8

FINANCIAL SECTOR DEVELOPMENTS AND STABILITY

The financial sector expanded and remained resilient supporting the growth momentum of the economy in spite of the uncertain global market conditions. Both banking and non-banking sectors have seen expansion in terms of the asset base. With the raising of capital funds from overseas by banks, sources of funding have diversified and the balance sheets have been strengthened. Amidst the expansion, financial system stability was maintained by way of strengthened supervisory and regulatory frameworks, improved risk management, enhanced legal frameworks, reinforcing liquidity support and confidence building through financial safety nets. However, the primary dealers and stock brokers experienced a contraction in their assets bases due to the marked to market losses in investments in the government securities market and stock market.

The macroeconomic policy measures such as the tightening of monetary policy, moving towards a more flexible exchange rate regime and the imposition of a credit ceiling on licensed banks implemented during this period in order to contain high credit and import growth have already started to take effect while the fiscal measures such as the increase in import tariffs and fuel prices have also dampened import growth thereby contributing to lower the demand for credit.

Several new policy measures have been introduced to curb excessive volatility in the foreign exchange market. The issue of the US dollars 1 billion sovereign bond and the receipt of the last tranche of the IMF SBA facility have also contributed towards stabilising the exchange rate and raising the international reserves. With respect to market interest rates, the yield rates in the government securities market increased responding to the increases in policy interest rates, the increased borrowing requirement of the government and rising inflation.

The stock market continued its downward trend until end August 2012 but showed signs of turnaround in September. Increased interest rates, limits imposed on stock brokers' credit, lack of market liquidity, as well as the spillover effects of the devolopments in globle financial markets contributed to the decline in stock prices. However, there has been continued foreign buying interest during the year due to the attractive price earnings ratios resulting in a net inflow of foreign funds.

The insurance sector experienced growth in terms of assets, income and profitability, although investment income declined due to marked to market losses from investments in government securities and equity.

The payment and settlement system operated with a high degree of availability and safety. The Central Bank continued its efforts to promote e-payment systems through mobile phones to create more secure and cost effective means to transfer small value payments. Measures were also taken to improve contingency planning among the key participants as well as to ensure customer protection.

Developments in Financial Institutions

Banking Sector

- **The banking sector remained stable and maintained profitability despite the moderation in lending activities since the second quarter of 2012.** Total assets of the banking sector increased by 15 per cent during the first eight months of 2012 against that of 11 per cent during the corresponding period of 2011. However, the increase in the assets base slowed down from 8 per cent during the first quarter of 2012 to 6 per cent since end March 2012 due to policy measures taken to contain credit expansion.

- **Deposits continued to be the main source of funding.** The banks continued to offer attractive products and expand their delivery channels. The banking sector reported a marginally higher increase of 12 per cent in total deposits during the first eight months of 2012 compared to that of 10.5 per cent in 2011.

- **The share of borrowings in total funding recorded an increasing trend from 14.9 per cent to 16.5 per cent, consequent to banks raising funds from overseas sources reflecting increased investor confidence in the long term stability and creditworthiness of banks.** The share of borrowings in foreign currency increased from 42 per cent in end 2011 to 55 per cent by end August 2012. During this period, the Bank of Ceylon successfully completed an international bond issue by raising US Dollars 500 million with a maturity of five years, becoming the first Sri Lankan entity other than the Government to raise funds in such manner.

- **The banking sector responded positively to the ceiling on credit imposed in March 2012.** The annual growth in lending slowed down from 36 per cent in end March 2012 to 32 per cent by end August 2012. However, the banking system continued to support the financial needs of the economy. Loans and advances granted during the first half of 2012 has been mainly to trade (22 per cent), agriculture and fishing (16 per cent), construction (11 per cent) and manufacturing (7 per cent) sectors.

- **The non - performing loans (NPLs) increased.** Gross NPL ratio (ratio of gross NPLs to total loans) and net NPL ratio increased marginally from 3.8 per cent and 2.1 per cent in end 2011 to 4.1 per cent and 2.5 per cent, respectively, at end August 2012. The provision coverage ratio declined from 57.1 per cent in end December 2011 to 50.2 per cent in end August 2012.

- **Profitability continued to improve.** Depreciation of the rupee, with the Central Bank allowing greater flexibility in the exchange rate resulted in an increase in the net gain from the revaluation of foreign currency assets and liabilities. Consequently, the banking sector recorded increased profits (after tax) of Rs. 53 billion during the first eight months of 2012 (Rs. 41 billion in 2011), despite the reduction in the interest margin and lower increase in other non interest income.

- **Both capital adequacy ratio (CAR) and overall liquidity of the banking system remained healthy.** CAR that indicates the ratio of capital to risk weighted assets of banks was at 14.8 per cent, while the statutory liquid asset ratio (ratio of liquid assets to applicable liabilities) was at 31 per cent. Both ratios were well above the regulatory minimum of 10 per cent and 20 per cent, respectively.

- **Access to finance increased further.** The service delivery channels of licensed banks continued to expand. The 33 banks operated throughout the country with 6,952 banking outlets, of which 68 were opened during the first eight months of 2012.

