

# Chapter 8

## FINANCIAL SECTOR DEVELOPMENTS AND SYSTEM STABILITY

### 8.1 Overview

**T**he financial sector continued to grow strongly and the financial system remained resilient in the face of external shocks and challenging domestic macroeconomic conditions. The main financial institutions maintained their financial soundness through continued profitability, stronger capitalisation, improved asset quality and enhanced risk management, which consolidated their capacity to deal with the testing environment. The regulation and supervision of the financial system was further strengthened with the implementation of several new prudential directives and measures, while the systemically important payment and settlement systems operated with high availability and safety. Hence, the near-term risks to the financial system seem to be manageable and the outlook for financial system stability is positive, with policies and measures being implemented to mitigate risks and address vulnerabilities.

**The financial services industry supported the continued expansion in economic activity.** The activities of all major categories of financial institutions, such as banks, finance and leasing companies, insurance companies, pension and provident funds, primary dealers, rural banks and micro-finance institutions and other financial institutions, expanded during the year. The banking sector experienced solid growth, with increases in the asset base, loans and advances portfolio, investments and deposit mobilisation. Bank lending growth was more moderate than in the previous year, influenced by higher interest rates and the tight monetary policy stance. The banking sector sustained its profitability and capital adequacy levels in 2007. The array of financial products and services and delivery channels broadened with the introduction of new schemes and Information and Communication Technology (ICT) based products and services, such as internet and mobile phone banking. There was a significant shift towards card-based





payment modes and automated teller machine (ATM) facilities. The finance and leasing companies expanded their branch network, although the financial facilities extended grew at a slower pace than in the previous year. A notable feature was the marked increase in hire-purchase (HP) facilities in comparison with finance leasing facilities, taking advantage of a tax benefit. The profitability of this sector declined slightly due to an increase in the cost of funds and a decline in interest margins in the higher interest rate environment. The increased capitalisation of this sector will help cushion it against such stresses. The insurance sector experienced a steady growth, with both life and general insurance business recording appreciable progress. The capital levels of the industry have improved with application of solvency requirements for the general insurance, while its profitability has been maintained. The assets and investment portfolios of the main superannuation funds, the Employees' Provident Fund (EPF) and the Employees' Trust Fund (ETF), increased, with a rise in their membership. The unit trust sector experienced a growth due to the establishment of a new closed-ended income fund during the year. Access to finance was further enhanced with financial institutions offering new and increased facilities to the agriculture sector and small and medium enterprises sector.

**The supervisory and regulatory framework governing the financial sector was further strengthened with several directives and measures introduced to improve soundness of both banks and non-bank financial institutions.** There was also a shift from compliance-based supervision towards risk-based supervision. The preparatory work for the implementation of the Basel II Capital Adequacy Framework for banks from 2008, was completed. The adoption of Basel II is expected to improve the soundness and risk management of banks by better aligning the bank's capital with its risk profile and by providing more comprehensive capital coverage for credit, market and operational risks. A direction on corporate governance for banks was issued by the Central Bank and a mandatory code for companies listed on the Colombo Stock Exchange (CSE) by the Securities and Exchange Commission (SEC). Regulations on card-based payment instruments were also issued and a direction setting out the prudential requirements of such service providers has been drafted and will be issued shortly. To strengthen the anti-money laundering (AML) regime, guidelines were issued to financial institutions on "know your customer" (KYC) and customer due diligence procedures.

Proposals to diversify the activities of primary dealers, subject to appropriate regulatory and prudential safeguards, were approved in 2007.

**The legal framework supporting the financial system was reinforced and updated.** The Finance Leasing Act was amended to enable specialised leasing companies to raise funds from the public through the issue of debt securities, in order to broaden their sources of funding. In addition, revisions to the Finance Companies Act to strengthen the Central Bank's regulatory and investigative powers with respect to finance companies were drafted. A new law to regulate and supervise Micro-Finance Institutions (MFIs) has also been prepared. A new securitisation law has been drafted to enable the issuance of asset-backed securities through bankruptcy remote special purpose vehicles and for the regulation of structured finance products. The Securities and Exchange Commission Act is being amended to bring financial derivatives under its ambit. The Regulation of Insurance Industry Act is also being amended to strengthen prudential supervision and to permit the appointment of banks and other financial institutions as agents for the distribution of insurance products. The Credit Information Bureau Act is being revised to extend the scope of its services to more diverse user groups and to provide value added services. There was much emphasis on business continuity planning (BCP) to improve the resilience of the payments and settlement system and financial system stability.

## 8.2 Financial System Stability

**The financial system, supported by the sustained expansion of the financial services sector, remained resilient and stable in 2007, despite increased pressures from external and domestic macroeconomic and financial market developments.** The main financial institutions maintained their soundness through strong profitability, increased capital levels and improved asset quality within an enhanced regulatory and supervisory framework, which has strengthened their resilience and risk absorption capacity. Although the outlook for financial system stability remains positive, the prevailing downside risks such as high interest rates associated with high inflation, high credit growth and slowdown in global economy require continued vigilance and risk mitigation to prevent the occurrence of events that could have an adverse impact.

**The turbulence in global financial markets since mid-2007 has increased liquidity, credit and market risk in these markets.** The turmoil, which was triggered by the US sub-prime housing mortgage

Table 8.1

## Selected Financial Soundness Indicators

Institution and Indicator	Per cent	
	2006 (a)	2007 (b)
<b>Licensed Commercial Banks</b>		
Regulatory Capital to Risk Weighted Assets	12.7	12.7
Tier 1 Capital to Risk Weighted Assets	11.3	10.9
Non Performing Loans Net of Provisions to Capital	13.0	10.5
Non Performing Loans to Gross Loans	5.5	4.9
Return on Assets (Before Tax)	1.8	1.9
Return on Equity (After Tax)	15.6	16.0
Interest Margin to Gross Income	37.9	33.1
Non-Interest Expense to Gross Income	32.0	25.4
Statutory Liquidity Ratio	23.9	24.8
Liquid Assets to Total Assets	16.9	17.9
Net Open Position to Capital Funds	0.01	0.01
<b>Licensed Specialised Banks</b>		
Regulatory Capital to Risk Weighted Assets	19.8	19.4
Tier 1 Capital to Risk Weighted Assets	20.7	22.9
Non Performing Loans Net of Provisions to Capital	21.9	23.4
Non Performing Loans to Gross Loans	6.7	6.8
Return on Assets (Before Tax)	2.0	1.8
Return on Equity (After Tax)	11.8	10.7
Interest Margin to Gross Income	36.0	26.3
Non-Interest Expense to Gross Income	18.4	16.0
Statutory Liquidity Ratio	63.6	59.9
Liquid Assets to Total Assets	44.5	40.6
<b>Registered Finance Companies</b>		
Regulatory Capital to Risk Weighted Assets	14.3	15.4
Tier 1 Capital to Risk Weighted Assets	12.9	13.2
Non Performing Loans Net of Provisions to Capital	9.4	8.8
Non Performing Loans to Gross Loans	5.5	5.1
Return on Assets (Before Tax)	2.5	2.3
Return on Equity (After Tax)	17.2	19.6
Interest Margin to Gross Income	33.0	27.8
Non-Interest Expense to Gross Income	31.0	31.1
Statutory Liquidity Ratio	17.1	18.1
Liquid Assets to Total Assets	9.3	9.9
(a) Revised	Source: Central Bank of Sri Lanka	
(b) Provisional		

problems, resulted in tighter credit conditions and higher risk premiums in international financial markets. Sri Lanka has not been directly affected by the recent bouts of volatility, as local financial institutions did not have exposure to the asset backed securities and derivatives.

**On the domestic front, robust economic growth continues to underpin financial system stability.** The growth of the financial services sector, which stood at 8.5 per cent in 2007 was an important driver of the growth momentum. However, sharply rising interest rates in response to tight monetary policy measures, exerted challenges to financial stability. Financial sector institutions need to be more vigilant of such risks and appropriate risk mitigating measures should be intensified in order to maintain the financial system stability. High inflation and interest rates increased macro-prudential vulnerability by affecting the debt servicing capacity of the business and household

sectors. The rising public debt service obligations exerted an upward pressure on interest rates in 2007 and, hence, a prudent debt management strategy has been implemented to address these concerns and the results of the strategy were already seen in more stable interest rates at the beginning of 2008.

**The debut international bond issue by the government in the global financial markets has helped to extend the maturity profile of foreign borrowings and build up foreign reserves.** In the past few years, there has been an increase in short-term foreign currency borrowings by the government which has increased the country's foreign exchange risk exposure and weakened its foreign exchange liquidity ratio. Hence, the mobilisation of foreign funds through a 5-year bond has had a positive impact on the external debt maturity structure and the country's foreign reserve position. The sale of Treasury bonds to foreigners also helped strengthen external reserves.

**Credit growth has been decelerating in response to policy measures, although it was higher than the targeted level.** This is beneficial for maintaining financial system stability, as it will dampen inflationary pressures and reduce the likelihood of an increase in credit risk in banks. In addition to tightening monetary policy, the Central Bank introduced several prudential requirements with effect from the fourth quarter of 2006 to curtail excessive bank lending and to mitigate the risks associated with increased lending. These measures include the imposition of general provisioning on all performing advances and the increase in risk weights in respect of loans secured by primary mortgages over residential properties and other loans and advances.

**Domestic financial markets were more volatile during the year.** The money market rates experienced intermittent periods of volatility, mainly due to weak management of liquidity by some banks and the tight monetary policy pursued by the Central Bank. Yields on government securities in both the primary and secondary markets increased following the increase in the Central Bank policy rates in February 2007. In the higher interest rate environment, investors showed a strong preference for short-term maturities (Treasury bills) and the market for medium-term Treasury bonds was relatively inactive. The foreign exchange market came under pressure during the year, due to the settlement of large petroleum import bills, but stabilised following the sale of Treasury bonds to foreigners and the international bond issue. The rupee, which depreciated against major currencies in the first three quarters, appreciated in the fourth quarter of 2007 and remained stable. The external reserve position



## Box 18

## The Sub-Prime Mortgage Market Crisis and Its Lessons

### The Sub-Prime Crisis

The term 'sub-prime' refers to a low credit-worthiness of the borrower. Borrowers who have problems with their credit history or are unable to prove that they have enough income to support the monthly payment on the loan for which they are applying are called subprime borrowers. Compared to prime loans, sub-prime loans or mortgages are risky for both creditors and debtors, because of the combination of high interest rates, bad credit history, and murky personal financial situations, which are often associated with such borrowers.

Due to several factors, the sub-prime mortgage market saw a rapid expansion in the last few years reaching close to US dollars 2 trillion by 2007. Rising interest rates in the US led to the bursting of the housing bubble in that country and consequential high default rates on sub-prime mortgages. Once housing prices started to drop moderately in 2006-2007 in many parts of the US, refinancing became rather difficult. The default of loans and foreclosure activity increased dramatically as interest rates of adjustable rate mortgages (ARM) were re-set higher. The increase in default rates affected not only mortgage lenders that retained credit risk, but also corporate and individual investors holding mortgage-backed securities (MBSs) or collateralised debt obligations (CDOs). They faced significant losses as the value of the underlying mortgage assets declined. Stock markets in many countries also were affected significantly. Perhaps the most severe effect was that the widespread dispersion of credit risk and the unclear impact on financial institutions caused lenders to reduce lending activity or to demand higher interest rates for credit, thus creating a liquidity and credit crunch. This tightening of liquidity conditions spread to many developed markets and even led to run on a British bank, viz, Northern Rock. This liquidity concerns compelled central banks in major economies to inject liquidity to the market on a large scale to maintain market and financial system stability.

