8

FINANCIAL SECTOR PERFORMANCE AND SYSTEM STABILITY

The financial sector stability continued to remain healthy with improved performance. All the subsectors, except the insurance subsector, have recorded improved operating performances for the eight-month period which ended in August 2015, while the financial conditions of all sub sectors remained healthy and stable without major stability concerns. However, international and domestic developments, emanating from lingering uncertainty due to the growing divergence in policy actions by advanced and emerging market economies, are expected to affect the performance, financial conditions and the underlying risk profile of the Sri Lankan financial system.

Licensed Banks (LBs) and Non-bank Financial Institutions (NBFIs) regulated by the Central Bank of Sri Lanka (CBSL) have recorded accelerated growth in assets, as well as profitability with increased branch and ATM network. This has been due to the rapid acceleration in loans and advances, in consumption related activities, backed by low interest rate regimes and the availability of relatively short-term funding from domestic and foreign sources. Even though the volume of non-performing loans (NPL) increased since beginning of 2015, the NPL ratio remained relatively low with adequate provision coverage. LBs and NBFIs have maintained adequate liquidity, but with increased reliance on short-term funding. The profitability of LBs and NBFIs sectors further improved during the period under review, while the capital position continued to be well above the minimum regulatory requirement, reflecting its loss-absorbing capacity in times of distress. Moreover, the LBs sector has been in compliance with the new capital requirements under Basel III. The CBSL continued to introduce new prudential policy measures with a view to enhancing the safety and soundness of the LBs and NBFIs sectors.

With regard to other subsectors, the Primary Dealer (PD) industry recorded improved operating performance. The unit trust (UT) sector recorded a healthy growth. The stock broker sector showed a mixed performance with subdued activities of the Colombo Stock Exchange (CSE). The superannuation funds sectors continued to record improved operating performance and growth. The operating performance of the insurance sector, however, has been affected by low interest rates.

In terms of financial markets' development during the period under review, the international and domestic developments associated with lingering uncertainties over the normalization process of the Fed's monetary policy and increased government borrowing from domestic sources have led to increased volatility and pressure on exchange rates and market interest rates, while leading to a gradual reduction of rupee liquidity. Meanwhile, payment and settlement systems facilitated transactions in increased volumes without any major systemic risk.

Developments in Financial Institutions

Banking Sector

- **The banking sector continued to expand its asset base during the first eight months of 2015.** Increased demand for credit from both the state and private sectors steered asset growth and improved financial performance of banks during this period. During the first eight months of 2015, the total assets of the banking sector surpassed Rs. 7.0 trillion, recording an increase of 7.4 per cent. Accordingly, the total assets increased from Rs. 6,972.0 billion as at end 2014 to Rs. 7,490.9 billion as at end August 2015.

- **Total loans and advances reported an increase of 11.4 per cent during the first eight months of 2015 and stood at Rs. 4,337.1 billion at the end of August 2015.** The year-on-year growth in loans and advances was 23.7 per cent at end August 2015. Growth in loans and advances was driven by a higher demand for credit due to lower interest rates. However, the pawning portfolio contracted during the first eight months, continuing the trend prevalent in the previous years, due to the decline in global gold prices. Meanwhile, increase in loans and advances were mainly reflected in the sectors of construction, infrastructure, trading, and financial and business services.

Chart 8.1 Assets of the Banking Sector

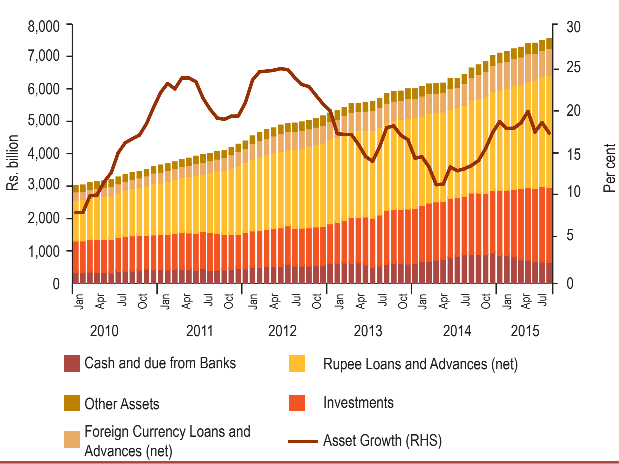
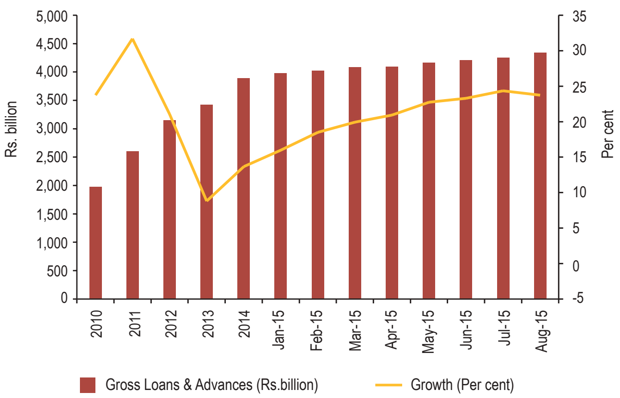


Chart 8.2 Loans and Advances of the Banking Sector



- **Deposits were the main source of funds for the lending activities during the first eight months of 2015 and contributed to 73.4 per cent of the total assets of the banking sector.** The deposit base of the banking sector grew by Rs. 380.9 billion and primarily consisted of rupee deposits. Further, the share of current and savings deposits as a percentage of total deposits improved to 39.9 per cent at end August 2015, compared to 36.6 per cent during the corresponding period in 2014. During the first eight months of 2015, increase in borrowings was mainly from rupee borrowings, which represented 42.8 per cent of total borrowings as at end August 2015.

Chart 8.3 Sources of Funding of the Banking Sector

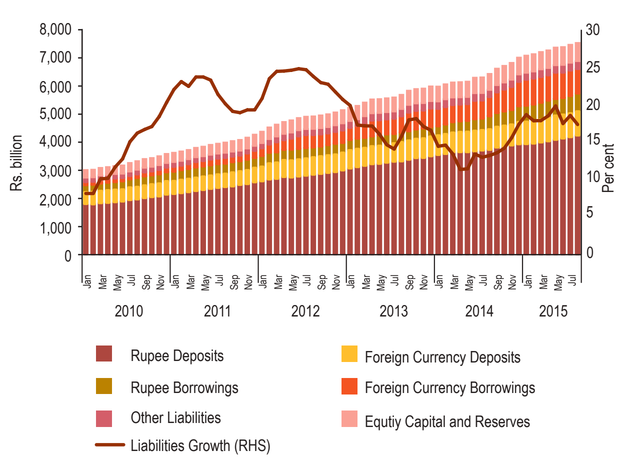


Chart 8.4 Non-performing Loans of the Banking Sector

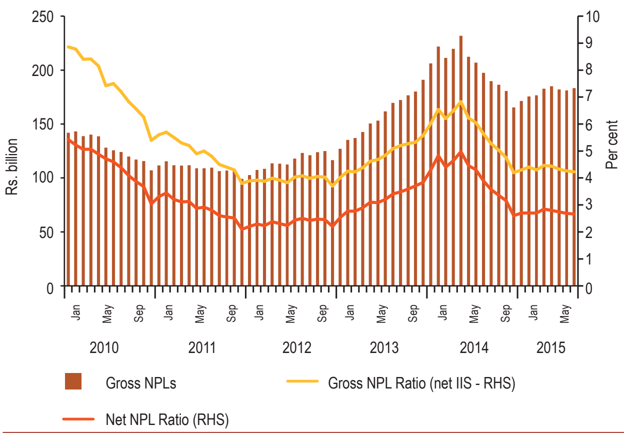
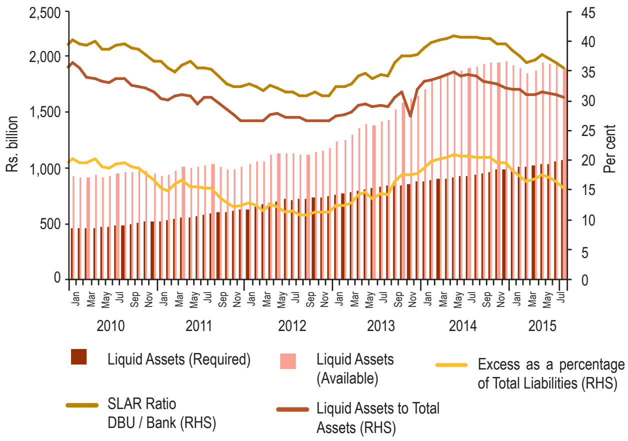


Chart 8.5 SLAR and Composition of Liquid Assets of the Banking Sector



- **Asset quality of the banking sector deteriorated slightly during the first eight months of 2015.** The total Non-performing Loans (NPLs) increased by Rs. 17.8 billion to Rs. 183.0 billion. Despite the increase in NPLs, the NPL ratio stood unchanged at 4.2 per cent at end August 2015, as in December 2014, mainly due to a higher growth in loans and advances. Increase in NPLs was recorded in all key lending sectors such as tourism, agriculture and fishing, services, as well as in products such as term loans and pawning advances. However, the NPL ratio is expected to improve in the latter part of 2015 as a result of increased loan books of banks.

