Chapter 8

FINANCIAL SECTOR DEVELOPMENTS AND SYSTEM STABILITY

8.1 Overview

The financial system continued to be resilient in the challenging environment of the global financial crisis and emerging world economic downturn, higher domestic interest rates and the impact of the failure of some unauthorised finance businesses. The financial services industry grew at a more moderate pace during the year, in response to the tighter monetary policy stance adopted to reduce inflationary pressures, and continued to support economic activity. Overall, financial institutions maintained their soundness with sustained profitability, increased capitalisation and improvements in risk management, supported by enhanced regulation and supervision. The financial indicators of the banking sector for 2008 show that profitability has been maintained, while lending has moderated in response to the tighter monetary policy stance. The capital adequacy ratios of the banking sector remained well above the minimum regulatory standards. The liquidity position of the banking sector was comfortable, while the non-performing loan ratio has risen slightly. The Central Bank took decisive action to arrange the rescue of a commercial bank that experienced liquidity problems due to the failure of a credit card company associated with the Ceylinco Group. Although the earnings of the finance and leasing company sector have been constrained due to higher funding costs, its resilience has been strengthened by improved capital positions. Since the last two months of 2008, some regulated finance companies have been experiencing high deposit withdrawals and liquidity pressures consequent to the failure of certain unauthorised finance businesses. A special support package for finance and leasing

companies by the Government and the Central Bank is being implemented to address this problem. The insurance sector maintained its solvency ratios and liquidity ratios, while their earnings moderated. The stronger financial positions that had been built up in recent years, as well as a range of prudential policies introduced by regulators to address vulnerabilities have enabled the institutions to deal with the more elevated level of risk stemming from both external and domestic sources.

The global financial crisis intensified resulting in a severe tightening of liquidity in global credit markets and leading to a downturn in world economic growth. The turmoil in global financial markets worsened in 2008 with the crisis spreading beyond the US subprime mortgage market to the prime real estate, consumer credit and other corporate credit markets in the US and Europe. The crisis was a fallout of an exceptional credit growth and leverage in the financial system of advanced economies during a long period of low interest rates, high liquidity and low volatility, which led to lax credit standards, deficiencies in risk management and inadequate regulation and supervision. Mounting losses on complex structured securities eroded the capital buffers of financial institutions causing the failure or near failure of several large financial institutions in the advanced economies. This triggered a sharp rise in counter-party credit risk aversion and a seizure in money markets in the US and Europe. In September and early October, confidence sank to critical levels, bringing these financial systems close to a systemic collapse. The financial crisis also caused a downswing in economic prospects, while equity markets across the world plunged. Governments and central banks in advanced economies responded by introducing a number of extraordinary measures aimed at stabilising and restoring confidence to financial markets, restructuring affected financial institutions and reducing the impact of the financial crisis on the real economy. The measures included the injection of liquidity to money and other credit markets, reduction in policy interest rates, guarantees on deposits and bank debt, recapitalisation, purchase of troubled assets and shares and the nationalisation of banks. Although the policy measures eased conditions in money markets to some extent, risk aversion remains high and liquidity in global credit markets continues to be tight. Emerging and developing countries have been affected in varying degrees by the high risk aversion and tight liquidity conditions in international financial markets which have limited credit availability and increased funding costs, capital outflows, declines in asset markets and strains on currency markets. The global financial shock has led to a severe downturn in world trade and output, with advanced economies moving into recession and emerging and developing countries experiencing a slowdown in economic growth.

The impact of the global financial crisis on Sri Lanka's financial institutions was limited in 2008, as domestic banks did not have direct exposures to US mortgage linked securities or to the failed financial institutions. The partial closure of the capital account and the regulatory regime has safeguarded financial institutions to a great extent from the direct impact of the global financial turmoil. Nevertheless, the negative impact of the slump in global trade on the export sector and the domestic economy has led to an increase in the non–performing loans. The Central Bank introduced several prudential measures in the last few years to strengthen the risk management and resilience of banks. These include the enhancement of minimum capital levels, general provisioning requirements, mandatory corporate governance requirements, revised loan classification and specific provisioning requirements, revised single borrower limits, and guidelines for integrated risk management. In addition, banks migrated to the Basle II Capital Adequacy Framework which covers credit, market and operational risk under the simpler approaches from January 2008. The regulatory and prudential framework governing other financial institutions has also been strengthened, with enhancements to capital requirements in some categories.

Although banks in Sri Lanka did not encounter major difficulties, domestic financial markets experienced the effects of the global financial crisis. The government securities market, which was recently opened to foreign investors, subject

Box 9

Banking Soundness Index (BSI)

Unlike price stability, financial system stability does not have an established aggregate indicator to measure it. A wide range of techniques are used to assess financial system stability which include quantitative indicators of financial system soundness and stress testing. These indicators attempt to cover financial stability as a systemic phenomenon and therefore concern not only financial institutions and markets but also the real, corporate, household and government sectors as the main debtors of financial institutions. The Financial Soundness Indicators (FSIs) proposed by the International Monetary Fund are a set of indicators which provide a broad indication of the soundness of the financial system as a whole. The FSIs are divided into two groups – the core set of indicators relating to the banking sector (12 indicators), while the encouraged (supplementary) set of indicators cover non-bank financial institutions, non-financial corporations, financial markets and property markets and households (27 indicators).The core set of FSIs relating to the banking sector cover the main areas of banking business relevant to the soundness of these institutions and are compatible with the CAMELS methodology - [C=Capital Adequacy, A=Asset Quality, M=Management Soundness, E=Earnings, L=Liquidity, S=Sensitivity to Market Risk].

A number of central banks have also attempted to construct a single indicator to assess the level of stability of the financial system. This is a difficult task given the complex nature of the financial system and the numerous links between financial institutions, financial market participants and the non-financial sector. Many of the attempts focus on constructing an aggregate indicator for the banking sector, which is the most important component of the financial system with respect to financial stability. For example, the Czech National Bank has constructed a simple banking stability index which is an aggregate indicator of banking sector stability using the weighted average of partial indicators of the financial soundness of banks, based on the CAMELS methodology. Table B 9.1 shows the types of financial stability/soundness indices compiled by selected central banks.

Table B 9.1
Types of Financial Stability/Soundness Indices

Country and Institution	Index	Partial Indicators/Variables	
Czech National Bank	Banking Stability Index	Capital Adequacy	Capital adequacy (%)
		Asset Quality	Non performing loans/total loans (%)
		Profitability	Return on assets (%)
			Return on equity (%)
		Liquidity	Quick assets/assets (%)
			Quick assets/client deposits (%)
		Interest Rate Risk	Cumulative net balance sheet position to 3 months / assets (%)
		Foreign exchange risk	Absolute value of open total position in foreign exchange / tier 1 capital (%)
			Absolute value of open balance sheet position in foreign exchange / tier 1 capital (%)
Central Bank of the Republic of Turkey	Financial Strength Index	Capital Adequacy	(Equity - fixed assets)/total assets
			Capital adequacy ratio
		Asset quality	Gross non performing loans/gross loans
			Net non performing loans/share holders equity
			Fixed assets/total assets
		Profitability	Net profit / total assets
			Net profit / share holders equity
		Liquidity	Liquid assets/total assets
		Interest Rate Risk	Interest sensitivity gap with a maturity up to 1 month/equity
			Interest sensitivity FX assets gap with a maturity up to 1 month/ equity
		Foreign exchange risk	On balance sheet foreign exchange position/regulatory capital
			Foreign exchange net general position/regulatory capital

Country and Institution	Index	Partial Indicator/Variables	
State Bank of Pakistan	Financial Soundness Index	Capital Adequacy	Capital to risk weighted assets ratio
			Net non performing loans to capital ratio
		Asset Quality	Non performing loans to advances ratio
			Net non performing loans to net advances ratio
			Provisions to non performing loans ratio
		Profitability	Return on assets
			Return on equity
		Liquidity	Liquid assets to total assets
			Loans to deposits ratio
Swiss National Bank	Stress Index	Indicators derived from bank balance sheets and performance	Change in profitability, Capital, Asset quality and the number of bank branches.
		Market indicators	Change in prices of banking shares and bonds.
		Other indicators	Inter-bank exposure and additional supervisory information.
Netherlands Central Bank	Financial Stability Conditions Index	Monetary conditions Index	Interest rate, the effective exchange rate, real estate and stock price
		Solvency of financial institutions	Capital ratios
		Volatility of the stock Index	Share prices of financial institutions
Bank of Canada	Financial Stress Index	Banking sector	Banks profits, credit growth, loan losses and bank share prices
		Foreign exchange market	Type of exchange rate regime
		Debt markets	Risk spreads - The spread between risky and risk free bond yield
			Liquidity measures - turnover ratios and bid-offer spreads
		Equity markets	Changes in stock market indices or market capitalization

Banking Soundness Index for Sri Lanka

The Central Bank of Sri Lanka has constructed a simple aggregate banking soundness index (BSI) on an experimental basis, using an approach similar to that taken by the central banks of the Czech Republic, Turkey and Pakistan. Financial market indicators were not included, due to the limited number of listed banks, minimal number of listed bank bonds and the relatively shallow and undeveloped capital market in Sri Lanka.

The partial individual indicators selected for the BSI are similar to the IMF's core set of banking sector indicators, with some minor differences. Capital adequacy and profitability indicate the cushion a bank has at its disposal against potential risks and is a measure of its ability to absorb a reasonable level of losses. The asset quality indicators reveal the credit risk associated with the bank loan portfolio. The liquidity indicators measure the bank's reserve against potential liquidity problems, such as loss of access to market sources of funding or large scale deposit withdrawals by the public. The interest rate risk measures the maturity mismatch between assets and liabilities and indirectly measures the potential losses caused by a rise in interest rates. The foreign exchange risk covers banks' exposure to exchange rate movements in either direction.

Table B 9.2 shows the partial indicators that were selected and the weights assigned. The interest rate risk was excluded for the time being, due to the non-availability of data for an adequately long period in an easily accessible form on the net balance sheet position of assets and liabilities. A partial indicator of interest rate risk will be included in the BSI in the near future.

In order to construct the index, as a first step the partial indicators are compiled for the normalised variables using the equal variance weighting scheme. The normalised value of a partial indicator = $(X_{it} - \mu_{it}) / \sigma_{it}$. X_{it} is the value of the indicator in t^{th} time period, μ_{it} is the mean of the indicator X_{it} and σ_{it} is the standard deviation of the indicator X_{it}.

Table B 9.2
Features of the Banking Soundness Index

Partial Indicators	Variables	Impact	Adjustment	Weight
Capital Adequacy	Tier 1 capital to risk weighted assets Capital base to risk weighted assets	Positive Positive	Normalised value Normalised value	0.12 0.12
Asset Quality	Gross non performing loans to total gross loans Net non performing loans net of provision to total loans	Negative Negative	Normalised value Normalised value	0.12 0.12
Earnings / Profitability	Return on assets (before tax) Return on equity (after tax)	Positive Positive	Normalised value Normalised value	0.12 0.12
Liquidity	Liquid assets to total assets Statutory liquid assets ratio	Positive Positive	Normalised value Normalised value	0.12 0.12
Foreign Exchange Risk	Net open position in foreign exchange to capital funds	Negative	Normalised value	0.05

An important factor in compiling the BSI is the allocation of weights, as it is difficult to judge the relative importance of each partial indicator to the index. This could be done by using statistical methods or using expert judgment. In this computation, the latter method has been used. The methodology does not take into account the potential correlation between individual partial indicators. The partial indicators and their weights may be revised from time to time, depending on their importance.

The aggregate BSI has been compiled using quarterly data from Licensed Commercial Banks and Licensed Specialised Banks, for the period 1998 (which is the base year) to 2008. The BSI indicates that the financial soundness of the banking sector has strengthened since 2000. The BSI declined marginally in 2008 from 2007 due to a slight decline in capital ratios, increases in non-performing loan ratios and a decline in the liquid assets to total assets ratio. However, the banking sector remains profitable, sound and resilient with adequate capital, liquidity and provisioning buffers, thereby preserving its stability.

a) **Capital Adequacy:** The capital adequacy partial indicator improved since 2000, but has declined slightly in 2008, as risk weighted assets have increased at a higher rate than capital funds. Banks migrated to the Basle II Capital Adequacy Framework which covers for operational risk, in addition to credit and market risk. The total capital adequacy ratio (CAR) at 13.5 per cent and the Tier 1 CAR at 11.5 per cent are well above the regulatory requirements, and thereby sustained the resilience of the banking sector.

b) **Asset Quality:** The asset quality partial indicator has been on a declining trend since 2001,which is a positive development for banking stability, because this partial indicator has a negetive impact on the BSI, but has risen in 2008 due to an increase in the non-performing loan ratios. The asset quality of the banking sector deteriorated slightly due to the slow-down in the economy. Banks would have to focus more on credit risk management to reduce non-performing loan ratios.

c) **Profitability:** The profitability partial indicator has been relatively stable since 2003. The return on assets ratio has increased in 2008, while the return on equity ratio has declined slightly due to a larger increase in equity capital relative to profits. The overall profitability position of the banking sector has been maintained.

d) **Liquidity:** The liquidity partial indicator improved since 2000, but has declined marginally in 2008 due to a slight decrease in the liquid assets to total assets ratio. The liquidity position of the banking sector was comfortable, as the statutory liquid assets to deposits ratio increased.

e) **Foreign Exchange Risk:** The exchange rate risk partial indicator has been relatively stable since 2004. The net open position in foreign exchange to capital funds increased in 2008, but is within prudential limits.

