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# Microfinance sector landscape in Sri Lanka

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## 1. Microfinance & its global context

Microfinance refers to the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low income households, entrepreneurs and small business owners and who do not have access to traditional sources of capital, like banks or investors. Although, microfinance is defined narrowly as microcredit or broadly as microcredit plus micro savings, microinsurance, pre and post loan technical trainings and business supports, in this article, the term microfinance is narrowly used for microcredit. Microfinance is defined as “provision of financial services to low income people” by the Consultative Group to Assist the Poor (CGAP)<sup>1</sup>.

The Microfinance Act No. 6 of 2016 provides a definition of the microfinance business, which is,

“Accepting deposits and providing:-

- (a) financial accommodation in any form;
- (b) other financial services; or
- (c) financial accommodation in any form and other financial services

1. <https://www.cbsl.gov.lk/en/financial-system/financial-system-stability/microfinance-sector>

mainly to low income persons and micro enterprises.....”

The goal of microfinancing is to provide individuals with money to invest in themselves or their business. Remenyi (1997) pointed out that microfinance is increasingly recognized as an effective instrument for poverty reduction.

Bangladesh's Dr. Muhammad Yunus is the pioneer of the modern version of microfinance which reached a much wider audience with the establishment of the 'Grameen Bank' Grcept. Microfinance is one of the most widely accepted instruments for poverty alleviation throughout the world and it has been used in Sri Lanka for several decades. The United Nations General Assembly, in recognition of the significance of microfinance in reducing poverty and achieving the Millennium Development Goals (MDGs), designated the year 2005 as the 'International Year of Microcredit'. The year was aimed at raising public awareness of the importance of microcredit and microfinance, supporting sustainable access to financial services and promoting innovation and new partnerships to expand the outreach of microfinance. There is a strong demand for small-scale commercial financial services – both credit and savings – from low-income households (Robinson, 2001). Economists had identified the poor as part of a

huge “informal” sector that remained “essentially invisible, in government plans and budgets, in economists’ models, in bankers’ portfolios, and in national policies” (Robinson, 2001, pp. 12).

The idea of providing credit to the poor as a tool for increasing their income and thereby reducing poverty, is not new. The novel dimension in microfinance is the innovative methods of providing credit to the poor (i.e., the usage of social collateral such as group guarantee instead of physical collateral, progressive lending approach, peer pressure and peer monitoring), mobilization of savings from the poor and linking credit provision to savings, social mobilization process that involves awareness building and formation of self-help groups and provision of other services such as insurance to cover risks and distresses faced by the poor.

## 2. Microfinance Institutions

Microfinance Institutions (MFIs) seek to create social benefits and promote financial inclusion by providing financial services to low income households. As these institutions build partnerships with their clients, it is important to define core values and fair practices and therefore ensure that microfinance services are provided in a manner that benefits and respects clients.

In addition to all regulatory guidelines introduced by the Government of Sri Lanka for the microfinance sector, this code of conduct adopted by Lanka Microfinance Practitioners’ Association is to ensure that the highest level of professionalism, ethical conduct and good governance is observed by all microfinance practitioners and their employees; and binds its member MFIs and their employees to total compliance as a condition of its membership.

## 3. History of Microfinance in Sri Lanka

Microfinance services in Sri Lanka have a wide geographical outreach. The context of microfinance

sector in Sri Lanka is different from other countries due to its low population and high financial access relative to other emerging economies. In Sri Lanka, microcredit is offered to finance income-producing activities with the goal of promoting local entrepreneurship. However, the extent of outreach of operators including NGOs and commercial banks in rural areas is rather limited. In recent years, microfinance has been looked upon as an effective instrument for poverty alleviation by many governments, international organizations and donors. Microfinance has helped households in middle quintiles to increase their income and assets. Further, it has assisted poor households to increase consumption expenditure; has worked as an instrument of consumption-smoothing among almost all income groups; and has helped women to increase their social status and improve economic conditions.

Provision of financial services to low income households has a long history in Sri Lanka i.e. the early years of the 20th century. ‘Cheetu’ in Sri Lanka, operating at least since the early 20th century, is an informal but effective way of saving and capital accumulation, and therefore, functions as a basic method of microfinance for the poor<sup>2</sup>. The microfinance movement in Sri Lanka dates as far back as 1906 with the establishment of Thrift and Credit Co-operative Societies (TCCSs) under the Co-operative Societies Ordinance introduced by the British colonial administration<sup>3</sup>. These were the first credit co-operatives to be established in Sri Lanka. These were the pioneers in providing financial facilities to the poor. Nevertheless, microfinance began to be widely recognized in Sri Lanka as a central tool for alleviating poverty and empowering the poor in late 1980s, with the enactment of the Government’s Janasaviya programme. In the 1990s, the expansion of

2. <https://www.cbsl.gov.lk/en/financial-system/financial-system-stability/microfinance-sector>

3. Athambawa Jahfer and Hansiya Abdul Rauf; An Analysis of Economic Impact of Microfinance Programs through Self Help Groups in Sri Lanka

microfinance activities embraced all sectors, namely governmental, non-governmental and cooperative sectors. The establishment of the National Development Trust Fund (NDTF) in 1991 as an apex lending institution was also another turning point in the microfinance sector in Sri Lanka<sup>4</sup>.

#### **4. Microfinance as a tool for poverty alleviation in Sri Lanka**

Currently, there is a wide range of institutions that are involved in providing microfinance services to low income groups in Sri Lanka. These include Cooperative Societies (e.g., TCCSs), hundreds of local and international Non-Governmental Organizations (NGOs), Licensed Commercial Banks (both state-owned and private) and development banks such as the Regional Development Banks (RDBs). The Government of Sri Lanka has launched several national poverty alleviation programmes after the economic liberalization period such as Janasawiya, targeted food stamp programme and Samurdhi programme. The Government's Samurdhi Savings and Credit Scheme established in 1996 is presently one of the largest microcredit and social mobilization programmes in Sri Lanka, with over 32,000 village level societies and over 1000 bank branches operating island-wide<sup>5</sup>. According to Centre for Poverty Analysis (CEPA), those programmes have been hindered by political aids and misallocation of resources including an inconsistent approach to poverty. The lack of a consistent poverty reduction strategy at national level over the past few decades has meant that the improved performance in the economy has not contributed to employment generation and human development in several groups<sup>6</sup>.

4. Tilakaratna Ganga, Wickramasinghe Upali & Kumara Thusitha; Microfinance in Sri Lanka: A Household Level Analysis of Outreach and Impact on Poverty

5. Tilakaratna Ganga, Wickramasinghe Upali & Kumara Thusitha; Microfinance in Sri Lanka: A Household Level Analysis of Outreach and Impact on Poverty

6. Poverty alleviation programmes ineffective - CEPA, Financial Times, 28.10.2007

The Central Bank of Sri Lanka (CBSL) is another key player, which functions as the executing agency of a number of rural credit programmes funded by various donor agencies and the Government of Sri Lanka (GOSL). Not only GOSL, but also Non Government Organizations have launched poverty alleviation programmes in the country.

Despite the large number of institutions involved in providing microfinance facilities in Sri Lanka, their impact on reducing poverty or improving household welfare is not very clear. Only a few studies have been undertaken to assess how microfinance has impacted poverty and living conditions of the households in Sri Lanka<sup>7</sup>.

Development of rural infrastructure facilities is of prime importance to improve the outreach of MFIs in remote rural areas and encourage the private and NGO sectors to have a more effective involvement in microfinance provision.

Three main donors i.e. the Asian Development Bank (ADB), the World Bank and the Japanese government provided over 60% of foreign aid to Sri Lanka and their efforts in poverty reduction focused on economic growth as the main driver. "However, the 'trickle-down' effect which this relies on has not borne fruit and economic inequality is worsening. Donors have failed to recognize and adequately engage with some of the political and social issues that have contributed to poverty in Sri Lanka and led to spatial and social inequalities," the CEPA said noting that issues of lack of sustainability, limited interaction between different donor activities, and a lack of accountability for the way funds are spent by donors and the state also limit the effectiveness of programmes<sup>8</sup>."

Sri Lanka hosted its first ever South Asian Micro-Entrepreneurs Network (SAMN) conference

7. Kumari J.A.P., 2016; Colombage, 2004; Shaw, 2004; Gunatilaka and Salih, 1999; Gunatilaka et al., 1997; Hulme and Mosely, 1996.

8. Poverty alleviation programmes ineffective - CEPA, Financial Times, 28.10.2007

recently, with the participation of over 280 micro-finance practitioners and industry stakeholders from across the region with the goal of exploring the possibilities for accelerating financial inclusion in the region, under the theme "Deepening Financial Inclusion in South Asia". This has been organized by the Lanka Microfinance Practitioners Association (LFMPA) which was established in 2006<sup>9</sup>.

## **5. Findings & Observations on Microfinance in Sri Lanka**

According to some studies of microfinance in Sri Lanka, microfinance has a significant positive impact on household income (Mithrarathna (2003) and Dias (2001)). Wickrama (1998) confirmed that client's socio-economic condition has improved with the intervention of microfinance. Thilakarathne et al., (2005) have also claimed that microcredit has a significant positive impact on household's socio-economic conditions. Colombage (2004) found that even though microfinance has several positive impacts on client's livelihood development, factors such as lack of entrepreneurial skills, small size of loans, investing in low value added activities, limited product diversification and poor physical infrastructure adversely affect the clients' socio-economic development. However, it is obvious that due to low financial literacy, many people utilize microfinance in respect of consumption instead of investments. Hence, those people have been unsuccessful in gaining the optimum results from various microfinance products.

## **6. Legal framework and Policy Implications**

### **6.1 Why a Regulatory framework for Microfinance in Sri Lanka**

Today, the microfinance sector consists of a large number of players ranging from banks, Non Bank Financial Institutions (NBFIs) and unlicensed

investment companies as 'Poli Mudalalees'. A rapid growth is seen in number of players in microfinance sector and is evident with the high sector penetration. Accordingly, the microfinance sector in Sri Lanka consists of 15,000 unregulated entities (approx.) which are involved in daily, weekly money lending activities.