- **The liquidity position of the banking sector continued to be maintained at healthy levels.** The Statutory Liquid Assets Ratios (SLAR) were well above the minimum statutory requirement of 20.0 per cent, while the ratio of liquid assets to total assets stood at 30.6 per cent and was lower than that of end 2014. However, the loans to deposits ratio increased from 83.1 per cent at end 2014, to 85.6 per cent at end August 2015 due to the increase in lending activities. The cumulative one year maturity gap widened to 23.8 per cent in June 2015, compared to a maturity gap of 18.7 per cent at end 2014.

- **The moderation of market interest rates during the first eight months of 2015 resulted in capital gains of Rs. 5.5 billion in Treasury bonds.** Further, the equity risk of the banking sector was minimal, as exposure to the equity market of Rs. 21.5 billion was only 0.3 per cent and 4.0 per cent of total assets and investments held for trading of the banking sector.

- **The banking sector reported an increase in profits during the first eight months of 2015, when compared with the corresponding period of 2014.** This performance was mainly due to the higher net interest income, which reported an increase of Rs. 39.0 billion. Overall

Chart 8.6 ROA and ROE of the Banking Sector

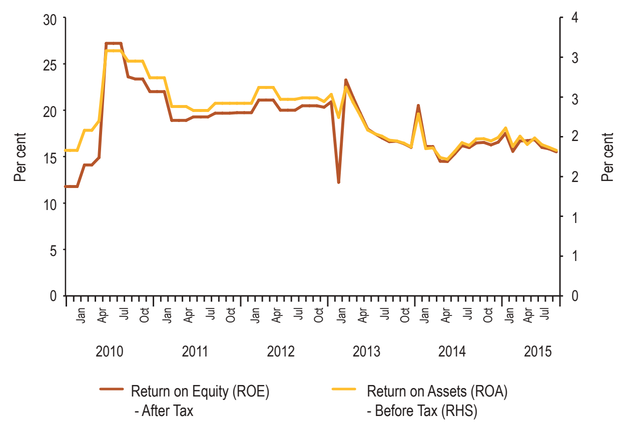
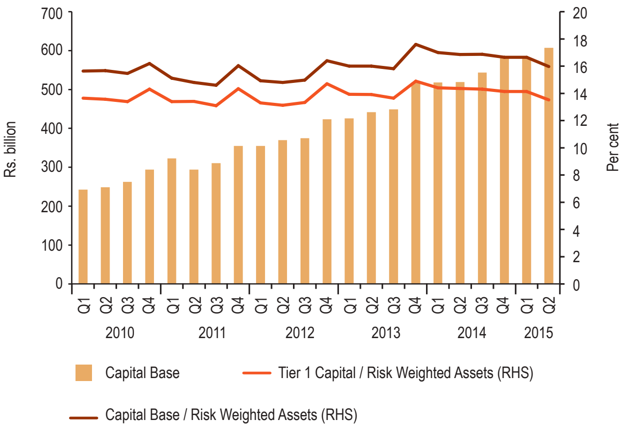


Chart 8.7 Capital Adequacy of the Banking Sector



business expansion, higher margins, increased lending and investment activity resulted in a favourable increase in net interest income. Profits after tax of the banking sector was Rs. 60.5 billion, an increase of Rs. 6.6 billion during the first eight months of 2015. Return on Assets (ROA) before tax slightly deteriorated to 1.8 per cent at end August 2015, compared to 1.9 per cent in the corresponding period of 2014. Further, Return on Equity (ROE) deteriorated to 15.5 per cent at end August 2015, compared to 16.2 per cent in the corresponding period of 2014.

- **The banking sector continued to maintain sufficient capital in order to absorb any adverse shocks.** The Core Capital Adequacy Ratio (CAR) and total CAR as at end June 2015 were 13.5 per cent and 16.0 per cent, respectively, and maintained at healthy levels well above the regulatory minimum of 10.0 per cent.

- **The bank branch network expanded during the first seven months of 2015, improving financial accessibility.** The total number of banking outlets increased to 3,548 during the first eight months of 2015, with 18 new banking outlets having opened during this period. Further, 60 new automated teller machines (ATMs) were installed during the first eight months of 2015.

- **The CBSL continued to introduce prudential policy measures and regulations with a view to enhancing the safety and soundness of the banking sector.** Accordingly, Directions on Liquidity Coverage Ratio (LCR) under Basel III Liquidity Standards were issued, requiring banks to maintain a minimum LCR of 60.0 per cent, commencing 1 April 2015. In order to encourage the receipt of export proceeds in a timely manner, the enhanced interest on

Table 8.1 Banking Sector - Selected Indicators

Item	End Aug 2013	End Aug 2014	End Dec 2014	End Aug 2015 (a)	Y-O-Y Change (%)	
					Aug 2014	Aug 2015 (a)
Total Assets (Rs.billion)	5,646.4	6,388.2	6971.8	7490.9	13.1	17.3
Loans & Advances (Rs.billion)	3,335.3	3,505.8	3894.5	4337.5	5.1	23.7
Investments (Rs.billion)	1,568.1	1,812.2	1927.5	2318.9	34.9	28.0
Deposits (Rs.billion)	3,970.8	4,432.2	4686.3	5067.2	15.5	14.3
Borrowings (Rs.billion)	938.3	1,164.4	1448.2	1520.2	24.1	30.6
Capital Funds (Rs.billion)	471.4	534.6	568.5	613.2	13.4	14.7
Tier 1 Capital Adequacy Ratio (%) (b)	13.9	14.4	14.1	13.5		
Total Capital Adequacy Ratio (%) (b)	16.1	16.9	16.6	16.0		
Gross Non-Performing Loans Ratio (%)	5.1	5.6	4.2	4.2		
Net Non-Performing Loans Ratio (%)	3.4	3.9	2.6	2.7		
Return on Assets (Before Tax) (%)	2.0	1.9	1.9	1.8		
Return on Equity (After Tax) (%)	17.0	16.0	16.2	15.5		
Statutory Liquid Assets Ratio (DBU) (%)	34.1	40.6	40.6	35.4		
Liquid Assets to Total Assets (%)	29.1	34.2	34.3	30.6		

(a) Provisional
(b) As at end June

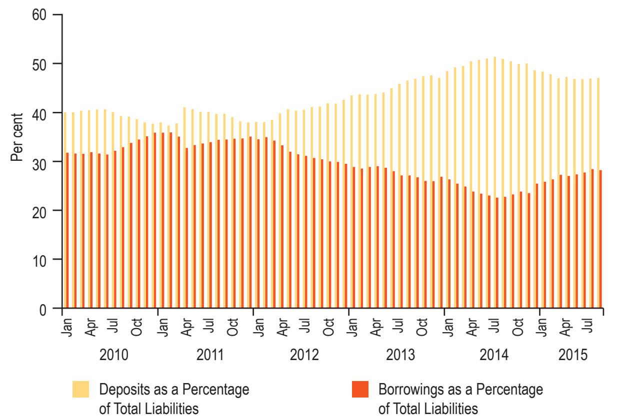
Source: Central Bank of Sri Lanka

accommodation to exporters was re-imposed. A maximum loan-to-value ratio of 70.0 per cent was imposed on loans and advances granted by licensed banks for the purpose of purchase or utilisation of motor vehicles, as a macro-prudential measure to avoid any excessive risk accumulation in the banking sector. Further, a Consultation Paper on the Implementation of Basel III Minimum Capital Requirements and Leverage Ratio was issued to banks and the regulations on the same will be issued in due course. Existing limits on share ownership of banks and assessment criteria of fitness and propriety of Board of Directors are being reviewed to further strengthen the governance and resilience of the banking sector. Benefiting from enhanced regulatory and supervisory framework and conducive macroeconomic factors, the banking sector is expected to enhance its performance and resilience during the remainder of 2015.

Licensed Finance Companies (LFCs) and Specialised Leasing Companies (SLCs)

- **The performance of LFC and SLC sector was notable during the first eight months of 2015.** This sector represents 7.0 per cent of assets of the Sri Lanka's financial system and consists of 47 LFCs and 7 SLCs, with a network of 1,187 branches. The LFC and SLC sector growth continued to show positive momentum since the second half of 2014, mainly on account of improved credit demand in a lower interest rate regime. Total assets of the sector expanded by 13.3 per cent (Rs. 113.8 billion) to Rs. 966.9 billion in the first eight months of 2015, compared to the growth of 8.8 per cent (Rs. 63.5 billion) in the corresponding period of 2014. Moreover, the low interest rate regime that prevailed in the market enabled the LFC and SLC sector to record a notable profit and maintain non-performing loans at a manageable level.

Chart 8.8 Total Deposits and Borrowings of LFCs and SLCs



- **Deposits grew at a slower rate.** Deposits grew by 9.8 per cent (Rs. 40.4 billion) to Rs. 454.5 billion in the first eight months of 2015, compared with the growth of 17.8 per cent (Rs. 60.1 billion) in the corresponding period of 2014. This is mainly due to the competitive interest rates of the banking sector and also availability of wholesale borrowings at relatively low rates from domestic financial institutions.