References:

Central Bank of the Republic of Turkey - "Financial Stability Report" 2007.
Czech National Bank - "Financial Stability Report" 2006 & 2007.
Mark Illing and Ying Liu- "An Index of Financial Stress for Canada" Bank of Canada Working Paper 2003, No.14.
State Bank of Pakistan- "Financial Stability Review" 2006.

to limits, suffered a significant reversal of capital flows in the fourth quarter of the year. There were also net foreign capital outflows from the equity market from October, although the amount was not significant. Increased pressures were felt in the domestic foreign exchange market, reflecting a shortage of US dollars, which spilled over into the domestic inter-bank money markets. The Central Bank took action to provide adequate liquidity to the financial system through its reverse repurchase window and by reducing the statutory reserve ratio (SRR) applicable to banks. In addition, the Central Bank supplied foreign currency to the market to meet the demand and smoothen volatility in the exchange rate. The Central Bank will continue to take pre-emptive and precautionary measures to increase the resilience of the financial system and maintain its stability in the face of uncertainties.

On the domestic front, the failure of unauthorised finance businesses has had a negative effect on some regulated financial institutions. The Central Bank intervened to maintain the stability of the financial system by taking steps to rescue a bank that was threatened by the risks posed by unauthorised and illegal deposit-taking entities. The crisis in the unregistered Golden Key Credit Card Company Ltd of the Ceylinco Group affected the public's confidence in Seylan Bank and other registered finance companies within the Ceylinco Group. As a consequence, Seylan Bank encountered liquidity problems due to deposit withdrawals and curtailment of credit lines from other banks. As the difficulties at Seylan Bank posed a potential danger to the stability of the financial system, the Central Bank in December 2008 took immediate action to preserve systemic stability. The measures included appointing persons to carry out the functions of the board of directors of Seylan Bank, the appointment of the state owned Bank of Ceylon to be the managing agent in order to facilitate business of Seylan Bank and the provision of liquidity support in the form of collateralised borrowings, mainly from the Central Bank. As a result, the situation at the Seylan Bank has stabilised and the bank continues to conduct business without disruption.

A special support package was announced by the Government and the Central Bank in February 2009 to assist troubled finance and leasing companies that are experiencing liquidity problems due to depositors losing confidence in them. The finance and leasing companies within the Ceylinco Group are the most affected. The main features of the scheme are that the Government through the state–owned Lankaputhra Bank will provide Treasury bonds to finance and leasing companies against the sale of landholdings at a price of 67 per cent of the market value; the Government would give a guarantee to banks for credit facilities extended to finance and leasing companies up to the level provided at 30 September 2008 and the liquid asset ratio applicable to finance and leasing companies would be reduced by 5 percentage points. For institutions availing themselves of the facilities under the package, there would also be limitations on the salaries of top management and directors, and transfers to related parties would be prohibited, as the package is being financed out of public funds.

A more intensive public awareness campaign is being conducted to caution the public against the danger of depositing/investing funds in unauthorised and illegal entities and laws will be strengthened to eradicate this problem. The Central Bank publishes regular notices in newspapers listing companies that are licensed by the Central Bank. In addition, the Central Bank carries out investigations into illegal entities and has taken legal action against a number of such entities. In certain cases, unauthorised entities have been given the option to register with the Central Bank by complying with the necessary requirements within a time frame. Those that do not register have been directed to repay their depositors and to wind up the business. Despite these warnings, some members of the public continue to deposit funds in these entities, attracted by the higher rates of interest offered and the opportunity to evade the payment of tax, and thereby risk losing their money when these scams collapse. The existence of these unauthorised and illegal entities results in the loss of depositors' funds, taints the integrity of the

financial system, damages public confidence and poses a threat to regulated institutions and financial stability. In addition to the measures so far taken to address these issues, the Finance Companies Act is in the process of being amended to strengthen provisions prohibiting illegal financial business and deposit-taking which is done under various guises to circumvent the law. The definition of "deposits" will be widened to cover a broader range of fund mobilisation activities. The acceptance of deposits without authorisation will be made an offence.

8.2 Financial System Stability

The stability of the financial system was maintained amidst a worsening external environment and domestic macroeconomic pressures. The main financial institutions were reasonably well capitalised, profitable and resilient in a less conducive environment marked by high domestic market interest rates and slower growth mainly as a result of the global economic crisis. Financial markets were relatively stable in the first three quarters of 2008, but became more volatile in the fourth quarter, primarily due to adverse developments in global markets. The systemically important payments and settlements system operated with a high degree of availability and safety, while the financial infrastructure continued to facilitate the smooth functioning of the payments system during the year.

Domestic financial markets experienced a mixed year. Interest rates in the inter-bank call money market were less volatile during the year, moving in a range of 13.5 -16.5 per cent on average. The market had surplus liquidity in the first nine months of the year, while liquidity strains were experienced in the fourth quarter, largely due to spillover effects from pressures in the foreign currency market. However, the volatility in call money rates was relatively low, as the Central Bank provided adequate liquidity to the market through its reverse repurchase facility at policy and penal rates and through reductions in the SRR. Yield rates on Treasury securities declined in the first nine months of the year, with the opening of the market to foreign investors (subject to limits) and strong investor preference for short-term Treasury bills. An upward movement in yields rates was observed thereafter. The Sri Lanka rupee was relatively stable against the US dollar, depreciating by 4 per cent in 2008. The equity market was on a downward trend throughout the year, with the price indices falling very sharply from September. The All Share Price Index (ASPI) declined by 41 per cent at end 2008. The depressed conditions in the stock market were mainly due to the high interest rates that prevailed during the year, lower company earnings and the dampening impact of the global financial crisis and economic downturn. Net foreign inflows to the stock market increased during the year, although there was a net outflow in the latter part of the year.

Table 8.1 Selected Financial Soundness Indicators

Per cent

Institution and Indicator	2007(a)	2008(b)
Licensed Commercial Banks		
Regulatory Capital to Risk Weighted Assets	13.6	13.0
Tier 1 Capital to Risk Weighted Assets	11.9	10.3
Non Performing Loans Net of Provisions to Capital	11.9	17.0
Non Performing Loans to Gross Loans	5.0	6.0
Return on Assets (Before Tax)	1.9	2.1
Return on Equity (After Tax)	15.0	14.9
Interest Margin	4.5	4.7
Non-Interest Expense to Gross Income	25.2	23.4
Statutory Liquidity Ratio	24.8	25.7
Liquid Assets to Total Assets	25.4	25.2
Net Open Position in Foreign Exchange to Capital Funds	1.2	1.7
Licensed Specialised Banks		
Regulatory Capital to Risk Weighted Assets	20.6	18.6
Tier 1 Capital to Risk Weighted Assets	21.2	23.8
Non Performing Loans Net of Provisions to Capital	23.0	24.4
Non Performing Loans to Gross Loans	6.7	7.7
Return on Assets (Before Tax)	1.7	1.6
Return on Equity (After Tax)	10.0	9.5
Interest Margin	3.5	2.8
Non-Interest Expense to Gross Income	15.7	14.5
Statutory Liquidity Ratio	61.0	62.1
Liquid Assets to Total Assets	42.0	43.6
Registered Finance Companies		
Regulatory Capital to Risk Weighted Assets	15.2	14.0
Tier 1 Capital to Risk Weighted Assets	13.3	12.3
Non Performing Loans Net of Provision to Capital	11.1	16.1
Non Performing Loans to Gross Loans	5.7	6.7
Return on Assets (Before Tax)	2.5	1.8
Return on Equity (After Tax)	13.1	8.4
Net Interest Income to Gross Income	28.0	20.6
Non-Interest Expense to Gross Income	31.0	28.0

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

The banking sector maintained its profitability and soundness in trying conditions in 2008. The banking sector expanded at a more moderate pace, reflecting the high interest rate environment prevailing in the economy. Lending by Licensed Commercial Banks (LCBs) grew by 6 per cent in

2008 in comparison with a growth of 19 per cent in 2007, while investments increased significantly. Their deposit mobilisation also moderated to grow by 7 per cent in 2008 as against a growth of 18 per cent in 2007, while borrowings were unchanged. The profitability of LCBs, as indicated by the return on assets (ROA) and return on equity (ROE) improved marginally, as LCBs were able to maintain their interest margins. Lending by Licensed Specialised Banks (LSBs) grew by 6 per cent in 2008 compared with a growth of 21 per cent in 2007. Their deposits increased by 11 per cent in 2008, while borrowings declined. The ROA and ROE of LSBs declined marginally due to a narrowing of interest margins. Banks migrated to the Basle II Capital Adequacy Framework from January 2008. The total risk weighted capital adequacy ratio (CAR) of LCBs and LSBs was maintained well above the minimum regulatory requirement, although significant variations among individual banks exist.

The banking sector's exposure to risk was at manageable levels. The sectoral distribution of bank credit is fairly broad-based. Credit for consumption purposes, including pawning and credit cards, accounted for 30 per cent of total bank loans. Credit for housing and construction (17 per cent), trading (15 per cent) and manufacturing, including apparel products (16 per cent) were the other sectors that account for the larger shares of bank lending. The asset quality of banks deteriorated marginally, indicating a slight increase in credit risk. Consequently, the non-performing loan ratio (NPL) of LCBs and LSBs increased in 2008. Hence, banks need to pay more attention to maintaining high credit standards to reverse this trend. LCBs were able to manage market risk adequately, while LSBs were slightly more exposed to interest rate risk. Both LCBs and LSBs had a low exposure to liquidity risk and were comfortably meeting the statutory liquid asset ratio requirement. The Central Bank recently issued guidelines on integrated risk management systems to banks, aimed at improving risk assessment and management to assist them in improving risk assessment and management through a holistic approach.

In the high interest rate environment that prevailed in 2008, finance companies were more vulnerable to interest rate risk. The growth in financial facilities provided by Registered Finance Companies (RFCs) moderated, increasing by 17 per cent in 2008 in comparison with 26 per cent in 2007. The profitability of the RFC sector declined slightly in 2008 due to the narrowing of interest margins in their main line of business, which is finance leasing and hire purchase. Their non-performing loan ratio also increased. The overall capital position of RFCs has improved, as the minimum capital requirements were increased recently by the Central Bank. Consequently, the CAR of the RFC sector has strengthened, increasing its resilience to shocks. The liquidity position of the RFC sector was satisfactory.

The profitability of specialised leasing companies also declined in 2008. The specialised leasing companies (SLCs) faced funding constraints during the year. SLCs are largely dependent on banks for their funding requirements and as banks are also competitors in the leasing business, SLCs have found it difficult to obtain funds at competitive rates. SLCs are now permitted to raise funds through the issuance of debt securities. The gearing ratio of SLCs was comfortable. In the latter part of 2008, public confidence in some RFCs and SLCs was seen eroding due to frauds in some unregulated business, which had a contagion effect among RFCs and SLCs. The Ministry of Finance and the Central Bank have announced a stimulus package to address these problems and to restore confidence in this sector.

The financial soundness of insurance companies improved in 2008. The growth of premium income of insurance companies has moderated in the case of both long-term and general insurance business. The overall profitability of the insurance company sector is expected to be slightly lower in 2008. The soundness of the insurance sector strengthened during the year, with all companies meeting the solvency requirements. The diversification of assets and the imposition of limits by the regulatory authority on different types of investment, enables insurance companies to mitigate risks to a large extent. Insurance companies are required to hold a large proportion of their portfolio in government securities, which has helped

them to manage credit and market risk in the present circumstances. All insurance companies were able to meet their claims during the year. There is also a Policy Holders Protection Fund which can be used in the event an insurer is unable to meet its obligations. 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 Insurance Board of Sri Lanka (IBSL) with respect to 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. To improve the financial strength and soundness of insurance companies and to promote the consolidation of the industry, the IBSL 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 2009.

The risk levels of the two largest superannuation funds - the Employees' Provident Fund (EPF) and the Employees' Trust Fund (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 securities. 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.

Looking ahead, the financial system is expected to be resilient, but risks could be higher during 2009. The slump in world trade and the economic downturn are likely to affect Sri Lanka's growth prospects to a certain degree. In these circumstances, the earnings of financial institutions may moderate and asset quality may decline. However, financial institutions have sufficient capital buffers to weather such adverse developments. Nevertheless, it is important that financial institutions implement prudent policies and improved risk management to maintain resilience in the challenging environment. On the upside, a positive feature is the decline in inflation and the consequential easing of interest rates which will stimulate economic activity and improve the performance of the business sector. Moreover, the reconstruction and development activity in the cleared Eastern and Northern provinces would provide new opportunities for further expansion of financial services. The Central Bank has taken a number of pro-active measures that have helped increase the resilience of the financial system and will continue to take pre-emptive and precautionary measures to preserve confidence in the financial system.