Table 8.1 Selected Data and Key Financial Soundness Indicators of the Banking Sector

Item	End August 2010	End August 2011	End August 2012 (a)
Data (Rs. bn)			
Total Assets (net)	3,288	3,960	4,881
Advances (net)	1,760	2,284	3,017
Deposits	2,380	2,858	3,436
Borrowings	464	578	805
Investments	1,082	1,156	1,163
Capital Funds	276	337	415
Indicators (Per cent)			
Tier 1 Capital Adequacy Ratio	13.4	13.1	13.1
Gross Non- Performing Loans Ratio	4.8	4.1	4.1
Return on Assets (Before Tax)	1.6	1.7	1.7
Return on Equity (After Tax)	19.3	20.0	20.0
Statutory Liquid Assets Ratio (DBU)	35.2	30.8	30.8
Liquid Assets to Total Assets	33.3	30.4	27.2

(a) Provisional

Source: Central Bank of Sri Lanka

- **Several policy measures were introduced to ensure stability in the banking sector.** In order to restrict the higher than desired credit growth of licensed banks, the Central Bank imposed a limit of 18 per cent (of the total outstanding of rupee credit as at end 2011) on the rupee credit growth during 2012. The smaller banks and those banks that had a lower level of lending in 2011 were permitted to lend up to Rs. 800 million. Where the banks were in a position to raise corresponding funds from overseas sources, the above limit were increased to 23 per cent and Rs. 1,000 million. Considering the recent trends in the market interest rates, licensed banks were given the option to increase the interest rates on housing loans to 16 per cent per annum and credit card advances to 28 per cent per annum.

- **Supervisory and regulatory framework was strengthened to enhance risk management in the banking sector.** An integrated risk management framework was implemented for all licensed banks. A consultation paper on Internal Capital Adequacy Assessment Process (ICAAP) was issued, which requires banks to assign capital for additional risks not covered under Pillar 1 of Basel II. Such process will foster a strong emphasis on risk management and encourage ongoing improvements in banks' risk assessment capabilities. In order to promote a high standard of business conduct and market practice for the orderly conduct of the foreign exchange trading activities in Sri Lanka, a direction was issued to licensed commercial banks covering market practices, ethics, standard of conduct and practices to be followed, the knowledge level that needs to be maintained and sanctions on non-compliance. In addition, to ensure good governance, locally incorporated licensed banks were requested to obtain prior approval of shareholders for any special payments/ benefits made to bank directors at their retirement in addition to normal remuneration and incorporate such special payments/benefits to the remuneration policy of the bank. Further, banks were requested to extend those special payments/ benefits to bank directors on arm's length basis and disclose the same in the Annual Report of the respective financial year.

Non-Bank Financial Institutions (NBFIs)

- **The Non-Bank Financial Institutions (NBFIs) Sector expanded further during the first eight months of 2012.** Total assets of the sector expanded by 13 per cent (Rs. 63.7 billion) compared to the growth of 15 per cent (Rs. 56.4 billion) in the first eight months of 2011. The NBFIs consist of 44 Licensed Finance Companies (LFCs) and 13 Specialised Leasing Companies (SLCs), which are under the regulatory and supervisory purview of the CBSL. While two new entrants and three SLCs obtained LFC status, the branch network expanded by 78 to 782 branches during the first half of 2012.

- **Deposits grew at a faster rate in response to competitive interest rates offered.** Deposits grew by 22 per cent (Rs. 41.3 billion) to Rs. 227 billion in the first eight months of 2012 compared with the growth of 21 per cent (Rs. 30.1 billion) in the corresponding period of 2011, while borrowings marginally decreased by 1 per cent in the first eight months of 2012.

- **A moderation in credit growth was seen, as demand for vehicle leases and hire purchases declined due to increased prices of motor vehicles.** Credit provided by the NBFIs increased moderately by 14 per cent in the first eight months of 2012 compared to the growth of 29 per cent in the corresponding period of 2011. The tightening of monetary policy, the flexible exchange rate regime, import duty on vehicles and increased fuel costs have stifled the growth of leasing and hire purchases in 2012. Finance leases and hire purchases grew only by 20 per cent and 3 per cent, respectively, in first eight months of 2012, compared with 60 per cent and 15 per cent, respectively, in the corresponding period of 2011.

- **Asset quality improved with a noteworthy decline in non-performing accommodations.** Despite higher interest rates, asset quality improved with the gross non performing loan ratio decreasing to 5.2 per cent at end August 2012 from 5.7 per cent at end August 2011.

- **The overall liquidity of LFCs improved.** The total liquid assets of LFCs increased by 22 per cent during the first eight months of 2012, recording a surplus of Rs. 4.2 billion compared to the overall stipulated minimum requirement of Rs. 23 billion. This was attributed to the turn around of several distressed companies, which now have improved liquidity positions as well as increased earnings and growth in funding channels.

- **The capital position of NBFIs strengthened with new capital infusions.** Capital funds increased by 22 per cent in the first eight months of 2012 and the Capital Adequacy Ratios of the NBFIs exceeded the regulatory minimum requirement. Subsequent to the listing on the CSE, several NBFIs brought in new capital through rights issues and strategic investments. As at end August 2012, the core capital ratio was 17.2 per cent and the total capital ratio was 17.8 per cent, well above the statutorily required 10 per cent.

Table 8.2 Selected Data and Key Financial Soundness Indicators of the Non-Bank Financial Institutions Sector

Item	End August 2010	End August 2011	End August 2012 (a)
Data (Rs. bn)			
Total Assets	341	444	553
Advances	233	343	443
Deposits	134	176	227
Borrowings	113	153	170
Capital Funds	42	57	83
Indicators (Per cent)			
Total Capital Adequacy Ratio	9.1	13.7	17.8
Tier 1 Capital Adequacy Ratio	22.6	13.9	17.2
Gross Non Performing Accommodations Ratio	9.6	5.7	5.2
Net Non Performing Accommodations Ratio	4.8	1.9	1.8
Return on Assets (Before Tax)	3.8	5.3	3.9
Return on Equity (After Tax)	17.6	30.1	18.3
Liquid Assets to Total Assets	4.7	4.2	5.6

(a) Provisional

Source: Central Bank of Sri Lanka

- **NBFIs recorded profits but declined marginally.** Profits of the NBFIs declined in the first eight months of 2012 to Rs. 10.1 billion from Rs. 11.3 billion in the corresponding period of 2011. The annualised ROA and ROE were lower at 3.9 per cent and 18.3 per cent, respectively, for the eight months period ending August 2012, compared with 5.3 per cent and 30.1 per cent, respectively, as at end August 2011, as the interest margins declined.

