

# Financial System Stability Review 2009



Central Bank of Sri Lanka

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# Financial System Stability Review 2009

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**Central Bank of Sri Lanka**

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# Financial System Stability Review 2009

The Financial System Stability Review 2009 was produced by the Financial System Stability Department under the guidance of the Financial System Stability Committee chaired by the Deputy Governor in charge of Financial System Stability with contributions from the Bank Supervision Department, Supervision of Non-Bank Financial Institutions Department, Economic Research Department, Payments and Settlements Department, Public Debt Department, Domestic Operations Department and the International Operations Department.

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# Introduction

**Financial system stability** can be described as the ability of the financial system to perform its key functions of mobilizing savings and allocating them to productive investments, managing risks and settling payments, effectively, including in the event of shocks and stressful circumstances.

The stability of the financial system depends largely on the resilience of the principal components of the financial system – the financial institutions, financial markets and infrastructure, individually and collectively to absorb any adverse systemic disturbances.

The financial system in Sri Lanka comprises the major **financial institutions** namely, licensed commercial banks, licensed specialised banks, registered finance companies, specialised leasing companies, primary dealers, the Employees' Provident Fund, the Employees' Trust Fund, private pension/provident funds, insurance companies, unit trusts, stock brokers/dealers and market intermediaries and **financial markets** such as the money market, bond market, foreign exchange market and the equity market and **financial infrastructure** consisting of the payments and settlement systems and the legal framework. The financial system is dominated by the Licensed Banks which account for about two thirds of the total assets of the financial system.

Sri Lanka has a multiple regulator system. The Central Bank of Sri Lanka regulates and supervises the banks, finance companies, leasing companies and primary dealers, while the Securities and Exchange Commission of Sri Lanka is responsible for supervising the stock exchange, stock-broking and dealing firms, unit trust management companies, investment managers, margin providers and credit rating agencies. The Insurance Board of Sri Lanka supervises insurance companies and brokers. There is also a large number of micro-finance institutions that are at present not supervised but will come under the purview of the proposed Micro Finance Institutions Act. The Central Bank is also responsible for the regulation of the payment, clearing and settlement systems.

As part of its mandate of maintaining financial system stability, the Central Bank of Sri Lanka conducts surveillance of the financial system to identify risks and vulnerabilities and to assess its capacity to cope with disturbances and shocks. The results are presented in the Financial System Stability Review (FSSR), which is published annually. The purpose of the FSSR is to provide information to financial institutions, market participants and the wider public to prepare for and to manage these risks, as well as to encourage awareness and debate on issues affecting financial system stability.

**FSSR 2009** is based on the performance of the financial sector during the first nine months of 2009 and is divided into six chapters. **Chapter 1** presents the overall assessment of financial stability, the potential risks and vulnerabilities that may arise in the future and the risk mitigating measures that should be implemented to address these risks. **Chapter 2** discusses the global and domestic macroeconomic developments and risks. **Chapter 3** deals with the recent developments in domestic financial markets. **Chapter 4** covers the performance of the banking sector, while **Chapter 5** deals with the developments in other financial institutions. **Chapter 6** provides an overview of the financial infrastructure, particularly the main payment and settlement systems and any changes in the legal framework relating to the financial sector.

Table A

Total Assets and Deposit Liabilities of the Main Institutions in the Financial System – June 2009<sup>(a)</sup>

Financial Institution	Assets		Deposits	
	Rs. bn.	Share (%)	Rs. bn.	Share(%)
<b>Central Bank of Sri Lanka (CBSL)</b>	<b>577.2</b>	<b>11.4</b>	<b>n.a.</b>	<b>n.a.</b>
<b>Institutions Regulated by the CBSL</b>	<b>3,935.0</b>	<b>77.9</b>	<b>2,152.3</b>	<b>95.5</b>
Deposit Taking Institutions	3,021.0	59.8	2,152.3	95.5
Licensed Commercial Banks	2,375.1	47.0	1,704.7	75.6
Licensed Specialised Banks	469.0	9.3	342.4	15.2
Registered Finance Companies	176.9	3.5	105.2	4.7
Other Financial Institutions	914.0	18.1	n.a.	n.a.
Employees' Provident Fund (b)	710.4	14.1	n.a.	n.a.
Primary Dealers	96.7	1.9	n.a.	n.a.
Specialised Leasing Companies	106.9	2.1	n.a.	n.a.
<b>Institutions Not Regulated by the CBSL</b>	<b>540.8</b>	<b>10.7</b>	<b>102.5</b>	<b>4.5</b>
Deposit Taking Institutions	122.6	2.4	102.5	4.5
Rural Banks	117.4	2.3	98.7	4.4
Thrift and Credit Co-operative Societies	5.2	0.1	3.7	0.2
Contractual Savings Institutions	384.3	7.6	n.a.	n.a.
Employees' Trust Fund	99.5	2.0	n.a.	n.a.
Private Provident Funds	97.1	1.9	n.a.	n.a.
Insurance Companies	166.2	3.3	n.a.	n.a.
Public Service Provident Fund	21.6	0.4	n.a.	n.a.
Other Financial Institutions	33.9	0.7	n.a.	n.a.
Venture Capital Companies	1.1	0.0	n.a.	n.a.
Unit Trusts	7.9	0.2	n.a.	n.a.
Stock Broking Companies	4.8	0.1	n.a.	n.a.
Credit Rating Agencies	0.2	0.0	n.a.	n.a.
Other	19.9	0.4	n.a.	n.a.
<b>Total Assets</b>	<b>5,053.0</b>	<b>100.0</b>	<b>2,254.8</b>	<b>100.0</b>

(a) Provisional

(b) Managed by the Central Bank

n.a. – Not applicable

Source : Central Bank of Sri Lanka

# 1. Overall Assessment of Financial System Stability

## Overview

**Sri Lanka's financial system remained resilient weathering the domestic economic slowdown caused by the global financial crisis and recession, and amidst stresses due to the failure of some entities engaged in unauthorized finance business.** Domestic financial markets which were somewhat volatile at the beginning of the year became more liquid and stable in the second half of 2009 with the declining inflationary pressures and the easing of monetary policy, resumption of capital inflows due to reduced risk aversion and improved investor sentiment following the end of the hostilities. Although the impact of the current global economic downturn and the decline in world trade exerted some pressure on the asset quality of banking institutions, stronger capital positions and enhanced risk management infrastructures that had been instituted have placed the financial sector on a stronger footing to absorb the impact of the economic slowdown.

**The domestic banking institutions maintained their soundness with adequate levels of earnings and improved risk management systems within a strong regulatory framework.** The Central Bank took immediate and decisive measures to rescue a systemically important bank which experienced deposit withdrawals due to the failure of an unregulated credit card company in a large financial conglomerate to which it was affiliated. The bank was successfully recapitalized and is conducting normal business operations. The finance and leasing company sector is beginning to rebound from the stresses experienced due to the failure of some entities which engaged in unauthorized finance business. The Central Bank and the Ministry of Finance intervened to assist the distressed companies and to rebuild confidence in the sector. The insurance sector remains stable with companies complying with solvency margin requirement. The systemically important payment and settlement systems operated with a high degree of availability and safety, with progress being made to regulate electronic payment instruments and to modernize the retail payment system.

**The outlook for financial system stability is positive in view of the more favourable macroeconomic developments.** Economic growth is forecast to move upwards with renewed investor confidence following the cessation of hostilities and the reintegration of the Northern and Eastern Provinces into the national economy and the reconstruction of the conflict affected areas. The recovery of the global economy and the decline in domestic inflationary pressures and interest rates will improve the prospects of the business sector and expand opportunities for financial institutions. Nevertheless, it is important that financial institutions practice good corporate governance and prudent risk management to improve their soundness and resilience.

## Global Developments

**After a year of deep recession in major advanced economies, the global economy is now rebounding and conditions in international financial markets have improved markedly.** The global economy is estimated to contract by about 1 per cent in 2009, with output in the advanced economies *i.e.*, US, Euro area, UK and Japan likely to shrink between 2.5 and 5.5 per cent. Growth in China and India is expected to hold up at 8.5 per cent and 5.5 per cent respectively. World trade is also forecast to decline by around 12 per cent in 2009. However, the wide-ranging public intervention policies by central banks including large interest rate cuts and liquidity injections and by governments such as major fiscal stimulus programmes, as well as capital injections and guarantees to banks, in advanced and emerging economies have resuscitated global financial markets and the economic activity. Equity markets worldwide have made substantial gains and corporate risk spreads have declined considerably. While spreads in interbank markets have fallen to levels close to those prevailing before September 2008 and securitization markets remain heavily impaired. Capital flows, particularly portfolio flows to emerging economies have restarted and there have been a number of sovereign issues by emerging and developing economies. According to the latest estimates by the International Monetary Fund (IMF), the global economy is forecast to grow by about 3 per cent in 2010 and average about 4 per cent growth in the next three years. The prospects for world trade are also improving and it is expected that international trade will increase by about 3 per cent next year.

## Domestic Macroeconomic Developments

**The growth momentum in the domestic economy is expected to pick-up in the second half of 2009.** Economic growth in Sri Lanka slowed down to 1.8 per cent in the first half of 2009 compared with 6.6 per cent in the first half of 2008, primarily due to the negative impact of the global recession on the external trade sector, with exports and imports contracting by 18 per cent and 35 per cent respectively. The financial services sub-sector moderated to 4.5 per cent in the first half of 2009 compared with 6.8 per cent in the same period last year. A positive sign is that the growth momentum is beginning to pick up, as indicated by the second quarter data. Several factors are contributing towards creating a conducive environment for the expansion of economic activities and improving investor confidence, such as the global recovery which will stimulate the growth of the export sector, the implementation of reconstruction and development programmes in the two provinces that affected by the conflict, the deceleration in inflation and the decline in interest rates. Consequently, the domestic economy is forecast to grow by 3.5 per cent in 2009 and a higher growth trajectory is expected for 2010, which augurs well for the outlook of the financial services industry and financial system stability.

**Inflation is expected to be contained at single digit levels this year and the next.** The rate of inflation measured by the point to point change in the Colombo Consumers Price Index (CCPI) declined rapidly during the year from 14.4 per cent in December 2008 to 0.7 per cent in September 2009. The reduction in inflationary pressures is a consequence of the monetary policy measures taken by the Central Bank, the decline in

Table 1.1 – Major Monetary Policy Changes in 2009

12-Jan-09	<ul style="list-style-type: none"> <li>Penal rate on Reverse repo was reduced by 200 basis points to 17.00 per cent.</li> </ul>
11-Feb-09	<ul style="list-style-type: none"> <li>Policy rates reduced by 25 basis points, Repo rate to 10.25 per cent and Reverse repo rate to 11.75 per cent.</li> </ul>
	<ul style="list-style-type: none"> <li>Penal rate on Reverse repo was reduced by 50 basis points to 16.50 per cent.</li> </ul>
24-Feb-09	<ul style="list-style-type: none"> <li>SRR reduced by 75 basis points to 7.00 per cent effect from 27 February 2009. Rs. 9.0 bn. was released.</li> </ul>
18-Mar-09	<ul style="list-style-type: none"> <li>Penal rate on Reverse repo was reduced by 175 basis points to 14.75 per cent.</li> </ul>
	<ul style="list-style-type: none"> <li>Margin deposit requirement on vehicle imports reduced from 200 per cent to 100 per cent.</li> </ul>
	<ul style="list-style-type: none"> <li>Margin deposit requirement on selected non-essential goods removed (by 100 per cent).</li> </ul>
8-Apr-09	<ul style="list-style-type: none"> <li>100% margin deposit requirement imposed on importation of motor vehicle on 22 Oct. 2004 was removed.</li> </ul>
22-Apr-09	<ul style="list-style-type: none"> <li>Repo rate reduced to 125 basis points to 9.00 per cent.</li> </ul>
	<ul style="list-style-type: none"> <li>Penal rate on Reverse repo was reduced by 175 basis points to 13.00 per cent.</li> </ul>
21-May-09	<ul style="list-style-type: none"> <li>Penal rate on Reverse repo was removed.</li> </ul>
	<ul style="list-style-type: none"> <li>Reverse Repo Rate reduced by 25 basis points to 11.50 per cent.</li> </ul>
	<ul style="list-style-type: none"> <li>Restriction on access to Reverse repo facility was removed.</li> </ul>
	<ul style="list-style-type: none"> <li>Restriction on placing funds with CBSL under Repo standing facility was removed.</li> </ul>
16-Jun-09	<ul style="list-style-type: none"> <li>Repo Rate reduced by 50 basis points to 8.50 per cent.</li> </ul>
	<ul style="list-style-type: none"> <li>Reverse Repo Rate reduced by 50 points to 11.00 per cent.</li> </ul>
11-Sep-09	<ul style="list-style-type: none"> <li>Repo Rate reduced by 50 basis points to 8.00 per cent.</li> </ul>
	<ul style="list-style-type: none"> <li>Reverse Repo Rate reduced by 50 basis points to 10.50 per cent.</li> </ul>
18-Nov-09	<ul style="list-style-type: none"> <li>Repo Rate reduced by 50 basis points to 7.50 per cent.</li> </ul>
	<ul style="list-style-type: none"> <li>Reverse Repo Rate reduced by 75 basis points to 9.75 per cent.</li> </ul>

Source : Central Bank of Sri Lanka

commodity prices in international markets and favourable domestic supply conditions in the food crop sector. The average inflation rate for 2009 is expected to be around 5 per cent and inflation is forecast to be low and stable in 2010.

**Steps are being taken to contain the fiscal deficit.** The Budget 2009 estimated the fiscal deficit to be 7 per cent of GDP in 2009. A further reduction in the fiscal deficit is expected in 2010. The proposed reduction in defense and security related expenditure and the decline in interest costs of servicing public debt will contribute towards lowering the deficit. A Tax Commission has also been formed to review the current tax policy and to make recommendations on broadening the tax base, strengthening tax collection and simplifying the tax system.

**The balance of payments and external reserve position has improved in the current year.** Although export earnings declined by 17 per cent during January to August 2009 due to the global recession, expenditure on imports declined by a greater proportion of 35 per cent. Consequently, the trade deficit narrowed significantly by 60 per cent. Private remittances continued to grow strongly by about 10 per cent and more than offset the trade deficit. The current account deficit is expected to decline to 1.2 per cent of the GDP in 2009 from 9.3 per cent in 2008. The balance of payments surplus is forecast at US dollars 2.8 billion for 2009. The external reserve position has also improved considerably.

The end of hostilities in May and obtaining the IMF Stand-By Arrangement in July led to resurgence in investor confidence and an increase in capital inflows particularly to investments in government securities. As a result, external reserves have built-up substantially to US dollars 4.8 billion at end October 2009, which is equivalent to about 5.9 months of import coverage.

## Developments in Domestic Financial Markets

Financial markets were more stable, with improved liquidity and declines in interest rates. With the sharp deceleration in inflation from late 2008, the Central Bank relaxed its monetary policy stance by reducing policy interest rates from 10 to 12 per cent in 2008 to 8 to 10.5 per cent in 2009. In addition, the penal interest rates and the restrictions on the access to the Reverse Repurchase Window were also removed and the Statutory Reserve Requirement was also reduced. These measures led to a downward movement in market

Chart 1.1 – Weighted Average Call Money Rate and Weighted Average Prime Lending Rate

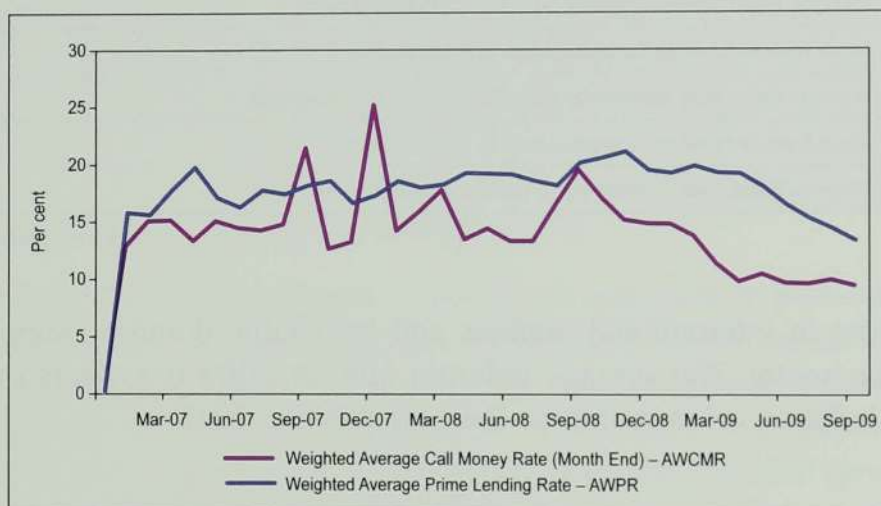


Chart 1.2 – Weighted Average Lending Rate (AWLR) and Weighted Average Deposit Rate (AWDR)

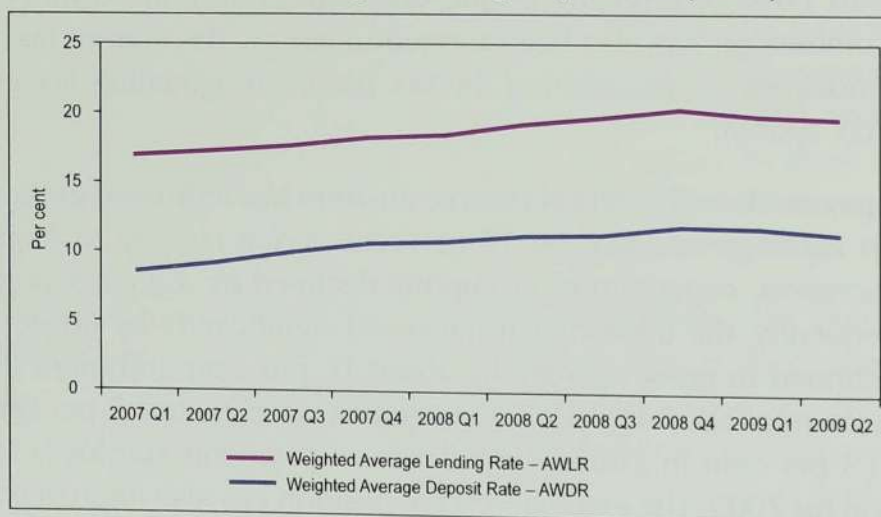
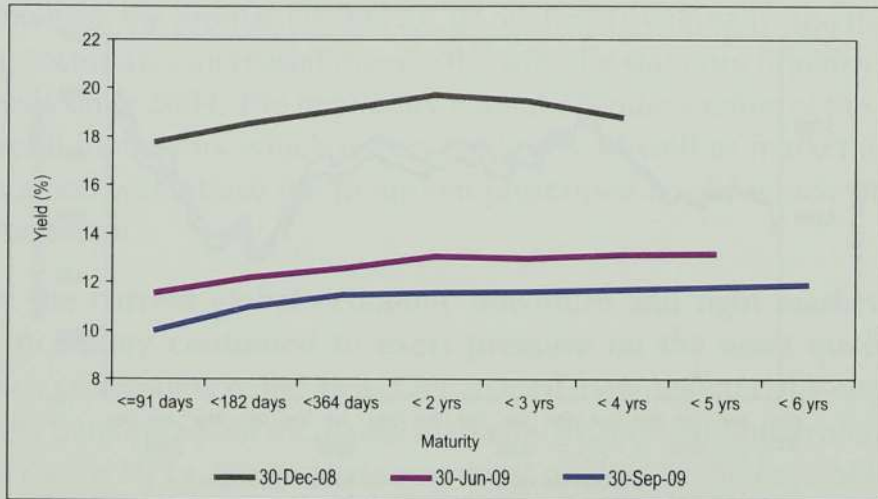


Chart 1.3 – Secondary Market Yield Curve



interest rates during the year. The inter-bank call money market rates declined appreciably from about 15 per cent at year end 2008 to around 9 per cent at end September 2009. Yield rates on government securities also declined markedly. Treasury bill yield rates dropped from about 17 per cent at end 2008 to about 9 per cent in September 2009.

**The exchange rate was also more stable.** The Rupee depreciated moderately against all major currencies, except the Yen, as at end September 2009. The Central Bank intervened in the foreign exchange market to maintain the stability of the currency. This entailed supplying US dollars to the market in the early part of the year and absorbing US dollars from the market in the second half of the year in order to contain excessive volatility of the exchange rate in the wake of increased foreign exchange inflows following the end of the conflict. The Real Effective Exchange Rate (REER) also depreciated slightly during 2009 thereby improving the currency competitiveness of exports.

Chart 1.4 – Nominal Exchange Rate and Real Effective Exchange Rate

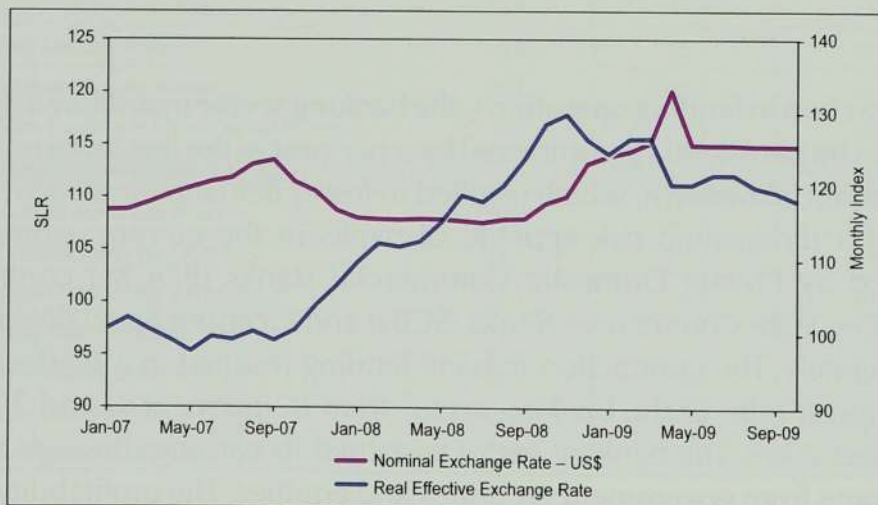
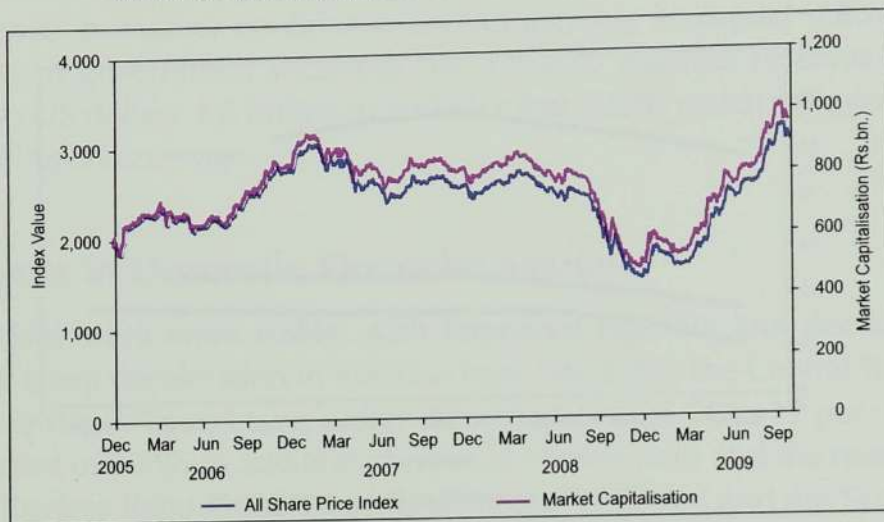


Chart 1.5 – All Share Price Index and Market Capitalisation



**Equity prices have surged upwards during the year.** The Colombo Stock Exchange became one of the best performing stock markets in the world with the All Share Price Index (ASPI) rising by 98 per cent at end October 2009. A number of factors contributed to the bullish market – positive investor sentiment following the end of the hostilities in May 2009, sharp decline in inflation and lower interest rates and renewed confidence following the granting of the IMF Stand-By Arrangement in July 2009. An upward trend was evident in all sectors, with the Diversified Holdings, Banks, Insurance and Finance, Food, Beverage and Tobacco and Hotels and Travel performing best. The market price earnings ratio (PE) rose substantially to 14.4 at end October 2009 from 5.4 at end 2008. Market capitalization reached record levels by crossing the Rs. 1 trillion mark in October 2009 from Rs. 489 billion at end 2008. Turnover levels have also risen appreciably. The stock market recovery was driven largely by domestic investors, who accounted for 72 per cent of all transactions. Foreign portfolio investment in the stock market has not made a major impact yet. Net foreign inflows were positive at Rs. 2 billion end October 2009.

## Developments in Financial Institutions

### Banks

**Despite a contraction in lending operations, the banking sector maintained its profitability and soundness.** The bank lending contracted by 3 per cent in the first three quarters of 2009 due to the economic slowdown, which resulted in lower demand for credit from corporate customers, and a diminished risk appetite of banks in the current economic climate. Credit extended by Private Domestic Commercial Banks (PDCBs) contracted, while credit provided by State Commercial Banks (SCBs) and Licensed Specialised Banks (LSBs) increased moderately. The contraction in bank lending resulted in a marked reduction in the credit to deposit ratio of the banking sector from 87 per cent at end 2008 to 74 per cent at September 2009. The banking sector sustained its earnings through an increase in investment income from government securities and equities. The profitability indicators of

the banking sector, such as return on assets (ROA) and return on equity (ROE) improved marginally. However, the profitability of PDCBs declined marginally. The liquidity position of the banking sector also increased manifestly, with the statutory liquidity ratios rising to the highest levels since 2004. The regulatory capital adequacy ratios of the banking sector under the Basel II framework which covers credit risk as well as market and operational risk was maintained well above the minimum prescribed levels, which strengthened the resilience of the sector.

**The impact of the current global economic downturn and tight market conditions of the domestic economy continued to exert pressure on the asset quality of banking institutions.** As a consequence, the gross NPL to total loan ratio and the net NPL to capital funds ratio of the banking sector increased markedly in 2009. Although all bank categories experienced a rise in NPLs, the increase was most marked in the case of PDCBs and the specialised housing banks. All increase in NPLs in manufacturing (including the apparel export sub-sector), trading, housing and construction and hotels sectors were higher than average NPL ratios. With the rise in NPLs loan loss provisioning levels declined.

Table 1.2 – Key Financial Soundness Indicators of the Banking Industry

(per cent)

Item	2007	2008	2009 Sept.
<b>Licensed Banks</b>			
Total Capital Adequacy Ratio	14.1	14.5	14.5
Tier 1 Capital Adequacy Ratio	12.6	12.5	12.3
Gross Non-Performing Loans Ratio	5.2	6.3	8.8
Return on Assets (Before Tax)	1.9	2.0	2.1
Return on Equity (After Tax)	14.0	13.5	14.7
Statutory Liquidity Ratio (DBU)	30.4	31.3	38.6
Liquid Assets to Total Assets	28.1	28.3	34.4
<b>Licensed Commercial Banks</b>			
Total Capital Adequacy Ratio	13.6	13.8	14.1
Tier 1 Capital Adequacy Ratio	11.9	11.1	11.4
Gross Non-Performing Loans Ratio	5.0	6.0	8.6
Return on Assets (Before Tax)	1.9	2.0	2.0
Return on Equity (After Tax)	15.0	14.8	14.1
Statutory Liquidity Ratio	24.8	25.7	32.8
Liquid Assets to Total Assets	25.4	25.4	31.5
Net Open Position in FX to Capital Funds	1.2	2.1	-0.7
<b>Licensed Specialised Banks</b>			
Total Capital Adequacy Ratio	20.6	21.0	17.9
Tier 1 Capital Adequacy Ratio	21.2	25.6	19.9
Gross Non-Performing Loans Ratio	6.7	8.9	10.7
Return on Assets (Before Tax)	1.7	1.5	2.5
Return on Equity (After Tax)	10.0	6.9	17.5
Statutory Liquidity Ratio	61.0	61.9	69.3
Liquid Assets to Total Assets	42.0	43.7	49.0

Source : Central Bank of Sri Lanka

It is anticipated that these trends will reverse, as the decline in interest rates in the credit market take effect.

**The banking sector maintained a high level of capitalization.** The capital funds of the banking sector increased in 2009 as investments in government securities increased. The banking sector migrated to the Basle II Capital Adequacy Framework under the simpler approaches in 2008. The Risk Weighted Capital Adequacy Ratios (CAR) of the banking sector were maintained well above international standards in 2009. Seylan Bank has also been recapitalised with an infusion of capital funds of Rs. 3 billion and its CAR is well above the minimum requirement (*See Box No. 4 – Resolution of a Bank in Distress - The case of Seylan Bank in Chapter 4*). The Merchant Bank of Sri Lanka (MBSL) purchased 78 per cent of Ceylinco Savings Bank (CSB) and initially injected Rs.100 million into the bank and the restructuring process is underway. The Bank of Ceylon and the Sri Lanka Insurance Corporation purchased a 10 per cent (Rs. 455 million) and a 15 per cent (Rs. 670 million) stake in Seylan Bank, while almost Rs.1.9 billion was mobilised through a public offering of new shares which indicated the capital market's confidence in the bank.

**Stress tests indicate that the banking sector is resilient to withstand shocks.** The Central Bank conducts regular stress tests on banking institutions and the banking sector to assess its ability to cope with credit risk, interest rate risk, exchange rate risk and liquidity risk shocks. The tests which used sensitivity analysis focused on the impact of moderate and extreme shocks on the banks' capital adequacy ratio and liquidity ratio. The tests indicated that banking sector has adequate capital buffers to withstand both moderate and extreme credit risk, interest risk, exchange rate and liquidity risk shocks.

## Box 1

## Banking Soundness Index

A Banking Soundness Index (BSI) is a simple aggregate indicator that can be used to assess the soundness of the banking sector, which is the most important component of the financial system with respect to financial stability. The BSI is based on selected financial soundness indicators representing capital, asset quality, profitability, liquidity and sensitivity to market risk. The BSI is used in a number of countries as part of the financial stability analysis to gauge the resilience of the banking system over time.

The Central Bank of Sri Lanka has constructed a simple BSI on an experimental basis, using the weighted average of partial indicators of the financial soundness of banks. Financial market indicators were not included, due to the limited number of listed banks, minimal number of listed bank bonds and the relatively shallow and undeveloped capital market in Sri Lanka. There are six sub-indices covering **capital, non-performing loans, profitability, liquidity, interest rate risk and foreign exchange risk** which are normalized before aggregation to achieve the same variance. The aggregate BSI for the banking sector of Sri Lanka has been compiled from 3Q/2006 (which is the base year) to 3Q/2009 using quarterly data.

Capital adequacy and profitability indicate the cushion a bank has at its disposal against potential risks and is a measure of its ability to absorb a reasonable level of losses. The non-performing loans (asset quality) indicators reveal the credit risk associated with the bank loan portfolio. The liquidity indicators measure the bank's reserve against potential liquidity problems, such as loss of access to market sources of funding or large scale deposit withdrawals by the public. The market risk indicators have two components – interest

## Box 1 (Contd.)

rate risk and foreign exchange risk. The interest rate risk measures the maturity mismatch between assets and liabilities and indirectly measures the potential losses caused by a rise in interest rates. The foreign exchange risk covers banks' exposure to exchange rate movements in either direction.

The features of the partial indicators of the BSI are shown in Table B.2.1.

Table B.2.1

## Partial Indicators and Variables of the Banking Soundness Index

Partial Indicators	Variables	Impact	Adjustment	Weight
Capital Adequacy	Tier 1 capital to risk weighted assets	Positive	Normalised value	0.125
	Capital base to risk weighted assets	Positive	Normalised value	0.125
Non-performing loans	Gross non-performing loans to total gross loans	Negative	Normalised value	0.150
	Net non-performing loans to capital funds	Negative	Normalised value	0.150
Profitability	ROA (before tax)	Positive	Normalised value	0.075
	ROE (after tax)	Positive	Normalised value	0.075
Liquidity	Statutory Liquid Assets Ratio	Positive	Normalised value	0.1
	Liquid assets to total assets	Positive	Normalised value	0.1
Interest Rate Risk	Cumulative gap of interest – bearing assets and liabilities up to 3 months to total assets	Negative	Normalised value	0.05
Foreign Exchange Risk	Net open position in foreign exchange to capital funds	Negative	Normalised value	0.05

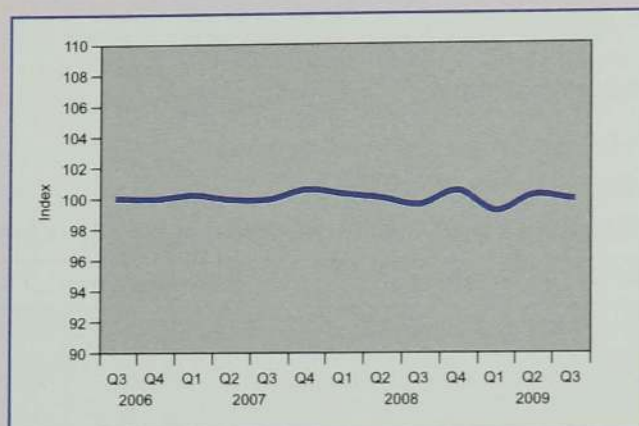
An important factor in compiling the BSI is the allocation of weights, as it is difficult to judge the relative importance of each partial indicator to the index. This could be done by using statistical methods or using judgment. In this computation, the latter method has been used. This does not take into account the potential correlation between individual partial indicators. The partial indicators and their weights may be revised from time to time, depending on their importance.

In order to construct the index, as a first step the partial indicators are compiled for the normalised weighted variables using the relevant variable weighting scheme. The normalised value of a weighted partial indicator =  $(X_{it} - \mu_{it}) / \sigma_{it}$ .  $X_{it}$  is the value of the indicator in  $t^{\text{th}}$  time period,  $\mu_{it}$  is the mean of the indicator  $X_{it}$  and  $\sigma_{it}$  is the standard deviation of the indicator  $X_{it}$ .

The aggregate BSI is shown in Chart B.2.1.

Chart B.2.1

## Banking Soundness Index



The BSI was in the range of 99.1 to 100.5 which implies that the financial soundness of the banking sector improved marginally during the period of 3Q/2006 to 3Q/2009. The BSI however, declined marginally from 100.4 in 4Q/2008 to 99.9 in 3Q/2009, mainly due to an increase in non-performing loans ratios and a decline in profitability of the banking sector.

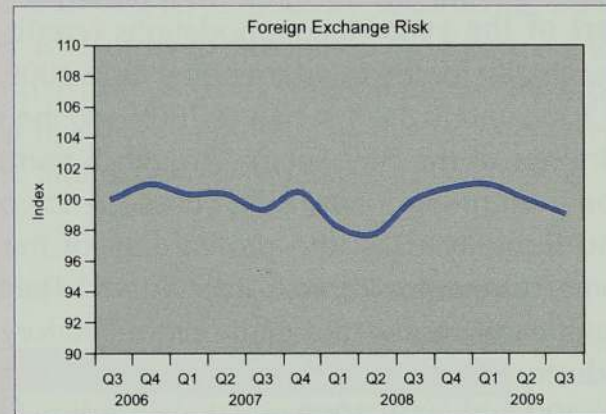
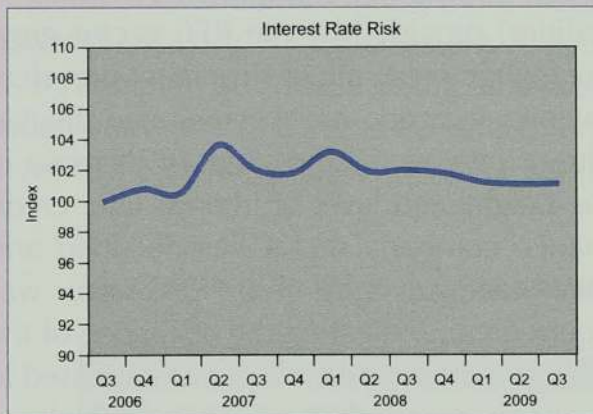
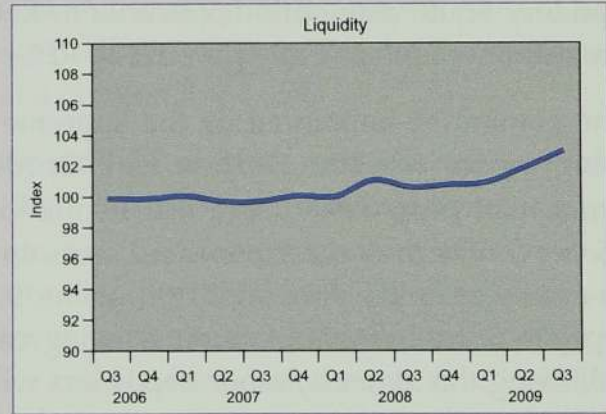
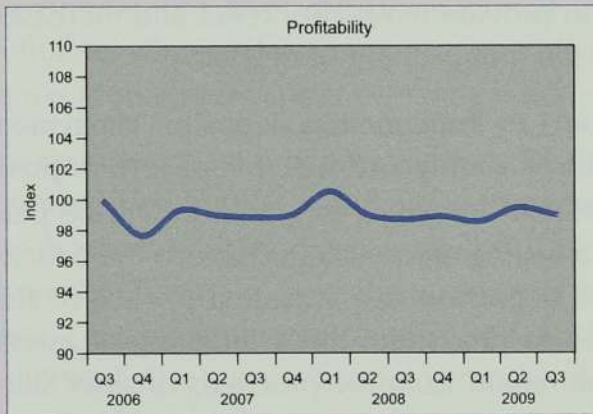
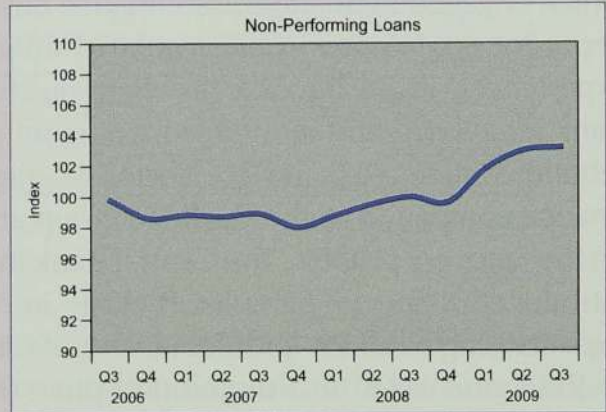
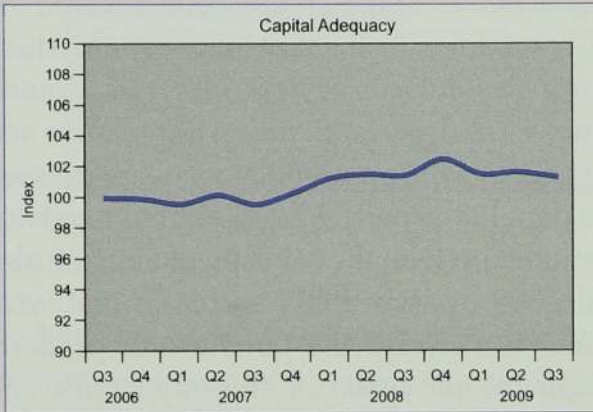
The partial indicators of the BSI are shown in Charts B.2.2.

