Box 11

An Evaluation of the Small Farmers and the Landless Credit Project

In 2005, the Central Bank conducted an Impact Assessment Survey of the Small Farmers and the Landless Credit Project (SFLCP). to evaluate the success of the SFLCP in lifting beneficiaries out of poverty and improving their living standards from a holistic standpoint. After being in operation for 15 years, a comprehensive Impact Assessment Survey was conducted in 2005 covering a sample of 1,200 beneficiary households which had been in the SFLCP for at least 5 years. Information collected included demographic and socio-economic characteristics, ownership of land, capital goods and consumer durables, housing conditions and amenities, income, indebtedness, loans, savings, investment, client satisfaction, and social capital of beneficiaries.

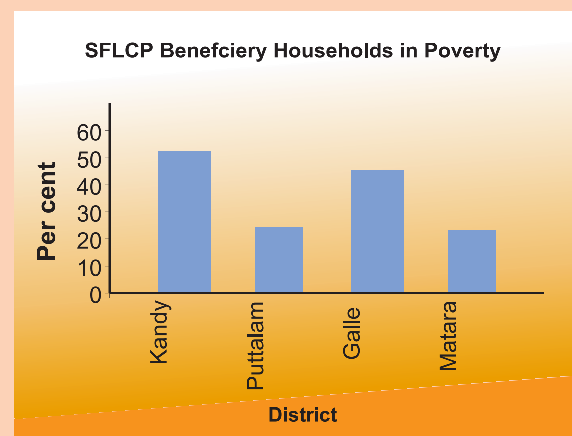
The SFLCP is a pilot poverty alleviation scheme operated by the Central Bank. Initial funding for this project was obtained from the International Fund for Agricultural Development (IFAD), the Canadian International Development Agency (CIDA) and the Central Bank (on behalf of the Government of Sri Lanka). The Project was managed by a Central Project Office (CPO) established in the Regional Development Department of the Central Bank and Project District Offices (PDOs) established in the districts of Kandy, Puttalam, Galle and Matara in which the project operated. This scheme has been in operation since 1990.

Under the SFLCP, field officers attached to the PDOs identify eligible poor beneficiaries and facilitate 4-6 beneficiaries to form Self Help Groups (SHGs). Members of SHGs are required to make regular weekly savings and are subject to social mobilization and training. Through this social mobilization process and training received, beneficiaries are in a position to identify potential income generating activities they would be able to pursue. Once an SHG has demonstrated the ability to save for a period of around six months, its members are allowed to borrow funds for income generating activities that could be undertaken by an individual beneficiary or as a group. Initial loans given cannot exceed Rs. 20,000 and are in practice usually as low as Rs.5,000. Once a loan is fully settled, a beneficiary is entitled to a larger loan in the next cycle of borrowing. The maximum loan provided under this scheme is Rs.50,000.

Findings of the Impact Assessment Survey

The average monthly household income (one month average of 12 months income) among beneficiaries was found to be Rs.13,101. There was district-wise variation, however, with average income levels in Puttalam (Rs.16,444) and Matara (Rs.16,294) being significantly higher than the corresponding figures in Galle(Rs.11,030) and Kandy(Rs. 9281) districts. Further, when district-wise poverty lines computed by the Department of Census and Statistics adjusted for inflation were used as thresholds for poverty, it was found that the proportion of households in poverty was around 37 per cent, implying that around 63 per cent of beneficiary households had moved out of poverty. Although this cannot be attributed solely to participation in the project, the fact that rural poverty had declined by only 5 percentage points during the period 1990/91-2002 in the country as a whole, according to data of the Household Income and Expenditure Survey, implies that SFLCP had been largely responsible for the reduction of poverty of 63 per cent of beneficiary households. There was district-wise variation, however, with the proportion of households in poverty being low in the Matara and Puttalam districts at 23 per cent and 24 per cent, respectively, and higher in the Galle and Kandy districts at 45 per cent and 52 per cent, respectively (Chart B 11.1 below).

Chart B 11.1



The undermentioned findings also support the conclusion that income levels have risen, poverty has reduced and living standards have improved.

(a) The quality of housing in which beneficiaries reside had improved.

(b) Access to amenities such as electricity and availability of latrine facilities had improved.

(c) Ownership of consumer durable items compared favourably with all island availability as revealed in the Consumer Finance and Socio-Economic Survey (CFS 2003/2004).

(d) Ownership of agricultural implements and capital goods had improved.

(e) A notable number of children from beneficiary households attended private tuition and weekend religious instruction classes.

(f) Around 63 per cent of households stated that SFLCP has been responsible for lifting them out of poverty.

(g) Around 2/3rds of beneficiaries were satisfied with their living conditions.

A very important fact observed revealed in the survey was that, compared to overall borrowing patterns revealed in the CFS 2003/2004, beneficiaries had very low dependence on informal sources for loans, due to the availability of project finance under the scheme. The scheme had thus freed them from the clutches of money lenders who charged exorbitant interest rates and from borrowing from friends and relations which could also involve a hidden cost. Further, when compared to the average borrowing patterns, a much greater proportion of loans had been devoted to productive activities by SFLCP beneficiaries.