- **Efforts to restructure and recapitalise the remaining distressed companies continued.** Strategic investors were found for all seven distressed companies of which five distressed NBFIs are currently carrying on regular business operations as a result of the resolution measures being adopted by the Central Bank since 2009.

The remaining companies are expected to commence their business as soon as the new investors take over the management.

- **Four NBFIs obtained listing on the CSE during the first eight months of 2012 bringing the total number of NBFIs listed on the CSE to 32 as at end of August 2012.** The remaining unlisted LFCs (apart from a few distressed companies) have been given time targets by the Central Bank based on each company's financial positions to obtain listing on the CSE.

- **Several measures were introduced to streamline the operations of NBFIs.** The maximum limit on rates of interest that could be offered by LFCs on time deposits and non-transferable Certificates of Deposits were revised while allowing for an additional 1 per cent interest above the ceiling for senior citizens. A circular was issued to all SLCs regarding the maximum rate of interest that could be offered on debt instruments, which is 1 per cent higher than the maximum limit for rates of interest offered by LFCs. A new Rule was issued with the objective of streamlining the application process for issuance of a license for a new finance business to be in line with the Finance Business Act No. 42 of 2011. The annual licensing fees were revised upwards as the regulatory / supervisory cost of the Central Bank has increased significantly.

- **Minimum core capital requirement for SLCs was raised, with a view of promoting their financial soundness.** The minimum core capital to be maintained by SLCs, which was Rs. 100 million until end December 2012 was increased to Rs. 150 million, to be effective from 01 January 2013 and further raised to Rs. 200 million, Rs. 250 million and Rs. 300 million to be effective from 01 January 2014, 2015 and 2016, respectively. A direction was issued to SLCs on the assessment of fitness and propriety of all directors and officers performing executive functions to promote good governance and effective risk management in SLCs. An amended liquid assets direction was issued in July 2012 for all SLCs, requiring the maintenance of liquid assets, not less than 5 per cent of the total liabilities and off-balance sheet items excluding the shareholders liabilities, securitisations and asset backed long term borrowings with effect from 01 September 2012 and not less than 10 per cent with effect from 01 July 2013 in order to enable companies to gradually improve their liquidity levels.

Insurance Companies

- **The insurance sector has experienced growth in total assets, premium income and profitability, although at a slower pace.** There were 22 insurance companies in operation as at end June 2012. Out of these, 12 companies were composite insurers, while 7 companies engaged exclusively in general insurance and 3 companies conducted long term insurance business. The total assets of the insurance sector increased by 15.4 per cent in the first six months of 2012 as against 23.6 per cent in the corresponding period in 2011. Further, the total gross written premium (GWP) of insurance companies rose only by 13.5 per cent in the first half of 2012 compared with an increase of 23.4 per cent in the same period in 2011.

- **Despite the decline in investment income, the total income of the insurance sector grew.** The decline in prices in the stock market affected investment income which decreased by 9 per cent during the first half of 2012 as against a marginal decline of 0.1 per cent in the corresponding period of 2011. However, the total income increased by 8.2 per cent in the first half of 2012. The aggregate profit before tax of the insurance sector increased by 27 per cent, on account of

Table 8.3 Selected Data and Key Financial Soundness Indicators of Insurance Companies

Item		End June 2010	2011	2012 (a)
Data (Rs. bn)				
Total Assets		196	242	279
Total Income (b)		43	51	55
Gross Premium Income (b)		31	39	44
Investment Income (b)		12	12	11
Profit Before Tax (b)		2	6	7
Indicators				
Solvency Margin Ratio (Times)	- Life Insurance	5.6	8.2	5.8
	- General Insurance	2.8	1.7	2.3
Retention Ratio (%)	- Life Insurance	96.7	96.6	96.3
	- General Insurance	71.5	76.9	78.3
Claims Ratio (%)	- Life Insurance	47.2	36.2	33.1
	- General Insurance	65.9	61.0	64.8
Combined Operating Ratio (%)	- Life Insurance	72.1	78.9	78.9
	- General Insurance	90.3	99.5	103.5
Return on Assets (ROA) (%)	- Life Insurance	0.7	2.7	1.0
	- General Insurance	2.3	2.0	5.1
Return on Equity (ROE) (%)	- General Insurance	5.4	4.3	9.7
Underwriting Ratio (%)	- General Insurance	17.8	23.2	16.1

(a) Provisional
(b) During the period up to end June

Source: Insurance Board of Sri Lanka

higher profits generated in the general insurance sector. The import duty concessions, which were available up to the 1st quarter of 2012 buoyed vehicle imports and thus increased vehicle insurance business during this period.

- **All insurance companies complied with the statutory solvency margin requirement for general insurance as at end June 2012 whereas one company was non-compliant with the minimum solvency requirement for long term insurance.** The overall solvency ratios for long term and general insurance remained at 5.8 and 2.3, respectively, at end June 2012.

- **The provisions in the Regulation of Insurance Industry (RII) Act, amended in January 2011, are to be implemented by 2015-2016.** Long term and general insurance businesses of the composite insurers are to be segregated into two separate companies by 2015. This regulatory requirement has been introduced primarily to ensure protection to the policy holders by enabling the identification of assets and liabilities of the two classes separately thus preventing the set off of losses of one class from the profits of the other. Listing on the Stock Exchange (by 2016) has been made mandatory for all insurance companies, providing these companies access to the stock market to raise capital when necessary and ensuring increased transparency. The Insurance Board of Sri Lanka (IBSL) has also initiated the move to a risk based capital adequacy framework for insurance companies. In addition, the solvency margin rule was further amended requiring insurers to maintain a solvency margin in respect of each class of insurance business.