- (a) **Capital Adequacy** : The capital adequacy partial indicator has improved since 3Q/2007 due to an increase in capital levels in the banking sector. The capital adequacy partial indicator of the banking sector declined slightly in 3Q/2009 with the decrease in both the total capital adequacy and the Tier 1 capital adequacy ratios. Banks migrated to the Basel II Capital Adequacy Framework from January 2008, which covers credit risk, market risk and operational risk. The total capital adequacy ratio and the Tier 1 capital adequacy ratio of the banking sector are well above the regulatory requirements and have sustained the resilience of the banking sector.
- (b) **Non-performing loans** : The non-performing loans partial indicator has been on an increasing trend since 4Q/2007 due to an increase in the non-performing loans ratios. The asset quality of the banking sector deteriorated slightly due to the slowdown in the economy.
- (c) **Profitability** : The profitability partial indicator has been relatively stable since 1Q/2007. The overall profitability of the banking sector has declined slightly in 3Q/2009 with a decrease in both the return on assets and return on equity ratios.
- (d) **Liquidity** : The liquidity partial indicator improved since 2Q/2007. The liquidity position of the banking sector was comfortable, mainly due to the increase in the statutory liquid assets to deposit liabilities ratio and liquid assets to total assets ratio.
- (e) **Interest rate risk** : The interest rate risk partial indicator has been on a declining trend since 1Q/2008 due to a decline in the cumulative gap of up to 3 months interest-bearing assets and liabilities to total assets ratio. This indicates that the banking system has managed interest rate risk adequately.
- (f) **Foreign exchange risk** : The exchange rate risk partial indicator has been relatively stable since 3Q/2006 and declined marginally in 3Q/2009 due to the decrease in the net open position in foreign exchange to capital funds ratio, which has a positive impact on the BSI.

Box 1 (Contd.)

Chart B.2.2

Partial indicators of the Banking Soundness Index



## Finance and Leasing Companies

**The registered finance and specialized leasing company sector was affected by adverse developments following the failure of unauthorized entities engaged in finance business.**

The failure of the unregulated Golden Key Credit Card Company of the Ceylinco group which engaged in unauthorised finance business activities at the end of 2008 affected the depositor confidence in the regulated finance companies in the Ceylinco group which experienced severe liquidity problems due to panic withdrawals by depositors. The Central Bank intervened and introduced a number of measures to assist troubled companies and rebuild confidence in the RFC sector. Managing agents were appointed to assist distressed finance companies in the Ceylinco group and a panel of experts was appointed to advice on the recovery process. The Central Bank in conjunction with the Ministry of Finance also introduced a Special Stimulus Package in April 2009 to assist RFCs and SLCs that were experiencing liquidity problems. The main features included the purchase of property of RFCs and SLCs at a discounted price through the provision of Treasury bonds and the provision of government guarantees for credit facilities provided by banks to RFCs. The package had an estimated value of Rs. 4.25 billion. The CBSL also reduced the statutory liquid asset ratio applicable to RFCs to provide temporary relief and increased the maximum interest rate payable by RFCs for the mobilization of deposits.

**The committee appointed by the Supreme Court to implement a depositor repayment programme for the Golden Key Credit Card Company has prepared deposit repayment programme.**

As a first step, depositors of less than Rs.1 million will be paid 75 per cent of their outstanding balances up to a ceiling of Rs. 100,000 due to the paucity of available funds. Around 3,800 of the 9,000 depositors are expected to receive this repayment installment. A audit is being carried to determine the availability of assets. Following this process, other depositors will be repaid from the proceeds of asset sales and debt recoveries.

**The rest of the RFC sector is now rebounding after the stresses experienced in the early part of the year.**

Accommodations (credit facilities) provided by the RFC sector grew marginally for the quarter ending June 2009. The high interest rate environment prevalent in 2008 and in the first half of 2009 and the slowdown in economic activities also affected earnings of the RFC sector through a narrowing of interest margins and an increase in non-performing loans. As a consequence of the heightened level of interest rate, credit and liquidity risks, the profitability of the finance company sector has declined and some companies also recorded losses. The capital adequacy ratio of the RFC sector was significantly above the minimum regulatory requirement, indicating the resilience of the industry to withstand shocks. The minimum capital requirement for RFCs was increased to Rs. 200 million in 2008 and the majority of RFCs have complied. The majority of the large and medium size RFCs are well capitalised and profitable and are rebounding strongly. The curtailment of credit facilities provided by banks to RFCs has inhibited their recovery to some extent. However, this situation is expected to improve with the expansion of economic activities in the second half of the year. A few small loss-making RFCs with lower capital levels need to build up their capital base to improve their viability.

Table 1.3 – Key Financial Soundness Indicators of Registered Finance Companies

(per cent)

Item	2007	2008	2009	2009 August
Total Capital Adequacy Ratio	14.2	14.5	14.4	14.5
Tier 1 Capital Adequacy Ratio	13.1	12.5	12.6	12.6
Gross Non Performing Loans Ratio	4.4	6.5	8.0	9.9
Return on Assets (Before Tax)	3.2	2.5	0.7	-1.6
Return on Equity (After Tax)	17.8	12.5	1.3	-16.1
Liquid Assets to Short-Term Liabilities	17.2	14.9	13.8	17.5
Liquid Assets to Total Assets	9.1	10.9	8.0	10.9

Source : Central Bank of Sri Lanka

**The business of SLCs has stagnated due to the same factors affecting the RFC sector.** In addition to interest rate and credit risk, SLCs also faced funding risk as they are dependent on borrowed funds from banks or through the issue of debt securities for financing their business activities. Both sources of funding were restricted in the tight market conditions. The profitability level of SLCs declined in 2009. Although the majority of SLCs were profitable, while a few companies recorded losses. All SLCs met the regulatory minimum capital requirement and the gearing ratio was at a comfortable level.

**The resurgence in economic activity in the second half of 2009 onwards will provide opportunities for RFCs and SLCs to expand their business operations.** It is necessary that these companies diversify their business into new activities, such as machinery and equipment leasing and expand business in the outstations. In this regard, it is recommended that the capital allowance on plant and machinery is revised to facilitate the leasing of such equipment. The current financing model of RFCs and SLCs exposes them to considerable interest rate risk due to the maturity mismatch between their assets (leases) which are longer term and their liabilities (deposits and bank loans) which are shorter term. Hence, RFCs and SLCs should mobilise more medium and long term funds by securitizing their lease receivables to a greater extent. A number of reforms to strengthen the finance and leasing company sector will be implemented in 2010 which would require higher levels of capitalisation. In this context, consolidation and mergers of companies may be necessary to ensure the viability of small companies in the future.

Table 1.4 – Key Financial Soundness Indicators of Specialised Leasing Companies

(per cent)

Item	2007	2008	2009 June
Capital Funds to Total Assets	16.7	16.6	18.0
Gearing Ratio	4.2	4.2	3.8
Non-Performing Accommodation to Total Accommodation	4.3	4.8	7.1
Return on Assets (Before Tax)	3.5	2.7	3.1
Return on Equity (After Tax)	15.2	10.5	9.6
Liquid Assets to Short-Term Liabilities	8.6	10.6	13.1
Liquid Assets to Total Assets	6.0	7.5	8.9

Source : Central Bank of Sri Lanka

## Insurance Companies

The insurance sector remained stable and sound, although there was a decline in premium income. The economic slowdown affected the growth of the insurance sector, as premium income from general insurance declined moderately, while life insurance premiums stagnated in the first half of 2009. All insurance companies complied with the statutory requirement of maintaining a proportion of reserves in government securities, thereby mitigating risks. All insurers (except two small companies) met the required solvency requirements for life and general insurance. The underwriting profits of insurance companies decelerated, while overall profits increased marginally due to income from investments in government securities and equities. A few small companies recorded losses in the first half of the year. However, this position is expected to turnaround with the higher growth momentum in the second half of the year.

Table 1.5 – Key Financial Soundness Indicators of Insurance Companies

Item	2007	2008	2009 June
<b>Life Insurance</b>			
Premium Growth (%)	21.2	13.9	0.3
Solvency Margin Ratio	3.6	5.0	4.7
<b>General Insurance</b>			
Premium Growth (%)	20.1	10.9	-7.9
Solvency Margin Ratio	2.5	2.7	3.2
Retention Ratio (%)	73.5	71.8	73.2
Claim Ratio (%)	62.7	60.6	48.3

Source : Insurance Companies

## Primary Dealers

The Primary Dealers performed well in 2009. Secondary market activity increased markedly with a shift toward medium term Treasury bonds. With the decline in yield rates, the profits of Primary Dealers increased significantly through capital and revaluation gains and increased trading activity. All financial soundness indicators for the industry improved during the year. A direction was issued to restrict the dividend payout from profits earned

Table 1.6 – Key Financial Soundness Indicators of Primary Dealers

Item	2007	2008	2009 Sept.
RWCAR	35.2%	16.7%	24.9%
Tier 1 Capital (RWCAR)	34.0%	16.3%	24.7%
Capital Leverage Ratio	7.3	10.3	7.6
Return On Assets (Before Tax)	2.0%	2.5%	8.1%
Return On Equity (Before Tax)	18.4%	28.2%	92.9%
Operating Expenses to Gross Income	4.5%	3.7%	2.7%
Total Cost to Total Income	86.2%	72.5%	59.2%
Duration of Assets & Liabilities	0.6	0.9	1.1

Source : Central Bank of Sri Lanka

in 2009 to enable Primary Dealers to build-up their capital base and to promote the soundness and stability of the industry.

## Unit Trusts

**The unit trust industry recovered with the upturn in the equity market.** The performance of the unit trust industry improved considerably with the surge in share prices on the Colombo Stock Exchange. The net asset value of the unit trust industry increased by 29 per cent at September 2009. The share of equities in the investment portfolios of unit trusts rose to over 50 per cent in 2009. A new closed ended unit trust was formed in 2009 which was listed on the Colombo Stock Exchange. The prospects for the growth of the unit trust industry appear to be favourable with the recovery of the share market and the industry is expected to play a greater role in the development of capital market instruments in Sri Lanka.

Table 1.7 – Selected Data of the Unit Trust Industry

Item	2006	2007	2008	2009 Sept.
Total Assets (Rs. Mn.)	5,380	6332	6,801	8,867
Net Asset Value (Rs. Mn.)	5,353	6,295	6,781	8,753
Investments in Equities (Rs. Mn.)	3,691	3,649	2,589	4,990
(3) as a Ratio of (2) (%)	69	58	38	57
Total No. of Unit Holders	23,424	23,191	22,699	22,622
No. of Units in Issues (Mn.)	356	470	638	559

Source : Unit Trust Association of Sri Lanka

## Superannuation Funds

**The major funds – the Employees' Provident Fund (EPF) and the Employees' Trust Fund (ETF) managed the risks to their portfolios adequately.** As the EPF and ETF investments are predominantly held in government securities, credit and liquidity risks were well managed.

Table 1.8 – Investment Portfolio of EPF and ETF

Investment		At September 2008		At September 2009	
		Rs. bn.	Share (%)	Rs. bn.	Share (%)
EPF	Government Securities	584.7	97.0	688.3	97.1
	Corporate Debt	8.5	1.4	8.5	1.2
	Equity	6.7	1.1	7.4	1.0
	Repurchase Agreements	3.2	0.5	4.9	0.7
	<b>Total Investments</b>	<b>603.1</b>	<b>100.0</b>	<b>709.0</b>	<b>100.0</b>
ETF	Government Securities	75.4	90.7	90.4	92.5
	Equity	1.4	1.7	1.2	1.2
	Debentures	1.4	1.6	1.4	1.4
	Unit Trusts	0.1	0.1	0.1	0.1
	Other	4.8	5.8	4.7	4.8
	<b>Total Investments</b>	<b>83.0</b>	<b>100.0</b>	<b>97.7</b>	<b>100.0</b>

Sources : Employees' Provident Fund Department  
Employees' Trust Fund Board

The interest rate risk has been mitigated as the EPF and ETF have distributed its investment portfolio in securities with differing maturities and varying yields. In the current declining interest rate environment, the portfolio of these funds is subject to reinvestment risk in the form of lower interest rates. The reinvestment risk can be mitigated to some extent by increasing EPF investments in the equity market. The proposed amendment to the EPF Act to enable EPF members to withdraw 30 percent of their EPF balances for housing purposes will not have a significant impact on the liquidity of the fund, as measures have been put in place to limit withdrawals and funds have been set aside for this purpose.

## Financial Infrastructure

### Payment and Settlement Systems

**The systemically important payment systems – LankaSettle’s Real Time Gross Settlement System and LankaClear’s Cheque Clearing System operated without disruption in 2009.**

The RTGS System is substantially compliant with international standards for systemically important payment systems prescribed by the Bank of International Settlements. The Central Bank continued to implement its business continuity programme for the RTGS and the LankaSecure (Central Securities Depository) System by overseeing improvements to the Disaster Recovery Sites of participant banks. The major project in the pipeline is the establishment of a Common Payment Switch (CPS) among banks which will facilitate online, real time, secure fund transfers for low value/retail payments on a 24x7 basis. The system is expected to roll-out in phases from 2010. The Phase 1 of the CPS will facilitate retail credit transactions of customers of banks (via teller counters, Automated Teller Machines, Internet banking facilities, phone banking facility and standing instructions), such as bill payments, international remittances, statutory payments, direct retail debit transactions and local credit card transactions. Transactions in E-cheques will be facilitated in Phase 2 of the CPS. Claims/obligations of participating banks under the CPS will be settled periodically on a multilateral net settlement basis through the RTGS System which is expected to reduce the settlement risk to a great extent.

**Regulations were issued for the control of electronic payment cards.** The Service Providers of Payment Cards Regulations No.1 of 2009 came into effect in August. The purpose of the regulations is to enhance the safety of electronic means of payments by setting out prudential requirements for all service providers of payment cards which will also include a set of terms and conditions to regulate mobile payment operators, in order to protect the interest of customers and minimize risks of electronic payments. The regulations cover the entire range of electronic payment instruments namely, credit cards, debit cards, charge cards and stored value cards including devices that include a code or any other means of access to an account. In terms of the Regulations, companies providing electronic payment cards and mobile payment services are required to register with the Central Bank. Eligible companies are Licensed Banks, Registered Finance Companies and public companies with unimpaired capital of Rs. 75 million. The Central Bank has issued guidelines to companies providing credit card services and mobile payment services.

## Regulation and Supervision

**The regulatory and supervisory framework is being strengthened to promote the soundness and safety of the financial system.** A discussion paper on draft amendments to the Banking Act was prepared by the Central Bank and provided to the banking industry seeking their comments. The proposed amendments include powers to conduct the consolidated supervision of banking groups, provisions to facilitate mergers and acquisitions of Licensed Banks, provisions to strengthen the bank resolution measures and certain changes necessitated by the new Companies Act. The Central Bank also proposes to issue guidelines to banks on integrated risk management and Pillar 2 of Basel II which relates to additional prudential requirements following supervisory review. In addition, work is in progress to prepare banks for the adoption of Sri Lanka Accounting Standards 44 and 45 (relating to fair value accounting) in 2011. During the year, the Central Bank issued prudential directives on risk management standards relating to foreign exchange business. A direction was also issued to facilitate any party acquiring a material interest in excess of 15 per cent of the issued capital (carrying voting rights) of a Licensed Bank that requires restructuring to avoid inadequacy of capital, insolvency or potential failure, to divest such interest in excess of 15 per cent during specified period, as determined by the Monetary Board on a case-by-case basis. Proposals are also being formulated to introduce a depositor insurance scheme to safeguard the interest of depositors and promote the stability of the banking system.

**The Central Bank has finalised proposals for a new Finance Companies law.** The definition of “deposits” will be widened to cover a broad range of fund mobilization activities. The powers of the Central Bank relating to the investigation of unauthorized finance businesses and deposit-taking will be strengthened and offenses will carry more severe penalties. In addition, the amendments will also enhance the powers of the Central Bank with respect to the examination of RFCs and the determination of capital and other prudential requirements.

**The regulation and supervision of the RFC sector is being strengthened.** Mandatory corporate governance rules to make the board of directors responsible and accountable for affairs of RFCs and to promote a robust risk management came into in 2009. Additional prudential measures will also be introduced to improve the soundness and resilience of the RFC sector. These include strict regulatory action for non-compliance with prudential directives (a system of prompt corrective actions), sector concentration limits, appointment of a panel of auditors and the listing of companies on the Colombo Stock Exchange within a specified time-frame. A depositor insurance and liquidity support scheme for RFCs will also be introduced to safeguard depositors.

**The supervisory framework of the insurance sector will also be updated.** The proposed amendments to the Regulation of Insurance Industry Act will strengthen the supervisory framework of the insurance industry. The proposed amendments will strengthen the powers of the Insurance Board of Sri Lanka to stipulate capital requirements for insurance companies and brokers, make rules and determinations and engage in dispute resolution. A “fit and proper” criteria for board directors of insurance companies and brokers will

also be introduced. The other proposed revisions include the appointment of institutional agents such as banks, the registration of loss adjusters and the requirement that life and general insurance companies be separately incorporated. The introduction of risk-based capital adequacy framework for insurance companies and the introduction of specific corporate governance rules for directors and senior management of insurance companies should also be implemented.

**Directives to improve the trading practices of Primary Dealers were issued and proposals relating to diversification of business were approved.** In order to mitigate the risk of ownership of investors in government securities which could arise out of non-recording of transactions in the CDS, a circular has been issued to Primary Dealers to record all transactions in the Central Securities Depository promptly and accurately. A Master Repo Agreement (MRA) was introduced by the CBSL in 2009 which could be adopted commonly by Primary Dealers and Licensed Commercial Banks (LCBs) when entering into repo transactions. The Public Debt Department is in the process of obtaining views of Primary Dealers and Licensed Commercial Banks on the introduction of a schedule to the Global Master Repo Agreement with an intention to make it mandatory to use either one of the above MRA's when a Primary Dealer or Licensed Commercial Bank enters in to a repo transaction. This is to safeguard the interest of the parties to the repo agreement. As the Primary Dealers are currently exposed to business concentration risk due to exclusively engaging in government securities business, the Central Bank has approved the proposals to diversify the Primary Dealers' business. Under different stages, the Primary Dealers would be permitted to engage in fee based services and to diversify into investments in quoted shares, unit trust and mutual funds and to borrow through debt instruments as approved by the Monetary Board of the Central Bank.

**Gaps in the regulation of unit trusts were addressed.** The Securities and Exchange Commission issued directives relating to the independence of trustees from managing companies, "fit and proper" criteria for personnel of trustees and managing companies, financial capacity of trustees, disclosure requirements by trustees and managing companies, investment restrictions for managing companies and minimum net capital requirements of trustees and managing companies of unit trusts.

**The new Securitization law which will come into effect shortly will provide an impetus for the development of asset-backed securities (ABS) market in a safe manner.** The proposed Securitization law will regulate the securitization industry, promote transparency and accountability in these transactions and specify appropriate measures and regulations for investor protection. The law will provide a framework for the formation of Special Purpose Vehicles (SPV) for the issuance of ABS, mechanisms for the origination and transfer of assets to the SPV and the stipulation of minimum standards for disclosure for the protection of investors. The proposed law will also introduce regulations for Originators, Trustees and Facilitators. The Securitization Bill was presented to Parliament in 2009 and is expected to become law next year.

**Amendments to the Securities and Exchange Commission Act will facilitate the development of the capital market.** The Securities and Exchange Commission (SEC) Act

was amended in 2009 to revise the eligibility criteria of Commission members and to facilitate the issuance and regulation of futures, options and other derivative instruments. The SEC Act would also provide for the demutualization of the Colombo Stock Exchange (CSE) *i.e.*, the conversion from a company limited by guarantee to a public company limited by shares. The demutualization of the CSE will segregate ownership and management from the trading rights of the members of the exchange. A comprehensive framework for the demutualization of the CSE will be prepared in 2010. Other reforms in the pipeline, are the introduction of exchange traded financial derivatives, which would enable investors to manage market risks. The establishment of a clearing corporation was identified as a prerequisite to handle the clearing and settlement risk in the derivative market. Hence, action has been initiated by the CSE to set-up a Central Clearing Corporation.

**A law to regulate and supervise micro-finance institutions is also being formulated.**

The different categories of micro-finance institutions are registered under various laws but are not regulated or monitored through a specific regulatory and supervisory authority or arrangement. In view of the diversity of these institutions and the complexity of the micro-finance sector and the existing laws, it has been decided that certain regulatory requirements should be imposed on these institutions.



# 2. Macroeconomic Environment

- ✦ The global economy shows signs of recovery in response to the aggressive policy actions adopted by both advanced and emerging economies.
- ✦ In advanced economies, the threat of deflation has declined and inflation is expected to remain at low levels. Emerging economies have also recorded moderate levels of inflation given the slow growth in demand.
- ✦ Growth prospects for the Sri Lankan economy have improved with the end of the conflict in the Northern and Eastern Provinces. However, the pace of growth will be lower than that recorded in 2008.
- ✦ Domestic inflation has moderated significantly.
- ✦ Credit flows to the private sector remain muted on account of subdued economic activity and stringent credit policies of banks to minimise non-performing loans. However, the decline in lending rates particularly following the recent measures to reduce lending rates of state banks, is expected to stimulate credit growth.

## 2.1 Global Macroeconomic Developments

### World Economic Growth

The world economy is estimated to contract by 1.1 per cent in 2009 constrained by the negative impact of the global financial crisis. However, early signs of recovery appear to be underway, led by improvements in manufacturing output, mainly in emerging and developing economies. Supported by continued policy stimulus, advanced economies are expected to record a sluggish growth of around 1.3 per cent in 2010, following a contraction of 3.4 per cent in 2009. The recovery in emerging economies is expected to be stronger than in advanced economies with output projected to grow by around 5 per cent in 2010. A number of economic indicators across the globe point to a likely recovery renewing optimism that the global economy is staging a recovery. China and India will remain the world's growth engine as both countries are projected to expand by above 5 per cent in 2010. Consequently, the growth of the world economy is expected to be around 3 per cent in 2010, although several downside risks remain to achieving this growth.

Table 2.1 – Economic Growth Prospects

Region / Country	2007	2008	2009 (Projected)	2010 (Projected)
World	5.2	3.0	-1.1	3.1
Advanced Economies	2.7	0.6	-3.4	1.3
USA	2.1	0.4	-2.7	1.5
Euro Area	2.7	0.7	-4.2	0.3
UK	2.6	0.7	-4.4	0.9
Japan	2.3	-0.7	-5.4	1.7
Emerging and Developing Economies	8.3	6.0	1.7	5.1
Developing Asia	10.6	7.6	6.2	7.3
China	13.0	9.0	8.5	9.0
India	9.4	7.3	5.4	6.4

Source : World Economic Outlook – October 2009

Table 2.2 – Inflation Forecasts

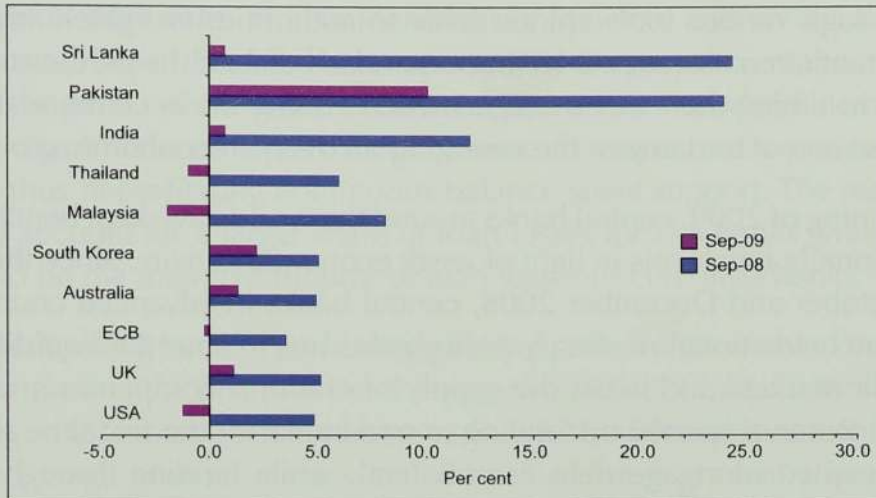
Region / Country	2007	2008	2009 (Projected)	2010 (Projected)
Advanced Economies	2.2	3.4	0.1	1.1
USA	2.9	3.8	-0.4	1.7
Euro Area	2.1	3.3	0.3	0.8
UK	2.3	3.6	1.9	1.5
Japan	0.0	1.4	-1.1	-0.8
Developing Asia	5.4	7.5	3.0	3.4
China	4.8	5.9	-0.1	0.6
India	6.4	8.3	8.7	8.4

Source : World Economic Outlook – October 2009

## World Inflation

While surging oil prices and record food prices drove inflation across the world to record high levels by mid-2008, the unwinding of the commodity price bubble and the rising economic slack, a result of the financial crisis, have led to a continued deceleration in inflation from the record levels experienced by many countries. Although the continuous fall in headline inflation in many countries sparked fears of deflation, particularly during the first half of the year, the fragile recovery, the gradual pick up in commodity prices and the continued monetary and fiscal stimulus have reduced the risk of a deflationary spiral. Inflation in the advanced economies, which remained around zero in 2009, is expected to rise moderately to around 1 per cent in 2010. Consumer prices in the United States rose by 0.2 per cent in September compared to the 1.3 per cent contraction a year earlier. Eurozone prices, which have contracted for five straight months up to October, are anticipated to pick up and inflation is expected to be 0.8 per cent in 2010. The contraction

Chart 2.1 – Inflation in selected countries



in Japan's consumer prices has eased to -2.3 per cent in September, from an unprecedented -2.4 per cent in August.

Similarly, inflation in emerging countries too is expected to decelerate from around 7.5 per cent in 2008 to around 3.0 per cent in 2009. The continued weakness in the global economy, coupled with lower commodity prices, has dampened inflation in emerging countries and inflation is expected to remain subdued in 2010.

### Inflation Expectations

Inflation trends remain subdued on the back of weak economic growth and the rise in unemployment in advanced economies. In emerging countries, inflation remains well below the levels observed a year earlier, despite the recent pick up in inflation, reflecting in part, the recovery in global economic activity. However, commodity prices, which fell sharply in 2008, have gradually recovered in 2009. Crude oil prices (Brent), which declined to around US dollars 38 per barrel at end December 2008 from the peak in mid-2008, have since rebounded. Oil prices are expected to remain at US dollars 82 in 2010. Food prices too have staged a recovery. However, food prices are expected to increase modestly in the near term devoid of any sharp fluctuations as witnessed prior to the global financial crisis.

### Monetary Conditions

In response to the deteriorating outlook stemming from the crisis in the global financial markets, monetary conditions have been relaxed significantly in both advanced and emerging countries since the third quarter of 2008. In many advanced economies, policy interest rates are near zero, while a number of unconventional measures have been relied upon to ease tight credit conditions in financial markets. With the gradual recovery in the global economy, the accommodative monetary policy practiced thus far by central banks now needs careful reassessing. Monetary authorities are now turning their attention

towards tightening their monetary policy stance in order to avoid a build-up of inflationary pressures. Although various tools are available to authorities to tighten monetary policy even in the current circumstances of having expanded balance sheets, the authorities need to be cautious in timing their exit strategies when ending the accommodative monetary policy stance, so as not to dampen the emerging recovery in economic growth.

Since the beginning of 2009, central banks around the world have kept benchmark interest rates at exceptionally low levels in light of weak economic activity. Since the coordinated rate cuts of October and December 2008, central banks in advanced countries resorted to a range of unconventional monetary policy measures to ease the liquidity constraints, to unclog credit markets and boost the supply of credit to companies and households. The US Federal Reserve opened up lending to non banks for the first time since the great depression, accepted mortgage debt as collateral, while lending through the discount window was used extensively to support weak financial institutions. Currently, four out of the five leading central banks, namely, the Federal Reserve, Bank of Japan, Bank of England and Bank of Canada maintain interest rates below 1 per cent, while the European Central Bank maintains its key refinancing rate at 1 per cent. However, Australia became the first country among the advanced economies to raise interest rates in October 2009 on account of emerging signs of rising inflation in the backdrop of brightening prospects for the economy, a further indication that the global economy is recovering.

During the first half of 2009, central banks in emerging markets continued with their accommodative monetary policy initiated since the height of the global financial crisis. India reduced its repo rate by a cumulative 175 basis points to 4.75 per cent since end December 2008, while the cash reserve ratio was lowered to 5 per cent from 5.5 per cent in January 2009. China's Central Bank also trimmed its one year Yuan lending rate by 216 basis points since end 2007 to 5.31 per cent to ensure a sufficient supply of liquidity to its banking system.

## Global Financial Markets

Signs of a gradual recovery in the global financial system has emerged with the rebounding of financial market sentiment and risk appetites, easing of emerging market risks, raising of new capital by banks and the gradual reopening of wholesale funding markets. The multitude of programmes launched by central banks individually or in a coordinated manner since the collapse of Lehman Brothers in September 2008 is credited with diffusing the panic and guiding short term credit markets to a partial recovery. Major government fiscal stimulus programmes and capital injections to prop up banks were also instrumental in reducing uncertainty and restoring confidence in world's financial markets. Hence, quick and forceful policy intervention played an important role in preventing greater economic damage and higher fiscal costs emanating from a crisis of a large magnitude. However, there is near unanimous consensus that the pace of recovery could be slow and the nature of recovery could be temporary in the absence of continued public policy action. At a policy level, recapitalising and repairing bank balance sheets so that financial institutions led by banks could support the economic recovery and attempts to reform the regulatory environment to avoid future crises are gaining support among policy makers.

Systemic risks in the financial markets in the United States and Europe have diminished since the height of the credit crisis but lending continues to remain weak on account of on-going restructuring of bank balance sheets. Credit growth remains muted as loan losses are yet to peak, while weak economic activity has subdued demand for credit by borrowers. Bank balance sheets will continue to come under pressure from credit deterioration, thus necessitating continuous balance sheet support. The residential sector is expected to account for a larger share of loan losses for U.S banks while foreign loans are expected to be the main contributor of loan losses in Euro area banks.

The implementation of a forceful and coherent set of policies has enabled emerging market countries to be among the first to offset the negative impact of the financial crisis. Credit flows have begun to improve while risk spreads, which widened to unprecedented levels across a broad range of asset classes and maturities, have gradually begun to decline. Equity prices in emerging markets remain volatile despite recent gains on the back of data pointing to a nascent recovery in the real sector. However, risks are still tilted towards the downside, for some countries, whose domestic credit growth has been fuelled from external funding sources and those who need to finance large current account deficits.

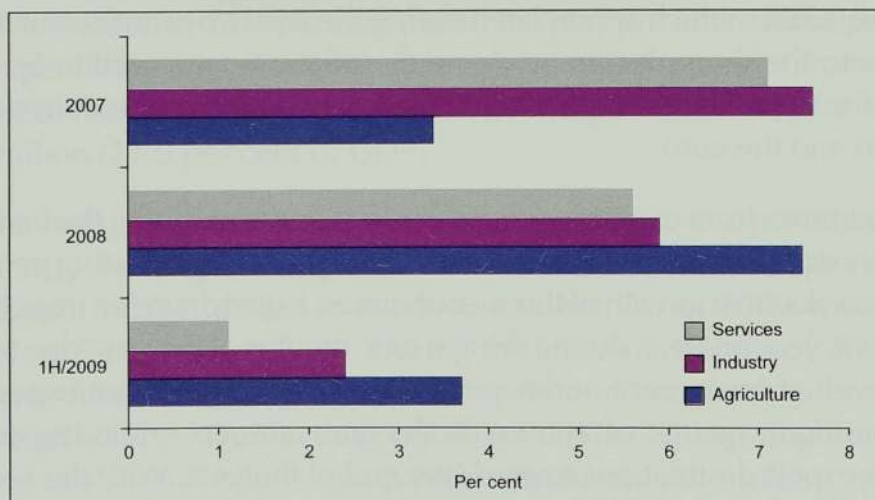
## 2.2 Domestic Macroeconomic Developments

### Economic Growth

Domestic economic growth is expected to slowdown to 3.5 per cent in 2009 compared to the growth of 6.0 per cent recorded in 2008. The slowdown in overall growth is mainly due to the low growth observed in the first half of the year. In the second half of the year, the recovery in the global economy as well as the end to the conflict strengthened growth prospects.

The resilience of the domestic economy in the face of adverse shocks was reflected once again as all three major sectors averted a contraction in growth and recorded reasonable growth rates under a difficult environment. The Industry and Services sectors grew by

Chart 2.2 – Sectoral Growth Rates



3.1 per cent and 2.5 per cent, respectively, for the first nine months of 2009 while the Agriculture sector recorded a growth of 2.1 per cent. The end of the conflict provides a significant upside to GDP growth on account of post war reconstruction and increased economic activities in the Northern and Eastern Provinces.

The unemployment in the country has been continually declining in recent years due to the expansion in the domestic economy, increased foreign employment opportunities and recruitment to the public sector. However, the recession in advanced countries and the slowdown in domestic economic activity has had a negative impact on domestic employment with the unemployment rate rising to 6.2 per cent (excluding the Northern Province) during the first half of 2009 from 5.5 per cent in the first half of 2008.

### External Sector Developments

The external sector has shown a remarkable turnaround during 2009. With the deepening global economic crisis, the external sector experienced a severe drawback due to the decline in external demand and the outflow of foreign investments, particularly during the last quarter of 2008 which also continued into the first quarter of 2009. The gross official reserves (excluding ACU receipts), which stood at US dollars 1,753 million by end December 2008, declined to US dollars 1,272 million by end March 2009. On April 24, 2009, the rupee depreciated to its lowest level, recording a rupee : dollar exchange rate of Rs. 120.25 per US dollar, owing to market speculations. In view of these developments, several measures including seeking assistance from the International Monetary Fund (IMF) in the form of a Stand-by Arrangement (SBA) facility with exceptional access were adopted to improve the external sector environment.

However, conditions have improved considerably since the end of the second quarter of 2009 with the end of the three decades long war. Positive investor sentiment was further strengthened with the approval of the largest ever loan to Sri Lanka by the IMF on July 24, 2009 in the form of an SBA facility. Liquidating of foreign currency positions by foreign exchange earners also helped shape market perception in support of the rupee in the foreign exchange market. Since foreign exchange inflows have continued to exceed outflows, the Central Bank has continued to purchase foreign exchange from the domestic foreign exchange market to avoid an excessive appreciation of the rupee. The Real Effective Exchange Rate (REER), which appreciated during the first two months of 2009, depreciated thereafter due to the sharp decline in domestic inflation compared to Sri Lanka's trading partners and the depreciation of the US dollar against other major currencies such as the sterling pound and the euro.

Meanwhile, earnings from exports declined by 16.8 per cent during the first nine months of the year mainly due to the lower demand from Sri Lanka's major trading partners, as a result of the rapid slowdown in growth of those economies. Expenditure on imports also declined by 35.3 per cent, year-on-year, during the first nine months of the year, due to lower demand for goods as well as lower commodity prices. However, exports are expected to record a growth for the fourth quarter of 2009 with the gradual recovery in the economies of Sri Lanka's major export destinations towards the end of the year. With the progress made on

the resettlement process and the ongoing large-scale infrastructure development projects around the country, the decline in imports is also expected to have decelerated towards the end of the year. During the first nine months of the year, the trade balance contracted by 59.7 per cent to US dollars 1,861 million. Workers' remittances increased by 10.3 per cent to US dollars 2,481.4 million during this period. Consequently, workers' remittances during the first nine months of 2009 were in excess of US dollars 633.6 million (about 34 per cent) over the trade deficit.

The external sector was further strengthened with the receipts of first and second tranches of the SBA facility, the receipt of the general and special allocation of Special Drawing Rights (SDRs) equivalent to about US dollars 508 million and the issue of the second international sovereign bond of US dollars 500 million. With all these developments, the balance of payment (BOP) which recorded a deficit of US dollars 192 million by end June 2009, improved by end November 2009 and recorded a surplus of US dollars 2,815.1 million. The gross official reserve level (excluding ACU receipts) has shown a remarkable improvement and exceeded the US dollars 5 billion level by November 2009, a level sufficient to cover more than 6 months of imports. The BOP is projected to improve to record a surplus of US dollars 2,843 million for 2009 and gross official reserves by end December 2009 increased to an estimated US dollars 5,353 million.

### **Fiscal Sector Developments and Government Debt**

According to provisional data, total government revenue increased by 12 per cent to Rs. 522 billion during the first nine months of 2009, from Rs. 465.6 billion recorded in the corresponding period of 2008. As a percentage of projected GDP for 2009, it remained at 10.6 per cent. According to the revised estimates, total government revenue in 2009 is estimated to be Rs. 727.7 billion (14.8 per cent of GDP).

Meanwhile, government expenditure increased by 18.6 per cent to Rs. 844.7 billion during the first nine months of 2009, from Rs. 712.5 billion recorded in the same period of 2008. Government recurrent expenditure grew by 26.2 per cent to Rs. 661.5 billion during the first nine months of 2009, compared to the same period in the previous year. Capital expenditure and net lending was reduced by 2.7 per cent to Rs. 183.2 billion during the first nine months of 2009. As a percent of GDP, recurrent expenditure during the first nine months of 2009 increased to 13.4 per cent from 11.9 per cent in the same period in 2008, while capital expenditure and net lending decreased to 3.7 per cent from 4.3 per cent. According to the revised estimates, total government expenditure in 2009 is estimated to be Rs. 1074.1 billion (21.9 per cent of GDP).