8.3 Developments in Financial Institutions

Central Bank of Sri Lanka

The total assets of the Central Bank increased by 6.5 per cent, which was a lower growth compared to 2007. The increase in total assets of the Central Bank was the result of an increase in domestic assets offsetting a decline in foreign assets. This scenario is a complete opposite of what occurred during the first three quarters of 2008, when an increase in foreign assets offset a decline in domestic assets. The increase in the Bank's foreign assets earlier in the year was mainly due to the purchase of proceeds to the government from a syndicated loan obtained, loans obtained from Offshore Banking Units (OBUs), the net sale of Sri Lanka Development Bonds (SLDBs) and the receipt of scheduled foreign loans and grants, as well as the absorption of foreign exchange by the Central Bank from the domestic inter-bank foreign exchange market when there were significant inflows of foreign investments into Treasury bills and Treasury bonds. As the Central Bank's purchases of foreign exchange led to an injection of rupee liquidity, the Bank sold Treasury bills it held in its portfolio to absorb the excess market

Table 8.2 Total Assets of the Major Financial Institutions

	2007(a)		2008(b)	
	Rs. bn	% Share of Total	Rs. bn	% Share of Total
Central Bank of Sri Lanka	**561.4**	**13.0**	**597.1**	**12.5**
Banking Sector	**2,504.2**	**58.1**	**2,714.2**	**56.7**
Licensed Commercial Banks (c)	2,098.3	48.7	2,277.0	47.5
Licensed Specialised Banks	405.9	9.4	437.2	9.1
Other Deposit Taking Financial Institutions	**175.3**	**4.1**	**220.1**	**4.6**
Registered Finance Companies	142.0	3.3	175.6	3.7
Co-operative Rural Banks	28.7	0.7	39.3	0.8
Thrift and Credit Co-op. Societies	4.7	0.1	5.2	0.1
Other Specialised Financial Institutions	**180.8**	**4.2**	**229.2**	**4.8**
Specialised Leasing Companies	95.5	2.2	109.9	2.3
Primary Dealers	53.9	1.3	86.2	1.8
Stock Brokers	3.6	0.1	3.2	0.1
Unit Trusts	6.3	0.1	6.8	0.1
Venture Capital Companies	1.1	0.0	1.1	0.0
Credit Rating Agencies	0.1	0.0	0.1	0.0
Other	20.2	0.5	21.9	0.5
Contractual Savings Institutions	**889.4**	**20.6**	**1,030.2**	**21.5**
Insurance Companies	134.9	3.1	155.1	3.2
Employees' Provident Fund	562.4	13.0	655.3	13.7
Employees' Trust Fund	78.7	1.8	92.4	1.9
Private Provident Funds	96.2	2.2	108.0	2.3
Public Service Provident Fund	17.3	0.4	19.4	0.4
Total	**4,311.2**	**100.0**	**4,790.8**	**100.0**

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

Source: Central Bank of Sri Lanka

liquidity thus created, thereby reducing its domestic assets, which enabled it to maintain reserve money at the targeted level. However, in the aftermath of the global liquidity crunch, withdrawals of foreign investments in Treasury bills and Treasury bonds by foreign investors were significant, leading to considerable outflows of foreign exchange. Hence, the Central Bank intervened in the foreign exchange market, as and when necessary, to contain undue volatility of the rupee exchange rate. While supplies of foreign exchange by the Central Bank led to a shortage of rupee liquidity in the money market, that warranted an injection of rupee liquidity to the market. The Central Bank injected rupee liquidity through purchases of Treasury bills in both the primary and secondary markets, which in turn increased the domestic assets of the Central Bank by the end of 2008.

With respect to liabilities of the Central Bank, currency issues of the Central Bank increased by 7.3 per cent in 2008. The deposits of the commercial banks held with the Central Bank for statutory reserve purposes declined by 9.6 per cent, compared to the 10.2 per cent increase in 2007. This reduction is attributed to the reduction in SRR by 225 basis points towards the latter part of the year, as well as the relatively lower growth of deposits due to the tight monetary policy. During 2008, currency issued by the Central Bank had been only Rs. 12.7 billion, compared with the Rs. 16.2 billion currency injection in 2007.

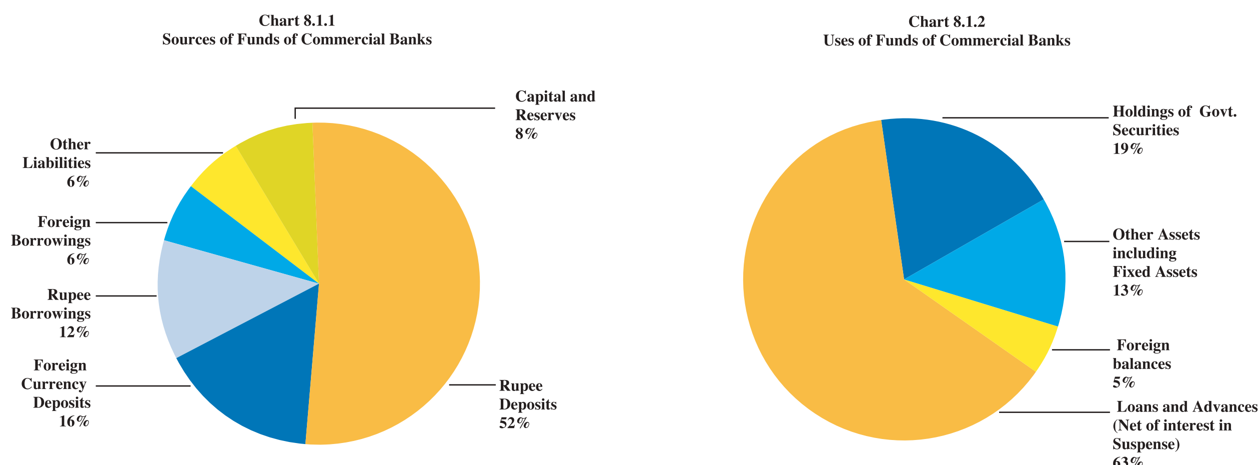
The unprecedented increase in domestic assets was necessitated by the global financial crisis and its impact on Sri Lanka's economy. The government had to resort to domestic financing, because access to external financing was limited as a result of tight liquidity conditions world over. Since there was a shortfall in rupee liquidity in the domestic market in the latter part of the year, the Central Bank had to take several measures to increase liquidity. Further, a significant reduction in foreign assets had to be offset through a corresponding increase in domestic assets to ensure adequate money is injected to the economy to facilitate the smooth functioning of economic activity. As a result, the balance sheet of the Central Bank weakened, and this situation would remain in the near future until the country receives a substantial inflow of foreign exchange.

Licensed Commercial Banks

The activities of LCBs expanded further during 2008, but at a slower pace. LCBs further improved their integrated risk management and risk absorption capacity. This improvement is commendable in the face of the global financial turbulence. There were 22 LCBs by end 2008, operating through a network of 2,068 branches and 2,665 other service outlets. There were also 1,583 Automated Teller Machines (ATMs) as at end 2008 reflecting the high reliance on card based payment modes by the banking community.

The growth in total assets decelerated to 8.5 per cent in 2008 as against 17.4 per cent in 2007. This is mainly attributable to the contraction in the growth of loans and advances portfolio consequent on the tight monetary policy implemented by the Central Bank, and enhanced prudential requirements. The total assets of the LCB sector stood at Rs.2,276.1 billion at end 2008. Within the

Chart 8.1 Sources and uses of Funds of Licensed Commercial Banks (as at end 2008)



LCB sector, the domestic private banks recorded a growth of 9.9 per cent in total assets, while the state owned banks had a growth of 8.7 per cent, supported mainly by its deposit base and capital funds. The foreign banks also reported a growth of 3.8 per cent. The contribution of domestic private banks, state owned banks and foreign banks to the total growth in assets was 52.6 per cent, 40.2 per cent and 7.2 per cent, respectively. Meanwhile, total loans and advances contributed 48.6 per cent of the total growth in assets in 2008, a sharp decline from the 69.0 per cent recorded in 2007 mainly due to the prudential regulations introduced by the Central Bank to moderate the rapid expansion in loans.

The growth in loans and advances slowed down significantly by end of 2008. The total loans and advances portfolio stood at Rs. 1,453.2 billion recording a growth of only 6.4 per cent during the year, as against 18.7 per cent in 2007. Domestic private banks and foreign banks contributed 58.3 per cent and 35.6 per cent, respectively, to the overall growth in loans and advances, while state banks contributed only 6.0 per cent. Foreign banks recorded the highest annual growth (16.9 per cent) in loans and advances followed by domestic private banks (7.8 per cent).

According to the purpose-wise distribution of private sector credit, overdrafts, pawning advances and credit granted through credit cards were the main growth drivers, despite the high rates charged by banks. Leasing facilities and credit for trading activities showed a sharp decline. Credit for consumption activities, including pawning advances and credit cards (29.5 per cent), trading (17.4 per cent), manufacturing including apparel products (16.3 per cent) and construction including housing and property development (14.9 per cent) are the sectors to which the LCBs have given most credit. These four sectors accounted for about 78 per cent of the total credit outstanding. However, the proportion of credit to some of these sectors has declined from the levels that prevailed at end 2007.

Credit extended through credit cards has decelerated noticeably due to the tight monetary policy stance and greater caution of banks in view of high non-performing loans. Nine LCBs provide credit through credit cards to the market.

Table 8.3 Credit Card Operations by Licensed Commercial Banks

Rs. million

	2007(a)	2008(b)	%Change
Total Number of Credit Cards issued	889,338	917,418	3.2
Local (accepted only locally)	57,374	57,641	0.5
Global (accepted globally)	831,964	859,777	3.3
Outstanding Credit at End Year (Rs.Mn)	28,838	34,212	18.6
Local (accepted only locally)	758	856	12.9
Global (accepted globally)	28,080	33,356	18.8
Overdues(as a % of Outstanding Credit)	7.02	6.91	
Pastdues(as a % of Outstanding Credit)	7.16	8.83	
Commission from Dealers(%)	1.5 – 4.0	1.5 – 4.0	

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

The interest rate applicable on unpaid balances on credit cards is in the range of 32.0 per cent to 48.0 per cent because of the unsecured nature of such lending. The total credit card portfolio stood at Rs. 34.7 billion, recording a growth of 18.9 per cent in 2008 in comparison to 34.2 per cent in 2007. The share of credit card loans in the total loan portfolio of LCBs increased marginally to 2.4 per cent in 2008 from 2.2 per cent in 2007 mainly due to slower growth in other areas of credit.

The overall exposure, both fee based and fund based, of commercial banks to the public sector continued to increase. This was due to the increased utilisation of bank credit by the Sri Lankan Government, including local government bodies and government corporations.

The main financial soundness indicators of LCBs were maintained at healthy levels, despite the global financial crisis. Profitability, in terms of pre-tax profit (ROA) improved to 2.1 per cent from 1.9 per cent, mainly due to the increase in the net interest margin and in other fee based income. However, the ROE reflected a slight decline due to the greater increase in average equity, built up mainly through capital infusions and retained profits. The LCB sector continued to reflect an improvement in cost efficiencies. The operating cost ratio further improved to 54.3 per cent in 2008 from 56.7 per cent in 2007 mainly due to the decline in the impact of staff cost on operational expenses. The capital adequacy ratio stood at 13.0 per cent relative to the minimum requirement of 10 per cent. The liquid asset ratio stood at 25.7 per cent as against the minimum requirement of 20 per cent.

However, the credit quality of LCBs deteriorated. This was reflected in the increase in the gross NPL ratio from 5.0 per cent at end 2007 to 6.0 per cent at end 2008. This is attributed to a deterioration in the repayment ability of the borrowers, coupled with a contraction in the credit portfolio across the banking industry in a tight economic environment. The cushion available for the absorption of credit losses through provision

Table 8.4 Assets and Liabilities of Licensed Commercial Banks

Rs. million

	End 2007(a)	End 2008(b)	Change 2008/2007 Amount	Change 2008/2007 %
Assets				
Liquid Assets	613,775	730,604	116,829	19.0
Cash on Hand	29,390	34,264	4,874	16.6
Due from Central Bank	95,238	88,624	-6,614	-6.9
Treasury Bills	92,297	86,838	-5,459	-5.9
Treasury Bonds	132,176	194,150	61,974	46.9
Other Assets	264,674	326,728	62,054	23.4
Loans and Advances (Net of Interest in Suspense)	**1,370,230**	**1,455,804**	**85,574**	**6.2**
Less: Provisions	48,468	56,412	7,944	16.4
Net Loans & Advances	1,321,762	1,399,393	77,631	5.9
Fixed and other Assets	**162,742**	**146,118**	**-16,624**	**-10.2**
Liabilities				
Capital Funds	161,710	180,564	18,854	11.7
Total Deposits	**1,456,701**	**1,562,779**	**106,078**	**7.3**
Demand Deposits	175,129	167,269	-7,860	-4.5
Time & Savings Deposits	1,208,363	1,330,279	121,934	10.1
Others	73,209	65,213	-7,996	-10.9
Borrowings	**373,853**	**409,920**	**36,067**	**9.6**
Local Borrowings	229,216	272,475	43,259	18.9
Foreign Borrowings	144,637	137,445	-7,192	-5.0
Other Liabilities	**106,015**	**122,852**	**16,837**	**15.9**
Total Assets/Liabilities	**2,098,279**	**2,276,115**	**177,836**	**8.5**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

coverage also declined to 64.7 per cent from 71.5 per cent at end 2007, as nearly 41.0 per cent of the current NPL is in the category, which requires below 50 per cent provisioning requirement. The net NPL to capital ratio also deteriorated from 11.9 per cent in 2007 to 17.0 per cent at end 2008 due to relatively faster growth in NPL.

Nevertheless, LCBs continued to perform well in 2008. This was mainly facilitated by the higher net interest margins from core lending activities, growth in fee based income and improvements in operational efficiencies due to the continued focus on cost management in banks, leading to greater productivity. Accordingly, profit before tax was Rs. 45.7 billion, a growth of 21.7 per cent compared to a 24.0 per cent growth in 2007. Foreign banks contributed 61 per cent of the growth in profits of the sector, while domestic private banks contributed 18.8 per cent. Interest income remained the core source of income. The net interest margin of LCBs improved marginally to 4.7 per cent in 2008 from 4.5 per cent in 2007. Profitability in terms of pre-tax ROA improved over the previous year and stood at 2.1 per cent. However, the ROE declined marginally despite the increase in profits, due to the greater increase in average equity.

