8 FINANCIAL SECTOR DEVELOPMENTS AND STABILITY

The outlook for the financial system in Sri Lanka continues to remain stable during 2008, thus far. A moderation in the credit extended by financial institutions has been evident during 2008, up to now, in view of the tighter monetary policy stance adopted by the Central Bank. Nevertheless, the overall performance of financial institutions, particularly the banks, remains satisfactory. The financial turbulence in international markets since late 2007 underlines the importance of sound financial systems for maintaining macroeconomic stability. Recent developments in the US sub-prime mortgage market and the resultant collapse of some financial institutions highlight how weak credit risk assessment can weaken financial markets and banks, in turn, by sharply reducing market liquidity. However, the impact of the sub-prime turmoil on the Sri Lankan financial system has been limited. The improvement of the risk management system with the strengthening of the regulatory framework and the payment systems has strengthened the capacity of the financial system to withstand shocks and mitigate risks at institutional and infrastructure levels.

Financial System Stability

- **The financial system remains resilient and stable despite increasing pressures from the external environment and the challenging domestic macroeconomic environment.** On the whole, financial institutions continued to be profitable and well capitalised with ongoing improvements in risk management capabilities supported by an enhanced regulatory and supervisory framework and oversight. The stronger financial positions that had been built up in recent years have enabled these institutions to cope with the increased levels of risk resulting from the high interest rates that prevailed during the year. The systemically important payments and settlement systems operated with a high degree of availability and safety. The overall outlook for financial stability remains positive, as the financial system is expected to continue to be resilient.

- **The current turbulence in global financial markets has not had a direct impact on the financial system, as domestic financial institutions did not have exposures to the US sub-prime and other structured finance and derivative products.** The domestic equity market seemed not to have been affected by the global financial turbulence. Foreign capital inflows to the Colombo Stock Exchange, (CSE) which rose to record levels in the current year with a foreign investor buying a stake in a domestic company, remain at healthy levels.

- **Interest rates in the domestic money market have exhibited greater stability during much of the first nine months of the year, when compared with last year,** which could be attributed to the availability of adequate liquidity as well as regulatory measures taken by the Central Bank. Yields in the Treasury bill market declined during most of the first nine months of 2008, mainly due to strong investor preference for short-term securities, but showed a tendency to increase towards the end of this period. The Treasury bond market at the medium-to-long end of the yield curve for government securities has remained largely inactive during this period, mainly due to rising inflation expectations during the first half of the year.

- **Activity in the inter-bank foreign exchange market increased with the exchange rate being more stable vis-à-vis the US dollar, in terms of which most of Sri Lanka's external transactions take place.** The rupee had appreciated by 0.75 per cent against the US dollar during the first nine months of 2008. With respect to the currencies of other major trading partners, the Sri Lanka rupee had appreciated against the Indian rupee, the Sterling pound and the Euro during this period, while it had depreciated against the Japanese yen.

- **The banking sector maintained its soundness and resilience amidst a challenging macroeconomic environment.** Profitability of the banking sector measured in terms of the return on assets (ROA) and the return on equity (ROE), during the first half of the year has been maintained at around the previous year's level. Although net interest margins narrowed somewhat, this was largely compensated for by higher earnings from investments in government securities. The sector concentration of bank lending appears to be at an acceptable level, as a single economic sector does not dominate. The sector-wise classification of bank advances at end June 2008 shows that lending to the trading sector (15 per cent), housing and construction sector (15 per cent), manufacturing sector (15 per cent) and consumption and others (30 per cent) were the most significant. The capital adequacy ratio of the banking sector was well above the minimum international standards, indicating the overall resilience of the sector.

- **Finance companies, which traditionally lend to the less credit-worthy customers that do not have access to bank finance, experienced a decline in profitability in the high interest**

rate environment, due to a narrowing of interest margins in the main lines of business, which are leasing and hire purchase. The minimum capital requirement for finance companies was increased from Rs.100 million to Rs. 200 million from July 2008 and most of the finance companies have already complied with the increased requirement. The overall capital adequacy ratio (CAR) of finance companies is well above the regulatory minimum.

