Chapter 11

Specialized Financial Institutions

In a modern economy, special emphasis is placed on improving the financial system of the country because a developed and sophisticated financial system is necessary to achieve efficient financial intermediation which is vital for rapid economic development. As economic development proceeds, the required financial facilities and financial services will expand and become more sophisticated. However, the usual financial institutions such as central banks and commercial banks are not adequately equipped to provide all of the required financial services. Hence, specialized financial institutions have to be established and expanded to provide these services through the intervention of authorities if the financial system has not developed sufficiently to give rise to them autonomously. Therefore, in the effort at developing an efficient financial system in a developing country, the central bank should make a special effort to establish and expand specialized financial institutions.

The specialized financial institutional sector, as defined in this paper, covers all financial institutions in Sri Lanka, except the Central Bank and the commercial banks. Since the latter two institutions are components of the monetary sector of the financial system, the definition of 'specialized financial institutional sector' in this study refers to the non-monetary financial sector of the country. Thus, this paper discusses the growth and progress of all financial institutions in the non- monetary financial sector of the country over the last four decades.[1] Following a brief discussion of the composition and overall trends of the non-monetary financial sector, the growth and progress of institutions are examined under four major sub-categories, namely, (i) deposit taking institutions, (ii) long- term lending institutions, (iii) contractual savings institutions and (iv) other specialized financial service institutions.

Composition and Overall Trends

When the Central Bank of Sri Lanka was established in 1950, the financial system of the country was very elementary, comprising only 10 commercial banks, which were mainly branch offices of foreign banks, and a limited number of non-bank financial institutions. Specialized financial institutions such as savings banks and long- term lending institutions were few in number and were at a very early stage of development. Thus, at the inception of the Central Bank, the institutional infrastructure of both the monetary sector and the non-monetary sector was woefully inadequate to meet the aspirations of an independent, developing nation. In this context, an important function of the Central Bank of Sri Lanka, as in any other developing country, was to promote the development of the financial system in the country. Therefore, the Central Bank has been greatly concerned about the development of specialized financial institutions since their services were necessary to facilitate economic development programmes implemented over the last four decades.

At present, the non-monetary (specialized) financial system in Sri Lanka is relatively sophisticated, comprising different types of deposit-taking institutions, long-term lending institutions, contractual savings institutions and other special financial service institutions such as merchant banks, leasing companies, etc. as shown in Chart 11.1.

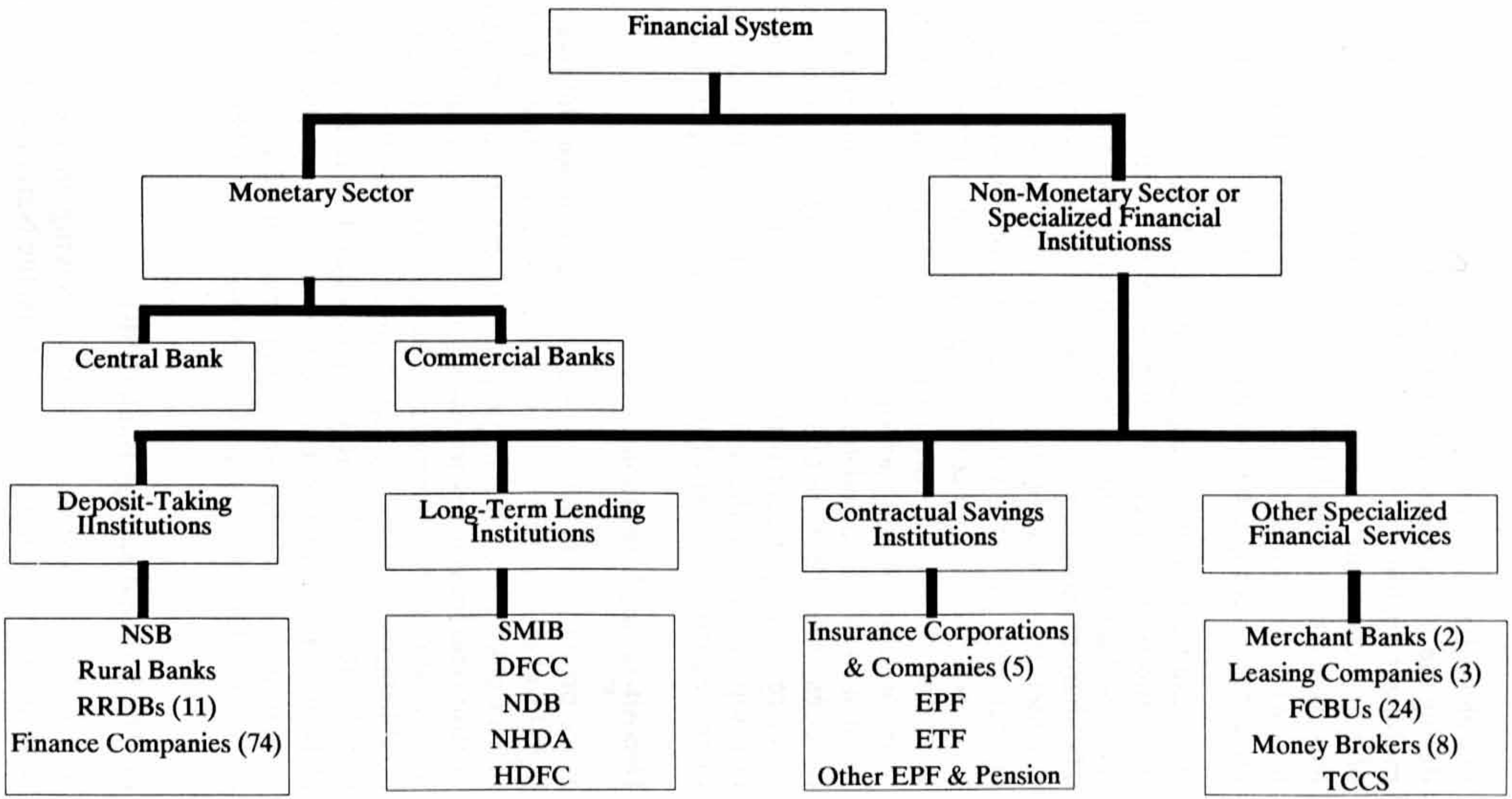
It is observed from Table 11.1 that some of these non-monetary financial institutions were established in the 1950s and expanded continuously during the last 40 years. Modern types of financial institutions such as

1 Growth and progress of Foreign Currency Banking Units (FCBUs) are not discussed in the paper since they are dealt with in Chapter 10.

Chart 11.1

Composition of Non-Monetary Financial Sector

As at end of 1989



merchant banks and leasing companies were introduced only recently, during the 1980s. Generally, services of the sector which include savings mobilization, long-term lending, disbursement of rural credit, financing of house construction, insurance, compulsory savings, hire purchasing, leasing and financial advisory services, are fairly diversified. With regard to ownership, some of them are public sector institutions while others are partly or completely owned by the private sector (Table 11.1).

As a result of continuous expansion of the non-monetary sector financial institutions, this sector's relative share in the financial system has increased during the last four decades in terms of total financial assets. The share of monetary sector assets in total assets of the financial system declined from 84 per cent in 1950 to 78 per cent in 1980 and further to 66 per cent in 1989, while the share of non-monetary sector assets increased from 16 per cent to 22 per cent and further to 34 per cent over the same period. According to sub-sectoral composition, the relative share of deposit-taking non-monetary financial institutions in the overall financial system varied between 10-14 per cent during the last four decades while the share of long-term lending institutions increased from 2 per cent to 4 per cent with some fluctuations. The most noteworthy development is that the sectoral share of contractual savings institutions increased from less than 1 per cent in 1950 to 17 per cent in 1989.

Deposit-Taking Institutions

Since promotion of savings is a pre-requisite for the maintenance of a high level of investment to achieve growth objectives, the Central Bank of Sri Lanka placed special emphasis on creating an efficient specialized institutional framework for savings mobilization, in addition to its efforts in developing the commercial banking system. In this context, the establishment and/or the development of the National Savings Bank (NSB), Rural Banks (RBs), Regional Rural Development Banks (RRDBs) and Finance Companies are noteworthy. The NSB is the largest institution in this sector in terms of total assets, accounting for 71 per cent of the total assets of this sub-sector in 1989.

