ECONOMIC REVIEW

April/May 2011

1961 - 2011

50TH ANNIVERSARY

Banking Industry

Some Aspects of Current Importance

A People's Bank Publication

Economic Review commemorates the 50th Anniversary of the People's Bank

This issue of the Economic Review on 'Banking Industry' is specially published with increased number of pages (53), to commemorate the People's Bank's 50th anniversary due to be held on 1st July, 2011.

In the mid 20th century, banking service was restricted only to elites who were a very small fraction of the society. The disadvantaged people, particularly those living in rural areas, who represent a large majority of population of the country, were deprived of it.

The People's Bank was established in 1961, after a series of deliberations at various levels over a period of few decades to create a proper banking system to cater to the banking requirements of the rural people in particular and to obtain their contributions towards the development of the country. Its main objectives were: (i) to develop the co-operative movement; (ii) to strengthen rural banking; and (iii) to provide agricultural credits.

Having achieved its original objectives, and going beyond further, the bank has rapidly expanded its services at present to cater to all banking requirements of different sections of the society. Becoming the most popular bank of the common man, presently, it directly serves 12.8 million customers (more than half of the population of the country) through its 687 branches / service centres (the largest bank branch network that covers every corner of the country) while its products and other programmes indirectly serve almost all the population of the country.

The bank, in its initial decades, strengthened the co-operative rural bank system and the co-operative movement of the country. It promoted saving habits of the nation, recording the highest deposit base of the banks in the country in the recent past. It contributed to increase national investment and production over the years by granting a large sum of loans and advances under a variety of loan schemes implemented covering all activities of the economy. The bank also supported successive governments as well as hundreds of thousands of needy people by providing various special financial supports with very easy terms and conditions in areas such as poverty alleviation, disaster recovery (i.e. Tsunami), self employment, etc.

At present, the People's Bank, while performing at the highest in many aspects of the banking industry in the country, provides a variety of services to the nation, ranging from primary banking services rendered to the illiterate sections in disadvantaged pockets of the society to technologically-advanced sophisticated products offered to affordable customers. Further, deviating from operational nature of most of its counterparts, the People's Bank plays a very significant role in promoting earning capacity, and thereby, living standards of low-income earners – the majority of the population of the country – by utilising a large share of its funds, staff and efforts to provide them with commercial banking services at a very low or zero profit margin.

Publication of the Economic Review journal, one of the main Corporate Social Responsibility (CSR) products of the bank, was started in 1975, as a contribution to Research and Development (R&D). By publishing about 275 journal issues with separate comprehensive special reports on various important development issues prepared by specialists and a large number of feature articles on other related disciplines authored by relevant experts, the journal has been making a unique contribution towards social and economic development of the country and the world as a whole.

At this occasion of the 50th anniversary of the People's Bank, the Economic Review commemorates with a great respect the founders of the bank who contributed their knowledge, creativities, abilities and energies to create such a useful and successful banking establishment for the well-being of the nation. The journal also uses this occasion to gratefully acknowledge the cooperation extended by its customers and the employees to bring the bank up to the present position of its successful journey. The present staff of the journal also wishes to take this opportunity to express its sincere gratitude to the pioneers as well as authors, readers and other supporters of the journal for their contributions to the success of the journal.

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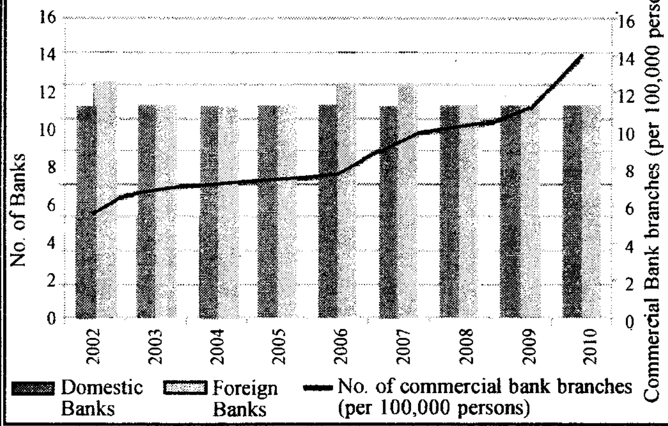
HIGHLIGHTS OF BANKING INDUSTRY
SRI LANKA

Distribution of Banks and Bank Branches

Category	End 2010 (a)
Licensed Commercial Banks (LCBs)	
i. Total No. of LCBs	**22**
Domestic Banks	11
Foreign Banks	11
ii.Total No. of LCB Branches and other Outlets	**5,119**
Branches	1,432
Domestic Bank Branches	1,386
Foreign Bank Branches	46
Extension Offices	898
Domestic Banks	728
Foreign Banks	170
Student Saving Units and other Outlets	2,789
Automated Teller Machines	1,848
Licensed Specialized Banks (LSBs)	
i. Total No. of LSBs	**9**
Regional Development Banks	1
National Savings Bank	2
Long-term Lending Institutions	2
Housing Finance Institutions	2
Private Savings and Development Banks	2
ii. Total No. of LSB Branches and other Outlets	**755**
Branches	500
Regional Development Banks	230
National Savings Bank	173
Long-term Lending Institutions	23
Housing Finance Institutions	28
Private Savings and Development Banks	46
Extension Offices	67
Student Saving Units and other Outlets	188
Automated Teller Machines	158
Total No. of Bank Branches and other Outlets	**5,874**

Expansion of Commercial Banks and No. of Commercial Bank Branches per 100,000 Persons (Banking Density)



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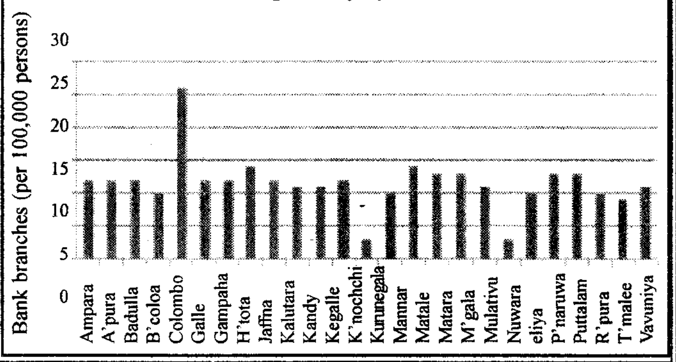

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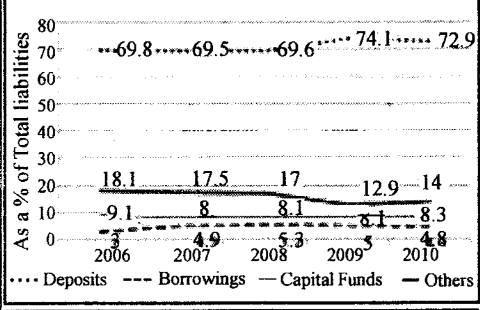

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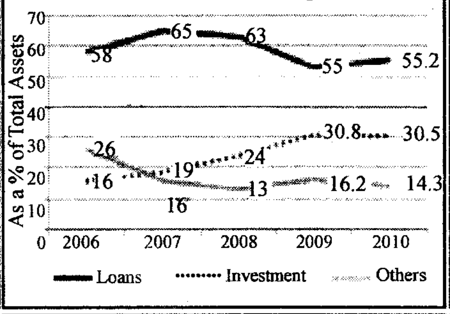

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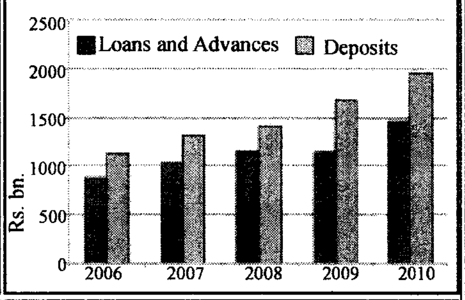

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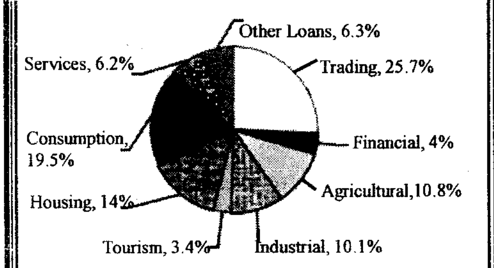
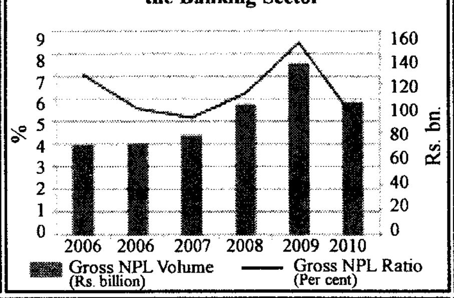


Non-Performing Loans (NPL) of the Banking Sector



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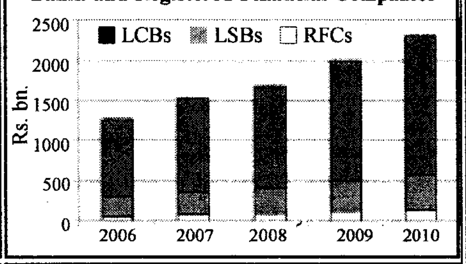

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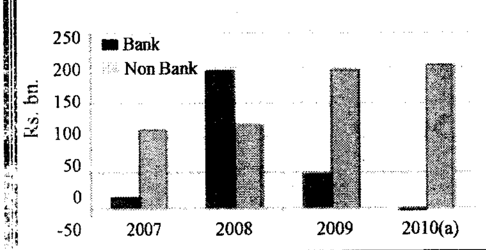

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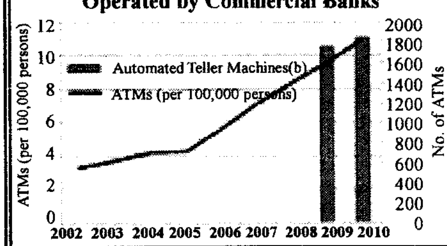

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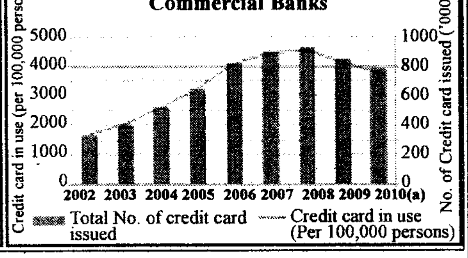

(a) Provisional (b) Data available only in 2009 & 2010

Source: Central Bank of Sri Lanka

Microfinance and Commercial Banking

H.M.S.P. Herath[1]

Head, Department of Banking and Finance Faculty of Business Studies and Finance, Wayamba University of Sri Lanka, Kuliyapitiya.

Abstract

This paper examines the link between microfinance and commercial banks. At the initial stage of evolving microfinance, commercial banks were not much interested in financing for the poor of developing countries, allowing other microfinance institutions to explore their work in this sector. Higher risk, higher transaction cost and socio-economic issues were the main reasons for lesser attention on microfinance activities. However, with increased competition in traditional market, commercial banks are gradually expanding their banking operations to the microfinance market, and this has supported to link formal and informal financial markets of developing countries.

Introduction

Microfinance refers to the provision of financial services to poor and low-income households. These financial services include loans, deposits, payment services, money transfers and insurance to people who are unable to access commercial banks and lacking of banking practices.

According to Mosley (2000), as quoted by Chandradasa (Dec 2004/ Jan 2005), the definition of microfinance often includes both financial and social intermediation. Some scholars, therefore, name these programs as "credit plus" approaches. According to Chandradasa (undated), the micro-finance is not simply banking, but a "development tool", because it includes;

i. Small loans (micro-credit), typically working capital,

ii. Informal appraisal of borrowers and investments,

iii. Collateral substitutes, such as group guarantees or compulsory savings,

iv. Access to repeat and larger loans, based on repayment performance streamlined loan disbursement and monitoring, and

v. Secure saving products.

In developing countries, three types of sources, namely, formal, semi-formal and informal institutions provide micro-finance services for poor or low-income households. Rural banks and cooperatives are the major players of microfinance in the formal sector. However, with commercialisation of microfinance activities, development banks and commercial banks in the formal sector have been increasingly involved in microfinance of developing economies. Second source includes semiformal institutions, such as non-government organisations (NGOs) which are offering financial services for the poor of developing economies. Informal sources include money lenders and shopkeepers, traders, etc.

Significance of Microfinance

The provision of credit and generation of savings have long been recognised as essential elements in any rural development strategy. The credit can play a crucial role in the modernisation of agriculture, but its role in the fight against rural poverty has seldom been recognised. Especially when addressing the issue of lack of capital for promoting agricultural enterprises and for up-lifting the social capital of the rural economy, the role of formal financial institutions, i.e., state or privately-owned commercial banking system is very much important. Those institutions can fulfil financial needs of the rural poor even by a way of granting credit facilities to improve their harvest or their businesses concerned. But, there is an allegation that even though those institutions are mobilising more and more rural savings, the provision of credit facilities to rural sector is very low. The rural poor men and women, landless, agricultural labourers and small fishermen have almost been excluded from these financial services either because they were not available (collateral and procedural requirements rendered to them inaccessible) or simply because they were not considered creditworthy. According to Karmakar (1999), the erroneous view is that the poor do not have any resources, do not save, that they cannot invest in view of immediate consumption needs, and that they are ignorant of the basic principles of sound money management. In the competition for a small quantum of financial resources, the poor naturally lost out in the institutional markets and were constrained to resort to exploitative informal sources of financing such as money lenders and traders. Further, rural financial services have mostly been controlled by rich farmers, who are able to use their large endowment base and influence within the local power structure to secure loans at very advantageous terms. As a result, this informal financial sector was playing a crucial role in meeting the credit needs of the rural poor than the formal sector institutions. This informal financial sector was able to respond quickly and with great flexibility to press demands, and exploit the poor and further compound their poverty since the credit was provided at exorbitantly high rates of interest. According to Qureshi *et al.* (1996) as quoted by Karunanayake (2003), the importance of this money lending has tended to decline in countries of South Asia in the wake of post-independence development initiatives.

As a result of suffering from both formal and informal unfair treatments by these rural poor, many national rural development programs in the form of integrated efforts or cooperatives have endeavoured to increase the availability of financial services, reduce collateral or other requirements, and adapt lenient procedures to rural clients. Even though such credit cooperatives are widespread in South-Asian countries, the principle of open membership caused most of the cooperatives to come under the control of well-to-do powerful farmers and have failed to make any contribution in the alleviation of poverty in the rural sector. Therefore, the benefits of these cooperative institutions have frequently been diverted to serve the interests of a selected few. From the world experience, since the rural economy was not properly served by formal financial institutions, at the beginning of the 1950s, many development projects began to introduce subsidised credit programs targeting at specific communities to fulfil the un-served financial needs of the rural poor. These subsidised schemes were rarely successful. Also, some institutions that have been specially established under these programs such as Rural Development Banks suffered massive erosion of their capital base due to subsidised lending rates and poor repayment discipline of the rural people. At the same time, the devoted funds did not always reach the intended beneficiaries, and instead, often ended up in the hands of better-off farmers (CGAP, 2003).

As a result, in the 1970s, experimental programs in Bangladesh, Brazil and a few other countries extended tiny loans (micro-loans/credit) to groups of poor women to invest in micro businesses through some NGOs. Because, during that time, the markets and governments failed to provide financial services to the poor, and later, it was widely accepted to select NGOs to accomplish this task. This type of micro-enterprise based credit was disbursed as solidarity group lending system in which every member of a group guaranteed the repayment of all members. Here, there are several factors, which have led to increased interest in micro-credit in promoting growth with greater equity. There has been a growth in the recognition of the importance of empowering all people by increasing their access to all factors of production, including credit. This enabled them to accumulate assets and raise household income and welfare. As a result, the value of the role of NGOs in development was received more attention. During the 1990s, many of these institutions transformed themselves into formal financial institutions to access and on-lend client savings, thus enhancing their outreach. Later, these institutions were given a specific name called Microfinance Institutions (MFIs).

Microfinance Institutions (MFIs)

A microfinance institution (MFI) is an organisation that provides financial services to the poor. This, a very broad definition, includes a wide range of providers that vary in their legal structure, mission, methodology, and sustainability. However, all share the common characteristic of providing financial services to clientele who are poor and more vulnerable than traditional bank's clients. Historical context can help explain how specialised MFIs developed over the last few decades. According to CGAP (2003), it is estimated that there are about three thousand MFIs in developing countries. These institutions also help create deeper and more widespread financial markets in those countries. These MFIs can be formal, semi-formal or informal service providers.

Formal providers are those that are subjected, not only to general laws, but also to specific banking regulation and supervision (e.g., development banks, savings and postal banks, commercial banks, and non-bank financial intermediaries). Formal providers may also be any registered legal organisations offering any kind of financial service. Semi-formal providers are registered entities subjected to general and commercial laws, but are not usually under bank regulation and supervision (e.g., Financial NGOs, Credit Unions and Cooperatives). Informal providers are non-registered groups such as rotating savings and credit associations and self-help groups.

According to ownership structure, MFIs can be government-owned, like the rural credit cooperatives in China; member-owned, like the credit unions in West Africa; socially minded shareholders, like many transformed NGOs in Latin America; and profit-maximising shareholders, like the micro-finance banks in Eastern Europe.

The focus of some providers is exclusively on financial services to the poor. Others are focused on financial services in general, offering a wide range of financial services for different markets. Organisations providing financial services to the poor may also provide non-financial services. These services can include business-development services, like training and technical assistance, or social services, like health and empowerment training.

Poor people need and demand the same types of financial services as everyone else. The most well-known service is non-collateralised "micro-loans," delivered through a range of group-based and individual methodologies. The menu of services offered also includes those adapted to specific needs of the poor, such as savings, insurance, and remittances. The types of services offered are limited by what is allowed by the legal structure of the provider, i.e., non-regulated institutions are not generally allowed to provide savings or insurance.

The biggest challenges for MFIs are ensuring the financial services to the poorest segment of the households and their enterprises (i.e., loan amount less than per capita income) and financial viability of MFI itself for their survival and sustainable growth. According to Harper (2003), the following measures are used to evaluate MFIs to measure the impact of microfinance on beneficiaries:

i. Profitability of the MFI

ii. Loans disbursed

iii. Savings Mobilised

iv. Loan repayment rate

v. Average loan size

vi. No. of borrowers

vii. No. of Savers

viii. Staff productivity (Volume of loans/savings per employee)

ix. No. of repeat borrowers

x. Proportion of women clients

xi. No. of clients who know they belong to groups which are poor, such as people who are living in a particular areas, or belong to particular tribes

xii. Regularity of attendance at group meetings

xiii Changes in clients' assets

xiv. Changes in clients' income

xv. Improvements in clients' family nutrition

xvi. Improvements in education and school attendance and,

xvii. Changes in client empowerment

Commercial Banks in Microfinance

Commercial banks offer an array of deposit accounts, including checkable deposits, savings deposits and time deposits. Also, banks provide range of loans products to their customers like, personal loans, housing loans, business loans, etc.

At the initial phase of evolving microfinance, commercial banks have not shown their interest on microfinance activities, as they have believed that microfinance as an unprofitable option. Microfinance experts have identified three basic reasons for the absence of microfinance activities in commercial banks in the past. Perception of high risk and high cost associated with microfinance transactions and socio-economic and cultural barriers were the main reasons for non-involvement of commercial banks in microfinance transactions. Traditional bankers perceived that micro-enterprises as bad credit risk. Non-availability and lack of collateral to guarantee demand for borrowings of micro-entrepreneurs was a major reason which discouraged commercial bankers for not involving in microfinance activities. Also, they perceived that micro-enterprises of the poor as unstable and unfeasible business which may make disable repayment of low-income groups' borrowings.

Also high cost associated with small loans was another reason which discouraged commercial banks to involve in microfinance. Transaction cost associated with finance activities is assumed to be decreased with the increase of loan size of borrowers. However, as micro credits are in small amounts and their maturity periods are shorter, transaction costs in micro credits were relatively high as compared to traditional loans of commercial banks, and this was another major reason for these banks to deviate from microfinance activities.

In addition, socio–economic and cultural barriers were another factor to depart banks from microfinance activities. Lack of education is a common issue for people who are living in low-income countries. As a result, they do not possess business records that can show their business feasibility. Also, these poor people in developing countries have some cultural and language barriers to adapt to modern banking sector.

However, by today, the situation has considerably changed. Commercial banks have increasingly been involved in financial transactions with low-income people. With increased competition in banking sector, commercial banks are now facing a major issue of decreasing their market share in financial transactions, thereby causing to decrease their profit margin. Therefore, the interest has been given on microfinance activities by commercial banks. For example, CGAP (Consultative Group to Assist Poor) has identified up to 3 billion potential clients in the microfinance market and over 225 commercial banks and other formal financial institutions engaged in microfinance activities in developing countries. Hence, participation of commercial banks in microfinance activities has been significantly increased during the last decade.

With high competitive advantage in microfinance activities, it has been identified that commercial banks use six approaches to enter the microfinance market (Isern and Porteous, undated) through either a microfinance service company (direct approach) or the existing microfinance providers (indirect approach).

In direct approach, commercial banks use three different ways to enter microfinance market. They include either opening an internal microfinance unit or a specialised financial institution or a microfinance service company.

Commercial banks use three different ways in indirect approach to microfinance market. They are outsourcing retail operations or providing either commercial loans or infrastructure and systems to MFIs.

Goodwin (1998) has identified the following factors for the success of commercial banks involvement in microfinance activities:

(i) Creating a small specialised bank or a separated microfinance unit within a large commercial bank

(ii) Treating savings as equally important to lending

(iii) Charging interest rates to cover all the costs of the lending products

(iv) Ensuring excellent Management Information System (MIS) and portfolio management

(v) Recruiting staff from outside the banks and/or give staff specialised training

(vi) Finding a champion or visionary who will see the program through to success

Microfinance and Commercial Banking in Sri Lanka

In Sri Lanka, various microfinance practitioners have been engaged over the last few decades. Commercial banks, Development banks, Finance companies, Public welfare organisations, Co-operatives, Co-operative Rural Banks (CRBs) and NGO-MFIs have been the key-players in microfinance of Sri Lanka. People's Bank, Bank of Ceylon and Hatton National Bank which offer various microfinance loans for poor people are the well-known commercial banks involved in microfinance of the country. Among development banks, Regional Development Bank and Sanasa Development Bank have been playing a vital role in microfinance market to meet the demand for financial transactions of poor people.

Among commercial banks in the country, the People's Bank, a State-owned bank and the second largest bank in Sri Lanka, provides access to financial services for the rural and poor households. Currently, it offers different microfinance loan schemes for small and medium agricultural entrepreneurs, agro-based industries, self employment, cottage industry, trade and services for more than 25 percent of household in the country. The People's Bank grants micro finance loans for starting, improving or expanding business of the poor. When the maximum loans amounts are considered, it shows a clear indication of commercialising microfinance activities in the country. For example, the People's bank provides a maximum amount of Rs. 250,000 for micro enterprises with only two personnel guarantees. Also maximum loan amounts for small and medium entrepreneurs are Rs. 2 million and Rs. 20 million respectively. Also, Bank of Ceylon (BoC) and Hatton National Bank (HNB) are the other key commercial banks in the country which have been engaged in microfinance for a long period of time. They are granting microfinance loans for agriculture, fisheries, self-employment, etc. Those two banks also grant loans with a maximum loan size of 1 million for micro-enterprises to fulfil their financial requirements.

Conclusion

There are various types and a large number of institutions and programs to finance and help promote micro-enterprises among the poor people. Hence, microfinance has become a vital tool in poverty alleviation of these low-income households. At the initial stage of evolution, commercial banks had perceived microfinance as a non-profit option. High cost of both credit risk and transactions was the main reasons that discouraged commercial banks to enter the market. However, with increased competition among formal financial institutions for the traditional market, commercial banks have shown an increased interest to enter the microfinance market using direct and indirect approaches to enter the microfinance market. In direct approach, commercial banks enter the market by starting a special unit or specialised institution. In addition to that, banks use indirect approach to enter the market by channelling funds via existing microfinance providers in the market. This has increased the number of commercial banks serving for financial needs of the poor people. Larger size of credits and supply of credit for the poor with an interest are some indicators which show commercialisation of microfinance activities. The involvement of commercial banks in microfinance activities has accelerated the amalgamation of formal and informal financial markets in developing countries.

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Footnote:

E-mail: shan@wyb.ac.lk

Electronic Banking in Sri Lanka: Prospects and Constraints

Prof. Sirimevan Colombage

Senior Professor, Open University of Sri Lanka.

