	9.50	9.00
Effective Interest Rate Declared on Member Balances (%)	9.59	9.13

** Provisional data* *Source : Employees' Provident Fund* accounting for the annual interest rate of 9 per cent declared for the year. In accordance with the statutory requirement of the Fund of declaring the rate of interest at the year-end member balance, this interest rate turns out to be an effective rate of 9.13 per cent. This effective rate is 3.49 per cent and 0.87 per cent higher than the commercial banks' Average Weighted Deposit Rate (AWDR) and Average Weighted Fixed Deposit Rate (AWFDR) of 5.64 per cent and 8.26 per cent, respectively.

The salient features of the EPF are presented in the Table II-8 .

7. Exchange Control

The management and regulation of receipts and payments of foreign exchange inflows to and out flows from the country is the key function of the Exchange Control Department (ECD). In the year 2005, all foreign exchange payments and receipts relating to current account transactions and some capital account transactions continued to be permitted without restrictions through commercial banks appointed as Authorized Dealers in foreign exchange and allowing them to use their judgement and discretion subject to exercising customer due diligence. In addition to authorized dealers, money changers, tourist hotels, travel agencies and duty free shops continued to deal in foreign exchange for specific purposes. These include exchanging and accepting foreign currency notes and coins, issuing foreign exchange in the form of Travellers Cheques and currency notes, and reconverting unspent Sri Lanka rupees of foreigners into foreign currency. In 2005, ECD, as a part of its management and regulatory functions, continued to issue operating instructions and guidelines to Authorized Dealers and restricted foreign exchange dealers, conducted on-site and off-site supervisions, monitored their foreign exchange transactions and imposed penalties on corporate and unincorporated bodies and individuals for violating the provisions of Exchange Control Act. In addition, the Department continued to grant permission, on certain capital account transactions such as investment abroad by Sri Lankan companies borrowing in foreign exchange, transfers to Sri Lankans migrated to other countries, etc. Another significant development in 2005 was the scheme evolved by the ECD in consultation with Electronic Fund Transfer Card (EFTC) issuing banks to clear any doubts with regard to the purposes for which card holders are permitted to make foreign exchange payments and also to make card holders aware that they are responsible for the payments made on their cards. A notice was published in this regard in the Government Gazette No.1411/5 of September 19th, 2005 under the Exchange Control Act. This was sequel to the large scale abuse of EFTCs detected in 2003 and 2004 to make payments to pyramid schemes conducted via Internet.

7.1 Major Developments in 2005

In 2005, progress was made in improving the country's foreign exchange management system. Significant among them is the introduction of a scheme to monitor repatriation of export proceeds. Information on export proceeds was gathered through a micro level survey conducted on quarterly basis covering nearly 3000 BOI and non-BOI exporters. During the year 2005, the Sri Lanka Rupee Account scheme, titled, Post Tsunami Inward Remittance Account (PTIRA), was introduced for all Non-Governmental Organisations (NGOs) as a disbursement account for inward remittances received by them for their social development and relief activities in the country. Funds received by these accounts were published regularly in the print and electronic media. By further relaxing Exchange Controls, airlines were permitted to quote prices of air tickets in US dollars. As an added incentive to the export sector, a foreign currency account scheme was also introduced for indirect exporters titled "Indirect Exporters Foreign Currency Account" (IEFCA) to allow indirect exporters to receive payments in foreign currency from direct exporters.

In the area of supervision and regulation, new criteria was introduced for the appointment of money changers requiring new and existing money changing companies to raise their equity capital from Rs. 1 million to Rs. 10 million with a view to raise their financial soundness. Further, a scheme to educate Electronic Fund Transfer Card (EFTC) holders, the type of foreign exchange payments permitted through their cards; and making them responsible for the payments made on their cards to non-resident entities was introduced in 2005.

7.2 Capital Transactions

(a) Investments

Existing Exchange Control regulations relating to investments in Sri Lanka by non-residents and investments abroad by resident Sri Lankan companies remained unchanged during the year 2005. BOI continued to be the facilitator of the foreign direct investment in Sri Lanka. In case of investment abroad by Sri Lankan companies, ECD evaluated their proposals and made recommendations on such proposals on their merit to the Hon. Minister of Finance. In 2005, fifteen Sri Lankan companies were permitted to invest US dollars 38.42 million in Joint Ventures, fully owned subsidiaries and branch offices abroad.

(b) Foreign Currency Borrowings

Borrowing abroad by resident companies other than companies approved by the BOI under Section 17 of the BOI Law with full exemption from the provisions of the Exchange Control Act requires prior approval of the Central Bank. During the year under review, the Department granted permission to two financial institutions and two resident companies to borrow funds totalling US dollars 22.26 million.

7.3 Trade Transactions

ECD continued to monitor import of goods for which payments had been made in advance with a view to ensure the arrival of such import of goods to the country. A significant change in the area of trade transactions in 2005 was the limit of advance payment stipulated for imports in Regulation 2(i) (d) published in the Government Gazette (Extraordinary) No.1022/6 of 8th April 1998, which was enhanced from US dollars. 7,500/- up to US dollars10,000/- in terms of a regulation made by the Hon. Minister of Trade Commerce & Consumer Affairs and published in the Government Gazette (Extraordinary) No.1393/21 of 20th May, 2005.

7.4 Registration of Freight Forwarders and Issue of Permits to Engage in Foreign Exchange Transactions

ECD continued to register freight forwarders, grant travel agencies the authority to issue Travellers' Cheques and issue licenses to money changers and other establishments such as hotels, duty free shops, travel agencies, etc. to accept foreign currency.

(a) Registration of Freight Forwarders

During the year 2005, 42 new companies were registered as freight forwarders bringing the total number of companies registered as freight forwarders to 173 at the end of the year. The increase in the registration of freight forwarders in 2005, compared with the previous year was mainly due to the new regulations made by the Hon. Minister of Ports & Aviation under Section 10 read with Section 3 of the Licensing of Shipping Agents Act No.10 of 1972, published in the Extraordinary Gazette Notification No.1402/19 of 22nd July 2005, enforcing a requirement to the companies carry on the business of a Freight Forwarder/Non-Vessel Operating Common Carrier in Sri Lanka under the said regulations to obtain a licence issued by the Director of Merchant Shipping. ECD continued to monitor credits and debits made to the Rupee Accounts maintained by Shipping and Airline Agents as well as freight forwarders on behalf of their foreign principals/agents during the year.

(b) Issuance of Licences to Money Changers

In 2005, the ECD issued 13 new licences to companies registered in Sri Lanka to engage in money changing business under the criteria introduced by the Central Bank for the appointment of money changers in 1999. The criteria was changed with effect from May 2005, raising the required capital, for a company to be appointed as a money changing company from Rs. 1 million to Rs. 10 million. Since the introduction of the new criteria, 5 applications were received and one such application was approved upon fulfilment of the requirements set out in the new criteria, thus bringing the total number of authorized money changers to 62 as at 31st December, 2005. Their total foreign currency purchases, which were subsequently tendered to Authorized Dealers, amounted to US dollars 70 million in 2005.

7.5 Monitoring

Since the liberalisation of Exchange Controls in 1994, Authorized Dealers and approved Travel Agents were permitted to release foreign exchange without restriction on current account transactions, exercising their judgement and discretion and after satisfying themselves with the bona fides of the requests. All Authorized Dealers and approved travel agents are required to report to ECD of their sales and purchases of foreign exchange on a regular basis for monitoring purposes. Foreign exchange sales over US dollars 5,000 per person are required to be reported daily, while sales less than US dollars 5,000 per person are to be reported on a weekly basis. In the case of foreign exchange releases through Electronic Fund Transfer Cards (EFTCs), card issuing banks are required to provide detailed monthly reports on EFTCs where monthly cumulative foreign exchange expenditure per person exceeds US dollars 5,000 per month. Releases of foreign exchange are monitored with a view to detect unauthorized capital transfers and funds linked to financing of terrorism or money laundering activities. At present, only the head offices and few outstation branches of commercial banks are electronically linked to ECD for the transmission of data on their foreign exchange transactions.

7.6 Investigations

Investigations into alleged violations of the provisions of the Exchange Control Act by individuals and corporate bodies were conducted in 2005. After the conclusion of the investigations, total of Rs. 29.4 million was imposed in respect of 29 cases for violating the provisions of the Exchange Control Act. Out of the above sum, Rs. 28 million recovered as penalties were credited to "Exchange Control Penalties Account" maintained with the Central Bank. In 2005, the ECD conducted a search at a business premises in Colombo on receiving information that unauthorised foreign exchange dealings were carried out at the premises, and recovered foreign currency notes equivalent to Rs. 1.6 million. The proprietor of the premises involved in the unauthorised foreign currency dealings was prosecuted in court.

8. Information

The Information Department continued to operate as the central information centre of the Bank, responsible for dissemination of information internally and externally while also providing photographic and artistic design services to the Bank. For internal circulation, the Department continued to publish Kauluwa, the in-house news and the features magazine. It helped the management and the staff to share information on Bank news and announcements on current themes. 10 issues of Kauluwa were released during 2005. The intranet web page, which is updated daily, was continued with a wider range of information. It provided the Bank staff with a vital link to local and international financial news and other current economic information.

The Department disseminates information to the public in various ways. During 2005, it published the daily exchange rates, weekly and monthly economic indicators, consumer price indices, information on Treasury bills and Treasury bonds, 934 press releases, 11 gazette notifications and 166 advertisements. To increase public awareness the Department commenced publishing a series of pamphlets in simple language targeting the general public. Under this series, the first two pamphlets were issued on Price Stability and Financial System Stability. The Department also published a brochure on the Bank's objectives, role and functions in all three languages. It organized 8 press conferences during the year on current economic issues and developments and handled the media coordination for the public lecture series organised by the Centre for Banking Studies. The Department continued to publish the bi-monthly publication "Satahana" (6 issues), quarterly publication News Survey (4 issues) and "Kurippedu", the Tamil version of Satahana.

With a view to educate the school children and the teachers on the objectives of the Central Bank, the Department produced a documentary on Bank's role in maintaining price and economic stability. This is the first part of the two-part documentary series. The second part will be on maintaining Financial System Stability.

The Department handled the distribution work through its sales outlets in the Bank and through a network of bookshops island-wide. As in the previous year, the Department actively took part in Colombo International Book Fair 2005. In addition, it participated in two Mahapola exhibitions, public events organised by the Universities and the exhibition which was held to mark the World Children's Day. Participation in these activities helped to enhance the public awareness about the Bank's publications.

The Department coordinated with other departments to facilitate the requests from schools to hold seminars and lectures on various topics in economics. In 2005, it organised 5 such educational seminars for school children and teachers.

The Bank's printing press continued to fulfil the Bank's printing requirements. The regular printing assignments included the printing of the Annual Report, Sri Lanka Socio-Economic Data, Economic and Social Statistics of Sri Lanka, News survey, Satahana, Kauluwa and Staff Studies. Some of the special publications printed during this year were the brochure on Central Bank of Sri Lanka – Functions, Objectives and Organization, Pamphlets on Price Stability and Financial System Stability and the Consumer Finance and Socio Economic Survey Report. Altogether with these printing work, the printing press undertook 306 printing assignments.

Library And Information Centre (LIC)

The Library and Information Centre (LIC) continued to provide library services for the Bank staff and others on request. It increased its collection of books from 17,194 to 18,784, reports from11,887 to 12,916, CDs from 900 to 965 and added 944 bound volumes to the collection during the year. The Library at the Centre for Banking Studies too increased its collection from 4,896 to 5,045 books.

