

## 8. FINANCIAL SECTOR DEVELOPMENTS AND STABILITY

*Financial sector activities increased and the resilience of the financial system further strengthened during the first half of 2005 benefiting from the continuing improvements in domestic and global economic conditions. The performance of the banking sector improved as reflected by enhanced capital funds and increased profits of banks. The volume of transactions in the foreign exchange market also increased and share market activities rose to new heights, with the Colombo Stock Exchange emerging as one of the best performing markets in the world by end September 2005. Several measures have been taken to strengthen and increase the efficiency of the financial sector, improve risk management, enhance access to finance, strengthen the payment and settlement systems and improve supervision and regulation.*

### Developments in Financial Institutions

#### *Licensed Commercial Banks*

- **Commercial banking operations improved in the first half of 2005.** Deposit mobilisation and lending activities expanded and profits and capital funds also increased. The total profits of the industry increased to Rs.8.4 billion compared to Rs. 7.3 billion during the first half of 2004. The Non Performing Loan (NPL) ratio improved to 8.9 per cent by August 2005 from 9.2 per cent as at end 2004.
- **The resource base of the banking system has increased further.** Rupee deposits held by commercial banks grew by 21 per cent during the first seven months of 2005 in comparison to the 16 per cent growth in the corresponding period of 2004. The growth in deposits was a reflection of improved economic activities as well as the monetary expansion. Foreign currency deposits of commercial banks also increased, by US dollars 1,868 million, as at the end July 2005 from US dollars 1,731 million as at end of December 2004, contributing 22 per cent of the total increase in deposits.
- **Banking services improved during the first half of 2005 due to product innovation, increased application of information technology and the expansion of the branch network.** The number of automated teller machines (ATMs) and electronic fund transfer facilities at point of sale (EFTPOS) increased to 847 and 6,575 respectively, during this period. The total number of credit cards increased by 31 per cent. The number of bank branches and service outlets increased from 1,890 at the end of 2004 to 1,923 by end June 2005.
- **Loans and advances granted by banks expanded at a faster rate reflecting the high expansion of credit to the private sector.** A major share of the credit has been given for trading, consumption, housing and agricultural activities. As the growth in deposits was slightly higher than the growth in loans and advances,

the credit to deposit ratio declined marginally to around 67.6 per cent by end June 2005, as against the 67.7 per cent growth reported by end June 2004.

- **The financial soundness of LCBs in terms of capital adequacy, profits and liquidity has improved.** The NPL ratio improved from 9.2 per cent as at end 2004 to 8.9 per cent as at end August 2005. The NPLs, excluding provisions, as a ratio of capital also improved from 41 per cent to 36.5 per cent during the same period, as a result of the injection of additional capital and the increase in provisions. The capital adequacy ratio (CAR), which remained above the minimum statutory limit of 10 per cent, increased to 10.8 per cent at end June 2005, from 10.3 per cent at end 2004.

#### *Licensed Specialised Banks*

- **The operations of Licensed Specialised Banks (LSBs) also expanded in tandem with the increase in economic activity, resulting in an improvement in**

**their key soundness indicators.** Improvements were seen in capital adequacy, the NPL ratio and liquidity, in the first half of 2005. The SME bank, which was set up as per a budget proposal in 2005, mainly to cater to the needs of the SME sector, commenced operations through the branch network of NSB and RDBs. Loans and advances granted to the private sector by LSBs increased by 28 per cent.

#### *Finance Companies*

- **Finance companies expanded their operations and the resource base, and were allowed to accept savings deposits.** The number of finance companies in operation increased to 28 by end June 2005, while their loans and advances and the investment portfolio expanded by 10.3 per cent and 17.6 per cent, respectively. These contributed to about 81 per cent of the growth in the total assets of finance companies. Deposits mobilised by finance companies increased by 12.2 per cent during the first half of 2005.