(a) The National Savings Bank (NSB)

In view of the need to promote saving in the economy, on the recommendation of the Central Bank, the National Savings Bank (NSB)

Table 11.1
Composition of Financial Institutions Non-Monetary Sector

Institutons	Year of Commencing Business	Ownership	Major Activities
1 Deposit-Taking Institutions			
1.1 National Savings Bank (NSB) [a]	1972	Public Sector	Savings Mobilisation
1.2 Rural Banks	1964	Public Sector	Rural Banking
1.3 Regional Rural Development Banks (RRDBs)	1985	Public Sector	Rural Banking
1.4 Finance Companies	pre - 1950	Private Sector	Deposit Accepting and Hire Purchasing
2. Long-Term Lending Institutions			
2.1 State Mortgage and Investment Bank (SMIB) (a)	1979	Public Sector	Lending for Housing
2.2 Development Finance Corporation of Ceylon (DFCC)	1956	Private and Public Sectors	Lending for Industrial Purposes
2.3 National Development Bank (NDB)	1979	Public Sector	Industry Project Finance Refinance and Equity Funding
2.4 Housing Development Financing Company (HDFC)	1984	Private and Public Sectors	Lending for Housing
2.5 National Housing Development Authority	1979	Private and Public Sectors	Lending for Housing
3. Contractual Savings Institutions			
3.1 Insurance Corporations and Companies	pre - 1950	Private and Public Sectors	Life and General Insurance
3.2 Employees' Provident Fund (EPF)	1958	Public Sector	Compulsory Contractual Savings
3.3 Employees' Trust Fund (ETF)	1981	Public Sector	Compulsory Contractual Savings
3.4 Sri Lanka Export Credit Insurance Corporation (SLECIC)	1979	Public Sector	Insurance
4. Other Specialized Financial Services			
4.1 Merchant Banks	1981	Private and Public Sectors	Advisory Services, Discounting and Leasing
4.2 Leasing	1980	Private Sector	Leasing
4.3 Foreign Currency Banking Units (FCBUs)	1979	Private Sector	Deposit Accepting and Lending in Foreign Currencies
4.4 Money Brokers	1979	Private Sector	Money Market Activities
4.5 Thrift and Credit Co-operative Societies (TCCs)		Private Sector	Rural Banking

Source: Central Bank of Sri Lanka

(a) Established by amalgamating then existing savings institutions

Table 11.2
Composition of Financial System

(Based on Total Assets)

Institutions	Rs.Million			Percentage		
	1950	1980	1989	1950	1980	1989
I. Monetary Sector	1,445	49,433	169,123	84	77	66
1. Central Bank	587	22,832	62,771	34	36	25
2. Commercial Banks	858	26,601	106,352	50	41	41
II. Non-monetary Sector	280	14,416	85,703	16	23	34
A. Deposit-taking Institutions	249	6,300	31,837	14	10	12
A.1. NSB	249	5,329	20,905	14	8	8
A.2 Rural Banks	-	335	2,212	-	1	1
A.3 Finance Companies	-	636	8,213	-	1	3
A.4 RRDBs	-		507	-	-	-
B. Long-term Lending Institutions	31	405	10,612	2	1	4
B.1 SMIB	31	127	2,620	2	...	1
B.2 DFCC	-	278	2,566	-	...	1
B.3 NDB	-	-	4,271	-	-	2
B.4 HDFC	-	-	1,155	-	-	...
C. Contractual Savings Institutions	-	7,711	42,098	-	12	17
C.1. Insurance	-	2,660	6,054	-	4	2
C.2 EPF	-	5,051	34,027	-	8	13
C.3 ETF	-	-	3,617	-	...	2
D. Other Specialized Financial Services	-		1,156	-	-	...
D.1 Merchant Banks	-		356	-	-	...
D.2 Leasing Companies	-		800	-	-	...
Total	1,725	63,849	254,826	100	100	100
Total (at 1952 prices) Real	1,782	20,065	30,695			

Source: Central Bank of Sri Lanka.

Table 11.3
Total Assets of Deposit Taking Institutions
Non-Monetary Sector

(Rs.Mn.)

Institution	1950	1960	1970	1980	1989	1989 % Share
1. National Savings Bank (Before 1972 CSB,POSB,SCF)	253	451	780	4,953	19,955	71
2. Rural Banks	-	-	17	368	2,212	8
3. Finance Companies	...	...	134	411	5,057	18
4. Regional Rural Development Banks	-	-	-	-	160	...
5. Agrarian Services Centres	...	...	...	109	204	1
6. Thrift and Credit Co-operative Societies	...	...	...	...	418	2
Total	253	451	931	5,841	28,004	100

Source: Central Bank of Sri Lanka.

was established in 1972 under the National Savings Bank Act No. 31 of 1971 by amalgamating the Post Office Savings Bank, the Ceylon Savings Bank and the Savings Certificates Movement. It is the only savings bank in the country and has been a key institution in the mobilization of private sector savings.

The objectives of the NSB were to mobilize savings, especially from small savers, and to provide savings opportunities in areas where banking facilities are not readily available. Presently, it competes with an extensive network of branches set up by the two state sector commercial banks, viz., the Bank of Ceylon and the People's Bank. At the end of 1989, it had 64 branches and used 507 post offices and 3,321 sub-post offices spread throughout the country as additional deposit-taking locations.

In addition to savings and time deposits, the NSB has introduced several other saving schemes tailored to the specific needs of savers in the country. The NSB premium savings bonds introduced in 1979 offer eligibility to a lottery drawing in lieu of interest on monies invested in such bonds. Special savings schemes introduced by the NSB include a pension plan for the self- employed, consisting of 60 consecutive monthly payments, that entitles the contributor to an annuity equal to the monthly payment; endowment schemes for education or dowries; savings certificates and a "save as you earn" scheme of automatic payroll deductions which are deposited into savings accounts. The interest rates offered by the NSB are made more attractive for tax-paying depositors by the tax exemption given on interest income. At present, one-third of the interest received on deposits, or Rs. 2000 per annum, whichever is lower, is exempt from income tax.

Time deposits are the major source of funds for the NSB. At end 1989, approximately 65 per cent of its resources came by way of time deposits, while only 25 per cent comprised savings deposits and the balance 10 per cent represented other special savings schemes. In terms of geographical distribution, a large part of its deposits, about 70 per cent, was from urban areas and the balance 30 per cent from rural areas. According to the size of deposits, most NSB accounts are small deposits. In 1989, approximately 95 per cent of its deposits were less than Rs. 10,000 each.

The combined total assets of the three savings institutions, which were subsequently amalgamated to form the NSB, only doubled during the 20

Table 11.4
National Savings Bank

(Rs.Mn)

	1972	1975	1980	1985	1989
A.Deposits					
1. Savings Deposits	913	1,414	2,146	3,701	7,931
2. Fixed Deposits	53	243	2,759	9,480	11,971
3. Savings Certificates	67	113	39	8	3
4. Premium Savings Bonds	-	-	6	9	9
5. NSB Pension Scheme	-	-	3	31	37
6. Total Savings Mobilised	1,033	1,770	4,953	13,229	19,951
B. Loans and Investments					
1. Government Securities and Treasury Bills	952	1,695	4,847	13,027	18,960
2. Housing and Property Loans	n.a.	n.a.	70	51	n.a.
3 Other Loans	n.a.	n.a.	31	168	n.a.
C. Interest Rates 12-months Fixed Deposits					
1. NSB %	7.5	7.5	20	15	15
2. Commercial banks %	4.5-7.5	7-7.5	20	12-18	11-20.5

Source: Central Bank of Sri Lanka.

year period from 1950 to 1970, increasing from Rs. 257 million to Rs. 565 million. After the establishment of the NSB, the rate of expansion of its assets accelerated, increasing from Rs.1,033 million in 1972, to Rs. 5,329 in 1980 and to Rs. 19,951 million in 1989.[2] This was largely due to an active promotional campaign to encourage savings, coupled with added incentives of attractive interest rates and tax-exemption on interest income. Between 1977 and 1984, the NSB offered higher interest rates than the two state-owned commercial banks, in pursuance of the government's policy of moving to a more appropriate interest rate structure. As a result, during this period the entire financial sector viewed the NSB as the pace- setting institution for deposit rates. However, since 1984, the NSB has followed a more flexible policy with respect to interest rate fixing without direct intervention by the government. At present, the deposit rates of the NSB are marginally higher than the corresponding rates of the two state banks.