The usage of the 'Science Direct' Database, which gives on-line access to over 90 journals on Economics, Econometrics and Finance was increased. Hence, LIC reduced the subscription of journals from 195 to 172.

During the year under review LIC continued to compile electronic publications such as Recent Additions (i.e. new books), List of selected Articles, News on Central Banking, News Alerts and disseminated them via the intranet.

In order to encourage the bank staff to use on-line library facilities, 12 user education programmes covering 11 departments and another programme for the participants of the Banking & Finance Network were conducted. For the first time, LIC organized a book exhibition during the Reading Month, exhibiting about 400 new titles purchased, and this was received with a good response by the Bank staff.

A lecture on "Reading for Success' was organised by the LIC to inculcate reading habits among the Bank Staff.

9. Information Technology

In 2005, the Information Technology Department (ITD) mainly concentrated on consolidating its activities in the past few years by strengthening the disaster recovery facilities and establishing Business Continuity Plans (BCPs) to quickly resume critical operations in the event of a major operational failure. In addition, the department continued its efforts to expand the IT facilities in the Central Bank and to improve the IT skills of the Bank's staff.

The functions performed by the department are as follows:

(a) Strengthening of disaster recovery facilities, business continuity planning & management ;

(b) Improving the IT skills of employees ;

(c) IT infrastructure enhancements ;

(d) Further automation of the functions handled by the user departments to enhance productivity ;

(e) Maintenance of the payments system, computer networks and other critical applications to ensure maximum system availability ;

(f) Identification of risks to IT systems through surveys and the implementation of remedial measures to mitigate operation risks.

Currently, the Central Bank operates in a predominantly automated environment. This environment has necessitated the Central Bank to device methods to mitigate the risks from operational breakdowns through business continuity planning, redundancies in operational capacities and establishing remotely located disaster recovery sites. Accordingly, a BCP was prepared to identify possible contingency events and remedial action and to ensure the continuity of operations from the Disaster Recovery Site (DRS). The site was equipped with furniture, computers and communication equipment needed for about forty contingency staff to take over the resumption of processes identified as critical. Several trial tests were conducted during the year with the participation of the contingency staff of the Central Bank and participants from the commercial banks, Primary Dealers and other foreign counterparties in international payment transactions. The mock operations from the DRS have enabled the contingency staff to be familiar with the facilities at the DRS, by providing hands-on training and building confidence to handle and manage contingency events.

The IT Department has been providing technical assistance with regard to IT related purchases and services of the Central Bank as well as other government organizations. During the year under review, the following infrastructure enhancements were made to strengthen the reliability of the systems:

(a) Upgraded the i-series (AS/400) computer systems at the Central Bank Primary & Disaster Recovery Sites to meet the expanding capacity demand and facilitate the business resumption from the DRS.
(b) Installation of the Internet firewall and the external access firewall.
(c) Installation of SQL/Web Servers.
(d) Implementation of the Central Authentication system (Digital Certification) for web application security.
(e) Upgrade of the Real Time Gross Settlement/Scripless Securities Trading System software to CAS 3.3 from CAS 2.68, which has more user friendly features.
(f) Expansion of Internet line capacity from 256 Mbps to 512 Mbps to expand the user coverage and facilitate the development of web-based applications.
(g) Wide Area Network connectivity was changed to IPVPN technology to ensure automatic connectivity to the DRS during a contingency event.

The Central Bank network currently has over 1000 computers connected directly to the network. In this network environment, around 900 e-mail addresses and 300 internet connections have been provided to facilitate office automation and easy access to information.

The IT Department continued to uplift the IT skills of employees through providing resource persons to conduct IT related courses at the Centre for Banking Studies (CBS). Regular meetings were also held with Departmental Liaison officers to educate them on improved security features and to provide guidelines on good practice of computer use. With the introduction of the IT Security Policy in the bank during 2005, several awareness programs were also conducted to educate the staff on policy guidelines.

One of the major responsibilities of the IT Department was to maintain the payment systems, namely the Real Time Gross Settlement System (RTGS), the Scripless Securities Settlement System (SSSS), the Treasury Dealing Room Management System (TDRMS) and the General Ledger System (GLS), to ensure maximum availability for real time settlement of transactions. As at 31st December 2005, the ITD has been able to achieve an uptime of 99.40 per cent for the Payment systems.

The application software used for RTGS/SSS systems, that is, CAS 2.68, was upgraded to CAS 3.3 which has enhanced features and is necessary to accommodate SWIFT upgrade. The ITD was responsible for the overall coordination with the software suppliers who also maintain the systems to ensure smooth operations of the Payment systems.

As a policy, the IT Department has decided to develop all future applications in the web environment whenever possible for easy maintenance. As an initial project, a Central Data base system to receive information from commercial banks was implemented for the Bank Supervision Department, which is expected to be expanded to the Non-Banking Financial and Economic Research areas. A web based system was also developed to store information on all movements of ownership of government securities in the Central Depository System to facilitate convenient access by the beneficial owners, of such securities.

In addition, as a means of automating the functions of the Central Bank, developing of several application software projects were undertaken . They were as follows:

(a) Foreign Loans Repayment System ;
(b) Dollar Bond Issue System ;
(c) System to record currency movements between vaults ;
(d) Export proceeds monitoring system ;
(e) Automation of the Government Treasury Bills/Bonds System ;
(f) Stores Management System for the Canteen ;
(g) System to monitor maintenance agreements and payments.

In addition, the IT Department continued to maintain all applications developed in-house and operational in the Central Bank. The EPF System, which is one of the major IT applications of the Central Bank also was maintained and required software modifications and enhancements were made to the system.

The IT Security Policy of the Central Bank and the BCP for all Payment systems were implemented during the year under review. The documents were further updated to accommodate the needs of the changing environment and the updated documents were approved by the Monetary Board. The IT

Strategy Plan and Procedure Manuals were also prepared during 2005.

External expertise was obtained as a means of mitigating security threats by educating the ITD officers on identification and analysis of Risks. A survey on IT system security was also conducted in order to identify the areas to be strengthened.

10. International Operations

10.1 Foreign Exchange Reserve Management

International Operations Department (IOD) of the Central Bank of Sri Lanka manages the country's official international reserves to facilitate maintenance of international stability of the Sri Lanka rupee and to assure the greatest possible freedom of its current international transactions. The IOD ensures liquidity and security of the foreign exchange reserves whenever such reserves are employed to earn sufficient returns. The Monetary Law Act No. 58 of 1949 requires the Central Bank to maintain an adequate international reserve in liquid currencies and a nuclear reserve in gold, in order to achieve the objectives mentioned above.

The official foreign currency reserve of the country was mainly invested in highly rated sovereign government securities, government guaranteed securities, and securities of government agencies and supra national institutions. Liquidity requirements were fulfilled through maintenance of sufficient proportions of reserves in liquid fixed income securities portfolio and money market portfolio in different currencies. Both money market and fixed income securities transactions were done through highly rated counterparties. In 2005, the Central Bank's foreign exchange reserve assets were held mainly in US dollars, euros, sterling pounds, Australian dollars and gold.

Investments of international reserves were carried out by the IOD in accordance with the guidelines set by the Foreign Reserve Management Committee (FRMC) and approved by the Monetary Board. The conduct of investment activities were measured against a predefined benchmark approved by the FRMC. In addition, the FRMC regularly reviewed the composition of assets, risk appetite communicated through the predefined benchmark and the overall performance of reserve management operations.

IOD made necessary changes to currency and asset compositions of the international reserve from time to time after reviewing changes in the economic fundamentals and geo-political developments in the international financial centres, major currencies and the interest rate environment. All investments were made through approved counterparties within the risk management framework approved by the Monetary Board paying due consideration to safety, liquidity and return on such assets. The Banks' debt service requirements and income generating abilities were also considered in determining portfolio composition of the foreign exchange reserve. Appropriate portfolio adjustments were made to preserve the value of the portfolio and to minimize the impact of market risk regularly from fluctuating interest rates. The total net foreign income generated through the foreign exchange reserve management operations was US dollars 77 million or Rs. 7,603 million during the year 2005. This was in excess of the budgeted income from reserve management operations amounting to US dollars 73.1 million and was achieved in a continuously increasing interest rate environment in which all previous investments were yielding low returns.

IOD ventured into complete electronic deal capturing and processing operations and completed the process of redefining the internal benchmark for better communication of risk preferences and investment targets as well as for accurate measuring of reserve management performance during the year.

10.2 Risk Management

Foreign exchange risk, market risk, credit risk, liquidity risk and operational risk are the major risks associated in reserve management. The Middle Office of IOD monitors the risk associated with foreign exchange reserve management activities.

Foreign exchange risk is the risk of capital loss as a consequence of fluctuations in exchange rates. The Bank managed the exchange rate risk by diversifying its holdings of foreign exchange reserve assets among different currencies. The currency distribution of the portfolio was reviewed and adjusted periodically to suit the targeted outcome. Interest rate risk or the exposure of the Bank's investment to movements in interest rate was assessed at portfolio levels in various currency segments and against the internal benchmark. The deviation of the investment portfolio from the internal benchmark were assessed periodically and compared against the approved levels.

The credit risk was managed by establishing eligibility requirements, confining exposures to high quality instruments, giving individual credit risk limits to issuers, counterparties and financial instruments in terms of counterparty credit risk management system approved by the Monetary Board and based, among other factors, on the creditworthiness of individual parties and credit ratings by independent rating agencies. Liquidity risk is the risk of the Bank incurring losses or significantly higher costs than estimated due to its failure to meet its payment obligations on time. To reduce the liquidity risk the major part of the international reserve was invested in liquid financial instruments with shorter maturities.

A range of measures were in place to manage the operational risk originating from human errors, flawed systems, inadequate procedures and controls, i.e. segregation of different functions of transaction processing and monitoring; having a decision making committee charged with the function of the management of foreign reserves (FRMC), building controls into the dealing operations, strengthening internal controls and processes etc. Automated as well as manual back up procedures were in place together with a set of comprehensive guidelines on reserve management activities comprising of specific controls and procedures in order to mitigate the impact of possible system flaws and failures.

A voice recording system was installed to capture deal conversations in the front office to mitigate the operational risks resulting from possible disputes between the counterparties and the Central Bank commencing from January 2005.

10.3 Monitoring the Domestic Foreign Exchange Market Developments

IOD continued to monitor closely the developments in the domestic foreign exchange market and overnight net foreign exchange open positions of commercial banks in order to ensure smooth functioning of the domestic foreign exchange market and orderly adjustment of the exchange rate of the Sri Lanka rupee during 2005.

The Sri Lanka rupee stood at 102.12 per US dollar as at 31.12.2005, as compared to 104.61 per US dollar on 31.12.2004 indicating an appreciation of 2.44 per cent. Weakening of other major currencies in the international market has resulted in relative appreciation of the Sri Lanka rupee against these currencies. The volume of inter-bank foreign exchange transactions have increased by 69 per cent (US dollars 2,966 million) to US dollars 7,245 million in 2005 compared to US dollars 4,279 million in 2004. The Central Bank was on both sides of the market to moderate the excessive volatility in the exchange rate of the Sri Lanka rupee. The purchases and sales of foreign exchange from and to commercial banks at market rates during the year were US dollars 290 million and US dollars 464 million respectively.

The department continued the process of providing indicative exchange rates of the Sri Lanka rupee on various currencies to Government Departments and Corporations and other relevant parties during the year.