Introduction

In the background of the unprecedented innovations of Information and Communication Technology (ICT) coupled with the liberalisation of the financial sector and the global financial integration, electronic applications are emerging in many spheres in the financial markets. These include e-banking, e-money, e-finance, e-brokering, e-insurance, e-remittances, e-fund transfers, and e-exchanges. Electronic banking (e-banking) is the latest delivery mode of banking services. Broadly, e-banking can be defined as an electronic connection between a bank and a customer that facilitates to prepare, manage and control a financial transaction. Electronic banking is offered on different platforms, including internet banking (or online banking), telephone banking, mobile phone banking (or m-banking), mobile money (or m-money), TV-based baking and PC banking (or offline banking). The degree of adoption of each of these channels varies from country to country. For example, m-banking is very popular in Kenya as against a country such as Sri Lanka.

The objective of this paper is to analyse the prospects and constraints for the development of e-banking in Sri Lanka. The analysis is based on the data collected by the author from a field study under a collaborative research project with the University of California, USA during 2009/2010. This study was motivated by the lack of data on e-banking in Sri Lanka despite the widespread adoption of e-banking. These data are essential for policy making purposes as well as for promotion of the industry. The rest of the paper is organised as follows: Section 2 provides an overview of the expansion of information and communication technology. Section 3 examines the use of e-banking in the country. Section 4 explores the potential for m-money systems. Concluding remarks are given in the final section.

The Expansion of Information and Communication Technology

In common with many other developing countries, Sri Lanka has experienced a phenomenal growth in telecommunication services during the last decade. In particular, the expansion of the use of mobile phones has been remarkable. As shown in Table 1, the number of mobile phones in use rose from 430,000 in 2001 to almost 14 million by 2009. This implies that every 68 persons out of 100 persons have a mobile phone. Thus, there is tremendous potential to popularise mobile banking in Sri Lanka.

Our survey data on the availability of information and communication equipment in the households also reflect the country's enormous capacity to adopt mobile banking even among the poor. Basic amenities, such as, electricity, radio and televisions are commonly available among a majority of households across different income groups,as shown in Table2. Electricity supply is available to around 93 percent of the total number of households. Around 61 percent of the surveyed households have fixed phones and 71 percent have mobile phones. This means that every 3 out of 5 households

Table 1: Telecommunication Services in Sri Lanka from 2000 to 2009

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Fixed Access Services										
Subcriber Base ('000)	767	829	883	934	991	1,244	1,884	2,742	3,446	3,431
Fixed Access Services ('000)	653	708	769	818	860	919	910	932	934	871
Wireless Access Services ('000)	114	121	114	116	131	325	974	1,810	2,513	2,560
Telephones per 1,000 persons	4.2	4.4	4.7	4.9	5.1	6.3	9.5	13.7	17.1	16.8
Other Services										
Mobile Phones ('000)	430	668	932	1,393	2,211	3,362	5,412	7,983	11,083	13,950
Mobile Phones per 100 persons	4	5	7	12	15	17	27	40	55	68
Public pay Phone Booths	8,222	7,281	6,681	6,440	6,095	6,285	7,561	8,526	7,417	7,936
E-mail and Internet subscribers	40,497	61,532	70,082	85,500	93,300	115,000	130,000	202,348	234,000	240,000

Sources : Sri Lanka Telecom Ltd.
Central Bank of Sri Lanka

have a mobile phone. It is significant to note that around 50 percent of poor households including the ultra-poor have mobile phones. The expansion of telecommunication networks by competing firms has led to a phenomenal growth in mobile phone usage. Household ownership of other equipment, such as, computers, email and internet facilities also showed a significant growth in recent years. Overall, around 13 percent of the households have desktop computers, and 6 percent of them have laptops. However, the ultra-poor households do not possess any computers or related equipment. Access to email and internet facilities is also largely confined to the non-poor and moderately-poor groups.

Table 2: Ownership of information and communication equipment (% of households) in Sri Lanka (n=859)

Item	Non-poor	Moderate poor	Ultra poor	All
Electricity	95.9	86.3	83.3	92.9
Radio	89.0	76.0	77.1	85.2
Television	94.1	82.4	72.9	90.1
Land phone	66.2	48.0	56.3	61.4
Mobile phone	78.6	53.9	47.9	71.0
Fax machine	7.7	5.4	0.0	6.8
Desktop computer	16.3	7.8	0.0	13.4
Laptop computer	6.8	3.9	0.0	5.7
Computer printer	8.4	5.9	0.0	7.3
CD drive	19.4	11.8	0.0	16.5
Scanner	7.1	4.4	0.0	6.1
Email	7.1	4.9	2.1	6.3
Internet	8.6	4.4	0.0	7.1

Source: *Household Survey on E-Money* conducted by the author, 2008/2009

The Use of Electronic Banking

In tandem with the growth of Information and Communication Technology (ICT) and the related e-banking facilities, the use of electronic banking (e-banking) facilities, such as, credit and debit cards, internet banking and phone banking, has emerged in Sri Lanka in recent years. As shown in Table3, internet banking, which accounts for about 5 percent of total retail payments in 2009, has surfaced as the most prominent electronic payment system. The use of phone banking is only 0.1 percent. The shares of credit cards and debit cards are 1.3 percent and 0.2 percent, respectively. Thus, the use of e-banking is still at an early stage in Sri Lanka. Bank cheques continue to remain as the main non-cash payment mode accounting for nearly 90 percent of the total value of non-cash payments in the country.

Commercial banks, specialised banks and several non-bank financial institutions have introduced a variety of e-facilities in recent times. Online internet (virtual) banking includes facilities such as balance inquiry, check status, stop payments, bill payments, inward remittances and fund transfers. Internet banking customers can also access from anywhere in the world on mobile phones. The use of mobile telephones is rapidly growing in Sri Lanka, and most of the internet banking services can now be accessed through mobile phones.

While the country has been enjoying an exceptionally high (traditionally-measured) literacy rate among developing countries, its computer literacy rate also has risen to about 40 percent by now. As shown in Table 4, nearly 70 percent of the households have some knowledge about ATM (Automatic Teller Machines), and 37 percent of them have knowledge about internet banking. Knowledge about phone banking is limited to about 17 percent of the households and SMS banking to about 12 percent of them. As regards, e-remittances, the moderate and ultra-poor have more knowledge relatively to the non-poor. This can be attributed to the fact that a larger proportion of migrant workers are mainly from the poorer segments of the population, and they have acquired knowledge about

Table 3: Modes of non-cash payments in Sri Lanka from 2001 to 2009

Composition of Values of Non-Cash Payment Systems (%)								
Payment system	2002	2003	2004	2005	2006	2007	2008	2009
Main Cheque Clearing System	62.5	4.4	95.0	94.3	92.1	90.3	89.9	87.7
Rupee Draft Clearing System	...	...	0.2	0.2	0.1	0.0	0.0	0.0
Sri Lanka Interbank Payment System	34.2	83.7	1.9	2.4	2.9	3.7	4.5	5.6
Credit Cards	0.5	2.0	1.1	1.2	1.3	1.4	1.4	1.3
Debit Cards	0.6	2.8	0.0	0.0	0.0	0.1	0.1	0.2
Internet Banking	1.5	6.9	1.3	1.4	2.4	4.2	3.8	4.9
Phone Banking	0.8	0.2	0.2	0.1	0.8	0.0	0.1	0.1
Postal Instruments	...	...	0.4	0.3	0.3	0.2	0.2	0.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Central Bank of Sri Lanka

e-remittances. But, the usage of such facilities is limited to non-poor households. The widespread e-banking literacy across different income groups reflects the potential to boost the mobile banking in the country.

According to our survey, only 0.8 percent of the households use their mobile phones for mobile banking as shown in Table 5. The majority use mobile phones for communication purposes including SMS messaging, which is very popular among the youth. A larger proportion of mobile phone users are familiar with some form of e-transactions. For instance, it is reported that US$ 10 million worth of reloading was carried out by small communication shops and boutiques largely located in rural areas for a particular mobile network last year. In this process, the clients hand over the money to such small shopkeepers as a prepayment to increase their balance for mobile phone usage. In most instances, these transactions take place without any documents, and this implies that the mobile phone clients have confidence in such small shopkeepers and mobile phone companies.

As depicted in Table 6, around 85 percent of the households have an account in commercial banks and 43 percent have accounts in credit co-operatives and Micro Finance Institutions (MFIs). A major reason for the high proportion of the banks in Sri Lanka is the rapid expansion of the banking network. In particular, on the initiative of the government, the two State-owned banks – the Bank of Ceylon and the People's Bank – have established a large number of branches in rural areas during the last four decades. Private banks also have expanded their outreach through their expanding branch networks. As mentioned earlier, the survey reveals that 71 percent of the households have mobile phones. This ratio is lower than the ratio of households who have a bank account which stands at 85 percent. This somewhat contrasts with the popular belief that the proportion of the banks is usually lower than the proportion of mobile phone owners in developing countries. There is an inverse relationship between the ratio of households who have bank accounts and the income levels. As expected, a larger proportion of non-poor households have bank accounts. It should also be noted here that the survey reveals that the amounts of deposits held by poor households are extremely low. Therefore, the mere ownership of a bank account does not necessarily reflect the savings capacity of a household.

A larger proportion of ultra-poor households have an account in specialised banks. This finding could be expected as most of these banks are savings and rural development banks which cater to lower income groups. The semi-financial sector which consists of credit co-operatives and Micro Finance Institutions (MFIs) plays a crucial role in providing deposit facilities, particularly to the poorer segments of the population. Overall, 43 percent of the total number of households has deposits in such institutions. There is a clear positive relationship between proportions of account holdings in the semi-formal sector and income groups. Over 50 percent of poor households have such deposits as against 37 percent of non-poor households.

Our focus group discussions indicate that people are increasingly using e-cards. However, non-availability of ATM facilities in most villages in the rural sector is pointed out as a major constraint.This is reflected in the lower proportion of ATM card users as against the high proportion of bank account holders, as shown in Table 7

Although the extent of the banked population is satisfactory, our qualitative survey reveals that a greater proportion of them are found to be under-banked for various reasons. A major factor is their low incomes which result in low savings. A large number of households indicated that they do not have sufficient savings in banks, and therefore, they do not require m-banking. We have observed through the focus group

Table 4: Awareness and Use of Electronic Banking in Sri Lanka (percentages of household members who are above 16 years of age, n=2,133)

Item	Have knowledge				Using			
	Moderate				Moderate			
	Non-poor	Poor	Ultra poor	All	Non-poor	Poor	Ultra poor	All
Internet banking	39.81	29.27	33.67	36.90	3.60	2.44	-	3.14
ATM machines	73.90	60.60	47.96	69.39	28.23	11.44	7.14	23.07
Phone banking	18.84	10.88	15.31	16.69	1.40	-	-	0.98
SMS banking	14.45	5.63	4.08	11.77	0.27	-	-	0.19
Cyber banking	4.53	1.13	-	3.47	0.27	-	-	0.19
e-remittances	20.24	24.77	35.71	22.08	1.60	-	-	1.13
Mobile cash	15.71	9.01	2.04	13.41	0.33	-	-	0.23

Source: *Household Survey on E-Money* conducted by the author, 2008/2009 discussions a diminishing trend of savings culture among the poor. Inadequacy of household incomes to cope with rising expenses was pointed out as a main reason for such decline by many households. Also, the negative real interest rates emanating from high inflation have inclined the households to purchase property and durable goods rather than to save money. Several households point out that they merely keep a minimum balance in their bank accounts for the purpose of obtaining a loan from the bank at a future date. Hence, motivation to build up savings could not be observed among many households during our discussions with them. Some low-income earners have borrowed from all possible sources, and the bulk of their monthly earnings is used to repay the debts. As shown in Table 8, another major reason for limited accessibility to mobile banking is that they did not have sufficient knowledge about how it works. Some households express their concerns about the security of accessing financial information using a mobile phone.

We have used the collected data to ascertain the relationship between e-banking and determining factors such as age, education, occupation and income, as shown in Table 9. Both the knowledge about e-banking and usage show a negative correlation with age. This finding is also supported by our focus group discussion which indicated that the younger people are more accustomed to e-banking. However, the correlation coefficients are not significant except for knowledge about internet banking. E-banking is positively linked to education, and most coefficients are significant at 0.01 level. There does not seem to be a decisive link between the level of occupation and knowledge/usage with regard to E-banking. The relation between income and e-banking is positive, as expected. The coefficients are significant at 0.01 level in most instances reflecting a strong nexus. As mentioned earlier, our focus group discussions also indicated the profound influence of household income on the use of banking facilities.

Table 5: Purposes of Using Mobile Phones in Sri Lanka

Purpose	%*
Communicate	52.7
Send SMS	32.1
Business	1.5
Obtain information	17.6
Employment	6.1
Banking	0.8
Purchase goods	2.3

Source: *Household Survey on E-Money* conducted by the author

Percentage of adult households who use mobile phones.

The Potential of Mobile Money Systems

This study has revealed that there are two specific segments which have vast potential to apply e-banking for the benefit of the poor. They are the microfinance industry and the inward remittance market. The country has a widespread network of microfinance institutions, as mentioned earlier. These institutions which are built up on the concept of 'group-lending' are much more flexible in providing financial facilities to low-income families. According to our survey, 44 percent of the surveyed households are members of microfinance organisations. This reflects the extensive outreach of microfinance industry in the country. However, we have observed that none of these institutions including the major ones has adopted e-banking facilities. A main reason for this is the non-application of ICT in their operations. Taking into account the large amounts of transactions they handle daily, on the one hand, and the widespread availability of mobile phones in households, on the other, there is considerable potential to adopt

Table 6: Percentage of households who have an account in a financial institution in Sri Lanka (n=834)

Sector	Non-poor	Moderate Poor	Ultra-poor	All
Formal Sector				
Commercial banks	89.2	74.9	68.8	84.7
Specialized banks	17.1	13.3	25.0	16.7
Non-bank financial institutions	4.1	1.5	0.0	3.3
Semi-Formal Sector				
Credit Cooperatives & MFIs	37.3	57.1	54.2	42.9

Source: *Household Survey on E-Money* conducted by the author, 2008/2009

Table 7: Use of commercial bank facilities (% of households) in Sri Lanka (n=834)

Facility	Non-poor	Moderate Poor	Ultra-poor	All
Commercial bank account	89.20	74.90	68.80	84.70
ATM card	41.79	22.05	16.67	35.73
Credit card	8.80	2.56	-	6.83
Mobile phone banking	2.88	1.03	-	2.28

Source: *Household Survey on E-Money* conducted by the author, 2008/2009 mobile banking in the microfinance sector. This will not only help to improve efficiency, but also to reduce transaction costs.

The other area that has potential to apply mobile banking is the inward remittance market. An estimated stock of over 1.6 million Sri Lankan migrant workers, mainly in the Middle East countries, annually remit foreign exchange over US$ 2.5 billion, easing the balance of payments disequilibrium. They account for about 8 percent of the country's GDP (Gross Domestic Product). Migrant workers send their earnings to their relatives and friends living in Sri Lanka by using different channels, including (a) formal banking channels, (b) by hand through persons travelling to the country, and (c) informal channels. Although the bulk of remittances are channelled though formal means, as much as 45 percent of total remittances are estimated to be remitted trough informal channels. The oligopolistic remittance setting in Sri Lanka as well as in host countries have led to the growth of informal channels. Meanwhile, banks have been increasingly popularising e-remittance facilities such as internet banking, e-Cash, X-press Money, MoneyGram, Ez-Money and Telemoney. Hence, a rapid expansion of e-remittance could be expected in the near future.

This study shows that currently the use of e-banking facilities is relatively low in Sri Lanka. Nevertheless, the country's widespread banking network and ICT infrastructure provide considerable potential to foster e-banking at a faster pace, benefiting the bottom of the pyramid. This will also be facilitated by the recently-improved computer literacy as well as the outstanding high common literacy level. Banks need to expand mobile banking and similar instruments to isolated rural and urban areas where customers have to spend a lot of time and money to visit a bank branch located in a far away place. This is feasible as mobile phones have penetrated in such areas as well. The banks will have to play an unconventional and proactive role in this regard to cater to the bottom of the pyramid through such devices. It is evident from our study that profit making and economies of scale are the overriding factors in the decision-making process of banks and other financial institutions, rather than reaching out the low-end customers through devices such as mobile banking. The household survey indicates that the majority of the poor, who are usually characterised by low financial literacy, do not have any understanding about mobile or e-banking facilities. This kind of information asymmetry can be overcome through counselling, advertising and publicity programs. Early action needs to be taken by the stakeholders to harness the potential to adopt m-banking in the microfinance industry and remittance market.

Table 8: Major reasons for not using mobile banking in Sri Lanka

Reason	%*
High costs	8.0
Less security	2.3
Difficult to use	9.4
No understanding	39.3
Never heard	15.5
Not necessary	25.6
All	100.0

Source: *Household Survey on E-Money* conducted by the author

* *As a percentage of households who do not use mobile banking*

Conclusion

Sri Lanka has experienced a phenomenal growth in ICT in the last two decades. The rapid penetration of mobile phones is particularly significant. These developments reflect the country's strong potential to take advantage of electronic banking and mobile money. These innovative financial

Contd. on page 35

Table 9: Pearson Correlation Coefficients between e-banking Variables and some of its Determining Factors in Sri Lanka (n=1,672)

Variables	Age	Education	Occupation	Income
Know about internet banking	-0.050*	0.196**	-0.007	0.136**
Using internet banking	-0.005	0.036	0.045	0.109**
Know about ATM machines	-0.043	0.256**	-0.340	0.090**
Using ATM machines	-0.047	0.251**	0.004	0.233**
Know about phone banking	-0.040	0.212**	-0.067**	0.130**
Using phone banking	-0.015	0.055**	0.010	0.073**
Know about SMS banking	-0.039	0.187**	-0.044	0.103**
Using SMS banking	-0.012	0.027	-0.014	0.009
Know about cyber banking	-0.015	0.127**	-0.035	0.068**
Using cyber banking	-0.004	0.017	-0.026	0.010
Know about e-remittances	-0.035	0.079**	-0.031	0.210
Using e-remittances	-0.012	0.037	-0.002	0.076**
Know about mobile cash	-0.045	0.197**	-0.071**	0.039
Using mobile cash	-0.014	0.020	-0.027	0.008

** *indicates Correlation is significant at the 0.01 level (2-tailed).*

* *indicates Correlation is significant at the 0.05 level (2-tailed).*

Source: *Household Survey on E-Money* conducted by the author

Financial Crises and their Lessons

Dr. W. M. Hemachandra

Assistant Governor, Central Bank of Sri Lanka.

Introduction

Financial crises are not new to the world. According to available literature, financial crises in the world date back to the 1819s when there was a major financial crisis in the United States of America (USA) (Wikipedia, 2011).

The causes of the financial crises were different. In the 19th and early 20th centuries, many financial crises were associated with bank runs, systematic banking crises and banking panics while many recessions coincided with these panics (Wikipedia, 2011). Financial crises can be banking crises, international financial crises and wider economic crises (i.e., recessions and depressions). A situation where a commercial bank suffers a sudden rush of withdrawals by depositors is called a bank run. In such situations, banks cannot immediately fulfil the entire demand for money by the general public, because the bank may have invested its money in a variety of assets, gains of which may realise during a long period of time. This may lead to a bank panic or banking crisis. Examples of bank runs can be seen in the USA during 1931. An international financial crisis may occur when a country is suddenly forced to devalue its currency because of a speculative attack. This may be referred to as a currency crisis or a balance of payment crisis. Likewise, when a country fails to pay back its sovereign debt, it is referred to as a sovereign default. A balance of payment crisis along with a sovereign default can lead to a sudden stop in capital inflows or a sudden increase in capital flight. During 1992 – 1993, some countries in Europe faced with a similar type of international financial crisis. Further, there were international financial crises in many Latin American countries, when they defaulted their debt in the early 1980s. A wider economic crisis may consist of a recession or a depression. A slow down in growth for a continuous period is usually called a recession. A prolonged recession may be referred to as a depression. The great depression in the 1930s is such an example for a depression. Similarly, the recent sub-prime mortgage crisis and the real estate bubble experienced around the world starting in 2008 led to a recession in the USA and in a number of other countries.

Causes of Financial Crises

The causes of financial crises vary depending on the nature of the crisis. Sometimes, recognition of only one cause for the crisis may be difficult, and a crisis may take place as a result of many causes. These causes may be due to macroeconomic circumstances, microeconomic policies or other reasons. Most of the time, adverse macroeconomic developments are blamed for financial crises. The trigger of financial crisis may be due to errors in macroeconomic policies adopted by relevant authorities. High interest rates, shift of exchange rate regimes and unnecessary slow down or sharp increases in inflation are some of the macroeconomic reasons that trigger a crisis. Although high interest rates may attract more short-term capital, they may create difficulties for financial institutions and governments. When countries are unable to maintain exchange rates, they automatically try to shift into different rate regimes, thus causing imbalances in the external sector. Examples for these can be seen during the Mexican Crisis from 1995 to 1997 and the South-East Asian Crisis from 1997 to 1998.

Prolonged deficits in the current account may lead to unstable macroeconomic conditions creating a financial crisis. The countries which have deficits will have problems in financing their budgets, mobilising savings and debt management. Likewise, the Mexican Crisis had a route of deficit in the current account, while the South-East Asian Crisis was created due to capital flight. Shifting of exchange rate regimes and high short-term borrowing created instability in these countries and ultimately led to capital flight, causing a financial crisis.

Unfavourable microeconomic policies can also cause financial crises. The Ireland's financial crisis occurred due to a property lending boom. Similarly, in most countries, weaknesses in the supervisory role of financial institutions either due to insufficient legal framework or weaknesses in supervision may lead to a failure of financial institutions. Lack of transparency in providing information to supervisory authorities sometimes leads to a collapse of financial institutions. Mismanagement of financial institutions is a common cause for failure of financial institutions in emerging markets. Examples for these types of financial crises can be found in Sri Lanka where several financial companies failed during 1988 – 1989.

Mismanagement of credit given to financial institutions may create credit bubbles, and bursting of which, may lead to failure of financial institutions. The credit crunch in the USA during 2007-2009 was one of the reasons for the recent financial crisis where US financial institutions failed as a result of their inability to repay loans. Sudden withdrawals of bank credit develop difficult situations for the borrowers to repay the credit.

Government directions sometimes due to political reasons can pave way for a financial crisis. For instance, sub-prime mortgage crisis in the USA was created partly as a result of over-supply of construction industry which was encouraged by government directions. The assassination of political leaders in Mexico created financial sector chaos and resulted in a withdrawal of short-term foreign finance which led to a financial crisis.

Financial products, if managed properly, would help develop financial markets. However, development of sophisticated financial derivatives beyond the safety levels may lead to a collapse in these financial markets. One good example for this type of crises is the recent US financial crisis which had a link to sophisticated and unmanageable derivative products.

Undue developments in the debt market, particularly in the government debt, are one of the common causes of financial crises which have common examples from most countries. During 2010–2011, failures in Greece, Ireland and in several European countries occurred due to excessive levels of public debt.

The foregoing explanation supports the fact that financial crises may occur due to one or a series of causes. At the initial stage, one of the several causes would adversely affect one sector such as commercial banking, which would impact other sectors creating worse situations. Similarly, a crisis occurred in one country may result in crises in other countries. For instance, the South-East Asian countries' financial crisis initially started in Thailand and spread to other countries subsequently. Therefore, a contagion effect is also a cause of a financial crisis. The US crisis in 2008 affected most of the other countries in the world. Therefore, depending on the severity of the crisis in one country, there would be global effects.

US Sub-Prime Mortgage Crisis from 2007

The US sub-prime mortgage crisis was one of the worst-hit financial crises. The crisis began with the bursting of the United State's housing bubble and high default rates on "sub-prime" and adjustable rate mortgages which approximately began in 2005/06. Sub-prime lending is the practice of making loans to borrowers who do not qualify for market interest rates owing to various risk factors, such as income level, size of the down payment made, credit history, and employment status. In the USA, borrowers are rated either as "prime" or as "sub-prime". The prime borrowers have a good credit rating based on their track records while sub-prime borrowers have track records in repaying loans below par. Loans given to sub-prime borrowers are categorised as sub-prime loans. Typically, it is the poor and the young who form the bulk of sub-prime borrowers.