Chart 8.1  
Gross Non Performing Loan Ratio - LCBs

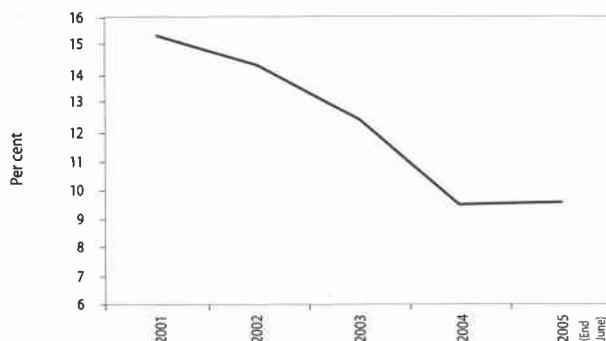
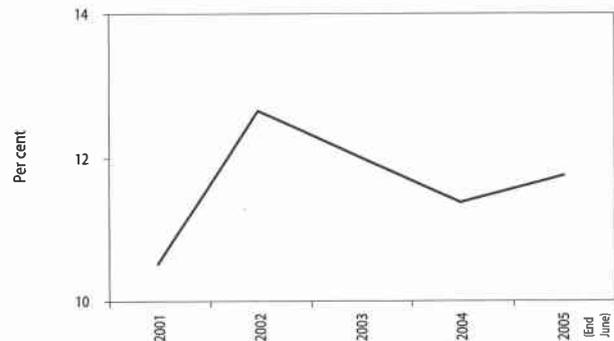


Chart 8.2  
Capital Adequacy Ratio - LCBs



## Developments in Financial Markets

### Inter-bank Call Money Market

- **Inter-bank call money market activities declined as reflected by the decline in volume. This decline was the result of each bank having adequate funds due to the excess liquidity in the market.** With the measures taken by the Central Bank to absorb market excess liquidity since April and the increases in policy interest rates, call money rates increased. The weighted average call money market rate, which was 7.77 per cent by end March increased to 10.14 per cent by end September 2005.

### Domestic Foreign Exchange Market

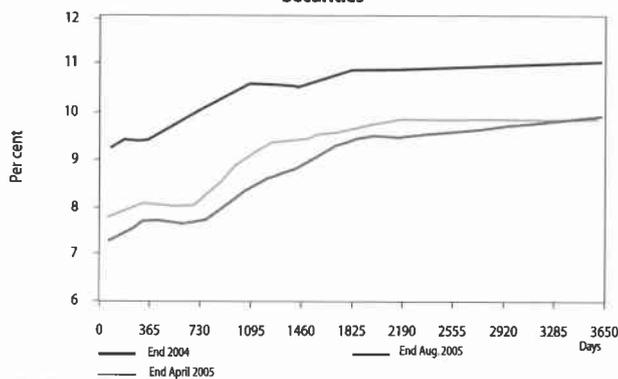
- **The volume of transactions in the domestic foreign exchange market increased significantly with the increase in external trade, increased foreign remittances and tsunami related inflows.** The total trading volume in the spot market increased from US dollars 2.2 billion in the first nine months of 2004 to US dollars 4.5 billion in the first nine months of

2005 while the forward market volume increased from US dollars 0.8 billion to US dollars 1.3 billion during the first nine months of 2005 as against the corresponding period in 2004. The forward premia against the rupee declined and were moving more in line with the interest rate differentials between the two currencies.

### Government Debt Securities Market

- **A greater market preference was seen for short-term government securities with the increase in yield rates of both Treasury bills and Treasury bonds.** Outright transactions and Repo transactions in Treasury bills in the secondary market increased by around Rs. 22 billion (7.2 per cent) and Rs.206 billion (52.6 per cent), respectively, compared with the first nine months of 2004. However, the outright transactions and Repo transactions in Treasury bonds declined at the secondary market by Rs.35 billion (11.8 per cent) and Rs.582 billion (26.9 per cent) respectively during this period, reflecting uncertainties regarding future changes in interest rates. The yield rates of Treasury bills increased across all maturities. In the primary market, yield rates increased by 215-237 basis points, and in the secondary market, yield rates increased by 218-243 basis points by the end of the first nine months of 2005. Primary market yield rates pertaining to 2 year and 3 year Treasury bonds also increased by 214 – 242 basis points while the increase in the secondary market rates during this period was 199 – 245 basis points.