- **The profitability of the specialised leasing companies also declined in the first half of 2008.** The industry ROA and ROE had declined to 1.2 per cent and 4.3 per cent at end June 2008. All leasing companies met the regulatory capital requirement and the gearing ratio (borrowings to capital funds) was comfortable at 4 times. However, the gearing ratios of some companies were above the maximum allowed ratio of 10 under the Finance Leasing (Gearing Ratio) Direction, No. 4 of 2006. The Non Performing Accomodation (NPA) ratio showed an improvement during the year and stood at 3.7 per cent at end June 2008.

- **Insurance companies recorded steady growth in terms of premium income and assets in 2008.** Although insurance companies, as a whole, had an overall underwriting loss, the earnings from investments off-set this position and the industry recorded an operating profit in 2007. The profits of insurance companies were slightly lower in 2007 than in the previous year due to significant growth in claims on motor and fire insurance and intense price competition in the general insurance business, which may have reduced margins. While the solvency margin is the main indicator to measure the soundness of insurance companies, most companies were compliant with the solvency requirement for general insurance. All life insurance companies met the solvency margin requirement. The Insurance Board of Sri Lanka (IBSL) intends to take further measures to improve the financial strength and soundness of insurance companies and to promote the consolidation of the industry.

Table 8.1
Commercial Banking Service Delivery Channels

Delivery Channel	End 2007	End June 2008
Automated Teller Machines (ATMs)	1,422	1,541
Electronic Fund Transfer Facilities at the Point of Sale (EFTPOS)	12,214	14,448
Credit Cards	889,338	908,362
Bank Branches and Other Banking Outlets	4,830	4,986

Source: Central Bank of Sri Lanka

Developments in Financial Institutions

Licensed Commercial Banks

- **Activities of licensed commercial banks (LCBs) further expanded in the first half of 2008, albeit at a slower pace.** Overall, performance of the LCBs remained healthy, due to continuing profitability and the strengthening capital position. Total assets of the LCBs expanded moderately by Rs. 133 billion or 6.3 per cent, resulting from the lower increase in bank credit due to the tight monetary policy stance of the Central Bank. Loans and advances increased by Rs. 67 billion or 4.9 per cent during the first six-month period as compared to the 11 per cent growth in the corresponding period of 2007. With the opening of 28 new branches during the first half of 2008, total bank branches operating in the country increased to 4,986 by end June 2008.

- **LCBs maintained their profitability, while their capital was maintained well above the required level.** Profit before tax of the LCBs reached Rs. 22 billion and profit after tax has increased to Rs. 13 billion for first half of 2008. As a result, key profitability indicators, i.e. ROA of the LCBs, both before tax and after tax, were maintained at 2 per cent and 1.2 per cent, respectively, in June 2008. Despite an increase in the capital funds through enhanced capital and retained earnings, the banking system was able to maintain the ROE at the previous years' level of 15 per cent.

The CAR of the LCBs stood at 12.9 per cent in June 2008, having increased from 12.6 per cent in June 2007. The non-performing loans (NPLs) to total loans ratio has shown a marginal increase over the period and remained at a level of 5.8 per cent in June 2008.

- **Credit growth is slowing down as a result of declining credit demand due to high costs of borrowing as a consequence of the continued tight monetary policy stance.** Lending activities in respect of all sectors have moderated during the first six months of 2008, from the high growth during the last two years. This moderation was evident particularly in relation to construction including housing, and manufacturing sectors. Further, demand for leasing facilities has also declined, contributing to the overall deceleration of credit.

Licensed Specialised Banks

- **The performance of the Licensed Specialised Banks (LSBs) also indicates some slowing down during the first half of 2008 amidst marginal increases in deposits and negative growth in borrowings.** The number of LSBs remained at 14 as at end June 2008. The growth in credit extended by them in the first half of 2008 was 3.7 per cent, compared to the 8 per cent growth in the corresponding period of 2007. Profits of LSBs for the first half of 2008 amounted to Rs. 3.5 billion compared to Rs. 3.2 billion in the first half of 2007. Accordingly, ROA and ROE ratios increased with an ROA (after tax) of 1.1 per cent and an ROE (after tax) of 11.4 per cent for the first half of 2008.