Primary Dealers in Government Securities

- **The performance of the Primary Dealer Industry (PDs) suffered a setback during the first eight months of 2012.** Total assets of PDs declined by 13.2 per cent to Rs. 129.0 billion and the total portfolio of government securities held by PDs declined by 13.8 per cent to Rs. 126.7 billion compared to the position at the end August 2011. This decline in assets could

Table 8.4 Selected Data and Key Financial Soundness Indicators of Primary Dealers

Item	End August 2010	2011	2012 (a)
Data (Rs. bn)			
Total Assets	135.7	148.7	129.0
Total Portfolio	132.2	147.0	126.7
Total Capital	12.7	14.8	14.2
Profit before Tax (b)	3.8	2.3	0.8
Indicators			
Risk Weighted Capital Adequacy Ratio (%)	18.2	21.5	25.5
Tier 1 Capital (RWCAR) (%)	18.2	21.5	25.5
Return on Assets (%)	4.8	2.5	0.6
Return on Equity (%)	41.7	22.3	4.6
Leverage Times	6.0	6.4	5.6
Operating Expenses to Total Income (%)	2.7	2.8	4.7
Total Cost to Total Income (%)	63.0	73.9	94.1
Duration of Assets and Liabilities (years)	1.3	0.9	0.8

(a) Provisional
(b) During the period up to end August

Source: Central Bank of Sri Lanka

be attributed to the downsizing of the trading portfolio of government securities held by PDs in order to avoid larger marked-to-market losses resulting from increased interest rates. Although the industry recorded a profit before tax of Rs. 792 million over the eight-month period, the annualised return on equity (ROE) and return on assets (ROA) declined to 4.6 per cent and 0.6 per cent, respectively, at end August 2012. PDs maintained capital over and above the minimum requirement of Rs. 300 million as at end August 2012. The Risk Weighted Capital Adequacy Ratio (RWCAR) of the sector improved during the period owing to the decline in Risk Weighted Assets. There were 12 PDs in operation as at end August 2012.

Unit Trusts

- **Despite the increase in the number of funds, the unit trust industry lost value during the first nine months of 2012 due to the decline in prices of listed shares.** Twelve new funds were launched during the period. There were 37 funds in operation managed by 11 unit trust management companies registered with the Securities and Exchange Commission of Sri Lanka (SEC). However, the net asset value (NAV) of the unit trust industry declined by 13.4 per cent to Rs. 23.1 billion at end September 2012 from Rs. 26.6 billion at end September 2011, due to the price declines in listed shares. As at end September 2012, the share of equities and government securities in the investment portfolios of unit trusts declined to 39.8 per cent and 20.9 per cent, respectively, compared to 40.3 per cent and 52.4 per cent as at end September 2011, while that of other investments (such as commercial paper, debentures, trust certificates and bank deposits) increased significantly to 39.6 per cent.

Stock Brokers

- **The performance of the stock brokers declined due to the decline in market liquidity, the rise in interest rates and restrictions on broker credit.** Total earnings, profits and capital funds of the 29 stock brokers declined in the first half of 2012, as the stock market experienced a bear run losing 20 per cent of market capitalisation during this period. The total income of the industry declined by 72 per cent to Rs. 994 million in the first half of 2012 from Rs. 3,542 million in the corresponding period in 2011. Hence, a net loss (before tax) of Rs. 443 million has been recorded for the first six months of 2012, compared to the net profit before tax of Rs. 297 million for the same period in 2011. Total assets of the stock broking sector also declined by 36 per cent to Rs 10.9 billion, while their net capital increased by 4.4 per cent to Rs 3.9 billion as at end June 2012. In order to reduce liquidity constraints of retail investors and to reduce volatility in the market, the credit extension by stock brokers was further relaxed by the SEC.

Table 8.5 Selected Data of the Unit Trust Industry

Item	End September		
	2010	2011	2012 (a)
Total Assets (Rs. mn)	18,079	26,707	23,226
Net Asset Value – NAV (Rs. mn)	18,005	26,626	23,067
Investments in Equities (Rs. mn)	12,797	10,739	9,180
Investments in Equities as a % of NAV	71	40	40
Total No. of Unit Holders	24,025	26,491	27,479
No. of Units in Issues (mn)	678	1,659	1,468
No. of Unit Trusts	19	24	35

Source: Unit Trust Association of Sri Lanka

(a) Provisional

Table 8.6 Selected Data of the Stock Broking Industry

Rs. million

Item	End June		
	2010	2011	2012 (a)
Turnover (b)	2,898	3,542	994
Net profit before tax (b)	1,595	297	- 443
Total Assets	14,288	17,087	10,885
Total liabilities	10,702	11,069	4,130
Net capital	2,987	3,754	3,918

Source: Securities and Exchange Commission of Sri Lanka

(a) Provisional
(b) During the period up to end June

Superannuation Funds

- **The superannuation fund sector consists of two major publicly managed funds (i.e., the Employees' Provident Fund (EPF) and the Employees' Trust Fund (ETF)), Public Service Provident Fund (PSPF) and about 170 privately managed approved provident and pension funds (APPFs).** The value of EPF was Rs 1,083 billion as at end June 2012 and represented 78 per cent of the total assets of the superannuation industry and 13.2 per cent of the total assets of the financial sector in Sri Lanka. As at end June 2012, there were 2.2 million active members in the Fund. There were also 11.2 million non-contributory accounts, which are accounts of members under their previous employers. Total contributions in the first half of 2012 increased by 12 per cent to Rs. 34.2 billion, while the refunds increased by 21 per cent to Rs. 23.4 billion. Hence, the net contributions (contributions minus refunds) stood at Rs. 10.7 billion. As at end June 2012, total assets of the EPF increased by 11.8 per cent to Rs. 1,080.4 billon while the total investment portfolio of the EPF amounted to Rs. 1,046.8 billion. Investment income of the Fund decreased by 6.9 per cent to Rs. 55.2 billion. Its investment portfolio consisted of 92.6 per cent government securities, 6.3 per cent equity and 0.9 per cent corporate debt and reverse repos as at end June 2012. In order to facilitate effective management of the fund and further benefits to the members, the EPF Act was amended in February 2012. Under the amended Act, members can withdraw 30 per cent of the individual balance for purposes of housing or medical purposes.