Chart 8.3  
 Secondary Market Yield Curves of Government Securities



### Commercial Paper Market and Corporate Bond Market

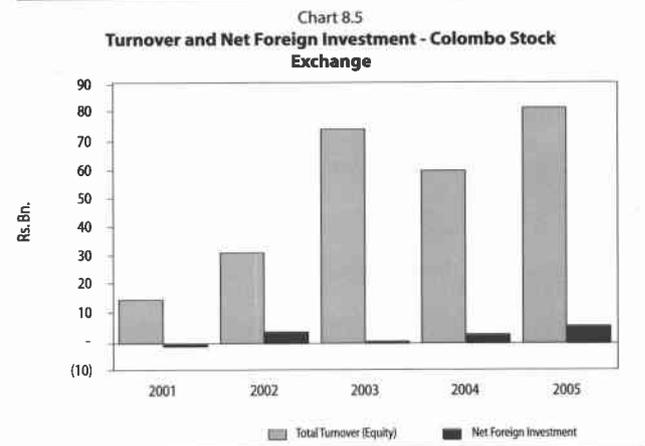
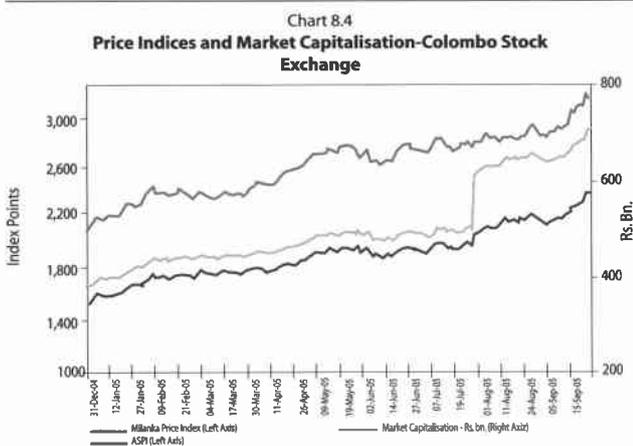
- **The commercial paper market has been suffering from the slump in activity since 2003** while the corporate bond market has also been less active. The amount of commercial paper issued with the support of banks amounted to Rs.4.3 billion during the period January to June 2005, in comparison to Rs.6.5 billion during the corresponding period in 2004. The removal of the withholding tax with effect from April 2005 is expected to make commercial paper an attractive source of funds for corporates, increasing activity in the commercial paper market. The corporate bond market has also remained subdued. There was one issue of debentures during this period, which was subsequently listed on the CSE.

### Equity Market

- **The share market improved further during the first nine months of 2005 with the Colombo Stock Exchange emerging as one of the best performing markets in the world by end-September 2005.**

While share prices of companies benefiting from reconstruction and related activities in the areas affected by the tsunami increased during the early part of the year, improved financial performance of some listed companies and the inclusion of Sri Lanka by the California Public Employees' Retirement System (CALPERS), the largest public pension fund in the USA, in its emerging markets investment eligibility list, impacted positively on market activity. Meanwhile, low real interest rates on most fixed income securities have also impacted positively on the share market.

- **Improved market activity was reflected in all key market indicators.** The average daily turnover increased from Rs.247 million in 2004 to Rs.472 million during the period January-September 2005. The All Share Price Index and the Milanka Price Index increased by 61.5 per cent and 54.7 per cent, respectively, during this period, while market capitalisation increased by Rs. 353 billion. A significant event during this period was the listing of Dialog Telekom on 28 July 2005, which increased



market capitalisation by 22 per cent and attracted a significant amount of foreign investment.