Registered Finance Companies

- **Registered Finance Companies (RFCs) continued to expand their activities during 2008 as well.** The number of RFCs in operation increased to 32 at end June 2008, with the granting of a license to one company in 2008. The total assets of RFCs increased by 13 per cent to Rs. 162 billion during the first half of 2008. Finance leasing, hire purchase and real estate continued to be the main spheres of business activity for RFCs. Finance leasing and hire purchase represented 71 per cent of the total accommodations, and real estate accounted for 10 per cent. The hire purchase business recorded the highest growth of 31 per cent, while finance leasing activities increased by 6 per cent. The majority of the leasing and hire purchase facilities were granted for financing of vehicles. Total deposit liabilities of RFCs increased by 20 per cent to Rs. 94 billion during the first half of 2008, which could be attributed to the higher interest rates that prevailed during the year and the expansion in the branch network of RFCs. Nevertheless, the profitability of RFCs, as measured by the ROA and ROE declined to 1.75 per cent and 8.65 per cent, respectively, for the six months ending June 2008, from 1.97 per cent and 10.95 per cent, respectively, for the corresponding period of the previous year. The asset quality of finance companies deteriorated somewhat, as indicated by an increase in the NPA ratio.

Developments in Financial Markets

Inter-Bank Call Money Market

- **Inter-bank call money rates have exhibited less volatility during the first nine months of 2008, when compared with the previous year,** as the Central Bank provided liquidity to the market through its Reverse repurchase window whenever overall liquidity in the money market was in a deficit or a balanced position. Following the last revision in the targets for reserve money in July 2008, which further tightened the monetary policy stance, and the subsequent gradual decline in money market liquidity, the average weighted call money rate, which was around 13.00 per cent by end-July, moved up to around 19.00 per cent by end-September. The daily average volume of inter-bank call money transactions declined somewhat, to Rs. 6.8 billion in the first nine months of 2008 from Rs. 7.8 billion during the corresponding period in 2007.

Domestic Foreign Exchange Market

- **The inter-bank foreign exchange (FX) market was more active during the first nine months of 2008, with both spot and forward market transactions increasing.** The daily average turnover in the FX market, including the forward market, was US dollars 58.3 million in the first nine months of 2008, which is considerably higher than the average daily turnover of US dollars 32.8 million in the first nine months of 2007. The total volume of inter-bank FX transactions, including forward market transactions, was US dollars 10.6 billion in the first nine months of 2008, up from US dollars 5.9 billion in the corresponding period of 2007. As a result of stability in the Sri Lanka rupee vis-à-vis the US dollar, the forward market volume increased to US dollars 4.2 billion (39.6 per cent of the total volume) in the first nine months of 2008 from US dollars 1.8 billion (30.5 per cent of the total volume) in the corresponding period of 2007.

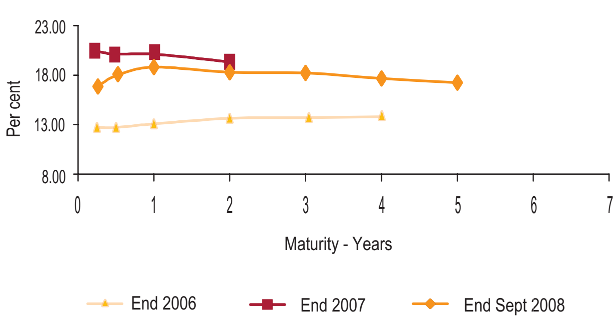
- **The Sri Lanka rupee (LKR) appreciated against the US dollar during the first nine months of 2008, by 0.75 per cent, and was at Rs. 107.91 per US dollar by end-September.** In comparison, it depreciated by 5.4 per cent in the corresponding period of 2007. The LKR also appreciated against the Indian rupee, the Sterling pound, and the Euro, while it depreciated against the Japanese yen during the first nine months of 2008. Intervening on both sides of the FX market, the Central Bank purchased US dollars 622 million and sold US dollars 517 million in the first nine months of 2008, compared with purchases of US dollars 366 million and sales of US dollars 478 million in the corresponding period of 2007.