- **Credit growth momentum continued.** Credit provided by LFCs and SLCs increased notably by 17.9 per cent (Rs. 115.1 billion) to Rs. 756.5 billion in the first eight months of 2015, compared to the growth of 7.4 per cent

Chart 8.9 Total Loans and Advances of LFCs and SLCs

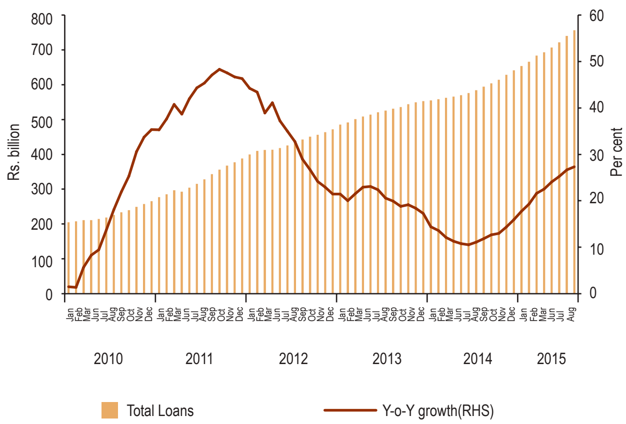


Chart 8.10 Non-performing Loans of LFCs and SLCs

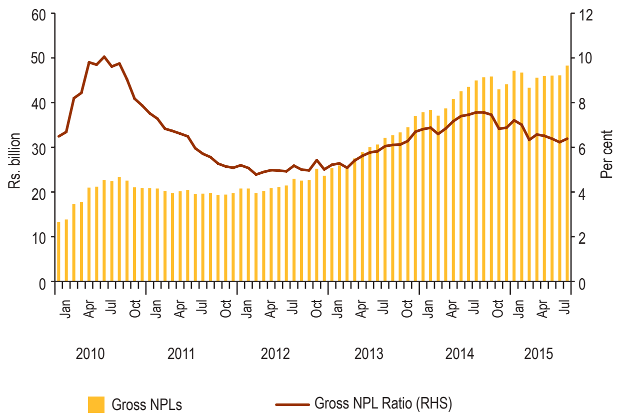
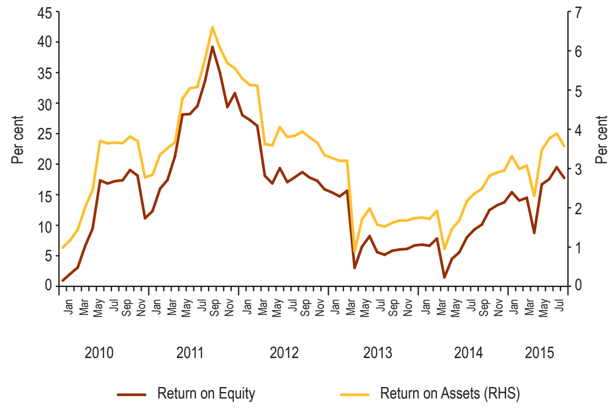


Chart 8.12 ROA and ROE of LFCs and SLCs



in the corresponding period of 2014. The core businesses of LFCs and SLCs, namely, finance leases and hire purchase portfolio grew by 15.5 per cent in the first eight months of 2015, compared with the marginal growth of 2.2 per cent in the corresponding period of 2014. Further, the secured loan category recorded a growth of 25.8 per cent in the first eight months of 2015, which mainly comprised micro finance loans.

- **NPL ratios improved mainly due to the fast growth in loans and advances.** The NPL ratio decreased to 6.4 per cent as at end August 2015, from 6.9 per cent as at end December 2014. However, the total amount of NPLs increased by 8.9 per cent to Rs. 48.3 billion during the first eight months of 2015. When the loan loss provision is considered, the net NPL ratio decreased to 1.9 per cent as at end August 2015, from 2.3 per cent as at end December 2014. The main portfolios that contributed to increase in NPLs were finance leasing (32.0 per cent), and hire purchases (19.0 per cent).

- **The overall liquidity position of LFCs and SLCs improved despite credit growth.** The overall statutory liquid assets as at end August 2015 were a surplus of Rs. 21.5 billion, over the stipulated minimum requirement of Rs.

Chart 8.11 Total Liquid Assets and Liquidity Ratio of LFCs and SLCs

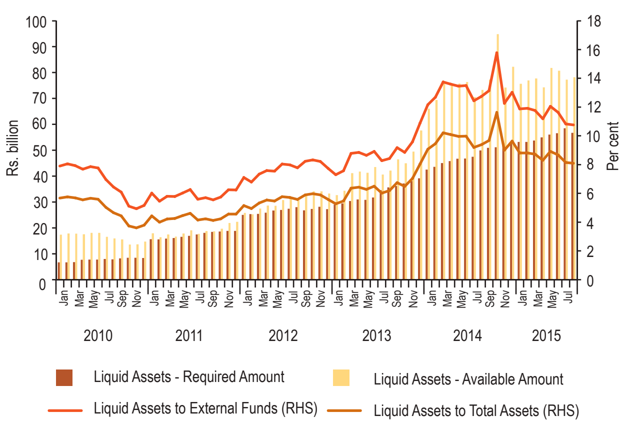


Chart 8.13 Capital Position of LFCs and SLCs

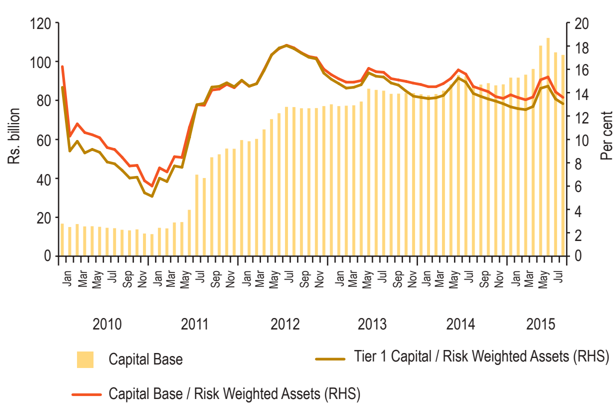


Table 8.2 LFCs and SLCs - Selected Indicators

Item	End Aug 2013	End Aug 2014	End Dec 2014	End Aug 2015 (a)	Y-O-Y Change (%)	
					Aug 2014	Aug 2015 (a)
Total Assets (Rs.billion)	680.3	781.1	853.2	966.9	14.8	23.8
Loans & Advances (Rs.billion)	531.1	594.2	641.3	756.5	11.9	27.3
Deposits (Rs.billion)	315.9	397.4	414.1	454.5	25.8	14.4
Borrowings (Rs.billion)	184.4	177.6	217.1	272.8	-3.7	53.6
Capital Funds (Rs.billion)	95.9	108.6	114.5	126.9	13.2	16.9
Tier 1 Capital Adequacy Ratio (%)	15.1	13.7	13.1	12.9		
Total Capital Adequacy Ratio (%)	15.7	14.5	13.5	13.6		
Gross Non-performing Accommodations Ratio (%)	6.0	7.6	6.9	6.4		
Net Non-performing Accommodations Ratio (%)	2.3	2.9	2.3	1.9		
Return on Assets (Before Tax) (%) - Annualised	2.1	2.5	2.9	3.9		
Return on Equity (After Tax) (%) - Annualised	8.5	10.1	13.8	18.3		
Liquid Assets to Total Assets (%)	6.2	9.4	9.6	8.1		

(a) Provisional

Source: Central Bank of Sri Lanka

56.8 billion. However, the liquid assets to total assets ratio decreased to 8.1 per cent as at end August 2015, from 9.4 per cent in the corresponding period of 2014.

- **Profitability improved significantly**. Profits of LFCs and SLCs sector were Rs. 14.9 billion during the first eight months of 2015, compared to the profit of Rs. 6.8 billion in the corresponding period of 2014. The re-pricing of assets and liabilities has positively impacted the net interest income of the sector mainly derived from the ability to obtain lower cost deposits. Accordingly, the annualized ROA and ROE ratios were at 3.9 per cent and 18.3 per cent, respectively, for the eight months period ending August 2015, compared with the 2.5 per cent and 10.1 per cent as at end August 2014.

- **Overall capital position of LFCs and SLCs maintained at healthy levels**. Capital funds increased by 10.9 per cent in the first eight months of 2015 to Rs. 126.9 billion. Furthermore, the capital adequacy ratios of LFC and SLC sector were above the minimum regulatory requirement despite a marginal deterioration when compared to the previous corresponding period. As at end August 2015, the core capital ratio was 12.9 per cent and the total capital ratio was 13.6 per cent and well above the statutory minimum of 5.0 per cent and 10.0 per cent, respectively.

- **The CBSL continued to introduce prudential policy measures and regulations with a view to enhancing the safety and soundness of the LFCs and SLCs sector**. A maximum loan-to-value ratio of 70 per cent was imposed on loans and advances granted by LFCs and SLCs for the purpose of purchase or utilisation of motor vehicles, as a macro-prudential measure to avoid any excessive risk accumulation in the sector with effect from 1st December 2015.