### The Causes of the Crisis

A number of factors have together contributed to the sub-prime crisis<sup>1</sup>. The following is a summary of the main causes to which the crisis is generally attributed.

a. *Increasing delinquency rates in sub-prime mortgages:* Delinquency rates on sub-prime mortgages started to pick up in the US as early as 2005 as higher interest rates and a slowdown of house price inflation made it more difficult for some borrowers to meet their financial obligations. This was particularly true for borrowers who had taken ARM

mortgages in which the interest payments increase over time.

b. *Intense competition among lenders and low quality lending :* This led to an undue relaxation of credit standards and excessive risk taking by some lenders. There were incentives for increasing quantity rather than quality, since the lenders repacked and sold mortgages, thus removing credit risk from their balance sheets, and fee income derived from this operation depended on the volume of credit granted. Furthermore, the prolonged period of low interest rates, high liquidity and low volatility, which preceded the current crisis led to financial institutions underestimating risks, a breakdown of credit and risk management practices in many financial institutions, and shortcomings in financial regulation and supervision.

c. *Off - balance-sheet-exposure of banks :* Many banks had set up structured investment vehicles to undertake structuring of their asset securitisation and credit derivative business through off-balance-sheet transactions. Banks began to face sudden liquidity problems when the demand for liquidity from these structured investment vehicles, which had credit line arrangements with banks increased. This led to a development of a liquidity crunch in the market.

d. *Rapid development of complex financial products through asset securitisation outside the regulated entities:* The dramatic increase in securitisation activity has modified the functioning of credit markets by reducing the fundamental role of liquidity transformation performed by financial intermediaries. Thus, the role of banks and other mortgage firms changed from "originate and hold" to "originate, repackage and sell" through securitisation. This enabled them to distribute credit, market and liquidity risks associated with lending activities and securitised assets to those who are more willing to hold them. These credit derivatives, based on mortgages and other types of loans were complex and very few understood their valuations. Furthermore, the distribution of credit risk among investors created uncertainty as to who actually held the risks.

e. *Lapses of credit rating agencies :* Rating agencies have not updated their ratings of MBSs, CDOs and other credit derivatives in line with the changes in the risk profile of the underlying assets, particularly sub-prime mortgages. Hence, investors were unable to differentiate between sub-prime backed credit derivatives and other good quality asset backed credit derivatives. Consequently the panicked

<sup>1</sup> See Box Article "Turmoil in Developed Credit Markets: Causes, Resolution and the Way Forward" Financial Stability Review 2007, Central Bank of Sri Lanka, for a detailed analysis of the causes.



demand for redemption of investments by investors affected all classes of credit derivatives, aggravating the crisis.

f. *Lack of transparency in the OTC markets:* Unlike publicly traded securities and futures contracts, these collateralised debt obligations and credit derivatives are not traded on exchanges. Instead, they trade in over-the-counter (OTC) markets. In an exchange, the exchange acts as the counterparty for every sale and purchase and the trades are done in a transparent manner. However, in OTC markets, trading is bilateral between customers and dealers, and prices and volumes of trades are not disclosed. The price discovery process is not transparent, and there is no surveillance of the market to identify where there are large or vulnerable positions. Moreover, unlike exchanges, these OTC markets have no designated or otherwise institutionalised market makers or dealers to ensure liquidity. As a result, when major events send prices reeling, dealers stop acting as market makers and trading can stop abruptly.

#### Lessons to be Learned from the Crisis

The crisis has highlighted some of the weaknesses in markets, financial institutions and regulatory framework. Some of the main lessons that could be learnt are:

- *Importance of liquidity :* The crisis underlined the critical importance of liquidity in managing and regulating banks. Unlike other financial institutions, banks are vulnerable to bank runs and panics, since their liabilities are subject to withdrawal on demand. Although liquidity risks are inherent in the maturity transformation services offered by banks, banks need to pay close attention to liquidity demand arising both from on-balance-sheet maturity mismatches and off-balance-sheet exposures. Therefore, adequacy of liquidity has to be given as much importance as capital adequacy in maintaining the soundness of banks. Capital adequacy, which indicates solvency, alone would not be a sufficient condition for survival in a stressed situation. The importance of looking at “cash flows” as a loan criteria re-emerged following the crisis.
- *The need for stress testing under extreme scenarios:* Hidden and unexpected risks cannot be seen under normal financial market conditions. Risks assumed to be manageable become extreme under crisis or stressed situations.
- *Model risks:* Pricing of complex credit derivatives created through securitisation were based on valuation

models, which functioned under certain assumptions. When the assumptions in-built in such models no longer hold, it becomes difficult to price such products, leading to stoppage of a market. Therefore, in the current financial environment where sophisticated models are used in many areas such as credit risk modelling, valuation etc., identification of models as a source of risk is essential. In order to mitigate model risks measures, such as awareness building, evaluation of and understanding of assumptions, use of simple models and back testing and stress testing are essential.

- *Enhancing transparency in markets and institutions:* Supervisory and regulatory frameworks need to be updated in line with new developments and financial innovations. This applies to both crisis prevention frameworks and crisis resolution frameworks. In USA some mortgage originators were unregulated entities and were not subject to appropriate disclosure and consumer protection requirements. Supervisors and regulators in other countries have to ask whether their frameworks are adequate, for instance, the opacity in the hedge fund activities and in the OTC market also point to the need for transparency and improved disclosures.
- *Adverse incentives :* The recent developments illuminated the adverse incentives that had been allowed to develop in the distribution chain for credit products, including the strong incentives for originators to put quantity above quality, for the rating agencies to expand their scope as widely as possible, and for banks to use off-balance-sheet vehicles to finance structured credits. It may also reveal some flaws in compensation schemes in banks. In some cases these incentives arose despite regulation; in others they were the consequence of faults in the regulatory system.
- *Pro-cyclicality of risk :* The crisis showed again how measures of risk used by companies and regulators can be pro-cyclical, encouraging more risk taking at the top of the cycle and potentially exacerbating the downswing.

The sub-prime led financial turmoil has taught and continues to teach many lessons to regulators, investors, financial institutions and markets. A common line running across many of the causes of the crisis and the lessons that it brought up is the importance of transparency and disclosures relating to financial markets and institutions and the importance of integrated risk management for organisations.



improved, thereby strengthening financial system stability. The equity market was on a downward trend for most of the year and the price indices declined in 2007 for the first time since 2000. A number of factors contributed to this development, such as the rising domestic interest rates, forecasts of a moderation in company earnings, heightened security concerns and issues relating to the structure and the size of the share market.

**The banking sector maintained its profitability, soundness and resilience in 2007.** The profitability of Licensed Commercial Banks (LCBs), as indicated by the return on assets (ROA) and return on equity (ROE) ratios was sustained at a high level, as these banks were able to maintain their net interest margins by effectively re-pricing deposit and loan rates. The profitability of Licensed Specialised Banks (LSBs) however, declined slightly due to a narrowing of net interest margins. The capital funds of banks have increased and the capital adequacy ratios of the banking sector exceeded both the local and international regulatory minimum levels, thereby providing a buffer that will contribute to shielding the industry from shocks and disturbances. The overall resilience of the banking sector is expected to increase with the improved risk management and enhanced capital requirements that would come into effect with the adoption of Basel II in 2008.

**Bank risk exposures were at manageable levels.** The asset quality of banks, which has improved significantly over the past few years due to better risk management techniques, loan recovery procedures and more stringent prudential requirements, is being maintained with a decline in the non-performing loan (NPL) ratio for the banking system in 2007. The provisioning levels have also increased, indicating greater resilience. However, the rapid expansion in bank credit in the last three years and the rise in interest rates in 2007 have resulted in a slight increase in credit risk, as indicated by the rise in the volume of non-performing loans. Hence, banks should maintain high credit standards to avoid adverse developments in this area. The sectoral distribution of bank credit is fairly broad-based. However, the rapid increase in bank lending to the consumption and housing, construction and property development sectors, warrants some attention, as these sectors can be especially vulnerable to credit risks. In particular, lending on credit cards has to be monitored closely as delinquencies are above the NPL ratio average. The LCBs were able to manage market risk (both interest rate and foreign exchange risk) adequately. The loan to deposit ratio of the banking sector has been rising and banks'

exposure to liquidity risk has increased in 2007. The reliance of a few banks on the money market to finance their funding gaps may pose risks, if maturity mismatches increase and market liquidity becomes tight. Hence, banks need to improve their asset liability management to mitigate this risk. In addition, the implementation of an integrated risk management framework is imperative for the proper management of risk in the future.

**Registered finance companies (RFCs) and specialised leasing companies experienced an increased exposure to interest rate risk in 2007.** This sector accounts for 5.5 per cent of total financial assets and caters to the important category of small and medium enterprises that do not have easy access to bank finance. In the higher interest rate environment that prevailed in 2007, finance and leasing companies became more vulnerable to interest rate risk. The profitability of finance and leasing companies has become constrained due to the contraction in interest margins, as funding becomes more expensive in the higher interest rate environment. These companies are predominantly engaged in the leasing finance business, which are typically medium-term contracts at fixed interest rates. Finance companies have to mobilise funds at higher rates than banks and therefore have to charge higher interest rates from their customers, hence they have a higher risk profile than banks. In addition, leasing companies are largely dependent on banks for their funding requirement and banks are also their competitors in the leasing business. However, the recently strengthened capital positions and provisioning policies of these companies will provide a financial buffer to withstand these stresses.

**The risk levels of the two largest superannuation funds - the EPF and the ETF, remained low.** As the majority of the EPF and ETF investment portfolio is held in the form of default risk free government securities, the credit risk is negligible. The funds were also not vulnerable to liquidity risk, due to the positive inflows of funds through member contributions and investments in Treasury bills. The main risk that the EPF and ETF are exposed to is interest rate risk due to the high concentration of investments in fixed income securities. However, this risk is to a large extent mitigated, as the bulk of these assets are held in investment accounts that do not require "marking to market." The other approved private pension and provident funds also have a risk profile similar to that of the major funds.

**The soundness of insurance companies is being strengthened with the introduction of new prudential standards and a risk based supervisory framework.** Solvency rules for general insurance business came into effect from May 2007, while solvency rules for life insurance were introduced some years ago. The majority of companies were compliant with the solvency margin requirements. The Insurance Board of Sri Lanka (IBSL) has commenced risk-based supervision, in terms of the CAMELS<sup>1</sup> rating system. The capital levels of insurance companies increased during the year. In addition, the minimum equity capital for insurance companies will be increased to Rs. 250 million for each line of insurance business in 2008, which may lead to industry consolidation. The proposed amendments to the insurance law will provide the IBSL with increased powers to supervise the insurance industry effectively and should be implemented soon. The proposals also include the appointment of institutional agents, which would facilitate the entry of banks and other financial institutions into the insurance industry.

**Improvements to the financial infrastructure systems continued during the year, with business continuity planning taking a centre stage.** The LankaSettle system operated by the Central Bank and the Cheque Imaging and Truncation (CIT) system operated by LankaClear together settle 99 per cent of all non-cash payments in the country. The LankaSettle system has been functioning without major interruption and the system availability was very high at 99.8 per cent in 2007. The CIT system experienced a minor disruption during the year, but that had no impact on financial system stability. Much progress was made with respect to business continuity planning and the establishment of fully functional disaster recovery sites for the systemically important payment and settlement systems. All clearing systems settle their net obligations in the LankaSettle system, except the two clearing systems operated by the CSE for equity and debt securities. To further strengthen the stability of the payments and settlement system, it is desirable that the net obligations of these two systems also be shifted to the LankaSettle system. The National Payments Council (NPC) is implementing its medium-term road map to modernise the financial infrastructure in keeping with the latest technological developments with a focus on improving the efficiency, security and risk management. A priority will be to launch chip-based credit cards and to introduce a nation-wide next day cheque clearing facility and an electronic funds transfer system for banks and their customers.

<sup>1</sup> Capital, Assets, Reinsurance, Actuarial, Management, Earnings, Liquidity, Solvency

**The overall outlook for financial system stability remains favourable.** The growth prospects of the Sri Lankan economy are expected to strengthen the performance of the business sector and improve the profitability of financial institutions. The continuation of policies to address the domestic macroeconomic imbalances is essential to stabilise domestic financial markets. Financial regulators and institutions will need to continue their vigilance and take proactive measures to promote the development, efficiency, soundness and stability of the financial system.

### 8.3 Developments in Financial Institutions

**The activities of financial institutions continued to expand supporting the financial needs of the economy.** The total assets of financial institutions increased by 16 per cent and amounted to Rs.4,323.0 billion in 2007, which is 1.21 times the GDP. The licensed banking sector (LCBs and LSBs) accounted for 58 per cent of total financial institution assets and continued to hold the dominant position in the financial sector. The LCBs accounted for 48.6 per cent of the total financial assets, while the LSBs accounted for 9.4 per cent. The contractual savings

Table 8.2

#### Total Assets of the Major Financial Institutions

	2006 (a)		2007 (b)	
	Rs. bn	% Share of Total	Rs. bn	% Share of Total
<b>Banking Sector</b>	<b>2,635.0</b>	<b>70.6</b>	<b>3,068.5</b>	<b>71.0</b>
Central Bank	492.8	13.2	561.9	13.0
Licensed Commercial Banks (c)	1,786.9	47.9	2,100.0	48.6
Licensed Specialised Banks	355.3	9.5	406.6	9.4
<b>Other Deposit Taking Financial Institutions</b>	<b>140.9</b>	<b>3.8</b>	<b>177.1</b>	<b>4.1</b>
Registered Finance Companies	108.2	2.9	142.5	3.3
Co-operative Rural Banks	27.8	0.7	28.7	0.7
Thrift and Credit Co-op. Societies	4.9	0.1	5.9	0.1
<b>Other Specialised Financial Institutions</b>	<b>170.8</b>	<b>4.6</b>	<b>192.9</b>	<b>4.5</b>
Specialised Leasing Companies	78.0	2.1	96.0	2.2
Primary Dealers	49.9	1.3	54.2	1.3
Merchant Banks	30.5	0.8	31.4	0.7
Stock Broking Companies	5.7	0.2	3.8	0.1
Unit Trusts	5.4	0.1	6.3	0.1
Venture Capital Companies	1.3	0.0	1.1	0.0
Credit Rating Agencies	0.1	0.0	0.1	0.0
<b>Contractual Savings Institutions</b>	<b>786.8</b>	<b>21.1</b>	<b>884.6</b>	<b>20.5</b>
Insurance Companies	117.0	3.1	133.1	3.1
Employees' Provident Fund	492.1	13.2	560.0	13.0
Employees' Trust Fund	67.0	1.8	78.8	1.8
Private Provident Funds	95.8	2.6	96.2	2.2
Public Service Provident Fund	15.0	0.4	16.5	0.4
<b>Total</b>	<b>3,733.5</b>	<b>100.0</b>	<b>4,323.0</b>	<b>100.0</b>

(a) Revised

(b) Provisional

(c) Consolidated assets of both DBUs and OBUs of LCBs

Source : Central Bank of Sri Lanka



institution sector, led by the EPF accounted for 20.5 per cent of financial sector assets. Finance and leasing companies accounted for 5.5 per cent, while the insurance sector accounted for 3.1 per cent of the financial system. The Central Bank represented 13.0 per cent of the assets of the financial sector.