10.4 Operating Instructions, Circulars and Directions issued during 2005

A new direction was issued during the year to the domestic foreign exchange market on financial derivative products in foreign exchange in order to bring the emerging derivative market under formal regulatory umbrella. These directions are expected to help diversifying the domestic financial market while making it broader and deeper. This direction permits the commercial banks in the country to deal in identified derivative products namely Interest Rate Swaps (IRS), Interest Rate Options (IRO), Forward Rate Agreements (FRA), Non-LKR Options (NLO), Cross Currency Swaps (CCS) not involving Sri Lanka rupees and Commodity Options limited to selected industrial products and precious metals.

11. Legal

In 2005, the Legal Department of the Central Bank continued its services in advising the Bank on legal matters, representing the Bank in courts and other legal fora and contributing to the legal reforms in the banking and financial sector.

During the year, the Legal Department continued its effort in reviewing the existing legal framework while introducing new legislation to facilitate the smooth functioning of the financial system. Addressing many uncertainties and lacunas that existed in the Banking Act, No. 30 of 1988 and widening the scope of the regulatory controls, 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' guidelines for directors, strengthening of provisions to minimise the concentration of ownership of licensed banks and strengthening of the governance aspects of licensed banks. The interpretation of the term 'deposit' was also introduced with these amendments by which the depositor protection aspects have been strengthened. These amendments have also played a significant role in safeguarding the stability of the financial system of Sri Lanka.

Another important development during the year 2005 was the enactment of the Payment and Settlement Act which will strengthen the legal framework governing payment services as efficient and reliable functioning payment system contributes to improve the soundness and smooth functioning of the financial system. This carries provisions for the regulation of the payment, clearing and settlement systems, for the regulation of providers of money services, for the electronic presentment of cheques.

The Finance Leasing Act was amended, among other things, enabling the leasing companies to securitise their lease portfolios. This would enable the finance leasing companies to finance their working capital needs which, in turn, would ease their liquidity shortfall issues. However, broader issues relating to securitisation in general are also under consideration with a view to introduce more generic legislation on the subject.

The Legal Department worked closely with several other departments of the Bank and outside government agencies to prepare legislation on prevention of money laundering and financing of terrorism. Sri Lanka joined the global effort to combat money-laundering and terrorist financing by passing the Convention on the Suppression of Terrorist Financing Act in mid 2005. The Bills on Prevention of Money Laundering and Financial Transactions Reporting were presented to the legislature in 2005 and passed in January 2006.

12. Management Audit

The Management Audit Department (MAD) continued to conduct risk based independent audit during 2005 and provided suggestions to add value and improve Bank's operations and systems of controls, so as to contribute effectively to achieve its strategic objectives.

The Audit Committee of the Monetary Board, too performed its role in overseeing the preparation of the Annual Audit Plan, audit process, financial statements of the Central Bank, the related financial reporting practices and the systems of internal controls. The MAD functioned as the secretariat of the Audit Committee.

In accordance with the Audit Charter, the Annual Audit Plan for 2005 was prepared on a risk based audit approach. As planned, several audit assignments were conducted to review the adequacy of the internal controls, introduced to protect the Central Bank from potential risks while continuing with compliance audits to verify that the established controls are functioning as intended. As in the previous year, follow-up audit reviews were also carried out to ascertain the implementation of audit recommendations.

The Management Audit Department reported significant issues related to processes for controlling actions of the Central Bank and also periodically provided information on the status and results of the Annual Audit Plan to the management and the Audit Committee.

The major audit activities undertaken during the year included the review of the payroll system of the Bank (outsourced to Ms. Ernst & Young), review of insurance policies of the Bank, procurement of goods for general maintenance, review of activities in the Regional Offices at Anuradhapura, Matale and Matara, analysis on the usage of cab services, fuel consumption and repair cost of the Bank vehicles, claim settlements under the Credit Guarantee Schemes of SMAP, MCPCDP, ARP & SMI IV and analysis of expenditure of the Printing Press, physical verification of stocks in the currency vaults, stores in the Regional Offices and Engineering Stores.

During 2005, the Department took initiative to formulate and implement a bank-wide risk management framework under the guidance of the Committee to assess the bank-wide risks. The Management Audit Department also issued rules and guidelines on risk management to all the departments. In house software was developed and installed in all departments to capture risks identified by the departments with a view to monitor bank-wide risks. Under the Management Audit Department's initiative and guidance, the compilation process of the departmental operation manual was successfully completed in 2005.

In order to build professionalism in internal and management audit, arrangements were made for the US based Institute of Internal Auditors (IIA) to conduct its examinations in Sri Lanka. The Department has been actively collaborating with the Sri Lanka Branch of IIA to promote its course and the Central Bank is accordingly represented on both its Governing Council and the Academic Board.

13. Payments And Settlements

Strengthening of payment system oversight, legal framework and business continuity planning were given a high priority in the activities of the Payments and Settlements Department (PSD) during 2005, as a part of fulfilling the Central Bank's objective of promoting a sound, stable an efficient financial system. PSD operated the Real Time Gross Settlement (RTGS) System which serves as the backbone of the payment and settlement infrastructure; processed and effected payment and settlement instructions in respect of the Central Bank's foreign exchange management operations and Open Market Operations (OMO); handled Bank's SWIFT communications; operated the payment gateway for the Bank's own transactions; and effected transactions under the Asian Clearing Union (ACU).

13.1 Operating the Real Time Gross Settlement (RTGS) System

The RTGS Operations Division continued to operate the System and to provide help desk services to participants. The value of transactions settled through the RTGS System during the year 2005 was Rs.17,543 billion, about 7 times higher than the annual gross domestic product of Sri Lanka. The daily average volume and value of transactions settled in 2005 were 629 and Rs.74 billion respectively. At end December 2005 there were 32 participants in the RTGS System including the Central Bank, 22 licensed commercial banks, 8 non-bank Primary Dealers and the Employees Provident Fund.

13.2 SWIFT Communications

During 2005, the SWIFT Communication Division handled all SWIFT related activities of the Central Bank. The department was involved in the following modifications and upgrading of the SWIFT system of the Central bank:

(a) Upgrading the "SWIFT Alliance Access" at the primary site from version release 5.00 to version release 5.5;

(b) Upgrading of the SWIFTNet Link (SNL) at the primary site from SNL 4.40 to SNL 5.00; and

(c) Updating of MT 5XX series with the new version.

13.3 Transactions under the Asian Clearing Union (ACU)

The total value of transactions of Sri Lanka effected through the ACU mechanism increased marginally by 4 per cent from Rs.161 billion in 2004 to Rs.167 billion in 2005. However, the total value of exports to other ACU countries recorded a growth of 38 per cent in 2005, when compared with that of 2004. This was mainly due to the increase of exports to India and Iran.

The rupee value of net settlements made under the ACU mechanism during 2005 amounted Rs.138 billion, a drop of 3 per cent when compared with the previous year.

The 34th Meeting of the Board of Directors of the Asian Clearing Union was held in Lahore, Pakistan in May, 2005. A decision was taken at this meeting to appoint a technical committee comprising representatives from all member countries to study and make recommendations on the future role of the ACU.

13.4 Payment System Policy and Oversight

Payment system oversight was focused on (a) strengthening of the payment system landscape and (b) persuading LankaSettle participants to have business continuity plans (BCP) with fully equipped disaster recovery sites (DRS) benchmarked to international standards to continue operations in a prolonged and widespread disruption. Having recognized the varying risk profile of different payment systems, PSD continued to adopt a risk based approach in overseeing payment and settlement systems. Oversight activities included monitoring and evaluating of systemically and system-wide important payment systems against their objectives, rules, regulations, best practices and where necessary to induce changes for further developments. Accordingly, oversight scope included: systemically important payment and securities settlement systems operated by the Central Bank (RTGS system, Scripless Securities Settlement system and Scripless Securities Depository); and system-wide important retail payment systems such as all retail level clearing systems operated by LankaClear (Pvt.) Ltd.; Debt Securities Trading System (DEX) operated by Central Depository Systems (Pvt.) Ltd., two domestic settlement systems operated by two commercial banks for Visa and MasterCard transactions and US Dollar Clearing and Settlement System operated by a commercial bank.

TABLE II-9

Trade and ACU transactions of Sri Lanka with other ACU countries

Rs. billion

	2004	2005
Total transactions channelled through ACU	161.1	166.8
Sri Lanka's exports to other ACU countries	51.0	70.6
Sri Lanka's imports from other ACU countries	199.9	250.0
Sri Lanka's total trade with other ACU countries	250.9	320.6
Net ACU settlements	143.3	138.4

Source: Central Bank of Sri Lanka

The payment system oversight carried out by PSD were directed towards system-wide issues with the aim of facilitating the operation of the national payment system in line with the best international standards. Accordingly, PSD collected qualitative and quantitative information periodically from all important payment and settlement service providers and LankaSettle participants for the purpose of monitoring and overseeing the operations of the systems and for publishing the Payments Bulletin quarterly.

PSD monitored the operations of LankaSettle participants as a part of its normal day to day operations and took appropriate measures to ensure the timely settlement of clearing balances and to reduce settlement risk. These measures include the imposition of a default charge on licensed commercial banks introduced with the amendment made to clause 8.3 of volume 2 of LankaSettle System Rules, with effect from October 1, 2005, for the failure to maintain adequate funds in their RTGS Settlement Accounts for settling net clearing obligations at stipulated times, to ensure the timely settlement of clearing balances and to reduce settlement risk.

Having considered the consequences of systemic risk, which could be caused by operational disruptions of LankaSettle participants, the Central Bank requested all LankaSettle participants to have documented BCPs by end March 2005. PSD held one to one meetings with each participant to explain the required standards of BCP and, advised them to submit revised BCPs by end August 2005. A set of guidelines on BCP was drafted by the PSD and forwarded to Sri Lanka Banks' Association (Guarantee) Ltd. and the Association of Primary Dealers to obtain their comments.

In early 2005, PSD was actively involved in the post implementation review of the LankaSettle System conducted by a team from the Sveriges Riks Bank (Central Bank of Sweden). The review too established that the implementation of LankaSettle System and the law reforms have significantly reduced settlement, operational and legal risks previously borne by the Central Bank and participants.

14. Premises

The Premises Department continued to carry out the maintenance and upkeep of the Bank's premises during the year 2005, in addition to providing support services such as transport and communication facilities to officers of the Bank

Most of the maintenance work and a part of the transport services have been outsourced with a view to obtaining services more efficiently and at lowest cost.

By the end of 2005, all departments of the Bank have been provided with modern furniture and Venetian blinds, thereby providing further conveniences to the employees and creating a conducive working environment.

The Premises Department during the year, added one more holiday home at Anuradhapura to its list of homes for employees and pensioners. Matale Regional Office was housed in a new building.

The Department continued to maintain the Light House Clock Tower with a historic landmark value adjacent to the Central Bank's Head Office.

15. Public Debt

In terms of Section 113 of the Monetary Law Act (MLA) the Public Debt Department (PDD) is entrusted with carrying out the function of debt management, which involves the issuance and management of domestic debt and servicing of both domestic and foreign debt of the government. Accordingly, the department has to ensure that the government financing needs are met at the lowest possible cost over the medium to long run, consistent with a prudent degree of risk and meeting the payment obligations in time. During 2005, the PDD mobilized a sum of Rs.259 billion through government securities and serviced the entire public debt portfolio including 605 foreign loans on time. In addition to these main tasks, the PDD handled two key projects during the year, namely, Sovereign Rating and Debt Moratorium. The PDD facilitated the process of obtaining an initial sovereign rating for Sri Lanka by calling and evaluating proposals from Rating Advisers and selecting Rating Agencies coordinating with the Lead Manager (Citigroup). The PDD, during the year also facilitated the implementation of debt moratorium provided by Paris Club members and other bilateral donors, particularly by coordinating with respective Diplomatic Missions of the donor countries. During the third quarter of the year, the PDD made arrangements and coordinated with the Lead Arranger, Citigroup, to obtain a syndicated loan for the government from international investors amounting to US dollars 100 million .