Insurance Companies

- **The premium income of insurance companies increased significantly, while total assets showed a moderate growth**. Total assets of the insurance sector recorded a growth of 0.8 per cent on year-on-year basis, by end June 2015, in comparison to the growth of 13.0 per cent recorded as at end June 2014. The gross written premiums (GWP) of the insurance sector grew by 11.7 per cent in the first half of 2015, when compared with the increase of 3.1 per cent in the corresponding period of 2014. Relatively high

Table 8.3 **Insurance Sector - Selected Indicators**

Item	End Jun 2013	End Jun 2014	End Dec 2014	End Jun 2015 (a)	Y-O-Y Change (%)	
					Jun 2014	Jun 2015 (a)
Total Assets (Rs.billion)	345.9	390.9	413.7	394.2	13.0	0.8
Total Income (Rs.billion) (b)	**62.6**	**65.8**	**134.2**	**68.0**	**5.2**	**3.3**
Gross Premium Income (Rs.billion) (b)	47.7	49.2	99.9	55.0	3.2	11.7
Investment Income (Rs.billion) (b)	14.9	16.6	34.3	13.1	11.5	-21.5
Profit Before Tax (Rs.billion) (b)	5.9	5.9	8.2	3.9	0.9	-34.4
Solvency Margin Ratio (Times)						
Long-term Insurance	7.2	8.7	9.7	9.3		
General Insurance	2.2	2.2	2.4	2.2		
Retention Ratio (%)						
Long-term Insurance	96.0	96.3	97.1	96.0		
General Insurance	78.5	78.5	83.3	80.6		
Claims Ratio (%)						
Long-term Insurance	41.9	42.4	48.4	40.1		
General Insurance	62.0	59.2	65.4	63.0		
Combined Operating Ratio (%)						
Long-term Insurance	89.5	89.7	100.1	88.0		
General Insurance	105.4	105.1	109.7	107.6		
Return on Assets (%)						
Long-term Insurance	3.4	2.9	1.9	2.0		
General Insurance	4.1	3.5	2.4	1.8		
Return on Equity (%) - General Insurance	7.2	6.0	4.1	2.9		
Underwriting Ratio (%) - General Insurance	15.7	18.1	13.3	14.6		

(a) Provisional
(b) During the period

Source: Insurance Board of Sri Lanka

growth in the premium income of the general insurance sector, particularly motor insurance, has largely contributed toward the high growth of overall GWP. This was mainly due to the significant increase in new vehicle registrations, primarily due to the reduction of tax on small motor cars. The premium income from motor insurance, which constitutes about 63.2 per cent of the general insurance premium, grew at a relatively high rate of 16.0 per cent in the first half of 2015, compared with the 3.7 per cent increase in the corresponding period of 2014. Further, the premium income from marine (share of 3.2 per cent), miscellaneous (19.8 per cent) and fire (13.7 per cent) increased by 9.7 per cent, 7.6 per cent and 0.03 per cent, respectively, year-on-year, in the first half of 2014.

- **Overall profits of the insurance sector declined, notably in investment income during the period under consideration.** The aggregate profits before-tax decreased by 34.9 per cent in the first half of 2015 when compared to the slight increase of 1.6 per cent in the corresponding period of 2014. The decline in investment income and higher claims negatively affected profits in the insurance sector. The investment income declined by 21.5 per cent, while claims increased by 12.5 per cent during the first half of 2015, when compared to the levels recorded in the corresponding period of 2014. In the case of low interest rates, the interest income of insurance companies was adversely impacted, as investments in government securities remained the main investment, representing 38.0 per cent of the total assets. Moreover, underwriting profits of the general insurance sector also declined during the period under consideration, reflecting a high intense price competition in the sector.

- **Insurance sector maintained its soundness.** Insurance Companies (ICs) met the statutory solvency margin requirement as at end June 2015. The solvency ratios for long-term and general insurance sectors were 9.3 per cent and

2.2 per cent, respectively, as at end June 2015. Moreover, the requirement of investing 20 per cent of the technical reserves in respect of general insurance and 30 per cent in respect of the long-term funds in government securities was complied with as at end March 2015. Accordingly, investments in government securities by the long-term and general insurance sectors accounted for 49.0 per cent and 28.6 per cent, respectively, of their total investment portfolio.

Primary Dealers in Government Securities

- **Total assets and total portfolio of the Primary Dealer (PD) industry increased during the first eight months of 2015.** The total assets of the PD industry increased by 28.4 per cent to Rs. 245.4 billion, while the total portfolio of government securities held by PDs increased by 29.0 per cent to Rs. 241.2 billion during the first six months of the year. This increase was mainly attributed to the increase in the held for trading portfolio. Borrowings under repo agreements increased by 12.3 per cent to Rs. 133.4 billion by end June 2015 when compared to end 2014.

- **Profitability has been maintained.** The profitability of the PD industry, measured in terms of ROA and ROE of standalone PDs, stood at 3.0 per cent and 34.8 per cent, respectively, during the first six months of 2015. Overall, the PD industry recorded a profit of Rs. 3.3 billion over the six month period ended June 2015 compared to the profit of Rs. 3.7 billion in the corresponding period of 2014. The PD industry recorded a total profit (realised and unrealised) of Rs. 1.7 billion for the six months that ended in June 2015, which was similar to the amount recorded in the corresponding period in 2014.

- **Capital was maintained at healthy levels.** All standalone PDs maintained their capital base above the minimum requirement of Rs. 300 million as at end June 2015. The Risk Weighted Capital Adequacy Ratio (RWCAR) of the industry was above the minimum RWCAR of 8.0 per cent, although the ratio decreased to 19.7 per cent by end June 2015, from 21.8 per cent at the end of 2014, owing to the increase in risk weighted assets due to investments in long term Treasury bonds.

- **Risk profile improved.** As the proportion of trading portfolio to total portfolio decreased from 71.3 per cent as at end June 2014 to

Table 8.4 Primary Dealers - Selected Indicators

Item	End Aug 2013	End Aug 2014	End Dec 2014	End Aug 2015 (a)	Y-O-Y Change (%)	
					Aug 2014	Aug 2015 (a)
Total Assets (Rs.billion)	215.4	194.4	191.1	245.5	-9.7	26.3
Total Portfolio (Rs.billion)	211.9	189.5	187.0	241.2	-10.6	27.3
Total Capital (Rs.billion) (b)	5.7	9.5	9.5	10.6	67.3	11.6
Profit before Tax (Rs.billion) (c)	4.5	6.3	8.7	3.8	40.0	-39.7
Tier 1 Capital Adequacy Ratio (%) (b)	22.3	13.9	21.8	19.7		
Total Capital Adequacy Ratio (%) (b)	22.3	13.9	21.8	19.7		
Return on Assets (%)	3.1	4.5	4.3	2.5		
Return on Equity (%) (b)	23.8	56.9	44.1	21.1		
Leverage Times (b)	8.6	7.1	6.6	6.1		
Operating Expenses to Total Income (%) (d)	2.8	5.8	6.0	6.5		
Total Cost to Total Income (%) (c)	71.1	61.1	60.9	68.7		
Duration of Assets and Liabilities (years)	1.1	1.7	1.3	1.3		

(a) Provisional
(b) Standalone PDs only
(c) During the period
(d) Revised

Source: Central Bank of Sri Lanka

Table 8.5 Unit Trust Sector - Selected Indicators

Item	End Jun 2013	End Jun 2014	End Dec 2014	End Jun 2015 (a)	Y-O-Y Change (%)	
					Jun 2014	Jun 2015 (a)
Total Assets (Rs.million)	33,298	75,906	126,531	133,849	128.0	76.3
Net Asset Value - NAV (Rs.million)	33,101	75,383	125,985	133,141	127.7	76.6
Investments (Rs.million)	33,165	75,944	126,499	133,647	129.0	76.0
Equity	9,174	11,695	13,575	13,486	27.5	15.3
Government Securities	9,229	23,443	56,146	55,446	154.0	136.5
Other (E.g.,Commercial Papers, Debentures, Trust Certificates & Bank Deposits)	14,762	40,806	56,778	64,715	176.4	58.6
Investments in Equity as a % of NAV	28.0	16.0	10.8	10.1		
Investments in Government Securities as a % of NAV	27.9	31.1	44.6	41.6		
Other Investments as a % of NAV	44.6	54.1	45.1	48.6		
Total No. of Unit Holders	28,168	29,797	32,584	35,660		
No. of Units in Issue (million)	2,362	5,516	9,382	9,585		
No. of Unit Trusts	44	53	63	70		

(a) Provisional

Source: Unit Trust Association of Sri Lanka

53.6 per cent as at end June 2015, the exposure of the industry to the market risk has decreased. In view of the large proportion of risk free government securities holdings of PDs, as well as the ability of PDs to use such government securities as collateral for obtaining funds to bridge any unforeseen liquidity gaps, the liquidity risk profile of PDs industry remained low. Further, most PDs had stand-by contingency funding arrangements to bridge liquidity gaps, if emerged.

Unit Trusts

- **The unit trust (UT) sector continued to expand with the formation of new funds.** Total number of unit trusts, managed by 14 unit trust management companies, increased to 70 funds by the end of June 2015, reflecting a further expansion of the sector. Meanwhile, the total number of unit holders and the number of units in issue also significantly increased to 35,660 and 9,584 million, respectively, as at end June 2015. At the same time, the net asset value (NAV) of the UT sector increased by 76.6 per cent, year-on-year, as at end June 2015, following a significant growth of 127.7 per cent as at end June 2014. The reduction in interest rates and the slow performance of the equity market negatively affected the growth of NAV of UTs. As at end June 2015, the share of equities in investment portfolios of unit trusts further declined to 10.1 per cent, from 15.4 per cent as at end June 2014, while the share of government securities in investment portfolios increased to 41.5 per cent, from 30.9 per cent, despite the low interest rates in the market. The setting up of new funds with more investments in government securities has largely contributed to upsurge the share of investment in government securities. The share of other investments, such as commercial paper, debentures, trust certificates and bank deposits, in the investments portfolio declined to 48.4 per cent at end June 2015 from 53.7 per cent as at end June 2014.

- **The National Budget proposal of income tax exemption on unit trusts encourages the progress of the unit trust sector.** Income tax exemptions on profits and income arising or accruing in any unit trust from investments made in US dollar deposits or US dollar denominated securities listed on any foreign stock exchange, with effect from 01 January 2015, will have a positive impact on the performance of unit trusts.