### The Central Bank of Sri Lanka

**Total assets of the Central Bank increased by 14.0 per cent in 2007 with an increase in foreign assets and a decline in domestic assets.** The increase in foreign assets was largely due to the purchases of foreign currency proceeds received by the government.

**Domestic assets of the Central Bank declined largely due to the decline in Treasury bill holdings.** During the year the Central Bank provided Rs.11.7 billion of provisional advances to the government. This, together with the increase in net foreign assets of the Central Bank by about Rs.63 billion largely due to the receipts of the debut international bond issue of the government, resulted in substantial excess liquidity in the market. The government retired its Treasury bill holdings with the Central Bank, worth of Rs.20 billion, using the bond proceeds and it helped to reduce part of excess liquidity in the market. Also, the Central Bank had to sterilise the excess liquidity through outright sales of the Bank's Treasury bill holdings. In addition, liquidity was absorbed through Open Market Operations (OMOs) on a daily basis. Accordingly, the Bank's Treasury bill holdings at end 2007 declined by Rs.23.5 billion to Rs. 41.8 billion. This, and the increase in other liabilities caused the decline in Net Domestic Assets (NDA) of the Central Bank by Rs.38.5 billion.

**On the liability side, the total currency issue of the Central Bank increased by 10.3 per cent (Rs.16.2 billion), compared with the 18.7 per cent (Rs.24.8 billion) growth in 2006.** The deposits of commercial banks held with the Central Bank for statutory reserve purposes increased only by 10.2 per cent (Rs. 8.4 billion) reflecting a substantial moderation compared with the 26.1 per cent growth in 2006. This was mainly a result of relatively low growth in deposits attributed to the tight monetary policy stance of the Central Bank.

**The strength of the Central Bank's balance sheet improved further during 2007,** with the increase in its general reserves as a ratio of domestic assets, which is necessary to mitigate any unforeseen risks in the future.

Table 8.3

### Distribution of Banks and Bank Branches

Category	End 2006 (a)	End 2007 (b)
<b>Licensed Commercial Banks (LCBs)</b>		
I.Total No.of LCBs	23	23
Domestic banks	11	11
Foreign banks	12	12
<b>II.Total No.of LCB Branches and Other Outlets</b>		
Branches	1,737	1,934
Domestic Bank Branches	1,675	1,758
Main Branches	1,171	1,253
Extension/Pay Offices/Service Counters	492	493
Overseas Branches	12	12
Foreign Bank Branches and Other Outlets	62	176
Branches	39	42
Other Outlets	23	134
Student Savings Units	1,800	2,269
<b>Licensed Specialised Banks (LSBs)</b>		
I. Total No. of LSBs	14	15
Regional Development Banks	6	6
National Savings Bank	1	2
Long-term Lending Institutions	3	3
Housing Finance Institutions	2	2
Private Savings and Development Banks	2	2
<b>II. Total No. of LSB Branches and Other Outlets</b>		
Branches	379	402
Regional Development Banks	204	215
National Savings Bank	114	115
Long-term Lending Institutions	11	13
Housing Finance Institutions	28	28
Private Savings and Development Banks	22	31
Other outlets	34	47
Student Savings Units	178	178
Total No. of Bank Branches and Other Outlets	4,128	4,830
Total No. of Automated Teller Machines (ATMs)	1,155	1,422
Total No. of Electronic Fund Transfer Facilities at the Point of Sale Machines (EFTPOS)	8,753	12,214
<b>Banking Density:</b>		
No. of LCB Branches per 100,000 Persons	8.7	9.7
(a) Revised	Source : Central Bank of Sri Lanka	
(b) Provisional		

### Licensed Commercial Banks (LCBs)

**Supported by continued economic expansion, the activities of LCBs improved further in 2007 as reflected by the growth of assets, expansion in distribution channels, improvement in risk management, risk absorption capacity, and innovations.** There were 23 LCBs by end 2007, operating through a network of 1,934 branches, and 2,269 other service outlets. Complementing this network, and reflecting the gradual shift towards card-based payment modes, there were 1,422 ATMs, 12,214 electronic fund transfer facilities at the point of sale (EFTPOS) machines, and 16 fully fledged Internet banking portals. With the increase in per capita income and increased competition, the total number of active credit cards increased from 811,289 at end 2006 to 889,780 at end 2007. In the face of increased competition, many banks introduced IT based innovative services such as banking through mobile



**Box 19****Corporate Governance in Banks****1. What is corporate governance?**

Corporate governance involves a set of relationships between a company's management, its Board, its shareholders and other stakeholders. It also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance, are determined.<sup>1</sup> Accordingly, the implementation of corporate governance principles ensures that companies are managed prudently and in a transparent way and that directors are held responsible and accountable for the business operations of the companies.

**2. The special need for corporate governance in banks**

Corporate governance has attracted a good deal of public interest because of its perceived importance for the economic health of an organisation. It has gained a higher level of importance following the massive corporate scandals and failures in the early 2000s, which rocked the business world, such as Enron and WorldCom. Subsequently, many organisations, regulators and supervisors around the world have developed and implemented a number of corporate governance codes.

It is generally accepted that banks unlike other firms have a special significance in a modern economy for a number of reasons. First, banks are the dominant component of the financial system and failures of banks will affect functions such as savings, investment and payment services in a country, which are essential for the smooth performance of an economy. Banking crises have been found to impose an enormous costs on an economy in terms of output cost and fiscal cost of restructuring failed financial institutions. Second, the banking system has the ability to create money through its business and this created money is the larger component of the money supply available for financing economic transactions. Therefore, failures of banks will adversely affect the monetary conditions and the economic well-being of the public.

There are two further related reasons why corporate governance takes on an added significance in relation to banks. First, there is a moral hazard issue with regard to operation of banks, because banks deal with depositors' funds, i.e., banks use money that is primarily borrowed from depositors. The shareholders' funds in a bank are minimal when compared to depositors' funds, making banks highly leveraged organisations. However, the shareholders get high returns from banks for their minimal

investment. If a bank were to fail, it would result in a far greater monetary loss to the depositors than to the shareholders. Therefore, it is vital that the interests of the depositors are protected. In this context, the importance of corporate governance in banks extends beyond the usual scope applicable to other companies, as the boards and management of banks have a duty to take care of the interest of the depositors who are non-shareholding stakeholders of the banks.

Second, in a banking institution, public/customer confidence is vital for the very existence of the business. The conduct of directors is an important aspect that contributes towards maintaining the confidence of the public in banks. Any loss of confidence in a bank may cause a run on that bank which would not only affect that bank, but could have a ripple effect and affect other banks as well, leading to instability in the financial system. Therefore, the development of a code of conduct for the directors and the management is an important ingredient towards protecting the economic health of banks and the financial system stability in general.

**3. Directions on corporate governance for licensed banks**

The Central Bank of Sri Lanka has a statutory responsibility to ensure price and economic stability and financial system stability. Hence, it uses the regulatory and supervisory authority entrusted to it by the Monetary Law Act and Banking Act to ensure the soundness and the stability of the banking system, which is a prerequisite for the financial system stability. Supervision focuses on promoting and ensuring that banks have proper systems, controls and procedures for the prudent management of risks inherent in their business. However, the moral hazard problem arising from the regulatory and supervisory role of the Central Bank, i.e., the tendency of bank customers and bank managers to take more risks than would be taken in the absence of the Central Bank, needs to be managed. The Central Bank cannot be the risk manager of banks, because it cannot step into the shoes of bank managers to conduct the banking business. Therefore, the boards of directors should have the primary responsibility and accountability for risk management of banks morally and statutorily because of the significance of the business of banks.

In this context, the Central Bank introduced a voluntary code of corporate governance which was formulated by a task force appointed from the banking industry in June 2002. In February 2006, the Basel Committee on Banking Supervision also issued an eight principles based system

<sup>1</sup> Organisation for Economic Co-operation and Development (OECD) Principles of Corporate Governance.



to enhance corporate governance for banking organizations. In view of the weaknesses inherent in a voluntary code and the global developments in corporate governance, the Central Bank announced in its “Road Map: Monetary and Financial Sector Policies for 2007 and Beyond” issued in January 2007 that mandatory corporate governance rules would be introduced in 2007. Accordingly, a draft code was issued in August 2007 to canvass views of the public and the banking community. Based on the feedback received, a revised draft was issued in November 2007 for further comments from the relevant parties. Incorporating views and suggestions received, a Direction on Corporate Governance was issued in December 2007, to be effective from January 2008.

These Directions have been developed on the basis of the fundamental principles of corporate governance. The main aspects covered are the broad responsibilities of the board of directors, board’s composition, criteria to assess

the fitness and propriety of directors, management functions delegated by the board, separation of duties of the Chairman and Chief Executive Officer, board appointed committees in relation to integrated risk management, audit, nomination, human resource and remuneration, related-party transactions and disclosure of financial statements.

In Sri Lanka, since the banking institutions control nearly 70 per cent of the financial system, it is important that the safety and soundness of these institutions are maintained to ensure financial system stability. In the circumstances, the Direction on Corporate Governance will ensure common standards of behaviour amongst all banking institutions, enhance public confidence and contribute towards strengthening the stability of banking institutions, thereby contributing towards maintaining financial system stability.

phones to improve efficiency in accessing new markets and maintaining existing market shares.

**The supervisory framework relating to LCBs was further strengthened with the introduction of new directions and a shift from compliance based supervision to risk based supervision during the year.** Several directions were issued during the year covering share ownership in banks, maximum amount of accommodation, corporate governance, Basel II and new capital instruments. These prudential measures are expected to improve soundness of banks through enhanced risk management, reduced conflicts of interests and improved corporate governance in

banks. In preparation for the adoption of new regulations, the Central Bank together with the banking industry, took measures to improve capacity building in the banks.

**Developments in the Structure of LCBs: The growth of total assets decelerated to 17.5 per cent compared to 22.3 per cent recorded in 2006 mainly on account of lower growth in loans and advances in 2007 induced by tight monetary policy and enhanced prudential requirements.** The total assets stood at Rs. 2,100 billion at end 2007. Within the banking sector, the domestic private banks recorded an 18.4 per cent growth of assets while the state owned

Chapter 8.1

Sources and Uses of Funds of Licensed Commercial Banks (as at end 2007)

Chart 8.1.1

Sources of Funds of Commercial Banks

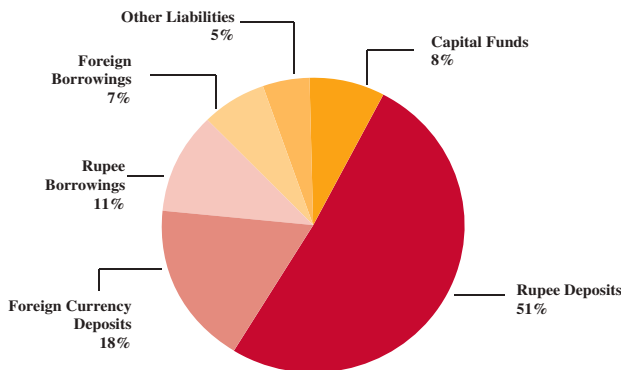


Chart 8.1.2

Uses of Funds of Commercial Banks

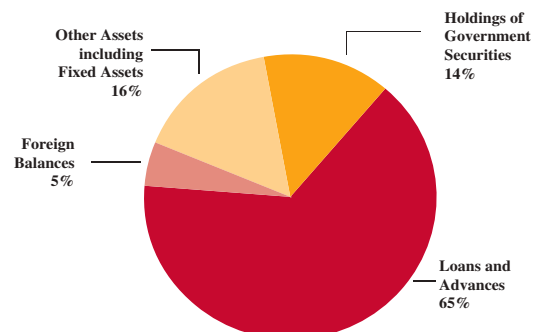


Table 8.4

## Assets and Liabilities of Licensed Commercial Banks (a)

Item	End 2006	End 2007 (b)	Rs.million	
			Change	
			2006/2007	
			Amount	%
<b>Assets</b>				
Liquid Assets	536,329	610,750	74,421	13.9
Cash in Hand	24,073	29,547	5,475	22.7
Due from Central Bank	88,424	95,036	6,612	7.5
Treasury Bills	61,143	89,408	28,265	46.2
Treasury Bonds	130,938	132,666	1,728	1.3
Other Assets	231,750	264,092	32,342	14.0
Loans and Advances (Net of Interest in Suspense)	1,151,160	1,365,236	214,076	18.6
Less: Provisions	46,440	49,206	2,766	6.0
Net Loans and Advances	1,104,720	1,316,030	211,310	19.1
Fixed and other Assets	145,900	173,248	27,348	18.7
<b>Liabilities</b>				
Capital Funds	129,744	162,491	32,747	25.2
<b>Total Deposits</b>	<b>1,235,537</b>	<b>1,450,095</b>	<b>214,558</b>	<b>17.4</b>
Demand Deposits	183,074	173,333	-9,741	-5.3
Time & Savings Deposits	993,021	1,204,879	211,859	21.3
Others	59,442	71,883	12,441	20.9
<b>Borrowings</b>	<b>338,013</b>	<b>372,721</b>	<b>34,708</b>	<b>10.3</b>
Local Borrowings	215,295	231,765	16,470	7.6
Foreign Borrowings	122,719	140,956	1,8237	14.9
<b>Other Liabilities</b>	<b>83,654</b>	<b>114,721</b>	<b>31,066</b>	<b>37.1</b>
<b>Total Assets/Liabilities</b>	<b>1,786,949</b>	<b>2,100,028</b>	<b>313,079</b>	<b>17.5</b>