Roughly, five years leading up to 2007, many banks started giving loans to sub-prime borrowers. They did so, because, they believed that the real estate boom would allow people to repay the loans they were taking to buy or build homes. Government also encouraged lenders to lend to sub-prime borrowers. With stock market booming and the system flushing with liquidity, many big fund investors saw sub-prime loan portfolios as alternative investment opportunities. Hence, they bought such portfolios from the original lenders. Thus the sub-prime loan market became attractive.

One major contributory factor for this crisis was the boom in the supply of housing, which resulted in falling prices and an increase in the default rate of sub-prime borrowers, many of whom were no longer able to repay their loans. Another factor was the problems in collateral for buying houses in the USA. This took place with increased supply of houses for sale while there was a low demand which resulted in decline in house prices. This was coincided with the slowdown in the US economy which made matters worse.

Since the risk of default on such loans was higher, the interest rates charged on sub-prime loans were also higher than the interest on prime loans. However, the repayment capacity of sub-prime borrowers was doubtful. Further, lenders devised new sophisticated instruments, such as derivative products, to reach more sub-prime borrowers. Sometimes, these instruments included payments from the borrowers on different mechanisms, such as the repayment of the principal portion which was to start later. The links of complex derivative products on the loan portfolios were very complicated. Therefore, there were more doubts about the ultimate re-payers.

Not only the reckless lenders, but also big institutions such as, Freddie Mac and Fannie Mae, which owned or guaranteed more than half of the outstanding in home mortgage in the USA were widely thought as being more prudent than many others in their lending practices. Ultimately, they too suffered from billions of losses. Not limiting to these financial institutions in the USA, the crisis affected institutions such as Citigroup and Merrill Lynch which are global banks and brokerages to write-off billions of sub-prime losses. Furthermore, despite efforts by the US Federal Reserve to offer some financial assistance, the crisis led to the collapse of Bear Sterns, one of the world's largest investment banks and securities-trading firms. The crisis also extended to Lehman Brothers and American Insurance Group.

This crisis affected, not only these American institutions, but also many banks in other parts of the world. Since the USA was the biggest borrower in the world, most countries which held their foreign exchange reserves in dollars and invested in the US Securities were badly affected. Countries like Japan, China and India which had invested in the USA had direct adverse impacts from this crisis. Also the global equity markets were badly hit from it. Other than these, countries which had trading links with the USA were affected due to the down-turn in the USA. Therefore, effects of the US crisis were, not only limited the US economy, but also to the global economy.

Consequences of the US Crisis

As a result of the mortgage crisis, lenders in the USA were unable to recover their credits. A number of financial institutions collapsed, and businesses of many non-financial institutions, such as car producers, garment sellers and food sellers faced difficulties in selling their products. Consumer prices in Advanced Economies as identified by the International Monetary Fund (IMF) grew only by 0.1 per cent in 2009. Mortgage giants such as, Fannie Mea and Freddie Mac were affected extensively. The fourth largest investment bank in the USA, the Lehman Brothers, Wall Street's fifth largest bank Bear Stearns, which was acquired by another organisation, and Merrill Lynch collapsed. A number of financial institutions were declared bankrupt, merged, acquired by other organisations, bailed out by the governments or nationalised. An Insurance major, American Insurance Group, was also under severe pressure and collapsed. Not only in the USA, but also in other countries of the Euro Banking Sector, a number of financial institutions as well as producing firms collapsed due to the US crisis. For instance, Northern Rock and European banking and insurance giant Fortis were partly nationalised to ensure their survival. The General Motors, which is a car-producing firm in the USA, and Mark & Spence were faced with a decline in their sales.

Rating Agencies downgraded their investment ratings of a number of financial institutions. Unemployment surged and growth of employment became negative in several countries. Unemployment in Advanced Economies (as classified by IMF) increased by 8 per cent in 2009. The Chief Executive Officers of several banks (Citi Group and Merrill Lynch) stepped down.

The World Bank and the IMF predicted a slow rate of economic growth in the richest nations and the globe. Current Account balances in a number of advanced countries became negative. Countries suffered with lack of demand for their goods and services and fell into recession. Prices of houses and other goods and services fell. The stock markets suffered with fallen markets. The US recession was officially declared by the National Bureau of Economic Research; a leading panel including economists from major academic institutions. The figures indicated that more US workers lost their jobs in 2008 than any year since the World War II.

Not only the US and European economies suffered, but also other countries such as China, Japan and India faced their biggest ever declines in exports. This was common even to other exporting countries in Asia and Africa. The IMF warned that the world economic growth was to fall to just 0.5 per cent in 2009. Data showed that world output in 2009 dropped by 0.6 per cent. The International Labour Organisation said that as many as fifty one million jobs worldwide could be lost in 2009 because of the global economic crisis.

In order to respond to the crisis, policymakers, including Federal Reserve Bank and the US government, took comprehensive measures to overcome the adverse effect which arose from the financial crisis. Because of the contagion effect of the US financial crisis, many other central banks around the world too took actions to correct the situations in their countries. Among the policy actions, there were monetary policy measures, amendments to legislation, government bail outs and other joint actions implemented. Under the monetary policy measures, reduction of the interest rates and providing liquidity assistance to the affected financial institutions were some of the policy measures implemented by countries. Likewise, new legislations were introduced under regulatory amendments. Legislations relating to lending practices, bankruptcy protection, tax policies, housing, credit counsellors, education and licensing of lenders were drafted or amended by affected countries. Governments came out with financial facilities and proposals for acquisition of financial institutions. Larger financial institutions such as Freddie Mac and Fannie Mae were taken over by the Federal Reserve Bank and several other financial institutions acquired some of the failed financial institutions. A number of larger financial institutions were acquired or amalgamated by other institutions in the USA, the UK (United Kingdom) and many other European countries. Also the US government started purchasing of large amounts of illiquid mortgage-backed securities form financial institutions. Several governments initiated actions to get the approval from their national legislatives to extend bail out amounting to billions of dollars as a measure to the crisis. Banks increased the amount of loans to small- and medium-sized enterprises. A number of regulatory measures for accounting standards were also proposed by many countries. In addition to these governmental efforts, the Federal Reserve, the European Central Bank, the Bank of England, the Bank of Japan, the Bank of Canada, the Swiss National Bank and the Swidish Riks Bank announced measures to release liquidity to financial institutions. The IMF provided financial assistance for some countries.

Financial Crises in Sri Lanka

So far, Sri Lanka has not faced a severe crisis. However, the country has faced some difficult economic situations, particularly in the financial sector. A banking crisis occurred in Sri Lanka during the1880s when the coffee plantations, one of the major sectors that contributed to national economy, were faced with a disease called coffee blight. Several banks which had extended their services to the plantation sector collapsed due to this, and the then government was compelled to intervene and bail out some affected banks during that time (Karunatilake, 1986). Other than this crisis, no noticeable financial crises have taken place in the history of Sri Lanka.

In the recent past, after the political independence in 1948, several financial companies in the country collapsed during 1988 and 1989. The Central bank of Sri Lanka responded to this crisis by extending financial support for distressed financial companies (Central Bank of Sri Lanka, 1988 and 1989). Some of the collapsed financial companies were closed and some were rehabilitated, however, this crisis was not wide spread.

During 1993-1996 government re-capitalised State banks, i.e., the Bank of Ceylon, the People's Bank and the National Savings Bank to strengthen the capital base of these institutions. However, this cannot be considered as a crisis situation, but as a step taken by the government to strengthen government banks.

In addition to these situations, in several occasions, the country faced with some hardships in regard to country's balance of payments and fiscal management. To set the economy on the right path, the government and the Central Bank of Sri Lanka obtained financial assistance several times under the standby arrangement facility of the IMF. Since 1965, the first year that the country received IMF funds under this arrangement, there were seven other instances up to date that the government has sought financial assistance from the IMF to overcome difficult situations in Sri Lanka.

Sri Lanka's financial system stability was not affected due to the US financial crisis. However, the country required to correct its reserve situation which was affected due to external developments. In the latter part of 2009 and 2010, the country was able to recover from the adverse situation which was experienced during the latter part of 2008 and the beginning of 2009. The terrible experience faced by the western world due to the US financial crisis was not experienced by Sri Lanka. The robust legal background available in Sri Lanka, closure of external capital account and corrective measures implemented in regard to financial institutions, particularly in the area of supervision of financial institutions, were some of the reasons that helped evade adverse impacts from the US financial crisis. However, with the intensification of the crisis that was spilled into the real sector of the economy, the effect of the US crisis was felt strongly by the external sector of the Sri Lankan economy.

As a result of the financial crisis, many investors who had intervened in short-term investments repatriated their investments back to their home countries to meet rising liquidity requirements. The foreign funds which were invested in debt instruments such as Treasury Bills and Long-Term Bonds in Sri Lanka were withdrawn from the country as a result of the global financial crisis.

Due to the slowdown in crisis-driven countries, the demand for Sri Lanka's exports, particularly apparel products, declined substantially. This was a combined effect of reduction in global demand for textile exports and high competitive nature of the export market. Similarly, there was a decline in Sri Lanka's export products such as tea and rubber. Also the growth of the industrial sector decelerated in 2008 compared to 2007. Meanwhile, some local industries resorted to short-term layoff of workers as a result of decline in demand for their export products. The growth of services sector also declined and adversely affected the tourism sector in which tourist arrivals dropped due to the global crisis.

The decline in export earnings and withdrawal of short-term investment by the foreigners, resulted in the balance of payment problems in Sri Lanka. The high growth of imports and lower growth of exports too contributed to a substantial expansion in the trade deficit in 2008 and built up pressure on the exchange rates. The Central Bank of Sri Lanka responded by selling its foreign reserves to prevent exchange rate from devaluation.

The impact of the global crisis through the channels as explained above ultimately resulted in a slow rate of economic growth in Sri Lanka. The impact of the crisis on the economic growth was severely felt during the last quarter of 2008 and the first half of 2009. The lowest economic growth in the first quarter in 2009 which was 1.6% indicated the adverse effects of global crisis on the Sri Lankan economy.

The financial system of the country was robust and was not directly affected by the crisis. No banks collapsed in Sri Lanka. Although some financial companies faced some difficulties during 2008, there was no threat to financial stability in the country. The country was able to maintain price stability too. The inflation declined to sharply to 4.8 per cent by the end of 2009 (Central Bank of Sri Lanka, 2009).

Lessons from the Financial Crises

As described above, financial crises are not new to the world, but they have occurred throughout history. These financial crises have taught many lessons to regulators, governments, financial institutions and to the general public at large. In spite of many lessons learnt from the historical financial crises, financial crises have occurred repeatedly. The lessons learnt may be of macro or micro importance. Some argue that to avoid financial crises, solutions should be tried. Conversely, Alan Greenspan, the US Federal Reserve's previous chairman, suggests that no one should try any action and says that things went well over the long period of deregulation and light-touched oversight, while arguing that the global financial system is now "unredeemably opaque" that policymakers and legislators cannot hope to address its complexity. However, some argue that Greenspan is wrong and crisis that threatened the foundation of the American economy, led to soaring unemployment, a continuing foreclosure crisis and weakened economies in the USA and Europe. It would have been a grave mistake not to address problems of inadequate regulation and lax oversight (Barney Frank, 2003). Hence, the arguments for and against the actions to be taken to prevent financial crises are different.

Based on these crises, the following lessons can be highlighted for regulators and financial institutions to overcome or at least to reduce adverse impacts from possible crises:

(i) Many financial crises have taught the necessity of strengthening regulations to tackle the behaviour of financial institutions. From the US crisis, it was emphasised that regulations are required to tackle institutions that are too big to fail. From the recent financial crisis, it appears that the weaknesses in regulatory mechanisms fuelled failed financial institutions and led to a financial crisis which had wider repercussions. The regulations are required, not only to regulate financial institutions, but also to regulate new products such as derivatives, to evade troubles. Further, these laws increase transparency through new financial services that will give powers to regulators to access information about the entire financial system. The mechanisms such as Basel II, Basel III, etc. also have imposed some capital requirements which will ensure the stability of institutions. These mechanisms are ex-ante preventive measures anticipating possible weaknesses in advance. However, some may argue that these regulations may impose controls preventing the liberalisation philosophy.

(ii) The Asian financial crisis was erupted due to poor economic "fundamentals". The nations exposed themselves excessively to speculative movements of capital and short-term capital flows, with no regulations and controlled mechanisms affected the most. This was purely because of the prevailing philosophy of openness to all kinds of financial flows. Therefore, regulators have to be careful. The fact is that Asia became very dependent on foreign investors whose concern was not whether a country had its fundamentals in order, but what other speculators were thinking. This created a very volatile structure and ultimately a chain reaction of crises. Short-term foreign borrowing increases vulnerability to shocks. The short-term flows coming in can quickly flow out. Thailand was an example for this where withdrawals of short-term finances created the financial crisis in South-East Asia. At present, the IMF supports imposition of controls on short-term finances.

(iii) The crises have taught us the necessity of proper macroeconomic management. In that, controlling inflation, prudent exchange rate management, deficit financing management have shown great importance. Some small economies such as Singapore and New Zealand have both liberalised capital accounts and floating exchange rates under their macro-economic framework. In these countries, institutional arrangements exist to limit the incentives for excessive risks taking. In Singapore, this is done through supervision and regulation. In New Zealand, there is an emphasis on transparency and managerial accountability to stock holders and public at large. Accordingly, under macro-economic management, proper external and internal economic management has to be in place to avoid crises and the necessity for carefully designed monetary policies which manage inflation and liquidity has been emphasised. In a number of financial crises, the regime shift of exchange rate has led to financial crises. To prevent this type of crises, proper management of external accounts including exchange rates and the external reserves is required.

(iv) The crises which led to reduce expenditure of households ended up with recessions. When there is a crisis, restrictions in the monetary side and credit will take place, resulting in a decline in demand for goods and services. These measures may impose restrictions on small- and medium-sized enterprises. The US crisis, which provides an example, led to reduce consumption of the households and resulted in a drop of demand for goods and services produced by firms. This ultimately led to a world-wide crisis, adversely affecting exports of emerging economies while it created a recession in many countries including the USA and the UK.

(v) Another lesson that can be learnt is the avoidance of overreaction to short-term developments. This may be relevant to domestic sector or to external sector activities. Korea, at end of 1997, experienced a sharp exchange rate devaluation which was largely unanticipated. This triggered an unprecedented banking crisis. Therefore, countries should consider long-term perspectives rather than short-term goals when they consider monetary and fiscal management.

(vi) The effects of the crisis are long term and costly. Many countries happen to spend a lot of taxpayers' money to rescue failed financial institutions. This was clear from the US crisis that billions of dollars were pumped from the government to bail out failed institutions. This was not limited to the USA, but also to many countries in the world that came up with financial assistance from the governments to rescue financial institutions both in the government and the private sectors. Even in Sri Lanka, during the period where there was a distress in the financial companies, the government (Central Bank) extended financial assistance to rescue finance companies from collapsing.

(vii) It is required to have sufficient supervision and adequate public disclosures to prevent the failure of financial institutions. Strong measures have been implemented by many countries to strengthen supervisory activities, while countries such as the USA and those in G20 came up with strong legislation to strengthen the supervision. Financial institutions should respond to this supervision favourably to prevent possible collapses. Even in Sri Lanka, prudential supervision and timely action on financial institutions protected the country from the adverse effects of the several crises that occurred around the world. Because of the strong supervision and timely measures implemented in Sri Lanka, the country was able to protect itself from adverse effects of the South-East Asian crisis and the US crisis. The measures implemented included issuing guidelines/instructions/ directions on capital and credit ratios, corporate governance, non-performing loans, business continuity plans, payments to imports, and limits of remuneration for bankers, commencement of risk-based supervision, implementation of Know Your Customer (KYC) policy, introducing limits on commercial banks' borrowings, and appointing management committees for financial institutions. The Korean financial crisis in 1997 was due to lax of provisioning, poor standard of concentration of risk and large exposures, lack of good internal liquidity management controls, and weaknesses in supervision and regulatory arrangements. Therefore, financial institutions should respect to supervision and regulatory arrangements to avoid future crises.

(viii) To protect the depositors, mechanisms such as Deposit Insurance Schemes provide favourable grounds to avoid adverse effects of the crises. In 1996, Japan came out with a deposit insurance scheme. In Sri Lanka too, provisions were made recently to establish a deposit insurance scheme. This move, which may be a part of risk management, provided authorities with improved flexibility to deal with failed financial institutions. The IMF has stated that world's largest and most important banks should pay additional fees to address the risk of liquidity shortfall in their institutions that may cause wider damage to the financial system.

(ix) Private financial institutions also should act proactively to regulators' actions. The perception that official resources can be used to bail out creditors generates moral hazards. It could lead to excessive risk taking by lenders and funding of less economically defensible projects and may aggravate the possibilities of crises. After the adverse experiences of the recent crisis in the USA, regulators are considering imposition of regulations to limit gearing capacity, enhance capital adequacy, and to conduct stronger stress tests on financial institutions. The private sector responses to governments' or the regulators' actions are required to prevent crises.

(x) Financial Institutions, especially banks, should carefully arrange investment portfolios drawing attention to both liquidity assets and profit-generating assets to maintain public confidence which is very important for their functions. Liquid assets and profit-generating assets have two ends, and their proper maintenance may ensure confidence of the public as well as profits of the financial institutions. The global financial crises have taught lessons emphasising the importance of maintaining a healthy financial system based on public confidence and generating profits.

(xi) Today, the handling of risk exposures of financial institutions plays a very critical role for their survival. In the current world, types of risks are different. Financial institutions have to tackle many types of risks to maintain their credibility, and hence, risk management has become very essential. Adverse risk management is partly responsible for the US financial crisis in which a number of financial institutions failed due to poor risk management. Maintenance of transparency is also a part of the risk management. The dealing with sophisticated derivative products which was the main cause behind the US crisis carried enormous risks to financial institutions. Therefore, financial institutions should pay attention, not only to current risks, but also to future risks.

(xii) One of the prominent characteristics behind financial crises has been the insufficient awareness of the financial products and activities of financial institutions. During the crises, it was evident that the staff of the financial institutions as well as the general public did not have proper knowledge of the financial products. The general public usually goes for high returns without considering much the security of the assets. This can create substantial losses to the depositors. The awareness of the staff members of the financial institutions on various developments is also essential when the functions of financial institutions are carried out. A team of well-qualified and experienced staff is required for financial institutions for which training and capacity building are essential.

(xiii) Some crises have erupted due to political reasons. The crises occurred with this background have created unemployment and problems in income distribution resulting in changes in political environment. For instance, in Thailand, the Prime Minister was forced to resign and President Suharto in Indonesia stepped down after 32 years of autocratic rule. South Korea also had political changes. In South Korea the autocratic government of Kim Young Sam was replaced by relatively untainted regime of Kim Dae Jung. So, the lesson learnt from this is that financial crisis may lead to a political crisis as well.

(xiv) Crises have shown the importance of international relations. A country alone cannot tackle a crisis. The crises such as in South-East Asia and the USA have proved the necessity of international action to avoid their adverse effects. The USA requested co-operation from Europe to tackle the financial crisis which had global repercussions. A number of countries in Europe responded to this by adopting parallel monetary and fiscal policy measures. A number of countries provided financial assistance to affected financial institutions. The reduction in the interest rates was one of the combined monetary policy measures adopted by many countries which helped in resolving adverse repercussions of the US crisis. Therefore, to tackle a crisis, international co-operation is required. Some argue that casualties of financial crises have come due to lack of North-South dialogue. It is said that a lack of North-South dialogue has put the whole burden of effects of financial crises on the developing countries.

The above-mentioned lessons can be treated as global lessons that we have learnt from the crisis situations. Sri Lanka was not adversely affected due to the recent crisis in the USA because of available improved macroeconomic situation, favourable regulatory background, prudent supervision and the timely action taken by relevant authorities. The Governor of the Central Bank of Sri Lanka highlighted ten lessons learnt from the financial crisis, as given below:

(i) Be prepared in advance: This is having to wear a life vest when the storm is coming when someone is on the deck. The action taken to introduce one percent general provision to all banks was one of the measures that the Central Bank took in advance, prior to the crisis.

(ii) Develop the ability to move quickly and decisively: The central bank gave clear signals on what exactly it was going to do. This prevented the impact crisis.

(iii) Read and realise the global developments quickly: For this, proper information was required and the Central Bank watched global developments such as crashing of big financial institutions and economies in the world.

(iv) Take a long-term view of the factors and take measures accordingly.

(v) Deal clearly and decisively: In this, it is required to tell clearly what is to be done by the stakeholders.

(vi) Implement package of policies without relying on one. Central Bank had multiple plans to deal with the problems that it faced with regard to international reserves.

(vii) Work closely with the government, the political authorities: This is required to achieve a common goal and to implement strategies accordingly.

(viii) Take advantages of opportunities in the market: The Central Bank built up not only the domestic currency market, but also the capacity of foreign currency market in Sri Lanka.

(ix) Think rationally of the law of unintended consequences: For instance, imposing a tax on gold reduced gold imports substantially in Sri Lanka.

(x) Address global problems in a globalised manner: The Central Bank took action to take up the issues as and when required with the IMF. So, granting of additional SDR (Special Drawing Rights) allocations to countries was one of the outcomes of this.

Although the above text indicated ten lessons from the financial crises, it is necessarily not needed to limit it to ten.

Conclusion

This paper attempted to classify financial crises in some order, find out causes of financial crises, while explaining the USA sub-prime mortgage crisis in 2007 with consequences of this crisis, and explaining the history of financial crisis in Sri Lanka. Finally, it highlighted lessons which were learnt from the crises. Examples were provided from many financial crises, such as Mexican crisis, South-East Asian crisis, Ireland financial crisis and the latest from the sub-prime mortgage crisis in the USA to identify the causes of financial crises. The paper identified the failures of financial institutions and the actions taken by authorities to resolve the adverse effects of the crises.

The paper highlighted many lessons that could be learnt from the crises. The need for and/or importance of regulatory requirements, macro- and micro-economic frameworks, supervisiòn, mechanisms such as deposit insurance to mitigate risks, a proactive role of the financial institutions, managing portfolios and risks and a team of skilled staff for financial institutions to avert/ manage financial were highlighted. It also showed that there were political reasons for some financial crises, and international relations to avoid adverse impacts of the crises were important. The paper finally indicated some actions that helped Sri Lanka to avoid repercussions of financial crises.

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The Role of Information Risk Management in Combating Global Money Laundering and Terrorism Financing

Wipul Jayawickrama

Infoshield Consulting

Introduction

Money laundering and terrorism financing are financial crimes that are becoming an increasing global problem since the 1980s. As a result, the Financial Action Task Force (FATF), a 33-member organisation whose main responsibility is to develop an international standard for anti-money laundering and combating of terrorism financing, was established, and the first internationally-recognised Anti-Money Laundering (AML) and Counter Terrorism Financing (CTF) programme was established.

Today, anti-money laundering and counter terrorism financing compliance is a regulatory requirement promoted by several conventions and international treaties. Compliance is required to:

i. Meet international obligations and needs to combat money laundering and financing of terrorism,

ii. Maintain good relations with foreign and international organisations,

iii. Avoid financial penalties, and

iv. Maintain reputation.

In its simplest form, an anti-money laundering and counter terrorism financing compliance requires an entity to:

i. Implement an organisational anti-money laundering and counter terrorism financing program,

ii. Verify the identity of customers before providing them with designated services, and

iii. Report suspicious as well as certain specifically defined transactions.

Anti-money laundering and counter terrorism financing compliance is an information intensive activity. The accuracy, completeness and timeliness of the information used in the program are essential for the success of the program. Information risks, such as, breach of confidentiality and integrity, lack of availability, uncertainty of authenticity and the ability to repudiate information-related activity can affect the success of the program. Therefore, risk management of information and related technology becomes an essential part of the anti-money laundering and countering terrorism financing programs.

What is Money Laundering and Terrorist Financing?

Money laundering is the process of hiding the origin of illegally-obtained money. As per the United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances (1988) and United Nations Convention against Transnational Organised Crime (2001), this includes:

i. Knowingly transferring or converting property that is proceeds of crime,

ii. Concealing the source, location, movement, and ownership and rights of property that is the proceeds of crime, and

iii. Acquiring, owning or using property, knowing that such property is the proceeds of crime.

Terrorist financing is the solicitation, collection and provision of funds to support terrorist acts or groups. The financing of terrorism can be done by both legally- and illegally-obtained funds. The International Convention for the Suppression of the Financing of Terrorism (1999) states that a person commits the crime of financing terrorism "if that person by any means, directly or indirectly unlawfully and wilfully, provides or collects funds with the intention that they are to be used, in full or in part, in order to carry out" acts of terrorism.