Despite this high financial access, formal financial institutions are restricted from providing microcredit services in the traditional manner, due to the lack of collateral and regular formal income among low-income borrowers. As a result, only microfinance institutions cater to the credit needs of the low- and irregular income segments. Despite the risks involved, a number of leading banks have established separate microfinance units to provide microcredit services to women from low-income households. However, the ineffective regulatory system has resulted in high interest rates and a number of malpractices that have severely impacted customers at the base of the pyramid.

Sri Lanka, the country of 21 million, enjoys a diverse range of financial institutions, with numerous formal, semi-formal and informal financial service providers. In fact, Sri Lanka has a high commercial bank density, with nearly 19 commercial banks per 100,000, according to 2015 World Bank statistics. Around 83 percent of Sri Lankan adults aged 15+ have a bank account at a formal financial institution, compared with a South Asian average of 46 percent<sup>10</sup>.

Microfinance is often promoted with the objective of providing affordable financial services in a fair and transparent manner to those excluded from the formal financial system. But the context is different for the microfinance sector in Sri Lanka, due to its low population and high financial access relative to other emerging economies.

9. Microfinance Sri Lanka Forum Vol II – April 2018, published by Lanka Microfinance Practitioners Association

10. The Little Data Book on Financial Inclusion 2018; World Bank Publication



The current microfinance industry should be shifted from consumption based lending while keeping a close tab on multiple borrowing, where many institutions today are servicing same clients of different financial institutions. Knowledge and capacity of existing staff, staff movement and target setting, lack of knowledge on client's informal lending position are internal challenges faced by the industry at present.

Regulatory frame work is essential to create a conducive environment to microfinance industry in any country. Hence, it is important to govern MFIs and NBFIs to maintain the stability of the financial system since CBSL plays a vital role in maintaining the financial system stability.

## **6.2 Regulatory framework for Microfinance in Sri Lanka**

To overcome the challenges in the microfinance industry, CBSL introduced a set of rules and for directions for Licensed Microfinance Companies (LMFCs). Accordingly, Microfinance Act No. 6 of 2016 was issued and this newly enacted Microfinance Act intends to license, regulate and supervise unregulated microfinance companies and microfinance non-governmental organisations (MNGOs). To comply with the regulatory requirements of the above Microfinance Act, it is required to obtain a license. Reputation/recognition, public deposits, commonly accepted regulatory framework, stability of the company through regulation and supervision are the benefits of obtaining a license for such entities.

The industry as a whole is now expected to be sufficiently standardized with the recently introduced regulations by CBSL.

## **7. Micro Finance Industry's 'Future'**

The recently introduced microfinance Act and regulations enable to bridge modern-day challenges and trends faced by LMFCs. As per financial analysts' opinion, Microfinance sector is overheating and all large players must discuss a way forward for long-term sustainability of the sector and not only short term profitability. MFIs can finance their portfolios through bank borrowings, corporate debt as well as with access to debt instruments in Capital Market, while calling on international lenders and technical assistance to further uplift the industry and SMEs. Technology can play a vital role in the development of microfinance sector. Technology can be integrated in areas of mobile money, mobile transactions, digital finance, paperless microfinance, etc.

Further, it should be considered that there is a significant transition from the conventional systems such as branches, centres, customer centric online real-time systems, mobile banking system. The next generation microfinance solutions will be branchless and no point of sales (POS) but mobile transactions, not Know Your Customer (KYC) but Know Your Data (KYD), no home visits but field data collection via apps and dashboards with big data intelligence. Accordingly, microfinance will affect the society in novel areas and it will grow in multi-dimensions in future.

# Taste of the Low-Country Tea which strengthens Sri Lanka's Economy

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## **Introduction**

According to the Central Bank Annual Report 2016, tea is the main agricultural crop in Sri Lanka after paddy and coconut. The said report further stated that agricultural sector contributed 7.1% to the GDP, of which 9.2% contributed by the tea cultivation. The Sri Lankan tea industry contributes a considerable amount of foreign exchange to Sri Lanka. Sri Lanka exports more than 90% of tea production. Even though tea was the main source of Sri Lanka's foreign exchange earnings up until the 1980s, later on earnings from foreign employment, apparel and tourism overtook tea as the top sources of foreign exchange. China and India are at the top of the world's tea producing countries and are the top countries that consume tea too. Therefore, their tea production is high, and tea consumption is also high. However, tea consumption in countries like Sri Lanka and Korea is not high compared to their tea production.



## **History**

### **First tea plant in Sri Lanka**



Throughout the generations, Tea produced in Sri Lanka has known all over the world as “Ceylon Tea”. The story of Ceylon Tea is a history of over 200 years since the time of the British colonial empire.

In 1824, for the first time, a British man was brought a tea plant to Sri Lanka from China and planted it in Peradeniya Royal Botanical Garden for non-commercial interests. A cinnamon crop which was imported from Assam and Calcutta by an Eastern Indian Company and started to cultivate it as a research plant in 1839.

### **Expansion of Tea as a commercial cultivation**

However, almost two decades from 1839, there was no remarkable progress in tea cultivation. Plantation of Tea

as a commercial cultivation in Sri Lanka was initiated by Scottish national James Taylor. James Taylor arrived in Sri Lanka in 1852 and settled in Looolecondara Estate in Kandy. Taylor went to India in 1866 and studied the basics of tea cultivation. As a result, in 1867 he started tea plantation in 19 acres of the Looolecondara Estate.



It is stated that cultivation of tea was started here as a commercial crop in Sri Lanka. Farmers who planted coffee gradually began to cultivate tea because of the spread of a fungus in the coffee plantations throughout Sri Lanka. Accordingly, tea cultivation was commenced in estates such as Hope, Rockwood and Mooloya, which was found around the Looolecondara estate in Kandy. Accordingly, the above estates are among the first tea estates established in Sri Lanka.

### **The First Tea Factory in Sri Lanka**

As a result of Taylor's research, the first tea factory in Sri Lanka was established in the verandah of his bungalow at Looolecondara Estate, Kandy in 1872. Here the tea leaves were overturned manually and firing of tea was done with fire charcoal in clay pots. Tea leaves were dried using wired plates. Delicious cup of tea was the result of the above process. Afterwards, simple machineries were produced by Taylor for overturning tea leaves and there was no lack of labor at that time. In 1875, Taylor carried out the shipment of the first Ceylon Tea from Sri Lanka to the London Tea Auction. It was about 23 tons in weight. Taylor contributed to the development of the tea industry based on his innovative thoughts and died in 1892.

### **The Era after Taylor**

The tea plantation saw a gradual development and later many estates that planted coffee switched in to planting tea. By 1899 tea plantations had spread across

a huge land mass as big as 400,000 acres. Later, the British people such as Ranolph Trafford, who came to Sri Lanka had a high knowledge about tea plantation and had maintained a close relationship with the main tea estates. In 1877, Samuel C. Davidson introduced a tea dryer named "Sirocco" to Sri Lanka. In 1880, John Walker & Company introduced a tea mixing machine. Later, machines imported from England were installed in tea estates such as Fairy Land Estate in Nuwara Eliya.

### **"Ceylon Tea" Auction**

In a short period of time, the brand "Ceylon Tea" started to gain popularity throughout the world. As a result, there was a need to intervene and supervise for the sale of tea. Accordingly, tea sale in tea auctions were begun. The first tea auction in Sri Lanka was held in the month of July 1883 at the Somer Ville & Company with the sponsorship of Ceylon Chamber of Commerce. In 1893, at the Chicago World Trade Fair, one million tea packets were sold at the London Tea Auction with a record price of £ 36.15 per kilogram.

### **Further Strengthening of Tea Trade**

In 1894, Ceylon Tea Traders Association was established and at present, the sale of tea is carried out through this association and the Chamber of Commerce. The Colombo Brokers Association commenced in 1896 establishing a new strength for the tea industry and in 1925 the Tea Research Institute was established. By 1927, Sri Lanka's tea production was over 100,000 metric tons and was almost entirely used for export.

In 1932, Tea Propaganda Board was established. In 1941, M/S Pieris & Abeywardane Company, the first tea brokering company in Sri Lanka commenced business. State Plantations Corporation was established in 1958. Accordingly, Sri Lankan tea production showed a continuous growth and it has grown to more than 200,000 metric tons in 200 hectares in 1960.

### **Being the Leader among Tea Exporters**

In 1963, instant tea production and exportation commenced in Sri Lanka. Sri Lanka became the world's number one tea exporter in 1965. In 1966, the first International Tea Conference was held in Sri Lanka marking a successful 100 year journey. In 1970, Ceylon Government nationalized tea estates owned by British companies. Accordingly, Sri Lanka Tea Board was established in 1976 to control above estates in



addition to the Janatha Estate Development Board, Sri Lanka State Plantation Corporation and Tea Small Holdings Development Authority. In 1976, Sri Lanka commenced exporting tea bags, opening new avenues for tea exportation in Sri Lanka.



Like this, the taste of Sri Lankan tea gradually came to be recognized all over the world. Sri Lankan tea was recognized as the official tea provider for the Moscow Summer Olympic Games in 1980. In 1982, Sri

Lanka was the official tea supplier for the 12th Commonwealth Games which was held in Brisbane as well as for the Expo 88 exhibition which was held in Australia in 1987.

Tea re-exportation was approved in 1981. The Green Tea, which is famous throughout the world, production and export was commenced in Sri Lanka in 1982. The 125th anniversary of Sri Lanka's tea manufacture took place in an impressive manner at the international conference in Colombo. When the period of 1992 – 1993 is considered, many of the state owned tea estates were privatized. Institutions such as Janatha Estate Development Board and Sri Lanka Plantation Corporation faced high risks due to high political interventions, high number of laborers, and low productivity and high losses resulted from weak management. Due to these reasons, 23 Regional Plantation Companies (RPCs) were established by privatizing the state owned tea estates in 1990.