The investments of the NSB are governed by the National Savings Bank Act, 1972. By law, the NSB is required to invest at least 60 per cent of its deposits in government or government guaranteed securities. In practice, however, almost all available resources are invested in government securities and at the end of 1989, investment in government securities accounted for about 95 per cent of total deposits of the NSB. Thus, the NSB was a major source of funds for financing the government budget deficit in the 1970s and 1980s.

Since the returns from investments in government securities were lower than the costs of funds to the NSB, the Government had to cover the difference through an interest subsidy from the Budget.

In the recent past, the NSB has taken some steps to diversify its portfolio by introducing new loan schemes such as a housing loan scheme for its depositors and a pilot rural credit scheme in the Matara district. Since 1989, it has been admitted as a participating institution under the Small and Medium Industry (SMI)-III credit programme. There are also two special loan schemes implemented by the NSB. Under the House and

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2 For a more meaningful comparison, these figures should be considered in real terms, i.e. adjusted for inflation. The corresponding real values adjusted by the Consumer Price Index (1952 = 100) were Rs.265 Mn. in 1950, Rs.409 Mn. in 1970, Rs.685 Mn. in 1972, Rs.1,675 Mn. in 1980 and Rs.2,403 Mn. in 1989.

Property Loans Scheme, it provides credit facilities for housing at an interest rate of 17-20 per cent per annum, depending on the magnitude of the loan. A loan scheme against fixed deposits was introduced in 1988 with the twin objectives of providing depositors with the facility to meet urgent cash requirements without premature withdrawals of their deposits and improving of its financial viability through increased generation of interest earnings. At the end of 1988, loans given under these two schemes totalled Rs. 207 million and Rs. 94 million, respectively. The NSB has also placed emphasis on improving its services to savers by expanding its branch network, introducing new savings instruments and improving customer services.

(b) Rural Banks[3]

The Central Bank encourages commercial banks to extend their services to the rural sector as a part of its broad objective to expand financial services available in the country. The Rural Banks (RBs) scheme was inaugurated in 1964 by the People's Bank for mobilizing rural savings and channelling credit to the rural sector. The objective of the scheme was to assist primary co-operatives at the village level to incorporate concrete proposals to encourage the development of their banking functions on efficient lines, and to raise their managerial and operational standards. According to the institutional structure, the People's Bank assists these societies by way of advances for re-lending to members, and for financing the purchase of equipment, etc. In collaboration with the Department of Co-operative Development, the People's Bank helps these societies in formulating and implementing plans for development in their respective areas.

In a strict sense, RBs are not commercial banks because they do not accept demand deposits or provide chequing facilities and their activities are limited. However, during the last three decades, the RBs grew in number, providing basic banking services to a large portion of the rural population. The multi-purpose co-operatives begun by the government in 1970, provided the necessary framework for the expansion of the rural bank scheme on a national scale, whereas earlier very few co-operatives qualified to have a rural bank. In fact, a rural bank for each of the new

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3 After 1971, Rural Banks have been called Co-operative Rural Banks (CRBs)

Table 11.5
Rural Banks

	1970	1975	1980	1989
No. of Branches	90	109	357	970
No.of Deposits ('000)	50	500	1,169	2,371
Amount of Deposits (Rs.Mn.)	17	74	368	1,908
No. of Loans ('000)	10	35	59	103
Amount of Loans (Rs.Mn)	7	37	80	409
No. of Pawnings ('000)	18	299	343	394
Amount of Pawnings (Rs.Mn)	2	50	97	421
Net Deposits (Rs.Mn.)	+8	-13	+192	+1,079
(Total Deposits - Total Loans - Total Pawnings)				

Source: Central Bank of Sri Lanka

co-operatives was established as a part of government policy in the rural sector. Consequently, the rural banks which started in 1964, increased in number to 90 in 1970, to 641 in 1980 and to 985 in 1989. Meanwhile, the total assets of the RBs increased to Rs. 17 million in 1970 and to Rs. 368 million in 1980 and further to Rs. 2,212 in 1989.

At present, in addition to mobilization of savings through savings and fixed deposit accounts, these RBs provide credit facilities to the rural sector, especially for production, housing, electrification, debt redemption, consumption and emergencies. Furthermore, RBs undertake the business of pawnbroking as agents of the People's Bank and assist in integrating credit programmes with production and marketing activities. As evident from Table 11.5, there has been a higher allocation for pawning than for loans in their portfolios. The surplus, defined as deposits minus loans and pawning, increased significantly, reflecting an outflow of financial resources from the rural sector to the urban sectors through the RBs.

(c) Finance Companies

Finance companies are the third largest group of deposit taking institutions in Sri Lanka, following commercial banks and the NSB. Historically, the finance companies first functioned as subsidiaries of motor vehicle dealers providing hire purchase facilities to prospective buyers of motor vehicles. These companies were known as "Hire Purchase Companies" with their principal business being the provision of hire purchase facilities. Although the history of these companies goes back to the pre-Independence period, a formally organized sub-sector of finance companies emerged only during the early part of the 1950s[4]. Since then, this sector showed a slow but constant growth until the end of the 1970s. After 1978, the expansion of finance companies accelerated in response to liberalized economic policies introduced in 1977/78. Also, finance companies expanded their services to new economic activities extending beyond hire-purchase facilities for vehicle buyers. Most of the branches of finance companies are located in major cities and their branch network is still smaller than that of the commercial banks.

Deposit mobilization is the major source of their funding, providing about 64 per cent of total resources in 1989, while capital and borrowings provided 11 per cent and 17 per cent, respectively. Other liabilities accounted for the balance 8 per cent of their resources. They are allowed to accept only term deposits in which the term structure ranges between three months and three years. Since 1978, the operations of finance companies have expanded rapidly with the offer of deposit rates higher than those offered by the commercial banks and the NSB. The outstanding deposits of finance companies increased from Rs. 134 million in 1970 to Rs. 636 million in 1980 and to Rs.7,676 million at the end of 1989.

On the lending side, finance companies provide hire-purchase loans, bridging finance, leasing, land and housing finance and loans to high risk clients, who normally do not have access to commercial bank credit for lack of suitable collateral. Hire-purchase business still dominates finance companies' assets portfolios, accounting for about 38 per cent

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4 Dr.H.N.S.Karunatilake, Banking and Financial Institutions in Ceylon, (1968), pp. 171 - 173.

of total assets in 1989. Meanwhile, loans and investments accounted for 28 and 9 per cent respectively in the same year, while the balance 25 per cent was accounted for by other assets. On the whole, finance companies generally offer higher rates on deposits and charge higher rates on loans than commercial banks. The growth of finance companies has decelerated to a certain extent in the recent past, mainly due to liquidity problems encountered by some finance companies necessitating official intervention and relief operations.

Until 1979, no steps were taken to control or regulate the activities of the finance companies because their role in the economy was not very significant. Until then, they were subject to regulation under some general legislation such as the Companies Act. The necessity for controlling/regulating the finance companies arose in the late 1970s for several reasons, including the rapid expansion of finance company activities and their considerable impact on the financial system of the country and the need to ensure the liquidity and solvency of these companies to protect the depositors. As a result, the Control of Finance Company Act No. 27 of 1979 was enacted, giving powers to the Central Bank to regulate and control finance company activities. With the implementation of this Act in 1982, finance companies could no longer be left unsupervised, especially in the determination of liquidity, interest rates and investments. According to the Act, a finance company is a company which accepts money by way of deposits, pays interest thereon, and lends money on interest, or invests money in any manner whatsoever. Under the Act, every finance company should be a public company and be registered and should have a minimum issued and paid up capital of not less than five million rupees. Regulations were imposed by the Central Bank on the operations of finance companies in order to (a) protect the interests of depositors, (b) monitor the effects of finance companies on the monetary system and the national economy and (c) to safeguard the stability and interests of the system of non-bank financial institutions, and thereby promote the smooth functioning of the financial system of the country.