Policy Implications of Survey Findings

(a) There is a need to encourage beneficiaries who require loans over and above the Rs.50,000 upper limit to resort to commercial borrowing. A notable proportion of beneficiaries stated that loans provided were insufficient for their present capital needs. This proves that their enterprises have developed beyond micro-enterprises and, therefore, are in need of commercial credit.

(b) More relevant training should be given and greater awareness created on marketing prospects. There was a high failure rate of project amog beneficiaries and marketing problems were a prominent reason for such failure. Therefore, before embarking on an income generating activity, beneficiaries require access to markets for their products.

(c) Steps should be taken to encourage beneficiaries to diversify their economic activities. Most beneficiaries were involved in agricultural, industrial and trading activities. Very few were involved in service activities other than trade. As the services sector is an expanding area, beneficiaries should be encouraged to move into this sector.

(d) To promote transparency of the scheme, the poverty thresholds used for targeting of beneficiaries should be regularly revised upward in line with inflation.

The Real Time Gross Settlement (RTGS) System: The RTGS system operated by the Central Bank is main inter-bank fund transfer system for large value and time critical rupee payments, accounting for 81 per cent of the total value of non-cash payments in Sri Lanka. The total number of transactions settled through the RTGS increased by 17 per cent, while the total value of transactions settled increased by 3 per cent to Rs.18,110 billion in 2006. The majority of the RTGS transactions were in relation to transactions in the inter-bank call money market, the government securities market, the foreign exchange market (rupee leg), open market operations, urgent payments of customers of LCBs and settlements of net obligations under the clearing systems operated by LankaClear. The Central Bank continued to provide the intra-day liquidity facility (ILF) to participating institutions in the RTGS system against the collateral of government securities. The use of the ILF declined marginally reflecting improved liquidity management by participants.

The LankaSecure System: The LankaSecure System comprises of the Scripless Securities Settlement (SSS) system and Scripless Securities Depository System (SSDS). The LankaSecure facilitates the issue of Government securities in electronic or scripless form and the settlement of trades of such scripless securities on a DvP basis. The total value of scripless securities held by LankaSecure at the end of 2006 amounted to Rs. 1,134 billion, accounting for 98.8 per cent of the total value of Treasury bills and Treasury bonds outstanding. These scripless securities consisted of Rs. 258 billion Treasury bills and Rs. 876 billion Treasury bonds. At the end of the year, LankaSecure maintained 26,936 accounts through dealer direct participants, covering both individuals and corporate customers.

The introduction of the Cheque Imaging and Truncation (CIT) System in 2006 by LankaClear (Pvt.) Ltd., which handles the inter-bank cheque clearing function, was a major improvement in the processing of retail and low value payments. The CIT system, which facilitates the electronic presentment of cheque images, ensures that cheques deposited in a bank in any part of the country are cleared and settled within 2 working days (T+1).

The total value of cheques processed through the main cheque clearing system operated by LankaClear accounted for 17 per cent of the total value of non-cash payments. The total number of cheques cleared by LankaClear increased by 11 per cent to 44 million in 2006 and the total value of cheques cleared increased by 13 per cent to Rs.3, 823 billion in 2006.

LankaClear also operates SLIPS, an off-line retail fund transfer system for the Central Bank and LCBs and their customers. The value of transactions cleared by SLIPS declined marginally to Rs. 85 billion in 2006, reflecting the popularity of other electronic retail banking services, such as phone banking, internet banking and electronic payment cards.

To facilitate the formulation of a national payments policy for the country and to take forward the modernization of the payments and settlements infrastructure, the Central Bank set up a National Payments Council in 2006 comprising representatives of all major stakeholders. The payments and settlements policy framework will address risk management and efficiency improvements and has provided a road map for the next four-year period - 2007 to 2010.

Legislative Enactments and Reforms

The Central Bank continued to review and initiate reforms to strengthen the existing legal framework and to introduce new legislation to facilitate the smooth functioning of the financial system. To widen the scope of the regulatory framework relating to the banking sector and to address ambiguities in the existing law, the Banking (Amendment) Act No. 46 of 2006 was enacted in 2006. The main amendments dealt with the provision of flexibility to the Monetary Board to determine the minimum equity capital requirements of licensed specialised banks, permitting a specialised bank whose licence has been suspended to merge with another specialised bank, subject to the approval of the Monetary Board and clarifying the provisions relating to the share ownership of banks.

The Monetary Law Act was amended to fix the minimum percentage of loans to be extended to any specified sectors of the economy by licensed banks. This amendment was made to give effect to the Budget proposal to make it mandatory that credit extended by banks for agriculture should be increased to 10 per cent of total credit over the next three years, as the volume of credit channelled to the rural agricultural sector was considered to be inadequate.

To promote the integrity of and confidence in the financial system and recognising the risks posed by money laundering, Sri Lanka introduced comprehensive anti money laundering legislation to combat this threat. In addition to the Suppression of the Financing of Terrorism Act, which was enacted in 2005, two laws were passed in 2006 to deal with the prevention of money laundering. While the Prevention of Money Laundering Act defines the offence of money laundering, the Financial Reporting Transactions Act provides for the mechanism to monitor and report financial transactions to ensure that the offences of money laundering and terrorist financing are dealt with effectively.

