PART II

PART II

ACCOUNTS AND OPERATIONS OF THE CENTRAL BANK OF SRI LANKA

BOX II - 1

John Exter: Central Banker for All Times[1]

The first death anniversary of John Exter, Founder Governor of the Central Bank, was commemorated on 28th of February 2007. He died in 2006 after living a very productive life for 95 long years.

John Exter lent his wisdom, intellect and experience, without any reservation, for the establishment of the Central Bank of Ceylon in 1950 through the recommendations made by him in a report, now known as the Exter Report. He became the first Governor of the Central Bank at the young age of 39. His task was to establish the Bank, staff it and lead it in the first few formative years, so that it could eventually be taken over by a Sri Lankan management. The rationale and philosophy of the Central Bank, which he evinced in his report in the late1940s, are equally valid even for today, as it carries a justification of each and every section of the Monetary Law, so that the later generations of central bankers would not have any ambiguity of what was meant by them. Hence, by any standard, Exter is a central banker for all times.

The story relating to the appointment of Exter for preparing a blueprint for the establishment of a more flexible central bank by replacing the Currency Board System, which the country had inherited from the British, has been narrated by Edmund Eramudugolla, a former Senior Deputy Governor of the Central Bank, in his book "Reminiscences of the Central Bank of Sri Lanka". According to him, the government decided to seek foreign assistance to prepare a blueprint for a central bank based on the country's specific position and future prospects and sought assistance from USA. Thus, the Federal Reserve Bank of New York was approached to get a qualified consultant for this purpose. The Bank in turn made available the services of John Exter who was at that time an advisor to the Ministry of Finance of the Philippines.

John Exter had an illustrious academic as well as professional career. After graduating from the College of Wooster, he completed postgraduate work at both the Fletcher School of Law and Diplomacy and Harvard University. Before accepting the Government of Ceylon assignment, Exter had worked with highest repute at MIT, Federal Reserve System and as an advisor to the Secretary of Finance of the Philippines. It is from there that he came as the consultant on the establishment of a central bank. He served 3 years as the Governor of the Central Bank. In 1953, Exter joined the World Bank for a year and then returned to the Federal Reserve System as its Vice President on international operations at the Federal Reserve Bank of New York. In 1959, Exter was approached to join the First National City Bank, which later became the Citibank. From 1960 to 1972, he was the Senior Vice President of the Citibank in charge of its relations with foreign central banks and governments. With a huge fortune made on gold assets at the time of collapse of the gold exchange standard in 1971, Exter took an early retirement in 1972 and went into private consultancy work.

Exter belonged to the old guard of economists who believed that economic prosperity cannot be attained by printing money. This was indeed going against the popular tides of Keynesianism of the late 1930s and 1940s. Exter doubted the validity of deficit financing as a strategy for attaining full employment both in his public speeches and writings. On the very first day of the establishment of the Central Bank of Ceylon, he warned against the use of Central Bank for things which it cannot fulfill. He pointed out that the Central Bank does not by itself produce goods and services, but it should, by creating the right monetary conditions help to bring about better living standards. Exter

[1] This box article is based on the article published in national news papers by Mr. W.A. Wijewardena, Deputy Governor, Central Bank of Sri Lanka on John Exter's first death anniversary commemoration.

maintained that the Central Bank was a necessary condition for future prosperity. The prosperity was to be created by maintaining price stability so that the economic agents could make economic decisions based on long run prospects. The Central Bank's only weapon is to print money and such money, by changing the price levels, acts only as an illusion. In the Exter Report, he argued that higher income created through money creation would simply stimulate consumption of imported goods and precipitate serious balance of payments difficulties. To safeguard any attempt to use the Central Bank as a tool of deficit financing, a provision was included in the Monetary Law prohibiting the Central Bank to engage in trade or otherwise have a direct commercial interest in asset building. Exter pointed out that such interests would lead to money creation, generate conflicts of interest and prevent making investment decisions based on hard-core economic principles. Central Bank's pursuing profits as a goal was also frowned upon by Exter. From a technical point of view, Central Bank's profit seeking has no meaning, because a central bank could make any amount of profits by inflating the economy. Hence, the Exter Report suggested a mechanism to avoid any inflationary or deflationary effects of transferring Central Bank's profits to the Government. Such transfers lead to commercial banks' building their reserves, thereby raising multiple credit creating capability in banks. Therefore, Exter has made special provisions in the Monetary Law regarding the appropriation of profits of the Central Bank. Accordingly, the Central Bank profits are first used for building its reserves to support the domestic currency, and then, used to retire the government's borrowings from the Central Bank or paid into the government as a normal profit transfer.

The issue relating to the Central Bank's independence was a key issue that was considered by Exter when designing the Bank's supreme decision making body, namely, the Monetary Board (MB) with the Secretary to the Ministry of Finance as a member. The question was whether the presence of the Secretary to the Ministry of Finance in the MB would lead to the fiscal policy overriding monetary policy. Though critiques have put forward this argument, Exter's response was to create an environment where both the government and the Central Bank was to have a peaceful and amicable cohabitation. The degree of independence was extended via the budget of the Central Bank, job security of the key officials, and power to make monetary policy being possible without consulting the government. The wisdom of Exter was that the Central Bank should, as far as, possible work in consultation with the government, rather than in isolation. Exter expected this arrangement to exist on the basis of experience, professionalism and political conventions and not through an established piece of legislation. Therefore, the lesson Exter has left for us in the twenty first century is that both the Central Bank and the government should know their rights and responsibilities well and act on an ethical platform in which they continue to appreciate the distinctive roles to be played by each one of them for the well being of the country.

BOX II - 2

Strategic Plan of the Central Bank of Sri Lanka 2007 - 2011

The Central Bank of Sri Lanka (CBSL), which was established in 1950 under the Monetary Law Act No.58 of 1949 (MLA) is the apex institution in the financial sector in Sri Lanka. The CBSL is governed by a five member Monetary Board, comprising the Governor of the Central Bank as Chairman, the Secretary to the Ministry of Finance and Planning and three appointed members. In terms of the MLA, the Central Bank is entrusted with the objectives of attaining economic and price stability and financial system stability, with a view to encouraging and promoting the development of the productive resources of Sri Lanka. Accordingly, the CBSL's focus is now mainly concentrated on achieving these twin objectives to positively contribute to the prosperity of the country. Towards this end, the CBSL has formulated a medium-term Strategic Plan for the period 2007-2011.

This Strategic Plan sets out the Central Bank's medium-term goals and how it intends to pursue them. The plan sets out the Vision and the Mission of the Bank, the overall direction of the Central Bank as well as the values that would be the basis on which the Bank would conduct its work. This Strategic Plan is the outcome of collective effort, spanning a period of over one year. In the consultation that ensued a wide group of employees participated. Several workshops, where the corporate and senior management actively participated, were held to set the strategic thinking in motion. Finally, the members of the senior management in consultation with the staff of the Central Bank finalized the vision, mission, values and the strategic plan.

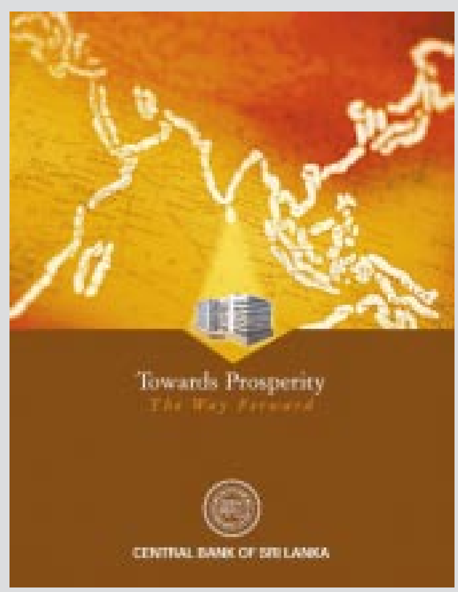
The Plan identifies the strategies which the Bank intends to follow in its key business areas. These key business areas have been identified on the basis of functional priorities. They consist of economic and price stability, financial system stability, currency issues and management, and agency services. Goals have been set with time targets in each of the areas to enable the measurement of performance, through a set of key performance indicators. The departments have prepared their own action plans based on the Bank's strategic plan, and resources would be determined and allocated to ensure delivery of departmental action plans. The action plans would also enable the Bank to conveniently monitor progress and direct its course towards the achievement of the planned goals. A separate Policy Review and Monitoring Department has also been recently established under the supervision of an Assistant Governor to monitor progress and ensure feedback.

Vision, Mission and Values of CBSL

Vision –
To be a credible and dynamic central bank contributing to the prosperity of Sri Lanka.

Mission –
Maintaining economic and price stability and financial system stability to support sustainable growth through policy stimulus, advice, commitment and excellence.

Values –
* *Commitment to inspirational leadership.*
* *Transparency in what we do.*
* *Accountability to our key stakeholders.*
* *Integrity- trust, dependability and honesty.*
* *Commitment to professional competence.*
* *Commitment to lifelong learning, knowledge sharing and innovation.*
* *Consistency, accuracy and timeliness of all actions taken by the Bank.*
* *Managing and ensuring operational autonomy for policy formulation and implementation.*
* *Urgent and continuous commitment to results and outputs.*
* *Commitment to collaborative and participatory work practices.*



The implementation of this Plan would be reviewed continuously. The departments have been instructed to provide feedback in terms of the progress on the implementation of the strategy through the formal decision-making and control structures of the Bank. A strategy review would be held before the end of each implementation cycle, in preparation for submitting a report on the strategic performance to the Monetary Board. The periodic performance reports are expected to summarize the progress made in achieving the identified strategic objectives.

1. ACCOUNTS AND FINANCE

CENTRAL BANK OF SRI LANKA

Balance Sheet

As at 31 December

	Note	2006 Rs. '000	2005 Rs. '000
Assets			
Foreign Currency Financial Assets			
Cash & Cash Equivalents	1	**105,601,686**	146,128,811
Financial Assets:			
- Securities at Fair Value through Profit or Loss	2	**107,413,474**	104,937,757
- Securities Denominated in Gold at Fair Value through Profit or Loss	2	**11,905,227**	8,743,882
- Available for Sale investments	2	**68,211,989**	13,992,948
IMF Related Assets	3	**67,276,214**	60,491,555
Other Foreign Receivables		**155,840**	163,667
Total Foreign Currency Financial Assets		**360,564,430**	334,458,620
Local Currency Financial Assets			
Investments Portfolio - Sri Lanka Government Securities		**67,507,503**	51,806,545
Advances to Government	4	**49,015,400**	39,746,300
Loans to Other Institutions	5	**2,487,446**	2,468,989
Other Local Receivables		**1,173,461**	678,665
Investments in Financial and Other Institutions	6	**45,185**	45,248
Other Assets		**600,997**	558,140
Total Local Currency Financial Assets		**120,829,992**	95,303,887
Total Financial Assets		**481,394,422**	429,762,507
Other Assets			
Inventories	7	**2,267,537**	1,351,677
Gold Inventory		**59,766**	59,766
Sundry Assets		**1,957,404**	1,590,099
Property, Plant & Equipment	8	**7,171,183**	7,717,108
Intangible Assets	9	-	115,787
Total Other Assets		**11,455,890**	10,834,437
Total Assets		**492,850,312**	440,596,944
Liabilities & Equity			
Liabilities			
Foreign Currency Financial Liabilities			
Amount Payable to Bank and Financial Institutions	10	**10,134,724**	15,630,980
Amount Payable to Asian Clearing Union		**33,477,598**	28,285,643
IMF Related Liabilities	11	**97,032,223**	102,635,004
Other Foreign Payables		**1,544,545**	1,326,619
Total Foreign Currency Financial Liabilities		**142,189,090**	147,878,246
Local Currency Financial Liabilities			
Deposits -Commercial Banks and Other Financial Institutions	12	**82,615,387**	65,483,580
Balances with Government & Govt. Entities	13	**1,356,351**	931,592
Treasury Bills & Bonds (Repurchase)		**562,000**	14,107,000
Balances with Employee Benefit Plans	14	**2,754,936**	199,344
Other Payables		**1,231,476**	838,397
Total Local Currency Financial Liabilities		**88,520,150**	81,559,913
Total Financial Liabilities		**230,709,240**	229,438,159
Other Liabilities			
Currency in Circulation		**157,239,605**	132,436,496
Diferred Government Grants		**59,985**	278,660
Pension and Other Post Employment Benefit Plans		**1,121,818**	974,983
Miscellaneous Liabilities & Accruals		**370,149**	333,013
Total Other Liabilities		**158,791,557**	134,023,152
Equity			
Capital & Reserves	15	**103,349,515**	77,135,633
Total Liabilities & Equity		**492,850,312**	440,596,944

Opinion of the Auditor - General

The Balance Sheet of the Central Bank of Sri Lanka as at 31 December 2006 and the related Income Statement and the Cash Flow Statement, Statement of Movements of Equity, Summary of significant accounting policies from 1.1 to 1.5 and other explanatory notes set out in Notes 01 to 24 for the year then ended were audited under my direction in pursuance of provisions 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 examinations and to the best of my information and according to the explanations given to me, the said financial statements have been prepared and presented in accordance with International Financial Reporting Standards and give a true and fair view of the financial position of the Bank as at 31 December 2006 and the results of its operations and its cash flows for the year then ended.

13 March 2007
Auditor - General's Department
Colombo 7.

P. A. Pematilaka	**Ajith Nivard Cabraal**	**K.M.A.N.Daulagala**
Auditor General	Governer	Chief Accountant

CENTRAL BANK OF SRI LANKA

Income Statement
For The Year Ended 31 December

	Note	2006 Rs. '000	2005 Rs. '000
Operating Income:			
Income from Foreign Currency Financial Assets			
Interest Income	16	**10,786,599**	6,924,471
Gain/ (Loss) from Unrealised Price Revaluations		**(80,208)**	(90,502)
Gain/ (Loss) Realised from Price Changes		**992,017**	768,660
Total Income from Foreign Currency Financial Assets		**11,698,408**	7,602,629
Expenses on Foreign Currency Financial Liabilities			
Interest Expense	17	**(2,258,478)**	(1,799,733)
Total Expenses on Foreign Currency Financial Liabilities		**(2,258,478)**	(1,799,733)
Net Foreign Exchange Revaluation Gain/ (Loss)		**22,358,038**	(12,955,088)
Foreign Currency Investment Income/ (Loss)		**31,797,968**	(7,152,192)
Income from Local Currency Financial Assets			
Interest Income	16	**5,330,970**	6,138,433
Interest Expense	17	**(381,426)**	(839,599)
Total Income from Local Currency Financial Assets		**4,949,544**	5,298,834
Other Income	18	**710,411**	1,101,691
Total Net Operating Income/ (Loss)		**37,457,923**	(751,667)
Operating Expenses:			
Personnel Expenses			
- Salaries & Wages	19	**(1,292,044)**	(911,107)
- Defined Contribution Plan Costs	19	**(181,476)**	(149,168)
- Post Employee Defined Benefit Plan Costs	19	**(4,625,893)**	(1,148,180)
		(6,099,413)	(2,208,455)
Depreciation & Amortisation		**(466,671)**	(458,876)
Cost of Inventory		**(1,543,026)**	(1,273,044)
Administration Expenses	20	**(876,632)**	(976,044)
Bad & Doubtful Debts and Net Sundry Write Offs		**-**	(8,209)
Total Operating Expenses		**(8,985,742)**	(4,924,628)
Profit/ (Loss) Before Income Tax		**28,472,181**	(5,676,295)
Income Tax		**(620,565)**	(570,182)
Net Profit/ (Loss) for the Year		**27,851,616**	(6,246,477)

CENTRAL BANK OF SRI LANKA

Cash Flow Statement For The Year Ended 31 December

	Note	2006 Rs. '000	2005 Rs. '000
Cash Flow from Operating Activities:			
Source:			
Interest Received - Foreign Currency		**9,777,792**	6,399,379
Interest Received - Local Currency - Others		**22,783**	48,895
Liquidity Management and Trading Income		**991,682**	768,660
Realised Exchange Gain / (loss)		**(352,657)**	1,703,091
Other Income Received		**474,810**	145,767
		10,914,410	9,065,792
Disbursements:			
Interest Paid - Foreign Currency		**2,130,611**	1,652,955
Interest Paid - Local Currency		**384,519**	840,641
Payments to Employees		**(470,892)**	1,326,591
Payments to Suppliers		**6,732,521**	2,659,687
Income Tax Paid		**531,545**	538,943
		9,308,304	7,018,817
Net Cash Flow from Operating Activities	21	**1,606,106**	2,046,975
Cash Flows from Investing Activities:			
Source:			
Net (Increase) / Decrease in Other Local Currency Financial Assets		**(666,266)**	(749,609)
Principal recoveries from the Loans and Advances to Other Institutions		**110,982**	(2,356,411)
Disposal / Redemption of Investments in Financial and Other Institutions		**406**	474,764
Sale of Property, Plant and Equipment		**15,025**	16,582
Income on Investments in Financial and Other Institutions		**9,049**	35,633
Net Increase/ (Decrease) in Securities Purchased under Agreement to Re-sell		**(13,545,000)**	6,894,000
		(14,075,804)	4,314,959
Disbursements:			
Net Increase / (Decrease) in Foreign Currency Securities		**40,459,822**	56,826,530
Net Increase / (Decrease) in Other Foreign Currency Financial Assets		**2,193,369**	131,617
Net Increase / (Decrease) in Other Foreign Currency Financial Liabilities		**924,448**	(2,050,609)
Net Increase / (Decrease) in Other Local Deposits & Payables		**192,672**	(191,819)
Purchase of Property, Plant and Equipment net of Grants		**102,230**	53,708
Net Increase/(Decrease) in Gold Inventory		**1,273,645**	93,810
		45,146,186	54,863,237
Net Cash Flow from Investing Activities		**(59,221,990)**	(50,548,278)
Cash Flows from Financing Activities:			
Source:			
Issue of Circulating Currency		**188,483,464**	151,998,690
Withdrawal of Circulating Currency		**(163,680,355)**	(135,471,163)
Net Issue of Circulating Currency		**24,803,109**	16,527,527
Less:			
Net Issue / (Withdrawals) of Circulation Currency on Government Transactions	22	**19,243,588**	(32,265,077)
Net Issue / (Withdrawals) of Circulation Currency on Bank and Financial Institutions Transactions	23	**(17,131,807)**	(11,613,517)
Net Issue / (Withdrawals) of Circulating Currency		**2,111,781**	(43,878,594)
		22,691,328	60,406,121
Disbursements:			
Repayment of Foreign Currency Term Liabilities		**(13,684,511)**	(10,970,720)
Payments of Surplus to Government		**-**	5,000,000
		(13,684,511)	(5,970,720)
Net Cash Flow from Financing Activities		**9,006,817**	66,376,841
Net Increase in Cash and Cash Equivalents During the Year		**(48,609,067)**	17,875,538
Exchange Rate Effect on Cash and Cash Equivalents		**8,081,942**	(15,257,617)
Cash and Cash Equivalent at the Biginning of the Year		**146,128,811**	143,510,890
Cash and Cash Equivalent at the End of the Year	24	**105,601,686**	146,128,811

CENTRAL BANK OF SRI LANKA

Statement of Movements in Equity For The Year Ended 31 December 2006

	Contributed Capital Rs. '000	Revaluation Reserve Rs. '000	Other Reserves Rs. '000	Accumulated Profits Rs. '000	Total Rs. '000
As at 01 January 2005	15,000	662,382	81,010,798	7,208,442	88,896,622
Net Loss	-	-	-	(6,246,477)	(6,246,477)
Transfer of Net Profit to the Government in respect of 2004	-	-	-	(5,565,152)	(5,565,152)
Transfer to RTGS Sinking Fund	-	-	26,476	(26,476)	-
Transfer to Medium and Long Term Loan Reserve	-	-	1,500,000	(1,500,000)	-
Transfer to General Reserve	-	-	103,123	(103,123)	-
Transfer of Net Foreign Exchange Revaluation Loss	-	-	(12,955,088)	12,955,088	-
Net Fair Value / (Loss) on Available for Sale Securities	-	-	50,640	-	50,640
As at 01 January 2006	15,000	662,382	69,735,949	6,722,302	77,135,633
Net Profit	**-**	**-**	**-**	**27,851,616**	**27,851,616**
Transfer to RTGS Sinking Fund	**-**	**-**	**40,263**	**(40,263)**	**-**
Transfer to CBSL Specific Reserves	**-**	**-**	**221,903**	**(34,540)**	**187,363**
Transfer of Realised Revaluation Gain	**-**	**(7,416)**	**-**	**7,416**	**-**
Net Effect of Adjustments and Reclassifications	**-**	**(181,909)**	**-**	**-**	**(181,909)**
Transfer of Net Foreign Exchange Revaluation Gain	**-**	**-**	**22,358,038**	**(22,358,038)**	**-**
Net Fair Value / (Loss) on Available for Sale Securities	**-**	**-**	**(1,643,188)**	**-**	**(1,643,188)**
As at 31 December 2006	**15,000**	**473,057**	**90,712,965**	**12,148,493**	**103,349,515**

CENTRAL BANK OF SRI LANKA

Notes to be read as part of the Financial Statements

		As At 31.12.2006 Rs. '000	As At 31.12.2005 Rs. '000
1	**Cash and Cash Equivalents**		
	Balances with Overseas Banks	**1,182,304**	2,487,257
	Time Deposits with Overseas Banks	**86,968,117**	112,950,743
	Time Deposits Contracted in	**9,416,427**	14,244,835
	Repurchase Agreement Accounts with FRB	**8,034,838**	16,445,975
		105,601,686	146,128,811
2	**Financial Assets**		
	Securities at Fair Value through Profit or Loss	**107,413,474**	104,937,757
	Securities Denominated in Gold at Fair Value through Profit or Loss	**11,905,227**	8,743,882
	Available-for- Sale Investments	**68,211,989**	13,992,948
		187,530,690	127,674,587
3	**IMF Related Assets**		
	Holding in Special Drawing Rights	**291,772**	154,585
	IMF Quota	**66,984,442**	60,336,970
	Total IMF Related Assets	**67,276,214**	60,491,555
4	**Advances to Government**		
	Revolving Credit	**49,015,400**	39,746,300
	Total Loans to Government	**49,015,400**	39,746,300
5	**Loans to Other Institutions**		
	Capital Outstanding	**2,198,616**	2,461,951
	Receivable under Susahana Tsunami Loan Scheme	**2,467,322**	2,441,860
	Interest Receivable	**4,217,107**	5,100,696
	Gross Receivable	**8,883,045**	10,004,507
	Less: Allowance for Doubtful Receivables	**(2,178,492)**	(2,434,822)
	Suspended Interest	**(4,217,107)**	(5,100,696)
	Net Receivable	**2,487,446**	2,468,989
6	**Investments in Financial and Other Institutions**		
	Credit Information Bureau Ltd	**12,185**	12,248
	Lanka Clear (Pvt) Limited	**29,500**	29,500
	Fitch Ratings Lanka Limited	**3,500**	3,500
		45,185	45,248
7	**Inventories**		
	Notes for Circulation	**1,757,198**	1,126,682
	Coins for Circulation	**440,354**	213,702
	Coins in Transit	**96,600**	43,627
		2,294,152	1,384,011
	Less: Allowance for slow moving items	**(55,300)**	(55,300)
		2,238,852	1,328,711
	Stationery and Sundry Inventory	**28,685**	22,966
	Total inventories at lower of cost and net realisable value	**2,267,537**	1,351,677