In the year 2005, the PDD took several initiatives, in particular, to strengthen the debt management process. Recognizing the need for implementing a formal domestic debt management strategy, the PDD took preliminary action to implement a risk management model with the assistance of international consultants. The department having identified the need for a debt consolidation programme to avoid any bunching problem of the existing debt portfolio and initiated several measures. In addition to the existing fixed rate domestic debt instruments, Indexed Linked Bonds were introduced for the first time, with a view of ensuring a positive real return to investors and diversifying debt instruments. Meanwhile, as in the previous year, the PDD was able to reduce the interest cost of the government on debt by Rs. 3 billion by exercising the early retirement option of Rupee loans. In addition the PDD, with a view to further facilitating the development of the government securities market provided Dealer Direct Participant status to Colombo Stock Exchange (CSE), commenced the process of introducing the Master Agreement on Repo/Reverse repo transactions, conducted training/workshop sessions for Primary Dealers (PDs) and conducted awareness programmes for investors. Stability of the PD system was also further strengthened by raising the minimum capital requirement and imposing restrictions on dividend distribution, etc.

15.1 Developments in 2005

(a) Debt Issuance and Cost

The Appropriation Act No 15 of 2004, approved by the Parliament for the year 2005, set the total gross borrowing limit of the government in terms of book value, at Rs. 436 billion. Of this, funds to be raised through domestic sources amounted to Rs. 331 billion. The PDD mobilized a sum of Rs. 259 billion through the government securities programme to meet a part of the budgetary requirement of the government. In addition, gross borrowings through Foreign Currency Banking Units (FCBUs) amounted to Rs. 59 billion (US dollars 585 million). The approved Treasury bill limit for the year remained unchanged at Rs. 300 billion.

The strategy of raising the required resources for 2005 was formulated by the Domestic Debt Management Committee (DDMC) comprising members from the Central Bank and the Ministry of Finance, thus effectively coordinating between monetary, fiscal and debt management policies. The debt management strategy adopted in 2005 aimed at mobilizing the bulk of the resources from tradable instruments such as Treasury bonds and Treasury bills and Indexed Linked Bonds. These instruments accounted for 83 per cent of the total funds, mobilized through government securities. There was a net repayment of Rs. 24 billion in respect of non tradable Rupee loans, thereby reducing their share in the total domestic debt stock from 14 per cent in 2004 to 11 per cent in 2005. During the year, there was a strong market appetite for short-term debt instruments as market participants changed their risk appetite to a risk aversion position due to their perceptions on market conditions. Efforts were made to strike a balance between the cost and the risk of the debt portfolio by issuing short term Treasury bills as well as medium to long term Treasury bonds. Of the total Treasury bond issues, approximately 61 per cent was Treasury bonds with more than 2 year maturity. In order to provide some cushion to their expectations on future inflation rates and to ensure a positive real rate of return, Indexed Linked Bonds were introduced to the market in 2005. Meanwhile, in order to mitigate pressure on the domestic market and to stabilize the rates, a foreign commercial borrowing (through a syndicated loan) amounting to US Dollars 100 million with a tenure of 3 years and at a rate of LIBOR+95 basis points was obtained through a Lead Arranger.

In 2005, the PDD conducted 52 Treasury bill auctions and raised a sum of Rs.486 billion on gross terms through auctions and placements. However, in net terms, there was a repayment of Rs. 9.7 billion to the system. Reflecting the market preference for short-term bills, of the total gross issues, 53 per cent was 91-day Treasury bills. With respect to Treasury Bonds, 64 auctions were conducted and a sum of Rs. 230 billion was raised through both auctions and direct placements. Due to the market appetite leaning towards the shorter end of the Treasury bond market, issues of 4-6 year maturities were limited to Rs.37 billion. The total number of series of Treasury bonds was further reduced to 56. There was a net repayment for Rupee loans in 2005. This repayment was mainly through the early retirement of callable Rupee loans which carried rates of 11 to 13 per cent.

Table II - 10 provides details of issues and maturities of domestic debt in 2005.

(b) Debt Outstanding

Total government debt outstanding stood at Rs. 2,217.1 billion by end 2005. In terms of GDP, total debt stock declined to 94 per cent from 105.5 per cent in 2004 mainly due to appreciation of rupee against the major currencies.

15.2 Debt service payments

Total debt service payments on account of the debt serviced by the PDD amounted to Rs. 339 billion. Principle repayments on domestic debt amounted to Rs. 202 billion. The cost of servicing the total foreign debt, which amounted to Rs.25 billion recorded a decline of 43 per cent; i.e. Rs.19 billion, over the previous year. This was due to a decline in both interest cost (by Rs.10 billion) and principal repayments (by Rs.17 billion) in view of the debt relief offered by way of the debt moratorium.

15.3 Debt Moratorium

Considering the devastating effects of the Tsunami, with a view to allowing Sri Lanka to allocate more resources to address humanitarian and reconstruction needs, Paris Club creditors (USA, Canada, Germany, Japan, Italy, Netherlands, Denmark, France) and other bilateral countries such as India and Korea agreed to defer debt service payments due during the year 2005. The deferred repayments would be repaid over a period of five years, which includes a grace period of one year. Accordingly the repayments will be commenced from December, 2006 and the moratorium interest accrued in 2005 would be capitalized and paid as a deferred amount. Outstanding debt due to Italy was fully written-off while that of China was partly written-off. In the meantime, the UK Government agreed to refinance 10 per cent of the debt service payments made to the World Bank (IDA). India offered a three year debt moratorium in relation to the Government of India lines of credit. The total savings from the debt moratorium amounted to Rs. 27 billion for the year 2005.

15.4 Yield rates of government securities

The yield rates pertaining to government securities, which started to stabilize towards the end of the year 2004, increased sharply during 2005 in both primary and secondary markets. In line with the changes in the policy rates of the Central Bank and due to the prevailing market conditions, the 91-day Treasury bill rate rose by 286 basis points. Parallel to the developments in the short end of the market, there was an upward shift in the upper end of the yield curve too. In both the primary and the secondary markets, yields on all maturities of Treasury bonds increased. On an average basis, in the primary market, 2 year and 3 year Treasury bond yields increased by 152 and 163 basis points, respectively.

TABLE II-10

Issue and Maturity of Domestic Debt in 2005

Rs. million

	Maturity	Issues	Repayments	Net Issues
Treasury Bills	91 day	259,713	213,531	46,182
	182 day	65,826	94,561	(28,735)
	364 day	100,458	112,457	(11,999)
	Other	59,772	74,932	(15,160)
	Total	485,769	495,481	(9,712)
T Bonds	1 year	3,200	12,970	(9,770)
	2 year	86,531	15,000	71,531
	3 year	103,187	77,810	25,377
	4 year	27,592	-	27,592
	5 year	5,415	14,550	(9,135)
	6 year	-	1,000	(1,000)
	8 year	3,625	-	3,625
	Total	229,550	121,330	108,220
R Loans	2/5 year	-	44,375	(44,375)
	2/6 year	820	-	820
	4/6 year	4,986	-	4,986
	4/7 year	3,575	-	3,575
	4/8 year	2,868	-	2,868
	4/10 year	31,430	-	31,430
	7/8 year	-	12,500	(12,500)
	Total	43,679	56,875	(13,196)
Sri Lanka Dev. Bonds	Total	-	-	-
Loans from FCBUs	<=1Year	58,968	17,236	41,732
	Total	58,968	17,236	41,732
Total		**817,966**	**690,922**	**127,044**

Source : Central Bank of Sri Lanka

15.5 Scripless Securities Settlement System (SSSS) and the Central Depository System (CDS) – (LankaSecure)

The services provided through LankaSecure were further expanded during the year. The value of transactions handled by LankaSecure rose by 61 per cent to 11,215 billion in 2005. These transactions include repositioning, delivery Vs payments, delivery free repos/reverse repos and Intra-day Liquidity Facility (ILF). The system made Rs. 64,250 million coupon payments on account of scripless Treasury bonds and Rs. 581,023 million maturity repayments in respect of both scripless Treasury bills and Treasury bonds.

The number of participants in the "LankaSecure" system was 32, comprising 8 commercial non-bank PDs, 22 Licensed Commercial Banks, the Employees' Provident Fund and the Central Bank. The number of investor accounts maintained by these participants in the system as at the end of 2005 was 24,411. The total number of transaction statements issued by LankaSecure during 2005 was 39,806 while the number of payment statements issued was 35,872. During the year, it further issued 20,374 holding statements to the security holders.

LankaSecure implemented a web based account verification system for account holders of the system. This is an additional facility developed in-house to provide an opportunity for investors to view their security holdings and income earning details through the Internet.

15.6 Supervision of the Primary Dealer (PD) System

The PDD continued to supervise the PDs through off-site surveillance and by conducting regular on-site examinations of PD activities, in order to ensure the stability of the PD system. A special on-site examination was conducted during the year of all PDs to identify the risk management techniques used by each PD to counter various types of risks. The PDs were advised to draft and maintain a business continuity plan for their respective business units in addition to the improvements to their other risk management tools. One on one discussions and regular PD meetings were also conducted throughout the year to exchange views and to take remedial measures in relation to the issues and concerns which came to light at the on-site examinations.

With a view to strengthening the PD system, the minimum capital requirement of PDs was increased from Rs. 200 million to Rs. 250 million from July 01, 2005, the details of which are in the Circular No. 08/24/002/005/005. It has been decided to increase their capital requirement further to Rs. 300 million and to introduce the Risk Weighted Capital Adequacy Framework (RWCAF) for them from July 01, 2006. Plans were underway to parallel run the RWCAF before moving to a live run from July 2006.

The Hongkong and Shanghai Banking Corporation (HSBC) withdrew from the PD system on June 30, 2005 while Commercial Bank Primary Dealer Ltd., a subsidiary of the Commercial Bank of Ceylon Ltd., ceased its operations as a PD company on October 01, 2005 with the parent bank commencing operations as the PD unit of the Commercial Bank of Ceylon Ltd.. The total number of PDs as at end 2005 stood at 11.

15.7 Developments in Secondary Market Transactions

During 2005, based on the information compiled through the PD weekly reporting system, where a PD was one party to a transaction, during 2005, the total value of secondary (outright and Repo) transactions declined by 19.7 per cent from the previous year. There was a significant decline in the Treasury bond transactions i.e. by 28 per cent, while Treasury bill transactions recorded an increase of 6 per cent, reflecting the increased appetite for short term instruments. Total repo and reverse repo transactions declined by 6 per cent while outright sales declined by 17 per cent between 2004 and 2005.

As in the previous year, it was observed that PDs have continued to take a position of risk aversion, leading to an increase in short-end market transactions such as overnight repos and reverse repos by 20 per cent in the secondary market .