The payments system was further strengthened by the introduction of a law to deter illegal and hazardous practices relating to payment devices. The Payment Devices Frauds Act, which was enacted in 2006, prohibits the fraudulent and unauthorised production, trafficking, possession and use of payment devices. The law covers all cards, plates, codes, account numbers, microchips, optical instruments or documents using magnetised encoding. Offenders can be arrested without a warrant and can be extradited.

Regulation and Supervision

The Central Bank, which is responsible for regulating and supervising all major financial institutions and overseeing the payment and settlement system, implemented several regulatory and supervisory initiatives in 2006 to enhance the safety, soundness and efficiency of the financial system. The institutions regulated and supervised by the Central Bank are LCBs, LSBs, RFCs, Registered Finance Leasing Establishments and Authorised Primary Dealers in government securities. In addition, the Central Bank is also responsible for regulating moneychangers. The Securities and Exchange Commission (SEC) is responsible for licensing and regulating stock exchanges, stockbrokers, stock dealers and unit trust companies. The SEC also registers underwriters, margin providers, credit rating agencies, investment managers and securities clearing houses. The Insurance Board of Sri Lanka (IBSL) regulates and supervises the insurance industry, insurance companies and their agents and insurance brokers. In addition, the Central Bank in co-ordination with other regulatory agencies is involved in developing an effective system for the supervision of domestic financial conglomerates in a consolidated manner.

The supervision of banking institutions was strengthened with the issue and application of several prudential directions and guidelines. A capital charge for market risk was introduced in 2006 in line with the Basel Capital Accord which requires all banks to maintain a minimum capital adequacy ratio of 10 per cent in relation to risk weighted assets covering both credit and market risk. The risk weights applicable to loans secured by primary mortgage over residential property and other loans and advances were increased from 50 to 55 per cent and 100 to 110 per cent respectively. A direction was also introduced on the classification and valuation of the investment portfolio into investment account and trading account.

The preparation for the implementation of Basel II Capital Adequacy Framework was facilitated by issuing guidelines to banks for the parallel computation of the capital charge. The Basel II framework will be introduced from January 2008 using the simplest approaches and banks will be required to maintain adequate capital to cover credit, market and operational risk.

Box 12

Regulation of Share Ownership in Banks

Banks are highly leveraged business enterprises that operate with a low level of capital or shareholders' funds because their core business is taking deposits from the public and lending and investing such money. For instance, in the Sri Lankan banking system, shareholders' funds constitute only 8 per cent of assets or liabilities while 70 per cent of assets accounts for deposits accepted from public. Therefore, it is customary for the bank regulators globally to impose several prudential requirements on shareholders' funds or capital of banks with the objective to protect depositors' interests and to promote the banking sector stability. The maximum limit of share ownership is one such measure. Minimum equity capital and minimum capital adequacy under the Basel Capital Accord are two other key prudential requirements.

Background in Regulation

Largely diversified share ownership in banks, i.e., shareholdings in small proportions by a large number of shareholders, is generally believed to be desirable because it prevents large shareholder-control in banks and promotes competition in the bank share market. However, share ownership concentration, i.e., majority holding of shares by a few shareholders, is also considered necessary in instances where some banks require restructuring through recapitalisation to resolve financial problems because such banks are unable to raise capital from the market at a fair price due to their weak financial condition. Therefore, both diversified share ownership and concentration in share ownership in banks are alternative means adopted by the regulators to promote banking and financial system stability. Principle 4 of the Basel Core Principles for Effective Banking Supervision (principles recommended by the Basel Committee of the Bank for International Settlements based in Basel as international best practice for guidance of the bank regulators) requires that bank regulators have the authority to review and reject any proposal to transfer significant ownership of controlling interest in banks. In line with this principle, many regulatory authorities worldwide determine the maximum limits of share ownership in a bank while specifying conditions and requirements for granting permission for acquisition of shares in excess of the maximum limits to ensure that the shareholders who acquire such large or controlling interest in banks are fit and proper persons and risks on corporate governance arising from such large shareholding are adequately mitigated. These limits will apply to shareholding by a single shareholder (an individual or entity) as well as shareholding by a group of connected shareholders (shareholding by acting in concert or indirect holding) through nominees or grouped companies. Such regulations of maximum share ownership in banks are implemented in many countries through several methods, i.e., specific provisions in the banking laws specifying the limits, regulations issued by the regulators specifying the limits in terms of banking laws and guidelines issued by the regulators. However, country practices in regulation of share ownership show diverse literature where it is difficult to derive a standard international practice. There are a large number of countries without such regulation as well. According to a survey of 157 countries conducted by the World Bank in 2003, 112 countries (71 per cent) did not have any limitations on bank ownership. The remaining 45 countries (29 per cent) implemented ownership limits ranging from 5 per cent to 50 per cent.