By 1996, Sri Lanka's tea production exceeded 250,000 metric tons, and by 2000, it exceeded 300,000 metric tons. Even though a certain growth can be seen recently due to privatization, tea plantation owners are facing

many challenges as a result of low productivity, high production cost, not using enough fertilizer, and low profitability. The privatization of local plantation companies resulted in greater opportunities for small holdings. Accordingly, at present, the importance of Regional Plantation Companies is declining and small tea plantations have garnered a considerable attention. Small tea estate owners contribute to more than 3/4 of the country's tea production, of which most of them own less than an acre. Details of tea production in the final quarter of 2017/2016 are given at table 01 below:

**Table 01 - Tea production in the last quarters of 2017 / 2016**

Category	Oct. - Dec. (Kg. Metric Tons)		Change	
	2017	2016	Volume (Kg. Metric Tons)	%
Categorization based on Altitude				
High	14.47	15.31	-0.85	-5.53
Central	10.55	10.47	0.08	0.78
Low	48.73	47.19	1.55	3.28
Total	73.75	72.97	0.78	1.07
Processing System				
Orthodox	67.66	68	-0.34	-0.49
CTC	5.59	4.43	1.17	26.37
Green Tea	0.49	0.54	-0.05	-9.28
Total	73.75	72.96	0.78	1.07

Source :- Tea Market Update Volume 13, No 04 – Sri Lanka Tea Board

2016 / 2017 Details of district-based tea production are given at table 02 below.

**Table 02 - Production of administrative districts**

Administrative District	2017	2016	Growth	Growth %
Rathnapura	70.99	68.00	2.99	4.40
Nuwara Eliya	58.26	60.23	-1.97	3.26
Galle	45.72	42.77	2.94	6.88

Matara	38.75	34.13	4.61	13.51
Kandy	33.44	33.71	-0.27	-0.80
Badulla	28.07	24.46	3.62	14.79
Kalutara	20.41	18.49	1.92	10.38
Kegalle	9.10	8.32	0.79	9.47
Matale	1.38	1.44	-0.06	-4.18
Colombo	0.78	0.6	0.18	30.05
Kegalle	0.19	0.22	-0.03	15.47
Total	307.08	292.36	14.72	5.03

Source -: Tea market update Volume 13, No 04 – Sri Lanka Tea Board

The main districts which tea plantation is carried out in the low country, Galle and Matara, have achieved a growth of 6.88% and 13.51% respectively in 2017, compared to 2016. In 2017, tea prices were higher than in 2016. Accordingly, the average price of a kilogram of low country tea has been increased by Rs.149.56, an increase of 31.92%. Accordingly, Table 03 below shows the sub-district auction prices.

**Table 03 – Tea auction prices in sub-districts**

Sub District	January to December 2017			
	2017	2016	Change in price of 1 Kg	Change %
Nuwara Eliya	598.57	432.17	166.4	38.5
Western (08 Regions)	613.18	462.52	150.66	32.57
Central (09 Regions)	556.92	416.76	140.17	33.63
Uda Pussellawa (02 Regions)	560.3	394.79	165.51	41.92
Uva (08 Regions)	574.77	431.31	143.46	33.26
Low country (10 Regions)	642.32	490.61	151.7	30.92
<b>Average Price</b>	<b>618.18</b>	<b>468.62</b>	<b>159.56</b>	<b>31.92</b>

Source -: Tea market update Volume 13, No 04 – Sri Lanka Tea Board

In 2017, the highest price for tea was reported from Matara, which was as high as Rs.650 per kilogram. Then, tea at Galle, Kalutara and Deniyaya respectively received a high price.

With the revolution of new technology, the first online tea sales were made by Forbers and Walker Company in 2001 at the Colombo Tea Auction. In 2002, a museum for tea was commenced in Kandy. By the end of 2013, Sri Lanka's tea production exceeded 340,000 metric tons.

The commercial tea production which was started in 1867 in Kandy in a 19 acre land, now cover 6 major areas. These major areas are, Nuwara Eliya, Dimbula, Kandy, Uda Pussellawa, Uva Province, and Southern Province.

## World Tea Consumption and Trade

### World Tea Consumption

Apart from water, the next most popular drink in the world is tea. At present, about 50 countries worldwide grow tea and people in more than 160 countries drink tea as a habit. In general, about 3 billion people worldwide consume tea. When the taste is considered, tea consumption is different from country to country. Consumers in countries like Korea are more towards consuming green tea since their early days. Even though the consumers in countries like Thailand, America have shifted their focus towards green tea in recent years, they generally prefer brown colored, fruit flavored, sweet taste, or in other words, tea that doesn't have a dark green color.

### Differences in Tea Tastes

Tea consumers in the world do not have the same taste of tea. For an example, even though countries like Russia and some commonwealth countries prefer Ceylon tea, the most popular drink of tea in Pakistan and Egypt is Cut-Tear-Curl (CTC). The most popular tea in North America is Light Liqueuring Tea.

### Improvements in World Tea Products and Processes

As most of us know, many countries used Loos Tea for a long time. But due to the inconveniences of that method, nowadays we can see different shapes of tea bag containers. As a result of these types of containers, a value has been added to the tea production. Here is a brief overview of the interest in tea in different countries

**Table 04**

No.	Type of Tea	Country/Countries
1.	Iced Tea	United States of America
2.	Fruit Flavored Tea	Europe
3.	Tea with Foam	Taiwan
4.	Medicinal Tea	America, China, Japan, and Thailand
5.	Ready to Drink Tea	Japan, America, and Taiwan

Green Tea and Black Tea are still regarded as a priority in tea consumption. However, Iced Tea, Fruit Flavored Tea, Foamed Tea, Medicinal Tea, Ready to Drink Tea, Instant Tea, and Organically Produced Tea will invade the market in near future. Also, tea-based products are coming in to the market. Examples are, Tea Rice, Tea Noodles, Tea Cake, Tea Biscuit, Tea Wine, Tea Candy, and Tea Ice Cream. Tables 04 and 05 show the interest in different types of tea products among consumers in various countries.

### US Tea Market

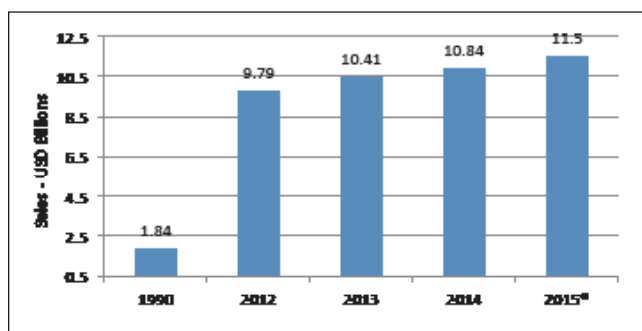
The United States has a very good market for tea. About 80% of US households are used to consume tea. The Tea Association of the United States shows that the growth of the American tea industry was also common in the year 2017. Population transformations such as Millennials, Gen-X, Gen-Y, Baby Boomers will increase the future demand for tea as well. Also, the already high demand for tea from the Gen-Z, will continue to hold the same tea demand. According to the American Tea Association, more than 158 million Americans consume tea per day. In 2017, tea imports increased by 1% over the previous year. In 2017, while the demand for Black Tea has increased by 2.3%, the demand for Green Tea has decreased and it's an extraordinary feature. Also, it is expected that tea prices will increase due to increase of cardboard, paper and energy and labor costs.

The 2017 market share for "Ready to Drink Tea" was as high as 45.7% and it was an increase of 3% to 4%. Although, the price of "ready-to-drink tea" is more expensive than the "tea bags" in the market, due to its flexibility, convenience and ease of use as an alternative to sugary drinks makes it more popular among consumers.

**Table - 05**

Type of Tea	2016	2017
Black Tea	80%	86%
Green Tea	16%	13%

Source -: American Tea Association

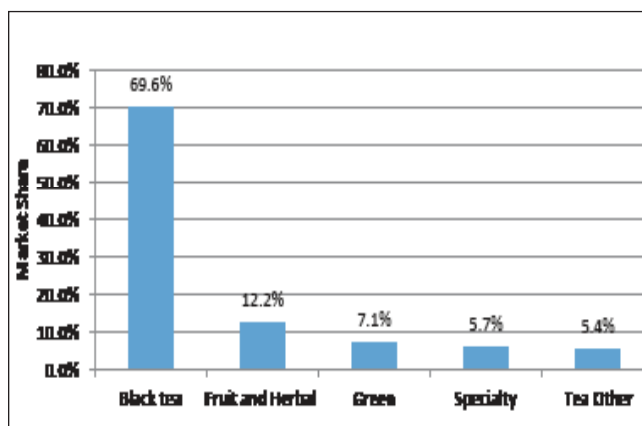
**Chart 1 : Tea Market in USA : Whole Stock Value 1990 - 2015**

Source: Tea Association of the USA; Statistica 2017

### Tea Market in United Kingdom

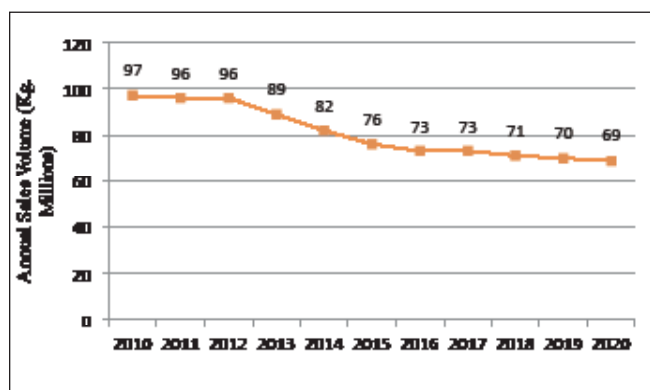
There is a high value for tea in UK. The UK is the highest tea consumer in Western Europe. As a percentage it is 63%. In the UK tea market, demand for black tea is about 60%, and there is a demand for fruit flavored and medicinal tea, as well as green tea. However, in the past few years, the UK tea market has seen a downward trend. Considering the period from 2010 to 2015, the UK tea consumption has fallen from 97 tons in 2010 to 76 tons in 2015 by 21% as per Chart 02 and 03.

According to Mintel's research, there's a tendency of consumers to use hot beverages with the most excitement.