Table 8.5 Distribution of Banks and Bank Branches

Category	End 2007(a)	End 2008(b)
Licensed Commercial Banks (LCBs)		
I. Total No.of LCBs	**23**	**22**
Domestic banks	11	11
Foreign banks	12	11
II. Total No.of LCB Branches and Other Outlets	**4,331**	**4,733**
Branches	1,934	2,068
Domestic Bank Branches	1,758	1,894
Main Branches	1,261	1,355
Extension/Pay Offices/Service Counters	497	539
Overseas Branches	12	12
Foreign Bank Branches and Other Outlets	176	174
Branches	43	41
Other Outlets	133	133
Student Savings Units	2,397	2,665
Licensed Specialised Banks (LSBs)		
I. Total No. of LSBs	**15**	**14**
Regional Development Banks	6	6
National Savings Bank	2	2
Long-term Lending Institutions	3	2
Housing Finance Institutions	2	2
Private Savings and Development Banks	2	2
II. Total No. of LSB Branches and Other Outlets	**620**	**636**
Branches	409	423
Regional Development Banks	218	219
National Savings Bank	118	125
Long-term Lending Institutions	14	18
Housing Finance Institutions	28	28
Private Savings and Development Banks	31	33
Other outlets	36	38
Student Savings Units	175	175
Total No. of Bank Branches and Other Outlets	**4,951**	**5,369**
Total No. of Automated Teller Machines (ATM's)	**1,370**	**1,583**
Total No. of Electronic Fund Transfer Facilities at the Point of Sale Machines (EFTPOS)	**19,227**	**23,447**
Banking Density:		
No. of LCBs Branches Per 100,000 Persons	9.7	10.2

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Table 8.6 Sectoral Distribution of Loans Approved by Licensed Specialised Banks (a)

Rs. million

	2007(b)	% Share of Total	2008(c)	% Share of Total
Total Loans Approved	**68,367**	**100.0**	**68,462**	**100.0**
Agriculture	3,532	5.2	2,544	3.7
Industry	16,728	24.5	5,076	7.4
Tourism	274	0.4	266	0.4
Commercial	5,584	8.2	2,556	3.7
Financial	11,653	17.0	11,655	17.0
Housing	17,378	25.4	13,080	19.1
Redemption of Debt	1,318	1.9	509	0.7
Other Loans	11,900	17.4	32,776	47.9
Loans Disbursed (d)	**59,766**		**66,087**	
Total Loans Disbursed as a Percentage of Total Loans Approved	87		97	

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

Source: Central Bank of Sri Lanka

Licensed Specialised Banks

The total number of LSBs stood at 14 at end 2008. Their branch network increased to 423 by end 2008. LSBs remained resilient despite the low growth in profits during the year. Their total assets grew by 7.7 per cent, in comparison with 14.3 per cent in 2007, while their loans and advances grew only by 5.6 per cent against 21.0 per cent in 2007. Total deposits increased by 10.9 per cent from end-2007 while borrowings declined by 11.6 per cent. Housing & property development (32.8 per cent), consumer lending (30.5 per cent) and financial services (11.1 per cent) dominated the loans and advances portfolio of LSBs.

Registered Finance Companies

Activities of RFCs expanded despite some unfavourable developments in both international and domestic financial markets. The total number of RFCs in operation increased to 34, with the

granting of licences to two new companies in 2008, while the total number of branches and service centres of RFCs increased to 248, from 201 at the end of 2007. The sector is quite concentrated with the two largest RFCs accounting for 46 per cent of total RFC assets, while the largest eight RFCs accounted for 75 per cent of the total assets of RFCs. The sixteen medium size RFCs accounted for 23 per cent of total assets, while the smallest eight RFCs accounted for 2 per cent of total assets. RFCs cater primarily to lower income groups and less creditworthy customers that do not have access to credit facilities from banks. The total assets of RFCs grew by 23 per cent to Rs. 176 billion during the year, compared to an increase of Rs. 142 billion in 2007.

The growth of accommodation to several sectors slowed down. Finance leasing, hire purchase and secured loans continue to be the main spheres of business for RFCs. Total accommodations granted by RFCs increased by 17 per cent to Rs.112 billion in 2008 compared to the 26 per cent growth recorded in 2007. The increase came mainly from hire purchase, pawning and secured advances. Hire purchase facilities, which accounted for 38 per cent of total accommodations, grew by 23 per cent while, finance leasing, which accounted for 31 per cent of total credit, recorded a decline of 1.5 per cent. The imposition of a ceiling on the claimable input Value Added Tax (VAT) on finance leases led to a decrease in the demand for lease facilities. Loans granted in relation to real estate have increased by 17 per cent to Rs. 10.8 billion during the year. Advances granted under pawning have increased by 107 per cent to Rs.5.5 billion in 2008 and may be considered an indicator of the financial difficulties of lower income groups.

Deposits continued to be the major source of funding. Deposits of RFCs accounted for 59 per cent of total resources of RFCs. Deposit liabilities increased by 32 per cent to Rs. 103 billion in 2008. The growth in deposits could be attributed to the higher interest rates that prevailed during the year and the expansion in the branch network of RFCs. The other two main sources of financing of RFCs were borrowings and capital funds, which accounted for 15 per cent and 14 per cent, respectively, of total resources.

RFCs experienced a decline in profitability in the high interest rate environment, due to a narrowing of interest margins in their main lines of business, i.e., leasing and hire purchase. Net operational profit of the RFCs (before tax) decreased by 12 per cent to Rs. 2.3 billion from Rs. 2.6 billion in 2007. Interest income of RFCs increased by 31 per cent, while interest expenses increased by 50 per cent, reducing the net interest income. Other operating income increased by 27 per cent to Rs. 5.1 billion, which supported the profits of RFCs. However, competition among the market players decreased the profitability of RFCs, through higher borrowing costs.

The capital position of the RFC sector strengthened. The minimum capital requirement for finance companies was increased from Rs.100 million to Rs. 200 million from July 2008. Most of the finance companies have already complied with the increased requirement, though some of the smaller companies have not yet met the requirement. The higher levels of capital helped RFCs to withstand the shocks encountered during 2008.

New directions were issued to finance companies, in terms of the Finance Companies Act, relating to interest rate ceilings on deposits and corporate governance. The Direction on Corporate Governance was aimed at making the boards of directors more responsible and accountable for the business operations of RFCs, in order to promote the overall risk management and soundness of RFCs. 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 the Chairman and the Chief Executive Director, board appointed committees and disclosures of financial statements. The Direction is applicable from 01 January 2009, with necessary transitional provisions. In addition, in terms of the provisions of the Finance Companies Act, the Department of Supervision of Non-Bank Financial Institutions continued its investigations of institutions allegedly engaging in finance business

without authorisation. However, the failure of several institutions engaged in finance business without authorisation led to increased uncertainty among the depositors and caused severe liquidity problems to some RFCs during the latter part of 2008.

Specialised Leasing Companies

Three new companies were registered in 2008 bringing the total number of SLCs to 22 in 2008. The four largest SLCs accounted for 71 per cent of total assets of SLCs, while 10 medium size SLCs and 6 small size SLCs accounted for 27 per cent and 2 per cent of total SLC assets. SLCs are predominantly involved in commercial and personal vehicle financing which accounts for over 90 per cent of total finance leasing and hire purchase business. Total assets of SLCs increased by 15 per cent to Rs 110 billion in 2008, while net profits declined by 20 per cent, compared to the last year. SLCs mainly depend on bank borrowings for their funding requirements and almost all banks engage in the leasing business in a competitive market. Hence, SLCs find it difficult to obtain funds at competitive rates from banking sources. In order to ease this situation, in 2008, the Central Bank allowed SLCs to mobilise funds through the issues of debt instruments. Most SLCs finance long-term assets through short-term borrowings, while interest rates are usually fixed. In an environment where interest rates are moving upwards, this has a negative effect on the profitability as experienced in 2008. The tight competition among market players, and the contagion effect of unfavourable financial market developments, both internationally and domestically, were also reasons for the reduced profitability of SLCs in 2008. However, the sound capital base maintained by SLCs enabled them to face those difficulties.

Table 8.7 Specialised Leasing Companies' Sectoral Classification of Leasing and Hire Purchase Facilities Granted

Rs. million

Sector	During 2007(a)	During 2008(b)
Agriculture	1,732	3,114
Industry	1,795	1,638
Trade	20,462	22,811
Transportation	26,245	33,369
Construction	1,165	1,000
Services	9,939	11,501
Others	2,797	3,207
Total	**64,135**	**76,640**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Other Financial Institutions

Primary Dealers

The primary dealer (PD) industry performed well during 2008, as yield rates in the government securities market declined during most parts of the year. However, some revaluation losses were seen during the latter part of 2008 due to a rise in market interest rates which led to a restructuring of portfolios by some PDs. The total portfolio of PDs increased by 59 per cent to stand at Rs.83 billion at end 2008. Their capital base too had increased by 14 per cent and stood at Rs.6.4 billion as at end 2008. Total unaudited pre-tax profits of the PD industry increased significantly to Rs. 1.6 billion in 2008. Consequently, the financial indicators of the PD industry improved. The ROA increased to 2.4 per cent while the ROE rose to 26.6 per cent. The risk weighted capital adequacy ratio decreased to 16.5 per cent from 35.2 per cent largely due to an increase in risk weighted assets. However, the CAR is well above the regulatory requirement of 8 per cent. The turbulence in the financial sectors that prevailed in the latter part of the year affected the PD industry to a limited extent, in the form of liquidity shortages. However, as PDs are allowed access to the Open Market Operations (OMO) window of the Central Bank, this issue was largely resolved.

Enhancing investor protection by introducing a Master Repurchase Agreement was a long felt need that was successfully completed in 2008. With a view to enhancing investor protection in respect of repurchase transactions in the secondary market, the Public Debt Department (PDD) introduced a Master Repurchase Agreement (MRA) which can be used in common by PDs and LCBs in their repurchase transactions. This agreement was finalised in collaboration with the Association of Primary Dealers and the Sri Lanka Bank's Association and is used in repurchase agreements since January 2009.

Unit Trusts

The unit trust (UT) industry expanded due to the formation of three new UTs in 2008. However

funds with significant investments in equities were affected by the decline in stock market prices in the latter part of the year. There were 17 UTs, of which 13 are open-ended funds, while 4 are closed funds. Of these UTs, 8 are income funds, 4 are growth funds, 4 are balanced funds and 1 is an index fund. The total number of unit holders declined marginally to 22,699 while the total number of units issued increased to 638 million, indicating an increase in the ownership concentration. The UTs are managed by 5 companies which are supervised by the Securities and Exchange Commission (SEC), which monitors the exposure levels of the UTs in terms of the investment limitations specified in their relevant trust deeds and the SEC's Unit Trust Code. The net asset value (NAV) of the unit trust industry increased by 8 per cent at end 2008. Funds with investments in equities experienced an erosion of NAVs as the stock market plummeted from September 2008. However, these funds performed better than the price indices of the Colombo Stock Exchange (CSE) due to the diversification of portfolios. Funds with more investments in government securities had higher gains. Equities accounted for 38 per cent of total unit trust investments at end 2008, although their share has declined over the last few years from 70 per cent in 2004 and 58 per cent in 2007. The share of investments in government securities increased to 38 per cent, while corporate debt securities declined to 24 per cent.

Venture Capital Companies

The primary business of Venture Capital Companies (VCCs) is to provide equity capital, mainly for new ventures launched by entrepreneurs. There was a marginal increase in activities during the year. The three companies in the industry had funded 34 projects with a total investment of Rs. 804 million at the end of 2008. The VCC continued to focus on investments in the energy and healthcare sector.

Contractual Savings Institutions

Superannuation Funds

The total assets of all funds, i.e., the Employees' Provident Fund (EPF), the Employees' Trust Fund (ETF), the Public Sector Provident Fund (PSPF), the Contributory Pension Fund (CPF) and the Private Provident Funds (PPF) grew by 16 per cent to Rs. 876 billion in 2008. The Public Services Provident Fund and the Contributory Pension Fund had asset bases of Rs. 19 billion and Rs. 1.2 billion, respectively. In addition, there were 176 private provident funds in operation in 2008 with total assets amounting to Rs. 108 billion.

The EPF, the major retirement benefit fund in the country, expanded with an increase in net contributions, investment income and assets. The EPF is administered by the Commissioner of Labour, while the responsibility for the management of funds is with the Monetary Board of the Central Bank. The EPF has about 12.5 million accounts, of which about 2.3 million are contributing active accounts. The difference is primarily on account of some members having multiple accounts. The total number of employers contributing to the EPF rose to 64,000 in 2008, an increase of 5 per cent over the previous year. The total assets of the EPF increased by 17 per cent to Rs. 655 billion at the end of 2008. The total contributions and refunds for the year were Rs. 46 billion and Rs. 26 billion, respectively, registering increases of 14 per cent, and 19 per cent, respectively. The total investment portfolio of the EPF increased by 16 per cent to Rs. 627 billion, consisting predominantly of government securities, which accounted for 97 per cent of the total portfolio. The EPF earned a gross income of Rs. 75 billion for the year. The effective rate of return declared on member balances was 13.4 per cent for 2008. This declared rate was higher than the annual average weighted deposit rate of 10.3 per cent in 2008.

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 8 million accounts, of which 2.1 million are active accounts. The total number of employers contributing to the ETF totalled 58,446, an increase of 6 per cent in 2008. The total assets of the ETF increased by 18 per cent to Rs. 92 billion, while total contributions increased by 14 per cent to Rs. 8 billion in 2008. The total superannuation benefits paid to

Table 8.8 Key Indicators of Major Superannuation Funds

	EPF		ETF	
	2007	2008	2007	2008
Number of Accounts (mn)	11.9	12.5	7.9	8.0
o/w; Active Accounts (%)	18.5	18.4	24.1	26.3
Number of Employers contributing	61,116	64,000	54,904	58,446
Total Contributions (Rs.bn)	40.6	46.0	7.3	8.3
Total Refunds (Rs.bn)	21.8	25.8	4.1	4.9
Total Outstanding Balance of Member Accounts (Rs.bn)	549.4	645.0	75.9	88.9
Total Assets (Rs.bn)	562.4	655.3	78.7	92.4
Total Investments Portfolio (Rs.bn)	541.5	627.2	73.5	86.8
o/w : Government securities (%)	96.5	96.9	90.6	91.4
Gross Income (Rs.bn)	59.4	74.7	8.3	11.5
Interest Rate paid for Member Accounts (%)	11.20	13.40	10.25	12.00

Source: Central Bank of Sri Lanka

members during the year was Rs.5 billion, registering an increase of 20 per cent. The net inflow of funds increased slightly in 2008. The total outstanding member balances in the ETF rose by 17 per cent to Rs. 89 billion at the end of 2008. Total investments stood at Rs. 87 billion at the end of 2008, an increase of 18 per cent, which were heavily concentrated in government securities (91 per cent).