Debt Securities Market

Government Securities Market

- **Yields on Treasury bills moderated along with the further liberalisation of the government securities market.** Foreign investments in Treasury bills, up to 10 per cent of the outstanding Treasury bills, were allowed from May 2008. Consequently, gross investments in Treasury bills by foreigners amounting to US dollars 210 million were recorded for the period January-September 2008. Investor preference for shorter-term securities, particularly 91-day Treasury bills, also resulted in the yield curve for the shorter-end of the market continuing to shift downwards till September 2008. From the end of September however, some upward pressure was witnessed in respect of yields on government securities. Yields on 91-day, 182-day and 364-day Treasury bills in the primary market were 17.22 per cent, 18.28 per cent and 19.06 per cent respectively, by end-September 2008, having declined by 90 to 400 basis points since end-2007. Total outright transactions of Treasury bills in the secondary market rose significantly by 34 per cent during the first nine months of the year as against the same period last year. The repo market also experienced increased trading, with volumes rising by 34 per cent in the first nine months of 2008 compared with the same period last year.

Chart 8.1
Government Securities - Secondary Market Yield Curve



- **The secondary market yield curve for government securities, which extended only up to a maturity period of two years at the end of 2007 due to high inflation expectations, was seen to elongate up to five years by end-September, as a result of the gradual downward shift in inflation expectations.** As a result of uncertainty regarding inflation, particularly during the first half of the year, the market for Treasury bonds with medium to long term maturities was largely inactive during the early part of the year. In the primary market, yields on Treasury bonds with maturities of 2 and 3 years were 19.33 per cent and 19.22 per cent, respectively, by end-September 2008. Outright transactions of Treasury bonds declined by 27 per cent, while repo transactions increased by 15 per cent, during the first nine months of 2008, compared with the same period of 2007. Foreign investments in Treasury bonds continued during the year. The market was further liberalised, with foreign purchases permitted up to 10 per cent of the total outstanding Treasury bonds, from December 2007. During January-September 2008, gross purchases of Treasury bonds by foreigners amounted to US dollars 286 million.

Corporate Debt Securities Market

- **The market for commercial paper has continued to be active in 2008, thus far.** The value of commercial paper issued with the support of commercial banks during the first eight months of 2008 amounted to Rs. 16.8 billion. In comparison, Rs. 20.3 billion had been raised in the corresponding period last year through issues of commercial paper. Interest rates applicable to commercial paper issued in August 2008 and maturing within a period of 3 months from the date of issue were in a range of 19.0 - 27.0 per cent. Interest rates applicable to similar instruments issued in December 2007 were in a range of 19.5 - 24.0 per cent.

- **The primary market for publicly quoted corporate bonds was largely inactive, due to the high interest rate environment.** There have been two new debenture issues in 2008, thus far, by Seylan Bank, which mobilised Rs. 500 million, and Singer Sri Lanka, which mobilised Rs. 301 million. While debentures issued by Seylan Bank had a maturity of five years, the rate of interest payable annually, which was one option given to investors, was 20 per cent. Debentures issued by Singer Sri Lanka had maturities of four and five years. While the fixed rates of interest offered on these debentures were 19.50 per cent and 19.75 per cent, respectively, the variable rates offered were determined based on the yields of 3-month and 6-month Treasury bills or the AWPR. The turnover of debentures listed on the Debt Trading System (DEX) of the CSE also decreased to Rs. 23 million in the first nine months of 2008 from Rs.89 million in the same period last year.