While similar methods are used for both money laundering and terrorist financing, and proceeds of money laundering may be used in the terrorist financing, the two processes do not share the same goal. The goal of money laundering is to conceal the source of illegally-obtained funds. The goal of terrorist financing is to collect and provide funds for terrorist activities.

How Big is the Problem?

Money laundering and terrorism financing are crimes that have far reaching negative economic and social impacts on the society, resulting in destabilised economies and wide-spread social impacts such as crime, substance misuse and loss of life. Unfortunately, both money laundering and terrorist financing are pervasive.

It is difficult to measure the actual amounts of money laundered or used to fund acts of terrorism. FATF has admitted that it is 'absolutely impossible to produce a reliable estimate of the amount of money laundered'. There is very little published statistics, but it is common agreement that billions of dollars of illegally obtained money is laundered each year.

The available statistics are staggering. In a recent report released by the Colombian Ministry of Finance, the estimated amount of money laundered internally was 8.667 Billion Dollars. This is 3 per cent of the Gross National Product (GNP) of Columbia. The report also states that there were 42,950 suspicious transactions reported over the past 5 years. It is surmised that a major proportion of this money comprises of cash smuggled out of US and Canada, and that it is used to finance the Columbian narcotics industry.

A report by the Australian Institute of Criminology in 2007, estimated that AUD 2.8 to 6.3 billion was laundered 'in and through' Australia.

Regardless of the actual figures, money laundering and terrorist financing pose a significant problem to governments and society as a whole.

Combating Money Laundering and Terrorist Financing

Due to the transnational nature of both money laundering and terrorist financing, international cooperation is required to combat these global threats. It also requires internationally-accepted policy and standards to ensure a unified and coordinated approach. Since 1989, FATF has been the body that develops and promotes international policy. FATF has published 40 recommendations and 9 special recommendations, commonly known as the 40+9 recommendations and a 'Methodology for Assessing Compliance with the FATF 40+9 Recommendations'.

Other influential internationally-accepted conventions and directives include:

i. United Nations Convention against Corruption,

ii. Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime and on the Financing of Terrorism,

iii. European Parliament Directives on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing,

iv. United Nations Conventions against Terrorism.

Many governments have implemented legislative frameworks to combat money laundering and terrorist financing activity that are compliant with the above-mentioned conventions and directives. Legislation acts as a deterrent to money laundering and terrorist financing activities, and provides a framework for taking action against identified perpetrators of these activities.

Impact on Financial Institutes

Financial institutions and banking systems constitute a large proportion of the platform that is used to convert and transfer illegal funds. Instruments such as, bank credits, travellers' cheques, bank cheques, money orders, shares, securities, bonds, drafts and letters of credit, are used in both money laundering and terrorist financing activities. There is a serious concern about the use of financial institutions and the banking system in these illegal activities. As a result, compliance with anti-money laundering and counter terrorism financing regulation is mandatory to financial institutions.

The penalties for non-compliance can vary in different jurisdictions. Non-compliance can result in legal and financial penalties, and depending on the jurisdiction, local law can also hold individuals within an organisation liable to penalty. For example, in Australia, a breach of anti-money laundering legislation can result in civil and criminal penalties to organisational leadership.

Financial penalties can be heavy. There are several instances where financial organisations that are in breach of compliance requirements have been heavily fined. Some examples of fines imposed on financial institutes in the past few years include:

(i) Bank of Ireland - £375,000 in 2004 for issuing 40 unidentifiable bank drafts,

(ii) Royal Bank of Scotland - £ 750,000 in 2002 for not having adequate controls to verify the identity of their clients £5.6 million in 2010 for lending to people on government ban lists,

(iii) Abbey National Banking Group - £2.3 million in 2003 for breaches of the anti-money laundering regulations and breakdowns in systems and control procedures,

(iv) Riggs Bank - US$25 million in 2004 for failing to design and implement a suitable anti-money laundering program. A further US$ 16 million criminal fine,

(v) ANZ Banking Corporation US$5.75 million in 2009 for violations of US sanctions against Sudan and Cuba,

(vi) Pacific National – US$ 7 million in 2011 violation to the Bank Secrecy and US Patriot acts.

The impact on financial institutes is not limited to financial loss. Reputational damage can be significant, and may result in restrictions and sanctions imposed on the institution depending on the extent of the breach, both resulting in loss of revenue and their competitive edge.

Therefore, the establishment of anti-money laundering and counter terrorism financing programs is a non-negotiable requirement for the financial industry.

The Organisational Anti-Money Laundering and Counter Terrorism Financing Program

Many countries have imposed mandatory reporting requirements for large transactions to respective reporting authorities. For example, in the United States of America, there is a requirement to report all transactions over USD 10,000 to the Internal Revenue Service. Similarly, in Sri Lanka transactions over LKR 1,000,000 have to be reported to the Central Bank's Financial Intelligence Unit (FIU). Most banking and financial systems possess the capability to identify and generate automated reports of these transaction.

However, experienced money launderers do not conduct large transactions that result in drawing attention to them. It is the responsibility of the financial institution to implement suitable procedures and systems to:

(i) Identify sanctioned and suspicious customers and transactions, and

(ii) Report sanctioned and suspicious transactions to appropriate authorities.

To be able to identify and report sanctioned and suspicious transactions, the organisation needs to have a robust anti-money laundering and counter terrorism financing program. Aspects of this programme include:

i. Maintaining an anti-money laundering and countering terrorist financing policy,

ii. Maintaining organisational awareness of the policy and its implications,

iii. Maintaining a list of global sanctions obligations,

iv. Providing training to relevant staff on identifying and reporting sanctioned and suspicious transactions,

v. Designing business rules to ensure that no individual transaction can knowingly breach anti-money laundering and countering terrorist financing,

vi. Defining clear processes to enable identification and reporting sanctioned and suspicious transactions,

vii. Implementing controls to prevent deliberate subversion of the compliance requirement,

viii. Ensuring that business partners do not engage in business activities that can lead the organisation breaching applicable compliance requirements, and

ix. Screening new and existing customers and staff to ensure that they are not on a sanctioned list.

The Role of Information Technology in the Compliance Process

There is an on-going attempt to subvert the anti-money laundering and countering terrorist financing programs. These attempts are becoming increasingly sophisticated. Therefore, access to timely, accurate and relevant information is critical to a successful anti-money laundering and countering terrorist financing program. This requires efficient use of information-related technologies to filter customer data and inspect this data for anomalies

Typically, technology used in the anti-money laundering and countering terrorism financing uses rule-based analytics capable of name analysis and profiling of transactions. For example, the frequency and size of transactions and flags to indicate that a certain person is on a watch list were used to identify transactions that potentially could be related to money laundering and terrorism financing activity. However, detection based on such rules and analytics can be subverted using smaller and distributed transactions and using associates to conduct transactions. To ensure that such subversive activity is detected, intelligence capabilities such as link analysis, peer group analysis and time sequence matching should be integral to a good anti-money laundering and countering terrorism financing technology implementation.

The Role of Information Risk Management

Anti-money laundering and countering terrorist financing programmes are information intensive. The use of inaccurate information, for example something as simple as a mis-spelt name or a name with alternate spelling can result in a severe compliance breach. A premature release of information may result in the inability to prevent a suspicious transaction. Many other information risks can affect the integrity of an otherwise successful anti-money laundering programme. Therefore, is it important to ensure that information risk is managed throughout the anti-money laundering and counter terrorist financing program.

Information risk management is the application of the generic process of risk management to information assets and the information environment. All aspects of information risk, i.e., the risk of breaches of confidentiality; integrity and availability on information as well as non-repudiation of information-related activity are applicable in the anti-money laundering and countering terrorist financing information management environment. Other information-related risks can include breach of privacy and data protection legislation.

Due to the sensitive nature of the anti-money laundering and countering terrorist financing information environment, an active approach to information risk management should be adopted. Information is subject to various vulnerabilities and threats. These could be inherent to the information systems as well as deliberate attempts of subversion. Internal risk management frameworks, information governance frameworks and information security management programmes should be used to create a secure environment for storing, processing transmitting and archieving of information used in the anti-money laundering program.

In Summary

There are global obligations and compliance requirements imposed on governments and various commercial and non-commercial entities to identify and report suspicious transactions that may support money laundering and terrorism financing activities. Anti-money laundering and counter terrorism financing reporting programs are highly information intensive. Breach of information attributes, such as, confidentiality, integrity, availability authenticity and non-repudiation can impact the outcomes of these programs resulting in penalties, reputational loss and negative impacts on international relationships. Therefore, it is important to ensure that an effective information risk management program is in place to support the objectives and integrity of these programs. ■

Development of Banking Law in Sri Lanka: A Critical Assessment

Dr. Wickrema Weerasooria

Insurance Ombudsman and Senior Consultant to Postgraduate Institute of Management

Banks and Banking Development

Despite the establishment of the Ceylon Savings Bank, the State Mortgage Bank and the Bank of Ceylon, nothing meaningful happened in the area of banks and banking law in the country until independence and the establishment of the Central Bank of Ceylon. Also, banking in pre-independence Ceylon was dominated by foreign banks (mainly British) and some Indian Banks.

The South Indian Natukottai Chettiar "merchant bankers" and the native "shroffs" of the foreign banks, acted as the middlemen between the Ceylonese borrowers and the lender banks. For an excellent discussion of banking and finance of that period, any researcher or student should look at the Pockhanawala Commission of 1934 as the country's first Banking Commission that was named after its Indian Chairman, Sir Sorabji Pockkanawala.

The Finance Minister of the first post-independence government of Ceylon (J.R.Jayawardena) deliberately looked not to England, our colonial master - but to the United States for assistance to setup our banking system. The Americans gave as Mr. John Exter who had just completed an overhaul of banking for the Philippines. John Exter transplanted his legislation for Philippines on Ceylon. His report (now a Sessional Paper) is an excellent one. By the Monetary Law Act of 1948, he set up a Monetary Board (the legal entity) and a Central Bank (popularly called Reserve Bank in Western Countries and even in India). J.R. Jayawardena was said to have been very pleased with John Exter and invited him to be the first Governor of the Central Bank of Ceylon which post he accepted.

As a relevant anecdote, the name "Central Bank" posed no problem in the English language, but in Sinhalese and Tamil, it meant "*Madyama Bankuwa*" like a translation of "Central Province". The well-known Professor G.P. Malalasekera is said to have solved this dilemma. He had said to use the term "*Maha Bankuwa*" and no one will contest it. Also, the *legal entity* is the Monetary Board and not the Central Bank. In other words, any legal action by or against the Central Bank has to be in the name of the "Monetary Board"

Another post-independence milestone was the establishment by statute of the People's Bank in 1961 to take over and improve on the Co-operative Federal Bank which had been set up in 1949, but which had not been a success. Thereafter, (in my view) until about the mid 1977, when a new government espousing an open and liberalised economy was elected, nothing significant occurred in the manner we have now come to accept what banks can do to galvanise the economy. Until July 1977, except for the few developments mentioned above, as a whole, the country had a highly-regulated banking and financial system with strong Central Bank control.

Development of Banks and Banking Law after July 1977

After the election of a new government in July 1977, with the advice and assistance of the International Monetary Fund (IMF) and the World Bank (WB), significant developments took place in banking and the law associated with it. The most important was the enactment of the Banking Act. The Banking Act No 3 of 1988 (amended since then) supplemented the post-independence statute (Monetary Law Act No 58 of 1949) which established the Central Bank of Ceylon. It is these two statutes plus their amendments that banks should bind together and always have with them along with the several Gazette Notifications and Circulars issued by the Central Bank of Sri Lanka. The Banking Act defines "banking business" for Sri Lanka and provides the procedures for licensing of banks and their regulation and control by the Central Bank of Sri Lanka. Only incorporated bodies approved (licensed) by the Central Bank of Sri Lanka can engage in banking business.

Special Debt Recovery Laws for Banks

I now turn to what is considered as an extraordinary and special privilege that bankers in Sri Lanka enjoy. This type of privilege enjoyed by our banks is not found even in developed countries. We are here referring to the statutes (legislation) entitled:

(i) Recovery of Loans by Banks (Special Provisions) Act No 4 of 1990 as amended.

(ii) Debt Recovery (Special Provisions) Act No 2 of 1990 as amended by Debt Recovery (Special Provisions) Amendment Act No 9 of 1994.

These two statutes which are categorised as special debt recovery legislation were the product of a report issued in 1983 by a Debt Recovery Committee, chaired by Mr. D Wimalaratne, a retired Supreme Court Judge. The legislation was not enacted until 1990, because of very strong opposition from the Sri Lankan Bar Association which argued that the proposed legislation was "discriminatory, draconian in their nature and harsh and superfluous". Yet despite all opposition, both statutes became law from 1990.

Recovery of Loans by Banks (Special Provisions) Act No 4 of 1990

Currently, this Act provides one of the most important statutory remedies (popularly called "*Parate Execution*") available to banks against defaulting borrowers. Whenever default is made in the payment of any sum due on a loan, the Board of Directors of any commercial or other specified bank may by resolution in writing authorise any person to sell by auction any property mortgaged to the said bank or may authorise any person to enter upon any immovable property mortgaged to the bank and to take possession of such property and thereafter, to manage and maintain such property until all monies due to the bank have been fully paid.

The majority of the reported case law on banks and banking since 1990 up to date is on "Parate Execution" cases. The country's newspapers have also benefited because, everyday, Parate Resolutions of Banks are advertised (as required) in the media.

Debt Recovery (Special Provisions) Act No 2 of 1990 as Amended by Debt Recovery (Special Provisions) (Amendment) Act No 9 of 1994

This is the second statute which gives extraordinary power to banks. This statute applies to all 'lending institutions' as defined in Section 30 of the Act. The term includes all licensed commercial banks and finance companies and specialised financial institutions. The statute provides a very easy summary procedure for the recovery of overdue debts. The term 'debt' is also given a wide definition in Section 21 of the Act (as amended).

While under Section 22 of the Act no money specified as a *penalty* for default or delay in payment of a debt can be recovered by a lending institution under these special procedures, the Roman-Dutch Law rule prohibiting the recovery of interest in excess of the principal sum lent has been abolished by this legislation. Even the Civil Law Ordinance of 1852 prohibited the recovery of interest in excess of the principal sum lent, but section 18 of the Amended Act No 2 of 1990 permits the recovery of interest in excess of the principal sum lent.

Issuing Cheques without Funds to Honour them

Although titled the Debt Recovery (Special Provisions) Act No 2 of 1990, the above-mentioned statute (quite strangely) also legislates on matters not connected with debt recovery. For instance, Section 25 of the Act makes it an offence for a person:

(i) To draw cheques knowing that there are not sufficient funds in his bank account to honour such cheques;

(ii) To draw cheques and then countermand their payment so that the cheques will not be honoured.

Many law enforcement officers and even some lawyers are not aware of the above new provisions (may be because it is found in this statute) and still proceed to prosecute such offenders under the "cheating" provisions of our Penal Code.

Supreme Court Narrows Down "Parate Execution" by Banks

In 2005, in a Five-Judge Supreme Court decision headed by the then Chief Justice Sarath Silva (with one dissent of Justice Shirani Bandaranayake) the Court refused to recognise that any property mortgaged <u>other than by the borrower</u> will be subject to parate execution. In other words, <u>third party mortgages</u> would be excluded from the right to parate execution. This judgment was delivered in the case of *Chelliah Ramachandran v Hatton National Bank,* Supreme Court Appeal Nos 5 and 9/2004 – S.C. Spl. Leave No. 32 & 33, decided on 1 April 2005). Accordingly, the signal sent by the Supreme Court is very clear. The judiciary will not extend parate execution. Rather, the judicial trend will be to narrow its operation. More recently, in 2011, Parliament passed amending legislation under which "Parate Execution" will not be permitted in the case of loans under Rs 5 million.

Nominations in Bank Accounts

Another little known development in banking law is the provisions enabling "Nominations" to any bank account other than current accounts. This was done by an amendment in 1993 to Section 544 of our Civil Procedure Code. Now, any customer can nominate any person of his choice to be the *beneficiary* of the assets of that account (e.g. Savings account or fixed deposit) and such nomination takes precedence even over a Last Will of that customer. Public awareness must be created about this "nomination" because banks as a matter of routine get customers to sign such nominations without advising them of their effect. A customer may nominate a person known to him for convenience, but never intending that the nominee should benefit over his natural heirs.

Confidentiality of Bank Accounts

In England and many other countries, bankers' confidentiality and secrecy about bank accounts is an established principle of English common law. However, in Sri Lanka, these secrecy provisions have been embodied in section 77 of our Banking Act of 1988. My view is that we should have let the common law handle this topic because when you legislate lawyers often want to *interpret the legislation* to suit the case in hand!

Bank's Duty on Dormant Accounts

On the other hand, a good legislative provision is the provision in the Banking Act of 1988 relating to Dormant Accounts and abandoned property of customers. These are accounts not operated for over ten years. From 2008, the Central Bank of Sri Lanka has, *for the first time*, activated these statutory requirements, and now, all banks must report to the Central Bank of Sri Lanka any such assets (balances). The public would have seen newspaper advertisements of banks on this topic. In other countries, this is done every year, because, the statute applies to accounts that are not operated for ten years; so every year, the ten-year rule will apply to a few accounts. Up to 2008, one wonders what happened to monies in such dormant accounts.

No Significant Litigation and Judicial Decisions on Banking

A book published by the author, *Casebook on the Law of Banking and Cheques in Sri Lanka,* clearly shows that we do not have any major issues in this area. From the time of the Civil Law Ordinance of 1852, it was the English law that clearly applies to banks and banking issues in the Island. Some doubts about the application of Roman-Dutch Law to banking was cleared by a Bench of Five Judges of our Supreme Court in the famous case of *De Costa* v *Bank of Ceylon* decided in 1969. In that case, the Bank of Ceylon was successfully sued for liability for *conversion* of a negotiable instrument as a Collecting Bank. There, five Judges of our Supreme Court gave several interesting judgments on how the English Law of Banking came to be applied in Sri Lanka. All the judgments run into a total of about seventy pages. In my view, the best judgment in that case was by Judge Christie Weeramantry who has now become a globally-recognised jurist of great eminence. By reading and understanding the judgments delivered in that case, one will get a good idea of banking law and its application in Sri Lanka.

Roman-Dutch Law is, however, our Common Law. Although it now applies only in two out of over 190 countries in the world (South Africa and Sri Lanka), any activity outside the "business of banking" (for example, guarantees and safe custody) will be governed by Roman-Dutch Law. However, in practice after the decision in *De Costa* v *Bank of Ceylon*, there has been no conflict for bankers between English and Roman-Dutch Law. Both laws have existed "in harmony" and the diversity of our country's legal system has not caused concern to bankers.

"Customary Banking Practices"

As stated earlier, English law applies to "banks" and "banking business". Section 86 of our Banking Act of 1988 in defining "banking business' speaks of customary banking practices. In June 2008, as a guide to our judiciary, the Association of Professional Bankers of Sri Lanka (APB) published in a booklet thirty four areas of activity engaged in by banks which are regarded as "customary banking practices" and which should, therefore, be governed by English Law. At the APB's request, this writer compiled this publication which was launched by Senior Supreme Court Judge Mr. Justice Saleem Marsoof at a public event in Colombo. This compilation of "customary banking practices" in 2008 was a landmark event because no other country has done so.

Salgado Presidential Commission on Finance and Banking (1991)

It is appropriate to mention the work done by the Salgado Commission (named after its Chairman Dr. M.R.P Salgado) appointed by the then President in 1991. It issued nine reports on many important areas of banking and all these reports were published as Sessional Papers and contain invaluable information and data on the subject.

Whom does Banking Law Favour, Bankers or their Customers?

The answer to this question is not easy. Many bankers and average customers will say that banking law favours banks and that the scale is always tilted in favour of banks. However, if one does a careful evaluation of banking law and read through an established English text on banking law (such as *Paget* or *Chorley*), one will come to the conclusion that banking law favours customers rather than their banks. The following reasons are highlighted for the above view:

Firstly, banks have to comply with several statutory provisions in legislation such as the Banking Act, the Monetary Law Act, and other more recent legislation. The customers need not worry, because it is the obligation of banks to ensure that the legislative requirements are observed. As a famous English judge said, "The business of banking is not the business of the customer but that of the bank".

Second, banks act at their peril and take obvious risks in undertaking the payment and collection of cheques for their customers. No doubt, they make a profit by dealing in cheques, but when one closely examines the judicial decisions relating to payment and collection of cheques, it is clearly evident that banks have an onerous responsibility compared to their customers. A collecting bank's only protection from liability to an action for conversion is to prove that it acted in good faith and without negligence. Owing to the number of cheques that go through the banking system everyday, and because of the elaborate frauds practised by persons who steal other people's cheques, sometimes banks fail to prove that they were not negligent. Similarly, a paying banker's obligation is also onerous though he is not exposed to as many risk as a collecting bank. Forgery of signatures of cheques is also common risk. A bank that pays a forged cheque is liable to its customer. A forged mandate is no mandate.

On the other hand, compared to the onerous, day-to-day responsibility of banks, customers of banks, owe only *two* duties to their banks. First, to draw cheques carefully so as not to facilitate forgery. This is called the *Macmillan* duty after the English case that established it: see *London Joint Stock Bank Ltd* v *Macmillan* [1918] AC 777. The second duty is to inform the bank immediately of any forgery of his or her cheques, if such forgery has occurred. This is called the *Greenwood* duty based on the English decision in the case of *Greenwood* v *Martins Bank* [1933] AC 51.

Thus, it is evident that the law has placed a higher legal burden and responsibility on banks than on their customers. It is only when customers borrow or take loans from banks that the roles are reversed. The customer – originally the depositor – creditor, now becomes the borrower – debtor and in lending transactions the law favours the banks such as by giving them special parate *execution* powers.

What I have said the above does not mean that it is easy to litigate against a bank. My advice is against it. The costs and delays in litigation will exhaust and frustrate any individual customer.

Recent Legislation of Importance to Banks and other Financial Institutions

Today in 2011, Sri Lanka has a vibrant Banking sector with local banks and branches of well-known foreign banks operating side by side. However, still the State banks (the Bank of Ceylon, the People's Bank and the National Savings Bank) dominate the banking sector with nearly 70% of the business. As regards Banking Law, we have in place today all the necessary statute law. I refer in particular to the following pieces of legislation which every banker should be conversant with:

i. The Monetary Law (Amendment) Act No. 32 of 2002,

ii. Information and Communication Technologv Act No. 27 of 2003,

iii. The Banking (Amendment) Act No. 2 of 2005,

iv. Financial Transactions Reporting Act No. 6 of 2006,

v. Prevention of Money Laundering Act No. 5 of 2006,

vi. Convention on the Suppression of Terrorist Financing Act No. 25 of 2005,

vii. Payment and Settlement Systems Act No. 28 of 2005,

viii. Electronic Transactions Act No. 19 of 2006,

ix. Computer Crimes Act No. 24 of 2007.

x. Companies Act No. 7 of 2007,

xi. Intellectual Property Act No. 36 of 2003,

xii. Consumer Affairs Authority Act No. 9 of 2003,

xiii. Payment Devices Frauds Act No. 30 of 2006,

Of the above legislations, the Financial Transactions Reporting Act of 2006 is of great day-to-day importance to banks. It laid down verification requirements for identification of customers, and under it, cash deposits of over Rs one million have to be notified to the Financial Intelligence Unit (FIU) now set-up in the Central Bank Sri Lanka. Under the Payment and Settlement Systems Act of 2005, cheque clearance is fully automated and now handled by Lanka Clear Ltd. and what we now get is a computer-generated facsimile of the cheque. The Electronic Transactions Act of 2006 and the Computer Crimes Act of 2007 takes care of the developments of E-Commerce.

I conclude this brief synopsis of the major *banking law* developments since independence in 1948 with comments about our Banking Regulator and the newly-established Financial Ombudsman Scheme.

The Central Bank's Role as the 'Regulator".

As a Regulator the Central Bank of Sri Lanka has been "Pro-Active" when required to be so and acted as a Supervisor – which, in my view, should be its normal role. Today in 2011, we do not want "Regulators". What we want are "Facilitators". The Central Bank's duty is to safeguard the monetary system and the payment system. In the open economy which we now have in Sri Lanka too much regulation will impede development.