Insurance Companies

The insurance industry recorded moderate growth. The insurance sector accounts for about 3 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 16 companies, of which 11 companies are composite insurers engaging in both long-term and general insurance business, while 3 companies engage exclusively in general insurance and 2 companies conduct only long-term (life) insurance business. Five companies have collaborations with foreign insurance companies. In addition, there are about 50 insurance brokers and about 25,000 insurance agents. The insurance industry is highly concentrated, with two companies accounting for about 66 per cent of the total industry assets, while the largest five firms accounted for 94 per cent of total insurance assets. Premium income for long-term insurance and general insurance grew by 14 per cent and 11 per cent in 2008, indicating a moderation when compared with the previous year. The total assets of insurance companies increased by 15 per cent to Rs. 155 billion at end 2008. The majority of insurance companies made both underwriting and operating profits in 2008.

All companies met the solvency margin requirements. The solvency margin is the main indicator to measure the soundness of insurance companies. All companies were compliant with the solvency margin requirement in respect of both long-term and general insurance in 2008. The increase in the industry solvency margin ratios for both long-term and general insurance during the year points to an improvement in the level of soundness of the industry. As a prudential requirement, insurance companies have to maintain a minimum of 30 per cent of their long-term fund and 20 per cent of their technical reserves for general insurance in government securities. Insurance companies held a large proportion of their assets in government securities of differing maturities (49 per cent of long-term and 29 per cent of general insurance reserves) in 2008 which has strengthened their earnings and helped to mitigate risks. From January 2008, insurance companies were required to cede 20 per cent of the general reinsurance premium to the National Insurance Trust Fund which will ensure that a higher proportion of the gross premia are retained in the country. The Policy Holders Protection Fund is financed by a cess levied on insurance companies and can be utilised for the protection of policyholders in the event an insurer fails to meet its obligations.

The regulatory framework, supervision and enforcement regime pertaining to the insurance industry continues to be strengthened. The Insurance Board of Sri Lanka (IBSL) conducts off-site surveillance and on-site inspection of insurance companies and brokers to monitor compliance with regulations, as well as to assess the risk profiles of insurance companies and to ensure that risk mitigation measures are implemented. The IBSL proposes to increase the minimum capital requirement of insurance companies from the current Rs. 100 million to Rs. 250 million for each class of insurance business in 2009 and action has been initiated to move to a risk-based capital adequacy framework by 2010. Comprehensive revisions to the Regulation of Insurance Act have been prepared by the IBSL to strengthen the powers of the regulator

with regard to the prudential supervision of the entire insurance industry and should be enacted without further delay.

8.4 Developments in Financial Markets

Inter-bank Call Money Market

The liquidity position of the banking system was in surplus in the first nine months of 2008, in contrast to a liquidity shortfall in the last quarter. The average daily excess liquidity in the first three quarters of 2008 was Rs.5 billion, while the average daily liquidity shortage in the fourth quarter was Rs. 10 billion. The daily volume of inter-bank call money transactions rose from Rs.6.8 billion in the first three quarters to Rs. 11.8 billion in the fourth quarter, reflecting the liquidity deficit in the latter part of the year. The daily volume of inter-bank call money transactions averaged Rs.8 billion in 2008 which was similar to the previous year. The rupee liquidity deficit in the fourth quarter was mainly due to the Central Bank supplying foreign exchange to the domestic foreign exchange market to offset shortages in liquid dollar balances in the market, following the global financial crisis.

The Central Bank was able to contain volatility in the inter-bank call money market rates. During the first nine months of 2008, the call money market rates ranged between 13.5 - 15.5 per cent, although rates rose to 19-21 per cent on a few occasions when there were liquidity shortages, such as during the festive season in April and on some days in January, May and June. Call money market rates moved up to average between 15 - 16.5 per cent in the last quarter. However, volatility in call market rates was relatively small even during this period. The penal rate of interest charged by the Central Bank on its reverse repurchase transactions with market participants, which remained at 19 per cent during 2008 and served as a benchmark for market interest rates; and the injection of funds to the market by the Central Bank through its open market operations and by way of two consecutive reductions in the SRR towards the end of the year, which released Rs. 24.5 billion on a permanent basis, helped contain volatility in money market rates in 2008.

Table 8.9 Money Market Operations 2006 – 2008

Rs. million

		Call Money Market	Primary Treasury Bill Market			
		Daily Average Volume	Amount Issued	Amount Purchased		
				Central Bank	Primary Dealers	Others (a)
2006	1st Quarter	4,807.71	147,481	16,796	117,443	13,242
	2nd Quarter	7,013.61	144,412	28,731	101,630	14,051
	3rd Quarter	6,494.94	152,254	47,755	88,144	16,355
	4th Quarter	8,767.95	183,719	71,581	89,785	22,353
2007	1st Quarter	7,555.30	141,804	35,051	89,069	17,684
	2nd Quarter	6,274.05	239,165	78,726	98,530	61,909
	3rd Quarter	7,220.77	212,007	68,138	94,253	49,616
	4th Quarter	7,592.39	224,212	40,946	106,606	76,660
2008	1st Quarter	6,295.21	201,330	8,156	92,186	100,988
	2nd Quarter	6,208.72	212,181	17,139	78,232	116,810
	3rd Quarter	5,579.00	164,368	10,262	57,746	96,360
	4th Quarter	9,657.76	201,697	148,170	24,432	29,095

(a) Amount issued through placements. Source: Central Bank of Sri Lanka

Domestic Foreign Exchange Market

There were increased foreign currency inflows up until end August 2008, but the trend reversed significantly thereafter. The further liberalisation of foreign investment in government securities permitting foreign investors to hold up to 10 per cent of Treasury bonds from December 2007 and 10 per cent of Treasury bills from May 2008 contributed to the increased foreign exchange inflows to the country till end August 2008. During this time the Central Bank purchased foreign currency from the market to build up external reserves and to contain the volatility and undue appreciation of the exchange rate. However, the situation changed after September 2008 as a consequence of the global financial crisis, which brought on tight liquidity conditions internationally. In the context of the tight liquidity conditions in the domestic foreign exchange market following the significant outflow of foreign funds, particularly from government securities, demand for US dollars from importers exerted pressure on the exchange rate. Hence, the Central Bank intervened in the domestic foreign exchange market by selling US dollars. At the same time, the Central Bank reduced the net open positions in foreign exchange of commercial banks in order to contain their speculative activities.

As in the past, the Central Bank intervened on both sides of the foreign exchange market in 2008 to smoothen the excessive volatility in the exchange rate of the Sri Lanka rupee. A total of US

dollars 674 million was absorbed from the market, while a total of US dollars 1.5 billion was supplied during 2008. This has resulted in a net supply of US dollars 858 million during the year, which is considerably higher than the net supply of US dollar 123 million in 2007. The higher net supply in 2008 was mainly for the settlement of petroleum import bills incurred when prices were still at high levels, and for facilitating the withdrawal of investments in Treasury bills and Treasury bonds by foreigners as a consequence of the global liquidity crisis.

The Sri Lanka rupee was relatively stable in 2008. Although the rupee appreciated by 0.68 per cent during the first three quarters, the depreciation in the last quarter resulted in an overall depreciation of 4 per cent against the US dollar by end 2008. The rupee also depreciated against other major currencies; it depreciated against the yen by 22 per cent and the euro by 1 per cent. The Sri Lanka rupee appreciated against the Pound sterling by 32 per cent and the Indian rupee by 17 per cent, mainly due to the depreciation of these currencies against the US dollar. The level of activity in the inter-bank foreign exchange market increased significantly during 2008. The daily average volume of inter-bank transactions was US dollar 59 million in 2008 compared with US dollar 38 million in the previous year, an increase of 55 percent.

Government Securities Market

The main focus of the issuance strategy was to smoothen the maturity structure of the outstanding Rupee debt stock and to minimise the bunching of debt maturities. Hence, the issuance of 364-day Treasury bills was increased, while limiting the issuance of 91 day bills. The composition of the maturity structure of Treasury bills was changed, whereby the volume of the weekly maturities was significantly reduced in 2008 when compared to 2007. Accordingly, out of the total gross issues of Treasury bills in 2008, only 32 per cent were 91 day bills, when compared with the 67 per cent in 2007. In addition, the weekly maturing volume of Treasury bills was reduced to a manageable level of around Rs.10 billion.

In order to finance a part of the government's budgetary requirement and the short-term cash flow needs, the Public Debt Department (PDD) of the Central Bank issued Treasury bonds and Treasury bills through auctions as well as direct placement arrangements. Treasury bill issues totalled Rs. 780 billion in gross face value terms, in 2008. During the first nine months of the year, yields on Treasury bills declined significantly, due to the opening up of the Treasury bill market to foreigners in May 2008 and the strong preference for short-term paper, in the face of limited issues of government securities with short-term maturities. However, yields on Treasury bills rose towards the end of the year to between 17 to 19 per cent, as foreigners cut back their investments as the global financial crisis intensified and the domestic money market was in a deficit position during much of the last quarter.

The total funds raised through bond issues in 2008 amounted to Rs. 489 billion in terms of face value. Out of this, a sum of Rs. 33 billion was raised through Treasury bond auctions, while the balance Rs. 456 billion was issued through direct placements to the market. The limit on foreign investment in Treasury bonds was increased in December 2007 and this contributed to the decline in the yield rates of Treasury bonds. The secondary market yield rates for 2 year Treasury bonds declined in the first nine months of the year. However, the yield rate pertaining to 2 year Treasury bonds moved upwards to around 20 per cent in the fourth quarter of 2008, as foreigners sold off their Treasury bond holdings. The issue of long-term Treasury bonds was limited during the year, due to the high yield rates demanded for long-term maturities in the market during 2008. However, as inflation pressures subsided, small quantities of 3 and 4 year Treasury bonds were issued through private placements. The PDD continued the policy of re-opening the existing Treasury bond series, limiting the introduction of new bond series, as much as possible, to address high fragmentation of the bond market. However, the sharp increase in borrowings from domestic sources due to the sharp decline in funds available from external sources, affected the planned reduction of a number of bond series in 2008. Despite this issue, the PDD was able to maintain the total number of Treasury bond series at 42 at the end 2008, as in 2007.

The Public Debt Department continued to raise foreign currency denominated debt in 2008. In order to pay off the maturing SLDBs, the PDD mobilized US dollars 335.3 million in 2008 by re-issuing SLDBs in June and September. The PDD raised US dollars 275.3 million in June, by re-issuing SLDBs with a two year maturity period, at a rate of six month LIBOR plus 294.9 basis points. It raised US dollars 60 million in September by re-issuing SLDBs at a rate of six month LIBOR plus 289.50 basis points, for a two-year maturity period. During 2008, maturing SLDBs amounting to US dollars 10 million were retired. Further, a loan amounting to US dollars 593 million that had been obtained from OBUs was converted to SLDBs with a maturity period of two years, in July 2008. Meanwhile, US dollars 77 million was raised through OBU borrowings in 2008. A foreign commercial borrowing too was made in 2008, through a syndicated loan amounting to US dollars 150 million, with a tenure of 3 years, with a put option on anniversary dates. This loan was raised at the rate of six months LIBOR plus an effective margin of 256 basis points.

Corporate Debt Securities Market

Commercial Paper

The level of activity in the Commercial Paper (CP) market declined during the year. The total value of CP issues, including reissues supported by banks, amounted to Rs. 24 billion in 2008 in comparison with Rs. 30 billion in 2007. The interest rates on CPs rose to a range of 17 - 36 per cent in 2008, compared with 12 - 25 per cent in 2007. CPs with a maturity of 3 months or less accounted for 91 per cent of the market, while the share of 6 month CPs was 8 per cent. The total outstanding value of CPs amounted to Rs.55 billion at end of 2008 compared with Rs.61 billion at end 2007.

Corporate Bonds

The corporate bond market suffered due to the higher interest rate environment. During the year, there were five new issues of debentures listed on the CSE, amounting to Rs.6.8 billion, compared with seven issues totalling Rs. 8.2 billion in 2007. The Bank of Ceylon was the largest issuer of debentures and mobilised funds amounting to Rs. 4.6 billion. Debentures carrying both fixed and floating interest rates were issued. The interest rates on debentures varied between 17 - 24 per cent during the year. The turnover of debentures listed on the Debt Trading System of the CSE was Rs. 103 million in 2008 compared with Rs. 99 million in 2007.

Equity Market

The equity market fell sharply in 2008 due to a combination of external and domestic factors. Share prices on the Colombo Stock Exchange (CSE), which were fairly volatile during the first eight months of the year, declined very sharply from mid-September 2008. The All Share Price Index (ASPI) and the Milanka Price Index (MPI) fell by 41 per cent and 50 per cent respectively in 2008, compared with a decline of 7 per cent and 11 per cent in 2007. Many factors contributed to the depressed conditions in the stock market, such as high interest rates, lower company earnings, legal cases relating to past privatisation, which affected certain “blue-chip” companies, and the impact of the global financial crisis and the ensuing economic downturn. This was the second consecutive year in which the ASPI and the MPI recorded a downward movement. The price earnings ratio declined to 5.4 at end 2008 from 11.6 at end 2007, indicating a significant deviation from the long-term trend.