Table 8.6 **Stock Broker Companies - Selected Indicators**

Item	End Jun 2013	End Jun 2014	End Dec 2014	End Jun 2015 (a)	Y-O-Y Change (%)	
					Jun 2014	Jun 2015 (a)
Total Assets (Rs. million)	12,370	11,040	11,334	11,032	-10.8	-0.1
Total Liabilities excl. equity (Rs. million)	6,213	5,073	4,924	4,581	-18.4	-9.7
Net Capital (Rs. million)	5,050	4,550	4,966	4,750	-9.9	4.4
Income (Rs. million) (b)	1,034	1,231	3,087	1,196	19.0	-2.9
Net profit/(Loss) before tax (Rs. million) (b)	-273	-59	728	-87	-78.4	48

(a) Provisional
(b) During the period

Source: Securities and Exchange Commission of Sri Lanka

Stock Brokers

- **The stock broker sector showed a mixed performance with subdued activities that prevailed in the CSE.** The income of stock brokers slightly declined in the first half of 2015. Consequently, the extent of losses before tax of stock brokers marginally increased during the period under consideration. The total assets marginally declined as at June 2015, while the net capital of stock brokers improved when compared to the first half of 2014. The slow performances experienced in the CSE have negatively affected the activities of the stock brokers. However, the stock brokering industry has shown overall progress in terms of the provision of services introduced in the recent past with the formation of a number of new funds.

Superannuation funds

- **The Employees' Provident Fund (EPF) is the largest superannuation fund in Sri Lanka with an asset base of over 1.59 trillion rupees as of August 2015.** The total number of member accounts of EPF reached the 15.4 million mark in June 2015, having increased by 2.7 per cent when compared with the previous year. Total contributions during the first eight months of the year increased by 15.2 per cent to Rs. 66.7 billion, while refund payments increased by 28.4 per cent to Rs. 49.8 billion, compared to the corresponding period in the previous year. However, for the first eight month period ending August 2015, the net contributions (contributions minus refunds) stood at Rs. 16.9 billion, which is a marked decline of 11.5 per cent when compared to the corresponding period of 2014. The total assets of the EPF increased by 12.2 per cent to Rs. 1,594.5 billion as at end August 2015. The total investment portfolio of the EPF consists of 92.1 per cent government securities, 6.2 per cent equity and 2.2 per cent corporate debt and reverse repo. Investment income, which is the major source of income to the fund, increased by 7.6 per cent to Rs. 112.1 billion. The capital gains, from secondary market transactions in government securities and equities, also increased during the period under consideration.

- **The Employee's Trust Fund (ETF) has about 12.2 million accounts, of which about 2.4 million are active accounts.** Total contributions and benefits paid to members during the first six months of 2015 increased to Rs. 8.8 billion, an increase of 13.8 per cent, and Rs. 6.1 billion, an increase of 5.9 per cent, respectively, from Rs. 7.7 billion and Rs. 5.7 billion during the corresponding period of 2014. Consequently, the net contributions of the ETF significantly increased by 36.4 per cent to Rs. 2.7 billion during the period under consideration. The total assets of the ETF increased by 11.7 per cent to Rs. 210.6 billion as at end June 2015. As in the case of the EPF, the investment portfolio of the ETF is highly

Table 8.7 Superannuation Funds - Selected Indicators

Item	Employees' Provident Fund (EPF)			Employees' Trust Fund (ETF)		
	End Aug 2014	End Aug 2015 (a)	Change (%) (a)	End Jun 2014	End Jun 2015 (a)	Change (%) (a)
Total Contributions (Rs. billion)	57.9	66.7	15.2	7.7	8.8	14.3
Total Refunds (Rs. billion)	38.8	49.8	28.4	5.7	6.1	7.0
Total Assets (Rs. billion)	1,422	1,595	12.2	188.6	210.6	11.7
Total Investment Portfolio (Rs. billion)	1,562	1,387	-11.2	177.4	196.0	10.5
o/w, Government Securities (%)	91.6	92.1	0.5	90.1	92.6	2.8
Gross Income (Rs. billion) (b)	112.3	104.5	-6.9	8.8	9.4	6.8

(a) Provisional
(b) During the period

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

concentrated in government securities, which account for 92.6 per cent of the total portfolio. Investments in equities and corporate debt securities accounted for 4.5 per cent and 1.0 per cent, respectively.

- **The Public Service Provident Fund (PSPF) had 231,908 members as at end June 2015.** The total assets of the PSPF amounted to Rs. 43.6 billion as at end June 2015. Total contributions and refunds of the PSPF during the first six months of 2015 amounted to Rs. 689 million and Rs. 192 million, respectively.

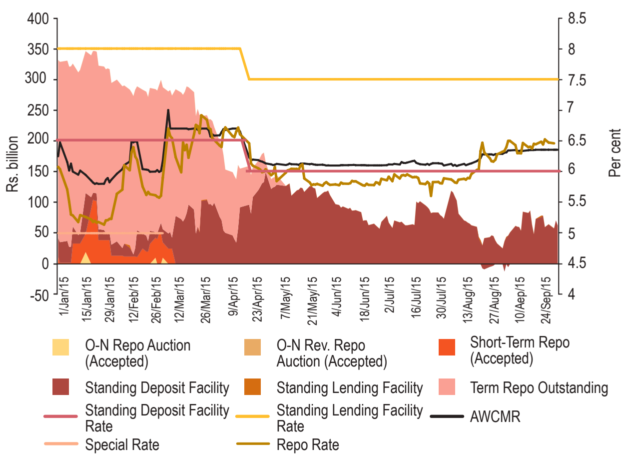
- **There were 156 privately managed Approved Provident Funds (APFs) with about 168,900 members as at end June 2015.** The total assets and investments of APFs increased by 11.0 per cent and 5.2 per cent, respectively, to Rs. 151.2 billion and Rs. 116.7 billion as at end June 2015.

Developments in Financial Markets

Inter-bank Call Money Market

- **High excess liquidity that prevailed throughout 2014 in the inter-bank domestic money market declined significantly during the first nine months of 2015.** Excess liquidity in the domestic money market, which stood as high as Rs. 325.6 billion by end December 2014, has declined to Rs. 62.4 billion by end September 2015. This was mainly due to the net sales of foreign currency by the Central Bank, maturing of Treasury bills held by the Central Bank and the outright sales of Treasury bills to absorb liquidity on a permanent basis. During this period, foreign currency sales of the Central Bank amounted to about US dollars 2,334.3 million, thereby absorbing about Rs. 314 billion. Meanwhile, liquidity absorbed by way of the outright sale of Treasury bills, maturating Treasury bills and currency withdrawals by the Central Bank, were Rs. 84.9 billion, Rs. 66.5 billion and Rs. 46.8 billion, respectively. Although, the Central Bank actively engaged in absorbing excess liquidity in the money market on overnight, short term and long term basis during the year 2014, auctions for outright sale of Treasury bills were conducted after 27 February 2015, in order to mitigate associated risks by permanently absorbing liquidity. In the meantime, all outstanding short term repos matured by 04 March 2015, while all outstanding long term repos matured by 30 April 2015. Hence, market liquidity during the first half of the year was largely absorbed on overnight basis through the Standing Deposit Facility (SDF), in keeping with the desired path for the inter-bank call money rate.

Chart 8.14 Inter-bank Call Money Market



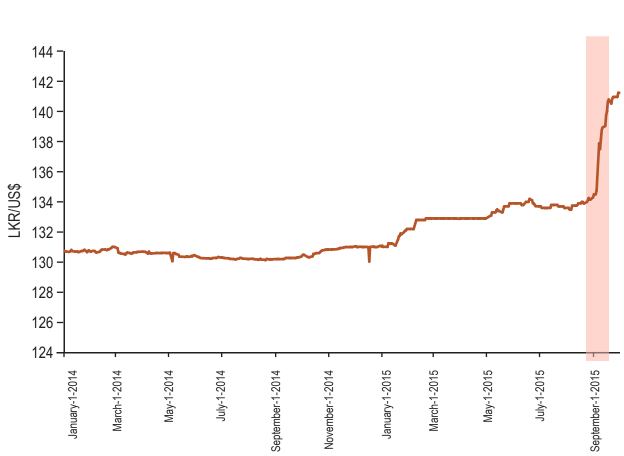
- **The Average Weighted Call Money Rate (AWCMR) that exhibited some volatility in 2015 until end April stabilized towards the lower bound of the policy rate corridor until mid-August 2015 and showed an increasing trend thereafter.** The rationalization of SDF and the aggressive borrowings from the call money market, by a few small banks mainly, contributed to the volatility in the market during the first nine months of 2015. The recovery of the growth in credit to the private sector by commercial banks since the latter part of 2014, as well as the signs of re-emergence of sustained credit growth in 2015, resulted in the removal of the ceiling on SDF with effect from 02 March 2015. Although the AWCMR increased to 7.0 per cent on 2 March 2015, it declined thereafter and stabilized around 6.7 per cent until mid-April 2015. Considering the low inflation environment and investment needs of the economy, the Central Bank reduced policy interest rates by 50 basis points with effect from 15 April 2015. Accordingly, the Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR) were reduced to 6.0 per cent and 7.5 per cent, respectively. As a result, the AWCMR decreased to 6.2 per cent by 16 April 2015, declining 47 basis points and continued the declining trend thereafter and stabilized around 6.1 per cent, being closer to the lower bound of the policy rate corridor. However, the concentration of liquidity among a few market participants in the midst of declining liquidity level and increasing yield rates in the government securities market, exerted pressure on the call money rate, resulting in the gradual increase in the AWCMR to 6.35 per cent by the beginning of September 2015.