The Bank Supervision Department of the Central Bank started supervision and examination of finance companies in 1983. Regulations were imposed with respect to the liquidity requirements of finance companies in 1982. Initially, a minimum liquidity ratio of 5 per cent of deposits was imposed and in 1984, this minimum liquidity ratio was

Table 11.6
Operations of Finance Companies

(Rs.Mn.)

	1971	1980	1985	1989	1989 % share
1. No. of Registered Companies	56	56	71	72	
2. No. of Reported Companies	31	40	54	46	
3. Source of Funds					
3.1 Capital Account	42	74	564	835	11
3.2 Deposits	71	411	3,883	4,915	64
3.3 Borrowings	21	79	332	1,325	17
3.4 Other Liabilities	37	72	752	1,600	8
4. Uses of Funds					
4.1 Hire purchase business	82	311	2,216	2,918	38
4.2 Loans outstanding	19	73	1,212	2,137	28
4.3 Investments	-	-	259	656	9
4.4 Other Assets	70	252	1,184	1,965	25
5. Total Assets/Liabilities	171	636	5,531	7,676	100

Source: Central Bank of Sri Lanka.

raised to 10 per cent of deposits. At the same time, finance companies were required to maintain reserves equivalent to 3 per cent of deposits in the form of Treasury bills and Government or Central Bank securities. This liquidity ratio was further raised to 15 per cent in 1985. In 1987, the Central Bank imposed ceilings on interest rates paid by finance companies to depositors at 17 per cent per annum on 12- month deposits and 18 per cent per annum on deposits with maturities longer than one year. Having taken into account the changes in the market interest rates, the upper limit of fixed deposit rates of finance companies was raised to 20 per cent per annum in June, 1988 and further to 21 per cent per annum in August, 1988, on deposits with maturity periods of less than two years and 24 per cent per annum on deposits with maturity periods of two years or more. Furthermore, measures were taken to ease the burden on the borrowers from finance companies. Accordingly, finance companies were directed to calculate interest on loans and hire- purchase business on the reducing balance basis instead of on the original principal,as had been done by many of them hitherto. In addition, finance companies were required to inform the borrowers in writing of the agreed rate of interest and also of any additional charges as a percentage per annum.

The supervisory role of the Central Bank over finance companies was strengthened in order to ascertain the extent to which these companies had complied with the directives issued by the Central Bank. On-site examination of finance companies was started in 1987. Even with these regulations and supervision activities, some finance companies faced severe liquidity problems after 1986 and were unable to honour their obligations to depositors. Of these, the business activities of six finance companies were suspended in 1987 and of another three in 1988.

As the existing laws were found to be inadequate to deal with these complex problems of finance companies, a comprehensive new legislation, called the Finance Companies Act No. 78 of 1988, was enacted by Parliament for enhancing the powers of the Monetary Board in controlling the affairs of finance companies. The Central Bank established a new Department called the Department of Supervision of Non-Bank Financial Institutions in 1988 to regulate and supervise finance companies under the new Act.

In 1988, the Central Bank introduced a financial assistance programme under its refinance programmes to assist finance companies to solve their short-term liquidity problems and a scheme to grant relief to depositors of finance companies in distress. A period of two years has been granted for these finance companies currently in operation to comply with the stipulations of the 1988 Act and this transitional period ends on December 18, 1990.

Out of nine finance companies suspended in 1987 and 1988, only six companies remained vested in the Central Bank at the end of 1989. Of these, one was amalgamated with another finance company, three are being managed by a team of financial experts nominated by the Central Bank and two are being managed by firms under agreements signed with the Central Bank. Out of the three remaining finance companies, one was amalgamated with a major finance company and two have been considered for liquidation. As at the end of 1988, there were 72 finance companies registered with the Central Bank and this number remained without change in 1989. However, under the restructuring programme undertaken by the Central Bank, the total number of operational finance companies at end 1989 was only about 45. A further reduction in the number of finance companies is expected, but the financial viability of the remaining finance companies will improve following the strengthening of regulation and supervision by the Central Bank.

Long Term Lending Institutions

As in many other developing countries, commercial banks in Sri Lanka concentrate mainly on financing short-term financial requirements (i.e. working capital requirements) of the organized economic sectors. It has to be noted that the maturity structure of commercial banks' deposits is a constraint which limits their long-term lending activities. Commercial banks have to restrict themselves to short-term lendings in order to match the balance between the maturity patterns of their assets and their liabilities, because most of the deposits accepted by them have maturity periods of less than two years. Furthermore, commercial banks are not generally equipped with the required expertise to appraise projects involving complex agricultural or industrial production activities . Also, many new worthwhile enterprises do not have previous track records, which are normally required by commercial banks to appraise their repayment potential. Therefore, medium and long-term lendings are very often restricted to a select group of large and well established enterprises which have a high credit rating. Moreover, private capital markets, which provide most of the long-term financial requirements of investors in the developed countries, are generally under-developed in most developing countries including Sri Lanka. Consequently, the monetary authorities in most developing countries have established specialized development finance institutions to meet the long- term credit needs of the economy. In many cases, these development finance institutions have been established with financial support from the central bank, the government, commercial banks and international lending agencies.

Development finance institutions (DFIs) in Sri Lanka are by no means different from the scenario discussed above, since they were established to fill the orthodox "gap" in the provision of long-term credit in the financial system. Development finance institutions had been introduced into the country long before achieving political independence in 1948, though their development was moderate. The State Mortgage Bank (SMB) and the Agricultural and Industrial Credit Corporation (AICC) were major long-term development lending institutions operating at the time of Independence. The Loan Board (LB), the Housing Loans Board (HLB) and the Local Loans and Development Fund (LLDF) were the other long-term lending institutions existing before the establishment of the Central Bank in 1950.

Recognizing the inadequacy of the facilities available with respect to long-term credit under the existing financial system, the Central Bank has made special efforts directly and indirectly to develop the long-term financial institutional structure of the country during the last four decades. Accordingly, the Central Bank assisted in the re-organization of existing long-term lending institutions by resolving organizational weaknesses, introducing new institutions, making available funds by contributing to the capital of these institutions and mobilizing fresh funds through the issue of long-term debt instruments on their behalf, improving their viability through supervision and providing advice and technical expertise.

(a) The State Mortgage and Investment Bank (SMIB)

The earliest long-term lending institution in the country, the State Mortgage Bank (SMB), was established in 1931 under the Ceylon State Mortgage Bank Ordinance No. 16 of 1931 to provide long-term loans for agriculture and other prescribed purposes on the primary mortgage of land and property. The Agricultural and Industrial Credit Corporation (AICC) was established under Ordinance No. 19 of 1943 to provide

Table 11.7
Long-Term Lending Institutions
Purpose-wise Classification of Loans Approved

(Rs.Mn.)

Sector	1985			1989		
	SMIB	DFCC	NDB	SMIB	DFCC	NDB
1. Agriculture	18	18	-	6	67	39
	(3)	(5)		(2)	(6)	(3)
2. Industry	-	258	455	-	995	1,051
		(70)	(55)	-	(86)	(80)
3. Tourism	-	2	16	-	5	21
		(...)	(2)		(...)	(1)
4. Financial	79	33	-	-	28	165
	(14)	(9)	-	-	(2)	(12)
5. Housing	440	-	-	334	-	-
	(79)	-	-	(88)	-	-
6. Others	21	60	357	39	62	55
	(4)	(16)	(43)	(10)	(6)	(4)
Total (Approved)	558	371	828	379	1,157	1,331
	(100)	(100)	(100)	(100)	(100)	(100)

Source: Central Bank of Sri Lanka.

Note: Values in brackets are relative shares in percentage values long-term credit facilities to agriculture and industrial ventures against the primary mortgage of movable or immovable property or stocks of agricultural crops. Thus, the latter could lend for industrial, mining and some other purposes which were not within the purview of the former. The SMB obtained resources through debenture issues guaranteed by the government and borrowings from the government, while the AICC depended on borrowings from the government for financial resources. The issue of SMB debentures came under the Central Bank after 1950.

The expansion of activities of these two institutions were not very impressive. The two institutions which started operations on a very modest scale at the beginning expanded moderately thereafter. The value of total loans outstanding given by both institutions increased from Rs. 24 million in 1950, to Rs.91 million in 1960 and to Rs. 100 million in 1975. Meanwhile, total loans granted annually by them varied in the range of Rs. 9 to 17 million, which was not adequate to meet the demand for long-term funds in the economy. Expansion of their activities was limited by non-availability of funds, lack of trained staff to undertake aggressive lending activities and defects in land titles as securities.