Table 8.10 Share Market Performance

	2007	2008
All Share Price Index (a)	2,541.0	1,503.0
Year-on-year change (%)	(6.7)	(40.9)
Milanka Price Index (a)	3,291.9	1,631.3
Year-on-year change (%)	(11.3)	(50.4)
Market Capitalisation (Rs.bn.)(a)	821	489
As a percentage of GDP (%)	22.9	11.1
Market Price Earnings Ratio (a)	11.6	5.4
Turnover to Market Capitalisation (%)	12.8	22.6
Value of Shares Traded (Rs.mn.)	104,985	110,454
Number of Shares Traded (mn.)	2,952	3,155
Number of Companies Traded	231	232
Number of Companies Listed	235	235
Introductions (b)	0	1
Initial Public Offers/Offers for Sale (b)	0	2
Number of Rights Issues	21	9
Amount Raised through Rights Issues (Rs.mn.)	44,622	2,891

(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.

Source: Colombo Stock Exchange

Market capitalisation declined considerably in 2008. Market capitalisation reduced from Rs. 821 billion at end 2007 (23 per cent of GDP) to Rs. 489 billion at end 2008 (11 per cent of GDP). The price indices of all sub-sectors of the ASPI declined in 2008. The indices pertaining to the five largest sub-sectors, that is, Telecommunications (52 per cent), Banking, Finance & Insurance (45 per cent), Diversified Holdings (49 per cent), Food, Beverage & Tobacco (21 per cent) and Health Care (34 per cent), declined substantially, as given within parentheses.

Market turnover rose due to a few large value transactions during the year. The total equity turnover was Rs. 110 billion in 2008. The sale of Sri Lanka Telecom shares amounting to Rs. 33 billion was the largest transaction conducted in the history of the CSE. The average daily turnover increased to Rs. 465 million in 2008 from Rs. 435 million in 2007. However, daily turnover levels declined markedly in the latter part of the year to average Rs. 175 million in September, October and November and Rs. 70 million in December.

Foreign inflows to the equity market increased in 2008. The net foreign inflows rose to Rs.13.9 billion in 2008 surpassing the previous record of Rs. 11.2 billion in 2007, mainly due to several large value transactions in relation to a listed company. However, the global financial crisis resulted in a net outflow of foreign capital from the equity market amounting to Rs. 1.4 billion in the last quarter of 2008. Foreign investors accounted for 54 per cent of total turnover of the CSE in 2008. There were two initial public offerings (IPOs) of shares through which

Chart 8.2 Daily Average Turnover of Equity and Market Price Earnings Ratio

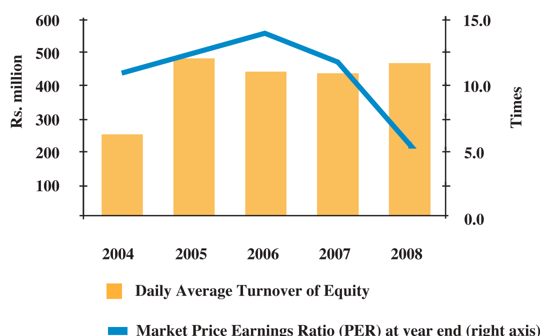
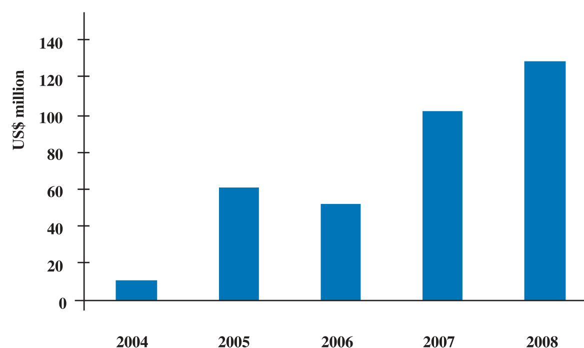


Chart 8.3 Net Foreign Purchases at the Colombo Stock Exchange (CSE)



Rs. 1.5 billion was raised, and 11 rights issues by way of which Rs.3 billion was raised in 2008

The CSE strengthened the monitoring and surveillance of market activities in 2008. An automated surveillance system, which is capable of detecting common market malpractices, such as insider dealing, price manipulations and front running, was introduced in June 2008. In addition, member firms are required to provide a minimum margin of 15 per cent on any purchase of a security over Rs. 20 million. The CSE monitors debtors' positions more closely and as a result the overall debtors' position has reduced considerably**.** A major change with respect to equity settlement that came into effect in 2008 was the introduction of a single tiered settlement cycle of T+3 for equity trades, which has mitigated the settlement risk to a great extent. Moving to a single-tiered settlement cycle will facilitate the introduction of a Delivery versus Payment system at the CSE in the future.

8.5 Development Finance and Access to Finance

During 2008, bank branch expansion continued with 107 new branches being established. Of these, 93 were branches of LCBs, while the balance 14 were branches of LSBs. Of the 93 new branches established by LCBs, 58 were located outside the Western Province. Seven new LCB branches were opened in the Northern and Eastern provinces. Of the 14 new LSB branches established, 8 were located outside the Western Province. Meanwhile, 42 new extension offices were established by LCBs in 2008 of which 32 were outside the Western

Province. Out of these 32, 5 were in the Northern and Eastern provinces. LSBs also established 2 extension offices during the year, both of which were outside the Western Province. A large number of bank branches opening outside the Western Province reflects growing economic activity in the regions at a faster rate than in the past.

As a result of the high interest rate environment that prevailed in 2008, the cost of funds for banks participating in interest subsidy schemes coordinated by the Central Bank rose substantially. Therefore, to ensure their continued participation in such schemes, it became necessary to revise upward the on-lending rates pertaining to the New Comprehensive Rural Credit Scheme (NCRCS) and the Krushi Navodaya Scheme from 8 per cent to 12 per cent. However, as this revision was made in July 2008, the bulk of lending under these two schemes took place at an interest rate of 8 per cent during the year.

Consistent with the robust growth in agriculture experienced during 2008, the demand for funds in most agriculture allied loan schemes increased substantially. Loan disbursement under the NCRCS scheme for cultivation etc. increased by almost 63 per cent in the Maha season of 2008 over the previous Maha season to reach Rs. 1,572 million. In the Yala season of 2008, the corresponding figure was Rs. 1,179 million representing a 38.4 per cent increase over Yala season of 2007. Meanwhile, under the Krushi Navodaya Scheme, disbursements in the first half of 2008 amounted to Rs. 552 million. As a consequence of high and volatile agricultural commodity prices, Forward Sales Contracts (FSC) grew in popularity during the year. The value of loans given for purchase of agricultural produce amounted to Rs. 3,918 million and Rs. 3,866 million in Maha 2007/2008 and Yala 2008 respectively. This represents increases of 104 per cent and 52 per cent respectively, over the corresponding seasons of the previous year. Funds to the agricultural sector also continued to be disbursed under the Second Perennial Crop Development Project Revolving Fund Scheme (SPCDP-RF) and the Tea Development Project Revolving Fund Scheme (TDP-RF) with Rs.117 million and Rs.263 million being disbursed through these two loan schemes, respectively, during the year.

The Central Bank commenced implementing the Agro-Livestock Development Loan Scheme (ALDL), introduced in Budget 2008, in April 2008. This loan scheme finances activities along the value chain of the dairy industry by providing loans at a concessionary rate of 12 per cent for small scale dairies, while also providing loans at a concessionary rate of 14 per cent to milk processing industrial units which have entered into FSCs to purchase the output of 1000-10,000 dairy farmers. It is expected that financing of milk processing industries would infuse private sector dynamism to the milk industry. Under the ALDL, financing is also provided to agro-processing units which have entered into FSCs to purchase the output of 1000-10,000 farmers. Participating Financial Institutions (PFIs) using their own funds for lending under ALDL are entitled to interest subsidy payments of 8 per cent in respect of loans provided to small dairies and 5 per cent in respect of loans provided to liquid milk processing and agro processing industries. The maximum loan size for small dairies is Rs. 400,000, while loans up to Rs. 300 million are permitted for liquid milk processing and crop processing industries.

Loan disbursement to Small and Medium Scale Enterprises (SMEs) at concessionary interest rates continued during the year. Funds disbursed under EIB (Contract-B) for the rehabilitation of tsunami affected SMEs was Rs. 582 million. As tsunami rehabilitation activities had been retarded earlier in the Eastern Province due to hostilities, the Susahana II (revolving fund) scheme was extended to cover all tsunami damaged micro, small and medium enterprises (MSMEs) in that province. This scheme had been earlier intended to cover only MSMEs registered for loans under the original Susahana scheme which had failed to obtain loans due to exhaustion of funds. Under the Construction Sector Development Project, funds to the value of Rs.632 million were released in 2008.

Microfinance

The National Development Trust Fund (NDTF) continued to disburse funds to the microfinance sector through partner organisations (POs). During the year, NDTF made a special effort to enrol grass-root level organisations at the Divisional

Secretariat level as POs. The total number of POs increased to 189 in 2008 from 135 in 2007. The quantum of loan funds disbursed by NDTF in 2008 was Rs. 1,402 million. This represents an appreciable increase of 27.1 per cent over the corresponding figure for 2007. Reflecting the buoyancy of the agriculture sector in 2008, total fund disbursement for agricultural activities grew by almost 46 per cent to reach Rs. 703 million. In fact, almost 74 per cent of the increase in total fund disbursements by NDTF in 2008 was due to the growth in disbursements to the agriculture sector. Lending to small and cottage industries, service activities and fisheries sector activities also increased in 2008.

Of the total loan disbursements through NDTF, 91 per cent in terms of value was for activities outside the Western Province. Among districts, loan disbursement was greatest in Hambantota and Polonnaruwa, with each district accounting for around 15 per cent of total disbursements. Around 93 per cent of funds disbursed was for paddy cultivation in the Polonnaruwa District. In Hambantota, however, while paddy cultivation accounted for 52 per cent of disbursements, there was appreciable disbursement for vegetable and fruit cultivation and for small business activities as well. With the improvement of the security situation, the share of disbursements to the Eastern Province grew significantly. In rupee terms, total funds disbursed to that province more than doubled from Rs. 57 million in 2007 to Rs. 118 million in 2008. Although still very far from adequate, fund disbursement to the Northern Province also improved from Rs. 1.3 million in 2007 to Rs. 6.2 million in 2008.

Meanwhile, funds continued to be disbursed through the poverty alleviation microfinance projects for which the Central Bank is the apex agency. Under the Poverty Alleviation Microfinance Project Revolving Fund (PAMP-RF) Scheme, Rs. 514 million was disbursed during the year for income generating activities. Unlike the former PAMP project which was confined to 6 districts only, PAMP-RF is operational throughout the country. Total funds disbursed to the Northern and Eastern provinces under this scheme were Rs. 58 million. Under the Small Farmers and Landless Credit Project (SFLCP), in respect of which management control has been devolved to beneficiary organisations (People's Companies for Project Beneficiaries) another Rs. 144 million was disbursed for income generating activities in the four districts in which the scheme is operational.

All preliminary work in connection with the forthcoming PAMP Phase II project was completed and the project is expected to be launched in early 2009. This scheme will be operational in 14 districts, namely Ampara, Trincomalee, Batticaloa, Jaffna, Killinochchi, Mannar, Mullativu, Vavuniya, Polonnaruwa, Anuradhapura, Badulla, Moneragala, Ratnapura and Puttalam. A total sum of yen 2,575 million is to be provided by the Japan International Cooperation Agency (JICA) as a soft loan for this project. Out of this amount, yen 2,100 million has been earmarked for credit. As the project will cover all districts in the North and the East, it is expected to have a significant positive impact on the poverty situation in conflict affected marginalized regions.

Credit supplementation schemes improve access to finance by reducing the risk faced by the lender. A new credit guarantee scheme for the Gem and Jewellery sector was introduced in 2008 and preliminary work in connection with the comprehensive credit guarantee scheme to cover the entire MSME sector was undertaken during the year.

8.6 Financial Infrastructure

Payment and Settlement Systems

The Central Bank of Sri Lanka is responsible for maintaining payment and settlement system stability in order to ensure financial system stability, one of the core objectives of the Bank. A secure, reliable and efficient payment and settlement system is vital for the proper functioning and stability of the financial system. The Central Bank has been given a legislative mandate under the Payment and Settlement Systems Act No. 28 of 2005 to develop and maintain infrastructure of such a national payment and settlement system and to oversee and regulate payment and settlement systems in the country.

Table 8.11 Non - Cash Payments: Volume and Value of Transactions

Payment Systems	2007 Volume ('000)	2007 Value (Rs.bn)	2008(b) Volume ('000)	2008(b) Value (Rs.bn)
Large Value Payment Systems	**195**	**21,266**	**229**	**25,131**
RTGS System	195	21,266	229	25,131
Retail Value Payment Systems	**74,723**	**4,760**	**77,084**	**5,221**
Main Cheque Clearing System	46,148	4,296	44,550	4,693
Rupee Draft Clearing System	n.a	2	n.a	1
Sri Lanka Interbank Payment System (SLIPS)	5,945	176	7,846	236
Credit Cards	18,261	67	18,866	73
Debit Cards	1,252 (a)	4 (a)	2,174	6
Internet Banking	2,809 (a)	202 (a)	3,310	197
Phone Banking	308 (a)	2 (a)	338	4
Postal Instruments	n.a	11	n.a	11
Total	**74,918**	**26,026**	**77,313**	**30,352**
US Dollar Cheque Clearing System	**84**	**23**	**71**	**26**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Systemically Important Payment Systems

The payment and settlement system of the country is benchmarked to internationally recognised systems with the introduction of two systemically important payment and settlement systems, namely, the LankaSettle system operated by the CBSL and the Cheque Imaging and Truncation (CIT) system operated by LankaClear (Pvt.) Ltd (LCPL). The LankaSettle system consists of two major components i.e., the Real Time Gross Settlement (RTGS) system, which settles high value and time critical payments in a real time network environment and the LankaSecure system which functions as the central depository for government securities and handles the settlement of securities transactions on a Delivery versus Payment (DvP) basis.