As a Regulator, Central Bank of Sri Lanka has done well. We have not had any major banking collapses. The Pramuka Bank collapse in 2002 was the last of recent origin. Despite, the "Golden Key" fiasco, the Central Bank of Sri Lanka stepped in and prevented any run on Seylan Bank. This Bank is now once again on a sound footing and doing well. True, a number of non – supervised financial enterprises failed – *Sakvithi, Danduwam* and then Golden Key – but to lay the blame for all these failures on the Central Bank of Sri Lanka is not fair. These were risky financial enterprises paying interest far above the normal possible rates. Also, Golden Key was not an institution supervised by the Central Bank of Sri Lanka which periodically by public notices informs the general public of Institutions supervised by them. When the Central Bank of Sri Lanka publishes notices naming the financial institutions supervised by them, they are indirectly saying all other financial institutions in question are not supervised and hence may be risky. This is the clear message. Also one cannot take legal action against the Central Bank of Sri Lanka for loss of deposits in unsupervised institutions. In England also, the Courts have rejected legal claims against the Bank of England which is the Regulator in that country. Similarly, our Supreme Court has held that our Central Bank of Sri Lanka (Monetary Board) cannot be sued for loss of deposits in failed, unsupervised financial institutions.

Financial Ombudsman Scheme

My last comment is about the Financial Ombudsman Scheme which was commenced in 2003 which, in my view, has been a tremendous success. When you appreciate that it is a free service to customers, the success is more meaningful. I am also happy and proud to record that I was responsible (together with Mr. Gaston Gunawardene, the then Secretary General of the Bankers Association of Sri Lanka) for setting up the scheme. I recommended it to the Central Bank of Sri Lanka in 2002 when I was working as a Consultant there. After some hesitation, the banking industry agreed. It was then to be called the "Banking Ombudsman", but since other supervised financial institutions like finance companies, leasing companies and primary dealers also wanted to join, it was ultimately called the Financial Ombudsman's Scheme.

Every year, about three to four hundred customers come before the Financial Ombudsman for some relief. It is a very friendly service run at No.143A, Vajira Road, Colombo 5. The procedure is not complex and inquiries are held without lawyers, and equitable decisions are given. The banks and other financial institutions who have joined the scheme support it and are anxious to ensure that it continues as a success.

It is from the success of the Financial Ombudsman Scheme that the Insurance Ombudsman Scheme was also commenced in February 2005, and I have been the Insurance Ombudsman from that date up to now. We both operate from the same building at 143A, Vajira Road, Colombo 5.

Now, we also have a Tax Ombudsman established by the Ministry of Finance. I am advocating that the government should encourage the setting up of more Ombudsman Schemes such as for private hospitals (now there are nearly 200 of them in the Island) for Electricity and Water services, etc. Even the Press Complaint Commission set up by the Editors Guild is a type of Ombudsman Scheme. We must encourage any system of dispute settlement which are alternatives to litigation which is both expensive and has long delays.

Footnote:

[1] LLB (Hons.), Ph.D (London) Attorney-At-law, Supreme Court of Sri Lanka; Barrister and Solicitor, Supreme Court of Victoria, Australia; Former Associate Professor of Law, Monash University, Australia; Insurance Ombudsman Sri Lanka; Senior Consultant, Post Graduate Institute of Management.

Banking Services in Post-conflict Development of the North and East of Sri Lanka

Kanesh Suresh
&
Jeyapraba Suresh

Lecturers
Department of Economics
Eastern University of Sri Lanka

Introduction

An effectively functioning banking sector is essential for a rapid economic growth of a country. Although in the past, banks have been shown on the supply side of economic models, today, they have changed their position from credit-creating institutions to multi-tasking institutions. Banks, not only grant long-term and medium-term loans and promote saving habits among their customers, but also serve in various dimensions, such as, finance service, insurance, housing subsidies, scholarships, foreign travel, etc. The banking and financial services sector is contributing 7.5% to the Gross Domestic Product of Sri Lanka in 2010 (Central Bank of Sri Lanka, 2010). Moreover, for the livelihood recovery of the war-affected regions, the role of the banking sector is crucial.

The crisis that prevailed in the Northern and Eastern provinces in the past three decades restricted not only the services of the banking sector, but also the customers' investments from various angles. Since the return of normalcy, the government has been focusing its attention on promoting regional equality. International financial institutions, such as, the World Bank and the Asia Development Bank, have been strengthening their network to develop short-term and long-term investments through concessional soft loans, deviating from the policy of providing development grants.

Banking service in Sri Lanka commenced with the launching of Cooperative Rural Banks in 1906. Subsequently, the Central Bank was established in 1950. Today, the Central Bank of Sri Lanka functions as a co-coordinating centre for the activities of the State as well as private banks. To initiate saving habits and rectify inflation situations, a savings bank was established under the name Ceylon Savings Bank in 1946. Following this, the Bank of Ceylon and the People's Bank were established in 1948 and 1961 respectively under the category of State commercial banks. Subsequently, many banks have been established under the names of Savings, Development and Investment with the objective of social and economic development of the country.

The Economy of the North and East

The North and East Provinces comprise of 29 percent of the total land area and 13 percent of the population of Sri Lanka. The available land and water resources and the skilled human resources of the two provinces play a major role in contributing to the national output. Due to natural and man-made disasters, the contribution of the Eastern province in 2008 was only as little as 5.5 percent while the contribution to the national product by the Northern Province was limited to a mere 2.9 percent only (Central Bank of Sri Lanka, 2010). The illegal taxes imposed by the rebel movements on production and trading and obstacles to inputs due to security reasons were the main reasons for the low output levels (Sarvananthan, 2008).

The frequent large-scale displacements in the North and East, heavy damages to social infrastructure, destructions to the production sectors, restrictions on service sectors, such as, education, health and banking, in addition to the restrictions imposed on inputs for reasons of security by both the warring parties resulted in the narrowing of the volume of development-related activities in these provinces. The agricultural activities of the Eastern Province which contributed 39 percent to the agriculture sector of the country had to be abandoned for many decades. In the 1980's, the contribution of North and East provinces to the total paddy cultivation was 27.8 percent, and this reduced to 24.9 percent in the year 2007 (Amarathunge, 2010).

Further, the taxes imposed on outputs, the barriers imposed on transport, marketing, etc. and other restrictions reduced the output levels of the fisheries sector manifold (Sarvananthan, 2007). These two provinces which contributed 52 percent to the fishing industry were able to contribute only 19 percent to the output in the year 2007, especially during the period of war (Amarathunge, 2010). As the A9 highway was closed, the sea food production was marketed through the Palaly airbase. The heavy taxes imposed on these products and the increasing cost of transportation to market, caused severe hardships to both manufactures as well as consumers.

With regard to the industrial sector, Kankesanthurai cement factory and the Paranthan chemical factory in the Northern Province and the Pulmoodai ilmanite factory in the East were closed down due to prolonged conflict. This caused unemployment problems to thousands of skilled employees. In addition the resources which were available were, abandoned without utilising them. In 2004, 72 percent of the Northern economy was contributed by service sector (Sarvananthan, 2008). The high level of education made a significant contribution to this. The displacement due to security reasons was the main reason for the domestic human resource migration. These caused an impact not only on the employment-related matters, but also on education.

Following the end of the war, State organisations as well as non-governmental organisations have been focusing their attention on public infrastructure development. Large-scale basic infrastructure is being developed, connecting Arugambay, Trincomalee, Muthur and Jaffna through transport networks. Government and Non-Governmental Organisations are making a significant contribution to the recovery of the livelihood of those living below the poverty line.

The "Marshall Plan" authored by the former U.S. Secretary of State George Marshall played a significant role in the reconstruction of the regions worst affected by World War II. This plan was implemented to reconstruct the economy of the European countries devastated by war. Under the Marshall Plan I, US $ 1,200 crores was invested during the four-year period between 1948 and 1951 (Kelegama, 2010). Here, except for the social infrastructure development, all other recovery of the destructed livelihood was made through banks. Further, banks functioned as long-term and medium-term investors, particularly easy loans for recovery, formed the basis of short-term rehabilitation.

Organisations, such as, Grameen of Bangladesh, Israel Free Loan Association (IFLA), play a vital role in uplifting the livelihood of people. However, formation of these people-centered social network organisations within a short period seems to be impossible. Moreover, the attention of Non-Governmental Organisations on rehabilitating the medium and large-scale investors who lost their investment seems to be not satisfactory. Considering the above fact, it appears that it is possible to rehabilitate and reconstruct the entrepreneurship opportunities in the affected areas with the support of the banking sector.

The Banking Sector and the Development of the North and East

It can be said that during the period of the war, banks safeguarded the liquid assets wisely. Although regional development is one of the special obligations, the activities of banks could not be carried out in the situation of war. Due to harassment and terrorism, banks did not have adequate security. Banks were robbed. There were incidents in the North and East where bank iron safes were looted from the police stations where they were kept for safety. Fear and uncertainty were the main reasons for banks not engaging in large-scale investments through public-private partnerships. The environment of the period was not conducive for major investments or creating fixed assets and their sustainability. Therefore, banks offered only limited primary services such as accepting savings, granting small loans and engaging in pawning services. As the rebel movement groups received information on savings, customers limited the saving activities. The people of the North and East were able neither to invest nor save with interest due to harassments.

Since the liberation of the East in 2007 and the North in 2009, the Government diverted its attention from the success at war to economic development. The Government and other international funding agencies are now implementing projects through the banking sector for the rehabilitation of the affected communities. Thus, under the program of *Mahinda Chinthanaya*, several development projects are being implemented in the North and East through *"Uthuru Vasanthaya"* (Northern Spring) and *"Nagenahira Navodaya"* (Eastern Reawakening) respectively. This aimed at increasing investment. On the other hand, assistance is offered in various ways to develop State bank networks to enhance the contribution of the banking service in the recovery of the war-affected regions.

Revival of the Banking Sector

The continuous crisis of the war in the past three decades limited the financial service outcomes at various levels in the North and East. Considering the security of the banks, the Ministry of Finance through the Central Bank of Sri Lanka has granted approval to extend limited services in the North and East provinces. People from the backward villages of Kokkadicholai, Vaharai, Karadiyanaru and Mandoor who had to travel over 40 km for their transactions are now able to receive the services at their doorstep. In

Table 1: Expansion of Licensed and Specialised Commercial Banks from 2006 to 2009 in the Northern and Eastern Provinces

	District	Total Branch & Banking Outlets*			
		2006	2007	2008	2009
1	Ampara	121	172	184	192
2	Batticaloa	58	61	72	82
3	Jaffna	123	163	176	190
4	Kilinochchi	5	12	13	13
5	Mannar	14	19	22	25
6	Mulaitivu	4	10	11	11
7	Trincomalee	63	76	80	85
8	Vavuniya	22	31	33	42
	Total	**410**	**544**	**591**	**640**

Note: * Includes extension offices, pawning centres, students' savings units and pay offices.

Source: Central Bank Statistics (http://www.cbsl.gov.lk/htm/english/08_stat/s_6.html)

the year 2006, there were 450 bank branches including extension offices in the North and East. This number increased to 640 in the third quarter of 2009, showing a 56 percent growth. Further, in the first half of the year 2010, twenty new banking outlets in the North and 40 new banking outlets in the East were established. Table 1 shows the district-wise expansion of banking network.

The Bank of Ceylon increased its branches from 55 in the year 2008 to 77 in 2009. The People's Bank increased its branches from 72 to 85 and Sampath Bank from 06 to 20, during the same period. In addition, the DFCC Vardhana, National Development Bank, Pan Asia Bank, Union Bank and Lanka Puthra Bank opened two, four, two, one, two and one branch/es respectively in the year 2009. Expansion of bank branches in North and East provinces during the period 2008-2009, is shown in Table 2.

It is significant that, no overseas banks opened their branches in the North and East until 2009. However in 2010, HSBC opened its branch in Jaffna while HABIB Bank expanded its activities to the East. Further, the Central Bank of Sri Lanka opened its fourth and fifth provincial offices in the North and East respectively for better collaboration with its financial institutions, implementation of development works and to promote financial institutions utilise available resources effectively for regional development. This is considered as another phase in the extension of banking service in the North and East regions.

Although the Ministry of Finance has intensified the opening of State and Private Banks in the North and East regions, when compared to other districts, the number of branches in proportion to the population seems limited. In the Colombo District, 658 branches are functioning on the basis of 3,831 people per branch and the Bank Density Index remains at 26 percent. In the backward districts of Polonnaruwa and Hambantota, the Bank Density Index is 13 percent and 14 percent respectively. Table 3 also shows that banking services have not been adequately expanded in the North and East provinces in line with the population density.

Lending Programmes for Regional Development Activities

Currently, the government is providing huge amounts of funds to the people of North and East at low interest rates, through expanded bank networks. As a part of this, the Department of Regional Development was established in the East in the early part of 2008, and its service was extended to the North in mid 2009.

Under the co-ordination of this Department, investments and loans are granted for development in various sectors such as agriculture, livestock and micro, small and medium sector enterprises. Long-term loans are also provided for activities such as reconstruction of houses damaged by war and for the purchase of vehicles. Investments shown in Table 4 confirm the huge investment by this Department for

Table 2: Expansion of Bank Branches in the North and East from 2008 to 2009

Name of the Bank	2008	2009
Bank of Ceylon	55	77
Commercial Bank of Ceylon PLC	09	9
Hatton National Bank PLC	16	19
People's Bank	72	85
Sampath Bank Ltd.	6	20
Seylan Bank PLC	7	7
Housing Development Finance	2	2
Corporation Bank of Sri Lanka		
National Savings Bank	24	26
Sanasa Development Bank	6	7
All Regional Development Banks	11	11
Total	**208**	**263**

Source: Central Bank Statistics (http://www.cbsl.gov.lk/htm/english/08_stat/s_6.html) the development of North and the East regions in the year 2009.

The improved security situation since the liberation of the Eastern Province in 2008 has enhanced the finance flow in this Province. As a part of agriculture and livestock development, as announced in the budget 2008, loans amounting to Rs. 52.1 million have been provided as poverty alleviation revolving fund for the benefit of 4,732 small entrepreneurs in the year 2008. Apart from this, loans amounting to Rs.432.7 million under rural micro-credit scheme, poverty alleviation micro-credit projects, revolving trust, Susahana -II and *Krushi Navodaya* scheme, were provided for highland crop cultivation, animal husbandry, fishery, business, tourism and long-term self-employment projects. Under the revolving scheme, these investments are used as continuous investments. In addition to this, an affected individual is offered with Rs 250,000 with a six-month grace period at the interest rate of six percent. A total of Rs.423.7 million has been granted. Apart from this, 2,262 loans worth Rs.250,000 each from Revolving Trust in the year 2008 and 1,123 loans worth Rs.147 million in December 2009 were obtained for livelihood development (Central Bank of Sri Lanka, 2009). Under the Poverty Alleviation Microfinance Project (PAMP), loans amounting to Rs 175 million were granted to 27,086 small ventures through the banks up to 2009, for the benefit of small entrepreneurs in the Eastern Province.

Since the liberation of the Northern Province in May 2009, industrial sector development has been rapidly improving due to the activities of the banking sector development under the "Awakening North" program. A sum of Rs.3 billion has been allocated for providing employment for the war-affected people in the five districts of the Northern Province for the recovery in agriculture, cattle raring, fishing, business and minor employment ventures. Under this scheme, loans to the amount of Rs.200,000 have been granted with a six-month grace period, at the concessionary interest rate of nine percent. This scheme is expected to enhance the investment, particularly the middle class. The loans granted to various sectors and the amounts since the implementation of "Awakening North" program 2009 is given in Table 5.

Under this scheme, up to the first half of 2010, 4,928 loans amounting to Rs. 676 million have been granted to middle-level investors; these loans were released with the objective of short-term recovery.

Table 3: Density as per Population

District	Population per Branch	Bank Density Index
Batticaloa	10,327	10
Trincomalee	11,152	09
Mullaitivu	35,800	03
Kilinochchi	35,800	03

Source:Central Bank Statistics (http://www.cbsl.gov.lk/htm/english/08_stat/s_6.html)

Development of the Agriculture Sector

A total of 323,000 hectares of agriculture land was abandoned due to security reasons. Now, the Department of Agriculture is engaged in recovering the land that remained abandoned since the liberation of the North and East Provinces. According to the Department of Census and Statistics (2010), national paddy production increased by 17.5 percent and livestock production increased by 2.6 percent in 2010 due to the commencement of re-cultivation in the liberated areas of the North and East and also due to the currently prevailing situation in these districts.

Under the New Comprehensive Rural Credit Scheme, Rs. 1,943 million was released for crop cultivation in 2008/2009. Out of

Table 4: Payable Loan Schemes for the Development of Northern and Eastern Provinces in 2009

Lending Programme	Fund Allocation
Awakening North special re-finance loan scheme	Rs. 3 Billion
Revolving Fund for Development of Eastern Province "Rising East"	Rs. 1 Billion
Agro-Livestock Development Project	Rs. 5 Billion
Krushi Navodaya Scheme	Rs. 3 Billion
Poverty Alleviation Microfinance Project (Revolving Fund) 2009-2013	Rs. 3 Billion
Poverty Alleviation Microfinance Project II	JPY 2.1 Billion

Source: Central Bank of Sri Lanka, 2009.

Table 5: Funds Provided under "Awakening North" Program from July 2009 to December 2009

Sector	Fund Allocation (Rs. million)	Number of loans granted
Trade and other self-employment activities	215	1,285
Agriculture and related activities	141	1,081
Livestock development	136	1,126
Micro and small enterprises	56	496
Fisheries and related activities	36	365
Total	**584**	**4,353**

Source: Central Bank of Sri Lanka, 2009.

this, 60 percent was granted for paddy cultivation. Further, under this system, loans were granted for the cultivation of paddy and cash crops such as potatoes, onions and chilies. Facilities and opportunities were also provided to farmers to obtain loans at a low interest rate of eight percent under the *Krushi Navodaya* scheme. Furthermore, the Bank of Ceylon has been promoting huge investments for the purchase of machinery for the adoption of technology in the agriculture sector with the aim of agriculture development in the East. Loans amounting to Rs. 4.7 million have been granted for the purchase of 85 paddy harvesters.

Agriculture and Livestock Development Loan scheme (ALDL) was introduced in the Budget 2008 to increase milk production. An allocation of Rs. 10 billion was made for the purchase of equipment for milk producers and farmers, and for the establishment of milk processing industries. Up to now, out of this only Rs. 70 million has been obtained as loan for a single milk production factory in the East and the balance has not been utilized yet. Managers of banks point out that the main reason for this situation is the drawback on the part of the people in preparing business plans.

The fisheries sector is the second important sector in the North East. Although, currently, there are several loan schemes for the development of the fisheries sector, medium-scale investors have obtained more benefits under these schemes. These schemes grant Rs. 250,000 for the purchase of fishing gear, out-motors, etc., at a very low interest rate of four percent, to be settled in ten instalments. Out of the recovery loans granted by banks, this is the only loan granted at the lowest interest rate. Further, the granting of loans up to Rs. 60 million to an individual for small and medium industrial development at 8.5 percent interest rate will lead to high investment. Since the end of the war, the contribution of the regions such as Mannar and Vavuniya which are favourable for fresh water fish production has raised the national fish production by 12.2 percent in 2010 (Department of Census and Statistics, 2010).

Short-term as well as long-term loans are being granted to the worst affected tourism sector in the North and East. The Bank of Ceylon grants loans for the development of hotels with 650 beds and for the purchase of vehicles for the use of tourists in Pasikudha and Nilaveli in the East. In addition, loans are also granted for the supply of meat, eggs, vegetables, etc. and for the development of support services such as yoga and Ayurveda. While banks are assisting the Eastern Province in tourism development in various aspects, the scheme will be extended to the Northern region once landmines are cleared in the coastal areas.

Special Poverty Alleviation Scheme

With the objective of improving income level of the poor, PAMP is implemented not only in the North and East provinces, but also in certain selected districts. In this, a single family is considered as a production and consumption unit. A group of 5-10 poor families can obtain a loan up to Rs. 50,000 at eight percent interest without any surety. This loan facility contributes considerably to the improvement of living standards through poverty alleviation. Further, it forms a basis for group-wise coordinated outcome. Moreover, according to the Manager, Bank of Ceylon, Eastern Region, this loan system has been almost 100 percent successful in the North and East when compared to other loan systems. Generally, uneducated ordinary people face numerous problems in obtaining bank loans as they cannot fulfil the conditions of obtaining loans. In such a situation, the responsibility of the co-ordination group forms a basis for granting this loan under reduced conditions.

Other Social Welfare Activities

Banks, along with other types of loans for employment initiatives in the North and East, also offer numerous loan-related support services. The Bank of Ceylon is engaged in reconstruction of houses for the people affected by tsunami. Banks have been offering loans up to Rs. 1 million at a very low interest rate of 4 percent to compensate for the loss of basic infrastructure of the middle-income group. They also provide credit on leasing of vehicles, materials, land, equipment, etc. at the interest rate of 8–12 percent, for entrepreneurship development. In addition, banks also release professional loans for educationalists at the rate of 8 -13 percent interest. It is a remarkable fact that the loan released by banks increased by 39.6 percent in 2010. It was for housing, business centres, buildings, asset development, etc. that a large amount of loan has been released.

Another contemporary evolution in the services of the banking sector is the pawning service. Pawning service which was carried out on a limited scale has now been simplified and an amount very close to the price of a gold sovereign (Rs. 40,000) is offered as a loan on a competitive basis. Apart from these, banks offer free employment and life insurance to trusted customers and security and surety bonds to contractors. In addition, multifaceted welfare subsidies, such as, scholarships to the children of customers, free scholarships for overseas studies, donation for public events, etc. are also offered by banks.

Challenges and Opportunities

A healthy environment has now been created for the people and the banks to function without pressure.

At the same time, livelihood and basic infrastructure re-construction in the North East region has been commenced as an essential service and intensified and expedited to contribute to national development. It is not an easy task within a short period of time to rebuild the severely-devastated and ruined networks that had suffered disasters simultaneously by man as well as nature continuously over the past 30 years. In this context, it is inevitable that the banking sector resort to strategies to face the following challenges to achieve the contemporary objectives which is regional development:

The customers who do not settle the loans which they obtained over the past 30 years due to destructions of war, are included in the defaulters' list and they are not eligible to obtain loans again and this has created gaps between the banks and customers. A new strategy with conditions needs to be developed to re-connect these customers. The "Highway theory" introduced by people like Mohamed Yunus offers solutions in this context.

Some of the entrepreneurs who obtained loans through banks under the war recovery scheme to engage in enterprise development were subjected to continuous natural disasters such as heavy floods in 2010/2011. They were unable to settle their loans as the appropriate insurance policy was not in force. Due to this, the liquid assets of the banks were blocked, and this caused a negative impact in the finance cycle. For disaster-prone investments, compulsory insurance plans such as those implemented by Grameen, Virac and Asha in Bangladesh need to be implemented to safeguard customers and Banks, in Sri Lanka.

Although, several new banks have opened to extend the banking activities in the North and East, there are still some challenges for short-term rehabilitation such as finding new customers and assessing their credibility. Divisional secretaries function as the certifying authority and play a significant role in confirming the personal details of customers. Therefore, the introduction of new customers on the recommendation of Divisional Secretaries and the acceptance of the group surety will lead to create credibility of customers easily within a short period.

Customers, who have become destitute having lost all their livelihood assets, face various problems in submitting the original documents of fixed property expected for the granting of loans. As a result, customers are deprived of receiving banking services. In such a situation, it is appropriate for the banks to accept personal guarantor systems.

Though the banking sector has expanded its services to several areas, few village areas do not have access to these facilities and the people spend several hours to obtain banking services. The expansion of banking services has been proposed by people as well as the banking sector. When such services are available at the doorstep of the people, there is no doubt that banking services will strengthen. Therefore, the Central Bank of Sri Lanka and the heads of the banks should take steps for the establishment of new banks and the expansion of bank branches already established.

With the objective of enhancing the production and employment opportunities and solving investment problems, soft loans are granted to investors who provide employment to over 50 persons under the out-of-district investor promotion scheme in the North East provinces. A criticism is levelled on the inclusion of out-of-district investors that it results in negative impacts due to the exploitation of local resources and denial of employment opportunities to local residents. This problem could be solved by adopting certain procedures such as giving priority to the investor in the affected areas, granting approval for new ventures taking into account the availability of resources and providing training for capacity development of the local workers.

While the banking sector is functioning with the concern of post-war development, providing low-interest loans will lead to livelihood recovery. It is stated that only high-interest loans are currently available for certain industry-related sectors and infrastructure development objectives. Further, it is pointed out that rigid procedures are followed by banks on interest rates and recovery methods. By introducing special co-ordinated soft loan model followed by organisations such as Israel Free Loan Association (IFLA) to reconstruct Israel from destructions, the recovery of losses and increase of investments can be simplified.