The Central Bank recognized these problems and proposed measures to correct them from time to time. In order to play a more dynamic role in the development process, the Central Bank recommended the enlargement of the powers of the SMB and the substitution of certain outmoded practices and procedures with modern development banking methods. These amendments were incorporated in Act No. 33 of 1968 by enlarging the scope and activities of the SMB, especially those connected with acceptability of title to lands and the SMB's ability to borrow under the refinance schemes of the Central Bank. Similarly, on the recommendation of the Central Bank, the AICC Act was amended by Act. No. 5 of 1970 to enable it to borrow under the same refinance schemes. However, these amendments were not strong enough to improve the performance of the SMB and the AICC and a complete revamping of the two development lending institutions, so as to provide a sufficient degree of dynamism and flexibility to accelerate the flow of development credits, was mooted.

Belatedly, the two institutions were amalgamated under Act No.13 of 1975 to establish the State Mortgage and Investment Bank (SMIB). It was considered that the amalgamation would provide a pooling of resources, both financial and human, enabling the medium and long-term credit needs of the economy to be met more effectively than could be done by the two institutions operating separately. The SMIB was given wider powers than the two earlier institutions. In addition to lending for agricultural and industrial activities, it was empowered to lend for housing construction as well. This bank was allowed to create and issue debentures, stocks, shares and securities for the purposes of carrying on its business. Also, it was allowed to accept term deposits from any person, above certain minimum amounts, and to invest these in the shares and debentures in agricultural or industrial enterprises. The authorized capital of the SMIB was Rs. 200 million.

After the amalgamation, the expansion of lending activities of the SMIB accelerated. The total value of outstanding loans granted by the SMIB increased from Rs. 113 million in 1979, to Rs. 857 million in 1985 and further to Rs.2,502 million in 1989. In the recent past, it has been concentrating largely on lending for housing construction. Housing loans accounted for about 90 per cent of the total outstanding loans in 1988. Thus, although the SMIB was originally conceived as a development bank, it has become effectively a mortgage bank lending primarily for housing in the1980s. Generally, interest rates charged by the SMIB have been lower than commercial bank lending rates. Under its housing loan scheme, the interest cost is fully deductible for income tax and capital repayments are deductible upto one third of the borrower's tax liability. The present lending rates are in the range of 12-16 per cent per annum and the lending period varies from 5 to 20 years.

The bulk of its resources are obtained from medium-term debenture issues and grants from the government and international agencies. These debentures are normally issued by the Central Bank and purchased by captive sources such as the EPF and the ETF. The Central Bank supervises and makes recommendations from time to time on the activities of the SMIB.

(b) The Development Finance Corporation of Ceylon (DFCC)

The Central Bank, considering the inadequacy of long term lending facilities in the early 1950s, recognized the necessity for creating a new development lending institution. In order to fill the gap in the development financing facilities of the country, the Central Bank made a proposal to the government to set up the Development Finance Corporation of Ceylon. The purpose of the proposed corporation was primarily to promote and assist new enterprises in industry, and to expand and modernize agricultural concerns. Consequently, the Development Finance Corporation of Ceylon (DFCC) was established under Act No. 35 of 1955 to provide long-term finance to private enterprises. The DFCC was set up as a limited liability institution established for development lending in the country. More specifically, the purpose of the DFCC, as set out in the Act, was to assist in the establishment, expansion and modernization of private industrial, agricultural and commercial enterprises in Sri Lanka and to encourage and promote the participation of private capital, both local and foreign, in such enterprises. In the pursuit of these objectives, the corporation offers financial assistance to such enterprises in the form of equity participation, loans, convertible debentures and guarantees.

The initial authorized capital of the DFCC was Rs. 8 million and as provided in the Act, the government made an initial contribution in the form of an interest free loan of Rs. 16 million. By an amendment to the Act, the authorized capital was raised to Rs. 24 million in 1967 and further to Rs. 300 million in 1982. In the recent past, foreign loans, largely from the Asian Development Bank (ADB) and the International Development Association (IDA), have become a major source of finance, contributing about 50 per cent of total funds. Also, in 1985, the DFCC issued debentures worth Rs. 333 million to commercial banks to augment its resource base.

The expansion of the DFCC was supported by the economic environment since its establishment coincided with increasing activities in the country in industrialization and economic development. The establishment of the Medium and Long-term Credit Fund (MLCF) by the Central Bank in 1964 also helped to expand the lending activities of the Corporation. The value of total loans granted and equities outstanding of the corporation increased from Rs. 28 million in 1960, to Rs. 59 million in 1970 and further to Rs. 2,254 million in 1989, while annual loans granted and equity investments increased from Rs. 5 million, to Rs. 214 million and to Rs. 798 million over the same period. The amount in equity investment was very small and amounted to only Rs. 12 million in 1989.

An amendment to the Act in 1982 provided the DFCC with powers to carry out merchant banking services, issue debentures, accept deposits, establish subsidiary companies, carry-out co-financing and hire-purchase activities and undertake equipment leasing. Presently the DFCC offers the following range of services:

equipment financing/leasing, equity participation, professional project appraisal, guaranteeing loan, consultancy services, underwriting of equity and granting long-term loans.

The lending rates of the corporation were in the range of 14-19 per cent per annum in 1989.

(c) The National Development Bank (NDB)

As a response to long-term credit requirements which were greatly expanding with the liberalized economic policies introduced after 1977, the National Development Bank (NDB) was established under the National Development Bank Act No. 2 of 1979. The objective of the establishment of this bank was to promote the development of industrial, agricultural, commercial and other sectors of the economy. In order to achieve this objective, the NDB was allowed to provide direct project finance, refinance and equity funding to private and public enterprises.In addition, the bank was empowered to undertake development projects, provide technical and consultancy services etc., in order to achieve its purposes.

The authorized capital of the bank was Rs. 2,000 million and the initial paid up capital was Rs. 450 million. The government provided Rs. 400 million in cash, the Central Bank Rs. 25 million in cash and Rs. 75 million in the form of promissory notes payable on demand, the Bank of Ceylon and the People's Bank Rs. 12.5 million in cash and Rs. 37.5 million in the form of promissory notes payable on demand, as initial contributions to the capital of the bank. By virtue of these contributions, the above four institutions have become shareholders of the bank. The NDB is allowed to borrow and issue stocks and debentures guaranteed by the government.

Immediately, after the NDB commenced operations in 1979, the government entered into a loan agreement with the IDA for US dollars 16 million, of which US dollars 12 million was made available to the NDB to refinance small and medium industry (SMI) projects. It provides credit facilities under the SMI schemes directly as well as through participating credit institutions (PCIs). The Central Bank guaranteed upto 80 per cent of the value of loans given under this scheme.

Activities of the NDB expanded continuously in the 1980s. Its direct annual lending, mainly to projects in priority sectors (export, industry, agriculture and tourism), increased from Rs. 72 million in 1980, to Rs.352 million in 1985 and to Rs. 450 million in 1989. The value of total loans outstanding increased from Rs. 72 million to Rs. 1,178 million and further to Rs.2,766 million in 1989. Outstanding equity investments in development projects increased from Rs. 4 million in 1980, to Rs. 71 million in 1985 and to Rs. 148 million in 1989. The outstanding value of refinance facilities provided by the NDB under the SMI scheme rose from Rs. 42 million in 1980, to Rs. 180 million in 1985 and to Rs. 881 million in 1989. At present, the NDB interest rates on refinance loans is 7 per cent per annum and is in the range of 14.5 - 18 per cent per annum for direct lendings.

The NDB expanded its financial facilities, keeping pace with the expansion of the economy in the 1980s. It suffered increased arrears in loan recoveries in recent years, largely due to unfavourable developments in the tourism sector due to civil disturbances. The combination of attractive lending schemes at subsidized rates of interest and limited external financial resource availability indicate that the NDB should move to a market-oriented resource mobilization programme in the long run to ensure the availability of resources.

In 1984, the NDB took the initiative to set up the Ceylon Development and Investment Corporation (CDIC) to undertake equity investments in developmental and commercial projects. The NDB contributed part of the capital of the new institution and has undertaken to manage it for an initial period of about five years.