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 As At 31.12.2006 Rs. '000	Total As At 31.12.2005 Rs. '000
At 01 January net of accumulated depreciation	6,404,761	881,856	220,746	209,745	**7,717,108**	8,238,062
Additions	11,843	1,907	23,762	64,721	**102,233**	146,982
Disposals	(14,696)	-	(13)	-	**(14,709)**	-
Net effect of Reclassification/ Written off	(282,560)	-	-	-	**(282,560)**	(209,060)
Depreciation charge for the year	(92,748)	(52,366)	(48,579)	(157,196)	**(350,889)**	(458,876)
At 31 December net of Accumulated Depreciation	6,026,600	831,397	195,916	117,270	**7,171,183**	7,717,108

		As At 31.12.2006 Rs. '000	As At 31.12.2005 Rs. '000
9	**Intangible Assets**		
	Computer Software:		
	Cost:		
	As at 1 January	**463,149**	463,149
	Additions	**-**	-
	Disposals	**-**	-
	As at 31 December	**463,149**	463,149
	Amortisation and Impairment:		
	As at 1 January	**347,362**	231,575
	Amortisation Charge for the year	**115,787**	115,787
	As at 31 December	**463,149**	347,362
	Net Book Value:		
	As at 1 January	**115,787**	231,574
	As at 31 December	**-**	115,787
10	**Amount Payable to Bank and Financial Institutions**		
	Payable to Banks	**9,587,227**	15,226,975
	Payable to other Financial Institutions	**547,497**	404,005
		10,134,724	15,630,980
11	**IMF Related Liabilities**		
	Interest bearing Loans – non current	**26,036,677**	23,704,228
	Interest bearing Loans – current	**279,102**	15,232,384
	Allocation of Special Drawing Rights	**11,482,955**	10,343,397
	Other Amounts Payable to IMF	**33,689,353**	30,390,652
	Quota liability	**25,544,136**	22,964,343
		70,995,546	78,930,776
	Total IMF Related Liabilities	**97,032,223**	102,635,004
12	**Deposits by Banks and Financial Institutions**		
	Deposits by Banks:		
	- Related Parties	**35,299,563**	28,801,112
	- Others	**47,306,679**	36,677,286
		82,606,242	65,478,398
	Deposits by Financial Institutions		
	- Related Parties	**60**	863
	- Others	**9,085**	4,319
		9,145	5,182
		82,615,387	65,483,580
Less: Advances under Intra-day Liquidity Facility		-	-
Total Deposits by Banks and Other Financial Institutions		**82,615,387**	65,483,580

		As At 31.12.2006 Rs. '000	As At 31.12.2005 Rs. '000
13	**Balances with Government and Governmental Entities**		
	Government Deposits	**741,648**	372,485
	Government Agencies and Funds	**614,703**	559,107
		1,356,351	931,592
14	**Balances with Employee Benefit Plans**		
	Employee Provident Fund – Related Party	**2,137**	153,160
	Employee Retirement Pension Scheme – Related Party	**1,558,055**	40,393
	Widows / Widowers & Orphans Pension Schemes – Related Party	**693,479**	5,791
	Payable in respect of Gratuity	**35,235**	-
	Payable in respect of Medical Benefit Scheme	**466,030**	-
	Total Other Deposits	**2,754,936**	199,344
15	**Capital & Reserves**		
	Capital	**15,000**	15,000
	Medium and long term credit Reserve	**9,425,000**	9,425,000
	Capital Contribution Account	**577,859**	577,859
	Fixed Assets Revaluation Account	**473,057**	662,382
	Market Valuation Reserve-Securities Available for Sale	**(1,778,265)**	(135,077)
	Profit for the year	**27,851,616**	(6,246,477)
	International Reserve Revaluation	**52,610,034**	30,251,996
	Other Reserves	**14,175,214**	42,584,950
		103,349,515	77,135,633
		2006 Rs. '000	**2005 Rs. '000**
16	**Interest Income from Financial Assets**		
	Interest Income from Foreign Currency Financial Assets		
	Cash & Cash Equivalents	**4,460,836**	3,912,533
	Financial Assets	**6,191,870**	2,925,756
	IMF Related Assets	**133,893**	86,182
	Total Interest Income from Foreign Currency Financial Assets	**10,786,599**	6,924,471
	Interest Income from Local Currency Financial Assets		
	Investment Portfolio – Sri Lanka Government Securities	**5,173,853**	6,080,552
	Investment in Financial and Other Institutions	**-**	14,209
	Other Loans and Advances	**157,117**	43,672
	Total Net Interest Income from Local Currency Financial Assets	**5,330,970**	6,138,433
	Total Interest Income from Financial Assets	**16,117,569**	13,062,904
17	**Interest Expense on Financial Liabilities**		
	Interest Expense on Foreign Currency Financial Liabilities		
	Amount Payable to Asian Clearing Union	**1,154,945**	548,417
	IMF Related Liabilities	**1,064,836**	1,249,248
	Securities Sold Under Agreements to Repurchase	**36,188**	**-**
	Other Foreign Payable	**2,509**	2,068
	Total Interest Expense on Foreign Currency Financial Liabilities	**2,258,478**	1,799,733
	Interest Expense on Local Currency Financial Liabilities		
	Securities Sold Under Agreements to Repurchase	**381,426**	839,599
	Total Interest Expense on Local Currency Financial Liabilities	**381,426**	839,599
	Total Interest Expense on Financial Liabilities	**2,639,904**	2,639,332
18	**Other Income**		
	Dividend Income -Related Party	**3,683**	9,121
	- Others	**525**	16,222
	Gain on Disposal of Property, Plant & Equipment	**316**	16,583
	Gain on Disposal of Investments in Financial and Other Institutions	**344**	622,913
	Amortisation of Deferred Grant	**221,835**	218,676
	Miscellaneous Income	**483,708**	218,176
	Total Other Income	**710,411**	1,101,691

		2006 Rs. '000	2005 Rs. '000
19	**Personnel Expenses**		
	Wages and salaries including PAYE paid by the employer	**1,292,044**	911,107
	Defined Contribution Plan Costs	**181,476**	149,168
	Post Employee Defined Benefit Plan Costs	**4,625,893**	1,148,180
		6,099,413	2,208,455
20	**Administration Expenses**		
	Repairs and Maintenance	**337,176**	312,417
	Information	**76,059**	70,088
	Operational Travel	**16,876**	23,009
	Rental Expenses	**1,547**	349
	Printing	**17,732**	15,645
	Audit Fees	**10,013**	8,200
	Remuneration to Members of the Monetary Board	**591**	437
	Medical Benefits Scheme : Pensioners Expense	**-**	20,519
	Write-off of Property, Plant & Equipments	**-**	93,049
	Interest Expense on CBSL Provident Fund	**195,000**	155,178
	Miscellaneous	**221,638**	277,153
		876,632	976,044
21	**Reconciliation of Operating Profit with Operating Cash Flow**		
	Reported Net Profit from Operating Activities	**27,851,616**	(6,246,477)
	Add (Subtract) Non-Cash Items		
	Depreciation	**466,672**	458,876
	Interest Received – Local Currency – Investment Portfolio	**(5,313,769)**	(6,080,522)
	Bad debt Written Off/ (Written Back)	**9,960**	(82,700)
	Provision for Post Employee Defined Benefits Plans	**4,625,893**	1,148,180
	Gross Unrealised Foreign Exchange (Gain) Loss	**(22,711,030)**	14,658,179
	Other Provision	**1,505,358**	(277,325)
	Diferred Grants	**(218,676)**	(218,676)
	Add (Subtract) Movements in Other Working Capital Items		
	(Increase) / Decrease in Inventories	**(915,860)**	(400,888)
	(Increase) / Decrease in Interest Receivable	**(1,010,442)**	(523,788)
	Increase / (Decrease) in Miscellaneous Liabilities	**(2,812,803)**	(5,583)
	Increase / (Decrease) in Interest Payable	**124,774**	145,736
	Increase / (Decrease) in Other Receivable	**(66,088)**	(46,330)
	Add (Subtract) Investing and Financing Activities		
	Income from Investments	**(4,840)**	(10,137)
	Dividend Received	**(4,208)**	(25,343)
	Gain on Sale of Property, Plant & Equipment	**(316)**	(16,582)
	Gain on Disposal of Investments	**(343)**	(612,776)
	Net Unrealised Market Value Changes	**80,208**	90,502
	Net Cash Flow From Operating Activities	**1,606,106**	2,046,975
22	**Issues / (Withdrawals) of Circulation Currency on Government Transactions**		
	Maturity of Government of Sri Lanka Securities Portfolio	**(132,655,180)**	(133,512,344)
	Purchases of Government of Sri Lanka Securities for Investment Portfolio	**148,788,162**	102,127,387
	Interest Received – Local Currency – Investment Portfolio	**(5,733,735)**	(5,728,286)
	Increase / (Decrease) in Loans and Advances to GOSL	**9,269,100**	4,955,200
	(Increase) / Decrease in Balances with Government and Government Entities	**(424,759)**	(39,157)
	Government Grant Received	**-**	(67,877)
		(19,243,588)	(32,265,077)

		2006 Rs. '000	2005 Rs. '000
23	**Net Issues / (Withdrawals) of Circulation Currency on Bank and Financial Institutions Transactions**		
	(Increase) / Decrease in Balances with Banks and Financial Institutions	**(17,131,807)**	(1,181,024)
	(Increase) / Decrease Intra-day Liquidity Facility to Banks and Financial Institutions	**-**	(10,432,493)
		(17,131,807)	(11,613,517)
24	**Cash & Cash Equivalents at the End of the Year**		
	Foreign Currency Assets		
	Cash Balances with Other Foreign Banks	**105,601,686**	146,128,811
	Cash & Cash Equivalents at the End of the Year	**105,601,686**	146,128,811

1.1. Accountability and the Financial Performance of the Central Bank of Sri Lanka in relation to its Objectives.

The Central Bank was established as the authority responsible for the administration, supervision and regulation of the monetary, financial and payment systems of Sri Lanka under the Monetary Law Act. In accordance with this Act, the Bank is charged with the responsibility of securing the core objectives of economic and price stability and financial system stability.

The basis of public accountability for the Central Bank and the success of its operations therefore would be the effectiveness of its policies and operations leading towards the achievement of its core objectives and not necessarily its profitability *per se*. These statutory objectives are the fundamental features that distinguish the Cental Bank from any entity in the private or public sector. Accordingly, a profitability related approach, if adopted by the Central Bank, could result in the Bank pursuing profits while compromising its core objectives, since it has the unique ability to create its own profits through its monetary policy activities which could influence interest rates and exchange rates. It therefore follows that the Central Bank's objectives of economic and price stability and financial system stability need to be distinguished and detached from the pure profitability objective which should essentially be incidental or academic only.

In this background, the Central Bank's financial statements record results in the implementation of its monetary policy operations, exchange rate management, issuing of currency, etc, at the values as realized and are presented in accrordance with applicable accounting and reporting standards to provide a basis for financial accountability as a partial fulfillment of the overall public accountability and hence, the financial performance as reported in these statements needs to be interpreted and understood in that context.

1.2. 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.

1.3. Accounting Policies

1.3.1. 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.

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. In the balance sheet, assets and liabilities are presented broadly in order of liquidity within such distinguished category. The Bank considers that this reporting approach provide appropriate reporting of the Bank's activities which are more fully described in Note 1.5.

Statement of Compliance

These financial statements of Central Bank of Sri Lanka for the year ended 31 December 2006 have been prepared in accordance with International Financial Reporting Standards (IFRS).

Currency of Presentation

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

1.3.2. 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.

Impairment of Available for Sale Investments

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.

Pensions and Other Post Employment Benefit Plans

The cost of defined benefit plans is determined using an actuarial valuation. The actuarial valuation involves making assumptions about discount rates, expected rates of return on assets, future compensation increases, mortality rates and future pension increases. Due to the long term nature of these plans, such estimates are subject to significant uncertainty.

1.3.3. Adoption of Amended IFRS during the year

The accounting policies adopted are consistent with those used in the previous year. The Bank adopted IAS 39: Financial Instruments- Recognition and Measurement, amended in connection with Financial Guarantee Contracts. The new accounting policy adopted is given in 1.4.2.

1.3.4. Standards, interpretations and amendments to published standards that are not yet effective

Certain new standards, amendments and interpretations to existing standards have been published that are applicable for the Bank's accounting periods beginning on or after 1 January 2007 or later periods but which the Bank has not early adopted, as follows:

IFRS 7, Financial Instruments: Disclosures, and complementary amendments to IAS 1, Presentation of Financial Statements – Capital Disclosures (effective from 1 January 2007). IFRS 7 introduces new disclosures to improve the information about financial instruments. It requires the disclosure of qualitative and quantitative information about exposure to risks arising from financial instruments, including specified minimum disclosures about credit risk, liquidity risk and market risk, including sensitivity analysis to market risk. It replaces IAS 30, Disclosures in the Financial Statements of Banks and Similar Financial Institutions, and disclosure requirements in IAS 32, Financial Instruments: Disclosure and Presentation. It is applicable to all entities that report under IFRS. The amendments to IAS 1 introduce disclosures about the level of an entity's capital and how it manages capital. The Bank is in the process of assessing the impact of IFRS 7 and the amendment to IAS 1.

IFRS 8, Operating Segments (effective from 1 January 2009) – IFRS 8 specifies how an entity should report information about its operating segments in annual financial statements. The Bank is in the process of assessing the impact of IFRS 8 and its voluntary application.

1.4. Summary of Significant Accounting Policies

1.4.1. Foreign Currency Conversions

Bank's functional and presentation currency is Sri Lanka Rupees (Rs). 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:

	2006 Rs.	2005 Rs.
1 Australian Dollar	**85.2221**	74.6987
1 Canadian Dollar	**92.8256**	87.7484
1 Euro	**141.5844**	120.9629
1 Japanese Yen	**0.9050**	0.8661
1 Special Drawing Rights (SDR)	**162.0330**	145.9530
1 Sterling Pound	**211.2861**	175.9428
1 United States Dollar	**107.7056**	102.1172

Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using exchange rates at the dates of initial transactions.

1.4.2. 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 would weaken the informational value of the financial statements.

All financial assets are initially recognised at cost, being the fair value of the consideration given and including acquisition charges associated with the investment. Subsequent measurement bases after initial recognition, 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.

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 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.

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 Other 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.

Securities denominated in Gold

Gold securities held with foreign counterparties are initially stated at cost. Gains and losses arising from changes in the market value of Gold Securities are recognised in the Income Statement. Where the Gold Securities are 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 Securities), this is reported as Gain / (Loss) Realised from Price Changes.

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.

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 to balances with the IMF are recorded immediately in the Income Statement.

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 of the transactions with GOSL and transactions with domestic banks and financial institutions. Transactions with GOSL include 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.

As the sole statutory authority, CBSL issues currency to the public in line with 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 Deposits by Banks and Financial Institutions. 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/pay order outflows.

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.

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.

Advances to Government

Advances 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.

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.

Securities Lending

Transfer of securities to counterparties under lending transactions is only reflected on the balance sheet if the risks and rewards of ownership are also transferred.

Impairment of Financial Assets

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

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 (i.e. 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.

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.

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.

Financial Guarantees

Financial Guarantees are initially recognised in the financial statements at fair value, under Other Payables at fair value. Subsequent to initial recognition, the Bank's liability under each guarantee is measured at the best estimate of expenditure required to settle any financial obligation arising as a result of the guarantee.

Other Financial Assets and Liabilities

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

1.4.3 Other Assets and Liabilities

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.

Gold Inventory

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

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.

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
Buildings on Lease Hold lands	Over the Lease Period
Plant & Plant Integrals	20 Years
Furniture & Equipments	10 Years
Motor Vehicles	5 Years
Computer Hardware	4 Years
Others	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 de-recognised upon disposal or when no future economic benefits are expected from its use or disposal. Any gain or loss arising on de-recognition 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 de-recognised. The asset's residual values, useful lives and methods are reviewed, and adjusted if appropriate, regularly.

Intangible Assets

Computer software not integral to computer hardware are shown as intangible assets and recognized at cost. Following initial recognition these intangible assets are carried at cost less any accumulated amortization based on a useful life of 4 years.

Receivables

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

Sundry Assets

Sundry assets are carried at expected realisable values.

Impairment of Non-Financial Assets

The Bank assesses at each reporting date if events or changes in circumstances indicate that the carrying value may be impaired, whether there is an indication that a non-financial asset may be impaired. If any such indication exists, the Bank makes an estimate of the asset's recoverable amount. Where the carrying amount of an asset exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable amount.

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.

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.

Pension and Other Post Employee Benefit Plans

Pension and other Post Employment Benefit Plans operated by the Bank are described below.

Defined Benefit Plans

The Bank operates defined benefit schemes for Pension, Widows' and Orphans' Pensions (W&OP), Widowers' and Orphans' 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. 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

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.

Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions in excess of the greater of 10% of the value of plan assets or 10% of the defined benefit obligation are charged or credited to income over the employees' expected average remaining working lives, in a systematic method that results in faster recognition of actuarial gains and losses.

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.

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.

Personnel Expenses

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

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.

Income Tax

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

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 result for the year.

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

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.

Dividends

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

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.

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.

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. Where applicable, such amounts are measured at best estimates.

1.5. Nature and Extent of Activities

The Monetary Board of the Central Bank of Sri Lanka is, 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, 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 policies.
- 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. Results of these activities are taken to mean Operating Activities in the context of the Income Statement.

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 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 custodial institutions.

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

Local Currency Activities

Local currency activities arise as follows:

(a) 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.

(b) 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.

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, as they do not form part of elements of financial statements of the Bank.

2. BANK SUPERVISION

The regulatory and supervisory function of the Central Bank of Sri Lanka (CBSL) relating to licensed banks 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 2006, there were 37 licensed banks consisting of 23 commercial banks (LCBs) and 14 specialized banks (LSBs) in operation under the regulation and supervision of the CBSL and names of licensed banks in alphabetical order are listed below:-

TABLE II-1
Licensed Commercial Banks

1	Bank of Ceylon
2	Citibank, N.A.
3	Commercial Bank of Ceylon Ltd
4	Deutsche Bank AG
5	DFCC Vardhana Bank Ltd.
6	Habib Bank Ltd.
7	Hatton National Bank Ltd.
8	ICICI Bank Ltd.
9	Indian Bank
10	Indian Overseas Bank
11	MCB Bank Ltd.
12	National Development Bank Ltd.
13	Nations Trust Bank Ltd.
14	Pan Asia Banking Corporation Ltd.
15	People's Bank
16	Public Bank Berhad
17	Sampath Bank Ltd.
18	Seylan Bank Ltd.,
19	Standard Chartered Bank
20	State Bank of India
21	The Hongkong & Shanghai Banking Corporation Ltd.
22	Union Bank (Incorporated in Pakistan) Ltd.
23	Union Bank of Colombo Ltd.

Licensed Specialized Banks

1	Ceylinco Savings Bank Ltd.
2	DFCC Bank
3	Housing Development Finance Corporation Bank of Sri Lanka
4	Kandurata Development Bank
5	Lankaputhra Development Bank Ltd
6	National Savings Bank
7	Rajarata Development Bank
8	Ruhuna Development Bank
9	Sabaragamuwa Development Bank
10	Sanasa Development Bank Ltd.
11	S M E Bank Ltd.
12	State Mortgage and Investment Bank
13	Uva Development Bank
14	Wayamba Development Bank

The main activities of the BSD in 2006 are summarized below. These activities broadly include implementation of prudential requirements and regulatory approvals, continuous monitoring (off-site surveillance) of the health of the banks and periodic examination of licensed banks.

2.1 Prudential Regulation

The BSD issued several new prudential regulations and guidelines as well as amendments to existing prudential requirements to the licensed banks in 2006. Details of these regulations and guidelines are in Part III of this report. A summary of the major changes is as follows.

(a) Classification of investment portfolio into two categories, i.e. the Investment Account and the Trading Account. Licensed banks should decide on the category of investment at the time of acquisition and the decision should be documented. Classification should be based on facts and the management's intent at the date of acquisition of investments. Transfers between categories after initial recognition are restricted. In addition, the banks are required to maintain two separate books for this purpose.

(b) Capital Adequacy Ratio (CAR): A capital charge for market risk in the maintenance of CAR was introduced in keeping with the Basel Capital Accord. Accordingly, all banks are required to maintain a minimum capital adequacy ratio of 10 per cent in relation to risk weighted assets covering both credit risk and market risk, with core capital constituting not less than 5 per cent of total risk weighted assets. Further, risk weights applicable to loans secured by a primary mortgage over residential property (50 per cent) and loans categorized as other loans and advances (100 per cent) in the computation of CAR were increased to 55 per cent and 110 percent, respectively.

(c) Guidelines on parallel computation of Basel II: Guidelines covering definitions and formats for parallel computation of Basel II were issued with the intension of implementing Basel II with the simplest approaches in January 2008.

(d) Reporting requirement on "Abandoned Property"(Bank Accounts without Transactions during a Long Period): All licensed banks should report details on "Abandoned Property" referred to in Section 72 of the Banking Act to the CBSL within six months of the end of each financial year. Abandoned property includes deposits or other moneys held in bank accounts without any transaction over a period of ten years or more and contents of safe deposit boxes with banks where the customer has failed to respond within three years to the notice sent by the bank upon expiry of the rental period.

(e) Introduction of a margin deposit on imports under Documents against Acceptance (DA): A 50 per cent margin deposit requirement was imposed on invoiced value of selected commodities imported under DA terms. The respective banks should not grant any advances to importers for the purpose of placing the margin deposit.

(f) Introduction of a general provision for loans: All banks should maintain a general provision of 1 per cent of total performing loans and advances and non-performing advances in overdue category (loans and advances in arrears for 3 months to six months) net of interest in suspense that has been debited to the respective accounts. The requirement was staggered for 10 quarters by making a provision of 0.1 percent in each quarter commencing from 31.12.2006.

(g) Minimum capital requirement: In April, 2005, the Monetary Board increased the minimum capital requirement of LCBs from Rs.500 mn to Rs. 2,500 mn and of LSBs from Rs. 200 mn to Rs. 1,500 mn. The existing licensed banks were given time till December 2006 to meet 50 per cent of the shortfall of the minimum capital requirement and the balance 50 per cent by December 2007. In 2006, a further extension of time was granted to licensed banks to infuse 50 per cent of the shortfall of capital by 2008 and the balance 50 per cent by 2009, provided that such banks submit a time-bound capital infusion plan committing to meet the minimum capital requirement by the new dates for approval on a case-by-case basis.