**Chart 2 : UK Tea Market Share based on Value 2015**

Source : Statista 2017

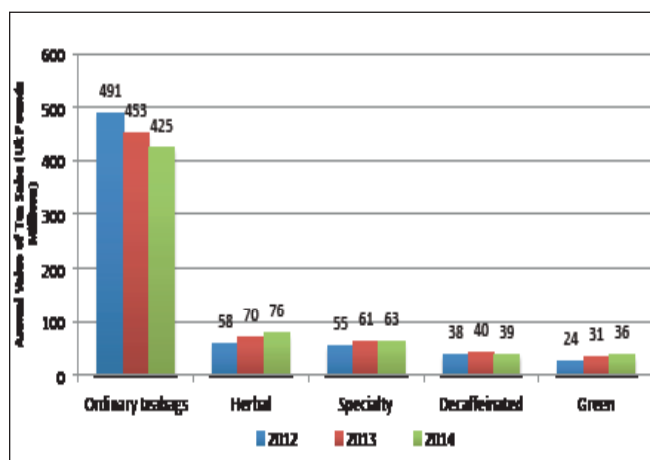
**Chart 3 : Tea Consumption in UK**



Source : Mintel

Demand for tea bags, which had been capturing the European tea market for a long time, has been steadily declining. Instead, the demand for fruit flavored/ medicinal tea and green tea can be seen as illustrated in Chart 4.

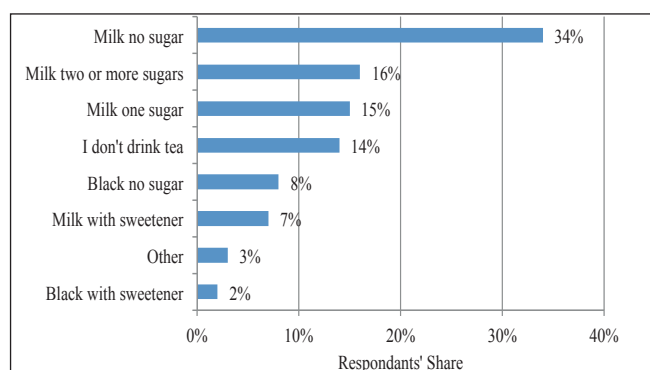
**Chart 4 : Tea Consumption Tendency in the UK**



Source : Mintel

In a research done by Statista in 2016 found that 34% have a tendency to drink tea with milk without adding sugar. See Chart 05 below

**Chart 5 : Style of Tea Consumption in UK 2016**



Source: Survey on "How do you take your tea?" - Statista 2017

## Present Tea Market in Sri Lanka

According to the Tea Exporters Association in Sri Lanka, tea production in 2016 was 292.5 million kilograms and in 2017 it was increased by 4.9% up to 307.08 million kilograms. Orthodox Tea showed an average increase of 4% on the basis of classifications, with the CTC and Green Tea showing an increase of 16.6% and 13.0% respectively compared to 2016.

However, in the case of tea exports, in 2017 there is little change in comparison to 2016. Tea exports in 2016 was 288.7 million kilograms and in 2017 it increased up to 288.9 million kilograms by a limited extent. However, considering the period 2016-2017, tea bag exports of 23 million kilograms in 2016 was reduced up to 21.7 million kilograms in 2017. In comparison with 2016, it was a reduction of 1.3 million kilograms, a 5.69% reduction. Sri Lanka's green tea exports are not so high despite global demand for green tea. It was reported in 2017 as 0.8 million kilograms. However, compared to the previous year it is an increase of 18.9%.

Accordingly, despite the insignificant growth in tea export volumes, the tea export earnings of Rs.184.07 bn. in 2016 was increased by Rs.48.6 bn. to Rs.233.3 bn. in 2017, a growth of 26.3%. This is the highest ever revenue earning from tea exports from the local currency, which was previously recorded as Rs.212.5 bn. The average FOB (Free on board) price for one kilogram of tea in 2017 is Rs.807.44 and in 2016 it would be Rs.639.88. It was an excellent price to the exporters, and this was particularly affected by the decline in tea production in Sri Lanka and the scarcity of the black tea in the world market. Therefore, in 2016, 2017, Sri Lankan tea exporters were very beneficial. According to the Sri Lanka Tea Exporters Association, the largest tea importer from Sri Lanka was Turkey. It was 37.8 million kilograms. It is followed by Iraq 35 million kg, Russia 33.3 million kg and Iran 27.4 million kg. The special feature in this is Russia, who was the main customer for Sri Lankan tea, lowering to the third place. In the year 2017, the main countries that purchased tea from Sri Lanka are listed at Table 06 below.



**Table 06 - Countries that purchased tea from Sri Lanka**

Country	2017	2016	Change		Total Exports	
			Volume	%	2017	2016
Turkey	37.81	27.06	10.75	39.72	13.6	9.6
Iraq	34.94	32.41	2.53	7.81	12.6	11.5
Russia	32.79	34.08	-1.28	-3.77	11.8	12.1
Iran	27.04	33.6	-6.56	-19.52	9.7	12
United Arab Emirates	15.23	17.83	-2.6	-14.6	5.5	6.3
Azerbaijan	12.27	10.54	1.73	16.37	4.4	3.8
Libya	10.38	12.62	-1.78	-14.14	3.9	4.5
China	9.47	7.46	2.01	26.93	3.4	2.7
Japan	7.82	7.67	0.15	2.02	2.8	2.7
Syria	7.28	11.96	-4.69	-39.18	2.6	4.3
<b>Total Exports</b>	<b>195.48</b>	<b>195.2</b>	<b>0.25</b>	<b>0.13</b>	<b>70.3</b>	<b>69.5</b>

Source -: Tea market update Volume 13, No 04 – Sri Lanka Tea Board

In the case of tea export figures in 2017, the demand for tea bags was reduced by 9.25%, a drop of 1.8 metric tons is significant. (See Table 07):

**Table 07 – Comparison of Export of Tea Products**

Type	2017			2016			Change			Change %	
	Volume	FOB	Value	Volume	FOB	Value	Volume	FOB	Value	Volume	FOB
Bulk	169.4	725.25	122,825.00	171.78	543.72	93,400.00	-2.4	181.53	29,426.00	-1.41	33.39
Packets	86.51	792.79	68,583.00	85.02	628.93	53,471.00	1.5	163.85	15,112.00	1.75	26.05
Tea Bags	17.81	1,382.51	24,619.00	19.62	1,199.13	23,530.00	-1.8	183.38	1,088.00	-9.25	15.29
Instant Tea	2.12	1,250.83	2,651.00	2.01	1,215.57	2,443.00	0.1	35.26	208.00	5.47	2.9
Green Tea	2.4	1,538.90	3,697.00	2.44	1,386.60	3,388.00	0	152.30	309.00	-1.67	10.98
Sub Total	278.2	799.35	222,376.00	280.87	627.44	176,232.00	-2.7	171.91	46,144.00	-0.95	27.4
Re-Exports	10.79	1,016.08	10,963.00	7.9	1,082.23	8,546.00	2.9	-66.15	2,417.00	36.63	-6.11
Total	289	807.44	233,338.00	288.77	639.88	184,778.00	0.2	167.56	48,560.00	0.07	26.19

Source -: Tea market update Volume 13, No 04 – Sri Lanka Tea Board

Especially in countries such as Syria and Libya, formerly Sri Lanka's tea-export market has been lost due to the confrontational situation. Accordingly, tea exports to Syria have declined from 11.96 metric tons in 2016 to 7.28 metric tons in 2017 by 4.69%. Libya has also declined from 12.62 metric tons in 2010 to 10.83 metric tons in 2017, down by 1.78%. Accordingly, for the first time in history, Turkey has become one of the leading importers of Ceylon tea.



Sri Lanka mainly produces “Orthodox Tea”. The products that are selected and produced according to “Unorthodox” method are Cut Tear & Curl (CTC). Also, Green Tea, Instant Tea, Bio Tea, and Flavored Tea are produced in Sri Lanka.

Flavors and smells make tea in hilly areas a popular drink. These tea that are grown in Dimbula and Nuwara Eliya have a high popularity. Also, when tea is exported, they are prepared in different ways such as Tea Bags, Tea Packets, Tea Stock, Instant Tea, Green Tea, Flavored Tea, etc. Tea production areas in Sri Lanka are classified under three categories (Source: Industry Capability Report 2016 – EDB).

Up Country/ Hill Country: Height of 1200 meters at sea

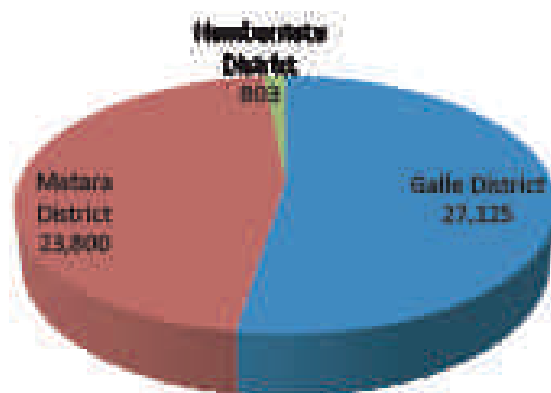
- Nuwara Eliya - Delicately fragrant
- Udupussellawa - Exquisitely tangy
- Uwa - Exotically aromatic
- Dimbula - Refreshingly mellow
- Central Country: Height of 600 - 1200 meters at sea
- Nuwara - Intensely full-bodied
- Low Country - Height of below 600 meters at sea
- Sabaragamuwa - Smooth & full – bodied
- Ruhuna - Distinctively Unique

Uva Tea, unleaded in the eastern hill country, is characterized by seasonal characteristics, especially used in countries such as Germany and Japan. Dark colored tea is a popular drink in countries such as Australia, Europe, Japan, and North America. Low

country tea is especially popular in countries such as West-Asian countries, Central Eastern countries, CIS Countries (Commonwealth of Independent Countries), and BRICS countries.