(a) This table has been revised to be consistent with data collected for regulatory purposes  
 (b) Provisional

Source: Central Bank of Sri Lanka.

banks showed an asset growth of 15.2 per cent. The contribution of domestic private banks and state banks to the total growth in assets was 47 per cent and 35 per cent, respectively. Meanwhile, assets of foreign banks grew at a relatively higher rate of about 21.3 per cent supported by the increase in capital funds. The loans and advances grew by 18.6 per cent in 2007 as opposed to 27.6 per cent in 2006. As a result, the contribution of loans and advances to the growth in assets declined from about 80 per cent in 2006 to 68 per cent in 2007. The introduction of the provisioning on performing loans also helped to moderate expansion in loans and advances.

**Despite the deceleration, the still high growth in loans and advances was mainly driven by expansion in the credit portfolios of state banks and domestic private banks.** Total increase in loans and advances amounted to Rs. 214 billion in 2007 compared to Rs. 249 billion recorded in 2006. State banks and domestic private banks contributed 40 per cent and 45 per cent, respectively, to the overall growth of 18.6 per cent in loans and advances. However, in terms of annual growth, foreign banks recorded the highest growth rate in loans and advances of 21.3 per cent, followed by domestic private banks with a growth rate of 18.6 per cent.

**Widening of net interest margins in an environment of rising interest rates, the improvement in operational efficiencies and recovery of non performing loans enabled LCBs to record a robust growth in profits.** Accordingly, profits before tax increased by 27 per cent to Rs.38 billion in 2007 compared to 32 per cent growth in 2006. Domestic private banks contributed to 54 per cent of the growth in profit of the sector. The profitability in terms of ROA and ROE improved over the previous year and stood at 1.9 per cent and 16.0 per cent, respectively, at end 2007.

**Sources and Uses of Funds of LCBs:** The increasing trend of borrowing witnessed in 2006 as a funding source reversed in 2007 though borrowings still accounted for 17.7 per cent of total funding. The share of deposits in the total funding structure remained unchanged at about 69 per cent. Reflecting higher disposable income of households and credit creation, the total deposits grew by 17.4 per cent to Rs.1,450 billion. On account of the higher opportunity cost of money in a rising interest rate environment, non-interest bearing rupee demand deposits declined by 5 per cent while rupee fixed deposits and savings deposits grew at higher rates of 38 per cent and 7 per cent, respectively, in 2007. The foreign currency



Table 8.5

## Credit Card Operations by Licensed Commercial Banks

	2006 (a)	2007 (b)	% Change
Total Number of Credit Cards issued	811,289	889,780	9.7
Local (accepted only locally)	61,982	57,104	-7.9
Global (accepted globally)	749,307	832,676	11.1
Outstanding Credit at Year End (Rs.Mn)	21,125	28,847	36.6
Local (accepted only locally)	709	754	6.3
Global (accepted globally)	20,416	28,093	37.6
Overdues (as a % of Outstanding Credit)	6.84	7.05	
Pastdues (as a % of Outstanding Credit)	5.24	7.16	
Commission from Dealers (%)	1.5-4.0	1.5-4.0	

(a) Revised  
(b) Provisional

Source: Central Bank of Sri Lanka

deposits, which grew by 20 per cent during the year, accounted for about 26 per cent of the deposit base of the LCBs.

**The share of capital funds in the total resource base recorded an increase from 7.3 per cent in 2006 to 7.7 per cent in 2007.** This was mainly due to the infusion of fresh capital by banks through share issues and retained profits. Meanwhile, the contribution from deposits, which is the largest funding source, remained unchanged at 69 per cent. However, borrowings declined from 19.0 per cent to 17.7 per cent between the two periods.

**Loans and overdrafts continued to absorb a dominant share of resources mobilised during the year.** Increase in loans and overdrafts absorbed Rs.214.1 billion, representing 68 per cent of the total resources mobilised during the year. Meanwhile, the share on investments was 16 per cent in 2007. In comparison, loans and advances and investment contributed about 65 per cent and 14 per cent to the total utilisation of funds in 2007.

**According to the purpose-wise distribution of private sector credit, credit granted for trading, housing and consumption purposes continued to account for a dominant share.** The share of credit for trading activities including domestic and international trade increased to 30.6 per cent by end 2007. Meanwhile, the share of credit absorbed by housing and construction decreased to 16.6 per cent while that of consumption activities increased to 20.6 per cent by end 2007. In the consumption category, loans granted for purchase of consumer goods accounted for the bulk of the increase while in the credit for housing activities, the residential housing sector contributed to the largest share. Trading, housing and consumption activities accounted for about 68 per cent of the total credit outstanding.

**Reflecting the impact of the tight monetary policy stance and higher non-performing ratios, the growth in credit card business decelerated in 2007.** Credit provided through credit cards by 10 banks increased by 37 per cent to Rs. 29 billion in comparison to 41 per cent growth recorded in 2006. The share of credit card loans in the total loan portfolio of LCBs increased marginally from 1.7 per cent to 2.1 per cent in 2007 due to loans and advances growing at a relatively lower rate. Due to the unsecured nature of such lending, an interest rate in the range of 38-40 per cent was being charged on credit card loans.

**The overall exposure of commercial banks to the public sector increased** as a result of an increased utilisation of bank credit by both the government and public corporations.

**Key Performance Indicators:** The main financial soundness indicators of LCBs improved providing greater risk absorption capacity. Profitability in terms of ROA and ROE improved mainly due to increases in net interest margin and operational cost efficiencies. Reflecting an improvement in cost efficiencies in the LCB sector, the operating cost ratio improved to 56.4 per cent in 2007 from 59 per cent in 2006. The capital adequacy ratio stood at about 13.0 per cent relative to the minimum requirement of 10 per cent. Credit quality of LCBs improved as reflected in the decline in NPLs from 5.5 per cent at end 2006 to 4.9 per cent at end 2007. This improvement was a net result of an expansion in lending portfolios, strong recoveries and some banks writing off bad debts. Providing a greater cushion for absorption of credit losses, provision coverage available for NPLs increased to 74 per cent in 2007. The net NPL to capital ratio declined from 13.0 per cent in 2006 to 10.5 per cent at end 2007 due to relatively faster growth in capital. The liquid asset ratio stood at 24.8 per cent as against the minimum requirement of 20 per cent.

**Improving the efficiency of the State Banks : Implementation of the strategic plans formulated by the state banks under the guidance of the Strategic Enterprise Management Agency (SEMA) to improve the efficiency, made progress in 2007.** Improvements were recorded in the areas of branch automation, capital adequacy, management information systems, loan recoveries and human resource development during the year. The capital adequacy ratio, NPL ratio and provision coverage ratio improved providing greater resilience.



## Licensed Specialised Banks (LSBs)

Despite lower profits, LSBs remained resilient in terms of main prudential indicators. Total assets grew by 14.4 per cent, while profit before tax declined by 1.4 per cent to Rs.6.1 billion in 2007. The capital adequacy ratio stood at 19.4 per cent compared to the minimum requirement of 10 per cent. Total deposits and borrowings increased by 11.5 per cent and 22 per cent, respectively. The total number of LSBs increased to 15 by end 2007 with the entry of Sri Lanka Savings Bank, which took over the business operations of Pramuka Savings and Development Bank whose management affairs was vested with the Director of Bank Supervision of the Central Bank following the suspension of its business in October 2002. The branch network of LSBs increased to 402 at end 2007.

The housing, industrial and financial sectors continued to absorb a dominant share of the loans of LSBs. Of the loans approved during the year, Rs.45.6 billion or 67 per cent was accounted for by these three sectors. Due to the existence of banks catering mainly to the housing sector, a substantial portion of the lending of LSBs is concentrated in the housing sector. Despite a decrease, investments mainly in the form of government securities still accounted for about 50 per cent of the total assets in comparison to the 17 per cent share in LCBs. The total outstanding loans and deposits of LSBs at end 2007 were Rs. 166 billion and Rs. 286 billion, respectively.

Table 8.6		Sectoral Distribution of Loans Approved by Licensed Specialised Banks (a)			
		Rs million			
	2006 (b)	% Share of Total	2007 (c)	% Share of Total	
<b>Total Loans Approved</b>					
<b>During the year</b>	<b>51,715</b>	<b>100.0</b>	<b>68,367</b>	<b>100.0</b>	
Agriculture	1,101	2.1	3,532	5.2	
Industry	4,548	8.8	16,728	24.5	
Tourism	777	1.5	274	0.4	
Commercial	5,907	11.4	5,584	8.2	
Financial	13,877	26.8	11,653	17.0	
Housing	15,239	29.5	17,378	25.4	
Redemption of Debt	243	0.5	1,318	1.9	
Other Loans	10,023	19.4	11,899	17.4	
<b>Loans Disbursed (d)</b>	<b>69,564</b>		<b>59,766</b>		
Total Loans Disbursed as a Percentage of Total Loans Approved	135		87		

Source : Central Bank of Sri Lanka

(a) Excludes Regional Development Banks  
 (b) Revised  
 (c) Provisional  
 (d) Includes loans approved in previous years but disbursed during the period under review.

## Registered Finance Companies (RFCs)

RFCs expanded further during 2007 although at a slower pace than in 2006. Total assets of RFCs grew by 31 per cent to Rs. 142 billion. An expansion in financial accommodations, in particular leasing and hire purchase facilities, which represent 50 per cent of total assets of RFCs, largely contributed to the growth. The deposit liabilities of RFCs accounted for 4.2 per cent of the total deposit liabilities of major deposit-taking institutions regulated by the Central Bank as at end 2007.

Credit granted by RFCs grew by 33 per cent in 2007. Leasing facilities, which accounted for 33 per cent of total credit, recorded a lower growth rate of 16 per cent while hire purchase facilities, which account for 33 per cent of total credit, recorded a growth of 40 per cent. The imposition of a ceiling on the claimable input Value Added Tax (VAT) led the RFCs to focus more on hire purchase facilities where rentals are not subject to VAT. Loans granted for real estate activities accounted for 9 per cent of total credit in 2007. Facilities under pawning showed a 58 per cent growth to increase its share of total assets to 3 per cent.

Deposits accounted for 55 per cent of total resources of RFCs and continued to be the major funding source. Total deposit liabilities increased by 33 per cent during 2007. The other two major funding sources, bank borrowings and capital funds, accounted for 14 per cent and 15 per cent, respectively of total resources.

The profitability of the RFCs declined in 2007. When compared to the previous year, before tax net profit of RFCs decreased by 5 per cent. During 2007 interest income increased by 43 per cent while interest expenses increased by 59 per cent. As a result, net interest income rose only by 20 per cent. Although the proportion of operating expenses, including provisions for bad and doubtful debts, to total expenses decreased from 43 per cent recorded in 2006 to 40 per cent in 2007, net profit before tax of Rs. 2.7 billion reported for the period ended 31 December 2006 had decreased to Rs. 2.6 billion for the period ended 31 December 2007. This can be attributed to the fact that the lending rates of RFCs did not adjust as swiftly as their cost of funds to the rise in interest rates in the economy during 2007.

## Other Financial Institutions

**Primary Dealers (PDs):** The activities of Primary Dealers, which began a recovery process in the previous year, consolidated its performance in 2007. The total income and profits of the PD industry

increased markedly during the year. The PDs engaged in significant portfolio restructuring, reflecting investor preference towards shorter maturities in the increasing interest rate environment experienced in the government securities market. Net profit before tax of the industry rose by 86 per cent to Rs. 1 billion in 2007. Consequently, the ROE increased to 18.4 per cent in 2007 from 11.2 per cent in 2006. The risk weighted capital adequacy ratio for the PD industry was 35 per cent in 2007, which was far above the minimum regulatory requirement of 8 per cent.