Provisions in the Banking Act

In terms of the Banking Act which contains provisions relating to regulation of share ownership, the maximum limit of ownership in shares carrying voting rights that can be acquired or held by a single shareholder or a group of connected shareholders in a commercial bank without regulatory approval is 10 per cent of the issued shares carrying voting rights. However, the Monetary Board of the Central Bank with the concurrence of the Hon. Minister of Finance is empowered to permit any acquisition of shares in excess of 10 per cent if such acquisition is in the interest of promotion of a safe, sound and stable banking system and fair competition prevailing in the banking system and such party or parties acquiring material interest are fit and proper persons. However, in the case of specialised bank, there is no such legal threshold for share ownership and the Monetary Board is empowered to determine such limits.

New Policy in Sri Lanka

In order to address some issues arising from acquisition of material interest in banks at various levels, the Monetary Board issued directions on a new policy for regulation of share ownership in banks on January 19, 2007. The highlights are as follows.

The maximum percentage of ownership permitted in the issued share capital carrying voting rights in a bank will be 15 per cent of the issued share capital (carrying voting rights). This limit will apply to acquisition or holding of shares by all categories of shareholders, individually or in a group (as specified in the Banking Act) whether acquired/held directly or indirectly or through a nominee or acting in concert with any other

categories of shareholders. However, in the case of licensed commercial banks, to acquire shares carrying voting rights in excess of 10 per cent requires prior approval of the Monetary Board given with the concurrence of Hon. Minister of Finance.

The Monetary Board may grant permission to acquire shares in excess of 15 per cent in the case of a licensed bank which requires restructuring to avoid inadequacy of capital, insolvency or potential failure, subject to the condition that the ownership of shares so acquired shall be reduced to 15 per cent within a specified period as may be determined by the Monetary Board on a case-by-case basis, provided also that such period shall not exceed five years from the date of granting permission.

Names of any shareholders who acquire shares of a bank in excess of the specified thresholds (10 per cent for commercial banks and 15 per cent for specialised banks) without the prior approval of the Monetary Board shall not be entered in the share register of the bank.

All shareholders who now hold shares carrying voting rights in excess of 15 per cent will be required to dispose of and/or reduce their shareholding to 15 per cent during the period not exceeding five years specified by the Monetary Board on a case-by-case basis. Voting rights of any category of shareholders who fail to comply with this will be limited to 10 per cent.

Need for Good Corporate Governance

It should however be noted that this regulation by itself cannot resolve all issues that may arise from shareholders' behaviour which may tend to influence the management of banks through directors appointed by them. For example, under the current legal provision, ten shareholders can own a commercial bank (by each holding 10 per cent legally permitted), appoint the Board of Directors and influence the management. It will be clear that this situation, even though legal, can be actually considered as a concentrated ownership of the Bank by just a few shareholders. Further, such shareholders may purchase shares of other banks within permissible limits and consolidate their position in the banking sector. Therefore, what is essentially and critically required to prevent possible management issues connected with share ownership is the speedy implementation of modern corporate governance principles effectively. It is true that shareholders have interests in the affairs of their bank. At the same time and even more importantly, depositors and creditors too have interests in banks, and the stability of banks depend on their confidence in banks. Modern corporate governance principles require that institutions manage their affairs in a transparent and accountable manner to safeguard of interests of all stakeholders such as shareholders, customers, employees and the general public.

In June 2002, the Central Bank issued a code of corporate governance to banks for their voluntary compliance. Good corporate governance principles are now well known to the corporate sector globally. Therefore, banks are expected to follow these principles without calling for corporate governance rules imposed by the regulators. However, in view of the recent developments in the domestic and international banking industry, the Central Bank has announced in its Road Map for 2007 and Beyond that a mandatory code of corporate governance will be introduced shortly.

Enhancement of the minimum entry capital requirement of banks. The Central Bank proposed to further enhance the minimum capital requirement of banks to promote the consolidation in the banking sector. In 2005, the Central bank increased the minimum equity capital requirement for LCBs to Rs.2,500 million from Rs.500 million and for LSBs (except Regional Development Banks) to Rs.1,500 million from Rs.200 million. The existing banks were given time till end 2006 to meet 50 per cent of the shortfall in capital and the balance 50 per cent by end 2007. The majority of banks have already complied with this requirement. However, a further extension of time was granted to banks to infuse 50 per cent of the shortfall of capital by 2008 and the balance 50 per cent by 2009, on a case by case basis, provided such banks submit a time-bound capital infusion plan committing to meet the minimum capital requirement by the new dates.

A general provision for loans was introduced at the end of 2006. All banks are required to maintain a general provision of 1 per cent of total performing loans and advances and non performing loans in the overdue category (loans and advances in arrears for 3 to 6 months.) The requirement will be implemented on a staggered basis during ten quarters commencing from the last quarter of 2006.

The prudential norms relating to registered finance companies (RFCs) were further strengthened by the imposition of new minimum core capital requirement and a capital adequacy ratio. In terms of these directions, finance companies are required to maintain unimpaired core capital of Rs.200 million by June 2008 (Rs.100 million by February 2007) and a risk weighted capital adequacy ratio of 10 per cent.