Domestic Foreign Exchange Market

- **The USD/LKR exchange rate depreciated by 1.98 per cent over the first half of 2015, reaching Rs. 133.7 by 30 June 2015, with increased outflows mainly through government bonds and import bills.** During this period, the rupee depreciated against the Sterling Pound due to the expectation of recovery of the UK economy and the market anticipation on a rate hike by the Bank of England. The rupee also depreciated against the Indian Rupee during this period. However, the Rupee appreciated against the Euro and Yen due to the uncertainty relating to economic recovery, debt repayment capacity of Greece, and the bond buying program of Japan to meet their inflation target.

- **The Central Bank intervened in the buying and selling of US dollars in the domestic foreign exchange market.** The purpose of such interventions was to curb excess volatility in the

Chart 8.15 Movement of Rupee Per US$



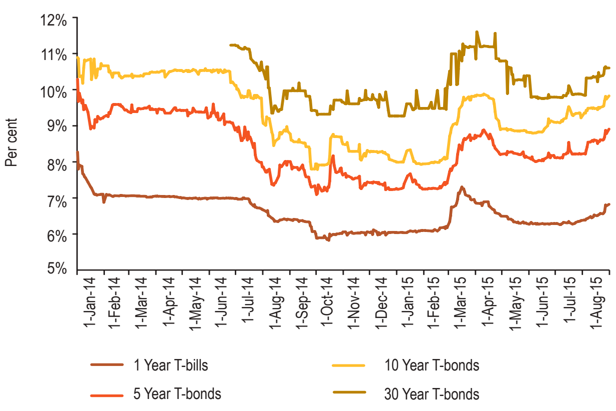
exchange rate. Accordingly, the Central Bank purchased US dollars 151.8 million and sold US dollars 1,221.8 million resulting in a net sale of US dollars 1,070 million during the first eight months of 2015. However, with effect from 4 September 2015, the CBSL decided to allow greater flexibility to the market in determining the exchange rate which resulted in a rapid depreciation of the rupee during the month of September 2015. During the first seven months of 2015, the rupee depreciated by about 7.0 per cent.

- **Trading volumes in the domestic foreign exchange market decreased by 21.9 per cent during the first half of 2015, compared with the corresponding period of the previous year.** The total volume of inter-bank foreign exchange transactions during the period under consideration in 2015 stood at US dollars 6.0 billion, as against US dollars 7.7 billion in the corresponding period of 2014. Accordingly, the daily average turnover in the inter-bank foreign exchange market decreased to US dollars 51.8 million as against US dollars 65.7 million in the corresponding period of 2014. However, the total volume of forward transactions up to 30 June 2015 increased to US dollars 3.4 billion, compared to US dollars 3.1 billion recorded in the corresponding period of 2014.

Government Securities Market

- **Yield rates of government securities declined, while average time to maturity increased during the first half of 2015, compared to the same period of 2014.** This was mainly attributed to the proactive public debt management, issuance and instrument strategies adopted during the period under review. Further, in the first half of 2015, majority of borrowing was sourced from domestic sources. The strategies adopted for debt issuance in the first half of 2015 included gradual diversification of foreign investments in government securities and sourcing of new funding through Sri Lanka Development Bonds (SLDBs). This was in order to offset any possibilities of crowding out of the available domestic funds while issuing a mix of maturities to meet investor preference. As a result, yield rates in the first half of 2015 remained at levels below that of 2014 and issued SLDBs amounting to US dollars 1,522.8 million.

Chart 8.16 Secondary Market Yield Curve of Government Securities



- **In the first quarter of 2015 yield rates were higher than the second quarter of 2015, even though the larger proportion of the debt service payments were executed during the second quarter of 2015**. Additionally, the easing of monetary policy by the Central Bank in April 2015, increased participation of domestic investors in the government securities market and the excess liquidity that prevailed in the money market during this period also contributed to the reduction in yield rates. Yield rates pertaining to 91 day, 182 day and 364 day Treasury bills declined by 45, 60, and 62 basis points, respectively, while those pertaining to Treasury bonds in the secondary market decreased by around 35 basis points to 115 basis points across the actively traded yield curve (2–10 years), in the first half of 2015. Treasury bill and Treasury bond holdings of foreigners declined to Rs. 425.6 billion by end June 2015, from Rs. 457.2 billion at end 2014, mainly due to the depreciation of the rupee.

Corporate Debt Securities Market

- **Comparatively low volumes in the commercial paper market in the first half of 2015**. The value of commercial paper (CP) issued with the support of banks amounted to Rs. 4.9 billion in the first six months of 2015, in comparison to the Rs. 5.4 billion in the same period of 2014. The interest rates on CPs decreased to a range of 7.0 per cent to 11.0 per cent in 2015 from a range of 8.5 per cent to 15.0 per cent in 2014. CPs with a maturity of up to 3 months accounted for 9.4 per cent of the market, while the shares of CPs with 6 month and 12 month maturities were 30.8 per cent and 59.8 per cent, respectively. The total outstanding value of CPs amounted to Rs. 6.0 billion as at end June 2015, compared to the Rs. 4.8 billion as at end June 2014.

- **The volumes in the corporate bond market continued to improve with increased issuances and diversified investor base.** During the first eight months of 2015, there were twenty nine listings of corporate debentures by fifteen institutions, amounting to Rs. 43.4 billion, compared with fifteen issues (by six companies) totalling Rs. 7.5 billion in the corresponding period of 2014. Funds raised through the corporate bond market have been on the increase since end 2013, mainly due to the removal of withholding tax on the interest income of corporate debt securities by the government. The finance and leasing arms of banks were the main issuers during the first eight months of 2015, at rates varying from 8.25 per cent to 10.50 per cent, primarily to meet their regulatory capital requirements. Local corporate bond issuances proceeded with attractive investment opportunities, together with healthy returns and relatively low risks, mainly due to the low interest rate environment in the domestic market and most of the regional countries, as well as the moderation of excess liquidity in the money market, which restricts the availability of bank credit. However, the turnover of debentures listed on the Debt Securities Trading System (DST) of CSE was Rs. 3.8 billion during the first eight months of 2015 when compared to the Rs. 5.3 billion recorded in the corresponding period of 2014, despite the availability of a positive environment for corporate debt market.

Equity Market

- **The equity market exhibited a slow performance with volatile movement in price indices during the first nine months of 2015**. The price indices, market capitalisation and turnover levels declined, while net foreign sales increased. Increased investor uncertainty over future policy directions and political changes, pressure on the exchange rate and global developments that resulted in significant foreign outflows from the market, seem to have created a negative

Chart 8.17 Movements of Share Price Indices

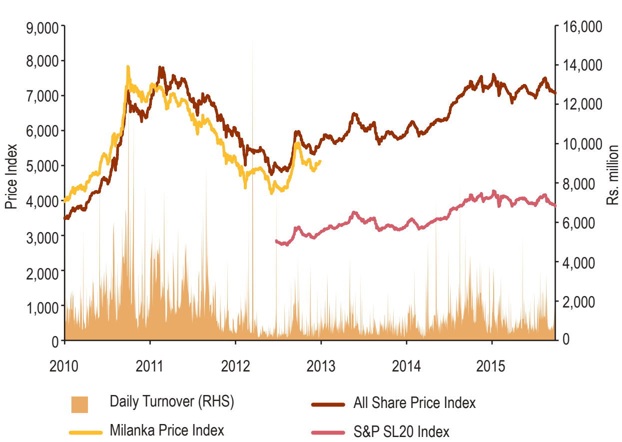


Table 8.8 Equity Market - Selected Indicators

Item	End 2013	End July 2014	End 2014	End Sep 2015
All Share Price Index	5,912.8	6,813.9	7,299.0	7,059.9
Year to date change (%)	4.8	15.2	23.4	-3.4
S&P SL 20 Index (From 26 June 2012)	3,263.9	3,772.5	4,089.1	3,826.2
June to date change (%)	5.8	15.6	25.3	-6.4
Market Capitalisation (Rs.Bn)	2,459.9	2,856.9	3,104.9	2,990.8
As a Percentage of GDP (%)	28.4	32.9	35.8	30.6*
Market Price Earning Ratio	15.9	18.4	19.7	18.4
Average Daily Turnover (Rs. million)	828.0	1,087.4	1,415.0	1,115.4
Net Cumulative Foreign Purchases (USD million)	178.7	11.0	22.1	-3.2
Number of Companies Listed	289.1	295.1	294.1	296.1
Number of Right Issues	9.1	3.1	13.1	9.0
Amount raised through Right issues (Rs. billion)	25.6	1.8	11.3	9.9
Initial Public Offers	1.1	0.0	5.1	2.0
Amount raised through IPOs (Rs. billion)	0.5	0.0	3.3	0.3

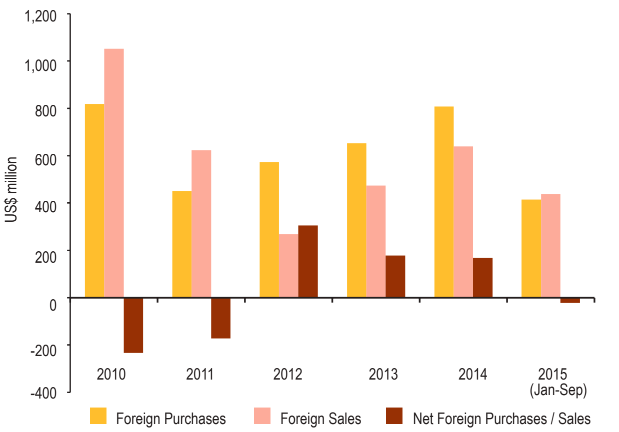
*Based on actual GDP for 2014 (Rs.9,785 billion)

Source: Colombo Stock Exchange

impact on the equity market despite a low interest rate environment in the market. Consequently, the All Share Price Index (ASPI) and S&P SL 20 index dropped by 3.4 per cent and 6.4 per cent, respectively, during the period under review. In line with the movement of the ASPI, the market capitalisation also dropped to Rs. 2,991 billion as at end September 2015 from Rs. 3,104 billion at end December 2014. The price indices of the majority of sub-sectors recorded losses, while others registered gains during the period under consideration. The overall Price Earnings Ratio (PER) of the market stood at 18.4x as at end September 2015, which is relatively higher than the average PER (15.4x) of other Asian Stock exchanges.