#### PDs need to diversify activities to mitigate risk.

PDs are currently exposed to business concentration risk as they engage exclusively in the government securities market. In terms of the diversification proposals approved by the Central Bank, PDs will be able to increase the range of services offered, in two stages. Under the first stage, PDs will be allowed to engage in fee based services such as portfolio management, project appraisal, loan syndication services, brokering in corporate bonds/debentures both quoted/unquoted and to invest in ordinary shares or debentures of their own group of companies, subject to some limits. In the second stage, which will be introduced after six months from the implementation of stage one, PDs will be allowed to maintain investments in other quoted shares/debentures or bonds and commercial papers and they will be allowed to form mutual funds/unit trusts and invest in mutual funds/unit trusts. Further, PDs will be allowed to carry out their activities by borrowing through debt instruments. At present, the amendments to the laws are being effected and the new business plan will be launched in 2008. Initiatives are also being taken to launch a new online PD data reporting system to the Central Bank, which is expected to be implemented in the first half of 2008.

**Stress tests, which assess the resilience of the PD portfolio to a change in interest rates, revealed that there is no imminent threat to the stability of the PD system.** The outcome of stress testing, which measured the impact on the value of the portfolio and the capital base of PDs of an upward movement of interest rates by 100 bps, indicated that the PDs would lose Rs. 171 million of their portfolio value or 2.85 per cent of their capital base, as at end 2007.

**Specialised Leasing Companies (SLCs):** At end 2007, total assets of SLCs increased to Rs. 96 billion or by 23 per cent. Net profits increased by 17 per cent, which was a deceleration compared with the previous year. During the year three SLCs were

Table 8.7

### Specialised Leasing Companies Sectoral Classification of Leasing Facilities

Sector	Rs million	
	During 2006(a)	During 2007(b)
Agriculture	1,603	1,351
Industry	1,918	1,523
Trade	6,982	5,409
Transportation	4,397	4,118
Construction	1,117	886
Services	8,952	6,833
Others	4,387	3,524
<b>Total</b>	<b>29,356</b>	<b>23,644</b>

(a) Revised

(b) Provisional

Source : Central Bank of Sri Lanka

registered as RFCs while three new companies were registered as SLCs. Accordingly, at end 2007 the total number of SLCs remained at 20 as in the previous year. SLCs depend mainly on bank borrowings and as almost all the banks engage in the finance leasing business, SLCs find it difficult to borrow from banks at competitive rates. This leads them to raise funds through the issue of debt instruments. The Central Bank, taking into consideration the implications in mobilising funds from the public, issued a direction stipulating requirements to be fulfilled by SLCs in raising funds through the issues of debt instruments.

**Unit Trusts: The unit trust industry expanded due to the entry of a new close-ended income fund in 2007.** The total assets of the unit trust industry increased by 17 per cent to Rs. 6.3 billion in 2007. There were 5 institutions managing a total of 14 funds in 2007. Of these funds, 6 were income funds, 4 were growth funds and 4 were balanced funds. Although equities were still the main instrument of investment in unit trusts, the share declined to 65 per cent, while the share of private debt securities increased to 26 per cent. The total number of unit holders declined marginally to 23,191 while the total number of units in issue increased to 470 million, indicating an increase in the concentration in ownership.

**Merchant Banks: The operations of merchant banks were sustained due to an increase in fund-based activities during the year.** The asset base of merchant banks has increased by about 3 per cent in 2007. Leasing, hire-purchase and lending activities were the main business lines during the year due to limited opportunities in the equity market. There were 9 merchant banks in operation in 2007.

## Venture Capital Companies (VCC):

### The activities of VCC slackened during the year.

The primary business of VCC is to provide equity capital for high risk investments, mainly new ventures launched by entrepreneurs. The VCCs faced liquidity problems due to higher provisions for bad debts, delays in the recovery of returns and the lack of new investments. The higher rates in the government securities market also made investment in VCC less attractive. In order to sustain their business, VCC continued to focus on investments in healthcare, energy and the real estate sector.

## Contractual Savings Institutions

**Superannuation Funds:** The total assets of all funds, i.e., the EPF, ETF, the Public Sector Provident Fund (PSPF), the Contributory Pension Fund (CPF) and Private Provident Funds (PPFs) grew by 12 per cent to Rs. 751.5 billion in 2007, which represented 17 per cent of financial system assets at the end of 2007. The EPF accounts for about 75 per cent of the sector.

**The EPF, the major retirement benefit fund in the country, expanded with an increase in investment income and net contributions.** The EPF is administered by the Commissioner of Labour while the responsibility for the management of funds is with the Monetary Board of Central Bank.

**The ETF, the employer contributory retirement benefit scheme in the country, also recorded an increase in its asset base, with higher net contributions and investment income.** The ETF, which is managed by a board of trustees, has about 7.9 million accounts, of which 1.9 million are active accounts. Total investments stood at Rs. 74 billion at

the end of 2007, an increase of 16 per cent, and was heavily concentrated in government securities.

## Insurance Companies

**The insurance industry recorded solid growth in terms of premia and assets in 2007.** The insurance sector accounts for about 3.1 per cent of the total assets of the financial system. As insurance coverage is estimated to be less than 10 per cent of the population, there is considerable scope for growth in the industry. The insurance sector consists of 15 companies, of which 11 firms are both life and general insurers, while 3 firms are general insurers and 1 firm is a life insurer. Five firms have collaborations with foreign insurance companies. The insurance industry is highly concentrated, with two firms accounting for about 70 per cent of the total assets of the industry while the largest five firms accounting for 95 per cent of total insurance assets. The total assets of insurance companies grew by 14 per cent in 2007. General insurance premia rose by 23 per cent while life insurance premia increased by 21 per cent during the year. The overall profitability of the industry is expected to be sustained at a level similar to the previous year.

### Soundness of insurance companies improved.

The solvency margin is the main indicator to measure the soundness of insurance companies. New solvency margin requirements for the general insurance business came into effect in 2007. All insurance companies were compliant with the solvency margin requirement for general insurance, except for two companies, which were marginally below the requirement. All life insurers met the solvency ratio. The capital levels of insurance companies also increased during the year. Four insurance companies have obtained ratings on their claim paying ability from a local rating agency in 2007.

**The regulatory framework of the insurance sector is being strengthened.** The insurance regulator, the IIBSL has initiated action to conduct risk based supervision of insurance companies based on the CAMELS rating system. To improve the financial strength and soundness of insurance companies and to promote the consolidation of the industry, the IBSL also proposes to increase the minimum equity capital of insurance companies from the current level of Rs. 200 million to Rs. 250 million for each type of insurance business in 2008.

**Amendments to the insurance law are being finalised.** The legal framework relating to prudential regulation and supervision will be upgraded with the proposed revisions of the Regulation of Insurance Industry Act. The powers of the IBSL with respect to



Table 8.8	Key Indicators of Major Superannuation Funds			
	EPF		ETF	
	2006	2007	2006	2007
Number of Accounts (mn)	11.3	11.8	7.9	7.9
o/w: Active Accounts (%)	18.3	17.8	24.1	24.1
Number of Employers contributing	57,996	60,496	50,509	54,904
Total Contributions (Rs. bn)	34.9	40.6	6.1	7.3
Total Refunds (Rs. bn)	17.4	21.8	3.4	4.1
Total Outstanding Balance of				
Member Accounts (Rs.bn)	477.6	546.4	65.7	75.9
Total Assets (Rs. bn)	490.4	560.0	67.0	78.8
Total Investment Portfolio (Rs. bn)	471.8	535.0	63.7	73.6
o/w: Government securities (%)	96.9	96.0	92.3	90.5
Gross Income (Rs. bn)	46.4	59.0	6.5	8.1
Interest Rate Paid for Member Accounts (%)	10.1	10.8	10.0	10.3

Source: Central Bank of Sri Lanka

Table 8.9

### Money Market Operations 2005 - 2007

		Rs.million				
		Call Money Market		Primary Treasury Bill Market		
		Total Lending/ Borrowings	Amount Issued	Amount Purchased		
				Central Bank	Primary Dealers	Others
2005	1st Qtr	310,678	98,810	29,923	64,279	4,608
	2nd Qtr	230,345	108,231	27,943	72,365	7,923
	3rd Qtr	283,380	147,252	35,209	103,162	8,881
	4th Qtr	232,835	131,476	14,834	103,719	12,921
2006	1st Qtr	311,359	147,481	16,796	117,443	13,242
	2nd Qtr	453,677	144,412	28,731	101,630	14,051
	3rd Qtr	455,027	152,254	47,755	88,144	16,355
	4th Qtr	609,438	183,719	71,581	89,785	22,353
2007	1st Qtr	499,650	141,804	35,051	89,069	17,684
	2nd Qtr	419,730	239,165	78,726	98,530	61,909
	3rd Qtr	504,036	212,007	68,138	94,253	49,616
	4th Qtr	497,833	224,212	40,946	106,606	76,660

Source: Central Bank of Sri Lanka

the stipulation of capital requirements, making rules and determinations, and enforcement will be strengthened. The "fit and proper" test for directors of insurance companies and brokers and the registration of loss adjusters will be a requirement. The appointment of institutional agents will be introduced. The other important changes will be the requirement that life and non-life companies be separately incorporated within a period of three years and the listing of insurance companies on the stock exchange within a year.

## 8.4 Developments in Financial Markets

### Inter-bank Call Money Market

The daily average volume of inter-bank call money transactions, which was about Rs. 10 billion during the fourth quarter of 2006, declined to about Rs. 8 billion during the year 2007. This decline is identified as being due to the liquidity surplus in the banking system and the non-concentration of excess liquidity in a few banks, during the period.

On average, money market rates continued to be stable at around 14-15 per cent during 2007. However, significantly larger movements were observed on the days when the market was short of liquidity. The continuous reliance of a few banks on the call market to fund their requirements was a concern as it resulted in volatility in the money market rates, particularly when the market was short of liquidity. This could be a potential risk to the stability of not only these institutions but also the market as a whole, hence prudent liquidity management by these institutions is required.

## Domestic Foreign Exchange Market

Sri Lanka continued to follow a floating exchange rate regime during 2007. In order to smoothen out excessive volatility in exchange rate, the Central Bank intervened in the foreign exchange market during the year. The market was more stable in 2007 following the sales of Treasury bonds to foreign investors and the inflow from the international bond issue of US dollars 500 million. The volumes in the inter-bank foreign exchange market decreased slightly during 2007 to US dollars 9,275 million against US dollars 10,792 million in 2006. The daily average volume of inter-bank transactions in 2007 was US dollars 38 million against US dollars 44 million in the previous year.

## Government Securities Market

**Rupee Denominated Debt:** The government continued to mobilise funds through rupee denominated instruments, namely Treasury bonds, Treasury bills and Rupee Loans, to finance a part of its budgetary requirements. Accordingly, through the auction system, the government issued Treasury bills amounting to Rs. 817 billion in gross face value terms, an increase of Rs.189 billion over 2006. Of the total gross issues, 67 per cent had maturities less than or equal to 91 days. In net terms, there were new issues worth Rs. 49 billion. In view of the rising interest rate environment and the future inflation expectations, the bids received at these auctions reflected a market preference towards short- term maturities.

Under the Treasury bond programme in 2007, the total funds raised through bond issues amounted to Rs. 401 billion in face value terms, of which Rs. 18 billion was issued through auctions and the balance Rs. 383 billion raised through direct placements. The government securities market was further liberalised in 2007 by increasing the maximum limit of rupee denominated Treasury bonds available for foreign investors to 10 per cent of the outstanding bond stock, from the initially allowed maximum of 5 per cent. Compared to the previous year, there was a significant reduction in raising funds through auctions as yield rates of the bids received at the majority of the auctions were unacceptably higher than the current market rates. In addition, the government raised Rs.23 billion by issuing non-tradable Rupee Loans.



### Yield rates in the government securities market showed an increasing trend throughout the year.

The upward movement in secondary market yields were in line with primary market rates. Yield rates, which were in the region of 13 per cent at the beginning of the year, rose markedly to about 19 per cent at the end of the year. Treasury bill yields increased by 854, 721 and 700 basis points for 91, 182 and 364 day maturities, respectively, between December 2006 and December 2007, while yields for Treasury bonds with a maturity period of 2-3 years increased in the range of 258-383 basis points during the same period.

**US dollar Denominated Debt: Sri Lanka Development Bonds (SLDBs) with a maturity of two years were issued in 2007.** The auction was oversubscribed and a total of US dollars 215 million was raised at the rate of six month LIBOR plus a margin of 155 basis points. In addition, US dollars 106 million was raised through OBU borrowings in 2007. A foreign commercial borrowing amounting to US dollars 210 million through a syndicated loan was obtained in 2007 with a tenor of 3 years at the rate of three month LIBOR plus a margin of 155 basis points. Sri Lanka's debut sovereign international bond issue helped to ease the pressure in the domestic debt securities market.