Other than financial facilities, the NDB provides advisory and training facilities for investors. The training programme of project evaluators has contributed largely to expand project evaluation facilities in the financial sector.

(d) The National Housing Development Authority

Different types of lending institutions were set up to provide housing loan facilities during the last four decades. First, the Housing Loans Board was set up under the Housing Loans Act No. 26 of 1949 for the purpose of granting loans to companies, associations, firms and other individuals for housing schemes approved by the Board. The funds of the Board were obtained through Parliamentary appropriations. Loans were normally given to individuals who did not own houses suitable for occupation and who belonged to the middle and lower income classes. The work of the Board was taken over by the Department of National Housing under the provisions of the National Housing Act No. 37 of 1954. Under the same Act, the National Housing Fund was established in the same year to construct residential buildings, manufacture and import building materials, provide water, electricity and roads and to develop land for housing. Sources of funds were Treasury loans and debenture issues by the Central Bank. Also, the Monetary Board of the Central Bank was entrusted with the establishment and maintenance of a sinking fund on behalf of these loans. Debenture issues were the major source of funds during the initial years but thereafter the Fund depended heavily on Treasury loans.

The National Housing Development Authority (NHDA) is a statutory authority established by Act No.17 of 1979. It was set up under the Ministry of Local Government, Housing and Construction to implement and promote the government's housing policies.

According to the Act, the NHDA is expected to engage directly in the construction of housing, formulate housing development schemes, clear and re-develop slums and shanty areas, promote housing development, land development for housing, provide financial or other assistance and co-ordinate and conduct housing development activities. So far, it has engaged in programmes for the construction of housing in rural and urban areas, government offices, and to sell or rent its houses. These housing programmes have been largely targeted to lower income groups.

(e) The Housing Development Finance Corporation (HDFC)

The Housing Development Finance Corporation of Sri Lanka Limited (HDFC) was incorporated as a Building Society in 1984 under the provisions of the National Housing Act. 37 of 1954. The objective of the HDFC is to construct or purchase houses and lands, flats and other buildings suitable for residential purposes and engage in the development of land for sale, or for housing and building schemes with the approval of the Commissioner of National Housing. It is a joint venture where capital is shared by the government and the public ,with paid-up shares and subscription shares. The paid-up shares are in the nature of ordinary capital, while subscription shares are held by those qualifying for borrowing to meet housing needs.

The HDFC provides mortgage financing only to its members. It finances 80 per cent of the cost of a house, or up to five times the value of the membership shares held by the borrowers. Maturities of its loans vary from 10 to 20 years. Its main sources of funding are loans from the National Housing Development Authority and membership shares. The interest rate on its deposit shares is 9 per cent while lending rates vary between 9.5 per cent and 22 per cent, depending on the risk of the loan and the income of the borrower. The rationale given for charging these different interest rates over different income groups is that the effective interest rate after tax deduction is equalized by such procedures.

The values of loans outstanding of NHDA and HDFC increased from Rs. 451 million and Rs. 34 million respectively in 1985, to Rs.1,156 million and Rs.266 million in 1989. The key constraint to the expansion of the HDFC is lack of funding.

Contractual Savings

Provident and pension funds and insurance institutions are the major sub-components of the contractual savings sector. These types of financial institutions are designed to provide their members and/or dependents of members with an increase of social security in the form of retirement, medical, death or disability benefits. A common characteristic of these different types of funds and schemes is that they are all contractual or compulsory long-term savings schemes, requiring their members to contribute fixed sums periodically to a central fund, from which benefits are paid on fulfilment of the respective terms and conditions. The most important characteristic of these funds is that since the savings are not generally permitted to be withdrawn before predetermined events, the savings in these funds are illiquid compared with savings in other financial institutions. This specific property allows these institutions to invest the greater part of their funds in long-term financial assets. Thus, contractual savings institutions have a dual role in an economy. First, they provide their members (or their beneficiaries) some measures of financial protection on retirement or death, when the normal flow of income is severely curtailed or cut off. Second, these funds serve as important mobilisers of long-term savings in the economy, which are required for long-term investments. Thus, these institutions are the major investors in long-term financial assets, particularly those issued by the government. The present major contractual financial savings institutions in the economy are the insurance institutions, employees provident funds, employees trust funds and pension funds.

Table 11.8
Contractual Savings Institutions

(Rs.Mn)

	1960	1965	1970	1980	1989
1. ICSL					
Life Insurance Policies Outstanding					
Number	-	85,110	151,015	227,957	207,361
Value	-	412	998	2,660	6,055
Total Assets					
2. EPF	187	327	1,188	5,051	30,358
3 . Private Provident Funds	115	377	315	n.a	n.a
4. ETF	-	-	-	326*	3,488

Source: Central Bank of Sri Lanka

* 1982

(a) Insurance

The insurance business in Sri Lanka existed long before the country gained political independence in 1948. However, the indigenous insurance business in Sri Lanka started only after 1939. The establishment of the Insurance Corporation of Ceylon in 1961 was the major event in the insurance business of the country.

Before the establishment of the Insurance Corporation of Ceylon, insurance business services were provided by some 122 companies, both local and foreign.[5] Of these, 57 companies were in the life insurance business either exclusively or combined with general insurance services. Of those companies, 29 were foreign companies and 28 indigenous companies. Until the nationalization of the insurance business, insurance companies were subject to the provisions of the Companies Act and hence virtually remained uncontrolled. A large part of savings available in these firms was not made available for domestic investments because a large portion of their investments was in foreign assets.

(b) The Insurance Corporation Of Sri Lanka (ICSL)

The Insurance Corporation of Sri Lanka (ICSL) was established under the Insurance Corporation Act No. 2 of 1961 and commenced its business in 1962. From its inception, the Corporation had a monopoly in life insurance, while general insurance business was undertaken in competition with private insurance companies. The Finance Act No.11 of 1963 also vested in the Corporation the sole right of transacting general insurance as from January, 1964. The initial authorized capital of the Corporation was Rs. 10 million, of which Rs. 2 million was contributed by the government. The Act stipulated that at least half of the assets of insurance companies operating in Sri Lanka should be invested in government securities and that the investment of the remaining assets should be approved in writing by the ICSL.

Upto 1979, the life insurance business predominated, though thereafter, general insurance has gradually emerged as the key market for the ICSL. This may be a result of the relative lack of attractiveness of life insurance in the 1980s due to high interest rates on alternative savings instruments and the steep increase of general insurance, especially due to the rapid increase of motor vehicle imports after 1977. The ICSL introduced various types of insurance facilities during the first four decades. Among these are endowment assurances, marriage endowment, education endowment, childrens' deferred endowment, convertible life insurance, three stage assurance, joint life endowment assurance, double endowment assurance, multipurpose assurance,

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5 Dr. H.N.S. Karunatilake, Banking and Financial Institutions in Ceylon, 1968. pp.165-167.

Table 11.9
Insurance Activities -1989

(Rs.Mn)

	ICSL	NIC	CIC	UAL	CTCE
1. Capital	10	2	55	100	100
2. Life Insurance	364	61	24	9*	38
	(28)	(20)	(19)	(4)	(20)
3. General Insurance	929	245	100	205*	154
	(72)	(80)	(81)	(96)	(80)
3.1 Motor	257	110	3	91*	19
	(20)	(36)	(2)	(43)	(10)
3.2 Others	672	135	97	114*	134
	(52)	(44)	(79)	(53)	(70)
Total of (2) and (3)	1,293	306	124	214	192

Source: Central Bank of Sri Lanka

Note: Values in brackets are percentage values of total insurance in each institution.

ICSL - Insurance Corporation of Sri Lanka
NIC - National Insurance Corporation.
CIC - Ceylinco Insurance Company
UAL - Union Assurance Ltd.
CTCE - CTC Eagle Insurance Co. Ltd.

* 1988 Value

immediate annuity, deferred annuity, mortgage protection and "Podhu Jana Raksana" for farmers and fishermen.

The total number of life insurance policies increased from 33,949 in 1962, to 151,015 in 1970 and to 209,956 in 1989, while the value of outstanding life insurance policies increased from Rs. 143 million, to Rs. 998 million and further to Rs. 2,643 million during the same period. Traditionally, a large part of the ICSL's assets was invested in government securities. In recent years, there has been a policy of diversification by investing in ordinary shares and fixed deposits. In addition, the Corporation is engaged in the provision of housing loans to its policy holders and its employees. At the end of 1989, its investment in government securities and Treasury bills was Rs. 2,388 million, while total loans outstanding stood at Rs. 1,236 million.