The Real Time Gross Settlement System

The RTGS system continued to be the main inter-bank fund transferring system in Sri Lanka for high value and time critical payments. The RTGS system covered 81 per cent of the total value of non-cash payment instruments. The total number of transactions settled through the RTGS system increased by 17 per cent, while the total value of transactions settled increased by 18 per cent to Rs. 25,131 billion in 2008 when compared with 2007. The RTGS system settles rupee transactions relating to the inter-bank call money market, the government securities market, open market operations, third party customer transactions and settlement of net obligations under the LCPL cheque clearing system. The Central Bank provides an Intraday Liquidity Facility (ILF) to participating institutions in the RTGS system against the collateral of government securities. The daily average value of the ILF requested was Rs. 9.1 billion, of which the ILF utilised by participants was Rs. 4.8 billion in 2008.

The LankaSecure System

The LankaSecure system consists of the Scripless Securities Settlement System and the Central Depository System for scripless government securities. The total value of scripless securities held by LankaSecure at the end of 2008 amounted to Rs.1,713 billion accounting for 99.9 per cent of the total value of Treasury bills and Treasury bonds outstanding. These scripless securities consisted of Rs. 409 billion Treasury bills and Rs. 1,304 billion Treasury bonds. LankaSecure maintained 56,041 accounts through dealer direct participants, covering corporate as well as individual customers.

Cheque Imaging and Truncation System

The CIT system was introduced in 2006 and is operated by LCPL, the national cheque clearing house, with the objectives of eliminating costs involved in a manual cheque clearing process,

Box 10

Establishment of a Local SWIFT Service Bureau

- Another milestone in the modernisation of Sri Lanka's Payment and Settlement System

Setting a landmark in the development of financial infrastructure in Sri Lanka, the 'LankaSettle' system was introduced in 2003/2004. The LankaSettle system is a systemically important payment and settlement system, which comprises of the real time gross settlement (RTGS) system that facilitates the settlement of large value and time critical payments and the scripless securities settlement (SSS) system that provides the facility for settlement of government securities transactions. The RTGS system also supports the settlement of inter-bank payment obligations resulting from clearing of cheques and payments relating to market transactions involving government securities.

The payment and securities messages between transacting parties i.e., participating institutions(PIs) of the LankaSettle system are transmitted using the SWIFTNet, the internationally accepted on-line message carrier for financial transactions. In addition, commercial banks use the SWIFTNet system to transact with their overseas correspondent banks. The Society for Worldwide Inter-bank Financial Telecommunication(SWIFT) provides the SWIFTNet system. It is a global financial message transmission network, which uses advanced Information and Communication Technology for exchange of payment and securities information in a secure manner between transacting parties. The availability of the SWIFTNet for operations is ensured by the SWIFT through full redundancy (a hot backup site which ensures automatic switching of sites during an equipment failure), advance recovery mechanisms, reliable operations and customer support services. A PI requires specific hardware and software to connect their internal computer applications to access the SWIFTNet system.

The continuous availability of the LankaSettle system for the PIs to send and receive payment and securities messages is critical for the stability of the payment and settlement system and thereby for the stability of the financial system of the country. As the operator, the Central Bank of Sri Lanka (CBSL) prepared a complete business continuity plan (BCP) and established a disaster recovery site (DRS) for the LankaSettle system. The CBSL also maintained a dedicated SWIFTNet connectivity at the DRS, to be used in a contingency situation, though the CBSL had to bear a considerable cost on maintaining such an additional SWIFTNet connectivity. Further, having considered the possible consequences of systemic risk which could be caused by the disruption to operations of PIs of the LankaSettle system, the CBSL also persuaded the PIs to have proper BCPs and fully equipped DRSs with dedicated SWIFTNet connectivity in order to achieve consistent level of resilience in the LankaSettle system. Even though the PIs prepared BCPs and established DRSs, they could not obtain separate SWIFTNet connectivity for their DRSs mainly due to the fact that acquisition of SWIFTNet connectivity was very costly, particularly for small to medium sized banks with moderate to low transaction message volumes.

In this context, PIs requested the CBSL to execute their payment and securities messages on behalf of them, in the event where their SWIFTNet connectivity was disrupted. To resolve the problem of not having SWIFTNet connectivity for the DRSs, the available options were evaluated and found that the best alternative was to establish a SWIFT Service Bureau(SSB) in Sri Lanka and to obtain the connectivity through the SSB. An SSB is an organization that is registered with the SWIFT to provide SWIFTNet connectivity, management and data processing services to SWIFT users, including provision of SWIFTNet connectivity for DRSs through the network of SWIFT. The SSB model is currently promoted by the SWIFT in the context of efficiency and convenience of maintenance.

Accordingly, the National Payments Council (NPC), the decision making body which represents all stakeholders of the national payment system and the Sri Lanka SWIFT user group (SLSUG) made a business decision to set up a local SSB. A separate legal entity duly incorporated under the laws of Sri Lanka and fully owned by the PIs of LankaSettle system i.e., commercial banks, primary dealers (PDs) and the CBSL, named as the Lanka Financial Services Bureau Ltd. (LFSBL) was established in June, 2007 and has been in operation from February, 2008. LFSBL is the eleventh SSB to be established and become operational in Asia. Establishing the LFSBL was jointly handled by the CBSL, Sri Lanka Banks' Association and the SLSUG.

Through the operations of the LFSBL, the commercial banks and PDs can share the infrastructure and various costs associated with maintaining a SWIFTNet connectivity individually such as: on-going costs

including capital costs associated with the purchase of hardware and software and their maintenance; costs of employing dedicated technical personnel to manage the SWIFTNet; system integration costs; costs related to training and transfer of technical skills and costs relating to SWIFT network and systems support. The commercial banks and PDs will also be able to reduce down time of the SWIFTNet, by using the service of LFSBL. As most institutions are moving towards outsourcing their non-core activities that require very specialised skill levels, the LFSBL would give the banks and PDs the freedom to work on their core business areas, while benefiting from substantial cost savings. Such benefits are expected to improve the efficiency of provision of financial services to the general public and contribute to further development in the financial sector.

As at 31st December 2008, 21 PIs including commercial banks and PDs have connected to the LFSBL, making use of the LFSBL as a gateway to the SWIFTNet. The CBSL is also a member of the LFSBL. Establishing a local SSB is a milestone achieved on the road-map of the CBSL and the NPC for the year 2008.

reducing settlement risk involved in the lengthy clearing cycle to T+1 (where T is the day on which LCPL receives the cheque for clearing and 1 is the following business day) and eliminating the regional disparities in accessing means of payment. An inspection carried out by the Central Bank revealed that some banks have failed to adhere to the cheque realisation time of T+1 and therefore, a direction was issued by the Central Bank in December, 2007 requiring all banks to formulate procedures and norms on cheque collection, crediting cheque proceeds to customers' accounts and the modalities for handling customer complaints. Having conducted a progress review meeting regarding the implementation of the Direction, the Central Bank instructed banks to submit a half yearly report on details of cheques of which the proceeds were not credited on T+1 and reasons for such delays. These reports revealed that 60 per cent of banks have been able to credit cheque proceeds on a T+1 basis. The total value of cheques cleared in 2008 amounted to Rs. 4,693 billion, an increase of 9.2 per cent when compared with 2007.

Sri Lanka Inter-bank Payments System (SLIPS)

SLIPS is an off–line retail fund transfer system operated by LCPL for banks and their customers. The use of SLIPS for payments has increased considerably since 2006 and therefore, LCPL enhanced the capacity of the system to accommodate new and emerging demand for SLIPS payments. The value of transactions cleared by SLIPS increased by 34 per cent in 2008 mainly due to the use of SLIPS for payment of salaries and wages of public and private sector institutions.

Payment System Policy and Oversight

Having considered the systemic importance of the LankaSettle system and its participants, internal payments and settlements systems and core banking systems, the Central Bank issued business continuity planning guidelines with the objective of making the payments and settlements system resilient as a whole. The Central Bank examined the business continuity plans of LankaSettle participants and LCPL and recommended actions to improve the documented business continuity plans and to equip disaster recovery (DR) sites to face any widespread and prolonged disruptions. The efficiency of a payment and settlement system depends on the ability of the system to settle payments quickly, accurately and safely, and failure in any one of these elements would affect financial system stability. To ensure the system availability during any contingency event in the financial system, the Central Bank developed a PC based system for LankaSettle.

National Payment Council

The National Payment Council (NPC), the highest decision making body on payments and settlements systems in the country, was established in 2006 by the Central Bank with the objective of ensuring an active industrywide forum represented by all major stakeholders in the development of the payments and settlements

systems. In 2007, the NPC formulated a Road Map with action points covering the period 2007-2010 for the development of payment and settlement infrastructure. During 2008, the progress of proposed action points was evaluated and the performance of completed actions was reviewed. The Lanka Financial Services Bureau (LFSB) was established to provide more economical and safer common connectivity points at Primary and DR sites of LankaSettle participants to communicate with SWIFTNet. All participants with local SWIFT connectivity have joined the LFSB in 2008. Migration to chip based credit card technology, which provides enhanced security, was fully implemented by one bank and another bank has implemented this for higher credit limit customers. The rest of the card issuers are expected to comply by 2011. The groundwork has been finalised to implement the Common Payment Switch in 2009 which will enable real time settlement of retail payments. Necessary arrangements have been made to achieve direct connectivity for submission of cheque images to the CIT system by the participating banks to LCPL. As an alternative solution, all banks will move towards the submission of cheque images in compact disks (CDs) to LCPL during the year 2009.

SAARC Payment Initiative (SPI)

SPI was established with the objective of strengthening the existing payments and settlements systems in the SAARC region to facilitate an efficient, robust, stable and convergent payments and settlements system that benchmarks with international standards. Further, promoting regional harmonisation and integration of domestic payments and settlements systems of member countries for the development of intra regional payments and settlements systems was expected in establishing SPI. A stock taking exercise of the payments and settlements systems of member countries was conducted and all members are expected to implement Real Time Gross Settlement systems by 2011 in order to achieve regional connectivity in 2015. Actions were also initiated to collect information on cross broader remittances between member countries.

Legal Enactments

The legal framework continued to be strengthened to enhance the efficiency and stability of the financial sector. A new law, the Pradeshiya Sanwardhana Bank Act provides for the amalgamation of the Regional Development Banks (RDB) into a new national bank. The proposed Pradeshiya Sanwardhana Bank is expected to strengthen the regional banks through financial consolidation, diversification and other synergies and make them more competitive. The Credit Information Bureau (CRIB) Act was amended to enable CRIB to expand its services to other credit granting institutions, as well as insurance companies, utility providers and state agencies, including the Central Bank for regulatory purposes. The CRIB has also been authorized to collect and provide information on dishonoured/returned cheques. Any citizen will be able to obtain a self-inquiry credit report directly from CRIB with the right to dispute records, in line with the principles of consumer protection. A dispute resolution process will be introduced to rectify incorrect information to maintain the quality and integrity of data.

Several laws to strengthen the regulatory framework are under preparation. The Finance Companies Act (FCA) will be amended to strengthen the laws prohibiting persons and companies from conducting unauthorised finance business and deposit-taking, which is done under various guises to avoid the law. The definition of “deposits” will be widened to cover a broad range of fund mobilisation activities. The powers of the Central Bank relating to the investigation of unauthorised/illegal finance will be strengthened and offences will carry more severe punishment. In addition, the amendments will also enhance the powers of the Central Bank with respect to the examination of RFCs and the determination of capital and other prudential requirements. A law to regulate and supervise micro-finance institutions is also being formulated. The different categories of micro-finance institutions are registered under various laws but are not regulated or monitored through a specific regulatory and supervisory authority or arrangement. In view of the diversity of these institutions and the complexity of the micro-

finance sector and the existing laws, it has been decided that certain regulatory requirements should be imposed on these institutions. The Regulation of Insurance Industry Act will be amended to strengthen the powers of the IBSL to issue directions to insurance companies, brokers and loss adjusters, to deal with disputes and enforcement, in order to protect the interest of policy holders. Eligibility criteria for directors of insurance companies and brokers will also be specified. The other proposed revisions to the law include the appointment of institutions as agents of insurance companies and the requirement that long-term (life) and general insurance business be conducted in separately incorporated companies, with existing composite companies being given time to segregate business into two companies. To promote the development of the capital market, a new law on securitization has been prepared to facilitate the issuance of asset-backed securities through the creation of special purpose vehicles (SPVs) and for the regulation and supervision of securitized transactions by the SEC. The SEC Act will also be amended to provide for derivatives as a recognised investment instrument and to formulate a regulatory framework for these securities and to refine the eligibility criteria pertaining to SEC Board members.

Regulation and Supervision

The Central Bank issued several prudential directives to licensed banks, in terms of the Banking Act during the year. The direction on Basle II Capital Adequacy Framework covered the implementation and reporting requirements for credit risk using the standardised approach, market risk based on the standard measurement approach and operational risk using the basic indicator approach. The direction on the classification of loans and advances, income recognition and provisioning was aimed at improving credit risk management and the direction on corporate governance related to amendments to certain transitional provisions with respect to the age limit, length of service and the number of directorships that could be held by directors of licensed banks. Furthermore, draft guidelines on outsourcing activities and integrated risk management systems in banks, were issued for comments of the industry. Also, the road map for the adoption of Sri Lanka Accounting Standards 44 and 45, and margin requirements on letters of credit and forward sales transactions were issued during the year under review.