### Corporate Debt Securities Market

**Commercial Paper: The level of activity in the Commercial Paper (CP) market increased substantially during 2007 reflecting the increasing short-term lending rates of commercial banks.** The total value of CP issues, including reissues supported

by banks, was Rs. 31.2 billion in 2007 in comparison with Rs. 23.5 billion in 2006. The interest rates on CPs ranged between 12 per cent to 25 per cent in 2007 compared with 8.5 per cent to 17 per cent in 2006. The higher short-term interest rates for traditional bank lending that prevailed during the year provided an impetus to firms to raise funds through the CP market. The CP market is heavily concentrated (91.7 per cent) in the less than three-month maturity, with CPs of six months duration accounting for 7.9 per cent. The twelve months duration of CPs accounted for the balance 0.4 per cent. The total outstanding value of CPs amounted Rs.4.4 billion at end of 2007.

**Corporate Bonds: Banks played a key role in the fund-raising through the corporate bond market.** Banks were the main issuers of corporate bonds i.e., debentures in the medium and long-term market. During the year, seven banks mobilised funds amounting to Rs.8.2 billion through debentures, compared to Rs.2.3 billion raised in 2006. The funds were mainly for the purpose of meeting the capital adequacy requirements of banks and for business expansion. Debentures carrying both fixed and flexible interest rates were issued. The interest rates on debentures varied between 13.5 per cent to 17.5 per cent. The turnover of corporate bonds listed on the Debt Trading System of the CSE amounted to only Rs. 99 million in 2007 compared to Rs. 405 million in 2006.

### Share Market

**Prices and trading on the Colombo Stock Exchange (CSE) experienced increased volatility during 2007.** The share market reached record levels in the first two months of the year with strong interest by local investors, particularly in the telecommunications sector, but moved downwards thereafter due to a combination of factors such as heightened security concerns, rising interest rates, which attracted investors to government securities and fixed deposits, forecasts of a moderation in company profit growth and the initial impact of the introduction of rules on margin trading by the SEC. In addition, the small size of the CSE in terms of market capitalisation and the public float of shares affected market liquidity and contributed to the volatility in prices.

**Key market indicators of the CSE declined.** The All Share Price Index (ASPI) and the Milanka Price Index (MPI), which rose to their highest levels in February, declined by 7 per cent and 11 per cent for the year 2007, compared to an increase of 42 per cent and 51 per cent, respectively, in 2006. The market price earnings ratio declined from 14 per cent in 2006 to 11.6 per cent in 2007.



Table 8.10

## Share Market Performance

Item	2006	2007
All Share Price Index (a)	2,722.4	2,541.0
Year-on-year change (%)	41.6	-6.7
Milanka Price Index (a)	3,711.8	3,291.9
Year-on-year change (%)	51.4	-11.3
Market Capitalisation (Rs.bn.)(a)	835	821
As a percentage of GDP (%)	30.0	23.0
Market Price Earnings Ratio (a)	14.0	11.6
Turnover to Market Capitalisation (%)	12.6	12.8
Value of Shares Traded (Rs.mn.)	105,154	104,985
Number of Shares Traded (mn.)	3,912	2,952
Number of Companies Traded	232	231
Number of Companies Listed	237	235
Introductions (b)	1	0
Number of Initial Public Offers/Others for Sale (b)	2	0
Number of Rights Issues	16	21
Amount Raised through Rights Issues (Rs.mn.)	4,705	43,056

Source: Colombo Stock Exchange

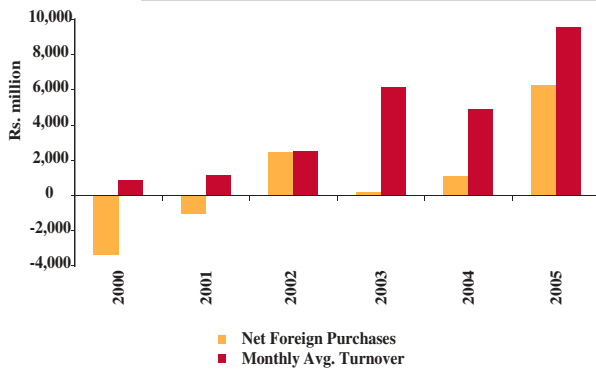
(a) End of the year

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



Chart 8.2

Turnover and Net Foreign Participation at the Colombo Stock Exchange (CSE)



**Market capitalisation also declined to Rs.821 billion at end 2007 from Rs.835 billion at end 2006.** The average daily turnover was at the same level as in 2006 at Rs.435 million. The sector price indices of the three largest sectors, which account for over two thirds of market capitalisation and turnover, namely the Banks, Finance and Insurance rose by 5.9 per cent while Telecommunications and the Diversified Holdings group declined by 15.8 per cent, and 11.7 per cent respectively.

**Funds raised through rights issues increased significantly.** A positive development was the record level of funds mobilised through rights issues in 2007. A total of 21 companies raised Rs. 43 billion in this manner. This was the highest amount of capital raised though the CSE in any given year either through the primary or the secondary market. However, there were no initial public offerings of shares during the year. Domestic investors accounted for 61 per cent of the total turnover of the CSE while foreign investors accounted for 39 per cent in 2007. The net foreign inflows rose to Rs.11.2 billion, reflecting the increasing interest of foreign investors in the local stock market. The number of companies listed on the CSE was 235. Two listed companies were de-listed in 2007.

**Several market development initiatives were embarked upon.** The CSE has started on a programme to promote the listing of new companies and to broaden the investor base, as well as measures to increase market liquidity by increasing the public float and permitting short-selling of securities and the introduction of derivative products. The SEC, which is responsible for the regulation and supervision of the activities of the CSE and listed companies, introduced mandatory rules on corporate governance for listed companies and issued a directive to investment managers to improve investor protection with the aim of improving public confidence in the equity market.

The SEC Act is being amended to facilitate the issue of derivatives and the Company Takeover and Mergers Code is also being amended. The SEC is also handling in preparation of a new law on Securitisation. The proposed law will provide for a mechanism for creating securitisation vehicles, transferring assets to such vehicles and the issuance of asset backed securities by such vehicles. This Act is expected to maintain tax neutrality and will provide for investor disclosure and protection. It is expected to be finalised by the end of 2008. In addition, the SEC has initiated the implementation of the Capital Market Master Plan to develop the capital market and, in collaboration with the IBSL, has established a Financial Services Academy to provide professional level education to industry participants.

## 8.5 Development Finance and Access to Finance

**During 2007, the outreach of the banking sector improved with the expansion of the branch network of both LSBs and LCBs.** There was a notable increase in the number of bank branches outside the Western Province. The number of new branches opened by LSBs was 17, of which 16 were outside the Western Province. In the case of LCBs, 66 new branches were opened, with 49 being outside the Western Province. Further, 12 extension offices were opened by LSBs, for the purpose of facilitating main bank branches, of which 7 were outside the Western Province. LCBs also opened 130 extension offices, of which 45 were outside the Western Province.

**Even though the market interest rates increased substantially, loans at concessionary rates of interest continued to be made available** for key sectors under a number of refinance schemes operated by the Central Bank and National Development Trust Fund (NDTF), and under interest subsidy schemes of the Government operated by the Central Bank.

**In the agriculture sector, fund disbursement under the Second Perennial Crop Development Project Revolving Fund (SPCDPRF) credit scheme and the Tea Development Project Revolving Fund (TDPFRF) credit scheme continued steadily during the year.** In 2007 these two schemes have distributed Rs. 540 million and Rs 411 million, respectively at an interest rate of 9 per cent, for eligible activities.

**Short term cultivation loans to the value of Rs. 967 million and Rs. 869 million were disbursed under the New Comprehensive Rural Credit Scheme (NCRCS) in Maha 2006/07 and Yala 2006/**

**07, respectively.** This is a sharp increase when compared to the previous year when the amount of funds disbursed in Maha 2005/06 and Yala 2006 stood at Rs. 737 million and Rs. 663 million, respectively. Under the NCRCS scheme, funds are made available at an interest rate of 8 per cent for both cultivators and produce buyers, with the government bearing the cost of an interest subsidy of 9 per cent. It has now been decided to increase crop/product coverage under the scheme. Accordingly, in future, the cultivation of pineapple, sugar cane, betel, anthuriums (for export) and orchids (for export) and the production of bee honey would be eligible for credit under the NCRCS.

**Credit was also provided at an interest rate of 8 per cent under the Krushi Navodaya Scheme introduced in the Budget 2007.** A total of 5,069 loans, to a value of Rs. 333 million has already been disbursed under this scheme. Activities eligible for financing include improving agricultural activities, processing of agricultural commodities, animal husbandry, purchase of equipment for the development of agriculture and allied activities, agro-based and agro related industries, developing micro irrigation and drip irrigation and distribution systems, enhancing storage facilities, development of protected agriculture, organic farming, production of organic fertiliser and extension services for agriculture.

**Recognising the urgent need for developing the dairy industry in the wake of escalating global powdered milk prices, a special credit package aimed at reducing the cost of funds for dairy producers/ processors was included in Budget 2008.** Under this scheme, Rs. 7,000 million is to be disbursed to dairy farmers over a period of three years commencing 2008 at a concessionary interest rate of 8 per cent. The government will be paying an interest subsidy of 9 per cent to the participating financial institutions (PFIs). A further Rs. 2,000 million is to be disbursed within a period of three years for dairy processing / dairy product manufacturing at a concessionary interest rate of 12 per cent, with the government bearing an interest subsidy cost of 8 per cent. Budget 2008 also contained a special credit package for providing loans at a concessionary rate of 12 per cent for small and medium scale agro processing, which will cater to the funding requirements of agro processors needing loans over Rs. 100,000 (the upper limit for loans granted under the Krushi Navodaya Scheme). By covering processing activities in addition to cultivation/production, these special credit packages would be providing finance along the value chain of agricultural/ dairy products and thereby provide a host of benefits

to the farmer/dairy farmer, quite apart from the receipt of concessionary funds for cultivation/production. These include the establishment of a stable market and an attractive price for their products. Most of the agro processors seeking this facility have already declared their intention of purchasing their raw material requirements under forward sales contracts.

**There were several developments in the microfinance sector in 2007.** NDTF, the successor to the Janasaviya Trust Fund, is an apex institution for disbursement of microfinance in Sri Lanka. NDTF's strategy to reach the poor in remote areas is to make use of community-based grass-root organisations which are included among its partner organisations for fund disbursement. Total funds to the value of Rs. 1,102 million were made available by NDTF for lending to micro enterprises in agriculture, animal husbandry, fisheries, cottage industries and other income generating activities. Total loan disbursements were somewhat lower than in the previous year due to termination of disbursements under tsunami associated schemes.

**NDTF places great emphasis on achieving balanced regional development by enhancing fund availability outside the Western Province.** The highest proportion of loans was disbursed in the North Central Province by NDTF, with almost a third (32.5 per cent) of the total value of lending being concentrated in that province. Around 16.6 per cent of the value of loans went to the North Western Province, with the Kurunegala District alone accounting for 10.4 per cent of total value of loans disbursed islandwide. In contrast, only 8.9 per cent of the total value of loans disbursed by NDTF went to the Western Province. Funds under NDTF lending programmes reached 1,354 borrowers in the Northern and Eastern Provinces. During the year, the North East Coastal Community Development Project (NECCDP) was put in place to channel funds to the conflict affected areas of the Northern and Eastern province. However, credit disbursement under this project in these areas continued to be slow.

**There were some operational changes made in 2007 to the model used hitherto by the Central Bank in its poverty alleviation schemes.** These helped to increase the geographic coverage of the schemes and to maximise the funds available for loan disbursement. After the termination of foreign finance assistance for the Poverty Alleviation Microfinance Project (PAMP) in December 2006, the Poverty Alleviation Microfinance Programme Revolving Fund Scheme (PAMPRFS), which is financed out of loan recoveries of the PAMP scheme, commenced



operations. Unlike PAMP, which was confined to 6 districts only, activities of PAMPRFS were undertaken in the most vulnerable Divisional Secretariat divisions throughout the country. The Central Bank also completed negotiations with the Japanese Bank for International Cooperation (JBIC) on PAMP Phase II, which is to be operated in conflict affected areas and lagging regions. Foreign finance assistance for PAMP II will be around Rs. 2.6 billion and project activities will be undertaken in 14 districts. In order to achieve maximum geographic outreach, it has been decided to operate the PAMPRFS in future in districts other than the 14 districts in which PAMP Phase II is operational and thus PAMPRFS and PAMP II will together span the whole island. Further, while the PFIs were mainly confined to the 6 development banks in the original PAMP programme, PAMPRFS and PAMP II will be operated through 14 PFIs, to further enhance the outreach of the programmes. In order to rationalise the administrative expenditure of the PAMPRFS, a greater role was assigned to the PFIs.

## 8.6 Financial Infrastructure

### Payment and Settlement Systems

**Systemically Important Payment Systems:** The LankaSettle system operated by the Central Bank and the Cheque Imaging and Truncation (CIT) system operated by LankaClear are the two systemically important payment settlement systems. The LankaSettle system has two components: the inter-bank settlement system that transfers funds to cover payments between participant institutions i.e., the commercial banks and primary dealers, through

settlement accounts held with the Central Bank, in a real time network environment; and the LankaSecure system, which is the central depository for government securities in scrip-less form. The LankaSettle system also supports the settlement of inter-participant transactions in government securities on a delivery versus payment basis. The CIT system enables the clearing of cheques and the post clearing, routing of cheques to the paying banks and transfer of inter-bank payment obligations for the settlement in the LankaSettle system.