16. Regional Development

The Regional Development Department (RDD), as the apex agency of 11 development credit schemes sponsored/funded by the Government of Sri Lanka (GOSL) and donor agencies, continued its operations during 2005 for the further implementation of the schemes. In addition, in 2005, the RDD was assigned with the responsibility of implementing three new credit lines particularly designed for the resumption of business activities in the Tsunami affected areas, thus bringing the total number of credit schemes implemented by the RDD to 14. Further, on behalf of the GOSL, the RDD introduced two new Credit Guarantee Schemes to cover a part of the credit risk undertaken by lending banks in granting loans for the modernization of factories in the apparel sector and for the resumption of business activities in the Tsunami affected areas. With a view to obtaining funds to implement further credit schemes to develop and strengthen the construction sector and facilitate the reconstruction and rehabilitation of Tsunami affected infrastructure, the RDD participated in the negotiations carried out by the GOSL with the European Investment Bank (EIB) and the French Government.

Among the functions of the RDD in implementing credit schemes are issuing operating instructions/guidelines to Participating Financial Institutions (PFIs), disbursement of refinance or payment of government interest subsidy, recovery of refinance in respect of the development credit schemes while monitoring and supervising of their operations. Further, the RDD is responsible for conducting awareness programmes for all stakeholders and the general public in collaboration with line ministries, community based organizations (CBOs) and PFIs, and the maintenance of data bases/information records and keeping accounts in respect of each credit scheme to facilitate the relevant functions of the donors and the government.

The projects implemented by the RDD during the year 2005 are given in Table II - 11.

During the year under review, in addition to the projects that were hitherto implemented, the RDD was assigned with the responsibility of implementing the Tsunami Relief Credit Programme (SUSAHANA) introduced by the Central Bank under the government's livelihood restoration programme in the Tsunami affected areas. The objective of the loan scheme was to grant loans on concessional terms towards the commencement of livelihood operations by the affected parties. Initially, Rs.5 billion was allocated for the programme, i.e. Rs.3 billion from the Central Bank for disbursement through formal sector banking institutions and Rs.2 billion from the government for disbursement through registered finance companies and leasing establishments. As at the end of 2005, under the SUSAHANA credit scheme, Rs.4,280 million has been disbursed among 9,186 affected micro, small and medium scale enterprises by 15 formal

TABLE II - 11
Credit Schemes operated by the Regional Development Department during 2005

Name of the Project	Funding Agency	Broad Mission	Original Allocation	Annual InterestRate to theBorrowers	(i) No. of loans granted and (ii) Amount(in Rs. Mn) as at end Dec. 2005	Recovery Rate where applicable
1. Tea Development Project(1999-2005)	ADB	Increase tea small holders' income on a sustainable basis, improve the natural environment in the project area and develop the necessary infrastructure in the sector	US $ 28 Mn.	Field development 8.5 – 10.5Factory modernization AWDR + 6	(i) 2,678 (ii) 2,963	96%
2. Second Perennial Crops Development Project (1998-2005)	ADB	Commercialisation of the perennial crop sector, increase production, nursery development, post-harvest handling and processing activities and marketing	SDR11.562 Mn	On the basis of Average Weighted Deposit Rate 8.5 – 10.5 per cent	(i) 6,250 (ii) 1,453	95%
3. Skills Development Project (2000-2006)	ADB	Improve quality and relevance of skill training programmes to build a high quality workforce and address issues of skills mismatch and unemployment among rural and urban youth	SDR 0.657 Mn.	10 per cent	(i) 549 (ii) 56	97%
4. Urban Development & Low Income Housing Project (2000-2005)	ADB	To provide capital to support low income households for housing improvements	USD 20 Mn.	11.9 per cent	(i) 28,971 (ii) 1,873	91%
5. Poverty Alleviation Micro-finance Project (2000-2006)	JBIC	Setting up of an effective credit delivery mechanism for channelling formal credit to income generating activities of the rural poor and improve the economic conditions and general welfare of the beneficiaries	JPY 1368 Mn.	16-20 per cent	(i) 36,981 (ii) 741	94%
6. Small Farmers & Landless Credit Project (ISURU) (1990-2005)	IFAD, CIDA and GOSL	To establish a cost effective and sustainable micro credit delivery system to generate employment and improve savings habits among the low income receiving people	SDR 4.85 Mn.	Market Rates16-20 per cent	(i) 106,632 (ii) 1,513	96%
7. Matale Regional Economic Advancement Project (2000-2006)	IFAD	Raising and sustaining the income of small entrepreneurs and rural and farmer families of project area	SDR 2 Mn.	12 per cent	(i) 639 (ii) 52	94%
8. New Comprehensive Rural Credit Scheme	PCIs own funds and govt. interest subsidy	Provision of the working capital requirement of small farmers - short term production loans - production of seeds and plant material - purchase of agricultural commodities under Forward Sales Contracts	PFIs own funds	8 per cent	(i) 70,196 (ii) 1,620 During the year	91%
9. Sabaragamuwa Rural Development (Revolving Fund) Project (1997-2006)	GOSL	Uplift the standard of living of the people in the Project area by promoting income generating activities	SLRs.100 Mn.	10 per cent	(i) 13,410 (ii) 569	92%
10. Southern Province Rural Development (Revolving Fund) Project(2000-2006)	-do-	To improve the quality of life of the people in the Southern Province	USD 8.1 Mn.	12 per cent	(i) 2,100 (ii) 100.6	
11. Tsunami Relief Loan Scheme (SUSAHANA)	CBSL	Resumption of enterprises affected by Tsunami	SLR 3 billion	6 per cent	(i) 9,360 (ii) 4,445	Within the grace period
12. Small Business Revival Programme (SBRP)	JBIC	Resumption of SMEs affected by Tsunami	JPY 3 billion	6 per cent	Some of the loans granted under SUSAHANA are transferred to SBRP	-do-
13. Jeevana Sakthi micro credit programme	UNDP	Assist to re-start micro enterprises affected by Tsunami	USD 1 Mn	6 – 8 per cent		
14. Rural Financial Sector Development Project(RFSDP)	ADB	To strengthen the micro finance sector in the country	USD 70 Mn	Policy loan to support the stakeholders to develop their capabilities and structures		Not applicable

sector banking institutions while 174 enterprises were provided with Rs.165 million by 15 registered financial companies and leasing establishments. The disbursement of loans by purpose as at end December 2005 is given in Table II - 12.

In the latter part of the year, in line with the government's reconstruction and rehabilitation programmes, the Japan Bank for International Cooperation (JBIC) and United Nations Development Programme (UNDP) joined the Central Bank to provide assistance through the banking network for the resumption of micro, small and medium scale enterprises affected by the Tsunami. Accordingly, the RDD introduced two separate loan schemes, to supplement the SUSAHANA loan scheme for the provision of assistance to affected enterprises in the coastal areas of the country. Two programmes, i.e. Small Business Revival Programme (SBRP), funded by JBIC, and Jeevana Sakthi micro finance scheme operated with a grant from the UNDP, came into operation in the fourth quarter of the year 2005.

The RDD continued the promotion of Forward Sale Contracts (FSCs) among farmers and buyers, for agricultural marketing in the country. FSC is an agreement between a buyer and a farmer to trade agricultural produce on an agreed future date at a pre determined price. This system, introduced in 1999, assisted a large number of farmers and buyers to resolve their marketing difficulties continuously. The RDD promotes this scheme by coordinating the activities undertaken by different stakeholders including PFIs, buyers, farmers, farmer associations and government and non government organizations throughout the country. During the year under review, the RDD in association with Regional Offices and PFIs conducted several awareness programmes with a view to promoting FSCs in the major agricultural areas of the country. A large share of the local production of maize, soya bean, sunflower, ginger, green gram, bee honey and ground nuts was traded under FSCs while thousands of paddy farmers and other agricultural producers along with the major buyers were also benefited from this system. In view of the beneficial impact of FSCs on agricultural markets, particularly during the glut periods, to stabilize commodity prices, the Central Bank with the concurrence of the government increased the upper limit of purchasing loans granted in connection with FSCs, from Rs.25 million to Rs.50 million per borrower, during the year 2005.

The RDD, in collaboration with Regional Offices in Anuradhapura, Matale and Matara, continued its efforts to improve agricultural productivity through the introduction of new hybrid seed varieties, farm equipment, post harvesting methods, micro irrigation technologies and new crops which could generate higher income for farmers. A remarkable progress both in relation to productivity and farmers' income levels has been observed in respect of the cultivation of maize, ginger and sunflower during the year under review. The RDD conducted several preparatory meetings during the year under review with input suppliers, seed importers, seed producers, exporters, agricultural commodity buyers and PFIs in order to coordinate the programme on productivity improvement. Forward Sales Contracts and productivity improvement programmes were promoted through the expansion of the New Comprehensive Rural Credit Schemes (NCRCS) which offer support by way of an the interest subsidy from the government. During the two cultivation seasons in 2004/05 Maha and 2005 Yala, a total sum of Rs.4.03 billion has been disbursed by PFIs for 66,953 farmers and 1,269 buyers under the NCRCS.

The RDD continued to monitor the performance of the six Regional Development Banks (RDBs) with a view to ensuring their long run financial viability. All RDBs achieved a remarkable improvement in all financial ratios and recorded profits exceeding their budgetary targets during the year 2005. In order to facilitate the RDB restructuring programme under the Rural Financial Sector Development Project (RFSDP), all shares and debentures held by the Central Bank in RDBs were transferred to the GOSL in June 2005. Accordingly, 16 million shares in six RDBs amounting to Rs.160 million at a nominal

TABLE II - 12

SUSAHANA Loan Scheme - 2005
Purpose-wise Disbursements

Purpose	No. of borrowers	%	Loans approved Rs.Mn.	%
Agriculture	98	1.05	18.2	0.41
Industry	741	7.91	338.7	7.62
Fisheries	3486	37.24	1282.4	28.85
Trading	2496	26.67	1235.3	27.79
Tourism	1219	13.02	895.7	20.15
Transport	349	3.73	196.4	4.42
Self-employment	283	3.03	447.2	10.06
Other services	688	7.35	31.1	0.70
Total	**9360**	**100.0**	**4445.0**	**100.0**

TABLE II - 13

Forward Sales Contracts

Crop	No. of contracts signed	No. of farmers benefited	Forward price determined (Rs. per kg)	Amount of purchasing loans granted by PFIs under FSC (Rs. mn.)
Maize	34,071	40,500	16-18	687
Paddy	14,270	16,200	14-17	745
Soya	6700	6700	30-38	375
Green gram	1,200	1,200	47-52	51
Finger Millet	520	540	20-25	14
Ginger	610	610	370	—
Other crops *	11,800	11,800	20-65	540
Total	**69,171**	**77,550**	-	**2,412**

* Sesame, vegetable, papaya, sunflower

value were transferred for a consideration to be calculated on the basis of the value of net assets of such RDBs as at end 2004. Subsequent to the above share transfer, the role of the RDD in monitoring RDB performance also ceased to function.

Three development credit programmes funded by the ADB, i.e. Tea Development Project (TDP), Second Perennial Crop Development Project (SPCDP) and Urban Development and Low Income Housing Project (UDLIHP), were concluded satisfactorily as scheduled in 2005. At the request of the relevant Ministries, negotiations were finalized to implement two revolving fund credit schemes in respect of the first two projects mentioned above, during the year under review.