A further series of directions were issued to RFCs to improve the regulatory framework. The directions comprised the prudential requirements relating to the bad debt provisioning, investments, single borrower limits, accommodation to related parties, business transactions with directors and their relatives, advertisements and the publication of financial statements and branch office expansion.

Box 13

Draft Micro Finance Institutions Act (MFI Act)

Many diverse entities including Cooperative Rural Banks (CRBs), Thrift and Credit Cooperative Societies (TCCSs), Samurdhi Banking Societies, Sarvodaya Development Finance Centres and several Non Government Organisations have been carrying out micro finance services in Sri Lanka. As a result, the establishment of a regulatory and supervisory mechanism for this sector has been a long felt need. It is necessary to regulate Micro Finance Institutions (MFIs) as the funds held by them are those of the poor and vulnerable, and if such persons lose their savings, they will inevitably sink further into poverty. Further, the poor will lose confidence in the financial system in such circumstances, which would impede their savings activities. Also, if the micro-credit sector is sufficiently large, failure of several MFIs could pose a threat to financial system stability. Therefore, regulation is necessary to safeguard the interests of the depositors on the one hand, and to develop an efficient, viable and sustainable MFI sector, on the other.

On these considerations, a few years ago, the Rural Finance Sector Development Programme initiated action to establish a regulatory mechanism for rural sector financial institutions. In the immediate post-tsunami period in particular, a large volume of funds became available to NGOs for post-tsunami reconstruction and rehabilitation work, including livelihood development, and the number of NGOs involved in micro finance business grew sharply. As a result, establishing a regulatory mechanism for such entities became important in order to ensure effective utilisation of resources to achieve the desired objective. It was in this background that the MFI Act was formulated.

Micro Finance Business for the purpose of this Act is defined to be the "acceptance of deposits or receiving and/or obtaining external funds and providing financial accommodation in any form and other financial services, particularly to low income persons and to small and micro-enterprises". The Act comprises 53 sections organised under the following 14 parts:

Part I prevents any entity commencing or carrying out micro finance business without a licence. However, several categories of institutions, namely licensed commercial banks, licensed specialized banks, finance companies, cooperative societies registered under the Cooperative Societies Law and non-profit organisations which accept deposits only from registered

Table B 13.1

Structure of the Proposed Micro Finance Act

Part I	Licensing MFIs
Part II	Functions and powers of the Monetary Board to impose restrictions on Licensed Micro Finance Institutions (LMFI)
Part III	Relevant authority for supervision
Part IV	Power to issue directions
Part V	Management of LMFI
Part VI	Provision of documents and audit
Part VII	Provision of documents and information
Part VIII	Powers of scrutiny and action against carrying on micro finance business without a licence
Part IX	Power to examine a LMFI
Part X	Protection of deposits
Part XI	Cancellation or suspension of a licence of a MFI
Part XII	Immunity
Part XIII	Offences
Part XIV	Miscellaneous

members with the approval of the Monetary Board of the Central Bank are exempted from the licensing requirement. Cooperative societies, however, are required to comply with certain requirements of the Act. All entities carrying out micro finance business when the Act comes into force are given a two year phase-in period for obtaining a licence, provided that within 6 months of the Act coming in to force, they furnish the Monetary Board with their name, address and other information and declare whether or not they intend to obtain a licence within 2 years. In order to be eligible for a licence, the institution is required to be a limited liability public company. Further, the Act recognizes MFIs operating at 4 different levels, namely the national level, provincial level, district level and divisional secretariat level, and specifies the minimum capital requirements for operating at each level. The core capital requirement for operating at a national level is Rs. 50 million.

In terms of Part III of the Act, the responsibility of supervision of LMFIs vests with the director of the Department of the Central Bank to which the subject of micro finance is assigned by the Board. The Board has decided to assign this subject to the Department of Supervision of Non Bank Financial Institutions (SNBFI). This Part also permits the appointment of agents for supervision of micro finance institutions.

Management of LMFIs is dealt with in Part V which requires that such management be vested in a board of directors or its equivalent of the respective institution. An important aspect with regard to transparency and accountability of LMFIs is dealt with in Part VI which requires every LMFI to prepare a balance sheet, a profit and loss account, a cash flow statement for each financial year containing the minimum requirements stipulated in the Act. The LMFIs are required to publish such financial statements within 5 months after the expiry of each financial year.

The power for the Director SNBFI to obtain any relevant information is granted in Part VII, while the power to penalise entities carrying out Micro Finance business without a licence is granted in Part VIII. The penalty stipulated here is a fine not exceeding one million rupees. Another important aspect of the Act is the requirement that LMFIs maintain a Deposit Protection Fund and the power given to the Board to take necessary action to safeguard the depositors through deposit insurance (Part X). The Act also gives the Board the power to cancel or suspend a licence of an LMFI (Part XI) and provides immunity for the Board, the Director, SNBFI, and any other officers with regard to acts done in good faith (Part XII).

The MFI Act is now being finalised by the Legal Draftsman and is expected to become law in 2007.