- **The ETF had a value of Rs. 149 billion as at end June 2012.** The ETF has about 9.6 million accounts, of which, about 2.1 million are active. Total contributions and benefits paid to members during January to June 2012 increased to Rs. 6.2 billion and Rs. 4.1 billion, respectively, compared to Rs. 5.4 billion and Rs. 3.4 billion during the corresponding period of 2011. The net contribution increased by 10.6 per cent to Rs. 2.1 billion during the period under consideration. The total assets of the ETF increased by 11 per cent to Rs. 148.8 billion as at end June 2012. As in the case of the EPF, the investment portfolio is concentrated in government securities, which accounts for 91 per cent of the total portfolio. Investments in equity and corporate debt securities accounted for 4.2 per cent and 0.8 per cent, respectively.

Table 8.7 Key Information of Major Superannuation Funds

	End June 2011		End June 2012 (a)	
	EPF	ETF	EPF	ETF
Number of Accounts (mn)	13.5	9.5	13.4	9.6
o/w, Active Accounts (mn)	2.3	2.1	2.2	2.1
Total Contributions (Rs. bn) (b)	30.6	11.1	34.2	6.2
Total Refunds (Rs. bn) (b)	19.3	7.8	23.4	4.1
Total Assets (Rs. bn)	968	141	1,080	149
Total Investment Portfolio (Rs. bn)	932	134	1,047	140
o/w, Government Securities (%)	92.2	90.0	92.6	91.0
Gross Income (Rs. bn) (b)	59.5	13.4	55.2	6.4

(a) Provisional
(b) During the period up to end June

Sources: Central Bank of Sri Lanka
Employees' Trust Fund Board

- **The PSPF had 227,602 members while the APPFs had 167,096 active members as at June 2012.** Total assets of the PSPF and APPFs amounted to Rs. 31.3 billion and Rs.115.1 billion, respectively, at end June 2012. Total contributions and refunds of the PSPF during the first six months of 2012 amounted to Rs.723 million and Rs. 266 million, respectively.

Developments in Financial Markets

Inter-bank Call Money Market

- **During the first nine months of 2012, movements in the short - term interest rates in the inter - bank market reflected the impact of policy rates adjustments and the rupee liquidity levels.** In terms of volume, market liquidity was in surplus position for about 93 per cent of the time. The Repurchase and Reverse rates of the Central Bank were revised upward twice, from 7.00 per cent and 8.50 per cent to 7.50 per cent and 9.00 per cent, respectively, on 3 February 2012 and then to 7.75 per cent and 9.75 per cent, respectively, on 5 April 2012. The daily weighted average call money rate varied between 8.53 per cent and 10.71 per cent with an average of 9.93 per cent during the period. The tax adjusted call rate fluctuated between 7.68 per cent and 9.64 per cent, with an average of 8.93 per cent. Market liquidity varied from a deficit of Rs.13.5 billion to a surplus of Rs.58.9 billion, while a daily surplus average of Rs.11.2 billion during the period. The lack of appetite to lend which was visible among market participants during the previous year, seemed to have reversed to a great extent during this period. This was mainly due to the improved credit environment and the selected administrative measures taken by the CBSL to encourage inter-banking lending.

Domestic Foreign Exchange Market

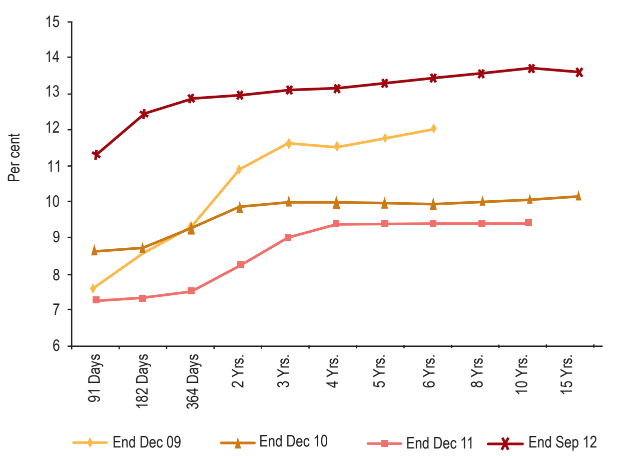
- **Sri Lanka changed its exchange rate policy from managed floating rate system to a market based system allowing currencies to float freely responding to demand and supply pressures in February 2012.** After the policy change allowing market to determine the exchange rate, Sri Lankan rupee was depreciated from Rs. 113.90 to Rs. 133.96 as at end June 2012. This depreciation was evident againsed other major currencies as well. A series of policy mesures were initiated by the government as well to curb the high demand of imports. As a result, growth of imports has decelerated and stability has returned to the foreign exchange market with a gradual appreciation of the currency. Inflows of funds to the country along with sovereign bond issue, IMF SBA facility, investments in the stock market, increased worker remittances and enhanced income generated from tourism sector helped to increase the confidence and to reverse the depreciating trend in exchange rate.

- **The trading volumes in the domestic foreign exchange market during this period recorded a marginal decline when compared with the corresponding period of the previous year.** The total volume of inter - bank foreign exchange transactions decreased to US dollars 10.4 billion in the first nine months of 2012 from US dollars 11.9 billion in the corresponding period of 2011. Similarly, the total volume of forward transactions also decreased to US dollars 3.2 billion during this period compared with US dollars 4.1 billion in the corresponding period of 2011. The daily average turnover in the inter-bank FX market (including the forward market) was US dollars 57.2 million as against US dollars 66.8 million in the corresponding period of 2011.