In addition, new Directions relating to share ownership in banks and the maximum limit of accommodation granted by banks were finalized during the year 2006.

2.2 Approvals for Banks, Branches and Other Banking Outlets

During the year 2006, 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. Licenses were issued to Lankaputhra Development Bank Ltd. and to Sri Lanka Savings Bank Ltd. to operate as LSBs and to ICICI Bank Ltd. and Standard Chartered Bank (Pakistan) Ltd. (SCBP) to operate as LCBs. A license was issued to SCBP to continue the operations of the Union Bank Ltd. (Incorporated in Pakistan) as UBLP in Sri Lanka, as UBLP cease to exist following an amalgamation of UBLP's business with SCBP in Pakistan. During the year, approvals were granted for 113 new branches and 91 banking outlets (such as extension offices, pawning centers and student savings units), relocation of 120 branches and 39 banking outlets, upgrading of 9 banking outlets and 85 new off-site Automated Teller Machines (ATMs). Accordingly, there were 1,630 branches, 1,986 other banking outlets and 1,127 ATMs in operation as at the end of 2006.

2.3 Continuous Monitoring (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. The new on-line web-based reporting system through a central database in the CBSL covering all the licensed banks in the banking industry except the Regional Development Banks which was launched on a test basis in 2005 was fully implemented in July 2006. Accordingly, scrip-based reporting system hitherto in operation was discontinued. To facilitate effective and prompt corrective action system, an on-line early warning system is being developed.

2.4 Statutory Examinations of Licensed Banks

The BSD continued to adopt a risk-based examination process which focuses on identification of banking risks, the management of these risks and the assessment of the adequacy of resources to mitigate risks. In 2006, the BSD engaged in 30 statutory examinations which included 23 examinations that commenced in 2006 and the completion of 7 examinations that commenced in 2005. The examinations of 18 banks were completed through formal meetings with the management of respective banks and submission of reports to the Monetary Board in 2006 and 12 examinations awaited completion. Under-estimation of non-performing advances and provision for bad and doubtful loans, overstated capital adequacy ratio, exposure to related party transactions, weak administration of loan accounts and potential credit risk and lapses in submission of periodical returns to the regulatory authorities were some of the supervisory concerns observed during the examinations.

2.5 Investigation into Conduct of Prohibited Schemes

The BSD commenced investigations into conduct of schemes prohibited in terms of Section 83C of the Banking Act. The schemes where a participant is required to contribute or pay money and the benefits earned depend on the increase in the number of participants or the contributions made by the participants in the schemes are the prohibited schemes. The Department attended to proceed with a number of legal cases against some parties suspected as promoters of such schemes. In addition, the CBSL published 17 advertisements in the news papers at a cost of Rs. 1.3 million with a view to educating the public and advising them to stay away from such fraudulent and deceptive schemes of pyramid nature.

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

Following the suspension of the business of PSDB in October 2002, the management of the affairs of PSDB was vested with the Director of Bank Supervision. Consequent to the budget proposal in 2005, a recommendation was made to set up a new state bank to take over the business of PSDB. Accordingly, on 01 August 2006, a license to Sri Lanka Savings Bank Ltd. (SLSBL) to operate as a LSB was issued with the objective of vesting the business of PSDB in it. An amendment to the Banking Act was passed by the Parliament on 15 November, 2006 to provide the legal framework for the vesting of the business of PSDB by the Monetary Board and formulation of a scheme by the Monetary Board for meeting the claims and demands of depositors and creditors on liabilities of

PSDB by the bank in which the business of PSDB is vested. The scheme for meeting the claims on liabilities was drafted, pending the commencement of operations of the SLSBL to enable the Monetary Board to issue the order for vesting of the business of PSDB in SLSBL and implementation of the scheme for meeting the claims on liabilities of PSDB.

2.7 Financial Safety Net - Administration of the Voluntary Deposit Insurance Scheme

The BSD continued to administer the voluntary Deposit Insurance Scheme, which commenced operations in 1987. This scheme is opened to banking institutions licensed by the CBSL and co-operative societies registered under the Co-operative Societies Law No.5 of 1972, which accept deposits. In 2006, 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 CBSL in 1997 stood at Rs.204 million as at 31 December 2006. These funds have been invested in government securities with a face value of Rs.253 million. The proposal for a mandatory deposit insurance scheme to replace the existing voluntary scheme and its feasibility was further discussed at financial sector cluster meetings. A workable mandatory Deposit Insurance Scheme is under consideration.

2.8 Common Banking Forum

The institutional arrangement that has been established to provide a common forum for the debate and discussion of timely issues continued in 2006. The arrangements consisted of the followings.

(a) Monthly meetings with Chief Executive Officers of Banks:

These meetings serve as a forum for exchange of views on issues and policies relating to banking operations. With a view to obtaining a feed back from the banks, all major policy and operational matters are discussed at these meetings prior to their implementation. Some of the major policy and operational issues discussed were the post-implementation issues of cheque imaging and truncation project, delays in cheque clearing, implementation of the Basel II Capital Accord, introduction of a capital charge for market risk, implementation of the new web-based reporting system, banks' responsibilities under the Prevention of Money Laundering Act and the Financial Transactions Reporting Act, mandatory lending to the agriculture sector, amendments to the regulations on Single Borrower Limit, reporting of abandoned property, high rate of credit expansion and potential risks to the banking system, the need to reduce the use of the reverse repo facility of the Central Bank, introduction of a general provision for advances and credit card operations. In addition, the CEOs were regularly apprised of economic and monetary developments in the economy to facilitate more informed business decisions by banks.

(b) Financial Stability Committee (FSC): BSD serviced the financial Stability Committee. The remit of the FSC is the assessment of risks and vulnerabilities that could lead to a major financial system instability and recommending policies to promote financial system stability which is one of the two statutory objectives of the CBSL. The FSC had 6 meetings in 2006 and released the second Financial Stability Review which is aimed at improving awareness among financial market participants and the general public on financial sector developments and potential sources of risks to financial stability.

(c) Working Group of Regulators for Financial Conglomerates: The working group appointed in October 2005 comprises representatives of the CBSL, Insurance Board of Sri Lanka, Sri Lanka Accounting and Auditing Standards Monitoring Board, Securities and Exchange Commission of Sri Lanka and Registrar of Companies. Assistant Governor in charge of financial stability functioned as the Chairman of the committee. The objective of the Working Group is to assess and monitor the systemic risks of the financial conglomerates and to propose necessary legal reforms to address the existing limitations relating to regulation and supervision of financial conglomerates. The committee held six meetings during the year and submitted an interim report on the findings to guide the activities of the Working Group in the medium term.

(d) Financial Sector Cluster (FSCL): BSD also participated in the activities of the FSCL. The FSCL is one of the 24 Clusters set up under the National Council for Economic Development (NCED) in June 2004 under Article 33 of the Constitution. During the year 2006, the FSCL was combined with the Capital Market Cluster (CMC) due to the similarities of the activities performed by the banking sector and capital market sector. The key objective of both these clusters is the formulation of policies to promote financial system stability and increase access to finance and financial instruments for all segments of the population, especially local entrepreneurs, Small and Medium Enterprises

(SMEs) and the rural sector. The FSCL, co-chaired by the Deputy Governor of the Central Bank and a Deputy Secretary to the Treasury, has eight members, whilst the CMC co-chaired by the General Manager of DFCC Bank and a Deputy Secretary to the Treasury comprises 15 members. The FSCL and CMC had 10 combined meetings in 2006. The activities of the two clusters focused on developing a vision and road map for the financial system and submitting proposals for the budget of 2007 relevant to financial sector policies. The activities of the two Clusters focused mainly on increasing access to finance and financial products through reduction of transactions/intermediation costs, enhancing public awareness on financial products and services, increasing information of borrowers through expanding the scope and services of the Credit Information Bureau and reducing delays in the legal system.

2.9 Preparation for Inprementation of Basel II

The BSD has been progressively engaged in capacity building for implementation of Basel II. Accordingly, 17 officers were given foreign and local training under 12 training programs on Basel II related subjects in addition to a series of lecture sessions conducted for the staff during the year. A committee appointed in 2005 consisting of officials from the CBSL, banks and auditors continued their work relating to the development of policies for definitions and IT related issues. On the basis of guidelines issued to the banks on parallel computation of Basel II the impact of implementation was monitored during the year.

2.10 Public Awareness of the Financial System

In 2006, the BSD published three advertisements in the press. They were (i) Monthly advertisement "Institutions Legally Permitted to Accept Deposits from the Public" repeated in 9 months, (ii) "Have You Deposited Your Money in Institutions Legally Permitted to Accept Deposits?" repeated 2 months and (iii) "Do You Have Bank Accounts Without Transactions During a Long Period?" published once in all three languages in national news papers. These advertisements were intended to enhance the public awareness about the financial system, advise the public to be cautious of the risks and return on their transactions with financial institutions and inform the legal position on abandoned property of customers held in licensed bank.

3. COMMUNICATIONS

In 2006 the Monetary Board re-named the Information Department as the Communications Department. As the central information dissemination centre of the Bank, the Department was renamed to further emphasise its mandate to promote understanding of the policies and procedures of the Bank more effectively, by facilitating a two way communication process in the dissemination of information between the Bank and the public.

During the year, the Department continued it's efforts at timely dissemination of information, and took steps to improve its information dissemination through electronic media viz. e-mail and website. The Bank website, which was daily updated and maintained by the Department, has recorded around 600 hits per day in 2006. Re-designing of the website is in progress to improve coverage, timeliness and accessibility of information by providing easy navigation and more organized information. The new website is expected to be launched to the public by mid 2007. In the dissemination of information to the public, periodic information from daily to annual has been provided in the form of press releases and notices via print and electronic media. In the year 2006, the Department released daily Exchange Rates, weekly and monthly Economic Indicators, Consumer Price Indices and information on Government Securities such as Treasury Bills and Treasury Bonds. The number of published press releases and notices was 1,140, Gazette Notifications, 12 and Advertisements, 157. To increase public awareness and understanding of Central Bank activities, the Department continued in 2006 to publish a pamphlet series in simple language targeting the reading public. During the year, 5 new pamphlets were issued titled "Exchange Rate", "Institutions Authorized to Accept Deposits from the Public", "Dangers Posed by Pyramid Schemes and Network Marketing Programs", "Lanka Secure", and "Preventing Money Laundering and Combating the Financing of Terrorism". These pamphlets have been printed in all three languages.

During the year, the Department organized 18 press conferences on various economic issues and developments. It also conducted public awareness workshops jointly with other Departments for the police and media personnel on pyramid schemes, and a one day training programme for media personnel on current economic issues. The documentary film on Price Stability which was released in 2005 to educate the public on the Bank's role in maintaining price and economic stability was given wider publicity during 2006, by telecasting it on Rupavahini and at various forums, exhibitions and seminars. In the global dissemination of information, the CBSL website was linked to Bankers' Almanac and ISC (Internet Securities Incorporated) World Wide Data Dissemination Systems during the year.

The Department actively participated in the sale of publications at the Colombo International Book Fair, 'National Law Week' exhibition organized by the Bar Association of Sri Lanka and at other exhibitions and public events in 2006, which helped to enhance distribution and awareness about the Bank's publications.

The Printing Press continued to undertake the bulk of the printing requirements of the Bank while maintaining high quality and output. The total number of printing works completed by the Press was 330.

The Department, in collaboration with the other Departments and Regional Offices of the Bank, continued to facilitate requests from schools to hold lectures and seminars on various economic topics mainly for Advanced Level students. In 2006, the Department organized 11 such school programmes, mostly for schools in the rural areas.

The Department also continued to disseminate information among Bank staff by publishing 'Kauluwa' the internal news magazine featuring important events in the Bank. Eleven issues of 'Kauluwa' were released during the year 2006. The Bank continued to publish the Sinhala publication 'Satahana' and 'Kurippedu", the Tamil version of Satahana, once in two months (6 issues) and 'News Survey', quarterly (4 issues).

The Department also formulated a Free Distribution Policy for Bank publications and revised the policy on selection criteria for newspapers for advertisements during the year.

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 18,784 to 19,791, reports from 12,916 to 13,334, CDs from 965 to 1,019 and added 526 bound volumes to the collection during the year. The Library at the Centre for Banking Studies too increased its collection from 5,045 to 5,143 books.

The usage of the 'Science Direct' Database, which gives on-line access to over 100 journals on Economics, Econometrics and Finance increased. Hence, the LIC reduced its subscriptions for journals from 172 to 120.

During the year under review the LIC continued to compile electronic publications such as "Recent Additions" i.e. (new books), "List of Selected Articles", "News on Central Banking" and "News Alert" and disseminated them via intranet. A Selective Dissemination of Information (SDI) service was commenced for Heads of Departments by preparing a user profile and matching it with the databases.

In order to encourage bank staff to use on-line library facilities, 04 user education programmes covering 04 departments and 03 presentations for CBSL staff were held. The Banking and Finance Network (EbanklibnetSL) was re-activated and its 22 member libraries benefited immensely by sharing information via e-mail. The LIC organized a book exhibition during the National Reading Month (NRM) in October, exhibiting about 450 new titles purchased, where a good response was shown by the staff. A Book Review Competition and Quiz Programme by e-mail were other popular items of the NRM. A lecture on "Value of Reading" was organised by the LIC to further inculcate reading habits among the Bank Staff, as an item of the NRM programme.

4. CURRENCY

4.1 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 2006. The volume of currency notes and coins in circulation by the end of 2006 stood at Rs.157 billion, an increase of 19%, over the stock of Rs.132 billion at the end of 2005. 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 187 million pieces with a total value of Rs.404 mn. The comparable figures for 2005 have been 115 million pieces with a total value of Rs.250 mn. The quantity and value of coins issued to commercial banks during the period 2000 - 2006 are given in TABLE II-2.

4.2 High Denomination New Currency Note

A high value currency note in the denomination of Rs.2000 was issued for circulation on 17th October 2006. This Heritage series new currency note was introduced in view of the shift in demand for high denomination currency notes, changes in price levels and increase in per capita GDP in the country in recent times. This note contains several current and new advanced security features.

TABLE II - 2
Quantity and Value of Coins Issued to Commercial Banks 2000 - 2006

Year	Coin Denomination and Quantity (No of coins, in thousands)											Total Value (Rs.in '000)
	Rs.10	Rs.5	Rs.2	Re.1	Cts.50	Cts.25	Cts10	Cts.05	Cts.02	Cts.01	Total quantity	
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
2006	215	44,917	49,129	69,354	15,762	6,560	248	147	220	5	186,557	403,907

In keeping with bank's policy of continuous upgrading of security features of currency notes, the security thread of the existing Rs.500 note was upgraded with color shifting "star chrome" security thread while a new cornerstone watermark feature was introduced. Such measures help to reduce the incidence of counterfeits. For example, the number of counterfeit notes certified in Rs. 500 denomination notes decreased from 66 notes per million notes in 2005 to 18 notes per million notes in circulation in 2006.

4.3 New Commemorative Coins

The Central Bank of Sri Lanka issued three commemorative coins in the denominations of Rs.2000, Rs.1500 and Rs.5 to mark the 2550th anniversary of the Buddha on 15th May, 2006. The Rs.2000 and Rs.1500 coins were minted in frosted proof condition with sterling silver, while the Rs.5 coin was minted in brass plated steel. The Rs.2000 coin is a selective gold plated coin of which the Bodhisathva Siddhartha on seven lotus blossoms was the main feature. These crown size silver coins are round in shape with a diameter of 38.61 mm. and each coin weighs 28.28 gms. The Rs. 5 circulation coin which was issued to mark the above event depicts the Sripada mountain with "Dharma Chakra" as the obverse design while denomination of the coin and the year 2006 appear as the reverse design. The size, colour and weight of this Rs.5 coin are similar to the existing Rs.5 coin that is in circulation, at present.

TABLE II- 3
Commemorative Coins & Notes Available for Sale

Commemorative Event	Year on coin	Face Value (Rs.)	Metal / Material	Selling Price (Rs.)
2500th Anniversary of Buddha	1957	5	Silver	*
40th Anniversary of Central Bank of Sri Lanka (Presentation. Box)	1990	500	Silver	*
5th South Asian Games held in Colombo (Capsule)	1991	500	12Kt. Gold	*
3rd Anniversary of the Induction of President R Premadasa (Capsule)	1992	1	Silver	*
3rd Anniversary of the Induction of President R Premadasa (Capsule)	1992	1	Cu-Ni (Frosted Proof)	250
2300 Anu-budu Mihindu Jayanthi (Presentation Box)	1993	500	Silver	*
2300 Anu-budu Mihindu Jayanthi (Capsule)	1993	500	Silver	*
50th Anniversary of the UNO (Capsule)	1995	5	Nickel Brass	200
50th Anniversary of Independence of Sri Lanka (Presentation Box)	1998	1,000	Silver	*
50th Anniversary of Independence of Sri Lanka (Note Folder)	1998	200	Polymer	400
Cricket World Cup 1996 (Presentation Box)	1999	1,000	Silver	*
50th Anniversary of Sri Lanka Army (Presentation Box)	1999	1	Nickel Plated Steel (Proof)	400
50th Anniversary of Central Bank of Sri Lanka (Presentation Box)	2000	1,000	Silver	*
50th Anniversary of Sri Lanka Navy (Presentation Box)	2000	1	Cu-Ni (Proof)	500
2550th Anniversary of Buddha (Presentation Box)	2006	1,500	Silver	5,000
2550th Anniversary of Buddha (Presentation Box)	2006	2,000	Selective Gold Plated Silver	7,000

* Selling prices of these coins are determined on the basis of daily market prices of gold and silver and will be displayed at the Central Bank counters

4.4 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 minimise counterfeiting attempts. These measures as well as the introduction of new security features, upgrading of existing security features, and conducting of awareness programs have contributed to both the detection of counterfeiting attempts and to maintain relatively more reliable currency notes in circulation. Accordingly, the number of counterfeit notes detected in the country and referred for certification to the Central Bank as required by the Monetary Law Act decreased from 11.8 notes per million notes in circulation in 2005 to 2.23 notes per million notes in circulation in 2006.

4.5 Bank Note Processing

During the year under review the two currency verification, counting and sorting (CVCS) machines processed 92.4 million serviceable currency notes and destroyed 39.8 million unserviceable notes as a part of maintaining the clean note policy objective.

4.6 Sale of Commemorative Notes and Coins

The Department continued to sell commemorative notes and coins to numismatists, collectors and the general public. The Central Bank web site provides updated information about these coins. Details of commemorative coins and notes that are available for sale at the Central Bank together with their selling prices are given in TABLE II - 3

4.7 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 recirculation of coins for bank officers, police officers, school children, government employees and the general public through public lectures, seminars and electronic and print media. Articles to news papers and Journals were written on the issue of new coin series, issue of the new Rs.2000 bank note and counterfeiting aspects of currency. Several posters and leaflets were also issued to educate the public on security features of the new Rs.2000 and Rs.500 notes.

A three day training program on counterfeit detection was conducted under the auspices of De La Rue Currency UK for Central Bank and Police officers in August 2006. The department conducted 16 seminars on identification of counterfeit notes and 8 TV and radio programs on introduction of Rs.2000 new currency note and issuing of commemorative coins to mark the 2550th Anniversary of the Lord Buddha. Increased number of queries by the public indicated that such programmes have improved enthusiasm among the public to know about currency notes and their features.

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

(a) Educational Exhibition in commemoration of the 10th Anniversary of the establishment of Sabaragamuwa University in Belihuloya from 30th January to 2nd February 2006

(b) "Anurapura Udanaya", the annual exhibition for business development service providers jointly organized by the Anuradhapura District Chamber of Commerce, Industry and Agriculture and the Central Bank Regional Office, was held in Anuradhapura from 9th to 12th March 2006

(c) Educational exhibition held at Yasodara Devi Balika Maha Vidyala Gampaha from 5th to 9th April 2006

(d) Mahapola educational exhibition held at Nalanda College Minuwangoda from 24th to 29th October 2006

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

5. DOMESTIC OPERATIONS

The Domestic Operations Department (DOD) continued to perform major functions of implementing the monetary policy of the Central Bank, being the banker to commercial banks and the government and facilitating the Real Time Gross Settlement System (RTGS) by providing Intra Day Liquidity Facility (ILF) to commercial banks and primary dealers.

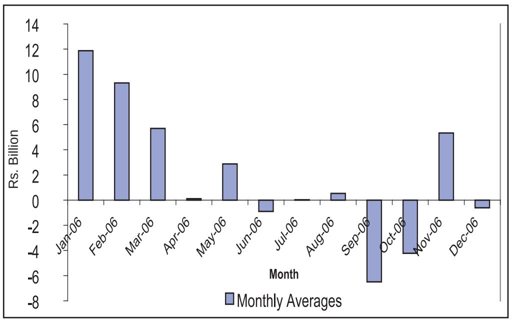
5.1 Implementation of Monetary Policy

(a) Open Market Operations (OMO)

The department continued to conduct OMO based on the framework of market based monetary policy operations introduced in 2003 within a corridor of interest rates formed by repurchase (Repo) and reverse repurchase (Reverse Repo) rates of the Central Bank. OMO consisted of several operations, (i) conducting daily auctions either for Repo transactions to absorb excess liquidity or Reverse Repo transactions to inject liquidity, if there is a shortage of liquidity, on a daily basis, (ii) provisions of Repo and Reverse Repo facilities under standing facilities and (iii) conducting outright sales of Treasury bills or purchases of both Treasury bills (in the primary and secondary markets) and Treasury bonds (in the secondary market) at the discretion of the Central Bank to induce permanent absorption or injection of liquidity. The eligible Participating Institutions (PIs) in OMO until 19 June 2006 were all commercial banks and primary dealers. Thereafter the eligible institutions were limited only to licensed commercial banks. The Central Bank increased its policy rates, Repo and Reverse Repo rates, by 125 basis points in four steps from 8.75 per cent and 10. 25 per cent to 10.00 per cent and 11.50 per cent respectively.

Liquidity in the banking system which was at a surplus during the first half of the year gradually declined and turned into a deficit towards the end of the year (CHART II - 1).

CHART II - 1
Liquidity - Monthly Average - 2006



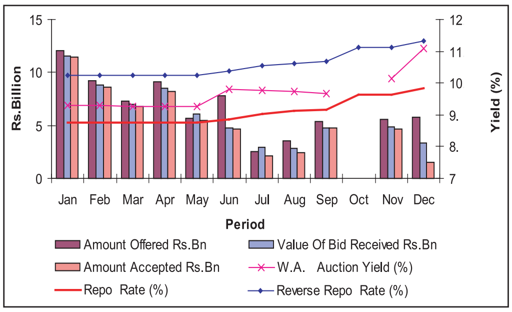
The liquidity surplus during the first half of the year was largely increased due to the release of provisional advances to the government and net inflows of foreign exchange. The liquidity shortage in the latter part of the year was mainly due to foreign exchange transactions of the CBSL in domestic foreign exchange market and increase in currency in circulation, arising on seasonal demand. The Bank engaged in conducting OMO to absorb or inject liquidity as and when required.