**The two systemically important payment systems accounted for 99 per cent of the non-cash payments during 2007, and are benchmarked to international standards.** The systemically important payment systems have a special significance, as they have a potential to become a channel through which financial risks can be transmitted across financial institutions and financial markets. Such contagion risks are greatly minimised by ensuring the safety and efficiency of the payment and settlement system and regular system upgrades to keep up with growth in transaction volumes, transaction message throughput, security and new technology.

**The LankaSettle - Real Time Gross Settlement (RTGS) System:** The bulk of the RTGS transactions by value were in relation to transactions in the government securities market (42 per cent), the inter-bank call money market (38 per cent), and third party customer transactions (10 per cent). The total value of transactions settled through the LankaSettle

Table 8.11

## Non - Cash Payments : Volume and Value of Transactions

Payment System	2006 (a)		2007 (b)	
	Volume ('000)	Value (Rs.bn.)	Volume ('000)	Value (Rs.bn.)
Large Value Payment Systems	175	18,110	195	21,266
RTGS System	175	18,110	195	21,266
Retail Value Payment Systems	67,560	4,174	74,334	4,759
Main Cheque Clearing System	44,343	3,823	46,148	4,296
Rupee Draft Clearing System	n.a	4	n.a	2
Regional Cheque Clearing Systems	510(c)	25(c)		
Sri Lanka Interbank Payment System (SLIPS)	4,165	121	5,945	176
Credit Cards	16,391	55	18,261	67
Debit Cards	516	1	863	3
Internet Banking	1,316	101	2,693	150
Phone Banking	319	33	424	54
Postal Instruments	n.a	11	n.a	11
<b>Total</b>	<b>67,735</b>	<b>22,284</b>	<b>74,529</b>	<b>26,025</b>
US Dollar Cheque Clearing System	98	21	84	23

a. Revised

b. Provisional

c. Data up to 10th May 2006 as the regional clearing system was terminated after CIT commenced operations on 11th May

Source : Central Bank of Sri Lanka



system increased by 17 per cent to Rs. 21,266 billion in 2007. The Central Bank continued to provide intra-day liquidity facility (ILF) to participating institutions in the RTGS system against collateral of government securities. The daily average value of the ILF requested was Rs. 4.9 billion, while the ILF utilised was Rs. 1.2 billion in 2007, compared with Rs. 2.2 billion and Rs.500 million, respectively, in 2006.

**The LankaSecure System:** The value of scrip-less securities held by LankaSecure as at end 2007 amounted to Rs. 1,374 billion and accounted for 99.6 per cent of the total value of Treasury bills and Treasury bonds outstanding. The scrip-less securities consisted of Rs. 307 billion Treasury bills and Rs. 1,067 billion Treasury bonds. LankaSecure maintained 41,953 accounts through dealer direct participants, covering corporate as well as individual customers.

**Cheque Imaging and Truncation (CIT) System:** The total value of cheques cleared increased by 12 per cent to Rs. 4,296 billion in 2007. The operation of the CIT system achieved greater stability in 2007 with the system availability for processing of cheques, displaying a substantial improvement over 2006. The strengthening of the disaster recovery facilities and the business continuity plan at LankaClear, enabling convenient switch-over of operations to the disaster recovery site, have contributed to the improvement. The Central Bank's oversight activities were mainly focused on crediting the proceeds of cheques to customer accounts on a T+1 basis, reducing the cheque returns and ensuring the operational robustness of the system. Some of the measures that have been initiated are to encourage direct connectivity to LankaClear to reduce transportation time, directions issued to the bank branches to display notices informing the cut-off times and the time scale for crediting funds to customer bank accounts after the clearing process. Moreover, the request for additional days for clearing by bank branches has been substantially reduced with the implementation of the procedure that such requests are required to be conveyed centrally from the top management of member banks. As a measure to reduce cheque returns, a policy decision was taken to stop the representation of cheques with "Refer to Drawer" with effect from 1 April 2008 and to impose a penalty on banks on dishonoured cheques, while steps have been initiated to amend the Credit Information Bureau Act to post information of individuals and companies involved in issuing cheques without funds in their respective accounts. Currently the returned cheques account for 5.5 per cent by volume of cheques presented for clearing, while value-wise they amount to 3.2 per cent.

### **Sri Lanka Inter-bank Payments System (SLIPS) and other electronic retail banking services :**

LankaClear also operates SLIPS, which is an off-line retail fund transfer system for banks and their customers. The value of transactions cleared by SLIPS increased by 45 per cent to Rs. 176 billion in 2007. The increase was mainly on account of the use of the system for the payment of salaries and wages of public sector and private sector institutions. LankaClear also upgraded the system to accommodate the growth in volumes and security. The popularity of other electronic retail banking services such as internet banking, phone banking and electronic payment cards also rose significantly in 2007. The value of transactions made by internet banking, phone banking and payment cards increased by 49 per cent, 64 per cent and 25 per cent, respectively, to Rs.150 billion, Rs.54 billion and Rs.70 billion, respectively, in the year.

### **Payment System Policy and Oversight: The Central Bank devoted much attention to strengthening the oversight framework.**

The activities during the year focused on improving the operational robustness of the systemically important payment and settlement systems, including business continuity planning and the establishment of full functioning disaster recovery sites in the Central Bank, LankaClear and the participant institutions. Work in the other areas included the promotion of further migration to electronic payments from predominantly cash/paper based retail payments, issuing directions to service providers of card-based payment instruments and subsequent oversight for compliance and encouraging banks to pass the cost savings and efficiency benefits to customers.

**National Payment Council (NPC):** Payment transfers require a common infrastructure that combines systems, structure and service providers to create an overall functional payment system. The challenge is to create an efficient development process to implement the enhancement of the infrastructure, taking into consideration the need to foster cooperation among the Central Bank, individual banks and customers, to give suppliers in building infrastructure competitive opportunities and to meet the reliability standards of the system. Accordingly, the NPC was established and has formulated a Road Map covering 2007-2010. The main elements of the Road Map, which will be implemented in 2008, include the establishment of a common payment switch for banks to facilitate electronic fund transfers for their third party customers and the migration to chip-based credit cards.



**SAARC Payments Initiative** : A SAARC payments initiative was launched to collectively decide on a high level strategic direction for reforms in payment and settlement systems of member countries to reduce risk and increase efficiency and safety in line with international best practice, standards and new technology and to promote regional harmonisation and integration of the respective domestic payment systems to further facilitate intra-regional commercial activities.

### Legal Enactments and Amendments

The Central Bank continued to review and initiate reforms to strengthen the existing legal framework and to introduce new legislation to keep pace with financial innovations. The Finance Leasing Act was amended in 2007 to enable specialised leasing companies to mobilise funds from the public by issuing debt securities, thus broadening their funding sources. The Central Bank is also preparing amendments to the Finance Company Act to strengthen the prudential requirements of finance companies and its investigative powers relating to unauthorised businesses. In order to introduce a regulatory framework for micro-finance institutions, the Central Bank has drafted legislation to formalise the institutional arrangements of micro-finance service providers and to establish a supervisory mechanism, which would enable these entities to have access to wider sources of funding and to promote their financial sustainability. The Credit Information Bureau Act is also being revised to extend the scope of its services to more diverse user groups and to provide value added services. In addition, amendments to the Debt Recovery (Special Provisions) Act are being considered to curb threats posed by cheques returned due to the non-availability of funds.

Further important legislation relating to the development and stability of the financial sector is also being finalised. A Securitisation law has been prepared to facilitate the issuance of asset-backed securities through the creation of special securitisation vehicles and the regulation of securitised transactions. The proposed legislation is expected to promote risk management and capital market development. The Securities and Exchange Commission Act is also being amended to facilitate the development of the derivatives industry. The Regulation of Insurance Industry Act is also to be amended to strengthen prudential supervision and to permit the appointment of banks and other financial institutions as agents for the distribution of insurance products. The new Companies Act that came into effect in 2007 has a

direct impact on financial institutions, which are companies. The law introduced the new concept of "stated capital" and the provision that a company could declare a dividend only if it has positive accumulated reserves. In addition, corporate governance issues are addressed by specifying the responsibilities of directors and the interests of minority shareholders have been strengthened.

### Regulation and Supervision

The Central Bank, which is responsible for regulating and supervising licensed banks, introduced several prudential measures, in terms of the Banking Act, during the year to strengthen the framework. A new share-ownership direction was issued with regard to shares carrying voting rights with the objective of broad basing the share-ownership and addressing any conflicts of interests that may arise due to large shareholdings. The maximum percentage of ownership permitted in the issued share capital carrying voting rights will be 15 per cent of issued share capital. In order to mitigate credit concentration risk, a direction on the maximum amount of accommodation was issued. Accordingly, the maximum amount of accommodation to a single counterparty and to a group of companies will be limited to 30 per cent and 33 per cent of the capital base, respectively. Enhanced limits are permitted, subject to meeting specified conditions. The capital instruments eligible for inclusion in the regulatory capital were expanded to include perpetual debt as core capital. The eligibility criteria for hybrid capital and subordinated debt instruments were also expanded.

A Direction on Corporate Governance was issued to banks aiming at making the Board of Directors more responsible and accountable for the business operations of banks, in order to promote the overall risk management and soundness of banks. The main aspects of the direction relate to the composition and responsibilities of the board of directors, criteria to assess the fitness and propriety of directors, management functions delegated by the board, separation of duties of Chairman and Chief Executive Officer, board appointed committees and disclosure of financial statements. The direction will be applicable from January 2008, with necessary transitional provisions.

The adoption of the Basel II Capital Adequacy Framework is expected to improve the safety and soundness of the banking system, by aligning capital adequacy assessment more closely with the risk profile in banks. Banks are required to apply

## Box 20

## Implementation of Basel II Capital Adequacy Standard in Sri Lanka \*



### Basel II – An Introduction

“International Convergence of Capital Measurement and Capital Standards”, widely known as Basel II, provides a framework to foster integrated risk management in banks. It is an attempt to address some of the deficiencies in the previously adopted capital adequacy standard, Basel I, through the incorporation of a capital charge for operational risk (in addition to the credit and market risks) and three interlinked pillars, namely, (1) minimum capital requirements, (2) supervisory review process and (3) market discipline. Therefore, Basel II is a comprehensive framework that provides: (1) banking institutions stronger incentives to improve risk measurement and management, (2) regulators to take measures to improve bank safety and soundness by more closely linking regulatory capital requirements with banking risk, and (3) complementary use of market mechanism to create a greater accountability and transparency to bank management and other stakeholders of banks.

### Adoption of Basel II in Sri Lanka

As announced in its “Road Map for Monetary and Financial Sector Policies in 2007 and beyond”, the Central Bank of Sri Lanka (CBSL) has adopted the Basel II capital adequacy standards for all licensed banks in Sri Lanka effective from January 2008. Accordingly, all banks are required, in computing the capital charge for capital adequacy purposes, to follow the Standardised Approach for credit risk, Standardised Measurement Approach for market risk and Basic Indicator Approach for operational risk, commencing 1st January 2008. In this regard, the preparatory work undertaken since 2006 is as follows: -

- a. Self-assessments by banks that commenced in March 2005 to assess the impact on banks were continued. No adverse impact was observed for the banking industry since the Capital Adequacy Ratio (CAR) estimated under Basel II for the industry was around 13 per cent as against the minimum requirement of 10 per cent.
- b. The CBSL continued to work closely with the Sub-Committee of the Sri Lanka Banks’ Association (SLBA) to finalise modalities for implementing Basel II, in particular, resolving issues relating to certain definitions.
- c. In March 2006, guidelines were issued on parallel computation of the CAR under Basel II with effect from the second quarter of 2006.

\* The Central Bank Annual Report 2005 in Box Article 17 presented information on Basel II, its benefits and action taken by the Central Bank towards implementation of Basel II in Sri Lanka. This article provides an update on the progress made in adopting Basel II and the way forward approach followed in the other countries in the SAARC region.

- d. A Help Desk was set up at the Bank Supervision Department to guide and assist banks to move to Basel II. The Help Desk held continuous discussions with the SLBA and banks individually on implementation issues.
- e. A Consultative Paper was issued to banks in June 2007 and banks submitted their views mainly on the risk weights applicable on different classes of assets and clarifications on certain terms used in the paper. A parallel reporting of CAR based on the Consultative Paper and accuracy of calculation by banks was verified.
- f. While encouraging all banks to train their staff adequately on Basel II, three half-day interactive seminars for bank officials and an International seminar on “Integrated Risk Management and Implementation of Basel II” were conducted by the CBSL to enhance awareness.
- g. New software to submit the quarterly returns on Basel II in place of Basel I to the CBSL under the web based online reporting system was developed and final testing was carried out for the quarter ending 2007.
- h. Guidelines were also issued on preparation for moving towards advanced approaches covering setting up data warehouses, stress testing, credit risk mitigation, enhancing market discipline etc.
- i. In December 2007, the CBSL issued the Direction on Maintenance of CAR under the Basel II replacing Basel I.