Government Securities Market

- **Yield rates in the government securities secondary market increased during the first nine months of 2012, responding to the increase in policy interest rates and yield rates at primary auctions, the increased borrowing requirement of the government and higher inflation since March 2012.** Accordingly, the primary market yield rates for 91-day, 182-day and 364-day T-bills increased

Chart 8.1 Government Securities-Secondary Market Yield Curve



by 262 basis points, 386 basis points, and 371 basis points, respectively, during the first nine months of 2012. The increase in primary market rates for T-bonds with maturities up to 20 years ranged from 492 to 590 basis points. The corresponding increase in secondary market yield rates for T-bills and T-bonds ranged from 268 to 373 basis points and 310 to 366 basis points, respectively.

Corporate Debt Securities Market

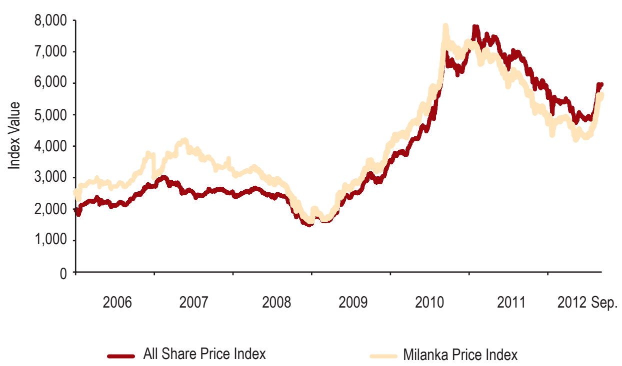
- **The commercial paper market has been relatively active in the first nine months of 2012.** The value of commercial paper (CP) issued with the support of banks amounted to Rs. 25.9 billion in the first nine months of 2012 in comparison to Rs. 6.4 billion in the same period of 2011. This could be due to the credit restrictions imposed on banks and the high lending rates charged by banks as well as finance companies. However, the interest rates on CPs also increased to a range of 11.25 – 20 per cent in 2012 from a range of 8.26 - 12.80 per cent in 2011. CPs with a maturity of up to 3 months accounted for 87.4 per cent of the market, while the shares of CPs of 6 month and 12 month maturities were 2.2 per cent and 10.4 per cent, respectively. The total outstanding value of CPs amounted to Rs. 10.7 billion as at end September 2012 compared to Rs. 4.2 billion at the September 2011.

- **Corporate bond market was relatively dormant in the first nine months of 2012.** There were six listings of corporate debentures by two banking institutions with the maturity period of 5 years listed on 3 January and 13 July 2012. These debentures mobilised funds amounting to Rs. 7 billion, carrying both fixed and floating interest rates. The fixed rates of interest, payable annually, pertaining to five debentures were in the range of 10.50 – 11.50 per cent, while one debenture was issued with a floating rate. The trading turnover of debentures listed on the Debt Securities Trading System (DEX) of the CSE was significantly low at Rs. 39.3 million in the first nine months of 2012 compared to Rs. 2,678 million in the corresponding period in 2011.

Equity Market

- **The Colombo Stock Exchange (CSE) showed signs of recovery in the month of September 2012.** Although in the first eight months of the year, equity price indices saw a downward movement reflecting negative investor market sentiments contributed by increased interest rates, limits imposed on stock brokers' credit, lack of market liquidity, as well as the spillover effects of the developments in global financial markets, equity prices surged upwards from the end of August 2012 reflecting positive market sentiments among investors. The All Share Price Index (ASPI) declined by 2 per cent, while the Milanka Price Index (MPI) increased by 8 per cent during the first nine months of 2012. The CSE introduced a new S&P SL20 index on 27 June in 2012 with a view to increasing the level of transparency and integrity in the market and this index has increased by 14 per cent by end September 2012. The market price earnings ratio declined to 16 by end September 2012 from 18 at end September 2011. Market capitalisation increased by 3 per cent (or Rs. 71 billion) to Rs. 2.3 trillion at end September 2012, which is equivalent to about 30 per cent of GDP.

Chart 8.2 Movements of Share Price Indices



The number of companies listed on the CSE increased by 16 to 287 by end September 2012. There were 5 Initial Public Offerings (IPOs) through which Rs.1.6 billion was raised and 12 rights issues through which Rs.6.4 billion was mobilised during the period.

- **Although daily average turnover declined, foreign investors remained net buyers while domestic investors dominated the market.** The average daily turnover declined to Rs. 954 million during the first nine months of 2012, compared with Rs. 2,286 million in 2011. Domestic investors accounted for about 69 per cent of turnover. There was a net inflow of foreign funds to the market, in the first nine months of 2012 amounting to Rs. 31.5 billion (or US dollars 243 million), compared to a net outflow of Rs. 17 billion (or US dollars 154 million) in the corresponding period of 2011.

- **Several measures were introduced by the SEC to facilitate the smooth functioning of the stock market.** The 10 per cent price band imposed for 5 market days on volatile securities was removed in April 2012 and several measures were also introduced to mitigate settlement risk. A number of revisions have been made to the listing rules of the CSE as well.