(i) Daily Auctions Under OMO

Repo Transactions

The department continued to conduct auctions for Repo transactions to absorb temporary liquidity surplus in the banking system on a daily basis. The excess liquidity recorded on most days during the year was absorbed through the daily auctions by selling Treasury bills on repurchase basis. On average about Rs. 7.4 bn. were offered for the auction and it amounted to 94.00 percent of the estimated excess liquidity. The weighted average yield rate at the auction which was around 9.29 per cent and at the lower bound of the corridor at the beginning of the year, increased gradually towards the upper bound of the corridor by the end of the year, following the upward revision of policy rates and the liquidity shortage prevailed in the banking system in the latter part of the year. The weighted average yield rate was about 11.00 per cent by the end of the year (CHART II - 2).

CHART II - 2
OMO Repo Auctions - 2006
(Monthly Average)



Reverse Repo Transactions

Daily auctions for Reverse Repo transactions were continued to conduct till June 2006, to provide liquidity whenever the liquidity in the banking system fall into a short position. In view of the continued excessive expansion in monetary aggregates in June 2006, conducting of auctions for Reverse Repo was discontinued and allowed the market to operate closer to the upper bound of the interest rate corridor. However, auctions for Reverse Repos were reintroduced in September, 2006 to conduct it only when it is deemed necessary. Weighted average rate of the auctions held were in the upper bound of the corridor due to large liquidity shortage prevailed in that period.

(ii) Standing Facilities

Standing facilities were continued to be an avenue for those PIs, which were unable to manage their short term liquidity requirements fully through the inter bank money market and or at the daily auctions under OMO. These facilities were provided at the Repo and Reverse Repo rates of the Central Bank

Repo Transactions

The PIs that were not successful or unable to participate at the Repo auctions, or unable to use entire excess funds to lend in money market due to, self imposed limits of banks on their interbank operations, resorted to standing facilities at the Repo rate of the Central Bank. However, as auctions for Repo transactions were conducted to absorb almost full amount of excess liquidity in the banking system due to excessive monetary expansion continued during the year, the use of standing facility for Repo transactions declined substantially during the year.

Reverse Repo Transactions

The Reverse Repo Facility (RRF) of the Bank as a standing facility is available to the PIs to meet their liquidity needs and is designed to be accessed as a last resort. However, it was observed that certain banks have resorted to the use of RRF as a regular source of funding. It was also noted that PIs have used the facility even when the liquidity is broadly in balance or the market operates with relatively on a small surplus. In view of the continued excessive expansion in monetary aggregates during the year, and considering the ill effect of continuous excessive borrowings in June 2006, the Bank decided to discontinue the auctions for reverse repurchases, and to discourage the use of Central Bank funds under the standing facility on regular basis through moral suasion. PIs were advised to limit the use of standing facility to it only as a last resort and confine their operations to the resources available, through appropriate adjustments in their balance sheets.

The availability of standing facility was suspended with effect from 26 September 2006 and a decision was taken to conduct daily auctions for Reverse Repo transactions to provide liquidity to the banking system when it is deemed necessary. However, the standing facility was recommenced on 28 September 2006. Further, the Bank decided to discontinue Reverse Repos under standing facility when there is a liquidity surplus in the banking system as per the Central Bank estimates with effect from 01 January 2007.

(iii) Outright Transactions

The Central Bank engaged in conducting auctions to sell Treasury bills outright out of its own portfolio, to absorb excess liquidity on a permanent basis. During the year Bank sold Treasury bills to the total value of Rs. 34.9 bn. through auctions. These Treasury bills were very short term with number of remaining days to maturity ranging from 10 to 46 days. These sales were at yield rates, which were below the rate comparable with the prevailing weighted average yield rates for 91 days Treasury bills in the primary market at the time of each outright sale.

(b) Statutory Reserve Requirement (SRR)

The department continued to enforce SRR which remained at 10.00 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 15.00 per cent. However, this rate was inoperative since no bank resorted to borrow from the Central Bank at the Bank Rate.

5.2 Maintaining Banking Services to Commercial Banks and the Government

(a) Accounts of Financial Institutions

Being 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.

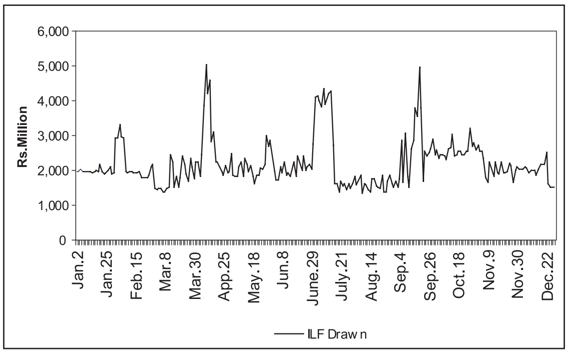
(b) Maintaining Government Accounts

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 38 as at end 2006. During the year, 8 new accounts were opened and 3 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 (10.00 per cent of the estimated government revenue) was increased by Rs. 8.3 bn. to Rs. 49.5 bn. in 2006. There was no interest charged on these advances.

5.3 Provision of Intra Day Liquidity Facility

The department continued to provide an Intra day Liquidity Facility (ILF), to commercial banks and primary dealers, to ensure smooth and efficient operations of the RTGS System. The ILF was 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 year. The total value of ILF drawn during the year was Rs. 538.6 bn. compared to Rs. 543.0 bn. during the previous year. The average value of ILF drawing per day was around Rs. 2.1 bn. (CHART II - 3). 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.

CHART II - 3
ILF Drawn - 2006



6. ECONOMIC RESEARCH

During the year, the Economic Research Department (ERD) continued to perform its key function as the 'Economic Think Tank' in the Central Bank. This job required it to collect and analyse economic and social statistics and conduct policy oriented economic research for the guidance of the Monetary Board and the management of the Central Bank. Its research papers were an essential input for formulating, implementing, and executing monetary policy and for performing Central Bank's function as the economic advisor to the government. ERD released socio-economic data and information regularly to the general public through the Bank's statutory publications. In addition, timely and updated economic data were released to the markets through the publication of weekly and monthly selected economic indicators which were posted in the Central Bank website as well. ERD continued to issue regular monthly press releases on International Trade and Monetary Policy Review in 2006. In addition, a number of press releases were also issued from time to time clarifying various important economic issues of interest to the general public.

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, an emphasis was placed on further strengthening the monetary policy decision-making process. The Department played its most vital role of facilitating on the deliberations of the Monetary Policy Committee (MPC) by providing a comprehensive analysis of economic and monetary sector developments.

In this sense, ERD functioned not only as a watch-dog of price stability, but also as an initiator of appropriate monetary policy to attain the same goal. In addition, ERD staff continued to undertake research in subjects of contemporary importance, some of which were published in the "Staff Studies" edited by ERD. These rsearch papers were;

(a) Communication Policy of Central Banks: The Case of Sri Lanka by Dr. H.N.Thenuwara

(b) Active Open Market Operations: A Review of Experience by Dr. D.S. Wijesinghe

(c) Modelling and Forecasting Currency in Circulations in Sri Lanka by Mrs. Rupa Dheerasinghe

(d) The Impact of Fertilizer Subsidiary on Paddy Cultivation in Sri Lanka by Mrs. H.K.J Ekanayake

After extensive studies on the serious macroeconomic implications of sharp volatility in oil prices, the department recommended the CPC to enter into hedging arrangements when purchasing petroleum products from the international market. ERD prepared a presentation on " Maintaining Stability in a Volatile Global Oil Market" which was presented by the Governor to the Cabinet of Ministers. Consequently, with the approval of the Cabinet, the CPC was able to commence hedging part of its oil requirements in February 2007.

The staff of ERD was also engaged in conducting joint research with international organizations, such as SEACEN Centre, and SAARCFINANCE. Several senior officers of ERD served on various important committees, both within and outside the Bank. During the year, three rounds of negotiations were held with the Indian authorities on a Comprehensive Economic Partnership Agreement (CEPA) with India. The ERD staff also served as directors on the Boards of several key institutions, and as resource persons in training programmes conducted by the Centre for Banking Studies (CBS) as well as by other foreign and local organizations.

ERD actively contributed to the formulation of the Bank's Strategic Plan for 2007 - 11, especially in the core area of economic and price stability. It also developed a Core Inflation measure to identify the price behaviour influenced by nominal demand factors. This measure, free from seasonal variation of prices, provides an indicator for taking appropriate monetary policy measures by the Bank. In addition, a Vector Auto Regression (VAR) model and Auto Regressive Moving Average (ARMA) model were developed to improve the inflation forecasting as a forerunner for adopting inflation targeting as the Bank's key monetary policy strategy.

Preparing the Bank's statutory reports and other special reports in all three languages is a primary responsibility of ERD. The department coordinated the publication of the Bank's Annual Report for 2005, Recent Economic Developments - Highlights of 2006 and Prospects for 2007, and 12 monthly bulletins in 2006. ERD prepared a booklet titled 'Sri Lanka: Now Is the Time' to increase the awareness of the international investors on the investment opportunities available in Sri Lanka, facilities and incentives offered to inventors by several public sector agencies and on recent economic developments in the country. In addition, ERD prepared several statutory reports, which the Central Bank is required to submit to the Minister of Finance under the provisions of the Monetary Law Act. ERD has continuously been educating the general public on key macro economic variables.

ERD, on behalf of the Bank and the Government, continued to coordinate relations with international multilateral financial organizations. Accordingly, it coordinated Sri Lanka's relations with the IMF, especially the Article IV consultations missions, 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 an Finance Secretaries. In 2006, 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 SAARCFINANCE seminar on 'Oil Price Hike: Implications for SAARC Countries' in January 2006. In addition, ERD assisted the Department of National Planning in the preparation of a Ten Year Horizon Development Framework 2006-2016 Discussion Paper in 2006. This discussion paper was presented to the development partners by the ERD. ERD staff actively participated and exchanged views on several key issues in a number of clusters functioning under the National Council for Economic Development (NCED).

Being the economic advisor to the government, ERD continued to evaluate the terms and conditions of all foreign loans obtained by the government from multilateral and bilateral donors and commercial sources and presented several board papers to the Monetary Board indicating monetary implications. ERD also prepared responses to questions raised by the Members of Parliament on economic issues from time to time.

ERD organised a Sri Lanka Economic and Investment Forum in Singapore during September 2006 alongside the IMF-World Bank Annual Meetings to showcase Sri Lanka as a better investment destination among the potential investors, who attended the annual meetings. ERD also organised a meeting in November 2006 for selected representatives of commercial banks, private sector institutions, trade chambers and associations and media personnel to increase their awareness on the recent Central Bank policies that were implemented to attain the economic and price stability. In addition, ERD organised several meetings with exporters and importers to discuss issues faced by them. ERD prepared the "Road Map: Monetary and Financial Sector Policies for 2007 and Beyond", which was announced to the stakeholders on January 2, 2007. It reflects on the developments in the economy and the conduct of monetary and financial sector policies in the year 2006, sets out the challenges in meeting monetary policy and financial stability objectives in 2007, and provides a detailed account of the Central Bank's monetary policy strategy for the near future.

7. 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 employers, members and the Fund, investing excess monies in suitable investments, and paying benefits to the members of the Fund. These activities were carried out during 2006 in close co-ordination with the EPF Division of the Department of Labour.

7.1 Member Balances and Refunds

During the year the total value of member balances increased, by 14 per cent, to Rs.477 bn. from Rs.418 bn in 2005. About 8,099 new employers joined the Fund, increasing the number of contributing employers to 64,023 at end 2006. The main outflow of the fund, the refunds to members, during the year was Rs. 17.6 bn.

7.2 Investment Activities and Returns

During the year, the total investment portfolio of the Fund grew by 14.8 per cent, to Rs 465 billion, from Rs. 405 bn in 2005 (TABLE II - 4). At the end of the year, 96.8 per cent of the total EPF investment portfolio was in gilt-edged government securities, due to the non-availability of acceptable alternative investments with low risk. However, market interest rates did not adjust promptly to widely fluctuating inflation rates. As such, the Fund was not able to declare a positive real return on a yearly basis.

TABLE II - 4
EPF Investment Portfolio and Returns as at end 2006

Instrument	Cost value (Rs. bn)	%
Treasury Bond and Bill	393.8	84.78
Rupee loans	56.1	12.08
Corporate Debentures	7.0	1.50
Repos	4.0	0.86
Equity	3.6	0.78
Total	464.5	100.00

Income Source	Income (Rs. mn)	%
Interest income	44,104	95.0
Dividend	120	0.3
Capital gain	1,017	2.2
Amortized gain	1,073	2.3
Surcharges	76	0.2
Total	46,390	100.0

Source: Employees' Provident Fund

The investments in Treasury Bonds, a long-term marketable investment instrument, had increased to 85 per cent of the total investment portfolio at end 2006, as against 83 per cent in the previous year. The investments in Government Rupee securities, a non-marketable instrument, were further reduced to 12 per cent of the portfolio from 14 per cent at end 2005.

The realised returns from equity investments, in terms of capital gains and dividends, during 2006 amounted to Rs 435 mn, recording a return of 13.25 per cent, while the total return including the unrealised capital gains, amounted to 35.15 per cent (TABLE II- 5). During the entire investment period of nine years from 1998 to 2006, the EPF earned a healthy return of 20 per cent, on average, from the equity investment portfolio, which constituted only 0.8 per cent of the total EPF portfolio as at end 2006.

TABLE II - 5
EPF : Performance of Listed Equity Portfolio during 2006

Rs.mn

Item	2005	2006
Average Equity Portfolio	2,335	3,283
Total Dividend Income	91	115
Total Realised Capital Gains	817	320
Total Unrealised Capital Gains	1.2	719
Total Dividends and Capital Gains	909	1,154

Source : Employees' Provident Fund

Capital gains realised from government securities declined in 2006 compared to 2005 due to non-conducive market conditions. The yields on government securities moved up as a result of several policy rate increases and the escalating inflation during the year. The capital gains realized from Treasury bills and bonds declined marginally and the realized capital gains from the equity portfolio decreased by 61 per cent to Rs. 320 mn in 2006, from Rs 817 mn recorded in 2005. High unrealized capital gain of Rs. 719 as at end of December 2006 is a result of holding shocks to build a long term equity Portfolio for realizing long term gains. (TABLE II - 6).

TABLE II - 6
EPF : Secondary Market Activities during 2006

Rs.mn.

Item	Volume Purchased		Volume Sold*		Capital Gain	
	2005	2006	2005	2006	2005	2006
Treasury Bonds	5,188	8,385	11,433	9,159	774	696
Treasury Bills	196	-	381	238	0.12	0.19
Equity Shares	2,703	1,244	1,628	591	817	320
Total	8,087	9,629	13,442	9,988	1,591	1,016

* at cost values

Source : Employees' Provident Fund

7.3 Total Member Balance and Rate of Interest for 2006

The total member balance of the EPF grew by 15 per cent during the year to record a value of Rs 477 bn as at end 2006, after accounting for the declared interest rate of 10.1 per cent to be declared to members for the year. In accordance with the statutory requirement of the Fund to pay the interest on the entire balance, including the contributions received during the year, the effective rate of interest is estimated at 10.2 per cent per annum, which is 3.5 per cent higher than the Average Weighted Deposit Rate (AWDR) of 6.80 per cent paid by commercial banks. Although it is not feasible for the EPF to declare a positive real effective return to members annually, the EPF is striving to provide a positive real effective rate of return to members on a cumulative basis.

7.4 Member Disclosures

The semi-annual member statements for the second half of 2005 were issued to members through their employers during September 2006. The posting of semi-annual member statements for the first half of 2006 was initiated in December.

7.5 Housing Loan Facilities

A facility has been available from 1988 for EPF members to obtain a loan for housing purposes from approved lending institutions keeping their EPF balances as collateral. In addition, a second loan is also available upon the successful settlement of the first loan.

During 2006, the EPF issued 15,136 member balance certifications for a total approved credit volume of Rs 3,049 mn. (TABLE II - 7). However, in spite of the lending institutions charging a penal rate of about 36 per cent per annum on the amounts defaulted, the members continued to default the repayment of these loans. This has compelled the Fund to deduct and pay to the lending institutions the defaulted amount, together with a penal interest from the relevant EPF member's account, resulting in an aggressive erosion of retirement benefits to the members concerned. The defaulters are not entitled to a second loan or a loan at 4 per cent interest rate under the Shramodha Home Loan Scheme.

Table II -7
Details of Housing Loan Facility EPF

Year	Member balance certificates issued (No.)	Amount of credit approved (Rs mn)	Housing loans defaulted (Cumulative No.)	Amount paid by EPF on housing loan defaults p.a. (Rs mn)
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	51,823	900
2006	15,136	3,049	66,000*	1,100*

* Estimated Source : Employees' Provident Fund

7.6 Public Awareness

To increase the level of awareness of the activities of the Fund, eight seminars were held during 2006. Of these, six seminars were organized by the Matale Regional Office of the Central Bank of Sri Lanka and held in six different districts, while the balance two were held at individual work places.

7.7 System Improvements

Efficiency improvements to various activities of the Fund continued to provide an enhanced service to members. Significant improvements to processes in the Accounting and Fund Management Division, by implementing a new accounting and investment package (SAP), have increased the efficiency and the accuracy of the management of the Fund.

The EPF successfully implemented the SAP Investment Module, which is a complete Enterprise Resource Planning (ERP) solution, providing EPF with strategic insight, ability to differentiate and increase productivity. It is a service-oriented business solution helping to align people, information, and business processes across organizational and technological boundaries.

The EPF website (www.epf.lk) was redesigned and launched in October 2006 to provide more information to the public in all three languages. The upgraded website also includes renewed features to provide a better interaction with stakeholders. This website provides facilities for the members and the employers to download Forms related to the EPF and includes a Frequently Asked Questions (FAQ) section. A facility exists to submit any other queries, whereby the relevant officer can get back with the requested information. General information regarding other EPF procedures are incorporated in the website.

The EPF also commenced a project, with the concurrence of the Labour Department, to collect contributions from larger employers with more than 150 employees on monthly basis through electronic media, thereby facilitating real time updating of member accounts. This system will expedite the refund process and the issuance of housing loan certificates. The fund expects to get more employers into this system during 2007. The emphasis placed on promoting the process of collecting member contribution data through electronic media resulted in 41 new employers joining the system, increasing the total number of such employers to 254.

In order to address numerous operational problems that had risen due to the maintenance of two independent databases on employer and member records by the Labour Department and the EPF, the Fund continued to undertake its re-engineering programme to collect its member information and develop a clear database without ambiguities which is critical for the smooth operation of the EPF and to provide an efficient and effective service to its members. Prior to the re-registration of the current contributing members, with a view to introducing a unique member identification number, a pilot project was carried out to ascertain the feasibility of the implementation of the scheme. The pilot project covered employers in three sectors, namely estate, services and industries.

Salient Features of EPF are presented in TABLE II - 8.

TABLE II - 8
Salient Features of the EPF

Item	2005	2006 *
Total Number of Members Accounts	10,799,915	11,299,000
Currently Contributing Members Accounts (CCMA)	2,002,652	2,032,000
Currently Non-contributing Members Accounts (CNMA)	8,797,263	9,267,000
Contributing employers	55,924	64,023
Total Contributions (Rs.mn.)	27,720	31,720
Total Refunds (Rs.mn.)	16,990	17,623
Number of Refunds	93,841	90,550
Total Investment Portfolio (Rs.bn.)	405	465
Government Securities Investments as a % of Total Investments (%)	97.8	96.8
Private Sector Investments as a % of Total Investments (%)	2.2	3.2
Realized Rate of Return on Average Portfolio (%)	11.43	12.22
Total Members Balance (Rs.bn.)	418	477
Total Gross Income (Rs.mn.)	41,817	46,389
Income Tax (Rs. mn.)	3,201	2,762
Operating Expenses (Rs.mn.)	411	425
Operating Expenses as a % of Gross Income (%)	0.98	0.92
Annual Interest Rate Declared on Member Balances (%)	9.00	10.1
Effective Interest Rate Declared on Member Balances (%)	9.13	10.2

* Provisional data

Source : Employees' Provident Fund

8. EXCHANGE CONTROL

The key function of the Exchange Control Department (ECD) is to monitor foreign exchange inflows into and outflows from the country. In the year 2006, all foreign exchange payments and receipts in relation to current international transactions and certain capital account transactions continued without restrictions through commercial banks appointed as authorised dealers in foreign exchange. The authorised dealers were required to exercise their judgement and discretion after satisfying themselves with the bona-fides of the transactions. In addition to authorised dealers, money changers, tourist hotels, travel agencies and duty free shops which are authorised to accept foreign currency continued to deal in foreign exchange for specific purposes during the year.

In the year 2006, as part of its management and regulatory functions, ECD continued to issue Operating Instructions and Guidelines to authorised dealers and restricted foreign exchange dealers. The Department continued to conduct on-site and off-site supervision to monitor their foreign exchange transactions and, where necessary, imposed penalties on corporate and unincorporated bodies and individuals who violated the provisions of the Exchange Control Act. It continued to allow certain capital account transactions in the form of foreign investments by residents, foreign currency borrowings by resident companies from overseas and fund transfers to Sri Lankans who have migrated to other countries etc.

8.1 Developments in 2006

A scheme was introduced for investments in rupee denominated Treasury Bonds (T. Bonds) by foreign investors under which foreign country funds, regional funds or mutual funds approved by the Securities and Exchange Commission of Sri Lanka, corporate bodies incorporated outside Sri Lanka and citizens of foreign states have been permitted to invest in T. bonds not exceeding 5 per cent of the total value of T. bonds outstanding at any given point of time. In order to facilitate these transactions, authorised dealers have been permitted to open and operate Treasury Bond Investment External Rupee Account (TIERA) in the name of the investor. Money changers were permitted to encash travellers' cheques in addition to foreign currency notes with a view to implementing the scheme effective from 1st January 2007.

The minimum turnover required to be considered for the renewal of money changing permit has also been increased upto US$ 600,000 per annum from its present level of US$120,000 per annum. In the year 2006, as announced by the Budget for 2007, two separate foreign currency accounts were introduced under the titled "Foreign Currency Account for Professional Services Providers (FCAPS)" and "Foreign Currency Account for Suppliers of Inputs (FCASI)". The former was expected to encourage professional services providers, who render their services to residents outside Sri Lanka and/or to local firms or companies who earn foreign exchange, while the latter was expected to promote local companies already engaged in supplying material inputs to companies earning foreign exchange.

The Department also conducted an awareness programme for registered money changers to make them aware on various issues such as terms and regulations stipulated in the Anti-Money Laundering Act (AMLA) and Convention on the Suppression of Terrorist Financing Act (CSTFA), etc.