This major policy initiative would contribute to promoting higher standards of risk management amongst the banking institutions and help a bank to better align its capital with its risk profile.

### Implementation of Basel II in the SARRC Region

Although the Basel II framework provides several options for its implementation based on the level of sophistication and development of the banking system and country situation, the policy approach taken by almost all the countries in the SARRC region is to adopt the most simple approach initially and thereafter to move to advanced approaches in the medium term. In this process, almost all the countries in the region have already issued consultative papers to the banking community for their views and recommendations.

- India has announced that Indian banks will initially adopt the Standardised Approach for credit risk and Basic Indicator approach for operational risk and



expects to migrate to Basel II in 2009. The necessary infrastructure is being assembled and developed. The Reserve Bank of India has allowed banks to migrate to the Internal Ratings Based (IRB) approach, provided that the required skills are developed by both banks and by the supervisors.

- Pakistan will migrate to the Standardised Approach for credit risk and the Basic Indicator Approach for operational risk from January 2008 and expects to apply the IRB approach from January 2010. Nevertheless, the banks which have the capacity to migrate to IRB approach are allowed to apply it before 2010. Pakistan has started a parallel run in 2006 aiming at moving towards IRB approach from 2008.
- Bangladesh and Nepal are also moving to Basel II and the required transition arrangements are being carried out in order to facilitate a smoother transition from Basel I.

#### Way forward in migrating Sri Lankan Banks to Advanced Approaches

- a. Additional guidelines will be issued in 2008 under the standardised approach with regard to the computation of capital charge for market risk for derivative products and securitisation.
- b. Considering the current level of internal systems, it is expected to introduce Pillar II, Supervisory Review Process, in 2010 to ensure that banks maintain adequate capital to support all material risks. The additional risks considered under Pillar II include credit concentration risk, interest rate risk in the

banking book, liquidity risk, strategic and reputational risk.

- c. Capacity building for banks and for officers of the Bank Supervision Department will be continued through regular training programmes and interactive seminars for creating data warehouses, risk modeling and validation and stress testing on business.
- d. It is decided to move to Advanced Approaches from 2013 (after 5 years), by when the banks are expected to have appropriate risk models, risk management systems and data warehouses.
- e. Guidelines will also be issued to banks on integrated risk management to improve the risk management processes of banks. This will provide a greater awareness and better assessment of existing and potential risks of banks to initiate pro-active measures by adopting up to date risk management techniques to mitigate such risks. This will also facilitate banks to obtain the full benefit of adopting Basel II.

Basel II is a risk sensitive capital framework that provides incentives for better risk management as it gives greater encouragement for banks to adopt more risk sensitive approaches and procedures since more refined risk measurement procedures will lead to capital relief. The differentiation of risks afforded under Basel II allows competitiveness for banks that have developed a good risk management culture. Thus, the adoption of Basel II will strengthen the risk management in banks thereby enhancing the safety and soundness of the banking system.

the Standardised Approach for credit risk and market risk and the Basic Indicator Approach for operational risk from January 2008.

**New directions were issued to finance companies, in terms of the Finance Companies Act, relating to the prohibition on granting financial accommodation to directors or their relatives, and to business transactions permitted with directors and their relatives.** A direction was also issued to specialised leasing companies stipulating the requirements that should be fulfilled in raising funds from the public through the issue of debt securities under the Finance Leasing Act.

**Regulations on electronic payment cards were issued under the Payments and Settlements Systems Act and directions are to be issued for the supervision of card-based payment instruments.** Guidelines were also issued on

'Customer Due Diligence' and KYC procedures under the Financial Reporting Transactions Act to banks, finance companies, insurance companies, securities companies and money changers, as part of the efforts to prevent money laundering and the financing of terrorism, to protect the integrity of the financial system. The Central Bank also intensified its public awareness programme on educating the public on the risk of investing money in unauthorised and prohibited institutions and schemes, to mitigate risks to the financial system.

**The SEC introduced mandatory Rules for Corporate Governance for companies listed on the CSE in 2007.** A directive was also issued to investment managers to improve investor protection.

**An Inter Regulatory Institutions Council (IRIC) was established to co-ordinate policies and activities between financial regulatory agencies for**



**Box 21****Multi Level Marketing and Pyramid Schemes****Introduction**

Prohibited schemes such as 'Pyramid or Pyramid type Schemes' are being promoted in different parts of the country. Complaints have also been made that these prohibited schemes are being marketed in the guise of Multi Level Marketing (MLM) Schemes. Many countries including Canada, Malaysia, Singapore, Japan, USA, UK and India have issued several guidelines and definitions to distinguish MLM from illegal pyramid schemes, and have introduced new laws to deal with them. For example, in Singapore, the Multi-Level Marketing and Pyramid Act was passed in 2000. In China, Regulations on Prohibition of Multi Level Marketing promoting Pyramid Schemes were issued in 2005. Chapter 3 of the Laws of Japan - Act on Specified Commercial Transactions 1976 - Act No. 57 of June 4, 1976 contains legal provisions to combat pyramid type multi level marketing schemes.

**Multi Level Marketing (MLM)**

In general terms, MLM, known as "network" or "matrix" marketing or "referral" marketing, is a way of selling goods or services through distributors without intermediary retail stores. MLM builds a sales force by recruiting others to sell products. An extremely important feature is that the compensation or commission for a promoter who joins the scheme would mainly be a percentage based on the sale of products.

**Main Characteristics of Pyramid Schemes**

Many pyramid schemes often disguise themselves as MLM schemes, which sell collectors' items, software, training programs, etc, although they make money through recruitment. Members of the public who attend sales talks conducted by promoters must be vigilant of such schemes. Illegal MLM schemes, which are in reality pyramid schemes, usually share the following characteristics:

- Generally, a pyramid scheme is a recruiting game, which ultimately results in loss to its participants.
- Participants in pyramid or pyramid type multi level marketing schemes receive compensation/commission for recruiting other participants into the scheme, who,

in turn, obtain commissions by recruiting more participants.

- Promoters emphasise that the way to earn large sums of money and get rich in a very short time is by recruiting others to join the scheme.
- Many pyramid or pyramid type multi level marketing schemes involve selling products or services. The product or service that is to be sold is not something people can buy at the given price. However, the sale of the merchandise or service is not the focus of pyramid type schemes.
- Participants are required to invest money to join the scheme, either in the form of a joining fee, or by buying a product.

If a pyramid scheme is to continue, more and more participants need to be recruited. A pyramid scheme will eventually collapse when it runs out of new participants. When this happens, the vast majority of participants lose whatever time and money invested, while the originating company or person and a few frontline distributors profit from those who lose their money.

The general public have been advised by the Central Bank through newspaper advertisements and pamphlets to be cautious about illegal pyramid and pyramid type multi level marketing schemes and not to engage in illegal activities by joining these schemes. The public are also requested to provide information to the Central Bank in the event that they come across any suspicious schemes. The public must understand that persons participating in pyramid and pyramid type multi level marketing schemes eventually lose their hard-earned money.

**Penalties under the Banking Act**

The general public are cautioned that they must not, in any way, participate in such schemes since these are illegal and criminal activities prohibited under Section 83 (C) of the Banking Act. Any person who contravenes subsection 83(C) (1) of the Banking Act, shall be guilty of an offence and shall be liable on conviction after summary trial before a Magistrate, for imprisonment of either description for a term not exceeding three years or to a fine not exceeding rupees one million or to both such imprisonment and fine.





**the development of the financial markets and for safeguarding financial system stability.** This high level council was formed in 2007 and is chaired by the Governor of the Central Bank and comprises the heads of the SEC, IBSL, NPC, CSE, Registrar of Companies, Sri Lanka Accounting and Auditing Monitoring Board, Institute of Chartered Accountants and the Department of Co-operative Development. Working Group of Regulators on Financial Conglomerates which is required to assess the systemic risks posed by financial conglomerates and to propose mechanisms for the supervision of these complex financial institutions, is expected to report to IRIC.

### Credit Rating

**The sovereign rating of the Government of Sri Lanka for 2007 was maintained at the same level as in the previous year.** Fitch Ratings assigned a long-term foreign and local currency rating of "BB-" (BB minus), while Standard and Poor's (S & P) assigned a rating of "B+" (B plus). The sovereign rating assisted the government in raising US dollar 500 million through the issue of a five year fixed interest rate bond in the international capital market.

**There were two credit rating agencies operating in Sri Lanka in 2007.** The Central Bank requires deposit-taking institutions (licensed banks and registered finance companies) to obtain a credit rating from an independent rating agency and to disclose it to the public, to further improve confidence in the financial system. In 2007, 22 LCBs and 10 LSBs had obtained investment grade ratings, while 11 RFCs also had investment grade ratings.

### Credit Information

**The Credit Information Bureau (CRIB), which provides credit information reports on borrowers, recorded an increase in the number of reports provided to member credit institutions, namely LCBs, LSBs, RFCs and SLCs.** CRIB issued 884,620 credit reports on corporate and individual borrowers in 2007 compared with 801,508 reports in 2006, indicating that these reports are becoming an integral part of the credit appraisal procedure of lending institutions. The number of reporting credit institutions also increased to 95 in 2007, from 93 in the previous year. Until the end of 2007, CRIB collected information on both positive (regular) and negative (irregular) credit facilities, which were Rs.500,000 and over and information on credit cards with outstanding balances of Rs.5,000 and over, which were more than 90 days overdue.

**CRIB launched on-line operations and will continue to collect both positive and negative credit information without any limits on restrictions including all types of credit facilities from the beginning of 2008.** The new CRIB law is to be passed by the Parliament in 2008 and it would enable CRIB to expand its services to other credit grantors, insurers, utility providers and state agencies and for the provision of value added services, such as credit scoring and fraud prevention. CRIB will also be authorised to collect data on returned cheques and function as the filing office for secured transactions under the proposed Securitisation (Secured Transactions) law.

**Box 22****Major Economic Policy Changes and Measures: 2007<sup>1</sup>****Real Sector**

- 04 January 2007 - Contributory Pension Scheme introduced in 2003 for public employees, was abolished and they were awarded the membership in Widows'/Widowers & Orphans' Pension Scheme.
- 24 April 2007 - Mihin Lanka (Pvt.) Ltd., the second national carrier, commenced its operations as a fully government owned enterprise.
- 27 April 2007 - Postal charges were revised.
- 01 July 2007 - Passenger bus fares were increased by about 17.5 per cent.
- 01 November 2007 - Domestic tariff of Sri Lanka Telecom (SLT) including monthly rental was revised.
- 01 February 2008 - Passenger bus fares were increased by about 4.6 per cent.
- March 2008 - Electricity tariff was increased by 30 per cent.

**External Sector****Trade and Tariff**

- 31 January 2007 - Full duty waiver applicable on importation of selected food items such as dried fish, Maldivian fish, B' Onions, red onions, chickpeas, green gram, cowpea and chillies was extended until 15 February 2007.
- 02 February 2007 - Import duty on petrol was increased from Rs.5.00 per litre to Rs.20.00 per litre.
- 14 February 2007 - A duty waiver of Rs. 15.00 per litre was granted on importation of petrol for a period of one month.
- 10 March 2007 - Full duty waiver applicable on importation of selected food items such as cod, Maldivian fish, sprats, chickpeas, green gram, chillies and prepared or preserved fish was extended and a duty waiver of Rs.10.00 per kg on B' Onions was granted until 30 April 2007.
- 29 March 2007 - A duty waiver of Rs.5.00 per kg was granted on importation of potatoes until 30 April 2007.
- 17 April 2007 - The duty waiver on importation of petrol was increased to Rs. 20.00 per litre (full duty waiver) from Rs. 15.00 per litre.
- 25 April 2007 - Permission was granted to selected public officers to import motor vehicles under concessionary duty rates, through a permit issued by Ministry of Finance and Planning.
- 01 June 2007 - Full duty waiver applicable on importation of selected food items such as cod, Maldivian fish, sprats, chickpeas, green gram and chillies was extended until 30 June 2007.
  - Duty waivers of Rs.5.00 per kg on potatoes, Rs.10.00 per kg on B' Onions, Rs.2.00 per kg on cane sugar, beet sugar, other sugar and sakkara, Rs.3.00 per kg on white crystalline cane sugar and white crystalline beet sugar were granted.
- 01 August 2007 - A full duty waiver was granted on importation of selected fresh fish varieties.
  - Import duty on importation of copra was removed until 29th February 2008.
  - A 10 per cent duty waiver was granted on importation of edible oil for a period of one month.
  - A duty waiver of Rs. 1.50 per kg was granted on importation of beet sugar and jaggery.
  - Single specific customs duty rates were introduced on ten selected food items instead of the surcharge on imports, Value Added Tax (VAT), Social Responsibility Levy (SRL),

<sup>1</sup> This includes major economic policy changes and measures implemented during 2007 and the first three months in 2008. Policy changes and measures that have been announced and are to be implemented in 2008 are also included.