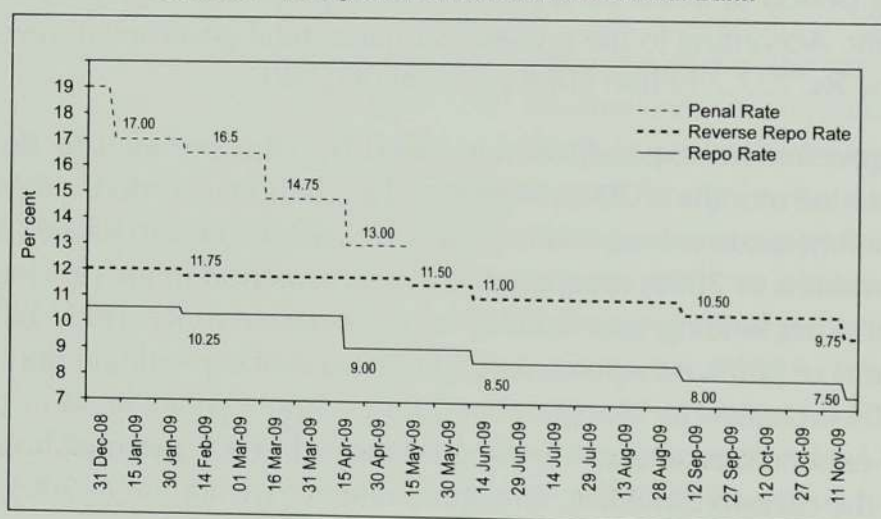
According to the revised estimates, the overall budget deficit as a percentage of GDP in 2009 is expected to be around 7.0 per cent compared with the 7.7 per cent recorded in 2008. The overall budget deficit in the first nine months of 2009 is estimated to be Rs. 322.6 billion (6.5 per cent of GDP). During the first nine months of 2009, the overall budget deficit was financed with Rs.166.5 billion from domestic sources and Rs. 156.1 billion from foreign sources. During this period, government borrowing from the banking sector amounted to Rs. 48.7 billion compared with the Rs. 52.1 billion recorded in the

first nine months of 2008. The outstanding government debt increased by Rs. 445.6 billion to Rs. 4,023.6 billion, by September 2009, compared to that at end 2008. Domestic debt increased by Rs. 199.5 billion to Rs. 2,328.8 billion while foreign debt increased by Rs. 246.1 billion to Rs. 1,694.8 billion during this period.

### Monetary Sector Developments

In 2009, the Central Bank eased its monetary policy stance significantly, following measures taken in the last quarter of 2008 and early in 2009 to maintain markets liquid and support economic activity. Additional liquidity was injected to the market by way of a reduction in the Statutory Reserve Ratio (SRR) in several steps to 7 per cent by February 2009. The penal rate on reverse repurchase transactions with commercial banks and primary dealers, was gradually brought down and finally removed in May 2009. The Repurchase and Reverse Repurchase rates, which form the policy rate corridor of the Central Bank, were also reduced in several steps: the Repurchase rate was reduced by a total of 300 basis points to 7.5 per cent and the Reverse Repurchase rate by 225 basis points to 9.75 per cent by end November 2009. Following the decline in policy rates, market interest rates have also declined gradually. A downward adjustment in market interest rates is necessary in order to stimulate credit to the private sector, which has been underperforming partly due to the uncertainty that has prevailed in the financial sector.

Chart 2.3 – Policy Interest Rates of the Central Bank



### Domestic Credit

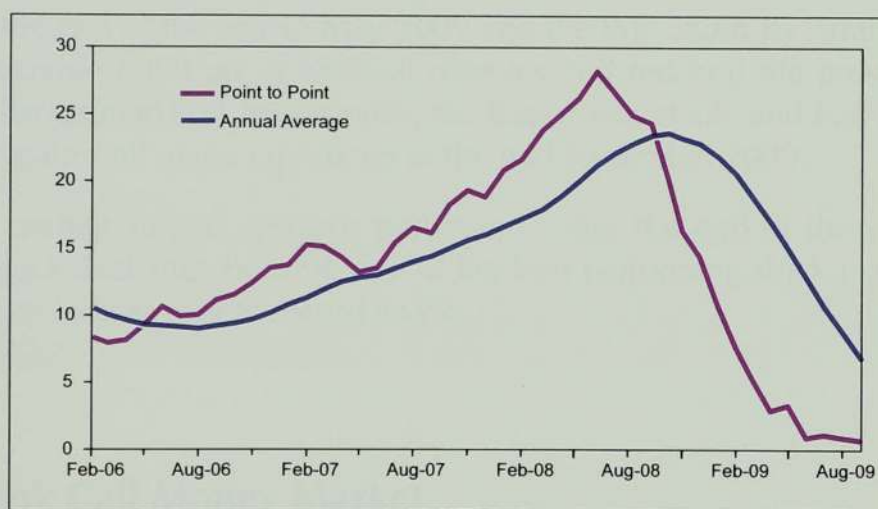
Domestic credit increased marginally during the nine months upto September 2009 as net credit disbursed by commercial banks to the government as well as credit disbursed to public corporations increased while credit obtained by the private sector, which accounts for more than 60 per cent of domestic credit, contracted during this period. Demand for credit by the private sector has been low mainly in view of the slowdown in economic

activity. On a year-on-year basis credit obtained by the private sector has contracted by 5.2 per cent by September 2009. However, given the decline in market interest rates along with the recent reductions in policy rates and the anticipated pickup in economic activity, it is expected that conditions in the domestic credit markets would ease further, thereby facilitating an increased flow of credit to the economy.

## Inflation

Inflation, as measured by the year-on-year change in the CCPI (2002=100), has moderated considerably in 2009. Year-on-year inflation, which was 14.4 per cent at end 2008, declined and reached the lowest level of 0.7 per cent in September 2009 before reaching 4.8 per cent at end 2009. The tight monetary policy stance adopted by the Central Bank in the past along with positive supply side developments domestically and especially externally supported this steady decline : demand side pressures on inflation were contained through proper demand management policies by the Central Bank, while supply side inflationary pressures have remained subdued due to the significant decline in international commodity prices since the latter part of 2008. Accordingly, inflation, on a year-on-year basis, is expected to remain within single digits at end 2009. However, possible upward risks to inflation are likely as the global economy picks up thus exerting

Chart 2.4 – Inflation



upward pressure on international commodity prices. Since such developments could drive up domestic inflation in 2010, the Central Bank will continue to exercise caution in its exercise of monetary policy to ensure that inflation and inflation expectations are contained.

The first part of the paper discusses the general situation of the country and the position of the Government. It then goes on to discuss the various departments and the work of each of them. The paper concludes with a summary of the work done during the year.

**Administrative and Financial**

The administrative and financial departments have been working hard to improve the efficiency of the Government. They have been successful in many ways, and their work has been well received by the public. The financial department has been particularly successful in its work, and its efforts have been well rewarded. The administrative department has also been successful in its work, and its efforts have been well received by the public.

Table 1. Income



The income of the country has been increasing steadily over the years. This is due to the efforts of the Government and the people. The Government has been successful in its work, and the people have been working hard to improve the country. The income of the country is now at a high level, and it is expected to continue to increase in the future.

# 3. Financial Markets

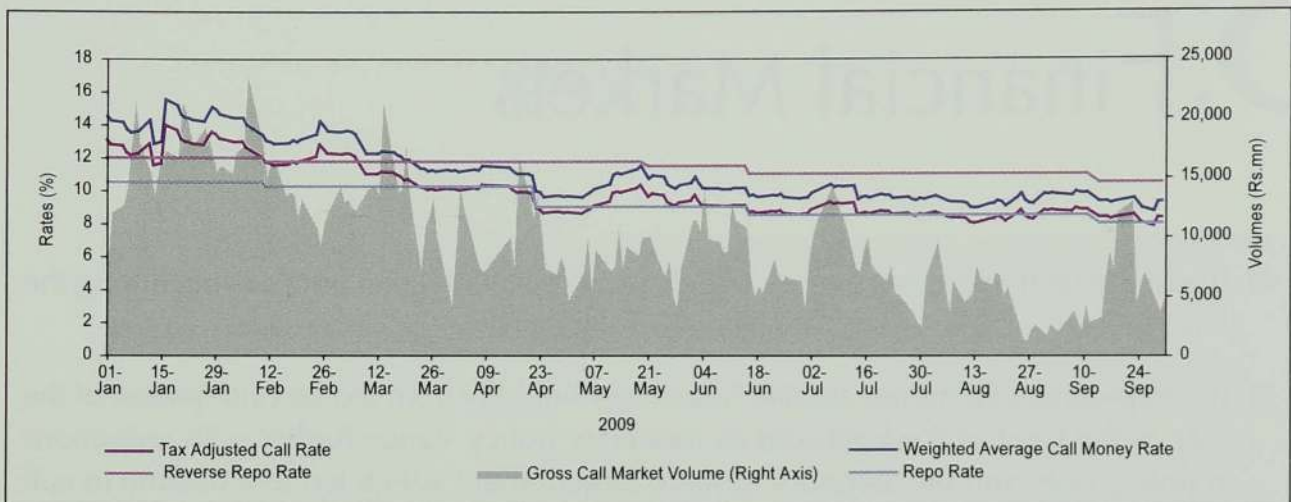
- ✧ The financial markets were more liquid and stable, with asset prices rising during the year.
- ✧ The inter-bank call money market has excess liquidity from the second quarter of the year as the Central Bank relaxed its monetary policy stance further with reductions in policy rates and the Statutory Reserve Requirement which led to a decline in call money market rates.
- ✧ Yield rates in the Treasury bill and bond markets also declined sharply and the market for medium term government securities became more active. The more conducive interest rate environment is expected to revive the corporate debt securities market in the future.
- ✧ The withdrawal of foreign investment from the government securities market resulted in a decline in external reserves to a low level in the first quarter of 2009 and put pressure on the foreign exchange market. The resumption of foreign capital flows after the end of the war in May 2009 and the IMF Stand-By Arrangement led to an appreciable build up in external reserves and reduced the pressure on the foreign exchange market. Consequently, the Rupee was stable and had depreciated marginally against all major currencies at the end September 2009.
- ✧ The equity market surged upwards particularly after the end of the war and the Colombo Stock Exchange became one of the best performing stock markets in the world as price indices rose to record levels.

## 3.1 Inter-bank Call Money Market

The call money market, in which the commercial banks trade their day-to-day liquidity imbalances, is the most active segment of the money market. The interest rates in the call money market are highly sensitive to the demand and supply factors and it is presumably the most closely watched variable in day-to-day conduct of monetary operations. The stability of the money market is influenced by overall liquidity in the banking system, its distribution among banks, monetary policy decisions and operations of the Central Bank. Thus, stable and orderly functioning money market is vital for minimizing the liquidity risk in the entire banking system.

Overall, the banking system reported a surplus liquidity position during the first nine months of 2009. At the beginning of the year there was a liquidity surplus of

Chart 3.1 – Volumes and Rates in the Money Market



Rs. 12.9 billion in the system. This was turned into a deficit in mid January 2009 and continued for few months until reversing to a surplus during the second quarter. On average, the daily liquidity position in the banking system was a deficit of Rs. 5 billion during the first three months of the year. The liquidity shortfall was largely attributed to the supplying of foreign exchange to the market by the Central Bank to meet the demand arose mainly from the withdrawal of foreign investments in Government securities with the intensification of global financial crisis. The Central Bank provided adequate liquidity to the system through its standing facilities and term reverse repo under Open Market Operations (OMO). Moreover, the Statutory Reserve Requirement (SRR) of commercial banks was further reduced to provide liquidity into the money market. Similar to the previous years, the market experienced a liquidity shortage during the Sinhala and Tamil New Year festive season due to the high demand for currency, which was subsequently normalized with the returning of such funds to the system.

The liquidity in the market improved particularly towards the end of May with a surplus position maintained thereafter. The average excess liquidity of about Rs. 13.2 billion that prevailed from June to September, was primarily due to the large inflow of foreign currency to the banking system, which was purchased by the Central Bank. The market liquidity reached its peak level in July. During the first 9 months, the average liquidity during the days when there was a surplus in the banking system was Rs. 10.9 billion. From June to end September, the liquidity surplus varied in the range of Rs. 0.5 billion to Rs. 28.8 billion. The Central Bank absorbed the excess liquidity appropriately through its OMO to ensure the stability of the money market.

During the first nine months of 2009, the inter-bank call money market rates were less volatile compared to the previous year. Improved liquidity management through OMO and re-establishment of interest rate corridor by removing the penal rate and the restrictions on repo and reverse repo facility of the CBSL, were mainly responsible for this development. The weighted average call money market rate, which was about 14.5 per cent at the beginning of the year, declined gradually to a single digit level towards the end of June 2009 and commenced its move around the middle of the policy rates since then

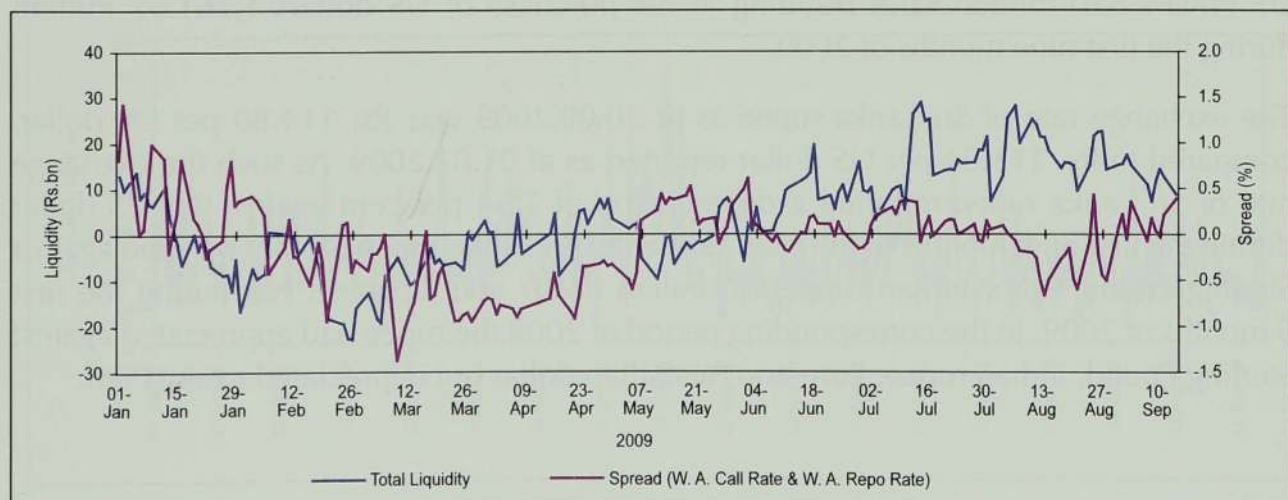
9.5 per cent towards the end of June 2009 and hovered around 9.5 per cent in July and August. This was in line with the gradual reduction in penal rate from 19 per cent to 13 per cent until its subsequent removal coupled with the downward revision of CBSL Repurchase and Reverse Repurchase rates from 10.50 per cent to 8.00 per cent and 12.00 per cent to 10.50 per cent, respectively. The spread between minimum and maximum call money rates which was as high as 415 bps (basis points) on average during the first four months of 2009 narrowed down significantly to 125 bps on average during the next five months reflecting the continued improvement of the stability in the money market.

During the first three months, the weighted average call money rates of about 13.3 per cent on average, moved within the range of CBSL Reverse Repurchase rate (policy rate) and the penal rate, effectively forming lower bound and upper bound for money market rates. The restrictions on borrowing under Reverse Repo standing facility and liquidity shortfall prevailed in the banking system resulted in higher market rates in the early part of the year. By mid March, weighted average call money market rate moved towards the policy rates and reached to 11 per cent, *i.e.*, below reverse repo rate, following the large reduction in penal rate by 225 bps in two occasions within a period of one month and on the improved liquidity in the banking system. During the subsequent period, the weighted average call money rates varied within the interest rate corridor defined by the CBSL policy rates *i.e.*, Repo and Reverse Repo rates.

With the re-establishment of interest rate corridor by removing both the Reverse Repurchase facility at penal rate and the restrictions on overnight Repurchase and Reverse Repurchase under standing facility in May, the weighted average call money rates performed well showing a tendency to move closer to the middle of the interest rates corridor that stood then between 8.50 per cent and 11.00 per cent, reflecting high level of stability.

Up to end April, the spread between the inter-bank weighted average call money rate and the weighted average overnight market repurchase rate indicated negative values. This was mainly due to the unexpected liquidity issues associated with few banks resulting market players to tighten bank-by-bank exposure limits and demand collateralized instruments

Chart 3.2 – Spread between Call Rates and Repo Rates Vs. Market Liquidity



to minimize the credit risk exposure to respective counter parties. Moreover, the banks preferred to invest in the CBSL repo facilities than in uncollateralized call market for further reduction of credit risk. However, this trend was reversed in May with spread between call money rate and overnight market repo rate turning into positive values reaffirming the stability in the banking sector. During the first nine months in 2008, the average spread was 37 bps (Chart 3.2). In a thin money market this kind of behavior could be attributed mostly to the involvement of limited number of participating institutions in the market transactions.

## 3.2 Domestic Inter-Bank Foreign Exchange Market

The pressure on the exchange rate of the Sri Lankan Rupee that prevailed in the last quarter of 2008 continued in 2009 and as a result CBSL intervened in the foreign exchange (FX) market to mitigate the volatility in the exchange rate especially in the first few months of 2009. Nevertheless, the rupee depreciated against the major currencies during the period March to early May 2009. The resumption of foreign investment in government securities following the end of the war in May 2009, funds obtained from the IMF Stand-By Arrangement and special allocation in July 2009 contributed to the appreciation of the Sri Lanka rupee since the second quarter of 2009.

### 3.2.1 Exchange Rate

The exchange rate in the inter-bank FX market is determined through market forces with limited intervention by the Central Bank to mitigate excessive volatility, as and when necessary. The CBSL has implemented several policy measures, such as monitoring of foreign currency transaction activities and over night net foreign exchange positions of commercial banks, moral suasion, prudential regulations and foreign currency intervention in the domestic FX market in order to maintain an orderly FX market.

The increase demand for foreign exchange on imports in the first quarter and the determination of exchange rate without CBSL intervention, contributed towards the depreciation of the Sri Lanka rupee. With the increase of foreign exchange inflows after May 2009, CBSL purchased US dollars 2,411.75 million from the market against the US dollars 650 million sales resulting in net purchase of US dollars 1,761.57 million during the first nine months of 2009.

The exchange rate of Sri Lanka rupee as at 30.09.2009 was Rs. 114.80 per US dollar, compared to Rs. 113.04 per US dollar reported as at 01.01.2009. As such the exchange rate of Sri Lanka rupee reported a depreciation of 1.54 per cent against the US dollar during the first nine months of the year. While the Sri Lanka rupee has depreciated against Sterling Pound, Euro, Indian rupee, Australian dollar and Japanese yen during the first 9 months of 2009, in the corresponding period of 2008 the rupee had appreciated against Sterling Pound, Indian rupee, Euro and Australian dollar but depreciated against Yen.

Chart 3.3 – Movements of Rupee per USD



### 3.2.2 Trading Volume

The daily average turnover in the inter-bank FX market (including the forward market) was US dollar 45.18 million during the first 9 months of 2009, with a range of US dollar 14.5 million to US dollar 113 million. In the corresponding period of 2008, the daily average turnover was US dollar 58.31 million, with a range of US dollar 15.25 million and US dollar 150 million. The total volume of inter-bank FX transactions, including the forward market transactions, was US dollar 8,088.11 million in the first 9 months of 2009, in comparison to US dollar 10,613 million in the respective period of 2008 recording a decline of 23.7 per cent. The forward volume in the inter-bank FX market decreased to US dollar 3,366 million (41.6 per cent of total volume) during January to September 2009 from US dollar 4,174.81 million (39.3 per cent of total volume) in 2008. The higher turnover in the inter-bank FX market during 2008 resulted due to inter-alia permitting foreign nationals to invest in government treasury bills and bonds, whilst in early 2009 the economic down turn following the financial crisis led to large foreign exchange outflows and decrease in turnover.

Chart 3.4 – Daily Inter-Bank FX Volumes

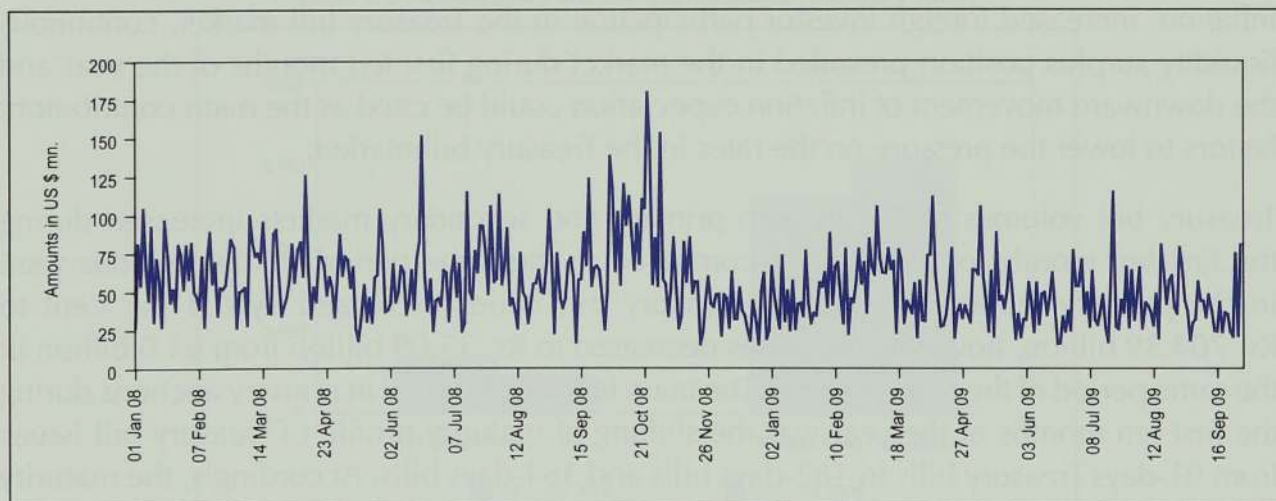
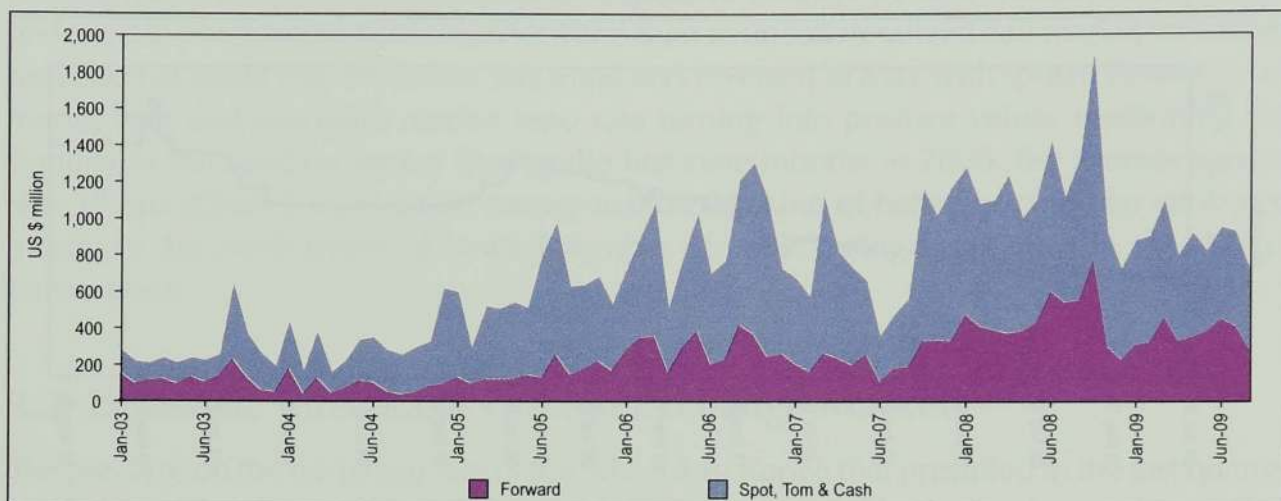


Chart 3.5 – Monthly Inter-Bank FX Volumes



### 3.2.3 Foreign Reserves

The year 2009 continued to be a challenging year for reserves management as major economies gradually entered into a deeper recessionary environment despite unprecedented quantitative easing of major central banks. However, during the first nine months of 2009, CBSL was able to absorb foreign exchange from the domestic foreign exchange market, obtain the first tranche of the IMF Stand-By Arrangement and replenish the foreign reserves to a comfortable level due to the positive sentiments that developed with the restoration of peace in the island. Accordingly, gross official reserves (without ACU funds) reached US dollar 4,226.7 million by end September 2009. As such, CBSL was able to maintain the exchange rate of the Sri Lanka rupee at a stable level during this period.

## 3.3 Treasury Bill Market

Treasury bills continued to be the most liquid and largely traded instrument operating in the financial market in 2009, reflecting their popularity as a repo market and short-term investment instrument. Interest rates in the Treasury bill market recorded a considerable reduction during the first ten months of 2009. Easing of the monetary policy, decline in inflation, increased foreign investor participation in the Treasury bill market, continuous liquidity surplus position prevailed in the market during first ten months of the year and the downward movement of inflation expectation could be cited as the main contributory factors to lower the pressure on the rates in the Treasury bill market.

Treasury bill volumes traded in both primary and secondary markets increased during the first ten months of 2009 when compared to the same period of the previous year. In the primary market, total gross Treasury bill issues increased by 8.3 per cent to Rs. 704.39 billion, however, net issues decreased to Rs. 35.09 billion from 63.0 billion in the same period of the previous year. The main feature observed in primary auctions during the first ten months of the year was the shifting of maturity profile of Treasury bill issues from 91-days Treasury bills to 182-days bills and 364-days bills. Accordingly, the maturity

profile compared to the same point in the previous year indicates a slight movement of tenure towards 364 days T-bill from 182 days T-bill (refer table below).

**Table 3.1 – Maturity Profile of Treasury Bills**

	91 days T-bill	182 days T-bill	364 days T-bill
31/10/2008	6%	31%	63%
31/10/2009	7%	27%	66%

Source : Central Bank of Sri Lanka

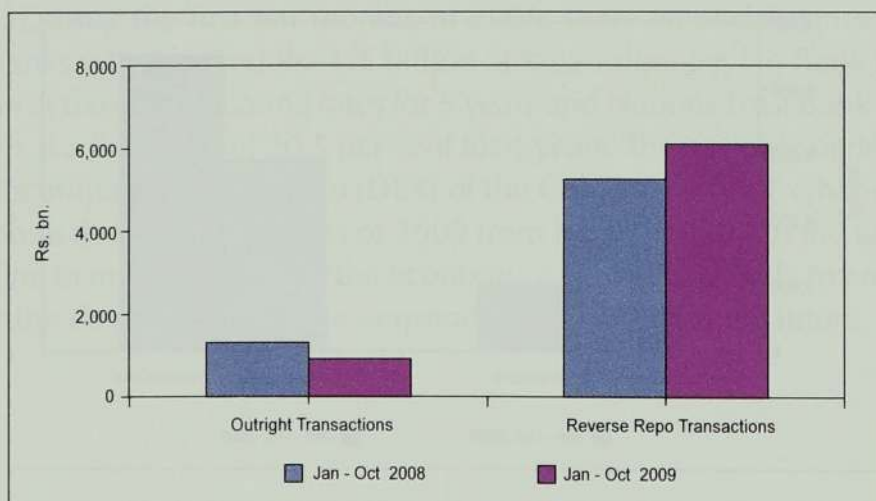
In the secondary market, according to the records at LankaSecure, total repo transaction volume of Treasury bills increased by 16.3 per cent in first ten months of 2009 as against in the same period in 2008, however Treasury bills outright transaction volume in the secondary market dipped to Rs. 912 billion from Rs. 1,312 billion.

The yield rates of Treasury bills in the primary market decreased in the range of 883 – 920 bps (basis points) during the first ten months of 2009 when compared with the rates prevailed as at end 2008. In line with this reduction, yield rates in the secondary market also decreased in a range of 970 – 1,025 bps, with the shorter end of the yield curve recording a sharp decline.

Public Debt Department (PDD) continued to use fund mobilization techniques, to fund the Treasury cash flow operations during the first ten months of 2009 such as pre-funding arrangements, forward funding arrangements, reducing auction size, and issuing Treasury bills with odd maturities in addition to traditional issues of 91 days, 182 days and 364 days bills. These strategies enabled to reduce bunching problems in the maturity structure of Treasury bill stock, thereby, lowering the refinancing risk.

Foreign investments in Treasury bills increased significantly after May 2009 as investor confidence built up with the end of the 30 year war and upon receiving the IMF

**Chart 3.6 – Secondary Market Transactions (Treasury Bills)**



Stand-By Arrangement facility. The total foreign investment in Treasury bills, in gross face value terms increased by Rs. 30.2 billion during the first ten months of 2009.

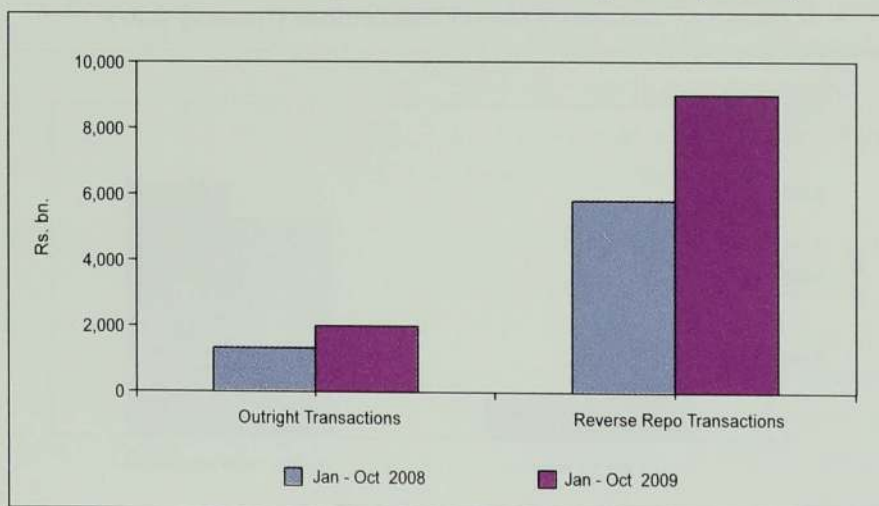
### 3.4 Treasury Bond Market

Interest rates in the Treasury bond market have shown a downward movement during 2009 in line with the reduction of Treasury bill interest rates and recorded a decline in the range of 566 – 1,093 basis points in the secondary market during the first ten months of 2009. Some of the reasons are easing of the monetary policy, decline in inflation, increased foreign investor participation in the Treasury bond market, and continuous liquidity surplus position prevailed in the market during first ten months of the year. A remarkable development observed during this period was renewed foreign investor participation in the government securities market. Foreign investments in Treasury bonds recorded the highest level of Rs. 145 billion in face value as at 31st October 2009 with the inflow of Rs. 127.4 billion face value during the first ten months of 2009. Market players showed a re-adjustment of their bond portfolios in order to obtain possible marked-to-market gain arising from holding long-term bonds in a declining interest rate scenario.

With these developments, the extension of the yield curve up to 6 year horizon was witnessed during this period, reflecting the long term investment view of the market.

Reflecting the lower inflationary expectations; Treasury bond volumes traded in the secondary market increased in first ten months of 2009 compared with the volumes traded in the same period in 2008. This increase was observed in both outright transactions as well as repo transactions. According to the records at LankaSecure, total repo transaction volume of Treasury bonds in the secondary market increased by 55.4 per cent in the first ten months of 2009 as against in the same period in 2008, and Treasury bonds outright transaction volume in the secondary market hiked to Rs. 1,994 billion from Rs. 1,324 billion. The increase of repo transactions was partly due to the popularity of Treasury bonds among investors to use as collateral in such transactions.

Chart 3.7 – Secondary Market Transactions (Treasury Bonds)

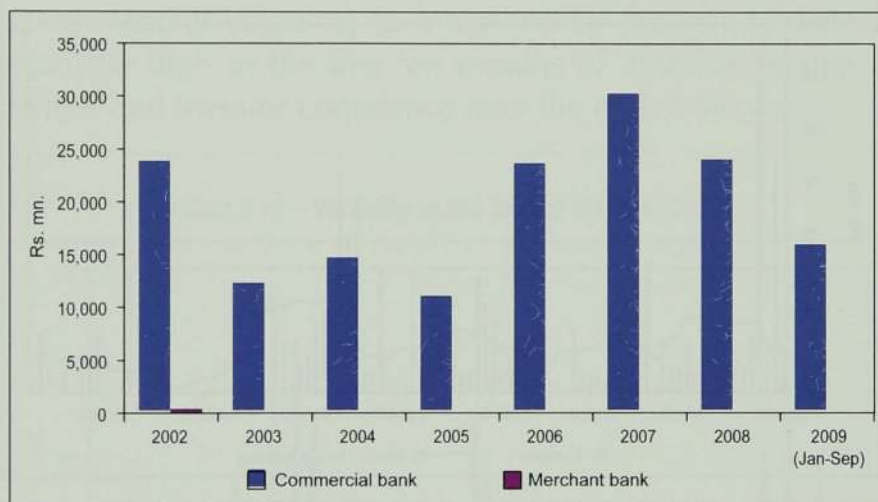


## 3.5 Corporate Debt Securities Market

### 3.5.1 Commercial Paper Market

Activity in the corporate debt securities market was limited during the first nine months of the year. The total value of commercial paper issued with the support of banks amounted to Rs. 17.7 billion during the first nine months of 2009, in comparison with Rs. 18.8 billion during the corresponding period of 2008. The interest rates varied between 11 per cent to 36 per cent in the current year, compared with the range of 17 per cent to 36 per cent in the previous year. Commercial paper with a maturity of 3 months or less accounted for 81 per cent of the market, while the share of commercial paper with a 6 month maturity was 11 per cent. The total outstanding value of commercial paper amounted Rs. 6.1 billion at end September 2009, compared with Rs. 5.1 billion at end September 2008.

Chart 3.8 – Commercial Paper Issues



### 3.5.2 Corporate Bond Market

The corporate bond market was also relatively inactive due to the narrow issuer and investor base. During the first ten months of 2009, there were debenture issues by two commercial banks which raised Rs. 1.1 billion at face value. Seylan Bank PLC mobilized Rs. 630 million at fixed and floating rates for 5 years and Nations Trust Bank PLC mobilized Rs. 500 million at a fixed rate of 20.5 per cent for 4 years. The turnover of debentures listed on the Debt Securities Trading System (DEX) of the Colombo Stock Exchange increased to Rs. 103 million in the first ten months of 2009 from Rs. 97 million in the same period last year. The decline in interest rates and the economic recovery are likely to create conditions conducive for the development of the corporate debt market in the future.

Chart 3.9 – Listed Debenture Issues

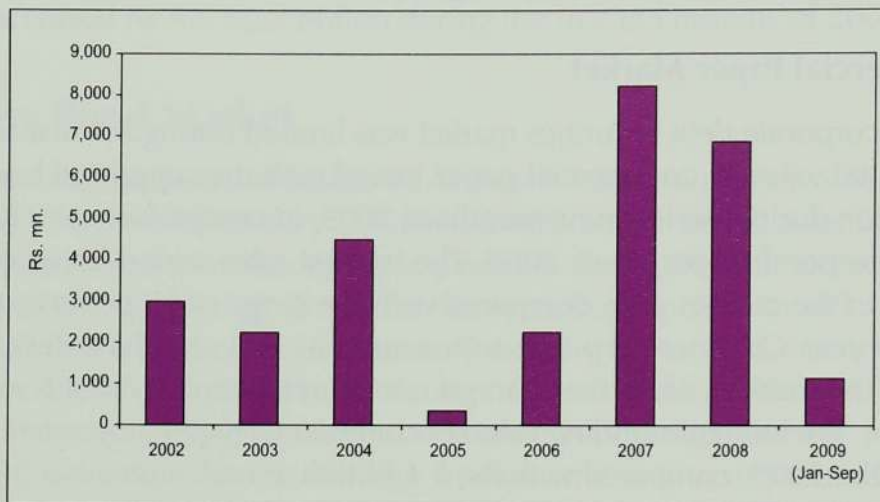
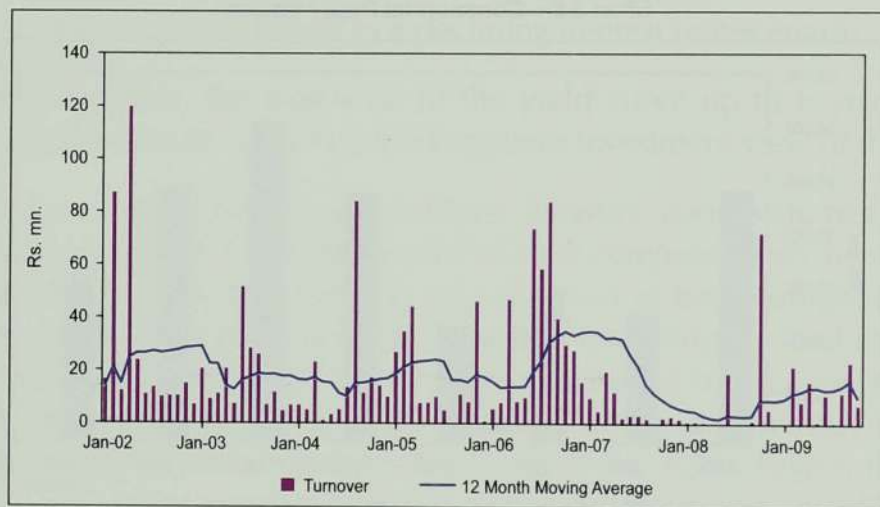


Chart 3.10 – Listed Corporate Bond Market (Monthly Turnover)

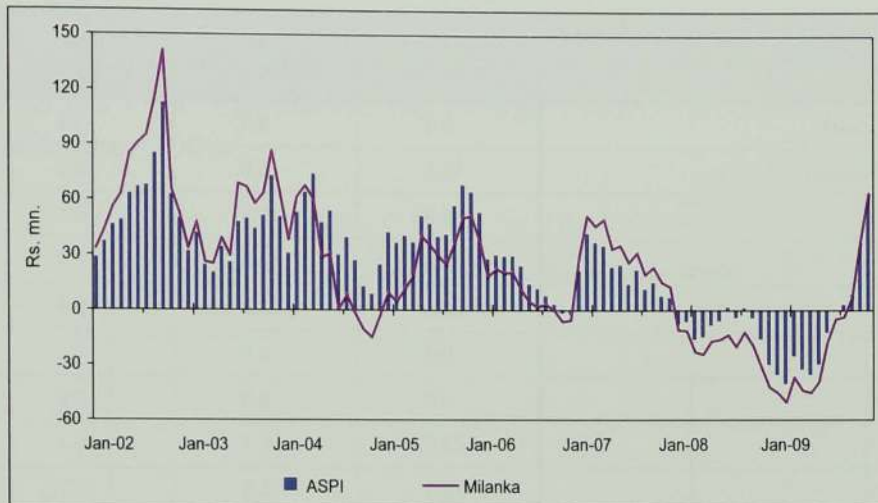


### 3.6 Equity Market

The Colombo Stock Exchange (CSE) became one of the best performing markets in the world, with the All Share Price Index achieving its highest level of increase. Equity prices rose steadily from the beginning of the year and surged upwards from May 2009 reflecting the positive market sentiment following the end of the war. The market price earning (P/E) ratio which had dropped to a very low level, rocketed to double-digit levels in October 2009. Other factors which contributed to the buoyant stock market was the sharp decline in inflation, lower interest rates, renewed investor confidence and following the granting of the IMF Stand-By Arrangement.