Table 8.2

Stock Market Indicators

	2006	2007	Jan – Sep 2008
All Share Price Index (end period)	2,722.4	2,540.9	2,142.3
Milanka Price Index (end period)	3,711.80	3,291.9	2,397.2
Market capitalisation (Rs.bn – end period)	835.00	820.7	699.3
Net cumulative foreign purchases (Rs.mn – during the period)	5,338.4	11,254.0	14,042.3

Source: Colombo Stock Exchange

Chart 8.2

Movements of Share Price Indices

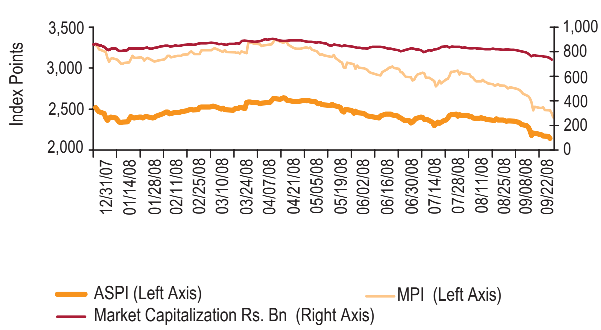
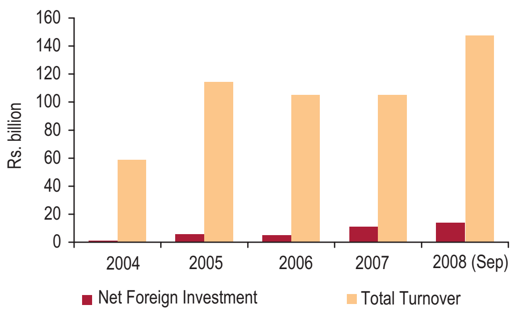


Chart 8.3
Turnover and Net Foreign Investment - CSE



Stock Market

- **Equity prices rose in the first quarter of the year and reached record levels by April although the market could not maintain the upward momentum and equity prices declined during the second and third quarters of 2008.** The All Share Price Index (ASPI) declined by 16.3 per cent by the end of September 2008, compared with a decline of 7.5 per cent in the whole of 2007. Following the same trend, the Milanka Price Index (MPI) has declined by 27 per cent by the end of September 2008 compared with a decline of 12 per cent in 2007. Market capitalisation further declined by 14.8 per cent to Rs.699 billion at the end of September 2008 from Rs. 821 billion at end 2007. The average daily turnover at the CSE during the period January-September 2008 rose to Rs. 568 million from Rs.435 million in 2007, on account of a few large value transactions. During this period, domestic investors accounted for about 37 per cent of the total turnover at the CSE and foreign investors accounted for about 63 per cent of the turnover at the CSE. The CSE had only one new listing thus far in 2008. Rights issues have also been low in 2008 when compared with 2007 where there were 21 rights issues by listed companies. By end August 2008, there were 9 rights issues by way of which Rs. 3 billion has been raised.

Access to Finance

- **Access to finance in the agricultural sector continued to improve in 2008.** Given the high priority given to the development of the dairy sector in the wake of unprecedented increases in milk powder prices, a new loan scheme aimed at the dairy farming and liquid milk and crop processing sectors named Agro-Dairy Development Loan (ALDL) scheme was introduced in April 2008. The total value of short term cultivation loans disbursed under the New Comprehensive Rural Credit Scheme (NCRCS) during Maha 2007/08 increased by 63 per cent when compared with Maha 2006/07 while loans released by banks for the purchase of agricultural commodities under Forward Sales Contracts (FSC) in Maha 2007/08 increased by 104 per cent when compared to Maha 2006/07. The Krushi Navodaya scheme under which medium-term micro and small loans are made available for a range of activities allied to agriculture and animal husbandry continued to be operational in the first half of 2008 while refinance facilities continued to be made available during the first half of 2008 under the Second Perennial Crop Development Project Revolving Fund Scheme and the Tea Development Project Revolving Fund Scheme. In the microfinance sector, the Central Bank operated the Poverty Alleviation Micro Finance Project Revolving Fund (PAMP-RF), which covers the whole island, and the Small Farmer and Landless Credit Project Revolving Fund (SFLCP-RF) Scheme.