Various welfare schemes are being implemented through the banking sector in the North East by the government. It is also stated that these benefits have not reached the villagers. Seminars on banking services, advertisements on radio, television, newspaper, etc. will help develop the investment network of banks.

Banks release medium-scale and large-scale loans based on project reports. Entrepreneurs who are unable to prepare the project reports in the proper manner and get approval are unable to benefit from this loan scheme. Providing opportunities to middle-level as well as high-level entrepreneurs on awareness in designing project reports and awareness on finance, technology, marketing and management will be useful.

Organisations such as Employees Trust Fund, North East Coastal Community Development Project (NECCDEP) Planning Office, Sri Ram Sri Lanka, BRAC Sri Lanka and YMCA take simplified micro-credit schemes to the doorstep of the people under the small employment ventures livelihood recovery. Absence of rigid conditions, customer–centred group mechanism for the granting of loans, recovery mechanism, limited administration costs, etc. provide opportunities to obtain loans at low interest rates. This has resulted in the customers of the bank to move towards micro-credit organisations. Banks, particularly those which follow traditional banking systems, need to change from traditional policies and function with the objectives of providing easy services at the doorstep of the people to sustain their existence, which is the need of the hour.

Conclusion

Commercial banks function with two conflicting objectives of maintaining solvancy and profitability. Having realised the significant contribution of the banks in the post-war development, more attention needs to be focused on the view of banks maintaining solvancy.But, State as well as private banks function with the objective of high profitability. They show hesitation in granting loans to people living under poverty line. They are interested in providing investment assistance to the elite to ensure recovery of their capital as well as profit. It is only when this situation is changed, the banking sector could contribute successfully to the post-war development of the North and the East.

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products could be used to reach out the financially-excluded low-income households in the remote villages. Our survey reveals that a fair proportion of the households, even in the ultra-poor group, have some knowledge about e-banking and e-money. But, the application of such modes is rather low, even among the richest households. ATMs are the most popular type of e-banking.

It is widely recognised that mobile applications are likely to improve the socio-economic conditions of the people at the base of the pyramid in developing countries. As in the case of many other developing countries, availability of cheaper mobile phones and low-cost prepaid phone cards have led to an exponential growth of mobile telephony in Sri Lanka. While the people at the bottom of the pyramid have been increasingly using mobile phones, a vast majority of them remain unbanked or under-banked in Sri Lanka. If they use m-banking, they would be able to overcome the opportunity costs relating to geographic access to bank branches.

The objective of this study was to explore the potential of using mobile money systems in Sri Lanka to extend financial facilities to the poor so as to smoothen their economic activities. The findings of the study reveal that although mobile phones have rapidly penetrated in Sri Lanka during the last decade covering rural areas where there is acute poverty and lack of access to formal banking institutions, they are hardly used for financial transfers and payments. As a result, the country has been losing opportunities to use mobile phones to extend financial facilities to the poor who do not have access to formal finance. The study also reveals that there is considerable potential to popularise mobile money systems in the country in the backdrop of the extensive use of mobile phones. The lack of awareness about mobile banking acts as a major impediment to the expansion of mobile money systems. The application of mobile banking is largely limited to commercial bank customers in Sri Lanka, making it an additive model. Our focus group discussions reveal that most of the bank customers are unaware of such facilities. A major reason for this could be that mobile banking is not widely publicised. In Sri Lanka, the mobile phone operators are yet to launch mobile transaction systems. The mobile transactions platform needs to be harnessed in the country without further delay to overcome the problem of financial exclusion in the country.

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The Role of State Banks in the Sri Lankan Economy with Special Reference to the People's Bank

Dr. Upalinie Ajitha Tennakoon

Department of Economics, University of Kelaniya.

Abstract

In 2011, the People's Bank, which was established on 1 July 1961, completes 50 years of valuable service to the nation. The setting up of the People's Bank gave an entirely new dimension to banking activities in Sri Lanka. It has been a long journey since then and the Bank has grown in size and stature to encompass every area of present-day banking activity and has carved a distinct identity of being Sri Lanka's Premier Public Sector Bank. The purpose of this paper is to examine the role of state banks in the Sri Lankan economy with special reference to the People's Bank. Throughout the years, the Bank has continued to demonstrate that it is tightly woven into the social fabric of the Sri Lankan people, and in a larger sense, into the economy. To cater to the needs of different types of customers and meet the future challenges, the Bank need to identify new business niches, to implement innovative strategies and to capture new market opportunities. It will be necessary for the Bank to reconcile economic efficiency with social equity to achieve growth which will have a tangible impact on disadvantaged sections of the society.

Introduction

As reported by the Central Bank of Sri Lanka (CBSL), Sri Lanka's economy grew by an impressive 8 per cent in 2010, reflecting a fast recovery from the setback suffered in 2009 and moved to a high and sustainable growth path. All key sectors of the economy including financial services sector demonstrated a commendable performance in 2010, underpinned by the peaceful domestic environment, and improved investor confidence, favourable macroeconomic conditions and gradual recovery of the global economy from one of the deepest recessions in history (CBSL, 2010a).

The contribution of the services sector and the financial sector to GDP (Gross Domestic Product) in Sri Lanka, 59% and 9% respectively in 2010 reflects the importance of the two sectors to the economy. Today, one of the faster growing segments in Sri Lanka's economy is the financial sector. This is manifested in developments in money and capital markets, where the volume of transactions has expanded considerably and the degree of sophistication has grown markedly. The financial system in Sri Lanka mainly consists of banks, finance companies, other credit-providing institutions (including microfinance institutions), leasing companies, insurance companies, primary dealers, stock brokers/ dealers, investment managers, margin providers, stock underwriters, unit trusts, provident and pension funds. The banking sector accounting for 52 per cent of the financial system's total assets continued to dominate the financial sector in Sri Lanka (CBSL, 2010b).

Today, the role of banks has expanded like never before and has become the most integral part of every society. Banks offer a wide range of products and services, customised to cater to specific needs of different categories of customers. These ranged from current accounts, savings products, term deposits, foreign currency deposits, trade, finance, leasing, factoring, personal lending, pawning, housing, credit/debit cards, inward remittances, investments in government securities, fund management, project finance and special lending schemes for areas such as fisheries, agri-business and small and medium enterprises. If the banking system in a country is effective, efficient and disciplined, it brings about a rapid growth in various sectors of the economy. The role of banking in the economy thus can be considered to be very significant and imperative.

The purpose of this paper is to examine the role of State banks in the Sri Lankan economy with special reference to the People's Bank. This paper is organised into four sections. The next section presents a brief historical overview of the domestic banking industry in Sri Lanka with special reference to the State banks. The second section discusses the outcomes of financial reforms in Sri Lanka that have been introduced since the latter part of 1977 to create an efficient and competitive market in brief. The third section analysis the role of People's Bank in the economy considering its performance, risk management, achievements and innovations. The last section presents conclusions of the analysis.

Historical Overview

During the mid 19th century, the Ceylonese had no access to the foreign Banks (mainly British and Indian Banks), and it was the Nattukottai Chettiar who provided the Ceylonese with all banking facilities, and they were regarded as the official money lenders to the nation (Weerasuriya, 1973). There was no direct communication between the bank officials and the Ceylonese business community. The village farmers who cultivated rice, vegetables, and other subsidiary food crops were entirely dependent on the village money-lenders, indigenous bankers, pawn-brokers, traders and merchants, landlords, friends and relatives who acted as intermediaries in the unorganised credit market. Interest rates that prevailed in the unorganised market were higher than those in the organised market. Therefore, a necessity arose to establish a national bank to cater to the requirements of the local entrepreneurs and to provide financing on a progressive scale to diversify the economy.

Realising the fact that the Nattukottai Chettiars could not continue in their role as money lenders and financiers to the nation, the Banking Commission appointed by the Governor in 1934, headed by Sir Sorabji Pochanawala recommended to the government the establishment of an indigenous Government-sponsored commercial bank to cater to the needs of Ceylonese agricultural and business interests. The State Council of Ceylon approved this recommendation, and the Bank of Ceylon (BOC) was established on 1st of August 1939, under Bank of Ceylon Ordinance (No. 53 of 1938), as Sri Lanka's first State-owned commercial bank.

In 1961, the establishment of the People's Bank, under the People's Bank Act No.29 of 1961 as a public sector bank and the nationalisation of the Bank of Ceylon in 1961 to facilitate the national development efforts of the country, marked a 'turning point in the history of banking' in Sri Lanka. Having been inspired by a larger social responsibility, the two state banks- the Bank of Ceylon and the People's Bank have served national priorities and objectives such as rapid growth of agriculture, small industries and exports, increase of employment levels, encouragement of new entrepreneurs and development of backward areas. For much of the Sri Lanka's history, these two state banks have played a major role in the economy - at times controlling over three-fourths of deposits and assets of the banking system – and they continue to control nearly half the assets and deposits of the banking system today. They have ensured the right to have access to credit on reasonable terms without discrimination to all people of Sri Lanka, irrespective of class, race or religion.

Financial Reforms

After nearly 30 years of inward-looking economic policies and financial repression, the economic policy reforms package which was introduced in 1977 included some structural changes in relation to deregulation of the financial services sector, along with other economic reforms in Sri Lanka. Prior to that policy change, economic stagnation, financial repression, policy distortions and excessive government intervention impeded the development of an efficient and a viable financial system in the country. Financial reforms implemented in Sri Lanka during the past two decades were intended to create an efficient, competitive and developed financial system, while strengthening financial stability (CBSL, 2000).

Among the significant measures that have been taken to deregulate the financial sector since 1977 include interest rate deregulation, introduction of market-oriented credit allocation, relaxation of market entry for foreign and domestic banks, implementation of institutional reforms, and improvement of supervisory framework including appropriate legislative measures to safeguard the financial system (Edirisuriya, 2007). A number of policy changes were introduced since then, and the process has been continuing according to the changing domestic and international environment.

The banking sector, which had been rigidly controlled, was liberalised. Foreign banks were encouraged to enter the Sri Lankan financial market and were permitted to open branches in Sri Lanka. In addition, the domestic private sector was allowed to engage in commercial banking. New types of financial institutions, such as, money brokers, venture capital companies, merchant banks and unit trusts were permitted to commence operations. The removal of barriers to entry broadened the financial market, and increased efficiency through competition.

The two State banks were recapitalised and granted greater autonomy in their commercial operations to restore their financial viability and profitability (CBSL, 2000). Those drastic policy changes were affected to expand the scope of the banking industry as well as to increase the number of firms in the industry. The financial services industry thus supported the continued expansion in economic activity in the country. The expansion of the financial services has shown in the Table - 1

As at the end of 1979, there were 14 banks - consisting of 4 domestic banks, and 10 foreign banks. The domestic banks consisted of two state banks and two private banks, namely, the Commercial Bank of Ceylon (established in 1969 as the first private bank) and the Hatton National Bank (established in 1970 as the second private bank). The number of foreign banks increased to 28 at the end of 1982 while 4 indigenous banks were permitted to open branches in outstations. Thus, the competition became acute as large portion of the financial market share hitherto held by the State banks were acquired by the new-comers to the banking industry.

Table 1: Composition of the Banking Sector as at 30 September 2010

Type of Banks	Number of Institutions	Number of Main Branches	Total Assets Rs.Bn	Market share of industry (%)
Licensed Commercial Banks	**22**	**1,408**	**2,809**	**83.5**
State banks	2	640	1,156	34.4
Private domestic banks	9	722	1,248	37.1
Foreign banks	11	46	405	12.0
Licensed Specialised Bank	**9**	**468**	**553**	**16.5**
State banks	6	405	470	14.0
Private banks	3	63	83	2.5
Banking Industry	**31**	**1,876**	**3,362**	**100.0**

Source: Central Bank of Sri Lanka, (2011).

In 2000, the total number of commercial banks operating in the country was 26 consisting of 2 state banks, 8 domestic private banks and 16 foreign banks. The total number of bank branches stood at 1,084 at the end 2000. The increase in branch network was mainly through opening of new branches by the domestic banks. Accordingly, the total branch network of domestic banks reached 1046 while foreign bank branches increased to 38. In 2009, the total number of branches of commercial banks rose to 2,214, consisting of 2000 domestic bank branches and 214 foreign bank branches. The state banks had the largest number of branches; numbering 1,175, consisted of 679 People's Bank branches and 496 Bank of Ceylon branches. The distribution of commercial banks branch network for the period of 2000-2009 is given in Table 2.

The banking sector, which is the most dominant and systemically important sector in the financial system, has shown a significant expansion during the last two decades, reflecting the increase in financial transactions to facilitate the growing economy. As at end of 2010, the number of banks stood at 31 comprising 22 licensed commercial banks (LCBs) and 9 licensed specialised banks (LSBs). There were 1,932 bank branches, 965 extension offices, 2,977 other banking outlets by the end of 2010. This network was further strengthened by 2,006 Automated Teller Machines (ATMs) indicating an increasing reliance on card-based payment modes by the banking community (CBSL, 2010a). Sri Lanka now has 9.1 branches for every 100,000 individuals as opposed to the global median of 8.4 branches for every100, 000 individuals (CBSL 2011). Overall, the banking sector experienced solid growth maintaining its soundness and profitability, with increases in the asset base, loans and advances portfolio, investments and deposit

Table 2: Bank Branch Network of Commercial Banks 2000-2009

Item	2000	2005	2008	2009
Licensed Commercial Banks (a)	1,084	1,627	2,071	2,214
Domestic Banks	1,046	1,585	1,857	2,000
Bank of Ceylon	341	390	455	496
People's Bank	**343**	**602**	**653**	**679**
Commercial Bank of Ceylon	81	140	177	179
Hatton National Bank	120	150	177	182
Sampath Bank	39	84	115	137
Seylan Bank	90	114	114	114
Other (b)	32	105	166	213
Foreign Banks	38	42	214	214
Population per Bank Branch	6,642	5,293	4,369	4,201
Commercial Bank Branches per 100,000 Persons	5.7	8.3	10.2	10.8
No. of Commercial Banks	26	22	22	22
Domestic Banks	10	11	11	11
Foreign Banks	16	11	11	11

(a) Includes main branches and other extension banking offices except Pawning Centres, Student Savings Units and mobile banks

(b) Includes Union Bank of Colombo Ltd., Pan Asia Banking Corporation Ltd., Nations Trust Bank PLC, National Development Bank PLC and DFCC Vardhana Bank Ltd.

Source: Central Bank of Sri Lanka, (2010c).

Table 3: Number of State Bank Branches by Province_by end 2009

Item	Western	Central	Southern	Northern	Eastern	North Western	North Central	Uva	Sabara gamuwa	All Island
Bank of Ceylon	134	58	55	36	41	47	40	37	45	493
People's Bank	203	90	83	32	53	72	44	45	57	679
Total	337	148	138	68	94	119	84	82	102	1,172

Source: Central Bank of Sri Lanka, (2010c).

mobilisation in the face of external shocks and challenging domestic macroeconomic conditions (CBSL, 2010a).

The Role of the People's Bank

This year, the People's Bank (known as the Pulse of the People), which was established on 1 July 1961, completes 50 years of valuable service to the nation. It is a licensed commercial bank established under the Banking Act No. 30 of 1988. The setting up of the People's Bank gave an entirely new dimension to banking activities in Sri Lanka. By statute, the purposes of the Bank shall be " to develop the co-operative movement of Ceylon, rural banking and agricultural credit, by furnishing financial and other assistance to co-operative societies, approved societies, cultivation committees and other persons" (People's Bank Act No. 29 of 1961, Section. 4).

As stated, the Vision of the Bank is to be the Bank of the aspiring people of Sri Lanka, empowering people to become value creating, competitive and self-reliant. The Mission of the Bank is to take pride in providing an excellent service for customers in the most caring, responsive and professional manner; generate benefits for the national economy whilst being independent and commercially viable; and create opportunities for employees to benefit from their high performance by becoming value-creating, skilled, self-confident and professional individuals who are also team players (People's Bank, 2009)

The People's Bank pursued an aggressive branch expansion programme from the beginning, bringing the total number of its branches to 100 within a decade in 1971 and expanded to 300 in 1982. In 1993, the total number of bank branches stood at 330. Today, People's Bank has the largest branch network of over 680, covering all provincials of Sri Lanka (Table 3) and over 12 million strong customer base. The total number of employees stood at 8,863 at the end of year 2009 (People's Bank, 2009). In 2010, 266 branches and 283 service centres totalling 549 were online and interconnected to provide fast and easy service to the nation. Bank's ATM network 330 in numbers in 2010, serve the people 365 days 24 hours in all 24 districts of the country. The Bank also has its expansive correspondent banking network numbering 300 in over 105 countries.

Historically, the People's Bank has been one of the domestic banks that have consistently provided its services to people in the most remote areas of the country. The Co-operative Rural Banks (CRBs) scheme, which focused mainly on meeting the specific needs of rural households, was inaugurated in 1964 with the help of the People's Bank. At the initial stages, the accounting and financial systems of CRBs were supervised by the Bank and as a consequence, the People's Bank introduced micro-credit to rural communities.

In 1967, the Bank commenced a new Agriculture Credit Scheme, becoming the pioneer lender to the small farm sector. The Comprehensive Rural Credit Scheme (CRCS) was launched in 1973 to provide both consumption and production credit facilities and continued to function as the major source of institutional credit to the rural sector. The New Comprehensive Rural Credit Scheme (NCRCS) was introduced in 1986 with several new features and strategies for lending in rural areas for agriculture. One of the objectives at that time was to bring down the transaction cost of credit to small borrowers. The Bank also extended its credit facilities to small-and medium-scale enterprises and industries (such as agriculture, agro based industries, self-employment category industry, trade and services) under the Poverty Alleviation Micro Finance Project (Revolving Fund) refinanced by Central Bank of Sri Lanka and Poverty Alleviation Small Enterprise Development Loan Scheme Refinance by National Development Trust Fund.

The People's Bank Provides credit facilities to entrepreneurs who are being trained and introduced by the 'Vidatha Resource Centers' by the Ministry of Science and Technology under the Vidatha Loan Scheme (Technology to the Village), to up-lift the economic level and skills of the rural people. Also, the Bank implements 'Vanitha Navodya' loan scheme – under the sponsorship of the Ministry of Child Development and Women's Empowerment and financial contribution from the United Nations Development Fund for Women (UNIFEM), for women who faced with economic difficulties due to natural disasters (as flood, landslides, typhoons, hurricanes etc.), and due to the war – like situation prevailing in certain areas in Sri Lanka. Table 4 shows the micro-finance and other Government- directed loans and advances of the People's Bank.

Table 4: Government Directed Loans & Advances of the People's Bank 2008-2010

	2008 (Rs.'000)	2009 (Rs.'000)	2010 (Rs.'000)
Microfinance	285,583	237,694	307,725
Agriculture and other development loans	1,647,661	1,142,836	2,356,863
Housing loans granted to government servants	9,364,049	9,521,640	14,646,427

Source: People's Bank, (2009, 2010).

The People's Bank has introduced various specialised services, such as savings accounts, current accounts, fixed deposits, foreign currency accounts, business, personal and home loan facilities, leasing facilities, and credit card services to exclusively cater to high-net-worth customers. The Bank offers innovative savings schemes for infants (*Nidahase Upatha* and *Isuru Udana*), children (*Sisu Udana*)[1], school leavers (Yes Future Stars), young executives (YES), women (*Vanitha Wasana*), senior citizens (*Parinatha*), pensioners (*Visrama Suvaya*), Government sector health personnel (*Suwa Sevana*), internet banking users (*AMEX*), home dreamers (*Jaya Nivasa*), Self-employed people (*Surathura*), agriculturists (*Aswenna*), and migrant workers (*Videshika*), teachers (*Guru Setha*) with a host of facilities, which can be customised to suit the individual needs of the account holders. The Bank also provides exclusive financial facilities under various projects such as *Uturu Wasanthaya*, *Nagenahira Nawodaya* and 'Reawakening of the North' to rebuild shattered livelihoods of the People in North and East of the country.

Assets and deposits structure

The People's bank holds the second largest asset base in the industry. As shown in Table -5, the total assets of the Bank recorded a significant growth of 15% in 2010 which ended at Rs. 547 Bn, as compared to the growth of around 14% in the banking industry. This could be attributed to the significant growth of 27.4 in investments, which accounted for around 20 percent of the total assets by the end 2010. Meanwhile loans and advances, which represented the major portion of around 65% of the Bank's assets, also displayed a significant growth of nearly 26% in 2010. At the end of 2010, the Bank had loans and advances (net) exceeding Rs. 357 Bn. as against Rs. 283 Bn. as at end 2009, an increase of 24 percent over 2009.

Table 5: Composition of Assets of the People's Bank in 2009 and 2010

Item	2009 (Rs. Mn)	2010 (Rs. Mn)	Change %
Cash in Hand	8,975	8,997	0.2
Balance with Central Bank	22,717	26,739	17.7
Due from banks and other financial institutions	41,356	37,359	9.7
Investments	95,729	96,653	27.4
Loans and Advances (net)	283,760	357,336	25.9
Other Assets	23,708	20,532	23.0
Total Assets	476,245	547,616	15.0

Peoples Bank, (2010).

Table 6: Composition of Liabilities of the People's Bank in 2009 and 2010

Item	2009	2010	Change %
Total Deposits	**396,157**	**462,140**	**16.7**
Demand	37,352	40,617	8.7
Savings	174,735	203,003	16.2
Time	181,259	215,107	18.7
CD & Others	2,811	3,411	18.7
Total Borrowings	**41,884**	**44,132**	**5.4**
Other Liabilities	20,403	20,505	1.0
Total Liabilities	**458,445**	**526,777**	**14.9**

Source: People's Bank, (2010).

Deposits continued to be the main source of funding of the Bank accounting for 88% of total liabilities. The value of total deposits of the Bank increased by 17% surpassing Rs. 462 Bn in 2010, which was significant when compared to the 22% increase totalling 396 Bn increase in 2009, (People's Bank, 2010). The total increase in deposits was directly influenced by the growth in rupee Savings Deposit base by 16%, which ended at Rs. 203 Bn, despite intense competition from other commercial banks and term deposit demand driven by high yields. The rupee-Fixed (Time) Deposits which represent a significant portion of the deposit portfolio grew by 19 percent over 2009, ended at 215 Bn in 2010. Demand account balances closed at Rs. 40.6 Bn contributed primarily by the expansion of its branch networks. Current and savings accounts over total deposits averaged at 53% to total deposits in 2010 when compared to the average of 54% in 2009. The structure of deposits has given in the Table 6.

At the end of 2010, the growth of loans was mainly in respect of the pawning, construction, trade, other services sectors, and agriculture and fishing with annual growth of 34%, 19%, 18%, 10% and 8% respectively (Table 7). The Pawning business has grown to become an integral part of the loans and advances sector of the Bank. Currently, People's Bank is the market leader in pawning and the most preferred and sought-after pawning service provider. According to the Bank 'this business yields good returns and is a major contributor to Bank's bottom line in addition to being very capital efficient," (People's Bank, 2009). The growth of credit to the services sector (including trade) and manufacturing sector was in line with the improved performances of these sectors in GDP, where the services sector grew by 59% and the manufacturing sector by 16% in 2010.

Table 7: Sector-wise Credit Exposure of the People's Bank in 2009 and2010

Sector	2009 Rs. Mn.	Composition %	2010 Rs.Mn.	Composition %
Agriculture and Fishing	34,442	11.5	29,204	7.9
Manufacturing	21,912	7.3	20,014	6.2
Tourism	4,287	1.4	3,200	0.9
Transport	257	0.1	356	0.1
Construction	55,687	18.6	71,725	19.3
Traders	50,551	16.9	65,443	17.6
Financial andBusiness Services	5,344	1.8	4,375	1.2
Infrastructure	605	0.2	254	0.1
Other Services	25,572	8.6	38,307	10.3
Credit Card	875	0.3	834	0.2
Pawning	97,534	32.6	133,299	35.9
Other	2,011	0.7	1,792	0.4
Total	299,077	100	371,804	100

Source: People's Bank Annual Report, (2010).

It is noteworthy that the share of total loans to the agricultural sector is less than 8%, demonstrating the Bank's lack of enthusiasm for lending to the agriculture sector. It is believed that one of the major reasons for the poverty is a low accessibility for credits by rural poor. Although there are inherent inefficiencies and vulnerabilities that have made the agriculture sector risky and costly, as a State bank, it is a responsibility of the Bank to help and restore the confidence in the minds of rural farmers by providing more accessibility towards credit and other facilities.