8.2 Capital Transactions

(a) Investments

The existing Exchange Control Regulations relating to investments abroad by resident Sri Lankan Companies remained unchanged. ECD evaluated the requests made by Sri Lankan companies to invest abroad and recommended certain requests, based on their merits, for the approval of the Hon. Minister of Finance as required under section 17 of the Exchange Control Act. In 2006, the Hon. Minister of Finance permitted 25 Sri Lankan companies to invest abroad on recommendations made by ECD. Total investments approved in year 2006 amounted approximately to US$ 29.4 million. The areas in which such investments were permitted included tourism, freight forwarding, processing of agricultural products and apparel industries etc.

Exchange Control regulations relating to investments in the shares of the companies incorporated in Sri Lanka by non-residents remained unchanged during the year 2006. BOI continued to be the facilitator of the foreign direct investments in Sri Lanka.

(b) Foreign Currency Borrowings

Borrowing abroad by resident companies, other than companies approved by the BOI under section 17 of the BOI Act with full exemption from the Exchange Control Act, requires prior approval of the Central Bank. During the year under review, ten companies were permitted by ECD to borrow from abroad to a total sum of approximately US$ 91.6 million. This was a sharp increase in foreign borrowings in this category compared to the previous year's figure of US$.22.26 million.

8.3 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

The registration of freight forwarders was carried out in terms of the 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 carrying on the business of Freight Forwarder/Non-Vessel Operating Common Carrier in Sri Lanka under the said regulations to obtain a license issued by the Director of Merchant Shipping. During the year under review, 37 new companies were registered as freight forwarders bringing the total number of companies registered as freight forwarders to 210 at the end of the year. 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) Licenses to Money Changers

In the year 2006, two new licenses were issued to companies registered in Sri Lanka to engage in money changing business under the revised criteria introduced in 2005. Further, four licenses were issued to branch offices of existing money changing companies. The total collection of foreign currencies reported by money changers during the year amounted to US$ 103.6 million.

8.4 Monitoring & Follow up Work

Since the liberalization of Exchange Controls in 1994, authorized dealers and approved travel agents were permitted to release foreign exchange without restrictions on current account transactions, exercising their judgement and discretion after satisfying themselves with the bona-fides of the requests. All authorized dealers and approved travel agents are required to report their sales and purchases of foreign exchange to ECD on a daily basis for monitoring purposes irrespective of the amount of foreign exchange released. For this purpose, the Head Offices of all authorized dealers have been connected to the Central Bank electronically through Wide Area Network. 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. Foreign exchange transactions are monitored with a view to detecting unauthorized capital transfers, funds linked to financing of terrorism or money laundering activities, and to gather data and information to facilitate effective decision making in macro-economic management.

The Exchange Control Department continued its postal survey to monitor repatriation of export proceeds during the year 2006 with the intention of strengthening the monitoring mechanism and assisting the effective decision making system in the macro economic management. The data was collected on quarterly basis from nearly 3000 BOI and Non BOI companies. Majority of the exporters have been continuously participating in this survey since 2005.

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.

8.5 Investigations

Investigations into alleged violations of the provisions of the Exchange Control Act by individuals and corporate bodies were conducted in the year 2006. After the conclusion of the investigations, approximately, a sum of Rs. 2.4 million was collected as penalties in respect of 38 cases for violating the provisions of the Exchange Control Act and this was credited to "Exchange Control Penalties Account" maintained with the Central Bank. In addition, ECD also undertook investigations of financial institutions and companies on alleged large-scale unauthorized outward transfers of funds.

9. INFORMATION TECHNOLOGY

During the year under review, Information Technology Department mainly focused on strengthening the disaster recovery facilities and enhancing Business Continuity Planning to resume IT related critical business operations within an internationally accepted recovery time. Further, the department continued developing software to improve the overall performance of the bank through automation of processes. In addition, the department continued its efforts in enhancing ICT competencies among the Bank staff.

Main functions performed by the department are as follows.

(a) Strengthening of Disaster Recovery Site (DRS) facilities, management and execution of disaster recovery plan (DRP)

(b) Further automation and provisioning of value added IT services

(c) Maintaining the national payment and settlement system, general ledger system, treasury dealing room management system, Employees Provident Fund System and other critical business applications and IT infrastructure to ensure maximum system availability

(d) Enhancing IT infrastructure for strengthening of information system security, productivity and efficiency

(e) Enhancing ICT competencies of CBSL staff

9.1 Strengthening of DRS Facilities, Management and Execution of DRP

As a means of testing the DRP, IT department successfully conducted operations of critical IT applications from the DRS on business days with the participation of contingency staff of the Central Bank, financial institutions and other foreign counterparties.

9.2 Further Automation and Provision of Value Added IT Services

Considering the cost and compliance with Intellectual Property Rights act and institutional Information Security Policy (ISP), ITD decided to purchase an e-mail solution combined with collaborative software such as e-mail, document management and workflow systems and other office automation features providing added benefits to corporate users. The new e-mail system, Lotus Dominos will be implemented from the 2nd week of January, 2007. As a strategic approach for easy deployment of software applications and to be in par with technological advancements, IT department continued to develop applications in the web environment. The initial project in line with this approach was implemented on 01.06.2006 to submit required financial returns by licensed commercial and specialized banks to CBSL. This was extended to cover the returns from finance companies. In order to maintain the Central database concept, and to avoid duplication of submission of forms, the project will be extended to cover the requirements of several other departments during 2007.

In addition, IT department engaged in developing several applications in order to automate functions.

Major application developments undertaken during the year are given below.

(a) Enhancement of the electronic bidding system used for active Open Market Operations

(b) Facilitating the Cheque Imaging and Truncation project that was implemented by LankaClear (pvt) Ltd in May, 2006.

(c) Expansion of Off-site surveillance information reporting system

(d) Implementation of Linux- based collaborative e-mail system

(e) Automation of the functions of Asian Clearing Union division

(f) Development of a Risk Model to monitor and mitigate risk factors in handling public debt

(g) Weekly information reporting system for primary dealers

(h) Automation of Sri Lanka Nations Development Bond issues.

(i) Changes to RTGS software to accommodate SWIFT standards upgrade

In addition to coordinating the software development work with the outsourced software vendors, IT department continued to maintain all IT applications developed in-house including the EPF system which is one of the major applications handled by the Bank. With a view to secure the electronic data collection system of EPF, data encryption software was developed and implemented. A procedure manual that describes the activities of each division of the department was reviewed during the year and necessary changes were made to standardize the operations of the department. As a means of cost reduction, IT department evaluated the possibility of using open source software in office automation.

9.3 Maintenance of Critical Business Applications and IT Infrastructure to Ensure Maximum System Availability

IT department continued to operate the national payments and settlements system and managed to maintain systems availability on average at 99.55 % during the year under review, while maintaining 100% availability during 9 months. Storage of General Ledger servers located at Head office and DRS were also expanded to achieve maximum system availability and efficiency. SWIFT servers were purchased and in the process of implementation to facilitate the next SWIFT upgrade, namely SWIFTNet phase II in 2007.

9.4 IT Infrastructure Enhancements with the Intention of Strengthening Information System Security, Productivity and Efficiency

A storage area network server was purchased with a view to centrally maintain backup copies of all sensitive information for easy retrieval and to reduce copies of large volumes of data and image movements within the network to enhance network performance. Collaborative software was purchased to facilitate the new e-mail system, document management and work flow which will be fully implemented by 2008. An open source solution was installed to monitor the status of servers and the network for early detection of failures which would provide the ability to implement corrective measures before a breakdown would occur. IT department continued to provide technical assistance to IT related procurement and services of the Bank, as well as other government organizations and projects of national interest. As a measure of mitigating the risks and protecting the Bank's network from widely spreading computer viruses, Anti Virus Software used by the Bank was upgraded with the enhanced product e-Trust Threat Management 8.0 which included protection from Spam and Spyware, in addition to virus protection.

9.5 Enhancing ICT Competencies

IT department continued to enhance ICT competencies among the staff of CBSL and financial institutions by providing resource persons to conduct IT related training programs at Centre for Banking studies. Regular meetings with departmental IT Liaison officers were also conducted quarterly to educate the staff on latest developments in the IT field and to cultivate a strong ICT culture among the bank staff. The Liaison officers are used as the media for communicating ICT and information security related issues to other Bank staff.

Considering the expansion of IT related activities at the bank and also considering the importance of maintaining IT security, IT department prepared a user version of the ISP which was also translated to Sinhala for the convenience of the bank staff. The ISP versions are available in the departmental website. ISP and the BCP documents were further revised to accommodate latest developments and will be available during 2007.

10. INTERNATIONAL OPERATIONS

10.1 Foreign Exchange Reserves Management

International Operations Department (IOD) is entrusted with the responsibility of managing the official foreign exchange reserves of the country to facilitate maintenance of external stability of the Sri Lanka rupee and ensure required freedom in country's international transactions. The Monetary Law Act requires the Central Bank to maintain an adequate international reserves in liquid currencies and a nuclear reserve in gold, in order to achieve the above objective.

In 2006, the foreign exchange reserves were held mainly in US dollars, euros, sterling pounds, Australian dollars and gold. In terms of assets, the reserves were invested in two main asset classes, namely, money market instruments and fixed income securities of highly rated sovereign government securities, government guaranteed securities and securities of government agencies and supranational institutions. Liquidity requirements were fulfilled through the maintenance of a sufficient proportion of reserves in highly liquid short-term instruments of both asset classes. The transactions on investments were performed only through highly rated and approved counterparties within the limit structure approved by the management, paying due consideration to safety, liquidity and return on such assets.

Investments of foreign exchange reserves were done in accordance with the guidelines approved by the Monetary Board. The Foreign Reserves Management Committee (FRMC) supervised the overall operation of foreign exchange reserves management very closely and provided necessary guidance as appropriate during the year.

During the year 2006, the financial markets were influenced by episodes of record high oil prices reaching over US$ 78 per barrel (the benchmark West Texas Intermediary Brand). Global headline inflation picked up in response to high oil prices and, as a result, rising of interest rates were experienced by almost all economies. This created continuously challenging environment for reserves management operations specially with the valuation changes of the existing investments. To meet this challenge, IOD made necessary changes to currency and asset composition of the international reserves from time to time after reviewing the possible changes in the market/ economic fundamentals in selected currencies/ countries. Bank's foreign exchange obligations in the immediate future, and income generating abilities played a major role in determining the portfolio composition of the international reserves.

Overall reserve management operations have generated a net foreign exchange income of US$ 100.5 million or Rs. 10,453.4 million during the year 2006, exceeding the budgeted income of US$ 86.6 million and the income of the previous year amounting to US$ 77.0 million. The official foreign exchange reserves of the country has grown from US$ 2,257.0 million to US$ 2,323.0 million during this period, reflecting a net inflow of US$ 66 million. The increase in the income is the combined outcome of the increases in the level of reserves and interest rates.

10.2 Risk Management

The risks associated with the foreign exchange reserves and their investments are monitored by the Middle Office of the IOD. The foreign exchange reserves and their investments are exposed to various categories of risks. Among these risk categories, foreign exchange risk, interest rate risk, credit risk, liquidity risk and operational risk are considered as major components.

Foreign exchange risk or the risk of capital loss as a consequence of fluctuations in exchange rates is managed mainly through diversification of investment currencies. Interest rate risk or the exposure of the Bank's reserves portfolio to movements in the interest rate was managed through the appropriate adjustment of the duration of the portfolio. Counterparty Credit Risk Management System (CCRMS) is used by the IOD to minimize the credit risk. The liquidity risk which is the risk of incurring capital losses in the event of forced liquidation is managed by establishing liquidity requirements. The operational risk resulting from human error, flawed systems and inadequate procedures and controls were managed through a range of measures.

The IOD is in the process of developing an improved customized benchmark in order to better communicate the Bank's risk appetite and investment objectives as well as to enhance the performance evaluation approach of foreign reserves management activities.

10.3 Monitoring the Domestic Foreign Exchange Market Developments

IOD continued to closely watch the domestic foreign exchange market, foreign exchange transactions and overnight net foreign exchange open positions of commercial banks with a view to promoting the smooth functioning of the domestic foreign exchange market and to ensure an orderly adjustment of the exchange rate of Sri Lanka.

The US dollar/rupee rate which stood at Rs.102.12 at the end of December 2005 depreciated to Rs.107.71 at the end of 2006, recording a depreciation by 5.19 percent during the year, as against the appreciation of 2.44 percent in 2005. Given the relative strengthening of other major currencies in the international market, the rupee depreciated against all major currencies except for Japanese yen.

The volume of inter-bank foreign exchange transactions increased to US dollars 10,792 million from US dollars 7,245 million in 2005 recording a 33 percent growth during the year. In 2006, Sri Lanka operated in an environment mired by volatile exchange rates and higher expectation of inflationary pressures brought about mainly by high oil prices and resultant escalation of expenditure on imports. This has necessitated the Central Bank to be on both sides of the market to moderate the excessive volatility in the exchange rate of Sri Lanka rupee. The Bank absorbed foreign exchange amounting to US dollar 307 million from the domestic foreign exchange market, while the injection of foreign exchange to the market amounted to US dollar 791 million, during the year.

As a result of the initiatives taken by the Sri Lanka Forex Association along with the CBSL, the domestic foreign exchange market has adopted the ACI (Association Cambiste Internationale) Model Code in the domestic foreign exchange market.

10.4 Operating Instructions, Circulars and Directions issued during 2006

A new direction on LKR Options was issued to the domestic foreign exchange market during the year. Under these guidelines Authorized Foreign Exchange Dealers were allowed to offer Sri Lanka Rupee (LKR) based Cross Currency options subject to certain conditions. These directions are expected to help diversifying the domestic financial market while making it broader and deeper.

11 LEGAL

The Legal Department of the Central Bank (CBSL) continued to provide its services in advising the Bank on legal matters, representing the Bank in courts and other legal and quasi-legal fora and contributing to legal reforms in the banking and financial sector, in 2006.

The Department worked closely with other relevant departments in the CBSL in preparing amendments to existing legislation and in drafting rules, regulations, directions, contracts and other legal documents relevant to the operations of the CBSL.

During the year, the Department continued reviewing the existing legal framework while introducing new legislation to facilitate development and smooth functioning of the financial system. The Banking (Amendment) Act, No. 15 of 2006 and the Banking (Amendment) Act, No. 46 of 2006 were passed in Parliament in March and November 2006 respectively, to address certain lacunae in the Banking Act, No. 30 of 1988.

The Banking (Amendment) Act, No. 15 of 2006 introduced new requirements for licensed specialized banks in terms of equity capital. The amendment brought in provisions to determine the maximum percentage of share capital of a licensed specialized bank that could be held by companies in each of which an individual or a company may have directly, indirectly or beneficially a “substantial interest” or a significant management interest. It is believed that these amendments would play an important role in safeguarding the financial system stability within Sri Lanka. The Banking (Amendment) Act, No. 46 of 2006 introduced provisions relating to the vesting of a licensed specialized bank in a state bank and requirements pertaining to such vesting.

The Monetary Law (Amendment) Act, No. 9 of 2006 passed in March 2006, contained provisions to enable regulations to be made by the Monetary Board relating to lending to specific sectors thereby facilitating the grant of credit to vulnerable sectors.

Sri Lanka joined hands with the rest of the world in combating money laundering activities with legislation passed in March 2006, i.e. the Prevention of Money Laundering Act, No. 5 of 2006 and the Financial Transactions Reporting Act, No. 6 of 2006. The Legal Department worked closely with several departments of the CBSL and other government agencies in preparing the above legislation and subsequent regulations in 2006.

12. MANAGEMENT AUDIT

The Department of Management Audit (DMA) carried out its internal audit and management services functions in 2006 to facilitate the Bank to achieve its strategic objectives by making recommendations to improve the Bank’s operations and systems of controls. The focus was to transform internal audit to a risk based audit approach which was implemented in 2006. The Department also served as the secretariat to the Audit Committee of the Monetary Board.

In accordance with the Audit Plan 2006, 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 Department of Management Audit also has reported significant issues related to processes for controlling actions of the Bank and periodically provided information on the status and results of the Audit Plan to the management and the Audit Committee.

The Department carried out several management evaluation studies beyond the Audit Plan during the year 2006 with the objective of improving efficiency, economy and effectiveness of the Bank’s operations. The major management evaluation studies were : the survey on productive deployment of employees in the categories of Personal Secretaries, Personal Assistants, Stenographers in CBSL; study of alternatives available for destruction of currency notes; initial procedural audit on Financial Intelligence Unit and selection of a Store Keeper for the Canteen activities within the Welfare Department.

In addition to the above, the major audit activities undertaken during the year included a review of the procedure of holding the contingency currency stock outside the Bank premises by the Currency Department, physical verification of stocks in the currency vaults, closing of credit guarantee files of the Regional Development Department (RDD), post claims recovery action of RDD, physical verification of final round compensation payments to the Kuwaiti Dinar depositors, analysis on programmes conducted by CBS, review of activities of the Regional Offices, effective use of the access card system in the Bank premises, analysis on the diesel purchased and consumptions, maintenance of generators and elevators in CBSL, ascertain the ownership of vehicles purchased on behalf of CBSL by CECB, review of transport facilities provided by the Premises Department, a review of payments for janitorial services, electricity bills, purchasing modular furniture and audit of the payments system of water bills.

During 2006, the Department continued to improve the Bank-wide risk management system. As an initial step of monitoring the progress of risk management system, a request has been made to all departments to report on the following to ascertain implementation of the process.

(a) Whether department level risk management activities/discussions are held at regular intervals ?

(b) If so, whether the Committee has recognized and recorded any new risk exposures and loss events ?

(c) Whether the Committee has developed action plan to mitigate any potential risks ?

In order, the departments to incorporate the above changes/additions to the risk database some improvements on the risk software were made during the latter part of 2006. These improvements facilitated the Management Audit Department to recognize separately, any new risk events identified and risk mitigation measures taken by each and every department.

The Bank continued to make arrangements for the US based Institute of Internal Auditors (IIA) to conduct its examinations in Sri Lanka, mainly to build and maintain professionalism in internal and management audit. The Department has been actively collaborating with the Sri Lanka Chapter of IIA to promote its courses and the Central Bank is accordingly represented for the second successful year on both its Governing Council and the Academic Board.

13. PAYMENTS AND SETTLEMENTS

The Central Bank's responsibilities in national payment system including operation of the RTGS System, policy formulation, handling Sri Lanka's transactions through Asian Clearing Union and oversight were continued to discharge by the Payments and Settlements Department (PSD). In addition, PSD carried out three types of activities enabling the Central Bank to settle its own transactions efficiently without risk. First, Back Office operations to process and effect payment and settlement instructions in respect of Central Bank's Open Market Operations and foreign exchange reserve management. Second, handling and managing of SWIFT transactions. Third, operating the payment gateway for Central Bank transactions in the LankaSettle System. During 2006, management of operational risk was given a high priority by the PSD to ensure that operation of systemically important payment and settlement systems meets high standards of availability and resilience of services both in normal operations and in an event of prolonged and widespread disruption to normal operations. Under the responsibility vested on the Central Bank by the Payment and Settlement Systems Act (PSSA) No.28 of 2005, which came into operations in May, 2006, the PSD with the cooperation of all stakeholders of payment and settlement, has drafted a payment system policy statement and an action plan for the next four year period (2007 - 2010) for improving the payment and settlement infrastructure to ensure a safe and secure payment and settlement system to foster payment system stability.

13.1 Operating the Real Time Gross Settlement (RTGS) System

The RTGS Operations Division continued to operate the RTGS System with a high standard of operational reliability, integrity and security. The emphasis was to further reduce the potential operational risk and increase efficiency. In May, 2006 the daily operation schedule of RTGS System was revised and the time for closing of business was extended from 4.00 p.m. to 4.30 p.m. to accommodate the settlement of net clearing file of the settlement clearing system under the Cheque Imaging and Truncation (CIT) System. In 2006 the total number of RTGS transactions increased by 17 per cent, while the total value of transactions increased by 3 per cent. The daily average value of Intraday Liquidity Facility obtained by participants in 2006 declined marginally to Rs.2.2 billion. In January 2006, Central Depository Systems (Pvt) Ltd and the ICICI Bank Ltd joined the LankaSettle System. Accordingly, at the end of 2006, there were 34 participants in the RTGS System.

13.2 Settlement of Deals under Foreign Exchange Reserve Management

The Forex, Gold and Foreign Securities Settlement Division of PSD continued back office operations via bespoke Treasury Dealing Room Management System (TDRMS) for transactions done by International Operations Department (IOD).

During 2006, the Division was involved in upgrading the Back Office Module of the TDRMS. The department effected 6,286 settlement instructions, resolved settlement problems and monitored the Nostro balances of foreign currency accounts and safe custody balances of holdings of securities held with counterparties abroad.

13.3 Settlement of Transactions under Open Market Operations

OMO Settlement Division of PSD continued the Back Office functions relating to OMO transactions and Intraday Liquidity Facility (ILF). During 2006, the Division effected settlement instructions of 3,372 repo transactions amounting to Rs.1,013.592 billion, 872 Reverse-repo transactions amounting to Rs.514.665 billion and 188 outright sale of securities amounting to Rs.34.875 billion.

13.4 SWIFT Communications

The SWIFT Communication Division of PSD continued to handle and manage SWIFT message inflows to and outflows from the Central Bank. In 2006, 445,290 SWIFT messages were received by the Central Bank. Out of them 120,005 were related to Central Bank's own transactions. The balance was relating to LankaSettle transactions. The total number of messages sent by the Central Bank was 671,224.

The PSD was involved in the following modifications of the SWIFT System of the Central Bank carried out by the Information Technology Department:

* Upgrading of SWIFT Alliance Access/Entry (SAA/SAE) Servers for FIN message standards 2006;
* Installing of message syntax table and SAA/SAE patch version 5.5.60;
* Updating of bilateral key exchange certificate (CV); and
* Upgrading of infrastructure in readiness for the SWIFTNet Phase 2 migration.

13.5 Transactions under the Asian Clearing Union (ACU)

The total value of transactions of Sri Lanka effected through the ACU mechanism increased significantly by 60 per cent from Rs.167 billion in 2005 to Rs.268 billion in 2006. This was mainly due to increased oil imports from India and Iran.

The rupee value of net settlements made under the ACU mechanism during 2006 increased sharply by 70 per cent and amounted Rs.236 billion in 2006.