Development Finance and Access to Finance

- **In the first half of 2012, the Central Bank continued to provide financial assistance for the strategic economic sectors and vulnerable social groups in order to promote inclusive growth and access to finance particularly to the low income people.** In this endeavour, about 22 credit schemes were implemented providing cost effective credit delivery to the agriculture, livestock and micro, small and medium sector enterprises (MSME) sectors through Participating Financial Institutions (PFIs). In total, loans amounting to Rs 9,459 million were disbursed to 100,895 borrowers during the first half of 2012, which show an increase of 53 per cent and 22 per cent, respectively, compared to the first half of 2011. Altogether, PFIs have provided Rs. 6,477 million through Central Bank implemented credit schemes in the first half of 2012 on agriculture development, registering an increase of 77 per cent over the corresponding period of the previous year and promoting long term investments in agriculture, agro-processing and agribusiness activities in the country with a view of uplifting the living conditions of farmers.

- **The flow of funds to the conflict affected areas and lagging regions continued during the first half of 2012.** The two loan schemes, "Awakening North – Phase II" and "Resumption of Economic Activities in the East – Phase II", which were implemented with a view to boosting the livelihood development of the people and to assist Internally Displaced Persons (IDPs) to commence/restart their livelihood and economic activities after resettlement, disbursed a total of 4,167 loans amounting to Rs. 538 million through the PFIs.

- **The Central Bank continued to assist the MSME sector with a view to creating income generating activities and employment opportunities among educated and unemployed youth, women and self-employed.** The 'Saubhagya' Loan Scheme, which provides credit facilities to start up new MSMEs and restart disaster affected MSMEs, disbursed Rs. 1,111 million during the first half of 2012, among 2,635 recipients. Further, Provincial Development Loan Scheme and Self Employment Promotion Initiative Loan Scheme also provided assistance for the MSME sector development. The Poverty Alleviation Microfinance Project II (PAMP II) disbursed Rs. 603 million of loans among 9,476 beneficiaries, during the first half of 2012, by addressing poverty related issues and promoting financial inclusiveness among the low income people in 14 districts covering Northern, Eastern, Uva, North Central and parts of Sabaragamuwa and North Western provinces. In the meantime, Poverty Alleviation Micro Finance - Revolving Fund Loan Scheme also released Rs. 165 million worth of loans among low income earners to commence their own income generating activities.

Payment and Settlement Systems

LankaSettle System

- **The Central Bank continued the operations of the LankaSettle system, which is the systemically important electronic payment and settlement system for high value time critical interbank payments and government securities transactions, in order to ensure a reliable and safe mechanism for efficient settlement of transactions.** Accordingly, the LankaSettle system recorded a system availability rate of 99.76 per cent during the first nine months of 2012. Further, in order to ensure readiness of the system to operate during contingency events, the Central Bank successfully conducted live operations twice from its disaster recovery site in 2012.

LankaSecure System

- **The Scripless Securities Settlement System (SSSS) and the Central Depository System (CDS) for Government Securities, collectively known as the LankaSecure, held scripless T-bills and T-bonds amounting to Rs. 3,184 billion (face value) consisting of T-bills amounting to Rs. 704 billion and T-bonds amounting to Rs. 2,480 billion as at 30 September 2012.** The corporate and individual customer accounts maintained by the LankaSecure stood at 78,520 at the end September 2012 compared to 75,871 accounts maintained as at end September 2011. The value of transfers of government securities during the first three quarters of 2012 amounted to Rs. 29,231 billion (face value).

Cheque Imaging and Truncation (CIT) System

- **The CIT System, introduced in 2006 with the objective of increasing the efficiency of cheque clearing by reducing the island-wide cheque realisation time to one day (T+1), continued to perform well to ensure a secure and efficient retail payment system.** The total volume and value of cheques cleared during the first nine months of 2012 were 35,633,156 and Rs. 4.9 trillion, respectively.

Sri Lanka Interbank Payment System (SLIPS)

- **Sri Lanka Interbank Payment System (SLIPS) which clears pre-authorised low value payments through an offline mechanism was enhanced in 2010 to an online mechanism to facilitate high transaction volumes with T+0 settlement for transactions.** The volume and value of transactions settled through the SLIPS were 10,559,196 and Rs. 398 billion, respectively, during the first nine months of 2012.

Electronic Payment Cards

- **The Central Bank issued licences to 2 new service providers in 2012 under the Payment Cards Regulation No. 1 of 2009 to engage in payment card business.** The Central Bank continued to monitor compliance of service providers with the guidelines issued by the Central Bank during this period. The total number of credit cards in use as at end June 2012 was 910,008, which was an increase of 5.5 per cent when compared with December 2011. Credit card transactions in terms of volume and value stood at 9,642,572 and Rs. 53,015 million, respectively, at end June 2012. In order to strengthen the security of the electronic payment cards, the Central Bank mandated financial acquirers to implement Terminal Line Encryption technology for the Point of Sales terminals operated by them and the progress of the project is being monitored by the Central Bank.

E-money Systems

- **A mobile phone based e-money scheme was introduced in June 2012.** Subsequent to the approval of the proposal submitted by a mobile telecommunication network operator to operate a mobile phone based e-money scheme, the Central Bank issued a license to this network operator under the Service Providers of Payment Cards Regulation No.1 of 2009. This scheme facilitates fund transfers, payments for goods and services and variety of other services through electronic cash.

Prospects for 2013

- **The overall prospects for the financial sector in 2013 are favourable in view of the conducive domestic macroeconomic conditions, overall soundness in the financial institutions and expected growth in the financial markets.** The business expansion expected in line with the projected growth for the economy would magnify the opportunities for further growth and consolidation in the financial sector.

- **The banking sector will continue to play a leading role in supporting economic growth.** The high credit growth seen in the banking sector is expected to moderate within the credit ceiling and the sector is expected to remain financially strong and resilient with increased capital requirements, improved risk management and enhanced governance practices. The adoption of Sri Lanka Accounting Standards (LKAS) 32, 39 and Sri Lanka Financial Reporting Standards (SLFRS) 7 will facilitate financial reporting of banks to be on par with international standards while improving the quality of disclosures. The current surveillance system will be further strengthened, while a supervisory rating system is to be established. Capacity building of bank directors and the bank supervision staff will be carried out on an on-going basis in order to keep abreast of regulatory developments. Asset quality will be closely monitored in the wake of expected credit moderation and increased interest rates. Further improvements will be made to risk management, compliance culture, internal controls and governance. Promoting higher standards of business conduct and market practice for the orderly conduct of the foreign exchange trading activities will also be done.