Capital adequacy

People's Bank has continuously increased its Capital Base (combination of Tier I & Tier II Capital as approved by CBSL under Basel I & II) with maximum ploughed-back earnings, capital from the Government and two debenture issues to the value of Rs. 5 Bn. In keeping with the agreement signed between the Government of Sri Lanka, ADB (Asian Development Bank) and the People's Bank, the Ministry of Finance injected capital to the Bank as four tranches of Equity Capital Investment of LKR. 2 Bn, Rs. 1 Bn, Rs. 1.5 Bn and Rs. 1.5 Bn for the years 2005, 2006, 2007 and 2008 respectively based on the capitalisation plan and on conditions of People's Bank achieving certain performance targets and key performance indicators. These strategies together with retained earnings for the year 2009 of Rs. 1.9 Bn and the marginal growth in risk-weighted assets during the year, have enabled the Bank to reach a Capital Adequacy Ratio (CAR) of 12.8% by the end 2010 compared to 13.4% in 2009 (Table 8). This ratio was above the

Table 8: Selected Performance Indicators of the People's Bank, 2009-2010

Indicators	2009	2010
Total Capital Adequacy Ratio (Minimum Requirement 10%)	13.4	12.8
Tier 1 Capital Adequacy Ratio (Minimum Requirement 5%)	7.7	7.9
Gross NPL Ratio (%)	6.6	5.0
Return on Assets (%) - (Before Tax)	1.4	1.7
Return on Equity (%) -(After Tax)	19.7	26.9
Capital Adequacy Ratio (%)	13.4	12.8
Statutory Liquidity Ratio (DBU)	29.9	23.4

Source: Peoples Bank, (2010).

Table 9: Selected Financial Highlights of the People's Bank 2009 - 2010

Item	2009 Rs Mn.	2010 Rs Mn.	Change %
Gross Income	69,049	62,532	9.4
Total Interest Income	62,341	56,534	9.3
Total Interest Expenses	38,414	30,635	20.2
Net interest income	23,926	25,898	8.2
Total other income	5,331	4,939	9.4
Non Interest Income	5,332	4,939	8.2
Non Interest Expenses	16,879	17,670	4.7
Profit before Taxation	6,076	8,771	44.4
Profit after Taxation	3,320	5,206	56.8
Operating profit for the period	3,320	5,206	56.8

Sources: Peoples Bank, (2009, 2010).

statutory requirement of the CBSL. This is a remarkable achievement given that this ratio was negative or below 10% a few years ago.

Compared to the banking industry's Non- Performing Loan (NPL) ratio which stands at just under 9% in 2009, People's Bank's NPL remains below this average at 5.5%, in 2010 compared to 6.7% in 2009. The Bank's NPL coverage ratio is over 70% compared to less than 50% in the industry (People's Bank, 2010). Overall, the Bank achieved the highest recorded profit before tax of Rs. 8.8 B n 2010 compared to Rs. 6.1 Bn in 2009; a 44.4 % increased, certainly a great achievement given the extreme market conditions. Profit after tax is posted at Rs. 5.2 Bn, an increase of nearly 57% from the 2009 figure of Rs. 3.3 Bn. Net Interest Income was recorded at 8.2 % growth amounting to Rs. 25.9 Bn, despite a reduction in lending rates during the year and the challenging macro environment (Table 9).

Achievements

As one of the most transparent and accountable financial institution in the South Asian region, People's Bank received a SAFA (South Asian Federation of Accountants) award for the 2008 Annual Report for the first time in the Bank's history, competing with several well--known public sector entities from countries including Pakistan, India, Nepal, Bangladesh and Sri Lanka underlining its commitment to upholding highest standards. The Bank also received SAFA award for the first place in the Public Sector Category for the 2009 Annual Report.

The People's Bank won the popular SLIM (Sri Lanka Institute of Marketing) Brand Excellence Awards – 'Services Brand of the Year 2009 (Gold Award) ' award for the first time by the Sri Lanka Institute of Marketing and the People's Award for the fourth consecutive year in the Banking and Financial sector at the People's Awards in 2009, in recognition of its services to accomplish the social responsibility and in uplifting the lives of Sri Lankan people. The Bank also won the People's Service Brand of the Year 2010 Award presented at the SLIM Nielson People's Awards for the fifth consecutive year.

Moreover, the Bank's Core Banking initiative won the Best Core Banking Implementation and Deployment Award for South Asia and the Middle East from Silverlake and IBM at the Banking Technology Summit held in Perth, Australia in 2009.

These achievements enabled the Bank to boost its rating during the year 2010, raising its position to AA- (positive) from A (stable) by Fitch Rating Lanka Ltd, further augmented by AAA rating by RAM Ratings Lanka Ltd, reflecting Bank's strong financial profile in terms of capital base, profitability and assets quality.

Innovations

The array of financial products and services and delivery channels of the Bank broadened with the introduction of new schemes and Information and Communication Technology (ICT)- based products and services, such as internet banking, mobile phone banking (joining with Dialog Axia), Palm Top banking and SMS banking. Core-Banking system was further extended across the 'branch network, increasing the total number of interlinked branches to 461 in 2010. This was an innovative way of providing quick access to urgently-required banking facilities in a far lesser time than a conventional branch. There was a significant shift towards card-based payment modes and ATM facilities. With these innovations, Bank can be developed customer relationships and service standards together with improvements in delivery timing.

Challenges Ahead

The financial liberalisation and continuous deregulation has made the financial market in Sri Lanka extremely competitive with greater autonomy, and operational flexibility. At the same time, globalisation of domestic banks has also been facilitated by tremendous advancement in information and communications technology. In the future, banking will be driven more of technology and telecommunication systems. These increased convergences present great opportunities for banking institutions to broaden their activities over potential markets. Therefore, the banks who understand the market dynamics, perceive threats, anticipate volatility, show high degree of professionalism and dynamism in their functioning and respond promptly to the market needs would sustain and prosper.

Given the new environment, the State banks in Sri Lanka can't remain unaffected by the changes round and challenges before them. Therefore, State banks need to restructure themselves by bench marking of service standards to improve competitiveness and productivity. Moreover, the State banks must improve the capacity and qualifications of officials and experts and renovate working methods and business thinking and expanding its capital scale to improve the quality of services and business efficiency.

Although the People's Bank has shown impressive financial performance over the last several years, it is indeed important to take several steps to improve the competitiveness and efficiency of the Bank to meet the future challenges and continue the market leadership. The enhancement of customer service; introduction of innovative and diversified products, application of advanced technology; implementation of Basel II; improvement of risk management systems; implementation of new accounting standards; enhancement of transparency & disclosures; and compliance with KYC (Know Your Customer) aspects are a few broad challenges faced by the Bank today. These challenges require the Bank that has its own dynamism and agility to respond proactively to the changing requirements of the economy, as it stands on the threshold of completing the golden jubilee. Thus, the vision, mission, innovations, and social commitments of the People's Bank can convert these challenges into opportunities.

In addition, the excluded segments of the population require products which are customized, taking into consideration their varied needs. Their banking requirements being small, the issue of servicing and delivery in a cost-effective manner assumes significance.

At the same time, the State banks in Sri Lanka need to go further to improve their efficiencies to bring them up to the standard of international financial markets. Therefore, both the public and private sector banks should be fully prepared to face the new global standards referred to as Basel III which will be implemented in phased manner over 5 years from 2013.

Conclusions

The Sri Lankan banking industry has experienced structural changes over the last four decades, as a consequence of deregulation of the financial services sector. The reforms aimed to enhance both the productivity and efficiency and the degree of competition of financial market. The State banks have long been the backbone of the Sri Lanka's banking system. Since their inception, they have served as a driving force behind the growth of small to medium businesses from major cities to rural outposts across the country. During the past fifty years, the People's Bank has evolved and undergone various changes based on the economic and social needs of the people and forces of economic development in Sri Lanka. Today, the People's Bank has emerged as a dynamic and fast-growing bank with a firm financial stability, and a leading market share. Supported by the latest technology, the Bank has made rapid strides in product innovation and delivery, thereby improving quality of customer service. The stronger capital positions, prudent retention of earnings and improved risk management systems supported by an enhanced regulatory and supervisory framework, has placed the Bank on a stronger footing to absorb the impact of the global economic slowdown.

Nevertheless, enhancement of customer service, innovations in technology, improvement of risk management systems, and diversifying products are necessary to maintain the market leadership of the Bank. Since access to finance has been seen as a critical factor in enabling people to transform their production and employment activities and to exit poverty, the Bank needs to look towards the vulnerable and other excluded sections of the population as bankable, reconciling economic efficiency with social equity. And that is the key challenge.

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Footnote:

1 *Sisu Udana* is one of the most successful student-oriented products of the Bank conceptualised to reach beyond the conventional banking ethos. The scheme enfolds the lives of over two million children, resulting in a notable mobilisation of Rs. 3 Bn during the year 2009.

Fiscal Devolution: A stepping Stone Towards Conflict Resolution in Sri Lanka[1]

Dr.Muttukrishna Sarvananthan[2]

Principal Researcher, Point Pedro Institute of Development.

Introduction

For too long, the political processes in Sri Lanka to resolve minority grievances have been preoccupied with the nature of the state (unitary versus federal), unit of devolution of political and administrative power (village, district, or province), language, land, police, and other administrative issues. Very little discussions have taken place regarding the division of financial/ fiscal powers between the centre and the peripheries. All the previous political processes have failed on one political and/or administrative issue or the other.

Even the externally-imposed provincial council system under the Thirteenth Amendment to the Constitution has not lived up to the expectation of the minority communities because of the lack of devolution of land, law and order, and fiscal powers. Though land, and law and order power devolution continues to be contested, the matter of fiscal devolution has not attracted the attention of the protagonists or the opponents of the Thirteenth Amendment thus far. So, this window of opportunity should be made use of to promote fiscal devolution as a stepping stone towards a durable political solution to the grievances of the minorities, particularly the Tamils of the North and the East of Sri Lanka.

Therefore, this paper would analyse the current fiscal architecture in Sri Lanka and propose a devolved fiscal set-up that could possibly be a stepping stone towards a durable political and economic solution to the enduring ethnic conflict in Sri Lanka.

Public Finance

Whilst the government revenue as a percentage of GDP (gross domestic product) was just 15%, government expenditure as a percentage of GDP was 25% in 2009. Therefore, the (national) budget deficit in 2009 was little over 10% of the GDP. Further, the total public debt as a share of the GDP was 86% in 2009 (Central Bank of Sri Lanka, 2009). Moreover, the total government revenue is inadequate to meet the recurrent expenditures of the government (it has been the case since 1989) or the annual servicing of the public debt. In other words, part of the recurrent expenditure and the entire capital expenditure of the government and a part of the public debt servicing are paid for by borrowed money.

In these precarious circumstances of the public finance, it is imperative to rationalise government expenditure and increase government revenue at the national, provincial, and local levels. The current government revenue as a proportion of the GDP in Sri Lanka (15%) is one of the lowest among the lower middle-income countries. It has to be increased to at least 20%. Revenue mobilisation by the provincial and local governments is miniscule compared to the revenue mobilisation of the national government (*see the following section*); therein lies the potential to increase public revenue through fiscal devolution.

Two-thirds of the government revenue accrues from consumption (indirect) taxes and just 20% accrues from income (direct) taxes (*see Table 1*). Theoretically, consumption taxes are regressive and income taxes are progressive, because the rates of consumption taxes are equal to all who purchase goods and services irrespective of their income levels whereas the rates of income tax rise as the income of individuals or businesses rise (i.e., the amount of income tax is proportionate to the amount of income; higher the income, higher the income tax one pays – the principle of 'ability to pay').

Therefore, it is high time the government thinks out of the box to fix its fiscal deficit by transforming the nature, content and extent of the fiscal architecture of the national government vis-à-vis the provincial and local governments. The Presidential Tax Commission in deliberations during 2009-2010 could, hopefully, come up with some innovative ideas to narrow the gap between government revenue and expenditure and thereby practice fiscal prudence (in place of fiscal profligacy of the post-1977 period). If need be, amendments to the present Constitution should be made, for which the necessary parliamentary majority is within the grasp of the present government.

Provincial Finance

The total provincial revenue (from all eight provinces) has been between 3.5% (1999) and 4.3% (2004) of the total revenue of the national government during the 1999-2004 period. Whilst the total provincial revenue as a percentage of the national GDP has been constant at 0.6% during 1999-2004 period, the total revenue of the national government as a percentage of the GDP has consistently dropped from 17.7% in 1999 to 15.3% in 2004 (Waidyasekera, 2005).

On the other hand, the total provincial expenditure (by all eight provinces) has been between 10.2% (1999) and 11.7% (2003) of the total expenditure of the national government during the 1999-2004 period. In absolute amount, for example, while the total provincial expenditure in 2004 was LKR.57 billion, the total provincial revenue was LKR.14 billion in 2004 (Waidyasekera, 2005).

Table 1: Composition of Government Revenue – 2009

		LKR Million	***Percentage***
Taxes on Income (direct)		**1,39,558**	**20**
Personal	28,229		
Corporate	66,751		
Tax on interest	44,578		
Taxes on Expenditure & Production (indirect)		**4,77,704**	**67**
VAT	1,71,510		
Sales Taxes	97,604		
Import duties	79,810		
License fees	3,269		
Stamp duty/Cess levy/SRL/RIDL/ SCL/NBT & other	81,190		
Debit tax	8,036		
Port & Airport development Levy (PAL)	36,286		
Profits, Dividends & Interest		**41,025**	**6**
Gross Receipts of Trading Enterprises		**8,566**	**1**
Railways	4,020		
Posts	4,546		
Other Current Receipts		**44,526**	**6**
National Lottery	1,542		
Other	42,986		
TOTAL		**7,11,379**	**100**

Source: Central Bank of Sri Lanka, *Annual Report 2009*, Statistical Table 91, Colombo

Internationally, the sub-national government revenue as a percentage of the central government revenue has been high as circa 50% in Brazil (in 1998) and India (in 1999), moderate in Malaysia (15.4% in 1997) and Thailand (17.0% in 2002), and low in Indonesia (3.2% in 1993), Philippines (2.7% in 1993), and Sri Lanka (4.3% in 2004) (Waidyasekera, 2005). The sub-national government expenditure as a percentage of the central government expenditure has been high as 88.7% in India (in 1999), moderate in Indonesia (13.7% in 1993), Malaysia (12.4% in 1997), and Sri Lanka (11.7% in 2003), and low in Philippines (5.5% in 1993) and Thailand (6.0% in 2002) (Waidyasekera, 2005) The foregoing international comparison data is based on different years and therefore should be considered cautiously.

During the period 2000-2004, provincial revenue growth has been higher than the provincial GDP growth in all but the North-East and Uva provinces (Waidyasekera, 2005). For instance, the total revenue of the North-East Provincial Council in 2004 (LKR.141 million) was only 0.08% of the Provincial GDP of the combined North-East Province in 2004 (LKR.166,200 million) (Waidyasekera, 2005).

Hence, the Provincial Councils in Sri Lanka depend heavily on the transfers from the national government. For example, while the total provincial revenue from all eight provinces was LKR.13.6 billion, total transfers to all eight provinces by the national government amounted to LKR.38.5 billion in 2004 (see Table 2). The Finance Commission set up to assess the needs and disburse the financial transfers from the national government to the provincial governments has published only one Annual Report (2004) in the past twenty two years, which is an indication of the lacklustre in the implementation of the Thirteenth Amendment to the Constitution.

There is an argument that the second tier of government (i.e., provincial council system) is a costly exercise with overlapping of functions and very little benefits to the provinces (Hewavitharana, 1997)[3]. It is true that in 2009, the Ministry of Local Government and Provincial Councils (LKR.102 billion or USD.0.90 billion) was the fourth largest spending ministry after the Ministry of Finance (largely public debt repayment) (LKR.831 billion or USD.7.23 billion), Defence (including Public Security and Law and Order) (LKR.212 billion or USD.1.85 billion), and Public Administration and Home Affairs (LKR.106 billion or USD.0.93 billion).

However, it has to be noted that bulk of the expenditure of the Ministry of Local Government and Provincial Councils is for salaries and other consumption expenditures (76% in 2009) of the provincial public servants, who were transferred from the national public services to the provincial public services when the provincial councils were set up in 1988. Currently, out of the 1.3 million public servants (including semi-government employees), almost 300,000 are in the provincial services. Thus, only a small number of new recruitment was made directly to the provincial administrative services since 1988. Further, there were hardly any new buildings put up to house the provincial public administration in any province. Largely, the existing public buildings were used by the provincial councils or were hired from private property owners.

Therefore, there was hardly any additional public expenditure incurred due to the setting up of the provincial councils. It was a

Table 2: Provincial Finances — 2004

Province	Share of Population 2004	Share of Provincial Public Sector Employees 2002	Central Government Grants to Provincial Councils 2004 (LKR million)	Share of Provincial Revenue 2004 (LKR million)
Central	12.9 (2,506,000)	12.9 (39,762)	14.4 (5,764)	7.9 (1,073)
North Central	5.9 (1,145,000)	7.8 (24,143)	9.1 (3,514)	2.6 (356)
North East	**13.7 (2,662,000)**	**15.8 (48,643)**	**16.6 (6,403)**	**1.0 (141)**
North West	11.4 (2,214,000)	12.0 (36,949)	14.3 (5,533)	7.2 (977)
Sabaragamuwa	9.4 (1,840,000)	8.8 (27,044)	10.7 (4,140)	4.6 (623)
Southern	12.1 (2,346,000)	13.5 (41,628)	13.7 (5,286)	7.6 (1,028)
Uva	6.3 (1,223,000)	7.3 (22,523)	9.3 (3,596)	2.3 (317)
Western	28.4 (5,526,000)	21.9 (67,548)	11.0 (4,236)	66.8 (9,079)
Sri Lanka	**100.0 (19,462,000)**	**100.0 (308,240)**	**100.0 (38,472)**	**100.0 (13,594)**

Source: Waidyasekera (2005), *Decentralization and Provincial Finance in Sri Lanka: 2004 An Update*, pp7&30-31; Department of Census and Statistics, *Census of Public Sector and Semi-Government Sector Employment 2002*, Colombo.

mere transfer of public expenditure from the national to provincial level. In other words, suppose the provincial councils were to be abolished today, there would not be much savings on public expenditure because the provincial public servants have to be re-absorbed into the national public services.

Rationale for Fiscal Devolution

Fiscal decentralisation has gained momentum in capitalist and communist/socialist countries (such as, China and Myanmar, for instance) and in unitary and federal States alike since the last quarter of the twentieth century. Country experiences have shown that fiscal decentralisation do enhance public goods and services delivery and poverty reduction (Ehtisham and Brosio, 2009). However, designing of fiscal decentralisation should be country-specific (Fedelino and Ter-Minassian, 2009). This author's case for fiscal devolution is not based on the dichotomy of unitary versus federal constitutional cum political models, but stems from the evolving business model globally towards subcontracting and outsourcing the production line and the supply chain (Sarvananthan, 2009). However, not everyone agrees that administrative, political and fiscal decentralisation is the panacea for economic efficiency *(see, for e.g. Hewavitharana, 1997).*

Public administration is most effective when it is closer to the people, which apply to tax administration as well. Closer the revenue authorities to the people, higher the revenue collection. Therefore, the present Inland Revenue Department and Excise Department should be decentralised. Thus, provincial and local inland revenue and excise departments should be set up to collect direct and indirect taxes effectively at the lowest possible public administration unit. Information on local businesses and professions could be gathered more effectively by the local offices of the inland revenue and excise departments rather than by the centralised departments located in Colombo.

The devolved government revenue raising departments should have appropriate incentives and penalties for performance or lack thereof. That is, the national government should set annual target of revenue at each level of the devolved units of revenue mobilisation. Incentive payments should be paid to those units that overshoot the target. Conversely, penalties should be imposed to those units that fall short of the target. By this way, the national government could incentivise the revenue collection at the provincial and local levels with rewards and penalties.

Financing the Post-War Reconstruction

Government's avowed strategy for the economic revival of the conflict region is focused on physical(dwellings, roads, bridges, etc.), economic (electricity, water, telecommunications, railways, etc.), and social (schools, hospitals, etc.) infrastructure development, which are indispensable. However, this author has serious reservations about the proposed financing of such infrastructure projects. Given the very tight fiscal space of the government as noted above, I do not think the government has adequate resources to finance such infrastructure development, because they are costly. Moreover, in the context of global financial crisis coupled with precarious external political relations of the present government, it is unlikely that the government will be able to mobilise adequate concessionary finance from external donors (both bilateral and multilateral). Infrastructure development is not a one-off capital expenditure. It has a recurrent expenditure in terms of the maintenance cost of such infrastructure for a long period of time.

In this scenario, the best option left for the government is to attract private capital (both domestic and overseas) for investment in infrastructure in the former conflict-affected region and beyond under BOO (Build, Operate, and Own) or BOT (Build, Operate, and Transfer) modalities. The government's attempt to re-build the rail line beyond Vavuniya up to Kankesanthurai (in the Jaffna peninsula) is laudable, because the northern rail line (legendary 'Yarl Devi') used to be the highest revenue earner for the erstwhile Ceylon Government Railways (CGR) prior to its termination in the mid-1980s as a result of the civil war. Besides, rail transport is cheaper than road, ocean or air transport due to lower fuel cost per passenger, and the absence of traffic congestion and security checkpoints.

However, I do not think the government has sufficient financial resources to spend on this ambitious but worthwhile project. The government is explicitly appealing to the people for contributions, and Sri Lanka's diplomatic missions abroad are organising 'benefit show' to mobilise finance from the diaspora, which are highly unlikely to yield desired results. According to the Central Bank Annual Report (2008), the Department of Railways incurred operating loss of Rs.12.5 million every single day during 2008 (annual loss was LKR 4,553 billion or approximately USD 43 million). Our suggestion is that, whilst the government could invest its own money as well as borrow from foreign donor/s to re-build the rail tracks and stations (infrastructure), it should open up the passenger transport to private capital (both domestic and foreign). That is, locomotives and rail cars/carriages could be invested, managed, and operated by the private sector. This kind of public-private partnership could be the best way to beat the fiscal crunch faced by the government. Although the national government could re-build the rail tracks and stations initially, the maintenance of the same should be handed-over to the respective provincial governments.

Similar public-private partnerships for infrastructure development in the former conflict- affected areas could be explored amidst shrinking fiscal space at the national level.

Tax Reform Propositions

Presently, income tax collection is based on self-assessment made by the payee (either individual or corporate entity), which is not satisfactory. Instead income tax should be collected at source (PAYE – Pay As You Earn) as much as practically possible to improve compliance.

Tax reforms in Sri Lanka should be based on streamlining and reducing the number of direct and indirect taxes payable by individuals and corporations and rates of such taxes, and increasing the number of individual and corporate taxpayers. That is, widening the tax base is the need of the hour, rather than deepening the number of taxes and their rates. Imposition of income tax on public sector employees and professionals is *sine qua non* for the widening of the tax base. Public sector employees in Sri Lanka are in an envious position, vis-à-vis most other countries, because their income is not subjected to PAYE tax. In India, for instance, the income of public sector employees (including armed forces personnel) is subjected to PAYE tax. Similarly, professionals, such as, doctors (who work privately as well in addition to their government ·job), lawyers, accountants, and teachers, should be brought under the PAYE tax scheme.

The foregoing propositions could be best achieved under a devolved taxation system where tax avoidance and evasion could be minimised by being closer to the people. Bribery and corruption involved in tax evasion could also be minimised when the unit of surveillance is smaller and local.

In post-war Sri Lanka, the national government should abdicate most of its functions and responsibilities to all nine provinces and local authorities, except monetary currency, defence, and foreign affairs. The national government's primary function should be regulator of the provincial and local governments under a unified country, such as imposing a cap on provincial budget deficit. In order to fulfil its functions and responsibilities, provincial and local governments should be given fiscal autonomy. That is, the provinces and local governments should be vested with the powers to raise and earn income and spend on public goods and services within the respective province and local authority (municipal, urban and village councils). Each province should impose and collect taxes, except import duty and excise duty and value added tax on imports. Hence, the national government's revenue should primarily accrue from duties and taxes on international trade. Businesses within each province should register with and pay taxes (both direct and indirect) to their respective provincial government. Both the public and private sector employees within each province should pay income tax to their respective provincial government. At the same time, national government employees (such as the Central Bank staff, employees of the three armed forces, Ministry of Finance employees, and semi-government employees) should pay income tax to the national government. Appropriate mechanism could be devised to share the consumption (indirect) and income (direct) taxes earned by the provincial and local governments with the national government. As a corollary, public utilities, such as, electricity, water, road and rail transport, etc., should be regionalised.