Galle and Matara Districts specially contributes to low country tea industry. According to the 2016 statistical report published by the Chief Secretary's Office of the Southern Province, 27,125 hectares have been cultivated in the Galle District and 23,800 hectares in the Matara District. Although tea has been cultivated in 803 hectares of land in Hambantota District, the dry weather conditions are not suitable for tea cultivation. as per Chart 06 below

**Chart 06 – Tea cultivated land volume in Southern Province**



Source: 2016 statistical report published by the Chief Secretary's Office of the Southern Province

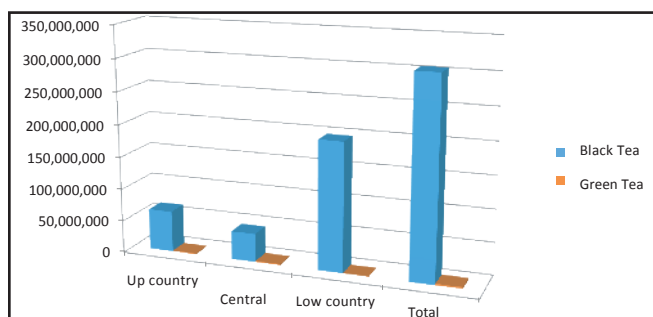
Especially Galle and Matara Districts can be identified as suitable climatic conditions for tea cultivation (E.g.: Annual rainfall between 2500mm – 3000mm, temperature between 22c – 27c, adequate and suitable sunlight).

**Table 08 – Tea production in 2017 (Kg.)**

	Black Tea	Green Tea	Total
Up Country	63,667,840	975,757	64,643,597
Central	44,077,411	1,577,181	45,654,592
Low Country	197,312,801	108,816	197,421,617
Total	305,058,052	2,661,754	307,719,806

Source -: Sri Lanka Tea Board

**Chart 07 – Tea production in 2017 (Kg.)**



Source -: Sri Lanka Tea Board

Accordingly, 64.7% of Black Tea production in 2017 was contributed by the tea producers in low country. But, for green tea, low country contribution is only 4.1%. Accordingly, low country tea producers have made a remarkable contribution of 64.2% of total tea production. Tables 08, 09 and Chart 07 provide a summary of tea production by up country, central country and low country producers of tea in Sri Lanka

**Table 09 – Total tea production (Kg.)**

	2016	2017
Up Country	64,424,774	64,643,597
Central	44,510,198	45,654,592
Low Country	183,638,644	197,421,617
Total	292,573,586	307,719,806

Accordingly, when compared with 2016, the low country tea production has increased by 7.5%, or 13,782,972 Kg.

The lion symbol which is printed on tea packets are not only a record of the country it was produced in, but also an assurance of the quality of the product. The owner of this symbol is the Sri Lanka Tea Board, which is registered in many countries around the world. Lion symbol can be used subject to the following:

- I. This logo can be used only in Ceylon Tea consumer packages.
- II. Packages should consist of 100% pure Ceylon Tea.
- III. Different brands should be packaged in Sri Lanka when using the lion symbols. Even though the packages are pure Ceylon Tea, overseas importers / packers are not allowed to use this tag.

- IV. The companies that use the lion symbol are required to comply with the standards set by the Sri Lanka Tea Board.

### Sri Lankan Tea with Different Tastes

The tea flavor varies according to the tea tree grown region. This is the special feature of Sri Lankan tea. Accordingly, the variety of flavors in Sri Lanka can be classified as below.



**Black Tea:** Among many tea consumers, black tea is a very popular drink. Black Tea is produced with the tea leaves plucked by the hands of tea plucking women. The leaves are filtered for different grades. In each and every grade can see different color and intensity. Accordingly, different black tea categories can be seen, which are mixed in unique manners. Black tea categories which can be seen in Sri Lanka are English Breakfast, English Afternoon, Irish Breakfast, Earl gray, Lap sang souchong, Spiced Masala, Rose and French Vanilla & Black Tea with Berries.

**Green Tea:** Ceylon Green Tea can be seen with high attractiveness. Examples for Green Tea produced in Sri Lanka are Real leaf green tea, Jasmine green tea, Mint green tea & Lemongrass green tea.

**White Tea:** White tea is an endemic tea in Sri Lanka. Price is of very high value. The tea used to produce white tea is a delicately and carefully harvested tea buds. White tea is a completely handmade product. “White Tea” is also called as “Silver Tea”. White Tea that can be seen in Sri Lanka are Real white tea, Ceylon silver tips, White litchie hand rolled tea, Jade butterfly handmade white tea, etc.

In addition, various flavored teas are currently being added to the export market. Examples are Raspberry tea,

Lemmon flavored tea, Ginger flavored tea, Strawberry flavored tea, Mint flavored tea, Vanilla flavored tea, Cinnamon flavored tea, etc.

### Leading Tea Exporters

- i. Akbar Brothers Pvt. Ltd.
- ii. Jafferjee Brothers Exports Pvt. Ltd.
- iii. George Steuart Teas Pbt. Ltd.
- iv. Empire Teas Pvt. Ltd.
- v. Anverally and Sons Pvt. Ltd.
- vi. Ceylon Tea Services PLC
- vii. Imperial Tea Exports Pvt. Ltd.
- viii. Union Commodities Exports Pvt. Ltd.
- ix. Uniliver Lipton Ceylon Ltd.
- x. Finlays Colombo PLC
- xi. Sunshine Tea Pvt. Ltd.
- xii. Uniworld Teas Pvt. Ltd.
- xiii. Inter Tea Pvt. Ltd.
- xiv. Van Rees Ceylon Ltd.
- xv. Quick Tea Pvt. Ltd.
- xvi. Ranfer Teas Pvt. Ltd.
- xvii. Stassen Exports Pvt. Ltd.
- xviii. Stassen International Pvt. Ltd.
- xix. Heritage Teas Pvt. Ltd.
- xx. Vintage Teas Ceylon Pvt. Ltd.

(Source - Industry Capability Report 2016 - EDB)

### Institutions working in Sri Lankan Tea Industry

- I. Sri Lanka Tea Board (SLTB):- The Sri Lanka Tea Board is responsible for regulatory activities, development activities and promotions regarding tea, and was established in 1976.
- II. Tea Research Institute (TRI):- Tea Research Institute is the premier institution responsible for tea research. The Low-country Regional Center of Tea Research Institution is located in Rathnapura District, Central-country Policy Center in Kandy District, Uva Project Center in Badulla District, and other project centers are located in Galle, Deniyaya, and Kalutara areas.
- III. Tea Small Holdings Development Authority (TSHDA):- The Tea Small Holdings Development Authority is the institution that introduced

to support the small tea-growers in Sri Lanka. The institution was founded in 1975 as a semi-government agency. Private cultivators with less than 50 acre were eligible to receive the assistance of this company.

- IV. Planter's Association of Ceylon (PAC):- Founded in 1854, this institution provides assistance to plantations and private tea growers.
- V. The Colombo Tea Trader Association (CTTA):- This institution was formed in 1894 and consists of tea buyers and sellers. This company manages the Colombo Tea Auction.
- VI. Private Tea Factory Owners Association (PT-FOA):- This association was created in 1982 to start tea plantation with the aim of establishing the ownership of the tea industry.
- VII. Tea Exporter Association (TEA):- This union was created in 1989 with the intention of overcoming the challenges faced by tea exporters.

### Major Challenges face by Sri Lanka's Tea Industry

Due to the privatization of tea cultivation lands and other situations, the tea industry has faced major changes. These kind of structural changes have been challenging the tea industry. Accordingly, training and development has become difficult, and the increase in cost of production and employee wages have also imposed severe challenges. High competitiveness in the international tea market, emergence of new suppliers in the tea export market, emergence of alternative beverages for tea as well as other reasons have created a challenging environment in the tea industry, and also problems with the quality and quantity of tea have also arisen. Accordingly, the 50-year-old tea industry is facing many challenges today.

#### 1. The emergence of new tea-growing countries in the world and the high competitive pressure exerted by other tea producing countries and the sluggish market slip

Countries like China, India, Kenya, Sri Lanka and Indonesia have been invading the tea market for decades, but the emergence of new tea-growing countries in the world has provoked intense competition. Especially countries such as Malaysia, Argentina, Brazil, Uganda and Cuba are imposing a great threat. Russia was the



leading country which exported tea from Sri Lanka in 2014, but at the end of 2017 it has declined to the second position. According to trade statistics for international business development, about 20% decrease in tea demand is observed. Similarly, in 2010 UAE's demand Sri Lanka's tea was very high, but at present, the UAE has reduced its demand by up to 40%. Considering Syria, Sri Lankan tea had a very good demand from Syria in 2011, but due to the tremendous military situation, Syrian demand for tea has now reduced by more than 60%. (Trade Map). The main tea producers are China, India, Sri Lanka, Kenya and Turkey (FAO IGG Secretariat). Please see Table 10 for further information

**Table 10 – Tea Production (In tea ton thousands)**

	2012	2013	2014	2015	2016
World Tea Production	4784.5	5063.9	5,195.0	5285.0	5,945.1
China	1789.8	1924.5	2,095.6	2,278.0	2,414.8
India	1129.0	1200.4	1,207.3	1,208.7	1,252.2
Sri Lanka	328.4	343.1	338.0	328.9	349.3
Kenya	373.1	436.3	445.1	399.2	473.0
Turkey	225.0	227.0	226.8	258.5	243.0

Source - FAO IGG Secretariat

In recent times, in the world production of tea, countries such as China, India, Sri Lanka, Kenya and Turkey are among the leading producing countries, but some countries are gradually losing control of this status. In 2003, 27.4% of the world's tea production was produced by India, 24.6% by China, 9.75% by Sri Lanka, and 9.4% by Kenya. In 2013, surpassing India, China has become the world leader in tea production, producing 38% of world tea production. Sri Lanka's contribution to the world tea production, which stood at 9.75% in 2003, has dropped to 6.77% by 2013 (Source - FAO NEWS Room). Countries such as Vietnam, Cuba, Argentina, Brazil, Peru, Uganda, Bangladesh and Malaysia have developed their tea production at present.

## **2. The degradation of the quality of tea produced in Sri Lanka**

There is a great demand for Sri Lankan tea, especially due to the climatic conditions of the country, soil

fertility, etc. High-standard tea leaves which are needed to produce high-quality tea, receive a high value at the tea auction. However, today's tea conversations regarding the quality of tea in Sri Lanka are not so favorable to the Sri Lankan tea industry.

Especially due to reasons such as not using standard fertilizers, lack of proper maintenance, poor re-cultivation, shortage of workers, acceptance of low-quality tea leaves by factories, lack of updated tea processing activities, re-fermentation of rejected tea, lack of regulatory method, labor shortage, the quality of tea has come down. Similarly, the recent revelations such as mixing tea with sugar, have a strong impact on the export market in the future.