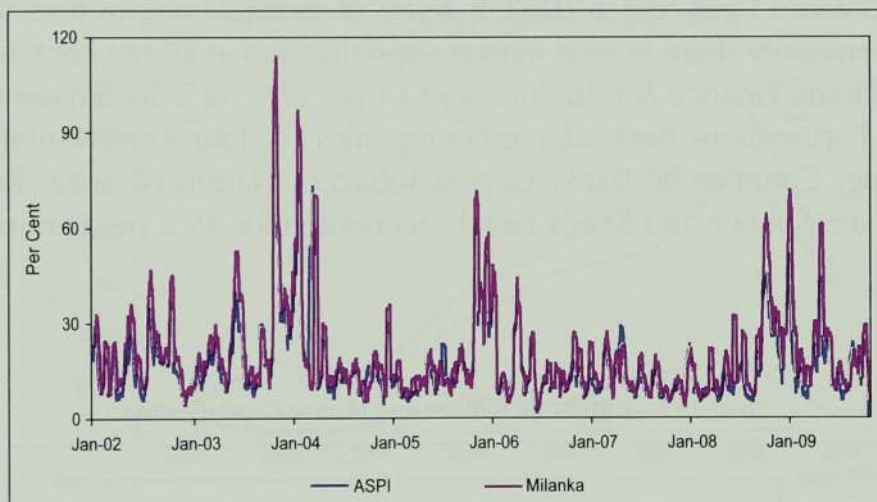
The All Share Price Index (ASPI) increased by 98 per cent at end October 2009, in contrast to a 41 per cent decline recorded in the previous year. The Milanka Price Index rose by 104 per cent at end October 2009, reflecting a substantial gains in the value of many blue-chip companies. The bullish trend was reflected in the sector indices of the CSE during the period under consideration. Of the five largest sectors in terms of market capitalization, the price indices of Diversified Holdings, Bank Finance &

Chart 3.11 – Annual Growth in CSE Price Indices



Insurance, Telecommunication, Beverage Food & Tobacco and Hotels Travels increased by 150 per cent, 123 per cent, 30 per cent, 99 per cent and 166 per cent respectively at end October 2009. Market volatility, as measured by the standard deviation of daily returns, was relatively high in the first ten months of 2009, reflecting an increase in speculative activities and investor confidence after the end of the war.

Chart 3.12 – Volatility in the Equity Market (CSE)



The overall market price earning (P/E) ratio increased to 14.4 at end October 2009 from 5.4 in December 2008. However, the market PE ratio has not deviated significantly above its long-term average, indicating that prices were in line with the economic fundamentals of the companies. It should be noted that the PE ratios of most emerging economy stock markets are much higher than the Sri Lanka market.

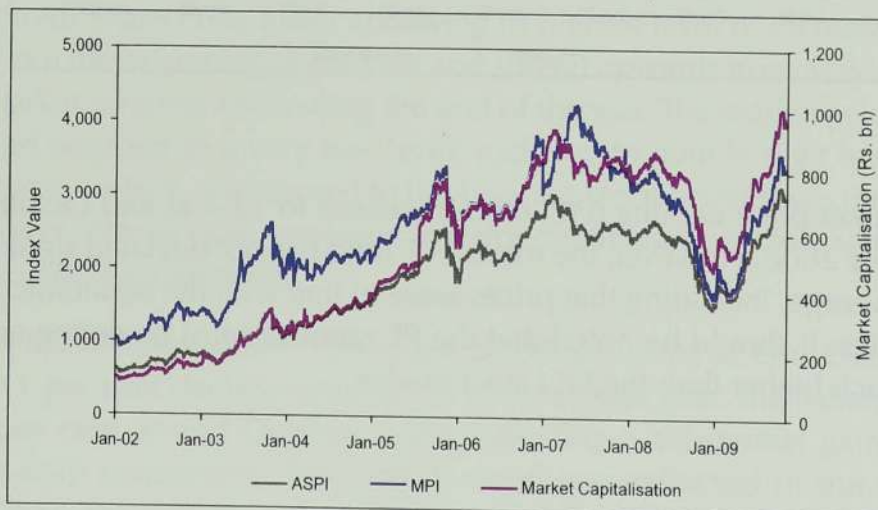
Table 3.2 – Price Earnings Ratios of Major Sectors of CSE

Sector	2006 December	2007 December	2008 December	2009 October
Bank, Finance & Insurance	8.5	8.8	3.9	10.0
Beverages, Food & Tobacco	10.5	8.9	5.8	13.9
Diversified	18.6	15.7	5.1	18.0
Telecommunication	24.4	17.6	7.2	18.5
Hotels Travels	22.8	23.2	15.9	64.7
Manufacturing	9.1	6.5	7.2	16.0
Oil Palms	9.0	9.0	2.9	32.8
Health Care	29.5	36.7	46.3	59.5
Plantations	10.3	15.6	2.7	11.0
<b>Market Price Earnings Ratio (P/R)</b>	<b>13.9</b>	<b>11.6</b>	<b>5.4</b>	<b>14.4</b>

Source : Colombo Stock Exchange

Market capitalization reached record levels, crossing the Rs. 1,000 billion mark in October 2009. This reflects a significant increase from the level of Rs. 489 billion registered at end December 2008. The market capitalization of CSE, which consists of 231 companies from twenty business sectors, was about 19.5 per cent of the country's GDP compared with 11 per cent in 2008. In terms of sectoral composition, the Diversified sector held the majority share in total market capitalization at 20 per cent as compared to 19 per cent for Bank Finance & Insurance and 14 per cent for Telecommunication at end October 2009. Furthermore, the ten largest companies *i.e.*, John Keells Holdings, Sri Lanka Telecom, Dialog, Commercial Bank, Ceylon Tobacco, Hatton National Bank, Carsons, Distilleries, Aitken Spence and Keells Hotels accounted for 45.5 per cent of total market capitalization.

Chart 3.13 – CSE Price Indices and Market Capitalisation



The average daily turnover at Rs. 531 million during the first ten months of 2009 was marginally higher than Rs. 529 million for the same period last year. Domestic investors accounted for 72 per cent of total turnover on the stock market, while the share of foreign investors was 28 per cent. Cumulative net foreign inflows remained positive at Rs. 2.1 billion by end October 2009.

Chart 3.14 – Equity Market Turnover Velocity Ratio

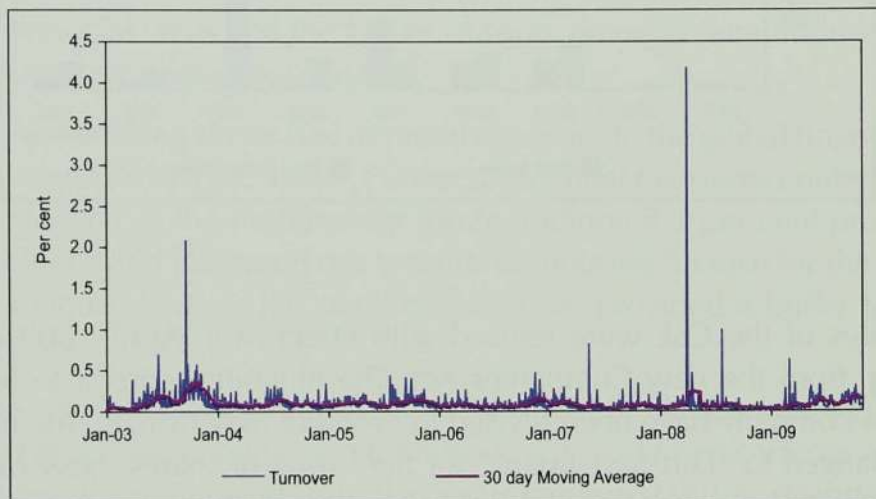
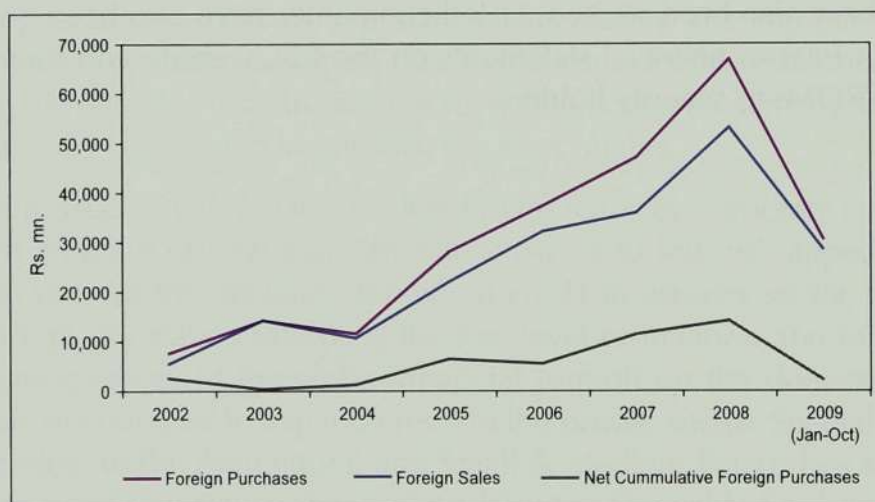
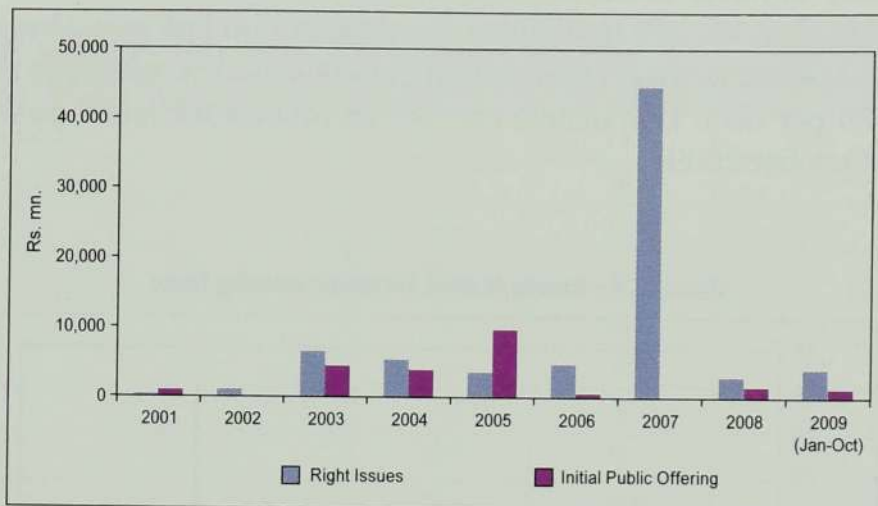


Chart 3.15 – Foreign Participation in the CSE



There were seven right issues and three Initial Public Offering (IPO) of shares, which raised Rs. 4 billion and Rs. 1.2 billion respectively during the first ten months of 2009. Further, the Seylan Bank also had a public share issue of 54.3 million shares to raise Rs. 1.9 billion to augment its capital. The first closed-end unit trust – NAMAL Acuity Value Fund was listed on the CSE with an IPO of Rs. 500 million

Chart 3.16 – Funds Raised from the CSE



The Listing Rules of the CSE were revised with effect from April 2009 incorporating changes arising from the new Companies Act. The eligibility criteria to list equity and debentures of a company have been revised to promote new listings. The name “Second Board” was changed to “Diri Savi Board” for the listing of shares. New rules have also been incorporated to list units of closed-end funds, scrip dividends, re-purchase of shares, redemptions, minority buy-outs and the further issue of shares by public subscription by listed companies. Rules relating to rights issues, capitalization of reserves, share swaps and warrants have also been revised. Listed companies have also been given the option of posting their interim financial statements on the CSE website and forwarding annual reports on CD ROMs to security holders.

# 4. Banking Sector

- ✦ The banking sector remained stable and resilient despite the challenges caused by the global financial crisis and the failure of some domestic unauthorised institutions engaged in finance related businesses.
- ✦ The Sri Lankan banking sector had minimal exposure to the global financial crisis due to the non-exposure to toxic assets. Further, prudential measures implemented by the Central Bank such as the requirement for an additional 1 per cent provision for all performing loans and increased risk weights on housing finance for the computation of capital adequacy before the onset of the crisis, provided a buffer to absorb any adverse impact.
- ✦ Overall, the key financial soundness indicators in the banking sector were maintained at healthy levels. Strong capital and liquidity levels, sustained earnings and improved risk management systems resulted in maintaining stability despite a marginal deterioration in the assets quality.
- ✦ The credit risk continued to be at a manageable level and banks have been advised to strengthen recovery processes to enhance asset quality. The improvement in loan repayment ability of bank customers due to the considerable reduction in interest rates during the past few months and the revival in economic activity, both globally and domestically, is expected to improve the asset quality.
- ✦ Credit growth decelerated due to low demand for loans by corporate customers and reduction in granting of new loans by banks owing to low risk appetite of banks. However, in view of the declining growth in credit to privates sector, relaxation in the monetary policy stance following the low level of inflation and to mitigate the negative consequences of the global financial turmoil on the domestic economy, the banks are encouraged to expand credit to the private sector. Special emphasis is made on lending to the Agricultural and Small & Medium Enterprises sectors. With the declining trend in interest rates and availability of loanable funds in the market, expansion in credit is expected in the near future.
- ✦ The exposure of the banks to market risk was negligible due to the low trading portfolios in banks. The liquidity risk of the banking sector too remained at a manageable level. However, the banks should manage the maturity gaps between assets and liabilities cautiously.
- ✦ The regulatory framework of banks remains strong with the implementation of Basel II and a mandatory Direction on Corporate Governance. With a view to standardising and strengthening the foreign exchange risk management systems of banks, Directions were issued on risk management relating to foreign exchange

business of licensed commercial banks. In order to further strengthen the supervisory framework for banks it is proposed to amend the Banking Act and to introduce consolidated supervision of banks. The initiatives taken by the Central Bank to facilitate the banking industry to adopt Sri Lanka Accounting Standards 44 and 45 in 2011 are continuing through close dialogue with the stakeholders.

- ✦ The unexpected financial difficulties faced by Seylan Bank PLC, a systemically important bank, towards the end of 2008 due to contagion of the failure of the Golden Key Credit Card Co. (Pvt) Ltd. was averted through immediate measures taken by the Central Bank under the provisions of the Monetary Law Act. The Bank of Ceylon was requested to appoint a team to carry out the functions of the Board of Director of Seylan Bank PLC and further to provide managerial assistance to the Seylan Bank. Such measures restored the public confidence in the bank and the operations of the bank were brought in to normalcy. The recapitalisation process of the bank carried out under the direction of the Central Bank was completed successfully which strengthened the liquidity and capital levels of the bank. The bank is carrying out its operations independently under the direction of its board of directors, which consists of directors representing the new strategic investors.

## 4.1 The Structure of Banking Sector

The banking sector continued to maintain its dominance in the financial sector further diversifying its operations while strengthening its risk absorption capacity. As of end September 2009, the banking sector accounted for about 58 per cent of the total assets of the financial system. The banking sector comprised 22 licensed commercial banks (LCBs) and 14 licensed specialised banks (LSBs) with assets of LCBs and LSBs accounting for 83.6 per cent and 16.4 per cent, respectively, of the total assets of the banking sector. During the first nine months, 25 branches and 64 extension offices were opened and the total number of banking outlets in the country amounted to more than 5,600 with 1,825 ATMs. These include several banking outlets opened in the Northern and Eastern provinces with the liberation of the two provinces.

During the first three quarters of 2009, the total assets of the banking sector recorded a growth of 9.0 per cent supported by an expansion in the deposit base of banks. The high interest rates that prevailed during the period and the shifting of savings from the non-banking sector facilitated a growth in deposits (15.1 per cent). However, the low demand for loans by corporate customers and the low risk appetite of banks under the prevailing volatile market conditions resulted in a negative growth in loans of 2.5 per cent. This has resulted in a gradual improvement in liquidity in the banking sector due to banks investing the excess funds in Government securities. The borrowings too recorded a negative growth of 14.5 per cent.

The six Systemically Important Banks (SIBs), comprising two state commercial banks and the four largest private domestic commercial banks, represented about 76.6 per cent of

LCB sector assets and 64.0 per cent of banking sector assets. The strength of the banking sector is largely dependent on the soundness of SIBs. During the first nine months of 2009, SIBs recorded a growth in assets of 8.8 per cent. In terms of deposits, the market share of SIBs was 80.7 per cent and 67.0 per cent of the LCB sector and the banking sector, respectively. LCBs as a whole, recorded a growth of 8.6 per cent in their asset base.

The activities of LSBs too showed a noticeable growth in assets of 12.2 per cent during the first nine months of the year. The two largest LSBs, a government owned savings bank and a private domestic bank, together accounted for 80.7 per cent of assets and 83.2 per cent of deposits of LSB sector. The 6 regional development banks (RDBs) that accounted for 8.2 per cent of assets of LSB sector, are to be amalgamated to a national level bank under the provisions of an Act of Parliament.

The state owned banks comprising two LCBs and eleven LSBs including six RDBs together accounted for nearly 48.2 per cent of the assets of the banking system. These thirteen state banks contributed to 68.2 per cent of the total growth in banking sector assets. The two state commercial banks have a share of 41.2 per cent of assets in the LCB sector, while the state owned LSBs, represent nearly 84.5 per cent of the assets of the LSB sector.

The main source of funds of the banking sector continued to be deposits which accounted for 73.5 per cent of total liabilities at the end of September 2009 as against 69.6 per cent during the comparative period in 2008. Part of the funds mobilised was utilized to repay borrowings which resulted the share of borrowings to reduce from 17.0 per cent to 13.3 per cent of total liabilities. On the whole, this shift would have resulted in a reduction in the cost of funds of the banking sector. The capital funds increased by Rs. 21.5 billion (by 9.8 per cent) while the share of capital in total funding structure increased marginally from 8.0 per cent to 8.2 per cent. The growth in capital was mainly due to the new capital infusion. Despite the tight liquidity position that remained during the period under review, banks were able to raise about Rs. 3.2 billion by way of new capital infusion to strengthen the quality of capital of the banking industry.

Income from fund based activities continued to be the main source of income for banks, representing 86.1 per cent of the total income compared with a share of 75.0 per cent in end 2008. It is observed that interest income as a percentage of average assets is declining at a higher pace (by 50 bps) than the interest expenses (40 bps), thereby reducing the growth rate of the net interest income. However, the interest margin of the banking sector remained unchanged at 4.4 per cent in September 2009. Further, the fee base income has marginally declined during the first three quarters of 2009, compared to last year, mainly due to the effects of global recession.

The Off-balance sheet exposure of the industry has decelerated at a noticeable pace during the first three quarters mainly attributable to the global economic conditions which created uncertainties in the financial markets. The exposure of 62.4 per cent of the off-balance sheet assets which prevailed as at end 2008 declined significantly to 45.1 per cent of the on-balance sheet assets as at September 2009.

## 4.2 Assessment of Risks in the Banking Sector

The availability of sound risk management systems is the key to the success of a banking sector as banks are exposed to a variety of risks due to the nature of its core business activities. It is essential for banks to ensure that adequate policies, procedures and systems are in place to identify, assess, control and manage the range of risks the banks are faced with.

### Credit Risk

Credit risk is still the single most important risk in the banking sector as lending operations are the core of the banking business. Although the growth in credit has depicted a decline in the recent past the lending operations still account for about 54 per cent of banks' assets as against 61 per cent at end 2008. The recent global financial turmoil experienced by many countries has reiterated the importance of adopting sound risk management systems as credit risk has a direct influence on the earnings and solvency of banks.

On the whole, the deceleration in credit growth in the banking sector continued during the first nine months of 2009 due to the low demand for loans by both the corporate and private sector customers and a reduction of granting of new loans by banks owing to the low risk appetite of banks attributable to the volatile market conditions prevailed during the period. While the overall credit in the banking industry recorded a negative growth of 2.5 per cent (Chart 4.1), the credit portfolio of LCBs recorded a negative growth of 3.6 per cent. However, the lending activities of LSBs grew by 6.4 per cent respectively. The decline in credit growth was mainly a result of the deceleration in export bills, leasing facilities, term loans, credit cards and housing loan facilities. However, credit for import bills, pawning advances and overdrafts grew despite the high interest rates charged by banks. The sectoral distribution of credit of the banking sector as at end September 2009 shows that 46 per cent of the lending activities of the banks were concentrated towards the trading sector (28.1 per cent) and consumer lending (18.0 per cent) that included pawning and credit cards (Table 4.1). The other key sectors were housing and property development (13.8 per cent) and agricultural (10.2 per cent) sectors.

Chart 4.1 – Rate of Credit Growth

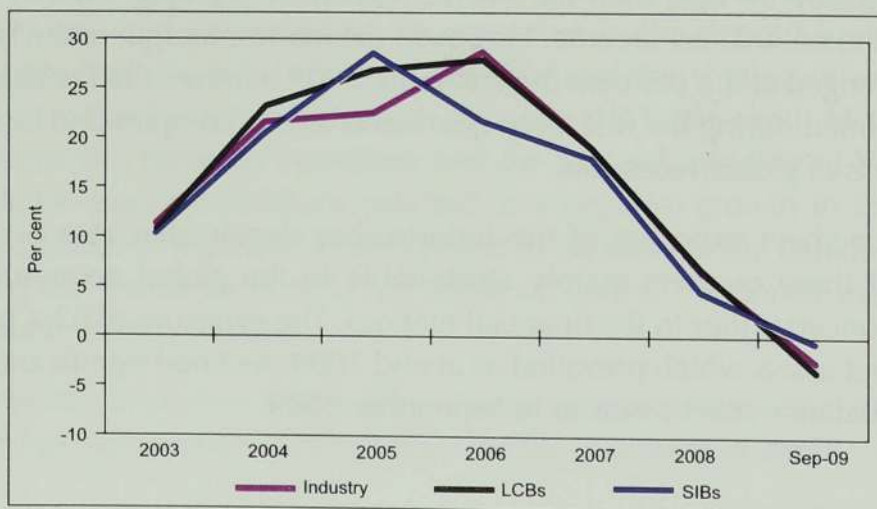


Table 4.1 – Micro Prudential Indicators

Indicator	2004	2005	2006	2007	2008	2009 Q3
<b>Licensed Commercial Banks</b>						
1. Capital Adequacy Ratio – Tier 1 Capital Ratio (%)	9.3	12.2	11.3	11.9	11.1	11.4
2. Capital Adequacy Ratio – Total Capital Ratio (%)	10.3	12.8	12.7	13.6	13.8	14.1
3. Gross Non-Performing Assets as a % of Total Loans and Advances	9.0	6.8	5.5	5.0	6.0	8.6
4. Net Non-Performing Assets as a % of Capital Funds	29.8	16.5	13.0	11.9	16.7	30.2
5. Sectoral Credit Distribution (%)						
Trading	35.7	32.6	29.7	30.6	28.1	28.1
Financial	4.8	5.2	6.1	6.5	5.7	4.2
Agriculture	3.8	4.3	3.9	4.0	4.2	10.2
Industry	10.0	9.7	8.8	8.2	8.4	9.0
Tourism	1.3	1.5	1.5	1.2	1.2	3.3
Housing and Property Development	14.3	14.4	16.2	16.6	15.1	13.8
Consumption	13.7	15.0	14.4	20.6	24.4	7.2
Others	13.7	15.0	14.4	12.3	12.9	24.2
6. Return on Assets (%) (before tax)	1.4	1.7	1.8	1.9	2.0	2.0
7. Return on Equity (%)	18.3	16.8	17.4	15.0	14.8	14.1
8. Liquidity Ratio, % (DBU)	26.3	24.5	23.9	24.8	25.7	32.8
9. Net Open Position (NOP), % of Capital Funds	2.8	1.2	0.7	1.2	2.1	-1.4
<b>Licensed Specialised Banks</b>						
1. Capital Adequacy Ratio – Tier 1 Capital Ratio (%)	27.0	25.7	20.6	22.6	24.7	19.8
2. Capital Adequacy Ratio – Total Capital Ratio (%)	19.3	20.0	19.7	19.1	20.0	17.7
3. Gross NPA as a % of Total Loans and Advances	10.4	8.8	6.8	6.7	8.9	10.7
4. Net NPA as a % of Capital Funds	19.7	21.1	21.9	23.0	26.7	33.3
5. Return on Assets (%)	2.7	2.5	1.9	1.7	1.4	2.5
6. Return on Equity (%)	17.7	15.4	12.1	10.0	6.9	17.5
7. Liquidity Ratio (%)	69.4	69.4	63.6	61.0	61.9	69.3

Source : Central Bank of Sri Lanka

The number of banks granting advances through credit cards increased to 11 at end September 2009 from 10 at end 2008, while the total credit card portfolio stood at Rs. 32.9 billion. The share of credit card operations which is part of consumer lending in the total loan portfolio is only 2.0 per cent. Advances granted under credit cards recorded a noticeable negative growth of 5.2 per cent during the first three quarters of 2009, a sharp decline from the growth of 8 per cent in the corresponding period of 2008. This was mainly due to stringent monitoring of the banks and low demand for credit cards due to high rate of interest attached to the product. Although the share of credit card operations in the total loan portfolio of LCBs continued to remain low at 2.3 per cent, the relatively high NPL ratio (8.2 per cent) in this sector requires further careful monitoring of the credit card portfolio.

Pawning advances that form a major component of consumer lending has been increasing during the past years due to the high preference indicated by banks in lending through pawning advances. Nevertheless, the growth of pawning has decelerated from 16.4 per

cent as at end September 2008 to 7.0 per cent as at end September 2009 mainly due to high rates of interest charged by banks during the period. Further, the share of pawning advances in total loans has also declined from 9.9 per cent to 7.2 per cent during the corresponding periods.

In order to restrain any adverse shocks to banks through possible vulnerabilities due to high credit exposures to large borrowers, the Central Bank has issued prudential directions and guidelines on maximum amount of accommodation. The criteria adopted in this case are based on the capital base of the banks, the status of risk management of banks in terms of capital adequacy ratio of the banks and the external credit ratings of the borrower and the bank. As at September 2009, the banking sector exposure to large groups of companies, numbering 41, amounted to Rs. 136 billion, which accounted for about 8.9 per cent of total outstanding credit of banks. The risk arising from such exposure is mitigated as these groups carry out well diversified business operations.

The non-performing loans (NPL) ratio, which indicates the ratio of non-performing loans to total loans of the banking industry, reflected a marginal deterioration in the first three quarters of 2009 mainly due to the lagged effects of high growth in bank lending during 2007 up to mid 2008, high interest rates prevailed in the market and the impact of the global crisis on the domestic economy that made repayments of loans difficult. As at end September 2009, the NPL ratio had increased to 8.8 per cent from 6.3 per cent in end 2008. However, since then the NPL ratio of the banking sector has moderated due to the more favourable macroeconomic environment prevailing in the country. The composition of the NPLs reflects that around 22.3 per cent of the NPLs were in the three to six months default category (special mention category).

In the LCB sector, the NPL ratio stood at 8.6 per cent at end September 2009, compared with 6.0 per cent at end December 2008 (Chart 4.2). Further, the NPL ratio of state commercial banks has deteriorated from 5.8 per cent as at end 2008 to 7.2 per cent at end September 2009. The NPL ratios of the LSBs and SIBs were at 10.7 per cent and 9.5 per cent, respectively, slightly higher than the industry average of 8.8 per cent (Chart 4.3).

Chart 4.2 – NPL Ratio to LCBs

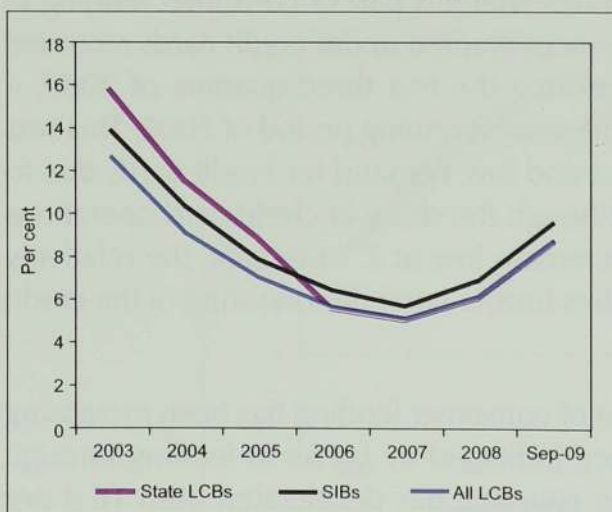
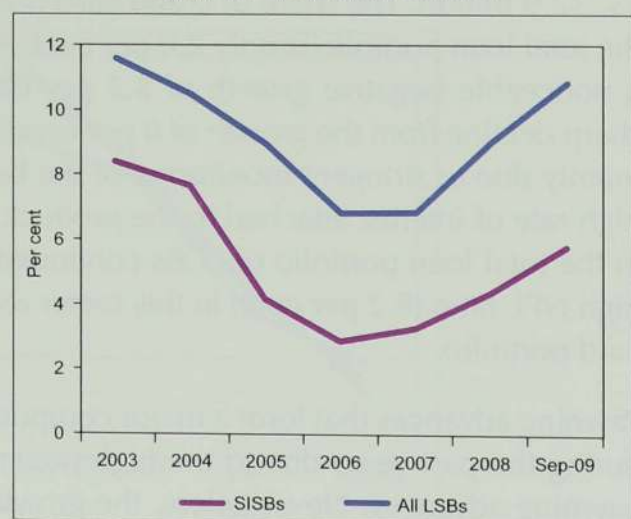


Chart 4.3 – NPL Ratio to LSBs



A bank should strongly focus on credit risk mitigation tools in its risk management framework, in order to reduce the impact of non-repayment of loans by customers to the continuity of banking operations. Therefore, in assessing the actual level of credit risk of banks, credit risk mitigating tools such as the level of loan loss provisions, value and availability of collaterals should be considered. Accordingly, the net NPL ratio which takes provision cover into account is considered in reviewing the actual quality of credit portfolio. As at end September 2009, the provision cover of the industry was 47.4 per cent. The net NPL ratio of LCBs after considering the provision cover of 50.8 per cent stood at 4.4 per cent compared to that of 2.2 per cent at end 2008. However, during the first nine months of 2009, the provision coverage for bad debts has declined by 15.1 per cent, resulting in the net NPA deteriorating by 230 basis points during the first three quarters of 2009. The reduction in provision coverage is in line with the increase in NPLs as the transfer of these new NPLs to special mention category, required only 1 per cent general provision.

However, it is necessary for banks to take precautionary measures to mitigate any potential credit risk by enhancing recovery procedures and as a last resort, increasing their provision coverage. The state commercial banks showed much resilience to credit risk despite having a higher NPL ratio due to the relatively high provision cover of 64.0 per cent as at end September 2009 (Chart 4.4). However, the increased NPL volume has resulted in a deterioration of the net NPL ratio to 2.7 per cent by 110 basis points (Chart 4.5). The provision cover of SIBs was at 47.8 per cent and was lower than the average of LCBs. In the case of LSBs, provision cover was at a low level of 27.2 per cent due to the availability of collateral in the form of mortgaged property associated with lending to the housing sector (Chart 4.6). This has resulted in LSBs recording a relatively high net NPL ratio of 8.0 per cent as at end September 2009 (Chart 4.7).

Chart 4.4 – Ratio of Loan Loss Provisions to NPL of LCBs

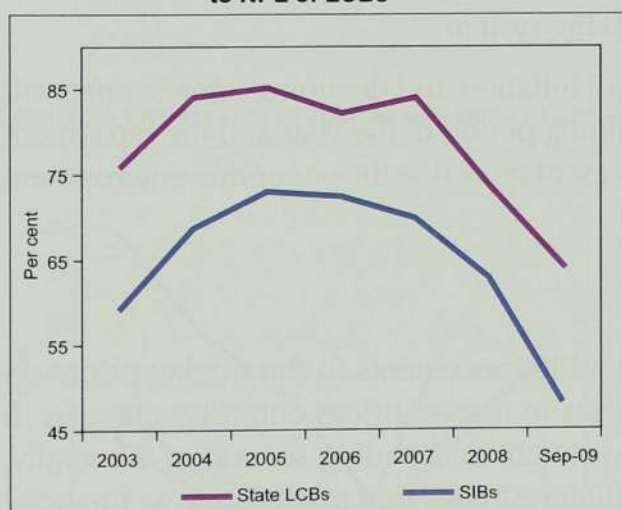


Chart 4.5 – Ratio of Net NPL to Total Advances of LCBs

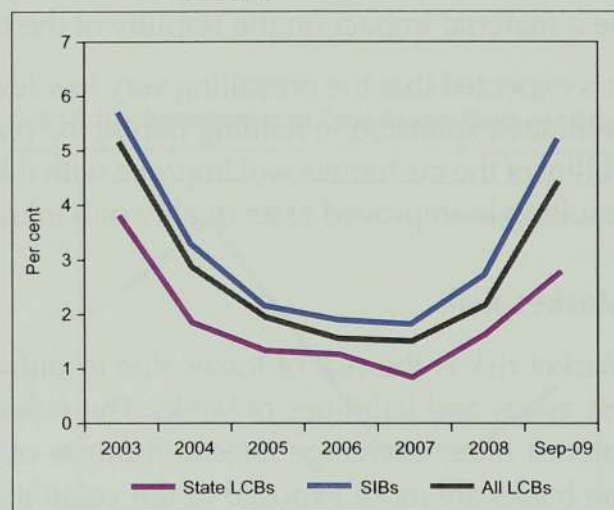


Chart 4.6 – Ratio of Loan Loss Provisions to NPL of LSBs

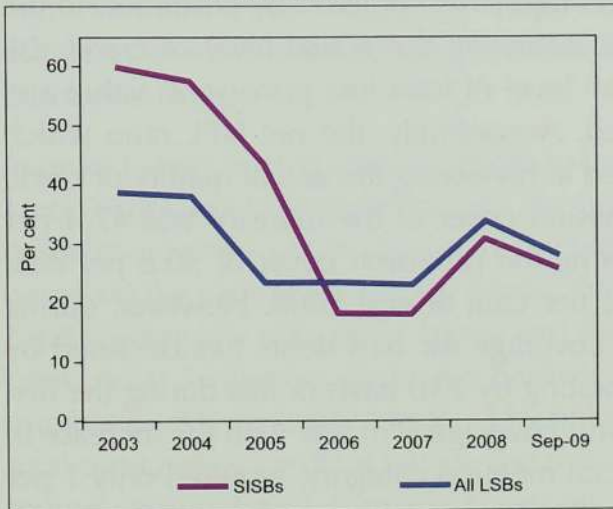
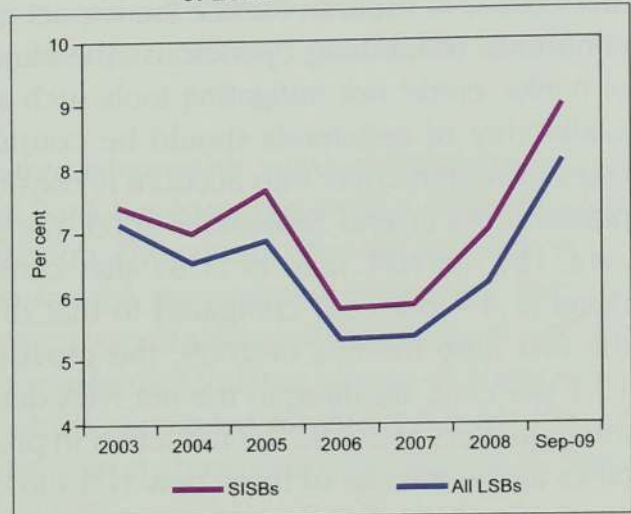


Chart 4.7 – Ratio of Net NPL to Total Advances of LSBs



Since September 2009, the deteriorating trend in the NPL ratio has moderated. However, the banks need to continue to strengthen their credit risk mitigation measures to maintain the stability of the banking sector. As such, it is essential for banks to carry out proper evaluation of credit applications and closely monitor repayment capacity and cash flow of the borrowers to ensure that expansion of credit will not pose a further risk to financial system stability.

During the year, Central Bank took several measures with a view to encouraging lending and to improve the asset quality of banks. This includes informing banks to reduce interest rates charged from the customers in line with the policy measures taken by Central Bank to facilitate a reduction in lending rates, requesting banks to grant concessions to institutions that were affected due to the setback in global economic activities, advising banks to take appropriate measures to expand credit to the private sector based on the evaluation of the credit risk of customers with a view to facilitate economic activities and requiring banks to strengthen the recovery processes and credit administration. Further, the stress tests conducted to assess the impact of the rising trend in NPLs have shown that there will not be a material impact on the stability of the banking system.

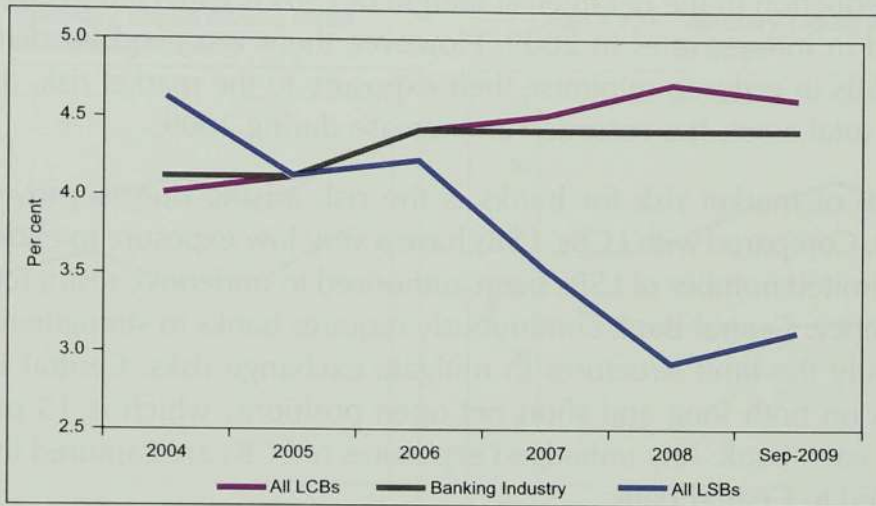
It is expected that the prevailing very low level of inflation and declining interest rates will facilitate expansion in lending during the remaining period of the year and the repayment ability of the customers will improve with the present revival in the economic environment resulting in improved asset quality of banks.