TABLE II - 9
Trade and ACU Transactions of Sri Lanka with Other ACU Countries

Rs.billion

	2005	2006
Total transactions channeled through ACU	166.8	267.9
Sri Lanka's exports to other ACU countries	70.6	67.9
Sri Lanka's imports from other ACU countries	250.0	321.2
Sri Lanka's total trade with other ACU countries	320.6	389.1
Net ACU Settlement	138.4	235.9

Source: Central Bank of Sri Lanka

The 35th Meeting of the Board of Directors of the Asian Clearing Union was held in Kathmandu, Nepal in May, 2006. A decision was taken at this meeting to appoint a technical committee comprising representatives from all member countries to: identify the areas of weaknesses, inefficiencies, inflexible rules and regulations that frustrate clients/users; examine whether the non-compliances of ACU procedures are due to absence of an effective monitoring mechanism or due to the incapability of ACU mechanism; identify the issues that can be remedied in the short term; and prepare a BCP which sets out ways and means as well as clear rules and procedures in conducting business in an emergency which could involve one or several member countries. Accordingly, a meeting of the Technical Committee was held at Bangladesh Bank in Dhaka during 18 - 19 July, 2006.

The findings and recommendations of the Technical Committee for the consideration at the next meeting of Asian Clearing Union Board of Directors are as follows:

(a) Increase awareness through issuance of guidelines, among all authorized commercial banks in member countries to handle ACU transactions in accordance with the ACU mechanism and strictly follow the standard international best practices and International Chamber of Commerce (ICC) Rules. The guidelines should include:

(i) improve their services and act promptly to any queries raised by their counterparties in ACU countries; and

(ii) issue ACU Dollar account statements as and when a transaction occurs and on a monthly basis.

(b) Member central banks may prescribe the commercial banks to pay minimum rate of interest at 2.00 per cent per annum on the balances of ACU dollar accounts.

(c) Dedicated contact persons for ACU may be identified by each member central bank and their contact details can be posted at the web site of ACU Secretariat. At least an interim reply must be given by the member central bank if the issue cannot be resolved within three working days.

(d) The use of Euro as a freely usable currency can be worked out in future when each of the members would prefer to use more than one currency in ACU transactions.

(e) As the current Chairman of ACU, Nepal Rastra Bank, in consultation with the ACU Secretariat, may identify potential ACU members among the former CIS countries that were not approached earlier and invite them to attend ACU meeting as observers and join ACU as members, elaborating the benefits that exist and future development possibilities.

(f) The ACU Secretariat may write to the Economic and Social Commission for Asia and the Pacific (ESCAP) to obtain their views/inputs on the possibility of extending membership beyond the (ESCAP) region.

(g) A Business Continuity Plan (BCP) to set out clear rules and procedures in conducting business in an emergency which involve one or several of the member countries may be prepared by the ACU Secretariat. The ACU Board of Directors may decide the location in a member country other than Iran, where back up data may be stored.

(h) The possibility of ACU clearing and settlements by a Central Clearing House (CCH), which could be an independent entity or a section of a member central bank, needs further examination to check whether it is consistent with the ACU objectives and the ACU settlement mechanism.

(i) The prospects of all the countries having their own RTGS System in place seem a medium or long-term endeavor. As a near term measure, the interfacing of the ACU payment system with the payment and settlement platform provided by the SWIFT can be explored.

13.6 Payment System Policy and Oversight

The Payment and Settlement Systems Act No.28 of 2005 (PSSA) which came into force on May 11, 2006 assigned the responsibility and statutory powers for the Central Bank to perform a wide range of activities from the formulation of payment system policy to enforcement of such policy. The PSD geared to perform the task of policy formulation with the representatives of the National Payment Council (NPC), the highest decision making body which comprises representatives of all stakeholders of the payment and settlement systems. Accordingly, the PSD was involved in formulating the draft national payment and settlement system vision, policy and action plan for the next four year period (2007 - 2010). The PSSA provides the required statutory responsibilities and powers for PSD to carry out payment system oversight in a more effective manner to foster safety and efficiency of the payment and settlement system. The move of the Central Bank to publish the payment system policy and 4 year action plan, and follow up the said policy framework will provide a predictable environment for market players to plan ahead and take the advantage in the payment industry.

The PSD prepared the General Direction issued by the Central Bank to LankaClear (Pvt) Ltd and participants of the Cheque Imaging and Truncation (CIT) System, providing the legal recognition to electronic cheque presentment and operation of the CIT System.

The PSD played an active role in upgrading the LankaSettle System, testing its readiness at the disaster recovery site (DRS), improving the business continuity planning and updating the LankaSettle System Rules to meet changing needs. LankaSettle System availability which recorded 99.54 per cent showed that LankaSettle was operated reliably in 2006.

On a request of participants a circular was issued to LankaSettle participants in 2006, requesting them to have norms and standards in settlement of inter participant transactions in the LankaSettle System. Accordingly paying participants should ensure settlement of all future value dated transactions in the System by 10.00 a.m. on the value date and effect same day value transactions for money market and foreign exchange transactions (rupee leg) within two hours of entering into such transactions.

With the introduction of 'Default Charge' in 2005, the liquidity management of participants in the RTGS System to ensure smooth settlement of net clearing balances improved. The number of occasions of failure of participants to keep adequate funds in their RTGS Settlement Accounts declined from 10 in 2005 to 4 in 2006. The PSD developed a set of Business Continuity Plan Guidelines which were issued by the Central Bank in March 2006. The BCP guidelines provide the appropriate minimum standards of BCP to LankaSettle participants and payment system operators such as LankaClear (Pvt) Ltd. In its assessment of BCPs of participants of LankaSettle System received in September 2006, PSD found that most of the participants have attempted to improve their BCPs. But the non-availability of SWIFT connectivity at the DRS of participants was a cause of concern. Therefore, PSD emphasized the importance of having SWIFT connectivity at the DRS of participants. In response, the SWIFT user group has established a local SWIFT service bureau to provide a common connectivity for users to communicate with SWIFTNet.

The PSD continued its dialogues with other payment system operators and participants in a cooperative environment and collected information periodically from them to monitor and oversee the payment and settlement systems and for publishing the 'Payments Bulletin quarterly'.

14. PREMISES

The Premises Department continued to carry out the maintenance and upkeep of the Bank's premises during the year 2006, 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 2006, the Premises Department completed its landscaping project at the front portion of the Central Bank Head Office Building which was commenced with a view to beautifying with blooming and having sufficient greenery to make the area pleasant and pleasing to the eye.

The Premises Department awarded the tender for repair and refurbishment of the Hostel Block at Centre for Banking Studies (CBS) Rajagiriya to State Engineering Corporation (SEC) in August, 2006, enabling the CBS for conducting Residential Training Programmes for local and foreign participants from various financial institutions. The work has already been commenced and will be expected to complete the project by the end of December, 2007.

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

15. PUBLIC DEBT

The issuance and management of domestic debt, servicing of both domestic and foreign debt and developing an efficient and liquid market for government securities are the key functions of the Public Debt Department (PDD). Accordingly, the PDD has to ensure that the government financing needs are met at the lowest possible cost over medium to long run with a prudent degree of risk and payment obligations are met on time. During the year, several initiatives were taken to diversify and broad-base the government securities market, strengthen the Primary Dealer (PD) system and improve the debt market infrastructure. The Rupee denominated Treasury bond market was opened for foreign investors with effect from November 1, 2006 broadening the investor base and increasing the competition in the bond market. In order to provide an opportunity for patriotic Sri Lankan citizens to participate in the development process and also to diversify the debt instruments, a retail type new sovereign debt instrument, Sri Lanka Nation Building Bonds (SLNBBs) was introduced in February 2006. With a view to strengthening the PD system and to provide a cushion for the rising market risk, the minimum capital requirement for Primary Dealers was further increased from Rs. 250 million to Rs. 300 million with effect from July 1, 2006. A risk weighted capital adequacy framework which was based on the internationally accepted Basle risk based capital framework was introduced for PDs. Bloomberg electronic trading platform was introduced in May, 2006 to enhance the efficiency of trading through efficient price discovery in the secondary market for government securities. Similarly, with a view to further facilitating the development of the government securities market, direct participant status was provided to Colombo Stock Exchange in January, 2006.

15.1 Developments in 2006

Borrowing Targets and the Strategy

The total gross borrowing limit set under the Appropriation Act No. 39 of 2005, approved by the Parliament for the year 2006 was Rs.548 billion. Of this, funds to be raised through the domestic sources amounted to Rs. 378 billion while the balance Rs. 170 billion was expected to be raised from foreign sources. In the year 2006, the PDD mobilized a sum of Rs.348 billion through government securities programme as against a target of Rs. 338 billion envisaged in the borrowing programme. Since the original commercial foreign borrowing programme was not implemented during the year as expected, a part of commercial type foreign borrowing programme was shifted to the domestic borrowing programme thereby slightly exceeding the originally envisaged targets under government securities programme. The approved Treasury bill limit remained unchanged at Rs. 300 billion during the year.

The domestic debt management strategy adopted in 2006 aimed at mobilizing funds through tradable instruments such as Treasury bonds including Index linked bonds and Treasury bills. Of the total domestic resource mobilization, 77 per cent was on tradable debt instruments such as Treasury bonds and Treasury bills. In respect of non tradable Rupee loans, there was a net repayment of Rs. 19 billion reducing the outstanding Rupee loan stock from 11 per cent in 2005 to 08 per cent in 2006. As part of the debt management strategy, the investor base of the debt market was further broadened by partly liberalizing the capital account and opening up the Treasury bond market for foreign investors subject to a limit of 5 per cent of the Treasury bonds outstanding. The entry barriers for foreign investors such as minimum holding period of one year, restrictions on maturity period and use of bonds for Repo transactions were removed in early part of 2007 to attract more investors. A new debt instrument called SLNBBs was introduced in early 2006 mainly targeting Sri Lankan community working abroad.

It has been observed that there is a considerable bunching of debt stock on the shorter end of the maturity profile. Of the existing domestic debt, 24 percent is estimated to be maturing within one-year period while 86 percent is estimated to be maturing within a 3-year period. The analysis shows that both the average maturity period of domestic debt (instruments based rupee debt) and ‘duration’ of such debt declined in the past few years. Having recognized the urgent need to address the emerging bunching problem and resulting rollover risk, the PDD initiated action to develop an appropriate debt consolidation plan through buy back operations, as used in most developed debt markets which is expected to be implemented in 2007.

15.2 Issuance

In 2006, the PDD conducted 52 Treasury bill auctions and issued a sum of Rs. 628 billion in gross terms and new issues of Rs. 24 billion in net terms. Reflecting the strong market preference towards the short term bills, 64 percent of the total gross issues were for maturities of less than or equal to 91 day Treasury bills. The PDD was able to raise Rs. 310 billion through Treasury bond programme by conducting 70 auctions as well as making private placements. Fifty four percent of the total issues of Treasury bonds were for more than 3 year maturities which helped to extend the duration of the debt stock. In addition to the conventional type Treasury bonds, Index linked bonds of Rs.6 billion were issued in June 2006. PDD took measures to address high fragmentation in the bond market in 2006. It continued the policy of reopening the existing Treasury bond series, that helped to reduce the total number of series of Treasury bonds from 56 at end 2005 to 53 at end 2006.

Sri Lanka Development Bonds (SLDBs) were issued through three consecutive auctions namely; June, August and September 2006. All three auctions were oversubscribed and a total of USD 580 million was raised with two year (USD 320 million) and three year (USD 260 million) maturities. The interest cost of these bond issues were six month LIBOR plus a margin of 132 basis points for 2 year tenure and six month LIBOR plus 141 basis points for 3 year tenure.

TABLE II-10
Issue and Maturity of Domestic Debt in 2006

Rs. Million

	Maturity	Issues	Repayments	Net Issues
Treasury Bills	91 day	299,505	308,296	(8,791)
	182 day	72,462	69,132	3,330
	364 day	74,454	100,099	(25,645)
	Other	181,445	126,781	54,664
	Total	627,866	604,308	23,558
T Bonds	1 year	-	11,250	(11,250)
	2 year	24,023	107,224	(83,201)
	3 year	119,972	23,550	96,422
	4 year	69,505	19,221	50,284
	5 year	79,803	-	79,803
	6 year	8,980	14,500	(5,520)
	8 year	7,865	-	7,865
	Total	310,148	175,745	134,403
R Loans	4/6 year	23	-	23
	1/10 year	-	19,393	(19,393)
	10 year	-	4,480	(4,480)
	Total	23	23,873	(23,850)
Sri Lanka Dev. Bonds	2 year	51,343	25,924	25,419
	3 year	8,782	-	8,782
	Total	60,125	25,924	34,201
Loans from FCBUs	<=1Year	19,674	24,887	(5,213)
	1.5 Years	1,623	3,180	(1,557)
	Total	21,297	28,067	(6,770)
Total		1,019,459	857,917	152,760

Source : Central Bank of Sri Lanka

In the meantime, a foreign commercial borrowing through a syndicated loan amounting to USD 100 million with the tenure of 3 years and at a rate of six months LIBOR plus 75 basis points was obtained to mitigate the pressure on domestic debt securities market and to stabilize the rate structure. The Citi Bank N.A. acted as the lead manager for this bond issue.

Rising interest rates for government securities fuelled by rising inflation and due to a shift of a part of the original foreign commercial borrowing programme to the domestic borrowing programme created a heavy pressure on the overall domestic borrowing programme in 2006. Especially, during the second half of the year, the increase in yield rates in primary and secondary markets was significant with uncertainty prevailing in the market due to breakdown of peace negotiations and in the wake of rising inflation. In order to mitigate the undue pressure on interest rates at auctions, government relied more on non-auction type borrowing by raising funds from institutional investors.

The increasing trend in interest rates also shifted the investor appetite to the shorter end of the market. This resulted in changing the acceptance pattern at the primary auctions. Towards the end of the year, about 69 percent of accepted volume of Treasury bills at primary auctions was 91 day bills. This has resulted in an increase in the size of weekly auctions and increased rollover risk. It also reduced the duration of the public debt portfolio from 1.87 years in 2005 to 1.83 (up to September) years in 2006. Further, a wide divergence in the interest rates between primary and secondary markets resulted in the secondary market activities getting dried up, which in turn reduced the normal resource flow to primary market. This caused further pressure on the primary auctions.

15.3 Debt Service Payments

During the year, the PDD serviced both foreign and domestic debt which amounted to Rs. 445 billion. Total debt service payments on domestic debt amounted to Rs. 385 billion while total foreign debt service payments, which stood at Rs. 60 billion recorded an increase of Rs. 35 billion over the previous year. This increase was mainly on account of lower debt service payments in 2005 due to the debt moratorium received during 2005 on account of Tsunami and commencement of usual foreign debt service payments according to the loan agreements entered into in 2006. The depreciation of Rupee against foreign currencies can also be cited as the other reason for the increase in external debt service payments in 2006.

15.4 Yield Rates and the Secondary Market Performance

The yield rates on government securities which remained stable during the first half of 2006, increased significantly during the latter part of the year. Higher rate of inflation and high inflationary expectations in the market, upward revision of the CBSL policy rates (by 125 bps), and additional borrowing pressure that emerged in the government securities market due to shifting of part of the original foreign borrowing programme to the domestic borrowing programme, were the main reasons for this sharp increase in the interest rates. Treasury bill yields increased by 266, 244 and 261 basis points for 91, 182 and 364 day maturities respectively, between December 2005 and December 2006, while those for Treasury bonds with a maturity period of 2-3 years increased by a range of 150-175 basis points during the same period. Secondary market activities in government securities declined further by 5.6 percent during 2006. Notable features were the significant increase in activities relating to Repo/Reverse repo market and sharp decline in outright sales and purchases which clearly reflects the investors preference to deal on the shorter end of the yield curve.

15.5 Primary Dealer Supervision

The PDD continued to supervise PD activities through off-site surveillance and on-site examinations. Six regular on-site examinations were carried out during the year and continuously engaged in off-site surveillance activities by reviewing financial statements and monitoring PD performance in primary and secondary markets.

Risk Weighted Capital Adequacy Framework (RWCAF) for PDs has been introduced with effect from July, 1. 2006. RWCAF covers the capital required for market risk in the trading portfolio as well as reverse repos, additional capital requirement depending on the long and short positions of PD portfolio and counter party credit risks. The required RWCAF would be the higher of the minimum capital requirement of Rs. 300 million or its required risk weighted capital based on the risk position of the PDs. Under the RWCAF, required capital adequacy ratio is 8 per cent of the risk weighted assets. The department has conducted a series of seminars and discussions to educate PDs on RWCAF.

The PDD introduced a mechanism to assess PDs based on a criteria which is linked to their performance with the objective of encouraging PDs to upgrade themselves. The assessment is based on the number of qualitative and quantitative factors such as participating levels at auctions, market making ability, risk levels, financial performance, compliance to reporting requirements etc.

With the objective of registering all transactions in the Central Depository System and enhancing safety of investments in the government securities market, actions have been initiated to expand the coverage of CBSL wide area network to allow market participants to do repositioning overnight repo transactions. The scheme is to be implemented in early 2007.

15.6 Scripless Securities Settlement System (SSSS) and the Central Depository System (CDS) - LankaSecure

PDD continued the Lanka Secure operations with its participants, including 23 Licensed Commercial Banks (LCBs), 8 non-bank primary dealers, Employees' Provident Fund and Central Depository Systems (Pvt.) Ltd of the Colombo Stock Exchange (the CDS Ltd.) In 2006, a total number of 184,476 transactions with a total value of Rs. 11,425,496 million had taken place through SSS System. Total number of registered investor accounts maintained at the CDS amounted to 26,936. During the year, the value of scripless Treasury bill issues stood at Rs. 627,864 million (face value) and the value of scripless Treasury bond issues stood at Rs.310,148 million (face value). In total, maturity payments amounting to Rs. 764,116 million had been made on behalf of scripless Treasury bonds and Treasury bills where as coupon payments on scripless Treasury bonds amounted to Rs.81,111 million.

16. REGIONAL DEVELOPMENT

The Regional Development Department (RDD) of the Central Bank continued with its main functions in 2006, including acting as the apex agency in implementing government sponsored and donor funded loan schemes, operating credit guarantee schemes, administrating the Regional Offices of the Central Bank and providing policy advice to the Government and other agencies with regard to regional and rural development.

16.1 Operation of Loan Schemes

During 2006 the RDD continued to act as the apex agency for the implementation of the undermentioned loan schemes.

16.2 Agricultural Sector

Second Perennial Crops Development Project Revolving Fund Loan Scheme - SPCDPRF

Tea Development Project Revolving Fund Loan Scheme - TDPRF

New Comprehensive Rural Credit Scheme - NCRCS

16.3 Small and Medium Enterprise Sector

Matale Regional Economic Advancement Project - MREAP

Sabaragamuwa Province Integrated Rural Development Project - SPIRDP

Small Business Revival Programme - SBRP

SUSAHANA Loan Scheme

Skills Development Project - SDP

16.4 Micro Finance Sector

Small Farmers and the Landless Credit Project - SFLCP

Poverty Alleviation Micro Finance Project - PAMP

Jeewana Shakthi Programme (refinance now concluded)

In 2005, the ADB funded Tea Development Project (TDP) and Second Perennial Crop Development Project (SPCDP) loan schemes were concluded and the Tea Development Revolving Fund (TDPRF) Project and Second Perennial Crop Development Project Revolving Fund (SPCDPRF) came into operation in 2006. In project addition, preliminary work relating to new credit lines, namely, the Post Tsunami Line of Credit (Contract B) funded by the European Investment Bank, the Construction Sector Development Project funded by Agence Francaise De Developpment (AFD) on behalf of the French Government and the Dry Zone Livelihood Support Partnership Programme funded by IFAD was completed. The activities undertaken in this regard were negotiating with the donor agencies and drafting of administrative agreements with the Government and on-lending agreements with the Participating Financial Institutions (PFIs). Preliminary work was also accomplished on the Small Holder Out-Grower Development Programme. Further, granting of refinance under the Jeewana Shakthi programme (a UNDP funded micro finance sector credit programme to rehabilitate livelihoods of micro entrepreneurs affected by the Tsunami) concluded during the year.

The details of currently operational loan schemes and those to be operational in the future by the RDD are given in TABLE II-11.

TABLE II -11
Features of Regional Development Lending Programmes Implemented by the Regional Development Department

Project and Implementation Period	Source of Funds	Broad Mission	Nature of Suppert	Fund Allocation	Present Position *
1. Agricultural Sector					
1.1 Second Perennial Crops Development Project (SPCDPRF) 2006-2014	GOSL	Commercialization of Perennial Crop Sector, increase production, nursery development, post-harvest handling and processing activities and marketing.	CBSL refinances the PFIs	SLR1 bn	Rs. 800 mn. was available for credit as at December 2006. Interest rate to borrower is 9%
1.2 Tea Development Project (Revolving Fund) - (TDPRF)- 2006-2018	GOSL	Increase tea small holders' income on a sustainable basis and develop the necessary infrastructure required for meeting the requirements of the export market. In this connection, assistance is available basically to modernize tea factories to acquire HACCP certification.	CBSL refinances the PFIs	SLR1.1 bn	Rs. 900 mn. was available for credit as at end December. Interest rate to borrower is 9%.
1.3 New Comprehensive Rural Credit Scheme - (NCRCS) (Continuous Programme)	PFIs 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.	Govt. Interest subsidy at a rate of 6% per annum to PFIs and Credit Guarantee up to 60% of the losses of the PFI	Loans granted by PFIs using their own funds	Project is in operation. Interest rate to borrower is 8%. Recovery Rate is 88%.
2 Small and Medium Enterprises Sector					
2.1 Matale Regional Economic Advancement Project - (MREAP) (2000-2007)	IFAD	Raising the income of rural and farm families by providing funds for small and medium scale enterprises in the District.	CBSL refinances the PFIs	SLR 197.04 mn (SDR 2 mn)	By end December 2006, available balance for refinancing was limited. Implementation of a revolving fund scheme is under consideration. Interest rate to borrower is 12%.
2.2 Sabaragamuwa Province Integrated Rural Development Project (Revolving Fund) - SPIRDPRF) (2000-2007)	GOSL	Upliftment of the living conditions of the people in the project area by promoting income-generating activities.	CBSL refinances the PFIs	SLR 147 mn	Project Activities will conclude by end February 2007. Revolving Fund to be implemented from March 2007. Interest rate to borrower is 10%. Recovery Rate is 92%
2.3 Small Business Revival Project - (SBRP) (2005-2007)	JBIC	To assist Tsunami affected small and medium scale enterprises for resumption of their businesses.	CBSL refinances the PFIs	SLR 2.6 bn (JPY) 3 bn	Total allocation is committed. SBRP Revolving Fund Credit Scheme will be operated for applicants already registered under the project.