Directions were issued to finance companies on interest rates and corporate governance under the Finance Companies Act by the Central Bank. The Direction on interest rates which was applicable from April 2008, specified limits on the maximum annual interest rate that may be paid on time deposits, savings deposits, bonds and other instruments issued at a discount, with the objective of lowering the cost of funds and reducing lending rates. The main purpose of the Direction on corporate governance, which is similar to the Direction issued to banks in 2007, is to make the board of directors responsible and accountable for the affairs of finance companies, thereby promoting a robust risk management framework and the overall soundness of the these institutions. The main features of the Direction, which comes into effect from January 2009, relates to the composition and responsibilities of the board of directors of RFCs, management functions delegated by the board, separation of duties of the chairman and the chief executive officer, board appointed committees, risk management systems, the disclosure of financial statements and transitional provisions.

To ensure a secure environment for the growth of the electronic payment cards, a direction has been formulated by the Central Bank for the supervision of service providers of payment cards. The proposed direction which will be issued in 2009, will specify the minimum prudential requirements for all service providers of payment cards to protect the interest of card-holders, to prevent frauds and to ensure confidence in electronic payment instruments.

A Master Repurchase Agreement (MRA) based on a best international market practice was issued in 2008, which could be used by both primary dealers and commercial banks. The MRA, which is a standardised contract governing repurchase transactions between traders and customers,

Box 11

The Global Efforts in Combating Money Laundering and Terrorist Financing

What is Money Laundering?

Money Laundering (ML) is the fraudulent system in which money earned from illegal activities is introduced into the formal financial system to conceal its illegal origin. Hence, the money launderer's attempt to conceal the sources of funds. The illegal (unlawful or criminal) activities which could generate funds that need laundering include, among other things drug trafficking, human trafficking, illicit arms trafficking, corruption or bribery, fraud, counterfeiting of currencies, environmental crimes, murders, smuggling, extortion and kidnapping. And these activities are detrimental to the well-being of societies and the peaceful coexistence of their members.

What is Terrorist Financing?

Terrorist Financing (TF) is the provision of financial support for any form of terrorism or for those who encourage, plan or engage in terrorism. Funds used to support terrorism may originate from legitimate sources as well as criminal activities. The highly adverse socio-economic consequences which terrorism would bring on the whole world have drawn the attention of the international community to combat terrorist financing.

International Efforts in Combating Money Laundering and Terrorist Financing

i. United Nations Conventions: Global efforts in combating Money Laundering and Countering the Financing of Terrorism began in 1980s. The United Nations was the first international organization to undertake actions to fight money laundering on a worldwide basis. This was begun with the adoption of the UN Convention Against Illicit Traffic in Narcotic and Psychotropic Substances, popularly known as the Vienna Convention. Subsequently, UN has issued various conventions and Security Council Resolutions in this regard and all the UN member countries are bound by these conventions and resolutions.

ii. Financial Action Task Force (FATF): FATF was formed in 1989 as an inter-governmental policy making body to combat ML. It has adopted a set of 40 recommendations on ML, which constitute a comprehensive framework for anti-money laundering. Subsequent to the September 11th attack on the US in 2001, FATF adopted nine special recommendations on countering terrorist financing.

The 40 recommendations cover main areas such as, establishment of Financial Intelligence Units, receiving suspicious or currency transactions above a certain limit, giving instructions to financial institutions and issuing guidelines, establishment of a computerized database, compliance control and supervision powers, and exchange of information domestically and internationally. Nine Special Recommendations on TF adopted in October 2001 have broadened the scope of the reporting obligation to include transactions suspected of being related to TF as well. These 40+9 are the mandate for action by a country if it wants to be viewed by the international community as being compliant with international standards.

iii. Asia Pacific Group on Money Laundering and Other Regional Monitoring Bodies: As of today, various regional monitoring bodies have been set up to monitor the efforts of the countries and regions in combating ML and TF in affiliation with the FATF. The Asia Pacific Group on Money Laundering (APG) which was set up in 1997 consists of 39 members from the Asia Pacific region and monitors the compliance with FATF recommendations and best practices. Sri Lanka is a founder-member of the APG. Other regional bodies include the Caribbean Financial Action Task Force, Council of Europe, Eastern and Southern Africa Anti - Money Laundering Group, Financial Action Task Force on Money Laundering in South America, and the Middle East and North African Financial Action Task Force.

iv. Egmont Group: The Egmont Group which operates since 1995 is an association of Financial Intelligence Units to assist countries through sharing information on ML and TF. This Group has a membership of over 100 countries. FIU Sri Lanka holds the observer status at present and expects to receive the full member status by mid-2009.

v. Financial Intelligence Units: Since early 1990s, Financial Intelligence Units (FIUs) have been set up to receive and analyse information on financial transactions to identify and detect any links of possible ML and TF. The establishment of FIUs worldwide rapidly expanded with FATF recommendations on ML and TF. There are three broad categories of FIUs in operation at present, i.e., Administrative FIUs, Law Enforcement or

Judicial FIUs, and Hybrid FIUs. Administrative FIUs collect information on financial transactions and disseminate the information on suspicious transactions to the law enforcement agencies. The law enforcement or judicial FIUs undertake the investigation and prosecutorial function using the law enforcement powers given. Hybrid FIUs contain a combination of powers of administrative and law enforcement/judicial FIUs.

vi. Establishment of the Financial Intelligence Unit of Sri Lanka: In Sri Lanka, formal efforts in combating ML and FT commenced with the enactment of three pieces of legislation, namely Financial Transactions Reporting Act No. 06 of 2006 (FTRA), Prevention of Money Laundering Act No. 05 of 2006 and Conventions on the Suppression of Terrorist Financing Act No. 25 of 2005. The FIU was established in March 2006 in the Central Bank of Sri Lanka under the provisions of the FTRA. The FIU at present receives information on financial transactions (Cash transactions & Electronic fund transfers), analyses and disseminates suspected transactions to the regulatory and law enforcement authorities for further investigations and to initiate legal action. FIU's responsibilities include among others, to record financial information on unlawful activities, conduct examinations on suspicious transactions, request relevant information from institutions , issue rules and guidelines to financial institutions on Know Your Customer (KYC) and Customer Due Diligence (CDD) etc., conduct awareness programs and enter into agreements with local and foreign parties to share information.

The establishment of the Financial Intelligence Unit in Sri Lanka has contributed to the effective implementation of anti-money laundering and the countering of the financing of terrorism framework in line with international standards and best practices.

will enhance investor protection and facilitate the regulation and development of the secondary market in government securities.

The Securities and Exchange Commission (SEC) issued a number of directives. These relate to approval criteria for the issuance of unlisted debt securities. Stock brokers and other market intermediaries are required to submit interim financial reports to the SEC on a monthly basis. New guidelines for trustees and managing companies of unit trusts were formulated by the SEC in 2008, stipulating the independence of the trustee and management company to avoid conflict of interest, financial capacity of the trustee, fitness and propriety of trustee and management company directors and employees and required disclosures in the annual accounts of unit trusts, to protect the interests of unit holders. The Colombo Stock Exchange issued new regulations to stock broker companies trading on their own account in 2008.

The anti-money laundering and countering the financing of terrorism regime was further strengthened. Directives were issued to the insurance industry on "Know Your Customer and Customer Due Diligence" (KYC & CDD) procedures and reporting requirements by the Financial Intelligence Unit under Financial Transactions Reporting Act. In addition, further directives were issued to LCBs, LSBs, RFCs and stock-brokering firms to enforce strict compliance with KYC & CDD reporting requirements. The threshold for reporting all cash transactions and electronic fund transfers was increased to Rs. 1 million.

The Inter Regulatory Institutions Council (IRIC) established to co-ordinate policies and activities between financial regulatory agencies for the development of the financial markets and safeguard financial system stability met regularly. This high level Council was formed in 2007 and is chaired by the Governor of the Central Bank and comprises the heads of the Securities and Exchange Commission, Insurance Board of Sri Lanka, National Payments Council, Colombo Stock Exchange, Registrar of Companies, Sri Lanka Accounting and Auditing Monitoring Board, Institute of Chartered Accountants and the Department of Co-operative Development. The IRIC also has a Working Group of Regulators on Financial Conglomerates which assesses the systemic risks posed by financial conglomerates in order to propose mechanisms for the supervision of these complex financial institutions.

Credit Rating

Deposit-taking institutions regulated by the Central Bank are required to obtain a credit rating from an independent credit rating agency and disclose it to the public, in order to assist the depositors to assess the soundness of these institutions. There were two credit rating agencies operating in Sri Lanka. In 2008, 21 LCBs, 10 LSBs and 11 RFCs had obtained investment grade ratings. SLCs are also required to obtain a credit rating if they mobilize funds from the public through the issue of debt securities.

Credit Information

The Credit Information Bureau (CRIB) provides credit information reports on borrowers to its member credit institutions. The new system named the Credit Information Management System (CRIMS), launched by the CRIB in January 2008 provides more comprehensive credit reports on borrowers. In 2008, the CRIB issued 817,887 credit reports on corporate and individual borrowers, indicating that these reports have become an integral part of the credit appraisal procedure of lending institutions. The system does not have a threshold for the collection of data on credit facilities. The number of reporting credit institutions was 94. The new amendments to the CRIB law empower it to expand its services to other credit granting institutions, as determined by the Minister of Finance. In this regard, CRIB proposes to collect information from insurance and telecommunication companies and include information on dishonoured cheques in its credit reports. CRIB has also been permitted to issue credit reports to any citizen of Sri Lanka. There is a dispute resolution process under which inaccurate information can be rectified.

Box 12

Lessons from the Global Financial Turmoil: The Importance of Risk Management and Corporate Governance

The global economy is now experiencing a severe downturn, which is the worst after the Great Depression of 1930s. This has been triggered off by the onset of a financial crisis in major advanced economies. Some of the world's largest financial institutions have declared bankruptcy, operations of many others have been affected due to credit related write downs, market volatility and uncertainty have increased, and central banks have eased monetary policy and provided unprecedented amounts of liquidity. Many countries are grappling with protracted de-leveraging in financial markets, which has serious implications for their financial system stability and on real economic activity. The failure to monitor counter-party risk and analysis of risks in the sub-prime market and the management's acceptance of ratings by credit rating agencies that had failed to capture risks posed by structured financial instruments, had caused significant losses in the financial institutions and created funding/liquidity problems. Hence, the current crisis highlights the importance of undertaking a re-assessment of principles and practices in risk management and corporate governance.

Risk management: The international financial market turmoil has revealed several shortcomings in some fundamental aspects of risk management in financial institutions.

The weaknesses in underwriting principles, among other factors, were a key contributor to asset quality problems. The present crisis was linked to the US sub-prime mortgage business, in which US banks gave high-risk loans to people with poor credit histories. That means, the banks had failed to stick to sound underwriting principles in the face of tough competition incited by escalating property values and a good economy. Although there was a high growth in credit, especially in the form of mortgage lending supported by rapid development of securitisation, a thorough credit risk analysis has not been undertaken based on borrowers' ability to repay the loans. Moreover, the low interest rates that prevailed for a long period under a benign low inflation regime and lax regulations promoting home ownership, had ignored the resultant weakening of risk management.

The credit crisis also revealed a lack of enterprise-wide risk management, i.e., banks and other financial institutions have failed to identify, measure and manage the entire range of business opportunities and risks. There was little monitoring of counterparty risk and analysis of risk in the sub-prime market. Instead, ratings by credit rating agencies had generally been accepted. Unfortunately, these secondary sources of information and analysis had not been successful in capturing the

risks posed by structured investment vehicles. Thus, some banks were caught completely unaware by concentrations in the sub-prime market.

Another cause of the current crisis has been the existence of skewed incentives for lending institutions. Instead of the traditional focus on a borrower's ability to repay a loan, many banks had focused on generating a high volume of loans and booking the fees received for originating the mortgages as income. The mortgage loans were bundled into portfolios or structured financial instruments, and sold on to investors globally. The regulatory framework and accounting standards also encouraged banks to adopt an 'originate and distribute' model. Many financial institutions relied on liquidity through marketability of long-term credit instruments and, hence, there was a significant mismatch in maturity transformation – holding longer term assets than liabilities. This has resulted in a serious underestimation of liquidity risk.

Even many sophisticated financial institutions, which had used complex financial models to measure their risks before investing in structured finance products, were not successful in mitigating the risks as they did not appreciate the limitations in the models. In particular, inadequate attention has been paid to events with low probability of occurrence. Hence, it is necessary that financial institutions be vigilant and ensure that effective plans are in place in dealing with such risks in complex financial instruments.

Weaknesses in Corporate Governance: A number of shortcomings have also been apparent in the area of corporate governance practices.

Key responsibilities of boards of directors, such as strategic decisions to retain large exposures to these securitized debt portfolios, and putting in place appropriate control measures have been missing in many cases. Moreover, stress testing and related scenario analysis, which are important risk management tools for the boards to oversee the management and review of risks, were found to have been disregarded by many. At the same time, some institutions found it difficult to persuade the senior management and business line management to develop and review the results of forward-looking stress scenarios.

Further, the quality of the work by credit rating agencies has been a significant issue in the current turmoil. The boards also failed to assess the ratings given by the rating agencies, and had not encouraged internal risk assessments. The crisis also revealed that high remuneration and incentives at lower levels often due to the lack of appropriate policies on remuneration and incentives, have favoured excessive risk taking and the losses were finally borne by the banks and shareholders.

The foregoing discussion confirms that there were several shortcomings in risk management and governance practices. Accordingly, a proper evaluation of risks including a enterprise-wide integrated risk management framework and initiating internal assessment of risks on new products with the use of financial models and adopting more rigorous stress testing for extreme and worst case scenarios are some of the key lessons to strengthen risk management and corporate governance. It is also essential that, at the board level, key risks are appropriately managed and continually re-assessed, taking into consideration the evolving conditions in the financial markets and the economy.