Civil disturbances after 1983 caused large losses to the Corporation, although a substantial part of these claims was covered by reinsurance overseas. A special fund, namely Strikes, Riots and Civil Commotion (SRCC) Fund in respect of all insurance policies to meet claims arising out of strikes, riots and civil commotion was established on a government decision. All insurees are required to contribute a premium to obtain coverage of damages due to such extraordinary events. Consequently, premia in the types of insurance directly affected by civil unrest were adjusted to reflect increased risks. In the recent past, the motor insurance business has become a loss making sub-sector to the ICSL and premia charged in this area were revised significantly upward in 1989.

(c) The National Insurance Corporation (NIC)

The National Insurance Corporation was established under Section 3 of the Insurance (Special Provisions) Act No. 22 of 1979. This was set up in pursuance of the government policy of demonopolising the insurance business and encouraging healthy competition through the establishment of parallel services.

The NIC operated mainly through the principal agents system and expanded its activities early in the 1980s. However, the condition of the NIC has deteriorated in the recent past as most of its principal agents moved to establish their own insurance companies and also due to some problems in the structure of its insurance policy composition.

(d) Private Insurance Companies

To further the new economic policies introduced after 1977 and to improve insurance business in the country through competition, the insurance business was opened to the local private sector in 1985 by abolishing the public sector monopoly. So far, three private insurance companies have been established, viz., Ceylinco Insurance Company (1989), Union Assurance Ltd and CTC Eagle Insurance Company Ltd. All these three were established by groups of other leading private companies. The Ceylinco Group established the Ceylinco Insurance, while Aitken Spence & Co. Ltd. Carson Cumberbatch & Co. Ltd, Mercantile Credit Ltd and Whittall Boustead Ltd, pooled their combined experience and expertise to establish the Union Assurance Ltd. The Eagle Insurance Company was set up by the Ceylon Tobacco Company Ltd. These insurance companies offer all types of insurance facilities, competing with the ICSL.

(e) The Sri Lanka Export Credit Insurance Corporation (SLECIC)

The Sri Lanka Export Credit Insurance Corporation (SLECIC) was established by Act No. 15 of 1978 and commenced operations in 1979. This was established to provide insurance cover to exporters against commercial and non-commercial risks as well as to provide guarantees in respect of export finance facilities obtained by exporters from banks. With the idea of promoting and diversifying the country's export trade, SLECIC introduced two schemes in 1979, namely, the Credit Guarantee Scheme and the Export Payment Insurance Scheme. Under the Guarantee Scheme, the pre-shipment, post-shipment and export performance guarantees issued at end of 1989 were Rs. 1,150 million, Rs. 217 million and Rs. 135 million, respectively.

(f) The Employees' Provident Fund (EPF)

The Employees' Provident Fund was established by the Employees' Provident Fund Act No. 15 of 1958 as a contributory social security scheme to provide superannuation benefits to employees in the public corporations public and private sector throughout the island. It was the first public social security scheme established by the government and it is the largest contractual savings scheme of the country, covering a large part of the employees in public corporations and the private sector of the economy.

Table 11.10
Performance of the SLECIC

(Rs.Mn)

Activities	1980		1985		1989	
	No.	Value	No.	Value	No.	Value
1. Pre-shipment Guarantees	212	423	392	903	510	1,150
2. Post-shipment Guarantees	37	32	77	99	122	217
3. Export Performance Guarantees	14	81	30	96	47	135
4. Export Credit Insurance Policies in Force	128	180	267	577	367	854

Source: Central Bank of Sri Lanka

Note: End of period values.

Briefly, both employees (members) and employers contribute monthly to the Fund and the accumulated funds, together with accrued interest are paid to the employees at the end of their working life as a retirement benefit. The functions and operations of the EPF have been divided between the Labour Department and the Central Bank. The former is in charge of the general administration of the Fund such as registration of employers/members, enforcement and determination of claims. The latter has been entrusted with the investment and accounting functions of the Fund such as receiving contributions, maintaining employer/employee accounts, investing funds and paying out benefits.

With the establishment of the EPF, there appeared a new group of contractual savers in the country. This group had hitherto contributed very little or nothing at all into national savings efforts. At the inception of the Fund, employers who were covered by the EPF Act were required to contribute 10 per cent of the total earnings of their employees to the Fund on a monthly basis, comprising 4 per cent paid by the employee from his salary or wage and the balance 6 per cent paid by the employer.

The current rate of 20 per cent comprising 8 per cent by the employee and 12 per cent by the employer has been effective from 1981. As at the end of 1989, the total number of active accounts under the EPF was about 1.5 million compared with 1.0 million recorded in 1970. Members' balances in the Fund at the end 1989 stood at Rs. 30.4 billion. Thus, the savings generated through the contributions to the Fund constitute a very high percentage of national savings when compared with alternative savings mobilization schemes.

In terms of Section 5(1)(e) of the EPF Act, it is a requirement that resources of the Fund that are not immediately required should be invested in such securities as the Monetary Board may consider suitable. Accordingly, the surplus resources of the Fund have been invested in government securities, government guaranteed securities and Treasury bills. The EPF has become one of the principal subscribers to the government's loan programme, holding about 20 per cent of the total outstanding domestic public debt at the end of 1989. Under the category of government guaranteed securities in the investment portfolio, the Fund has invested small sums in SMIB debentures and Urban Development Authority (UDA) debentures. In 1988, the EPF Act was amended to enable the members to obtain loans of upto 75 per cent of the balance outstanding to their credit from selected lending institutions for housing purposes. This obviated the need for mortgaging movable property or providing guarantors to obtain a housing loan.

Thus, the EPF is a multifaceted and multipurpose scheme. First, it is a social security scheme for a large portion of the private sector work force. Secondly, in an economic sense, it is a major long-term savings mobilizing scheme. Thirdly, it has served as a source of non-expansionary financing of the budget deficit. It facilitates obtaining housing loans for its members from other financial institutions, providing the required security to back such loans.

(g) The Employees' Trust Fund (ETF)

The Employees' Trust Fund was created by Act No. 46 of 1980 and became fully operational in 1982. The objectives of the ETF are to provide meaningful retirement benefits to employees in the private sector, including public corporations, and to promote employee participation in the ownership of enterprises in the private sector. Accordingly, its objectives are specified as (a) to promote employee ownership, employee welfare, economic democracy through participation in financing and investment and, (b) to promote employee participation in management through equity investments. Thus, it is a form of a Unit Trust. Contributions to the EPF are made solely by employers amounting to 3 per cent of each employee's monthly earnings. At the end of 1988, about 1.5 million employees were beneficiaries of the scheme and total assets of the ETF were Rs. 3,594 million.

The ETF Board, which operates under the Ministry of Labour, is expected to invest its resources in private sector instruments such as equity. Its equity participation in any single enterprise is limited to a maximum of 10 per cent of the company's capital. At present, the ETF has shares in more than 29 companies. According to the Act, the Fund is empowered also to establish and operate commercial and industrial undertakings and to develop immovable property. The total investments of the ETF at the end of 1989 amounted to Rs. 3,594 million, of which Rs. 1,646 million was in the form of investment in Treasury bills and Rs. 865 million in housing investments through the SMIB and the NHDA. Investments in debentures and shares of companies amounted to Rs. 262 million and Rs. 530 million, respectively. Its investment in government securities was Rs. 10 million in the same year. Thus, the ETF has become a major source of funds for private sector share issues. In 1986, it introduced a non-contributory life insurance scheme, which automatically covers all members of the ETF.

(h) Private Provident Funds

There were about 230 private provident funds in operation at the end of 1989, including some associated with state banks and corporations. The total assets of these funds amounted to Rs. 277 million and covered 1.5 million cumulated accounts in 1989. When the EPF was established, companies and corporations that had their own provident funds were exempted from contributing to the EPF. The practice of maintaining private provident funds is, however, discouraged by the Department of Labour. These funds offer more facilities to members, such as loans, and follow more liberal withdrawal policies. These easy withdrawal facilities to some extent are constraints to the growth of these funds.