					Interest rate to borrower is 6%. Recovery Rate is 91%
2.4 Susahana Loan Scheme (2005-2007)	CBSL	To assist Tsunami affected small and medium scale enterprises for resumption of their businesses.	CBSL refinances the PFIs Credit Guarantee upto 50% of the loan subject to a maximum of Rs 2.5 mn.	SLR 3 bn	Total allocation is committed. Susahana Revolving Fund Credit Scheme will be operated for applicants already registered under the Project. Interest rate to borrower is 6%. Recovery Rate is 90%.
2.5 Post-Tsunami Line of Credit - EIB Contract B Loan Scheme (2006-2014)	EIB	To assist the affected medium and large scale enterprises in the Tsunami affected districts.	CBSL refinances the PFIs	SLR 2.9 bn (EURO 20 mn)	Disbursement started in December 2006. Interest rate to borrower is 9%
2.6 Construction Sector Development Project (2007-2015)	AFD	Funds to purchase machinery for Post-Tsunami construction by companies rated by the Institute of Construction, Trade and Development.	CBSL refinances the PFIs	SLR 1.46 bn (EURO 10 mn)	Project is scheduled to be implemented in 2007. Interest rate to borrower is 10%.
3. Micro Finance Sector					
3.1 Dry Zone Livelihood Support and Partnership Programme (2006-2012)	IFAD	Poverty alleviation and income generation among the poor farmers in the selected districts i.e. Monaragala, Kurunegala, Badulla and Anuradhapura.	CBSL refinances the PFIs	SLR 200 mn	Preliminary activities commenced and beneficiaries have to be identified in the project areas.
3.2 Small Holder Out Grower Development Project (2007-2015)	IFAD	Poverty alleviation among out growers living in the state owned estates and in nearby villages.	CBSL refinances the PFIs	SLR 400 mn	Project is scheduled to be implemented in 2007. Interest rate to borrower is 9%.
3.3 Small Farmers & Landless Credit Project - (SFLCP)	IFAD, CIDA and GOSL	Setting up of an effective credit delivery mechanism for channeling formal credit to income generating activities for the rural poor to improve the economic conditions and general welfare of the beneficiaries.	CBSL refinances the PFIs	SLR 512.7 mn	Revolving Fund is in operation. Interest rate to borrower is 16%-20%. Recovery Rate is 96%.
3.4 Poverty Alleviation Micro-finance Project - (PAMP)	JBIC	Setting up of an effective credit delivery mechanism for channeling formal credit to income generating activities for the rural poor to improve the economic conditions and general welfare of the beneficiaries. Poverty eradication of identified borrowers through promotion of income generating activities among them. Organize low-income groups to link with the formal banking system.	CBSL refinances the PFIs	SLR 967.2 mn (JPY 1368 mn)	Revolving Fund Loan Scheme is scheduled to be implemented from april 2007. Interest rate to borrower is 17%. Recovery Rate is 93%.

* Recovery rates are provisional

Agriculture Sector

As mentioned earlier, the TDPRF and the SPCDPRF commenced operations during the course of 2006 out of the recoveries of the ADB funded TDP and SPCDP programmes, in order to continue to support the tea and perennial crop sectors. Several PFIs which did not participate in the original TDP and SPCDP schemes were enrolled under the revolving fund schemes to promote the flow of funds to these vital sectors. Action was also taken on the budget proposal to make it mandatory for all licensed commercial banks and licensed specialized banks to allocate 10 percent of their lending to agriculture, inclusive of agriculture processing. For this purpose, the RDD is to explore the possibility of establishing an Agricultural Fund to which banks which are unable to reach these targets could contribute the mandatory amount, and thereby satisfy the requirement.

Forward Sales Contract System

Forward Sales Contracts (FSCs), which are agreements signed between buyers and farmers to trade selected agricultural produce at pre-determined prices, were introduced in 1999, to protect farmers from sustaining losses due to depression of prices during the harvesting season. Under NCRCS, loans are provided to buyers who purchase agricultural produce under FSCs. The RDD, together with the Regional Offices (ROs), continued to promote FSCs by coordinating the activities of stakeholders, including PFIs, buyers, farmers and farmer organizations in 2006 as well. During 2005/06 Maha a total of 392 loans to the total value of Rs. 1.3 bn. were provided to buyers to purchase produce under FSCs while in Yala 2006, 301 loans to the total value of Rs 1.3 bn were granted for this purpose. The main crops for which FSCs were entered into were maize, soya beans, kurakkan, black gram and ginger. A total of 27,000 acres had been cultivated with maize in the Anuradhapura district and the entire 54,000 metric tons of maize produced were sold under FSCs bringing an income of Rs. 900 million to farmers. Several awareness campaigns on the FSC were also conducted during the year both by the RDD and the Regional Offices of the Central Bank.

Small and Medium Enterprise Sector

During the year under review, the granting of refinance for Susahana and SBRP loan schemes, which had been introduced in 2005 to rehabilitate small, medium and micro enterprises affected by the Tsunami, concluded. However, the demand for loans to rehabilitate Tsunami affected enterprises still exists and it is expected that Contract B of the Post Tsunami Line of Credit will meet some of the needs of medium scale enterprises. It has also been decided to establish a revolving fund out of recoveries of Susahana loans to meet any further demand from Tsunami affected enterprises. Further, as mentioned earlier, preliminary work was concluded with respect to the new line of credit to be obtained from the French Government (Construction Sector Development Project) for the purpose of providing finance to construction companies involved in post-tsunami construction activities.

Micro Finance Sector

As mentioned earlier, granting of refinance in respect of the UNDP funded Jeewana Shakthi loan scheme concluded operations during the year. The Small Farmer and Landless Credit Scheme (SFLCP), which is a pilot micro finance scheme operated by the RDD in the districts of Kandy, Puttalam, Galle and Matara, progressed successfully after the major administrative functions were handed over to the People’s Companies for Project Beneficiaries, which are companies formed by clustering beneficiary societies. The Report on the Impact Assessment Survey of the SFLCP conducted in 2005 was published during the year. The results of this survey indicate that around 63 percent of the beneficiary households sampled (the sample consisted of beneficiary households which had been in the SFLCP for 5 years or more) had crossed the poverty line within a period of 5 years or more. The best results in this regard were reported in the districts of Puttalam and Matara where more than 75 percent of beneficiary households in the sample had escaped from poverty. Improvements in living standards in terms of quality of housing, access to amenities and ownership of consumer durables and capital items were observed in all four districts. The survey also revealed that an appreciable number of beneficiary households credit needs have moved beyond the upper threshold for microcredit of Rs. 50,000 and, therefore, their present requirement was credit on commercial terms. A survey covering major indicators of wealth, ownership of consumer durables and capital goods, housing conditions, indebtedness and savings was undertaken in December 2006 using a sample of 754 beneficiaries of the Poverty Alleviation Micro Finance Project (PAMP) which is another pilot poverty alleviation project operated by the Central Bank in the districts of Kurunegala, Kalutara, Nuwara Eliya, Badulla, Matale and Hambantota. Preliminary information on this survey indicates that 55 percent of beneficiary households in the sample had escaped poverty. This is a salutary development as 88 percent of households sampled had joined the PAMP scheme after 2004. It has been decided to conduct this survey annually on the same sample of beneficiaries to build up panel data which would permit the analysis of chronic poverty and transitory poverty among beneficiaries. During the year under review, the outreach of the PAMP programme expanded by 12,968 households. A more comprehensive Impact Assessment Survey on the PAMP in line with the survey conducted on the SFLCP is also expected to be conducted in 2007.

Credit Guarantees

The RDD, as the agent of the Government of Sri Lanka (GOSL) or on behalf of the GOSL, guarantees the loans granted by banking institutions under special loan schemes in order to promote the flow of funds to priority areas. Some of these credit guarantee schemes are operated with seed funds from the Central Bank, while for others seed funds have been provided by the Government. The RDD continued with its credit guarantee operations, which includes issuing guarantee cover notes, collecting premiums and processing of credit guarantee applications, in 2006. The details of Credit Guarantee Schemes in respect of credit schemes currently operational are given in TABLE II-11. However, processing of credit guarantee claims related to several credit schemes that have now concluded was also undertaken in 2006.

Regional Offices of the Central Bank

The RDD continued to supervise the Regional Offices (ROs) of the Central Bank in Anuradhapura, Matale and Matara in 2006. During the year, several conventional Central Banking activities hitherto undertaken by the ROs such as currency issue and regional cheque clearing activities were terminated, enabling the ROs to focus exclusively on regional development activities. Major activities undertaken could be broadly categorized into activities aimed at agricultural development, creating awareness, supervising and monitoring special loan facilities, entrepreneurship development, regional data collection, dissemination of data, providing logistic support to the Country Wide Data Collection System of the Statistics Department of the Central Bank and representing the Central Bank in regional fora. Specific activities undertaken by each Regional Office are given in TABLE II - 12.

TABLE II - 12.

Specific Activities Undertaken by Each Regional Office

Activity	Matara	Matale	Anuradhapura
1. Promoting FSC	x	x	x
2. Facilitating FSC between Maize Cultivators and agro-processing companies			x
3. Promoting FSCs between producers of ginger and agro processing companies		x	
4. Encouraging paddy farmers to diversify into other crops such maize and black gram in the Yala season			x
5. Providing technical know-how on reducing post harvest losses		x	
6. Conducting workshops and awareness programmes on production of rice based products			x
7. Improving productivity on small and medium rice mills			x
8. Conducting workshops on undercropping in coconut land, cultivation of fruits and home gardening activities	x		
9. Initiating cash crop cultivation in the Muruthawela Irrigation Scheme	x		
10. Conducting awareness progrmmes on the Susahana and Jeewana Shakthi loan schemes and monitoring of use of funds under the Susahana loan scheme	x		x
11. Conducting awareness programs on the Jeewana Shakthi loan scheme for bank officers in the eastern and northern provinces			x
12. Representing the Central Bank in preliminary discussions relating to the proposed Dry Zone Livelihood Support Partnership programme			x
13. Coordinating the IFAD funded Matale Regional Economic Advancement Programme		x	
14. Conducting awareness programmes on investment in government securities and identification of counterfeit currency	x	x	x
15. Conducting educational programmes on economic issues for school children	x	x	x

17. SECRETARIAT

In 2006, the Secretariat Department continued to carry out its administrative functions such as 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 disposal of obsolete items etc. The department also effected all payments relating to travel, procurement of goods and services and settlement of advances. Mail Room operations which were outsourced earlier, continued under the same arrangement.

Consequent to the re-organization of the core functions of the Finance Department, the Secretariat Department with effect from 01.09.2006, also carried out all the administrative functions of the Central Bank Pension Scheme, Widows' & Orphans' Pension Fund and Widowers' & Orphans' Pension Fund hitherto carried out by the Finance Department.

18. SECURITY SERVICES

The main objective of the Security Services Department (SSD) is to protect the employees of the Central Bank whilst performing duties, and its visitors, buildings and properties, and to provide security to the currency consignment while in transit. To achieve its objective, Security Services Department of the Central Bank took following actions during the year 2006:

(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 our security officers and a special team of officers from departments of CBSL 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 for security officers were conducted 20th November 2006 and 3rd and 4th of December 2006.

(e) A special programme had been launched to enhance the efficiency of the Security Officers through better training and on-going dialogue with the staff. The special residential training on HR and Security related matters was provided for a batch of 46 new security officers recruited to the Security Service of the bank in August 2006.

(f) Strengthened the security of the Central Bank Head Office with the assistance of Government Security Forces & Police.

(g) Action has been initiated to procure the following security equipment to enhance the checking procedures at the Central Bank Head Office, its Regional Offices and Centre for Banking Studies, Rajagiriya.

(i) Explosive Detectors

(ii) Walk Through Metal Detectors, and

(iii) Hand Held Metal Detectors

(h) Number of programmes were conducted to educate the employees of the Central Bank on action to be taken in case of an emergency and also to gain their co-operation in all security related matters.

19. STATISTICS AND FIELD SURVEYS

The Statistics Department continued its operations on collection, compilation, analysis, and dissemination of data on national accounts, prices and wages, labour force and employment, and other socio economic sectors in 2006 as well. The department also engaged in improving existing systems and developing new information systems including short term and medium term projections for economic growth and inflation. One of the major achievements of the Department during the year was the extension of its operations into new areas such as conducting land price surveys, business confidence surveys and inflation expectation surveys. In addition, the Department actively participated in the public awareness programme of the CBSL as a source of resource persons, for training programmes, seminars and media discussions during the reference year. Many officers in both staff and non-staff grades participated in both local and foreign training programmes, workshops and seminars to further their knowledge and skills during the year which enabled them to improve the quality and productivity of the Department.

Statistical Surveys

The Department initiated a programme to collect asset prices to meet the requirements of the Financial System Stability Committee (FSSC) as well as to expand the Bank's data coverage. As an initial step, a land price survey was conducted within the Colombo District in two rounds. The First round focused on the land transactions that were taken place in 2003 as a benchmark to find determinants of land prices. The second round of the survey was on transactions in 2004 and 2005 to derive the trends in land prices. The findings of the survey were reported to both the Monetary Board and FSSC. The Department also conducted a business confidence survey (BCS) among the CEOs of companies listed in the Colombo Stock Exchange (CSE) through e-mail. This survey will be conducted frequently with further improvements based on the experience of the initial survey with expanded coverage. Findings of the survey were submitted to the Monetary Board and were presented to the Monetary Policy Committee (MPC) along with an introduction to the Inflation Expectation Survey initiated in 2006 for the same sample frame as for the BCS and a sample of economists representing Sri Lanka Economic Association (SLEA) and Institute of Policy Studies (IPS).

Country Wide Data Collection System (CWDCS)

Data collection under the CWDCS was continued through an island-wide network of school teachers who function as field investigators. With the improvements introduced to the system by initiating data collection from the centers in the Northern and Eastern Provinces (NEP), the CWDCS collected data from 107 centres during 2006. With the introduction of new formats to update data collection, the supervision of field investigators was also further strengthned to ensure quality and timeliness of information received according to an annual time table set at the beginning of the year. Supervision of the centres located in the NEP was carried out off site, as the prevailing security situation did not permit field supervision in those areas. As in the past, four regional seminars were conducted in Colombo, Matara, Anuradhapura and Kandy to provide refresher training to the investigators in order 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 can be transferred to school children and other members of the society. The effectiveness of such programmes was reflected in the improved awareness and the enthusiasm among the teacher investigators. Arrangements have been made to reduce the number of data collection centers to 100 effective from January 2007 under the programme initiated in 2005 to rationalize the data collection under the CWDCS by restructuring the data collection centers. Data collection from the Pettah market was rationalized to be more cost effective without compromising the quality and availability of data.

National and Regional Income Accounts

The Department continued to compile the annual and the quarterly estimates of Sri Lanka's national accounts. These included the collection of primary and secondary data and the estimation of key parameters in relation to overall production, consumption, saving and investment in the country. Estimates of Private Consumption Expenditure (PCE) were improved with the latest information of the CFS 2003/04. A system to use information available in the database of the Employees' Provident Fund (EPF) was also introduced to strengthen the national income estimation further. The presentation of information on GDP was improved through the reclassification of annual and quarterly GDP estimates in line with the International Standard Industrial Classification (ISIC). The estimates were disseminated to the public through the print and electronic media in 2006 as well. The quarterly estimates were disseminated through 3 media conferences. The work initiated in 2003 to build a data series on quarterly national accounts by the expenditure method continued through 2006 as well.

As in the recent past, the Department also compiled the annual Gross Domestic Product disaggregated by province with a lag of one year, for 2005. The series of statistics that was introduced in the 2003 Annual Report was maintained in 2006 as well. The series provides comprehensive statistics for policy makers in analyzing and identifying regional disparities in economic activities and growth performances in the country.

Prices, Wages and Employment

The Department compiled and analysed six monthly price indices. While the five regional consumer price indices measured the aggregate price movements in retail prices in five different regions, the Wholesale Price Index measured the same for producer or wholesale prices. The prices necessary for the compilation of all indices were either collected through the CWDCS or other forms of data collection.

In addition, the Department continued to analyse 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). Projections for short term and medium term inflation prepared by the Department to be used as leading indicators for the future direction of price movements. The Informal Sector Wage Rate Index (ISWRI) was further improved by improving the quality of data. A composite CPI to represent the entire country with latest weight structure based on the Consumer Finances and Socio Economic Survey (CFS) 2003/04 conducted by the Department was compiled on experimental basis. Compilation of Provincial CPIs in line with new composite CPI was also initiated during the latter part of 2006. A new software package with advanced features was developed with the help of the IT Department to process CWDCS data.

The Department continued to conduct its Annual and Quarterly Public Sector Employment Survey. Information from both surveys was used in the compilation of the National Income Accounts. Key findings from the quarterly survey were reported on a regular basis to the Monetary Board throughout the year. The quarterly labour market review was initiated by extending the quarterly coverage to the areas of foreign employment, labour relations and labour market reforms, in addition to the annual and quarterly analysis of labour force and labour market. Analytical coverage of the reports on labour market developments was expanded by incorporating new areas.

Dissemination of Statistics

During the year, the Statistics Department released its two annual publications titled “Sri Lanka Socio Economic Data 2006 - Volume XXIX” and “Economic and Socio Statistics of Sri Lanka 2006 - Volume XXVIII” both in June 2006. The statistical tables in the pocket diary 2007 of the Bank were also updated with new information.

The Department made its regular contributions to statutory as well as several other Bank publications during the year. The Monetary Board was kept informed of the current situation with regard to national income, inflation, prices, wages and the labour market, as and when necessary. 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.

Contributions to Public Awareness Programmes of the CBSL

Senior staff of the Department regularly functioned as resource persons at several seminars, workshops, training sessions and media discussions organized by the Bank, government ministries, educational institutions and the media. The total number of such forums where officers of the Statistics Department participated as resource persons was 29 for the year. The Department also provided in house industrial training to two undergraduates from the Statistics Departments of the University of Colombo during the year.

20. SUPERVISION OF NON-BANK FINANCIAL INSTITUTIONS

The Department of Supervision of Non-Bank Financial Institutions (SNBFI Dept) carried out its functions as envisaged in the Finance Companies Act, No. 78 of 1988 (FCA) and the Finance Leasing Act, No. 56 of 2000 (FLA), with the view mainly to ensuring that the Registered Finance Companies (RFCs) and Registered Finance Leasing Establishments (RFLEs) coming under its purview did not pose a threat to the stability of the financial system.

During the year 2006, one more company was newly registered as a finance company and with this the total number of RFCs increased to 29. Meanwhile, six institutions, comprising four licensed banks and two public companies were registered under the FLA to carry on finance leasing business and the certificate of registration granted to one company under the FLA was cancelled. As a result, the total number of RFLEs as at end December 2006 stood at 72.

20.1 Registered Finance Companies (RFCs)

(a) Off-site Surveillance

Off-Site Surveillance of RFCs was carried out by analyzing the information received through periodic returns submitted by the companies with a view to ascertaining the financial condition of RFCs and their compliance with the Directions issued and Rules made by the Monetary Board under the provisions of the FCA.

(b) On-site Examinations

On-site examinations were carried out with a view to assessing the asset quality, capital adequacy, management efficiency, earnings, profitability, systems and controls and the status of the corporate governance of RFCs. During the year 2006, six on-site examinations were conducted by the SNBFI Dept. In addition, 23 spot examinations were conducted to examine selected critical areas such as liquidity, credit administration, capital adequacy and systems and controls of the RFCs that were not subject to comprehensive on-site examinations during the year.

Findings of both comprehensive on-site and spot examinations were communicated to the Boards of Directors and the senior management of the respective RFCs and they were directed to take urgent corrective action regarding deficiencies. Prompt corrective actions were taken wherever such action was required and firm commitments with specific timeframes were given by the Boards of Directors for correcting any remaining deficiencies.

(c) Issue of Directions

During the year, seven Directions and a Rule were issued to RFCs covering several important aspects. Of these, one was a new Direction, while the other Directions and the Rule replaced Directions and a Rule issued previously on relevant aspects.

* The Finance Companies (Minimum Core Capital) Direction No. 1 of 2006

  This Direction requires every RFC to maintain at all times an unimpaired core capital of not less than Rs 200 million. The RFCs whose core capital was less than Rs 200 million as at 01.02.2006 were given an extended period of 30 months to comply with the provisions of the Direction.

* The Finance Companies (Risk Weighted Capital Adequacy Ratio) Direction No. 2 of 2006.

  This was issued replacing the Finance Companies (Risk Weighted Capital Adequacy Ratio) Direction No. 2 of 2003 as it became necessary to incorporate certain changes consequent to the imposition of the minimum core capital requirement of Rs. 200 million.

* The Finance Companies (Provision for Bad and Doubtful Debts) Direction No. 3 of 2006

  This replaced the Finance Companies (Provision for Bad and Doubtful Debts) Directions No. 1 of 1991 and the Finance Companies (Provision for Bad and Doubtful Debts) Directions No. 2 of 1991. The objective of the Direction was to introduce a single provisioning criterion to all RFCs while affording greater flexibility to them by allowing the deduction of the values of a range of assets against the accommodation for provisioning purposes.

* The Finance Companies (Single Borrower Limit) Direction No. 4 of 2006

  This Direction replaced the Finance Companies (Single Borrower Limit) Direction No. 1 of 1992. The new Direction while enhancing the limits on accommodations to single borrowers and amount of unsecured accommodations that can be granted by an RFC, placed certain restrictions on the total amount of accommodations given to single borrowers.

* The Finance Companies (Lending) Direction No. 5 of 2006

  This Direction replaced the Finance Companies (Lending) Direction No. 8 of 1991 and Finance Companies (Lending) (Amendment) Direction No. 2 of 2001. This Direction contains revisions that were consequential to the provisions incorporated in the Finance Companies (Single Borrower Limit) Direction No. 4 of 2006.

* The Finance Companies (Business Transactions with Directors and their Relatives) Direction No. 6 of 2006

  This Direction replaced the Finance Companies (Business Transactions with Relatives) Direction No. 5 of 1991. The new Direction allows RFCs to accept deposits from its directors and relatives of its directors on terms and conditions applicable to other depositors. Further, the maximum value of a transaction that can be conducted with directors and relatives of directors without the approval of the Central Bank was increased.

* The Finance Companies (Investment) Direction No. 7 of 2006

  This Direction replaced the Finance Companies (Investments) Direction No. 12 of 1991 and the Finance Companies (Investments) (Amendment) Direction No. 3 of 2001.In terms of the earlier Direction, RFCs were not permitted to invest in the share capital of any company exceeding 40 per cent of the issued ordinary share capital of the investee company. This restriction has now been relaxed permitting an RFC having a core capital of Rs. 200 million and above to form subsidiary companies or acquire shares exceeding 50 per cent of the issued ordinary share capital of a company.

(d) Issue of Rules and Guidelines

(i) The Finance Companies (Advertisements) Rule No. 1 of 2006 was issued replacing Finance Companies (Advertising) Rule No. 1 of 2001.Under the new Rule some requirements imposed in the earlier Rule have been relaxed, while some additional information such as credit rating is required to be included in advertisements.

(ii) Further, the following Guidelines were issued to RFCs during 2006.

  * Finance Companies (Opening of Branches/ Offices) Guidelines No 1 of 2006
  * Finance Companies (Publication of Half Yearly Financial Statements) Guidelines No 2 of 2006.