By providing fiscal autonomy to the provincial and local governments, the national government could promote competition among provinces and local authorities to attract businesses and investments (both domestic and foreign). The fiscal space opened-up (or envisaged) for the provinces and local authorities by the aforementioned method would create an environment for productive competition among provincial and local governments. The national government should do away with the nanny state it currently operates, vis-à-vis the provinces and local authorities, by way of providing annual grants to the provinces and local authorities based on various criteria. Present financial transfers from the centre to the provinces are barely adequate to pay for salaries, pensions, and recurrent expenditures of the provinces. On the contrary, provinces should be encouraged to earn and spend their own money based on their priorities and decisions.

The foregoing propositions would require amendments to the present Constitution that could be incorporated in the upcoming overhaul of the Constitution by the present government. Alternatively, if there is no political or bureaucratic will to transfer fiscal powers to the provinces and local authorities, economic rationalism would suggest to abolish the second (provincial councils) and third (municipal, urban, and village councils) tiers of government despite the fact that the savings in public expenditure would be only small.

Conclusion

There is a lot of concern about the lop-sided economic growth and wealth concentration in Sri Lanka whereby the Western Province (Colombo, Gampaha, and Kalutara districts) accounts for almost half of the national Gross Domestic Product. There could be several causes for this concentration of economic output and wealth in just one province out of the total nine provinces in the country. The tax incidence or the source/s of tax revenue is one of the principal factors affecting income inequality among the population and the regional dispersion of economic growth and wealth. When a tax system overwhelmingly depends on consumption taxes, income will be concentrated in the hands of the wealthy individuals, institutions, and regions of the country. After 1977, indirect or consumption tax as a proportion of the total tax revenue has increased at the same time direct or income tax has decreased. This is one of the primary causes of the skewed production and wealth among people and places in Sri Lanka. Moreover, the consumption tax revenue and savings of people from the provinces are transferred to the centre (part of Western Province) which promotes regional inequality. Therefore, giving freedom to the provinces to retain their respective consumption tax revenue and savings of the respective populations and increasing the proportion of the direct or income taxes in the total tax revenue would significantly disperse production, income, and wealth to the regions away from the Western Province. Therefore, fiscal devolution is proposed for inclusive equitable growth among the different provinces as well as a means of conflict resolution in Sri Lanka.

Although the Thirteenth Amendment to the current Constitution has vested some powers of revenue mobilisation to the provinces, it falls short of an effective and efficient mechanism to make the provinces financially viable and minimise their dependence on the national government. The tendency in the past twenty two years of the operation of the provincial councils (1988-2010) has been the monopolisation of taxation by the national government.

The political establishment of Sri Lanka and the psyche of the masses at present appear to be incapable of undertaking radical changes to the political and administrative architecture. Therefore, incremental devolution appears to be the pragmatic way forward for durable conflict resolution in Sri Lanka. Fiscal devolution, one such step in the incremental devolution process, could presumably attract stronger government and public support (than the devolution of political and administrative powers) under the present unitarian government.

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Footnotes:

[1] A speech given at the International Conference entitled 'Taking the Sri Lankan Peace Process Forward' organised by the Observer Research Foundation in New Delhi on May 11, 2010.

[2] Principal Researcher, Point Pedro Institute of Development, Point Pedro, Northern Province, Sri Lanka. http://pointpedro.org corrections, comments and suggestions are welcome to sarvi@pointpedro.org

[3] Retired Prof. Hewavitharana is currently an economic adviser to the President and Chairperson of the Institute of Policy Studies (IPS) of Sri Lanka.

Agriculture and Rural Development in Sri Lanka:

A Felicitation Volume in Honour of Dr. S.M.P. Senanayake

Reviewed by
Prof. Sirimevan Colombage
Open University of Sri Lanka

The recently published book, "Agriculture and Rural Development in Sri Lanka", is a sequel of the untiring efforts of a group of academics in the Department of Economics at the University of Colombo and some of his friends outside the university who have been keen to pay tribute to their eminent colleague and friend, Prof. S.M.P. Senanayake for his vast academic contributions. Having an illustrious career as a dedicated university teacher and a formidable researcher, Prof. Senanayake has mostly concentrated on the issues relating to agriculture and rural development as reflected in his numerous publications including several books and monographs based on the ground realities.

In the face of economic liberalisation and globalisation, Sri Lanka's agricultural sector faces enormous challenges. This sector, once protected by stringent tariff and non-tariff barriers, has now been exposed to foreign competition under the trade agreements with the World Trade Organisation (WTO) which provides legal ground rules for a free global trading system. In terms of the rules pertaining to the agricultural agreements, the member countries of the WTO are committed to formulate market-oriented policies with regard to market access, domestic support and export subsidies. These policies are meant to drastically curtail the protective policy measures that had been provided by the government to agriculture for several decades. In the backdrop of these market-oriented policy initiatives, the question is whether the agricultural sector of Sri Lanka has been able to face the global competition. Several papers in this volume address this critical issue. This volume also covers other themes of current interest including economic development and agriculture, rural farming, small enterprises, food security, climate change and non-plantation agriculture.

Global Challenges

G.M. Henegedara, in his paper, articulates the implications of the global challenges, focusing on the paddy-dominated food crop sector which has a considerable bearing on food security and rural employment. Referring to both partial and general equilibrium models, the author argues that though the domestic food production has increased over time, this sector has not been able to effectively deal with the problems of hunger, food insecurity, income inequity and urban-rural disparities. Production inefficiency, comparative disadvantage, low labour productivity and land fragmentation are some of the key factors that inhibit the growth of the food crop sector. Hence, the need to implement conducive policies to sustain small farming in the context of the evolving WTO negotiations is emphasised in the article.

Saman Kelegama, in his paper on liberalisation of tea exports, highlights the adverse consequences of continuing export of bulk tea in pure form. He emphasises the need to formulate a long-term strategy to this vital industry in the face of rising cost of production and vulnerability of the local tea industry to international shocks. Raising value addition should be an important component of this long-term strategy. In this regard, promotion of blended tea production could play a vital role. Liberalisation of tea trade by allowing the manufacturers to import different types of tea will promote the tea blending industry and thereby enhance value-added tea exports. This will enable the country not only to regain some of her lost markets, but also to reduce the cost of production and to mitigate the adverse effects of domestic production fluctuations. Taking into account the sector-specific and macroeconomic benefits, the author strongly recommends liberalisation of the tea trade.

U.P.P. Serasinghe questions the effectiveness of the neo-liberal policies with regard to plantation agriculture in Sri Lanka. The author points out that the removal of State monopolies and technical provisions in line with the liberalisation have had adverse repercussions on the plantation agriculture. Various facilities given by the government to the plantation sector, such as, extension services and subsidised credit schemes, were withdrawn following the liberalisation. In the meantime, the agrarian service centres and commodity purchase department outlets were gradually closed down. The privatisation process was carried out based on the low efficiency and productivity arguments. Despite these reforms, the average yield and labour productivity of the plantation sector in Sri Lanka still remain well below those of the major foreign competitors. The author also argues that the new world trading order manifested by liberalisation and globalisation has not been favourable to countries like Sri Lanka.

Deepthi Wickramasinghe examines the implications of climate changes on agriculture. Drawing evidence from the literature, the author points out that climate changes, such as, increased frequency of heat stress, droughts and floods, negatively affect crop yields and livestock. Climate variability also escalates the risks of fires, and pest and pathogen outbreaks, negatively affecting food production. Rising carbon dioxide levels, high temperature, shortage of water resources and extreme weather conditions are the major climate-related factors that hinder agricultural development. The author points out that the corrective actions, such as, changes in crop patterns, effective use of water, fertiliser and pesticides, prudent irrigation systems and improved farmer adaptation strategies should be taken to overcome the adverse consequences of the climate changes.

Economic Development and Agriculture

Examining the future role of agriculture, Nimal Sandaratne emphasises that, irrespective of the declining share of agricultural production in the national output due to structural changes of the economy, this sector could still make a major contribution to economic development by way of meeting the domestic food demand. Acceleration of domestic food production will help, not only to ease the balance of payments difficulties, but also to reduce rural poverty, unemployment and malnutrition. The positive contributions that could be derived from plantation agriculture are also unquestionable. Development of the agricultural sector calls for marked shifts towards commercialised agriculture, viable part-time and mixed-cropping systems and use of productive technologies. The selection of crops, the farming practices, the size of holdings, the technology used and the marketing and processing of crops would have to be necessarily different. The author draws the attention of the policy makers to place greater emphasis on productivity improvements, research, better extension services and market facilities.

Siri Gamage reviews the evolving development models in the light of the needs of the developing countries. Each of these models focused on different dimensions of development such as basic needs, free market mechanism and modernization. The author shows how the international agencies, governments and development thinkers influence developing countries to determine the direction and texture of development understandings and undertakings. Such bodies are instrumental in the process of transferring development thinking, knowledge, and related funding to developing countries. Therefore, Gamage concludes that the sustainable development models advocated by international agencies have to be critically examined from a developing country perspective so as to judge how much of local autonomy, participation, and inputs are included from the beginning to the end of development projects in the rural agricultural sector.

Bilesha Weeraratne and Takuya Hasbe focus on intergenerational dynamics with regard to the choice of being a farmer. Using the micro-level data on rural investment climate, the authors find a significant impact of the first generation occupational choice of being farmers on the second generation individual being a farmer. However, such a clear relationship was not evident in the case of second generation effect on third generation individual being a farmer. It was also found that the third generation individuals' choice of being a farmer is greatly influenced by their grandparents being farmers. The authors attribute this empirical irregularity to the fact that the second generation is still active in the farm, while the third generation is still in an exploratory phase in terms of occupational choice. Based on these findings, they conclude that when parents are farmers, there is a high probability of the child to follow parents' footsteps, and therefore, agriculture is unlikely to lose its share in the labour force.

Rural Farming and Small Enterprises

S.P. Premaratne analyses the role of clusters and networks as a tool for development of small enterprises. It is noted that, individually, small enterprises have limited capacity to capture market opportunities due to their smallness and isolation. Clusters and networking could help them to overcome these capacity constraints and to improve their competitiveness. A cluster, which is a group of firms located in a particular geographic area and working in the same industry, could engage in backward and forward linkages. A network is a collection of firms working in cooperation which are not necessarily in same place or in same industry. Networks could be developed within or out of clusters, and they could be eventually converted into a cluster. Both types of grouping could give small firms comparative advantages and collective efficiency benefits. Considering the severe shortage of resources among the small enterprises, the author argues that collective efforts in the form of clusters and networks must be encouraged.

J.A. Karunaratne puts forward the argument that rural areas are not disjointed from the urban regions as treated in the standard definitions, but an integral component of the market economic system. This denotes a distinction between the feudal countryside and the capitalist rural economy, as much as there is a distinction between the feudal town and the capitalist urbanity. The capitalist development is not merely a massive shift of human resources in favour of urban concentration, but it also involves a transformation of the countryside towards ruralisation. In effect, the countryside becomes the centre of production of agricultural and non-agricultural goods supplying food products and industrial raw materials. Karunaratne concludes that the process of transition from the feudal system to capitalism reflects a major paradigm shift with regard to the rural sector.

K.Amirthalingam and R.W.D.Lakshman, in their article on agricultural livelihoods and IDPs (Internally-Displaced Persons) in Sri Lanka, analyse how civil conflicts decimate agriculture. Using the household survey data gathered from selected conflict-affected areas in the country, the authors provide economic quantification of increased impoverishment risk resulted from displacement. The study reveals that IDPs have various coping strategies for their survival. Human capital on its own is of marginal use as a source of livelihood, and the physical capital assets and institutional structures are essential to make use of human capital effectively. The study also reveals that different types of agricultural livelihoods respond differently to displacement.

Ranjith Bandara examines the impact of the drip irrigation system on the livelihood of the small-scale farmers who benefited from this system in two districts by using the data collected from a sample of households. Based on the results of paired 't' tests, the author finds a positive relationship between the household income and the use of drip irrigation. However, he observes certain deficiencies, primarily in technology delivery and confidence building in rural communities in the current phase of drip irrigation system. Hence, there is an urgent need to disseminate knowledge amongst all stakeholders so as to bridge the information gap. Bandara draws the attention of the policymakers to take appropriate action in this regard in the next phase of the drip irrigation project.

Fredirck Abeyratne, in his paper, analyses the nexus between poverty and governance, and its impact on the agricultural sector focusing on the non-plantation sector. Despite the significant contribution of agriculture to the country's GDP (Gross Domestic Product), employment, and foreign exchange earnings, a substantial proportion of those who are engaged in agriculture remains poor. Limitations, such as, the absence of a consistent long-term vision/ mission, people's participation, and results-oriented strategy and the dichotomy of research and extension, have retarded the growth of the agricultural sector. Unless these governance parameters are in place, investment in agriculture will not contribute towards alleviating the poverty status of the vast majority who are engaged in this enterprise. Abeyratne argues that, in the context of worldwide attention on governance issues, the prospects of solving governance-related issues are more promising now than ever before.

Food Security and Non-Plantation Agriculture

W.G. Somaratne presents an extensive analysis of the factors affecting the global food crisis and its impact on Sri Lankan agriculture with special reference to food security in the country. The author warns that the global food crisis will continue in the future, resulting in a further rise in the price of food to unprecedented levels in this century. Globally, demand for food is expected to escalate due to rapid economic growth in many developing countries, particularly in China and India. On the contrary, there will be a decline in food supply as a result of the unfavourable climate changes and the diversion of farm products to the production of bio-fuel as a substitute for fossil fuel. In the background of these adverse trends, the author stresses the critical role of government intervention in ensuring food security in Sri Lanka. The government needs to take a gamut of initiatives including investment in R&D (Research and Development), supply chain development and management, marketing, public food delivery systems and value addition. High priority should also be given to invest in rural infrastructure to provide an enabling environment for growth in the agricultural sector. Somaratne underscores that the government should recognise and support the role of different stakeholders, including the private sector and NGOs (Non-Government Organisations), in the agricultural promotion drive.

Anura Ekanayake deals with domestic agriculture and food security in his presentation. The paper begins with an outline of the instability of global food markets and their causes of instability including climate change. The paper cautions that a step change in food output occurred following the ethnic conflict does not necessarily guarantee a sustainable growth of food production in Sri Lanka to meet the growing food demand. Considering the adverse trends, such as, declining value added, slow productivity growth, low incomes and high poverty levels in the rural sector coupled with the declining labour absorption, the author emphasises the need to change the food cultivation strategies. More productive farming practices, such as, higher levels of mechanisation, better post-harvest technology and cost effective storage facilities, should be encouraged so as to enhance farm-level returns. Ekanayake, however, notes that there is no reason to rely solely on one form of agriculture to suit the needs of Sri Lanka. As in many other sectors, an appropriate combination of small, medium and large entities will have to exist based on market conditions and other realities. The author concludes that the best approach would be to allow the markets to function and for any number of feasible models to emerge in keeping with the market dynamics will.

Rev. Wijitapure Wimalaratana thera analyses the role of the agricultural information system in promoting the food sector in Sri Lanka. The author points out that the agriculture sector lacks free flow of information, which is a basic requirement for efficient operation of competitive markets. This has resulted in a considerable gap between the actual and potential market signals. The responsibility of collection of agricultural statistics lies with different government agencies, and therefore, the agricultural information system in the country is scattered and poorly coordinated. Allocation of the subject of agriculture among several ministries, departments and organisations has further worsened the situation. The need to establish a centralised and timely agricultural information system so as to facilitate market operations is emphasised in the paper.

Timely Publication

Given the current challenges faced by the agricultural sector in the midst of global competition, climate change, food insecurity, productivity limitations and rural poverty, this volume is an appropriately-timed publication. As discussed above, the volume deals with all these critical issues at this crucial juncture when the agricultural sector of the country is at crossroads. It draws the attention of the reader to the dismal performance of the sector in spite of the policy reforms. This calls for drastic changes in the current policy strategies. This volume is a fitting tribute to Prof. S.M.P. Senanayake for his enormous academic contributions in the fields of rural development and agriculture. I would like to take this opportunity to congratulate the organising team led by Rev. Wijitapure Wimalaratana thera for painstakingly undertaking the mammoth task of compiling this valuable volume. I am confident that this will be an important reference material to policymakers, researchers, academics, students and to those who are interested in the field in years to come. ■

Contd. from Diary of Events.....

14th The President Mahinda Rajapaksa declared the year commencing from Vesak Full Moon day 2011, as 'the 2600th Sri Sambuddhatva Jayanthi commemoration year' in the sacred city of Anuradhapura.

Singapore founding father, Lee Kuan Yew, resigned from the Cabinet, ceding leadership to a younger generation after his party's worst election result.

15th The President Mahinda Rajapaksa, by commemorating '2600th Sambuddhatva Jayanthi', declared open the newly-constructed 'Sambuddhatva Jayanthi Mandiraya' at Havelock Road in Colombo and the road was renamed as 'Sambuddhatva Jayanthi Mawatha.

The head of Britain's armed forces urged NATO to widen its bombing campaign as a revolt against Libya's regime entered its fourth month.

16th In the joint communique issued at the end of Sri Lanka External Affairs Minister Prof. G. L. Peiris's three-day visit to New Delhi, India has urged Sri Lanka to swiftly implement measures to ensure resettlement and genuine reconciliation, including early return of Internally-Displaced Persons (IDPs) to their respective homes, early withdrawal of emergency regulations, investigations into allegations of human rights violations, restoration of normalcy in affected areas and redress of humanitarian concerns of affected families.

17th Buddhists in Sri Lanka and other parts of the world celebrated the '2600th Sambuddhatva Jayanthi' on Vesak Full Moon Poya Day.

20th A newly-built International Buddhist Museum in Kandy was opened by the President Mahinda Rajapaksa to mark the '2600th Sambuddhathva Jayanthi'

21st NATO staged an air strike near Muammar Gaddafi's compound in Tripoli.

North Sudanese army forces took control of the main town in the disputed Abyei region after fighting with its southern forces.

22nd The death toll from a monster tornado that hit Joplin and Missouri in the USA rose to 123 while 750 people were injured and many more were reported missing.

23rd The President Mahinda Rajapaksa inaugurated a three-week residential training for new university entrants to develop their leadership abilities and positive thinking .

24th China said it would support the Sri Lankan government's efforts towards reconciliation, and indicated it would back the country against any international pressure following a recent UN's report accusing the government regarding the war crimes.

26th Afgan President Hamid Karzai condemned the US-led military operation that killed several people in troubled Northern Afganistan.

27th The second Victory-Day anniversary and tribute to war heroes was held at the Galle Face green, Colombo under the patronage of President Mahinda Rajapaksa.

30th The United Nations Human Rights Council (UNHRC) was commenced its 17th session in Geneva.

African and Islamic members of the 47-nation at the UNHRC moved to quell attempt made to reopen the debate on Sri Lanka's conduct at the end of the war using 'Channel 4' video clip which was already rejected by the government of Sri Lanka. ■

DIARY OF EVENTS

April

2nd At least 35 people were killed due to floods and mudslides triggered by heavy rains in southern Thailand.

4th The International Monetary Fund (IMF) disbursed its seventh tranche of Sri Lanka Stand-By Arrangement (SBA) of SDR 137.8 million (approximately US dollars 218.3 million)

5th Turkey and Indonesia called for a ceasefire in Libya, and promised to help rebuild the country, as rebels and government forces battled for key eastern cities that are under the UN (United Nations) no-fly zone.

13th Sri Lanka's Ministry of External Affairs stated that the government has received a copy of the report of the UN Secretary General's Panel of Experts on alleging war crimes against Sri Lanka's political and military leadership (Darusman report).

16th The Afghan President Hamid Karzai and the visiting Pakistani Prime Minister Yusuf Raza Glani agreed in Afghan capital, Kabul, to boost joint efforts to make peace with the Taliban insurgents.

The World Bank and the International Monetary Fund, at their annual spring meetings in Washington, said that Middle East political turmoil needs to be closely watched lest it throws the global economic recovery off track.

18th The President Mahinda Rajapaksa visited Bangladesh on an invitation of the Bangladesh President Zia Ul Rahaman.

The Cardinal Malcolm Ranjith, Archbishop of Colombo said, a controversial report by a three-member UN Panel on accountability issues regarding the final stage of the war in Sri Lanka is part of a conspiracy against Sri Lanka.

The Asian Tribune reported that Portugal, Russia and China had strongly objected UN Secretary General's Experts Panel's report on war crimes of the last armed conflict in Sri Lanka, at its Security Council meeting.

19th Sri Lanka and Bangladesh signed five Memoranda of Understanding (MOUs) based on mutual cooperation to develop and expand trade, fisheries, agriculture, vocational education , science and culture of the two countries, following official talks held between the Sri Lanka President Mahinda Rajapaksa and the Bangladeshi Prime Minister Sheikh Hasina Wazed in Dhaka.

20th Tens of thousands of protesters again hit the streets across Yeman to urge President Ali Abdullah Saleh to step down. The President said he would "resist" calls to resign.

21st The External Affairs Minister Professor G.L.Peiris said that the government strongly objects the publication of the report of the UN Secretary General's Panel of Experts on war crimes of the last armed conflict in Sri Lanka and for taking of measures based on the recommendations made by the panel since the panel is not appointed according to the UN system.

Japan banned people going within 20 km of the tsunami-hit Fukushima nuclear plant, which has been leaking radiation.

Russian Foreign Minister Sergei Lavrov warned against a Western ground operation in Libya, saying it would be an "extremely risky" action with unpredictable consequences.

26th Navi Pillay, the United Nations human rights chief, urged further investigations into the reports of war crimes in the last armed conflict in Sri Lanka.

The Sri Lanka government again rejected the 'Darusman Report' after it was published by the UN.

Russian Prime Minister Vladimir Putin criticised NATO (North Atlantic Treaty Organisation) over its military intervention in Libya, saying the West has violated the UN mandate by trying to kill Libyan ruler Muammar Gaddafi.

27th The Sri Lanka government reiterated its position that the 'Darusman Report' is fundamentally flawed in many respects, while the report is based on biased material, which is presented without any verification.

28th Associated Press (AP) reported that over 300 people across six States in the United States of America (USA) died in the worst tornadoes.

30th Chinese Foreign Ministry spokesman Hong Lei said that China believes the Sri Lankan government and people will handle properly problems regarding its war and called upon the international community not to complicate the issue.

May

1st The Libyan government announced that Saif al-Arab, the youngest son of Muammar Gaddafi, and three grandchildren of the Libyan leader were killed in a NATO airstrike.

2nd The United State's (US) Assistant Secretary of State in-charge of South and Central Asian Affairs, Robert O' Blake visited Sri Lanka.

US media reported that the mastermind of September 11th, 2001 terrorist attacks in the USA and the world's most wanted terrorist Osama bin Laden was killed by US forces in Pakistan.

3rd The Russian Ambassador to Sri Lanka Vladimir Mikhaylov said that he was surprised by the language used in the UN Expert panel report and the baseless allegations of it on the part of Sri Lanka.

The External Affairs Minister Prof. G.L. Peiris said in parliament that Sri Lanka will send a detailed response on the controversial Darusman Report to United Nations Secretary General, Ban ki Moon.

4th The US Assistant Secretary of State, Robert O'Blake declared in Colombo that Velupillai Prabhakaran and Osama bin Laden were two of the most ruthless terrorist leaders in the world.

Parliament members and lawyers of Pakistan condemned the US for 'violating' Pakistan's sovereignty by carrying out a military operation without awareness of Pakistan to kill Al-Qaeda leader Osama bin Laden.

5th China criticised the US for violating Pakistan's sovereignty by carrying out a military operation to kill Al-Qaeda leader Osama bin Laden.

6th The Maldives government opposed the controversial Darusman Report issued by a panel appointed by the UN Secretary General without approval from the UN body.

11th The UN Secretary-General Ban Ki-moon called for an "immediate, verifiable ceasefire" in Libya where rebels are fighting to end Muammar Gaddafi's 41-year regime.

Russia backed the USA's right to hunt down and kill Al-Qaeda Chief Osama bin Laden as Russian leaders prepared to hold talks with visiting Pakistani President Asif Ali Zardari.

12th The European Parliament called on Sri Lanka government to implement the recommendations of the UN panel of experts on alleging war crimes and conduct a genuine investigation.

13th The Amnesty International has called attention to failing human rights record of the US due to its use of flewed detention and execution systems.

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