### Market Risk

Market risk is the risk of losses due to unfavourable movements in the market prices on the assets and liabilities of banks. The movements in market prices comprise changes in interest rates, exchange rates and prices of investment and trading securities. Generally, the banks are more exposed to the volatility of interest rates due to their role as financial intermediaries resulting in high dependence on interest income as the main source of income. However, the exposure of banks to market risk does not appear to create significant impact on the banks that would affect the stability of the banking system.

The net interest income of LCBs has increased by 7.5 per cent in September 2009 compared to September 2008. However, the net interest margin of LCBs which was 4.7 per cent in end 2008 reduced slightly to 4.6 per cent in September 2009 (Chart 4.8).

Chart 4.8 – Net Interest Margin



During 2009, investments of LCBs in debt and equity markets have increased by 48.0 per cent as against the declining trend recorded in the earlier years. Even though the investments of LCBs in the debt and equity market increased to 8.0 per cent of total assets from a minimal of 0.6 per cent in 2008 the exposure to market risk remained insignificant. Total investments, including gilt-edge securities, of all LCBs increased to 24.7 per cent of total assets at the end of September 2009 from 20.1 per cent in December 2008 (Chart 4.9). While SIBs also have followed the same trend, the state commercial banks have recorded a significant reduction in their investments from 25.2 per cent to 23.9 per cent during the first nine months of the year.

Chart 4.9 – Investments to Total Assets Ratio of LCBs

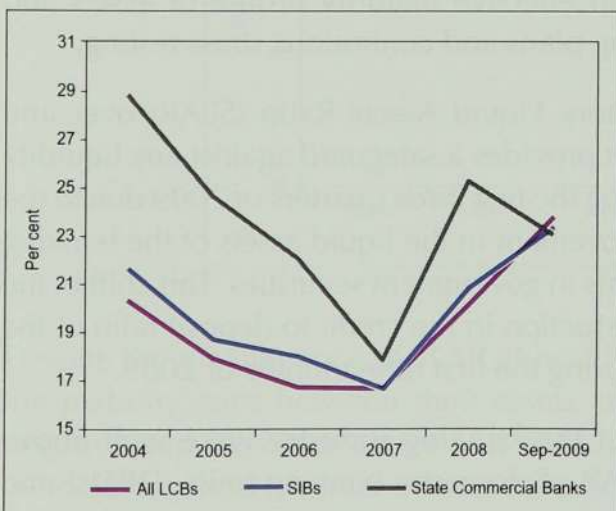
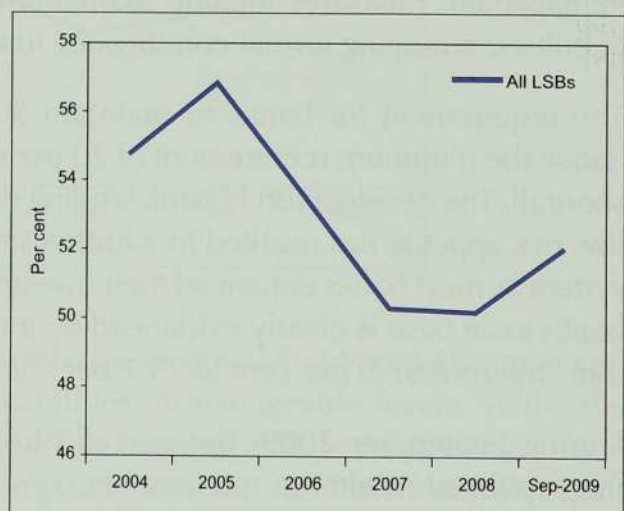


Chart 4.10 – Investments to Total Assets Ratio of LSBs



The mandatory requirement for the National Savings Bank (NSB) to invest not less than 60 per cent of its deposit base in government securities continued to expose the LSBs to a higher level of market risk since total investments of LSBs accounted for around 53.0 per cent of the total assets (Chart 4.10). NSB held 70.3 per cent of its deposits in government securities as at end September 2009. The pressure caused by higher interest rates in 2008 resulting in a reduction in the net interest margin of LSBs is expected to ease out with the declining trend in interest rates in 2009. However, there is a need for diversification of the assets of LSBs in order to minimise their exposure to the market risk, as the share of investments in total assets has recorded an increase during 2009.

Another source of market risk for banks is the risk arising due to movements in the exchange rates. Compared with LCBs, LSBs have a very low exposure to exchange rate risk due to only a limited number of LSBs been authorised to undertake restricted transactions in foreign currency. Central Bank continuously requires banks to strengthen their internal controls specially the limit structures to mitigate exchange risks. Central Bank also has imposed limits on both long and short net open positions, which is 15 per cent of the capital base of each bank. Any unhedged exposures of LCBs are captured in the net open position reported to Central Bank.

Any losses that may be incurred by banks on their trading portfolio due to adverse fluctuations in market prices are covered by the capital charge for market risk. Even though the LSBs show a decrease in net interest margin due to their assets structure, the LCBs show a relatively stable performance. As the LCBs represent almost 84.0 per cent of the assets in the industry, it can be concluded that the exposure of the banks to the market risk does not appear to be significant in creating instability in the banking system.

### Liquidity Risk

The importance of liquidity risk management in banks was widely witnessed during recent financial crises, both domestically and globally. The loss of public confidence and the resultant impact on the stability of the financial system due to contagion amply demonstrated that banks should maintain adequate liquidity cushions as the inherent nature of banking business give rise to liquidity risks. Other essential liquidity risk management measures include maintaining an effective maturity profile of assets and liabilities, arranging formal contingency funding plans and continuous stress testing.

The requirement for banks to maintain Statutory Liquid Assets Ratio (SLAR) over and above the minimum requirement of 20 per cent provides a safeguard against any liquidity shortfall. The deceleration in bank lending during the first three quarters of 2009 due to the low risk appetite has resulted in a further improvement in the liquid assets of the banking system as most banks enhanced their investments in government securities. This shift in the banks' asset base is clearly evidenced by the reduction in the credit to deposit ratio of the industry from 87.0 per cent to 73.7 per cent during the first nine months of 2009.

During September 2009, the overall SLAR of the banking industry were well above the stipulated minimum requirement, *i.e.*, SLAR of domestic banking units (DBUs) and

off shore banking units (OBUs) were at 38.4 per cent and 51.5 per cent, respectively (Chart 4.11). Keeping in line with the industry ratios, the overall SLAR of LCBs during September 2009 too were maintained at 32.8 per cent and 51.5 per cent in DBUs and OBUs, respectively (Chart 4.12).

Chart 4.11 – Statutory Liquid Assets Ratio of Banking Industry

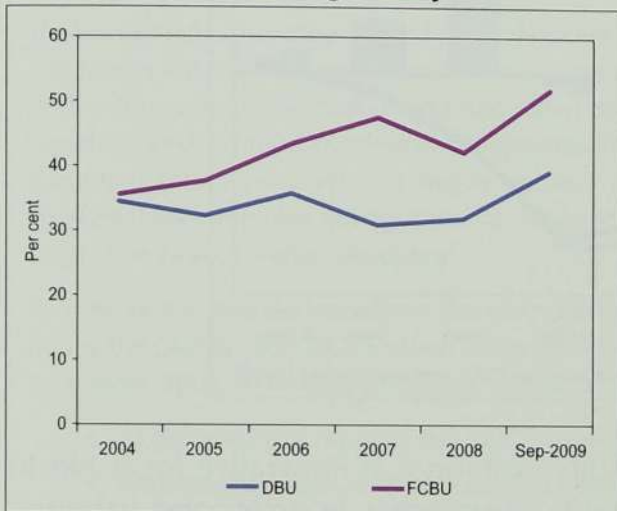
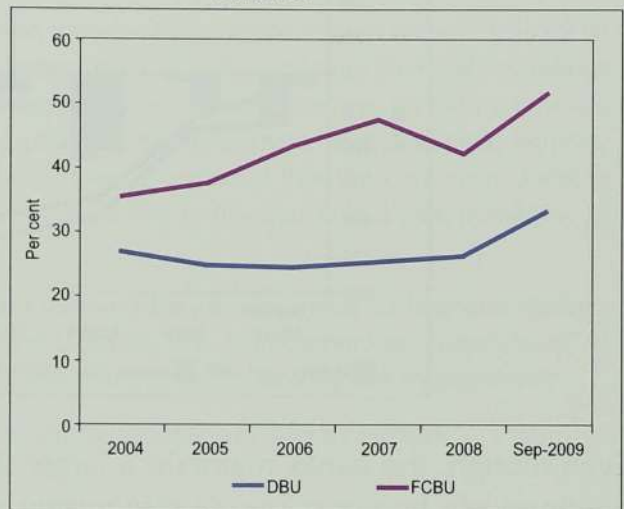
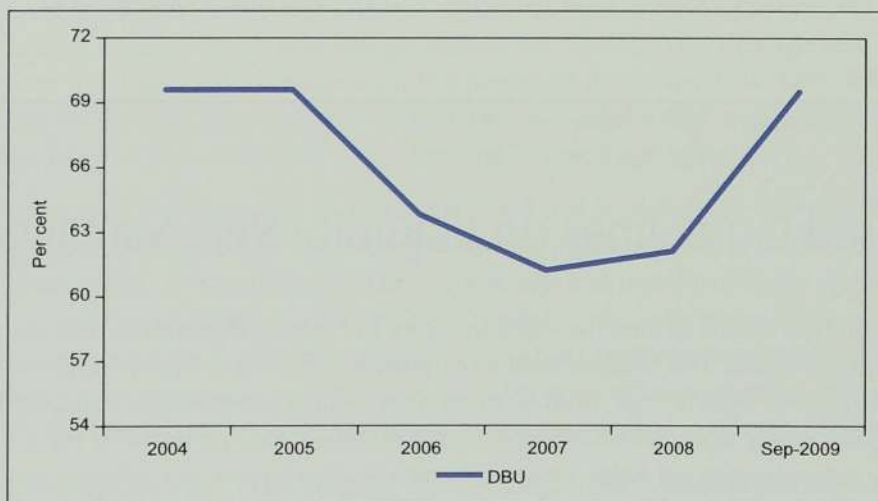


Chart 4.12 – Statutory Liquid Assets Ratio of LCBs



Overall LSBs maintained their SLAR at a relatively higher level as a major portion of their deposits was invested in government securities. During September 2009, SLAR of LSBs was high at 69.3 per cent mainly due to NSB’s mandated investments in Treasury bills and bonds (Chart 4.13).

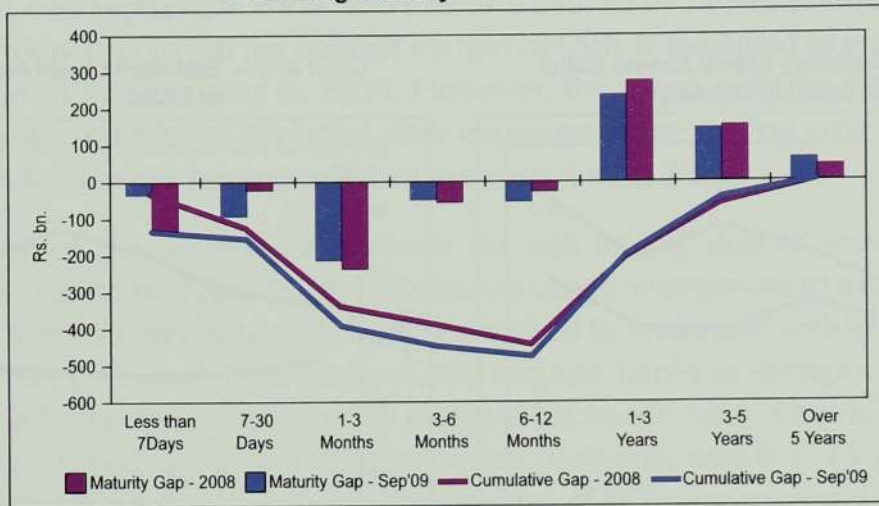
Chart 4.13 – Statutory Liquid Assets Ratio of LSBs



Despite the maintenance of SLAR at healthy levels it is essential that banks also maintain the maturity gaps between their assets and liabilities at manageable levels. While the negative gap between assets and liabilities of the banking industry maturing within 07 to 30 days and 01 to 03 months reflects an improvement, the cumulative negative gaps

between assets and liabilities maturing within 07 days, 07 - 30 days and 01 to 03 months have increased (Chart 4.14).

Chart 4.14 – Maturity & Cumulative Gap of Assets and Liabilities of Banking Industry



Even though, the banks maintain a larger liquidity cushion it is imperative for banks to continuously be conscious of minimising maturity mismatches in assets and liabilities specially in the short-term. To improve the effectiveness of maturity gap analysis, computation of gaps based on the behavioural maturity of cash inflows and out flows is recommended as against the remaining time to maturity or contractual maturity dates. Specially, cash flows from deposit activities and lending would not follow their time to maturity mainly due to premature withdrawals and also due to prepayments or delayed payments of loans and advances. Hence, the behaviour of individual cash flows, on the basis of historical patterns, is required to be estimated in order to obtain a reasonably accurate figure.

## Box 2

### Proposed Guidelines on Liquidity Risk Management

“Liquidity is the ability of a bank to fund increases in assets and meet obligations as they come due, without incurring unacceptable losses. The inherent nature of transforming short-term deposits into long-term loans makes banks vulnerable to liquidity risk, both of an institution-specific nature and that which affects market as a whole. Virtually, every financial transaction or commitment has implications for a bank’s liquidity. Effective liquidity risk management helps ensure a bank’s ability to meet its cash flow obligations, which are uncertain as they are affected by external events and other agent’s behaviour. Therefore, liquidity risk management is of paramount importance because a liquidity shortfall at a single institution can have system-wide repercussions. Financial market developments in the past decade have increased the complexity of liquidity risk and its management” (the Basel Committee on Banking Supervision (BCBS).

The recent global financial market turmoil that began in mid 2007 amply highlighted the crucial importance of liquidity to the functioning of financial markets and banking sector and the fact that it is a key

**Box 2 (Contd.)**

determinant of financial system stability. It also highlighted the need for bankers and regulators to pay closer attention to liquidity risk management in banks, particularly in view of the speed at which market liquidity conditions can change and the length of time required by markets to recover from such deterioration in liquidity conditions.

**Guidelines on liquidity risk management issued by the Bank for International Settlements**

The lessons learnt from the recent financial market turmoil revealed that most banks and non-bank financial institutions did not have proper framework for the management of liquidity risk. Many financial institutions in developed financial markets too had failed to consider the liquidity requirement, including possible liquidity needs to fund contingent obligations. This is probably because severe and prolonged liquidity disruption was considered as a highly unlikely event. Further, it appeared that the contingent funding arrangements were also not appropriate owing to lack of stress test results that linked with possibility of longer duration of market disruption.

In view of the lessons learnt from the global financial crisis and the developments in financial markets during the past decade, BCBS issued "Principles for Sound Liquidity Risk Management and Supervision" in September 2008, to provide additional guidance on the following areas in liquidity risk management:

- Acceptability of liquidity risk and the need to establish liquidity risk tolerance limits
- Maintenance of an adequate level of liquidity
- Allocation of liquidity costs, benefits and risks to all significant business activities of a bank
- Identification and measurement of all liquidity risks, including contingent liquidity risk
- Design and use of severe stress testing scenarios
- Need for establishing contingency funding plans
- Management of intraday liquidity risk and collateral
- Need for public disclosure as a means to promote market discipline.

**Guidelines proposed to be issued by the Central Bank of Sri Lanka**

In line with the recent international and domestic financial market developments, the Central Bank of Sri Lanka is planning to issue comprehensive guidelines on liquidity risk management in banks as part of its guidelines on integrated risk management. The proposed guidelines have been framed in line with BCBS's "Principles for Sound Liquidity Risk Management and Supervision" and recognize and reflect the interaction of liquidity risk in all activities across banking business appropriately.

The proposed framework encompasses broader guidelines on liquidity risk management and liquidity stress testing methodologies. They include: vesting the primary responsibility of understanding the liquidity risks assumed by the banks with the Board of Directors; analysis of liquidity through tracking of behavioral cash flow mismatches; need for assessment of liquidity profile of banks under different stress situations; preparation of contingency plans and the need for establishing back-up liquidity support in the form of committed lines of credit, reciprocal arrangements, liquidity support from other external sources, liquidity of assets etc.; and the need to disclose information to market participants on a regular basis.

The proposed guidelines form part of an ongoing effort by the Central Bank of Sri Lanka to further strengthen risk management processes in banks. The Central Bank believes that liquidity is crucial to the ongoing viability of any banking organisation operating in Sri Lanka. But the importance of liquidity transcends the individual bank since a liquidity shortfall in a single bank can have systemic repercussions. The management of liquidity risk is therefore among the most important activities in a bank and the proposed guidelines provide, inter-alia, a guidance on the minimum requirement to be followed by banks in formulating their liquidity risk management mechanisms.

## Operational Risk

The exposure of the banks to operational risks is becoming more important with the increasingly complex and interconnected systems, financial products and IT solutions. Accordingly, currently applicable capital standard, Basel II, has introduced a separate capital charge to cover operational risks in banks and has heightened expectations for the management of operational risk. Further, the banks are required to widen the scope of their risk management framework to include operational risk and improvements are expected in the internal governance framework.

Central Bank issued guidelines to banks to adopt the Basic Indicator Approach for computing regulatory capital for operational risk as per Basel II. Accordingly, as of end September 2009, overall, a capital charge of Rs. 20.9 billion, which represented 9.4 per cent of the total capital base, has been maintained by banks to cover operational risks. Considering the need for the increased focus in operational risk management, the advanced approaches in computing capital for operational risk would be introduced in the future.

The discussions on publication of the external auditors' certification on the effectiveness of the internal control mechanism in the annual reports of banks as directed by the Banking Act Directions on corporate governance is currently in progress. This would ensure that the banks have adopted adequate measures in establishing sound internal control mechanisms, regulations and supporting frameworks for mitigating operational risk posed through breakdowns in internal controls and corporate governance.

In the present context, outsourcing is increasingly used by the banks in order to reduce costs and achieve strategic objectives. The increased reliance on the outsourcing of activities would affect the ability of the banks to manage the operational risks and monitor the compliance with regulatory requirements. Identifying the possible increasing operational risk through outsourcing activities, guidelines are to be issued to the banks on outsourcing activities.

### 4.3 Adequacy of Resources to deal with Potential Risks

The banking sector continued to maintain its capacity to mitigate risks through healthy profitability and capital levels. The implementation of Basel II capital adequacy standards, enhancement of risk based supervision, implementation of the Direction on corporate governance of banks are some of the prudential measures taken by the Central Bank to ensure resilience of the banks.

#### Profitability

Profit before tax continued to grow mainly due to the increase in net interest income. During the first three quarters of 2009, profit (after tax) grew by 17.4 per cent (Rs. 3.8 billion) compared with the 4.3 per cent (Rs. 0.9 billion) growth during the first three quarters of 2008 (Chart 4.15).

Chart 4.15 – Profit after Tax

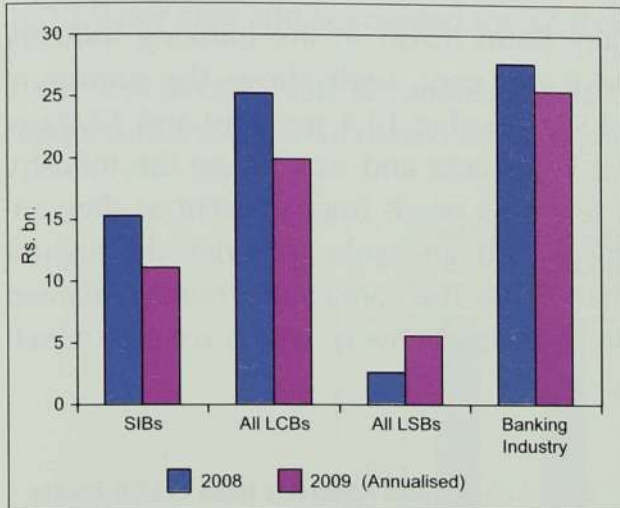
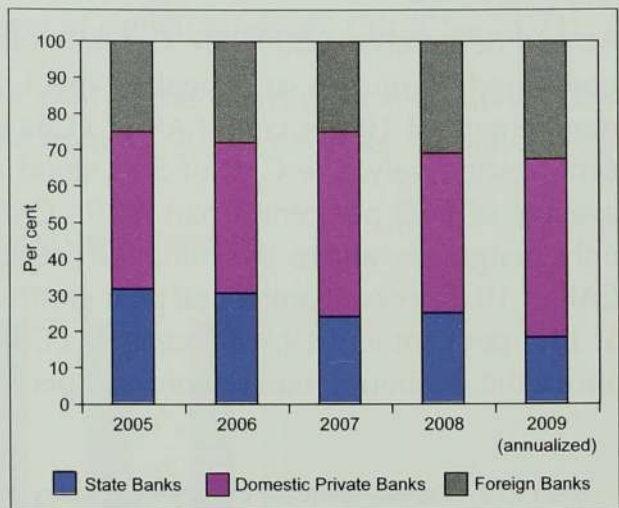


Chart 4.16 – Contribution to the LCB Profits (After Tax)



78.2 per cent of total banking industry profits were contributed by LCBs recording a slight decrease from its contribution of 86.7 per cent in 2008. Of the total profits of LCBs, the share of state commercial banks has marginally increased from 17.1 per cent in first three quarters of 2008 to 17.9 per cent in 2009. On the other hand, the shares of SIBs and foreign banks in the total profits of LCBs have reduced from 61.7 per cent to 55.6 per cent and from 35.1 per cent to 32.8 per cent, respectively, during the first nine months of 2008 and 2009 (Chart 4.16). The profits recorded from LSBs during the first three quarters of 2009, have shown a significant improvement of 93.0 per cent compared to the slight improvement of 5.1 per cent during first three quarters 2008.

The profitability of LCBs in terms of Return on Assets (ROA) continued to remain at 2.0 per cent by end September 2009, same as in end 2008 (Chart 4.17), while the Return on Equity (ROE) has shown a decrease from 14.8 per cent to 14.1 per cent by end September 2009 (Chart 4.18). ROA and ROE of LSBs reflected a substantial increase and stood at 2.5 per cent and 17.5 per cent, respectively, by end September 2009 when compared to 1.4 per cent and 6.9 per cent by end 2008 due to the interest income and capital gains recorded by NSB on the investment in government securities.

Chart 4.17 – ROA (Before Tax)

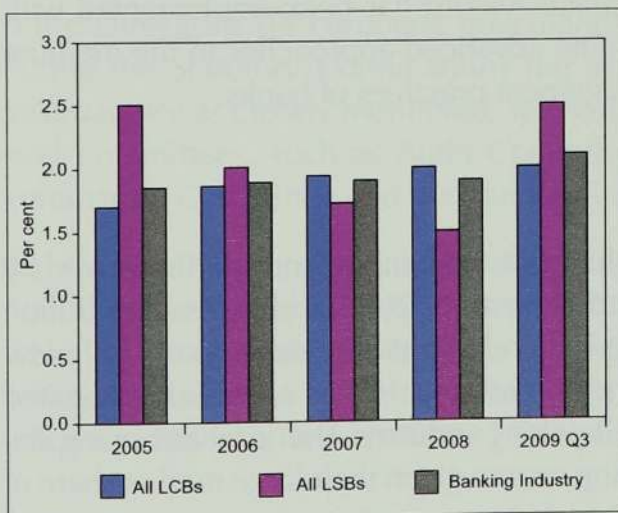
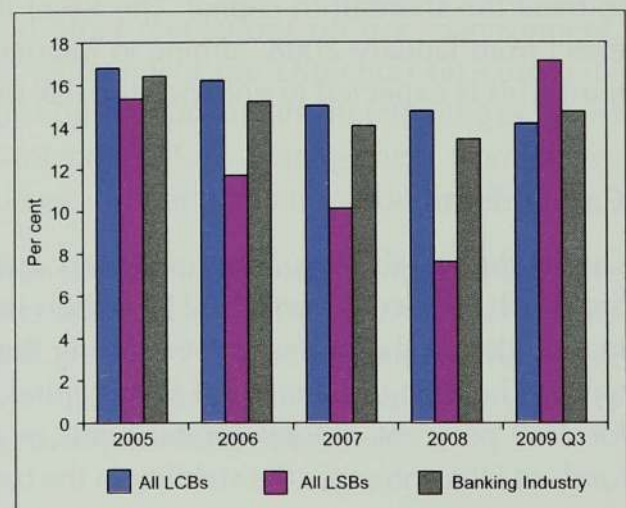


Chart 4.18 – ROE



## Capital Adequacy

At end September 2009, the Capital Adequacy Ratio (CAR) in the banking industry continued to remain at a healthy level at 14.5 per cent, well above the minimum requirement of 10 per cent. CAR of LCBs and LSBs stood at 14.1 per cent and 17.9 per cent, respectively. The CAR of SIBs stood at 12.3 per cent and was below the industry average of 14.5 per cent (Chart 4.19). CAR of few SIBs needs improvement as they are only marginally above the minimum requirement. Foreign banks recorded the highest CAR of 19.2 per cent among all peer groups (Chart 4.20). The core capital ratios remained at 11.4 per cent and 19.9 per cent for LCBs and LSBs, respectively, which were also well above the minimum requirement of 5 per cent.

Chart 4.19 – Capital Adequacy of Banking Industry

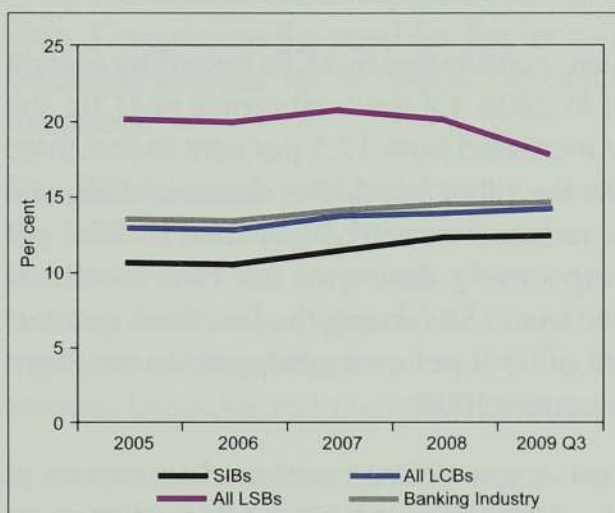
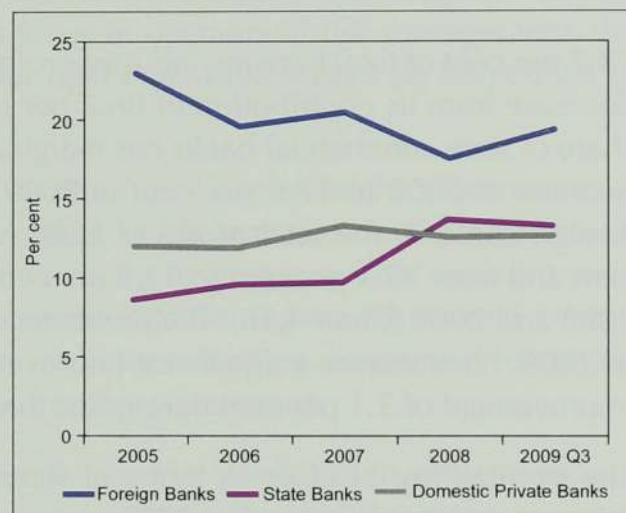


Chart 4.20 – Capital Adequacy Ratio of LCB Sector



The capital position of the banking sector is expected to increase further as banks are in the process of complying with the enhanced capital requirements and the Basel II requirements. At the end of September 2009, five LCBs and two LSBs were in the process of reaching the minimum capital requirements stipulated by the Central Bank of Rs. 2,500 million for LCBs and Rs. 1,500 million for LSBs. The Central Bank has granted time till mid June 2010 to meet the shortfall in capital. The Basel II Capital Accord has been implemented with effect from January 2008, aiming to migrate to the advanced approaches in the medium term. This is expected to enhance the risk management practices of banks.

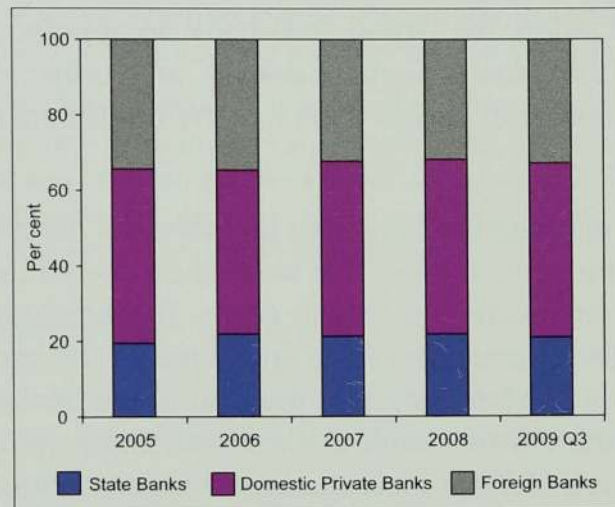
## Capital Funds

During the first three quarters of 2009, capital funds of the banking industry improved by around 10 per cent from Rs. 219 billion in end December 2008 and to Rs. 240 billion mainly due to the profits earned during the period and capital infusions made by a few banks. The SIBs too increased their capital funds by around 10 per cent and accounted for 45.9 per cent of total capital funds of the banking industry. The increase in capital funds of SIBs enhances the stability in the banking system given their large market share of

64.0 per cent in the banking industry. The capital funds of foreign banks increased notably by 13.0 per cent and accounted for 32.8 per cent of capital funds of LCBs (Chart 4.21).

In the LSB sector, NSB accounted for 30.9 per cent of the growth in capital funds. The capital funds of LSBs increased by 12.0 per cent from Rs. 40 billion to Rs. 44 billion.

Chart 4.21 – Composition of Capital Funds in LCB Sector



#### 4.4 Management and Corporate Governance

One of the major lessons of the global financial crisis is the importance of corporate governance in the banking industry. Given the important and dominant role of banks in the financial sector, the directors and the senior management of the banks and the regulators need to pay more attention on strengthening governance practices in banks.

The Central Bank has issued several prudential regulations on corporate governance and on risk management. Adherence to these regulations has enabled the Sri Lankan banking industry to face the financial turmoil successfully. In order to further strengthen the corporate governance culture of banks, the Central Bank continues to monitor banks' adherence to the Directions on corporate governance and other regulations on risk management. During the Statutory Examinations the implementation of the Direction on corporate governance was closely monitored, specially the constitution and the functioning of Board level committees, such as Audit Committee, Integrated Risk Management Committee, Nomination Committee and the Human Resources and Remuneration Committee.

The Central Bank continued its dialogue with the banking community through the monthly meetings of its Chief Executive Officers and meetings with Boards of Directors of banks. The Central Bank held the second Bank Directors' Symposium under the theme "Meeting Challenges in the New Era" with a view to ensuring that the banking system is well geared to face new challenges in rapidly growing banking operations.

## 4.5 Other Measures

In late December 2008, prompt intervention of the Central Bank was essential to avert the potential danger to the stability of the financial system due to the distress situation faced by the Seylan Bank PLC, a systematically important bank, as a result of financial difficulties faced by the Golden Key Credit Card Company (Pvt) Ltd. The Monetary Board of the Central Bank took immediate measures under Section 30 (9) of the Monetary Law Act, No.58 of 1949, to discontinue the services of all current directors of the bank whilst requesting the Bank of Ceylon, the largest state bank, to appoint a team to carry out the functions of the Board of Directors of Seylan Bank PLC and further to extend its managerial assistance to the bank in order to Seylan Bank to carry on its banking operations without any interruption.

The Central Bank was well prepared to resolve the potential danger to the stability of the financial system due to the uncertainties that were encountered by the Seylan Bank PLC through the resolution framework that was in place. The timely intervention of Central Bank ensured the smooth continuance of the operations of the bank and restored public confidence not only in the Seylan Bank PLC but also in the banking system as a whole. During the year 2009, the Central Bank made further improvements to the resolution framework to be better poised for any eventuality and is committed to further strengthen it.

The Seylan Bank PLC was recapitalised by issuing new shares amounting to approximately Rs. 3 billion which strengthened the capital and liquidity levels of the bank. The bank is currently carrying on its normal operations independently under the direction of its Board of Directors, which consists of directors representing the new strategic investors.

The draft guidelines on integrated risk management of banks were issued for industry comments in order to strengthen the risk management framework of banks and enhance the supervisory approach. Further, with a view to facilitating the licensed banks adopting the Sri Lanka Accounting Standards (SLAS) 44 and 45, the banks were required to conduct a gap analysis to identify areas to be upgraded/ developed in the process of such migration and examinations were carried out on parallel reporting done by banks.

Directions and guidelines were issued on risk management relating to foreign exchange business of licensed commercial banks in order to standardise and strengthen the foreign exchange risk management systems of banks. Further, a Direction was issued to banks on identification, reporting, transferring and maintenance of abandoned property with a view to safeguarding unclaimed assets of banks' customers.

With the end of three decade long civil war in the country in 2009, and with the integration of the Northern and Eastern Provinces to the rest of the country for economic activity, the Central Bank approved the establishment of banking outlets in the two provinces to facilitate greater access to finance. During the second quarter of 2009, approvals were granted for banks to open 89 new banking service outlets in the Northern Province. This is the largest number of approvals given during a comparable period.

## Resolution of a Bank in Distress

### The case of Seylan Bank

Box 3

#### 1. Introduction

- 1.1 The recent events in the international financial markets resulted in many financial institutions facing difficulties globally. The general public lost their life time deposits, retirement benefits and employment. Many Governments had to introduce bailout packages that cost large sums of money.
- 1.2 Emerging economies too felt the impact, although not in a direct and a serious manner, in terms of withdrawal of funds by some of the major financial institutions. Seizing-up of the international credit markets, where credit flows through the international banks and global bond markets to emerging market countries dried up. Further, the impact of the crisis on economic activity in terms of reduced exports and imports resulted in a slowdown of the economy.

#### 2. The Central Bank's Preparedness

- 2.1 These events prompted the Central Bank of Sri Lanka (CBSL) to formulate a resolution plan for banks to enable prompt and effective resolution of any bank in distress with a minimum impact to the stakeholders of such bank, the general public at large and to avert any public spending.
- 2.2 The Resolution Framework for banks in distress was prepared in keeping with the provisions of the existing legislation. It entailed actions to be implemented in relation to CBSL's involvement and assistance, appointment of a new management and included detailed action plans to ensure prompt and smooth implementation of this Framework.

#### 3. The Case of Seylan Bank PLC

- 3.1 The Seylan Bank PLC (SBP), the fifth largest commercial bank in the country, with a market share of 7 per centum in terms of assets was a part of a large Conglomerate, viz., Ceylinco Group having more than 200 subsidiaries and associate companies that operate in many sectors including the financial sector. Notably, a significant number of the companies of the Ceylinco Group, which operated in the financial sector, were not regulated.
- 3.2 **Potential distress in the Group:** Towards end of year 2008, a crisis occurred at the Golden Key Credit Card Company (Pvt) Ltd., which is a group company of the Ceylinco Group, where it has been involved in a major credit card scam. This resulted in certain companies within the Ceylinco Group showing signs of stress, including the SBP.
- 3.3 **Imminent financial distress to the bank:** Inability to honour customer requests to repay deposits in certain companies of the Group led to the deterioration of depositor and creditor confidence in the SBP too. A heavy out flow of deposits mainly due to unusual withdrawal of deposits led the bank to a deficient liquidity position with the Statutory liquid assets ration falling much below the required level of 20 per cent during the period from December 2008 – January 2009. SBP being a bank operating in the inter-bank market, any failure on its part to honour payments will have had a ripple effect on the entire financial system, perhaps, causing a systemic crisis. This situation inevitably invited the prompt intervention of CBSL in order to safeguard the overall financial system stability.

#### 4. Timely intervention by CBSL and effective execution of the Resolution Framework

- 4.1 **Immediate intervention of CBSL:** The Resolution Framework was activated to meet the difficulties of SBP, which presented a potential danger to the stability of the financial system. The Monetary Board of the Central Bank took immediate measures under Section 30(9) of the Monetary Law Act, No.58 of 1949, to discontinue the services of all directors of the bank whilst appointing an independent Board

**Box 3 (Contd.)**

to carry on business of the bank. At the same time the Bank of Ceylon, the largest state bank, was requested to extend its managerial assistance to SBP in order to restore public confidence and enable SBP to carry on its banking operations without any interruption. The public was kept informed of the steps taken by CBSL in this regard via press notices to negate the adverse impact on the reputation of the bank.