20.2 Registered Finance Leasing Establishments (RFLEs):

(a) Registration of Finance Leasing Establishments

During the year under review, 6 institutions comprising two LCBs, two LSBs and two public companies which are referred to as Specialized Leasing Companies (SLCs), were registered under the provisions of the FLA. Also, during the year, one SLC was merged with an LCB and the certificate of registration granted to one public company was cancelled. Accordingly, the total number of RFLEs stood at 72, comprising of 15 LCBs, 9 LSBs, 28 RFCs and 20 SLCs as at end December 2006.

(b) Issue of Directions to SLCs

During the year 2006, the following five Directions were re-issued in order to strengthen the reporting requirements.

The Finance Leasing (Minimum Capital) Direction No. 1 of 2006.

The Finance Leasing (Provision for Bad and Doubtful Accommodations) Direction No 2. of 2006.

The Finance Leasing (Single Borrower Limit) Direction No. 3 of 2006.

The Finance Leasing (Gearing Ratio) Direction No. 4 of 2006.

The Finance Leasing (Reserve Fund) Direction No 5 of 2006.

In addition, the following two Directions were issued in order to obtain financial, operational and corporate information from SLCs on a regular basis.

The Finance Leasing (Financial Statements) Direction No. 6 of 2006.

The Finance Leasing (Corporate and Operational Information) Direction No. 7 of 2006

(c) Monitoring of SLCs

SNBFI Dept. continued its off-site surveillance of SLCs on a quarterly basis during the year 2006. In addition, 17 spot-examinations were conducted by the Department in order to ascertain the accuracy of financial reporting and to check the compliance with the Directions by SLCs. The companies that did not comply with the Directions were directed to take corrective actions within a specific period of time and the Department closely monitored the progress relating to action taken by them.

20.3 Failed Finance Companies

The administration and management of nine failed finance companies had been vested with the Monetary Board since 1988 under the provisions of the FCA. Of these, one company was wound up in 2006 bringing the total number of companies that were wound up to three. The process of liquidation continued in the case of five other companies. The other company which commenced another round of partial refund of deposits in 2005 following the recovery of some dues from a related company, continued to make the payments to depositors during 2006.

During the year, an audit firm and two legal firms were assigned the task of investigating and recommending the course of action that can be taken in respect of failed finance companies. Arrangements were made to submit the investigation reports and other necessary information to relavant authorities to take appropriate action based on the findings and recommendation.

20.4 Unauthorized Conduct of Finance Business

The Department continued investigations into the affairs of the institutions, which were allegedly engaged in finance business without legal authority. In respect of 6 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 up by taking appropriate action under the provisions of the FCA regarding those institutions.

During the year, the Department initiated legal action against six companies, which failed to comply with the Directions issued by the Monetary Board after determining that such companies had been conducting finance business without legal authority.

There has been a marked decline in the number of inquiries/complaints received in respect of persons conducting finance business in an unauthorized 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 programmes.

20.5 Public Awareness Programmes

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

(a) Publication in newspapers:-

(i) An explanatory note providing 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. These notices were published on a monthly basis jointly with the Bank Supervision Department.

(ii) Names and addresses of 5 companies in respect of which the Monetary Board had made determinations under section 11(2) of the FCA.

(iii) A reader friendly notice under the caption “Be mindful of where you place your savings” indicating the risks associated with investing funds with institutions which are not authorized to take deposits.

(iv) A press release on the proposed Micro Finance Intuitions Act.

(v) A press notice to inform the public of the cancellation of registration under the FLA of a specialized leasing company.

(b) Publication of a Pamphlet titled "Institutions authorized to accept deposits from the public"

(c) Participating at interviews conducted by print and electronic media particularly on risks associated with depositing money with unauthorized deposit taking institutions.

21. THE CENTRE FOR BANKING STUDIES (CBS)

In keeping with the mission i.e., "imparting knowledge and developing skills through training to personnel in the financial sector and equip them with necessary competencies to meet the challenges arising from technological advancement and financial innovations", the Centre for Banking Studies (CBS) continued to offer training programmes to personnel in the financial sector including the Central Bank of Sri Lanka (CBSL) and other financial institutions during 2006. Programmes were also conducted on microfinance to cater to the training needs of the rural sector in which stakeholder institutions, i.e., Regional Development Banks, Co-operative Rural Banks, Samurdhi Authority, National Development Trust Fund participated. Training courses/seminars and workshops were designed to meet the training needs of the financial institutions which were conducted by a panel of well experienced and qualified resource persons from the Central Bank and non Central Bank institutions.

The CBS conducted 62 programmes, compared with 73 programmes offered in 2005, a breakdown of which is given in the TABLE II-13. 62 programmes included 48 scheduled local programmes, one international programme and 13 seminars/courses, offered on demand. For the first time, the CBS, in collaboration with IMF/STI Singapore conducted a successful training course on Financial Programming and Policy from 15 - 26 May 2006 for officers of the Central Bank and Ministry of Finance. At the request of commercial banks, 5 programmes on demand covering the area of Exchange Control Regulations were conducted. The courses of Hire Purchase and Lease Financing, Lending on Pledge of Jewellery, Preparation of Effective Credit Analysis, MS Word for Advanced Users, Basic Tamil and Urban Agriculture had a high demand. Six officers from the Nepal Rastra Bank participated in the programme on Non Performing Advances (NPAs) and Banking System Failure. Further, the CBS conducted a Certificate Course on Commercial Banking, Accounting and Economics for 92 staff officers recruited/promoted to Staff Class of the CBSL in 2005 and 2006. CBS conducted 12 educational seminars on topics that were of interest to Advanced Level school students and teachers. 1,389 students participated in these educational seminars.

TABLE II - 13
Scheduled Training Programmes by Subject Conducted by CBS in 2006

Classification	No. of Programmes	Trainees			Total Training Hours
		CBSL	Other	Total	
1.Banking & Finance	22	130	570	700	270
2.Information Technology	17	250	29	279	660
3.Languages & Communication Skills	3	64	15	79	146
4.Management	3	17	56	73	30
5.Rural Sector Development & Micro Finance	3	0	113	113	36
6.Special Programmes	14	164	363	527	330
Total	62	625	1,146	1,771	1,472

Source: CBS, Central Bank of Sri Lanka

Under the Rural Financial Sector Development Programme (RFSDP), which was funded by ADB and the Government of Sri Lanka, 04 Training of Trainer (TOT) modules were arranged by the CBS and conducted by internationally accredited Consultative Group to Assist the Poor (CGAP) trainers. CBS also conducted 07 retail programmes on the same modules under the supervision of the International Trainers. An overview of microfinance training was conducted for RFSDP stakeholders by an international consultant under the same project.

Thirteen (13) public and commemoration lectures of which details are given were conducted by eminent local and foreign speakers, which provided a forum for professionals, senior executives of financial institutions and members of the public to express their views on important current issues.

TABLE II - 14
Public and Commemoration Lectures Conducted in 2006

1. "Challenges in Achieving and Maintaining Price Stability in Developing Countries" - Dr. Narendra Jadhav, Principal Adviser and Chief Economist, Department of Economics Analysis & Policy, Reserve Bank of India.
2. Independence Commemoration Lecture "E-government: current issues and the relationship of experience of developed nations to Sri Lanka", - Professor Julian Teicher, Monash University, Australia.
3. "Financial Reforms and Financial Crises: The Swedish Experience" - Dr. Lars Nyberg, Deputy Governor, Riks Bank, Sweden.
4. Economic Issues of Transport (in Sinhala) - Mr. K.G.D.D. Dheerasinghe, Assistant Governor, Central Bank of Sri Lanka.
5. Republic Commemoration Lecture "State of the Economy as reflected in the Central Bank Annual Report 2005" - Dr. H.N. Thenuwara, Director, Economic Research Dept., Central Bank of Sri Lanka.
6. "State of the Economy as reflected in the Central Bank Annual Report 2005" (in Sinhala) - Mr. K.D. Ranasinghe, Deputy Director, Economic Research Dept.
7. "Unleashing Sri Lanka's Potential" - Dr. Shantayanan Deverajan, Chief Economist, South Asia Region, The World Bank, Washington DC, USA.
8. "Trade, Markets and Economic Growth" - Prof. Harry Flam, Institute of International Economic Studies (IIES), Stockholm University, Sweden.
9. 56th Anniversary Lecture of CBSL "Central Banking Evolution and the Future Course for Central Banking - Dr. (Mrs.) Nalini Jeyapalan, USA.
10. "Poverty Alleviation thro' Microfinance" (in Sinhala) - Mr. W.M. Karunaratne, Director, Regional Development Dept., CBSL.
11. "Future Challenges for Sri Lankan Labour Market" - Mr. C.P.A. Karunatilake, Deputy Director, Statistics Dept., CBSL.
12. "Electricity Sector Development in Sri Lanka: Way Forward" - Prof. Priyantha Wijayatunga, Director General, Public Utilities Commission of Sri Lanka.
13. 25th Anniversary Lecture of CBS "The Evolving Role of the World Bank for Countries like Sri Lanka" - Ms. Naoka Ishii, Country Director, World Bank Office, Colombo.

22. TRAINING

Recognising the importance of developing skills and competencies of the staff to enable them to perform their duties efficiently and in a more productive manner, the Bank as in the previous years, continued to train its staff at all levels both locally and abroad. At the same time, in order to implement the new learning and training policy, the Bank initiated action to create an environment conducive for the staff to learn, train themselves and share knowledge, expertise and experience with other members of the staff.

During the year under review, the Bank provided opportunities for 122 officers to participate in training programmes conducted abroad, while 975 were nominated for participation in training programmes conducted locally by reputed training institutions. The majority of officers trained locally were in programmes conducted by the Centre for Banking Studies in the area of Information Technology. In addition, a special training programme was conducted for the benefit of the officers recruited to the staff class to familiarize themselves with the work handled by Departments. A training programme on commercial banking was also arranged for these officers to get practical experience with the assistance of commercial banks.

The Bank continued with its policy of providing facilities for its staff to acquire postgraduate qualifications from reputed universities in the UK, USA, Canada and Australia under the Central Bank Scholarship Scheme. Accordingly, 10 officers commenced their postgraduate studies during 2006, while 07 officers resumed duties in the Bank after successfully completing their postgraduate studies abroad.

Recognising the fact that the Bank will get multiple benefits by enabling the trainees to impart the knowledge they have gained by participating in training programmes/seminars to other officers in the Bank, the Bank continued with its weekly seminar series during 2006.

In addition, the Bank arranged familiarization programmes for its staff to visit the Riksbank in Sweden on short-term study visits to familiarize themselves with the rules, regulations and procedures followed by the Riksbank in the areas identified as useful to the Bank. Accordingly, arrangements were made for a team of officers to visit Riksbank to familiarize themselves in the areas of IT and communication

23. WELFARE

The Welfare Department continued to provide facilities and amenities necessary to improve the quality of life of staff and their families through different schemes such as loan schemes at concessionary interest rates and the provision of medical benefits to employees, pensioners and their dependents. The total number of beneficiaries amounted to 9055 as at end 2006. The Department also provided the important in-house services such as health clinic, catering and other ancillary welfare services.

During the year under review, the Department established a new Fund called, "Central Bank of Sri Lanka Employees' and Pensioners' Distress Relief Fund" with a view to helping Bank employees and pensioners with financial assistance in instances where the cost incurred for medical treatment for sudden terminal illnesses, major surgeries and prolonged illnesses exceeded limits on prevailing benefits.

The Housing Loan Scheme was further expanded in 2006 by adopting the Public Administration Circular to enable both employee and his/her spouse to avail himself/herself of separate housing loans in the event both of them are employed in the Bank and simplifying the rules to enable employees to obtain loan facilities for housing purposes notwithstanding the fact that the employee already has a house property. Loan reschedulement was also done for housing loan balances of the pensioners in order to ensure the settlement of the entire loan by the age of 70 years.

Catering service was further improved to be cost effective and efficient and to cater for official functions at the Central Bank premises.

24. HUMAN RESOURCES MANAGEMENT

Human Resources Management functions of the Bank were regrouped in 2006 as one cluster with a view to aligning same with the strategic plan of the Bank. Under this arrangement, the Human Resources Department (HRD) carried out its activities in the areas of recruitment, placement, succession planning, performance evaluation, promotions, and transfers in line with the human resource needs identified by the Bank. Simultaneously, HRD also adopted a strategic orientation to improve employee motivation with a view to achieving the goals and objectives of the Bank.

Voluntary Early Retirement Scheme (VERS)

As a measure of further rationalizing human resource management a voluntary early retirement scheme (VERS) was offered to staff class employees in May 2006. Under this scheme, 20 employees were given an opportunity to retire from the Bank service. Out of the 20 employees, 18 employees retired effective from 1st August 2006 while the retirement of the balance 2 employees was staggered according to the requirements of respective departments. One such employee retired from the Bank service effective from 1st November 2006.

Recruitment

The new recruitments in 2006 were aimed at meeting competency requirements and filling the identified vacancies in various departments. A total of 13 staff class officers were recruited to the permanent cadre while 45 security officers, 2 IT technicians, 1 analyst programmer and 1 Tamil typist were recruited on contract basis, during the year. The vacancies of Director of Security Services Department and the Chief Librarian were also filled in 2006.

Promotions

Career progression of all employees of CBSL was considered when grade promotions and position promotions were granted in 2006. Marks of performance evaluations and the recommendations made by heads of department were used as criteria for grade promotions. On this basis, a total of 190 officers in staff class, non-staff class and minor employee categories were promoted in 2006. In the case of position promotions, 4 heads of department were promoted to staff class special grade and designated as Assistant Governors. One staff class grade IV officer was promoted to staff class special grade and designated as Senior Head of Department.

Employer - Employee Relations

A close dialogue between the trade unions and Bank management continued during the year. The Bank concluded the salary revision during the year and signed the collective agreement with trade unions valid for up to 31st December 2008.

Performance Management System (PMS)

Performance appraisal for the year 2005 for all employees of the Bank was completed successfully during the year. Individual and departmental goal setting for the year 2007 was also carried out concurrently with the implementation of the strategic plan of the Bank.

Manpower Planning

In 2006, a total of 39 employees including those under the VERS retired from the Bank service. In addition, 5 employees resigned from the bank service for personal reasons. At the end of the year 469 staff officers, 525 non staff officers and 96 minor employees were in the service.

Implementation of e-HR System

The HR Department introduced the web-based e-HR System in December 2006. The system has been customized to align with the requirements of the strategic plan. With the introduction of the system employees are able to view their personal information online and the system also assists taking timely decisions on HR related matters with minimum administration overheads. Staff training on the subject commenced in 2006 is expected to be completed within the first quarter of 2007. The collection and updating of personal information of employees has also commenced.

Strategic Management Forum

The HRD facilitated the organization of the corporate management workshop which was held with the participation of all heads of department, corporate management team and the strategic planning committee. This forum provided an opportunity for all participants to discuss and agree on the departmental plan and the strategic plan for 2007 - 2011.

MEETINGS ATTENDED BY GOVERNORS

During January - June 2006, the Governor Mr. Sunil Mendis attended the following meetings.

(i) 41st SEACEN Governors' Conference held in Brunei from 2 - 7 March.

(ii) IMF/WB Spring Meeting held in Washinton DC from 22- 26 April.

During July-December 2006, the Governor Mr. Ajith Nivard Cabraal attended the following meetings.

(i) IMF/WB Annual Meetings 2006 & G-24 Meetings & Sri Lanka Economic and Investment Forum held in Singapore from 15-20 September.

(ii) Road Show on Sri Lanka Development Bonds held in Hong Kong from 22-23 September.

(iii) Conference of the South Asian Federation of Accountants (SAFA) on "Accounting Profession in South Asian Region - Value and Perspective" held in Chennai, India on 30th September, to deliver keynote address on "Governance in the Banking System and the Role of Audit Committees and Accountants".

(iv) Fund Managers' Conference held in Singapore and hosted by Colombo Stock Exchange in association with the Sri lanka High Commission in Singapore on 22nd November to deliver keynote address on "Economic Overview of Sri Lanka".

APPOINTMENTS / PROMOTIONS

1 Mr. Ajith Nivard Cabraal was appointed as Governor of the Central Bank of Sri Lanka, with effect from 01 July 2006, for a term of 4 years, by His Excellency the President.

2 The following promotions and appointments were made effective from 11 October 2006.

(i) Dr. (Mrs.) Anila D. Bandaranaike was appointed as Assistant Governor in addition to her position of Director of the Statistics Department.

(ii) Dr. P. W. R. B. A. U. Herat who has been released to the International Monetary Fund as an Alternate Executive Director, was appointed as Assistant Governor.

(iii) Dr. H. N. Thenuwara was appointed as Assistant Governor in addition to his position of Director of the Economic Research Department.

(iv) Dr. D. S. Wijesinghe, Director of the Domestic Operations Department, was appointed as Assistant Governor.

3. Mrs. J. A. N. Dissanayake, Acting Secretary was appointed as Secretary of the Secretariat Department with effect from 29 June 2006.

4. Dr. W. M. Hemachandra, Additional Superintendent of the Public Debt Department was appointed as Acting Director of the Centre for Banking Studies with effect from 01 August 2006.

5. Major General S. Wanigasekara was appointed as Director of the Security Services Department with effect from 02 May 2006 on contract basis.

6. Mr. A. Kamalasiri, Additional Director of the Domestic Operations Department was appointed as Acting Director of the Domestic Operations Department with effect from 15 November 2006.

7. Mr. D. Wasantha, Acting Controller of the Exchange Control Department was appointed as Controller of the Exchange Control Department with effect from 10 July 2006.

8. Mr. P. Samarasiri, Additional Director of the Bank Supervision Department was appointed as Acting Director of the Bank Supervision Department with effect from 14 August 2006.

9. Mr. George N. Fernando was appointed as Chief Executive Officer of the Financial Intelligence Unit with effect from 01 June 2006 on contract basis.

RESIGNATIONS/RETIREMENTS

1. Mr. Sunil Mendis, Governor, resigned from the position with effect from 30 June 2006.
2. Mr. P. D. Rodrigo, appointed member of the Monetary Board, resigned from the Board with effect from 15 February 2006.
3. Dr. A. G. Karunasena, Assistant Governor, retired from the bank service with effect from 15 June 2006.
4. Dr. U. Vidanapathirana, Assistant Governor, who was on release to the Ministry of Internal Administration, retired from the bank service with effect from 29 October 2006.
5. Mr. H. A. G. Hettiarachchi, Controller of the Exchange Control Department, retired from the bank service with effect from 10 January 2006.
6. Mr. W. S. L. Fernando, Secretary of the Secretariat Department, retired from the bank service with effect from 29 June 2006.
7. Ms. J. P. T. de Zilva, Director of the Bank Supervision Department, retired from the bank service with effect from 14 August 2006.
8. Mrs. P. T. Perera, Senior Head of Department (Special Officer/Legal Reforms Project) retired from the bank service with effect from 11 December 2006.
9. Major General W. P. P. Fernando, Director of the Security Services Department, service contract expired on 14 April 2006.

OFFICERS ON RELEASE/LEAVE

1. 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.
2. Dr. P. W. R. B. A. U. Herat, Assistant Governor, to the International Monetary Fund as an Alternate Executive Director.
3. Mr M. M. Attanayake, Director of the Centre for Banking Studies, to the Ministry of Enterprise Development and Investment Promotion.
4. Mr. S. R. Attygalle, Staff Class Grade III officer, to the Ministry of Finance and Planning.
5. Mrs. Y. M. Indraratne, Staff Class Grade III officer, to the Ministry of Industrial Development.
6. Mr. M. Mahinda Saliya, Staff Class Grade I officer, to the Ministry of Finance and Planning.
7. Mrs. A. K. Hettiarachchi, Personal Secretary, to the International Monetary Fund.
8. Mrs. M. C. J. Fernando, Personal Secretary, to the Ministry of Finance and Planning.
9. Mrs. D. G. D. I. Ekanayake, Staff Class Grade I officer, to the Ministry of Finance and Planning.
10. Mr. E. W. K. J. B. Ehelapola, Staff Class Grade I officer, to the Ministry of Finance and Planning.
11. Mr. K. A. U. S. K. Thilakarathne, Staff Class Grade I officer, to the Ministry of Finance and Planning.
12. Mr. E. A. Hettiarachchi, Staff Class Grade IV Officer on no pay leave.

25. THE FINANCIAL INTELLIGENCE UNIT (FIU)

Its establishment

By Gazette Order of 23rd March, 2006 made by H.E. The President, the FIU of Sri Lanka was established in the Central Bank of Sri Lanka in terms of the provisions of the Financial Transactions Reporting Act No.6 of 2006(FTRA), and has been operational since then. The FTRA constitutes one of the three pieces of legislation enacted to combat the financing of terrorism and financial crime, the Convention on the Suppression of Terrorist Financing Act No.25 of 2005(CSTFA) and the Prevention of Money Laundering Act No.5 of 2006(PMLA) representing the other two. This legislation represents Sri Lanka's commitment to collaborate with international efforts on anti money laundering and combating the financing of terrorism(AML/CFT) and consolidates the Central Bank's responsibility for financial system stability.

Its mandate

The mandate of the FIU in terms of the law is to receive, analyse and disseminate information to combat money laundering and terrorist financing, which is required to be undertaken both domestically and internationally. The need for an effective information sharing mechanism is crucial to this objective. Accordingly, financial institutions designated by law, are mandated to generate suspicious activity reports and other mandated disclosures, such as cash transaction reports and forward them to the FIU. The centralization of this function and designating the FIU as the receiver of financial information, is fundamental for effective prevention, both in a national and international framework for AML/CFT.

Mandatory Reporting Requirements

By Gazette Order No.1437/25 dated 23rd March, 2006, the first Regulations under the FTRA were made by H.E. The President in his capacity as the Minister of Finance. Accordingly, Financial Transactions Reporting Regulation No.1 was issued whereby the reporting threshold for the purposes of Section 6(a) of the FTRA was determined to be, any transaction exceeding Rs.500,000 in cash or its equivalent in foreign currency and in terms of Section 6(b) electronic fund transfers (EFTs) in excess of Rs.500,000 or its equivalent in foreign currency.

Its scope

In discharging its mandate in terms of the law, the FIU has required, in the first instance, the licensed banks and the registered finance companies, to report all mandated cash transactions, EFTs meeting the stipulated threshold and any suspected transactions relating to money laundering and terrorist funding activities. The data received is analysed by the FIU and appropriate action is taken in terms of the law in collaboration, where necessary, with the law enforcement agencies.

As the institutional and resource capabilities of the FIU expand, the mandatory reporting requirements of the FTRA will be extended, progressively, to other financial institutions and designated non-financial institutions as defined in the FTRA. The coverage of institutions in terms of the law is very wide, in line with international best practice, and includes entities and persons in finance business, as well as entities and persons in designated non-finance business as defined in the FTRA.

Notwithstanding these reporting requirements, however, all mandated financial institutions and designated non-financial institutions are required to comply with the provisions of the FTRA.

The know-your-customer(KYC) and customer due diligence(CDD) guidelines and regulations required to be complied with by financial institutions in terms of the law, have already been drafted and will be issued to the licensed banks and the registered finance companies shortly.