Tea industry in Sri Lanka is facing many challenges due to its intrusion of individuals who engage in activities such as mixing good tea with tea powder, forging labels, dyeing of tea and the use of unsuitable fertilizer for human health, in order to achieve extremely high profits.

## **3. Declining Productivity of the Land**

Decreasing the productivity of tea production has become a complicated issue faced by Sri Lanka today. Sri Lanka's tea industry has a low average productivity compared to the major countries producing tea such as Kenya, India and Indonesia. Reasons such as no repeat cultivations, not replanting adequately enough, not using enough manure and quality fertilizers, banning the use of fertilizers like glycoset, traditional methods of planting, washing away of the soil, and not taking steps to fertilize the soil, high labor costs, insufficient number of employees, lack of technological advancement, high production cost and low profitability, etc., have highly contributed to the declining of productivity.

When comparing with other tea producing countries, the productivity level achieved for the land in Sri Lanka cannot be cared for. However, when comparing small-scale tea growers and large-scale tea growers, there are very significant differences in the productivity of the land. The main reasons for reducing the productivity of the ground is,

- Lack of proper cultivation of land and lack of proper land use pattern

Many lands that are not cultivated in tea-growing areas can be seen. Such a space causes a decline in the density of the tea bushes, which directly affects the productivity of the ground.

#### ii. Weaknesses in re-planting

Maintenance of most tea estates is not satisfactory. It can be done with a great deal of efficiency, but it has to be done with a lot of investment, a shortage of labor, a considerable amount of time for reaping tea, and a reduction in the subsidies on re-cultivation (Amarasooriya, 2012).

Not all spaces are suitable for tea cultivation. However, it can be seen that the growers have used lands that are not suitable for tea cultivation due to the scarcity of recent tea lands. Especially due to the use of highly rocky lands, flooded lands that water is not properly descending, lands with low soil depth, lands with low soil organic layer, it can be seen that the land is not properly used.

#### iii. Poor agricultural practices and moving away from good agricultural practices

The correct and timely use of fertilizer should be done to get better productivity for the soil. Also the tea shrubs should be well maintained. According to the Tea Research Institute's 2010 Annual Report, the quality of the soil has been affected by tea cultivation practices over a hundred years. Shrubs have been weakened and dead due to lack of proper agricultural practices. The excessive use of herbicide has also helped reduce the productivity of tea lands.

If replanting, it should be done after a proper land preparation. However, it is well known that these lands are directly replanted without proper land preparation. Especially small tea estate owners follow such methods. Without proper land preparation, the old soil is saved in the land and fungal diseases can be easily spread to the new plantations. It also strongly affects the growth of the roots of the new plants.

#### iv. Usage of poor nursery plants

The use of poor nursery plants that are substandard has led to a reduction in the productivity of the land. Most of

these plants are ground plants and they are weak. Also, these plants can be seen full of pests and defects. These plants cannot successfully face the rough conditions that arise after planting on the field, and conditions such as decay may arise. Also, not using proper shelter for the nurseries has contributed to the reduction in quality.

Productivity can be weakened by not using correct austerity measures. In order to increase the harvest, tea growers cut the tea tree very closely. But it shouldn't be done that way. Therefore it is possible to lose a lot of tea shrubs. Similarly, the lack of caution in pruning also contributes to reduced productivity. The fact that most people do not know is that the decayed parts, pest affected parts of the plant should be carefully studied and purified when the cuts are done. If these conditions are let to be developed, one day they will be developed to a state that cannot be cleaned.

### 4. Lack of labor productivity

Lack of labor productivity is a threat to the tea cultivation as well as the lack of productivity of the land. Sri Lanka's labor productivity is not satisfactory in comparison with labor productivity in other tea-growing countries.

Smaller growers can be seen as more labor-productive when comparing with regional plantation companies. Small tea cultivators often rent the labor and pay for the weight of picked tea leaves. But this is not the case with the regional plantation companies. Some plantations may have redundant labor. And no technique is used to measure the productivity of labor. The trade unions are very powerful in these estates and the labor productivity has been reduced also due to their day-to-day activities.



## 5. Less use of technological methods

Although Sri Lanka has inherited tea production for over 160 years, the technology used in tea production has changed little. Most of the factories are in production while using outdated machines. Modern machines are slowly approaching the market, and farmers are also reluctant to accept them. Especially the tools used for killing, grinding, drying and chopping are still traditional tools.

## 6. High production cost

The above conditions directly affect the cost of production. Similarly, situations such as the rise in fuel prices, higher paycheck, higher cost of restoration of machinery, have affected the cost of production. Sri Lanka is in the number one regarding costs in compared to other tea producing countries, as shown by the Department of Census and Statistics.

Due to the increase of production cost, it will be very difficult for Sri Lanka to successfully face the cold competition which has arisen in the world tea market. And in spite of the loss of profits, the growers in the industry are discouraged and discourages new investors entering the industry.

## 7. Labor Shortages

Another important challenge faced by tea growers is labor shortages. A very large labor input is required for the tea industry. The increase in cost of living, lower salaries in the industry, poor recognition regarding the profession, particularly women employed in the industry are looking for other jobs, employment in foreign countries, and the new generation are seeking new avenues, have mainly affected the labor shortage. In the past, if a person was working in a tea factory, most of his family were engaged in the factory-related jobs. Also, the children in that family select factory-related jobs. But today, the situation has changed.

## 8. Environmental Factors

Similarly, landslides, floods, insufficient rainfall, and natural hazards can cause serious harm to the tea plantations. Today, there is an increase in such hazards. Factors such as increase in temperature can also be challenging to tea plantation.

## 9. Value Additions

There is a lack of systematic program to add value to tea and this can pose a threat to future tea demand.

## 10. Changing Conditions

Changing consumer preferences, health and environmental conditions are becoming increasingly difficult for the tea industry.

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Authors' note: all pictures used in this article are for illustrative purposes only and were obtained from a Google search on Sri Lankan tea industry

# Introduction of New Financial Market Infrastructures to Promote the Government Securities Market

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## 1. Overview

Financial Market Infrastructures (FMIs) are key components of the financial system, delivering services critical to the smooth functioning of modern financial markets. Well-designed and reliable FMIs are a source of both financial stability and operational efficiency. FMIs also act as a coordinating device, bringing a network of counterparties together to support trading liquidity and the netting of exposures and settlement obligations. FMIs establish secure arrangements for the timely clearing and settlement of obligations between counterparties; assist institutions in the management of counterparty credit risks; and help to coordinate actions in the event of a market participant's default. In this light, the Central Bank of Sri Lanka (CBSL) has taken the initiative to establish a state-of-the-art FMI and the enabling legal and regulatory framework in Sri Lanka, based on international standards and best practices to promote the domestic market activities in Government Securities. Accordingly, with a view to enhance the efficiency, effectiveness and transparency as well as to develop the government securities market, the CBSL has initiated several measures to develop the Government Securities Market. To deepen and broaden the secondary market

for government securities, preliminary measures have been taken to establish a distinct Electronic Trading Platform (ETP), a Central Counterparty (CCP) arrangement for government securities and an upgraded Central Securities Depository (CSD) along with required legal reforms. Further, this will establish a mechanism to disseminate information on debt instruments in the secondary market with a view to enhance transparency and reduce asymmetrical information risk. It is expected that these FMIs will facilitate transparent and efficient primary and secondary market operations in government securities transactions, which is vital for the development of government securities market and modernization of the public debt management lowering the borrowing cost of the Government.

## 2. Role of Central Bank of Sri Lanka in Financial Market Development

CBSL has always been in the forefront of upgrading the environment that support the continued expansion of the financial system. Accordingly, CBSL constantly introduces international standards and best practices into the FMIs facilitating resilience of the financial system. In order to further develop the Government Securities Market, minimise any risks in settlement, increase liquidity, comply with



international standards and best practices and attract foreign investors, CBSL as the Fiscal Agent of the Government and the Regulator of the Government securities market explored the possibility of implementing modern FMIs such as electronic trading (e-trading) and central counterparty clearing (CCP clearing) to work in tandem with the existing payment and settlement systems. These measures are expected to promote the Government Securities Secondary Market activities by eliminating most of its existing limitations.

### **3. Existing Limitations in the Government Securities Secondary Market Activities**

There are several limitations identified in the existing Government Securities Secondary Market activities requiring improvements. A few of the main limitations identified in the current Government Securities Secondary Market activities are summarized below.

#### **(a) Dealing conducted using Telephones**

- i. lack of price transparency
- ii. difficulty in regulation
- iii. less competition
- iv. tendency to price fixing
- v. possibility of high spreads and lack of protection of investor interest

#### **(b) Dealing only with counterparties known to each other**

- i. dealing only with certain counter parties
- ii. counterparty limits
- iii. lack of liquidity, less demand for Government Securities, leading to high borrowing costs for GOSL

#### **(c) Gross settlement**

- i. needs large amounts of liquidity in terms of funds and securities

- ii. possibility of transactions getting queued and unsettled towards the end of day creating risk of settlement failure (replacement risk and cost)
- iii. Risk management, if any, at individual participant level

### **4. Proposed Infrastructure Improvements for Government Securities Market to Mitigate Limitations**

Setting up of the essential IT infrastructure, including an ETP and a CCP, facilitating transparent and efficient primary and secondary market operations in government securities transactions are aimed at mitigating and eliminating the limitations identified in the Government Securities Secondary Market activities.