- **The regulatory framework of the banking sector is being further strengthened.** The proposed amendments to the Banking Act are expected to be implemented in 2013. Implementation of Internal Capital Adequacy Assessment Process (ICAAP) under Pillar II of Basel II will further facilitate improvements to risk management and capital planning of banks. The banking industry will move to advanced approaches in computing the capital charge for operational risk required for computing the capital adequacy ratio. Appropriate reforms will be introduced in line with Basel III requirements and the readiness of banks to comply with Basel III and advanced approaches of Basel II will be closely monitored. A supervisory framework for consolidated supervision of banking groups will also be developed.

- **The NBFI sector is expected to significantly expand in the next five years with sustained business demand as projected from agriculture, construction, trading and tourism sectors.** It is also expected to foray further into Northern and

Eastern provinces giving ample opportunities to consolidate their businesses. The increased minimum core capital requirements of NBFIs and the listing of LFCs on the CSE would bring additional funds to consolidate and expand the existing business operations. Restoration of depositors' confidence and the assurance given to the public through the deposit insurance scheme will continue to bolster the LFC industry. More SLCs are expected to be upgraded to LFC status in order to enhance their funding sources by way of deposits. Consolidation among the NBFIs is likely with the increased capital requirements. NBFIs would however, continue to face severe competition from the banking sector as more banks are now diverting from their low risk core business products to high risk products such as finance leases, margin trading and pawning. Although the prevailing interest rate gap between banks and LFCs would enable the LFC sector to attract new deposits, the upward trend in interest rates would have pressure on the asset quality, NPA ratios and the cost of funds which may result in tightening of margins.

- **The regulatory framework is being further strengthened to combat unauthorised deposit taking.** The Finance Business Act No. 42 of 2011 has already given the impetus to curb unauthorised finance businesses which in turn will contribute to stability in the financial sector. The proposed Microfinance Act will introduce a regulatory framework for the financial institutions dealing with public deposits at grass root level, thereby ensuring all deposit taking institutions operate within a legal framework.

- **Expansion prospects for the insurance sector will remain positive given the current low penetration levels.** The growth momentum in insurance companies with regard to premium income and assets will continue during 2013, supported by the overall improvement in macroeconomic conditions and expected increase in disposable income. The capital position of the insurance companies is expected to strengthen with the increase in minimum capital requirement for new licensees with the expectation that this increase would be extended to existing companies as well in the near future. The requirement to move to a risk-based capital model and the mandatory listing requirement are expected to strengthen the overall risk management framework and accountability and transparency of insurance companies. Further, the segregation of long term and general insurance business by 2015 may also see some consolidation in the sector. However, non-availability of long-term investment assets in the market to match the long term liabilities of the sector owing to the underdeveloped corporate debt market will continue to be a challenge for insurance companies.

- **Although the performance of the stock market has been subdued during the first eight months of 2012, some turn around was seen during the month of September.** However, the attractive PE ratios are expected to continue to attract foreign investors into the stock market. The proposed implementation of the minimum free float requirement is expected to increase the liquidity and turnover in the market. The establishment of a central counterparty clearing corporation is on the cards and this would address settlement risks enabling moving to a delivery versus payment mechanism. Further, it will facilitate the introduction of new products, such as exchange traded derivatives. Emphasis is also being given to creating a well informed and educated investor base. The draft bill for the demutualisation of the CSE is being finalised by the legal draftsman. The challenges faced by the CSE is lack of supply of high quality, large volume listings on the exchange, lack of a broad investor base and the narrow product range currently available.

- **The development of the corporate bond market is necessary in order to meet the long-term financing needs of the corporate sector, as bank financing is predominantly short-term.** Several measures have been taken to address the impediments to the development of the corporate bond market. Foreign investors are now allowed to invest in the corporate bond market. The tax treatment for corporate bonds has been made similar to that of government securities. However, much remains to be addressed. Development of an institutional investor base, strengthening the regulatory framework, establishing a centralised trading platform for both listed and unlisted debt securities, strengthening the market intermediation function, enabling the repo facility for highly rated corporate bonds and the establishment of a long term government securities yield curve, which can be used as the benchmark for the pricing of corporate bonds are some areas that require early attention to fast track the development of the corporate debt market.

- **The National Payment Council (NPC) has instituted plans to introduce a Common Card and Payment Switch (CCAPS), in order to provide a nation-wide common platform for the electronic retail payments in Sri Lanka.** The CCAPS, which has been designated as the national payment switch in Sri Lanka will consist of five switches, namely, a) Common ATM Switch - to facilitate holders of ATM cards to use any ATM machine domestically for cash withdrawals and balance inquiry, b) Shared Services Switch - to provide ATM facilities for customers who have bank accounts with banks that do not own an ATM machine network, c) Common POS Switch – for routing POS transactions domestically when the issuing and acquiring banks are local but not same, d) Common EFT Switch – for switching of real time EFT transactions and e) Common Mobile Switch – to connect bank mobile payment switches.

- **The CCAPS project is expected to be implemented in 2013 and it would be scalable, robust, and highly extendable to new functionalities and diverse payment mechanisms while maintaining international standards and best practices.** It would also bring significant cost efficiencies through sharing of resources by all banks, while facilitating the higher transaction volumes anticipated in the payment industry due to expected economic growth, changing spending patterns of consumers and increased disposable income. It will also provide greater customer convenience, security and efficiency of payment systems at a low cost.