- 4.2 **Immediate provision of Rupee liquidity:** Due to the distress faced, SBP was not in a position to find much needed funds, even on fully secured (inter-bank repo) basis. Accordingly, CBSL decided to provide the required rupee liquidity to SBP under Central Bank reverse repo window.
- 4.3 **Addressing the negative foreign currency liquidity position:** When it was revealed that SBP was facing a shortfall in foreign currency liquidity, attempts were taken by the bank to bridge same through short-term (mainly overnight) borrowings from the domestic market and overseas money markets. Such attempts were not successful and the bank ran the risk of overdrawing its nostro accounts where it would have had severe negative implications on the bank, in particular, and the country's banking system, in general. CBSL decided to provide much needed foreign currency liquidity in order to fund the bank's nostro accounts. Overall, the liquidity short falls were bridged through collateralised borrowings from the CBSL, the Bank of Ceylon, other counter parties and SWAP transactions.
- 4.4 **Prompt restoration of public confidence:** The timely intervention of CBSL ensured the smooth continuance of the operations of the bank and restored public confidence not only in SBP but also in the banking system as a whole. The financial stability within the bank and the banking industry was safeguarded with minimum impact to the depositors.
5. **Re-capitalization of SBP**
- 5.1 With the objective of further strengthening the capital, management and operations of the bank, in terms of the powers vested under the Monetary Law Act, CBSL initiated appropriate steps to restructure the bank by seeking a strategic investor for the bank.
- 5.2 The strategic investor was expected to make a total investment of a sum of Rs. 5.7 billion (US \$ 50 mn) in the ordinary shares of the bank (both voting and non-voting), and a further investment in debentures.
- 5.3 The selected strategic investor was permitted the following:
- Acquire 33 $\frac{1}{3}$  per cent of the issued share capital carrying voting rights of SBP.
  - To hold such shareholding for a period of 15 years from the date of investment.
  - To appoint up to  $\frac{1}{3}$  of the Board of Directors of SBP, as long as the strategic investor holds 33 $\frac{1}{3}$  per cent of the issued share capital carrying voting rights of SBP during the 15 years period, After the expiration of the said period, if the investor continues to hold 15 per cent of the issued share capital carrying voting rights, it was to be permitted to appoint  $\frac{1}{6}$  of the Board of Directors.
  - In the event the strategic investor discontinues to hold the percentages of issued share capital carrying voting rights set out above, the eligibility of the investor to appoint directors to the Board of Directors of the bank were to be on the basis of the Articles of Association of the bank and other applicable laws in the country.
6. **Selection process of a strategic investor**
- 6.1 Six parties expressed their interest to be a strategic partner of SBP by investing in shares and debentures of the bank, responding to the notice published in newspapers by CBSL for "Expression of Interest".
- 6.2 The Committee for Evaluation of Bids on Seylan Bank PLC (Evaluation Committee) selected five parties and the said parties were provided with an opportunity to submit their bids. Accordingly, two parties submitted their bids.

**Box 3 (Contd.)**

- 6.3 However, the Monetary Board decided to cancel the bids received from the two bidders due to the bids not being fully compliant with the requirements specified in the Bid Document issued by CBSL.
- 6.4 After obtaining due clearance from the Hon. Attorney General, the Monetary Board invited fresh bids from all five (5) selected prospective investors and for this purpose the bidders were provided with an Addendum to the Bid Document with certain terms and conditions being amended. The selected prospective investors were supposed to submit fresh bids and one bid was received in response.
- 6.5 After careful evaluation of the bid, the Monetary Board decided that the offer made by the strategic investor has not fulfilled the parameters set by CBSL in relation to the ownership limits. Accordingly, the Monetary Board rejected the said bid and decided to direct SBP to issue shares to raise the required capital.

**7. Resumption of business**

- 7.1 Any order made by the Monetary Board under Section 30(1) of the Monetary Law Act suspending the banking business of the bank shall cease to have effect upon the expiration of a period of six months from the date on which it is made. Accordingly, the Monetary Board permitted the bank to resume its banking business with effect from June 29, 2009 subject to several terms and conditions.
- 7.2 CBSL extended the tenure of the Board of Directors for a further period of three years from June 29, 2009, required SBP to raise capital of around Rs. 3.0 bn through a private placement and a public issue and required the bank to invite a maximum of three new Directors after the share issue.
- 7.3 In order to ensure smooth continuance of operations of the bank, the Monetary Board requested Bank of Ceylon to continue with the managerial assistance provided to SBP until the Monetary Board considers the withdrawal of such assistance.
- 7.4 On the direction of the Monetary Board, SBP invited few large State owned financial institutions to contribute to the capital of the bank to enhance investor confidence on the bank and provide stability to the bank. Accordingly, the Bank of Ceylon (10 per cent) and the Insurance Corporation of Sri Lanka (15 per cent) acquired a sizable stake in the bank through a private placement.
- 7.5 The remaining shares were offered to the general public with a preference given to the existing shareholders. The share issue was oversubscribed and the bank managed to raise new capital of Rs. 3.0 bn. Two reputed private sector companies acquired a material interest in the bank through their allied companies.

**8. SBP continuing with its normal operations**

- 8.1 With the raising of new share capital, the bank has significantly improved its capital adequacy and liquidity levels. The bank is currently, carrying out its operations independently under the direction of its board of directors, which consists of directors representing the new strategic investors. It has also commenced expanding its branch network by opening several banking outlets in the Northern Province.

**9. Conclusion**

- 9.1 The preparedness and the proactive measures taken to avert a major crisis in the financial sector has resulted SBP to return to normalcy within a short time without a heavy burden to the State or the public at large.

## 4.6 Future Direction

With a view to further strengthening the regulatory framework for licensed banks, the Central Bank is currently in the process of amending the Banking Act in discussion with the banking industry. These amendments are expected to incorporate the changes necessitated by the new Companies Act, strengthen the bank resolution measures, facilitate mergers and acquisitions of licensed banks and its related parties, strengthen powers to conduct consolidated supervision and definition of “deposit” etc.

The Central Bank is also in the process of formulating mandatory deposit insurance scheme to provide a financial safety net and promote public confidence, thereby contributing to strengthening the overall stability of the financial system.

In 2010, the Central Bank will move forward in implementing the Pillar II under Basel II with a view to promoting better risk management systems and facilitate an effective capital planning process in banks. The Central Bank in its guidelines on Pillar II of Basel II on the Supervisory Review Process will explicitly state the responsibilities of the Boards of Directors of banks and the supervisor, in aligning capital levels with the risk profiles of banks. Going forward, banks will be required to maintain capital not only on credit, market and operational risks but on all other risks including liquidity risk, credit concentration risk and interest rate risk on the banking book. The Central Bank will also increase the minimum capital requirement of banks to ensure that banks will have an adequate cushion to meet any unforeseen loss.

### Box 4

## Banking Act – Proposed Amendments

The Banking Act, No. 30 of 1988 provides the legislative framework for licensing of banks and regulation and supervision of licensed commercial banks and licensed specialised banks. The Act has been amended in the years 1990, 1995, 2005 and 2006 to strengthen the supervisory and regulatory framework of banks. It is now proposed to introduce further amendments to the Banking Act in line with best practices and standards adopted, both locally and internationally, and to reflect the recent market and legislative developments. The proposed amendments will facilitate the following:

- (i) Aligning with current developments in the banking sector: In relation to consolidation and mergers of banks, the existing provisions will be expanded to facilitate speedy and an orderly process in relation to merger of a branch of a licensed commercial bank with any subsidiary or associate of a Licensed Commercial Bank or a Licensed Specialised Bank. The proposed amendments will specify pre-requisites and the procedure for such consolidation.
- (ii) Expanding the criteria to determine “material interest”: Currently, material interest is determined solely on the basis of share ownership. The proposed amendments will facilitate to recognize material interest also based on significant management control.
- (iii) Strengthening bank resolution measures: At present, the Banking Act provides only for vesting of a bank with another bank and for liquidation of a bank in distress. The proposed amendments will include appointment of a managing agent with a view to turning around a bank in distress or if a bank is operating in a manner, which is prejudicial to the soundness of the financial system, or is not conducted in a prudent manner. The proposed amendments will specify the powers and the role of the managing agent. Also the provisions relating to the suspension of banking business that are currently addressed in the Monetary Law Act are proposed to be incorporated to the Banking Act suitably.

**Box 4 (Contd.)**

- (iv) Expanding provisions on offences and penalties: At present, monetary penalties are imposed on banks that do not comply with provisions in relation to maintenance of the Statutory Liquid Assets Ratio in terms of the Banking Act and the provisions in relation to the Statutory Reserve Requirement under the Monetary Law Act. The proposed amendments will empower the Monetary Board to impose penalties on banks that fail to comply with prudential requirements prescribed in terms of the Act.
- (v) Broad-basing the definition of deposits: The definition of deposits is to be expanded to curtail unauthorised deposit taking institutions in the guise of investments.
- (vi) Implementing the provisions in the Basel II capital adequacy framework: The proposed amendments to the Banking Act will strengthen the powers of the supervisor to recommend a higher capital charge upon individual banks the risk profile of the bank.
- (vii) Undertaking consolidated supervision: Considering the importance of consolidated supervision to the financial system stability it has become necessary to extend the central bank's supervisory role to subsidiaries and associates of banking groups. The proposed amendments will empower the Central Bank to supervise of entities in the Group and issue prudential Directions to the Group as a whole and to the individual entities in the Group.
- (viii) Extending regulatory requirements applicable to Licensed Commercial Banks to Licensed Specialised Banks: This will strengthen the regulatory framework to provide a level playing field.
- (ix) Aligning with the provisions in the Companies Act, No. 7 of 2007: These amendments are proposed to avoid inconsistencies with the provisions in the new Companies Act and to introduce new concepts such as stated capital.
- (x) Disclosing of financial statements to the Public: The proposed amendments will reduce the time period given to banks for the submission of published accounts. Accordingly, the time period will be reduced to 3 months after the closure of the financial year. This will facilitate the availability of timely information on the financial condition of the bank to the public at large, and to the regulator.

The Central Bank is committed to adopt a consultative approach in finalising the proposed amendments to the Banking Act to ensure that all stakeholders; banking community, auditors and the Central Bank, work towards promoting financial system stability.

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# 5. Other Financial Institutions

- ✧ The Registered Finance and Specialised Leasing Company sector experienced stress due to contagion effect of the failure of some unauthorized deposit-taking entities and are now rebounding with the recovery in economic activity.
- ✧ Ceylinco group affiliated finance and leasing companies suffered contagion due to the failure of the Golden Key Credit Card Company and became severely distressed as these companies were unable to meet depositor withdrawals. The Central Bank intervened and brought these RFCs under the management of the Merchant Bank of Sri Lanka and depositor repayment plans are being processed. The Ministry of Finance also offered a stimulus package to distressed companies for the purchase of assets and guarantees for bank credit.
- ✧ The Central Bank has set up a secretariat to assist a committee appointed by the Supreme Court to implement a depositor repayment programme for the unregulated Golden Key Credit Card Company.
- ✧ The insurance sector performed creditably and remained sound, although premium incomes and profitability declined in the economic slowdown.
- ✧ The financial position of Primary Dealers improved as yield rates on Treasury securities declined.
- ✧ The unit trust industry recovered with the upturn in the stock market.
- ✧ The main superannuation funds – the Employees' Provident Fund and the Employees' Trust managed their risks adequately.

## 5.1 Registered Finance Companies

There were 35 Registered Finance Companies (RFCs) as at end June 2009, with a new company registered under the Finance Companies Act, No. 78 of 1988 (FCA) in 2009. RFCs continued to provide a notable contribution to the economy, especially in the areas of vehicle financing, by catering to a diverse and important customer base that does not have easy access to bank finance. By end June 2009, the two largest companies accounted for approximately 40 per cent of the industry, with the remainder being distributed amongst the other RFCs.

Some stresses were experienced in the financial system, especially towards the latter part of 2008 primarily led by the failure of unauthorised finance businesses. As a result, public confidence in some of these institutions eroded, creating an initial contagion effect, leading to a drop in new deposits as well as sudden heavy withdrawal of deposits causing liquidity constraints to several RFCs. Consequently, overall performance and profitability of the sector declined resulting in a decrease in the core capital level of the industry coupled with the decrease in total accommodation and assets. Though, the industry has showed prospects of recovery, concentration risk, poor liquidity management, slower growth in some sectors in the economy and the operations of unauthorized deposit taking institutions still pose a threat to the profitability and sustainability of these financial institutions.

With the registration of Citizens Development Business Finance Ltd (CDBF) which was a Specialized Leasing Company (SLC), the number of RFCs increased to 35 at end June 2009. The total assets of RFCs, during the first six months of 2009, decreased by 3.2 per cent to Rs.169.8 billion from Rs.175.6 billion (exclusive of total assets of CDBF), while the total deposit liabilities rose marginally by 0.1 per cent from Rs. 103.5 billion. The number of branches of RFCs increased from 248 to 261 during this period.

The changes in market share of 3 categories of RFCs, in total assets of RFCs during this period, are shown in Table 5.1.

Table 5.1 – Distribution of Total Assets of RFCs

Category in term of Assets	No. of RFCs		Total Assets			
			Amount (Rs. millions)		Percentage	
	31.12.2008	30.06.2009	31.12.2008	30.06.2009	31.12.2008	30.06.2009
Small (Less than Rs.1,000 mn.)	7	8	4,297	3,771	2.5	2.1
Medium (Rs. 1000 mn. ≤ Rs. 5,000 mn.)	19	18	42,484	43,311	24.9	24.5
Large (More than Rs. 5,000 mn.)	8	9*	123,606	129,800	72.6	73.4
All Companies	34	35	170,387	176,882	100.0	100.0

\* inclusive of CDBF

Source : Central Bank of Sri Lanka

Salient feature is that nine companies in the large group contributed to 73 per cent of total assets of the industry. However, the sector continued to be dominated by two companies, representing more than 40 per cent of the total assets and 34 per cent of total branch network. On the other hand, these RFCs concentrate on different niches (eg. real estate, vehicle loans etc.) and some companies operate from regions. (eg. Kandy, Chilaw).

Finance leasing and hire purchase businesses are the major areas of business of RFCs and they represented 74 per cent of total accommodations at end June 2009. During the first six months period of 2009, finance leasing portfolio of RFCs decreased by 6.5 per cent and hire purchase portfolio decreased by 7.2 per cent due to restricted lending and aggressive

recovery procedures deployed by RFCs in order to increase their liquidity level to face the excess demand for deposit withdrawals. As a result, total accommodations of the sector contracted by 6.7 per cent to Rs.100.2 billion during the period under review.

Total interest income increased to Rs. 29 billion from Rs. 23 billion, during the financial year ending March 2009. But, the net interest income decreased by 5.3 per cent to Rs. 7.1 billion from Rs. 7.5 billion during the previous financial year, while non-interest income increased from Rs. 5.7 billion to Rs. 6.1 billion. However, net profit before tax decreased sharply by 184 per cent to Rs. 1.3 billion from Rs. 3.7 billion, largely due to high interest cost on deposits and significant increase in provisioning for bad and doubtful debts during the financial year ending 31 March 2009. Key financial indicators of RFCs sector are given in Table 5.2.

**Table 5.2 – Key Financial Indicators of RFCs (as at end March)**

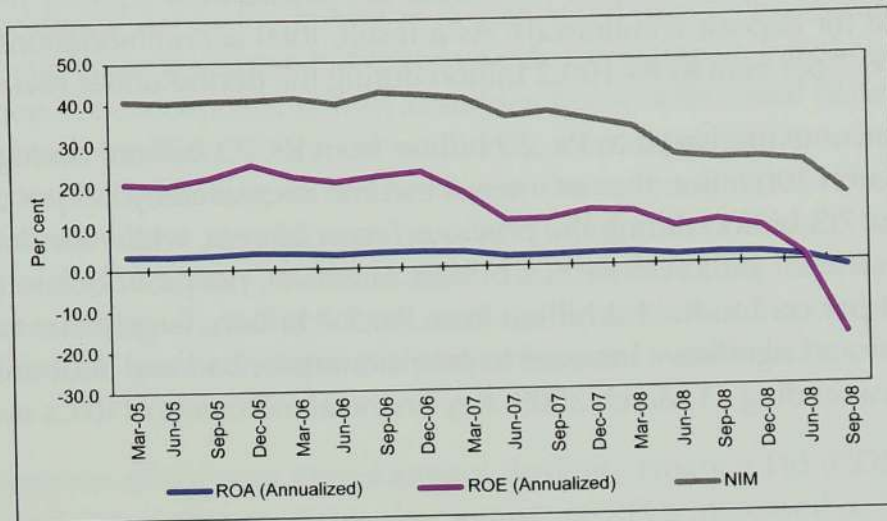
Indicator (%)	2003	2004	2005	2006	2007	2008	2009
Capital Funds / Total Assets ratio (%)	12.3	13.2	14.3	15.0	16.5	15.3	13.3
Capital Funds / Deposit Liabilities ratio (min. requirement 10%)	19.9	21.8	24.7	28.0	29.2	27.2	22.3
Core Capital ratio (min. requirement 5%)	11.9	13.3	14.0	14.7	13.1	12.9	12.6
Total Capital ratio (min. requirement 10%)	14.5	15.7	16.4	16.5	14.3	15.0	14.4
NPAs / Total Accommodations ratio (%)	10.0	10.0	8.6	5.7	4.4	5.8	7.9
Provisions made / Total accommodations ratio (%)	7.0	7.3	6.6	4.9	3.0	3.1	3.6
Provision made / NPAs ratio	67.1	70.1	77.0	83.4	68.1	47.2	43.2
Return on Equity (ROE) (%)	19.8	22.3	20.5	21.9	17.8	12.4	1.3
Return on Assets (ROA) (%)	2.0	2.5	2.9	3.3	3.2	2.4	0.8

Source : Central Bank of Sri Lanka

It is evident from Table 5.2, that increasing trend of the capital strength has reversed from the financial year ended March 2008. In terms of capital adequacy, six RFCs failed to increase their core capital above the required minimum level of Rs. 200 million, as required by the Finance Companies (Minimum Core Capital) Direction No. 1 of 2006. Those companies have been required by a special direction to fulfil the requirement by end 2009. In addition, core capital level of five RFCs have decreased below the minimum level of Rs. 200 million, due to continuous losses incurred by those RFCs. Stringent actions have already been taken by the Monetary Board to ensure that these RFCs comply with the prudential requirement, by the specified deadlines.

The latter part of the financial year 2008 was challenging for smooth operations of the RFCs due to liquidity crisis faced by the sector. Some RFCs ended up with operating losses during the period, due to scaling down of businesses in order to prevent cash outflows to face the excess demand for deposit withdrawals. As a result, as shown in Chart 5.1, ROE and ROA for the financial year ending 31 March 2009, declined to 1.3 per cent and 0.8 per cent respectively, from 12.4 per cent and 2.4 per cent respectively, for the financial year ended 31 March 2008.

Chart 5.1 – Prudential Ratios of RFCs



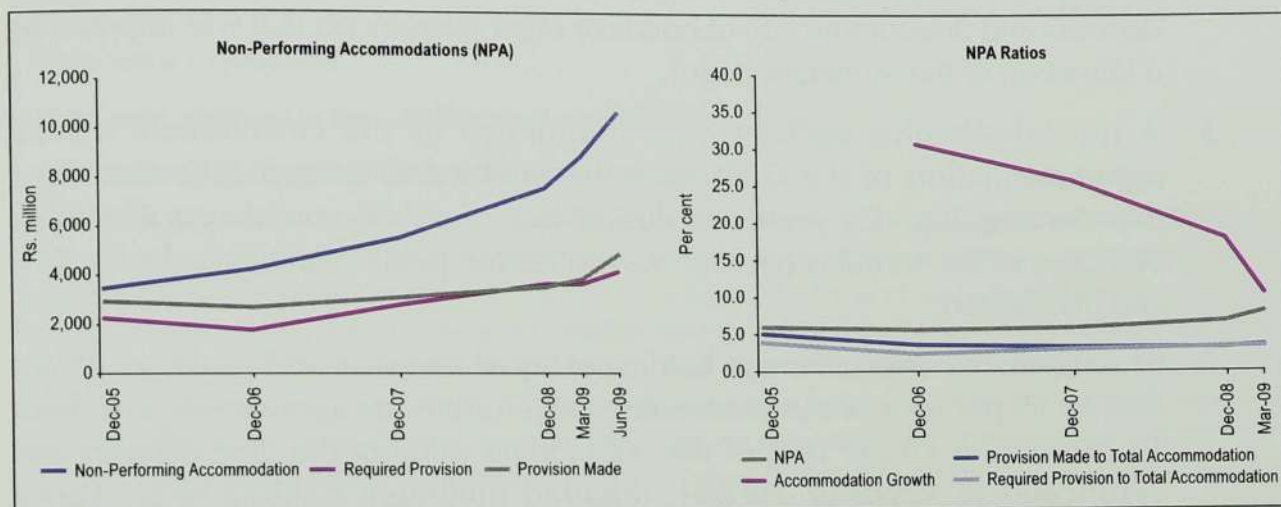
## Risk Assessment

Risk management involves not only identifying, assessing and mitigating risks and vulnerabilities which may affect financial institutions, but also the means to reduce the information gap and enhancing market confidence in market participants. Hence, RFCs should properly assess risks and vulnerabilities, and also should base their operations on sound management principles and disclosure requirements that safeguard their financial resources and profitability. It is noted that risk management practices in the sector are relatively weak and vary widely across the industry due to diverse reasons. However, RFCs have begun to address this issue primarily via improvements in management information systems, credit appraisal techniques and streamlined recovery procedures. Nevertheless, it is essential that relatively large finance companies maintain an adequate capital cushion and adhered to capital requirement regulations announced by the CBSL, to avoid any threats to their stability.

## Credit Risk

RFCs are exposed to credit risk as they mobilise deposits and lend such funds through finance leases, hire purchase facilities and direct loans. The ratio of non-performing accommodations to total accommodations (NPA ratio) is an indicator of credit risk of any financial intermediary. The NPA ratio of the RFC sector increased to 10.2 per cent from 6.8 per cent during the first six months in 2009, due to the worsening external environment and domestic macroeconomic conditions. In order to reduce the NPA ratio and thereby to increase the quality of portfolios, RFCs have now expedited the recovery actions by way of aggressive recovery procedures and disposing the repossessed vehicles at yards.

Chart 5.2 – Asset Quality



## Liquidity Risk

The Central Bank monitors the liquidity of RFCs on a monthly basis through its off-site surveillance. The overall liquidity position of RFCs was adversely affected mainly due to large deposit withdrawals from some RFCs which arose as a result of the failure of certain unauthorized businesses. As a result, as at end June 2009, 10 RFCs were unable to maintain the regulatory liquidity requirement due to excessive demand for deposit withdrawals.

## Policy Action by CBSL for Distressed RFCs

During the first half of the year, the foremost and challenging task of the CBSL was to restore the public confidence in the sector which was severely affected by the failure of unauthorized finance businesses, threatening the stability of the sector. The loss of public confidence in the RFCs in the Ceylinco Group posed a major threat to the stability of the sector while spreading it to other RFCs, outside the Ceylinco Group, as well.

In this regard, the following actions were taken by the CBSL to restore public confidence in the RFCs.

1. Merchant Bank of Sri Lanka PLC (MBSL) was appointed as the managing agent of The Finance Company, The Finance & Guarantee Co. Ltd., Asian Finance Ltd., and Ceylinco Investments & Reality Ltd. (Initially Lankaputhra Development Bank was appointed as the Managing Agent of the latter 3 RFCs).
2. An Expert Group was appointed as per a decision of the Cabinet of Ministers, to assist the RFCs that were facing problems especially RFCs in the Ceylinco Group.
3. Under the guidance of the CBSL, controlling interest (84.5 per cent of shares) of Seylan Merchant Leasing PLC (SMLP) was acquired by Peoples Leasing Company Ltd. and as a result the business affairs of SMLP have become normalized.

4. Enhancing the upper limit of the rate of interest that can be paid by RFCs for deposits and discounting rate of bonds or other instruments that was imposed by a Direction of the Monetary Board.
5. A special stimulus package was announced by the Government on the recommendation of the CBSL to assist troubled RFCs and SLCs that were experiencing liquidity problems due to loss of public confidence. The main objective of the stimulus package was to restore public confidence in the RFC and SLC sectors.
6. In addition, required minimum holding of liquid assets was reduced from 20 per cent to 15 per cent of the outstanding value of the savings deposits and, from 15 per cent to 10 per cent of the outstanding value of the time deposits and certificates of deposits. Further, required minimum holding of Sri Lanka Government and Central Bank Securities was also reduced from 10 per cent to 7.5 per cent of the average month end total deposit liabilities of the twelve months of the proceeding financial year.

The CBSL also implemented specific prudential measures to mitigate potential risks. These included an enhancement of risk based supervision, requirement of strict compliance with the rules for bad debts provisioning. In order to make the boards of directors of finance companies responsible and accountable for the companies' performance and risk management, the CBSL issued the Finance Companies (Corporate Governance) Direction with effect from 01 January 2009.

## Box 5

## New Finance Companies Law

### *Why it is necessary to have a New Finance Companies Law*

The Finance Companies Act, No. 78 of 1988 (FCA) which was enacted in 1988, has been amended only once in 1991. With the passage of time spanning 21 years, the need to amend the FCA has been felt by the industry and the regulator in order to update the law with the developments in technology and practices, combating unauthorized deposit taking activities and effectively stabilize the financial sector in the wake of challenges. The current stresses in the finance industry involving unregistered deposit taking institutions have also underscored the need to bring in an effective legal framework to enable timely action on such entities.

It is proposed to amend, repeal or replace 47 sections out of the 51 sections of the Finance Companies Act. Further, 22 new sections will also be introduced to the Finance Companies Act. This results in a complex and ad-hoc structure in the statute which makes it difficult to be followed and understood. When an Amendment Act is passed by the Parliament, it is printed as a separate Act and not consolidated into the current statute. Therefore, when a section is amended by two Amendment Acts, a person who refers to that particular section must refer to the Original Act and the two Amendment Acts. Unless a law is easily understood and followed by the members of the public, it will not yield the intended results. In the circumstances, it is proposed to pass a new legislation in the name of Finance Business Act with a view to maintaining a smooth flow in the statute.

**Box 5 (Contd.)****Major revisions proposed**

Major areas proposed to the draft Finance Business Act are as follows:

- **Acceptance of deposits without authority is made an offence**

In terms of the provisions of the Finance Companies Act, in order to prove carrying on of finance business, three aspects of the business has to be proved, *i.e.*, acceptance of money as deposits, payment of interest thereon and lending/investment of such money so accepted. In terms of such definition, a person who accepts deposits from public but does not invest or lend money will not be guilty of carrying on finance business without authority. Even though acceptance of deposits and payment of interest thereon may be proved by documentary evidence, it is extremely difficult to find substantial evidence with regard to lending/investment of such deposits. Therefore, revisions are proposed to make acceptance of deposits by a person other than a person authorised to carry on finance business under the Finance Companies Act and a person exempted from the application of the provisions of the Finance Companies Act, an offence. The Committee on Public Enterprises (COPE) has also required CBSL to amend the Finance Companies Act urgently in order to prevent the general public from being caught to fraudulent money soliciting schemes.

- **Definition of “deposit” is introduced**

The Finance Companies Act does not have a definition to the term ‘deposit’. As accepting deposits is an integral part of finance business, the lacuna of a definition gives rise to difficulties in proving the offence of carrying on finance business without authority. A separate section is proposed to deal with the definition of “deposit” and to confer power on the Monetary Board to determine whether a sum of money is a deposit or not, having regard to the frequency of the occurrence of such transaction and to the characteristics thereof.

- **Examination / Investigative powers enhanced**

Powers given to the Director of Department of Supervision of Non-Bank Financial Institutions for examination/investigation of licensed finance companies/persons carrying on finance business without authority or persons accepting deposits without authority are enhanced. Further, it is provided for the Director to require the Inspector General of Police or any Divisional Secretary to conduct an investigation to ascertain whether a person is carrying on finance business without authority or accepting deposits without authority.

- **Enhanced powers to curb unauthorized finance / deposits taking businesses**

- o To obtain a court order to compel a person to provide information and books relating to illegal deposit taking institutions/persons
- o To freeze assets of persons carrying on finance business/accepting deposits, without authority
- o To impound passports of persons carrying on finance business/accepting deposits, without authority
- o To call for information regarding the assets and liabilities of the directors of institutions carrying on finance business/accepting deposits without authority
- o Police and Divisional Secretaries to provide information on persons carrying on finance business/accepting deposits, without authority, if the Director so requires them
- o Advertising soliciting deposits without authority/Publication of advertisements soliciting deposits without authority are made offences.

## Box 5 (Contd.)

- **Restricting/prohibiting the use of certain words**

In order to make it easier for the public to identify whether a company is a licensed finance company by its name and to prevent fraudulent companies from misrepresenting and misleading the public by using names similar to names or acronyms of licensed finance companies the following measures are proposed in the Draft Act:

- o *Restricting the use of the words 'finance', 'financing' and 'financial' in a name or description of an entity*

It is made mandatory for the registered finance companies to have the word 'finance', 'financing' or 'financial' in their name and the other institutions are prohibited from using the word 'finance' 'financing' or 'financial' in their name or description without the prior written approval of the Monetary Board.

- o *Restricting the use of name, abbreviated name or acronym of a Finance Company*

A company should not be registered with a name that contains as part of it, the abbreviated name or acronym of any finance company without the approval of Director, Supervision of Non-Bank Financial Institutions. No person other than the respective finance company shall use its name, abbreviated name or acronym in any of its advertisements promoting its business without the prior written approval of Director, Supervision of Non-Bank Financial Institutions.

- **Enhancing Supervisory Action on registered finance companies**

Where a finance company is following unsound or improper financial practices, detrimental to the interest of its depositors or is likely to be carrying on its business in a manner detrimental to the interest of its depositors or has contravened or failed to comply with any provisions of the Finance Companies Act, only a few remedial measures are available under the Finance Companies Act. It is proposed to empower the Monetary Board to do the following:

- o publish the name of the finance company as a finance company regarding which the Board has serious supervisory concerns
- o appoint a Managing Agent
- o restrain any director, manager or controller of the finance company from carrying out any function in or in relation to the finance company
- o re-organize the finance company, by arranging for the increase of its capital or reconstituting its board of directors or both such measures
- o amalgamate the finance company with another finance company or any other institution, with the consent of such other finance company or institution
- o review any contract entered into by a depositor with the finance company and vary the terms of such contract
- o review any agreement or contract entered into by the finance company, with any person and vary the terms of such agreement or contract
- o guarantee loans and other accommodation granted to a finance company by a credit institution.

- **Enhancing Public Disclosure**

In order to enable the public to take informed investment decisions and to improve their awareness on unauthorized deposit taking businesses the Monetary Board is empowered to do the following under the draft Act:

**Box 5 (Contd.)**

- a. To publish the names of finance companies including the supervisory rating of those companies
- b. To publish the name of a finance company as a finance company regarding which the Board has serious supervisory concerns
- c. To publish the name and address of a person determined by the Board as carrying on finance business or accepting deposits without authority.

- **Empowering the Monetary Board to establish a mandatory deposit insurance**

Under the FCA there are provisions to have a deposit insurance scheme if the Central Bank wishes to establish such a scheme. Similar provisions are proposed under the draft Act for the Monetary Board to establish and maintain a scheme of insurance of deposits. When a deposit insurance scheme is established by the Monetary Board, it shall be mandatory for the licensed finance companies to insure, the deposits held by them, under such scheme. It is further provided for in the draft Act that the Monetary Board may authorise a body corporate to carry out its functions in that regard. This is proposed to be introduced as a measure of safeguarding depositors' interests.

- **Improving the reporting requirements for licensed finance companies**

Reporting requirements for licensed finance companies are improved by introducing provisions to the following effect:

- o The Monetary Board may issue guidelines to D/SNBFI to monitor the compliance with the directions issued by the Monetary Board to finance companies and authorize D/SNBFI to direct finance companies to comply with such directions forthwith or within such period as may be specified by D/SNBFI
- o D/SNBFI may require any director, manager, employee of a finance company to make a declaration of his assets and liabilities as at a date as may be specified by D/SNBFI.

This will enhance the monitoring and supervisory action in respect of licensed finance companies.

- **Revising the winding up process by including a list of priority of claims**

In the order mentioned in list of priority the depositors would be paid. This is proposed to be introduced as a measure of safeguarding depositors' interests.

- **Enhancing the penalties under the Act. Further, abetting to commit an offence is also made an offence under the draft Act. Carrying on finance business without authority and accepting deposits without authority are made indictable offences by the Attorney General in the High Court**

Provisions to the above effect are proposed to make litigation action under the draft Act more effective and a deterrent to those who contravene the law.

Carrying on finance business or accepting deposits without authority would carry a penalty of imprisonment of either description not exceeding 5 years and/or a fine not exceeding Rs. 5 million.

## 5.2 Finance Leasing Establishments

The total number of finance leasing establishments registered under the Finance Leasing Act, No. 56 of 2000 (FLA) stands at 74, consisting of 19 licensed banks, 34 RFCs and 21 Specialized Leasing Companies (SLCs) which are public companies, whose primary business is finance leasing. Close monitoring of SLCs continued through off-site surveillance and on-site examinations, during the period under review.

The outstanding total finance lease portfolio of all Registered Finance Leasing Establishments stood at Rs. 127 billion as at end June 2009, recording a decrease of 13 per cent as against Rs. 146 billion recorded at end June 2008. Licensed banks accounted for 45.9 per cent of the finance lease portfolio while RFCs and SLCs accounted for 29.5 per cent 24.6 per cent, respectively.

At end June 2009, the total assets of SLCs slightly increased to Rs. 107 billion as against Rs. 106 billion recorded at end June 2008, while total outstanding of accommodations decreased by 8.3 per cent to Rs. 77 billion from Rs. 84 billion during the period. As SLCs are not permitted to accept deposits from the public, they depend mainly on funds raised through issue of debt instruments. At end June 2009, the total outstanding borrowings of SLCs stood at Rs. 73 billion, while their capital funds stood at Rs. 19 billion. Selected key financial indicators of SLCs are given in Table 5.3.

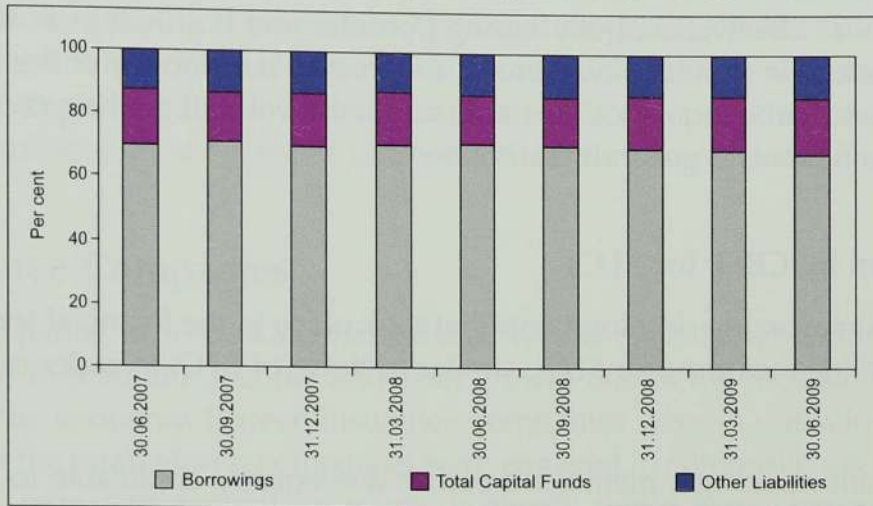
Table 5.3 – Selected Key Financial Indicators of SLCs

Financial data	End June 2008 (Rs. bn)	End June 2009 (Rs. bn)
Capital Funds	16.7	19.2
Accommodations	84.3	78.6
Borrowings	84.0	73.0
Provision for NPAs	2.4	3.0
Required Provision	1.9	2.9
Profits for the period	0.7	0.9
<b>Ratios (%)</b>		
NPAs	4.2	7.1
Return on Assets (ROA)	2.3	3.0
Return on Equity (ROE)	8.6	9.6

Source : Central Bank of Sri Lanka

Leasing and hire purchases were the major business activities of SLCs, which accounted for more than 73 per cent of total accommodations. SLCs mainly depend on borrowings as their major source of financing and the outstanding borrowings represented 70 per cent of the total liabilities of the SLCs, while capital funds represented only 17 per cent (Chart 5.3).

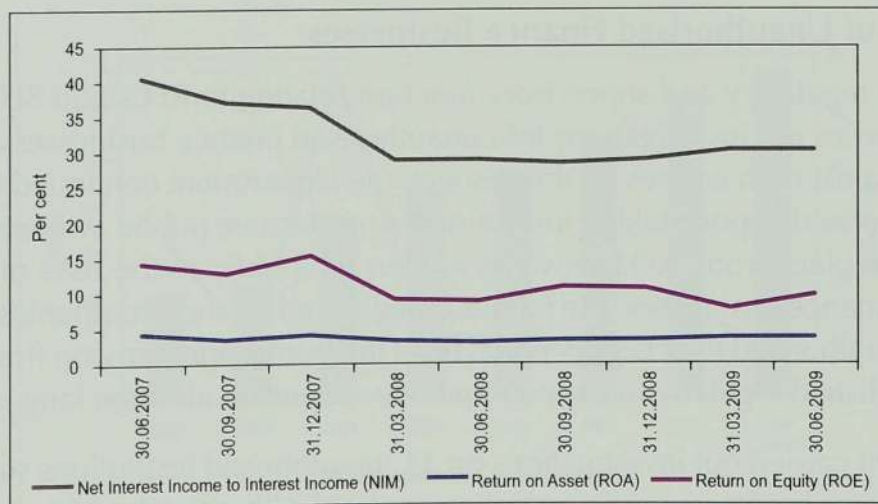
Chart 5.3 – Liabilities (financing of assets) of SLCs



### Risk Assessment

The profitability of most of the companies has declined, mainly due to decline in net interest income during the first half of 2009. As SLCs finance long term assets through mainly short term high interest rate borrowings and the interest rates are usually fixed for assets and liabilities, hence the affected interest rate margins and then the profitability of SLCs. Further, the contagion effect of unfavorable economic conditions, both internationally and domestically, and recent failure of some unauthorized finance businesses also contributed to decline in profitability of SLCs. Decrease in borrowings and withdrawal of investments made by investors through debt instruments caused funding constraints to SLCs. However, the SLCs whose capital strength was high were less vulnerable to this effect. The competition faced by the industry in its major business activity of leasing, from licensed banks and from RFCs, could also have contributed to the decline in profitability of SLCs. As SLCs are permitted to borrow from the public through the issue of debt instruments, some SLCs were able to mitigate the high interest cost to some extent.

Chart 5.4 – Profitability of SLCs



At end June 2009, 6 SLCs accounted for 80 per cent of total assets of SLCs. This concentration was observed in both leasing portfolio and borrowings as well. Although there was a decline in profitability, there is no threat to the stability of the SLC sector, as SLCs maintain capital adequacy status at a satisfied level and as their compliance with prudential requirements is generally satisfactory.

### **Policies Action by CBSL for SLCs**

In view of the unfavorable developments that took place in the financial sector, the CBSL took several policy measures for SLCs, similar to those of RFCs in order to stimulate the industry.