The regulation and supervision of specialised leasing companies were intensified in 2006. Several prudential norms were issued to SLCs covering minimum capital, gearing ratio, provisions for bad and doubtful debts, single borrower limit, reserve fund requirements, preparation of financial statements and reporting of corporate and operational information. It is expected that compliance with these Directions will significantly improve financial discipline and stability of SLCs. SLCs are closely supervised through regular off-site surveillance and on-site examinations conducted on a selected basis.

The major development in the micro finance sector was the progress made in formulating the proposed Micro Finance Institutions (MFI) Act by the Central Bank. Taking into account the concerns of the stakeholders, the draft Act underwent several revisions and it is expected to be finalised in 2007. Once enacted, this law will put in place a sound regulatory regime for MFIs. The resultant greater transparency and accountability of the sector will inevitably create more development partner confidence in the micro finance sector and promote the flow of funds to that sector.

The Central Bank conducted a series of public awareness campaigns to warn the public on the dangers of investing in illegal deposit taking institutions and participating in pyramid, multi-level marketing and other unauthorised schemes.

The proposed amendments to the insurance law to strengthen the supervision of the industry were finalised in 2006. The revisions will empower the Insurance Board to stipulate the minimum share capital for insurance companies, make rules and determinations and to initiate action for non-compliance with regulations. The other provisions relate to the introduction of a fit and proper criteria for directors of insurance companies and brokers and the appointment of corporate agents and loss adjusters. In order to reduce the industry-wide regulatory risk, Insurance Amendment Act may need to be enacted without further delay.

Several measures were taken to mitigate risks and to increase stability of the PD system. The minimum capital requirement was increased to Rs.300 million from Rs. 250 million and the risk weighted capital adequacy ratio (RWCAR) was increased to 8 per cent from 5 per cent. All PDs complied with the enhanced minimum capital and RWCAR.

Credit Rating and Credit Information

The sovereign rating of the Government of Sri Lanka for 2006 was maintained at the same level as in the previous year. Fitch Ratings assigned a long-term foreign and local currency rating of "BB-"(BB minus), while Standard and Poor's assigned a rating of "B+" (B plus). Sri Lanka's sovereign rating is on par with other countries, such as Vietnam, Indonesia, Brazil and Turkey. The number of credit rating agencies operating in Sri Lanka remained at two in 2006. The Central Bank requires all deposit-taking institutions (licensed banks and registered finance companies) to obtain a credit rating from an independent rating agency and to disclose it to the public, in order to assist depositors and investors to assess the financial performance and capacity of these institutions and to further improve confidence in the financial system. In 2006, 20 of the 23 commercial banks and 12 of the 14 specialised banks had obtained investment grade ratings, while 26 of the 29 finance companies had also obtained ratings.

Credit Information

The Credit Information Bureau (CRIB), which provides credit information reports on borrowers, recorded a considerable increase in the number of reports supplied to lending institutions. CRIB issued 801,508 credit reports on corporate and individual borrowers in 2006 compared with 607,990 reports in 2005.With the expansion of credit to the private sector, the demand for credit reports has increased, as it has become an essential part of the credit appraisal procedure of lending institutions. CRIB currently collects both positive (regular) and negative (irregular) information on advances which are Rs.500,000 and over and information on credit cards with outstanding balances of Rs.5,000 and over which are more than 90 days overdue from lending institutions, such as commercial and specialised banks, registered finance companies and specialised leasing companies. The number of positive (regular) advances reported to CRIB increased by 38 per cent over 2005 and the number of negative (irregular) advances reported to CRIB declined by 56 per cent in 2006.

Measures are being taken to modernise and widen the scope and improve the coverage of CRIB. A modernisation project has commenced to provide on-line access to CRIB credit information reports. In addition, amendments to CRIB Act have been proposed that will enable CRIB to service more diverse user groups and to provide value added services, such as credit scoring, fraud prevention and consumer protection.

8.6 Financial System Stability

The financial system continued to be robust, resilient and stable in 2006 sustained by strong economic growth, expansion of the financial services sector, improvements in the profits and soundness of the main financial institutions and the safe operation of the payments and settlement system. Risks to the financial system in the short-term remain subdued.

The soundness of the major financial institutions improved during the year. The financial performance of the banking sector and finance companies improved in terms of profitability, asset quality and capital levels. Credit risk, which is the main risk faced by banks continued to be at manageable levels with the decline in non-performing loans. The banking sector was not adversely affected by market risk in the rising interest rate environment. Liquidity risk management was also satisfactory. The capital levels and capital adequacy ratios of financial institutions increased, signifying their improved health and soundness. There is a concentration of credit by financial institutions in the areas of housing and construction, vehicles and consumption that will have to be closely supervised and risk mitigation measures, such as loan-specific capital buffers or increasing provisions for fast growing credit categories may have to be introduced.