TABLE II - 14

Disbursement under New Comprehensive Rural Credit Scheme 2004-2005

Cultivation Season	No. of farmers	Loan Amount (Rs.million)	No. of agricultural produce buyers	Loan Amount (Rs.million)
2004/05 Maha	39,641	964.9	678	1,389.5
2005 Yala	27,312	655.5	591	1,022.8
Total	**66,953**	**1,620.4**	**1,269**	**2412.3**

All three Regional Offices (ROs) of the Central Bank at Matara, Anuradhapura and Matale continued their operations in the respective regions under the supervision of the RDD. The two ROs in Anuradhapura and Matale were able to penetrate into the remote rural locations in their respective regions, taking a package of financial and non financial services for the upliftment of the economic and social conditions of the rural households. The RO in Matara assisted the RDD in the field inspections carried out in implementing the SUSAHANA Loan Scheme in the southern region. The three ROs continued to promote agricultural marketing through FSCs and improvement in agricultural productivity, while assisting other Departments of the Central Bank in collecting regional data and information and providing other services.

Two ROs were able to facilitate 33,700 FSCs to the value of Rs.815 million for paddy, maize, soya bean, ginger and papaya in the North Central and Central Provinces.

17. Secretariat

In 2005, the Secretariat Department continued to carry out its administrative functions including the procurement of goods and services for the Bank, attending to matters relating to foreign and local travel of bank officials, general administration, protocol functions, leave policy matters and other miscellaneous administrative operations such as the disposal of obsolete items. The department also effected all payments relating to travel, procurement of goods and services and settlement of advances. Mail Room operations, which were out-sourced earlier, continued under the same arrangement.

Under Phase II of the Early Voluntary Retirement Scheme, which was implemented as a part of the Modernization Program of the Bank, eight employees attached to the Secretariat Department retired at the end of the year 2005.

18. Security Services

The main objective of the Security Services Department (SSD) is to protect the employees of the Central Bank, its buildings and properties, and provide security to the currency consignment while in transit.

(a) The SSD actively participated in the preparation of the Business Continuity Plan for the critical operations of the Central Bank .

(b) A departmental contingency plan was prepared in readiness to face any contingency event. Under the contingency plan, we have trained a special team of officers to assist in bringing a threatening situation under control, providing first aid to the injured and leading a safe evacuation of the employees.

(c) In addition to the employees at the Head Office, the employees of CBS, Rajagiriya and Regional Offices were also provided with the practical training on fire fighting, during the year.

(d) Weapon training and live firing training were conducted on 20 November 2005 and 3rd and 4th of December 2005.

(e) Strengthened the physical security of the Central Bank Head Office and the CBS, Rajagiriya.

(f) A special programme had been launched to enhance the efficiency of the Security Officers through better training and on-going dialogue with the staff.

19. Statistics

The Statistics Department continued to collect, compile, analyse, and disseminate data on national accounts, prices and wages, labour force and employment, and other socio-economic sectors in 2005 as well. The Department concentrated on both improving the existing data systems and developing new information systems towards enhancing the quality and timeliness of national socio-economic statistics. One of the major achievements of the Department during the year was the release of the Report on the Consumer Finances and Socio-economic Survey (CFS) 2003/04 in both printed and electronic formats, followed by public lectures and presentations at several seminars. In addition, the Department actively participated in public awareness programmes of the Central Bank by providing resource persons for training programmes, seminars and media discussions on socio-economic issues, throughout the year. Many staff members participated in training programmes and workshops to further their knowledge and skills during the year towards improving the quality and productivity of the Department.

19.1 Consumer Finances and Socio Economic Survey (CFS) 2003/04

The year marked the completion of the periodic project of the Department, the CFS 2003/04. This was the 8th in the series of multi-purpose household surveys that commenced in 1953. A major achievement of this survey was its coverage of the household population in the Eastern province and most of the Northern province, excluding only Kilinochchi, Mannar and Mulaitivu Districts.

The CFS Report 2003/04 was disseminated in two parts. Part 1 of the Report contains an overview and analysis of the findings of the survey covering the seven areas of demography; education and health; labour force; housing and living conditions; income; consumption and expenditure; and savings, investment and borrowings of households. Part 1 of the Report also provides a comparison with the findings of the previous CFS 1996/97. Part 2 of the Report provides detailed tabulated information under the seven main areas covered in Part 1 of the Report, disaggregated by province and sector (urban, rural, estate). As a more wide-spread dissemination strategy, the Department published summary reports in Sinhala and Tamil on the key findings from the CFS 2003/04, which were also launched with Part 1 and Part 2 of the Report in September 2005. In addition, the Department has made the micro data from the CFS 2003/04 and the CFS 1996/97 available on CD to potential users for research purposes. Cost recovering through sales of the reports and micro data of around Rs. 1.5 million had been achieved by March 2006.

19.2 Countrywide Data Collection System (CWDCS)

Collection of data on prices and wages under the CWDCS, analysis of collected information and dissemination of results were continued. With the expansion of the CWDCS to market centres in the Northern and Eastern Provinces (NEP) in 2004, the Department collected data from 107 CWDCS centres during 2005. With respect to updating data, along with the introduction of new formats for data collection, the supervision of teacher investigators was also strengthened to ensure quality and timeliness of information in accordance with the annual time table set at the beginning of the year. Off-site as well as on-site field supervision was conducted in respect of all centres outside the NEP, while off-site supervision was conducted in respect of all 7 centres established in the NEP. As in the past, four regional seminars, in Colombo, Matara, Anuradhapura and Kandy, were conducted to provide refresher training to the teacher investigators to improve the accuracy, quality, efficiency and timeliness of their data collection and also to educate them on contemporary developments in the economy, so that such knowledge could be transferred to their students and communities. The effectiveness of such programmes was reflected in improved awareness and interest in economic issues among the teacher investigators. The preliminary work to rationalise data collection centres under the CWDCS was also completed during the year.

19.3 National and Regional Income Accounts

The Department continued to compile and disseminate annual and quarterly estimates of Sri Lanka's national accounts with further improvements. Estimates of Private Consumption Expenditure (PCE) were improved using information from the CFS 2003/04. A system to extract and incorporate information available from the Employees' Provident Fund (EPF) database in the national accounts compilation was also developed in 2005 following the initial work undertaken in the previous year. Also, the performance of companies listed on the Colombo Stock Exchange (CSE) was studied with a view to evaluating their contribution to overall economic activity and Gross Domestic Product (GDP). The presentation of information on GDP was improved through the reclassification of the annual and quarterly GDP estimates in line with the International Standard Industrial Classification (ISIC). The work initiated in 2003 to build a data series on quarterly national accounts computed on the basis of the expenditure method continued through 2005 as well.

As in the previous years, the Department compiled and disseminated data on the annual GDP disaggregated by Province (PGDP), with a lag of one year, for 2004. The Department noted that the PGDP data series have now entered mainstream policy discussions aimed at identifying and addressing regional disparities in economic activities and the growth performance of the country.

19.4 Prices, Wages and Employment

The Department compiled and analysed six monthly price indices. While the five regional consumer price indices measure the aggregate price movements in retail prices in five different regions, the Wholesale Price Index measures the same for producer or wholesale prices. The prices necessary for the compilation of all indices were either collected through the CWDCS or by investigators to whom data collection had been outsourced but were trained by the Department. Under the outsourced data collection system, information was collected from 7 market centres in the Colombo District and 3 regional economic centres.

In addition, the Department continued with the analysis of movements of consumer prices based on the Colombo

Consumers' Price Index (CCPI) and the Sri Lanka Consumers' Price Index (SLCPI), which are compiled by the Department of Census and Statistics (DCS). The Department continued to issue a monthly media release on inflation movements as measured by the CCPI and the CDCPI. Development of the Informal Sector Wage Rate Index (ISWRI) continued, with a focus on improving the quality and the coverage of the data on informal sector wages. A project to compile CPIs for all nine provinces using information on consumer expenditure from the CFS 2003/04 was initiated in 2005.

The Department continued to conduct its Annual and Quarterly Public Sector Employment Surveys. Information from both surveys was used in the compilation of the national accounts and in quarterly reports. A quarterly labour market review was initiated by extending the coverage of the quarterly report to the areas of foreign employment, labour relations and labour market reforms, in addition to the annual and half yearly analysis of the labour force and the labour market.

19.5 Dissemination of Statistics

During the year, the Department released its two annual publications titled " Socio Economic Data 2005" (volume XXVIII) and "Economic and Social Statistics of Sri Lanka 2005" (Volume XXVII) in June and November respectively, in addition to the four CFS 2003/04 publications that were released in September. The statistical tables in the Central Bank pocket diary 2006 were also updated, while new tables were introduced in all publications to provide preliminary statistics from the CFS 2003/04 to users.

The Department made its regular contributions to statutory, as well as other Central Bank publications, during the year. The Monetary Board was kept informed of the current key findings with regard to national accounts, inflation, prices, wages and the labour market, on quarterly and annual bases. The Department continued to routinely update its Departmental website on the local area network, *Sta-Net*, and to contribute to the Bank's website throughout the year.

19.6 Contributions to Public Awareness Programmes of the Central Bank

The Department's senior staff regularly functioned as resource persons at seminars, workshops, training sessions and media discussions organised by the Central Bank, the government, private organisations, educational institutions and the media. The Department continued to provide in-house industrial training to two undergraduates from the Statistics Department of the University of Colombo and to support the graduate development programme at the University of Moratuwa in 2005, as well.

20. Supervision of Non-Bank Financial Institutions

The Department of Supervision of Non-Bank Financial Institutions (SNBFI Dept.) continued to carry out regulation and supervision of registered finance companies (RFCs) to ensure that RFCs comply with the prudential requirements stipulated by the Central Bank. The Department also performed the tasks of registering, regulating and monitoring of registered finance leasing establishments (RFLEs).

During the year, one new finance company was registered increasing the total number of RFCs to 28 by end 2005, and three leasing companies were registered, increasing the total number of RFLEs to 6[illegible] as at the same date.

20.1 Registered Finance Companies

(a) Off-Site Surveillance

In the process of carrying out off-site surveillance of RFCs, periodical returns submitted by RFCs were analysed with a view to ascertaining the financial condition of RFCs and monitoring their compliance with the Directions and Rules issued under the Finance Companies Act No. 78 of 1988 (FCA).

Directions issued under the FCA covered, inter alia, minimum capital and liquidity requirements, provisioning for bad and doubtful debts, single borrower limits, and limits on equity investments.

In general, RFCs complied with the prudential Directions on a continuous basis, although there have been occasional non-compliances by a few. Such non-compliant RFCs were given specific time frames to rectify the violations and the Department closely followed up the corrective action taken by them.

(b) On –site Examinations

The Department conducted comprehensive on-site examinations of four RFCs during the year in order to assess capital adequacy, asset quality, management efficiency, earnings, liquidity, internal controls and systems, and compliance with statutory requirements. Spot examinations were conducted in respect of the other twenty four RFCs. These spot examinations covered selected critical areas such as non-compliance with Directions and deficiencies in systems and controls.

Findings of the on-site examinations were discussed with the Boards of Directors of the respective RFCs and the Department insisted on taking urgent corrective action to eliminate deficiencies. Prompt corrective action has been taken wherever possible and firm commitments were given by the Boards of Directors for correcting any remaining deficiencies.

(c) Issue of Directions and Rules

During the year, the Finance Companies (Deposits) Direction No.1 of 2005 was issued, replacing the Finance Companies (Deposits) Direction No.1 of 2002, permitting RFCs to accept savings deposits. The Finance Companies (Interest) Direction No.2 of 2005 and Finance Companies (Liquid Assets) Direction No.3 of 2005 were issued, replacing the existing Directions on respective aspects, to incorporate prudential requirements applicable to acceptance of savings deposits by RFCs. The rationale for those Directions is that RFCs will be able to mobilise low cost funds through the operation of savings accounts, thereby extending the benefits to the savers by providing an alternate avenue for investment.