- The stimulus package, mentioned earlier was equally applicable to SLCs as well. A separate direction was issued in respect of the implementation of the same for SLCs.
- A Guideline was issued to SLCs for the implementation of the decision of the Cabinet of Ministers on Transfer of Repossessed Vehicles and Equipment to the Original Users, to encourage their productive use. The main objective of this Guideline was to restore the public confidence in the SLCs industry.
- The CBSL encouraged small SLCs to seek the possibility of amalgamating with similar SLCs or RFCs and to find strategic investors to expand their businesses and also to improve financial stability.
- The CBSL encouraged SLCs that are capable of meeting the requirements, to seek registration under the FCA, as a means to resolve their funding constraints. Accordingly, Citizens Development Business Finance Ltd. (formerly known as Ceylinco Development Bank Ltd.) was registered as a finance company under the FCA with effect from 11.05.2009.
- Exposure draft on Corporate Governance for SLCs was prepared and is under review.
- Interest rate margins were revised to strengthen the liquidity position of SLCs.

### **Investigation of Unauthorised Finance Businesses**

Apart from the regulatory and supervisory function relating to RFCs and SLCs, the SNBFI Department carries out investigations into unauthorised finance businesses and instituted legal action against such entities. In this respect, the Department continued to take action against unauthorised deposit-taking institutions. An extensive public awareness campaign has been put in place from 2003 onwards to alert the public to the risks of dealing with unauthorised finance businesses. The names of registered finance companies and licensed banks that are authorised to accept deposits from the public and carry on finance business have been published regularly in the national newspapers in all three languages.

The Department carried out investigations on 31 unauthorised institutions suspected to be involved in finance business and discussions were held with officials of 18 such companies

during the period. In addition, the CBSL conducted nine awareness programmes in different parts of the country during the period, to educate the general public about the risks of depositing funds in unauthorised institutions. Moreover, with a view to strengthening the provisions relating to regulatory action against unauthorised deposit taking institutions, amendments to the current Finance Companies Act have been proposed.

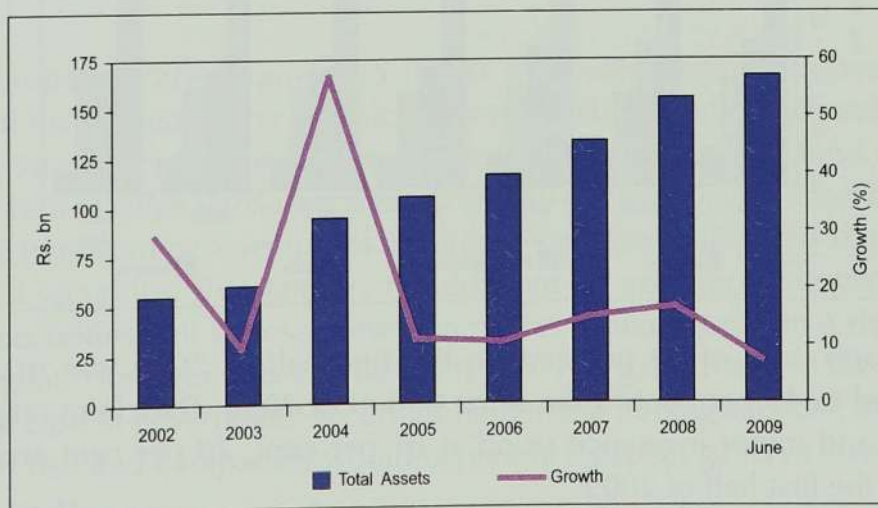
### 5.3 Insurance Companies

Insurance companies in Sri Lanka remained relatively stable although a slight deceleration was witnessed in premium income and asset growth due to the recessionary conditions prevailing in the economy. Sixteen insurance companies were in operation at the end of June 2009. Of the total, eleven companies were engaged in composite insurance carrying on both long term and general insurance business, while two companies conducted only long term insurance business and three companies were solely involved in general insurance. Seven insurance companies were listed on the Colombo Stock Exchange and six companies have foreign collaboration.

The insurance sector is still small in size accounting for about 3 per cent of financial sector assets and about 1.3 per cent of GDP in terms of premium income. The insurance industry is highly concentrated with the two largest companies accounting for 65 per cent of the total assets and five companies accounting for 93 per cent of total assets as at end June 2009. There were 54 insurance brokering companies involved in general insurance business at the time of renewal of registration for the year 2009 and about 25,000 insurance agents who play a key role in marketing life insurance products.

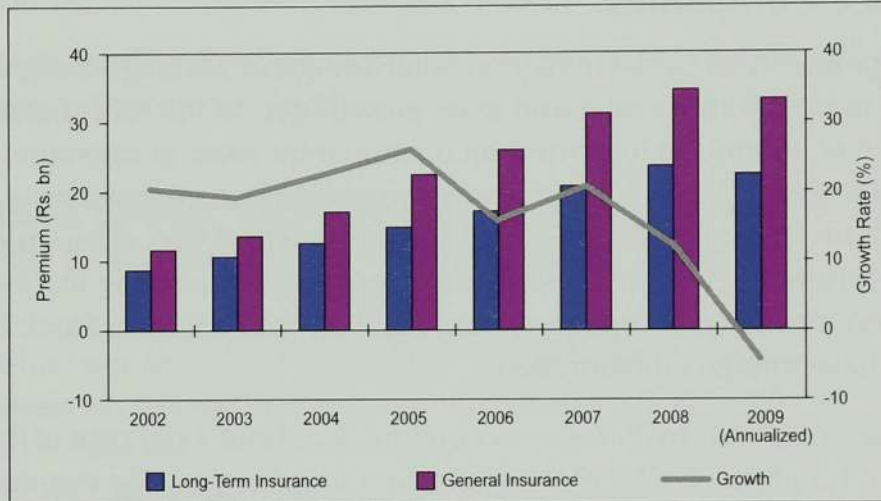
Total assets of insurance companies stood at Rs.166 billion as at end June 2009 compared with Rs. 144 billion at end June 2008, representing an increase of 15 per cent. The total assets of long-term insurance business amounted to Rs. 107 billion at end June 2009 representing 65 per cent of the total assets of insurance companies. The total assets of general insurance amounted to Rs. 59 billion at end June 2009 accounting for 35 per cent of total assets of the industry.

Chart 5.5 – Total Assets of Insurance Companies



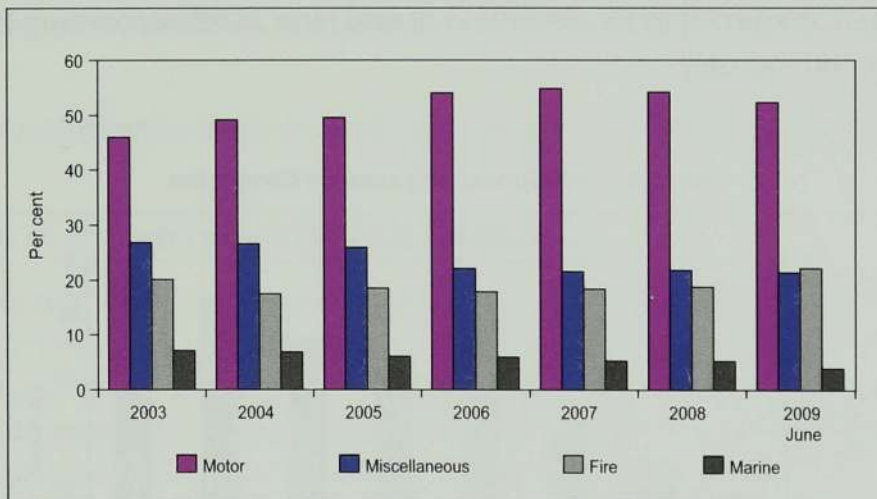
Premium income for both life and general insurance declined marginally by 5 per cent to Rs. 27.8 billion during the first half of 2009 from Rs. 29.2 billion in the first half of 2008. Life insurance premium income marginally increased by 0.3 per cent to Rs. 11.2 billion (accounting for 40 per cent), while general insurance premium income declined by 8 per cent to Rs. 16.6 billion (accounting for 60 per cent). The premium income for

Chart 5.6 – Total Gross Premium of Insurance Companies



motor insurance, which constitutes 52 per cent of the total premium of general insurance, recorded a slight decline of 2 per cent against a 10 per cent growth in 2008. Premium income on account of fire insurance increased by 12.5 per cent while that on account of miscellaneous insurance services declined by 15 per cent, accounting for shares of 22 per cent and 21 per cent respectively of general insurance premium income.

Chart 5.7 – Class-wise Gross Written Premium of General Insurance of Insurance Companies

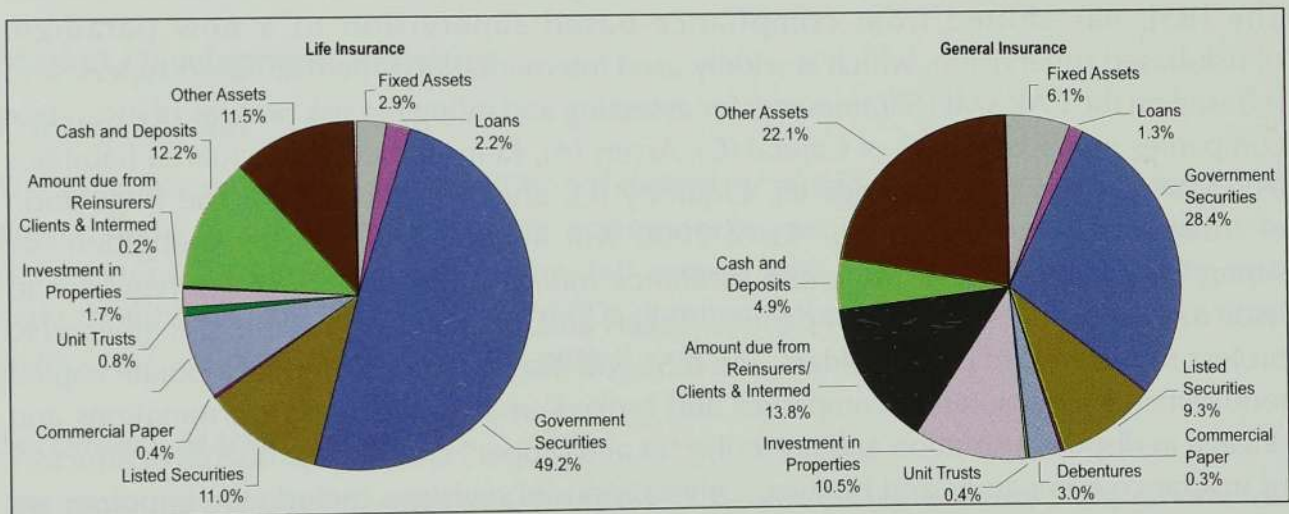


The overall claim ratio of 48 per cent in the first half of 2009 was marginally high when compared to 45 per cent in the same period of 2008. The claim ratios of marine, miscellaneous and motor insurance stood at 81 per cent, 70 per cent and 42 per cent respectively in the first half of 2009.

Insurance companies were able to retain around 73 per cent of their gross premium, while 27 per cent was ceded as reinsurance premium to cover for large risks. Motor insurance continued to maintain the highest retention of 96 per cent when compared to other classes. Miscellaneous insurance and marine insurance with retention levels of 76 per cent and 48 per cent respectively in the first six months of 2009, showed a marginal increase when compared with the corresponding period retention levels of 68 per cent and 43 per cent respectively, for the previous year.

Twelve out of the sixteen insurance companies made profits, while four small companies made losses during the first six months of 2009. Of the loss making companies, two companies were composite insurance companies while one was a life insurance company and the other a general insurance company. The majority of general insurance companies recorded underwriting profits in the first half of 2009. Three companies made underwriting losses in the first half of 2009, mainly due to lower premiums and higher claims. Hitherto, most insurance companies offset their underwriting losses on general insurance business with investment income, which increased significantly due to high interest rates. However, in the current declining interest rate scenario, low interest rates could impact adversely on the investment income of insurance companies.

Chart 5.8 – Concentration of Assets of Insurance Companies



Insurance companies are required to invest in government securities not less than 20 per cent of their assets in the technical reserves maintained for general insurance and not less than 30 per cent of their assets in the long term insurance fund. As at end June 2009, 28 per cent of general insurance assets and 49 per cent of long-term insurance assets were invested in government securities. Insurance companies invested 10 per cent of their assets in listed securities. The statutory requirement for insurance companies to invest in government securities will expose these companies to market risk in a declining interest rate environment. However, this will be partly offset by gains made in the buoyant equity market. In the case of government securities held in the trading account, the value of such securities will rise and companies would experience capital gains in a declining interest rates environment.

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SPECIAL COLLECTION

The solvency margin, which reflects an insurance company's ability to meet the obligations arising from its insurance contracts, is the main indicator to measure the soundness of insurance companies. Prevailing insurance regulations require all insurance companies to maintain a minimum solvency margin for each class of insurance business at any time. All insurance companies met the solvency margin requirement for life insurance business at end June 2009, while two companies were non-compliant with the minimum solvency requirement for general insurance business. The non-compliant insurance companies however were small in terms of assets and premium income, which were 0.8 per cent and 1.6 per cent respectively of the industry total at end June 2009. The overall solvency ratio for life and general insurance increased to 4.71 and 3.15 respectively at end June 2009 from 4.12 and 2.09 respectively at end June 2008.

The Sri Lankan insurance market received a positive boost from the reduction on the country's war risk rating. The London Joint Cargo Committee (JCC) reduced the war risk premium on Sri Lanka from 3.4 to 3 by changing the risk status from "severe" to "high" in June 2009. In addition, air-war / strikes and air-war risks have been removed for Sri Lanka with the presently applicable risks being marine war, marine strikes and ground war strikes. The reduced war-risk rating in turn results in lower prices of goods imported to Sri Lanka due to a lower surcharge on ships carrying cargo to Sri Lanka.

The Insurance Board of Sri Lanka (IBSL) is the regulatory body for insurance companies. The IBSL has shifted from compliance-based supervision to a new paradigm of risk-based supervision, which is widely used internationally. The risk-based supervision is based on the CAMELS framework for assessing and rating the risk profiles of insurance companies in the key areas of Capital (C), Assets (A), Reinsurance (R), Actuarial liabilities (A), Management (M), Earnings (E), Liquidity (L), and Subsidiaries (S). The Regulation of Insurance Industry Act, No. 43 of 2000 will also be amended to strengthen the supervisory framework of the entire insurance industry. The powers of the regulator to issue directions to insurance companies, brokers and loss adjusters will be strengthened to protect the interest of policyholders. The IBSL will also be empowered to stipulate capital requirements for insurance companies and brokers, make rules and determinations and engage in dispute resolution and prescribe "fit and proper" criterion for boards of directors of insurance companies and brokers. Other proposed revisions include the appointment of institutions as agents of insurance companies and the requirement that long-term and general insurance business be conducted in separately incorporated companies, with existing composite insurers being given time to segregate business into separate companies. Insurance companies will also be required to list on the stock exchange. The IBSL has also decided to request all insurance companies to obtain a rating of Insurers' Financial Strength (IFS) indicating their ability to pay claims from a rating agency. Accordingly, four insurance companies have already got their companies rated by local rating agencies.

## 5.4 Primary Dealers

Primary Dealer (PD) industry showed improved performance in market development activities recording an increase in secondary market transactions with a significant shift towards Treasury bonds during first eight months of the year, over the same period in the previous year. A downward shift in the yield curve resulting from a low inflation, lower inflationary expectations, relaxation of monetary policy, and inflows to the government securities market through foreign investments, created more demand for government securities with longer maturities. Effectively participating at the primary market, non state owned PDs and state owned PDs dominated the contribution in the Treasury bill auctions and Treasury bond auctions respectively. The PD industry maintained all risk indicators including capital adequacy ratio, capital leveraging level and repo/asset ratio at accepted levels leading to improved stability. Further, financial performance of PDs improved remarkably during first eight months of 2009 reporting high profitability ratios such as Return On Equity (ROE) and Return On Assets (ROA). A Master Repurchase Agreement (MRA) was introduced on January 01, 2009 which could be used commonly by both Primary Dealers (PDs) and Licensed Commercial Banks (LCBs). As the PDs are currently exposed to business concentration risk due to exclusively engaging in government securities business, the Central Bank of Sri Lanka (CBSL) has approved a proposal to diversify PD activities.

### Market Development Activities

#### *Primary Market*

The contribution of state owned PDs in the primary auctions had increased during first eight months of 2009 compared to the corresponding period in 2008. However, the non state sector PDs dominated the Treasury bill auction with a 55 per cent share during first eight months in 2009. The state owned PDs dominated the Treasury bond auctions with a share of 62 per cent during the same period.

#### *Secondary Market*

The secondary market transactions through PD system during the first eight months of 2009 was valued at Rs. 4,053.5 billion recording an 8.0 per cent increase compared to Rs. 3,761.0 billion during the corresponding period in previous year. Treasury bond transactions had increased by 82 per cent while Treasury bill transactions had decreased by 44 per cent over the two periods under consideration showing the shift in demand for government securities with longer maturities. Since 2008 CBSL has taken several steps to diversify the investor base in government securities by liberalizing the government securities market and also by conducting promotional campaigns vigorously.

### Assessment of Risks

#### *Market Risk*

PDs are highly vulnerable to market risk, since they are operating as a single product business, *i.e.*, the government securities business. Therefore, movements in market

interest rates directly affects the trading portfolio and the capital base of the PD industry. However, the market risk of the PD industry was considerably low during the first eight months of 2009 due to continuous drop in secondary market interest rates, in line with the downward movements in the primary market interest rates. This downward shift of the yield curve could be attributed mainly to the favourable developments in the market including low inflation, lower inflationary expectations, relaxation of monetary policy, and inflows to the government securities market through foreign investments.

The results of stress testing which is used to measure the impact on the value of trading portfolio and the capital base of PDs for a change in interest rates, shows that as at end August 2009, the PD industry would lose 5.9 per cent of capital if interest rates moves upward by 100 bps, while its impact on the value of the trading portfolio would be a loss of Rs. 554.7 million. The modified duration of the trading portfolio of the PD industry was 0.74 as at end August 2009, reflecting the holding of securities of longer maturities compared to end August 2008, where the modified duration was 0.65. However, still the modified duration could be considered to be low indicating the prevalence of a refinancing risk.

### ***Liquidity Risk***

Liquidity shortages prevailed in the local market towards end 2008 and first half of 2009, slightly affected the PD industry. However, this liquidity issue was resolved by allowing the PDs to access the Open Market Operation (OMO) window at the CBSL and also by making them available with term reverse repo facilities. Towards mid 2009, the liquidity risk exposure of the PDs eased off with the liquidity surplus situation in the market.

The liquidity risk exposure of the PD industry is measured through gap/maturity structure analysis. The gap analysis measures the level of mismatch between the assets and liabilities of the PDs in different maturity periods. The PD industry reported a negative overnight mismatch of Rs.5 billion as at end August 2009, which accounted only for 5.4 per cent of its total portfolio (Trading portfolio and reverse repo portfolio). This indicates a lower borrowing pressure in the short term and no undue risks for the PD industry.

### ***Operational Risk***

Operational risk of PDs is kept at minimal by conducting regular on site examinations and continuously engaging in off site surveillance activities by the Public Debt Department (PDD). The PDD reviews the financial statements of PDs periodically and monitors PD performance in primary and secondary markets and assesses the internal control systems, risk evaluations, internal and external audit functions and overall compliance with the directions and regulations issued by the PDD, in order to mitigate the operational risk. Further, it has been ensured that all PDs have Business Continuity Plans (BCPs) in place. All PDs have been advised to set up off-site disaster recovery centers and some PDs have developed on-line data backup systems as well.

## Other Risks

In order to mitigate the risk of ownership to the investors, which could arise out of non recording of transactions in the CDS, a circular has been issued to PDs to record all transactions in the CDS promptly and accurately.

A Master Repo Agreement (MRA) was introduced by the CBSL on January 01, 2009, which could be adopted commonly by PDs and Licensed Commercial Banks (LCBs) when entering into repo transactions. PDD is in the process of obtaining views of PDs & LCBs on the introduction of a schedule to the Global Master Repo Agreement with an intention to make it mandatory to use either one of the above MRA's when a PD or a LCB enters in to a repo transaction. This is to safeguard the interest of the parties to the repo agreement.

As the PDs are currently exposed to business concentration risk due to exclusively engaging in government securities business, the Central Bank of Sri Lanka (CBSL) has approved the proposals to diversify the PDs' business. Under different stages, the PDs would be allowed to engage in fee based services and would be permitted to diversify investments in quoted shares, unit trust and mutual funds and to borrow through debt instruments as approved by the Monetary Board of the CBSL.

Table 5.4 – Selected Financial Data and Indicators of Primary Dealers

Indicator	Unit	January – August	
		2008	2009
Total Capital	Rs.Mn	6,184.7	9,361.4
Total Portfolio	Rs.Mn	61,429.2	101,624.5
Trading Portfolio	Rs.Mn	41,944.0	66,469.9
Total Assets	Rs.Mn	63,265.5	106,980.4
Risk weighted Capital Adequacy Ratio	%	31.8	19.0
Tier I Capital Adequacy Ratio	%	30.8	18.9
Capital Leverage	Times	8.0	8.5
Return on Assets	%	2.7	7.9
Return on Equity	%	28.4	91.6
Operating Expenses <sup>1/</sup> to Total Income	%	3.7	2.9
Total Cost <sup>2/</sup> to Total Income	%	84.1	60.3

Source : Central Bank of Sri Lanka

1/ Operating expenses consist of administration, selling and finance expenses excluding taxes.

2/ Total cost consists of operating and interest expenses.

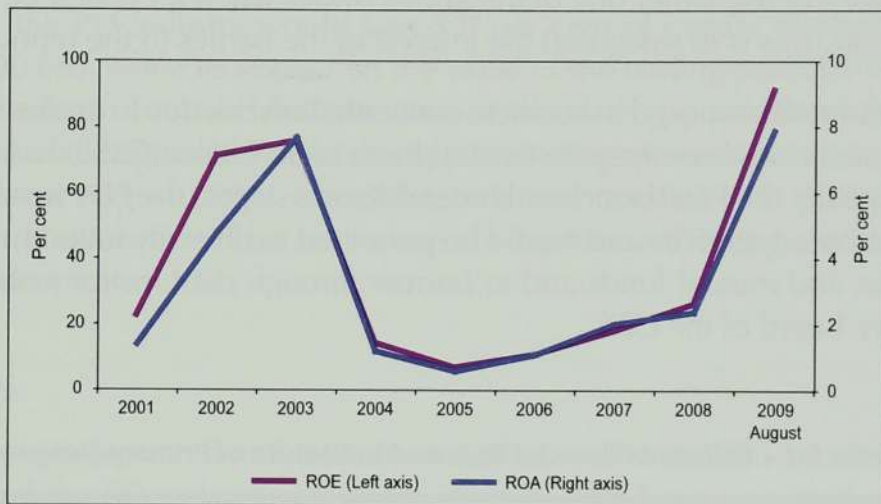
## Financial Performance of Primary Dealers

The total capital base of the PD industry increased by 51.4 per cent to Rs 9.4 billion from end of August 2008 to end of August 2009, mainly due to accumulation of profits. The risk weighted capital adequacy ratio of the PD industry remained over and above the regulatory requirement of 8 per cent, though it had decreased from 31.8 per cent at end August 2008, to 19.0 per cent over the same period. The industry leveraging level, which

shows the borrowed funds of PDs compared to its equity capital, was 8.5 times compared to 8 times at end August 2008.

The trading portfolio of the PD industry increased considerably by 58.5 per cent, *i.e.*, from Rs. 41.9 billion to Rs. 66.5 billion from end August 2008 to end August 2009. Besides, the total assets stood at Rs. 107.0 billion as at end August 2009, an increase of 69 per cent over asset value as at end August 2008.

Chart 5.9 – Return on Assets (ROA) and Return on Equity (ROE)



The industry recorded a pre-tax profit of Rs 4,855 million for the first eight months of 2009, showing a significant improvement over the pre-tax profit of Rs 1,103 million for the same period in 2008. A significant increase in capital gains, and increased net interest income enabled the industry to earn substantial profits. In addition, many positive factors, such as high contribution of non state owned PDs in the Treasury bill primary market and lower inflationary expectations which led to increased secondary market transactions helped to boost the profits. The improvements are reflected in the overall ROE of the PD industry, which rose to 91.6 per cent as at end August 2009 from 28.4 per cent as at end August 2008.

Considering the extremely high profits earned by the industry, PDD issued a direction restricting the dividend payout out of the profits earned during 2009 with a view to promote safety, soundness and stability of the PDs and to build up its capital base. Accordingly, PDs are allowed only to pay 50 per cent of the realized profits out of the profits earned during 2009.

## 5.5 Unit Trusts

The unit trust industry expanded with the formation of a new closed-ended fund in 2009. There are 18 unit trust funds, which are managed by five unit trust management companies. Of these funds, 13 are open-ended funds and 5 close-ended funds. These funds can be categorized as income funds (6), balance funds (4), growth funds (5), money market

funds (2) and index fund (1). The Namal Acuity Value Fund was the first closed - ended unit trust to be listed on the Colombo Stock Exchange in September 2009.

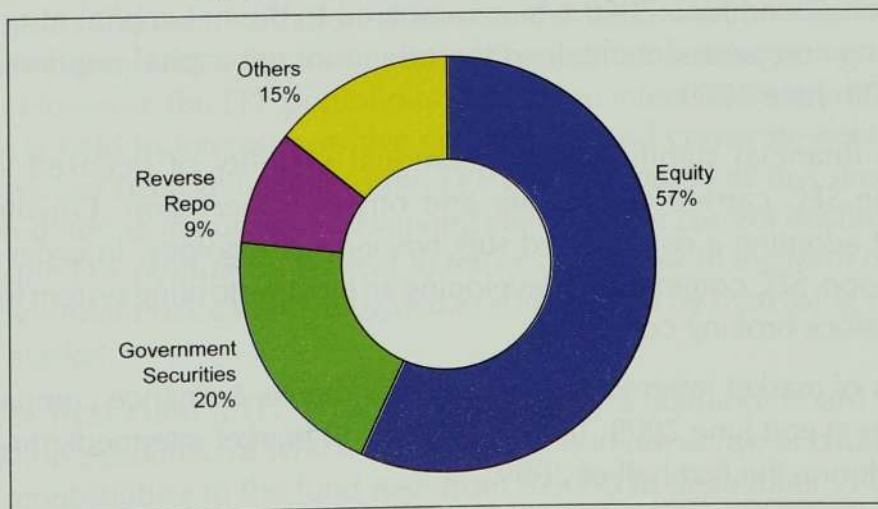
Table 5.5 –Selected Data of the Unit Trust Industry

Details	2001	2002	2003	2004	2005	2006	2007	2008	2009 Sept.
Total Assets (Rs.Mn.)	2,874	4,432	3,586	4,176	4,537	5,380	6,332	6,801	8,867
Net Asset Value (Rs.Mn.)	2,794	4,415	3,565	4,161	4,494	5,353	6,295	6,781	8,753
Investments in Equities (Rs.Mn.)	1,806	2,443	2,348	2,905	2,973	3,691	3,649	2,589	4,990
(3) As a Ratio of (2) (%)	65	55	66	70	66	69	58	38	57
Total No. of Unit Holders	25,936	25,291	24,067	23,650	21,520	23,424	23,191	22,699	22,622
No.of Units in Issues (Mn.)	380	459	317	340	336	356	470	638	559
No. of Unit Trusts	12	13	12	13	13	13	14	17	18

Source : Unit Trust Association of Sri Lanka

The performance of unit trust industry improved in 2009 in line with the upturn in the Colombo bourse. The Net Assets Value (NAV) of unit trusts increased by 29 per cent to Rs. 8.8 billion at end September 2009 in comparison to a net asset value of Rs. 6.8 billion at end 2008, reflecting gains made through investments in the share market. The share of equities in the investment portfolio of unit trusts increased to 57 per cent at end September 2009 from 38 per cent at end 2008. The share of government securities and other fixed income securities in the investment portfolio of unit trusts was 20 per cent and 23 per cent respectively, at end September 2009. The total number of unit holders and unit issues declined to 22,622 and 559 million respectively as at end September 2009. The prospects for unit trusts, particularly equity funds appear to be favorable on account of the appreciation in share prices in 2009.

Chart 5.10 – Investment Portfolio of Unit Trusts



The total assets of the five unit trust management companies increased to Rs. 621 million at end September 2009 from Rs. 603 million at end September 2008. The net profits (profits before tax) of the companies increased slightly to Rs. 70.8 million in the first nine months of 2009 from Rs. 65.4 in the first nine months of 2008. The unit trust management companies are supervised by the Securities and Exchange Commission (SEC) which monitors the exposure levels of unit trusts in accordance to the investment guidelines and limitations set out in the relevant Trust Deeds and the Unit Trust Code.

The SEC strengthened the regulation of unit trust management companies during the year. New directives were issued relating to the independence of trustees from managing companies, investment restrictions and minimum net capital requirements for unit trust managing companies, financial capacity of trustees and disclosure requirements for trustees and management companies.

## 5.6 Stock Brokers and Market Intermediaries

Stock brokers are authorized by the Securities and Exchange Commission (SEC) to buy and sell equity and debt securities on behalf of investors, on the Colombo Stock Exchange (CSE). At present, there are 21 stock brokers who are members of the CSE. The SEC also registers and supervises a category of companies as market intermediaries to ensure the proper conduct of business. Under this category, companies engaging in business as underwriters, investment managers and margin providers are registered.

The turnover and net profit (before tax) of 21 stock-broking companies declined in the first half of 2009 mainly due to lower turnover levels and prices in the early part of the year compared with the previous year. The turnover of these companies declined to Rs. 601 million in the first half of 2009 from Rs. 610 million in the same period of 2008. The net profit (before tax) of the stock-broking industry also declined by 10 per cent to Rs. 148 million during the first six months of 2009 from Rs. 163 million in the same period of 2008. However, all companies made profits in the first half of 2009.

Total assets of stock-broker companies increased by 5 per cent to Rs. 4.8 billion at end June 2009 from Rs. 4.6 billion at end June 2008. The net capital remained at the same level of Rs. 1.6 billion at end June 2009 when compared to the net capital at end June 2008. All stock broking companies maintained the minimum net capital requirement of Rs. 35 million as at 30th June 2009.

To ensure the financial stability and operational viability of licensed stock broking companies, the SEC carried out on-site and off-site supervision. On-site inspections are carried out adopting a risk focused supervisory methodology. In order to strengthen off-site supervision, SEC commenced developing an electronic filing system for maintaining a database for stock broking companies.

The total assets of market intermediaries (excluding banks & finance companies) stood at Rs. 10 billion as at end June 2009. The net profit of all market intermediaries amounted to Rs. 27 billion during the first half of 2009.

## 5.7 Superannuation Funds

The superannuation fund sector consists of two major publicly managed funds – the Employees Provident Fund (EPF) and the Employee Trust Fund (ETF) – the Public Service Provident Fund (PSPF) and about 171 private provident funds. The superannuation fund sector, which accounts for 18 per cent of the total assets of the financial system, is dominated by the EPF, which accounts for about 13.7 per cent of the total financial assets. The EPF is administered by the Commissioner of Labor, while the responsibility for the management of the fund lies with the Monetary Board of the Central Bank. The EPF has a total of about 12.4 million accounts, of which 2.1 million are active accounts. The number of contributing employers increased from 57,474 at end June 2008 to 62,625 at end June 2009. Total contributions increased by 6 per cent to Rs. 23.2 billion in the first half of 2009, while refunds rose by 13 per cent to Rs.14.5 billion at end June 2009 reflecting a higher rate of increase in outflows.

The value of the EPF fund stood at Rs.710 billion as at end June 2009 with the total liability to members at Rs. 651 billion accounting for a substantial portion of the fund. The liability to members registered a growth of 17 per cent over end June 2008 owing to an increase in the number of members and their contributions during the period. The EPF investment portfolio at the end of June 2009 stood at Rs.680 billion, with income from investments amounting to Rs.52 billion in the first half of 2009.

The financial performance of the EPF indicates that the fund was able to manage its risks adequately in the first half of 2009. The main risks faced by the EPF are credit risk, liquidity risk, operational risk and market risk. The credit risk of the fund is negligible as 97 per cent of the EPF portfolio is invested in government securities. Investments in corporate debt and equities account for only 1.3 per cent and 1.1 per cent respectively of the EPF portfolio. The liquidity risk of the EPF is also negligible as inflows to the fund are greater than its outflows. A portion of the inflows was invested in the Repo market in order to meet the liquidity requirement while earning significant returns. The proposed amendment to the EPF Act to enable EPF members to withdraw 30 per cent of their EPF balances for housing purposes will not have a significant impact on the liquidity of the fund as measures have been put in place to limit withdrawals and funds have been set aside for this purpose. The operational risk to the fund has been reduced through the strengthening of internal controls and the installation of an Accounts and Investment Software Package to enhance the efficiency and accuracy in accounting, material management and investment management. However, the EPF portfolio is exposed to interest rate risk as the majority of its investment is held in interest sensitive government and corporate debt securities. The interest rate risk has been mitigated as the EPF has distributed its investment portfolio in securities with differing maturities and varying yields. In the current declining interest rate environment, the EPF portfolio is subject to reinvestment risk in the form of lower interest rates. The reinvestment risk can be mitigated to some extent by increasing EPF investments in the equity market.

The Employees Trust Fund (ETF) which is managed by a statutory board of trustees, has about 8.9 million accounts, of which about 2.1 million are active accounts. The number of employers contributing to the fund rose from 57,058 in September 2008 to 60,857 in September 2009. Total contributions increased to Rs. 6.4 billion in the first nine months

of 2009 from Rs.6.2 billion in the first nine months of 2008 registering a growth of 4.4 per cent during the period under review. Superannuation benefits paid to members during January to September 2009 amounted to Rs.4.7 billion registering a growth of 29 per cent over the comparable period of last year.

**Table 5.6 – Key Indicators of Major Superannuation Funds**

	EPF (June '09)	ETF (Sept. '09)
Number of Accounts (mn.)	12.4*	8.9
o/w; Active Accounts (%)	17.3	23.6
Number of Employers Contributing	62,625	60,857
Total Contributions (Rs.bn.)	23.2	6.4
Total Refunds (Rs.bn.)	14.5	4.7
Total Assets (Rs.bn.)	710.4	103.3
Total Investments Portfolio (Rs.bn.)	679.7	97.7
o/w : Government securities (%)	97.1	92.5
Gross Income (Rs.bn.)	52.1	10.7

\* Estimated

Sources : Employees' Provident Fund Department  
Employees' Trust Fund Board

The total assets of the ETF fund increased by 16.0 per cent to Rs. 103 billion as at end September 2009 from Rs. 89 billion at the end of September 2008. The outstanding on account of member balances was Rs. 90.7 billion. Total investments of the ETF as at end September 2009 stood at Rs. 97.8 billion - up from Rs. 83.0 billion at end September 2008. The risk profile of the ETF is similar to that of the EPF with the majority (92 per cent) of its investments in government securities. Investments in corporate fixed income securities and equity accounted for 1.4 per cent, 1.2 per cent respectively of total investments.

Privately managed provident funds, which are monitored by the Department of Labour, numbered 171 with a total membership of 122,462 persons. Assets of such provident funds stood at Rs.97 billion while investments were Rs.96.9 billion as at end June 2009. The Public Service Provident Fund (PSPF) which is managed by the Department of Pensions had 226,746 active members in September 2009. Total contributions to the fund decreased by 12 per cent to Rs. 814 million, while refunds amounted to Rs. 177 million. Assets of the fund stood at Rs. 22 billion as at end September 2009.

The absence of a supervisory authority for pension and provident funds can be identified as one of the gaps in the regulation of the financial system. The main risks stemming from largely unregulated entities are the loss of contributor funds and loss of confidence in the financial system. The establishment of a regulatory authority for superannuation funds is therefore a necessary step towards ensuring the integrity and confidence of the financial system.

# 6. Financial System Infrastructure

- ✦ The systemically important payment system operated by the CBSL - the LankaSettle operated with 99.9 per cent system availability and is substantially compliant with international standards, in terms of the Core Principles for Systemically Important Payment Systems of the Bank of International Settlements.
- ✦ Regulations for Service Providers of Electronic Payment Cards came into effect in 2009. The CBSL will regulate the electronic payment card and mobile payment services business and protect the rights of card-holders and service providers by stipulating prudential requirements.
- ✦ A major project being implemented is the establishment of a Common Payment Switch (CPS) for banking institutions, which will facilitate the on-line real-time retail fund transfers. The CPS is expected to become operational by end 2009.
- ✦ The legal framework relating to the financial sector continues to be upgraded. The Secured Transactions Act came into effect in 2009. Other laws in the pipeline are the Securitization Act, the new Finance Business Regulation Act, the Regulation of Micro Finance Institutions Act and the amendments to the Regulation of the Insurance Industry Act.

## 6.1 Payment and Settlement System

The payments and settlements system (PSS) is one of the components along with financial institutions and financial markets which comprise the financial sector. Therefore, it is important to enhance the safety, efficiency and user friendliness of PSS by adapting to the changing social and economic needs. At the same time, in line with the modernization of information and communication technology, new payment technologies have become more popular for financial transactions and the demand for such innovative mechanisms have to be facilitated by setting up a more secure environment. The Central Bank of Sri Lanka (CBSL) as the responsible authority for promoting safety, efficiency and stability of PSS and supervising of such PSS through the powers entrusted by the Payment and Settlement Systems Act, No. 28 of 2005, continued to ensure payment and settlement stability to achieve financial system stability in the country.

In its oversight and regulatory activities, the CBSL focused mainly on maintaining the reliability, reducing the payment, settlement and operational risks, ensuring the continuity of systemically important PSS and preparing sound legal underpinning for electronic

payment systems and retail payment systems. The CBSL made special attempts to balance the costs involved in minimising risks with the needs and practicality to promote financial inclusion. In addition, to the promotion of the national PSS under its statutory mandate, the CBSL maintained its prominence in the South Asian region, facilitating for PSS development in the SAARC member countries through the SAARC payments initiative and hosting the Asian Clearing Union Board of Directors meeting at which several decisions were taken to enhance the regional co-operation.