To enhance business continuity and to mitigate operational risks, the Central Bank has implemented a comprehensive business continuity plan (BCP) for the LankaSettle system. The BCP includes a fully equipped

Table 8.10 Soundness Indicators of Systemically Important Financial Institutions

Per cent

Institution and Indicator	2005 (a)	2006(b)
Lisensed Commercial Banks		
Non Performing Loans to Gross Loans	6.8	5.4
Non Performing Loans net of Provisons to Capital	16.5	12.6
Regulatory Capital to Risk Weighted Assets	12.8	11.7
Return on Assets (ROA)	1.7	1.8
Return on Equity (ROE)	16.8	18.5
Interest Margin to Gross Income	38.4	37.6
Non Interest Expense to Gross Income	33.7	31.9
Statutory Liquidity Ratio (DBUs)	24.2	23.9
Licensed Specilised Banks		
Non Performing Loans to Gross Loans	8.8	7.3
Non Performing Loans net of Provisons to Capital	21.1	22.9
Regulatory Capital to Risk Weighted Assets	20.0	20.3
Return on Assets (ROA)	2.5	2.0
Return on Equity (ROE)	15.3	12.6
Interest Margin to Gross Income	37.5	36.1
Non Interest Expense to Gross Income	17.8	18.1
Statutory Liquidity Ratio	69.4	61.8
Finance Companies		
Non Performing Loans to Gross Loans	8.4	5.3
Non Performing Loans net of Provisons to Capital	15.5	9.4
Regulatory Capital to Risk Weighted Assets	17.4	15.0
Return on Assets (ROA)	2.9	2.5
Return on Equity (ROE)	17.6	17.0
Interest Margin to Gross Income	29.3	33.0
Non Interest Expense to Gross Income	38.7	31.0
Statutory Liquidity Ratio	18.6	16.9

(a) Revised
(b) Provisional

Source : Central Bank of Sri Lanka

Box 14

Monitoring Financial Conglomerates

What are Financial Conglomerates?

A financial conglomerate is a group of entities or a holding company which undertakes financial services business in at least two different financial sectors, i.e., banking, finance, insurance and securities trading with a significant presence in any one sector. Financial conglomerates have evolved with the diversification of traditional specialised activities. Technological innovation, liberalisation of financial markets and removal of legal and trade barriers have encouraged the development of diversified financial conglomerates with complex management and corporate structures. In addition, many conglomerates are organised along global business lines and manage some or all of their major risks across the various entities within the group, in a manner that cuts across legal entity lines. The rapid evolution of such financial conglomerates which offer a comprehensive range of financial services, including banking, securities and insurance services on a global basis poses significant challenges to both the management of these firms and the supervisors with responsibility for regulating these entities within the conglomerate.

Financial Conglomerates in Sri Lanka

According to a preliminary study conducted by the Central Bank, 11 conglomerates are identified operating through 141 entities with assets of Rs. 1,896 billion representing nearly 68 per cent of assets of all financial institutions in Sri Lanka. Assets of individual conglomerates range from 3 per cent to 18 per cent of total assets of all conglomerates. Six conglomerates with significant presence in banking business hold 81 per cent of total assets while three of these conglomerates representing 46 per cent of assets are owned by the government. Out of the 141 entities identified, there are 69 entities which are not regulated and supervised by financial regulators, i.e., the Central Bank, Securities and Exchange Commission of Sri Lanka and the Insurance Board of Sri Lanka. However, assets of such unregulated entities constitute only 7 per cent of total assets of all conglomerates, indicating operations at a low key. Intra-group transactions and exposures will pose various operational risks to the regulated entities as well as regulators. In view of the significant share in the financial system, and the linkages with systemically important banks financial conglomerates are systemically important entities.

Supervisory concerns of operations of financial conglomerates

- **Intra-group transactions and exposures or related party transactions:** Intra-group transactions and exposures (ITEs) can genecate synergy among different entities of the conglomerate by operating with efficient cost structures, profit maximisation, improvements in risk management and more effective control of capital and funding. However, material ITEs are the sources of contagion within the conglomerate and they have the potential to complicate the resolution or failures of institutions. ITEs can take the form of direct and indirect claims between companies within a financial conglomerate and originate from a variety of transactions, i.e., (a) cross shareholdings; (b) trading operations whereby one group company deals with, or on behalf of, another group company; (c) central management of short-term liquidity within the conglomerate; (d) guarantees, loans and commitments provided to, or received from, other companies in the group; (e) the provision of management and other service arrangements, e.g., back office services; (f) exposures to major shareholders (including loans and off-balance sheet exposures such as commitments and guarantees); (g) exposures arising through the placement of client assets with other group companies; (h) purchases or sales of assets with other group companies; (i) transfer of risk through reinsurance; and (j) transactions to shift third party-related risk exposures between entities within the conglomerate.

  ITEs also give rise to conflicts of interest among the entities in the conglomerate through (i) directors, (ii) preferential treatment to group companies and related parties of the group, (iii) obtaining services from companies within the group and payments of service fees in large sums, (iv) same staff engaged in different sectors of financial business operations within the group and (v) reporting lines and information flows between the parent and subsidiaries or between two companies within the group that lead to share potential proprietary, confidential or otherwise sensitive information among different companies within the group (lack of internal barriers or Chinese Walls).