Development in Financial Infrastructure

Payment and Settlement Systems

- **The efforts of the Central Bank to increase the reliability and efficiency of the payments and settlements systems continued during the first nine months of 2008, with a focus on Business Continuity Planning (BCP).** The LankaSettle System recorded a system availability of 99.9

per cent in the first half of 2008. In a bid to ensure the business continuity of the LankaSettle system, the CBSL conducted its live operations on 8 February 2008 from its Disaster Recovery (DR) site. The Cheque Imaging and Truncation (CIT) System, which was introduced with the objective of increasing the efficiency of cheque clearing, by reducing the cheque realisation time island-wide from 10 days to one day i.e. T+1 (where T is the day on which LankaClear receives the cheque for clearing and 1 is the following business day) continues to progress. The volume of Sri Lanka Interbank Payment System (SLIPS) transactions grew by more than 35 per cent in the first six months of 2008. Therefore, LankaClear enhanced the capacity of the system to accommodate new and emerging demand for SLIPS payments.

- **One of the action points of the Road Map, which sets out the future developments in the payments system is to establish a Common Payment Switch (CPS) which supports real time retail fund transfers/payments between banks 24 hours a day.** Participating banks' obligations/claims under the CPS will be settled periodically on a multilateral net settlement basis in the RTGS System. In the first phase, the CPS will facilitate retail credit transactions of customers of banks via the teller counter, the ATM, the internet banking facility, the phone banking facility and standing instructions for bill payments, international remittances, statutory payments, direct retail debit transactions and local credit card transactions.

Regulation and Supervision

- **The Central Bank has continued to strengthen the supervisory and regulatory framework with the aim of promoting safety and soundness of the financial system.** To strengthen risk management and promote the effective use of capital, the Basel II International Capital Adequacy Standard was introduced in January 2008 and banks have commenced the application of the Basel II standardised approach for managing credit risk, the standardised measurement method for managing market risk and the basic indicator approach for managing operational risk. The implementation of the direction on corporate governance issued to banks was also commenced in 2008, facilitating the conduct of the banking business in a responsible and accountable manner, thereby further strengthening the risk management framework. A road map for the full implementation of International Accounting Standards (IAS) 32 and 39 by 2011 was issued to banks and the parallel reporting by banks based on the corresponding Sri Lanka Accounting Standards (SLAS) 44 and 45 was commenced in June 2008. A new policy for the establishment of bank branches was introduced to facilitate the enhancement of economic development in areas outside the Western province in order to achieve balanced regional development. Promoting transparency, guidelines for opening new banks, the licensing procedure and the evaluation criteria were published in the public domain.

- **Initiatives have been taken to improve the efficient functioning of equity trading.** The Securities and Exchange Commission (SEC), which regulates the stock exchange, the clearing house, stock brokers, unit trust management companies, investment managers, margin providers, underwriters and credit rating agencies, introduced rules on corporate governance for listed companies in 2007 and mandatory compliance was required with effect from the financial year beginning April 2008. The SEC increased the minimum net capital requirement for stock brokers to Rs.35 million with effect from 2008. In line with best practices, the amount of credit extended by stock brokers to their clients for share trading has been reduced from 75 per cent to 50 per cent of their securities portfolio, from January 2008.

Prospects for 2009

- **The overall outlook for financial system stability remains positive despite a challenging external and domestic environment.** The steady growth prospects of the domestic economy and the continuation of policies to address macroeconomic imbalances will further stabilise domestic financial markets and improve the performance of financial institutions. The regulatory authorities will continue to be vigilant and introduce measures to improve risk management, corporate governance, and public disclosure of financial institutions, thereby strengthening the resilience of the financial system.

- **Financial infrastructure, particularly the retail payment system, will be modernised.** This would increase the efficiency and security of the financial infrastructure and will increase competitiveness of the financial sector.