The following Directions and Rules were also issued during 2005.

(i) Finance Companies (Closure of Office/s for Business) Direction No.4 of 2005

(ii) Finance Companies (Structural Changes) Direction No.5 of 2005

(iii) Finance Companies (Opening/Shifting/Closure of Branches/Offices) Direction No. 6 of 2005

(iv) Finance Companies (Registration and Licensing) Rules No. 1 of 2005.

20.2 Registered Finance Leasing Establishments (RFLEs)

(a) Registration of finance leasing establishments

In terms of the FLA, the registration under the Act is necessary to conduct finance leasing business. During the year, 3 institutions comprising one LCB and two public companies which are referred to as specialized leasing companies (SLCs), were registered under the provisions of the FLA. At the end of 2005, the total number of RFLEs stood at 68 comprising 13 LCBs, 7 LSBs, 28 RFCs and 20 SLCs.

(b) Monitoring of SLCs

In August 2003, a Direction was issued by the Director SNBFI Department to obtain vital information on a regular basis from SLCs. Since then the Department has been closely monitoring the affairs of SLCs. Having considered the business characteristics of RFLEs and the already existing regulatory arrangements for LCBs, LSBs and RFCs, the Department issued the following Directions to SLCs to promote soundness of their operations and stability.

(i) Finance Leasing (Minimum Capital) Direction No. 1 of 2005

(ii) Finance Leasing (Provision for Bad and Doubtful Debts) Direction No. 2 of 2005

(iii) Finance Leasing (Single Borrower Limit) Direction No. 3 of 2005

(iv) Finance Leasing (Gearing Ratio) Direction No. 4 of 2005

(v) Finance Leasing (Accrued Interest) Direction No. 5 of 2005

(vi) Finance Leasing (Reserve Fund) Direction No. 6 of 2005.

These Directions became effective from 2 January 2006. The Department also initiated action to compile statistics relating to the finance leasing business of LCBs, LSBs and RFCs on quarterly basis.

20.3 Failed Finance Companies

Nine failed finance companies had been vested with the Monetary Board since 1988 under the provisions of the FCA. Six of those had been under liquidation at the beginning of 2005. During 2005, two were wound up and the liquidation process continued in the case of the other four companies.

Of the remaining three companies, two were handed over to the liquidators during 2005. The other company, which was able to recover some dues from a related company, commenced another round of partial refund of deposits and also repaid a part of the principal of the loans obtained from the Central Bank.

20.4 Unauthorized Conduct of Finance Business

The Department continued investigations into affairs of the institutions, which were allegedly engaged in finance business without legal authority. In respect of eleven such institutions, the Monetary Board, on consideration of the reports submitted by the Department, made determinations under section 11(2) of the FCA that they were conducting finance business in contravention of the provisions of the FCA. This was followed by taking appropriate action under the provisions of the FCA against those institutions.

During the year, the Department initiated legal action against one company, which failed to comply with the Directions issued by the Monetary Board after determining that that company had been conducting finance business without legal authority. As at the end of 2005, the Central Bank had taken legal action against 6 institutions for offences committed under the FCA.

In March 2005, the Supreme Court refused to grant leave to two companies to appeal against a judgement delivered by the Court of Appeal on 22.09.2004. The respondents of the Supreme Court case were the Director, SNBFI Dept. (D/SNBFI) and the Monetary Board. The judgement of the Court of Appeal had emphasized the powers conferred on D/SNBFI for requiring information from the two companies to ascertain whether they were engaged in finance business as defined in the FCA.

There has been a marked decline in the number of inquiries/ complaints received in respect of persons conducting finance business in an unauthorised manner. This may be partly due to the action taken by the Central Bank on a continuous basis regarding such persons and the intensified public awareness programme.

20.5 Public Awareness Programme

The Department continued to educate the public mainly on matters relating to the unauthorized conduct of finance business. The public awareness programme implemented by the Department included the following:-

(a) Publications in Newspapers: -

(i) A list of registered finance companies (January 2005).

(ii) An explanatory note including the definition of deposits, categories of institutions/organizations authorized to take deposits under different laws and a list of institutions authorized by the Central Bank to accept deposits (March 2005). From July 2005, this notice was published on a monthly basis. These notices were published jointly with the Director of Bank Supervision.

(iii) Press release on Supreme Court's refusal to give leave to proceed to two companies, which appealed against a judgement of the Court of Appeal objecting on several grounds to requiring information and documents by D/SNBFI from them for an investigation conducted under section 11(1) of the FCA (March 2005).

(iv) Names and addresses of 4 companies in respect of which the Monetary Board had made determinations under section 11(2) of the FCA (May, September, October and November 2005).

(v) A notice indicating the names and addresses of 10 institutions in respect of which the Monetary Board had made determinations up to November 2005, under section 11(2) of the FCA (November 2005).

(vi) A notice under the caption "Be mindful of where you place your savings" indicating the risks associated with investing funds with unauthorized deposit taking institutions, a list of institutions in respect of which the Monetary Board had made determinations under section 11(2) of the FCA, categories of institutions/organizations authorized to take deposits and a list of registered finance companies (November 2005).

(b) Requesting Grama Niladaries to display notices explaining the risks associated with depositing of money with unauthorized deposit taking institutions and giving a list of institutions authorized to accept deposits from the public.

21. The Centre For Banking Studies (CBS)

The CBS strives to ensure the total development of financial sector personnel. The CBS is one of the leading training centres in the banking and financial sector, providing high quality training to personnel in the Central Bank, the banking sector and other financial institutions including those engaged in Rural Sector Development and Micro Finance with the mission of equipping them with necessary competencies to meet the challenges in a fast developing sector. According to an annual training needs survey in the financial sector, seminars, workshops and short-term courses are designed and conducted by a panel of well experienced and qualified resource persons from the Bank and external institutions. The CBS is equipped with modern training facilities and is expected to meet the training needs in the SAARC region as well. In the long term the CBS is expected to develop into a self-financing entity.

The CBS conducted 73 short-term training programmes in 2005 compared to 69 programmes conducted in the previous year, covering the fields of Banking, Finance, Information Technology, Languages and Communication Skills, Management and Rural Sector Development including Micro Finance. Courses in Languages and Communication Skills and Information Technology were primarily targeted at fulfilling the

TABLE II - 15

Training Programmes Conducted by CBS in 2005

Classification	No. of Programmes	Trainees CBSL	Trainees Other	Trainees Total	Total Training Hours
1. Banking	8	55	196	251	102
2. Finance	10	45	276	321	108
3. Information Technology	23	329	25	354	846
4. Languages & Communication Skills	5	98	8	106	186
5. Management	3	32	30	62	24
6. Rural Sector Development & Micro Finance	4	-	112	112	48
7. Special Programmes	20	367	182	549	624
Total	73	926	829	1,755	1,938

Source: CBS, Central Bank of Sri Lanka

TABLE II - 16

Public and Commemoration Lectures conducted in 2005

Date	Topic	Resource person
13 Jan. 2005	Economic Liberalization and Industrial Restructuring in Sri Lanka: Achievements and Policy Options	Prof. Prema -Chandra Athukorala Dept. of Economics, Australian National University, Canberra
02-Mar-05	The Impact of the Tsunami Disaster on the Economy of Sri Lanka & Challenges for Rebuilding the Nation (Independence Commemoration Lecture)	Dr. P B Jayasundara Secretary to the Treasury, Ministry of Finance
31-Mar-05	Recent Amendments to the Banking Act and its impact on the banking industry	Mr. A H M D Nawaz, Senior State Counsel, Attorney General's Department
28-Apr-05	Preparedness & Interorganizational Relations in Disaster Management	Prof. D.S. Withane, Prof. of Organisation, Theory & Strategy, University of Windsor, Ontario, Canada
05-May-05	State of the Economy as reflected in the Central Bank Annual Report 2004 (Republic Commemoration Lecture)	Dr. H.N Thenuwara, Director, Economic Research Dept., CBSL
02-June-05	Combating Pyramid schemes	Mr. Robert L FitzPatrick, President, Pyramid Scheme Alert, USA
14-Jul-05	Governance: Issues in Contemporary Economic Development	Prof. Bibek Debroy, Director, Rajiv Gandhi Institute, New Delhi
25-Aug-05	Development & Change : The Sri Lankan Economy 1950-2005 (55th Anniversary Lecture of the CBSL)	Dr. Nimal Sanderatne , Chairman, Centre for Poverty Analysis
14-Sep-05	Consumer Finances and Socio Economic Survey (CFS) Report 2003/04	Dr. Mrs. Anila Dias Bandaranaike Director, Statistics Department, CBSL *Reviewed by :* Mrs. Vishaka Hidellage, Country/Regional Director, Intermediate Technology Development Group (ITDG), South Asia
02-Dec-05	Public Lecture- Book Launch of "Ellangawa" and Translation of Manual of the North Central Privince	Dr. M U A Tennakoon, Former Executive Director, CBSL
22-Dec-05	Beyond Indo-Lanka Free Trade Agreement: Comprehensive Economic Partnership Agreement between India and Sri Lanka (24th Anniversary Lecture of the CBS)	Dr. H.N Thenuwara, Director, Economic Research Dept. CBSL *Panellists :* 1. Dr. Saman Kelegama Executive Director, Inst. Of Policy Studies 2. Mr. H.M. Wijeratne Director of Commerce, Dept. of Commerce

Source: CBS, Central Bank of Sri Lanka

training needs of Central Bank officers. Twenty Special programmes were conducted of which 3 programmes were conducted on the request of the National Development Bank Ltd., exclusively for their officers. The total number of participants in CBS programmes increased by 16 per cent to 1,755 in 2005 from 1,507 in 2004. The CBS also conducted 11 Public and Commemoration lectures with eminent local and foreign speakers, and these lectures provided a forum for professionals, senior executives in the financial sector and members of the public to express their views on important current issues. The CBS continued conducting seminars for Advanced Level students and teachers on the Economy of Sri Lanka and Banking. While 11 schools participated in these seminars, 02 schools were from Batticaloa.

22. Training

The new training and learning policy introduced in 2004, which emphasized the importance of learning in the pursuit of knowledge, was continued during the year 2005. Within the new framework, both the management and the staff are required to take a joint responsibility for creating a core knowledge base in the Bank. While the Management would take the responsibility for providing opportunities to its staff to learn, train themselves and share their knowledge and experience with others, the staff is expected to make use of such opportunities to upgrade their knowledge and skills. In the implementation of the new training and learning policy, the Bank provided opportunities to its staff to acquire technical, professional and managerial skills.

During the year under review, 191 officers participated in short-term training programmes held abroad mainly in the areas relating to the core functions of the Bank while 1,253 officers participated in local training programmes conducted by the Centre for Banking Studies (CBS) and reputed local training institutions. In addition to the opportunities made available to the staff to develop their skills and competencies, the Bank recognized the importance of providing facilities to its staff to develop managerial skills and personnel skills to make them effective managers. Therefore, with the objectives of developing and strengthening leadership qualities, team building, decision making skills, innovative thinking and to broaden their perception of the scope of their duties and responsibilities, the Bank provided an opportunity for 687 officers to participate in Outward Bound Professional Development Training Programmes conducted by the Sri Lanka Business Development Centre. In addition, the Bank provided opportunities to the senior staff to participate in several Management Development Programmes conducted by Franklyn Covey (South Asia) Pvt. Ltd. In response to specific requests made by departments, two professional courses were conducted on Investment Analysis and International Trade, utilizing the funds allocated by the Swiss International Development Agency. During the year 2005, 08 officers participated in familiarization programmes in Sweden under the Staff Exchange Programme while 10 officers participated in familiarization programmes in Pakistan under the SAARC Staff Exchange Programme.