Table 11.11
Operations of the EPF and ETF

(Rs.Mn.)

	1960	1970	1980	1985	1989
A. EPF					
1. Operative Accounts (Mn.)	0.8	1.0	1.1	1.2	1.5
2. Outstanding Balances of Members	187	1,188	5,013	14,756	30,358
3. Total Investments	179	1,138	4,800	14,052	32,274
3.1 Government Securities	177	1,128	4,757	13,610	31,648
	(99)	(99)	(99)	(97)	(98)
3.2 Treasury Bills	-	-	36	150	-
	-	-	(1)	(1)	-
3.3 SMIB & NHDA Bonds	-	-	3	291	291
	-	-	(...)	(2)	(1)
3.4 Others	2	10	4	1	335
	(1)	(1)	(...)	(...)	(1)
B. ETF					
1. Outstanding Balances of Members	-	-	-	1,475	3,488
2. Total Investments	-	-	-	1,386	3,594
2.1 Government Securities	-	-	-	140	10
				(10)	(1)
2.2 Treasury Bills	-	-	-	-	1,646
					(46)
2.3 SMIB & NHDA Bonds	-	-	-	-	865
					(24)
2.4 Shares	-	-	-	288	530
				(21)	(14)
2.5 Others	-	-	-	958	543
				(69)	(15)

Source: Central Bank of Sri Lanka.

Note: Values in brackets are percentage shares of total investments

Other Specialized Financial Institutions

(a) Merchant Banks

Merchant banks specialize in corporate financing, advisory and related services aimed at assisting entrepreneurs and investors in an economy with a view to increasing productivity by promoting development. In essence, merchant banks in many countries are a new breed of banks, offering specialized services with the support of their particular expertise and finance facilities from major banks to assist firms to meet the new challenges of modern economic systems. The two existing merchant banks in Sri Lanka were established as subsidiaries of the two State sector banks to provide specialized financial services required for rapid economic development in the 1980s. To cater to the growing demand for specialized financial services, the Bank of Ceylon established a separate division in 1981 to deal exclusively with merchant banking activities and consultancy services. In 1982, this division was replaced by the Merchant Bank of Sri Lanka, a subsidiary of the Bank of Ceylon. In the same year, the People's Bank established the People's Merchant Bank as a subsidiary in collaboration with the Guinness Mahon & Co Ltd. a British merchant bank. Thus, the emergence of merchant banks in the country in the 1980s coincided with the rapid expansion of the economy in response to new economic policies introduced in 1977/78. In the context of liberalized economic polices, there was a need for the emergence of active and modern financial systems with an active share market. Also, the requisites of other specialized financial services such as portfolio management, business and financial advice, etc., emerged with new investment activities. Under these circumstances, the services of merchant banks were a crucial element in improving the financial sector.

The main services provided by the two merchant banks in the country include promotion and financing, corporate financing, investment advice, discounting of commercial papers and leasing.

(b) Leasing Companies

There are three leasing companies dealing with leasing activities in Sri Lanka namely, Lanka Orient (Orix) Leasing Co. Ltd, Mercantile Leasing Ltd and Maharaja Leasing Company Ltd. All three commenced business in the 1980s. From inception, their activities have been largely confined to vehicle and office equipment leasing. At present, their equipment leasing ranges from industrial machinery to computers and office equipment.

(c) Money Brokers

The role of a money broker is to facilitate transactions in financial markets by matching the requirements of buyers and sellers of money. An efficient money market is a necessary condition to achieve efficient intermediation and monetary management, which is the primary responsibility of a central bank. Accordingly, the Central Bank of Sri Lanka emphasized the need for developing money brokering activities in the country.

At the end of 1989, there were seven money brokering firms operating in Sri Lanka, primarily as subsidiaries of leading mercantile companies. These were:

Keels T & R Ltd, Piggot Chapman Ltd,
Bartleets, Mecklai and Roy Ltd, Forbes Money Brokers Ltd,
George Steuart Ltd, DSP Forex Ltd,
Mercantile Financial Brokers Ltd.

Their activities are mainly in the inter-bank call money market, Treasury bills market, internal foreign exchange market and the offshore market. Activities in the inter-bank call money market expanded significantly after the establishment of new foreign banks, since most of them had to depend on borrowings in the call money market for maintaining liquidity due to their limited deposit base. Internal foreign exchange transactions were done on "spot" or very short-term forward basis, dealing with FCBUs. In the Treasury bills market, they operate mainly in secondary Treasury bills and as agents under the "tap" system in the primary Treasury bills market. Their business income is based on commission charges.

(d) Thrift and Credit Co-operative Societies (TCCS)

The Thrift and Credit Co-operative Society (TCCS) is a village level organization which serves to mobilize rural savings and make credit available to its members at rates of interest well below those prevailing in the non-institutional credit market. The rate of interest varies in different TCCSs and maximum limits on the quantum of loans, as well as the conditions under which loans are granted, vary among TCCSs.

TCCSs are voluntary associations of low income people operating at a local level. Membership of a TCCS usually ranges from 40 to 60, but there are some societies which have reached a membership exceeding 150. TCCSs, as institutions, represent the collective strength of groups of low income people who normally do not have mortgageable assets or who do not have access to commercial banks. Therefore, TCCSs are formed by this group of people for the purpose of meeting their savings/credit/investment requirements.

There has been a steady expansion of TCCSs in the country since their inception before Independence. As at the end of 1989, there were 5300 TCCSs operating in the country, holding Rs. 418 million worth of deposits and Rs. 416 million worth of loans.

(e) The Regional Rural Development Banks (RRDBs)

Despite the rural bank programme introduced by the People's Bank and the programme of establishing bank branches at the Agrarian Service Centres by the Bank of Ceylon, banking facilities in rural areas did not expand to a satisfactory level. Therefore, the Central Bank introduced Regional Rural Development Banks (RRDBs), based on the barefoot banking concept, to meet the shortage of rural credit, largely for agriculture and small industry. The primary objective of the RRDBs is the development of the rural economy by providing facilities to agriculture, cottage and small scale industry, the fishing industry, commerce and other development activities in rural areas.

These banks combine the functions of commercial banks and development banks. At the same time they are unit banks at district level, each with full autonomy in regard to operations and management. Thus, the RRDBs are authorized to undertake all types of banking business, including the acceptance of demand deposits, but are debarred from undertaking foreign exchange transactions.

Their sources of funds are mobilization of deposits, grants from the Central Bank and borrowings subject to the Central Bank's approval. Their initial share capital was contributed by the Central Bank, but it is expected that after some time, up to 49 per cent of their capital may be

Table 11.12
Regional Rural Development Banks

(Rs.Mn.)

	1985	1985 share %	1989	1989 share %
A. Deposits				
A.1 Savings	3.1	91	144	84
A.2 Fixed	0.3	9	28	16
Total	3.4	100	172	100
Average Size of Deposits (Rs.)	248		863	
B. Loans				
B.1 Agriculture	2.0	42	194	45
B.2 Fisheries	-	-	8	2
B.3 Livestock	0.5	11	25	6
B.4 Small Industries	1.0	21	66	15
B.5 Trade and Commerce	0.8	16	102	23
B.6 Others	0.5	10	39	9
Total	4.8	100	434	100
Average size of Loan (Rs).	4,392		7,047	
C. Number of RRDBs	4		11	
Branches	21		89	

Source: Central Bank of Sri Lanka

divested to the domestic commercial banks and/or co-operatives. They have access to Central Bank refinance schemes, and may, in addition, borrow from the Central Bank upto 10 per cent of their capital/resources. They can also borrow from the government and overseas subject to the approval of the Monetary Board.

They are allowed to undertake pawnbroking in addition to their normal domestic banking services and have the flexibility of utilizing a more efficient loan recovery procedure than the commercial banks.

The number of RRDBs had increased to 11, with a network of 89 branches at the end of 1989. Meanwhile, their total outstanding deposits increased to Rs. 172 million in the same year while outstanding loans and advances stood at Rs. 434 million.

The Central Bank has initiated a programme to improve the financial performance of RRDBs through closer supervision and monitoring of their activities. In most cases, their lending activities and recoveries are impressive. Furthermore, RRDBs have been accepted as participating institutions under the SMI-III programme, which will be helpful in expanding their development banking activities.