- **Business volumes in the equity market were moderated in terms of value and volumes.** The total turnover for the period amounted to Rs. 264.7 billion, indicating a significant decline of 16.2 per cent, while the total number of trades and shares traded declined to 1.2 million and 7.4 billion, respectively, charting a decrease of 15.6 per cent and 38.7 per cent, respectively, when compared to the relevant values registered in the corresponding period of 2014. Moreover, the average daily turnover declined by 15.2 per cent to Rs. 1.1 billion during the first nine months of 2015, from Rs. 1.3 billion in the corresponding period of 2014, while turnover velocity ratio (annualised share turnover to average market capitalization) decreased to 8.7 per cent during the first nine months of 2015, from 11.8 per cent in the corresponding period of 2014. During this period, domestic investors accounted for about 70.4 per cent of the turnover, compared to the 58.0 per cent recorded in 2014. Among the domestic investors, retail investors accounted for around 37.8 per cent of the turnover, while the corporate sector accounted for about 32.6 per cent only.

Chart 8.18 Foreign Participation at the CSE



- **Continued increase in foreign participation over the last three years slowed down during the first nine months of 2015, mainly due to the market anticipation of an interest rate hike in advanced economies and increased investor uncertainty over the recent political changes in the country.** Consequently, foreign investors in the equity market were net sellers, resulting in a cumulative net foreign outflow of Rs. 3.2 billion during the first nine months of 2015, when compared to Rs. 22.1 billion of net foreign inflows during 2014. Foreign purchases accounted for 29.5 cent of the total turnover. Further, foreign corporates accounted for 93.0 per cent of the total foreign purchases, while foreign individuals accounted for 7.0 per cent.

- **There were two Initial Public Offerings (IPO) at the CSE during the first eight months of 2015, which raised Rs. 0.3 billion.** A further Rs. 9.9 billion was raised through nine right issues.

Development Finance and Access to Finance

- **During the first half of 2015, the Central Bank continued to channel credit through many concessionary credit schemes.** The main focus of these schemes was to promote strategic economic sectors, lagging regions and vulnerable social groups with a view to increase regional development and thereby achieve inclusive and balanced growth of the economy. In this process, the Central Bank implemented 11 credit schemes targeting the development of Agriculture, Livestock, as well as Micro, Small and Medium Scale Enterprises (MSMEs) sectors through Participating Financial Institutions (PFIs). Under these schemes, refinance facilities, credit guarantees and/or interest subsidies were provided to PFIs. Altogether, the Central Bank disbursed Rs.11,827.0 million loans to 128,928 beneficiaries through loan schemes implemented during the first eight months of 2015.

- **The Central Bank continued to assist the MSMEs sector through five credit schemes, namely, the Saubagya Loan Scheme (SLS), Self-Employment Promotion Initiative Loan Scheme (SEPI), Small Holder Plantation Entrepreneurship Development Program (SPEnDP), Dry Zone Livelihood Support and Partnership Programme (DZLiSPP-RF) and Awakening North Loan Scheme – Phase II (ANLS - II), which disbursed a total of Rs. 2,221.0 million loans among 11,124 beneficiaries.** Of the total, SLS, the flagship Scheme which operates island-wide to provide loans to the Small and Medium Enterprises (SME) sector, disbursed Rs. 1,967.0 million or 88.6 per cent of loans among 82.0 per cent of the borrowers. Overall, the loan disbursements during the first half of 2015 to the SME sector

Table 8.9 Loan Disbursements to the MSME Sector

Loan Scheme	Loan Disbursements				Share (%)		Growth (%)	
	2014 Jan - Aug		2015 Jan - Aug		2015 Jan - Aug		2015 Jan - Aug	
	No. of Loans	Amount Rs. Mn.	No. of Loans	Amount Rs. Mn.	No. of Loans	Amount Rs. Mn.	No. of Loans	Amount Rs. Mn.
Saubagya	9,115	2,312.7	9,136	1,967.0	82.1	88.6	0.2	-15.0
SEPI	176	38.3	60	20.5	0.5	0.9	-65.9	-46.4
SPEnDP	366	43.4	414	60.7	3.7	2.7	13.1	39.7
DZLiSPP-RF	1,001	73.9	111	11.8	1.0	0.5	-88.9	-84.1
ANLS - II	4,603	504.5	1,403	160.0	12.6	7.2	-69.5	-68.1
Total	**15,261**	**2,972.8**	**11,124**	**2,220.9**	**100.0**	**100.0**	**-27.1**	**-25.3**

Source: Central Bank of Sri Lanka

Table 8.10 Loan Disbursements under the Microfinance Loan Schemes

Loan Scheme	Loan Disbursements				Share (%)		Growth (%)	
	2014 Jan - Aug		2015 Jan - Aug		2015 Jan - Aug		2015 Jan - Aug	
	No. of Loans	Amount Rs. Mn.	No. of Loans	Amount Rs. Mn.	No. of Loans	Amount Rs. Mn.	No. of Loans	Amount Rs. Mn.
PAMP II RF	17,945	1,177.2	14,311	962.8	54.9	61.7	-20.3	-18.2
PAMP RF	8,516	401.3	8,346	410.9	32.0	26.3	-2.0	2.4
SFLCP RF	4,143	162.5	3,414	186.0	13.1	11.9	-17.6	14.4
PAMP II	3,284	246.0	-	-	-	-	-	-
Total	**33,888**	**1,987.0**	**26,071**	**1,559.7**	**100.0**	**100.0**	**-23.1**	**-21.5**

Source: Central Bank of Sri Lanka

were less than that of the corresponding period of 2014. The funds disbursed under these loan schemes between the two corresponding periods of 2014 and 2015 are given in Table 8.9.

- **Three microfinance loan schemes were in operation with a view to broadening the financial outreach among the masses and promoting poverty alleviation.** These loan schemes, namely, the Poverty Alleviation Micro-Finance Project II- Revolving Fund (PAMP II–RF), the Poverty Alleviation Micro-Finance Project - Revolving Fund (PAMP-RF) and the Small Farmers and Landless Credit Project - Revolving Fund (SFLCP-RF) together disbursed loans amounting to Rs. 1,560.0 million among 26,071 beneficiaries during the first half of the year. Of the total disbursements, 64 per cent of loans were granted to the Small Industries and the Agriculture Sectors, followed by Livestock (15.0 per cent) and Trade and Services (15.0 per cent) and Fisheries and others sectors (5.0 per cent). The performance of the microfinance loan schemes during the first half of 2015, compared to the corresponding period of the previous year, are given in Table 8.10.

- **Of the total disbursements, a bulk of credit was directed towards the Agriculture and Livestock Sectors.** Funds released to these sectors accounted for about 68.0 per cent of the total disbursements during January to August 2015. These loans were mainly delivered through the New Comprehensive Rural Credit Scheme (NCRCS), which provides loans to meet working capital requirements of the small scale farmers for 32 crop varieties. Among all districts, Anuradhapura (19.0 per cent) received the highest amount of agriculture loans disbursed

Table 8.11 Loan Disbursements to the Agriculture and Livestock Sector

Loan Scheme	Loan Disbursements				Share (%)		Growth (%)	
	2014 Jan - Aug		2015 Jan - Aug		2015 Jan - Aug		2015 Jan - Aug	
	No. of Loans	Amount Rs. Mn.	No. of Loans	Amount Rs. Mn.	No. of Loans	Amount Rs. Mn.	No. of Loans	Amount Rs. Mn.
NCRCS	78,261	6,162.5	90,327	7,120.8	98.5	88.5	15.4	15.5
CSDDLS[1]	158	572.0	1,374	918.8	1.5	11.4	769.6	60.6
Tea Development Project-RF	52	10.7	32	7.0	0.0	0.1	-38.5	-34.8
Total	**78,471**	**6,745.3**	**91,733**	**8,046.6**	**100.0**	**100.0**	**16.9**	**19.3**

Source: Central Bank of Sri Lanka

under the NCRCS, followed by Pollannaruwa (12 per cent), Badulla (9.0 per cent), Jaffna (9.0 per cent) and Ampara (8.0 per cent) districts. Paddy, being the major crop item, received the highest share of 66.0 per cent of the total loan disbursement.

- **The Credit Guarantee Scheme for Pawning Advances (CGSPA) also continued to operate during the first eight months of 2015**. The Scheme, which was introduced in June 2014 to increase the credit growth in the Agriculture and SME sectors and reduce the risk exposure of PFIs due to the decline in gold prices, guaranteed pawning advances totaling Rs. 22,634.0 million by the Central Bank, by end August 2015.