### **LankaSettle System**

The CBSL as the operator of the LankaSettle System continued to ensure a reliable and safe mechanism for efficient settlement of transactions through the Real Time Gross Settlement system with finality for large value interbank payments and a Delivery versus Payment (DvP) mechanism for government securities transactions. The LankaSettle System recorded a system availability of 99.99 per cent as at end August 2009. In order to ensure the business continuity of the LankaSettle System, the CBSL successfully conducted live operations from its disaster recovery (DR) site in two separate occasions, during the first nine months of 2009. Meanwhile, as one of its projects under the SAARC Payment Initiative, the CBSL carried out self assessment of the LankaSettle System in March, 2009 against the 10 Core Principles for systemically important PSS (CPSIPS) put forward by Bank for International Settlements (BIS). It was observed that the LankaSettle System remains closer to observing all 10 CPSIPS and action was taken to improve the deficient areas. Accordingly, the LankaSettle System Rules were updated to ensure the smooth functioning of the system and initial actions were taken to facilitate provisioning of Intra-day Liquidity Facility at the participant's discretion. In updating the System Rules, attention was paid to incorporate amendments made to the system during last five years, selection criteria for LankaSettle participants, handling of contingency events and dispute resolutions. Once these two requirements are fulfilled, the LankaSettle system would fulfill all 10 CPSIPS put forward by BIS.

### **LankaSecure**

The LankaSecure System consists of the Scripless Securities Settlement System and the Central Depository System for scripless Government Securities. The total value of scripless securities held by LankaSecure as at 30 September, 2009 amounted to Rs.2,056 billion, accounting for 99.9 per cent of the total value of Treasury bills and Treasury bonds outstanding. These scripless securities consisted of Rs.450 billion Treasury bills and Rs.1,606 billion Treasury bonds. LankaSecure maintained 63,534 accounts through dealer direct participants, covering corporate as well as individual investors. In comparison with the past three years the gradual increase of the value of the secondary market transactions is clearly evident. The value of the securities transacted during the first three quarters of 2009 was at Rs.24,303 billion that indicates a 37 per cent increase with comparison to the same period in 2008.

LankaSecure continued to dispatch three types of statements to investors, in terms of the Registered Stock and Securities Ordinance (RSSO) and Local Treasury Bills Ordinance (LTBO) to ensure that investors are well informed of transactions in their accounts and their outstanding balances. The total number of LankaSecure statements sent to investors during the first three quarters in 2009 was 184,378. LankaSecure Net facility is another free service provided by LankaSecure, providing online access to the investors' CDS account to view their balances of Government Securities held at the CDS.

In view of broadening and diversifying the Government Securities market Public Debt Department continued to undertake an effective awareness and marketing campaign centered on the main cities of the country. The lack of awareness in secure investments opportunities among the general public would create a conducive environment for informal and unauthorized money market activities that could lead to weaken the transition mechanism of the financial system in the economy. It was observed that the general public has responded positively to the awareness programmes. However the estimation of the direct impact of such awareness programmes is obviously a difficult task as the level of investments (number of investments and volume of investments) in Government Securities would also be affected by several other factors such as interest rate in both Government Securities and alternative investment opportunities, security, liquidity in the market and market perceptions other than awareness. The number of accounts maintained at the CDS totalled to 63,534 at the end of that quarter in 2009, reporting a 20 per cent increase in comparison to the same period in 2008.

## **Retail Payment and Settlement Systems**

Retail payment systems are experiencing rapid changes due to technical innovations, introduction of new transaction types and measures taken to reduce fraud. The CBSL, realizing the importance of a safe and efficient national payment system, continued its mission on achieving the objectives through the implementation of customer centric retail payment systems for the nation.

## **Cheque Imaging and Truncation System**

The CBSL monitored the adherence of participating institutions to the General Direction issued in 2007 in terms of Section 44 of the Payment and Settlement Systems Act No.28 of 2005 to formulate procedures and norms on cheque collection, crediting cheque proceeds to customers' accounts and the modalities for handling customer complaints, under the Cheque Imaging and Truncation (CIT) System. CIT system which is operated by the LankaClear (Pvt.) Ltd. (LCPL) was introduced in 2006 with the objective of increasing efficiency of cheque clearing, by reducing the cheque realization time island-wide from 10 days to one day *i.e.*, T+1 (where T is the day on which LCPL receives the cheque for clearing and 1 is the following business day). Having observed that T+1 rule is not adhered nation-wide as expected, the National Payment Council (NPC) decided in 2008 to conduct a customer survey and a bank survey, in order to understand the issues from the customers' point of view and to obtain the general view of the public on cheque clearing process.

The CBSL made preliminary arrangements for the customer survey by designing the methodology for the survey, preparing questionnaire, meeting the budgetary requirements and selecting required samples. The survey is expected to be conducted during the fourth quarter of the year 2009. Based on the results of the proposed survey, it is expected to implement corrective measures to ensure that all banks are fully adhered to the T+1 rule.

The NPC, having observed an increasing trend of the cheque returns towards the end of the year 2008, requested the LCPL to provide statistical reports on cheque returns to the CBSL with reasons for returns. The bank-wise analysis prepared by the CBSL based on information provided by LCPL revealed that 88 per cent of cheque returns were still due to unavailability of sufficient funds in respective accounts, even though banks have taken several actions to reduce cheque returns at branch level. Accordingly, NPC decided to instruct the Sri Lanka Banks' Association to investigate the matter and take necessary actions to reduce the cheque returns due to unavailability of funds in accounts.

Adhering to the request made by the CBSL, LCPL reported monthly details of additional days requested for settlement of cheques by banks under the CIT System, enabling CBSL to monitor the progress of Pls on adhering to the T+1 norm. Even though, a formal procedure was arranged to communicate the request from banks for additional days to LCPL through the senior management of the respective LCB, it was revealed that the additional day requests were still considerably high and the major reasons for such requests were the courier delays in delivering the images to the bank/branches and system errors due to technical faults. This matter was discussed at the NPC meeting in detail and a decision was taken to expedite the adoption of CD submission mode and Direct Connectivity Submission Mode of cheque images and the CBSL and LCPL along with Sri Lanka Banks' Association to take action to ensure speedy implementation of these programmes.

### **Sri Lanka Interbank Payment System (SLIPS)**

The volume of SLIPS transactions grew by 18 per cent in the first eight months of 2009 and the rate of growth is likely to continue since salary payments of public servants are increasingly made through SLIPS. The increasing volumes and the settlement risks will be addressed through the implementing of the proposed Common Payment Switch (CPS). With the implementation of the CPS, the SLIPS which currently operates as an off-line system will migrate to an on-line payment system, facilitating efficiency gains and greater security in transaction completion.

### **Business Continuity Plan (BCPS)**

In order to make the PSS resilient, the CBSL continued its business continuity policy in 2009, by overseeing the improvements made by the participants to the respective BCPs and Disaster Recovery Sites (DRS) as per the recommendations made by the CBSL at the first round of supervision in 2008. At the same time, the Bank Supervision Department and the Public Debt Department evaluated the BCPs and DRS during their normal supervision visits to ensure adherence of participants.

The Lanka Financial Services Bureau (LFSB), which was established in June, 2008 was also informed to develop a BCP on its activities and to establish a DR site, as per the BCP guidelines issued by the CBSL. Accordingly, LFSB submitted a report on BCP and DRS on which the CBSL is expected to conduct supervision during the second half of 2009.

## Regulations

The Service Providers of Payment Cards Regulations No. 1 of 2009 which was drafted by the CBSL in consultation with the Legal Draftsman and submitted to Ministry of Finance was authorized by the Minister of Finance with effect from 30 July 2009. The purpose of the Regulations is to enhance the safety of payment card industry by setting out prudential requirements for all service providers of payment cards. The Regulations will also include a set of terms and conditions to regulate mobile payment operators, protect the interest of customers and minimize risks of card based electronic payments. The Regulations cover the entire range of card based electronic payment instruments namely, credit cards, debit cards, charge cards and stored value cards including devices that include a code or any other means of access to an account. In order to ensure a successful implementation of the Regulations, guidelines for credit cards and mobile payment service are being prepared by the CBSL. Through these guidelines, it is expected to enhance competition, efficiency and mitigate risks in card based electronic payments while ensuring consumer protection.

## Security – Certification Authority and Public Key Infrastructure

With the introduction of electronic means as payment instruments, security of such transactions has to be maintained. Privacy of transactions and authentication are important factors to consider during the transmission of electronic transactions. In the financial markets, the concept of 'Certificate Authority' or 'Certification Authority' which is an entity that issues digital certificate to authorize electronic transactions has been established in e-commerce applications and PSS in order to provide legal protection.

Having considered the increasing use of electronic payment means in Sri Lanka, the CBSL took initiatives to appoint LCPL as the financial sector Certificate Service Provider (CSP) to issue and manage security credentials and public keys for message encryption. Therefore, LCPL under the guidance of the CBSL and ICT Agency of Sri Lanka and with the technical assistance of TechCERT launched Sri Lanka's first Certification Authority (CA) under the brand name of LankaSign. The LankaSign, established in accordance with the Electronic Transaction Act, No.19 of 2006 and the Computer Crimes Act, No. 24 of 2007, offers legal protection arising from electronic frauds. The objectives of this exercise among other things are to promote public confidence, integrity and reliability of data messages, electronic documents, electronic records or other communications and non-repudiation in electronic transactions and electronic data transfer among the financial institutions. The establishment of the Certification Authority to issue digital certificate that can be used for the purpose of signing and encrypting electronic transactions was another milestone in the financial industry which provides greater value to the PSS in Sri Lanka and also would lead to the establishment of the National Certificate Authority.

## Service Providers of Payment Cards Regulations No.01 of 2009

The global payment industry has undergone significant change as a result of new technological innovations, changes in consumer preferences and diversification of financial services. Further, the adoption of modern technology has reduced the cost of processing of electronic payments relative to cheque payments. Payment cards, such as credit cards, debit cards, charge cards and stored value cards, have become widely accepted means of electronic payments for both local and international transactions. Payment cards are a more convenient, secure and cost effective method of effecting payments than using currency and cheques.

In the recent past, usage of payment cards in settling day to day transactions in Sri Lanka has also gained an increasing importance due to the growing preference of customers to use convenient payment instruments. Even though the popularity of card based payment instruments increased over the years, there were no legal provisions to protect the rights of card holders and to regulate the payment card businesses. Having considered the increasing popularity in using payment cards and the economic benefits of such instruments in one hand and risks associated with the existence of non-regulating businesses and their negative impacts on the financial system on the other, it became necessary to regulate the payment card industry, in order to promote the growth of card based payment instruments in a safe, secure and efficient manner and to protect the interests of the card holders.

The Payment and Settlement Systems Act, No. 28 of 2005 (PSSA) has entrusted the CBSL, the financial regulator in the country, with the responsibility of ensuring the soundness and stability of the national payment system and the financial system, in order to guarantee the legal certainty of payments and reduce risks. The National Payment Council (NPC), the highest decision making body in the payments and settlement area, identified and recommended the necessity of issuing regulations/directions on card based payment instruments to safeguard the stability of the national payment system. Accordingly, the CBSL took steps to prepare the Service Providers of Payment Cards Regulations No. 01 of 2009, and as per the provisions under the PSSA, H.E. the President, as the Minister of Finance has authorized the regulations to be effective from 31 July 2009. The main objective of the regulation is to ensure that all service providers of payment cards observe international standards and best practices and thereby reduce the risks of credit card frauds and increase public confidence in card based electronic payments.

Under the Regulation, the CBSL will function as the Supervisory Authority, with required powers to regulate the payment card industry. According to the regulations, the eligible institutions that are able to carry out card based payment services are licensed commercial banks, licensed specialized banks, registered finance companies and public companies having an unimpaired capital of over 75 million. Eligible institutions that are engaged in or expected to commence payment card business are required to register with the CBSL. At the registration, the CBSL issues a license authorizing them to carry out functions of payment card business. Such licenses are required to be renewed annually. To efficiently implement, administer and enforce the provisions of the regulation, the CBSL is empowered to issue circulars, directions, guidelines and operating instructions in this regard. In addition, the CBSL has authority to monitor all new products relating to the payment card industry before they are introduced to the market to ensure that such products are consistent with the provisions in this regulation. Accordingly, new payment instruments such as e-money and e-wallet will also be regulated as stored value card payments under this regulation.

It is expected that these regulations will bring several benefits to service providers of card based payments and users of such services in particular, and the economy as a whole. The supervision by the CBSL would minimize potential losses for service providers since they are permitted only to operate within a given regulatory framework. Card holders will also benefit by minimizing risks of credit card frauds and financial losses. Further, public confidence would be enhanced due to the intervention of the CBSL, thereby increasing the use of such facilities which would help to reduce transaction costs. Furthermore, new technology relating to card based payments would be introduced under the supervision of the CBSL which will enable operations of such systems in a more secure environment.

## Common Payment Switch

During the first nine months of 2009, the CBSL facilitated the LCPL to prepare the ground work to establish the proposed Common Payment Switch (CPS) in accordance with the Road Map of the NPC. CPS is expected to support on line, real time, secure and reliable fund transfers/payments for low value interbank payment on a 24x7 basis. The LCPL has developed the required systems with the assistance of a software vendor and drafted the System Rules for CPS with the concurrence of the CBSL. The Direction on the CPS, approved by the Monetary Board of the CBSL was issued to the participants of the CPS. The Phase 1 of the CPS will facilitate retail credit transactions of customers of banks (via teller counter, ATM, Internet banking facility, phone banking facility and standing instructions), such as bill payments, international remittances, statutory payments, direct retail debit transactions and local credit card transactions. It is expected to facilitate the e-cheques at the Phase II of the CPS. Claims/obligations of participating banks under the CPS will be settled periodically on a multilateral net settlement basis through the RTGS System which is expected to reduce the settlement risk to a greater extent.

The CPS will provide higher operational efficiencies, capabilities to generate higher revenue and adoption of Hi-Tec standards. Bank customers will have the benefits of faster realization of interbank payments in a secured manner on 24x7 basis. On the whole, the CPS will provide a path to rapid economic growth by providing fast and higher liquidity for economic activities. The final goal of the implementation of this process would be to promote CPS as the only designated payment system authorized to process all internet, mobile devices, cards, ATM and POS based transactions.

## 6.2 Legal Framework

The legal framework governing the financial sector is being continually upgraded, in order to keep up with the new financial products, technologies and processes introduced to the market and also to address and manage risks that may arise in connection with these developments. Some of the important new laws and amendments to existing legislation enacted or currently under preparation are described below.

### Secured Transactions Act, No. 49 of 2009

The Secured Transactions Act was passed in September 2009 which will facilitate the extension of credit secured on movable collateral, thereby increasing the access to finance of a wider range of entities, such as small and medium enterprises. The law will promote commercial activities through a new set of legal provisions which secure loans granted on a pledge, mortgage or obligation of easily moveable property, such as machinery and stock in trade. For this purpose, the law provides for the establishment of a filling office called a "Secured Transactions Register" and the Credit Information Bureau will be responsible for maintaining the registry. The Secured Transaction Register will consist of a database in which secured creditors (such as banks, finance and leasing companies, credit organizations and private lenders) can give notice of their security interest in the movable

goods of an enterprise or individual. The Secured Transaction Registry also provides for the creditor to establish priority of the security interest. The general rule is that the first registered security interest in the collateral has first priority. The database will also enable interested parties to search if there are prior security interests in goods pledged by a debtor.

### **The Securities and Exchange Commission Act, No. 36 of 1987**

The Securities and Exchange Commission (SEC) Act was amended to revise the composition of the Commission Board to increase the level of private sector representation in order to achieve a balanced representation of public and private sector interests. Other revisions include empowering the SEC to issue directives to listed public companies to protect the interests of investors and to ensure that professional standards are maintained in the capital market and to facilitate regulation of derivatives such as futures and options.

### **The new Securitization Law**

The new Securitization law for the regulation of the asset-backed securities industry by the SEC, has been presented to Parliament. The law provides the legal framework for the establishment of Special Purpose Vehicles (SPVs) for securitization, transferring assets to the SPV and issuing asset backed securities by the SPV. The regulation of persons involved in securitization transactions such as originators and trustees is also covered by the law. Appropriate measures to ensure investor protection and to promote transparency and accountability in these transactions will be introduced.

### **Proposed new Finance Business Regulation Law**

A new law governing deposit-taking and finance business has been drafted to replace the existing Finance Companies Act which has several limitations and lacunae. The new law makes both unauthorized finance business and deposit-taking, an offence. The definition of “deposits” will be widened to cover a broad range of fund mobilisation activities. The powers of the Central Bank relating to the investigation of unauthorised finance businesses and deposit-taking will be strengthened and offences will carry more severe penalties. The establishment of companies with names or acronyms of registered finance companies (RFCs) will be prohibited. The proposed law will also enhance the reporting requirements of RFCs and the remedial measures required to be taken by RFCs who are not in compliance with the law. The winding up process is being revised, including a list of priority of claims whereby depositors would be paid on the basis of priority. The proposed law also provides for a mandatory deposit insurance scheme for RFCs.

### **Proposed law for the Regulation of Micro Finance Institutions**

A draft Act is being prepared by the CBSL for the regulation and supervision of micro finance institutions. The different categories of micro-finance institutions are registered under various laws but are not regulated or monitored through a specific regulatory and

supervisory authority or arrangement. In view of the diversity of these institutions and the complexity of the micro-finance sector and the existing laws, it has been decided that certain regulatory requirements should be imposed on these institutions. The implementation of the proposed regulatory mechanism will be done in consultation with the Ministry of Finance and Planning.

### **Amendments to the Regulation of Insurance Industry Act, No. 43 of 2000**

The Regulation of Insurance Industry Act will also be revised to strengthen the supervisory framework of the entire insurance industry. The powers of the regulator, the Insurance Board of Sri Lanka (IBSL) to issue directions to insurance companies, brokers and loss adjusters will be strengthened to protect the interest of policy holders. The IBSL will also be empowered to stipulate capital requirements for insurance companies and brokers, make rules and determinations and engage in dispute resolution and prescribe a “fit and proper” criteria for boards of directors of insurance companies and brokers. Other proposed revisions include the appointment of institutions as agents of insurance companies and the requirement that long-term and general insurance business be conducted in separately incorporated companies, with existing composite insurers being given time to segregate business into separate companies.

### **Amendments to the Banking Act, No. 30 of 1988**

The Banking Act provides the legislative framework for the licensing and regulation of commercial and specialized banks. It is proposed to introduce further amendments to the law to strengthen the regulatory and supervisory framework. These relate to strengthening bank resolution measures, including the appointment of managing agents, undertaking consolidated supervision of banking groups, expanding the provisions on mergers and consolidation, broad-basing the definition of deposits, expanding the criteria to determine “material interest”, expanding the provisions on offences and penalties for non-compliance with prudential requirements, reducing the time period for disclosing financial statements to the public, extending the regulatory requirements applicable to LCBs to LSBs to provide a level playing field, implementing the provisions in the Basel II capital adequacy framework relating to higher capital charge for individual banks depending on their risk profile and aligning with the provisions of the Companies Act, No. 7 of 2007.



## Appendix Tables

Appendix Table 1

## Financial Soundness Indicators – All Banks

	2006	2007	2008	2009 September
<b>1. Capital Adequacy</b>				
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)				
1.2 Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	13.3	14.1	14.5	14.5
1.3 Net Non-Performing Loans to Total Capital Funds	12.1	12.6	12.5	12.3
1.4 Debt to Capital Funds	14.8	14.1	18.5	30.8
1.5 Capital to Assets Ratio	238.5	220.0	209.6	163.0
	7.6	8.0	8.1	8.2
<b>2. Asset Quality</b>				
2.1 Gross Non-Performing Loans (NPL) to Total Gross Loans (w/o Interest in Suspense)	5.6	5.2	6.3	8.8
2.2 Gross Non-Performing Loans (NPL) to Total Gross Loans (with Interest in Suspense)	7.4	6.8	8.1	11.1
2.3 Net Non-Performing Loans to Total Gross Loans	1.9	1.9	2.6	4.8
2.4 Provision Made against Gross Loans	3.8	3.3	3.8	4.2
2.5 Provision Coverage Ratio (Total)	66.9	64.5	60.8	47.4
2.6 Provision Coverage Ratio (Specific)	61.2	55.3	47.6	37.5
2.7 Sector-wise NPL to Total Loans				
Agriculture and Fishing	5.7	6.4	7.1	4.3
Manufacturing	7.9	8.3	8.3	20.4
Tourism	6.1	4.4	3.7	5.4
Transport	5.3	6.5	7.4	8.5
Construction	6.3	5.6	8.6	12.3
Traders	11.3	8.0	10.1	12.0
New Economy	6.2	1.8	3.1	5.3
Financial and Business Services	1.8	2.1	2.3	7.1
Infrastructure	5.5	2.0	3.1	4.9
Other Services	2.8	3.3	2.1	10.4
Other Customer	3.1	3.3	3.3	6.1
2.8 Sectoral Distribution of Loans to Total Gross Loans				
Agriculture and Fishing	4.5	4.9	5.2	9.9
Manufacturing	14.8	16.1	17.3	15.0
Tourism	2.1	2.1	2.4	2.5
Transport	1.9	2.1	2.1	1.8
Construction	17.0	17.9	16.8	16.4
Traders	13.9	12.6	12.9	13.5
New Economy	3.5	2.3	1.3	1.4
Financial and Business Services	5.8	6.2	5.6	3.7
Infrastructure	1.4	1.3	1.3	1.4
Other Services	4.5	4.7	5.7	5.5
Other Customer	30.6	29.8	29.4	28.9
2.9 Provision Made against Total Assets	2.3	2.0	2.3	2.3
2.10 Total Loans (Gross) to Total Assets	60.2	61.3	60.6	54.2
2.11 Investments to Total Assets	22.8	22.1	25.0	29.4
2.12 Total Income to Total Assets	10.6	12.7	14.7	14.2
2.13 Net Interest Income to Total Assets	4.0	4.1	4.3	4.2
2.14 Operating Income to Total Assets	5.5	5.7	6.3	6.2
<b>3. Earnings &amp; Profitability</b>				
3.1 Return on Equity (ROE) - After Tax	15.2	14.0	13.5	14.7
3.2 Return on Assets (ROA) - Before Tax	1.9	1.9	2.0	2.1
3.3 Return on Assets (ROA) - After Tax	1.2	1.1	1.1	1.2
3.4 Interest Income to Gross Income	85.6	87.4	86.3	86.1
3.5 Net Interest Income to Gross Income	37.5	31.9	28.9	29.4
3.6 Non-Interest Income to Total Income	14.4	12.6	13.7	13.9
3.7 Non-Interest Expenses (Operating Expenses) to Total Income	29.6	23.7	22.4	21.6
3.8 Staff Expenses to Non-Interest Expenses	43.8	44.2	44.5	46.9
3.9 Personnel Expenses to Total Income	13.0	10.5	9.9	10.1
3.10 Provisions to Total Income	3.8	3.6	4.2	3.5
3.11 Total Cost to Total Income	77.4	79.2	79.7	78.3
3.12 Efficiency Ratio	56.7	55.6	55.4	52.5
3.13 Interest Margin	4.4	4.4	4.4	4.4
<b>4. Liquidity</b>				
4.1 Liquid Assets to Total Assets	26.7	28.1	28.3	34.4
4.2 Statutory Liquid Assets Ratio - DBU	30.4	30.4	31.3	38.6
<b>5. Assets / Funding Structure</b>				
5.1 Deposits	69.8	69.5	69.6	73.5
5.2 Borrowings	18.1	17.6	17.0	13.3
5.3 Capital to External Funds	8.6	9.2	9.4	9.4
5.4 Credit to Deposits	86.3	88.1	87.0	73.7
5.5 Credit to Deposits & Borrowings	68.5	70.3	70.0	62.4
5.6 Credit to Deposits & Borrowings & Capital	63.1	64.4	64.0	57.0

Source : Central Bank of Sri Lanka

Appendix Table 2

## Financial Soundness Indicators – Licensed Commercial Banks

	2006	2007	2008	2009 September
<b>1. Capital Adequacy</b>				
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	12.7	13.6	13.8	14.1
1.2 Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	11.3	11.9	11.1	11.4
1.3 Net Non-Performing Loans to Total Capital Funds	13.0	11.9	16.7	30.2
1.4 Debt to Capital Funds	260.5	231.2	224.2	171.3
1.5 Capital to Assets Ratio	7.3	7.7	7.9	8.0
<b>2. Asset Quality</b>				
2.1 Gross Non-Performing Loans (NPL) to Total Gross Loans (w/o Interest in Suspense)	5.5	5.0	6.0	8.6
2.2 Gross Non-Performing Loans (NPL) to Total Gross Loans (with Interest in Suspense)	7.4	6.6	7.8	10.9
2.3 Net Non-Performing Loans to Total Gross Loans	1.5	1.5	2.1	4.4
2.4 Provision Made against Gross Loans	4.0	3.6	3.9	4.4
2.5 Provision Coverage Ratio (Total)	73.4	71.5	65.8	50.8
2.6 Provision Coverage Ratio (Specific)	67.4	61.6	53.4	41.6
2.7 Sector-wise NPL to Total Loans				
Agriculture and Fishing	6.4	6.3	6.7	3.9
Manufacturing	8.1	8.5	8.3	20.8
Tourism	6.2	4.2	3.3	5.0
Transport	5.5	6.6	7.1	8.1
Construction	3.6	3.8	6.8	10.0
Traders	11.5	8.1	10.2	11.9
New Economy	6.5	1.1	2.4	4.9
Financial and Business Services	1.8	2.3	2.3	8.3
Infrastructure	5.7	0.2	4.1	6.4
Other Services	2.7	3.3	2.0	10.4
Other Customer	3.4	3.5	3.5	6.6
2.8 Sectoral Distribution of Loans				
Agriculture and Fishing	5.5	5.2	5.4	10.6
Manufacturing	14.4	16.9	17.9	15.6
Tourism	2.0	2.2	2.6	2.7
Transport	1.9	2.3	2.2	1.9
Construction	13.9	16.4	14.6	13.9
Traders	13.9	13.6	13.8	14.6
New Economy	3.2	1.1	1.1	1.2
Financial and Business Services	4.5	5.5	4.9	2.9
Infrastructure	1.1	0.9	1.0	1.2
Other Services	5.8	4.9	6.0	5.8
Other Customers	33.7	30.9	30.6	29.7
2.9 Provision Made against Total Assets	2.6	2.3	2.5	2.5
2.10 Total Loans (Gross) to Total Assets	64.4	65.1	64.4	57.3
2.11 Investments to Total Assets	16.7	16.6	20.1	24.7
2.12 Total Income to Total Assets	10.5	12.8	14.7	14.1
2.13 Net Interest Income to Total Assets	4.0	4.2	4.6	4.4
2.14 Operating Income to Total Assets	5.7	5.9	6.6	6.4
<b>3. Earnings &amp; Profitability</b>				
3.1 Return on Equity (ROE) - After Tax	16.2	15.0	14.8	14.1
3.2 Return on Assets (ROA) - Before Tax	1.9	1.9	2.0	2.0
3.3 Return on Assets (ROA) - After Tax	1.2	1.1	1.2	1.1
3.4 Interest Income to Gross Income	83.4	86.5	86.0	85.9
3.5 Net Interest Income to Gross Income	37.8	32.9	30.9	31.4
3.6 Non-Interest Income to Total Income	16.6	13.5	14.0	14.1
3.7 Non-Interest Expenses (Operating Expenses) to Total Income	32.0	25.2	23.9	23.3
3.8 Staff Expenses to Non-Interest Expenses	42.7	42.9	43.4	45.8
3.9 Personnel Expenses to Total Income	13.6	10.8	10.4	10.7
3.10 Provisions to Total Income	4.3	4.0	4.6	3.9
3.11 Total Cost to Total Income	77.1	78.7	79.1	77.8
3.12 Efficiency Ratio	58.6	56.7	56.2	54.7
3.13 Interest Margin	4.4	4.5	4.7	4.6
<b>4. Liquidity</b>				
4.1 Liquid Assets to Total Assets	23.3	25.4	25.4	31.5
4.2 Statutory Liquid Assets Ratio	23.9	24.8	25.7	32.8
<b>5. Assets / Funding Structure</b>				
5.1 Deposits	69.1	69.4	69.0	73.3
5.2 Borrowings	18.9	17.8	17.7	13.7
5.3 Capital to External Funds	8.3	8.8	9.1	9.2
5.4 Credit to Deposits	93.2	93.8	93.4	78.1
5.5 Credit to Deposits & Borrowings	73.2	74.7	74.3	65.8
5.6 Credit to Deposits & Borrowings & Capital	67.6	68.6	68.1	60.3

Source : Central Bank of Sri Lanka

Appendix Table 3

## Financial Soundness Indicators – Licensed Specialised Banks

	2006	2007	2008	2009 September
<b>1. Capital Adequacy</b>				
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	19.8	20.6	21.0	17.9
1.2 Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	20.8	21.2	25.6	19.9
1.3 Net Non-Performing Loans to Total Capital Funds	21.9	23.0	26.3	33.3
1.4 Debt to Capital Funds	151.3	172.4	144.3	126.4
1.5 Capital to Assets Ratio	9.2	9.4	9.2	9.1
<b>2. Asset Quality</b>				
2.1 Gross Non-Performing Loans (NPL) to Total Gross Loans (w/o Interest in Suspense)	6.7	6.7	8.9	10.7
2.2 Gross Non-Performing Loans (NPL) to Total Gross Loans (with Interest in Suspense)	8.1	8.0	10.3	12.7
2.3 Net Non-Performing Loans to Total Gross Loans	5.3	5.3	6.1	8.0
2.4 Provision Made against Gross Loans	1.5	1.5	3.0	2.9
2.5 Provision Coverage Ratio (Total)	22.9	22.4	33.3	27.2
2.6 Provision Coverage Ratio (Specific)	19.2	17.6	15.7	13.6
2.7 Sector-wise NPL to Total Loans				
Agriculture and Fishing	8.6	8.5	14.4	17.2
Manufacturing	6.2	6.0	9.7	13.7
Tourism	4.5	8.0	13.6	16.2
Transport	1.7	4.8	12.9	14.4
Construction	16.1	13.8	15.5	19.5
Traders	6.8	6.6	8.4	16.3
New Economy	4.2	3.7	5.5	6.8
Financial and Business Services	1.8	1.6	2.6	4.4
Infrastructure	4.7	5.4	0.6	1.1
Other Services	3.4	3.6	4.0	10.9
Other Customers	0.4	0.3	0.4	0.7
2.8 Sectoral Distribution of Loans to Total Gross Loans				
Agriculture and Fishing	3.7	3.1	3.1	3.2
Manufacturing	14.1	11.8	10.8	10.1
Tourism	1.3	1.0	0.9	0.9
Transport	0.8	0.8	1.4	1.0
Construction	35.5	35.2	38.8	39.4
Traders	5.8	5.2	4.4	3.6
New Economy	4.7	4.1	3.2	2.6
Financial and Business Services	14.5	12.7	12.9	11.1
Infrastructure	3.6	4.3	3.9	4.0
Other Services	2.1	2.6	2.7	2.6
Other Customers	14.0	19.1	18.0	21.5
2.9 Provision Made against Total Assets	0.6	0.6	1.2	1.1
2.10 Total Loans (Gross) to Total Assets	39.0	41.3	40.7	38.7
2.11 Investments to Total Assets	53.5	50.2	50.1	53.0
2.12 Total Income to Total Assets	11.0	12.5	14.9	14.7
2.13 Net Interest Income to Total Assets	4.0	3.3	2.8	2.9
2.14 Operating Income to Total Assets	4.4	4.3	4.6	4.8
<b>3. Earnings &amp; Profitability</b>				
3.1 Return on Equity (ROE) - After Tax	11.7	10.0	6.9	17.5
3.2 Return on Assets (ROA) - Before Tax	2.0	1.7	1.5	2.5
3.3 Return on Assets (ROA) - After Tax	1.1	0.9	0.7	1.6
3.4 Interest Income to Gross Income	96.1	92.2	87.8	86.8
3.5 Net Interest Income to Gross Income	36.1	26.2	18.7	19.8
3.6 Non-Interest Income to Total Income	3.9	7.8	12.2	13.2
3.7 Non-Interest Expenses (Operating Expenses) to Total Income	18.4	15.7	14.3	13.7
3.8 Staff Expenses to Non-Interest Expenses	53.1	54.9	53.8	55.7
3.9 Personnel Expenses to Total Income	9.8	8.6	7.7	7.6
3.10 Provisions to Total Income	1.5	1.6	2.0	1.3
3.11 Total Cost to Total Income	78.4	81.7	83.4	80.7
3.12 Efficiency Ratio	44.7	47.7	49.8	39.5
3.13 Interest Margin	4.2	3.5	2.9	3.1
<b>4. Liquidity</b>				
4.1 Liquid Assets to Total Assets	43.8	42.0	43.7	49.0
4.2 Statutory Liquid Assets Ratio	63.6	61.0	61.9	69.3
<b>5. Assets / Funding Structure</b>				
5.1 Deposits	72.9	70.1	72.6	74.5
5.2 Borrowings	14.0	16.2	13.2	11.1
5.3 Capital to External Funds	10.6	10.9	10.7	10.5
5.4 Credit to Deposits	53.5	58.9	56.0	51.9
5.5 Credit to Deposits & Borrowings	44.9	47.9	47.4	45.0
5.6 Credit to Deposits & Borrowings & Capital	40.6	43.2	42.8	40.7

Source : Central Bank of Sri Lanka

## Financial Soundness Indicators – Registered Finance Companies

	2006*	2007 *	2008 *	2009 *	2009 August
<b>1. Capital Adequacy</b>					
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	16.5	14.2	14.5	14.4	14.5
1.2 Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	14.7	13.1	12.5	12.6	12.6
1.3 Capital Funds to Assets Ratio	15.0	15.6	15.0	12.9	12.3
1.4 Capital Funds to Deposits Liabilities	28.0	29.2	27.2	22.3	19.7
1.5 Non-Performing Loans Net of Provisions to Capital Funds	4.4	6.4	14.9	22.9	26.5
<b>2. Asset Quality</b>					
2.1 Non-Performing Accommodation (NPA) to Total Accommodation	5.9	4.4	6.5	8.0	9.9
2.2 Provisions to Non-Performing Accommodation	83.4	68.1	47.2	43.2	47.0
<b>3. Earnings &amp; Profitability</b>					
3.1 Return on Assets (ROA) - Before Tax	3.3	3.2	2.5	0.7	-1.6
3.2 Return on Assets (ROA) - After tax	3.3	2.8	1.9	0.2	-2.0
3.3 Return on Equity (ROE) - After Tax	22.0	17.8	12.5	1.3	-16.1
3.4 Net Interest Income to Gross Income	29.4	31.9	26.4	19.8	14.2
3.5 Net Interest Income to Total Assets	4.9	5.4	4.9	4.1	2.8
3.6 Non-Interest Expenses (Operating Expenses) to Income	30.3	30.9	30.8	29.1	28.1
3.7 Staff Expenses to Non-Interest Expenses	41.1	40.6	35.9	34.1	37.1
3.8 Total Cost to Total Income	75.6	77.5	84.6	92.3	99.5
<b>4. Liquidity</b>					
4.1 Liquidity Assets to Total Assets	9.8	9.1	10.9	8.0	10.9
4.2 Liquidity Assets to Short Term Liabilities	18.1	17.2	14.9	13.8	17.5
<b>5. Assets / Funding Structure</b>					
5.1 Deposits	53.8	53.2	56.4	57.6	62.4
5.2 Loans & Advances	67.9	70.8	65.9	65.1	62.3
5.3 Investments	3.0	2.3	2.0	1.7	1.9
5.4 Credit to Deposits	126.2	133.0	117.0	113.0	99.8
<b>6. Lending</b>					
6.1 Total Accommodation Growth	34.9	37.5	16.1	10.4	-1.8

\* As at end of the financial year (March)

Source : Central Bank of Sri Lanka

Appendix Table 5

## Financial Soundness Indicators – Specialised Leasing Companies

	2006	2007	2008	2009 June
<b>1. Capital Adequacy</b>				
1.1 Capital Funds to Total Assets	16.8	16.7	16.6	18.0
1.2 Total Borrowings to Capital Funds (Gearing)	4.1	4.2	4.2	3.8
<b>2. Asset Quality</b>				
2.1 Non-Performing Accommodation (NPA) to Total Accommodation	3.5	4.3	4.8	7.1
2.2 Provisions to NPA	52.5	58.9	60.2	54.5
2.3 Total Advances to Total Assets	85.3	81.5	80.5	73.6
2.4 Total Advances to Total Borrowings	125.3	116.3	114.1	107.7
2.5 Provision Made against Total Advances	2.1	2.5	2.5	3.9
<b>3. Earnings &amp; Profitability</b>				
3.1 Net Profits Before Tax to Total Assets (ROA)	3.7	3.5	2.7	3.1
3.2 Operating Profit Before Provision to Total Assets	4.6	4.4	3.1	4.5
3.3 Profit After Tax to Capital Funds (ROE)	17.7	15.2	10.5	9.6
3.4 Interest Income to Interest Expenses	183.2	156.7	140.3	143.0
3.5 Net Interest Income to Gross Income	38.3	30.4	24.5	24.9
3.6 Net Interest Income to Total Assets	6.2	5.5	5.0	5.4
3.7 Net Interest Income to Net Profit Before Tax	168.1	156.1	190.6	176.6
3.8 Operating Cost to Net Interest Income	66.8	73.2	94.0	85.8
<b>4. Liquidity</b>				
4.1 Net Loans to Total Borrowings	122.6	113.4	111.2	103.5
4.2 Liquid Assets to Total Assets	4.3	6.0	7.5	8.9
4.3 Liquid Assets to Total Borrowings	6.3	8.6	10.6	13.1
<b>5. Assets / Funding Structure</b>				
5.1 Bank Borrowings	68.0	70.1	70.1	68.3
5.2 Loans / Accommodation	85.3	81.5	80.8	73.6
5.3 Investments	2.2	3.4	4.9	5.2
<b>6. Lending</b>				
6.1 Total Accommodation Growth	24.0	17.0	14.2	-11.5

Source : Central Bank of Sri Lanka

Appendix Table 6

## Financial Soundness Indicators – Primary Dealers

	2006	2007	2008	2009 September
1. RWCAR	44.3%	35.2%	16.7%	24.9%
2. Tier 1 Capital (RWCAR)	42.4%	34.0%	16.3%	24.7%
3. Capital Leverage Ratio	8.3	7.3	10.3	7.6
4. Return On Assets (Before Tax)	1.1%	2.0%	2.5%	8.1%
5. Return On Equity (Before Tax)	11.2%	18.4%	28.2%	92.9%
6. Operating Expenses to Gross Income	5.8%	4.5%	3.7%	2.7%
7. Total Cost to Total Income	87.6%	86.2%	72.5%	59.2%
8. Duration of Assets & Liabilities	0.5	0.6	0.9	1.1

Source : Central Bank of Sri Lanka