The Bank continued with its policy of nominating officers to undertake postgraduate studies at reputed universities in the UK, the USA, Australia and Canada. During the year under review, 13 officers commenced their postgraduate studies abroad. Four officers returned to Sri Lanka having completed their postgraduate studies successfully.

The Training Department continued with the practice of conducting seminars. The weekly seminar series was continued to provide an opportunity to those who have participated in training programmes as well as those who have undertaken research for their postgraduate studies to share their experiences with other officers in the Bank. During the year under review, 47 seminars were conducted under the Seminar Series.

23. Welfare

The Welfare Department, which is entrusted with the task of providing welfare benefits to the Central Bank employees, pensioners, widows/widowers and their registered dependents totalling 9,332 as at end 2005, continued to extend such facilities during the year under review. The welfare benefits consisted of loan facilities under different categories at concessionary rates of interest for employees, the provision of medical benefits for employees, pensioners and dependents and the maintenance of an in-house health clinic, canteen facilities and other ancillary welfare services.

The Housing Loan Scheme was expanded in May 2005 to grant a second housing loan up to a maximum of Rs. 3 million at 7.5 per cent per annum for employees who intend to dispose of the first house already constructed with financial assistance from the Bank. This is in addition to the existing second housing loan at 2.5 per cent made available to employees, where it is impossible or hazardous to life or health for the employee concerned to reside in a place of residence for which the first loan was obtained.

The Medical Benefit Scheme was also expanded in June 2005 with the beneficiaries now being able to claim reimbursements up to Rs.350,000 in a lifetime in respect of a cochlear implant or hipbone replacement surgeries.

23.1 Other Activities

The catering service was further strengthened to be cost effective and efficient and to cater for official functions of the Bank. Computerization of activities relating to the canteen was finalized with a view to improving the reporting system.

24. Human Resources Development

During 2005, the Human Resources Department (HRD) continued to engage in its operational and strategic functions, having particular regard to the on-going modernization programme of the Central Bank. The HRD activities were carried out in the areas of recruitment, placement, promotions, succession planning and performance evaluation, in view of identified human resource needs of the Central Bank.

24.1 Voluntary Early Retirement Scheme (VERS)

In response to requests made by certain categories of employees, a VERS was offered for all Non-Staff Class Officers and Minor Employees in August 2005. Under this VERS, 106 employees retired, effective from 1st December 2005.

24.2 Recruitment

Recruitment was carried out in order to fill identified vacancies and to meet the competency requirements of the Bank. A total of 57 officers were recruited to the Staff Class through a rigorous screening process which included an open competitive examination conducted by the Examinations Department and structured interviews conducted by the Central Bank. In addition, a Civil Engineer, a Court Clerk and 4 IT Technicians were recruited on contract basis to meet the corporate services needs of the Bank.

24.3 Promotions

Career progression of all employees of the Central Bank were considered in terms of grade promotions and position promotions during the year. Based on the employee performance and recommendations made by the respective Heads of Department, 148 employees in Non-Staff Class and Staff Class categories were promoted. In the case of position promotions, 23 Non-Staff Class officers were promoted to Staff Class Grade I and 15 Non-Staff Class Personal Assistants were promoted to Staff Class Grade I as Personal Secretaries. Meanwhile, 2 Heads of Department positions and 2 Deputy Heads of Department positions were filled after conducting interviews, in terms of the stipulated promotion criteria of the Central Bank.

24.4 Employer - Employee Relations

There was continuous dialogue between the Bank's trade unions and the management during the year. For the benefit of the office bearers of trade unions, two study visits were organized to the State Bank of Pakistan and the Bank Negara, Malaysia, to familiarize with the activities of the Central Banks of the two countries. The recommendations of the Salary Anomaly Committee were implemented during the first quarter of the year in order to resolve salary anomalies that existed among certain categories of employees. In addition, discussions were commenced with regard to the Collective Agreement, which will be effective from 2006.

24.5 Performance Management System (PMS)

Under the new PMS, performance appraisals for all employees of the Central Bank for the year 2004 was completed during the year. In fulfilment of a requirement of the Collective Agreement, a performance based incentive scheme was introduced to recognize exceptionally outstanding performance of employees. Departmental and individual goal settings for 2005 were completed during the early part of the year.

24.6 Manpower Planning

In 2005, a total of 124 employees retired under the VERS and under the normal retirement scheme and 7 employees resigned from the Bank service. At the end of the year there were 494 Staff Officers, 478 Non-Staff Officers and 105 Minor Employees. The HR Department completed a key person risk analysis as a part of the succession plan. Accordingly, the management was informed of the future requirements of human resources of the Central Bank.

24.7 Implementation of the e-HR System

The HR Department introduced a web-based e-HR system, which will enable the management to take timely decisions with minimum overhead cost to the bank. After completing the tender procedure, a system has been procured and work on customization was carried out during the latter part of 2005. Discussions were held with the user departments and data migration to the e-HR system was completed. The Staff of the departments need to be trained on the use of the new system. A fully pledged e-HR system that covers the processes and database from recruitment to retirement will be available after completing the automation process, which is in progress.

24.8 Closure of the Management Development Centre (MDC)

The activities of the MDC, which commenced in 2001, were handed over to other departments namely, Training and the Centre for Banking Studies. The MDC basically focused on the development of competencies of the Bank's employees, with assistance from the Swedish International Development Agency (SIDA). The MDC was closed down with effect from 28 March 2005.

24.9 Meetings Attended by the Governor

The Governor, Mr. Sunil Mendis, attended the following meetings during the year 2005.

(i) SEANZA Governors' symposium held in Manila, Philippines from 25th – 28th February, 2005

(ii) G24, IMFC and Development Committee Meetings held in Washington DC, U S A from 11th – 17th April, 2005

(iii) 40th SEACEN Governors' Conference and 24th SEACEN Board of Governors' Meeting held in Nadi, Fiji from 31st May – 3rd June, 2005

(iv) Annual General Meeting of the Bank for International Settlement held in Basel, Switzerland from 25th – 27th June, 2005

(v) SAARCFINANCE Governors' Symposium 2004 held in Mumbai, India from 8th – 10th September, 2005

(vi) 2nd Annual Meeting of the Commonwealth Central Bank Governors held in Barbados on 18th September, 2005

(vii) G-24, IMF and Development Committee Meetings and IMF/World Bank Annual Meetings and Governors' Forum on Reserve Management held in Washington DC, U S A from 20th – 25th September, 2005.

24.10 Appointments

(i) Mrs. J A N Dissanayake, Acting Additional Director of the Management Audit Department was appointed as Acting Director of the Management Audit Department with effect from 01st January 2005. Subsequently she was appointed as Additional Secretary, Secretariat Department, with effect from 16 July 2005.

(ii) Mr. Y A De Silva, Acting Additional Director of the Premises Department was appointed as Acting Director of the Premises Department with effect from 10 February 2005.

(iii) The following appointments were effected on 14 February 2005.

Mr. M M Attanayake, Director of the Regional Development Department was appointed as Director of Centre for Banking Studies.

Mr. W M Karunaratne, Additional Director of the Regional Development Department as Director of Regional Development Department.

Mr. M V M Fernando, Acting Additional Director of the Centre for Banking Studies as Acting Additional Director of the Regional Development Department. Subsequently he was appointed as Additional Director of the Welfare Department with effect from 01 August 2005.

(iv) Miss S H Gunawardena, Deputy Director of the Centre for Banking Studies was appointed as Acting Director for Mr. M M Attanayake, Director, who was released to the Ministry of Enterprise Development and Investment Promotion, with effect from 01 April 2005.

(v) Mr. S H A M Abeyratne, Additional Director of the Human Resources Department was appointed as Acting Director of Human Resources Department with effect from 01st May 2005. Subsequently he was appointed as Director of Human Resources Department with effect from 01 November 2005.

(vi) Mr. E A Hettiarachchi, Additional Chief Accountant of the Finance Department was appointed as Acting Chief Accountant of the Finance Department with effect from 01 May 2005. (on overseas leave from 04 July 2005)

(vii) Mr. M I Sufiyan, Deputy Director of the Management Audit Department was appointed as Acting Director of Management Audit Department with effect from 16 July 2005.

(viii) Mrs. K M A N Daulagala, Deputy Chief Accountant of the Finance Department was appointed as Acting Chief Accountant of the Finance Department with effect from 16 July 2005.

(ix) Mr. D Wasantha, Acting Additional Director of the Statistics Department was appointed as Additional Controller of the Exchange Control Department with effect from 1 September 2005.

(x) Mr. H M P Herath, Additional Controller of the Exchange Control Department was appointed as Additional Director of the Premises Department with effect from 1 September 2005.

24.11 Retirements

(i) Mr. G L Amarasena, Acting Director of the Premises Department; service contract expired on 9th February 2005.

(ii) Mr. K Jeganathan, Director of the Centre for Banking Studies retired from the Bank Service with effect from 14 February 2005.

(iii) Mr. D L Katuwawala, Chief Accountant of the Finance Department; service contract expired on 30 April 2005.

(iv) Mr. M A Nandasiri, Director of the Human Resources Department who was on a service contract, resigned from the service contract with effect from 01 May 2005.

(v) Mr. C K Paranawithana, Additional Director of the Centre for Banking Studies, who was declared missing following Tsunami Disaster on 26 December 2004, was considered to have retired from the Bank service with effect from 03 August 2005.

(vi) Mrs. S Kadurugamuwa, Director of the Legal Department, retired from the Bank service with effect from 04 December 2005.

24.12 Officers On Release

(i) Mr. R A Jayatissa, Assistant Governor, to the Ministry of Finance and Planning as Senior Economic Policy Advisor and the Deputy Secretary to the Treasury.

(ii) Dr. U Vidanapathirana, Assistant Governor, to the Ministry of Disaster Management as Secretary.

(iii) Mr M M Attanayake, Director of the Centre for Banking Studies, to the Ministry of Enterprise Development and Investment Promotion.

(iv) Dr. P W R B A U Herat, Director of the Economic Research Department, to the International Monetary Fund as an Alternate Executive Director.

(v) Brigadier W P P Fernando, Director of the Security Services Department, to the Ministry of Defence.

(vi) Mr. S R Attygalle, Staff Class Grade III officer, to the Ministry of Finance and Planning.

(vii) Mrs. Y M Indraratne, Staff Class Grade III officer, to the Ministry of Industrial Development.

(viii) Mr. M Mahinda Saliya, Staff Class Grade I officer, to the Department of National Budget and Fiscal Policy of the General Treasury.

(ix) Mrs. A K Hettiarachchi, Personnel Secretary, to the International Monetary Fund.

(x) Mrs. M C J Fernando, Personnel Secretary, to the Ministry of Finance and Planning.

(xi) Miss D K M G D Indunil, Staff Class Grade I officer, to the Ministry of Finance and Planning.

(xii) Mr. E W K J B Ehelapola, Staff Class Grade I officer, to the Ministry of Finance and Planning.

(xiii) Mr. K A U S K Thilakarathne, Staff Class Grade I officer, to the Ministry of Finance and Planning.

(xiv) Mr. S Prabagar, Staff Class Grade I officer, to the Ministry of Finance and Planning.