- **The Central Bank has taken a number of policy measures to strengthen effective credit delivery through concessionary loan schemes**. The rate of interest applicable for borrowers under the SPEnDP, and that of refinance to PFIs from the Central Bank was reduced to 7.0 per cent and 3.0 per cent per annum, respectively, with effect from 29 May 2015. At the same time, fund allocation was increased by the International Fund for Agricultural Development (IFAD) to SDR 2.6 million from SDR 1.75 million. The operational period of CGSPA was extended again from 01 July 2015 to end December 2015, in view of the global forecasts of gold prices, which was observed to be on a declining trend in the short run. Operating instructions were also issued to PFIs to include the warehouse receipts financing system under the NCRCS, to enable small scale farmers to obtain short-term credit from the registered financial institutions, by pledging the warehouse receipts issued by the government owned warehouse as a collateral. Under this scheme, it is expected to provide farmers access to modern warehouses, which are established by the government with the assistance of the World Bank.

- **With the strategic objective of awareness building, the Central Bank continued to promote financial literacy/inclusiveness through a number of programmes and workshops conducted during the reference period**. These programmes mainly covered the areas of financial literacy, entrepreneurship development and training of trainers and project appraisal workshops for entrepreneurs. Formation of self-help groups and educating them about financial management was also given priority. Further, the information on banking and finance was disseminated to the general public through print and electronic media.

Developments in the Payment and Settlement Systems

- **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**. Accordingly, the LankaSettle System recorded a system availability of 99.9 per cent during the first eight months of 2015. Further, in order to ensure the readiness of the system to operate during contingency events, the Central Bank successfully conducted live operations from its disaster recovery site on 08 May 2015.

- **The Central Bank facilitated the establishment of the Common Card and Payment Switch (CCAPS) in order to provide a nation-wide common platform for electronic retail payment systems**. The Common ATM Switch (CAS) which is the first phase of CCAPS, started live operations in July 2013. At present, twelve licensed banks have joined CAS, connecting about 80 percent of ATMs in the country. The Common Electronic Funds Transfer Switch (CEFTS), the second phase of CCAPS, facilitate real time retail fund transfers, was implemented in August 2015. The CEFTS will provide common infrastructure to clear payments effected through multiple payment channels such as ATM, Internet Banking, Mobile Banking, Kiosks and over-the-counter on real time basis. The shared ATM switch was launched with the Pradeshiya Sanwardhana Bank in August 2015.

- **The Central Bank continued the regulation of service providers of payment cards and mobile payment systems in relation to the provisions of the Payment Cards and Mobile Payment Systems Regulations No.1 of 2013.** Accordingly, during the first nine months of 2015, the Central Bank issued two licences to a licensed commercial bank and a finance company to function as issuers of Payment Cards, and a licence to a licensed commercial bank to function as a financial acquirer of payment cards. Approval was granted to a licensed service provider operating a custodian account based mobile payment system, to provide an inward remittance service through the e-money scheme operated by the service provider.

Prospects for 2016

- **Capital levels of banks will remain at healthy levels with enhanced minimum capital requirements, whereby existing domestic licensed commercial banks will be required to maintain Rs. 10.0 billion while licensed specialised banks and foreign banks will be required to maintain Rs. 5.0 billion as core capital commencing from 01 January 2016.** The increased capital requirement is expected to result in some consolidation among the banks. Basel III Minimum Capital Requirements and Leverage Ratio will be implemented on a staggered basis commencing 01 January 2016, in line with international timelines.

- **The credit growth is expected to continue at a stable rate in the medium term due to favorable macroeconomic conditions.** The prevailing low interest rate regime is expected to continue in the medium term, which in turn will create a conducive environment to promote Small and Medium Enterprises (SME) and entrepreneurship in the country. There has been a gradual improvement in the relative level of performing loans with the decline in low quality assets. However, banks should always be cautious of the increase in NPLs that are associated with increase in credit and ensure that proper risk management mechanisms are in place to mitigate such risks.

- **The liquidity position of banks which is over and above the minimum statutory requirement of 20 per cent will continue to be maintained at a healthy level.** Banking Act Directions on Liquidity Coverage Ratio under Basel III Liquidity Standards were issued in the first quarter of 2015, which would strengthen the short-term resilience of banks' liquidity risk profile. Further, it is expected to improve the ability of the banking sector to absorb shocks arising from financial and economic stress, reducing the risk of spill over from the financial sector to the real economy in the coming years. Under the potential implementation of leverage ratio, banks may need to reassess the balance sheet size and business expansion, as the proposed minimum leverage ratio does consider assets growth regardless of the relative risk of different assets classes. Further, impact on maturity mismatches of assets and liabilities will be assessed and monitored in order to ensure the stability of the banking sector.

- **The banking sector is expected to enhance access to banking to all citizens while increasing financial inclusion and supporting economic activities throughout the country.** Banks are also expected to upgrade and strengthen their management information systems and related technological platforms to enhance banking access through digital initiatives such as mobile/phone banking and online banking.

- **Increase in foreign exchange exposure will be closely monitored, including potential risks and adverse effects that may arise when raising foreign funds from the international capital markets.** Large commercial banks will also look into avenues of regional expansion, which will lead to an increase in the geographical reach of the banking sector.

- **Macro-economic changes in the region, as well as the global trends will be monitored in order to take appropriate proactive measures to strengthen the stability of the financial system of the country.** The banking sector is set to adopt various policy measures in line with macroeconomic policies in the medium term. The supervisory framework will be further strengthened in line with Basel Core Principles on Effective Bank Supervision and other international and regional best practices, while closely interacting with other local and regional regulators.

- **The resilience of the LFC and SLC sector is expected to improve and continued to complement the banking system in financial intermediation.** When considering the projected economic growth, the sector is expected to record notable growth rates and continue to be a major player in the financial landscape. With sustainable economic growth projected for sectors such as agriculture, construction, trading and tourism, LFCs and SLCs too could augment their core business activities. Further, the sector is expected to play a key role in the microfinance sector, catering to customers at the grass root level of the economy.

- **LFCs and SLCs are encouraged to review their existing models.** The LFC and SLC sector would experience intense competition due to the increased number of players currently existing in the sector. Further, competition from the banking sector too would be significant as banks are entering into product segments such as finance leasing and hire purchase. The financial sector needs to structure itself in such a way that the grass root level customers are catered to by the banking sector and the LFC/SLC sector will be able to work closely with the banking sector either through absorption or partnership. LFCs and SLCs take a higher risk by catering to the bottom of the pyramid customers, whilst banks operate with benign risk models in the economy. In many developed countries all these segments in the economy are addressed by the banking sector.

- **A restructuring process is underway aiming at strengthening distressed LFCs.** At present there are a few financial institutions facing liquidity constraints due to the liquidity crisis created through the collapse of the Ceylinco group. These LFCs are still operating either as negatively capitalized entities or cash strapped entities mainly due to large amounts of non-performing and non-earning assets. Such entities pose a threat to the financial system, with possible systemic and contagion risks that may spill over to other financial entities. Therefore, these companies are currently undergoing a restructuring process aimed at strengthening their balance sheets.

- **Small entities to be consolidated: The LFC/SLC sector has been driven mainly by the top tier institutions of the sector while this tier continued to innovate and dominate the sector with their synergies and economies of scales.** The prognosis is that the group of large sized LFCs and SLCs will grow further, with the elevation of these institutions from medium to the large category in terms of the asset base, with the expansion of business. Hence, peer pressure on LFCs and SLCs in the small sized category with lower asset and capital bases may give rise to liquidity constraints due to lack of funding. Hence, consolidation would be necessary for these entities to compete with the large LFCs and SLCs.

- **The outlook of the insurance sector is stable with on-going regulatory changes**. The segregation of long-term insurance and general insurance from 2015 will promote greater transparency and policyholder protection in the insurance sector. However, some insurance companies could face operational uncertainties due to factors such as increased cost in relation to the duplication of some functions after the segregation and long-drawn-out nature of legal procedures required in effecting the split. The proposed risk based capital (RBC) model for the supervision of the insurance sector is expected to create better risk management in the sector. Moreover, the increased minimum capital requirement of the insurance sector is expected to promote efficient capital allocation among insurance companies. However, prevailing intense price competition in the motor insurance sector, leading to weak technical results and significant reduction in investment income, due to falling interest rates and subdued performance in the equity market, is likely to moderate the performance of the sector.

- **The low interest rate environment coupled with higher growth in expected earnings, will be continued to complement the equity market in the medium term**. Further, several reforms have been introduced to develop the activities of CSE and these projects are expected to finalise over the next three years. These reforms include; promoting listing, introducing new investment tools, attracting new funds, demutualising of CSE, increasing capital adequacy requirement of stock brokers and implementing Central Counter Party (CCP) and Delivery vs Payment (DVP) systems.

- **Implementation of first and second phases of CCAPS and strengthening of the regulatory framework will enhance the efficiency and soundness of the national payment and settlement system in the country**. The common ATM Switch marked a remarkable progress and is expected to increase usage with more financial institutions obtaining membership in the switch. CEFTS, which provides clearing and settlement facilities for interbank transactions effecting through electronic payment channels, is expected to contribute to popularizing electronic payments. These new retail payment products will offer customer convenience at a relatively low cost. On the other hand, regulations, directions and guidelines on payment and settlement systems will ensure smooth operations of the payment and settlement systems in the country.