- **Poor application of modern corporate governance principles.** At present, there exists a voluntary code of corporate governance for banks issued by the Central Bank in 2002. Further, the Central Bank has issued prudential requirements under the Banking

Act with regard to certain areas connected with corporate governance such as ownership of shares and accommodation granted to bank directors, their relations and entities in which directors have substantial interest. In addition, a few corporate governance rules were introduced to listing rules at the Colombo Stock Exchange in April 2007 which will become mandatory from April 2008. The poor corporate governance is a general issue on the governance of the corporate sector in Sri Lanka and in many other countries as the banks and financial institutions do not give much attention to the voluntary codes.

- Setting up companies or entities in financial and non financial business areas to benefit from regulatory arbitrage.
- Lack of disclosure of financial information on the group and individual companies in the group together with exposure to group companies.

Coordinated Approach by Multiple Regulators

As in many other countries, Sri Lanka too has a multi-regulatory system as opposed to a single regulatory system in some other countries.

- The Central Bank regulates banks, finance companies, leasing companies and primary dealers in government securities.
- The Securities and Exchange Commission regulates securities firms (licensing stock exchanges, stock brokers and unit trust management companies), listed securities and listed companies.
- The Insurance Board of Sri Lanka regulates insurance companies.
- The Commissioner of Co-operative Development and Provincial Commissioners of Co-operative Development regulate co-operative societies and thrift societies.
- In addition, the Consumer Affairs Authority, Registrar of Companies and Sri Lanka Accounting and Auditing Standards Monitoring Board also have specific regulatory purview in terms of their statutes.

There are no specific regulators for merchant/ investment banking institutions and NGOs undertaking micro-finance business although they may have been registered under the Companies Act or Social Services Act.

However, some countries have already set up single regulator systems. According to a report of the World Bank on a survey of 77 countries, 22 (or 28 per cent) countries have single regulators while the rest (72 per cent) have multiple regulatory systems. Singapore, Korea, Japan, Germany, Sweden, Austria, Denmark, Ireland and UK are among the single regulators. USA, India, Malaysia, Philippines, Thailand, Indonesia, Hong Kong and France are some of the countries with multiple regulators.

The Central Bank formed a Working Group of Regulators in October 2005 as a workable solution within the multiple regulator system for the purpose of monitoring systemic risks of financial conglomerates and promoting consolidated supervision. In order to address the supervisory concerns, the Working Group has already made recommendations relating to (i) framework for supervisory information sharing among the regulators, (ii) framework for application of capital requirement to detect and restrict double or multiple gearing, i.e., where the same capital is used simultaneously as a buffer against risk in two or more entities, (iii) framework for fit and proper principles for directors and managers of all entities, (iv) introduction of modern corporate governance principles and v) introduction of disclosure requirements.

In addition, a high level committee (Inter-Regulatory Institutions Council) chaired by the Governor of the Central Bank and represented by the Heads of other Regulatory Authorities was also established in January 2007 to take appropriate policy decisions to facilitate the process for consolidated supervision.

disaster recovery site, which can accommodate a prolonged disruption. To ensure that participants of the LankaSettle and LankaClear systems have effective BCPs, in 2006, the Central Bank in consultation with LankaClear, issued guidelines to financial institutions outlining the minimum standards of BCPs.

The supervisory system was strengthened and further measures are in the pipeline to develop the financial system and to enhance its resilience. The main improvement to the supervisory framework will be the adoption of Basel II in 2008. Basel II will better align a bank's capital with its risk profile, enhance risk management and increase market discipline. Banks will also be required to set up integrated risk management systems and begin stress testing to assess their resilience to extreme shocks and to initiate corrective measures. A revised format for the publication of banks' financial statements will be introduced to improve disclosure requirements and to provide more information to market participants. The Central Bank will also facilitate the adoption of internationally accepted accounting and reporting standards, such as IAS 32, IAS 39 and IFRS 7. In view of the potential systemic risks posed by financial

conglomerates, the Central Bank, with the representations from other Regulatory Authorities, set up an Inter-Regulatory Institutions Council and working group for the purpose of monitoring systemic risks of financial conglomerates and promoting consolidated supervision and to take appropriate policy decisions to facilitate the process for consolidated supervision. In addition, the Central Bank revised its prudential requirements on single borrower limit of licensed banks with the objective of mitigating the banks' credit concentration risk arising from granting loans and other facilities to large customers and promoting the banks' risk management further.

The risk levels in the two largest superannuation funds i.e. EPF and the ETF remained low with adequate levels of liquidity and low levels of credit and market risk. The EPF managed to mitigate interest rate risks as a large part of the investments of the EPF were in marketable government securities. Since receipts continued to remain above cash flows, the EPF did not face a liquidity risk in 2006. The credit risk of the EPF is negligible as almost all its funds are invested in government securities. The installation of a new IT system enabled the EPF to mitigate its operational risk by facilitating single data point entry and streamlining the accounting and investment process.

A number of other laws to reinforce the legal and regulatory framework supporting financial system have been prepared. These include the Asset Management Company law to enable the speedy resolution of non-performing loans, the Debt Recovery law to expedite the loan recovery process of distressed banks and to create a creditor friendly environment, the Credit Information Bureau Act to widen the scope of CRIB and a Computer Crimes law to reduce the potential risks that may arise through computer frauds.