#### *Development Finance and Access to Finance*

- **Several measures were taken to improve the availability of funds for micro and small and medium scale industries.** The Central Bank introduced a special loan scheme named “Susahana” to provide relief to micro, small and medium scale enterprises (MSMEs) affected by the tsunami. Loans are being provided by the participating financial institutions (PFIs) to selected borrowers with a repayment period of 3 - 8 years, and a grace period of one year depending on the nature of the project. These efforts will be supported by ten ongoing loan schemes and two more loan schemes to be implemented through PFIs in the tsunami affected areas with yen 3 billion and euros 25 million, provided by the Japanese Bank for International Cooperation (JBIC) and the European Investment Bank (EIB), respectively.
- **Several special loan schemes are being launched with the assistance of the Asian Development Bank (ADB).** Under the Rural Financial Sector Development Project (RFSDP), which commenced operations in May 2005, the Central Bank has been requested to implement a programme for the regulation and supervision of micro finance institutions in the country. Accordingly, as the first step of the programme, the Central Bank, in association with the Department of Census and Statistics, has initiated a survey to identify active micro finance institutions (MFIs) in the country. Two more credit schemes

will be launched out of revolving loan funds of ongoing ADB funded development projects, namely the Tea Development Project, and the Perennial Crops Development Project, to promote nursery development, factory modernisation, replanting, commercial agriculture, processing and marketing.

#### **Developments in Financial Infrastructure**

##### *Payment and Settlement Systems*

- **Further measures were taken by the Central Bank during the first half of 2005 to expand and create a safe, secure and efficient payment and settlement system.** In September 2005, the Payment and Settlement Systems Act, which facilitates the regulation of payment, clearing and settlement systems, the disposition of securities on the books of the Central Bank, the regulation of providers of money services, and the electronic presentment of cheques was passed in the Parliament. The preparatory work in relation to the Cheque Imaging and Truncation Project that has been launched with the view to improving the efficiency and the speed of the cheque clearing process has progressed satisfactorily. Commercial banks and primary dealers have also been requested to provide a disaster recovery management and business continuity plan to ensure the continuity of business operations.
- **The Real Time Gross Settlement System (RTGS) recorded substantial increases in the volume and the value of daily transactions during the first half of 2005, compared with the corresponding period of**

the previous year. In February 2005, NSB received the direct access status in the Sri Lanka Inter Bank Payment System (SLIPS).

#### *Regulation and Supervision*

- **Several measures were taken to enhance the soundness of the financial institutions.** The minimum capital requirements of banks and primary dealers were increased. Banks were required to publish specified information in newspapers in all three languages. Keeping up with global trends, the Central Bank commenced preparatory work to adopt Basel II rules, which are the internationally accepted risk based standards for supervision of banks set out by the Basel Committee for banking supervision.

#### *Financial System Stability*

- **Financial institutions and markets benefited from the favourable global and domestic macroeconomic environments and there were no major risks to the maintenance of financial stability during the first half of 2005.** The tsunami disaster did not have a major impact on the health of financial institutions. The improvement in several key indicators, namely, higher provisioning levels, improved capital adequacy and the adherence to stricter prudential norms show the improved ability of the major financial institutions to absorb any unexpected adverse shocks. In order to improve the awareness of market participants and the general public about current developments and risks in the financial system, the Central Bank published its first Financial Stability Report in May 2005.

#### **Prospects for 2006**

- **The continuing expansion in domestic and global economic activities, and improved corporate sector profitability, together with the regulatory and supervisory measures taken, would impact favourably on the development and stability of the financial sector.** The enhancement of the capital requirement of the key financial institutions will improve the resilience of the financial sector. The preparatory activities that are being carried out for the introduction of Basel II in 2007 would instill greater risk sensitivity and risk management practices within the banking industry. However, an area of concern is whether the higher growth of credit to the private sector could increase NPLs, unless proper credit risk assessment and follow up measures are taken.
- **Measures taken during the last two years to develop and modernise the payment and settlement system will be further strengthened by the proposed Cheque Imaging and Truncation project (CIT) to be implemented by the end of 2005.** The implementation of the CIT will improve further the efficiency of the payment and settlement system by reducing the cheque clearing time.
- **Money and foreign exchange markets are likely to remain liquid with the overall surplus expected in the BOP along with the expansion of trade, remittances and other foreign inflows.** In response to the expansion of economic activity as well as measures taken by the CSE to expand the investor base, stock market activity is also expected to improve further in 2006.