#### **(a) The Current IT System for Government Securities**

The current financial market infrastructure, issuance, trading and settlement mechanisms of government securities are summarized as follows:

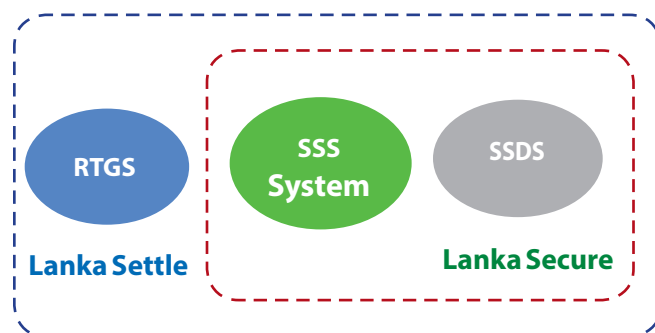
- i. CBSL owns and operates a RTGS to facilitate for the settlement of financial transactions in local currency (LKR). Authorised banks, PDs and other entities are allowed to maintain LKR settlement accounts with CBSL for settlement of funds. Market participants interface with the RTGS via the SWIFT messaging network using the FIN-Copy service.
- ii. RTGS facilitates the settlement of the funds in LKR and expects to enable multicurrency settlement in the near future. Currently Licensed Commercial Banks (LCBs), PDs, the CSE and the Employees' Provident Fund (EPF) maintain rupee settlement accounts with CBSL for this purpose. Above, participants interact with the RTGS via the SWIFT messaging network using the

- FIN-copy service, and the external systems submit batch files to the RTGS system with settlement instructions. The RTGS system can be configured to communicate via WebSphere MQ messaging interface.
- iii. CBSL also owns and operates a SSS System and CSD for government securities to facilitate settlement of government securities transaction. CSD holds government security title ownership of individual investors.
  - iv. Government securities are issued in scripless form. Majority of such securities are traded over-the-counter (OTC) in the secondary market. Settlement of these transactions is facilitated by the SSS System on a delivery versus payment mechanism on real-time gross basis (DVP1) in collaboration with RTGS. CSD records ownership transfers resulting from above transactions.
  - v. Other financial market transactions, including the domestic foreign exchange market transactions are conducted OTC and settlement of rupee leg of these transactions are facilitated by RTGS.
  - vi. SSS System, which facilitates settlement of government securities and recording of securities ownership in the CSD and RTGS to settle funds movement between participants. An online primary auction system is in operation for the primary issuance with the relevant IT infrastructure that was setup in 2003 and 2004 for RTGS and SSS System, respectively.
  - vii. However, the secondary market is an OTC market where securities transactions and ownership changes in the CSD are completely handled by PDs and LCBs.
  - viii. A graphical presentation of current IT System for Government Securities is depicted in Diagram 1.

The current secondary market process lacks transparency and price discovery and, therefore, development of the government securities market has been considerably lagged and therefore, new proposals were made by CBSL to develop the Government Securities Market.

## The Current IT System for Government Securities – Graphical Presentation

**Diagram 1**



Abbreviations	Description
RTGS	Real Time Gross Settlement system
SSSS	Scripless Securities Settlement System
SSDS	Scripless Securities Depository System
LankaSecure	Comprise of SSSS and SSDS
LankaSettle	Comprise of LankaSecure and RTGS

## (b) Proposed IT System Development for Government Securities Market

The proposed system has multifaceted objectives which include deepening and widening of the activities of the domestic financial market to facilitate efficient price discovery and enhanced efficiency through properly managed settlement and counterparty risks and greater investor protection to ensure financial system stability.

## (c) Objectives of the Proposed IT System

The proposed IT System development is expected to; deepen the government securities market, improve

price transparency and discovery, avail of an early warning system to mitigate any systemic risk, avoid/reduce the risk of adverse price movements, prevent any form of price fixing, if any, through continuous reporting/monitoring of all transactions, reduce liquidity requirements through net settlement of securities and cash via Model 3 of Delivery versus Payment (DVP 3), facilitate legally robust electronic collateralization, and comply with Principles for Financial Market Infrastructure (PFMI) as recommended by the International Organization of Securities Commissions (IOSCO) and the Committee on Payment and Settlement Systems (CPSS), and Remove counterparty and settlement risk (guarantee settlement and eliminate counterparty risk with legal certainty).

The proposed system includes;

- a. Provision of an ETP linked to SSS System for settlement of securities and funds on Delivery versus Payment Model 2 (DVP 2) Basis (gross basis for securities and net basis for funds) and T+0 or the settlement date agreed by dealers.
- b. Setting up of a CCP solution where both securities and funds will be settled on net basis (DVP 3 Basis). The settlement of both securities and funds will be guaranteed by the CCP.
- c. An upgraded CSD system to facilitate electronic trading and straight-through processing (STP) of transactions in domestic financial market.

A detailed description of the proposed systems of ETP and CCP is given in Section (d) to (f) below.

#### **(d) Electronic Trading Platform (ETP)**

- i. e-trading is a method of trading securities, foreign exchange or financial derivatives electronically. e-trading uses information and communications technology to bring together buyers and sellers (market participants) through an electronic trading platform and communication networks to create a virtual market place.

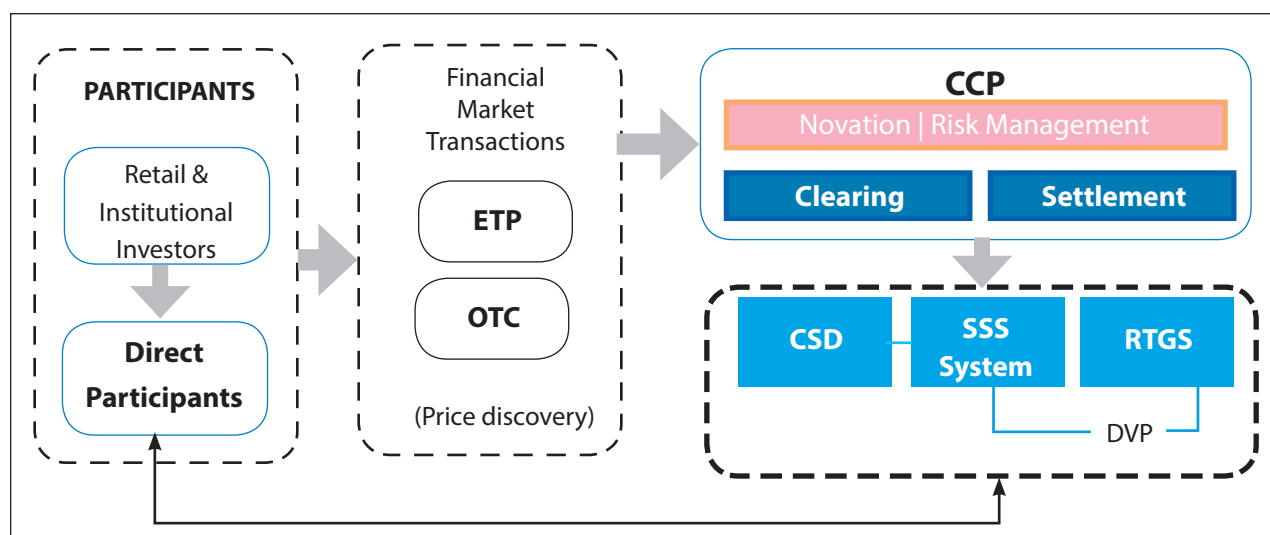
- ii. e-trading platform provides the market participants with facilities such as pre-trade price discovery; trade matching; post-trade data dissemination; automated real-time reporting to the regulator; straight through processing (for streamlining, price negotiations, trade entry, clearing and settlement); and integrated analytical tools to manage risk involved in trading.

#### **(e) Central Counterparty (CCP) Clearing**

- i. A CCP is an entity that provides an assurance to both parties in a transaction that if either party defaults discharging of its obligations, CCP would fulfil the obligations to the remaining party as agreed at the time of the transaction.
- ii. CCP serves two main functions; firstly, centralization and mitigation of counterparty risk and secondly, the improvement of operational efficiency in post-trade processes.
- iii. CCP acts as the seller to every buyer and the buyer to every seller (Novation).
- iv. CCP reduces systemic risk by eliminating the potential for contagion in the event of default by an institution by isolating the defaulting member's exposure to a single position with the CCP, against which the CCP holds margin collateral and the defaulting member's guarantee fund contribution.
- v. CCP facilitates preserving of anonymity of the trading parties through a safe and controlled post trade settlement process.
- vi. CCP also helps to increase liquidity in the market through facilitation of multilateral netting of individual obligations.
- vii. A graphical presentation of combined system of ETP and CCP is depicted below in Section (f), Diagram 2.

## (f) Combined Infrastructure Framework with ETP and CCP

**Diagram 2**



The introduction of ETP, CCP and upgrading of CSD with enabling legal and regulatory framework are the CBSL's prioritised goals in financial market development with special emphasis on Government Securities Market. This effort would support Sri Lankan Financial Market with State-of -the Art ETP, CCP and a CSD system, to facilitate electronic trading and straight-through processing (STP) of transactions in the domestic financial market based on international standards and best practices. Therefore, the proposed new IT system is expected to mitigate and eliminate the limitations identified in the Government Securities Secondary Market activities.

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3. Expression of Interest on Establishment of an Electronic Platform and a Bond Clearinghouse to facilitate trading and central counterparty clearing and settlement of Government Securities (2017)
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# Participation of Non-Banks in Retail Payment System

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Involvement of the non-banks in retail payment industry has expanded in recent years. The Committee on Payments and Market Infrastructures (CPMI) of Bank for International Settlements (BIS) has compiled a report on “Non-banks in Retail Payments”, based on the analytical study done by Working Group on Non-banks in Retail Payments of CPMI<sup>1</sup>. The aim of the report is to highlight the increasing involvement of non-banks in Retail Payment System (RPS) and its’ potential consequences for Central Banks in terms of efficiency concerns and risk management. The CPMI report covered important areas of the retail payments industry, such as dimensions of non-banks’ participation in retail payment services, drivers of non-bank activity in retail payment industry, consequences of non-banks for efficiency, risk and implications for central banks.

The Working Group of CPMI, has defined non-banks as “entities involved in the provision of retail payment services whose main business is not related to taking deposits from the public and using these deposits to make loans” (CPMI, 2014)” and the study considered entire activities of RPS with commonly used retail payment instruments such as credit and debit cards, credit transfers, direct debits, cheques, e-money products and remittances.

## **The stages of non-banks’ participation in the payment channel of Retail Payment System**

**Stage 1: Pre-transaction;** Contains initial process needed for accepting customer payments that consists of customer acquisition (for example, enrolment of front-end customers), provisions of actual payment instruments, hardware, software and network infrastructures such as Automated Teller Machines (ATM), Point of Sale (POS) terminals etc. and provision for technological arrangements related to customer security such as, online transaction security systems and digital signature services.

**Stage 2: Authorization stage;** Process related to authorization and approval of a payment. It includes services such as connectivity among networks, fraud and risk management services to customers and issuers of payment instrument (for example, verification and other identity authentication services) and compliance services.

**Stage 3: Clearing stage;** Includes activities that enable the submission of claims by members of the payment system (i.e. payers and payees), related calculations and dissemination of related information to both parties to settle the transactions.

**Stage 4: Settlement stage;** Involves the activities related to executing final payments between payers and payees and reversals of transactions, where necessary.

**Stage 5: Post-transaction stage;** Contains work related to the provision of value-added services such as generation of statements, reconciliation, dispute resolution and reporting in the stage of post settlement.

## **Type of services furnished by non-banks in Retail Payment System**

**Front-end providers:** Non-banks that provide an interface between end users of payment services (payers and/or payees) and clearing and settlement process. Their services are mostly related to the stages of pre-transaction, initiation, and post-transaction stages of a payment. In certain instances, front-end providers may compete with banks. However, in the process of clearing and settlement of transactions, they collaborate with banks. Providers of mobile wallets, internet payment gateway providers, credit card acquirers or payment institutions and e-money service providers are some examples of front-end providers.

**Back-end providers:** Non-banks that provide back-end services to banks, related to several payment instruments, such as technological support i.e. information technology (IT) services, data base management and audit or compliance services via outsourcing or cooperative arrangements. A direct

1. Committee on Payments and Market Infrastructures (2014): Non-banks in Retail Payments, September.

relationship with payers or payees are not maintained by them aiming at one or two phases of the payment chain.

**Operators of retail payment infrastructure:** Non-banks that provide back-end clearing and settlement services, cooperating with banks and other payment service providers in relation to different payment services. For example, provide network services such as Visa, or MasterCard. Further, those non-banks are focused on back-end clearing and settlement services only.

**End-to-end providers:** This contains the combination of the aforementioned services provided by non-banks. Payers and payees have a direct relationship with end-to-end providers generally, maintaining an account with them (e.g. providers of certain e-money products, such as PayPal, operators of remittance services). Further, to provide services such as remittances services, end-to-end providers may also use other non-banks and banks as agents to offer cash-out and cash-in services as the provision of such services.

#### **Drivers of non-bank activity in retail payments**

Assigning provision of duties to some outside third-party service provider can be identified as outsourcing. Enhancement of innovative Information Technology (IT), increasing competition and cost minimization have led to encourage outsourcing of back-end services by banks to non-banks. Non-bank entities have been able to gain economies of scale and scope by engaging in activities related to retail payment services with the specialization of providing more IT related back-end payment services (CPMI, 2014).

Further, changing consumer appetite towards speedy and convenient financial infrastructures consisted of different payment instruments, moving paper to electronic payment modes and increasing real time online payments have led to uplift the involvement of non-banks in the retail payments industry (CPMI, 2014).

Increased regulatory developments of non-banks enhanced consumer confidence on the services provided by non-banks. Sometimes, lower regulatory pressure on non-banks than banks may help enhance involvement of non-banks in the retail payment industry, especially, in providing cross boarder payment services. For example, non-bank players such as Western Union

and MoneyGram are operating in the migrant worker remittances markets of many countries under the existing regulatory framework (CPMI, 2014).

#### **Implications of non-banks for efficiency and risk**

**Efficiency:** Non-banks can gain economies of scale through specialization of payment services mainly due to outsourcing of back-end services by banks. Accordingly, non-banks can provide their services in retail payment industry at the lowest possible cost driven through specialization and use of innovative technology. In addition, competition among non-banks and between non-banks and banks have also lead to the discovering of wide array of new innovative payment instruments with different convenience options at a comparably low cost, resulting in higher efficiencies in retail payments. Efficiency can be improved through cooperation between banks and non-banks when providing payment services such as mobile payments, online payments, card based payments etc. However, the possibility of reducing efficiency of non-banks are high when back-end services are concentrated around one or a few non-bank entities.

**Risk:** Several risk factors are associated with the involvement of non-banks in the retail payment industry, mainly based on the type of non-banks and their services. Operational risks can occur due to concentration issues from outsourcing. For example, if one non-bank entity provides technological support for most of the banks, failure of such non-bank could generate operational risks in the entire market. Further, complexity of transactions may contribute to legal uncertainty that could caused to legal risk.

#### **Issues for Central Banks**

The CPMI report identifies following issues in relation to involvement of non-banks in retail payment industry.

**Concentration issues:** Failure of one or a few non-banks which are providing specialized back-end services mainly due to outsourcing process may create risks in entire market. Further, this issue may not be seen directly by the regulators with the existing limitations of regulatory framework for non-banks.

**Outsourcing issues:** Although activities of non-banks lead to enhanced efficiency of the payment system, if responsibilities between outsourcing entities and the non-banks are not clearly defined, regulatory and supervisory issues can occur. Moreover, cross-

border outsourcing makes regulatory and supervisory functions more complicated unless the responsibilities across different jurisdictions and authorities are clearly defined. Further, if one or a few non-banks dominate the market, the resulting monopolistic power may cause market frictions.

**Operational complexity issues:** Enabling more players and layers in the payment process may have operational, security and regulatory implications.

**Consumer protection issues:** Issues on privacy and security of consumer data and funds may arise as non-banks use the consumer data and ownership when they provide services. Further, end-to-end service providers may hold positive account balances for end users and if such non-banks fail to comply with appropriate capital and liquidity requirements, end users would be unable to access their funds.

**Level playing field issues:** Regulatory bodies have to face challenges on adequacy and applicability of regulatory framework, policy direction, supervisory procedures and market self-regulations in relation to non-banks' activities in the retail payments industry.

Further, with the development of the new technology, services of non-banks may be widespread throughout cross borders that contains different jurisdictions. Therefore, appropriate regulatory and supervisory frameworks need to be established to cater to such developments as well.

**Stakeholder involvement:** New players may enter into the market with different products resulting in a high degree of fragmentation. As a result, the existing industry agreements, standards and other arrangements may not be adequate to address such non-banks' involvement which may pose a challenge to authorities in formulating new regulations and standards.

### Recent Regulatory Measures for Retail Payment System in Sri Lanka

Central Bank of Sri Lanka (CBSL) has taken several measures to regulate and supervise non-bank entities who are participating in retail payments industry in Sri Lanka. Currently, CBSL has issued licenses for 14 non-bank institutions to carry out operations in retail payments. They are providing various types of services as shown in Table 1.

**Table 1**  
**Services Provided by Non-Bank Institutions in Retail Payment System in Sri Lanka**

Non- Bank Institution	Classes of Business						
	Issuer of Payment Cards						
	Debit Card	Credit Card	Stored Value Card	Charge Card			
<b>Finance Companies</b>	11	3	-	-	-	-	-
Central Finance Co PLC	√						
Citizens Development Business Finance PLC	√	√					
Commercial Leasing & Finance PLC	√						
L B Finance PLC	√						
LOLC Finance PLC	√	√					
Melsta Regal Finance Ltd	√						
People's Leasing & Finance PLC	√						
Senkadagala Finance PLC	√						
Singer Finance (Lanka) PLC	√	√					
The Finance Co PLC	√						
TKS Finance Ltd	√						
<b>Non-Finance Institutions</b>	-	-	1	-	1	-	2
Global Payments Asia - Pacific Lanka (Private) Limited					√		
Dialog Axiata PLC			√				√
Mobitel (Pvt) Ltd							√

Source: Central Bank of Sri Lanka, Payments Bulletin, 2018 (Fourth Quarter)

Although, banks are dominant in retail payment industry in Sri Lanka, non-banks provide a wide array of financial services such as, payment cards (debit cards, credit cards and stored value cards). They also operate customer account based mobile payment system and mobile phone based e-money systems. Presently, two non-bank entities provide mobile phone based e-money services, reflecting keen participation of non-banks in innovative products that suit the modern consumer requirements. Further, most of the non-banks which are currently operating in retail payments industry are issuing debit cards which could reduce cash based payments. Recently, CBSL has granted approval for a non-bank institution to use their own mobile payment app for processing their internal customer transactions.

CBSL has taken several policy measures by issuing Regulations, Directions and Guidelines, related to retail payment services in order to maintain financial system stability through mitigating possible risk concerns while guaranteeing safety of consumer data and funds. Accordingly, “Mobile Payments Guidelines No.1 of 2011 and No. 2 of 2011 respectively, for “Bank-led Mobile Payment Services” and Custodian Account Based Mobile Payment Services”, were issued by CBSL aiming to facilitate the development of emerging electronic payment mechanisms while promoting security, efficiency and trustworthiness of such mechanisms, and to provide guidance through establishing sound regulatory framework for innovative payment systems. Considering the possible implications of the involvement of non-banks in retail payment services in Sri Lanka, the Guideline No. 1 of 2018 on “Minimum Compliance Standards for Payment related Mobile Applications” was issued by CBSL with a view to establish secured, trusted and sound payment related mobile application eco system. Further, Payments and

Settlement Systems Circular No. 06 of 2018 on “The Establishment of a National Quick Response (QR) Code Standard for Local Currency Payments” was also issued by CBSL, in order to promote security, customer convenience and ensure interoperability of diverse payment instruments and mechanisms. Financial institutions will be able to provide access to low-cost and safe digital payments to customers and merchants, via adopting a standardized QR code to initiate payments. Accordingly, CBSL has taken various regulatory measures to ensure secured and smooth functioning of retail payments industry in Sri Lanka with the state-of-the-art, consumer convenient technological developments.

As the CBSL paves the way for a “less cash” society in Sri Lanka, not only the banking sector, but also the non-bank financial institutions would need to improve their digital payment platform. Therefore, consumer convenient and modernized payment instruments that are embraced with new technology need to be adopted by non-bank financial institutions to onboard new customers without being isolated and losing their business process in the prevailing dynamic retail payment industry. Accordingly, considering the current consumer appetite for innovative and convenient way of payment landscapes and expecting to journey towards a less cash society, CBSL has encouraged non-bank institutions to use modern retail payment instruments, while adhering to the regulatory guidance provided by CBSL.

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## REVIEWER ACKNOWLEDGEMENT

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